THE AUSTRALIAN

Investment bulls will be welcome in this China shop

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Though sceptical about the Chinese renminbi, Australian UHNW investors have seen its advance as a positive. Source: AFP

IT is said that necessity is the mother of all invention and as countries such as Australia and Japan sign new era bilateral trading accords, the Chinese have been doubling down their efforts to attract global capital and forge new ways for all investors to participate in Sino markets.

One way they hope to achieve this is through the recently announced "Shanghai-Hong Kong Stock Connect" pilot program which is set to begin in October 2014.

Trading between "A shares", which are mainland China-based companies listed on the Shanghai and Shenzhen Stock Exchanges and have only been available for purchase by mainland Chinese nationals, and "H shares", which are the same companies listed on the Hong Kong bourse, denominated in Hong Kong dollars and available to both domestic and foreign investors alike, has up until now, been complex.

As complexity is the enemy to transparency, the Chinese plan finally establishes mutual markets access between the Mainland and the World and enables the global investor direct access into the formerly forbidden cities.

Even though there have been highly sophisticated and synthetic ways of accessing "A shares" for Ultra High Net Worth (UHNW) global investors to date, this new development brings immediate simplification and benefit to all.

It will also mean that Australian SMSFs will now find a more direct and less complicated way of gaining access to the growth story of the emerging Middle Kingdom.

According to Chinese authorities, the program "creates for the first time a feasible, controllable and expandable channel for mutual market access between the Mainland and Hong Kong by a broad range of investors” and this will “pave the way for further opening up of China’s capital account and RMB internationalisation”.

Though sceptical about whether the Chinese renminbi will become a global reserve currency any time soon, Australian UHNW investors have seen this advance as a positive for not only future opportunities but also existing investments and exposures.

This is because this methodical transition reduces existing complexities and provides a road map for future changes.

It is in keeping with the stable, Confucian tradition of “crossing the river by feeling the stones”.

The Chinese are not, however, opening the flood gates and allowing in unlimited foreign inflows which could then see unwanted volatility spikes.

Through joint announcements, they have set daily trading limits for Shanghai and Hong Kong at Rmb(¥)13 billion and Rmb(¥)10.5bn, respectively.

This upper limit is not a cap on daily inflows, but rather a boundary for net total flows on any given day. This implies that the amount of capital to enter the Shanghai or Hong Kong markets in a single trading day could not exceed prior levels and thereby providing a natural ceiling to the “velocity” of money. The “Stock Connect” program will offer access to Shanghai Stock Exchange 180 and 380 indexes, as well as existing dual-listed “A/H shares”.

This is important for Australian investors as currently they have limited exposure to certain sectors in China through the Hong Kong bourse.

Through the “H-share” market, three sectors — financial, energy and telecom — account for 60 per cent of the index weighting.

This new channel would provide a greater diversified expo-sure as the “A-shares” lean more heavily toward sectors like food & beverage (i.e. Chinese spirits & soy sauce), healthcare (i.e. Traditional Chinese Medicines), media, travel & tourism, consumer staples and importantly, national defence and some capital goods, which the Australian bourse, the ASX, most definitely lacks.

Whereas highly regulated “red chip” (Mainland Chinese companies incorporated internationally and listed on the Hong Kong Bourse) investments previously provided some of this exposure, the new program supersedes these and provides comparatively straightforward access.

For the first time, Australian investment communities could directly invest in “Kweichow Moutai”, China’s most famous brand of baijiu liquor or “Anhui Heli”, a major player in the construction equipment industry, primarily known for producing forklift trucks and currently enjoying over $US1bn in turnover each year.

“A-share” investments may also suit the global investor as they offer diversification considering their low correlation with developed market indices such as the US S&P 500 and Eurostoxx50.

It is also well known that the markets differ in terms of investor breakdown, where, for instance, the “A-share” market is traditionally driven by individual investors, accounting for 80 per cent of daily trading volume compared to the Hong Kong which is mainly led by institutional investors, who account for over 60 per cent of trading volume.

Importantly as well, small-cap valuations and IPOs pricing and processes are quite different and this will have direct implications for Australian companies deciding where to list in the years ahead, assuming that the pilot program progresses to fruition.

In China, for example, IPOs are approval-based whereas in Hong Kong the process is registration-based — a subtle but key difference and consideration for future listings.

It is also hoped that this development will help mature the Chinese markets to more sophisticated market solutions already seen in Hong Kong.

These include futures, "callable bull/bear certificates" (known as Quoted MINI Warrants on the ASX), and other trading derivatives. These would then assist the global investor even further and "homogenise" access to capital markets for UHNW and retail investors alike.

For the arbitrage-minded global investor, this development has also presented a once-in-a-blue-moon opportunity to take advantage of differing pricing for the same assets.

This premium versus discount window has already begun to narrow since the announcement of the program on April 10 this year.

Even though "A" and "H" shares are not "fungible" and there is no mechanism to guide the convergence of valuations, the market has begun to reflect this "reversion from dichotomy".

This is a good outcome for Chinese, Cantonese and global investors as this development champions the primary purpose of an exchange based market, which is the pursuit of the "price discovery" process.

When this process works well, markets grow through prosperity not inflation and generate wealth for investors and the economy at large. This development is no longer a Cantonese whisper but now a Chinese welcome.

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