

SHOULD ETF INVESTORS BE WORRIED ABOUT THE DELISTING OF CHINESE EQUITIES?

Liqian Ren — Director of Modern Alpha
12/17/2020

On December 2, 2020, the House of Representatives voted to pass the Holding Foreign Companies Accountable Act, which passed the Senate in May. President Trump is expected to sign it into law.

Back in August, I broke down six reasons why I believe [the impact of Chinese equities delisting is insignificant](#) and secondary to the fundamental [earnings](#) factors that drive the performance of Chinese equities. The risk to Chinese equities from delisting—particularly the [non-state-owned](#) segment—is minimal.

The competitive landscape between of the U.S. and China still exists. The U.S.'s market efficiency, work ethic, freedom of speech and well-tested legal system is still a formidable advantage and attraction to foreign companies. But whether, and how, this issue is resolved is a good signal to watch regarding U.S.-China economic dynamics over the next four years.

To answer my question from the title, in short: no. Here are a few things to keep in mind around these recent announcements.

1. The Bill Provides a Three-Year Window for U.S.-China Negotiations.

The bill gives companies three years to become compliant. This is crucial, because in absence of a U.S.-China compromise, the natural home for delisted companies such as Alibaba Group Holding and Baidu is the Hong Kong Stock Exchange (HKSE), which has actively courted them to dual-list their shares.

Larger companies such as Alibaba, JD.com and NetEase have already finished dual-listing in Hong Kong and New York, and several other companies are preparing to do the same. HKSE has relaxed its rules to allow companies such as Alibaba and JD.com to dual-list, but it still has more stringent listing rules than U.S.-based exchanges.

Listing on HKSE requires a minimum market cap of HK\$40 billion (\$5.16 billion), or HK\$10 billion (\$1.29 billion) with revenue of more than HK\$1 billion (\$130 million).

There are about 150 small Chinese companies that could potentially be forced to delist from the U.S. that may not be able to list in HKSE. Within the WisdomTree China ex-State-Owned Enterprises Index, which targets more large- and mid-cap Chinese companies, the smallest company has a market cap of about U.S. \$1.5 billion as of now. In the worst-case scenario of all Chinese companies delisting from U.S. exchanges, less than 1% of the Index weight could potentially fall into this category.

Even now that the delisting law is forecast to become official, Chinese companies continue to list in the U.S., showing the attractiveness of the U.S. financial and legal system.

For example, Chinese dating app company BlueCity had its [IPO](#) in the U.S. in July. It gave investors renewed hope and confidence that this issue would be resolved.

The dispute is now focused on who has the power to audit the auditors such as Ernst&Young-China, Public Company Accounting Oversight Board (PCAOB) or China's equivalent organization.

Before the trade war in 2017, China and the U.S. were already testing a potential solution that would allow both regulators to have authority. PCAOB did an audit test run in tandem with its Chinese equivalent, though was not entirely satisfied with the process. With a new administration in the U.S. in 2021, this issue is highly likely to achieve satisfactory compromises on both sides.

2. ETFs Are Impacted Differently Than Individual Stocks, and WisdomTree Is Already Trading HK shares Where

Liquidity Is Sufficient

That brings us to the second point. If these companies already have dual listings by the time the law passes, investors in exchange-traded funds (ETFs) that seek to track indexes—such as the [WisdomTree China ex-State-Owned Enterprises Index \(CHXSOE\)](#)—wouldn't even notice the impact on their portfolios.

A swap of New York Stock Exchange (NYSE) shares for Hong Kong shares would most likely be treated as a corporate action, which portfolio managers deal with daily. For investors who directly own those stocks, it may be a bit more complicated, depending on how their brokerages handle corporate actions.

WisdomTree has already started trading the HK shares of dual-listed companies where liquidity is sufficient. For an ETF investor, this is already happening in the background. For individual investors, swapping the U.S. share for a Hong Kong share will be a taxable [capital gains](#) event in regular accounts. The tax advantage of the ETF structure shines through in events like this.

3. The Role of the PCAOB

The history of the PCAOB is as much about regulatory power as protecting investors from fraud; it was created in response to the 2001 Enron scandal. Enron's auditor is believed to have colluded with the company to manipulate and falsify its accounting records.

The PCAOB is supposed to be the auditor's auditor, regulating accounting companies such as Ernst & Young (EY) and PricewaterhouseCoopers (PwC).

The current issue is this: does a Chinese company such as Alibaba fall under the regulatory jurisdiction of the U.S. PCAOB because it is listed on the NYSE, or under the Chinese equivalent of the PCAOB because it is a Chinese company?

Most of the Chinese companies listed on the NYSE use the Chinese branches of the Big Four U.S. auditors. Chinese firm Luckin Coffee—which has been accused of committing accounting fraud—used EY as its auditor. But most news articles missed the fact that EY didn't certify Luckin's recent annual report, which is believed to have covered the period when the fraud allegedly occurred. Presumably for legal reasons, EY has been silent on whether its auditing independently uncovered fraud. Emerging markets companies generally carry a [valuation](#) discount for the possibility of accounting fraud, so it is not evident that delisting would help protect U.S. investors.

4. Other Regulatory Risks in Chinese Equities (Besides Delisting)

Chinese equities have other risks beyond delisting. If U.S. public opinion were to turn sharply against China—if, for example, an investment in any Chinese stock was seen as analogous to investing in South Africa during the apartheid era—then there would be substantial divestment, which could lead to lower valuations.

So far, that kind of opinion has not translated into mainstream investment actions. **Based on most of the sanctions imposed to date, the non-state-owned segment of the Chinese equity market is likely to be less politically controversial than banks or state-owned energy firms.** The latest White House executive order forbidding investment in some Chinese equities with military ties was also mainly directed toward state-owned companies.

Chinese technology companies also face relentless headwinds from Chinese regulators, such as Ant Group's IPO debacle and China's platform antitrust regulations released in November for comments. On December 14, subsidiaries of Alibaba and Tencent were fined the maximum amount allowed of 500,000 RMB (about \$77,000) for not filing for their acquisitions. Around the same time, Alibaba, JD, Meituan, Pinduoduo, etc., were sternly warned by the People's Daily against getting into the community grocery group shopping business, with the implication that these tech giants are threatening jobs of generally lower skilled local grocery workers.

In a separate, more detailed, Market Insight article, I lay out the legal and social history behind the antitrust issue and continue to argue that these headwinds are headline grabbing, but not of significant risk to China's tech and consumer discretionary sectors. Part of doing business in China is the challenge of whether/how much to accept and manage the constraints of opaque regulatory risk.

5. Potential Outcomes of a Reciprocity-Based Strategy

Based on the U.S. response to Chinese restrictions on airline travel between the two countries this year, as well as executive actions and legal challenges against TikTok and WeChat, a theme of reciprocity in market access seems to be driving economic conflicts.

This reciprocity-based strategy does not suggest a dramatic escalation of U.S.-China financial conflict over the next four years or so, such as forbidding U.S. investors from investing in any Chinese equity, whether listed on the HKSE or the Chinese mainland.

The hope—the belief—is still that the U.S. and China will work out some issues based on mutual benefits and common ground, with a whack-a-mole game of broad economic and political conflicts persisting decades down the road.

We can only follow Winston Churchill's advice: "It is a mistake to try to look too far ahead. The chain of destiny can only be grasped one link at a time."

6. The Primary Factor (Expected Earnings Growth Rate) Driving Chinese Equities Has Not Changed

The final point is that the primary factor driving Chinese equities is their expected earnings growth rate and whether actual growth supports current valuations.

Pinduoduo, an e-commerce company that directly competes with Alibaba and JD.com, has seen heavy [volatility](#) recently. It delivered high growth, but sometimes not as much as the Street had hoped given its rich valuation. The top non-state-owned Chinese firms, which are the most vibrant segment of the Chinese economy, have delivered significant sales growth compared to top U.S. firms in the [S&P 500](#).

Future earnings and stock price increases of these companies will come from both U.S. and Chinese economic growth continuing to support global growth.

CHXSOE: Top 10 Firms (Comm. Services, IT & Cons. Discretionary Sectors)"			
Company Name	Index Weight	Annualized Sales Growth (3 Years)	Annualized Sales Growth (5 Years)
Full Index		17.90%	18.00%
Tencent Holdings Ltd.	12.30%	27.00%	34.10%
Alibaba Group Holding Ltd.	9.40%	42.30%	43.30%
Meituan Class B	5.70%	NA	NA
JD.com, Inc. Sponsored ADR Class A	3.50%	26.40%	30.70%
NIO Inc. Sponsored ADR Class A	2.10%	NA	NA
NetEase, Inc. Sponsored ADR	2.10%	9.50%	27.60%
Pinduoduo, Inc. Sponsored ADR Class A	2.00%	NA	NA
Baidu, Inc. Sponsored ADR Class A	2.00%	8.90%	8.80%
Xiaomi Corp. Class B	1.70%	NA	NA
TAL Education Group Sponsored ADR Class A	1.30%	40.70%	48.20%
Top 10 Total/Median Sales Growth	42.00%	26.70%	32.40%

S&P 500 Index: Top 10 Firms (Comm. Services, IT & Cons. Discretionary Sectors)			
Company Name	Index Weight	Annualized Sales Growth (3 Years)	Annualized Sales Growth (5 Years)
Full Index		3.90%	4.10%
Apple Inc.	6.40%	6.20%	3.40%
Microsoft Corporation	5.40%	16.30%	10.20%
Amazon.com, Inc.	4.50%	29.20%	28.20%
Facebook, Inc. Class A	2.20%	29.40%	37.70%
Alphabet Inc. Class A	1.80%	18.00%	19.30%
Alphabet Inc. Class C	1.70%	18.00%	19.30%
Visa Inc. Class A	1.20%	6.00%	9.50%
NVIDIA Corporation	1.10%	18.10%	25.30%
Home Depot, Inc.	1.00%	8.20%	8.00%
Mastercard Incorporated Class A	1.00%	9.30%	10.30%
Top 10 Total/Median Sales Growth	26.20%	17.20%	14.80%

Sources: WisdomTree, FactSet, as of 11/30/20.

¹<https://www.scmp.com/tech/e-commerce/article/3113892/community-group-buying-groceries-surges-china-vast-market-size>

Important Risks Related to this Article

Neither WisdomTree Investments, Inc., nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax advice. All references to tax matters or information provided in this material are for illustrative purposes only and should not be considered tax advice and cannot be used for the purpose of avoiding tax penalties. Investors seeking tax advice should consult an independent tax advisor.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Core Earnings : Income generated by the company's daily operations rather than one-time events or market fluctuations.

Ex-SOEs : ex-state owned enterprises or companies that are neither wholly or partially owned and operated by a government.

Initial public offering (IPO) : The first sale of stock by a private company to the public.

Capital gains : Positive difference between the sale price of an asset and the original purchase price.

Valuation : Refers to metrics that relate financial statistics for equities to their price levels to determine if certain attributes, such as earnings or dividends, are cheap or expensive.

Volatility : A measure of the dispersion of actual returns around a particular average level. nbsp;.

S&P 500 Index : Market capitalization-weighted benchmark of 500 stocks selected by the Standard and Poor's Index Committee designed to represent the performance of the leading industries in the United States economy.