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MARKET INSIGHTS ALERT

Whither the GEM manager?

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MSCI may have just changed your global emerging markets (GEM) business model. Do you know it yet?

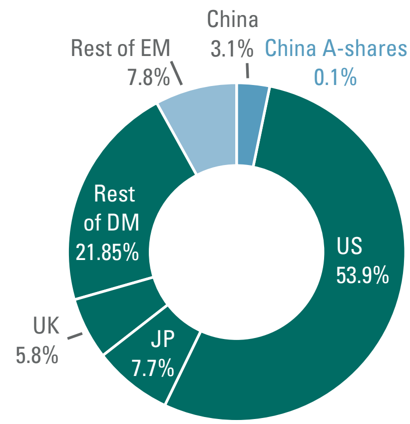
On June 20, 2017 MSCI issued its bureaucratically named "Results of MSCI 2017 Market Classification Review". In that review, MSCI announced that effective May 2018 it would begin to add Chinese A-shares to its global suite of much-followed indices including the MSCI ACWI and MSCI Emerging Markets indices. The news media was quick to highlight the potential implications of this change for Chinese equities' demand from global investors. As we feel those market implications are well-discussed elsewhere, that is not the subject of this paper. Here we will examine the business implications of this decision for allocators and managers. For both allocators and managers, we set out some practical recommendations on how to navigate these business changes over the next 5-7 years. This paper is the promised follow-up to the teaser set out in our Q2 Market Outlook, "Reality Trumps the Reflation Trade" from April 13, 2017.

MSCI INDEX CHANGES

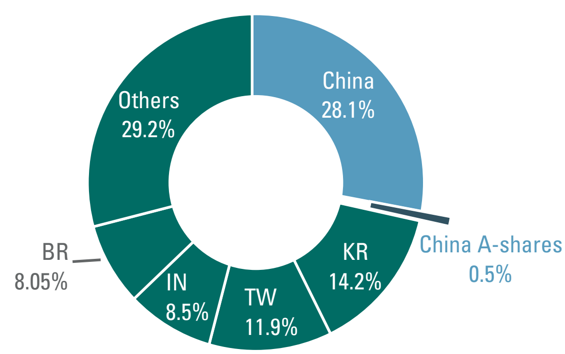
To review, MSCI's plan to include A-shares is in effect a compromise solution between the Chinese government and MSCI's major customers (such as Blackrock) whereby Chinese A-shares will gradually be added to the major indices, such that their initial weights in the major global indices will be trivial and thus least objectionable (see CHART 1). Therefore, at present, the recent hoopla over this announcement is more much ado about nothing than anything to move markets or even warrant much headlines. More critically is what this compromise portends for the future of the indices and all that comes with it. In securing this compromise with their leading stakeholders and market makers, MSCI has put Chinese A-shares on a bureaucratic path to full inclusion in their major indices over the next 4-6 years. Given the mammoth size of the Chinese A-share market, this shows the path forward for a radical change in index composition, which in turn, we believe, will precipitate an equally radical change in allocative behavior for a preponderance of the asset management industry.

Looking ahead several years, when the Chinese stock market is eventually given its full weight in the MSCI index, it will command greater than 50% of the index weight, even accounting for the expected inclusion of Saudi Arabia which should also occur by the time China reaches full inclusion (see CHART 2 on the next page)[1]. Moreover, if we remove Korea from the equation, which remains in the EM index pending only a technical revamp of its FX rules away from MSCI upgrade, China will approach 59% of the index (see CHART 3 on the next page). Together with Taiwan (which often is lumped together as a part of "Greater China"), this geographic region would surpass 63% of the emerging markets index. Even at today's levels, China is already by far the largest weight of any single market in the MSCI Emerging Markets Index since shortly after its inception in 1988 (when Malaysia represented 34% of the initial MSCI EM Index country weights). And no single market (or region) has ever approached the dominant 50% position, let alone the 60% threshold which China seems likely to do (see CHART 4 on the next page).

CHART 1 | ACWI
Percent; As of March 24, 2017



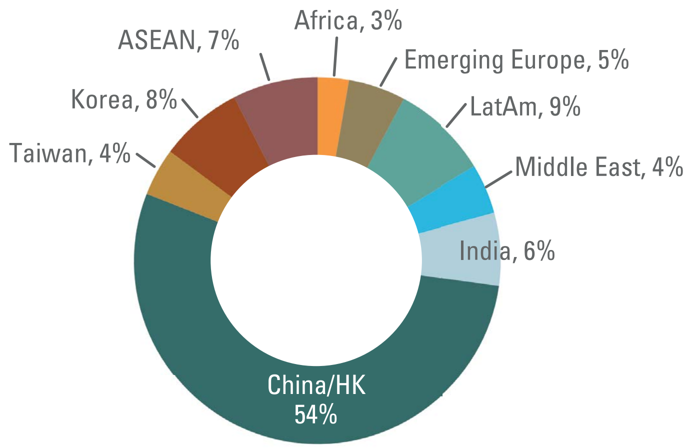
Emerging Markets



Source: MSCI

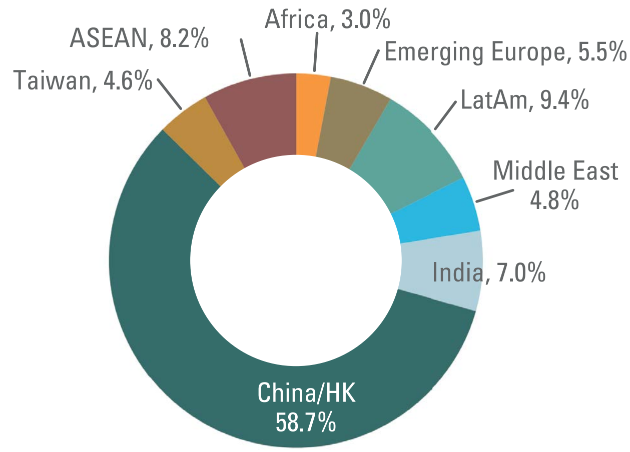
[1] *Chart 2 is based on current market cap weights and also includes Saudi Arabia, which appears on a path towards MSCI inclusion by 2020 or so. No projection is made for relative changes in composition from stock performance or new IPOs, most notably the expected IPO of Saudi Aramco.*

CHART 2 | Emerging Markets Weights with China A & Saudi Arabia



Source: Factset

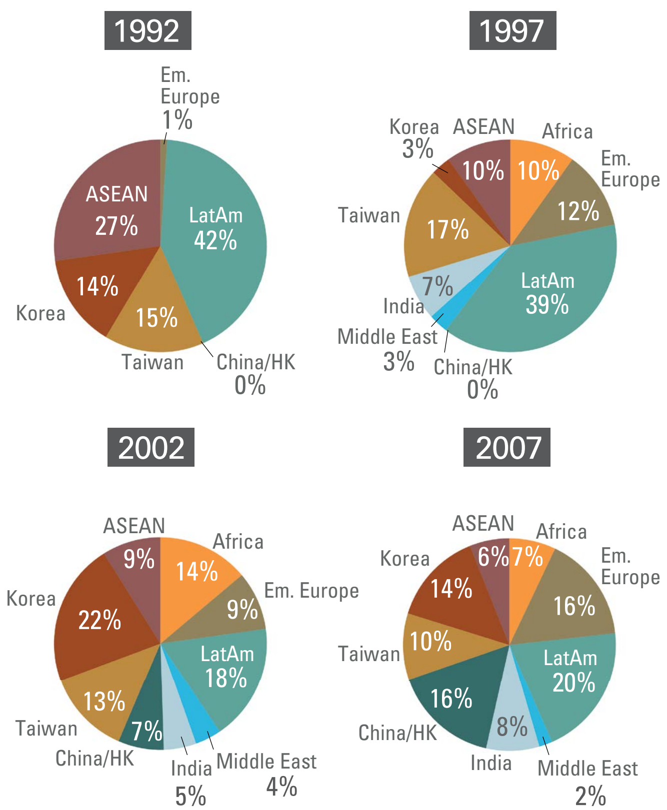
CHART 3 | Emerging Markets Weights with China A & Saudi Arabia, without Korea



Source: Factset

CHART 4 | MSCI Emerging Markets Index Historical Composition

Percent; As of March 24, 2017



Source: MSCI

Moreover, this concentration is not merely an arbitrary creation of market capitalization or free float skews. The raw number of companies in the current opportunity set – which is more emblematic of a benchmark agnostic active manager's investible universe – are broadly in line with the projected future cap weighted index composition (see TABLE 1).

TABLE 1

	$500 MILLION + MARKET CAP			$1 BILLION + MARKET CAP		
		% of EM	% of Global		% of EM	% of Global
Africa	104	1.8%	0.9%	70	1.9%	0.8%
Emerging Europe	220	3.8%	1.8%	154	4.2%	1.9%
LatAm	408	7.0%	3.4%	304	8.3%	3.7%
Middle East	167	2.9%	1.4%	118	3.2%	1.4%
India	490	8.4%	4.0%	311	8.4%	3.8%
China/HK	3,297	56.6 %	27.2%	2,028	55.1%	24.6%
Taiwan	272	4.7%	2.2%	155	4.8%	2.1%
Korea	284	4.9%	2.3%	177	4.8%	2.1%
ASEAN	579	9.9%	4.8%	364	9.9%	4.4%
United States	2,525		20.8%	1,982		24.0%
Developed Europe	1,779		14.7%	1,301		24%
Japan	1,089		9.0%	727		8.8%
Other	905		7.5%	568		6.9%
Total	12,119		100.0%	8,259		100.0%

Source: FactSet. Excludes dual-listings and inactive securities.

NEW EQUITY UNIVERSES

MSCI likes to emphasize that their indices are designed to be descriptive of markets, not instrumental to their creation. In other words, they claim to be the cart, not the horse. But their dominance in the industry as tools for allocative decision-making and benchmarking means that while the cart (MSCI index) may not entirely drive the horse (portfolio management), the size and shape of the cart definitely puts constraints on the size and shape horse you have to hire. With such a significant change in index composition forthcoming, we foresee equally significant changes in the portfolio management decisions that allocators will make. The size of the China universe alone, which is already on par with the U.S. in terms of investible companies, will by itself lead allocators to evaluate China-only equity strategies as a part of their asset allocation. The unique "Chineseness" of the Chinese equity market (greater correlation with policy announcements and expectations, extreme liquidity and momentum swings, etc.), will also create a natural barrier of expertise for asset managers and thus an increased openness and perhaps preference for such specialization among allocators. We believe all these factors will drive towards the creation of a new subset of the GEM universe: Global Emerging Markets x China. And like with Asia x Japan vs Asia or ACWI x US vs ACWI before it, we believe that within 5-10 years time, GEM x China will command at least 50% market share vis a vis GEM.

Looking beyond just the global emerging markets space, we also believe the broader acceptance of China as a dedicated allocative universe will also give rise to the ACWI x US x China (or can we propose, ACWI x Chimerica?) benchmark as a growing standard. Moreover, the growth of importance of Chinese savers and investors, will also create demand for ACWI x China products, just like UK pensions prefer ACWI x UK, Japanese banks demand ACWI x Japan, etc. The only difference is that ACWI x China might have 300-500 million customers within a shorter time frame.

FOR INSTITUTIONAL INVESTORS AND ALLOCATORS

Already many of the world's largest pension funds and allocators have significant money dedicated to onshore China assets, as evidenced by their significant QFII quotas (see TABLE 2). The QFII system was largely made irrelevant to pure equity investors with the launch of the Hong Kong Direct Connect in late 2014 (although given the custody and settlement kinks it was not in effect broadly open to global investors until about mid-2016). The nature of the QFII quota is "use it or lose it," so these quotas should generally be understood to represent capital that is actively deployed within China, though it is also not necessarily all in equities as the QFII quota can be deployed in bonds, fixed income, money market, etc. However, based on our own review of the Chinese boutique manager landscape (and their client lists), most of the institutions in this list have hired China specialist managers to invest significant portions of their QFII quotas in A-shares dating back to 2010 as an estimated average starting period.

TABLE 2 Leading Institutional QFII Holders

NAME OF QFII HOLDER	QUOTA (USD MILLIONS)
Monetary Authority of Macao	$3,000
Hong Kong Monetary Authority	$2,500
Norges Bank	$2,500
ABU Dhabi Investment Authority	$2,500
Temasek Fullerton Alpha Pte Ltd	$1,500
Kuwait Investment Authority	$1,500
GIC Private Limited	$1,500
Bank Negara Malaysia	$1,500
Canada Pension Plan Investment Board	$1,200
Qatar Holding LLC	$1,000
The Bank of Korea	$900

Source: State Administration of Foreign Exchange, China. As of July 31, 2017

Fortunately, for the next wave of institutional investors and allocators, these investing pioneers have paved the way in establishing a subset of Chinese specialist equity managers (many of whom are Chinese boutiques) that are familiar with institutional standards and equipped to communicate with global (i.e. non-Chinese speaking) investors. However, these QFII investors have also indirectly entrenched the long-standing trifurcation of the Chinese market (China listed, Hong Kong listed, and U.S. listed) in the way that portfolio managers construct their research universes. Based just on our own firm's work, over the past three years, FIS Group has reviewed approximately 200 managers with strategies focused mostly on China within the subset of independent, boutique managers. And of these, while we estimate that about 40-50% of these managers cover all three subuniverses of the Chinese equity market, we estimate that less than 20% of these have equal experience in covering the entire universe of Chinese stocks. It is only with the advent of the Hong Kong Direct Connect in late 2014 that offshore Chinese managers were given access to the onshore market and vice versa. Before that, the few firms that had equal access to the full market were either the very large asset managers who could get a QFII, mid-sized asset managers who could get the more liberal RQFII (only launched in late 2011) or firms with enough luck or good connections to get quota sub-allocations from their QFII eligible prime brokers.

For our institutional clients, their consultants, and our peers, as your allocative decision-making models shift to include research on China-only equity strategies, longevity and focus in the different parts of the Chinese equity market should be a critical part of your investment due diligence. If you work with or prefer working with the big global asset management firms, likely they will easily and happily sell you a China-only version of their standard global offerings (if they don't have one already). They may also reassure you that as a firm they've been covering both onshore and offshore listed stocks for longer than the boutiques, often because of their QFII quota access, which favored the large firms until about 2013. But we advise you to dig deeper. Ask how the research on both sides of the universe was actually done, whether analysts or PMs actually covered both onshore and offshore equities at the same time, and whether the quotas put floors or ceilings on the percentage of the portfolio that had to be dedicated to either universe (an artificial constraint on a PM's control over their own portfolio that should change the way they are evaluated). Turnover in the asset management industry in China and Hong Kong is also reportedly much higher than comparable averages in Singapore, New York, or London, so take extra time to dig into the personnel changes as well. If you're doing due diligence on any of the several hundred estimated China-focused boutiques, expect to travel. While a few such boutiques can be found in New York, San Francisco, or London, the vast majority are in Hong Kong and Shanghai with a smattering more in Beijing and Singapore. And for those firms based in mainland China, your biggest barrier may be language. While most established Chinese boutique managers have hired fluent English speakers into their client services and marketing divisions, the depth of English fluency at the portfolio management or operational levels is much lower (albeit better than in Korea or Japan, by comparison).

FOR MANAGERS

For China managers, sit tight…the market is coming to you. The one thing you can do, is to train more of your staff to be comfortable communicating in English. Just a little bit of English to be able to field routine communications independent of your fluent English speaking client services representatives, will reduce your dependency on such marketing personnel either as critical components of your business or as operational funnels through which all client interactions must pass. Furthermore, given the already immense preponderance of Greater China based and focused asset managers (we broadly estimate there are upwards of 500-1,000 already in the marketplace, ranging from small boutiques to large banks and conglomerates) it will help you stand out against your peers.

For GEM managers, as Yoda said: "Do or do not, there is no try." Either cover China completely, including all of the A-share universe, or prepare to get out of the pond and run your GEM strategy as a GEM x China portfolio. And if you haven't started covering A-shares yet, you are already 1-2 years behind the preponderance of your peers. If you choose to compete in the "all GEM universe," you might further be wise to start running China and GEM x China strategies, or at least carefully tracking your performance attribution and decision-making (or running model portfolios) that divide your portfolio construction decisions between China and x China so the two pieces within your current GEM strategy can reasonably be evaluated by allocators in the future. The more you can do to document these changes, the better equipped you will be vis a vis your peers when the time comes to compete in the new China-dominant marketplace.

Finally, for systematic managers or managers with strong factor filters in their process, if you aren't already aware, the A-share market can seem a bit wacky in comparison to other GEM markets. Extreme momentum behavior, a valuation premium for small caps over large caps, liquidity disproportionate to market cap, and completely different worlds for access to credit (and thus leverage measurements) between state-owned firms and private firms may compromise your quant models and factor filters, necessitating a unique approach to this behemoth market. Moreover, the higher incidence of frauds and stock suspensions also raises the bar. Get your calls right, and you may be richly rewarded; get it wrong, and you could see some of your holdings go to zero. Happy investing!