STRATEGY IN PRACTICE

Q&A: China Market Update

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August 2015

The mainland China A-share market has been highly restricted to foreign investors. In recent years, however, the market has undergone a number of reforms designed to gradually improve accessibility. While many investors have been encouraged by this positive trend, 2015 market turbulence and related events have raised concerns.

Given the size and importance of China's equity market, it may be useful to discuss recent events and highlight Dimensional's approach to investing in China.

Does Dimensional invest in China?

China is an eligible country for Dimensional's emerging markets equity strategies and global strategies that include emerging markets. Since 2007, Dimensional has invested in China through listings that trade outside of mainland China but provide exposure to firms incorporated in or controlled by Chinese entities. These securities primarily include H-shares and red chips traded in Hong Kong, which trade similarly to other securities listed on that exchange in Hong Kong dollars (HKD). Our investment universe also includes American depository receipts (ADRs) trading in the US and global depository receipts (GDRs) trading on exchanges in other approved markets.

Dimensional has not yet approved the mainland China A-share market for investment. These securities trade on the Shanghai and Shenzhen exchanges in Chinese renminbi (RMB). Historically, foreign access to these shares has been highly restricted. Our ongoing assessment of and research on the A-share market continues. Areas of evaluation have been wide ranging, as avenues for accessing the A-share markets have developed and changed over time.

How do foreign investors access Chinese A-shares?

Historically, one of the main forms of A-share access for foreign investors has been through the Qualified Foreign Institutional Investor (QFII) program. Foreign institutional investors can apply for an investment allocation in the A-share market. If an allocation is granted, there are restrictions around access and controls on the amount of quota received. The program also has restrictions on the injection and repatriation of capital, which has made investing in A-shares through a QFII program challenging for open-ended mutual funds.

Another similar form of access is through Renminbi Qualified Foreign Institutional Investor (RQFII) programs, which are similar to QFII programs but available only through certain approved jurisdictions such as Hong Kong, Singapore, and London, and not through any jurisdiction in the US. Investment must be made in RMB. RQFII programs have fewer restrictions than QFII programs, particularly with regard to injection and repatriation of capital.

Recently, there have been additional programs and methods that allow foreign investors to invest in A-shares. Notably, the Shanghai-Hong Kong Stock Connect program was introduced in November 2014. This program is a cross-boundary investment channel whereby foreign investors may invest within certain limitations in some Shanghai-listed A-shares via the Hong Kong Stock Exchange.

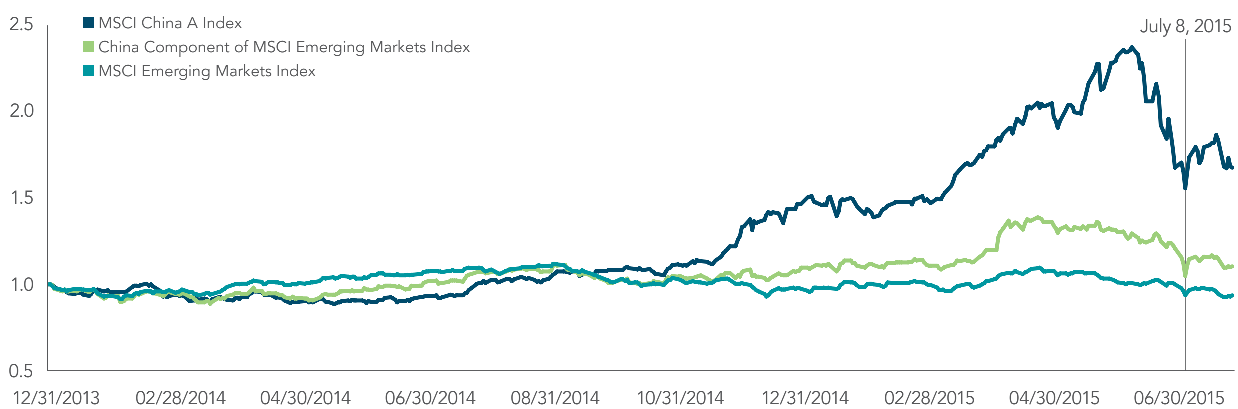
Methods of accessing local listings in China continue to develop. In the past year, RQFII programs have been expanded from four to 12 jurisdictions outside mainland China. Future possible developments include further liberalization of the QFII program and a Shenzhen-Hong Kong Stock Connect program.

What has been the effect of Chinese market performance and the trading suspensions?

While the Chinese equities market had strong positive performance for 2014 and the start of 2015, the market began experiencing declines during the second quarter. **Exhibit 1** shows returns during this period of the MSCI China A Index (USD), representing the A-share market; the China component of the MSCI Emerging Markets Index (USD), representing primarily Hong Kong and other overseas listings; and the full MSCI Emerging Markets

Exhibit 1: China Market Performance (USD)

January 1, 2014 to July 31, 2015



Past performance is no guarantee of future results. It is not possible to invest directly in an index. MSCI data copyright MSCI 2015, all rights reserved.

Exhibit 2: China A-Shares Performance (USD)

2015 Peak through July 8, 2015

	MSCI China A Index	China Component of MSCI Emerging Markets Index	MSCI Emerging Markets Index
Peak to July 8, 2015	–34.4%	–24.3%	–14.5%
Peak Date	Jun 12, 2015	Apr 27, 2015	Apr 28, 2015

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Index (USD). As indicated by **Exhibit 2**, in 2015 Chinese A-shares experienced a strong run-up to their peak on June 12, followed by a sharp downturn. By comparison, Chinese companies trading in Hong Kong and other overseas markets did not rise by as much and experienced a lesser downturn from their 2015 peak on April 27.

During this period, an unusually large number of securities were suspended from trading on the market. As of July 8, for example, an estimated 1,300 A-share companies had requested that their shares be suspended from trading, representing approximately 50% of all stocks trading on the Shanghai and Shenzhen exchanges. The percentage of companies that were suspended from trading varied day by day. In addition to these suspensions, at certain times many companies that continued to trade hit their limit down price, which is triggered in China when a stock's price moves by 10% from the previous day's close.

Under normal circumstances, any company listed on a Chinese exchange can request a halt to trading in its stock, and the exchange has discretion on whether to accept the request. As in many other markets, reasons for suspension may include corporate restructurings and new share placement. Companies may also request suspension due to any other material new information. While falling share prices are not an official reason to request a suspension, many companies apparently used the more subjective criterion of material new information to halt their shares from trading during the decline.

By contrast, the number of Chinese companies that list in Hong Kong and were suspended from trading was not unusual over this time period. The Hong Kong Stock Exchange applies stricter and less subjective criteria for a stock to be suspended from trading than the Shanghai and Shenzhen exchanges.

The number of suspensions in the market subsequently decreased from the peak in early July. However, as indicated in **Exhibit 3**, a large number were still in place the following week.

In addition to the trading halts, other reported interventions included government restrictions imposed on large shareholders from selling their shares in the A-share market for a period of about six months.

Have trading suspensions of Chinese companies impeded Dimensional's ability to trade?

The recent trading suspensions and government interventions have generally involved Chinese A-shares and have not greatly affected our ability to trade H-shares, red chips, and other listings outside mainland China. The investment universe of Chinese securities that we purchase by and large continued to trade. In fact, during the week of July 6, at the peak of the instability, overall trading volume actually increased for all securities listed on the Hong Kong exchange.

How does Dimensional evaluate countries and exchanges? Do you plan to add China A-shares to your strategies?

Dimensional regularly reviews markets in which we do not invest, as markets can change and evolve over time and may present new opportunities for additional diversification. We apply stringent criteria when evaluating and approving a particular market for investment. For every portfolio, we begin by considering the total opportunity set for the relevant region and asset class. We evaluate each country and exchange and may exclude those that are highly restricted or illiquid, lack transparency, or pose other special costs or challenges. We also regularly evaluate markets in which we currently trade to verify that they still meet our criteria.

Exhibit 3: Trading Suspensions in Chinese A-Shares

	As of July 8, 2015			As of July 16, 2015		
Status	**Number**	**% Number**	**% MCAP**	**Number**	**% Number**	**% MCAP**
Active	1,342	51%	65%	2,000	75%	83%
Trading Halt/ Suspension	1,313	49%	35%	655	25%	17%
Total Securities	2,655	100%	100%	2,655	100%	100%

For example, we have been carefully evaluating the A-share market for some time. The China A-share market is still a relatively young market, having been launched in its current form in the early 1990s. Members of the investment team have visited China on a number of occasions and conducted meetings with market participants and regulators.

There are many positives: The China A-share market is a large market that represents a meaningful portion of the overall China equity market. It offers potential for additional diversification into Chinese companies beyond what is available to investors through Chinese listings in Hong Kong, the US, and other exchanges outside mainland China. Recent positive developments include the continued expansion of the QFII/RQFII programs, introduction of the Shanghai-Hong Kong Stock Connect, and clarification of the capital gains tax.

However, restrictions remain, including controls surrounding quotas received through QFII and RQFII programs and remaining lock-up and repatriation restrictions involving certain forms of access through these programs. The Stock Connect program is a significant and important development, but still relatively new and not without restrictions. For example, the Stock Connect places a cap on the total net value of buys on a daily basis as well as a cap on the aggregate value of the net buys over time. These caps could become a limitation if large institutional investors increase their participation.

Another area of concern is the potential for market disruption, as indicated by events during the recent market downturn, including the large number of companies with shares suspended from trading and other government and regulatory actions to limit stock market losses.

While we have no immediate plans to add China A-shares to our portfolios, we will continue to closely assess and research this market.

SUMMARY

China is a large and important market—and the A-share segment represents a meaningful portion. The events surrounding trading suspensions and regulatory and government intervention have been directed at securities listed within the A-share market. Dimensional primarily invests in Chinese securities listed on the Hong Kong Stock Exchange. The China A-share market is not currently approved for investment for our strategies. We continue to monitor this market, evaluating the impact of recent events as well longer-term developments and reforms.

Dimensional has always emphasized that applying broad diversification across many countries and asset classes, as well as maintaining a consistent investment approach, is the best way to provide our clients access to the premiums offered by capital markets.

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