PREVAILING WINDS

How Exposed Are U.S. Investors to China?


Shanghai, China

- Looking beyond official statistics, U.S. investors appear to own around 535 billion USD worth of Chinese securities, of which more are listed on foreign exchanges than in China.
  - U.S. investors own around 2% of the local Chinese stock market, a much lower portion compared to the average U.S. ownership of the local stock markets of advanced economies (18%).
    - As an estimate, Chinese securities account for less than 1% of the total portfolio of U.S. investors.

AUGUST 2019

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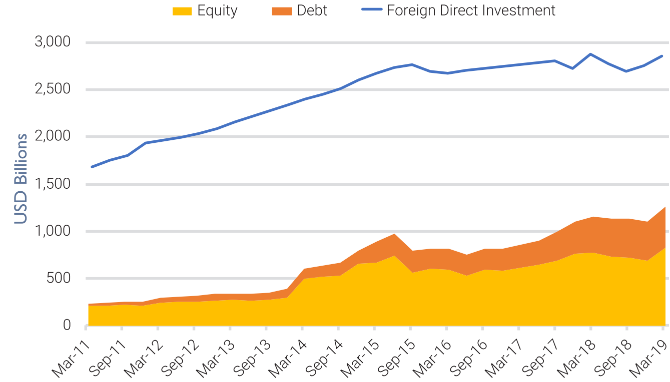
U.S. investments in China's capital markets are attracting increased scrutiny from politicians and the media. In June 2019, one U.S. senator declared that China's government "reaps the rewards of American and international capital markets while Chinese companies avoid financial disclosure and basic transparency, and place U.S. investors and pensioners at risk."[1] That same week, a journalist at a prominent U.S. newspaper wrote that "millions of Americans, without doing anything, will soon be betting on Chinese companies with their pension funds, mutual funds and exchange-traded funds."[2]

Given this context, it's worth investigating the current size of China within U.S. portfolios and the relative importance of U.S. investors for Chinese companies.

Portfolio Investment Outpacing FDI

A recent spate of reforms have led to a considerable opening of China's capital account.[3] Whether via the Stock Connect, the Bond Connect, the expansion of the Qualified Foreign Institutional Investor (QFII) program, or direct access to the interbank bond market, foreign investors have an unprecedented ability to buy and sell Chinese securities. Consequently, capital inflows into China have increased significantly, even amid the volatilities of its economy and stock markets.

Figure 1. Foreign Direct and Portfolio Investment into China 3/31/11 – 3/31/19



Source: Wind Information.

Between the first quarter (Q1) of 2011 and Q1 2019, the value of foreign portfolio investment (FPI) (equity and debt) in China increased 5.5 times. In comparison, the value of foreign direct investment (FDI) increased only 1.7 times.[4] While the stock of FDI remains larger, as shown in **Figure 1**, portfolio investment is rapidly gaining ground.

Prevailing Winds is a China-focused blog written by Nicholas Borst, Director of China Research at Seafarer. The blog tracks the economic and financial developments shaping the world's largest emerging market.

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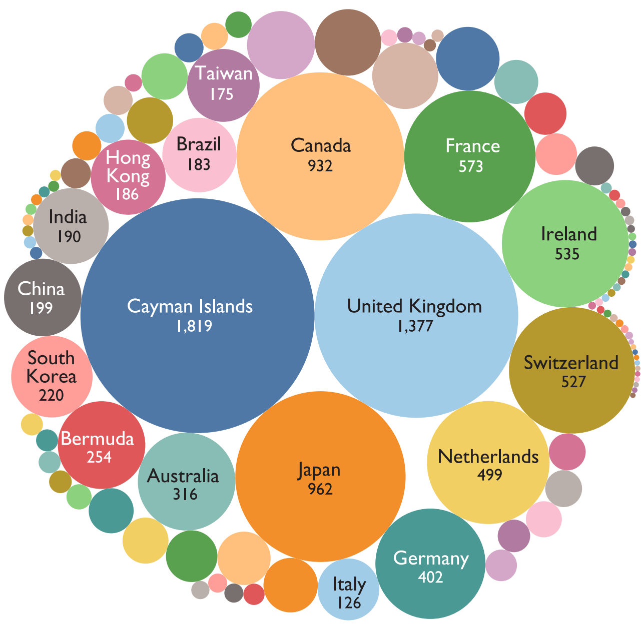
According to statistics from the U.S. Treasury, as of Q1 2019, U.S. investors held nearly 200 billion U.S. dollars (USD) in Chinese equity and long-term debt.[5] That is a substantial amount of money and it is approaching the cumulative value of all U.S. FDI into China.[6] However, these statistics do not tell the full story of U.S. investors' exposure to China.

The Cayman Complication

As shown in **Figure 2**, China does not loom large as a target destination for U.S. investors in the official data.[7] With the world's second-largest economy and stock market, China appears significantly underweight as an investment destination compared to many other smaller economies. For example, China ranks well behind Australia even though the Chinese economy expanded in 2018 by an amount equivalent to the entire Australian economy.[8]

Figure 2. U.S. Residents' Foreign Security Holdings, by Country
USD Billions
As of 3/31/19



Source: U.S. Department of Treasury.

International capital flows are notoriously difficult to track due to the roles of subsidiaries and offshore financial centers. As a result, actual foreign holdings of Chinese securities are likely higher due to the way residency is treated in the data.

In **Figure 2**, the Cayman Islands stands out as the largest source of U.S. foreign holdings. This seems strange seeing as the Caymans is a small country with a limited number of industries.

There are two important factors distorting the data. The first is the role of offshore funds. When an offshore fund is set up in the Cayman Islands, investment into that fund by Americans is treated as U.S. holdings of Cayman equity. These offshore funds primarily invest outside the Cayman Islands, often back into the U.S., and account for around 25% of the total for the Caymans.

The other factor is the role of subsidiaries. Many companies set up offshore subsidiaries in the Cayman Islands to issue equity and debt. Securities issued by these subsidiaries are counted towards the Cayman Islands' total, not the home country of the parent company. Indeed, this is the main reason behind both the incredibly high holdings total for the Cayman Islands and the undercounting of China in the official data.

From China to New York VIE the Caribbean

China's restrictions on foreign ownership in sectors considered strategic or sensitive are well known. Despite this, the lure of foreign capital markets has been irresistible to many Chinese companies seeking to go public. To sell shares to foreign investors while not violating domestic ownership requirements, Chinese firms have made use of a structure called a variable interest entity (VIE). In this case, the VIE is a Chinese-owned entity that enters into a contractual relationship with a foreign-owned company. This contract gives the foreign company the right to the economic benefits of the Chinese company and a degree of effective control. In this manner, the underlying company is still "Chinese" in the eyes of the regulators, while shareholders of the foreign company can receive most of the benefits of ownership.

The VIE structure is not without controversy. The business structure has attracted scrutiny from members of the media, politicians, and academics. A small number of VIE structures have failed and led to significant losses for investors.[9] Nonetheless, the VIE structure has allowed foreign investors access to many of China's most innovative and exciting companies that would normally be barred by Chinese law.

Hundreds of Chinese companies have registered offshore companies in the Cayman Islands that receive the profits from VIEs located in China.[10] The offshore Cayman entities then issue depositary receipts in New York, Hong Kong and other locations. A review of Cayman-registered companies issuing depositary receipts reveals that the vast majority are Chinese firms. The combined market capitalization of these entities is enormous, in excess of 2 trillion USD.[11]

U.S. investors own a substantial portion of these depositary receipts. On an annual basis, the U.S. Treasury produces a report showing a detailed breakdown of holdings by country for U.S. investors. As of the end of 2017, the most recent date available, 23% of U.S. holdings of Cayman equities was in the form of depositary receipts. If that ratio is applied to the Q1 2019 total, it results in an estimated U.S. holding of 314 billion USD in depositary receipts. An analysis of these depositary receipts shows that the vast majority are for companies whose ultimate parent company is Chinese.[11]

Chinese companies also issue debt in offshore jurisdictions through subsidiaries that is not counted in the official statistics. The U.S. Treasury estimated that Chinese

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companies have issued around 21 billion USD-equivalent in offshore jurisdictions as of the end of 2017.

Adding these items up, the holdings of Cayman depositary receipts and offshore debt increases U.S. holdings of Chinese securities from around 200 billion to 535 billion USD. After these adjustments, China emerges as the fourth largest foreign exposure for U.S. investors, after the U.K., Japan, and France (the Cayman Islands is excluded for the reasons stated above).

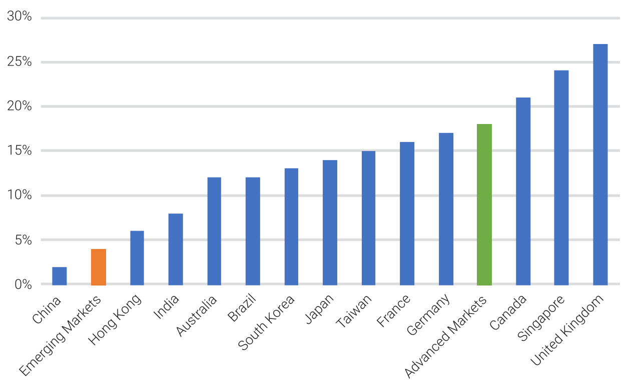
A Small Slice of the Domestic Market

The estimates above reveal that U.S. investors own significantly more Chinese securities than what the official data show. It also highlights the fact that U.S. investors own substantially more Chinese stocks listed on foreign exchanges than those listed within China.

This makes sense for two reasons: first, until relatively recently, purchasing A-shares on local Chinese exchanges has been difficult for foreign investors; and second, many of China's most promising companies have listed overseas in order to gain access to foreign capital.

As a result, U.S. investors do not yet play a significant role in China's domestic equity market. One way to look at this issue is the share of the local stock market held by U.S. investors. As shown in Figure 3, U.S. investors own a considerable portion of many of the world's largest equity markets.

Figure 3. U.S. Holdings as a Percentage of Domestic Market Capitalization
As of 12/31/17



Source: U.S. Department of Treasury.

The data in Figure 3 represents holdings in the secondary market; information on the participation of U.S. investors in initial public offerings (IPOs) in these markets is not readily available. Nonetheless, it's safe to say that U.S. investors play an important role in many of these markets. Secondary market investors can help provide liquidity, boost valuations, and participate in secondary offerings.

Figure 3 also makes clear that U.S. investors on average own a much larger portion of advanced economy[12] stock markets (18%) compared to emerging markets (4%). However, even compared to other emerging markets, the share of the Chinese market held by U.S. investors is low at around 2%. Consequently, it's hard to argue that U.S. investors play an important role as a source of capital for domestically listed Chinese companies.

Putting Everything in Context

In terms of single country exposure by U.S. investors, China ranks high and is likely to grow significantly over the next few years.

However, at the aggregate level, Chinese securities do not have a large weighting in the portfolios of American investors. At the end of Q1 2019, U.S. investors owned around 11.6 trillion USD worth of foreign long-term securities. U.S. investors are underweight foreign securities overall – this is referred to as "home bias." For example, foreign equities account for around 20% of U.S. investors' portfolios, whereas foreign stocks receive a 50% weighting in global equity indices.[13] For fixed income, U.S. investors display even higher levels of home bias.

Assuming 20% of total U.S. portfolio holdings are foreign, Chinese stocks and bonds would account for less than 1% of U.S. portfolio holdings at the aggregate level under the new revised estimates in this post (i.e. including the offshore depositary receipts linked to VIEs).

As a source of financing for Chinese companies, U.S. investors do not seem especially important. The entire market cap of all Chinese companies (both those listed inside and outside of China) is around 11 trillion USD-equivalent. Under the revised higher estimate of U.S. holdings of Chinese equities, U.S. investors account for less than 5% of the total.

As China further opens its capital account and receives a greater weighting in global indices, U.S. investors are likely to invest more in China's capital markets. This stands in contrast to the negative trend in FDI. Bilateral direct investment has plummeted as relations between the U.S. and China have deteriorated. While scrutiny of U.S. investors' rising exposure to China seems a bit premature, it is an important trend shaping the economic relationship between the two countries.

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[1] "Rubio Requests Information from MSCI Over Controversial Decision to add Chinese Companies in its Equity Indexes," The Office of Senator Marco Rubio, 13 June, 2019. https://www.rubio.senate.gov/public/index.cfm/2019/6/rubio-requests-information-from-msci-over-controversial-decision-to-add-chinese-companies-in-its-equity-indexes

[2] Josh Rogin, "China's infiltration of U.S. capital markets is a national security concern," *The Washington Post*, 13 June, 2019. https://www.washingtonpost.com/opinions/2019/06/13/chinas-infiltration-us-capital-markets-is-national-security-concern/

[3] www.seafarerfunds.com/prevailing-winds/2018/09/how-open-are-chinas-capital-markets-to-foreign-investment

[4] Portfolio investment is typically defined as non-controlling ownership interest. It most often takes the form of holdings of publicly listed stocks and bonds. In comparison, direct investment usually entails some degree of control on the part of the investor and often occurs through acquisitions and greenfield investments. For the data referenced in this post, direct investment is defined as "ownership or control, directly or indirectly, by one person or by a group of affiliated persons, of an interest of 10 percent or more of the voting stock of an incorporated business enterprise, or the equivalent in an unincorporated enterprise." See "U.S. Portfolio Holdings of Foreign Securities," U.S. Department of Treasury, October 2018. https://ticdata.treasury.gov/Publish/shca2017_report.pdf

[5] Long-term debt is defined as having a maturity of one year or greater.

[6] Thilo Hanemann, Daniel H. Rosen, Cassie Gao and Adam Lysenko, "Two-Way Street: 2019 Update US-China Direct Investment Trends," The Rhodium Group, 8 May 2019. https://rhg.com/research/two-way-street-2019-update-us-china-direct-investment-trends/

[7] Figure 2 includes both stocks held directly in the target country and depositary receipts (companies incorporated in China whose stock trades in another market).

[8] "China's slowdown masks its scale and resilience," *The Financial Times*, 15 July 2019. https://www.ft.com/content/867af020-a6ed-11e9-b6ee-3cdf3174eb89

[9] For a good explanation of some of the risks associated with VIEs, see Paul Gillis, "Testimony before the U.S.-China Security and Economic Commission," U.S.-China Security and Economic Commission, 28 February, 2019. https://www.uscc.gov/sites/default/files/gillis%20feb%2028%202019%20testimony.pdf

[10] In the typical VIE structure, there is a wholly foreign-owned enterprise (WFOE) that has a direct contractual relationship with the VIE. That WFOE is owned by the offshore entity which has issued the depositary receipts.

[11] Bloomberg. As of 22 July 2019.

[12] The "U.S. Portfolio Holdings of Foreign Securities" report by the U.S. Department of Treasury as of October 2018 defines "advanced economies" as the following: Member States of the European Union that have adopted the Euro as their currency, as well as Australia, Canada, Czech Republic, Denmark, Hong Kong, Iceland, Israel, Japan, New Zealand, Norway, Singapore, South Korea, Sweden, Switzerland, Taiwan, and United Kingdom, including Jersey, Guernsey, and the Isle of Man. https://ticdata.treasury.gov/Publish/shca2017_report.pdf

[13] Brian J. Scott, CFA; James Balsamo; Kelly N. McShane; Christos Tasopoulos, "The global case for strategic asset allocation and an examination of home bias," Vanguard Research, February 2017. https://personal.vanguard.com/pdf/ISGGAA.pdf

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Glossary

Bond Connect: a trading link that allows certain investors from Mainland China and overseas to trade in each other's bond markets through a special mechanism that was designed and implemented by the Hong Kong Stock Exchange.

China Interbank Bond Market (CIBM): an OTC market outside the Shanghai and Shenzhen stock exchanges. The major instruments traded in the CIBM are Chinese government bonds, PBOC bills, Policy Bank bonds and others.

Chinese A-Shares: a class of securitized common stock in Chinese companies, traded exclusively on Chinese stock exchanges (i.e., Shanghai and Shenzhen), and denominated in renminbi, China's currency. Historically, A-shares were inaccessible to foreign investors, but more recently China has allowed foreign investors to purchase A-shares through the Qualified Foreign Institutional Investor (QFII) program and the Stock Connect programs.

Depositary Receipt (DR): receipt for the shares of a foreign-based corporation held by a bank. The receipt usually entitles the shareholder to all dividends (excluding withholding) and capital gains. Depositary receipts (DRs) can be offered in many countries and are labeled according to the country where trading occurs, such as American Depositary Receipts (ADRs). DRs make it easier for investors to purchase the shares of foreign companies by reducing the administration and duty costs that would otherwise be levied on a cross-border transaction.

Foreign Direct Investment (FDI): investment in domestic businesses by foreign citizens.

Foreign Portfolio Investment (FPI): investment in securities and other financial assets by foreign investors that does not result in a controlling ownership interest.

Liquidity: the ability to buy or sell an asset readily and with reasonable volumes without affecting the asset's price.

Market Capitalization: the value of a corporation as determined by the market price of its issued and outstanding common stock. It is calculated by multiplying the number of outstanding shares by the current market price of a share.

Qualified Foreign Institutional Investor (QFII): a program that permits certain licensed global institutional investors to participate in China's renminbi-based mainland capital markets, subject to a quota.

Stock Connect: trading links that allow offshore, non-domestic-Chinese investors and entities to invest in Chinese A-shares listed on the Shanghai and Shenzhen Exchanges. Investment via the Stock Connect occurs through a special mechanism that was designed and implemented by the Hong Kong Stock Exchange. The Stock Connect also allows Mainland China investors to purchase certain Hong Kong-listed stocks via accounts with the Shanghai and Shenzhen Exchanges.

Variable Interest Entity (VIE): a legal structure created in order to facilitate investment by foreign companies into domestic companies in industries with foreign ownership restrictions.

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