China's Weight in Emerging Markets

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Building a global equity portfolio requires several levels of decisions- from defining the investable market to determining macro characteristics to selecting individual securities. China-registered companies present a special challenge for worldwide portfolios. Until recently, emerging markets mutual funds could only own B and H-shares of Chinese companies.

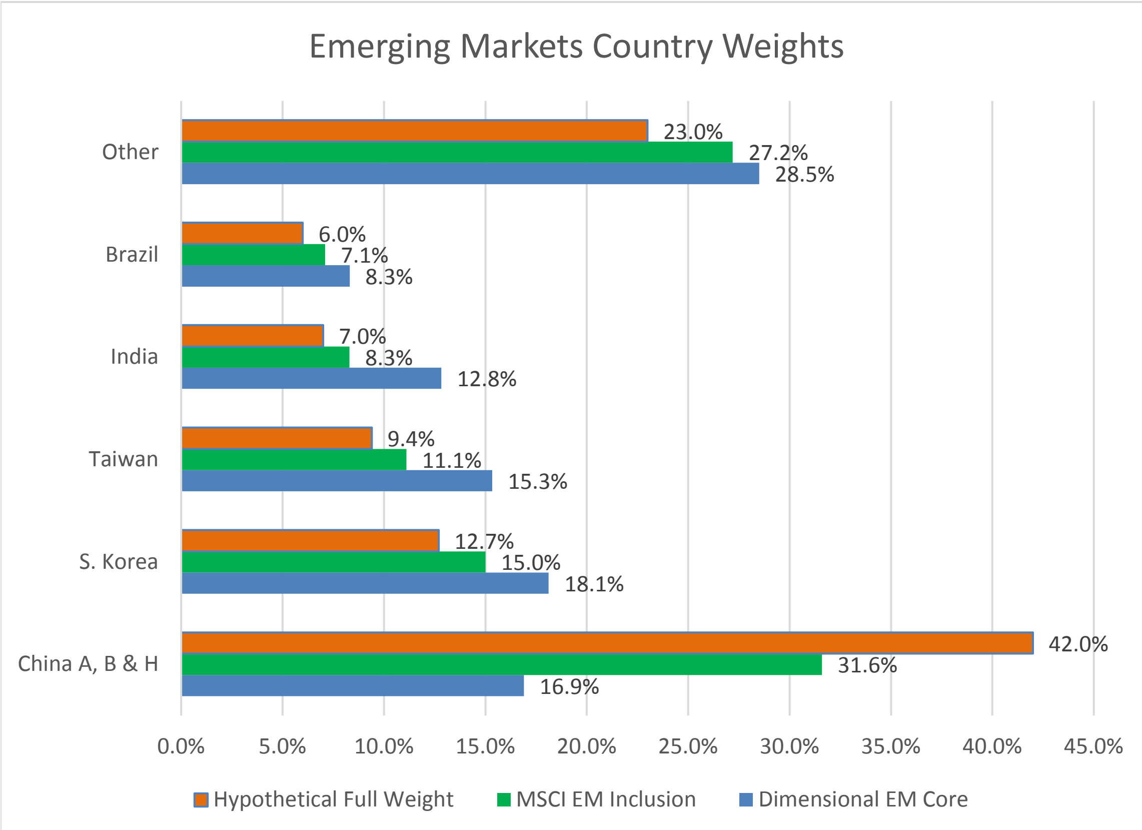
China opened its markets to foreign investors in the early 1990s with B-shares, which are shares of China-registered companies traded in foreign currencies. Regulators initially barred local investors from owning B-shares, though many found ways around the rules. B-shares were opened to domestic investors in 2001. H-shares of China-registered companies trade in Hong Kong, denominated in Hong Kong dollars.

Yuan-denominated A-shares of Chinese companies trade on mainland Chinese stock exchanges in Shenzhen and Shanghai. The A-shares market opened to foreign investors in 2003, but was limited to qualified institutions and subject to certain limits, including restrictions that made it hard to move money out of China. These limitations concerned mutual fund and exchange-traded fund managers, who must be able to meet daily buy and sell orders from shareholders.

More recently, restrictions have been eased. Since 2014, the Stock Connect program has linked the Hong Kong and mainland Chinese exchanges, making it easier for foreign investors to trade Chinese A-shares from outside the country. This program created cross-boundary investment channels whereby foreign investors could invest within certain limitations in some Shanghai and Shenzhen-listed A-shares via the Hong Kong Stock Exchange. In 2015, FTSE Russell, a provider of global benchmarks, started to include China A-shares in some of its benchmark indexes.

MSCI, another provider of global indexes, deliberated for several more years before adding China A-shares to its emerging markets, all-country world, and Asia indexes. The considerations focused on market volatility, accounting standards, the impact of speculators, and capital controls. China's financial regulators relaxed limits on trading and moving money out of China, but analysts still worry that a sharp sell-off could trigger problems like those seen in 2015, when at one point many of the roughly 2,800 listed companies stopped trading.

This summer, MSCI started to include China A-shares in its emerging markets and China indexes. MSCI will add approximately 230 A-shares to the MSCI Emerging Markets Index by the end of August. The orange bar in the following table shows that the hypothetical full weight of Chinese companies in the MSCI Emerging Markets Index would be 42% if the full value of China A-shares are added to the index. The green bar shows that MSCI's first stage of inclusion only increases the weight for Chinese companies to 31.6%.



Sources: CSRC, Shanghai & Shenzhen Exchanges via MSCI, Wall Street Journal, Dimensional, Morningstar

Index funds benchmarked to the MSCI Emerging Markets index must purchase the 230 China A-shares added to the index this summer to minimize tracking error. In contrast, Dimensional Fund Advisors can make its own decision about when to add A-shares and over what time period. The blue bar in the chart shows that Chinese companies represent 16.9% of the Dimensional Emerging Markets Core Equity mutual fund.

Dimensional has carefully evaluated the China A-shares market for a number of years. Members of the firm’s investment team have visited China and conducted meetings with market participants and regulators. Areas of evaluation have been wide-ranging, as avenues for accessing the A-shares markets have developed and changed over time. While Dimensional’s strategies do not rely on benchmark inclusion to determine either country or stock eligibility, benchmark providers’ country classifications represent an important consideration because many of its clients use indexes to make asset allocation decisions and evaluate performance.

Dimensional’s Investment Committee determines eligibility for countries, exchanges, companies, and share classes for each portfolio it manages. The portfolio management and trading teams provide input and monitor these countries and exchanges on a regular basis. The firm draws from multiple sources of information when making decisions about a country’s eligibility and classification.

In the near term, any decision on A-shares is likely to have a minimal impact on China’s weight in Dimensional’s Emerging Markets strategies. Dimensional will continue to assess potential changes and we will communicate any significant updates to you.

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