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China's "sunshine" hedge funds are poised for growth driven by demand from HNWIs

Nomura Research Institute, Ltd.

The Chinese fund industry's main product has historically been publicly offered funds. In recent years, however, the industry has seen a diverse influx of new entrants as the government has passed a series of laws related to private funds. Private funds' AUM is growing rapidly in response to investor demand, particularly from high-net-worth individuals.

China's fund industry

China's asset management industry offers two types of investment products: discretionary investment accounts and funds. Discretionary investment accounts are used by institutional investors such as pension funds and social insurance funds to outsource management of their portfolios. Assets under management (AUM) in discretionary investment accounts account for only about 10% of the Chinese asset management industry's total AUM. Funds account for the remaining 90%, making them the Chinese asset management industry's main pillar.

Funds include publicly offered funds and private funds[1]. The former, called securities investment funds[2], are offered by fund management companies. Although they are permitted to invest in a range of asset classes, including equities, bonds, and foreign securities, some 70% of publicly offered funds are equity funds, many of which are index funds. They source 90% of their AUM from retail investors and the remaining 10% from institutional investors, chiefly insurers.

Publicly offered funds have grown briskly since their advent. China's fund industry is already ranked in the global top-10 by AUM in publicly offered open-end funds, which account for over 90% of publicly offered funds' total AUM. As of December 31, 2010, Chinese open-end funds had AUM of US$364 billion, equivalent to roughly half of Japanese investment trusts' aggregate AUM. Since 2010, the Chinese government has eased regulatory constraints to promote growth in the asset management industry[3]. With the authorities now expediting approval of new products, publicly offered funds' AUM should grow further by virtue of expansion of investment product offerings.

Meanwhile, private funds ended 2010 with a modest $56.6 billion of AUM, equivalent to some 15% of publicly offered funds' AUM, but they have promising growth prospects. In 2011, private funds' AUM is projected to grow 90%. Demand for these funds, which pursue absolute returns, has been growing since 2010, when the Chinese equity market stalled. Their AUM has been growing over the past few years in particular, driven predominately by inflows from high-net-worth individuals (HNWIs) as the government has enacted a series of fund-related laws to lay the requisite legal groundwork.

Private fund providers and products

Private funds are offered by (1) fund management companies, (2) securities firms, and (3) trust companies. Specific product requirements differ among these three types of providers because they are each subject to different regulations (see table).

Exhibit. Products offered by China's fund industry

		Public funds	Private funds		
Players		Fund management companies		Securities firms	Trust companies
Products		Investment trusts	Segregated accounts	Pooled funds	Sunshine HFs
AUM as of Dec. 31, 2010		$387.0bn[1]	$20.1bn	$17.9bn	$18.6bn
Portfolio allocation limits	Any one stock	<10%	<10%	<10%	No limit
	Listed equities	60-95%	No limit	0-95%	No limit
	Listed bonds	80-95%	No limit	0-95%	No limit
	Listed index futures	Permissible[2]	Permissible	Permissible	Permissible
Fee structure	Management fee	1.5%	0.9%	2%	2%
	Performance fee	None	20%	20%	20%
AUM CAGR in 2009–10		-6%	+117%	+17%	+200%

Note: (1) Includes both open-end and closed-end funds.
(2) Permissible from April 2010 onward only if the fund's investment mandate disclosed in its prospectus includes listed index futures. Existing funds must amend their investment mandate with the unanimous consent of their investors. Consequently, no publicly offered funds have invested in listed index futures to date.
Source: NRI, based on CSRC and CBRC documents

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Fund management companies, in addition to managing publicly offered funds, can also provide asset management services tailored to customers' individual needs by setting up segregated accounts[4]. While fund management companies manage segregated accounts using investment strategies similar to those they use with their publicly offered funds, they seek to capture excess returns through such means as arbitrage. As of 2010, 34 fund management companies were managing 151 private funds. Securities firms, by contrast, are permitted to manage multiple customers' assets in pooled accounts[5]. They offer three types of funds differentiated by their investment objectives and minimum investment amounts: pooled funds, mini pooled funds, and individualized funds[6]. Pooled funds and mini pooled funds are mostly closed-end funds with 3–5 year maturities. Such funds have more investment freedom than those offered by fund management companies. Lastly, trust companies offer pooled trust services[7]. Fund managers can manage private funds' assets and invest in securities through accounts held at trust companies.

In comparison to publicly offered funds, these private funds are subject to laxer restrictions on their investments in equities and bonds. Additionally, fund managers' fees are linked to investment performance. By virtue of these characteristics, private funds appear to be succeeding in capturing fund inflows from HNWIs seeking absolute returns. Of the various funds offered by the three types of players, private funds that utilize trust companies are experiencing the most rapid growth in AUM.

Rapid growth in trust companies' private funds

Private funds that utilize trust companies are commonly known as "sunshine hedge funds." Sunshine hedge funds register with the regulatory authorities and also disclose information as required. Historically, China has had many "underground" hedge funds privately managed by fund managers that have raised funds from their personal acquaintances. In contrast to such underground funds, sunshine hedge funds are set up by utilizing the services of legitimate trust companies. The "sunshine" in their name refers to their having emerged from underground into broad daylight through the platforms provided by trust banks. Most sunshine hedge funds are long-only equity funds, unlike US and European hedge funds that commonly employ long-short equity and leveraged investment strategies. However, unlike fund management companies' segregated accounts and security firms' pooled funds, both of which are prohibited from investing more than 10% of their AUM in any single stock, sunshine hedge funds are not subject to any such investment restrictions. They consequently came to be called hedge funds because they have a relatively high degree of freedom to manage their portfolios.

Sunshine hedge funds have sharply increased in number in recent years as more and more fund managers that previously managed publicly offered funds at fund management companies have been striking out on their own to set up sunshine hedge funds. Another recent trend is growth in the prevalence of trusts of trusts (ToT), which are similar to funds of hedge funds in that they invest in multiple sunshine hedge funds. Private funds that utilize trust companies ended 2010 with aggregate AUM of $18.6 billion, a threefold increase from their year-earlier AUM of $6.2 billion. According to one forecast, their AUM is projected to exceed $46 billion in 2013.

In response to such rapid growth in sunshine hedge funds' AUM, the China Securities Regulatory Commission (CSRC) in August 2009 imposed a moratorium on opening of new accounts by trust companies out of concern about sunshine hedge funds' impact on the equity market. However, in China's complex financial regulatory regime, the agency with regulatory authority over trust companies is the China Banking Regulatory Commission (CBRC). Some concerned parties have advocated consolidating regulatory authority in the CSRC from the standpoint of the asset management business. China will presumably further develop its regulatory regime and legal environment. It is considering adopting uniform regulations for private funds and consolidating regulatory oversight of private funds in a single regulator. In such an event, institutional investors such as pension funds are likely to increasingly invest in sunshine hedge funds going forward.

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Note

1) Sponsors of private funds are prohibited from publicly soliciting prospective investors. They may solicit investments only from designated classes of investors that meet risk tolerance requirements.

2) PRC Securities Investment Fund Law (enacted in 2004)

3) Effective from January 2010, the maximum number of new funds for which a fund management company can seek regulatory approval with a single application was increased from two to six.

4) PRC Customer-Specific Asset Management Law (2008)

5) PRC Securities Firm Customer Asset Management Pilot Law (2004)

6) For pooled funds, the minimum investment per investor is RMB50,000 (if the fund invests in highly liquid products with high credit ratings) or RMB100,000 (if the fund is not subject to such restrictions). For mini pooled funds and individualized funds, the minimum investment per investor is RMB1 million.

7) PRC Trust Company Control Law and PRC Trust Company Pooled-Fund Trust Scheme Control Law (both 2007)

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