Understanding Chinese Security Share Classes

Investment Management

As China has catapulted itself to become the second largest economy in the world,[1] it is predicted that the Chinese economy could be the largest in the world by the year 2050.[2]

The ability to access the Chinese market is still a complex and confusing process. Index providers and asset managers alike are beginning to add more Chinese exposure to their portfolios and are implementing the process to do so in various ways. With seven separate stock share classes, understanding the accessibility constraints is critical to making an informed decision when evaluating a potential investment in a non-U.S. mutual fund or exchange-traded fund (ETF).

Seven Chinese Stock Share Classes

	INCORPORATION OF COMPANY	EXCHANGE TRADED	QUOTED CURRENCY	ACCESSIBILITY
A Shares	Mainland China	Shanghai Stock Exchange (SSE) Shenzhen Stock Exchange (SZSE)	CNY ¥	Available to non-Chinese investors via the Stock Connect program — daily investment limitations apply; Large institutions may access with QFII[3] or RQFII[4]
B Shares	Mainland China	SSE SZSE	US$ HK$	All investors may access; highly illiquid
H Shares	Mainland China	Hong Kong Stock Exchange (HKEX)	HK$	All investors
N Shares	Off-shore	NYSE NASDAQ	US$	All investors
P Chips	Off-shore, non-state owned	Hong Kong Stock Exchange (HKEX)	HK$	All investors
Red Chips	Off-shore, state owned	Hong Kong Stock Exchange (HKEX)	HK$	All investors
S Chips	Off-shore, non-stated owned	Singapore Exchange	SG$	All investors

CNY ¥ = Chinese Yuan US$ = United States Dollar HK$ = Hong Kong Dollar SG$ = Singapore Dollar

The Constraints of Investing in China A Shares

China A shares are a coveted share class of the Chinese securities market. Prior to the introduction of the Qualified Foreign Institutional Investor program (QFII) in 2002, foreign investors simply could not buy China A shares. With both the QFII and the Renminbi Qualified Foreign Institutional Investor (known as RQFII, introduced in 2011) programs, licensed institutions are now able to apply for a quota, and when granted, can invest in China A shares up to a pre-determined limit. Because a single fund and/or asset manager can only invest in China A shares in a limited capacity, as assets grow, there is strong potential that the fund in which the assets are held will either (a) close to investors (or in the case of ETFs, close to creates), (b) use alternative investment vehicles to continue to gain exposure to the Chinese market, and/or (c) seek a quota increase from the Chinese authorities. In the case of ETFs, a closed fund would be expected to begin trading at a premium to its net asset value (NAV).

Chinese Stock Exchange Connect Program – Additional Access to China A Shares

In 2014 Chinese regulators announced the Shanghai-Hong Kong Stock Connect program. This program, in addition to the Shenzhen-Hong Kong Stock Connect program launched in 2016, allow both the Chinese and Hong Kong markets to trade shares of the other market using local brokers and clearing houses, consequently allowing international investors direct access to Chinese stocks. To date, only China A shares are eligible for trading in this program. B shares, ETFs, bonds, and other securities are currently not included.[5] Purchasing stock through this program is limited by daily quotas set for each exchange. The daily quota for each exchange is CNY ¥52 billion net buying of eligible stocks into China. The selling of securities is always allowed, regardless of the quota level. Learn more about the Chinese Stock Exchange Connect Program by visiting the Shanghai Stock Exchange or Shenzhen Stock Exchange websites.

Evaluating Chinese Shares Index Inclusion Across Three Major Index Providers

MSCI

In May 2018, China A shares became eligible for inclusion in the MSCI Global Investable Market Indexes (GIMI)*. In June 2018, MSCI reported that the first inclusion phase of China A shares into the MSCI Emerging Markets Index and MSCI China Index had transpired, with the second inclusion to commence in September 2018.[6] Currently, only China A shares of companies qualifying for the large cap size-segment (as defined by MSCI) and trading through the Stock Connect program will be added to the MSCI Emerging Markets and MSCI China indexes. MSCI's review and inclusion of China A shares follows the Global Investable Markets Index methodology framework, however, MSCI clarifies that while all share classes from the China Equity Universe are part of the GIMI evaluation and construction, China A shares of companies assigned to the mid cap and small cap size-segments (as defined by MSCI) and those shares not available through Stock Connect will not be included in the MSCI Emerging Markets and MSCI China indexes.[7]

S&P Dow Jones

Currently, S&P Dow Jones includes all shares traded on developed market exchanges in their S&P Emerging Markets Core Index.[8] These shares are H and N shares and Red, P, and S chips. S&P Dow Jones stated in their December 2017 country classification press release that they will continue to exclude China A shares broadly, but will continue to closely monitor the China A share market.[9] Acknowledging that many global investors might prefer benchmarks that incorporate China A shares, S&P Dow Jones offers an alternative set of global benchmarks that include China A shares.

FTSE Russell

In March 2018, FTSE Russell disclosed that China A shares will continue to remain on their Watch List, but will be re-evaluated for possible inclusion in their secondary emerging market category during the FTSE Global Equity Index Series (GEIS) Annual Review in September 2018.[10] FTSE Russell currently provides investors with two separate versions of global indices allowing investors to choose whether or not they would like exposure to China A shares. The FTSE Global China A Inclusion Indexes offer market participants the option of investing in China A shares, while GEIS continues to exclude China A shares at this time.

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As one of the nation's largest asset managers, our goal is to provide investors with a diverse selection of foundational products that aim to deliver consistent performance at a competitive cost.

* Learn more about MSCI's Global Investable Markets Indexes by visiting https://www.msci.com/market-cap-weighted-indexes

[1] International Monetary Fund, 2018

[2] PricewaterhouseCoopers, "The Long View: How will the global economic order change by 2050?," (February 2017)

[3] Qualified Foreign Institutional Investor program (QFII). Launched in 2002, this program allows approved licensed international investors to access China's mainland stock exchanges. Access is limited by a quota obtained by the international institution (typically an asset manager) and issued by China's State Administration of Foreign Exchange (SAFE).

[4] Renminbi Qualified Foreign Institutional Investor (RQFII). Launched in 2011, the RQFII program allows the use of Chinese yuan renminbi funds raised in Hong Kong by the subsidiaries of domestic fund management companies in Hong Kong to invest in the domestic securities market. Access is granted by China Securities Regulatory Commission (CSRC) and a quota is issued by China's State Administration of Foreign Exchange (SAFE).

[5] A Joint Announcement was made on August 16, 2016 indicating that the China Securities Regulatory Commission (CSRC) and the Securities & Futures Commission of Hong Kong (SFC) will include ETFs as eligible securities under the mutual market access program once the Shenzhen- Hong Kong Stock Connect program has been operational for a period of time. (www.hkex.com.hk)

[6] "Results of MSCI 2018 Market Classification Review", www.msci.com (June 20, 2018)

[7] MSCI, May 2018

[8] S&P Dow Jones Indices, "S&P China Indices Methodology", p. 4. (June 2018)

[9] "S&P Dow Jones Indices Announces Country Classification Consultation Results," www.us.spindices.com (December 11, 2017)

[10] "FTSE Country Classification – March 2018 Interim Update", www.ftse.com

International investments involve additional risks, which include differences in financial accounting standards, currency fluctuations, geopolitical risk, foreign taxes and regulations, and the potential for illiquid markets.

Indexes are unmanaged, do not incur management fees, costs and expenses, and cannot be invested in directly.

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