November 2015

A better benchmark for China

MSCI are set to announce the inclusion of Chinese ADRs (American Depository Receipts) into its indexes. The announcement should come after markets close in the US on Thursday 12 November, (early Friday morning in Asia). This will:

1) **Offer investors who benchmark against MSCI China a better chance to benefit from China's "new economy" growth;**
2) **Ensure a more accurate reflection in MSCI China of China's economic development;**
3) **Lead to MSCI China capturing a more comprehensive picture of earnings and valuations.**

WHAT IS AN ADR?

American Depository Receipts are stocks that trade in the US and represent a specified amount of shares in a foreign company.

They can be an easy and cost effective way for investors to buy shares in a foreign company – especially so in the case of Chinese equities where access to its onshore stock markets is restricted.

ADDING WEIGHT TO THE "NEW ECONOMY"

The first stage of inclusion will start at the end of this month, with a second stage scheduled for May 2016. Most of new additions will be Chinese Internet names that are listed in the US.[1]

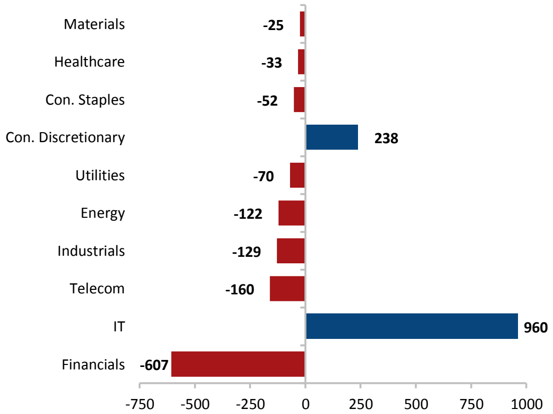
By the end of the second phase of inclusion Morgan Stanley estimate that these companies will make up around 15% of the total MSCI China index weight.[2] Alibaba, Baidu and NetEase will be the top three companies in order of weight.

Sector-wise, IT and consumer discretionary are expected to gain with financials being the biggest loser.

Chart 1: Estimated weight changes of top 5 winners and losers

	Oct 2015	Nov 2015	May 2016
ALIBABA GROUP HOLDING LTD	0%	2.45%	4.54%
BAIDU INC	0%	2.30%	4.26%
NETEASE INC	0%	0.58%	1.08%
CTRIP.COM INTL	0%	0.54%	1.01%
JD.COM INC	0%	0.49%	0.90%
TENCENT HOLDINGS	11.39%	10.49%	9.72%
CHINA MOBILE	8.84%	8.14%	7.55%
CHINA CONSTRUCTION BANK	7.31%	6.74%	6.24%
ICBC	5.58%	5.14%	4.76%
BANK OF CHINA	4.47%	4.12%	3.81%

Chart 2: Estimated change in sector weight by May 2016



Sources for Charts 1 and 2: Morgan Stanley Research, 19 October 2015

The biggest initial implication of this will be on the passive fund industry, specifically those funds that track MSCI indexes and that need to adjust to the new inclusions. Active funds will typically already have exposure to Chinese ADRs if they like them, but may adjust gradually to reflect the inclusion.

Analysts expect the rebalancing could see US$70 billion in flows to the newly-included stocks.[3] MSCI China's weight in MSCI Emerging Markets will increase, which could reduce the weighting of stocks listed in India, Taiwan and Korea.[4]

LOOKING AHEAD

In June this year MSCI decided not to include mainland-listed shares (A-shares) into its indexes. The inclusion of ADRs represents an important step towards opening up investor access to China and thus should be seen as a positive development and one that could eventually lead to full A-share inclusion and free A-share trading.

VIEWS FROM OUR INVESTMENT TEAM

"The inclusion of US ADRs into the MSCI China Index will significantly increase the weightings of internet-related stocks in the index. This could give a boost to some of China's leading internet giants, such as Alibaba and Baidu, as the move will trigger immediate buying among funds that passively track the index. As these new constituent stocks are more geared towards domestic consumption and "New China", it could also attract flows from actively-managed funds as investors are looking for exciting and sustainable growth stories in the low-growth world.

US-listed ADRs have experienced a good run since late September, suggesting that investors have been buying ahead of the inclusion in November, in anticipation of additional demand for these stocks. Meanwhile, as the inclusion of the ADRs will come largely at the expense of Chinese banks, Chinese banks may underperform in the medium term as they are expected to see some selling."

Raymond Ma, Portfolio Manager, FF China Consumer Fund

"The inclusion of US ADRs in to the MSCI China Index has been well communicated and will have a significant impact on the structure of the index. The inclusion process will be in stages, but once finished next year we expect US listed Chinese names to represent c.15% of the index. Over time Alibaba will become at least as big as Tencent - too big for investors to ignore. As a result, the index will become a better reflection of 'old' versus 'new' China and also private companies versus SOEs. I would also expect this change to attract more foreign institutional investors, which should dampen long-term volatility.

Also, if US-listed companies are favoured by investors we may see SOEs adopt a more shareholder friendly approach as a way of capturing foreign investment. This is a development we are ready for. We have had analyst coverage and owned these stocks for many years. I have been adding to US-listings over the past few months, partly in anticipation of this event and partly because recent volatility has presented value opportunities."

Jing Ning, Portfolio Manager, FF China Focus Fund

References:

1) Morgan Stanley, *MSCI to add HK-China ADRs in November 2015 and May 2016 reviews*, 22 October 2015
2) Morgan Stanley, *MSCI China: A Better Equity Benchmark of the Modern China Economy then HSCEI upon ADR Inclusions Next Month*, 19 October 2015
3) Reuters, 2 November 2015
4) Reuters, 2 November 2015

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