Morgan Stanley

INVESTMENT MANAGEMENT

Opportunities in A-Shares

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We remain focused on China's growth over the next decade, and this paper explains how we can participate by investing in China A-shares. The MSCI inclusion of China A-shares into the global indices will undoubtedly increase investor focus.

The $8 trillion plus A-shares market[1] is simply too big to ignore, and inclusion in the MSCI indexes will increase foreign interest in this vast and largely uncharted portion of China's complex and diverse stock markets. We have extensive experience in A-shares, and we believe there are plenty of investment opportunities in China's $13 trillion economy.[2]

In the half dozen foreign markets that list Chinese stocks, from Hong Kong to Singapore and the United States, there are about 1,300 Chinese companies with a total market cap of around $5.4 trillion.[3] On the existing MSCI China Index, which includes some of the better-known Chinese companies, there are about 500 companies, representing about $1.7 trillion in capitalization.[4] This number has grown due to MSCI's inclusion of more China A-shares companies in the MSCI China Index.

We believe the recent inclusion of China A-shares companies into the global indices will open the eyes of investors to a large domestic on-shore market that dwarfs the off-shore China markets. Furthermore, we expect MSCI will continue to gradually increase the weighting of China A-shares in the global indices.[5]

[1] FactSet, Wind, Goldman Sachs Research as of January 31, 2020.

[2] China National Bureau of Statistics as of January 31, 2020.

[3] FactSet, Wind, Goldman Sachs Research as of January 31, 2020.

[4] MSCI as of January 31, 2020.

[5] Bloomberg, as of January 31, 2020.

The A-shares market is large and liquid, but highly inefficient in our view—and therein lies both the dangers and the opportunities. It may be the only large stock market in the world in which individual investors account for the vast majority—we estimate about 80 percent—of daily trading volume.[6] In more established markets, retail investors are less influential on the market movement. Moreover, in the A-shares market, even most of the institutional investors act more like retail investors by trading constantly, often turning over their entire portfolio as many as four to five times a year.[7]

The result is big swings in stock prices, and unusually high dispersion in valuations. In an immature market like this, buy-and-hold strategies can be temporarily derailed by the fickleness of retail investors. But as long-term investors, we can ignore some of the daily noise and remain focused on the disciplined investment process.

Furthermore, because this market is so diverse, investors won't be punished for not holding a major stock in the A-shares index. In the existing MSCI China Index, in contrast, the two largest stocks account for around 30% of the index.[6] So for funds measured against the MSCI China Index, in our opinion much rides on getting a few company bets right.

Conversely, in the MSCI China A Index, the largest stock accounts for around 6 percent of the index.[8]

A market this immature and diverse also offers frequent opportunities to buy or sell stocks that are overlooked or misunderstood as some local A-shares investors trade on newsflow rather than changes to underlying fundamentals. We believe such inefficiencies are less readily available for those companies in the MSCI China Index, which are much larger, more transparent and more closely followed by analysts.

The China A-shares market offers more diversified industries, from industrials to healthcare, consumer services and media. Within our focus on the "new" China, we are tracking a few key themes, built around companies that are deploying a new generation of skilled workers, and companies that are catering to them as consumers.

Since China reformed its higher education system in the late 1990s, the number of graduates has risen from 1

[6] MSIM, Citi Research as of January 2020.

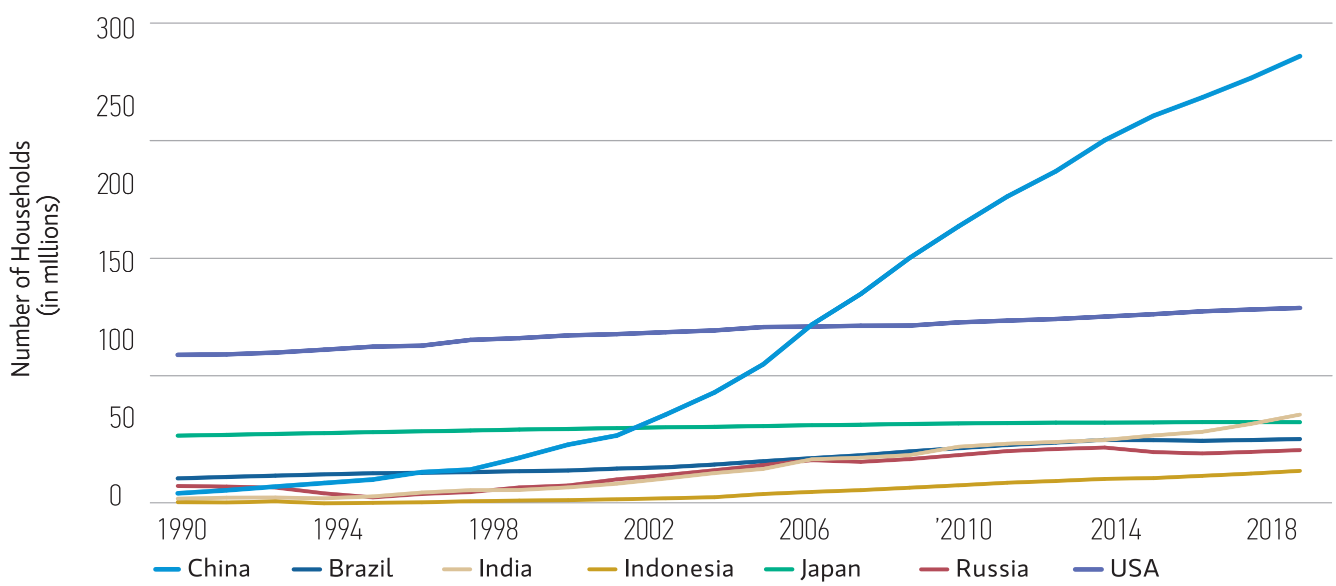
[7] MSIM, Bloomberg, as of January 2020.

[8] MSCI as of January 2020.

DISPLAY 1

More skilled workers may mean more high-end consumers

Household disposable income over $10,000



Source: MSIM, as of December 2019.

million to 8 million a year.[9] Graduates in fields from web design to marketing start out making less than $10,000 a year, perhaps a fifth of what they can make in Europe or the United States.[10] We see many Chinese companies taking advantage of this competitive intellectual labor to gain market share from global firms in communication services, technology and health care fields. The economic model is shifting from cheap manufacturing labor to cheaper, highly skilled labor.

Though Chinese companies used to avoid talking about R&D because local investors tended to view it as a drain on profits, there has been a shift towards research for companies to move up the value chain. In 2000, China spent less than 1 percent of GDP on R&D, but that figure has risen steadily to more than 2 percent, and has surpassed the European Union in both percentage and absolute terms.[11] It's now quite common to hear up-and-coming Chinese companies talk openly of aggressive research spending plans.

High-tech companies employing more skilled labor means higher income consumers. Those sub $10,000 annual salaries will rise quickly, and consumer companies will make their most significant gains in the most underpenetrated markets. In sectors such as luxury goods, entertainment, and beauty care, the average Chinese consumer still spends 5 to 10 times less on average than consumers in the G20 countries.[12] We believe there is plenty of room for the "new" China to grow, which adds to the excitement and appeal of the A-shares market.

We remain focused on looking for the best investment ideas and for companies that we believe will benefit from the multi-year structural stories in China. While there are concerns about the rising debt in China, we believe that the China A-shares market is big enough to offer interesting and profitable ideas for us to generate both absolute and relative outperformance.

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[9] MSIM, China National Bureau of Statistics, as of May 2018.

[10] OECD, MSIM, as of May 2018.

[11] OECD, MSIM, as of September 2019.

[12] World Bank, Euromonitor, Citi, as of August 2019.

DEFINITIONS:

Gross Domestic Product (GDP) is the monetary value of all the finished goods and services produced within a country's borders in a specific time period. It includes all private and public consumption, government outlays, investments and net exports. **Price-Earnings Ratio (P/E)** is a valuation ratio of a company's current share price compared to its per-share earnings. Calculated as Market Value per Share / Earnings per Share. The **MSCI China Index** captures large and mid-cap representation across China A-shares, B-shares, H-shares, Red-chips and P-chips. It reflects the Mainland China and Hong Kong opportunity set from an international investor's perspective. The **MSCI China A Index** is a free float-adjusted market capitalization index that is designed to measure equity market performance of the China A share market. The performance of the Index is listed in US dollars and assumes reinvestment of net dividends.

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