China’s total equity market makes up 15% of the world and about 50% of the emerging market universe as measured by market capitalization.\(^1\) However, for foreign investors, this significant growth opportunity was inaccessible as China’s government has historically limited access to the country’s domestic equity market, also known as the “A-Share” market.\(^2\) Instead, only a small subset of Chinese equities, known as B-Shares, H-Shares, N-Shares, L-Shares, S-Shares and red chips (roughly just 20% of China’s total equity market) had been made available to foreign investors.

International access to the local China A-Share market—roughly 80% of China’s overall equity market—has become more readily available due partly to Chinese policymakers’ push for market liberalization. Foreign investors authorized as Qualified Foreign Institutional Investors (“QFIIs”) and Renminbi QFII (“RQFII”), gained access to the A-share market in 2002 and 2011 respectively allowing the creation of new products to offer Chinese equity exposure. Currently, the total quota available via QFII and RQFII programs stands at almost 2% of China’s total market capitalization; with plans to increase this to 10–15% in the next few years.\(^3\) According to the Chinese government, these investment quotas are designed to regulate foreign investment and prevent massive outflows during market downturns.

**Qualified Foreign Institutional Investor (QFII)**

In 2002, the Chinese government — attempting to spur further investment in its equity markets — began issuing investment quotas, allowing “qualified institutional investors” to access the A-share market. Through offshore currency accounts, licensed QFII are able to invest in A-Share equities, bonds, index futures, warrants, open/closed-end funds and ETFs on both the Shanghai and Shenzhen exchanges. Approved QFII applicants must meet strict criteria by the China Securities Regulatory Commission (CSRC), including minimum thresholds of capital, years of business experience, and assets under management.

The total QFII quota currently stands at RMB467.2bn (USD$75.5bn).\(^5\)
China: Making Sense of the Share-class Alphabet

Renminbi Qualified Foreign Institutional Investor (RQFII)

Launched in 2011, the Renminbi Qualified Foreign Institutional Investor (RQFII) program is an extended version of QFII — facilitating foreign investment in the mainland via offshore renminbi accounts. RQFII participants can invest in the same range of investment products and are subject to many of the same restrictions as QFII participants. However, a RQFII uses renminbi to purchase securities, while a QFII uses their foreign home currency.

At launch, the RQFII program was limited to only Hong Kong subsidiaries of Chinese financial institutions. But over the past two years, the license has been extended to additional Hong Kong banks and asset managers as well as to financial institutions in locations such as London, Singapore and Taiwan.

The total RQFII quota stands at approximately RMB382.7bn (USD$61.8bn).6

Hong Kong ≠ China

(At least in terms of its China stock exposure)

Popular forms of gaining exposure to Chinese equities have included H-Shares, which are Hong Kong-listed Chinese stocks, or through Hong Kong companies; however, neither of these avenues provide complete or accurate representations of the Chinese equity market. H-Shares only comprise 13% of China’s equity market by market capitalization (Figure 1). Moreover, the Chinese companies listed on international exchanges, such as Hong Kong and New York, represent more mature corporations that may be more susceptible to movements in the global market. Additionally, Hong Kong stocks do not provide exposure to the Chinese economy.

Since Britain relinquished control of the Hong Kong territory in 1997, Hong Kong has been a separate entity governed as a special administrative region. Today, Hong Kong retains its own legal system, a high degree of autonomy, a “national” currency and a major capitalist service economy. Moreover, Hong Kong is a developed market, with half of its economic activity geared toward global business and financial services. In addition, Hong Kong’s economy is highly dependent on its export business, which comprises 230% of GDP.7 In contrast, developing China exports 26% of its GDP and is driven by local trends and growing domestic consumption.8 These differences are further illustrated by the relatively low correlations between the Hang Seng Hong Kong Composite Index (the total market benchmark for Hong Kong), and the CSI 300 Index (China’s leading equity benchmark). As of 30 June 2015, 3- and 5-year correlations for the Hang Seng Hong Kong Composite Index and the CSI 300 Index were 0.40 and 0.43, respectively.

A, H,...N?
Learning the Chinese Investing Alphabet

Investors new to China are frequently bewildered by the dizzying array of share classes: A, H, red chips, p chips, “dragons”...the list goes on. However, only a handful of the share classes are truly relevant. The China H exchange comprises stocks listed in Hong Kong. It’s an older market than China A (opening in the early 1980s, versus 1990 for A), and importantly, has always been open to investment from international investors. China A is only now widening its scope. For that reason, China H is actually treated as a developed market, and correlations between China H and other markets are much higher.

While some stocks are dual-listed on China A and China H, China A’s constituency — whether government-owned (red chips) or not (p chips) — is overall much more domestic-driven. China A offers relatively fewer financial stocks, and more consumer (both discretionary and staples), information technology and health care stocks — the exact sectors that will benefit most from the Chinese domestic growth story. However, many of the hot, mainland-based online retail or other tech companies (including retailing giant Alibaba), have increasingly chosen to list in New York (N share), either on the New York Stock Exchange or NASDAQ.

2  Shanghai Stock Exchange and Shenzhen Stock Exchange, as of March 31, 2015.
4  Source: Cheung, Christopher; Huguet, George; and Ng, Sunny. Value, Size, Momentum, Dividend Yield, and Volatility in China’s A-Share Market. The Journal of Portfolio Management, 41, No. 5: pp. 57-70.
5  Reuters, May 29, 2015: China’s QFII quota rises to $75.54bln in June (http://www.reuters.com/article/2015/06/30/china-investment-qfii-idUSB9N0YB01420150630).
6  Bloomberg, List of 129 China RQFIs as of May 2015 (http://www.bloomberg.com/offshorechina/rqfii/).
7  World Bank, October 2014.
8  World Bank, October 2014.
China: Making Sense of the Share-class Alphabet

Figure 1: Comparison of the Chinese Investing Alphabet

<table>
<thead>
<tr>
<th>A-Shares</th>
<th>B-Shares</th>
<th>N-Shares</th>
<th>H-Shares</th>
<th>Red Chips</th>
<th>L-Shares*</th>
<th>S-Shares</th>
</tr>
</thead>
<tbody>
<tr>
<td>The onshore domestic market providing full representation of all stocks and sectors traded</td>
<td>A subset of the full largecap market traded in foreign currency in China</td>
<td>A subset of the full market trading on exchange in the US</td>
<td>A subset of the full market traded in HK</td>
<td>A subset of directly or indirectly controlled government stocks traded in HK</td>
<td>A subset of the full small-cap market traded GBP in London</td>
<td>A subset of the full small to mid-cap market traded in SGD in Singapore</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Stock Exchange</th>
<th># of Constituents</th>
<th>Market Cap (USD)</th>
<th>Breakdown</th>
<th>Currency</th>
<th>Available to</th>
</tr>
</thead>
<tbody>
<tr>
<td>Shanghai</td>
<td>1058</td>
<td>$5.9tn</td>
<td>All</td>
<td>RMB</td>
<td>PRC citizens &amp; foreign investors who have been approved as QFII or RQFII</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>1696</td>
<td>$4.4tn</td>
<td>Small-Mid</td>
<td>Foreign Currencies</td>
<td>PRC citizens &amp; foreign investors</td>
</tr>
<tr>
<td>Shanghai</td>
<td>464</td>
<td>$15.8bn</td>
<td>Large</td>
<td>USD</td>
<td>All investors</td>
</tr>
<tr>
<td>Shenzhen</td>
<td>53</td>
<td>$23.9bn</td>
<td>All</td>
<td>HKD</td>
<td>All investors</td>
</tr>
<tr>
<td>Exchanges</td>
<td>51</td>
<td>$19bn</td>
<td>Mid-Large</td>
<td>GBP</td>
<td>All investors</td>
</tr>
<tr>
<td>ChiNext</td>
<td>154</td>
<td>$825bn</td>
<td>Small</td>
<td>SGD</td>
<td>All investors</td>
</tr>
<tr>
<td>NYSE, NASDAQ</td>
<td>186</td>
<td>$853.5bn</td>
<td>Small-Mid</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Hong Kong</td>
<td>138</td>
<td>$781.7bn</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>London</td>
<td>60</td>
<td>$27.8bn</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Singapore</td>
<td>179</td>
<td>$1.5bn</td>
<td></td>
<td></td>
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</tr>
</tbody>
</table>


Stock Connect and Beyond: Broader Reach into China for Retail and Institutional Investors Alike

In an effort to further relax controls on capital flows into and out of the country, China introduced a new trading link between Shanghai and Hong Kong in November 2014. Known as the “Stock Connect”, this program created a channel through which investors outside mainland China can trade and settle equity securities through Hong Kong brokerage accounts. At the same time, this “Express,” or “through train,” as it is known, also began operating a “southbound route,” making it easier for mainland investors to invest in more than 1,400 companies listed on the Hong Kong stock exchange. The Hong Kong-Shanghai Connect now gives anyone with a Hong Kong brokerage account the ability to tap an aggregate daily quota open to all market participants.

During the time of launch, these plans fueled a huge market rally on both exchanges. Regulators from China and Hong Kong have moved cautiously, highlighting the difficulties in linking up two systems at varied stages of progress under one unified program. An extension of this Stock Connect to include the Shenzhen Stock Exchange is scheduled for late 2015.

One additional touch point for investors is the addition of mainland China stocks into the MSCI EM Index (The MSCI Emerging Markets Index captures large and mid cap representation across 23 Emerging Markets (EM) countries). In June, MSCI announced that it would hold off from adding China A stocks to its benchmark indexes, saying that progress has been made but China needs to resolve “a few important remaining issues related to market accessibility.” When, eventually, passive flows move into China A-shares following their expected inclusion in MSCI EM, there will clearly be a tailwind, which should figure on top of the diversification that China A shares provide through their exposure to the domestic Chinese economy.
This document represents the views and opinions of our investment team based on market conditions as of 10 July 2015, and is subject to change as the situation in China continues to evolve. This material is provided for informational and educational purposes only and is not intended as investment advice.

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