

A Review of Hong Kong Securities Market Performance in 2007

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Summary

1. *The Hong Kong securities market during 2007 was generally bullish underpinned by strong corporate earnings, implementation of the QDII scheme, the proposed “Through Train” scheme and solid Mainland economic performance. However, towards the end of the year, market volatilities rose on worries over a recession in the US, subprime-related investment losses and tightening policies in the Mainland.*
2. *Trading in the cash market was very active during 2007, with average daily turnover rising 160% to HK\$88 bn. Based on an internal study of the trading patterns, it is estimated that:*
 - *institutional investors accounted for 63% of the trading activities and remained the largest group of investors in the Hong Kong market, while retail investors had a market share of about 37%. Although smaller in terms of trading activities, the retail group, which comprises a larger number of investors, was a major segment of the Hong Kong market.*
 - *despite the growth in turnover during 2007, the market shares of institutional and retail investors remained largely stable. A few exceptions were however observed on certain days in March, August and November when the markets corrected and became more volatile. On those days, the market share of institutional brokers stood higher.*
3. *Trading in derivative warrants increased in 2007, with average daily turnover rising 163% to HK\$19.1 bn. This accounted for 22% of the total market turnover. In terms of underlying assets, the trading of derivative warrants in 2007 was more diversified and included index warrants and stock warrants issued on Mainland stocks.*
4. *Trading and open interests in derivative contracts increased, lifted by stock options and HSCEI futures. The increase was very much in line with the underlying market.*
5. *Fund raising activities were active with 80 IPOs in 2007. Hong Kong was the fourth largest IPO centre in 2007, after New York, Shanghai and London. The IPOs were in general well-received with high over-subscription ratios.*

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2007 – A Year of Solid Growth

6. The Hong Kong securities market recorded strong growth during the year. As of the end of 2007, 1,241 companies were listed on HKEx with a market capitalisation of HK\$20.7 trillion. The total turnover of the cash market reached a record of HK\$21.7 trillion. The single-day turnover on 3 October 2007 reached a record high of HK\$211 bn. Both the HSI and HSCEI rose to record high levels during the year. Trading activities and the open interests in the derivative markets grew in line with the underlying market and reached record high levels.

Major Statistics in 2007				
	As of end 2007	Record Highs during 2007	As of end 2006	% change from 2006
No. of Listed Companies	1,241	Record High	1,173	+5.8%
Market Capitalisation	HK\$20,698 bn	HK\$23,197 bn on 30/10/07	HK\$13,338 bn	+55.2%
Total Turnover	HK\$21,669 bn	Record High	HK\$8,376 bn	+158.7%
Average Daily Turnover	HK\$88.1 bn	HK\$211 bn on 3/10/07	HK\$33.9 bn	+159.9%
HSI	27,813	31,638 on 30/10/07	19,965	+39.3%
HSCEI	16,124	20,400 on 30/10/07	10,340	+55.9%
No. of Derivative Warrants	4,483	Record High	1,959	+128.8%
<i>Average Daily Turnover</i>	HK\$19.1 bn	Record High	HK\$7.2 bn	+165.3%
<i>Market Share of Trading</i>	21.7%	-	21.4%	-
Derivative contracts traded	87,985,686	Record High	42,905,915	+105.1%
IPO Funds Raised	HK\$290.6 bn	-	HK\$333.9 bn	-13.0%

Source: SFC Research

Overview of Global Market Performance in 2007

7. During 2007, major equities markets were generally bullish, but market volatility increased. The benchmark indices of most markets rose to fresh record highs or multi-year highs during the year, driven by solid economic performance and robust corporate earnings. In the second half of 2007, the interest rate cuts by the US Fed also contributed to market gains. Nevertheless, major markets around the globe experienced three periods of major corrections in March, August and November due to fallouts from the subprime mortgage markets in the US, subsequent liquidity drain in the credit market and uncertainties over the global economic outlook.
8. During 2007, benchmark indices of most major markets advanced. In the US, the Dow and Nasdaq rose 6.4% and 9.8% respectively. Most Asian markets outperformed. The performance of Mainland markets topped other markets, with the Shanghai Composite Index and Shenzhen Composite Index surging 97% and 163% respectively. The performance of Hong Kong markets, particularly H-shares, outperformed most markets. The HSI and HSCEI gained 39% and 56% respectively.

Performance of Major Indices						
		Index Level		% change (end 2007/end 2006)		PE Ratio end 2007
		end 2007	Year's High	in local currency	in USD	
Hong Kong	-HSI	27,813	31,638 (Record high)	39.3%	38.9%	21.07
	-HSCEI	16,125	20,400 (Record high)	55.9%	55.5%	24.54
	-HSCCI	6,111	7,021 (Record high)	83.5%	83.0%	29.33
	-H-FIN	18,121	23,738 (Record high)	40.1%	39.7%	30.08
China	-Shanghai Composite	5,262	6,092 (Record high)	96.7%	110.3%	59.24
	-Shenzhen Composite	1,447	1,551 (Record high)	162.8%	181.1%	72.11
US	-Dow	13,265	14,165 (Record high)	6.4%	6.4%	57.63
	-Nasdaq	2,652	2,859 (7-year high)	9.8%	9.8%	37.68
	-S&P	1,468	1,565 (Record high)	3.5%	3.5%	18.25
Europe	-FTSE100	6,457	6,732 (8-year high)	3.8%	5.2%	11.83
	-DAX	8,067	8,106 (Record high)	22.3%	35.2%	13.64
	-CAC	5,614	6,168 (7-year high)	1.3%	12.0%	13.37
Japan	-Nikkei 225	15,308	18,262 (7-year high)	-11.1%	-5.3%	16.44
Australia	-AOI	6,421	6,854 (Record high)	13.8%	26.3%	15.49
Singapore	-STI	3,482	3,876 (Record high)	16.6%	24.3%	12.76
Taiwan	-TWSE	8,506	9,810 (7-year high)	8.7%	9.3%	19.17
Korea	-KOSPI	1,897	2,065 (Record high)	32.3%	31.4%	16.00
India	-Nifty	6,139	6,159 (Record high)	54.8%	73.8%	26.49
Thailand	-SET	858	915 (12-year high)	26.2%	50.2%	12.63
Malaysia	-KLCI	1,445	1,447 (Record high)	31.8%	40.6%	16.07
Indonesia	-JCI	2,746	2,811 (Record high)	52.1%	45.5%	18.22
Philippines	-PCOMP	3,622	3,874 (Record high)	21.4%	44.3%	15.20

Source: Bloomberg

Review of Local Market Performance

9. In 2007, the Hong Kong markets extended their 4-year rise which started from mid-2003, only with brief corrections in March, August and November 2007. Hong Kong listed Mainland stocks outperformed, supported by funds inflow, good corporate earnings, strong economic growth in the Mainland and a gradual, continuous appreciation of the RMB. The proposed “Through Train” scheme lifted the market further. The HSI and HSCEI rose to fresh record highs of 31,638 and 20,400 respectively in late October. However, in November 2007, the markets consolidated again. As at the end of 2007, the HSI and HSCEI had dropped 12% and 21% from their record highs, but remained 39% and 56% higher than the end 2006 levels.

Markets Corrected in March but Rebounded Quickly

10. From late February to early March 2007, market attention turned to the accelerating delinquency rate of US subprime mortgages. The HSI dropped to its year-low of 18,665 in early March. The markets soon rebounded strongly on the back of solid economic performance in the US and climbed back to a high level by late July.

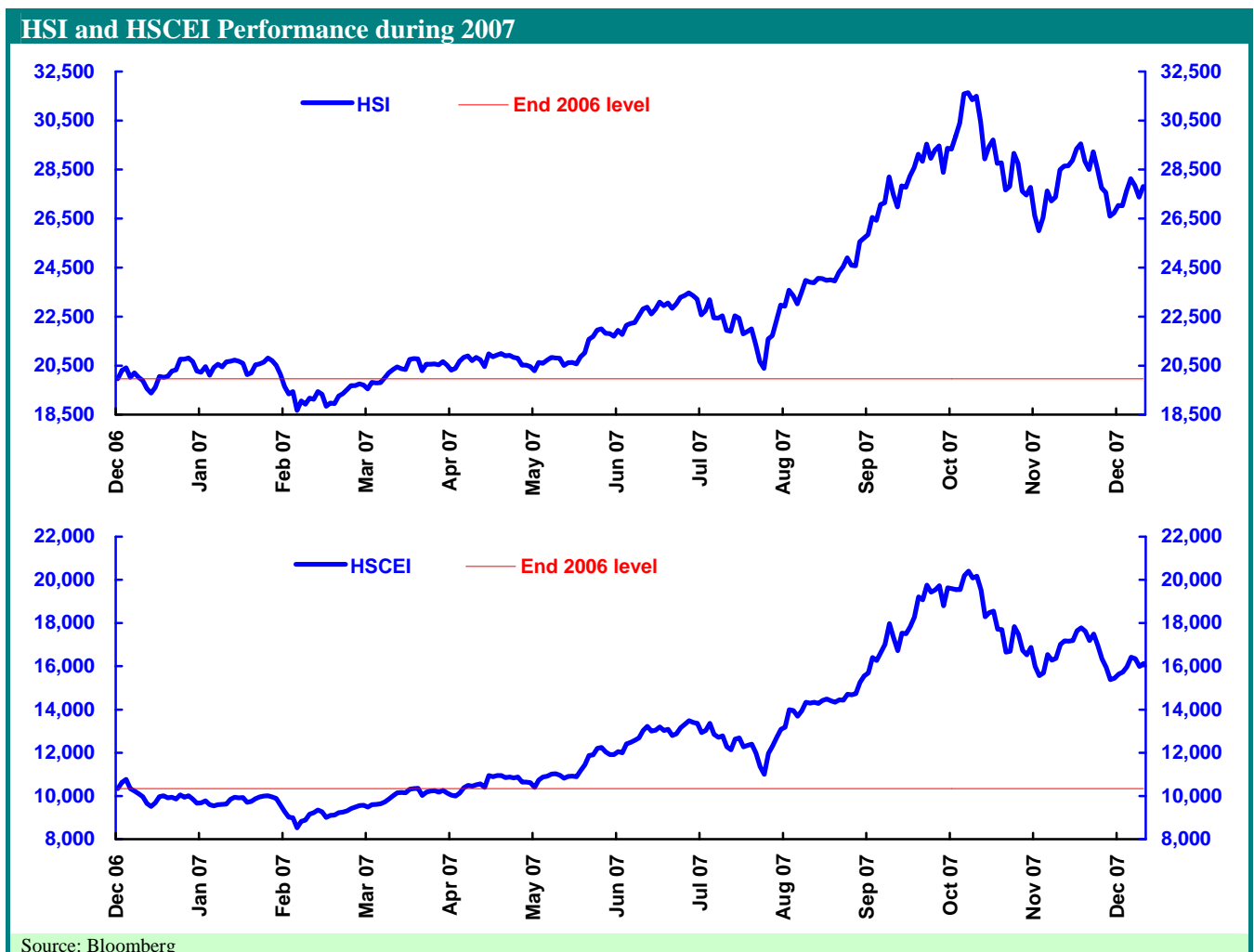
Markets Corrected in August, but Rebounded Strongly to Fresh Record Highs in September and October

11. From late July to mid August 2007, markets consolidated on revived concerns about the subprime mortgage problem. A number of funds in the US and Europe reported huge losses from investments in mortgage-related collateralised debt obligations.

Some funds also imposed redemption restrictions. Credit concerns led to liquidity drain in the banking system. In early August 2007, central banks in the US, Europe, Australia and Japan injected billions of dollars into the banking system. After the US Fed cut interest rates in September and October 2007 by a total of 75 basis points to 4.5%, markets in Hong Kong staged a major rebound. Within two months the HSI surged 55% to a record high of 31,638 on 30 October 2007. Another factor leading to the surge included the announcement in late August 2007 by Mainland authorities of the proposed “Through Train” scheme, which would allow individual Mainland investors to invest in Hong Kong stocks.

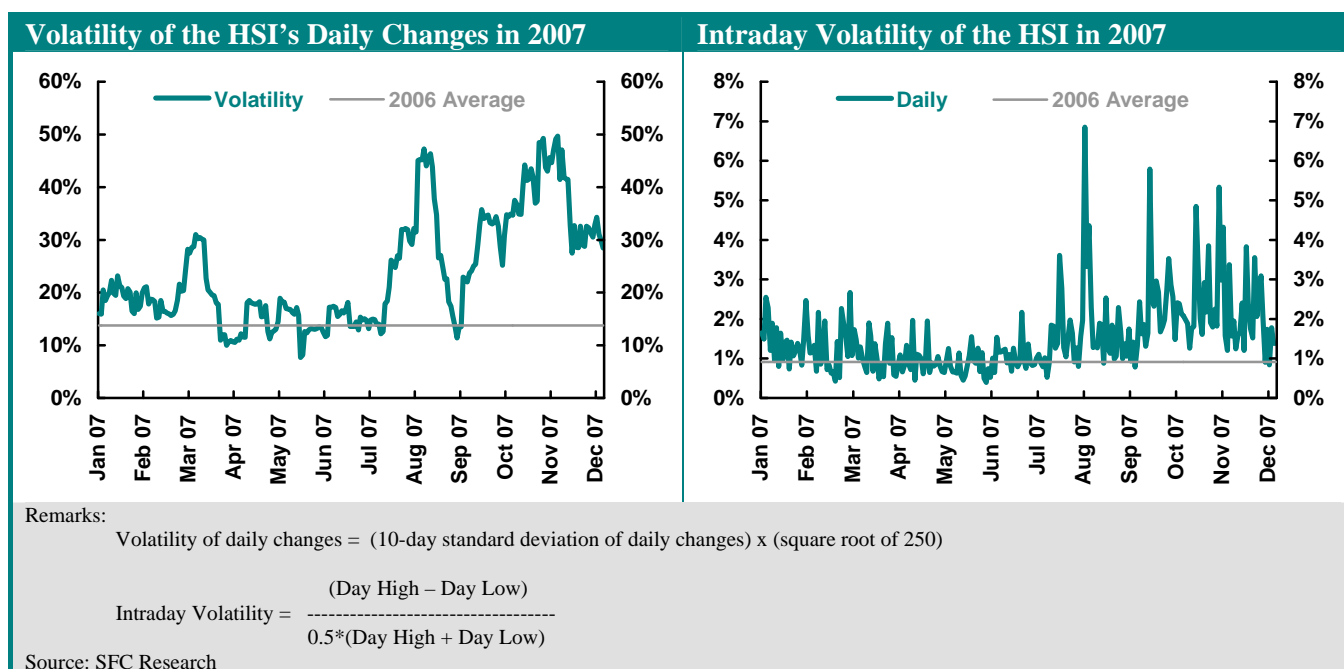
Markets Declined Again in November and December

- Local markets declined during November and December 2007 due to worries about monetary tightening in the Mainland and larger-than-expected write-downs by financial institutions in the US relating to subprime mortgages.



Increasing Market Volatility

13. Along with advances made in the local markets during 2007, market volatility rose to a 6-year high. The volatility of the HSI's daily changes and intra-day volatility rose to an average of 24% and 1.5% respectively in 2007, compared to the respective averages of 13% and 0.9% in 2006.

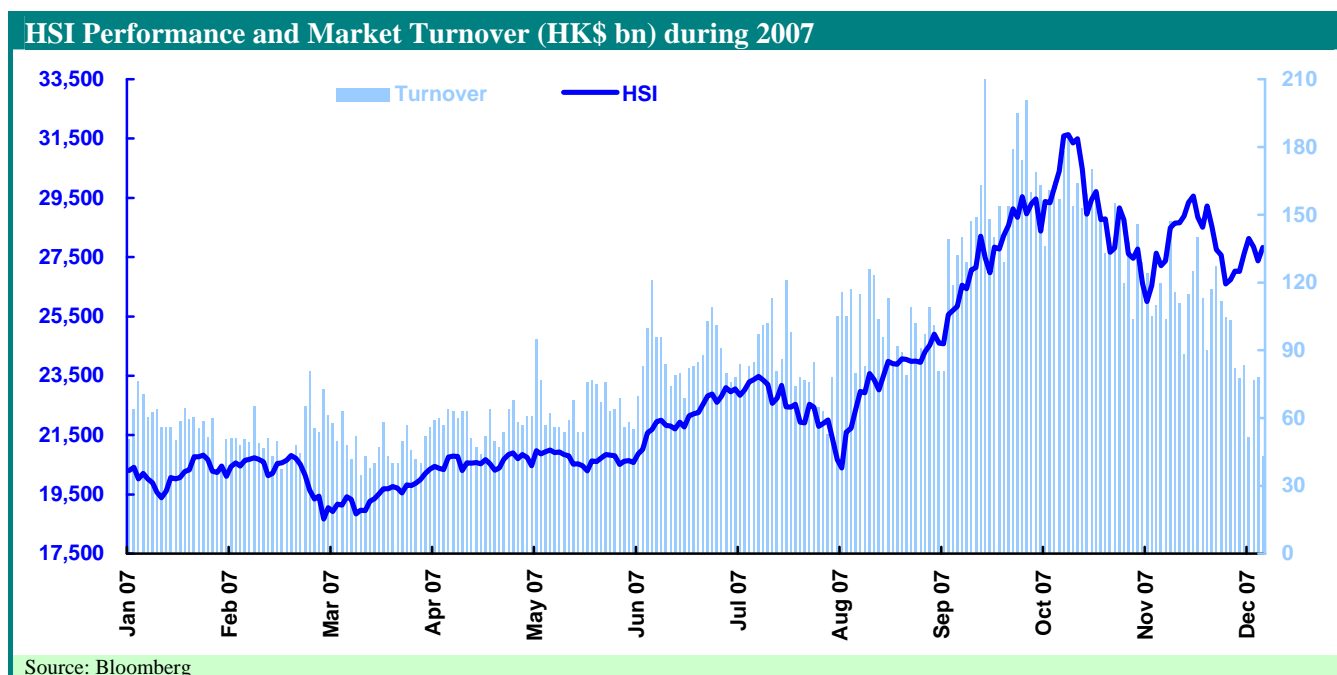


Trading Patterns of Institutional and Retail Investors in the Cash Market During 2007

14. Trading in the Hong Kong cash market was very active in 2007. Average daily turnover rose by 160% to HK\$88.1 bn compared to HK\$33.9 bn in 2006. By stock types –
- trading in Mainland stocks (i.e. H-shares and red chips) surged by 190% during 2007 and its market share of the total turnover rose to 49%;
 - trading in HSI constituents (excluding H-shares and red chips) rose by 78% and accounted for 14% of the total turnover;
 - trading in derivative warrants increased by 165% and accounted for 22% of the total turnover; and
 - trading in other stocks increased by 176% and accounted for 16% of the total turnover.

Average Daily Turnover (HK\$ bn) and Market Share (%)			
	2007	2006	% change from 2006
HSI constituents (ex H shares & red chips)	12.1 (13.7%)	6.8 (20.1%)	+78%
Mainland Stocks	42.7 (48.5%)	14.7 (43.4%)	+190%
<i>H-shares</i>	31.6 (35.9%)	10.3 (30.3%)	+208%
<i>Red chips</i>	11.1 (12.6%)	4.5 (13.1%)	+150%
Derivative Warrants	19.1 (21.7%)	7.2 (21.4%)	+165%
Other Stocks	14.2 (16.1%)	5.1 (15.1%)	+176%
Market Total	88.1 (100%)	33.9 (100%)	+160%

Source: HKEx



15. In the following paragraphs, we discuss the results of an internal study of the trading patterns of institutional and retail investors in Hong Kong. Since there is no available data on trading by different investor groups, their trading pattern is approximated by reference to the trading activities of different types of brokerages. The study is based on the following classification of brokerages and assumptions:

- Institutional investors are inclined to conduct transactions through international brokerages (with international business networks), such as investment banks, and their average deal size is relatively bigger.
- Retail investors tend to trade through domestic brokerages and commercial banks, and their average deal size is relatively smaller.

To the extent that actual practices may be different from the above assumptions, the estimates and analysis below are subject to limitations.

16. Based on the above classification and assumptions, in 2007, of the 425 brokerages –

- 32 were institutional brokers serving institutional investors – their average transaction size was about HK\$229,000; and
- 393 were retail brokers serving retail investors – their average transaction size was about HK\$86,500.

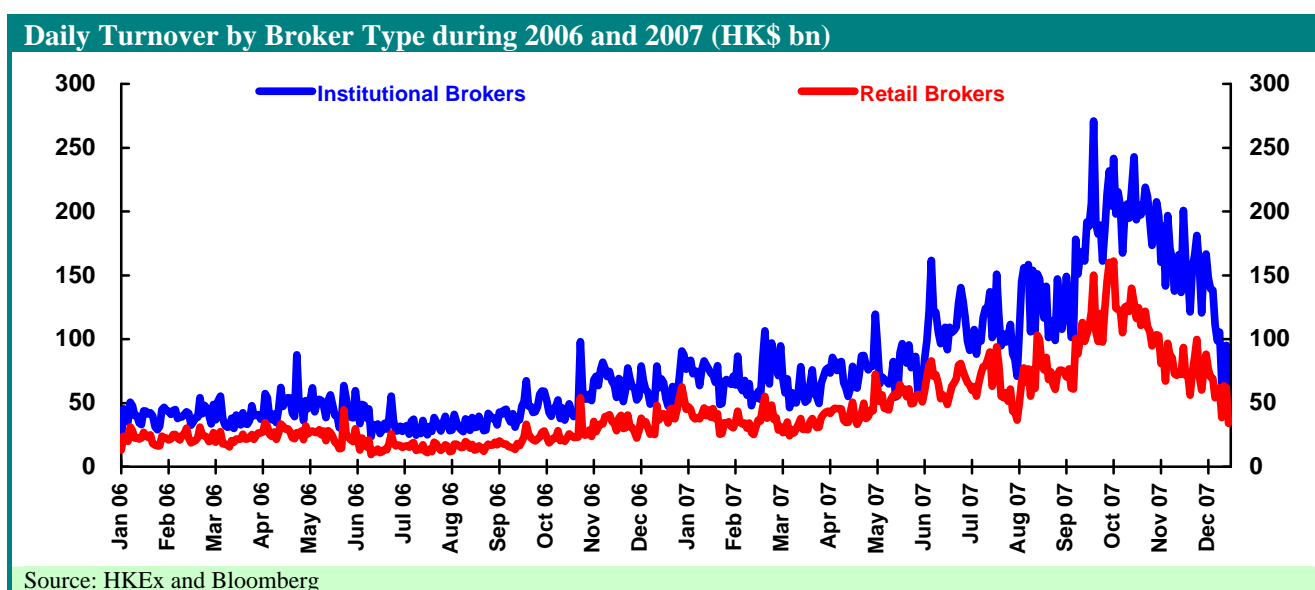
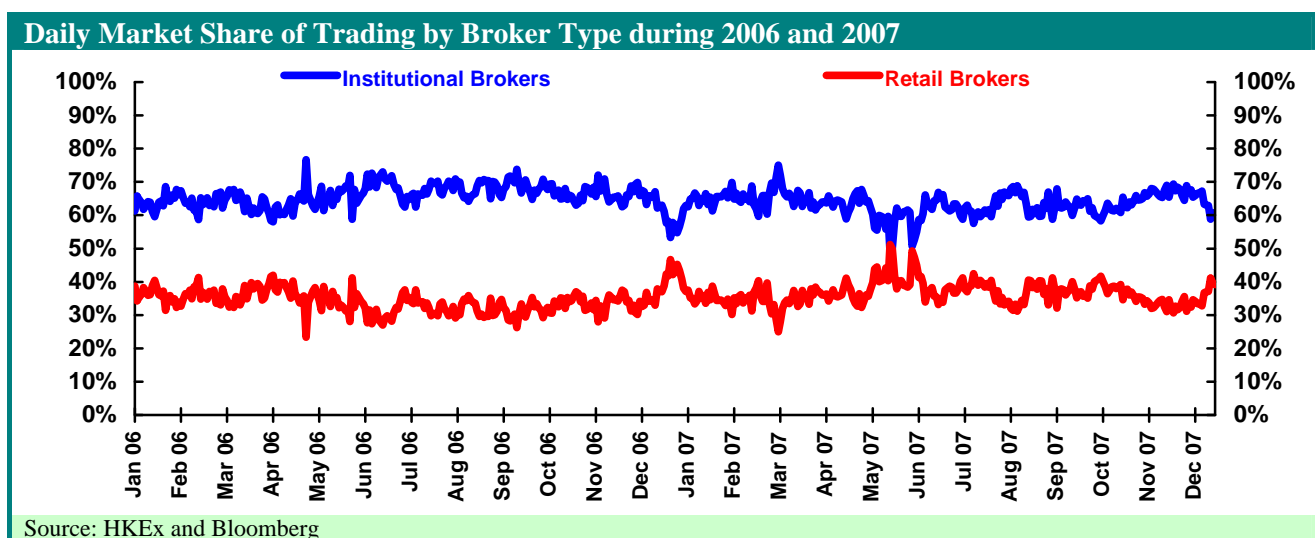
Average Daily Turnover and Average Deal Size of Brokers in 2007					
	Number of brokers ¹	Average Daily Turnover (HK\$ bn) ²	Market Share in Trading	Average Transaction Size (HK\$)	
Institutional Brokers	32	111.7	63.4%	229,201	
Retail Brokers	393	64.4	36.6%	86,487	
Overall	425	176.2	100%	142,936	

Remarks: 1. The brokers included in the study referred to those which had conducted trading during 2007.
2. Both buy and sell transactions are included.

Source: SFC Research

Overall Trading by Brokers

17. During 2007, institutional brokers accounted for 63% of the total trading value, and retail brokers 37%. The market shares of institutional and retail brokers had been stable, compared to 66% and 34% respectively in 2006. The study also showed that the market shares of institutional and retail brokers in the three stock classes (namely local HSI stocks, Mainland stocks and other stocks) had also been stable.
18. However, when the markets experienced higher volatility – in particular during the corrections in March, August and November 2007 – the market share of institutional brokers rose relative to that of retail brokers. This may be due to the fact that hedging and index arbitrage activities of institutional investors grew with market volatility because of increased hedging needs and more arbitrage opportunities, leading to an increase in their market share. In contrast, retail investors might have turned cautious at times of high market volatility, reducing their overall market share.



Trading of Brokers by Stock Type

19. By stock type, in 2007:
- Mainland stocks remained the most actively traded stocks among both institutional and retail brokers.
 - The market shares of trading in HSI stocks (excluding H-shares and red chips) decreased among both institutional and retail brokers.
 - The market shares of trading in derivative warrants among both institutional and retail brokers were stable.
 - Trading in other stocks (i.e. stocks other than HSI constituents, H-shares and red chips) among retail brokers increased significantly. This was in part attributable to active trading in newly listed stocks, especially during the first few days after their IPOs.

Market Share of Trading of Brokers by Stock Type in 2007 (and 2006)			
	Institutional Brokers		Retail Brokers
HSI constituents (excl H and Red)	17.3%	(23.1%)	7.6% (10.8%)
Mainland Stocks	50.3%	(43.5%)	44.4% (45.9%)
<i>H-shares</i>	37.1%	(30.8%)	32.9% (34.5%)
<i>Red chips</i>	13.2%	(12.8%)	11.6% (11.4%)
Derivative Warrants	21.1%	(23.1%)	21.3% (24.0%)
Others	11.3%	(10.2%)	26.7% (19.4%)
Overall	100%	(100%)	100% (100%)

Remark: Percentages in brackets show the corresponding market shares in 2006
Source: SFC Research

Derivative Warrants Market

20. Trading in derivative warrants grew significantly during 2007, with average daily turnover rising 163% to HK\$19.1 bn. As a percentage of total market turnover, however, it remained stable at about 22% (compared to 21% for 2006), and its daily market share ranged from 14% to 35%.
21. In terms of underlying assets, trading in derivative warrants in 2007 was more diversified between index warrants issued on the HSI and HSCEI and stock warrants issued on Mainland stocks. This was in contrast to 2006 when half of the trading of derivative warrants was concentrated in index warrants issued on the HSI.
22. As at the end of 2007, there were 4,483 derivative warrants listed on HKEx, representing a rise of 130% from the end 2006 level. Their total market value also rose – by 259% to HK\$50 bn – but still accounted for only 0.2% of the total market capitalisation.

Exchange-Traded Derivatives Market

23. Trading in the derivatives market was very active in 2007, with 88 million contracts being traded – a rise of 105% from 2006. This increase in derivatives trading was broadly in line with growth in the market capitalisation and turnover of the cash market. The growth in the trading of options contracts was particularly robust, rising 140% (compared to a 65% increase for futures contracts).
24. The strong growth in the options market was largely driven by a 150% increase in the trading of stock options which accounted for 83% of the total trading in options contracts. The surge in the trading of stock options was in turn driven by the relaxation of position limits on stock options in early 2006 and the narrowing of trading spreads on stocks in July 2005 and in July 2006. (For details, please see Research Paper 38 published in November 2007.)
25. In futures trading, HSI futures remained the most actively traded contract with trading volume increasing by 35% over 2006 and accounting for 52% of market transactions. HSCEI futures came second, with a market share of 33% and increase in trading volume by 122%. The high growth in HSCEI futures was mainly due to the strong interest in H-shares.
26. The open interests of most derivative products increased during the year. As at 31 December 2007, the total open interests of futures and options almost doubled their end 2006 levels. The increase was broadly in line with increases in the market capitalisation and turnover of the underlying markets.

Trading Volume of Derivatives by Product Type (Number of Contracts)				
		2007	2006	2005
Futures	HSI Futures	17,160,964	12,718,380	9,910,565
	Mini-HSI Futures	4,325,977	2,140,242	1,501,342
	HSCEI Futures	10,846,277	4,880,470	1,978,673
	Hang Seng China H-Fin Index Futures [#]	3,220	-	-
	FTSE/Xinhua China 25 Index Futures	3,244	8,154	2,882
	Stock Futures	351,514	102,010	13,069
	3-Month HIBOR Futures	31,678	13,888	24,935
	Other Futures products [*]	724	155	1,496
	Total Futures	32,723,598	19,863,299	13,432,962
Options	HSI Options	7,480,183	4,095,679	3,071,822
	Mini-HSI Options	69,512	53,456	30,595
	HSCEI Options	1,727,847	758,247	257,425
	FTSE/Xinhua China 25 Index Options	1,578	7,881	7,386
	Stock Options	45,982,968	18,127,353	8,722,393
	Total Options	55,262,088	23,042,616	12,089,621
Total Futures and Options		87,985,686	42,905,915	25,522,583

Remark: [#]Hang Seng China H-Fin Index Futures were launched on 16 April 2007
^{*}Includes One-Month HIBOR Futures and Three-year Exchange Fund Note Futures
Source: HKEx

IPO Activities and Performance in 2007

27. 2007 saw 80 IPOs raising a total of HK\$292.4 bn, making Hong Kong the fourth largest IPO market in the world, after New York, Shanghai and London. Nevertheless, the IPO funds raised in 2007 were 13% lower than 2006 in which there were a number of massive IPOs. During 2007, Hong Kong continued to be a fund-raising platform for Mainland companies. Privately-owned Mainland companies (Minyings) were particularly active in fund raising, accounting for 42% of the total funds raised. H-shares and red chips remained popular, making up 26% and 17% of funds raised respectively. The remaining 15% was accounted for by non-Mainland companies.
28. The IPOs were in general well-received and significantly over-subscribed, with robust performance on debut. On average, the closing prices on the first day of listing were 23% above the IPO prices with individual performance varying between a loss of 19% and a gain of 193%. The subsequent performance of these newly listed stocks was mixed. As at the end of 2007, the share prices of 41 IPOs were above and the other 39 were below their IPO prices, ranging from a loss of 69% to a gain of 266%.

Increasing Significance of Mainland Stocks

29. During 2007, the robust performance of and investors' interests in Mainland stocks (H-shares and red chips) have resulted in the increasing significance of Mainland stocks in the Hong Kong market. In 2007,
 - the market capitalisation of Mainland stocks accounted for 52% of total, rising from 47% as at the end of 2006;
 - the market share of Mainland stocks of trading activities rose to 48% from 43% in 2006;
 - the weighting of Mainland stocks in the HSI rose to 51% as of end 2007, from 41% as of end 2006; and
 - in the derivatives markets, both the trading and open interests of HSCEI futures contracts rose to record highs.

As at the end of 2007, 49 Mainland companies were dual-listed in both the A-share and H-share markets. These 49 companies accounted for 21% of both the total market capitalisation and turnover in the Hong Kong stock market. In addition, nine of these are constituents of the benchmark indices HSI and HSCEI. As Mainland factors become more important, the performance of the A-share markets will continue to impact on the Hong Kong market.

Conclusion

30. While the Hong Kong market recorded strong growth in 2007, factors such as economic development and interest rate movements in the US, capital flow, corporate earnings and the increasingly important Mainland factors will continue to impact on the performance of Hong Kong markets. This may in turn affect the participation of investors and issuers in various activities such as trading and fund raising.