TOPIC 2 - OVERVIEW

1. IDENTIFYING CLIENTS' INVESTMENT OBJECTIVES AND CONSRAINTS

- Before an investment takes place, the following question needs answered:

  "What are your investment objectives and constraints?"

- In answering the question, the following should be addressed and recorded:
  - Return requirements
  - Risk tolerance
  - Investment horizon
  - Tax considerations
  - Liquidity requirements
  - Legal restraints
  - Unique preferences and needs
- Clients' circumstances change over time, which requires reviewing their objectives and constraints and revising portfolios, as required

1.1 Investment Planning

1.1.1 Investment Policy Statement

- **Reasons** why an asset manager should construct an investment policy statement for clients (both high net-worth and institutional):
  - Helps state goals and objectives of the investment plan
  - Provides an evaluation system for benchmarking performance
  - Sets boundaries for strategies and product purchases
  - Helps communicate the investment policy, especially when there is a dispute or change in fund manager
- The Statements should include the following:
  - Statement of purpose
  - Investment objectives
  - Roles and responsibilities of investment managers
  - Investment guidelines and boundaries
- **Objectives** should indicate medium- and long-term performance targets, the benchmark and return performance and asset allocation strategies for each asset class
- **Guidelines and boundaries** should indicate the investment choices that are prohibited and any investment vehicles/tactics that should be avoided
- Estimated maximum permitted loss should also be included

1.1.2 Financial Position of the Client

- Firstly, a client's current **income and asset position** needs to be established
- **Typical questions** posed by financial advisers are:
  - *Do you have any liabilities or planned future expenditure items to meet?*
  - *Are you earning surplus income?*
  - *How are you funding (or planning to fund) your retirement lifestyle?*

1.1.3 Risk Tolerance

- Risk tolerance levels **range from conservative to aggressive**, depending upon:
  - Client's attitude to risk
  - Personal background
  - Investment experience and knowledge
  - Stage in investment life cycle
- In **establishing a client's level of risk tolerance**, consideration should be taken of the client's views regarding:
  - Losing some or all of the capital
  - Earning a negative return
  - Earning less than inflation
  - Substantial price swings in an investment's value
- A client's personal background, investment experience and knowledge should also be considered, including:
  - Diversification of current investments
  - Interpretation of investments' past performance
  - Ability to set and adhere to a budget, or other investment goals

1.1.4 Human Capital

- When determining the investment strategy for a client, the wealth manager should consider the human capital – that is, the **ability to earn income in the future**
- Can be measured as the **present value of future labour income**
- Two concepts related to human capital:
  - **The Hedging Effect**: the more stable a person's future regular income, the more risk can be taken with financial investments, as there is an element of diversification
  - **Labour Supply Flexibility**: The ability to work overtime for extra pay. The stronger the cushion effect of labour supply flexibility, the riskier a client's portfolio can be

1.2 Investment Constraints

Liquidity

- The ease with which an asset can be **converted to cash**
- **Affected** by:
  - Type of asset (eg listed shares are more liquid than unlisted shares)
  - Market supply and demand
  - Size of asset
  - Divisibility of asset

Investment Horizon

- The time an investor is **willing to retain an investment**
- Critical when assessing a client's **risk tolerance**
- **Long-term investors** (at least 10 years) can ride out short-term price movements
- **Short-term investors** (1 to 3 years) are less tolerant of short-term price

Tax Considerations

- Focus should be on **returns after tax**
- Tax can arise from:
  - Capital gains
  - Dividends
  - Interest
  - Rental income
  - Sale of an estate

Legal Restrictions

- Certain types or amounts of investments can be restricted for statutory/operational reasons

Unique Preferences and Needs

- Examples could be:
  - Religious beliefs
  - Family and/or business relationships
  - Environmental concerns

Life-stage Considerations

- A person's stage in life will influence investment requirements and decisions
- Each person's experience at a particular stage of life is unique
- See following table for a summary of life cycle stages

Investment Life Cycle Stages

No.	Life-cycle Stages	Usual Age	Lifestyle Issues
1	Single employed	15 - 25	First job and income, rent, first credit card
2	Family nest	25 – 45	Marriage, birth of children, demanding career, need for life insurance, preparation of a will, living on one income
3	Shrinking family	45 – 65	Children leaving home, two incomes, liabilities paid off, caring for aged parents, serious retirement planning
4	Retirement	65+	Commence pension, establish retirement income and expenditure, travel plans, health requirements

1.3 Implications for the Investment Strategy of Managed Funds

1.3.1 Strategic Asset Allocation

- An allocation strategy based on **a longer term investment philosophy** (5 years+)
- Asset mix should be driven by policies **assuming efficient markets**
- Usually a **relatively constant mix of weightings** for various asset classes
- A 5% deviation from the benchmark weighting may trigger **portfolio rebalancing**
- A **very early step** to advanced asset allocation strategies that exploit market timing and pricing inefficiencies
- Requires selection of appropriate **investment management styles**

1.3.2 Tactical Asset Allocation

- A dynamic strategy aiming to enhance returns, lower risk or both
- Allows fund manager to trade aggressively and make frequent shifts in asset allocation

1.3.3 Diversification

- Through portfolio diversification, returns can be maximised while minimising risk
- Benefits of diversification are increased when investments that have low return correlations with each other are combined
- Optimal asset allocations lie on the efficient frontier

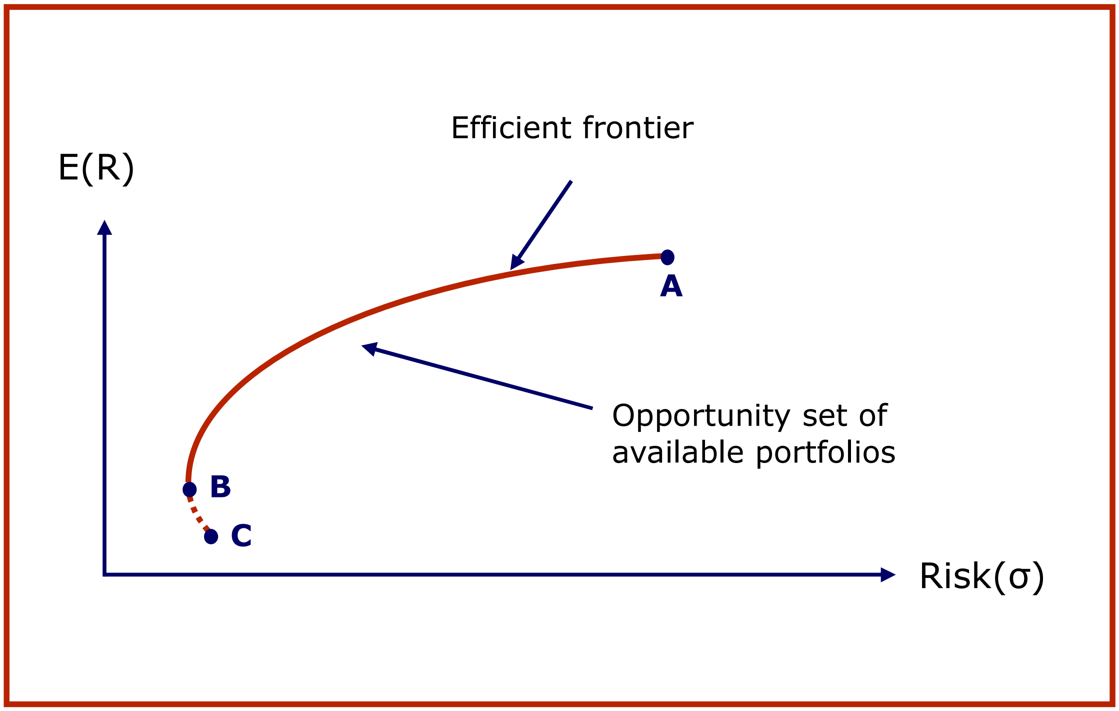


Figure 1: Markowitz Efficient Frontier

- Optimal asset allocations lie on the **efficient frontier**
- The minimum-variance frontier, A–B–C, represents the lowest level of risk for each possible level of return
- The efficient frontier, A–B, represents the set of portfolios that will give an investor the **highest return for each level of risk assumed**
- Note that the B–C section of the line is "inefficient" as an investor may achieve a higher return for the same level of risk by moving vertically upwards
- Portfolio B is the **global minimum-variance portfolio**

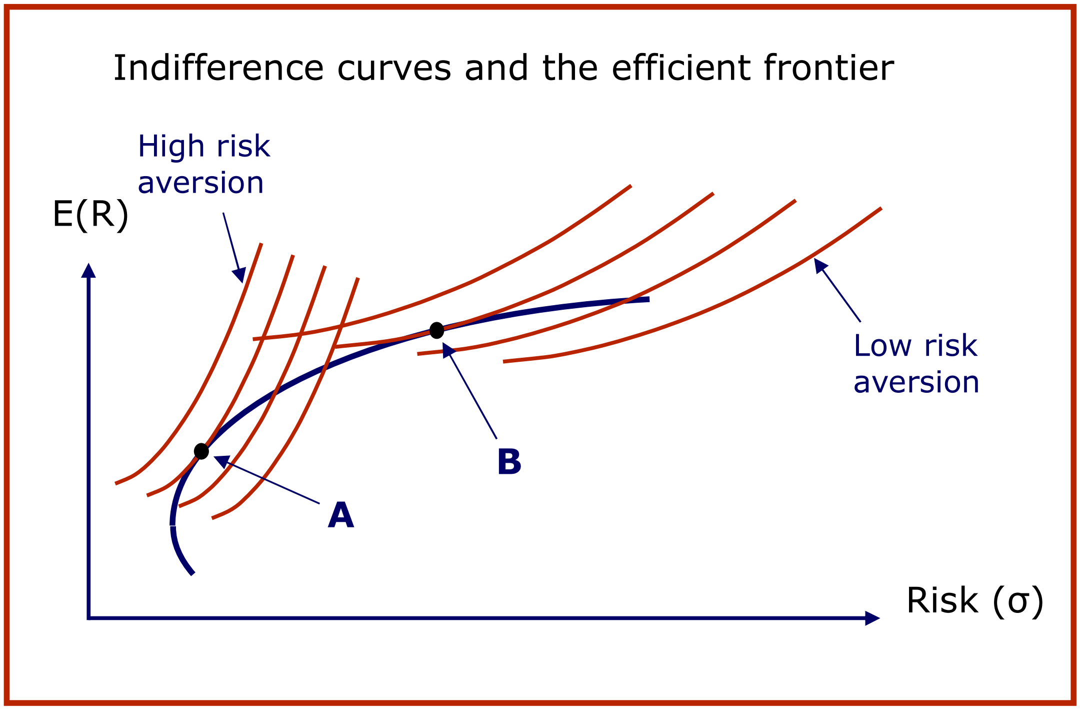


Figure 2: Optimal Portfolios

- The **optimal portfolio** for each investor is the **highest indifference curve** that is tangential to the efficient frontier. It is the investable portfolio with the highest utility
- A **more risk-averse investor** may have Portfolio A as his optimal portfolio, while a **less risk-averse investor** may have Portfolio B as his optimal portfolio.
- The choice between optimal portfolios will ultimately depend on each investor's **risk/return appetite**, and hence the slope of their indifference curves
- The more risk averse an investor, the lower the risk (and therefore expected return) of the optimal portfolio.

1.3.4 Risk Positioning

- Process of selecting assets that will yield the highest return for a stated level of risk
- Investment strategy may be constrained by:
  - Minimum and maximum weightings for investments in each asset class
  - Gearing policy
  - Derivatives policy
  - Foreign exchange exposure

1.4 Know Your Client and Suitability Requirements

1.4.1 Know Your Client (KYC) Requirement

- KYC requirements are outlined in the **Code of Conduct** for Persons Licensed by or Registered with the Securities and Futures Commission
- An **asset manager** or a **fund distributor** should establish a client's:
  - True and full identity
  - Financial situation or strength
  - Investment experience
  - Investment objectives
- Before executing any transaction for a client, the intermediary must **establish the identity** of the ultimate beneficiary responsible for origination the transaction – exception is a CIS
- **Recommendations** made to clients should be **suitable**, given their circumstances
- When a client **without knowledge of derivatives** wishes to invest in a derivative product, the risks should be explained
- Face-to-face account opening best way to verify identity
- If not possible, the documents should be certified by appropriate person (licensed person, JP, bank manager, accountant, lawyer, notary)
- Proper records must be kept of procedures followed

1.4.2 Suitability Requirement

- As per the **Code of Conduct,** an asset manager or fund distributor should ensure the suitability of a recommendation or solicitation for the client
- Suitability obligations include:
  - *KYC*, as discussed above
  - *Product due diligence*: asset managers/fund distributors should fully understand an investment product before recommending it to clients
  - *Suitability assessment*: asset managers/fund distributors should match the risk-return profile of an investment product to the personal circumstances and needs of a client
  - *Information for clients*: all relevant information regarding an investment product should be provided to clients
  - *Competence and training*: competent staff should be employed and provided with appropriate training
  - *Record retention*: all information supporting product recommendations should be retained
- From 9 June 2017, the Code of Conduct requires a clause stating that any financial product solicited for sale or recommended will be suitable for the client

2. THE MAIN ASSET CLASSES

2.1 Equities

- Over the long-term, shares have historically outperformed all other asset classes
- Volatility of equity prices is higher than other investment types

2.1.1 Characteristics of Equities

- Usually provide high returns over the long term
- Volatile due to uncertain dividend cash flows and share price fluctuations
- With company liquidations, investors can lose their entire investment
- A portfolio of equities is subject to both systematic and unsystematic risks
- Shares have lower transaction costs and greater liquidity than direct investments

2.1.2 Evaluating Equities

- Fund managers analyse stocks quantitatively (known as fundamental analysis) using the following models:

Dividend Yield

- Shows the level of income an investor can expect to receive from a share

$$\text{Dividend yield} = \frac{\text{Dividend per share}}{\text{Share price}}$$

Earnings per Share (EPS)

- The most quoted reference in the financial markets

$$\text{Earnings per share} = \frac{\text{Profit after tax} - \text{preference dividends}}{\text{Weighted average number of shares}}$$

Price Earnings Ratio (PE ratio)

- Represents the multiple of current year's earnings that must be paid to buy a share
- A relatively high PE stock implies strong future earnings growth and is referred to as a growth stock
- A relatively low PE stock implies that the stock is cheap and is referred to as a value stock
- The **historical PE ratio** is based on current earnings, the **prospective PE** ratio is based on expected future earnings

$$\text{PE ratio} = \frac{\text{Market price per share}}{\text{Earnings per share}}$$

Price to Net Book Value Ratio (P/B ratio)

- Shows market premium above a stock's net book value
- A high P/B ratio indicates a high growth opportunity, leading to a higher price premium

$$\text{P/B ratio} = \frac{\text{Current stock price}}{\text{NBV of equity per share}}$$

2.2 Fixed Income Securities

- Interest bearing loans where the investor lends money to the company/organisation at a certain interest rate (coupon rate) for the life of the loan
- **Coupon rate** can be either fixed or floating
- A **preference share** is commonly considered to be a fixed income security in substance as shareholders receive a fixed preferred dividend, regardless of operating performance
- Debt securities with terms of one year or less are known as **bills or paper**
- In the US, **treasury bills** have a maturity of one year or less, **treasury notes** between two and ten years and **treasury bonds** of more than ten years
- In **Hong Kong**:
  - Exchange Fund Bills have a maturity of one year or less
  - Exchange Fund Notes have a maturity of two years
- Governments/government agencies/**supranational organisations** (World Bank & Asian Development Bank) can issue bonds

2.2.1 Bond Pricing

- Usually provide high returns over the long term
- The price/value of a coupon security is the sum of the present values of all future cash flows
- Future cash flows comprise of coupon payments and the principal repayment
- A three-year 10% coupon bond, with a face value of HK$100, providing a yield of 8% will be priced at HK$105.17

Year	Cash Flow	Amount (HK$)	Discount Factor	PV of Cash Flow
1	Coupon	10	0.926	9.26
2	Coupon	10	0.857	8.57
3	Coupon	10	0.794	7.94
3	Principal	100	0.794	79.40
				105.17

$$P = \frac{10}{(1.08)^1} + \frac{10}{(1.08)^2} + \frac{10}{(1.08)^3} + \frac{100}{(1.08)^3}$$

$$= 9.26 \quad 8.57 \quad 7.94 \quad 79.4$$

$$= 105.17$$

2.2.2 Duration

- A measure of duration approximates to the percentage change in a bond price for a 1% change in interest rates
- Can also be thought of as the average number of years it takes for the discounted cash flow to be returned to the investor
- The **longer the time to maturity**, the **higher the duration**
- The **lower the yield**, the **higher the duration**
- The **lower the coupon rate**, the **higher the duration**
- A bond portfolio can be **immunised** by matching the **duration** of assets and liabilities, thus enabling a target rate of return, regardless of bond prices or interest rate variations

2.2.3 Characteristics of Fixed Income Securities

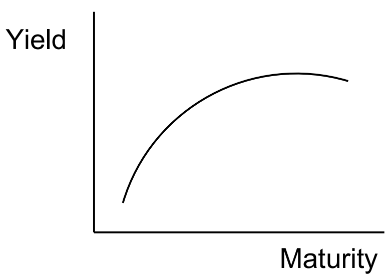
- Provide a steady income stream
- Income is known in advance (not floating rate securities)
- Ideal for funding future liabilities/expenses
- Less volatile than stocks in normal circumstances
- Securities issued by governments/large corporations have high liquidity
- Value heavily influenced by interest rates

- Exposed to:
  - **Credit risk** – risk that issuer does not pay interest/principal
  - **Interest rate risk** – risk of move in interest rates
  - **Industry risk** – yield spreads between industries

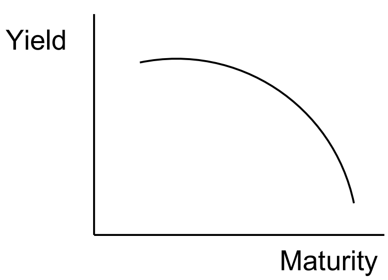
2.2.4 The Yield Curve

- The yield of a security is its effective annual return expressed as a percentage of the current market price and is determined by a number of factors
- Remember: ***The higher the yield, the lower the price, and the lower the yield, the higher the price***
- The **yield curve** is a line plotting the yields of selected benchmark securities of the same type, with different maturities from short- to long-term
- Yield curves are considered by country and by market and are used to forecast the future direction of interest rates and inflation

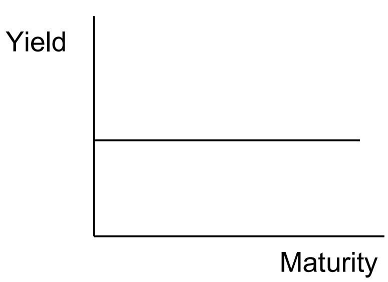
Types of Yield Curve



Positive or Normal
Yield increases with an increase in term to maturity. The longer the term, the greater the uncertainty, the higher the required return. Consistent with expectations of rising inflation.



Negative or Inverse
Opposite to the positive yield curve where longer term interest rates are expected to be lower than current and short-term interest rates.



Flat
Can reflect expectations of stable interest rates or the transition from a positive to a negative yield curve, or vice versa.

2.3 Hybrid Securities

- A single financial security that combines the characteristics of two or more financial instruments
- An example is a **convertible bond**, which gives the holder an option to exchange it for a specified number of ordinary shares issued by the bond issuer
- **Contingent convertible bonds** (CoCo bonds) have become popular since 2014, due to bank capital requirement regulations
- **CoCo bonds** will automatically convert into equity when a pre-set finance threshold is met. This effectively writes off the associated debt when financial health weakens

2.4 Property

- Property involves the ownership of real assets
- **Typical sectors of property** that fund managers invest in are:
  - Commercial (eg office buildings)
  - Retail (eg shopping centres)
  - Industrial (eg factories and warehouses)
  - Residential (eg apartment buildings and houses)
  - Tourism (eg hotels)
  - Rural (eg plantations)
- As property is sizeable, many small fund managers gain access through **syndicates or listed property trusts**
- Investing a portion of a balanced portfolio in property can **reduce total volatility** without significantly reducing returns

2.5 Derivatives

- Financial instruments, the prices of which are based on the value of the **underlying assets**
- Provides a means to **transfer risk** from one party to another
- Allow **future prices to be set in the present**, protecting investors from the risk of future price changes
- Derivatives traded through a formalised exchange are called **exchange-traded instruments**
- Those traded outside an exchange are known as over-the-counter (OTC) instruments
- Examples of OTC instruments are: swaps, forward rate agreements and OTC options

Futures

- A contract to buy or sell an underlying financial instrument or commodity at a specific price at a specific time in the future
- Contracts are usually closed out by a **reversing trade** before expiry
- **Contracts available in Hong Kong** include: equity index, individual share, interest rate, renminbi and commodity futures

Options

- Provides the holder (buyer) the **right**, but not the obligation, to buy (call) or sell (put) a specified commodity, currency, security or futures contract at a designated price on or before the exercise date
- **Fund managers use options** in many ways, including:
  - Buying call options as a cheap way of purchasing shares in a rising market
  - Buying put options when share prices are expected to fall and shares cannot be sold immediately
  - Using options to hedge a position

2.6 Foreign Exchange

- While most currencies in the western world **float**, governments can still intervene, when required
- Hong Kong operates a **linked exchange rate** system where the Hong Kong dollar is pegged to the US dollar at a rate of USD1 to HKD7.8 – this ensures that the USD/HKD rate will not deviate much
- In Hong Kong, managed funds are usually denominated in foreign currencies – most offshore fund managers do not hedge their portfolios against the HK dollar
- **Hong Kong dollar-based fund managers** can do the following:
  - No hedging, thereby maintaining exposure to currency movements
  - Hedge all foreign investments to eliminate all foreign exchange risk
  - Actively manage currency as a separate asset class

2.7 Alternative Investments

- Alternative investments are all investments **outside the traditional classes** of cash, bonds and stocks
- **Characteristics of alternative investments** can include the following:
  - Assets held have limited liability
  - Investment managers tend to be more specialised and probably use active management strategies
  - The relevant markets may be less regulated and less transparent
  - Historical return and risk data may not be widely available
  - Legal structures may be specialised and tax treatments may be different
  - Fee structures may have relatively high management fees with performance/incentive fees

- Investments have low correlations with traditional investments making risk diversification and return enhancement possible
- More likely to emphasise absolute return
- May pursue excess returns from market inefficiencies

- **Buyers of alternative investments** are mainly institutional and high net worth investors including:
  - Pension plans
  - Foundations and endowment funds
  - Family offices
  - Private wealth management advisory firms
  - Sovereign wealth funds
  - Hedge funds and funds of funds
  - Private equity funds
  - Commodity trading advisers
  - Separately managed accounts of high net worth investors

- **Major types of alternative investments** include:
  - Hedge funds
  - Commodities
  - Private equity
  - Real estate
  - Islamic products
  - Tangible collectibles such as wines, stamps, cars, antiques or art or virtual assets

2.8 Virtual Assets

- Virtual assets are **digital representations of value** which include digital tokens, such as digital currencies, utility tokens or security or asset-backed tokens
- There is a **growing investor interest** in gaining exposure to virtual assets via funds and unauthorised/unlicensed trading platforms
- **SFC has identified significant risks** associated with virtual asset investing such as lack of generally accepted valuation principles and illiquidity as well as cybersecurity and safe custody of assets
- SFC published "**Proforma Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets**" in October 2019
- The **first virtual asset fund** tracking the price of Bitcoin was launched for professional investors in April 2020

3. MAJOR TYPES OF MANAGED FUNDS

- Funds can be classified in many ways including:
  - **Legal structure**: under a trust arrangement (unit trusts) or through a limited liability company (mutual funds)
  - **Investors**: institutional, private client or retail
  - **Tax structure**: taxable or non-taxable
  - **Open**-end or **closed**-end
  - **Underlying investment policy**: equity funds; fixed income funds; money market funds; or balanced funds
  - **Client benefits**: defined contribution vs defined benefits

No of funds at 31 March 2020 and NAV at 31 December 2019

Product Type	No of Funds	Fund Size (USDm)
Bond	465	600,639
Equity	945	736,578
Diversified	184	169,628
Money Market	43	19,773
Fund of funds	104	23,479
Index	170	127,457
Guaranteed	3	67
Hedge	1	N/A
Other specialised	N/A	145
Total	**1,915**	**1,677,766**

Source: Securities and Futures Commission

Authorised Funds' 10 Largest Managed Fund Sectors as at 30 April 2020

Sector	No of Funds	Fund Size (USDm)
Fixed Income Global	114	193,403
Asset Allocation Global	91	116,485
Equity Pan Europe	74	68,840
Sector Funds	121	132,862
Equity Global	99	92,768
Equity North America	72	63,122
Fixed Income USD	68	159,924
Fixed Income Europe	41	73,869
Equity Global Emerging Markets	46	44,636
Equity Far East & Pacific	47	39,455

Source: Hong Kong Investment Funds Association

3.1 Closed-end and Open-end Funds

Closed-end Funds

- Offered with a specific start and end date
- Funds growth is limited to earnings generated from the initial invested sum
- The number of shares issued is constant
- Shares are listed and can be traded on a stock exchange, however they are not redeemable by the investment company
- Shares can be traded at a premium or a discount
- Majority of closed-end funds trade at discounts because of low liquidity
- Closed-end funds offered in Hong Kong must register a prospectus with the Registrar of Companies and they must be SFC authorised
- Although less popular than open-ended funds in Hong Kong, their benefits include:
  - They do not suffer from large swings in subscriptions and redemptions
  - Fund managers are not forced to liquidate investments to meet investor redemptions
  - Fund managers can concentrate on managing the portfiolio rather than being distracted by cash injections and withdrawals
  - Fund managers can consider long-term investments with relatively low liquidity

Open-end Funds

- Remain open to receive money from new investors, expanding the portfolio
- Represent the majority of managed fund products offered to the Hong Kong public
- Can suffer from large swings in subscriptions and redemptions
- Fund managers may be forced to liquidate investments to meet investor redemptions

3.2 Guaranteed Funds

- Guaranteed returns of guaranteed funds usually offer:
  - An **annual return** – referred to as a “**hard**” guarantee; or
  - A **return over a certain period** (working life or minimum service period), called “**soft**” guarantees
- **Soft** guarantees are more common than **hard** guarantees in the MPF schemes
- As per the **Code on Unit Trusts and Mutual Funds** (CUTMF), the guarantor of a guaranteed fund must be:
  - A **licensed bank** authorised under the Banking Ordinance; or
  - An **insurance company** authorised under the Insurance Companies Ordinance; or
  - A substantial financial institution approved by the SFC

- To achieve a guaranteed rate of return and security of capital, funds are mainly invested in zero-coupon bonds and deposits
- Only a limited exposure to equities and derivatives for return enhancement
- When markets are falling or very volatile, guaranteed funds are popular

3.3 Equity Funds

- Primarily invested in securities that are **listed on a stock exchange**
- Equity funds provide investors with access to **diversified portfolios**, however such portfolios will be subject to stock market volatility
- When generating income is important, stocks with a **high dividend yield** are selected
- **Smaller companies' stocks** tend to be more volatile than those of larger companies because:
  - they are less liquid
  - have fewer issued shares
  - focus on the local market; and
  - have less diversified sources of income
- The higher volatility of **developing market stocks**, such as China, is an important concern for fund managers when determining the weighting of emerging market equities in an investment portfolio

3.4 Fixed Income Funds

- They invest in long-term interest-bearing securities, with maturities of at least 12 months, and cash
- The longer the securities' **term to maturity**, the higher the yield
- Fixed income investors tend to receive **higher returns** than those in money market funds
- Fixed income **fund returns** come from:
  - Interest income
  - Capital gains from the secondary market
  - Currency movements, when unhedged funds are held in a foreign currency
- To **eliminate currency risk**, managers hedge portfolios by effectively fixing the exchange rate through the buying/selling of forward contracts
- Fixed income securities are subject to **interest rate risk** as well as **credit risk**
- Credit risk, as perceived by the market, **increases** in the following order of securities:
  1. Government securities
  2. Government agency securities
  3. Bank-backed securities
  4. Corporate securities with collateral
  5. Corporate debentures and commercial paper without collateral

3.5 Money Market Funds

- Also known as **cash funds** or cash management trusts
- **Highly liquid funds** invested in money market instruments issued by governments, banks or companies
- **Return is interest** calculated daily and payable daily, monthly or quarterly
- Appeal to investors seeking **higher interest** than that from bank savings accounts
- In Hong Kong, the **US dollar** is the major currency of money market funds

3.6 Property Funds

- Mainly **invest directly in property** and can be public or private, listed or unlisted, and taxable or non-taxable
- Hong Kong property funds offered to the public must be **SFC authorised** and in the form of investment trusts
- A **Real Estate Investment Trust (REIT)** is a collective investment scheme that invests in property-related items. Related points include:
  - Investments are made in income-generating properties such as:
    - Shopping malls
    - Offices
    - Hotels
    - Service apartments
    - Warehouses
    - Real estate financing
  - A substantial amount of a **REIT's income** is distributed to investors on a regular basis
  - **Public REITs** are listed and traded on a stock exchange, while **private REITs** are issued to a selected group of investors
  - **Public REITs** can be classified as follows:
    - *Equity REITs*: directly own and operate income-generating properties – the most common type
    - *Mortgage REITs*: lend money directly to property owners or invest in mortgage loans or mortgage-backed securities
    - Hybrid REITs: combine advantages of both equity and mortgage REITs
  - For a REIT to be SFC authorised, it must plan to list on SEHK and distribute income to investors
- Real estate markets can be very volatile, with large price swings at times

3.7 Balanced Funds

- Also known as asset allocation, diversified or **total return funds**
- Fund manager decides on asset allocation and allocation of funds
- Fund manager can also change short-term composition of portfolio, known as **tactical asset allocation**
- Most asset allocation fund managers offer a **variety of diversified funds**, including the three most common:
  - ***Capital preservation***: aim is to maintain capital and produce income over the medium to long term. About 70% of funds are invested in fixed income securities and cash
  - ***Balanced***: aim is to grow capital, avoid risk of capital loss and produce income over the medium to long term. About 70% of funds are invested in equities
  - ***Growth***: aim is to provide capital growth and income over the medium to long term. Majority of funds are invested in growth assets

Typical Asset Allocations for Different Types of Funds

	Types of funds		
Asset classes	Capital Preservation	Balanced	Growth
Cash/fixed income	70%	30%	10%
Equities	30%	70%	90%

3.8 Other Types of Funds

3.8.1 Warrant Funds

- Warrant funds invest in various warrants with various exercise dates – can be extremely volatile
- Requirements for Hong Kong authorisation include:
  - No more than 10% of fund net asset value can be invested in warrants from one issuer
  - At least 90% of underlying securities must be listed on the stock exchange

3.8.2 Hedge Funds

- Private investment funds that generally target more sophisticated investors
- Regulations are less restrictive than those for general mutual funds
- Fees and charges are higher than regular investment products and funds

- **Major hedge fund categories** include:
  - ***Market trend or directional strategies***: broadly exploit currencies, commodities, equities and interest rates
  - ***Event-driven funds***: exploit events such as bankruptcies, mergers and takeovers
  - ***Arbitrage strategies***: exploit differences among closely related securities
  - ***Fund of funds***: invests in several single strategy hedge funds to diversify risk. Minimum subscription for an individual hedge fund is US$50,000 and US$10,000 for a fund of hedge funds

3.8.3 Undertakings for Collective Investment in Transferable Securities (UCITS)

- UCITS directives are produced by the **European Parliament**
- In 2006, the **SFC authorised** the first retail 130/30 UCITS III fund in Hong Kong
- A 130/30 fund may take **long positions** up to 130% of the fund's net asset value and **short positions** up to 30%

3.8.4 Exchange-traded Funds (ETF)

- An ETF is regarded as one of the **greatest innovations** since the introduction of mutual funds for investors who cannot afford to diversify
- At the end of 2019, Hong Kong had a total of **111 listed ETFs**, with an annual turnover of HK$1,076 billion
- An ETF is an **open-end fund**, passively managed that tracks the performance of an underlying index
- There are **two broad ETF types**:
  - **Physical ETFs**: fund manager buys constituents of the underlying index to replicate its exact composition and weighting
  - **Synthetic ETFs**: fund managers use synthetic replication strategies by investing in derivatives such as futures, forwards, swaps and options

3.8.5 Defined Benefit (Retirement) Funds

- A fund guarantees to make a specific payment to the investor in the event of retirement, death, invalidity or redundancy
- The investor knows with certainty what will be received should specific events occur
- Investment risk is borne by the trustee
- In contrast, defined contribution funds cannot guarantee the final return, only the required contribution. Investment risk is borne by the investors (eg MPF schemes)

3.9 Related Issues

3.9.1 Mutual Recognition of Funds (MRF)

- The Mainland-Hong Kong Mutual Recognition of Funds (MRF) scheme was launched by the **China Securities Regulatory Commission (CSRC) and the SFC** on 1 July 2015
- Eligible funds in China and Hong Kong can be distributed in each other's market through a **streamlined vetting process**
- The underlying principle is that a fund authorised by the authority in one jurisdiction (**home jurisdiction**) is generally deemed to have complied in substance with the requirements of the other jurisdiction (**host jurisdiction**)
- The following **requirements must be met by Mainland funds** that are to be distributed in Hong Kong:
  - ➢ The fund is established, managed and operated in accordance with **PRC laws**
  - ➢ A publicly offered investment fund, **registered with the CSRC** under PRC laws
  - ➢ Fund must have been established for **more than one year**
  - ➢ Fund must have a **minimum size of not less than RMB200 million** or foreign currency equivalent
  - ➢ Fund must not primarily invest in the **Hong Kong market**
  - ➢ Value of shares/units sold to Hong Kong investors **should not exceed 50%** of the value of the fund's total assets
- As at May 2019, there were **six MRF arrangements** between the SFC and regulators of Mainland China, France, Switzerland, Netherlands, Luxembourg and the UK

3.9.2 Renminbi (RMB) Investment Products

- There are a broad range of RMB investment products that are **denominated and settled in RMB** or RMB-linked assets or investments
- RMB investment products are subject to **currency risk**

3.9.3 Mandatory Provident Fund Products

- An employee, as a member of an MPF scheme, has the **right to choose among the MPF constituent funds**, which are limited to those offered by the master trust of the MPF scheme chosen by the employer
- According to the MPFA, there are five major types of constituent funds:
  - ➢ ***MPF conservative fund***, previously known as capital preservation fund
  - ➢ ***Guaranteed fund***, also known as capital guaranteed fund
  - ➢ ***Bond fund***, also known as fixed income fund
  - ➢ ***Mixed assets fund***, also known as balanced fund, stable fund, long-term accumulation fund or capital stable fund

    - ***Equity fund***, also known as aggressive fund, growth fund and global, country or regional fund

- All MPF schemes must have a **Default Investment Strategy (DIS)** as the standardised low fee default strategy
- **Features of a DIS** are:
    - **Default option** if an employee does not select a particular fund
    - Uses a **standardised investment strategy** set by the MPFA with a mix of bonds and equities
    - Automatically **reduces investment risk** as an employee approaches retirement age
    - **Management fee** will be kept at 0.75% or below of fund assets
    - **Out-of-pocket expenses** are capped at 0.2% of fund assets
- **Two constituent funds** under the DIS:
    - ***Core Accumulation Fund***: Mixed asset fund which invests 60% of net asset value in higher risk investments, such as global equities, and 40% in lower risk investments, such as global bonds
    - ***Age 65 Plus Fund***: Mixed asset fund which aims to invest 20% in higher risk investments and 80% in lower risk investments. From the age of 50 onwards, accrued benefits of a default scheme member will gradually be switched to this fund and wholly invested in it when the member reaches 65 years old

3.9.4 Investment-Linked Assurance Scheme (ILAS) Products

- ILAS is a **life insurance policy with investment elements** that provides both investment protection and investment options
- Key features and risks of these products are:
    - Policy value is subject to **investment risk/market fluctuations**
    - **Long-term product**, usually with a lock-up period of at least five years
    - **Complex fee structure**
    - Different levels of insurance protection
    - **Underlyings of investment options** belong to the insurance company
    - Policyholders can **switch between options**, although switching charges may be applicable