# China A Shares: The Shanghai-Hong Kong Stock Connect

Over the summer months, we were pleasantly surprised by the details and planned timeline of a scheme which would allow foreign investors to invest in Chinese A-shares and for Chinese investors to invest in H-shares. This scheme is known as the Shanghai-Hong Kong Stock Connect or Through-Train for short. It was scheduled to be in place by the end of October 2014, however we suspect December might be more realistic.

Investors have been here before, in August 2007 the Chinese authorities briefly opened Hong Kong to domestic investors. The intention was for the heat to be taken out of the A-share market (which had rallied 130% in 2006 and 60% in 7M 2007) by diverting investors' money into a cheaper, more developed market. Domestic investors would be allowed to invest in Hong Kong listed stocks with few restrictions. The Hong Kong Stock Exchange index (HSCEI) rose 80% in the two months following the announcement and market turnover tripled as a result. The GFC subsequently triggered a global market collapse and the authorities ceased the program in November 2007.

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The mainland A-share market, encompassing the Shanghai and Shenzhen exchanges, has a US$4tn market cap and the average daily turnover is four times that of the HKSE. The split between retail and institutional investors is 70:30 respectively. In developed markets, this ratio is typically reversed. The market's reputation is not high amongst institutional investors, with their recent experiences characterised by:

- poor corporate governance
- low corporate access
- insider trading
- non-alignment of interest between SOE management and minority shareholders; and
- abysmal returns

The SHASHR index is down 18% in the last 5 years despite the country's economic growth and for many domestic investors, property or cash have been much better investments.

Prior to the announcement of this scheme there already existed a method of investing for foreigners known as the Qualified Foreign Institutional Investor program (QFII). International investors' have not had much enthusiasm for A-shares in recent years and of the US$150bn quota allowed, only US$56bn had been taken up by foreigners as of June 2014. An implicit hope of opening up the market to foreigners is that they will start demanding an improvement in governance and management.

Opening up the stock market, albeit gradually at first, is a requirement in China's longer term goal to free its capital account and promote the Renminbi as an alternative reserve currency to the greenback. A recent report from the IMF estimated that should capital be free to move in and out of China, domestic investors would look to diversify and reduce their home bias, resulting in a net outflow of 11-18% of GDP. This sum, if invested entirely in equities, would account for 3% of the MSCI World index or 25% of the EM index. US Treasury yields on the other hand would probably rise as China funnelled its savings elsewhere. The Renminbi would also devalue as a result of the outflow. The Chinese government are not keen on such a disruptive 'big bang' exodus, so their approach will be a gradual opening over the next 5 years.

The mechanism for the Through-Train will work as follows. There will be a total limit of RMB300bn (US$49bn) northbound investment (i.e. investors in HK buying mainland shares). Net daily investment will be limited at RMB13bn (US$2.2bn); there will be no daily limit on investors selling securities. Investors can choose from 568 stocks in the Shanghai 180 and 380 indices which make up 90% of the mainland total market cap. Settlement will be in offshore Renminbi and the scheme will be open to anyone. Southbound investors will be limited to institutions and investors with over RMB500k in their securities account. They will be able to choose from the 195 shares making up the HSI Large and Midcap indices. Execution will be in HKD but settlement will be in RMB. The scheme will be capped at RMB250bn (US$41.5bn) with a RMB10.5bn (US$1.7bn) daily limit. Day trading will be allowed southbound but not northbound. This is important for the scheme to gain any traction on the mainland because retail investors tend to 'trade' rather than invest.


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The SHASHR has rallied 14% since the announcement of the scheme in July (though it is still in the trading range it entered in late 2011) so there has been some anticipation of foreign interest in the market. Using the QFII quota as an indicator of demand, it isn't clear cut that foreign investors will flood into A-shares all at once however. Certain ambiguities over capital-gains tax (CGT) also remain which will deter institutions. In theory investors are liable to a 10% CGT, but since mainland brokers haven't collected it for their predominantly retail client base, international investors accessing through the QFII route haven't been paying it either. Thinking about the southbound flow, we suspect that the majority of interest from the mainland, at least initially, will come from retail investors. Institutional appetite in China for foreign investments is currently low as judged by the take up of the QDII scheme (the quota for domestic funds to invest abroad), which was only 10% as of June 2014.

We think that Southbound investors will primarily seek investments in sectors that have been performing well in the domestic market. This means Software, Healthcare and Media. Another focus for investors could be sectors which they have no


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domestic access to; for example the three telecoms companies are only listed in Hong Kong. The Macau casinos may also benefit. It has to be noted that there not much evidence for a value investing culture amongst mainland investors, so picking beneficiaries in the H-share market could be tricky.

The preferences for Northbound investors seem more predictable. Local Hong Kong investors cherish value, earnings stability and high dividends. The analysis of existing QFII holdings shows a similar set of preferences amongst foreign institutions for high quality Chinese blue chips. Given the problems about governance quality identified above, we think this is understandable and matches our approach. The A-share market contains a higher number of consumer-related stocks than Hong Kong. For example Qingdao Haier – one of China's largest home appliance manufacturers and Kweichow Moutai, the number one premium liquor brand in China. and Shanghai Automotive or SAIC, the largest car producer in China with


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successful JVs with VW and GM along with loss making own brands. The Shanghai-Hong Kong Stock Connect is firm indicator that the present regime are serious about modernising and opening China's financial system. Allowing foreign access to the domestic stock market is an elegant way of improving corporate governance and institutionalising a retail market.

The impact of the scheme will be modest to begin with, but can be expanded easily should it prove successful. The mechanism also looks as if it can be replicated in other stock exchanges such as London and New York. Such a move would further push the Renminbi as a credible international currency.