

# China A-Shares

## Introduction

As a follow up to our decision last year not to include China A-shares in the March, 2019 reconstitution, RAFI Indices has recently concluded a second review of the China A-shares market and have again decided not to include China A-shares in the upcoming March, 2020 reconstitution. In this memo we summarize our review and concerns regarding the China A-shares market. RAFI Indices plans to consider A-shares again next year for the March, 2021 reconstitution.

## Current Practice on China Equity Share Classes

Several types of share classes of Chinese equities are available for investors. Some of the share classes are eligible for our indices, while others are not. Our policy on each share class is as follows:

### Currently Eligible for Inclusion:

- H-Shares: Stocks from companies incorporated in mainland China, but traded on the Stock Exchange of Hong Kong in Hong Kong dollars.
- Red-Chip: Stocks from Chinese companies incorporated outside mainland China and traded on the Stock Exchange of Hong Kong. These companies are substantially owned by mainland China state entities.
- P-Chip: Stocks from Chinese companies incorporated outside mainland China and traded on the Stock Exchange of Hong Kong. These companies are substantially owned by private sector entities.
- S-Shares, N-Shares and L-Shares: Stocks from Chinese companies incorporated outside mainland China, but traded on the Singapore Stock Exchange (S-Shares), NYSE, NASDAQ, or NYSE MKT (N-Shares) and the London Stock Exchange (L-Shares).

### Currently Ineligible for Inclusion:

- A-Shares: Stocks from companies incorporated in mainland China and traded on the Shanghai and Shenzhen stock exchanges.

- B-Shares: Stocks from companies incorporated in mainland China and traded on the Shanghai and Shenzhen stock exchanges in US dollars or Hong Kong dollars.

## Evaluation of RAFI Weight in China A-Shares

The inclusion of China A-shares in the eligible universe would result in a noticeable increase in Chinese equities as a percentage of the overall universe. An examination of the 2019 RAFI Global Equity Investable Universe (GEIU) shows that free-float-adjusted Chinese equities constituted 3.2% when China A-shares are excluded. When China A-shares are included in the analysis, free-float-adjusted Chinese equities (both A-shares and off-shore) constituted 6.7% of the universe.

Examining the RAFI Emerging Markets Index, free-float-adjusted Chinese equities composed 26.0% of the RAFI Emerging Markets Index at the 2019 reconstitution (excluding China A-shares). When including A-shares, Chinese equities would have composed a more substantial weight in the overall index, with a 41.6% allocation.

## Current Position on China A-Shares

The inclusion of China A-shares in the GEIU would have a significant impact to the allocation of Chinese equities in RAFI Indices™. Currently, RAFI Indices does not plan to make China A-shares eligible for inclusion in the GEIU for the 2020 reconstitution due to our concerns regarding accessibility and implementation, among others.

### Accessibility:

- Through the Stock Connect program, quotas are in place that can impact not only liquidity, but also trade execution, should the quota be reached, (for both the Shanghai and Shenzhen Stock Connect programs, the daily quota is 52B RMB). Once the daily quota is triggered, investors are only able to sell China A-share equities. Given that several index providers and asset managers will be adding China A-shares over the next year, we have concerns regarding the liquidity of China A-shares.
- Foreign ownership limits will impact the level of A-shares that can be included in the index. Individual foreign ownership is currently limited at 10%, with total foreign investment not to exceed 30% of a security.
- Eligible stocks in the StockConnect program can be recalled, resulting in a restriction on the purchase of that stock.



- Additional trading restrictions could apply due to the following:
  - The A-share is no longer part of an eligible index under the StockConnect program.
  - The A-share is placed under a risk alert
  - The Corresponding H-share ceases to trade.

### **Implementation:**

- Local account set up is needed to facilitate same-day trade settlement, for which purchases are subject to pre-funding and repatriation of currency is not immediate.
- Under the Stock Connect program, trading suspensions for securities, while improving, still occur. Trading suspensions often occur without an indication of the reason for the suspension or a timeline for the expected length of the suspension.

### **Other Concerns:**

- Trading under the StockConnect program is not protected by the Investor Compensation Fund.
- Limits on short selling and lack of accessibility for hedging and derivatives hampers investors' ability to implement and risk manage.
- Inconsistent settlement cycle, (T+0 for mainland securities, T+2 for Hong Kong)
- Difference in trading day and hours could result in a risk of price fluctuations in the A-share market when StockConnect is closed.

RAFI Indices will continue to monitor the development of the Stock Connect program and the China A-shares market and seek consultation from clients to determine when inclusion of A-shares would be appropriate.



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