Core Values, Polar Views of China’s Foreign Investor Channels

By Eric Johnson

It may be too simplistic to use the “bull and bear” analogy to describe the complex international sentiments toward the main channels through which non-Chinese institutions are accessing China’s US$6.5 trillion equities market.

And yet recent investor activity points to opposite approaches to the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programs, which as of July 1 gave hundreds of firms a way to put into play a combined US$157 billion.

Each approach – one cautious, the other brimming with enthusiasm – reflects a mutual confirmation of the intrinsic value of Chinese equities, fixed-income products and, increasingly, bonds in a huge investment arena that’s still labeled “emerging” and yet is very much in the global market forefront, given China’s clout as the world’s second-largest economy with a securities market boasting the world’s second-largest market capitalization.

No doubt most of the programs’ participating investors would agree with Rodney Comegys, Asia Pacific head of investments for Vanguard Investments Australia Ltd., who attributes his firm’s recent decision to join RQFII for the first time to the importance of China as “one of the world’s key emerging economies.” Regulators awarded the firm a US$4.5 billion investment quota in January.

“Our participation in this program is supported by the belief that A shares can provide the diversification benefit of spreading risk among a greater number of companies, and will thus offer significant value to investors, including individuals, over the long term,” Comegys told Institutional Investor.

The foreign investment inflow programs were at the heart of a series of financial market reform measures announced between February and June, including a five-fold raising of the investment ceiling for QFII participants to US$5 billion from the previous US$1 billion, and the June granting of a roughly US$38 billion RQFII quota to U.S. firms that hold Chinese currency.
Bearish Tone

What could be called a bear-like investor response to RQFII and QFII is in fact a bow to the yellow lights flashing as China’s economy continues a seven-year-old, government-managed deceleration, the market digests a recent decision by stock indexer MSCI to delay inclusion of China’s A shares in the firm’s Emerging Markets Index, and the investment community recovers from sell-offs that rocked the Shanghai and Shenzhen stock exchanges in June and August, 2015, as well as last January.

Investors in the cautious camp also appear to be giving the Chinese government more time to advance a financial markets liberalization campaign that, according to some analysts, eventually may fully open China’s equity and bond environment to overseas investors.

The liberalization effort is working hand-in-glove with internationalization of the yuan, also called the renminbi, which last year was accepted into the elite club of Special Drawing Right currencies alongside the U.S. dollar, euro, yen and pound maintained by the International Monetary Fund.

One of the most telling indicators of this caution has been a significant slowdown in investment firm applications and awards of new RQFII quotas, from the QFII and RQFII supervisor, the State Foreign Exchange Administration (SAFE). Only 14 new quotas were awarded in the first half of 2016, compared to 61 in full-year 2015, which brought the total quota level to US$76 billion as of July 1.

Among the most recent qualifiers were PMCO Asia Pte Ltd., which secured a quota of US$270 million; CF Financial Markets (UK) Ltd., which got permission to invest up to US$150 million; and AXA Investment Managers Paris, awarded a US$510 million quota.

Meanwhile on the QFII side, the 36 new quotas announced during the first six months of 2016 reflected a brisker pace for program participation than in 2015, when SAFE approved quotas for 65 firms. Total quotas have now topped US$81 billion, up from US$50 billion in early 2014.

But an increase in quota awards is nothing new, as the field has been growing wider every year, jumping to last year’s level from 56 in 2014 and 36 quotas in 2013. Moreover, many of the latest quotas were new awards for long-time participants such as divisions of UBS, Citigroup and Morgan Stanley. Hong Kong domiciled mainland asset managers such as E Fund Management (Hong Kong), China Asset Management (Hong Kong) and China Asset Management (Hong Kong) and also upped their quotas.

Ten of this year’s first-half quotas were handed out on the last day of the second quarter, including a US$1.29 billion award for UBS AG, a US$338 million quota for Morgan Stanley Investment, a US$650 million investment level for Merrill Lynch International and a US$350 million quota for KB Asset Management Co. Ltd.

Somewhat bearish sentiment also reflects the wider opening of Chinese financial markets. Since 2013, as part of the government financial markets liberalization campaign, the QFII and RQFII programs have been complemented by another door to mainland equities called the Shanghai-Hong Kong Stock Connect scheme, which lets non-Chinese trade A shares on the Shanghai Stock Exchange and mainlanders play the Hong Kong Stock Exchange.

The connect program’s “net buy” daily limit for A-share investments is US$1.95 billion – money that theoretically might have made its way into China through QFII or RQFII if not for the connect program. Qualified mainlanders are allowed to invest a combined US$1.58 billion in Hong Kong stocks every day.

Bull Side

So who’s bullish about QFII and RQFII? Included in this camp are asset managers who’ve been participating in the programs for years, many of whom loyally stuck with

Comparing Stock Connect with QFII/RQFII

The Shanghai-Hong Kong Stock Connect, QFII and RQFII are channels through which international investors can invest in the Chinese Capital Market. Although they share many similarities, these three channels have differences as well. Below is a table illustrating some major differences between the three channels.

<table>
<thead>
<tr>
<th>Eligible Investor</th>
<th>Stock Connect</th>
<th>QFII</th>
<th>RQFII</th>
</tr>
</thead>
<tbody>
<tr>
<td>SSE Members, institutional investors &amp; individual investors* in Mainland for HK Stock Connect trades</td>
<td>Selected institutional investors</td>
<td>Selected institutional investors</td>
<td></td>
</tr>
<tr>
<td>All Hong Kong and overseas investors for Shanghai Stock Connect trades</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Currency</th>
<th>Stock Connect</th>
<th>QFII</th>
<th>RQFII</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactions in RMB</td>
<td>Transactions in USD and other foreign currencies</td>
<td>Transactions in RMB</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Quota</th>
<th>Stock Connect</th>
<th>QFII</th>
<th>RQFII</th>
</tr>
</thead>
<tbody>
<tr>
<td>Applies to market as a whole</td>
<td>Allocated to each institutional investor</td>
<td>Allocated to offshore regions</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Eligible Products</th>
<th>Stock Connect</th>
<th>QFII</th>
<th>RQFII</th>
</tr>
</thead>
<tbody>
<tr>
<td>Selected A-listed and H-listed Stocks</td>
<td>RMB denominated products approved by CSRC**</td>
<td>RMB denominated products approved by CSRC</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Regulation of Funds</th>
<th>Stock Connect</th>
<th>QFII</th>
<th>RQFII</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds must return to origin; No lock up period</td>
<td>Funds subject to lock up period and can stay in mainland afterwards</td>
<td>Funds subject to lock up period and can stay in mainland afterwards</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Investors’ Rights</th>
<th>Stock Connect</th>
<th>QFII</th>
<th>RQFII</th>
</tr>
</thead>
<tbody>
<tr>
<td>Subject to limitations***</td>
<td>No limitations</td>
<td>No limitations</td>
<td></td>
</tr>
</tbody>
</table>

Source: sse.com.cn

*Individual investors must have balance of at least 500,000 in their cash and securities accounts.
**Stocks, bonds, warrants, funds, index futures fixed income products in interbank market; primary market activities such as IPO, convertible bond issuance, additional shares issuance and seasoned equity offerings.
***Shares acquired as entitlements can only be sold if they are not one of the eligible stocks of the Stock Connect but are SSE listed and cannot be bought or sold using the Stock Connect scheme if they are not SSE listed.

(continued on page 7)
Tang Xiaodong Takes the High Road with ChinaAMC
China Asset Management Co. Ltd. CEO Tang Xiaodong remembers the 2015 turmoil on the Shanghai and Shenzhen stock exchanges as a “watershed for both investors and asset managers.”

Previously China’s “domestic investors paid little attention to asset allocation,” Tang told Institutional Investor during a July 5 interview in Beijing. “But now asset allocation – the ‘bread and butter’ of international investment – is becoming more popular.”

“People are beginning to believe in asset allocation.” They’re also believing in ChinaAMC, which in June reported a China market-leading US$165.83 billion in total assets under management. And they’re trusting Tang at the wheel, now that he’s steered the firm through bad times as well as good.

ChinaAMC weathered the storm while retaining its position as the nation’s No. 1 asset manager by AUM in 2015. The firm also emerged with a stronger-than-ever reputation as a reliable provider of long-term investment tools for international and domestic clients.

Today’s China is “an exciting market for sophisticated asset managers,” Tang said.

ChinaAMC’s sophistication stands in sharp contrast to the folly of firms with wildly high yield offers. Before the stock sell-off, through risky equity products offered by some asset managers, “anyone, the cab driver, the hair dresser, could play the market and get a 70, 80 percent return,” he said.

ChinaAMC did not match those irrational yet popular retail products. “We did not want to compete solely on return without risk consideration,” Tang said.

“Then came a bear market and a lot of people suffered substantial losses,” he said. “Investors started to take into account diversification and risk-reward in their investment decisions. It’s a great opportunity for asset managers like us.”

For domestic and international institutional investors, it’s also a great opportunity rooted in China’s robust investment climate, a market regulation system that encourages innovation, ample liquidity, and a slowing yet still growing blockbuster of an economy. Corporate governance, market access and transparency issues that have long cast a shadow over foreign investor interest in China are gradually being addressed. And because the sell-off tempered risk appetite, the playing field is now less cluttered and the remaining players more mature.

ChinaAMC has always taken the high road in its role as an adviser and service provider for a wide range of market participants, from overseas institutional investors including sovereign wealth funds, central banks and public pension funds that access China’s stock market through the Qualified Foreign Institutional Investor (QFII) and Renminbi Qualified Foreign Institutional Investor (RQFII) programs, to government officials in Beijing who supervise the financial sector. Tang said his firm in recent years “has been playing an active role” at the forefront of the nation’s asset management sector.

“We strive to provide the regulators with constant feedback,” said Tang, who before joining ChinaAMC in August 2014 served at the China Securities Regulatory Commission, which oversees the nation’s stock markets, as deputy director-general at its Department of Fund Supervision and then at the Department of International Affairs.

An MBA graduate of the University of Chicago, Tang also earned dual master’s degrees in computer science and physics from Drexel University in Philadelphia, and a bachelor’s degree in physics from the University of Science and Technology of China in Hefei.

Before joining CSRC in 2009, Tang served as managing director and chief of U.S. corporate correlation trading at RBS Greenwich Capital, and headed U.S. exotic credit derivatives trading at ABN AMRO.

Because ChinaAMC manages “a substantial portion of the assets” flowing into China through the QFII program “we receive feedback from our investors, and we pass on the suggestions to the securities regulators,” Tang said.

Tang said based on his Wall Street experience during the U.S. subprime mortgage crisis of 2007 and subsequently the global financial meltdown of 2008, he could sense China’s coming storm in early 2015. “The market was becoming more and more irrational,” he said. “We held frequent internal meetings to discuss
contingency plans and implemented measures to manage the liquidity of the funds. During the crisis, we had a constant dialogue with the regulators, providing them with real-time market information and suggestions.”

“My diverse experience has enabled me to communicate effectively with different players in the market, from foreign institutional investors, to domestic regulators and investors,” Tang said. “The financial market in China is a welcoming place for people with international experience. I have personally benefitted from the openness and rapid growth of the asset management industry in China.”

Also on the receiving end of Tang’s and ChinaAMC’s communication line is the stock exchange indexer MSCI Inc., which disappointed the China market recently by declining, at least for now, to add the country to its influential Emerging Markets Index. MSCI has laid out a roadmap for China financial system reform in hopes its A-share market can qualify for the index in the future. Meanwhile, according to Tang, ChinaAMC “is communicating with MSCI, and explaining to them the substantial progress that has been made by the regulator.”

MSCI inclusion is inevitable, Tang said confidently. “It’s only a matter of time.”

The A-share market is simply too big and too important for international investors to ignore. And by encouraging foreign investment in China, Tang said, ChinaAMC is indirectly paving the way for MSCI inclusion by means of the international institutional investor’s ability to “influence the capital market, improve transparency, (and) promote value-based investment.”

“Having a solid institutional investor base is crucial,” Tang said. “What we truly need is long-term and value-oriented capital.”

In the past year there’s been a philosophical shift among China investors from high-risk, leveraged products to more rational, diversified investing that mirrors major institutional investor strategies.

“A lot has changed,” Tang said. “On the regulatory side, you see more measures to promote market stability. On the product offering side, they (regulators) are paying more attention to embedded leverage and investor suitability.”

ChinaAMC has made a deliberate decision not to offer some of the complicated but popular retail products on the domestic market. One such product called a “split fund” was also known as a “leverage fund,” Tang said, because it was subject to a deleveraging mechanism that, when triggered, could slash 50 to 60 percent of an investor’s principle in one day. About 70 percent of the investor complaints filed with market regulators at that time revolved around split funds, he said.

“We were one of the very few asset managers that did not offer the product,” Tang said. “It really enhanced our reputation.”

By holding its ground, Tang said, ChinaAMC’s product specialists were “free to design funds that offer better risk-adjusted returns to our investors.” And that trend is continuing now that the equities market is recovering, China’s bond market is maturing, and the economy is continuing to grow, albeit more slowly than a decade ago.

Consider, for example, the firm’s decision to reach out to institutional investors. About 70 percent of China’s money market funds are now targets for institutional investors, even though a little over a year ago retail investors dominated that sector. ChinaAMC is thus “rallying our sales team to broaden relationships with institutional investors” including banks, insurance companies and the financial arms of various companies, he said.

“We have established good relationships with the wealth management divisions of commercial banks in China that have
amassed assets worth more than US$4 trillion,” Tang said. Before the sell-off, wealth management products were able to offer attractive fixed return by providing margin lending for stock purchases. Regulators later imposed rules that put a damper on the practice.

“Subsequently, we came up with alternative solutions. We showcased our fixed-income product offerings and provided asset allocation strategies to clients of ours who are searching for stable yield in the new market environment.”

ChinaAMC is also cultivating relationships with major overseas financial firms with the goal of providing clients with a broader mix of asset allocation strategies. For example, Tang said his firm has teamed up with PanAgora Asset Management, a quantitative shop in Boston.

“PanAgora’s specialty is in risk parity portfolio construction. It’s been proven in the U.S,” he said. “It’s our thesis... that risk parity methodology could work better in China than in the U.S.”

“China is still in the loosening monetary policy regime,” he continued. “On the fixed income side, the yield still has the potential to come down further. And on the equity side, the valuations are becoming more attractive.”

“We believe that asset allocation decision-making will be the focus of the investment community in China.”

Factoring into that forecast is Tang’s overall outlook for China, which is sometimes portrayed as a slowly declining economy rather than what it is – a strong economy that’s growing more slowly than in years past.

“We’ve noticed that, geographically, the farther away you are from China, the more pessimistic you become,” Tang said. “Domestic institutional investors are quite confident about the strength of the economy, and market conditions have improved.”

“The Chinese economy and Chinese capital market are playing an influential role on the global financial market,” he said. “What’s happening in China will have a ripple effect around the world.”

“In the long run, I am very optimistic about the growth of the economy. China has a solid consumer base and a rapidly growing middle class,” Tang said. “The service industry in China is maturing, and as this trend continues the service industry will be able to capture the enormous spending power of the middle class.”

“The demand is there. That’s a luxury that not a lot of countries have.”

It’s a luxury that Tang and his ChinaAMC colleagues are not only enjoying but actively cultivating for clients in China, with the goal of leading the domestic industry through good times and bad, for a long time to come.

“We see ourselves as a regional leader, based in China, specializing in China-related markets,” Tang said. “We’re a China specialist.”

CONTACT US
Email: international@ChinaAMC.com
Website: http://www.chinaamc.com
Linkedin: http://www.linkedin.com/company/china-asset-management-company

With Global Reach, ChinaAMC Leads the Pack

| 18 years of successful asset management | 700+ employees | 200+ investment professionals | US$166 billion Total AUM | 350 institutional accounts | 40m+ retail accounts |

Our overseas institutional clients can be found worldwide.

ChinaAMC has been serving overseas clients since 2004. Sources of more than 90% of the assets we manage are foreign central banks, sovereign wealth funds and public pension funds. We offer relative equity, absolute equity, fixed income, indexed investment, and other products. ChinaAMC is the leading QFII and RQFII manager. We also offer overseas clients access to the China markets through the Shanghai-Hong Kong Stock Connect and other schemes.
China will “deepen the reform of the financial system, accelerate the improvement of the modern financial regulatory regime and increase the efficiency of financial services in supporting the real economy.”

Prime Minister Li Keqiang

been around since the program’s inception. But firms with 20 of the 273 quotas have participated in QFII since before 2010.

Daiwa Securities Capital Markets and Power Corporation of Canada have each had a US$50 million quota since 2004, while since 2006 the firms Nomura Securities Co. Ltd. and Goldman, Sachs & Co., have been allowed to invest up to US$350 million and US$300 million, respectively.

The two-thumbs-up for QFII-RQFII crowd also includes many asset managers who’ve applauded the government’s gradual relaxing of foreign investor access restrictions. Their patience was rewarded with several major reform steps in the first half of this year.

“There have been meaningful adjustments of the QFII-RQFII program in the past few months” that have made the programs “more convenient and attractive,” says Fred (Jiachun) Chen, executive director and head of QFII/RQFII Business at CITIC Securities (Jiachun) Chen, executive director and head of QFII/RQFII Business at CITIC Securities Co. Ltd., with permission to invest US$120 million – has tight foreign currency exchange controls. Participants include asset managers, insurance companies, banks and pension funds. Each participant designates a Chinese custodian bank to handle its securities business and works with Chinese brokers as well as foreign and-or Chinese advisers.

The role of RQFII, which is nicknamed “little QFII,” has been limited to repatriating offshore yuan back to the mainland and into investment targets, which for the most part have been equities. The program initially offered a way home for yuan parked in Hong Kong and Macau, and later expanded to other countries with yuan clearing such as Singapore, South Korea, France, Germany and Britain.

The United States joined the yuan clearing club in June and was subsequently granted a 250 billion yuan (roughly US$38 billion) RQFII quota, thus giving U.S. firms a means to invest Chinese currency on the mainland. Under the agreement signed by China’s central bank and the U.S. Federal Reserve, the United States will become the second-largest RQFII base after Hong Kong. China also agreed to designate yuan clearing banks in the United States.

The U.S.-China agreement came on the heels of deep adjustments to the QFII-RQFII schemes in order to facilitate the gradual, now 12-year-old process of opening China’s financial markets, as well as the Beijing government’s ongoing push to elevate the yuan to the status of a truly global currency.

Addressing an often-repeated foreign investor complaint about money-flow restrictions in China, regulators at SAFE in February slashed to three months a mandatory lock-up period for QFII participants who want to move cash in to or out of China. The previous period was one year.

SAFE also announced that it would “no longer define a unified upper limit on the investment quota of a single institution and assign an investment quota (basic quota) to the institution in proportion to the size of its assets or assets under management.”

Ongoing Reform

But most asset managers want more from China’s reforms. Institutions such as MSCI are also indirectly encouraging China to speed up liberalization. Indeed, what MSCI considers an unacceptably restrictive investor environment was the key reason for China’s failure to win a place on the Emerging Markets Index, frustrating government officials who’ve been lobbying the indexer for firms.

Many foreign asset managers can’t wait for the day when regulators ease a rule that prevents a QFII participant from moving more than 20 percent of its assets out of China in a single month. SAFE’s February announcement emphasized that this rule, as well as a requirement that all money be moved in “batches or installments,” remains in force.

Neil Flynn, an analyst for the Shanghai-based China market consultancy Z-Ben Advisors, says he expects Chinese regulators to continue making adjustments “to push forward MSCI inclusion and encourage FX (foreign exchange) inflows...going forward.”

If you look at recent inbound access reforms, China is moving towards a quota-less, restriction-light environment,” says Flynn, citing the examples of a recent reform to the interbank bond market and the expected launch of a Shenzhen-Hong Kong stock connect program to build on the success of the Shanghai-Hong Kong program. The government has said it plans to launch Shenzhen-Hong Kong Connect this year, probably late in the third quarter. Future connect programs could link the Singapore stock market to mainland exchanges.

In February, the central bank announced the lifting of all investment limits by foreign central banks and similar institutions participating in the Chinese interbank foreign exchange and bond markets, thus offering no-quota access to interbank bonds. The only stipulation is that foreign banks and institutions register every investment; interbank foreign exchange market deals are registered with the China Foreign Exchange Trade System, and bond
Institutional Investor 
Sponsored Report on QFII and RQFII

INSIGHT

Approved QFII & RQFII List and Quota

As of February 2016, 279 foreign institutions have been granted with QFII licenses, and the total quota is USD 80.795 billion. 158 foreign institutions have been granted with RQFII licenses, and the total quota is RMB 471.425 billion.

QFII quota approved since 2003 / US$bn

QFII quota approved since 2011 / RMBbn

Source: Wind. Note: Each data is collected at the end of each year.

investments are tallied by the central bank.

“China encouraged institutional investors to invest in its interbank bond market as a means of financial opening up,” according to a Shenzhen Stock Exchange statement. The central bank “PBOC will introduce more QFII (participants) to the interbank bond market with streamlined regulations and no quota restrictions.”

While large-cap, A share equities are currently the chief target for most QFII and RQFII investors, government reforms could generate more interest in the bond market in the months and years to come.

Chinese companies have stepped up bond issues in recent years as a way to manage debt without resorting to fundraising on the volatile stock market. Bonds are also popular among local governments that in recent years, due to the nation’s weakened property market, have sought to diversify away from raising money by selling land to developers.

At the same time, though, the widening of access channels such as the Shanghai- and Shenzhen-Hong Kong stock market schemes, together with the lingering gap between what foreign investors want and regulators are willing to give has raised questions among bulls and bears alike.

Flynn says his questions center on “the long-term viability of QFII and RQFII in their current state,” adding that in his opinion “they need to adapt or die.”

Nevertheless, future adjustments by Chinese regulators toward “a restriction-light environment will be more step-by-step than immediate,” Flynn says. “Our long-term view is that the choice between QFII and RQFII will not matter” to institutional investors in the future, as which program to play will become “a technicality that the back office handles, leaving portfolio managers free to trade China, unrestricted by quotas.”

Vanguard’s Comegys noted that for China and “all emerging markets, trading access can change over time. Currently, we can also access A shares through other programs such as (the Shanghai-Hong Kong) Stock Connect.”

Clearly, there’s no definitive consensus about a future path for QFII and RQFII. Market forecasting in emerging China has never been an exact science, of course, as even the most reasonable predictions can be blown away by a flash of volatility – a fact underscored by dramatic stock market selloffs over the past year.

But unlike other major economies, every China market forecaster starts from the same reference point. That’s because every prediction must in some way revolve around the directives and official comments expressed by the nation’s financial system gatekeepers at SAFE, the central bank, the China Securities Regulatory Commission and similar agencies.

Eliciting one of the latest commentaries that attracted forecaster attention was SAFE Administrator Pan Gongsheng, who doubles as the central bank’s deputy governor, while meeting in March with Blackstone Group LP President Hamilton “Tony” James and Euromoney Institutional Investor CEO Andrew Rashbass.

According to an official summary of Pan’s comments, China “will not resort to capital controls as it did before” but will focus on “risk prevention” and “vigorously promoting trade and investment facilitation.”

“Going forward,” Pan says, “China will focus on advancing structural reform, especially supply-side structural reform, to better balance economic growth, structural adjustment and risk prevention.” The goal will thus be “sustainable and stable economic development.”

Although Pan did not mention investment inflow, his superior Prime Minister Li Keqiang told an economic forum June 27 that the government would “provide more investment opportunities to foreign businesses and foster a fairer, more transparent and predictable investment environment.”

Speaking at the annual Summer Davos Forum in Tianjin, Li promised to “deepen the reform of the financial system, accelerate the improvement of the modern financial regulatory regime and increase the efficiency of financial services in supporting the real economy.”

The premier also called on the world’s major economies to “steadfastly advance trade and investment liberalization and facilitation” with China to “build a fairer, more just and open international economic system.”

8 • Institutional Investor Sponsored Report • July/August 2016