Inclusion of China A-shares in the MSCI Emerging Markets Index

September 2017 | By Andrew Howson, *Senior Portfolio Manager, Global Equity Beta Solutions*

Starting in 2018, effective with the May rebalance, MSCI will include 222 large-cap, China A-shares in the MSCI Emerging Markets (EM) Index. As of the time of writing, MSCI will implement a two-step inclusion process, however this may later be revised to a single phase should the Stock Connect daily limit be abolished or significantly expanded prior to implementation.

What will happen and when are the two-steps?

The first step of the inclusion will see 222 China A-shares added with an Index Inclusion Factor (IIF) of 2.5% of their market capitalisation in the MSCI China Index. This represents a weight of approximately 0.37% in the pro forma MSCI EM Index. The second phase, currently expected to be effective at the August rebalance, increases the IIF to 5% and the weight of the China A-shares to 0.74% of the pro forma MSCI EM Index.

Does an Emerging Portfolio need to purchase China A?

With these China A-shares making their way into the MSCI EM Index, the question is, *"do you need to invest in them?"* To answer this, let's look at the numbers and the potential impact the inclusion will have on your portfolio(s).

In the MSCI EM Index there are 222 names being added which will represent 0.37% (see Figure 1) of the index. The impact to ex-ante tracking error of not holding these, all else being equal, is roughly 0.05%. The mis-weights across sectors are not material with the extremes being 0.05% underweight financials and 0.08% overweight information technology.

Gaining access to the China A market is not straightforward. If taking the Qualified Foreign Institutional Investor (QFII), or RMB Qualified Foreign Institutional Investor (RQFII) approach, a number of steps need to be completed before investing:

- Applications need to be submitted and approved for a license by the China Securities Regulatory Commission (CSRC).
- Once a license is granted an application needs to be submitted for an investment quota.
- A trading account is set up.
- After an injection of capital a local broker can be designated.

If, on the other hand, access is to be gained via Stock Connect, there are quotas in place that restrict daily volumes which means an order may not get executed if the quota is reached. Purchases are also subject to pre-funding and repatriation of settled proceeds from sales is not immediate.

What about the H-shares?

Of the 222 China A securities being added to the index 49 of those have an H-share[1] alternative. The weight of the 49 A-shares in the MSCI EM Index that have an H-share alternative is roughly 0.11% in aggregate. An option available to investors is to purchase and overweight the H-share of any company that has both listings by the value of the A-share.

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To make matters simpler, 39 of those 49 H-share securities are already constituents of the MSCI EM Index. The remaining 10 available H-shares are not constituents and would be held as non-index securities. The total weight of these 10 names amounts to roughly 0.01%. It is debatable whether their inclusion in a portfolio is worthwhile, as they will incur trading and custodian costs without any reduction in tracking error.

By purchasing the H-shares instead of the A-shares for those 39 names, and not investing in the remaining 173 A-shares, the ex-ante tracking error versus the benchmark comes down to roughly 0.04%.

What will happen in September 2018?

At this point in time, when MSCI increases the IIF of China A to 5%, the weight of China A within the MSCI EM Index will increase to roughly 0.74% (see Figure 2), with an expected ex-ante tracking error of 0.10%. Running through the above scenario of purchasing the H-share in lieu of the A-share the ex-ante tracking error falls to roughly 0.09% (from 0.10%).

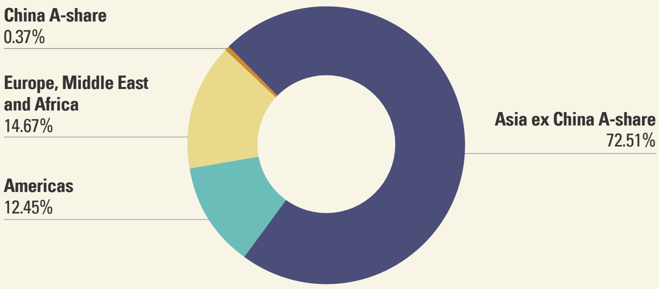
Final Considerations

There is a strong argument not to invest in China A-shares at the May rebalance when considering the costs of investing against the relatively low weight and low tracking error impact of the inclusion. The custody ticket charges, brokerage and other trading costs, to gain exposure to 222 stocks with a weight of 0.37% is an expense that could justifiably be considered too high for risk reduction of 0.04%. Even in the second phase of implementation, the cost of including 0.75% of China A-shares to reduce tracking error by 0.10% could be considered inefficient.

However, as MSCI increases the exposure to China A-shares within the MSCI EM Index, the effectiveness of H-shares as alternatives will diminish, and exposure to the China A-shares will need to be incorporated into portfolios tracking the benchmark. How quickly this will happen is unknown as MSCI has not announced any implementation plans past September. One thing is for sure, China A-shares cannot be ignored as they move towards 100% IIF and a weight of roughly 13.0% in the MSCI EM Index as Figure 3 illustrates.

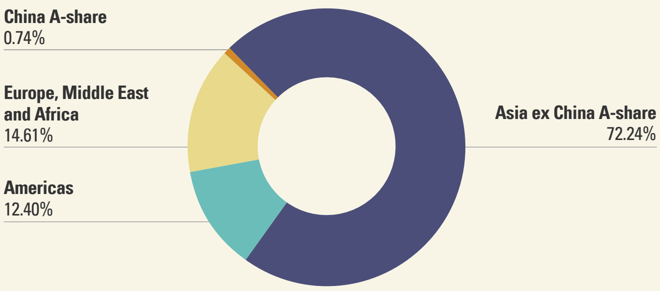
Circling back to the question of the implementation of China A large-cap shares into an emerging markets portfolio, we will be working alongside clients to determine the best approach for their portfolio(s) and our trading strategy will be tailored around those discussions.

Figure 1: Weight of China A-shares in the MSCI EM Index with 2.5% IIF



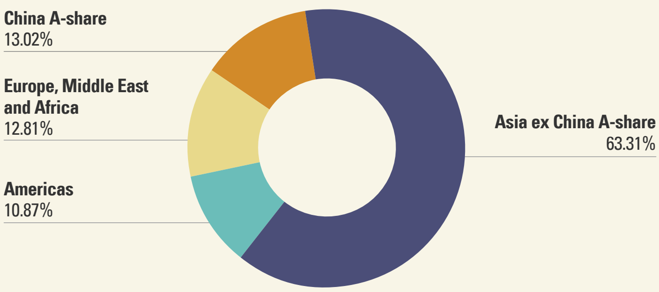
Source: FactSet, State Street Global Advisors (SSGA).

Figure 2: Weight of China A-shares in the MSCI EM Index with 5.0% IIF



Source: FactSet, SSGA.

Figure 3: Weight of China A-shares in the MSCI EM Index with 100% IIF



Source: FactSet, SSGA.

[1] H-shares are shares of a company incorporated in the Chinese mainland that are listed on the Hong Kong Stock Exchange or other foreign exchange. Source: HKEX (Hong Kong Exchanges and Clearing Limited), SSGA.

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