Talking Points

Why we can expect a China A-shares inclusion in the MSCI Emerging Markets index within the next two years

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Given current market sentiment it is perhaps not surprising that MSCI erred on the side of caution and earlier in the week made the decision not to include China A-shares in its Emerging Markets index. However, we believe a small percentage of inclusion, such as 5%, is highly possible in the next year or two.

MSCI has previously indicated the need for Chinese regulators to address some issues prior to China A-shares being included in indices, such as increased market accessibility and capital mobility and the limitation of widespread voluntary trading suspensions. When these issues are resolved, we anticipate it will prompt global investors to increase emerging market equity allocations and shift toward a more holistic "China All Shares" approach to obtaining China exposure that will include China A-shares, H-shares and American depository receipts (ADRs).

Aligning China's economic representation in global indices

As the world's second largest economy, China's position in global equity indices is still relatively low (2.4% weight within the MSCI All Country World Index compared to 53.2% for the US)[1]. What is currently included in global indices represents only a fraction of the entire Chinese investment universe.

China A-share markets, meanwhile, are some of the world's largest and most liquid – with a combined market capitalisation of approximately US$6.0 trillion (compared to US$23 trillion for the US and US$4.8 trillion for Japan)[2]. Yet, at present, global investor participation in China A-shares is less than 3%[3]. As a result, there is a need to align global index composition to better reflect the size and importance of the Chinese economy to global markets.

Impact on asset allocation

Once China A-shares are added to the Emerging Markets index, an obvious impact will be the increased importance of EM investing. As of June 30, 2015, the amount of assets tracking the MSCI EM index was US$1.6 trillion, compared to US$2.3 trillion tracking the Developed Markets index[4]. We believe the gradual addition of a US$6 trillion China A-share market will lead to a sizeable expansion of the EM investment universe and market capitalization, making it too big to ignore. Over time, the greater representation of China in the EM index will likely lead global investors to increase their allocations to the EM asset class as a whole.

If you get China right, you get EM right

An inclusion of China A-shares will also transform the way investors obtain their emerging markets exposure. Under a pro-forma full inclusion scenario, Greater China markets would represent around 51% of the EM index. If we further include commodity-driven economies like Brazil and Russia, which are highly influenced by Chinese demand, the remainder of the EM index breakdown is very fragmented across various countries. Therefore, making the right investment call about China is likely to be critical when it comes to successful EM investing.

It could also lead to an increase in more dedicated Chinese equity mandates. In our view, more global investors will decide to invest directly in dedicated Chinese equities (and potentially select EM markets), instead of EM equities as a whole, given China's sizeable influence in the EM.

Unrivalled opportunities

The current MSCI China index is relatively narrow, consisting of only 155 stocks[5], and primarily made up of state-owned enterprises (SOEs). The concentration of SOE ownership is most evident in strategic industries such as utilities (independent power producers), financials (mostly banks and insurance), telecoms and energy. The two phases of ADR inclusion should significantly increase private enterprise exposure within the IT sector and indirectly dilute SOE exposure of existing SOE-heavy sectors. Looking ahead, the potential inclusion of China A-shares should meaningfully shift the ownership dynamics of the MSCI China Index. The MSCI China A index, with its broader constituent base of ~800 companies, is made up of more mid-cap private enterprises, which tend to be more efficient and offer higher return on equity potential[5].

What this may mean for asset managers

Similar to global investors, asset managers will also need to adapt to the evolving investment landscape. The Chinese equity universe is expanding rapidly, driven by the emergence of new Chinese listed companies via IPOs, ADR issuances and the anticipated addition of China A-shares to more indices. With less distinction between different Chinese share classes (i.e. onshore versus offshore), traditional offshore Chinese asset managers investing in H-shares and possibly Chinese onshore asset managers investing in China A-shares may need to expand their research coverage to cover all Chinese equity shareclasses.

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1 Source: MSCI, Factset, as of March 31, 2016. China weight refers to Chinese companies listed offshore and does not include China A-shares and Hong Kong companies.

2 Source: Bloomberg, as of March 30, 2016.

3 Calculated using a combination of used balance for the northbound link of Shanghai-Hong Kong Stock Connect and the total QFII and RQFII quotas as of February 2016.

4 Source: MSCI, eVestment, Morningstar and Bloomberg as of June 30, 2015(latest available data). Assets tracking EM index refers to those assets that track the MSCI Emerging Market Index, while Developed Markets index refers to assets tracking the MSCI World index.

5 Source: Invesco, Factset, as at March 31, 2016.

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