# CONSULTATION PAPER

*Proposal to enhance the "Hang Seng Index" as regards continuing to serve as the most representative and important benchmark of the Hong Kong stock market*

**December 2020**

Note:
The information and questions in this document are for the sole purpose of gathering opinions from market participants and various stakeholders. Changes to the relevant indexes, if any, will be announced at a later date.

**Responding to the Consultation**

Please send us your responses to research@hsi.com.hk **by 24 January 2021**. Thank you.

All responses will be kept strictly confidential and used solely for the purposes of internal research and discussion by Hang Seng Indexes Company Limited ("Hang Seng Indexes Company").

If you wish to provide your responses in hardcopy format, please mail to:

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**Respondent Details**

In order to better understand your valuable opinions, we may further contact you via e-mail and / or phone for follow-up after you return your responses. Please provide your contact information for this purpose. Failure to provide valid contact details may result in your responses being excluded from this consultation. Thank you.

**Name:** _____

**Job Title:** _____

**Organisation:** _____

**Professional Profile:**
☐ Academic or Institute      ☐ Asset Owner
☐ Broker or Dealer           ☐ Exchange
☐ Individual Investor        ☐ Investment Manager
☐ Passive Fund Manager       ☐ Regulatory
☐ Others (please specify) _____

**Contact Number*:** _____

**E-mail address*:** _____

**Date:** _____

*\* Please provide at least one channel through which you can be contacted*

**Important Note**

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# A. Background: The Past and the Present of the Hang Seng Index ("HSI")

**The Evolution of the Hong Kong Stock Market**

- The Hong Kong stock market underwent significant structural changes over the past 15 years. The total market capitalization grew by 458%, i.e. from HK$8.2 Trillion in 2005 to HK$45.6 Trillion in 2020. Meanwhile, the proportion of Mainland companies increased from 41.6% to 79.0% during the same period and the Information Technology ("IT") overtook the Financial as the largest industry in 2019.

**Exhibit 1: Market Capitalisation of Hong Kong and Mainland Companies\***
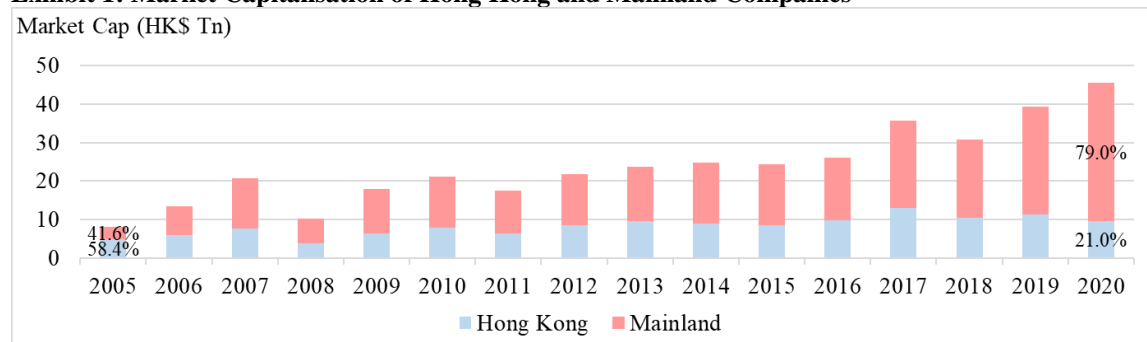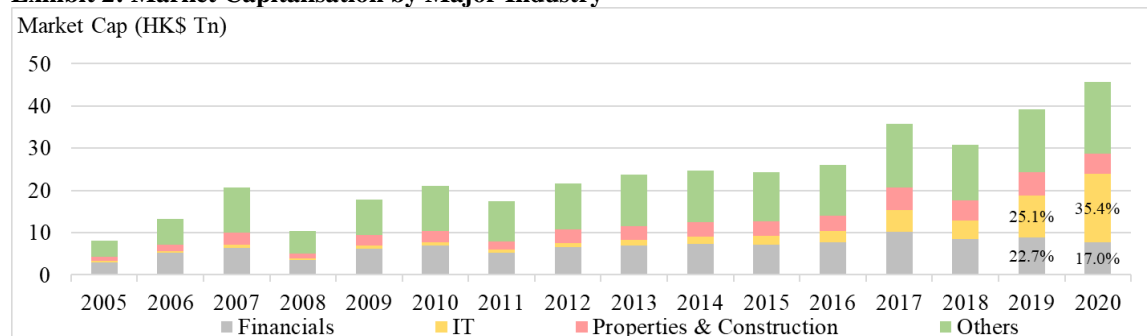


**Exhibit 2: Market Capitalisation by Major Industry\***



\* Excludes Foreign Companies

- The prominence of IT rose after the HKEX established a series of new listing chapters, such as Chapter 8A, 18A and 19C, in 2018 to accommodate companies in industries characterized by innovations and technologies. The new development encouraged a number of sizable new listings under the weighted voting right ("WVR") or secondary-listing structure in Hong Kong.

**Exhibit 3: Distribution of New Listings (listed after 30 April 2018)**
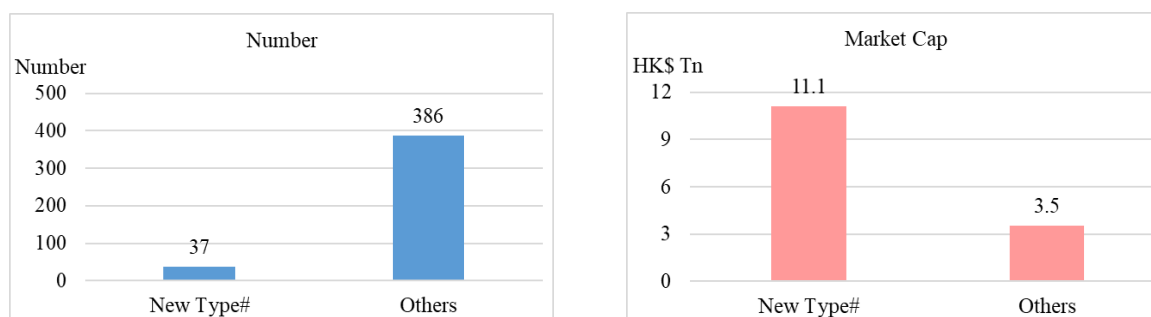


# Companies listed via Chapter 8A / 18A / 19C of HKEX Listing Rules

3

**Development of the HSI**

- The HSI was launched in 1969 and has been acting as the benchmark of the Hong Kong stock market.

- Started with only 33 constituents at launch, the number of constituent increased to 38 in 2007 when it began to include H-shares companies.

- The HSI then gradually expanded and reached 50 constituents in 2012 when there were around 1,380 listed companies in Hong Kong and the HSI covered roughly 60% of the aggregate market capitalisation at that time. The number of constituents remained unchanged at 50 for more than 8 years and expanded to 52 in December 2020.

- The HSI constituents are principally selected based on the sizes of the companies and the potential candidates usually have at least 2 years of listing history. The index is freefloat market capitalization-weighted with a cap of 10% on individual constituent weighting. Secondary-listed/ WVR constituents are subject to a 5% weighting cap.

- Given the rapid changes in the landscape of the Hong Kong stock market, the HSI is planning to have the following enhancements:

    1. *Expansion in industrial representation*
    2. *Enlargement in market coverage*
    3. *Prompt inclusion of sizeable new listings*
    4. *Representation of Hong Kong companies to remain intact*
    5. *Enrichment in constituent weighting distribution*

4

# B.    Summary of the Proposed Methodology Enhancement

- Hang Seng Indexes Company announced in August 2020 to study the HSI composition and submitted an initial proposal to the Advisory Committee in November 2020.

- In this consultation, Hang Seng Indexes Company wishes to solicit market feedback on the proposals to enhance the Hang Seng Index as regards continuing to serve as the most representative and important benchmark of the Hong Kong stock market.

- The proposals are depicted in Exhibit 4.

**Exhibit 4: Comparison of the Existing Index Methodology and the Proposed Index Methodology**
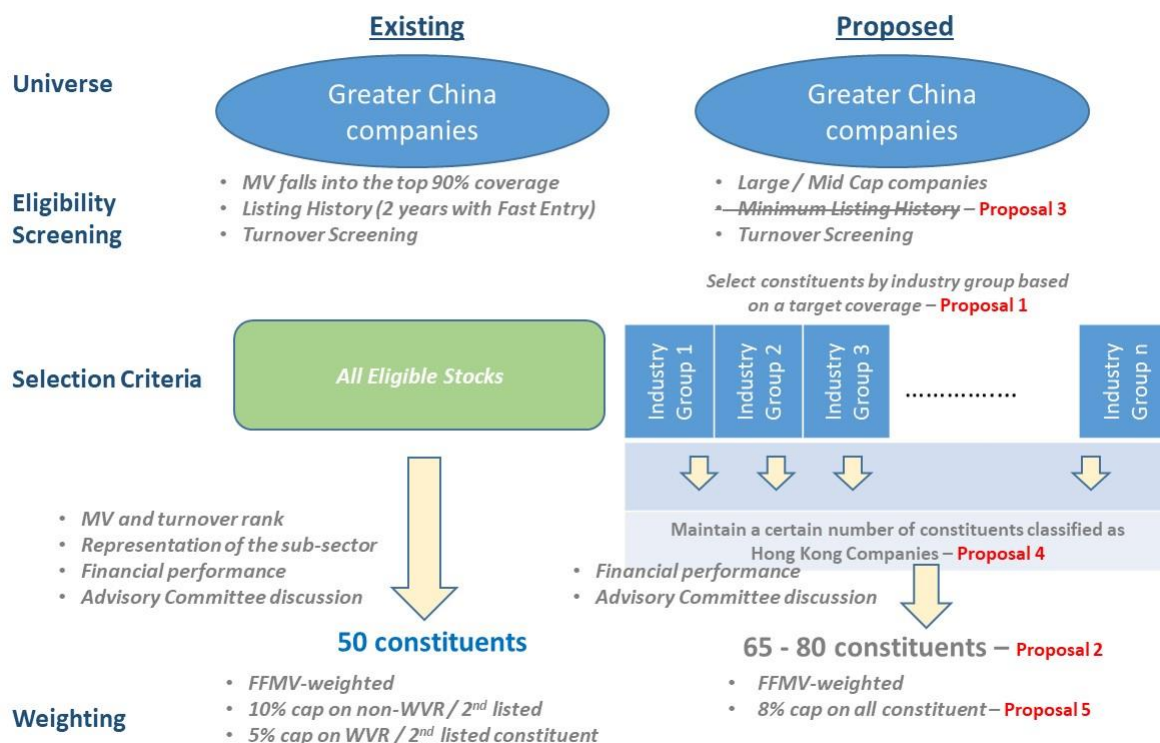
# C.    Enhancement Proposals

## Enhancement 1:    Expansion in Industrial Representation

> **Proposal 1:    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**
>
> *Rationale:    This method ensures a more balanced representation for the major industries identified in the Hong Kong stock market. In addition, our simulation indicates that selecting constituents by industry group can alleviate the weight concentration issue for certain industries.*
>
> Summary of the simulation results (see Appendix)

## Relevant Information

- The dominance of Financials in HSI has been a widely discussed topic for a long time. More recently, the significance of constituents in the new economy and IT industries of HSI also brought investors' attention following the admission of WVRs and secondary listings to the HSI.

**Exhibit 5: Weighting Distribution by Industry**
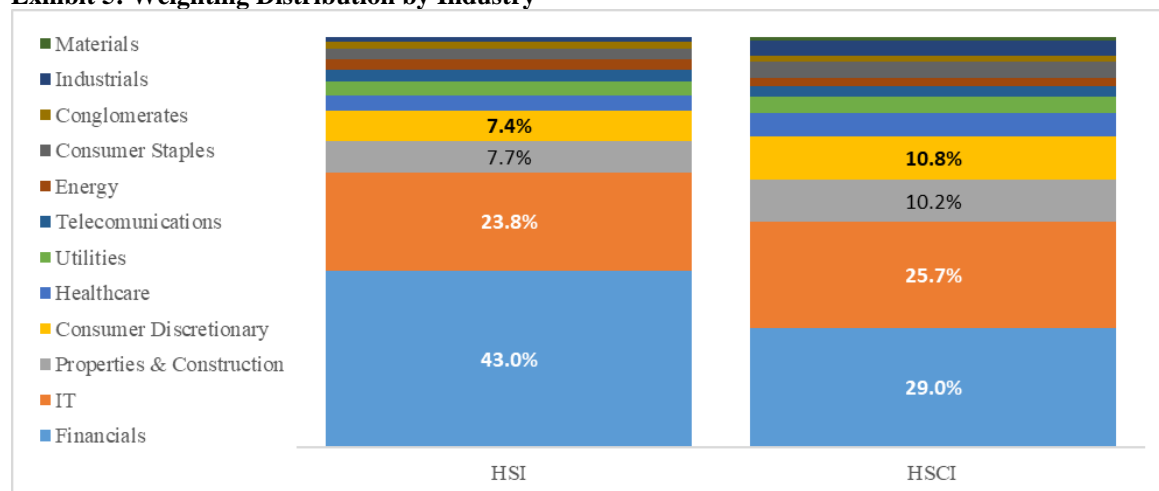


HSCI: Hang Seng Composite Index
Data as of 4 December 2020 after index rebalancing

- Among the 12 industries, Telecommunications, Financials and IT achieved a coverage of over 80% in terms of market captialisation within the industry as of 4 December 2020. Conversely, the industrial coverage was less than 40% for industries such as Materials, Industrials, Consumer Staples, Consumer Discretionary and Healthcare. The uneven coverage can be attributed to the different size distribution within the industries, which are often considered to be a phenomenon of the Hong Kong stock market.

**Exhibit 6.1: Market Capitalisation Coverage by Industry**

| Industry | 2015 | 2016 | 2017 | 2018 | 2019 | 2020* |
|---|---|---|---|---|---|---|
| IT | 88.7% | 86.8% | 89.5% | 77.1% | 61.4% | 88.0% |
| Financials | 83.5% | 80.2% | 80.9% | 83.5% | 84.0% | 83.8% |
| Telecommunications | 95.4% | 95.3% | 94.9% | 87.4% | 86.2% | 83.3% |
| Energy | 74.3% | 76.7% | 71.7% | 75.4% | 88.7% | 79.5% |
| Conglomerates | 81.3% | 80.7% | 76.5% | 74.0% | 77.4% | 65.9% |
| Utilities | 49.2% | 65.2% | 59.7% | 56.8% | 45.6% | 42.8% |
| Properties & Construction | 49.2% | 49.7% | 50.8% | 46.5% | 46.7% | 42.2% |
| Consumer Discretionary | 40.2% | 40.7% | 39.8% | 40.7% | 40.7% | 37.3% |
| Consumer Staples | 36.2% | 20.1% | 36.2% | 36.7% | 28.9% | 37.1% |
| Healthcare | 0.0% | 0.0% | 0.0% | 23.3% | 24.8% | 29.3% |
| Industrials | 10.4% | 19.5% | 31.5% | 17.6% | 28.4% | 21.7% |
| Materials | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% | 0.0% |
| **Overall** | **64.3%** | **65.0%** | **64.4%** | **62.7%** | **58.1%** | **57.6%** |

* Data as of 4 December 2020 after index rebalancing

**Exhibit 6.2: Number of HSI and HSLMI Constituents by Industry**

| Industry | 2015 HSI | 2015 HSLMI | 2016 HSI | 2016 HSLMI | 2017 HSI | 2017 HSLMI | 2018 HSI | 2018 HSLMI | 2019 HSI | 2019 HSLMI | 2020* HSI | 2020* HSLMI |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| IT | 2 | 14 | 2 | 17 | 2 | 20 | 1 | 21 | 1 | 21 | 4 | 22 |
| Financials | 12 | 38 | 12 | 47 | 12 | 46 | 11 | 46 | 11 | 42 | 11 | 40 |
| Telecommunications | 2 | 5 | 2 | 5 | 2 | 5 | 2 | 7 | 2 | 7 | 2 | 7 |
| Energy | 6 | 26 | 6 | 28 | 6 | 27 | 6 | 23 | 4 | 10 | 3 | 8 |
| Conglomerates | 3 | 8 | 3 | 7 | 3 | 7 | 3 | 9 | 3 | 7 | 2 | 7 |
| Utilities | 5 | 19 | 6 | 21 | 5 | 19 | 5 | 19 | 4 | 21 | 4 | 20 |
| Properties & Construction | 9 | 54 | 9 | 51 | 11 | 51 | 10 | 56 | 11 | 62 | 10 | 63 |
| Consumer Discretionary | 6 | 45 | 6 | 46 | 4 | 44 | 5 | 53 | 6 | 59 | 7 | 58 |
| Consumer Staples | 4 | 20 | 2 | 18 | 3 | 18 | 3 | 15 | 4 | 20 | 4 | 20 |
| Healthcare | 0 | 12 | 0 | 15 | 0 | 14 | 2 | 17 | 2 | 19 | 3 | 28 |
| Industrials | 1 | 30 | 2 | 32 | 3 | 33 | 2 | 30 | 2 | 24 | 2 | 22 |
| Materials | 0 | 9 | 0 | 10 | 0 | 7 | 0 | 11 | 0 | 12 | 0 | 10 |
| **Total** | **50** | **280** | **50** | **297** | **51** | **291** | **50** | **307** | **50** | **304** | **52** | **305** |

HSLMI: Hang Seng Composite LargeCap & MidCap Index

* Data as of 4 December 2020 after index rebalancing

**Proposal 1:** **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 capitalization, turnover etc.) to select**

**Your view:**

☐ I support this proposal without further comment

☐ I have the following comments on the proposal

**Enhancement 2:    Enlargement in Market Coverage**

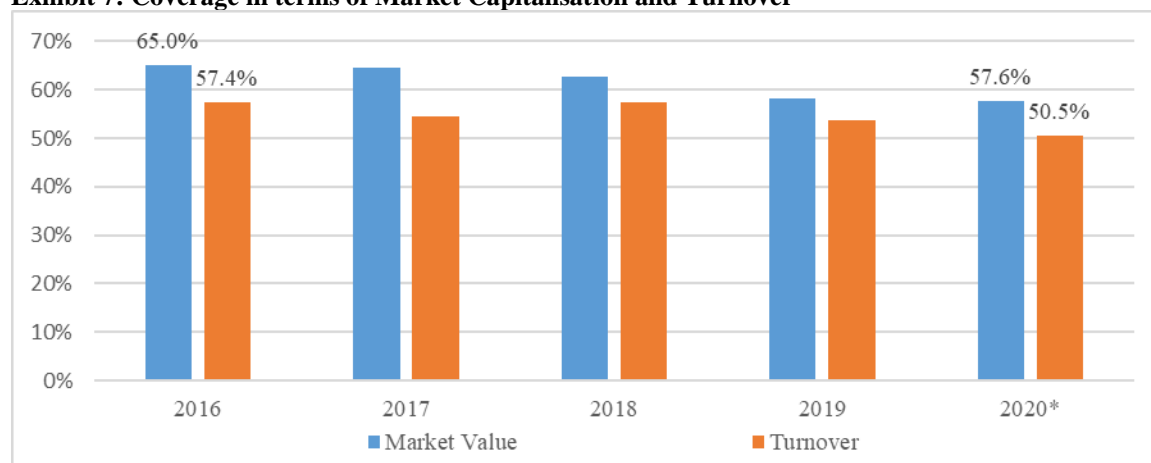**Proposal 2:    Increase the number of constituents to between 65 and 80**

*Rationale:*    *Assuming we adopt the above-mentioned constituent selection mechanism, the current number of index constituents will not be sufficient to achieve an appropriate level of representation. Our simulation suggests that increasing the number of constituents to between 65 and 80 can improve the overall coverage of the index and achieve a reasonable representation for each industry.*

Summary of the simulation results (see Appendix)

## Relevant Information

- The market capitalisation coverage of HSI gradually decreased from 65.0% as at the end of 2016 to 57.6% in December 2020.  The coverage based on turnover also decreased from 57.4% to 50.5% in the same period.

**Exhibit 7: Coverage in terms of Market Capitalisation and Turnover**



\* Data as of 4 December 2020 after index rebalancing

**Proposal 2:    Increase the number of constituents to between 65 and 80**

**Your view:**

☐ I support this proposal without further comment
☐ I have the following comments on the proposal

**Enhancement 3:**  **Prompt Inclusion of Sizable New Listings**

**Proposal 3:**  **Remove the Minimum Listing History Requirement for Eligible Candidates**

*Rationale:*  *The removal of this requirement increases the flexibility for the HSI Advisory Committee to allow representative new listing to join the HSI on a timely basis.*

Summary of the simulation results (see Appendix)

**Relevant Information**

- Exhibit 8 shows the minimum listing history requirement of HSI. The newly listed companies in Exhibit 9, despite having larger market capitalisations compared to that of some existing HSI constituents, are not yet considered in the HSI constituent review due to the Minimum Listing History Requirement.

**Exhibit 8: 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$bn) | 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

**Proposal 3:**  **Remove the Minimum Listing History Requirement for Eligible Candidates**

**Your view:**

☐ I support this proposal without further comment

☐ I have the following comments on the proposal

9

**Enhancement 4:      Representation of Hong Kong Companies to Remain Intact**

> **Proposal 4:**   **Maintain a certain number of constituents classified as Hong Kong Companies (around 25 under the current situation) to sustain the level of representation of Hong Kong portion in the index**
>
> *Rationale:*   *Despite decreasing proportion in terms of market capitalization for Hong Kong Companies, HSI should maintain a certain level of representation of this geographical segment given its status of the main benchmark of Hong Kong stock market.*
>
> Summary of the simulation results (see Appendix)

**Relevant Information**

- The weighting of Hong Kong Companies in HSI gradually decreased from 45.3% as at the end of 2016 to 42.2% in December 2020.  As the number of sizable new listing from Mainland increases, the number and weighting of Hong Kong Companies are expected to further decrease based on the current HSI methodology.

**Exhibit 10: Weighting Distribution of Hong Kong and Mainland Companies**
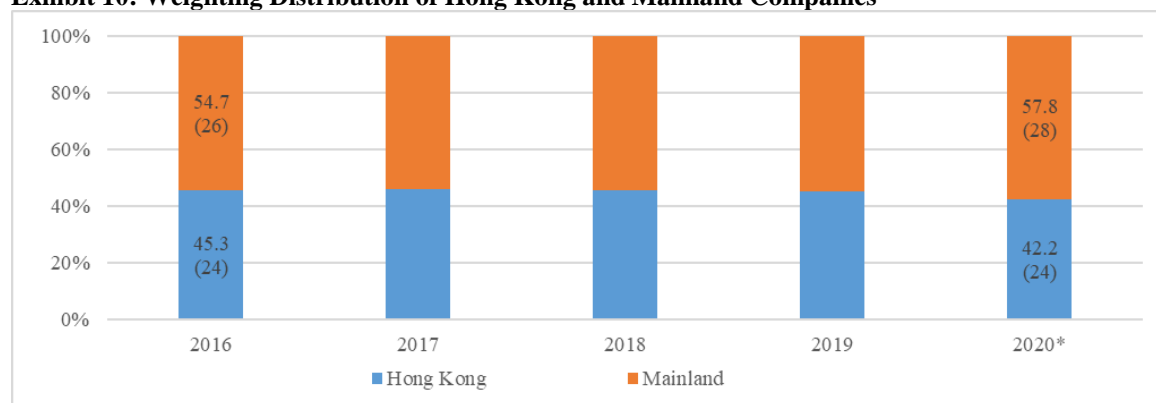


* Data as of 4 December 2020 after index rebalancing          ( ) No. of Constituents

**Proposal 4:      Maintain a certain number of constituents classified as Hong Kong Companies (around 25 under the current situation) to sustain the level of representation of Hong Kong portion in the index**

**Your view:**

☐ I support this proposal without further comment

☐ I have the following comments on the proposal

**Enhancement 5:    Enrichment in Constituent Weighting Distribution**

> **Proposal 5:** **Lower the weighting cap of individual constituent from 10% to 8%; and align the weighting cap of WVR and/or secondary listed constituents with that of other HSI constituents, i.e. 8%**
>
> *Rationale:* *The decrease in individual constituent capping to 8% can enhance the diversification effect of HSI by decreasing the aggregate weighting of large constituents. The current weighting cap on Greater China secondary-listed or WVR constituents is set at 5%. As more companies are expected to be listed under these structures, the capping of these constituents should align with that of other HSI constituents.*
>
> Summary of the simulation results (see Appendix)

## Relevant Information

- Currently, the largest five constituents accounted for around 40% of the index weighting. As a result, the performance of the HSI could possibly be affected by the price fluctuations of these large constituents.

- Despite their massive sizes, WVR/Secondary listed constituents are currently subject to a more restrictive individual stock capping of 5% as they are listed under a relatively new structure introduced by HKEX.

**Exhibit 11: HSI Constituent Weighting Distribution**
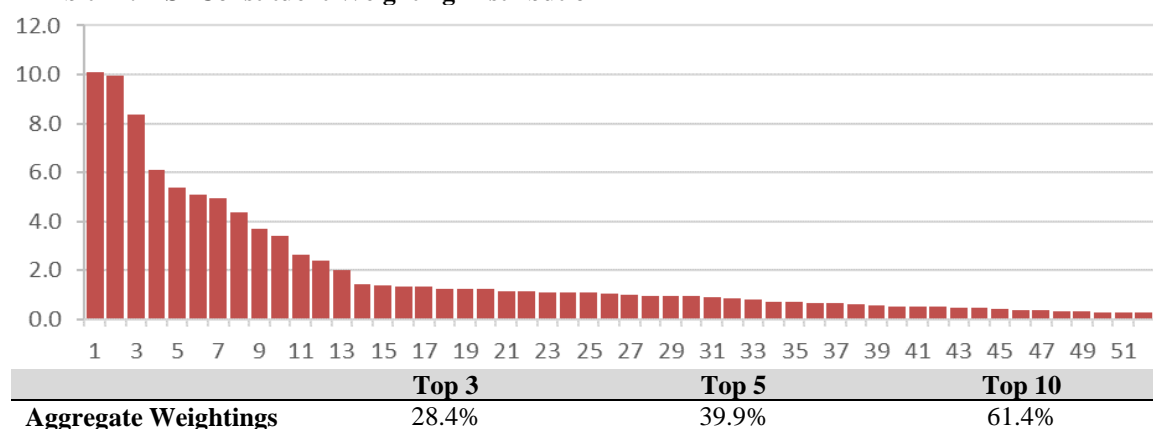


|  | Top 3 | Top 5 | Top 10 |
|---|---|---|---|
| **Aggregate Weightings** | 28.4% | 39.9% | 61.4% |

\* Data as of 4 December 2020 after index rebalancing

11

**Proposal 5:** **Lower the weighting cap of individual constituent from 10% to 8%; and align the weighting cap of WVR and/or secondary listed constituents with that of other HSI constituents, i.e. 8%**

<u>**Your view:**</u>
☐ I support these proposals without further comment
☐ I have the following comments on the proposals

<br>

12

## Other Related Questions

**Implementation of the Enhanced Methodology**

- Assuming our aforementioned enhanced methodology entails an increased number of constituents between 65 and 80, the simulated one-way turnover is estimated to be between 15% and 20%.

- As the expected turnover is deemed to be manageable, the Hang Seng Indexes Company proposes <u>to implement the transition to the enhanced methodology within one year</u>.

<u>**Your view:**</u>
☐ I support to implement the transition to the enhanced methodology within one year
☐ I have the following comments on the proposals

 

**Other Dimensions for HSI Constituent Selection**

- Besides size, liquidity and industry representation, any other dimensions should be considered when selecting the HSI constituents?

<u>**Your view:**</u>

 

~ Thank you ~

## Appendix - Key Simulations for the HSI under the Enhanced Methodology

**Assumptions:**
- The simulated portfolios are based on our aforementioned proposals.

- Select constituents by industry group: Six industry groups, i.e. 1) Financials; 2) IT & Industrials; 3) Property & Construction; 4) Healthcare; 5) Consumption (combining Consumer Discretionary & Consumer Staples); and 6) Others (combining other industries in one group), are taken as an example for illustration purpose.

- Number of constituents: Two scenarios are simulated, i.e. 65 and 80.

### Comparison Between the Simulated Portfolios and the Existing HSI

**Exhibit 12: Weighting Distribution by Industry**
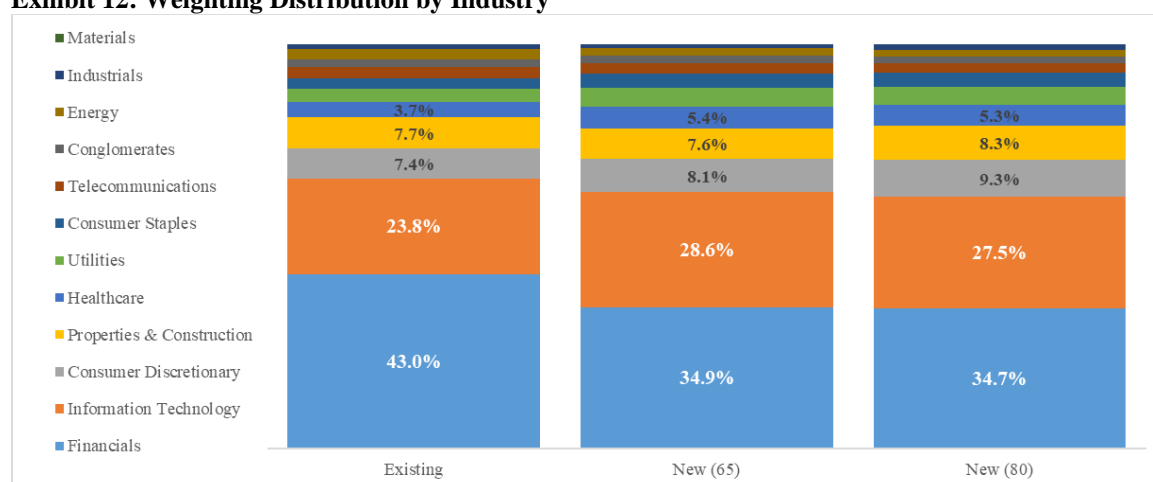

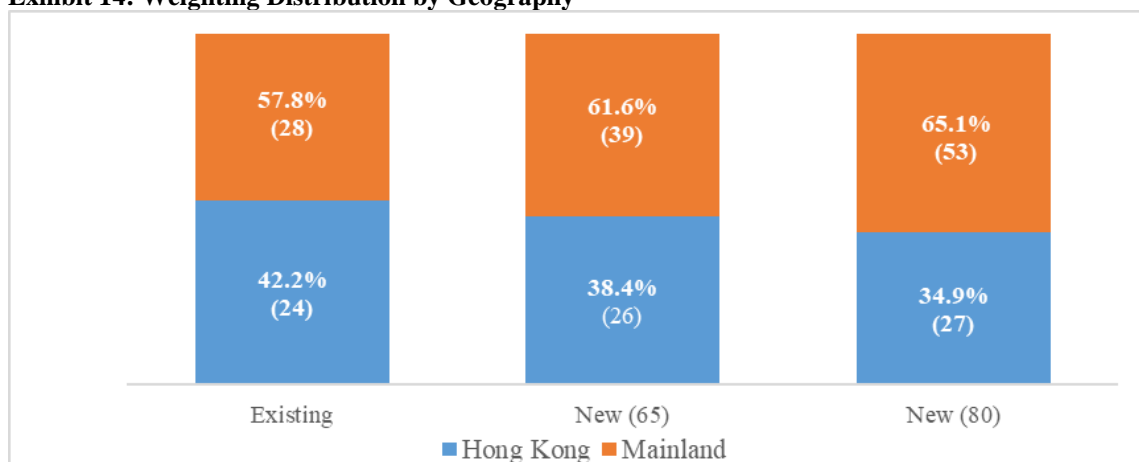
* Data as of 4 December 2020 after index rebalancing

**Exhibit 13: 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
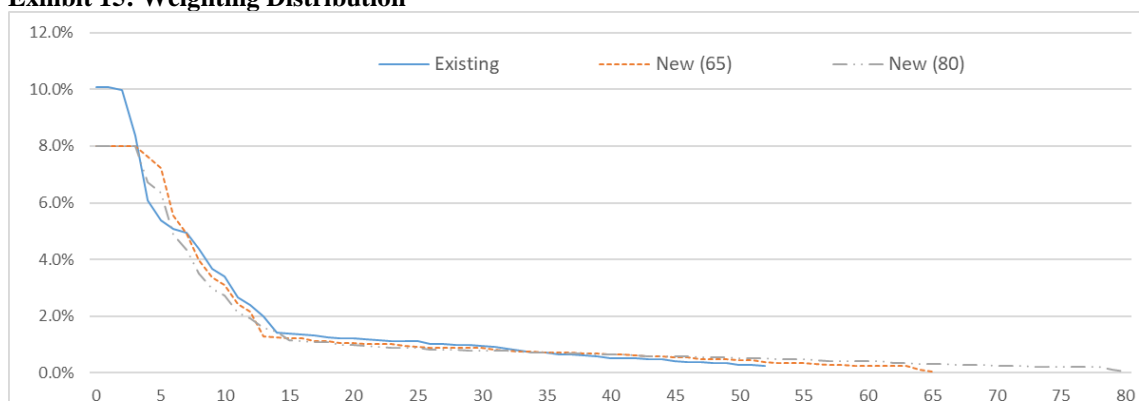^ Using HSLMI as universe

14

**Exhibit 14: Weighting Distribution by Geography**



* Data as of 4 December 2020 after index rebalancing          ( ) No. of Constituents

**Exhibit 15: Weighting Distribution**



| Aggregate Weightings | Top 3 | Top 5 | Top 10 |
|---|---|---|---|
| **Existing** | 28.4% | 39.9% | 64.1% |
| **New (65)** | 24.0% | 38.9% | 62.2% |
| **New (80)** | 24.0% | 37.1% | 57.6% |

* Data as of 4 December 2020 after index rebalancing

**Exhibit 16: Weighting Distribution (Number)**

| Weighting | Existing | New (65) | New (80) |
|---|---|---|---|
| >= 10% | 1 | 0 | 0 |
| [8%, 10%) | 2 | 3 | 2 |
| [5%, 8%) | 3 | 3 | 3 |
| [2%, 5%) | 7 | 6 | 6 |
| [1%, 2%) | 14 | 11 | 7 |
| [0.5%, 1%) | 15 | 23 | 33 |
| < 0.5% | 10 | 19 | 29 |
| **Total** | **52** | **65** | **80** |

* Data as of 4 December 2020 after index rebalancing

15

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