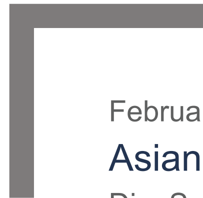

February 2013

Asian Market Commentary

Dim Sum Bonds: Still Just an Appetizer

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CAMBRIDGE ASSOCIATES LLC

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Dim Sum Bonds: Still Just an Appetizer

While the dim sum bond market has grown rapidly and there are good reasons to expect it to provide investment opportunities in the future, we do not presently advocate a direct allocation to dim sum bonds given issues such as size, illiquidity, lack of transparency, and governance.

China's growing economic strength and share in the fortunes of many multinationals are well known, but investors seeking direct exposure to the Chinese growth story have been hampered by the country's immature capital markets and investment restrictions, including capital controls. For example, just 50% of domestically listed shares float freely, and direct investment in those shares open to investment by foreigners is limited to "qualified foreign institutional investors" (QFIIs), which themselves are subject to an investment quota and maximum level of foreign investment.[1] In addition, government ownership is prevalent, control opportunities are at best highly restricted, and shareholder activism is a pipe dream.[2] Investors looking to play both sides of the equities market are constrained by the fact that short selling is mostly banned on the mainland (though not in Hong Kong).[3]

Access to Chinese bonds issued on the mainland is likewise limited to QFIIs. Indeed, bondholders seeking direct exposure to China have faced even more obstacles than equity investors, who can at least buy depository receipts for Chinese equities offshore. Investors have accessed US$-denominated Chinese debt to a very limited degree via broad emerging markets debt funds that track the J.P. Morgan Corporate Emerging Markets Bond Index Broad Diversified (corporate debt) and the J.P. Morgan Emerging Markets Bond Index Global Diversified (sovereign debt) (Figure 1).[4] However, these options obviously represent much less pure forms of exposure to Chinese bonds, which make up just 5.9% of the former index and 3.0% of the latter, and represent a substantially limited opportunity set given the $3.8 trillion onshore Chinese bond market.

The J.P. Morgan Government Bond Index Emerging Markets (GBI-EM) Broad, which tracks the performance of local currency–denominated emerging markets debt, does include a substantial weighting (presently 22.1%) to Chinese bonds. However, most managers do not consider onshore Chinese bonds investable, given access and liquidity issues. The J.P. Morgan GBI-EM Global and the J.P. Morgan GBI-EM Global Diversified—J.P. Morgan's most investable local currency emerging markets bond indices—both *exclude* Chinese (and Indian) bonds (Figure 1). Over the last few years, however, a new market for RMB-denominated bonds that is accessible by foreign investors has begun to develop in Hong Kong. This market is composed of bonds issued in CNH rather

[1] The quota under the QFII program, which was increased in April 2012 to 80 billion renminbi (RMB) from RMB 30 billion, permits the purchase of bonds and other securities. RMB 37.4 billion in quotas have been granted under the program thus far, with purchases heavily weighted toward equities. Meanwhile, institutions hold combined quotas of RMB 67 billion under the newer Renminbi Qualified Foreign Institutional Investor (RQFII) program; the ceiling on this program was raised to RMB 270 billion (from RMB 70 billion and, before that, RMB 20 billion) in the last few months.

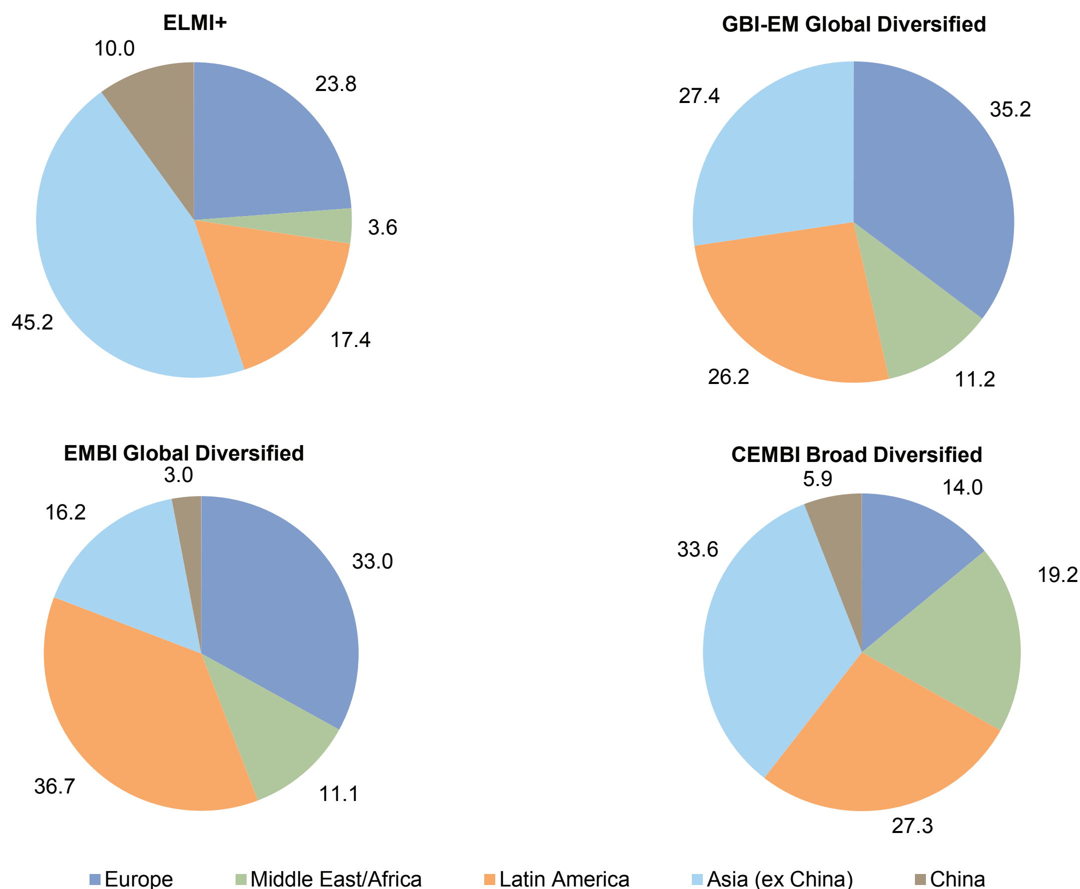
[2] As of July 2012, QFII funds were permitted to hold (collectively) a maximum of 30% of individual stocks, an increase from the prior 20% cap.

[3] Meanwhile, access to private investments in China is even more limited than access to listed securities.

[4] Traditional emerging markets bond indices thus have less exposure to China than their equity counterparts: Chinese equities make up 18.9% of the MSCI Emerging Markets Index and 2.4% of the MSCI ACWI.

Figure 1. J.P. Morgan Emerging Markets Bond Index Characteristics

As of January 31, 2013



	EMBI+	GBI-EM Global Diversified	EMBI Global Diversified	CEMBI Broad Diversified
Asset Type:	EM Currency	Sovereign Debt	Sovereign Debt	Corporate Debt
Inception:	December 31, 1993	December 31, 2002	December 31, 2002	December 31, 2001
Debt Denomination:	NA	Local	U.S. Dollar	U.S. Dollar
Average Life (Years):	53 (Days)	7.1	10.9	7.8
Yield:	3.0	5.5	4.6	4.6
S&P/Moody's Rating:	NA	BBB+/Baa2	BB+/Baa3	BBB/Baa2
Market Cap (US$ billions):	NA	988	328	266
No. of Countries Represented:	23	15	55	43

Source: J.P. Morgan Securities, Inc.
951m modified

A Note on the Renminbi

The terminology related to the Chinese currency can be confusing. While the terms "yuan" and "renminbi" are often (and misleadingly) used interchangeably, the yuan is the unit of account used for domestic purposes; the Chinese character for yuan appears on Chinese paper and metal money. The renminbi refers to the Chinese currency and is therefore used in reference to foreign exchange rates or offshore markets (although onshore prices may sometimes be listed in renminbi). The distinction is somewhat analogous to that between British pound and sterling. "Dim sum" bonds are denominated in renminbi, as are programs such as the QFII that are directed at foreign investors. We will use the terms "renminbi" and the abbreviation "RMB" interchangeably in this paper. Complicating matters further is the fact that the term CNH (literally, "Chinese yuan deliverable in Hong Kong") is the currency symbol for offshore renminbi. Unlike the CNY (the abbreviation used to refer to the onshore currency), which is managed against a basket of currencies, the CNH is allowed to float freely. The CNH and CNY normally track each other quite closely, but can diverge significantly. One example was in September/October 2011, when the CNY was much stronger against the U.S. dollar.

than CNY (see "A Note on the Renminbi" above). These bonds are commonly known as "dim sum bonds," a word play on the popular Chinese delicacy. The name is reminiscent of "samurai bonds" or "yankee bonds," terms used to describe yen-denominated debt offered in Japan by non-Japanese firms and US$-denominated debt offered in the United States by non-American companies, respectively.[5]

[5] RMB-denominated bonds issued in mainland China by non-Chinese firms are called "panda bonds." Dim sum bonds are sometimes referred to as "CNH bonds."

The dim sum bond market is still relatively small, but has grown rapidly, and there are many reasons to expect this trend to continue. We therefore look at the opportunities and risks associated with investing in dim sum bonds, as well as investment vehicles. We conclude that despite the roughly $33 billion market,[6] both passive and active manager options remain limited, particularly for large investors. However, given this market's high potential to grow and increase as a percentage of world market indices, investors would do well to monitor its development. In addition, investors with the underlying capabilities do have the option of investing directly in particular dim sum issues, while other investors may gain limited exposure through managers with broader emerging markets bond or Asian fixed income mandates.

The Dim Sum Bond Market

The dim sum bond market originated in July 2007, when China Development Bank issued a two-year RMB 5 billion bond bearing a 3% coupon. At first, only Chinese and Hong Kong banks were allowed to issue dim sum bonds. By 2009, foreign financial institutions incorporated in mainland China were permitted to issue dim sum bonds.

The market grew rapidly after restrictions were further eased in July 2010. That month, Hong Kong–listed Hopewell Highway Infrastructure became the first non-financial corporation incorporated outside the mainland to list. McDonald's

[6] For purposes of our analysis, our dim sum bond universe excludes short-term and money market instruments with maturities less than 18 months (e.g., three-month bank paper). This appears to be consistent with the practice of financial publications such as *The Wall Street Journal* and was confirmed by our data provider (which also publishes the broader data set).

followed with an issue the following month.[7] Subsequent foreign corporate issuers included Caterpillar, Unilever, and Volkswagen. The Asian Development Bank became the first supranational financial issuer in October 2010 and Baosteel became the first mainland corporate issuer in December 2011. All of these firms issued in Hong Kong.

In 2011, 76 entities issued 97 dim sum bonds worth RMB 89.5 billion (US$13.9 billion), which was 21% more than the total of *all* prior issuance. While many observers expected the market to double in 2012, issuance actually decreased slightly to RMB 88.3 billion, although it was the same in US$ terms thanks to RMB appreciation.[8] As of January 31, 2013, RMB 263 billion (US$40 billion) worth of dim sum bonds had been issued, with RMB 213 billion (US$33 billion) and 235 bonds outstanding as of January 31, 2013 (Figure 2).

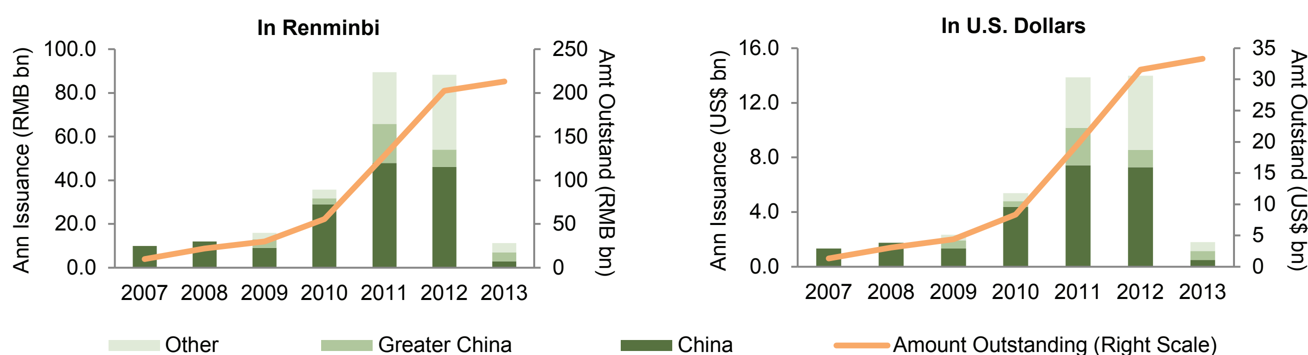
Mainland Chinese entities accounted for 55% of dim sum bonds outstanding as of January 31, and Hong Kong entities for another 13%. Other Chinese entities operating out of the Cayman Islands, Bermuda, and the British Virgin Islands also issue dim sum bonds. Non-Chinese firms, meanwhile, play an increasingly important role. For example, U.S., U.K., German, Japanese, and South Korean issuers accounted for at least 15% of the outstanding dim sum bond market, compared with just 9% in June 2011 (Figure 3).[9] As for the types of issuers, financial institutions and banks accounted for 38% of outstanding

[7] It is useful to keep in mind that the (non-financial) corporate bond market on the mainland itself only dates back to 2007.

[8] In 2012, 79 issuers sold a total of 112 bonds.

[9] Note, however, that including all outstanding short-term and money market instruments in the analysis (see Footnote 6) would skew the breakdown much more toward short-term maturities and Chinese and financial issuers.

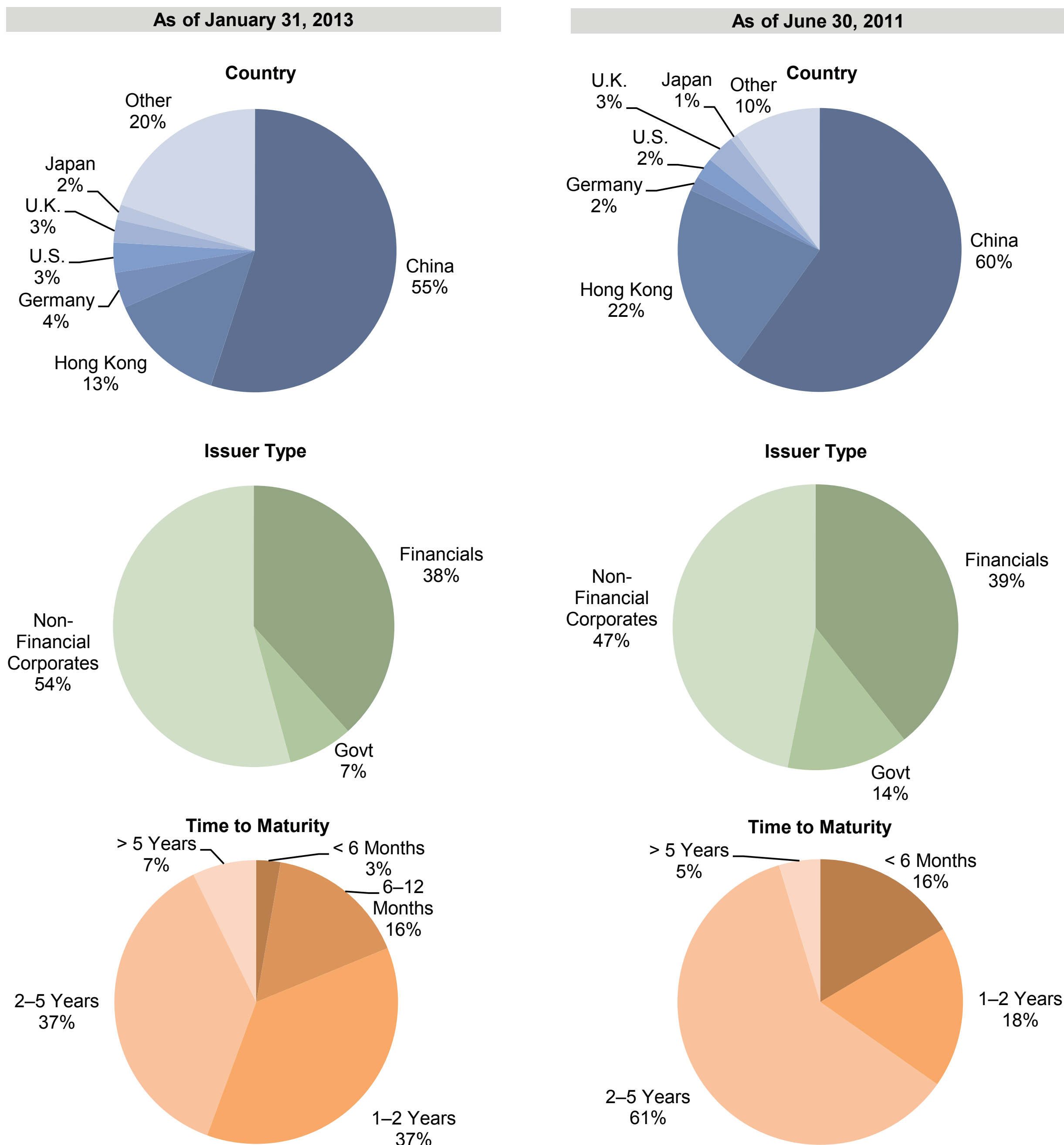
Figure 2. Dim Sum Bond Issuance
2007–13



	2007	2008	2009	2010	2011	2012	2013
Number of Issues	5	5	9	23	97	112	11
Number of Issuers	3	4	4	16	76	79	11
Avg Size per Issue (RMB bn)	2.0	2.4	1.8	1.6	0.9	0.8	1.0
Avg Size per issuer (RMB bn)	3.3	3.0	4.0	2.2	1.2	1.1	1.0

Source: Dealogic. Dealogic updates its database on a regular basis, therefore historical data may change.
Notes: Data for 2013 are as of January 31. Greater China refers to Hong Kong and Taiwan. Due to limited CNH rate history, RMB issuance is calculated using the CNY/USD rate until August 24, 2010, and the CNH/USD rate thereafter.

Figure 3. Dim Sum Bond Market: Breakdown of Outstanding Issues



Source: Dealogic.
Notes: Charts represent breakdowns of outstanding issue amounts. Dealogic updates its database on a regular basis, therefore historical data may change.

bonds, with Chinese government and quasi-government organizations (7%) and non-financial corporations (54%) accounting for the remainder (Figure 3). Tellingly, there are presently only four mainland Chinese non-financial corporations with outstanding dim sum bonds, and the three that had issued as of January 31 collectively accounted for just 5% of outstanding issuance.[10, 11]

Dim sum bond maturities are short, with only 7% of outstanding issues carrying maturities of greater than five years. Of the amount outstanding, 19% matures within 12 months, and another 37% in less than two years (Figure 3). Coupons are primarily fixed rate and 60% of deals are between RMB 300 million and RMB 1.3 billion; non-financial institutions issue in larger sizes than financials.

Performance history is very short since the market is but five years old. The three oldest indices all date back to December 2010. Their returns since inception range from 3.7% for the Bank of China (Hong Kong) (BOCHK) Offshore RMB Bond Index to 5.2% for the Citigroup Dim Sum (Offshore CNY) Bond Index, largely driven by strong performance in recent months. The BOCHK index constituents (and returns) look much like that of the third index, HSBC Offshore Renminbi Bond Index, and cover a high percentage of dim sum bonds that mature in more than one year and for which there is at least RMB 500 million outstanding, while the Citigroup index is smaller (Figure 4). However, the yield on

[10] This subset of companies is defined as Chinese firms incorporated in China.
[11] Chinese financial institutions listed on the mainland accounted for another 17% of outstanding issuance as of January 31. Non-financial corporate bonds made up a much higher percentage of the onshore bond market issuance, although state-owned enterprises dominate this market.

Figure 4. Dim Sum Bond Index Statistics
As of January 31, 2013

	BOCHK Offshore RMB Index	Citigroup Dim Sum (Offshore CNY) Index	HSBC Offshore Renminbi Bond Index
Total Return since inception (12/31/10)	3.73%	5.18%	4.34%
Avg Yield	4.33%	3.62%	3.58%
Market Cap (RMB billions)	244	149	199
Number of Issuers	119	64	120
Number of Issues	173	89	166
Average Duration	2.28	2.85	2.60
Coupon	3.90%	3.63%	3.55%

Sources: Bank of China, Citigroup Global Markets, and HSBC.
Notes: HSBC Offshore Renminbi Bond Index issue data and BOCHK Offshore RMB Index statistics are as of January 16. Total returns are in local currency.

the HSBC index has been lower than that on the BOCHK index since shortly after inception. Today, the average yield and coupon on the HSBC index more closely resembles that of the Citigroup index than that of the BOCHK index. The yield on the latter index has ranged from a low of 1.74% in January 2011 to a high of 6.27% in October 2011—even as equity markets rallied. It fell to a 19-month low of 4.2% as of January 31, 2013—higher than that on the regional Asian local currency bond benchmark (the HSBC Asian Local Bond Index), but less than that on the broader emerging markets bond index (Figure 5). The HSBC and Citigroup indices both yielded 3.6% as of January 31.

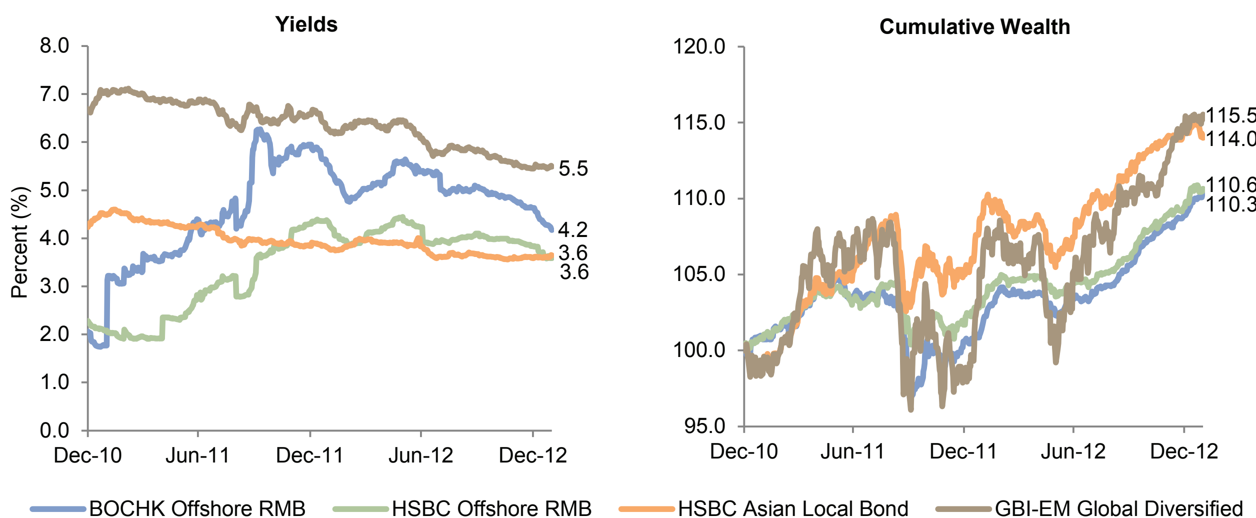
Market Outlook

Factors Supporting Market Development

The dim sum bond market is still less than 1% the size of the onshore Chinese bond market, which itself accounted for less than 4% of the global bond market as of December 2011. The underrepresentation is even greater with respect to non-financial corporates. A strong case can be made, however, that the dim sum bond market, particularly its new corporate component, will continue to grow rapidly because of the benefits it offers to its various constituents. For example, Chinese corporations can sometimes secure funding at lower rates than on the mainland thanks to high external demand,[12] expectations (now diminished) for RMB appre-

[12] For example, the yield on a recently issued three-year RMB 1.5 billion Huaneng Power International dim sum bond was 3.85%, compared to an onshore issue from the same firm that matures in about one year and yields 4.58%.

Figure 5. RMB Bond Indices Versus Emerging Markets Bond Local Currency Indices
December 31, 2010 – January 31, 2013



Source: Thomson Reuters Datastream.
Note: On the cumulative wealth graph the indices have been rebased to 100 at December 31, 2010.

ciation, and the fact that offshore investors may not fully appreciate the credit risk.[13]

Non-Chinese companies, meanwhile, have benefited from a supply/demand imbalance as well as the fact that it has sometimes been cheaper to issue in CNH and swap into their home currencies (e.g., U.S. dollars) than to issue in such currency thanks to the sharp decline in transaction costs.[14] Regulations were amended in late 2011 to allow firms to repatriate funds to China,[15] giving them the opportunity to invest or match exposures on the mainland, thereby neutralizing currency risk. This has perhaps become more important for non-Chinese firms than the opportunity to issue at lower rates (which was available until late 2011). Dim sum bonds also allow corporations to access a retail and institutional investor base in Hong Kong with substantial RMB holdings (Figure 6).

Offshore investors are likely to support the dim sum market. Dim sum bonds, particularly those issued by Chinese entities, offer yield, diversification, and exposure to the Chinese growth

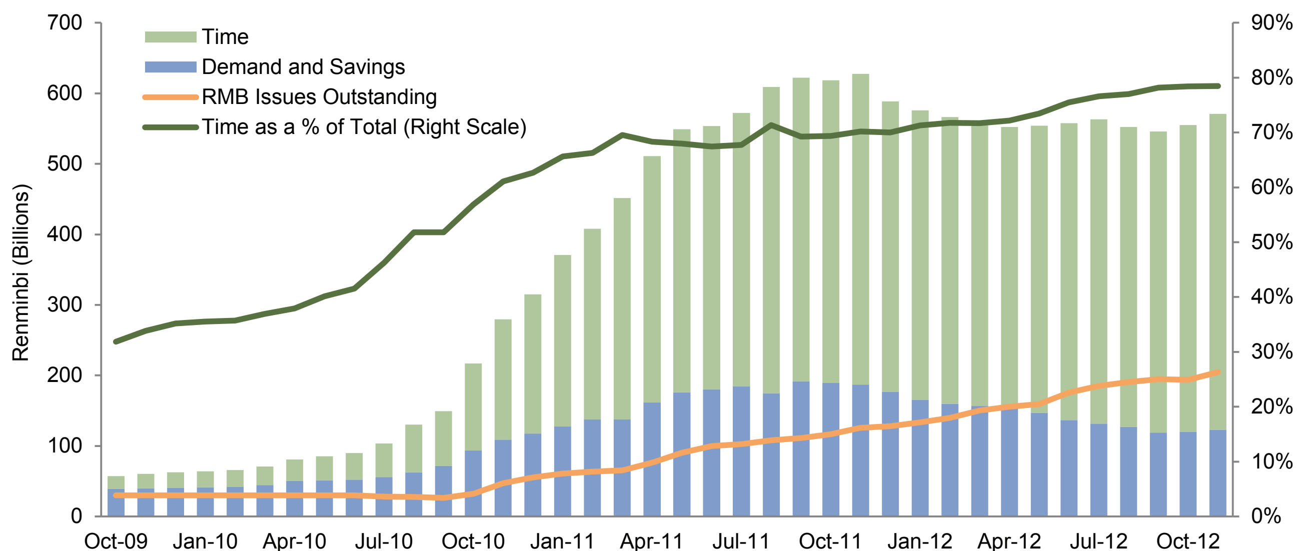
[13] One manager with whom we spoke last summer estimated that offshore yields came in at roughly 200 basis points (bps) lower than onshore yields as a result of mispriced credit risk. In addition to the basic issue of the credit quality of the issuer, the buyer's ability (or lack thereof) to have legal recourse to mainland-based assets is important.

[14] However, foreign firms may no longer be able to issue at spreads that are tighter than those denominated in other currencies such as the U.S. dollar, which was likely the result of expectations that the renminbi would appreciate against the dollar. Moreover, companies with access to inexpensive financing at home thanks to loose monetary policy may have less incentive to issue in renminbi. In such circumstances, the role of those firms that plan to use RMB proceeds to invest on the mainland assumes increasing importance.

[15] For a short period prior to this, RMB-denominated foreign direct investment was permitted on the mainland on a case-by-case basis.

Figure 6. Renminbi Deposits in Hong Kong

October 31, 2009 – November 30, 2012



Sources: Dealogic and Hong Kong Monetary Authority.

Note: Dealogic updates its database on a regular basis, therefore historical data may change.

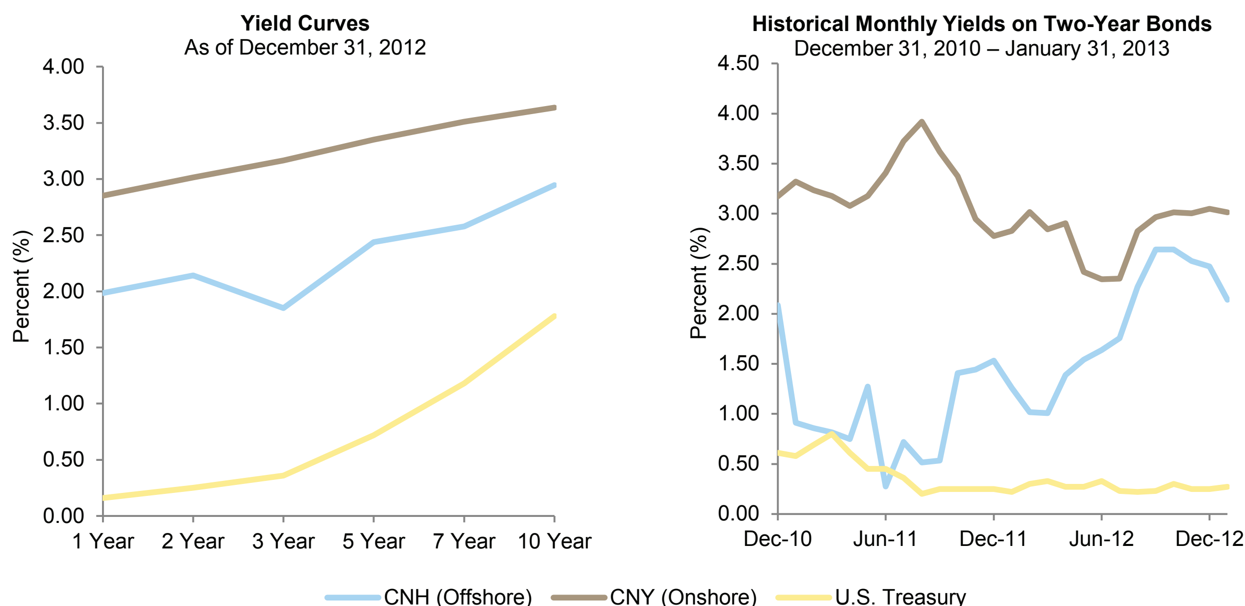
story, and may represent an attractive currency play. While RMB appreciation has leveled off—a fact reflected in lessened investor interest in dim sum bonds—the currency would likely strengthen significantly if it becomes a reserve currency (more likely a longer-term proposition). For mainland investors, although local bonds still offer higher yields (Figure 7), dim sum bonds can provide exposure to foreign credits without the currency risk.

A strong dim sum market would also benefit other parties, such as issuing or trading banks and asset managers. It can help Hong Kong diversify its securities market and maintain its position as a leading financial center—or assist other jurisdictions in their own competitive efforts. Hong Kong already faces competition from the mainland: the Shanghai and National Development and Reform Commission published a plan in January 2012 that would, *inter alia*, encourage foreign companies to issue RMB-denominated bonds on the Shanghai Stock Exchange. Hong Kong penned a deal with the United Kingdom that same month aimed at turning the City of London into an offshore trading center for the renminbi. Three months later, HSBC launched a three-year RMB 2 billion (US$300 million) bond in London, the first RMB bond issued outside of China or Hong Kong.[16]

In September 2012, the Singapore Exchange approved a plan to list the first Singapore RMB-denominated fund, a REIT. Significantly, as discussed below, dim sum bonds are an important element in China's broader effort to make the renminbi an international currency. In short, it bodes well for the future of the dim sum bond market that the interests of so many parties are aligned with its growth.

[16] European investors took up 60% of the issue, with most of the rest purchased by Asian investors.

Figure 7. Chinese Offshore and Onshore Yields



Sources: Bloomberg L.P., FactSet Research Systems, and Thomson Reuters Datastream.

Cautionary Factors

Of course, like any other investments, dim sum bonds carry risk, most notably credit risk. The vast majority of outstanding bonds are unrated, which means that they have not passed even the most rudimentary rating agency or financial tests.[17] Bonds also generally lack the protective covenants that are standard in US$ bond issues. There is a question mark surrounding the security of assets backing these bonds, which are often issued by holding companies with no operating revenues. As with all bonds, there is counterparty risk. Investors should not expect that Chinese state officials will necessarily be sympathetic to their concerns in the event disputes arise.

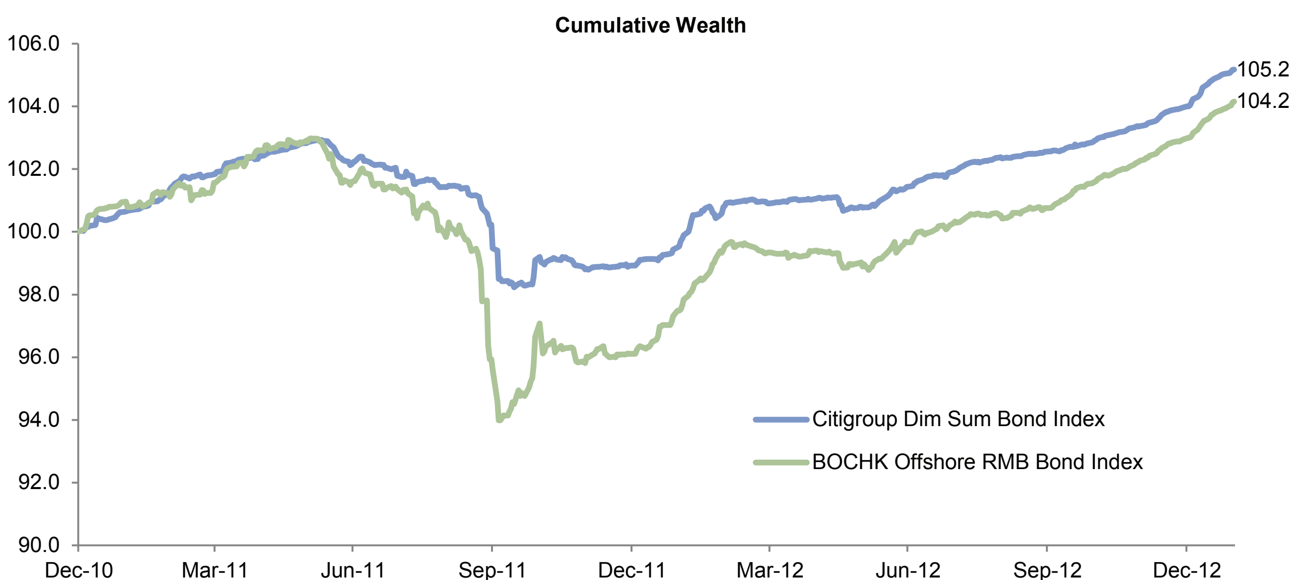
Bond prices can be hit if the cost of funding in Hong Kong exceeds that in other issuer jurisdictions or if there is a rise in inflation or interest rates. Liquidity has never been high: daily trading volume in dim sum bonds was about $150 million as of early 2012; while much higher than even a few months earlier, this figure still paled in comparison with the $13 *billion* to $21 *billion* (CNY 80 billion to CNY 130 billion) traded each day on the mainland as of December 2011. Bid-ask spreads, meanwhile, are much higher than for onshore Chinese bond trading, let alone the spreads in developed bond markets.

Dim sum bonds are unlikely to protect in strong risk-off environments. Thus, between early July and October 2011, the BOCHK Offshore RMB Bond Index lost 7.2%, with bond yields jumping by nearly 200 bps. The Citigroup Dim Sum (Offshore CNY) Bond Index held up better, returning -2.8% (Figure 8). Multinationals like Caterpillar and Tesco have reportedly inserted

[17] Admittedly, many bonds are issued by Chinese government entities.

Figure 8. Performance of Dim Sum Indices

December 31, 2010 – January 31, 2013 • Rebased to 100 at December 31, 2010



Source: Thomson Reuters Datastream.

provisions into their bond documents allowing them to postpone payments and settle transactions in U.S. dollars instead of RMB in certain circumstances, raising further uncertainty over realizable returns.

In addition, decisions made in Beijing can have a big impact on the market, affecting RMB flows into and out of Hong Kong or other offshore markets, liquidity, and supply.[18] Indeed, the offshore deposit pool is down from its fourth quarter 2011 peak as funds have flowed back to the mainland or into local time deposits, which now account for 78% of all deposits, compared with 32% in October 2009. The RQFII program that began in December 2011 could hurt demand for dim sum bonds, as could other liberalizing measures associated with China's push to make the renminbi an international currency and Shanghai a top international financial center.[19] This program allows the Hong Kong subsidiaries of Chinese brokerages and fund managers incorporated on the mainland to use renminbi they have raised offshore to purchase mainland-issued securities (primarily fixed income products) and to sell these securities to foreign institutional and retail investors. For investors, this represents a new way to access onshore Chinese bonds but raises other challenges such as a different governing law, withholding taxes, and legal risks (issues are rated by Chinese rather than international ratings agencies).[20]

Finally, expectations for continued RMB appreciation have waned. The currency appreciated 24% on a trade-weighted basis (and 21% against the U.S. dollar) between July 2005 (when the peg against the U.S. dollar was removed) and February 2009 (Figure 9). However, it then depreciated 11% over the next 26 months and has still not recovered to its 2009 high (on a trade-weighted basis).[21] The decline came as a surprise to many investors.

Meanwhile, the opportunity for a direct play on the renminbi has increased thanks to the launch of deliverable offshore CNH futures.[22] The forward market was previously limited to US$-denominated non-deliverable instruments. (Foreigners continue to face restrictions in the onshore CNY market.) This could reduce demand for dim sum bonds. Of course, it could also increase the liquidity and robustness of the market as investors focus more on yields and issuer creditworthiness.

Chinese Premier Wen Jiabao said in a March 2012 speech that the renminbi was close to its "equilibrium value," a view echoed by People's Bank of China Governor Zhou Xiaochuan.

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[18] For one thing, the People's Bank of China pays the interest paid on offshore CNH deposits held in Hong Kong. The People's Bank of China jointly regulates the CNH market with the Hong Kong Monetary Authority.

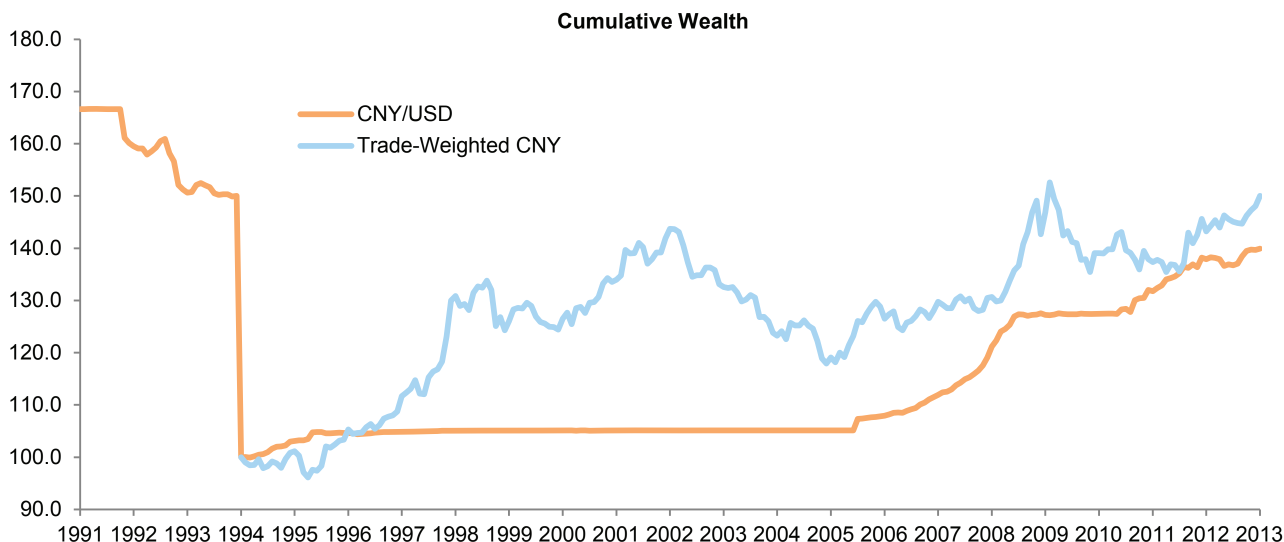
[19] However, fees for RQFII funds were reported in September 2012 to be high—an upfront fee of 3% to 5% for most funds, with annual management and custodial fees of around 150 bps. An RQFII plan is also expected to be launched in Taiwan. As of February 2013, Taiwanese citizens were allowed to deposit renminbi in local banks.

[20] The chairman of the China Securities Regulatory Commission revealed in mid-January 2013 that an "RQFII 2" program is being prepared as well, but details were not provided.

[21] According to the Bank for International Settlements, the currency has appreciated since July 2005 in real terms by ~30% against a basket of currencies used by 61 economies. Despite losing ground against the U.S. dollar in the first seven months of 2012, the renminbi/yuan is now at a post-1994 high versus the greenback in nominal terms. (The Chinese government devalued the currency substantially in 1994.)

[22] This began in June 2010 with offshore CNH futures deliverable in Hong Kong. In February 2013, CME Group began offering USD/Offshore RMB (CNH) futures, in addition to its existing RMB/USD futures.

Figure 9. Chinese RMB Appreciation
January 31, 1991 – January 31, 2013 • Rebased to 100 at January 31, 1994



Sources: J.P. Morgan Securities, Inc. and Thomson Reuters Datastream.
Note: Graph uses monthly data.

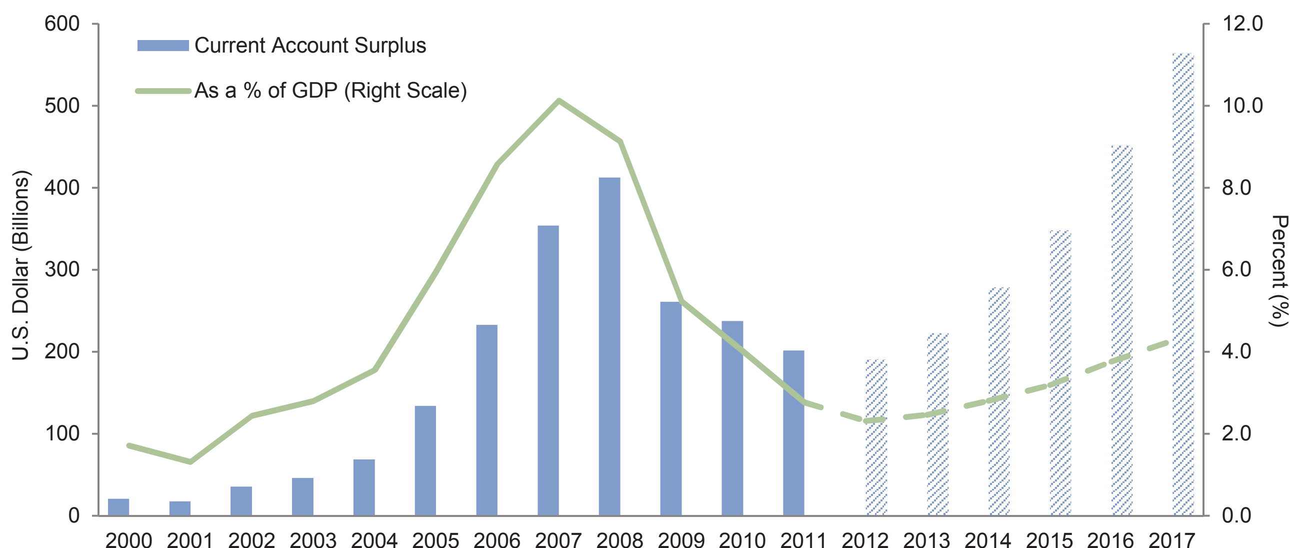
Last July, the International Monetary Fund changed its evaluation of the currency from "substantially undervalued" to "moderately undervalued" against a basket of currencies. This view is supported by purchasing power parity data and, from 2008 through 2011, a sharp narrowing of China's trade and current account surpluses, both in absolute terms and as a percentage of GDP (Figure 10). Deliverable and non-deliverable forwards imply *depreciation* of 140 bps to 180 bps against the U.S. dollar over the next year (Figure 11). Indeed, China's decision to increase QFII and RQFII quotas may have reflected concern about a potentially prolonged weakness in the renminbi.[23]

Relationship with Onshore Market and Broader Chinese Policy Goals

The dim sum market must not be viewed in isolation as its development is tied to broader Chinese policy goals. China's closed capital markets are a legacy of both its long pre-1992 history without national capital markets and its subsequent efforts to maintain control of economic growth. Given the pace of growth over the past two decades, it is hard to argue with the results achieved in domestic economic terms. The policy has, however, been a prime contributor to huge global trade and investment imbalances and appears unsustainable in the longer term, and has created significant trade tensions with the United States and other countries that view the renminbi as artificially weak. Moreover, capital controls may continue to hinder China's ostensible efforts at more consumption-led growth.

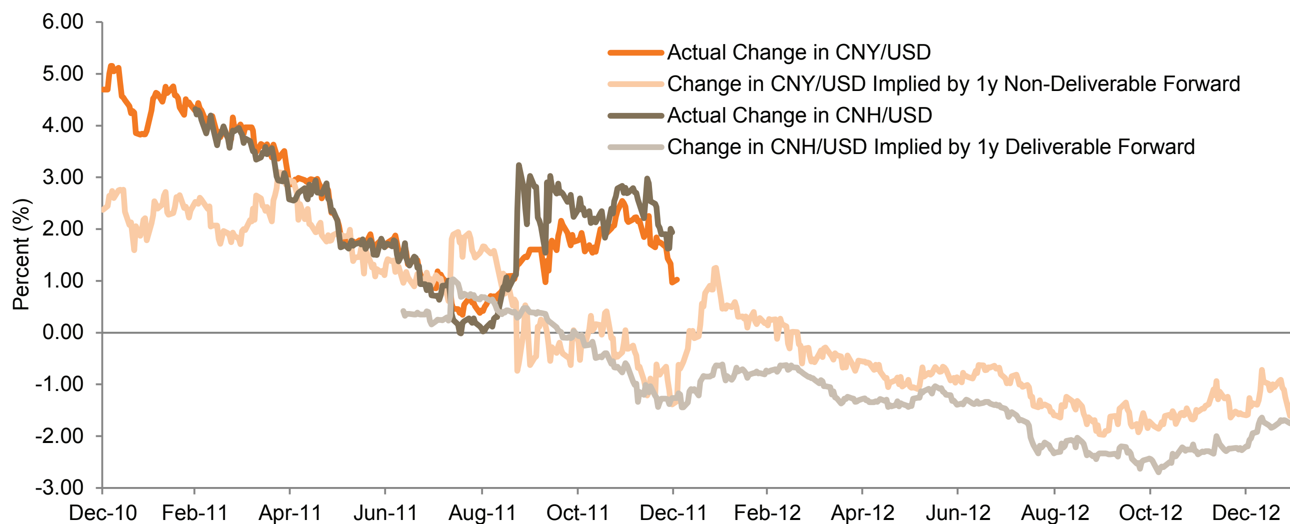
[23] These measures could also be viewed as encouraging signs of Beijing's efforts to open and modernize the market. On the other hand, it can be argued that China attempted to prop up the renminbi as the U.S. presidential election loomed.

Figure 10. China's Current Account Surplus
2000–17



Source: International Monetary Fund - World Economic Database, October 2012.
Note: Striped bars represent IMF estimates.

Figure 11. Historical Implied Versus Actual Change in Chinese Renminbi Versus U.S. Dollar
December 31, 2010 – January 31, 2013



Source: Thomson Reuters Datastream.
Notes: CNH/USD represents the offshore renminbi deliverable in Hong Kong. CNY/USD represents the non-deliverable onshore renminbi. Spot rates are graphed on a 12-month lag to indicate the percentage change in the actual spot.

For China to assert itself fully on the international stage, it will ultimately need to liberalize its markets and currency regime. As far back as 1993, Deng Xiaoping, the architect of China's economic modernization, identified allowing the renminbi to gradually become a convertible currency as a crucial objective. Yet as the think tank Chatham House has noted, convertibility and opening of the capital account have always *preceded* the international use of a currency: "The attempt to create an international and eventually fully convertible currency through a policy-driven process is unprecedented—nothing like this has ever been tried before, even partially."[24]

Hong Kong is serving as a laboratory for China's effort to promote RMB internationalization prior to full liberalization. The dim sum bond market enables Chinese firms both to access capital and to diversify their funding away from bank lending, and, at the same time, gets investors accustomed to supplying capital to issuing entities. Related reforms have included allowing Chinese companies (beginning in 2009) to settle their import or export bills in renminbi,[25] the inception of the RMB interbank market in 2010 (following an agreement between the People's Bank of China and the Hong Kong Monetary Authority), the growth of the Hong Kong RMB bank deposit market,[26] and currency swap agreements with at least 17 countries. Hong Kong Exchanges and Clearing Limited introduced RMB currency futures in third quarter 2012.[27] All of these measures are supportive of a growing and more liquid dim sum bond market.

Investability

As noted earlier, broader investable emerging markets bond indices offer little exposure to Chinese debt denominated in renminbi (or in US$ terms, for that matter). Even if investors decide that the value proposition for a direct allocation to dim sum bonds outweighs the concomitant risks, implementation challenges are likely prohibitive at this point in time. As of December 2011, 36 asset managers (16 in Asia and 20 outside the region) are said to have launched dim sum bond funds, with an estimated $4.2 billion in total assets under management.[28] While this figure is very small relative to total outstanding Chinese debt, the overwhelming majority of Chinese debt is accessible only via the onshore market. As the above discussion indicates, demand for dim sum bonds still outstrips supply.

Dim sum bond funds therefore tend to hold much more than just dim sum bonds. Indeed, it was estimated that just half of their assets under management at the end of 2011 were actually invested in dim sum bonds—the remainder was invested in currency deposits or US$-denominated China bonds linked with

[24] Paola Subacchi, "One Currency, Two Systems: China's Renminbi Strategy," Chatham House, October 2010, p. 4.

[25] In 2011, 10% of China's trade was settled in renminbi. However, as the *Financial Times* has noted, "the bulk of the renminbi trade deals so far has taken place between Chinese companies and their offshore subsidiaries, often for the purposes of financial arbitrage." Robert Cookson, "Renminbi Begins to Go Global," *Financial Times*, May 23, 2012.

[26] This includes certificates of deposit. Offshore RMB deposits in Hong Kong now represent 9.5% of total banking deposits compared with almost nothing in 2009.

[27] In addition, in 2013 Taiwanese banks will be permitted to clear transactions in renminbi.

[28] Cerulli Associates, "Keeping the Dim Sum Warm," *Asia Monthly Product Trends*, February 2012. Three exchange-traded funds (ETFs), all of which incepted in September or October 2011, also exist, but they cumulatively hold less than US$28 million in assets. Like the mutual funds, these ETFs include a substantial amount of currency forwards as well as bonds of non-Chinese issuers.

CNH forward currency hedges. Given disappointing 2012 issuance numbers, the situation is unlikely to have changed materially, making the high fees even more unattractive. It can also be hard to differentiate among funds.

Moreover, investors intoxicated by the idea of such bonds providing exposure to the Chinese growth story will likely be sobered by the makeup of the actual dim sum bond universe, which is almost entirely bonds issued by financials, Chinese government–related entities, or non-Chinese entities. While investors can conceivably buy individual dim sum issues directly in Hong Kong, this is not really a viable option (for a variety of reasons) for the vast majority of institutions or families. Even locally based funds, which have access to a local client base with RMB-denominated bank accounts, do not necessarily view the dim sum bond market as a standalone market. The market's illiquidity—the result not only of its small size, but also because local banks are holding many dim sum bonds to maturity—means that funds (and hence investors) cannot really "buy" the market in its current state.

Conclusion

There is much to like about the dim sum bond market. It provides a way in which investors can access the Chinese growth story while diversifying their portfolios, has grown quickly, and seems poised for good long-term growth given the alignment of interest among issuers, investors, and other interested parties. The continued development of new dim sum bond indices and the efforts of different jurisdictions to develop markets for the issuance of these bonds also suggest high expectations. Over time, dim sum (as well as onshore) bonds are likely to become much more prominent in broader debt indices.

At the same time, the market is still small and illiquid, and suffers from governance issues and a lack of transparency. Fees are high, particularly given the fact that the limited number of dim sum bonds means that investors will get substantial exposure to currency deposits or non-RMB bonds, as well as to RMB-denominated bonds issued by the Chinese government or by non-Chinese or supranational entities. These may provide some safety and yield, but they are less likely to produce outsized returns corresponding to Chinese growth. Dim sum bond valuations are also subject to the vagaries of Chinese government policy; for example, while the offshore RMB market was created explicitly as part of a process to make the renminbi more international while keeping domestic markets sequestered from global markets, programs such as the RQFII have opened up such markets somewhat.

For these reasons, we do not presently advocate a direct allocation to dim sum bonds. We are comfortable with emerging markets debt managers holding these bonds (whether in renminbi or hedged). In the medium term to longer term, we think it may be worthwhile to directly allocate funds to dim sum bonds and therefore advise investors to monitor the development of this market, as we certainly will continue to do. ■