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MSCI INCLUSION OF DOMESTIC 'A' SHARES IS CHINA'S GRAND ENTRANCE ONTO WORLD STAGE

Summary

In June 2017, MSCI announced the inclusion of China 'A' shares into its key Emerging Markets and World indices. Come August 2018, the 'A' shares market will account for a symbolic 0.7 per cent and 0.1 per cent of both benchmarks respectively. We believe this representation is a drop in the ocean compared to the actual size of China's domestic stock market. We explain why we think China is currently under-represented and the country's potential if it were to be fairly accounted for.

1. MSCI is slated to initially include 222 stocks worth a market capitalisation (market cap) of USD 34.85bn, after adjusting for a foreign inclusion factor (FIF) and index inclusion factor (IIF). Before adjustments, total full market cap would have been worth USD 3.8trn.

2. Four key factors that could lead to a greater representation of China in the indices include: raising the IIF by the MSCI, including China mid-caps into its index, successful implementation of financial reforms which could boost the FIF and adding other stocks within the broader Shanghai and Shenzhen exchanges into the MSCI indices.

3. Given the above factors, China has the potential to grow its included market cap in the MSCI from USD 697bn to USD 6.4trn. The country could potentially in time become the 2nd largest weighting in the Index.

Overview

Investors today are used to designing and managing portfolios of Asia ex-Japan or even Asia-Pacific ex-Japan stocks. But imagine a day when Asia ex-China portfolios are the norm. We think this is not too far-fetched an idea.

The inclusion of China 'A' shares in the MSCI EM Index and broader MSCI AC World Index was met with a lukewarm response by investors, who pointed to the country's small representation in the benchmarks. But we think this misses the point and argue that China's MSCI inclusion helps to not only boost China's creditability as a global economic power, but also helps to increase global fund inflows into the domestic market.

It is also a wake-up call for investors to re-think their strategy towards an economy that is now the world's second largest. China's growth has been significant over the past decade, but historically China's small weighting means that global investors had dismissed its value add. However, we believe that China will one day – and very quickly – represent a large proportion of investment benchmarks in a way that investors will no longer be able to ignore.

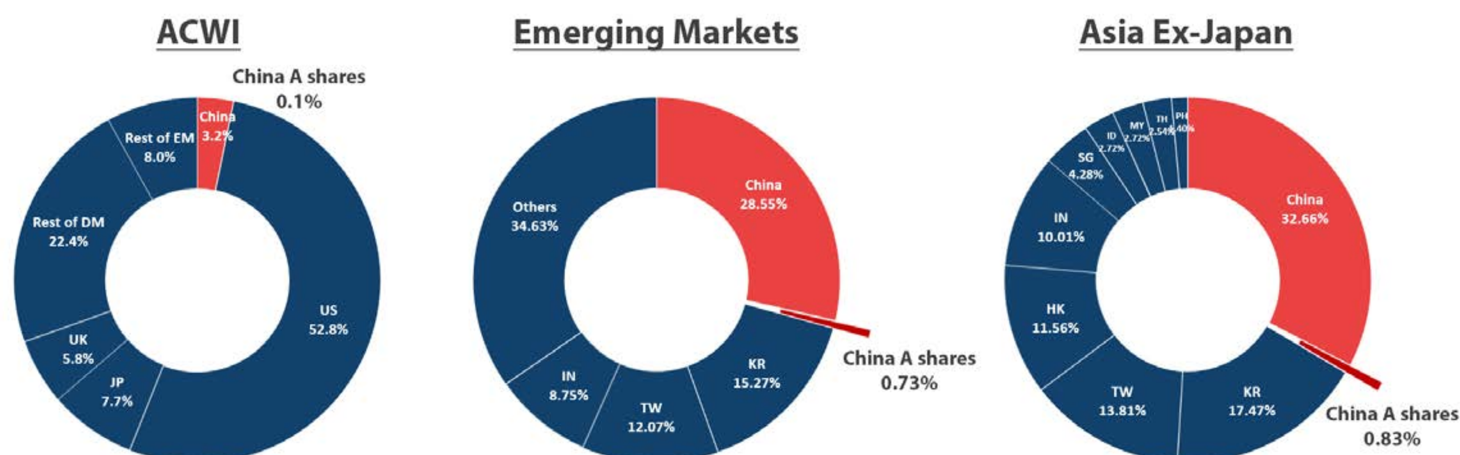
How MSCI includes China 'A' shares in its index calculations

The MSCI inclusion of China 'A' shares into its emerging market (EM) and World indices entails adding 222 large cap stocks, which have a total full market cap of USD 3.8trn[1]. However, it only takes into account USD 697bn in what they call 'foreign inclusion factor-adjusted' (FIF) market cap. In some ways, this is like a discount for issues, such as foreign ownership limits that China imposes on some sectors of its economy and stocks. On top of that, it applies another discount – including only 5 per cent in what it calls partial 'index inclusion factor' (IIF) on the USD 697bn market cap. This is ostensibly due to the fact that China still has some way to go in its financial reform, its strict capital controls, and the barriers that foreign investors still face in accessing the market.

By the time the inclusion is fully implemented in August 2018, China 'A' shares will account for just 0.7 per cent of the MSCI EM Index and 0.1 per cent in the wider MSCI AC World Index[2].

1. MSCI, as at June 2017
2. To be clear, China 'A' shares should not be confused with China 'H' shares, which are China companies listed in Hong Kong, freely accessible to international investors and already well represented in the EM index.

Chart 1: China’s representation in MSCI indices



Source: MSCI, data as of 19 June 2017

China’s roadmap to greater inclusion

We think the double discount imposed on China unfairly penalises it and results in an under-representation of the domestic market. We strongly believe that the 5 per cent inclusion factor for China ‘A’ shares can and will be raised speedily to 100 per cent by MSCI, just as it is currently for Taiwan, Korea, Japan, Singapore and even for most Chinese companies listed in Hong Kong and USA. Both Korea and Taiwan have significant weights in the MSCI EM index, at 15 per cent and 12 per cent respectively, despite their smaller economies and stocks, and charted their paths to full index inclusion in less than seven years. Simply raising China’s index inclusion factor from 5 per cent to 100 per cent has the potential to increase the ‘A’ shares’ weight by 20 times – from 0.7 per cent in MSCI EM index to 14 per cent.

In the meantime, MSCI has highlighted several factors which, if improved, could lead MSCI to rethink the discounts it ascribes to China in due time:

- a greater alignment of the China ‘A’ share market with international market accessibility standards
- the resilience of its Stock Connect programme
- the relaxation of daily trading limits
- continued progress on trading suspensions
- further loosening of restrictions on the creation of index-linked investment vehicles.

Going forward, the discussions on the future inclusion roadmap for China ‘A’ shares will centre on: 1) raising the index inclusion factor that has been set at an ultra-low 5 per cent – the lowest it has given to any country being introduced into its indices for the first time; 2) including China mid-caps into its index. We estimate that adding mid-cap stocks alone, using MSCI’s stringent screening criteria, will almost double the number of stocks being included from the current 222; 3) should the positive momentum of financial reforms continue, we could see a boost to FIF; and 4) we think the vast potential of the market extends beyond the current MSCI universe where the market cap it applies is a fraction of the universe of stocks listed on the domestic Shanghai and Shenzhen exchanges—where 3,500 stocks are listed with a total market cap of USD 8.6trn.

Case studies of Korea and Taiwan – how Korea took almost six years and Taiwan eight years

In the case of Korea, its path to a 100 per cent inclusion factor in the MSCI EM Index took seven years (1991–1998). From 20 per cent IIF in 1992 when the Korea Stock Exchange (KSE) opened all certified securities houses to foreigners, to 50 per cent IIF in 1996, when the market showed continued progress towards financial liberalisation and market opening, Korea finally got a 100 per cent IIF in 1998 even though it only abolished foreign investment ceilings in 1998. Korea’s market liberalisation was spurred by the Asian Financial Crisis when it was required to open up its financial sector in exchange for funds from the International Monetary Fund (IMF).

For Taiwan, the path to full inclusion in the MSCI EM Index took almost eight years (1996-2004). Its inclusion factor at 50 per cent started in mid-1996 when the market allowed investment by all foreign investors with an aggregate foreign limit of 10 per cent, to 80 per cent IIF in 2000 when foreign limits were fully abolished and finally to 100 per cent IIF in 2004 when QFII (Qualified Foreign Institutional Investor) regulations were eased. The Asian Financial Crisis took its toll on Taiwan’s stock market, but its export-driven economy flourished with the help of huge US dollar inflows. Its push for market liberalisation came from a progressive and proactive Taiwanese government that was keen to thrust the territory onto the world’s financial stage.

We believe this could be a similar playbook for China given its progress in opening up its financial markets, which have accelerated in the last three years.

The China playbook for full index inclusion

We believe that the China playbook for full index inclusion has all the parts of Korea and Taiwan and will conclude at a faster pace. The stage has already been set with market liberalisation gathering pace.

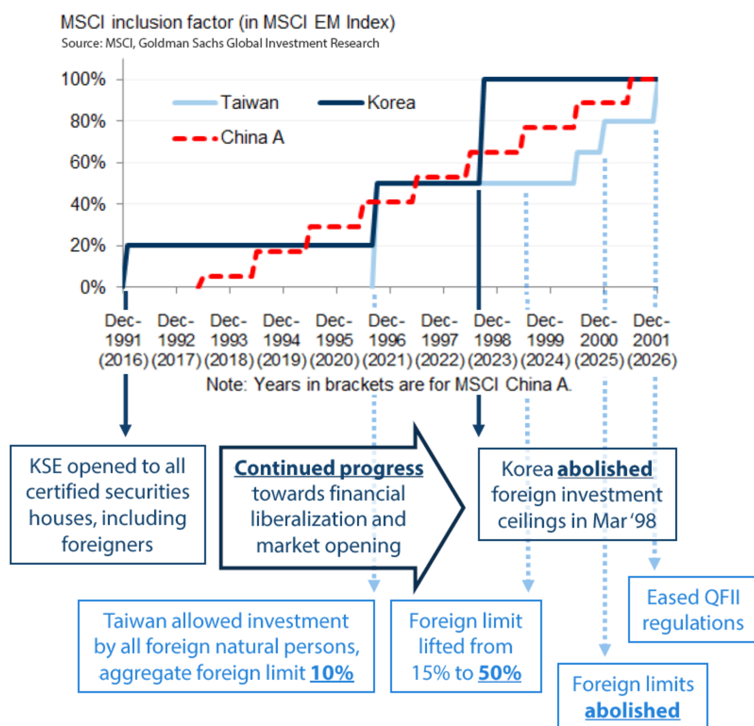
China's first act towards market liberalisation in recent years started in 2014 when it raised the foreign ownership limit from 20 per cent to 30 per cent and launched the Shanghai Stock Connect programme. China has already started implementing some liberalisation of its currency through the renminbi (RMB) offshore trading programs in various countries most notably in Hong Kong since 2004 but accelerating in recent years.

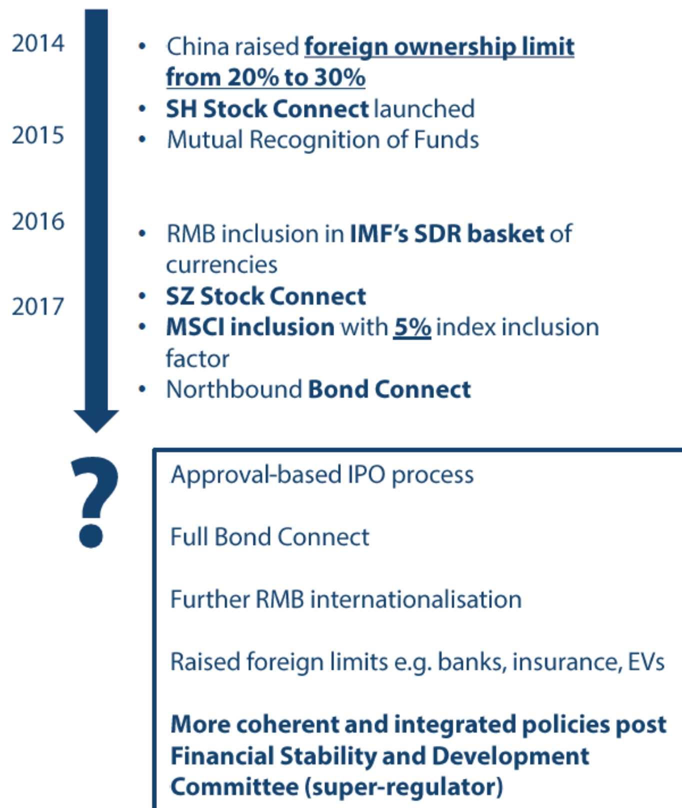
The International Monetary Fund (IMF) added the RMB to its special drawing rights (SDR) basket of currencies in 2016, which is testament to the integration of China's financial market into international finance. China's commitment to liberalisation resulted in the Shenzhen Stock Connect in December 2016 and Northbound Bond Connect in July 2017. The recent expansion of the Stock Connect programme, which allows international institutional investors more flexible access than the restrictive QFII[3] and RQFII regimes, was billed as a game changer for market opening of China 'A' shares. Further steps to open its financial sector were announced in November last year (2016) with foreign ownership limits in financial institutions being raised significantly and in some subsectors, i.e. asset management, removed completely.

We believe the next steps in its liberalisation will include an approval-based IPO process, a full 2-way Bond Connect programme, further RMB internationalisation and full removal of foreign ownership limits. More coherent and integrated policies will also be enacted with the formation of a Financial Stability and Development Committee acting as a 'super-regulator'.

We think the speed of reform will drive China's move towards 100 per cent MSCI index inclusion at a pace quicker than that for Taiwan and Korea. This is aided by China's two unique factors: its sheer size and its command economy that can see things decided and implemented quickly. Although its size is massive and has been a hindrance in heavier weighting inclusion for global investors worried about its disruptive impact, we believe that the eventual smooth implementation in 2018 will accelerate its full inclusion. It is likely to start slow but speed up due to its importance.

Chart 2: China's roadmap for full index inclusion





Source: MSCI, Goldman Sachs Global Investment Research, 2017

3. QFII refers to Qualified Foreign Institutional Investors and RQFII refers to RMB Qualified Foreign Institutional Investors

Inclusion of mid-caps to further boost universe

Beyond raising the index inclusion factor that can easily increase China 'A' shares' weight in the MSCI EM index by 20 times, we believe the addition of mid-cap stocks will be an imminent next step on the index provider's future inclusion roadmap. This will quickly double the number of stocks being included in the EM index.

MSCI currently has a China 'A' International Index consisting of 459 stocks, 195 of which are mid-cap stocks. Using the index provider's stringent criteria, these mid-cap stocks which, have a full company market cap of USD 1.0trn, can be whittled down to USD 280bn in 'foreign inclusion factor-adjusted' market cap. Assuming that these 195 mid-cap 'A' shares are added to the EM index, this will enlarge the universe from 222 large-cap stocks to 417 stocks. Correspondingly, with 100 per cent index inclusion (instead of MSCI's current 5 per cent IIF), the adjusted market cap will rise from USD 697bn for the large-caps only to a total of USD 977bn (including mid-caps).

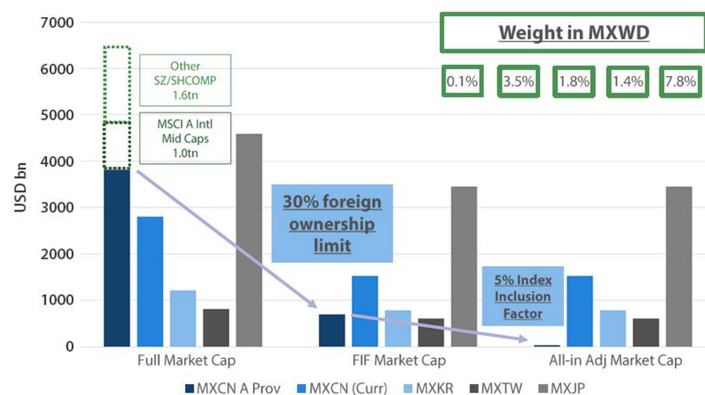
Closing the gap between China's actual and applied market cap

If the potential for close to USD 1trn market cap of stocks does not make investors sit up and take notice, we wish to point out that this number is only a fraction of the actual full market cap of the named stocks. The MSCI EM is a free float adjusted market cap weighted index. A FIF is applied based on the foreign ownership limits that a country or equity market imposes on stocks in certain sectors. For example, the USD 697bn applied to the 222 stocks being included in the EM index only account for less than 20% of their full market cap of USD 3.8trn based on their free float.

In November 2017 China announced plans to open up its financial sector by raising foreign ownership of securities, funds management and futures trading joint ventures to 51 per cent and removing all limits after three years. The 20 per cent ceiling on foreign ownership of Chinese banks and financial asset management companies, and 25 per cent limit on total holdings in the same, would also be ended. Foreign ownership of insurance joint ventures would be lifted to 51 per cent in three years and removed entirely after five years.

Given that China has already made clear its intention to remove the ceiling on foreign ownership of its domestic companies, we think MSCI's FIF adjustments, which assume a 30 per cent foreign ownership limit, will also be removed in due time to reflect the full market value of the stocks. We recognise the heavy weighting of state-owned enterprise in China and the low free float but believe that over time, its development will be similar to Singapore where free float will increase. As such, we estimate that the impact of this will be to raise the market cap of eligible China 'A' shares – both large-cap and mid-cap – from almost USD 1trn to USD 4.8trn.

Chart 3: Huge gap between China's actual and applied market cap



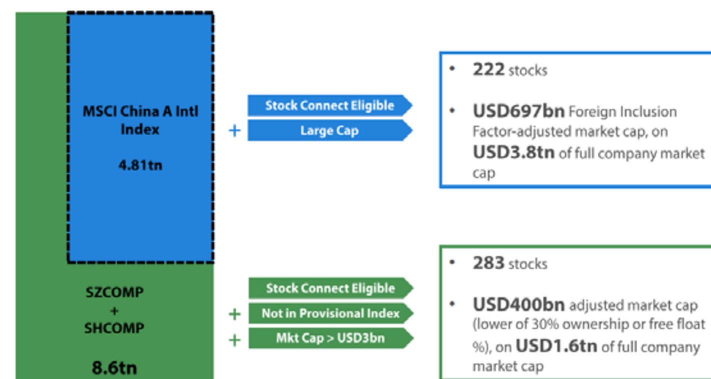
Source: MSCI, 2017

Looking beyond the 'A' share universe

Beyond the MSCI universe of large and mid-cap stocks in its current China 'A' International Index, we think there is even further potential for investing in the domestic market. There are more than 3,500 stocks listed on the two domestic exchanges of Shenzhen and Shanghai with a combined market cap of USD 8.6trn. To be fair, some of these stocks are not investible by institutional investors due to their small size, illiquidity, trading suspensions or other undesirable factors.

From our screening of domestic listed companies eligible for Stock Connect, with a market cap of more than USD 3bn and not already in the provisional MSCI index, we short-listed another 283 stocks that could be potential inclusion candidates. The full market cap of these companies totals USD 1.6trn and after taking into account the lower of 30 per cent ownership or free float percentage, the adjusted market cap is at least another USD 400bn that could be added.

Chart 4: Potential outside of MSCI China 'A' International Index



Source: MSCI, 2017

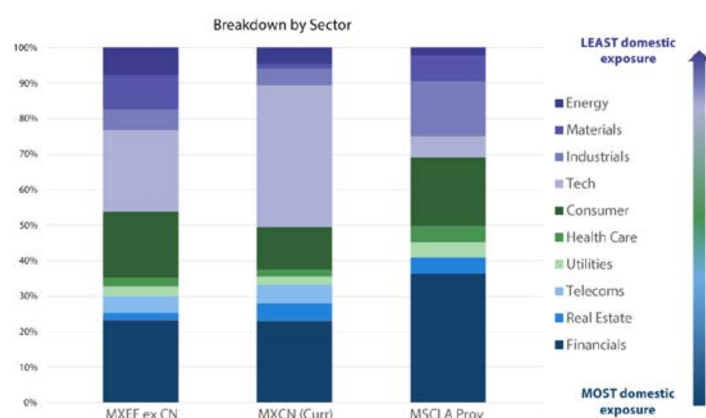
China 'A' shares offer greater direct exposure to domestic trends

While international investors are familiar with and have direct access to the offshore China equities or China 'H' shares, most have limited understanding of the domestic 'A' share market, which has its own internal dynamics. China 'H' shares, which are Chinese companies listed in Hong Kong and freely accessible, currently make up about 28 per cent of the MSCI Emerging Market Index.

The composition of sectors in the EM index will change with the inclusion of China 'A' shares as the domestic stock market is more representative with China's transitioning economy. For instance, consumer and other domestic-led companies, such as financials, industrials and healthcare, form a bigger part of the China 'A' share index while energy and technology hardware sectors have a smaller representation.

This will address a long-standing frustration of investors who bemoan the disconnect between economic data and market representation. A burgeoning middle-income population, increasingly flexing its consumer power, has been propelling the economy. But this is rarely reflected in the performance of the offshore market. Hence the inclusion of China 'A' shares will offer greater direct exposure to domestic structural trends in China.

Chart 5: Sector breakdown within China 'A' shares



Source: MSCI, 2017

China's index weight could surpass Japan

Given the sheer size of the China domestic market, which by our estimate totals USD 6.4trn (including only Shenzhen and Shanghai Stock Exchange but not China companies in the Hong Kong Stock Exchange) we think that in time, China's total weight in the global MSCI World index (at 2.9 per cent) could top that of Japan. Japan's weight in the index is 7.8 per cent and its total market cap is lower at less than USD 5trn.

It is thus not an unthinkable proposition that in time, an Asia ex-Japan ex-China index could be a norm with the depth and importance of the China market warranting its own dedicated investment strategy and investment team. China's market liberalisation is a structural force that will gather speed and its inclusion in MSCI's EM and World indices is a harbinger of the vast investment opportunities available. Given that China has been ignored and likely underweight in most global investors' portfolios, investors need to recalibrate their China exposures and strategy to take advantage of these trends or risk being left behind.

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