Managers

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Funds

Guinness Asian Equity Income Fund
Invests in Asian companies with persistently high return on capital, that are well placed to pay a sustainable dividend into the future.

Guinness Best of China Fund
Invests in companies benefiting from exposure to economic expansion and demographic trends in China and Taiwan.

Guinness Emerging Markets Equity Income Fund
Invests in dividend paying companies in Emerging Markets world-wide.

Is inclusion into MSCI benchmarks a game changer for China A shares? Yes and No.

The Chinese stock markets are big. The combined market capitalisation as at 23rd June 2017 of the major Chinese stock exchanges in Shanghai and Shenzhen amounts to almost $7.75 trillion which compares to the New York Stock Exchange capitalisation of $22 trillion, NASDAQ $9.4 trillion, Tokyo $5.4 trillion and London at $3.18 trillion. China's stock markets are also active with turnover on that day of $37 billion which compares with $67 billion in New York and $49 billion on Nasdaq and $6.5 billion in London.

Source: Bloomberg. Data as at 23rd June 2017

All of this makes it no surprise that at some point China's domestic shares would one day be included in international benchmarks. China's economy is the second largest in the world; it does more trade in goods ($3.8 trillion a year) than any other country; its market for passenger cars in 25 million a year – GM sells 4 out of every 10 cars it produces to China. The notion that Chinese companies should be kept out of international benchmarks indefinitely was clearly not likely.

What has MSCI done?

MSCI has now taken the view that Chinese stocks are important enough and that access to them has been made easy enough for 'index-linked investment vehicles' to include them in their index calculations from May 2018. There are however remaining difficulties that mean that there are some quite specific criteria attached. Chinese A shares are not yet easily available to all investors and those that are can be accessed through Connect Schemes established between the stock exchanges of Hong Kong, Shanghai and Shenzhen. It is through the Hong Kong Stock Exchange that A shares can be bought and sold. So MSCI has included only the largest shares by capitalisation, that are available through the Connect Schemes and whose managements did NOT elect to suspend their shares when Chinese markets fell sharply in 2016. And MSCI has decided to limit the weighting of these shares to 5% of the market capitalisation (defined by MSCI as the number of freely traded shares multiplied by the current market price).

What is the impact on benchmarks?

China A shares will only be included in the Emerging Market components of MSCI indices and of course their China benchmarks. The total market capitalisation of the 222 shares as at 31st May 2017 was $3,210 billion; by using only the free float in the calculation the market cap falls to $1,000 billion meaning that at 5% of the free float market cap the inclusion comes to $50 billion. The MSCI Emerging Markets benchmark had an overall market capitalisation of $4,601 billion so as at the end of May China A shares would have accounted for around 1% of that index (or 0.73% at the time of MSCI's announcement).

Chinese stocks traded outside of the mainland, in Hong Kong and the US already account for 27.66% or ($1.27 trillion) of the MSCI Emerging Markets Index so an additional $50 billion does not make much difference today. For the $1.6 trillion in Index fund assets tracking this benchmark it means they will need to buy ~$12 billion (to replicate the 0.73% weight). As we pointed out in the first paragraph, with turnover on Friday 23rd June of $37 billion, the impact will not be significant.

The question of course, is what happens next. Eventually we must surely see the 5% limit of market capitalization rise together with the inclusion of more mid cap China A shares. A rise in the 5% limit to 50% would see China A shares rise to 10% of the Emerging Markets Index and China overall to reach 34.7%. It would also have to come at the expense of others: the Asian component of the Emerging Markets Index would rise above 75% while Latin America would shrink further from 12.5% down to 11.25%.

Do we care about the benchmark anyway? (Answer: We don't)

But so what about the benchmarks? That is only relevant for passive investors and the 'fire & forget' solution offered by index tracking we would argue is not always appropriate. This is not the S&P 500 we're talking about here. We can and should be interested in exactly what we're buying. MSCI is including China A shares at the behest of those who track their benchmarks. This does not make them all great stocks. Size, liquidity and access are the criteria. China's economy has two very distinct sides to it: on the one side is a dynamic and progressive manufacturing and services economy supporting the rising consumer class and on the other, a heavy industrial sector weighed down by debt and excess capacity whose time is past. Naturally enough the stocks included by MSCI today reflect both sides.

What this means to us

- We believe that this step is important from a top down level in that it gives China an 'official' recognition of the progress made in developing and opening their capital markets.

- The engagement of international investors will very likely have a positive effect on market operations, pricing, information disclosure and overall dynamics just as it did for China shares listed as H shares in Hong Kong from 1993.

- Inclusion in benchmarks will force investors to look again at China with a view to putting money to work; for that group ignoring China as being too difficult will no longer be an option. These 'unwilling volunteers' may well discover for themselves, as we have long argued, that there is much that is good in China for investment.

- This supports China's integration into the global financial system which began with renminbi and its inclusion as the fifth reserve currency in the International Monetary Fund's SDR basket in 2016 and is expected to be followed by the establishment of a Connect Scheme for China massive domestic bond market (the world's second largest bond market).

Our approach to investment is an Active one. We believe that buying good quality companies, defined as those that have generated a return on capital above the cost of capital for many years, will probably stay good. If their current market price undervalues the likely persistence of those returns then we probably have a good investment opportunity. In Asia, we have 300 companies that have achieved our quality criteria in terms of return on capital and low debt. Out of the 222 new additions into MSCI's benchmark there are 37 that are of potential interest. Of these, 12 are banks which are all subject to largely the same drivers (good and bad) many of which trade in Hong Kong in any case, leaving 25 names in consumer discretionary, consumer staples, health care, industrials and technology.

MSCI's decision adds extra impetus to China's stock markets to resolve lingering operational matters because as they do so the weighting in MSCI indices is expected to rise with the 'Push' from China being matched by the 'Pull' from institutional demand outside China.

Edmund Harriss

Manager, Guinness Asian Equity Income Fund

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Fund managers

Edmund Harriss has managed Asian Funds since 1994 both from London and Hong Kong. He worked for ten years from 1993 for Guinness Flight, which merged with Investec in 1998. He joined the Far East Investment Desk in 1994 as part of the team managing the China & Hong Kong Fund (now the Guinness Atkinson China & Hong Kong Fund, for US investors). In 1998 he moved to Hong Kong and became the Fund's lead manager. Edmund now manages Asia funds and China & Hong Kong funds in a Dublin OEIC for Guinness Asset Management and SEC-registered funds (for US investors) for Guinness Atkinson Asset Management. Edmund graduated from Christ Church, Oxford, with a Master's degree in Management Studies and has a Bachelor's degree in History from the University of York. He is an Associate of the Society of Investment Professionals.

Mark Hammonds joined Guinness Asset Management as an investment analyst in September 2012. Previously he qualified as a Chartered Accountant at Ernst & Young. Mark graduated from Corpus Christi College, Cambridge, in 2007 with a First Class degree in Management Studies.

Sharukh Malik joined Guinness Asset Management as an investment analyst in October 2015. Sharukh graduated from Fitzwilliam College, University of Cambridge, in 2014 with a degree in Economics.

Guinness Asset Management

Guinness Asset Management provides a range of long-only actively managed funds to individual and institutional investors. Founded in 2003, Guinness is independent and is wholly owned by its employees.

We believe in in-house research, intelligent screening for prioritisation of research and well-designed investment processes. We manage concentrated, high conviction portfolios, with low turnover and no benchmark constraints. At heart Guinness is a value investor.

Since our establishment we have developed a variety of specialisms in global growth and dividend funds, global sector funds and Asian regional and country funds.

The Guinness funds sit within an Irish-listed OEIC. They are managed alongside a range of mirror SEC-registered funds offered to US investors by our US sister company, Guinness Atkinson Asset Management Inc.

We also offer Enterprise Investment Schemes investing in UK renewable energy projects and AIM-listed companies.