Guide to Accessing China

November 2018

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China has grown over the years to become the world’s second largest economy. It drives around a fifth of the world’s GDP growth today. China’s dominance in the global economic landscape is also reflected in the size of its capital markets: outstanding Chinese onshore bonds total USD 12 trillion while Chinese onshore equity market capitalization amounts to USD 7.7 trillion. This enormous onshore market has been gradually allowing foreign investors access through various channels as the Chinese government takes steady steps to liberalize its economy and markets and to improve its financial system. Global index providers for bonds and equities are now beginning to add Chinese onshore securities into their indices, prompting global investors to rethink asset allocation strategies.

Chinese bonds represent 10% of the global bond market

...but account for less than 1% of Bbg Barclays Global Aggregate (BGA) Index

Chinese equities represent about 15% of the global equity market

...but account for 5% of MSCI AC World Index

1: From bottom to top: US = NYSE + NASDAQ; China = SSE + SZE + HKEx; India = BSE + NSE


Source: MSCI, Bloomberg, data as of September 2018.
Chinese equity market structure

Market structure of onshore and offshore equity markets

Shenzhen A-shares (onshore)
- ~2,180 stocks (including SME & ChiNext)
- USD3.2trn market cap (40% free float)
- ~900 stocks available via Shenzhen-HK Connect
- 1-year ADV: USD39bn
- 12.8x forward P/E
- TTM dividend yield: 1.35%

Shanghai A-shares (onshore)
- ~1,500 stocks
- USD4.5trn market cap (31% free float)
- ~570 stocks available via Shanghai-HK Connect
- 1-year ADV: USD27bn
- 9.5x forward P/E
- TTM dividend yield: 2.63%

Hong Kong Stock Exchange (offshore)
- ~1,900 stocks (including H-shares)
- USD4.4trn market cap (68% free float)
- 1-year ADV: USD14.6bn
- 10.7x forward P/E
- TTM dividend yield: 3.94%

Investor profile
- The onshore A-share market is largely owned by retail investors, who often lack the necessary market knowledge and are easily swayed by sentiment. Therefore, A-shares tend to display greater volatility than offshore H-shares

Company size
- There are a larger number of small- and mid-cap stocks in the A-share market, which tend to be under-researched and often mispriced. Having a greater percentage of large-cap companies gives Hong Kong a more mature profile

Sector breakdown
- The Hong Kong market is dominated by financials, real estate and traditional industries, whereas the A-share market, especially Shenzhen, offers more opportunities in new economy sectors such as technology, healthcare and e-commerce

Valuation dispersion
- The A-share market has greater valuation dispersion due to less mature investor profiles. Hence, stocks can sometimes trade significantly higher or lower than their fair value

1 removed top and bottom 1% outliers to calculate average

Source: HKEx, SSE, SZE, Bloomberg, HSBC Global Asset Management, data as of November 30, 2018. ADV = average daily trading volume.
Chinese bond market structure

Market structure of onshore and offshore bond markets

Years-to-maturity profile

- Chinese bond markets have relatively short duration compared to US, Euro and EM markets. The offshore CNH market has shorter duration as 20% of the market is composed of non-rated certificates of deposit (CDs). The offshore Chinese USD market is more liquid for long-dated bonds.

Credit profile

- Credit rating of Chinese onshore bonds show little differentiation as they are rated only by local rating agencies that use a different rating scale. As deleveraging continues and insolvent companies start to fail, local rating agencies and investors will reassess their perception of the bond market, improving credit pricing in future.

Sector breakdown

- Government, local government and policy bank bonds account for almost 70% of the onshore bond market, while the rest are made up of issues from local government financing vehicles and corporates.

Gross issuance

- New CNH bond issuance dwindles with the onshore bond market becoming more accessible and liquidity being better in the USD market. However, more favorable tax treatment over onshore bonds and attractive yield carry makes CNH bonds appealing.

1Reference indices: CNY – ChinaBond New Composite Index; USD – JACI China Index; CNH – Markit iBoxx ALBI China Offshore Index

Equity market liberalization

The Shanghai-Hong Kong Stock Connect, launched in 2014, and the Shenzhen-Hong Kong Stock Connect, launched in 2016, are effective, simple and straightforward channels for foreign investors to access onshore Chinese equities and have also served as the key trigger for the decision by MSCI to add Chinese A-shares into its indices. Access under the Stock Connect channels has also improved over time, as evidenced by the significant expansion of the daily quota allowed. The introduction of Chinese Depository Receipts (CDRs) is another step towards market liberalization, one intended to encourage tech giants to seek onshore listing. As market liberalization continues to speed up, so should the increased representation of Chinese markets in global indices and benchmark-tracking portfolios.

Growing presence in global indices
- MSCI launched a consultation in September 2018 to potentially bump up the inclusion factor for A-shares in its EM index from 5% currently to 20% in August 2019 and to include mid-cap A-shares using a similar inclusion factor in May 2020
- Global index provider FTSE Russell has also said it will start including mainland Chinese shares in its major benchmarks starting in June of next year
- The decisions by MSCI and FTSE are a shot in the arm for Chinese regulators, who have been trying to drum-up foreign interest in the past four years

Investors are increasing allocation to Chinese equities
- Benchmark-tracking investors have been adding to Chinese equities aggressively since 2016
- In the longer term, increased flows and foreign ownership could encourage listed companies in China to improve their corporate governance standards and business models. This in turn will help attract more flows into the market

Northbound flows have begun to catch up with southbound flows
- Although China A-shares have come under pressure in 2018 amid concerns over moderating growth and heightened trade tensions, northbound flows continue to be strong and hit historical highs in November 2018

Foreign ownership still significantly lags those of other major markets
- Foreign ownership of onshore equities has grown by 70% yoy to USD190 billion but is a mere 2.7% of the total tradable market. While it took around 7-10 years for Korean and Taiwanese stocks to be fully included into MSCI indices, the pace of inclusion for A-shares will be driven by the pace of liberalization

Source: MSCI's forecast, data as of September 2018. For “Non-Asia”, Saudi Arabia to be included in June 2019

Source: Bloomberg, data as of November 12, 2018.

Source: CEIC, Citi Research, data as of May 2018.
Bond market liberalization

Onshore bonds will be included in the BGA index for the first time thanks to the launch of Bond Connect in 2017, which further opened up onshore bond markets to foreign investors. Unlike other channels available to access onshore bonds, Bond Connect does not require a domestic account and custody, and its offshore infrastructure enables foreign investors to trade onshore bonds while following international practices. This, along with the newly available onshore FX hedging provision and a more liberalized currency, allows foreign investors to manage positions and risk at lower cost and higher efficiency. In a move to drum up more interest from foreign investors, China recently revised rules to spur trading activity through Bond Connect. Real-time delivery-versus-payment and block trades have been permitted since late August, effectively reducing settlement risk and allowing for sizeable trades. Foreign investors will be exempt from paying corporate income tax and value-added tax on interest gains from holding onshore Chinese bonds for three years.

As onshore bonds become better represented in key indices, it will be increasingly difficult for foreign investors to stay on the sidelines as Chinese bonds offers attractive yields and diversification benefits.

Impact of onshore bond inclusion into BGA index

- Starting in April 2019, the inclusion will take place over 20 months with a 5% scale factor. The index will fully include onshore government and policy banks issues by November 2020, bringing around USD140bn into the market

<table>
<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>51</td>
<td>100</td>
<td>138</td>
<td>211</td>
<td>308</td>
<td>407</td>
<td>617</td>
</tr>
</tbody>
</table>

6.36% by Nov 2020 (Forecast)

Growing number of foreign institutions with access to onshore bond market

- Significant ease of access and anticipation for further index inclusion, which may bring in a total of USD250bn-USD350bn flows to the onshore bond market, have led to an unprecedented rise in the number of registered institutional investors since 2017

Source: BIS, PBoC, Bloomberg, data as of September 2018.

CNH deposits on the rise

- Improved access to the onshore market will increase demand for offshore RMB and lead to more CNH deposits. This, in turn, also benefits the liquidity of the offshore bond market. However, strength in USD is a factor to watch out for

Source: Bloomberg, data as of September 2018.

Large potential for foreign participation

- To many foreign investors, onshore Chinese bonds offer good yield carry with relatively short duration
- With low foreign ownership and a less-correlated monetary policy compared to other major markets, these bonds provide good diversification within global portfolios
Why HSBC Global Asset Management?

Investing in China’s rapidly-changing economy and markets requires not only high-quality research, but also local insights and knowledge of various atypical market rules and practices. Investors also need to understand the different access channels that are available to them and the suitability of these channels for fulfilling their investment objectives.

**HSBC Global Asset Management** is a pioneer in Chinese investments, with deep experience in investing in both offshore and onshore Chinese securities. Our large team of investment professionals located in Hong Kong and Shanghai help investors understand the changing dynamics within Chinese markets, interpret their implications effectively and take appropriate investment decisions.

**Strong track record managing Chinese assets since 1992**

**Significant local resources and presence in China**

**A well-resourced, stable and award-winning team**

**A robust investment process built on solid proprietary research**

A network of opportunities

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1 Asia-Pacific includes employees and assets of Hang Seng Bank, in which HSBC has a majority holding. 
Source: HSBC Global Asset Management as at September 30, 2018. Any differences are due to rounding.
HSBC Global Asset Management offers investment options, encompassing Chinese equities, fixed income, multi-asset and liquidity, to institutional and wholesale investors. Our Chinese equity, bond and multi-asset strategies can invest in the Chinese onshore and offshore markets to capture investment opportunities across the board, and our passive strategies provide clients a cost-efficient way to stay on top of the ongoing inclusion of Chinese assets into global indices.

### HSBC Global Asset Management’s China investment capabilities

<table>
<thead>
<tr>
<th>Investment strategy</th>
<th>Chinese equity</th>
<th>RMB fixed income</th>
<th>China multi-asset</th>
<th>Passive China-A</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>High-conviction and diversified portfolio focusing on stocks with below average valuation for a given level of profitability</td>
<td>Focusing actively on term structure, duration, sector allocation, product selection and credit rating</td>
<td>Mixed asset with income tilt. Flexible allocation across onshore/offshore equities and bonds within a risk budget</td>
<td>Passive strategy tracking the progressive inclusion of China-A shares into the MSCI EM index</td>
</tr>
<tr>
<td>Investment universe</td>
<td>H-shares</td>
<td>Onshore RMB and offshore RMB/non-RMB denominated fixed income/debt securities</td>
<td>A/B/H-shares, red chips and ADRs</td>
<td>Stocks included in the MSCI A-share Inclusion Index</td>
</tr>
<tr>
<td></td>
<td>Red chips</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>A- and B-shares</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

### Segregated mandate considerations

**Market-access options and their pros and cons**

#### QFII/RQFII (equity and bond)

- + Broader range of products available
- + Primary market participation (e.g., IPO)
- - Licensing from CSRC; quota approval from SAFE; account opening with onshore custodian
- - Pre-funding required
- - Cannot be borrowed or transferred. Clients must apply themselves

#### CIBM Direct (bond)

- + Easy access to interbank bond market without quota
- + Hedging tools available
- - Onshore account opening and regulatory filing
- - Pre-funding required

#### Stock Connect (equity)

- + Not subject to individual quota
- + Easier registration process
- + Delivery versus payment available
- - Less coverage than QFII/RQFII
- - No primary market activity

#### Bond Connect (bond)

- + Simplest access without onshore custodian and account opening without quota
- + Use of international practices and offshore infrastructure
- + No pre-funding requirement
- - Lack of trading platform option
- - Limited hedging tools

Source: HSBC Global Asset Management. For illustrative purpose only. Please refer to appendix for more information on each option.
# Appendix I: Accessing onshore equity and bond markets

## Qualified Foreign Institutional Investors (QFII) and Renminbi Qualified Foreign Institutional Investors (RQFII)

QFII and RQFII are the earliest vehicles created for foreign investors to access the onshore markets. However, foreign ownership of the onshore markets did not see explosive growth, in part due to complex application process, capital control and lack of currency-hedging tools. As part of its effort to open up Chinese capital markets in the recent years, the government has not only further increased the approved quota, but also, starting in June 2018, removed the 3-month lock-up period and 20% monthly repatriation limit and allowed onshore FX hedging.

<table>
<thead>
<tr>
<th></th>
<th>QFII</th>
<th>RQFII</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Launch</strong></td>
<td>2002</td>
<td>2011</td>
</tr>
<tr>
<td><strong>Approved/available quota</strong></td>
<td>USD99bn/ USD51bn</td>
<td>RMB616bn/ RMB1,324bn</td>
</tr>
<tr>
<td><strong>Available instruments</strong></td>
<td>Exchange-traded securities (including IPOs), equity index futures and funds</td>
<td>Fixed income products traded in interbank bond market (CIBM)</td>
</tr>
<tr>
<td></td>
<td>Other instruments approved by CSRC and FX derivatives (for hedging purpose)</td>
<td></td>
</tr>
<tr>
<td><strong>Eligibility</strong></td>
<td>Approved institutional investors</td>
<td>Approved institutional investors</td>
</tr>
<tr>
<td>No. of approved investors</td>
<td>308</td>
<td>221</td>
</tr>
<tr>
<td><strong>Currency</strong></td>
<td>Onshore RMB</td>
<td>Offshore RMB</td>
</tr>
<tr>
<td><strong>Price limits</strong></td>
<td>+/- 10% (and 5% for stocks under special treatment)</td>
<td></td>
</tr>
<tr>
<td><strong>Foreign ownership limits</strong></td>
<td>Individual investor: 10% of a company’s total issued shares</td>
<td>Aggregate: 30% of a company’s total issued shares</td>
</tr>
<tr>
<td><strong>Settlement cycle</strong></td>
<td>Stocks on T; cash on T+1 (fail trade not allowed)</td>
<td></td>
</tr>
<tr>
<td><strong>Lock-up period</strong></td>
<td>No</td>
<td></td>
</tr>
<tr>
<td><strong>Repatriation limit</strong></td>
<td>10% withholding tax on coupon and dividend. Exempt for government bonds</td>
<td>No. Daily limit for open-end funds</td>
</tr>
<tr>
<td><strong>Tax treatment</strong></td>
<td>Capital gains tax only temporarily waived for QFII and RQFII from November 17, 2014</td>
<td>No value-added tax (VAT) for deposit interest, dividend and trading income</td>
</tr>
<tr>
<td></td>
<td>Capital gain is temporarily exempt from VAT</td>
<td>Capital income from non-government bonds is subject to 6% VAT</td>
</tr>
<tr>
<td></td>
<td>Coupon income from non-government bonds is subject to 6% VAT</td>
<td></td>
</tr>
<tr>
<td><strong>Market entry timeframe (indicative only) and process</strong></td>
<td>5-7 months time for full China access</td>
<td>CSRC: application for QFII/RQFII license</td>
</tr>
<tr>
<td></td>
<td>SAFE: quota filing (within basic quota), or approval (exceeding basic quota)</td>
<td>SAFE: quota filing (within basic quota), or approval (exceeding basic quota)</td>
</tr>
<tr>
<td></td>
<td>PBoC Shanghai: filing within SAFE quota for CIBM investment</td>
<td>PBoC Shanghai: filing within SAFE quota for CIBM investment</td>
</tr>
<tr>
<td><strong>Advantages over other channels</strong></td>
<td>Participation in primary market, including IPO, rights and warrants issuance</td>
<td>Broader access to instruments such as investment funds</td>
</tr>
<tr>
<td></td>
<td>Invest in stocks that are not included in Stock Connect</td>
<td></td>
</tr>
</tbody>
</table>

Source: HSBC Securities Services, HSBC Global Asset Management, data as of June 30, 2018. Available quota = Total quota (QFII = USD150bn; RQFII = RMB1,940bn) – Approved quota
Appendix I: Accessing the onshore equity market

Shanghai-Hong Kong and Shenzhen-Hong Kong Stock Connect programs

<table>
<thead>
<tr>
<th>Shanghai-Hong Kong (Northbound)</th>
<th>Shenzhen-Hong Kong (Northbound)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Launch</strong></td>
<td>◆ 2014</td>
</tr>
<tr>
<td><strong>Daily quota</strong>&lt;sup&gt;1&lt;/sup&gt;</td>
<td>◆ RMB52bn</td>
</tr>
<tr>
<td>(no aggregate quota)</td>
<td></td>
</tr>
<tr>
<td><strong>Available instruments</strong></td>
<td>◆ All constituent stocks on SSE 180 Index and SSE 380 Index</td>
</tr>
<tr>
<td></td>
<td>◆ All constituent stocks on SZSE Component Index, SZSE Small/Mid Cap Innovation Index with market cap &gt; RMB6bn</td>
</tr>
<tr>
<td><strong>Eligibility for northbound</strong></td>
<td>◆ All investors, except ChiNext is open to institutional investors only</td>
</tr>
<tr>
<td><strong>No. of stocks available</strong></td>
<td>◆ ~570</td>
</tr>
<tr>
<td><strong>Currency</strong></td>
<td>◆ Offshore RMB</td>
</tr>
<tr>
<td><strong>Settlement cycle</strong></td>
<td>◆ Stock on T and cash on T+1</td>
</tr>
<tr>
<td><strong>Lock-up period</strong></td>
<td>◆ No. Unless 1) the securities cease to be constituent stock of relevant indices; 2) placed under risk alert, or delisted from SEHK</td>
</tr>
<tr>
<td><strong>Repatriation limit</strong></td>
<td>◆ No</td>
</tr>
<tr>
<td><strong>Trading</strong></td>
<td>◆ No block trade, day trading and naked short selling</td>
</tr>
<tr>
<td><strong>Latest developments</strong></td>
<td>◆ Quadruple expansion of daily quota</td>
</tr>
<tr>
<td><strong>Potential changes in future</strong></td>
<td>◆ ETF Connect for southbound investors</td>
</tr>
</tbody>
</table>

Stock Connect trade flow illustration

Appendix I: Accessing the onshore bond market

China Interbank Bond Market (CIBM) Direct and Bond Connect

<table>
<thead>
<tr>
<th></th>
<th>CIBM Direct</th>
<th>Bond Connect (Northbound)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Launch</td>
<td>♦ 2016</td>
<td>♦ 2017</td>
</tr>
<tr>
<td>Quota</td>
<td>♦ No. Pre-file amount to invest</td>
<td>♦ No. Also no pre-filing with PBoC</td>
</tr>
<tr>
<td>Available instruments</td>
<td>♦ Interbank market cash bonds, repo and FX, interest rate and bond derivatives</td>
<td>♦ Interbank market cash bonds and FX derivatives</td>
</tr>
<tr>
<td>Eligibility</td>
<td>♦ Sovereign entities, financial institutions and their products, and other eligible mid/long term investors</td>
<td>♦ All institutional and retail investors</td>
</tr>
<tr>
<td>No. of approved investors</td>
<td>♦ 1,010 foreign investors and products</td>
<td>♦ 356</td>
</tr>
<tr>
<td>Currency</td>
<td>♦ Offshore RMB or other currencies</td>
<td>♦ Offshore RMB or other currencies</td>
</tr>
<tr>
<td>Settlement cycle</td>
<td>♦ T+0, T+1 or T+2</td>
<td>♦ T+0, T+1 or T+2</td>
</tr>
<tr>
<td>Lock-up period</td>
<td>♦ No</td>
<td>♦ No</td>
</tr>
<tr>
<td>Repatriation limit</td>
<td>♦ No</td>
<td>♦ No</td>
</tr>
<tr>
<td>Market entry timeframe (indicative only) and process</td>
<td>♦ 6-11 weeks for non-sovereign entities ♦ 7-15 weeks for sovereign entities ♦ Assessment by settlement agent ♦ Registration with PBoC ♦ Account opening with intermediaries</td>
<td>♦ Abide to international laws and trading practices ♦ Use of offshore infrastructure from Hong Kong to access onshore bonds ♦ No onshore filing and account opening with onshore custodian</td>
</tr>
<tr>
<td>Potential changes in future</td>
<td>♦ ISIN codes to be assigned to all bonds</td>
<td>♦ Access to repo and derivatives markets ♦ Discounts of up to 50 per cent in Bond Connect transaction fee</td>
</tr>
<tr>
<td>Latest development</td>
<td>♦ N/A</td>
<td>♦ Block trade is allowed</td>
</tr>
<tr>
<td></td>
<td></td>
<td>♦ Implementation of real-time delivery versus payment</td>
</tr>
</tbody>
</table>

Bond Connect trade flow illustration

Key risks

The value of investments and any income from them can go down as well as up and investors may not get back the amount originally invested.

• **Exchange rate risk**: Investing in assets denominated in a currency other than that of the investor's own currency perspective exposes the value of the investment to exchange rate fluctuations

• **Liquidity risk**: Liquidity is a measure of how easily an investment can be converted to cash without a loss of capital and/or income in the process. The value of assets may be significantly impacted by liquidity risk during adverse market conditions

• **Emerging market risk**: Emerging economies typically exhibit higher levels of investment risk. Markets are not always well regulated or efficient and investments can be affected by reduced liquidity

• **Derivative risk**: The use of derivatives instruments can involve risks different from, and in certain cases greater than, the risks associated with more traditional assets. The value of derivative contracts is dependent upon the performance of underlying assets. A small movement in the value of the underlying assets can cause a large movement in the exposure and value of derivatives. Unlike exchange traded derivatives, over-the-counter (OTC) derivatives have credit and legal risk associated with the counterparty or the institution that facilitates the trade

• **Operational risk**: The main risks are related to systems and process failures. Investment processes are overseen by independent risk functions which are subject to independent audit and supervised by regulators

• **Concentration risk**: Funds with a narrow or concentrated investment strategy may experience higher risk and return fluctuations and lower liquidity than funds with a broader portfolio

• **Interest rate risk**: As interest rates rise debt securities will fall in value. The value of debt securities is inversely proportional to interest rate movements

• **Derivative risk (leverage)**: The value of derivative contracts depends on the performance of an underlying asset. A small movement in the value of the underlying can cause a large movement in the value of the derivative. Over-the-counter (OTC) derivatives have credit risk associated with the counterparty or institution facilitating the trade. Investing in derivatives involves leverage (sometimes known as gearing). High degrees of leverage can present risks to sub-funds by magnifying the impact of asset price or rate movements

• **Emerging market fixed income risk**: Emerging economies typically exhibit higher levels of investment risk. Markets are not always well regulated or efficient and investments can be affected by reduced liquidity, a measure of how easily an investment can be converted to cash without a loss of capital, and a higher risk of debt securities failing to meet their repayment obligations, known as default

• **High yield risk**: Higher yielding debt securities characteristically bear greater credit risk than investment grade and/or government securities

• **Contingent Convertible Security (CoCo) risk**: Hybrid capital securities that absorb losses when the capital of the issuer falls below a certain level. Under certain circumstances CoCos can be converted into shares of the issuing company, potentially at a discounted price, or the principal amount invested may be lost

• **Real Estate** investments are subject to many of the risks associated with direct real estate ownership, such as changes in economic conditions, credit risk, property taxes, zoning laws, and interest rate fluctuations.

• **Non-diversification** occurs when portfolio assets are invested in fewer securities, industries, currencies or countries than in diversified investment portfolios. Non-diversification increases risk because each investment has a greater effect on portfolio performance and can also be affected by single economic, political or regulatory occurrences.

• **Geographic concentration** occurs when a portfolio concentrates its investments in one country or region. Portfolio performance is expected to be closely tied to the social, political, and economic conditions in that country or region, and may therefore be more volatile than the performance of more geographically diversified funds.
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