



Preparing Chinese Holdings for Potential US Action

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Tensions between the US and China are flaring up again, but tariffs probably aren't on the table this time. With pressure mounting on Chinese stocks listed in the US, including those widely held in emerging-market portfolios, investors need to consider how to prepare for the mounting risks.

Four months after the phase-one trade deal raised hopes of a US-China de-escalation, the pandemic has fueled fresh sparring between the superpowers. The US is pressing the World Health Organization to investigate China's handling of the global outbreak. More measures are preventing US technological exports to China. Supply chains through China are being shaken up by unresolved political issues and corporate reconfigurations amid the global shutdowns.

These developments aren't surprising. While both sides took a step back from the trade war, the US-China relationship may well be thorny for years to come. Investors should focus on the potential implications for their investment portfolios.

US Targets Chinese Companies

In late April, Chinese stocks began to make headlines in the US. The US Securities and Exchange Commission published a statement warning that Chinese companies could not be relied upon to provide transparent reports. Investors who are harmed by disclosure failures would have "substantially less access to recourse, in comparison to US domestic companies," the SEC said.

Less than a month later, the US federal government retirement fund stopped plans to invest in Chinese companies. And on May 20, the Senate passed a bill that would bar foreign companies from US exchanges if they cannot prove that they aren't controlled by a foreign government and if they do not allow greater US oversight of company financials. While this would only apply if the company isn't compliant for three years, it could clearly lead to large Chinese companies being delisted from American exchanges. The China Securities Regulatory Commission said on May 24 that Chinese and US regulators have made "continuous efforts" to "enhance audit oversight cooperation" and that the Senate act would hurt both US and Chinese interests if enacted.

Some equity investors with Chinese holdings are concerned. Chinese stocks have become a growing component of international investment portfolios in recent years. MSCI has increased the weights of Chinese onshore stocks in its global and emerging-market indices. MSCI indices have 226 Chinese American depository receipt (ADR) companies listed with a combined market cap of \$966 billion. Shares of major companies that have become global household names, including Alibaba Group and NetEase, suddenly looked vulnerable to forces beyond their control.

Are Chinese Companies Less Transparent?

So are Chinese stocks really less transparent? The recent accounting scandal at Luckin Coffee, China's largest coffee shop chain, has certainly put the spotlight on corporate China's financial transparency. That's why active investors must always properly research Chinese candidates to make sure that the most attractive businesses comply with rigorous accounting practices. In fact, we believe that China's listing requirements are more stringent than widely perceived and some companies seek US listings to avoid tighter scrutiny at home.

Conflicting regulatory frameworks are also a source of discord. For example, three Chinese banks were held in contempt by a US court for failing to disclose information and violating North Korean sanctions in June 2019. Under US anti-terror law, these companies were obliged to disclose client information related to suspicious accounts. However, doing so would breach Chinese rules. Although there is currently no mechanism for resolving this type of technical regulatory conflict, recent reports suggest that US and Chinese officials are discussing potential solutions.

What about the withdrawal of federal pension investments from Chinese equities? We don't think this is a material issue for Chinese stocks or investors because there is no significant investment in these stocks from federal pension investments. That said, the message aims to deter US investors from putting money in Chinese stocks.

How to Prepare for Potential Delisting

Delisting Chinese ADRs from US exchanges is a possibility. Even though it could dissuade companies in other countries from issuing shares in the US, the US political momentum to take action against Chinese companies is growing. So investors shouldn't rule out the possibility of measures that could disrupt the normal trading of Chinese ADRs.

Investors can prepare for such a scenario without forfeiting exposure to Chinese shares. Today, more Chinese companies with ADRs are seeking dual listings in Hong Kong, and the Hang Seng Index is taking steps to make it easier for them to do so. The Chinese government is also encouraging companies to consider dual listings.

As Chinese ADRs establish their secondary listings in Hong Kong, one way investors can prepare is to swap US-listed Chinese holdings to Hong Kong shares. While this does incur switching costs, we think it can help avoid disruptions in Chinese equity exposure if Chinese shares in the US become illiquid.

Looking Beyond Political Tension

While the coronavirus crisis will likely fuel US-China friction in the months to come, we think equity investors shouldn't let these tensions overshadow investment opportunities in China, where the economy is recovering and earnings have remained relatively resilient.

Of course, any company—in China and elsewhere—should be scrutinized for financial transparency. And investors cannot let their guard down about the potential political risks. For investors who want to capture the potential of China's economic recovery and vibrant corporate sector, holdings of domestic Chinese A-shares can provide access to attractively valued stocks that are less exposed to unpredictable regulatory risk and international tensions.

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