China A share inclusion set to transform global investment landscape

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At the end of May, MSCI, the index provider, will add 233 Chinese mainland-listed stocks (A shares) to its global indices for the first time. In our view, this marks a significant step in China's integration into global stockmarkets, a process which is arguably long overdue given the size and importance of China's economy.

Up to this point, investors have been able to ignore Chinese onshore companies by focusing their attention on Chinese offshore stocks listed in Hong Kong or overseas. Foreign ownership of A shares represents just 2%. When MSCI includes A shares in their widely followed indices, they will become more prominent and investors will be obliged to pay attention.

We believe opening the door to Chinese's large domestic stockmarkets and the huge range of opportunities on offer represents an incredibly important development. The decision could eventually transform the global investment landscape and have a profound impact on investors' focus and priorities.

What is happening?

Following extensive consultation with investors and regulatory and trading changes over the past few years, MSCI has decided the time is right to include Chinese A shares in its indices. A shares are companies incorporated in Mainland China, listed on the Shanghai or Shenzhen Stock Exchange and traded in Renminbi. Until this point, access to A shares has been limited, and most foreign investors had invested in Chinese companies listed on the Hong Kong stock exchange (H shares) or on overseas exchanges such as the US stock exchange.

The reason why this decision is attracting so much attention is that China's A shares market is the second largest equity market in the world by market cap. There are around 3,500 stocks listed in Shanghai and Shenzhen, with a combined market cap of US$8.6 tn. Having access to a market this size would open up a huge opportunity set for investors that has previously been out of reach.

In addition, these companies are some of the more exciting businesses in China that are exposed to the country's continued economic development. There is a greater representation of so-called 'new economy' stocks in areas like technology, consumer discretionary and healthcare than there is in the H share market for example.

Initially, MSCI is planning to include just a small selection of A shares – 233 out of the 3,500 have been selected. They will also only have a small representation in the index as MSCI is using a 5%

inclusion factor. To begin with, A shares will just represent around 0.8% of the MSCI Emerging Markets Index. Chinese offshore stocks currently represent around 31% of the index.

Although this is a cautious first step, there will still be an impact. It is estimated that inflows to A shares will be around US$ 16bn as passive investors who track MSCI indices will be obliged to buy these shares.

Over time, there will be a significant shift in the index as the weighting of the A shares is increased. If and when the stocks are included at a rate of 100%, analysts estimate they will represent over 16% of the index. This is a larger weighting than Korea, Taiwan and India.

While the inclusion next month will have a modest impact, it is clear that eventually Chinese A shares will be a big deal for emerging market investors. They will be forced to think about how they approach China as the combined weighting of all Chinese stocks is expected to reach 40% of the index.

What are the opportunities and risks?

With 3,500 stocks, the A shares market is vast and represents an exciting source of potential investment opportunities. There are notable differences in the composition of A shares market to the types of Chinese companies available offshore. There are far more consumer-focused stocks, which provide access to the 'new economy' theme of increased consumption and services. The Shenzhen market, in particular, has significant exposure to consumer discretionary, healthcare and technology companies. These companies are growing rapidly with high levels of earnings growth.

Given the size of the opportunity set and the lack of coverage by analysts, we believe there will inevitably be scope for selective stockpickers to identify attractive investments.

The challenge investors face in the A share market in our view comes down to two aspects: valuations and corporate governance.

We believe A shares are expensive. The tech-focused Shenzhen market in particular trades on an elevated valuation. We think this partly related to the fact the market is dominated by retail investors. As the market opens up and institutional investor involvement increases, valuations may become more reasonable. However, at present, we still see greater value among H shares.

Another concern we have about the A shares market is corporate governance standards. In our view, the quality of management, shareholder focus and transparency at mainland companies are generally pretty poor. In our experience, these issues make it hard for investors to truly understand how a company operates and allocates capital.

Even MSCI has warned investors that the companies being added to the MSCI Emerging Index have low Environmental, social and corporate governance (ESG) ratings compared with other stocks in the index.

We have noted some improvement in the quality of A share companies and it is likely that more interest from overseas and institutional investors will lead to further improvements.

Long-term transformation

The impact of MSCI's A shares inclusion is unlikely to be felt immediately. In our view, the change is largely symbolic for the time being but it has the potential to become a significant development as the weighting in the index increases. As China has become an increasingly important force in the global economy, China's stockmarket is arguably destined to become an increasingly large part of investors' portfolios.

While there are an enormous range of opportunities on offer in mainland China, our research has not yet identified a company that meets our valuation and corporate governance criteria. We will continue to look for attractive investments but currently we think there are more opportunities in Chinese stocks listed in Hong Kong and offshore.