China A-Shares Added to EM Index

A cura di Kevin D. Anderson, Responsabile Investimenti Asia-Pacifico, State Street Global Advisors

What does the addition of China's USD 7.7 trillion domestic equity market1 into MSCI's emerging markets benchmark mean for global investors?

If Wuliangye Yibin or Shanghai Pudong Development Bank don't ring a bell to investors outside China, that is about to change. After four rounds of review since 2013, the index giant MSCI has finally decided that companies traded on Chinese stock exchanges — known as A-shares — should be included in the USD 1.5 trillion global MSCI Emerging Markets (EM) Index.

For China, MSCI's decision is more than a symbolic prize. Following years of carefully paced reforms to address transparency and other governance and structural issues previously cited by MSCI as reasons not to include A-shares in the EM index, this is an historic milestone along China's path to open its domestic financial markets and attract capital flows from foreign investors.

Implications for EM Investors

Various market restrictions had made A-shares hard to come by outside China, but now investors in the MSCI EM Index will automatically gain exposure in their index. Over the next 14 months, portfolios will need to be rebalanced to match the new weighting, and some institutions have already begun to re-allocate in anticipation of the change. However, the index provider is taking a gradual approach to including Chinese A-shares, perhaps reflecting persistent concerns over structural issues. The initial exposure will include 222 large cap China A-share companies, or 0.73% of the MSCI EM Index on a pro forma basis,2 with the potential for more to be added over time dependent on certain conditions being met in future.

Alleviating Lingering Concerns

In the short term, certain market policies and arrangements may continue to weigh on some investors' minds. For example, trading suspensions of China A-shares, which most recently peaked in 2015, can create challenges for investors. Chinese stock exchanges also require pre-approval of any financial products linked to China A-shares. MSCI has highlighted the potential for disruptions to offering existing financial products based on the MSCI EM Index if a Chinese exchange denies approval of MSCI's licensing of that index.

Along with capital restrictions, these concerns formed the basis of MSCI's argument against opening up the index to China A-shares in 2016. But several decisions were taken to help alleviate those concerns:

Following consultation with institutional investors, MSCI significantly scaled back the original proposal of 448 shares.

MSCI narrowed the focus of eligible stocks to those tradable through Stock Connect, which avoids having to use special programs such as the Qualified Foreign Institutional Investor (QFII) and the Renminbi Qualified Foreign Institutional Investor (RQFII).3

To allay liquidity risk concerns, MSCI has proposed to exclude or remove stocks subject to long suspension periods from the index.

Next Steps

Reservations remain over pre-approvals and technical issues related to Stock Connect, including the timely execution of trades and settlement, as well as a segregated accounts model that remains out of line with international standards. By and large, however, investors appear to be confident enough about the current framework.

As many investors will likely ponder the best pathway for accessing China in the newly reweighted MSCI EM Index, we believe long-term thinking is essential. With China continuing to pursue its reform agenda, and the domestic market now too big to ignore, China's ultimate aim of full inclusion should be the focus. China A-shares are estimated to grow to as much as 15% of the EM Index market cap, yet the timeframe for that remains uncertain. Today, the first step for many EM investors is deciding how to use the MSCI EM Index to access this new opportunity — whether through a pooled fund or directly via Stock Connect. At this point, managers with long-term experience in the region should be best equipped to help investors review their options for accessing the growth potential of China.