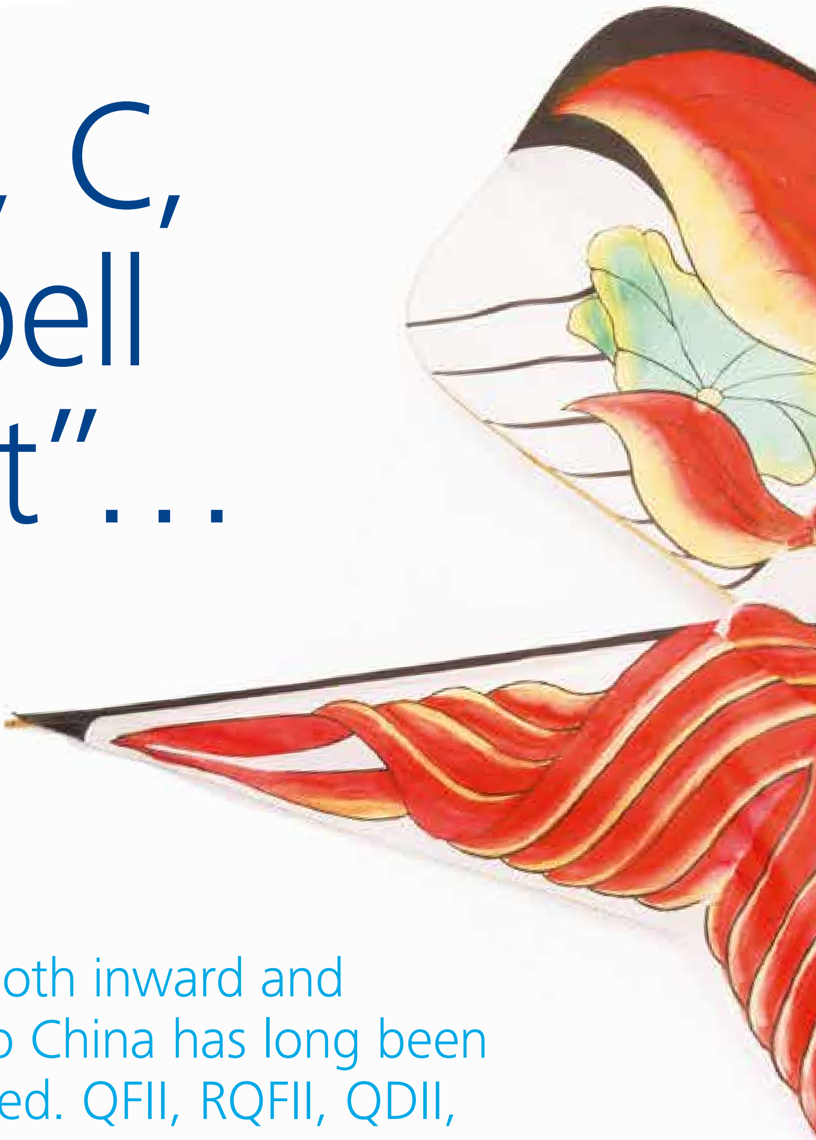
When A, C, and H spell “Connect”…



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The alphabet soup for both inward and outward investment into China has long been a preserve for the initiated. QFII, RQFII, QDII, the more esoteric QDLP, and QFLP (yes they do exist—go to look them up!) may seem bewildering to the outsider, and a form of almost club-ish shorthand used among those in the know.

This is perhaps a little exaggerated as a perception, but overall there is the feeling that yes, it is possible to invest in China, even to some extent to distribute products in China (did you know that you can sell UCITS to QDIIs?), but to do so you must invest the time and effort to understand how the various structures work, to determine the most appropriate, and then to apply for the relevant authorizations.

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The way in which China has developed these regulations—progressively, patiently, and over time—has also meant that to a large extent the market perception has been reinforced. The solutions are there, but it will take time before we can speak of genuine free access.

Stock Connect, or, more specifically, Hong Kong–Shanghai Stock Connect, therefore came as something of a surprise. Certainly there had been rumours of new initiatives in the making, but rumours had also implemented mutual recognition in Hong Kong almost monthly for over a year. Initially the project did not attract exceptional interest on the international stage—another initiative to be followed, monitored, and considered.

Then all of a sudden things accelerated. The last details were being worked out, there was a go-live date announced that was imminent. Finally, it dawned on the market that here for the first time was a scheme allowing access to a very significant Chinese market—the A-shares traded on the Shanghai board with minimal procedural difficulty and very little constraint.

And guess what? It was due to happen next month! In the end there were a couple of last minute delays that sent the cynics off muttering something to the effect of believing it when they saw it, but for once they were proved wrong. A new date, also imminent, was announced, and lo and behold China Stock Connect went live that day and exists.

The interest from asset managers was immediate. Not perhaps so much from those who were already active in the region, the giants, or the locally focused, but for many others either running emerging market equity funds, or even with a client base alive to the macro-economic opportunities in China, this was a golden opportunity to play catch up and to compete with those big boys by offering a product that had a similar investment profile but did not require the long lead time of an RQFII or QFII setup.

The basis for Stock Connect is very simple: it is a trading “infrastructure” routing in two legs. The “northbound” leg from Hong Kong to Shanghai allows anyone placing an order through a Hong Kong registered broker to purchase China A-shares quoted on the Shanghai Stock Exchange, while the “southbound” leg allows Chinese investors to purchase the shares in the Hang Seng large- and mid-cap index and any additional C- and H-shares that are not in those two indices but quoted in Hong Kong. The system does have a number of constraints. There is a quota system in place (as a Chinese friend remarked recently, quotas are in Chinese DNA).

There is a total overall allocation for the northbound route of 300 billion renminbi and a daily quota of net 13 billion renminbi on the purchase side. When the daily net volume of transactions originated in Hong Kong reaches 13 billion renminbi, purchasing stops.

There is no limitation on sales, so foreign investors in Hong Kong or elsewhere accessing Hong Kong via the system are assured of liquidity— and their sales are netted against purchases in calculating the quota usage.

Currently of the overall quota approximately 40 percent has been used. Perhaps more surprisingly, the south-bound route that allows Chinese investors access to selected stocks in Hong Kong, saw a surge in recent months (before the current market setback), resulting in not infrequent daily volumes that hit the daily threshold as the value disparity between A-shares and other related stocks attracted investors. Perhaps this is one of the first instances when sponsored schemes have arbitraged out market discrepancies rather than creating them. Certainly as a pilot scheme, Stock Connect has already shown its capacity to take center stage. So the Hong Kong-Shanghai Stock Connect is here to stay. But what else is on the horizon? What else should we be looking out for in the ever-changing landscape of Chinese investing?

As mentioned, for those watching China, certain themes quickly become familiar, and, interestingly, they are common to both Hong Kong and the mainland, perhaps underscoring yet again that Hong Kong is part of China and developments involving the two are carefully coordinated.

One of these themes is that announcements of proposed developments are made at regular intervals. This was the case with mutual recognition, where the announcement of the scheme pre-dated its eventual launch by two years or more. Secondly, announcements that have been made some time in the past can very quickly accelerate and be implemented even after months or, in some cases, years when nothing very much seems to happen. To understand this process, it is important to understand that, almost without exception, all these announcements concern schemes or developments that are "pilots" within the greater objective of bringing the Chinese currency to the full status of a recognized and used reserve currency, and the complete opening of Chinese markets accompanied by the equivalent unhindered access of Chinese capital and investment to foreign and global markets.

Parallel to the notion of a "pilot" in terms of developments in China is the notion of quotas. The two concepts together are considered to be the cornerstones of development that have allowed China to leave the chaos and confusion of the early years of the previous century, to survive the shocks of civil and world war in the middle of the century, and finally to emerge from the upheaval and trauma of the Cultural Revolution to its current status on the world economic and geopolitical stage.

So each of these initiatives is seen as a continuum of several parts to a greater goal. In one respect, as noted, this can be confusing because it can also be noted that only one major initiative will be under way at any given time. This is best illustrated when we consider mutual recognition and Stock Connect. Mutual recognition, in addition to delays necessary to sort out certain technical issues and reach all important guidelines around the thorny issue of misselling, was to some extent sacrificed to allow space for Stock Connect.

Now that Stock Connect is functioning, what is likely to come next? Currently there are a number of initiatives that have been mentioned, or rather announced:

- The extension of Stock Connect to include Shenzhen, where, in addition to the remaining A- share market—those not quoted on Shanghai—there is also a mid-cap board and a small-cap board on the exchange that may eligible, as may be, as it is rumored, certain ETFs
- The extension of the QDII scheme to encompass six new cities
- The review of current RQFII and QFII regulations to bring them into line
- The "relaunch" of the QDLP and the QFLP schemes

The extension of Stock Connect to Shenzhen was considered to be key and central at one stage, and it probably still is. The initial launch date was expected for this year—by year end—although it looks likely now that it could well be pushed back to 2016. (Once again it is worth adding a note of caution. As we described earlier with the initial Stock Connect, all of a sudden it was on top of us; we cannot exclude a similar surprise for Shenzhen.) The importance of Shenzhen Stock Connect is that it extends or rather completes the A-share world—with, as mentioned, those A-shares not listed on Shanghai.

This is an important step in the bigger picture and probably a sine qua non for inclusion in the MSCI—certainly that is the strategic importance of the move that has been much discussed. Having said that, the potential inclusion of the mid-cap and small-cap offering alongside ETFs could also be far reaching in its implications. Thus far, the universe available via Stock Connect is limited to the A-shares: any other foreign investment requirement needs to be satisfied via an RQFII or QFII arrangement.

Many RQFII and QFII investors envisage the coexistence of both routes in their investment strategy, so an extension of Stock Connect into other fields would be a very welcome development.

At the same time we should not lose sight of what has been happening both under the existing Stock Connect arrangements and in the wider Chinese market itself. Some of the flows under Stock Connect have been probably different to what was anticipated. The "limit up" (in terms of quota) for a reasonably long period on the southbound track is something of a surprise. The degree of potential interest northbound is also hard to assess, especially when one remembers that this is indeed a pilot. What difference would MSCI inclusion have made? What difference would less reticence on the part of European funds have made? (The main foreign fund actors under Stock Connect to date have been offshore hedge funds and US 40 Act funds, while Europeans have struggled a little with the challenge of making Chinese and European regulation tie up, something that may not be over yet when one considers that UCITS V still has to be implemented). These considerations must also be evaluated against the backdrop of recent and current market turbulence in China, attributed in many cases to domestic and retail leverage, although rumors have also circulated to the effect that foreign houses may have found means to illicitly short the market.

Perhaps taking all these considerations together, and the prudent step-by-step approach that is characteristic of the way China is opening its markets, a period of further evaluation and analysis may not go amiss. After all, what is six months to the economy that will almost inevitably grow in time to be the world's largest?

The extension of the QDII regime might well prove the wild card and the surprise. The QDII regime allows qualifying domestic Chinese investors to invest directly in foreign securities.

This was initially considered to be limited to stocks and bonds, but some QDIIs have taken foreign investment funds to be securities, and it is under the QDII arrangement that some UCITS have found their first distribution outlet in China. On the whole, take up under QDII has been muted, although this has been largely attributed to a combination of poor marketing and an overly competitive domestic market in terms of return.

Sometimes referred to as QDII2, it is reported that the new version will initially be launched in six Chinese cities: Shanghai, Tianjin, Chongqing, Wuhan, Shenzhen, and Wenzhou, and it is expected to be open to investors with financial assets of at least (the equivalent of) US$160,000. Details as to the total quota, etc. are as yet sketchy; however, it is widely believed that the range of eligible investments may well include foreign investment funds. Clearly, with a certain amount of uncertainty creeping into domestic markets and some pressure for foreign funds to be included under Mutual Recognition arrangements, QDII2 could be the next step in opening China's new affluent markets to foreign investments.

Certainly it is the one for UCITS distributors to be watching. The current QFII and RQFII rules can represent their own challenges. Since initially introduced over a decade ago, QFII and subsequently RQFII rules, like the geographic allocation of RQFII quota, have changed significantly over time. This has had the greatest impact on the level to which ultimate beneficial owners may be segregated within the books of the QFII or RQFII without losing either specific rights or quota in the event of disinvestment and, more recently, the more flexible structures that may be obtained when running an "open-ended China fund" versus segregated mandates under the RQFII system. (An "open-ended China fund" benefits from flexible rules on regular repatriations without loss of quota, facilitating the use of the quota for foreign mutual funds; however, "fund" quota and mandate quota are not fungible and must be clearly identified from the outset.) Clearly a harmonization of the rules around the most flexible procedures would be a great boon to investment managers in planning their offering in Chinese markets to foreign investors.

QDLP (Qualified Domestic Limited Partnership) and QFLP (Qualified Foreign Limited Partnership) were schemes introduced in certain Chinese cities—with, once again, Shanghai figuring prominently, designed to facilitate the creation of joint ventures in the first instance to offer investment products to Chinese investors and to invest in domestic Chinese companies, respectively. It is probably fair to say that these two options, while finding immediate "takers" in terms of being setup, have not realized the potential that might have been anticipated. Again, a relaunch, possibly with more flexible rules, clarification on certain fiscal uncertainties, and a broader scope could both attract much greater interest and begin to unlock further parts of the jigsaw puzzle of investing in China.

Which of these initiatives will be prioritized? Only time will tell, although we would have a sneaking suspicion that QDII2 may well work its way up the agenda.

Or perhaps none of them.

For is one more, one that has yet to be announced, and yet one that must inevitably come. It may even be the greatest opportunity for Sino-European collaboration, but for that to happen, many moving parts would have to fall into place at the same time. This would be infrastructure investment. At the same time, as the EU is launching its ELTIF (European long-term investment fund) product designed specifically for this asset class, China has underway two of the most ambitious infrastructure projects in history. Sometimes decried as too ambitious, the Silk Road Economic Belt and the 21st Century Maritime Silk Road are designed to provide major trading and economic development links between China, through Asia to the western world.

The geopolitical challenge is immense, and the ambition is truly staggering. Some say that it may never happen. However, one of the first cornerstones for infrastructure development—the Asian Infrastructure Investment Bank—despite similar criticism and skepticism is well on the way to becoming a reality. What greater way for favoring inward and outward investment could there be for China to design and structure its own equivalent of the ELTIF. Indeed would it be far-fetched to suggest that voices calling for an extension of mutual recognition might look first at an infrastructure project vehicle for Chinese-EU mutual recognition rather than existing fund structures.

Certainly the idea is too complex, too advanced, and too sensitive for it to trouble the current calendar of initiatives that are progressively opening up Chinese markets to inward and outward investment. But in the future? Who knows. Infrastructure is in many ways the last investment horizon—it ticks so many boxes but poses so many challenges. It does, however, have one unique geo-political advantage. In creating physical infrastructure, it provides incentives to geopolitical stability that cannot be torn up on the whim of a single man or country. Food for thought indeed. China investment is here to stay.

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To the point

- Investment and product distribution in China is becoming more and more a reality due to "pilot" schemes launched in Hong Kong and mainland China
- The Hong Kong-Shanghai Stock Connect is one of these pilot schemes. It constitutes a trading infrastructure that reaches in two directions. The "northbound" route from Hong Kong to Shanghai allows someone placing orders through a Hong Kong registered broker to purchase China A-shares that are quoted on the Shanghai Stock Exchange. The "southbound" route allows Chinese investors to purchase the constituent stocks of the Hang Seng Composite Large Cap Index and Hang Seng Composite Mid Cap Index. They can also purchase all H-shares that are not included as constituent stocks of the relevant indices but that have corresponding A-shares listed in Shanghai except for Hong Kong shares not traded in Hong Kong dollars and H-shares that have shares listed and traded not in Shanghai
- The only constraint to the Hong Kong-Shanghai Stock Connect is the quota system in place on the purchase side (i.e., the "northbound" route). There is a cap at 13 billion renminbi for daily net transaction volumes and a cap of 300 billion renminbi for total overall allocation
- The announcements of such proposed pilot schemes and developments are often made years before implementation. However, the launch itself is often difficult to predict; sometimes the launch date is continuously pushed back. At other times, the scheme surprises investors by being implemented with unexpected speed.
- Other schemes that deserve some attention are the extension of the Stock Connect scheme to include Shenzhen, which may potentially also include ETFs, the extension of the QDII scheme to include Shanghai, Tianjin, Chongqing, Wuhan, Shenzhen, and Wenzhou, the review of the current RQFII and QFII regulations as well as the relaunch of the QDLP and QFLP schemes
- The objective of facilitating foreign investment in Hong Kong and China is simple: China wishes to open its market to the world and bring the Chinese currency to the full status of a recognized and used reserve currency. This objective dovetails with the holistic strategy of developing major trading and economic links from China through Asia to the western world. The Silk Road Economic Belt and the 21st Century Maritime Silk Road are the two major infrastructure projects envisioned to meet this challenge. One of the prerequisites to tackle this geo-political challenge, the Asian Infrastructure Investment Bank, is already well on its way to becoming a reality