China A-Shares: Too Big to Ignore

China A-shares make up 34% of the total China investment opportunity set yet are often missing from a typical institutional investor’s portfolio due to policy benchmarking, market accessibility and operational concerns. As a result, many global investors own an incomplete China portfolio. In this paper, we examine the opportunity cost and implications of not having an A-shares allocation in a global equity portfolio, and make the argument why investors should embrace a more comprehensive China portfolio.

KEY FINDINGS

- Market accessibility is the overriding reason why China A-shares are not represented in the policy benchmarks of many global investors.

- Rising correlations between developed and emerging market equities have diminished the diversification effect of emerging markets investing. China A-shares still offer low correlations with the rest of the world.

- The market accessibility of A-shares is comparable to that of frontier markets.

However, A-shares are far more investable in terms of the capacity, concentration, liquidity and cost of replication.

- China is still the largest contributor to global economic growth. Investors may find it difficult to capture China’s long-term economic growth without access to the A-shares market.

- By combining the MSCI China and MSCI China A indexes, one can potentially capture revenue opportunities equivalent to 65% of China’s GDP.
**Introduction**

China A-shares, which make up 34% of the total China investment opportunity set, are often missing from a typical institutional investor’s portfolio. A-shares are simply not on the “radar” of global investors, who rely on the policy benchmark to guide their allocation decisions. Market accessibility is the overriding issue why A-shares are not yet included in some mainstream global indexes, followed by uncertainty concerning the application of capital gains taxes, the lack of proper nominee ownership structure and a very short settlement cycle.

These issues aside, no investor can ignore the significance of China in the global economy. In terms of the global equity market, the A-shares market is already one of the largest and the most liquid in the world, as can be seen in Exhibit 1. Combining both the Shanghai and Shenzhen stock exchanges, China currently has a market capitalization of US$3.9 trillion, putting it just behind the United States and Japan.

We encourage investors to look beyond the current accessibility issues and consider the following issues:

- What are global investors missing when they avoid investing in A-shares?
- What are some of “implicit costs” of not having A-shares in a global equity portfolio?
- What is the potential role of A-shares [if any] in global equity allocation?

**A-Share: Correlations and Growth**

The role of A-shares in a global equity portfolio is best understood in the context of emerging markets investing. From 1998 to 2013, the MSCI Emerging Markets Index achieved an annualized gross return of 11.2% compared to 4.8% for the MSCI World Index. Investors allocate to emerging markets for two primary beliefs:

**DIVERSIFICATION**

An emerging markets allocation with low correlations to developed markets creates diversification effects at the total portfolio level.

**GROWTH**

Emerging countries typically display higher economic growth rates, which investors believe will translate into higher risk-adjusted returns over the long term.

One of the key challenges for emerging market investors today is the convergence of correlations between emerging markets equity and developed markets in recent years. The correlation for monthly returns between developed and emerging markets equities is 0.88 for the period of December 2004 to June 2014 versus 0.76 in the previous decade. At its current level of correlation with the rest of the world, the diversification motivation for investing in emerging markets has diminished.

**EXHIBIT ONE**

**WORLD’S LARGEST EXCHANGES BY MARKET CAP**

<table>
<thead>
<tr>
<th>COUNTRY/REGION</th>
<th>EXCHANGES</th>
<th>TOTAL MARKET CAP (USDM)</th>
<th>YTD VALUE TRADED (USDM)</th>
</tr>
</thead>
<tbody>
<tr>
<td>U.S</td>
<td>NYSE+NASDAQ OMX</td>
<td>25,850,054</td>
<td>13,691,881</td>
</tr>
<tr>
<td>Japan</td>
<td>Tokyo</td>
<td>4,624,444</td>
<td>2,743,502</td>
</tr>
<tr>
<td>China</td>
<td>Shanghai SE + Shenzhen SE</td>
<td>3,934,402</td>
<td>3,497,111</td>
</tr>
<tr>
<td>Europe</td>
<td>Euronext</td>
<td>3,818,241</td>
<td>999,014</td>
</tr>
<tr>
<td>Hong Kong</td>
<td>HKSE</td>
<td>3,089,438</td>
<td>708,056</td>
</tr>
</tbody>
</table>
The MSCI China A Index, however, exhibits low correlation with developed markets. China A has a correlation of 0.39 with developed markets and 0.49 with emerging markets, well below those of even frontier markets. The MSCI China A Index and MSCI World Index moved in opposite directions 35% of the time in the recent 9.5-year period. Such negative correlation can be useful particularly in times of high equity market volatility. Additionally, China A-shares offer a significantly larger investment opportunity set with higher liquidity and capacity.

The Low Correlation Puzzle
Practitioners and academics alike debate why China A-shares have such a weak correlation with global equity markets and whether such a low correlation is likely to continue. Two explanations that may account for this relationship are discussed:

OPENNESS OF THE A-SHARE MARKET
In the absence of free flow of capital, the China A-share market has been insulated from global capital events. Historically, the China A-share market has been dominated by retail investors with limited institutional participation. Trading restrictions also play a big part in contributing to the inefficiency of the China A-shares market.

MACROECONOMIC CYCLES AND A-SHARES
Some experts believe macroeconomic cycles play a role in China’s low correlations with the rest of the world. As can be seen in Exhibit 2, China entered major up cycles in 1991-1994 and 2000-2007 with accelerating growth each year, while global GDP growth plateaued over the same periods. In addition, world GDP growth bottomed in 2008-2009, yet China maintained high growth of more than 9% at the same time.

The Growth Argument
In addition, emerging markets have generated superior economic growth in recent decades. Many investors relying on macroeconomic views have turned to emerging markets stocks to capture those countries’ economic growth. Empirical data for the last two decades ending 2010 show that emerging markets’ higher relative GDP growth coincided with higher relative equity return compared with developed markets. (See Exhibit 2)

Despite the spectacular growth in Chinese GDP (a compound annualized growth rate of 16% over the 20-year period), the MSCI China Index returned only 2% annually. On the other hand, the MSCI China A Index returned close to 12% annually for the same period, a pattern that is more similar to the other BRICS countries. This striking contrast suggests we need to dig deeper into the relative composition of these two China indexes to fathom the implications for investors.

EXHIBIT TWO
GDP GROWTH RATES OF CHINA VS. REST OF WORLD (1988-2013)
What Drives the Big Mismatch?
The underlying composition of the two China equity opportunity sets represented by the MSCI China Index and the MSCI China A Index can partially explain the index performance differential in response to the same GDP growth. Compared to the other major global equity markets, the China stock market has historically offered a poor representation of the country’s economic activities. Ten years ago, the unique revenue contribution of the MSCI China Index was only 8.7% of GDP, compared to 13.2% for the MSCI China A Index.

Today, the combined revenue of MSCI China A and MSCI China companies, including the dual-listings, equals about two-thirds of the country GDP, more than double from 27% in 2004. This has two implications:

- Both opportunity sets now offer better representations of China’s GDP than before
- Combining the two sets could offer a more accurate reflection of the economic landscape in China.

CONCLUSION
Many global investors have overlooked the potential strategic role of China A-shares. Valuation and investment outlook considerations aside, adding them to a global equity portfolio could provide diversification and help capture a long-term economic growth premium. It is important for investors to understand that the A-shares market is by far the largest missing piece of the China equity puzzle. Getting this exposure right is likely to have long-lasting effects on their portfolios. By combining the MSCI China and MSCI China A indexes, one can potentially capture revenue opportunities equivalent to 65% of China’s GDP. This is a powerful argument as to why investors should embrace a more comprehensive China portfolio.

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The authors

Chin Ping Chia, CFA
Managing Director,
Head of Research (Asia Pacific)
chin-ping.chia@msci.com

Mr. Chia is Managing Director, Head of Research (Asia Pacific) at MSCI Inc. Based in Hong Kong, he oversees the firm’s R&D efforts across various businesses and product lines in the region. Functioning as the “Chief Investment Officer” in Asia, Mr. Chia is tasked with formulating the firm’s research and product development agenda as well as delivering clear insights for leading institutional investors, asset managers and sovereign wealth funds in the region.

Qi Wang, CFA
Executive Director,
Asia Index Applied Research
qi.wang@msci.com

Qi Wang is Executive Director at MSCI where he is responsible for index applied research for the Asia region. Previously he was a Chief Investment Officer and Investment Director at China Everbright Limited (CEL), where he co-founded and ran the firm’s Asset Management Department. Prior to CEL, Mr. Wang was an Investment Director at hedge fund manager Elliott Advisors (H.K), responsible for its fundamental long-short strategy in Asia Pacific and Japan. He also served as a Director in the Equity Research Department of UBS, where he co-founded the Global Tech Strategy Group in 2000.
### AMERICAS
- **Americas**: 1 888 588 4567 (toll free)
- **Atlanta**: +1 404 551 3212
- **Boston**: +1 617 532 0920
- **Chicago**: +1 312 675 0545
- **Monterrey**: +52 81 1253 4020
- **New York**: +1 212 804 3901
- **San Francisco**: +1 415 836 8800
- **Santiago**: +56 2 2364 4243
- **São Paulo**: +55 11 3706 1360
- **Toronto**: +1 416 628 1007

### EUROPE, MIDDLE EAST & AFRICA
- **Cape Town**: +27 21 673 0100
- **Frankfurt**: +49 69 133 859 00
- **Geneva**: +41 22 817 9777
- **London**: +44 20 7618 2222
- **Milan**: +39 02 5849 0415
- **Paris**: 0800 91 59 17 (toll free)

### ASIA PACIFIC
- **China North**: 10800 852 1032 (toll free)
- **China South**: 10800 152 1032 (toll free)
- **Hong Kong**: +852 2846 9333
- **Mumbai**: +91 22 6784 9160
- **Seoul**: 00798 8521 3392 (toll free)
- **Singapore**: 800 852 3749 (toll free)
- **Sydney**: +61 2 9033 9333
- **Taipei**: 008 0112 7513 (toll free)
- **Tokyo**: +81 3 5290 1555

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