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China ETF Prospects And Risks IShares China ETF Up Rallies 8% in three days after government reforms announced

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China's stock market and ETFs scaled new heights after the government announced sweeping financial and legal reforms in hopes of supercharging the already rapidly growing economy.

Investors are cheering the end of the one-child policy, pledges of more free-trade zones and increased access to public services, among many other improvements.

"The reform initiatives (despite some shortcomings) are rather comprehensive, and being a positive surprise to the market, it should be seen as a positive factor to China's long-term growth and financial stability outlook," Credit Suisse analysts wrote in a strategy report released Monday. "Near-term growth also showed signs of stabilization, which should be seen as positive to the cyclical sectors."

Analysts at Investazor.com, a trading news and analysis website, recommends holding Chinese stocks over the next three to six months. They reason that investors will opt for China over U.S. and European stocks because the Federal Reserve will have to taper its easy-money policies and the recent eurozone interest-rate cut may be insufficient in helping the economic recovery.

"It's such a big economy that influences consumption around the world, any new economic policy can influence and push the market into high volatility," Andrei Costescu, CEO of London-based Investazor.com, said in an email.

Among more than 30 ETFs offering exposure to the world's second-largest economy, iShares China Large-Cap (FXI) is the largest by assets. It's rallied 8% since Friday, when details of China's plan emerged.

FXI has returned about 1% after rallying from a 22% decline at midyear. IShares MSCI Emerging Markets Index (EEM) is down about 3% this year, while iShares MSCI EAFE Index (EFA), tracking developed foreign markets, is up 19%.

FXI holds only 26 stocks, with financials accounting for 56% of assets, telecom 16% and energy 12%.

Stocks in FXI trade at a cheap price-earnings ratio of 9 and price-to-book value of 1.4, and have a dividend of 3.6%, according to ETF Research Center. By contrast, EEM trades at nearly 12 times earnings, a P/B of 1.5 and yields 2.7%. EFA sports a P/E of nearly 15, a P/B of 1.6 and yields 2.9%.

Schwab investment strategists issued a neutral rating on China, saying that low valuations and bearish investor sentiment (a contrarian indicator) were tempered by economic data that fail to confirm the government's claims of recovery.

Troubling Signs

"Commodity prices are soft, despite the economic strengthening in the third quarter being led by infrastructure and property spending, and recent announcements of increased spending on railway construction and reconstruction of shantytowns," Schwab wrote in a report Friday. "Defensive sectors of the stock market are leading, and property stocks are lagging, indicating Chinese stocks could fall further."

The risks of investing in China remain very high as the results of the reforms may not be seen for months, or even years. They also face tremendous from interest groups.

"This breathless zeal is premature and stocks will fall, hopefully not in a hard landing," **Usha Haley**, a China expert and professor at West Virginia University, said in an email. "The hard part in China is not drafting but implementing the changes."

For example, China has the world's most stringent laws on intellectual property rights, but it's the world's greatest violator.

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