Manulife Investment Management

Investment note

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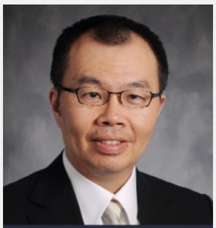

Winson Fong
Senior Portfolio Manager
Greater China Equities

Hong Kong's Hang Seng Indexes has announced that it plans to include weighted voting right companies (WVRs) and secondary-listing companies in its benchmark Hang Seng Index (HSI). This move is the Hang Seng's most significant index methodology revision in more than a decade. Winson Fong, Senior Portfolio Manager, Greater China equities specialist, discusses the implications of these reforms for both the index and investors and assesses any potential investment opportunities that may arise from the changes.

The Hang Seng Index changes present new opportunities for investors looking for growth

Following its May consultation on the inclusion of WVRs and secondary-listed firms from the Greater China region (i.e. Hong Kong, mainland China, Macau, and Taiwan), Hang Seng Indexes announced on 14 August 2020 that it would make three constituent changes to the HSI, two of which are WVRs[1]. The revisions will come into effect on 7 September 2020.

Hang Seng Indexes will also conduct a comprehensive six-month study of the HSI. The review will look at its composition and selection of constituents, the number of constituents, weightings, as well as industry and geographical representation.

The number of constituents in the HSI may increase to more than 50 during this period.

A natural evolution

The addition of WVRs and secondary-listed companies – which are mainly from the "New Economy" sectors – has diverse implications. For one, we believe that the HSI will likely reduce its current skew toward financials and provide a better representation of the market. In that sense, it is a natural evolution. But it will not be an overly drastic one. Investors should note that the rebalancing exercise is not 100% rule-based, but supplemented by qualitative judgement made by a committee. This approach should reduce the chance of extreme bias towards new-economy stocks and ensure a holistic market-wide representation.

From a valuation perspective, we expect that the price-to-earnings (P/E) multiples, as well as earnings-per-share (EPS) growth of the HSI, to be higher after the inclusion, at least in the near-to-medium term. However, volatility is not expected to shift in a big way by simply changing a few names.

What it means for investors

The change to the HSI is a continuation of the push toward making Chinese equities a more holistic proposition for foreign investors – a drive initially triggered by MSCI's inclusion of A-shares, which phased out the segregation between offshore and onshore Chinese stocks. We think the "return" of American depositary receipts (ADRs) and biotech IPOs will not only further enhance the breadth and depth of the market, but also offer more attractive fast-growing candidates to investors. The inclusion of these new sectors and stocks into the HSI thus also makes such a push more official and visible.

Foreign investors aside, the return of these ADRs demonstrates that demand from Asian investors and the regulatory framework have reached a critical point whereby new economy companies can reliably source their equity financing here in Hong Kong. This is likely to also lead to more southbound investing flows. Whether translates into higher

[1] Hang Seng Indexes quarterly index review results, 14 August 2020. The information neither indicates any actual portfolio holdings nor constitutes any investment recommendation or advice.

growth of investments and shareholdings by mainland investors will, we believe, ultimately depend on if the China Securities Regulatory Commission (CSRC) is willing to relax southbound investing rules for onshore retail investors, such as by abolishing the minimum RMB 500,000 threshold[2].

Trends and opportunities

The combination of a strong policy push and prolonged low interest rate outlook can only accelerate investments in innovation sectors in China, and especially in the Greater Bay Area. As a renowned service provider with superb infrastructure, we believe Hong Kong market is the top IPO destination for mega-cap, consumption, financial and professional services related companies. We believe that the HSI composition changes and the type of IPOs listed will, therefore, serve as an accurate reflection of Hong Kong's economic structure evolution.

Conclusion

The stock market of Hong Kong is undergoing a major structural evolution. Some initiatives have already come to play while many others are in the making. For instance, the updated listing guidance for biotech companies[3] was also a success, and it is expected to continue attracting more biotech companies to the Hong Kong Exchange Mainboard. This index rebalancing by HSI and the launch of the Hang Seng TECH Index are only some of the reflections of this trend.

Given WVR and secondary-listing names tend to come from the high-growth new-economy sectors, investors can take advantage of these new opportunities. What's more, investors can consider the new share classes, such as WVRs, from an environment, social, and governance (ESG) perspective to ensure that shareholder rights would not be undermined.

Chart 1: Major HSI Milestones

1969 HSI is officially launched to the public (with 33 constituents)

1994 First red-chip company is added to HSI

2006
- HSI calculation methodology is changed to free-float adjusted market-capitalisation weighted (from full market-capitalisation weighted)
- Maximum number of HSI constituents is increased to 38
- First H-share company is included in HSI

2007 Maximum number of HSI constituents is further increased to 50

2014 First real estate investment trust (REIT) is included in HSI

2020 WVRs and secondary-listed companies are added to HSI universe

Source: Hang Seng Indexes, August 2020.

[2] SH-HK stock connect information book for investor, 25 October 2019 version. Only Mainland institutional investors and those individual investors who satisfy the eligibility criteria (i.e. Individual investors who hold an aggregate balance of not less than RMB 500,000 in their securities and cash accounts) will be accepted to trade Hong Kong-listed eligible securities in Southbound trading.

[3] Hong Kong Exchanges and Clearing Limited, 28 April 2018. On 30 April 2018, Hong Kong Exchanges and Clearing Limited added new listing rules, under Chapter 18A, to permit listings of biotech issuers that do not meet any of the Main Board financial eligibility tests.

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