June 2024

VF EMERGING ASIA

INVESTING IN CHINA

Your Introduction to the Chinese Stock Market

In This eBook:

INTRODUCTION

Purpose of the Starter-Kit

Despite the size of the Chinese economy and the media attention it has garnered in recent years, the Chinese capital market remains extremely complex and opaque—even for seasoned experts. That's why it's high time for a concise reference guide that summarizes and explains the key characteristics of the Chinese stock market. This is exactly the aim of this Starter Kit. At the same time, it is intended to serve as a complement and orientation aid to the ''VF Emerging Asia" and also includes, for example, strategic considerations for building portfolios.

The topics have been selected based on their relevance, which has become increasingly clear over the past years — particularly through subscriber feedback. The guide starts by outlining the most sensible ways private investors can gain exposure to Chinese stocks and highlights key aspects to consider when it comes to stock listings.

The following two chapters build on this foundation and explain the differences between the various types of Chinese shares, as well as the much-discussed but rarely understood offshore structure (VIE) that is tied to many Chinese stocks.

Next, the investment risks associated with Chinese equities are examined in more detail—a topic that has gained even more importance in the past three years due to geopolitical developments.

The final section focuses on how attractive returns can be achieved with Chinese stocks—exploring sectors, risk categories, and emerging trends.

BASICS

How and Where Can I Trade Chinese Stocks?

In principle, investing in Chinese stocks is not fundamentally different from investing in other markets, as it also requires a securities account with a broker (an intermediary), where the shares are held after purchase. However, the choice of exchange and broker is more significant than, for example, when trading European stocks.

Buying on International Exchanges

Most Chinese companies have their primary listings on the New York Stock Exchange (NYSE) or NASDAQ, the Hong Kong Stock Exchange (HKEX), or the two mainland Chinese exchanges in Shenzhen (SZSE) and Shanghai (SSE). For completeness, it's worth mentioning that a third mainland exchange now exists in Beijing (BSE).

To trade on these exchanges, investors need a brokerage account that provides access to international markets. Trading with such international brokers is generally cheaper—both in terms of fees and tighter spreads due to higher liquidity. However, they can be more complex to use, particularly in terms of user interface, currency conversion, and tax implications. Especially for our more Speculative China Portfolio, it's essential to buy certain stocks directly on the NYSE or HKEX via international brokers.

Special Considerations for Overseas Trading

Many Chinese stocks are listed exclusively on the mainland exchanges in Shanghai and Shenzhen. While access for international investors has been eased through programs like Stock Connect, direct trading on these markets remains complicated and requires special authorizations and account setups.

Due to these challenges, these stocks are not currently included in our portfolios. Occasional individual analyses may still be published, but they will not form part of the model portfolios. The goal is to ensure that all portfolio components are realistically accessible to western investors.

Choosing the Exchange: USA or Hong Kong?

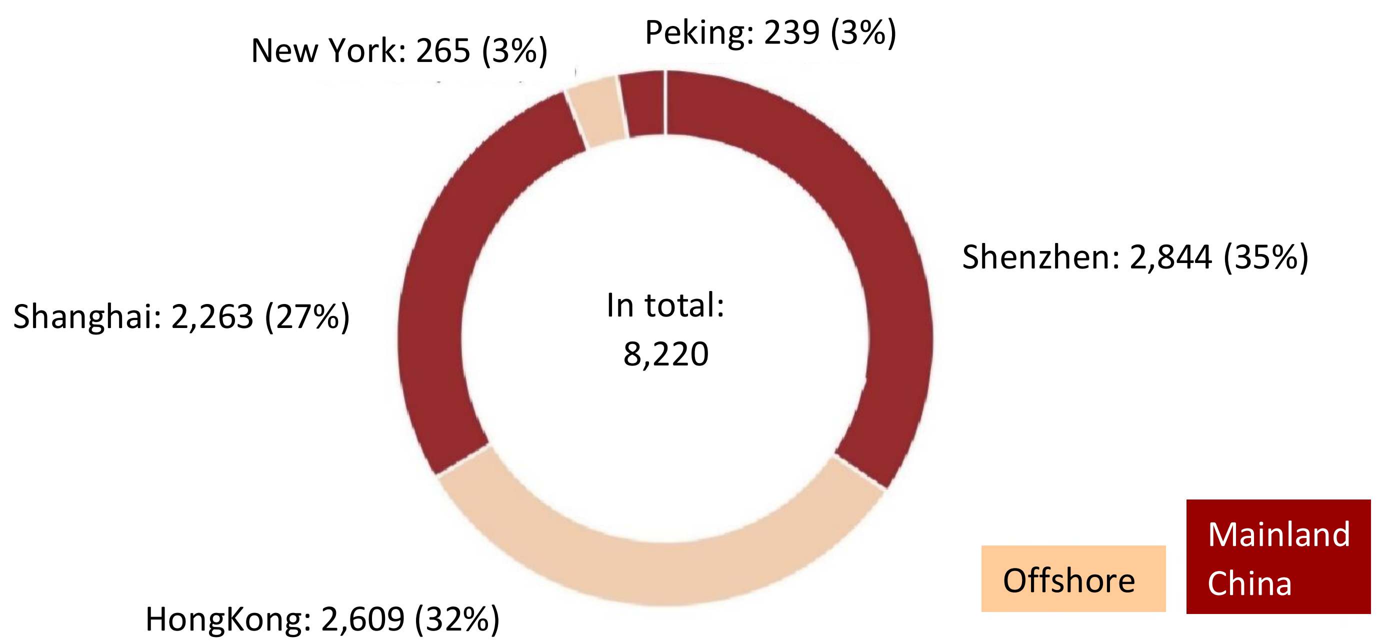
Many Chinese companies now have dual listings. In such cases, a company's shares are listed on at least two stock exchanges—most commonly, a primary listing in New York that is later supplemented by a secondary listing in Hong Kong. The typical reasons for this step include better access to capital and increased liquidity. In the case of Chinese stocks, political motivations often play a significant role as well. Hong Kong's stronger connection to mainland Chinese investors is also an important factor.

Should I Trade in the U.S. or in Hong Kong?

This is a frequently asked question when a Chinese stock is listed on both exchanges. As a general rule, it's advisable to trade on the exchange with higher liquidity. It's also important to consider whether the exchange is open at the time of trading. In the long run, the stock's price performance should be the same on both exchanges.

Currently, there is no immediate risk of delisting for Chinese stocks listed in the U.S. If, however, trading were to be prohibited in the future, switching to Hong Kong would offer only limited consolation: not only would the stock's performance likely be significantly impacted, but in an extreme scenario, trading could even be restricted directly by the broker (who typically is not based in China). More on this in the "Risks" chapter.

Chinese Stock Listings Worldwide



Data as of June 2024
Source: USCC, GovCN

TYPES OF SHARES

The World of Chinese Share Classes

When investing in Chinese stocks, there are several classes of shares that differ in terms of their listing, accessibility, and regulatory framework. The following section provides a detailed explanation of each.

A-Shares are shares of companies listed on the Shanghai and Shenzhen stock exchanges. They are traded in China's official currency, the Renminbi (RMB), and are primarily accessible to Chinese citizens. Foreign investors can gain access to A-shares through the Qualified Foreign Institutional Investor (QFI) program or via the Stock Connect programs.

B-Shares are also listed on the Shanghai and Shenzhen exchanges but are traded in foreign currencies (USD in Shanghai, HKD in Shenzhen). Originally, they were considered more accessible for foreign investors due to this feature. However, B-shares are now less popular and have lower liquidity compared to A-shares.

H-Shares are shares of companies based in China but listed on the Hong Kong Stock Exchange (HKEX), traded in Hong Kong dollars (HKD). They are easily accessible to international investors. A well-known example of an H-share is Tencent, which is also listed as an ADR on the Nasdaq.

N-Chips refer to Chinese companies primarily based in China but listed on U.S. stock exchanges. These companies typically use American Depositary Receipts (ADRs) to facilitate their listings.

ADRs (American Depositary Receipts) are certificates, not a distinct class of shares nor exclusive to Chinese stocks. ADRs represent ownership in the shares of a foreign company and enable trading on U.S. exchanges.

Red Chips are companies headquartered in Hong Kong but controlled by the Chinese government. They are generally considered to be fairly liquid and relatively safe investments. The name “Red Chip” was coined as a play on “Blue Chip,” highlighting the state influence under a socialist economic philosophy.

P-Chips are private Chinese companies listed in Hong Kong. Unlike Red Chips, they are not state-controlled and are traded in HKD.

S-Chips are Chinese companies listed on the Singapore Exchange (SGX). These firms usually have their operational base in China, but their shares are traded in Singapore.

Share Type	Listing Location	Trading Currency	Example Stock	Internationally Investable?
A-Share	Mainland China	RMB	Kweichow Moutai	Via QFII or Stock Connect
B-Share	Mainland China	USD / HKD	Shanghai Electric	With additional regulations
H-Share	Hong Kong	HKD	Tencent	Yes
N-Chip	USA	USD	Baidu	Yes
Red Chip	Hong Kong	HKD	China Mobile	Yes
P Chip	Hong Kong	HKD	Meituan	Yes
S Chip	Singapore	SGD	Yanlord Land	Yes

OFFSHORE STRUCTURES

Demystifying the VIE Structure

The almost mythical VIE structure is a frequent subject of debate and criticism when it comes to Chinese stocks. It is especially popular among media and analysts whenever regulatory or political tensions arise. For this reason, many investors seek clarity—which is provided below.

It should be noted that the VIE model is indeed complex and multilayered. The following explanation is therefore a generalization and simplification. In practice, there are many special cases and additional entities involved, often for tax reasons or to provide founders with greater flexibility and control.

How the Model Works

A VIE (Variable Interest Entity) is a legal business structure in which investors have a controlling contractual claim to a company without owning a majority of the voting rights. Specific agreements ultimately govern profit entitlements and distributions. Technically, in the context of Chinese stocks, the VIE refers to a company operating in China that is wholly owned by Chinese nationals with no foreign shareholders.

The VIE is managed (but not owned) by a multinational corporate structure—known as the holding company—which may include both Chinese and foreign shareholders. For this purpose, a special-purpose vehicle (SPV) is established, typically registered in the Cayman Islands, although other offshore jurisdictions like the British Virgin Islands are also possible. This offshore entity is the listed company that later appears on a foreign stock exchange (e.g., as an ADR on the Nasdaq).

One of its main roles is to isolate the actual assets of the VIE (in China) from the balance sheet of the listed entity (e.g., in the Cayman Islands). The Chinese founders and shareholders typically hold common shares of the Cayman entity, while foreign investors hold preferred shares and thus have no voting rights.

The Role of the Offshore Entity and WFOE

The offshore entity (usually based in the Cayman Islands) establishes a Wholly Foreign-Owned Enterprise (WFOE) in China. This allows it to legally invest capital into the Chinese mainland. The WFOE then enters into contractual agreements with the operational company (the VIE) to gain control and transfer profits from operations. These profits can then be funneled back through the WFOE to the offshore holding company—ultimately reaching the shareholders of the listed entity.

History and Reasons for Use

In China, the VIE structure is commonly used to enable foreign investors to participate in industries where direct foreign ownership is restricted—such as education, internet, and media. This explains why even some companies listed in Hong Kong use the VIE structure.

Furthermore, for many Chinese companies, this model provided a relatively simple and flexible path to raise capital abroad, which they rely on for business growth. U.S. stock exchanges, for instance, have historically had less stringent listing requirements compared to those in mainland China or Hong Kong. As a result, many Chinese companies chose to go public in the U.S., especially in their early stages.

The Sina Corporation is considered a pioneer in using the VIE model. In the early 2000s, Sina was one of China's largest internet firms. At that time, China's financial market was not sufficiently developed or regulated to handle the requirements of modern IPOs. Moreover, China lacked the necessary capital market scale, expertise, and equity culture to support its rapidly growing internet giants. Consequently, foreign listings through the VIE structure—especially in the tech sector—proved to be significantly more lucrative.

Model Issues and Criticism

One of the main criticisms of the VIE system is that foreign investors purchasing shares of a company using a VIE structure are technically buying shares of an offshore shell company, not of the actual operating business in China.

The operating entity remains formally under Chinese ownership, often still controlled by its founders. Despite this control risk, it's important to note that there are clear rules for profit distribution (dividends). As long as these are followed, the arrangement is economically legitimate. The market performance of the listed offshore company reflects the value of the business, allowing foreign investors to participate directly in market value developments.

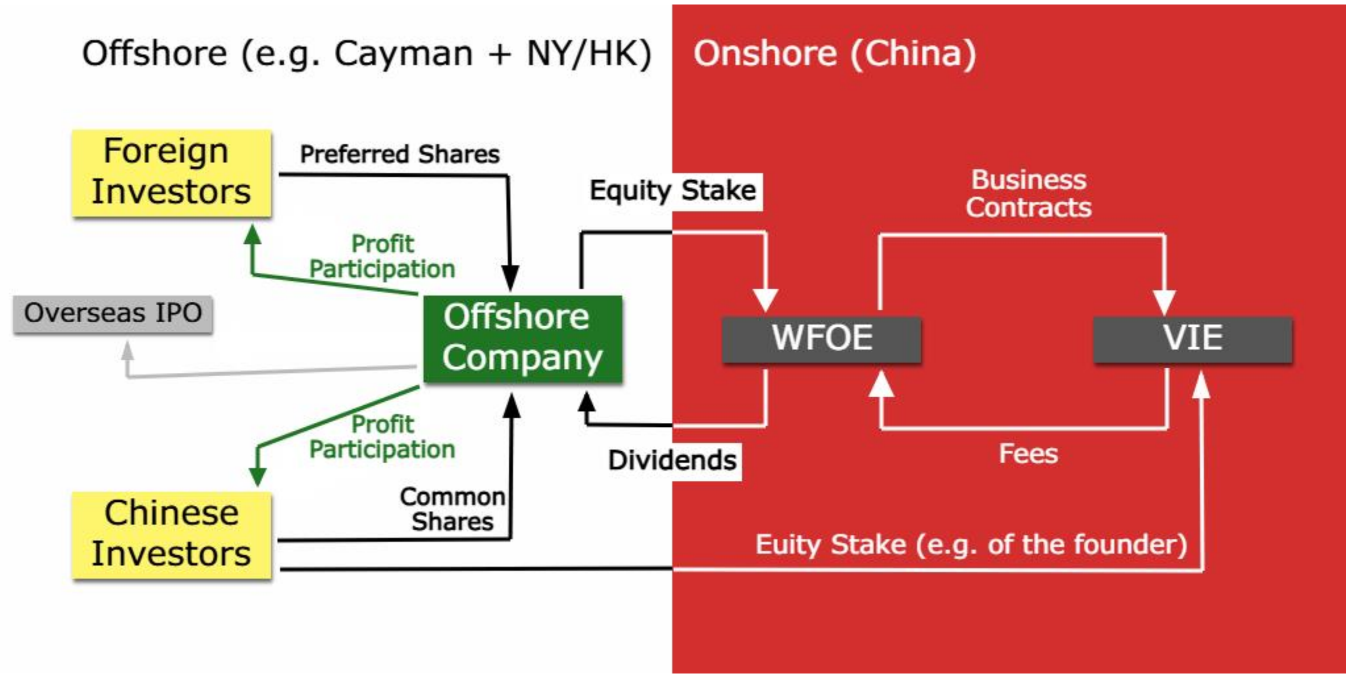
Another recurring concern is the alleged illegality of the VIE model. Technically, the legal status is unclear, placing it in a regulatory gray area—a common phenomenon in China.

The Chinese government has tolerated the structure due to the economic benefits it brings to domestic companies, many of which would likely not have grown so successfully without it. However, it's true that Beijing has never officially endorsed or recommended the use of VIEs.

Critics also argue that the Chinese government could intervene at any time, potentially forcing delistings or privatizations. While this legal risk cannot be completely ruled out, the economic damage such a move would cause makes it highly unlikely. Even in such an extreme case, shareholders—many of whom are Chinese—would likely receive compensation, so a total loss is improbable.

Another legitimate criticism is that the VIE model is highly complex and opaque. Very few retail investors fully understand it, which contradicts the basic principle of market transparency. While this rarely results in material harm to individual investors, it does lead to uncertainty and hesitation, especially among private investors.

THE VIE MODEL



VIE = Variable Interest Entity
WFOE = Wholly Foreign Owned Enterprise

Source: Hong Kong Lawyer

RISKS

Risks of Investing in China

There are three generic risks associated with Chinese equities: company risk, market risk, and currency risk. In addition, there are three more specific risk factors that many Western market observers view as particularly critical: delistings, overregulation, and manipulation. We will examine all six of these risk aspects in more detail below, and show how they can either be mitigated or at least put into perspective.

Company Risk

In general, stocks offer a level of capital security, since capital remains intact unless the company invested in goes bankrupt. The market value (stock price) of a company develops according to its perceived value, which is primarily based on future profit expectations. In this respect, China is no different from other markets.

This means the operational risk is not inherently higher simply because a company is Chinese. As with any investment, individual company risk exists and must be assessed through due diligence beforehand. Based on this risk profile, investors can then make an informed purchase decision.

Market Risk

China's economy is heavily reliant on specific sectors. Exports and the domestic real estate market, for example, account for approximately 20% and 25% of GDP, respectively. Should these sectors experience significant weakness—especially simultaneously, as seen in 2023—it would almost inevitably impact the entire stock market, even if certain individual stocks are only partially affected.

Market risk also includes dependency on macroeconomic factors such as commodities and currencies. Particularly noteworthy is the US dollar, which shows a clearly measurable negative correlation with the Chinese stock market. During phases when the USD demonstrates relative strength, Chinese equities are noticeably more vulnerable to price declines due to the increased attractiveness of the US market.

Currency Risk

Investing in Chinese equities involves currency exposure, as shares are typically traded in RMB, HKD, or USD on their home exchanges, depending on the listing. For U.S. investors, this risk is limited, since many Chinese stocks trade directly in USD (as ADRs) or HKD, which is closely pegged to the USD, offering relative stability.

However, for investors using other base currencies — like the euro — there's an additional FX layer. Even if the stock is bought in USD or HKD, any gains or losses must still be converted into their home currency, potentially impacting returns. While hedging is possible, it's generally not necessary for well-diversified portfolios and may add complexity and cost.

Overregulation (Government Intervention)

China's capital markets do not offer the same level of transparency and economic autonomy that many investors are used to from Western financial centers. Political intervention is also more pronounced, especially during phases of restructuring or strategic realignment.

In such times, the government may introduce measures that create considerable uncertainty among investors—particularly because, without proper context and understanding of China, the implications of these actions are difficult to interpret.

However, one thing is clear: despite sometimes unconventional actions, China's current leadership is not fundamentally anti-business. The state continues to pursue social stability, with the economy—including the capital markets—playing a key supporting role.

Delisting (Expropriation)

Another major risk lies in forced delistings or trading bans on Chinese stocks. Delistings could occur even due to seemingly minor issues, such as failure to meet audit requirements. However, the consequences would be far more severe in the event of a major economic or military conflict between China and the West—such as one triggered by an escalation over Taiwan.

If such a scenario were to unfold, it would be extremely difficult to predict how events would progress. Nevertheless, one must assume that Western investors would likely face substantial losses in Chinese equities. These losses would not be limited to declines in market value. Even more damaging would be a complete exclusion of Chinese stocks from Western investment markets.

Similar to what happened with Russian stocks (ADRs and GDRs) a few years ago, investors might, in the worst case, be left holding worthless remnants that cannot be traded or redeemed.

The only effective preventive measure would be to hold such assets in a Hong Kong-based account—or better yet, directly in China, which for most retail investors is not feasible due to the complexity and costs involved.

Author's Personal Comment

I personally do not hold a securities account in China (I only use international brokers for access to Hong Kong and New York) and currently consider the risk of such an escalation to be low. Anyone who feels too anxious or worried about this should fundamentally rethink their financial exposure to Asia and also be aware that, in an extreme scenario, a global stock market crash would be virtually unavoidable.

Manipulation

The idea that China manipulates or embellishes economic data mainly originates from past decades. Today, Chinese listed companies trade on transparent exchanges that are subject to strict regulatory oversight—including regular financial reporting and audits. Furthermore, the Chinese judiciary has no interest in tolerating fraud or market manipulation, as Chinese investors themselves would be affected. In recent years, authorities have cracked down very harshly on violations.

The Chinese government has also taken strong measures against corruption and data manipulation, particularly the kind that used to occur at provincial levels. Therefore, the overall risk of falling victim to fraud as an equity investor in China is no longer significantly higher than it is in Western markets.

Conclusion

In general, Chinese stocks are more risk-laden than many Western equities, as these markets have historically not undergone the same degree of stabilization, and the economic and political systems offer a different form of security.

As a result, investors must often accept larger discounts in market valuations—literally taking them in stride. Another consequence is significantly higher price fluctuations (volatility). While this should not be equated with risk, it is certainly a side effect that accompanies investing in China.

STRATEGY

The Most Important Investment Components

The VF Emerging Asia is entering the market with no fewer than three portfolios. Investors should therefore clearly understand the focus, including the opportunities and risks, associated with each portfolio. However, readers are not required to choose one portfolio over another — they can theoretically combine the holdings according to their personal risk profile and preferences.

All three portfolios follow a similar investment philosophy despite differences in segment and risk allocation: the focus is primarily on long-term investments in so-called trend stocks. These are intended to provide more stability through value stocks, and to capitalize on additional opportunities through opportunity stocks.

Category Definitions

There are many different definitions of trend stocks, so the following is tailored specifically to the context of our service. Many people use the term "growth stocks" instead.

According to our definition, trend stocks are shares in companies that have shown long-term (more than 10 years) upward trends in both earnings and revenue, which are also reflected in a rising market value (stock price). Temporary trend interruptions are allowed, as long as they are legitimate (e.g., due to external factors) and not permanent. Trend stocks have a high likelihood of outperforming the overall market. However, it is also essential that—besides their track record—their future prospects continue to suggest growth, primarily through strong product demand, cost efficiency, and competitiveness.

Value stocks, on the other hand, are typically more established companies that are considered undervalued. This may be reflected in low valuation metrics (e.g., P/E ratio, P/S ratio, P/B ratio), as well as relatively high cash reserves or above-average dividend yields. These stocks can appear undervalued for a variety of reasons. However, as long as the company's financial situation remains stable, these investments can be attractive due to potential catch-up effects and high dividend payouts—even if profit growth prospects are more modest than those of trend stocks.

The third category consists of so-called Opportunity Stocks. As the name suggests, this is about acting tactically during certain phases and taking advantage of additional opportunities. Such an opportunity exists, for example, when a stock has experienced an extreme drawdown that appears exaggerated and/or only partially justified, with a reasonable likelihood of a swift recovery. Another type of opportunity is a newcomer, such as a company that has recently gone public (post-IPO). Generally, post-IPO investments should be approached with caution. However, there are cases where it makes sense to invest shortly after the IPO. Opportunity stocks are significantly more speculative than the other categories and are therefore given a smaller weighting within the portfolios.

Portfolio Structure

All portfolios share the common characteristic of generally containing no more than 10 holdings. The level of investment should be adjusted based on market conditions. The securities included are pure equity or ETF investments — no derivatives or short strategies are used.

The Conservative China Portfolio

This portfolio will primarily include strong-trend stocks (approx. 50–70%). These will be supplemented by value stocks (20–30%) and opportunity stocks (10–20%). Overall, this portfolio has a more defensive orientation, which does not equate to low performance, but rather to lower volatility. At the same time, this portfolio is intended to provide a counterbalance to the more tech-heavy Speculative Portfolio. For this reason, it will cover other sectors, such as consumer goods and infrastructure, more comprehensively.

The Speculative China Portfolio

This portfolio is explicitly reserved for more speculative stocks. The allocation here will shift more from value to opportunity. However, this does not mean that random "hype stories" will be included. In many cases, these will be companies with a shorter track record and lower market capitalization — and thus more volatility.

In other words, many of these holdings are not yet established trend stocks, but they have the potential to become them in the long term and offer strong short-term growth momentum. In today's emerging AI world, this offers particular opportunities in areas like software, semiconductors, and IoT, which we aim to capitalize on. Some holdings from this portfolio may only be tradable via international brokers on exchanges such as New York or Hong Kong.

The Asia Portfolio

The Asia portfolio will geographically focus on the Southeast and East Asian corridor. Additionally, it may be complemented by stocks from the Middle East, Central Asia, and South Asia. Of course, a portfolio with just ten holdings cannot claim to fully represent all of Asia. However, this limitation actually creates a significant performance opportunity, since it allows higher weighting of the faster-growing markets. The core idea is to tactically take advantage of specific phases and capitalize on regional momentum. For example, if a country has recently seen a correction in its stock market, and then starts showing signs of a turnaround — whether due to economic recovery or an oversold situation — such developments can be exploited.

ETFs will also be included in the Asia portfolio (target share: 10–30%). This is not due to a lack of expertise, but rather due to the unfortunate reality that many stocks in these regions are simply not accessible to western retail investors.

Final Selection Process

The selection of individual holdings is based on various internally defined parameters:

1. Soft-Factor Check: Qualitative questions regarding market, management, and business model are assessed.

2. Fundamental Analysis (Hard Facts): This includes a classic analysis of the balance sheet, profit & loss statement, and cash flow. Various developments and key metrics are evaluated and must meet the criteria of the defined investment profile.

3. Technical Analysis: Even though this is not a short-term trading strategy, it's essential to evaluate the stock chart as well as oscillators and indicators from a technical standpoint.

In addition to individual stock selection, the portfolios must also be diversified on a macro level. Given current market dynamics — especially in China — tech stocks will play a dominant role. However, the term "tech" is often misunderstood, as today almost any company can be labeled a "tech" firm. For us, the focus will be on identifying companies that are most likely to monetize the new tech-driven opportunities in the future — whether they belong to traditional industries, consumer sectors, or high-tech segments.

Criteria	Trend Stocks	Value Stocks	Opportunity Stocks
Track Record	Long	Long	Short
Volatility	Moderate	Low	High
Expected Performance	Moderate	Low	High
Market Valuation	Moderate	Low	Case-dependent
Dividend Yield	Low	High	Low
Action Frequency	Moderate	Low	High