An increasing exposure to China in indices - what does it mean for investors?

By Janina Slawski

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Investors would generally hope that the index they choose to invest in passively, or to use as a benchmark for an active manager, will capture the desired economic exposure that they are seeking.

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But this is often not the case. In a particularly stark example, China ranks second after the United States in terms of share of world GDP, and yet the exposure to China in global equity indices has been a fraction of its economic exposure. One of the main reasons for this has been that investing in Chinese shares has been complex, with foreign investors historically only able to invest in certain classes of offshore China shares.

Offshore China shares have for some time been included in indices and represent approximately 30% of the MSCI Emerging Market (EM) index. onshore or Chinese A-shares have, however, been excluded from indices until partial inclusion commenced by MSCI on 1 June 2018. China A-shares are stocks of companies incorporated in China, listed in China and traded in local currency only. Despite the Chinese A-share market being the world's second largest equity market after the United States, foreign investors have had limited ability to own these shares. Until November 2014, foreign investors could only access China A-shares through quotas allocated in terms of the qualified foreign institutional investoror (QFII) or Renminbi qualified institutional investor (RQFII) schemes, which came into effect in 2002 and 2011.

Access was extended in 2014 through the launch of the Stock Connect programme. Stock Connect is a link between the Shanghai Stock Exchange and the Stock Exchange of Hong Kong, which expanded the connection between the mainland Chinese stock market and the rest of the world. In late 2016, a similar link was established between the Shenzhen Stock Exchange and the Stock Exchange of Hong Kong. The daily quota on Stock Connect was quadrupled from 1 May 2018 to increase liquidity in time for the MSCI's inclusion of 226 China A-shares in its EM index on 1 June 2018.

Inclusion in indices

The inclusion of these China A-shares in the MSCI's global equity indices represented just 2.5% of the A-share market, increased to 5% in September 2018. On 28 February 2019 MSCI announced an increase in the 5% inclusion factor to 20% in three steps, with increments of 5% in May, August and November 2019, with additional large and mid-cap shares to be added in May and November. On completion of the three-step implementation, the weighting of Chinese stocks in the MSCI Emerging Market (EM) Index will increase to 3.3% from the current approximately 0.8%. FTSE Russell and S&P Dow Jones have announced similar plans to include A-shares from June 2019 and September 2019 respectively.

The initial impact of the inclusion of the A-shares has been limited but in the longer term the inclusion will have a significant impact, especially for MSCI EM benchmarked portfolios. Once 100% of the China A-shares are included, an estimated 42% of the EM index will then be exposed to China shares.

Investment opportunities

The China A-Share market may be attractive to investors for many reasons. The Chinese A-share market has over 3,000 shares and a market capitalisation in excess of $8trn. Chinese A-shares make up approximately 70% of the market capitalisation of all Chinese listed stocks, with a significant level of diversification. The market is the most liquid in the world with an aggregate trading volume exceeding that of the New York and Nasdaq stock exchanges combined.

Historically, Chinese A-shares have exhibited a low correlation with global equity markets, to a large extent because they are still mainly driven by local retail investors, who own more than 75% of the shares. The correlation with other markets will increase over time as markets open up, but this will take time to realise.

Investment risks

However, investors need to be aware of the risks associated with investing in China A-shares, not least the concerns about Chinese corporate governance and market practices which have not necessarily improved since the MSCI previously rejected inclusion of A-shares in its indices.

Although the market is large and liquid, it is subject to significant volatility and has suffered from liquidity droughts, especially in July 2015 when more than half of the 2 800 companies listed on the Shanghai and Shenzhen exchanges were able to suspend trading of their shares through a stock suspension mechanism that allows companies to apply to regulators for a trading halt. The market has experienced high levels of stock suspensions with between 5% and 10% of listings suspended on any day.

Investors may also be concerned about the potential for government intervention, given that the Chinese authorities have exhibited a strong inclination towards control of their financial markets. During the 2015 stock market crash, the Chinese authorities intervened by punishing short selling, suspending initial public offerings, urging fund managers to buy more stocks and providing central bank-backed funds to boost share prices.

What does it mean for investors?

Investment in listed Chinese shares will be difficult for investors to ignore as they become a larger and larger portion of EM and all-country indices. Key takeaways for investors include the following:

- Purely passive investors investing in either all-country indices or a combination of developed markets (DM) and EM indices will take on more exposure to Chinese A-shares as they are added to the all-country and EM indices.
- Given the large portion that China will represent in the EM indices in future and the concerns that investors may have about this exposure, some passive investors may consider splitting their investments between DM, EM ex-China and China indices, with the potential for active over- or under-allocation between these sub-sectors.
- Investors who allocate active mandates to managers will need to consider whether current all-country or EM indices are appropriate for defining the universe for existing active managers, or whether separate China or China A-share mandates should be considered. The research process and skill set required for active selection within the A-share universe is likely to require significantly different approaches given the diverse conditions and factors currently driving this market.
- In any event, investors will need to consider whether existing investment approaches and risk measures sufficiently capture the different characteristics that A-shares may have compared with other sub-sectors of their investment universes.

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