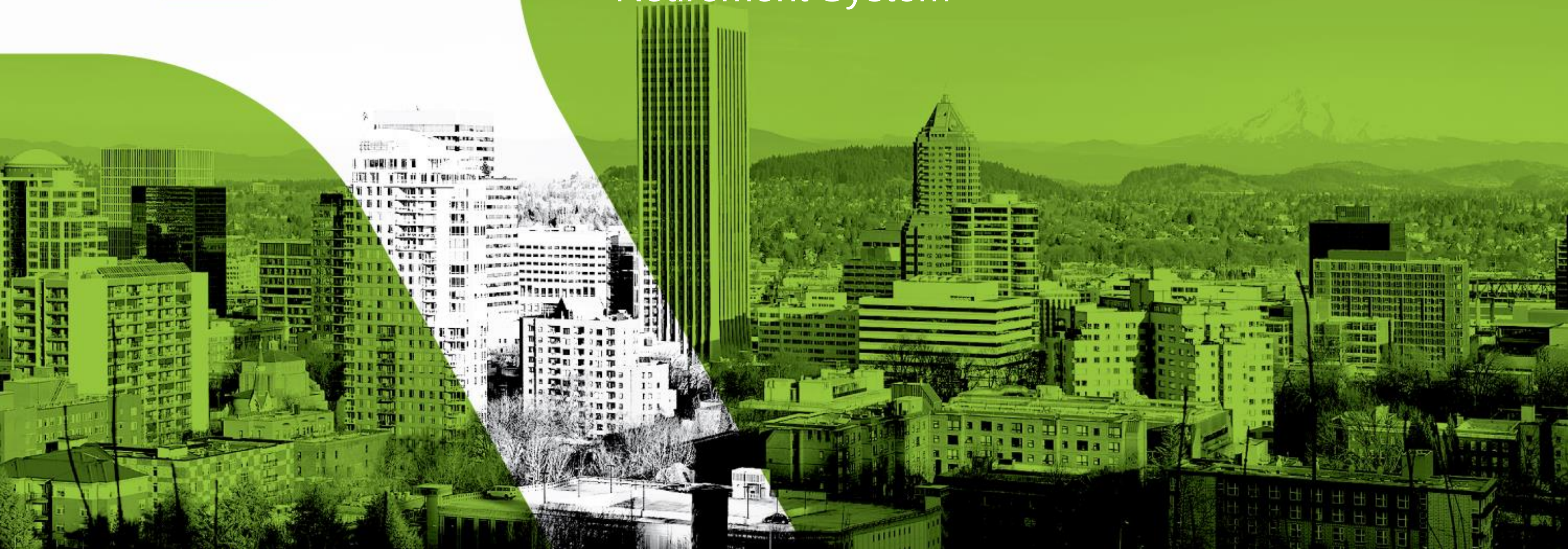
September 27, 2023

China Equity Discussion

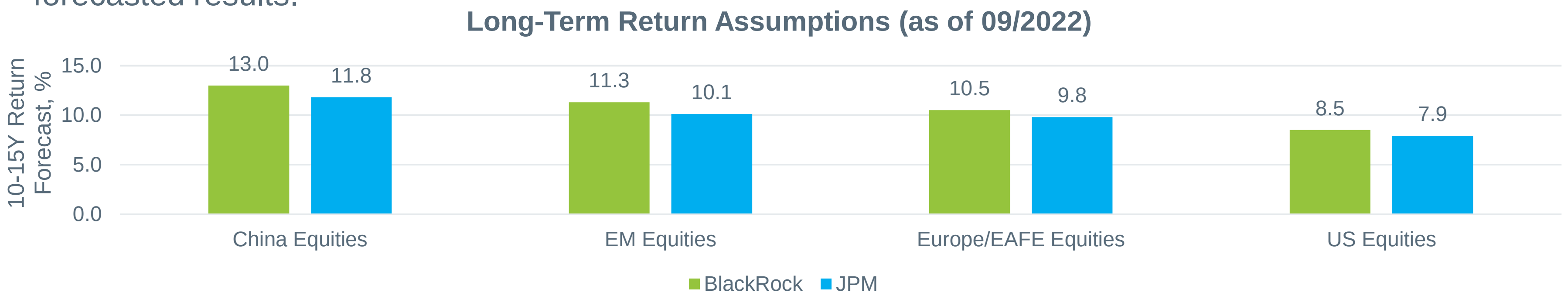
Santa Barbara County Employees' Retirement System



Public Equity in China

Summary

- Given geopolitical events and government policy responses, many investors are reviewing their current exposure to investments within China and seeking an understanding of the merits and risks associated with those investments.
- Based on forward looking assumptions, the potential for attractive returns is present within Chinese equities (as shown in the following figure), however this presentation will walk through the threats to achieving these forecasted results.



- A summary of the general pros and cons of removing exposure to Chinese equities is provided below.

- Pros:
  - Remove exposure to risk created by an authoritarian regime with a history of sudden interventions in capital markets to the detriment of shareholders.
  - Reduce exposure to risk of escalated conflict between the US and China.

- Cons:
  - China is a large component of the global economy with higher projected rates of economic growth than much of the developed world. As an investment opportunity there are potential significant portfolio return and diversification benefits.
  - Likely more expensive to implement non-US equity portfolio structure through customization that removes China.

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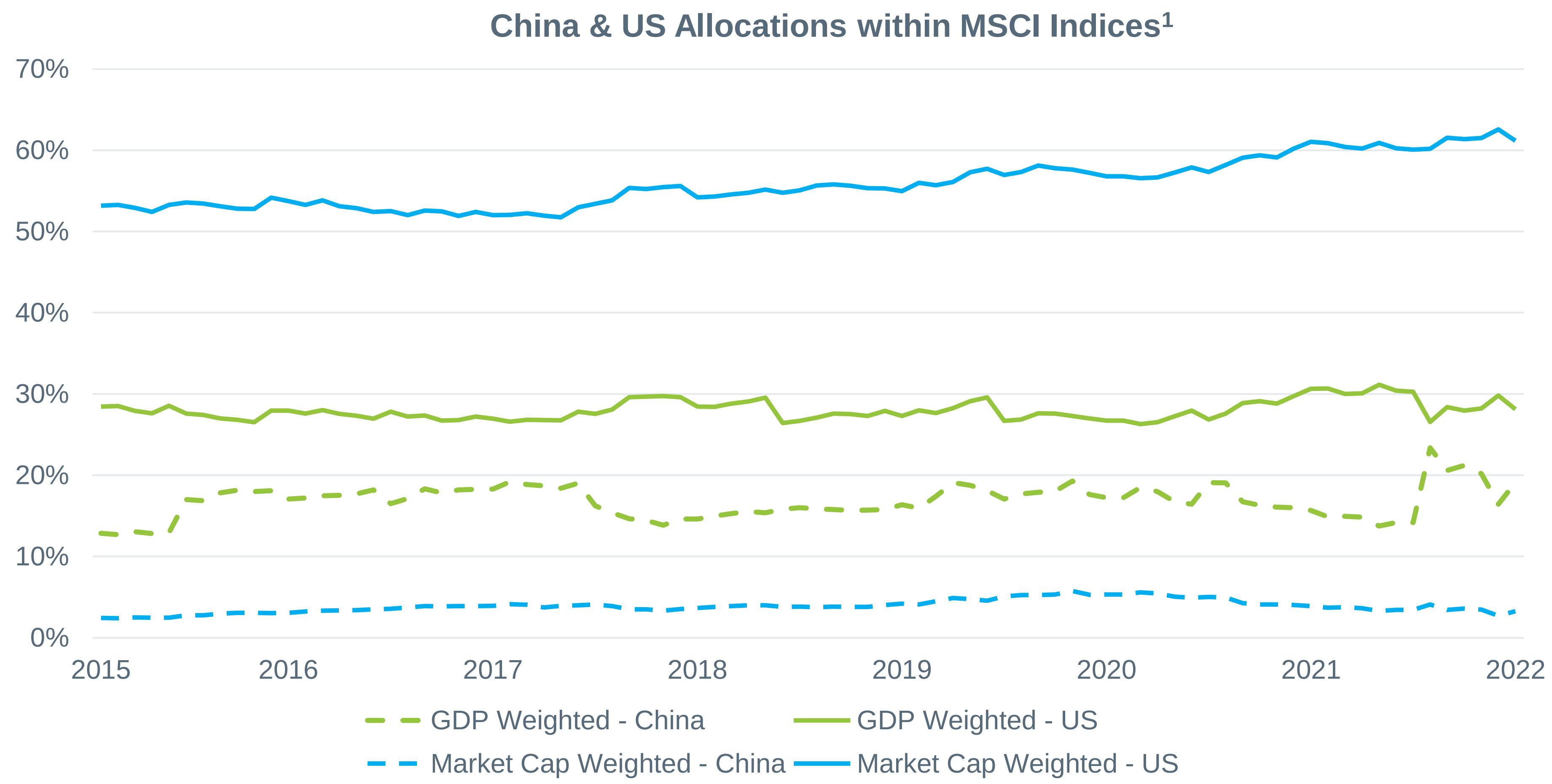
Market Capitalization versus Economy Size

- China has grown to become the second-largest economy in the world. It is expected to become the largest economy by 2027-28 given current GDP growth projections.
- At the end of 2022, China accounted for less than 4% of MSCI ACWI Index, which uses a cap-weighted methodology, compared to a 20% allocation in the MSCI ACWI GDP-weighted Index.



(1) Data sourced from Morningstar.

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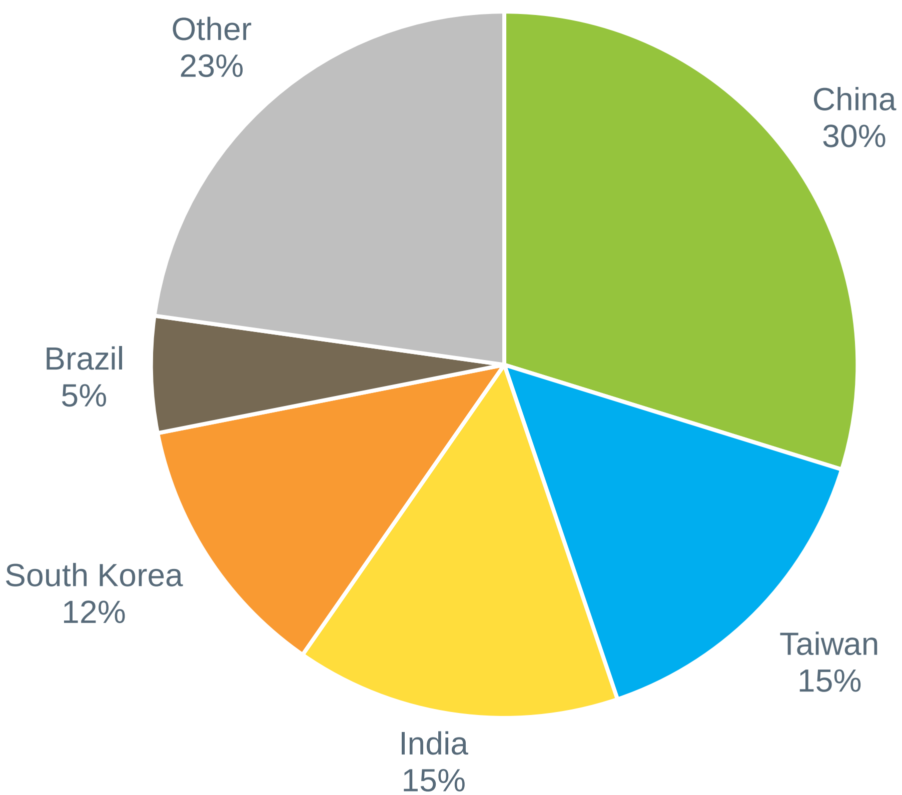
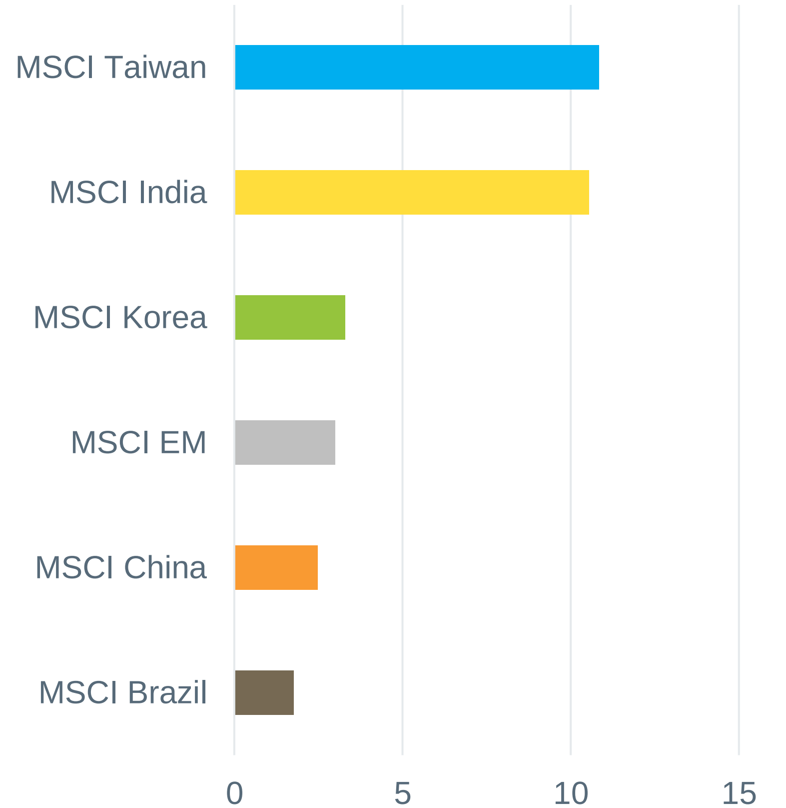
China Within Emerging Markets

- The allocation to China within emerging markets has grown over time due to the introduction of A-shares exposure to market indexes – however it has declined over the past two years due to market depreciation.
- The weight of China within passive indexes should be expected to grow should providers expand the inclusion of A-shares (below allocations reflect a 20% inclusion used by MSCI).
- As a result, the country drives an increasing amount of risk and return for the full region.

MSCI EM Index - Country Allocations, %



10 Year Return, %



Data sourced from MSCI (as of 08/31/2023).

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Prohibitions on Business Ties with Chinese Companies

- The ban on Huawei Technologies represented the first notable company to be prohibited from doing business with the US. They are currently the third largest manufacturer of mobile phones in the world and were second largest prior to the embargo.
  - This first started in early 2018 when the Director of the FBI issued a warning about the purchasing of Chinese handsets as companies beholden to a foreign government that don't share US values should not have a stronghold in our telecommunications network.
  - On May 5, 2019, President Trump issued an executive order banning the use of telecommunications equipment from foreign firms that are deemed a risk.
    - The ramifications of this for Huawei were significant. For instance, Google cut Huawei off from their suite of products, including the Android Operating System, on which their phones operated.
    - There were also negative ramifications for some domestic companies. For instance, Huawei network equipment was being used by some wireless providers.
- The technology embargo started as a narrow effort against Huawei, but now includes more than 60 companies subject to prohibitions due to national security concerns.
- Semiconductor Manufacturing International Corporation (SMIC), China's top chipmaker, was included on this list. They supply chips to US companies, such as Qualcomm.
    - This will not only impact SMIC's sales but will also hinder their production as they cannot access equipment from US manufacturers.
- The ban on these companies continues even though some are fighting back. Litigation is being pursued by some of these companies against the US; these efforts are ongoing.

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Investment Restrictions

- Executive Order 13959 was signed on November 12, 2020 prohibiting domestic investors from direct or indirect investment in companies tied to the Chinese military.
- Initially, 31 companies were listed. These companies are, according to the US government, providing direct or indirect support to the Chinese military. It was later clarified that this also includes subsidiaries of the prohibited companies. The order took effect on January 11 and divestment needed to take place by November 11, 2021.
- The list of prohibited securities has been expanded. It now includes a total of 44 Chinese companies. Of note, China Mobile and China National Offshore Corporation (CNOOC) are both prohibited.
- Both the investment industry and index providers have stated their willingness to comply. For instance, MSCI delisted seven Chinese companies on January 5, 2021 with FTSE and S&P taking similar action.
- RVK has also been in contact with active managers regarding compliance with the order. This has not affected the industry broadly, most managers we have spoken to have no exposure or the exposure is de minimis. However, China Mobile had been an area of contention for some.
- Effective August 2, 2021, Executive Order 14032, “Addressing the Threat From Securities Investments That Finance Certain Companies of the People's Republic of China” has since expanded the scope of Executive Order 13959 prohibiting U.S. persons from investing in Chinese companies identified by the U.S. government as having ties to China's military or surveillance industry.

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Impact of Tariffs

- Since 2018, the US has executed 7 separate tariff actions against China, and China has in turn responded with 6 retaliatory tariff actions.
- The February 2020 implementation of the "Phase One" deal between the US and China established new US tariffs on imports from China for the foreseeable future. Average US tariffs on imports from China will remain elevated at 19.3%, more than 6x higher than before 2018. Average Chinese tariffs on imports from the US also remain elevated at an average of 20.3%.
- US tariff rates have historically had a negative impact on the long-term Shanghai Stock Exchange Composite Index returns, while China's retaliatory tariff actions have had a statistically insignificant impact on US markets.
- On average, the US and Chinese tariffs have directly hurt targeted firms/sectors abroad as intended, but they have also hurt firms at home. Tariffs have also resulted in unintended effects on third parties, as a result of global value chain disruptions.
- As capital markets were held captive by the US-China trade war, equity markets became increasingly reliant on central banks to boost liquidity provisions since underlying demand was no longer able to keep economic activity at a sufficient level on its own. As a result, monetary authorities all over the world embarked on an easing cycle to offset the growth-hampering effects of the trade war.
- As businesses have shifted their supply chains beyond China's borders, Vietnam has emerged as the primary destination. However, this shift in trade flows has put pressure on Vietnam's still developing infrastructure, which has struggled to accommodate the increased traffic resulting in higher shipping costs, delays, and port congestion. As a result, most Asia based enterprises have kept the majority of their operations in China despite the direct risks presented by tariffs aimed at harming China's economy.

Portfolio Exposures

	Market Value	% of Exposure to China
Total Fund	**$4,094,805,534.96**	**1.78%**
Developed Non-US Equity Composite	**$411,572,165.42**	**1.01%**
PanAgora Dynamic International Equity (SA)	$212,818,724.57	0.09%
Artisan Non-US Growth (SA)	$141,560,053.59	1.96%
Acadian Non-US Small Cap Equity (CF)	$56,422,345.69	2.16%
Emerging Markets Equity Composite	**$259,499,710.45**	**26.48%**
DFA Emg Mkts Value;I (DFEVX)	$128,941,579.45	25.86%
RBC Emerging Markets Equity (CF)	$130,558,131.00	27.08%

Data shown is as of 06/30/2023. The % shown are estimated based on a review of the underlying fund holdings and/or data provided by the investment managers. Composite market values include residual assets from terminated managers.

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Recommendation for Managing China Exposure

Maintain Exposure Through Active Managers

- As of 06/30/23, portfolio exposure within the Developed Non-US Equity and Emerging Markets Equity Composites was only 1.78%.

- Currently, SBCERS does not have any passively managed Developed Non-US Equity or Emerging Markets Equity managers.

- SBCERS' actively managed Developed Non-US Equity and Emerging Market Equity managers are experts in their assigned field and should be allowed to execute investment decisions without constraints applied.

- The current active managers with exposure to China only own Chinese securities as a product of their active management decisions, in which risks and rewards are fully evaluated.

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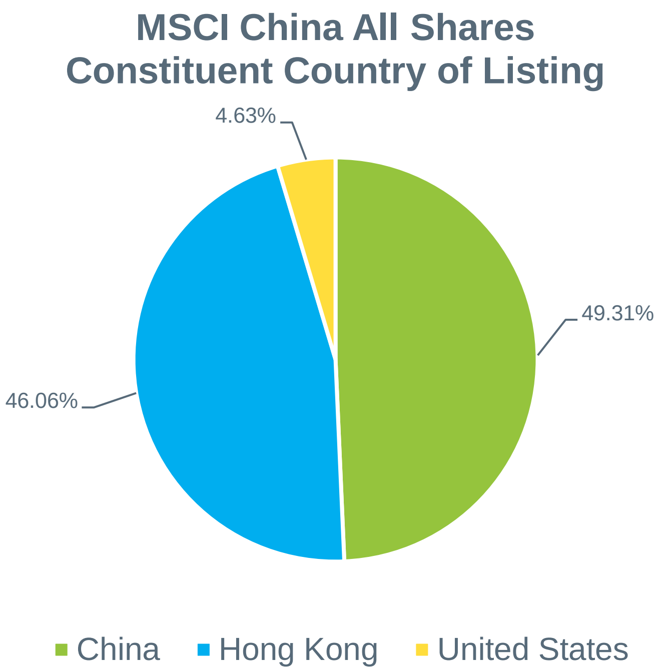
Appendix

Public Equity in China

Current Equity Market Profile

- Returns from China have trailed broad global equity returns for the past decade – with higher levels of risk.
- Generally, where exposure to China exists, it is recommended that it is actively managed.



	Return – 5 Yr	Return – 10 Yr	Annualized Std Dev – 5 Yr	Annualized Std Dev – 10 Yr	Sharpe Ratio – 5 Yr	Sharpe Ratio – 10 Yr
MSCI China All Shares	-0.86	3.31	23.80	22.42	0.01	0.20
MSCI ACWI	7.45	8.56	17.99	14.49	0.40	0.56

Data sourced from MSCI (as of 08/31/2023).

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Public Equity in China

Onshore and Offshore Public Equity Share Categories

- As shown in the table below, there are avenues for investing in China beyond direct onshore exchanges including investing through exchanges in Hong Kong and the US.

Share Class	Country of Incorporation	Country of Listing	Currency	Exchanges	Market Capitalization ($B)[1]
A-Shares	China	China	Chinese Renminbi	Shenzhen Stock Exchange Shanghai Stock Exchange	$1,781
B-Shares	China	China	US Dollar Hong Kong Dollar	Shenzhen Stock Exchange Shanghai Stock Exchange	$6
H-Shares	China	Hong Kong	Hong Kong Dollar	Hong Kong Stock Exchange	$480
ADRs/ Overseas	Various, including within China	USA Singapore	US Dollar Singapore Dollar	NYSE NASDAQ Singapore Exchange	$203
Red-Chips	Outside China (State Owned Enterprises)	Hong Kong	Hong Kong Dollar	Hong Kong Stock Exchange	$124
P-Chips	Outside China (Non-State Owned Enterprises)	Hong Kong	Hong Kong Dollar	Hong Kong Stock Exchange	$1,128

(1) J.P. Morgan, “Guide to China”, Q1 2023

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Increased Foreign Access to A-Shares

- Up until recently, A-Shares were traditionally accessible only to Chinese residents, however access has improved in recent years.

2002	• Qualified Foreign Institutional Investor (QFII) allowed to own A-shares with restrictions
2011	• Renminbi (RMB) Qualified Foreign Institutional Investor (RQFII) given more flexibility to transact in RMB with fewer restrictions
2014	• Shanghai-Hong Kong Stock Connect gives foreign investors near free-flow movement into and out of A-shares (within daily trading limit)
2016	• Shenzhen-Hong Kong Stock Connect offers foreign investors connections to more options, especially in technology and health care, "New China", companies
2018	• MSCI begins including China A-shares within passive indices at an inclusion factor of 5% over a two-step, five-month inclusion process.
2019	• February – MSCI further increases China A-shares inclusion factor within passive indices to 20% over a three-step, nine-month inclusion process • June – FTSE Russell begins including China A-shares within passive indices at an inclusion factor of 25%

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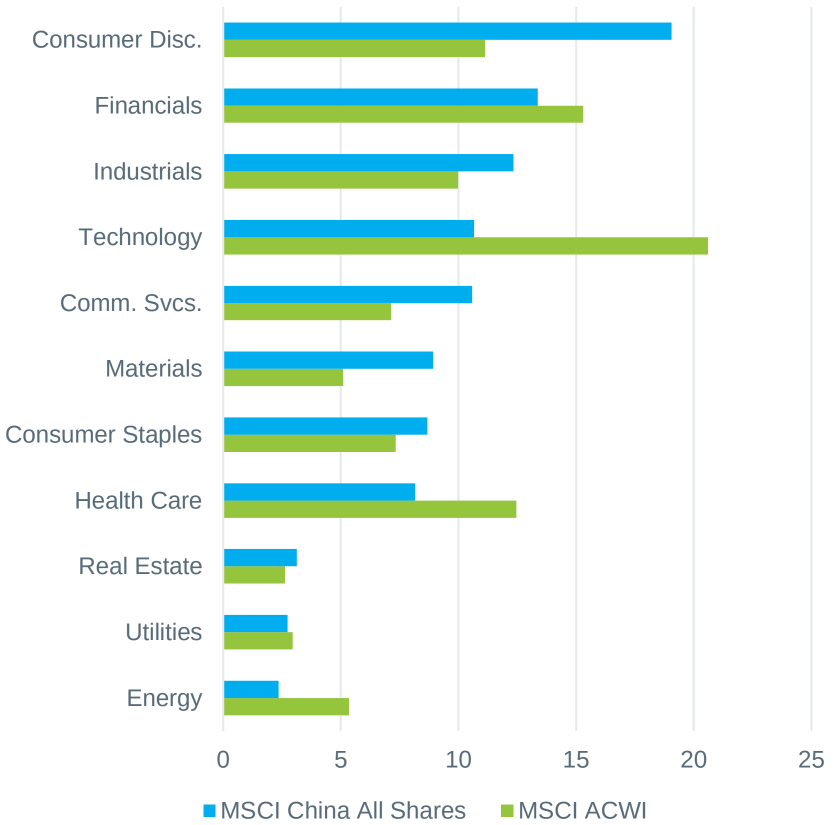
Current Equity Market Profile

- The opportunity set within China is more biased toward consumer-oriented stocks and the mega cap segment compared to the broad global universe.

Sector Weights, %



MSCI China All Shares Index

	Value	Blend	Growth
Large	27	39	30
Mid	1	2	1
Small	0	0	0

Market Cap	%
Market Cap Giant %	62.0
Market Cap Large %	33.4
Market Cap Mid %	4.0
Market Cap Small %	0.1
Market Cap Micro %	0.0

MSCI ACWI

	Value	Blend	Growth
Large	20	32	32
Mid	5	7	4
Small	0	0	0

Market Cap	%
Market Cap Giant %	47.7
Market Cap Large %	36.1
Market Cap Mid %	16.1
Market Cap Small %	0.1
Market Cap Micro %	0.0

Data sourced from MSCI (sector data) and Morningstar Direct (size and style).

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PORTLAND BOISE CHICAGO NEW YORK

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