



RESEARCH PAPER

April 2021

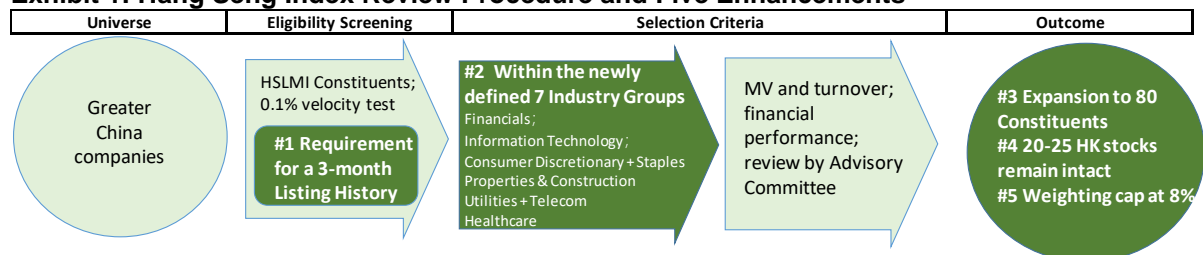
Hang Seng Index – An Important Benchmark for Hong Kong Blue-chips

The Hang Seng Index ('HSI') is the leading benchmark for investors to gauge the performance of the Hong Kong stock market. Since its inception in 1969, the HSI has been comprised of a relatively small number of representative constituent stocks. It is not a purely rules-driven index, focusing instead on size, liquidity and financial fundamentals to form a blue-chip barometer of the local bourse.

The methodology and composition of the HSI have been regularly updated to keep pace with the changing market landscape. The number of constituents is currently 55 compared with 33 in 1969, and the index uses public floats for constituent weightings to take care of the investability consideration. Currently, mainland China stocks form the larger portion of the HSI, reflecting Hong Kong's position as a key centre for serving the capital needs of Mainland corporations. With the index market cap at HKD23 trillion covering some 50% of the total market cap, the HSI is the underlying benchmark for a comprehensive range of index-linked financial products and derivatives.

The latest major enhancement in the methodology serves to maintain the HSI's role as a representative blue-chip barometer. The rapid rise of the technology and healthcare sectors, new forms of corporate shareholding structure and secondary listings of mega-sized stocks with high liquidity all call for the adoption of a more dynamic constituent selection process for the HSI to better track market dynamics. Prudent management will remain the central guiding principle in making changes to the HSI to accommodate new market realities.

Exhibit 1: Hang Seng Index Review Procedure and Five Enhancements



Source: Hang Seng Indexes Company
Date as at 30 March 2021



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Executive Summary

Hang Seng Index – An Important Benchmark for Hong Kong Blue-chips

The Hang Seng Index ('HSI') has been serving as the key performance tracker of Hong Kong blue-chips (the largest and the most liquid stocks of the major industry sectors) since its launch in 1969. Apart from employing more stringent requirements compared with the Hang Seng Composite Index ('HSCI') when assessing each constituent's eligibility in respect of the index universe, market cap, turnover, and listing history, etc, given that the HSI is not a purely rules-driven index, fundamental and financial analysis will also be conducted in the index review process. Finally, the results will be endorsed by the HSI Advisory Committee. Importantly, diversification is one of the key philosophies consistently upheld by the HSI as it can lower the index's unsystematic risk.

Evolution of the Hong Kong Stock Market Before 2021

In line with the rapid growth of mainland China's economy and new technological innovation in the past decades, the Hong Kong stock market has undergone significant structural changes to embrace mainland Chinese companies and the New Economy players. In 2020, the proportion of Mainland companies in terms of market cap increased to 79%, and the largest industry was Information Technology, representing 35% of the total. Moreover, 63% of the fresh blood in the stock market was New Economy companies in terms of the IPO funds raised. Being the most representative and important benchmark of the Hong Kong stock market, the HSI has been proactively transformed to keep pace with the dynamic market changes, by way of: 1) inclusion of Red-chips, H-share, and REITs, 2) adoption of the freefloat-adjusted stock weighted cap for each constituent to reflect the proportion of their freefloat shares and to avoid heavy concentration in a large cap stock in the index, and 3) addition of Greater China Weighted Voting Rights ('WVR') and secondary-listed companies to the HSI universe. The HSI's constituent number increased from 33 in 1969 to 52 in 2020, with the index market cap expanding by nearly 5x from 1969 to HKD23 trillion (~50% of the market cap coverage in Hong Kong) in 2020.

Advancement of the HSI to Maintain Its Representativeness

Going forward, to maintain the HSI's broad base representation for Hong Kong blue-chips, its constituents will be selected from the newly-defined seven Industry Groups, each of which with an above 50% target market cap coverage. Moreover, we aim to increase the number of constituents of the HSI to 80 by mid-2022 and ultimately to 100, to ensure that the HSI can cover the performance of leaders in emerging industries. To facilitate the timely inclusion of suitable IPO stocks, we will shorten the listing history to three months regardless of the newly listed companies' market cap. We will maintain 20-25 "Hong Kong constituents" in the HSI as their low return correlation with "mainland Chinese constituents" will help reduce the index volatility as well as maintain the distinct identity of the index from the Hang Seng China Enterprises Index ('HSCEI'). To avoid weighting concentration in the HSI after expanding the constituent number, the weighting cap on all kinds of constituents will be lowered from 10% to 8%. Overall, the index philosophy of the HSI, with regard to maintaining a high degree of representativeness with diversified constituents, should remain intact.



Hang Seng Index – An Important Benchmark for Hong Kong Blue-chips

The Hang Seng Index ('HSI') is the key performance tracker of Hong Kong blue-chips (the largest and the most liquid stocks of the major industry sectors) since its launch in 1969. Apart from employing more stringent requirements in respect of the index universe, market cap, turnover, and listing history, etc., compared with the Hang Seng Composite Index ('HSCI') when assessing each constituent's eligibility, given that the HSI is not a purely rules-driven index, fundamental and financial analysis will also be conducted in the index review process. Finally, the results will be endorsed by the HSI Advisory Committee. Diversification is one of the key philosophies consistently upheld by the HSI as it can lower the index's unsystematic risk. Moreover, to maintain the index's representativeness, the HSI has a proven track record of making timely adjustment in its methodology to keep pace with substantial market changes.

Mission of the HSI – Blue-chips Performance Tracker

The HSI was launched in 1969 and has been the most important flagship index in the Hang Seng Family of Indexes. Starting with 33 constituents at launch versus 59 listed companies in Hong Kong, the HSI has been the key index to reflect the performance of the Hong Kong stock market. An expansion in the number of listed companies in Hong Kong to above 700 in 2001 prompted Hang Seng Indexes Company Limited ('Hang Seng Indexes Company') to launch the HSCI as a broad-based index with 200 constituent stocks to reflect the performance of the Hong Kong stock market with an all-encompassing perspective. Later on, as the number of listed companies on the main board of the Hong Kong Stock Exchange ('HKEX') increased to above 1,100 in 2009, the index composition of the HSCI has been revised to cover 95% of the total market cap of companies listed on the main board. As the role of the HSI remains to track the performance of **blue-chip stocks** (the largest and the most liquid stocks of the major industry sectors) in Hong Kong, more stringent requirements have been applied for its constituent selection.

For example, the HSI only includes securities of Greater China companies that are listed on the Main Board of the HKEX versus the HSCI's inclusion of foreign companies as well among its constituents. In terms of turnover requirement, the assessment conducted by the HSI is based on a longer period of time (24 months vs 12 months for the HSCI). Also, before implementing the enhancement proposals for the HSI in its May 2021 Index Review, there is a high-threshold listing history requirement for the HSI (at least 24 months unless the company has a very large market value) versus no such prerequisite for the HSCI. Importantly, the HSI is not a rules-driven index. Rather, there is a stringent constituent selection process governed by the **HSI Advisory Committee**, of which 10 out of the 14 committee members are independent from the Hang Seng Indexes Company and specialise in the areas of statistics, finance-related academia and professional services, institutional investment, and investment consultancy. Leveraging on the committee members' broad experience, fundamental and financial analysis are conducted on existing and potential constituents in the Index Review to determine inclusion and/or removal of index constituents.



Exhibit 2: Constituent Eligibility – HSI versus HSCI

	HSI *	HSCI
Universe	HKEX Mainboard-listed securities, excluding: - Investment Companies, - Foreign Companies, - Stapled Securities, - Biotech stocks ending with marker "B"	HKEX Mainboard-listed securities, excluding: - Investment Companies
MV	Covers top 90% of MV (based on average month-end MVs in the past 12 months)	Covers top 95% of total market cap listed on Main Board
Turnover	Scoring approach based on the past 8 quarterly sub-periods, if among the top 90% of turnover coverage as below: -Two points if achieved in the latest four sub-periods; -One point if attained over the previous four sub-periods; -At least 8 points out of the maximum 12 points	Velocity test at 0.05% as below: -Minimum 0.05% at least 10 out of the past 12 months, AND -Minimum 0.05% for at least 5 out of past 6 months
Listing History	Over 24 months normally, depending on MV rank by review cut-off date: -Top 5, minimum 3 months; -6 to 15, minimum 6 months; -16 to 20, minimum 12 months; -21 to 25, minimum 18 months; -Below 25, minimum 24 months	No listing requirement
Number of Constituents	50	No limit
Regular Review	Quarterly (Cutoff: end of Mar, Jun, Sep, Dec)	Half-yearly (Cutoff: end of Jun, Dec)

*Remark: Prior to Nov 2020 Review

Source: Hang Seng Indexes Company

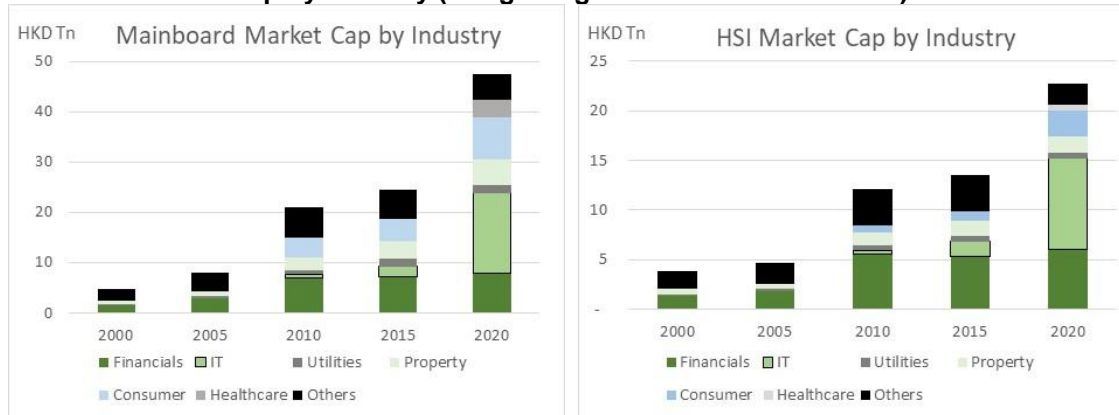
Date as at 30 March 2021

Maintaining a High Degree of Representativeness with Diversified Constituents

Diversification is one of the key philosophies employed by the HSI given that it can lower the index's unsystematic risk as systematic or market risk is generally unavoidable. For example, let us say that there is an index only composed of consumer discretionary stocks. Share prices of its constituents will drop following any bad news on slowdown in economic growth as consumers are more likely to reduce or postpone their discretionary purchases when times are tough. Holding consumer staples stocks can counterbalance the impact on the index given essential goods are those products that people are unable or unwilling to cut off from their budgets regardless of their financial situation. While consumer discretionary and consumer staples sectors have a strong correlation and will be both adversely affected by any spike in the unemployment rate, the unsystematic risk can be diversified by including stocks from different industries. For instance, utilities companies that provide public services, such as water, electricity and sewage services, are essential for daily life and not sensitive to market swings. Overall, the unsystematic risk of an index can be mitigated through diversification into different industries, hence, reducing the volatility of the index's performance.



Exhibit 3: Market Cap by Industry (Hong Kong Stock Market vs the HSI)



Source: Hang Seng Indexes Company
Date as at 30 March 2021

Exhibit 3 shows that over the past 20 years, the total market cap of the Hong Kong stock market has surged by nearly 9x to HKD47 trillion, with the number of listed companies increasing by nearly 2x to approximately 2,200 at the end of 2020. As the performance tracker for Hong Kong blue-chips, the number of constituents of the HSI increased from 33 at the end of 2000 to 52 at the end of 2020, with the index market cap increasing by nearly 5x to HKD23 trillion. With an increasing number of mainland Chinese companies listed in Hong Kong after 2005, the business variety of locally listed companies has expanded significantly, including mega-sized State-owned Enterprises ('SOE') in the areas of Financials, Telecom, Industrials, Energy, Materials, etc. To preserve the HSI's broad base representation, the index has diversified its constituents' industry distribution and weighting accordingly, with a significant rise in weightings for Information Technology, Consumer and Healthcare at the expense of Financials, which was heavily weighted in early 2000. Given that some of the new constituents were leading SOEs, the HSI has employed the free-float market-cap methodology to avoid over-concentration in companies with a large market cap but only a minimal amount of shares available for trading in the market. Moreover, a stock weighting cap has also been applied to prevent any single constituent from exerting a disproportionate influence on the HSI, hence distorting the benefits of index diversification. Overall, the philosophy of the HSI, with regard to maintaining a high degree of representativeness with diversified constituents, has remained intact.



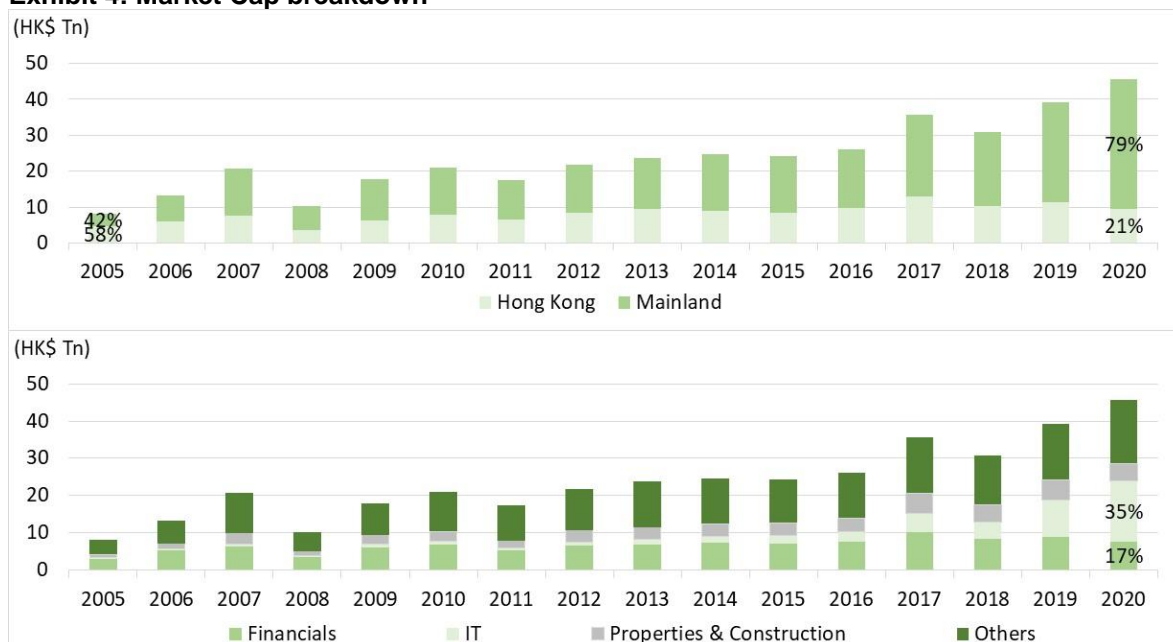
Evolution of the Hong Kong Stock Market Before 2021

In line with the rapid growth of mainland China's economy and new technological innovation in the past decades, the Hong Kong stock market has undergone significant structural changes to embrace mainland Chinese companies and the New Economy players. In 2020, the proportion of Mainland companies in terms of market cap increased to 79%, and the largest industry was Information Technology, representing 35% of the total. Moreover, 63% of the fresh blood in the stock market was New Economy companies in terms of the IPO funds raised. Being the most representative and important benchmark of the Hong Kong stock market, the HSI has been proactively transformed to keep pace with the dynamic market changes, by way of: 1) inclusion of Red-chips, H-shares, and REITs, 2) adoption of the freefloat-adjusted stock weighted cap for each constituent to reflect the proportion of their freefloat shares and avoid heavy concentration in a large cap stock in the index, and 3) addition of Weighted Voting Rights ('WVR') and secondary-listed companies from the Greater China region to the HSI universe.

Rapid Development of the Hong Kong Stock Market

With the rapid growth of new innovation and technology in the past 15 years, new business ideas, such as the data-driven, subscription-based, online-retail, B2B models, etc. have re-shaped the global competitive landscape and our daily lives. The New Economy segment has grown into a force that can sway the capital markets. As a result, the Hong Kong Stock Market, acting as a gateway between mainland China and the world, has undergone significant structural changes. Exhibit 4 shows that the proportion of mainland companies, with a growing combined market cap, in the local market cap coverage increased to 79% in 2020 (from 42% in 2005); with Information Technology as the largest industry, representing 35% of the total in 2020 (vs 17% for Financials).

Exhibit 4: Market Cap breakdown



Source: Hang Seng Indexes Company
Date as at 30 March 2021



In response to the rising New Economy segment (companies typically engaged in the healthcare, technology or other related industries), the HKEX introduced a series of new listing chapters in 2018 to echo with market changes. Exhibit 5 shows that the Hong Kong IPO funds raised for New Economy stocks rose to 63% of the total in 2020 (from 49% in 2018), with the number of IPO deals increasing to 51 in 2020 (from 31 in 2018) versus a decline for traditional economy companies (103 in 2020 from 187 in 2018).

Exhibit 5: Hong Kong IPO Funds Raised and Number of Deals



Sources: Hang Seng Indexes Company, Hong Kong Stock Exchange
Date as at 30 March 2021

Adjustments to the HSI to Keep Pace with Market Changes

Exhibit 6 shows the major milestones that HSI has laid down since its launch in 1969, such as the gradual inclusion of Red-chips, H-shares and REITs; adoption of the freefloat-adjusted market cap; increasing the number of constituents; and the addition of WVRs and secondary-listed companies to the HSI universe.

In 1969, the Hang Seng Index was launched with 33 constituents. Out of merely 59 listed companies in Hong Kong, the 33 stocks accounted for about 70% of the market cap at the time. During the 1990s, with mainland China's rapid economic development, listed companies in Hong Kong had growing business exposure in mainland China. In 1994, the first red-chip, Guangdong Investment, was included in the index.

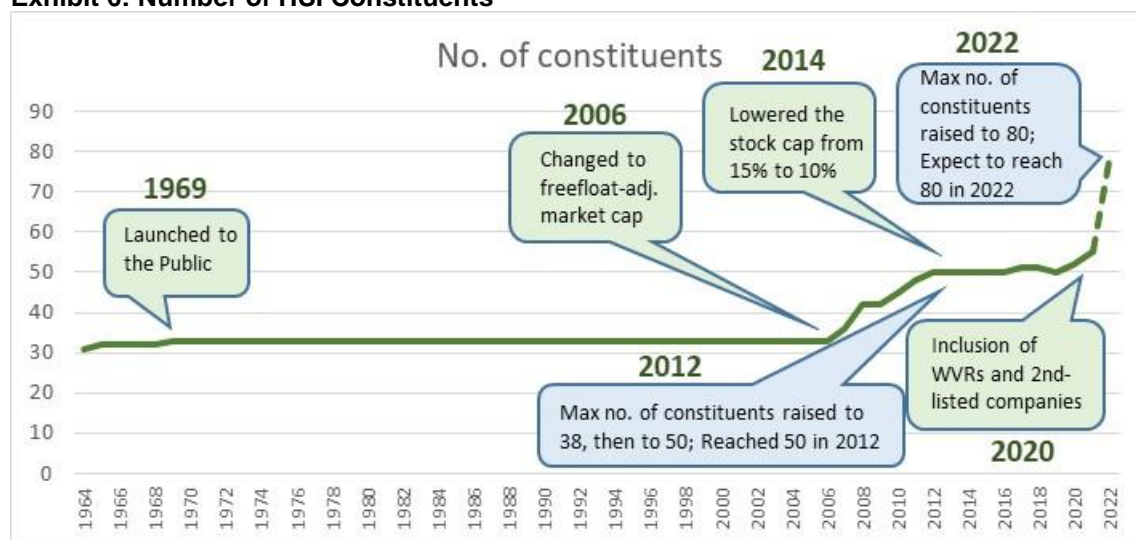


In August 2006, the first H-share, China Construction Bank, was included in the HSI to reflect the increasing importance of H-shares. As of end-July 2006, the H-share combined market cap was HKD1.9 trillion, representing 19% of the Main Board's total. The average daily turnover of H-shares was HKD8.7 billion in the first seven months of 2006, accounting for 28% of the total turnover on the Main Board. At that time, 21 H-shares met the requirements for index inclusion. To reflect the proportion of constituents' freefloat shares and to avoid heavy concentration in a single large cap stock within the index, the index methodology was changed to freefloat-adjusted market-cap weighted (from full market-cap weighted), with a 15% cap on individual stock weightings. The initial H-share inclusion first led to a net increase in the number of HSI constituents to 38 (i.e. no removal of the 33 non H-share constituents). To enlarge the coverage of the index, the maximum number of constituents was raised in 2007 to 50, which was eventually reached in 2012.

Notably, the HKEX established several new listing chapters in 2018 to attract issuers engaged in innovations and technologies. For instance, **Chapter 8A** allows the introduction of the weighted-voting-rights ('WVR') structure ('W' marker, listing of Alibaba, NetEase, JD.com), **Chapter 18A** has opened the door for the listing of pre-revenue biotech companies ('B' marker), and **Chapter 19C** offers a concessionary route for eligible companies to get listed via secondary listing ('S' marker). To catch up with the measures introduced by the HKEX, in May 2020, Hang Seng Indexes Company began to allow WVR companies and secondary-listed companies from the Greater China region to be included as constituents of the HSI with an individual weighting cap of 5%. In September 2020, the HSI included two leading Chinese tech companies (Alibaba, Xiaomi) as its constituents.

In March 2021, five enhancements were adopted, including an increase of the maximum number of constituents to 80 by mid-2022, and ultimately to 100.

Exhibit 6: Number of HSI Constituents



Source: Hang Seng Indexes Company
Data as at 30 March 2021



Exhibit 7: Summary/Timeline of the HSI Advancement

Year	Enhancements of Hang Seng Index
1969	HSI was officially launched to the public, with 33 constituents
1994	The first Red-chip company (Guangdong Investment) was included in the HSI
2006	<ul style="list-style-type: none">- HSI's index methodology was changed to freefloat-adjusted market-capitalisation weighted (from full market-capitalisation weighted)- Maximum number of HSI constituents was increased to 38- The first H-share company (China Construction Bank) was included in the HSI
2007	Maximum number of HSI constituents was increased to 50
2012	Number of HSI constituents reached 50
2014	The first real estate investment trust (Link REIT) was included in the HSI
Jan 2020	Consultation Paper on Eligibility of WVRs and Secondary-listed companies to be included in the HSI
May 2020	Approval on the inclusion of WVRs and secondary-listed companies in the HSI
Sep 2020	WVRs and Secondary-listed companies (Alibaba, Xiaomi) were included in the HSI
Dec 2020	Consultation Paper on Five Enhancements for HSI

Source: Hang Seng Indexes Company
Data as at 30 March 2021



Advancement of the HSI to Maintain Its Representativeness

To maintain the HSI's representativeness for Hong Kong blue-chips, its constituents will be selected from the newly-defined seven Industry Groups, each of which with an above 50% target market cap coverage. Moreover, we aim to increase the number of constituents of the HSI to 80 by mid-2022 and ultimately to 100, to ensure that the HSI can cover the performance of leaders in emerging industries. To facilitate the timely inclusion of suitable IPO stocks, we will shorten the listing history to three months regardless of the newly listed companies' market cap. We will maintain 20 to 25 "Hong Kong constituents" in the HSI as it will help maintain the distinct identity of the index from the Hang Seng China Enterprises Index ('HSCEI'). Given their low return correlation with "mainland Chinese constituents", it will also help reduce the index's volatility. To avoid weighting concentration in the HSI after expanding the constituent number, we will lower the individual constituent weighting cap from 10% to 8% for all constituents, including Greater China Weighted Voting Rights ('WVR') and secondary-listed Greater China companies, as the market has become quite familiar with their corporate structures.

Constituent Selection by the Seven Industry Groups

To achieve a more balanced industrial distribution for the HSI, its constituents will be selected based on the seven Industry Groups as shown in Exhibit 8: 1) Financials, 2) Information Technology, 3) Consumer Discretionary & Consumer Staples, 4) Properties & Construction, 5) Utilities & Telecom, 6) Healthcare, and 7) Energy, Materials, Industrial, and Conglomerates. Moreover, we have set a target market cap coverage of above 50% for each Industry Group.

Exhibit 8: Grouping of Seven Industry Groups for Constituent Selection

	HSICS Industry classification		HSICS Industry classification	Remarks
#	New 7 Industry Groups	#	Existing 12 Industries	
1	Financials	1	Financials	<ul style="list-style-type: none"> Traditional core industries Group Consumer Discretionary and Consumer Staples together to form Consumption
2	Properties & Construction	2	Properties & Construction	
3	Consumption	3	Consumer Discretionary	
		4	Consumer Staples	
4	Utilities + Telecom	5	Utilities	<ul style="list-style-type: none"> Critical infrastructure Defensive Industries
		6	Telecommunications	
5	Information Technology	7	Information Technology	<ul style="list-style-type: none"> Emerging new economic sectors
6	Healthcare	8	Healthcare	
7	Others	9	Energy	<ul style="list-style-type: none"> Relatively smaller segments (individual weighting <5%)
		10	Materials	
		11	Industrials	
		12	Conglomerates	

Source: Hang Seng Indexes Company
Data as at 11 February 2021



Exhibit 9 shows the number of constituents, market cap amount and percentage weighting, and index weighting for the Hang Seng Composite Index ('HSCI') for each Industry Group before and after the new grouping. After regrouping the HSCI constituents into the current seven Industry Groups, Information Technology and Financials are still the top two Industry Groups and account for 28.7% and 26.3% of the index market cap respectively, followed by Consumer Discretionary & Consumer Staples (14.9%), Properties & Construction (8.7%), Healthcare (6.6%) and Utilities & Telecom (5.5%). Given Energy, Materials, Industrials and Conglomerates are relatively smaller industries with an index weighting of only 1.0-4.1% each, the index weighting of this new group "Others" (8.1%) will be comparable to that for Group 3-6.

Exhibit 9: Market Cap and Index Weighting by Industries (before and after the new grouping)

Hang Seng Composite Index ("HSCI")										
HSICS Industry (Existing grouping)	No.	Market Cap HK\$bn %		Index Wgt %		7 Industry Groups (New grouping)	No.	Market Cap HK\$bn %		Index Wgt %
1 Financials	57	7,958	17.9	26.3		1 Financials	57	7,958	17.9	26.3
2 Information Technology	39	14,210	32.0	28.7		2 Information Technology	39	14,210	32.0	28.7
3 Consumer Discretionary	90	5,691	12.8	10.8	→	3 Consumer Discretionary + Staples	117	7,917	17.9	14.9
4 Consumer Staples	27	2,225	5.0	4.1						
5 Properties & Construction	103	4,435	10.0	8.7		4 Properties & Construction	103	4,435	10.0	8.7
6 Healthcare	41	3,024	6.8	6.6		5 Healthcare	41	3,024	6.8	6.6
7 Utilities	29	1,482	3.3	3.6	→	6 Utilities & Telecom	38	2,743	6.2	5.5
8 Telecommunications	9	1,261	2.8	1.9						
9 Industrials	41	1,561	3.5	4.1	→	7 Others	80	3,311	7.5	8.1
10 Conglomerates	8	604	1.4	1.2						
11 Energy	12	696	1.6	1.8						
12 Materials	19	449	1.0	1.0						
FC, SS and 18A^	17	752	1.7	1.3		FC, SS and 18A	17	752	1.7	1.3
Total	492	44,350	100.0	100.0		Total	492	44,350	100.0	100.0

Remark: ^ FC = Foreign companies, SS = Stapled Securities, and 18A = pre-revenue biotech companies listed via Ch18A
Source: Hang Seng Indexes Company
Data as at 11 February 2021

When deciding the possible number of constituents for each Industry Group, size distribution and the number of listed companies, as well as the overall weighting by Industry Group compared with the HSCI, will be the key considerations. Exhibits 10 shows that there are mega-sized stocks in the Information Technology and Financials Industry Groups, and they have substantially distorted the Industry Groups' market cap distribution given their constituents' market cap averages are substantially higher than the median value (Average/Median ratio of 6.6 to 18.7). On the other hand, the average sizes of the constituents from Properties & Construction and Consumer Discretionary & Staples are smaller compared with other Industry Groups, and their constituents' distribution by market cap are relatively more even. As a result, more constituents will need to be selected from Properties & Construction and Consumer Discretionary & Staples when the HSI is expanded to 80 constituents ('HSI-80').



Exhibit 10: HSCI Statistics by 7 Industry Groups

	# of Co.	Mkt cap, HKD million				Average/Median (x)
		High	Low	Median	Average	
Information Technology	40	6,612,086	3,663	18,167	340,426	18.7
Financials	57	1,533,863	5,176	21,379	142,137	6.6
Utilities + Telecom	38	1,126,152	3,744	27,625	76,343	2.8
Healthcare	42	400,267	3,458	22,067	63,616	2.9
Consumer Discretionary & Staples	117	359,690	583	25,391	60,820	2.4
Properties & Construction	103	345,126	2,494	18,004	45,638	2.5
Others	80	405,845	3,888	19,863	41,523	2.1
HSCI overall	477	6,612,086	583	21,338	88,952	4.2

Source: Hang Seng Indexes Company
Data as at 4 March 2021

This new method of constituent selection will be implemented starting from the next index review in May 2021. In order to ensure that this enhancement will work properly, the combination of the Industry Groups is subject to review every two years.

Constituent Number Targeted to Expand to 80 by mid-2022 and Ultimately to 100

We target to increase the number of constituents for the HSI to 80 by mid-2022. Given that more mega-sized US-listed Chinese companies and “unicorns” are planning to seek a listing in Hong Kong, which will play the role of a platform for investment and financing to facilitate the Belt and Road Initiative under the Outline Development Plan for the Greater Bay Area, we are confident that the HSI's constituents will ultimately increase to 100. Overall, our position is to ensure that the HSI can cover the performance of leaders in emerging industries. In addition, in case any constituent faces an industry-specific cyclical downturn and suffers a market cap shrinkage as a result, expansion of the constituent space will allow it to stay in the HSI without being removed before the turnaround of the industry cycle.

Shortening the Listing History Requirement to Three Months

After evaluating the pros and cons of removing the listing history requirement (e.g. increasing the flexibility of including suitable IPO stocks in a short period of time), we have decided to keep the listing history requirement with the span shortened to three months regardless of the market cap for the newly listed company, on the grounds that this will allow enough time for investors to evaluate their investment decision. Moreover, the HSI Advisory Committee can act as a gate keeper to decide whether a candidate is appropriate to be included in the HSI. This enhancement will be effective from the next Index Review in May 2021.



Number of “Hong Kong Constituents” Remains Intact at 20 to 25

Currently, of the existing 24 “Hong Kong constituents” in the HSI, nearly 90% are well-established Financials (59%), Properties & Construction (12%), Consumer Discretionary & Staples (12%), and Utilities (7%) companies in Hong Kong. Given that Hong Kong will be upgraded into an international metropolis with enhanced competitiveness under the outline plan for the Greater Bay Area, we believe that these 24 companies will still play crucial roles in the economic development of Hong Kong. In all, we target to keep 20 to 25 “Hong Kong constituents” in the HSI as it can maintain the distinct identity of the index from the HSCEI. Given that our definition of “Hong Kong constituents” excludes foreign companies in the first place, and is further confined within the space of Greater China Companies, Hong Kong companies must have at least 50% of their sales revenue derived outside mainland China (return on assets will also be taken into consideration to better reflect the company's business performance), and their return correlation with “mainland Chinese” constituents should be low. By virtue of the above, the HSI's constituent space is expected to be even more diversified, which is conducive to containing the index's volatility.

With the number of HSI constituents increasing from the current of 55 to 80 by mid-2022, the combined index weighting for Hong Kong companies is set to drop to 33.1% from the current 41.5%. In order to ensure that this enhancement will work properly, the combination of the Industry Groups is subject to review every two years.

Adopting a Weighting Cap of 8% on All HSI Constituents

After taking into consideration that the HSI constituent number will expand to 80 by mid-2022, we have decided to apply the same weighting cap to WVR and/or secondary-listed constituents and lower the current individual constituent weighting cap from 10% to 8% to avoid any over-concentration of the index weighting in a particular industry. The HSCEI will adopt the same constituent weighting cap and arrangement in order to ensure that the two indexes employ similar treatment to their constituents. This enhancement will be effective from the Index Rebalancing in June 2021.



Appendix 1 – Feedback from the HSI Consultation

Summary of Responses Received

At the end of the public consultation on the HSI, which took place from 22 December 2020 to 24 January 2021, we have received responses from various categories of stock market participants as well as from academics and institutes. Overall, 60 responses from 55 organisations were received. Exhibit 11 shows that responses from traders/market makers, active investment managers, passive investment managers accounted for 23%, 20% and 17% of the total responses respectively.

Exhibit 11: Responses from 55 Organisations

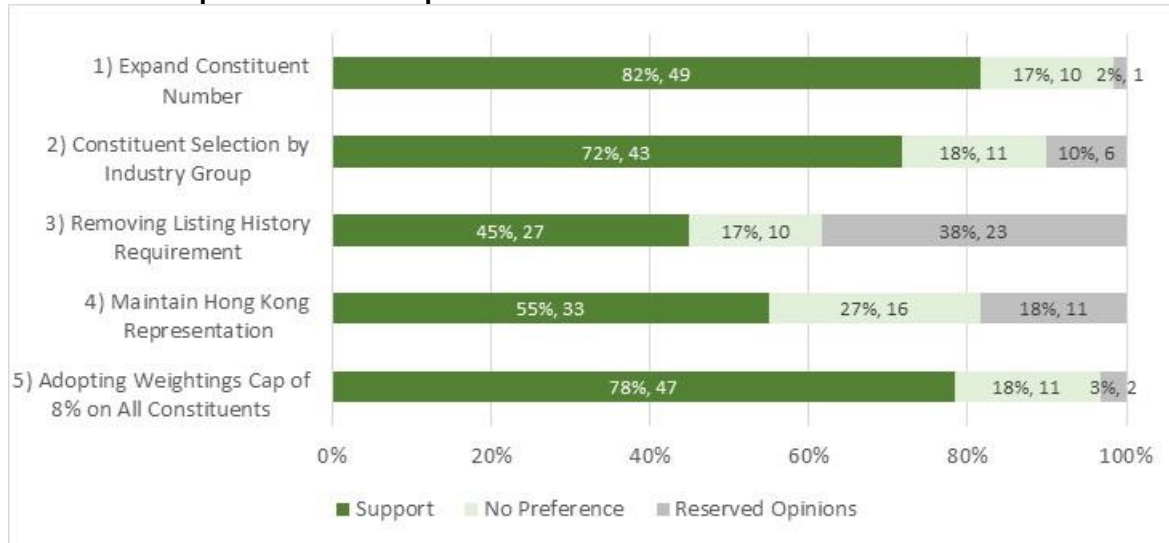
Categories	No. of Respondents	% of Respondents
Traders/ Market Makers	14	23%
Investment Managers (Active)	12	20%
Investment Managers (Passive)	10	17%
MPF Providers	5	8%
Asset Owners	3	5%
Structured Product Issuers	3	5%
Academics/ Institutes	2	3%
Others	11	18%
TOTAL	60	100%

Source: Hang Seng Indexes Company

Regarding the responses for the five proposals as shown in Exhibit 12, except for Proposal 3 – “Removing Listing History Requirement”, over 50% of the respondents support the changes. For Proposal 3, 38% of the respondents vote for keeping the existing listing history requirement, while 62% of the respondents vote to support (45% of total) or have no preference (17% of total) on removing the existing listing history requirement.



Exhibit 12: Responses to the Proposals



Source: Hang Seng Indexes Company

Enlargement of Market Coverage

More than 80% of the respondents support the proposal to expand the number of constituents in the HSI, while 17% of the respondents have no preference on the change and 2% of the respondents have reserved opinions on the proposal. Among the feedback, some suggest having a variable number of constituents with a target on overall market coverage. However, we believe that this may result in adjusting the number of constituents frequently, which is too difficult to implement.

Expansion of Industrial Representation

On the proposal to expand industrial representation for the HSI, 72% of the respondents support a change in constituent selection by Industry Groups, with only 10% of the respondents having reserved opinions on the proposal and 18% of the respondents having no preference on the change. Despite the fact that a minority of feedback prefer the HSI to represent the overall market performance rather than individual sectors, the proposed constituent selection is welcomed by a majority of the respondents on the grounds that a more balanced industry distribution can be achieved, hence better reflecting the performance of the Hong Kong stock market. In order to execute the proposed constituent selection effectively and transparently, respondents would like to know any specific rules that we will follow to define the Industry Groups as well as the number of constituents within each group. Among the feedback, we also see suggestions to merge Telecom and Utilities into one Industry Group as they are both classified as defensive industries and normally generate stable dividend income to investors.



Timely Inclusion of New Listings

Despite the fact that less than half of the respondents support the proposal of “Removing Listing History Requirement” (45% of total respondents) as it may allow timely inclusion of suitable IPO stocks, still more than 38% of the respondents have reserved opinions on the proposal. It is mainly due to market concerns that newly listed companies may have volatile price movements during the early days of their listings, hence, affecting the performance of the HSI. Moreover, some respondents believe that the trading history of listed companies is important in helping them to formulate investment decisions.

Representation of “Hong Kong Companies” to Remain Intact

On the proposal of maintaining the representation of Hong Kong companies, 55% and 27% of the respondents support or are neutral on keeping a certain number of constituents classified as “Hong Kong companies”. The remaining 18% of the respondents hesitate on the move due to their belief that the HSI should represent the overall Hong Kong stock market and this arrangement is unfair to some “mainland Chinese companies”. Also, there are suggestions to fix a specific weighting for “Hong Kong companies” rather than one based on the number of constituents. However, we believe that it may be difficult to implement as it may trigger frequent adjustments in the number of “Hong Kong companies” when there are significant changes in their market caps or after inclusion of mega-sized companies from mainland China in the HSI.

Enrichment of Constituent Weighting Distribution

The proposal for adopting a weighting cap of 8% on all HSI constituents is strongly supported by the market, with 78% of the respondents in favour versus only 18% and 3% of the respondents being neutral or having reserved opinions on the proposal. The adoption of a lower weighting cap of 5% for WVR and secondary-listed companies from the Greater China region since 2018 was due to the fact that we had implemented a prudent approach to start with and that the WVR company structure was then relatively new to Hong Kong as well as non-WVR shareholders who carry relatively lower voting rights. As now the market is quite familiar with WVR and secondary listings, it may be a good time to apply the same weighting cap to all kinds of constituents.



Appendix 2 – Pro-forma Analysis After Implementing Changes

Our pro-forma analysis suggests that after implementing the five enhancements we have concluded from the HSI Consultation, the HSI-80's market cap coverage and turnover coverage will increase significantly by 15 percentage points and 16 percentage points respectively, and its weighting distribution by industry is likely to become more balanced and diversified, hence, improving the index's representativeness of Hong Kong blue-chips' performance.

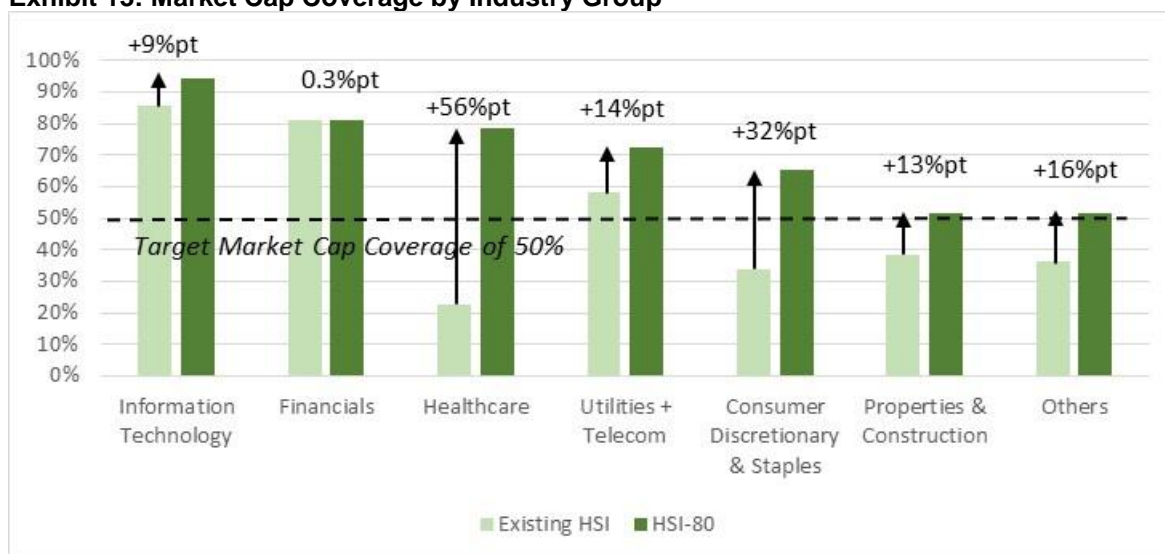
Index Characteristics When Reaching 80 Constituents by Mid-2022

We have conducted a pro-forma analysis of the HSI, after implementing the five enhancements we have concluded from the HSI consultation. Our analysis suggests that the HSI-80's weighting distribution by industry will become more diversified, and its weighting distribution by share class will also be able to reflect the presence of a large number of mainland Chinese new economy companies newly-listed since 2018.

More Balanced Coverage by Industry Group

After expanding the number of constituent stocks to our target of 80, the market cap coverage for the seven Industry Groups will expand significantly. As shown in Exhibit 13, the market cap coverage for the seven Industry Groups will be all above our target of 50%. Among them, Healthcare is likely to have the biggest uplift (up 56 percentage points from 22% to 78%), followed by Consumer Discretionary & Staples (up 32 percentage points from 33% to 65%), Others (up 16 percentage points from 36% to 52%), Properties & Construction (up 13 percentage points from 38% to 51%), Utilities & Telecom (up 14 percentage points from 58% to 72%) and Information Technology (up 9 percentage points from 86% to 95%). In contrast, the market cap coverage for Financials, which is already staying at a high level of 81%, will only increase marginally by 0.3 percentage points.

Exhibit 13: Market Cap Coverage by Industry Group



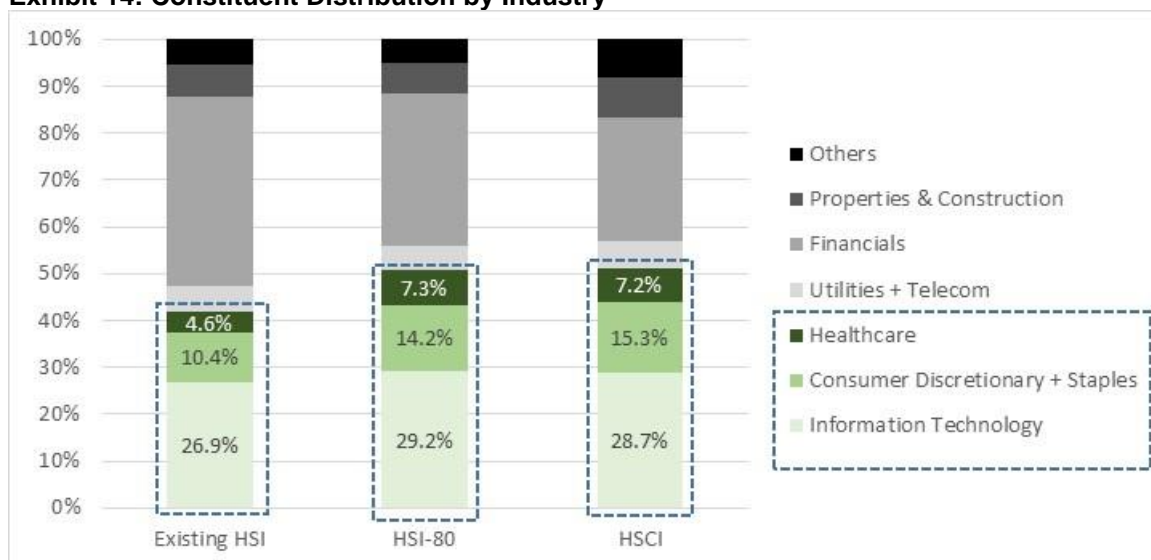
Source: Hang Seng Indexes Company
Data as at 11 February 2021



Diversification to Be Enhanced Substantially

After the enhancement of the HSI, Exhibit 14 shows that its constituent weighting distribution by industry will become more aligned with that of the HSCI. In particular, the combined index weighting for “New Economy” industries like Information Technology, Consumer Discretionary & Staples, and Healthcare will become 50.7%, largely in line with the HSCI’s 51.2%. The key difference in index weightings for the two indexes will be Financials, which accounts for 32.6% in the HSI-80, 6.3 percentage points higher than that in the HSCI (26.3%). This will be offset by the lower combined index weighting of Properties & Construction (-2.5 percentage points) and “Others” (-2.9 percentage points). For Telecom & Utilities, the industry’s index weighting in both the HSI-80 and the HSCI is roughly the same at 6%.

Exhibit 14: Constituent Distribution by Industry



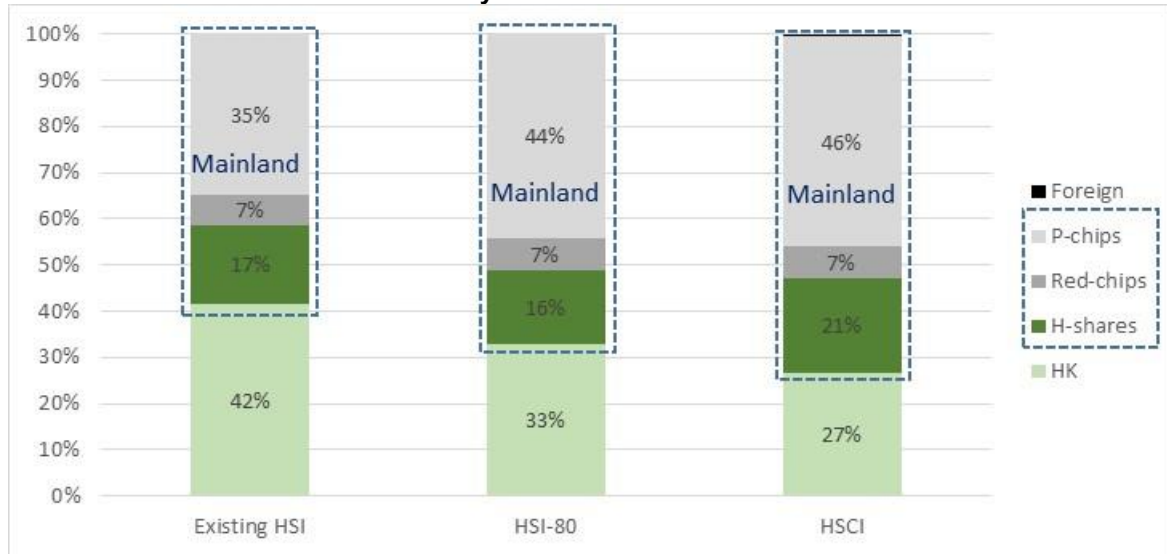
Remarks: Industry weightings exclude foreign companies, stapled securities, and biotech Co. ending with marker “B”
Source: Hang Seng Indexes Company
Data as at 11 February 2021

Improving Representation by Share Class

Despite a large number of mainland Chinese new economy companies having been listed in the Hong Kong stock market since 2018, Exhibit 15 shows that the HSI has substantially understated the constituent distribution of the mainland Chinese share class when compared with the case for the HSCI. Based on our pro-forma analysis, the HSI-80 will narrow the discrepancy substantially through lifting the proportion of the mainland Chinese share class (from the current 58% to 67%) versus 74% for the HSCI.



Exhibit 15: Constituent Distribution by Share Class



Source: Hang Seng Indexes Company
Data as at 11 February 2021

Comprehensive Measurement of Market Performance and Valuation

Exhibit 16 shows that there has been a divergence in performance between the HSI and the HSCI since early 2020. We believe that it is due to the fact that the industry coverage of the HSI has not fully reflected the listing of a large number of mainland Chinese new economy companies over the past two years. Moreover, the strong performance of new economy companies relative to the market is also another reason to explain the difference in performance of the two indexes. According to our pro-forma analysis, with an increase in diversity for the HSI-80, its volatility will remain similar to that of the current HSI despite the adding of constituents from newly emerging sectors with a shorter listing track record.

Exhibit 16: Performance of HSI vs HSCI (Since 2016)



		2016	2017	2018	2019	2020	YTD	Since 2016
Return (%)	HSI	0.4	36.0	-13.6	9.1	-3.4	8.2	34.4
	HSCI	-0.9	38.3	-16.7	11.0	12.2	9.2	55.3

Source: Hang Seng Indexes Company
Data as at 1 March 2021



As shown in Exhibit 17, the HSI-80 will become less concentrated on mega-sized stocks, and its market cap coverage and turnover coverage will increase significantly to 71.2% (from 56.5% for existing HSI) and 66.0% (from 50.2% for existing HSI), respectively. Moreover, after the uplift in weightings for new economy stocks, it will also imply a higher PE ratio and lower dividend yield.

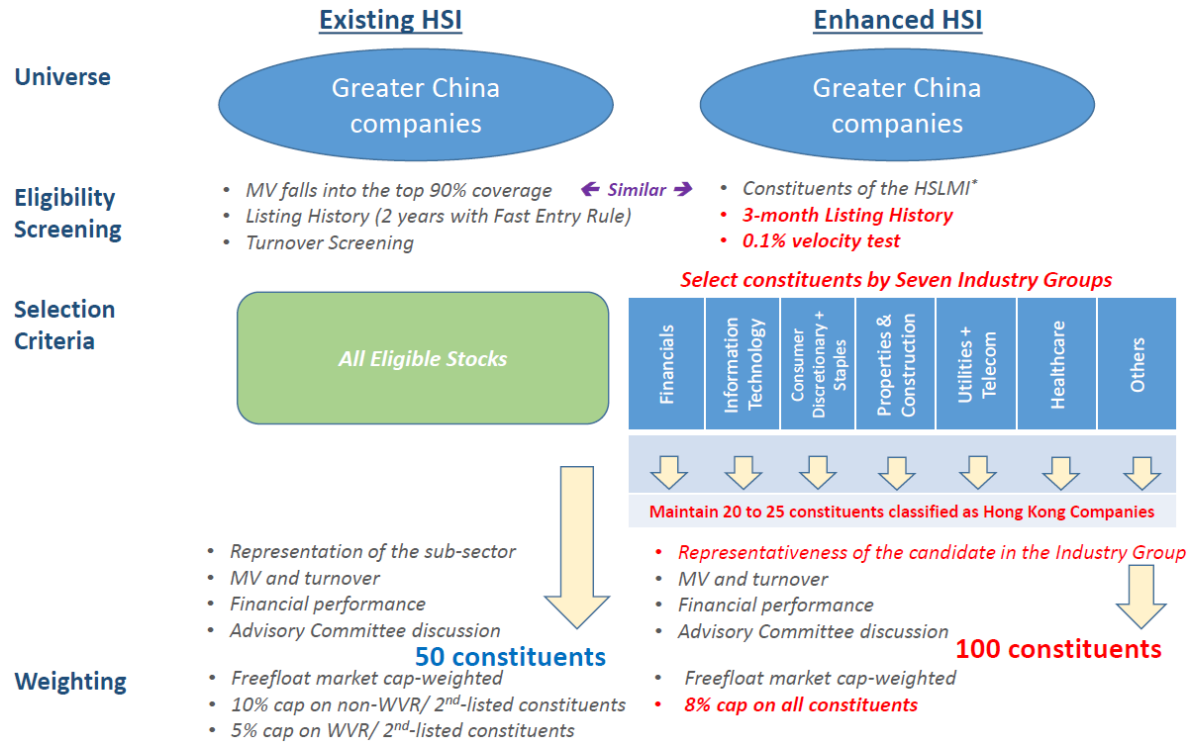
Exhibit 17: Constituent Distribution by Share Class

	Existing HSI	Pro-forma HSI-80
Market Cap (HK\$bn)		
Index	26,703	33,375
Largest	7,254	7,254
Average	514	417
Median	224	216
Smallest	51	90
Top 5 Weighting	41.10%	36.10%
Coverage		
Market Cap	56.50%	71.20%
Turnover	50.20%	66.00%
Fundamentals		
Price Earnings	15.7x	19.1x
Dividend Yield	2.60%	2.10%

Source: Hang Seng Indexes Company



Appendix 3 – Summary of the Enhancements



*Hang Seng Composite LargeCap & MidCap Index
Source: Hang Seng Indexes Company



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