MSCI's Announcement to Add China A-Shares to its Emerging Markets Index

Looking Beyond the Tiny Percentage

August 2017
Introduction

On June 20, 2017, MSCI announced that it will add 222 China A Large Cap shares to the MSCI Emerging Markets (EM) Index. When the inclusion is officially launched in June 2018, China A Large Cap shares are expected to account for about 0.73% of the MSCI EM Index. As the latest note in a series of three on the globalization of China’s financial markets, this paper explains the background of the index change, estimates future changes in the Index composition, and also points out the potential implications on institutional investors if China A-Shares claim 17% or more in the MSCI EM Index.

We believe:

- In the near term, the announcement has more of a symbolic meaning than actual impact.

- However, this tiny index change could potentially open up a huge opportunity in the future.

- Further inclusion of A-Shares could happen much sooner than the initial review process.

- The potential influx of institutional money could reach at least 5.3% of the value of all A-Shares.

- Institutional investors should understand the implications and adjust accordingly.

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1 Aon research: Onshore Chinese Bonds Enter the Global Bond Universe, by Lucinda Downing
Aon research: All Aboard the Through Train, China A-Shares, by James Jackson
China A-Shares, a big market but a tiny weight in the MSCI EM index

Being the second largest economy in the world, China has expanded its equity markets over the past three decades to a size only ranked after the U.S. by market capitalization (Figure 1).

However, international investors’ participation in China’s equity markets has not been proportionate to its share of the world economy and of the global capital market, primarily due to the tight control of foreign ownership and access by Chinese authorities. Based on listing locations and accessibility to different groups of investors, China’s equity market is unique in its regulation and structured with multiple classes of shares such as A, B, and H shares, as well as Red and P chips and overseas listings. “A-Shares” refers to stocks of those companies incorporated in China, listed in China, and traded only in Renminbi (RMB) in either the Shanghai or Shenzhen stock exchange. Please refer to Aon research *All Aboard the Through Train, China A-Shares*, by James Jackson for a detailed introduction to the China A-Shares market.

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2 Aon research: *All Aboard the Through Train, China A-Shares*, by James Jackson
The table below shows a comparison of the multiple classes of shares:

### Table 1: Comparison of multiple classes of shares

<table>
<thead>
<tr>
<th>Incorporation Location</th>
<th>A-Shares</th>
<th>B-Shares</th>
<th>H-Shares</th>
<th>Red Chips</th>
<th>P Chips</th>
<th>Overseas Listings</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>China</td>
<td>China</td>
<td>China</td>
<td>Outside of China</td>
<td>Outside of China</td>
<td>China</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Listing Location</th>
<th>China</th>
<th>China</th>
<th>Hong Kong</th>
<th>Hong Kong</th>
<th>Hong Kong</th>
<th>U.S./Singapore</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Trading Currency</th>
<th>RMB</th>
<th>USD/HKD</th>
<th>HKD</th>
<th>HKD</th>
<th>HKD</th>
<th>USD/SGD</th>
</tr>
</thead>
</table>

<table>
<thead>
<tr>
<th>Availability to Foreign Investors</th>
<th>Only under QFII, RQFII, and Stock Connect</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
<th>Yes</th>
</tr>
</thead>
</table>

Source: HKEX, SSE

Among the multiple share classes—such as A, B, and H shares, as well as Red and P chips and overseas listings—A-Shares count for the lion’s share of China’s equities listed in Shanghai and Shenzhen. Out of more than 4,500 Chinese companies listed, 3,277 are A-Shares but are currently not included in the MSCI China Index universe (Table 2).

Although China already comprises 28% of the MSCI EM Index as of May 31, 2017, the MSCI China sub-index includes only securities accessible to foreign investors such as B-Shares, H-Shares, Red chips, P chips, and overseas listings (Figure 2):

### Table 2: Comparison of A-Shares listings in onshore China markets with other China listings

<table>
<thead>
<tr>
<th>Hong Kong</th>
<th>Shanghai</th>
<th>Shenzhen</th>
<th>Nasdaq</th>
<th>NYSE</th>
</tr>
</thead>
<tbody>
<tr>
<td>Main board</td>
<td>Chi-Next A-Shares</td>
<td>B-Shares</td>
<td>A-Shares</td>
<td>B-Shares</td>
</tr>
<tr>
<td>No. of listed companies</td>
<td>1,746</td>
<td>287</td>
<td>1,294</td>
<td>51</td>
</tr>
<tr>
<td>No. of listed H-Shares</td>
<td>222</td>
<td>24</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>No. of listed red chips</td>
<td>152</td>
<td>6</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>No. of listed P Chips*</td>
<td>614</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>No. of listed securities</td>
<td>10,003</td>
<td>288</td>
<td>1,294</td>
<td>51</td>
</tr>
<tr>
<td>Market capitalisation (billion USD)</td>
<td>$3,623</td>
<td>$34</td>
<td>$4,489</td>
<td>$15</td>
</tr>
<tr>
<td>Floating market capitalisation (billion USD)</td>
<td>N/A</td>
<td>N/A</td>
<td>$3,764</td>
<td>$15</td>
</tr>
<tr>
<td>Total market turnover (million USD)</td>
<td>$10,006</td>
<td>–</td>
<td>$24,147</td>
<td>–</td>
</tr>
</tbody>
</table>

Source: HKEX, NYSE, NASDAQ

Exchange rate used: 1 USD = 7.80 HKD, 1 USD = 6.78 RMB

*As of 5/31/2017
According to MSCI, its initial step to include A-Shares in its Emerging Markets indices will be to add 222 Large Cap stocks in a two-phased process beginning in June 2018. By then, China A-Shares are expected to count for only 0.1% of the MSCI All Country World Index (ACWI) Index, 0.73% of the MSCI EM Index, 0.83% of the MSCI Asia ex Japan Index, and 2.5% of the MSCI China Index (Figures 3). China A-Shares have been on MSCI’s review list since 2013. When the initial inclusion weight is compared to the size of the entire China A-Shares market, 0.73% is indeed a baby step that MSCI made. MSCI would not have even included such a tiny weight if it were not for a decade-long effort by China to open up its capital markets. It has been a long journey for both China and MSCI to make this change happen, and there is still a lot more room for China to open its domestic equity markets to international investors, and thus MSCI, to fully integrate China into global equity markets.

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Background of the baby step

China’s A-Shares market has not been easy for foreign investors to access. They could only gain access to China’s A-Shares market through strictly controlled quota schemes—such as the Qualified Foreign Institutional Investor (QFII) scheme and the Renminbi Qualified Foreign Institutional Investor (RQFII) program—and Stock Connect, the latest platform since 2014. The Stock Connect program allowed foreign investors to access A-Shares traded in the Shanghai or Shenzhen stock exchange via the Hong Kong stock exchange, though with some restrictions such as daily trading volume. Embracing foreign capital in its domestic equity market was a slow and extremely cautious process for China.

The process for MSCI to include China A-Shares in its index series has also been very slow. Among MSCI Global Market Accessibility criteria, “openness to foreign ownership” and “ease of capital inflows/outflows” are among the major obstacles to MSCI not including China A-Shares in the EM Index after three annual reviews prior to 2017. China has gradually relaxed its QFII scheme and RQFII program since 2012. MSCI and the institutional investment community welcomed this liberalization of China’s domestic equity market and applauded when China launched the Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect program since 2014. After China’s onshore stock market crisis in the summer of 2015, Chinese authorities fought hard to stop capital outflow as concerns over slower economic growth and Renminbi devaluation drove massive capital flight overseas. China’s foreign currency reserves dropped below $3 trillion from as high as $4 trillion (Figure 4).

Figure 4: Historical trend of China’s foreign currency reserve

While keeping tight hands on capital outflows by Chinese residents and business entities, Chinese authorities also welcomed foreign capital inflows in efforts to slow the decline of its foreign currency reserve. On the other hand, the International Monetary Fund (IMF) announced that Renminbi (RMB) is included in the basket of Special Drawing Rights (SDR), elevating RMB in the global reserve currency system since October 2016. While RMB’s globalization makes solid progress, we expect China’s onshore equity and debt markets to be more open to international investors. Following China’s onshore bonds inclusion in the Bloomberg and Citigroup local bond indices since early 2016, it is widely expected that the global equity market index will embrace China’s onshore stocks as well.

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4 Aon research: All Aboard the Through Train, China A-Shares, by James Jackson
4 Aon research: Onshore Chinese Bonds Enter the Global Bond Universe, by Lucinda Downing
When A-Shares are fully included

As MSCI stated, “Further inclusion of China A-Shares could potentially include an increase of the currently announced 5% inclusion factor\(^1\) as well as the addition of China A Mid Cap shares\(^2\) depending on “how China’s A Shares market aligns with international market accessibility standards.” MSCI has the discretion to increase the initial 222 Large Cap A-Shares names only available through Stock Connect to a much larger pool. China’s country weight could potentially increase from 28% currently in the MSCI EM Index to as much as 41% in the future, according to MSCI (Figure 5). However, such a leap is primarily dependent on the willingness of China to continue to open and transform its domestic equity market.

![Figure 5: Evolving MSCI EM Index composition](image)

Source: MSCI

Given China’s ambition to solidify its global leadership, further including foreign capital in its domestic equity market is likely in the interest of China. We expect future inclusion of more China A-Shares in the global equity market index to accelerate. Along with this process, institutional investors need to incorporate the index composition changes in investment policy setting, equity research, manager selection, and operations management. The potential magnitude of the A-Shares weight change could be unprecedented compared to any historical development in the MSCI EM Index.

\(^{1}\) A multiplication factor ranging from 0% to 100% that MSCI uses to adjust the weight of constituents’ stocks
Implications

If China’s country weight claims 41% in the EM Index, and A-Shares alone count for 17%, as MSCI has illustrated as a future possibility, investors will need to incorporate the A-Shares market risk/return profile in their capital market assumptions for Emerging Markets Equity. When A-Shares are at a full inclusion stage, we believe investors need to re-evaluate the capability of their broad mandate managers in Emerging Markets or Asia markets and be ready to deploy specialist managers if necessary. Whether adopting a passive or active strategy, investors will have to assess their prior experience and exposure and identify available resources.

Certain style and factor investment managers will need to calibrate their factor investing approaches for some unique characteristics of A-Shares. On the operational front, investors need to embrace different trading and settlement rules.

1. Capital market assumptions

Historically, investors’ base of A-Shares has been dominated by retail investors and the historical performance was primarily driven by speculation. When measured by the China Securities Index (CSI) 300 Index, Large Cap A-Shares performed differently from the MSCI China Index, as illustrated below in Figure 6 and Table 3.

![Figure 6: Historical growth comparison](image)

Source: MSCI

<table>
<thead>
<tr>
<th>Table 3: Comparison of annualized historical return and risk</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>As of 6/30/2017</strong></td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td>1 Year</td>
</tr>
<tr>
<td>3 Years</td>
</tr>
<tr>
<td>5 Years</td>
</tr>
<tr>
<td>10 Years</td>
</tr>
</tbody>
</table>

Source: MSCI, Bloomberg

The CSI 300 Index consists of the 300 largest and most liquid A-Shares stocks traded in the Shanghai and Shenzhen stock exchanges.
When A-Shares in Shanghai and Shenzhen are largely open to international investors, an influx of institutional money and trading patterns could change the returns and risk profile of A-Shares. Investors trying to develop a fair assumption of expected return and risk could take only limited reference from the historical performance. Though Chinese authorities have relaxed their stock suspension rules after the 2015 onshore stock market crisis, stock suspension remains a unique factor that needs to be considered.

2. Passive vs. active considerations
Asset owners need to evaluate whether a passive or active strategy is the best approach to gain exposure. We believe investors without prior exposure or experience with A Shares are better off to adopt a passive strategy. Nevertheless, the challenge is then shifted to managers and custodian banks, which need to be ready to include 2,000+ companies. Investors already embracing an active strategy in their Emerging Markets Equity mandate need to realize that current active Emerging Markets managers will be challenged with a far broader research base, yet presented with opportunities of alpha generation. Asset owners need to check whether their equity fund managers have sufficient resources to develop insights around the A-Shares market.

3. Broader mandate or specialist manager
We still believe a broader mandate of Emerging Markets and ACWI Asia would be appropriate at the initial stage of MSCI EM Index inclusion. However, at a full inclusion stage, investors must determine whether a broader mandate manager has sufficient capability to cover the entire China market. Otherwise, a specialist manager should be considered. By that time, we suspect that MSCI might roll out the Emerging Markets ex China Index to pair with the China Index so that investors have sufficient flexibility to deploy different strategies. We encourage investors to review and evaluate their current Global Equity and Emerging Markets managers in the context of the evolving landscape.

4. Calibration of style and factor investment approach
We would like to point out some unique China A-Shares market characteristics for investors who are used to mature markets in the U.S. and Europe. For example, many state-owned enterprises (SOEs) are traded at relatively low price-to-earnings (P/E) ratios compared to the broader A-Shares. We suggest that traditional value investors resist comparing SOEs to other value stocks on the same platform. Due to the unique stock suspension rule in Shanghai and Shenzhen exchanges, historical volatility might not accurately reflect a stock’s real risk level. Low-volatility managers will need to calibrate their approach to count in the impact of stock suspensions. High turnover of fund managers7 is common in China. Therefore, short track records of many funds in A-Shares are another reality for investors relying on back testing.

5. Different trading and settlement rules
A-Shares are subject to some unique trading rules, such as a daily price limit of +/−10% and unit of trading quantity. Most A-Shares are limited to a daily trading price range of +10% to −10% of the prior day’s closing price. Currently, trading quantity of A-Shares cannot be any random number of shares, but has to be in the multiples of 100 shares. In addition to the trading rule difference, the current settlement cycle of A-Shares through Stock Connect is also different from the schedule in the U.S. Securities settle on T day and money on T+1 day for A-Shares through Stock Connect, as compared to securities on T day and money on T+3 in the U.S.8 If such a settlement cycle difference remains in the future, we don’t see it as a risk for managers and brokers. Over the past few years, working with local brokers, sub-custodian banks, and clearing houses in China, many institutions have already handled investing, and custody and accounting in the China market effectively through Stock Connect.

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7 Aon Hewitt Retirement & Investment Blog: “Volatility in China’s Stock Market” by Fei Amy Shang and John Thompson

8 http://english.sse.com.cn/investors/shhkconnect/clear
More than the influx of passive money

As of December 31, 2016, assets in passive and active strategies benchmarked to MSCI ACWI (including ACWI Investable Market Index and ACWI ex USA) total $2.88 trillion, and the MSCI EM Index totals $1.59 trillion. In Table 4, we estimated the institutional money that could follow the index change when A-Shares weight ranges from 0.73% to 16.9% of the MSCI EM Index.

Table 4: Estimate of institutional money influx

<table>
<thead>
<tr>
<th></th>
<th>China A-Shares Initial Weight</th>
<th>Potential China A-Shares Weight</th>
<th>Benchmarked A-Shares AUM Range ($billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI ACWI</td>
<td>0.08%</td>
<td>1.88%</td>
<td>$2.3–$54.0</td>
</tr>
<tr>
<td>MSCI EM</td>
<td>0.73%</td>
<td>16.90%</td>
<td>$11.6–$268.7</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>$13.9–$322.7</td>
</tr>
<tr>
<td>As A % Of The Entire A-Shares Market</td>
<td></td>
<td></td>
<td>0.23%–5.32%</td>
</tr>
</tbody>
</table>

The above calculation has not considered assets benchmarked to other indices such as the FTSE series. As MSCI illustrated in Figure 5, if China’s weight rises to 41%, H-Shares would count for 18%, B-Shares and overseas 6%, and A-Shares 17%. By then, Mid and Small Cap stocks could be included within the basket of A-Shares, as compared to only Large Cap stocks at the initial inclusion stage. This composition could be different depending on China’s market openness. A-Shares could weigh more and other share classes less in the total weight of China. The potential influx as a percentage of the entire A-Shares market size could be much higher than 5.3%, which is already a huge inflow of capital.

In addition to the massive institutional money that could follow the index change, we would also point out potential alpha sources for active managers such as sectors sensitive to domestic consumptions and Mid to Small Cap stocks that align better with China’s economic growth orientation.

In comparing the sector weights of the current MSCI China Index to the CSI 300 Index, A-Shares will challenge active managers with a drastically different sector exposure (Figure 6). Sectors such as Materials, Consumer Staples, Health Care, Industrials, Consumer Discretionary, and Financials are weighted much higher in the CSI 300 Index than the level in the current MSCI China Index.

Based on the broadest CSI China A-Shares Index, the distribution of Large Cap, Mid Cap, Small Cap, and Mini Cap is 33% / 15% / 16% / 20%, respectively, while the Large and Mid Cap split in the MSCI China Index is 87% / 13%, respectively. Active managers could access a much larger pool of Mid to Small Cap stocks. In addition, the P/E ratio differences between A-Shares and other China share classes could be explored by active managers as well as for alpha generation.

Source: MSCI, eVestment, Morningstar, Bloomberg
Summary

We welcome MSCI’s move to include China A-Shares in the MSCI EM Index, as investors start to access the investment universe of the second largest economy in the world. In the near term, the announcement has more of a symbolic meaning than actual impact on market participants. We encourage investors to look beyond the initial tiny weight that A-Shares constitute in the MSCI EM Index. We expect A-Shares to claim higher weight in the EM Index and at a much faster pace if China further opens up its domestic equity market. Before A-Shares account for a more substantial weight, we believe that investors should understand the potential implication of such a change and make adjustments on investment policy setting, manager selection, investment approach, and operational management accordingly.

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Figure 7: Sector weight comparison

Source: MSCI, China Securities Index
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