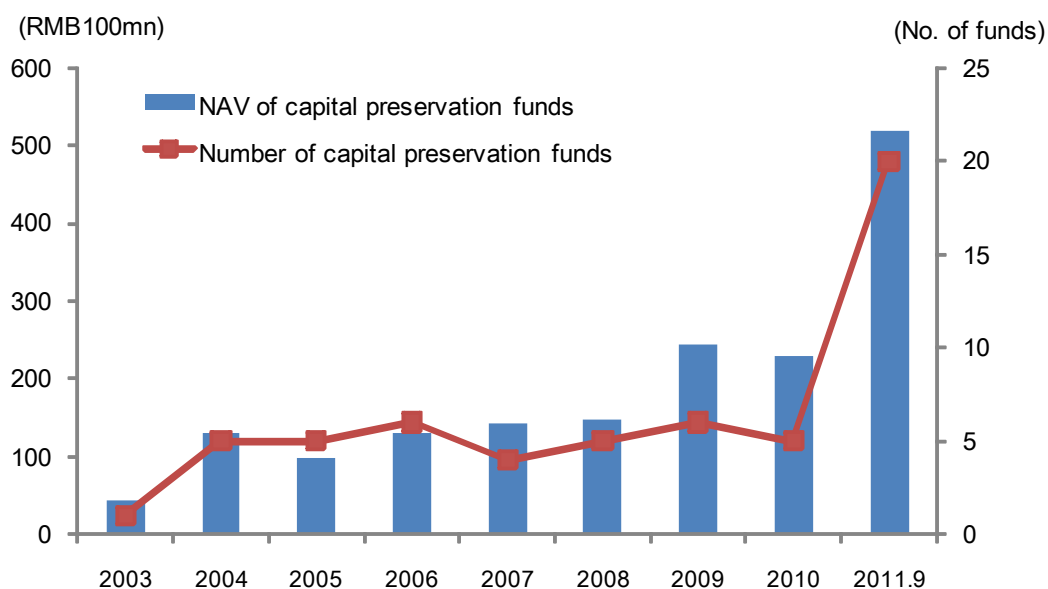

The Surge in Capital Preservation Funds in China

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I. NAV of Chinese capital preservation funds more than doubles in nine months

The surge in offerings of and subscriptions to capital preservation funds since the start of 2011 has attracted considerable interest. The first capital preservation fund to be launched in China was in 2003, and, as of end-September 2011, such trusts accounted for only 2.2% of the net asset value (NAV) of all investment trusts in China. In the first nine months of 2011, however, the number of such trusts quadrupled to 20, while their NAV rose by 130% to RMB51.79 billion (roughly ¥627 billion)¹ (Figure 1). Furthermore, the average offering amount of the 15 capital preservation funds launched between January and September 2011 was RMB2.1 billion (roughly ¥25.4 billion), 80% more than the average for all the investment trusts launched during that period (RMB1.17 billion, roughly ¥14.1 billion). We expect more capital preservation

Figure 1: Net asset value and number of capital preservation funds



Source: Nomura Institute of Capital Markets Research, from Shanghai Wind Information Co., Ltd. data

¹ We have converted amounts in renminbi to yen using the mid-rate on 30 September 2011 (RMB1 = ¥12.1) except where there is a footnote to the contrary.

funds to be launched and their NAV to continue to rise in both absolute and relative terms.

II. Use of constant protection portfolio insurance

The Chinese for "capital preservation fund" is *baoben jijin*. *baoben* is a portmanteau word composed of *baozheng* ("protect") + *benjin* ("capital"); *jijin* means "fund." The following are the main features of the capital preservation funds that have been launched in China thus far.

- (1) The amount invested ("the capital") is guaranteed only if trust units have been purchased in the primary market and held until maturity (three years later). In other words, units may be purchased in the secondary market; but the amount invested is not guaranteed.
- (2) The fund management company uses constant proportion portfolio insurance (CPPI) as a flexible means of rebalancing the portfolio.
- (3) Responsibility for guaranteeing the capital is shared by the fund management company and a guarantee company.
- (4) The portfolio normally consists of 0–40% of equities and 60–100% of bonds.
- (5) More than 90% of the units in this type of investment trust are held by normal investors (as of the end of 2010).
- (6) The funds are benchmarked to the rate on three-year fixed-term deposits (Figure 2).

Figure 2: Mainland Chinese interest rates

Deposit rates (%)		Lending rates (%)	
Sight deposits	0.50		
Fixed-term (3-month) deposits	3.10		
Fixed-term (6-month) deposits	3.30	6 months	6.10
Fixed-term (12-month) deposits	3.50	12 months	6.56
Fixed-term (24-month) deposits	4.40	13-36 months	6.65
Fixed-term (36-month) deposits	5.00	37-60 months	6.90
Fixed-term (60-month) deposits	5.50	61 months-plus	7.05

Note: Applicable from 7 July 2011.

Source: Nomura Institute of Capital Markets Research, from PBOC data

Also, capital preservation funds are subject to the same four types of fees as normal investment trusts: a sales fee, an annual management fee, an annual custodian fee, and a redemption fee. However, the redemption fee is much higher than that on a normal investment trust if the units are sold soon afterwards and before maturity (Figure 3).

CPPI divides a portfolio into low-risk, low-return reserve assets (such as bonds) and high-risk, high-return active assets (such as stocks). The proportion invested in each type of asset can be varied flexibly, with the return generated by any capital gains from the stocks as well as the income from the bonds. Popular with hedge funds and European institutional investors, this approach has also been adopted by Chinese fund management companies for their capital preservation funds. One prospectus describes the way CPPI has been used in the fund concerned as follows.

"For example, RMB900 million (roughly ¥10.9 billion) of a portfolio's assets of RMB1,000 million are invested in bonds that will generate RMB100 million (roughly ¥1.21 billion) of interest income by maturity, while the portfolio's remaining assets of RMB100 million are invested in stocks. Therefore, even if the stock investments fail and end up worth nothing, the amount invested (RMB1,000 million) is guaranteed at maturity by the amount invested in bonds (RMB900 million) and the interest income (RMB100 million) from the bonds. As it is unusual for all of a portfolio's stock investments to end up worth nothing, the balance between stocks and bonds can be varied flexibly by means of CPPI once the bonds in the portfolio have generated more than a certain amount of income, allowing the portfolio to generate an additional, unspecified return while guaranteeing the amount invested."²

In other words, CPPI ensures that the interest income covers any losses on the stocks in the portfolio and guarantees the amount invested by allowing the proportion invested in stocks and bonds to be adjusted to ensure that any losses on the stocks do not exceed the interest income. The proportion invested in stocks and bonds is adjusted regularly using CPPI, and the proportion invested in bonds can be increased

Figure 3: Fees charged by capital preservation funds

Purchase amount	Sales fee		Management fee	Custodian fee	Holding period (regardless of amount)	Redemption fee
	Primary	Secondary				
< RMB1mn	0.8 ~ 1%	1 ~ 1.2%	1.2%	0.2%	< 12 months	1.5 ~ 2%
RMB1–3mn	0.6 ~ 0.8%	0.8 ~ 1%			12–24 months	1.2 ~ 1.6%
					24–36 months	1 ~ 1.2%
RMB3–5mn	0.4 ~ 0.6%	0.6 ~ 0.8%			37 months-plus	0%
RMB5mn-plus	RMB1,000				Normal investment trust	0 ~ 0.5%

Note: Data as of end-September 2011. RMB1mn = approx. ¥12.1mn.

Source: Nomura Institute of Capital Markets Research, based on variety of product prospectuses

² Taken from prospectus of Golden Eagle Capital-Guaranteed Mixed-Type Securities Fund.

to a maximum of 100% in a bear market. In the event of a stock market crash that causes the portfolio to "break the buck," the fund management company and the guarantee company are obliged to make good the loss (see below).

This type of scheme only works if the bonds in a portfolio generate enough interest income. However, this condition appears to be satisfied by the relatively high rates of interest in China. An examination of the annual reports of a number of Chinese capital preservation funds reveals that their bondholdings, many of which have maturities of less than three years, comprise T-bills, policy bank debentures³, corporate bonds, and commercial paper as well as government bonds, and that the rates of interest on the government bonds, T-bills, and policy bank debentures vary between 2% and 4% while those on corporate bonds and commercial paper vary between 4% and 6%. A combination of the income from such relatively high interest rates and capital gains on shareholdings has ensured that all of the capital preservation funds launched before 2010 have outperformed their benchmarks, with some achieving an annual return of 10% or more (Figure 4).

In Japan, Mitsubishi UFJ Securities has sold the Man IP220 International fund of hedge funds (launched in 2006) and a fund (launched in 2008) that tracks the performance of one advised by Winton Capital Management. Both are capital preservation funds. Whereas these investment trusts use zero coupon bonds to guarantee the principal at redemption and invest their remaining assets in leveraged stock and futures positions, the Chinese investment trusts use coupon bonds to guarantee the principal and invest their remaining assets in cash stocks without any leverage. The Chinese trusts are also different in that the redemption proceeds are paid in local currency (i.e., renminbi, with no exchange rate risk), the investment period is shorter, and the minimum investment amount is lower.

III. Three reasons for surge in capital preservation funds

We can think of three main reasons for the surge in capital preservation funds in China since the start of 2011.

1. Relaxation of rules governing guarantee companies

The first is a relaxation of the rules governing guarantee companies. There are two types of guarantee companies in China: financing guarantee companies, which guarantee loans, trade loans, and project finance, and nonfinancing guarantee companies, which guarantee the performance of a contract and the protection of assets. Financing guarantee companies are licensed by local governments and can also act as

³ Debentures issued by a policy bank.

Figure 4: Details of actual capital preservation funds

	Fund name	NAV (¥100mn)	Cumulative return	Type	Launch	Benchmark	Guarantor	Maturity	Fund manager
1	China Southern Risk-Avoided and Value-Added Fund	1,244	253.5%	Balanced	2003/6/27	S&P/CITIC Composite Bond Index 80% + S&P/CITIC Composite Index 20%	Zhongtou Credit Guarantee Co., Ltd.	3 years	China Southern Fund Management Co., Ltd.
2	Yinhua Principal-Protected and Value-Added Fund	452	75.2%	Balanced	2004/3/2	Fixed-term bank deposit rate during investment period	Beijing Capital Guarantee & Investment Co., Ltd.	3 years	Yinhua Fund Management Co., Ltd.
3	China Southern Hengyuan Principal Guaranteed Mixed Type Fund	272	19.5%	Balanced	2008/11/12	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	China Southern Fund Management Co., Ltd.
4	BOCOM Guaranteed Fund	251	10.0%	Balanced	2009/1/21	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	Bank of Communications Schroder Fund Management Co., Ltd.
5	Guotai Jinlu (Golden Deer) Principal Guaranteed Value Added Mixed Fund	236	-0.5%	Balanced	2010/7/2	2-year fixed-term bank deposit rate	China Jianyin Investment Securities Co., Ltd.	3 years	Guotai Asset Management Co., Ltd.
6	CCB Principal Guaranteed Fund	349	-3.1%	Balanced	2011/1/18	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	CCB Principal Asset Management Co., Ltd.
7	China Universal Capital Protection Fund	286	-0.5%	Balanced	2011/1/26	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	China Universal Asset Management Co., Ltd.
8	GF Juxiang Principal Guaranteed Mixed Type Fund	480	-0.6%	Balanced	2011/3/15	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	GF Fund Management Co., Ltd.
9	Orient Principal Guaranteed Fund	174	-1.8%	Balanced	2011/4/14	3-year fixed-term bank deposit rate	China Post Group Corp.	3 years	Orient Fund Management Co., Ltd.
10	Guotai Principal Guaranteed Fund	315	-1.3%	Balanced	2011/4/19	3-year fixed-term bank deposit rate	Chongqing Three Gorges Guarantee Group Co., Ltd.	3 years	Guotai Asset Management Co., Ltd.
11	Dacheng Principal Guaranteed Fund	167	-0.1%	Balanced	2011/4/20	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	Dacheng Fund Management Co., Ltd.
12	Lion Principal Protected Fund	328	1.0%	Balanced	2011/5/13	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	Lion Fund Management Co., Ltd.
13	Golden Eagle Guaranteed Fund	110	0.3%	Balanced	2011/5/17	3-year fixed-term bank deposit rate	Guangzhou International Group Co., Ltd.	3 years	Golden Eagle Asset Management Co.
14	Changsheng Tongxin Principal Guaranteed Fund	368	0.7%	Balanced	2011/5/24	3-year fixed-term bank deposit rate	Anhui Credit Guaranty Group Co., Ltd.	3 years	Changsheng Fund Management Co., Ltd.
15	Galaxy Principal-guaranteed Hybrid Securities Investment Fund	128	-1.1%	Balanced	2011/5/31	3-year fixed-term bank deposit rate	China Galaxy Financial Holding Co., Ltd.	3 years	Galaxy Asset Management Co., Ltd.
16	Southern Principal Protected Fund	603	0.5%	Balanced	2011/6/21	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	China Southern Fund Management Co., Ltd.
17	Yinhua Yongxiang Guaranteed Fund	173	0.2%	Balanced	2011/6/28	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	Yinhua Fund Management Co., Ltd.
18	Xingquan Principal Guaranteed Fund	172	-5.0%	Balanced	2011/8/3	3-year fixed-term bank deposit rate	Chongqing Three Gorges Guarantee Group Co., Ltd.	3 years	AEGON-Industrial Fund Management Co., Ltd.
19	KBC-Goldstate Momentum Principal Guaranteed Investment Fund	34	0.1%	Balanced	2011/8/16	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	KBC-Goldstate Fund Management Co., Ltd.
20	CMF Anda Principal Guaranteed Mixed Fund	126	0.8%	Balanced	2011/9/1	3-year fixed-term bank deposit rate	China National Investment & Guaranty Co., Ltd.	3 years	China Merchants Fund Management Co., Ltd.

Note: Data as of end-September 2011. Converted at a rate of RMB1 = 12.1. All of the above 20 funds are open-end funds.

Source: Nomura Institute of Capital Markets Research, from Shanghai Wind Information Co., Ltd. data

nonfinancing guarantors. However, they are not allowed to take deposits or grant loans⁴. As of the end of 2010, there were 6,030 financing guarantee companies in China, of which 1,427 were public-sector institutions and 4,603 private-sector institutions. Furthermore, outstanding guarantees by financing guarantors as of the end of 2010 stood at RMB1,150.3 billion (roughly ¥14.1 trillion)⁵, up 64.6% year on year⁶. More than half (namely, 11) of China's capital preservation funds are guaranteed by one of the country's largest guarantee companies, China National Investment & Guaranty Co., Ltd. (CNIGC) (Figure 4). As of the end of 2010, CNIGC's outstanding guarantees totaled RMB105.7 billion (roughly ¥1.3 trillion), equivalent to roughly 9% of all the guarantees by financing guarantee companies.

When a Chinese fund management company sets up a capital preservation fund, it has to comply with the requirements of the China Securities Regulatory Commission (CSRC) concerning matters such as capital, net assets, net profit, and the maximum guarantee. In addition, it shares with the guarantee company the responsibility for making good any losses investors suffer if a capital preservation fund breaks the buck (e.g., as a result of a stock market crash or the default by issuers of any corporate bonds in a fund's portfolio). As a result, the CSRC's criteria for selecting guarantee companies were very strict, and this made it difficult for fund management companies to choose a guarantee company. This, in turn, was one of the main reasons why capital preservation funds failed to grow either in number or in NAV⁷.

However, on 26 October 2010, the CSRC promulgated its *Guiding Opinions on Capital Preservation Funds* with the aim of fostering the development of capital preservation funds, and relaxed considerably two of its requirements for guarantees by nonfinancial institutions by lowering the net asset requirement from RMB5.0 billion (roughly ¥60.5 billion) to RMB2.0 billion (roughly ¥24.2 billion) and by raising the maximum guarantee from 200% of net assets to 1,000%⁸. Soon afterwards, four fund management companies applied to launch new capital preservation funds, triggering the surge in such trusts.

⁴ *Interim Measures on the Administration of Financing Guarantee Companies* (promulgated on 10 March 2011).

⁵ We have converted amounts in renminbi to yen as of the end of 2010 using the mid-rate on 31 December 2010 (RMB1 = ¥12.3).

⁶ *Explanation by CBRC Spokesperson of the Development and Current Regulatory Situation of Financing Guarantee Companies* (promulgated on 15 June 2011).

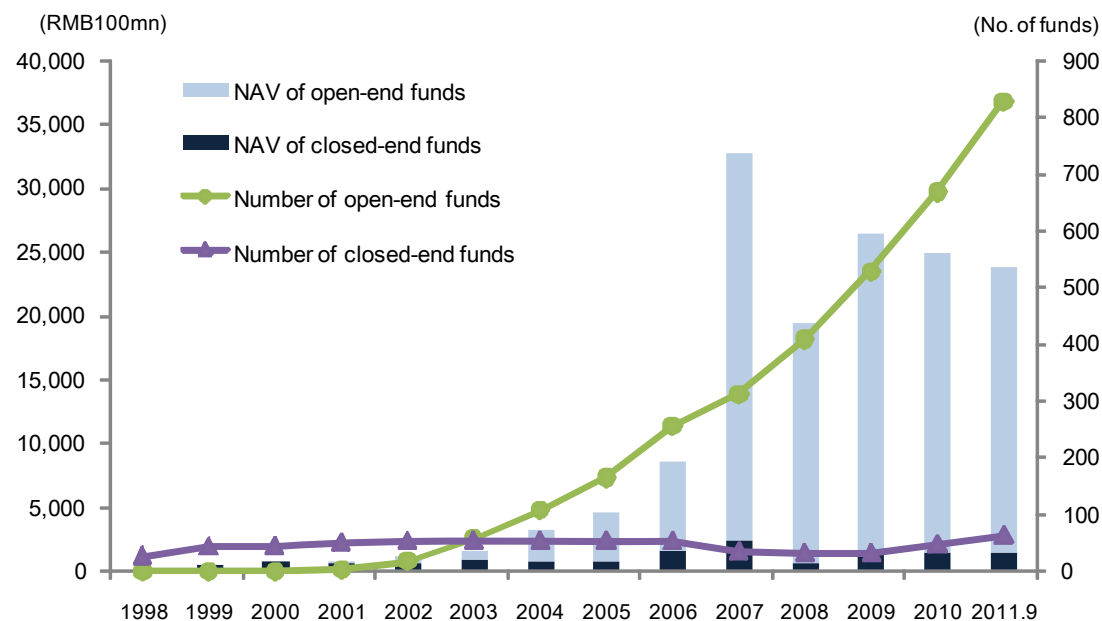
⁷ See JC Economic Information, 21 March 2011.

⁸ The requirements for a securities company or other financial institution seeking to act as a guarantee company are also that it must have net assets of RMB2.0 billion and that the maximum loan amount may be ten times its net assets. However, the requirements for capital, net profit and number of years in operation are less demanding than those for nonfinancial companies.

2. Banks as sales outlets for investment trusts

The second reason for the surge in capital preservation funds in China since the start of 2011 is that banks in China are now allowed to sell investment trusts. In China four types of company are allowed to sell investment trusts on behalf of the fund management company: (1) banks, (2) securities companies, (3) investment advisory companies, and (4) independent investment trust sales outlets (independent advisors). However, as of the end of June 2011, there was only one licensed investment advisory company in China and not even one independent advisor⁹. Therefore, to all intents and purposes, there are only three types of company selling investment trusts in China: banks, securities companies, and fund management companies selling their own investment trusts directly. Banks are a particularly important sales outlet for investment trusts, accounting for some 60–70% of investment trust sales by value¹⁰. The Chinese investment trust market has grown rapidly since 2001, when banks were allowed to sell investment trusts and open-end investment trusts, and stood at RMB2,488.9 billion (roughly ¥30.6 trillion) as of the end of 2010, roughly 30 times larger than at the end of 2001 (Figure 5). The country's four state-owned commercial banks (Bank of China, Industrial and Commercial Bank of China, Agricultural Bank of China, and China Construction Bank) have a particularly large presence in the market, with over 60,000 domestic branches and access to the assets of a wide range

Figure 5: Net asset value and number of capital preservation funds



Source: Nomura Institute of Capital Markets Research, from Shanghai Wind Information Co., Ltd. data

⁹ According to *Measures for the Administration of Sales of Securities Investment Funds* (promulgated on 9 June 2011), independent advisors and (local subsidiaries of) foreign banks were due to be eligible to apply for permission to market investment trusts with effect from 1 October 2011.

¹⁰ See ifeng.com, 28 March 2011.

of investors. It is largely thanks to them that savings have flowed into investment trusts, helping the market to grow. They have also played a major role in the growth of capital preservation funds and are likely to continue to do so.

3. Outperformance

The third reason for the surge in capital preservation funds in China since the start of 2011 is that they have outperformed their benchmark. Since capital preservation funds invest mainly in bonds, they tend to underperform stock investment trusts in a bull market. However, the opposite is the case in a bear market. Another of their characteristics is that, because their performance initially depends on the bond interest they are earning, they do not come into their own until they start investing in stocks. Over the long term, however, most capital preservation funds outperform the three-year fixed-term deposit rate against which they are benchmarked (Figure 4). It seems that this performance, combined with the capital guarantee, has a strong appeal with investors and has gone a long way to attract their money.

IV. Conclusion

According to market sources, 89 capital preservation funds were in the process of being originated, most with a view to being launched by the end of 2011, as of 25 April 2011¹¹. As of end-September, capital preservation funds accounted for only 2.2% of the net asset value (NAV) of all investment trusts in China. As this compares with a figure of 4% for their share of the UCITS¹² market in Europe (excluding Ireland and the Netherlands), which was worth some €199.0 billion¹³ as of the end of September 2010, we think that the Chinese market for these products still has considerable growth potential. We also think that these products will benefit from the shift in investor needs, as the financial crisis takes its toll of Chinese stocks, from a search for high returns to one for low risk and low volatility as well as from the perception of these products as an inflation hedge.

As capital preservation funds are currently only allowed to invest in stocks, bonds and stock futures, there have been calls from fund management companies to be allowed to invest in a wider range of products. It will therefore be interesting to see how the market for these products grows as problems are overcome and products become more diverse.

¹¹ See qianhuaweb.com, 25 April 2011.

¹² UCITS (Undertakings for Collective Investment in Transferable Securities) are investment vehicles that, once approved in one EU member state, can be marketed throughout the EU. See Hayashi, Hiromi, "Kouhyou Sareta Oushuu Tousei Shintaku Shijou ni Kansuru Guriin Peepaa" (Publication of Green Paper on EU Market for Investment Funds), Capital Market Quarterly, Autumn 2005 (in Japanese).

¹³ See JC Economic Information, 21 March 2011.