Saudi Arabia: A key player of global investments

The 20th June 2018 was a milestone for Saudi Arabia and its equity market. MSCI announced on that day the inclusion of Saudi Arabia in the MSCI Emerging Markets Index for the year 2019. This will happen in two steps in May and August 2019. Besides MSCI also FTSE Russell upgraded Saudi Arabia to their Emerging markets index with the inclusion happening in March and December 2019.

The Saudi Equity Market is comparable with many existing emerging markets. The domesticindex in Saudi Arabia is called Tadawul All Share index and has almost 200 stocks and an overall market cap of around half a billion dollars. The mid and large-cap focussed MSCI Saudi Arabia index is big enough to make up about 2.5% of the MSCI Emerging Market index and 2.7% of the FTSE EM Index when it joins and has then about the same size as the likes of Mexico, Malaysia and Russia So it will be from day one, one of the heavyweights of the Emerging Market Indices. The weight of Saudi Arabia can even significantly increase to 7% should the USD 200 billion IPO pipeline with among others Aramco and companies out of the aviation, health care and chemical sector materialize. Also fairly typically for an emerging market, the Saudi market is dominated by Financials, Materials and Telecoms. Some investors may be surprised but the index has very little Energy exposure, although this is likely to change with the expected Aramco IPO, which, when it comes to market, has the potential to be the world's biggest IPO ever.

Over the past few years various measures made it possible for the inclusion of Saudi Arabia into the MSCI EM index. The key changes have been the settlement changes of the Saudi exchange from t+0 to the market standard t+2. The relaxation of Qualified Foreign Investor (QFI) rules in order to make it easier for non-Saudi investors to access the market. The minimum threshold for foreign investors to have access to the Saudi equity Market has been reduced to USD 500 million with an increase in the maximum weight of foreign investors in Saudi companies from 20% to 49%. For smaller investors direct access is therefore not possible but pooled investment vehicles like the Invesco Saudi Arabia UCITS ETF (ISIN: IE00BFWMQ331) that was launched in June can provide efficient exposure.

The Saudi government's "Vision 2030" plan is intended to transform Saudi Arabia into a global investment powerhouse and epicentre of trade. This will require growth in investment in the economy, and an open capital market is a vital part of this. Based on data from MSCI we estimate that the immediate impact of the inclusion could result in around $50bn Passive and Active inflows into the Saudi market in the short term, with significant scope for this to increase as the Saudi equity market grows.

The greatest beneficiaries in terms of immediate inflows on the MSCI inclusion days in May and August 2019 will be the largest stocks and sectors. This is because the free-float market cap weighting approach of the MSCI index puts more weight on the largest stocks. It is also because investors that use a sampling approach to index replication generally seem to use the largest stocks to get an approximate exposure to the market. Currently Saudi Basic Industries Corporation (SABIC) has the highest weight in the MSCI Saudi Arbia index. SABIC is a chemical company with activities in over 50 countries. Further companies with a high weighting are the Al Rajhi Bank, National Commercial Bank and Samba Bank that have their focus on the deposits and therefore a more defensive approach. The quintet of the five largets companies is completed with Saudi Telecom which is a heavyweight in the Middle East. Over the longer term however, the smaller stocks and sectors in the index are likely to benefit from the easier access to capital that is provided by greater foreign investor participation in Saudi Arabia.

By mid-2019, all funds benchmarked to the MSCI Emerging Markets index will most likely either buy exposure to Saudi Arabia, or face the risk of being underweight in this rapidly growing and modernising market. This provides a strong tailwind of demand which, as we have seen with the inclusions of other Middle East markets, such as UAE and Qatar, can lead to significant rallies in the stocks of the included countries during the months between announcement and inclusion. The Saudi market is very underrepresented in foreign portfolios. Only 2% of the Saudi market is held currently by foreign investors as Saudi Arabia is currently not represented in any international index. UAE and Qatar had during their time of the inclusion in the MSCI EM index already 10% foreign ownership as they were part of Frontier Indices. A lot of emerging market trackers will take around nine months' time to invest in Saudi Arabia for them. . As the only UCITS ETF in Europe providing pure exposure to the Saudi Arabian equity market, the Invesco MSCI Saudi Arabia UCITS ETF is an easy, quick and cost-effective way to do this already now.

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