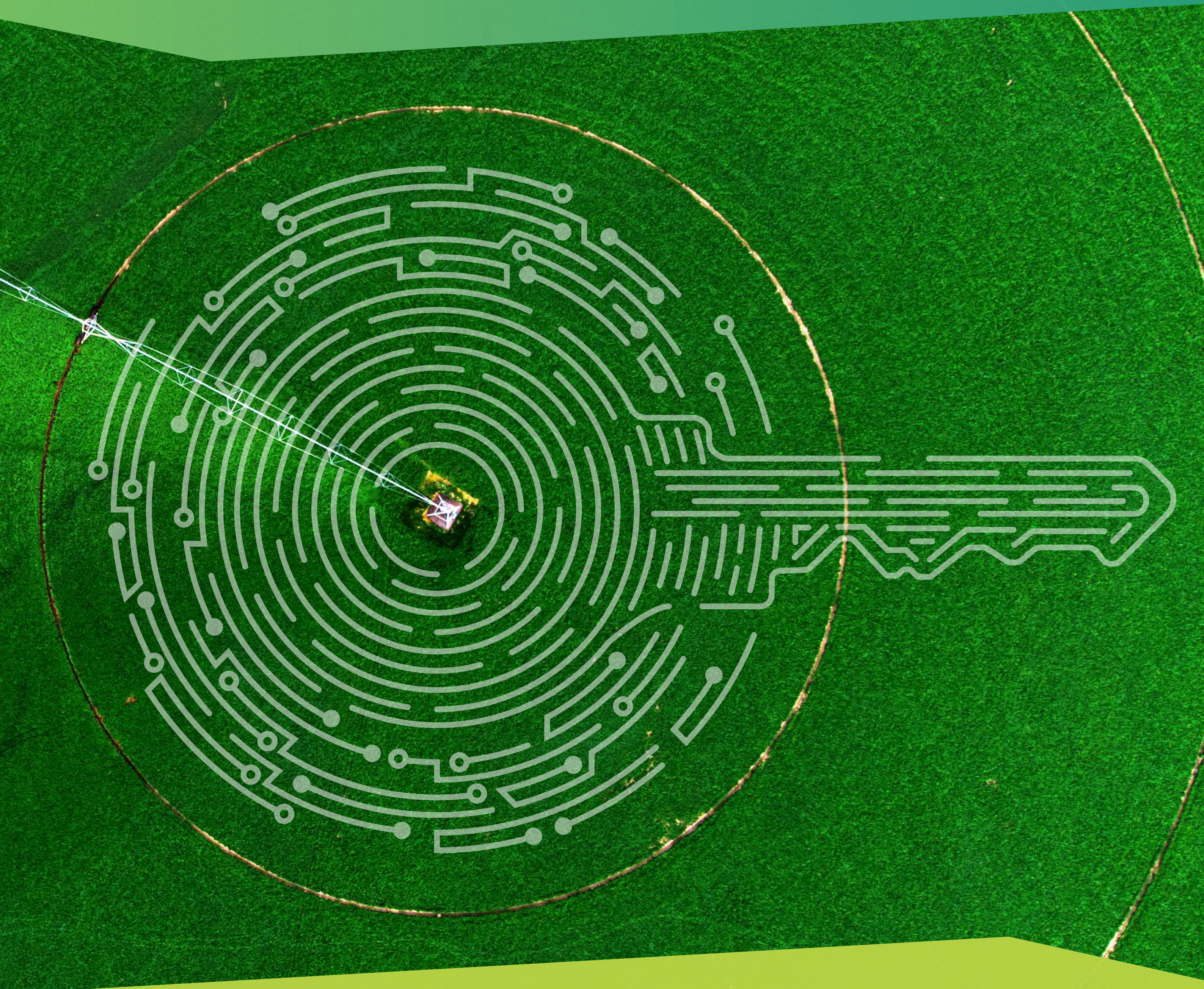
Value Partners
Since 1993

Dividend-driven total-return investing

Unlocking the potential of China's A-share market



Introduction

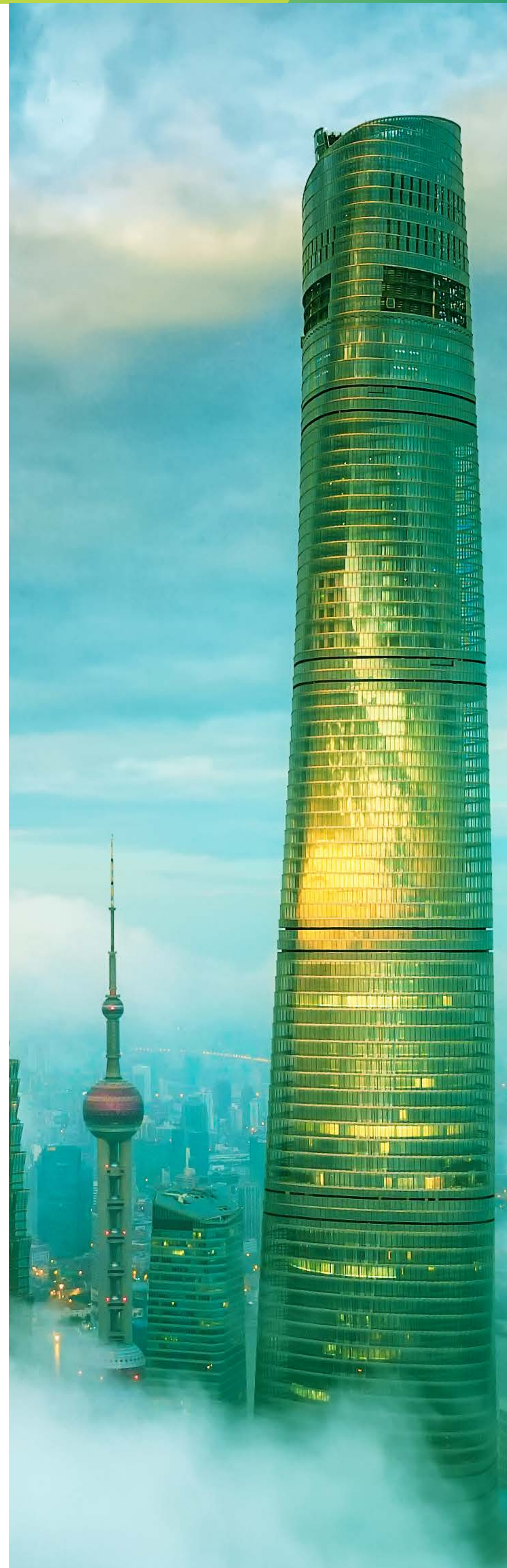
At Value Partners, we believe that the best way to invest in China is through an actively managed total-return approach that favours stable, sustainable, high-quality companies with dependable dividends.

Despite common perceptions, successful investing in China has not been just about harnessing growth; historically, dividend-paying stocks have outperformed. But we believe that conditions are becoming even more favourable for dividend-focused investors, with supportive long-term structural trends in place on both the supply and demand sides.

- As China's growth normalises and its population ages, we expect deflationary pressures to lead to a sustained period of low interest rates, creating a positive environment for income-paying equity investments.
- At the same time, a great asset reallocation is underway as China's population diversifies exposure away from the property market to other investment opportunities and as an older population seeks alternative sources of income. The development of China's private pensions industry and new regulations in the insurance industry should also create robust and sustainable demand for dividend stocks.
- Meanwhile, the Chinese government is taking action to improve returns on equity, payout ratios and overall shareholder returns from state-sector companies. More broadly, companies listed on the main boards of the Shanghai and Shenzhen stock exchanges are now required to meet minimum payout ratios. These reforms bode well for income returns from the equity market.

Collectively, these structural trends should provide strong support for dividend-driven investing in China now and in the decades ahead.

In this paper, we set out the case for this dividend-focused approach. We hope this will help investors to reappraise why they invest in China and how they can best extract alpha from the country's equity markets.



Getting over growth

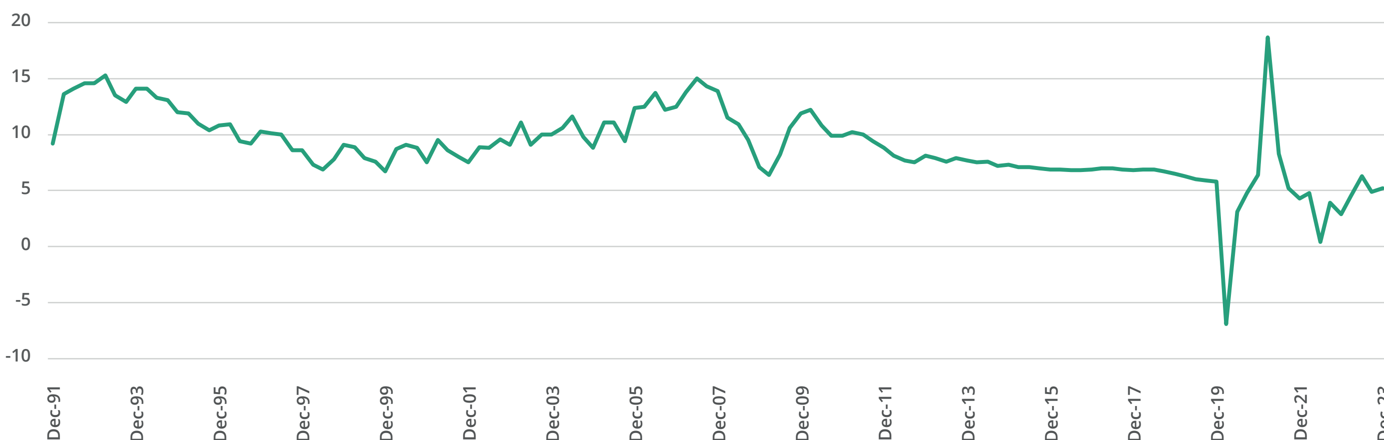
It's now more than 20 years since China's domestic equity markets opened to foreign investors. Over that period, the overriding aim of investing in China has been to harness the country's extraordinary economic growth.

The record here has been mixed. The correlation between economic growth and stock market returns has often been challenged, and studies have shown that this relationship is uncertain at best.[1] Since Deng Xiaoping began his programme of economic reforms in 1978, China's economy has grown at an annual average rate of over 9% – but returns from the domestic A-share market have been much lower: the annualised long-term return from the MSCI China A Onshore Index is just 4.40%.[2] Some of this differential may be attributable to relatively esoteric factors, such as higher-growth companies seeking listings on exchanges such as Hong Kong or as American Depositary Receipts. Although the impact of such contributing factors may be declining for a variety of reasons, we believe that investing in the A-share market ultimately warrants a different perspective.

Our thesis is that investors need to reappraise their historic fixation with growth. China's striking growth rates of recent decades did not herald stellar stock market returns as many hoped they would. And in any case, China's growth is normalising. Rather than pushing or achieving double figures as in the 2000s and 2010s, the Chinese economy is likely to continue to grow at 4 or 5% per annum in the years ahead. Even allowing for the disruption caused by Covid, the long-term trend in China's growth rate is clear.

That alone should prompt reconsideration of the Chinese equity opportunity. Growth of 4% or 5% is still attractive relative to the UK, Europe and Japan, but it is markedly different from the Chinese growth rates of the first two decades of this century.

Figure 1: China's growth rate was falling to around 5% even before Covid



Source: National Bureau of Statistics of China

1 (PDF) A Study on the Correlation between China's Stock Market and Economic Growth (researchgate.net)
2 MSCI China A Onshore Index (data as at 31 December 2023; inception of index is 29 December 2000)

Dividend-focused investing – a winning strategy

Although returns from the broad A-share market have failed to capture China's growth, dividend-focused investing has been much more successful. As the chart below shows, dividend-focused investing has proved a superior strategy in the A-share market since the launch of the MSCI China A Onshore High Dividend Yield Index in June 2013 – in large part because dividend stocks have been sold off less severely during times of stress. Perhaps significantly, the marked outperformance of high-dividend stocks became clearer from 2015, when doubts were emerging about China's ability to return to near-double-digit growth rates.[3,4,5,6]

Figure 2: a dividend-focused approach has been a winning strategy

Source: Bloomberg, MSCI, Value Partners, data as at 31 December 2023.

Why dividend investing works

Ultimately, a company's dividend is strongly correlated with its return on equity (ROE). The dividend is an expression of corporate governance, shareholder returns and the quality and sustainability of the company's growth. In simple terms, companies that achieve a high ROE are better placed to return cash to shareholders.

This is not something startling or new. In fact, the correlation between high dividends and strong performance is a well-observed phenomenon in many other markets. Since its inception in 1995, the MSCI World High Dividend Yield Index has outperformed the MSCI World Index – despite the surge in high-growth US tech stocks in recent years.[7] And in the US, companies that consistently increase their dividend have outperformed the S&P 500 since 1989.[8]

We believe there are good grounds to expect sustained outperformance from China's high-dividend stocks in the years ahead. These include normalising growth, shifting demographics and the prospect of deflation, along with the changes that these will prompt in monetary policy, regulation and investor behaviour. Together, these forces are creating favourable dynamics on both the supply and demand sides and support the continued delivery of 'all weather' returns from the dividend-stock universe – making a dividend-focused China strategy even more attractive than it has been in the past.

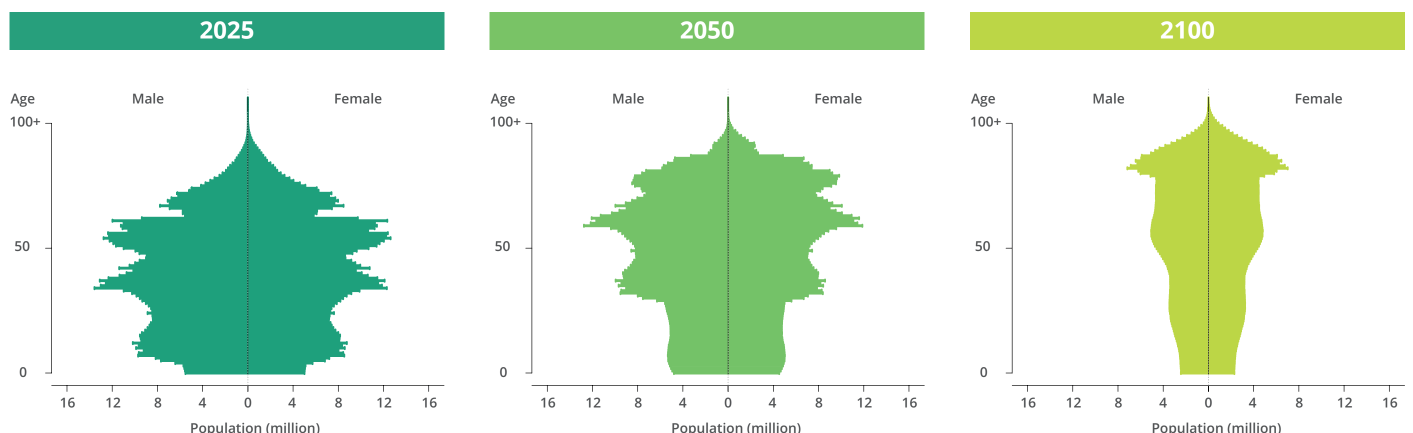
3 Why Demographic Trends Spell Trouble For China And Russia – And Prosperity For US (forbes.com)
4 Is China's one-child policy to blame for its economic slowdown? | PBS NewsHour
5 China's Growing Pains (linkedin.com)
6 China, India To Lead World By 2050, Says PwC – The Diplomat
7 MSCI World High Dividend Yield Index
8 S&P 500 Dividend Aristocrats: The Importance of Stable Dividend Income (spglobal.com)

A greying population and the implications for interest rates

The ageing of the Chinese population has been much discussed.[9] 'Projected population pyramids' show this in a visually stark manner and enable simple comparisons and analogies with, for example, the United States and Japan. What these illustrations can't provide, however, are insights into how such shifts will help to reshape the Chinese investment environment.

An area where China's changing demographics will have a profound impact is in monetary policy. A consequence of an older population is that demand tends to fall. Insufficient demand can lead to low inflation or even deflation – a dynamic observed in both Japan and South Korea in recent decades.[10,11] Deflation is already a challenge for China's authorities, with real interest rates currently elevated as a result of falling prices. As the population ages further, this challenge will only increase. The likely consequence is lower interest rates as the People's Bank of China takes steps to stimulate demand.

Figure 3: China's changing demographics



Source: United Nations Population Division

9 Ageing and health – China (who.int)
10 Why is inflation in Japan one of the lowest in the world | World Economic Forum (weforum.org)
11 A First Drop in South Korean Prices Would Flag Deflation Risk – Bloomberg

China's hunt for yield

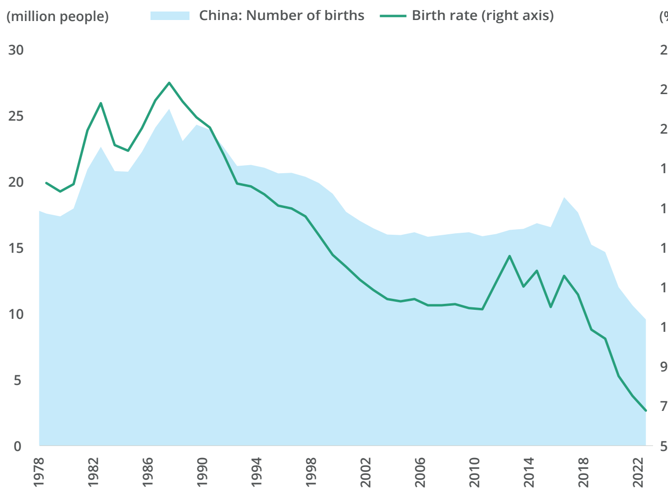
In an environment of low interest rates and thus low yields from bank deposits and bonds, income-paying investments should be increasingly prized. This is the same dynamic that we saw in the 'hunt for yield' that characterised developed markets in the aftermath of the global financial crisis of 2007/8 – a prolonged period of demand for higher-yield assets that came to an end only when central banks began to raise interest rates once more.

The Western 'hunt for yield' points to the scale of the opportunity in China. More than a decade after the global financial crisis prompted central banks to slash interest rates to near zero, most yields on the US$60 trillion global bond market were below 1%.[12] Investors had been driven into a broad range of alternatives, leading to sustained bull markets in assets such as private debt, leveraged loans and dividend stocks.[13,14,15]

The tables below illustrate the relationship between demographics and interest rates. With China's interest rates set to decline further and remain low for the foreseeable future, income-paying investments such as dividend stocks are likely to have long-term appeal to a population that has grown increasingly disenchanted with its traditional investment of choice, property.

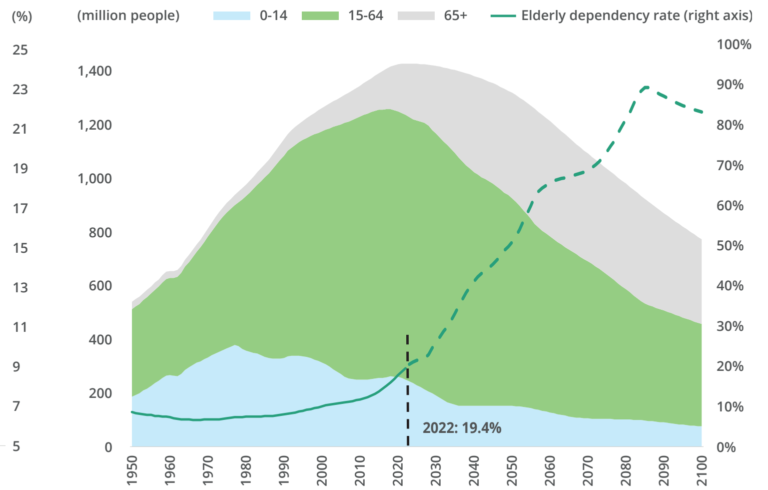
Figure 4: demographics and interest rates

Birth rate



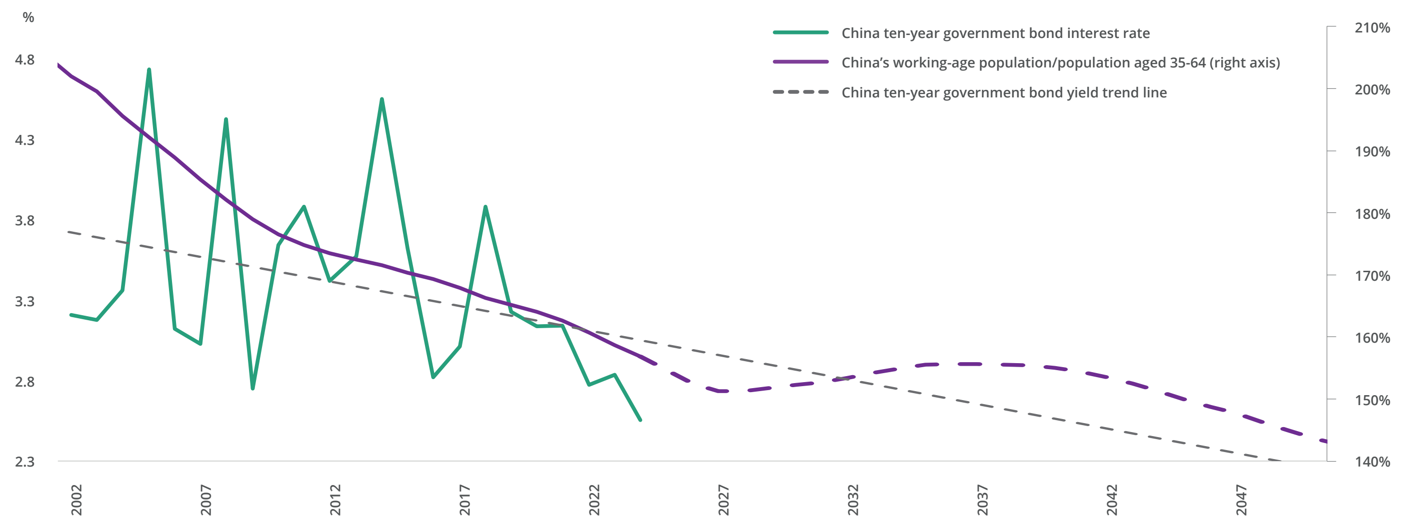
Source: Wind, CICC Research

Dependency ratio



Source: UN, CICC Research

China interest rate



Source: UN, Wind, CICC Research

12 Desperate hunt for yield forces investors to take 'extreme risk' (ft.com)
13 Private Debt: A Lesser-Known Corner Of Finance Finds The Spotlight | S&P Global (spglobal.com)
14 Leveraged loan market continues to shatter records in Q3 amid hunt for yield | S&P Global Market Intelligence (spglobal.com)
15 Big dividend stocks win in yield hunt (ft.com)

The great asset reallocation

At the same time as low interest rates are leading to a 'hunt for yield', a dramatic shift is taking place in Chinese people's investment preferences. Historically, the Chinese public have traditionally turned to property as their investment of choice. An estimated 70% of Chinese household wealth is invested in property.[16]

The asset class has proved attractive for cultural reasons as well as financial ones: home ownership is closely tied with conceptions of personal success in China; for young men, it has often been considered a prerequisite for marriage.[17] In addition, there has been a channelling of large amounts of wealth from older generations to younger ones – a process accelerated by the one-child policy, whereby four grandparents often have only a single grandchild among them.

But China's appetite for property has resulted in an asset bubble, prompting the authorities to take action. At the 19th Party Congress in 2017, President Xi Jinping declared that "houses are built to be inhabited, not for speculation".[18] In 2020, the government restricted the levels of debt that property developers could take on. The subsequent crisis has been well documented.

With overleveraged developers shut off from finance, many homebuyers were left unable to occupy properties that had been paid for but were yet to be built. In response, the government focussed its attention on project delivery and offered emergency finance to developers to allow them to complete presold projects. But the market has remained weak, and, perhaps more importantly, the public's attitude to and expectations of the property market appears to have shifted decisively, particularly where prices are concerned. Historically, individuals purchasing a property had an inherent expectation that the price would rise. Given government policy and what has happened over the past few years, however, people now generally expect prices to remain stable and certainly don't expect to see any significant increase in the near-term.

As a result, a great deal of private wealth is now coming out of property. At the same time, wealth that would have been invested in property in previous years is being allocated elsewhere. With risk appetites typically low, especially among the old, demand for stable, high-dividend stocks is set to grow – providing a powerful market driver in the long term.

Indeed, there is empirical evidence that an ageing population is positive for the performance of dividend stocks as older people seek sources of reliable income – precisely the scenario that is now unfolding in China.[19]

The development of China's private pensions industry

An additional driver on the demand side is the development of China's pensions industry. Essentially, the huge forecast growth in Chinese private and occupational pensions should ensure that demand for dividend-paying domestic equities remains high – with positive implications for the best dividend-paying stocks.

China has long-established state pensions ('the first pillar') and has had occupational pensions ('the second pillar') since 2004, albeit with limited take-up. But private pensions ('the third pillar') are still very much in their infancy. In 2018, pilot third-pillar schemes were introduced in a few provinces. Take-up was somewhat disappointing, but the rollout of a nationwide programme is now underway.

Both second-pillar and third-pillar pension assets are set for massive growth in the near future. According to research by KPMG China and ASIFMA Asset Management Group, these assets could reach a total of Rmb15–21 trillion by 2030 – representing a near-tripling of China's total pension market.[20]

There is an urgent need for this huge expansion. China's ageing population will no longer be able to rely on younger generations for the necessary level of support. And given the shrinking proportion of working-age people, it is increasingly important that the young start paying into pensions too. As China's ratio of workers to retirees approaches parity by the middle of this century, the first pillar (the state pension) will be far from sufficient.[21]

Private pension products require assets with stable return profiles. So the forecast surge in pension assets should lead to a further increase in demand for stocks with dependable dividends.

Insurers' increasing appetite

Yet another source of demand for dividend-paying stocks stems from China's new accounting standards for insurance companies. These have already been implemented for listed companies and will come into force for unlisted companies in 2026.

Under these new standards, dividend-paying stocks hold particular attractions for insurance firms as they can be classified as 'fair value through other comprehensive income' (FVOCI). The FVOCI classification means that these stocks have less impact on an insurance company's balance sheet than other equity-paying assets and are thus more desirable. So insurance firms are likely to continue to increase their allocations to dividend stocks, providing a further long-term driver for this segment of the A-share market.

16 China's Real Estate Crisis Is Wiping Out Middle Class Wealth – Bloomberg
17 The economics of marriage: Evidence from China | Humanities and Social Sciences Communications (nature.com)
18 Housing Should Be for Living In, Not for Speculation, Xi Says – Bloomberg
19 Demographics and the Long-Horizon Returns of Dividend-Yield Strategies in the US Munich Personal RePEc Archive (uni-muenchen.de)
20 China Pensions Reform (kpmg.com)
21 China: working-age adults to elderly ratio 2100 | Statista

A renewed focus on corporate governance

Besides low interest rates and growing demand for income, a third source of support for dividend stocks comes from the Chinese authorities' efforts to improve corporate governance and shareholder returns.

As China's growth continues to normalise, capital allocation is becoming a more pressing concern for the government. When GDP growth was close to double digits, projects with relatively low returns on invested capital (ROIC) could pass unremarked, as the high overall growth rate allowed more room for laggards. But normalising growth calls for greater efficiency in the utilisation of capital.

To achieve this, the Chinese government is now accelerating the reform of the state-owned enterprises (SOEs): the part of the corporate sector over which the authorities have the most control. These recent measures are just the latest in a long line of reforms stretching back decades.

The aim of the latest reforms is to transform the SOEs into more efficient users of capital. The government is pushing them to become more disciplined and to return more capital to shareholders – shareholders that include, of course, both local and central government.

Here, there are instructive parallels with Japan. The Japanese government's programme of corporate-governance reforms has led to a new focus on efficiency and sustainability – which has already borne fruit in improved corporate earnings. In February 2024, South Korea launched its own programme of reforms, hoping to achieve similar successes to Japan. In this regard, China's efforts can be seen as part of a regional trend as East Asian countries shake off some of the hidebound practices that have constrained their corporate performance in the past.

Figure 5: the reform of the SOEs is now well into its fifth decade

Stage number	Time period	Key policy focus
Stage 1	1978-1983 1983-1992	"Management reform", which focussed on giving more autonomy to SOEs. The "dual-track" system was established to further promote managerial responsibilities and introduced profit tax.
Stage 2	1992-1998 1998-2003	Introduced ownership reform to privatise some small/medium-size SOEs and introduced the segregation of duties between government and corporates. A period of restructuring to tackle the debt and non-performing loan issues facing the SOEs.
Stage 3	2003-2013	Set up the SASAC to supervise the SOEs with a focus on strategically important industries. Started the development of the mixed-ownership system.
Stage 4	2014-2020	Focused on the scale and depth of SOEs, including the encouragement of SOE M&A. Further encouraged the mixed ownership system and development of public-private-partnership projects. Also launched supply-side reform and deleveraging, such as through capacity curtailment.
Stage 5	2020-2022	Launched the "three-year action plan" to improve the corporate governance system, enhance operating efficiency, and encourage technological innovation.
Stage 6	2023-present	Further improvement of the governance system, enhancement of the SOEs role in serving national strategic goals, and initiation of the "Valuation system with Chinese characteristics.

Return on equity and minimum payout ratios

In China, one recent reform is the move by the State-owned Assets Supervision and Administration Commission (SASAC) to set new key performance indicators (KPIs) for state-sector companies. Among these are operating revenue and ROE. This new set of KPIs has the potential to improve the operating efficiency of SOEs and lead to higher shareholder returns. Following the introduction of these KPIs by SASAC, there have been sustained efforts by both SOEs and the Shenzhen and Shanghai stock exchanges to improve their investor relations.

Figure 6: the latest round of reforms focuses on shareholder returns

Date of announcement	Responsible party	Key regulations	Major measures
May 2022	SASAC	Work plan for listed Central SOE Quality Improvement	Target improving and strengthening asset quality of listed central SOEs by 2024, via asset injection, M&A, equity transfers, etc.
November 2022	CSRC	–	Yi Huiman, chairman of the CSRC, said at the Financial Street Forum annual conference that efforts should be made to grasp the logic of valuation for different types of listed companies, and to explore ways to build a valuation system with Chinese characteristics so that the market plays a better role in resource allocation. This also includes considerations of the multiple ownership schemes and to bolster the core competencies and strengthen the IR management of listed companies.
December 2022	Shanghai Stock Exchange	Three-year Action Plan for Servicing Central SOEs	Deliver valuation enhancement of central SOEs through improved investor communications, provide further assistance on restructuring, and foster a cohort of flagship central SOE listed companies.
February 2023	SASAC	–	SASAC committee director, Zhang Yuzhup, introduced the main objectives and tasks for 2023, including promoting the growth rate of total profits of central SOEs to be higher than the national GDP growth rate. Key financial targets are stable asset-liability ratios, ROE, R&D intensity, labour productivity, and operating cash ratios.
January 2024	SASAC	–	SASAC officials emphasised the capital market management mechanism of the central SOEs as part of their management's assessment. This is intended to prompt management to focus more on share price performance, conveying confidence and stabilising expectations in a timely manner via market-oriented share purchases, buybacks, etc., and increasing cash dividends to enhance investor returns. This is also being considered as a means to better align the interests of SOEs with minority shareholders.

The increasing pressure on state-sector firms to deliver greater shareholder returns helps to provide central and local governments with much-needed income. This will remain the case nationally for the foreseeable future as the economy grows at a more normalised rate and, at a local level, with continuing reduced returns from land sales to property developers. But perhaps more importantly, the recent reforms herald a significant positive shift in the alignment of interest between major and minority shareholders, which in turn offers support for investors with a dividend focus.

More broadly, since September 2023, all companies listed on the main boards of the Shanghai and Shenzhen stock exchanges are strongly encouraged to meet minimum payout ratios of 30%.[22] These companies can maintain more capital, but if they decide to do so, they are now required to explain to the authorities why they are sitting on cash and what they plan to do with it.

All of this creates a fertile environment for dividend-driven approaches to the Chinese equity market. Crucially, the need for government income and sustainable GDP growth should ensure that policy support for shareholder returns remains in place for the long term. Never before has there been such a constructive and sustainable alignment of interest between majority and minority shareholders.

22 The China Securities Regulatory Commission plans to further improve the normalised dividend mechanism of listed companies, strengthen institutional constraints and supervise dividend distribution for companies that do not distribute dividends or have low dividends – 瞭望新时代 – 瞭望时代 放眼世界 (lwxsd.com)

Conclusion

In recent years, the withdrawal of foreign capital from China's equity markets has been dramatic. But, for the reasons we have outlined, we expect the stocks in the A-share dividend universe to be supported and driven by domestic capital, with support from both government policy and long-term structural trends.

In our view, capturing headline growth should no longer be the goal for China investors. As the Chinese economy matures and normalises, we believe the best approach to extracting alpha from this vast, deep and diverse market is an actively managed, total-return one that is driven by dividends.

As we have shown in this paper, dividend-driven investing has proven a successful strategy in the A-share market over the past 15 years. With increasingly favourable dynamics for dividend stocks on both the supply and demand sides, we believe that this success is set to continue.

- As China's growth normalises and its population ages, we expect deflationary pressures to lead to a sustained period of low interest rates, creating a positive environment for income-paying equity investments.
- A great asset reallocation is underway as China's population diversify exposure away from the property market to other investment opportunities and as an older population seeks alternative sources of income.
- The development of China's private pensions industry and new regulations in the insurance industry should create additional demand for dividend stocks that is robust and sustainable.
- The Chinese government is taking action to improve returns on equity, payout ratios and overall shareholder returns from state-sector companies. While such reforms help to generate much-needed income for central and local government, they also represent an important and positive shift in the alignment of interest between major and minority shareholders. This in turn offers support for investors with a dividend focus.
- More broadly, companies listed on the main boards of the Shanghai and Shenzhen stock exchanges are now required to meet minimum payout ratios. These reforms bode well for income returns from the equity market.

Collectively, these structural trends should provide strong support for dividend-driven investing in China now and in the decades ahead.

To discuss this thesis in detail or for further information on Value Partners' expertise and actively managed investment capabilities in the China A-share market, please contact your usual company representative.

Appendix 1:
a deep and diverse universe

A dividend-focused approach offers ample scope for diversification in the Chinese market. If we define 'dividend stocks' as those with a yield of over 3%, we are left with a universe of around 550 stocks in the A-share market alone.

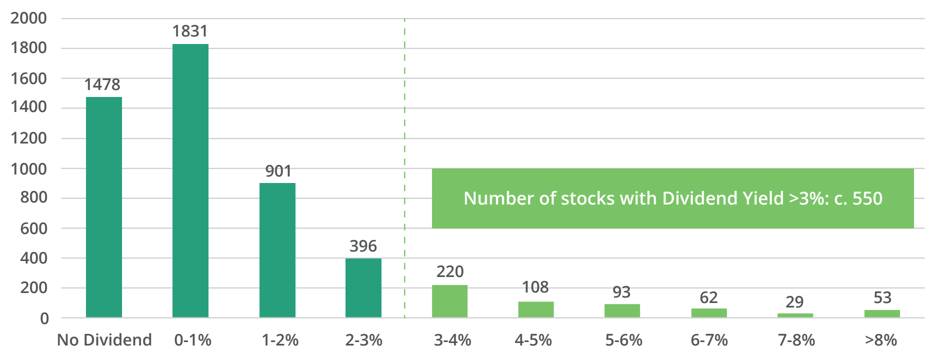
And, as Figure 8 shows, those stocks span the full spectrum of sectors – this market opportunity is most certainly not just a 'defensive' story.

Nor is the opportunity confined to the state sector. In recent years, dividend payouts have increased at both state-owned and private enterprises.[23]

Many sector leaders in China have entered the stable-growth phase of their development, with strong cashflows and balance sheets. In the years ahead, many more companies will enter this phase, ensuring a sustained supply of listed firms with the ability to pay attractive dividends and a surprisingly diverse universe of stocks in which to hunt for alpha.

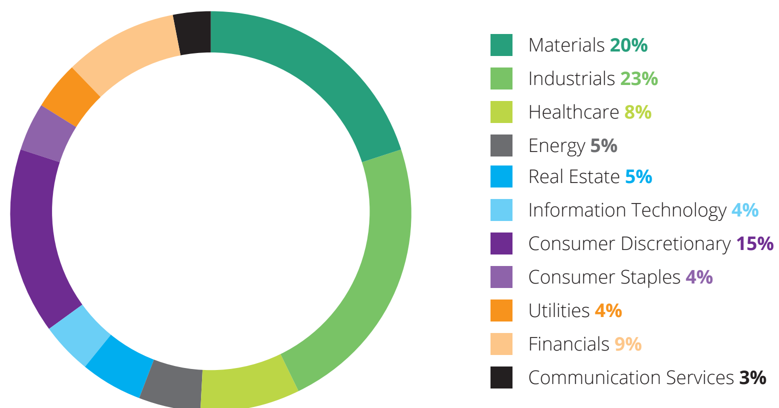
When it comes to sustainability, a dividend-based approach to investing in China has clear advantages. If you invest in stocks that pay dependable dividends, you are likely to be fishing in a pool of inherently sustainable companies. As Figure 9 shows, dividend yields and ROE are positively correlated, underscoring the quality of the companies targeted by a dividend-focused strategy.

Figure 7: Shanghai- and Shenzhen-listed stocks by dividend yield



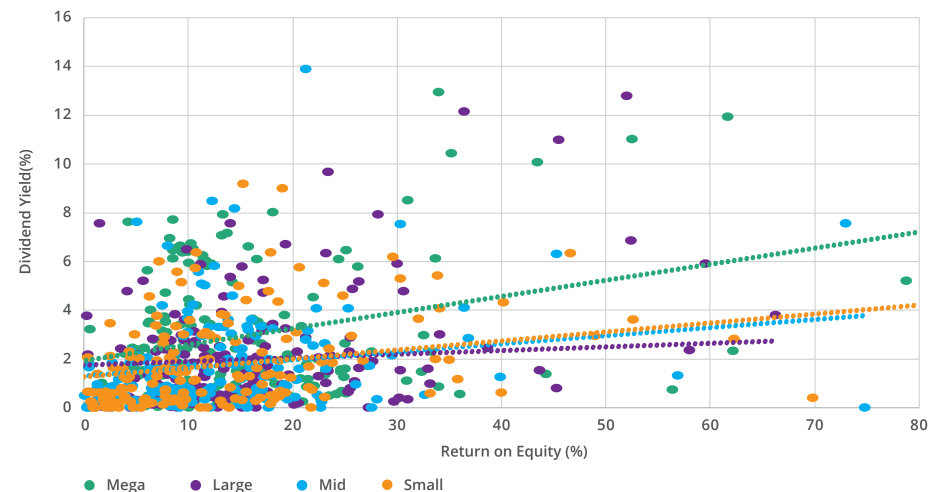
Source: FactSet, Value Partners, analysis based on all companies listed on the A-share market, data as at 31 December 2023.

Figure 8: the China A-share dividend universe



Source: FactSet, Value Partners, analysis based on all companies listed on the A-share market, data as at 31 December 2023.

Figure 9: the positive correlation between dividend yield and ROE



Source: Bloomberg, MSCI, Value Partners, data as at 31 December 2023.

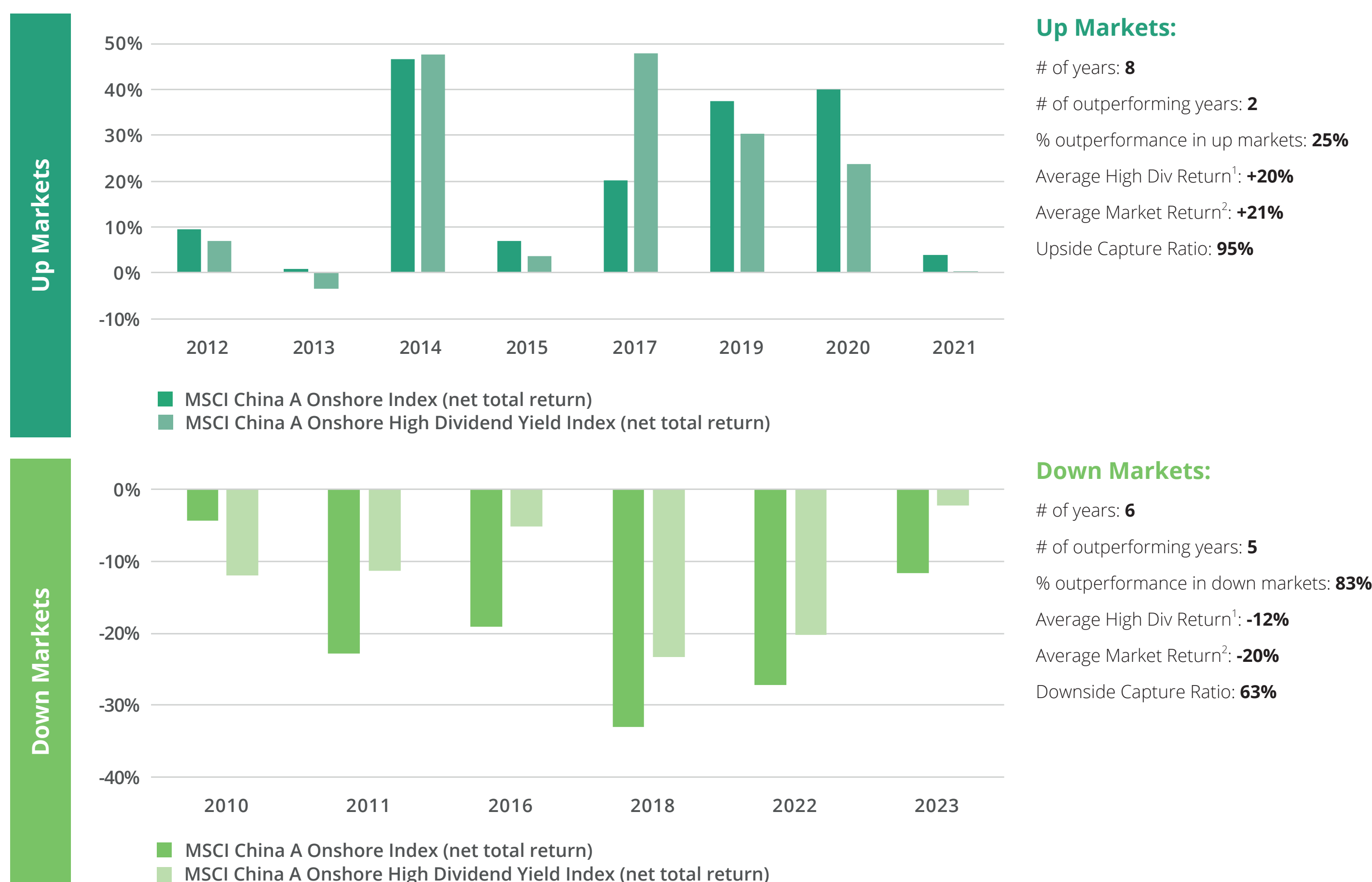
23 A shares in anatomy (goldmansachs.com)

Appendix 2:
an attractive risk-return profile

When it comes to the risk-return profile of outcomes delivered by a dividend-based approach to investing in China, the advantages are clear.

One of the biggest concerns that international investors have with China's equity market is its volatility. The domestic Chinese stock market is becoming increasingly institutionalised and, as we have highlighted throughout this paper, we expect this process to accelerate. However, although individual retail investors make up less than a quarter of the market, they still account for the bulk of the trading volumes.[24] This excitable cohort can exert a dramatic influence on the overall volatility of the market by chasing – and deserting – growth 'stories', which impacts the broader market return.

Figure 10: high-dividend performance behaviour in the China A-share market



Source: Bloomberg, MSCI, Value Partners, data as 31 December 2023.
1. Refers to the average return of the MSCI China A Onshore High Dividend Yield Index.
2. Refers to the average return of the MSCI China A Onshore Index.
Past performance is not indicative of future results.

By contrast, the typically large, mature and stable businesses that are the best candidates for dividend-driven strategies are less likely to be subject to short-term speculative whims.

This combination of strong upside participation in positive market environments and robust downside avoidance in negative market environments has enabled the high-dividend A-share opportunity set to consistently outperform the broader market.

24 Institutional ownership and momentum in the Chinese A-share market – ScienceDirect

Appendix 3:
China and the DDM

For dividend-driven investors, the dividend discount model (DDM) is a trusted formula for assessing a company's value. In the DDM, the numerator is the present value of future dividends while the denominator is the required rate of return. When the numerator is high and the denominator low, the DDM may produce a value higher than a stock's current price, indicating that it offers good value.

Figure 11: the dividend discount model (DDM)

$$P_0 = \sum_{t=1}^{\infty} \frac{DPS_t}{(1+r)^t} \approx \frac{DPS_1}{r - g}$$

$$P_0 = \frac{DPS_1}{r - g} = \frac{EPS_1 * \text{Payout Ratio}}{r - g}$$

$$r = R_f + ERP$$

When we apply this formula to the Chinese A-share market as a whole, we can see that several factors should keep the required rate of return (the denominator) low. These include the normalisation of growth, demographic challenges, deflationary pressures, atypically high real interest rates and the prospect of a long-term cycle of interest-rate cuts. Collectively, these factors suggest that stocks with high dividends are likely to offer good value. And with state support for shareholder returns and improving returns on equity, the supply of stocks with attractive dividends looks set to stay strong – boosting the numerator in the DDM.

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Value Partners Hong Kong Limited
43rd Floor, The Center, 99 Queen's Road Central, Hong Kong
T +852 2143 0688
F +852 2564 8487
E vpl@vp.com.hk

Value Partners Asset Management Singapore Pte. Ltd.
9 Raffles Place, #13-04 Republic Plaza, Singapore 048619
T +65 6718 0380
E vpams@valuepartners.com.sg

Value Partners Fund Management (Shanghai) Limited
701, Citigroup Tower, 33 Hua Yuan Shi Qiao Road,
Pudong New District, Shanghai 200120, China
T +86 21 3818 6888
F +86 21 6841 0030

Value Partners Investment Management (Shanghai) Limited
702, Citigroup Tower, 33 Hua Yuan Shi Qiao Road,
Pudong New District, Shanghai 200120, China
T +86 21 3818 6888
F +86 21 6841 0030

Value Partners (UK) Limited
City Tower, 40 Basinghall Street, London EC2V 5DE,
United Kingdom
T +44 20 3907 3870
E vpuk-sales@valuepartners-group.com

www.valuepartners-group.com