COMMENTARY

November 21, 2014

Dear clients and colleagues,

On November 17, China launched a pilot program called Shanghai-Hong Kong Stock Connect, allowing investors to trade on both stock markets. We think this important structural move is worth your attention because China is counting on it to help open up its capital account, boost local equity valuations, and globalize its currency, the Renminbi. Chinese savers may start moving some of the $8 trillion of private wealth currently held in deposits into overseas stocks. If the two stock markets became further integrated, they would form the world's third-largest equity market with a $5.6 trillion capitalization, according to Allianz Global Investors.

Before its launch, investors in Hong Kong and from overseas could only participate indirectly in the Mainland's securities markets. Exposure was limited to a handful of investment products such as the Qualified Foreign Institutional Investor (QFII) funds, Renminbi Qualified Foreign Institutional Investor (RQFII) funds, and RQFII A-share Exchange Traded Funds (ETFs).

Now the two-way program, both northbound and southbound, caps total investment at Renminbi 550 billion (USD 90 billion) and has a daily quota of Renminbi 23.5 billion. Northbound trading allows all HK and overseas investors to invest in 568 stocks in the Shanghai Comp 180, Shanghai Comp 380, and dual-listed A+H shares. Mainland institutional and individual investors with at least Renminbi 500,000 in securities accounts can look south and invest in 266 stocks in the HSI-large cap index, HSI-mid cap index, and dual-listed A+H shares.

The impact of this program on our portfolio is small. We do not invest in A-shares, and only one holding in our international small cap portfolio is on the eligible H-share list, Xinyi Glass, with less than a 1% weight. Xinyi Glass is a top glass conglomerate in China with the largest export volume. Management owns 47% of the company.

Initial flows for the Stock Connect are disappointing on both sides of the link. Northbound trades reached the quota on Monday, but achieved only 37% on Tuesday, 20% on Wednesday, and 18% on Thursday. It was expected that southbound activity would be lighter, as mainland investors have shown little enthusiasm for previous schemes to invest abroad, preferring the lure of real estate. Even so, the take-up was dismal, falling from 17% on the first day to 2% on Thursday.

The following provides mostly quoted explanations:

- Rich valuation: News of the connect was already priced in. The Shanghai Composite reached a three-year high on November 12, and the Hang Seng Index traded at the highest in two months on November 14.
- Short notice: The plan to launch was unveiled in April but only formally approved last week. Beijing only made clear that investors would be exempt from capital gain taxes in the afternoon of November 14.
- Poor rules: International investors are required to deliver stocks to a broker the day before sale in Shanghai, which leaves the seller exposed to movement in the stock for longer. The government has yet to clarify the tax treatment for the program. Some fund managers are wary of a retrospective tax charge.

We think all the above reasons are valid. What interests us at Global Alpha is not what percentage of quota was reached in the first week, but how far China has come in opening its capital markets. Let's look at a few milestones.

2002: China started Qualified Foreign Institutional Investor quota
2004: allowed Renminbi business in HK
2006: allocated Qualified Domestic Institutional Investor quota
2007: issued Renminbi bonds in HK
2010: allowed foreign investors to participate in Renminbi bond market
2011: issued Renminbi Qualified Foreign Institutional Investor quota
2012: allowed Renminbi business overseas by individuals
2013: started cross-border Renminbi loan in Qianhai economic zone
2014: launched Shanghai-Hong Kong Stock Connect

In the 2014 annual review, MSCI decided not to include A-shares in its Emerging Market Index. This was based on feedback from international institutional investors who highlighted investability constraints linked to the QFII and RQFII quota systems, but also mentioned that A-shares will remain on the review list for 2015.

We believe the Shanghai-Hong Kong Stock Connect should be very positive in the long term.

Have a great weekend.

The Global Alpha team