
# Getting "A" Share of the Chinese Market

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**After several years of consideration, in 2018 MSCI added a small portion of the China A-share market to the MSCI Emerging Markets Equity Index. While only about 0.7% of the index currently, we expect A-shares to become a larger part of both institutional benchmarks and portfolios over the coming years.**

With that in mind, this article looks to answer four key questions:

- What are A-shares?
- Why do we care about them?
- What do they look like?
- What is their future?

### What are A-Shares?

A-shares are Chinese companies that are traded on local Chinese stock exchanges. There are two exchanges, the Shanghai and the Shenzhen. Over the last 15 years the number of companies listed on Chinese stock exchanges has grown from 1,300 to 3,500. As a point of comparison, the NYSE and Nasdaq have over 4,000 listed companies. Historically these local Chinese markets have been closed to U.S. and other foreign investors but that changed in 2013 when China announced its Stock Connect program, which opened its markets to investors outside of China. This was a major reason why MSCI, the institutional benchmark provider, decided to include a small piece of A-shares in the Emerging Markets Equity Index starting in 2018.

Historically, U.S. investors have accessed Chinese equities largely through H-shares. H-shares are Chinese companies that are listed on the Hong Kong Stock Exchange. There are many companies that are listed in both the H-share market and the A-share market however there are more unique investment opportunities within the A-share market. As China continues its transition to a consumer-based economy, many of the newer consumer focused companies are listed in the A-share market.

### Why do we care about them?

We care about this market because it is being included in institutional portfolios and benchmarks and we expect this to grow over time. In addition to MSCI's 2018 inclusion, in 2016 Vanguard, one of the world's largest index fund providers, announced it would include A-shares in its Emerging Markets Equity Index Fund. As of June 2018, that fund had 6.9% in A-shares.

Between 2000-2017, the Chinese economy contributed 27% of the world's GDP growth. With the growth of the economy, the country's stock market has grown as well. Based on market capitalization, it is the second largest in the world, with only the U.S. being larger. The A-share market is also liquid. Through the first six months of 2018 it was second to the U.S. in dollar transaction volume. Size and liquidity are two traits that we look for in institutional portfolios and these are key reasons why groups like MSCI and Vanguard have added exposure.

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### What do they look like?

In one word the A-share market looks volatile. Over the last ten years, its standard deviational (volatility) has been higher than that of the broader emerging markets index. This has produced big swings in performance. While the volatility has been high, the correlations to other major equity asset classes have been low. Over the last ten years the A-share market  has a 0.35 correlation with the S&P 500. In comparison, the MSCI EM Equity Index has a 0.80 correlation. Historically, the A-share market has been a good diversifier within equity markets.

A key reason why A-shares have been so volatile is due to the groups that trade and own the market. As of April 2018, 45% of the market was owned by retail and high net worth investors in China. These investors tend to be more trading oriented, moving in and out of stocks much more frequently. This has led to higher levels of volatility.

### What is their future?

In 2018, MSCI added a small portion of the A-share market to its Emerging Markets Equity Index using a 5% inclusion factor. What would happen if MSCI used a 100% inclusion factor? A-shares would go from constituting just 0.8% of the benchmark to 16.2% of the benchmark. How long will it take to go to full inclusion? MSCI has not provided any specific timeline for this, however in September 2018 they proposed a 20% inclusion factor following the successful implementation of an initial 5% inclusion factor.

MSCI's rationale for the suggested expansion of A-share inclusion is largely driven by the incremental improvements in market accessibility implemented by China. Since the announcement of MSCI China A shares inclusions in July 2017, the daily trading limit and number of new accounts opened has significantly increased within the Stock Connect program, which is an investment channel between Hong Kong, Shanghai, and Shenzhen that allows international and mainland Chinese investors to trade securities in each other's markets. MSCI will solicit feedback from the investment community and announce its decision in February 2019. While MSCI's consultation may or may not lead to changes in the MSCI indices, this proposal indicates growing confidence in market liberalization within China and reaffirms our view that institutional investors will increasingly have exposure to China's local markets over the medium to long-term horizon.

Currently, Marquette does not recommend a dedicated allocation to the China A-share market. However, Marquette believes that stock exposure in a broader emerging markets equity allocation can provide diversification and a source of alpha.

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