Financial Services Research Group

Hong Kong Asset Management Landscape : A Look at Rapidly Evolving Products and Markets

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The Financial Services Research Group (FSRG) is proud to share our latest update on asset management based on insightful contributions from a number of experts.

In this edition, “Hong Kong Asset Management Landscape: A Look at Rapidly Evolving Products and Markets”, we walk through the distribution of traditional mutual funds in Hong Kong, with a particular focus on Exchange Traded Funds (ETFs) as a popular product in the traditional fund market; and, at the other end of the spectrum, private assets, a fast growing asset class that is currently undergoing rapid change as fund promotors work on extending their reach to the retail space.

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Warm regards,
Ching Yng Choi, Treasurer
FSRG

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Distribution of Traditional Mutual Funds in Hong Kong

Introduction

The Hong Kong Asset Management and Funds Industry

For more than 40 years there have been unit trusts or mutual funds set up in Hong Kong to provide global investors access to Asian region stock markets and local investors access to global securities markets. In the early days, they were unit trusts invested into Japanese stocks for UK and international pension funds and institutional investors. This developed into a broader choice of Asian markets, and also started to attract retail investors.

Today there are almost 3,000 funds authorised for sale to the retail investor, that cover virtually every conceivable securities market around the world. Funds from Luxembourg, Ireland, the UK and other international locations compete directly with local Hong Kong domiciled funds. Fund managers in Hong Kong not only provide portfolio management for the local funds, they also do so for many of the overseas domiciled funds that might invest into Asian region securities markets.

The chart below shows the numbers of mutual funds (Collective Investment Schemes) authorised in Hong Kong by the Securities and Futures Commission (SFC), under a number of different categories as at 31 September 2023.

Authorised Collective Investment Schemes

	As at 30.09.2023	As at 31.03.2023	Change %	As at 30.09.2022	YoY % change
Unit trusts and mutual funds – HK domiciled	923	913	1.1	882	4.6
Unit trusts and mutual funds – non HK domiciled	1416	1417	-0.1	1393	1.7
ILAS	314	305	3.0	301	4.3
Pooled retirement funds	32	32	0.0	32	0.0
MPF schemes	26	26	0.0	26	0.0
MPF pooled investment funds	191	221	-13.6	219	-12.8
Others	25	25	0.0	25	0.0
Total	**2927**	**2939**	**-0.4**	**2878**	**1.7**
Registered OFCs	187	131	42.7	100	87.0
Authorised unlisted structured investment products	277	231	19.9	234	18.4

Source: HK SFC Quarterly Report July– September 2023

1. What funds get distributed ?

a. Traditional

Typically, a traditional fund in Hong Kong will be a unit trust or mutual fund that invests directly into securities markets with the objective of achieving consistent medium to long term investment returns. To enable them to be widely distributed to retail investors, they are required to have been authorised by the Hong Kong SFC for the purpose. Such funds would normally be "long only" thus they don't incur borrowing, they generally don't use financial derivative instruments (FDI), other than for what is termed portfolio hedging purposes. Hedge and alternatives funds are generally not distributed to retail investors. This is because most of these types of funds have not been authorised for sale to retail investors by the SFC and are usually not capable of being authorised.

b. Unit Trusts and Mutual Funds

Initially, when funds were first offered to retail investors in Hong Kong some 40 years ago, they were set up as unit trusts. Subsequently, as the European model for funds, ie. Undertakings for Collective Investment in Transferable Securities (UCITS) developed, these were of a corporate type, thus mutual funds. But the US style of mutual fund has never been able to gain approval for sale in Hong Kong, thus has not been offered in the market.

What are the differences ? A unit trust is set up with a trustee and custodian ensuring independent responsibility for safeguarding the assets. The trustee is regarded as the ultimate owner/controller of the assets, and appoints the investment adviser, usually the sponsoring fund manager, to manage the portfolio. The trustee will also appoint other service providers, including the custodian, auditors, banks etc., all usually in consultation with the sponsoring fund manager.

A mutual fund in Hong Kong will usually be a fund set up in the European markets of either Luxembourg or Ireland as a UCITS. This is a quasi corporate type of fund, which does not have a trustee, where the ultimate ownership is the vehicle itself. UCITS appoint their own depositary which will usually provide custodian services, auditors and investment advisers for their portfolios.

From an end investor point of view, there is little difference between these two types. Throughout this article the term "mutual funds" is used, as a descriptor for unit trusts, mutual funds and open ended fund companies (OFCs).

The SFC allows local authorisation of UCITS under the Code on Unit Trusts and Mutual Funds (Code) and doesn't differentiate in their requirements between UCITS, Mutual Funds, Unit Trusts and OFC, for use with retail investors.

Open Ended Fund Companies OFCs were first created in Hong Kong in 2019, and were developed by the SFC to be a mutual fund type product that could compete with UCITS in the local market. OFCs have all the attributes and benefits of both unit trusts and mutual funds, and also have no discernible differences from the end investor perspective, from an investment point of view.

c. ETFs

Hong Kong has a large number of ETFs listed on the Hong Kong Stock Exchange (HKSE) and authorised by the SFC. The Tracker Fund of Hong Kong (TraHK) was the first ETF listed in Asia, in 2001, and remains the largest locally listed and domiciled ETF.

Over the last 20+ years, retail distribution of ETFs has been muted primarily because with the banks as dominant fund distributors, and ETFs not paying any commission rebates to them for sales, banks have generally avoided using ETFs, preferring to use mutual funds that do pay them commission for sales.

Where listed ? Hong Kong has allowed ETFs that have been set up elsewhere to get cross listed on the HKSE provided they have also been authorised by the SFC. Thus, not only are there Hong Kong domiciled ETFs, there are also ETFs listed and domiciled in both Luxembourg and Ireland that have been approved for sale in the market to retail investors. These are often referred to as "cross listed" funds. Some of the Luxembourg and Irish ETFs may also be cross listed in other markets, including Singapore, London, Paris and Frankfurt, which obviously allows for far wider distribution potential.

Despite it offering the largest number and range of ETFs, there have been no instances to date of US (New York) listed ETFs seeking to also be authorised and listed in Hong Kong.

d. Hong Kong SFC authorised

It is a requirement of the regulations, that retail banks may only distribute mutual funds to their customers that have been authorised by the SFC. Gaining authorisation for a fund is a relatively simple and straightforward process these days. The SFC has on its website a detailed description (Code) of the requirements, to be found here: https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/sfc-handbook-for-unit-trusts-and-mutual-funds/sfc-handbook-for-unit-trusts-and-mutual-funds.pdf

The latest version of the Code is dated January 2019: however, it is regularly updated and amended to reflect revised ideas, changes and market needs.

As far as the banks are concerned, although they are regulated by the Hong Kong Monetary Authority (HKMA), when it comes to sales of financial products to retail investors via bank branches, the HKMA cedes to the SFC and requires retail banks for follow the SFC Guidelines.

2. Who distributes traditional funds ?

Accurate statistics on the sources of sales of traditional funds by distributors are not available in Hong Kong. Various statistical providers have historically provided approximate numbers, although consistency of these has been poor. The SFC does a regular survey of the sale of non listed financial products. Although this doesn't cover all sources, it can be regarded as a good approximate guide to the aggregate sales of funds. As an approximation, the market has for a number of years, generally accepted that banks (both retail and private banks) represent around 80% of retail traditional fund sales, and that the top five institutions share more than 60% of those sales.

a. Banks

Banks have actively distributed mutual funds to their retail customers since the early 1990s. Initially, they focused on selling their own inhouse products, however, they soon learnt that adopting an "open architecture" approach to fund selling provided infinitely more opportunities to increase the sales made per customer.

"Open architecture"

In the context of fund selling by banks and insurance companies, "open architecture" means the potential use of all available fund managers and their products, within selected categories. Often, if the bank or insurance company has its own fund range, it might favour use of those, but equally, if funds from third party fund managers offer better returns to investors, they became the priority and can be included.

Why do banks distribute mutual funds ? Primarily, the revenues created from mutual fund sales have proven to be very attractive to banks, especially during the last 20 years when interest rates have fallen sharply. These commissions made from fund sales are regarded as "off balance sheet revenue" thus more appealing to analysts who study how banks make their money. At different times, the volume of this revenue has amounted to as much as 10% of revenues from retail banking, and due to the recurring nature of part of this revenue, ie. the trail commission (or retrocessions), this too has sustained higher profitability for banks than might otherwise have occurred.

Maintains customer relationships. Another key aspect of the use of "open architecture" fund selling, has been the importance of maintaining customer relationships. In Hong Kong, a large number of bank customers maintain multiple banking relationships. One might be the account they set up which is with the same bank as their employer (in past times, this ensured salary payments were received quicker), and another account with a local bank, for paying regular bills such as utilities or other household items. Thus, banks sought to find ways to capture more of their customers wealth, by offering more services, of which mutual funds were a part.

Avoids allowing customers to go elsewhere for funds. As mutual funds have become more popular with end investors, so they become more interested in ensuring they are getting the best funds available to suit their needs. Shopping around for funds thus became popular, especially when one bank might not be offering products of leading fund managers, and another does. This, from a bank perspective, could endanger their customer relationships.

Initially, when banks first started selling mutual funds, there was no proper or organized set up for doing so. Whoever, in their branches, might be interested or knew something about funds, might undertake the selling role. Then it was the branch managers, where the banks had them, and/or the Customer Relationship Managers (CRM), who tended to operate in front of the tellers at bank counters. In due course, the HKMA and SFC mandated that those involved in fund selling should be properly trained, and more importantly, were required to occupy a separate area of the bank floor space, either a dedicated room, or separately partitioned areas. Not all banks had the available space to achieve this, thus larger branches became more active in fund selling.

An interesting observation of the relationship between banks and their customers is that customers still retain a high degree of trust with their banks in Hong Kong (and Asia generally), which is very unlike the situation in Europe and America, where in many instances, the relationship has fractured.

How do banks use funds ? In the early days of fund selling, the banks became very adept at selling "flavour of the month" funds. This they could do through active promotion through their branch network, through joint events with the fund managers, such as seminars and via telephone campaigns by their sales staff. After a while, this type of approach led to an element of fund churning, where investors who had bought a promoted fund some months earlier were encouraged to switch to another newly promoted product. Naturally, each time a switch occurred, more revenues were earned. But equally, from the fund managers perspective, it meant they were seeing excessive turnover of assets in their funds. Regulators reminded banks to be less proactive in switching their customers between funds.

Subsequently, a number of the largest bank distributors focused more on giving advice on portfolios suitable to the future investment needs of their customers, thus they might create portfolios deemed suitable for a number of typical retail investor needs such as:

a. Retirement planning
b. Education funding
c. Property purchase
d. Inheritance or gifting
e. Capital growth
f. Income provision or planning
g. Short or long term investment planning

As portfolios, this meant that each customer would automatically invest into multiple funds with differing objectives, with a view to achieving the stated aims. The need to switch between funds was therefore drastically reduced. Further, as market conditions changed, minor adjustments could occur readily without the need to exit in full one fund to buy another in its place, which is what churning had been doing.

"Flavour of the month funds"

This is a term widely used to describe heavily promoted funds within the distribution networks. It could refer to new fund launches as well as the promotion of existing funds, often those with top rated past performance. It is widely accepted that many inexperienced investors are more attracted to high historical returns than to future prospective returns.

b. Private banks

Hong Kong has many private banks (PB). Almost all the major PBs globally have set up an office in Hong Kong, to service the needs of the wealthy, most often described as High Net Worth Investors (HNWI). Typically, PB services can be offered to customers with investible wealth starting from as low as US$100,000. The service offered can graduate significantly the greater the scale of wealth involved. Many PB offer additional services for Family Offices or for Ultra HNWIs (UHNWIs).

Customers of retail banks will often get passed on to their respective PB on achieving minimum net worth levels, as this enables more personal attention and time, than might otherwise occur at the retail level. Although the Swiss banks are probably most famous for providing PB services, US banks have entered the market aggressively over the last 20 years, especially at the UHNWI level, as they can often provide greater access to the US securities markets that appeal to such investors in Hong Kong and Asia. But Asian banks, as the "home team" have also developed strong PB credentials in the last 10 to 15 years. It can be expected that in due course, Mainland Chinese banks will follow suit.

The range of products offered by PB includes traditional mutual funds as well as a wide array of other financial options, such as hedge and alternatives funds, structured products, equities and fixed income investments, property related investments, and a number of other esoteric offerings all under the title of "private markets". Apart from traditional mutual funds, all other types of investment products offered via PBs tend to be unauthorised by the SFC.

When the PB come to select mutual funds for their customers, if they are a part of a large retail banking business, usually they will use the same selection as offered in the retail space, but they also have the option of selecting non SFC authorised funds. For the larger (Swiss and US owned, usually) PB they may well choose funds from both the broad European market base or even from within the United States.

All this is possible because the HKMA and SFC has determined that "professional investors" can include HNWI, where their investible wealth exceeds approximately HK$8million (US$1million).

c. Wealth management advisers

Hong Kong has, in recent years, seen a number of so called "Wealth Management Advisers" (WMA) get set up, often by those that had previously worked as private bankers. These WMA can range from simple investment advisory firms to offering quasi PB services. They may also choose to offer services for fees, rather than accept commission rebates from the sale of mutual funds products.

WMA have also developed in Hong Kong from the ranks of what were previously known as Independent Financial Advisers (IFA), which have existed in Australia, Europe and America for many years. These IFAs tended to provide a broad range of advice, often related to tax saving, or mortgages for home purchase, or pensions planning, targeted at the expatriate community. As they grew, so also did the types of clients they sought, which increasingly became local Chinese as well as expats.

Many of these firms would use insurance products (such as ILAS, see below) established in places such as the Isle of Man, offshore from the United Kingdom, as they offered certain tax benefits for doing so, and also substantial commissions for selling them.

In the last few years, use of the word "Independent" has been stopped by the regulators, on the grounds that being in receipt of commissions for making sales rendered the advisers biased, thus not independent. This, despite the continued use of the term in most overseas markets. Nevertheless, in Hong Kong, many previous IFAs therefore rebranded themselves as WMAs.

These WMA don't have the scale of coverage nor the numbers of clients to compete directly with the banks or PBs, but they do compete on the basis of the advice they can give, the level of service and professionalism they can offer, and by maintaining close relations with their clients. Many may also choose to compete with the banks by seeking to offer fund choices that the banks don't or won't offer. A few WMAs have also sought to become fee charging rather than commission earning, which in effect

means that they aim to discount front end loads on fund sales to zero, and may also either rebate or offset and trail commission earned, against their annual management fees, which can range from 0.5% to 1.5% of assets managed, depending on scale and complexity.

d. Insurance companies

Insurance companies in Hong Kong have long aimed to participate in the offering of investment products. Usually, in the past, this was through use of Investment Linked Assurance Schemes (ILAS), where there may be a small life insurance value attached to investment funds in the event of death. These at one time, were largely unregulated, however, in the last 10 years, a full regulatory regime has been introduced to ensure that such ILAS products no longer circumvent the restrictions that the SFC or HKMA may impose on banks and other investment advisers. Thus, all ILAS products sold in Hong Kong are required to gain authorisation from the SFC and/or the Hong Kong Insurance Authority (HKIA).

Many insurance companies aimed to restrict the range of funds offered to those created by their own businesses, however, as occurred with the banks, demand for "open architecture" choice of funds grew rapidly, to the point where most insurance companies now offer a wide choice of funds available through their ILAS products.

Of course, insurance companies have the benefit of large sales forces. Some of the largest exceed 15,000 salespeople, although quite clearly also, not all insurance salespeople are either suitable, qualified or properly licensed for sales of ILAS products.

e. Securities companies

It would seem a natural extension of the securities business for securities companies to add on wealth management advice to the range of services offered. However, to date few of the local securities companies in Hong Kong have built up any substantial presence in the wealth management area.

Similarly, it could have been expected that securities companies might naturally include ETFs in the range of securities products they offer their clients. This too has not occurred. A reason given for this is that many of the local clients of local securities companies still prefer to speculate in their buying and selling activities using stocks listed on the HKSE, and that ETFs don't provide the same level of speculative returns that stocks may provide.

f. Online fund distribution

In the last five years, a number of new online fund distribution networks have been set up in Hong Kong, with varying degrees of success. Usually, and to perhaps ensure some success, these online firms package a number of different services within their offerings, so that might include mutual funds, ETFs, securities, bonds, deposits and other securities products.

It is notable that the typical clients of these online firms tend to be younger, more savvy, and willing to do their own research before buying. As a consequence, the websites tend to be heavily populated with information. Another aspect of this, is that the average size of accounts maintained will likely be much smaller than at the retail banks, but these clients are more likely to accumulate their investments

by regularly adding to their portfolio as and when more resources are available, either through earnings or inheritance.

g. Why are some banks better than others at wealth management and fund distribution ?

There is no doubt that there are clear differences among the banks when considering their relative success at fund distribution. Indeed, the whole concept of providing "Wealth Management Services" differs markedly from one bank to another.

It might seem logical that as more Mainland Chinese people move to Hong Kong and bring their wealth with them, that the Hong Kong branches of Mainland banks with which they are more familiar and maybe hold their accounts in China with, would seek to target this customer base more aggressively to provide suitable wealth management services and advice. However, this attractive group of prospective customers is also a major target of the well established Hong Kong local banks, who appear to have more success at winning them as customers than their Chinese counterparts do.

To date, only a few of the more than twenty Mainland banks with branches in Hong Kong, have properly and fully engaged with developing a full range of wealth management services for their prospective customers. This does of course leave the field open to others to compete and achieve success. Some of the areas that banks need to focus on to improve their wealth management offerings to retail customers include:

a. Establishing wealth management as a full product line in major branches with strong leadership
b. Develop their own standard portfolios suitable for Mainland Chinese investors
c. Create focus lists that "tilt" towards usual investment needs of Mainlanders
d. Link up with their Mainland based counterparts for introductions
e. Populate a dedicated website with wealth management content
f. Employ dedicated, trained teams of wealth management advisers in branches
g. Use social media, including WeChat, etc., to promote their wealth management services

h. How do the HKMA and SFC regulate bank distribution of funds ?

Over the years, both the HKMA and the SFC have issued many reminders to banks of their expectations in how sales of investment (and investment linked insurance) products are sold to retail customers. Quite often also, both may do "mystery shopping" whereby they get to find out to what extent banks have adopted the practices they have mandated.

On 30 July 2014 the HKMA issued a letter (https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2014/20140730e1.pdf) directly to all the Chief Executives of all Authorised Institutions (AI) they regulated, setting out their views on "Issues and good practices in relation to the sale of investment products". This, in effect, is their byword on all practices adopted and what needed to be done at that time to correct what they saw as issues.

On 21 December 2018 the HKMA again issued a letter (https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2018/20181221e1.pdf) to the CEOs of AI about "Misconduct Risks in Selling of Investment Funds", where they focused on fund churning, incentive systems and training at AIs, which they had identified as needing to be corrected.

In September 2020 the HKMA issued a report (https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2020/20200930e1.pdf) on the findings of their mystery shopping of Authorised Institutions on the sale of investment and insurance products, which identified multiple issues needing to be corrected.

On 24 September 2021 the HKMA issued another letter (https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2021/20210924e2.pdf) to the CEOs of AI in "Distribution of Investment and Insurance Products through Non-face-to-face Channels", in which they set out their expectations for internet sales by both the banks and virtual banks being set up in Hong Kong, and in the light of the various restrictions being imposed by covid.

Through these various missives, the banks as a whole have a full prescription of what they are and are not allowed to do when selling mutual funds to their customers. The HKMA and SFC continue to do mystery shopping regularly, thus they will continue to find out to what extent the banks have implemented their guidance and instructions.

3. How to get on fund distribution lists ?

The priority of virtually all fund managers operating in the Hong Kong market, is to get onto the fund distribution lists of the major banks. Yet, the most common complaint of fund managers, is about how difficult it is to achieve that. There is a "golden rule" about bank distribution of funds that is often forgotten by fund managers' front line representatives, when seeking to promote their products.

The Golden Rule of Fund Distribution by Banks:

"Banks are not a sales team of the fund manager but the trusted adviser of their customer."

The following few paragraphs aim to provide more detailed information about how banks view the inclusion of mutual funds on their distribution lists. It is worth remembering, there is no magic wand involved, it can involve a lot of hard work, many and detailed reports to be provided, and ultimately patience, patience, patience on the part of the fund house.

a. Three Ps

The "Three Ps" are an important aspect for consideration in any effort made to get inclusion. It is essential for these all to be handled correctly, answered correctly and for them to be maintained.

i. **People** – Those who have ultimate responsibility for managing the assets of a fund need to demonstrate longevity in the role. So called "Star Managers" may often achieve that status through having managed their fund(s) over a reasonably long period, delivering consistently above average returns, and by being able to communicate well with all parties on how they achieved it. But they will also need support in the form of colleagues who can similarly communicate with the potential distributors, who can open the doors, and provide the right level of detailed analysis to enable confidence of bank frontliners to use the fund, explaining it to end investors/customers.
Typically, it would normally be expected that the portfolio manager (PM) can show a clear investment style, that has been used for many years to manage the fund and that has achieved the performance record. This would normally be expected to be repeatable, not involve lucky

stock selections, and cover a multiple of investment phases, ie. both rising and falling market conditions. The PM may be the team leader, or part of a larger team, but most importantly, should have held the role for at least 3 to 5 years.

ii. **Price** – Mutual funds in Hong Kong generally have a front end load of 5% plus management fees that vary in accordance with the asset type being managed, of between 0.6% to 1.75%. These are standard across the market. For banks to consider selling the funds of any manager, they expect to receive the whole of the front end load (5%) as a commission. This they may discount to the customer, sometimes in full, normally though, by 3%, depending on the size of the customer relationship and amounts being invested.
The management fee will usually include a proportion that is paid to bank distributors that amounts to between 0.25% to 0.75% depending on investment type. Banks expect to also receive reward for high volume sales, thus, where, for example, the aggregate assets held with a single fund house exceeds say, US$100million, there may be incentive management fees added. The larger the aggregate AUM the higher the incentive sought

iii. **Performance** – Ultimately, without top rated performance, funds simply won't get considered for inclusion on bank platforms. All funds are categorized into geographic and market sectors, depending on the fund objectives and underlying assets. They can then be measured over multiple time periods to evaluate their absolute and relative performance verses both their benchmark index and their peer group. Any fund that displays performance below average, i.e., in the bottom 50% of their peer group, has no chance to be considered. Top rated performance in a single year may not warrant inclusion on lists either, but sustained top performance will do.

b. Basic considerations

For a bank to consider including any fund onto its platform, it will have multiple considerations to take into account. The following is the usual list of criteria. Different banks may vary these according to their own circumstances, and may occasionally waive them for say, a new fund launch from a trusted manager, or for a fund they believe will resonate well with their customers.

i. A "focus list"
ii. Size and scale of fund
iii. Consistency of performance
iv. Top decile in category
v. Relative volatility
vi. Longevity of portfolio management team and leader
vii. Repeatable processes to achieve results
viii. Investment style, i.e., value, growth, momentum, etc.
ix. Small funds are usually excluded
x. Smaller sized managers are usually excluded
xi. Replacing existing funds/managers
xii. How do "own label" funds fit ?

c. Gatekeepers

All the banks employ "gatekeepers" to provide a form of liaison between the fund managers and the banks' own frontline staff. Often there can be multiple people in the role and with specialist abilities in reviewing funds for inclusion on platforms. Whether they are employed in Hong Kong, Singapore or elsewhere, will often depend on the set up of the bank. For example, Swiss private banks are likely to

have significant teams in the Zurich or Geneva offices, that can provide guidance to their Asian counterparts.

i. Role and importance
ii. Usually team not individual
iii. Conduit of information good and bad
iv. Need to know info on corporate changes first
v. Use of Morningstar data
vi. Customized mini Morningstar sites

d. Terms of business

Increasingly, banks prefer that the Terms of Business they agree with fund managers are as similar as possible, as this ensures limited scope for any form of preference based on commissions paid. However, it is quite likely that the top 20 fund managers on any bank platform will be in receipt of highly attractive volumes of sales, thus the bank will expect to see this rewarded in the form of an incentive deal. But again, this would most likely be the same for all those in the top tier group, with those not included (because their volumes are lower) not expected to offer similar terms.

i. 100% of front end load
ii. 60%+ of management fee as trail
iii. No load funds don't work
iv. Occasional special deals
v. Banks like to avoid favoritism
vi. Positioning for Top 20 providers

4. Marketing and sales strategies by fund managers

To achieve success in Hong Kong, as is probably true in most markets, fund managers need to combine a number of elements within their marketing and sales strategies. It doesn't work just turning up in the market and saying "We're here!!". Success can depend on many issues, including timing, product, trends, performance returns, etc. There is no single aspect that can change, and time is clearly important. Ultimately, as fund managers don't seek to make direct sales of funds to the retail investor, it is mainly about ensuring they have successfully got across their "brand" and that there is sufficient familiarity with their brand for that to not be the cause of a negative reaction at the point of investing.

a. Wholesaling vs Retailing
b. Role of Business Development Managers, Relationship Managers, Portfolio Managers in marketing
c. Role of marketers to educate, train, promote products, funds, markets
d. Bank branch visits
e. Why direct sales don't occur in Hong Kong
f. Advertising
    i. MTR Central
    ii. Side of buses and trams
g. Websites

5. Product types

When reviewing the list of "traditional" funds available for retail investors, what is most notable about the Hong Kong market, is that there is a wide choice of both locally domiciled as well as Luxembourg and Ireland domiciled funds available. As covered earlier, the SFC will authorise funds from many different locations, with equal treatment given to all. Generally, hedge and alternatives type funds have not been able to achieve SFC authorisation and thus are not made available to retail investors.

Virtually all major securities markets are represented by the choice of funds available. Whether by geography or by sector, whether single country, regional or global, or by specific objectives such as ESG or Indexation, there are equity, bond and fixed income funds available. Although there are a few money market funds included, unlike in China, these have tended not to be popular with investors, which is probably a reflection of the very low interest rate environment of the last 10 years.

Apart from traditional mutual funds there are also ETFs widely available, although as covered earlier, these have tended not to be used by most distributors due to the commission issues described.

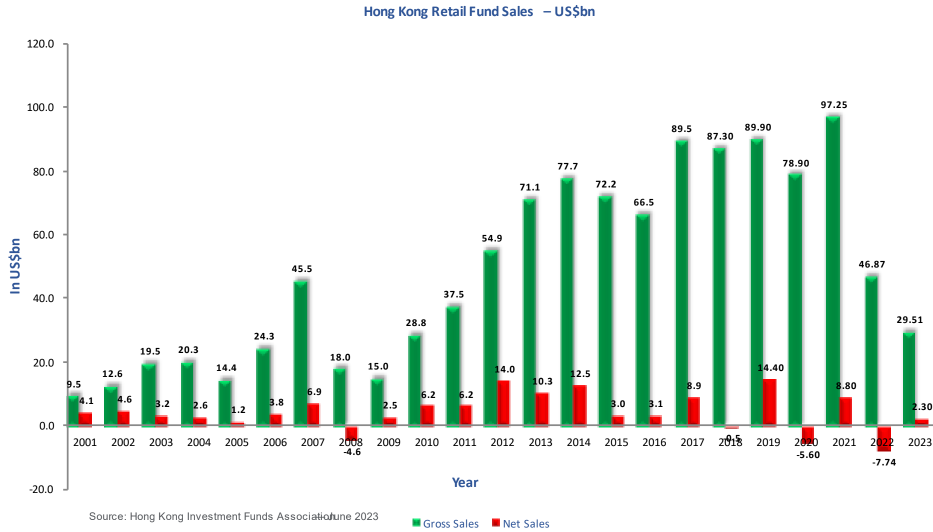
Many of the UCITS products from Luxembourg and Ireland also include multiple share classes, to cater for different types of investors. Of the share classes available, the most popular for use with retail investors remains "A" shares. These allow both front end loads and annual management fees from which commissions to distributors may be paid. Generally, they also require only a modest minimum investment, say US$5,000, to get started. Other share classes provide for different needs, such as "I" shares, which are targeting institutional investors with no front end loads and low management fees, but then they also require minimum initial investment of between US$1million and US$10million depending on the fund manager offering. Another type, "B" shares, have been made available from time to time. This type may have no front end load, but will charge both a higher annual management fee and a redemption charge of up to 5% on redemption of the holding within the first 4 or 5 years, again, depending on the fund manager requirements. This Contingent Deferred Sales Charge (CDSC) enables commissions to be paid to distributors, and have been perceived to discourage frequent switching between fund managers by distributors, although that aspect can be argued to be detrimental to the best interests of investors.

Very recently, some ETFs have begun to offer unlisted share classes of their listed ETFs. This is being done to both enable their product to be used by distributors within the Greater Bay Area under Wealth Management Connect, and these share classes include fees that can then be used to pay commissions to distributors.

a. Historical fund sales and redemptions

As can be seen from the chart below, which shows the gross and net sales of Hong Kong authorised funds over the last 18 years, there has been a strong and rapid increase in the aggregate sales volume in the last five years. However, when redemptions are taken into account, the net sales figures are clearly less attractive. That said, for new market entrants, this should be seen as a form of encouragement, as it clearly demonstrates that there will always be opportunity to make sales in the market. The challenge for all fund managers, is to retain the money under management once received, and for this, quite obviously continued top rated performance will be essential.

Hong Kong Fund Sales: Gross and Net

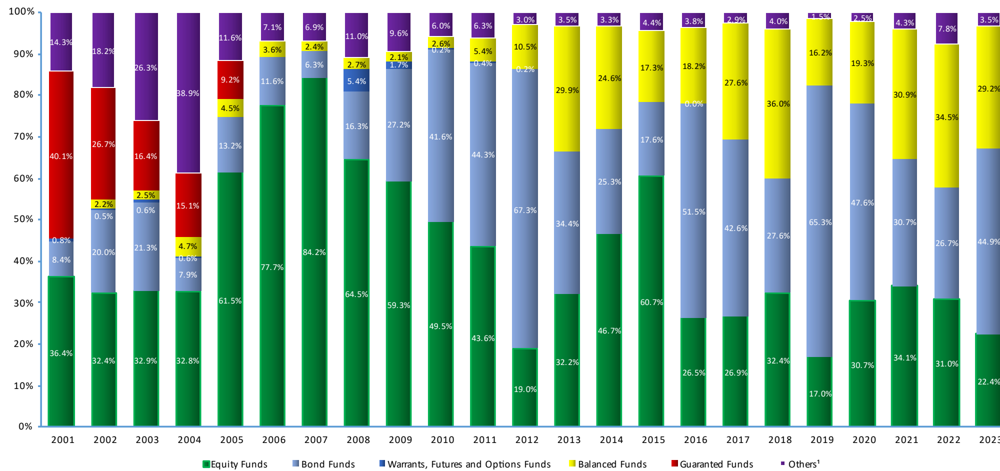


b. Popular market sectors

The following chart shows the flows of money into the major market sectors such as equities, bonds and fixed income, multiasset and money markets. These flows can also be seen as an indicator of market trends. Thus, when investors are seeking income, bond funds tend to be popular.

In Hong Kong: What's Hot, What's Not!

Yearly Gross Sales Breakdown by Major Fund Categories



Source: Hong Kong Investment Funds Association June 2023
1. Include Money Market Funds/Liquidity Funds, Equity Index Funds, Fund of Funds, Hedge Funds and Other Funds.

Conclusions

1. The Hong Kong market for unit trusts and mutual funds remains vibrant, competitive and active.
2. The market for ETFs at the retail level is more subdued.

3. The distribution of funds is dominated by banks (market share approx. 70%), with private banks, wealth managers, insurance companies and others holding the rest. Commission, both front end and trail, remains essential for success.
4. Due to the need for commission for sales, the ETF market still has some way to travel before it can succeed.
5. Among funds, UCITS from Luxembourg and Ireland are dominant, with a market share of around 70%.
6. The scope for growth in locally domiciled funds in Hong Kong is rapidly changing, as the various “connect” schemes with China only allow Hong Kong domiciled funds to participate.
7. The opportunities for global fund managers to set up in Hong Kong and participate in the business remain strong.
8. Whilst the rate of turnover of fund buying and selling in Hong Kong is high by comparison to many other global locations, this also means that with a top rated product it is possible for new entrants to achieve success relatively quickly.

Exchange Traded Funds in Hong Kong

1. In the Beginning .. There was The Tracker Fund of Hong Kong

The Tracker Fund of Hong Kong (TraHK) was launched in 1999, and is considered a pioneer of the Asian region Exchange Traded Fund (ETF) industry. In 2023, it remains as one of the largest and most liquid ETFs in the Hong Kong market. Currently managed by Hang Seng Investment Management Limited (HSIM), TraHK provides a cost efficient means of gaining exposure to Hong Kong Stock Exchange listed equities for a range of investors, large and small.

In August 1998, the Government of the Hong Kong Special Administrative Region (HKSAR government) acquired a substantial portfolio of Hong Kong shares during a period of extreme market disruption. Exchange Fund Investment Limited (EFIL) was established in October 1998 by the HKSAR government and one of its functions was to advise on the disposal of this portfolio in an orderly manner. To then dispose of these shares, the HKSAR government chose what it believed would be a stock neutral solution that would create minimal disruption to the market. TraHK, which met these requirements and added depth to Hong Kong's capital markets, was launched in November 1999 as the first step in the HKSAR government's disposal programme. State Street Global Advisors Asia Limited was appointed as the Manager in 1999 and State Street Bank and Trust Company was appointed as the Trustee and Custodian of TraHK.

With an issue size of HK$33.3 billion (approximately US$4.3 billion), TraHK's Initial Public Offering (IPO) was the largest IPO ever in Asia ex Japan at the time of launch. Through the IPO of TraHK and its Tap Facility, approximately HK$140.4 billion (by 15 October 2002) in Hang Seng Index constituent stocks had been returned to the market.

TraHK aimed to track the performance of the Hang Seng Index (HSI), which is the benchmark for performance of Hong Kong stocks. Whereas in 1999 when TraHK was launched, the HSI was primarily composed of stocks of Hong Kong companies, by 2023 the HSI is now more than 65% Chinese companies listed on the Hong Kong Stock Exchange.

From September 2022, HSIM officially became the manager of the TraHK, replacing State Street Global Advisors. A consequence of the success of TraHK, which at one time had more than 300,000 individual investors, has been the confidence of many of the big global providers of ETFs to set up and offer their products in Hong Kong.

2. **Arrival of "BIG" Names, eg. iShares, X-Trackers, Lyxor and Many Global Firms**

From around 2004, many major global providers of ETFs began to offer their products in Hong Kong. This was as a direct result of the SFC allowing a cross listing in Hong Kong of ETFs that were established as UCITS products, listed and domiciled in other locations, specifically Dublin, Ireland or Luxembourg.

Thus, major names such as BlackRock iShares, Lyxor, X-Trackers and a few others, listed their UCITS ETFs in Hong Kong. This had the effect of broadening the investment objectives of ETFs on offer, as these new arrivals aimed to provide ETFs benchmarked to indices of major stock markets worldwide.

As a further consequence of listing their products in Hong Kong, many of these same firms sought to also list products in Singapore, where the Monetary Authority of Singapore (MAS) was playing "catch up" in the usual competitive spirit that exists between the two locations.

By 2010, in addition to the major global names, a few "local" fund managers in Hong Kong had also created some ETFs and were offering their products to the market.

A key issue during this period, was the way in which different ETFs chose to manage their assets to achieve investment returns in line with their chosen benchmark index. Most had "full replication" strategies, whereby their assets were composed of the listed stocks of the index in line with the proportions they represented. But a few providers were offering "synthetic" replication, which is where they could use market "swaps" or other derivatives, that also gave exact replication, but only used around 10% to 20% of the holdings to achieve this, with the remainder of the portfolio held as cash. The cash could then be lent to the market to earn interest which helped cover the costs of managing the portfolio and provided the fund manager with slightly higher revenues.

But at the same time as these synthetic products began appearing, there was a significant negative market event that caused major concerns, especially to regulators, on the validity of derivative products. Thus, the SFC delayed approving synthetic ETFs for an extended period while they considered the implications.

Unsurprisingly, the SFC eventually relented and began to approve the use of swaps and derivatives to enable replication by ETFs, but by then the damage had been done, and synthetic ETFs failed to achieve popularity or success in Hong Kong as a result.

Securities lending, by ETF providers has also been an issue of concern by the SFC. Rightly, their concern centred around whether the lending was properly managed, to whom were securities being lent, what proportion of assets was involved, and how were the fees earned by it being distributed. The fees from securities lending by ETF companies can generate substantial fees, so of importance was whether any part of these was being paid back into the fund or retained by the fund manager to supplement fees from the managing of the fund. The cautious approach of the SFC on these matters, which has been to protect the interests of investors, has meant many ETFs have not come to market from overseas location.

3. Arrival of Chinese Fund Management Companies with ETFs

From around 2010 onwards, a small number of China owned fund management companies (FMC), that had already established themselves in Hong Kong with mutual funds, added ETFs, mainly invested into Chinese markets, to their offering. This development had been greatly assisted by the rapid opening up of the Chinese securities markets and access between Hong Kong and China. Routes such as Stock Connect and Bond Connect, made a massive difference.

Initially, ETFs linked to the major Chinese stock market indices were offered, and were particularly successful in attracting money from institutional investors who had previously only been able to invest into China via "access vehicles" or "B" and "H" shares. Subsequently, more ETFs were added that met the demand for fixed income as well as equity investing, and also for specific market sectors.

4. Regulations

The Hong Kong SFC is generally very supportive of the ETF market. They have allowed cross listing of products from Dublin, Luxembourg and other locations in the same way as they have for mutual funds, most typically UCITS. Often the time taken to gain fund authorisation for UCITS ETFs can be much longer than for locally domiciled products. This is due to a need to coordinate between regulators in different locations.

The SFC has recently allowed the development of “feeder” ETFs provided certain criteria, mainly on size and turnover, are met. Whilst this does offer a route to bringing successful funds from overseas to the Hong Kong market, to date there has been little success achieved for these. The SFC also allow OFC ETFs, which can operate in an identical manner to the local unit trust type.

The market has generally benefited from the SFC approach to regulating ETFs, but from time to time, due mainly to the SFC’s cautious attitude, there have also been restrictions and slow movement on developments that has slowed progress too. These include such issues as synthetic products, Leverage/Inverse (L/I) products etc. The SFC would undoubtably like to see a bigger ETF market operating in Hong Kong, but they can’t force it either. Future possible regulatory changes could include: unlisted share classes, “active” ETFs, cross border inclusion in Wealth Management Connect, ETF Connect and Mutual Recognition of Funds.

5. Cash and Synthetic, Regulation Changes

As discussed above, the ETF market in Hong Kong in the 2010-2012 era, was particularly impacted by regulation changes. The SFC in Hong Kong, out of concern for protection of the investor, wanted to take time to consider the impact of use of derivatives, specifically swaps, to provide the investment return on ETFs. Although this route had been popular and successful in Europe, and had been able to creep into the Hong Kong market, it was the result of some unrelated market collapses and the banking crisis in 2008 in the US and elsewhere and the collapse of a few providers of derivatives products that caused concern to Asian region regulators, thus an attempt to slow the further introduction of such products occurred.

The SFC and the HKSE issued multiple guidance notes, in effect attempting to alert the market to their concerns. Eventually in 2011-12 the SFC appeared to be satisfied that those synthetic products seeking to be authorised in Hong Kong met their requirements and were then allowed to proceed, provided adequate “warning” labels were attached and that their Stock Exchange “ticker” number had a mark to reference they were synthetic products.

But by now the market in Hong Kong and Asia was wary of anything using derivatives, and thus most synthetic based ETFs failed to achieve the level of success that the regular “cash” based products had achieved.

Regulations have played an important part in the development and success of ETFs, and generally the SFC in Hong Kong has been supportive of newer developments. However, a common cause of concern in Hong Kong among global ETF issuers active in the market, has been that unlike in the US or many parts of Europe, it can take time to get authorisation to launch new funds and the procedures for closing funds that fail to be viable can be arduous and long winded.

Until relatively recently, the process to obtain SFC authorisation for the launch of a new ETF could take between 3 and 6 months, depending on the speed and experience of the lawyers that would handle such applications and/or the complexity of the product itself. The process would necessitate multiple submissions to the SFC in line with their requirements for disclosure and in accordance with the needs of the SFC Code on Unit Trusts and Mutual Funds. Stand alone funds would take significantly longer to receive authorisation than would additional sub funds of “umbrella” products. But in the last few years, the SFC has streamlined the process somewhat, to enable faster approval processes to occur. UCITS ETFs are generally slower to gain authorisation.

But the termination of an authorised ETF remains a slow process. As can often be the case with ETFs, if a product fails to capture sufficient assets and thus is too small to be viable, the best course of action is to close it. In many overseas markets, this can be done swiftly, and investors in the ETFs have their money returned promptly. In Hong Kong however, due to a need to comply with the SFC Code, ETFs that wish to close need to go through a notification process that can often take 3 to 6 months to complete. Investors in the funds are required to vote for or against proposals to terminate, shareholder meetings are required, a minimum quorum of shareholders are required to attend, and thus this can often take far longer than the fund house finds desirable.

6. New Products, Leverage/Inverse, Thematic etc.

As the development of new indices has occurred, so also has the introduction of more ETFs to track them. Particularly popular has been the development of thematic ETFs. Thus, in addition to the traditional choices of individual stock markets, and sectors of them such as mid or small cap stocks, there has been development of themes that have been popular with end investors. These have ranged from technology, to healthcare, autos to leisure, autonomous vehicles and electric battery makers, etc. Each theme can potentially "have its day in the sun" and be popular with investors, but from the fund company perspective the key issue is to get the timing right and be able to offer such thematic funds at the same time as investors pour money into these areas, and thus benefit from the ride.

Similarly, L/I ETFs have developed in a number of markets. Initially these L/I products had been popular in the US, especially with professional investors such as hedge funds and thus that were confident in picking market trends. Leverage of an ETF (in the US) was offered up to as much as 10 times, thus offering a potential of a daily return of as much as 10 times the upward market movement for that day. Inverse products aimed to capture a multiple of the downside movement of the market, thus giving positive returns on a falling market. Korea, Taiwan and a few other locations also saw great success being achieved by L/I products. ETF providers were keen to bring them to the Hong Kong market, as it was seen to be a product many local punters in securities might wish to use.

In Hong Kong, the SFC initially had declined attempts to gain authorisation for L/I products, believing them to be offering too high a level of risk for local investors. This despite the popularity of warrants in Hong Kong shares which have represented as much as 30% of the daily turnover in the market. Eventually however, the SFC did begin to approve L/I products subject to certain restrictions and provisions.

7. Open Ended Fund Companies, Feeders, Active, Money Market, Index Development

To date, "active" ETFs have not emerged in Hong Kong. The SFC does allow such products and has occasionally expressed keenness to see them launched, but the industry has been slow in seeking to use this development opportunity. The key issue for ETF product providers has been whether there are enough investors in "active ETFs" to enable their launch to prove viable. When the obvious competition to "active" is the traditional mutual fund upon which it might be based, where a commission is paid to distributors and intermediaries (no equivalent is paid on ETFs), then it is clear there is unlikely to be a significant level of support, sufficient to make the scale of these ETFs viable commercially.

Money Market ETFs are beginning to be developed again. There used to be a few of these in the early days in Hong Kong's ETF history, but as interest rates dropped to almost zero in most major currencies,

the attraction of Money Market ETFs disappeared. Now that interest rates are returning to higher levels (July 2023), then the appeal of these types has begun to return.

OFC type products have been developed in Hong Kong by the SFC in parallel with existing formats, to offer fund management companies an alternative structure that is somewhat similar to UCITS products from Europe. The first OFC ETFs were launched in 2021 and have proven to be very successful, and sit alongside other legal formats. From an end investor perspective there is no difference in these structures. It is expected that over time many more ETFs will be set up as OFC.

Index development by index companies has been another catalyst for product development. Whether it is the more traditional index providers such as Hang Seng Indices, FTSE, S&P, MSCI, Dow Jones or the more recent providers such as Solactive, Bloomberg etc., many new indices are being created to attempt to find a new combination of securities that might give better, more consistent returns. This can involve use of market sectors as well as geographic sectors, it might mean inclusion or exclusion of selected factors, whatever might be able to contribute to better returns. Most topical among these in recent times has been Environmental, Sustainable and Governance (ESG) issues, with many index providers offering ESG factor indices from which ETFs can be derived. This route has not yet developed in Hong Kong and Asia, due to a lower appreciation in the region of the importance of ESG than exists in Europe and the US.

8. Why Should ETFs Have a Place in the Funds Market ?

Cross Listing in Hong Kong

Cross listing of mutual funds in Hong Kong, Singapore and some other markets in Asia is nothing new. The first cross listed funds were UCITS products from Luxembourg, more than 30 years ago. Since then, UCITS products have come to dominate the Hong Kong and Singapore mutual fund markets, taking an estimated 75%+ market share consistently for most of the last 25 years. UCITS products have gained the trust and respect of investors in Asia, offering some advantages over locally domiciled products. But many investors will still buy ETF exposures on Wall Street, often due to unwarranted perceptions on liquidity concerns for Asian listed ETFs.

Cross listings are now a practical proposition in Hong Kong and Singapore following relaxation of restrictions by regulators and to linkages in both markets established with organisations such as Euroclear. The adoption of cross listed ETFs has become increasingly popular with investors attracted to their low cost, liquidity and investment diversification. Cross listed funds could use Euroclear Bank's centralized clearing model, the international central securities depository (ICSD) system, which has transformed ETF trading in Europe. Instead of requiring local approved participants to issue units, as was the case in the past, any local Asian exchange participants with access to the ICSD now would be able to transfer shares to and from the Hong Kong and Singapore exchange. It reduces the time it takes to move ETF shares from Europe to Hong Kong and Singapore. This centralized system is expected to result in reduced spreads and lower costs for investors. The ICSD system could also encourage greater institutional interest due to fewer restrictions on order size.

Different Market Strategies

There is no "one size fits all" approach to accessing Asia's ETF markets, therefore international issuers are exploring the best options. The time and regulatory requirement for a new listing varies across different markets and master feeder structures is the only practical route in jurisdictions like South

Korea, Japan, Thailand, and Australia. Additionally, a majority of ETF transactions are still traded via OTC or on exchange in the European or US time zone.

The Hong Kong Stock Exchange experienced significant changes in 2020 to boost liquidity and trading efficiency. These included settlement extension, continuous two sided quotes, and reduced tick sizes. Thematic and short selling exemptions also contributed to doubling daily average trading volumes in ETFs, reaching a peak of HK$16.5 billion (US$ 2.1 billion) in November 2022. 10% of this turnover related to ETF Connect with China.

The Singapore Exchange has also experienced doubled ETF assets management in the last three years, reaching S$11 billion (US$8.25 billion). However, its on exchange trading has seen flat growth, with fixed income products making up half the market. Due in large part to Singapore's success in increasing retail interest in ETFs, the number of retail accounts has tripled, accounting for 35% of AUM and 25% of trading volumes. This increase is attributed to robo advisers, which simplify the distribution of ETFs by lowering buying lot sizes.

Active ETFs

The first active ETF was launched in 2008 in the United States but was slow to take off due to cost and time consuming process by the regulators. With evolving and progressing on accompanied rules, there are a total 939 active ETFs in 2022 compared with only 13 in 2008. (source: Statista 2023). Australia became the first in APAC to embrace active ETF. In March 2023, active ETFs in Australia made up 18% of the whole ETF market.

This upward shift in active ETFs has been due to fund managers converting established mutual funds or LICs (Listed Investment Companies) into ETFs and new listings. The dual access model, allowing active managers to run a single register for both unlisted and listed investments, offers greater operational and investment efficiencies. This practice is gaining popularity in the market.

South Korea launched its first active ETF in 2017, expanding to equities in 2020. China approved its first active fixed income ETFs in 2020, with 32 products. Tokyo bourse announced on 30 June 2023 that it had opened applications for domestic and foreign asset managers to list active ETFs in Japan. While in Hong Kong, it's more eye catching that actively managed ETFs backed with virtual assets, were the very first in APAC, including one on bitcoin futures and one on ether futures, that were listed on HKEx in December 2022. The third ETF was listed in January 2023, offering two ETFs on bitcoin futures and one on ether futures. Mirae Global X Investments (Hong Kong) also rolled out its latest first actively managed fixed income ETF addition to their existing 25 listed ETFs in Hong Kong. The Average Daily Turnover of approximately HK$9.3 million (US$ 1.2 million) (Source: ETFs and the Growing Virtual Asset Ecosystem in Global Financial Markets by HKEx, April 2023). The successful launch of those actively managed ETFs in Hong Kong reflects authorities' commitment to the virtual asset ecosystem and the market's appetite for related products.

9. Why Are ETFs in Hong Kong Not as Successful as in the US, Europe, Australia, Taiwan, Korea, China ?

Distribution of mutual funds in Hong Kong and the majority of the Asian region, has been highly dependent on the distributor receiving commission both up front on the amount invested, as well as "trail" or "retrocession" of a small percentage on the amount of assets retained by the fund house. The banks' wealth management businesses have been built around this concept, to the point where this represents a significant proportion of the aggregate revenues of a bank, all of which is "off balance sheet" thus worth considerably more in the greater scheme of things.

ETFs do not have any allowance for commission payments built into their structure, although the trading of them on the stock exchange does allow a brokerage payment to the securities broker or bank, amounting to between 10bps to 25bps depending on size and market where traded. Banks are the dominant distributor of funds in most of Asia, representing as much as 80% market share in some markets. Apart from banks, there are a number of wealth managers and other financial advisory firms operating. These too have tended to rely on the receipt of commission to finance their activities, however, there has recently begun a trend towards fee charging for advice, by some newer wealth management firms. This has allowed them to consider the use of ETFs as part of their investment advice to clients, as they are unencumbered by the necessity of using commission earning products. In the US and Europe, there has been a development of "robo advisory firms" using technology to provide active management of selected portfolios. These types of firms are also users of ETFs. In Asia, to date, there has been very little success for these types of businesses so far.

All analysis of how and where ETFs have achieved success in the mass retail market has shown quite clearly that when ETFs compete with commission bearing products in distributor dominated markets, ETFs lose out. When countries such as Australia, the UK and the Netherlands introduced a ban on commissions (and retrocessions), the ETF market subsequently boomed.

Nevertheless, in Asia, ETFs are increasingly popular with institutional investors, who represent possibly more than 80% of the assets raised. Institutions such as pension funds, insurance companies, sovereign wealth funds and even hedge and alternatives funds can be active users of ETFs. Many large investment banks cater to these investors providing services for the creation and redemption of shares in ETFs, cheaply, quickly and in accordance with the needs of these investors, especially when they make significant and sizeable investments into funds.

10. The future of ETFs in Hong Kong

The outlook for ETFs in Hong Kong remains positive. Institutional investors, such as pension funds, insurance companies and sovereign wealth funds, are already active users of ETFs and can be expected to greatly increase the proportion of their assets invested via ETFs in the coming years. Institutions are thus well engaged with this product.

The challenge is to get retail investors to buy. How will this be achieved ? Across the Asian region there are a few examples where retail buyers have become active in ETFs and it is instructive to review these.

For example, in Taiwan, there has been much success in the retail space achieved by a number of ETF providers, through being able to offer products the retail investor considers appealing in a timely manner and offering investment return potential. Taiwanese investors are notoriously short term in their investment horizons, yet this has suited the ETF market there as it has enabled products to be created that can appeal to this way of investing. In addition, Taiwan was an early exponent of the use of L/I products, which suited the short term speculative approach of many. The development of ETFs in Taiwan was also supported by extensive use of social media, telephone sales, advertising and minor celebrity endorsement. This combination worked, and the ETF industry in Taiwan has grown strongly as a result.

In Korea, there has been a similar story, particularly with the use of timely launches of new thematic products that appealed especially to younger investors.

In Hong Kong many of the smaller ETF providers are active in their promotional efforts. They may advertise products widely, may use telephone sales techniques, and aim to have timely launches to

stir up market activity and interest. Thematic funds have also been launched with varying degrees of success.

But absent from the product developments seen in the Hong Kong market are “local” products that might be better understood by the average/typical local investor in securities in Hong Kong. For example, there are few, if any, ETFs that exclusively invest into Hong Kong domestic companies, whether large, medium or small capitalization. There are few, if any, ETFs that invest exclusively into Hong Kong market sectors such as property, conglomerates, leisure or banks. Inevitably, most socalled local ETFs include a significant proportion of their investments made into China securities listed in Hong Kong. This is an inevitable factor given the proportion of China stocks now listed in Hong Kong.

In China there are many thematic ETFs that cover both market as well as geographic sectors. These can be available to Hong Kong investors also via the ETF Connect scheme, but to date there has been little comparative information provided in the market for investors to consider and make informed decisions.

Thematic ETFs are popular with retail investors more than with institutional investors, but their success also depends heavily on timing.

Getting local securities brokers active in using ETFs should be a major priority of both the product providers as well as HKEx. This has not yet occurred, mainly because many local brokers earn the majority of their revenue from securities trading through highly active turnover. In the last 30+ years, the warrants market in Hong Kong (ie. warrants of local Hong Kong listed companies that enable the purchase of the ordinary shares at a fixed price at a future date, and that can often be for a multiple of five to ten times) has achieved up to 30% market share of daily turnover.

More online brokerages and investment advisory businesses operating in the market might also help as they seem to be a key component of success in other markets.

But the “big elephant in the room” for ETFs to be successful in Hong Kong and Asia generally, is the commission paid to banks and distributors by mutual funds, against which ETFs have been unable to compete. Will a “commission ban” be brought into the Asian markets ? Probably not. The regulators do regularly review this position, but to date they have seen no reason to introduce a ban, and in any event, if they were to do so, there would probably be considerable lobbying by banks as well as fund houses against this notion.

Investors in Hong Kong and most of Asia like to follow “trends” when considering where to put their money. A potential key to future success for ETFs is to get trend followers to support the product. There is already some evidence that many younger investors have a preference to the lower costs that ETF investing provide. But they don’t yet have the volume that their parents’ generation has, to put money into investment products. We have seen good support for trend investing through the thematic approach. Picking the right theme, getting the timing right and delivering top notch performance are all factors that can help towards success in the local and regional ETF market.

“Retailization” of Private Assets in Asia

1. Introduction

Asia Pacific’s share of global assets under management (AIM) (public and private) rose to 30% at the end of 2021, and over the previous 10 years Asia Pacific’s private equity AUM grew 2.4 times faster than for North America and 3 times faster than for Europe (source: Bain & Company’s Asia Pacific Private Equity Report 2022) demonstrating both the investors’ interest in Asia Pacific, and the number of new private market opportunities in the region.

The growth in private markets has been visible in private equity with both a fast increasing number of unicorns (privately held startup companies with a value of over US$1 billion) across the region, and also in private credit thanks to a challenging lending environment created by regulatory changes at banks, real estate, infrastructure and more recently energy and natural resources, and these private markets have in the last decade become an integral part of the capital markets.

Private investors across the region, and in particular retail investors were barely able to invest in private assets for a number of reasons, most notably the complexity of such investments, high capital requirements and regulatory restrictions.

Times are changing and the focus of private investors is increasingly shifting towards the private markets. Private equity has demonstrated its ability to generate high returns, even in recent years where public markets have shown some volatility. As an example, and according to Bain & Company, Asia Pacific private equity returns rose to a new high of a 15% median net IRR (internal rate of return) in 2022, from 13.9% a year earlier. Top quartile funds continued to deliver robust returns well above expectations, at 25% median net IRR.

The “retailization of private assets” describes this trend whereby alternative investment funds are opening to new investors, smaller entities and individuals who have not had the opportunity to invest into private markets before as these asset classes were mainly invested into by large, established institutional Limited Partners (LPs).

But why do General Partners (GPs) and private assets’ fund managers in Asia Pacific want to open this asset class to a new source of investors, knowing that this may cause some significant challenges ?

2. Opportunity – the search for new capital

The next couple of years could prove more difficult and challenging for Asian private assets fund managers.

Bain & Company’s Asia Pacific Private Equity Report 2023 describes an uncertain outlook for the private equity landscape, saying that private equity funds turned cautious in 2022, ending two years of record deal making, and that by midyear an economic slowdown collided with mounting global and regional uncertainties to produce a perfect storm for investors.

According to Bain & Company’s data, Asia Pacific deal value, exit and fundraising fell sharply below 2021 levels, and Greater China – the region’s economic private equity powerhouse suffered the biggest contraction in deal activity due to Covid lockdowns, declining growth and China US tensions.

With this gloomy outlook in mind, it is not surprising to see this vast untapped market of private investors becoming increasingly attractive for GPs in APAC. The definition of private investors varies – and in this article we shall refer mainly to High Net Worth Individual (HNWI) to Ultra HNWI (UHNWI), not the mass affluent who don't have enough capital to access these asset classes or benefit from the advices of a wealth manager or private banker.

According to Bain & Company, if individual investors hold around 50% of the global assets under management, this number falls to 16% if we only look at assets held in alternative investment funds.

If we add that by 2030, Asia Pacific will boast more than three times (amounting to US$2.7 billion) the number of middle class consumers than Europe and North America, it is easy to see why this topic is going to be one of the favourite conversation topics amongst GPs and LPs in the region.

Alternative investments have become increasingly interesting for wealthy individuals as they are looking to diversify their investments away from traditional markets and secure better returns. In the 2022 Hubbis Survey on Alternative Investments for Asia's private clients, 86% of Asia's wealth private clients say that they are more interested in alternative assets since the mainstream market declines and geopolitical uncertainties of 2022.

According to Ernst & Young, this growing appetite can be explained by the same factors that drove professional investors a few decades ago: the resilience of the asset class, the diversification of their overall asset allocation and the historical outperformance of the strategy in a context of volatility of the public markets. For retail investors the trend is further reinforced by the recent rise of real estate markets, growing wealth of certain segments of the retail investors and the willingness to invest side by side with professional investors sometimes described as "smart investors".

3. Challenges

We mentioned that private assets products were invested into by large institutional investors, and not by private investors mainly because of the difficulty to access such investments, higher capital requirements and regulatory restrictions. There are multiple reasons explaining this, but fundamentally institutional investors invest on different terms and with different objectives than retail investors.

- **Illiquidity**

Private equity investing is full of characteristics that may seem daunting for first time investors. Illiquidity is often mentioned as the first and potentially the main barriers to entry (and exit) at scale for private investors. Private individuals may need to think about investment periods in a different way to how pension funds or sovereign wealth funds might think about commitment drawdowns – long investment periods may be daunting for private clients. If a client wants to invest a million dollars today, but the capital is only being called over a five year period, they will feel their amount is blocked and not entirely put to work. Private asset funds that target HNWI may need to think about faster drawdowns.

FAQs from private individuals often include questions such as "what if I need my money back sooner, or when do I get my money back ?" – communication up front is key, and this is probably something GPs will need to factor in when setting up this new distribution channel.

- **Education / communication**

Movies rated G are suitable for all ages – by analogy, private equity investments are surely not a “G rated” asset class and generally require a certain level of investor sophistication and education. An insufficient understanding of the asset class is something that has historically held fund managers back from engaging with individual investors. Retail LPs may be lured in by the promise of high returns, without fully understanding the risks. Unlike traditional institutional investors that have been investing into private markets for a long time, HNWI or wealthy families (and their wealth managers) may have little or no prior experience of what exactly private markets investing entails and as a consequence they might not be making a well informed decision over the liquidity and risk profile. Education is therefore key to unlocking this new and potentially lucrative investor base’s full potential.

When it comes to non institutional LPs, GPs tend to be extra cautious about making sure they understand what they are investing in, with an added layer of making sure they are investing in a secure environment, with the highest level of information and right level of advice. This can lead to turning down some investors if the feeling is that these LPs do not have the right level of understanding about the risk they are taking.

Education can come in various shapes or forms: GPs and / or wealth managers may use workshops, education sessions, newsletters, factsheets, podcasts, webinars or electronic Q&As to make sure wealth managers and their investors are well informed.

The role of the wealth manager and its relationship manager is also key – and it is important for GPs to make sure that – even prior to educating the end investors – intermediaries are educated, trained about the risks and specificities of investing into this type of (often) closed ended and less liquid structures. The more layers between a GP and the end investor, the greater the risk that communication issues arise. The intermediated distribution of private assets funds to retail investors will require a distribution process that takes into consideration this important feature, with additional resources that can deal with this distribution channel.

- **Distribution channels**

GPs have traditionally built lasting relationships with a limited number of large institutional investors – now if they want to actively go after retail investors, they may need to create a distribution and marketing infrastructure in order to reach these investors and build awareness among them. Private assets, and the broader alternatives industry lack brand recognition and a clear understanding among many high net worth individuals of how the business model works. According to Bain & Company, when asked to list up to three firms wealthy individuals are familiar with that provide investments into alternatives assets, “I don’t know” rises to the top in terms of answers, followed by large asset managers such as Fidelity, Charles Schwab or Goldman Sachs.

One of the most common ways for GPs and private asset fund managers to reach wealthy individual investors is via an intermediated way, through private banks, wealth advisers or family offices. GPs may use feeder funds to channel private wealth and HNW investor capital into their main vehicles. The use of master feeder structures is becoming increasingly popular to achieve this “retailization” of private assets. In such structures, investments – which often start with a minimum investment of US$100K – are pooled in independent Luxembourg or Cayman domiciled feeder funds which invest directly into the underlying target funds. This is a model that will not impact the traditional fee structure of private equity funds, and the 2% / 20% fee model.

- **Fees**

At the heart of the private assets' model is the notion that GPs are incentivised to maximise returns for their investors, in particular due to the fact that they will be investing alongside LPs. However, if the majority of investors are non institutional investors, that invest via feeder funds or private wealth channels via their banks, they will have less negotiating power than large institutional investors, and as such it might be more challenging for them to push GPs to put more skin into the game. Yet, by investing at scale, they may be able to get into a room with GPs and discuss the management fee. A 2% management fee, which is the norm in the private equity landscape is unlikely to be accepted as such in a fund that is mainly targeting retail money as these investors pay an average of 0.7% when investing into international equity mutual funds according to Morningstar.

4. Solutions

Private assets fund managers can build trust and confidence with individual investors by ensuring alignment with their goals and providing appropriate flexibility and liquidity, for example by providing a higher level of transparency, the right products and a regular communication. First time private investors might feel more comfortable with semi liquid strategies, which have proliferated in recent years, with lower minimums (around US$25K minimum commitment) and where investors may be given the possibility to subscribe on a monthly basis and redeem on a quarterly basis. This may require appointing service providers with different characteristics, such as a custodian bank that can hold in custody liquid listed assets and handle subscriptions and redemptions, which is not necessarily needed with large institutional investors and closed ended funds. The choice of the right structure is an important aspect and depending on the preferred domicile – Hong Kong, Cayman or Luxembourg - there are various options available for fund houses to build products that are more understandable and accessible for this investor group.

Some alternative fund managers have already built up separate internal departments to increasingly focus on these new distribution channels. While the market is broad, many of the distribution channels are narrow, creating first mover advantage. Private banking is a good example, as the banks tend to have a high concentration – meaning low number of products on their shelves for each asset class.

Private asset fund houses may want to look for technology solutions to unlock some longstanding barriers to access, in particular platforms that help combining, aggregating large numbers of small investors to create meaningful pools of capital for funds. These platforms capture inflows from multiple investor segments via a bank or wealth management institution and channel those to a particular private equity house.

As a conclusion, there is no doubt alternatives asset managers in Asia Pacific but also globally have moved from being a relatively small island in the investment landscape towards the mainstream to attract a new source of funding. It will be interesting to see if traditional fund managers – traditionally geared towards mutual funds – will develop a new product offering to address the retail investors' appetite for private markets.

Glossary of Terms and Acronyms

AI – Authorised Institution

AML – Anti Money Laundering

AUM – Assets Under Management

Code – The Code on Unit Trusts and Mutual Funds

https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/codes/sfc-handbook-for-unit-trusts-and-mutual-funds/sfc-handbook-for-unit-trusts-and-mutual-funds.pdf

CBIRC – China Bank and Insurance Regulatory Commission

CDSD – Contingent Deferred Sales Charge

CIS – Collective Investment Schemes

CSRC – China Securities Regulatory Commission

EFIL – Exchange Fund Investment Limited

ESG – Environmental, Sustainable, Governance

ETF – Exchange Traded Funds

Family Office – A business, account or other organized grouping, to provide advice for a single family

FEL – Front End Load

FMC/AMC – Fund Management Company/Asset Management Company

GP – General Partner

HKMA – Hong Kong Monetary Authority

HNWI – High Net Worth Investor

HSI – Hang Seng Index

HSIM – Hang Seng Investment Management Limited

ICSD – international central securities depository

IFA – Independent Financial Adviser

ILAS – Investment Linked Assurance Scheme

IRR – internal rate of return

KFS – Key facts Statement

KIID – Key Investment Information Document

KYC – Know Your Client

L/I – Leverage/Inverse product

LIC – Listed Investment Companies

LP – Limited Partner

MAS – the Monetary Authority of Singapore

MF – Mutual Funds

MRF - Mutual Recognition of Funds

OFC – Open ended Fund Companies

PB – Private Bank

PBoC – People's Bank of China

PM – Portfolio Manager

SFC – Securities & Futures Commission

TraHK – Tracker Fund of Hong Kong

Trail/Retrocession – Commissions paid from part of the management fees of funds

UCITS – Undertakings for Collective Investment in Convertible Securities

UT – Unit Trust

UHNWI – Ultra High Net Worth Individual

WM – Wealth Manager

WMC - Wealth Management Connect

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The Financial Services Research Group was established in 2021 by a group of financial services and business professionals to support the development of the Hong Kong's financial markets and to accelerate Hong Kong's leadership in the rapidly evolving areas of green finance, sustainable investment and global asset management. FSRG is an independent body that seeks to collaborate with policy makers, businesses, financial institutions and civil society in building on Hong Kong's existing capabilities to maintain its premier position in the region, as well as identifying new opportunities for growth and competitive advantage.

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