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CHINA'S ASSET MANAGEMENT INDUSTRY: CROSS-CULTURAL MARRIAGES CAN OFFER BEST OF BOTH WORLDS

Overview

Recent moves by the Chinese government to further liberalize its fund management industry have generated a lot of interest with some observers projecting that China will overtake the UK to be the second-largest asset management market. In particular, new regulations allowing wholly foreign-owned entities (WFOEs) to operate in China have led to excitement that these globally established fund managers will spur growth and provide a new avenue for global investors to access the nascent market.

We look at some of the historical milestones in the development of the asset management industry in China that have culminated in the recent rule changes and the various broad structures that global investors can choose from. In particular, we focus on three avenues: 1) via domestic fund managers, 2) the new option of WFOEs and 3) existing arrangements of joint ventures (JVs).

We provide insights into the workings of each of these structures and highlight the advantages and shortfalls of each. We argue that while the new regulations allowing WFOEs open up a new option, the existing arrangement of JVs present the potential to marry the best of both worlds – domestic market intelligence with global institutionalized portfolio management expertise. Challenges exist for bridging the cultural differences but successful integration and cooperation will indeed make it the best of both worlds. The catch is in making these cross-cultural partnerships work.

Regulatory changes: history and implications of recent moves

Changes announced by China's vice-finance minister, Zhu Guangyao, in November last year (2017) to allow foreign entities to own a majority stake[1] in mutual fund management companies (FMCs) created a lot of buzz, with many research houses and consultants projecting rapid growth in the asset management industry in the mid-term. China has been touted to overtake the UK to become the second-largest market in total managed assets after the US by as early as 2019[2]. The foreign ownership limit for FMCs was raised from a maximum of 49 percent previously to 51 percent. The sector is expected to be fully liberalized with restrictions slated to end after three years, or as early as 2020.

In November last year (2017), the People's Bank of China issued a joint statement with other financial regulators to set out new guidelines, unifying the rules covering asset management products (AMPs) issued by securities institutions, banks and insurers, and setting leverage limits for all products[3]. This followed the government's move to set up a "super regulator," the Financial Stability and Development Commission to cover the entire financial system, after the 19th Party Congress in October (2017)[4].

These moves by the Chinese government mark a shift in attitude towards the financial sector and are part of its bid to reduce the so-called "shadow banking" sector, where massive off balance-sheet financing by banks present difficulties in quantifying and controlling risk in the banking system. One way of doing this is to place the asset management industry on a more professional and healthy growth path, where global institutions can play a part to set industry standards.

At the end of 2017, China's assets under management were worth a combined 53.6 trillion yuan (US$8.22 trillion), up 3.5 percent from 2016, according to statistics from the Asset Management Association of China (AMAC). These were held by "traditional" asset managers such as fund management firms, securities firms and futures companies, and privately offered investment funds[5].

However, the total size of China's wealth management market in the broadest sense, including so-called "quasi" asset managers, is estimated to be more than 100 trillion yuan[6]. The

[1] Reuters business news "China widens foreign access to its giant financial sector", 10 November 2017
[2] CaseyQuirk by Deloitte report "Leadership in times of plenty: Future winners in China's asset management industry", November 2017
[3] South China Morning Post report "China's asset-management growth plummets after sweeping regulations rain down on shadow banking sector", 11 Jan 2018
[4] ibid
[5] ibid
[6] Oliver Wyman report "Global asset managers in China: Riding the waves of reform", March 2018

majority of these assets, which are managed by these non-traditional asset managers, are held in bank wealth management products (WMP) and trust companies. The recent asset management regulations are expected to address several issues in the industry such as the "implicit guarantees" provided by bank WMP, the multiple layers of product nesting between different types of wealth management products, and the significant maturity mismatch between investment products and invested assets[7].

Size and growth of traditional asset managers

"Traditional" asset managers	2017	Growth from 2016
Total assets under management (AUM)	RMB 53.6 trillion (US$ 8.22 trillion)	+3.5% (from RMB 51.79 trillion)
Fund management firms and subsidiaries	RMB 13.9 trillion	-17.6%
Securities firms	RMB 16.8 trillion	-4.4%
Futures companies	RMB 200 billion	-28.6%
Private investment funds	RMB 22.7 trillion	33.1%

Source: Asset Management Association of China, South China Morning Post

Even before the regulatory changes in 2017, the opening up of China's fund management industry has had a history of more than 15 years. Foreign financial institutions have tried to muscle into the China market since it opened its financial services sector under WTO commitments in the early 2000s, but most have been marginal players due to structural constraints such as unfavourable local regulations.

History of liberalization of China's fund management industry

2002	Implementation of Qualified Foreign Institutional Investors (QFII) scheme allowing foreign investors to invest in public securities
2010	Qualified Foreign Limited Partner (QFLP) scheme allowing foreign investors to invest in private equity funds
2004	Qualified Domestic Institutional Investor (QDII) scheme allowing Chinese investors to invest in offshore markets
2013	Qualified Domestic Limited Partner (QDLP) scheme allowing Chinese investors to invest in offshore hedge funds via an onshore feeder

Source: Nikko AM, HKICPA

In June 2016, China's AMAC released a document FAQ No. 10[8] confirming that foreign financial institutions can now engage in the private securities investment fund management business in China via setting up WFOE or JVs. Prior to that, foreign financial institutions were only allowed to engage in the public securities investment fund business joint ventures, with a maximum 49 percent foreign shareholding. Several large asset managers have entered the Chinese mutual fund market via this route, with a total of 50 joint ventures as at September 2016[9]. These have had mixed success due to cultural differences, ownership issues and a lack of clear direction set for some of these JVs. With the introduction of FAQ No. 10, foreign financial institutions are now given the opportunity to enter the domestic market through a wholly owned entity.

Rule change: what it means for global investors

With the latest changes in regulation, global investors now have three broad choices in trying to access the domestic China market such as in 'A' shares or local RMB bonds:

1. Hire a purely domestic fund manager with no international expertise;
2. Hire a full-fledged 100% foreign-owned global asset manager (WFOE) that is now permitted to operate under latest rules; or
3. Hire a foreign-Sino joint-venture where domestic fund managers combine with the expertise of a foreign partner, a structure that has existed before recent rule changes.

We delve into the workings of each of these three choices and lay out the advantages and shortfalls of each.

Domestic fund managers

Global investors engaging a domestic fund manager can invest via offshore entities and various quota programmes such as the Qualified Foreign Institutional Investor (QFII) and Qualified Foreign Limited Partner (QFLP) schemes. With the stock connect programme, investors now also have the option of hiring a domestic fund management company to run their 'A' share book.

The key advantage of hiring a local mutual fund manager is the huge resources for research that a domestic firm – even a mid-sized one – has. With the huge and growing assets under management, the burgeoning fee income generated means that these local houses have the resources to hire large research teams to cover the ever-changing vast universe of companies within the 'A' share market.

The need for big teams results from the resource-intensive nature of the market. Not only is it massive, China is not a homogenous country but one consisting of 22 provinces, five autonomous regions and four municipalities – each with their local governments, different regulations as well as fiscal budgets. Also, China is still an emerging market (EM) in the throes of development, with constantly changing rules – on the macro-economy, industry and company-specific levels. Demographics, consumer tastes and infrastructure are also constantly in flux.

[7] Ibid
[8] Hong Kong Institute of Certified Public Accountants (HKICPA) A Plus magazine, "A game changer for foreign asset managers", December 2016
[9] Ibid

The EM nature of the market means that information flow is not efficient and to exploit these opportunities to beat the market requires a lot of resources to keep tabs on developments on the ground. A key advantage of most domestic fund managers is the army of analysts that they typically have to monitor developments.

However, domestic managers also tend to have some China-specific characteristics, which are at odds with what is widely considered global industry standards that are derived from modern theories of finance and portfolio management.

Firstly, most domestic fund houses tend to have too many strategies – having 20 to 30 strategies each is not uncommon. This presents a challenge for global investors having to pick the appropriate product to meet their investment goals. Related to this, the fund houses tend to cherry-pick the best-performing strategy and present it as being representative of the firm's performance. This gives a misleadingly rosy picture and is at odds with objective and accurate performance presentation standards such as Global Investment Performance Standards (GIPS). In fact, a common complaint is that investors who choose a particular firm based on the track record presented, are often disappointed with the actual performance of their portfolio, which falls below expectations.

A second characteristic of Chinese domestic managers is that the industry is young and still very much driven by the retail market, where the focus is on the short term. There is a tendency for very high portfolio turnover with an average of 325 percent and even as high as 700 percent[10]. Given the nature of the market, which has less regard for long-term performance and favours rotation, managers feel pressured to trade excessively. The high turnover translates into higher trading costs, which ultimately crimps performance.

Thirdly, there is a tendency for huge rotation in the performance of fund managers or strategies. The Chinese market is focused on an absolute peer ranking, with most jostling to be the top-performing manager, attracted by the fame and monetary reward given to a star fund manager. This often results in excessive risk-taking, with little regard for risk-adjusted returns, risk controls and trading costs. In fact, studies have shown that funds do not usually stay in the top percentile for a sustained period of time and often, they fall to the bottom of the table in the subsequent period. Hence, it would be wiser to pick the steady chuggers that consistently deliver a reasonable amount of outperformance over time, with limits on risk and minimizing huge drawdowns.

These peculiarities of the China investment market are known to local investors but may not be widely recognized by global investors. Hence, they may turn out to be pitfalls in choosing a pure domestic fund manager.

Wholly foreign-owned entities (WFOEs)

With the recent regulatory changes, global investors now have the choice of hiring a 100 percent foreign-owned fund manager to gain exposure to the domestic China market. This opens up the options for many reputable global asset managers who have track records and proven investment expertise established over a longer history than domestic fund managers.

The advantages of such WFOEs are clear: they have an integrated company and investment management process, a sound and tested investment philosophy and a proven track record. Most are also GIPS compliant, so their reported performance would be in line with internationally acceptable standards. Global managers also adopt international best practices and sound portfolio construction methods with appropriate risk-control measures. With 100% ownership, the asset manager is in addition presumably more dedicated, as its reputation is on the line and it is solely responsible for the outcome of all discretionary investment decisions. This contrasts with a joint venture where the success depends on the relationship between the two partners and neither has full control, or in some cases, full commitment.

With the advantages offered by WFOEs, they may appear to be the clear choice for global investors. However, WFOEs are hampered in some areas, mainly in research resources, and are at a disadvantage in trying to access the vast information network in China.

Firstly, foreign managers typically have small teams in China, which put them at an information disadvantage. The size of their assets under management (AUM) is generally small compared to domestic houses. This means the economics of hiring an army of analysts – warranted by the intensity of research needed – just doesn't add up. For example, at one top global fund manager, which reportedly has an AUM of US$25 billion in China, hiring more than a dozen research staff just is not financially viable. This is insufficient to cover the vast and disparate market. In comparison, even a mid-sized firm with AUM of about US$40 billion would have a staff of 40. The intensity of coverage needed in China to track the constant industry changes also means that each analyst can cover only a maximum of 25 stocks in depth as compared to more developed markets where a buy-side analyst can easily cover a far greater number of stocks. Hence, a team of 10 analysts in China would be able to cover only the top 250 companies – very narrow coverage against the Shenzhen and Shanghai markets, which have more than 3,500 stocks.

Related to the small size of foreign fund houses is a second disadvantage: a lack of access to company management. Having lower AUMs and typically trading less frequently means foreign managers generate lower commission fees for brokers. These "sell-side" firms, which are typically the ones providing access to the management of invested companies, would tend to allocate the limited meeting slots they have to their larger domestic clients. Hence, foreign fund managers

[10] Source: WIND, 30 June 2018

would have a lower priority in meeting and gaining direct insights from the management of companies they invest in.

There is a misconception that one can simply transplant a foreign team into China and base them in key cities such as Shenzhen or Shanghai. In fact, China runs on a whole different system and IT infrastructure network. The largest domestic sell-side firms such as Citic Securities or CICC have more than 100 analysts each, while even a mid-sized one has 60 to 80 analysts. This compares with a top foreign brokerage, which might have fewer than 10 'A' share analysts.

Finally, foreign fund houses that are not fully plugged into the domestic market would not be able to access the information network for independent channel checks, such as with company suppliers, consumers and competitors – something the domestic fund houses have built up over years.

So, for all the excitement about the recent liberalization, WFOEs may not be the best way forward. In fact, this may be a route taken by late entrants where the early birds who are already in the China market have picked their mates to form JVs. Those foreign fund managers who missed out on earlier rounds of match-making, or whose unions with local partners have not worked out well, could seek this new avenue to take a second bite of the China pie.

Joint ventures: an existing structure that potentially offers the best of both worlds

A third way for global investors to invest in China – by hiring Sino-foreign joint venture asset managers – has been an option for more than a decade.

We think that this actually has the potential of achieving the best of both worlds – harnessing the advantages of domestic fund managers, plus adopting the global best practices of a reputable foreign house. However, as the Chinese saying goes, this has mostly been 纸上谈兵 (an exercise that looks good only on paper). JVs have had mixed success, with most not working out well in practice.

This is mainly because in the past, with a foreign shareholding limit of 49 percent, the foreign manager has mostly played a minority role, with most holding just a 25-30 percent stake. Hence, many of the JVs have been plagued by the negative perception that they essentially operate like a domestic asset manager, with all the attendant pitfalls such as having high stock turnover, governance issues and a lack of risk management and controls. Most JVs have not worked out due to a clash of culture between both partners, a lack of integration in processes, and a lack of respect and reciprocity in the relationship.

However, we think that if both partners are able to work through the relationship, JVs are the best way to gain exposure to the China market, as it can tap the advantages of foreign and domestic parties, while avoiding the pitfalls of both.

We think that to translate these "paper benefits" into reality requires an understanding of the nuances of the cultural differences, with an emphasis on creating a harmonious relationship built on mutual respect and discussion. A heavy-handed approach where the foreign player imposes what it perceives as global standards or superior investment methods usually backfires, with the local player baulking at such an aggressive interventionist approach. Instead, a lot of time and effort is needed to cultivate the relationship where an early foreign entrant that has helped its smaller domestic partner grow – both on the business as well as on the personnel level – go a long way. A constant exchange of research ideas with the foreign player gaining local insights from its domestic partner also aids the investment process.

To harness the merits of both parties, we tap the expertise and market intelligence of a domestic partner, which has a large team plugged into the China information network. We then overlay this research advantage with our own portfolio construction process – an investment process held up to the scrutiny of international standards and honed through years of experience with a proven track record. This investment process incorporates a cap on portfolio turnover, and takes into account risk control with a limit on drawdowns. It measures risk-adjusted returns and decomposes returns into alpha and beta to tease out the source of outperformance and risk, such that adjustments to active bets are made accordingly. The aim is to beat client benchmarks by a consistent and realistic margin, with an emphasis on long-term outperformance.

In utilizing the vast research resources of its local partner, we also add value by deciphering the useful information – data, facts and market intelligence – and then adapt them to use within our proven research process. We adopt an institutional framework in our valuation methodology such as discounted cash flow and dividend yield valuation methods to evaluate investment targets, going beyond the crude comparable methods such as price-to-earnings and growth metrics that local investors focus on. In this way, the mix of Chinese and foreign ingredients work to produce a more robust investment process.

In conclusion, with the continued liberalization of China's asset management industry, global investors now have more options to gain exposure to a burgeoning market that offers many hidden gems. Both domestic as well as foreign fund managers offer advantages, with the former being strong in local knowledge, while the latter having more established investment processes. A marrying of both strengths in a joint venture, with the right ingredients for making the partnership work, has the potential to offer the best of both worlds.

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