

A SMARTER WAY TO APPROACH CHINESE EQUITY

Alejandro Saltiel – Head of Indexes, U.S.
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More than 20% [government ownership in an emerging market \(EM\) company can create a conflict between the interests of shareholders and government stakeholders](#), which may, in turn, affect profitability and future returns. With this premise in mind, we developed a framework allowing us to answer this question: “what impact does meaningful government ownership have on equity returns?”

China represents a very large opportunity set for global equity investors, and its economy is the perfect example of how government ownership affects a company’s performance. With China’s importance to overall emerging markets unquestioned, we figured it made sense to use that as an initial case study in this piece.

Quantifying Government Ownership: Is It Worth Owning State-Owned Enterprises?

Considering that 2017 has been a notable year for China’s equity market, we wanted to measure the impact of [state-owned enterprises \(SOEs\)](#) on the return of a commonly used beta benchmark such as the [MSCI China Index \(MXCN\)](#). To do so, we split MXCN’s constituents into SOEs and non-SOEs, and ran the following contribution to total return analysis.

Returns: SOEs vs. Non-SOEs

12/30/16–10/31/17	Avg. Weight	Segment Return	Contribution to Total Return
MSCI China Index Non-State Owned Segment	52.91%	78.47%	38.74%
MSCI China Index State Owned Segment	47.09%	22.54%	10.83%
Total	100.00%		49.57%

Sources: WisdomTree, FactSet. Past performance is not indicative of future results. You cannot invest directly in an index.

Year-to-date, MSCI China Index has had roughly the same exposure to SOEs and non-SOEs, with the latter segment significantly outperforming. Said a different way, MXCN can attribute almost 80% of its total return to non-SOE exposure.

How to Capitalize on the non-SOE Opportunity

Building off these observations, in 2015 we launched a less-conventional approach to tap into the Chinese equity market, focusing on those companies that are free of significant government ownership. The [WisdomTree China ex-State-Owned Enterprises Index \(CHXSOE\)](#) measures the performance of Chinese stocks that are not state-owned enterprises (less than 20% government owned). To measure its success thus far, we used a similar concept

mentioned above and ran a performance attribution analysis for CHXSOE versus MXCN, splitting their constituents into SOEs and non-SOEs.

CHXSOE vs. MXCN (04/30/15–10/31/2017)									
Segment	Attribution Components				Average Segment Weights			Segment Performance	
	Allocation	Stock Selection	Interaction	Total Attribution	WT Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
Non-SOE	6.79%	7.97%	-9.91%	4.85%	100.00%	42.14%	57.86%	13.67%	18.16%
SOE	5.03%	0.00%	0.00%	5.03%	0.00%	57.86%	-57.86%	-	-6.37%
Total	11.82%	7.97%	-9.91%	9.88%				13.67%	3.79%

Sources: WisdomTree, FactSet. Past performance is not indicative of future results. You cannot invest directly in an index.

Since its inception, CHXSOE has outperformed the MSCI China Index by almost 1,000 [basis points \(bps\)](#) annually. During this period, MXCN’s average exposure to SOEs was 58%, which means CHXSOE had an active under-weight in that category of 58%. This under-weight in SOEs and the corresponding over-weight in non-SOEs during the period explain most of CHXSOE’s excess return. The right-most column shows, once again, how MXCN exposure to SOEs has been a drag to its performance, as they’ve returned -6.37%, underperforming non-SOEs by more than 24% annually during the period.

Non-SOEs as a Proxy for [Quality](#)

While conducting this analysis, we realized that companies with less government ownership have, on average, higher [return on equity \(ROE\)](#). Using our [newly developed factor attribution framework](#), we can show that favoring non-SOEs is also a way to access the quality factor. Taking ROE as a measurement for quality, we segmented the EM equity universe into five ROE quintiles, the first being the top 20% measured by ROE (representing the highest-quality segment of the market) and the fifth quintile being the bottom 20% (representing the lowest-quality segment).

CHXSOE vs. MXCN (04/30/15–10/31/2017)									
Category	Attribution Components				Average Category Weights			Category Performance	
	Allocation	Stock Selection	Interaction	Total Attribution	WT Index Weight	Benchmark Weight	+/- Wgt	WT Index Return	Benchmark Return
1st Quintile (Highest Quality)	2.49%	-0.57%	0.22%	2.13%	39.49%	23.64%	15.85%	18.93%	22.65%
2nd Quintile	0.08%	1.14%	0.48%	1.70%	25.58%	25.71%	-0.13%	9.39%	2.33%
3rd Quintile	0.21%	4.42%	-1.88%	2.74%	12.38%	23.78%	-11.40%	26.87%	2.72%
4th Quintile	0.17%	3.05%	-1.25%	1.97%	5.80%	10.53%	-4.73%	24.06%	-4.01%
5th Quintile (Lowest Quality)	0.42%	0.92%	-0.58%	0.76%	5.32%	10.93%	-5.61%	4.27%	-5.05%
Negative ROE	-0.52%	0.20%	0.42%	0.10%	10.21%	2.79%	7.42%	1.64%	-9.98%
Not Classified	0.28%	0.63%	-0.43%	0.48%	1.22%	2.62%	-1.40%	7.95%	-7.98%
Total	3.12%	9.79%	-3.03%	9.88%				13.67%	3.79%

Sources: WisdomTree, FactSet. "Not Classified" refers to those companies with negative common equity or missing data. Past performance is not indicative of future results. You cannot invest directly in an index.

Since inception, CHXSOE was on average almost 16% over-weight in the highest-quality segment of the market, amounting to 250 bps of annual outperformance. Conversely, CHXSOE was less exposed to the three lowest-quality segments of the market.

Conclusion

We believe non-SOE exposure could be a smarter way to approach Chinese equity markets. Having shareholder interests as a top priority helps companies be more profitable and could increase future expected returns.

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DEFINITIONS

State-owned enterprise: Companies in which governments have a significant ownership stake and the potential to influence the firms' actions over time.

MSCI China Index: A free float-adjusted, market capitalization-weighted equity index designed to measure the performance of the Chinese equity market.

Basis point: 1/100th of 1 percent.

Quality: Characterized by higher efficiency and profitability. Typical measures include earnings, return on equity, return on assets, operating profitability as well as others. This term is also related to the Quality Factor, which associates these stock characteristics with excess returns vs the market over time.

Return on Equity (ROE): Measures a corporation's profitability by revealing how much profit a company generates with the money shareholders have invested.