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GLOBAL MARKET COMMENTARY

REASSESSING THE HONG KONG MARKET

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Seth Hurwitz
Marcelo Morales
Andrew Kim

Reassessing the Hong Kong Market

Introduction

In our recent paper, *Investing in Asia*, we discuss the benefits of investing in mature and stable Asian markets, which offer both homegrown benefits and the opportunity to capitalize on continued Chinese growth. Hong Kong is one such market. Despite its population of just seven million, Hong Kong's strong legal and regulatory tradition has helped it maintain one of the world's largest stock exchanges. Moreover, the region's unique status as both part and not part of China has allowed its capital markets to benefit from the mainland's growth. At the same time investors in the Hong Kong stock market should understand that there are significant differences in the degree to which exchange-tracking indices include Chinese shares, and that the increasing prominence of Chinese companies on Hong Kong's stock exchange has been changing the character of the market.

Market Overview

Hong Kong's first formal stock market was established 115 years ago, although there had been at least 25 years of securities trading by that time.[1] The Stock Exchange of Hong Kong Limited (the Exchange) is one of the world's most sophisticated stock market regimes. It operates pursuant to the territory's laws, Securities and Future Commission (SFC) regulations, administrative procedures, and guidelines, and the Exchange's own rules and regulations. The SFC, a statutory body that is not part of the civil service, oversees the Exchange. The SFC chairman and other directors are appointed by Hong Kong's chief executive for fixed terms.

The number of companies listed on the Exchange[2] has grown steadily since 1990, as has total market capitalization (Tables A and B). As of June 30, 2006, the Exchange boasted 948 companies with a market capitalization of US$1.26 trillion. Since 1999 the Exchange also has had a Growth Enterprise Market section, on which 200 smaller firms with a market capitalization of US$10.6 billion were listed as of June 30, 2006.

The Exchange includes a significant number of "Chinese" entities, both red-chip and H-share companies. Red-chip and H-share firms each have the Chinese government or one of its entities as their ultimate controlling shareholder.[3] However, while H-share firms are incorporated on the mainland, red chips are incorporated overseas (including Hong Kong). H-share companies have been permitted to list on the Exchange since July 1993.

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[1] More information is available at the extensive website of the Exchange's parent company, the Hong Kong Exchanges and Clearing Limited (http://www.hkex.com.hk/).

[2] Unless otherwise noted, references to the Exchange refer only to the stocks listed on the Main Board of the Exchange.

[3] Ultimate control of red-chip companies means that Chinese government-controlled entities directly or indirectly hold at least 20% to 30% ownership, depending on certain factors. See Martin Wheatley, "Hong Kong: A prime centre for Chinese companies in the primary IPO and secondary markets," Mondo Visione, 2006, available at http://www.exchange-handbook.co.uk/index.cfm?section=articles&action=detail&id=60625.

Investing in Exchange-Listed Firms

Investors seeking to track the performance of Exchange-listed companies can choose from various options. A broad index, which tracks some 200 stocks and aims to cover 90% of the market cap of stocks listed on the Exchange, is the Hang Seng Composite Index. The Hang Seng Index (HSI), is a more focused subset of the Composite Index, which tracks 33 large-capitalization shares that account for approximately 70% of the market cap of eligible stocks listed on the Exchange. Historically, H-share companies have been excluded, but the HSI compilation methodology has recently been revised to reflect the growing importance of Chinese firms. Effective August 2006 H-share companies, subject to certain conditions,[4] will be eligible for inclusion in the HSI. Red chips accounted for 31.8% of the market weight of the HSI as of June 27, 2006. The HSI has used a full market capitalization-weighted formula, but from September 2006 to September 2007 will move to a free float-adjusted market capitalization-weighted formula with a cap on individual stock weightings.[5]

Morgan Stanley Capital International has a Hong Kong Index (MSCI Hong Kong) which, like the other MSCI country indices, targets 85% of each industry group's free float-adjusted market capitalization, thereby capturing 85% of the (eligible) local market cap. However, investors should be aware that Chinese companies listed in Hong Kong will generally be captured in the MSCI China Index rather than in MSCI Hong Kong.[6] Only one Chinese company is represented among the 42 firms that make up MSCI Hong Kong. As a result, even though all but one of the 23 non-Chinese companies that make up the HSI are part of MSCI Hong Kong, the two indices are substantially different.[7]

A variety of other indices cover more specialized sectors (by size, style, industry, etc.) of Exchange-listed firms. Moreover, there are also a number of exchange-traded funds (ETFs) that track the Exchange, including the Tracker Fund of Hong Kong, the Hang Seng Index ETF, and MSCI Hong Kong iShares.

Reassessing the Hong Kong Market

Along with Japan and Singapore, Hong Kong has long been considered one of only three developed Asian markets. It is attractive both to companies—more than 80% of Exchange-listed companies are incorporated outside Hong Kong[8]—and to investors, who recognize the benefits of Hong Kong's free economic system and strong legal and regulatory regime. Nevertheless, although its risk and return

[4] As of June 26, 2006, 20 H-share companies met the conditions for inclusion in the HSI.
[5] HSI Services Limited press release, June 30, 2006.
[6] Although the MSCI China Index can also include B shares listed in the Shanghai and Shenzhen and N shares listed in New York, Hong Kong-listed companies presently make up 78 of its 80 constituents. Chinese companies that derive more than 80% of their revenues and profits from Hong Kong will be included in MSCI Hong Kong rather than MSCI China.
[7] HSBC, which is excluded from the MSCI Hong Kong index, makes up about 30% of the HSI, and therefore is also a major reason for the difference between the two indices.
[8] Martin Wheatley, "The standard of governance required of listed companies and the role the SFC plays in stamping out corporate corruption and management misconduct," The 3rd Independent Commission Against Corruption Symposium, May 10, 2006 (hereafter "Wheatley, 'The standard of governance'").

characteristics have differed from those of emerging Asia, including China (Table C), the Hong Kong market has clearly been viewed as a door into the mainland ever since China began its free market reforms. This may help explain Hong Kong's very high GDP growth rate (Table D).

Over the last several years, the Exchange's composition has changed significantly. Property sector firms, which made up 26.5% of the Exchange's market cap at the close of 1995, dropped to 14.6% in 2000, and 10.6% as of June 30, 2006. Industrials grew substantially, from 7.0% in 2000 to 17.4% as of June 30, 2006. The financial sector rose from 24.3% to 38.9% over this period (Table E)—and will no doubt be substantially higher by the end of 2006 thanks to the Bank of China initial public offering (IPO) in June and the planned IPO of the Industrial and Commercial Bank of China (China's largest lender) this fall.

The growth in the number of Exchange-listed companies and the increased number of H-share companies has also resulted in a slightly less concentrated market. Whereas the Exchange's largest five and ten companies made up 45.3% and 58.1%, respectively, of its total market capitalization five years ago, the comparable numbers today are 38.5% and 49.6%. The difference is reflected in the tracking indices as well. Whereas just three companies accounted for 53% of MSCI Hong Kong five years ago, the top eight now account for 51.3%.

The most important change over the last several years has been the increasing role of Chinese firms as a result of large H-share company IPOs. The amount of money raised in H-share IPOs on the Exchange in 2005 (US$17.7 billion) was 26.2% greater than for the four previous years combined—and 2006 is on pace to be 41.3% higher than last year. Growth in 2005 was due in part to the suspension of China's domestic IPO market from the second quarter of 2005 until mid-2006 while listed companies began programs to make their nontradable shares (which constituted about two-thirds of the stock market's capitalization) tradable.

The upshot? The market capitalization of H-share companies as a percentage of the Exchange has tripled from 6.9% in 2004 to 20.1% today. H-shares and red chips (which have accounted for approximately 21% to 23% of the Exchange's market cap for the last five years) now make up 41.2% of the Exchange's market cap (Table F) despite the fact that they account for only 18.2% of the number of companies.[9] Moreover, H-share and red-chip companies presently account for 53.5% of market turnover. Four of the six largest firms by market cap on the Exchange today are H-share companies compared with just one in 2001.

Implications for Investors

Hong Kong has for many years attracted investment not only because of its strengths as a developed market but also, as suggested earlier, because it has been as a safer way to play the China growth story than directly investing in domestically listed Chinese equities. Compared with the Exchange, the Shanghai and

[9] As of June 30, 2006 the Exchange's 948 members included 87 red chips and 86 H-share companies. Privately owned Chinese firms are also listed on the Exchange.

Shenzhen stock exchanges have small market caps, limited product offerings, and are illiquid and not subject to a strong and transparent regulatory authority.

Yet the jump in the number of H-share listings means that the Exchange is increasingly becoming a direct China play. This has some obvious benefits for investors. The listing of Chinese companies on the Exchange has helped diversify it, for example, with less weight to the local real estate market and more weight to global industries, such as industrials, energy and financials. H-share companies provide investors with new opportunities and a way to invest in Chinese firms under conditions that should inspire some measure of confidence since H-share companies are subject to the same rules as all other Exchange-listed firms.

On the other hand, investors also need to recognize that in terms of its listed companies Hong Kong is starting to look much more like an emerging market than it has in the past. Can investors be comfortable that H-share companies will have been properly vetted before listing and that Hong Kong regulators will have sufficient enforcement and other powers over them after listing?

Indeed, earlier this year Martin Wheatley, the Chairman of the SFC, referred to "executives who disappear across the border before they can be brought to justice" and expressed his concern that the SFC has no jurisdiction on the Mainland. The SFC must rely on the co-operation of the China Securities Regulatory Commission (CSCR) in order to provide effective enforcement.[10] While emphasizing that relations with the SFC's Chinese counterpart were excellent, Wheatley called for augmented CSRC power and CSRC accession to the multilateral agreement to which the great majority of world securities markets belong.[11]

Conclusion

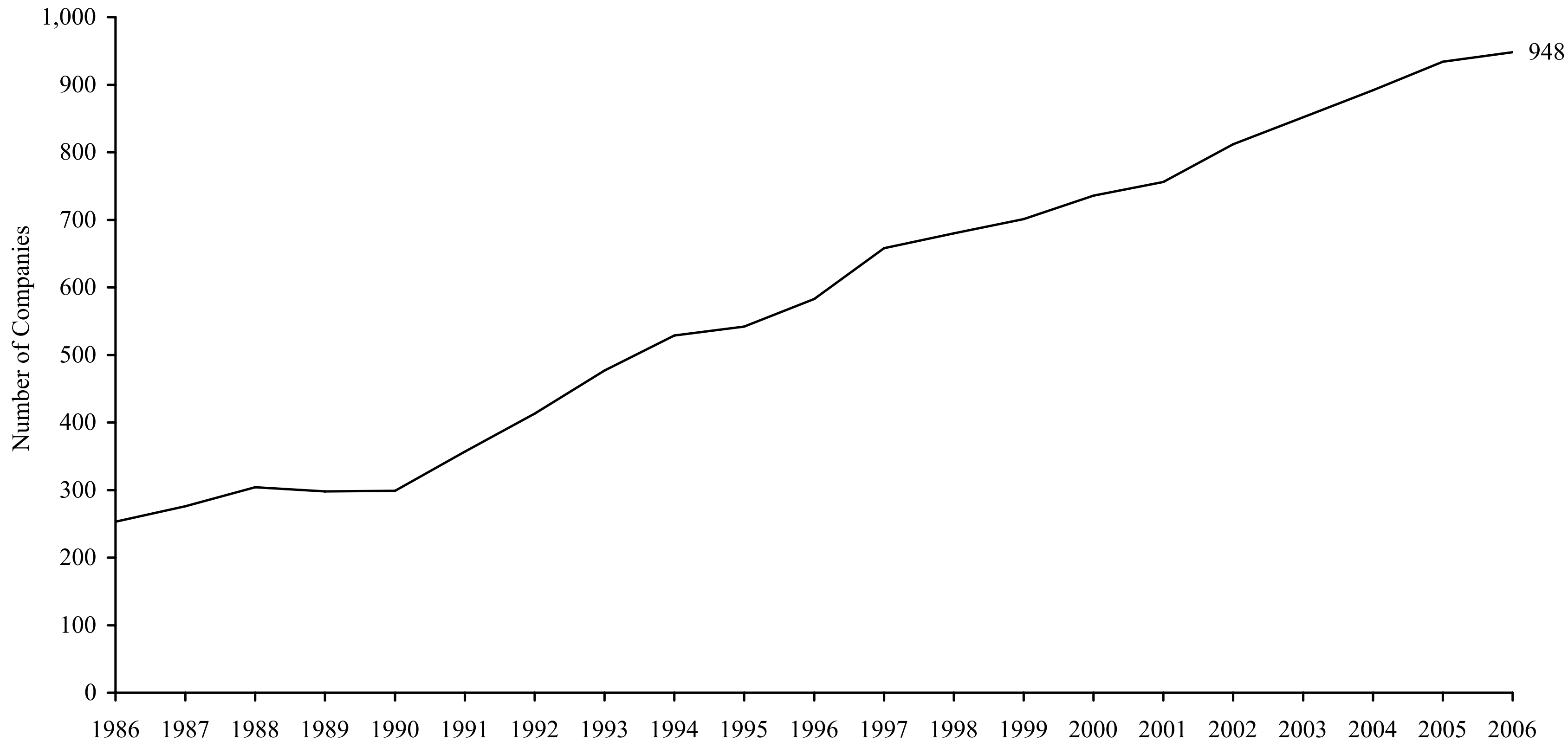
The Hong Kong Exchange is becoming an increasingly useful market for obtaining direct exposure to mainland Chinese companies. However, vehicles tracking the Hong Kong market can vary significantly in the degree to which they include exposure to Chinese firms. Furthermore, investors should be aware that the character of the Hong Kong market has changed significantly. Prospective risk and return characteristics may bear more similarities to emerging markets than to developed markets. At the same time, the Exchange has become more diversified across sectors and slightly less concentrated in its largest holdings.

[10] Wheatley, "The standard of governance."
[11] In June 2006 the chairman of the CSRC announced that the CSRC would apply later in 2006 to sign on to the agreement (for cross-border enforcement cooperation). Justine Lau, "China regulator aims for cross-border powers," *Financial Times*, June 8, 2006.

Table A

NUMBER OF LISTED COMPANIES FOR THE HONG KONG STOCK EXCHANGE

1986-2006



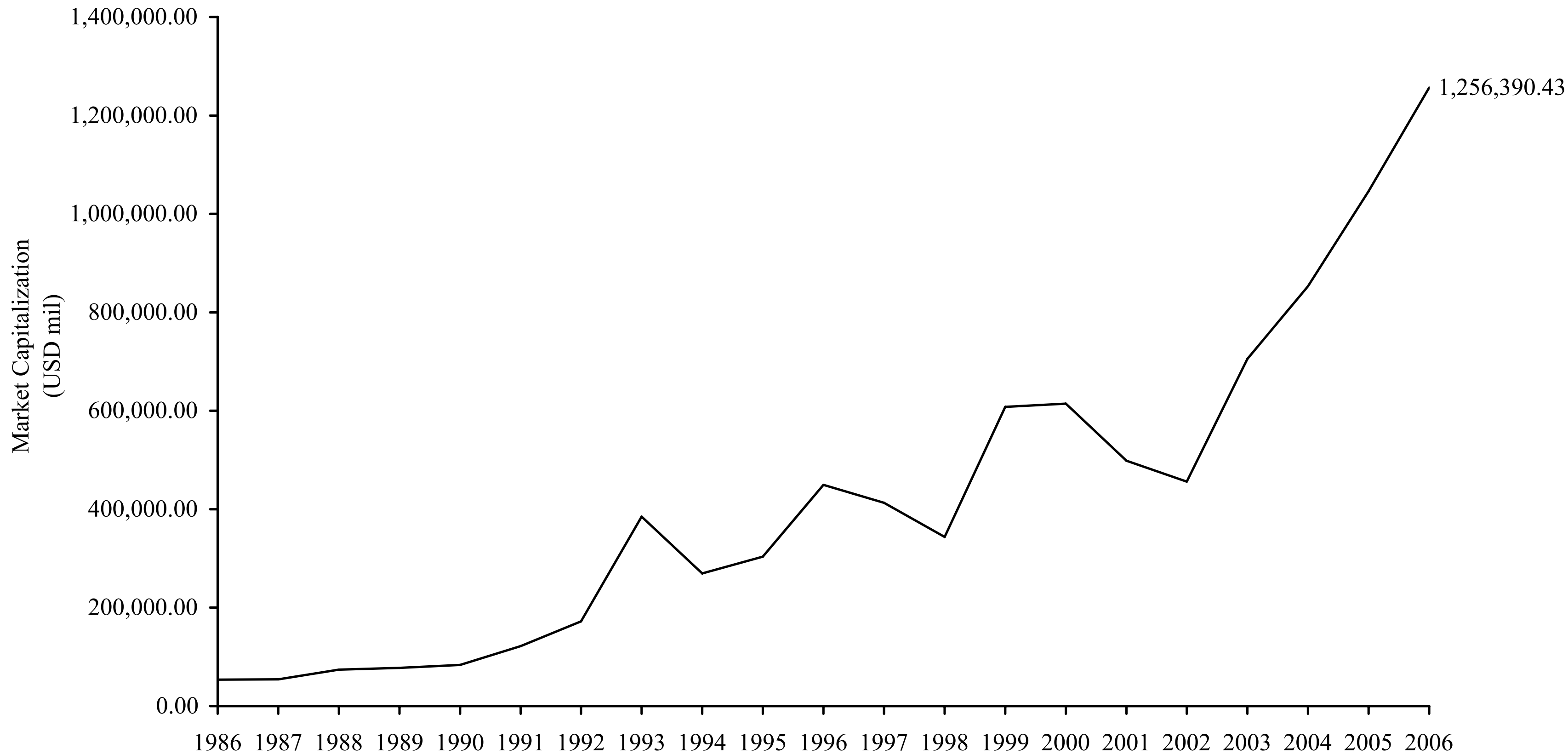
Sources: Hong Kong Exchanges and Clearing Limited.

Notes: Data for 2006 are as of June 30. Number of companies represents the total number of companies, including domestic and foreign companies. Data excludes investment funds. The Stock Exchange of Hong Kong Limited (the Exchange) commenced trading on April 2, 1986. Data prior to this date represent the combination of the four national exchanges that merged into the Exchange.

Table B

MARKET CAPITALIZATION FOR THE HONG KONG STOCK EXCHANGE

1986-2006



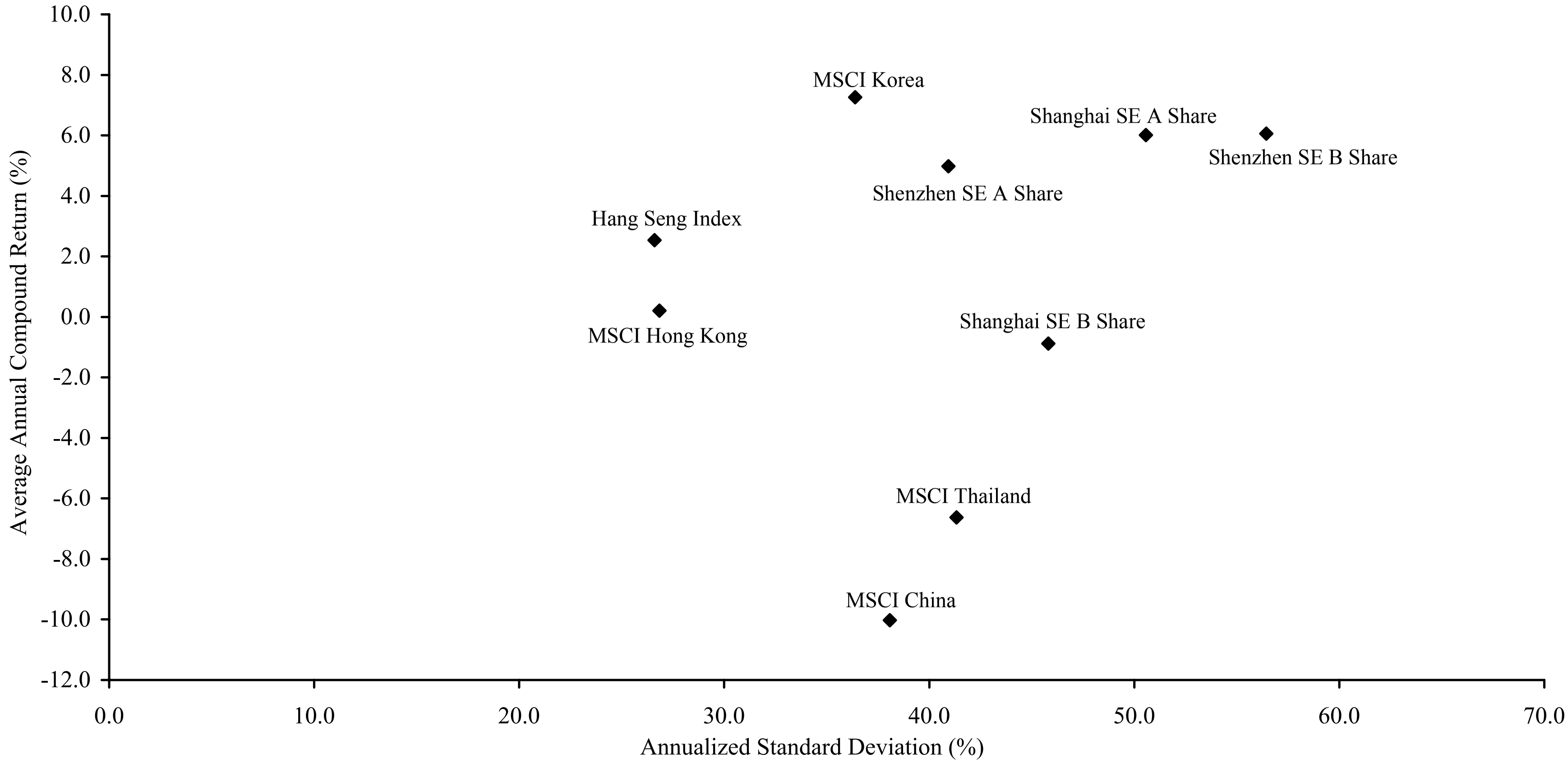
Sources: Hong Kong Exchanges and Clearing Limited.

Notes: Data for 2006 are as of June 30. The Stock Exchange of Hong Kong Limited (the Exchange) commenced trading on April 2, 1986. Data prior to this date represent the combination of the four national exchanges that merged into the Exchange.

Table C

RISK AND RETURN COMPARISON

January 1, 1994 - June 30, 2006



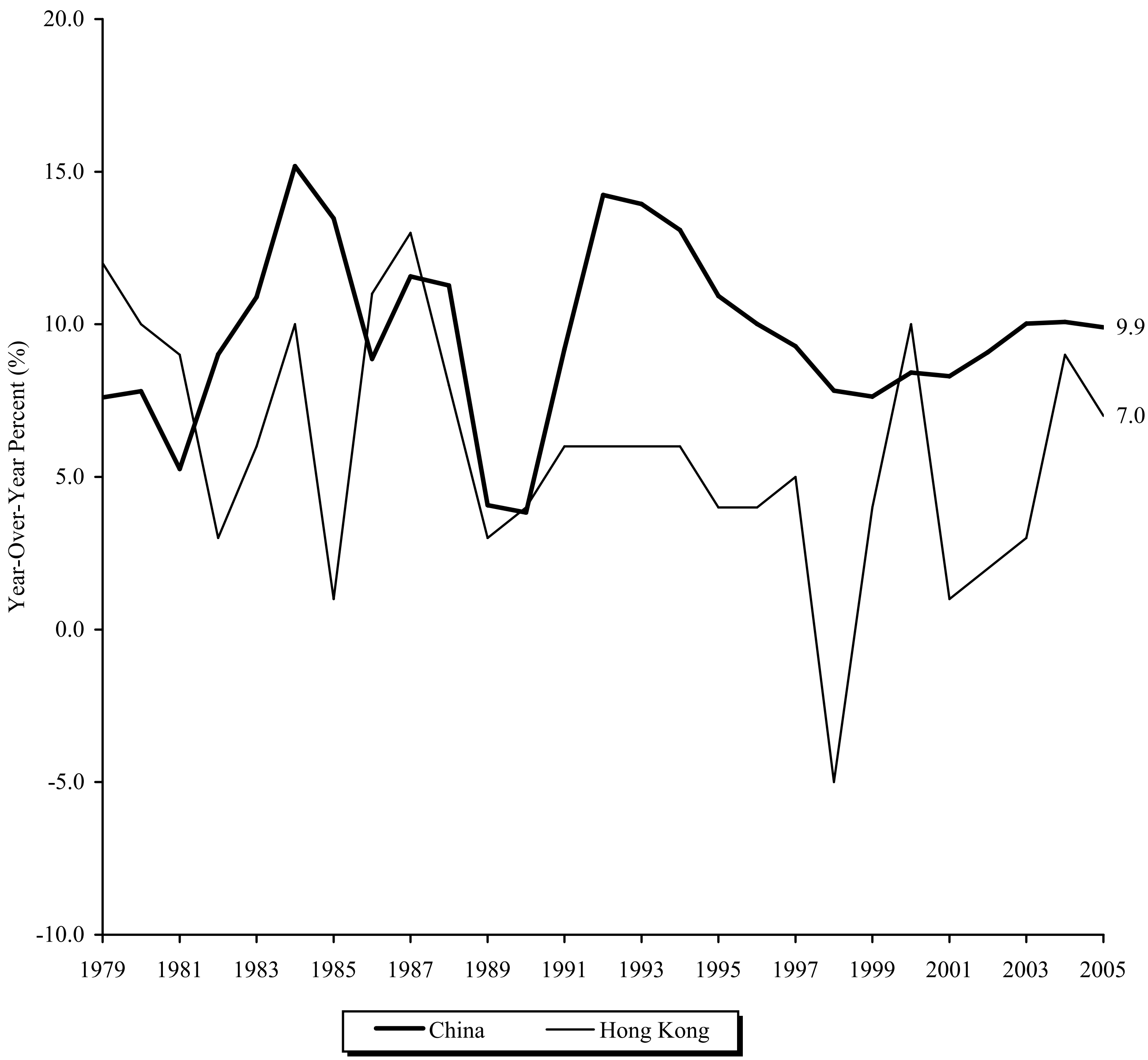
Sources: Thomson Datastream and Morgan Stanley Capital International. MSCI data provided "as is" without any express or implied warranties.

Notes: The Shenzhen SE B share and MSCI Hong Kong indices are in Hong Kong Dollars, the Shanghai SE A Share, Shenzhen SE A Share, and MSCI China indices are in local currency. The Shanghai SE B Share Index data are in U.S. dollars. MSCI Korea are in South Korean won and MSCI Thailand are in Thai baht. All calculations are based on monthly price returns.

Table D

REAL GDP GROWTH RATES: HONG KONG AND CHINA

1979-2005



Source: Thomson Datastream.

Note: Gross domestic product data are annual.

Table E

HONG KONG STOCK EXCHANGE SECTOR WEIGHTS (%)

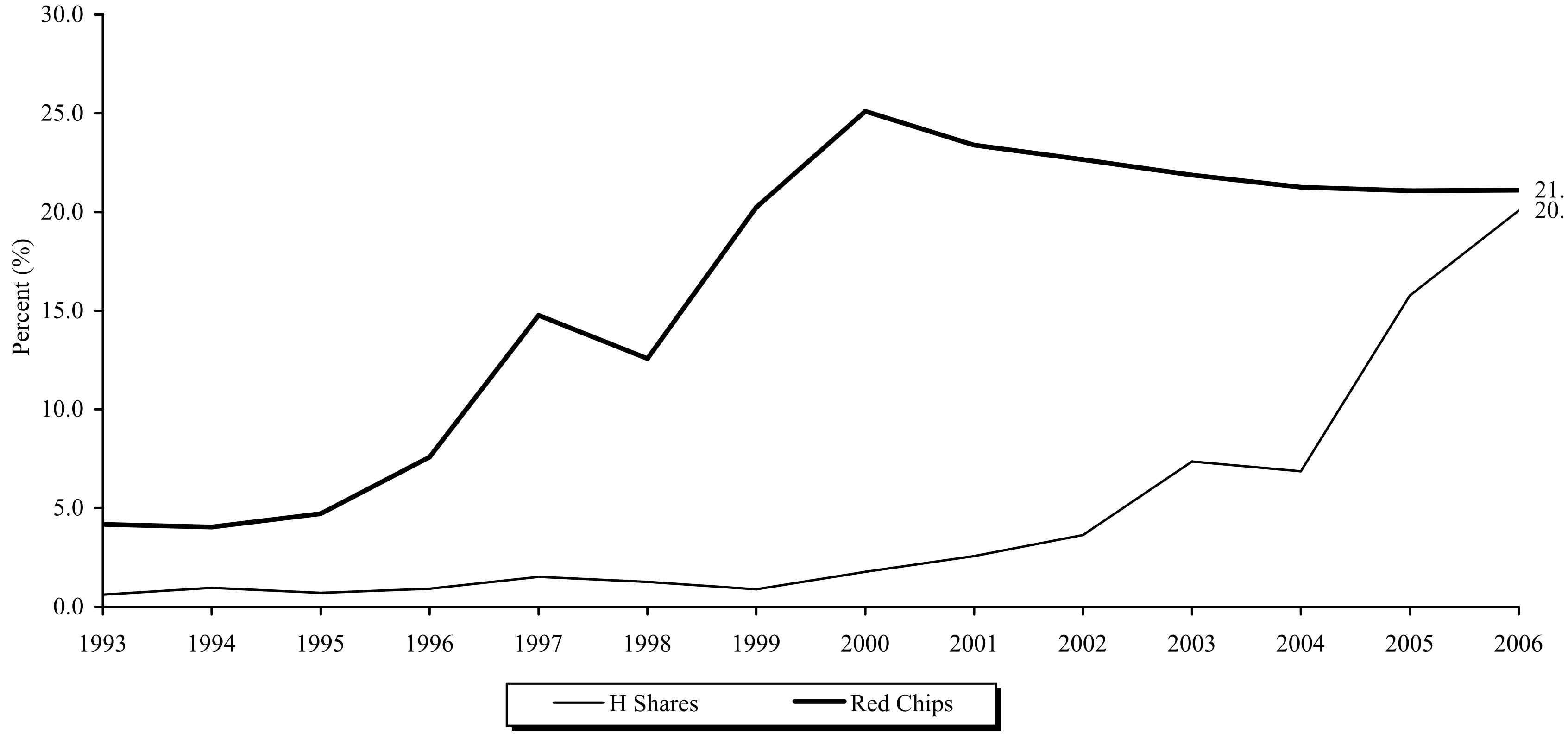
	12/31/95	12/31/00	12/31/05	06/30/06
Finance	24.3	30.1	36.9	38.9
Utilities	14.0	6.1	5.6	4.9
Properties	26.5	14.6	11.2	10.6
Consolidated Enterprises	27.0	41.1	28.2	27.0
Industrials	5.9	7.0	17.0	17.4
Hotels	2.2	0.7	0.8	0.8
Miscellaneous	0.2	0.6	0.3	0.3
Total	**100.0**	**100.0**	**100.0**	**100.0**

Sources: Hong Kong Stock Exchange and Clearing Limited.

Table F

MARKET CAPITALIZATION OF CHINESE STOCKS AS A PERCENTAGE OF THE STOCK EXCHANGE OF HONG KONG

1993-2006



Sources: Hong Kong Exchanges and Clearing Limited.

Note: Data for 2006 are as of June 30.