Global Asset Management

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MSCI Prepares to Include China A-Shares in EM Index

What happened?

After reviewing the issue for four consecutive years, MSCI has finally decided to include China A-shares in its Emerging Markets (EM) Index on a gradual basis, beginning in 2018. In the previous three years MSCI decided against including the A-shares in the EM index but they relaxed their investment criteria in March in a bid to address concerns on capital repatriation and suspended stocks. The reasons MSCI Chairman and CEO Henry Fernandez listed for their inclusion (on CNBC) were:

1. The expansion of Stock Connect has been a game changer for the market opening of China A-shares. (Stock Connect is the program giving foreign investors access to the Shanghai and Shenzhen stock markets through Hong Kong.)

2. The reduction in the number of suspended stocks since the decline in the market. So there's less control and more availability in the shares.

3. The loosening of restrictions on the data in order to create index-linking investment vehicles.

What are China A-Shares?

China A-shares are the shares of companies incorporated in mainland China and traded in Shanghai or Shenzhen, quoted in Chinese renminbi (RMB).

How are China A-Shares different from China B-Shares?

Mainland China has two stock exchanges, in Shanghai and Shenzhen. These two exchanges have both A and B-share markets. The main difference between A-shares and B-shares is that A-shares are denominated in China's local currency, the renminbi, while B-shares are denominated in a foreign currency (US dollars in Shanghai and Hong Kong dollars in Shenzhen).

In addition, as described by the Financial Times, "For a long time, the other main difference between the two, from a regulatory standpoint, was that the A-share market was closed to foreign investors while the B-share market was open only to foreigners. However in 2001, the Chinese authorities tried to boost the B-share market by opening it to individual Chinese investors. And in 2003, a scheme was introduced whereby select foreign institutions were allowed to buy A-shares. Some companies have their stocks listed on both boards, but their B-shares trade at a large discount to their A-shares, which tend to see much larger trading volumes."

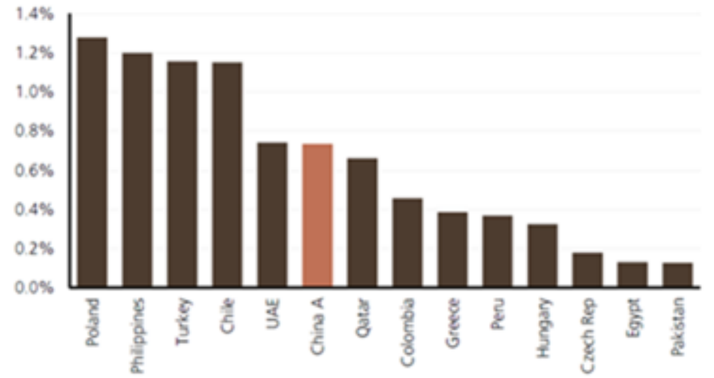
Why does this matter (especially to China)?

Some analysts believe that the full inclusion of domestic Chinese stocks in the MSCI EM Index could pull more than $400 billion of funds from asset managers, pension funds and insurers into mainland China's equity markets over the next decade. Also, similar to when a stock is initially included in an index, capital inflows will occur almost immediately (when this is implemented in 2018) into China's domestic equity market, as all passive index funds and ETFs that track the MSCI EM index will be forced to add China A-shares to their portfolios. What's probably most important to China, is that the inclusion will be considered a milestone to them in the opening up of the mainland Chinese equity market to the world, which they believe could bolster the country's credibility as the world's second-largest economy and allow China to take a bigger role on the international stage.

How will MSCI implement this change?

MSCI will start by adding 222 large-cap stocks for initial inclusion into the index, which is much higher than the proposed number of 169 stocks. It is also important to note that many of these names are large state owned enterprises (SOEs), including Bank of China, China Merchants Bank, Guotai Junan and Ping An Insurance, among others. These 222 companies represent a pro-forma weight of 0.73% of the MSCI EM index, at a 5% partial inclusion factor (i.e., 5% of the free float market cap of the stock). Together with the existing MSCI China stocks, China's EM weight will rise to 28.5% from below 28% today. If China continues with market reform, this weighting could increase. (See figure 1.)

Exhibit 1 - MSCI GEMs: Weights of Small "Markets"



Source: MSCI, Datastream, UBS

Note: MSCI will partially add China A-Shares into EM on May 31, 2018

At this stage the inclusion is planned to be phased over two steps. The first inclusion step would coincide with the May 2018 semi-annual index review followed by the second step which would take place as part of the August 2018 quarterly index review. However, if northbound daily limits in Stock Connect are revised up, there is a chance the inclusion can be done in May alone.

Longer term, as the inclusion factor moves to 100%, we can see China's weight in the MSCI EM index moving to >38%. Looking at emerging markets such as Korea and Taiwan, the journey from small initial inclusion in MSCI indices to full inclusion has taken 6-10 years, during which time participation continuously rose among foreign and institutional investors. MSCI has said the further inclusion (and the inclusion of A-share mid-caps) will be subject to "a greater alignment of the China A shares market with international market accessibility standards, the resilience of Stock Connect, the relaxation of daily trading limits, continued progress on trading suspensions, and further loosening of restrictions on the creation of index-linked investment vehicles."

Conclusion

This announcement marks an important milestone in the integration of China's equity markets with the rest of the world. We don't expect this to materially impact our investment decisions in the near term, particularly given the low inclusion factor. We will analyze these A-share companies as we would all other companies, and only include them in our strategy providing that these stocks follow our investment philosophy and process.

We are currently invested in A-shares in the Emerging Markets Equity Strategy, and can do so via the Shanghai/Shenzhen-Hong Kong Stock Connects. However, A-share inclusion may be different for separate accounts based on client guidelines, or for other EME investment vehicles based on how long it takes the custodian to open access (as some custodians still do not have access but are working on it).

For the full MSCI press release, click here.

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