Research Insight

"A" Opening to the Great Wall

Paving the Way to China

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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 2,500 stocks with a total market capitalization of about USD 3.9 trillion. However, despite the establishment of China's Qualified Foreign Institutional Investor (QFII) scheme over 10 years ago, foreign participation accounts for only slightly more than one percent of the market capitalization as of the end of 2011. The low proportion of foreign ownership has been largely due to the stringent requirements of the QFII system and the slow deployment of the QFII quota.

Over the past few years, the landscape has started to evolve. 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. Notable measures included i) the increase of the total QFII quota limit from USD 30 billion to USD 150 billion, ii) the relaxation of entry requirements and liquidity restrictions for QFII investors and the iii) introduction of the Renminbi Qualified Foreign Institutional Investor (RQFII) scheme in Hong Kong. More recently, the RQFII scheme has further expanded to Taiwan, London and Singapore, providing alternative channels for international investors to access the mainland China A-share market. As a result of these changes, the number of qualified (QFII + RQFII) investors has more than doubled from 135 as of the end of 2011 to close to 300 as of the end of December 2013.

As access barriers fall away, China A-shares could soon become a viable investment opportunity set for global investors. The potential inclusion of A-shares in global indexes raises critical questions:

1) what are the investment implications of the 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 response to the expanding access, MSCI initiated a review in June 2013 to consider the potential inclusion of China A-shares in the MSCI Emerging Markets Index. In an extreme hypothetical case, if the A-shares market were to fully open up to foreign investors with no major accessibility restrictions, our estimates show that it could potentially comprise up to 13% of the MSCI Emerging Markets Index. To put this number in perspective, the weight of A-shares alone could be larger than the weight of many large EM countries such as Brazil, Russia, India or Taiwan. Further, China's total weight in the MSCI Emerging Markets Index could rise from the current 20% to 30%. Given the potential impact of further market liberalizations and new IPOs, the share of China in the MSCI Emerging Markets Index could easily surpass 30%. Foreign investors who are not well-prepared for such a change could be caught short in the process. It must be emphasized, however, that a full inclusion of China A-shares in the MSCI Emerging Markets Index remains a hypothetical scenario at this point as accessibility obstacles—such as the existence of a quota system and stringent capital mobility restrictions—continue to exist.

In this paper, 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 in the opening of the China A-share market and the implications for global institutional investors. In section III, we examine the characteristics of various segments of the China equity opportunity set and highlight their implications 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, listed in Hong Kong, and 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:

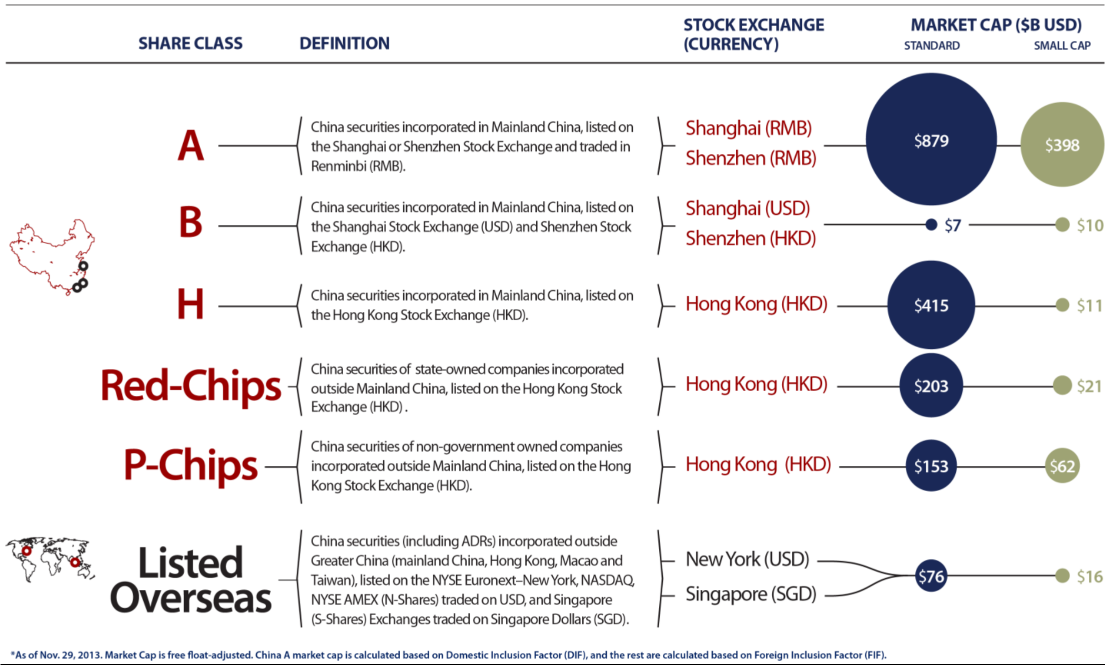
- *H-shares* are China securities incorporated in the People's Republic of China (PRC), listed on the Hong Kong Stock Exchange and traded in Hong Kong (HK) dollars.
- *Red Chips* refer to China securities that are not incorporated in the PRC, but that are listed on the Hong Kong Stock Exchange and (directly 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 the end of November 2013, these four share classes collectively represented approximately 45% of the total China investment opportunities as proxied by their index market capitalization weights.

China A-shares, which comprise the remaining 51% of the entire 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 to foreign investors via the QFII or RQFII schemes, through mutual funds operated by managers with a QFII quota or through the participation in the A-share ETF products listed outside mainland China. The MSCI China A Index, which proxies this share class, is yet to be represented in the MSCI Emerging Markets Index.

The remaining 4% are represented by a small number of China securities such as Baidu, Netease and Sina are listed on exchanges in the United States, Singapore, or other markets.

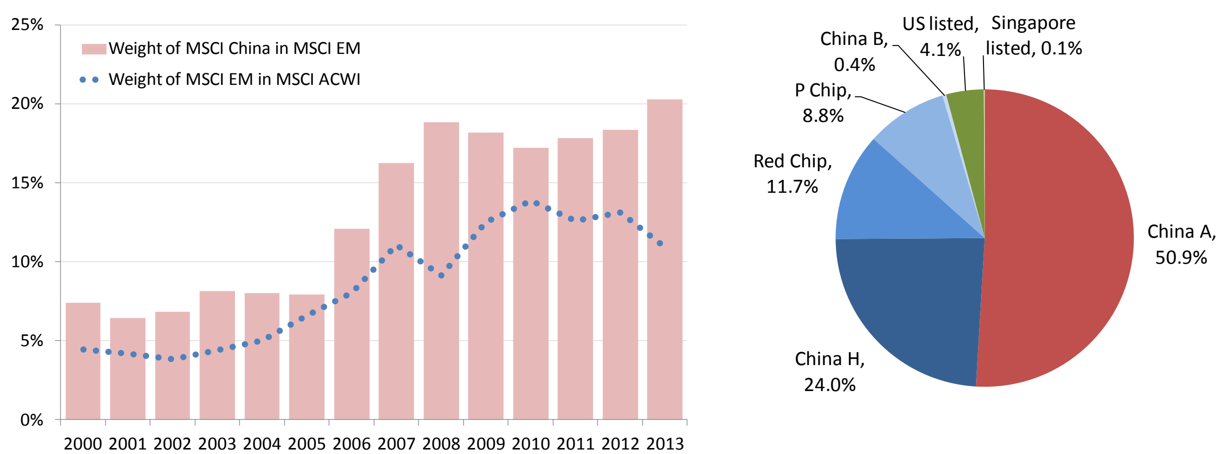
Exhibit 1: Characteristics of the Various China Share Classes in the MSCI All China Indexes



Source: MSCI, data as of end of November 2013

As shown in Exhibit 2, the continuous expansion of China investment opportunities over time has contributed significantly to its importance in a global portfolio. Today the MSCI China Indexes already the largest component country in the MSCI Emerging Markets Index, with a weight of 20% excluding domestic A-shares.

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 2013, which is as of end of November 2013.
Right chart: Shows index market cap data as of end of November 2013. 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 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).

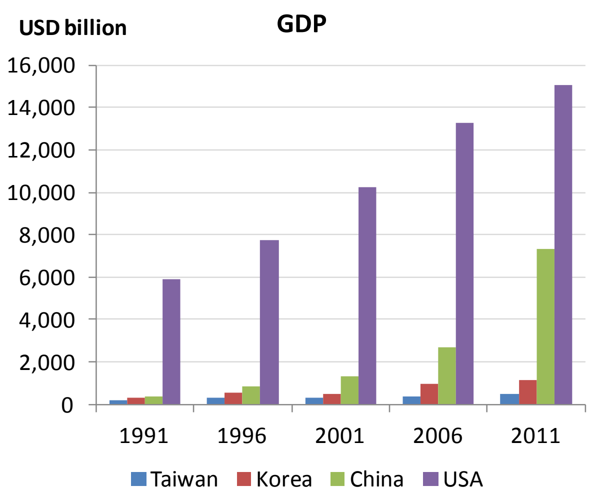
Exhibit 3: World's 25 biggest companies, 1998 vs 2013

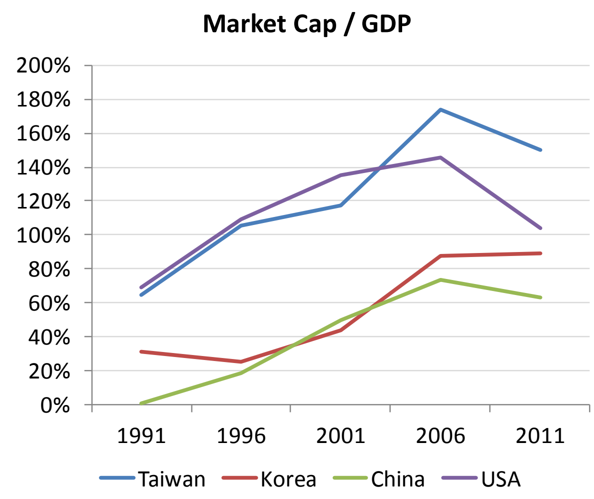
	Year 1998		Year 2013	
Rank	Company name	Country	Company name	Country
1	MICROSOFT CORP	USA	APPLE	USA
2	GENERAL ELECTRIC CO	USA	EXXON MOBIL CORP	USA
3	INTEL CORP	USA	GOOGLE	USA
4	WAL-MART STORES	USA	MICROSOFT CORP	USA
5	EXXON CORP	USA	BERKSHIRE HATHAWAY	USA
6	MERCK & CO	USA	GENERAL ELECTRIC CO	USA
7	PFIZER	USA	JOHNSON & JOHNSON	USA
8	IBM CORP	USA	WAL-MART STORES	USA
9	COCA-COLA CO	USA	ROCHE HOLDING GENUSS	SWITZERLAND
10	LUCENT TECHNOLOGIES	USA	CHEVRON CORP	USA
11	CISCO SYSTEMS	USA	NESTLE	SWITZERLAND
12	AT & T CORP	USA	PETROCHINA CO	CHINA
13	BRISTOL-MYERS SQUIBB CO	USA	WELLS FARGO & CO	USA
14	PHILIP MORRIS COS	USA	PROCTER & GAMBLE CO	USA
15	MCI WORLDCOM (WORLDCOM)	USA	SAMSUNG ELECTRONICS CO	KOREA
16	GLAXO WELLCOME	UNITED KINGDOM	ICBC	CHINA
17	NOVARTIS NAMEN	SWITZERLAND	CHINA MOBILE	CHINA
18	PROCTER & GAMBLE CO	USA	ROYAL DUTCH SHELL	UNITED KINGDOM
19	CITIGROUP	USA	JPMORGAN CHASE & CO	USA
20	JOHNSON & JOHNSON	USA	TOYOTA MOTOR CORP	JAPAN
21	ROYAL DUTCH PETROLEUM CO	NETHERLANDS	NOVARTIS	SWITZERLAND
22	SBC COMMUNICATIONS	USA	PFIZER	USA
23	BANKAMERICA CORP (NEW)	USA	HSBC HOLDINGS	UNITED KINGDOM
24	TOYOTA MOTOR CORP	JAPAN	CHINA CONSTRUCTION BK	CHINA
25	AMERICAN INT'L GROUP	USA	IBM CORP	USA

Source: MSCI. Data as of end of November 2013.

As an economy grows, the role of the public capital market typically becomes more important. One natural question to explore is where the development of the China equity market stands today and whether there is room for further expansion. To gain insight on this, we can look at the current stage of the China public equity market versus the size of its economy and contrast this ratio with the historical development of other emerging and developed economies. Although China's market capitalization to GDP ratio has grown overtime, it is still low when compared to other emerging and developed economies. For example, as of 2011 the ratios for Korea, Taiwan and the USA were 93%, 150% and 100% respectively, while the ratio for China was only 60%. The examples suggest that there is still potential room for China's capital market to grow, especially considering the large pipeline of Chinese companies waiting to go public.

Exhibit 4: The Growing Role of Public Capital Markets as Economies Develop





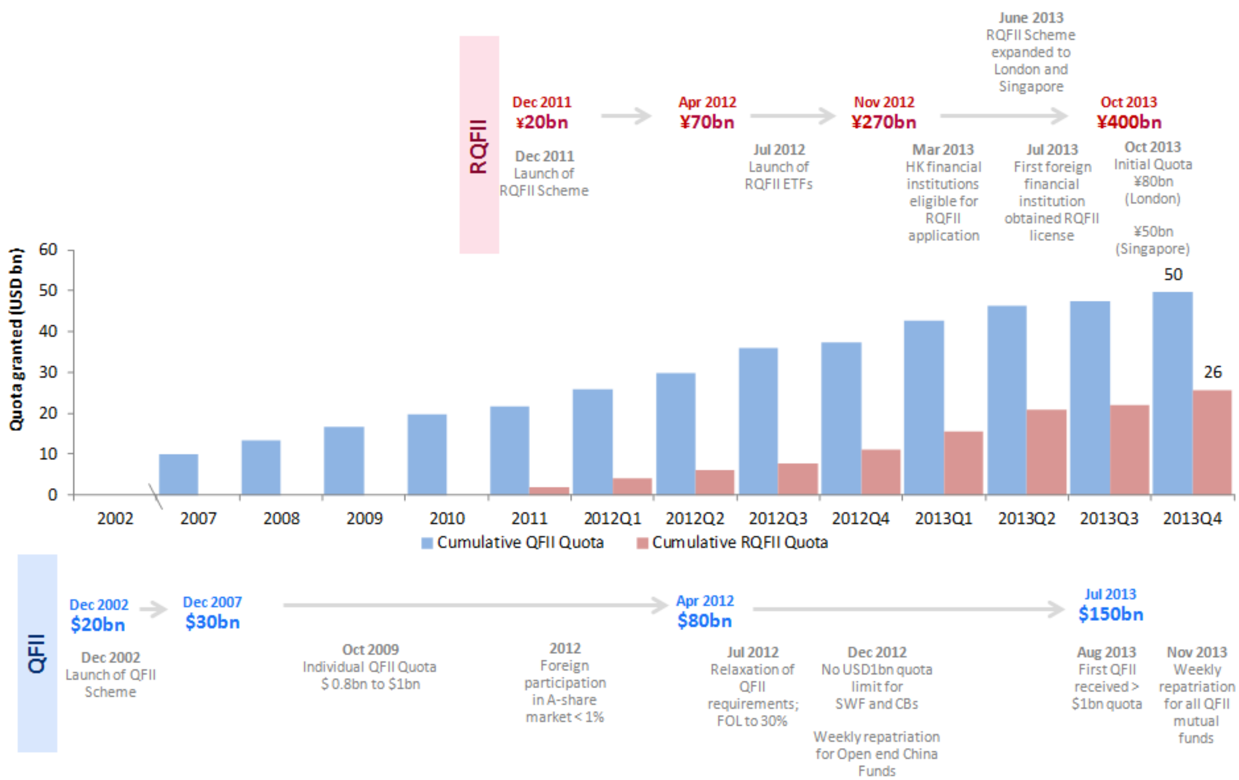
Source: GDP data based on World Bank and IMF. Market capitalization to GDP data for Korea and USA is based on World Bank. Market capitalization of Taiwan is based on Taiwan Stock Exchange, while market capitalization for China includes both domestically listed and Hong Kong listed companies, and is calculated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

Developments of the China QFII and RQFII Schemes

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) and the State Administration of Foreign Exchange (SAFE) piloted the Qualified Foreign Institutional Investor (QFII) scheme allowing licensed foreign investors to participate in the domestic A-shares market. The initial QFII investor requirements (USD 5 billion minimum AUM and at least 5 years of operation) and investment quotas (country level of USD 20 billion and a maximum of USD 1 billion per institution) were severely limited. By the end of 2011, there were only 135 licensed QFII investors with a total QFII quota deployment of USD 22 billion.

The pace of liberalization has picked up significantly since 2012 as the Chinese regulators initiated a series of steps to further open up the China A-shares market to foreign investors. Exhibit 5 summarizes the key developments of the China QFII and RQFII schemes.

Exhibit 5: Developments of the China QFII and RQFII Schemes



On the QFII scheme front, the total QFII country quota was raised from USD 30 billion in 2007 to USD 80 billion in 2012 and again increased to USD 150 billion in 2013. 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).

This was followed by a removal of the individual QFII quota limit of USD 1 billion for central banks and sovereign wealth funds. In December 2013, the SAFE also made an amendment to the capital mobility restriction by shortening the repatriation period from one month to one week for all open-ended QFII funds, effectively providing open-ended global funds a greater degree of capital mobility. In addition, there were also notable improvements in the speed of QFII license approvals and quota granting processes. From 2012 to 2013, the SAFE has approved almost USD 28 billion of QFII quota, effectively doubling the quota granted in the previous decade and bringing the aggregated approved QFII quota to USD 50 billion.

The advances in the QFII scheme should be viewed in conjunction with the rapid development of the RQFII scheme. Starting as a pilot scheme at the end of 2011 with an initial quota of RMB 20 billion, the RQFII scheme was intended to serve as an alternative access channel to the China capital market by taking advantage of the large deposit base of Renminbi in Hong Kong. At the beginning, the RQFII scheme limited its participation to a small group of Hong Kong subsidiaries of Chinese brokers and fund management companies by allowing them to offer Renminbi-based investment products. However, in the span of 24 months, a number of significant changes have taken place:

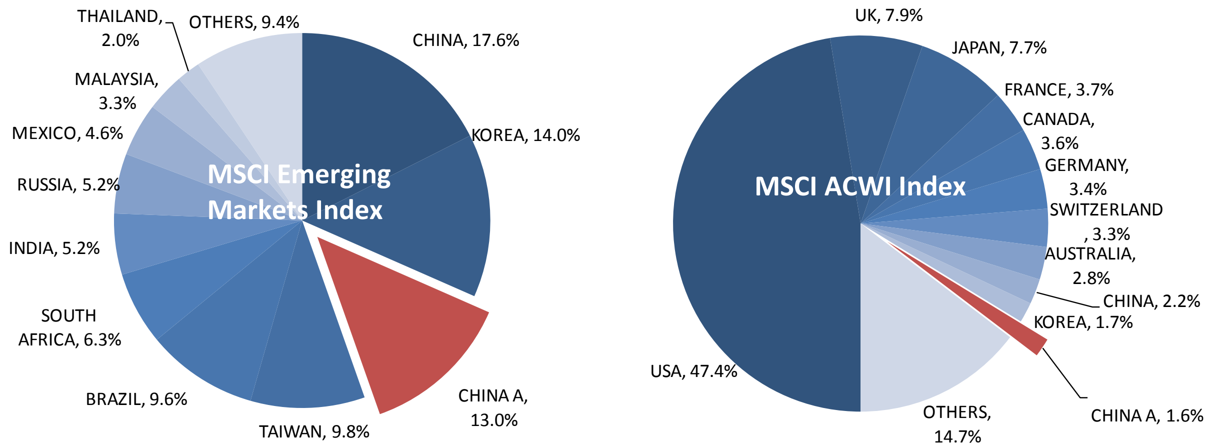
- The RQFII quota increased on three separate occasions to RMB 400 billion (or USD 66 billion, which is approximately 40% of the total current QFII quota)
- Non-Chinese financial institutions incorporated in Hong Kong were allowed to participate in the Hong Kong RQFII scheme
- The RQFII scheme was expanded to Taiwan, London and Singapore

In addition, China also launched the Shanghai Free Trade Zone (FTZ) in September 2013 as a pilot scheme to allow qualified investors to gain unrestricted access its capital markets, effectively creating a new access channel for foreign investors.

Implications of Opening A-shares to Global Investors

If the liberalization of the China QFII and RQFII schemes continues, a growing number of global investors would be allowed to participate in the A-shares market as part of their investment universe. In the extreme hypothetical case, if the current quota system is to be abolished and various accessibility restrictions lifted, we estimate that China A-shares could represent up to 13% of the MSCI Emerging Markets Index[1]. In combination with the currently investable MSCI China Index, China could have a free float market capitalization weight of more than 30% in the MSCI Emerging Markets Index. Exhibit 6 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 6: 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 end of November 2013.

If the China economy should continue to expand and the pace of privatization and equitization of corporations accelerate, China A-shares could assume a much larger weight within the MSCI Emerging Markets Index. The implication is that investors with a current market neutral weight in China would find themselves significantly underweighted in China; they would need to rapidly rebalance their portfolios to regain their market neutral weight to China.

We must emphasize, however, that the full inclusion scenario highlighted in Exhibit 6 remains hypothetical in the current context. This is because international investors continue to experience restrictions in accessing the China A-shares market. The first critical issue is related to the quota allocation mechanism. While the QFII and RQFII quotas have expanded significantly and now total more than USD 216 billion, there is still a significant mismatch between the distribution of quota and the distributions of managed assets. The imbalance in quota supply and potential A-share demand is particularly glaring for the North American asset managers and European and North American asset owners. Exhibit 7 illustrates this issue.

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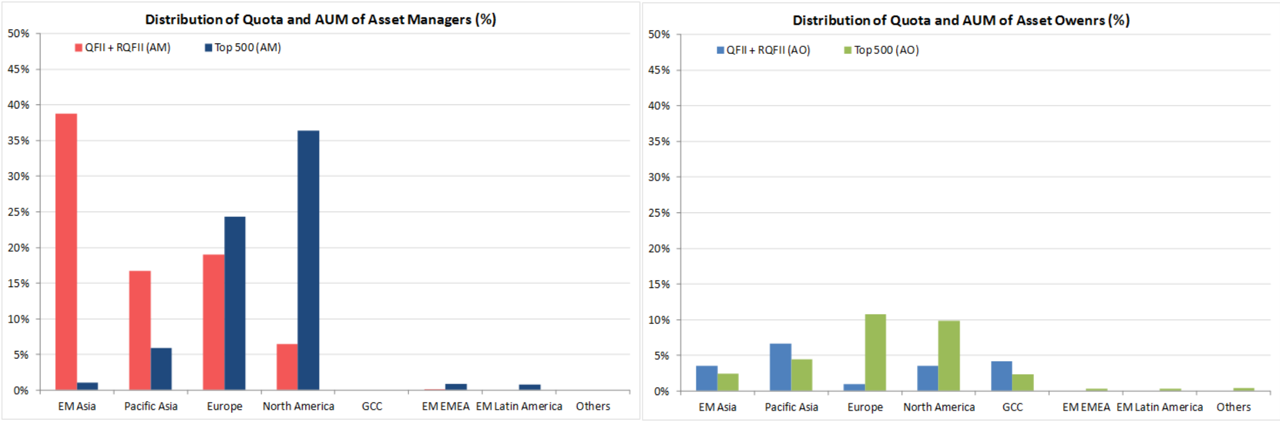
[1] Based on the MSCI Market Classification Framework, a full inclusion in MSCI Emerging Markets Index can only be achieved if the market is open and accessible to global institutional investors without significant investment restrictions and by meeting a majority of the market accessibility measurements. This is still not the case with the MSCI China A Index today. The pro forma index weight of 13% is estimated based on the free float-adjusted market capitalization of the existing MSCI China A Index assuming a 30% foreign ownership restriction.

Exhibit 7: QFII and RQFII Quotas for Asset Managers and Asset Owners Distributed by Region



Source: MSCI, CSRC and SAFE, AI Global 500, P&I 500. Data as of end of October 2013.

In addition, the individual QFII quota limit of USD 1 billion (except for central banks and sovereign wealth funds) is problematic for large institutional investors. In our previous hypothetical scenario, where the MSCI China A Index was fully 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 that tracks the MSCI Emerging Markets Index had assets under management (AUM) of USD 40 billion (December 2013). To fully replicate an inclusion of the China A shares 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 1.85 trillion (December 2012). If this manager were to allocate to emerging markets based on the weight of the MSCI Emerging Markets Index (approximately 11%) in the MSCI ACWI Index, this allocation would be about USD 203 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 13% hypothetical weight of the fully included China A-shares in the MSCI Emerging Markets Index.

Apart from the quota allocation issue, the current QFII rules stipulate that 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 challenging as they can severely hamper the flow of funds in the investment process. Importantly, the lack of daily liquidity due to capital mobility restrictions can significantly impact the smooth running of open-ended listed funds such as mutual funds and ETFs. This being said, the recent change of capital repatriation rule from one month to one week for open-ended funds should be seen as an encouraging development as it helps alleviate liquidity concerns to a certain degree.

Finally, 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. In some cases, tax issues may even discourage investors from applying for a QFII license.

Apart from the restrictions mentioned above, there are a few other market accessibility issues that exist for A-share investors. 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 8, 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 of the MSCI Emerging Markets classification framework, reform measures addressing market accessibility issues are needed to justify the reclassification of A-shares.

Exhibit 8: 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
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 602 mm	USD 1204 mm	USD 2408 mm
Security size (float market cap) **	USD 41 mm	USD 602 mm	USD 1204 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 2011: GNI per capita of USD 12,615 (World Bank, Atlas method)
** Minimum in use for the November 2013 Semi-Annual Index Review, updated on a semi-annual basis

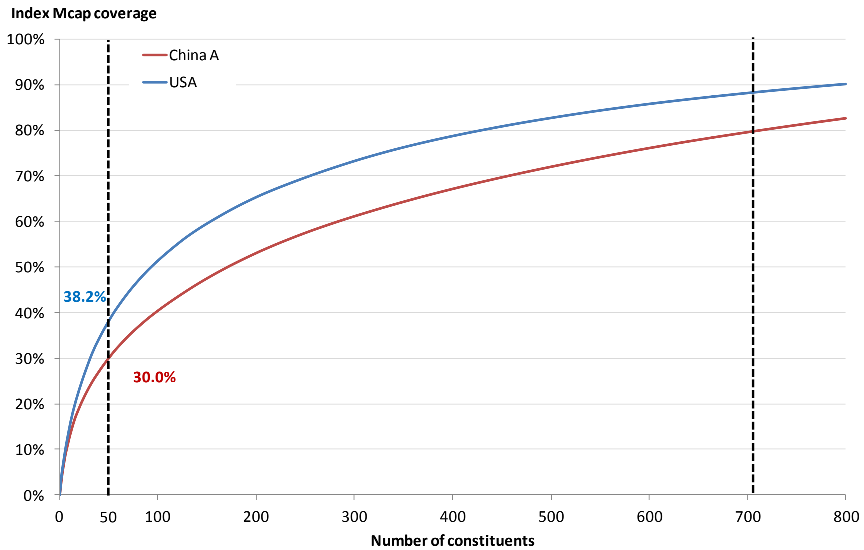
Source: MSCI.

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, 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 Indexes. 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 in the future.

To understand why a broad-based A-share index 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 9 shows the cumulative free float market capitalization of the China A-share and the USA 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 38%. 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 700 stocks (before screening for investability requirements) compared to 400 stocks for the USA. Given this unique structure, to capture the domestic A-share market comprehensively, the index must be broad-based in nature to be representative.

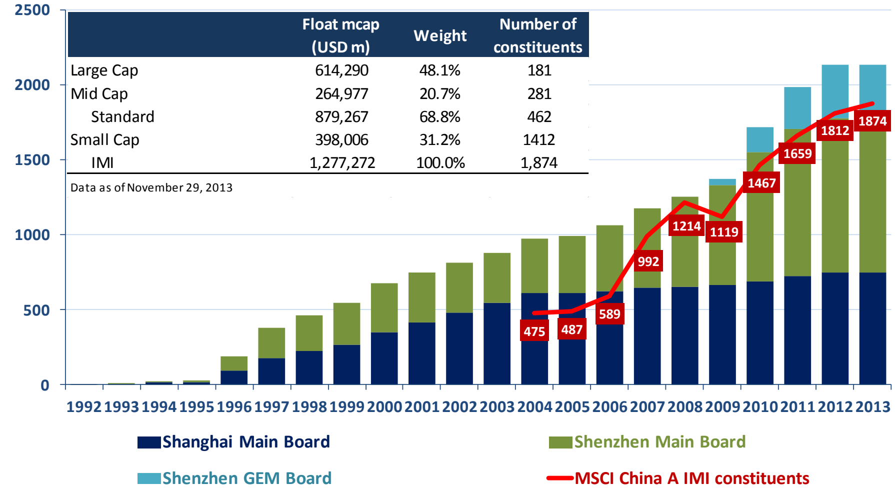
Exhibit 9: Cumulative Free Float Market Capitalization.



Source: MSCI. Data as end of November 2013.

The China A-share market is one of the fastest growing equity markets in the world. As highlighted in Exhibit 10, the number of listed securities in the domestic China market has expanded rapidly over the last two decades. Due to this fast-paced growth, a fixed number stock portfolio may initially capture a significant proportion of the total China A market, but then lose its effectiveness over time (i.e., its breadth, coverage, and representativeness). For example, a top 300 stock index that may have captured 86% of the free float-adjusted market capitalization in 2005 would have seen its representation shrunk by almost one-third, or to 61%, in 2013. Today, a 300-stock index is unlikely to be considered representative in the context of gaining a deep exposure to the China A-share market and would only become less and less effective should the market continue its expansion.

Exhibit 10: Rapid Expansion of the Domestic China Equity Market and the Evolution of the MSCI China A Indexes



Source: MSCI, Bloomberg

The MSCI China A Indexes 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 Indexes transitioned to the MSCI Global Investable Market Indexes Methodology in 2009 aiming to capture a fixed proportion of the investable opportunity set and extending coverage into the small cap segment. As of the end of November 2013, the MSCI China A Index had 462 large and mid cap constituents and the MSCI China A Small Cap Index included 1,412 securities.

The dynamic nature of the China A-share market is best illustrated in the evolution of its sector weights (see Exhibit 11). In 2004, the largest sectors in the MSCI China A Index were Industrials (22%), Materials (22%) and Consumer Discretionary (13%). Today, the largest sectors are Financials (33%), followed by Industrials (16%) and Consumer Discretionary (12%). China's unique industry profile and fast-changing industry structure pose particular challenges and risks for narrow indexes such as ones consisting of just the top 50 largest stocks. While Financials represented only approximately 21% of the MSCI China A 50 Index in 2004, today it represents 60% of the index weight. In addition, versus the broader MSCI China A Index, this top 50 index would significantly underweight two of the largest sectors—Industrials and Materials. While narrow indexes may be efficient tools for a quick representation of the underlying market, they suffer from critical limitations in the context of building a fully representative portfolio.

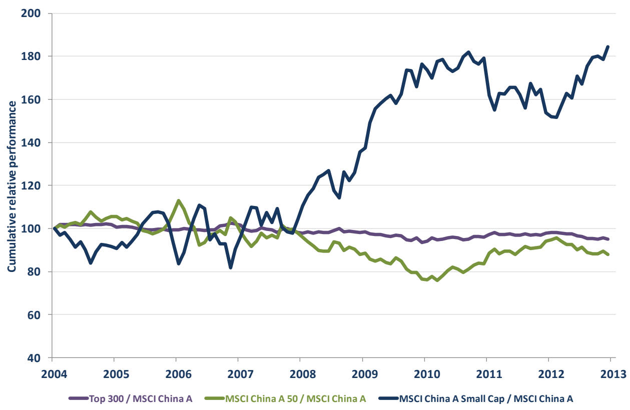
Exhibit 11: Evolution of the Sector Weights of the MSCI China A Index vs. the MSCI China A 50 Index

Sector Weight	Nov 04		Nov 13	
	MSCI China A	MSCI China A 50	MSCI China A	MSCI China A 50
Consumer Discretionary	13%	10%	12%	10%
Consumer Staples	5%	3%	7%	6%
Energy	3%	5%	5%	5%
Financials	12%	21%	33%	60%
Health Care	3%	-	8%	5%
Industrials	22%	18%	16%	5%
Information Technology	8%	7%	5%	2%
Materials	22%	14%	10%	4%
Telecommunication Services	3%	7%	1%	1%
Utilities	8%	15%	3%	1%

Source: MSCI

Exhibit 12 shows the risk and return characteristics of different A-share indexes and their tracking errors against the MSCI China A Index for the period between 2004 to 2013. The MSCI China A Index had a rather similar return profile to the Top 300 index, but with lower risk. The MSCI China A 50 Index, on the other hand, displayed a different return profile, lagging the MSCI China A Index by 1.6% per annum. This reflected both the poor performance of large caps and the concentration in Financials. On the other hand, the MSCI China A Small Cap Index significantly outperformed its 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 12: Relative Performance Comparisons versus the MSCI China A Index



Historical Gross Return, RMB	MSCI China A	Top 300	MSCI China A 50	MSCI China A Small Cap
Total Return*	12.8%	12.2%	11.2%	20.8%
Total Risk*	33.2%	33.6%	32.6%	38.2%
Return/Risk	0.39	0.36	0.34	0.54
Maximum Drawdown	-69.5%	-70.5%	-71.0%	-68.1%
Active Return*		-0.6%	-1.6%	8.0%
Tracking Error*		2.6%	9.5%	16.9%
Information Ratio		-0.25	-0.17	0.47

* Annualized in RMB from 12/31/2004 to 11/29/2013

Absolute Performance *	MSCI China A	Top 300	MSCI China A 50	MSCI China A Small Cap
1-year Total Return	20.4%	16.8%	12.5%	44.3%
3-year Total Return	-6.7%	-6.2%	-2.3%	-5.4%
5-year Total Return	8.3%	7.6%	6.0%	21.3%
1-year Total Risk	27.5%	27.6%	27.5%	30.3%
3-year Total Risk	21.8%	21.2%	19.8%	28.1%
5-year Total Risk	27.5%	28.0%	27.3%	30.5%
1-year Return/Risk	0.74	0.61	0.45	1.46
3-year Return/Risk	-0.31	-0.29	-0.12	-0.19
5-year Return/Risk	0.30	0.27	0.22	0.70

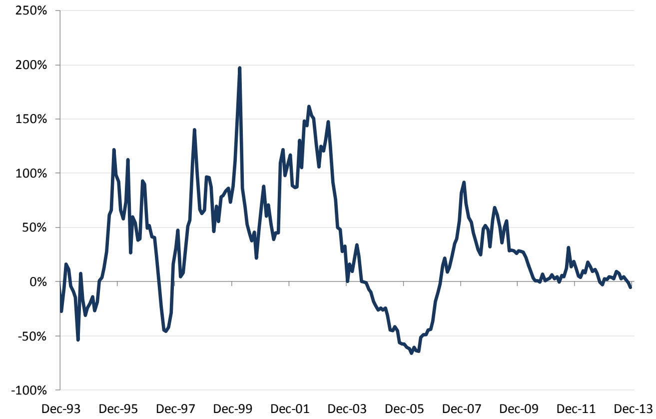
* Performance for period ending 11/29/2013

The A-Share Completion Index 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. 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 a 5% discount[2] (Exhibit 13).

[2] 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.

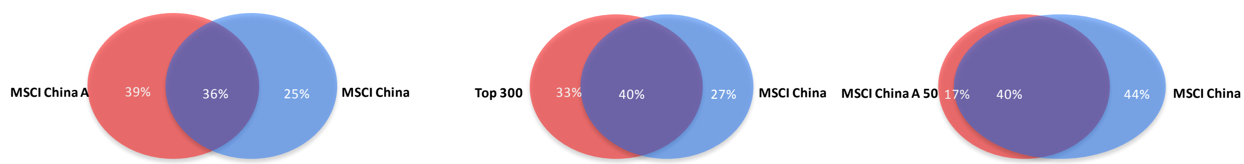
Exhibit 13: Historical A/H Premium



Source: MSCI

The existence of the overlapping share classes has important investment implications for international investors. Most international investors currently have exposure to China mainly through Hong Kong listed China companies that are included in the MSCI China Index. For example, about 70% of the largest 50 China A-share companies today overlaps with the MSCI China Index, an international investor holding such a portfolio will essentially find himself having a duplicate exposure. Exhibit 14 shows the overlapping weight of selected onshore China A-share indexes against the offshore China portfolio proxied by the MSCI China Index. The analysis demonstrates that a broad-based index such as the MSCI China A Index has less overlapping weight and is more effective in capturing the unique A-share investment opportunities.

Exhibit 14: Overlapping Representation between Onshore China A Indexes and the Offshore MSCI China Index

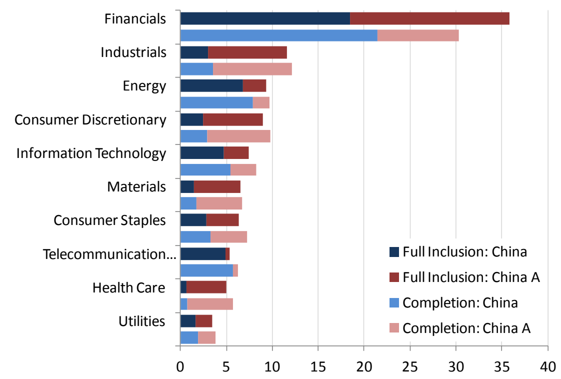


# of securities	418	88	94	255	90	93	31	38	119
Index mcap (USD m)	647	598	412	500	602	408	194	458	506
% of A share index (%)	52	48		45	55		30	70	
% of MSCI China A (%)		59	41		60	40		48	52

Source: MSCI, Bloomberg

The unique structure of A- and H-shares can be exploited in the construction of a China portfolio. Investors with a limited QFII quota allocation who wish to deploy capital efficiently can create an A-shares completion portfolio with no overlapping exposure to their existing China holdings. This may serve as an appealing alternative in the current phase of market development in China. Exhibit 15 illustrates the characteristics of a China A-shares completion index versus the MSCI China A Index. The combination of the MSCI China Index plus the China A-shares completion index displays a slightly different sector profile than the MSCI China Index, which stands as 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 index 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 a comprehensive representation of the China market.

Exhibit 15: Sector Weight of a China A Completion Index 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	5.3	15.2	12.2	9.8	9.0
Consumer Staples	5.9	8.8	6.7	7.2	6.4
Energy	14.5	3.9	4.8	9.7	9.3
Financials	39.3	19.5	32.8	30.3	35.9
Health Care	1.4	10.9	8.2	5.7	5.0
Industrials	6.4	19.1	16.2	12.2	11.6
Information Technology	10.0	6.2	5.1	8.3	7.4
Materials	3.2	10.9	9.6	6.7	6.6
Telecommunication Serv	10.5	1.2	0.8	6.2	5.4
Utilities	3.5	4.2	3.4	3.8	3.5

Source: MSCI, data as of November 29, 2013

Source: MSCI

For investors who do not meet the QFII or RQFII qualification requirements or who wish to make an allocation to China A-shares that exceeds their current quota, they can potentially do so either i) through a "borrowed" QFII quota from brokers, ii) through mutual funds offered by managers with a QFII or RQFII quota, or iii) through the various offshore A-share ETFs[3]. The growing number of A-share ETFs offered under the RQFII scheme is providing investors with further choices for constructing A-share portfolios.

Conclusion

Over the last two decades, China's capital market has been transformed in terms of size, issuance, and access. Even before accounting for A-shares, China comprises the largest country weight in the MSCI Emerging Markets Index today; its importance in a global emerging markets index is likely to rise as the A-share market continues its path to liberalization. Investors who are not well prepared for this progressive market opening could be caught short in the process.

Recent developments in the QFII and RQFII schemes have significantly broadened access to the China capital market for international investors. However, market accessibility restrictions—particularly with regard to quota allocation, capital mobility and taxation—continue to affect many global investors and

[3] 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 listed in Hong Kong are traded in dual-currency, i.e., in Renminbi and Hong Kong dollars, offering international investors convenient access for A-share exposure.

prevent China from formal recognition as part of the investable opportunity set in major global benchmark indexes. To assess the China A-shares opportunity, investors need to thoroughly examine the consequences of its market restrictions and the associated risk.

To build 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. Due to the unique structure of the China A-share market, a narrow index is less effective in representing the economic exposures of the underlying market, potentially submitting 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 index may be the more efficient way to benefit from the full opportunity set. Moreover, investors should be aware of how an A-shares completion index can help to exploit the historical existence of an A/H shares premium or discount as a unique feature of the China equity market. Finally, significant developments in the landscape of offshore A-share RQFII ETFs have provided 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	Previous Requirements (Pre-2013)	Revised Requirements
Commercial 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 QFII 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	Qualification requirements of QFIIs	The transparency & the duration of initial QFII license and quota approval	Individual quota ceiling of$1bn per QFII
Asset Managers (Passive)	Replicate the index portfolio with minimum tracking error and active risks	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	Low tolerance on long duration of application process due to the need to replicate index position closely Certainty for getting QFII license	A restrictive investment quota could limit the benchmark exposure a manager can seek to replicate
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		A bit more flexibility	A fixed quota could reduce a manager's flexibility to implement the investment views
Broker Dealers	Trading execution, liquidity facilitation, Investment product creation incl. structured products, total return swaps & etc		Low tolerance	Present a constraint in 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 (except central banks and SWFs)
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)	May affect the ability to service redemptions and rebalance portfolios	Prolonged capital lock-up will be an important consideration in the current challenging environment Impacts the ability to accommodate change in investment views	Global investors tend to rebalance their FX trade at London 4pm. No offshore FX liquidity at this time will contribute to tracking error	Potentially leads to pre-funding issues and is extremely problematic during rebalancing
Asset Managers (Active)			Less concern since active managers 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	May create issues in managing cash flow		Similar to passive managers	Similar to passive managers
Asset Owners	May affect the ability to service liability May 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 March 31, 2013, as reported on July 31, 2013 by eVestment, Lipper and Bloomberg*