

Gain Miles MPF Insights



Proposed Reform of Hang Seng Index – A Bless or A Curse?

Gain Miles agrees that reform of Hang Seng Index could be beneficial. However, it is still worth to consider the degree of regulation strictness and sustainability while improving its flexibility.

Released on 22 January 2021 by Gain Miles Group

Hang Seng Indexes Company Limited has released a press release on 22 Dec 2020 to seek market views on the potential changes to the Composition of Hang Seng Index (HSI). There are 5 proposed changes on the rules of composition and its eligibility. In this research paper, Gain Miles shares its view on the proposed reform of HSI.

1. Expansion in Industrial Representation

Hang Seng Indexes Company Limited has proposed to select constituents by industry group (e.g. consolidate the 12 industries into 6 groups); and based on a target coverage for each industry group (i.e. in terms of market capitalisation, turnover etc.) to select.

In respect to this, Gain Miles disagrees to focus on the coverage of each sector, instead, HSI should focus on the market coverage, which means the stocks listed in the Main Board or in the market. We suggest that the coverage for each sector should be determined by the market, instead of confining it with a minimum level to manually define the coverage in a particular sector. Otherwise, the proposal to introduce target coverage within an industry group may increase the representativeness of each industry by sacrificing the focus on the overall market.

Market Capitalisation Coverage and Number of Constituents by Industry

Industry	Existing		New (65)		New (80)	
	Coverage [^]	Number	Coverage [^]	Number	Coverage [^]	Number
IT	88.0%	4	94.4%	7	95.2%	8
Telecommunications	83.3%	2	83.3%	2	83.3%	2
Financials	83.8%	11	76.8%	8	83.1%	10
Conglomerates	65.9%	2	82.2%	3	82.2%	3
Healthcare	29.3%	3	71.0%	8	78.3%	10
Utilities	42.8%	4	68.7%	7	74.7%	8
Energy	79.5%	3	70.8%	2	70.8%	2
Consumer Discretionary	37.3%	7	54.4%	10	65.5%	14
Consumer Staples	37.1%	4	56.0%	5	64.4%	6
Properties & Construction	42.2%	10	52.3%	12	63.9%	15
Industrials	21.7%	2	16.4%	1	27.6%	2
Materials	0.0%	0	0.0%	0	0.0%	0
Overall	64.5%	52	72.5%	65	78.2%	80

* Data as of 4 December 2020 after index rebalancing

[^] Using HSLMI as universe

Source: Hang Seng Indexes Company's 20201222 Press Release Exhibit 13

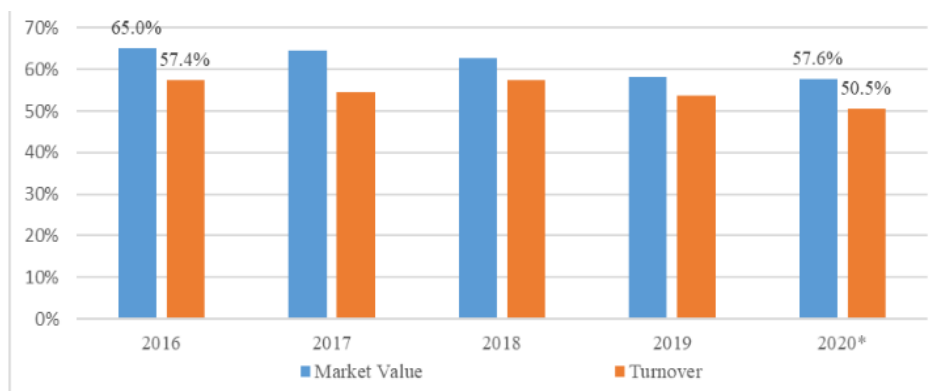
2. Enlargement in Market Coverage

Hang Seng Indexes Company proposed to increase the number of constituents to between 65 and 80.

Gain Miles agrees to increase the number of constituents with the aim to reach higher market coverage as the current market capitalization and turnover is decreasing over the years (i.e. from 65.0% and 57.4% in 2016 to 57.6% and 50.5% in 2020, respectively). The lack of market coverage may not be suitable for HSI to serve as the market benchmark of the Hong Kong stock market.

As of 13 January 2021, there were 2,175 companies listed in the Main Board. Keeping 52 companies as the constituents would no doubt introduce gap to conclude the performance by all companies listed in the Main Board. Gain Miles believes that increasing the number of constituents is a good action to increase representativeness and strongly suggest to increase to 80 to achieve the objective.

Coverage in terms of Market Capitalisation and Turnover



* Data as of 4 December 2020 after index rebalancing

Source: Hang Seng Indexes Company's 20201222 Press Release Exhibit 7

3. Prompt Inclusion of Sizable New Listing

Hang Seng Indexes Company proposed to remove the minimum listing history requirement for eligible candidates to enhance the flexibility for HSI Advisory Committee to include new listing as a HSI constituent.

Gain Miles disagree to remove the minimum listing history requirement for eligible candidates. Although the removal of this requirement increases the flexibility for the HSI Advisory Committee, this may allow speculators to take advantage to the lack of reinforcement / governance for HSI to include new listing into the index. The stability of HSI will be harmed and lead to the potential situation where the constituents switched too frequently by the newly listed companies.

Minimum Listing History Requirement of HSI

MV Rank [^] by Review Cut-off Date	Minimum Listing History
Top 5	3 Months
6 – 15	6 Months
16 – 20	12 Months
21 – 25	18 Months
Below 25	24 Months

[^] MV Rank among stocks in the HSI review universe

Exhibit 9: Market Capitalisations and Rank of Major New Listings in 2020

Market Capitalisation (HK\$bnn)	Number of New Listings	Market Cap Rank*
Over 1,000	1	5
Between 400 and 1,000	1	10
Between 200 and 400	4	16 - 26
Between 100 and 200	4	30 - 42

*Rank among HSI constituents

Source: Hang Seng Indexes Company's 20201222 Press Release Exhibit 8 & 9

The involvement of newly added shares will cause a rise to the P/E ratio of HSI. For illustration, based on Jun 2020 to Nov 2020 data, the below table comparison demonstrates the P/E ratio between the top 10 market cap newly listed shares and the HSI. It is noticeable that the P/E ratio of the newly added shares were much higher than HSI. Few shares were more than 10-times higher than the HSI P/E ratio. If there is no governance on the minimum listing requirement, the stability of HSI will be jeopardised.

Top 10 Market Cap newly listed shares from Jun 2020 to Dec 2020 and HSI's P/E ratio

Group/Investment	Ticker	P/E Ratio 6/2020	P/E Ratio 7/2020	P/E Ratio 8/2020	P/E Ratio 9/2020	P/E Ratio 10/2020	P/E Ratio 11/2020	P/E Ratio 12/2020
Hang Seng HSI PR HKD	HSI	10.27	10.34	10.62	10.92	11.37	12.42	13.96
NetEase Inc Ordinary Shares	09999	28.36	29.58	29.52	26.01	25.02	29.58	29.92
JD.com Inc Ordinary Shares - Class A	09618	106.57	109.58	38.70	36.40	38.40	31.13	31.20
Smooere International Holdings Ltd Ordinary Shares	06969		99.78	77.81	132.99	151.00	183.32	217.64
Hangzhou Tigermed Consulting Co Ltd Class H	03347			56.40	48.79	50.72	52.09	70.45
Nongfu Spring Co Ltd Class H Ordinary Shares	09633				69.87	69.70	81.75	104.96
Yum China Holdings Inc Ordinary Shares	09987				39.20	28.99	30.87	30.99
ZTO Express (Cayman) Inc Ordinary Shares	02057				28.33	28.49	27.66	27.87
New Oriental Education & Technology Group Inc Ordinary Shares	09901						69.46	76.02
Haier Smart Home Co Ltd Class H	06690							22.76
Ming Yuan Cloud Group Holdings Ltd Ordinary Shares	00909				147.00	165.63	190.70	230.29

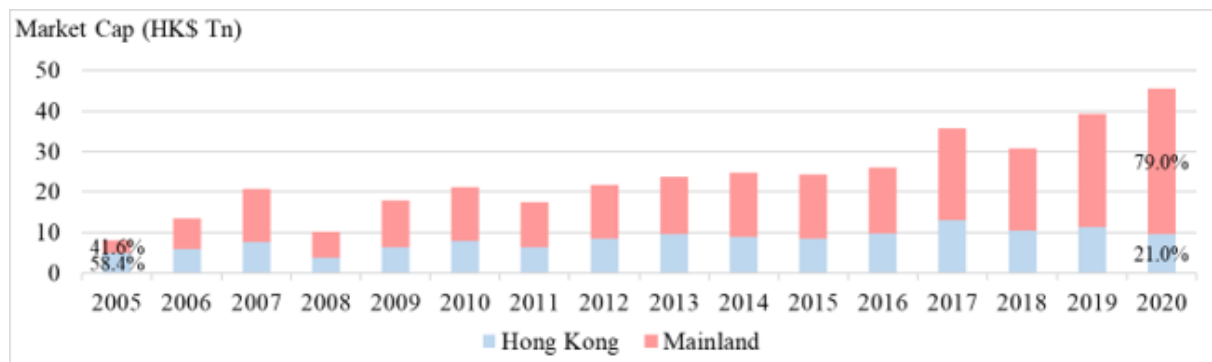
Source: Morningstar

4. Representation of Hong Kong Companies to Remain Intact

Hang Seng Indexes Company suggested to maintain around 25 Hong Kong companies under the current situation or a certain amount to sustain the level of representation of Hong Kong portion in the index

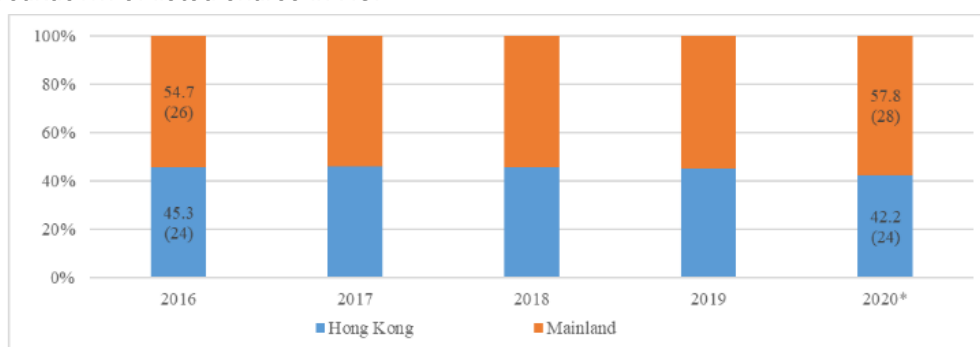
Gain Miles is neutral to this proposal but would like to suggest to refer to maintain a certain percentage of market representation instead of number of companies. Keeping the number of Hong Kong shares does not mean that Hong Kong companies will have a certain weighting in the HSI as it is about the asset size instead of the number of shares. Currently, 79% of the assets listed in the Main Board belongs to Mainland company and only 21% are Hong Kong company. Thus, Gain Miles can only say that keeping 25 Hong Kong companies (around 42.2%) as constituents will keep HSI being an index with its own characteristics.

Regional breakdown of listed shares in the Main Board



Source: Hang Seng Indexes Company's 20201222 Press Release

Regional breakdown of listed shares in HSI



* Data as of 4 December 2020 after index rebalancing

() No. of Constituents

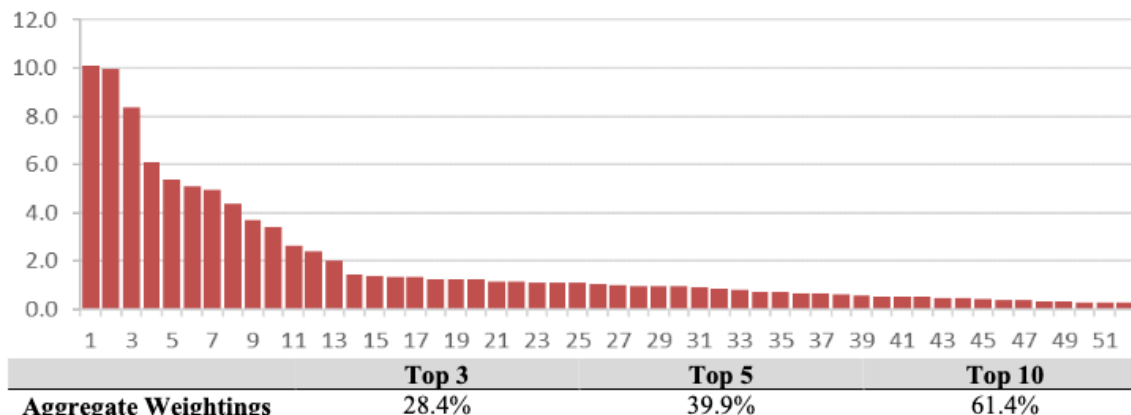
Source: Hang Seng Indexes Company's 20201222 Press Release Exhibit 19

5. Enrichment in Constituent Weighting Distribution

Hang Seng Indexes Company is willing to lower the weighting cap of individual constituent from 10% to 8%' and align the weighting cap of all shares to be 8%.

Gain Miles agrees that this could help including more WVR/ Secondary listed companies with higher weighting into the index. WVR/Secondary listed are common practice for technology and multinational enterprise on well developed markets like in US and EU. In Hong Kong, it is foreseeable that more secondary listed with large market capitalization will be listed in Hong Kong. Therefore, to more accurately report the situation in Hong Kong, it is better to align the weighting cap of every share.

HSI Constituent Weighting Distribution



* Data as of 4 December 2020 after index rebalancing

Source: Hang Seng Indexes Company's 20201222 Press Release Exhibit 11

All in all, Gain Miles agrees the reform of Hang Seng Index is a good thing. Yet, there are points that need to be considered. The minimum listing history requirement is vital and worth to consider again. As a representative and important investing index in Hong Kong, the regulation should be strict enough while considering the flexibility.

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About Gain Miles

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Gain Miles believes that people are always the most valuable asset and the key for every business to progress and sustain. With our extensive knowledge of the industry, professional team of consultants and substantial experience, we are set on tailoring the best solutions for clients that balance their considerations and needs of their employees.

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