Sinology

by Andy Rothman

May 14, 2020

- In response to White House pressure, the retirement fund for federal workers has postponed a decision to provide participants with the option to invest in Chinese-listed companies.
- In our view, this decision would not allow federal workers the same freedom that currently exists for private sector employees—to continue to be able to choose where they want to invest their own money.
- We also believe that this decision will not have a material impact on Chinese companies or the Chinese government, given that *all* U.S. investors hold only about 2% of the China market capitalization.

ANDY ROTHMAN lived and worked in China for more than 20 years, analyzing the country's economic and political environment, before joining Matthews Asia in 2014. As Investment Strategist, he has a leading role in shaping and presenting the firm's thoughts on how China should be viewed at the country, regional and global level.

FEDERAL EMPLOYEES MAY LOSE OPTION TO INVEST IN CHINA

In response to White House pressure, the board which administers the retirement plan for federal workers voted on May 13 to postpone its plan to provide participants with the option to invest in Chinese-listed companies. The decision by the managers of what Morningstar calls "the largest defined-contribution plan in the world," was in response to a May 11 letter by two of President Trump's top advisors, which stated that "the possibility that future sanctions will result from the culpable actions of the Chinese government with respect to the global spread of the COVID-19 pandemic" raises risks for investors.

In our view, blocking the Thrift Savings Plan (TSP) from expanding its menu of investment options to include Chinese equities would not allow federal employees the same freedom that currently exists for private sector employees—to continue to be able to choose where they want to invest their own money. As a Morningstar analyst explained, the original plan to include China as well as many other countries "seems like an obvious adjustment and would bring the TSP in line with more sophisticated 401(k) menus."

While a final decision by the TSP to abandon its initial plans to proceed with investing in Chinese equities would have a significant impact on federal employees' freedom to make investment choices, we do not believe it would have a material impact on Chinese companies or the Chinese government. Given that *all* U.S. investors hold only about 2% of the China market capitalization, the Chinese stock market does not provide Washington with much political or economic leverage.

In the following Q&A, we provide our views on why we believe a decision to exclude China from the TSP investment menu of options would disadvantage the more than five million workers who rely on it for their retirement, without helping the U.S. government achieve any broader political objectives.

What's new?

On May 11, the Trump administration asked the U.S. federal employee retirement fund to cancel its plan to include Chinese equities in its menu of investment options for fund participants. On May 13, the board overseeing the Thrift Savings Plan complied, postponing its plan to expand the scope of the TSP's international fund.

Why did the Trump administration take this step?

A May 11 White House letter signed by Trump's top economic and national security advisors, Larry Kudlow and Robert O'Brien, states that they took this action because of several risks, including "the possibility that future sanctions will result from the culpable actions of the Chinese government with respect to the global spread of the COVID-19 pandemic…scandals involving Chinese companies in recent years have cost investors billions of dollars…the Chinese government's intentional thwarting of U.S. investor protections…demonstrate the significant

risks to investors, especially retail investors…In addition…some of the Chinese companies themselves present significant national security and humanitarian concerns for the U.S., which increases the risk that they could be subject to sanctions, public protests, trade restrictions, boycotts and other punitive measures that jeopardize their business and profitability…Even if the Board [of the Thrift Savings Plan] believed that the [plan's international fund] investments should expand to include what MSCI has labeled "Emerging Markets," there are means by which the Board could make investments broadly tracking the rest of those markets while excluding China…"

What retirement funds does the White House directive apply to?

The White House letter is directed solely at the Thrift Savings Plan (TSP), a tax-deferred retirement savings and investment plan that offers federal government employees—including those serving in the military— the same type of savings and tax benefits that many private companies offer their employees under 401(k) plans. At the end of last year, the TSP had US$769 billion in assets under management (AUM).

Does the TSP invest in Chinese equities today?

The TSP offers federal employees the choice of investing in five individual funds, four of which invest only in U.S. equities and bonds. The fifth fund invests in an index based on the MSCI EAFE (Europe, Australasia, Far East) index, which has a 3.4% weighting for Hong Kong-listed stocks, but does not invest in mainland-listed Chinese companies. This index-based international fund had only US$54.3 billion in AUM at the end of last year, equal to about 7% of the total TSP AUM.

[Full disclosure: I am invested in this international fund, dating back to my State Department service.]

What change is the TSP proposing to its international fund?

In 2017, the board responsible for administering the TSP decided to expand the existing international fund to include a broader range of countries, by switching from the MSCI EAFE index to the MSCI World ex-USA Investable Markets Index (IMI), which includes stocks from 23 developed and 24 emerging markets, including China. The board reaffirmed that decision in November 2019, noting that federal employees should have the same 401(k)-style investment opportunities as their private sector counterparts. This decision was recommended by consultants from Aon Hewitt, who said the broader index more accurately matches the statutory language establishing the TSP's international fund.

Isn't it appropriate for the government to protect federal employees from the risks of investing in China?

Blocking the TSP from expanding its international fund from including Chinese equities would not allow federal employees the same freedom that currently exists for private sector employees—to continue to be able to choose where they want to invest their own money. All 10 of the largest publicly traded U.S. companies include access to the Chinese market in their 401(k) packages, and the same is true for the top 10 awarded federal contractors, as well as the 20 largest public sector pension programs. The TSP board chair said last year that they want to "leave it up to individual participants to have the options to invest how they choose, based on their beliefs and opinions. They just want the same options as those in the private sector." Any TSP participant now in the international fund who did not want to take advantage of the expanded offering could, at no cost, easily transfer money into the four domestic funds. This would protect their freedom of choice.

Investments involve risk. Past performance is no guarantee of future results. Investing in China may involve additional risks, such as social and political instability, market illiquidity, exchange-rate fluctuations, a high level of volatility and limited regulation.

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If the TSP was to cancel its plans to include Chinese companies in its international fund, would this generate pressure on those companies, or on the Chinese government, to modify their behavior?

While a decision by the TSP to abandon its plans to include Chinese companies in its international fund would have a significant impact on federal employees' freedom to make investment choices, we believe it would not have a material impact on Chinese companies or the Chinese government. The total AUM of the international fund is US$54.3 billion, and China has only a 10% weighting in the World ex-USA index, so that is potentially less than US$6 billion in a China universe with US$13 trillion in market cap and a daily trading volume of about US$81 billion. Keep in mind that U.S. investors hold only about 2% of the China market cap, so, overall, the Chinese stock market does not provide Washington with much leverage.

Isn't it a reasonable compromise for the TSP to switch to a modified international index that excludes China, but includes many other countries?

This would not allow federal employees the same freedom that currently exists for private sector employees, to continue to be able to choose where they want to invest their own money. This decision would not, in our opinion, generate any meaningful pressure on Chinese companies or the Chinese government, because the amount of money involved is so small relative to the size of the Chinese market. Private sector investors have the option of investing in an international ex-China index fund, and very few have decided to do so. Funds based on the MSCI suite of Emerging Markets (EM) indexes, which include China, have a combined AUM of US$1.9 trillion. Funds based on MSCI EM indexes which exclude China have a combined AUM of about US$95 million. Why deny federal employees the right to make this decision on their own?

Would the new international index chosen by the TSP board result in federal employees funding Chinese companies affiliated with the Chinese military?

According to our research, we estimate that the number of Chinese companies with military affiliation in the World ex-USA index is very small, accounting for 1.6 basis points (or 0.016%) of the index, and the amount of money involved at present is unlikely to be material for those companies.

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