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WILL PLAN SPONSORS BE READY FOR CHINA A SHARES?

US plan sponsors face a difficult challenge to generate sufficient returns to meet their long term liabilities and are increasingly tilting their portfolios overseas, with a particular interest in the economic growth engine of Asia.

However, the MSCI World indices, which have become a global institutional standard of measurement for both return opportunity and risk, have not yet fully incorporated China, creating a mismatch and a unique challenge to investors in navigating this new world order.

China is now 18.1% of global GDP[1], and over 35% of GDP growth[2]. However, it is less than 3.2% of MSCI ACWI[3] – but as indices increase the weighting of China assets, such will have profound implications for US investors.

US investors need to be ready for these changes, by understanding more about the risk/return profile of A Shares and the alpha opportunities and risks that they represent.

Why equity indices do not reflect the size of equity markets

The rules of inclusion

Investors looking at the China A Shares market through an MSCI ACWI lens would be unaware that it includes almost 3,700 stocks, many of which are disrupting the global competitive landscape, and is the second largest equity market in the world, with a market capitalization of $7.4 trillion[4].

The decision by MSCI in June 2017 to include 222 China A Shares Large Cap stocks, acknowledges that the expansion of Stock Connect has been a "game changer" for accessibility to China A Shares. However, the rules for inclusion set by MSCI have been highly limiting, with only up to 5% of the market cap of eligible A Shares stocks are allowed. Of eligible stocks, 30% are already available on MSCI via HK listings. After inclusion, A Shares will still only make up 0.73% of MSCI EM[5].

MSCI's review of A Shares will occur again in 2018. While some believe expansion will be slow – taking up to 15 years[6] - we believe that pressure for more rapid and comprehensive representation of China A Shares in global indices is coming.

If so, this would clearly have a significant impact on US investors who track the MSCI ACWI. It will require a re-evaluation of policy allocation to global equities, and how investors want managers to handle the inclusion. Do their managers understand the risks and returns and drivers of China A Shares? And do the managers fully understand the competitive implications that these companies have for other companies that might already be in their portfolio?

The Challenge for Plan Sponsors

A study by Callan Associates in 2016, found that a US plan sponsor targeting a 7.5% return would require the sponsor to invest across a minimum of 6 different asset classes, and would have a projected SD of 17.2%. Callan's forecast for 2015 – 2024 is that model portfolios will continue to become more complex and return targets harder to achieve[7].

Chart 1: Potential for Additional Qualifying Stocks

Source: MSCI, 2017

In this environment, it makes sense for US investors to increase their investment universe, and the inclusion of China A Shares would significantly expand opportunities for alpha generation and capture the risks embedded in the globally connected markets.

The key questions for US investors then are:

- How much impact will the inclusion of China A Shares have on MSCI ACWI have?
- What are the risks / returns that greater exposure to China A Shares brings to the surface?
- What skills are needed by investors to navigate China's inclusion?

The road to A Shares inclusion could be shorter and broader than anticipated

The decision to include 5% cap on eligible China A Shares opens the door for index investors but only slightly. However, we believe there are good reasons that from 2018, the inclusion process for China A Shares could progress faster and to a greater extent than many are currently forecasting.

- Firstly, China has been making steady progress in its financial reforms, and is well on its way to meeting the MSCI checklist for further inclusion. As China recognizes that steps towards market liberalization are not going to create social or economic disruption, these are likely to accelerate.
- The commitment from the 19th Party Congress in October that "China's open door will not be closed, it will be only opened wider" implies that key reforms (see Chart 4) will be implemented.
- If so, and China were to follow a similar path to inclusion of other Asian markets as they deregulated – then full inclusion and eliminating the 5% cap could take place in a few years.

MSCI has identified four main factors to determine if it will increase the allocation to A Shares in its indices:

- Resilience of Stock Connect
- Relaxation of daily trading limits
- Further progress on trading suspensions
- Lower restrictions on index-linked investment vehicles

Stock Connect continues to develop well, with over a trillion dollars in the three years since it was launched. Average daily turnover of foreign investors on Shanghai & Shenzhen exchanges flowing through Stock Connect is now around $0.63 billion, vs $0.38 billion per day in 2016[8].

Along with easing daily trading limits of USD 1.9 billion, MSCI is closely monitoring trading suspensions. Enhanced disclosure rules, and the reduction of length of suspensions down to five days, has resulted in a significant decrease in the number of these suspensions. This should make it easier for MSCI to proceed with broader inclusion in 2018.

Also, loosening pre-approval requirements by Chinese Stock Exchanges for financial products linked to China A Shares should also pave the way for index-linked investment vehicles[9].

These measures, and the commitment to further reform as evidenced by the announcement on 10 November by China to lift the 25% ceiling on foreign investment in Chinese banks, should open, we believe, a path to 100% inclusion.

The experience of others: Korea and Taiwan

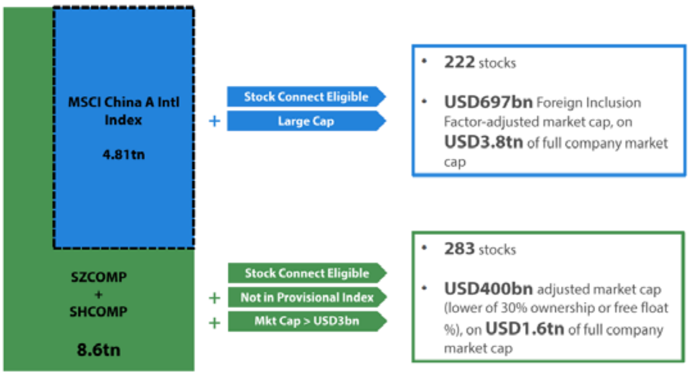
Korea's full inclusion in the MSCI Emerging Markets index took over seven years, and it is often mentioned as an example of why inclusion of China A Shares could take a long-time. Korean inclusion commenced in late 1991, when it opened trading in stocks to branches of foreign securities firms.

But there was no further significant steps taken by Korea to open capital markets until 1996, when Korea needed to meet requirements for OECD membership. This allowed foreign banks and securities firms to establish subsidiaries and phase out ownership ceiling limits.

It was not until the Asian Financial Crisis of 1997-98, that Korea fully embraced liberalization, including opening its bond, stock and money markets. As a result, MSCI moved to full inclusion of Korea in MSCI EM Index in late 1998.

In contrast to Korea, Taiwan moved aggressively to liberalize its markets between 1996 and 2001, and proceeded to full inclusion in MSCI indices over this period. Similar to Taiwan, we expect China to continue to move ahead proactively with capital market reforms that help it become a larger player in global financial markets.

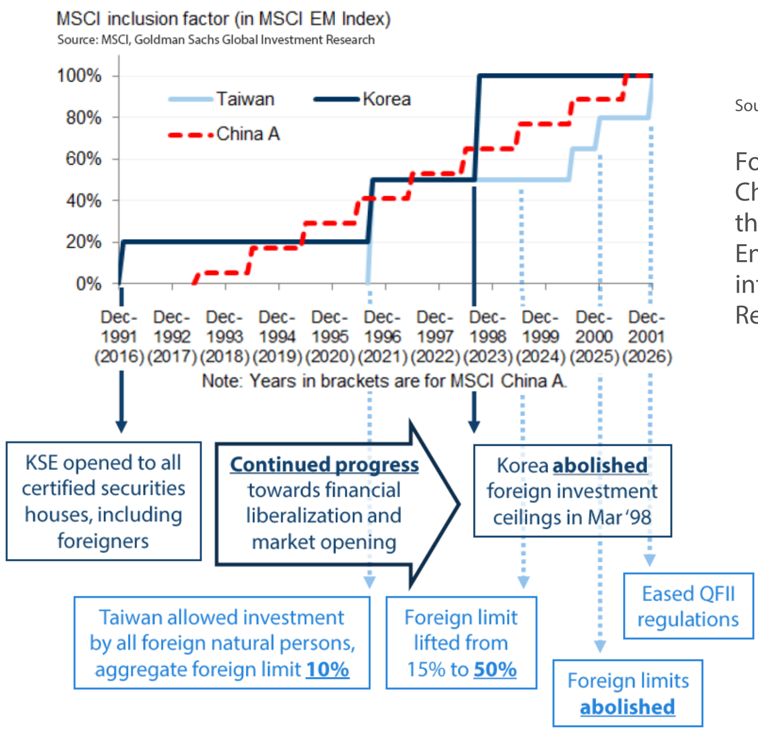
Chart 2: Potential Expansion of A Shares Inclusion



Source: MSCI, 2017

We see evidence of this in the removal of barriers that are similar to those which Korea and Taiwan previously maintained. The removal of foreign limits on insurance companies, asset management and the increasing of foreign ownership in banks to 50%, is similar to Taiwan's path. More rapid liberalization would not only address MSCI's checklist – but increase pressure for the inclusion cap of 5% to be raised to full inclusion.

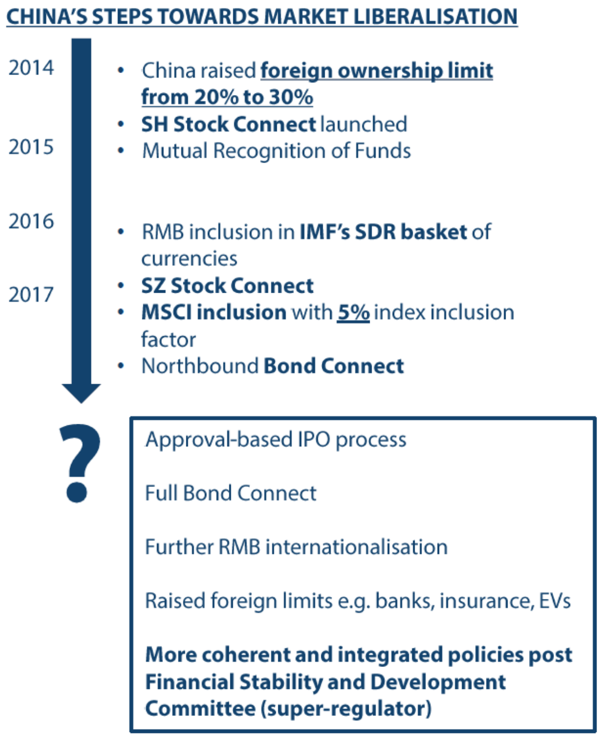
Chart 3: The Path Others Followed – China's / Korea / Taiwan



MSCI has already flagged that including Mid-Caps and increasing the 5% cap are possible next steps if Stock Connect continues to develop in a robust manner[10]. If so, an increase from 5% to allow up to the 30% foreign ownership limit could occur. If so, this would expand the market capitalization of China A stocks in the MSCI to roughly $697 billion.

The inclusion of A Shares on 30% foreign ownership basis, would put China on a similar path for inclusion as Korea and Taiwan, as MSCI lifted their limits on inclusion in line with those countries lifting caps on foreign investment. If so, China A Shares would increase from 0.73% of MSCI EM to 37.2%. Clearly, this would be a substantial change to investment opportunities in both indices.

Chart 4: Key Steps in Market Liberalisation



Source: MSCI, 2017

For US investors, this would open up greater exposure to Chinese sectors that are being driven more by domestic trends than are currently available via MSCI. For example, while Energy and Materials sectors tend to dominate China's international exposures, other key areas, such as Financials and Real Estate are far more domestically driven.

Implications of expanded A Shares inclusion for US investors

Full inclusion of China A Shares would dramatically alter both the Emerging Market as well as the Global Equity environment for US investors. It would require them to assess whether a passive or active approach is the best way to manage their allocations, and whether a specialist or generalist manager is best placed to manage these exposures. It will also make the inherent risks and return opportunities more transparent.

China A Share Returns

As part of these considerations, the move to full inclusion would open up a much broader investment universe. Sector weights within the A Shares universe tilt much more heavily towards Industrials, Materials, Consumer Staples and Health Care compared to MSCI China Index.

Similarly, full inclusion would also reweight the benchmark far more towards Mid-Small Cap than is currently accessible through the MSCI China A International Large Cap Provisional Index[11].

Both of these developments should open up significant alpha opportunities for US investors.

- Rising wealth accumulation and discretionary spending in China is driving strong increases in demand for consumer staples. Where they have a choice, Chinese consumers are exhibiting a preference for local brands. The size of the Chinese consumer markets is allowing these local brands to build scale even before they start targeting export markets.

- Increased domestic consumption, and the demographics structure in China, is also driving other sectors that can be accessed best through A Shares – such as Tourism and Healthcare.

China A Share Risks

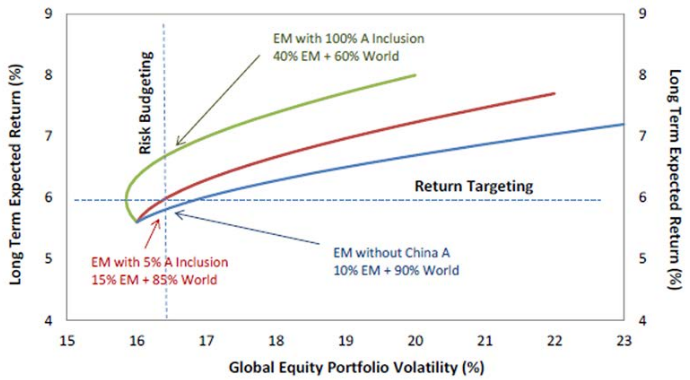
China A Shares factor exposures differ from other Emerging Market equities. The higher growth, smaller size characteristics of China A Shares have been key drivers of returns, compared other EM markets which are dominated more by large momentum stocks.

Another unique characteristic of the China A Shares has been the short cycle boom-bust phenomenon of IPOs, due to the strong demand for start-ups in China. This also reflects the significant role that retail investors play in these markets. In Shenzhen, in particular, the overall high volatility in the market is in large part driven by the price spikes associated with IPOs.

An offsetting factor to the high beta of China A Shares is that they have traditionally had a relatively low level of correlation to other markets.

According MSCI analysis, based on current dividend yields and IMF forecasts of GDP growth, at just the 5% level of inclusion, investors could have in theory increased the Emerging Market allocation from 10% to 15% and picked up a 20bp increase in returns at no extra cost in volatility. With a 100% inclusion of China A Shares into MSCI EM, and 40% weighting to MSCI EM, 60% to MSCI World – the projected investment frontier for US investors is significantly enhanced.

Chart 5: A Shares efficient frontier scenarios



Source: MSCI, June 2017

Apart from returns, there is also the ongoing issue on capital and trading controls in China. During the sell-off in China's equity markets after July 2016, many firms suspended their trading, leaving investors unable to divest. However, as noted above – the disclosure requirements and suspension limits imposed by the exchanges in China have significantly reduced this (albeit from a high base).

Another issue for some US investors is voting rights. There is a view that the quota system, given its recognition by the Chinese central bank, gave foreign investors some rights. However, this protection seems ambiguous.

The Variable Interest Entity (VIE) is another structure that allows US investors to access income streams from sectors where direct foreign ownership is prohibited, such as Internet related stocks. While the VIEs preclude voting rights, the huge capitalizations represented by VIEs mean that any threat to these structures would create a massive disruption to China's "new economy."

While the uncertainty over voting rights is an issue for investors, it is not dissimilar from the difficulties they can face in enforcing ownership rights in other markets. It should be treated as another factor in the cost / benefit of accessing A Shares.

Conclusion

Normally, the size of an economy's weight in global GDP is a strong indicator of its market cap weight in global benchmarks. In China's case, this is far from true now, but will most likely soon become so.

The rapid development of China (as with other Asian markets before it), requires index providers such as MSCI, to balance the opportunity they implicitly provide by inclusion of those countries' equities against the risks of capital controls in markets that are still liberalizing.

We believe that the cautious approach shown to date will shift to a more comprehensive inclusion approach, as market liberalization continues in China.

For US investors who believe that China will continue to be a strong driver of global growth and risks, a higher allocation to A Shares ahead of full inclusion, could help boost returns and transparency of risk management in an environment where achieving target returns for plan participants is increasingly difficult.

Footnotes

1. Statista, 2017. China: share of global gross domestic product (GDP) adjusted for purchasing-power-parity (PPP) from 2010 to 2021
2. Business Insider, June 2017. Half of expected world GDP growth in the next 2 years will come from the US and China
3. MSCI, November 2017
4. Goldman Sachs data, as of 28 April 2017
5. MSCI Press Release, Results of MSCI 2017 Market Classification Review – 20 June 2017 . 37.2% estimate is based on MSCI – Citi Research estimates as of 21 June 2017
6. Euromoney, 28 July 2017. MSCI explains next steps for China A Share inclusion
7. Callan Research Highlights Fall 2015
8. SCMP, 13 Nov 2017. Who are the winners in mainland-Hong Kong stock connect trading?
9. Seeking Alpha, 23 Jun 2017. MSCI To Add China A Shares To Emerging Markets Index: What Does It Mean For Investors?
10. Euromoney, 28 July 2017. MSCI explains next steps for China A Share inclusion
11. MSCI, June 2017. Are You Ready for China A Shares?

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