Investment Management

Overview

2021 Offshore China Asset Management Industry Report

Opportunities in the Greater Bay Area

香港中資基金業協會
Chinese Asset Management Association of Hong Kong

Bloomberg

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Introduction

Offshore Chinese funds in the Greater Bay Area (GBA) are poised for a period of growth unlike any other. China's economy, the second largest in the world, is recovering robustly from the COVID-19 pandemic, making it the hottest bet in global finance. Its stock markets are among the fastest growing in the world, and, with Hong Kong home to a skilled pool of financiers who have provided the world with a vital link to China for decades, the components are in place for the Chinese asset management industry to take off in 2021.

Bloomberg's "Offshore China Asset Management Industry Report" takes a deep dive into this exciting sector. Co-written with the Chinese Asset Management Association of Hong Kong (HKCAMA), the report examines recent trends and offers insights from the leading asset managers in the region.

Our report begins by setting the stage with an overview of sector trends during the past two decades before highlighting some recent successes as revealed in the 2020 edition of the Offshore China Fund Awards, which was held in Hong Kong in December.

We then share a range of interviews with senior executives at some of the region's leading funds, providing a 360-degree view of the present state of the offshore asset management sector and its growth prospects.

Finally, the report explores the six main trends in the offshore China fund sector for 2021: Opportunities in southern China's Greater Bay Area; Shenzhen's growing importance as a center of wealth creation; the potential for a thriving ETF market; China's expanding IPO market; growth opportunities for mutual funds; and the development of derivatives trading. These developments are expected to encourage mainland investors to diversify overseas and offshore investors to seek new opportunities in China.

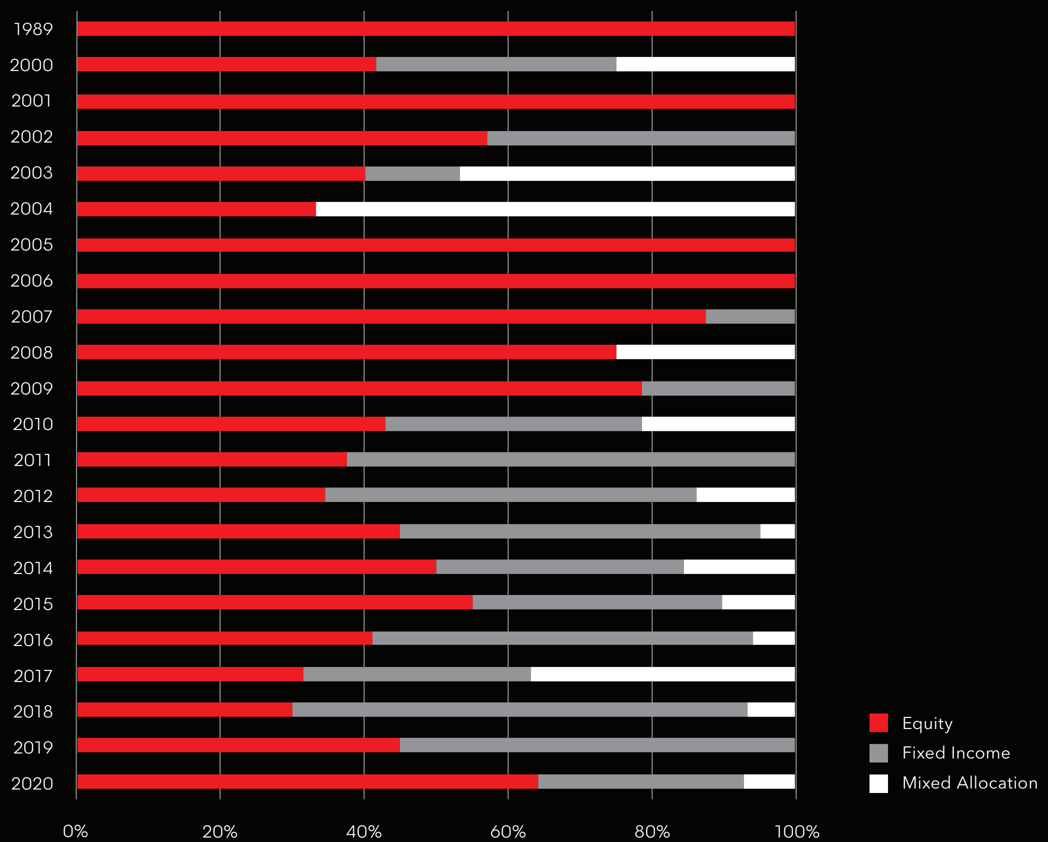
Section 1
Historical sector trends

Hong Kong has always been a vital gateway between China and the rest of the world. With an ideal combination of mainland connectivity and transparent, well-regulated markets, Asia's World City has cemented its position as one of the world's most important financial hubs – an essential part of the infrastructure bridging onshore opportunities with foreign liquidity pools.

Drawing on extensive data compiled by Bloomberg's Global Data team, we outline here some of the key historical attributes and focus areas of HKCAMA member funds. Although not a comprehensive representation of the entire China offshore fund sector, the trends highlighted provide a powerful insight into how the sector has evolved over time.

Fund asset allocation

Changes in funds asset class over the year



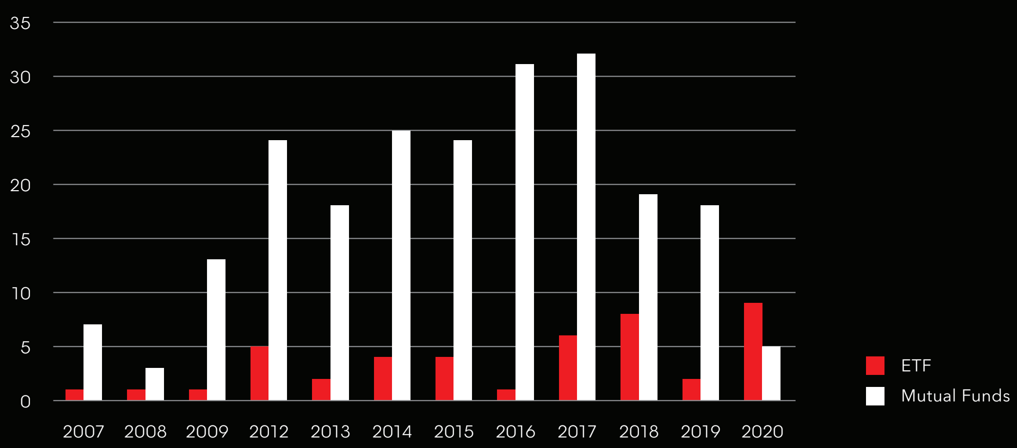
The graph above shows changes in asset class allocation trends over the past twenty years. Following their establishment in 1989, funds invested primarily in equities – a trend that continued for a decade.

In 2010, funds began moving toward a more mixed asset allocation, with fixed income taking up a larger share. This shift into fixed income – at times making up more than half of the portfolio – was primarily driven by low interest rates and, more recently, has been compounded by fiscal stimulus during the 2020 pandemic.

These trends can also be observed beyond the offshore fund sector, with many global funds diversifying over the past decade to accommodate investors seeking greater stability.

Fund types

Number of funds launched over the year

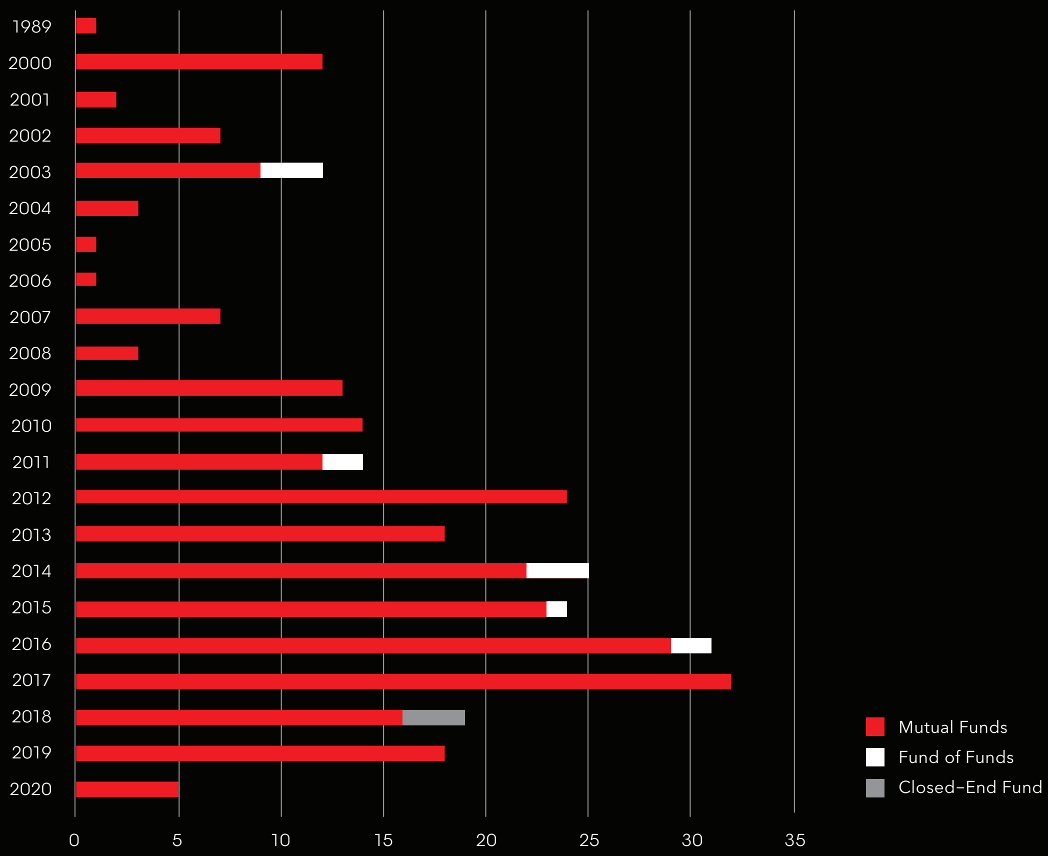


The total number of offshore China funds launched annually has grown steadily over the years.

From 2012, the number of ETFs established annually (as a proportion of total funds established) has grown as well, with roughly one-fifth of new funds launched each year being ETFs. This is in line with global trends that show a growing demand for passive investment, especially in thematic or smart-beta funds.

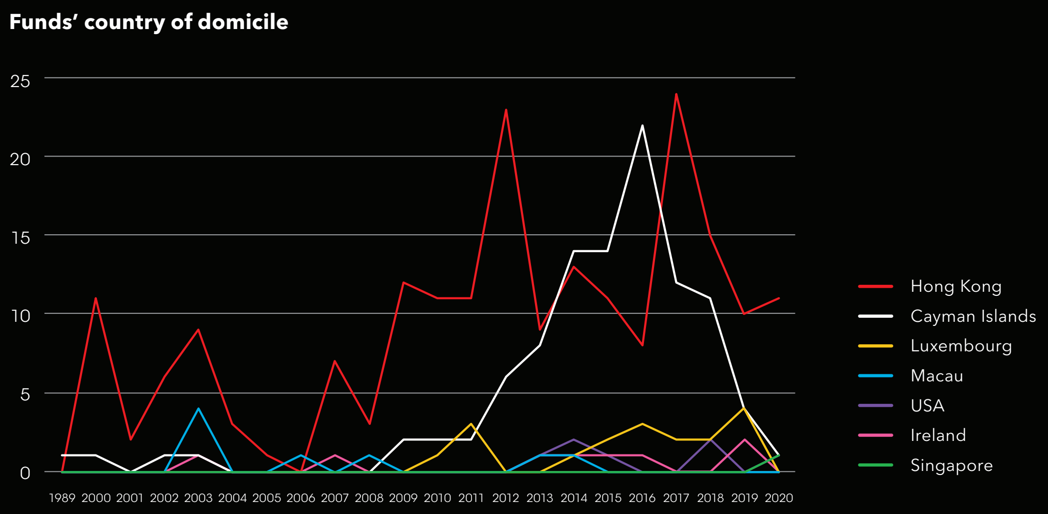
An increase in HKCAMA membership and the steady increase in mutual funds/ETFs/private funds created over the years suggests that more and more Chinese asset management firms are shifting their focus to Hong Kong. The significant spike in fund house openings since 2017 followed an increase in China-issued U.S. bonds, creating opportunities around issuing U.S.-bond-related funds, which are fixed income-focused.

Number of mutual funds launched over the year



The total number of mutual funds being established in the offshore market has also risen steadily over the past two decades, although it has dropped off in recent years. A number of fund-of-funds opened in the early 2010s, but there has not been much appetite for closed-end funds in the offshore mutual fund market. The slowdown in the number of mutual funds established by Chinese firms in offshore markets since 2017 coincides with the Chinese government's recent campaign to reduce financial risk.

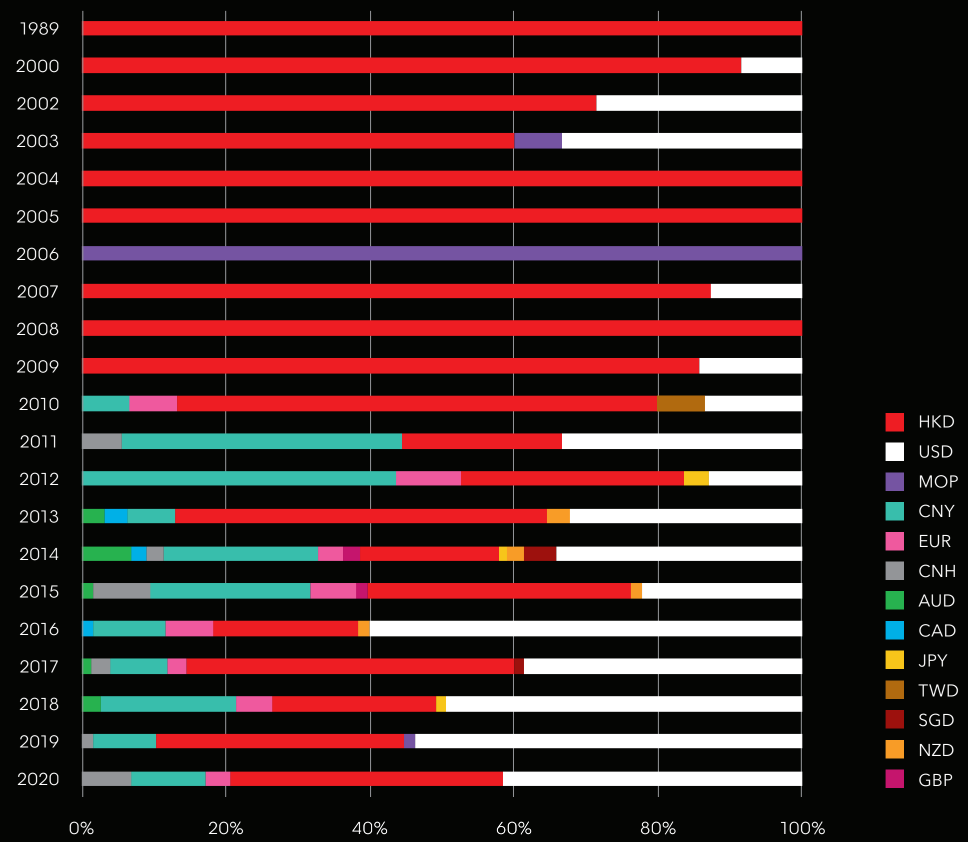
Fund country of domicile



This graph shows where offshore funds are domiciled and registered. Historically, Hong Kong has been the dominant country of domicile, because these funds predominantly focus on Chinese firms investing in offshore funds through Hong Kong. Outside of Hong Kong, there has been a rise in Cayman Islands-based funds since 2012, with most identified as private funds.

Fund share class currency

Fund share class currency (1989-2020)



This graph shows fund and investment manager views on the performance of various currencies in relation to other share classes. Historically, these offshore funds have invested mostly through HKD and some USD.

However, the trend has shifted since China began promoting RMB globalization, reflected by the base currencies in which funds choose to make their investments. Since 2011, CNY has represented an increasingly large share of the fund share class currency – a trend that we expect to continue.

The shift toward funds denominated in CNY coincides with the growing offshore circulation of the currency (CNH). However, CNY depreciation against the U.S. dollar in recent years may also affect the demand for yuan-denominated funds.

Section 2
Offshore China Fund Awards

The sixth annual Offshore China Fund Awards, held virtually late last year, offered a window into an industry now in full bloom. Jointly hosted by Bloomberg and HKCAMA, the awards draw on data compiled by Bloomberg to celebrate firms for their performance and contributions to China's offshore fund industry — and form part of HKCAMA's mission to support the development and performance of Chinese asset management institutions. Now in their sixth year, the awards have expanded from recognizing funds in just a handful of categories to awarding 35 separate honors across a wide range of competencies.

Chairperson of HKCAMA, Madam Chen Ding, commented, "As the homeland for offshore Chinese asset management institutions, the Chinese Asset Management Association of Hong Kong was formally established in 2013 to facilitate industry communication, optimize industry self-discipline standards, and improve the competitiveness of Chinese asset management institutions on the global stage." She added, "We're proud each year to host these awards with Bloomberg. They are a trusted all-weather partner, helping the offshore China community to connect and make better investment decisions."

"We are witnessing firsthand the coming-of-age of China's financial markets, which have been creating new opportunities for global investors to connect and launch innovative new products. We look forward to seeing further growth and performance from this exciting community of sophisticated offshore investors," **Bloomberg's head of APAC, Bing Li,** said at the event.

"Thanks to the wealth that our industry manages, Hong Kong is now the largest hedge fund and second-largest private equity fund hub in Asia," **financial secretary of the Hong Kong Special Administrative Region Government, Paul Chan,** said during the awards ceremony.

He pointed to recent innovations, including the creation of a limited partnership fund regime and Wealth Management Connect as fostering growth. The latter is a program that enables cross-border wealth management services to residents in GBA.

Mr. Chan described those innovations as "game changers for the sector and catalysts for the industry." While global companies keen to access the China market may already have operations in Hong Kong, the implementation of these programs in the GBA is likely to offer them even greater opportunities.

Section 3
Key insights from leading China offshore asset managers

In this section, we share insights from leading offshore Chinese fund houses on what they expect will shape investment and market trends this year, focusing on offshore China and the GBA development.

In 2021, our expert respondents see growth drivers varying across regions. On top of the COVID-19 crisis and widening social inequality, political developments – including the inauguration of the Biden administration, China's new five-year plan, more diverse connection mechanisms in the GBA and the continual rise in geopolitical tensions – will also influence the way investors allocate their resources in 2021.

Below, we explore the different macro themes provided by leading offshore Chinese fund houses that have their fingers on the pulse of the GBA's development. The consensus reveals that China's outperformance and continued internationalization will drive greater foreign interest in the renminbi (RMB or Chinese yuan) and China-linked assets. All the while, Hong Kong will continue to be an important part of this story as a strategic hub for China's financial opening-up process.

Investment strategy

Given the optimistic outlook for China's economy, the fund houses were largely aligned on the sectors and industries that showed the greatest development potential and opportunities in 2021. Private consumption, pharmaceuticals and the technology sectors, as well as the new energy sector, were common areas highlighted by industry respondents. Others noted that a shock like the COVID-19 pandemic also creates plenty of disruption, which will likely boost new business models. While disruption has short-term costs, these emerging business models will be able to generate strong returns in the long run, especially if investors invest in the right areas.

"The boundaries between industries have become very blurred. Traditional manufacturing has gradually been replaced by business models of the new manufacturing industry. And, in recent years, many manufacturing companies have seen product innovation and automation upgrading to achieve stronger and better products with more efficient operations. Similarly, in the consumer sector, many have had to upgrade their business models to adapt to the new internet age, with those that fail to adapt becoming obsolete. Therefore, the most important thing is not to look at a single industry, but to look for excellent companies from the bottom up. These companies can help investors achieve sustained profit growth," said **Sunny Yang, Associate Portfolio Manager at China Universal Asset Management.**

"Given the low interest rates globally, fixed income returns are falling and unable to meet investors' demands. This has led to the so-called 'fixed income+' strategy, which has gained popularity in China's domestic market. The '+' refers to including certain positions in equities, convertible bonds or maybe quantitative strategies in tandem with the traditional fixed income products. We see these types of products having relatively large investor demand in the future," said **Kai He, Head of Fixed Income at Bosera International.**

Other factors, including rising geopolitical tensions and an increasingly bipolar U.S.-China environment, have also encouraged the emergence of new industries and catalyzed China's economic transformation from traditional manufacturing-driven growth engines to smarter industries. The surveyed participants emphasized that the downward pressure and short-term impact of external issues, for example U.S. sanctions on Chinese companies, were of little concern.

"For some companies impacted by the U.S. sanctions, we have seen some downward pressure on their stock prices, but this trend is only on the surface and the companies continue to exhibit strong fundamentals. As such, this could also be a very good opportunity for some investors because these companies are now traded at a discount while still having strong fundamentals," said **Victor Tsang, Senior Portfolio Manager at Guotai Junan International.**

"For China's technology industry, anti-trust issues are suppressing valuations in the short term, but will help enhance the sector in the long run. When we look at the technology industry domestically and abroad, large internet companies often come under scrutiny for anti-trust issues, which ultimately make the industry and these businesses more compliant. This ensures operations are procedure-based and secures the long-term sustainable development of the entire industry," said **Martin Wang, Head of Equity Investment, ICBC Asset Management (Global).**

"Generally speaking, passive investment is growing rapidly from a global perspective. This is because, whether for ETFs or passive management, fees are relatively low and the diversification of passive products evolves quite fast. Passive products, especially ETFs, are relatively transparent and more convenient to trade, which may affect future investment patterns on online platforms and even in the field of online brokerages," said **Yi Wang, Head of Quantitative Investment, Senior Executive Director at CSOP Asset Management.**

Internationalization of China-linked assets

China's weight and importance in global investment benchmarks have steadily risen in recent years, including the entry of RMB bonds into the Bloomberg-Barclays Global Aggregate Bond Index in 2019. The fund houses unanimously said that the increase in accessibility has resulted in a rise in foreign interest in RMB- and China-linked assets.

"More and more clients have become interested in Chinese assets, and their allocation to Chinese assets has been increasing. From the perspective of disparity in economic growth, spreads, efficiency, room for policy adjustments and other factors, the attractiveness of Chinese assets is expected to further improve," said **Stephen Zhang, Sales Manager at Da Cheng International Asset Management.** "The value allocated to Chinese assets is expected to keep increasing in 2021 and beyond, because China's growth in 2021 is likely to be one of the fastest among major economies."

"Overseas investors have become increasingly interested in investing in A-shares, which is evident from the daily net northbound inflows. This also signals that the doors to China's A-share market have been completely opened to overseas investors. The weight of A-shares within MSCI's world index has also been growing, which has boosted the importance of A-shares globally," said **Jun Ning, Investment Manager at Fullgoal Hong Kong.**

"At present, there is strong demand among overseas investors for domestic RMB bonds, especially interest rate bonds, even though these bonds have no, or very few, international ratings. With the yield spread on 10-year Chinese government bonds at a record high of around 2% and expectations of a stable RMB exchange rate, China's local currency interest rate bonds offer inherent value and overseas investors are keen to invest in Chinese government bonds. ICBC Asset Management (Global)'s public funds can also invest in domestic RMB bonds through Bond Connect," said **Michael Wang, Head of Fixed Income, ICBC Asset Management (Global).**

Hong Kong opportunities in the China context

There was a common belief among the fund houses that Hong Kong plays a unique role in the context of China, with many highlighting that the quality of Hong Kong stocks and the steep discounts compared with the mainland provide opportunities for the city's market. Additionally, the relaxation of listing rules on the Hong Kong Stock Exchange and new tide of homecoming listings has significantly increased the number of IPOs and capital raised.

"There are many good opportunities for high-quality Hong Kong stocks with low valuations. Based on global periodic resonance theory, the sectors and manufacturing industries in the midstream and downstream of the cycle should be the focus of investment in 2021," said **Natalie Wong, Associate Director Marketing and Client Services at BOCHK Asset Management.** "As some overseas-listed Chinese stocks return, companies that were previously preparing for U.S. IPOs will now also be looking at the Hong Kong stock market. The growth of new economy growth sectors in the Hong Kong stock market will accelerate."

"Compared with the A-share market, the Hong Kong stock market has some highly discounted listed companies with good fundamentals that offer a number of possible investment opportunities. Judging from the data, the strong net southbound inflows in recent months prove the investment potential of the Hong Kong stock market," said **Victor Tsang, Senior Portfolio Manager at Guotai Junan International.** "We also expect that more American depositary receipts from the United States will return to Hong Kong, giving investors more quality choices and resulting in a significant improvement in the turnover value of Hong Kong stocks as a whole."

"Hong Kong continues to be a gateway for Chinese investment looking to go abroad as a large number of Chinese institutions set up branches in Hong Kong with various cross-border products, with QDII or QFII products in Hong Kong particularly active," said **Yi Wang, Head of Quantitative Investment, Senior Executive Director at CSOP Asset Management.**

"It's the best time to invest in China. China is undergoing economic transformation, and the transition between old and the new economy brings a lot of new business models and companies. The listing of both A shares and H shares is growing, especially in Hong Kong where there are a lot of bio pharmaceutical listings of late. However, there are also some unprofitable companies being listed," said **Sunny Yang, Associate Portfolio Manager at China Universal Asset Management.**

Risk outlook for 2021

While there are opportunities and optimism in the region, most of the surveyed participants noted that the risk of shifting geopolitics, rising inflation and liquidity remain major considerations in their investment strategies for this year. Adding to the list of concerns, many participants also highlighted the lingering impact and resurgence of COVID-19 cases in the region and globally as points of concern and caution for investors in 2021.

"The sustainability of China's economic recovery may falter in the second half of 2021 and China's share in export markets may change as other countries emerge from the pandemic. Uncertainty remains on the long-term stability of China's consumption recovery and disposable household income. On the policy front, the pace of China's macro leverage, social finance and credit tightening adds to concerns about the economic recovery. Investors should closely monitor these developments," said **Forest Peng, CEO at ICBC Credit Suisse Asset Management.**

"Compared with liquidity, the bigger risk is the bottom-up fundamental problem enterprises face: the risk that their profits fall short of expectations. Many companies with high valuations amid a low risk-free rate environment may get caught in a double-whammy on both downgraded valuations and earnings if their profits do not meet expectations," said **Martin Wang, Head of Equity Investment, ICBC Asset Management (Global).**

"In 2020, major economies around the world loosened their monetary policies to support economic recovery, which created a positive environment for financial assets; but as economies around the world gradually stabilize, central banks will look to tighten their policies in 2021. Added to this are the geopolitical risks associated with rising U.S.-China tensions, which means that investors should closely monitor the U.S. government's China policy," said **Natalie Wong, Associate Director Marketing and Client Services at BOCHK Asset Management.**

Connecting opportunities in the Greater Bay Area

Finally, participants emphasized the importance of Hong Kong as an international financial center and offshore RMB hub and anticipated the launch of the Wealth Management Connect in the GBA being another important milestone for the mainland's capital account liberalization following the Stock Connect and Bond Connect schemes. The launch of Wealth Management Connect is expected to provide investors with greater product diversity and asset allocation options, while also raising the bar for local financial institutions in terms of product design, service quality and risk management.

"During the initial phase of the Wealth Management Connect, wealth management products such as mutual funds or stable bond products with a lower level of risk and less complex structure may be introduced first, and we expect these to be highly welcomed by investors," said **Kai He, Head of Fixed Income at Bosera International.**

"We have plans to include our Hong Kong-based mutual funds in the cross-boundary Wealth Management Connect scheme once operational to provide an even more convenient channel for domestic investors to invest overseas," said **Michael Wang, Head of Fixed Income, ICBC Asset Management (Global).**

Section 4
Emerging opportunities in offshore China asset management

By Sharnie Wong and Francis Chan
Source: Bloomberg Intelligence

From our research into this fast-changing and exciting chapter in China's economic evolution, we have identified six key factors that could play a significant role in growing the region's offshore asset management industry.

First, we explore the opportunities presented by the creation of southern China's Greater Bay Area economic cooperation project. Next we take a look at Shenzhen, a city that's been designated a special technology zone and is expected to be a major creator of wealth. Efforts to develop the region's nascent ETF market and its expanding IPO market are detailed thereafter. Finally the burgeoning mutual fund industry is examined before we chart the potential for the creation of a local derivatives market.

Greater Bay Area wealth door to open

One of the most exciting developments for offshore asset managers is the Greater Bay Area (GBA) initiative, which is hoped will free up investment in and from the region. Comprising the semi-autonomous regions of Hong Kong and Macau as well as nine cities in neighboring Guangdong province, the region was given special economic status in July 2017. An official development office was created to oversee closer cooperation among the cities of the border-straddling region and to foster hubs of technological and financial innovation that build on the international expertise of Hong Kong.

The GBA's population of 70 million will be a testing ground for efforts to deregulate cross-border investments in wealth products and funds. And, with a variety of development programs in place, it's anticipated that the GBA could double the accessible wealth market of Hong Kong-based asset managers within a decade.

The GBA broadens the appeal of the southern Chinese region beyond Hong Kong. Guangdong, for instance, has a GDP of $1.6 trillion, and the Hurun Institute estimates 252,000 of the province's households have more than 6 million yuan of investable assets, versus 194,000 such households in Hong Kong.

Importantly, the region includes Shenzhen – oft-touted as an example of the Chinese economic miracle – which is being developed by the government as a global technology hub and special trade zone. This initiative is likely to enhance Hong Kong's role as a financial center and increase the prosperity of the GBA more broadly.

Hong Kong as wealth hub

Rising economic prosperity in China offers opportunities for Hong Kong financial firms to tap the nation's growing wealth. Mainland clients already contribute significantly to Hong Kong's private-wealth assets under management (AUM). The figure was 14% in 2019, while 50% came from local residents — and was likely boosted by wealthy mainland migrants, 820,500 of whom settled in the city between 2002 and 2019.

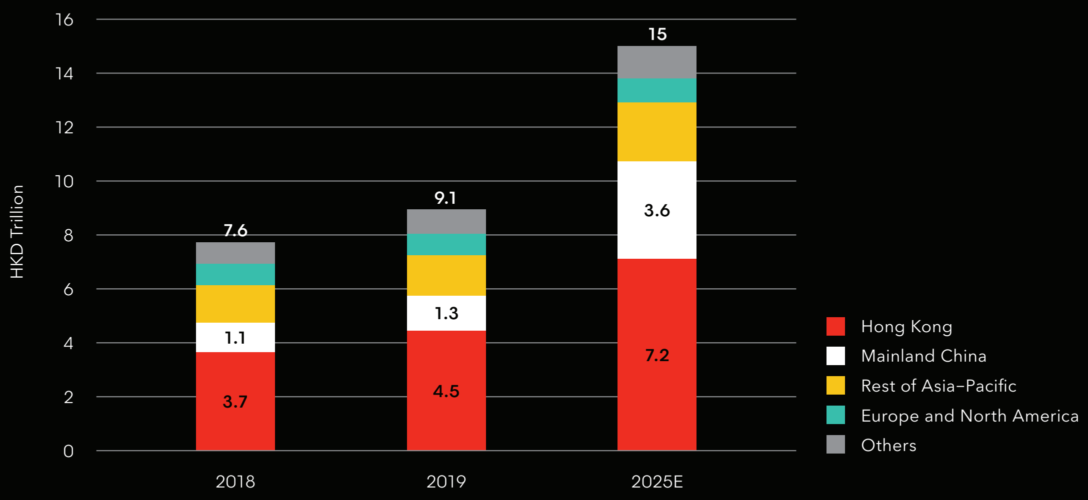
Those proportions could change dramatically. AUM sourced from mainland and local investors could rise more than 10% annually to HK$10.8 trillion by 2025, making up 70% of Hong Kong's total, based on the Bloomberg Intelligence scenario using Securities and Futures Commission data.

The mainland Chinese and Hong Kong governments proposed building on this potential in June 2020 with the creation of Wealth Management Connect (WMC), a program to allow easier cross-border investment in financial products. A memorandum of understanding outlining its principles was agreed to in February 2021. This initial pact provides for the foundational mechanisms that will enable transactions as well as investor-protection measures, including anti-money laundering and regulatory arbitrage processes.

While it is hoped WMC will be less restrictive than the Mutual Recognition of Funds (MRF) program under which asset managers currently work, the total WMC quota may only be 150 billion yuan each way and an individual quota of one million yuan could apply, according to the Hong Kong Monetary Authority. The MRF program is discussed in more depth later in this report.

As the hinterland develops, the commitment to Hong Kong of large private banks such as UBS, Credit Suisse, HSBC, Julius Baer and Morgan Stanley could enable them to tap private-banking opportunities. Some are already committing more resources and personnel to China. Credit Suisse expects to double its headcount in five years, while HSBC plans to hire up to 3,000 wealth planners within four years.

Hong Kong private wealth AUM by investor origin



Source: Hong Kong Securities and Futures Commission, Bloomberg Intelligence

Wealthy households by investable assets, 2018

	Number of households (Thousands)			
Number of households with total investable assets of	**Greater China**	**Mainland China**	**Guangdong**	**Hong Kong**
6 million yuan +	1,780	1,420	252	194
10 million yuan +	1,060	850	162	114
100 million yuan +	75	62	9.7	7.3
\$30 million (~200 million yuan) +	53	44	6.6	5.1
Households with more than 6 million yuan of investable assets as % of total Greater China		80%	14%	11%

Source: Hurun Research Institute, Bloomberg Intelligence

China's ambition in Shenzhen bodes well for Hong Kong banks

One of the great successes of the GBA has been the city of Shenzhen, which has grown from a tiny fishing village across the border from Hong Kong into a major financial hub with its own stock exchange. The city is China's first special economic zone and is a technology-focused economic powerhouse that has been dubbed China's Silicon Valley. Its GDP is among the highest of the cities in the GBA.

The granting of greater autonomy and liberalized business regulation in Shenzhen may boost a wide range of revenue streams at Hong Kong banks. Additionally, reforms to build Shenzhen into a global technology hub may complement Hong Kong's financial-center role and the GBA's development.

Eased rules

China eased rules on custodian services and bond underwriting last year, after earlier allowing overseas banks to conduct bankcard clearing. Restrictions on branches, local incorporation, ownership and capital were scrapped in 2019.

Favorable capital-market reforms for technology start-ups, new futures products, real estate investment trusts, offshore local government bonds and currency funding pools have been established in Shenzhen. That could boost revenue in securities trading, asset management and trust and custodian services.

For Hong Kong banks, this presents an opportunity to leverage their units in the city to serve domestic and overseas investors in expanding "Shenzhen" products. HSBC, Hang Seng Bank, Bank of East Asia and HKEx, for instance, have had joint ventures in the Qianhai district since 2017 thanks to the Closer Economic Partnership Arrangement between the mainland and Hong Kong.

Proposed reforms for private equity funds, third-board companies, China Depositary Receipts and intellectual property protection should reinforce Shenzhen's advantage as a technology hub. By permitting only limited competition with Hong Kong's existing financial business, the two cities should be able to support each other's continued development.

Currency pools

Additionally, new currency pools and offshore local government bonds could help promote yuan internationalization, a process in which Hong Kong participates.

Wealth fees from new Shenzhen products could deliver additional revenue to Hong Kong banks. HSBC charges Hong Kong retail clients 1.5–3% for initial subscription to open-end funds, for example, and switching fees of up to 1%.

Brokerage is also among the largest fee segments for Hang Seng and Bank of China Hong Kong (BOCHK). More retail and institutional investors may buy Shenzhen products through the banks, and the attraction of more private-equity firms, investment funds and tech start-ups to Shenzhen could boost trust and custodian services.

In the first half of 2020, brokerage, insurance, fund, trust and custodian fees accounted for 45% of Hang Seng and 67% of BOCHK's gross fee income. For HSBC, one of Asia's biggest custodian banks, investment distribution fees were 60% of its wealth management revenue.

While clouds are on the horizon in the form of geopolitical tensions between China and the U.S., the inauguration of a new president in Washington may herald a fresh approach from the White House that could at least dispel some concerns. However, in the worst case, if the Sino-American rift widens over time, foreign banks' share of the 300 trillion yuan market may shrink to 0.6% in 2025 from 1.1% last year.

Favorable 'Shenzhen' measures to Hong Kong banks

Business potential for Hong Kong banks	**Hong Kong financials in Qianhai, Shenzhen**
Trust, custodian services Asset management Securities trading	HSBC Qianhai Securities East Asia Qianhai Securities Qianhai units of Hang Seng Bank Qianhai mercantile exchange (HKEx)

- New shares and China depository receipts issuance for technology start-ups
- Issuance of offshore local government bonds in Shenzhen
- Creating RMB, forex funding pools for cross-border securities and derivatives trades
- Mechanism for the new third-board companies' transfer to mainboard
- Improving access to and regulations on private equity funds
- Shenzhen stock market futures and other stock futures products
- Promoting real estate investment trusts on transportation, water supply, logistics and industry parks
- Promoting fintech, green finance
- Bettering laws and business registration process for technology start-ups

Source: China's State Council, Qianhai Shenzhen-Hong Kong Modern Service Industry Cooperation Zone, Bloomberg Intelligence

Hong Kong aspires to be China's ETF gateway

The offshore Chinese asset management sector is also eager to take advantage of the growth potential of the region's exchange-traded funds (ETF) sector. Demand for ETFs among Chinese investors is surging. Inflows to mainland structures had risen an average 32% in the past decade to a trillion yuan by the end of September 2020.

Because of the highly domestic-focused ETF industry in China, Hong Kong would be able to provide a trusted conduit through its own highly developed market. The city can help mainland Chinese investors allocate capital across asset classes, geographies and currencies. Furthermore, because ETFs on the mainland are traded in yuan, accessing Hong Kong's ETF sector can provide mainland investors with exposure to the city's own currency and U.S. dollars. Hong Kong could also provide greater exposure to the Asia-Pacific and overseas equities as well as fixed income- and currency-based products, in contrast to China's domestic funds, which are locally focused.

New economy and money market strategies

The growing popularity of thematic, money-market and commodity funds may lift mainland China's ETF assets, even after they climbed 37% in the first nine months of 2020, faster than 15% growth for the Asia-Pacific region. The pipeline of Chinese technology IPOs on mainland and Hong Kong exchanges could generate demand for thematic ETFs. ETFs — enhanced by the increasing popularity of robo-advisories within the retail sector — could also catalyze the expansion of the broader Asian ETF sector, which is tiny compared with those of the U.S. and Europe. More fund providers that offer exposure to international and fixed income assets could be two key sources of growth in Asian institutional portfolios.

Authorities identified opportunities to connect Hong Kong and mainland China's ETF market long ago and have launched a pilot scheme, with Hong Kong's securities regulators authorizing two locally listed feeder ETFs to each invest 90% or more of their assets in an approved fund in Shenzhen under the Renminbi Qualified Foreign Institutional Investor (RQFII) program. At the same time, China's regulator approved two Shenzhen-listed ETFs to each invest in a Hong Kong-listed ETF through the Qualified Domestic Institutional Investor (QDII) program.

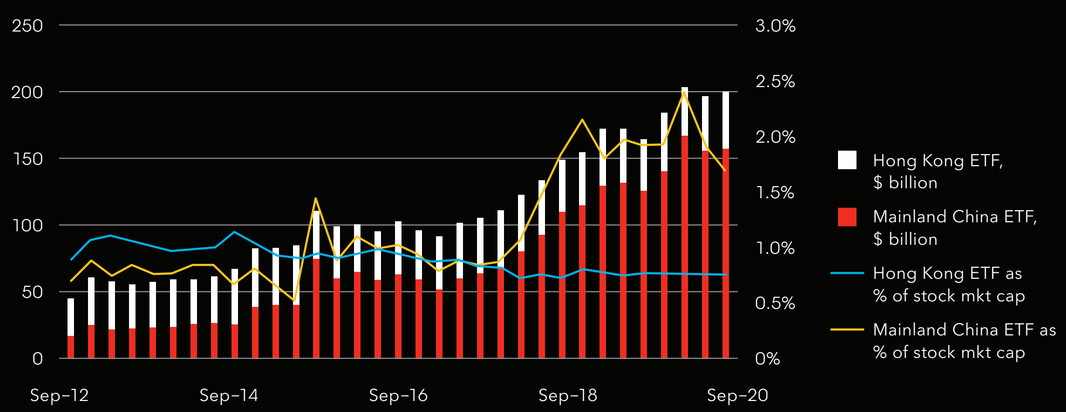
Challenges of a swift transition

The prospects of a swift transition to full cross-border ETF trades may be hampered by several factors, however. The creation of ETF Connect has been delayed as regulators from both sides continue to examine technical and operational issues between the Hong Kong and mainland markets. If the experience of Stock Connect is any gauge, the movement of capital southward is likely to build gradually, taking maybe two years before trading contributes even 5% to Hong Kong's ETF turnover.

Even when momentum does reach a critical level, the contribution of ETFs to Hong Kong market operator HKEX's revenue may be less than 1% in the first five years.

Additionally, each jurisdiction's market is differently structured. China's is dominated by retail investors who are less enamored of passive structures, while Hong Kong's is led by institutions that prefer more diversified portfolios.

ETFs' market capitalization, $ billion



Source: Bloomberg **FSRC <GO>**, Bloomberg Intelligence

China’s IPO pipeline could top global market

China’s bulging IPO pipeline is likely to reap rewards for Hong Kong and GBA managers as overseas and domestic investors seek to grab a piece of what is forecast to become one of the world’s largest listings market.

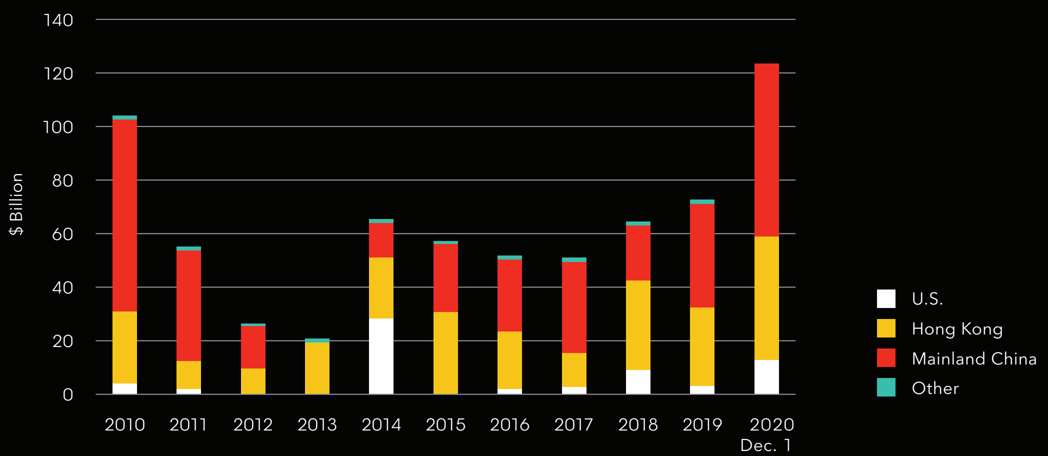
Domestic listings of unicorn companies – start-ups worth more than $1 billion – could rise as China’s economic recovery, capital-market reforms and geopolitical risks boost the allure of its exchanges as capital-raising venues.

China’s venues are predicted to be the chief beneficiaries of this surge in listings and may dominate the IPO market in the next five years.

Hong Kong may gain more secondary listings of U.S.-listed Chinese companies as well as dual listings on either side of the mainland border to appeal to offshore investors. Consequently, although Shanghai’s and Shenzhen’s IPO deal market share may reach 25% between 2021 and 2025, Hong Kong is still likely to grab 15%, according to Bloomberg Intelligence.

Among brokers expected to see their fee income surge as the IPO pipeline bears fruit are CICC and Citic Securities, which topped the APAC ex-Japan Equity IPO league table in 2020. Securities firms such as China Galaxy can also expect to see a revenue bump.

China’s IPO pipeline



Note: Based on IPO pricing data which differs from exchange data based on trading date.
Source: Bloomberg **IPO <GO>**, Bloomberg Intelligence

Mutual fund growth opportunities

Market liberalization combined with the growing need for mainland investors to diversify their portfolios could fuel the rise of the GBA's mutual funds industry and deepen its capital markets.

There is already appetite for these structures. Net assets of Chinese public funds saw a 21% rise in the nine months through September 2020, according to AMAC. The AUM of Hong Kong public funds authorized to sell on the mainland may also climb.

Financial institutions with Hong Kong operations would be best placed to take advantage of GBA opportunities, acting as springboards for cross-border investments, while attracting new clients from the mainland.

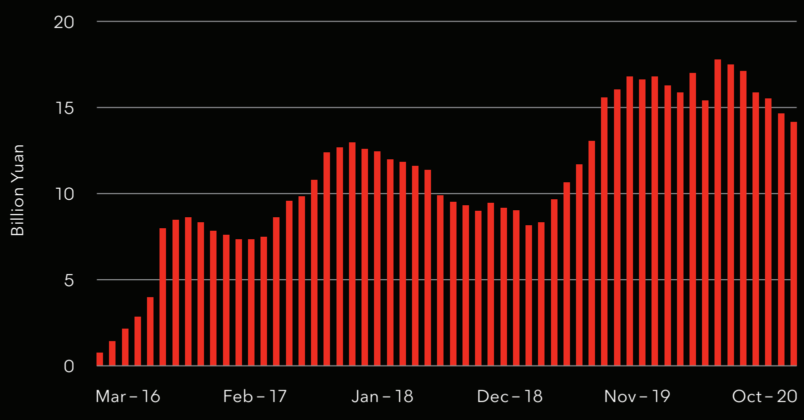
Already provisions for cross-border funds sales are in place through the MRF. Net of redemptions, these transactions reached 14 billion yuan at end of October 2019 — tiny compared with the city's $1.7 trillion of AUM of authorized unit trusts and mutual funds at the end of the same year.

The MRF was established in July 2015 when the investment quota was set at 300 billion yuan for net fund flows between the two jurisdictions. While it provides investors in both markets with more choices for fund products and the ability to diversify portfolios, the MRF is restrictive. Only equity, bond, index and mixed-asset funds can trade, while those based on money markets, commodities and real estate cannot.

The MRF is further limited by regulations that require half of all trades to originate in Hong Kong and that all funds be domiciled in the city. They must also have a minimum of 200 million yuan and a track record of at least a year.

Nevertheless, the GBA's GDP is more than four times that of Hong Kong's at 2019 values, presenting significant opportunities for the city's fund managers to expand.

Hong Kong fund sales in China under MRF



Note: Net of redemptions.
Source: State Administration of Foreign Exchange, Bloomberg Intelligence

Derivatives a priority amid China reform

The development of China's derivatives market and expanded access for international participants could provide a key revenue opportunity for offshore managers. China's derivatives market, which accounted for just 11% of the world's derivatives volume and 2% of open interest, could close the gap with the U.S. over the coming decade.

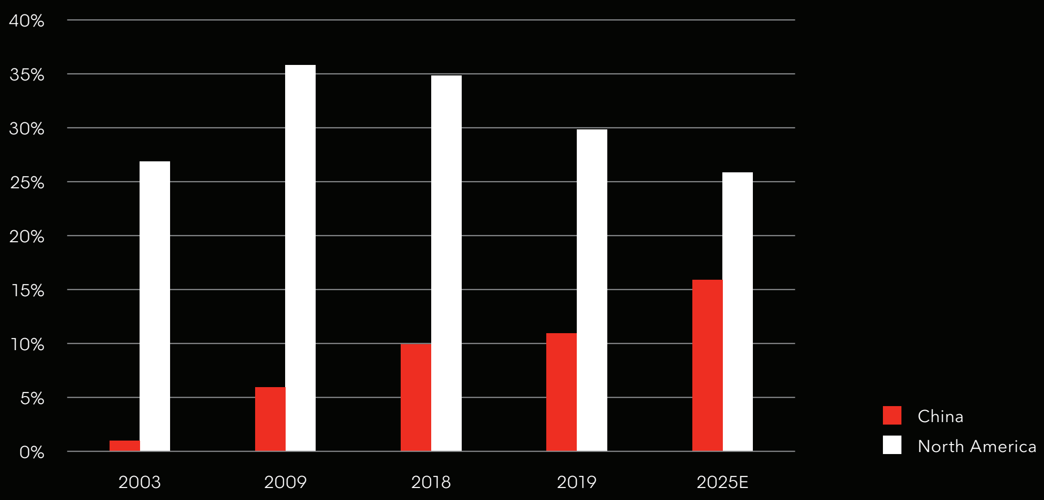
Allowing international participants direct access to trade yuan-denominated futures on China's exchanges is a key step to the internationalization of the country's financial markets and currency. Foreign companies could follow the lead of JPMorgan, which became the first global bank to fully own a futures firm in China following approval in June 2020.

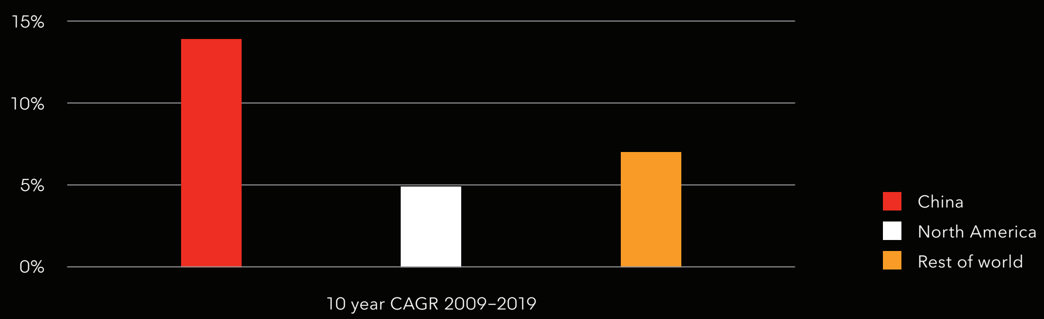
It is likely, however, that China would prioritize commodity derivatives over financial derivatives in the next five years, as the country aspires to become a price-setter of key global resources. China is not only the world's largest oil importer but also accounts for more than half of global consumption of cement, nickel, coal, copper and steel. It's expected, therefore, that mainland commodity futures would likely find strong uptake.

That would be a boon to Chinese brokers, building on the 32% growth in fee income experienced by the three largest H-share-listed Chinese brokers in the past half decade.

Haitong Securities, which generated gross fee income from futures of 1.4 billion yuan in 2019, could see revenue contribution rise 6% if its gross futures fee income grows at the same pace over the next three years (as the 29% CAGR did from 2014-19).

China’s derivatives volume share to rise





Source: Futures Industry Association, Bloomberg Intelligence

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