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OCCASIONAL VIEW

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The ‘Through Train’ arrives

By Michael Mulvihill, CFA

The much talked about Shanghai-Hong Kong Stock Connect (SSE-HK Connect), also called the ‘Through Train’, finally gets underway on 17 November, marking another step in the gradual opening of China’s vast financial system to foreign capital and global market forces. The scheme opens up a subset of China’s largely closed ‘A-share’ stock market to foreign investors through the Hong Kong stock exchange (SEHK), albeit with restrictions designed to keep the influence of foreign capital within limits acceptable to China’s policymakers. Ditto for mainland Chinese investors, who will now have access to SEHK-listed securities through the Shanghai Stock Exchange (SSE). Despite the restrictions, foreign investors should rightfully see this as an opportunity to gain exposure to the dynamic reform and development activity within mainland China.

The SSE-HK Connect is unique in allowing non-Chinese retail investors to buy mainland securities traded in Renminbi without a brokerage account in China proper. The SEHK and the SSE have been working for months on the back-end processing and regulatory infrastructure to enable most of the SSE’s securities to be traded through the SEHK by any accountholder of a HK brokerage house. Importantly, HK investors will be protected by the same market rules and laws with respect to A-share trading that apply to any SEHK shares.

However, a few important restrictions apply:

- First, the program doesn’t fling the SSE’s doors completely open, but applies to about 90% of SSE shares (by market cap), or, to look at it another way, approximately 568 stocks that represent 80% of the SSE’s daily trading volume. The total number comprises the constituents of the SSE180, SSE380, plus the A-shares of ‘dual-listed’ companies listed on both the SSE and SEHK.
- Second, the program limits the total value of trading that can take place. At the end of each trading day, Chinese authorities will calculate an ‘aggregate quota balance’ to make sure total net foreign investment in A-shares through the program has not exceeded RMB 300 billion. If it does, foreign investors will not be allowed to buy more A-shares in subsequent days (but can still sell) until the aggregate falls back within the limit. A similar process will be implemented in real time to shut off buying if net trading exceeds RMB 13 billion on any given trading day. These are important limitations that make the program less useful to institutional investors not accustomed to unpredictable limits outside their control. Finally, rules to control excessive speculation will be enforced, including limiting daily price movement of any security to +/-10% and disallowing short sales, day trading and margin accounts.

With the Chinese investment industry still in its infancy local markets are more prone to inefficiencies – making it possible to uncover many companies whose prices don’t reflect the intrinsic value of their businesses

The success of the program will depend on the level of foreign demand and there are good reasons to believe demand will be strong. In aggregate, the China A-share market, which is about 75% larger by market cap than the SSE-HK Connect universe, is among the largest equity securities markets in the world, with USD 3.8 trillion in value (see figure 1). In comparison, the ‘H-share’ market of mainland Chinese companies listed in Hong Kong covers just USD 633 billion.

Fig 1: **Broader, deeper selection**

	Market cap USD$	Annual turnover USD$	Number of listed companies	Description
A-shares	3,898	7,654	2,463	Mainland companies traded on Shanghai or Shenzhen exchanges
H-shares	633	544	182	Mainland Chinese companies traded on HK exchange
Red Chips	623	221	122	Mainland China companies incorporated outside mainland China and listed in Hong Kong
B-shares	27	24	106	Shares on the Shanghai and Shenzhen exchanges traded in foreign currencies
Total	**5,181**	**8,443**		

Source HSBC as at 31 December 2013.

Although quite a few companies are dual listed on both markets, what’s missed by foreign investors is a universe of companies more heavily weighted toward consumer discretionary, healthcare and industrials companies that cater to local demand. These companies are responding to new opportunities being made available as China gradually allows market forces and entrepreneurship to play stronger roles in allocating capital within the economy. Financial services companies are being allowed to offer new insurance and investment products, companies offering environmentally friendly solutions to industry are being helped by higher pollution control standards and providers of home healthcare products with strong brand recognition are

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taking advantage of rising incomes, to cite just a few examples. The opportunities are plainly reflected in the forecast earnings growth figures for the A-shares market (see figure 2) – at 16.0% for 2015 versus a mere 10.3% forecast for the constituents of the MSCI China Index of the H-share market (source: Ashmore, Bloomberg as at 8 September 2014). However, valuations do not yet reflect that favorable growth rate, as the A-shares market trades at a one-year forward price-to-earnings (PE) multiple that is almost identical to that of the H-share market.

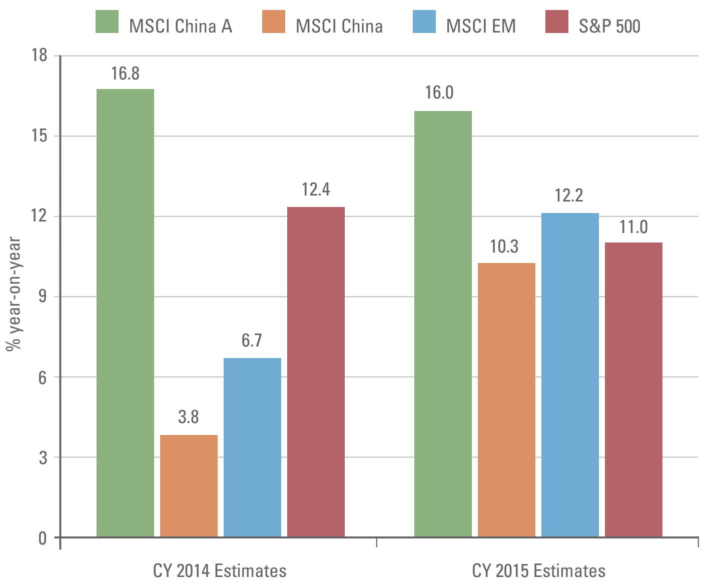
Structural reforms in China's economy and markets are reaching a tipping point that offers global investors a permanent role in helping determine China's future

As the Chinese investment management industry is still in its infancy, the local markets are dominated by retail investors, making them more prone to inefficiencies. Ashmore's own experience investing in the local market confirms that institutional quality practices of due diligence and research can uncover more than a few companies whose prices do not reflect the intrinsic value of their businesses.

The SSE-HK Connect scheme is an important step forward for China's equities markets. The program builds on earlier efforts to attract foreign investors, most notably the recently-launched Renminbi Qualified Foreign Institutional Investor (RQFII) scheme. As a successor to the more restrictive QFII program, RQFII has allowed approved institutional investors (including Ashmore) to begin offering daily valued mutual funds to institutional and retail investors. The program has fewer trading restrictions than the SSE-HK Connect and for the first time puts the entire market of local Chinese companies within the sights of mutual fund investors globally.

In light of China's gradual market opening through these various programs, major index providers have been rethinking the limited weight given to China equities within global indices and are likely to include more China stocks through a series of steps beginning in 2016. Once global market forces are introduced, it can be difficult and costly to reverse the momentum. The message for global investors may be that structural reforms within China's economy and markets are reaching a tipping point that will grant them a permanent role in helping to determine China's future.

Fig 2: **Earnings growth**



Source: Ashmore/Bloomberg as at 8 September 2014.

The RQFII scheme has fewer restrictions than SSE-HK connect and, for the first time, puts the entire local Chinese market in its sights

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