MSCI Includes China A-Shares in Global Equities – Investors Should Too

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MSCI Emerging Markets index (MSCI EM) turned 30 on December 31, 2017. Since its inception, the index has grown significantly in popularity, while the countries represented have evolved through improving liberalization and transparency of their capital markets. One such evolution is the availability of China A-shares1 more broadly to global investors. Beginning with just 234 companies and initially including 5% of their market capitalization into their calculations, Morgan Stanley Capital International (MSCI) is incorporating some A-shares into many of its emerging market indices. MSCI is taking a decidedly measured approach, however, even at just 5% inclusion of some of the largest A-shares traded in China, the move will create several effects in capital markets. We think these effects will be broadly positive for investors in China in the short and medium terms, and investors now have more options if they want to invest in this market.

Previously restricted from trading by non-Chinese citizens, (except a small number of pre-approved institutional investors) A-shares represent a large, liquid market which has been underrepresented in emerging market portfolios, relative to Chinese stocks traded elsewhere – MSCI China A Index, for example has a total market capitalization of USD $1.9T, while MSCI China (representing offshore-traded shares) has market capitalization of just USD $0.5T. In June 2017, MSCI announced that it will begin to include China A-shares in various indices, most notably in the flagship MSCI Emerging Markets (EM) index among others.

What is Happening?

On June 1, 2018 MSCI EM will have the first of a two-phase approach to include China A-shares in many of their benchmark EM indices. On June 1st MSCI will include 2.5% of the market capitalization of some of the largest A-shares listed companies, with the remaining 2.5% of this inclusion coming after the August 13th Quarterly Index Review at MSCI2.

Once the 5% inclusion is implemented, A-shares will represent 1% of the MSCI EM Index. While this is a small step, Mackenzie’s China Asset Management partner, China Asset Management Co. (CAMC) believes that it is just the beginning and points out that we have previously seen a similar pattern from MSCI, most notably for Taiwan and South Korea in the 1990s. CAMC points to the booms those countries experienced in the years post-inclusion as examples of what may be possible for China A-shares.

1 A-shares are the class of equity shares traded in mainland China’s stock exchanges, in Shanghai and Shenzhen
2 https://app2.msci.com/eqb/pressreleases/archive/MSCI_May18_SAIRM.pdf
What Does This Mean for Investors?

The first and most obvious effect is that the included stocks themselves will have forced buyers in index funds. While this is well telegraphed, the route to 100% inclusion is uncertain. This means the full effect of inclusion will not be completely realized in the short term, and the path there will matter significantly. In the short term, it is estimated that the move will result in approximately USD $19B of new flows into the 234 companies chosen for inclusion (see table).

<table>
<thead>
<tr>
<th>Index</th>
<th>Benchmarked Assets (US$ Billions)*</th>
<th>Post-inclusion % of A-shares</th>
<th>Estimated Inflows (US$ Billions)</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI EM</td>
<td>1,900</td>
<td>0.8%</td>
<td>15.2</td>
</tr>
<tr>
<td>MSCI ACWI</td>
<td>3,700</td>
<td>0.1%</td>
<td>3.7</td>
</tr>
<tr>
<td>Total</td>
<td></td>
<td></td>
<td>18.9</td>
</tr>
</tbody>
</table>

Source: MSCI, CICC, as of December 31, 2017.

Another, less obvious effect may be that the Chinese A-shares capital market in general experiences a longer-term rising of tides. With increased capital entering the region, there is an accompanying degree of legitimacy, marking the worthiness of those companies to investor capital. This may extend beyond the companies included in the indices in the short term. While China has already experienced high levels of growth over the past two decades (figure 2), the increased supply of capital available to companies may have an impact on its cost, thereby affecting long term company capital planning and, thus, further improving long term growth rates.

The combination of forced buying and increased capital portend a better markets experience for A-shares companies and investors alike.
How do Investors Buy China A-Shares?

China A-shares present a good investment opportunity, and a chance to diversify into this volatile, yet high-growth asset class. Most Canadian investors looking to invest in onshore China Equity will not be able to directly and will therefore need to invest in a fund with access to A-shares. While there are many China equity funds out there, few of them can connect with this market, and even fewer of them offer up a pure-play way to access it without some other residual EM exposures. At Mackenzie Investments, we offer an ETF with dedicated, pure-play China A-shares exposure: Mackenzie China A-Shares CSI 300 Index ETF (ticker: QCH). QCH tracks the CSI 300 Index, China’s onshore A-shares index, and has a management fee of just 0.65%.

Please speak to your Mackenzie representative for more information about, or for other options to invest in Chinese equity.