APAC Public Asset Owners Enhance China Returns

Case Study

The Client

The trade described in this case study has been completed by a number of sovereign wealth funds and other public asset owners in APAC and is under consideration by many more in the region and around the world.

The Challenge

Traditionally, public asset owners, such as sovereign wealth funds, public pension plans and central banks, mandate third-party asset managers to access specific equity exposure on a funded basis, where the cost of gaining exposure is equal to the exposure achieved. Increasingly, public asset owners want to free up cash for other investment opportunities, such as investing in alternatives including private equity or venture capital. As a result, many now prefer to access equities on an unfunded basis. This can be achieved by gaining synthetic exposure via a swap, where the client only has to pay the benchmark rate plus the funding cost.

At the same time, another trend is underway. In the past, many investors would split their exposure across the MSCI World and the MSCI Emerging Markets indices. Now investors are seeking more granular exposure to specific markets such as China in order to better manage their risk and control exposure, as well as more effectively exploit return opportunities. In the case of China, this desire is compounded by a belief that the country is underrepresented in the MSCI Emerging Markets index. China accounts for approximately 50% of emerging markets' GDP while its onshore stocks account for just 5% of the index.

Global public asset owners want to find an effective way to increase their exposure to China to a more representative level, while taking advantage of any opportunities to further enhance returns.

The Solution

In many countries around the world, investors that hold stocks are able to lend them to other market participants (to enable them to short that stock, for example) in return for a fee. Stock lending (also known as repo) enables investors to generate returns from both the equity performance of a stock and its lending value. This opportunity is also available to investors that access a stock (or index) on a synthetic basis. Typically, the cost of a swap is the benchmark rate plus the funding costs minus the repo value.

In China, there is considerable interest in borrowing shares, not least from hedge funds that offer long/short quant strategies on China onshore stocks. Typically, hedge funds trade long and short swaps with banks on single stocks in order to facilitate such strategies. There is no repo market in China: if an investor goes long on a physical stock, they cannot lend it. However, it is possible to monetize repo opportunities when synthetics are traded. Crucially, strong demand for such repo opportunities from quant funds and onshore investors means that the returns can be very significant, at between 2.0% and 12% per annum (compared to just 0.1% in many developed markets).

These sizeable returns available from repo enabled Citi to offer public asset owners in APAC a valuable investment opportunity. An investor seeking exposure to China's CSI 500 small and mid-cap index would ordinarily have to fully fund its exposure and, in return, would receive the performance of the index. However, if the investor goes long the CSI 500 index synthetically, via a swap, they only have to pay the benchmark plus funding costs but receive a payoff that combines the performance of the index and the monetization of the repo, which was around 8% per annum. in March 2022. The repo performance is guaranteed for the lifetime of the trade (typically between 3 months and 12 months).

The Result

A number of public asset owners have worked with Citi to gain synthetic exposure to the CSI 300 (large capitalization stocks) and CSI 500 indices and monetize the attractive repo value available (repo monetization on CSI 300 stocks is typically lower at around 5.0% per annum).

The strategy of generating additional returns from repo in the Chinese market is replicable for all investors as they switch from physical to synthetic exposure. In addition, this trade can be valuable to exchange traded fund (ETF) providers offering exposure to the CSI 300 and CSI 500 indices. ETF providers can switch from physical to synthetic exposure, gaining the benefit of repo monetization, which they can pass on to their clients in the form of lower fees and additional returns.

Citi can also package the trade within a securitized wrapper for private banks to distribute as a Citi note (offering the performance of the CSI 300 plus a guaranteed coupon, for example) to their clients. Alternatively, the coupon can be used to purchase protection (such as a put option), allowing the structuring of a note that offers the performance of the CSI 300 with protection for 90% of the index value at the time of the trade. Note structures also appeal to public sector entities in some countries where buying derivatives such as swaps is prohibited but the purchase of bonds and notes is allowed.

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