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Authors

Nicholas Yeo
Director and Head of Equities, China and Hong Kong

Nicholas Chui
Investment Director, Asian Equities

Our Thinking:
Thought Leadership

Our thought leadership papers deliver thought-provoking analysis of key investment themes. Through focused and unique insights into topical issues, we aim to provide investors with a deeper understanding of the challenges and opportunities within global investment markets.
Introduction

Why should you care about Chinese onshore equities? How do you invest? Is investing in so-called ‘A-shares’ worth the risks?

China’s Local Equity Market: ‘...How and Where and Who’, a companion piece to China’s Bond Market: ‘What and Why and When...’, seeks to answer these questions.

Rudyard Kipling’s six honest serving-men ‘(They taught me all I knew); Their names are What and Why and When, And How and Where and Who’ provides an analytical framework to help explain China’s onshore equity market.

We look at what the A-share market is, who the players are and the factors that drive the market. We show how foreign investor access has improved over the years. We also examine the risks that demand an active investment strategy based on rigorous research.

For investors looking for a deeper understanding, we employ our proprietary analytical framework to generate a 10-year outlook for investment returns. We also dig deeper into the small but important improvements in corporate governance. These show how efforts to make this market more professional are bearing fruit.

“We look at what the A-share market is, who the players are and the factors that drive the market”
China’s A-shares are undergoing rapid change. This marks the start of efforts to make this retail-driven market more professional.

The 3,420 renminbi-denominated shares that trade on the Shanghai and Shenzhen stock exchanges are important for several reasons:

- The A-share market is one of the biggest equity markets in the world with a market capitalisation of some US$5.6 trillion.
- The A-share market plays a key role in China’s plans to develop its capital markets to fund the pensions of an ageing population. An efficient stock market helps to price financial assets more accurately.
- A-shares reflect important changes in the economy. In particular, the emergence of agile private sector companies set up to serve the needs of discerning domestic consumers.
- Easier access for foreign investors and efforts to tackle their concerns regarding stock suspensions, have enabled A-share inclusion in MSCI and FTSE Russell indices. This ends years of isolation for this market.
- Ample liquidity and a low correlation with other markets mean A-shares provide a viable way for foreign investors to diversify their portfolios. The short-term earnings outlook remains healthy despite slowing growth and trade war concerns.

Deeper dives suggest further reasons to be optimistic:

- Craig Mackenzie, Head of Strategic Asset Allocation, uses a proprietary forecasting model and concludes that A-shares could deliver a probability-weighted mean expected return of some 8 per cent a year over the next 10 years. This is above our long-term forecast for global equities. It is also more than the 5.2 per cent annual return delivered by A-shares over the past decade.
- Nicholas Yeo, Director and Head of Equities, China and Hong Kong, shows us that corporate governance is improving. A handful of trailblazing companies have taken the first steps towards better Environmental, Social and Governance (ESG) awareness.

Investing in this market exposes investors to risks that include: a speculative and volatile trading environment; untested regulations; stock suspensions, slowing economic growth; taxation ambiguities; and potential for capital controls.

However, these risks are no more than those posed by other emerging markets. Perhaps the bigger risk for investors is to allow ignorance of what this market can offer to dismiss out of hand the opportunities that are available.
Part I

What is the A-share market?

A/B/H shares...

Investors who venture into the world of Chinese equities face an alphabet soup of seemingly random letters. There are A-shares, H-shares, S-chips and P-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. Shenzhen beat Shanghai as the first exchange of the modern era by some three weeks.

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

Chart 1: Alphabet soup of Chinese equities

<table>
<thead>
<tr>
<th>Shares</th>
<th>Listing</th>
<th>Currency</th>
<th>Country of incorporation</th>
<th>Country where company does most business</th>
<th>Index inclusion</th>
<th>Comments</th>
<th>Can Chinese investors buy?</th>
</tr>
</thead>
<tbody>
<tr>
<td>A-share</td>
<td>Shanghai + Shenzhen</td>
<td>Renminbi</td>
<td>China</td>
<td>China</td>
<td>CSI 300 or MSCI China A, MSCI EM from June 2018</td>
<td>Some have dual listing in H-share market</td>
<td>Y</td>
</tr>
<tr>
<td>B-share</td>
<td>Shanghai + Shenzhen</td>
<td>US dollar + Hong Kong dollar</td>
<td>China</td>
<td>China</td>
<td>None</td>
<td>Interest has collapsed since H-shares</td>
<td>Y</td>
</tr>
<tr>
<td>H-share</td>
<td>Hong Kong</td>
<td>Hong Kong dollar</td>
<td>China</td>
<td>China</td>
<td>MSCI China, MSCI EM</td>
<td>Often dual listing with A-shares</td>
<td>Y</td>
</tr>
<tr>
<td>Red chip</td>
<td>Hong Kong</td>
<td>Hong Kong dollar</td>
<td>Hong Kong</td>
<td>China</td>
<td>MSCI China, MSCI EM</td>
<td>May have American Depository Receipt too</td>
<td>Y</td>
</tr>
<tr>
<td>P-chip</td>
<td>Hong Kong</td>
<td>Hong Kong dollar</td>
<td>Cayman</td>
<td>China</td>
<td>MSCI China, MSCI EM</td>
<td>May have American Depository Receipt too</td>
<td>Y</td>
</tr>
<tr>
<td>S-chip</td>
<td>Singapore</td>
<td>Singapore dollar</td>
<td>Various</td>
<td>China</td>
<td>No major</td>
<td></td>
<td>N</td>
</tr>
<tr>
<td>ADR (American Depository Receipt)</td>
<td>New York</td>
<td>US dollar</td>
<td>Cayman</td>
<td>China</td>
<td>MSCI China, MSCI EM</td>
<td>May return to China as Chinese Depository Receipt</td>
<td>N</td>
</tr>
</tbody>
</table>

Source: Aberdeen Standard Investments, 31 Dec 18

1http://www.szse.cn/main/en/AboutSZSE/Milestone/
2http://english.sse.com.cn/aboutsse/sseoverview/brief/info/
‘A’ is for….

The focus of this white paper is the approximately 3,420 A-shares listed in mainland China4 (see Chart 2). These are renminbi-denominated shares traded on the Shanghai and Shenzhen exchanges. They boast a combined market capitalisation of some US$5.6 trillion5.

In 2017, the market capitalisation of listed domestic companies in China was only surpassed by that in the US, according to data compiled by the World Bank6.

However, the size of this market can be misleading. A big market tends to imply a level of maturity which, in the case of A-shares, isn’t there yet.

This is a market that is still finding its feet. Since the first companies listed in the early 1990s, it has operated in isolation, largely irrelevant to investors in the rest of the world. The obstacles to foreign investor participation were, until a few years ago, so daunting that most foreigners either stayed away or only paid lip service to the idea of investing in onshore Chinese equities.

Even today, foreign investors account for only 2 per cent of share ownership, or some 5 per cent of the free float7 (see Chart 3). This is despite the authorities and some of the more forward-looking A-share companies saying they would like to see more foreign participation.

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4Aberdeen Standard Investments, 31 Dec 18
5Bloomberg, 10 Jan 19. For illustrative purposes only. No assumptions regarding future performance should be made
6https://data.worldbank.org/indicator/CM.MKT.LCAP.CD?year_high_desc=false
7Wind, CSRC, CIRC, NSSF, UBS-S, as of Jun 16
Retail is not dead

On the other hand, local retail investors account for more than one-third of the free float and some 86 per cent of transactions (see Chart 4).

Chart 4: Retail vs institutional trading volumes

Retail investors in China, like their counterparts elsewhere, tend to be on the lookout for quick capital gains. They possess few investment convictions other than chasing the latest ‘hot’ tip. This helps explain the popularity in recent years of smaller high-growth companies. This is also why most Chinese companies do not see paying dividends as a priority (A-shares are low-yielding and dividend cuts are common).

This also means that A-shares are prone to frequent bouts of high volatility driven by investor speculation and sustained by momentum trading.

Analyst coverage of the market can be patchy. This may be a good thing for investors who do their own research, but it does nothing to improve transparency and investor education.

A tale of two cities

The Shenzhen Stock Exchange was the first modern bourse in China. But Shanghai, the northern exchange chosen by policymakers in the 1990s to host the country’s restructured state-owned enterprises, overshadowed it for much of its history. Even today, investors can find the massive state-owned banks, the energy giants and the national utilities listed in Shanghai.

Shenzhen didn’t come into its own until big private sector companies, a more recent phenomenon, started listing there. This is a reflection of the growing importance of the service sector in China. The bourse hosts many of the country’s new economy companies, especially those firms that benefit most from the expansion of domestic consumption. ChiNext, China’s Nasdaq, is a second board of the Shenzhen Stock Exchange.

The southern city of Shenzhen, just across the border from Hong Kong, is known as China’s Silicon Valley (dubbed Silicon Delta). It has become a magnet for money and talent, not just from China, but from the rest of the world. The city is home to the likes of internet giant Tencent, as well as countless technology start-ups all hungry to be the next Tencent.

National service

What is unusual in China’s equity market is the interventionist role played by the so-called ‘National Team’. This is a group of government-controlled firms tasked with stabilising the market by buying shares during big sell-offs.

Deployment of the ‘National Team’ is not an official policy, but an open secret. Its existence serves as a reminder that, while policymakers have embraced some market reforms, the not-so-invisible hand of the state still plays a role in determining asset prices.

The degree of government control may come as a surprise to investors used to the lighter regulatory touch of western markets. However, it reflects the state capitalism model which has been behind China’s economic success so far.

Market development is often a tug-of-war between the need for reform and the instinct of regulators to retain control. That’s why progress on reforms can sometimes be a case of two steps forward, one step back. This is especially true during times of market stress.
Why should investors care?

A mirror on China

China needs credible capital markets that will help fund pensions for a fast ageing population. The country’s leaders know this and this knowledge has been a big catalyst for reform.

The stock markets will play a pivotal role. What everyone wants to eventually see is an efficient mechanism for investing surplus capital. This will help people save for the future, as well as allocate money to the most deserving companies.

The some 3,420 securities listed in Shanghai and Shenzhen also provide a snapshot of modern China. There’s the ‘old’ China of nationalised industries providing jobs for tens of millions of workers. But there’s also the ‘new’ China comprising agile private sector companies serving the needs of consumers.

The A-share market is a broad and deep one (see Chart 5). In many cases, this market offers the only way for foreign investors to access the sort of companies that form the backbone of China’s consumption story.

Some firms may engage in familiar activities. For example, China International Travel Service runs duty free shops set to profit from more tourism. Foshan Haitian Flavouring & Food makes condiments and is the world’s largest manufacturer of soya sauce. Anhui Conch Cement supports China’s mammoth housing and infrastructure needs.

Others are in more unusual businesses, such as traditional Chinese medicine (e.g. Beijing Tongrentang) and Chinese baijiu liquor (e.g. Kweichow Moutai). These are hard to find outside China. Market leaders at home, they also have the potential to dominate in international markets when their products head overseas in the footsteps of the Chinese diaspora.

Earnings potential

Earnings growth, although under pressure, looks good when assessed against comparable markets (see Chart 6). This is not across the entire A-share universe, but a smaller portfolio of 537 companies selected for the MSCI China A Onshore Index. The Onshore benchmark represents about one quarter of the market capitalisation of the entire universe.

Chart 6: Earnings growth resilient

![Earnings growth chart]

Source: Bloomberg, 31 Dec 18. Forecasts are offered as opinion and are not reflective of potential performance. Forecasts are not guaranteed and actual events or results may differ materially.
Having said that, consensus forecasts suggest earnings growth in 2019 for the A-share market will beat those of companies in both the MSCI World and MSCI Emerging Markets indices. Consensus forecasts for the A-share market also expect earnings to beat projections for the MSCI China Index, which tends to track Chinese equities that trade offshore.\footnote{Bloomberg, 31 Dec 18. For illustrative purposes only. No assumptions regarding future performance should be made}

Chinese companies do face headwinds. China has tried to curb credit growth to tackle debt levels that reached some 274 per cent of GDP by mid-2017. The country, like others, turned to debt-fuelled stimulus following the global financial crisis more than a decade ago.

Private sector companies are more susceptible to the effects of credit restrictions. There are growing signs of distress in the form of more bankruptcies and defaults. Unlike state-owned companies, these firms have few financial lifelines when bank loans dry up and regulators clamp down on unofficial sources of credit. Stock picking – a focus on cash-rich firms with strong balance sheets – can help avoid problem companies.

There is some temporary relief though. Policymakers have been easing credit restrictions because of a deteriorating external environment. Domestic consumption can also take up some of the slack from weaker external demand.

Liquid assets

The A-share market attracts heavy trading. This shouldn’t be a surprise given the influence of retail investors in this market. These investors, given their susceptibility to rumour and speculation, tend to trade their portfolios too much. Many are oblivious to the fact that transaction costs have a negative impact on investment returns.

To show just how liquid this market is, we ranked the share turnover velocity of 63 stock exchanges in developed and emerging markets over a 12-month period. Share turnover velocity is a crude gauge of liquidity. It’s derived from dividing the number of shares traded over a period by the average number of shares outstanding during that period.

The Shenzhen Stock Exchange is the third-most liquid in the world, with the Shanghai Stock Exchange ranked fifth, based on data as of end-October 2018 compiled by the World Federation of Exchanges\footnote{World Federation of Exchanges members, affiliates, correspondents and non-members, Oct 18} (see Chart 7).

\footnote{Information of specific securities mentioned is for reference only. It does not constitute a solicitation or recommendation to purchase or sell any securities.}

\footnote{Bloomberg, 10 Jan 19. For illustrative purposes only. No assumptions regarding future performance should be made}

\footnote{Bloomberg, 31 Dec 18. For illustrative purposes only. No assumptions regarding future performance should be made}

\footnote{World Federation of Exchanges members, affiliates, correspondents and non-members, Oct 18}
Past isolation means low correlation

For decades the onshore market developed in isolation. Few foreign investors followed A-shares. Even today, an unsophisticated local investor base that reacts to domestic rather than external factors, drives this market. As a result, the A-share market tends not to transmit global shocks with the same intensity as markets elsewhere. The onshore market has therefore been an effective way for foreign investors to diversify a portfolio.

A review of the 15-year relationship between the MSCI China A index and five other indices shows the lowest correlation with the MSCI World Index (see Chart 8). The highest correlation, perhaps unsurprisingly, is with MSCI China. The other indices were MSCI Emerging Markets, MSCI Emerging Markets Asia and MSCI Asia ex-Japan. There are several reasons for this. Foreign investors play such a small role that the A-share market isn’t so susceptible to capital flight. Growing numbers of Chinese companies which depend on domestic demand aren’t as affected by global economic and interest rate cycles. Government-linked firms support the A-share market during periods of weakness.

What’s more, the retail nature of the local market means trading often bears no relation to what’s happening in businesses and the economy.

Meanwhile, the renminbi is one of the most heavily-managed currencies in the world. This helps dampen volatility for foreign investors and we have not seen the sort of currency capitulation that devalued the Argentine peso and Turkish lira in 2018.

<table>
<thead>
<tr>
<th>Chart 8: Lower correlation with global markets</th>
</tr>
</thead>
<tbody>
<tr>
<td>15 year correlation, based on monthly data, USD unhedged indices</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>MSCI China A Onshore</th>
<th>MSCI China</th>
<th>MSCI World Index</th>
<th>MSCI EM (Emerging Markets)</th>
<th>MSCI EM Asia</th>
<th>MSCI AC Asia ex JP</th>
</tr>
</thead>
<tbody>
<tr>
<td>MSCI China A Onshore</td>
<td>1.00</td>
<td>0.62</td>
<td>0.39</td>
<td>0.49</td>
<td>0.53</td>
<td>0.53</td>
</tr>
<tr>
<td>MSCI China</td>
<td></td>
<td>1.00</td>
<td>0.70</td>
<td>0.86</td>
<td>0.89</td>
<td>0.89</td>
</tr>
<tr>
<td>MSCI World Index</td>
<td></td>
<td></td>
<td>1.00</td>
<td>0.85</td>
<td>0.82</td>
<td>0.83</td>
</tr>
<tr>
<td>MSCI EM (Emerging Markets)</td>
<td></td>
<td></td>
<td></td>
<td>1.00</td>
<td>0.97</td>
<td>0.97</td>
</tr>
<tr>
<td>MSCI EM Asia</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.00</td>
<td>1.00</td>
</tr>
<tr>
<td>MSCI AC Asia ex JP</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td>1.00</td>
</tr>
</tbody>
</table>

Rolling 3 year correlation for MSCI A-shares vs key indices (USD unhedged)

Source: Aberdeen Standard Investments, 31 Dec 18
Index considerations

MSCI added more than 220 China A-shares to its ACWI and Emerging Markets indices in June and September 2018. This followed years of feasibility studies and market consultations.

Before the year was over, the index provider announced its intention to raise the weighting of A-shares to 20 per cent from the initial 5 per cent. If approved, this will happen in two stages in May and August 2019. MSCI also proposed to make securities listed on ChiNext eligible for inclusion, with mid-cap securities qualifying in May 2020.

Furthermore, another index provider, FTSE Russell, is planning a phased index inclusion starting in June 2019, with the A-share weighting likely to reach some 5.5 per cent.

Adding A-shares into these widely-followed indices could siphon at least $11 billion of passive money into China. However, the implications are even more far-reaching.

Index inclusion serves as an endorsement that will encourage many international investors to consider this market for the first time. This includes institutional investors who may add stability to the Chinese market.

More progressive A-share companies will seek to attract capital from foreign institutional investors because this money tends to be ‘stickier’, or less susceptible to short-term sentiment. A foreign investor base could help boost a company’s profile offshore and support any overseas ambitions it may have. Foreign investors could even enhance a company’s reputation at home.

To keep their new investors happy, firms will be more receptive to suggestions on how to improve corporate governance. For example, more could adopt stock-related compensation schemes that align the interests of management with those of shareholders.

“At least $11 billion of passive money into China

13Aberdeen Standard Investments, 31 Dec 18
14https://www.msci.com/documents/1296102/8328554/Consultation_on_China_A_Shares_Inclusion_Sep_2018.pdf/a015ebd8-fb4b-2337-dec7-886556f12aa4
16CLSA, MSCI, Bloomberg, as of Sep 18
Digging deeper:

**A Framework for Forecasting Long-Term Investment Returns**

Craig Mackenzie, Head of Strategic Asset Allocation

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What is the long-term outlook for the A-share market? Using our proprietary model we take a stab at forecasting investment returns over a 10-year period.

ASI's Global Strategy team's forecasts are based on:

- Our long-term macroeconomic outlook
- Our views on earnings trends in the corporate sector
- Equity valuation levels.

The chart below shows the components which make up our forecasts for China.

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Chart 9: A-share 10-year return factors

<table>
<thead>
<tr>
<th>% per annum</th>
<th>Positive contribution to returns</th>
<th>Subtraction from returns</th>
<th>Sum of components to the left</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue growth</td>
<td>6.9</td>
<td>3.1</td>
<td>2.6</td>
</tr>
<tr>
<td>Share count change</td>
<td>3.1</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Margin expansion</td>
<td>2.6</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>EPS</td>
<td>2.6</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Valuation rerating</td>
<td>3.1</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Price return</td>
<td>5.7</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Dividend income</td>
<td>7.6</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Total return (RMB)</td>
<td>8.9</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>FX (USD)</td>
<td>1.3</td>
<td>1.2</td>
<td>1.9</td>
</tr>
<tr>
<td>Total return (USD)</td>
<td>8.9</td>
<td>1.2</td>
<td>1.9</td>
</tr>
</tbody>
</table>

Source: Aberdeen Standard Investments, as of Jan 19

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**Earnings outlook**

We evaluate three components: projections for revenue growth; profit margins; and share count.

Projections for revenue growth – This is linked to nominal growth forecasts for the Chinese economy, which will be lower than what we have been used to. There is now less scope for catch-up growth, the working population is shrinking and China has been deleveraging. That said, at 6.9 per cent a year, our 10-year revenue growth forecast for the China A market is well above that of the developed world and many other emerging economies.

Profit margins – Our forecasts are probability weighted averages across different scenarios, so we assume that profit margins revert to long-run averages through the business cycle. Profit margins today are above this long-term average, so we assume they will fall from here.

Share count – A lot of corporate growth has been through equity issuance. For most of the past 20 years, the share count for China A-shares has grown at a rate of 10 per cent a year. This diluted earnings-per-share growth for existing shareholders. The pace of share issuance has slowed in recent years and is now in the low single-digits. Given expectations of weaker economic growth, we think it is reasonable to assume this slower rate of share issuance becomes the norm. But even this more modest pace of issuance will dilute existing shareholders (we forecast dilution of some 3 per cent a year). This is in contrast with the US market where there are net buybacks, which increase returns by some 1 per cent per annum.

All in all, robust revenue growth, flat margins and high dilution rate, suggest an earnings-per-share growth forecast of less than 3 per cent a year. This is below the 5 per cent or so we have seen over the past five years.

**Valuations**

A-shares are cheap: using our valuation basket the market is around 30 per cent below fair value. History suggests that valuations tend towards the average in the long run. A-shares should benefit from a strong tailwind to returns as the index reverts to fair value. This could add some 3 per cent a year over 10 years.
Dividend yield

Dividend income for A-shares is currently around 2 per cent, which is above the long-term average (and in line with the cheap valuation picture).

Local currency returns

Bringing all these components together gives a probability-weighted mean expected return of 7.6 per cent a year in local terms. This is above our long-term forecast for global equities and above the 5.2 per cent annual return delivered by A-shares over the past decade. The forecast of higher returns is appropriate given the higher risks of investing in this market.

US dollar returns (or other major foreign currencies)

Overseas investors will need to take into account the effects of currency movements on expected returns. We think the renminbi is a little cheap versus the dollar. Any future renminbi appreciation could boost returns for dollar investors to some 8.9 per cent a year. However, the renminbi is trading around fair value against the euro, which reduces the chances of currency movements enhancing returns.

Momentum opportunity

The long-term returns for A-shares have been disappointing when compared with other markets and in the context of China’s economic success. However, this market can offer spectacular rewards for more tactical investors.

The A-share market is driven by the speculative fervour of retail investors chasing the latest hot tip. These are more important than prosaic factors such as earnings.

The following charts (see Chart 10) show how A-shares differ from other markets. The top chart shows how A-share price movements bear little relation to earnings expectations. Prices rise during periods of speculative momentum buying and crash when exuberance fades. By contrast, the bottom chart shows a close relationship between the widely followed MSCI Emerging Markets index and consensus earnings expectations.

Momentum investors can achieve very high returns in the right market conditions. For example, A-shares achieved a 303 per cent gain in the 12 months to October 2007 and a 154 per cent advance in the year to June 2015 (see Chart 11).
A strategy of buying into this market during the early stages of a boom and exiting in a disciplined manner when momentum fades, would have produced exceptional results. Of course, this is easier said than done!

**Chart 11: A-share short-term price surges**

Today's cheap valuations provide fertile ground for a large momentum rally. But there needs to be a catalyst to reignite retail sentiment. The current concerns about trade wars and slowing growth make this seem unlikely in the short term. But at some point, this will reverse and create further momentum opportunities.

Over the longer term we expect the speculative nature of the A-share market to be replaced by more fundamentally-driven returns. As more institutional investors participate we will also see the growing influence of fundamental analysis.
Part III

How has the market evolved?

As recently as 2014, foreign private sector investors who wanted to access the A-share market had few options. They had to get a Qualified Foreign Institutional Investor (QFII) or a Renminbi Qualified Foreign Institutional Investor (RQFII) licence.

This was a painful process. Application and approval took a long time. Investors were subject to investment quotas. There were restrictions on the repatriation of profits. Public sector investors – foreign central banks, supranationals and sovereign wealth funds – were governed by separate rules.

Then came another option – the Stock Connect trading platform. This allows investors to trade shares in Shanghai and Shenzhen via the Hong Kong bourse (and vice versa). The Shanghai-Hong Kong Stock Connect began operations in 2014, while the Shenzhen-Hong Kong Stock Connect launched two years later.

Getting connected

The launch of Stock Connect means it has never been easier for foreign investors to access China’s onshore equity market. Foreigners covering the Chinese market had been waiting for something like this for years.

This trading platform removed the red tape that was one of the most daunting obstacles in the way of investing onshore. Stock Connect cuts the amount of time and effort needed to buy and sell A-shares for investors based outside the mainland.

Today, anyone with a stock trading account at a brokerage in Hong Kong can trade shares from a selection of some 1,500 onshore securities. Accounts are denominated in the fully convertible Hong Kong dollar (trading and settlement are in renminbi with foreign exchange conversion handled offshore). Settlement is T+1 (the day following a trade).

Residual restrictions

Stock Connect doesn’t give foreigners access to all the approximately 3,420 securities in the A-share universe. Trading is subject to daily quotas (although regulators have raised them). Different public holidays in Hong Kong and the mainland can disrupt trading and settlement.

Day trading – the buying and selling of a security within a daily trading session – is prohibited. Margin trading – trading with money borrowed from a broker – is only permitted for certain Shanghai-listed securities.

There are restrictions on covered short-selling – selling borrowed shares – of selected Shanghai-listed securities. There are also caps on foreign ownership of individual stocks. That said, ownership restrictions have been relaxed for selected parts of the financial industry, such as asset management companies.

Futures and options

Equity derivatives in China can be best described as ‘under development’. Regulations can change at any time but, at the time of writing, this market excludes foreign investors unless they operate a wholly foreign-owned enterprise (WFOE). This is an investment vehicle that allows foreigners to run a limited liability company without a local partner11.

That said, lack of access hasn’t been a big issue since most foreign investors run long-only strategies. Some hedge funds may be unhappy but they can circumvent restrictions by entering into swap contracts with offshore banks.

For investors who do have access, CSI300 (large and mid-cap), SSE50 (large cap) and CSI500 (small cap) index futures can be traded on the China Financial Futures Exchange. Respective monthly turnover is around RMB700 billion (US$104 billion), RMB300 billion (US$ 45 billion) and RMB400 billion (US$ 59 billion).

There are different trading restrictions depending whether you have a ‘hedging’ or ‘trading’ account. For example, there is a 50-contract daily new contract opening limit for trading accounts, whereas hedging accounts can operate with no such limit.

The most popular equity option contracts are SSE50 exchange traded fund options that are traded in Shanghai. The maximum long position limit is 5000 contracts (equivalent to an underlying exposure of RMB125 million or US$18.5 million). The maximum total position limit (long and short) is 10,000 contracts.

Heading home

Chinese companies once viewed an overseas listing, especially in the US, as a sign that a firm had finally arrived in the world. Overseas listings promise better standards of accounting and disclosure which can also be more attractive for foreign investors.

High-profile companies such as Alibaba and Tencent still go offshore. The former has a primary listing in New York, the latter in Hong Kong.

But the experience of overseas-listed Chinese companies can be disappointing. Many struggle to generate and sustain investor interest. Despite higher standards overseas, there have been cases of corporate fraud which have tarnished the reputation of legitimate businesses.

Chinese companies with securities listed in the US are also subject to a broad range of US rules. This can be a problem when, for example, a state-owned enterprise wants to do business with a country that’s been placed under US sanctions.

Policymakers in China have spent the past few years trying to persuade overseas-listed Chinese companies to return home. For all these reasons, Chinese firms that listed overseas a decade ago or more have been heading in the opposite direction.

11Aberdeen Standard Investments operates a wholly foreign-owned enterprise via its unit, Aberdeen Standard Asset Management (Shanghai) Co., Ltd. It is able to use derivatives within domestic portfolios but not within funds managed for offshore investors.
Every successful repatriation expands the pool of potential investments. For example, Qihoo 360 Technology, an internet company, delisted from New York in 2016 and re-emerged in Shanghai two years later via a back door listing. Wuxi AppTec, a contract medical researcher, left New York in 2016 and relisted on the Shanghai bourse in 2018.

Policymakers have also finalised the regulatory framework for the launch of Chinese Depository Receipts (CDRs). CDRs are a local version of the American Depository Receipt which will give Chinese investors access to overseas-listed Chinese companies. This development will have less significance for foreign investors because they have unrestricted access to these companies offshore. It is, nevertheless, another example of how reforms are slowly changing local markets.

"Stock Connect cuts the amount of time and effort needed to buy and sell A-shares for investors based outside the mainland"
Digging deeper:

**Finding the ‘G’ in ESG**

Nicholas Yeo, Director and Head of Equities, China and Hong Kong

Chinese companies aren’t known for good corporate governance. But things are improving slowly in the A-share market. We take a look at some of the trailblazers and what they’ve done.

**Pioneer generation**

Hangzhou Hikvision Digital Technology is a pioneer in China. Its state-of-the-art video surveillance technology has enabled some of the latest advances in artificial intelligence and robotics.

The Shenzhen-listed company is also a pioneer when it comes to corporate governance (the ‘G’ in ESG). It is one of the few that discloses information in English on a regular basis. It was one of the first companies with an employee stock ownership scheme. Its management is among the most accessible.

Unfortunately, companies like Hikvision are still rare in the domestic A-share market. The latest biennial study by the Asian Corporate Governance Association ranked China ninth of the 11 markets surveyed\(^1\). Only the Philippines and Indonesia were placed lower.

**Baby steps**

China has a poor track record on governance. Risks investors may face include: excessive use of stock suspensions; company founders who wilfully overstep their authority; political interference; and the questionable independence of independent directors.

Companies such as Hangzhou Hikvision show that things are changing, albeit at a slow pace. In 2017, around one-third of the some 3,500 companies in the A-share universe operated a stock option plan, according to data cited by sohu.com, a Chinese internet portal\(^2\).

Employee stock ownership schemes align the interests of management with minority shareholders, and they are something that we encourage.

From 2006 to 2017, the number of companies that made a stock exchange announcement in relation to stock options increased almost 10 times to 407, the data show. More than 90 per cent of the firms that made a stock options announcement in 2017 were in the private sector.

**Foreign influences**

At various times over the years policymakers have encouraged foreign investment in Chinese companies. In the 1990s, they made state-owned enterprises list in Hong Kong in a bid to make them more competitive through exposure to an international business environment.

Starting from 2014, foreign investors were given unprecedented access to the domestic markets. This was via the two Stock Connect trading platforms that link the Hong Kong bourse with its counterparts in Shanghai and Shenzhen.

We see this broadening of the shareholder base as a good thing. Greater foreign ownership can help expose local management to global standards of accountability and international best practice.

Some companies even tell us they want more foreign investors, and especially foreign institutions, as shareholders. While this would invite greater scrutiny, foreign institutional money tends to be longer term. Long-term investors can act as a balance to the speculative retail money that can often turn the stock market into a casino.

**Getting engaged**

Meaningful engagement between companies and foreign investors makes a difference. In our experience, open and regular correspondence can lead to higher dividend pay-outs.

For example, Kweichow Moutai, the world’s most valuable liquor company, saw an increase in foreign shareholders from 2 per cent to more than 10 per cent between 2013 and end-2018. This coincided with a rise in its dividend pay-out ratio from 30 per cent to some 51 per cent\(^3\).

Dividend pay-outs in general have been on the rise in recent years. This is more so at the Shenzhen exchange, which hosts a greater proportion of private sector companies. Shanghai, where more state-owned enterprises are listed, not so much.

The dividend pay-out ratio in Shenzhen rose from 32 per cent in 2010 to 52 per cent last year, according to data compiled by Bloomberg\(^4\). In Shanghai, there was a marginal increase from 34 per cent to 35 per cent over the same period, the data show.

Poor governance remains a serious concern but things are getting better. Investors ought to be cautious but they should also recognise the efforts of a handful of trailblazing companies. The road to better Environmental, Social and Governance (ESG) awareness is a long one, but it’s one in which the first steps are already taken.

Understanding the ESG risks of a company is not just a box-ticking exercise. It can provide investors with an important analytical edge to drive better performance.

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\(^{1}\) CG Watch 2016: Ecosystems Matter – Asia’s Path to Better Home-Grown Governance, Sep 2016

\(^{2}\) A-Share Listed Company Equity Incentive Statistics and Analysis Report 2017 (Chinese language), Sohu.com, 13 Mar 2018

\(^{3}\) Information of specific securities mentioned is for reference only. It does not constitute a solicitation or recommendation to purchase or sell any securities.

\(^{4}\) Bloomberg, 31 Dec 2018. For illustrative purposes only. No assumptions regarding future performance should be made.
<table>
<thead>
<tr>
<th>Governance practice</th>
<th>Yes</th>
<th>%</th>
<th>No</th>
<th>%</th>
</tr>
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<tbody>
<tr>
<td>Do independent directors meet the one-third minimum?</td>
<td>1,231</td>
<td>100</td>
<td>1</td>
<td>0</td>
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<tr>
<td>Unqualified audit opinion?</td>
<td>1,197</td>
<td>97</td>
<td>35</td>
<td>3</td>
</tr>
<tr>
<td>No public criticism?</td>
<td>1,193</td>
<td>97</td>
<td>39</td>
<td>3</td>
</tr>
<tr>
<td>Has the chairman of the board remained unchanged?</td>
<td>1,150</td>
<td>93</td>
<td>82</td>
<td>7</td>
</tr>
<tr>
<td>Have all four board committees been established?</td>
<td>1,142</td>
<td>93</td>
<td>90</td>
<td>7</td>
</tr>
<tr>
<td>Has the CEO remained unchanged?</td>
<td>1,041</td>
<td>85</td>
<td>191</td>
<td>15</td>
</tr>
<tr>
<td>Do directors own the company’s shares?</td>
<td>942</td>
<td>76</td>
<td>290</td>
<td>24</td>
</tr>
<tr>
<td>Does the CEO own the company shares?</td>
<td>887</td>
<td>72</td>
<td>345</td>
<td>28</td>
</tr>
<tr>
<td>Is the chairman and CEO separate?</td>
<td>653</td>
<td>53</td>
<td>579</td>
<td>47</td>
</tr>
<tr>
<td>Full attendance of directors at AGM?</td>
<td>624</td>
<td>51</td>
<td>608</td>
<td>49</td>
</tr>
<tr>
<td>Do supervisors own the company’s shares?</td>
<td>494</td>
<td>40</td>
<td>738</td>
<td>60</td>
</tr>
</tbody>
</table>

Source: ACGA China CG Report 2018, Li and Hao 2014
Part IV

Where are the risks?

Investors face the usual risks of investing in emerging markets and their currencies. In addition, investors in China’s A-share markets need to understand these unique risks.

Untested regulations

The rules that govern investing via QFIIs and RQFIIs are relatively new, novel and subject to revisions. The application and interpretation of those rules are untested and there is no certainty over how they will be applied.

This is even more the case with the regulations that govern the Stock Connect platform. A-shares traded via Stock Connect are subject to mainland laws and regulations. While concepts of ‘beneficial ownership’ and ‘nominee holdings’ are referred to under Chinese regulations, they are untested in the mainland courts. There is no guarantee these courts will recognise them in the event of a liquidation of a company’s assets. Mainland shares bought via Stock Connect are held by a sub-custodian in accounts with the Hong Kong Securities Clearing Company, which acts as the ‘nominee holder’.

While investors’ ownership may be ultimately recognised, there could be difficulties or delays when enforcing ownership rights.

Stock suspensions

Listed companies have the option to suspend trading of their own shares, an option that’s often exercised on the flimsiest of pretexts. These shares can remain suspended for months at a time.

During the height of the big market selloff of mid-2015, some 1,200 out of 2,808 listed companies applied for voluntary suspension. This was an unprecedented move amid efforts to avert a market meltdown. On that occasion, stock suspensions helped stop a share rout from turning into a systemic risk.

However, suspensions happen far too often. In such cases they prevent the normal functioning of the market and cause illiquidity.

That’s why, starting in November 2018, the China Securities Regulatory Commission announced a series of ‘guiding’ principles. These principles require companies to improve communication and transparency, and avoid long-term trading suspensions. Crucially, the new guidelines limit the circumstances under which a company can apply for suspension.

The issue of stock suspensions has been a bugbear for foreigners. Corporate governance standards in China are generally poor. This topic is addressed in more detail in Finding the ‘G’ in ESG. However, as policymakers seek to attract more foreign investor participation, they are making efforts to address concerns.

Slowing growth

The economy grew 6.5 per cent in 2018 and our economists are forecasting growth to decelerate to 6.1 per cent in 2019, and 5.8 per cent in 2020.

Even before the US-China trade war started keeping investors awake at night, China was already deleveraging to wean the economy off a decade of debt-fuelled stimulus. Stimulus had helped the country emerge unscathed from the global financial crisis.

But stimulus policies had funnelled money into unproductive investments. Recent moves to curb access to credit caused more damage for the private sector. These are companies that form the backbone of the consumer-driven, new-look economy that China wants to create. Defaults are rising and business sentiment is weakening.

There may be a temporary ceasefire with the US on trade. However, we see few signs that a sustainable circuit breaker on this, or broader geo-political tensions, are on the cards.

Chinese policymakers are trying to mitigate some of the effects of this deterioration in the business environment by resorting to stimulus again, albeit on a more modest scale. While this will prop up growth in the short term, it cannot (and will not) be a long-term solution.

The years when China’s economy grew each year at double-digits are gone. But even with annual growth of just over 6 per cent a year, China will account for some one-third of global GDP growth.

Taxation

Current rules offer temporary tax relief for foreign investors who have been investing in locally-listed shares since October/November 2014.

‘Caishui 2014 No. 79’ states that QFIIs and RQFIIs without an ‘establishment or place’ in China are temporarily exempt from withholding income tax on gains derived from equity investments after November 14 2014.

Meanwhile, ‘Caishui 2014 No. 81’ (October 31 2014) and ‘Caishui 2016 No. 127’ (December 5 2016) state that corporate income tax, individual income tax and business tax are temporarily waived on gains derived by Hong Kong and overseas investors on the trading of A-shares via Stock Connect.

That said, tax on dividends and bonus shares are still levied unless the investor is a tax resident of a jurisdiction that has signed a tax treaty with China which confers preferential treatment.

Tax relief, where it exists, is only temporary and the risk is that these rules may change at any time and taxes levied retrospectively.

23Haver, Aberdeen Standard Investments, Oct 2018
Capital controls

Capital controls pose a risk, albeit a small one. The renminbi is a managed currency and there are restrictions on the cross-border movement of money.

We believe any sustained attempt to prevent foreign investors from repatriating profits will damage China’s goal of opening up its capital market to overseas investment.

When Thailand imposed capital controls in December 2006, the move scared off foreign investors who were slow to return even after restrictions ended. Policymakers around the region would have learned that lesson well.

The Stock Connect scheme has also made capital repatriation much easier.

Currency risks

The renminbi is one of the most heavily managed currencies in the world. Currency management provides stability which helps dampen volatility for foreign investors.

But over the long term, many economists believe it is impossible to combine: a fixed and stable exchange rate; an independent monetary policy; and free international capital flows.

Most countries make do with two of the three. Attempts to achieve all three – as China is doing – have been disastrous. If China is forced to give up one component of the so-called ‘impossible trinity’, control of the currency could be at the top of the list.

That said, the likelihood of policymakers relinquishing control of the renminbi in the short term is still remote.

“The years when China’s economy grew each year at double-digits are gone. But even with annual growth of just over 6 per cent a year, China will account for some one-third of global GDP growth”
Conclusion

Investors outside China have enjoyed easier access to A-shares for some years now. But with FTSE Russell planning to add this asset class to a regional benchmark in 2019, and MSCI considering letting A-shares play a more important role in its own indices, there is little excuse for investors to dismiss this market as either parochial or irrelevant.

This is a market that is maturing. Both policymakers and market players are keen to introduce more professionalism to create a capital market more befitting China’s economic status. For investors with a greater risk appetite, a short-term trading strategy has yielded handsome rewards in the past. For those with a longer-term view, there are hidden gems to be unearthed.

China is the world’s second-largest economy, one that is set to overtake that of the US within a generation. It has created wealth and enriched its people in an unprecedented manner. In doing so, the Chinese have become one of the most powerful forces shaping consumption behaviour in the world today. A-shares offer unrivalled access to these historic changes.

That said, the development of the onshore equity market has lagged economic development. Growth hasn’t translated smoothly into broad-based and sustained share price gains. Standards of corporate governance, while improving, compare unfavourably with other markets. Investors who deploy passive strategies will likely be disappointed over the long run.

China also faces new uncertainties. It is trying to balance growth and sustainability. It must conduct business in a world that is more hostile to its goals. Changes in internal politics could deliver stability or just as easily stoke resistance.

Investing in A-shares may be riskier than investing in more established equity markets. But it is no more risky that investing in other emerging markets. They deserve, at the very least, careful consideration.

Today, the bigger risk for investors is ignorance. Should you invest in the market because the index weight is increasing? No! But you should spend the time necessary to understand the potential of the market before the index-following crowd arrives.
Important information

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*as at 30 Jun 2018

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