Matthews Asia

# Matthews Asia Q&A

## What Investors Should Know About MSCI's Rising China A-Shares Inclusion

*What does a China A-share increase into the MSCI Emerging Markets Index and other regional indices mean for investors? Matthews Asia's portfolio strategy team offers its views.*

### WHAT CHANGES ARE BEING MADE TO THE MSCI INDICES?

Index provider MSCI is poised to increase the weighting and breadth of China A-shares exposure in its emerging markets index as well as its China index and other regional indices. In total, the inclusion factor will go from 5% to 20%. The three-step implementation process begins in May with a 5% increase of the current 5% inclusion factor. The allocation will increase by 5% in August and by another 5% in November.

In addition to the increase in allocation to the existing securities, MSCI will also increase the breadth of the securities by including 27 ChiNext shares with a 10% inclusion factor in May, increasing that allocation to a 15% and 20% inclusion factor in August and November, respectively. Also, MSCI will add 168 mid-cap stocks at a 20% inclusion factor in November. In total, 421 securities will make up 3.3% of the MSCI Emerging Markets Index once allocations are completed in November, an increase from 239 securities, representing 0.72%.

### WILL THESE CHANGES IMPACT OTHER MSCI INDICES?

Yes. While the focus has been on the impact to the MSCI Emerging Markets Index, the changes also will affect all MSCI indices that include China. The changes will be disproportionately larger in Asia-focused indices. The A-share exposure in the MSCI All Country Asia ex Japan Index, for example, will increase from 0.8% to 4.0%, and the MSCI China Index allocation to A-shares will increase from 2.3% to 10.4%. The changes will also affect the MSCI All Country World Index (ACWI) as the allocation to A-shares will increase from 0.09% to 0.42%.

### WHY IS MSCI MAKING THESE CHANGES?

The move follows the successful implementation of the initial 5% inclusion of China A-shares in 2018 and wide support for the weight increase from international institutional investors. MSCI consulted with a large number of international institutional investors, including asset owners, asset managers, broker/dealers and other market participants worldwide as part of its review process.

A key driver of the increase has been the significant advancements in accessibility, including a tightening of the trading suspension rules and a quadrupling of the daily "Stock Connect" quota in 2018. The Stock Connect programs in recent years have linked the Shanghai and Shenzhen stock exchanges to the Hong Kong Stock Exchange and enabled foreign investors to buy A-shares with fewer restrictions.

According to Remy Briand, MSCI managing director and chairman of the MSCI Index Policy Committee, "the strong commitment by the Chinese regulators to continue to improve market accessibility, evidenced by, among other things, the significant reduction in trading suspensions in recent months, is another critical factor that has won the support of international institutional investors."

Additionally, there has been significant growth in the adoption of A-share investment by international investors as the number of northbound Stock Connect accounts has grown from 1,700 before the June 2017 inclusion announcement to over 7,300 in February and assets have grown 160% despite negative returns for the index over that time frame.

### WAS THE INCREASE EXPECTED?

While the increase from 5% to 20% inclusion was expected, the rebalancing is taking place slightly faster than anticipated. Due to the overwhelming support of over 90% of the investors that MSCI consulted with in its review process, and a preference by that audience for an accelerated three-step implementation, MSCI is moving ahead with the current process versus the proposed implementation from 5% to 12.5% in May 2019, and to 20% inclusion in May 2020.

The increase also follows the decision announced in January by Barclays that beginning in April of 2019, it will begin to include renminbi-denominated bonds in the Bloomberg Barclays Global Aggregate Index. This increase will take place over a 20-month period of 5% phase-ins culminating

1 ChiNext is a tech-heavy board of the Shenzhen Stock Exchange.

in November of 2020 with a 6.1% index weighting of the US$54.9 trillion index, only smaller than the exposure to the U.S., EU and Japan.

## ARE FURTHER INCREASES EXPECTED?

Over the past four years, China has been making significant efforts to further open its capital markets. In our view, with over 3,500 listed companies and a market cap of over US$7 trillion, China's A-share market has simply been too big to be overlooked by global investors. It is the second-largest equity market in the world, both in terms of market capitalization and turnover. Despite this increase, we believe the structure of MSCI indices are still lacking in their representation of China's overall markets and would expect the exposure to continue to grow in 2020 and beyond.

If the inclusion factor were to reach 100%, China would make up over 40% of the MSCI Emerging Markets Index, including a 16.2% allocation to A-shares.

That said, a future weight increase of China A-shares in the MSCI indexes beyond 20% would require Chinese authorities to address a number of remaining market accessibility questions. MSCI is in contact with the appropriate regulatory authorities to discuss the highlighted market accessibility constraints, including restrictions on access to hedging and derivatives instruments as well as operational concerns.

## HOW COULD THIS BENEFIT INVESTORS?

The current Chinese exposure within the MSCI Emerging Markets Index and other indices is heavily weighted to mega-cap internet companies and large Chinese banks. This increase in A-shares exposure and the broadening of the universe to include some midcap stocks will allow the indices to better reflect the opportunity set within Chinese equities.

Additionally, while active management flows into the space are difficult to predict, passive flows into A-shares from products that track the Emerging Markets Index are expected to total more than US$13 billion in 2019, in addition to flows for other MSCI index-based products.

## HOW OLD IS CHINA'S A-SHARE MARKET?

Started in 1992, China's A-share market is still relatively young. Undoubtedly, there are still challenges and improvements to be made. The overall market is currently dominated by retail investors. Trading could be volatile and government intervention can be heavy-handed. We are encouraged, however, by the strong potential and opportunities in the A-share market.

## HOW MUCH EXPERIENCE DOES MATTHEWS ASIA HAVE WITH CHINA A-SHARES?

Matthews Asia has extensively studied and invested in China's domestic A-share companies for many years. In 2014, our firm was awarded a Qualified Foreign Institutional Investor (QFII) license and quota that enabled us to invest directly into China's domestic securities market, including the market for China A-shares. We have also participated in A-shares via the Stock Connect programs.

We continue to be attracted by the fundamentally sound merits of many local companies listed in China. We realize that many quality A-share companies in growing industries can be priced at very rich valuation multiples, however, which makes our experience of carefully vetting them critical. We truly believe that long-term investors can benefit from exposure to A-shares.

At Matthews Asia, our focus has always been on taking a fundamental approach to finding leading A-share companies poised to benefit from the country's structural shift toward its domestic economy.

**—Matthews Asia Portfolio Strategy Team**

**Important Information**

Investments involve risk. Past performance is no guarantee of future results. Investing in international and emerging markets 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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**The MSCI China Index** is a free float -adjusted market capitalization -weighted index of Chinese equities that include China-affiliated corporations and H shares listed on the Hong Kong exchange, and B shares listed on the Shanghai and Shenzhen exchanges and P Chips and foreign listings (e.g. ADRs).

**The MSCI Emerging Markets Index** captures large and mid-cap representation across 23 Emerging Markets (EM) countries. With 833 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country.

**The MSCI All Country Asia ex Japan Index** is a free float -adjusted market capitalization -weighted index of the stock markets of China, Hong Kong, India, Indonesia, Korea, Malaysia, Pakistan, the Philippines, Singapore, Taiwan and Thailand.

**The MSCI ACWI** captures large and mid-cap representation across 23 Developed Markets (DM) and 24 Emerging Markets (EM) countries. With 2,757 constituents, the index covers approximately 85% of the global investable equity opportunity set.

**The Bloomberg Barclays Global Aggregate Index** (GAI) provides a broad-based measure of the global investment grade fixed-rate debt markets. The GAI contains three major components: The U.S. Aggregate Index, the Pan-European Aggregate Index, and the Asian-Pacific Aggregate Index. In addition to securities from these three benchmarks (94% of the overall Global Aggregate market value as of December 31, 2010), the Global Aggregate Index includes Global Treasury, Eurodollar, Euro-Yen, Canadian and Investment Grade 144A index-eligible securities not already in the three regional aggregate indices.





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