Chapter 1

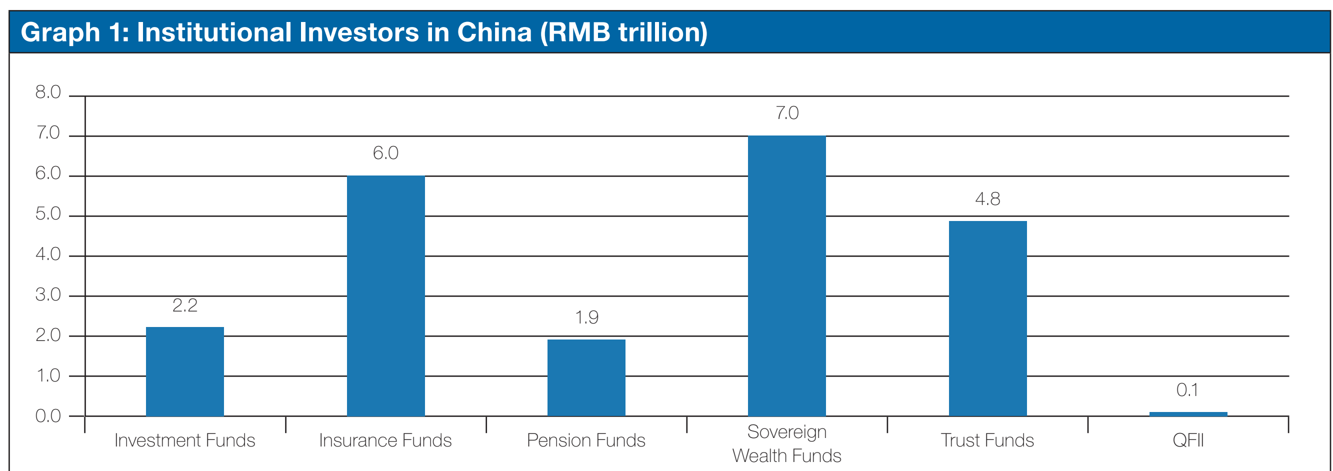
Introduction

Ten years ago, when the first edition of *Investment Funds in China* was written, China's funds industry had just started launching open-end funds. Over the past decade, things have changed; China has attracted even more attention as the most dynamic, complex and fast-changing economy among all emerging countries, as indeed it was ten years ago also.

The China miracle emanates from all the economic reforms since 1978, brought about by Mr Deng Xiaoping. In just three decades, China's annual real gross domestic product (GDP) grew more than 20 times, transforming it from a backward country to the second largest economy in the world after the United States. Meanwhile, the capital markets of China have achieved tremendous progress, with total stock market capitalization rising more than tenfold in the past ten years.

Currently, the investor landscape in China's capital markets is evolving towards a more even mix of investor classes, with institutional investors progressively taking over from retail investors as

Graph 1: Institutional Investors in China (RMB trillion)



Source: CSRC, CIRC, MoHRSS, CBRC, SAFE, Stirling Finance Research

- All data are dated 31 December 2011; the exchange rate used is RMB6.3009 to USD1 as at 31 December 2011, disclosed by the NBS.
- Pension Funds here represents accumulated balances in the State Urban Pension System.
- NSSF here is regarded as a SWF; Hong Kong Monetary Authority is not included as China's SWF here.
- Assets for Sovereign Wealth Funds are best estimates, obtained from the Sovereign Wealth Fund Institute.

the major force. As assets continue to expand, the role of both domestic and foreign institutions is growing, with more interaction among investment funds, pension funds, insurance companies, corporates, sovereign wealth funds (SWFs) and Qualified Foreign Institutional Investors (QFIIs).

This book, written in English, aims to describe and explain the changing financial markets and investment arena in China for an international audience. In addition to the investment fund industry itself, all related sectors and industries are described as well, since nowadays these different market forces interact with each other intensively. This book should be of interest and value to international fund managers, banks, security firms, insurance companies, academics, economists and all those with a genuine interest in the emergence of China.

After the first two chapters introducing the economic reforms and capital markets in China, the focus is on the fund management industry as discussed in Chapter 4. The funds industry in China officially began in 1998, with two closed-end funds launched by Guotai Fund Management Company (FMC) and China Southern FMC. Despite its short history, the fund industry has expanded rapidly, and reached a peak with RMB3.3 trillion of assets under management (AUM) in 2007, then shrank afterwards to RMB2.2 trillion as at 31 December 2011. It is currently a competitive industry, gauged by either the concentration ratio or the Herfindahl-Hirschman Index, with 69 FMCs and 914 retail funds launched.

The retail business of FMCs will be discussed in Chapter 5. During the 14-year history of the fund industry, China has developed a full line of investment funds to satisfy the different needs of investors. Although the industry started with closed-end funds, open-ended funds quickly gained more popularity among retail investors. Indeed, new fund types are continuously being developed, such as index funds, exchange-traded funds (ETFs) and ETF feeder funds, Qualified Domestic Institutional Investor (QDII) funds, innovative structured funds, etc.

Alongside the retail business, fund management companies are also competing for institutional monies and for certain other business lines. The FMCs interact actively with other financial institutions on enterprise annuities (EAs), segregated mandates, separate accounts and alternative asset business lines, as set out in Chapters 6 to 9.

Insurance companies are still the largest institutional investor in FMC products. Although the total assets for the insurance sector reached RMB6 trillion by the end of 2011, their asset allocation is still very conservative, with only a 2% holding of total stock market capitalization in the light of the industry's restrictive investment rules. Moreover, the asset management subsidiaries of insurance companies are now competing with the FMCs in managing insurance assets. Several concerns remaining in this sector will be further discussed, such as the high concentration of business with large companies in both life and non-life insurance sectors, imbalanced insurance product structure, regulatory barriers and minimal market share for foreign insurers, etc.

Pension funds have been the subject of heated discussion over the past several years. On the one hand, China is facing extreme demographic challenges; as the saying goes, "China is growing old before it is growing rich". On the other hand, limited channels for investment currently exist for pension assets, so that returns can hardly match price inflation rates and are woefully behind earnings increase rates. Some FMCs are involved as the investment managers for EA business, EAs being voluntary retirement plans supplementary to the urban pension system. However, with only sub-optimal tax benefits, EA business has not grown as fast as expected since its establishment. Several proposals are under consideration for pension funds investment management: to entrust some

provincial pension moneys to the National Social Security Fund (NSSF) for management; to set up an independent entity and operate directly; and to introduce a Chinese version of 401(k), which may integrate EAs and a new form of individual account pension plan. With the recent news that Guangdong province will entrust RMB100 billion into NSSF management, it seems that the central government is taking serious steps to further reform the investment side of the pension equation.

Compared to insurance funds and pension funds, sovereign wealth funds may not be well known to the public, but every small movement by China's SWFs is in fact closely watched by the finance industry. FMCs, as professional investment managers, are competing fiercely with each other to win external mandates from SWFs, especially from the NSSF. With huge foreign exchange reserves, China is probably one of the most significant economies to set up SWFs. Indeed, China now has four SWFs out of the top dozen throughout the world in terms of total assets, if we classify the Hong Kong Monetary Authority as an SWF as well. However, the asset management process and information disclosure are not fully transparent currently. With more SWFs likely to be set up in the near future, observers hope that China's SWFs will be operated in line with international standards.

Starting from 2008, separate account business has been allowed for some large-size experienced FMCs, with more flexibility as regards asset allocation and fee arrangements. Subsequently, smaller FMCs have been allowed to enter into the separate account business, hoping to improve their profitability in the current stagnant market. However, with very few hedging tools available in China markets, positive absolute returns can be difficult to realize with this line of business. By targeting both institutional money and high net worth individuals (HNWIs), this new line of business has joined the competition with wealth management products from banks, the so-called "Sunshine" funds from trust companies, and alternative investments provided by private equity (PE) managers. PE in China is constituted very differently from the international definition, and is outside the scope of this book.

Due to the recent financial turmoil, the performance of China's funds industry is far from satisfactory. Although the management fees continue to grow, the profitability of the fund industry is no longer as good as it was. On the one hand, the fund industry is competing fiercely with trust companies and PE firms over their customer base and recruiting experienced professional managers. On the other hand, distributing banks have been squeezing a larger and larger share out of the fund industry's management fees. Among the three main distribution channels for investment funds, bank distribution accounts for around 60% of the market, therefore they have bargaining power to negotiate up to 70% management fees as their trailer commission. However, new rules will now permit foreign banks and independent financial advisors to apply for a fund distribution licence. This new development is expected to redraw the distribution landscape for the funds industry, probably within the next ten years.

The last two chapters, 'Indices' and 'Regulation', aim to describe the general environment for the investment funds industry. Since 2002, when the China Securities Regulatory Commission (CSRC) required open-ended funds to specify their benchmarks before launch, indices in China have experienced rapid expansion. Nowadays, China is no longer a market lacking indices, with CSI indices and the stock exchange indices still dominating the China market despite the fact that global index companies such as MSCI, FTSE and Dow Jones have been involved in China since a very early stage. Regarding the regulatory landscape, China has achieved substantial progress during the past two decades. Currently three main regulators exist in the financial world, namely, the China Banking

Regulatory Commission (CBRC) for banks and trust companies, the CSRC for securities firms and fund management companies, and the China Insurance Regulatory Commission (CIRC) for insurance companies. However, no single regulator is responsible for pension funds, and there is much more complexity involved in the pension sector. To oversee China's pension funds more effectively, to preserve value and grow the assets in the pension sector, an independent regulator, say the Chinese Pensions Regulatory Commission (CPRC), should be established with more flexibility for pension participation in the capital markets.

It is now a critical time around the world: developed economies are facing an economic slow-down, with low expected GDP growth, high unemployment rates and the sovereign debt crisis still to be resolved. Meanwhile, it is also a challenging time for China: hard landing versus soft landing; being export driven versus focusing on domestic demand; and immense difficulties such as pension provision for the 670 million-strong rural population. In preparing this book at this time, deriving conclusions and making recommendations, the objective is to be neither optimistic nor pessimistic, but impartial.

The cut-off point of the book is essentially 1 January 2012. However, due to lack of transparency and late information disclosure in some areas, not all statistics are totally up-to-date. As at 31 December 2011 the exchange rate was RMB6.3009 to USD1.