A Greater Gateway:

Hong Kong's Future as a Fund Management Centre

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As mainland China moves to relaxing controls over flows of capital across its borders, Hong Kong's prime position as a fund management centre presents new opportunities for asset managers across the world. The city faces increasing competition for its HK$17.4trn (US$2.2trn) [1] fund management business. But its position as a gateway to China, combined with its reliable physical and legal infrastructure, will continue to give it a crucial advantage.

Hong Kong has long been of paramount importance as an offshore RMB hub, with a pool of over RMB1trn in 2015.[2] Now, as mainland regulators take steps to give international investors more direct access to Chinese assets and Chinese investors greater access to the outside world, Hong Kong's importance in fund management is being magnified. Landmark schemes like Stock Connect, linking the Hong Kong equities market with that in Shanghai and Shenzhen (to be launched on 5 December 2016), and the Mutual Recognition of Funds (MRF) program that allows funds domiciled in Hong Kong to be distributed in the mainland, and vice versa, are potentially game-changing.

In light of these developments, international asset managers are re-evaluating their presence in Hong Kong and considering the best means to seize the opportunities that its evolution as a gateway to China's capital markets present. Against this background, BNY Mellon is examining some of the fundamental issues shaping Hong Kong's future as a fund management centre and what they mean for fund managers keen to tap growing capital flows to and from China. How will the industry develop and how can asset managers globally position themselves to capitalise?

ETFs in Hong Kong: Poised for Growth

Though the pace of adoption of exchange traded funds (ETFs) in Hong Kong has so far been moderate, impending changes to cross-border investment schemes, combined with a more accommodating regulatory environment, mean this asset class is set to take off.

Globally, ETF assets have exploded in recent years, growing at over 24% annually for the past decade to reach US$3.3trn.[3] While the lion's share of these funds are still in Western markets (with US$2.4trn in the US alone), Asian markets have also seen a steady growth of institutional and retail funds flow into ETFs.

Hong Kong already leads in Asia (excluding Japan) in terms of market size, with 124 ETFs totaling some US$37.8bn in assets – versus US$34.4bn in mainland China and US$23.2bn in South Korea, the next biggest regional markets.[4] Globally these are modest numbers (the US and Europe each had over 1,500 ETFs by October 2015 [5]), but there are several reasons to suggest the market for such products in Hong Kong is set to expand dramatically.

The Stock Connect Effect

The likely inclusion next year of ETF products in the Stock Connect schemes linking the Hong Kong exchange to those in Shanghai and Shenzhen is the biggest impetus. Regulators announced the move in August 2016 that ETFs would be included in both schemes after the Shenzhen link had been in operation for "a period of time" and "upon the satisfaction of relevant conditions".

Though several practical questions about the move are yet to be answered, the inclusion of ETFs in Stock Connect could transform the Hong Kong market.

"This is the first opportunity that mainland investors will have to invest directly in foreign ETFs," says Alan Fong, APAC Product Segment Manager at BNY Mellon. "This stands to be transformational for the Hong Kong market, making it considerably more diverse and international."

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Fund managers in Hong Kong providing ETFs based on international indexes are likely to be the biggest winners, as Chinese investors seek greater (and quota-free [6]) exposure to overseas assets. Currently, the majority of Hong Kong ETFs are "vanilla" equity products, with mainland A-share based products accounting for around one-third of the average daily turnover,[7] but the demand for exposure to more diversified assets will intensify.

Southbound flows will also be boosted by greater capital flows from mainland institutional investors. Significantly, in September this year the mainland insurance regulator announced that insurers could buy equities through Stock Connect, which could unlock a large amount of capital into Hong Kong listed stocks - including ETFs when they are allowed into the schemes.

1 Source: Hong Kong Securities and Futures Commission's Fund Management Activities Survey 2015 report, published July 2016
2 Source: Hong Kong Securities and Futures Commission's Fund Management Activities Survey 2015 report, published July 2016
3 As of October 2016. Source: ETFGI
4 As of September 2016. Source: ETFGI
5 Source: ETFGI
6 Flows will still be subject to daily quotas in the Stock Connect schemes, although aggregate quotas for both schemes will be abolished. Source: Hong Kong Stock Exchange, presented by Charles Li, HKEX Chief Executive on 16 August 2016.
7 Source: Hong Kong Stock Exchange's ETF and L&I Product Market Perspective report (August 2016)

The Importance of Increasing Innovation

While mainland demand for exposure to international assets is likely to lead to greater diversification, the stage is also set for the launch of a wider range of product structures. These include inverse and leveraged ETFs (which allow going against the market and are designed to multiply price changes in the underlying assets), as well as actively managed and "smart beta" products.

Hong Kong regulators have understandably been cautious in allowing new ETF structures, with concerns over investors' understanding of the risks and the potential volatility caused by their daily unwinding of positions. South Korea, for example, already has 39 leveraged or inverse ETFs, worth 15.4% of the market,[8] while Hong Kong is only starting to approve such products this year (excluding, for now, those focused on Hong Kong and mainland stocks).[9]

Still, as increasing variety of ETF products becomes more popular in other markets, the outlook for their adoption in Hong Kong is positive. "Active" ETFs[10] have taken off in Europe in particular (thanks in part to the existence of an active UCITS share class), while new rules to rationalise the listing process for actively managed funds issued in the US in July this year will greatly speed up their approval.[11]

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Active ETFs could be particularly popular among mainland investors. "Many don't hold funds for long periods, preferring to trade in and out quickly," Alan Fong says. "So having active ETFs in the Hong Kong market at lower cost than traditional managed funds could be very attractive to mainland investors."

Another potential avenue for diversification is in "Smart beta" funds that are benchmarked against factors other than market capitalisation. These have proliferated worldwide, in part because they offer investors an appealing middle road between passive index-tracking funds and pricier active management. Their greater adoption in Hong Kong will to some extent depend on deepening investor education – which may also make regulators more relaxed about approving newer and more complex structures with a more informed investors base.

There is no doubt that an openness to innovative new fund structures and forms is equally as important to Hong Kong's fund management industry as the city's links to the mainland.

"To maintain competitiveness, Hong Kong fund managers and regulators need to consider more than just the city's position as a conduit to and from mainland China," says Steve Cook, Managing Director, Structured Product Services at BNY Mellon. "They must keep an eye on innovations and best practices among their peers, while also leveraging Hong Kong's central role in the opening of China's capital markets."

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Getting Ready

The impending inclusion of ETFs in the Stock Connect programs and the adoption of more varieties of exchange-traded products mean the outlook in Hong Kong for exchange-traded products, and fund management in general, is increasingly bright.

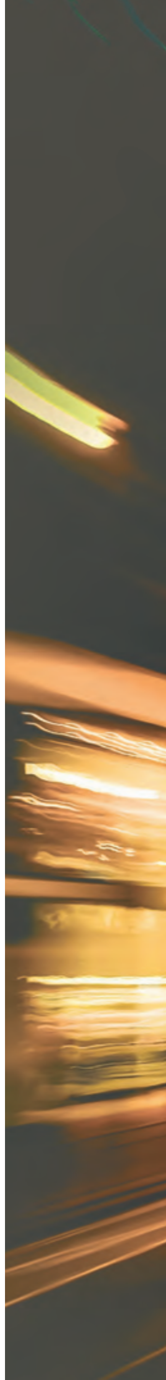
Of course, asset managers in the city offering such products will have to contend with the realities of maintaining increasingly complex ETF portfolios, with new structures requiring much more advanced custody, fund accounting and administration services. As ETFs come to play a crucial role in the movement of capital across China's borders, having these services available in Hong Kong, in real time, will be increasingly vital to maintaining competitiveness.

8 Additionally, it has 5 ETFs leveraged inverse ETFs. As of September 2016. Source: ETFGI

9 Source: Financial Times' article on 13 June 2016 titled "First leveraged ETFs launch in Hong Kong"

10 Actively managed ETF is "an exchange-traded fund that has a manager or team making decisions on the underlying portfolio allocation or otherwise not following a passive investment strategy. An actively managed ETF will have a benchmark index, but managers may change sector allocations, market-time trades or deviate from the index as they see fit. This produces investment returns that will not perfectly mirror the underlying index." Source: Investopedia

11 Source: Bloomberg article on 23 July 2016 titled "SEC Clears Rules For Speedier Approval of Actively Managed ETFs"



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