HedgeFund Intelligence

Onshore China fund managers poised for international stage
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In many countries, moving out of a big fund house to set up a hedge fund is now a normal career path for a successful mutual fund manager. But in China, the path to such entrepreneurial opportunities is not quite so obvious. Similarly, Chinese mainlanders who were educated and cut their hedge fund management teeth in the world's major financial centres don't find it quite so easy to set up a hedge fund back home.

Under regulation by the China Securities Regulatory Commission (CSRC), mutual funds must maintain a high investment level in equities, which limits ability to go to cash; short-selling is forbidden and derivatives are in their infancy in mainland China. However markets, like nature, abhor a vacuum. And despite the obstacles to setting up hedge funds, the demand for alternative investment has been met with a proliferation of private funds with an absolute return mandate and a management-plus-performance fee (mostly 2 plus 20) structure. It has been further escalated by the rising wealth quotient and a proliferation of high-net-worth clients in China that demand professional management for their capital.

This has given rise to a vibrant onshore private funds or pseudo hedge fund industry, which is understood be running assets in excess of $10 billion at present, and experiencing explosive growth. "For high-net-worth investors there are very few investment options in China - they either invest in mutual funds or real estate. Private funds have emerged as one of the key options for this higher end of the market," says Shirley Ye, head of investor relations and market development at Springs Capital in Beijing.

A large wave of star mutual fund mangers leaving those fund houses and setting up their own private funds started in 2007, and due to the regulatory changes, there has been a dramatic growth in them since then, notes Xuli Li, partner and CIO of China's largest private funds manager, Congrong Investment Management. "But the real explosion took place in 2009, and the introduction of hedging tools such as margin trading, index futures and stock lending will prove to be catalysts for similar growth over the next two-three years," he adds.

There are about 330 known private funds in China as of now, run by onshore managers based in Beijing, as the well as the homes of China's stock exchanges, Shanghai and Shenzhen. These private funds are renminbi-denominated, and mostly run fundamentals-driven long-only, equity strategies investing only in domestic China A shares. However, there are a handful of quantitative onshore managers as well, such as ShuJun (see p15), which exploit the market inefficiencies through arbitrage strategies. The capital for all these funds is sourced from domestic investors in China.

The private fund managers are already large and growing fast, with some managers reportedly seeing assets double every six months in recent times. Interestingly, almost all of them harbour ambitions to move into the offshore arena, with many launching offshore hedge funds and overseas offices (typically in Hong Kong) over the past couple years. This gives them not only access to international investors, and the ability to go short and leverage up, but also the status of an internationally regulated hedge fund entity.

While their counterparts in conventional mutual funds operate under CSRC regulation, private funds function in a legal gap in China - there is as yet no legal provision by which an onshore hedge fund can be CSRC-regulated (see box, p11). These funds are typically sold through trust companies which delegate their investment function to onshore managers. Mainland institutional investors and high-net-worth individuals can gain access to them but they remain closed to retail investors, and to offshore investors too.

For offshore investors wanting to invest in China, there are already other options of course - such as exchange-traded funds, long-only China mutual funds and offshore long/short China hedge fund managers. The latter typically play A shares long and go long or short in Hong Kong-listed H shares, and/or invest in Greater China including Hong Kong and Taiwan.

However, none of these options offers direct and exclusive access to the large A share investment universe, which is several times larger than the number of mainland listings on the Hong Kong bourse. While Hong Kong has listed 155 H shares and 116 red chips, Shanghai and Shenzhen have 854 and 800 listed stocks, respectively. Neither do these options offer direct access to the renminbi appreciation story. Moreover, ETFs, mutual funds and offshore China hedge funds were all disappointing under the stress test of 2008 when the A share market dropped 70%, and they were also unable to fully ride the upswing of the following year as the market rose 96%.

Private funds, on the other hand, arguably have informational and structural advantages that enable them to better respond to such volatility, and therefore generate absolute returns and justify the 2 plus 20 fee structure. They can go to cash as much as they want, for example, giving them at least one basic hedging tool. Based firmly inside China, they are also closer to the policy-makers and the management of listed companies.


Jerry Wang

"Locally based managers have a certain advantage, particularly in terms of information on capital flows, as well as their domestic point of view on how the domestic economy and policy relate to the stock market," says Jerry Wang, chief executive officer of Vision Investment Management. "That on-the-ground intelligence adds value. Offshore managers tend to be more big-picture and large cap-focused, whereas this is not necessarily the case for onshore managers."

Where the China market fits into the bigger picture of global stock markets is another interesting dimension to onshore managers. Since the end of 2007, China has led the trend in global equity markets. The Shanghai market, for example, was already down 50% prior to the Lehman collapse, but was then was the first to rebound in January 2009, months ahead of the rest of the world, and the first to take a dive again in January this year. Clearly, with the Qualified Foreign Institutional Investor (QFII) quota still below $40 billion and less than half of that being utilised, this is not due to the effect of foreign capital flows.

"I don't know that we have a full handle on this, but it could be that being the factory of the world gives you a certain understanding of the supply and demand chain," notes Wang. "We've not been able to validate it yet, but it's interesting that the A-share market has been the leading indicator. Of course, it could just be coincidence, that by the end of 2007 everything was so over-valued there was nothing left to buy, but some of them knew when to get out of the way."

Given that they are not regulated by the CSRC, onshore private fund managers cannot tap into offshore investors as their mutual fund counterparts do by setting up an offshore firm. Big mainland houses such as China AMC, Harvest Fund Management and Bosera Asset Management have all set up shop in Hong Kong, bringing with them mainland assets under the Qualified Domestic Institutional Investor scheme quota, but so far private funds have typically taken a more low-key route.

One channel is through offshore managed accounts that mirror the onshore manager's portfolio, with the manager acting as investment advisor. Access to A shares is through QFII quota, which will inevitably shave off some of the performance relative to the onshore vehicle because of the transaction costs incurred, but there are advantages to both sides of such an arrangement. For the onshore manager, this offers almost effortless access to offshore capital, while offshore investors can tap this pool of expertise yet keep their assets outside mainland Chinese jurisdiction.

With more than 300 identified private funds, clearly not all of them can get it right, and investing in onshore managers, or A shares at all for that matter, is not for the faint-hearted. "There isn't any QFII quota yet to trade the newly established A share index futures. So you need to have a longer horizon and be able to stomach a lot of volatility," says Wang. "Even though they are absolute return and can aggressively go to cash if they think the macro environment is unfavourable, they represent a bigger beta risk... As we are alpha seekers we have to have strong conviction [to invest in them]."