An Update on China

February 2016

The Chinese equity market started the year with a sharp decline in prices and then continued to experience volatility throughout January. News articles about China have appeared almost daily, speculating on the market volatility, the currency, government attempts to intervene in both, and the possible impact that China's woes could have on the rest of the world's markets and economies.

This article provides a brief review of the Chinese equity market and Dimensional's approach to investing there, and also discusses recent events while highlighting some of the differences between shares traded on local Chinese exchanges and Chinese shares traded in Hong Kong and other overseas markets.

CHINA AND DIMENSIONAL'S APPROACH

Does Dimensional Invest in China?

Chinese companies trading outside mainland China are eligible for Dimensional's emerging markets equity strategies and global strategies that include emerging markets. Eligible securities primarily include H-shares and red chips traded on the Hong Kong Stock Exchange, which trade similarly to other securities listed on that exchange in Hong Kong dollars (HKD). Also eligible are other overseas listings, such as 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. A-shares are listed directly on the Shanghai and/or Shenzhen stock exchanges and trade in Chinese yuan (CNY). The A-share market is not fully open to foreigners. It is mainly driven by local Chinese investors, who in turn do not have full access to capital markets outside of mainland China.

This restriction in the flow of capital is one of the reasons why Dimensional has not pursued investment in A-shares. When capital can flow freely, global investors can assess each market's prospects and risks within the context of a global investment opportunity set. Because local Chinese investors have constraints on their ability to invest globally, the result is market segmentation, where expected risks and returns are not determined in accordance with the global opportunity set.

What Is the Premium/Discount between A-Shares and H-Shares?

A number of Chinese companies have dual-listings: an A-share listed on a local exchange and an H-share listed in Hong Kong. Differences in prices between A and H-shares for the same company are driven by market restrictions and resulting market segmentation.

Exhibit 1 shows the Hang Seng China AH Premium Index, which includes approximately 60 of the larger, more liquid dual-listed companies and tracks the price premium (or discount) of A-shares to H-shares. An index level of 100 indicates price parity, a level over 100 indicates a premium on average of A-shares over H-shares, and a level below 100 indicates a discount on average of A-shares to H-shares. A large premium, for example, means that an investor in an A-share is paying a higher price for equity in the same company than an investor in an H-share.

As the exhibit indicates, there is volatility in the premium/discount over time, and the difference in prices can be significant at times.

How Big Is China's Stock Market?

To put China's stock market in perspective relative to other equity markets, as of December 31, 2015, the weight of China in the MSCI ACWI IMI, a marketwide benchmark that includes all developed and emerging markets, was 2.58%. This index does not include China A-shares, so taking them into consideration would increase the percentage.

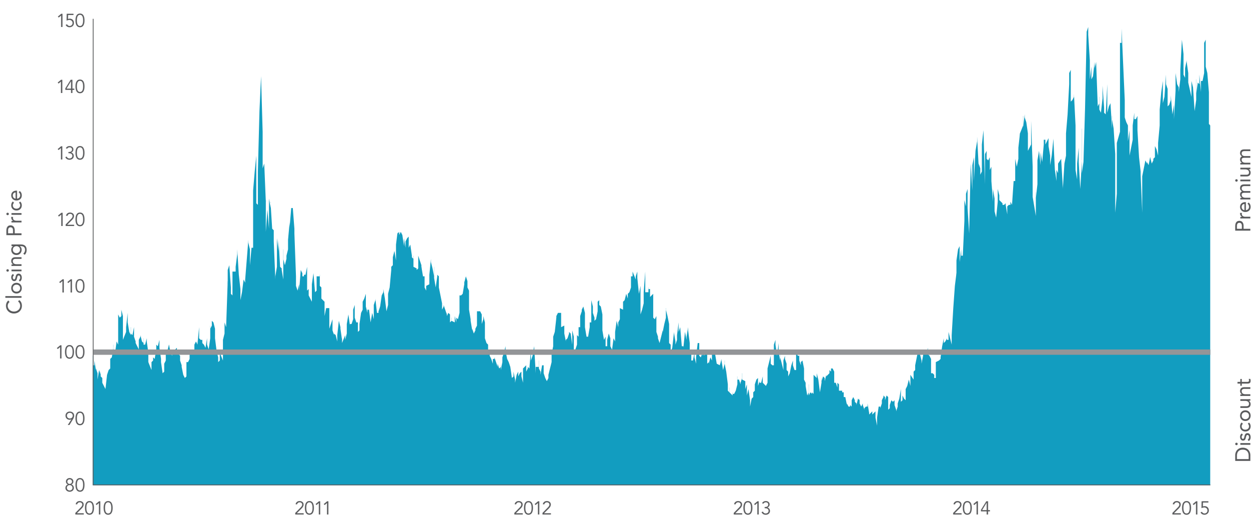
As of December 31, 2015, the total free-float adjusted market capitalization of H-shares, red chips, and other foreign listings was approximately $1.3 trillion. By comparison, the total free-float adjusted market capitalization of the China A-share market was approximately $1.9 trillion.[1]

CHINA: THE MARKET ENVIRONMENT IN JANUARY

The return and volatility of the China A-share market can be (and has been) different than those of Chinese stocks listed in Hong Kong and other markets. As a result, it is important to note these differences when reviewing the market performance of China.

For the month of January 2016, the MSCI China A Index (USD), representing the A-share market, declined 24.86%, while the China component of the MSCI Emerging Markets Index (USD), representing primarily Hong Kong and other overseas listings, declined 12.72%. By comparison, the MSCI Emerging Markets Index (USD) declined 6.49%.

Exhibit 1: Hang Seng China AH Premium Index



Past performance is no guarantee of future results. The Hang Seng China AH Premium Index provided by Hang Seng Indexes Company Limited.

1. Takes into consideration foreign ownership limits. Source: Bloomberg.

Using these same three indices and looking at large single-day price movements in January, the China A-share market experienced larger single-day price moves than the Hong Kong/overseas listings. For example, the China A Index declined by more than 5% on four different days in January. By comparison, the China component of the MSCI Emerging Markets Index had no days with price declines greater than 5% during the month.

MARKET HALTS AND CIRCUIT BREAKERS

China introduced circuit breakers (performance triggers that, if hit, would cause the exchange to suspend or potentially halt trading) on the Shanghai and Shenzhen exchanges on January 4, 2016, and then disbanded them four days later. During that short time frame, they were triggered on January 4 and January 7 before they were suspended.

On January 7, the last day that the circuit breakers were in use, trading was halted for 15 minutes within the first 15 minutes of the market's opening. After trading resumed, it was quickly halted again and then suspended the rest of the day. The MSCI China A-Share Index returned −7.94% on January 7. By contrast, the Hong Kong market continued to operate throughout the day, and the China component of the MSCI Emerging Markets Index returned −4.23% on that same date.

CURRENCY CONCERNS

Another recent theme in the financial press has been concern about the Chinese yuan, including speculation about possible future devaluation and reports of various types of government intervention. On January 7, the Chinese yuan depreciated 0.50% vs. the US dollar, its largest move in January and the same day as the sharpest equity market decline.

As background, in August last year the People's Bank of China (PBC) announced that it was taking a more market-oriented approach to how it sets its daily rate for the Chinese yuan. The immediate result of this action was a decline in the yuan of approximately 2%. Since the announced changes last August, the yuan has fallen more than 5%.

Exhibit 3 shows the exchange rate of Chinese yuan to a dollar (CNY to 1 USD) for the month of January. An increase in the number indicates a weakening of the Chinese yuan.

Media reports say the PBC has reduced its foreign currency reserves and suggest that this is an attempt to reduce any further depreciation of the yuan. Additional reports have discussed capital controls on repatriation of the yuan (repatriation is the process of converting a foreign currency into one's own local currency). These restrictions have largely affected Chinese financial institutions and residents, as well as foreign banks located in China.

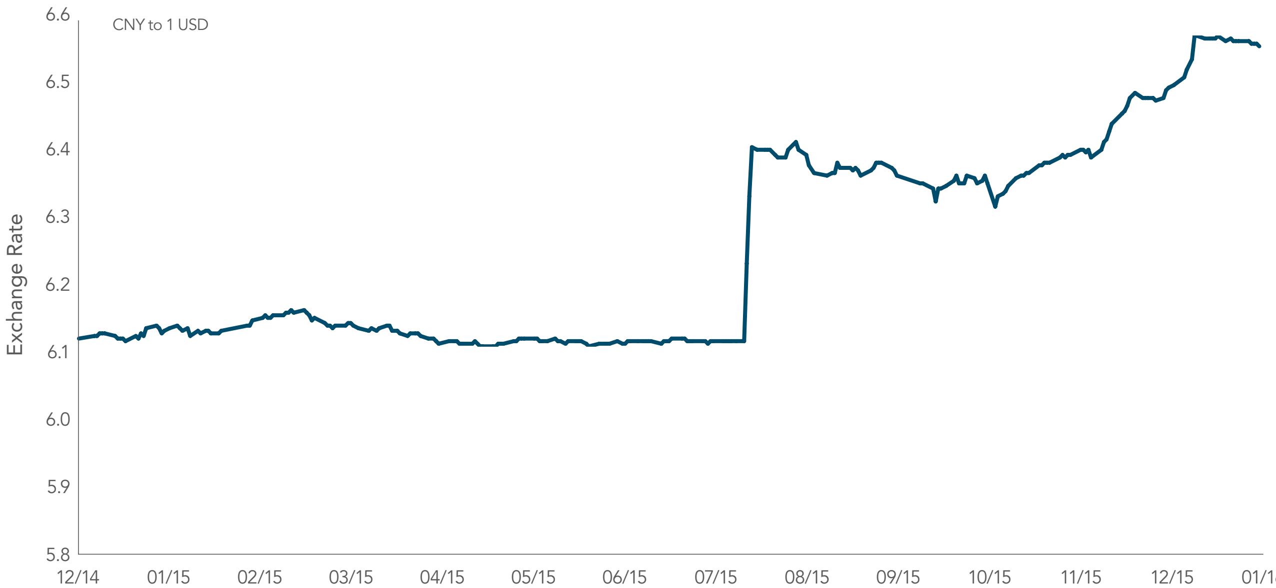
As Dimensional does not invest directly in the local Chinese market, none of our portfolios have direct exposure to the Chinese currency. Also, restrictions on currency flows have not been directed at investors holding Hong Kong listed shares and other foreign listings of Chinese companies.

Exhibit 2: Large Single-Price Moves in January 2016

	MSCI China A Index	China Component of MSCI Emerging Markets Index	MSCI Emerging Markets Index
January 4	−7.79%	−3.50%	−3.32%
January 7	−7.94%	−4.23%	−2.75%
January 11	−5.62%	−3.34%	−2.26%
January 26	−6.47%	−2.73%	−1.08%

Large price move is +/− 5% for either MSCI China A Index or China component of MSCI Emerging Markets Index. Performance is in USD net dividends. Past performance is no guarantee of future results.

Exhibit 3: USD CNY Midpoint



Based on CNY Central Parity Rate from 12/31/14 to 1/31/16. Data provided by China Foreign Exchange Trade System (CFETS).

SUMMARY

During the month of January 2016, the Chinese equity market had negative returns, with the China A-share market experiencing a sharper decline and a greater number of large price moves than Chinese equities trading in Hong Kong and other overseas markets. In the China A-share market, circuit breakers were introduced and then disbanded, causing market halts to occur on two separate days. Chinese listings in other markets were not impacted by the circuit breakers and continued to trade throughout the month.

Dimensional primarily invests in Chinese securities listed on the Hong Kong Stock Exchange and other overseas markets. The China A-share market is not currently approved for investment for our strategies. We will continue to monitor this market, evaluating the impact of recent events as well as longer-term developments and reforms.