MSCI has taken a cautious approach to A share inclusion that encourages China to increase foreign investor access and ultimately ability to redeem and repatriate funds in exchange for greater future index weightings. It’s a sensible plan.

If China is a master of incremental reforms to gain admission to select economic and financial circles, only to bend the rules after access is granted, MSCI appears well aware of its playbook. Whether involving commitments on trade following its 2001 accession to the World Trade Organization (WTO) or, more recently, the renminbi’s induction into the International Monetary Fund’s (IMF) reserve currency basket, China’s market reforms slowed after it managed to join the two clubs, and in certain respects its actions have gone against the spirit, if not the letter, of its membership obligations. No wonder the MSCI is accepting a sliver of China’s domestically traded stocks into its benchmark indices, and then only doing so incrementally.

Yet the acceptance of 222 “A shares”—those traded publically on the Shanghai and Shenzhen stock exchanges—is a step in the right direction, both for China and foreign investors. The A shares will together constitute just 0.73% of the MSCI Emerging Markets (EM) Index and 0.1% of the MSCI All Country World Index (ACWI) starting next year, phasing in first in May and then in August, and at just 5% of their market capitalization weighting. While it amounts to a tiny fraction of China’s $7.5 trillion domestic equity market, which sports nearly 3,300 listed companies, it’s still a significant, if well anticipated, event, after MSCI had rejected A share inclusion in each of the last three years.

The admitted A shares are all large-caps that aren’t in trading suspensions, a condition that has been all-too-prevalent in China’s equity market. Indeed, two years ago, trading in nearly half of Chinese stocks, mainly mid- and small-cap equities, was suspended amid a severe market downdraft at the time. Many of the suspensions lasted for months, while regulators pushed broad measures to contain the volatility. Some 100 stocks remain suspended, MSCI chief executive officer Henry Fernandez recently told Bloomberg in an interview, far more than normal across international markets.

The included A shares are accessible via the Stock Connect program linking the Hong Kong exchange with Shanghai and Shenzhen exchanges, or directly quoted in Hong Kong as “H” shares, skirting the contentious requirements of “qualified” or
“authorized” foreign investors seeking access to the onshore market. MSCI made clear that the China A-share weighting in its benchmark indices can increase once trading caps on the Stock Connect are further expanded or abolished. “When further alignment with international market accessibility standards occurs, sustained accessibility is proven within Stock Connect and international institutional investors gain further experience in the market, MSCI will reflect a higher representation of China A shares in the MSCI Emerging Markets Index,” Remy Briand, MSCI’s head of the Index Policy Committee, was quoted as saying in the indexer’s June classification announcement. “MSCI is very hopeful that the momentum of positive change witnessed in China over the past years will continue to accelerate.” That includes “further loosening of restrictions on the creation of index-linked investment vehicles,” MSCI noted.

Given the extended and diminutive A share inclusion design, MSCI retains plenty of leverage to ensure that Chinese companies and regulators stick to the program, if the future weighting of A shares is to grow beyond a symbolic representation. While initially symbolic, though, given the MSCI’s incentive structure the inclusion could ultimately become significant. Thornburg’s Charlie Wilson points out that China’s A share market boasts some excellent companies, including among the 222 to be inducted. “It will force global investment banks to increase their A share coverage, which, in turn, will bring more international investors to the market,” Wilson says. “It’s a snowball effect, with increasing company coverage leading to more trading, and then more analyst coverage and better (corporate) investor relations teams, and increasing trading volumes.” In other words, it could be the start of a virtuous cycle.

There are caveats, mainly involving continued accessibility of foreign investors to come and go in timely fashion. Rules on portfolio flows and stock redemptions should remain clear and stable, even when market conditions turn inclement. China’s record isn’t spotless in this regard. WTO members, including the U.S., have brought successful cases charging that China hasn’t abided by its WTO commitments on market access, non-discrimination and regulatory transparency. For example, foreign companies have complained about administrative abuse involving coercive technology transfers illicitly required of them for investment approvals, a practice running contrary to China’s WTO commitments. Enforcement of the rulings can also be difficult. Similarly, after the IMF finally admitted China’s renminbi into its reserve currency basket in 2015, it clamped back down on the opening of its capital account when capital outflows started to pick up, restricting the yuan’s tradability, a high degree of which is required of a reserve currency.

Beijing knows it stands to benefit from increased foreign investor inflows with the MSCI’s decision. If things go in the right direction over the medium term, China’s A share weighting will increase in the MSCI EM and ACWI indices. China could see an initial inflow of at least $10 billion as a result of the A share inclusion, according to one investment bank estimate. At the end of 2016, more than $1.6 trillion in assets were benchmarked to the MSCI EM index, according to MSCI, citing data from eVestment, Morningstar and Bloomberg.

MSCI is clearly doing its utmost to ensure that investors in China A shares aren’t mistreated, no doubt given the potential exposure of investors in passively managed products linked to MSCI’s index benchmarks. More nimble active managers may be better able to dodge adverse regulatory shifts and company trading suspensions than passive investors by picking and choosing their exposures and cashing out more quickly if they see shareholder unfriendly actions developing. In this regard, though, China’s equity market may be only relatively more tricky for foreign investors than other emerging markets, where regulatory predictability often isn’t a given.

The message that MSCI and foreign investors are sending China is that more inflows will come if regulatory predictability and transparency grows, and foreign investors are allowed not just to put money into China, but move it out when they see fit.

Read more Global Perspectives from Thornburg >>

Important Information

Before investing, carefully consider the Fund’s investment goals, risks, charges, and expenses. For a prospectus or summary prospectus containing this and other information, contact your financial advisor or visit our literature center. Read them carefully before investing.

The performance data quoted represents past performance; it does not guarantee future results.

The views expressed are subject to change and do not necessarily reflect the views of Thornburg Investment Management, Inc. This information should not be relied upon as a recommendation or investment advice and is not intended to predict the performance of any investment or market.

Investments carry risks, including possible loss of principal.

International investing involves special risks including currency fluctuations, illiquidity, volatility, and political and economic
risks. These risks may be heightened in emerging markets.

Please see our glossary for a definition of terms.

Thornburg mutual funds are distributed by Thornburg Securities Corporation.

Thornburg Investment Management, Inc. mutual funds are sold through investment professionals including investment advisors, brokerage firms, bank trust departments, trust companies and certain other financial intermediaries. Thornburg Securities Corporation (TSC) does not act as broker of record for investors.

© Thornburg Investment Management