Rhodium Group

China

# De-Risking US Securities Investment in China

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Thilo Hanemann (thanemann@rhg.com), Ciel Qi (cqi@rhg.com)

US policymakers have been pushing for new tools to discourage investors from financing problematic Chinese security issuers. However, there is no political consensus on more controversial steps like a comprehensive outbound investment screening mechanism covering passive investments, so the Biden administration has mostly used sanctions and other blacklists to keep US capital from flowing to China-based entities of concern.

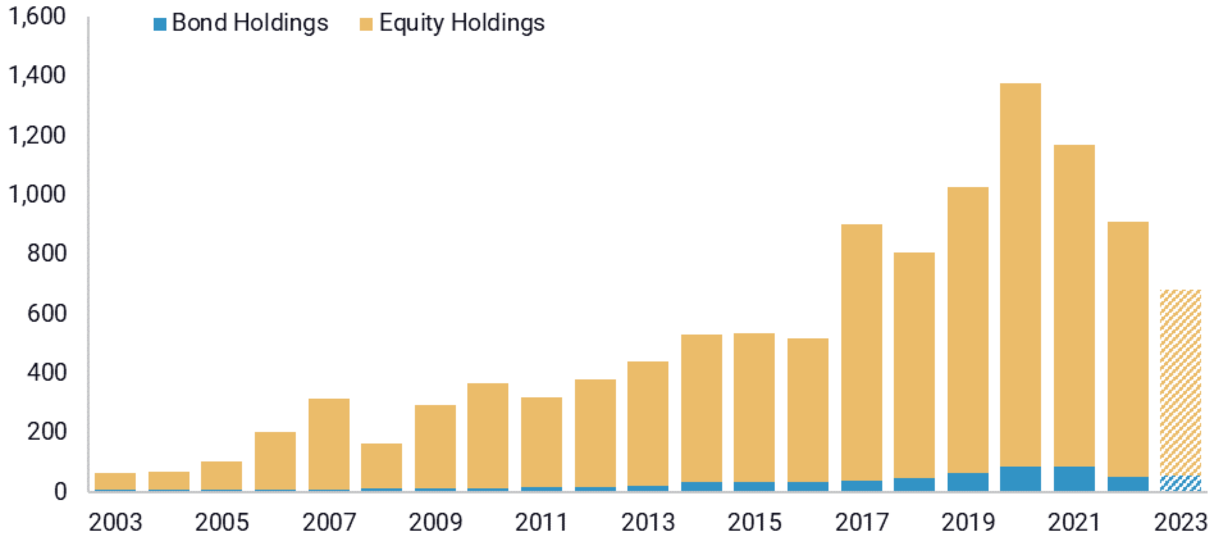
While US funds generally avoid blacklisted security issuers, they struggle to steer fully clear of issuers that are indirectly tied to blacklisted firms. Asset managers are also confronted with an even more difficult challenge: avoiding issuers that have problematic characteristics but are not yet sanctioned. Rhodium Group's Military-Political-Economic Risk (MPER) China framework allows investors to effectively de-risk from problematic Chinese issuers without wholesale divestment.

## The rise (and fall) of US securities investment in China

US investors have significantly expanded their holdings of Chinese securities in the past decade, but data is incomplete and distorted by China's legacy of capital controls and investors' tax optimization strategies. Our best guess is that holdings by US investors of PRC security issuers more than tripled from less than $400 billion in 2010 to $1.4 trillion in 2020. Since then, holdings have declined due to China's economic slowdown, higher US interest rates, and a changing risk-reward equation. We estimate US holdings have dropped below $700 billion by the end of 2023, the lowest level in five years (Figure 1).

However, the latest high-frequency data shows a rebound in foreign appetite for Chinese securities in early 2024. Foreign holdings of CNY bonds have increased for six months in a row, and fund flow data suggest that foreign purchases of equities also recovered towards the end of Q1 after Beijing managed to stabilize the stock market. Global investors remain significantly underinvested in Chinese securities relative to China's position in the global economy, and signs of stability in China's economy and financial markets will likely drive additional foreign inflows in 2024.

FIGURE 1
**US holdings of Chinese securities by type***
Market value on a nationality basis, in USD billion



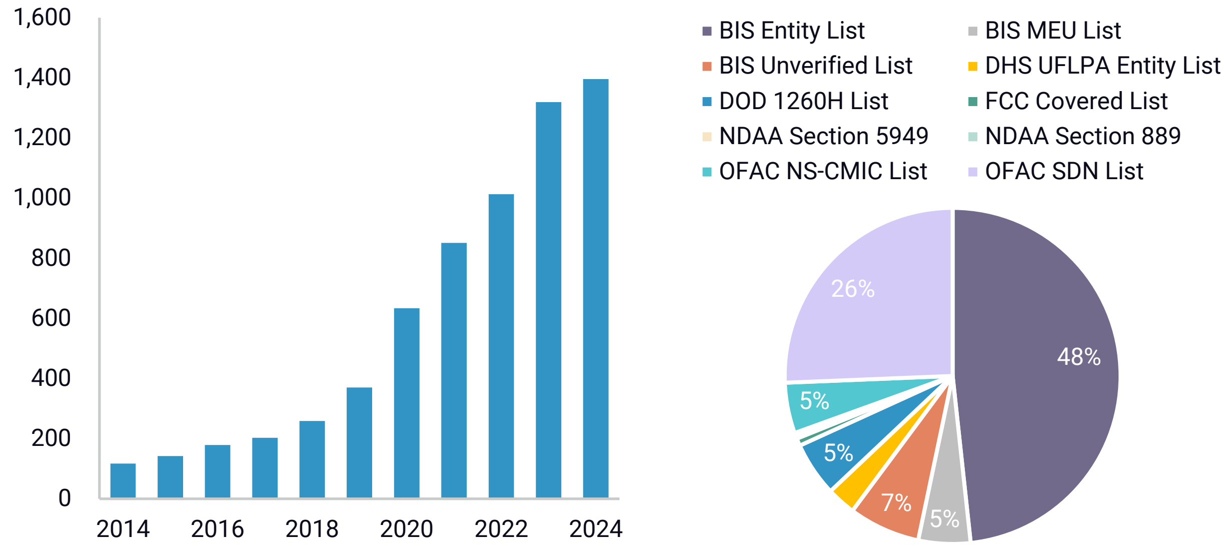

Source: Rhodium Group estimates based on Bertaut et al. (2023). *Mainland China, Hong Kong, and Macau combined; bond holdings include both government and corporate bonds; equity holdings include common stock, fund shares, and preferred and other equity; 2023 data is estimated based on PBOC data on foreign holdings of RMB assets and micro data on mutual fund and ETF holdings.

## A melting pot of US blacklists

The growth of foreign securities investment in China has raised concerns in Washington that US capital is potentially contributing to problematic companies in China. US policymakers have proposed expanding the policy toolkit to address these concerns but have struggled to find the right balance between national security interests and long-standing principled commitments to free capital markets. Proposals that could have regulated US securities investment in China—such as a 2024 NDAA provision that requires US companies to notify the Treasury Department before making investments in certain technologies in China—were dropped because of opposition from House Financial Services Committee members.

As a result, the US government has been relying upon sanctions programs and blacklists to target problematic Chinese security issuers. Between 2019 and May 2024, the US government issued more than a thousand sanctions or red-flag designations on Chinese companies (Figure 2). Those include regimes with severe legal consequences—such as OFAC's Specially Designated National List (SDN List) and Non-SDN Chinese Military-Industrial Complex Companies List (NS-CMIC List)—and lists that largely have signaling impact—such as the DOD's List of PRC Military Companies in accordance with Section 1260H of the NDAA for FY 2021 (1260H List). As of May 1, 2024, almost 1,400 such designations have been issued, covering nearly 1,300 individual Chinese companies.

FIGURE 2
**US sanctions and red-flag lists designations on PRC entities, 2014 to 2024***
Cumulative count of US blacklist designations on PRC entities (left), breakdown by list (right)



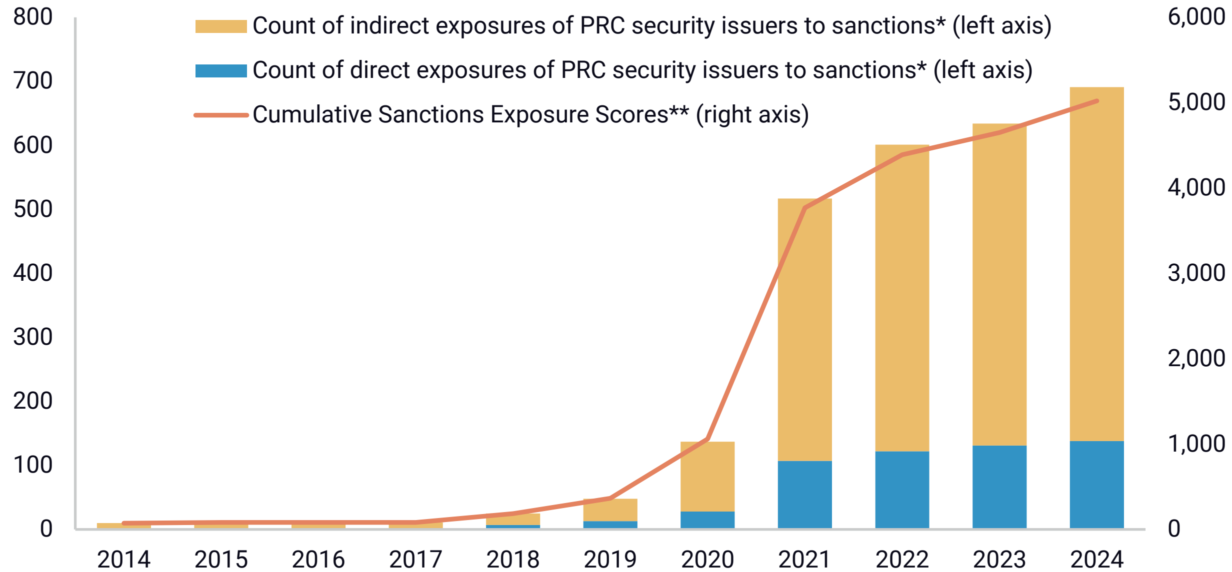

Source: Rhodium Group MPER China. *2024 data as of May 1, 2024

## Quantifying sanctions exposure

This melting pot of blacklisting poses a challenge for global investors. They need to not only track direct and secondhand exposures of security issuers to these lists, but also understand and ideally quantify the legal and reputational risks of each of the lists.

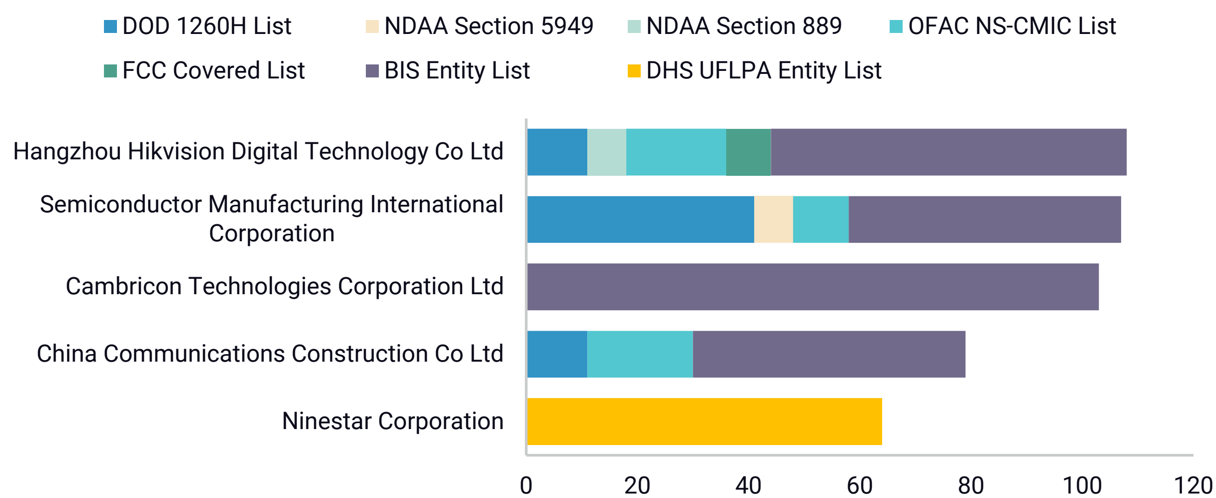
To address this problem, we have developed a **Sanctions Exposure Score** that captures both direct and indirect exposures of 8,148 Chinese security issuers to over 50 sanctions and red-flag programs by the US and other major market economy governments. Each issuer is assigned a score based on the exposure type (direct or indirect), the ownership relationship to the sanctioned or red-flagged entity, and the severity of the respective regime. We identified nearly 700 records of active sanctions or red-flag lists exposure, with the majority (80%) being indirect exposure (Figure 3). As US sanctions and red-flag lists have proliferated, the cumulative Sanctions Exposure Score has quintupled since 2000. Hangzhou Hikvision Digital Technology Co Ltd, Semiconductor Manufacturing International Corporation, and Cambricon Technologies Corporation Ltd are among the issuers with the highest Sanctions Exposure Scores (Figure 4).

FIGURE 3
**Sanctions Exposure of Chinese security issuers**
Active sanctions and red-flag lists exposure only




Source: Rhodium Group MPER China. Data as of May 1, 2024. *By count of records. **The total Sanctions Exposure Scores of 8,148 PRC security issuers. For detailed methodology, see mper.rhg.com.

FIGURE 4
**Chinese issuers with highest exposure to US blacklists**
Score reflects an issuer's direct and indirect exposure to various US blacklists




Source: Rhodium Group MPER China. Data as of May 1, 2024

## How are US investors responding to sanctions?

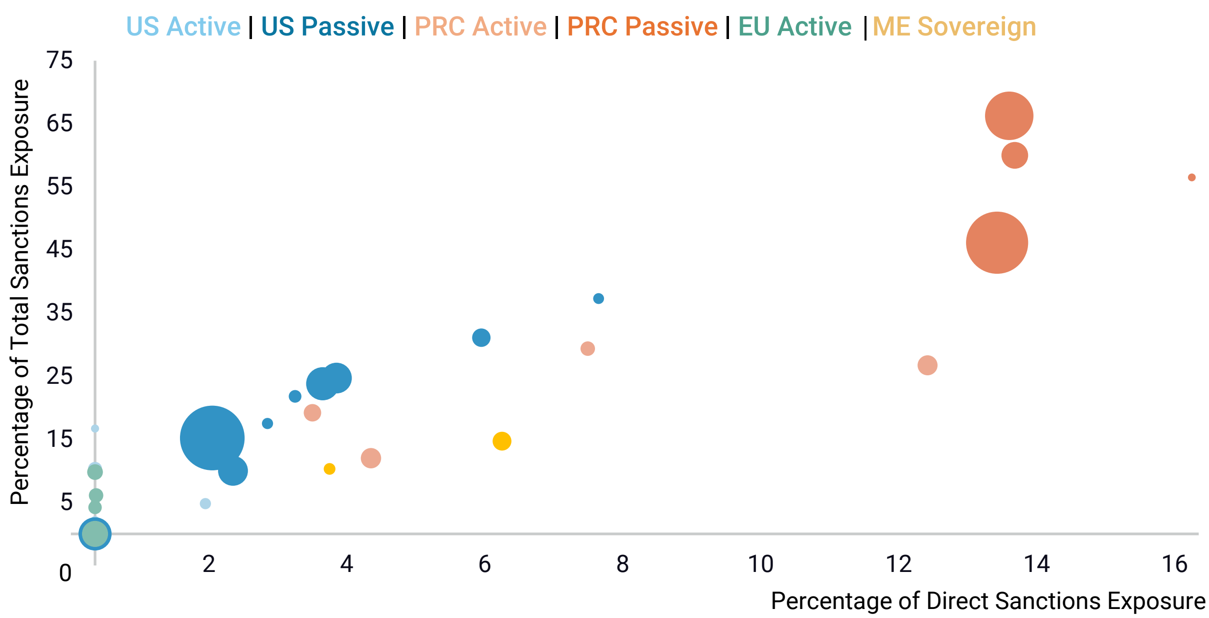
Our Sanctions Exposure data can help evaluate whether US sanctions and red-flag listings affect the China portfolios of global investment funds. Figure 5 shows the Sanctions Exposure of a representative sample of 33 funds domiciled in the US, Europe, PRC, and the Middle East that invest in mainland and Hong Kong equities. We show each fund's direct Sanctions Exposure (percentage of fund holdings that are directly blacklisted) and total Sanctions Exposure (percentage of fund holdings that are directly and indirectly blacklisted).

We find that China-domiciled funds have, not surprisingly, the highest exposure to sanctioned and red-flagged entities. Actively managed US- and EU-domiciled funds, on the other hand, have the lowest exposure. Middle East sovereign wealth funds have lower exposure to problematic issuers than China-based asset managers but higher exposure than US and EU-domiciled funds.

FIGURE 5

**Sanctions Exposures of various funds investing in Chinese securities**

Percentage of fund holdings that are directly blacklisted (X-axis); Percentage of fund holdings that are directly and indirectly blacklisted (Y-axis); bubble size: investments in Chinese public equities (USD million)

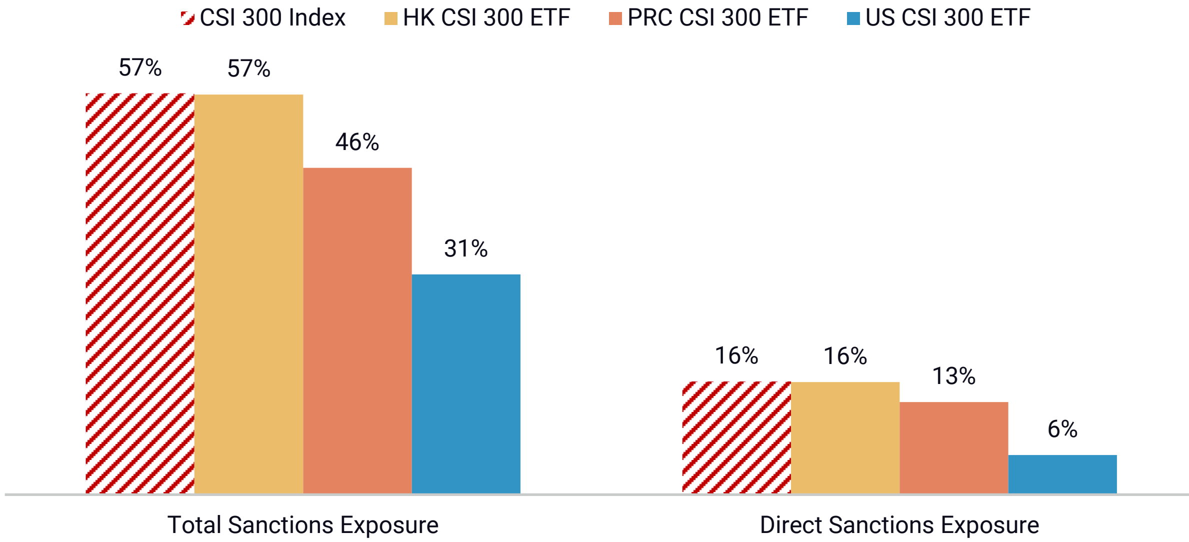



Source: Rhodium Group CDIT, regulatory disclosures. PRC fund holdings as of Q2 2024; US, EU, and ME fund holdings as of Q1 2024.

We can also illustrate that US managers at passive funds generally use the limited discretion they have—index funds are required by the SEC to track at least 80% of the index they brand themselves with—to filter out blacklisted entities. Figure 6 shows the risk profile of three ETFs that track the CSI 300 index, which consists of the 300 largest and most liquid stocks traded on the Shanghai and Shenzhen stock exchanges. The US ETF shows considerably lower exposure to problematic issuers compared to the original index and its Hong Kong and mainland counterparts.

FIGURE 6

**ETFs' Sanctions Exposure comparison by fund domicile**




Source: Rhodium Group MPER China. Funds public disclosures. Data as of Q1 2024.

## Quantifying risk from Chinese security issuers

Looking forward, global investors will have to brace for continued public scrutiny and policy uncertainty. There are efforts to streamline sanctions and red-flag lists, but there is no clear pathway for a more unified approach in the near future. Moreover, new areas of focus that could lead to public scrutiny of Chinese security issuers are emerging quickly in the US and elsewhere, like subsidies and predatory market practices.

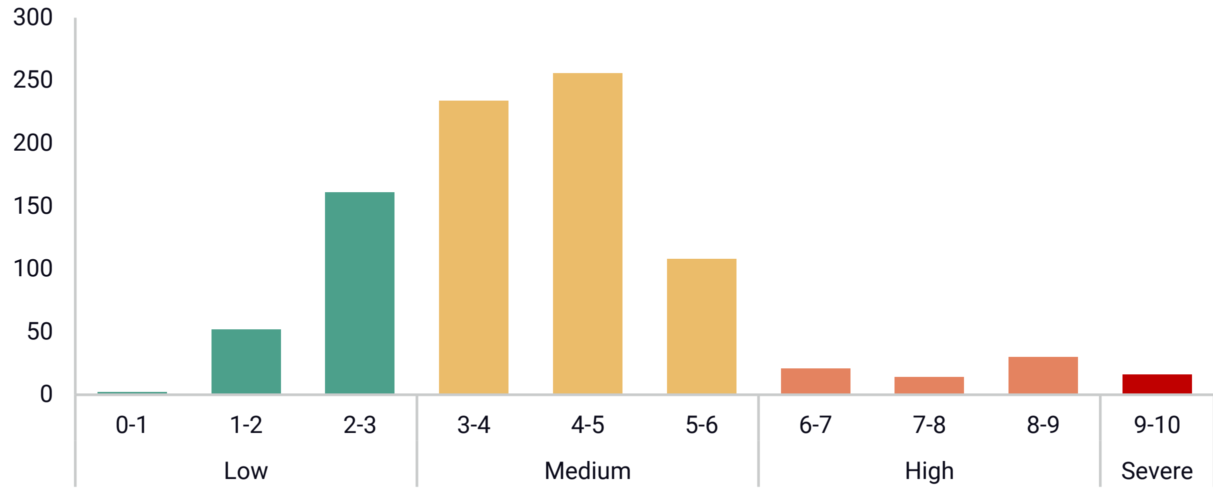
In the absence of policy and regulatory clarity, Rhodium Group has developed MPER China, a new data solution to screen Chinese security issuers for risks from a democratic market economy perspective. MPER China's Fundamental Risk Scores capture risks across military, political, and economic dimensions. Scores for **Autocratic Military Affiliation** capture an issuer's association with military entities controlled by an autocratic government. **Autocratic Regime Affiliation** captures an issuer's ties to an authoritarian government and its participation in autocratic practices at home and abroad. **Illiberal Economic Practices** captures an issuer's affiliation with problematic economic practices that undermine the principles of open market economies.

Figure 7 shows a breakdown of the Fundamental Risk Scores for a sample of almost 900 Chinese securities mostly commonly traded by foreign investors. Most of these securities exhibit low (215 securities, 24% of the total) to medium (598 securities, 67%) Fundamental Risk Scores. However, a small portion of these securities have high (65 securities) and severe (16 securities) risk scores, often associated with Sanctions Exposure. These numerical scores allow investors to distinguish between clearly unproblematic issuers, potentially problematic entities, and clearly problematic issuers.

FIGURE 7

**MPER Fundamental Risk Scores* distribution**

N=894




Source: Rhodium Group MPER China. Data as of Q1 2024. *A Sanctions Exposure Score override applies when an issuer's Sanctions Exposure Score is higher than its Fundamental Risk Score.

To pinpoint unsanctioned issuers with problematic characteristics that could land them on a blacklist in the future, MPER data also allows for detailed breakdowns of dimension scores and individual risk metrics. Figure 8 shows the Fundamental Risk Scores of a sample of issuers from different industries, along with a breakdown of their military, political, and economic dimension scores. While Fundamental Risk Scores help evaluate the overall risks associated with an issuer within a certain industry, dimension scores enable the identification of individual issuers that may be implicated in specific China controversies. For example, in the economic dimension, one of the metrics we track is whether a company receives government subsidies. An issuer receiving significant government grants will see an increased risk score in that domain.

FIGURE 8

**Fundamental Risk Scores of selected Chinese security issuers**

| | | | Dimension Score | | |
|---|---|---|---|---|---|
| Issuer Name | Industry | Fundamental Risk Score | Military | Political | Economic |
| Chow Tai Fook Jewellery Group Ltd | Specialty Retail | 1.26 | 0.00 | 1.95 | 2.40 |
| Chacha Food Co Ltd | Food Products | 3.06 | 0.00 | 4.95 | 5.40 |
| Oriental Pearl Group Co Ltd | Media | 4.08 | 0.60 | 6.45 | 6.30 |
| Kweichow Moutai Co Ltd | Beverages | 4.42 | 1.20 | 7.15 | 5.40 |
| Zhejiang Juhua Co Ltd | Chemicals | 5.47 | 3.30 | 6.75 | 7.25 |
| Agricultural Bank Of China Ltd | Banks | 5.70 | 3.60 | 7.50 | 6.30 |
| SAIC Motor Corp Ltd | Automobiles | 6.01 | 3.30 | 8.35 | 6.74 |
| CRRC Corporation Ltd | Machinery | 7.20 | 7.00 | 7.75 | 6.47 |
| BGI Genomics Ltd | Biotechnology | 8.00* | 5.20 | 5.35 | 6.97 |
| AECC Aviation Power Co Ltd | Aerospace & Defense | 9.00* | 8.70 | 6.65 | 5.50 |

Source: Rhodium Group MPER China. *Sanctions Exposure Scores override applied. Data as of Q1 2024.

As policymakers increase scrutiny on capital flowing to Chinese firms, there is growing pressure for investors to simply pull up stakes and remove themselves from the China market and its associated risks. A growing list of Chinese companies are ending up on sanctions and red-flag lists, while Congress is taking steps to scrub Chinese firms from index funds.

But a complete withdrawal from Chinese securities would be throwing the baby out with the bathwater—not all Chinese security issuers are equally problematic, and a large proportion of Chinese securities present manageable levels of economic, political, and military risks. By incorporating a systematic quantitative approach, tracking both direct and indirect exposure to sanctions lists and the behaviors that land issuers on them, investors can de-risk their portfolios without wholesale divestment from Chinese issuers.

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