

Overview of Fund Industry in China

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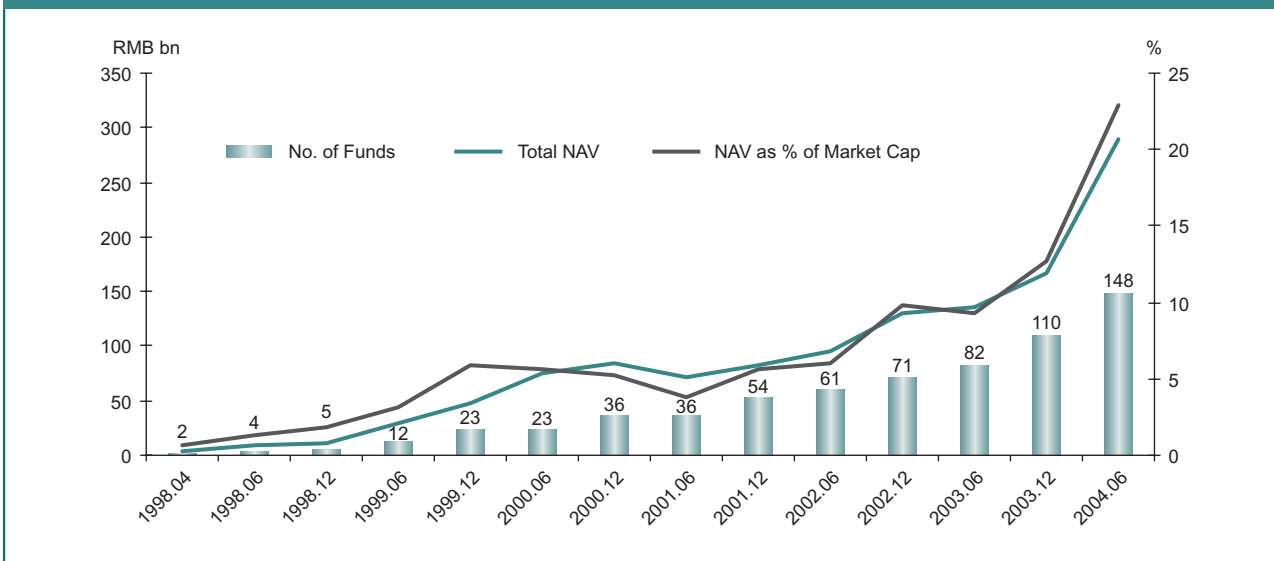
Brief History of the Development of Investment Funds

1. In October 1991, the first batch of investment funds, including the Wuhan Securities Investment Fund and the Shenzhen Nanshan Venture Investment Fund, were set up, signaling the advent of investment fund industry in China. In August 1993, the first exchange-traded fund, Zibo Town & County Enterprises Fund was listed in Shanghai Stock Exchange. By October 1997, the Central Bank and its branches had approved 73 investment funds and 47 pools, 22 of which were listed in Shanghai and Shenzhen Stock Exchanges.² These funds had following characteristics:
 - closed-end, and of contractual type;
 - relatively small in size, around RMB80 mn each on average;
 - undefined investment objectives and investment strategies; and
 - many did not have an independent trustee/custodian.
2. From October 1991 to October 1997, known as the “old era” for the fund industry in China, an era without consistent and nation-wide regulation, and an era when the infrastructure for fund industry had apparently not taken shape.
3. The promulgation of *Provisional Measures of Administration of the Securities Investment Funds (Measures)* symbolized the “new era” for China’s fund industry. With these *Measures* and related guidelines issued by the China Securities Regulatory Commission (CSRC), the new regulatory framework was established, under which two new funds were launched in March 1998, the funds were RMB2 bn each, similar to the unit trusts in the developed markets, except that they were still closed-end. In September 2001, the first open-end fund was successfully launched, having sold RMB5 bn initially.
4. In November 2002, the rules governing qualified foreign institutional investors (QFII) were issued, and UBS and Nomura were approved as the first two QFIIs with initial quotas of US\$300 mn and US\$50 mn respectively. This was a landmark in the opening of China’s capital market to foreign investors, even though still in a limited way.
5. December 2003 saw the first three money market funds (MMFs) launched, and the amounts of RMB6.28 bn, RMB4.25 bn and RMB4.65 bn were raised respectively. There were seven MMFs worth of around RMB29 bn as at the end of June 2004.
6. Six years later after the *Measures* came into effect in October 1997, to better protect investors, to foster the market confidence, and to promote rapid but stable development of the fund industry, People’s Congress of China issued *Securities Investment Law of PRC* in October 2003, and the Law became effective in June 2004.
7. Since 1998, China fund management industry has been enjoying tremendous growth, and managing more than RMB289 bn of funds (Chart 1) at the end of June 2004, through 148 securities investment funds. The largest fund was RMB12.3 bn, while the smallest was RMB0.098 bn. Despite the sluggish equity market during the years since early 2001, the fund industry in China has continued expanding rapidly (Chart 2).

¹ This paper is for pure fact-finding and research purpose, and is not an attempt to comment on the developments of any markets/ companies or interpret the policies concerned. The views expressed in this paper do not represent those of the SFC.

² See : China Renmin University (2004), “China Fund Industry Development Report (1991-2003)”, June 2004, China Finance Press.

Chart 1 – Fund Industry Development in China



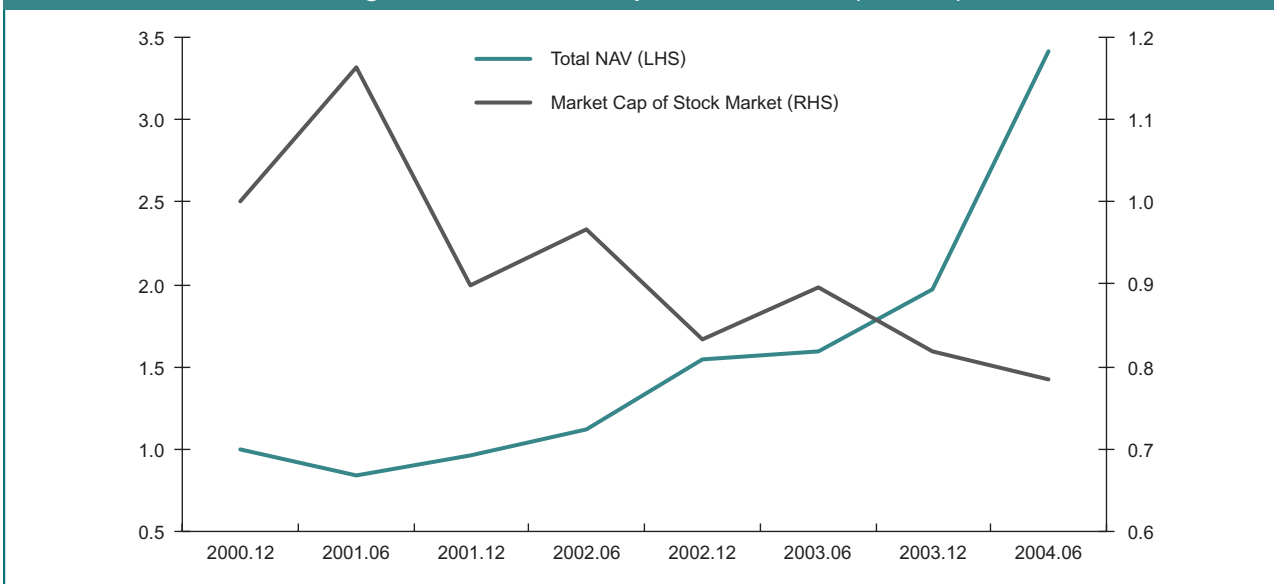
Sources: CSRC, SSE, SZSE, www.cnfund.com

Factors Contributing to the Expansion of the Fund Industry

8. In contrast to the developed markets where the value of assets under management is usually positively related to the performance of stock markets, China’s market shows an inverse

relationship, particularly since June 2001 when the fund industry grew strongly while the equity market slumped (Chart 2).

Chart 2 – Assets under Management and Market Cap of Stock Market (RMB bn)

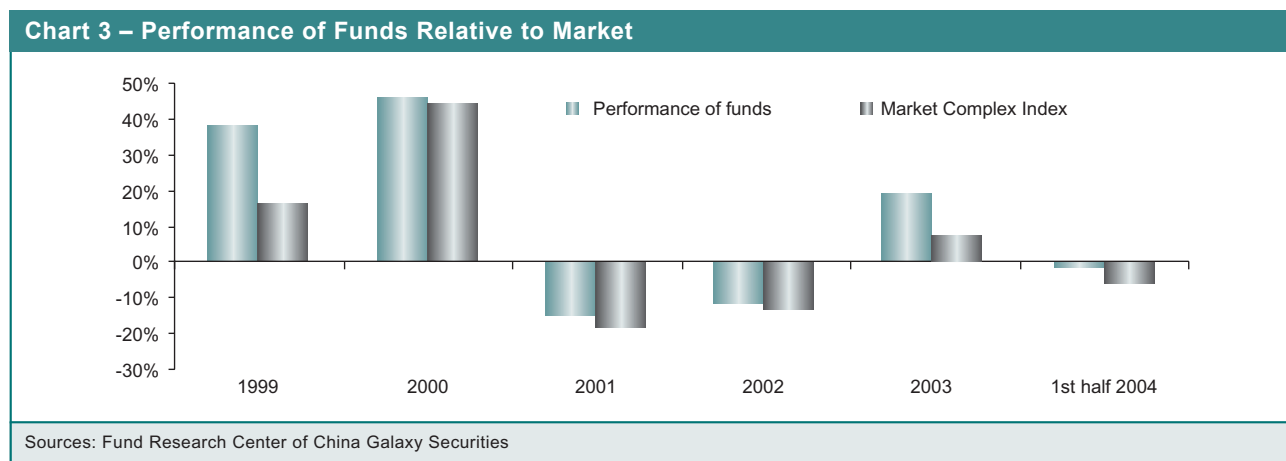


Sources: CSRC, Shanghai Stock Exchange (SHSE), Shenzhen Stock Exchange (SZSE), www.cnfund.com

9. The factors contributing to this development include:

- Increasing disposable incomes of households in an environment of continuing low deposit interest rates (e.g. 0.72% for saving deposits and 1.98% for 1-year time deposits) might have driven investors away from traditional deposits to seek higher return products.

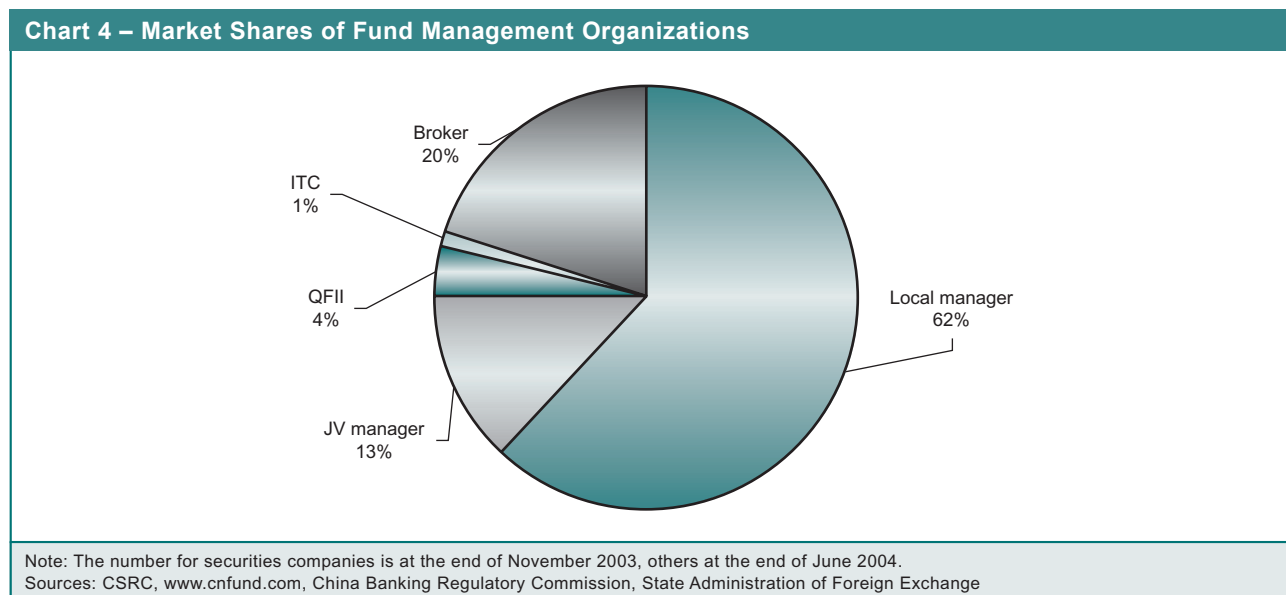
- Performance of mutual funds, on average, had beaten the market for several years by a substantial margin (Chart 3). This resulted in the shift of funds from direct equity holdings to investing in securities investment funds.
- Transparency of mutual fund operation also provides greater confidence in mutual funds.



Fund Management Organizations

10. Up to late 1998, the independent local fund management companies were the only kind of organization that was allowed to manage funds. Today, the market is much more diversified. The fund management organizations include

institutions such as independent local fund managers, independent sino-foreign joint venture fund managers, self-managed pension funds, QFIIs, and other operators such as Investment and Trust Corporations (ITCs) and securities companies (Chart 4).



- Independent local firms: They dominate the fund management market in China. By the end of June 2004, there were 38 local fund management firms managing 119 securities investment funds, of which 50 were closed-

end, with around RMB240 bn assets, accounting for 62% of the total assets under management. All of the top 10 fund management companies fall in this category, accounting for 57% of the fund management market as of the end of March 2004 (Table 1).

Table 1 – Top 10 Fund Management Organizations in China (end March 2004)

	Fund Manager	Amount (RMB bn)
1	Boshi	24.2
2	Southern	22.6
3	China	18.9
4	Jiashi	17.9
5	Huaan	16.7
6	Yifanda	15.6
7	Haifutong	15.0
8	Chengshen	11.7
9	Citic	11.4
10	Dacheng	10.8

Source: Various fund interim reports and websites of above companies

- Independent Sino-foreign joint ventures (JV): First Sino-foreign JV fund management was established in December 2002. By the early of July 2004, there were 11 JVs that managed

RMB51.46 bn of funds and absorbed 13.3% of market share. These JVs had 29 securities investment funds under their management, 4 of them are closed-end (Table 2).

Table 2 – JV Fund Management Companies (as of the early of July 2004)

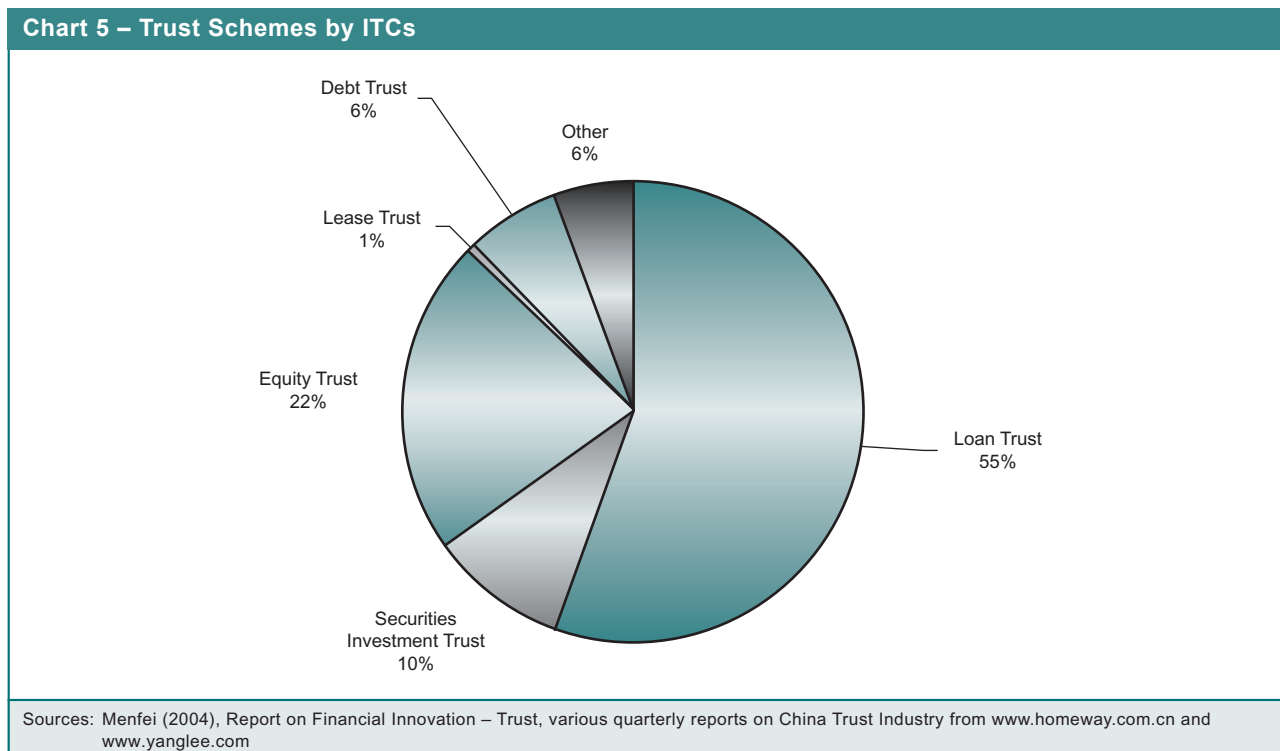
	JV Company	No. of Funds Under Mgt	Assets Under Mgt (RMB100 mn)	Registered Capital (RMB100 mn)	Date of set-up	Main Chinese Partner	Foreign Partner	Foreign ownership	Method of JV
1	SYWG BNP Paribas	1	64.2	1.00	Jan-04	Shenyin & Wanguo	BNP Paribas	33%	New JV
2	Everbright Pramerica	1	-	1.00	Apr-04	Everbright	Prudential Financial	33%	New JV
3	Fullgoal	7	76.1	1.20	Apr-99	Fullgoal	Bank of Montreal	16.67%	Buy Share
4	Xiangcai Hefeng	4	13.0	1.00	Jun-02	Xiangcai Securities	ABN AMRO	33%	Buy Share
5	China Merchants	5	66.1	1.00	Dec-02	China Merchants	ING	30%	New JV
6	Huabao Societe Generale	4	30.3	1.00	Mar-03	Huabao Trust	Société Générale	33%	New JV
7	Guotai Junan Allianz	2	99.4	1.00	Mar-03	Guotai Junan Securities	ADAM	33%	New JV
8	Haifutong	2	150.0	1.00	Apr-04	Haitong Securities	Fortis	33%	New JV
9	Invesco Greatwall	4	15.5	1.00	Jun-03	China Great Wall	Invesco	33%	New JV
10	China International Fund	1	-	1.50	May-04	SITICO	JP Morgan	33%	New JV
11	BOC International Investment Managers	0	-	1.00	Jul-04	BOCI	Merrill Lynch	16.50%	New JV

Sources: CSRC, various fund reports and websites of above companies

- Qualified Foreign Institutional Investors (QFIIs): The first two QFIIs entered the China market in November 2002. By the end of August 2004, there were 18 QFIIs, managing RMB14.32 bn in funds of foreign investors, with market share of 3.7%.
- Self-managed pension funds: These are social security funds, and some invest in securities markets, including the largest one, National Social Security Fund (NSSF). Some are self-managed, and even the NSSF continue to outsource their investment to outside managers.

- Investment and Trust Corporations (ITCs): After a couple of years of restructuring and reorganization, and with the promulgation of the Trust Law of PRC, more than 50 ITCs were licensed to offer trust schemes, with a ceiling of 200 investors for each scheme in

2002. By the end of June 2004, 47 ITCs had already issued 362 trust schemes, managing around RMB35 bn (Chart 5). Among them, 65 trust schemes were for securities investment, with about RMB5.5 bn under management, accounting for 1.4% of the market.



- Securities companies: Of the 132 securities companies, 70 provide asset management services. The assets under management were around RMB79 bn at the end of November 2003³, with a market share of 20%.

Distribution Channels

11. In China, banks with their extensive retail outlets are the major distribution channel for mutual funds, accounting for around 55% of market share, according to market estimates. Since early 2004, as more members of the public have become interested in investing in mutual funds, banks network has been playing a more important role. According to market estimates, banks took about

60% of market share for new funds sold in the first half of 2004. Initially, many fund managers preferred face-to-face sale, as corporate investors who were their major clients did not need to pay commission fees for transactions via this channel. Face-to-face sales were estimated to have a market share of more than 35%, whilst stock brokerages accounted for less than 5% of the total.

12. This distribution of fund sales is largely consistent with a survey conducted by the author in early September 2004 on two major fund management companies covering seven open-ended funds. The survey found that banks took the bulk of market share, at 59.8%, followed by direct sales, 37.1%, and the brokerage firms with 3.2%.

³ Page 66, Caijing Magazine, No. 17. 2004.

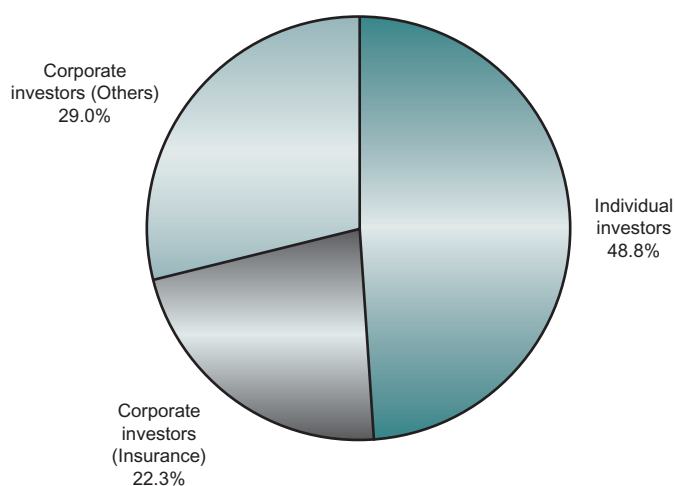
13. In mid-2003, some fund managers started to use the Internet to sell their products, but the Internet was far from being a popular tool.

Investors of Mutual Funds

14. As of the end of June 2004, there were around 4.94 mn individual investors, 2.58 mn more than the number at the end of 2003, according to the estimate by the Fund Research Center of China

Galaxy Securities Company.⁴ Based on 127 funds that provided information on their investor profile, the distribution was fairly even between individual investors (48.8%), and corporate investors (51.2%). Insurance companies are the most important corporate investors, accounting for 22.3% of all investments in mutual funds, at RMB64.3 bn (Chart 6). This is largely because insurance companies are not allowed to invest directly in the stock market, or to hold the shares of non-insurance companies.

Chart 6 – Investors of Funds



Source: Fund Research Center of China Galaxy Securities Co. CIRC

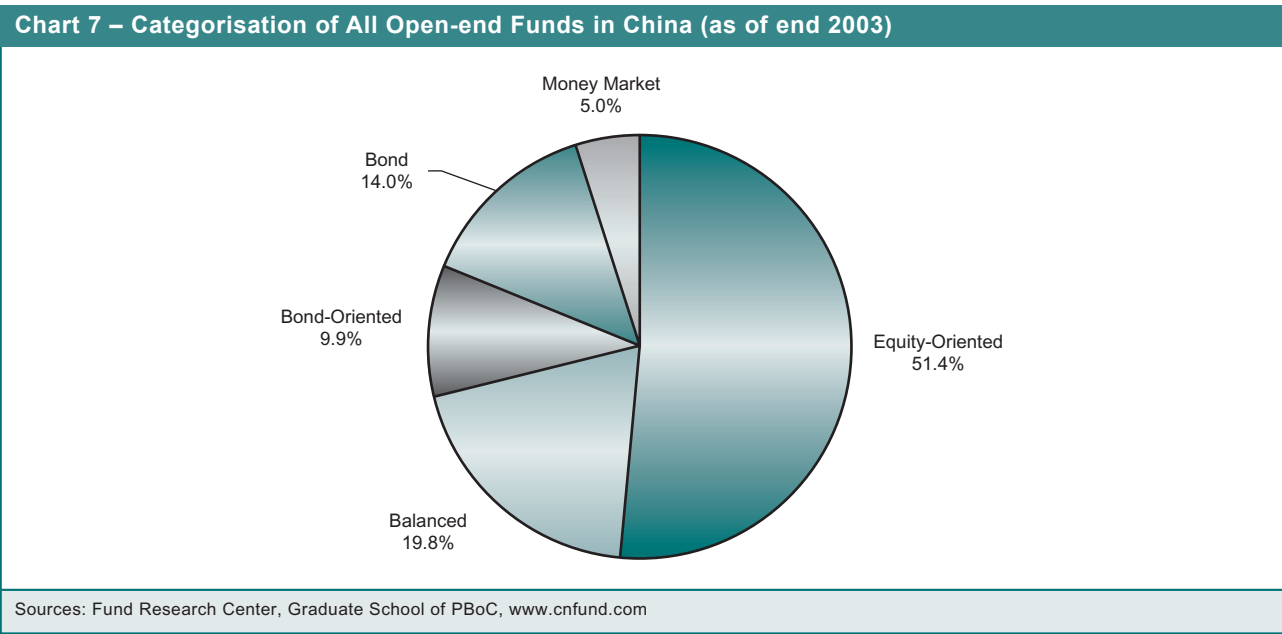
15. Compared with individual investors, corporate investors are more interested in investing in equity funds. According to a study, the top 10 funds with the largest interest of corporate investors are equity funds, whilst the top 10 funds with the largest interest of individual investors are either money market funds or bond funds.⁵

Composition of Total Net Assets of Funds in China

16. In contrast to many developed markets, China's fund industry has limited investment choices. Their investment choices include A-shares, T-bonds, money market instruments, financial bonds, and few corporate bonds. Therefore, a larger proportion of the managed assets are in the form of equity funds. By the end of 2003, 51.4% of all open-end funds were equity-oriented funds, followed by balanced funds and bonds funds, the least being in money market funds (Chart 7). The fact that money market funds accounted for the smallest share was probably due to its short history in the market.

⁴ An analysis on securities investment fund in China for first half of 2004, <http://www.cnfund.cn>

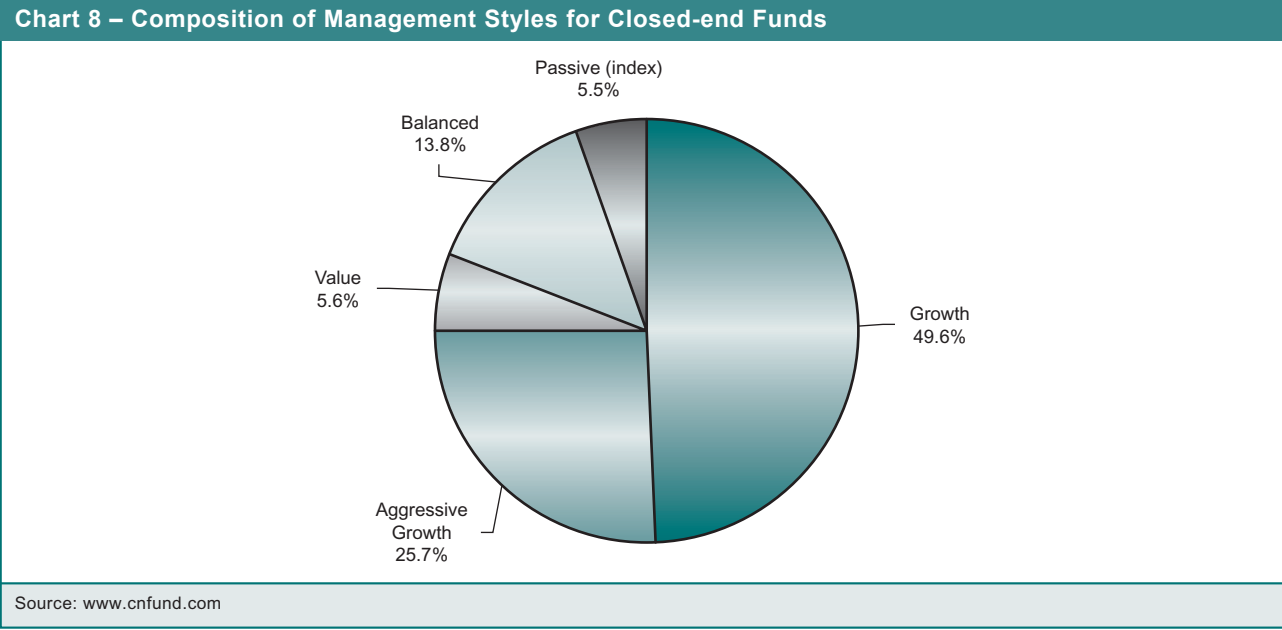
⁵ See website : <http://www.cnfund.cn>



Management Style and Strategy

17. Though the financial markets in China are not as sophisticated as the developed markets, the management style and strategies that fund managers employ are almost as much diversified

as those in the developed markets, including growth, balanced, value, and passive (index). Chart 8 shows the composition of management styles for all closed-end funds as of the end of June 2004.



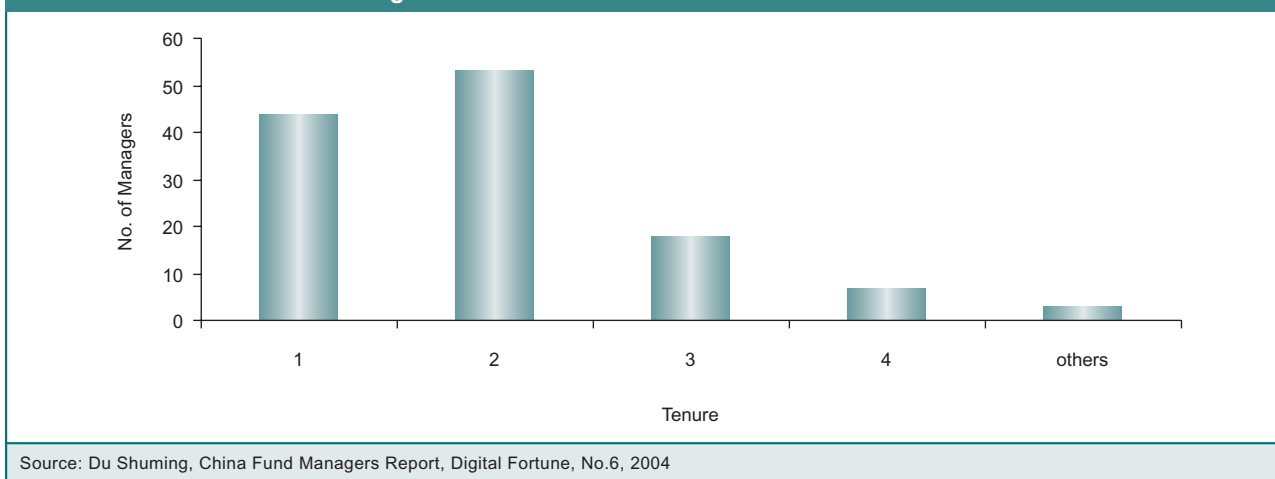
Fund Manager Turnover

18. China fund industry is about six years old since the start of the new era. As an emerging industry, there are some characteristic features of China fund managers, based on a recent study⁶.
19. The high turnover rate of fund managers was one of the most prominent features. The study shows that average tenure for all 145 fund managers from the end of 1998 to April 2004 is 1.5 years, much less than the average managerial tenure of 4.2 years

for all US funds or 8.4 years for older funds reported in Khorana's study⁷ (Chart 9). And a period of 1.5 years was apparently much less than the average tenure period of around three years for fund managers in Australia, which was already regarded as "a unique feature of the Australian market"⁸.

20. During 1999-2003, 48.1% of funds changed their managers each year on average. And only one fund had its manager for a term longer than four years, the longest-serving fund manager so far.

Chart 9 – Tenure of Fund Managers



21. A couple of factors contributed to the high turnover, according to the study:
 - Poor performance. A replacement of fund managers was highly related to their poor performance. When investment performance by an individual fund manager was not satisfactory to investors, the fund management companies usually replaced its fund manager to improve investors' confidence.
 - Change of majority shareholders. This does not only lead to changes in the management of the companies, but also changes in the fund managers.

- Establishment of many new funds. As many new funds had been set up in recent years, there was a strong market demand for fund managers, partly resulting in the high turnover of fund managers.

Performance and Capital Flow

22. Another feature for China's fund industry is the inverse relationship between performance and net capital flows.
23. Many studies have shown that capital tends to flow from poorly performing funds to well-

⁶ Du Shuming (2004), "China Fund Manager Report", Digital Fortune, No.6, 2004.

⁷ Khorana, A. (1996), "Top management turnover – An empirical investigation of mutual fund managers", Journal of Financial Economics 40(1996) 403-427.

⁸ David R. Gallagher & Prashanthi Nadarajah (2003), "Top management turnover: an analysis of active Australian investment managers".

performing funds. There is a positive relationship between return and capital inflow.⁹

24. In China, however, the reverse appears to be true for the relationship between performance and net capital flow. Due to limited access to data and short history of open-end funds, we do not have sufficient time series data to show a persistent link between performance of funds and redemption ratios. A regression analysis is conducted over 14 equity or equity-oriented funds, all of which experienced net redemption or net outflow of funds in 2003. The regression results show a moderate negative relationship (with a correlation co-efficient of -0.477) between net capital inflow and performance. In other words, i.e. the better the performance, the more is the net capital outflow.
25. Another regression is conducted on all 27 open-end equity or equity-oriented funds for the first half of 2004. The negative relationship disappeared, though the correlation between two variables was not statistically significant.
26. It is believed that such investor behaviour (i.e. redeeming the shares of funds when the funds are performing well and buying the shares of funds when they are doing poorly) is mainly the result of investors' attitude. Investors in China tend to regard the investment in mutual funds as similar to direct investments in stocks.

Regulatory Framework of Fund Management Industry in China

27. Fund management in China, particularly at the retail end, has been regulated by the authorities as part of the legal framework to protect investors. The China Securities Regulatory Commission (CSRC) is the main body to ensure the protection system operates effectively. The newly effected *Securities Investment Law of China* reinforces the efforts by China's government.
28. The regulation of fund management consists of three integral parts: first, fund management organizations, second, investment funds, and third, custodians or trustees.
29. As shown in Table 3, the regulation of independent fund management companies is focused on market entry, business scope, fitness and propriety test on senior management, corporate governance and internal control. On the regulation of fund operation, the CSRC has detailed requirements on the establishment and marketing of funds, investment, connected transactions, performance presentation, and information disclosure. The CSRC also imposes regulation on fund custodians or trustees, requiring custodians and trustees to play a role as a check and balance on fund management.
30. Two separate authorities in China in parallel carry out the regulation of fund management. In addition to CSRC's regulation of the securities investment funds, the China Banking Regulatory Commission (CBRC) also plays a regulatory role over fund management activities. The regulation of trust schemes offered by ITCs is within CBRC's jurisdiction. The legal framework for the operation of trust schemes by ITCs is the *Trust Law of China*, while that for securities investment funds is the *Securities Investment Fund Law of China*. Each of these laws has their own philosophy and objectives. The offer of trust scheme does not need the authorization of the CBRC, and the CBRC imposes no requirement on marketing, information disclosure, qualifications of managers of trust schemes, and valuation of schemes. The Rules imposed by the CBRC mainly consist of: a ceiling of 200 investors for each scheme, minimum investment threshold of RMB50,000, prohibition of guaranteed return. The rationale for this arrangement seems to be that the sale of schemes is akin to a private placement, and therefore, requires little if any, regulation. However, it should be noted that the reason that private placements are not subject to strict regulation is more because of the way the scheme is offered and the sophistication of the investors, rather than the number of investors. ■

⁹ Ippolito, R., (1992), "Consumer Reaction to Measures of Poor Quality: Evidence from the Mutual Fund Industry", *Journal of Law and Economics* 35, 45-70.

Table 3 – Regulatory Framework of Fund Management Industry in China

