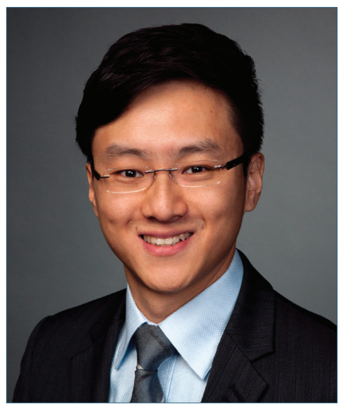
Asia ETF Forum 2018

Hong Kong ETFs spotlighted amid growing A-share interest

Hong Kong's exchange-traded fund market takes centre stage in international investors' foray into Chinese markets, experts say. By Hong Kong Exchanges and Clearing (HKEX)

As China prepares to overtake the US as the world's largest economy before 2030, its A-share market is becoming too large to ignore. According to the Institute of International Finance – a global association of financial industry members – inflows into China equities registered US$5.8 billion in August – 82% of all emerging market equity inflows during the month.

MSCI's inclusion of A-shares in its emerging-market index last year has renewed attention as it signals 'foreign investors' increasing confidence over A-share market liquidity," says Jackie Choy, Morningstar's director of exchange-traded fund (ETF) research for Asia.



Jackie Choy, Morningstar

Chris Pigott, Brown Brothers Harriman

Just across the border

Hong Kong is often the first place institutional investors look when attempting to gain exposure to the Chinese market. The city's common-law regime, free-market principles and a globally connected marketplace make its A-share ETFs attractive to global funds. But there are other factors to consider for international investors.

With a deep pool of offshore renminbi (CNH), Hong Kong has a competitive advantage when it comes to developing into an A-share transaction hub, as Choy explains: "The renminbi is not yet fully convertible. When overseas investors want to trade A-shares, they need CNH. Hong Kong is where the liquidity is."

To China with ETFs

Collective investment schemes such as ETFs are the preferred way for institutional investors to gain access to China due to their low transaction costs and diversification benefits. A recent survey by the Asia ETF Forum found that 67%[1] of institutional investors were investing in China through pooled products, compared with 41% via direct channels such as Stock Connect, or qualified foreign institutional investor (QFII) and renminbi QFII schemes.

In August 2018, the average daily turnover of Hong Kong's A-share ETFs was around HK$1.3 billion – eqivalent to about US$162.4 million – 40.6% of the territory's average daily exchange-traded product turnover.

The expanding variety of offerings is fuelling interest in Hong Kong's ETF market. "The majority of products listed in Hong Kong focus on broad-based, market cap-weighted Greater China equity," says Chris Pigott, head of Hong Kong ETF services at Brown Brothers Harriman, "but that's about to change – ETF issuers are bringing different types of products to the market."

This includes the world's first smart beta China equity ETFs that implement a multi-factor approach to screen China A-shares, as well as thematic A-share products covering different areas of the China market, such as MSCI China A Inclusion, 'new economy' stocks and digital disruption.

Solving a taxing problem

Tax advantages give Hong Kong ETFs an edge as an A-share trading tool for international investors. According to EY's 2018 ETF taxation report, Hong Kong-domiciled funds are more tax-efficient than US-regulated investment companies (RICs) for investors from Japan, Singapore, South Korea, Hong Kong, Thailand and Taiwan to invest in China.

The report further revealed that US RICs generally impose higher withholding tax rates on Hong Kong investors than funds domiciled in other major markets. That could be a driver of ETF utilisation locally, as Pigott remarks: "More and more investors have come to realise that the expense ratio shown in the ETF prospectus isn't the only consideration when evaluating cost. Increasingly, they're taking the total cost of ownership into consideration, including tax obligations and trading spreads."

Shifting regulatory attitude across the border also bodes well for A-share market development. "Chinese regulators are becoming more open towards market liberalisation, as evidenced by accelerated renminbi convertibility, the launch of Stock Connect, as well as other programmes such as QFII and RQFII," Choy concludes, "A-share internationalisation is progressing, without a doubt."

[1] *The survey was conducted by the Asia ETF Forum in Taipei, Hong Kong, Seoul, Bangkok and Singapore between April 17 and June 28, 2018. One hundred and eighty-five forum attendees responded to the question.*