

Development of the retail hedge fund market in Hong Kong

The fund management industry in Hong Kong has enjoyed sustained growth in the past decade. This is in no small part attributable to the robust regulatory framework administered by the Securities and Futures Commission (“SFC”), which has always been able to strike an optimal balance between investor protection and market development.

This is best illustrated in the authorization of hedge funds: Hong Kong is in the forefront in introducing a framework to facilitate hedge funds to be offered to the retail public. In May 2002, after extensive consultation, the SFC issued the Guidelines on Hedge Funds which set out the requirements for the authorization of hedge funds in Hong Kong. In view of the fact that hedge funds employ a wide array of investment strategies and require more investment flexibility, the SFC provides a pragmatic framework which accommodates the unique characteristics of these products and at the same time ensures that there is adequate disclosure to protect investor interest. There are certain features which are unique to the authorization of hedge funds and they include:

- Adopting a market segmentation approach via the following subscription thresholds:
 - Single hedge funds: US\$50,000
 - Fund-of-hedge funds: US\$10,000
 - Hedge funds with a capital guaranteed feature: no limit
- Instituting a set of standards to ensure suitability of fund managers, including the requirements to maintain suitable internal controls and risk management systems and for the fund to be managed in an acceptable inspection regime. In addition, entry requirements for management companies also include minimum asset under management and years of experience in hedge funds strategies in concern.

As the focus of the regime for hedge funds is on disclosure, the SFC also issues the Guidelines on Hedge Funds Reporting Requirements which set out details regarding hedge funds’ on-going reporting obligations; and the Circular to Registered Persons Regarding the Marketing of Hedge Funds to remind financial intermediaries of their obligations to assess whether hedge funds are suitable for their clients.

Meanwhile, in response to the feedback from the industry, SFC has started to review the Guidelines on Hedge Funds to facilitate market development. We believe there are certain areas which can be further relaxed to allow greater flexibility, such as the qualifications of the manager and its delegates, experience, compliance of constitutive documents; managed accounts, the treatment of sub-funds, limitation on assets charged to prime broker, and performance fees disclosure. The industry will continue to work closely with the SFC and render full support in the review exercise.

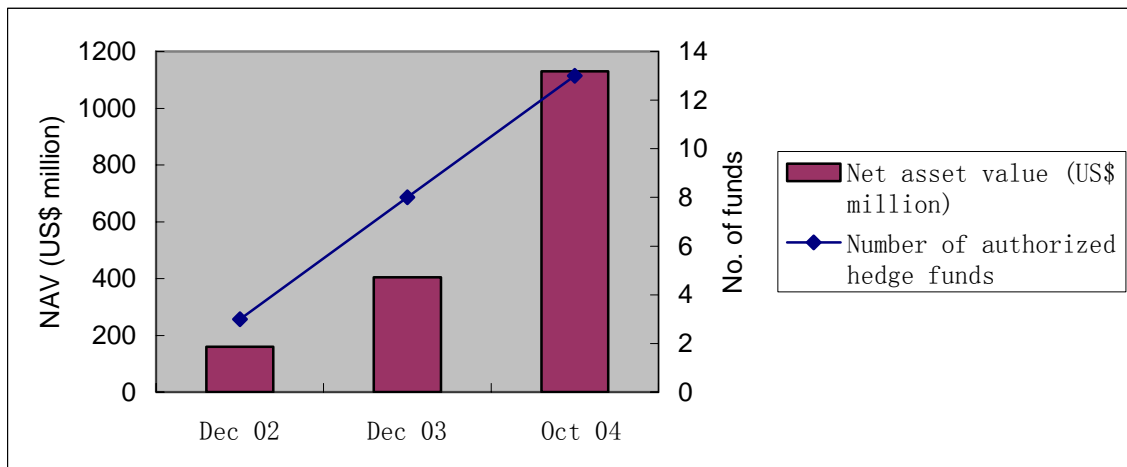
Demand from the retail public for hedge funds

The first batch of hedge funds was authorized in December 2002. As at the end of 2004, 13 hedge funds have been authorized, with total asset size of US\$1.13 billion vs. the US\$160 million recorded in December 2002.

The growth has been modest and is more or less in line with market expectations. The findings from a HKIFA survey indicate that whilst there is latent demand for this type of products, the early adopters probably are the more seasoned investors - according to a HKIFA survey commissioned in July 2002, one out of five fund investors (about 21% of the respondents) would consider investing in hedge funds. As expected, the percentage is much lower for non-fund investors – only about 2%. The most common reason cited for not buying hedge funds is unfamiliarity. Experience from overseas markets indicates that the early adopters are usually the more informed and sophisticated investors; and the rate of take-up is usually measured.

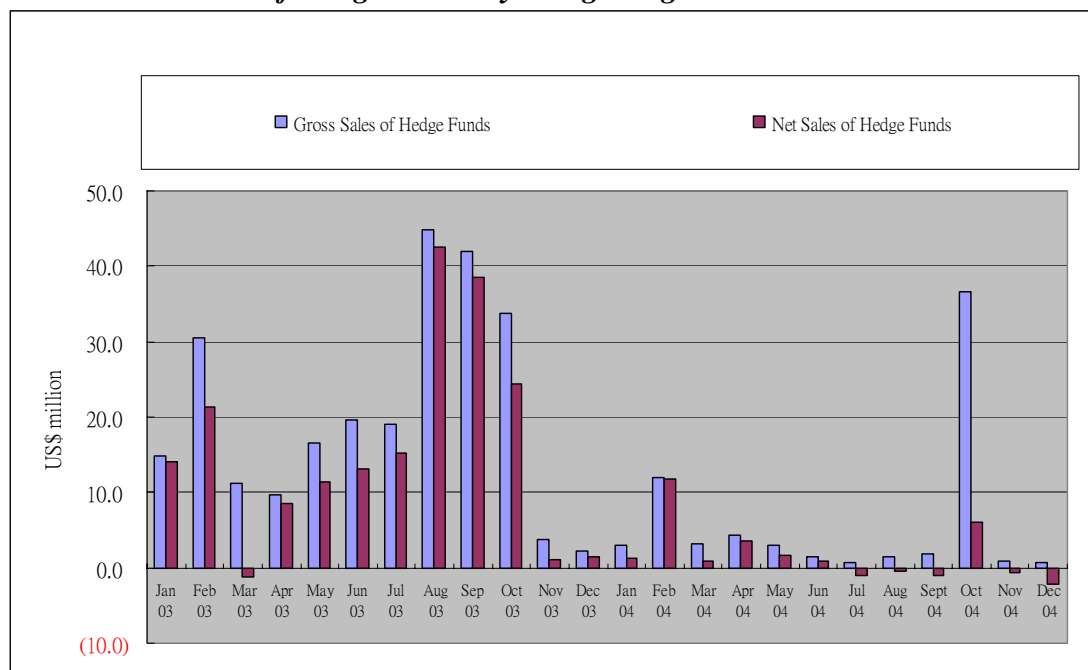
This pattern also applies to banks and other distributors, which account for over 90% of fund sales in Hong Kong. In selecting funds to add to their offerings, distributors have to undertake a very rigorous process of due diligence. This is usually supplemented by a series of very thorough training initiatives so as to ensure that the sales processes are properly conducted and products are properly sold to meet the clients' needs and profiles. As the investment strategies of hedge funds are more diverse than the traditional mutual fund products, the screening and education processes are relatively more complicated and protracted. Also, they generally require much more time and resources for education and for communication with the staff and investors; and the pace of take up has invariably been much more modest.

Number and Net Asset Value of SFC-authorized hedge funds



Source: SFC

Gross and net sales of Hedge Funds by Hong Kong Investors



Source: HKIFA. (The HKIFA's sales and redemption report covered SFC-authorized hedge funds managed by HKIFA members. At as the end of 2004, 6 hedge funds are covered by the report).

For the full year of 2003, gross sales of hedge funds reached US\$248.1 million, representing 1.3% of the industry total. They attracted net inflows of US\$190.4 million, equivalent to 5.9% of the industry net total. Sales of hedge funds had risen gradually from 2002, but the growth momentum seemed to have faltered since the end of 2003. For the year of 2004, gross sales of hedge funds were at US\$69.2 million, accounting for 0.3% of the industry total. Net inflows were at US\$21.1 million, equivalent to 0.8% of the industry net total. The drop in sales may be attributable to the fact that the global equity markets have picked up since the latter part of 2003, which have lured investors to return to the more traditional long-only products. Also, the subdued performance of certain hedge fund sectors might have arrested their penetration. According to the S&P Investment Performance Measurement Report, for the year of 2004, hedge funds managed by HKIFA members registered an average return of 8.8%, lower than the average return of 27.3% for the full year of 2003.

Outlook of the retail hedge fund market

We believe that whilst it is unlikely that retail hedge fund market will witness exponential growth in the short run, this segment will continue to witness steady growth as more and more retail investors appreciate the benefits of hedge funds. Meanwhile, the increasing use of hedge funds by pension funds and other institutional clients will also have a positive spilt-over effect on the retail market. But ultimately, the increased penetration of hedge funds in the retail market requires the investing public to have a basic understanding of the nature and the roles of hedge funds and HKIFA will continue to work closely with the industry and the regulator to undertake more educational initiatives so as to ensure that investors understand the nature of hedge funds and how to make use of them in a diversified portfolio.

(Note: HKIFA has provided a set of educational materials on its website, which include:

- A table comparing hedge funds with traditional unit trusts/mutual funds;
- A table comparing fund of hedge funds and traditional fund of funds;
- A list of questions that investors should ask before they invest in fund of hedge funds; and
- A glossary of key items on hedge funds.)

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