TOPIC 1 - OVERVIEW

1. AN OVERVIEW OF FUND MANAGEMENT AND MANAGED FUNDS

1.1 Overview and Definition

- **Asset management** involves the professional management of financial securities and/or real properties by a financial services provider for various clients/investors
- **Securities and Futures Ordinance** (SFO) defines asset management as real estate investment scheme management or securities and futures contracts management
- **Asset managers,** who offer products to the Hong Kong investing public or manage funds on a discretionary basis, must hold a Type 9 (Asset Management) license from the Securities and Futures Commission (SFC)
- Asia Pacific region has experienced **significant growth in funds under management** with the expansion of sovereign wealth funds, pension funds and family offices

Managed Funds

- ➢ Managed funds are indirect investments known as:
  - *Collective or pooled investments*
  - *Investment funds; or*
  - *Funds*
- ➢ Types of managed funds offered include:
  - *Unit trusts*
  - *Mutual funds*
  - *Retirement or corporate funds*
  - *Hedge funds*
  - *Private equity funds*
- ➢ Effectively, individuals delegate the management of their money to professionals who exercise investment discretion – hence funds are known as **discretionary investments**

1.2 Background of Fund Management Industry in Hong Kong

- Since the 1980s, Hong Kong has attracted financial institutions from the UK, the US, Canada and Europe
- In 1978, the **Code on Unit Trusts and Mutual Funds** was enacted in Hong Kong to help regulate funds being offered to the investing public
- The influx of investment fund managers over the years highlights the **appeal of Hong Kong as a fund management centre**, including:
  - ➢ Central location in the Asia region
  - ➢ Clear regulations covering local market authorisation
  - ➢ Just and equitable legal system

- Widespread use of English
- Experienced administrators
- Simple and low-rate tax system
- Proximity to China
- World class communication systems
- Stock market liquidity
- Accountants, lawyers and stockbrokers supporting the fund management industry

- The Hong Kong asset management industry is divided into **three categories**:

  (i) Institutional Investors

  - Active fund management companies
  - Passive fund management companies (eg ETFs)
  - Insurance companies
  - Banks
  - Sovereign wealth funds
  - Endowment funds
  - Corporate treasury management
  - Retirement schemes (MPF & ORSO)

  (ii) Retail Investors

  - Individuals with less sophisticated needs
  - Less complex objectives without investment mandates
  - Attracted to unit trusts and mutual funds

  (iii) Private Clients

  - Wealthy individuals with needs between retail and institutional investors
  - May set up family offices which aim to preserve and grow family wealth for future generations
  - The Hong Kong Monetary Authority has defined **Private Banking Customer**, to cater for the operational needs of private wealth management institutions, as a customer with either at least USD1 million of assets under management with an Authorised Financial Institution (AFI) or total investable assets of at least USD3 million
  - High net worth individuals are generally categorised as Individual PIs

- In 1994, the World Bank recommended a **three-pillar approach to protecting the elderly**:

  1. A publicly managed, tax-financed social safety net for the old
  2. A mandatory, privately managed, fully funded contribution scheme
  3. Voluntary personal savings and insurance

  Hong Kong adopted the Pillar 2 approach (MPF Scheme)

1.3 Types of Managed Funds

1.3.1 Unit Trusts

- A managed fund where a **trustee holds assets** on behalf, and for the benefit, of its beneficiaries
- Trustee owes a fiduciary duty to unit-holders
- Trustee is obliged to buy back units from unit-holders
- Units valued at net asset value (NAV)

1.3.2 Mutual Funds

- Same as unit trusts from an investment perspective, but set up as a limited company. See table below for comparison

Unit Trusts vs Mutual Funds

	Unit Trusts	**Mutual Funds**
Form of establishment	Trust	Limited liability company
Beneficiary	Unit-holders	Shareholders
Governing law	Trustee law	Companies law
Legal document in which the rules are detailed	Trust deed	Company's articles/bye laws and custodian agreement
Who protects investor interests	Trustee	Custodian
Who owns or holds the fund assets	Trustee for the benefit of the investors	Mutual fund company
Who is liable	Trustee	Company has limited liability; directors can be liable

Source: Hong Kong Investment Funds Association

1.3.3 Umbrella Trusts

- Master trusts offering a broader set of investment options with access to managed portfolios at institutional rates
- Two types: **discretionary trusts** and **fund of funds**

Discretionary Trusts/Umbrella Funds

- A single legal entity operating as a collective investment scheme (CIS)
- Several distinct sub-funds, traded as individual investment funds
- Clients can choose different sub-funds

Fund of Funds

- A structure that holds a portfolio of other investment funds
- Provides cost and administration efficiencies to investors
- Widely used in MPF schemes
- In Hong Kong, technically called a Unit Portfolio Management Fund (UPMF)

1.3.4 Mandatory Provident Funds

- Introduced in December 2000 to provide a retirement scheme for employees in Hong Kong
- Supplemented Hong Kong's long-running ORSO schemes, established for large employers
- An employer may choose from three types of MPF scheme:
  - **Master trust scheme**: open to company employees, self-employed and those transferring benefits from other schemes. Fee structure appeals to small- and medium-sized employers

    Employer selects the master trust; employees select from a set of constituent funds, one of which must be an MPF conservative fund
  - **Employer sponsored scheme**: only employees of a single company are eligible. Cost of establishing such a scheme means they are usually restricted to large employers
  - **Industry scheme**: designed for itinerant workers such as those in catering and construction industries – allows workers to continue contributing to same fund as they move employers within the same industry
- All MPF schemes must include a standardised, low-fee default strategy, known as a **default investment strategy (DIS)**

1.4 Onshore and Offshore Funds

- All managed funds offered to the Hong Kong investing public must be **authorised by the SFC,** with associated advertising materials being authorised, in compliance with the SFO
- All managed funds domiciled in Hong Kong are known as **onshore funds**
- Funds domiciled outside Hong Kong are permitted provided they meet SFC standards – known as **offshore funds**
- See following table for domiciles of Hong Kong unit trust business by origin, as at 31 March 2020

Domicile of Hong Kong Unit Trust Business as at 31 March 2020

Hong Kong	35.7%
Luxembourg	48.3%
Ireland	10.4%
UK	1.7%
Mainland China	2.3%
Cayman Islands	1.2%
Others	0.2%

Source: Securities and Futures Commission Annual Report 2019-20

- Reasons for popularity of offshore funds:
  - **Tax benefits** of offshore funds incorporated in tax havens
  - Economies of scale by being close to **large markets**
  - Lower level of **regulation**

1.5 Size and Sectors of the Fund Management Industry

1.5.1 Current Size and Sectors

Size of Hong Kong Industry Sectors by Fund Type as at 31 December 2019

Public funds	38%
Managed accounts	32%
Private funds	15%
MPF Scheme and ORSO funds	7%
Other funds	8%

Source: Asset and Wealth Management Activities Survey 2019

1.5.2 Reasons for Industry Growth

- Hong Kong's managed fund industry has experienced **significant growth** over recent years for many reasons, including:
  - Access to ever-growing regional opportunities, especially the emerging **China market**
  - Local asset management **talent**
  - Leading **Renminbi** offshore centre
  - Free flow of **capital**
  - Products launched under the Renminbi Qualified Foreign Institutional Investor (**RQFII**) scheme
  - **Stock Connect** and Bond Connect with Mainland China
  - Mainland-Hong Kong **Mutual Recognition** of Funds
  - Growth of **Mainland-related financial institutions** operating in Hong Kong
- Other reasons for continued growth include **demand for diversification**, better understanding of mutual funds and **education initiatives** in the fund management industry

1.5.3 Potential for Future Growth

- **Rapid expansion of the Mainland economy** has led to significant growth in foreign currency reserves leading to further opportunities for Hong Kong asset managers
- The Qualified Domestic Institutional Investors (**QDII**) scheme opens up channels for Mainland entities to invest abroad
- The Qualified Foreign Institutional Investors (**QFII**) scheme allows foreign access to domestic China securities
- Continued growth of:
  - **Shanghai-Hong Kong** Stock Connect (launched 2014)
  - **Shenzhen-Hong Kong** Stock Connect (launched 2016)
  - Bond Connect (launched 2017)
- **Wealth Management Connect** was launched in June 2020 – residents in Hong Kong, Macau and nine Guangdong cities can carry out cross-border investment in wealth management products distributed by banks in the Greater Bay Area (GBA)
- Continued growth of Mainland-Hong Kong **Mutual Recognition of Funds** (launched 2015)
- Hong Kong is ranked among the leaders for **hedge fund management** in the Asia Pacific region
- Institutional investors are the major investors in hedge funds, such as fund of hedge funds, banks, insurance companies, pension funds, endowment funds and sovereign wealth funds
- Efficiencies emerging from the development of the financial technology (Fintech) sector will further enable future growth

1.6 International Perspective

- Money from all over the world can enter and leave Hong Kong freely
- A significant proportion of assets managed in Hong Kong came from overseas
- Regulations continue to develop regarding the transparency of fund products and operations
- Hong Kong is being promoted as a financial centre for Islamic funds

1.7 Benefits and Costs of Managed Funds

- The **benefits of managed funds** include:
  - Access to professional investment management services
  - Diversification
  - Access to greater investment opportunities
  - Cost benefits from asset managers having access to volume discounts
  - Access to the use of technology
  - Liquidity – many funds can handle redemptions on a daily basis
  - Convenience of support from service providers
  - Taxation benefits
- The **disadvantages of managed funds** include:
  - Monetary costs: front-end fees; annual management fees; redemption charges; and performance fees
  - Foregoing control – investment manager determines what is bought and what is sold…and when
  - Higher risk than bank savings
  - Forward pricing – NAV is determined at the end of each day

2. RETAIL AND INSTITUTIONAL MANAGED FUNDS

- Although managed funds can be differentiated in terms of many factors, this text will focus on institutional vs retail markets

2.1 Investment Size

- Retail investors have a lower minimum investment level than institutional investors
- Private clients (high net worth individuals) are somewhere in between
- The higher the amounts invested, the lower the associated fees

2.2 Offer Document

- The offer document for managed funds catering to the **retail and private client** markets is known as a **prospectus**
- Prospectuses must have **prior SFC approval** before being released to the public
- Professional investors, including **institutional investors**, are exempt from the prospectus requirements, however a less detailed document must be sent to them, known as an **information (or explanatory) memorandum**
- As well as a prospectus or information memorandum, the **management company** should also provide:
  - ➢ Last audited annual report
  - ➢ Last unaudited semi-annual report
  - ➢ Key facts statement
  - ➢ Application form
  - ➢ Other pertinent information

2.3 Fees and Charges

- Four types of fees:
  - ➢ Initial subscription charge or front-end fee
  - ➢ Redemption fee
  - ➢ Annual management fee
  - ➢ Performance fee

Fee Structure of Different Types of Fund

	Front-end fee	Annual management fee	Redemption/performance fees
Money market	0 – 2%	0.25 – 1%	Vary: the more sophisticated the instrument, the higher the fee
Bond	3 – 5%	0.5 – 1.5%	
Equity	5 – 6%	1 – 2%	
Warrants	5 – 7%	1.5 – 2.5%	

Source: Hong Kong Investment Funds Association

Initial Subscription Charge or Front-end Fee

- Applied to the **initial investment** in a managed fund
- Fund houses pay a large part of this fee as **commission to distributors** who help promote the fund units to investors
- Distributor may choose to **rebate** some of the fee to the investor
- Institutional and most private client funds do not have front-end fees
- The bid offer spread is the price difference between the purchase and redemption prices

Redemption Fee

- Applies to funds that **do not charge a front-end fee** (referred to as **no-load funds**)
- Applied to withdrawals made from a fund, usually within a certain time period after purchase
- Also referred to as **contingent deferred sales charges**
- Do not normally apply to private clients/institutional investments
- Investors switching between investment options within an umbrella fund pay a switching fee, not a redemption fee

Typical Redemption Fee Charge Schedule

Years since purchase	**Front-end fee**
Up to 1 year	4%
Over 1 year and up to 2 years	3%
Over 2 year and up to 3 years	2%
Over 3 year and up to 4 years	1%
Over 4 years	0%

Annual Management Fee

- Comprises fees payable to fund manager as well as operating expenses
- May include a **trailer fee** paid to distributors
- Bond funds tend to have lower management fees than equity funds
- Institutional fund management fees are lower than for retail funds; private client funds are priced somewhere between the two levels
- An annual trustee fee is paid separately

Performance Fee

- Tends to apply to alternative investment strategy funds, including hedge funds and private equity funds
- Fee is charged when fund NAV exceeds previous highest water-mark and can be referred to as “high on high” or “water-mark”

3. PARTICIPANTS IN THE FUND MANAGEMENT INDUSTRY

- Details of the many participants in the Hong Kong asset management industry follow

3.1 Investors

- Include individuals, employers, institutions and trustees who provide money to be invested in managed funds – they own the fund units and bear all investment risks
- Fund marketers segment their actual and potential customers by geography, demographics or psychographics
- In 2019, 64% of funds in the asset management business of Hong Kong came from non-Hong Kong investors

3.1.1 Professional Investors (PIs)

- PIs do not need the same level of legal protection as ordinary retail investors do
- The SFC's Code of Conduct defines three types of professional investor:
  - **Institutional Professional Investors**
    - Recognized exchange companies
    - Recognized clearing houses
    - Recognized exchange controllers
    - Recognized investment compensation companies
    - Recognized automated trading services providers
    - Intermediaries
    - Authorized financial institutions
    - Authorized insurers
    - Authorized CIS
    - Registered MPF & ORSO schemes
    - Governments, banks & multilateral agencies
    - Wholly owned subsidiaries & holding companies of above
    - *Automatically entitled to all Code of Conduct exemptions*
  - **Corporate Professional Investors**
    - **Trust corporations, corporations or partnerships** holding a portfolio of not less than HKD8 million or total assets not less than HKD40 million
    - **Asset fund manager/distributor should be reasonably satisfied** that investor has appropriate corporate structure, investment process and controls, sufficient investment background and experience and is aware of investment risks involved
    - *Intermediaries satisfying above criteria are entitled to Code of Conduct exemptions*

- **Individual Professional Investors**
  - Individuals who have a portfolio of not less than HKD8 million
  - Asset manager/distributor has to obtain signed declaration from the client, fully explain to client consequences of being treated as a PI and that withdrawal is permitted
  - Intermediaries who serve individual PIs, cannot be exempted from Code of Conduct requirements fundamental to investor protection

3.2 Promoters

- Promoters **design, develop and maintain** managed fund products, involving:
  - Promoting their products either directly or via distributors
  - Selecting fund managers and administrators of each managed product – these tasks can be outsourced or conducted inhouse
- Typical promoters include:
  - Banks
  - Life insurance companies
  - Investment banks
  - Specialist managed fund companies
  - Some retirement fund trustees

3.3 Fund Managers

- They set investment objective and strategy, define investment management style, make and implement investment decisions and are **ultimately responsible for performance**
- In trying to outperform the market over a particular period, the following positions are required:
  - ***Chief Investment Officer*****:** oversees fund management team, liaising with promoters/distributors
  - ***Strategists***: advise on broad direction and strategy for fund investments
  - ***Economists***: analyse current state of economy while making short- and long-term economic forecasts
  - ***Portfolio managers***: participate in and implement investment decisions, ensuring that performance is reported accurately and in a timely manner
  - **Analysts**: research and evaluate potential/existing investments
  - **Dealers**: ensure fair allocation of order execution and ensure no front running – most fund managers place orders with dealers, not brokers
  - **Compliance officer**: oversees all regulated activities that must comply with the Code of Conduct
- Fund managers are generally incorporated including, subsidiaries of investment banks, commercial banks, insurance companies and stockbrokers
- Some are set up independently as specialist or boutique managers
- Fund management companies must be independent of the trustee, have paid-up capital of more than HKD1 million, always maintain positive net assets and have qualified executive directors

3.4 Trustee Companies

- In Hong Kong, **unit trusts must have a trustee**
- Promotors/fund managers can **nominate a trustee company** to perform trustee duties for their trusts
- Trustee must be **independent** of managed fund provider and have paid-up capital of at least HKD10 million
- Overseas trustees must be **authorised by the SFC**
- Most likely to be an AFI under the Banking Ordinance or a trust company under the Trustee Ordinance
- Trustees perform the following tasks:
  - **As custodian**, responsible for protecting fund assets, but not for supervising performance of fund manager
  - **Registry** – maintaining a register of unit-holders
  - **Settlement** of transactions by issuing and redeeming fund units
  - **Ensuring fund provider complies** with conditions stated in the trust deed – trustee has power to replace fund manager
  - Acting in the **interest of unit-holders**
  - **Liaising with fund management company** on behalf of unit-holders
- Trustee company charges a service fee

3.5 Distributors

- Distributors **market managed funds** to their clients on behalf of the promoters
- Two types of distributors:
  1. **Direct** – promoter or subsidiary of promoter
  2. **Indirect** – through an intermediary
- Intermediaries include:
  - Independent financial advisers (IFAs)
  - Life insurance agents
  - Banks
  - Discount brokers
  - Accountants and solicitors
  - Asset consultants

3.6 Other Supporting Participants

3.6.1 Actuaries

- Responsible for scheme design, liability forecasting and reserve requirements
- Typically work for life insurance companies and trustees, designing defined-benefit retirement funds

3.6.2 Accountants

- Advise on tax, auditing and other financial aspects of running a fund
- CUTMF requires investment schemes to appoint an auditor

3.6.3 Custodians

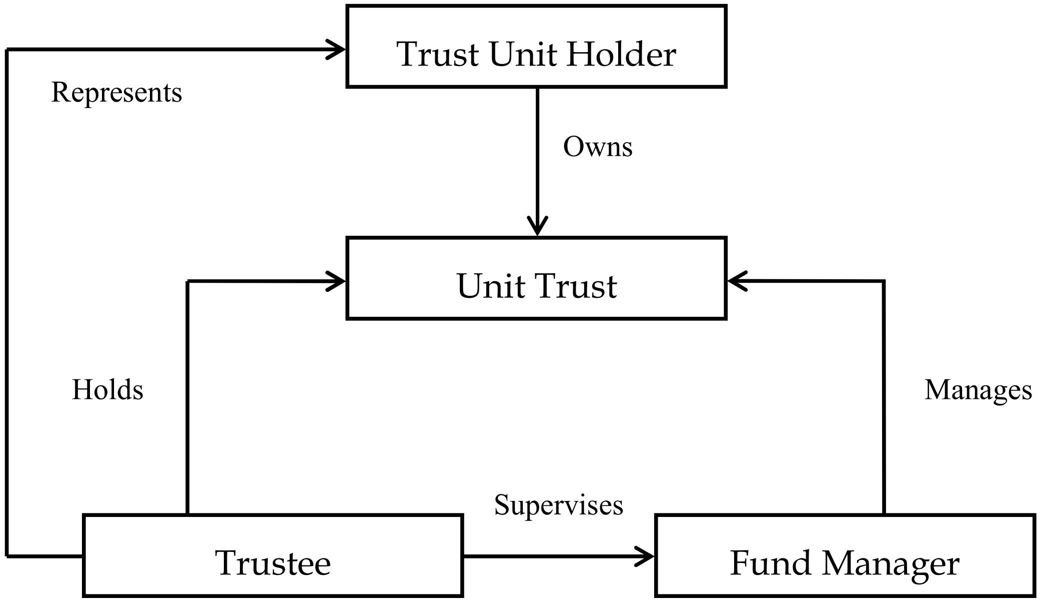
- Settle investment transactions and legally hold a fund's investments
- Eliminates credit risk of fund manager – if fund manager defaults, funds are safe with custodian
- Custodial services generally provided by banks
- HK mutual funds must appoint a custodian

3.6.4 Fund Research Houses and Fund Rating Agencies

- Provide detailed analysis, performance statistics and a ranking of funds
- Distributors use information to compare and select managed funds
- Morningstar and Lipper are fund rating agencies in Hong Kong

3.6.5 Credit Rating Agencies (CRAs)

- Assign credit ratings to issuers of debt and also individual debt issues, based on their ability to repay their debt obligations
- Ratings serve as a preliminary screen but do not replace the responsibility of an asset manager to conduct its own credit analysis
- Major CRAs include Moody's Investor Services, Standard and Poor's and Fitch Ratings



Roles of different parties in a managed fund

4. DISTRIBUTION CHANNELS

- Distribution aims to **deliver the right product** at the right place at the right time
- A distribution channel is a **set of marketing intermediaries** that operate between the managed funds provider and the customer

4.1 Market Share of Distribution Channels

- In Hong Kong, **retail fund distribution is dominated by the banking sector** – an outcome is that fund managers have to pay relatively high charges for fund distribution
- **Other major channels** of fund distribution in Hong Kong:
  - ➢ Investment-linked insurance products along with online platforms
  - ➢ Fund of funds
  - ➢ Master trusts
  - ➢ Insurance companies
- A **small** number of asset managers **distribute directly** to the market as there are no comprehensive platforms for direct distribution of funds

- The following **recommendations** were made by Hong Kong's Financial Services Development Council to enhance Hong Kong's status as the fund distribution centre for Asia Pacific:
  - Support diversification of fund distribution and innovation through **new online platforms**
  - Provide additional guidance on **know-your-client** (KYC) rules
  - Use Fintech to enhance the KYC process
  - Continue to engage with and develop cross-border initiatives with Mainland China and other Asia Pacific countries

4.2 Direct Distribution

- Technology is improving the efficiency and effectiveness of managed fund products and services
- Some investors still prefer face-to-face dealings with investment professionals
- Many managed fund providers have not taken to direct distribution over the internet

4.3 Insurance Companies and Investment-linked Insurance Products

- Insurance companies are increasingly providing investment products in Hong Kong through **long-term savings plans**
- Through investment-linked products serviced by financial planning professionals, middle-income investors can benefit from personal financial planning services without requiring time nor background knowledge to make detailed investment decisions