TRADING SHENZHEN CONNECT

STRATEGIES, CHALLENGES AND OPPORTUNITIES

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Contents

REUTERS/Bobby Yip

SHENZHEN-HONG KONG CONNECT

Just two years after launching a trading link between Shanghai and Hong Kong, the Chinese and Hong Kong authorities have launched another. Built upon the successes and lessons of the Shanghai-Hong Kong Stock Connect, the new link allows Hong Kong investors to trade more than 800 A-shares listed on the Shenzhen Stock Exchange. The combined market cap of the Shanghai, Shenzhen and Hong Kong exchanges is more than US$10.6 trillion, which when taken together, represents the second largest stock market in the world after the US.

Whereas Shanghai-listed A-shares are dominated by banks and state-owned enterprises, Shenzhen's companies offer investors the chance to capture more of China's macroeconomic pivot from hard assets to consumer spending. Shenzhen's A-shares feature a healthy concentratio n of the consumer electronics, pharmaceutical and internet companies that are expected to be at the vanguard of the next phase of Chinese GDP growth.

International investors have long eyed the potential alpha in the Shenzhen-listed companies, which despite high PE ratios and more pronounced volatility, offer more potential price appreciation. By comparison, Shanghai-listed stocks tend to offer far greater stability, but expectations for earnings growth is more muted than for Shenzhen-listed names.

Mainland authorities actively court institutional investors to help support their markets with new capital inflows. New sectors and an ability to more actively trade the Chinese domestic market is likely to encourage international investors to increase their scale of engagement in the northbound trade.

Thus far, southbound trading has been limited to institutional investors and retail traders meeting minimum capital requirements. Crucially for mainland investors, the closed loop model means the Connect program does not offer a way to move capital offshore. In addition, 100 small-cap Hong Kong-listed stocks have now been added to the list of firms mainland investors can trade.

What's different?

Much has been learned and borrowed from the launch of the link between Shanghai and Hong Kong, but there are three notable differences with the launch of the Shenzhen-Hong Kong Stock Connect.

1. 881 Shenzhen A-shares accessible to international investors
2. 100 Hong Kong small-cap stocks now also accessible to eligible mainland investors
3. The aggregate northbound and southbound quotas have been removed, concurrent with the announcement of the Shenzhen link in August 2016

From a strategic perspective, further integration with international markets is the Shenzhen Stock Exchange's aim and objective, according to Liu Fuzhong, Director of the exchange's International Department. "The aim is not simply to introduce more capital into the Chinese market or the Shenzhen market, nor is it simply providing the opportunity for Chinese investors to invest in Hong Kong's other markets," Liu explains. "Rather, international participation has been very low in terms of market capitalization, but foreign institutional investors' contributions are significant in terms of improving corporate governance, and investor structure as well as bringing in new trading practices and attitudes, which I think are more important," Liu adds.

Meanwhile, for the Hong Kong Exchange, the stock connect programs revitalize the city's claim as the access point to China. While the flow of physical trade between Hong Kong and China is already distributed throughout the mainland, from a financial perspective the connections with Shanghai and Shenzhen create a seamless pipe for international capital to access China's massive secondary market and tap the country's long-term economic growth.

"Since the first H-share IPO in 1993, the Hong Kong Exchange has remained China's offshore capital raising center," explained Romnesh Lamba, Co-Head of Market Development at HKEX. "Apart from a few quota schemes, China's domestic stock markets were inaccessible to international investors before the Connect project," he added.

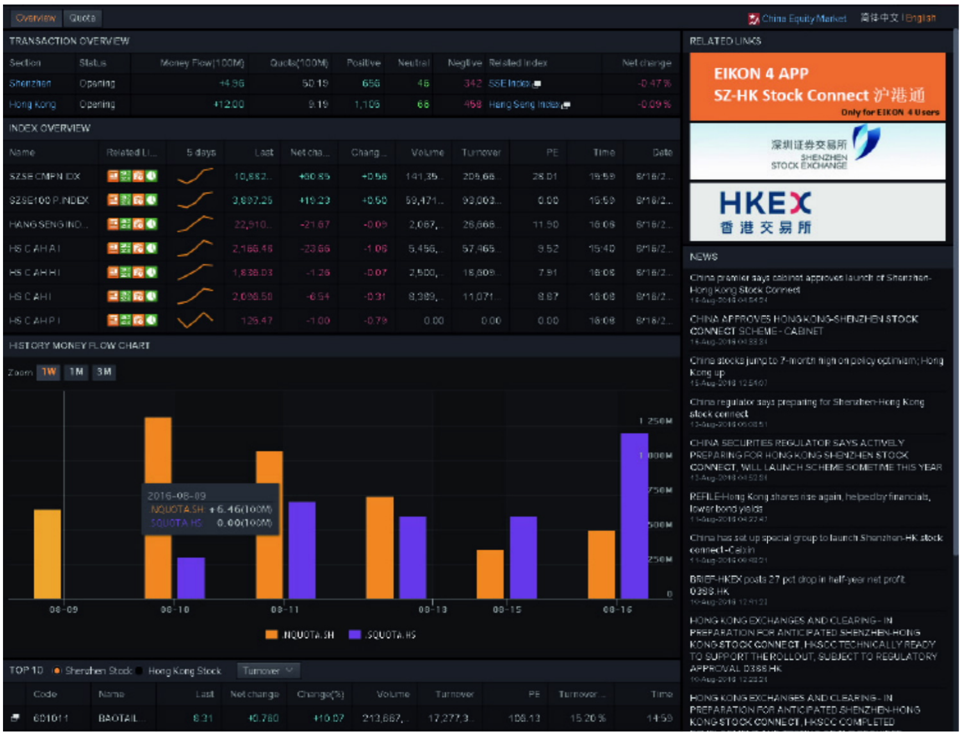
Both bourses agree that success will not be measured in initial volumes. "We are not concerned about volume in the first six months after the launch of the program; we have a longer-term vision," Liu said. "We want to provide good service and good infrastructure for when investors choose to use the Shenzhen-Hong Kong Stock Connect."

One key measurement of success is what percentage of international flow goes through the Stock Connects versus the quota systems (R/QFII), suggested Kevin Rideout, Head of Client and Marketing Services for HKEX. "We see connect assets growing in terms of assets under custody for A-shares and is already comparable to that of QFII," Rideout added. HKEX's main priorities are providing a mutual market platform that continues to be stable and reliable and does not have any regulatory issues Lamba said.

REMOVING BARRIERS TO MSCI INCLUSION

While investors on both sides of the border may cheer further trading connectivity, much of the impetus for the new trading link lies elsewhere. As a step toward the internationalization of the RMB, Beijing has long sought to have the China's A-shares included in major stock indices. Beginning with MSCI's annual market classification review in 2014, each year Beijing has sought to remove the remaining hurdles to inclusion of Chinese stocks in MSCI's Emerging Markets Index.

While the tens of billions estimated to flow into the country's domestic market would make most emerging market investors' eyes water, the effect will be minimal in China's US$7 trillion stock market. MSCI inclusion represents a step in a broader plan to liberalize and professionalize China's capital markets. This process is simultaneous with China's attempts to boost the use of the RMB outside of China and increasing the range of RMB-denominated investable assets may also provide a further boost.



Thomson Reuters Eikon: Shenzhen-Hong Kong Connect app
Investors can access China company information, market data, pricing and more using Thomson Reuters pricing and reference data, and real-time data.

MSCI's Remaining Concerns

In its 2016 A-Shares Index Inclusion Roadmap, MSCI laid out five key concerns to be met on the way to adding Chinese A-shares to its Emerging Markets Index.

1. Quota allocation process
2. Capital mobility restrictions
3. Beneficial ownership of investments
4. Voluntary suspensions from trading
5. Anti-competitive clauses restricting the launch of official products linked to indices that includeA-shares

BUSINESS OPPORTUNITIES: NORTHBOUND

RETAIL

Multiple factors are likely to attract institutional and local Hong Kong investors, with each group seeking slightly different goals. Local Hong Kong investors are looking for opportunities to capture part of the mainland's growth story after the International Monetary Fund cut its forecast for Hong Kong GDP growth in 2017 from 2.8% to 2.4%. The potential of higher stock prices, as well as any future changes in the exchange rate between the RMB and the US dollar, continue to attract Hong Kong's active retail market today.

Responsible for approximately HK$5 billion in turnover in Hong Kong stocks, local retail investors trade roughly one-fifth of the local cash market. Any increased preference for trading mainland versus HongKong-listed companies is likely to have limited relative impact on the A-share market, but it may affect Hong Kong-listed companies if retail investors sell Hong Kong stocks to buy mainland companies. However, it is more likely that any reduction in local retail participation in Hong Kong will be offset by increased participation from mainland investors.

INSTITUTIONAL

Institutional investors are seeking to profit from the rebalancing of their portfolios to exposure to the Chinese economy away from the old growth pillars of heavy industry and manufacturing, given many of the leading Chinese technology, consumer and healthcare companies are listed in Shenzhen. As China continues to push for outbound foreign direct investment (FDI) through acquisitions as well as through overseas expansion, the leading firms in these sectors are widely expected to outperform more traditional sectors such as financials, property developers and heavy manufacturers.

Long-only fund houses are likely to pursue buying Shenzhen names as possible hedges given the volatile macroeconomic conditions globally. Domestic companies listed on the mainland can be a hedge for fund houses to balance their portfolios as Shenzhen has limited correlation to international markets. Shenzhen may attract institutional investors as a relatively unique asset class that has shown an ability to grow despite global downturns, while still capturing the upside of a global market recovery.

One major hurdle for Shenzhen-listed companies looking for international investors is the quality of third-party information and analysis available. "Investors receive fragmented information about Shenzhen-listed companies and about the Chinese capital markets in general. We understand there are home biases, but for those international investors who are interested in Chinese companies, they do not get enough information," Shenzhen's Liu commented.

The Shenzhen Stock Exchange has invested heavily in the last year in an online investor relations portal, called Easy IR, to address this. By aggregating static data from all listed companies, the new portal allows investors to ask questions, in English, of management at Shenzhen-listed companies.

While the need for investor education continues, technology may offer Shenzhen-listed stocks a chance to facilitate that education process. As in most markets, investors tend to congregate around only those stocks which they are already familiar with and which are most liquid. However, quantitative funds and robo-advisors are designed to avoid the human mind's predilection for familiarity, instead focusing on mathematical analyses of data, explains Adam Garrett, Thomson Reuters' Enterprise Market Development Manager for Asia. Provided strategists can access the right quality of data and the models can be accurately attuned to the Chinese market, this may help smooth the familiarization process to investors. While relatively high transaction costs may put off high-frequency traders, there are lower frequency algorithms that do not rely on speed and are therefore less sensitive to trading costs; those types of funds, provided they have access to the right historical price data to be backtested and properly developed, are more likely to be early entrants into Shenzhen through the Stock Connect program, Garrett says.

REUTERS/ Jason Lee

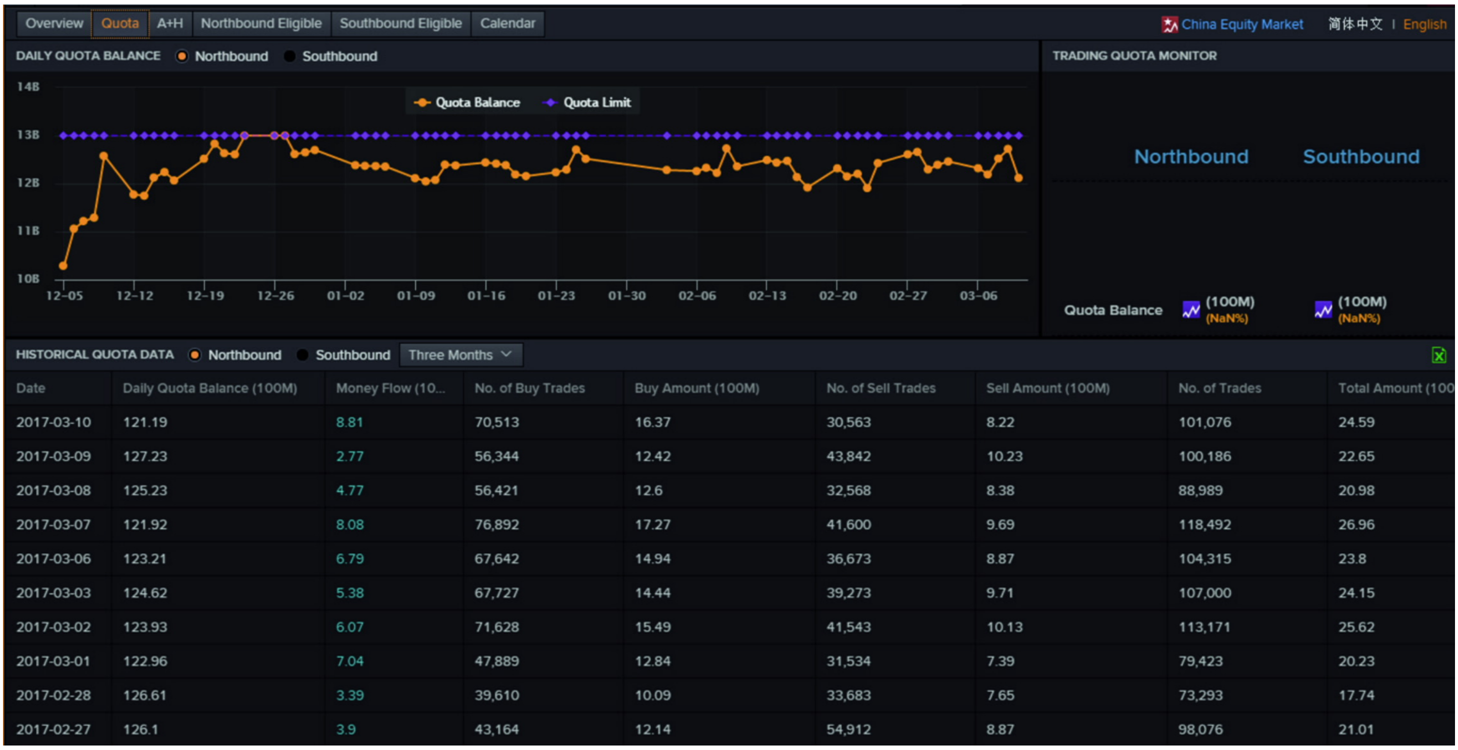
BUSINESS OPPORTUNITIES: SOUTHBOUND

Another interested party should be Chinese quantitative funds. The addition of new Hong Kong small cap stocks will give further opportunity for groups whose investment calculations are strongly based on market correlations. Mainland investors will now have access to Hong Kong's small-cap stocks - those with a market cap from HK$5 billion. This is in stark contrast to where previously the Shanghai-Hong Kong program only included Hong Kong's large and mid-cap stocks, as well as those that had a corresponding A-share trading in China. At that time the Shanghai-Hong Kong Connect was initially expected to reduce the spread between A-share and H-share listed companies, but the spread still has yet to budge. Will this be different in the case of the Shenzhen-Hong Kong Stock Connect?

According to the Hong Kong Exchange's 2014/2015 Cash Market Transaction Survey, released in February 2016, mainland investors' percentage of total market turnover grew from 5% in the 2013/2014 survey to 9%. Mainland investors currently account for 21.9% of all overseas investors, according to the same survey.

Chinese insurance companies are playing an increasing role in southbound trading and that number is likely to increase further. In a September 8 research note, UBS estimated that nearly 55% of mainland investment in Hong Kong stocks come from Chinese insurance companies. Chinese insurance companies' asset management arms have steadily grown the assets they manage in recent years. In its last half-year results, Ping An Asset Management reported external assets under management were $40.8 billion, which is 153% higher than at the end of June 2014. Similarly, Taiping Insurance Group's asset management unit saw its third-party assets under management rise by 30% over the same period.

While much of the impetus of the stock connect program is to give Chinese investment houses access to new tradable instruments, this is part of a larger push from the Chinese government to diversify Chinese households' cumulative wealth of more than US$20 trillion away from over-exposure to cash and real estate asset classes only.



Date	Daily Quota Balance (100M)	Money Flow (10...	No. of Buy Trades	Buy Amount (100M)	No. of Sell Trades	Sell Amount (100M)	No. of Trades	Total Amount (100
2017-03-10	121.19	8.81	70,513	16.37	30,563	8.22	101,076	24.59
2017-03-09	127.23	2.77	56,344	12.42	43,842	10.23	100,186	22.65
2017-03-08	125.23	4.77	56,421	12.6	32,568	8.38	88,989	20.98
2017-03-07	121.92	8.08	76,892	17.27	41,600	9.69	118,492	26.96
2017-03-06	123.21	6.79	67,642	14.94	36,673	8.87	104,315	23.8
2017-03-03	124.62	5.38	67,727	14.44	39,273	9.71	107,000	24.15
2017-03-02	123.93	6.07	71,628	15.49	41,543	10.13	113,171	25.62
2017-03-01	122.96	7.04	47,889	12.84	31,534	7.39	79,423	20.23
2017-02-28	126.61	3.39	39,610	10.09	33,683	7.65	73,293	17.74
2017-02-27	126.1	3.9	43,164	12.14	54,912	8.87	98,076	21.01

Trading volumes on Shenzhen Connect as shown on Thomson Reuters Eikon
Daily quota balance as shown on Thomson Reuters Eikon

BUSINESS CHALLENGES: BACK OFFICE AND INFRASTRUCTURE FOR NEW CONTENT FLOWS

Beyond investment nous, capturing value from the increased trading opportunities arising from the Shenzhen-Hong Kong link requires robust preparation for both trading firms’ front and back offices. Owing to the relatively time-sensitive nature of the original Shanghai-Hong Kong Stock Connect’s rollout, many investors and brokers focused on solving connectivity issues to ensure they were ready to trade on Day One. Nevertheless, many found themselves having to play catch-up to ensure their back office systems were ready in time. Also, the legal hurdles related to settlement and beneficial ownership have now been largely resolved in the two years since the Shanghai link’s launch, and are being prudently replicated with the structure of the Shenzhen link.

Major brokers have been investing in building up local A-share research capabilities, so the depth of coverage is developing quickly. In addition, new research from local Chinese brokers may offer further valuable insights for those trading firms who have access to it. For most international fund houses, working with partners who can aggregate local research will be an essential step in building the broader investment process.

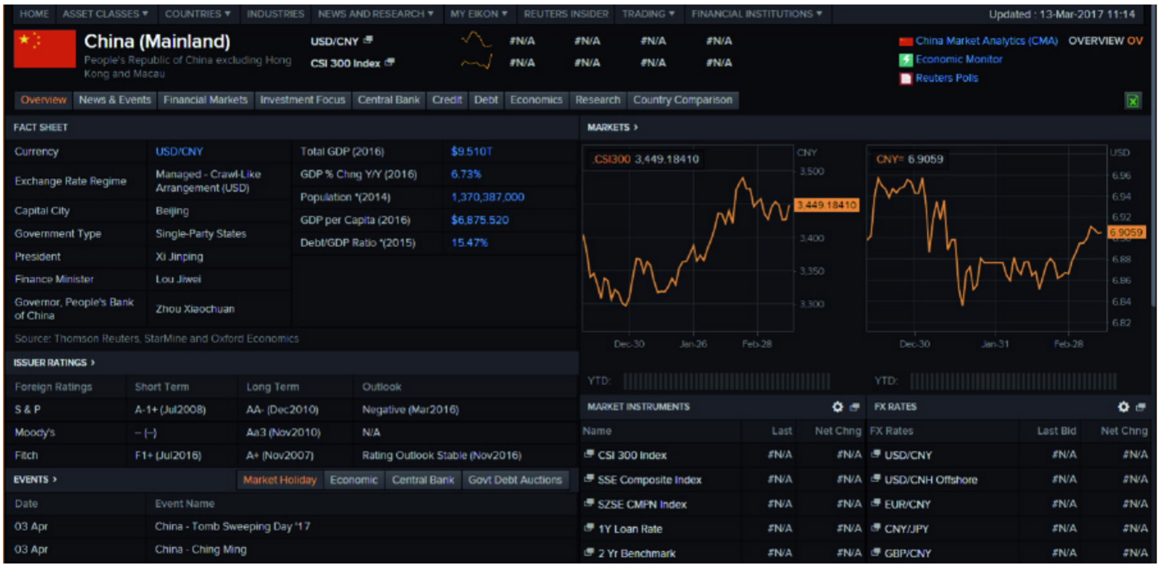
Assessing investments for political risk is another important informational component fund houses will need to take into account. Politically sensitive businesses, companies run by politically important persons or companies that have done business with sanctioned entities have to be filtered across the investable universe of new Shenzhen stocks to ensure full compliance with local and home market regulators. Beyond the regulatory due diligence, many funds also have internal ethical standards related to the environment and corporate governance which they need to ensure they adhere to.

BUSINESS CHALLENGES: DATA TESTING AND MODELING

Before any new launch, trading desks must test their feeds to ensure they have covered all possible eventualities in terms of the type of data they are receiving. One simple example is the additional fields regarding trading eligibility. Trading desks must also be sure their systems can handle intraday changes in field values to avoid placing orders in the market that should not be executed or might possibly result in them taking a position in a stock that is suspended or rendered ineligible before the order can be successfully canceled.

These complexities are not lost on the Shenzhen exchange. "The question we often get is how we provide data feeds to data vendors," Liu explains. "Investors often prefer bundled data from major financial information providers, so we are working with such vendors to figure out the most efficient means of providing our data feeds to provide the most robust information services possible for international investors," he adds.

Structuring the data is another of the challenges investment managers must tackle in China. While the Shenzhen exchange is investing in systems and education to increase international investors' access to company financial and performance data, much of the data is unstructured. Some quantitative houses may have the expertise to structure the data themselves, but for other investors, assistance may be required to make sense of the unstructured data. Data visualization can also play a significant role for investors looking to make more sense of their newly expanded investable universe.



China Business Information
China market information in English, via Thomson Reuters Eikon

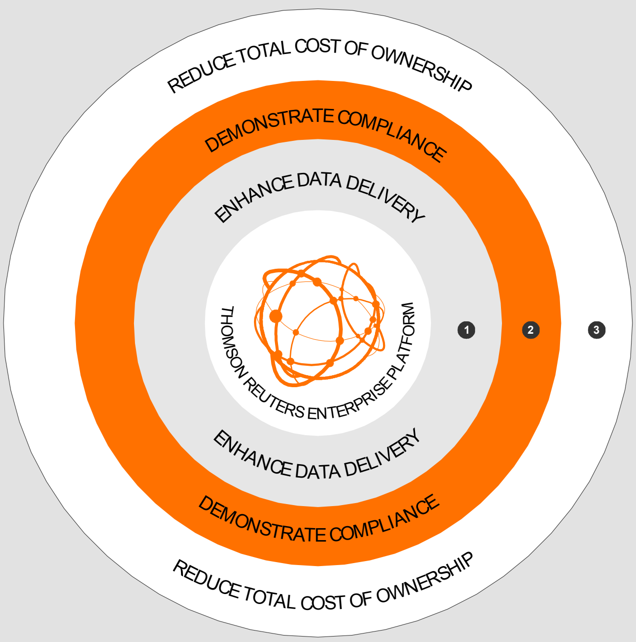
BUSINESS CHALLENGES: IN-HOUSE vs MANAGED OR DEPLOYED SERVICES

For the largest firms, and especially for executing brokers, the proprietary systems developed for the Shanghai link will be expanded and repurposed to cover the additional Shenzhen A-shares. This process will require new content, data and analytics to be built, but it is primarily a business decision to onboard an additional venue in order to achieve improved investment returns or to offer an additional valued service to clients.

However, smallerrfis may struggle to pass additional operational and technological costs on to their clients, and without a deep enough balance sheet to absorb the costs, they may need outside help. Whether through managed services provided via secure cloud interfaces or through deployed services developed by third-parties but operated on the client's premises, the options available to international investors and brokers today are more robust and mature than they were at the launch of the Shanghai-Hong Kong trading link two years earlier.

Case Study

A retail brokerage wants to leverage their existing technology, built on the Thomson Reuters Enterprise Platform (TREP), to integrate, aggregate and distribute data for the Shanghai-Hong Kong Stock Connect. The client requires their own fund data to be integrated alongside Thomson Reuters and other third-party data feeds, but they lack the resources to complete the system integration work themselves. Using a deployed service model, Thomson Reuters is able to provide a fial solution which combines Thomson Reuters data, news and risk information, and their proprietary fund data that continues to leverage on their deployed TREP in Hong Kong to service retail customers in Asia, Europe and the US.



Thomson Reuters Enterprise Platform will help you leverage your full potential.

PROSPECTS: WHAT HAPPENS AFTER MSCI A-SHARE INCLUSION?

The Shanghai and Shenzhen Stock Connect programs with Hong Kong create a common market of sorts. The combined weight of these exchanges, coupled with the gradual harmonization of trading rules, over time will create a very liquid, and therefore attractive, market for investors. While not all of MSCI's criteria for A-share inclusion have been met today, the expectation is one day they will be.

If and when A-shares are included in MSCI's Emerging Markets Index, their eventual weighting is likely to settle in the low to mid teens. All signals point to a gradual introduction with initial weighting mooted to be around one percent of the index. Capital flows anticipated from such a small weighting will not be the tidal wave some have suggested, but there will be knock-on effects. MSCI inclusion, more than anything else, such as Irish UCITS funds approval, will provide a catalytic change to both volume and flow in the Connect programs, Lamba suggested.

A-share inclusion is seen in Beijing, and by many investment managers, as a sign of greater acceptance of China into the world of developed international financial markets. Regardless, and prestige aside, if China continues to achieve its GDP growth targets, A-shares are likely to draw continued substantive investment from investors seeking economic growth in liquid instruments.

PROSPECTS: BOND CONNECT IS THE NEXT STEP

Much will depend, however, on the next steps the authorities in China and Hong Kong will take after the Shenzhen-Hong Kong Stock Connect. Charles Li, CEO of the Hong Kong Exchange, is quoted as saying he is open to other possible connect programs for initial public offerings, commodities and bonds; and China's Premier Li Keqiang announcing plans to introduce a bond connect program by end 2017.

Shenzhen has more of its stocks included in the new Connect program than Hong Kong, but the 400 from the latter accounts for more than 80% of its market cap, Lamba noted. "HKEX would like to extend beyond single shares to products listed on each other's exchanges, such as mainland ETFs and listed bonds", he added.

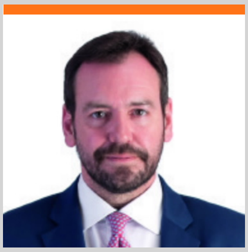
Such a connect would deepen liquidity in China's nascent bond markets if international institutional investors more actively traded mainland issuances. More than that, the bond connect program may help China realize one of its trickier goals, which is to remove the moral hazard of over-leverage. All too often, when large Chinese firms have racked up debts they cannot pay, the central government, either directly or through financial entities it controls or creates, has bought the debt at above market rates, rescuing indebted corporations without requiring them to undergo costly defaults. This has created what some consider a lack of accountability for Chinese corporate management, and the discipline of international investors may provide the backstop China needs and has been looking for.

"The most important thing is that international practices will be adopted in China and then international investors will be more comfortable in working with the Chinese," Liu suggested. "The overall strategy is to make the Chinese capital market more responsible, more internationally aligned, and more integrated into the broader global capital markets."

Whatever further connect programs lie in store for greater China, the mold has already been shaped by the launch of the Shanghai-Hong Kong Stock Connect, and the further success of the Shenzhen-Hong Kong link will only give greater confidence that both China and the international community will continue to benefit from such programs including Bond Connect.

REUTERS/ Jason Lee

ABOUTTHECONTRIBUTORS

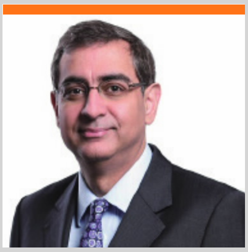


KEVIN RIDEOUT, Managing Director, Head of Client and Marketing Services, Market Development Division, Hong Kong Exchanges and Clearing Ltd ("HKEX")

Mr Kevin Rideout joined HKEX in April 2015 as Head of the Client and Marketing Services of Market Development Division. He is principally responsible for the division's client relationship management and marketing services.

Mr Rideout joined HKEX from Citigroup, where he served as Head of Wholesa Execution Services, Asia and Chief Spokesman on the implementation of Stoc Connect in Hong Kong and was based in London of Citi as the Global Head o Market Infrastructures and HFT Clearing Group.

Prior to joining Citi, Mr Rideout spent 10 years at Thomson Reuters. He held various positions in Thomson Reuters, including Regional Manager Hong Kon Regional Director Japan and Korea, Managing Director Asia in Singapore and Managing Director - Global Head of Relationship Management and Sales in London for the Omgeo (DTCC) Division. Mr Rideout holds a Bsc (Hons) Environmental Chemistry from the University of Hertfordshire UK.



ROMNESH LAMBA, Co-Head of Market Development, Hong Kong Exchanges and Clearing Limited

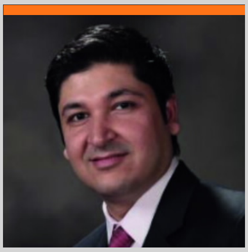
Mr Lamba is the Co-Head of the Market Development Division at HKEX Grou which includes all product development, project management, client and marketing services, mainland affairs, and corporate communications. Mr Lamba runs Market Development alongside his co-head Mr Li Gang.

Mr Lamba is also a Director of the Stock Exchange of Hong Kong Limited and Hong Kong Futures Exchange Limited, as well as a member of the HKEX Management Committee. Mr Lamba joined HKEX in February 2010 and has held various positions in senior management. In 2012, Mr Lamba and his team were instrumental in leading HKEX's acquisition of the London Metal Exchange. Mr Lamba has also been representing HKEX in regular discussion with the company's institutional shareholders and the investor community.

Mr Lamba has 29 years of experience in the financial services industry. Prior to joining HKEX, Mr Lamba was a Senior Advisor to JP Morgan's Asia Investmen Banking and Capital Markets business, with strategic and operating responsibilities from 2008. He has also worked at Merrill Lynch Asia Pacific for eight years as a Managing Director, where he led the firm's regional Energy and Power investment banking group and served as the Chief Operating Officer of the firm's China Origination business. At Merrill Lynch, Mr Lamba led several landmark listings of Mainland enterprises in Hong Kong. Prior to moving to Hong Kong in 1994, Mr Lamba worked in the financial services industry in the US for nine years. Mr Lamba holds Master of Business Administration and Bachelor of Science in Economics degrees from The Wharton School of the University of Pennsylvania in the US.

LIU FUZHONG, Director of International Department, Shenzhen Stock Exchange

Mr. Liu Fuzhong is Director of International Department of the Shenzhen Stock Exchange. Mr. Liu has made extensive research about the strategies to facilitate market-based financing for small and medium-sized enterprises (SMEs). He is one the task force for developing Shenzhen-Hong Kong Stock Connect. He also contributed to the WFE's FOCUS magazine to discuss the SZSE's effort in facilitating financing for SMEs and infrastructure projects (Small is Beautiful and Simple Product, Great Expectation). In his previous role as regional chief representative of listing promotion, he visited over a large number of SMEs and has first-hand experience of growth the SME sector in China.Mr. Liu Fuzhong graduated from London School of Economics with Master of Science in management.



GAUTAM VERMA, Head of Market Development, Enterprise Content and Capabilities, Asia Pacific, Thomson Reuters

Gautam began his career in data management for global markets in the Unite States with Reuters America based in New York, focusing on financial services customers. His experiences in the US markets built his exposure to complex customer needs and the solutions that could address their challenges. During a time of bull and bear markets, Gautam developed an interest in the impact o real-time data, latency, and the expertise on trading decisions with banks and brokers. In 2009, Gautam relocated to the dynamic markets of Asia, initially in Japan where market data solutions were fuelling expansion of trade across asset classes and within Asia-Pacific. He moved to Hong Kong in 2010 to be part of the growing market for cross-border, cross-asset trading that defines Hong Kong's place as a financial centre.

In his role at Thomson Reuters, Gautam analyses the market across the breadth of the Asia-Pacific and Japan regions developing the business for real time and historical market data and analytics solutions that help clients optimize decision making and operations with comprehensive cross asset data solutions and deployment models. His remit includes market research, market development, technology innovation and launch to support customers requiring enterprise-grade solutions for information, data, technology and expertise.

Gautam studied Finance at Bryant University, Rhode Island, United States anc lives in Hong Kong where is currently completed his MBA from Manchester Business School.

MICHAEL GO, Head of Market Development, FX - Asia Pacific
Thomson Reuters

Michael heads Foreign Exchange Market Development in Asia and is responsible for Financial & Risk's FX franchise in the region, including pre-trade, transactions capabilities and post trade services. He is also responsible for business development of China's internationalization, across asset classes.

With over 25 years' experience working in markets businesses of a number of international investment banks in Asia and Europe (including BZW, Barclays and ABN Amro), commercial banking in Australia (NAB) and in setting up an exchange to accommodate the move of OTC products to an electronic venue, he is well placed to support the market in the current regulatory climate. Michael also has extensive experience in the Chinese market, having worked with the regulators and central banking authority in China over a number of years.

He most recently held the role of Head of Markets which included responsibilit for markets business and policy, a market news /information business as well as the technology group along with ownership and charged with ensuring the IOSCO compliance of systemically important benchmarks.

ADAM GARRETT, Market Development Manager for Enterprise Content & Capabilities, Asia

Adam Garrett is a member of the Thomson Reuters Market Development team, Asia, responsible for driving the Enterprise Content & Capabilities business across Hong Kong, Taiwan and Korea. He began his financial career in 2002 as an equity quant trader at Lehman Brothers in Tokyo before moving to structuring and then volatility-trading roles, firstly with Lehman Brothers in Hong Kong and later with Mizuho Securities again in Tokyo. Adam holds a Master's degree in Engineering and Computing Science from Oxford Universit an MBA from the International University of Japan, and a Certificate in Quantitative Finance from 7City; he has been with Thomson Reuters since 2012.