

View from UBS Indexing

China A-shares' 4x weight increase in MSCI EM Index: implications for index investors

UBS Asset Management

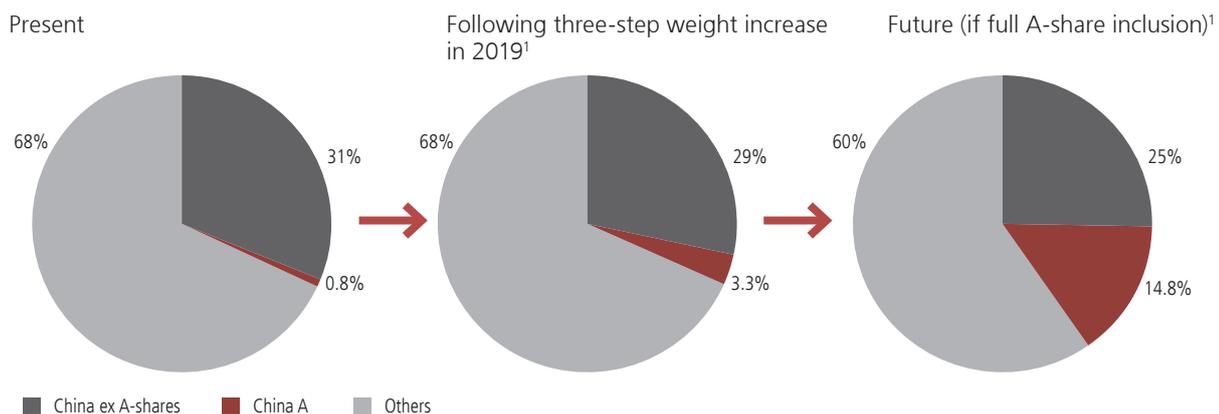


On 28 February 2019, MSCI announced the expected increase of China A-shares' weight in MSCI Emerging Markets Index to over 3.3% from the current 0.8%.

Highlights

- MSCI announced the (largely expected) results of its consultation on China A-shares' further weight increase in MSCI Emerging Markets Index: as per its proposal, MSCI will increase China A-shares inclusion factor to 20% from the current 5%, i.e. China A-shares weight will rise to 3.3% from the current 0.8%*.
- In addition to the stocks in the current eligible universe (large caps listed on the Shanghai or Shenzhen HK Stock Connect), mid-caps and ChiNext stocks will now also be in scope. ChiNext is a board on the Shenzhen Stock Exchange that aims to attract innovative, fast growing firms, especially in the high tech sector. As a reminder, the advantage of the HK Stock Connect, which links Hong Kong with Shanghai and Shenzhen, is that it allows international investors to trade China A-shares in Hong Kong without the same restrictions they would face buying shares on the mainland using renminbi.
- Implementation will take place at three steps: at the MSCI index reviews in May, August and November 2019.
- Estimated aggregate trade for index investors at the three-step inclusion process is c. USD 13 billion, which, at each of the three steps, we do not envisage to create a significant market impact.

MSCI Emerging Markets Index: China A-shares inclusion roadmap



* Sources: UBS Asset Management, MSCI. Data as at 28 February 2019.

¹ Percentage inclusion number refers to Inclusion Factor applied to free float adjusted market cap of China A-share constituents in the pro-forma MSCI China A Large Cap Index and MSCI China A Mid Cap Index.

Detail

- In September 2018, a day before FTSE Russell announced the initial inclusion of China A-shares in FTSE Emerging Index (at 25% investability weight) as part of the FTSE Annual Country Classification Review, MSCI opened a consultation on the further weight increase of China A-shares in MSCI Emerging Markets Index.
- We participated in the consultation, and were largely supportive of the proposed weight increase. As per the consultation proposal, MSCI will increase the weight of China A-shares in MSCI Emerging Markets Index to 3.3% (20% inclusion factor) from the current 0.8% (5% inclusion factor) in three steps: at the May, August and November 2019 index reviews.
- In addition to the stocks in the current eligible universe (large caps listed on the Shanghai or Shenzhen HK Stock Connect), mid caps and ChiNext stocks will now also be in scope. The first two steps will see the weight of large caps (including ChiNext stocks) increase, while at the third step both the weight of large caps will increase and mid caps will be added for the first time. On completion of the three-step implementation, there will be 253 large cap and 168 mid cap China A-shares, including 27 ChiNext stocks, representing 3.3% index weight. There are currently 234 China A-shares representing 0.8% index weight.
- As a reminder, the Shanghai or Shenzhen HK Stock Connect provide foreign investors an access to a selection of large and mid cap China A-shares, without QFII/RQFII licence, but with a daily limit on aggregate traded value on the HK Stock Connect Exchange. The latter restriction was mitigated materially in 2018, when the daily net buy quota quadrupled.

Implications for index investors

- **Market impact:** USD 2.3 trillion are estimated to track MSCI Emerging Markets Index, both on an active and passive basis, of which c. USD 500 billion* are estimated to be in index assets (source: MSCI). A 2.5% weight increase of China A-shares would imply a c. USD 13 billion aggregate trade for index investors at the three-step implementation: c. USD 3.5 billion estimated trade at each of the first two steps, and c. USD 6 billion trade at the third step. Each of the three trades represent c. one day's average trading volume, which, on its own, would be unlikely to create a significant market impact. However, as the initial inclusion of China A-shares in FTSE Emerging Index (at 25% investability weight) will take place over similar timeframe (three tranches in June and September 2019 and March 2020), we would envisage increased demand for this basket of stocks.

- **Investor impact:** As with the initial inclusion of China A-shares to MSCI EM Index in 2018, index investors would not need to secure a quota and/or investment vehicle with a quota (e.g. pooled fund or ETF) with this phase of inclusion. Investors would need to keep in mind that the projected 421 A-shares in MSCI Emerging Markets Index would have only c. 3.3% aggregate index weight, therefore, we would likely continue to apply stratified sampling in the relevant index equity portfolios to minimise transaction costs.
- Weight increase of China A-shares beyond 20%: MSCI have said that future weight increase of China A-shares in MSCI EM Index would require Chinese authorities to address the remaining market accessibility concerns, including:
 - Lack of suitable derivative instruments: the current absence of exchange traded index futures hampers the efficient implementation of index portfolios.
 - Short settlement cycle: the T+0/1 settlement of China A-shares is sub-optimal from operational and index tracking perspective in the context of the MSCI EM Index where the other constituent markets operate on a T+2/ T+3 settlement cycle. In January this year we met with representatives from the Shanghai Stock Exchange (SSE), and one of the topics we discussed was the T+0/1 settlement, expressing our view that aligning China A-shares settlement cycle with other markets would be a positive step.
 - HK Stock Connect trading holidays: misalignment between onshore China and HK Stock Connect holidays continues to create investment frictions.

Recent developments

- HK Stock Connect daily quota quadrupled.
- QFII quota doubled
- The China Securities Regulatory Commission launched a consultation to harmonise and further relax the QFII/RQFII schemes.
- SSE introduced MOC.
- Voluntary stock suspension rules have been tightened further.

UBS Indexing experience

(data as at 31 December 2018)

- Over 30 years' indexing experience, USD 308 billion AUM, tracking over 150 indices.
- Over a decade's experience in managing emerging markets index equity with AUM of over USD 15 billion.
- Big enough to benefit from economies of scale, but not too big to face liquidity constraints when trading for index changes.
- Building upon the experience of the broader UBS Asset Management: experience in all operational aspects of managing emerging markets mandates, over 20 years' China equities investment experience.

* Source: MSCI, based on 2018 data and estimates

For marketing and information purposes by UBS. For professional clients / qualified / institutional investors only.

This document does not replace portfolio and fund-specific materials. Commentary is at a macro or strategy level and is not with reference to any registered or other mutual fund.

Americas

The views expressed are a general guide to the views of UBS Asset Management as of March 2019. The information contained herein should not be considered a recommendation to purchase or sell securities or any particular strategy or fund. Commentary is at a macro level and is not with reference to any investment strategy, product or fund offered by UBS Asset Management. The information contained herein does not constitute investment research, has not been prepared in line with the requirements of any jurisdiction designed to promote the independence of investment research and is not subject to any prohibition on dealing ahead of the dissemination of investment research. The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith. All such information and opinions are subject to change without notice. Care has been taken to ensure its accuracy but no responsibility is accepted for any errors or omissions herein. A number of the comments in this document are based on current expectations and are considered "forward-looking statements." Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of UBS Asset Management's best judgment at the time this document was compiled, and any obligation to update or alter forward-looking statements as a result of new information, future events or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual security, asset class or market generally, nor are they intended to predict the future performance of any UBS Asset Management account, portfolio or fund.

EMEA

The information and opinions contained in this document have been compiled or arrived at based upon information obtained from sources believed to be reliable and in good faith, but is not guaranteed as being accurate, nor is it a complete statement or summary of the securities, markets or developments referred to in the document. UBS AG and / or other members of the UBS Group may have a position in and may make a purchase and / or sale of any of the securities or other financial instruments mentioned in this document. Before investing in a product please read the latest prospectus carefully and thoroughly. Units of UBS funds mentioned herein may not be eligible for sale in all jurisdictions or to certain categories of investors and may not be offered, sold or delivered in the United States. The information mentioned herein is not intended to be construed as a solicitation or an offer to buy or sell any securities or related financial instruments. Past performance is not a reliable indicator of future results. The performance shown does not take account of any commissions and costs charged when subscribing to and redeeming units. Commissions and costs have a negative impact on performance. If the currency of a financial product or financial service is different from your reference currency, the return can increase or decrease as a result of currency fluctuations. This information pays no regard to the specific or future investment objectives, financial or tax situation or particular needs of any specific recipient. The details and opinions contained in this document are provided by UBS without any guarantee or warranty and are for the recipient's personal use and information purposes only. This document may not be reproduced, redistributed or republished for any purpose without the written permission of UBS AG. This document contains statements that constitute "forward-looking statements", including, but not limited to, statements relating to our future business development. While these forward-looking statements represent our judgments and future expectations concerning the development of our business, a number of risks, uncertainties and other important factors could cause actual developments and results to differ materially from our expectations.

UK

Issued in the UK by UBS Asset Management (UK) Ltd. Authorised and regulated by the Financial Conduct Authority.

APAC

This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in APAC. This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in your jurisdiction. No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of your jurisdiction. Using, copying, redistributing or republishing any part of this document without prior written permission from UBS Asset Management is prohibited. Any statements made regarding investment performance objectives, risk and/or return targets shall not constitute a representation or warranty that such objectives or expectations will be achieved or risks are fully disclosed. The information and opinions contained in this document is based upon information obtained from sources believed to be reliable and in good faith but no responsibility is accepted for any misrepresentation, errors or omissions. All such information and opinions

are subject to change without notice. A number of comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results may prove to be different from expectations and any unforeseen risk or event may arise in the future. The opinions expressed are a reflection of UBS Asset Management's judgment at the time this document is compiled and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. You are advised to exercise caution in relation to this document. The information in this document does not constitute advice and does not take into consideration your investment objectives, legal, financial or tax situation or particular needs in any other respect. Investors should be aware that past performance of investment is not necessarily indicative of future performance. Potential for profit is accompanied by possibility of loss. If you are in any doubt about any of the contents of this document, you should obtain independent professional advice.

Australia

This document is provided by UBS Asset Management (Australia) Ltd, ABN 31 003 146 290 and AFS License No. 222605.

China

The securities may not be offered or sold directly or indirectly in the People's Republic of China (the "PRC"). Neither this document or information contained or incorporated by reference herein relating to the securities, which have not been and will not be submitted to or approved/verified by or registered with the China Securities Regulatory Commission ("CSRC") or other relevant governmental authorities in the PRC pursuant to relevant laws and regulations, may be supplied to the public in the PRC or used in connection with any offer for the subscription or sale of the Securities in the PRC. The securities may only be offered or sold to the PRC investors that are authorized to engage in the purchase of Securities of the type being offered or sold. PRC investors are responsible for obtaining all relevant government regulatory approvals/licenses, verification and/or registrations themselves, including, but not limited to, any which may be required from the CSRC, the State Administration of Foreign Exchange and/or the China Banking Regulatory Commission, and complying with all relevant PRC regulations, including, but not limited to, all relevant foreign exchange regulations and/or foreign investment regulations.

Hong Kong

This document and its contents have not been reviewed by any regulatory authority in Hong Kong. No person may issue any invitation, advertisement or other document relating to the Interests whether in Hong Kong or elsewhere, which is directed at, or the contents of which are likely to be accessed or read by, the public in Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to the Interests which are or are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" within the meaning of the Securities and Futures Ordinance (Cap. 571) and the Securities and Futures (Professional Investor) Rules made thereunder.

Japan

This document is for informational purposes only and is not intended as an offer or a solicitation to buy or sell any specific financial products, or to provide any investment advisory/management services.

Korea

The securities may not be offered, sold and delivered directly or indirectly, or offered or sold to any person for re-offering or resale, directly or indirectly, in Korea or to any resident of Korea except pursuant to the applicable laws and regulations of Korea, including the Capital Market and Financial Investment Business Act and the Foreign Exchange Transaction Law of Korea, the presidential decrees and regulations thereunder and any other applicable laws, regulations or rules of Korea. UBS Asset Management has not been registered with the Financial Services Commission of Korea for a public offering in Korea nor has it been registered with the Financial Services Commission for distribution to non-qualified investors in Korea.

Taiwan

This document and its contents have not been reviewed by, delivered to or registered with any regulatory or other relevant authority in the Republic of China (R.O.C.). This document is for informational purposes and should not be construed as an offer or invitation to the public, direct or indirect, to buy or sell securities. This document is intended for limited distribution and only to the extent permitted under applicable laws in the Republic of China (R.O.C.). No representations are made with respect to the eligibility of any recipients of this document to acquire interests in securities under the laws of the Republic of China (R.O.C.).

Source for all data and charts (if not indicated otherwise): UBS Asset Management © UBS 2018. The key symbol and UBS are among the registered and unregistered trademarks of UBS. All rights reserved. 27049A

