# COUNTRY REPORT HONG-KONG 2008

## 1. Economic and Financial Background

**2007**

The Hong Kong economy sustained a robust growth momentum throughout 2007, with GDP registering a growth of 6.3% in real terms. (GDP growth in 2006 was at 7.0%).

On the trade front, Hong Kong's merchandise exports showed a notable growth in 2007, although the growth pace moderated somewhat in the second half of the year. Although the US and Japan markets were weak, it was compensated by the strong growth in the Mainland and other emerging Asian markets. For 2007 as a whole, total exports of goods rose by 7.2% in real terms, compared with the 9.3% increase in 2006.

Local consumption demand grew robustly in 2007, particularly in the second half of the year, on the back of rising income, a robust labour market and strong performance of the asset markets. Private consumption expenditure (PCE) grew by 7.8% in real terms for 2007 as a whole, up from 6.0% in 2006.

The labour market improved distinctly further amidst the sustained economic expansion. Total employment increased by 2.5% in 2007, accelerating further from the 2.1% gain in 2006, and the total number of employed persons reached an all-time high of 3.53 million in the fourth quarter of 2007 (and rose further to a new high of 3.55 million in the three months ending January 2008). Since the trough in 2003, a total of 366,300 additional new jobs had been created. In tandem, the seasonally adjusted unemployment rate fell to 3.4% in the fourth quarter of 2007, the lowest in almost ten years.

Consumer price inflation climbed up during 2007 alongside the sustained brisk economic expansion. Apart from the external forces such as global food and energy inflation and the weakening of Hong Kong dollar given the drop in US dollar, the strengthened pricing power of retailers because of the buoyant consumption market and the edging-up of housing cost were factors that put upward pressure on local prices in spite of the sustained productivity gains. The headline Composite Consumer Price Index in 2007 rose by an average of 2.0% over 2006, while the underlying Composite CPI (which nets out effects of public rental waiver in February 2007 and rates concession for the second and third quarters of 2007) for the year as a whole was 2.8% higher than in 2006.

**1st half of 2008**

The Hong Kong economy continued to enjoy robust growth in the first half of 2008. In the second quarter, the GDP grew by 4.2% in real terms over a year earlier, followed a strong 7.3% growth in the first quarter.

The value of total exports of goods rose by 7.1% in real terms in the first half of 2008. Within this total, the value of re-exports increased by 8.0%, whereas the value of domestic exports continued to decline by 13.3%.

While the firm labour market remained a supportive factor, the stock market correction, rising inflation and dimmer global economic prospects began to weigh on consumer sentiments. PCE rose by 3.1% in real terms in the second quarter, slower than the rapid increase of 7.9% in the first quarter.

Consumer price inflation, in terms of the Composite CPI, rose to 5.3% (underlying) and 5.1% (headline) in the first half of 2008 respectively. The sustained surge in food prices against the background of global food price inflation was the main factor underlying the pick-up in the consumer price inflation. The pressure generated from the demand side, the elevated energy prices, the gradual appreciation of the Renminbi and the weak US dollar also added to the inflationary pressure. Nevertheless, the relief measures announced in the 2008-09 Budget by the Chief Executive in mid-July would help to lower the headline inflation in the latter part of the year.

The Hong Kong economy is expected to grow moderately further in the rest of 2008, at a rate more in line with the trend growth rate over the past decade. Taking into account the notable growth of 5.8% of the economy in the first half of the year, the GDP forecast for the year of 2008 as a whole is kept unchanged at

4-5%.

## 2. Key trends in flows and assets under management

**Asset size and number of SFC-authorized funds**

Details on unit trusts and mutual funds authorized by the Hong Kong Securities and Futures Commission ("SFC"):

| | **Number** | | **NAV** (US$ Million) | |
|---|---|---|---|---|
| | **Mar-08** | **Mar-07** | **Dec-07** | **Dec-06** |
| Bond | 342 | 350 | 224,116 | 184,431 |
| Equity | 1,042 | 887 | 637,641 | 510,371 |
| Diversified | 157 | 124 | 85,690 | 55,033 |
| MM | 46 | 68 | 79,882 | 126,790 |
| FoFs | 112 | 97 | 8,326 | 6,794 |
| Index | 48 | 27 | 28,536 | 11,632 |
| Guaranteed | 193 | 253 | 6,375 | 11,838 |
| Hedge | 12 | 14 | 1,732 | 1,662 |
| Other Specialized* | 10 | 9 | 4,862 | 1,703 |
| Total | 1,962 | 1,829 | 1,077,160 | 910,254 |
| Umbrella Structure | 161 | 151 | | |
| **Grand total** | **2,123** | **1,980** | | |

* Includes futures & options funds and leveraged funds.

*Source: SFC (The data are published once a year – no. of funds in March 2008 and NAV in December 2007.)*

The total number of SFC-authorized funds was 2,123 at the end of March 2008, up by 7.2%. The following categories saw an increase in the number of funds – equity funds from 887 to 1,042 (up by 17.5%); diversified funds from 124 to 157 (up by 26.6%); fund of funds from 97 to 112 (up by 15.5%); index funds from 27 to 48 (up by 77.8%); and other specialized funds from 9 to 10 (up by 11.1%) in the period. Meanwhile, the following categories saw a drop – bond funds from 350 to 342 (down by 2.3%); money market funds from 68 to 46 (down by 32.4%); guaranteed funds from 253 to 193 (down by 23.7%); and hedge funds from 14 to 12 (down by 14.3%).

In terms of NAV, the industry saw an increase of 18.3% at the end of December 2007, as compared with December 2006. NAV of other specialized funds and index funds had increased substantially by 185.5% and 145.3% respectively. This was followed by diversified funds (55.7%), equity funds (24.9%), fund of funds (22.5%), bond funds (21.5%) and hedge funds (4.2%). NAV of guaranteed funds and money market funds had dropped by 46.1% and 37% respectively.

**Origin of SFC-authorized Funds**

Offshore funds can be marketed in Hong Kong as long as they obtain SFC's authorization. At the end of March 2008, about 5.1% of SFC-authorized funds were domiciled in Hong Kong.

| | **Number** | **%** | **NAV** (US$ Million) | **%** |
|---|---|---|---|---|
| Hong Kong | 109 | 5.13 | 18,564 | 1.72 |
| Luxembourg | 1,163 | 54.78 | 710,852 | 65.99 |
| Ireland | 338 | 15.92 | 238,034 | 22.10 |
| Guernsey | 37 | 1.74 | 8,366 | 0.78 |
| United Kingdom | 50 | 2.36 | 58,088 | 5.39 |
| Other Europe | 7 | 0.33 | 3,503 | 0.33 |
| Bermuda | 27 | 1.27 | 4,113 | 0.38 |
| British Virgin Island | 21 | 0.99 | 5,106 | 0.48 |
| Cayman Islands | 366 | 17.24 | 25,777 | 2.39 |
| Others | 5 | 0.24 | 4,757 | 0.44 |
| **Total** | **2,123** | **100** | **1,077,160** | **100** |

*Source: SFC (Number of funds: as at March-end 2008. Asset size: as at December-end 2007.)*

**Sales and redemptions**

(i) January 2007 – December 2007 (Note 1) (Appendix 1)

For the full year of 2007, the fund industry registered gross and net sales of US$45,546.15 million and US$6,946.07 million respectively. Compared with 2006, gross sales went up by 87.1% and net sales rose 82.5%.

In line with the trend of the past few years, equity funds continued to account for the lion's share of the industry sales in 2007. Compared with 2006, gross sales of equity funds doubled and reached US$38,344.67 million, accounting for 84.2% of the industry gross total. On a net basis, they attracted US$9,463.68 million, 84.1% higher than the net inflows registered in 2006.

Amongst all equity categories, Asian equity funds were the most popular. In aggregate, the six Asian equity fund categories attracted gross inflows of US$25,285.15 million, 1.7 times higher than 2006. They represented 66% of the total inflows into equity funds.

In 2007, gross sales of bond funds only edged up by 1.3%, to US$2,854.08 million. On a net basis, they witnessed an outflow of US$552.15 million – compared with net inflow of US$1,161.46 million in 2006. Net outflows were almost witnessed across the board: all bond funds categories registered net outflows except for Emerging Markets bond funds which managed to attract marginal net inflows of US$9.25 million. On a gross basis, this sector pulled in US$1,290.46 million, representing 45.2% of total gross inflows into bond funds.

(ii) January 2008 - June 2008 (Note 1) (Appendix 2)

In the first half of 2008, the fund industry attracted gross and net inflows of US$13,755.49 million and US$667.44 million respectively. Compared with the corresponding period in 2007, gross sales and net sales went down by 33.1% and 84.1% respectively.

Aggregate gross inflows into equity funds were at US$9,252.73 million, down by 43.2% as compared with the first half of 2007 and represented 67.3% of the industry total. On a net basis, they attracted US$9.61 million inflows in the first half of 2008.

Asian equity funds attracted gross inflows of US$5,614.24 million, down by 44.9% as compared with the first half of 2007 and accounted for 60.7% of the total inflows into equity funds. Net sales went down to US$439.66 million, from US$3,450.67 million in the first half of 2007.

Sales of Asian Single Market (non Japan/non HK) equity funds came first in the first half of 2008: gross sales reached US$2,026.17 million and accounted for 14.7% of the industry's gross total. However, net sales were down by 6.1%, from net inflows of US$966.62 million in the first half of 2007 to US$907.66 million.

Sales of Emerging Markets equity funds came second: up by 6.9% in aggregate gross sales to US$1,864.32 million, which accounted for 13.6% of the industry total. On a net basis, they attracted inflows of US$107.81 million and accounted for 16.2% of the industry total, compared with net outflows of US$175.48 million in the first half of 2007.

Bond funds registered aggregate gross inflows of US$2,074.09 million, down by 2% from the first half of 2007 and accounted for 15.1% of the industry total. On a net basis, they pulled in inflows of US$1,044.19 million, 2.5 times higher than the first half of 2007.

**Fund penetration rate**
According to SFC's Retail Investor Survey 2005, the popularity of funds (excluding MPF investments) has grown significantly: from 9% in 2001 to 9.8% in 2003 and further to 18.1% in 2005.

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Note 1: Only retail transactions (including switches) are covered and sales attributed to institutional sources are excluded from the report. Data covered HKIFA members only.

## 3. Legal and regulatory developments

**A new regulatory regime for notices and advertisements**
In order to enable fund managers to launch products and to notify investors in a more timely manner, the SFC has moved from a pre-vetting regime to a post-surveillance one (came into effect on August 1, 2008). This means that the majority of notices of authorized schemes and advertisements falling within the exemptions under section 103 of the Securities and Futures Ordinance will no longer be required to be pre-vetted.

In tandem with this, the SFC has established a common set of Advertising Guidelines for all schemes under the various Product Codes to provide better guidance to the industry. Advertisement issuers can continue to follow the current Advertising Guidelines until the end of this year, but they must comply with the revised Guidelines from January 1, 2009.

These changes are warmly welcomed by the industry as we have repeatedly pointed out that pre-vetting had resulted in delays, put unnecessary regulatory burden on the industry and prevented fund managers from meeting clients' needs readily. To enable the fund industry to be fully geared up for this revamp, the HKIFA has developed a range of initiatives with the SFC to ensure a smooth transition.

**A new Code on Unit Trusts and Mutual Funds ("UT Code")**
The SFC has set as part of its work plan for 2008 the task of conducting a comprehensive review of the UT Code, together with the Recognized Jurisdiction Scheme and Acceptable Inspection Regime Scheme.

Though the details remain to be worked out, the changes envisaged are that the revamped Code will allow greater flexibility and scalability to accommodate growth by avoiding prescriptive measures, unless they were necessary to illustrate how a principle would work. Also, it will not attempt to restrict funds to any rigid asset classes or investment structures. There will be guiding investment principles in line with international standards and practices, but the fundamental investor protection tenets will remain, such as the requirement for segregation of custody from management.

**Cross border cooperation with Mainland China**

- In April 2007, the SFC signed an MOU with the CBRC for Hong Kong to become the first overseas jurisdiction that Mainland commercial banks could invest in. Hong Kong was the first market to benefit from the expansion of the investment scope of Mainland bank QDII.

- In June 2007, the CSRC announced provisional rules for QDII funds investing in overseas markets. The first QDII fund was launched in September 2007. Up to 40 per cent of the fund's assets are allocated to the Hong Kong market.

- In March 2008, a Regulatory Co-operation Agreement of Understanding was signed with the CIRC, which is the first agreement on regulatory co-operation and information exchange on the use of

Mainland insurance funds outside the Mainland.

**Recent regulatory development - The Mandatory Provident Fund ("MPF") System**

- In June 2007, the Mandatory Provident Fund Schemes (Amendment) Bill 2007, which covers around 30 proposals to amend the MPF legislation in respect of scheme administration and enforcement, was introduced into the Legislative Council and passed on 9 January 2008. With the corresponding Mandatory Provident Fund Schemes (Amendment) Ordinance 2008 gazetted on 18 January 2008, most provisions have become effective, with the exception of provisions relating to:
  - housing allowance (removing the housing allowance/benefit exclusion from the definition of "relevant income");
  - arrears recovery (removing the 30-day settlement period following the contribution day with a view to speeding up the arrears recovery process); and
  - unclaimed benefits (streamlining the treatment of unclaimed benefits).

  These provisions shall come into operation on November 1, 2008.

- In July 2007, the Mandatory Provident Fund Schemes Authority ("MPFA") launched Phase I of the Comparative Platform on fees and charges of MPF funds on its website (www.mpfa.org.hk). Phase I of the platform provides scheme members with information about fees and charges as measured by the average/highest/lowest fund expense ratio of the six main types of MPF funds, enabling comparison of fees and charges across different types of MPF funds. The majority of trustees have reduced management fees or provided fee rebates on some or all their MPF funds since the launch of the platform.

  There will be a second phase of the platform – but amendment to Mandatory Provident Fund Schemes Ordinance (MPFSO) is required to empower the MPFA to release the fees and charges of individual MPF funds provided by trustees publicly. Phase II of the platform, which will show the names and other detailed fee information about individual MPF funds, would be launched after the relevant legislative amendments are enacted by the Legislative Council.

- In February 2007, the MPFA published a revised version of the Code on Disclosure, containing improvements to provisions in the Code regarding fee tables and fund fact sheets. In the 2007-08 financial year, the MPFA has started another phase of review, focusing on requirements in relation to on-going cost illustrations.

  The MPFA formally issued the revised Code on Disclosure on in February 2008 to specify the new content requirements. Annual benefit statements issued in respect of financial periods ending after September 1, 2009 will need to comply with the revised Code on Disclosure.

- The MPFA has put forward a proposal to increase employee control over investment by allowing employees to transfer accrued benefits derived from their own mandatory contributions from the scheme chosen by their employers to an MPF scheme of their own choice at least once per year. This proposal would have the effect of enhancing market competition and could result in around 60% of MPF benefits being portable among trustees.

**Data on MPF** *(Appendix 3)*

**Taxation of Retail Investment Funds**

- Generally, no tax will be payable by investors in Hong Kong in respect of dividends or other income distributions of the company, or in respect of any capital gains arising on a sale, realization or other disposals of shares, except that Hong Kong profits tax may arise – if such a gain is of a revenue nature, and arises from the carrying on by the investor of a trade, profession or business in Hong Kong.

- But it must be noted that investors in overseas countries may be liable to tax of their own countries applicable to the acquisition, holding and redemption of units/shares by them under the laws of the places of their citizenship, residence and domicile.

## 4. Product developments

Several new types of products were authorized by the SFC from July 2007 to June 2008, as follows:

- the first actively managed closed-end fund investing primarily in the A share market was listed in July 2007;
- the first retail 130/30 UCITS III fund was authorized in July 2007;
- the first UCITS III fund that has significant exposure to hedge fund indices was authorized in November 2007; and
- the first retail Islamic fund was authorized in November 2007.

## 5. Other Major Issues and Development

**Use of electronic means for dissemination of information**

In April 2008, the SFC and The Stock Exchange of Hong Kong Ltd. published a joint consultation paper on the proposal to allow the issue of paper application forms for public offers which have electronic prospectuses available on certain prescribed websites.

The proposal will allow paper application forms for public offers to be handed out at receiving banks without also having to hand out paper prospectuses if electronic prospectuses are available online and other requirements aimed at investor protection are satisfied. Under the proposal, investors may ask for paper prospectuses at specified branches of receiving banks.

We leveraged on this consultation exercise to exhort the SFC to revisit the issue of dissemination of information to holders of authorized collective investment schemes by electronic means.

**Mainland and Hong Kong Closer Economic Partnership Arrangement ("CEPA")**

In May 2008, the China Securities Regulatory Commission (CSRC) announced new measures to allow qualified fund management companies in the Mainland to set up operations in Hong Kong under the Supplement IV to CEPA. Under the arrangement, both fund industries in Hong Kong and Mainland will benefit from increased opportunities to strengthen their co-operation. The SFC is working closely with the CSRC to ensure a smooth implementation of the measures under the Supplement.

(Prepared: September 2008)

**Appendix 1 – Retail Sales & Redemptions by Hong Kong Investors 2007**

| TYPE OF FUND | (US$ MILLION) | | |
|---|---|---|---|
| | SALES | REDEMPTIONS | NET SALES/ (REDEMPTIONS) |
| **A. Equity Funds** | | | |
| Asia Regional (excl. Japan) | 8,160.25 | 4,699.68 | 3,460.57 |
| Asia Regional (incl. Japan) | 741.11 | 708.89 | 32.22 |
| Greater China Region | 10,755.62 | 7,234.12 | 3,521.50 |
| Japan | 320.41 | 895.87 | -575.46 |
| Hong Kong | 393.31 | 259.33 | 133.98 |
| Asian Single Market (non Japan/non HK) | 4,914.45 | 3,750.91 | 1,163.54 |
| International | 1,746.36 | 1,404.39 | 341.97 |
| European Regional Market | 1,510.55 | 2,143.73 | -633.18 |
| European Single Market | 52.15 | 67.78 | -15.63 |
| North American | 155.71 | 171.87 | -16.16 |
| Emerging Markets | 5,580.71 | 4,046.91 | 1,533.80 |
| Sector Funds | 3,642.59 | 3,125.31 | 517.28 |
| REITs-related Funds | 371.45 | 372.20 | -0.75 |
| *Sub-total* | *38,344.67* | *28,880.99* | *9,463.68* |
| **B. Balanced/Managed Funds** | 1,076.57 | 1,192.53 | -115.96 |
| **C. Bond Funds** | | | |
| Global Bond | 972.38 | 1,151.82 | -179.44 |
| US | 315.44 | 521.68 | -206.24 |
| Europe | 73.56 | 202.11 | -128.55 |
| Asia | 202.24 | 249.41 | -47.17 |
| Emerging Markets | 1,290.46 | 1,281.21 | 9.25 |
| *Sub-total* | *2,854.08* | *3,406.23* | *-552.15* |
| **D. Money Market Funds/liquidity Funds** | 1,534.46 | 1,327.58 | 206.88 |
| **E. Guaranteed Funds** | 126.26 | 2,612.26 | -2,486.00 |
| **F. Equity Index Funds** | 184.42 | 165.66 | 18.76 |
| **G. Fund of Funds (Traditional Long-only)** | 757.20 | 648.18 | 109.02 |
| **H. Hedge Funds** | 5.09 | 22.13 | -17.04 |
| **I. Other Funds** | 663.40 | 344.52 | 318.88 |
| ***Grand total*** | ***45,546.15*** | ***38,600.08*** | ***6,946.07*** |

*Source: HKIFA (The sales and redemptions data only cover funds managed by HKIFA members.)*

## Appendix 2 - Retail Sales & Redemptions by Hong Kong Investors 2008 (from Jan to Jun)

*Source:HKIFA (The sales and redemptions data only cover funds managed by HKIFA members. As the end of June 2008, HKIFA members managed about 1,270 HKSFC-authorized funds with asset size above US$773 billion.)*

| TYPE OF FUND | (US$ MILLION) | | |
|---|---|---|---|
| | SALES | REDEMPTIONS | NET SALES/ (REDEMPTIONS) |
| **A. Equity Funds** | | | |
| Asia Regional (excl. Japan) | 1,611.92 | 1,624.79 | -12.87 |
| Asia Regional (incl. Japan) | 195.65 | 154.09 | 41.56 |
| Greater China Region | 1,595.53 | 1,965.08 | -369.55 |
| Japan | 29.02 | 211.33 | -182.31 |
| Hong Kong | 155.95 | 100.78 | 55.17 |
| Asian Single Market (non Japan/ non HK) | 2,026.17 | 1,118.51 | 907.66 |
| International | 503.87 | 401.21 | 102.66 |
| European Regional Market | 84.94 | 458.74 | -373.80 |
| European Single Market | 15.70 | 18.16 | -2.46 |
| North American | 45.47 | 137.70 | -92.23 |
| Emerging Markets | 1,864.32 | 1,756.51 | 107.81 |
| Sector Funds | 1,060.64 | 1,230.26 | -169.62 |
| REITs-related Funds | 63.55 | 65.96 | -2.41 |
| *Sub-total* | *9,252.73* | *9,243.12* | *9.61* |
| **B. Balanced/Managed Funds** | 389.93 | 398.12 | -8.19 |
| **C. Bond Funds** | | | |
| Global Bond | 1,048.12 | 434.19 | 613.93 |
| US | 183.21 | 141.14 | 42.07 |
| Europe | 32.34 | 59.57 | -27.23 |
| Asia | 291.70 | 104.14 | 187.56 |
| Emerging Markets | 518.72 | 290.86 | 227.86 |
| *Sub-total* | *2,074.09* | *1,029.90* | *1,044.19* |
| **D. Money Market Funds/liquidity Funds** | 819.39 | 721.21 | 98.18 |
| **E. Guaranteed Funds** | 6.54 | 891.20 | -884.66 |
| **F. Equity Index Funds** | 149.61 | 56.09 | 93.52 |
| **G. Fund of Funds (Traditional Long-only)** | 79.55 | 154.42 | -74.87 |
| **H. Hedge Funds** | 6.16 | 5.12 | 1.04 |
| **I. Warrants, Futures and Options Funds** | 856.13 | 477.83 | 378.30 |
| **J. Other Funds** | 121.36 | 111.04 | 10.32 |
| ***Grand total*** | ***13,755.49*** | ***13,088.05*** | ***667.44*** |

**Appendix 3 - Data on MPF as at June-end 2008**

| | Number |
|---|---|
| **MPF Schemes** | |
| Registered Schemes | 38 |
| Approved Constituent Funds | 326 |
| Approved Pooled Investment Funds | 296 |
| Approved Index-tracking Collective Investment Schemes | 94 |
| **Enrollment** | |
| Employers | 99.2% |
| Employees | 98.1% |
| Self-employed persons | 74.8% |
| **Total Assets** (HK$ million) (including assets transferred from the ORSO schemes[1]) | 249 548 |

*Source: MPFA*

[1] ORSO schemes are voluntary private occupational retirement schemes registered under the Occupational Retirement Schemes Ordinance ("ORSO"), which has been in operation since 1993. With the introduction of MPF, legislation has been introduced to set out arrangements for the interface of the existing voluntary ORSO schemes with the new MPF System. The arrangement is intended to minimize the interference with existing schemes and avoid upsetting the contractual relationship between employers and employees. An ORSO registered scheme may be MPF-exempted if it meets certain criteria.