MSCI

Research Insight

“A” Opening to the Great Wall

Implications of China’s Changing Equity Landscape

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Executive Summary

The China A-share market has witnessed tremendous expansion over the last two decades. Today, the Shanghai and Shenzhen stock exchanges have more than 2,400 stocks with a total market capitalization of about USD 3.5 trillion dollars. However, despite the establishment of China's Qualified Foreign Institutional Investor (QFII) scheme over 10 years ago, foreign participation currently accounts for only slightly more than one percent of the market capitalization. The low proportion of foreign ownership is largely due to the stringent requirements of the QFII system and the slow deployment of the QFII quota.

Recently, the Chinese equity landscape has started to change. Since the end of 2011, the Chinese authorities have embarked on a series of efforts to accelerate the opening of the Chinese domestic capital market. As access barriers fall away, China A-shares could soon become a viable investment opportunity set for global investors. This raises critical questions:

1) what are the investment implications of increasing access to the A-share market
2) what are the principal opportunities and obstacles to investing in China A-shares today
3) what are the key considerations for a global investor in constructing a comprehensive China equity portfolio

In an extreme hypothetical case, if China's domestic equity market were to fully open up to foreign investors with no major accessibility restrictions, our estimates show that the A-share market could potentially comprise 14% of the MSCI Emerging Markets Index—larger than the weights of Korea, Brazil or Taiwan. Further, China's total weight in the MSCI Emerging Markets Index could rise from the current 18% to about 30%. Given the potential impact of further market liberalizations, foreign investors who are not well-positioned for this change could be caught short in the process. It must be emphasized, however, that the inclusion of China A-shares in the MSCI Emerging Markets Index remains a hypothetical scenario at this point as major accessibility obstacles—notably capital mobility restrictions—continue to exist.

Due to the unique structure of the China A-share market, a broad-based portfolio based on the MSCI China A Index is the most effective option for capturing the diverse and dynamic opportunities of A-shares over the long run. In the short run, however, with constraints of a limited QFII quota allocation, the overlapping exposures and valuation differences of A- and H-shares, a "completion" portfolio based on A-shares could represent an efficient alternative for global investors.

In this short note, we seek to cast a comprehensive light on the implications of opening the China A-share market to global investors. The paper is organized in the following sections. In section I, we survey the landscape of China equities. In section II, we review the recent developments of the China QFII scheme and highlight its implications for global institutional investors. In section III, we examine the characteristics of various segments of China equity opportunities and examine the possible implementation options for portfolio construction.

Landscape of China Equity Investment Opportunities

Understanding the China equity investment opportunity set requires an appreciation of the complexity of different China share classes. Today, most international investors gain exposure to China through the freely accessible H-shares, Red Chips and P chips, all listed in Hong Kong, and through the B-shares listed in Shanghai and Shenzhen. These share classes are currently captured in the MSCI China Index, which is

a component of the MSCI Emerging Markets Index. Share classes are differentiated primarily by their respective countries of incorporation, listing venues, ownership structures and in some cases, the geographical breakdowns of revenues and assets. For example:

- *H-shares* are China securities incorporated in the People's Republic of China (PRC), listed on the Hong Kong Stock Exchange and traded in Hong Kong dollars.
- *Red Chips* refer to China securities that are not incorporated in the PRC, but that are listed on the Hong Kong Stock Exchange and (directly or indirectly) controlled by organizations or enterprises that are owned by the state, provinces, or municipalities of the PRC.
- *P Chips* are China securities owned by PRC individuals, incorporated outside PRC and listed on the Hong Kong Stock Exchange. These companies typically derive a majority of their revenues from the PRC and/or have the majority of their assets located in the PRC.
- *B-shares* are China securities incorporated in China and listed on the Shanghai Stock Exchange (in US dollars) or Shenzhen Stock Exchange (in HK dollars).

As of July 31, 2012, these four share classes collectively represented approximately 42% of the total China investment opportunities as proxied by their index market capitalization weights.

Of the remaining 58%, a small number of China securities (about 3%), such as Baidu, Netease and Sina, are listed on exchanges in the United States, Singapore, or other markets.

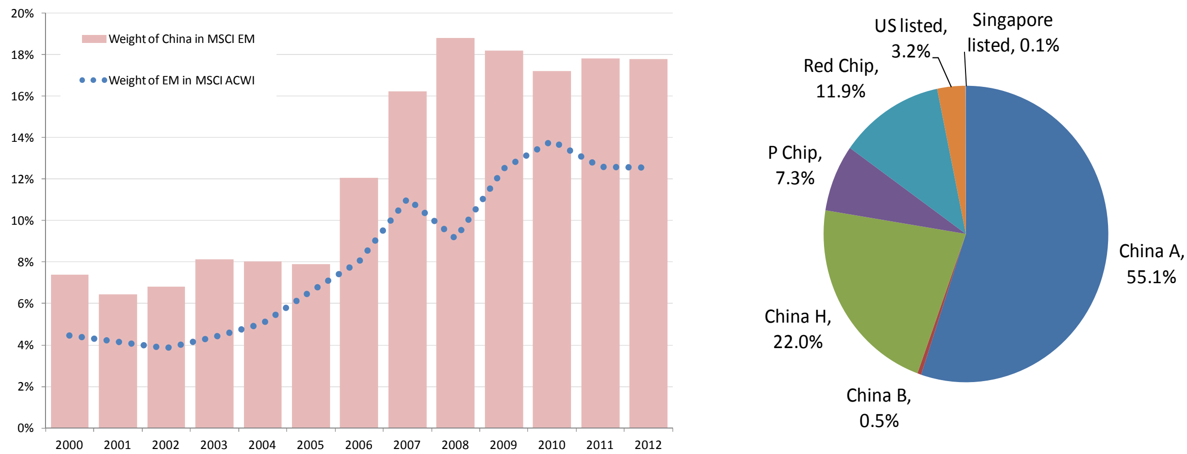
China A-shares, which comprise the remaining 55% of the total China equity opportunity set, are securities listed on the Shanghai or Shenzhen Stock Exchanges and traded in Renminbi. Presently, China A-shares are only accessible by foreign investors via the QFII scheme, mutual funds operated by managers with a QFII quota or through the participation in the A-share ETF products listed mainly in Hong Kong. The MSCI China A Index, which proxies this share class, is yet to be part of the MSCI Emerging Markets Index due to the QFII restrictions on foreign investor access.

Exhibit 1: Characteristics of the Various China Share Classes in the MSCI All China Index

MSCI Index	MSCI China A	MSCI China				MSCI Overseas China
Share Class	A	H	B	Red Chip	P Chip	Oversea Seas
Characteristics	--	--	--	PRC government linked	PRC enterprises deriving majority of assets and revenue from PRC	PRC enterprises deriving majority of assets and revenue from PRC
Country of Incorporation	PRC	PRC	PRC	Outside PRC	Outside PRC	--
Stock Exchange	SSE and SZSE	HKeX	SSE and SZSE	HKeX	HKeX	NYSE, NASDAQ, NYSE AMEX. SGX
Quoted Currency	RMB	HKD	USD/ HKD	HKD	HKD	USD/ SGD
# constituents Standard/ Small Cap	540/1165	65/43	4/59	29/47	45/181	8/52
Index mcap Standard/ Small Cap ($bn)	771/241	308/8	6/8	167/13	102/38	45/8
Index wgt in MSCI EM Standard/ Small Cap	--	9.4%/1.8%	0.2%/1.8%	5.1%/3.0%	3.1%/8.9%	--
Top 3 sectors	Financials 30.7% Industrials 16.3% Materials 13.8%	Financials 36.7% Energy 17.8% Telecom. Services 14.0%				Info Tech 86.5% Cons Disc11.8% Industrials 1.7%
Weight of top 10 securities	17.1%	53.4%				100.0%
Inception date	Nov 30, 2004	Dec 31, 1992				Sep 7, 2011
History since	Dec 31, 2000	Dec 31, 1992				May 31, 2008

Source: MSCI, data as of July 24, 2012.

Exhibit 2: The Increasing Weight of China within the Global Investment Opportunity Set



Source: MSCI. Left chart: based on year end data for each year except for year 2012, which is as of July 31, 2012.
Right chart: Shows index market cap data as of July 31, 2012. The weight of the MSCI China A Index in the pie chart is calculated based on the domestic free float-market capitalization which does not factor in the restriction on foreign ownership. Today, China A-shares have a foreign ownership limit of 30%.

The continuous expansion of China investment opportunities over the years has played an important role in contributing to its rising importance in a global portfolio. Today, with an index weight of 18%, China is already the largest component country in the MSCI Emerging Markets Index. This weight predominantly reflects China securities listed in Hong Kong and does not include domestic A-shares. The growing significance of China can also be observed at the company level. Fifteen years ago, the largest companies in the world all came from developed markets. Today, four out of the top 25 largest companies are Chinese (Exhibit 3).

Exhibit 3: World's 25 biggest companies, 1997 vs 2012

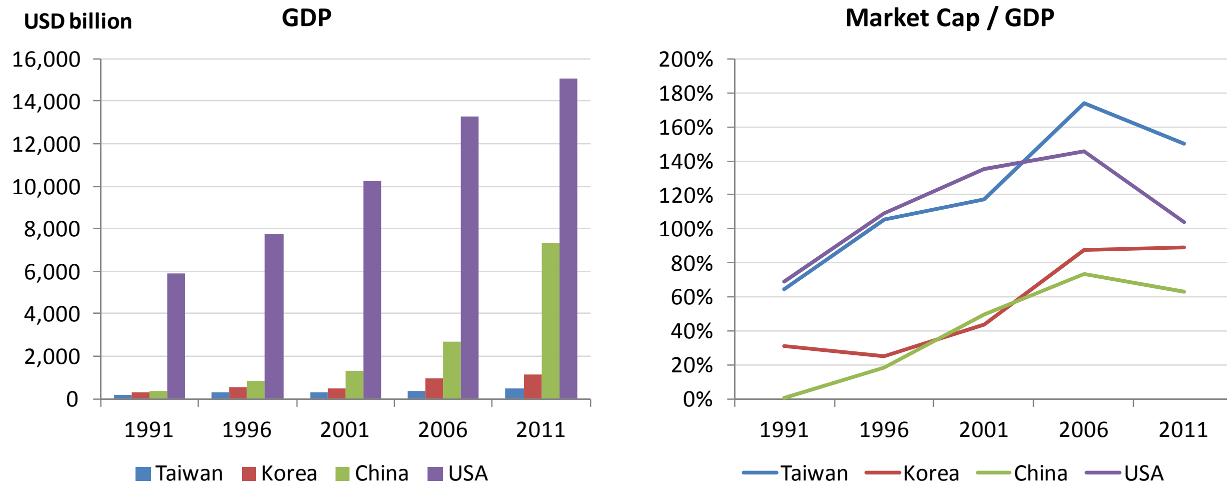
	Year 1997		Year 2012	
Rank	Company name	Country	Company name	Country
1	GENERAL ELECTRIC CO	USA	APPLE	USA
2	COCA-COLA CO	USA	EXXON MOBIL CORP	USA
3	MICROSOFT CORP	USA	PETROCHINA	CHINA
4	EXXON CORP	USA	WAL-MART STORES	USA
5	MERCK & CO	USA	MICROSOFT CORP	USA
6	ROYAL DUTCH PETROLEUM CO	NETHERLANDS	CHINA MOBILE	CHINA
7	INTEL CORP	USA	IBM CORP	USA
8	NTT CORP	JAPAN	ROYAL DUTCH SHELL	UNITED KINGDOM
9	PHILIP MORRIS COS	USA	GENERAL ELECTRIC CO	USA
10	TOYOTA MOTOR CORP	JAPAN	CHEVRON CORP	USA
11	PROCTER & GAMBLE CO	USA	BERKSHIRE HATHAWAY	USA
12	IBM CORP	USA	AT&T	USA
13	NOVARTIS NAMEN	SWITZERLAND	GOOGLE	USA
14	AT & T CORP	USA	ICBC	CHINA
15	PFIZER	USA	NESTLE	SWITZERLAND
16	BRISTOL-MYERS SQUIBB CO	USA	JOHNSON & JOHNSON	USA
17	WAL-MART STORES	USA	PROCTER & GAMBLE CO	USA
18	JOHNSON & JOHNSON	USA	PFIZER	USA
19	GLAXO WELLCOME	UNITED KINGDOM	WELLS FARGO & CO	USA
20	LILLY (ELI) & CO	USA	COCA-COLA CO	USA
21	AMERICAN INT'L GROUP	USA	SAMSUNG ELECTRONICS CO	KOREA
22	BRITISH PETROLEUM	UNITED KINGDOM	CHINA CONSTRUCTION BK	CHINA
23	BELL ATLANTIC CORP	USA	NOVARTIS	SWITZERLAND
24	ROCHE HOLDING GENUSS	SWITZERLAND	PHILIP MORRIS INT	USA
25	LLOYDS TSB GROUP	UNITED KINGDOM	ORACLE CORP	USA

Source: MSCI. Data as of July 31, 2012

As the economy grows, the role of public capital market typically becomes more important. One natural question worth exploring would be where does the development of the China equity market stand today and could there be room for further expansion. To gain insight on this, we look at the current

stage of the public equity market versus the size of the economy and contrast it with the historical development of other emerging and developed economies. One observation is that although the market capitalization to GDP ratio of China has grown overtime, it is still low when compared to other emerging and developed economies. As of 2011, the ratios for Korea, Taiwan and the USA were 93%, 150% and 100% respectively, while China was only at 60%. Based on the experience of other countries, it may suggest that there are still potential rooms for China’s capital market to grow.

Exhibit4: MSCI Market Classification Framework



Source: GDP data based on World Bank and IMF. Market capitalization to GDP data for Korea and USA is based on World Bank. Market capitalization of Taiwan is based on Taiwan Stock Exchange, while market capitalization for China includes both domestically listed and Hong Kong listed companies, and is calculated based on Shanghai and Shenzhen Stock Exchanges and Hong Kong Stock Exchange.

China QFII Scheme and Its Recent Revisions

When the Shanghai and Shenzhen Stock Exchanges were established in the early 1990s, the domestic China equity market was characterized by stringent regulation and tight capital controls. Inflows and outflows of assets were highly restricted and foreign investors were confined to the B-share market. In 2002, as part of its plan to attract more foreign capital, the China Securities Regulatory Commission (CSRC) piloted the Qualified Foreign Institutional Investor (QFII) scheme allowing licensed foreign investors to participate in the domestic A-shares market. With an initial quota of USD 30 billion divided among all investors, the initial QFII investor requirements (USD 5 billion minimum AUM and at least 5 years of operation) and investment quotas (a maximum of USD 1 billion per institution) were severely limited. At the end of 2011, there were only 135 licensed QFII investors with a total QFII quota deployment of USD 21.5 billion.

In 2011, CSRC initiated a series of modest steps to further open up the domestic China A-shares market to foreign investors. The total QFII quota was raised to USD 80 billion from USD 30 billion dollars and a new Renminbi Qualified Foreign Institutional Investor (RQFII) scheme of RMB 20 billion was introduced in late 2011 and later raised to RMB 70 billion in April 2012.

In July 2012, the CSRC also lowered the QFII qualification requirements for different groups of investors which:

- reduced the minimum operation requirement from 5 years to 2 years;

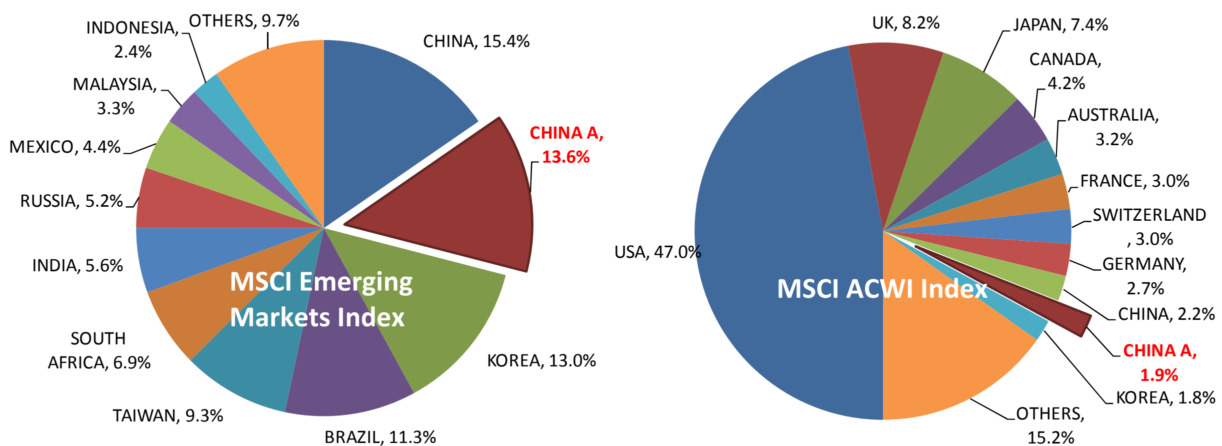
- lowered the minimum AUM from USD 5 billion to USD 0.5 billion for insurance companies, asset management institutions and other institutional investors;
- expanded the investment scope of QFIIs to include additional types of assets;
- increased the foreign ownership limit from 20% to 30%; and
- streamlined the QFII application process (see further details in the Appendix).

In addition, there were also notable improvements in the speed of the QFII license approval and quota granting process. In 2012 the State Agency for Foreign Exchange (SAFE) approved almost USD 9 billion of QFII quota in 2012 (through September) bringing the aggregated approved quota to USD 31 billion to date.

Implications of Opening A-shares to Global Investors

As the liberalization of the China QFII scheme continues, potentially a growing number of global investors may be allowed to participate in the A-shares market, treating it as part of their investment universe. In the extreme hypothetical case, if the quota system were to be abolished and various accessibility restrictions lifted, we estimate that China A-shares could represent up to 14% of the MSCI Emerging Markets Index[1]. In combination with the currently accessible MSCI China Index, China could have a free float market capitalization weight of close to 30% in the MSCI Emerging Markets Index. Exhibit 5 shows the impact of a hypothetical full inclusion of the MSCI China A Index in the MSCI Emerging Markets Index and in the MSCI ACWI Index which includes both developed and emerging markets.

Exhibit 5: Hypothetical Inclusion of China A-shares in the MSCI Emerging Markets Index (left) and in the MSCI ACWI Index (right)



Source: MSCI. Data as of July 24, 2012

[1] Based on the MSCI Market Classification Framework, a full inclusion in? MSCI Emerging Markets Index can only be achieved if the market is open and accessible to global institutional investors without significant investment restrictions and by meeting a majority of the market accessibility measurements. This is still not the case with the MSCI China A Index today. The pro forma index weight of 14% is estimated based on the free float-adjusted market capitalization of the existing MSCI China A Index assuming a 30% foreign ownership restriction.

The information included in Exhibit 5 is calculated based on the current level of market capitalization. As highlighted in the previous section, the market capitalization ratio to GDP of China is still modest in comparison to other emerging and developed economies. If the China economy continues to expand and the pace of privatization and equitization of corporations accelerates, China A-shares could potentially assume a much larger weight within the MSCI Emerging Markets Index. One significant implication of such a move would cause investors with a current market neutral exposure to China to become significantly underweighted in China; they would need to rapidly rebalance their portfolios to regain their market neutral exposure to China.

We must emphasize, however, that the numbers highlighted in Exhibit 4 remain hypothetical in the current context as international investors continue to experience significant restrictions in accessing the China A-shares market. Based on the current QFII rules, investment capital must be remitted within 6 months upon receiving the quota approval and principal capital can only be repatriated after a minimum period of 3 months to a year, depending on the type of financial institution. Such capital mobility restrictions are problematic as they can severely hamper the flow of funds in the investment process. The capital remittance rule limits the investor's flexibility in timing and getting into the market and the capital repatriation restrictions impact the investor's ability to service redemptions and rebalance portfolios. For international mutual fund managers, the lack of a liquidity mechanism to address daily fund flows is critical as it can impede smooth fund operations and lead to increased tracking error. From MSCI's perspective, these kinds of capital mobility restrictions are among the key factors that prevent a reclassification of China to emerging markets status.

In addition, the limit of individual quota of USD 1 billion is problematic especially for very large investors. In our previous hypothetical scenario, where the MSCI China A Index was included in the MSCI Emerging Markets Index, many large institutional investors would have found it difficult, or nearly impossible, to align their portfolios to the increased hypothetical market weights. For example:

- One of the largest ETFs based on the MSCI Emerging Markets Index had assets under management (AUM) of USD 41 billion (November 2012). To fully replicate an inclusion of the MSCI China A Index in the MSCI Emerging Markets Index would have required an individual quota of more than USD 5 billion.
- The largest global asset manager today has an equity allocation of USD 1.77 trillion (September 2012). If this manager were to allocate to emerging markets based on the weight of the MSCI Emerging Markets Index (approximately 13%) in the MSCI ACWI Index, the allocation would total approximately USD 230 billion. As such, the QFII quota limit of USD 1 billion per qualified institution would translate to less than 50 basis points of allocation to China A-shares—a small fraction of the 14% hypothetical weight of China A-shares in the MSCI Emerging Markets Index.

In addition to the capital mobility and QFII quota restrictions, another frequently highlighted concern is the lack of clarity regarding the tax treatment of capital gains for offshore A-share investors. This uncertainty has forced many investment managers to set aside a capital provision for future tax obligations, which in turn, has affected portfolio tracking error.

Apart from the restrictions mentioned above, which are specific to QFII investors, there are further market accessibility issues that exist. For example, the lack of both an efficient offshore Renminbi market and a tight clearing and settlement time cycle of t + 0, has the potential to require the prefunding of security trades. Prefunding can exacerbate tracking error and is particularly problematic during portfolio rebalancing.

As illustrated in Exhibit 6, the MSCI Market Classification Framework focuses on three major factors for categorizing a market: (1) the sustainability of its economic development, (2) the size and liquidity of its

equity market, and (3) its market accessibility from the perspective and the experience of global investors as actually reported. While the China A-share market meets the size and liquidity requirements[2] of the MSCI classification scheme in comparison to other global emerging markets, the China A-shares market fares poorly when assessed in terms of market accessibility. Before a reclassification to an emerging markets status can be considered, capital mobility restrictions associated with fund remittance and repatriation will need to be significantly relaxed or abolished. Further examples of accessibility issues can be found in the Appendix.

Exhibit 6: MSCI Market Classification Framework

Criteria	Frontier	Emerging	Developed
A Economic Development			
A.1 Sustainability of economic development	No requirement	No requirement	Country GNI per capita 25% above the World Bank high income threshold* for 3 consecutive years
B Size and Liquidity Requirements			
B.1 Number of companies meeting the following Standard Index criteria	2	3	5
Company size (full market cap) **	USD 449 mm	USD 898 mm	USD 1796 mm
Security size (float market cap) **	USD 33 mm	USD 449 mm	USD 898 mm
Security liquidity	2.5% ATVR	15% ATVR	20% ATVR
C Market Accessibility Criteria			
C.1 Openness to foreign ownership	At least some	Significant	Very high
C.2 Ease of capital inflows / outflows	At least partial	Significant	Very high
C.3 Efficiency of the operational framework	Modest	Good and tested	Very high
C.4 Stability of the institutional framework	Modest	Modest	Very high

* High income threshold for 2010: GNI per capita of USD 12,276 (World Bank, Atlas method)
** Minimum in use for the May 2012 Semi-Annual Index Review, updated on a semi-annual basis

Implementing China Exposure

For many QFII investors, the principal motivation for investing in China A-shares is to seek comprehensive exposure to the China opportunity set. A well-diversified A-share portfolio—as proxied by the MSCI China A Index, for example—can provide broad coverage of the dynamic underlying opportunity set and bring benchmark consistency to an equity policy framework based on the MSCI ACWI or MSCI ACWI IMI Indices. This kind of broad-based approach can help position investors for the potential integration of China A-shares into the MSCI Emerging Markets Index and avoid possible benchmark misfits going forward.

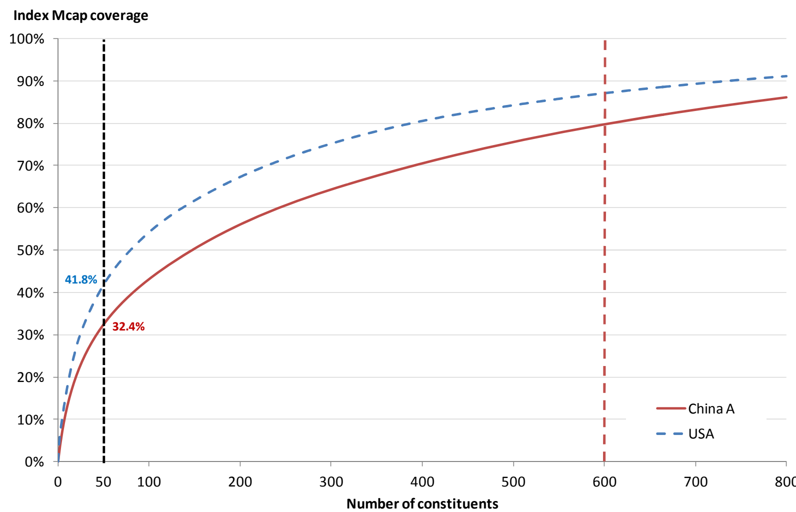
For other QFII investors with a limited QFII quota allocation and that are mindful of the overlapping exposures and valuation differences of A-shares and H-shares, a "completion" strategy may serve as an attractive transition approach. These investors might complement their existing China portfolios with an allocation to an A-share portfolio that avoids any overlapping exposures.

To understand why a broad-based A-share portfolio is essential in the context of building a representative A-share portfolio, it is important to consider the unique structure of the China market. Exhibit 7 shows the cumulative free float market capitalization of the China A-share and the USA

[2] Sustainability of economic development is not a criterion for the MSCI Emerging Markets Index.

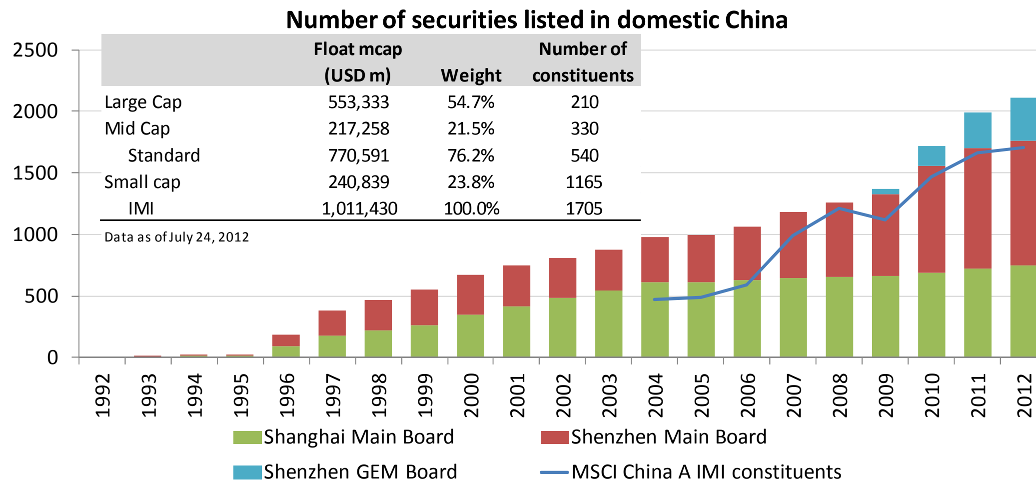
markets. The China A-share market is characterized by a very flat structure. For a given number of securities, the MSCI China A Index has a lower free float market capitalization coverage than the MSCI USA Index. Specifically, the top 50 stocks today represent less than one-third of the A-share free float market capitalization whereas a similar top 50 portfolio in the USA would have achieved a representation of 40%. Therefore, an investor who wishes to capture the full diversity of A-share companies (say, with at least 80% coverage of the total market) would require a portfolio of at least 600 stocks (before screening for investability requirements) compared to 400 stocks for the USA. Given this unique structure of China’s A-share market, an A-share portfolio would need to be broad-based in nature to be representative.

Exhibit 7: Cumulative Free Float Market Capitalization.



Another reason for investors to consider a broad-based approach is that the China A-share market is one of the fastest growing equity markets in the world. As highlighted in Exhibit 8, the number of listed securities in the domestic China market expanded rapidly over the last two decades. A result of this fast-paced growth is that a fixed number stock portfolio may initially capture a significant proportion of the total stock market, it will likely lose its effectiveness (i.e., its breadth, coverage, and representativeness) over time. A top 300 stock portfolio that may have captured 86% of the free float-adjusted market capitalization in 2005, for example, would have seen its representation shrunk by almost one-third, or to 60%, in 2012. Today, a 300-stock portfolio in the A-share market is unlikely to be considered representative and would only become less and less effective should the market continue its expansion.

Exhibit 8: Rapid Expansion of the Domestic China Equity Market and the Evolution of the MSCI China A Indices



Source: MSCI, Bloomberg

The MSCI China A Indices have been dynamically capturing the expansion of the China A-share market for close to a decade. Launched in 2004 to represent the large and mid cap segments of the market based on a sampling methodology, the MSCI China A Indices transitioned to the MSCI Global Investable Market Indices Methodology in 2009 aiming to capture a fixed proportion of the investable opportunity set and extending coverage into the small cap segment. As of July 2012, the MSCI China A Index has 540 large and mid cap constituents and the MSCI China A Small Cap Index includes just under 1,200 securities.

The dynamic nature of the China A-share market is also illustrated in the evolution of its sector exposures (see Exhibit 9). In 2005, the largest sectors in the MSCI China A Index were Industrials (22%), Materials (19%) and Financials (15%). Today, the largest sectors are Financials (31%), followed by Industrials (16%) and Materials (14%). China’s unique industry profile and fast-changing industry structure pose particular challenges and risks for narrow portfolios such as one consisting of just the top 50 largest stocks. While Financials would have represented approximately 25% of a top 50 portfolio in 2005, today it would represent 60%. In addition, this top 50 portfolio would have no representation in Information Technology and would significantly underweight two of the other largest sectors in the China A market (i.e., Industrials and Materials). While a narrowly designed portfolio may be an efficient tool for achieving quick exposure to the underlying market, it suffers from critical limitations in the context of building a representative portfolio.

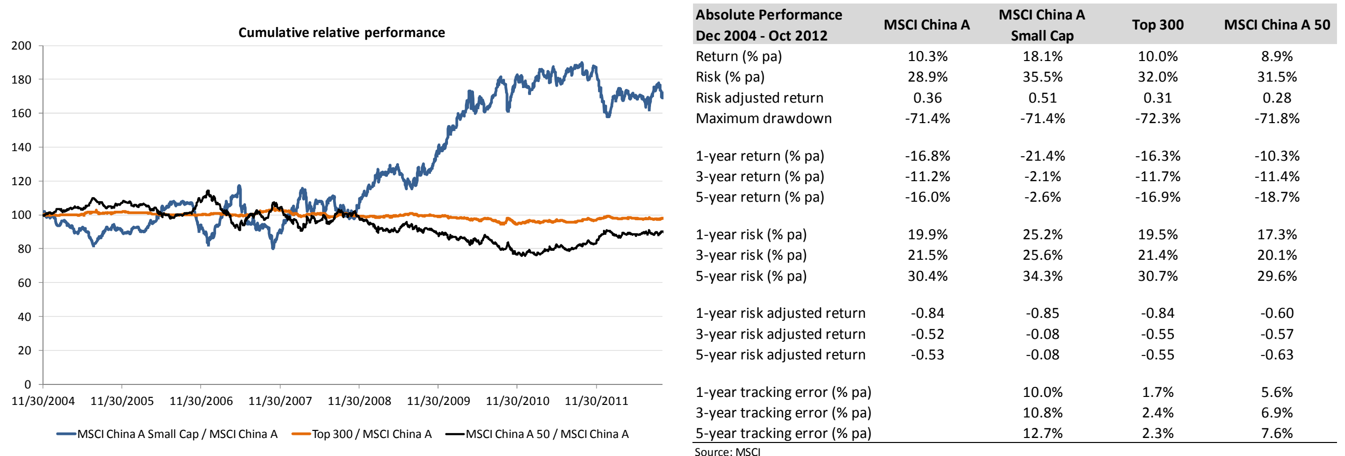
Exhibit 9: Evolution of the Sector Exposure of the MSCI China A Index vs. the MSCI China A 50 Index

	Oct-05		Oct-12	
Sector weight	**MSCI China A**	**MSCI China A 50**	**MSCI China A**	**MSCI China A 50**
Consumer Discretionary	13%	7%	10%	7%
Consumer Staples	6%	7%	9%	11%
Energy	5%	5%	7%	7%
Financials	15%	24%	31%	55%
Health Care	3%	1%	7%	2%
Industrials	22%	15%	16%	6%
Information Technology	6%	5%	4%	0%
Materials	19%	16%	14%	8%
Telecommunication Services	3%	6%	1%	1%
Utilities	9%	14%	3%	2%

Source: MSCI

Exhibit 10 shows the relative performances of different A-share portfolios and their tracking errors against the MSCI China A Index since its inception (December 2004). The MSCI China A Index had a rather similar return profile to the Top 300 portfolio, but with lower risk. The MSCI China A 50 Index, on the other hand, displayed a different return profile, underperforming the MSCI China A Index by 1.4% per annum and reflecting both the poorer performance of large caps and the concentration in Financials. Note that small cap A-share stocks significantly outperformed their large cap and mid cap counterparts since late 2008. This highlights yet again the value to investors in capturing the full diversity of the A-share opportunity set.

Exhibit 10: Relative Performance Comparisons against the MSCI China A Index



Absolute Performance Dec 2004 - Oct 2012	MSCI China A	MSCI China A Small Cap	Top 300	MSCI China A 50
Return (% pa)	10.3%	18.1%	10.0%	8.9%
Risk (% pa)	28.9%	35.5%	32.0%	31.5%
Risk adjusted return	0.36	0.51	0.31	0.28
Maximum drawdown	-71.4%	-71.4%	-72.3%	-71.8%
1-year return (% pa)	-16.8%	-21.4%	-16.3%	-10.3%
3-year return (% pa)	-11.2%	-2.1%	-11.7%	-11.4%
5-year return (% pa)	-16.0%	-2.6%	-16.9%	-18.7%
1-year risk (% pa)	19.9%	25.2%	19.5%	17.3%
3-year risk (% pa)	21.5%	25.6%	21.4%	20.1%
5-year risk (% pa)	30.4%	34.3%	30.7%	29.6%
1-year risk adjusted return	-0.84	-0.85	-0.84	-0.60
3-year risk adjusted return	-0.52	-0.08	-0.55	-0.57
5-year risk adjusted return	-0.53	-0.08	-0.55	-0.63
1-year tracking error (% pa)		10.0%	1.7%	5.6%
3-year tracking error (% pa)		10.8%	2.4%	6.9%
5-year tracking error (% pa)		12.7%	2.3%	7.6%

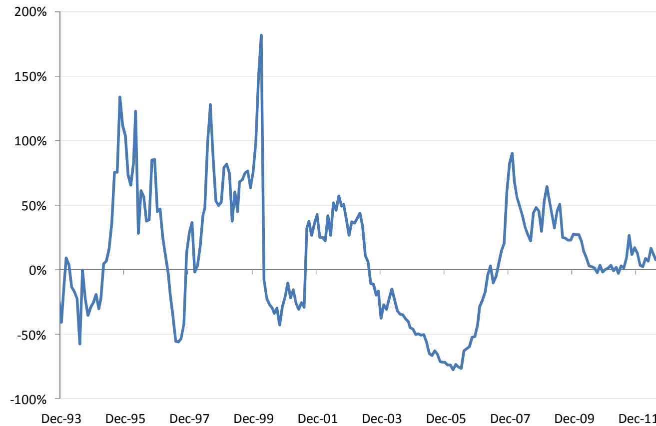
Source: MSCI

The A-Share Completion Portfolio Concept

One unusual feature of the China market is that many large Chinese companies have traditionally raised capital both domestically (via the A-share markets) and internationally (via Hong Kong in the form of H-shares). While the A-shares and H-shares of the same company receive similar economic rights, they do not always trade in price parity. In practice, we find that the A/H premium, defined as the price of A-shares over H-shares of the same company after accounting for the exchange rate differential, has historically been volatile and currently stands at 8%[3] (Exhibit 11).

[3] Among the possible explanations for the continued existence of the A/H premium include: the non-fungibility of the two share classes; the absence of a perfect arbitrage mechanism due to shorting constraints, the cross-border capital mobility restrictions; the different degrees of market openness; and the influences of other geographic-specific factors.

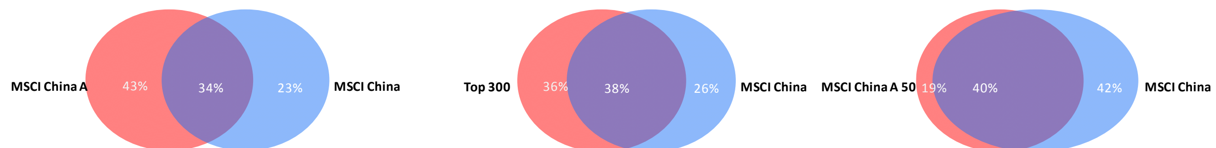
Exhibit 11: Historical A/H Premium



Source: MSCI

The existence of the A/H premium has important investment implications for international investors who already have exposure to China (mainly through Hong Kong listed China companies which are included in the MSCI China Index). For example, an investor can acquire around 70% of the largest 50 China A-share companies by purchasing their often cheaper Hong Kong listed counterparts. (There have been some periods, however, when A-shares traded at a discount to H-shares). Exhibit 12 shows the overlapping exposure of selected onshore China A-share portfolios against the offshore China portfolio proxied by the MSCI China Index. The analysis demonstrates that a broad-based portfolio such as one that is proxied by the MSCI China A Index has less overlapping exposure and is more effective in capturing the unique A-share investment opportunities.

Exhibit 12: Overlapping Exposure between the Onshore MSCI China A Index and the Offshore MSCI China Index



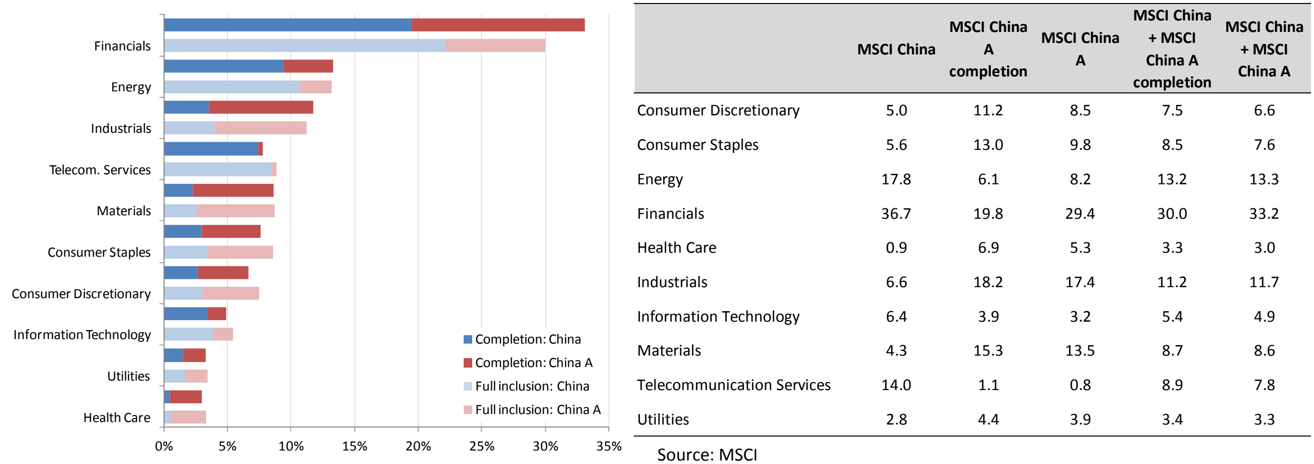
# of securities	494	92	97	255	90	98	31	38	124
Index mcap (USD m)	582	460	311	436	460	315	173	363	382
% of A share index (%)	56	44	--	49	51	--	32	68	--
% of MSCI China A (%)	--	60	40	--	59	41	--	49	51

Source: MSCI

The unique structures of A- and H-shares can be exploited in the construction of a China portfolio. For investors with a limited QFII quota allocation and who wish to deploy capital efficiently, an A-shares completion portfolio with no overlapping exposure to their existing China portfolio may serve as an appealing alternative in the current phase of market development in China. Exhibit 13 illustrates the portfolio characteristics of a China A-shares completion portfolio versus the MSCI China A Index. The combination of the MSCI China Index plus the China A-shares completion portfolio displays a slightly

different sector profile than the MSCI China Index, a proxy for the typical global investor’s China exposure. Specifically, it overweights the Consumer Discretionary, Consumer Staples, Industrials, Health Care and Materials sectors, but underweights Financials, Telecommunication Services and Energy. Interestingly, the combination of the MSCI China Index plus the A-shares completion portfolio produces a very similar sector profile to the MSCI China Index plus the MSCI China A Index and can therefore serve as a framework for gaining comprehensive China exposure.

Exhibit 13: Sector Exposure of a Completion China A Portfolio Compared to One Assuming Full Inclusion of the MSCI China A Index



	MSCI China	MSCI China A completion	MSCI China A	MSCI China + MSCI China A completion	MSCI China + MSCI China A
Consumer Discretionary	5.0	11.2	8.5	7.5	6.6
Consumer Staples	5.6	13.0	9.8	8.5	7.6
Energy	17.8	6.1	8.2	13.2	13.3
Financials	36.7	19.8	29.4	30.0	33.2
Health Care	0.9	6.9	5.3	3.3	3.0
Industrials	6.6	18.2	17.4	11.2	11.7
Information Technology	6.4	3.9	3.2	5.4	4.9
Materials	4.3	15.3	13.5	8.7	8.6
Telecommunication Services	14.0	1.1	0.8	8.9	7.8
Utilities	2.8	4.4	3.9	3.4	3.3

Source: MSCI

Investors who do not currently meet the QFII qualification requirements or who would like to make an allocation to China A-shares that exceeds their current quota can potentially do so either through a “borrowed” QFII quota from brokers, through mutual funds offered by managers with a QFII quota, or through the various offshore A-share ETFs[4] listed predominantly in Hong Kong. More recently, the growing number of A-share ETFs offered under the RQFII scheme provides investors with further choices for constructing A-share portfolios.

[4] The offshore A-share ETFs can be generally classified into two groups: 1) *synthetically replicated ETFs* created through a broker’s QFII quota and 2) *physically replicated ETFs* offered through the RQFII scheme. The main differences lie in the structure of the ETFs and ownership of the QFII/RQFII quota. Managers of synthetic ETFs do not own the quota. Instead, they replicate portfolio positions using access products offered by QFII brokers. The creation and redemption of ETF units are executed through brokers and in turn the brokers issue notes to the managers. In contrast, RQFII ETF managers own the quota directly and can therefore physically replicate the ETFs with actual A-share holdings without an intermediary. In addition, most of the RQFII ETFs are traded in dual-currency, i.e., in Renminbi and Hong Kong dollars, offering international investors convenient access for A-share exposure.

Conclusion

Over the last two decades, the China capital market has been transformed in terms of size, issuance, and access. Recent changes in the QFII regulations have brought global investors additional access to the China market and have raised their hopes for more. Even before accounting for A-shares, China already comprises the largest country weight in the MSCI Emerging Markets Index today; its importance in a global emerging markets portfolio is likely to rise as the A-share market continues its path to liberalization. Investors who are not well prepared for this progressive market liberalization could be caught short in the process.

The latest QFII revisions represent a welcome step in this respect. However, market accessibility restrictions—particularly with regard to capital mobility—continue to affect many global investors and prevent China from formal recognition as part of the investable opportunity set in major global benchmark indices. Investors need to thoroughly examine and understand the consequences of such market restrictions and the associated risk before accessing the China A-shares opportunity.

In the context of building a representative China portfolio, investors should fully understand the dynamics of the Chinese equity market. The China A-share market has expanded rapidly and is likely to continue to grow in terms of size and issuance. To successfully capture these diversified opportunities, an A-share portfolio should ideally be broad-based and dynamic in nature. Due to the unique structure of the China A-shares market, a narrow portfolio is less effective in capturing the economic exposure of the underlying market and could submit investors to considerable concentration and tracking risk. We have also demonstrated the significant size effect in the A-share market where large cap stocks have underperformed their small cap counterparts in recent years, suggesting that a broad-based portfolio may be the more efficient way to benefit from the full opportunity set. Moreover, investors should be aware of how an A-shares completion portfolio can help to exploit the historical existence of an A/H shares premium as a unique feature of the China equity market. Finally, there have been some significant developments in the landscape of offshore A-share ETFs providing non-QFII investors with easy and cost-efficient ways to gain access to the China A-share market.

To conclude, the continuing liberalization of the China A-share market is an important trend that is likely to persist and significantly affect the opportunity set of global investors in the nearer-term future. While the pace of opening this market will depend on regulatory developments in China, investors should take care to consider how best to prepare for and capitalize on the changing China investment landscape.

Appendix A—Details of Recent Revisions to the China QFII Scheme

Types of QFIIs	Existing Requirements	Revised Requirements
Banks	Top 100 Banks	10 years exp, Capital > USD 300m, AUM > USD 5bn
Insurance companies	5 years exp, AUM > USD 5bn	2 years exp, AUM > USD 0.5bn
Asset management institutions	5 years exp, AUM > USD 5bn	2 years exp, AUM > USD 0.5bn
Other institutional investors (pension, trust, foundations)	5 years exp, AUM > USD 5bn	2 years exp, AUM > USD 0.5bn
Securities companies	30 years exp, AUM > USD 10bn	5 years exp, Net Assets > USD 500m, AUM > USD 5bn

Development areas	
Operational convenience	• Allowed to open multiple securities accounts & select multiple brokers
Investment scope and constraints	• Invest in China's inter-bank bond market stock index futures • QFIIs are also allowed to participate in bonds issued by small and medium-sized enterprises
Foreign Ownership Limit	• Increase from 20% to 30%
QFII application process	• Accelerated and simplified • Electronic submission • Enhanced transparency
Types of QFIIs Investors	• Private equity are allowed
Transaction fees	• Transaction costs cut by 20%

Appendix B—Examples of Investment Obstacles of the Current China QFII Scheme

Investor Type	Investment Process	Qualifications requirements of QFIIs	The transparency & the duration of initial QFII license and quota approval	Country quota ceiling of $80bn	Individual quota ceiling of $1bn per QFII
Asset Managers (Passive)	Replicate the index portfolio with minimum tracking error and active risks		Low tolerance on long duration of application process due to the need to replicate index position closely Certainty for getting QFII license	Provision of daily liquidity (inflows/outflows) is a critical consideration for asset managers. A restrictive investment quota could present severe risks to their ability to service liquidity need	
Asset Managers (Active)	High discretion over asset allocation process Freedom to deviate from from the benchmark to express investment views Ability to go both long and short	Larger players should meet the QFII requirements under the newly proposed changes; However, Smaller players may not be able to participate thereby creating an unlevel playing field	A bit more flexibility	Same as above	Implementing active investment views could result in an over/underweight allocation to a country. A fixed quota represents a severe restriction to manager's ability to implement their investment views
Broker Dealers	Trading execution, liquidity facilitation, Investment product creation incl. structured products, total return swaps & etc		Low tolerance	Limit their ability for liquidity facilitation	
Asset Owners	Investment process is typically long term, asset allocation, internal/outsourcing, cash flow and liability management		Investment Policy Consideration	Same as managers	Same as managers
Hedge Funds	Much more active involving long and short	Not Applicable			

Investor Type	Repatriation restrictions	Quota remit period of 6 months	Currency convertibility	Clearing and settlement at t + 0
Asset Managers (Passive)	Affect the ability to service redemptions and rebalance portfolios		Global investors tend to rebalance their FX trade at London 4pm. No offshore FX liquidity at this time will contribute to tracking error	Potentially lead to pre-funding issues and is extremely problematic during rebalancing
Asset Managers (Active)		Prolonged capital lock up will be an important consideration in the current challenging environment Impact the ability to accommodate change in investment views	Less concern since active manager have the flexibility of timing of executing their FX trades	Lower concern since investors are allowed to deviate from benchmark weights but it still creates stress in trading execution
Broker Dealers	Create issues in managing cash flow		Similar to passive managers	Similar to passive managers
Asset Owners	Affect the ability to service liability Restrict asset allocation rebalancing		Shared similar concern to both passive and active managers	Similar to asset managers
Hedge Funds	Not Applicable			

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[1] *As of June 30, 2011, based on eVestment, Lipper and Bloomberg data.*