INVESTING IN CHINA – A PRIMER

The media has made much this year out of China's booming stock market. China's economy has swiftly recovered from the global recession, thanks in part to enormous government stimulus both at home and abroad, and China will soon resume leadership of global economic growth. Many US investors are wondering how they can participate in this rising tide. Investing directly in Chinese stocks is tricky, and while ETF options are available, investors don't necessarily understand what exposure and risk they are really getting. Hong Kong listed companies often provide good exposure to mainland growth. Some Chinese companies have American Depositary shares listed in the US. In what follows, we endeavor to help US investors navigate the options available for investing in China.

A note on media references to soaring Chinese stocks: often these refer to the performance of local indices - either the Shanghai Composite Index or the Shenzhen Composite Index. These have gained 55% and 73% respectively this year through the end of September. Are these returns attainable to a US-based investor? In a word, no, for reasons we will explain below.

Chinese Share Classes

"A" shares are domestic shares reserved exclusively for trading by and between domestic mainland investors. Foreigners are prohibited from investing in this market as A shares are denominated in renminbi (RMB) which are not fully convertible to foreign currency.

"B" shares, previously known as "foreign" shares until they were opened to mainland residents in 2001, are traded in either HK or US dollars, depending on whether they trade in Shanghai or Shenzhen. Foreign investors can trade these shares provided they have local custodial arrangements in place.

"H" shares are foreign shares issued by mainland state-owned entities (SOEs) that are primarily listed in Hong Kong and trade in HK dollars. Shares of China Petroleum and Chemical, commonly known as Sinopec, are traded as H shares.

The B share and H share markets are completely segregated. SOEs which have issued H shares cannot issue B shares and vice versa.

SOEs can have both A shares and H shares, however, and many companies do. But they trade very differently. A shares typically trade at a premium to H shares even though they represent ownership in the same underlying entity, reflecting the paucity of investment options for Chinese residents. (There is no secondary bond market to speak of, and government severely restricts foreign investment.) The premium ranges from the current level of around 20% based on the Hang Seng AH Premium Index, to the high of 108% reached in January 2008.

The reason this is important is that when Chinese stocks are mentioned in the media, the reference is usually to the local markets – the Shanghai or Shenzhen Composite Indices. But of course these indices track the performance of local A and B shares, and the A shares, which trade at a premium, are off limits to foreign investors. So the quoted returns do not represent the return that a US-based investor could attain.

Red Chips

Another important "China play" is the "red chip". This describes stock in companies that are not incorporated in mainland China, but with business, assets, markets and ownership that have a strong mainland orientation. Red chips are usually Hong Kong-incorporated companies and trade on the Hong Kong exchange the same way as any other Hong Kong-listed company. Cathay Pacific Airways, Hong Kong's flag carrier, which owns Dragonair and a stake in Air China, the national flag carrier, would be considered a red chip stock.

ETFs

The largest and most liquid of the China ETFs is the iShares FTSE/Xinhua China 25 Index Fund (FXI), which tracks an index representing the 25 largest companies in China that are available to foreign investors. Exposure to the Chinese growth story is thus limited to the very largest and already well-established companies. The average weighted market cap is $114 billion and the median is $97 billion. Since Chinese banks are now the world's largest in terms of market capitalization, over 50% of the exposure is to financials (which an investor may or may not find appealing), and 16% is to telecom. The fund's top ten holdings represent over 61% of the fund's total assets. Year-to-date through September 30, FXI has returned a very respectable 42%.

A possible alternative to FXI is the Hong Kong iShares ETF (EWH). Rather than direct exposure to the mainland's largest companies, there is greater "red chip" exposure through Hong Kong-based companies. EWH contains about 40 securities with average weighted market cap of $17 billion, and a median holding of $15 billion. It has returned 52% this year through September.

Regional ETFs are also available for investors who see value in the overall Asian growth outlook.

ADRs

A number of Chinese companies have chosen to sponsor ADR programs for their shares, either to raise capital or to increase liquidity and familiarity. These ADRs trade on US exchanges in US dollars, are registered with the SEC and adhere to US GAAP requirements. An investor can purchase these securities like any other US security. Several of China's largest companies have ADRs, such as China Mobile, PetroChina, and China Life Insurance Co. While none of the Chinese banks have ADRs, many smaller-cap options are available in sectors such as technology, services and materials. A US investor couldn't replicate the FXI with ADRs, but could certainly build a diversified, multi-cap portfolio of Chinese companies.

Of course, companies all over the world are keen to capitalize on China's rapid growth, and many have made extensive investment to this end. So one can also "play China" by investing in companies who are themselves devoting significant resources to leveraging Chinese and regional growth.

A portfolio that combines some of the above options may provide investors some security in addition to good prospects for long term gains. A multi-cap portfolio of Chinese and regional ADRs that may also include stock of developed market companies that are capitalizing on China's growth could offer good upside with perhaps a little more downside protection.

Investment Ideas

Here are a few ADRs that we believe will benefit from rapid growth in China and the Asia Pacific region.

CNOOC (China, energy) CEO: China National Offshore Oil Company is China's largest producer of offshore crude oil and natural gas and one of the largest E&P companies in the world. CNOOC is aiming for 18% production growth this year and 7-11% CAGR over the next five years, well above the industry average of 1-2% growth. The recent Liwan gas and Jinzhou light oil finds have enormous potential, and reserves additions from its 20+ projects under construction in 2009 are likely. CNOOC is amongst the world's best in terms of production growth and profitability, and as energy prices have rebounded, is set to see strong earnings growth from 2H 2009 forward.

Posco (South Korea, steel) PKX: Posco is the world's third largest steelmaker, producing more than 30 million tons of steel a year. South Korea accounts for two-thirds of its sales, with China as its largest export market. In 2005 it launched the largest foreign investment ever in India – a $12 billion steel plant in the eastern state of Orissa with annual capacity of more than 12 million tons. Posco was the first foreign firm operating an integrated stainless steel mill in China in 2006, and they have recently applied to the Chinese government to build another 10 million ton plant.

Kubota (Japan, capital goods) KUB: Kubota's is Japan's top agricultural machinery manufacturer, its internal combustion engine division accounting for about 80% of operating profit. Recent weakness in US and Japan has been offset by strong growth in Asia, up 49% in the year ended March. Sales to Asia are projected to be 26% of total sales and 40% of operating profit by FY 2011. Asian sales are mainly to Thailand, China and Korea, with China and Thailand driving growth. Sales to China gained 85% in the year to March 2009 thanks to the need to mechanize agriculture, and the expansion of subsidies by the government. Chinese subsidies for agricultural machinery have increased from RMB600 million in 2006 to RMB4 billion in 2008 and are expected to reach RMB10 billion this year.

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