China ETFs set to flourish amid rising red tape and fee disclosure

Mounting regulatory costs and greater transparency over fees offer exchange-traded funds an opportunity, particularly those focusing on China. Tobias Bland of Enhanced Investment Products explains how his company aims to benefit.

Investors' hunger to gain exposure to some of the fast-growth areas in China's economy remains undiminished.

However, the country's local markets can be quite restrictive for international retail investors, and many of its companies that have listed internationally have chosen to do so in other regions, principally the US.

Meanwhile, regional fund management companies are grappling with the advent of new rules around fee disclosure that are prompting a shift towards performance-driven management fees for distributors.

Tobias Bland, chief executive officer of Enhanced Investment Products (EIP), notes that his own company is spending about US$750,000 per year on compliance staff who simply take care of the reporting requirements and keep an eye on the overall regulatory environment with respect to its operations.

Yet he believes these rising compliance and transparency requirements are more of an opportunity than a challenge for exchange-traded funds (ETFs) – particularly ones focused on China.

CHINESE APPEAL

"In developed markets that have brought in fee disclosure, distributors have realised that they need to be on the same side as their clients and move to offering a performance-based model," says Bland.

"They then start to look for products that provide the most efficient way to access the chosen asset allocation. ETFs have come into that thought process. Overall, we expect bank after bank to go for the performance model."

China ETFs could prove to be especially popular. Asia has been bullish on the country for a while now, but the world's interest has also grown this year, as its stock market has soared. The

TOBIAS BLAND
Enhanced Investment Products

Shanghai Stock Exchange Composite Index rose from 2,030.5 on June 9, 2014 to reach 5,068.47 on June 8 this year. Investors outside of the country have been looking for ways to invest in China to benefit from such rapid growth, but navigating its capital and foreign exchange controls has limited their ability to do so.

EIP has been seeking to fill this need by teaming up partners to take full advantage of these opportunities. The company has conducted several recent China-focused ETF fund launches.

Among recent ones, EIP has the China Opportunities Fund on the hedge funds side of its business and the XIE Shares FTSE Chimerica ETF (Chimerica Fund).

The company is preparing to launch more in the coming months, says Bland. He is optimistic about the prospects.

UNIQUE OFFERING

The ability to invest in Asia's largest emerging market for a low cost has enticed many investors.

EIP launched its China Opportunities Fund in December last year, after investors agreed to support it to the tune of US$23 million. It invests in mispriced securities and relative value strategies.

"These are very interesting opportunities for us," says Bland. "The China Opportunities Fund is a multi-strategy fund that invests in anomalies between onshore and offshore arbitrage opportunities in Chinese instruments."

A recent example of such an opportunity has been the breadth of the spread between the A-shares and H-shares of dual-listed Chinese companies. A-shares have been trading at an effective 40% premium for the same underlying asset.

In April this year, EIP then launched the Chimerica ETF. This new fund covers the FTSE N Series Index, which consists of many of the most prominent Chinese companies listed in the US, including internet firms like Alibaba. It has bought the stock of 26 Chinese internet and technology companies listed there.

Bland says Asian investors know these companies well but haven't been able to invest into them in real time so far.

The new fund has so far raised US$32 million in AUM. Bland believes it is only ETF in Asia to offer real-time access to N-shares during Asian trading hours. N-shares refer to Chinese companies stock listed on the New York Stock Exchange, Nasdaq or the NYSE MKT.

China, by taking advantage of the low-cost, transparent, and easily tradable nature of ETFs.

Additionally, the Chinese fixed income market holds many opportunities. Bland notes that it has US$3 trillion to US$4 trillion of issued bonds from a variety of household names. It's a huge market with a lot of potential, and EIP is considering new products to help offshore investors gain access to it soon.

FLEXIBLE APPROACH

Bland hopes the ETFs will ultimately appeal to investors because of the flexibility they offer to track exciting parts of China's fast-growing capital markets.

"Distributors have realised that they need to be on the same side as their clients and move to a performance-based model. They then start to look for products that provide the most efficient way to access the chosen asset allocation. ETFs have come into that thought process."

The appeal of the Chimerica ETF could be underlined by index producer MSCI's recent announcement that it will include N-shares into its MSCI China and Emerging Markets Indices from November 2015.

"Most people should spend more time focusing on US-listed Chinese companies to really feel the impact of the MSCI inclusion," says Bland.

His key objective is to distribute the Chimerica ETF to private banks, family offices and retail investors operating in

The advent of new regulations should merely underline these advantages.

The funds have also become very liquid, with their net asset values (NAVs) now being published every day instead of just calculated once a week, as used to take place. This gives investors more confidence to enter and leave the ETFs whenever they wish.

This combination of qualities is appealing at a time of rising compliance complexities and costs. It also promises to stand EIP in good stead. ■