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# Viewpoint

Fund distribution  
strategies in Asia Pacific



This paper explores the ongoing changes to cross-border investment fund distribution in Asia Pacific. It examines the success of Undertakings for Collective Investment in Transferable Securities Directives (UCITS), the way that patterns of demand are changing, and some of the obstacles to greater pan-regional activity. It also sets out some possible trends in cross-border fund sales and ends with a call for asset managers to avoid being left behind by market developments.



## Asian fund markets remain very distinct, but have huge growth potential

This, our latest paper in the asset management *Viewpoint* series, focuses on the Asia Pacific market. It draws on a panel discussion that took place during Ernst & Young's recent Asset Management Executive Plenary in Hong Kong. The discussion explored potential changes to patterns of investment fund distribution in the region, with a particular focus on cross-border activity.

Asia Pacific investment fund markets are highly diverse in terms of size and maturity. They range from large, mature, domestically focused markets such as Japan and Australia, through more outward-looking, expanding markets like Hong Kong and Singapore, to the emerging giants of India and mainland China.

Adding to this diversity, investors in some Asia Pacific markets prefer to invest in property, commodities and their own businesses. As a result, funds under professional management in several of the region's largest economies remain small compared to aggregate savings. Furthermore, 2010 saw negative net fund sales in several key markets, including India, mainland China and South Korea<sup>1</sup>, as investors reacted to indifferent equity performance. In India, demand was further weakened by new restrictions on up-front intermediary fees, which boosted sales of insurance-based savings products at the expense of pure investment funds.

Despite these variations, the long-term outlook for investment fund markets in Asia Pacific remains encouraging. The past 10 to 15 years have shown strong aggregated growth, and the region's swelling middle class, high savings rates and limited public-sector health care provision suggest potential for further expansion. If anything, these trends have been boosted by the global financial crisis, which has tipped the scales of economics and investment more firmly towards the East.

<sup>1</sup> "Asian fund sales fail to materialise", *Financial Times*, 20 February 2011.

## Asian cross-border fund sales are dominated by UCITS, but the market is evolving rapidly

Any discussion of cross-border investment sales in Asia Pacific needs to acknowledge the success of the European Union's UCITS regime. UCITS have far outsold US mutual funds in the region, thanks partly to the treatment of capital gains in Luxembourg and Ireland, and partly to the perception of good standards of investor protection. UCITS account for a majority of fund sales in offshore-oriented markets such as Hong Kong, Singapore and Taiwan, and generate significant sales in Japan, Malaysia and Thailand. UCITS are distributed in South Korea via local feeder funds, and UCITS managed in Hong Kong have also attracted some funds from mainland China via the Qualified Domestic Institutional Investor regime.

Whatever the success of UCITS funds, they are far from being the only retail investment product in Asia Pacific. Markets in the region are maturing quickly, and while UCITS continue to play a dominant role in cross-border sales, local asset managers are also increasingly eager to develop local products tailored to Asian investors' requirements. Many firms are focusing on funds incorporating a capital guarantee element, and others are hoping to offer their high net-worth investors a range of alternative strategies similar to those permitted under the UCITS III regime.

The growing availability to retail customers of alternative investment products ties in with another area of rapid change in Asia Pacific investment fund markets – regulation. The mini-bond scandal of 2008 pushed the topic of investor protection into the regulatory spotlight, and supervisors in the region are placing an increasing emphasis on pre-contractual disclosure, distribution oversight and risk management processes. The Hong Kong Securities and Futures Commission (HKSF) in particular is seen as having become less likely – or at least slower – to approve new funds for sale.

## **Local and global firms alike are looking to expand their footprint in Asia Pacific**

Asset managers worldwide are hoping to take advantage of the growing importance of Asia Pacific investment markets. Asian investors are increasingly focused on local opportunities, and a new wave of capital from Europe and North America is heading toward the region, leading both local and global firms active in Asia Pacific to develop their distribution capabilities.

A sign of the increasing interest in cross-border activity is bullish statements of intent from European and North American asset managers about their aspirations in Asia. As they recover from the financial crisis, a fresh wave of firms are looking to enter or expand in Asia Pacific. BlackRock and T. Rowe Price have all made recent acquisitions, and numerous other firms are searching for targets that would expand their footprint or complement existing capabilities.

Many Asian asset managers are looking for different methods of expansion – developing products that can be distributed in Asia, Europe and elsewhere. With this in mind, many are setting up Luxembourg-domiciled UCITS funds with the objective of distributing them worldwide. A number of Asian firms are also looking to expand geographically within the region. Australian and Japanese firms are among those considering investments in other Asia Pacific markets, and several Chinese asset managers have opened offices in Hong Kong.

Whatever the strategy adopted, Asian and global asset managers usually have similar strategic goals. These are typically to offer customers a global range of investments and to attract new customers to existing areas of expertise. In these circumstances, it is only logical that local and global asset managers want to increase levels of cross-border sales in Asia Pacific. However, they face two significant obstacles.

## **Asia Pacific investment markets still lack a cross-border fund product**

The first barrier to higher levels of cross-border fund distribution is the lack of an Asia Pacific fund product that could achieve UCITS-like acceptance across the region. The problem is illustrated by the fact that Hong Kong-domiciled funds cannot currently be sold in Singapore – and vice versa. Asia Pacific asset managers would welcome a product template that could bypass national variations in tax, regulation and governance.

The concept of an Asia Pacific fund passport is not new, but it has been given a boost by the Australian Government's formal proposal to set up a new regional scheme. The potential benefits are obvious, including broader investor choice, easier capital flows and more efficient fund structures. In theory, an Asian fund passport scheme would allow a compliant fund to be offered for sale in every signatory nation.

In practice, a pan-regional regime looks very hard to achieve. The global financial crisis may have led to a degree of regulatory convergence, but there are still huge differences in governance, tax treatments, market maturity, customer preferences and legal systems to overcome before a true passport scheme could emerge. Agreement would also be needed on product licensing, monitoring, disclosure, sales practices and enforcement. The fact that many asset managers remain skeptical about a pan-Asia Pacific fund passport is an indicator that it will remain little more than a concept for the foreseeable future.



## Entrenched patterns of distribution are a real challenge to cross-border business

The other major obstacle to greater cross-border business within Asia Pacific is the question of distribution. The greatest challenge for new entrants to any Asia Pacific fund market is developing relationships with local distributors. In many countries in the region, a handful of local banks dominate mass-market and mass-affluent distribution, with financial advisor networks and private banks typically controlling the majority of high net-worth relationships. Getting products onto these distributors' recommended lists is a crucial consideration and one that often trips up new arrivals. Asia Pacific is far from unique in this regard; achieving good distribution in Europe can be equally challenging – and expensive – for new entrants.

Some firms are responding by setting up distribution partnerships with counterparts in other markets, sometimes supported by a strategic investment or cross-shareholding. More than one distribution agreement has been established between UK and Japanese firms in the past two years, for example. As already discussed, some Asia Pacific asset managers are also considering setting up – or acquiring – operations elsewhere in the region, especially if their home markets are mature. However, expanding in this way is new to many in the industry, so firms are typically feeling their way forward slowly.

The distribution challenge is perfectly illustrated in mainland China. Market fundamentals are highly attractive, but fund distribution is dominated by the four largest domestic banks, with local asset managers benefiting from strong brands and established relationships. Foreign houses seeking distribution have typically formed joint ventures with local firms, although outside ownership remains capped at 49%. More than 30 such

arrangements are already in place but, in most cases, these only operate within a handful of large cities. The topic has been discussed as part of the Sino-US Strategic and Economic Dialogue<sup>2</sup>, but with no concrete plans for change yet announced it looks likely that opportunities for foreign firms to enter the Chinese market will remain few – and potentially very expensive – for the foreseeable future.

## We expect to see a variety of fund distribution strategies emerge in Asia Pacific

Despite these obstacles, we have no doubt that the asset management industry will find ways to develop cross-border fund sales in Asia Pacific. The question is: how? We are certain there will be no single answer. Asia is not Europe – there is no common currency or regional rule-making body, and one strategy will never work for the entire region. Instead, we expect to see several approaches to regional fund sales over the next few years.

First, we would not be surprised to see an intra-regional distribution agreement emerge, even if a true Asia Pacific fund passport looks far off. Given Hong Kong's desire to defend its role as a financial center within China, a bilateral agreement with the mainland might be a likely starting point. Alternatively, a core group of countries including Australia – perhaps Commonwealth nations with comparable legal systems – could be created. We think it may prove easier to develop a new model or platform than to try and adapt existing rules and practices. The examples of Luxembourg and Ireland show that early movers are most likely to develop critical mass, and the same could be true for any cross-border agreement.

<sup>2</sup> "China's fund sales reform won't challenge local banks' dominance", Reuters, 11 May 2011.





Nonetheless, we do not expect asset managers in Asia Pacific to wait for formal cross-border distribution agreements that may take years to emerge. As already discussed, we expect firms in the region to continue to set up European UCITS funds that can be sold in a variety of European and Asian territories.

Our next prediction is that managers in key cross-border hubs such as Hong Kong and Singapore will set up UCITS-like funds with an Asia Pacific focus, with the goal of selling them in countries where UCITS are already part of the investment landscape. There is a sense in the industry that local regulators may become more willing to approve products that look and behave like a UCITS fund, even if they are locally domiciled. For example, the HKSFSC has recently approved a new retail product that offers daily liquidity, but enables investors to go long and short across a range of futures markets. This is just one of several alternative products the regulator has approved in recent months.

We also expect individual firms continue to develop bilateral or even multilateral distribution agreements, especially in more mature markets where new entrants are likely to find it particularly hard to gain a foothold.

Last, in the long term we expect Asia Pacific asset managers to acquire in Europe and other developed markets, as the surest means to lock in both product manufacturing and local distribution capabilities.

## **With many firms already adapting their distribution strategies, rivals need to stay alert**

This is a time of rapid change in the Asia Pacific funds industry. Changing patterns of distribution are a central theme, given the increasing demand for more Asia Pacific-focused products and the desire of asset managers from around the world to do more business in the region. However, firms' wishes to expand their cross-border operations are blocked by the lack of a pan-Asian fund product and entrenched patterns of distribution.

At the same time, asset managers are aware of the risk that the rapid development of Exchange Traded Funds (ETFs) and the alternative investment sector pose to traditional investment fund structures, with several exchanges in the region agreeing to cross-list ETFs.

It is too early to say what patterns of cross-border distribution will become dominant during the decade, but we believe that several themes are likely to emerge. The crucial point is that the asset management industry cannot afford to wait for inter-governmental agreements, or for an industry consensus to emerge. Many firms are already taking steps to revise their distribution strategies in Asia Pacific. Their competitors need to ensure they are not left behind.





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