**Asia Brief - Special Report: China's Rising Stock Market**
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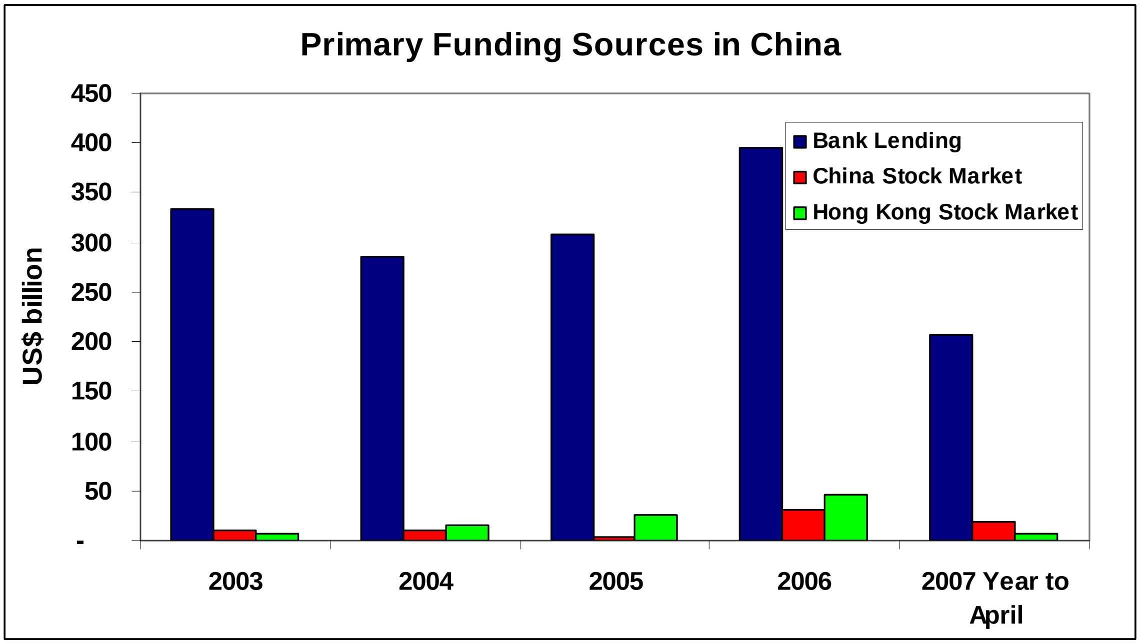
**In the sixteenth century China relinquished its position as the world's largest economy, a position it had held for much of recorded history. Now China is awake and the shaking is being felt across the world.**

The strength of China's stock markets continues to worry and amaze observers in equal measure, most recently in a thoughtful article by James T. Areddy on the front page of the Wall Street Journal on October 16. The concerns he raises about the speed of the rise, the valuation of stocks and the heavy retail involvement are all valid. He also raises the interesting point that the profits of many companies are being given a boost from gains these companies are making from their own stock investments, rather from operations. This is true. And we know this because the companies themselves disclose it.

But what does this mean for China's economy, Chinese investors and international investors?

The short answer in our opinion is that for China's economy the stock market plays only a minor role in driving growth. Relative to China Inc's overall funding needs the domestic stock markets supply less than 10%. Fund raising in China's stock markets grew substantially in 2006 which was more than six times the amount raised in 2005. This was attributable to a slew of initial public offerings as well as rights issues involving new share issuance to address the illiquid state owned shares in a number of companies. Nevertheless, the $31 billion raised in the Chinese stock markets is rendered almost trivial when compared to $396 billion increase in bank loans during 2006.




Sources: China Securities Regulatory Commission, BNP Paribas, UBS Securities Asia

For Chinese investors who for the most part are unable to invest outside China, the risks are all too real. For them, the range of investment opportunities is very limited. A six month bank deposit currently pays 3.42% interest. Bonds and life assurance yield little more. Until the Chinese are allowed to invest overseas, the only remaining investment options are domestic real estate and domestic stocks. Stocks rather than real estate have become the preferred destination for savings.

But we need to remember that although, as the Wall Street Journal article points out, the overall market value of stocks listed in Shanghai and Shenzhen is $3.7 trillion the amount of stock available for investment is one third of that. Around two-thirds of the market capitalization is not owned by individuals or corporations but is owned by the state and is locked away in the form of non-tradeable state shares. The combined free float makes the effective size of China's stock markets smaller than those of Hong Kong and Australia.

With Chinese insurance companies, fund companies, banks, industrial companies and individuals all chasing stocks and all obliged to keep their money in Renminbi and inside China, it is not a surprise that valuations are being pushed up to heavy levels.

International investors however, are able to buy Chinese companies listed outside China, in Hong Kong and the U.S. Indeed in Hong Kong international investors are able to buy *the very same companies* that domestic Chinese are buying into but at much lower valuations. There are 44 companies trading in Hong Kong which also have shares listed in Shanghai and in aggregate their Hong Kong-listed shares are trading at a 40% discount to those in Shanghai.

And this opens up another prospect. The Mainland authorities are aware of the precariousness of the recent domestic stock market strength and indeed have been trying to talk the market down in recent months. But they are also aware that the lack of alternative opportunities is also a factor and to that end they are opening channels for savings to be invested outside China. Under government auspices a number of domestic mutual funds have been permitted to raise funds specifically to invest overseas. Four have been launched. Last week the latest fund to be launched raised $9.3 billion in just one day. There are still quota restrictions on how much funds can invest overseas and so it was only allowed to keep $5 billion. Three more funds are expected this year and a further eighteen are waiting their turn over the course of 2008, many of which are joint ventures with overseas fund management groups.

So what conclusions can we draw?

Stock markets in China have gone up dramatically over the past two years and this does raise the prospect of a bubble. But this growth has been the result of a massive redeployment of savings and with a savings rate of around 40%, this pool is large.

New outlets for Chinese savings are now emerging with the result that the next few years should see a steady increase in the flow of Chinese capital into overseas markets whether from sovereign wealth funds, companies or individuals through mutual funds.

Chinese stocks, which are familiar names to these investors, will likely be the initial beneficiaries. And since as we have pointed out these are trading at much lower multiples of earnings, (28 times estimated earnings compared to 48 times estimated earnings in Shanghai) stocks trading in Hong Kong look much more attractive.
For international investors we need to look carefully at what we buy. The potential flow of money is large and is likely to be a fact of life for a while. Chinese economic growth remains strong and we want to ensure that we are buying into companies benefiting from this in the form of profits and cash from operations. We can see which companies are making more from securities purchases because of the disclosure regime in Hong Kong, and China for that matter, is good enough for us to see.

Ultimately, what we are seeing is a vindication of the rationale for launching the Guinness Atkinson China & Hong Kong Fund in 1994. The argument we made then is as good today as it was then, namely that we believe the correct way to invest in China is through Hong Kong. The rise of China is unstoppable and for investors who want to be a part of it, the road lies through Hong Kong.

Edmund Harriss

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Commentary for our views on Asia Pacific and energy markets is available on our website. Please click here to view.

**Performance data quoted represents past performance and does not guarantee future results. Index performance is not illustrative of Guinness Atkinson fund performance and an investment cannot be made in an index. For Guinness Atkinson Fund performance visit gafunds.com.**

**Mutual fund investing involves risk and loss of principal is possible. The Fund invests in foreign securities which involves greater volatility, political, economic and currency risks and differences in accounting methods. The Fund is non-diversified meaning it concentrates its assets in fewer holdings than diversified funds. Therefore, this Fund is more exposed to individual stock volatility than diversified funds.**

The Price to Earnings multiple reflects the multiple of earnings at which a stock or group of stocks in an index, sells. It is equal to the market capitalization of a stock, or group of stocks in a index, divided by the after tax earnings for that stock or index.

This information is authorized for use when preceded or accompanied by a prospectus for the Guinness Atkinson Funds. The prospectus contains more complete information, including investment objectives, risks, fees and expenses related to an ongoing investment in the Funds. Please read the prospectus carefully before investing.

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