THROUGH-TRAIN FROM SHANGHAI TO HONG KONG

No, we are not talking about the TGV-beating high-speed link between the two main financial centers of China, even though one such railway has indeed been in the works. We are, of course, referring to the April 10 announcement from the China Securities Regulation Commission (CSRC) that in about six months, investors in mainland China will be allowed to trade a basket of preapproved shares listed in Hong Kong. And just as a “railway” is bi-directional, investors based in Hong Kong will also be allowed to trade a select set of shares currently listed on the Shanghai bourse.

According to well-informed market participants, investors wishing to trade in the other bourse will not need to open new accounts and will not need to perform currency exchange. All clearing and settlement functions as well as currency conversion will be handled centrally by the China Securities Depository and Clearing Corporation (CSDC). Any cross-border funds exchanged via this channel can only be used for the trading of designated stocks and not for real-estate or other investment purposes.

A TALE OF TWO CITIES

One major purpose for the proposed “through-train” investment scheme is to pave the way for the eventual internationalization of China’s currency, the Renminbi. However, there is also a political angle to the new arrangement.

From the very first day the Special Administrative Region was established and Hong Kong ceased to be a British crown colony, its citizens were caught between a natural resistance to big brother in the north of the border and an occasional reliance on the super-sized neighbor. With the explicit backing of the Beijing government, Hong Kong successfully defended its currency which was (and still is) pegged to the U.S. dollar since the 1997-1998 Asian financial crisis. The political-economic confusion in 2003, amplified by the SARS epidemic, was only resolved when the Hong Kong economy had a decisive upswing after mainland China allowed its citizens to visit Hong Kong en masse.

In recent years, however, there are signs that the central government is favoring Shanghai over Hong Kong in key development projects. Citizens of Hong Kong watched in disbelief when Shanghai got the go-ahead to build a full-sized Disneyland which would make the one already built in Sunny Bay, Hong Kong look puny and childish in comparison. Then, last summer, soon after taking over as head of the government, premiere Li Keqiang formally announced the establishment of a free-trade zone in Shanghai. This was viewed as further evidence that Hong Kong is not necessarily the default choice as the launch pad for China’s currency reform. Coincidentally, or perhaps partly as a result, there has been a noticeable rise in negative sentiment against Beijing’s involvement in a host of other areas in Hong Kong.

The fact that Premiere Li was the one who broke the news about the Shanghai-Hong Kong “through-train” arrangement made it clear that this represents a significant step in the chain of reform measures yet to take place over time. Coupled with other developments in the realm of State-Owned Enterprise (SOE) reform, which would presumably also tend to boost the competitiveness of Hong Kong, it sends an unmistakable signal that the central government fully recognizes the unique role that Hong Kong can and should play in the grand scheme of things.
THE A/H SHARE PHENOMENON: AN ENCORE

In its initial stage, the “through-train” scheme will be restricted to a subset of the listed companies in Shanghai and Hong Kong. Among the choices are the 76 Chinese firms that are already dually listed in China (A-shares) and in Hong Kong (H-shares).

In our January letter for the Pine River China Fund, we made several observations regarding the curious relationship between A/H price differentials and firm size. We explained the existence of the pronounced “small firm” effect in Shanghai in terms of asymmetric information and the fact that small firms, no matter how poorly managed, retain their value as a “shell company” because of the floor value that is set for essentially all listed firms in China.

We also made a few predictions: “...the A/H premium for small cap firms would dissipate over time as China adopts the measures entailed in the decisions adopted in November aimed at further opening up its capital markets. A partial list of such measures include the adoption of listing rules that are based on merits as opposed to quota; enforcement of delisting rules more uniformly and expeditiously; and encouraging more active involvement in the Chinese securities market by international capital.”

Indeed, as soon as the news broke about the cross-border investment scheme, A/H price differentials shrank noticeably, yet the valuation gaps are still large, particularly for small firms.

Another corollary that we did not spell out explicitly in the January letter but was clearly based on related reasoning is that the Pine River China Fund has made major investments in Chinese Securities firms and in the Hong Kong exchange. These will be among the most obvious beneficiaries of any relaxation of fund movement and securities investment across borders.

WHENCE THE THROUGH-TRAIN?

Details of the limited two-way, cross-border trading platform are sketchy at this stage. One thing we can state fairly confidently is that, like many other reform ideas, it is going to be an evolving project. Over time, the daily volume limit and the universe of tradeable shares are expected to increase. There is also reason to expect A/H share price differentials to narrow.

Cross-border arbitrage will necessarily bring along competition among the bourses. Generally speaking, the side with overall lower transactional costs should win out, provided companies can freely choose the venue to list their shares.

An influx of foreign capital into Shanghai’s equity market is likely to have positive impact on a number of fronts, including corporate governance, protection of minority investors’ interests, and an emphasis on value investing. Blue-chip stocks will likely benefit.

Perhaps an even larger impact would be felt in the Hong Kong market because the stocks that mainland investors are more likely to focus on are typically smaller firms. Their valuations tend to be cheaper than their counterparts listed in Shanghai, where investors are more prone to engage in trend-chasing and insider trading.

The launch of “through-train” is further proof that the pace of comprehensive reform is quickening in areas such as capital control, market access, and the broadening of business activities. We look forward to this new era of investing in Greater China.