
2019 Market Classification Results

China A-shares to be included in emerging markets and Kuwait to be classified as emerging market.

Morningstar Indexes

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The Morningstar Index Committee has confirmed that as part of its 2019 market classification review, Kuwait will be classified as an emerging market from June 2020. Large and mid-cap China A-shares will also be included in the emerging-markets list at a partial inclusion factor of 25% from June 2020. There is no change in the market classification of South Korea, which shall remain an emerging market. There is also no change for Argentina, which continues to be unclassified.

2019 Review Results

China A-Shares

Large and mid-cap China A-shares will be included in Morningstar's Emerging Markets Index at a partial inclusion factor of 25% from June 2020. The inclusion decision was primarily backed by the continuous improvement of the QFII\RQFII and stock connect facilities and implementation of stricter regulations against the arbitrary trading suspension by mainland companies. The inclusion of only large and midsize segments and partial inclusion factor for China A-shares is driven by stern foreign ownership limits and lack of features to facilitate trading for investors.

Since the start of 2015, commendable steps have been taken by the China Securities Regulatory Commission to open the mainland market for foreign investors. Removal of the monthly 20% cap on the funds that investors have been allowed to take out of China via the dollar-dominated QFII scheme and its yuan-denominated sibling, RQFII being the most notable of these steps. In 2018, the daily quota limit for the Hong Kong-Shanghai and Hong Kong-Shenzhen stock connects was also quadrupled for China A-shares. Regulators also removed lockup periods for investment principal and said they would allow investors using the schemes to hedge currency risk onshore. Hong Kong Exchanges and Clearing successfully implemented real-time delivery versus payment for the northbound-related transactions of stock connect.

The biggest hindrance to China A-shares being included in emerging markets last year was the issue of voluntary arbitrary trading suspension by companies. CSRC made it harder for mainland exchange-listed companies to suspend trading of their shares when they face the risk of a serious drop in their price. The

suspension period for a major asset restructuring was shortened from six months to 10 days. Shares of companies whose major asset restructurings do not involve the issuance of new shares cannot be suspended.

Although there have been significant improvements in the mainland market, there are still several issues that impede a full inclusion of A-shares. Though the stock connect has proved to be better for investors, it has some issues of its own. The eligibility criteria for China A-shares to trade on the stock connect don't provide exposure to the whole mainland market. Also, a dynamic sell-only list makes ongoing maintenance tricky. The 10% individual and 30% overall limit to foreign ownership of a company, which remains more restrictive than any of our current emerging markets, is a further hindrance for China A-shares to be included at full weight.

Acknowledging the improvements in the China A-shares market, but keeping in mind the restrictive ownership limits and stock connect eligibility criterion for companies, Morningstar has decided to include large and mid-cap China A-shares classified as an emerging market at a partial inclusion factor of 25% from June 2020 onward. Only A shares trading via the Stock Connect will be eligible for inclusion.

Kuwait

Kuwait will be classified as an emerging market as part of Morningstar's 2019 annual review.

Boursa Kuwait and the Kuwait Direct Investment Promotion Authority have taken significant steps to open the market to foreign investors. The foreign direct investment law allows 100% foreign ownership in several industries, such as infrastructure, insurance, information technology, and software development. In a recent reform, foreigner investors are now allowed to own 100% of Kuwaiti companies, including the banking sector, which constitutes approximately 26% of the equity market. Along with the T+3 settlement system implemented earlier, Kuwait put in place a delivery versus payment system for stock settlement and fail-trade mechanisms. A segmented market system was initiated in which each stock is classified into one of three tiers based on multiple criteria to promote market liquidity and company quality, with the Premier and Main market segments being the most liquid. The Boursa Kuwait also made it compulsory for Premier segment companies to disclose information in both Arabic and English.

These improvements, along with Morningstar's positive outlook on the foreign investment conditions in Kuwait, have culminated in the decision to classify Kuwait as an emerging market from June 2020 onward.

South Korea

South Korea will continue to be classified as an emerging market by Morningstar Indexes owing to no material development in the past year to warrant a developed-market status.

The lack of concrete steps by Korean authorities to resolve the low convertibility of the Korean won serves as the major issue for an upgrade. Although the introduction of omnibus accounts in 2017 was a

positive step, the restrictions on off-exchange and in-kind transactions remain an impediment to reclassification.

With no material progress from past reviews, Morningstar Indexes will continue to classify South Korea as an emerging market and will maintain it on its review list for 2020.

Argentina

Argentina will remain unclassified by Morningstar Indexes and thus will not be included in the Emerging Markets Index. This decision is prompted by macroeconomic issues that plague the country and the low liquidity of the local exchange.

The new government had taken notable strides toward opening the economy to foreign investors, including working to remove the capital-control mechanisms put in place by previous authorities. As a further step to removing capital control, Argentina's government ended a required holding period for foreign capital to attract investment while the country is mired in recession. The government passed a decree allowing foreign investors to pay lower Argentine capital gains rates depending on the type of asset and the currency. The rate of the corporate income tax has been gradually reduced.

Notwithstanding an ongoing crisis of confidence in the economy, the government is sticking with its politically risky austerity plan of budget cuts and tax increases to close the fiscal gap. The amount of foreign investment is still restricted in specific sectors, such as aviation and media. Macroeconomic factors such as inflation, interest rates, debt/GDP, and so on, are degrading, with a \$50 billion credit line agreed on with the International Monetary Fund for a bailout from the current currency and inflation crisis. The price-control mechanisms that were lifted earlier were reimplemented to counter the rising inflation in the country. These issues need to be addressed for the country gain traction among foreign investors.

Morningstar will continue to monitor Argentina as part of its review list for 2020.

Exhibit 1 2017 Morningstar Indexes Market Classification Results (⊕ Pass, ⊖ Fail, ● Restricted)

Criteria	Developed	Emerging	Market	Potential Addition to Emerging Markets Index		
			Reclassification	South Korea	China A	Argentina
World Bank GNI Per Capita Rating	High (3-Yrs cons.)	High/Middle	High	Upper Middle	Upper Middle	High
Degree of Economic Freedom Score	>50	>50	72.3	58.4	52.2	60.8
Credit Quality	—	—	Investment	Investment	Non Investment	Investment
Market Structure & Regulatory Environment						
Regulatory Environment	⊕	—	⊕	⊕	⊕	⊕
Information Availability	⊕	—	⊕	⊕	⊕	●
Equitable Treatment	⊕	—	⊕	⊖	⊕	⊖
Market Accessibility	⊕	⊕	●	⊖	⊕	⊕
Market Structure-Equity	⊕	⊕	⊕	⊕	⊖	⊕
Market Structure-FX	⊕	⊕	●	●	●	⊕
Trading Conditions						
Ease of Entering Market for Foreign Investors	⊕	⊕	⊕	●	⊕	⊕
Quality of Brokerage	⊕	⊕	⊕	⊕	⊕	⊕
Market Liquidity	⊕	⊕	⊕	⊕	⊖	⊕
Capital Flow (Inflow/Outflow)	⊕	⊕	⊕	●	⊕	⊕
Nominal Transaction Costs	⊕	⊕	⊕	⊕	⊕	⊕
Short Selling Allowed	⊕	—	⊕	⊖	●	⊖
Off-Exchange Transactions Allowed	⊕	—	●	⊖	⊕	⊕
Stock Lending and Margin Trading	⊕	—	⊕	⊖	●	⊕
Transparency	⊕	⊕	⊕	⊕	⊕	⊕
Taxes	⊕	—	—	—	—	—
Settlement						
Clearing and Settlement Cycle	⊕	⊕	T+2	T+0	T+2	T+3
Quality of Custodian Services	⊕	⊕	⊕	⊕	⊕	⊕
Delivery Free of Payment Facility Available	⊕	—	●	⊕	⊖	⊕
Availability of Omnibus Account Facilities	⊕	⊕	⊕	⊕	⊖	⊕
Market Capitalization	>\$5 Billion	>\$5 Billion	⊕	⊕	⊕	⊕
Ratio of Market Capitalization to GDP	Top 80%	Top 80%	⊕	⊕	⊕	⊕
Market Classification Results	—	—	Unchanged	Added	Not Added	Added

Source: Morningstar.

2020 Review List

As part of the 2019 annual review, the Morningstar Index Committee will continue to monitor the following countries/market segments for potential reclassification.

South Korea	Potential reclassification from emerging market to developed market.
Poland	Potential reclassification from emerging market to developed market.
Argentina	Potential reclassification from stand-alone market to emerging market.

Appendix

Regulatory Environment

The existence of a strong market regulator with a well-established track record; the timely, independent and uniform implementation of regulations; and an overall regulatory structure adhering to global best practices.

Equitable Treatment

The absence (or minimal incidence) of regulations with a bias against foreign owners and minority shareholders and the existence of laws for the adequate protection of their interests.

Market Accessibility

The existence of minimal individual and collective foreign ownership restrictions at the security, sector, and market levels.

Market Structure-Equity

The existence of a well-structured and sufficiently mature equity market along with healthy market depth, breadth, and size.

Market Structure-Foreign Exchange

The existence of a fairly liquid and a developed offshore currency market.

Ease of Entering Market for Foreign Investors

The absence of an excessively time-consuming, involved, or restrictive procedure for the registration of foreign investors.

Quality of Brokerage

The existence of a competitive broking landscape with reasonable low costs, smooth execution of orders, and the provision of services like algorithmic trading and dark-pool trading.

Market Liquidity

The existence of highly liquid capital markets in terms of immediacy, volume, and price resilience.

Capital Flow (Inflow/Outflow)

The absence of any significant quantity or time-based restrictions on either the inflow or repatriation of funds.

Nominal Transaction Costs

The existence of a low-transaction-cost environment with greater transparency regarding these costs.

Short Selling Allowed

The existence of provisions for the short selling of a wide range of securities with minimal restrictions.

Off-Exchange Transactions Allowed

No prohibitive restrictions on both off-exchange and in-kind transactions.

Stock Lending and Margin Trading

The existence of provisions for stock lending and margin trading facilities.

Transparency

The existence of laws for the fair and transparent dissemination of price information and price-sensitive information to all market participants along with an overall regulatory and operational transparency in the market.

Taxes

The existence of unambiguous tax laws and the absence of unreasonably high withholding tax and capital gains tax levels.

Clearing and Settlement Cycle

The existence of a settlement cycle in harmony with globally accepted norms and the existence of a delivery v/s payment (DVP) system to minimize counterparty credit risk.

Quality of Custodian Services

The existence of healthy international and local competition among custodian banks along with low costs and provisions for the adequate protection of client assets against misappropriation.

Delivery Free of Payment Facility Available

The immediate availability of a short-term line-of-credit facility for stock-buying with minimal restrictions.

Availability of Omnibus Account Facilities

The recognition of the concept of an omnibus account and the absence of any operational or regulatory hurdles for its setup.

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For More Information

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