William Blair

January 2018
Perspective
Global Equity

Why China A, Why Now?

The domestic Chinese equity markets are some of the largest and most liquid in the world, and they offer unique investment opportunities—yet they have been largely neglected by institutional investors. That, in part, is because they were historically difficult for foreign investors to access. However, with the launch of the Shanghai-Hong Kong Stock Connect a few years ago and the Shenzhen-Hong Kong Stock Connect in December 2016, and enhancements made to safeguard A-Share investors' interests, a new opportunity has arisen. In this paper, we discuss the China A-Share opportunity, and why institutional investors may want to consider actively allocating to this market.

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The China A-Share market is uncorrelated, under-researched, and inefficient, providing investment opportunities for active managers committed to fundamental research.

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China is commonly characterized as a smokestack economy, addicted to debt, infrastructure investment, cheap manual labor, low-value exports, and polluting industries. But this is inaccurate, in our view. An ongoing innovation boom is quickly transitioning "Made in China" to "Invented in China."

Domestic Growth Sectors: Dominated by China A-Shares
Foreign investors can now access rapidly growing parts of the Chinese economy that were not previously accessible, and these opportunities span sectors—capital goods, retail, healthcare, and consumer staples, among others.

*China A-Shares are represented by a blend of indices: the Shanghai A-Share Stock Prices Index starting in 1999, joined by the MSCI China A Index in 2001. See figure 4.

> **"Many high-quality Chinese companies are listed on overseas exchanges via American depositary receipts (ADRs), but they do not provide exposure to a big part of the Chinese market. China A-Shares—which are stocks of Chinese companies traded on the Shanghai Stock Exchange and the Shenzhen Stock Exchange—do."**
>
> — Casey Preyss

The Chinese Equity Market: Large, Liquid, and Growing Quickly

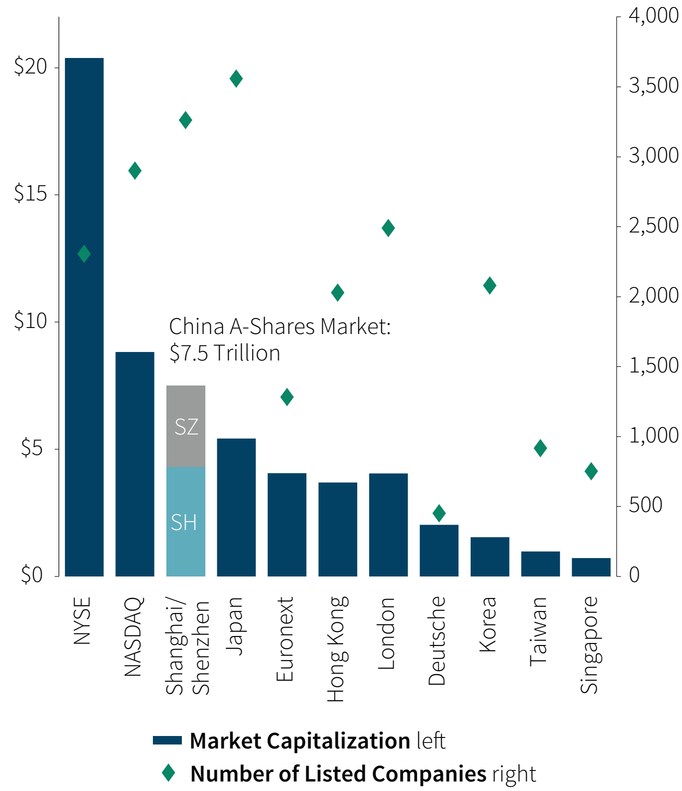
As the world's second largest economy, China has long been considered an economic powerhouse. Less known, however, is that it is one of the largest, most liquid, and fastest-growing equity markets in the world.

The Shanghai and Shenzhen stock exchanges list 3,500 companies with an aggregate market capitalization of $7.5 trillion, as shown in figure 1. That is second only to the New York Stock Exchange and Nasdaq, and multiples larger than other major emerging markets, such as Korea and Taiwan. Figure 2 shows the number of companies listed on Chinese onshore and offshore exchanges.

The Shanghai and Shenzhen stock exchanges also have an average daily trading volume of nearly $70 billion, the highest in the world, making these exchanges more liquid than even the New York Stock Exchange.

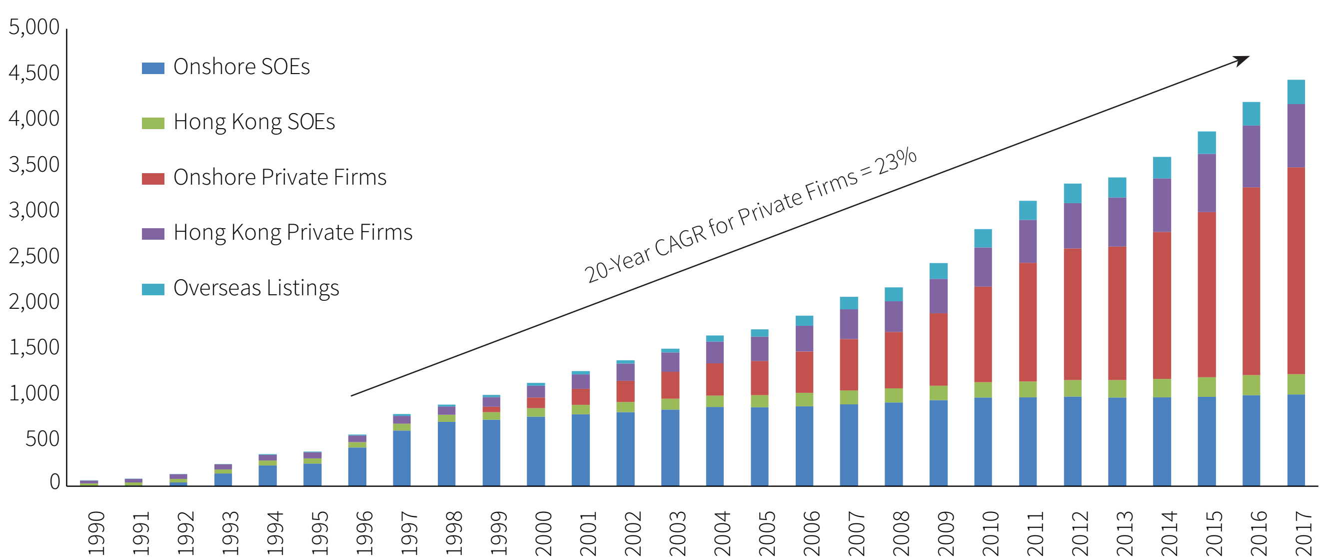
And, these mainland Chinese equity markets are growing rapidly. Over the past two years, there have been more than 500 initial public offerings (IPOs) per year on the Shanghai and Shenzhen stock exchanges. Moreover, we have seen a boom in private-sector growth, with the number of privately listed enterprises nearly quadrupling over the past decade. Of the 262 global private start-ups valued at $1 billion or more, 34% are Chinese. That is second only to the United States (which has 47%), according to McKinsey Global Institute. The rest of the world totals just 19%.

Figure 1:
World's Largest Stock Exchanges (in Trillions)



Source: Goldman Sachs, as of July 17, 2017.

Figure 2:
Number of Companies Listed on Chinese Onshore and Offshore Exchanges



Sources: Gavekal, as of May 31, 2017. SOEs are state-owned enterprises. CAGR refers to compound annual growth rate.

> “There is plenty of room for growth in foreign ownership of China A-Shares.”
>
> — Casey Preyss

China A-Shares: Under-Represented in Global Equity Indices

China A-Shares are under-represented in global equity indices relative to macroeconomic indicators and their role in the equity markets, leading us to believe that China’s weight in global benchmarks—and thus its relevance to investors—will increase materially over the next decade.

When looking at various macroeconomic indicators, China accounts for a substantial part of the world: 15% of global gross domestic product, 11% of global trade, 11% of the International Monetary Fund (IMF) reserve currency basket, and 11% of global consumption. Yet China accounts for just 3% of the MSCI All Country World Index (ACWI).

Moreover, China A-Shares represent 20% of global equity turnover, 11% of global equity market capitalization, and 2% of foreign equity ownership. Yet when MSCI includes them in its indices in June 2018, China A-shares will represent just 0.75% of the MSCI Emerging Markets Index and 0.1% of the MSCI ACWI.

To provide some historical context about how fast China’s weight in global benchmarks could increase, consider the evolution of the MSCI Emerging Markets Index since its inception in 1988. In the index’s early years, Malaysia, Mexico, Brazil, and Thailand represented about 75% of the market. Today, they represent less than 15%. China was first introduced to the MSCI Emerging Markets Index in 1996, and has grown rapidly since, now representing about 30% of the index. This is a trend that we expect to accelerate as China A-Shares are included in MSCI’s benchmarks.

A Largely Domestic, Retail-Oriented Market With Substantial Potential

The ownership structure of China A-Shares, which is characterized by limited foreign investment and a high share of domestic retail investors, has led to a more thematic, news-driven market environment. However, this ownership structure also creates opportunities as the share of foreign investment is poised to grow and domestic flows are supportive.

Historically, China A-Shares were accessible only to domestic investors or foreign institutional investors through the Qualified Foreign Institutional Investor (QFII) system.

With the launch of the Shanghai-Hong Kong Stock Connect in November 2014 and the Shenzhen-Hong Kong Stock Connect in December 2016, that changed.

Yet despite a decade of the China A-Share market slowly opening, foreign investors still account for less than 5% of the market. Thus, there is plenty of room for growth in foreign ownership of China A-Shares.

Currently, domestic retail investors dominate the China A-Share market, accounting for nearly two-thirds of overall market ownership and 85% of trading volume on the Shanghai and Shenzhen stock exchanges. Moreover, 75% of retail investors have account balances of less than $20,000. While this high level of retail investment activity has resulted in a more thematic, news-driven, and sometimes more speculative environment than in other emerging markets, it also provides opportunities.

MSCI Inclusion Driving Growth

The inclusion of China A-Shares in the MSCI Emerging Markets Index and MSCI ACWI beginning in June 2018 should be positive for China’s market.

Initially, it will use a 5% inclusion factor and include only 222 large-cap companies. Based on that, China A-Shares should represent about 0.75% of the MSCI Emerging Markets Index.

As MSCI increases its inclusion rate, and includes 450 or so mid-cap China A-Shares to the benchmark, China A-Shares could reach nearly 10% of the index.

At full inclusion of more than 3,500 companies, China A-Shares could represent more than 15% of the MSCI Emerging Markets Index—but that is likely far in the future.

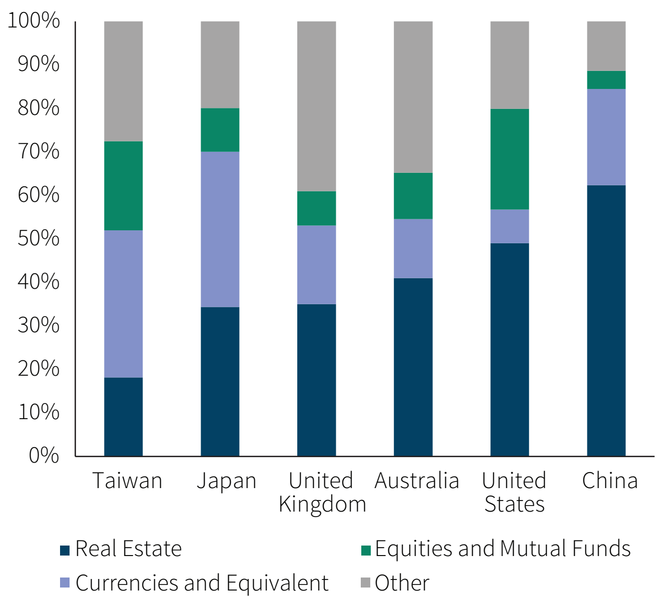
Reaching full inclusion takes a great deal of time, as evidenced by Taiwan and South Korea. Taiwanese equities took nine years (from 1996 to 2005) to achieve full inclusion, and South Korean equities took six (from 1992 to 1998). China is starting with a much lower inclusion factor of 5% (versus 20% for South Korea and 50% for Taiwan), so we believe it will take at least a decade for full inclusion to be achieved.

The pace of inclusion typically takes into account the limitations that could arise in the opening of equity markets to foreign investors. In the case of China A-Shares, significant changes have also been made to the QFII program, and we believe MSCI wants to see those changes implemented properly before increasing its inclusion level. A few key developments we will look for include the streamlining of the approval process for quotas, the development of the repatriation limit for the QFII program (QFIIs currently cannot repatriate more than 20% of previous year end’s total assets each month), and the effectiveness of trading suspension limits implemented in May 2016.

We expect domestic retail investors to gradually increase their allocation to the Shanghai and Shenzhen stock exchanges. Currently, 85% of Chinese household wealth is held in cash or real estate. As figure 3 illustrates, this is well above international norms, and we expect it to decline as the financial markets in China mature and Chinese savers gain more investment options.

Furthermore, we expect volatility to gradually diminish as more foreign investors enter the market and it matures. In fact, we have seen market volatility subtly decline.

Figure 3:
Composition of Chinese Household Balance Sheets



Source: Goldman Sachs, as of Septemeber 2017. "Other" includes insurance, pensions, and other securities.

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>
> — Casey Preyss

Compelling Performance Supported by Strong Fundamentals

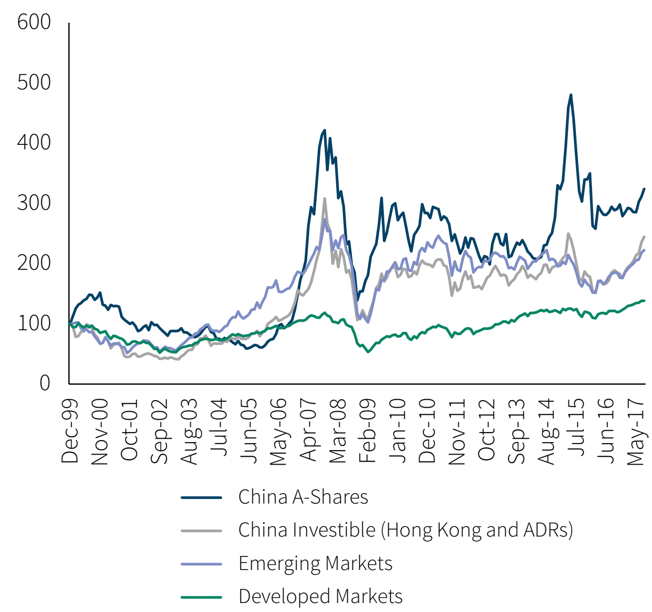
Despite the China A-Share market's volatility, over the longer term it has shown compelling performance supported by strong fundamentals.

As figure 4 illustrates, China A-Shares have more than tripled in value since 1999, supported by a nearly sevenfold increase in earnings per share.

China A-Shares' stock-market performance and earnings growth have both outpaced those of Chinese H-Shares (the shares of companies incorporated in mainland China that are traded on the Hong Kong Stock Exchange) and ADRs, emerging markets, and developed markets.

Moreover, valuations of stocks listed on the Shanghai and Shenzhen Stock Exchanges are reasonable relative to their offshore counterparts (i.e., ADRs), which trade at roughly 30 times earnings. Shanghai-listed stocks trade at 12 times earnings, and Shenzhen-listed stocks trade at 20. This is also true on a sector level: The majority of China A-Share sectors are trading in line or at the lower end of their longer-term trading range.

Figure 4:
China A-Shares Outperformance of Developed and Emerging Markets



Sources: MSCI China Index, MSCI Emerging Markets Index, MSCI World Index, as of August 31, 2017. China A-Shares are represented by a blend of indices: the Shanghai A-Share Stock Prices Index starting in 1999, joined by the MSCI China A Index in 2001. Past performance is no guarantee of future results. A direct investment in an unmanaged index is not possible.

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Increased Accessibility and Investor Protection

The opening of the Connect increased accessibility to China A-Shares, and enhancements made to safeguard China A-Share investors' interests made the market much more appealing.

As noted above, foreign institutional investors previously had very limited access to domestic Chinese equity markets, but with the launch of the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect, a new opportunity arose.

Today, foreign institutional investors can access China A-Shares in three ways: the Renminbi Qualified Foreign Institutional Investor (RQFII), the Qualified Foreign Institutional Investor (QFII), and either the Shanghai- or Shenzhen-Hong Kong Stock Connect.

The Connect is a much simpler system. There are restrictions regarding eligible investors under the RQFII and QFII that do not exist with the Connect. The application process for the RQFII and QFII is rather onerous, with quotas required, which is not the case with the Connect. And there are lockups under the RQFII and QFII, but not on the Connect.

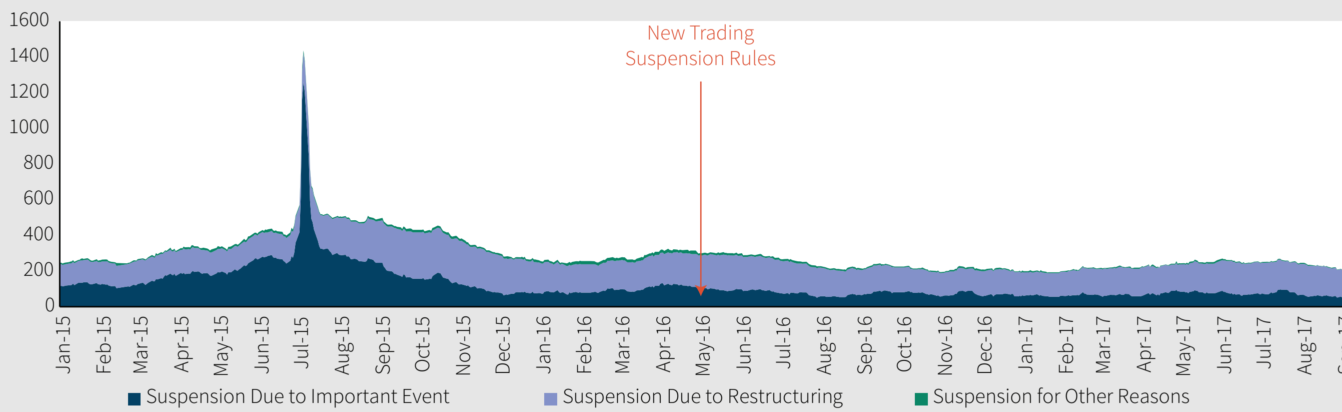
Moreover, enhancements have been made to safeguard China A-Share investors' interests. Examples of such enhancements include:

- In 2015, trade settlement was enhanced through the introduction of *Special Segregated Accounts* (SPSA) model. This also allows investors to use a maximum of 20 brokers to achieve best execution.
- In 2015, the China Securities Regulatory Commission (CSRC) clarified international investors' beneficial ownership. Investors are legally entitled to all the rights and benefits of shares acquired through the Northbound trading link (including voting rights, dividends, distributions of earnings, etc.).
- In 2016, a Delivery Versus Payment (DVP) settlement system was introduced to ensure delivery when payment occurs, and crucial enhancements to trading suspension rules were implemented.

Enhancements to Trading Suspension Rules

In July 2015, more than 1,400 companies constituting approximately 50% of the China A-Share market suspended their Shanghai- and Shenzhen-listed shares. In response, China introduced stricter regulations around voluntary suspensions. Key areas of improvement included expanding coverage and trading suspension rules, creating duration limits, enhancing disclosures relative to suspensions, giving exchanges the authority to stop accepting suspensions, and reinforcing controls and sanctions. As shown in figure 5, suspensions have stabilized since then.

Figure 5:
Stock Suspensions by Type



Sources: Shanghai Stock Exchange, Goldman Sachs Research, as of September 8, 2017.

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II. A Significant Opportunity for Active Managers

Uncorrelated, Under-Researched, Inefficient Market

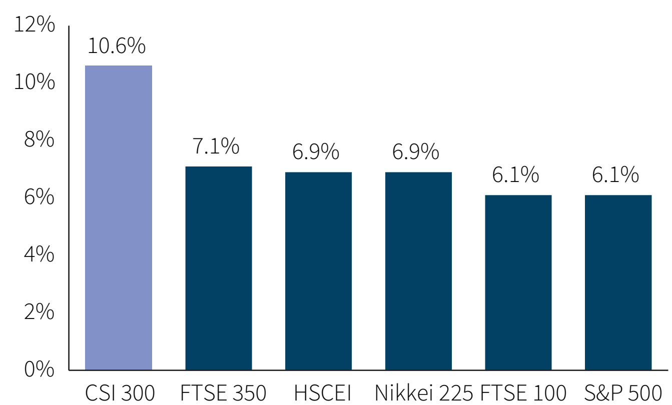
The China A-Share market is uncorrelated, under-researched, and inefficient, providing investment opportunities for active managers committed to fundamental research.

Broadly speaking, emerging markets have become increasingly correlated to other global asset classes. But, as figure 6 shows, China A-Shares tend to have limited correlation to other emerging markets and developed markets. This is likely due to the China A-Shares market's insulated nature and heavy retail presence.

The China A-Share market is also under-researched. There are more than 1,500 listed Chinese companies with coverage from fewer than five sell-side analysts. This number is further reduced when considering just the global brokerage firms with English language research. They tend to cover just 300 to 400 China A-Shares at any given time.

Lastly, the China A-Share market is a stock-picker's market. As figure 7 illustrates, the dispersion of returns among Chinese stocks (as represented by the CSI 300) is substantially higher than any other broad equity benchmark.

Figure 7:
Seven-Year Average Monthly Standard Deviation of Constituent Returns



Source: UBS, as of September 2017.

Figure 6:
Low Correlation Between China A-Shares and Global Equity Indices

	China A	China H	Asia	Japan	US	EU	EM	DM	Average
China A		55%	35%	18%	20%	19%	33%	25%	29%
China H	55%		86%	48%	47%	52%	84%	63%	62%
Asia	35%	86%		56%	60%	69%	95%	79%	69%
Japan	18%	48%	56%		47%	52%	51%	62%	48%
US	20%	47%	60%	47%		76%	61%	94%	58%
EU	19%	52%	69%	52%	76%		71%	91%	62%
EM	33%	84%	95%	51%	61%	71%		80%	68%
DM	25%	63%	79%	62%	94%	91%	80%		70%

Sources: Citi, UBS, Goldman Sachs, as of September 2017. Data is weekly, past five years. US refers to United States, EU to European Union, EM to emerging markets, DM to developed markets.

Active Management Key To Access

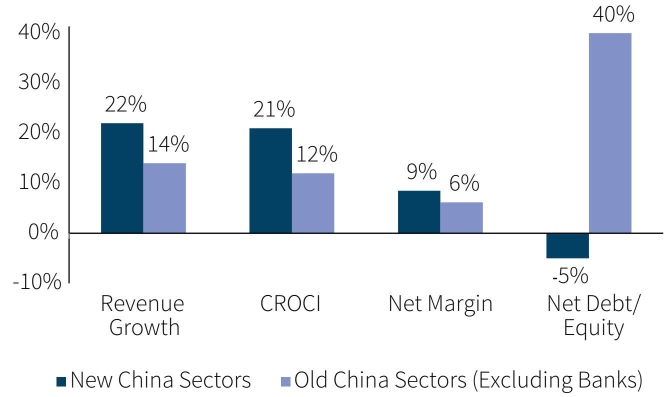
We believe an active approach is a necessity when accessing the China A-Share market because benchmark indices do not provide a fair representation of real growth opportunities in China.

First, state-owned enterprises (SOEs), which tend to be less efficient and less profitable than their private-sector peers, make up a vast majority of the market: 63% of the MSCI China Index and 74% of the CSI 300 Index. This is particularly notable given that SOEs account for less than 10% of Chinese GDP and 5% of Chinese employment. Clearly, SOEs are overrepresented in these equity indices.

Second, the "old China" sectors—financial, real estate, commodity, and heavy industry—dominate Chinese equity indices, accounting for 82% of the CSI 300 Index. The "new China" sectors—healthcare, IT, media, and renewables—account for just 18% of the CSI 300 Index. This is significant, because old China tends to have lower growth, lower return, and more debt, as figure 8 illustrates. Indeed, new China has delivered stronger fundamental performance and higher equity-market returns, as figures 8 and 9 illustrate. We expect these trends to continue.

> **"New China has delivered strong fundamental performance and higher equity-market returns."**
>
> — Casey Preyss

Figure 8:
Superior Fundamentals in New China



Sources: Goldman Sachs, WFE, as of July 2017. CROCI refers to cash return on capital invested. New China includes GICS sectors healthcare and information technology and GICS sub-industries education, publishing, advertising, movies & entertainment, travel & leisure, internet retail, environmental services, and renewable electricity.

Figure 9:
Market-Cap-Weighted Price Returns

Sources: FactSet, Goldman Sachs Global Investment Research, as of December 13, 2017. Past performance is no guarantee of future results. A direct investment in an unmanaged index is not possible.

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Significant Opportunities for Quality Growth Investors

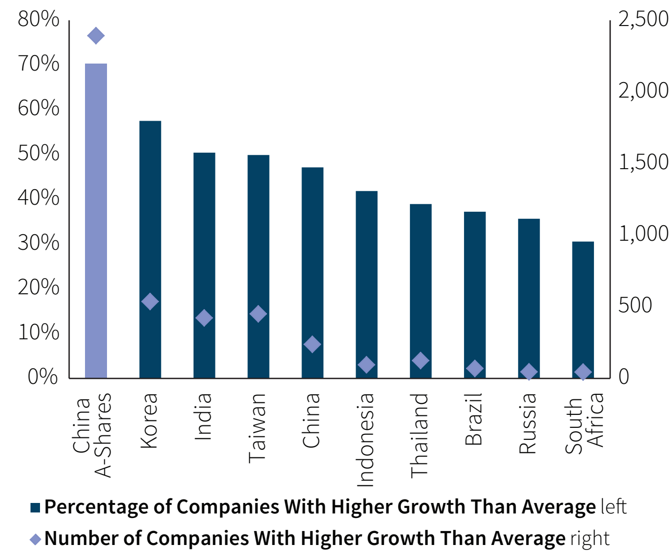
China’s equity markets are populated by many high-quality companies experiencing dynamic growth, making them ideal for quality growth investors..

China’s equity markets are the most dynamic and entrepreneurial in the emerging markets today. As figures 10 and 11 show, 70% of China A-Share companies are growing faster than the emerging market average of about 12% annually—and that 70% represents 2,392 companies listed on the Shanghai and Shenzhen stock exchanges (versus less than 550 for each of the other emerging markets shown).

Moreover, Chinese companies are high quality. Using return on equity (ROE) as a proxy for quality, China A-Shares are slightly below average in terms of overall profitability. However, the number of companies that have a higher-than-average ROE than the emerging market universe is still significant—more than 1,000. India has just 263.

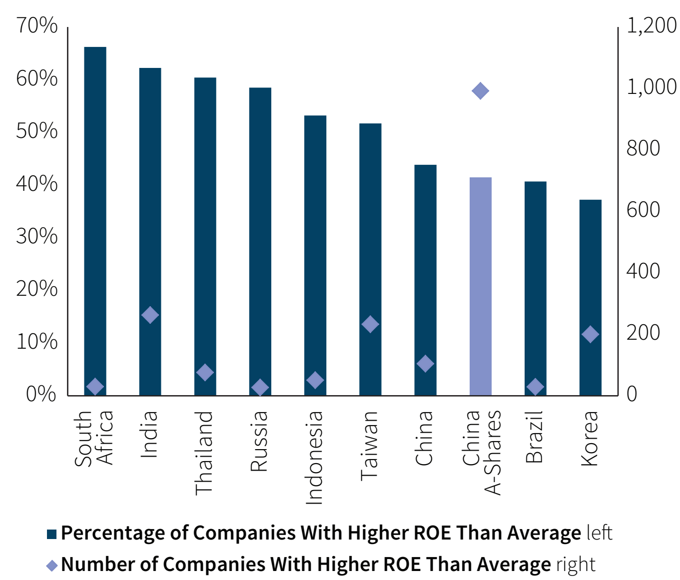
> “Nearly 12,000 start-ups are established every day in China, equating to more than 4 million a year—versus 600,000 in the United States.”
>
> — Casey Preyss

Figure 10:
Higher Growth Profile



Sources: FactSet, William Blair, as of October 2017. Universe consists of all listed emerging market companies with market caps above $100 million. Growth is the William Blair long-term growth rate, which is based on a combination of realized and forecast growth rates. Actual growth rate for the emerging markets universe is 12.5%.

Figure 11:
High-Quality Opportunities



Sources: FactSet, William Blair, as of October 2017. Universe consists of all listed emerging market companies with market caps above $100 million. ROE for the emerging market universe is 7.9%.

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III. Exploring Opportunities in China A-Shares

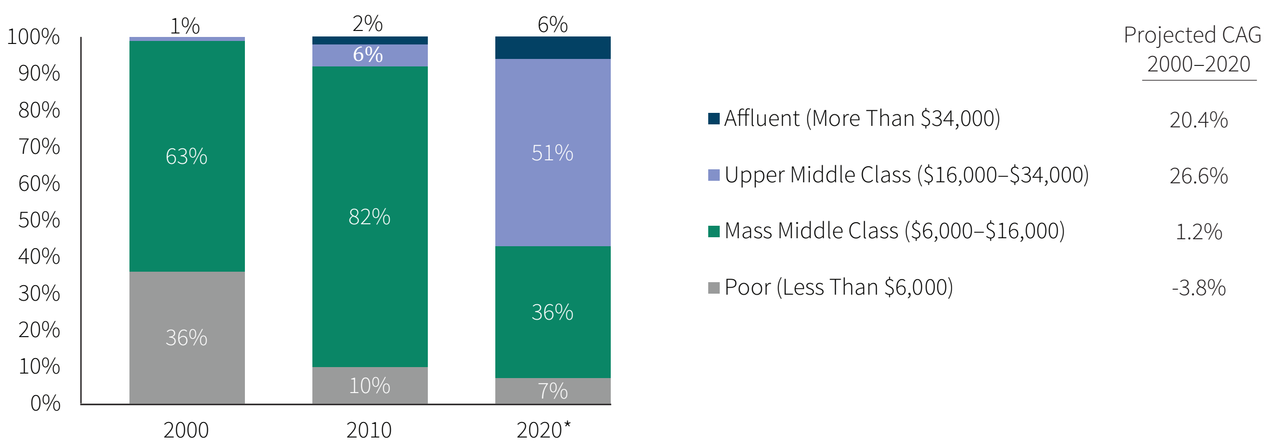
China’s Rising Middle Class: The Engine of Global Consumption

The well-documented growth in China’s middle class presents significant investment opportunities in consumer-related themes, many of which can only be captured through China A-shares.

However, we still believe the potential is underappreciated. The Chinese consumption story still has a long runway for future growth. China now has the largest middle-class population in the world, with 109 million adults (versus 92 million for the United States and 62 million for Japan). China’s middle-class consumption is also the fastest growing after India. In 2010, roughly 8% of Chinese households were classified as upper middle class or affluent—a number that is forecast to grow to almost 60% by 2020. That is a compound annual growth rate of more than 20%. Figure 12 illustrates.

We believe China A-Shares offer the broadest exposure to the Chinese consumption story. Chinese companies in the home furnishings, white goods, advertising, and media sectors, for example, are mainly listed on the Shanghai and Shenzhen stock exchanges.

Figure 12:
Projected Chinese Household Income Shift by 2020



Sources: McKinsey Global Institute. Middle class is defined as four-person households with annual income $14,600 to $146,000 in 2005 purchasing power parity terms. CAGR refers to compound annual growth rate.

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From Smokestack to Labtech: Innovation Boom

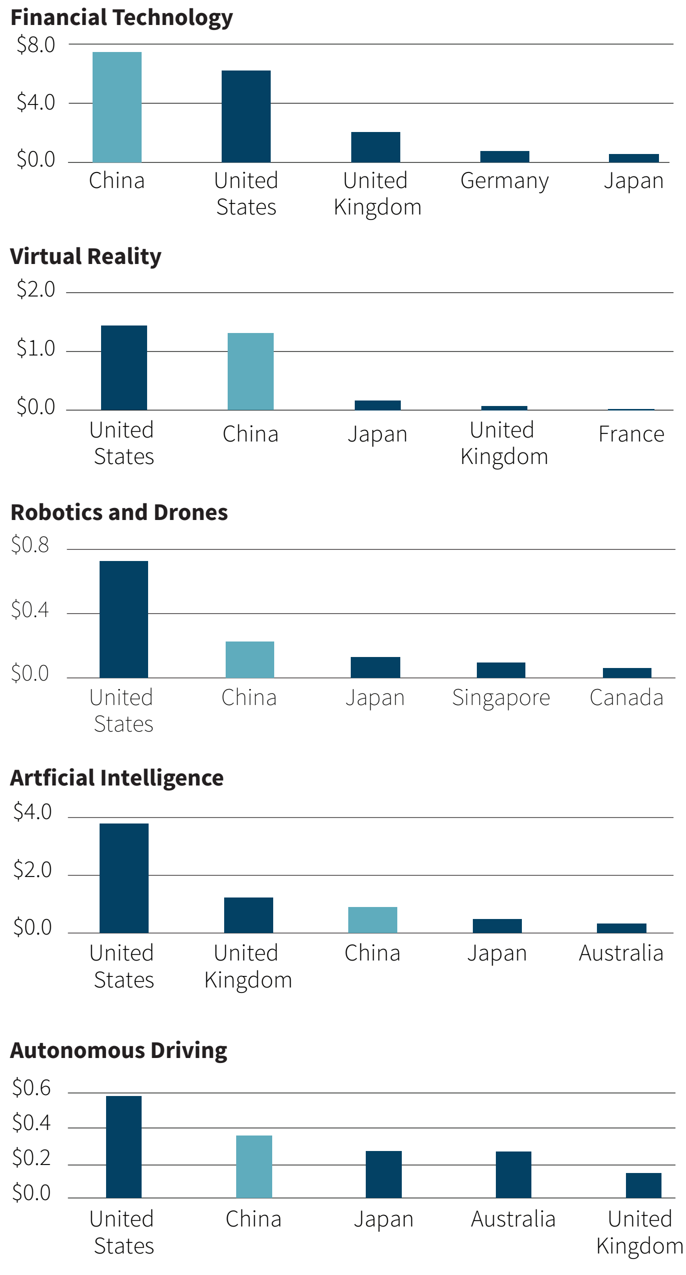
China is commonly characterized as a smokestack economy, addicted to debt, infrastructure investment, cheap manual labor, low-value exports, and polluting industries. But this is inaccurate, in our view. An ongoing innovation boom is quickly transitioning “Made in China” to “Invented in China.”

In regard to some of the most innovative technologies and growth industries—financial technology, virtual reality, artificial intelligence, robotics—China is comparable to the United States today in terms of venture capital investment, as figure 13 illustrates.

Another example is China’s e-commerce market, which is now twice as large as that of the United States. China’s two leading mobile payment apps now process $10 trillion in online payments annually, more than Visa and MasterCard combined. China is also the world’s largest market for electric vehicles, solar power, and wind turbines.

The level of innovation has clearly accelerated from five years ago, and has done so much more quickly than most envisioned.

Figure 13:
Venture Capital Investment by Technology (in Billions)



Source: McKinsey Global Institute, as of December 31, 2016.

Domestic Growth Sectors: Dominated by China A-Shares

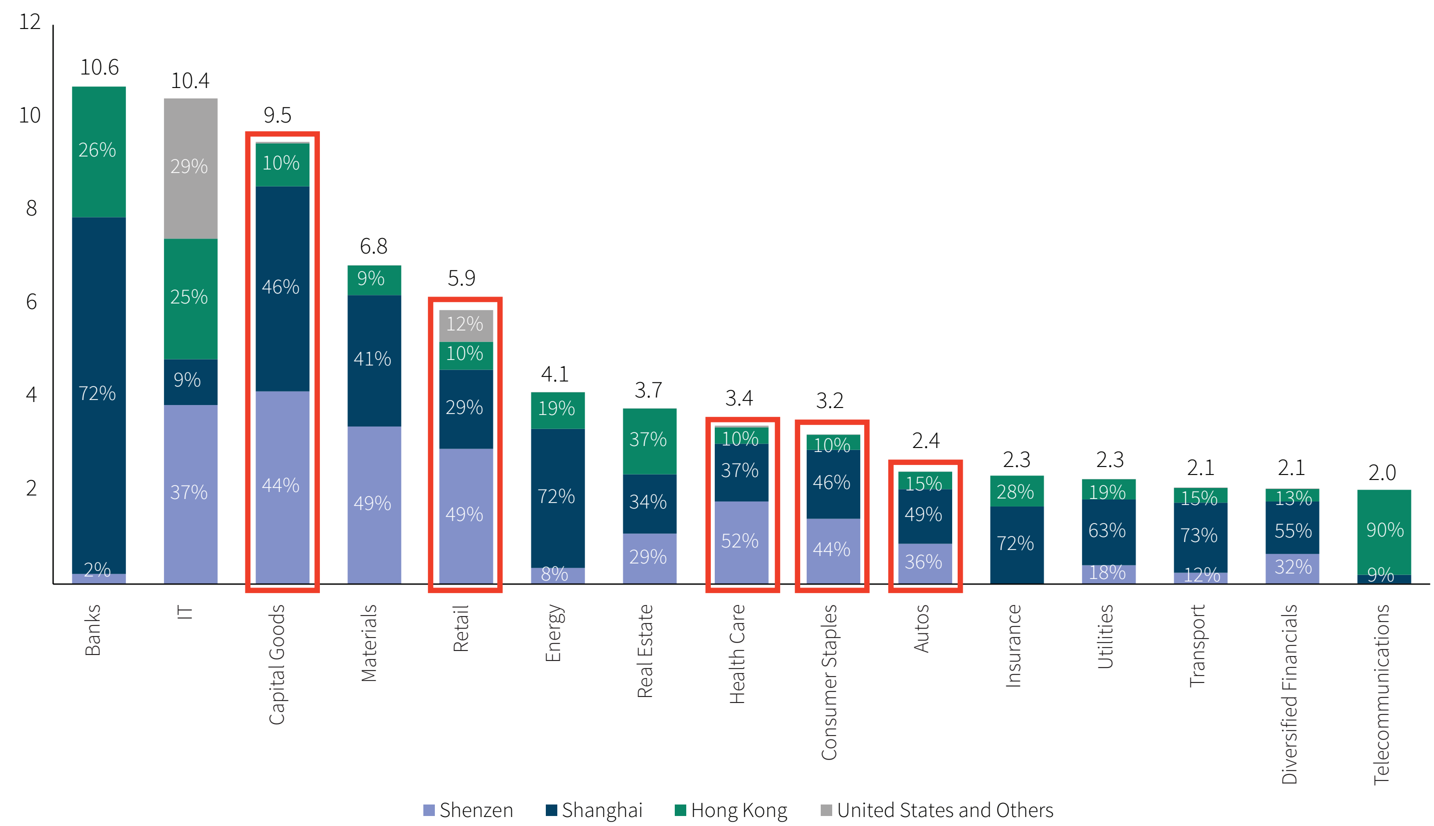
Foreign investors can now access rapidly growing parts of the Chinese economy that were not previously accessible, and these opportunities span sectors—capital goods, retail, healthcare, and consumer staples, among others.

Looking at the investible market capitalization of China A-Shares by exchange—Shanghai Stock Exchange, Shenzhen Stock Exchange, Hong Kong Stock Exchange, and American depositary receipts (ADRs)—it is readily apparent that China A-Shares listed in Shanghai and Shenzhen account for the majority of the investible opportunity set in China's domestic growth sectors.

Figure 14 illustrates. Hong Kong tends to host the majority of China's older-economy sectors, such as real estate, financials, materials, and heavy industry. And China's large IT companies are well represented in New York via ADRs. But look at Chinese growth sectors. The Shanghai and Shenzhen stock exchanges represent 90% of the investible market capitalization in capital goods, 90% in consumer staples, 89% in healthcare, 85% in autos, and 78% in retail.

China A-Shares are clearly where investors want to be to gain access to Chinese growth opportunities. The opportunity is vast, not just in size, but in opportunity for active managers, because most of these companies are not well covered. Active managers with experience in China A-Shares will have a rare opportunity to seek potential winners in the most exciting growth jurisdiction available today. ■

Figure 14:
Total Market Value Distribution by Exchange (in Trillion Renminbi)



Source: Citi, as of September 2017.

Biographies

Casey K. Preyss, CFA, Partner

Casey Preyss is a portfolio manager for the Emerging Markets Growth and Emerging Markets Small Cap Growth strategies. Since joining William Blair in 2000, Casey has been a research analyst covering industrials, IT, and resources and has also served as portfolio manager for the China A-Share strategy. Prior to his fundamental research responsibilities Casey was a quantitative analyst with the team. Prior to joining the firm, Casey was with Thomas White International, where he was an international equity research sales associate. Education: B.S.B.A., The Ohio State University; M.B.A., University of Chicago Booth School of Business.

Terry O'Bryan, Partner

Terry O'Bryan joined William Blair in June 2007 as head of international equity trading. Terry has more than 10 years of trading experience and worked most recently at Lehman Brothers in Chicago as the manager of the equity sales and trading desk. Before that, he was employed by Goldman Sachs in Chicago for five years in equity sales trading. Before his role at Goldman Sachs, Terry was employed by the U.S. Navy on the West Coast for 11 years as an F/A- 18 pilot. Education: B.A., economics and history, University of Vermont in Burlington.

Index Definitions

The **CSI 300 Index i**s a free-float weighted index that consists of 300 A-Share stocks listed on the Shanghai or Shenzhen stock exchanges.

The **FTSE 350 Index** is a market-capitalization-weighted stock-market index incorporating the largest 350 companies by capitalization that have their primary listing on the London Stock Exchange.

The **Hang Seng China Enterprises Index (HSCEI)** is the major index that tracks the performance of China enterprises listed in Hong Kong in the form of H-Shares.

The **Nikkei 225 Stock Average** is a price-weighted index comprising Japan's top 225 blue-chip companies traded on the Tokyo Stock Exchange.

The **Financial Times Stock Exchange (FTSE)** 100 Index is a share index of the 100 companies listed on the London Stock Exchange with the highest market capitalization.

The **Standard & Poor's (S&P) 500 Index** is a stock-market index that tracks the 500 most widely held stocks on the New York Stock Exchange or Nasdaq.

The **MSCI China Index** is designed to capture large- and mid-cap segments of the Chinese stock market with H-Shares, B-Shares, red chips, P chips, and foreign listings (e.g., ADRs) of Chinese stocks.

The **MSCI China A Index** captures large- and mid-cap representation across Chinese securities listed on the Shanghai and Shenzhen exchanges.

The **MSCI Emerging Markets Index** consists of 24 countries representing 10% of world market capitalization.

The **MSCI All Country World Index (ACWI)** represents mid- and large-cap countries across 23 developed markets and 24 emerging markets.

The **Shanghai A-Share Stock Price Index** is a capitalization-weighted index that tracks the daily price performance of all A-shares listed on the Shanghai Stock Exchange that are restricted to local investors and qualified institutional foreign investors.

Indices are unmanaged, do not incur fees and expenses, and cannot be invested in directly.

About William Blair

William Blair is committed to building enduring relationships with our clients and providing expertise and solutions to meet their evolving needs. We work closely with private and public pension funds, insurance companies, endowments, foundations, sovereign wealth funds, high-net-worth individuals and families, as well as financial advisors. We are 100% active-employee-owned with broad-based ownership. Our investment teams are solely focused on active management and employ disciplined, analytical research processes across a wide range of strategies, including U.S. equity, non-U.S. equity, fixed income, multi-asset, and alternatives. As of September 30, 2017, William Blair manages $73.9 billion in assets. William Blair is based in Chicago with an investment management office in London and service offices in Zurich and Sydney. William Blair Investment Management, LLC and the investment management division of William Blair & Company, L.L.C. are collectively referred to as "William Blair."

Important Disclosures

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