RESEARCH SPOTLIGHT

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.

China A-Shares:

TOO BIG TO IGNORE

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

COUNTRY/REGION	EXCHANGES	TOTAL MARKET CAP (USDM)	YTD VALUE TRADED (USDM)
U.S	NYSE+NASDAQ OMX	25,850,054	13,691,881
Japan	Tokyo	4,624,444	2,743,502
China	Shanghai SE + Shenzhen SE	3,934,402	3,497,111
Europe	Euronext	3,818,241	999,014
Hong Kong	HKSE	3,089,438	708,056

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.

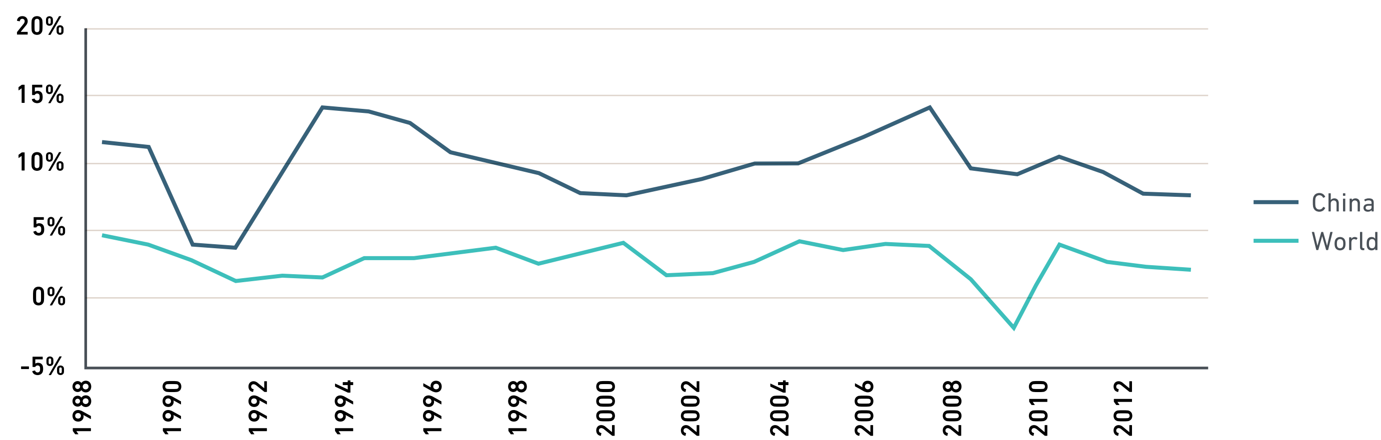
The Growth Argument

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.

"By combining the MSCI China and MSCI China A indexes, one can potentially capture revenue opportunities equivalent to 65% of China's GDP."

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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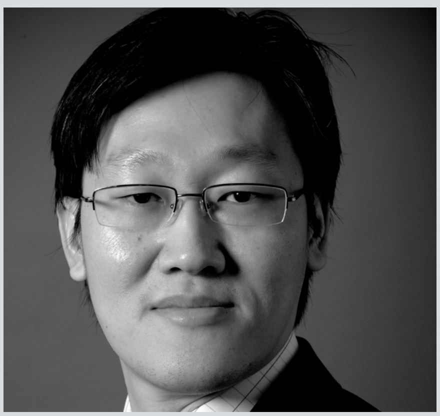

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