The Market Index Debates Come to China

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For thousands of years, humans have demonstrated a deeply held need to measure how they are doing versus others. This need shows up in many ways, whether it's keeping score at games or counting the number of enemy casualties in battle. And the process of such measuring has often (if not always) impacted the way we do things because our behaviour is affected by the desire to "measure up" in the best possible way. Nowhere is this behaviour effect more evident than among investors in stock markets.

While some minority of investors eschew a comparison with indices and focus only on achieving a certain level of absolute returns, most institutional investors today, in markets around the world, are in a constant battle to achieve results relative to a benchmark index. This majority of investors, be they passive or active players, look at their portfolio results in comparison to an index benchmark.

As a result, the way in which an index is constructed, its constituents and the way its constituents change can have a very direct impact on investor portfolios and what is in them. So changes in an index can often mean changes to a real portfolio of invested assets. And changes in portfolios mean that money has moved around, a great deal of money.

Institutional investors subject themselves to this benchmarking discipline mostly because their clients, the people who "own" the money, want to know how their managers are doing. Failure to achieve satisfactory relative results will cause asset owners to move their funds to a different manager or to try a different investment approach. None of this is necessarily a bad thing but we should always recognise that real decisions about real assets are affected by index benchmarks and how they work.

The people who create and maintain market indices do so based on very specific criteria and methodologies in order that index users can rely on what is being measured and how accurate the outcome. Index providers such as MSCI, FTSE and many others, have worked hard to produce useful and reliable benchmarks that give investors what they need – measurements that are accurate and reproducible.

Reproducibility is important because if you can’t actually invest in the constituents of your benchmark, you run a measurement mis-match risk. And when it comes to markets such as China however, reproducibility has been a problem. Investor restrictions, different listing venues and changing policies inevitably make index construction a challenge.

The subject of market indices has recently gained prominence among market participants, index providers and government policy makers following the launch of the Shanghai-Hong Kong Stock Connect last year. Taken together with recent landmark listings by Chinese companies overseas, such as Alibaba, there is a growing likelihood that major index providers such as MSCI and FTSE will make changes to expand China’s representation in some of their indices. Such changes will impact investor portfolios and almost certainly expand fund exposures to stocks in China, potentially changing valuation levels and the cost of capital along the way. These kinds of changes will certainly be positive for Chinese companies in terms of access to wider pools of capital and are likely to encourage both governance and regulatory changes that enhance investor confidence.

For investors, market operators and government policymakers, the question is what they can or should do to encourage change in the way indices measure their markets. The result of such changes will have important implications for investors because major index changes will generate potential huge portfolio flows. Restrictions on some groups of investors versus others will always be a source of concern for international index providers and Chinese regulators are well aware that both market and foreign exchange restrictions are an ongoing impediment to full China market inclusion in international indices. And with every effort made to reduce those hurdles, Chinese regulators are bringing the day of fuller inclusion closer. As investors can own more companies in unrestricted ways, they will want indices that reflect the changed “real world”.

Inevitably, as China takes a growing percentage of emerging market capitalisation, other such markets will be concerned about the fallout from their perspective. This can however, be a “win-win” situation for some if they pursue the right policy changes over time. Markets like Korea and Taiwan are far more “developed” than those of China and should be looking to create an environment in which their “developed” status is reflected in their treatment by index providers. This will not be an overnight process as it demands changes in both market practice and government policy. Still, the rewards can be substantial and certainly worth the effort. Even taking a leaf out of China’s playbook by developing international direct links with other major markets will help drive the process of change to the benefit of both companies and investors.