Foreign Investment in China's Fund-Management Industry: Opportunities and Challenges

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Declaration

I, the undersigned, hereby declare that the work contained in this assignment is my own original work and that I have not previously in its entirety or in part submitted it at any university for a degree.

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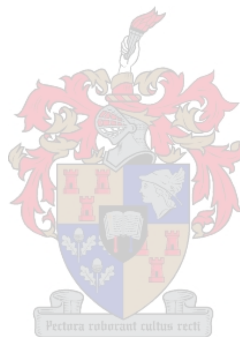

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Abstract

The study addresses foreign investment in China’s fund–management industry, with a detailed analysis of the opportunities and challenges that foreign investors may face. With the entry of China into the World Trade Organisation (WTO) in 2001, foreign investors have been allowed to hold up to 33% of a joint fund-management firm, which has increased to 49% from the end of 2004.

As a trendy investment tool, investment funds, and particularly mutual funds, have expanded significantly especially as regards market size and economic importance in developed economies. This study starts with an introduction to the investment fund, which includes types of investment funds and the advantages of mutual funds. Then, the history of China’s fund-management industry is described to give a brief picture of this nascent industry.

In order to justify the promising future for foreign investment in China’s fund-management industry, the study first analyses the sustainability of China’s economic growth, which is driven by some favourable aspects such as the gradual development of an economic structure, continued FDI inflow and WTO membership. Another two specific factors that may be favourable for the fund-management industry in this regard, namely pension fund reform and increased income, are also discussed.

Foreign investors in China’s fund-management industry are also exposed to some challenges. For investment funds, the main platform is the financial markets, which means that the development of the fund-management industry is tied closely to the development of the financial markets. In the case of China, the financial markets are still developing and have not grown into efficient capital allocation mechanisms due to the restricted involvement of foreign participants and substantial government intervention.

However, this study only focuses on major opportunities and challenges associated with foreign investment in China’s fund-management industry. A detailed analysis of each of various relevant aspects can be conducted in a future study, as well as a pertinent survey.

Opsomming

Hierdie studie handel oor buitelandse belegging in Sjina se fondsbestuur-industrie, met ’n gedetailleerde analise van die geleenthede en struikelblokke wat buitelandse beleggers mag teëkom. Na Sjina se toetrede tot die Wêreld Handelsorganisasie in 2001 is buitelandse beleggers toegelaat om tot 33% aandeel te hê in ’n gesamentlike fondsbestuur maatskappy. Hierdie aandeel is toegelaat om tot 49% in 2004 te styg.

As ’n gewilde beleggingsopsie het beleggingsfondse en veral onderlinge fondse grootskaalse groei getoon veral wat betref markgrootte en ekonomiese belangrikheid in ontwikkelde ekonomieë. Hierdie studie begin met ’n inleiding tot die beleggingsfonds, wat die verskillende tipes beleggingsfondse en die voordele van onderlinge fondse insluit. Dan word ’n geskiedkundige oorsig gegee van die ontwikkeling van die fondsbestuur-industrie in Sjina sodat ’n beter begrip van hierdie jong industrie by die leser aangewakker kan word.

Ter regverdiging van die belowende toekoms vir belegging in Sjina se fondsbestuur-industrie, fokus die studie eers op die volhoubaarheid van Sjina se ekonomiese groei, wat gedryf word deur voordelige aspekte soos die stelselmatige ontwikkeling van ekonomiese strukture, aanhoudende Buitelandse Regstreekse Belegging (BRB) en lidmaatskap van die Wêreld Handelsorganisasie. In hierdie verband word nog twee aspekte wat die fondsbestuur-industrie tot voordeel mag strek, naamlik pensioenfondshervorming en toenemende inkomste, ook bespreek.

Buitelandse beleggers word ook gekonfronteer met sekere struikelblokke sover dit die fondsbestuur-industrie aangaan. Die hoofbasis vir beleggingsfondse is die finansiële markte, wat impliseer dat die ontwikkeling van die fondsbestuur-industrie ten nouste afhang van die ontwikkeling van hierdie markte. In die geval van Sjina, is hierdie markte nog besig om te ontwikkel en het nog nie die wasdom bereik om effektiewe kapitaal-allokasie-meganismes te wees nie weens die gevolg van beperkte toegang vir buitelandse deelnemers, en grootskaalse inmenging deur die Sjinese regering.

Hierdie studie fokus egter slegs op belangrike geleenthede and uitdagings wat gepaard gaan met buitelandse belegging in Sjina se fondsbestuur-industrie. ’n Gedetaileerde

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analise van elk van die relevante aspekte asook die nodige opnames kan in ’n verdere studie gedoen word.

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List of Acronyms

AMCs	Asset Management Corporations
CAGR	Compound Annual Growth Rate
CBRC	China Banking Regulatory Commission
CIRC	China Insurance Regulatory Commission
CSRC	China Securities Regulatory Commission
CPC	Communist Party of China
DCE	Dalian Commodity Exchange
FDI	Foreign Direct Investment
FIEs	Foreign-invested enterprises
GATT	General Agreement on Tariffs and Trade
ICI	Investment Company Institute
IP	Individual Person
LP	Legal Person
MOFCOM	Ministry of Commerce
NCSSF	National Council for Social Security Fund
NPLs	Non-performing Loans
OTC	Over-the-Counter
PAYG	Pay-As-You-Go
PBOC	People's Bank of China
PE	Price-Earnings
SBS	State Bureau of Statistics
SHFE	Shanghai Futures Exchange
SHSE	Shanghai Stock Exchange
SOEs	State-Owned Enterprises
SZSE	Shenzhen Stock Exchange
T-bonds	Treasury Bonds
WTO	World Trade Organisation
ZCE	Zhengzhou Commodity Exchange

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Chapter 1
Introduction

1.1 Background

In recent years, China[1] has been drawing increasing attention to itself in lieu of its booming economy. Many changes have been taking place in the Chinese economy, the most fundamental of which is the movement away from a largely agrarian economy towards a socialist market economy that has implemented most principles of a market based economy (Areff, 2003: 1). This process of modernisation has largely replaced the economic 'self-isolation,' that has governed Chinese economic policy since the creation of the communist state in 1949, with an economy that is benefiting from greater access to the information and technologies of developed countries (Chartier, 1998: 260).

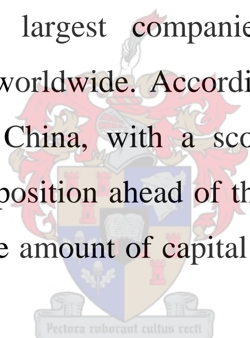
Since the process of 'reform and opening up' was introduced in 1978, the economic influence of non-governmental organisations and private citizens has increased. Driven by policies that aim to increase foreign trade and investment, China has made stunning achievements in terms of economic growth and social development. China has maintained an average growth above 9 percent in its GDP from 1978 to 2004 (Economist, Jan 2005), which is approximately 2.5 times the current global average. According to Stiglitz (1997), the former senior vice president and chief economist of the World Bank, the top twenty economies that have been growing the fastest in the world between 1978 and 1995 would all have been Chinese, provided that the thirty provinces in China were counted as individual economic entities.

At the same time China's average income per capita, though still quite low, has increased seven times in the last two decades, leading to an increase in living standards, literacy rates, and more importantly, improving the way businesses are run (Areff, 2003: 2). In the last

[1] In this study, China refers to the Mainland of the People's Republic of China, excluding Hong Kong SAR, Macao SAR and Taiwan region.

two decades, China has also managed to turn itself from being one of the poorest countries – with about 80 percent of the population earning less than 1 US dollar a day – to a country that has doubled its consumption rate and lifted a staggering 200 million people out of abject poverty (Anonymous A, 2001).

One of the most important drivers behind this economic growth is the unmatched amount of FDI (Foreign Direct Investment) that has been flowing into China over the past two decades. According to Time Magazine (June 2005: 24), FDI in China exceeded 60 billion US dollars in 2004 – up from 40 billion in 1999. According to A.T. Kearney (2004), one of the largest business-strategy consulting firms worldwide, China is considered the top destination for FDI according to its FDI Confidence Index which measures the possibility of investment in specific markets. This index is based on several surveys and interviews with executives from the 1000 largest companies in the world who contribute approximately 70 percent of FDI worldwide. According to its 2004 index, a third of all managers interviewed considered China, with a score of 2.03, as the most favoured investment destination, giving it a position ahead of the United States with 1.45. This has furnished China with a considerable amount of capital which has also helped to accelerate its economic growth.



Bearing all these things in mind, it is reasonable to ask whether China's economy can continue to grow at its current breakneck speed and how long this growth can be sustained. Despite these questions, global investors are optimistic. According to A.T. Kearney's global FDI report (2004), about 40 percent of executives expressed a more positive outlook on China's economy while only 10 percent were more pessimistic. In fact, China has been implementing 'very forceful measures' to cool the 'overheating' economy and create a 'soft landing' by imposing restraint in certain sectors, reducing land release to developers, and raising interest rates for the first time since 1995 – all of this happening at a time when most countries are struggling to achieve high economic growth rates (Economist, Jan 2005). There seems to be little stopping the expansion of the Chinese economy.

More specifically, China's huge population provides vast reserves of cost-efficient labour and a growing market for all kinds of businesses. It is projected that, within the next five years, half of the 400 million new consumers with annual incomes over 10,000 US dollars will be Chinese (Anonymous B, 2002: 1), which means a massive market for investors. Large-scale reconstruction and the expansion of its energy-producing capabilities have also enabled China to explore further potential for economic progress. Greater political stability, a sound investment environment, and WTO membership will attract more capital from around the world and fuel China's rapid economic growth. In addition to this, the successful bid for the 2008 Olympics is estimated to represent an investment of 34 billion US dollars, generate 700 000 jobs and contribute 170 billion US dollars to the output of the Chinese economy (Anonymous C, 2005).

According to a study done by the Chinese Academy of Social Sciences, China's GDP in 2020 will be 10 times the size of its GDP in 1990, while it will be 19 times in 2030. During this latter stage, China will become the world's leading economic power, exceeding the GDP's of the United States, Japan and Germany. This trend is confirmed by Krugman (Cheng, 2000: 122-157) who estimates that China's GDP will be 82 percent of that of the United States in 2010 – even if China only manages a moderate growth of 7 percent for the next 8 years. This rosy future, and the attractive benefits that it presents for business, necessitates a closer scrutiny of the various opportunities that exist in the Chinese economic landscape.

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When one considers capital markets in China, various opportunities have been created after the implementation of a radical program of liberal reform against the background of a booming macro-economy. Formal stock markets were only implemented in 1990, but official statistics show that total market capitalization[2] in 2002 reached 458 billion US dollars – up from a base of less than 1 billion in 1990 (Green, 2003: 6; Anonymous D, 2005). China's capital markets have attracted considerable interest from foreign investors in

[2] Market capitalization is a measure of market size calculated by multiplying the number of shares by the share prices (Anonymous E, 2005).

lieu of China's WTO commitments, which include the gradual opening of these markets. This means that, despite certain constraints, and the fact that capital markets in China are not completely and unlimitedly open to the world, various business opportunities are becoming available for foreign investors. With China's gradual 'opening-up' of these markets, one of the most attractive opportunities is the fund-management industry.

The fund-management industry represents one of the most dynamic – and likely to become one of the largest – parts of the global financial services sector in the years ahead (Walter, 1999). According to the Global Mutual Funds report by Datamonitor (2003), the global mutual fund market has experienced moderate growth in recent years and has reached a value of 14 trillion US dollars by the end of 2003, having grown with a compound annual growth rate (CAGR) of 5.5 percent during the 1998-2002 periods. By 2007 the market is forecast to reach a value of 15.3 trillion, an increase of 27.6 percent since 2002. It is also forecast to have a volume of 53,640 million funds, an increase of 13.3 percent since 2002.

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When compared to mature markets, China's fund management industry is still in its infancy and relatively small. According to Investment Company Institute (ICI), a US-based information provider for statistical data on the investment company, the number of investment funds in US and the total NAV[3] managed by fund managers were 50 times and 25 times them in China at the end of 2004, respectively (Chin Knowledge, 2005: 13). However, this seven-year-old sector is one of fastest growing, vibrant markets in the world. The total NAV of China's funds increased thirty times from 1998 to 2004 with a remarkable CAGR of 63.6 percent and assets under management of China's funds also accumulated to 39 billion US dollars at the end of 2004 (China Knowledge, 2004: 13-14). The continued growth of China's economy provides a fertile environment for the expected booming of its nascent fund-management industry. With one of the highest personal

[3] NAV, net asset value, is the value of each share of investment companies and equals assets minus liabilities expressed on a per-share basis.

$$\text{NAV} = \frac{\text{market value of assets minus liabilities}}{\text{shares outstanding}}$$

(Anonymous F, 2005)

savings rates in the world, millions of Chinese households could fuel this growth. Current reforms, such as pension reform and improvements on legal issues, are boosting the growth of the fund-management industry, which enjoys the general support of the Chinese government. In addition, the ever-increasing appetite for more financial products is forming a fast-growing market for investment funds in China.

China's fund-management industry rightly represents an attractive market for foreign investors. However, there are a lot of challenges regarding investment in China's capital markets and, more specifically, the fund-management industry. Despite China's economic growth and various economic reforms, several problems still exist in its economy and other relevant fields. The capital markets are very small and immature, compared to the size of China's economy and some countries in Asia (Green, 2003: 4). With the initiative to refinance state-owned enterprises, China's stock markets are also heavily influenced by the government. More importantly, the stock markets are still not *guifan* (Chinese for 'well-ordered'), in spite of rapid growth and great achievements, according to former Premier Zhu Rongji of China (Green and Wall, 2000: 4). Speculation, fraud and manipulation still influence markets. Worse yet, stock markets lack legal support to protect investors, especially small individual investors. There was no particular law applied to stock markets and legal departments were refused to deal with stock-related court cases until January 2002 (Li, 2003).

According to China's WTO commitments, a joint fund-management venture is allowed to invest in China's fund-management industry, with an initial stake of 33 percent, with an increase to 49 percent within three years. However, a joint fund-management venture, like other joint businesses in a communist country, is exposed to various uncertainties in terms of legal and economic issues.

1.2 Research questions

China's role in the international economic arena is growing as it embraces globalization on economic and financial fronts, driven especially by economic globalization. Everything about China is super-sized and massive opportunities exist to attract investors from around the world as can be seen by the booming of FDI in China. With gradual integration into the world, China's capital markets and relevant industries are becoming another opportunity for foreign investors to explore and compete in. China's capital markets have been recognized as a means to solve various problems existing in its financial sector and other relevant fields and are crucial to determine its success in the global competition (Jingu, 2002: 2).

Considering China's commitments to the WTO and the potential of the current nascent situation in certain fields, it is also worthwhile to invest in China's fund-management industry. Apart from the opportunities in the fund investment itself, it is fundamental to analyze the history and current situation of China's fund-management industry. Therefore, it is important to firstly understand how China's fund-management industry has changed and what the current situation is. To achieve such an understanding, several specific questions are investigated to justify investment in this immature industry, which include current growth projections for China's economy and the subsequent effects on its capital market. At the same time, one should be aware of the opportunities that the fund-management industry and, more importantly, foreign investors will have. One must also consider the challenges that will influence the development of China's fund-management industry and foreign investment. Lastly, one should consider the changes that the fund-management industry may experience in the future.

1.3 Purpose of the study

There is no doubt that China is becoming one of the leading role-players in terms of economic and political power as its economic performance influences many other countries around the world, both directly and indirectly. Therefore, it is important to conduct studies

and monitor China's economic growth so that one may benefit from it. The main purpose of this study is to provide some insight into China's capital markets and guide foreign investors with regards to its fund-management industry.

To achieve these aims, this study begins with an introduction to the fund-management industry in general, which includes a discussion of the various types of fund-management products and some characteristics of fund investment. By doing this, the possibilities of internal development of the fund industry can be explained. Next, the history and the current state of the Chinese fund-management industry will be introduced.

There seems little disagreement regarding the various business opportunities that exist with regards to investment in China. However, when it comes to the financial sector, and more specifically the fund-management industry, both opportunities and challenges exist. To understand this dichotomy, two studies will be conducted to clarify the potential development of China's fund industry. The first will analyze the future development of China's macro economy and the environment it provides for fund industry development. This will then be compared to the fund-management industry in some mature markets, such as Europe and U.S. The second study will identify some micro aspects which drive the fund-management industry in China, such as WTO membership, increased income, high savings and pension fund reform. These studies form the basis of chapter three.

At the same time it is also important to consider the challenges involved in fund-management investment in China. While the facts and figures relating to China's growth and related business opportunities are highly impressive, it is very complicated to conduct fund investment successfully in China. Chapter four will identify some of the challenges that relate to the investment in China's fund-management industry, such as the lack of variety of fund products, the quality of listed companies, volatility of the stock market and underdevelopment of the bonds market.

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To attract investment in its capital markets, and more specifically in the fund-management industry, China is busy implementing various changes to improve the investment environment in legal and economic terms. Chapter Five will discuss these issues and their influence on the future development of China's fund-management industry.

1.4 Methodology

This research project, which needs to assess various facts, necessitates both a qualitative as well as a quantitative approach. The analysis will be descriptive when introducing the benefits of fund investment and assessing the potential development of China's macro economy and fund-management industry respectively. Quantitative methods will be used to analyze some indicators, such as market size, saving rates and volatility of the capital markets.

Since the study needs to analyze the correlations of many sectors to the fund-management industry, it includes various related studies. To this end, a number of data types and sources will be used in this study, which will concentrate mainly on reports and documents about this topic that have been published, such as the report of the China Fund Management Industry published by China Knowledge Press and reports from the Royal Institute of International Affairs and the Investment Company Institute, an America-based organisation. Another important means of achieving this is to make use of various speeches, especially in some recent relevant conferences and seminars, such as a conference on May 9, 2002 organized by the Asia Society at its New York headquarters. It is also useful and important to contact the authors of related studies and the organizers of some of these seminars about China's fund-industry to get more information.

A number of newspapers and other publications such as academic journals and books will be utilized for data. The nature of this study requires up-to-date statistics that change on a quarterly basis, and these figures will be accessed from governmental websites such as the

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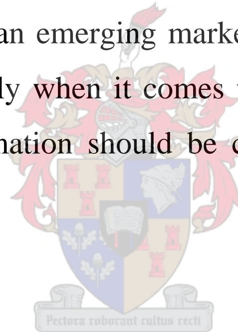
China Securities Regulatory Commission (CSRC), People's Bank of China (PBOC) and various other international organizations.

In summary, the main sources of relevant information for the study include as the following:

- China Knowledge
- Investment Company Institute
- the Royal Institute of International Affairs
- the Asia Society
- CSRC
- PBOC

However, it is also important to mention some challenges associated with information sources. Since this topic concerns an emerging market in an emerging country, there is a lack of relevant literature, especially when it comes to books and academic publications. Therefore, the limitation of information should be considered when going through this study.



Chapter 2

An Introduction to the Fund-management Venture and China’s Fund-management Industry

The fund-management venture, more often called the investment company, is the intermediary between individual investors and capital markets. It also launches various funds as investment vehicles for investors. For foreign investors, an important means to get directly involved in the China’s fund-management industry, and the huge potential benefits concerned, is to establish a joint fund-management company with domestic participants in China. Therefore, fundamental knowledge of the fund-management venture is indispensable for the whole study.

For this purpose, the starting part of this chapter is to present and clarify some basic information on mutual funds. First of all, certain key points of an investment company and the two most basic types of investment companies – closed-end fund and mutual fund – are introduced. This is followed by a focus on the mutual fund and the various types that exist. Finally, the benefits of investing in mutual funds are analysed.

China has become a buzz in the business world and topics relating to China are omnipresent in all kinds of media. However, when compared to other, more familiar opportunities in China, the fund-management sector is still relatively unknown to most foreign investors. For this reason, the second part of this chapter serves to lift the veil and reveal China’s fund-management industry. The history and current situation of China’s fund-management industry is also presented, with an emphasis on the status of joint fund-management ventures.

2.1 An Introduction to the Investment Company

The investment company is a financial intermediary, which invests the money of investors in a wide variety of securities and other assets. The fundamental idea behind an investment company is to pool a number of assets to provide investors, especially small investors, benefits involved with large-scale investing. According to the United States Investment Company Act of 1940, investment companies can be classified into unit investment trusts and managed investment companies. The portfolio composition of a unit investment trust is basically fixed for the life of the fund once the fund is established, which simply implies that little active management is involved. A unit investment trust is normally referred to as 'unmanaged' and is not the topic of this study *(Bodie, Kane and Marcus, 2001: 99-100).*

2.1.1 Closed-end Funds and Mutual Funds

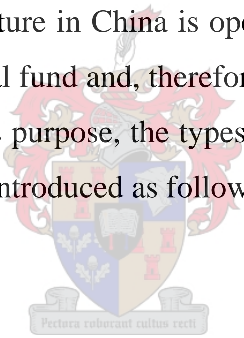
In contrast to the unit investment trust, managed investment companies imply that the portfolio is actively managed, instead of being fixed, and basically include two types – closed-end investment companies and open-end investment companies. Both closed-end funds[4] and mutual funds[5] are investment companies that function like any other listed company whose shares are traded on organised exchanges. Basically, the closed-end and mutual funds make the initial public offering to exchange money from investors with their shares, and make investments on behalf of shareholders. Investors can then enjoy some advantages involved with the fund investment philosophy that is often referred to as the 'pooling of assets'.

The key difference[6] between a closed-end fund and a mutual fund is the way in which they operate after the initial public offerings (Reilly and Brown, 2000: 1101). Normally, for

[4] Closed-end 'fund' and closed-end 'investment' are interchangeable and the former is used in this study.
[5] Mutual fund, open-end fund and open-end investment are interchangeable and the former is used in this study.
[6] There are other differences between a closed-end fund and a mutual fund, like pricing of shares, which are derived from this key difference.

investors with shares in a closed-end fund, the usual way to withdraw money from their shares is to sell shares in the public secondary market and basically there is no redemption. On the other hand, a mutual fund provides another different approach for investors to 'cash out' their shares, which makes mutual funds quite attractive as a financial investment means. Investors can sell shares[7], at NAV, back to the mutual fund that makes the initial public offering, if they want to cancel their investment in mutual funds. This redemption mechanism makes managers of mutual funds prudent in investing investors' money. The mutual fund itself can also use this approach to change the size of outstanding shares or achieve other particular business objectives, which means that mutual funds can continue to sell additional shares and redeem outstanding shares after the initial public offering *(Bodie, Kane and Marcus, 2001: 100-101), (Reilly and Brown, 2000: 1102-1104).*

Since a joint fund-management venture in China is operated in the form of a mutual fund, this study concentrates on the mutual fund and, therefore, a further understanding of mutual funds needs to be achieved. For this purpose, the types of mutual funds and the benefits of investment in mutual funds will be introduced as follows.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2.1.2 Types of Mutual Funds

Since the first mutual fund was established in 1924 in the United States, this type of investment has become more and more popular, and various innovative mutual funds have been created to meet the differing needs of investors (Anonymous K, 2005: 2). In general, mutual funds can be categorised into fives types of funds in terms of portfolio makeup, including stock funds, bond funds, hybrid funds, money market funds and index funds. It is important to keep in mind that each type of mutual funds also consists of various sub-categories, some important ones of which will be identified as well.

[7] Investors normally sell shares to the mutual fund at NAV, which is also the price, with or without charges, for the mutual fund to sell and repurchase shares after the initial public offering (Reilly and Brown, 2000: 1104).

Stock funds

This type of mutual fund, also sometimes called an equity fund, invests only in domestic or international stock markets and is consequently involved with both great potential risk and returns. Stock funds vary to a large extent due to different fund objectives, styles of management and the types of companies that invest in them. For example, income funds invest primarily in stocks of particular companies with good dividends and aim to provide investors with a source of income, while growth funds focus on capital appreciation, instead of dividends, by investing in stocks of well-established companies or the potential of significant earnings or revenue growth. Stock funds can also concentrate on stocks of certain sectors or regions according to investor appetites.

Bond funds

Differing from stock funds, bond stocks invest primarily in a wide range of bonds and other debt securities, and provide services on the preservation of invested capital and high current income at the same time. Therefore, this type of mutual funds does not get involved with more risk for significant returns, relative to stock funds. Normally, a decision to invest in bond funds is made with the consideration of two important factors: income-generation and diversification. Bond funds also include various types of funds in terms of different investment policies, the three biggest categories of which are government bond funds, municipal bond funds and corporate bond funds.

Pectora roborant cultus recti

Hybrid funds

The type of mutual funds, also referred to as balanced funds, is designed to provide both capital appreciation and current income. For this purpose, the portfolio of hybrid funds combines investments in stocks, bonds and other debt securities, and the ratio of stocks to bonds or other securities vary to a large extent to meet the needs of investors. In fact, it is very common for mutual funds to be mixed and a pure mutual fund is rare. The reason for this is the motivation to provide the liquidity necessary to meet the potential redemption of shares (Bodie, Kane and Marcus, 2001:103).

Money market funds

Money market funds started in the 1970s and have been growing significantly. This type of mutual fund invests primarily in diversified portfolios of short-term securities, such as Treasury bills, certificates of bank deposits and commercial paper. The objectives are to generate current income and provide safety of capital and liquidity. Money market funds provide high stability and sometimes function just like bank accounts in terms of the fact that investors can even write checks against their accounts.

Index funds

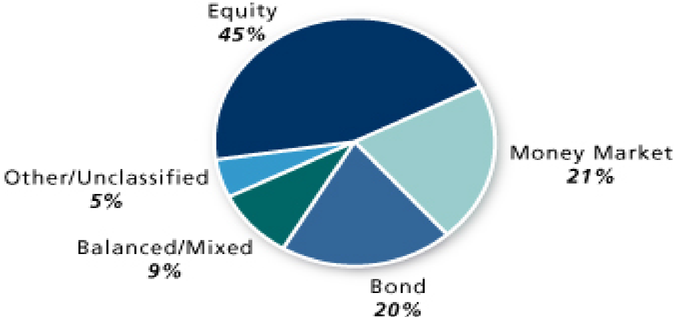
According to various studies, most investors, more specifically fund managers, are unable to outperform the market consistently on a risk-adjusted basis over time, which is why an index fund develops. An index is normally created to monitor the movement of certain sectors or market, which can be stock markets, bonds markets, or any mixed sources of securities markets. An index fund invests in a particular index or indices and is managed 'passively' to mirror and track the performance of certain market or segments of the market. Index funds provide various advantages in comparison with other mutual funds in that they are 'actively' managed, which have made them more and more popular during the past few decades. One of the main advantages is that index funds benefit from a series of low costs involved with transaction, management and capital gains taxes *(Bodie, Kane and Marcus, 2001:103-104), (Reilly and Brown, 2000: 154, 251-252 & 1106-1107) & (Anonymous G, 2005).*

A great number of mutual funds have been created that mirror the various needs and appetites of investors and there seems to be no stop to this trend. It is reasonable to believe that the family of mutual funds will probably only become bigger in the future. Today's market of mutual funds is dominated by stock funds and money market funds in terms of asset shares. According to the latest statistics[8] on worldwide mutual funds published by the Investment Company Institute, the asset shares of stock funds and money market funds are

[8] This includes statistics from 40 countries and the sample is available on pages 141 and 142 of *2004 Mutual Fund Fact Book* published by the Investment Company Institute and is available on: *http://www.ici.org/stats/mf/2004_factbook.pdf*.

45% and 21% respectively of all worldwide mutual fund assets, followed by bond funds with 20% of the total, at the end of 2004.

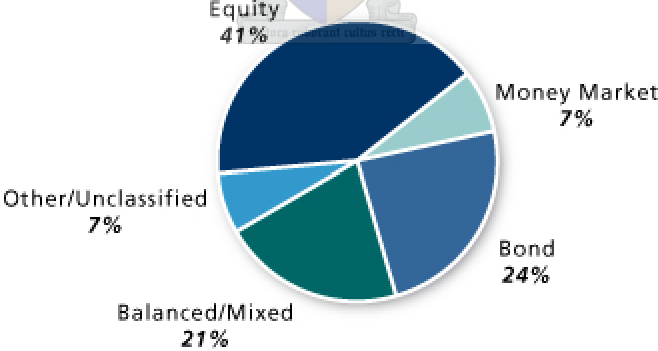
Figure 2.1 Worldwide Mutual Fund Assets by Type of Fund, 2004: Q4 (%)[9]



Source: "Worldwide Mutual Fund Asset and Flows---Fourth Quarter 2004" of Investment Company Institute, 2005

When considering the number of mutual funds in the world, according to the same report, there were 54 986 mutual funds worldwide at the end of 2004, with stock funds and bond funds representing 41% and 24%, respectively.

Figure 2.2 Worldwide Mutual Funds by Type of Fund, 2004: Q4 (%)



Source: "Worldwide Mutual Fund Asset and Flows---Fourth Quarter 2004" of Investment Company Institute, 2005

[9] The sector *Other/Unclassified* includes index funds.

2.1.3 The Benefits of Investment in Mutual Funds

The size of the mutual fund industry has been increasing in the past few years. According to the *2004 Mutual Fund Fact Book* by the Investment Company Institute (2005), the net assets and the number of mutual funds worldwide at the end of 2003 reached 13 trillion U.S dollars from 9 trillion in 1998 and 54 015 funds from 50 835 in 1998 in 40 countries. It is impossible to isolate this outstanding growth from the internal advantages provided by mutual funds. Generally speaking, the benefits of the various mutual funds mainly include diversification, professional management, low costs and flexibility (Anonymous G, 2005; Anonymous H, 2005; Anonymous I, 2005; and Investment Company Institution (1), 2005: 7-8).

Diversification

Basically, investment risk contains two kinds of risk, namely systematic or market risk and unsystematic risk. As a common rule in the financial field, market risk is caused by particular events that affect the whole market and therefore cannot be reduced or eliminated. Unsystematic risk, on the other hand, can be reduced or eliminated by diversification. Mutual funds normally invest in a diversified portfolio at an economical cost, and thereby provide the benefits of diversification that are usually only available to institutional or wealthy investors and those involved with a large investment.

Professional management

Mutual funds are managed by full-time professional managers with more experience, knowledge and information than most individual investors are. The investment decisions of fund managers are made on behalf of investors with interest in the fund and are normally based on extensive research of the performance of certain securities. Therefore, investors do not have to be quite as knowledgeable on the markets, but they can still monitor their investment on a daily basis.

Low costs

Mutual funds provide the benefits of low costs in two areas. On the hand, investors are able to spend a relatively small amount of money on a portfolio that would probably be a huge investment if there were no mutual funds available. Therefore, investors can save money to a large extent. On the other hand, the 'pooling of assets' in mutual funds give rise more to economies of scale when doing transactions, which may consequently reduce the cost of shares of mutual funds.

Flexibility

As stated earlier, the family of mutual funds includes various types of funds and therefore provides investors investment opportunities among a wide range of investment approaches. The flexibility offered by mutual funds also implies liquidity and convenience for investors. Mutual funds function just like any other listed companies in terms of the mechanism of shares-trading and investors can simply cash out by selling shares to willing buyers.

2.2 History of China's fund-management industry

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Since the main investment platform for fund-management ventures is capital markets, the development of the fund-management industry is directly related to the situation of capital markets. In the case of China's fund-management industry, the formal centralised stock trading system, which made the establishment and development of fund-management companies possible, was established in the early 1990s[10] - two exchanges in Shanghai and Shenzhen. China's fund-management industry took off soon after the creation of these stock markets. According to the industry report *China Fund Management in China*, published by China Knowledge (2005), the history of China's fund-management industry is divided into three stages in terms of regulation issues and industry development.

[10] More information on China's stock markets is available in Chapter 4.

The 'Old funds' stage

As mentioned above, the birth of China's fund-management industry followed the establishment of a formal stock exchange. The Wuhan Securities Investment Fund was established as China's first securities investment fund in October 1991. The first specialised fund-management company, Shenzhen Investment Fund Management Co., came into operation in October 1992. The year of 1992 also saw the first boom in China's fund-management industry as 37 funds were set up. It is important to remember that, at that time, this nascent industry was unregulated and there was no specific regulation or governing body. The local governments or branches of China's central bank, the People's Bank of China, acted as the governing body and approved most of the funds. For example, the Wuhan Securities Investment Fund was launched by the Wuhan Branch of the People's Bank of China *(China Knowledge, 2005: 3).*

It is important to mention that the *Zibo Township Enterprises Fund* was the first fund to go public during that period and was listed on Shanghai Stock Exchange. With the rapid growth during the first stage of 6 years, 72 closed-end funds[11] were operating, raising RMB[12] 6.6 million by the end of October 1997 *(China Knowledge, 2005: 3).*

In general, China's fund-management industry was characterised by its unregulated status, small size, and poor performance at that stage. As discussed earlier, neither particular regulation nor nationwide governing organisation existed to administer the fund-management industry. The funds at that time were initiated by a wide range of institutions, which included banks, trust and investment companies, securities firms, insurers, corporations, while trust and investment companies and securities firms had dominating positions, with 51% and 20% respectively (China Knowledge, 2005: 3). Another aspect of this unregulated status was that the structure of most of these funds was not standardised,

[11] There were only closed-end funds at that time and mutual funds did not exist until 2002. More detail on this issue is available in the following parts.

[12] RMB is the currency in China and stands for Ren Min Bi which means 'People's Currency' (Anonymous J, 2005).

since a single entity could be operating as the fund management company, custodian company, and the promoter at the same time.

Despite the rapid growth of the number of funds, the sizes of funds were very small with assets under management of only RMB 80 million on average (China Knowledge, 2005: 3). When compared with the market capitalisation[13] of stock markets, the position of the fund-management industry was also not that dominating and the funds were playing a trifling role in the capital markets. For example, the total assets under management of funds stood at only 1.27% of the market capitalisation of China's stock markets in 1997 (China Knowledge, 2005: 3).

In addition, the investment strategies of most of the funds were ambiguous and various fields were regarded as investment targets. As a result, the performance of China's fund-management industry did not seem as attractive during that period and losses were caused by speculative investments in real estate, hotels and stock markets (Green and Wall, 2000: 22).

<u>The 'New funds' stage</u>

All these problems made policy-makers aware of the importance of the existence of relevant regulations for the healthy development of China's fund-management industry and more importantly, for prosperous capital markets, especially stock markets. This awareness directly brought about the *Provisional Measures of Administration of Securities Investment Funds* in 1997, which provided relevant clarifications and guidelines regarding some critical issues involved in the industry, such as fund structure, duties of fund managers and so on.

Another momentous outcome of these Measures was to enable the *China Securities Regulatory Commission* (CSRC) to get out of an authority conflict with the PBOC (the

[13] This is only the market capitalization of tradable shares in the stock markets and the detail on types of shares in China's stock markets is discussed in Chapter 4.

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People's Bank of China), concerning the fund-management sector. The CSRC now became the governing power to regulate and supervise China's fund-management industry. In order to change the unregulated nature of the industry, the CSRC released a series of rules with regards to various issues in China's fund-management industry.

The 1997 Measures played such an important role that 1998, rather than 1991, is often recognised as the starting point of China's fund-management industry. 1998 also saw the first six 'new' fund management companies come into operation, despite tight control by the CSRC (Green and Wall, 2000: 22).

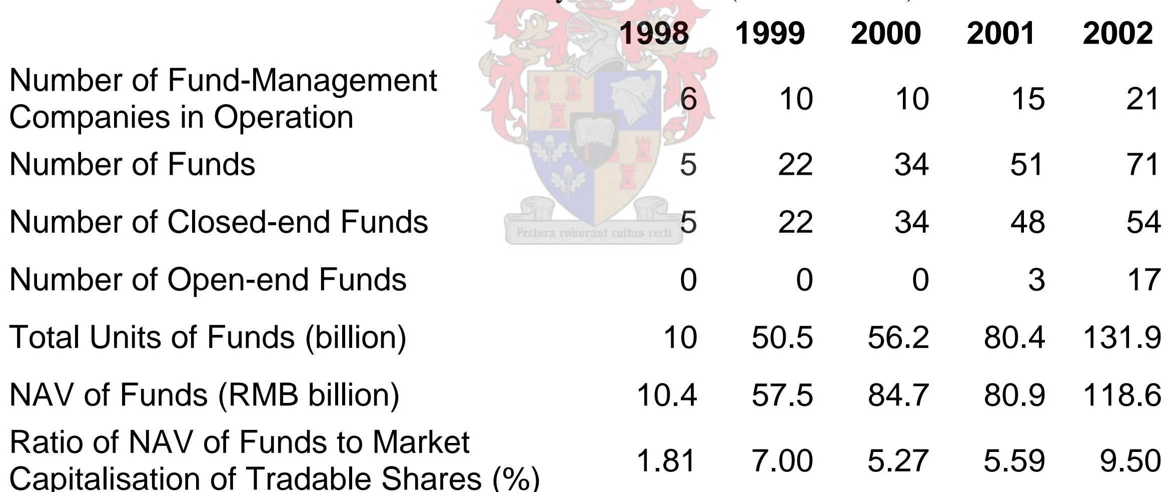
In the beginning of this stage, the newly standardised industry faced an obstructive situation. On one hand, restrictions were imposed by the CSRC on launching funds and the qualified promoters of funds only included securities, trust and investment companies, and other non-bank financial institutions according to the *Provisional Measures Securities Investment Funds*. This certainly limited the number of funds. On the other hand, the existing market participants, especially manipulators, were not friendly towards these 'new' funds. It was not uncommon that these market manipulators made use of their influence and market power to ostracise those stocks held by these 'new' funds and, consequently, the 'new' funds themselves *(China Knowledge, 2005: 4-6).*

However, these 'new' funds still enjoyed attractive expansion. The total NAV of funds launched by the first five fund-management companies reached RMB 10.4 billion and 57.5 billion at the ends of 1998 and 1999, respectively (China Knowledge, 2005: 6). More importantly, the authority had recognised the potential and importance of the fund-management industry to fight against these pervasive market manipulations and build healthy stock markets. Therefore, the 'new' funds benefited from the favour and a series of supportive policies from the CSRC. For example, 20% of new offering shares were distributed to fund-management companies, which was profitable at that time when initial public offerings simply guaranteed returns (China Knowledge, 2005: 6).

At the same time, the standardisation process moved to the funds that were set up before 1997 and the authority commenced to restructure 'old' funds. The result of this is that 4 'new' funds were created by consolidating 10 'old' funds in 1999. There were also no new fund-management companies approved by the CSRC in 2000 *(China Knowledge, 2005: 6).*

Generally, this stage saw gradual growth of China's fund-management industry, especially within the fledging stock markets. According to industry statistics published by the CSRC in April 2004, the number of funds increased from 5 in 1998 to 71 in 2002, while the NAV reached RMB 118.6 billion in 2002 from only 10.4 billion in 1998. More importantly, the role that fund-management companies were playing was becoming significant, as indicated by the ratio of NAV to market capitalisation of tradable shares that increased to 9.50% in 2002, from 1.81% in 1998.

Table 2.1 Industry Statistics[14] (1998 to 2002)

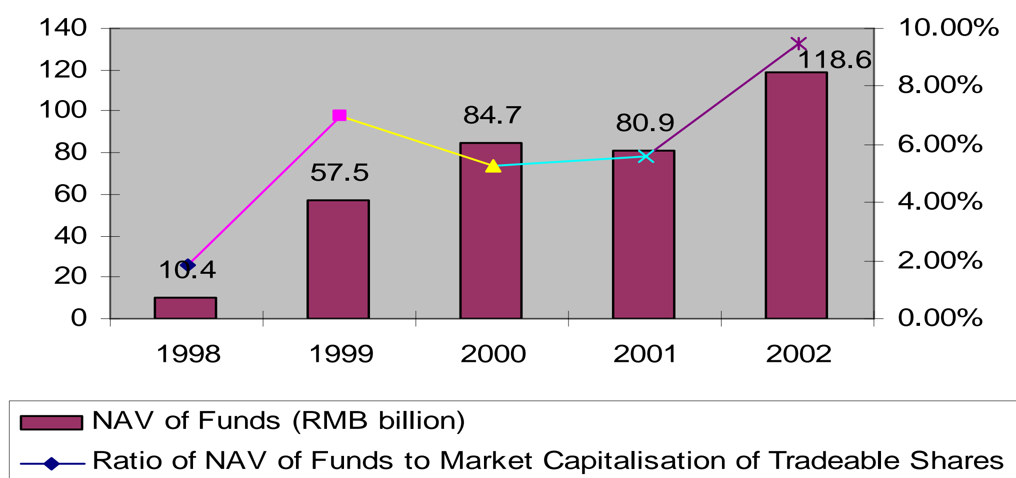


	1998	**1999**	**2000**	**2001**	**2002**
Number of Fund-Management Companies in Operation	6	10	10	15	21
Number of Funds	5	22	34	51	71
Number of Closed-end Funds	5	22	34	48	54
Number of Open-end Funds	0	0	0	3	17
Total Units of Funds (billion)	10	50.5	56.2	80.4	131.9
NAV of Funds (RMB billion)	10.4	57.5	84.7	80.9	118.6
Ratio of NAV of Funds to Market Capitalisation of Tradable Shares (%)	1.81	7.00	5.27	5.59	9.50

Source: CSRC April 2004 Report, China's Securities and Futures Markets

[14] The number of fund-management companies was summarised by China Knowledge according to the information provided by individual fund-management companies.

Figure 2.3 Expanding Gradually: China's Fund-Management Industry (1998 to 2002)



Source: CSRC April 2004 Report, China's Securities and Futures Markets

With the expansion of the fund-management industry, funds steadily gained acceptance by investors as vehicles to invest in capital markets. However, the stricter regulations, when compared to the past, did not completely rule out a series of market manipulations. Some 'new' fund-management companies also joined manipulators for huge illegal returns. In October 2000, an article, Inside Story of Fund Management Industry, in *Caijing*[15] revealed the illegal operations in the China's fund-management industry, which was based on two research reports by an employee in the Shanghai Stock Exchange. The two reports analysed the funds trading data between August 1999 and April 2000 and pointed out some irregularities of fund managers in manipulating the stock prices. After investigations by the CSRC, 8 fund-management companies out of 10 were proved to be on the list of guilty participants, including some leading companies. Although this unfortunate incident stopped the ongoing boom in China's fund-management industry, there is no doubt about its strategic significance in the long term *(China Knowledge, 2005: 7-8).*

In September 2002, the 54th closed-end fund, Yinfeng Fund, went public on the Shanghai Stock Exchange, which was also the last closed-end fund in China's fund-management

[15] Caijing is the Chinese for finance and this magazine is one of the leading financial journals in China.

industry (China Knowledge, 2005: 8). This is why the second stage ended in 2002. Since 2001, when the first mutual fund, Hua'an Creative Fund, was established, mutual funds had become more and more popular due to their intrinsic advantages relative to closed-end funds. There were 17 mutual funds in total by the end 2002 as indicated in the *table* 2.1.

In addition, 2002 also witnessed innovative achievements in this nascent sector. The first fixed income fund and index fund were launched at the end of 2002, which certainly made China's fund-management industry more diverse.

The 'Explosive' stage

China's fund-management industry continued its growth mainly in terms of size and variety in 2003. More and more new fund products were being created and it was becoming increasingly popular for investors to invest in China's capital markets. For example, the first set of umbrella funds[16] was formed by *China Merchants Fund Management Co.* in April and more innovative products were available on the list later that year, which included the first principal protected fund by *China Southern Fund Management* and the first monetary market fund by *Hua'an Fund Management* (China Knowledge, 2005: 8). A more and more wide-ranging fund family provides various choices for numerous individual investors, and has the potential to become an important investment destination for massive consumer savings.

The potential of this promising sector had been generally confirmed, especially by numerous investors, which accelerated the expansion of China's fund-management industry, both directly and indirectly. The attractive performance[17] of the whole industry drew the attention of various investors. In 2003, 13 new fund-management companies came into operation, which made the number of fund-management companies reach 34 and the NAV

[16] Umbrella fund is a collective fund including several sub-funds, each of which is involved in investment in a different sector, market or country. The key advantage is the lower cost for fund investors to move from one sub-fund to another, when compared with other mutual funds (Anonymous K, 2005).
[17] The weighted average growth rate of NAV of all funds achieved 20.27%, compared to 10.27% increase of the Shanghai Stock Exchange Index, in 2003 (China Knowledge, 2005: 9).

under management RMB 169.9 billion (China Knowledge, 2005: 9). More specifically, the outstanding growth was almost solely attributable to the mutual funds sector. By the end of 2003, the number of mutual funds reached 56, with RMB 85.7 billion of NAV involved, compared with the number of 54 and 77.9 billion of NAV from the side of closed-end funds (China Knowledge, 2005: 9). This simply means a strategic evolution in China's fund-management industry.

2004 was another important year for China's fund-management industry. The industry continued the gradual growth and more importantly, enjoyed the support of the authorities. It has been generally recognised that the capital markets, especially the stock markets, play a critical role in solving some complicated problems, such as SOEs (State-Owned Enterprises) reform and pension system reform, in China's economy and at the same time, the fund-management industry is necessary for healthy stock markets. In February 2004, a blueprint to develop stock markets was released by the State Council, which is usually called the *9-point Guidelines on Promoting Reform, Opening-up and Steady Development of China's Capital Market*. These guidelines encouraged institutional investors, which mainly included fund-management companies and insurers, to replace the individual investors as the major players in the stock markets. Accordingly, fund-management companies were given more space for further growth in terms of deregulations of fund sales and product innovations *(China Knowledge, 2005: 9-13).*

Unfortunately, China's stock markets experienced several big drops in 2004, due to the general lack of confidence from investors, even though the markets were strong for a while because of the 9-point Guidelines. This directly influenced the performance of the fund-management industry on the whole. However, China's fund-management industry still benefited from another rapid boom. By the end of 2004, the number of fund-management companies reached 45, which included 13 joint fund-management companies. As indicated by *figures* 2.4 and 2.5, the number of funds and total NAV reached 161 and RMB 326.2 billion respectively (China Knowledge, 2005: 10).

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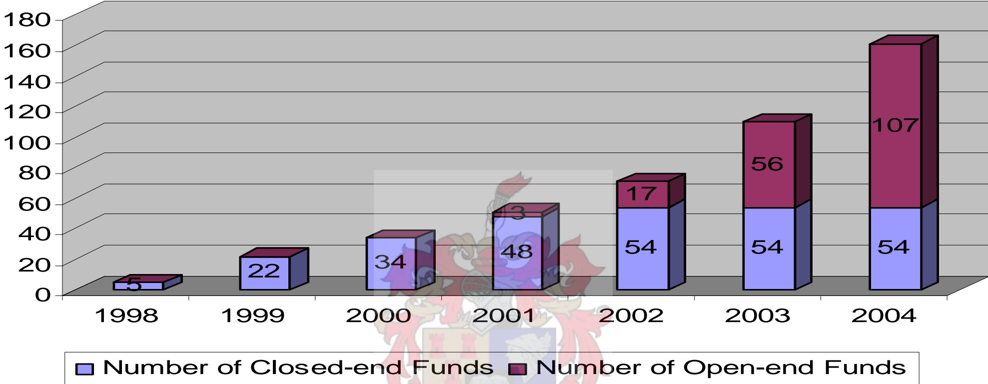
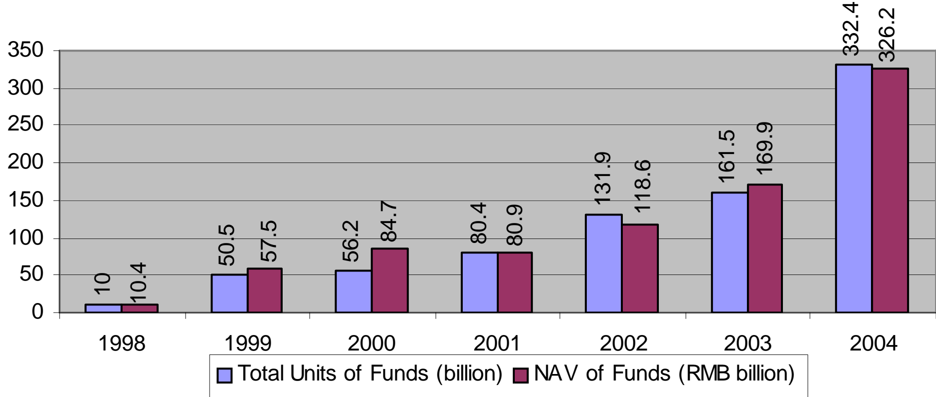
More importantly, China's fund-management industry played an increasingly important role in the capital markets, especially the stock markets. By the end of 2004, the ratio of total NAV to market capitalisation of tradable shares on exchanges increased to 28.04%, as showed in *figure* 2.6. The ever-increasing influence of the fund-management sector on the stock markets made market participants and decision makers have to take into account the attitudes of fund mangers, which simply implies a strategic change in China's stock markets (China Knowledge, 2005: 13).

Figure 2.4 Number of Funds (1998 to 2004)



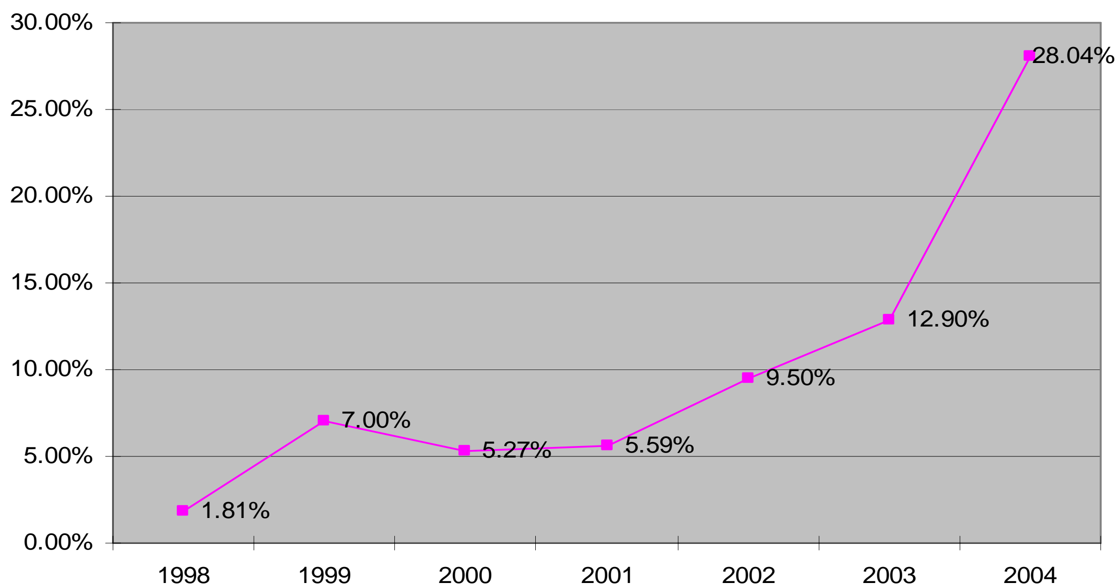
Source: Data before 2004 from CSRC April 2004 Report, China's Securities and Futures Markets; data in 2004 from company information

Figure 2.5 Number of Total Fund Units and Total NAV (1998 to 2004)



Source: Data before 2004 from CSRC April 2004 Report, China's Securities and Futures Markets; data in 2004 based on individual fund data published by www.csc108.com

Figure 2.6 Ratio of Total NAV to Market Capitalisation of Tradable Shares (1998 to 2004)



Source: Data before 2004 from CSRC April 2004 Report, China's Securities and Futures Markets; data in 2004 were calculated on the basis of company information and data released by the CSRC.

2.3 The Situation of Joint Fund-Management Companies

Considering that this study is focused on the investment of foreign investors in China's fund-management industry through joint-venture vehicles, this part of study will introduce the current situation of joint fund-management companies.

Since 2001 when China entered into the WTO, foreign financial institutions were allowed to establish joint ventures with domestic fund-management companies. This meant vast benefits for both domestic and foreign players. When compared to other mature markets in America or E.U., China's fund-management industry is still in its infancy, despite great growth. Various aspects are obviously underdeveloped, which include the legal base, firm structure, product innovation and so on. The joint-venture company can provide access for domestic fund managers to benefit from the advanced expertise and abundant capital from foreign investors (Justin Sommers, 2002, 11).

China's fund-management industry has vast potential, especially when considering the continued rapid economic growth and enormous consumer savings in the banks. For foreign investors, a joint venture offers great opportunities involved with existing distribution channels and client pool from the side of domestic players (Justin Sommers, 2002, 11). Actually, the keenness for foreign investors to enter China's fund-management industry has been considerably impressive. Several foreign fund managers started in the form of technical advisory agreements with local fund managers and shared their expertise and other resources, even when the formal partnerships had been approved by the CSRC (Dalla-Costa, 2004: 2).

The recognition by both sides of this great potential has led directly to the prevailing establishment of joint fund-management companies. In October 2002, the first license for a joint fund-management company was issued to Guotai Junan Allianz Fund Management Co. with a registered capital RMB 100 million, which was coestablished by Shanghai-based Guotai Junan Securities, a leading securities company in China, and German financial group Allianz AG (ChinaDaily, 2002: 1). According to the CSRC, the number of joint fund-management companies until July 2005 increased to 17, as indicated by *table* 2.2. The list apparently points out the active involvement of well-known international fund managers, and probably will become more impressive in the near future.

In order to build legal base for the joint fund-management firms, in 2002, the regulatory authority, CSRC, issued the Rules on the Establishment of Foreign-shared Fund Management Companies that came into force on July 1 2002. According to the Rules, the organisational structure of a joint fund-management firm is limited company and correspondingly subject to the relevant regulation. There are also some requirements that the foreign shareholders in the joint venture should meet, which mainly include:

- being financial institutions established according to the laws of their home countries and continuing to exit validly, and having not been given major punishment by the securities regulatory bodies or judicial organs in the last 3 years;

- their home countries shall have sound securities legal and regulatory system;
- the paid-in capital shall be freely convertible currency equal to no less than RMB 300 million yuan;

At the same time, like other investment funds, a joint fund-management firm is also under the supervision of the Investment Fund Law that became effective on June 1 2004. According the Investment Fund Law, investment funds in China are not separate legal persons, but created on the base of contractual relationships among a fund management company, a fund custodian and investors. In order to establish and manage investment funds, there are also some criteria for a fund-management company to meet, including:

- the company must have rehistered capital of RMB 100 million yuan or more;
- the principal shareholder(s) of the company must be in the business of securities management, securities investment consulting, trust asset management, or other financial asset management;
- each principal shareholder must have registered capital of no less than RMB 300 million yuan.

In order to maintain necessary liquidity, mutual funds are also required to hold a certain level of cash and treasury bonds on the purpose for potential redemptions. Basically, funds can make investment decision among listed stocks, bonds and other securities authorised by CSRC. In addition, the Investment Fund Law also points out certain types of investment or business activities are not allowed, which mainly include:

- underwriting securities, extending loans, or buying other funds unless approved by the State Council;
- making equity investments in the management company or custodian of the fund;
- buying securities issued by a controlling shareholders of the fund-management company or of the fund custodian, or by other companies that share a material interest with the fund-management company or the fund custodian;
- buying, within the underwriting lock-up period, securities underwritten by a controlling shareholder of the fund-management company or of the fund custodian,

or by other companies that share a material interest with the fund-management company or the fund custodian.

Since 2001 when the joint fund-management companies started, this type of fund-management firms has grown at a rapid pace over only a short period. At present, around 20% of the whole industry’s assets under management are managed by the joint fund-management companies (De Ramos, 2005: 2; Dalla-Costa, 2004: 4). According to China’s commitments to WTO, 49% share in a joint fund-management company is allowed three years after its entry. This is to say that foreign investors can possess 49% share in the joint-venture vehicles since the end of 2004, which means more involvements and opportunities in this promising market.

2.4 Summary

The investment company, as a financial intermediary, invests in a diversified portfolio on behalf of investors and provides various benefits associated with the “pooling of assets”. The managed investment company includes two types of funds, namely closed-end funds and mutual funds. The main difference between these two types of funds lies in the way that investors can cash out their investments. Differing from the closed-end fund, a mutual fund allows investors to redeem their shares to fund managers, which provide investors considerable flexibility and at the same time expose fund managers to great uncertainty. For this reason, mutual funds have expanded significantly in some matured economies, the first mutual fund being established in 1924 in the United States.

In terms of the underlying portfolio of investment funds, mutual funds can be divided into five main categories and different funds are designed to meet the various needs of investors. Some of the main benefits from mutual funds are also identified to justify the outstanding growth of this type of investment fund, which include diversification, professional management, low costs and flexibility.

Differing from other sectors in China, the financial markets are still under strict supervision and strange to foreign investors. As a part of China's financial markets, the fund-management industry was established officially in 1998, although some investment funds already started business in 1991. An inpression of this emerging sector is its impressive growth rate and increasing importance in China's financial markets despite its short history and various the problems involved. With China's entry into the WTO, the participation of foreign investors in the fund-management industry implies greater growth in the potential of this nascent sector. Attracted by the huge opportunities, a number of foreign investors have become involved in China's fund-management industry in the form of joint fund-management firms.

Table 2.2 List of Joint Fund-Management Companies

	Name of Companies	Major Shareholders/ Promoters
1	China Merchants Fund Co. Ltd	**ING Group.**
		China Power Finance Co. Ltd.
		China Hua Neng Finance Co. Ltd.
		COSCO Finance Co. Ltd.
		China Merchants Securities Co. Ltd.
2	Fortune SGAM Fund Management Co., Ltd	**SG Asset Management Co.**
		Fortune Trust & Investment Co., Ltd.
3	Guotai Junan Allianz Fund Management Co., Ltd	**Allianz AG.**
		Guotai Junan Securities Co., Ltd.
4	Fortis Haitong Investment Management Co., Ltd	**Fortis Investment Management**
		Haitong Securities Co., Ltd.
5	INVESCO Great Wall Fund Management Co., Ltd	**AMVESCAP**
		Dalian Shide Group Co., Ltd.
		Great Wall Securities Co., Ltd.
		Kailuan Group Co., Ltd.
6	Fullgoal Fund Management Co., Ltd.	**Bank of Montreal Financial Group**
		Haitong Securities Co., Ltd.
		Shenyin & Wanguo Securities Co., Ltd.
		Huata i Securities Co., Ltd.

		Shandong International Trust & Investment Company
		Fujian International Trust & Investment Company
7	ABN AMRO XIANGCAI Fund Management Co. Ltd	**ABN Amro Asset Management**
		Xiangcai Securities Co. Ltd.
		Shandong Xinyuan Holding Co., Ltd.
8	Everbright Pramerica Fund Management Co., Ltd.	**Pramerica Investment Management**
		Everbright Securities Co., Ltd.
9	SYWG BNP PARIBAS Asset Management Co., Ltd.	**BNP Paribas Asset Management**
		Shenyin & Wanguo Securities Co., Ltd.
10	China International Fund Management Co., Ltd	**J.P. Morgan Asset Management (UK) Limited**
		Shanghai International Trust and Investment Co., Ltd.
11	BOC International Investment Managers	**Merrill Lynch Investment Managers**
		BOC International Holdings Limited
		BOC International (China) Limited
12	Franklin Templeton Sealand Fund Management Co., Ltd	**Franklin Templeton Inventments**
		Sealand Securities Co. Ltd
13	AIG-Huatai Fund Management Co., Ltd.	**AIG Global Investment Corp**
		Huatai Securities Co., Ltd.
		Suzhou New District Hi-tech Industrial Co., Ltd.
		Guohua Energy Investment Corporation (China)
		Jiangsu Communications Holding Co
14	UBS SDIC Fund Management Co., Ltd	**UBS**
		State Development & Investment Corp.
15	Harvest Fund Management Co., Ltd.	**Deutsche Assets Management**
		China Credit Trust Co.,Ltd.
		Lixin Investment Co., Ltd.
16	ICBC Credit Suisse Asset Management Co., Ltd	**Credit Suisse First Boston**
		Industrial and Commercial Bank of China
		China Ocean Shipping (Group) Co
17	Bank of Communications Schroder Fund Management Co. Ltd	**Schroder Investment Management Limited**
		Bank of Communications
		China International Marine Containers (Group) Ltd.

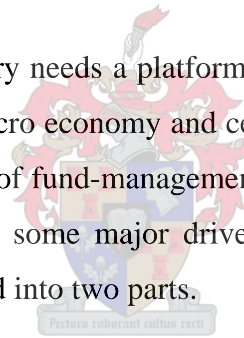
Source: CSRC, 2005

Note: Foreign role players are highlighted with bold and underline.

Chapter 3
Opportunities for Foreign Investment in China's Fund-Management Industry

This chapter focuses on the opportunities for foreign investment in China's fund-management industry. For a long time, China has been regarded as a wonderful destination for ubiquitous business opportunities and dazzling profits. China's fund-management industry is no exception. Although it has only existed for a short period and is still small in comparison with other matured markets, this nascent field has been enjoying rapid growth and has huge potential for foreign investors.

Since the fund-management industry needs a platform where the whole economy provides the sources, the situation of the macro economy and certain relevant micro factors, directly or indirectly, influence the growth of fund-management sector. For this reason, this part of the study is conducted to identify some major drivers for the growth of China's fund-management industry and is divided into two parts.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The first part of the study analyses the prospects of China's economy and aims to evaluate how the rapid pace of China's economic progress is likely to continue. This part focuses on the macro level of China's economy and will identify some aspects that play a critical role in making economic growth sustainable, such as FDI inflow and WTO membership. Then a comparison of China and some other developed countries with regards to fund management will be conducted to draw a picture of how far China's fund-management industry can develop, given the continued growth of the economy.

In the second part, certain key drivers at the micro level that directly boost this emerging sector, such as pension fund reform, increased income and high level of savings will be analysed.

3.1 Continued Economic Growth in China

Since 1978, when the Chinese government initiated the historic "reform and opening-up", China has seen numerous large-scale changes in both economic and social fields. It is especially the rapid economic growth that makes China absolutely outstanding worldwide. While some are amazed at the seemingly unachievable GDP growth, proliferation of skyscrapers and pervasive "made-in-China" commodities, a question is often raised: how sustainable is China's economic growth? In other words, how long can China's economy continue growing at the same speed as it has been doing for the past few decades? Fortunately, a positive attitude on this issue seems pervasive in the international business community. This part of the analysis is to verify this widespread upbeat outlook.

3.1.1 The General Prospects for China's Economy

As one of only a few present-day communist countries, China's development seems to be a process of exploration with regards to socialist theories that were established more than 100 years ago. However, most theories have become outdated and more importantly, no communist nation has ever had a similar situation to that of China. There is no experience or lesson upon which China can draw or learn from and apply to construct both economic and social policies for the future. All China can do is to "cross the river by feeling each stone", as stated by Deng Xiaoping, one of the second generation of leaders, who decided to open China up to the Western countries in the early 1990s. Obviously, China has been making significant achievements that astonish the rest of world and itself as well. To a certain extent, previous and subsequent accomplishments have proven the suitability and constructive consequence of major policies and the capability of the Chinese people to carry their country's development to an even higher level.

One of the key issues that could drive China's economic growth is the position of market power in the economy. During China's reform process of the past few years, the importance of the market role in economic development has been generally recognised and various

policies have been implemented to realise its critical role in the allocation of resources and the improvement of the whole economy in terms of structure and effectiveness. As indicated by the 14th National Congress of the CPC (Communist Party of China) held in 1992, the fundamental goal of China’s economic reform was to transform a planned economy to a socialist market economic system (Wu, 2000: 3). The socialist market economy is a kind of combined economic system where a nation can utilise market power in the economic movement while the central control of government remains intact to a certain extent.

Although the role of markets in China’s current economic life is not yet critical or pervasive, a primitive form of a market economy has been set up (Wu, 2000: 5). After the past few years of economic reform, the basic functions of the market have been apparently improved and enhanced, and the basic structure has been set in place and given shape. According to the government agenda, China is committed to continue this economic transformation and make the socialist market economy comparatively sound by 2010 and mature by 2020 *(Anonymous L, 2001: 2)*.

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The introduction of the market function in China’s economy has helped to liberalise various economic factors that were previously controlled directly by government in the older planned economic system, and has injected more energy into the process of ongoing economic reform. More and more resources are becoming dynamic, which improve the level of effectiveness and efficiency in China’s economy. One of the most important changes that has resulted from China’s economic reform to establish a socialist market economic system is the shift of economic growth patterns from the extensive to the intensive type (Anonymous M, 2001: 2). This shift in the form of economic growth provides powerful support for a sustainable economic development, because the intensive pattern of economic growth involves more technology in the economic growth and improves the rates of return on investments. According to a productivity analysis on China, the economic growth in the 1980s was mainly driven by efficiency improvement and growth in inputs, while technological improvement, one of the important features in the

intensive pattern of economic growth, had become a vital factor needed for an economic boom in the 1990s (Wu, 1999: 14).

More and more involvement of market functions is also changing the structures of China's economy, especially after China's inclusion in WTO, which improved the economic growth mechanism and enabled China's stable and sustainable economic expansion. The first change in economic structure is the proportion of shares of the agriculture, industrial and tertiary industry in China's economy. According to the Economist (2004), China's economy, in general, was characterised by considerable increases in shares of the industrial and tertiary sectors. The industrial sector has replaced the agriculture sector to become the most important sector, accounting for 51.1% of GDP in 2002. The contribution to total output of the tertiary sector increased from about 21% in 1979 to over 30% at present. The tertiary sector has replaced the manufacturing industry as the criterium for evaluating a country's modernization (Anonymous M, 2000: 2). Lagging development of the tertiary sector can tear down demand, specifically consumption, affecting the growth prospects of other sectors and the development stability of the economy as a whole (Guo, 2001: 5). Although China's tertiary sector is still small, when compared with 50% of the GDP in some developed countries and 75% of GDP in America, this sector has grown at a steady pace and more importantly, its importance has been appreciated by the government as one of the key drivers of China's continued economic growth (Anonymous N, 2000: 2).

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Another change in China's economic structure is the increasing importance and shares of the non-state-owned sector, especially private enterprises. The reform in SOEs ("state-owned enterprises") is probably the most difficult part in the whole economic reform of China, since various interests in the old economic system are deeply rooted. Those SOEs are involved with some serious problems that resulted from the old planned economy system, such as pervasive ineffectiveness, low profit margin and so on. For example, the SOE sector contributed approximately one third to the GDP in 1999, while consuming two thirds of the country's capital resources (Wu, 2000: 2). Although many problems still exit, and although there is a long way to go to complete the SOEs reform, the proportion and

importance of SOEs in China's economy have declined to a large extent and SOEs have become more cost-effective and have enjoyed steady profit growth[18]. The reforms also have been enjoying unambiguous recognition and continuous supports from the central government and more specifically, the 16th National Congress of the CPC in 2002 promulgated a series of policies to continuously encourage the non-state-owned sector and the private sector in particular (Anonymous N, 2003: 1). According to the Statistical Yearbook of China (2000), the SOEs' composition of national industrial output and national retail sales decreased to 28.5% and 24.3% in 1999, from 77.6% and 54.6% in 1978, respectively. The emergence of non-sate-owned enterprises, especially private businesses, the most dynamic sector in China's economy, is consistent with the philosophy of a market economy and would contribute towards sustainable economic growth (Rawski, 1999: 10).

In general, both China's political and economic developments are principally dependent on how to deal with its upward internal imbalances in both social and economic areas, as confirmed by Dr Jürgen Stark (2005), vice president of the Deutsche Bundesbank. One of the noteworthy imbalances is the tension between urban and rural areas. As noted above, the agriculture sector has been replaced by the industrial sector as the engine of economic growth and the consequent industrialisation has led to various largely underdeveloped rural areas and jobless peasants. At the same time, this also represents a rural market with considerable potential and business opportunities. One straightforward comparison between rural markets in 2002 and urban markets in 1999 has been conducted to illustrate the vast potential involved in rural markets. Net income per capita in rural areas in 2002 was RMB 2 476, with an increase of 22.3% relative to that of urban areas in 1999. However, the penetration rates of some electric appliances in rural areas in 2002 were considerably lower than the rates in urban areas in 1999, as indicated in *table* 3.1 (Lin, 2004: 17-19).

[18] According to the State-owned Assets Supervision and Administration Commission (SASAC), more than 170 central SOEs that are directly supervised by the central government realized profits of 140.4 billion RMB, with a 31.2% profit growth and a 22.7% revenue growth year-on-year, in the first three months of 2005 (Beijing Portal, 2005: 1).

Table 3.1 Penetration Rates[19] of Durable Consumption Goods and Net Income Per Capita

	2002 Urban	2002 Rural	1991 Urban
Color TV	126	61	68.4
Refrigerator	87	15	48.7
Washing Machine	93	32	80.6
Net Income Per Capita	7 703	2 476	2 025

Source: SBS 2003: 352 and 375

In order to explore the rural markets and massive business opportunities involved, the key factor is to make the appropriate and relevant infrastructure available, which has been in the government's agenda since the beginning of the reforms. This is also confirmed by the changes in China's fiscal policy in 2004 and 2005. With policy transition to a prudent policy from a proactive policy that started in 1998, rural development, more specifically the "Sannong Problem"[20], has been given priority for development and great progress has been made with the reforms, especially since 2004 (Gao, 2005: 7). All these can favour the improvement of rural markets and consequently the whole national economy.

Normally, a country's economy is driven by investment, export and consumption. However, in the case of China, the rapid race of economic growth in the past two decades has, to a large extent, been driven by export and investment and the domestic consumption has not played as big a role as supposed in terms of its economic size. Obviously, one of the fundamental advantages that China has is a huge consumer market which is also a major reason that numerous foreign investors flood into China. To explore the domestic consumer market has been recognised by policy-makers as the next driver for China's economic progress. According to the Chinese Business Forecast Report (2005), retail sales increased by 14.5% on a year-to-year basis in December 2004, which is the fastest pace since May 2004; expansion in domestic demand is expected to incorporate other economic drivers and

[19] Per 100 households.

[20] Sannong is the Chinese for three kinds of agriculture-related issues and includes the problems concerning rural development, farmers' income and agriculture (Gao, 2005: 8).

enable the economy to maintain the stable growth rate, especially in an environment of low inflation in China.

To summarise, the importance of the market function has been increasingly acknowledged by policy-makers and consequently the whole economy is becoming more and more market-oriented. This trend will certainly change the pattern of China's economic growth and should keep China's economy humming for the next few years. Before an analysis of certain micro drivers for economic growth, some comments on China's economic sustainability are given to confirm the logic of economic growth in the future (The China business Review, 2005 May-June: 10; Anonymous O, 2005: 1 and Xinhua, 2002: 1):

- *"China is likely to grow in GDP at 8 percent annually or more for at least a generation, that is to 2040, and perhaps beyond that date." (Robert Fogel, Nobel Prize laureate, at the 2005 Annual Conference of the Chinese Economists Society.)*
- *"I think, like most other economists, that 7 to 8 percent is the sustainable range for GDP growth over the next 10 years." (Stephen Green, senior economist, Global Research at Standard Chartered Bank.)*
- *"The growth rate may go down a little bit but be more sustainable at 7 to 8 percent for the next 20 years." (Vanessa Rossi, director of international economics and model analysis at Oxford Economic Forecasting.)*
- *"The 10-year outlook is very good, probably with growth the same as over the past two decades." (Nicholas Lardy, senior fellow at the Institute for International Economics.)*
- *China's economy is expected to grow at an average 6% annually for the coming two decades and become the second largest in the world next to the United States by 2030. (the International Investment Bank)*

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3.1.2 Continued FDI Inflow

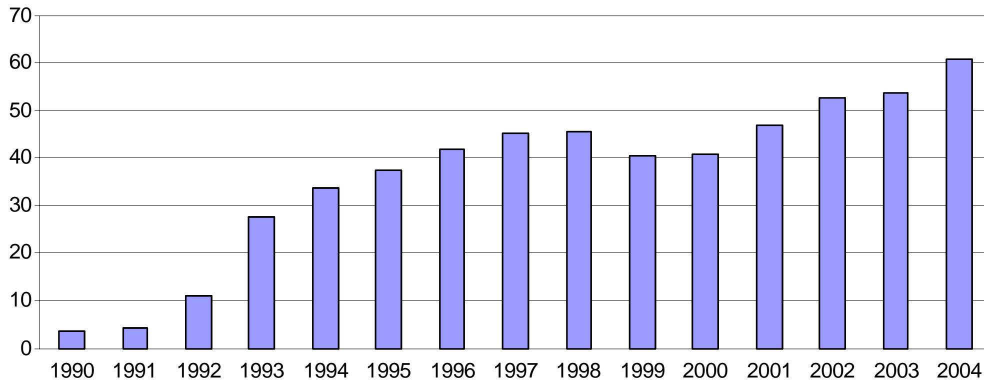
Since China's initiation of the "reform and opening-up" policy, attracting foreign investment has been regarded as a critical part of the whole economic development. Initiated by millions of overseas ethnic Chinese, the foreign investment in China boomed in the early 1980s (Economist, Mar 2005: 1). Broadly speaking, the two main considerations for most foreign investors to make direct investments in China are to make use of cheap labour and take a strategic position in and gain access to the biggest consumer market in the world. These natural advantages provided by China attract massive foreign direct investment (FDI) from around the world.

The Chinese government has also recognised the importance of this external source to accelerate economic growth. Accordingly, various favourable policies to encourage FDI have been conducted by government at different levels. For example, the number of localities open for FDI increased from 117 in 1989 to 1 784 in 1992 within a few months after Deng Xiaoping's historic tour to Southern China (Wong, 1998: 4).

Both these natural advantages and support from the central government has resulting in considerable FDI flowing into China. According to the Ministry of Commerce (MOFCOM), the amount utilised of total FDI in China was only 18.47 billion US dollars for a whole 10-year period between 1979 and 1989, but exceeded 50 billion and 60 billion in 2002 and 2004, respectively. The average growth rate for the amount of utilised FDI between 1990 and 2004 is 29.72%, as illustrated in *figure* 3.1. This also makes the amount of FDI utilised in China achieve about 560 billion U.S dollars in total from 1979 to 2004 (Economist, Mar 2005: 1). Although China's official data is frequently under serious suspicion and "round-tripping[21]" exists, China's FDI, however quantified, has been remarkable, especially as confirmed by various independent institutions, such as A.T. Kearney.

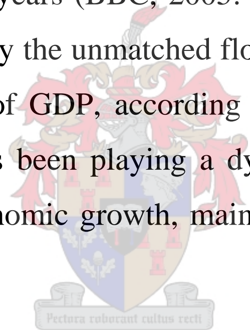
[21] In the case of China, "round-tripping involves the circular flow of capital out of China (in most cases to foreign affiliates of Chinese transnational corporations) and the subsequent "re-investment" of this "foreign" capital in China for the purpose of benefiting from fiscal entitlements accorded to foreign investors. By round-tripping, Chinese investors avoid the regulatory regime governing domestic investment by channeling

Figure 3.1 Amount of FDI Utilised in China (1990 to 2004), billions of US $



Source: Ministry of Commerce and the US-China Business Council
(www.uschina.org/statistics/fdi_cumulative.html)

According to the State Bureau of Statistics, China's average annual GDP growth rate has been about 9.4% over the past 27 years (BBC, 2005: 1). This booming economic growth has, to a great extent, been driven by the unmatched flow of FDI into China. Take 2004 for example. FDI was equal to 36% of GDP, according to China Business Forecast Report (2005). More specifically, FDI has been playing a dynamic role in accelerating China's market-oriented transition and economic growth, mainly income growth (Zhang, 2000: 1; Lardy, 1995; Pomfret, 1997).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According to the standard propositions of the neoclassical theories, four aspects can be used to illustrate the reason for FDI as an engine of host economic growth (Markusen and Venables, 1999 and UNCTAD, 1992):

1. *improved capital formation and employment augmentation,*
2. *promoting manufacturing exports,*
3. *introducing host economy's special resources such as management know-how, the access of skilled labour to international production networks and established brand names*
4. *accelerating technology transfer and spill-over effects.*

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capital through foreign affiliates and thereby bringing this capital under the more favorable regime governing foreign investment." (Chunlai, 1996: 37)

In the case of China, the constructive effects from FDI are mainly represented as the significant contribution to the manufacturing of exports. Foreigner-invested enterprises (FIEs) have been playing a great role not only in expanding China's export volumes, but also improving the export structure (Zhang, 2000: 3). For example, according to SBS (State Bureau of Statistics, 1999), exports by FIEs in China were growing 66.7% annually over the 1980-1998 period. This growth improved China's exports in terms of volume and structure. China's exports were ranked as 9th worldwide in 1998, with a volume of 184 billion U.S dollars and 89% as manufactured goods, fundamentally different from 26th ranking with 184 billion and 47% as manufactured goods in 1980.

At the same time, FDI also has accelerated China's economic growth in terms of improving capital formation, amplifying industrial output, creating employment and increasing tax revenue (Zhang, 2000: 4). From 1991 to 1998, FDI has played a significant role in improving and driving China's economy, as indicated by *table* 3.2. In addition, FDI also brought in advanced production techniques and processes, management know-how, access to information and suppliers and extensive import and export networks (Gao, 2004: 4).

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Table 3.2 Importance of FDI and Foreigner-invested Enterprises (FIEs) in China

	1991	**1995**	**1998**
FDI flows as a ratio of gross domestic investment (%)	3.9	15.1	15.2
Exports by FIEs (billions of U.S dollars)	12.4	46.9	88.6
Share of exports by FIEs in total exports (%)	17.0	31.3	44.1
Share of industrial output by FIEs in total industrial output (%)	5.0	11.7	14.9
Number of employees in FIEs (millions persons)	4.8	16.0	18.0
Tax contributions from FIEs as share of total tax revenue (%)	4.1	10.0	13.2

Notes: The number of the tax contributions by FIEs in 1991 and 1998 are actually for 1992 and 1997, respectively, due to unavailable data for the two years.

Sources: Computed from *China Statistics Yearbook* by SBS (1997, 1998 and 1999), and *World Investment Report* (1998 and 1999) by UNCTAD.

Apart from the effects of expanding economic growth, FDI also has accelerated a fundamental shift in China's economy, from a planned economy to a market-oriented economic system. According to Zhang (1993), the spill-over effects can be demonstrated by

four aspects. First of all, as noted above, one of the fundamental components in China's reform is to change the ownership structure from a single state-ownership dominated system to a more diversified system with state-owned, collective and private ownerships. The increasing FIEs have been accelerating the transformation by contributing to the output and share of the private sector in the whole economy, as indicated in *table* 3.1 and 3.2.

Secondly, FDI has been playing a significant role in introducing a market-oriented institutional system. In order to attract FDI, China has promoted various favourable policies, including setting up special economic zones, relaxing certain restrictions and improving the legal framework, all of which should be consistent with the philosophy of a market-oriented system and which should eventually improve the level of the market function in China's economy.

Thirdly, FDI has also enhanced and facilitated the reform of SOEs in China. Such effects are achieved either directly through joint ventures with SOEs or indirectly through the demonstration effects from the FIEs' operations (Zhnag, 2000: 5). In addition, FDI has contributed to China's economic transition by introducing more competition and deepening China's integration into the global economy.

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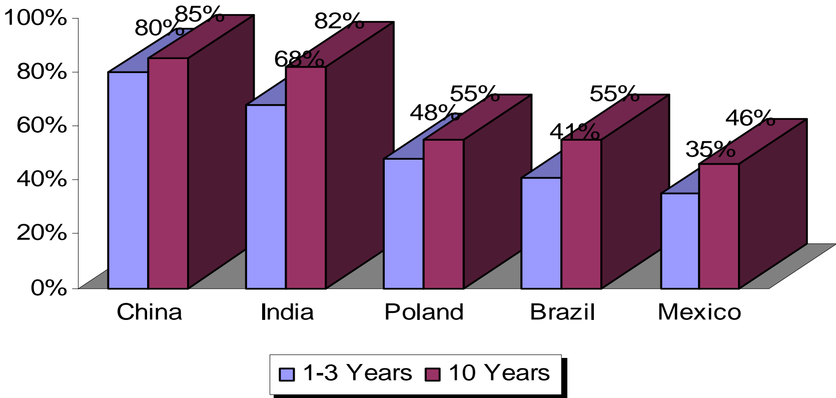
When it comes to the future of FDI in China, a market-oriented economic system makes it possible to maintain the sustainability of FDI inflow. As China continues with its economic reform and improves its legal and regulatory frameworks, and more importantly its continued economic growth, it is likely that FDI will flow in at a reasonably escalating pace (Gao, 2004: 4). This is confirmed by the *2004 FDI Confidence Index* conducted by A.T Kearney. According to its survey, China is the number one destination for the third consecutive year, after it overtook the United States for the first time in 2003. More importantly, nearly half of global investors are planning to make a first-time investment in China and about 40% of global investors possess a positive attitude towards China's economy, four times the number of executives with a negative view of China, as indicated in *figure* 3.2 below. The figure shows the attractiveness regarding the FDI demonstrated by

percentage of total respondents in the same survey conducted by A.T Kearney. This will certainly continue providing impetus to China's economic growth.

Figure 3.2 Relative Short- and Medium-term Attractiveness



Source: A.T Kearney, 2004

3.1.3 WTO Membership

In order to expand levels of openness and enhance its economic growth, China embarked on negotiations to resume contracting party status in the General Agreement on Tariffs and Trade (GATT) in 1986, from which it left in 1950 (Adhikari and Yang, 2002: 1). After 15 years of laborious negotiations, China finally joined the World Trade Organisation (WTO) as the 143rd member in December 2001. China's entry into the WTO not only indicates a continual moving forward of the economic globalisation process, but also marks its entry into the world, as if its opening to the world was signalled by the "reform and opening-up" policy (Chow, 2001: 1; Cheng, 1999: 1).

Although China faces relatively serious competition and various challenges because of its WTO membership which may cause certain problems, such as increased unemployment and a negative impact on the agriculture sector, which may influence and even damage China's sustainable economic progress, WTO access will improve economic efficiency, benefit China's domestic consumers and, more importantly, enhance the sustainability of its

economic growth in the long term. According to empirical studies as indicated by *table* 3.3 below, the annual gains from the liberalisation of merchandise trade are in the order of 4 - 30 billion U.S dollars for China and 20 - 56 billion for the world. China's GDP increase can benefit from 1.5% to more than 10% *(Adhikari and Yang, 2002: 4-5).*

Table 3.3 Economic Effects[22] of China's WTO Accession

Study	Effect on China	Global effect
Walmsley and Hertel (2000)	Welfare: $23.7-25.6 billion GDP increase: 8.7 - 10.8%	Welfare: $35.7-38.2 billion
Wang (1997)[23]	Welfare: $12.4-30.3 billion	Welfare: $25.3-56.7 billion
Zhai and Li (2000)	Welfare: 1.2% of GDP GDP increase: 1.5%	
Walmsley and others (2001)[24]	Welfare: $3.9-10 billion	Welfare: $20.5-25.7 billion
Lanchochivina and Martin (2001)[25]	Welfare: $28.6 billion GDP increase: 2.2%	Welfare: $56.1 billion GDP increase: 0.2%

Source: Compiled by Yang (2002)

More specifically, China, as a member of the WTO, can achieve economic gains mainly through three aspects, namely stability in external economic relationships, firmer and speedier economic reform and long-term growth based on efficiency and innovation, according to Cheng (1999). First of all, WTO membership provides China an economic platform with less uncertainty of policy changes and reasonable mechanisms for trade disputes. The stable relationships with other countries (mainly WTO members) makes China more attractive for FDI and therefore it would lead to massive capital inflows.

WTO accession also entails external pressures and obligations for China, which will probably enhance and accelerate its economic reform. Experience from other countries has proven that pressure and obligation from outside the country can help counteract the resistance of powerful domestic interest groups. When it comes to China, various interest

[22] Results pertain to the medium- or long-run effects of liberalisation in merchandise trade.
[23] This study includes the effect of accession of China's Province of Taiwan to the WTO.
[24] This study also includes the effect of accession of China's Province of Taiwan to the WTO and the lower bound number takes into account duty exemptions and drawbacks.
[25] This is measured in equivalent variation that is an indication of the consumption value of the WTO accession.

groups from the old economy system, especially state-owned enterprises (SOEs), have been decelerating the process towards a market economy. However, China's commitments to the WTO will function as a series of guidelines for China's economic reform for the coming decade (Cheng, 1999: 2).

More competition between domestic and foreign firms, directly as a result of WTO accession, will cause extensive restructuring in industry and certain other sectors (Cheng, 1999: 2). At the same time, China agrees to reduce tariffs for imports in various sectors[26], which leads to or accelerate massive important changes in economic structures, mainly including the decline of the agricultural sector and the increase of industrial and tertiary sectors in terms of proportions in the whole economy on the one hand and the decline of the state sector and correspondingly the increase of the private sector on another hand (Chow, 2002: 2-3).

Another benefit to China from the WTO accession is that economic reform is recognised from a legal perspective. As WTO rules are supposed to be translated into laws and regulation, WTO membership can enhance its regulatory reform and improvement of legal institutions (Cheng, 1999: 3). China is obliged to make improvements in accordance with international standards in this area and remove improper practices with regards to intellectual property and other issues. This legal reform certainly attracts more FDI in China.

Finally, WTO accession exposes China to an environment where the economy is more market-oriented and more competition is involved. Both competition and market forces will automatically remove inefficient firms and reward efficient and innovative ones. The improved legal environment, especially for intellectual property, enhances respect for technology and consequently increases the proportion and importance of technology in China's economic growth *(Cheng, 1999: 3-4).*

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[26] According to agreement between China and the WTO, tariffs should be lowered from 31.5% to 14.5% on agriculture products overall by January 2004, from 35% to 17 % on industrial products within 5 years.

In conclusion, WTO accession will enhance China's achievements in terms of FDI and export, as confirmed by the numbers. In the second year after its WTO entry, China exported 307.7 billion U.S dollars and imported 298.56 billion of goods in the first nine months, up by 32.3% and 40.5%, respectively, on a year-on-year basis, and the contractual and actually utilised foreign investment also increased to 36% and 11.9%, respectively, on a year-on-year basis for the same period (Anonymous P, 2003: 1). More importantly, the WTO provides various constructive factors, as described above, for China to enjoy immense gains from the economic transition to a market economy and carry on the sustainable economic growth, despite certain economic and social challenges in the short term.

3.1.4 Comparison of Mature Fund-Management Industries with China's Fund-Management Industry

With the picture of China's promising economic future in mind, it is rational to ask what the future or potential of its fund-management industry is. Generally speaking, China's fund-management sector is still quite small, relative to other mature markets. As illustrated by *figure* 3.2 below, the size of total assets of mutual funds in the Chinese mainland was about 226 times smaller than that of the US, 31 times smaller than that of France, 11 times of the UK, 10 times of Canada, 9 times of Japan and 7 times of Hong Kong.

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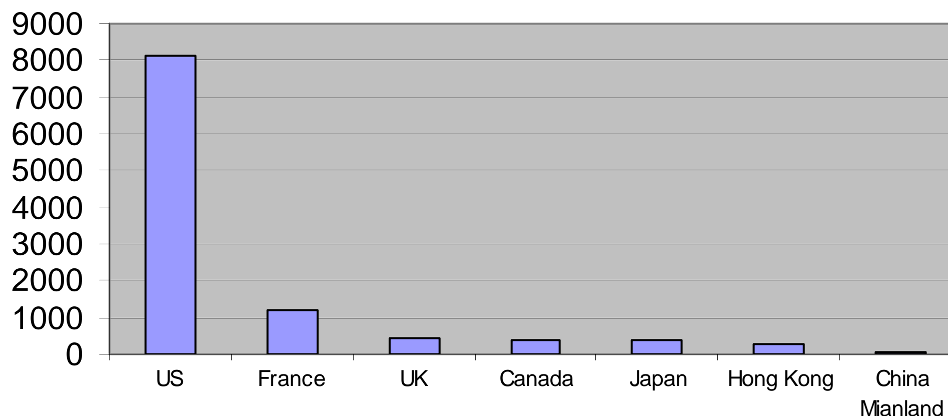
Figure 3.3 Country Disparities in Total Assets of Mutual Funds in 2004, billions of US$

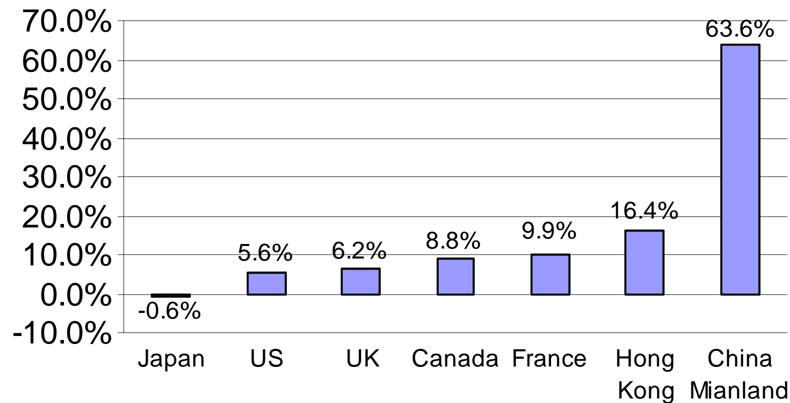


Note: 1. Data for the Chinese mainland and US as at the end of 2004; data for the remaining countries as at the end of Q3 2004.
2. Definition of mutual funds may vary from one country to another. The data for the Chinese mainland include both close-ended and open-ended funds.
Source: compiled by China Knowledge based on ICI, ITA, and Chinese fund-management companies.

However, it also implies a huge potential for China's fund-management industry and foreign investors involved in this sector. China will overtake Japan as the world's second-largest economy by 2016, and will overtake the US by 2041, according to recent research from Goldman Sachs, an investment bank, which forecasts long-tern growth rates for a few countries, including China, until 2050 (China Business Forecast Report, 2005: 2).

As indicated in chapter 2, China's fund-management industry formally started in 1998. Within an eight - year period, China's fund-management industry, one of the most vibrant sectors, has become one of the fastest growing markets worldwide. The annual growth rates of total NAV for every year from 2000 to 2004 (except 2001) in China's fund-management industry were all above 40%. The total NAV in China's fund-management industry has therefore increased 31 times, with an outstanding CAGR of 63.6% from 1998 to 2004, as indicated in *figure* 3.3 *(China Knowledge, 2004: 13-14)*.

Figure 3.4 Country Disparities in CAGR of Total NAV (1998 to 2004)



Note: Data for the UK, Japan and Hong Kong in 2004 were estimated figures based on the performance of the first three quarters

Source: Compiled by China Knowledge based on data released by ICI, ITA and Chinese fund-management companies.

3.2 Micro Drivers for China's Fund-Management Industry

Apart from stimulus from certain factors at macro level and the promising future of economic growth as a whole, there are some main factors at micro level that can help develop China's fund-management industry. In general, the health of the financial sector plays a critical role in the development of the fund-management industry which in return can enhance the mechanisms of the financial market in the whole economy. In the case of China, the development of stock markets to a large extent directly determines the growth of the fund-management industry at this stage, because the stock market is the main investment platform for fund-management companies.

Although there are various problems involved with China's stock markets[27], this financial sector has experienced steady growth rates in terms of market capitalisation and importance in the field of corporate financing, especially when considering its short history and compared to the initiation. One thing that is worth mentioning here to validate a positive

[27] More information about this issue is available in Chapter 4.

outlook on China's stock markets is the policy to attract foreign investors to invest in China's stock markets, which is often called QFII, Qualified Foreign Institutional Investors.

QFII was introduced in late 2002 to open domestic stock markets to international investors and cultivate healthier investment philosophies with domestic investors who are often too speculative at present (Gray, 2005 March: 1). The qualified institutional investors[28] need to get a quota for investment from the CSRC and are allowed to invest in RMB denominated shares listed on China's stock markets, treasuries listed in China's stock exchanges, convertible bonds and enterprise bonds and other financial instruments approved by the CSRC (CSRC and PBOC, 2002: 3).

In order to monitor the money in the QFII channels and control hot money flows for speculation on an appreciation of Chinese currency, the authority require that funds are locked up for one year and only 20% can be repatriated every quarter afterwards (CSRC and PBOC, 2002: 5). Despite these strict rules, licenses have been granted to 26 international investors for 3.5 billion US dollars until March 2005, and UBS, a Swiss financial firm, possessed 800 million US dollars, as the biggest investor. These huge money flows certainly are favourable for Chinese capital markets. More importantly, QFII has a profound impact on the reform of corporate governance of listed companies in the long term. According to Ferguson and McGuinness (2004), QFII can accelerate the diversification of ownership in SOEs, and improve corporate governance which includes the increased level of disclosure and governance standards.

Another favourable factor for China's fund-management industry is the positive effects from the WTO accession on the whole financial industry, especially the bank industry. The biggest problem for China's bank industry is probably a notorious amount of non-

[28] The qualifications for international investors are the followings: 5-year experience and a minimum amount of AUM of 10 billion US dollars for fund-management companies; 30-year experience, a minimum amount of paid-in capital of 1 billion US dollars and a minimum amount of managing securities assets of 10 billion US dollars for insurance companies and security companies; ranging among the top 100 worldwide in terms of the total assets and a minimum amount of managing securities assets of 10 billion US dollars for commercial banks (CSRC and PBOC, 2002: 2).

performing loans (NPLs) that resulted from the misallocation of bank loans by the government to the state-owned sector over years. Despite the difficulty to reach the exact figure, the book value of those NPLs is generally believed to be more than 500 billion US dollars (Justin Sommers, 2002: 8). However, four asset management corporations (AMCs) were established by the Ministry of Finance to replace banks' obligations for these NPLs and resell these loans. This certainly relieves the banks of perilous NPLs and improves the bank sector to a large extent. According to the official figures, the proportion of NPLs on banks' book values declined to 13.2% at the end of 2004, relative to 18% at the end of 2003 (Economist, Aug 2005: 1).

More importantly, with the entry into the WTO, China is obligated to open its financial sector to foreign investors, as indicated above. In the case of the banking sector, foreign investors are allowed to possess up to 25% of a Chinese bank[29]. Some international banks have become involved in China's banks, including HSBC's stake of 19.9% in the Bank of Communications, the fifth-biggest bank in China, in 2004, the Bank of America's 9% in the China Construction Bank in June 2005 and the Royal Bank of Scotland's 10% in Bank of China in August 2005 (Economist, Aug 2005: 1). The entry of foreign banks can bring with it capital and expertise and help solve the bad-loan problem, which will finally improve the health of the financial sector in China.

In the following part of this chapter, another two factors that could accelerate the growth of China's fund-management industry will be analysed, which include pension fund reform and, increased income and high savings.

[29] However, the maximum percent for a single investor is 20%.

3.2.1 Pension Fund Reform

Due to the significant improvements in life expectancy[30] and "one-child policy" that was introduced in 1979, China is facing an ageing population (Leckie, 2002: 147). In order to solve this critical problem and more importantly ensure social stability that is probably the most important thing for a huge country like China, the central government has been aware of the necessity for massive changes in the pension system, especially when considering the potential insufficiencies of the old pension system from the planned economy.

In the old pension system, an urban- and enterprise-based PAYG (pay-as-you-go) pension system was retained until the late 1980s, which covered mainly SOEs and some large collective enterprises. Although this SOE-backed pension system sufficiently served the planned economy for four decades, it was still subject to various problems. The pension system was particularly fragmented and the benefits from the system were too generous[31]. Another serious problem is the conflict between SOEs' social functions and their role as market players. All these problems were becoming serious and obvious with the process of China's economic and social reform, which made those enterprises and the pension system into a financially distressful situation *(Ma and Zhai, 2001: 1)*.

Since the late 1980s when China initiated reform of the pension system that was based on the SOEs, a number of changes and experiments were carried out at different places within various regional levels to improve the pension system. In 1997, various pension plans across China were unified by the State Council, which points out that China is undertaking a pension reform characterised by a partially funded basic pension scheme. This scheme consists of a defined, PAYG system for older employees and retirees and a multi-pillar system for younger employees. The multi-pillar system is designed to include three pillars, namely a mandatory defined-benefit paid out of the social pooling account (Pillar 1), a

[30] The average life expectancy (male and female combined) was 71 years in 2002, in comparison with 50 years in 1949 (Leckie, 2002: 147)
[31] The age to receive pension was 60 for male and 55 for female (50 for factory workers), with pension benefits equal to about 80% of final salary (Leckie, 2002: 148).

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monthly annuity paid out of the defined-contribution individual account (Pillar 2), and a supplemental voluntary individual account (Pillar 3), consistent with what was recommended by the World Bank (1997) *(Wang, 2004: 1-2 and Ma and Zhai, 2001, 7).*

Normally, a close relationship between pension system and capital markets exists, especially in developed countries. The reform of pension systems from PAYG to funded systems has played a critical role in the development of capital markets, which has been backed up in some Latin American and East European countries in recent years (Sanches, 1998; Wang, 2004: 5 and Aiyer, 1997). According to Wang (2004), the promotional effects that a funded pension system has on the capital markets mainly include the increased national savings and investment, enhancement of financial competition, acceleration of financial innovation, reinforcement of financial regulation to achieve better protection of investors, stabilisation of securities markets and modernisation of trading systems, and an improvement in corporate governance.

At the same time, the realisation of these favourable effects needs certain preconditions provided by the pension system and government. For example, without market stability, an effective financial legal basis, and sound commercial banking and commercial insurance systems, it is quite difficult, if not impossible, to implement a funded pension system (Vittas, 1998). Apparently, in China, those critical preconditions are immature at the moment and the extent to which the pension fund reform and finally the establishment of a funded pension system can accelerate capital markets still depends on various relevant reforms, particularly the reform of SOEs. However, it is rational to believe that the pension system reform or the establishment of a funded pension system in the end can become a driving force for China's capital markets in the long term, when considering the critical importance of a sufficient and sound pension system in China.

Apart from a profound impact on the capital markets in general, the pension fund reform also has some positive effects on the fund-management industry in particular. The most noteworthy event is that the National Council for Social Security Fund (NCSSF) was

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established as trustee to manage the National Social Security Fund in September 2000. The National Social Security Fund is mainly collected from the sales of government stakes in SOEs and budgetary allocations from the Ministry of Finance, which is designed to strengthen the PAYG program as a last resort for Pillar 1 and 2 (Justin Sommers, 2002: 13 and Leckie, 2002: 149).

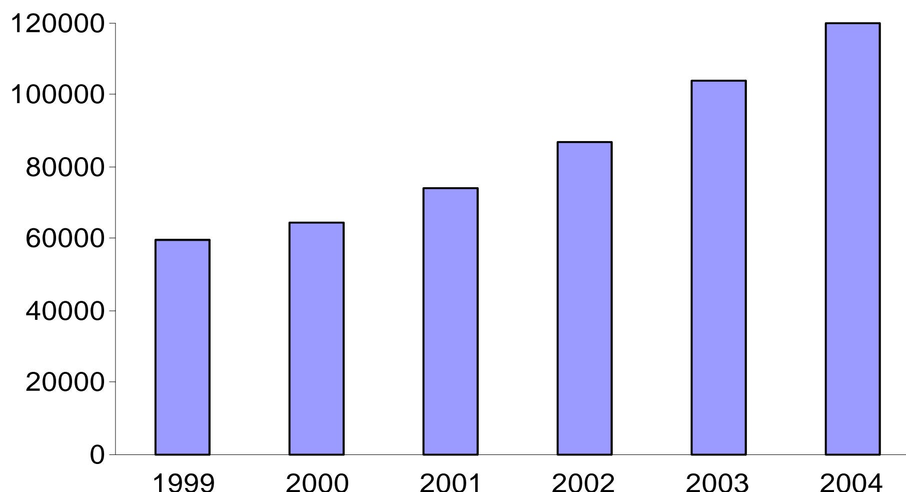
In order to strengthen the rates of returns of pension funds, various investment options and effective investment management have been introduced. The fund has increased the shares of investment in stocks and mutual funds, with the regulatory permission of 40% of funds in equity markets, despite the main proportion of the funds invested in government bonds and cash. At the end of 2002, six mutual funds were granted licences to manage the NCSSF investment in domestic securities markets. The pension assets is estimated to increase at a rate of at least 30% annually for the coming several years and is forecast by the World Bank to be accumulated to reach 1.8 trillion US dollars by 2030 (Leckie, 2002: 149). Therefore, the pension reform will introduce enormous assets to China's capital markets in general and the fund-management industry in particular.

3.2.2 High Savings and Increased Income

With the process of a series of reforms and consequent economic booming, Chinese people have made remarkable achievements in term of income and saving levels. "According to the World Bank, it took Britain about 58 years to double its per capita income from 1780 - 1838, 34 years for Japan (1185 - 1919) and 11 years for South Korea (1966 - 77), but only 9 years for China (1978 - 87) and another 9 years to double again (1987 - 96)" (Wong, 1998: 1). The increasing income amount directly leads to an eye-catching high savings rate. Despite a negative interest rate on savings[32] and various policies to encourage consumption, deposit savings exceeded 6 trillion RMB in 2000 and surpassed 12 trillion by the end of 2004, as indicated in *figure* 3.4 below.

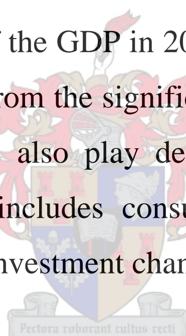
[32] The current interest rate on one-year deposit is 2.25% in China, while the inflation rate was 3.9% in 2004.

Figure 3.5 Increase in Deposit Savings, 100 million RMB



Source: compiled from “Monetary Survey” (1999-2004) of People Bank of China

High savings rates, more than 40% of the GDP in 2004, have become one of the prominent features in China’s economy. Apart from the significant impact on economic growth, other various social and economic factors also play decisive roles which result in the huge volume of savings, which mainly includes consumption patterns, the unsound social security system, and a lack of sound investment channels (Beijing View, 2005: 2).



As mentioned before, consumption, as one of three basic economic driving forces in general, plays a critical role in China’s sustainable economic growth. Given the country’s size, huge savings can explore huge potential in domestic market, particularly rural areas and eventually enhance the economic growth. The central government has been aware of the critical importance and huge potential of domestic consumption in China’s long-term economic growth and has implemented a series of policies to encourage consumers to get money out of the banks and spend and invest it. The latest policy is the coming regulation change concerning an increase in the threshold for personal income tax from the present 800 RMB (US$99) to 1 200 RMB (US$148) or personal income tax rate, which will simply increase personal wealth (Su, 2005: 1).

Apart from the considerable effects on economic growth, increased income and high savings can directly accelerate China's fund-management industry. In most developed countries, to invest in mutual funds is an important and common means to get involved in stock markets. According to the *2005 Investment Company Fact Book* from ICI, about 50% of all U.S households owned mutual funds in 2004 and the average number of mutual funds that every household owns is 4. Therefore, a huge consumer market is available for China's fund-management industry, especially when considering the sustainable economic growth and consequent continuous increase in personal income.

3.3 Summary

Similar to some sectors in China, the fund-management industry is another category where provides attractive business opportunities, due to the impressive growth history and huge potential. However, the potential is closely related to the prospect of national economy in general and development of financial markets, the level of consumer income and other relevant fields in particular. In the case of China, with the ongoing reform and opening-up policy that started in 1978, the country is on the way to developing into a more market-based economic system, compared to the socialist system. A more modern economic structure, a huge domestic consumer market and a more open society make it reasonable to believe that China can continue its economic growth for some time in the future, as confirmed generally by a number of economists and analysts worldwide. In addition, other critical factors, such as the continuous FDI inflows and the WTO membership, also provide energy for the economic transition to a market economy and sustainable economic growth.

In spite of the outstanding CAGR of 63.6% from 1998 to 2004, China's fund-management industry is still small, when compared with some developed countries. However, there is also a huge potential for this emerging sector. Given the prospect of the continuous economic growth in China, it is reasonable to believe that the fund-management fund can become another booming sector with attractive returns for foreign investors. This optimistic

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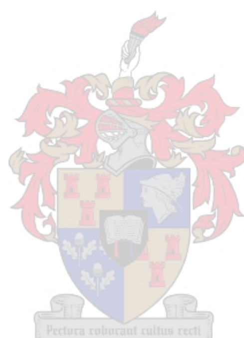
outlook is furthermore confirmed by the positive effects of the progress in China’s financial markets, the pension reform and ever increasing level of personal income.



Chapter 4

Challenges for Foreign Investment in China's Fund-Management Industry

Despite attractive potential business opportunities and promising economic growth, China, like any other emerging market, also faces certain challenges with regard to foreign investment. In addition to some general risks that foreign investors may face, regardless of which industry they invest in, there are also some specific risks associated with this particular industry. This part of the study is conducted to analyse certain particular challenges for foreign investment in China's fund-management industry. These include challenges that are defined and focused on from an international business perspective, such as cultural differences, which are beyond the scope of this sector in the study.

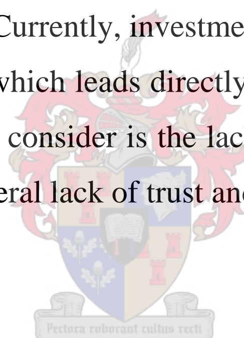
As indicated in previous chapters, China's fund-management industry is still at its early stage in terms of market size and efficiency and new to foreign investment when compared with some other industries in China. With the huge potential of China's fund-management industry in mind, foreign investors also need to be aware of various challenges and problems that result from its immaturity. The Chinese government only started opening its capital markets to foreign investors relatively recently. When it comes to China's fund-management industry, the challenges are mainly derived from the important platforms for investment funds, namely the stock market, bonds market and futures market.

In order to develop a good understanding, it is worth mentioning one of the most significant characteristics in China's financial asset structure first. In general, the indirect financing structure for companies represents an exceptionally high proportion in China's economy in comparison with direct financing, which means that bank loans are still the main source of corporate financing. In 2003, for example, new loans in financial institutions amounted to RMB 3 trillion, representing 85% of total financing, while the sum of new issuance of stock,

T-bonds and corporate bonds reached only RMB 534 billion, at 15% of total financing *(Wu, 2004: 1).*

What this means is that the stock and bonds markets in China are underdeveloped, which impedes to a large extent the growth of the fund-management industry. This chapter is structured to analyse some problems associated with each of the three main platforms for investment funds. At the same time, some general information about the three financial sectors, including their history, product variety and problems, will be introduced and analysed.

In addition, there are also some particular problems associated with the nascent industry itself. With a history spanning only a 6-year period, China's fund-management industry lacks a healthy investment culture. Currently, investment and trading decisions are based on speculation and short-term vision, which leads directly to high redemption rates for mutual funds. Another critical challenge to consider is the lack of interest from investors to invest in funds which may be due to a general lack of trust and limited knowledge.



4.1 Stock Markets

The history of the PRC's stock markets[33] can be traced back to the early 1980s when informal stock markets were set up. At that stage, firms that issued debentures and internal employee shares were usually collective firms, because SOEs were still entitled to easy access to bank loans. Shanghai Yanzhong Industrial became the first to make public offerings of standardised corporate equity in 1985 and the next year saw some over-the-counter markets developing in Shanghai and Shenyang *(Green and Wall, 2000: 9).*

[33] Actually, China's stock market started in the 1860s, when brokerage firms opened to trade shares of foreign companies in Shanghai and the Shanghai Stock Exchange became the largest in Asia by the 1930s. After the establishment of People's Public of China in 1949, however, the Shanghai Stock Exchange and two other exchanges were soon closed (Liu and Green, 2003: 3).

Broadly speaking, China's equity markets were largely ineffective in the 1980s and a central trading system became more and more necessary. More importantly, the central government also realised the importance of the securities markets in the reform of SOEs. Therefore, stock markets were established with the intention to serve large SOEs. In fact, the philosophy of stock markets to finance the SOEs and progress their reform was dominant in the 1990s (Seddighi and Nian: 2004: 786).

At the same time, the stock markets were also regarded as a policy instrument to achieve certain political objectives, according to Yadong Liu from Medley Global Advisors (Justin Sommers, 2002: 7). As China's reform carried on, government was trying to gradually loosen the ties with most of the SOEs and put them into a more market-oriented economic system. Without favourable policy and financial support from government, most of the SOEs were unprofitable and nearly bankrupt. The stock markets were supposed to replace the government's support and particularly state-owned banks as the source of refinancing SOEs mitigating the severity of subsequent lay-offs (Justin Sommers, 2002: 7).

All these intentions and factors played a significant role in the mechanism and function of China's stock markets afterwards, which caused various problems seen within the sector today, such as the restraining of growth. This aspect will be discussed in the following part of this study.

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4.1.1 Stock markets and share varieties

Two exchanges were established in Shanghai and Shenzhen in 1990. The Shanghai Stock Exchange (SHSE) and the Shenzhen Stock Exchange (SZSE) are two national public exchanges in China and each of them adopts a computerised market trading system based on the principle of price priority and time priority, with modern electrically automated technology. Currently, two types of shares are trading on each of these two exchanges, namely A-shares and B-shares.

There are eight types of shares that a company in China can issue to obtain financing. These include A-shares and B-shares as well as six other types of shares, including legal person (LP) shares, state shares, employee shares, H-shares, N-shares and red-chips. Each of these eight types of shares are described in detail as follows (Seddighi and Nian, 2004: 787; CSRC, 2004: 5-21; and Green and Wall, 2000: 10):

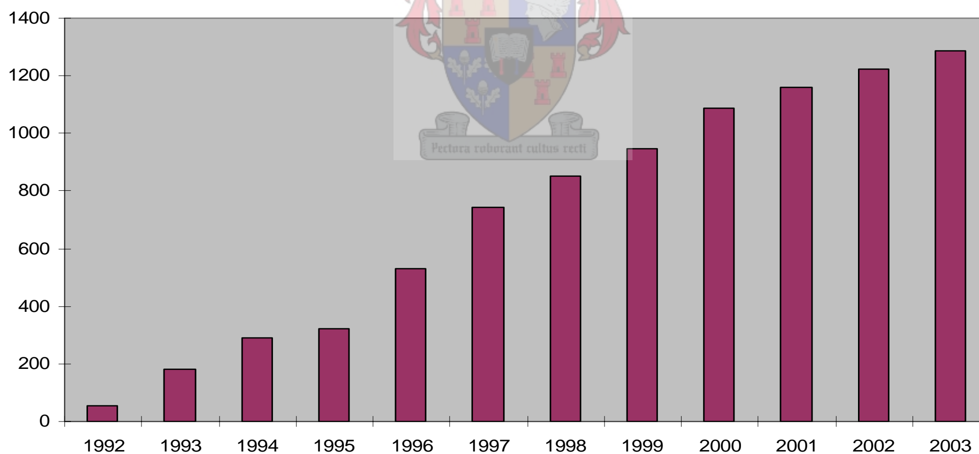
- *A-shares* are domestically listed shares issued by Chinese companies and denominated in the Chinese currency, RMB. Foreign investors cannot directly invest in A-shares, except QFIIs as described in Chapter 3.
- *B-shares* are also domestically listed shares issued by Chinese companies, and denominated in U.S dollars in the SHSE and H.K dollars in the SZSE. They were initially designed for Chinese companies to raise financing in foreign currency from domestic and foreign institutional investors, but became available for domestic individual investors since 2001 after approval by the CSRC.
- *Legal person (LP) shares* are the shares held by other domestic institutions, but are not tradable.
- *State shares* [34] are the shares transferred, with the permission of CSRC, to governments at local and central levels, their departments and enterprises wholly owned by the state.
- *Employee shares*, also called internal holdings, are the shares provided to employees at a discount price and not tradable either.
- *H-shares* and *N-shares* [35] represent the shares that are issued by mainland-registered companies, but listed on the Hong Kong Stock Exchange and New York Stock Exchange, respectively.

[34] The practice of state shares and legal person shares allowing the government to state issuances of shares is not equal to privatisation (Xu and Wang, 1997).
[35] N-shares are in the form of American Depository Receipts (ADRs).

- *Red-chips* are the shares that are also listed overseas, but issued by companies registered overseas and controlled by entities or departments of the Chinese government.

As an important part of China's reform, the stock markets have made considerable achievements in terms of market size, infrastructure, legal structures and so on, especially with the support from of the central government and have been playing a significant role in the establishment of China's socialist market economy, the reform of SOEs, and accelerating structural improvement and economic development (CSRC, 2004: 5). The volume of total stock trading increased from about 4 billion shares in 1992 to 416 billion by the end of 2003. During the same period, the number of listed companies increased to 1 278[36] from 53, with an average annual expansion rate of 43.42%, as indicated in *figure 4.1* below.

Figure 4.1 Number of Listed Companies (A- and B- shares) (1992 to 2003)



Source: *China's Securities and Futures Markets*, CSRC, 2004.

However, China's stock markets are still quite small in terms of market capitalisation and its ratio to GDP. As noted above, there are eight types of shares issued by Chinese companies, but not all of them are tradable. In order to avoid the improperly large

[36] It includes 1146 companies issuing A-shares only, 30 issuing A- and H-shares, 87 issuing A- and B-shares and 24 issuing B-shares only.

privatisation of SOEs, the State Council defined three different categories[37] of shares in 1992 and all SOEs have had to issue three of them, namely individual person (IP) shares, state share and legal person shares (Green, 2003: 6-7). The category of individual person shares theoretically includes A-, B-, H- and N-shares. When considering non-tradable shares in the public market, it is irrational to include state shares and legal person shares, at least at market price[38], when calculating market capitalisation.

Table 4.1 Ration of Market Capitalisation to GDP (1992 to 2003), 100 million RMB

	GDP	Total Market capitalization	Market capitalization/ GDP	Market capitalization of tradable shares (A and B shares)	Tradable capitalization/ GDP
1992	26 638.10	1 048.13	3.93%		
1993	34 634.40	3 531.01	10.20%		
1994	46 759.40	3 690.61	7.89%	964.82	2.06%
1995	58 478.10	3 474.28	5.94%	937.94	1.60%
1996	67 884.60	9 842.38	14.50%	2 867.03	4.22%
1997	74 772.40	17 529.24	23.44%	5 204.43	6.96%
1998	79 552.80	19 505.64	24.52%	5 745.59	7.22%
1999	82 054.00	26 471.17	31.82%	8 213.97	9.87%
2000	89 404.00	48 090.94	53.79%	16 087.52	17.99%
2001	95 933.00	43 522.20	45.37%	14 463.16	15.08%
2002	102 398.00	38 329.12	37.43%	12 484.55	12.19%
2003	116 694.00	42 457.71	36.38%	13 178.51	11.29%

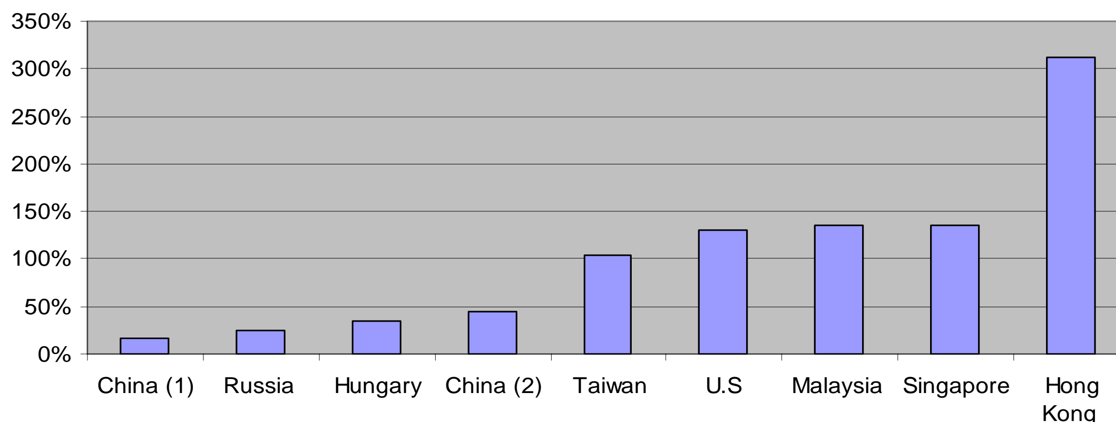
Source: China's Securities and Futures Markets, CSRC, 2004.

After the adjustment of the market capitalisation as indicated in *table 4.1*, China's stock markets become less impressive to a large extent. Taking 2001 for example, the market capitalisation of tradable shares was about 1.4 billion, which was 20th worldwide and 1.2% of that of the United States, while the market capitalisation of whole shares was about 9.6 billion, as the second largest in Asia and 8th largest in the world (Green, 2003: 7). As far as the ratio of market capitalisation to GDP is concerned, China's stock markets have not expanded as substantially as was supposed in terms of the size of its economy, also when

[37] Basically, three categories of shares are invented by almost equal proportion, which means each of them is about one third of a SOE's equity (Green, 2003: 6)
[38] Non-tradable shares, mainly state and legal person shares, are traded at auction or in the form of one-to-one deals, but priced much less than the listed individual person shares, usually one tenth (Green, 2003: 7).

compared to some countries in Eastern Europe that started stock markets almost at the same time as China did. (see *figure 4.2* below)

Figure 4.2 Ratio of Market Capitalisation to GDP (2001)



Source: Compiled from Standard and Poor's, Economist Intelligence Unit and *China's Stock Market: Eight Myths and Some Reasons to Be Optimistic*, Green, 2003

Note: China (2) is involved with the total market capitalisation, while China (1) is derived from the market capitalisation of tradable shares.

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4.1.2 Challenges in the stock markets

Broadly speaking, stock markets are expected to function as catalysts to increase the efficiency of capital (Levine, 1997; Calvo and Frenkel, 1991; Fisher and Reisen 1993: 105; and Pardy, 1992). However, the extent to which the efficiency is achieved depends on a series of factors relevant to the capital markets, such as the environment where companies can compete freely, certain "soft infrastructure" including reliable professionals and a complete legal basis, and so on. In the case of China, these critical factors are not available to various extents, which results in some severe problems in the stock market *(Green, 2003: 10).*

First of all, the lack of liquidity is pervasive in China's stock markets. As indicated above, only 30% of shares issued by Chinese companies are trading in the markets and this

directly reduces the size of markets, and therefore also the level of liquidity. Even among tradable types of shares, two national exchanges exist and dual listing is not allowable, which makes the stock markets fragmented and diverts the possible liquidity (Justin Sommers, 2002: 5). Moreover, significant differences in share valuations exist. According to Seddighi and Nian (2004), the PE (Price-Earnings) ratio of A-shares is about four times and three times that of B-shares issued by the same company in Shenzhen and Shanghai respectively.

Another serious problem in China's stock markets is its volatility. To a large extent, the central government is still playing a decisive role in the movement of equity prices and trading activities. Designed to serve SOEs, China's stock markets are to a certain extent administered directly by the government, which explained the other name for this sector, "*Zhengfu Shi*" (Government Market). The sector is therefore quite sensitive to political news. For this reason, a large number of investors assign considerable weights on policy movement and speculate, which may contribute significantly to the market volatility as confirmed by Baily (1994), Chan and Wei (1996) and Su and Fleisher (1998).

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The characteristic of investor profiles in the stock markets also causes volatility. It is generally believed that individual investors dominate the stock markets, particularly with regards to A-shares. According to a conference report by the Asia Society (2002), institutional investors only account for 0.48% of all investors in the market and 4.71% of free-floating domestic market capitalisation, which makes China's equity sector represent a retail-driven environment. However, not all individual investors should be included, because some investors illegally open more than one account for some undisclosed trading, manipulation purposes and discount IPO shares, as explained by Green (2003).

More importantly, individual investors generally are trading from a short-term perspective and this leads directly to high turnover rates. In other words, China's stock markets lack a healthy and long-term investment culture, which also spreads to other financial sectors and impedes the growth of the fund-management industry as explained in the last part of this

chapter. At the same time, institutional investors, with their increasing proportion and importance in the markets, are also blamed for the volatility of China's stock markets. Seduced by attractive returns, institutional investors, particularly securities companies and funds, manipulate the market and operate in various unethical and illegal ways, such as the illegal operations of some fund-management companies in 2000 as discussed in Chapter 2. Their unacceptable activities certainly increased the volatility of China's stock markets

According to Poon and Lin (2000), China's stock markets provided about 20% of annual returns, the second highest among 12 countries[39] and the highest among emerging markets, but were also characterised by the highest annual volatility, more than 40%, during the period of 4th May, 1994 – 31st December, 1999. Based on speculations[40], most investors exchange shares on a substantially frequent basis, which increases the turnover rate to a large extent. For example, the average turnover rate in the Shanghai and Shenzhen stock markets was about 504.75% during the period of 1994 – 2001 (Gao, 2002: 1). When compared with other stock markets, China's stock markets are characterised by considerably high volatility in terms of turnover rates, as indicated in *table* 4.2 below.

Table 4.2 Turnover Rates on the Main Stock Markets Worldwide (1994 to 2001) (%)

	Shanghai	**Shenzhen**	**Taiwan**	**New York**	**Tokyo**	**South Korea**	**London**	**Hong Kong**	**Thailand**	**Singapore**
1994	1 135	584	366	53	25	174	77	40	63	28
1995	366	255	228	59	27	105	78	37	40	18
1996	228	1350	243	52	27	91	58	44	30	14
1997	243	817	407	66	33	146	44	91	50	56
1998	407	407	314	70	34	207	47	62	69	64
1999	314	425	289	75	49	345	57	51	78	75
2000	289	509	259	88	59	243	69	61	55	59
2001	449	483	207	87	60	219	84	44	91	59

Source: Compiled from China Securities and Futures Statistical Yearbook (2002), the World Federation of Exchanges and Viability and the Development of China's Capital Markets (Lin, 2004).

[39] They include the UK, US, Japan, Singapore, Hong Kong, Malaysia, Thailand, Philippines, Korea, Indonesia, Taiwan and China.
[40] According to Xu (2001), the proportion of speculation is more than 60%, in comparison with about 15-20% in the U. S. stock market.

Last, but certainly not least, is the widespread and deep-rooted fraud in China's stock markets (Li, 2003: 1). This emerging market contains various corrupt practices, including market manipulation, insider trading, accounting fraud and so on. That is why China's stock markets are believed to be worse than casinos in some ways, as confirmed by Wu Jinlian in 2001, one of the leading economists in China, that "even casinos have rules and you can not look at other people's cards" (Chang, 2003: 3). Many incredible cases have been reported concerning fraud at different levels. A cathode-ray-tube company in Sichuan province replaced an actual loss of 53 million with a fake profit of 54 million RMB in the year before it made IPO, with the purpose of meeting IPO requirements[41], which was the first reported fraud case in China's stock markets (Li, 2003: 3). Guangxia Industry, a Shenzhen-listed company, even made up almost 95% of its reported earnings in 1999 and 2000 (Chang, 2003: 4).

Since stock markets provide an important platform for fund management, the situation of the stock markets has direct and significant influence on the development of the fund-management industry. In the case of China, it is critically important for foreign investors in the fund-management industry to consider the various challenges that China's stock markets face, as mentioned above. Despite various great achievements for the last 20 years, China's stock markets are still underdeveloped in terms of its national economy scale and, more importantly, exhibit some critical problems. Foreign and domestic investors in the fund-management sector are subject to almost the same problems associated with China's stock markets. All these immature features in China's stock markets certainly restrain the development of various relevant industries, including the fund-management sector in this study, and should be given adequate emphasis in any analysis concerning investment in this particular sector.

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[41] An IPO company needs to have a certain profit growth for three consecutive years prior to the listing.

4.2 Bond Markets

Since 1949 when the first domestic bond market was launched, China's bond market, as a whole, has grown considerably, when considering the number of participants and its function in China's economy (Ji and Thomas, 2005: 30). It has become an important means to transfer massive domestic savings to a range of economic activities (Jingu, 2002: 6). However, in general, China's bond market is still underdeveloped, relative to the size of its national economy.

4.2.1 Bond varieties

There are basically two main types of bonds classified in terms of Chinese issuers, namely government bonds and corporate bonds. Government bonds are issued by government entities and include Treasury bonds (T-bonds) and financial bonds that are issued by the Import and Export Bank of China, China Development Bank and other policy banks, while corporations mainly issue corporate bonds and convertible bonds. The main purpose of Chinese government bonds is to finance government's deficit and certain infrastructure projects. With the natural and direct support from the central government, the market for government bonds has a dominating position in China's whole bond market, while underdevelopment is obvious in the sector of corporate bonds.

Government bonds

Since 1981 when the issuance of government bonds restarted, China has issued a variety of government and semi-government bonds[42]. The bonds market has expanded substantially in terms of market size. For example, a total of 510 billion RMB in government bonds was issued to accelerate economic growth from 1998 to 2001 (Jingu, 2002: 7). As mentioned before, the main purpose of government bonds is to finance the government deficit and a

[42] State-owned banks issued semi-government bonds for some financial entities until 1995 when one of them went bankrupt (Ji and Thomas, 2005: 31).

number of giant projects, and to enable open market operation for the central bank as well. More specifically, the proportion of deficit financing of government bonds was higher than that of project financing from 1997 to 2003, as illustrated in *table* 4.3 below.

Table 4.3 Cumulative Outstanding T-Bonds for Direct Financing and Construction Costs, billion RBM

	1997	1998	1999	2000	2001	2002	2003
Deficit Financing							
Amount	554.8	776.6	1 052.4	1 367.4	1 561.8	1 933.6	2 242.6
% of GDP	7.5	9.9	12.8	15.3	16.3	18.9	19.9
Construction Costs							
Amount	349.1	512.1	644.7	738.3	853.4	1 005.4	1 019.4
% of GDP	4.7	6.5	7.8	8.3	8.9	9.8	9

Source: Ji and Thomas, 2005

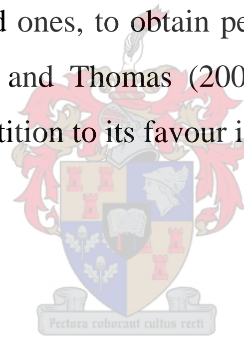
At the same time, China's government bonds can also be categorised into two types in terms of different target investors, namely certificate-type government bonds and registry-type government bonds. While the registry-type government bonds are issued to members of the inter-bank market, the certificate-type government bonds, similar to a certificate of bank deposits, are available for individual investors. This classification approach directly leads to two types of government bond markets, the inter-bank market and exchange-traded market, as explained in detail in the following part.

<u>Corporate bonds</u>

The issuing of China's post-1949 corporate bonds started in 1987, yet China's corporate bond market is probably one of the most underdeveloped financial sectors. Corporate bonds are only available on two exchange markets, while government bonds can be traded in both inter-bank and exchange bonds markets. Similar to the stock market, China's corporate bond market is also favourable for SOEs and plays an important role in the reform of SOEs. By 2002, several large SOEs listed on the stock exchanges had issued about 270 billion RMB, and 324 corporate bonds had been traded on the two exchanges by June 2004 (Ji and Thomas, 2005: 32).

Basically, the use of debt can reduce the taxes a firm pays, enabling shareholders to remain in control and make managers more disciplined (Brigham and Daves, 2004: 487 - 488). As one of the three major fund-financing tools, corporate bonds have a significant role in developed markets and corporate bond markets have expanded substantially. The ratio of value of corporate bond markets to GDP is about 140% in the United States, about 95% in Japan and 85% in the 15 member nations of the European Union, but only less than 1% in in China in 2003 (Ji and Thomas, 2005: 32).

One of the main reasons for the incredible immaturity is that corporate bond issuance is subject to a number of formal restrictions. Strict quotas are imposed on the issuance and interest rates are subject to administrative control (Green and Wall, 2000: 14). Therefore, it is difficult for firms, even qualified ones, to obtain permission from the authority to issue corporate bonds. According to Ji and Thomas (2005), one possible reason is that the government wants to reduce competition to its favour its SOEs.



4.2.2 Bond markets

As mentioned before, investors can trade Chinese bonds in two markets, namely the inter-bank bond market and the exchange-traded bond market. In both bond markets, a spot trading market and a repurchase (repo) market are available for investors. Basically, these two bond markets are designed for different investors and different economic purposes. However, the inter-bank bond market is more active and bigger in terms of market size, relative to the exchange-traded bond market.

Inter-bank bond market

The inter-bank bond market, as a quota-driven over-the-counter (OTC) market, was established in 1997 and is currently under the supervision of the People's Bank of China. This bond market functions as the most important market for block trading of bonds among

financial institutions and also as a platform for open market operations conducted by China's central bank (PBOC). T-bonds, financial bonds and a small amount of central bank bills are the major products in this bond market. The major participants in the inter-bank bond market are institutions[43], which include the PBOC, commercial banks, securities companies, insurance companies[44], securities investment funds and credit cooperatives. *(CSRC, 2004: 30)*

According to the CSRC (2004), in the end of December of 2003, the outstanding T-bonds, financial bonds and the central bank bills in the inter-bank bond market amounted to RMB 1 749.1 billion, 1 160.8 billion and 337.7 billion respectively, and spot trading amounted to RMB 3 084.8 billion, while the turnover in repo's amounted to RMB 11 720.3 billion. By the end of March 2005, 5 596 participants were trading in this market, compared to 1 613 at the end of 2003 (Su, 2005: 1).

Exchange-traded bond market

The exchange-traded bond market is an order-driven market and comprised the bond markets on the two domestic stock exchanges, namely the Shanghai Stock Exchange and Shenzhen Stock Exchange. The major participants include securities companies, insurance companies, securities investment funds, trust and investment companies, credit cooperatives, other non-financial institutional investors and individual investors. The PBOC and commercial banks[45] do not trade in this market *(CSRC, 2004: 30).*

[43] Non-financial institutions can also trade bonds in the inter-bank bond market through qualified commercial bank participants through counters at their branches. It is sometimes referred to as the "Commercial Bank OTC Market", which is relatively new and still in its infancy. *(CSRC, 2004: 30)*
[44] Since late 1999, some qualified securities companies and investment-management companies have been allowed to trade in the inter-bank bond market in order to solve their problems related to severe shortages of capital (Green and Wall, 2000: 15).
[45] In August 1997, commercial banks were banned from the exchange-traded bond market due to the illegal practice of providing long-term loans to securities companies that did not have access to formal loans (Green and Wall, 2000: 15)

T-bonds, corporate bonds and a small amount of convertible bonds are major products in the exchange-traded bond market. T-bonds have a dominating position in this market, with RMB 354.4 billion of market value, compared with the 36.4 billion of corporate bonds and 20.9 billion of convertible bonds at the end of 2003. *(CSRC, 2004: 30)* More information about the exchange-traded bond market is explained in *table* 4.4 below.

4.2.3 Challenges in the Bond markets

After the introduction of the abovementioned bond varieties and bond markets, although the government bond market has developed significantly, a basic impression about China's bond markets is one of major immaturity. The bond market is probably regarded as the least efficient sector in China's capital market (Justin Sommers, 2002: 15). It cannot be overestimated that its immaturity and inefficiency could influence the improvement of financial markets and constrain prospective economic growth. In addition to some problems inherent in the bond market that have already been mentioned above, there are other challenges regarding this sector, which should be considered and analysed when investing in China's bond markets and other relevant sectors, such as the fund-management industry.

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First of all, two kinds of imbalances exist in China's current financial asset structure. The first type of imbalance is between fixed-income instruments and equity instruments for financing. In market economies, the common situation in the direct financing market is that fixed-income instruments, with corporate bonds as the central component, dominate the market with a 2/3 proportion, while equity instruments represent another 1/3 of the total market share. However, in the case of China, with the risk of redemption of corporate bonds in the 1980s and 1990s being still fresh in the memory, the incentive to accelerate the SOEs' reform make the State Development and Reform Commission, the supervisory authority of corporate bonds, impose severe restrictions on the issuance of corporate bonds. The unfavourable environment has compelled companies to raise financing mainly in the stock market. At the end of November of 2004, RMB 127.3 billion was raised by

enterprises through the stock market, while only 24.5 billion was raised through the bond market *(Wu, 2004: 2).*

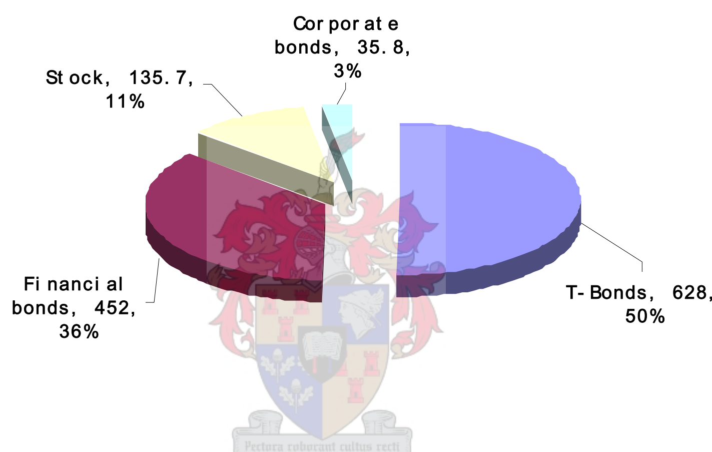
Table 4.4 Exchange Bond Market Trading Summary (1995 to 2003)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Trading volume (10,000 lots)	100 660	174 297	161 732	203 161	170 716	197 979	204 707	329 480	620194
Corporate bonds	29	38	356	946	471	906	672	639	26 973
-spot	29	38	356	946	471	906	672	639	3 439
-repo									23 534
Convertible bonds	70 905	0	0	833	3 133	11 717	3 684	688	5 830
T-bonds	29 726	174 259	161 376	201 381	167 111	185 355	200 351	328 152	587 390
T-bond spot	6 105	44 172	32 615	45 973	38 206	38 018	45 474	83 955	57 391
T-bond repurchase	2 468	130 086	128 761	155 407	128 905	147 336	154 876	244 196	529 998
Turnover (100 million yuan)	59 367	18 039	16 476	21 661	18 284	19 119	20 417	33 272	62 136
Corporate bonds	1	1	18	40	47	92	68	70	2 717
-spot	1	1	18	40	47	92	68	70	363
-repo									2 353
Convertible bonds	6	0	0	20	44	135	45	73	663
T-bond spot	775	5 029	3 582	6 059	5 300	157	4 815	8 708	5 756
T-bond futures	57 336	0	0	0	0	0	0	0	0
T-bond repurchase	1 248	13 008	12 876	15 540	12 890	14 733	15 487	24 419	52 999

Source: CSRC, 2004

The second imbalance is the excessively high proportion of government bonds in the area of direct financing. According to a speech by Wu Xiaoning, the Deputy Governor, at the 9th Forum of China's Capital Market, the government has a dominant control of financial resources. Taking 2003 as an example, the total amount of direct financing was about RMB 1 251 billion in China's financial markets. T-Bonds accounted for about 50.2%, with RMB 628, followed by financial bonds issued by policy banks, representing 36.1%. The stocks amounted to RMB 135.7 billion, accounting for 10.8%, compared with corporate bonds with only 35.8, as indicated by *figure 4.3* below.

Figure 4.3 Direct Financing Structure in 2003, billion RMB



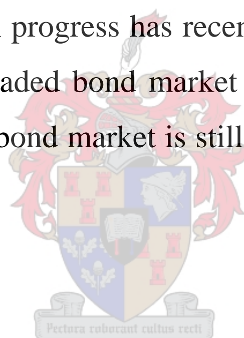
Source: Wu, 2004: 2

The second challenge in the bond markets is the lack of a rating system and an atmosphere of information disclosure. As mentioned before, the issuance of corporate bonds is subject to strict administrative restriction. Due to the small size of the bond markets, to invest in a corporate bond is usually not the first choice for investors. In addition, there is not a sound system of information disclosure in the corporate bond market. These factors make the credit rating of corporate bonds artificial, far from a market-based credit system with professional agencies *(Wu, 2004: 10 and Ji and Thomas, 2005: 32.)*

Another challenge that China's bond markets face is an overlap in supervision. As shown in the introduction of China's bond markets, there are mainly three types of bonds – T-bonds, financial bonds and corporate bonds, and two bond markets – the inter-bank bond market

and exchange-traded bond market. However, they are under the supervision of different regulatory authorities. The issuance of T-bonds, financial bonds and corporate bonds are supervised by the Ministry of Finance, the People's Bank of China (PBOC) and the State Development and Reform Commission, respectively. The China Securities Regulatory Commission (CSRC) is responsible for bonds trading in the exchange-traded bond market, while the inter-bank bond market is under the supervision of the People's Bank of China. The poor coordination between these regulatory authorities certainly has a negative impact on the development of China's bond market *(Wu, 2004: 11).*

In addition, similar to the stock markets, China's bond market also lacks liquidity. Besides two trading bond markets, namely the inter-bank bond market and exchange-traded bond market, China's stock market includes another sector, the voucher bond market, which does not have a public market. Although progress has recently been made to combine the inter-bank bond market and exchange-traded bond market together, the final combination will takes time and liquidity in China's bond market is still unfavourable for this growth *(Justin Sommers, 2002: 15).*



4.3 Futures market

As another important platform for investment funds, the futures market plays an essential role in the portfolio arrangement and risk management of the fund-management industry. The investment idea of "pooling assets" enables investment funds to provide an economical diversified portfolio and help achieve expected returns. The futures market provides specialised derived instruments consistent with this diversification purpose. Basically, these products are designed to hedge the risk that investors face from relevant businesses or investments in other fields. Therefore, the growth of the fund-management sector is closely related with the situation in the futures market, including product variety, market efficiency and so on. In the case of China, the futures market is under strict supervision and still very young.

These instruments in the futures market are considered by various investors as tools for speculation, rather than for hedging risk. China's futures market has been plagued by insider trading, price manipulation and poor regulation for the last decade (Tarallo, 2002: 1). In early 1995, the government shut down the futures market for government bonds that was introduced to institutional investors in late 1992 and opened it to the general public one year later (Chen and Zhou, 2003; 1).

At this moment, there has been no financial futures market in China since 1995, although the introduction of derived financial instruments is becoming important. China's futures market is only comprised of three futures exchanges in which investors are trading commodity futures. The three futures exchanges are under the supervision of the CSRC and located at three different cities in China, namely Shanghai Futures Exchange (SHFE), Dalian Commodity Exchange (DCE) and Zhengzhou Commodity Exchange (ZCE).

Shanghai Futures Exchange (SHFE)

Based on Shanghai Metal Exchange, Shanghai Cereal and Oils Exchange and Shanghai Commodity Exchange, Shanghai Futures Exchange (SHFE) came into operation officially in December 1999 and had 219 members in total at the end of 2003. The main commodities on the SHFE are copper, aluminum, and natural rubber. The trading volume reached 80.16 million lots, with an annual increase rate of 229% and the turnover increased 229% to RMB 6 054 billion, accounted for 56% of the national total in 1993.

Dalian Commodity Exchange (DCE)

The Dalian Commodity Exchange (DCE) was established late 1993 and had 197 members at the end of 2003. Futures on soybean and bean meal are primarily traded on the DCE. The DCE is the second largest soybean futures market and the largest futures market for non-transgenic soybeans worldwide. In 2003, the trading volume at the DCE increased 55% and

reached 149.95 million lots, accounting for 53% of the national total volume. At the same time, the turnover amounted to RMB 3 989.6 billion, with a proportion of 37% of the national total turnover, up by 91% from 2002.

Zhengzhou Commodity Exchange (ZCE)

Zhengzhou Commodity Exchange (ZCE) was established as the first futures market in China in 1990 and had 218 members at the end of 2003. The products that are trading on the ZCE include wheat (ordinary national-standard wheat and quality-enhanced wheat), mung bean, small red bean and peanut kernel. In 2003, the trading volume at the DCE reached 49.82 million lots, up 172.6% and the annual turnover increased by 253.4% to RMB 796.1 billion *(CSRC, 2004: 55-56).*

4.4 Other Problems in China's Fund-Management Industry

In addition to some challenges associated with the two main platforms for China's fund-management industry, foreign investors also need to consider some particular problems in this emerging sector itself. The fund-management industry has only been growing for about 6 years and is still very young and immature, in spite of its remarkable growth rate as illustrated in Chapter 2. Similar to other sectors in China's financial markets, the fund-management industry is also subject to administrative control, which hampers the construction of a sound market-based system to a certain extent. Furthermore, the entire financial market is underdeveloped at different levels and exhibits a series of problems. All these factors make it necessary to investigate these particular challenges and take them into consideration when investing in China's fund-management industry.

First of all, there is a lack of a healthy investment culture in China's financial markets. In other words, investors, especially individuals in China, usually take a short-term and speculative approach to investment in the financial markets. As mentioned above, this

unhealthy investment view is most obvious in the stock market, as illustrated by the high turnover rates of stocks and consequent volatility. Since the stock market is one of the main platforms for the fund-management industry, a close relation exits between these two sectors. The fund-management industry is infected by this short-term and speculative investment culture.

As explained in Chapter 2, the last closed-end fund in China went public in September 2002 and afterwards all new funds were mutual funds. Therefore, mutual funds are the products provided by all the joint fund-management companies. When compared with closed-end funds, one of the main advantages of mutual funds is that investors can redeem, at NAV, their shares of funds with unsatisfactory performance. The redemption mechanism puts fund-management companies under the pressure of losing the amount of funds invested in assets and a consequent reduction of assets-under-management.

In China's fund-management industry, the short-term and speculative investment culture is demonstrated by the high redemption rates. According to Dalla-Costa (2004), in 2003, several joint fund-management companies suffered a quick and large decline in the assets under management due to unexpectedly fast redemptions.

- In March, ING Investment Management set up the first greenfield joint fund-management firm, China Merchants Fund Management, and raised RMB 4.5 billion in the launch of its first mutual fund. By the end of December 2003, the initial assets declined by 26%.
- In April, ABN Amro Asset Management, the first foreign firm to enter China's fund-management industry, raised RMB 2.63 billion through the public offering for its first mutual fund, but by the end of December, the assets of this umbrella fund only amounted to 1.43 billion, almost 50% less than the IPO. More specifically, between the launch date and the end of 2003, its growth, stable and cyclical sub funds lost 60%, 47% and 20%, respectively.

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- In August, Fortis Haitong Investment Management, a joint fund-management firm established by Fortis Investment Management and Haitong Securities, raised RMB 3.7 billion, but the initial assets dropped by 44% by the end of the same year.
- In October, GTJA Allianz Fund Management, the first joint venture to get a license, raised RMB 3.7 billion, but had lost 24% of its initial assets by the end of 2003.

Another reason for the high and speedy redemption rates is the lack of post-sales marketing. On the one hand, fund managers spent more time launching new funds than on subsequent marketing. On the other hand, there is no incentive for fund distributors to keep assets in a particular fund. According to Peter Alexander, an independent China fund-management consultant and long-time China watcher, distributors normally get 100% of front-end and back-end loading, which means the distributors mostly benefit both from selling the maximum number of units at launch and when the redemption occurs *(Dalla-Costa, 2004: 1)*.

In addition to this unhealthy investment vision in general, there is also a lack of incentive to invest in these funds. One of the most obvious reasons is that investors still do not trust fund managers. The memory of some scandals, particularly in 1999 and 2000, is still fresh and makes investors reluctant to believe that fund managers act to improve the fund performance and maximise investors' assets, rather than to further their own interest by some illegal or unethical practices.

4.4 Summary

In spite its attractive business potential, foreign investors in China's fund-management industry still need to consider various challenges associated with their investments. Since financial markets are the main platform for investment funds, this chapter focused on some major problems that exist in China's financial markets and consequently influence the development of the fund-management industry.

Generally speaking, China's financial markets are characterized by immaturity, especially due to the limited participation of foreign investors and government intervention at certain levels. Also, efficient capital allocation mechanisms have not yet been properly established in the financial markets. In order to present a clear picture of these various challenges, three main sectors, namely the stock market, bonds market and futures market, were analysed with focus on the market structure and some of its major problems.

First of all, China's stock market was basically designed to accelerate the reform of SOEs, which caused a series of problems. For the non-SOEs, the access to the stock market is subject to certain restrictions and this directly reduces the possible size and liquidity of the stock market, especially with the dilution of non-public shares required by the authority. At the same time, high volatility and widespread fraud in the stock markets also influence the development of the fund-management industry and consequently the foreign investment involved.

China's bond market is also significantly underdeveloped in terms of the size of its national economy. In spite of the considerable pace of expansion of the government bond market, the current size is still small and the corporate bond market is drastically undersized, when compared to other mature markets. Besides the low liquidity, the lack of a rating system and a sound atmosphere of information disclosure also slows down the growth of China's bond markets.

The futures market, another important platform for investment funds, is still under the strict supervision of the government because of historical reasons. There is no financial futures for investment funds to diversify risk. In addition, China's fund-management industry is also infected by the negative impression that investors have of these three platforms and there is still a lack of basic understanding and acceptance of investment funds, which leads directly to high redemptions applicable to mutual funds.

Chapter 5
Conclusion

After the discussion of challenges that foreign investors could face, a more complete picture should appear in the mind of the foreign investor planning to invest in China's fund-management industry. Despite its high growth rate and huge potential in the future, the immaturity of China's financial markets in general and the relatively strict supervision make it essential for foreign investors to analyse and handle some critical challenges. However, like any other study, a static vision should be avoided. This is extremely important in studies related to China. This emerging country has grown at a remarkable pace and made progress far faster than any analyst in the 1970's could have imagined (Areff, 2003: 86).

It is therefore reasonable to conclude that many changes are to take place in China's fund-management industry. An analysis of the future should be conducted to make the investment analysis more comprehensive. Although China's fund-management industry is still at its early stage, more and more institutional investors are coming to set up investment funds and compete for some market share. Among these investors, commercial banks and insurance companies in China are going to be important players in the near future, especially when considering some of their noteworthy advantages.

To conclude this study, a brief review of the previous chapters is necessary. At the same time, some suggestions for a future study with a similar topic will be provided.

5.1 Future Development

In China's fund-management industry, domestic fund-management firms and joint ventures are the main players. However, with the ongoing reform of the financial markets, restrictions are gradually being removed. More and more investors are allowed to

participate in the fund-management industry, which brings about more competition in terms of trading and sales. Among those players, commercial banks and insurance companies are most likely to play important roles and help toughen the competition.

From the point view of existing fund-management firms, the increasingly fierce competition makes it hard to maintain the current market share, which may reduce profits. However, there are some positive effects of the increased competition on this emerging industry and on individual firms as a whole. First of all, the increasing competition can also eliminate some unqualified firms with poor performance, which improves the quality of the players involved. Then, more importantly, fund-management firms are motivated or forced to pay more attention to the appetites and interests of investors and provide more products that investors want, which can improve service and industry standards.

A draft regulation on the establishment of fund-management firms by commercial banks was issued in November 2004 and the People's Bank of China (PBOC), the China Banking Regulatory Commission (CBRC) and the China Securities Regulatory Commission (CSRC) are currently working on the final one. Actually, China's commercial banks were constrained in the business of deposits and loans and were not allowed to invest in the non-banking financial sectors until a law, governing securities brokerages' investment in fund management companies and some changes of legal issues on commercial banks, came out in 2004.

In addition to some potential positive effects on the fund-management industry, the introduction of commercial banks to this non-banking financial sector also benefits the banking industry itself. As mentioned in Chapter 4, one of the most significant imbalances in China's financial markets is the excessively high proportion of indirect financing in the financing structure. The deregulation of commercial banks' investments can diversify their business and create a favourable environment to deal with the challenge of the low rate of direct financing.

According to the draft, a commercial bank can establish up to 2 fund-management firms. When compared with existing players in the fund-management industry, one of the most noteworthy advantages for commercial banks is their considerable customer base that stands for super access to potential investors. More importantly, their close relationships with government implies great credibility, which is regarded as the most essential quality by most individual investors, according to Yi Xianrong, director of the finance development division of the Chinese Academy of Social Sciences' Institute of Finance and Banking.

Another notable new player in China's fund-management industry is the insurance company. In 2003, two insurance companies, China Life and People's Insurance Company of China, were approved by the China Insurance Regulatory Commission (CIRC), the regulatory authority for insurance companies, to establish their own fund-management firms. In China, investment funds are the only means for insurance companies to invest in the securities markets.

The entrance of insurance firms to the fund-management sector influences the sector in two ways. On the one hand, a huge amount of assets will move from the existing investment funds to new funds set up by insurance companies themselves. According to Peter Alexander, insurance assets in the fund-management industry accounted for about 29% of the total industry assets under management at the end of 2003. Furthermore, the total assets of the insurance industry are roughly 100 billion U.S dollars, with about 30% of the annual growth rate, as estimated by Lechkie *(Dalla-Costa, 2004: 2).*

On the other hand, similar to the impact of the entrance of commercial banks, the permission for insurance companies to set up their own investment funds also intensifies the competition in China's fund-management industry. This competitor group includes 6 national domestic insurance firms, about 20 life insurers and several sino-foreign joint insurance firms.

5.2 Review of Previous Chapters

For the last two decades, China has been attracting considerable attention from around the world. As an emerging country, its continuous economic growth rates have been outstanding and impressive. The promising economic future and a huge consumer market motivate foreign investors to invest in China. It is generally recognised that the 21st century belongs to China, as confirmed by Laurence J. Brahm:

"In the coming century, there will be no other industrialised or industrialising country so poised to grow and expand as China. Given its high rate of growth and mammoth export potential, China's competitiveness as an international trading partner will be formidable. Projected levels of consumer spending, based on current savings, and a population which is one quarter of the world's total population, makes China's market ever more seductive. For multinationals everywhere, the equation is pretty clear: not to participate in China's economy is not to participate in the world's economy in the century ahead."

When it comes to China's fund-management industry, this nascent sector holds enormous potential because of its current immaturity. As an important part of China's financial markets, the fund-management industry was only established about 6 years ago, but has been expanding at a rapid pace and has made significant achievements in terms of market size and its importance in the entire financial field.

According to China's agreements with the WTO, the financial sector as a whole will become more and more market-based and open for foreign investors. In the case of the fund-management industry, foreign investors are allowed to make investment in the form of a joint fund-management firm with a 33% share within the first 3 years and up to 49% afterwards. However, due to various strict supervisions, China's financial markets, especially the fund-management industry, are still strange to foreign investors when compared with other industries in China. Therefore, this study was conducted to introduce some basic knowledge of China's financial sectors relevant to investment funds and analyse

the opportunities and challenges involved with foreign investment in the fund-management industry.

In order to present a clear picture of challenges associated with the foreign investment in China's fund-management industry, a list of major problems that foreign investors may face is illustrated as follows:

Sector	Major Challenges
Stock market	underdevelopment
	lack of liquidity
	high volatility
	widespread fraud
Bond Market	underdevelopment (especially in the corporate bond market)
	lack of a rating system and an atmosphere of information disclosure
	supervision overlap
	lack of liquidity
Futures market	underdevelopment
	no financial futures available
Fund-management industry	mistrust of fund managers
	widespread speculative investment vision of investors

First of all, some basic knowledge about the investment fund and China's fund-management industry was introduced in Chapter 2. This chapter started with two main types of investment funds, namely closed-end and mutual funds. Since mutual funds are the main product that a joint fund-management firm can provide, the concept of mutual funds was then given more focus. There are five types of mutual funds in terms of the different underlying investment. In the end, the benefits of investment in mutual funds were analysed in order to justify the significant expansion of this financial product in the developed markets.

After that, the history of China's fund-management industry was briefly shown, which was divided into three stages in terms of fund variety and market efficiency. Some quantitative information was also used to help draw a clear picture of what China's fund-management industry has been like. Then, the current situation of the joint fund-management companies was introduced, as well as some relevant legal issues. It was obvious to see the incentive of foreign investors in investing in this emerging financial sector, especially from the participation of some international well-known financial institutions.

Since profit is probably the most important thing for investors, chapter 3 analysed the investment opportunities in China's fund-management industry. First of all, some positive factors at macro level, such as healthy economic changes, continuous FDI inflow and WTO membership, were identified as drivers that make China's economic growth sustainable. A comparison with other countries was also conducted to justify the big potential for China's fund-management industry. Secondly, some micro aspects helpful to the expansion of the fund-management industry were analysed, including pension fund reform, high savings and increased income levels.

However, like any other businesses in China, the joint fund-management firm is also exposed to certain risks, which was the focus of chapter 4. Since the stock, bonds and futures markets are the main platforms for investment funds, the challenges involved with each of the three platforms were identified and analysed. At the same time, a brief history, the current situation and some challenges of each of the three sectors were also introduced. In general, China's financial markets are underdeveloped to various extents due to excessive government intervention. This immaturity is characteristic in various financial sectors, which considerably impedes the growth of the fund-management industry. In the end of chapter 4, some specific challenges associated with the fund-management industry were also examined, which mainly included high redemption rates and the lack of incentive of investing in the investment funds.

As more and more players become involved and strict supervision is gradually relaxed, the competition among the fund-management firms is becoming more intense, which was investigated in the first part of chapter 5.

The main purpose of this study is to make use of the fund-management industry to provide some basic knowledge about China's financial markets. At the same time, the focus was on the analysis of opportunities and challenges of foreign investment in the fund-management industry and therefore provides some information which may be found useful by investors.

5.3 Suggestions for further study

Since China only started opening its financial markets, particularly the fund-management sector, a short period ago, there are not many studies that have been conducted with a similar focus. Therefore, it is necessary to take into consideration the lack of information and relevant sources for this study. Although the study has covered some key sectors in close relation with investment funds, the information is brief and each aspect could be expanded in greater detail.

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There is no doubt that there are a number of differences between Chinese consumers and those in the countries of foreign investors. For example, investment funds in the mind of most Chinese consumers are still new and subject to misunderstanding and mistrust. A future study can also be conducted to analyse these characteristics and achieve further understanding of how to design investment funds and to appeal to Chinese consumers.

In addition, the challenges of foreign investment in China's fund-management industry can also be defined and analysed from the perspective of international business, such as culture differences and political risks. At the same time, a survey may also be conducted to help get some insights of foreign investment in China's fund-management industry.

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