Edging Closer: MSCI's Inclusion of China A-Shares

May 2017

Invesco Equity Investment Team in Asia

Introduction

June 2017 marks MSCI's fourth annual review for the inclusion of China A-shares in their MSCI EM index[1] – an index that tracks USD 1.6 trillion[2] worth of assets around the world. This ongoing review is in recognition of China's gradual market liberalization efforts to open up its domestic capital markets. In its 2016 annual review held last June, MSCI did not include China A-shares in the MSCI EM index and other indices. As a result of this review, China A-shares had zero weighting in the index. Last year, we expressed our view that it is only a matter of time before they would be included[3].

We believe China A-shares inclusion is now much closer, and could realistically begin this year. Both China and MSCI have been very constructive, showing effort to 'make it happen'. In our view, over the past year, China has made good progress in opening up its equity market access such as by introducing the Shenzhen-Hong Kong Stock Connect program. MSCI, in a practical and timely manner, also changed the inclusion framework from the obsolete 'Qualified Foreign Institutional Investor' (QFII) scheme to a more representative 'Connect' program.

In this paper, we elaborate on the developments over the past year that we believe making inclusion more likely. We also discuss the roadmap for the inclusion, and why the A-shares stock addition would provide a better representation of the Chinese economy and diversified exposure to the current MSCI offshore Chinese equity universe.

One year on – what has changed?

Historically, market accessibility and investability of A-shares have been issues holding back MSCI's inclusion of A-shares in the MSCI EM index.

MSCI cited three remaining requirements that need to be fulfilled:

1. The effective implementation of QFII policy changes and removal of the 20% monthly repatriation limit;
2. The effective implementation of a new resolution to trading suspensions; and
3. The pre-approval from local exchanges when launching financial products.

As a collaborative effort, over the past year, both the Chinese government and MSCI have dedicated effort to remove the remaining hurdles.

MSCI's assessment framework

In our view, the most significant change from MSCI is the consideration of the "Stock Connect" programs, rather than the QFII/RMB Qualified Foreign Institutional Investor (RQFII) programs, as indicators of increased Foreign accessibility to Chinese markets. MSCI had been using the QFII/RQFII program as a gauge since its initial review in June 2013.

We welcome MSCI's change to the assessment framework. We believe the reason for this change is twofold: the significant improvement of market accessibility and capital mobility with the launch of the Shenzhen-Hong Kong Stock Connect, and the obsolescence of the QFII/ RQFII programs. We believe this positive development effectively removes MSCI's first hurdle for inclusion.

[1]Because the MSCI EM index is part of the MSCI All Country World index (ACWI), once A-shares are included in the EM index, they will also simultaneously be included in other regional and global MSCI indices, such as the MSCI Asia ex-Japan index.
[2]Source: MSCI, eVestment, Morningstar and Bloomberg as of December 31, 2016 (latest available data), released by MSCI on April 21, 2017.
[3] "Countdown to MSCI China A-share Inclusion", Invesco, May 2016.

Launch of Shenzhen-Hong Kong Stock Connect:
The Stock Connect programs offer a more realistic assessment and better gauge of improved capital mobility in and out of the China A-shares market. These are programs for global investors to access A-share markets directly without the entry barriers imposed by the QFII/RQFII quota program.

In 2016, the SZ-HK Stock Connect was launched, with no overall aggregate quota[4]. The aggregate quota for Shanghai-Hong Kong Stock Connect (launched at end of 2014) was also abolished on August 16, 2016 (the date when the SZ-HK Connect was announced). Investors can now access approximately 1,480 Shanghai and Shenzhen stocks through both SH-HK and SZ-HK Stock Connect schemes. Together, both Shanghai and Shenzhen Northbound Stock Connect stocks cover 76%[5] of total A-shares and 97% of MSCI China A-shares by market cap. The impact is significant. Without the need to apply for the restrictive QFII quotas and be subject to capital mobility restrictions, foreign investors can have access to the onshore market by directly investing in individual stocks, instead of investing in separate mandates or mutual funds via the QFII scheme.

QFII/ RQFII programs:
The QFII/RQFII programs are no longer representative channels to invest in A-shares and are, in fact, becoming obsolete with the rise of the SH-HK and SZ-HK Stock Connect programs. The QFII/ RQFII schemes are highly restrictive and are only available to institutional investors that have been approved by Chinese authorities after detailed submissions and fulfilling capital and asset size requirements. They can gain access to A-shares based on investment quotas and are subject to repatriation limits. Despite these schemes having been in existence for years, there were only 309 institutional investors with QFII status and 219 with RQFII status[6].

Figure 1 - Comparison: Stock Connect (Northbound) vs QFII and RQFII

	Stock Connect (Northbound)	QFII and RQFII
Quota Size	No aggregate quota limit[7]	218/150bn
Eligibility	All Investors	Only licensed investors who have obtained quotas approved by SAFE
Capital Mobility	Daily repatriation available	Daily repatriation available but non-open-ended funds may be locked for 3 months
Currency	Offshore RMB (CNH)	QFII: onshore RMB (CNY) RQFII: offshore RMB (CNH)

Source: Hong Kong Exchange and CSRC websites.

Reduction of Voluntary Trading Suspensions
The widespread imposition of voluntary trading suspensions, implemented at times of market volatility – particularly those in mid-2015, was one of the obstacles to the inclusion in 2016. Since July 2015, Chinese regulators have stepped up their control on trading suspensions by tightening information disclosure requirements and reducing the length of suspensions. The implementation of new trading suspension policies by local exchanges has brought the number of voluntary trading suspensions back to pre mid-2015 levels. As a result, the number of suspended A-shares companies dropped considerably from the peak of 18% of total A-shares in mid-2015 to 7% of total A-shares in March 2017. This should effectively address the second hurdle of the three outstanding requirements from MSCI.

Working hand-in-hand with the Chinese regulators to control trade suspensions, MSCI's latest proposal for A-share inclusion not only removes index constituents that have been suspended for more than 50 days, but also bars companies that have been suspended for more than 50 days total over the previous 12 months from inclusion.

[4]Shenzhen-Hong Kong Stock Connect was launched on December 5, 2016. Source: HKEx.
[5]Data as of March 30, 2017.
[6]As at March 2017.
[7]Source: MSCI, Consultation on China A-shares Potential Inclusion, published on March 23, 2017. The Northbound Stock Connect channel is subject to a daily investment quota of RMB 13 billion (or USD 1.9 billion). However, HK Stock Exchange Chairman Mr. Charles Li has expressed that the daily investment quota will be larger in the future (Xinhua News, August 17, 2016).

Another key change is that MSCI proposes to include large cap companies accessible through the Connect programs. It would also remove overlap exposures of companies that are dual-listed in the Mainland and Hong Kong. We believe it makes sense for MSCI to keep the initial benchmark universe to a reasonable size to improve investability.

Figure 2 – MSCI's Original and New Proposals

	Original Proposal	New Proposal
Universe	Large, Mid and Small-cap companies	Only Large-cap companies that are accessible through the Stock Connect program
Number of A-Share Companies to be Included	448	169
Weight of A-Shares within MSCI EM Index	1.04%	0.48%
Action on Stock Suspension	Remove index constituents that have been suspended for more than 50 days at zero quotable prices	Remove index constituents that have been suspended for more than 50 days, plus an ***additional restriction***: Securities suspended for more than 50 days in the past 12 months are not eligible for index inclusion

Source: Hong Kong Exchange and CSRC websites.

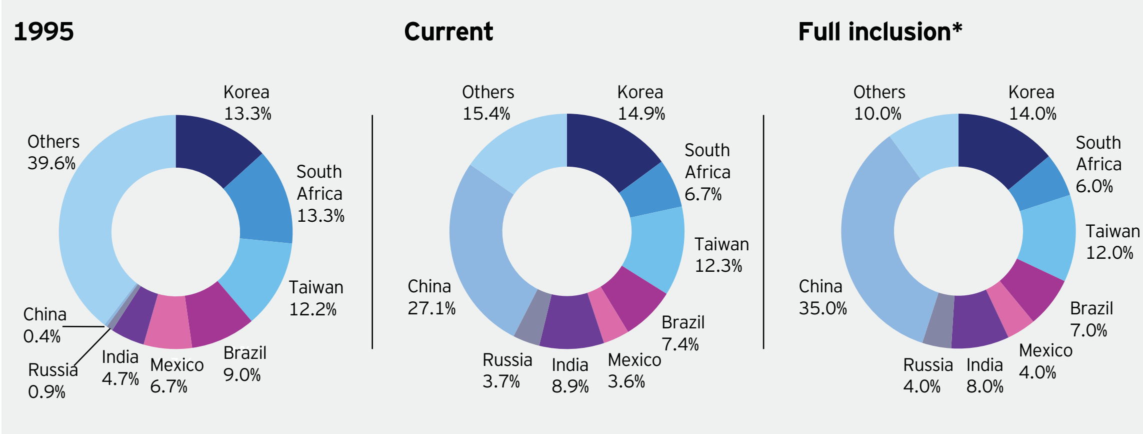
With two out of MSCI's three stated objections to inclusion having been addressed, the remaining requirement is the pre-approval of MSCI's index licensing requirements by local exchanges. Existing financial products based on the MSCI EM Index might be in danger of having their trade disrupted if China A-shares were included. In the past, one Chinese exchange previously withheld the approval of MSCI's licensing of the MSCI EM Index. We do not think this will be a showstopper. MSCI is already in discussions with Chinese exchanges in an effort to reach a resolution.

The Roadmap of Inclusion

If the inclusion takes place, the initial stage of China A-shares inclusion will bring an additional 169 large-cap A-shares stocks to MSCI indices, which are expected to be added at a 5% initial inclusion factor - meaning that 5% of the A-shares free-float market cap will be implemented. This would lead to 0.48% of the weight of A-shares being included in the MSCI EM index (2% in the MSCI China index).

It would be unlikely for the full inclusion of China A-shares in MSCI to take place abruptly; instead it would likely occur in gradual steps. While it is difficult to predict the exact timeline of the full inclusion, we can use MSCI's past experience with the inclusion of Korea and Taiwan in its EM index as reference. It took six years (1992 to 1998) in the case of Korea and five years for Taiwan to be fully included (1996 to 2001). For China, investors should be prepared that the timing of full inclusion is now closer. Full inclusion is estimated to have a 9% weight in China A-shares, and a 35% weight (to be confirmed) in the MSCI EM index together with offshore China.

Figure 3 – Country Weights in the MSCI Emerging Markets Index

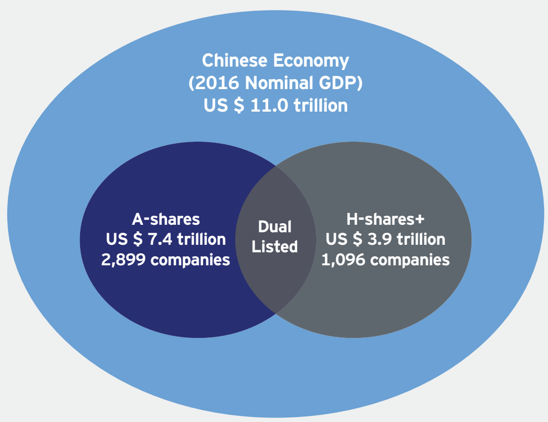


Source: MSCI, Factset, EIU, IMF, Datastream, Morgan Stanley Research, as at 28 April 2017.
Note: China A-shares are not included in MSCI.
* Upon full-inclusion of China A-shares in MSCI Emerging Market Index.

Offshore Chinese equities alone do not represent the entire Chinese Economy

MSCI's decision on A-shares inclusion recognizes China's increasing importance and validates China A-shares as "recognized" markets, offering adequate market access and investability. However, it is important for global investors to rethink their strategic allocation to China and realize that offshore Chinese equities alone do not represent the entire Chinese economy. In fact, there is greater breadth and depth to the domestic onshore market, given that 2,899 companies are listed in the onshore exchanges in addition to 1,096 companies with listed offshore equities.

Figure 4 – Comparison of A-shares and Offshore Chinese equities by number of companies and market cap



Source: Goldman Sachs; data as of 28 April 2017; H-shares+ includes H-shares, red chips, HK listed China offshore and US listed China offshore. There are 95 A-H dual listed companies with H-share market cap at US $616 billion and A-shares market cap at US $1,708 billions as of 28 April 2017.

In our view, the onshore A-shares market and offshore Chinese equities would offer investors a better representation of the underlying economy. A-shares also offer complementary exposure to existing offshore Chinese equities. Currently, the MSCI China index provides good exposure in large overseas listings of Chinese banks and Internet companies. The proposed 169 A-shares stocks for inclusion are, on the other hand, closer to China's real economy, with a higher proportion of consumer discretionary, consumer staples, industrials and materials. At the same time, A-shares also contain many unique companies that are not abundant in the offshore space, such as household furnishings, chemicals, renewable power producers, biotechnology and pharmaceutical companies etc.

Table 5 – Sector/Industry breakdown of MSCI China and the 169 potential A-shares constituents

<table>
<tr><th></th><th>MSCI China (%)</th><th>The 169 Potential A-Shares Constituents (%)</th><th>As % of GDP</th></tr>
<tr><td>Consumer Discretionary</td><td>10</td><td>13</td><td>24</td></tr>
<tr><td>Automobiles & Components</td><td>3</td><td>4</td><td></td></tr>
<tr><td>Consumer Durables & Apparel</td><td>1</td><td>3</td><td></td></tr>
<tr><td>Consumer Services</td><td>2</td><td>1</td><td></td></tr>
<tr><td>Media</td><td>0</td><td>3</td><td></td></tr>
<tr><td>Retailing</td><td>4</td><td>2</td><td></td></tr>
<tr><td>Consumer Staples</td><td>2</td><td>11</td><td>12</td></tr>
<tr><td>Food & Staples Retail</td><td>0</td><td>1</td><td></td></tr>
<tr><td>Food, Beverages & Tobacco</td><td>1</td><td>10</td><td></td></tr>
<tr><td>Household & Personal Products</td><td>1</td><td>0</td><td></td></tr>
<tr><td>Energy</td><td>6</td><td>2</td><td>3</td></tr>
<tr><td>Financials</td><td>26</td><td>23</td><td>8</td></tr>
<tr><td>Banks</td><td>17</td><td>13</td><td></td></tr>
<tr><td>Diversified Financials</td><td>2</td><td>10</td><td></td></tr>
<tr><td>Insurance</td><td>7</td><td>0</td><td></td></tr>
<tr><td>Health Care</td><td>2</td><td>6</td><td>4</td></tr>
<tr><td>Health Care Equipment & Services</td><td>1</td><td>1</td><td></td></tr>
<tr><td>Pharmaceuticals, Biotechnology & Life Sciences</td><td>1</td><td>5</td><td></td></tr>
<tr><td>Industrials</td><td>6</td><td>16</td><td>26</td></tr>
<tr><td>Capital Goods</td><td>4</td><td>12</td><td></td></tr>
<tr><td>Commercial & Professional Services</td><td>0</td><td>1</td><td></td></tr>
<tr><td>Transportation</td><td>2</td><td>2</td><td></td></tr>
<tr><td>Information Technology</td><td>33</td><td>7</td><td rowspan="5">5</td></tr>
<tr><td>Semiconductors & Semiconductor Equipment</td><td>0</td><td>1</td></tr>
<tr><td>Software & Services</td><td>31</td><td>1</td></tr>
<tr><td>Technology Hardware & Equipment</td><td>2</td><td>5</td></tr>
<tr><td>Telecommunication Services</td><td>7</td><td>2</td></tr>
<tr><td>Materials</td><td>1</td><td>8</td><td>10</td></tr>
<tr><td>Real Estate</td><td>4</td><td>7</td><td>7</td></tr>
<tr><td>Utilities</td><td>3</td><td>6</td><td>2</td></tr>
<tr><td>Grand Total</td><td>100</td><td>100</td><td>100</td></tr>
</table>

Source (The 169 A-shares constituents): MSCI, as of 3 Mar 2017.
Source (MSCI China): Invesco, Factset, as at 31 Mar 2017.
Source (% of GDP): CEIC, NBS, FactSet, MSCI, Citi Research estimates, as at May 2017.
Note: There is no official sector breakdown by GDP in accordance with the GICS sector definition.

Conclusion

In conclusion, we believe that MSCI's inclusion of A-shares is edging closer, based on a joint effort of China increasing access to its capital market over the past year and MSCI changing its assessment framework for inclusion to reflect a more realistic and representative gauge of market accessibility and capital mobility. We are seeing great willingness from both MSCI and Chinese regulators to move forward constructively and pragmatically in the MSCI A-shares inclusion process by creating an encouraging environment.

While inclusion will be a major positive for global investors, A-shares are expected initially only to have a 0.48% weighting in the MSCI EM Index[8], which is currently too negligible to make a difference in terms of inflows and the MSCI A-shares market. This structural change to the MSCI EM index, however, will be significant for years to come, as well as a wake-up call for global investors in terms of rethinking their investment in China.

[8]Source: MSCI, Consultation on China A-shares Potential Inclusion, published on March 23, 2017.

Important information

This document has been prepared only for those persons to whom Invesco has provided it for informational purposes only. This document is not an offering of a financial product and is not intended for and should not be distributed to retail clients who are resident in jurisdiction where its distribution is not authorized or is unlawful. Circulation, disclosure, or dissemination of all or any part of this document to any person without the consent of Invesco is prohibited.

This document may contain statements that are not purely historical in nature but are "forward-looking statements", which are based on certain assumptions of future events. Forward-looking statements are based on information available on the date hereof, and Invesco does not assume any duty to update any forward-looking statement. Actual events may differ from those assumed. There can be no assurance that forward-looking statements, including any projected returns, will materialize or that actual market conditions and/or performance results will not be materially different or worse than those presented.

The information in this document has been prepared without taking into account any investor's investment objectives, financial situation or particular needs. Before acting on the information the investor should consider its appropriateness having regard to their investment objectives, financial situation and needs.

You should note that this information:

- may contain references to amounts which are not in local currencies;
- may contain financial information which is not prepared in accordance with the laws or practices of your country of residence;
- may not address risks associated with investment in foreign currency denominated investments; and
- does not address local tax issues.

All material presented is compiled from sources believed to be reliable and current, but accuracy cannot be guaranteed. Investment involves risk. Please review all financial material carefully before investing. The opinions expressed are based on current market conditions and are subject to change without notice. These opinions may differ from those of other Invesco investment professionals.

The distribution and offering of this document in certain jurisdictions may be restricted by law. Persons into whose possession this marketing material may come are required to inform themselves about and to comply with any relevant restrictions. This does not constitute an offer or solicitation by anyone in any jurisdiction in which such an offer is not authorised or to any person to whom it is unlawful to make such an offer or solicitation.