BACK TO BUSINESS

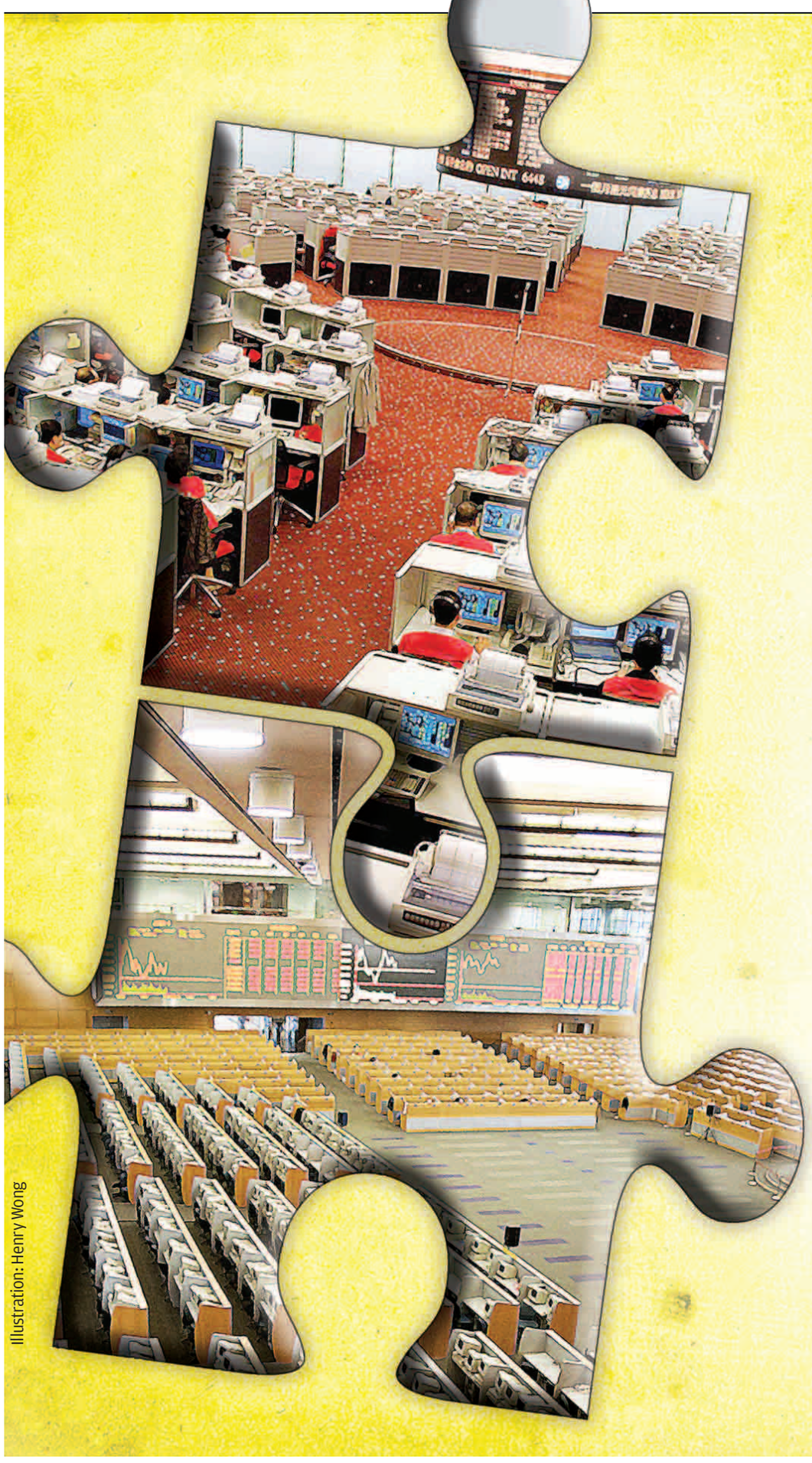

Illustration: Henry Wong

THE VIEW
RICHARD HARRIS

Two systems, one market

Hong Kong's exchange may have lost its independence on the world stage, but global investors could view it as a reliable, safe proxy for China stocks

Securities trading in Hong Kong was first recorded as long as 140 years ago, and the city's first formal stock exchange was established in 1891 – 123 years ago.

Yet many global investors regard the Hong Kong market as "emerging"; ridiculous, but to be a good investor you have to worry about other people's perspectives, rather than just your own.

Global investors have traditionally viewed the Hong Kong market as giving them deep, liquid Asian exposure but as having a volatile nature, driven by a retail investor culture.

Hong Kong has always been regarded as an independent market, like Singapore or Denmark, with its own economic, political and financial features.

Global investors initially bought Hong Kong for its domestic economy, first based on cheap manufacturing and then later dominated by trade with the mainland, banking and real estate. This was always considered to be a Hong Kong growth story rather than a China one.

In the past 15 years or so, the local indices have become increasingly dominated by listings of mainland enterprises, mainly state-owned.

The exchange's 123 years of experience provides these firms with a window to foreign investors and global standards of corporate governance, compliance and regulation. This is very attractive to global investors, for although the mainland market is essentially closed to foreigners, Hong Kong gives them exposure to the developing mainland economy.

Take away the listings of mainland firms, however, and the market is composed of a smattering of global conglomerates with a bias towards local property, some local counters and some big companies that can just as easily be bought on other stock markets.

In essence, Hong Kong has lost its independence as an investable market.

It seems that around the middle of 2011, and certainly by the end of 2012, the Hang Seng Index subtly delinked itself from broadly following global market influences to more closely shadow the Shanghai Composite Index.

It may be that one is leading the other, but the effect is the same – a mimicking of movements that indicates a strengthening correlation.

There is no better example of this linkage than the sharp rally on the mainland that began in the middle of last month when rumours of increased liquidity there caused the Shanghai index to leap about 8 per cent in a few days. The rally was echoed by the Hong Kong indices, regardless of other fundamentals.

Market consolidation is being spurred by policies such as the much-trumpeted Stock Connect plan that will allow direct dealing between the Hong Kong and Shanghai stock exchanges.

If, as scheduled, it is implemented in October, it will be the culmination of a proposal dating back seven or eight years.

The Hong Kong stock exchange has 140 years of history.

> **This process of assimilation with the mainland market will continue**

We must expect to be disappointed by the small size of the quotas, but nevertheless the "through train" will finally be pulling into the station, even if the carriages are few in number.

June's white paper in which Beijing reasserted its sovereignty over Hong Kong will inevitably mean closer ties.

Major mainland economic policy will flow through to the city faster than ever before, leaving it with domestic policy decision-making that is likely to have minimal impact on the local index.

Global investors are therefore likely to look at the Hong Kong and mainland stock markets as sub-markets of a bigger Chinese market, analogous to the huge and diverse US market.

The narrow Hang Seng Index could be compared to the Dow Jones Index; a narrow list of mainly large, "old industry" stocks.

The H-share index might be loosely compared to a focused index like the Nasdaq Composite, while the Shanghai Composite might be seen as a broad index – perhaps a combination of the S&P 500 and the Russell 2000 small-cap index.

Short of a game changer, such as the Hong Kong stock exchange establishing a cross-listing agreement with a global market to provide 24-hour trading of global titan stocks, this process of assimilation with the mainland market will continue.

Hong Kong may have lost its independence as a major global stock market with its increasing correlation to the mainland market, but the perspective of the global investor might have another twist in the tail.

If the markets are so correlated, perhaps it is worth investing only in the Hong Kong market, as a proxy for China? You get the exposure that you seek, as well as the security of knowing that you have 140 years of history and global standards behind it.

Richard Harris has been involved in the investment management industry in Asia for 35 years and is the chief executive of Port Shelter Investment Management in Hong Kong