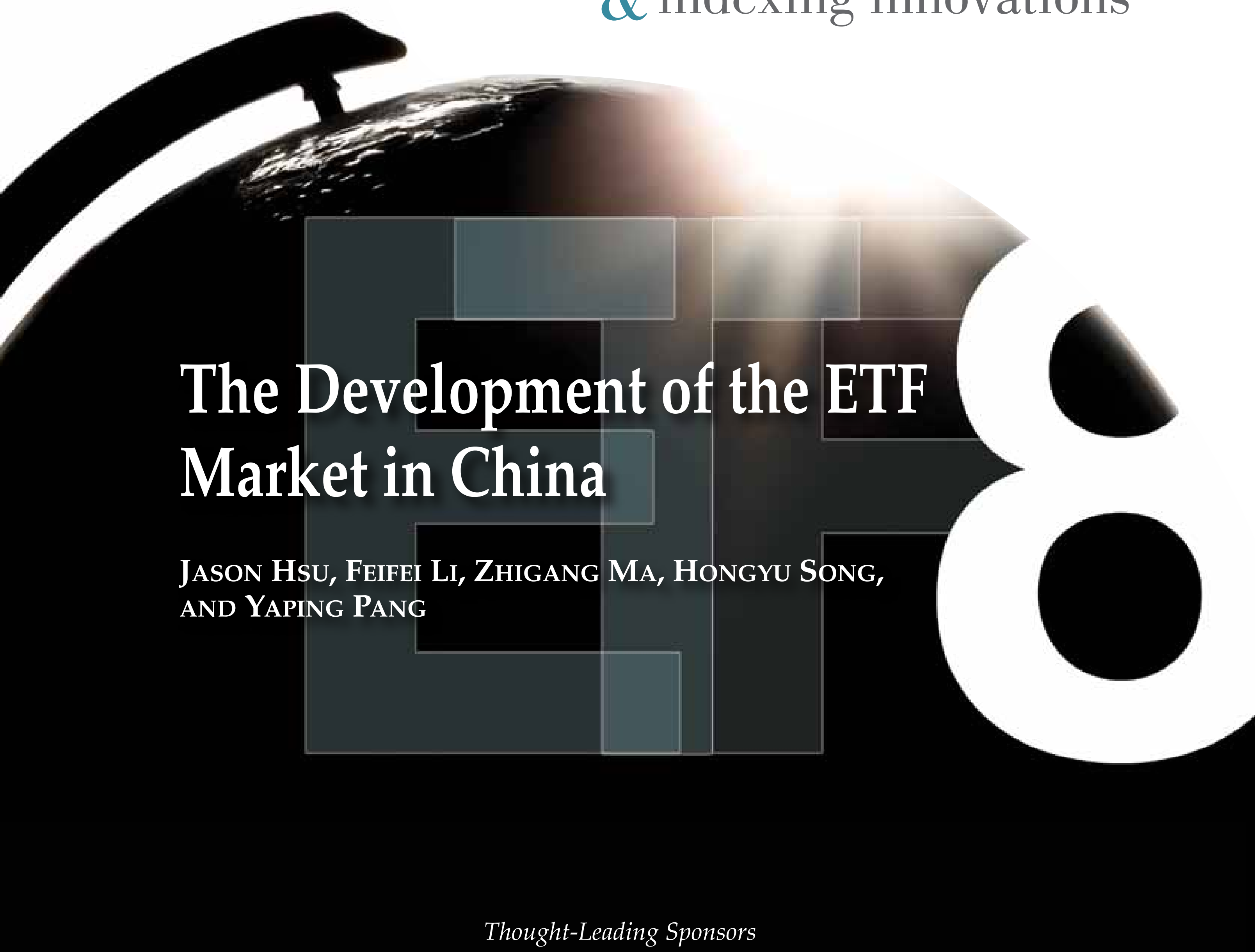
Institutional Investor Journals
The Voices *of* Influence | www.iijournals.com

eighth annual *guide* to
fall 09

EXCHANGE TRADED FUNDS & indexing innovations



The Development of the ETF Market in China

Jason Hsu, Feifei Li, Zhigang Ma, Hongyu Song, and Yaping Pang

The Development of the ETF Market in China

Jason Hsu, Feifei Li, Zhigang Ma, Hongyu Song, and Yaping Pang

Jason Hsu
is the chief investment officer at Research Affiliates, LLC in Newport Beach, CA.
hsu@rallc.com

Feifei Li
is a director of research at Research Affiliates, LLC in Newport Beach, CA.
li@rallc.com

Zhigang Ma
is the CEO at China Securities Index Co. in Shanghai, China.
zgma@sse.com.cn

Hongyu Song
is a manager of research and development department at China Securities Index Co. in Shanghai, China.
hysong@sse.com.cn

Yaping Pang
is an analyst of research and development department at China Securities Index Co. in Shanghai, China.
yapingpang@sse.com.cn

It has been nearly 20 years since the establishment of the Chinese stock market, which now lists some 1,700 companies with a combined market capitalization of 20 trillion RMB (roughly $3 trillion USD), making it increasingly influential in the global capital market. With the rapid growth in the trading volume and listings, other innovations have also made remarkable progress. In recent years, exchange-traded funds in particular have become one of the more important innovations in the Chinese exchange-based markets.

The initiative to develop ETF products was first proposed by the Shanghai Stock Exchange (SSE) in 2001. Tremendous effort, since then, has been spent on researching the market mechanisms and logistics necessary to support ETFs. The first China A-shares ETF product, the China SSE 50 ETF, was launched on Dec, 30, 2004 and was listed for trading on February 23, 2005. In 2006, four more ETF products were launched. As of the writing of this article, there are five ETF listings—E-Fund SE 100 ETF, China SME ETF, China 50 ETF, HuaAn 180 ETF, and AIG-Huatai Dividend ETF. In aggregate, assets under management for the five ETFs are 35 billion RMB (roughly 5.2 billion USD) as of June of 2009. This represents a growth of 61% per annum in ETF asset since the initial launch in 2005. Additionally, ICBC Credit Suisse will be launching its core enterprises 50 ETF in late July on the Shanghai Stock Exchange.

In addition to the ETFs, there are 22 equity index tracking mutual funds in China. The aggregate assets under management total 151 billion RMB (roughly 22 billion USD). This represents an annual asset growth of 74% since 2005 in index mutual funds. The combined public index fund assets stand at just over 27 billion USD, making China the second-largest index fund market in Asia, after Japan, and one of the largest index fund markets. However, relative to the size of the Chinese equity capital market, which stands at 3 trillion USD, index funds represents less than a 1% market share.

CHINA SECURITIES INDEX CO.

In examining the Chinese ETF market, we need to first examine the local market indexes and the local index providers. There are two primary local index providers in China. They are the China Securities Index Company (which took over the Shanghai Securities Information Company) and Shenzhen Securities Information Company, which is a subsidiary of the Shenzhen Stock Exchange. Other global index companies or joint venture index companies also compute China A-Shares indexes. These index companies include MSCI, Dow Jones, and FTSE/Xinhua. However, they represent a very small market share in the Chinese domestic market.

Based on total index offerings and index-linked assets under management (AUM), the China Securities Index Company (CSI) has a leadership position in the Chinese index market. It currently computes more than 50 indexes with more than 140 billion RMB (roughly 21 billion USD) in CSI index tracking funds and ETFs; additionally, a significant number of active funds are benchmarked to the CSI indexes. CSI is a joint venture between the Shanghai Stock Exchange and the Shenzhen Stock Exchange. CSI is a quasi-government (but for-profit) entity, which specializes in the creation and management of indexes and index-related services. The organization is mandated to serve the Chinese capital market and promote financial index innovation; it works closely with the two exchanges to facilitate index related businesses.

The Shenzhen Securities Information Company (SZSI) currently computes 9 core indexes as well as various style and industry indexes based on companies listed on the Shenzhen Stock Exchange. SZSI also specializes in computing small and midsize enterprise indexes, as more small and midcap companies are listed on the Shenzhen Stock Exchange. An estimated 12 billion RMB (1.7 billion USD) in mutual fund assets are invested in SZSI indexes.

The most successful Chinese index fund product has been the Harvest CSI 300, which is an open-end index mutual replicating the CSI 300 index. The CSI 300 is the broad market aggregate index which includes the 300 largest Chinese companies listed on the Shanghai and Shenzhen stock exchanges. CSI collaborated with Harvest Fund Management to launch the fund in 2005. Today, the fund has grown to 31 billion RMB (roughly $4.6 billion USD). The second-largest index fund is the E-Fund CSI/SE 50 mutual fund, which stands at 26 billion RMB, followed by the China CSI/SE 50 ETF, which stands at 21 billion RMB. There are now 27 index funds (mutual funds and ETFs) in China today with an aggregate AUM of more than 186 billion RMB.

The Chinese market is also warming up to index products outside of the traditional large-cap core areas. Both CSI and SZSI have been developing various style indexes as well as smid enterprise indexes. They have also recently added non-capitalization-weighted strategy indexes to their rosters. Value-oriented and dividend-based indexes have gained popularity with CSI and SZSI, providing these indexes both publicly as well as on custom bases. More recently, CSI has launched a series of Fundamental Indexes (CSI/RAFI indexes), headlined by the CSI/RAFI A50, in collaboration with the California-based asset manager Research Affiliates, LLC. The Research Affiliate Fundamental Index strategy was awarded "Most Innovative New Index" in 2005 by Index Universe and "Best Strategy Index" in 2009 by Global Pensions. Harvest Fund Management has again taken the lead and will launch the first RAFI-based index fund in China at year-end 2009.

CSI is also looking to expand its index licensing business more aggressively outside of its local market. A number of China A-Shares ETF and index fund products have recently been listed and cross-listed in Hong Kong, Taiwan, and Japan. Bank of China-Prudential Asset Management launched the WISE CSI 300 ETF in Hong Kong in July of 2007. The ETF now has 6.8 billion HKD in assets (roughly $900 million USD). The ETF has recently cross-listed in Taiwan; at the writing of this article, assets under management are 10 billion TWD (roughly $310 million USD).

The cross-listing activities, which have been only recently allowed and encouraged, are particularly relevant for global investors. Until recently, very few products offered pure access to the China A-shares market. Most China theme funds either invest in highly illiquid and restricted China B-share or in HK, Taiwan, and U.S.-listed companies that conduct significant business in China. In the first case, liquidity is extremely poor and transaction costs are very high; also, investors do not enjoy the same rights as the A-shares investors and often face additional investment restrictions. In the second case, the China-related stocks listed outside of China can often show higher correlation with the market they list in and lower correlation with the Chinese stock market.

CURRENT TREND IN THE CHINESE ETF MARKET

As of July, 8, 2009, there are five ETFs listed in China, with an aggregate AUM of 38 billion RMB (roughly $5.6 billion USD). The details are listed in Exhibit 1.

These ETFs have outperformed open-end active funds on average, similar to their U.S. and European counterparts. In Exhibit 2, we compare these 5 ETFs to the universe of 519 comparable open-end equity mutual funds using 2009 year-to-date performance. Among the 519 funds, E Fund SE 100 ETF, which tracks the CSI Shanghai 100 Index, ranks No.1 in YTD performance.

From Exhibit 3, we see that the Chinese ETF tracking error, daily turnover, and price-to-NAV discount

EXHIBIT 1

Current ETF Products Summary (July 8, 2009)

Identifier	Launch Date	Shares at Inception	Fund Shares Today	AUM (RMB)
China 50 ETF	2004-12-30	5,435,330,000	8,707,659,554	21,777,856,545
E Fund SE 100 ETF	2006-03-24	5,157,740,000	1,867,166,634	7,011,210,711
AIG-Huatai Dividend ETF	2006-11-17	2,222,990,000	1,639,426,941	4,178,899,273
HuaAn 180 ETF	2006-04-13	1,072,820,000	2,958,859,063	2,192,514,566
China SME ETF	2006-06-08	3,965,970,000	1,185,983,301	2,594,931,463

EXHIBIT 2

Current ETF Fund Performance Statistics (July 8, 2009)

Identifier	Accumulated return since inception	Accumulated return in 2009	2009 Ranking
E Fund SE 100 ETF	245.08%	89.74%	1
HuaAn 180 ETF	154.29%	80.86%	10
China 50 ETF	211.92%	79.92%	13
AIG-Huatai Dividend ETF	29.01%	75.40%	25
China SME ETF	120.12%	55.17%	134

Note: as of July 8, 2009, there were 519 open-end funds in local market.

EXHIBIT 3

Chinese ETF Basic Statistics (2009 July 08)

Identifier	Tracking Error (annualized)	Daily Average turnover	Daily Average Trading Value (in Trillion RMB)	Price-to-NAV discount
HuaAn 180 ETF	0.67%	2.60%	0.267	−0.06%
China 50 ETF	0.45%	4.46%	5.212	−0.12%
China SME ETF	0.60%	1.56%	0.505	−0.08%
E Fund SE 100 ETF	0.51%	3.84%	1.514	−0.28%
AIG-Huatai Dividend ETF	0.37%	4.67%	1.761	−0.26%

are in line with their global counterparts. From Exhibit 4, we find that the ETF assets represent a very small fraction of the total market capitalization of the indexes they replicate, relative to what is observed in the more-developed ETF markets. This suggests significant growth in ETF assets in the forthcoming years as the Chinese investment community converges to its U.S. and European counterparts in passive investing appetite. Exhibit 5 shows the annual index rebalancing turnover in absolute terms (RMB) and compares to the actual ETF rebalancing/trading turnover.

LOCAL ETFs AND INTERNATIONAL ETFs COMPARISON

Today China has the third-largest ETF market by assets among Asian markets, behind Japan and Hong Kong. Currently, the China CSI/SE 50 ETF, with assets under management of 22 billion RMB, is the largest ETF in China. Compared with other international ETF products, such as SSgA's Tracker Fund of Hong Kong (TraHK), Polaris's Taiwan 50 Tracker Fund, and SSgA's S&P 500 Spydr and PowerShares's Nasdaq QQQQ, the China CSI/SE 50 ETF has reached a level of maturity that is comparable to the largest ETF products, in terms of trading activity, premium/discount, and tracking error.

International fund rating agencies and research houses have also started to take notice of Chinese ETFs—specifically, the China CSI/SE 50 ETF. It won the Chinese Innovation Award in 2004, given by Asian Asset Management, and the Asian Pacific Innovation Award in 2006 and 2005, given by ExchangeTradedFunds.com.

CONSTRAINTS IN DEVELOPING LOCAL ETF MARKET

By comparison, the ETF offerings in China are still very narrowly focused on traditional large-cap equities. The lack of product diversification as well as ETF innovation remain a concern as investor needs and risk preferences are not adequately addressed by the current ETF offerings.

EXHIBIT 4

Current ETF and Benchmark Market Cap Comparison (July 8, 2009)

Identifier	Fund Market Cap (RMB)	Benchmark Market Cap (RMB)	Fund to Benchmark Ratio
China 50 ETF	21,777,856,545	2.58E+12	0.84%
E Fund SE 100 ETF	7,011,210,711	1.30E+12	0.54%
AIG-Huatai Dividend ETF	4,178,899,273	5.26E+11	0.79%
HuaAn 180 ETF	2,192,514,566	3.78E+12	0.06%
China SME ETF	2,594,931,463	3.14E+11	0.83%

EXHIBIT 5

Recent ETF and Benchmark Annual Trading Volume Comparison (July 8, 2009)

Identifier	ETF Trading Volume (RMB)	Benchmark Trading Volume (RMB)	Fund to Benchmark Ratio
China 50 ETF	3.02E+11	7.42E+12	4.06%
E Fund SE 100 ETF	6.81E+10	4.77E+12	1.43%
AIG-Huatai Dividend ETF	4.44E+10	2.37E+12	1.87%
HuaAn 180 ETF	1.03E+10	1.30E+13	0.08%
China SME ETF	1.06E+10	1.52E+12	0.69%

However, investor participation in new ETF products has also been lukewarm relative to traditional active mutual funds. This is in part driven by a limited knowledge regarding indexes and ETFs at the retail level. This lack of knowledge regarding product and passive investing undermines market participation, which hurts asset managers' willingness to bring new products to the market.

Technical challenges also hamper the ETF development in China. Limitations in existing settlement systems impede the development of ETFs, which invest in stocks listed on the Shanghai and Shenzhen Stock Exchanges. Right now, an ETF listed on the Shanghai Stock Exchange can only invest in stocks listed on the same exchange. This single market limitation exacerbates the undesirable segmentation of markets and stymies the growth of the ETF market and its innovation.

MARKET POTENTIAL

ETFs are efficient investment instruments that give trading flexibility to institutional and retail investors who desire low cost-passive investing. As the Chinese financial market liberalizes, we are starting to see progressive regulations that allow short-selling and the use of more complex financial derivatives and structures. We anticipate an explosive growth for Chinese ETFs with the advent of these new developments. On the horizon are bond ETFs, commodity ETFs, corporate governance ETFs, short ETFs, and leveraged ETFs.

The Chinese Securities Regulatory Commission (CERC) released the final draft of Index Tracker Fund Audit guidelines for ETFs on June 6, 2009. The latest guidelines continue the commission's efforts to develop the local ETF market, increase market demand, and improve liquidity. With more progressive guidelines, innovation in product offerings will increase.

The concept of passive investing has also gained more acceptances through education provided by the index calculators and index fund asset managers. The education work should continue to improve awareness and knowledge and thereby help increase the rate of investor participation in ETFs and index products.

Finally, with the recent success in the cross-listing of Chinese A-Shares ETFs, China investing has become more convenient for global institutional and retail investors. This will spur additional China ETF product offerings, which are designed specifically for non-Chinese investors and encourage greater innovation in the sourcing of restricted Chinese A-Shares through borrowed QFII quotas and OTC derivatives.

To order reprints of this article, please contact Dewey Palmieri at dpalmieri@iijournals.com or 212-224-3675.