2013

The Door Is Opening: An Overview of the Chinese A-Share Market

Aaron Costello | Jason Widjaja

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Executive Summary

- Ten years after the launch of the Qualified Foreign Institutional Investor (QFII) program, China is now opening the door a bit wider for foreign investors: over the past year, a host of changes to the QFII program have been announced, including the near doubling of its size to US$150 billion. Given that access is improving, the question again is whether investors should seek exposure to the A-share market.
- In our opinion, the key attraction of the A-share market is the potentially larger universe of stocks in a less efficient market, which should allow active managers scope to generate alpha. By having those managers focus on areas of the A-share market less represented by the Hong Kong–listed universe (either by sector or stock coverage), investors can achieve differentiated exposure to China. By nature, such an allocation should be viewed as strategic, not tactical.
- Passive investments in the A-share index as it currently stands do not seem appealing given overlapping exposure with the Hong Kong–listed market—both are still dominated by the sectors most at risk from China's economic rebalancing from investment-driven to consumption-driven growth (financials and industrial-related sectors). Despite the conventional sales pitch that the A-share market offers more exposure to "new China" via consumer plays, it also has even more exposure to "old China" via industrials and smaller SOEs. Furthermore, the offshore market can be accessed without the additional liquidity/access restrictions (and higher fees) that investors in A-share products must bear.
- Over the past dozen years, the A-share market has underperformed the Hong Kong market amid a market driven more by domestic retail fund flow than fundamentals. Several arguments have been advanced to explain this performance gap, most notably lower profitability, higher valuations, and new issuance and dilution of the A-share market relative to Hong Kong–listed shares.
- Many investors are leery of Chinese equities due to poor corporate governance, lack of disclosure, and seemingly laxer accounting standards and enforcement. The A-share market is perceived to be more prone to fraud than the offshore market, which is not necessarily the case. Investing in the A-share market and SOEs does not entail more exposure to fraud than the offshore market, especially among private companies.
- One argument in favor of A-shares today is that most investors are underweight China relative to the size of its markets and arguably very underweight relative to the size of its economy. There is talk of including the A-share market in the major global equity benchmarks and therefore the passive index products that track them. However, before this can occur, the size of the QFII program must increase and repatriation rules be further relaxed.
- A more compelling case for the A-share market is that valuations are near all-time lows. Thus, the market will not be plagued by the valuation overhang that has weighed down returns over the past decade. Still, offshore equities trade at even lower valuations, making the relative valuation case not so simple.

- Put simply—the A-share market is not for everyone. Don't be in a rush to hop in, and make sure you have a good guide. "Alpha" and even absolute performance are never guaranteed and are particularly challenging in a market as volatile and fund flow–driven as mainland China. The near-term headwinds facing the A-share market mean investors must have even more confidence in their manager selection skills to take the plunge today. Given the limited (but growing) product offerings available, investors should pinpoint managers that have the skill to navigate the still-evolving nature of the A-share market. ■

In late 2002, the launch of China's Qualified Foreign Institutional Investor (QFII) program, which granted global investors access to the country's previously closed domestic stock market, created much excitement. Given China's economic emergence, the A-share market was touted as a way to capture the country's growth prospects. However, this excitement was misplaced as the program was small in size and burdensome for investors, and the performance of the A-share market has lagged well behind the growth of the Chinese economy.

Ten years later, China is now opening the door a bit wider for foreign investors: over the past year, a host of changes to the QFII program have been announced, including the near doubling of its size to US$150 billion. Given that access is improving, the question again is whether investors should seek exposure to the A-share market.

In this paper, we provide an overview of the A-share market and implementation considerations for investors. Ten years ago, we were skeptical and advised against participating in the A-share market.[1] Today, we are more constructive, but feel investors should not rush in—the market is still evolving and passive investment options are limited. Finding a skilled manager to navigate the challenges still facing the market is key.

[1] Please see our reports *Investing in Listed Chinese Equities* (2003) and *Chinese Listed Equities Revisited* (2004).

Comparing the Onshore and Offshore Markets

Most investors have exposure to China via companies listed in Hong Kong and included in most emerging markets benchmarks and products, such as the MSCI China Index.[2] The primary difference between the A-share market and the universe of Hong Kong–listed China stocks is depth, but important differences in sector and small-cap exposure also exist.

Market Size

The overall A-share market is roughly 2,500 stocks, with a total market capitalization of US$3.7 trillion, which dwarfs the 675-stock, US$1.7 trillion Hong Kong–listed universe. However, the investible universe is considerably smaller. Government entities own large stakes in state-owned enterprises (SOEs), often exceeding 50% of market capitalization. Furthermore, many of the companies in both the onshore and offshore markets are small, relatively illiquid stocks. Based on the MSCI China A Index, the universe of investible large- to mid-cap A-shares is roughly 500 stocks and US$800 billion in free-float market cap, while

[2] Hong Kong–listed Chinese equities fall into three broad classifications. H-shares are companies incorporated in the People's Republic of China (PRC). Red chips are companies incorporated outside of the PRC but with the majority of assets and revenue derived from China and owned by PRC government entities. P-chips are privately owned companies incorporated outside of the PRC, but with the majority of their assets and revenue from China. B-shares are another share class available to foreign investors, representing US$- and HKD-denominated shares listed in Shanghai and Shenzhen. However, B-shares account for less than 1% of the MSCI China Index. U.S.-listed Chinese companies and American Depositary Receipts are not included in the MSCI China Index or most Chinese benchmarks.

the MSCI China Index covers only 137 stocks with a free-float market cap of $700 billion.[3]

Market Sectors

Aside from the size difference, the onshore and offshore markets have notable differences in sector composition. Financial stocks dominate both markets at 34% for the MSCI China A Share Index and 39% for the MSCI China Index, but the A-share market has more exposure to the industrials and materials sectors, while the offshore market is tilted toward energy and telecoms.

While it is often said that the A-share market provides more exposure to the Chinese consumer, this is only partially true. The A-share index is overweight consumer staples, consumer discretionary, and health care by a combined 15 percentage points. However, it is also overweight industrials and materials sectors by a combined 16 percentage points. Furthermore, the A-share index effectively has zero exposure to telecom stocks and is underweight IT (Figure 1). This is striking, given the growing importance of mobile phones and social media in China.

This difference in composition reflects Hong Kong's role as the gateway for foreign capital. China established domestic stock markets in

[3] We have focused on the MSCI China A Index given its breadth, comparable methodology to MSCI's global indices, and use by foreign asset managers. The other major A-share benchmark is the China Securities Index 300, which includes the 300 largest stocks listed on the Shanghai and Shenzhen stock exchanges. The CSI 300 is the index used by most domestic asset managers and the index on which the recently launched A-shares futures contracts are based. Performance and sector weightings for the CSI 300 are very similar to the MSCI China A Index given 100% overlap of companies, although there are differences in weighting due to free-float adjustment methodologies.

Figure 1. Onshore vs Offshore China MSCI Indices
As of July 31, 2013

	MSCI China A	MSCI China	Differences
Free Float Market Capitalization (US$ bn)	766	664	101
No. of Companies	463	137	326
Sector Weights (%)			
Telecommunication Services	0.9	12.0	-11.1
Energy	5.0	15.0	-10.0
Financials	33.5	39.1	-5.6
IT	4.5	8.5	-4.0
Utilities	3.5	3.5	0.0
Consumer Staples	7.1	6.0	1.1
Consumer Discretionary	11.1	5.2	5.9
Materials	10.0	3.2	6.8
Health Care	9.1	1.4	7.7
Industrials	15.2	6.0	9.2

Sources: MSCI Inc. and FactSet Research Systems. MSCI data provided "as is" without any express or implied warranties.
Note: MSCI China A indices cover stocks listed on the Shanghai and Shenzhen stock exchanges while MSCI China indices cover mostly Hong Kong–listed stocks.

the early 1990s and saw rapid listing of SOEs, but the amount of capital raised was small given limited domestic savings. Select SOEs and private companies were allowed to list in Hong Kong, but they too only raised relatively small amounts of capital. As China engaged in SOE reform over the mid-1990s, consolidation of various provincial SOEs created "national champions." These companies, owned by the central government, were listed in Hong Kong to raise large amounts of fresh capital, rather than tap domestic savings. Thus, Hong Kong became the destination for the largest companies in the most strategic sectors (telecoms, energy, and financials), while the A-share market remains home to more domestically focused, if not provincially focused, companies.

Although plenty of smaller SOEs and private companies have listings in Hong Kong, the Hong Kong market is dominated by the big, centrally owned national champions. This is reflected in the more concentrated nature of the Hong Kong market, with the top ten stocks accounting for 53% of the MSCI China Index, compared to 18% for the MSCI China A Index.

Overlap among the top ten stocks of each index is small, but given dual listings, especially among the large banks, the constituents of the full indices overlap to a large degree. Some 80+ companies have dual listings, and MSCI estimates that there is 34% overlap between the MSCI China A and MSCI China. This overlap increases to almost 50% if the universe is limited to just the 50 largest stocks (Figure 2).

Figure 2. Top Ten Constituents of MSCI China Indices
As of July 31, 2013

MSCI China A

Company	Sector	Weight (%)
China Minsheng Banking Corp. Ltd.	Financials	3.0
China Merchants Bank Co. Ltd 'A'	Financials	2.6
Ping An Insurance (Group) Co. of China Ltd.	Financials	2.0
Industrial Bank Co. Ltd.	Financials	1.8
Shanghai Pudong Development Bank Co. Ltd.	Financials	1.7
China Vanke Co. Ltd.	Financials	1.7
CITIC Securities Co. Ltd.	Financials	1.6
Bank of Communications Co. Ltd.	Financials	1.4
Haitong Securities Co. Ltd.	Financials	1.4
Industrial & Commercial Bank of China Ltd.	Financials	1.3
Top 10		**18.4**

MSCI China

Company	Sector	Weight (%)
China Mobile Ltd.	Telecom	9.7
China Construction Bank Corp.	Financials	8.1
Industrial & Commercial Bank of China Ltd.	Financials	7.3
Tencent Holdings Ltd.	IT	7.0
CNOOC Ltd.	Energy	4.9
Bank of China Ltd.	Financials	4.7
PetroChina Co. Ltd.	Energy	3.7
China Petroleum & Chemical Corp.	Energy	2.9
China Life Insurance Co. Ltd. (China)	Financials	2.7
Ping An Insurance (Group) Co. of China Ltd.	Financials	1.8
Top 10		**52.7**

Overlapping Companies	Overlap (%)
Top 50	48.0
Top 300	38.0
Full Index	34.0

Sources: MSCI Inc. and FactSet Research Systems. MSCI data provided "as is" without any express or implied warranties.
Notes: Weights are based on free float–adjusted market cap. Analysis on overlapping companies provided by MSCI.

Small-Cap Exposure

The A-share market offers substantially more exposure to small caps than the offshore market. The MSCI China A Small Cap Index has nearly 1,400 stocks versus roughly 300 stocks for the MSCI China Small Cap Index. Most small caps are listed on the Shenzhen Stock Exchange, with Shanghai home to more large caps.[4]

The sector composition of the small-cap space is quite different from the main index, with financials only accounting for 7%, while consumer discretionary and technology are notable overweights versus large caps. Still, industrials and materials are the largest sectors. The pattern is roughly the same for the Hong Kong–listed small-cap space. However, given the very small size of many of the A-share small caps (average free-float market cap of US$242 million), many managers are reluctant to go too far down the cap spectrum (Figure 3).

[4] The Shanghai Stock Exchange has 944 companies with an average unadjusted market cap of $2.7 billion. The Shenzhen Stock Exchange has three boards. The main board has 472 companies with an average unadjusted market cap of $1.1 billion. The small and medium enterprise (SME) board has 701 companies with an average unadjusted market cap of $652 million. The ChiNext board for start-ups has 355 companies with an average unadjusted market cap of $389 million.

Performance of Chinese Equities

Despite the overlap and concentrated exposure to financials, the onshore and offshore markets behave very differently. Since 2000, the correlation between the MSCI China A Index and the MSCI China Index has been only 52%; two-year rolling correlations have ranged from as high as 74% to slightly negative (Figure 4).

Figure 3. Onshore vs Offshore China MSCI Indices: Small Caps

As of July 31, 2013

	MSCI China A Small Caps	MSCI China Small Caps	Differences
Free Float Market Capitalization (US$ bn)	330	88	241
No. of Companies	1,365	322	1,043
Sector Weights (%)			
Financials	7.3	13.3	-6.0
Energy	2.0	4.7	-2.7
Utilities	3.6	6.2	-2.6
Consumer Discretionary	16.9	17.6	-0.7
Consumer Staples	7.1	7.8	-0.7
IT	13.5	14.1	-0.6
Telecommunication Services	0.3	0.1	0.2
Health Care	7.2	6.5	0.7
Industrials	23.4	18.0	5.4
Materials	18.6	11.7	6.9

Sources: MSCI Inc. and FactSet Research Systems. MSCI data provided "as is" without any express or implied warranties.
Note: MSCI China A indices cover stocks listed on the Shanghai and Shenzhen stock exchanges while MSCI China indices cover mostly Hong Kong–listed stocks.

Aside from sector disparities, the differences in performance stem from China's closed capital account, leaving the A-share market driven more by domestic liquidity conditions, while the Hong Kong market is more correlated to global financial markets. Since 2000, the correlation between the MSCI China Index and the MSCI World Index has been 70%, compared to only 33% for the MSCI China A Index. A-shares were only 41% correlated to emerging markets equities over the same time period.

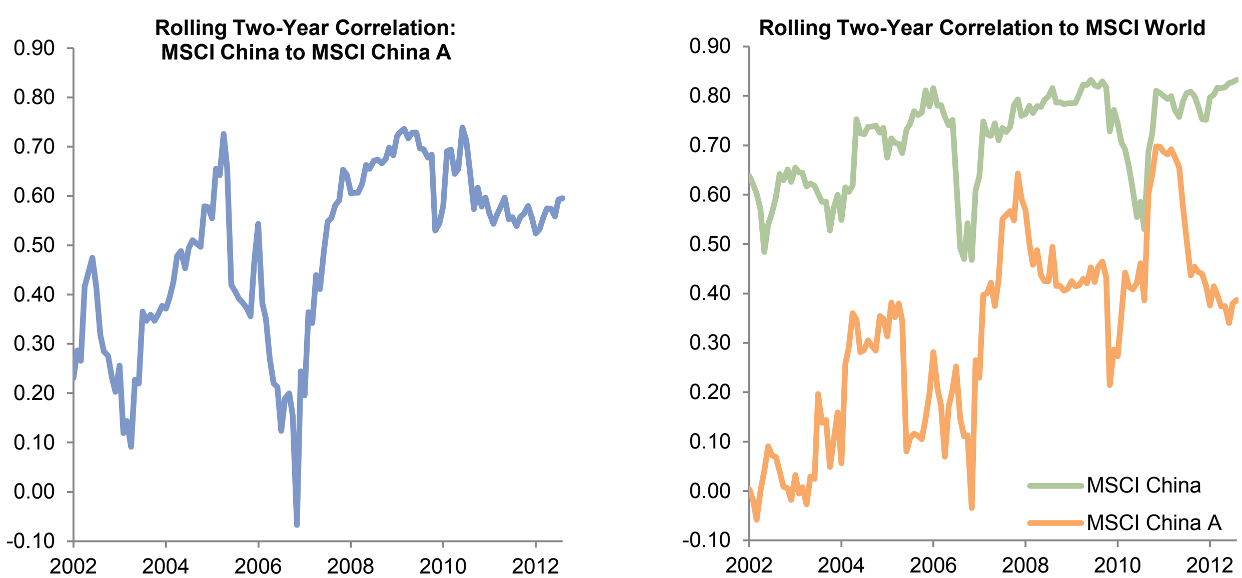
Though on the surface such low correlations appear to be a positive trait, cynical investors would argue this "diversification benefit" stems from A-share underperformance. The past 12 years certainly have not been kind—over 2001–12, the annualized total return for the MSCI China A Index has been 3.8% versus 11.7% for the MSCI China Index, in local currency terms (Figure 5). Even after adjusting for the recent appreciation of the renminbi, the A-share market has also underperformed over the past three-, five-, and ten-year periods (Figure 6).

Why Have A-Shares Lagged?

Several arguments have been advanced to explain this performance gap, most notably lower profitability, higher valuations, and new issuance and dilution of the A-share market relative to Hong Kong–listed shares.

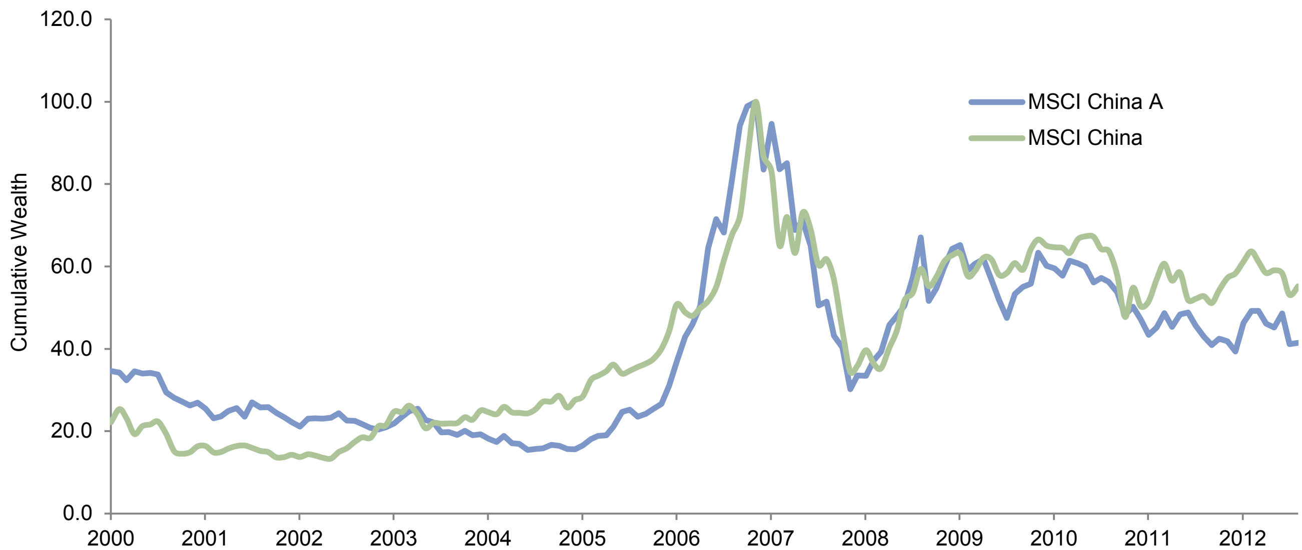
Lower Profitability. Given the concentration of national champions among Hong Kong–listed companies, some argue they are simply more profitable. This argument has some merit, with average return on equity (ROE) for the offshore companies modestly higher than that of A-shares (Figure 7). However, this gap does not seem to adequately explain the wide performance differential.

Figure 4. Correlation of Onshore and Offshore China MSCI Indices
December 31, 2000 – July 31, 2013 • U.S. Dollars



Source: MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

Figure 5. Chinese Equity Performance: Cumulative Wealth
December 31, 2000 – July 31, 2013 • Local Currency



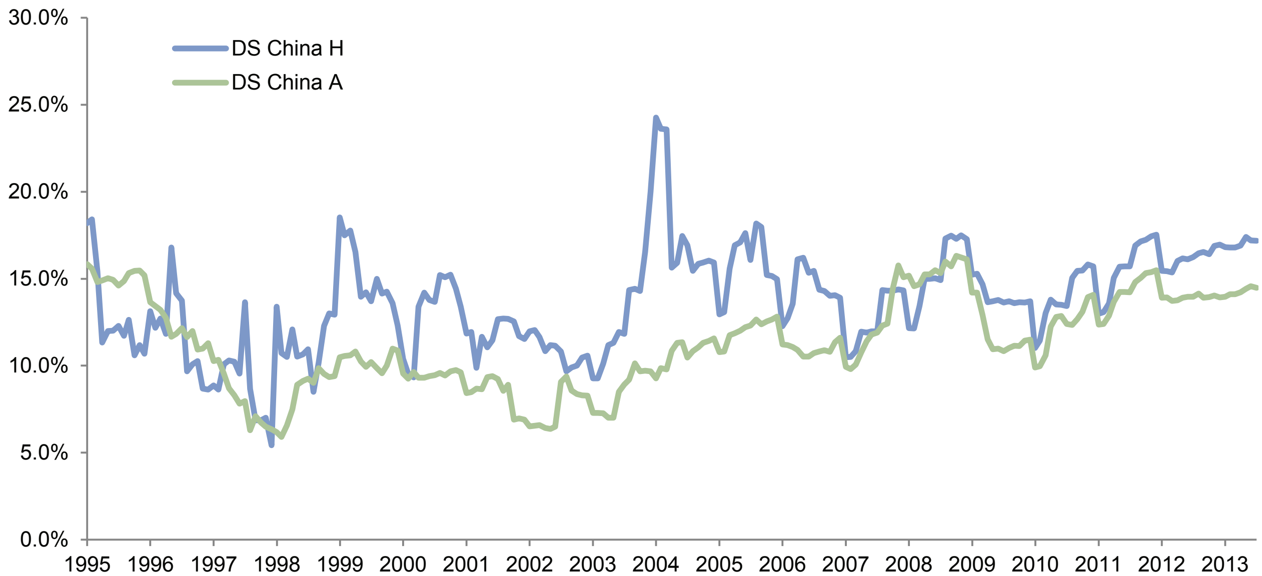
Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: Rebased to 100 on October 31, 2007.

Figure 6. Chinese Equity Performance: Annualized Returns
Periods Ended July 31, 2013 • U.S. Dollar

	Annualized Total Returns (%)			
Index	One-Year	Three-Year	Five-Year	Ten-Year
MSCI China A	2.3	-3.3	-0.7	11.2
MSCI China	8.2	-0.1	0.8	15.4
MSCI China A Small Caps	15.1	-0.8	9.7	N/A
MSCI China Small Caps	32.2	-1.8	8.8	16.0
Shanghai Composite*	-1.6	-5.8	-4.3	6.2
Shenzhen Composite*	15.2	-1.0	4.9	12.2
MSCI Emerging Markets	2.3	1.3	0.9	13.5
MSCI World	24.0	13.4	4.9	8.2

Sources: MSCI Inc., Shanghai Stock Exchange, Shenzhen Stock Exchange, and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
* Shanghai and Shenzhen Composite returns are price returns.

Figure 7. Return on Equity for China H and China A Shares
January 31, 1995 – July 31, 2013



Source: Thomson Reuters Datastream.

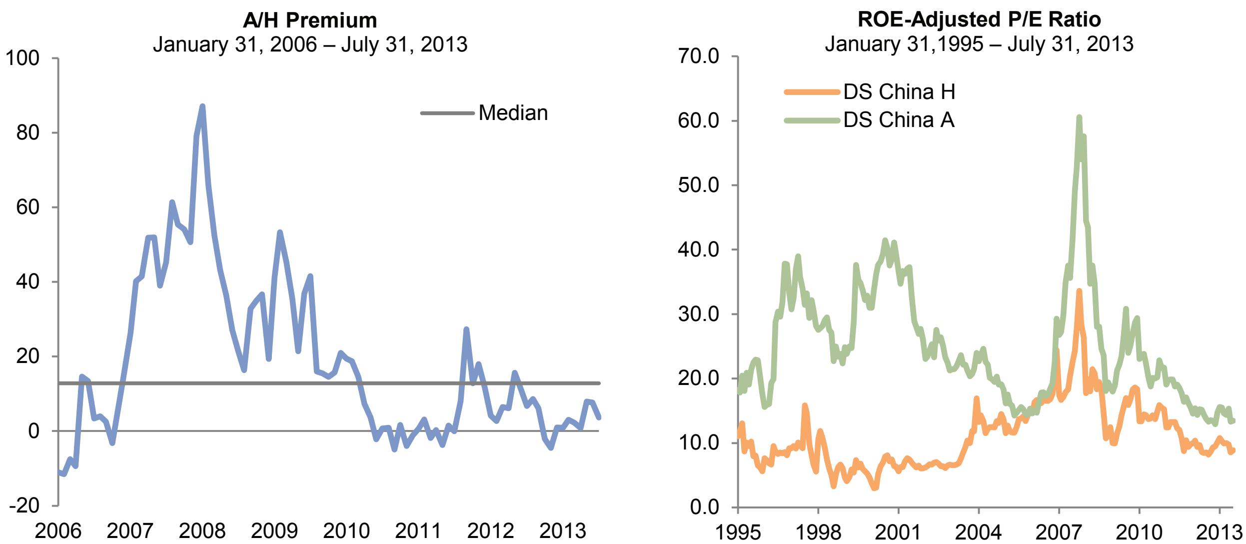
Higher Valuations. A-shares tend to trade on higher valuations, even for the same companies. For the dual-listed stocks, the median premium for A-shares over their matching H-share has been 13%, although today it stands at only 4%. At the overall index level, A-shares have almost always been more expensive on an ROE-adjusted P/E basis. Thus, A-share investors have overpaid and suffered for it. This was especially the case in the late 1990s and late 2007, when the A-share index traded at very high premiums (Figure 8).

The premium valuations are said to reflect the "retail-driven" nature of the A-share market, while the Hong Kong market is more "institutional" and therefore driven more by fundamentals and valuation. The perception is that the mainland markets are more volatile and prone to over- and undershoot, given short-term performance chasing by investors.[5] Historically, the A-share market has been more volatile, though recently the volatility of both markets has trended lower and converged around 20% to 25% annualized (Figure 9). Still, the relative lack of dedicated institutional investors leaves the A-share market subject to swings in domestic fund flows.[6]

[5] Mutual fund portfolio turnover greater than 300% is not uncommon.

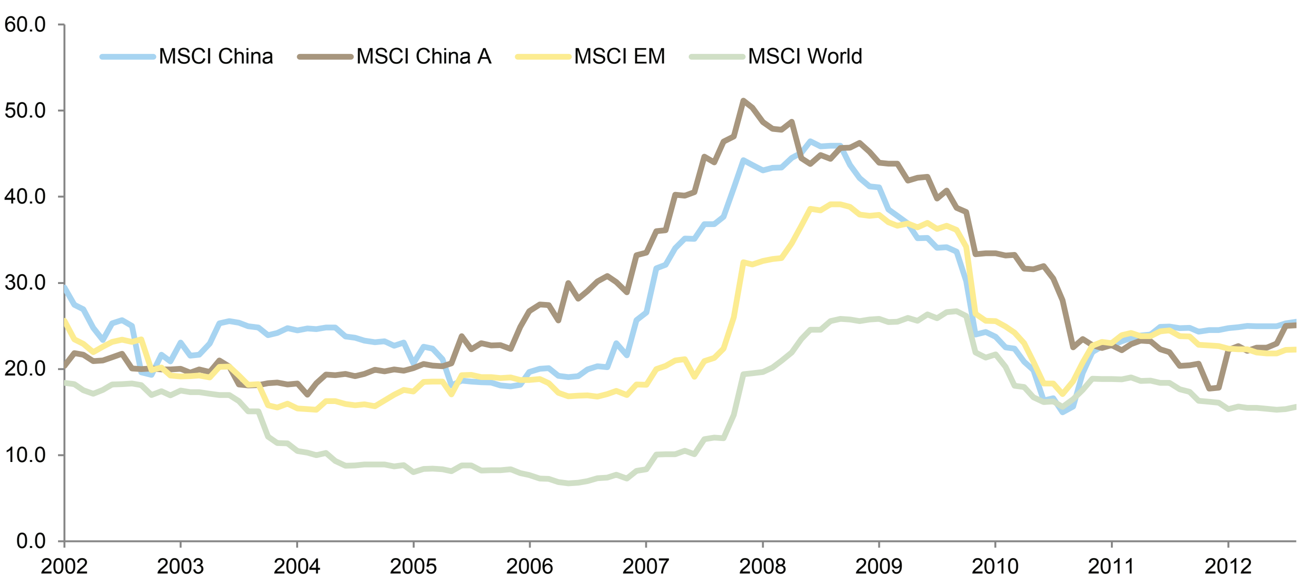
[6] Non-institutional investors account for an estimated 60% to 80% of market trading. Foreign investors own very little; filled QFII quotas only account for around 7% of MSCI China A Index free-float market cap.

Figure 8. China A/H Share Premium and ROE-Adjusted P/E Ratio



Sources: Hang Seng Bank and Thomson Reuters Datastream.
Note: Data are monthly.

Figure 9. Two-Year Volatility of Onshore and Offshore China MSCI Indices
December 31, 2000 – July 31, 2013 • U.S. Dollars



Source: MSCI Inc. MSCI data provided "as is" without any express or implied warranties.

New Issuance and Dilution. New issuance and dilution have also weighed on the A-share market.[7] The key divergence between A-shares and Hong Kong stocks occurred over 2003–05. While global equities rallied strongly over this period, the A-share market steadily declined amid concerns over the large overhang of government-owned shares set to hit the market. The resolution of the overhang issue in late 2005 set the stage for the tremendous market rally over 2006–07. More recently, the A-share market has absorbed large amounts of initial and secondary offerings despite waning investor interest. As a result, since the middle of 2012, authorities have suspended the IPO market not only to support the flagging market, but also to reform an IPO process generally viewed as flawed.

Overall, the A-share market has faced the unfortunate headwinds of high valuations, dilution, and lack of faith by domestic market participations. Aside from the speculative run-up over 2006–07, the past 12 years or so have been a prolonged bear market.[8]

[7] Neuberger Berman estimates that over 2003–12, the number of companies on the A-share market doubled, while free-float market cap nearly tripled, rising from 27% to 68%.

[8] Return data for the MSCI China A Index begin December 2000. China's stock market history begins in earnest in 1992. The 1990s were extremely volatile but effectively a bull market. From 1993 to 2000, the Shanghai Stock Exchange Composite Index rose at an 8% annualized rate, with 67% annualized volatility. The offshore MSCI China Index, however, had a rough start; from 1993 to 2000, the index returned -17% annualized with 45% volatility. The poor early performance for Hong Kong–listed stocks reflected high valuation, accounting scandals, the Asia crisis, and the bursting of the tech bubble.

Economic Growth and the A-Share Market—Miles Apart

The gap between China's economic performance and stock market performance is striking—and, to some observers, expected. The domestic market is dominated by SOEs, whose senior managers are political appointees and serve purposes other than maximizing value for minority shareholders.

The other disconnect is that while SOEs make up the majority of the A-share market (83% of the number of companies), private businesses actually account for the majority of China's economy and employment.[9] To be clear, SOEs remain important in the Chinese economy, accounting for half of China's domestic investment spending, while most private small and medium enterprises (SMEs) are tiny family-run firms. However, the most dynamic part of the Chinese economy is still underrepresented on Chinese stock markets.

It is tempting to assume that most of the smaller companies on the A-share market are private firms. Although more private firms are in the small-cap space, the majority are simply smaller SOEs. Of the 2,500 listed A-shares, only 400 are non-SOEs, according to data from Goldman Sachs. The Shenzhen Stock Exchange has an SME board and even smaller incubator board for start-ups (the ChiNext), but these stocks are not widely held by most managers, given their tiny size and speculative nature. Still, the Shenzhen Composite Index has handily beaten the Shanghai Composite over the past few years.

The offshore market provides more exposure to private companies, or so-called P-chips. Of the

[9] Official statistics imply SMEs account for approximately 60% of GDP and nearly 75% of employment.

300 odd small caps in the MSCI China Small Cap Index, more than half are classified as P-chips, accounting for about 40% of the index market cap. Among large caps, P-chips account for less than 20% of market cap and are concentrated in the IT sector, which is almost entirely listed offshore.

Thus, most listed companies in China are not private firms. Perhaps this is why private equity investments have done well in China over the past decade—the Cambridge Associates China Private Equity Index returned 12.7% annualized for the ten years ending 2012.[10] Finding private companies in need of capital has been the best way to capture the dynamic growth in the economy—an idea not lost on local Chinese high-net-worth investors. Disappointed by equities and restricted from further property speculation, these investors have flocked to the domestic Chinese private equity market.

Corporate Governance and Fraud

Many investors are leery of Chinese equities due to poor corporate governance, lack of disclosure, and seemingly laxer accounting standards and enforcement. The A-share market is perceived to be more prone to fraud than the offshore market, which holds companies to international standards. This is not necessarily the case.

Many of the most high-profile frauds have occurred in companies listed on offshore exchanges (including Hong Kong, Singapore, and the United States) and vetted by international accounting and ratings agencies (although the fraudulent activity has occurred in China). Most of the frauds were committed by smaller private companies, not large SOEs, some of which are very profitable, enjoying near monopolies. Many managers consider large-cap SOEs much “safer” than private companies. This is not to imply that SOEs are incapable of fraudulent reporting, but rather that investing in the A-share market and SOEs does not entail more exposure to fraud than the offshore market, especially among private companies.[11] Given the deficiencies in corporate governance, investing in Chinese companies listed on any exchange requires extra diligence and a different skill set than other markets.

Currency Exposure

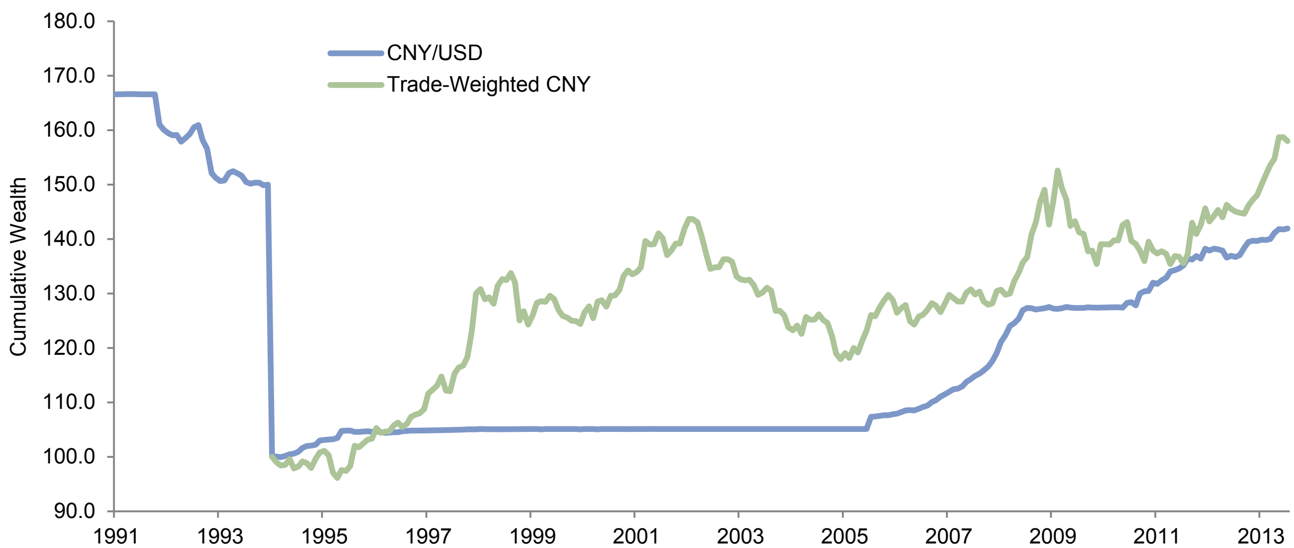
Currency exposure is a final key difference between the A-share and Hong Kong–listed markets, with the former denominated in renminbi and the latter in the Hong Kong dollar, which is pegged to the U.S. dollar. From 1994 to 2005 the renminbi was also pegged to the U.S. dollar, but since 2005 it has appreciated 35%, or roughly 4% annualized (Figure 10).

So far, the Chinese authorities have kept a close grip on the renminbi, allowing it to gradually appreciate, but also preventing sharp falls amid periods of market stress (such as 2008). This has mitigated currency volatility in down markets, similar to the pegged nature of the Hong Kong dollar. While many investors see the added exposure to the renminbi as an attractive attribute for the A-share market, Chinese authorities have expressed their view that the renminbi is no longer undervalued

[10] Pooled end-to-end calculation based on 46 China private equity funds (includes buyouts and growth equity funds), including fully liquidated partnerships formed between 1994 and 2012. Pooled end-to-end return net of fees, expenses, and carried interest.

[11] The rash of accounting scandals among U.S.-listed Chinese stocks is an example, while China Metals and Recycling is the latest Hong Kong–listed P-chip to declare bankruptcy amid fraud allegations.

Figure 10. Chinese RMB Appreciation
January 31, 1991 – July 31, 2013



Sources: J.P. Morgan Securities, Inc. and Thomson Reuters Datastream.
Notes: Graph is based on monthly data. Data have been rebased to 100 at January 1994.

and that market forces will play a larger role in setting the exchange rate. Investors should not assume the volatility of the renminbi will remain as muted as in the recent past, nor is it a given the renminbi will continue to appreciate at its recent pace.

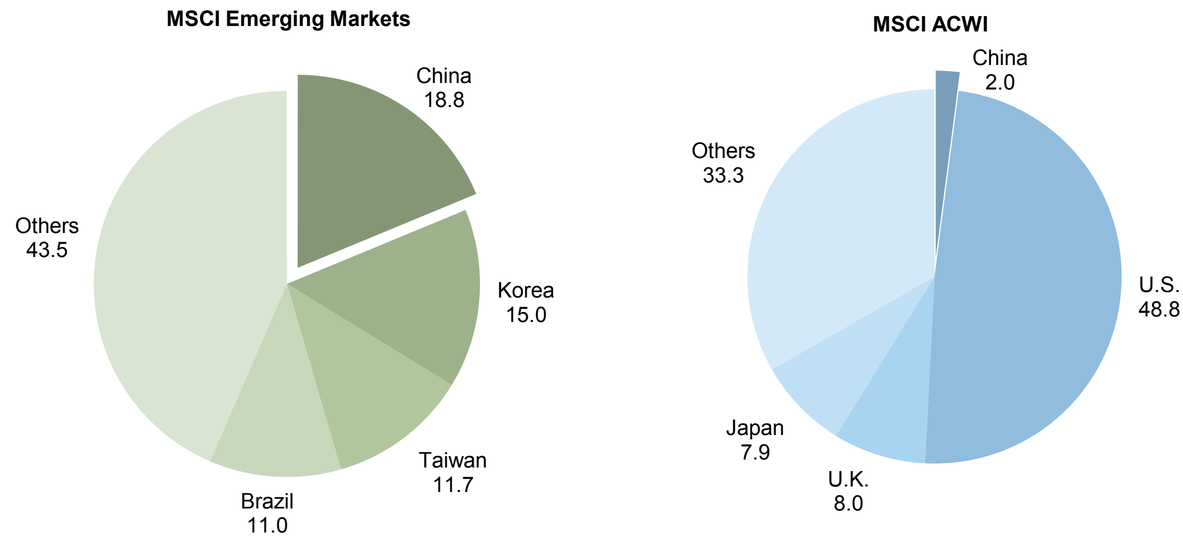
Why Own A-Shares at All?

Given the unsavory characteristics discussed, it is little wonder that investors (foreign and domestic) have curbed their enthusiasm for A-shares.

One argument in favor of A-shares today is that most investors are underweight China relative to the size of its markets and arguably very underweight relative to the size of its economy. Despite being the second-largest economy in the world, China currently only accounts for 2% of the MSCI All Country World Index, although it accounts for roughly 19% of the MSCI Emerging Markets Index (Figure 11). At the same time, A-shares account for over 50% of the total Chinese equity universe (Figure 12).

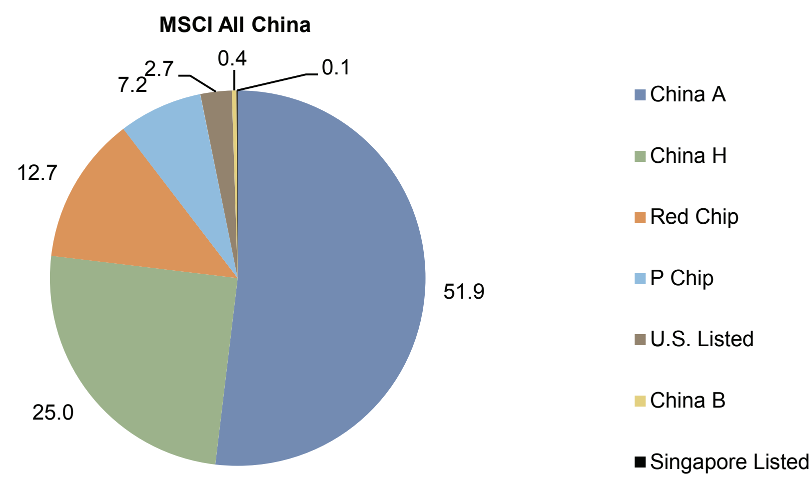
With increased investor access, there is talk of including the A-share market in the major global equity benchmarks and therefore the passive index products that track them. Indeed, MSCI recently estimated that if A-shares were included in the MSCI Emerging Markets Index, China's overall weight would increase to approximately 30%; if A-shares were included in the MSCI All Country World Index, China's weight would double from 2% to 4%. In other words, you may not own A-shares now, but you may be forced to own them in the not-too-distant future.

Figure 11. Comparing China's Weight in MSCI Emerging Markets and MSCI ACWI
As of July 31, 2013 • Country Weights (%)



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All weights are based on free-float adjusted market cap.

Figure 12. Share Class Weights for Chinese Equities
As of December 31, 2012 • Percent (%)



Sources: MSCI Inc. and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Note: All weights are based on free-float adjusted market cap.

However, before this can occur, the size of the QFII program must continue to increase and repatriation rules be further relaxed. While MSCI and other index providers have begun "consultative" discussions, widespread inclusion in global portfolios remains a few years away (please see the Appendix for more details).

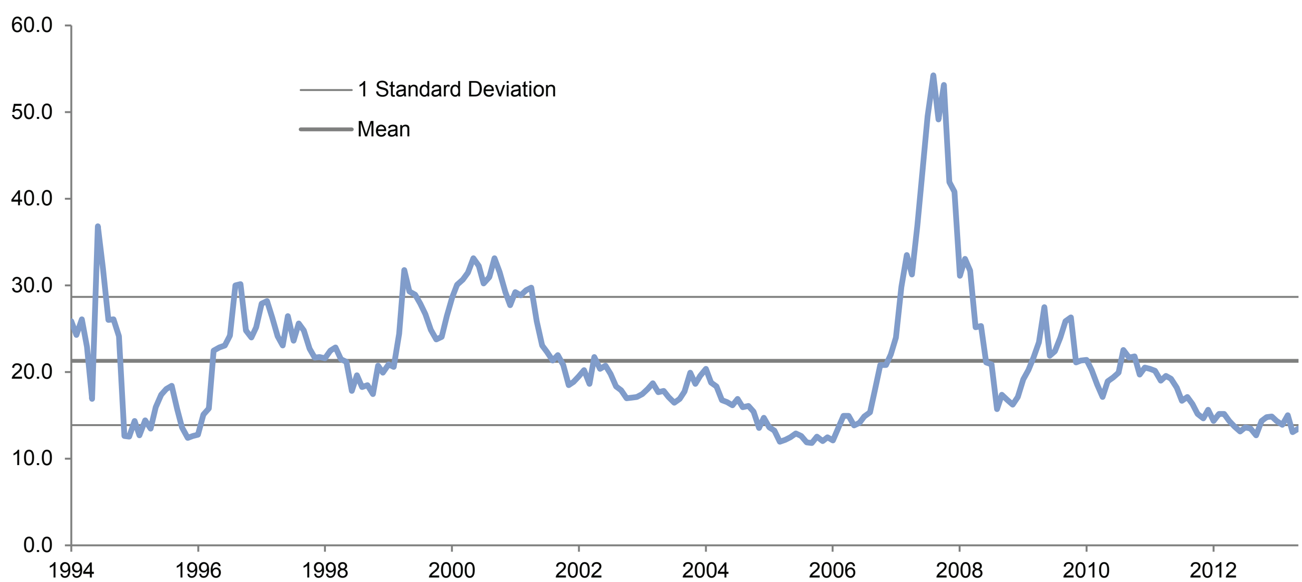
A more compelling case for the A-share market today is that valuations are near all-time lows. If overpriced stocks were a key headwind of the past decade, that is certainly not the case going forward (Figure 13).

Still, offshore equities trade at even lower valuations, making the relative valuation case not so simple. Also, the A-share market faces the eventual headwind of a reopened IPO market and further dilution should SOEs and banks need to raise additional capital.

Investing in the A-share index as it currently stands does not seem appealing given overlapping exposure with the Hong Kong–listed market—both are still dominated by the sectors most at risk from China's economic rebalancing from investment-driven to consumption-driven growth (financials and industrial-related sectors).

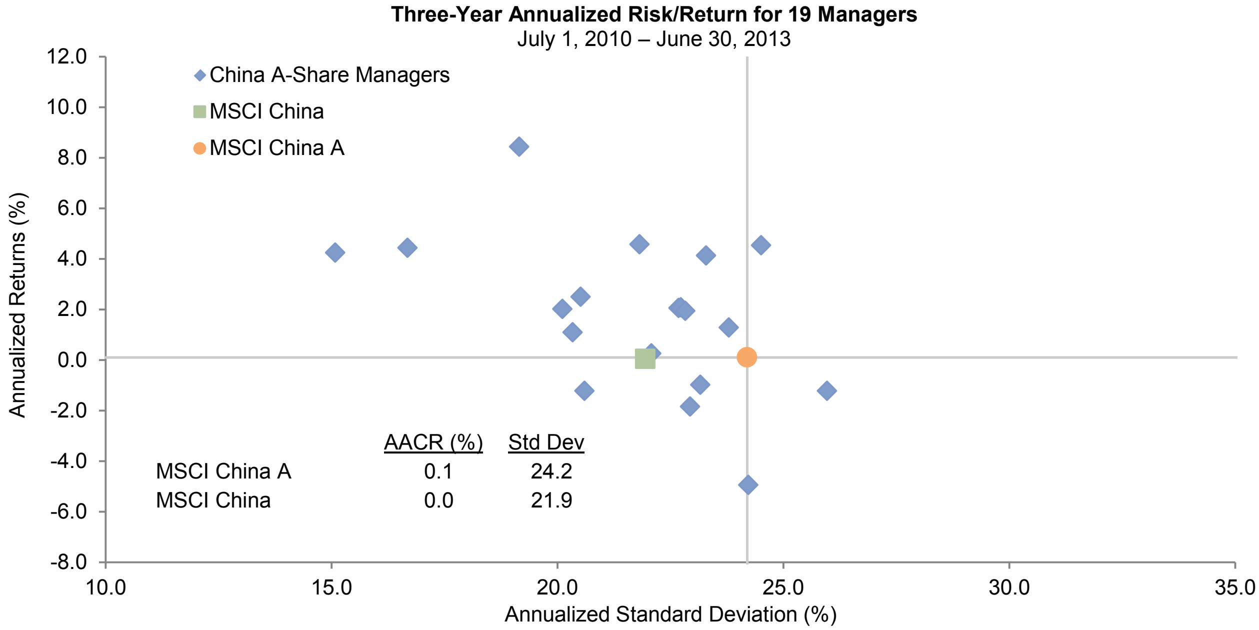
In our opinion, the key attraction of the A-share market is the potentially larger universe of stocks, which should allow investors to focus on areas less represented by the Hong Kong–listed universe, thereby achieving differentiated exposure to China. Active managers should be able to build portfolios of companies best suited to the next phase of China's economic growth and navigate what remains a challenging period for the country. The deeper and seemingly less "efficient" A-share market should allow managers to achieve superior risk-adjusted returns in a volatile market, which seems to have been the case over the past few years (Figure 14).

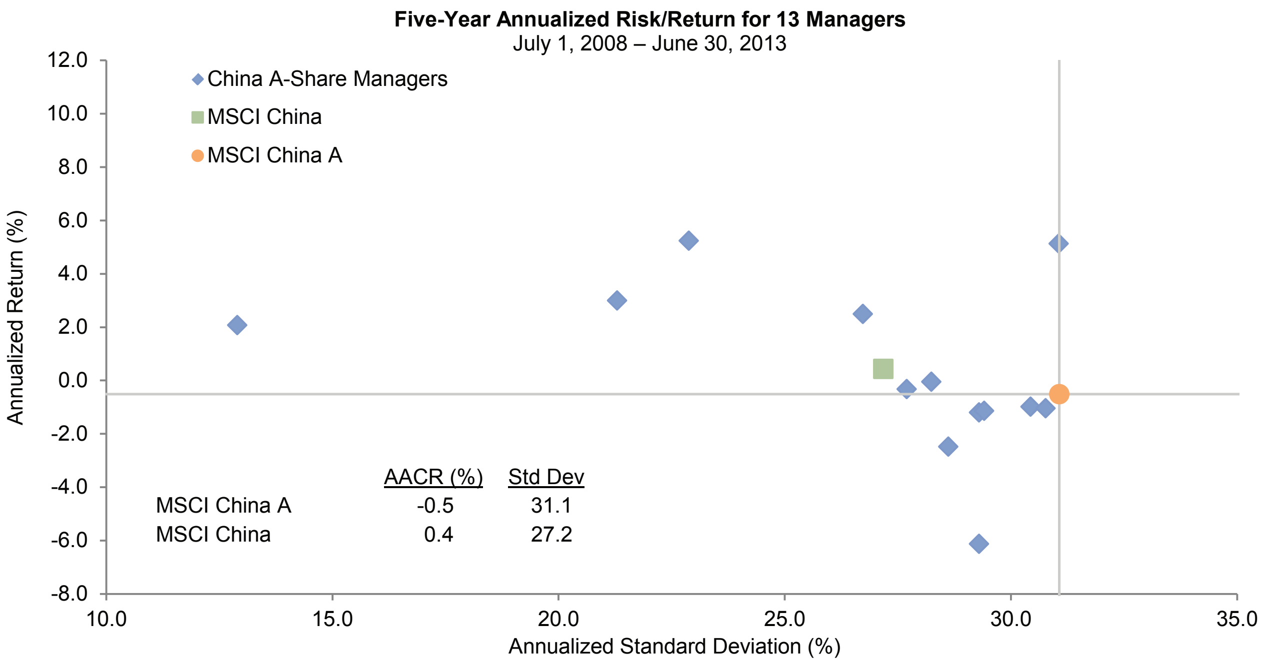
Figure 13. China A-Shares Non-Financials ROE-Adjusted P/E Ratio
March 31, 1994 – July 31, 2013



Source: Thomson Reuters Datastream.

Figure 14. China A-Share Managers: Risk/Return Analysis
As of June 30, 2013 • U.S. Dollar





Sources: Cambridge Associates LLC, MSCI Inc., and Thomson Reuters Datastream. MSCI data provided "as is" without any express or implied warranties.
Notes: All manager returns are net of an assumed 2.0% management fee. Index returns are total returns. All returns are in U.S. dollars.

However, investors should view such an "active" A-share allocation as strategic and be willing to tolerate swings in relative performance. In the near term, the beaten-up banks and industrials are cheap, while consumer plays have outperformed and appear relatively expensive (Figure 15). Small-cap stocks have also done well recently and trade at high premiums to large caps. Managers with sizeable tilts toward these segments may lag amid a rebound in the broad market.

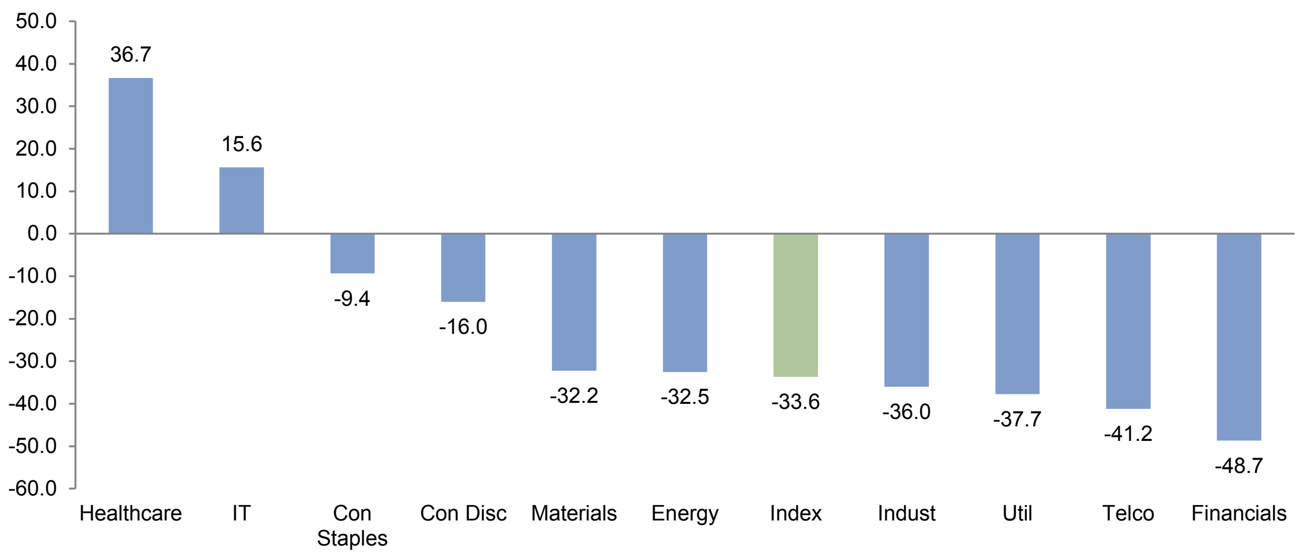
At the same time, should domestic investor confidence (or speculative fervor) return and liquidity flow back into the market, the A-share index would likely explode upward, and active managers would lag behind, as was the case in 2007 and 2009. Over the longer term, we would expect managers to continue to add value, but for investors seeking a tactical bet on beaten-down cyclicals, offshore equities seem better suited, given ease of access.

Access and Implementation

After allowing the QFII program to stagnate for years, several critical changes have been announced in what seems to be a clear push by Chinese regulators to increase foreign participation in the A-share market (please see the Appendix for more details). As a result, investment managers can more easily establish commingled open-ended mutual funds.

Investors can apply for their own QFII license and quota. Given the minimum quota size of $50 million, this route is only viable for large institutions that want to commit a sizable amount for an extended period of time. While repatriation of gains/income is allowed, repatriation of principal will result in a reduced or removed quota. Individual investors are limited to monthly repatriation (after a three-month lock-up) and require the permission of Chinese

Figure 15. DS China A Sectors: Price-to-Book Percentage Above/Below Median
January 31, 2002 – July 31, 2013



Source: Thomson Reuters Datastream.
Note: All sectors are valued based on post-2001 median and standard deviation.

authorities in advance. The QFII program is clearly designed to attract long-term fund flows, requiring investors to make a strategic allocation to the A-share market. Obtaining an individual quota does give investors the most flexibility and control in asset deployment. Investors can manage the assets on their own or appoint sub-advisors to run separate accounts, greatly increasing the manager options (including domestic Chinese managers). Recent changes now allow up to 49% of an investor's QFII quota in the Chinese interbank bond market, granting local currency fixed income exposure previously off limits.

Still, the numerous administrative hassles and costs should be seriously considered before applying for a QFII quota. Most investors should choose to invest in an open-ended fund product run by an asset manager with their own QFII quota, as this removes nearly all of the administrative hassles and grants the ability to redeem principal. However, such funds are currently still limited to only weekly repatriation, and new funds are subject to a three-month lock-up. Despite the growing number of A-share funds, we consider only a limited number of A-share products "institutional quality." This is especially true of the domestic mutual fund universe in China, which suffers from high turnover and momentum chasing.

Even for institutional-quality managers, actual A-share track records may be limited (as opposed to offshore track records). Many managers have beaten the index in recent years, though absolute returns remain poor and flattered by the rising renminbi. At the same time, investors are subject to higher fees than offshore equity products and can only redeem on a weekly basis. Assets under management for some funds may be small, meaning large investors may face fund liquidity risk.

Regarding hedge funds, true long/short equity investing does not exist in the A-share market, which only started allowing stock shorting in early 2013. China-focused long/short funds operate in the Hong Kong–listed market, which does allow single stock shorting. While some hedge funds trade A-shares "rented" by their prime broker and try to arbitrage A-H valuation gaps, no dedicated A-share hedge funds exist as of this writing. To the extent that the ability to short stocks improves, long/short strategies may become an effective way mitigate A-share volatility, but it is very early days.[12]

For all investors, when and how a capital gains tax will be imposed is an unresolved issue. Uncertainty over tax liabilities has prevented some QFII holders from repatriating gains and deterred some institutions from seeking quotas. While a ruling on this is expected in early 2014, it is important to understand how managers plan to deal with any taxation issues.[13]

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[12] The class of domestic Chinese managers called private fund companies or "sunshine hedge funds" are the closest proxy to hedge funds in China. These funds use fixed income and market timing to reduce volatility and protect capital. While QFII holders could in theory hire such managers to sub-advise their portfolios, these funds are far from what most investors would consider "institutional-quality" funds despite apparent investment talent.

[13] Currently, domestic Chinese investors face no capital gains taxes. For foreign investors, the authorities have not yet ruled whether an "Enterprise Income Tax" should be levied on investment gains. QFII holders have been advised to set some money aside for eventual tax payment, with many managers setting aside 10%, though it is not clear if this applies on a transaction/trade-by-trade basis, or at the fund level (net performance). If the latter, new investors could be hit with old tax liabilities unless the manager has properly provisioned.

From a passive implementation perspective, investors can also access A-share exchange-traded funds (ETFs) traded in Hong Kong and elsewhere, as well as a few closed-end funds. Of the 36 ETFs tracking A-share benchmarks, only six are physically backed ETFs denominated in renminbi while the rest are synthetic ETFs using derivatives to gain exposure. These products are currently geared toward retail investors, and also charge higher fees than most passive products, especially synthetic ETFs, which entail collateral charges and counterparty risks.[14] Many of these ETFs track very narrow indices, targeting only the top 50 stocks, resulting in even more concentrated exposure to financials at 65%. As the QFII program evolves to target the offshore renminbi market (the RQFII program), passive products geared to institutional investors may soon emerge; today, passive index options for the A-share market remain limited (please see the Appendix for more details).

[14] The largest A-share ETF is the iShares FTSE A50 China Index ETF, with US$7 billion in assets under management and an average daily turnover in 2013 of US$164 million. It charges a 1.0% management fee, but as a synthetic ETF incurs collateral charges of 1% to 2%. The fund also states it has not provisioned for capital gains taxes. The largest physically backed A-share ETF is the CSOP FTSE China A 50 ETF, with only US$2.7 billion in assets under management and US$83 million in daily turnover. It charges a 1.0% fee, but keeps 10% of profits for tax purposes. By comparison, the iShares MSCI China ETF charges a 0.6% management fee.

Conclusion

Despite its much larger size, the A-share market offers similar, if not overlapping, exposure to the Hong Kong–listed universe to which most investors already have exposure. While the conventional sales pitch is that the A-share market offers more exposure to "new China" via consumer plays, it also has even more exposure to "old China" via industrials and smaller SOEs. The "low correlation" of the market is a reflection of poor performance amid a market driven more by domestic retail fund flow than fundamentals.

Though Chinese regulators are now actively seeking to open the market to foreign investors, lingering accessibility issues remain. Investing in the A-share market now, prior to its inclusion in passive index products, may give investors "first mover advantage," but index inclusion does not appear to be on the immediate horizon.

While investors can seek passive exposure to the A-share market, doing so today is not ideal, given the similar (and slightly more undervalued) exposure available in the Hong Kong–listed market. Furthermore, the offshore market can be accessed without the additional liquidity/access restrictions (and higher fees) that investors in A-share products must bear.

In our opinion, the key attraction of the A-share market is the potentially larger universe of stocks in a less efficient market, which should allow active managers scope to generate alpha. By having those managers focus on areas of the A-share market less represented by the Hong Kong–listed universe (either by sector or stock coverage), investors can achieve differentiated exposure to China. By nature, such an allocation should be viewed as strategic, not tactical.

However, "alpha" and even absolute performance are never guaranteed and are particularly challenging in a market as volatile and fund flow–driven as mainland China. The near-term headwinds facing the A-share market mean investors must have even more confidence in their manager selection skills to take the plunge today. Given the limited (but growing) product offerings available, investors should pinpoint managers with the skill to navigate the still-evolving nature of the A-share market.

Put simply—the A-share market is not for everyone. Don't be in a rush to hop in, and make sure you have a good guide. ■

Qualified Foreign Institutional Investor Program: An Update

When the Qualified Foreign Institutional Investor (QFII) program launched in December 2002, it only offered a toehold for foreign investors. The initial program was relatively small in size (US$20 billion), available to only the largest of institutions (minimum assets under management [AUM] of US$5 billion), and burdensome to access, taking a year at best to obtain a quota.

Global investment banks constituted most of the early holders. Those individual institutional investors (endowments and foundations) patient enough to be granted a quota eventually became annoyed by the administrative hurdles and difficult implementation, not to mention the poor performance. As a result, the program never really took off; despite eventually increasing the program size to $80 billion, less than half of that amount was taken up by investors.

Since late 2012, activity has picked up sharply, with the program size nearly doubled and the hurdles lowered in what seems to be a clear push by Chinese regulators to increase foreign participation in the domestic A-share market.

Tables 1 and 2 summarize the recent changes to the program.[1] Most notably:

- the overall quota has been expanded to US$150 billion, with potentially more to come;
- the AUM threshold for institutions has fallen from US$5 billion to US$0.5 billion;
- the approval process has been shortened, taking between three and six months;
- open-ended China funds can now repatriate funds weekly with no preapproval, provided net repatriations within any given month are less than 20% of total assets;
- custodians can now administer repatriation for individual quota holders, though the frequency remains monthly and requires approval; and
- QFII holders can now invest up to 49% of their quota in the interbank bond market.

As a result of these changes, investment managers can more easily to establish commingled open-ended mutual funds with weekly liquidity. This should expand the number of institutional-quality managers offering A-share products and allowing existing "China" funds to gain A-share exposure, rather than "rent" their quota from prime brokers for a fee.

As of September 2013, with over 230 QFII licenses granted and only approximately US$46 billion of the available $150 billion quota filled, there is considerable scope for more investor participation, and the Chinese authorities have been actively granting new quotas and increasing existing ones.

The expanded QFII program may allow A-shares to be included in broader emerging markets and global equity indices and therefore the passive products that track these benchmarks. However, significant hurdles remain before this can occur.

First, the $1 billion individual quota limit is too small for most large index funds. MSCI provides an example. The largest emerging markets exchange-traded fund (ETF) today has AUM of approximately $45 billion. Given that MSCI estimates A-shares could be as large

[1] We cover only those guidelines that apply to individual institutional investors (pension funds, insurance funds, endowments/foundations, and sovereign wealth funds) and asset managers with open-ended mutual funds. A different set of guidelines applies to banks and securities firms.

Table 1. Qualified Foreign Institutional Investor Program

	Previously	Currently
Total Quota	• US$30 billion	• US$150 billion • 230+ approved applicants • Possible future expansions
Qualification Requirements (Insurance Companies, Asset Managers, Pension, Trust, Foundations)	• Years Experience: 5 • AUM: >US$5 billion	• Years Experience: 2 • AUM: >US$0.5 billion
Individual Quota	• Minimum: US$50 million • Maximum: US$1 billion • Long approval process	• No change of max limit for individual investor • SWF and central banks can apply >US$1 billion • Can invest up to 49% of quota in the inter-bank bond market • Today, approval process takes between three and six months
Repatriation Rules (Open-Ended China Funds)	• Three-month initial lock-up period • Monthly repatriation = net redemptions allowed after lock-up • Ten days in advance approval from SAFE for >US$50 billion	• Three-month initial lock-up period • Weekly repatriation = net redemptions allowed after lock-up • Weekly repatriations within a month (<20% total assets in China of prior) • No preapproval required from SAFE
Repatriation Rules (Other QFIIs)	• Three-month initial lock-up period • Each repatriation requires approval from SAFE	• Three-month initial lock-up period • Pre-approval still required by SAFE • Can be administered by custodians • Monthly repatriation allowed after lock-up (<20% of total assets in China of prior year)
Accounts	• One security trading account in RMB	• Up to six security trading accounts
Remaining Issues	• Lack of clear guidance on capital gains taxes • Upper limit of US$1 billion problematic for large mutual funds	

Table 2. Renminbi Qualified Foreign Institutional Investor Program

	Previously	Currently
Total Quota	• RMB70 billion (~US$11.6 billion) • RMB20 billion in “balanced funds” • RMB50 in A-share ETFs	• RMB270 billion (~US$45 billion)
Qualification Requirements	• Hong Kong subsidiaries of PRC fund management and securities companies	• Expanded to include foreign financial institutions incorporated in Hong Kong with existing asset management business • Planned expansion to London, Singapore, and Taiwan
Asset Allocation Restriction	• Minimum 80% in fixed income	• No restriction
Permissible Investments	• Mostly balanced funds and China A ETFs	• Inclusion of index futures • Interbank bond market securities • Permission for active mutual funds
Accounts	• One security trading account in RMB	• Up to six security trading accounts
Remaining Issues	• Lack of clear guidance on capital gains taxes • Currently, only SFC-authorized Hong Kong funds have taken advantage of RQFII • Non–Hong Kong RMB investors soon to be able to invest through non–Hong Kong domiciled investment vehicles managed by qualified investors	

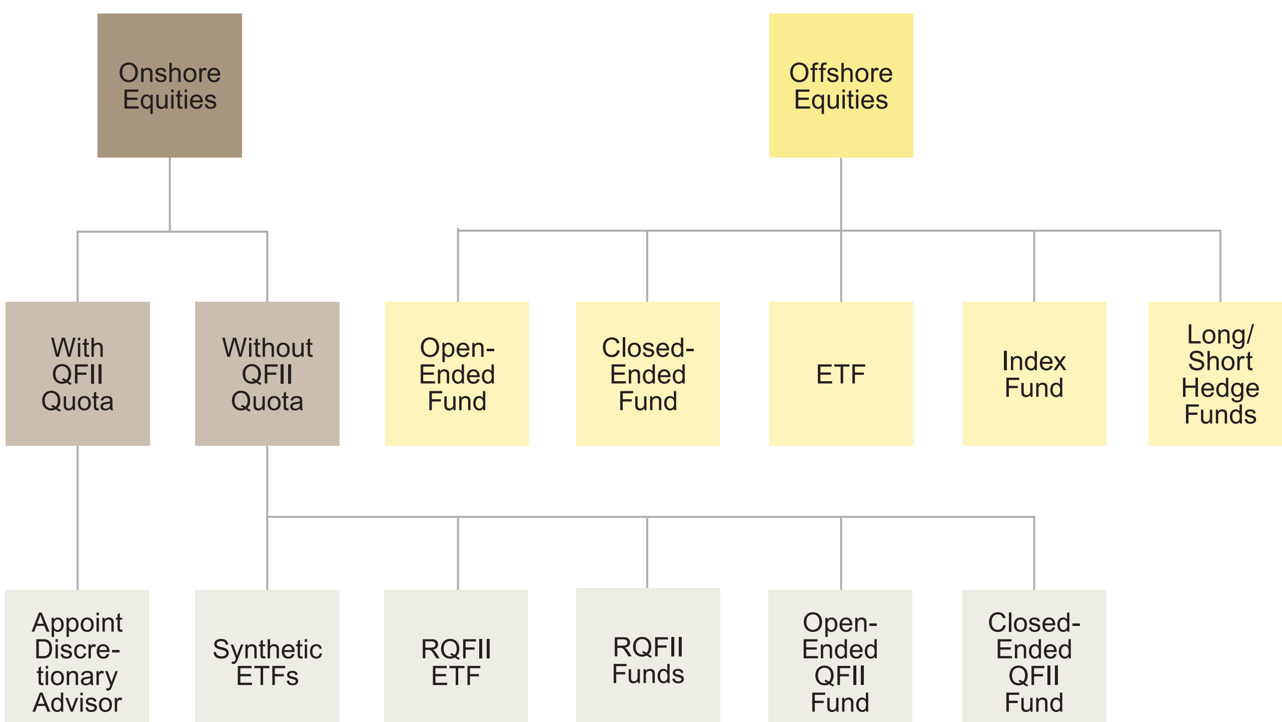
Sources: CSRC and MSCI Inc. MSCI data provided “as is” without any express or implied warranties.

as 14% of the emerging markets index, such an allocation would require a quota over $6 billion. Repatriation is also an issue. Lack of daily liquidity reduces the ability to rebalance and increases tracking error for funds. Given that weekly repatriation is only available for “open-ended China funds” that must hold 70% of their assets in China, most emerging markets or global funds would be resigned to monthly repatriation. Until large funds can scale up and access is improved, MSCI will not include A-shares in the global benchmarks.

While rumors are afoot that Chinese regulators may soon increase individual quota sizes up to $5 billion for “key” investors (particularly for sovereign wealth funds and central banks), as of September 2013 only two central banks have been granted quotas greater than US$1.5 billion. Many more are set to follow, but these institutions may be just as interested in deploying their quota into China’s fixed income market as into equities.

Nevertheless, MSCI has stated that even if its accessibility requirements are met in the near term, it will conduct a year-long “consultation” with asset managers before making any index changes. For now it seems the inclusion of A-shares in global benchmarks is two years away at best. Still, investors should monitor developments in the QFII program closely.

Figure 1. Implementation Options for Chinese Equities



RMB Qualified Foreign Institutional Investor Program: The Backdoor?

In addition to the QFII program, another investment scheme offers access to the A-share market. The Renminbi Qualified Foreign Institutional Investor (RQFII) program targets the offshore renminbi market (also known as CNH) and seeks to expand its investment options, helping to internationalize the use of the renminbi.

When launched in December 2011, the RQFII program was quite small at RMB20 billion (US$3 billion) and confined to Hong Kong subsidiaries of mainland China fund management companies. These managers were restricted to offering balanced funds with only 20% maximum allocations to equities, sold to the Hong Kong retail market. By the middle of 2012, an extra RMB50 billion in quota was extended to the same managers for the creation of physically backed A-share ETF products.

The program was initially seen as training ground for mainland fund managers to become comfortable operating in both the onshore and offshore RMB markets and marketing to non-mainland investors.

However, the program has rapidly expanded since November 2012, with the quota raised to RMB270 billion (US$45 billion) and in 2013 the program extended to include foreign asset managers with Hong Kong subsidiaries. As of September 2013, six non-Chinese asset managers have been granted quotas, although more will follow. Pilot programs will also be launched at some point in London, Singapore, and Taiwan (Figure 1).

With the 20% equity cap now lifted, there are plans to offer active A-share mutual funds in addition to ETFs and fixed income funds. While no active RQFII funds have yet been launched, a few managers have been granted permission to do so. RQFII offers daily liquidity to investors in open-ended funds, a key advantage. The program can offer daily liquidity because the currency of settlement is the CNH market, which is outside of China's capital controls.

While the RQFII program is targeted to the offshore RMB market, with Hong Kong the dominant hub, the implication of allowing foreign managers access is the potential to tap their global distribution platforms. For now, the RQFII program remains small (only US$12 billion in products launched) and geared toward retail investors. However, investors could technically access the A-share market today by purchasing ETFs trading in Hong Kong. Thus, the RQFII program potentially represents a "backdoor" entrance to China's capital markets. Further expansion of the program could over time see the launch of institutional-quality products, but for now investors will need to see how this program develops. ■