



OPINION SURVEY REPORT

- I) SECTOR WEIGHTINGS OF THE HANG SENG INDEX**
- II) ELIGIBILITY OF FOREIGN COMPANIES IN THE HANG SENG FAMILY OF INDEXES**

JANUARY 2011

www.hsi.com.hk



HANG SENG INDEXES
恒 生 指 數

A wholly-owned subsidiary of Hang Seng Bank

Table of Contents

	Page
1. Background	2
About the Survey	2
Survey Issues	2
Issue 1: Sector Weightings of the Hang Seng Index	2
Issue 2: Eligibility of Foreign Companies in the Hang Seng Family of Indexes	2
2. Survey Process and Response	3
Survey Process	3
Response	3
3. Survey Results	4
Issue 1: Sector Weightings of the Hang Seng Index	4
Issue 2: Eligibility of Foreign Companies in the Hang Seng Family of Indexes	6
4. Comments Received	7
Issue 1: Sector Weightings of the Hang Seng Index	7
Issue 2: Eligibility of Foreign Companies in the Hang Seng Family of Indexes	8
5. Analysis and Conclusions	9
Issue 1: Sector Weightings of the Hang Seng Index	9
Issue 2: Eligibility of Foreign Companies in the Hang Seng Family of Indexes	10
6. Disclaimer	11

1. Background

About the Survey

- 1.1 In September / October 2010, Hang Seng Indexes Company Limited ("HSIL") conducted an opinion survey to obtain opinions about: 1) sector weightings of the Hang Seng Index ("HSI") as compared with the broad market benchmark, i.e. the Hang Seng Composite Index ("HSCI"); and 2) the eligibility of Foreign Companies in the Hang Seng Family of Indexes.

Survey Issues

Issue 1: Sector Weightings of the HSI

- 1.2 In recent years, the sector distribution of the HSI has shown increasing deviation from that of the broad market benchmark, the HSCI, with overweighting in the Finance Sector particularly prominent.
- 1.3 As at 30 June 2010, the Finance Sector accounted for about 47% of the HSI weighting, significantly higher than the 35% weighting recorded in the HSCI (a proxy of the whole market).
- 1.4 The survey was to solicit opinions on whether the issue should be addressed and, if determined that it is necessary, how it should be handled.

Comparison of Sector Distribution of HSI vs HSCI (as at 30 June 2010)

Sector	Weightings (%)		
	HSI	HSCI	Diff (+/-)
Finance	47.16	34.76	12.40
Utilities	5.58	4.94	0.64
Properties	10.39	12.65	-2.26
C&I	36.86	47.64	-10.78

Issue 2: Eligibility of Foreign Companies in the Hang Seng Family of Indexes

- 1.5 A number of large-cap Foreign Companies have listed on the SEHK in recent years. As at 30 June 2010, 14 Hong Kong-listed companies were classified as Foreign Companies¹ by HKEx. Four of these companies were listed in the past 12 months, the latest being Prudential PLC (2378.HK). It is anticipated that a growing number of Foreign Companies will list in Hong Kong in the future.
- 1.6 The survey was to solicit opinions on whether to admit Foreign Companies to the Hang Seng Family of Indexes in general, and the HSI in particular.

¹ HKEx provides the following definition of a Foreign Company – "a listed company would be classified as a foreign company if it is incorporated overseas AND has a majority of its business outside Hong Kong and China."

2. Survey Process and Response

Survey Process

- 2.1 HSIL published a survey questionnaire in September 2010 (“the questionnaire”). In addition to posting the questionnaire on HSIL’s website to invite responses, questionnaires were also sent to over 65 target respondents. Conference calls and meetings were arranged with various market participants upon request.
- 2.2 The questionnaire highlights key considerations in the development of suitable selection criteria and lists questions at the end of each section.

Response

- 2.3 A total of 31 responses from respondents in different sectors were received by the survey closing date (end October 2010).

Category	No. of Respondents
Fund Managers	10
Derivatives Issuers	15
Others	6
Total	31

- 2.4 The results of the opinion survey were presented at the HSI Advisory Committee Meeting in November 2010. Analysis of the responses and various proposals were discussed during the meeting and Advisors’ opinions were incorporated in the final decision on the matters.

3. Survey Results

Issue 1: Sector Weightings of the HSI

Opinions on current sector distribution of HSI (Q1-Q3)

- 3.1 80.0% of respondents expressed that the HSI's current sector distribution – i.e. that the weighting of the Finance Sector exceeds that of the market benchmark by about 12 percentage points – is acceptable. (Q1)
- 3.2 70.0% would accept a further increase in the overweighting of the Finance Sector, e.g. an HSI Finance Sector overweighting of more than 50%, compared to 35% in the broad market benchmark. (Q2)
- 3.3 60.0% believed that overweighting in the Finance Sector does not generate higher risk as regards the role of the HSI as a market benchmark. (Q3)

Opinions on whether special rules should be created to address sector overweighting of HSI (Q4, 9 -11)

- 3.4 60.7% thought that Hang Seng Indexes should not create special rules to manage sector weightings. (Q4)
- 3.5 46.7% thought that it is not essential for the HSI to reflect market sector weightings. (Q9)
- 3.6 62.1% indicated that Finance Sector overweighting might not be a long-term issue and therefore significant manipulation of the HSI may not be necessary. (Q10)
- 3.7 90.0% agreed that HSIL needs to take minimum distortion, market impact and transaction costs into account in addressing the issue of sector overweighting. (Q11)

Opinions on the feasibility of the three proposed options (Q5 - 8)

- 3.8 Respondents' opinions on the feasibility of the three proposed options are summarised below: (Q5, 6 & 8)

Options	Considered Feasible	
	Yes	No
Option 1: Remove (Add) Constituents in Overweight (Underweight) Sectors	17.9%	82.1%
Option 2: Cap Overweight Sector	38.7%	61.3%
Option 3: No Change, But Freeze Number of Constituents in Overweight Sector	31.0%	69.0%

- 3.9 Among the respondents who considered Option 2: Cap Overweight Sector a feasible option, their suggested best tolerance and capping level are as follows: (Q7)

Tolerance Level*	Capping Level* = Market Benchmark				Total
	+ Tolerance Level	+ 0%	+ 5%	+ 10%	
10%	20%	10%	-	-	30%
15%	30%	-	10%	-	40%
20%	20%	-	-	10%	30%
Total	70%	10%	10%	10%	100%

* In terms of sector weighting of market benchmark (Hang Seng Composite Index)

Preferred option to address the issue of sector overweighting (Q12)

- 3.10 About half of the respondents selected one of the three proposed options to address the issue of sector overweighting. The other half of respondents suggested other options.
- 3.11 Of the half of respondents who did not select any of the proposed options, a majority of them felt that no changes should be made at this moment and suggested "No Change" to the existing selection criteria of HSI constituents. 35.3% of the total number of respondents gave this response.
- 3.12 Respondents' preferences on the options to address the issue of sector overweighting are summarised below:

Options		% of Respondents
HSIL Proposed Options	Option 1: Remove (Add) Constituents in Overweight (Underweight) Sectors	2.9%
	Option 2: Cap Overweight Sector	35.3%
	Option 3: No Change, But Freeze Number of Constituents in Overweight Sector	14.7%
	Sub-total	52.9%
Other Options Suggested by Respondents	No change	35.3%
	Reduce the cap of single stocks / Apply a sliding scale of caps (e.g. 10%, 9%, 8%...for the 1 st , 2 nd , 3 rd constituents)	2.9%
	Top 70% percentile by market capitalisation in each classification	2.9%
	Split into more sectors / sub-sectors	2.9%
	Capping should only be applied in extreme cases	2.9%
	Subtotal	47.1%

Issue 2: Eligibility of Foreign Companies in the Hang Seng Family of Indexes

Opinions on the role of HSI (Q13, 14)

- 3.13 36.7% of respondents suggested that HSI should reflect Hong Kong / mainland China concepts; 56.7% suggested that HSI should represent all companies listed in Hong Kong. (Q13)
- 3.14 65.5% of respondents would continue to view the HSI as the Hong Kong market benchmark in the event that large-cap Foreign Companies joined the index and took up significant weight. (Q14)

Opinions on the approach for handling the eligibility of Foreign Companies in the HSI (Q15, 16)

- 3.15 83.3% of respondents viewed a prudent approach as the best way to handle the eligibility of Foreign Companies, i.e. wait for further market developments before making any changes. (Q15)
- 3.16 When asked about appropriate timing for considering Foreign Companies joining the HSI, 64.5% of respondents indicated that the issue should be considered in 2-5 years' time. (Q16)

Appropriate Timeframe for Considering Foreign Companies joining HSI	% of Respondents
Now	16.1%
2-5 Years	64.5%
Never	19.4%

Opinions on the separate treatment of Foreign Companies in the HSI and the HSCI (Q17)

- 3.17 The treatment of Foreign Companies in the HSI and the HSCI series was separated to provide greater choice for respondents' consideration. Opinions are summarised below: (Q17)

Treatment	Eligibility of Foreign Companies in:		% of Respondents
	HSI	HSCI	
Option A	No	No	19.4%
Option B	No	Yes	29.0%
Option C	Yes	Yes	51.6%

4. Comments Received

Issue 1: Sector Weightings of the HSI

General comments on the need to address overweighting issue

- 4.1 One respondent thought that setting rules to manage sector weightings could prevent the HSI suffering too heavily in the event of an extreme event in a single industrial sector, e.g. the financial tsunami.
- 4.2 One respondent thought that the Hong Kong market is as immature as that in mainland China and that rules are needed to avoid high volatility in the HSI.
- 4.3 Some respondents thought it is unnecessary to set rules to manage sector weightings as the high Finance Sector weighting reflects the current structure of the Hong Kong stock market.

Comments on the three proposed options

- 4.4 Some respondents expressed concern about Option 1 (Remove (Add) Constituents in Overweight (Underweight) Sectors), noting that it would have a drastic impact on the market as large banks or financial institutions might be at risk of exclusion.
- 4.5 Some respondents found the calculation methodology of Option 2 – (Cap Overweight Sector) to be complicated and were concerned about lower transparency of the HSI.
- 4.6 One respondent commented that although the calculation methodology of Option 2 (Cap Overweight Sector) is technical, it can be clearly defined as a transparent process and is only an extension of the single stock capping concept.
- 4.7 A few respondents expressed concern about Option 3 (No Change, but Freeze Number of Constituents in Overweight Sector) as it may exclude representative stocks from the HSI.

Other treatments suggested

- 4.8 Some respondents suggested no change to the existing selection criteria.
- 4.9 One respondent suggested reducing the caps of single stocks or applying a sliding scale of caps (e.g. 10%, 9%, 8% for the first, second and third constituents).
- 4.10 One respondent suggested including the top 70% percentile by market capitalisation in each sector classification.
- 4.11 One respondent suggested splitting the existing sectors into more sectors or sub-sectors.
- 4.12 One respondent thought that capping should only be applied in extreme cases.

Issue 2: Eligibility of Foreign Companies in the Hang Seng Family of Indexes

Comments in favour of Foreign Companies joining the HSI

- 4.13 Respondents in favour of Foreign Companies joining the HSI thought that Foreign Companies should be included in the Hang Seng Family of Indexes as long as they meet the selection criteria.
- 4.14 Some respondents thought that the overall performance of all important stocks listed in Hong Kong should be considered and they can be sub-divided by a “market/business” concept.
- 4.15 Some respondents noted that Hong Kong is an international financial centre. More Foreign Companies listing in Hong Kong is a structural change and the Hang Seng Family of Indexes should reflect it.

Comments against Foreign Companies joining the HSI

- 4.16 Some respondents raised the concern that local investors are not familiar with Foreign Companies and their respective local regulations and governance.
- 4.17 Some respondents expressed concern about the long-term performance of Foreign Companies at the moment.
- 4.18 Some respondents were concerned about the ability of the HSI to act as a benchmark for funds which track the performance of the Hong Kong and Mainland markets if Foreign Companies are included.
- 4.19 Some respondents thought it would be prudent to review the quality and performance of Foreign Companies and to see how well they are accepted and understood by analysts and investors.
- 4.20 One respondent suggested creating a Foreign Companies index rather than including Foreign Companies in the existing one.

5. Analysis and Conclusions

Issue 1: Sector Weightings of the HSI

Analysis

- 5.1 An analysis of the survey responses gives rise to two main conclusions.
- 5.2 First, there is a general acceptance of the current sector weightings of the HSI despite the deviation from the broad market sector weighting:
- a) 80% of respondents accept current weightings;
 - b) 70% of respondents would accept further increase in weightings;
 - c) 60% of respondents believe Finance Sector weighting may not be a long-term issue; and
 - d) 61% of respondents believe no special rules should be created to manage sector weightings.
- 5.3 Second, there is no majority support for any of the options proposed, and no consensus on which option is best when asked to select one of the options:
- a) 60%-80% of respondents indicated that none of the options are feasible to solve the issue.
 - b) There are the same level of support for option 2 and for making no changes to the current weighting methodology (each received support from 35.3% of respondents).
 - c) Another 14.7% of respondents preferred option 3, which has proposed no change to the current weighting methodology but would institute a freeze on new constituents from the overweight sector.

Further Considerations

- 5.4 Taking into account the above results, HSIL has identified the following considerations in drawing its conclusions:
- a) There is a strong and clear message from the opinion survey that the current overweighting in the Finance Sector is not a major issue. Therefore, any changes – which would inevitably complicate the criteria or methodology in selecting HSI constituents – must be carefully considered and only be adopted if absolutely necessary.
 - b) The lack of consensus on any of the proposed options lends support to HSIL's view that each of the options has its own strengths and weaknesses. In addition, the existing methodology of constituent selection has strong support with 35.3% of respondents proposing 'absolutely' no change, and another 14.7% selecting a freeze on the number of constituents in the overweight sector but no change in methodology.
 - c) As the Hong Kong market benchmark, the HSI should reflect the performance of the largest (in terms of market capitalisation) and most liquid companies. Sector weighting is of secondary importance. Therefore, selecting constituents by sectors, which would result in dropping many large-cap and liquid stocks, would not be appropriate. Similarly, omitting or freezing out certain large-cap stocks because of sector weighting issues would weaken the HSI's role as the leading market benchmark.
 - d) Although Option 2 (Cap Overweight Sector) received the most support among the three options, there are many questions remaining. These include what is the appropriate level for each sector, and its relation to single stock cap levels. Moreover, there is a concern that this methodology would complicate the calculation methodology and thereby lower the transparency of the HSI.

Conclusion

- 5.5 After careful consideration of the points raised and having taken into account discussions at the November 2010 Advisory Committee Meeting, it has been concluded that:

- No changes will be made to the selection criteria of the HSI to manage the sector (over)weighting issue. HSIL will retain the existing mechanism for deciding whether (or not) to add financial stocks in upcoming reviews.
- The Advisory Committee will continue to monitor the weighting of the Finance Sector, and may consider using an appropriate method or methods to address it in the future if necessary.

Issue 2: Eligibility of Foreign Companies in the Hang Seng Family of Indexes

Analysis

- 5.6 An analysis of the survey responses gives rise to two main conclusions.
- 5.7 First, there is a general consensus that HSIL should take a prudent approach in handling the eligibility of Foreign Companies:
- 83.3% of respondents advocated a prudent approach – i.e. wait for further market developments before making any changes – as the best way to handle the eligibility of Foreign Companies in the HSI at the current time.
 - 64.5% of respondents felt that the eligibility of Foreign Companies should be considered in 2–5 years' time.
- 5.8 Second, adding Foreign Companies to HSCI is generally viewed as acceptable.
- Over 80% of respondents would accept Foreign Companies being eligible to join the HSCI.
 - Of this 80%:
 - 52% would accept Foreign Companies being eligible to join both the HSI and the HSCI.
 - 29% would accept Foreign Companies being eligible to join HSCI only.

Further Considerations

- 5.9 Taking into account the above results, HSIL has identified the following considerations in drawing its conclusions:
- There is a clear message from the opinion survey that HSIL should take a prudent approach in managing the eligibility of Foreign Companies in the HSI.
 - Local investors are not familiar with Foreign Companies and their respective local regulations and governance. Moreover, the long-term performance of Foreign Companies is also uncertain.
 - Allowing Foreign Companies to join HSCI is generally considered as acceptable.
 - Creating a Foreign Companies Index could be an alternative way to reflect the presence of Foreign Companies in the Hong Kong market.

Conclusion

- 5.10 After careful consideration of the points made and having taken into account discussions at the November 2010 Advisory Committee Meeting, it has been decided to:
- Continue to apply the interim policy announced in June 2010 to exclude Foreign Companies from HSI and conduct a review in the second half of 2012.
 - Study the best way of adding Foreign Companies to the HSCI.
 - Compile a Foreign Companies Index when the market becomes more mature.

Disclaimer

All information contained herein is provided for reference only. Hang Seng Indexes Company Limited ("HSIL") ensures the accuracy and reliability of the above information to the best of its endeavours. However, HSIL makes no warranty or representation as to the accuracy, completeness or reliability of any of the information contained herein and accepts no liability (whether in tort or contract or otherwise) whatsoever to any person for any damage or loss of any nature arising from or as a result of reliance on any of the contents of this document, or any errors or omissions in its contents and such contents may change from time to time without notice.

The information contained in this document is not intended to provide professional advice and should not be relied upon in that regard. Persons intending to use any information obtained from this document are advised to obtain appropriate professional advice.

© Hang Seng Indexes Company Limited 2011. All rights reserved.

- End -