ASIA

Changes to the Emerging Markets Club: China (A Shares), Argentina and Saudi Arabia

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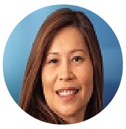

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There have been some noteworthy recent changes in the composition of two broad emerging market indexes that have investors taking notice. Domestic Chinese equities now have a greater presence in both the MSCI and FTSE Emerging Markets Indexes—with more shares still to be added. Meanwhile, Argentina and Saudi Arabia also saw status upgrades. Our Dina Ting and Louis Hsu discuss the significance of these changes for these countries, and for investors.

As the end of summer approaches, we are taking stock of significant changes to both the MSCI Emerging Markets (EM) Index and the FTSE Emerging Index. The changes to these broad emerging market indexes have been taking place in phased approaches since May 2018 for MSCI and March 2019 for FTSE. Each index provider is taking a slightly different approach to including additional equities.

The most recent prominent index changes so far in 2019 included:

- The increased allocation to domestic Chinese equities (known as A shares).
- The inclusion of Argentina and Saudi Arabia due to their reclassification to emerging market status from frontier and stand-alone,[1] respectively.

China's Evolving Presence

China's presence in the MSCI EM Index and the FTSE Emerging Index has evolved due to the inclusion of China A shares. These represent shares of mainland China-based companies denominated in renminbi and were unavailable to foreign investors until 2002 upon the implementation of the Qualified Foreign Institutional Investor (QFII) program.

The subset of China A shares added were even more accessible through the Shanghai and Shenzhen Stock Connect program, which does not require a quota as in the QFII program. The inclusion of the A shares reflects improvements the Chinese government has made to create a more open market by increasing accessibility and transparency.

Pressure from investors to have more exposure to this region was another rationale for increasing the inclusion factor.[2] Another interesting component of this opportunity set is ChiNext stocks, which represent a specific market focused on innovative growth companies and start-ups.

MSCI has been integrating China A shares since May 2018. As of May 2019, a 5% inclusion factor was added to the existing 5% inclusion (for a total of 10%). In August this rose to 15%, and in November 2019 it will rise to 20%.[3] Furthermore, 27 ChiNext specific stocks have become eligible from May 2019 in addition to the 168 mid-capitalization and 253 large-capitalization stocks to be added to the MSCI EM Index in November 2019.[4]

FTSE has taken a shorter time frame for implementing changes to China's position in the FTSE Emerging Index. In June 2019, FTSE began with an initial inclusion factor of 5% for securities on the China Stock Connect Exchange, which includes large and mid-cap stocks from the Shanghai, Shenzhen and ChiNext stock exchanges. There will be two final phases in September 2019 and March 2020, when a 10% inclusion factor will be added on each date to reach the final inclusion factor of 25% for Chinese stocks.

Ultimately, although we believe China has made significant improvements in opening its markets to foreign investors, there remain some challenges against becoming a fully free and open market, and reaching a 100% inclusion factor.

As Chinese stocks are going to be a significant portion of these indexes, such hurdles become even more relevant to global investors. For example, trading capabilities are limited when trading suspensions in the China A shares market continue to happen frequently. Additionally, trading quotas, access to derivatives and hedging methods remain limited in Chinese equity markets.

Argentina's Long Road to Becoming an Emerging Market

The inclusion of Argentinian stocks in the MSCI EM Index took place at the end of May 2019. International investors have voiced their general belief that the country will be able to maintain current equity market accessibility, this being a key determining factor for MSCI reclassification.

The country's upgrade to emerging market status rounds off exactly a 10-year period from when MSCI reclassified it to frontier market status. It should be noted that all eight Argentinian stocks included are available for purchase in the form of American Depositary Receipts (ADRs) and took up 0.26% of the index in US-dollar terms as of the inclusion date.[5]

FTSE is currently reviewing Argentina's possible reclassification into the FTSE Emerging Index. It is on what FTSE calls a "Secondary Emerging Watch List," which reviews characteristics to determine a country's status. Argentina's exclusion from FTSE's emerging market indexes is primarily attributed to what it believes to be insufficient broad market liquidity to support considerable global investment.

The recent turmoil in Argentina—after indication of a likely political populist victory in the October presidential election—created a brutal selloff and currency devaluation that further highlighted the evolving nature of emerging countries.

Saudi Arabia Makes Leap into Emerging Market Classification

Saudi Arabia's inclusion into emerging market indexes from stand-alone status has come to fruition after its markets were opened to foreign investors just four years ago. Various barriers have been removed since then, and during that time Saudi Arabia has had one of the most liquid emerging markets, allowing the country to bypass the normal route of starting with frontier market status.

MSCI began to add Saudi Arabian stocks to the MSCI EM Index in May 2019, with a second phase completed in August 2019. At completion, the 69 Saudi Arabian stocks added comprised approximately 2.8% of the index.[6]

FTSE has taken a more long-term approach, adding 44 Saudi Arabian stocks to its Emerging Index over five phases, which started in March 2019. The first three phases have been completed increasing the weight of the constituent stocks to 50% of the final target. The remaining 50% weight will be evenly added during the last two phases (September 2019 and March 2020), bringing Saudi Arabia's ultimate weighting in the index to 2.9%.[7]

We observed that the Saudi market traded US$7.7 billion on the first day of inclusion in the MSCI EM Index. This was nine times higher than the historical average daily volume, highlighting the importance and impact this inclusion had on the Saudi market. Additionally, we have seen some large intraday moves in the market, with prices fluctuating from -3.5% to +9.5% as of May 28, 2019, demonstrating the impact of these stocks being added into the emerging market index had on the domestic market.[8]

Index Providers Evolve in Different Ways

We expect the composition of emerging market indexes to continue to change, reflecting the evolution and growth of constituent countries' economies.

It is not uncommon for FTSE and MSCI to classify countries differently. For example, MSCI currently classifies South Korea as an emerging market but FTSE classifies it as a developed market.

As another example, Kuwait was added to FTSE's Emerging Index in September 2018, while MSCI only recently announced the addition of Kuwaiti stocks into the MSCI EM Index. The inclusion will take place in May 2020, when the index has its semiannual review. For both index providers, the country's upgrade from frontier market to emerging market status comes as a result of enhanced regulatory and operational procedures to try and achieve increased levels of global investor access to the Kuwaiti stock market.

For MSCI, the graduation of Kuwait to emerging market status will be contingent on the introduction of a number of new regulatory mechanisms before November.

We believe these to be exciting changes that will enable global investors to access more diverse opportunities across different equity markets. In consideration of the varying and often contradictory classification methods among the major index providers, we will continue to monitor these developments.

What Are the Risks?

All investments involve risk, including possible loss of principal. The value of investments can go down as well as up, and investors may not get back the full amount invested. Stock prices fluctuate, sometimes rapidly and dramatically, due to factors affecting individual companies, particular industries or sectors or general market conditions. Investments in foreign securities involve special risks including currency fluctuations, economic instability and political developments. Investments in emerging markets, of which frontier markets are a subset, involve heightened risks related to the same factors, in addition to those associated with these markets' smaller size, lesser liquidity and lack of established legal, political, business and social frameworks to support securities markets. Brokerage commissions and ETF expenses will reduce returns. ETF shares may be bought or sold throughout the day at their market price on the exchange on which they are listed. ETFs trade like stocks, fluctuate in market value and may trade above or below the ETF's net asset value. However, there can be no guarantee that an active trading market for ETF shares will be developed or maintained or that their listing will continue or remain unchanged. While the shares of ETFs are tradable on secondary markets, they may not readily trade in all market conditions and may trade at significant discounts in periods of market stress.

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1. Stand-alone status: A market that is not yet classified by a market index provider, or one that has been temporarily reclassified in the case of severe deterioration in market accessibility or size and liquidity for that market.
2. Inclusion factor: The proportion of free float market capitalization of new securities that are being included within an index.
3. Source: MSCI, as of May 24, 2018. The MSCI Emerging Markets Index captures large- and mid-cap representation across 24 emerging market countries. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. 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.
4. Source: Bloomberg, "MSCI to Boost China Stocks Weighting as Bull Market Builds," February 28, 2019.
5. Source: MSCI. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. 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.
6. Source: MSCI, "Saudi Arabia inclusion and emerging markets," March 28, 2019.
7. Source: FTSE Russell. Indexes are unmanaged and one cannot directly invest in them. They do not include fees, expenses and sales charges. Important data provider notices and terms available atwww.franklintempletondatasources.com.
8. Source: Franklin Templeton Research.