Why H comes before A in China's alphabet soup

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Investing in China's equity markets requires more than careful research and an assessment of the potential risks and rewards. A close familiarity with the contents of a tin of Alphabetti spaghetti could be considered an advantage too. Between A shares and B shares, H shares, N shares and L shares, investors new to these markets could be forgiven for being more than a little confused, but the basics are not as complex as they might seem at first glance.

Both A shares and B shares are issued by companies listed on the exchanges in mainland China; A shares can be bought by Chinese individuals and B shares by overseas investors. H shares are shares in companies listed on the Hong Kong stock exchange, while N and L shares are for Chinese companies listed on New York and London respectively.

So far, so good, but there's a twist. All men might be created equal, but Chinese share classifications aren't – and neither are all China closed-end funds. There's been a sharp divergence in performance between different share classes in recent months, with remarkable inflows from domestic investors driving A shares to a substantial premium over H shares.

This recent volatility in A shares, and the perception that this area of the market may be becoming fully valued has led to deep discounts across most of the China closedend funds on the market, but the strategy being pursued by these funds hasn't been identical, and we believe this presents investors in the Greater China Fund with an opportunity.

The perception that all China closed-end funds are equally exposed to the same market risk and volatility simply isn't true. Individual closed-end funds can experience varying levels of market risk and volatility depending on their allocation to different types of share. Unlike a number of competitor funds, our preference has been for Hong Kong listed H shares over mainland China-listed A shares, with just 6.4% of the fund invested in the China A share market as at the 17th July this year. This has helped to mitigate the risk and volatility we experienced to our NAV during the recent correction in the A share market.

We believe the different risk profile of the Greater China Fund, but continued strong portfolio performance, means that the current discount to Net Asset Value is not justified, and that this, in turn, presents investors with an attractive investment opportunity. As this comes to be recognised more widely, as we believe it should, we expect the discount to net asset value to contract, to the benefit of investors.

We also have strong fundamental reasons for believing that H shares right now offer a much more attractive and more fairly valued way for investors to gain exposure to China's growth story than the volatility and highly valued A share market. One again the reasons for this come down to the alphabet soup of China's share classifications, and the fact that all are not created equal.

First, imagine this if you will. Two shares for the same company, trading on different exchanges but otherwise identical. Yet, one share is trading at an 870% premium to the other. It doesn't take a hedge fund mathematical genius to spot that something seems to be wrong, but that is exactly what happened to the shares of Chinese company Luoyang Glass at the end of April this year. At a time when the share price on the Hong Kong Exchange was HK$0.87, the price on the mainland Chinese Shanghai Exchange was a robust RMB 8.32, the equivalent of HK$8.45.

Admittedly that's an extreme example – and right now the shares in that company are suspended from trading – but by no means is it an isolated one. At that date more than eighteen companies listed on both exchanges were trading at a premium of more than 100% in mainland China, with many more still not far short of that. Why, then, have not the hedge fund investors come in to arbitrage out this anomaly and generate returns for their investors? After all, the proudest claim of many in this industry is that they act to improve the efficiency of markets. By ironing out these glitches, hedge funds act as Adam Smith's invisible hand.

Unfortunately, there is a problem, and it's a big one. China's renminbi-denominated A share market is not an open one. With a few exceptions, overseas investors cannot participate. Foreign investors are invited to participate in the hard currency B share market in China instead, but as demand for these is much more limited, they have never risen to the same

premium as China's A share market, nor have the H shares listed on the Hong Kong exchange. With artificial constraints on who can invest in each market, the laws of economics cannot apply and the arbitrageurs have not been able to iron out these wrinkles.

Not only have foreign investors not been able to participate in the A share market, but the flipside of that has been that investors in mainland China have not been able to invest outside their domestic market. In fact, this has been one of the driving forces for the remarkable price appreciation seen in China's A share market in recent years. In 2006 alone, the Shanghai A Share Index returned 130%, and so far this year it's up by a remarkable 42.4% already, to the 17th July 2007.

This isn't to argue that we are negative on China. The re-industrialisation of China over the last few years has been one of the most remarkable transformations of any economy in recent years, and the way companies have successfully started to move up the value chain from low valued added assembly work to skilled precision engineering and construction has been nothing short of remarkable. We expect China to continue to deliver growth in the region of 10% each year, not just in the run up to the Beijing Olympics but beyond, well into the medium to long term.

Even so, there has been a slight question market over the medium to longer term outlook for China's A share market. This is one of the main reasons why we have long been wary of investing too heavily in China's domestic market, favouring the less highly valued Hong Kong-listed H shares instead.

The second of our reasons for continuing to favour Hong Kong-listed H shares over their mainland equivalents is the impact of a recent change in Chinese legislation relaxing the restriction on Chinese citizens investing overseas.

The qualified domestic institutional investor programme, or QDII, was established in June last year, and nineteen financial institutions have been qualified under the scheme, eighteen of them commercial banks. Until now, little of the US$14.5 billion raised by these banks to date has been invested overseas, as they were required to invest in foreign money markets and fixed income products which generated little interest from their retail clients.

Now though, changes introduced just last month permit QDIIs to invest up to half of their investment quota in overseas stocks. In the near term, we expect Hong Kong listed companies to be the primary beneficiaries of this wave of liquidity, with China related markets across Asia likely to benefit later.

With the help of this additional investment from mainland Chinese investors, it is our contention that the valuation of Hong Kong listed H shares will gradually converge with China A shares, with those at the most significant discounts to mainland valuations likely to benefit the most. The positioning of the Greater China Fund reflects this thinking, with a strong preference for Hong Kong listed H shares over China A shares in the current environment overlaying the investments we have chosen for the fund on the basis of earnings surprise and likely outperformance of the broader market.

The valuation premium attached to many of the companies listed on the domestic China A share market is an anomaly, and we have positioned the fund as hopefully one of the beneficiaries of the inexorable laws of economics as China continues to open up to the world. Medium to longer term though, we remain confident that the broader China story is a multi-year one, set to run through next year's Beijing Olympics and well beyond.

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