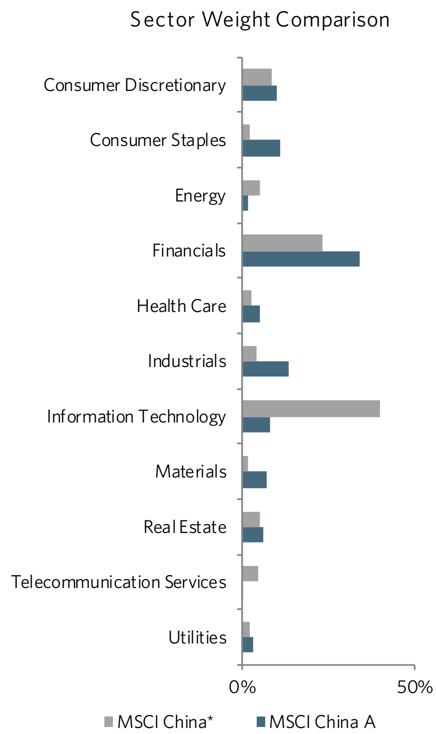
Making Way for China A: Accessing the Onshore China Equity Market

The China equity market is the second largest in the world (behind the United States) but has been historically under-represented in the MSCI Emerging Markets Index because offshore investors face challenges in accessing the onshore market. China is currently the largest country exposure in the MSCI Emerging Markets Index, with a weight of nearly 30%, and comprises 4% of the MSCI ACWI Index.[1] However, the more accurate representative weight of China in the MSCI Emerging Markets Index is estimated to be above 45%[2] after combining onshore and offshore Chinese stocks.

This weight discrepancy in the MSCI Emerging Markets Index is mainly due to the limited investor access to the entire breadth of the onshore China equity market. Historically, MSCI China has primarily included only large- and mid-sized Chinese stocks listed on exchanges outside of mainland China. In order to address this imbalance, index provider MSCI has phased in the inclusion of onshore China A shares, beginning with the most recent quarterly index rebalance in May 2018.

China A shares are local in nature and provide a more accurate representation of the domestic China market. China A shares have larger weights in financials, industrials, and consumer staples than was reflected in MSCI China prior to the addition of China A shares, as shown in Exhibit 1.

Exhibit 1: Sector Exposure for MSCI China and MSCI China A



*MSCI China before inclusion of China A shares.
Data as of April 30, 2018. Source: MSCI

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HOW HAS MSCI CHANGED THE BENCHMARK?

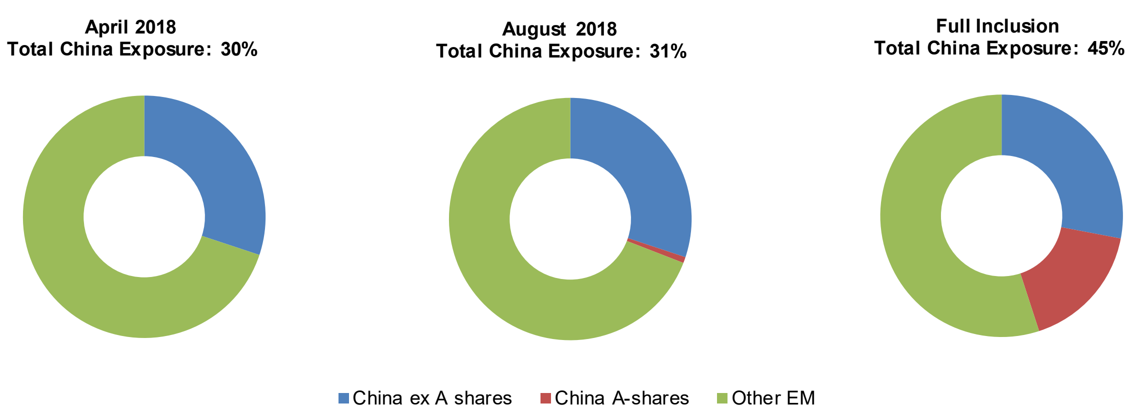
MSCI now includes more than 200 China A large-cap equity stocks in its flagship equity emerging markets and global benchmarks. The new securities are being added to the indexes in a two-step process. 2.5% of the companies' FIF-adjusted market capitalization[3] was added during the May quarterly rebalance, which will be followed by another 2.5% during the August quarterly rebalance, for a total of 5%. The weights are designed to mitigate any daily trading volume limits and provide a gradual increase in China exposure. As of the May 2018 rebalance, the China A domestic equity stocks represent approximately 0.39% of the weight of the MSCI Emerging Markets Index and about 0.05% of the global MSCI ACWI Index. Further increases are expected over time to bring China to full inclusion, as displayed in Exhibit 2.

HOW CAN INVESTORS ACCESS DOMESTIC CHINA?

Investors have historically accessed the China market via onshore or offshore approaches. Onshore equities can include A shares and B shares.

- A shares are securities incorporated in China, listed on the Shanghai or Shenzhen exchange, and are traded in renminbi (CNY). A shares are considered to be the most representative of mainland China's economy. There are approximately 3,000 Class A share companies listed on the two exchanges.
- Foreign investors can access the market through the Stock Connect Program, a cross-border trading channel between Hong Kong and the mainland exchanges. There are daily quotas/limits, and the Stock Connect Program provides a means for trading renminbi, which is otherwise restricted. Alternatively, foreign investors can access the China A market via the Qualified Foreign Institutional Investor (QFII) or RMB Qualified Foreign Institutional Investor (RQFII) approach. The QFII and RQFII programs require an application, licensure, and a trading account setup.
- B shares are securities incorporated in China and listed on the Shanghai (in U.S. dollars) or Shenzhen exchange (in Hong Kong dollars). Only A shares, not B shares, are included in the Shanghai and Shenzhen Stock Connect Program. B shares have become less popular with foreign investors with the expansion of the A shares and are mainly represented today in the MSCI small-cap universe.

Exhibit 2: Progression of China A Share Exposure in MSCI Emerging Markets Index



Source: MSCI

Offshore China equities include H shares, Red Chips, P Chips, and foreign listings.

- H shares are securities incorporated in China, listed on the Hong Kong Stock Exchange, and traded in Hong Kong dollars. There are approximately 300 companies with Class H shares.
- Red chips (state-owned Chinese companies) and P-chips (non-state-owned Chinese companies) are incorporated outside of China and also trade on the Hong Kong Stock Exchange.
- China overseas securities are listed on foreign exchanges like the New York Stock Exchange or the Hong Kong Stock Exchange.

Since these securities are traded in Hong Kong or other developed market countries, no special setup or paperwork is required.

Due to the limited overlap of offerings, investors who seek to use H shares as a proxy for A shares will see significant tracking error due to constituent and sector differences, as shown in Exhibit 1.

WHAT ARE SOME OF THE RISKS OF INVESTING IN CHINA A?

- *Quota limit risk on Stock Connect*: There is a daily maximum net buy of cross-border trades under each of the Shanghai and Shenzhen Connect exchanges.
- *Foreign shareholder limit risk*: Foreign investors are not allowed to hold more than 30% of A shares that are issued by a People's Republic of China-listed company.
- *Trading in round lots*: Investors must buy in round lots of 100 shares but can sell any amount. A purchase may get hit with an odd lot sell and a round lot trade may not be completed.
- *Trading volume*: Trading volumes are generally spread throughout the day, with a low volume at the close. While the MSCI benchmark calculates daily index returns using the closing price, the market liquidity does not favor market-on-close trading to tightly match the index.
- *Currency Risk*: The MSCI China A Inclusion Index is calculated using the Stock Connect listing based on the offshore yuan exchange rate (CNH) instead of the onshore currency (CNY). While this does not mitigate currency risk, it simplifies the currency trading process.[4]

EXPANDED OPPORTUNITY SET

MSCI's measured inclusion process will allow investors to adjust to the new onshore market and trading conventions in a risk-controlled way (i.e. small inclusion amounts in 2018) and will provide the framework over time for China to become more accurately weighted in the MSCI Indexes according to total market capitalization. While there are well-documented concerns with accessing the China A share market and the implementation is gradual, the opportunity set for institutional investors to invest in the growth of the overall China economy is significant.

ENDNOTES

1. As of April 30, 2018.
2. Source: MSCI
3. FIF is an acronym for foreign inclusion factor. Source: MSCI
4. Source: Hong Kong Exchanges and Clearing Limited, MSCI, May, 2018

PUBLICATION DISCLOSURES

Effective on January 31, 2018, The Boston Company Asset Management, LLC (TBCAM) and Standish Mellon Asset Management Company LLC (Standish) merged into Mellon Capital Management Corporation (Mellon Capital), which immediately changed its name to BNY Mellon Asset Management North America Corporation

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