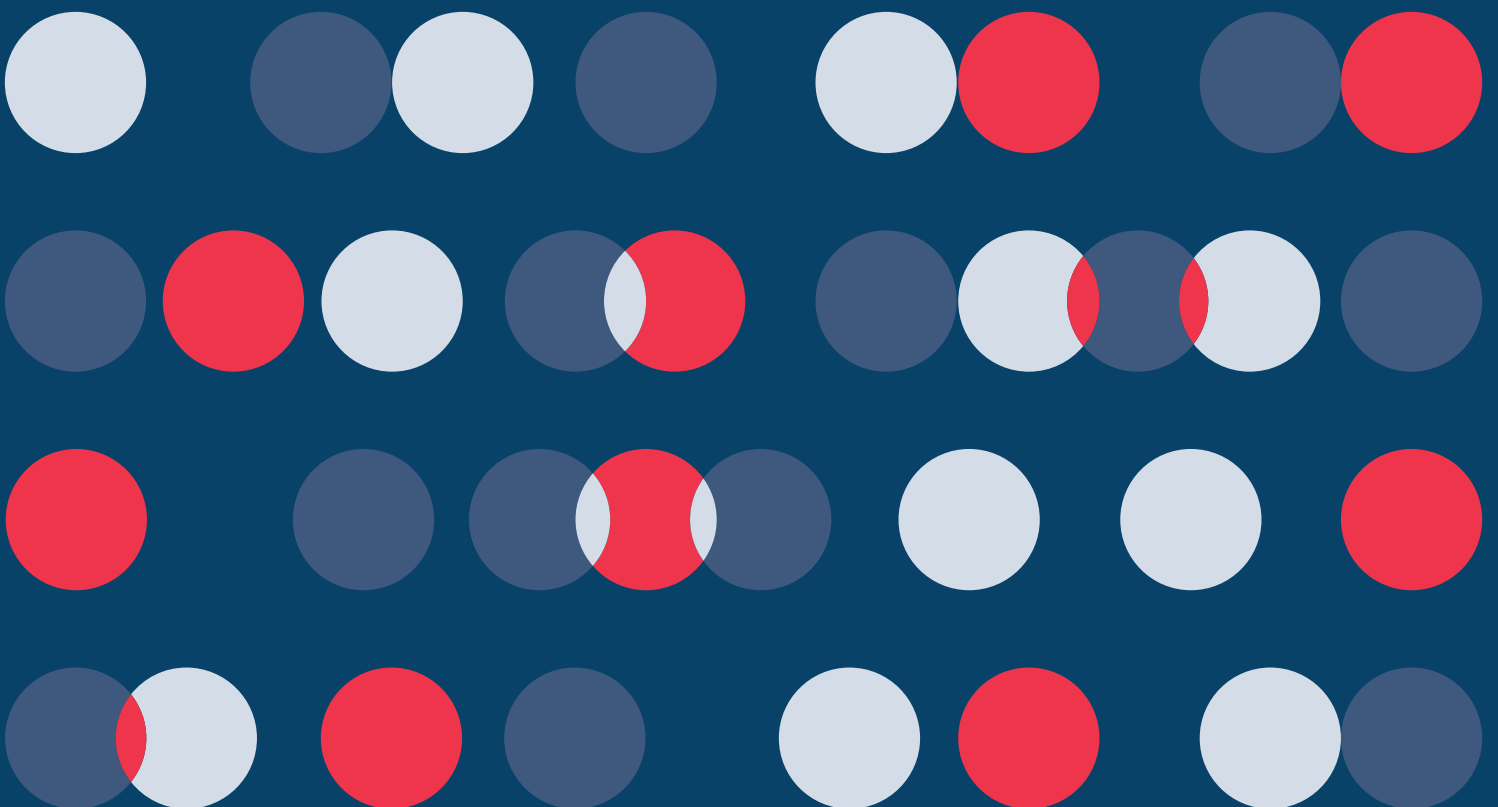


March 2017

RESEARCH REPORT

SHANGHAI AND SHENZHEN STOCK CONNECT —  
A “MUTUAL MARKET” FOR MAINLAND AND  
GLOBAL INVESTORS



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## SUMMARY

The Shanghai-Hong Kong Stock Connect (“Shanghai Connect”), the first initiative under the Mutual Market Access pilot programme (the “Pilot Programme”) between Mainland China and Hong Kong launched on 17 November 2014, offers a brand new official channel for overseas investors to invest in the Mainland stock market and for Mainland investors to invest in the Hong Kong stock market. The channel enables closed-loop Renminbi funds flow across the border in an orderly manner, thereby reducing the potential financial risk impact on the Mainland domestic market. The extended initiative — Shenzhen-Hong Kong Stock Connect (“Shenzhen Connect”), with an expanded scope of eligible securities — was already launched on 5 December 2016. The “Mutual Market” model across Shanghai, Shenzhen and Hong Kong has been basically formed. The Mutual Market model between Mainland China and Hong Kong is a symbolic breakthrough in the capital account opening process of Mainland China, under which global investment opportunities will be increasingly opened up to Mainland investors and more Mainland investment opportunities will be opened up to global investors.

Experience of the Shanghai Connect shows that Mainland investors have an increasing appetite for investment in Hong Kong stocks through Southbound trading. Their investment is not limited to large-cap blue chips but also in smaller-sized stocks in various industries. In Northbound trading, global investors also have an increasing interest in smaller-sized Mainland stocks of diversified industries. The Shenzhen Connect covers more small-sized stocks to meet the needs of both Mainland and global investors. Regulators on both sides had reached consensus on, extending the Mutual Market Access scheme to cover exchange-traded funds (ETFs), for which specific schedule will be separately announced. Subject to regulatory approval, the scheme can possibly be extended to bonds and other securities, commodities and derivative products in the future. Through Southbound trading under the “Mutual Market” model, Mainland investors are open to global asset allocation opportunities for potentially better returns and an increasingly diversified scope of investment and risk management instruments than in the domestic market. Trading experience in an international market would also help nurture the maturity of Mainland investors, especially the retail investors.

With increasing cross-border investment activities, there will likely be increasing demand for the inclusion in the Mutual Market model of related cross-border portfolio hedging tools such as RMB equity derivatives, RMB interest rate and currency derivatives.

## 1. THE STOCK CONNECT PILOT PROGRAMME — UNPRECEDENTED CONNECTIVITY WITH THE MAINLAND STOCK MARKET TOWARDS A “MUTUAL MARKET”

The Mutual Market Access pilot programme (the “Pilot Programme”), launched in November 2014 with initially the Shanghai-Hong Kong Stock Connect (Shanghai Connect), is an unprecedented mechanism that connects stock trading, albeit within a confined scope, between the Mainland stock market and an overseas market. Prior to this, foreign participation channels in the Mainland stock market had been limited mainly to the Qualified Foreign Institutional Investor (QFII) scheme and the Renminbi Qualified Foreign Institutional Investor (RQFII) scheme and foreign retail investors could only participate through investment funds offered by QFIIs and RQFIIs<sup>1</sup>. In the opposite direction, the Qualified Domestic Institutional Investor (QDII) scheme and the Renminbi Qualified Domestic Institutional Investor (RQDII) scheme had been the only national official channels of Mainland participation in overseas stock markets<sup>2</sup>. Following successful and smooth operation of the Shanghai Connect, the Shenzhen-Hong Kong Stock Connect (Shenzhen Connect) was announced in August 2016 and subsequently launched in December that year. Hereinafter, Shanghai Connect and Shenzhen Connect are collectively referred to as the “Stock Connect” scheme.

The Stock Connect scheme is in fact a milestone step in the capital account opening of Mainland China. With daily quota imposed and a closed loop of cross-border funds flow, it allows cross-border capital investment activities to take place and develop in an orderly way with close monitoring, thereby reducing the potential financial risk impact onto the Mainland domestic stock market. The programme is scalable in size, scope and market segments to match with the pace of the opening of the Mainland market as it further develops. The vision is to establish a “Mutual Market” of Mainland China and Hong Kong for Mainland and global investors.

Sub-sections below give a brief on the two Stock Connect schemes. Section 2 presents the hitherto performance since launch of Stock Connect and Section 3 discusses the opportunities that the “Mutual Market” model offers.

### 1.1 Shanghai Connect

The pilot programme for the establishment of mutual stock market access between Mainland China and Hong Kong — Shanghai Connect — was jointly announced by the China Securities Regulatory Commission (CSRC) and the Hong Kong Securities and Futures Commission (SFC) in April 2014. Mutual order-routing connectivity and related technical infrastructure (Trading Links) were built by the Stock Exchange of Hong Kong Limited (SEHK), a wholly-owned subsidiary of HKEX, and the Shanghai Stock Exchange (SSE). Correspondingly the clearing and settlement infrastructure (Clearing Links) was established by the Hong Kong Securities Clearing Company Ltd (HKSCC), also a wholly-owned subsidiary of HKEX, and the securities clearing house in Mainland China — China Securities Depository and Clearing Corporation Ltd (ChinaClear). After several months’ market preparation and system testing, the Shanghai Connect was formally launched on 17 November 2014. The theme of the programme is to enable Hong Kong and overseas investors to trade SSE-listed securities in the Mainland market (SH Northbound Trading) and Mainland investors to trade SEHK-listed securities in the Hong Kong market (SH Southbound Trading), within the eligible scope of the programme.

<sup>1</sup> The B-share market (traded in foreign currency and separated from the A-share market) on the Shanghai and Shenzhen Stock Exchanges, which was launched in 1992 as the Mainland’s first attempt of stock market opening to foreign investors, had become inactive in the new wave of market opening.

<sup>2</sup> There are special pilot schemes launched by local governments, e.g. the Qualified Domestic Limited Partnership (QDLP) programme in Shanghai and the Qualified Domestic Investment Enterprise (QDIE) in Shenzhen Qianhai. However, these are limited to mainly privately offered funds or investment vehicles not widely accessible by general investors as these target mainly the institutional investors and high-net-worth individuals, compared to QDII products which target general investors.



In the initial phase, **eligible securities in SH Northbound Trading** comprise SSE-listed A shares (the SSE-listed “Northbound stocks”) which are:

- Constituent stocks of the SSE 180 Index and SSE 380 Index; or otherwise
- A shares which have corresponding H shares listed on SEHK;

except those which are not traded in Renminbi (RMB) and those under risk alert<sup>3</sup>.

**Eligible securities in SH Southbound Trading** comprise SEHK-listed shares on the Main Board (the SEHK-listed “Southbound stocks”) which are:

- Constituent stocks of the Hang Seng Composite LargeCap Index (HSLI); or
- Constituent stocks of the Hang Seng Composite MidCap Index (HSMI); or otherwise
- H shares which have corresponding A shares listed on the SSE;

except those which are not traded in Hong Kong dollar (HKD) and H shares which have the corresponding SSE-listed A shares put under risk alert.

Among the Northbound stocks, the SSE 180 Index constituents are the most representative 180 A shares on the SSE while the SSE 380 Index constituents are the 380 stocks with modest scale, representing the segment of emerging blue chips outside the SSE 180 Index on the SSE<sup>4</sup>. The Northbound stocks in SSE 180 Index are therefore considered “large-cap” stocks in parallel with the Southbound HSLI stocks and the Northbound stocks in SSE 380 Index are considered “mid-cap” stocks in parallel with the Southbound HSMI stocks.

Within the eligible scope of securities, there were 715 SSE-listed Northbound stocks as at the end of February 2017 (including 139 stocks eligible for sell only<sup>5</sup>) and 317 SEHK-listed Southbound stocks<sup>6</sup>.

In respect of **investor eligibility**, all Hong Kong and overseas investors are allowed to participate in Northbound trading while only Mainland institutional investors and those individual investors who hold an aggregate balance of not less than RMB 500,000 in their securities and cash accounts are allowed to participate in Southbound trading.

In Northbound trading, investors in Hong Kong will trade through Hong Kong brokers and trades are executed on the SSE platform. In Southbound trading, Mainland investors will trade through Mainland brokers and trades are executed on the SEHK platform. Northbound trading and Southbound trading follow the market practices of their respective trade execution platforms. In particular, day trading is not allowed for Mainland A shares market while being permissible in the Hong Kong market. Notably, Northbound SSE stocks are traded and settled in RMB only and Southbound SEHK stocks are traded in HKD and settled by the Mainland investors with ChinaClear or its clearing participants in RMB.

Trading under the Shanghai Connect is subject to investment quota, initially with an Aggregate Quota on the maximum cross-border investment value and a Daily Quota. The Aggregate Quota was set at RMB 300 billion for Northbound trading and RMB 250 billion for Southbound trading. This Aggregate Quota was subsequently abolished on the announcement date (16 August 2016) of the Shenzhen Connect. The Daily Quota, which is currently still applicable, limits the maximum net buy value to RMB 13 billion for Northbound stocks and RMB 10.5 billion (~HKD 11.7 billion as at end-2016) for Southbound stocks.

<sup>3</sup> Shares which are placed under “risk alert” by SSE, including shares of “ST companies” and “\*ST companies” and shares subject to the delisting process under the SSE rules.

<sup>4</sup> Source: SSE website.

<sup>5</sup> Originally eligible SSE-listed stocks which subsequently ceases to be eligible according to the set criteria.

<sup>6</sup> Source: HKEX and SSE websites, viewed on 28 February 2017.



Since the launch of Shanghai Connect in November 2014, investor interest in Northbound and Southbound trading fluctuated over time. Since launch, Northbound trading was more active than Southbound trading for most of the time. However, the trend since late 2015 shows that Southbound trading value has picked up and surpassed Northbound trading. Northbound trading in December 2016 increased significantly upon the launch of Shenzhen Connect. Data showed that nearly 30% of Northbound trading in the month accrued to Shenzhen Connect. (See section 2 for details.)

## 1.2 Shenzhen Connect

On 16 August 2016, the CSRC and the SFC jointly announced the establishment of the Shenzhen Connect — the mutual stock market access between Shenzhen and Hong Kong. This is an extended version of the Mutual Market Access pilot programme between Mainland China and Hong Kong on the foundation of the Shanghai Connect which has been running successfully since launch. The Shenzhen Connect will be established by the Shenzhen Stock Exchange (SZSE), SEHK, ChinaClear and HKSCC in a similar way as for the Shanghai Connect. This was subsequently launched on 5 December 2016. With this in place, the Pilot Programme now comprises the following Trading Links:

		<u>Stock Connect</u>	
		Shanghai Connect	Shenzhen Connect
Trading type	Northbound	Northbound Shanghai Trading Link	Northbound Shenzhen Trading Link
	Southbound	Southbound Hong Kong Trading Link under Shanghai Connect	Southbound Hong Kong Trading Link under Shenzhen Connect

**Northbound eligible securities** under the Shenzhen Connect comprise the following:

- All constituent stocks of the SZSE Component Index (SZCI) and of the SZSE Small/Mid Cap Innovation Index (SZII) which have a market capitalisation of RMB 6 billion or above; and
- All SZSE-listed A shares of companies which have corresponding H shares listed on SEHK; except those which are not traded in RMB and those under risk alert<sup>7</sup>.

On top of Southbound eligible securities of the Shanghai Connect, the scope of **Southbound eligible securities** under the Shenzhen Connect is expanded to include the following:

- All constituent stocks of the Hang Seng Composite SmallCap Index (HSSI) which has a market capitalisation of HK\$5 billion or above; and
- All SEHK-listed H shares of companies which have corresponding A shares listed on the SZSE;

except those which are not traded in HKD and H shares which have the corresponding A shares put under risk alert.

<sup>7</sup> Shares which are placed under “risk alert” by SZSE including shares of “ST companies and “\*ST companies” and shares subject to the delisting process under the SZSE rules.

While Mainland eligible investors for Southbound trading under Shenzhen Connect are the same as that under Shanghai Connect, eligible investors for Northbound trading of shares listed on the ChiNext board of SZSE are confined, at the initial stage, to institutional professional investors as defined in the relevant Hong Kong rules and regulations<sup>8</sup>.

The same daily quota as for the Shanghai Connect is applied to the Shenzhen Connect and aggregate quota is no longer applicable.

Table 1 below summarises the common and different key features for the Shanghai and Shenzhen Connect schemes.

<b>Table 1. Key features of Shanghai Connect and Shenzhen Connect</b>		
<b>Feature</b>	<b>Shanghai Connect</b>	<b>Shenzhen Connect</b>
Northbound eligible securities	<ul style="list-style-type: none"> <li>• Constituents of the SSE 180 Index and SSE 380 Index</li> <li>• SSE-listed A shares which have corresponding H shares listed on SEHK</li> </ul>	<ul style="list-style-type: none"> <li>• Constituent stocks of the SZSE Component Index and of the SZSE Small/Mid Cap Innovation Index which have a market capitalisation of RMB 6 billion or above</li> <li>• SZSE-listed A shares of companies which have corresponding H shares listed on SEHK</li> </ul>
	<ul style="list-style-type: none"> <li>• Excluding risk alert stocks and stocks not traded in RMB</li> </ul>	
	<ul style="list-style-type: none"> <li>• 576 eligible stocks for buy and sell (as of 28 Feb 2017)</li> </ul>	<ul style="list-style-type: none"> <li>• 904 eligible stocks for buy and sell (as of 28 Feb 2017)</li> </ul>
Southbound eligible securities	<ul style="list-style-type: none"> <li>• Constituents of the Hang Seng Composite LargeCap Index (HSLI)</li> <li>• Constituents of the Hang Seng Composite MidCap Index (HSMI)</li> </ul>	
	<ul style="list-style-type: none"> <li>• H shares which have corresponding A shares listed on the SSE</li> </ul>	<ul style="list-style-type: none"> <li>• Constituents of the Hang Seng Composite SmallCap Index (HSSI) which has a market capitalisation of HK\$5 billion or above</li> <li>• H shares which have corresponding A shares listed on the SSE or the SZSE</li> </ul>
	<ul style="list-style-type: none"> <li>• Excluding H shares where the respective A shares are risk alert stocks and stocks not traded in HKD</li> </ul>	
	<ul style="list-style-type: none"> <li>• 317 stocks (as of 28 Feb 2017)</li> </ul>	<ul style="list-style-type: none"> <li>• 417 stocks (100 on top of Shanghai Connect Southbound stocks) (as of 28 Feb 2017)</li> </ul>
Northbound eligible investors	<ul style="list-style-type: none"> <li>• All Hong Kong and overseas investors (individuals and institutions)</li> </ul>	<ul style="list-style-type: none"> <li>• ChiNext eligible stocks are initially open only to institutional professional investors</li> <li>• All Hong Kong and overseas investors (individuals and institutions) for other eligible stocks</li> </ul>
Southbound eligible investors	<ul style="list-style-type: none"> <li>• Mainland institutional investors, and individual investors with an aggregate balance of ≥RMB 500,000 in their securities and cash accounts</li> </ul>	
Daily quota	<ul style="list-style-type: none"> <li>• Northbound: RMB 13 billion</li> <li>• Southbound: RMB 10.5 billion</li> </ul>	
Aggregate quota	<ul style="list-style-type: none"> <li>• Nil</li> </ul>	
Northbound trading, clearing and settlement	<ul style="list-style-type: none"> <li>• Following SSE and ChinaClear Shanghai market practice</li> </ul>	<ul style="list-style-type: none"> <li>• Following SZSE and ChinaClear Shenzhen market practice</li> </ul>
Southbound trading, clearing and settlement	<ul style="list-style-type: none"> <li>• Following SEHK and HKSCC market practice</li> </ul>	

<sup>8</sup> See the definition of “Institutional Professional Investor” in the Securities and Futures (Professional Investor) Rules under the Securities and Futures Ordinance.



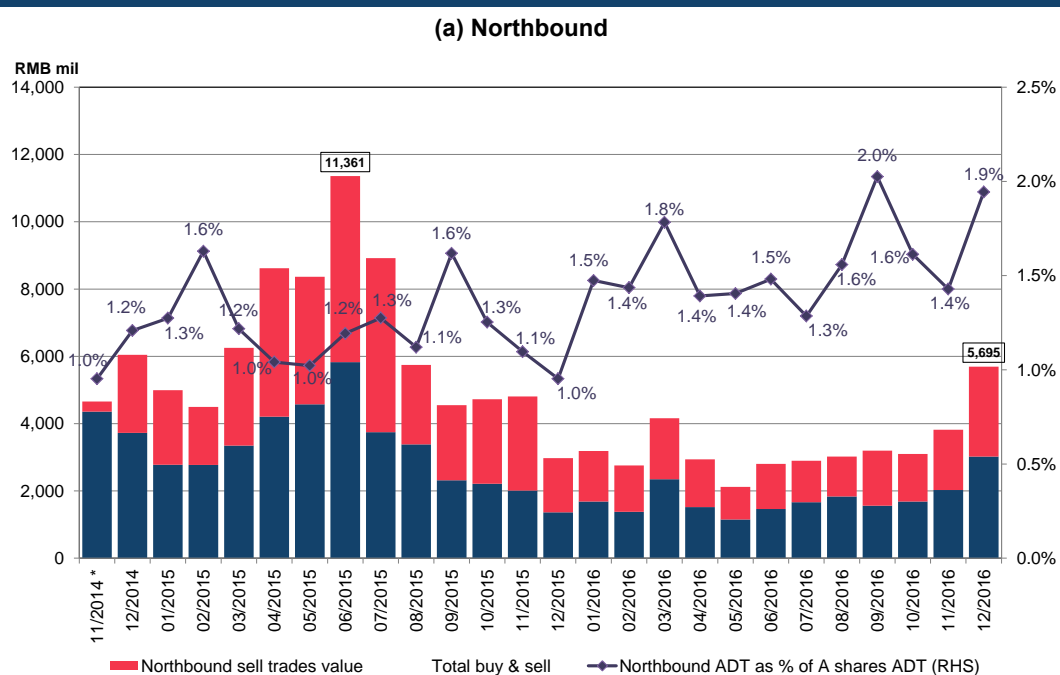
## 2. HITHERTO PERFORMANCE OF STOCK CONNECT (UP TO END-2016)

### 2.1 Overall Northbound and Southbound trading

Both Northbound and Southbound trading value have fluctuated over time, along with changes in market sentiment. Yet, the average daily trading value (ADT) of Northbound trading has maintained a relatively steady level between 1% and 1.6% of the ADT of the Mainland total A-share market. On the other hand, after a rise and fall of Southbound trading in the first 9 months after launch, a strong upward trend was observed for Southbound trading relative to the SEHK Main Board total market trading since the fourth quarter of 2015, rising from 2.1% of the Main Board ADT in September 2015 to 10.8% in September 2016. The upward trend of Southbound trading continued despite a decrease somewhat at times. For the first time after April 2015, Southbound ADT exceeded Northbound ADT in June 2016 and time and again in subsequent months. (See Figures 1 and 2 below).

Notably, during the 17 Northbound trading days from the launch of Shenzhen Connect on 5 December 2016 to the end of 2016, Northbound trading under Shenzhen Connect constituted 27% of Stock Connect’s total Northbound trading value and 40% of Stock Connect’s total buy trade value. This shows that global investors have considerable interest in Shenzhen stocks.

**Figure 1. Stock Connect average daily trading value (Nov 2014 – Dec 2016)**

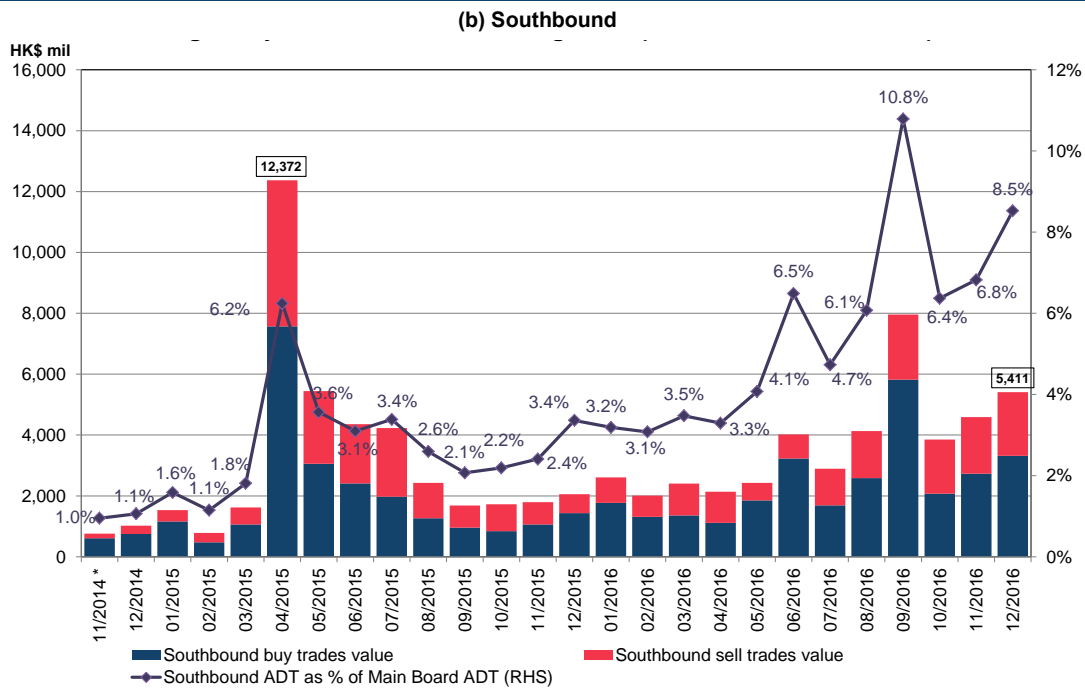


\* Starting from 17 Nov 2014 when Shanghai Connect was launched.

Note: Shenzhen Connect data is included since the launch date of Shenzhen Connect (5 Dec 2016); the base reference data of Mainland A-share market includes SZSE A-share market since that date.



**Figure 1. Stock Connect average daily trading value (Nov 2014 – Dec 2016) (cont'd)**

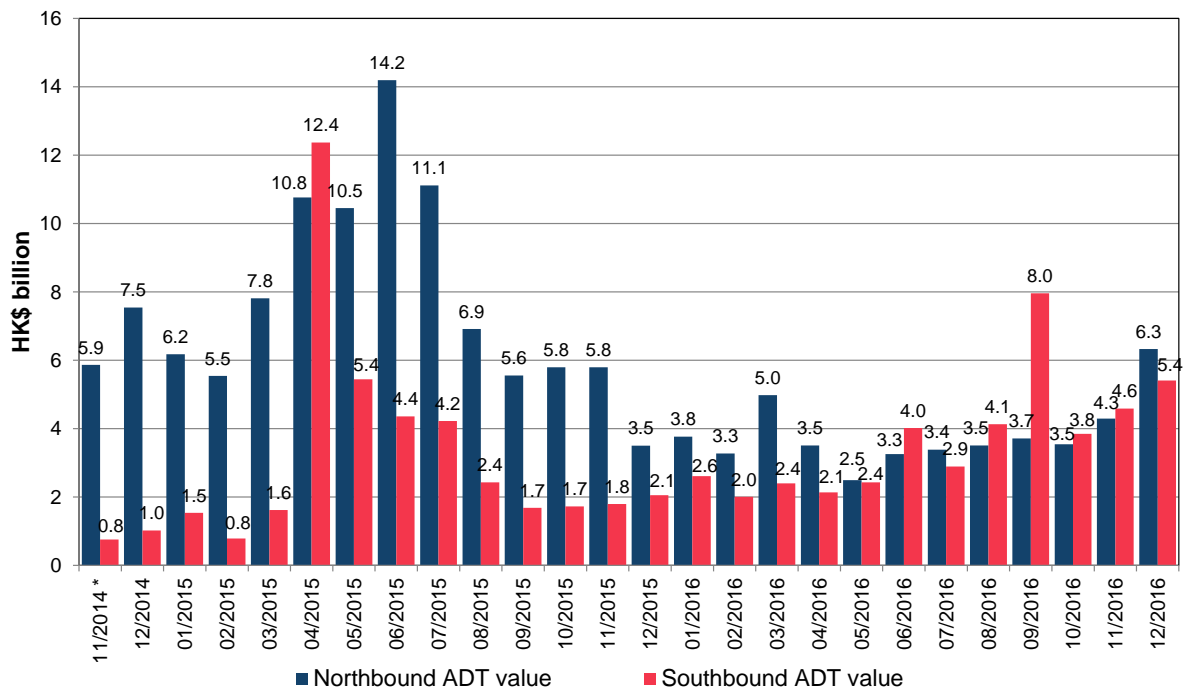


\* Starting from 17 Nov 2014 when Shanghai Connect was launched.

Note: In calculating the ratio to the total market ADT, Northbound/Southbound trading values were two-sided (buy and sell values counted separately) while the total market trading values were one-sided transaction values (buy and sell counted in a single transaction value). Shenzhen Connect data is included since the launch date of Shenzhen Connect (5 Dec 2016).

Source: HKEX

**Figure 2. Average daily Stock Connect Southbound total trading (buy and sell) value in comparison with Northbound (Nov 2014 – Dec 2016)**



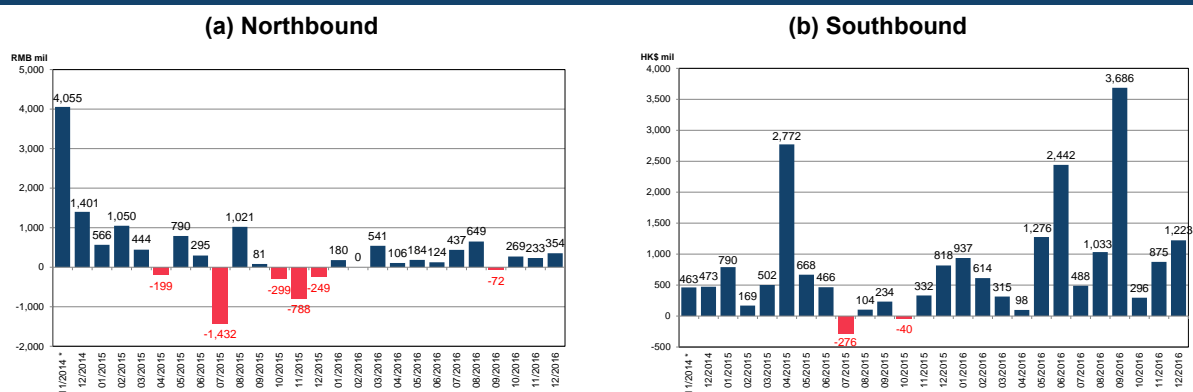
\* Starting from 17 Nov 2014 when Shanghai Connect was launched.

Note: Northbound trading values are converted to HKD using month-end exchange rates from Hong Kong Monetary Authority website. Shenzhen Connect data is included since the launch date of Shenzhen Connect (5 Dec 2016).

Source: HKEX

Moreover, Southbound trading had much higher average daily net buy values than Northbound trading since late 2015. Net sell value was recorded for Southbound trading in only two months since launch up to the end of 2016, vis-à-vis 6 months for Northbound trading (see Figure 3). Of the 485 Southbound trading days during the period, 86% had a net buy value (vs 56% for Northbound out of its 494 trading days). However, the net-buy daily quota consumption has been low for both Northbound and Southbound trading — under Shanghai Connect, only 18% of the Northbound trading days and 16% of the Southbound trading days had a daily quota usage exceeding 10%; and 6% respectively of the Northbound trading days and Southbound trading days had the usage exceeding 20%.<sup>9</sup> Under Shenzhen Connect, 4 out of 17 Northbound trading days (24%) had a daily usage exceeding 10% and only one day (6%) had the usage exceeding 20%; Southbound trading’s daily quota usage had never exceeded 10%. (See Figure 4 and Table 2 below.)

**Figure 3. Average daily net buy/sell value in Stock Connect Northbound and Southbound trading (Nov 2014 – Dec 2016)**



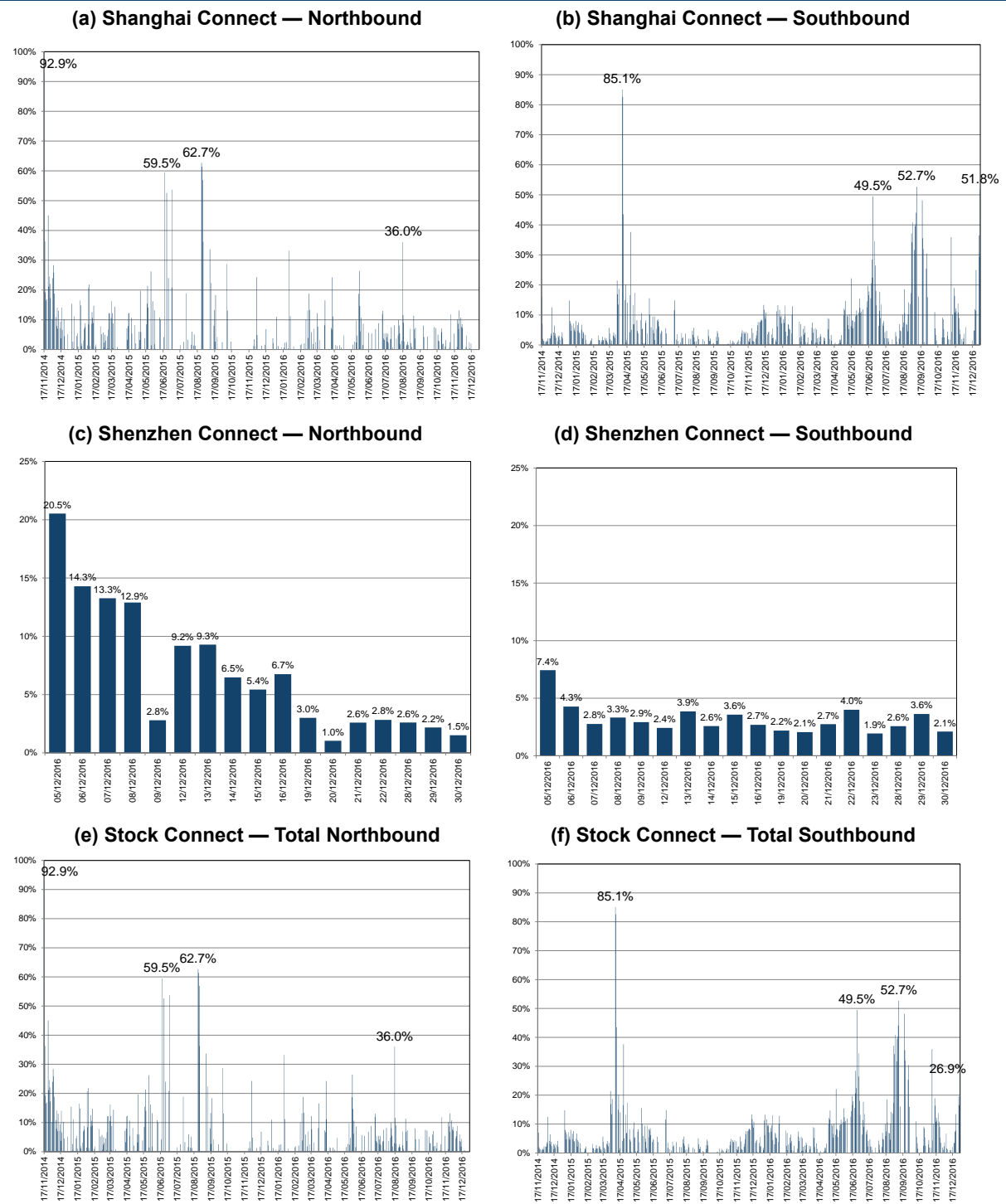
\* Starting from 17 Nov 2014 when Shanghai Connect was launched.

Note: Shenzhen Connect data is included since the launch date of Shenzhen Connect (5 Dec 2016).

Source: HKEX

<sup>9</sup> For Northbound trading, a daily quota usage exceeding 10% means that the net-buy value exceeds 10% of the given Northbound daily quota of RMB 13 billion, i.e. net-buy value amounts to over RMB 1.3 billion. The same applies to Southbound trading, but with reference to the Southbound net-buy daily quota of RMB 10.5 billion and currency converted to HKD based on the daily RMB/HKD exchange rate as obtained from Thomson Reuters.

**Figure 4. Net-buy daily quota consumption in Stock Connect (17 Nov 2014 – 31 Dec 2016)**



Note: Since 5 December 2016, Stock Connect total Northbound and total Southbound daily quota is the sum of those of Shanghai Connect and Shenzhen Connect.

Source: HKEX; daily trading value converted to RMB at daily exchange rates obtained from Thomson Reuters for calculating Southbound quota consumption

<b>Table 2. The usage of daily quota in Stock Connect (17 Nov 2014 – 31 Dec 2016)</b>				
	<b>Shanghai Connect</b>		<b>Shenzhen Connect</b>	
	<b>Northbound</b>	<b>Southbound</b>	<b>Northbound</b>	<b>Southbound</b>
Total no. of trading days	494	485	17	18
% of trading days with net buy	55%	85%	100%	100%
<b>Daily quota usage range</b>	<b>Northbound (no. of days / % of total)</b>	<b>Southbound (no. of days / % of total)</b>	<b>Northbound (no. of days / % of total)</b>	<b>Southbound (no. of days / % of total)</b>
>0% - 10%	186 / 37.7%	317 / 65.4%	13 / 76.5%	18 / 100%
>10% - 20%	58 / 11.7%	66 / 13.6%	3 / 17.6%	0 / 0%
>20% - 30%	17 / 3.4%	10 / 2.1%	1 / 5.9%	0 / 0%
>30% - 40%	5 / 1.0%	11 / 2.3%	0 / 0%	0 / 0%
>40% - 50%	1 / 0.2%	6 / 1.2%	0 / 0%	0 / 0%
>50% - 60%	4 / 0.8%	2 / 0.4%	0 / 0%	0 / 0%
>60% - 70%	2 / 0.4%	0 / 0%	0 / 0%	0 / 0%
>70% - 80%	0 / 0%	0 / 0%	0 / 0%	0 / 0%
>80% - 90%	0 / 0%	2 / 0.4%	0 / 0%	0 / 0%
>90% - 100%	1 / 0.2%	0 / 0%	0 / 0%	0 / 0%
<b>Total Stock Connect</b>	<b>Northbound</b>		<b>Southbound</b>	
Total no. of trading days	494		485	
% of trading days with net buy	56%		86%	
<b>Daily quota usage range</b>	<b>Northbound</b>		<b>Southbound</b>	
>0% - 10%	191 / 38.7%		324 / 66.8%	
>10% - 20%	58 / 11.7%		67 / 13.8%	
>20% - 30%	17 / 3.4%		9 / 1.9%	
>30% - 40%	5 / 1.0%		10 / 2.1%	
>40% - 50%	1 / 0.2%		6 / 1.2%	
>50% - 60%	4 / 0.8%		1 / 0.2%	
>60% - 70%	2 / 0.4%		0 / 0%	
>70% - 80%	0 / 0%		0 / 0%	
>80% - 90%	0 / 0%		2 / 0.4%	
>90% - 100%	1 / 0.2%		0 / 0%	

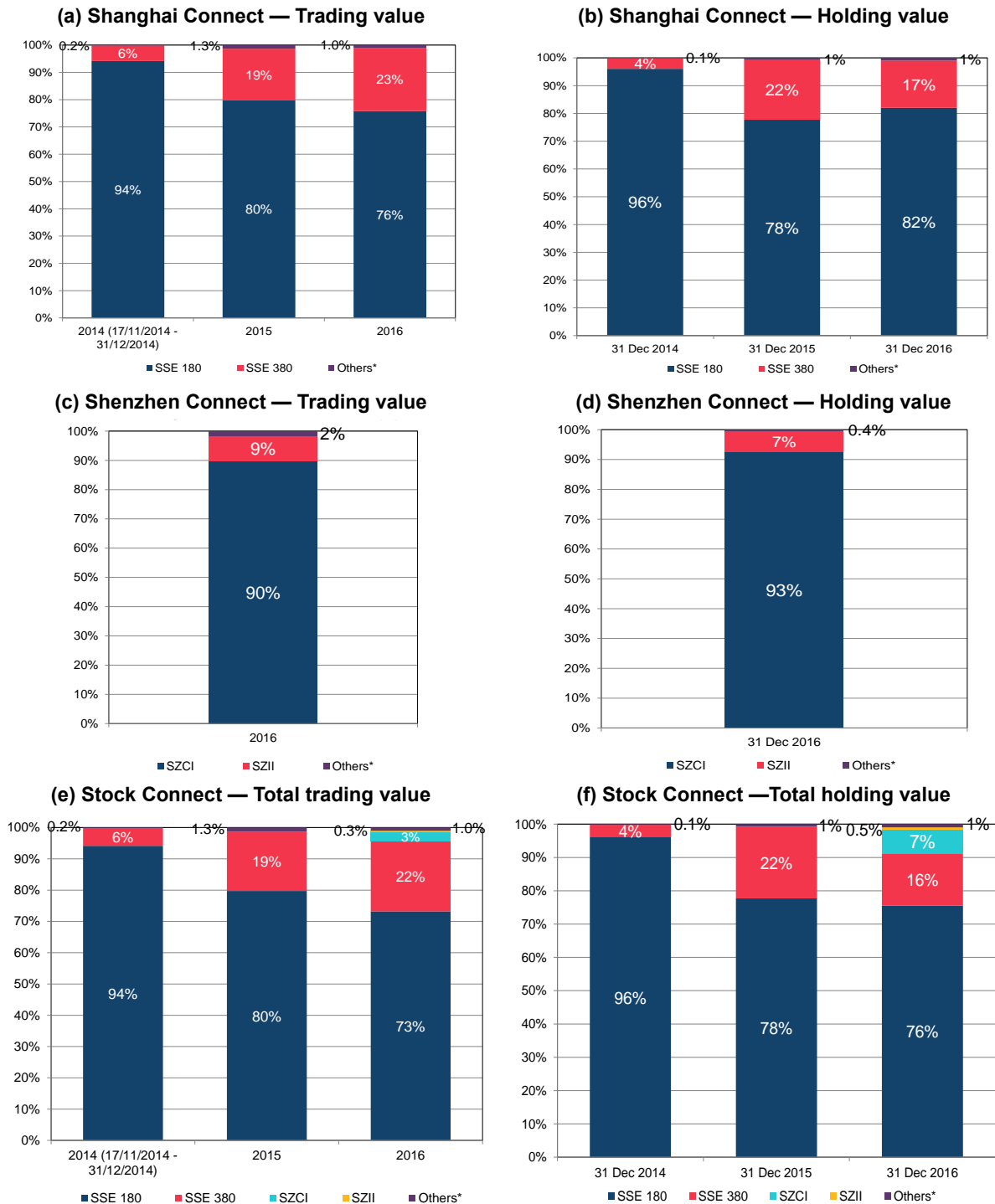
## 2.2 Global investors' interest in Northbound stocks

At the initial stage after the launch of Shanghai Connect, global investors' trading and holding of Northbound stocks were predominantly in the large-cap SSE 180 Index constituents (94% of trading value in 2014 and 96% of holding value at the end of 2014). Northbound trading in the mid-cap SSE 380 Index constituents gradually increased from 6% during 2014 to 23% during 2016. Northbound holding of these mid-cap stocks jumped to 22% at the end of 2015 and decreased to 17% at the end of 2016, still much higher than the 4% at the end of 2014. Nevertheless, global investors' main interest was in the Mainland large-cap blue chips under Shanghai Connect. (See Figures 5a and 5b.)



For Shenzhen Connect launched on 5 December 2016, trading and holding of Northbound stocks by global investors also concentrated on the blue-chips in SZCI — 90% of trading value in 2016 and 93% of year-end holding value. (See Figures 5c and 5d.)

**Figure 5. Stock Connect — Distribution of Northbound trading value and investor holding value by stock type (Nov 2014 – Dec 2016)**



\* Others include non-eligible-index A shares with SEHK-listed H shares and stocks removed from Stock Connect eligible stock list during the period (sell-only stocks).

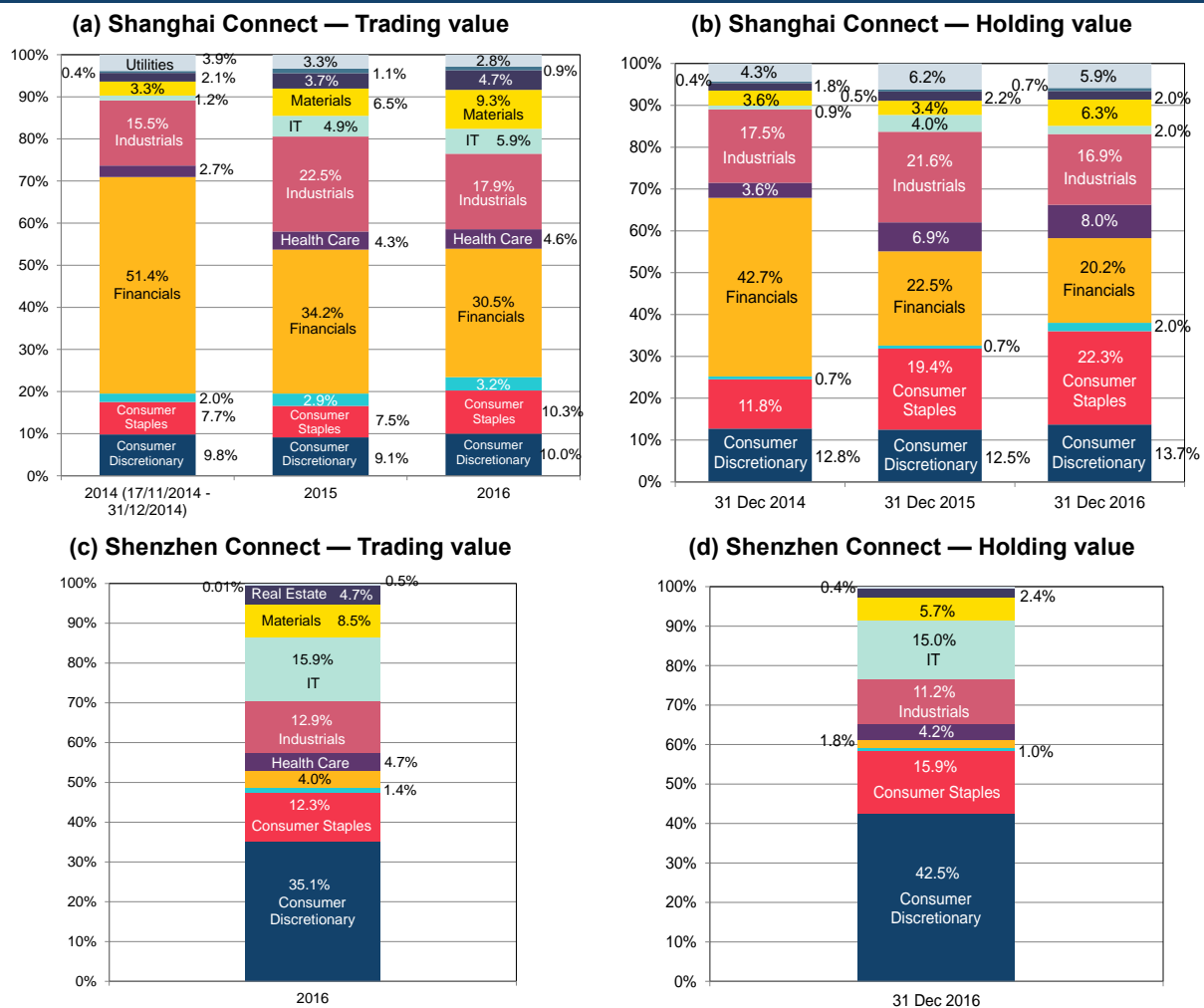
Note: Shenzhen Connect data starts from the launch date of Shenzhen Connect (5 Dec 2016). Percentages may not add up to 100% due to rounding.

Source: HKEX

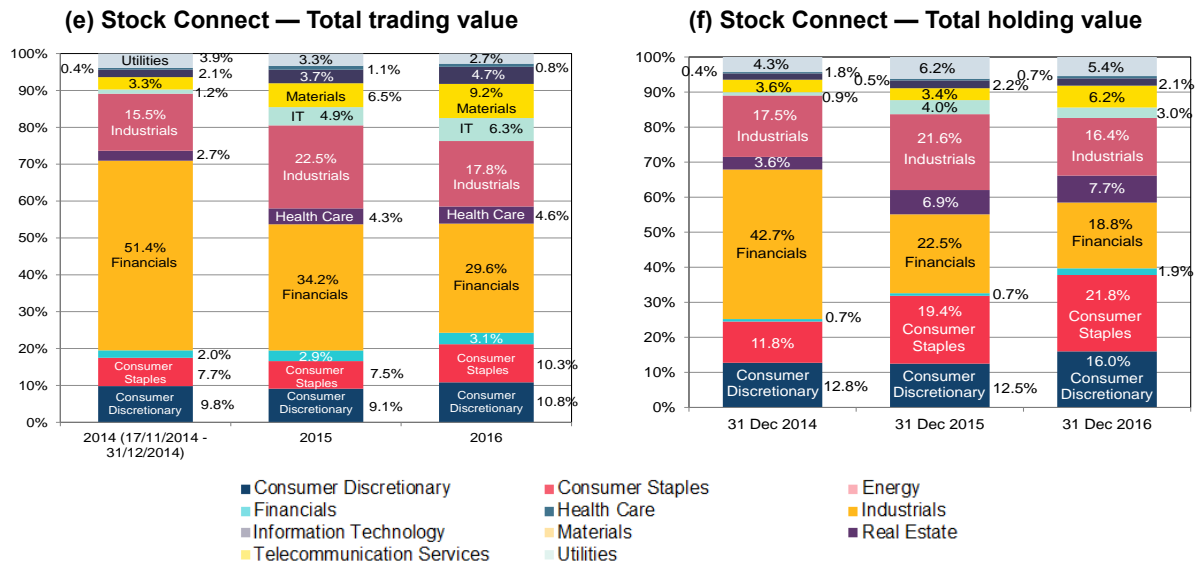
Under Shanghai Connect, global investors maintained a steady interest in Mainland consumer stocks (Consumer Discretionary and Consumer Staples) — these stocks’ trading contribution rose somewhat to 20% share of Northbound trading value in 2016 since launch and had an increasing percentage share of Northbound holding value. The share of consumer stocks was even higher under Shenzhen Connect — 47% of Northbound trading value in 2016 and 58% of year-end holding value. Shanghai and Shenzhen Connect combined, global investors’ holding of Mainland consumer stocks was as high as 38% as at the end of 2016.

Mainland Industrial stocks under Shanghai Connect also attracted considerable interest — over 17% of Northbound trading value and period-end holding value in 2016. The degree of dominance of Financial stocks under Shanghai Connect (all were large-cap SSE 180 constituents) gradually reduced — from 51% of Northbound trading value and 43% of period-end Northbound holding value in 2014 to 31% and 20% respectively in 2016. Information technology (IT) stocks under Shenzhen Connect were considerably attractive to global investors, sharing 16% by trading value in 2016 and 15% by period-end holding value. The launch of Shenzhen Connect further drove up the share of IT stocks in Northbound trading. (See Figure 6.)

**Figure 6. Stock Connect — Distribution of Northbound trading value and investor holding value by industry sector (Nov 2014 – Dec 2016)**



**Figure 6. Stock Connect — Distribution of Northbound trading value and investor holding value by industry sector (Nov 2014 – Dec 2016) (cont'd)**

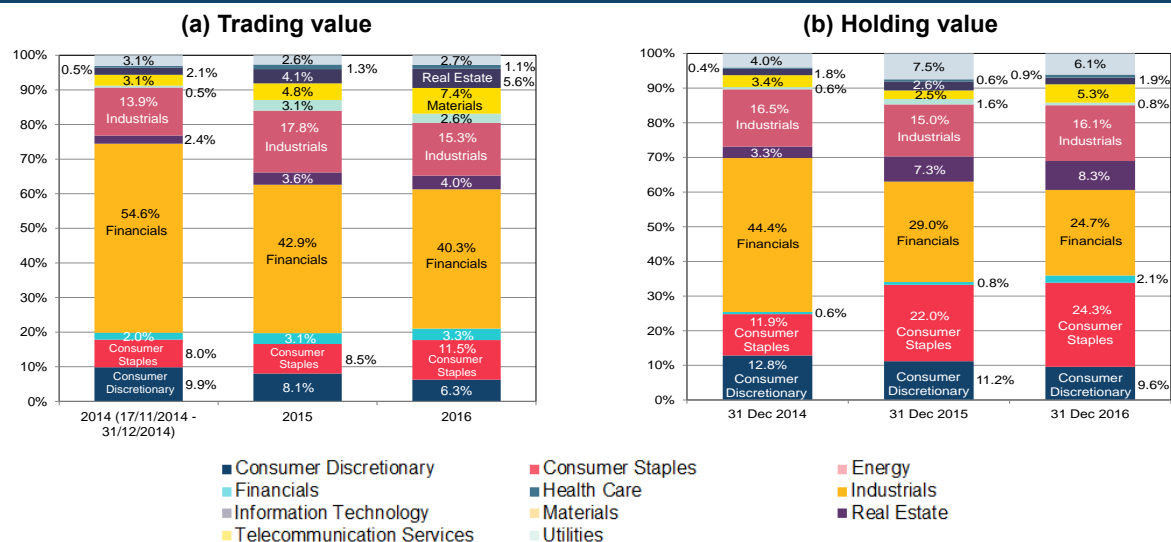


Note: Shenzhen Connect data starts from the launch date of Shenzhen Connect (5 Dec 2016). Percentages may not add up to 100% due to rounding.

Source: HKEX; stock classification is according to Global Industry Classification Standard (GICS) obtained from Bloomberg or Thomson Reuters.

While the majority share of Northbound trading in the large-cap SSE 180 stocks was contributed by Financial stocks, considerable share of Northbound trading in the mid-cap SSE 380 stocks was contributed by Industrial stocks. Consumer stocks contributed a significant share of Northbound trading in the large-cap SSE 180 stocks while the share of consumer stocks and IT stocks in Northbound trading in the mid-cap SSE 380 stocks showed an increasing trend. Apparently, although the mid-cap SSE 380 stocks had no financial stocks, IT stocks, Material stocks and Health Care stocks in the indices could attract relatively more diversified investment by industry than in the large-cap SSE 180 stocks. (See Figures 7 and 8.)

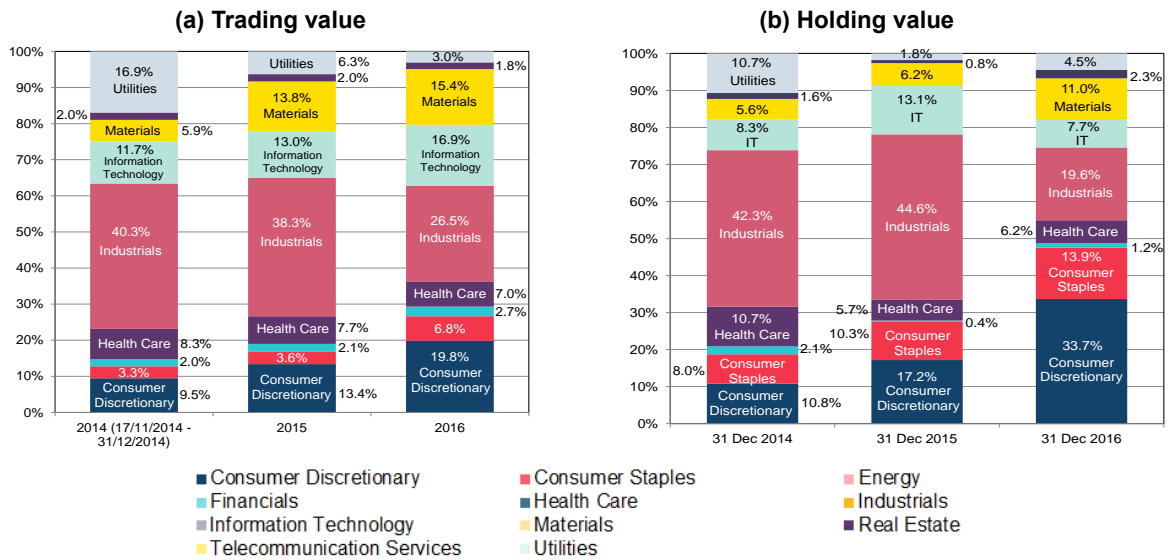
**Figure 7. Shanghai Connect — Distribution of Northbound trading value and investor holding value by industry sector for SSE 180 Index constituents (Nov 2014 – Dec 2016)**



Note: Percentages may not add up to 100% due to rounding.

Source: HKEX; stock classification is according to Global Industry Classification Standard (GICS) obtained from Bloomberg or Thomson Reuters

**Figure 8. Shanghai Connect — Distribution of Northbound trading value and investor holding value by industry sector for SSE 380 Index constituents (Nov 2014 – Dec 2016)**

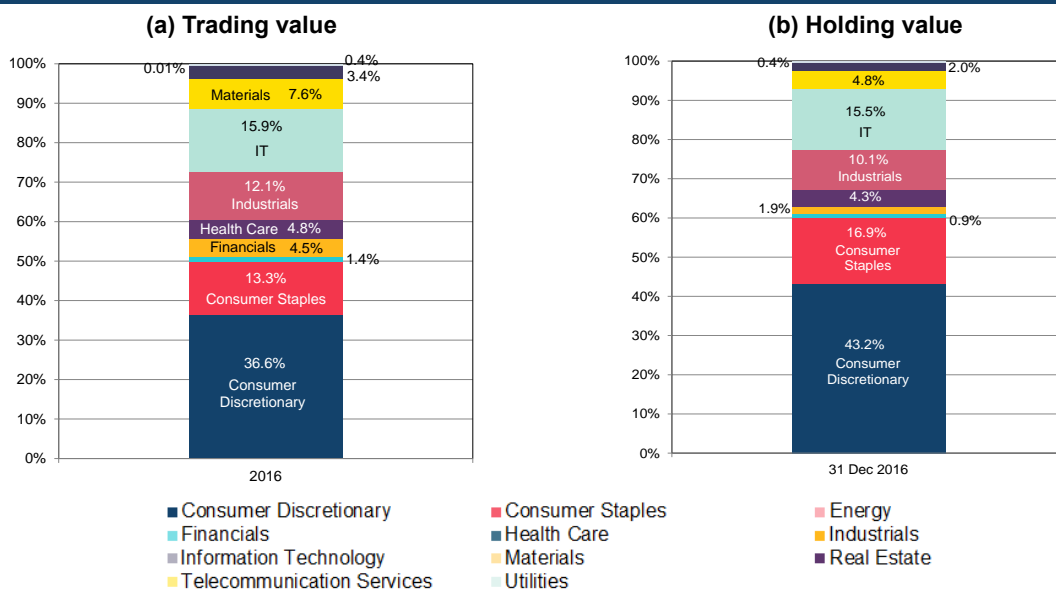


Note: Percentages may not add up to 100% due to rounding.

Source: HKEX; stock classification is according to Global Industry Classification Standard (GICS) obtained from Bloomberg or Thomson Reuters.

For Shenzhen Connect, in the Northbound trading of the blue-chip SZCI, the shares of consumer stocks in trading value and holding value were considerably high and the share of IT stocks were also quite high. In the Northbound trading of the SZII stocks, Industrial, IT and Material stocks had rather high percentage share in trading value, while Consumer Discretionary stocks took the lead in holding value. (See Figures 9 and 10.)

**Figure 9. Shenzhen Connect — Distribution of Northbound trading value and investor holding value by industry sector for SZCI constituents (Dec 2016)**

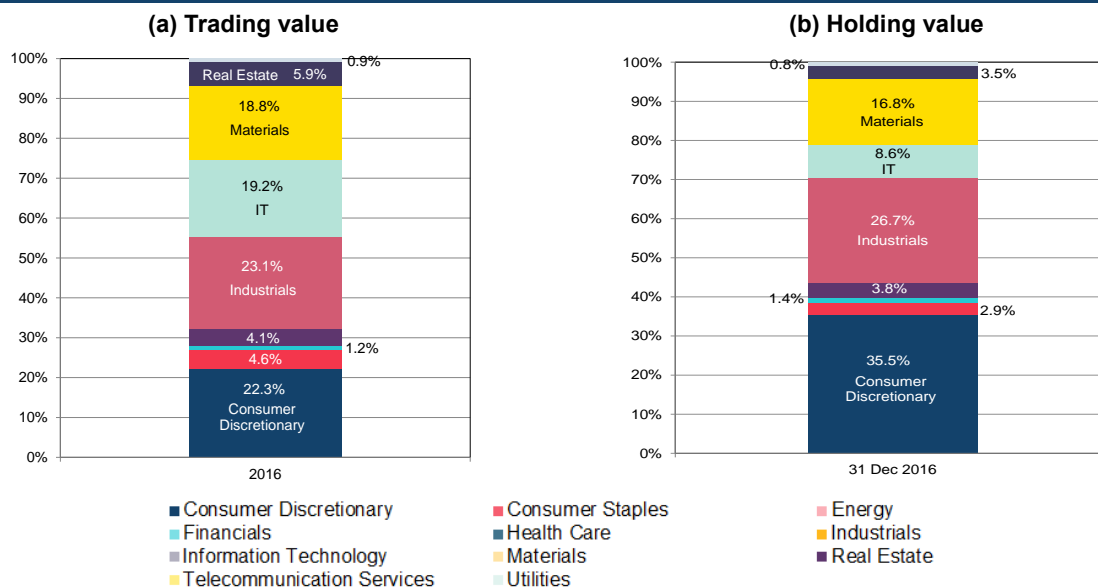


Note: Shenzhen Connect data starts from the launch date of Shenzhen Connect (5 Dec 2016). Percentages may not add up to 100% due to rounding.

Source: HKEX; stock classification is according to Global Industry Classification Standard (GICS) obtained from Bloomberg or Thomson Reuters.



**Figure 10. Shenzhen Connect — Distribution of Northbound trading value and investor holding value by industry sector for SZII constituents (Dec 2016)**



Note: Shenzhen Connect data starts from the launch date of Shenzhen Connect (5 Dec 2016). Percentages may not add up to 100% due to rounding.

Source: HKEX; stock classification is according to Global Industry Classification Standard (GICS) obtained from Bloomberg or Thomson Reuters.

### 2.3 Mainland investors’ interest in Southbound stocks

Figure 11 shows the Southbound trading and investor holding in SEHK-listed stocks by eligible stock type. In contrast to Northbound investment, the majority of Southbound trading value and period-end holding value was in the mid-cap HSMI constituents at the launch of the scheme in 2014. This had shifted to some extent to HSLI constituents in 2016. Nevertheless, HSMI stocks still maintained a considerable share in 2016 (~40%).

Apart from the large-sized HSLI stocks and the mid-cap HSMI stocks, Southbound eligible stocks also include the small-cap HSSI stocks under Shenzhen Connect. HSSI stocks constituted considerably high percentage share in Southbound trading under Shenzhen Connect during the 18 trading days in 2016, the same as the 42% for HSMI stocks and even had a higher percentage share in holding value than HSMI stocks (46% vs 42%). However, owing to the low market value of HSSI stocks by definition, the percentage share of HSSI stocks in total holding value of Southbound stocks under Stock Connect was very small (4%).

**Figure 11. Stock Connect — Distribution of Southbound trading value and investor holding value by stock type (Nov 2014 – Dec 2016)**



\* Others include non-eligible-index H shares with SSE-listed or SZSE-listed (since 5 Dec 2016) A shares and stocks removed from Stock Connect eligible stock list (“sell-only” stocks).

Note: Shenzhen Connect data starts from the launch date of Shenzhen Connect (5 Dec 2016). The stock types in calculating holding value are the period-end status, which may have changed during the period. Due to this reason, stocks held under Shanghai Connect may include HSSI stocks while the trading of these stocks in such status is counted into “others”. Percentages may not add up to 100% due to rounding.

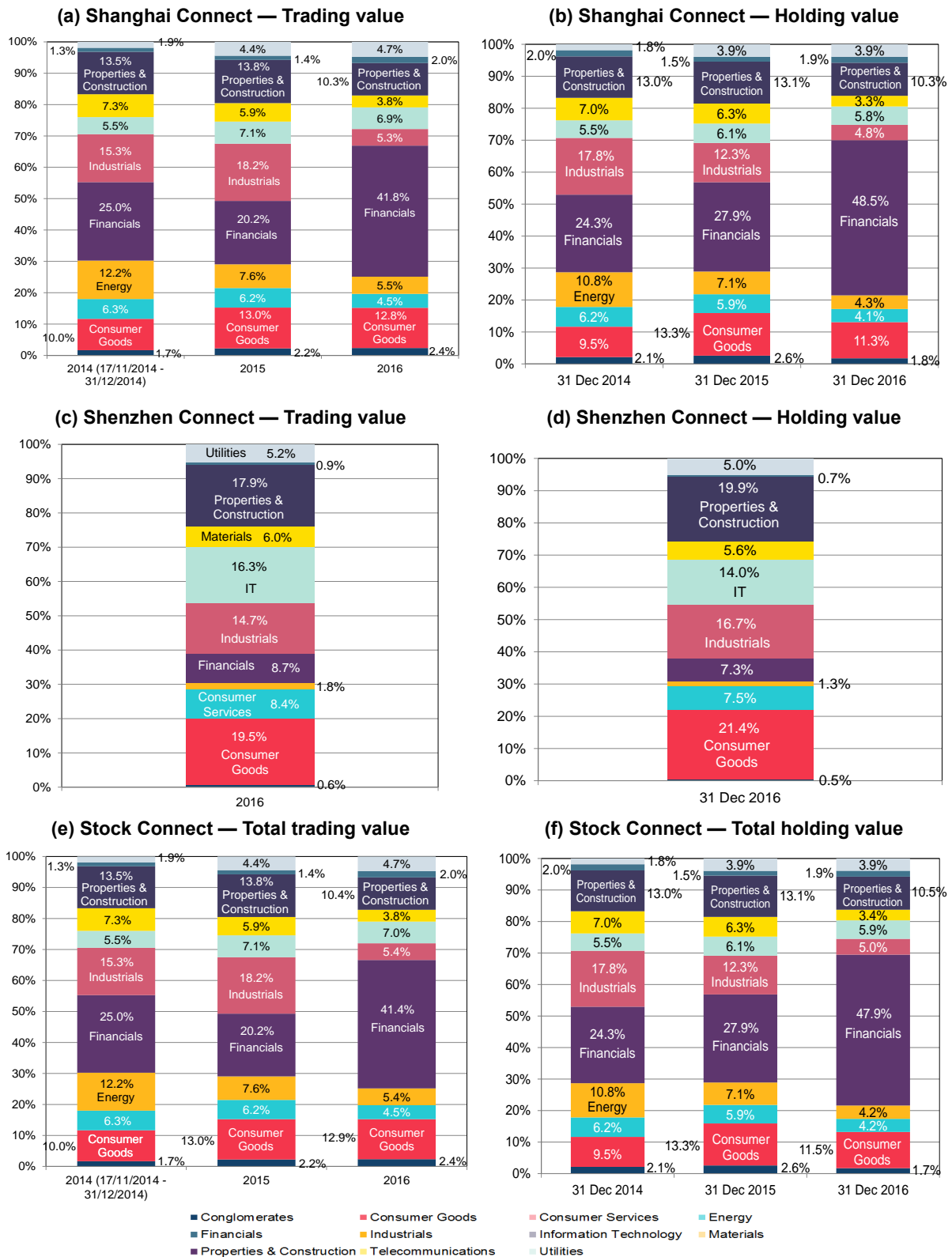
Source: HKEX for trading value; Webb-site Who’s Who Database for holding values. Stock classification according to Hang Seng Indexes Co Ltd.



In terms of industry sector, there had been increasing investor interest in Financial stocks, which had the largest share in trading and holding values in 2016. Other more popular sector stocks were Consumer Goods, and Properties and Construction. However, Southbound trading and holding under Shenzhen Connect were not concentrated on Financial stocks but distributed across Consumer Goods, Properties and Construction, IT and Industrials sectors. (See Figure 12.)

However, the dominance of Financial stocks in Southbound investment was mainly in respect of HSLI stocks. For Southbound investment in the mid-cap HSMI stocks, Mainland investor trading and holding were very much diversified across different industrial sectors. In 2016 up to August, Southbound trading and period-end holding had considerable share in Consumer Goods stocks (~25-27%, and close to 30% when including Consumer Services stocks) and Properties and Construction Stocks (~16-18%) among HSMI constituents. Financial stocks ranked third in Southbound trading and holding of HSMI constituents, in contrast to their dominance in that of HSLI constituents. Similar different distributions by industry sector in trading and holding values for HSLI and HSMI stocks were observed under Shenzhen Connect. As for among HSLI stocks under Shenzhen Connect, IT stocks apparently attracted considerably high percentage share in trading and holding values. (See Figures 13 to 15.)

**Figure 12. Stock Connect — Distribution of Southbound trading value and investor holding value by industry sector (Nov 2014 – Dec 2016)**



Note: Shenzhen Connect data starts from the launch date of Shenzhen Connect (5 Dec 2016). Percentages may not add up to 100% due to rounding.

Source: HKEX for trading value; Webb-site Who’s Who Database for holding values. Stock classification according to Hang Seng Indexes Co Ltd.

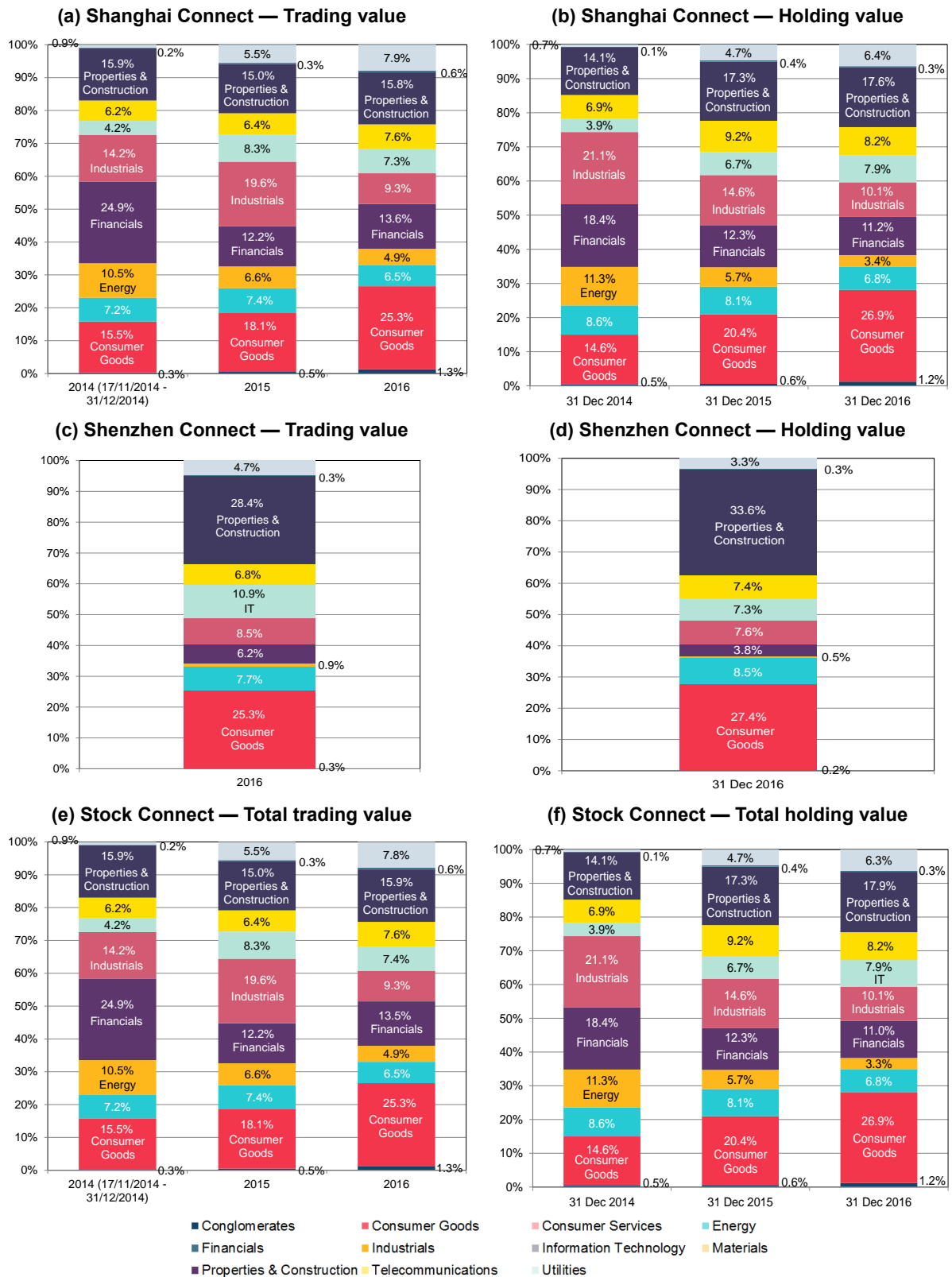
**Figure 13. Stock Connect — Distribution of Southbound trading value and investor holding value by industry sector for HSLI constituents (Nov 2014 – Dec 2016)**



Note: Shenzhen Connect data starts from the launch date of Shenzhen Connect (5 Dec 2016). The stock types in calculating holding value are the period-end status, which may have changed during the period. Percentages may not add up to 100% due to rounding.

Source: HKEX for trading value; Webb-site Who’s Who Database for holding values. Stock classification according to Hang Seng Indexes Co Ltd.

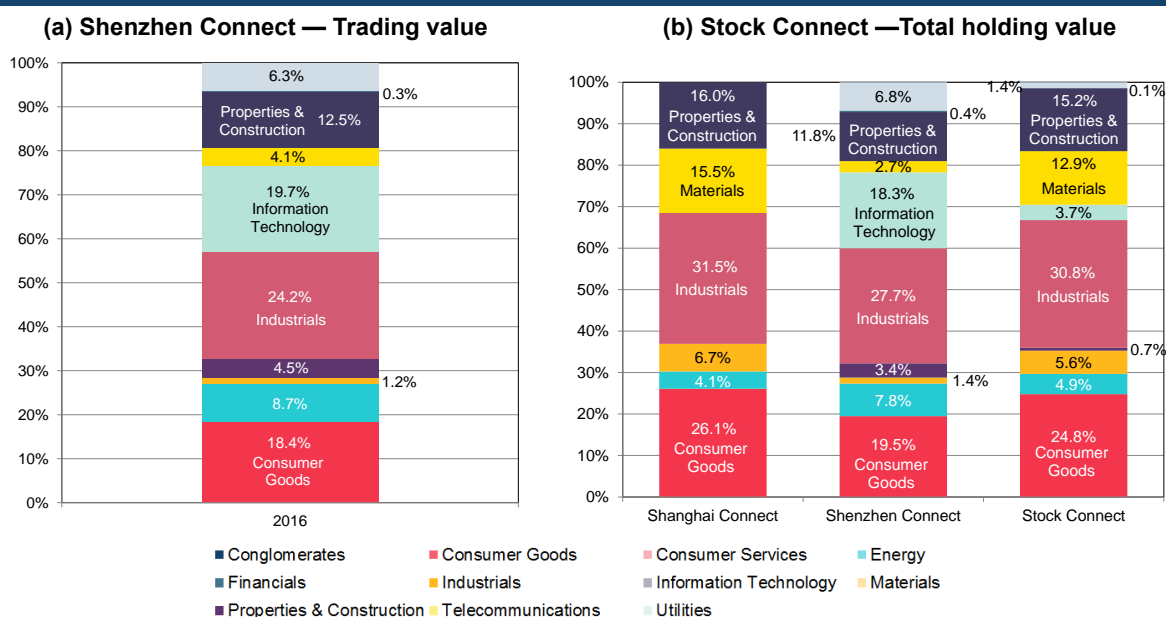
**Figure 14. Stock Connect — Distribution of Southbound trading value and investor holding value by industry sector for HSMI constituents (Nov 2014 – Dec 2016)**



Note: Shenzhen Connect data starts from the launch date of Shenzhen Connect (5 Dec 2016). The stock types in calculating holding value are the period-end status, which may have changed during the period. Percentages may not add up to 100% due to rounding.

Source: HKEX for trading value; Webb-site Who’s Who Database for holding values. Stock classification according to Hang Seng Indexes Co Ltd.

**Figure 15. Stock Connect — Distribution of Southbound trading value and investor holding value by industry sector for HSSI constituents (Dec 2016)**



Note: Shenzhen Connect data starts from the launch date of Shenzhen Connect (5 Dec 2016). The stock types in calculating holding value are the period-end status, which may have changed during the period. Percentages may not add up to 100% due to rounding.

Source: HKEX for trading value; Webb-site Who's Who Database for holding values. Stock classification according to Hang Seng Indexes Co Ltd.

In other words, as far as Shanghai Connect offers, Mainland investors have considerable investment interest in Southbound trading of mid-cap stocks of a variety of industry sectors. While large-cap stocks would have high concentration in Financial stocks, **smaller-sized stocks in fact could offer a diversified scope of stocks by industry sector of interest to the Mainland investors.**

### 3. THE “MUTUAL MARKET” MODEL — OPPORTUNITIES TO MAINLAND AND GLOBAL INVESTORS

After the launch of Shenzhen Connect, the basic model of “**Mutual Market**” across Shanghai, Shenzhen and Hong Kong will be established, albeit within the limited scope of eligible securities. As the mutual stock market access scheme is scalable, this potentially opens up a Mainland-Hong Kong mutual stock market of a combined equity market value of US\$10,514 billion (as of end-2016) and an average daily equity turnover of about US\$84.3 billion (2016), ranking 2<sup>nd</sup> by market value (following New York Stock Exchange) and 2<sup>nd</sup> by equity market turnover among world exchanges<sup>10</sup>. Moreover, the “Mutual Market” model may go beyond equities in multiple dimensions. As mentioned in the joint announcement of the CSRC and SFC on 16 August 2016 regarding the in-principle approval for the establishment of Shenzhen Connect, the two authorities have reached a consensus **to include exchange-traded funds (ETFs) as eligible securities** under the scheme. A launch date will be announced in due course after Shenzhen Connect has been in operation for a period of time and upon the satisfaction of relevant conditions. In addition, the CSRC and the SFC will jointly study and introduce other financial products to facilitate and meet the need of Mainland and global investors to manage price risks in each other's stock markets.

<sup>10</sup> World Federation of Exchanges (WFE) statistics, from WFE website (20 January 2017 for market value data and 1 March 2017 for trading value data). Average daily turnover was calculated from the combined shares turnover value for 2016 up to August from WFE statistics using the total number of trading days (244 days) for the Mainland market. Ranking was based on 2016 up to December combined trading value.

Under the “Mutual Market” model, overseas products of various kinds could be offered to the Mainland investors and vice versa for offering different Mainland products to global investors. Southbound trading opens up **a regularised channel for Mainland investors, both individuals and institutions, to invest in overseas assets**. The channel is a closed system with prudential monitoring of the usage of the daily quota, and yet with considerable flexibility in the absence of an aggregate quota. Without the limitation of an aggregate quota, investors may allocate their portfolio investment in cross-border assets more freely than before. This offers **global asset allocation opportunities to Mainland investors**. Since the system is closed in the sense that the RMB (after converted into HKD) used to purchase overseas assets under the model will be reverted back to Mainland China (after being converted back to RMB) upon the sale of the overseas assets, there is essentially no capital outflow problem in the long run. **The model effectively extends the universe of investable assets for Mainland investors**. Under such an environment, the connectivity channel compensates the relative shortage of investable assets in the Mainland, allowing Mainland investment monies to **possibly obtain better potential returns** from investing in overseas than in the domestic market. Acknowledging the advantage of this, the China Insurance Regulatory Commission (CIRC) issued a policy document<sup>11</sup> in early September 2016 to allow insurance funds to participate in Southbound trading under the Shanghai Connect. Eligible Mainland investors for Southbound trading under Shenzhen Connect are the same as Shanghai Connect. The expanded investment scope in the Mutual Market with Shenzhen Connect in place would offer more diversified investment choices to the Mainland investors in Southbound trading.

In addition, Southbound trading is effectively investment in a foreign currency, i.e. HKD which is pegged to the US dollar, for Mainland investors. At the time of expected depreciation of the RMB, Southbound investment could offer **alternative investment options from a currency value perspective**.

As the eligible instruments under the “Mutual Market” model are expandable, it is believed that the Mutual Market will offer **an increasingly diversified scope of investment tools to Mainland investors**, albeit in the short term the available instruments may only be cash market securities including equities and possibly ETFs. After the launch of Shenzhen Connect, Southbound eligible securities will include the HSSI constituents with a market capitalisation of HK\$5 billion or above, in addition to HSLI and HSMI constituents. All H shares with A shares listed in the Mainland market will be included, not just those with SSE-listed A shares. HSLI and HSMI already cover up to 95% of the total market capitalisation of the Hang Seng Composite Index (HSCI), which in turn covers the top 95% of the total market capitalisation of the Hong Kong market<sup>12</sup>. As a result, some further 100 stocks will be added to the eligible list. More importantly, the expanded scope will include stocks in a large variety of industries, including new economy sectors of information technology and consumer goods and services.

Moreover, **the trading experience offered by an international stock market** like Hong Kong where the dominant participants are international professional institutional investors will be of value to Mainland domestic investors, especially the retail investors. Professional investment strategies in a mature market are usually based on stock fundamentals, and economic and industrial factors. These would help balancing the short-term speculative trading behavior of certain Mainland investors. **Southbound trading experience is therefore expected to help nurture the maturity of the Mainland investor base**.

Apart from secondary market trading, **connectivity in the primary market**, i.e. the initial public offering (IPO) market, can be offered under the model subject to regulatory approval,

<sup>11</sup> “關於保險資金參與滬港通試點的監管口徑”，9 September 2016.

<sup>12</sup> The Hong Kong market universe of the HSCI refers to all stocks and real estate investment trusts (“REITs”) that have their primary listings on the SEHK, excluding securities that are secondary listings, foreign companies, preference shares, debt securities, mutual funds and other derivatives. (Source: Hang Seng Indexes Co Ltd website)





allowing investors on either market to subscribe for IPOs in the other market. Products to be covered in the future (subject to regulatory approval) may also extend to **bonds, commodities and risk management tools including equity derivatives, RMB interest rate and currency derivatives**. In fact, in view of the successful implementation of the Stock Connect scheme, a more imminent issue is to meet the needs of investors for hedging their cross-border stock portfolios. In the Mainland, investors are allowed to trade Hong Kong stocks but there are no **Hong Kong index/stock futures and options for hedging**. Similarly in Hong Kong, there is also the lack of **A-share hedging tools like A-share index futures and options**. Related derivatives on either market may be included in the Mutual Market model in the future.

The “Mutual Market” model in fact is a symbolic breakthrough in Mainland China’s capital account opening process. In the long run, a highly diversified suite of investment and risk management tools could be offered under the “Mutual Market” model before the potential full opening of the Mainland capital market. Mainland investors could thereby benefit from enhanced asset allocation and investment portfolio management, and global investors could benefit from an open channel to more Mainland investment opportunities with related risk management tools available.

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