ASIA

Chinese A Shares Get MSCI Nod

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Index provider MSCI recently announced plans to add more than 200 domestic Chinese equities to two of its benchmark indexes in two phases, starting May 31. Sukumar Rajah, senior managing director, Franklin Templeton Emerging Markets Equity, breaks down the implications for investors. He says the decision represents broad support of the government's positive policy changes.

Effective in June 2018, index provider MSCI will include 233 Chinese large-capitalization (large-cap) A shares in its Emerging Markets Index and All Country World Index (ACWI), as well as its China Index.[1]

An initial 5% inclusion will be implemented in two phases, 2.5% effective June 1, and 2.5% on August 31. For the May inclusion, the A shares will have a weighting of 0.40% in the Emerging Markets Index, which will increase to 0.796% effective September 3.[2]

This decision has broad support from international institutional investors given the policy changes the government has introduced over the past few years to open up the markets there.

A key policy change for this effort was the relaxation of restrictions on accessibility of the China A shares (domestic) market through the Stock Connect programs. The Stock Connect programs allow for trading between China's mainland markets in Shanghai and Shenzhen and the Hong Kong Stock Exchange, bringing heightened foreign investor access to China's domestic market.

THE ABCS OF CHINESE EQUITIES: SHARE CLASSES AND WHERE THEY ARE TRADED

- **A-shares:** Chinese companies incorporated on the mainland and traded in Shanghai or Shenzhen, quoted in renminbi.
- **B-shares:** Chinese companies incorporated on the mainland and traded in Shanghai and quoted in US dollars or traded in Shenzhen and quoted in Hong Kong dollars.
- **H-shares:** Chinese companies incorporated on the mainland and traded in Hong Kong.
- **Red chips:** State-owned Chinese companies incorporated outside the mainland (primarily Hong Kong) and traded in Hong Kong.
- **P-chips:** Non-state-owned Chinese companies incorporated outside the mainland and traded in Hong Kong.
- **N-shares:** Chinese companies incorporated outside the mainland, most often in certain foreign jurisdictions, and US-listed on the New York Stock Exchange or Nasdaq.

In addition, a London-Shanghai Stock Connect initiative appears likely to come to fruition later this year, allowing international businesses to directly list on the mainland Chinese exchange.

China's domestic stock market is one of the largest in the world by volume and market capitalization, so integration with the global marketplace is noteworthy. MSCI's addition represents just a small amount of the total universe of Chinese equities, but represents a big step, in our view. Using MSCI China All Shares Index as reference, China A-shares weight in the index will be around 38%.[3]

Implications of Inclusion

While the A-share additions will represent a relatively small weighting in the MSCI Emerging Markets Index, pension funds, endowments and exchange-traded funds globally will have to purchase domestic Chinese shares to track the widely used benchmark index. So, we expect more investor flows likely to come into the market.

While we view MSCI's decision to include China A shares as positive, it is important to note that many investors—including us—have been able to invest in China A shares for a number of years through both the Qualified Foreign Institutional Investor (QFII) and Stock Connect programs.

While the initial weight is modest, in our view, the MSCI move represents a seminal first step toward the full integration of China A shares. The timeline for full inclusion has not been announced, and we believe it would likely take multiple years, depending on the continued opening of the capital and currency markets.

If the A-share market were to be included at its full market capitalization (100% inclusion factor as opposed to the initial 5% already announced), China would make up 45% of the MSCI Emerging Markets Index, based on today's levels.

As to the next phase of inclusion and the roadmap ahead, MSCI may make an announcement in its country classification review, scheduled in June. MSCI has made it clear that further inclusion beyond 5% is dependent on further relaxation of the daily trading limit (which has been raised fourfold already), progress on trading suspensions and easing of restrictions on the creation of index-linked investment products.

Ripple Effects

We are optimistic about the forthcoming inclusion of China in the MSCI Emerging Markets Index in particular. We believe the inclusion of A shares could trigger policy action to increase company disclosure and improve market accessibility, thereby enabling us to access to wider range of differentiated companies in structural growth sectors such as pharmaceuticals, consumer and technology. As bottom-up investors with a longer-term investment horizon, we are confident in our ability to benefit from higher market volatility. We also continue to closely monitor further developments in the A-share market, such as the creation of Chinese depository receipt (CDR) listings enabling the US internet-company advanced depository receipts (ADRs) to list in China.

Given the sheer size of the A-share market (measured by market capitalization), we see a likelihood of higher index inclusion in the future, thus potentially driving further flows into the market, as well as the potential for higher allocation of domestic capital into the stock market.

There are concerns associated with China's A-share market, including corporate governance and volatility. MSCI has reported that on average, the Chinese companies to be in included in its indexes rank poorly on environmental, social and governance (ESG) criteria when compared with other stocks in the MSCI Emerging Markets Index.

That said, we think A shares offer a potentially compelling and deep set of investment opportunities on the theme of state-owned enterprise reform, as well as exposure to differentiated companies in strong structural growth areas.

While the news has triggered heightened interest in A shares, we could see outflows in other existing Chinese share classes, such as H shares, red chips and P chips. In addition, other regional markets and certain sector stocks could fall out of investor favor as they adjust portfolios to accommodate the new index makeup.

In the near term, it is unlikely that the A-H share premium will disappear. The nature of the markets is different, as the H-share market is more institutional-based, while the A-share market is more retail-driven. In addition, due to capital restrictions, domestic investors have a more limited set of capital-allocation options. In the long term, we think there is scope for the premium to narrow as the markets become more interconnected.

The MSCI announcement is an important milestone, but as investors, we always look beyond the indexes and headlines and focus on individual companies which we think appear poised to benefit from structural drivers.

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1. Source: MSCI, as of May 24, 2018. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging-market countries. The MSCI All Country World Index captures large- and mid-cap representation across 23 developed markets and 24 emerging-market countries. Indexes are unmanaged and one cannot directly invest in them. Past performance is not an indicator or guarantee of future performance. MSCI makes no warranties and shall have no liability with respect to any MSCI data reproduced herein. No further redistribution or use is permitted. This report is not prepared or endorsed by MSCI. Important data provider notices and terms available at www.franklintempletondatasources.com.

2. Source: MSCI, as of May 24, 2018.

3. Source: MSCI, as of April 30, 2018.