Comparison of Shanghai and Hong Kong Stock Exchange

History & Background

Shanghai Stock Exchange (SSE) was established in 1990, as part of the 1979 economic reform originally led by Xiaoping Deng. Until 1996, the SSE did not become a modern stock market. Although the Chinese government has been improving the openness and transparency of the SSE, SSE is still relatively young and immature in various aspects compared to any other major stock exchanges. Hong Kong Stock Exchange(SEHK), is the third largest stock market regarding market capitalization in Asia, behind the Tokyo Stock Exchange and the SSE. The history of the SEHK can go back to the mid-19th century; therefore, the SEHK is a more mature, standardized and developed stock market which needs fewer government interventions. Nonetheless, Hang Seng Index(HSI) and Shanghai Composite Index(SHCOMP) are very closely related, as many mainland Chinese companies are listed in both Shanghai and Hong Kong.

Key Differences: Volatility And Risks

Although there are over 100 companies listed on both mainland China stock exchanges (Shanghai & Shenzhen) and the SEHK, the performances of both individual stock and indices are different. Regarding the performance of exchange indices, SHCOMP, in general, is more volatile. In "*Information Efficiency Comparison Between Shanghai and Hong Kong Stock Market"*(Qu 2008), the author calculated the log return on both indices from 2002 to 2008. He concluded that the log return of SHCOMP has higher variance, skewness, and Kurtosis; namely, the distribution of the log return of SHCOMP is more dispersed and has a fatter tail. Based on historical indices data for the last decade, we can also observe that SHCOMP is more volatile than HSI. There are several plausible explanations for the volatility of SHCOMP: Firstly, the investment philosophy of investors in the two markets could be different. Mainland stock investors tend to rely on short-term speculations as the majority of them are less experienced retail investors. On the other hand, there are lots of institutional and experienced investors across the globe participating in the SEHK. These investors tend to focus on long-term goals and are more value-oriented. Secondly, the mainland China stock market is thinly traded compared to the SEHK. Only 7% of China's population owns stocks. The minority of those who participate owns the majority of tradable shares, and they can drive the price changes in China's stock market. Thirdly, incomplete information leads to a less efficient market. Not only the domestic stock market participation is low; foreign investors only have limited access to stocks listed on the SSE as well. Therefore, generally, it takes a longer time for China's stock market to digest and reflect new information and knowledge(domestically and globally), leading to prolonged and lagged adjustments of stock prices.

AH Premium

An interesting phenomenon among SH-HK stock exchanges is that companies which are listed on both markets have a different price per share in these two markets. Generally speaking, A-shares(in Shanghai) are traded at a 20% premium compared to H-shares(in Hong Kong) for the same company. Theoretically speaking, A-shares and H-shares have the same intrinsic value. There are several explanations for the seemingly unplausible price disparity. First, investors in mainland China and investors outside of mainland China may have asymmetrical information regarding those dual-listed companies, resulting in different valuation on their shares. Additionally, A-shares are considered more liquid than H-shares, as Chinese investors have fewer investment channels, comparing to foreign investors. Moreover, limited access for foreign investors make it very hard to short A-shares overseas; therefore traditional convergence trades are less viable. Lastly, international investors often are suspicious about Chinese firms' financial reporting practices, and state-controlled management.

Performance of Private Firms in Mainland China

One key character which differentiates China's stock market from the Hong Kong stock market(or western stock markets) is that many state-owned enterprises(SOE) giants are listed on China's stock market. Due to the design of SHCOMP(weighted by market cap), SHCOMP largely reflects the performance of those SOE giants, instead of the performance of mid-small cap private firms. However, empirical research on China's economy has shown that private firms have been consistently outperforming SOEs regarding the allocation of resources, the growth of earnings and financials. For instance, CSI 500 is an index developed by China Securities Index Co., which contains 500 mid-small cap stocks(the vast majority of them are private firms). For the most recent decade, the annualized returns(including dividends) for HSI, SHCOMP and CSI 500 are about 6.5%, 3.5%, and 8.7% respectively. The performance of the private sector in mainland China beat that of the companies enlisted on the SEHK. Nonetheless, indices like CSI 500 still share similar volatility issue as SHCOMP; particularly, these indices also have higher volatility compared to indices of well-developed markets, such as HSI.

Past Performance and Future

In the last decade, HSI has outperformed SHCOMP with less volatility. On the top of this, companies listed on the SEHK, in general, also provide better dividend return. Having these said, HSI seems to be a dominant choice over SHCOMP at this moment. However, this does not mean that China's stock market has a gloomy future. The Chinese government has been continually improving the openness, and the legal framework of the SSE and China's stock market may become a good alternative for portfolio managers in the future, given the economic size and economic growth of China. Moreover, compared to western stock markets, China's stock market is relatively cheap(approx. 13 PE ratio), after the downward movements in the recent years. Furthermore, the frequent mispricings due to volatility can also be interesting opportunities for value investors. Last but still important, SHCOMP does not represent the performance of lots of mid-small cap private firm stocks enlisted on the SSE, and these mid-small cap stocks actually have very strong performance empirically.