MSCI INCLUSION OF CHINESE DOMESTIC SHARES & IMPACT ON MARKETS

Kübra Şebnem Koldemir / Poly Consulting General Manager

Last summer, MSCI, a New York-based indexing group revealed for the first time that it will make a minor modification to its emerging markets index; it will add Chinese domestic A-shares. This year MSCI did go ahead with this decision and started including 226 China large-cap A shares to the MSCI Emerging Markets Index; in two phases: initial phase started on May 31, while the balance to be added in August.

Historically, it has been difficult for many international investors to trade these shares, but market accessibility has improved in recent years. All that said, market participants' estimates report that as a result of this decision investors who track the index will invest only about $20 bn in the Chinese shares initially, with real flows and much larger amounts invested (such as $300 bn) coming to the market on the long-term. In other words, after the initial inclusion in 2018, China A-shares will only represent 0.73% in the whole Emerging Markets Index. iThis is mere drop in the ocean compared to the actual size of the China domestic market, because the size of MSCI Emerging Markets Index, which was tracked by more than $1.9 trillion in assets, as of the end of 2017.[ii]

> *MSCI included 226 China large-cap A shares to the MSCI Emerging Markets Index in two phases: Initial phase started on May 31, while the balance to be added in August.*

Some say as a result of this decision by MSCI, Emerging Markets will never be the same in the future. They say it is a milestone that will force us to look into the future differently. Maybe this statement will be correct on the very long term. However the truth is that for now this is only a symbolic move by MSCI.

When China is included at its full weighting at a very future point in time, experts say it could make up 40% all of MSCI index. This does sound serious. Just like it sounds serious when we realize for instance that China and India together make up 35% of the whole world's population.

Most non-professional investors would go by the assumption that anything that has the designation of "emerging markets" should already be greatly weighted to China. They would be correct: the MSCI index is indeed currently 26% China. Then they would also presume that some of the stocks in that weighting would be listed on the mainland. However then they would be wrong: Until May 31th, the index had not included A-shares (those traded in Shanghai and Shenzhen in renminbi) at all. China is indeed the heaviest weighted country in the index, yet until very recently it used to happen only through shares quoted in New York and Hong Kong.

As much as China is very content with this new decision by MSCI index, the reality is that this subject is more hyped in the media than it deserves. The initial inclusion will mainly impact ETF's (passive funds) primarily, much less active investors. MSCI is making no assurances that it will intensify the weighting to a more significant level any time soon. There isn't a definite long-term timetable for how it expects to move forward. MSCI is in fact using this occasion to exercise power over China by trying to move China in the right direction.

2/3 of the companies that were just included in the index are Chinese government entities, either controlled by local or central governments. Obviously, investors make rightfully the assumption that the main goal of these entities is to serve the Chinese government rather than serving investor's interests. This is no different case in China than in many other emerging markets. Across EM, a large number of government owned entities, for instance mining or steel companies, prioritize projects that keep workers employed to avoid unrest related to unemployment rather than focusing on projects that will actually increase shareholder value. Governance does matter to institutional investors. And it matters a lot. Such state-owned companies do remain undervalued for years over years no matter how cheap valuations they trade at.

Investors know that China has some major homework to do in terms of liberalization of its mainland stock market as well as fighting government interference and corruption at state level in order to attract large amounts of investment dollars. MSCI has said further inclusion will be subject to China's moves to deregulate its capital markets, including granting foreigners more accessibility to its markets, making continued progress on trading suspensions, and further loosening restrictions on the creation of index-linked investment vehicles.[iii]

Despite the current focus on MSCI inclusion in index or not, we need to recognize that China in fact does not even need foreign capital. With its huge reserves, China is more an exporter of capital to the rest of the world. And like Japan two decades ago, it will increasingly result in new growth dynamics in other parts of Asia, which need capital to continue on their growth path. China's OBR - one belt one road - initiative and how China is willing to invest in infrastructure in other countries is the perfect example for this.

The initial inclusion will mainly impact ETFs (passive funds) primarily, much less active investors. MSCI is making no assurances that it will intensify the weighting to a more significant level any time soon.

China's transition from an export-led economy with low wages to a consumer-led economy with higher wages is continuing. A new generation of freer-spending, sophisticated consumers and the increasingly powerful role of e-commerce play an important role.

Various experts have come to different conclusions for the future: Some say, in the future, investors will no longer differentiate between developed markets vs. emerging markets. Their criteria will be to focus on companies that have strong governance vs. weak governance. Others say China will not be able to make decent progress to have gain more significance in the index citing recent foreign exchange controls and interference to defend the currency.

Some say, in the future, investors will no longer differentiate between developed markets vs. emerging markets. Their criteria will be to focus on companies that have strong governance vs. weak governance.

Our conclusion is a different one: We believe that at the moment there is a changing relevance of emerging markets with Asia going on its own growth path with lower risk premium than the rest of the EM. We believe that China is becoming increasingly more part of this trend, aligning itself with the fast–growing Asian economies and with more hope in the future to receive recognition for this progress.

This has led us to the investment insight that maybe in the future Asia may separate itself from the rest of EM. In other words, in the future there may be a need to think of EM in two buckets as opposed to only one: Asian markets, possibly combining developed and emerging markets and non-Asian emerging markets. And a possible full inclusion of Chinese domestic shares, which could bring China's exposure to 40% in the MSCI EM index would certainly be a part of this future insight.

[i] http://www.xinhuanet.com/english/2018-04/27/c_137141777.htm

[ii] https://www.cnbc.com/2018/05/14/msci-announces-234-china-a-shares-to-be-added-to-equity-indexes.html

[iii] https://www.reuters.com/article/us-china-stocks-msci-explainer/what-is-chinas-a-share-msci-inclusion-idUSKBN1HY0BO