March 2021

Chinese Equities - The Guide

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Introduction

Investors who venture into the Chinese stock universe face an alphabet soup of seemingly random letters. There are A-shares, H-shares and S-chips to name just a few (see Chart 1).

These letters represent various attempts to develop the equity market in a country where people traded the first shares as long ago as the 1860s. But something resembling a modern stock market, the Shenzhen Stock Exchange, didn't start operations until December 1 1990.[1] Shenzhen beat Shanghai as the first exchange of the modern era by some three weeks.[2]

The Hong Kong Stock Exchange, a forerunner to the city's current bourse, began operations in 1914 but developed under British colonial rule.[3] Investors view Hong Kong as a separate and distinct market.

Chart 1: Alphabet soup of Chinese equities

Shares	Listing	Currency	Country of incorporation	Country where company does most business	Examples	Index inclusion	Comments	Can Chinese investors buy ?
A-share	Shanghai + Shenzhen	Renminbi	China	China	Shanghai International Airport Co.	CSI 300 or MSCI China A Onshore. MSCI EM since June 2018	Some have dual listing in H-share market	Y
B-share	Shanghai + Shenzhen	US dollar + Hong Kong dollar	China	China	N/A	None	Interest has collapsed since H-shares	Y
H-share	Hong Kong	Hong Kong dollar	China	China	PetroChina, China Construction Bank, Industrial and Commercial Bank of China	MSCI China All Shares, MSCI EM	Often dual listing with A-shares	Y
Red chip	Hong Kong	Hong Kong dollar	Hong Kong	China	China Mobile	MSCI China All Shares, MSCI EM	May have American Depository Receipt too	Y
P-chip	Hong Kong	Hong Kong dollar	Cayman	China	Tencent	MSCI China All Shares, MSCI EM	May have American Depository Receipt too	Y
S-chip	Singapore	Singapore dollar	Various	China	Yanlord Land Group	No major		N
ADR (American Depository Receipt)	New York	US dollar	Cayman	China	OneSmart International Education Group, Alibaba Group, Autohome	MSCI China All Shares, MSCI EM	May return to China as Chinese Depository Receipt	N

Note: These securities have been used for illustrative purposes only to demonstrate the investment management style, not as an indication of performance and should not be considered as a solicitation or recommendation of these securities. Source: Aberdeen Standard Investments, 31 March 20.

Where can you find Chinese stocks?

By far the biggest component of this investment universe are the approximately 3,900 A-shares listed in mainland China[4] – renminbi-denominated securities that are traded on the Shanghai and Shenzhen exchanges (see Chart 2). A-shares have a market capitalisation of almost US$8 trillion (see Chart 3).[5]

There are equities that are listed in Hong Kong – H-shares (mainland-incorporated firms that are traded in Hong Kong dollars) and Red chips (Chinese companies that are incorporated outside China, do most of their business on the mainland and are Chinese government-controlled).

In addition to the A-shares listed on mainland bourses, there are also a handful of onshore US dollar and Hong Kong dollar-denominated securities. These are known as B-shares and they are very different from the shares of Chinese companies that are listed on US stock exchanges and traded in US dollars.

There are more than 300 Chinese companies listed in the US. Most are there via the American Depository Receipt (ADR) instrument. However, several high-profile companies, such as e-commerce and e-payments behemoth Alibaba Group, agriculture technology platform Pinduoduo and e-commerce platform JD.com, have their primary listing there.

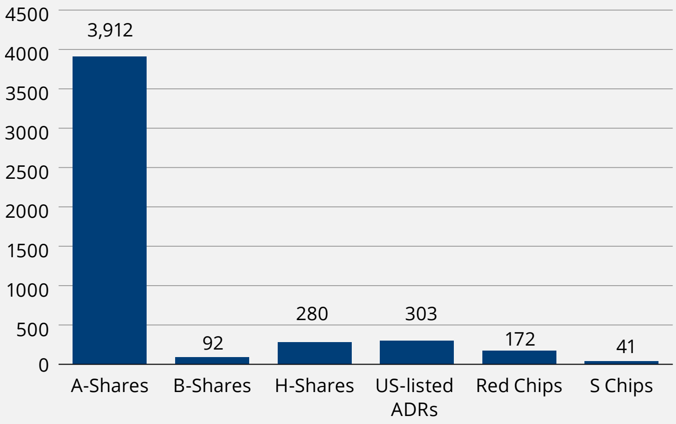
In the past, many innovative Chinese companies (such as the internet firms) chose to list offshore due to restrictive listing requirements in the domestic market. However, those restrictions have started to ease with the launch of the innovation-focused Star market (see Latest developments).

Last, but not least, there are S-chips – shares of Chinese companies that are incorporated outside the mainland, listed in Singapore and traded in Singapore dollars.

[1] Shenzhen Stock Exchange website [accessed 5 January 2021].
[2] Shanghai Stock Exchange website [accessed 5 January 2021].
[3] Hong Kong Exchanges and Clearing website [accessed 5 January 2021].
[4] Aberdeen Standard Investments, 31 October 2020.
[5] Aberdeen Standard Investments, 31 October 2020.

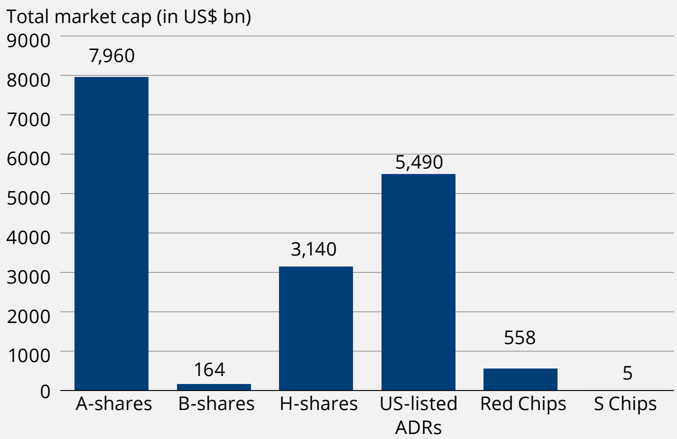
Aberdeen Standard Investments

Chart 2: Number of listed companies by market



Source: Aberdeen Standard Investments 31 October 20.

Chart 3: Market capitalisation of listed companies by market



Source: Aberdeen Standard Investments 31 October 20.

Mainland vs Hong Kong market dynamics

Local retail investors account for some 86% of trading volumes in the A-share market[6] (see Chart 4). Retail investors in China, like their counterparts elsewhere, tend to be on the hunt for quick capital gains. They have few investment convictions other than chasing the latest 'hot' tip.

This helps explain the popularity in recent years of smaller high-growth companies in the mainland, or onshore, market. This is also why most Chinese companies do not see paying dividends as a big priority. For example, A-shares tend to be low-yielding and dividend cuts are common.

A-shares can be prone to bouts of shifting sentiment driven by retail speculation and sustained by momentum trading. Analyst coverage can be patchy. This is a good thing for active managers – investors who can do their own company research and have a better chance of staying ahead of the market.

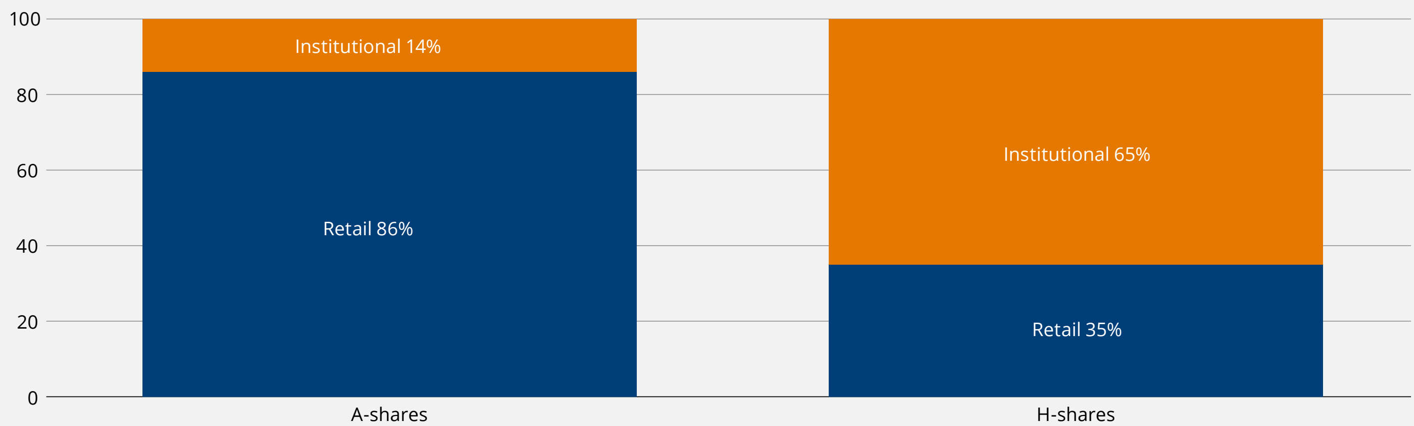
For many foreign investors operating offshore, the most practical way to invest in Chinese companies is to do so via Hong Kong. Even though things are changing on the mainland, on the whole, Hong Kong's legal and regulatory environments continue to offer better investor protection.

In fact, Hong Kong could provide a glimpse of what onshore markets could look like in the years to come – a better balance of retail and institutional investors, with greater foreign investor participation.

Institutional investors account for some 65% of trading volumes in the H-share market in Hong Kong (see Chart 4). This is a legacy of a time, not so long ago, when Hong Kong was the *only* way for foreign investors to invest in the more attractive Chinese companies.

What's more, it's a reflection of the types of businesses investors will find when they look offshore, as opposed to those businesses that are listed in Shanghai and Shenzhen.

Chart 4: Retail vs institutional trading volumes



Source: CEIC, UBS-S, May 2018.

[6] CEIC, UBS-S, as of May 2018.

Onshore vs offshore opportunities

The onshore and offshore markets can host different types of businesses. For example, internet firms that have become investor favourites during the global pandemic of 2020/21 tend to be listed offshore.

Online gaming giant, Tencent, is listed in Hong Kong; Alibaba has a primary listing in New York with a secondary one in Hong Kong.

In addition to the internet sector, offshore markets provide unique investment opportunities in sectors such as education, gaming and telecoms. For example, private education investment opportunities such as OneSmart International Education Group are, for now, only available in the offshore markets.

In Hong Kong, investors will also find the Hong Kong dollar-denominated shares of China's state-controlled telecoms giants (e.g. China Mobile), the state-backed banks (e.g. Bank of China), the big energy companies (e.g. PetroChina) and the government-owned insurers (e.g. China Life).

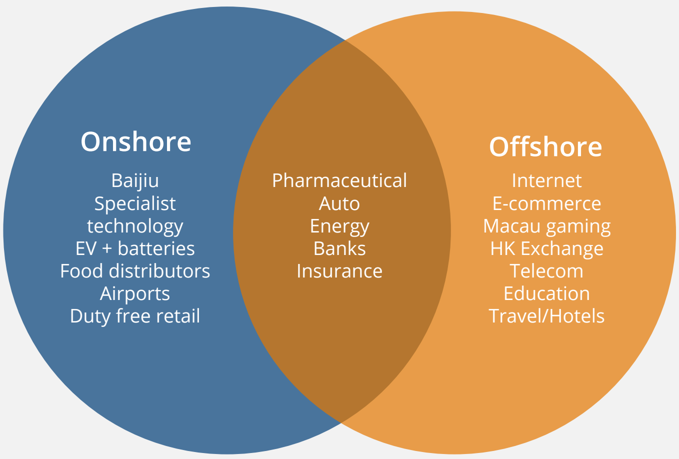
There may be some overlap between the offshore and onshore markets. For example, Bank of China, PetroChina and China Life also have A-shares that are traded in Shanghai. Overall, there are about 110 companies that are dual-listed in both A- and H-share markets. That means investors can seek to profit from minor differences in the two share prices of the same company.

The domestic A-share market is where there are many unique home grown firms, in industries not accessible via offshore markets, that are well placed to take advantage of rising affluence.

One example is Shanghai-listed Kweichow Moutai Co. which produces expensive *baijiu*, a fiery spirit highly prized by wealthy consumers. Demand for domestic and international travel means listed airports (e.g. Shanghai International Airport Co.) and duty free retailers (e.g. China Tourism Group Duty Free Corp) are popular with investors.

However, in practice, both onshore and offshore markets offer access to opportunities arising from greater wealth and better living standards in China. The Chinese consumer is moving rapidly towards premium, or higher value, goods and services.

Chart 5: Onshore vs offshore sectors



Source: Aberdeen Standard Investments 30 September 2020.

Insulated from the world

Equities on mainland Chinese stock exchanges exhibit a low correlation with other big equity markets. In other words, A-shares provide a great opportunity to diversify portfolio risk and potentially enhance returns.

A review of the 15-year relationship between the MSCI China A Onshore index and six other indicies shows the lowest correlation with the US S&P 500 Index (see Chart 6).

The reasons? Foreign investors play such a small role in this market that A-shares aren't so susceptible to capital flight when global stocks are volatile.

Growing numbers of Chinese companies that depend on domestic demand aren't as affected by global economic and interest rate cycles. Government-linked firms also support the A-share market during periods of weak investor sentiment.

What's more, the retail-driven nature of the local equity market means that trading can be affected more by sentiment, and less by the fundamental quality of companies.

Despite the launch of new trading platforms such as Stock Connect (see Market access), domestic investors still face limitations on access to offshore investments. China's closed capital account – restrictions on the movement of money in and out of the country – means most domestic investors are more focused on the onshore markets.

Chart 6: China A - lower correlation with global markets

15-Year Correlation, based on monthly data, US$ unhedged indices

	MSCI World	MSCI China	S&P500	MSCI AC Asia ex Japan	MSCI Europe	MSCI EM ex China
MSCI China A Onshore	0.421	0.646	0.391	0.563	0.401	0.459

Source: Bloomberg, 31 October 2020 (unhedged US$). For illustrative purposes only.

Past performance is not a guide to future results.

The MSCI China All Shares Index – which tracks A-shares, B-shares, H-shares, Red chips and foreign listings – also has a fairly low correlation with other indices, especially the S&P 500 (See Chart 7).

That said, its correlation with global indices is generally higher than that between the MSCI China A Onshore index and major equity benchmarks around the world.

Offshore Chinese equities, which make up more than 50% of the MSCI China All Shares Index, are part of international capital markets, such as Hong Kong and New York.

These securities tend to move more in tandem with other shares that trade outside mainland China. What's more, the broader investment universe is also exposed to international currency fluctuations via the US dollar, the currency of global finance and trade.

Chart 7: China All Shares - lower correlation with global markets

15-Year Correlation, based on monthly data, US$ unhedged indices

	MSCI World	S&P500	MSCI Europe	MSCI EM ex China
MSCI China All Shares	0.629	0.584	0.599	0.693

Source: Bloomberg, 26 November 2020 (unhedged US$). For illustrative purposes only.

Past performance is not a guide to future results.

Market access

Investing in stocks listed on mainland Chinese bourses used to be a pain for foreign investors. It was a process that involved permits, restrictions and red tape. It was not something for the faint hearted.

Everything changed with the Stock Connect programme, which launched in 2014 and has been evolving ever since. These days, any investor with a brokerage account in Hong Kong can invest in the top 1,500 companies listed in Shenzhen and Shanghai.

Those 1,500 companies give investor access to most of the onshore market capitalisation of the Chinese equity universe. Investors who also hold the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) licences can buy any stock listed on the two mainland exchanges.

Stock Connect has changed the way people invest in Shanghai, Shenzhen and Hong Kong. In the same way that investors outside mainland China can more easily invest in companies listed in Shanghai and Shenzhen, mainland investors also have better access to stocks that are listed in Hong Kong. These so-called 'northbound' and 'southbound' capital flows have grown steadily since 2014 (see Chart 8).

Investing in mainland Chinese stocks that are listed on Hong Kong and overseas exchanges, is governed by local listing rules and the financial market regulations of each of those jurisdictions.

Currency stability

The yuan (CNY) or renminbi, China's currency, behaves differently to many other emerging market currencies in that volatility has been relatively subdued for many years.

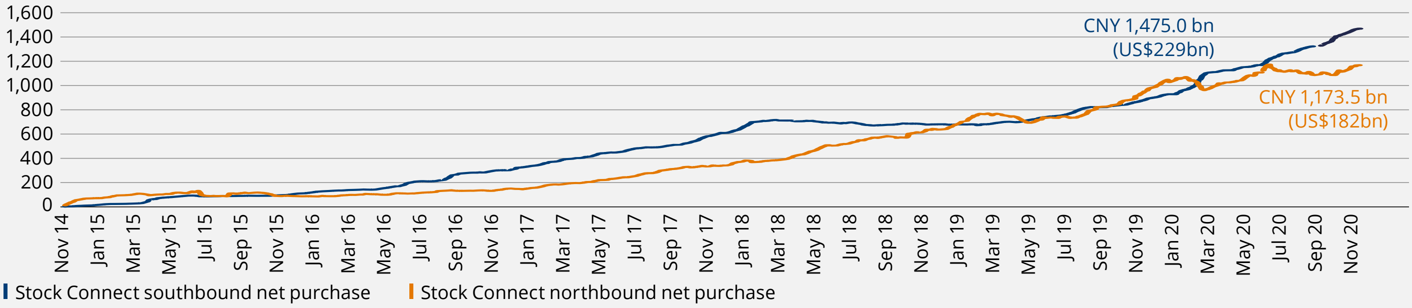
In fact, the US$/CNY exchange rate has traded within a range of about US$1 to 6 -7 yuan for the past 10 years (see Chart 9). This reflects the authorities' management of the currency (maintaining currency stability is an explicit goal of the People's Bank of China, the central bank).

While many emerging market currencies have suffered during times of upheaval or crisis, the onshore yuan (there is a separate offshore currency rate) has been far more resilient.

As the world dipped into a pandemic-induced recession last year, the CNY actually strengthened. Even though investors must contend with currency fluctuations, China's currency risks appear to be far more balanced.

> "Everything changed with the Stock Connect programme, which launched in 2014 and has been evolving ever since."

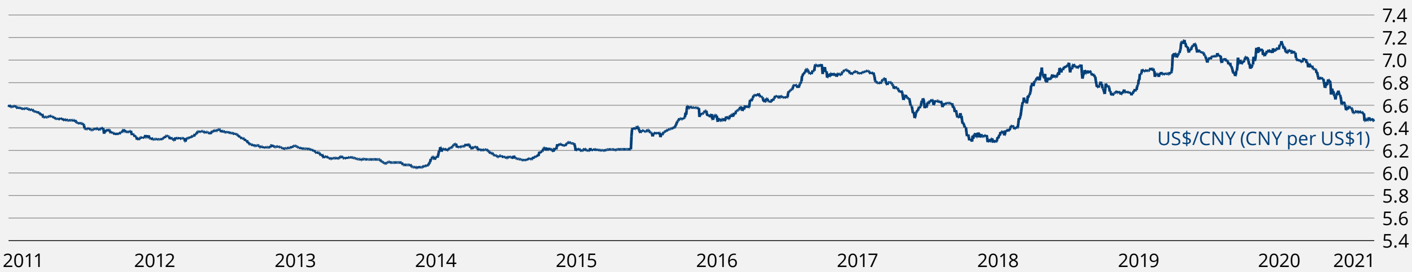
Chart 8: Stock Connect investment flows



Source: CICC Research, CEIC, Wind, Bloomberg, 16 December 2020. Conversion rate as at 10 Feb 2021. Source Bloomberg.

Past performance is not a guide to future results.

Chart 9: China's currency - range bound, subdued volatility



Source: Bloomberg, 27 January 2021. For illustrative purposes only. No assumptions regarding future performance should be made.

Past performance is not a guide to future results.

Latest developments:

Rising Star

The Star market, China's answer to Nasdaq, was launched in July 2019. This tech-heavy second board offers Chinese companies a new way to raise money, especially when raising funds would otherwise be difficult (e.g. when a start-up can't show a record of profitability).

The universe of Star companies has grown from the 25 names at launch to more 200 today. This number is likely to grow even further given the pipeline of more than 300 companies that are seeking registration and listing.

High-tech industries represented by these listed companies include: software, high-end medical equipment, semiconductors and the internet-of-things. Market capitalisation has quickly grown to more than US$300 billion[7]. This number will likely become much higher in the years to come.

The Environment

In recent years, China has played a leading role in tackling climate change. It has committed to becoming 'carbon neutral' by 2060.[8] The country already dominates the supply chains that support many of the new 'green' industries.[9]

That's why there are onshore investment opportunities in areas such as energy consumption, waste disposal, land development, carbon emissions, renewable energy and clean technology.

A national focus on the environment also explains why environmental disclosures by companies are relatively robust. Chinese firms, especially the larger ones, are very conscious of their carbon footprint.

'Coming home'

China's companies are 'coming home'. Even before US-China relations deteriorated to the point where Chinese companies no longer feel welcome on US bourses, policymakers in Beijing began urging overseas-listed firms to heed the call of the motherland.

Many of these companies opt for a secondary listing in Hong Kong. Larger companies – defined as those with a market capitalisation of at least HK$40 billion (US$5.2 billion), or a market capitalisation of more than HK$10 billion and revenues greater than HK$1 billion – have typically taken this route.

For example, Alibaba secured a secondary listing in Hong Kong in November 2019. A number of companies including NetEase Inc., JD.com, New Oriental Education & Technology Group Inc., Huazhu Hotels Group Ltd. and GDS Holdings Ltd. have followed the same path.

This trend will only accelerate. Many smaller companies listed in the US via ADRs would also list in Hong Kong, if the city's bourse was to change its minimum listings requirements. Otherwise, smaller firms could consider alternatives that include the Star market.

Grade A

On June 1 2018, A-shares were included in a number of mainstream MSCI indices for the first time, including MSCI China, MSCI Asia ex-Japan and the MSCI Emerging Markets Index. It was a big deal because it took years for these securities to make the grade.

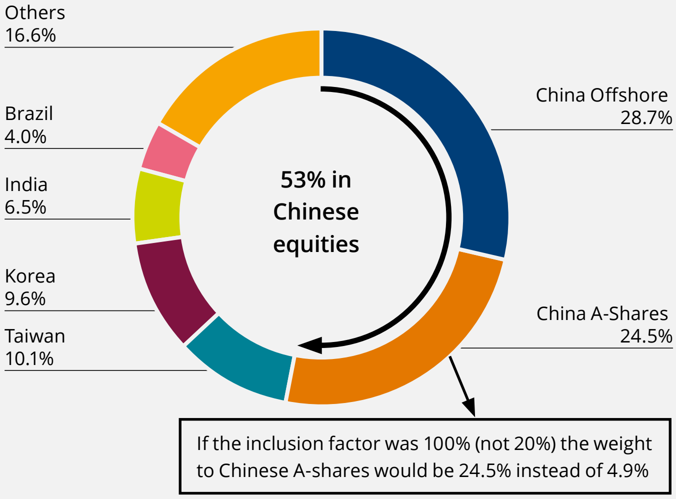
MSCI inclusion showed just how far China had progressed in its capital market reforms – specifically on internationalising the renminbi and linking its stock exchanges with bourses in the rest of the world.

Currently MSCI has capped the inclusion factor of A-shares at 20%, which means only 20% of the market capitalisation is recognised. As it stands, A-shares are still severely under-represented in global indices.

For example, A-shares only make up some 5% of the MSCI Emerging Markets Index. However, fully represented, they ought to comprise around 25% of the benchmark (see Chart 10). We expect it is only a matter of time before MSCI announces a higher inclusion factor for A-shares.

[7] Aberdeen Standard Investments, 27 January 2021.
[8] BBC, Climate change: China aims for 'carbon neutrality by 2060', M. McGrath, 22 September 2020.
[9] Sanford C. Bernstein, Bernstein Hydrogen: Making money in fuel cells - lessons from solar, wind and batteries, October 2020.

Chart 10: Potential impact of China A on MSCI EM weighting



Note: Country classifications use Bloomberg country of risk classification. Source: MSCI, Bloomberg, Aberdeen Standard Investments, 14 August 2020. Figures may not always add up to 100 due to rounding

Environment, social and governance (ESG)

Chinese firms tend to be associated with poor understanding of ESG. Yes, corporates can be of mixed quality. But appreciation of the value that ESG and engagement can bring is catching on. Corporate governance is improving, albeit more slowly than environmental awareness. For example, the China Securities Regulatory Commission has strengthened protections for minority shareholders. There has been a rise in dividend pay-out ratios at some major companies and moves to diversify share ownership. Hundreds of firms publish corporate social responsibility reports (although the information disclosed isn't consistent). We've also found many companies more willing to engage with us on all aspects of running a business including on social factors, such as how they interact with employees and vendors.

> "An asset class that was once overlooked by the majority of international investors has finally become mainstream."

In response to our request for information, one personal financial services group organised an investor day to give us access to decision-makers and insights into its operations. Elsewhere, employee stock ownership schemes that align the interests of management with those of minority shareholders are becoming more common. Some 52% of 337 Chinese companies that listed in the US or Hong Kong between January 2016 and July 2019 operated equity incentive schemes, according to a PWC survey.[10] A further 337 listed companies on domestic bourses announced equity incentive plans in 2019, the data show.

Looking ahead

A lot has been going on in the world of Chinese equities in recent years. As a result, an asset class that was once overlooked by the majority of international investors has finally become mainstream.

China's companies listed on the mainland and elsewhere have become a viable and increasingly attractive way for foreign investors to gain exposure to the rapid economic and social changes that continue to transform the country (and the world).

China's diverse equity markets are big and accessible. In some instances they are also becoming more sophisticated. That's not to say there aren't problems, but the best companies behave more and more in ways that foreign investors have come to expect from responsible corporate citizens.

This is just the start. In years to come, investing in China will be as unremarkable to investors in New York, London or Frankfurt as committing money into their own markets. Investors who choose to ignore these developments, do so at their own risk.

[10] Thomson Reuters Practical Law, Employee share plans in China: regulatory overview, Feng, Li, Zhu, He [accessed 11 Jan 21]

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The value of investments and the income from them can go down as well as up and investors may get back less than the amount invested. Past performance is not a guide to future results.

Investing in China involves a greater risk of loss than investing in more developed markets due to, among other factors, greater government intervention, tax, economic, foreign exchange, liquidity and regulatory risks.

Investing in China A shares involves special considerations and risks, including greater price volatility, a less developed regulatory and legal framework, exchange rate risk/controls, settlement, tax, quota, liquidity and regulatory risks.

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