THE CHINA EFFECT

WHY DUAL-LISTED CHINESE SHARES ARE PRICED DIFFERENTLY ON THE SHANGHAI (A-SHARE) AND HONG KONG STOCK MARKETS (H-SHARE)

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THE CHINA EFFECT

AN INTRODUCTION

Despite ongoing financial reforms and the renminbi (RMB) internationalisation, one of the most striking and enduring inefficiencies in China's capital markets remains the valuation gap between A-shares and H-shares. These dual-listed equities issued by the same companies and offering identical claims to cash flows are frequently priced very differently on the Shanghai (A-share) and Hong Kong (H-share) stock exchanges.

This anomaly challenges classical notions of market efficiency and persists across sectors and cycles. Empirical analysis across a representative sample of dual-listed firms shows that A-shares, on average, trade at a 37.5% premium, with 92% of firms sampled exhibiting higher valuations on the Shanghai exchange than in Hong Kong. Yet the reasons for this persistent distortion are deeply embedded in China's financial system's structure, psychology, and governance.

WHY THE A/H SHARE PREMIUM PERSISTS—DESPITE REFORM

Over the last two decades, China has made measured attempts to liberalise its capital markets. Despite these reforms, the pricing gap remains. Liberalisation in China is controlled and incomplete. Local investors face restrictions in accessing H-shares, and foreign investors are subject to quotas, licensing schemes, and opaque regulatory regimes when investing in A-shares.

While financial reforms have been encouraged, they are often reversed during periods of volatility or political sensitivity, highlighting the non-linear and policy-dependent nature of China's capital markets. The dual-track nature of reform creates a "two-speed" equity market that undermines price convergence

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THE DUAL-TRACK NATURE OF REFORM CREATES A "TWO-SPEED" EQUITY MARKET THAT UNDERMINES PRICE CONVERGENCE

THE INVISIBLE HAND OF THE STATE IN MARKET PRICING

China's stock exchanges operate under a fundamentally different premise. They are state-owned and guided by the China Securities Regulatory Commission (CSRC), serving broader policy objectives such as social stability and industrial planning.

Government or quasi-government entities hold the majority of shares in every sampled dual-listed company. This dominance affects supply, demand, and investor psychology. With limited free-float shares available, A-share prices are influenced by scarcity, state signals, and speculation.

> *"The government frequently intervenes in markets—through IPO suspensions, changes in transaction taxes, or capital injections—injecting a policy premium into A-share pricing"*

INFORMATION ASYMMETRY AND CAPITAL CONTROLS CREATE STRUCTURAL FRICTION

Valuation discrepancies stem from asymmetrical access to information. H-shares are subject to stricter disclosure and international accounting standards. A-shares, by contrast, often provide limited transparency.

Research by Li, Brockman, and Zurbruegg (2015) confirms that H-shares incorporate significantly more firm-specific information. Capital controls prevent seamless arbitrage. While Stock Connect and QFII programs provide access, they limit short-selling and cross-border fund mobility, reducing convergence.

IS THE A/H PREMIUM AN ARBITRAGE OPPORTUNITY?

The valuation gap seems like a textbook arbitrage opportunity. However, structural barriers limit its exploitation:

- **Capital Controls**: Restrictions on short-selling A-shares and moving capital across borders.
- **Ownership Restrictions**: Mainland retail investors face hurdles accessing H-shares.
- **Regulatory Uncertainty**: Sudden changes in trading rules derail arbitrage strategies.
- **Liquidity and Execution Risk**: H-shares often trade with less volume.
- **Tax and Currency Risk**: Varying tax treatments and FX exposure.

Thus, while the spread exists, arbitrage is largely **inaccessible to most investors**. The pricing anomaly persists not because it's undiscovered, but because it can't be easily closed.

WHEN A-SHARES UNDERPERFORM EVEN BANK DEPOSITS

A revealing inefficiency is that many A-shares yield less in dividends than bank deposits. In over a third of sampled stocks, dividend yields fall below 1-year deposit rates.

This suggests low marginal efficiency of capital and supports Keynes' theory: investment is not always based on rational return calculations, but on confidence, psychology, and speculative behaviour, especially in state-influenced environments.

WHAT PORTFOLIO MANAGERS CAN LEARN FROM KEYNES AND MARKOWITZ

- **Keynes**: The beauty contest analogy explains speculative pricing, where investors guess not the real value of a stock but the popular opinion collective of the stock price. This is visible in A-share speculation.
- **Markowitz**: Portfolio diversification reduces unsystematic risk, but in China, state dominance makes diversification less effective. Political risk is systemic.
- **Miller & Modigliani**: Their dividend irrelevance theory falters here. With many A-shares yielding below bank rates, the dividend policy does impact investor behaviour.

These theories show why **standard financial models fall short** in the Chinese context of state-controlled capitalism.

CONCLUSION

The A/H-share premium is not merely a mispricing anomaly—it is a reflection of China's unique brand of managed capitalism. While traditional theory would interpret this as an arbitrage opportunity, in reality, it is an institutionalised outcome of market segmentation, state intervention, and regulatory control.

Understanding the A/H-share gap is not just useful for pricing equities, but essential for grasping how capital markets function in an emerging superpower that blends state control with market dynamics.

If you would like the full story or want to know more about Chinese stock markets, please send me an email: Neville.Edwards@we-henley.online