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# Investing in China with ETFs

Choosing the Right Flavour and Avoiding Potential Pitfalls

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**MORNINGSTAR®**

# Agenda

- ▶ Picking the right “flavour” of China exposure
- ▶ Can ETFs be used to exploit the differences between A and H shares?
- ▶ The risks of using ETFs to gain China exposure
  - ▶ Tax issues
  - ▶ QFII, RQFII

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# Picking the right “flavour” of China exposure

# A-Shares & H-Shares: Similar But Different

## ▶ Similar

- ▶ It's the same company!

## ▶ Different

### A- Shares

- ▶ Trade on the Shanghai and Shenzhen stock exchanges
- ▶ Quoted in Renminbi (RMB)
- ▶ Only domestic Chinese investors and QFIIs/RQFIIs are able to invest directly in the A-Share market
- ▶ Indices: CSI 300, FTSE China A50, MSCI China A

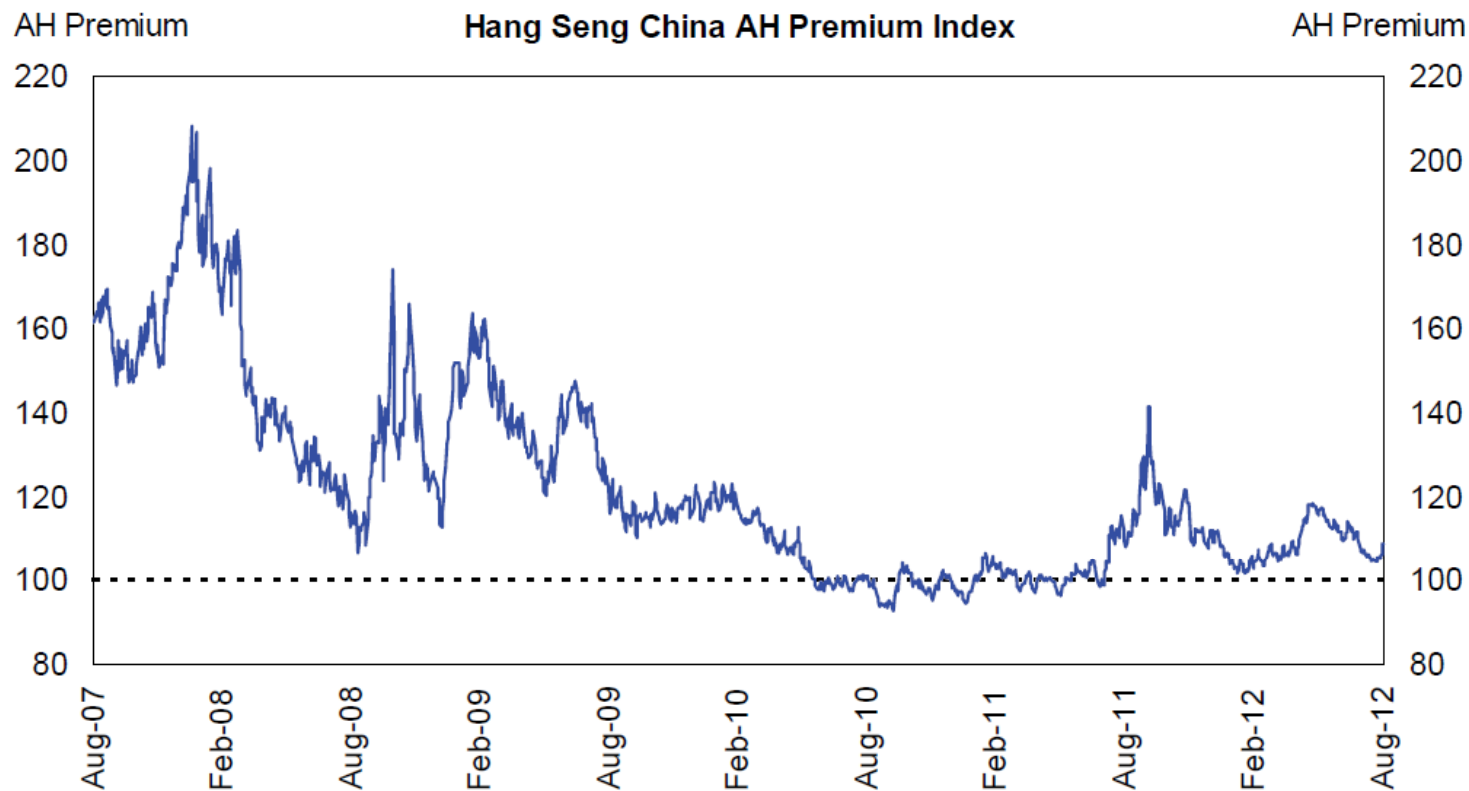
### H-Shares

- ▶ Trade on the Hong Kong Stock Exchange
- ▶ Quoted in HKD
- ▶ Open to international investors
- ▶ Many companies with H-Share listings also have A-Shares
- ▶ Index: Hang Seng China Enterprises Index (HSCEI)

# A-Shares & H-Shares: Similar But Different

- ▶ Which is more expensive?
  - ▶ A-Shares?
  - ▶ H-Shares?

# A-Shares & H-Shares: Similar But Different

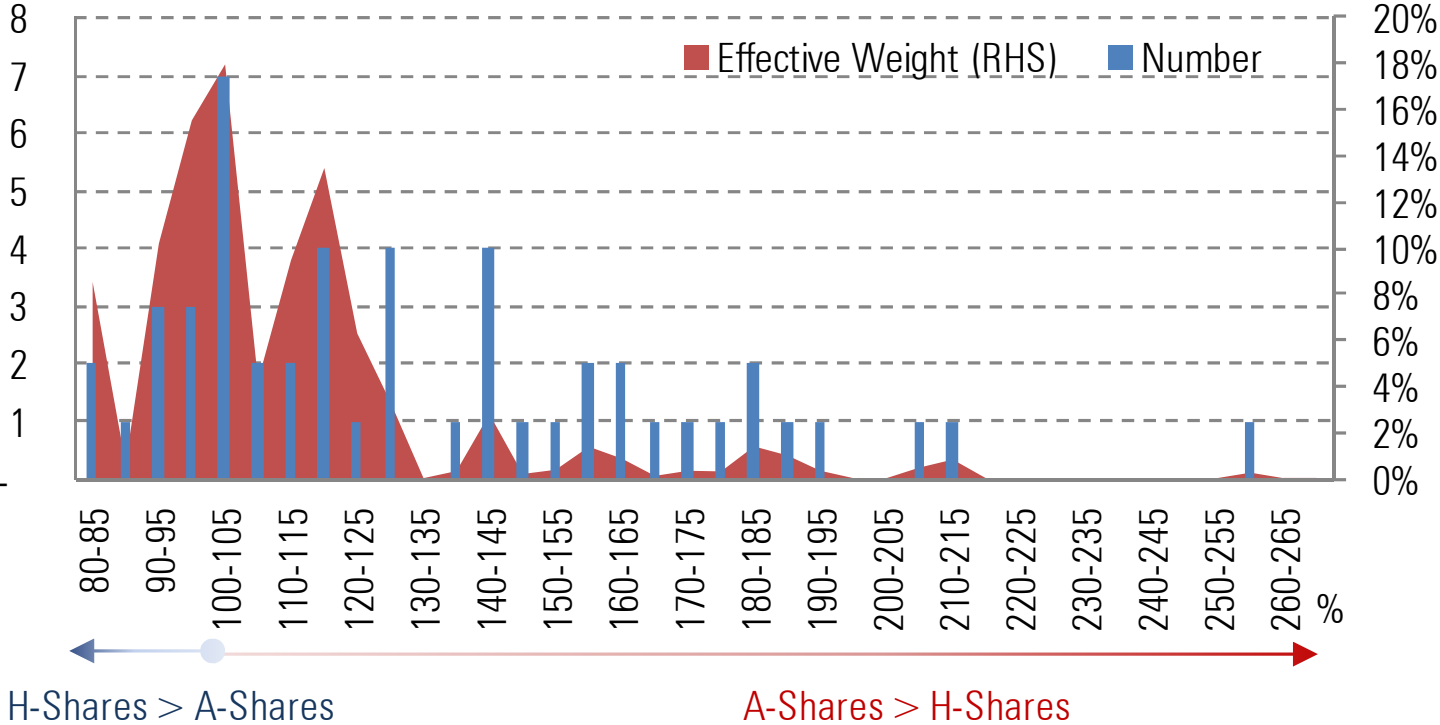


Source: Hang Seng Indexes Company Ltd.

- ▶ Measures the premium/discount of A-Shares over H-Shares of AH Companies
- ▶  $> 100 \Rightarrow$  A-Shares more expensive
- ▶  $< 100 \Rightarrow$  H-Shares more expensive

# A-Shares & H-Shares: Similar But Different

## AH Ratio within HSAHP



Source: Hang Seng Indexes Company Ltd., Morningstar Research (Data as of end-August 2012)

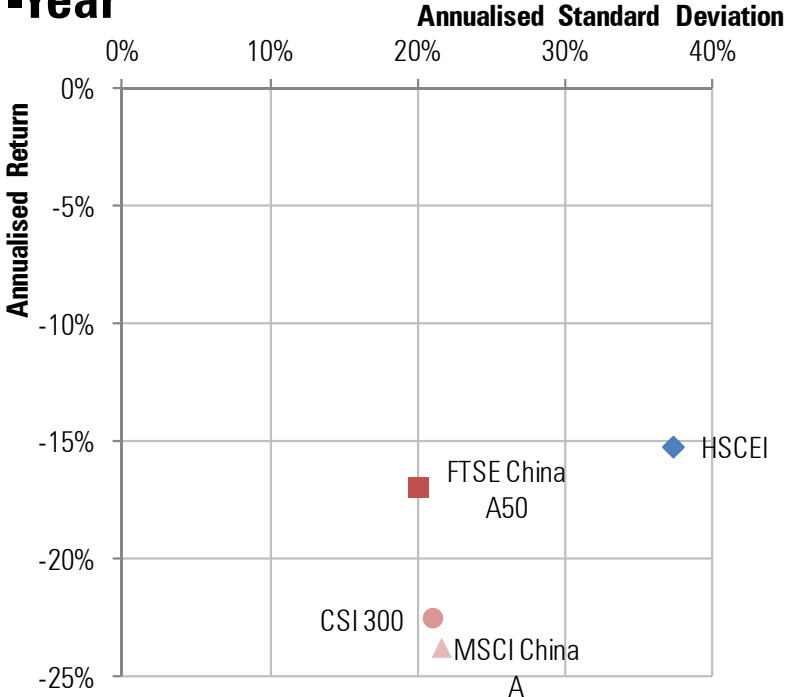
## A-Shares & H-Shares: Similar But Different

- ▶ Which gave you better return in the past 1 year?
  - ▶ A-Shares?
  - ▶ H-Shares?
  - ▶ Not sure?
  
- ▶ Which gave you better return over the past 3 years?
  - ▶ A-Shares?
  - ▶ H-Shares?
  - ▶ Not sure?

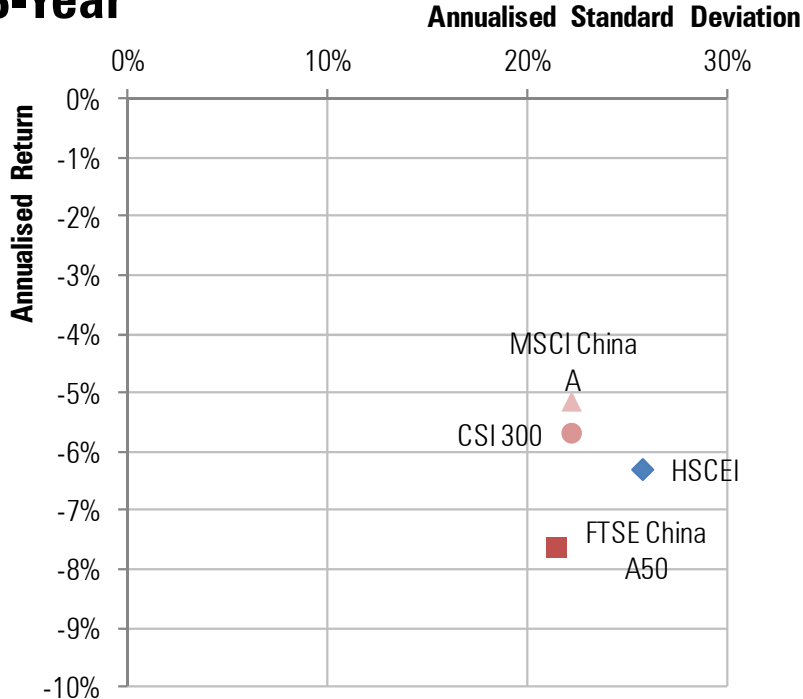


# A-Shares & H-Shares: Similar But Different

## 1-Year



## 3-Year



Source: Morningstar Direct (Data as of end-August 2012)

# A-Shares & H-Shares: Similar But Different

**1 Year Correlation (1 Sep 2011 to 31 Aug 2012)**

	HSCEI	FTSE China A50	CSI 300	MSCI China A	MSCI EM Asia	MSCI World	S&P 500
HSCEI	1						
FTSE China A50	0.86	1					
CSI 300	0.66	0.92	1				
MSCI China A	0.71	0.95	0.99	1			
MSCI EM Asia	0.96	0.78	0.62	0.65	1		
MSCI World	0.83	0.56	0.43	0.43	0.92	1	
S&P 500	0.81	0.54	0.41	0.42	0.89	0.98	1

**3 Year Correlation (1 Sep 2009 to 31 Aug 2012)**

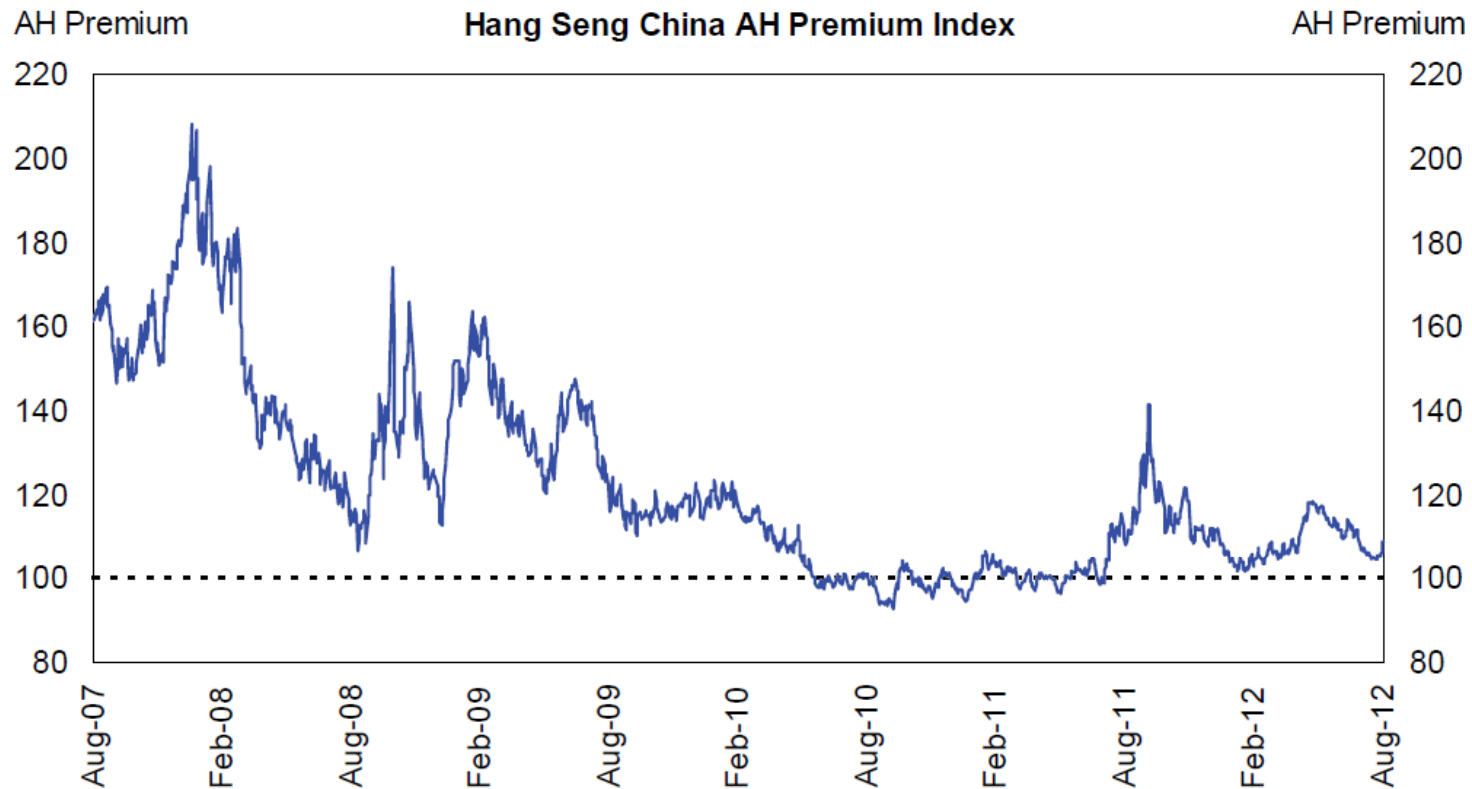
	HSCEI	FTSE China A50	CSI 300	MSCI China A	MSCI EM Asia	MSCI World	S&P 500
HSCEI	1						
FTSE China A50	0.71	1					
CSI 300	0.59	0.92	1				
MSCI China A	0.62	0.95	0.99	1			
MSCI EM Asia	0.87	0.61	0.50	0.51	1		
MSCI World	0.72	0.60	0.53	0.54	0.85	1	
S&P 500	0.69	0.56	0.50	0.51	0.80	0.98	1

Source: Morningstar Direct

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Can ETFs be used to exploit the differences between A and H-Shares?

# Hang Seng China AH Premium Index (HSAHP)



- ▶ An indicator of the premium/discount of A-Shares over H-Shares of AH Companies
- ▶  $> 100 \Rightarrow$  A-Shares more expensive
- ▶  $< 100 \Rightarrow$  H-Shares more expensive

# Exploiting Price Differences Between A-Shares & H-Shares

- ▶ In theory, shouldn't A-Shares and H-Shares trade at par?
- ▶ Logically, if an A-Share trades at a higher price than its H-Share counterpart:
  - ▶ Go LONG the H-Share...
  - ▶ ...and SHORT the A-Share
- ▶ But... this is not feasible for non-Chinese investors

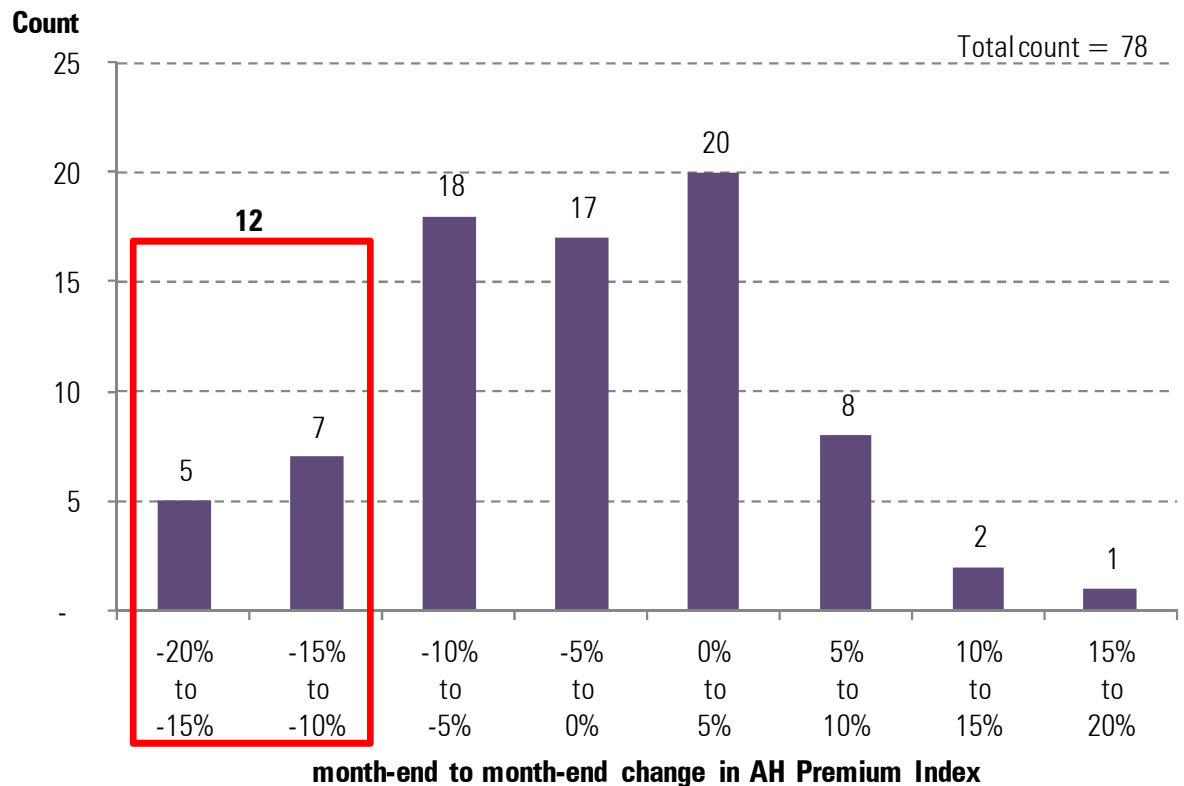
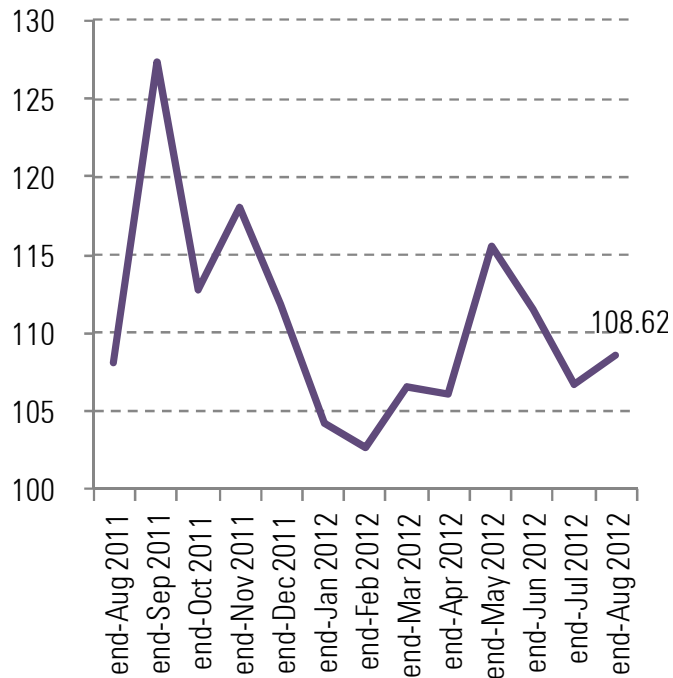
# Exploiting Price Differences Between A-Shares & H-Shares

- ▶ So... Use ETFs
  - ▶ LONG an ETF tracking an H-Share basket
  - ▶ SHORT an ETF tracking an A-Share basket
- ▶ Would this work?
- ▶ If so, how well?

# Exploiting Price Differences Between A-Shares & H-Shares

- ▶ If you have a view on AH Premium Index, say, it will narrow by 10%

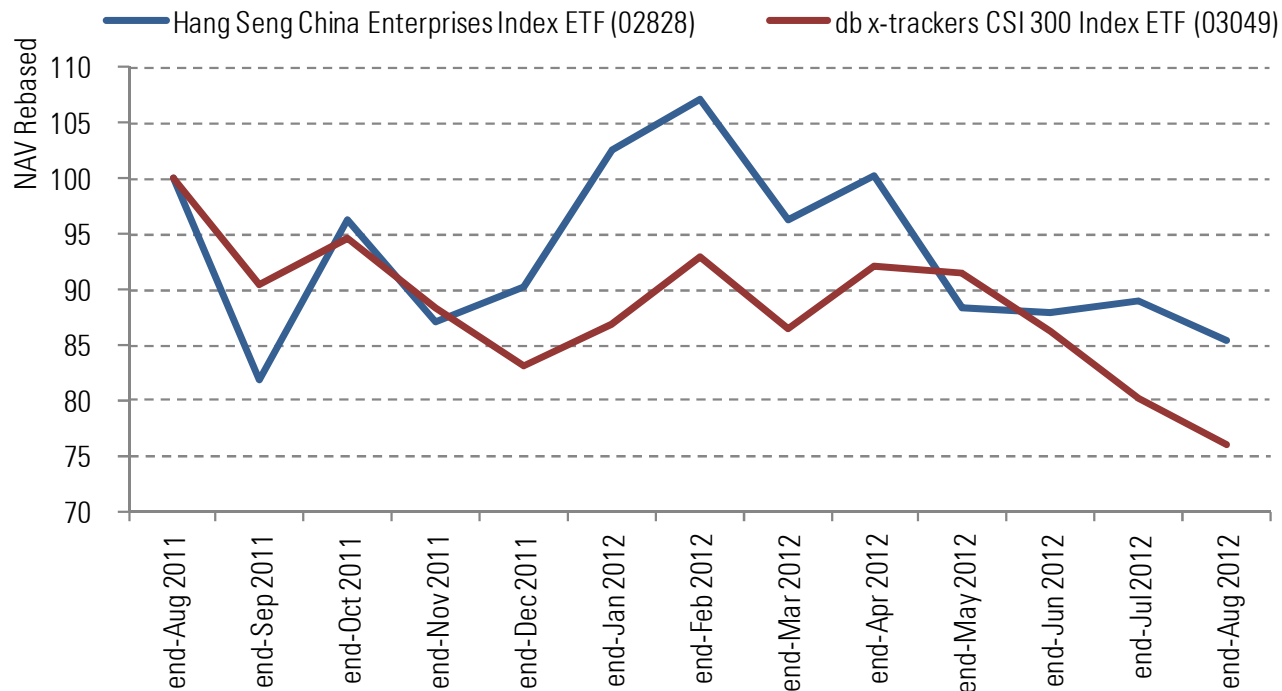
**Hang Seng China AH Premium Index**



Source: Hang Seng Indexes Company Ltd., Morningstar Research

# Exploiting Price Differences Between A-Shares & H-Shares

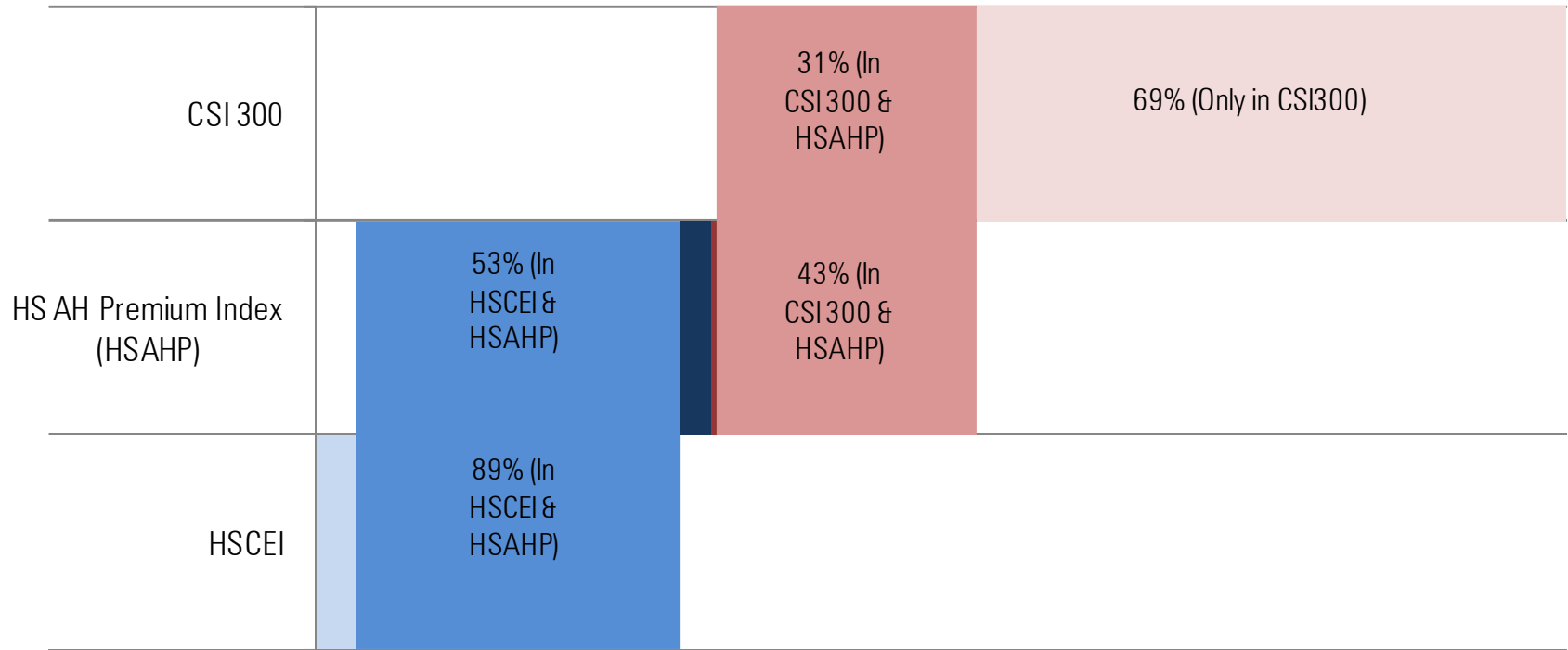
- ▶ So... Choose ETFs
  - ▶ Go LONG an ETF tracking an H-Share basket
  - ▶ And SHORT an ETF tracking an A-Share basket



Source: Morningstar Direct, Morningstar Research



# Exploiting Price Differences Between A-Shares & H-Shares



Source: Hang Seng Indexes Company Ltd, Morningstar Research

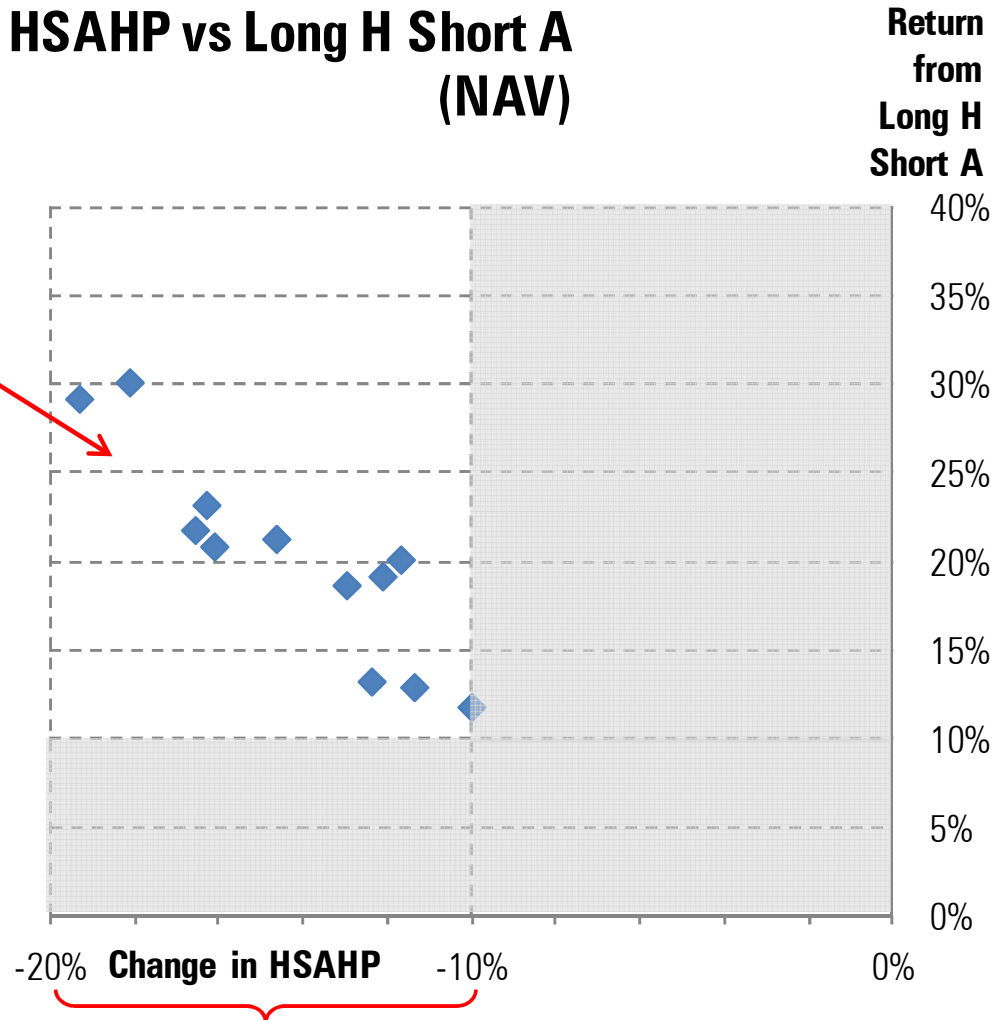
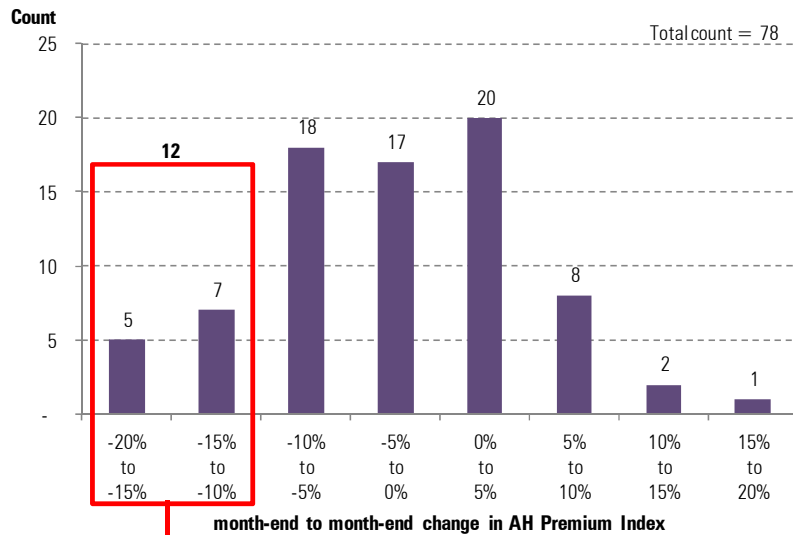
*\*Index total weights not to scale*

Source: Morningstar Direct, Morningstar Research (Data as of end-August 2012)

# Exploiting Price Differences Between A-Shares & H-Shares

## HSAHP vs Long H Short A (NAV)

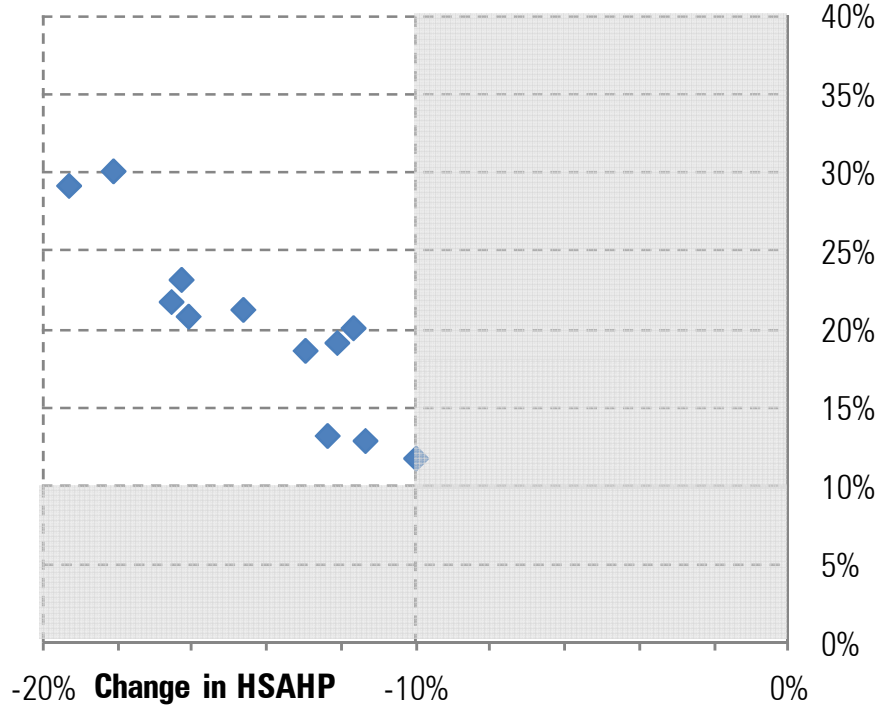
12 out of 12 times when AH Premium narrowed by >10%, strategy return >10%



Source: Morningstar Direct, Morningstar Research (Data as of end-August 2012)

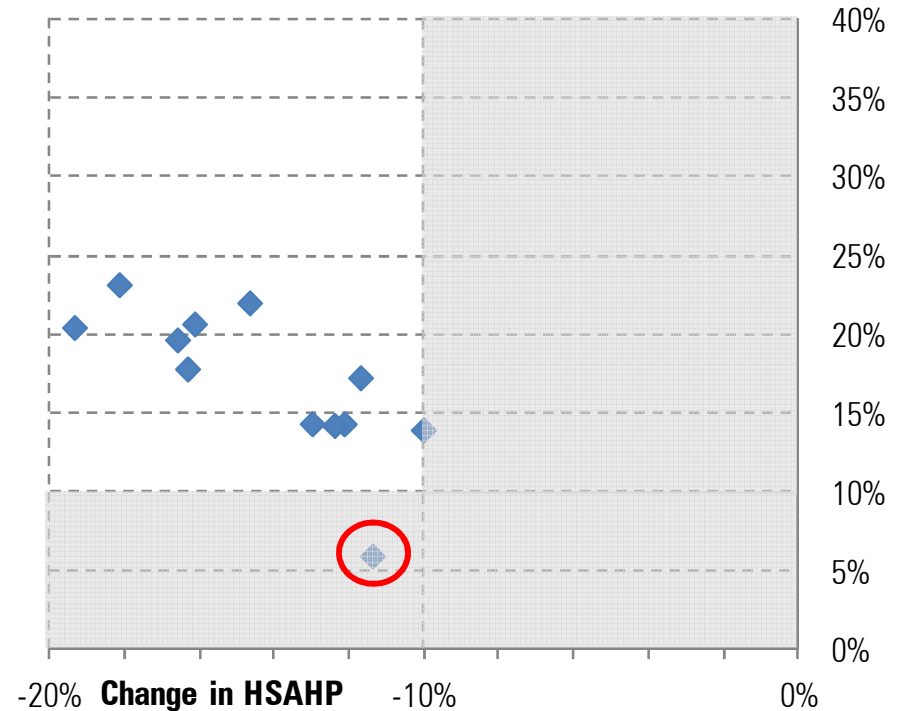
# Exploiting Price Differences Between A-Shares & H-Shares

**HSAHP vs Long H Short A (NAV)**



Use NAV:  
 12 out of 12 times  
 when AH Premium narrowed by > 10%,  
 strategy return > 10%

**HSAHP vs Long H Short A (Market Price)**

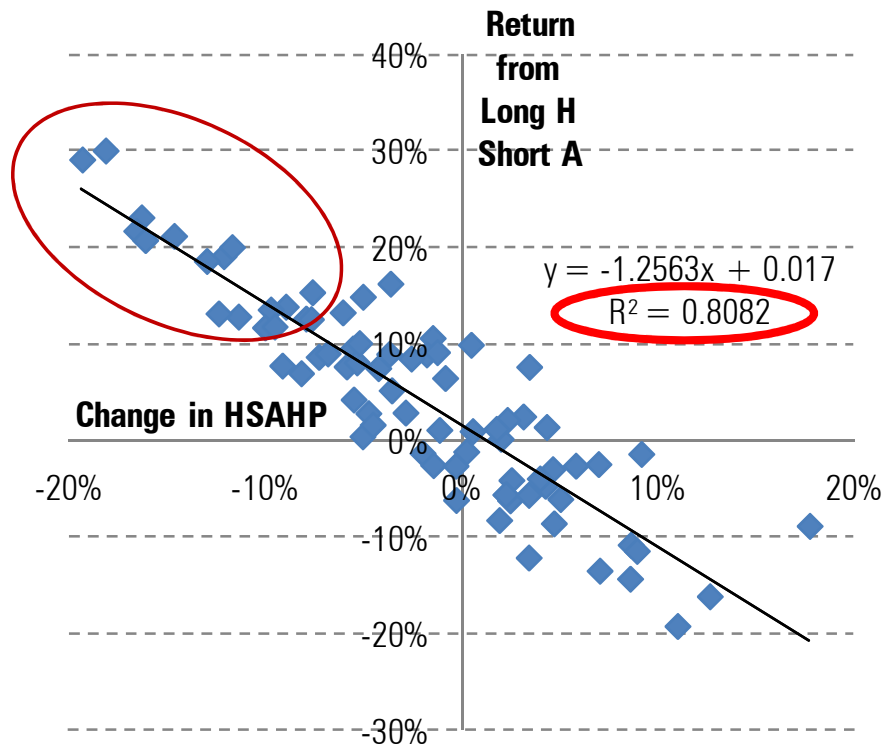


Use Market Price:  
 11 out of 12 times  
 when AH Premium narrowed by > 10%,  
 strategy return > 10%

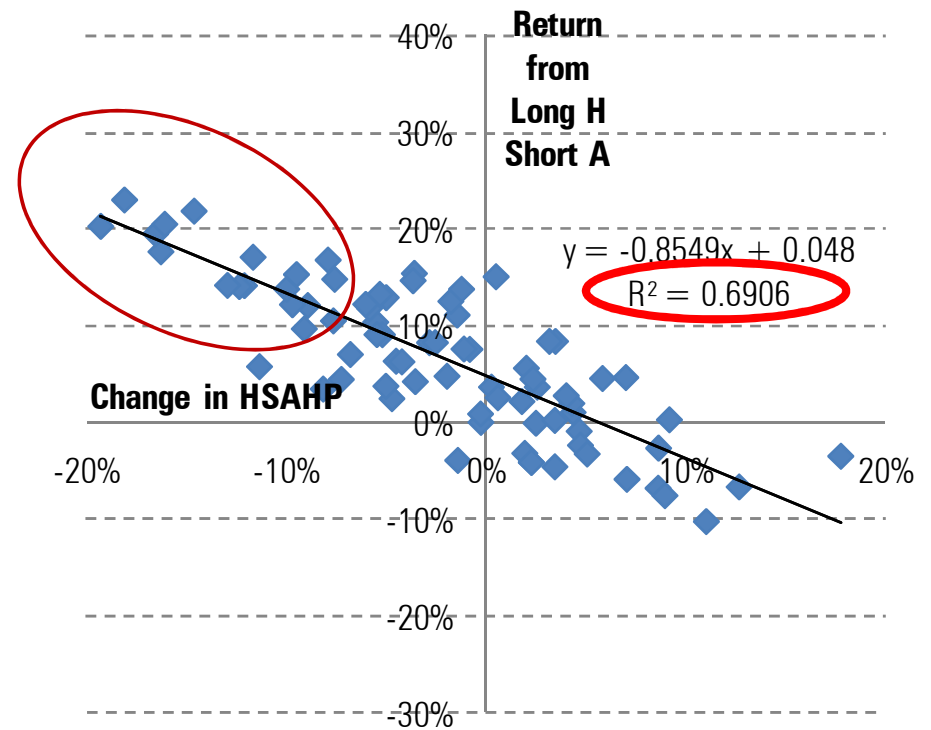
Source: Morningstar Direct, Morningstar Research (Data as of end-August 2012)

# Exploiting Price Differences Between A-Shares & H-Shares

## HSAHP vs Long H Short A (NAV)



## HSAHP vs Long H Short A (Market Price)



Source: Morningstar Direct, Morningstar Research (Data as of end-August 2012)

# Exploiting Price Differences Between A-Shares & H-Shares

- ▶ Broad A-Share and H-Share ETFs
  - ▶ More A-Share ETFs become available (e.g. the RQFII ETFs)
  - ▶ Potentially (ideally) trading closer to NAVs
- ▶ Best Practice
  - ▶ Form investment thesis  $\Rightarrow$  Choose ETF  $\Rightarrow$  Execute
  - ▶ Consider the risks at all times

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# Potential Pitfalls

## Potential Pitfalls – Tax Issues

- ▶ Directly from an A-Share ETF's prospectus:

*“Capital gains – Specific rules governing **taxes on capital gains** derived by QFIs or RQFIs from the trading of PRC Securities **have yet to be announced**. It is possible that the relevant tax authorities may in the future clarify the tax position on capital gains realised by the Sub-Fund dealing in PRC Securities or by a relevant QFI from dealing in onshore PRC securities. In the absence of such specific rules, the income tax treatment should be governed by the general tax provisions of the PRC CIT Law. If the foreign investor is a non-tax resident enterprise without PE in the PRC, a 10% WIT would be imposed on the PRC-sourced capital gains, unless exempt or reduced under current PRC tax laws and regulations or relevant tax treaties.”*

# Potential Pitfalls – Tax Issues

- ▶ ETF's treatment on capital gains tax:
  
- ▶ From ETF A:
  - ▶ *"The Manager **will at present make a provision of 10%** for the account of the Sub-Fund in respect of any potential WIT on capital gains."*
  
- ▶ From ETF B:
  - ▶ *"**Tax provisions are not made** at the ETF level and therefore any retrospective enforcement may result in a substantial loss to the ETF."*



# Potential Pitfalls – Tax Issues

## A-Share ETFs in Hong Kong and Singapore Tracking Broad Indices

Ticker	ETF	Provisions Made for Potential Capital Gains Tax?	Provisions Already Made as % of AUM	Potential Capital Gains Tax % of AUM (net of amounts already provided for)	Data as of
02818	Ping An of China CSI RAFI A-Share 50 ETF	Provisions made by access product issuers	0.5%	N/A	31-Dec-11
02823	iShares FTSE A50 China Index ETF	Some access products issuers withheld the tax	1.3%	6.8%	31-Dec-11
02827	W.I.S.E - CSI 300 China Tracker	Yes	3.5%	N/A	31-Dec-11
02846	iShares CSI 300 A-Share Index ETF	Some access product issuers withheld the tax	0.2%	0.4%	31-Dec-11
03024	W.I.S.E. - SSE 50 China Tracker	Yes	3.4%	N/A	31-Dec-11
03049	db x-trackers CSI300 Index ETF	No	0.0%	0.6%	31-Dec-11
83188	ChinaAMC CSI 300 Index ETF	Yes	Recently listed	N/A	
83100	E Fund CSI 100 A-Share ETF	Yes	Recently listed	N/A	
82822	CSOP FTSE China A50 ETF	Yes	Recently listed	N/A	
KT4	db x-trackers CSI300 Index ETF	No	0.0%	1.6%	31-Dec-11
JK8	United SSE 50 China ETF	Deducted by P-Notes issuer	Not disclosed	N/A	

Source: ETF Annual Reports, Morningstar Research

- ▶ Very different treatment and exposure for different ETFs
- ▶ Different implications on NAV if tax is being levied / not levied

## Potential Pitfalls – QFII / RQFII Quotas

### ▶ QFII

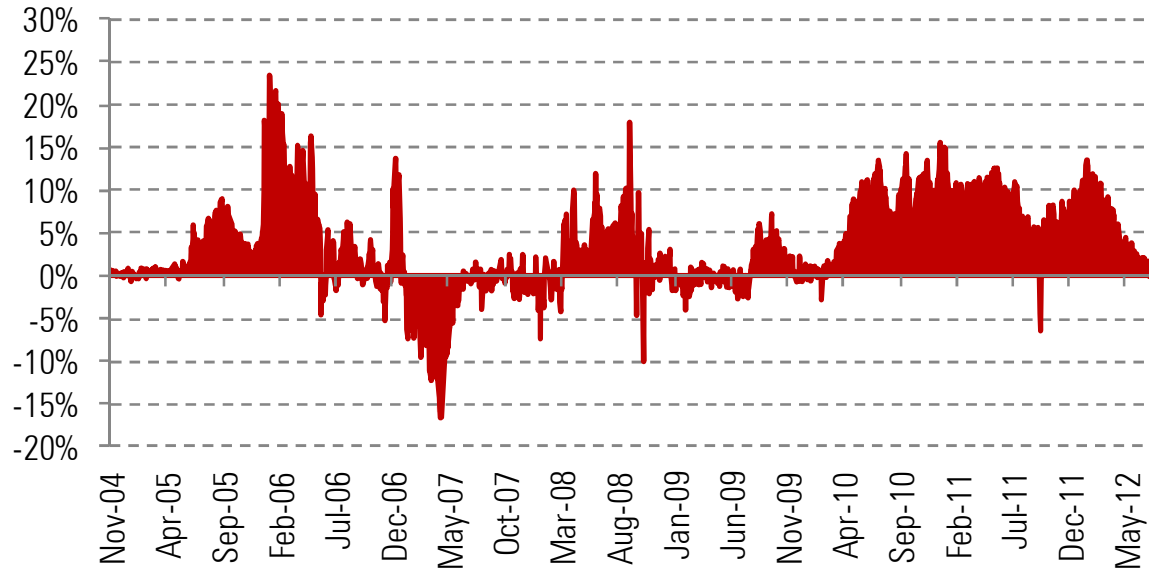
- ▶ US\$80 billion limit (uplifted from US\$30 billion in April 2012)
- ▶ US\$24.6 billion granted as of March 2012
- ▶ Each QFII has its own quota limit

### ▶ RQFII for ETFs

- ▶ Rmb 50 billion limit
- ▶ Rmb 12 billion granted (consumed by the 3 RQFII ETFs)
- ▶ Each RQFII has its own quota limit

# Potential Pitfalls – QFII / RQFII Quotas

**Price Premium/Discount over NAV of  
iShares FTSE A50 China Index ETF**



Source: iShares website, Morningstar Research

- ▶ If quotas are reached, unit creation can be disrupted and lead the ETF's market price to stray from its NAV
- ▶ However quota issues are not the sole cause of premiums/discounts in A-Share ETFs

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