Hong Kong Phoney

What future does the Hong Kong stock market have under China's growing influence?

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July 2024 marked 27 years since Hong Kong's handover from part of the British Empire to become a special administrative region of China. This means that Hong Kong is in the territory of the infamous '27 Club', an eclectic group of famous artists, such as Jimi Hendrix and Amy Winehouse, who have passed away at the young age of 27. This anniversary feels oddly ominous when considering the changes in laws and regulations seen in Hong Kong in the past couple of years, as China looks to bring Hong Kong's legislature more in line with that of the mainland. This has raised questions over the status of the so-called 'one country, two systems' regime that was established in 1997, and led to investors wondering what this means for the future of investing in Hong Kong. So here, we look a bit closer at the Hong Kong market, what differences there are to investing on the mainland and what the future may hold for investors in the region.

Background

Hong Kong has historically been viewed as a gateway to investing in mainland China, and the country's international finance centre. The Hong Kong stock exchange is open to trading for all international investors, and trades in Hong Kong dollars, which are pegged to the US dollar and can be easily exchanged. The exchange has over 2,000 companies, with around 350 of these being H-shares, some of the largest companies incorporated in China but listed in Hong Kong. These H-shares make up around 12% of the index (by market cap), though when combined with so-called 'red chips', which are companies owned by Chinese individuals or the government, but incorporated outside China, this figure jumps to over 75%, showing how much of the Hong Kong market is dependent on China in one way or another.

By listing in the country, these companies have had to uphold the rule of law in Hong Kong, which operates under a separate legal system from China and is based on the principles of British common law. As such, investors have strong legal protections and property rights when investing in these companies.

However, in the past few years, there have been several new laws that have undermined Hong Kong's special status. The largest of these has been the implementation of a new national security law, despite huge protests, which has raised concerns over the future of Hong Kong's democracy. This has curtailed press freedoms, after criminalising material that is considered to promote secession from China. Furthermore, oversight on the implementation of these laws is now in the hands of Beijing, as the national security commissioner is appointed by China rather than Hong Kong. There have also been tweaks to market regulations, primarily around the corporate governance rules of the c. 150 H-shares that are dual-listed in mainland China. This has led to many warnings that the shareholder protections of a listing in Hong Kong have been diminished. This has been borne out in the statistics too, with Hong Kong falling to the 13th best market to IPO in in 2024, according to the London Stock Exchange Group, after being consistently placed in the top three for much of the decade prior, and in first place as recently as 2019.

China's domestic market growth

Hong Kong's waning star has come at a time when China's stock markets have been looking to increase their international standing and representation in global indices. By way of background, there are two major markets in China, the Shenzhen and the Shanghai stock exchanges. The larger of the firms listed here are called A-shares. A-shares are traded in Chinese yuan renminbi (CNY) and are mainly available to citizens of mainland China, although foreign investors are able to invest through a heavily regulated structure. The CNY is subject to capital controls meaning it cannot be exchanged without permission from the government, and the exchange rate is controlled centrally.

Listed companies in China are subject to the Chinese civil law system, which is based on socialist principles. Changes in legislation can be made centrally by the government which oversees the regulator, and these can occur quickly with limited legal recourse. This was the case in 2021 when the government effectively banned for-profit companies in private education, decimating the sector almost overnight. Governance rules are less strict than for H-shares though, which has led to comments that the onshore Chinese market is both overly regulated, due to government restrictions, and not regulated enough due to lower governance standards.

Despite this, the A-share market continues to grow. As the country develops, more companies are looking to public markets as a way to fund their future growth and are choosing the A-share market to do so. The lower regulatory requirements are often cited as a reason behind this, with pressure from the Chinese government also a potential factor as they have historically favoured having oversight of their domestic champions. However, the A-share market is more developed now than it was just a few years ago, meaning raising capital domestically is a much more viable option for Chinese firms, rather than having to tap international investors via the H-shares market or listing on other foreign exchanges.

Chinese equities were first included in the MSCI Emerging Market Index in 2000 at a c. 7% weight. Until 2018, when A Shares were included for the first time, it was mostly H-Shares, Red Chips and companies listed in the US via American Depositary Receipts. The overall Chinese weighting peaked at 41% in 2020. This has since pulled back to around 30% now after the country struggled with headwinds as a result of the extended zero-covid policy, as well as sluggish growth. In contrast, Hong Kong is less than 1% of the MSCI Emerging Markets Index. On a more local basis, Hong Kong makes up just 4.5% of the MSCI Asia Pacific ex Japan Index, compared to China's 21.2% making it the largest country allocation in the index as of July 2024.

Compare and contrast

As a result of their differences, the A-share and H-share markets have big differences in their valuations. There are c. 150 H-shares that have a dual A-share listing, making direct comparisons very straightforward. The AH Index is used to calculate this, with a current level of 147. This means that A-shares are at an average 47% premium to their H-share equivalents. This is fairly typical, with A-shares having traded at a premium for all of the past five years.

The reason behind this is the investor base. Whilst restricted to international investors, the A-share market is also one of the few places the huge domestic Chinese investor base can invest. This huge domestic demand has led to A-shares trading at a premium, despite the challenges inside the country.

However, a high proportion of this domestic demand comes from retail investors, which is estimated to be over 80% of trading volume, despite owning only around 25% of the market. By way of contrast, around 11% of the UK's quoted shares are owned by UK individuals, with trading volumes less than 20% of the total. As such, the A-share market is a relatively high volatility market as retail investors tend to be more short-term and reactionary.

As a result of this higher volatility, as well as the fear of government intervention, A-shares are typically considered the higher-risk way of accessing Chinese companies. However, this comes with the greater potential of capturing the numerous growth opportunities in the country, and potentially getting them earlier in their growth journey. In contrast, H-shares are typically more well-established companies which therefore may offer lower risk, but perhaps less upside potential.

Investment trust balances

In order to find a balance between these two factors, investors may wish to use the services of a professional manager, such as through an investment trust, and the restrictions on retail investors trading A-shares may necessitate such an approach for most.

In the table below, we have shown the allocations of the trusts focussed on the Asia (ex Japan) region versus their respective benchmarks for both Hong Kong and China. We analysed the China weights in a **previous piece** on allocations versus India, however, there was no consideration as to how the Hong Kong weights play into this. As such, we have also shown the two weights combined to assess their combined allocation. We have used MSCI AC Asia Index weightings for Henderson Far East Income as its formal benchmark, the MSCI AC Asia High Dividend Index does not declare the Hong Kong weighting.

This table illustrates that the majority of managers show a preference towards Hong Kong, with 11 of the 14 managers overweight at an average level of 2.1%. In contrast, only five managers are overweight China with an average underweight of 5%. Overall, there are only five managers that are overweight the two areas combined, with an average underweight of 3%. As such, these results show us that investment trust managers have generally taken a preference towards the stability of Hong Kong over China, albeit the negativity towards China has offset some positivity to Hong Kong.

Hong Kong & China Allocations

TRUST/INDEX	HONG KONG % (LONG)	CHINA % (LONG)	HK OVER / UNDER	CHINA OVER / UNDER	COMBINED OVER / UNDER
MSCI AC Asia Pacific ex Japan	3.8	23.2			27.0
abrdn Asian Income	6.6	9.4	2.8	-13.8	-11.0
Schroder Asian Total Return Inv. Company	8.7	6.6	4.9	-16.6	-11.7
MSCI AC Asia ex Japan Small Cap	2.8	9.5			12.3
abrdn Asia Focus plc	3.7	12.1	0.9	2.6	3.4
Fidelity Asian Values	10.6	25.8	7.8	16.3	24.1
Scottish Oriental Smaller Cos	4.9	18.7	2.1	9.2	11.3
MSCI AC Asia	4.7	27.5			32.2
Henderson Far East Income	11.5	21.4	6.8	-6.1	0.7
MSCI AC Pacific ex Japan	4.7	28.7			33.4
Schroder Oriental Income	7.9	11.4	3.2	-17.3	-14.1
MSCI AC Asia ex Japan	4.6	27.7			32.3
Pacific Assets	2.3	7.7	-2.2	-20.1	-22.3
Scottish Oriental Smaller Cos	4.9	18.7	0.3	-9.0	-8.8
Schroder AsiaPacific	9.3	16.5	4.8	-11.3	-6.5
JPMorgan Asia Growth & Income	3.4	28.5	-1.2	0.8	-0.4
Pacific Horizon	0.4	26.6	-4.2	-1.2	-5.4
Asia Dragon	5.6	22.6	1.0	-5.2	-4.2
Invesco Asia	6.5	28.9	1.9	1.2	3.1
		Average	**2.0**	**-5.0**	**-3.0**

Source: Morningstar

However, this impact is even greater when adjusting for the smaller companies sector. China has a much lower weight in the MSCI AC Asia ex Japan Small Cap Index at only 9.5%, versus an average weight of 26.8% in the other indices. As such, all three smaller companies trusts are overweight China, but not in the context of the wider region. Only one trust, **Fidelity Asian Values (FAS)**, is close to the average index weighting in China, with co-managers Nitin Bajaj and Ajinkya Dhavale allocating significantly to the country due to what they believe are compelling valuations. Similarly, the managers of **abrdn Asia Focus (AAS)** have often varied their allocations between the two depending on their outlook. They acknowledge there is a significant difference in the small-cap versus large-cap market and highlight that this is one of the key attractions of the smaller companies sector.

These figures therefore show a clear negative sentiment towards China. We believe this preference reflects several factors. Richard Sennitt, manager of **Schroder Oriental Income (SOI)** and co-manager of **Schroder AsiaPacific (SDP)** has a big China underweight in both trusts. In the recent **SDP results**, he cited concerns over the struggling property market, geopolitical tensions, and domestic regulatory risks as primary reasons. However, he acknowledged there are some compelling valuations in the country due to the high level of negativity. Despite this, he has preferred to take an overweight in Hong Kong as a way of keeping exposure to the Chinese story, but without the risks of more direct exposure.

Future

Whilst the legal changes in Hong Kong have attracted some concerning headlines, investment trust managers have still shown a preference for Hong Kong over China for the time being. Looking forward, there are plenty of reasons to believe Hong Kong still has a place for investors despite the headwinds. Whilst some of the regulations caused concerns over China's influence, this has been done, ostensibly, to bring the two markets closer together for the benefit of both. There has been the introduction of Stock Connect, two interconnections between the Shanghai-Hong Kong and Shenzhen-Hong Kong markets to enable better cross-border trading and some of the new regulations have been designed to improve efficiency and governance transparency on dual-listed shares.

Furthermore, Hong Kong continues to exhibit many benefits that are unlikely to be changed through closer integration with China. Key features include its simple, low-rate tax system which makes it a much more attractive, as well as simpler country to operate in. For example, China's corporate tax rate is 25%, with further taxes on VAT and consumption, plus customs duties.

These also need to be paid at both local and state levels. Meanwhile, Hong Kong has a 16.5% tax on corporate income paid directly to the country's inland revenue department. This makes the ease of operating in Hong Kong considerably higher.
There is also the currency factor which should also not be underestimated. Hong Kong is the only country in Greater China without any foreign exchange controls. Capital controls are a significant hurdle for any international firm, and these show no signs of being reversed. This also leans into the significant geopolitical tensions China is facing, with most major economies turning against the influence of China and Chinese firms to protect their own domestic industries. This has resulted in tariffs, de-listing of Chinese firms, and the banning of firms in industries considered critical to national security. All of this has contributed to a sense of negativity towards China.

Meanwhile, Hong Kong has avoided such direct measures. It is no doubt affected by weakened sentiment towards the region, but there are few if any direct restrictions, despite the strong overlap with China. The free-floating currency and system of law based on internationally accepted principles is likely a major factor. Therefore, for international investors looking to gain access to the world's second-largest economy and one of the largest stock markets, Hong Kong will likely continue to have a vital role to play.

Conclusion

Hong Kong has historically held a globally significant role as a gateway to China and its growth story. However, as China has grown beyond all expectations, the authoritarian government has looked to exercise further control over its economy by chipping away at Hong Kong's unique status. In turn, it has also supported its own domestic stock markets at the potential expense of Hong Kong.

However, active investment managers, who are free to allocate between the two, have shown a strong preference for Hong Kong over China and remain on average overweight their benchmarks. Some of this is due to the weakness of China itself, though the benefits of Hong Kong, namely an exchangeable currency and strong rule of law, mean the country remains popular.

As such, despite China's growing influence, we think Hong Kong is unlikely to be the latest victim of the 27 Club, albeit in the context of a future that will be increasingly tied to the mainland.

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