Invesco Global Insights

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Countdown to MSCI China A-Share Inclusion

Executive Summary
- Whether or not MSCI adds China A-shares to the MSCI Emerging Markets index as part of their next round of updates in June, we believe that implementation of a gradual inclusion process is only a matter of time given China's central role in the emerging markets.
- MSCI has previously indicated the need for Chinese regulators to address four issues prior to China A-shares being included in indices: (1) increasing market accessibility and capital mobility; (2) clarifying beneficial ownership issues, (3) eliminating pre-approval requirements for index-linked products and (4) curbing widespread voluntary trading suspensions.
- In recent years China has taken a number of steps to help smooth the path to inclusion such as expanding foreign access to China A-shares through the Shanghai-Hong Kong Stock Connect program and clarifying uncertainty relating to beneficial ownership.
- We anticipate that the inclusion of China A-shares in the MSCI index, whenever it occurs, 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).

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In recent years, there has been increasing discussion of the potential inclusion of China A-shares, stocks listed onshore on the mainland Shanghai and Shenzhen stock exchanges, in the MSCI Emerging Market (EM) index[1], an index tracked by around US$1.6 trillion[2] in assets. At present, China A-shares carry zero weight in the MSCI EM index. In fact, the topic of the 'inclusion' has been on MSCI's annual review agenda for years, for which the results of this year's review are expected in June.

In our view, MSCI China A-shares will *eventually* be added to the MSCI EM index, even if not this year. Such a move would be further evidence of China's ongoing progress in liberalizing its financial system and opening its capital accounts. As this development will impact how global investors manage their portfolios, we believe it pays to be aware of the implications and prepared to act.

Aligning China's economic representation in global indices

Why is there a need to include China A-shares in the MSCI EM index? 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)[3]. What is currently included in global indices represents only a fraction of the entire Chinese investment universe–primarily offshore stocks, such as Hong Kong-listed shares and overseas American Depository Receipts (ADRs).

1 A-share inclusion would also apply to other global MSCI Indices, such as MSCI Asia ex Japan.The MSCI EM index is part of the MSCI All Country World index (ACWI).
2 Source: MSCI, eVestment, Morningstar and Bloomberg as of June. 30, 2015(latest available data).
3 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.

Chinese equities are traded in both 'onshore' and 'offshore' markets.

Onshore: *refers to China A-shares, meaning those listed on the mainland Shanghai and Shenzhen stock exchanges. China A-share stocks are traded in Renminbi terms.*

Offshore: *includes H-shares (Chinese companies traded on the Hong Kong Stock Exchange) and ADRs for Chinese companies. Offshore stocks are traded in Hong Kong dollar or US dollar terms.*

China A-share markets, meanwhile, are some of the world's largest and most liquid – with a combined market capitilization of approximately US$6.0 trillion (compared to US$23 trillion for the US and US$4.8 trillion for Japan)[4]. Yet, at present, global investor participation in China A-shares is less than 3%.[5] 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.

Progress toward MSCI China A-Share Inclusion

In recent years, MSCI has been exploring the possibility of adding China A-shares to its indices, consulting with various global investors to gauge the potential impact, feasibility and concerns. In March 2014, MSCI issued a detailed roadmap setting out the pre-requisites for the addition of China A-shares to the index. This was appreciated by global investors as it provided a much clearer picture of the path to inclusion. The same year, MSCI previewed the composition of the Chinese stocks that would be included in the EM index upon full inclusion by introducing a China All Shares index, that incorporates the full spectrum of onshore and offshore Chinese equities.

However, the inclusion of China A-shares in the EM index did not happen during the MSCI's 2015 annual review, when investors' expectations were running high, due to concerns over market accessibility discussed in the next section. However, MSCI formed a working group with the China Securities Regulatory Commission (CSRC) to discuss the technical aspects required of China for MSCI to include China A-shares in its indices, and we believe that this will lead to positive developments going forward.

Pre-requisites for China A-share Inclusion

The key pre-requisite for China A-share inclusion to occur in the future is satisfactory resolution of the 'market accessibility' issue for global investors. This boils down to the fact that China's capital account is not yet fully open. Restrictions remain on remittance and investment amounts in China's domestic stock markets, primarily via the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) schemes, which are only open to global institutional investors (see shaded box for details).

More needs to be done for China to improve the market accessibility issue. Essentially, MSCI has made it clear that the decision on whether to add China A-shares to the EM index will depend on 1) positive feedback from international institutional investors regarding market accessibility and capital mobility, 2) clarifying issues relating to beneficial ownership of China A-shares, 3) removal of the pre-approval process for China A-share index-linked products, and 4) the prevention of widespread voluntary trading suspensions.

1. Easing market accessibility and capital mobility - Global investors are concerned whether the current QFII/RQFII/Stock Connect quotas (see shaded box for details) are commensurate with the size of their assets under management. MSCI has also been adamant about improving capital mobility,for example by extending daily liquidity to all investment vehicles and removing lock-ups and repatriation restrictions.

Although this issue has not been completely resolved, we have seen improvements. QFII/RQFII quotas have been significantly expanded over the years. In February of this year, the State Administration for Foreign Exchange (SAFE) announced a lowering of the capital requirement threshold for gaining QFII status, as well as relaxed application procedures to allow more investors access to China A-shares. SAFE also reduced the lock-up period for open-ended QFII funds, and allowed subscriptions and redemptions on a daily instead of weekly basis, as long as monthly redemptions do not exceed 20% of the total investments made onshore.[6] A remaining MSCI concern is whether the daily limit for trading in the northbound link of Stock Connect can be eliminated to remove any uncertainty in trading China A-shares for global investors.[7]

4 Source: Bloomberg, as of March 30, 2016.
5 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.
6 Source: State Administration for Foreign Exchange (SAFE), China, as of February 2016.
7 The daily quota for the northbound trading link is set at RMB 13 billion, equivalent to approximately US$ 2.3 billion (using the exchange rate as of March 31, 2016)

2. Beneficial ownership - It is crucial for China to provide clear recognition of the ultimate beneficial ownership of underlying China A-share securities for separate account owners. Last year, following the launch of Stock Connect, the CSRC provided some details on how ownership rights will be granted for global investors using the Stock Connect program. The CSRC has also opined that it recognizes beneficial ownership of China A-shares through separate accounts via the QFII and RQFII regimes, although this has yet to be tested in Chinese courts.[8]

In brief:
Global investors can access China A-shares through the QFII (Qualified Foreign Institutional Investor) and RQFII (RMB Qualified Foreign Institutional Investor) schemes. However these schemes are available only to institutional investors who can fulfill capital and asset size requirements. Detailed submissions and pre-approvals are also needed.

QFII: *Since the launch of the QFII program in 2002, institutional investors from around the world have applied for QFII quotas to invest directly in China's onshore capital markets. As of February 2016, there were 295 institutional investors authorized under the QFII scheme, which includes asset management companies, insurance companies, pension and sovereign wealth funds.*

RQFII: *Launched in 2011, the RQFII program is a policy initiative from Chinese authorities that allows qualified holders of RQFII quotas to use offshore Renminbi to directly invest in mainland China securities, within the approved investment quota. As of February 2016, there were 193 institutional investors authorized under the RQFII scheme.*

Source: Hong Kong Exchange & CSRC websites

3. Removal of pre-approval process for indexed products - Currently all financial products (including ETFs) which are linked to an index containing China A-shares need to be pre-approved by the local Chinese stock exchanges even if the product is listed internationally. MSCI considers this pre-approval process to be an 'anti-competitive measure'. It is now pending further resolution with local Chinese stock exchanges.

4. Prevention of widespread voluntary trading suspension - MSCI is concerned about the liquidity issues associated with Chinese regulatory market interventions, as well as the widespread use of voluntary stock suspensions by listed companies when markets are volatile. This concern was raised following the market volatility spikes during the summer of 2015 and earlier this year. At the peak of market turmoil in early July 2015, the number of suspended stocks reached 50% of the total number of listed companies due to the relatively simple procedures for initiating trading suspensions.[9] That said, some improvements have been made since July 2015, with regulators tightening information disclosure requirements and reducing the length of suspensions.

8 Source: CSRC, May 15, 2015. CSRC issued a FAQ clarifying that the Shanghai-Hong Kong Stock Connect program supports the concept of nominee shareholding. The CSRC Stock Connect rules expressly stipulate that, in northbound trading, overseas investors shall hold Shanghai Stock Exchange securities through Hong Kong Securities Clearing Company Limited and are entitled to proprietary interests in such securities as shareholders. In addition, the CSRC has noted that it respects the contractual relationships between asset managers and beneficial owners that govern separate accounts, including the related governing law provisions. This clarification was likely intended to address concerns previously raised by MSCI, asset managers and other market participants. It should be noted however, that decisions as to whether to recognize and enforce beneficial ownership of China A-shares will ultimately be made by Chinese courts and not the CSRC.

9 Source: Citic Securities, statistics as of July 9, 2015. On that day, 1,415 companies traded on the Shanghai and Shenzhen stock exchanges were suspended from trading out of 2,781 listed China A-share companies in total. Although A-share companies can request voluntarily suspension of the trading of company shares on the same day by simply issuing a notice and completing the relevant filing with the stock exchanges, the regulator has been tightening the information disclosure requirements and reducing the length of the suspension since July 2015.

Stock Connect – A 'Game-Changer':
Launched in November 2014, the Shanghai-Hong Kong Stock Connect is a securities trading and clearing links program that allows both international and domestic investors to make cross-border stock purchases between the Shanghai and Hong Kong stock markets. It is generally seen as a 'game changer' in China's capital account opening and reflects the evolution and further deregulation of financial markets by Chinese regulators. The Connect program substantially relaxed the hurdles associated with the QFII/RQFII schemes by significantly expanding the investor base to include individual investors and not requiring a detailed approval process.*

In addition, there is a plan to complete a similar link with the second stock exchange in China,[10] which could happen anytime. This development would be further evidence of China's aim to deregulate its markets and increase accessibility and investment opportunities for foreign investors.

** Individual investors with an eligible brokerage account can participate in the Shanghai-Hong Kong Stock Connect program.*

Implications for global investors
Regardless of when the inclusion of China A-shares takes place, the change is expected to transform the way global investors make allocations to Chinese equities, as well as the way they invest in emerging markets.

Timing for inclusion - a gradual process
As some hurdles remain, more time may be required before MSCI decides to add China A-shares to its EM index. Nevertheless, we believe a small percentage inclusion, such as 5%, is highly possible in the next year or two as Chinese regulators continue to work with MSCI to address outstanding issues. Once the decision is made to include China A-shares, MSCI will adopt a gradual inclusion factor approach to adding them to the EM index.[11] Future increases by MSCI are likely to be gradual and subject to China's continued progress in opening up its capital account.

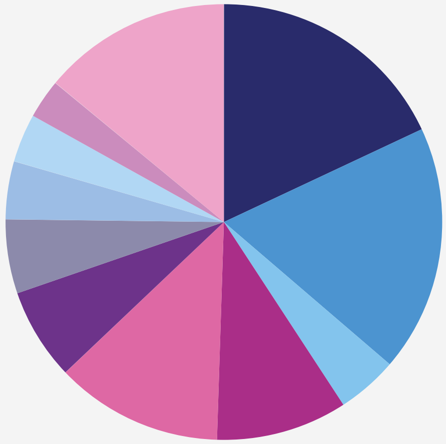
Over the past few years, China has taken a number of steps in this regard. For example, the Chinese government has demonstrated its commitment to internationalizing the Renminbi (RMB). Last November, the RMB became the fifth currency in the International Monetary Fund's Special Drawing Rights basket.[12] Opening up China's capital account will be a multi-year effort, as the Chinese government is also focused on maintaining a stable currency, as demonstrated by the resilience of the RMB against many world currencies since the global financial crisis.

Increasing allocation to emerging markets v. developed markets
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 is US$1.6 trillion, compared to US$2.3 trillion tracking the Developed Markets index.[13] 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
The 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, leading to less need for investors' attention. 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.

10 There are currently two stock exchanges in China, one based in Shanghai and the other in Shenzhen.
11 A certain percentage of the free float adjusted market capitalization of China A-share constituents.
12 IMF's Special Drawing Rights basket effective October 1, 2016, will be made up of 41.73% US dollar, 30.93% Euro, 10.92% RMB, 8.33% Japanese Yen and 8.09% British pound.
13 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.

MSCI Emerging Market Index
Potential full (100%) China A-share inclusion



Greater China - 51%

China listed in HK	18.0%
China A-shares	18.3%
China Overseas	4.5%
Taiwan	9.7%

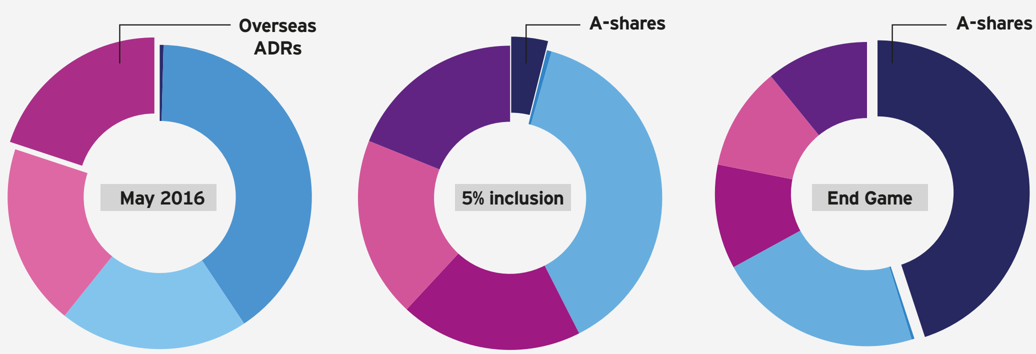
Korea	12.4%
India	6.8%
South Africa	5.5%
Brazil	4.3%
Mexico	3.6%
Russia	2.9%
Others	14.0%

Source: MSCI, Consultation on China A-Shares. Index Inclusion Roadmap, updated as of April 1, 2016

The shift to "China All Shares" investments

Within allocations to dedicated Chinese equities, investors will also no longer need to differentiate among the various Chinese equity share classes that have arisen as China's equity markets developed (see shaded box for details). In 2014, MSCI created the China All Shares index, a pro-forma index that includes the full spectrum of Chinese equity opportunities once there is full China A-share inclusion. The index shows investors the end game of what the opportunity set should look like. Eventually, the MSCI China index, with China gradually included, should transition to where it is the same as the MSCI China All Shares index. In our view, the best way to position Chinese equity portfolios is to take a 'China All Shares' approach: a holistic view that incorporates all forms of China's related securities such as H-shares, A-shares, ADRs, etc. While 'China All Shares' focused investments are not widely used at present, we expect to see more such allocations going forward.

MSCI China index converges with MSCI China All Shares index



	%
B-shares	0.4
H-shares	40.2
Red-chips	20.1
P-chips	19.3
Overseas ADRs	**19.9**

After Inclusion of overseas listed Chinese ADRs as of May 2016 157 stocks

	%
A-shares	**3.9**
B-shares	0.5
H-shares	38.1
Red-chips	19.4
P-chips	19.2
Overseas ADRs	18.9

5% Inclusion of China A-shares 608 stocks

	%
A-shares	**45.0**
B-shares	0.3
H-shares	21.8
Red-chips	11.1
P-chips	11.0
Overseas ADRs	10.9

Full Inclusion of China A-shares 608 stocks

Source: MSCI, as of Jan. 29,2016

Better opportunities

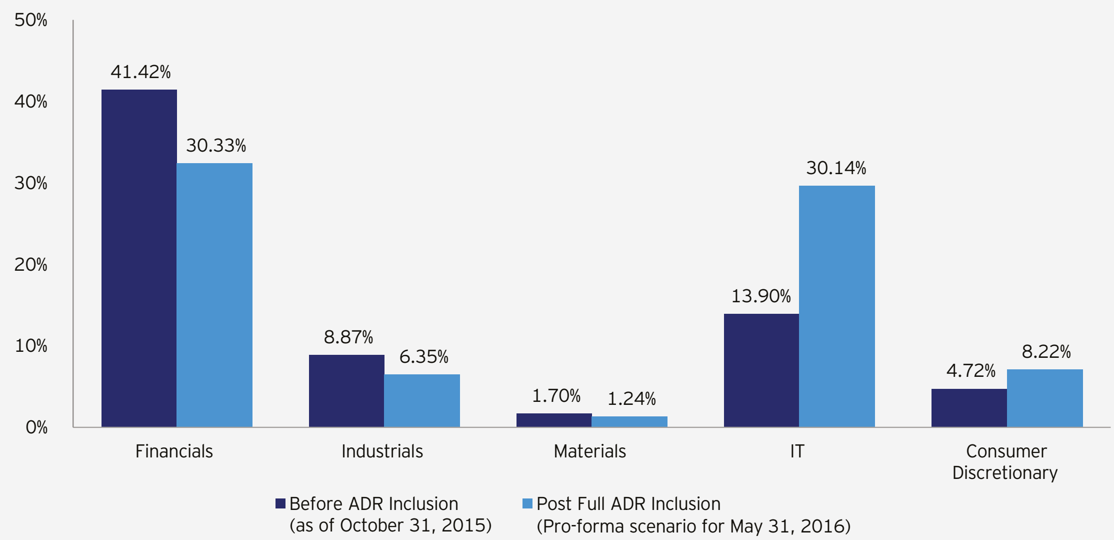
The current MSCI China index is relatively narrow, consisting of only 155 stocks,[14] and primarily made up of state-owned enterprises (SOEs). The concentration of SOE ownership is most evident in strategic industries such as utilities (independent power producers), financials (mostly banks and insurance), telecoms and energy. The two phases of ADR inclusion (see shaded box for details) 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.[14]

MSCI ADR inclusion

In 2015, MSCI started to add overseas-listed Chinese companies (i.e., ADRs) to its EM and China indices. The first of two scheduled ADR inclusions happened on November 30, 2015 with the second phase planned for May 31, 2016.

We can see the change in company composition most clearly by analyzing sector changes within the MSCI China index. The inclusion of ADRs has led to increased weightings for the IT and consumer discretionary sectors, areas of the economy that are rapidly changing.

MSCI China index – Key sector changes – Before and after full inclusion of ADRs in May 2016



Source: MSCI, Pro-forma sector weights are calculated based on the projected MSCI China index stock constituents list, with prices as of May 11, 2016.

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 share classes.

Conclusion

As China's capital markets continue to open, we believe that the inclusion of China A-shares in the MSCI EM index is only a matter of time. We are preparing for this change and expect that it will prompt global investors to take greater heed of Chinese equities. In particular, the inclusion could increase the tilt to Chinese equities in the MSCI EM index to a level where some investors may consider investing in dedicated Chinese equity mandates. Rather than seeking exposure solely through offshore Chinese equities, these investors will likely be more inclined to adopt the holistic China All Shares approach discussed above, with a much broader investment universe that includes both onshore China A-shares and offshore Chinese equities.

14 Source: Invesco, Factset, as at March 31, 2016

About the contributors

Mike Shiao has 24 years of investment experience. He joined Invesco in 2002. In April 2015, he became Chief Investment Officer, Greater China, leading the Greater China equities team. He was appointed as Chief Investment Officer, Asia ex Japan, in April 2016. Mike has been the lead manager of the Greater China equity portfolios since 2008, and became the lead manager of the Asia opportunities equity portfolios in July 2014. He is also responsible for China focus equity portfolios, Hong Kong & China portfolios, and institutional portfolios investing in Hong Kong/China. Mike was previously Head of Equities for Invesco Taiwan Ltd. He moved to Invesco Hong Kong Ltd to expand his coverage to Greater China markets in 2006.

Mike started his investment career in 1992 at Grand Regent Investment Ltd., where he worked for six years as a project manager supervising venture capital investments in Taiwan and China. In 1997, he joined Overseas Credit and Securities Inc. as a senior analyst covering Taiwan technology sector. Mike also worked at Taiwan International Investment Management Co., as a fund manager and was responsible for technology sector research.

Mike holds a Bachelor's degree from National Chung Hsing University, Taiwan and a Master of Science degree in Finance from Drexel University, Philadelphia.

William Yuen joined Invesco in 2004 as Fund Manager and is currently Associate Director. He has been the lead manager of Invesco's Asia consumer demand portfolios since its launch in 2008. Effective 30 March 2015, William also took up lead-manager responsibility for the PRC equity portfolios. William covered Asia ex Japan markets at Merrill Lynch Investment Managers from 1999 to 2004. Prior to that, he was a research analyst at RCP & Partners, a consulting firm.

William is a holder of the Chartered Financial Analyst designation. He has a Master of Commerce degree and a Bachelor of Economics degree from the University of Sydney, Australia.

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All information is sourced from Invesco, unless otherwise stated. All data as of May 13, 2016 unless otherwise stated. All data is USD, unless otherwise stated.

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