China A shares into MSCI benchmarks

Is inclusion into MSCI benchmarks a game changer for China A shares? Yes and No.

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The Chinese stock markets are big. The combined market capitalization as at June 23, 2017 of the major Chinese stock exchanges in Shanghai and Shenzhen amounts to almost $7.75 trillion which compares to the New York Stock Exchange capitalization of $22 trillion, NASDAQ $9.4 trillion, Tokyo $5.4 trillion and London at $3.18 trillion. China’s stock markets are also active with turnover on that day of $37 billion which compares with $67 billion in New York and $49 billion on Nasdaq and $6.5 billion in London.

![Stock market capitalization (US$ trillion)](image)

Source: Bloomberg. Data as at June 23, 2017

All of this makes it no surprise that at some point China’s domestic shares would one day be included in international benchmarks. China’s economy is the second largest in the world\(^1\); it does more trade in goods ($3.8 trillion a year) than any other country\(^2\); its market for passenger cars is nearly 25 million a year\(^3\) – GM sells 4 out of every 10 cars it produces to China\(^4\). The notion that Chinese companies should be kept out of international benchmarks indefinitely was clearly not likely.

What has MSCI done?

MSCI has now taken the view that Chinese stocks are important enough and that access to them has been made easy enough for ‘index-linked investment vehicles’ to include them in their index calculations from May 2018. There are however remaining difficulties that mean that there are some quite specific criteria attached. Chinese A shares are not yet easily available to all investors

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\(^1\) World Bank data  
\(^2\) China Customs data & Bloomberg  
\(^3\) 24,479,768 cars in the 12 months to May 31, 2017. China Automotive Information Net  
\(^4\) Source: General Motors.
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and those that are can be accessed through the Connect Schemes⁵ established between the stock exchanges of Hong Kong, Shanghai and Shenzhen. It is through the Hong Kong Stock Exchange that A shares can be bought and sold. So MSCI has included only the largest shares by capitalization, that are available through the Connect Schemes and whose managements did NOT elect to suspend their shares when Chinese markets fell sharply in 2016. And MSCI has decided to limit the weighting of these shares to 5% of the market capitalization (defined by MSCI as the number of freely traded shares multiplied by the current market price).

What is the impact on benchmarks?

China A shares will only be included in the Emerging Market components of MSCI indices and of course their China benchmarks. The total market capitalization of the 222 shares as at May 31, 2017 was $3,210 billion; by using only the free float in the calculation the market cap falls to $1,000 billion meaning that at 5% of the free float market cap the inclusion comes to $50 billion. The MSCI Emerging Markets benchmark had an overall market capitalization of $4,601 billion so as at the end of May China A shares would have accounted for around 1% of that index (or 0.73% at the time of MSCI’s announcement).

Chinese stocks traded outside of the mainland, in Hong Kong and the US already account for 27.66% or ($1.27 trillion) of the MSCI Emerging Markets Index⁶ so in this context we believe an additional $50 billion does not make much difference today. For the $1.6 trillion in Index fund assets tracking this benchmark it means they will need to buy ~$12 billion (to replicate the 0.73% weight). As we pointed out in the first paragraph, with turnover on Friday, June 23, 2017 of $37 billion, the impact should not be significant.

The question if course, is what happens next. Eventually we must expect the 5% limit of market capitalization to rise together with the inclusion of more mid cap China A shares. A rise in the 5% limit to 50% could see China A shares rise to 10% of the Emerging Markets Index and China overall to reach 34.7%. It would also likely come at the expense of others: the Asian component of the Emerging Markets Index would rise above 75% while Latin America would shrink further from 12.5% down to 11.25%.

Do we care about the benchmark anyway? (Answer: We don’t)

But so what about the benchmarks? That is only relevant for passive investors and the ‘fire & forget’ solution offered by index tracking we would argue is not always appropriate. This is not the S&P 500 we’re talking about here. We can and should be interested in exactly what we’re buying. MSCI is including China A shares at the behest of those who track their benchmarks. This does not make them all great stocks. Size, liquidity and access are the criteria. China’s economy has two very distinct sides to it: on the one side is a dynamic and progressive manufacturing and services economy supporting the rising consumer class and on the other, a heavy industrial sector weighed

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⁵ The Shanghai-Hong Kong Stock Connect and the Shenzhen-Hong Kong Stock Connect (the ‘Connect Schemes’) were launched in 2014 and 2016 respectively. It is a cross-boundary investment channel that connects the Shanghai and Shenzhen Stock Exchanges with the Hong Kong Stock Exchange. Under the program, investors in each market can trade shares on the other market using their local brokers and clearing houses.

⁶ The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries. With 830 constituents, the index covers approximately 85% of the free float-adjusted market capitalization in each country. Note: One cannot invest directly in an index.
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down by debt and excess capacity whose time is past. Naturally enough the stocks included by MSCI today reflect both sides.

What this means to us

• We believe that this step is important from a top down level in that it gives China an ‘official’ recognition of the progress made in developing and opening their capital markets.

• The engagement of international investors will very likely have a positive effect on market operations, pricing, information disclosure and overall dynamics just as it did for China shares listed as H shares in Hong Kong from 1993.

• Inclusion in benchmarks will force investors to look again at China with a view to putting money to work; for that group ignoring China as being too difficult will likely no longer be an option. These ‘unwilling volunteers’ may well discover for themselves, as we have long argued, that there is much that is good in China for investment.

• This supports China’s integration into the global financial system which began with renminbi and its inclusion as the fifth reserve currency in the International Monetary Fund’s SDR basket in 2016 and is expected to be followed by the establishment of a Connect Scheme for China massive domestic bond market (the world’s second largest bond market).

Our approach to investment is an Active one. We believe that buying good quality companies, which we define as those that have generated a return on capital above the cost of capital for many years, will probably stay good. If their current market price undervalues the likely persistence of those returns then we believe we probably have a good investment opportunity. In Asia, we have 300 companies that have achieved our quality criteria in terms of return on capital and low debt. Out of the 222 new additions into MSCI’s benchmark there are 37 that are of potential interest to us. Of these, 12 are banks which are all subject to largely the same drivers (good and bad) many of which trade in Hong Kong in any case, leaving 25 names in consumer discretionary, consumer staples, health care, industrials and technology.

MSCI’s decision adds extra impetus to China’s stock markets to resolve lingering operational matters because as they do so the weighting in MSCI indices is expected to rise with the ‘Push’ from China being matched by the ‘Pull’ from institutional demand outside China.

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