RECENT TRENDS IN THE MUTUAL FUND INDUSTRY IN TAIWAN

1 HENG-HSING HSIEH, 2 KATHLEEN HODNETT
1,2 University of the Western Cape, Cape Town, South Africa
E-mail: 1 ahhsieh@uwc.ac.za, 2 khodnett@uwc.ac.za

Abstract- Offshore fund houses in Taiwan are perceived to possess better capabilities over onshore fund houses and are regarded as excellent vehicles to offer enhanced yields through a large variety of innovative products and superior customer services. Despite the recent regulatory changes that aim at curbing the growing dominance of the offshore fund market, Taiwan remains an attractive location for global fund houses to grow their businesses. The increased demand for retirement needs due to the aging population and low birth rate calls for pension reform that offers ample growth opportunities for the mutual fund industry in Taiwan. The relaxed political tension and the progressive partnership between China and Taiwan also stimulate the interest of global fund houses to establish their businesses in Taiwan.

Index terms- Investors, mutual funds, performance persistence, asset management, SITCA, Taiwan.

I. INTRODUCTION

In Taiwan, mutual funds are issued by securities investment trust companies (SITCs). The first Taiwanese mutual fund company, International Investment Trust Co. was established in 1983. At the time, the mutual fund industry was highly regulated with limited number of SITCs; and offshore fund institutions could only introduce their products in Taiwan by setting up security investment consulting companies that merge with or partially invest in local SITCs. Such regulation was relaxed in 1996 with the first fully-fledged foreign SITC introduced by American International Group in 1997 (Chiu, 2000). According to the Citi Investor Services Report published by Citibank in 2014, Taiwan’s demographics of a large middle-aged, middle-class population, with high average earnings and savings rate, coupled with strong appetite for foreign assets, make Taiwan an excellent location for registering offshore mutual funds. Investors in Taiwan generally prefer to invest in offshore funds to onshore funds despite their higher charges and management fees because offshore funds enjoy liberal restrictions on how they may invest their assets, which could potentially deliver better performance compared to highly-regulated onshore funds. The much relaxed political tension between Taiwan and China also helps to stimulate the interest and the growth of the mutual fund industry in Taiwan (Aldcroft, 2014). This paper aims to provide insight into the recent trends in the Taiwanese mutual fund industry in the past decade by exploring important aspects such as reasons leading to the growing dominance of the offshore fund market over the onshore fund market in Taiwan, regulatory changes targeting at promoting onshore fund business, investor preferences in the local market and opportunities ahead for global fund houses.

II. GROWING DOMINANCE OF THE OFFSHORE FUND MARKET

Over the past decade, the offshore fund market has grown substantially and surpassed the market share of onshore funds in Taiwan. The assets under management (AUM) of the onshore funds versus the offshore funds since 2006 are illustrated in Figure 1. After the global financial crisis in 2008, the AUM of offshore funds has surpassed the AUM of onshore funds in Taiwan.

Figure 1: Assets under management (AUM) for onshore funds and offshore funds

According to a report published by Roland Berger Strategy Consultants in 2013, Taiwanese investors share a strong appetite for risky assets in Taiwan and offshore funds are regarded as an excellent vehicle to offer enhanced yields, alleviate currency risk, diversify assets and are perceived to provide superior customer services despite higher charges and management fees. The Roland Berger report explains that although the limited range of onshore products and the relatively poorer returns offered by domestic stocks and bonds contribute to the preference for offshore products, the success of offshore fund houses could not be possible without a carefully planned and executed strategy. The important factors determining the success of offshore fund houses in Taiwan highlighted in the Roland Berger report include dedicated commitment to broaden...
distribution channels, premium commissions offered to distributors, innovative product lines and excellent client services.

The local regulating body, Financial Supervisory Commission (FSC), on the other hand, attributes the substantial growing interest in offshore funds to the unfair advantage created by the master agent agreement that allows offshore funds to avoid the costly process of setting up local distribution channels compared to the stricter regulations faced by onshore funds (Fulco, 2015). In 2004, the Regulations Governing Offshore Funds were passed to grant permission to offshore asset managers to market their products in Taiwan by mandating an approved securities investment consulting enterprise (SICE), securities investment trust enterprise (SITE) or securities broker to act as their master agents.

The data provided by Securities Investment Trust & Consulting Association (STICA) shows that there were 35 master agents, 54 offshore fund institutions offering 721 offshore funds with a total amount of NTD1,368 billion invested in the offshore fund market as of 31 December 2006. These figures have grown to 45 master agents, 78 offshore fund institutions offering 1,024 offshore funds worth NTD3,084 billion by 31 December 2015. Compared to a total amount of NTD2,203 billion invested in 672 onshore funds as of 31 December 2015, the offshore fund market dominates the Taiwanese mutual fund industry with roughly 58 percent of the market share.

III. INVESTOR PREFERENCES

Figure 2 illustrates the composition of the onshore fund market in Taiwan as of 31 December 2015. Close to 50 percent of onshore fund investments is concentrated in money market funds. The equity funds category receives the second highest market share (over 20 percent) in the onshore fund market investments. Each of the remaining categories (fixed-income funds, balanced funds, exchange traded funds (ETFs) and fund of funds) receives less than 10 percent of investments in the onshore fund market.

The investor preference in the offshore fund market in Taiwan is quite different from their preferences in the onshore fund market in Taiwan. Figure 3 demonstrates the market shares of various mutual fund categories in the Taiwanese offshore fund market as of 31 December 2015. In contrast to a mere NTD509 billion of AUM in the onshore equity funds category, the AUM of NTD1,288 billion invested in the offshore equity funds is approximately double of the AUM in the onshore equity funds. The equity funds category also receives the large market share of 41.77 percent in the offshore equity fund market in Taiwan. In addition, the offshore market share for the high yield bond funds of 28.95 percent is greater than the combined market share of the remaining fund categories (various bond funds, balanced funds, money market funds, ETFs and others).

Equity and high yield products are often viewed as more sophisticated products by investors due to the higher risk inherent in these products. The popularity of equity and high yield bond products in the offshore fund market in contrast to the preference of safer money market products in the onshore fund market once again suggests that offshore fund houses are perceived to possess better capabilities over onshore fund houses in Taiwan. The desire of Taiwanese investors to take short-term profits rather than wait for long-term gains has led to the active trading of mutual funds, which could pose a potential challenge to fund houses. It is also worth mentioning that ETFs...
in Taiwan have not yet gained its popularity as a passive investment vehicle as it had in the international markets. This could be due to the higher risk appetite of Taiwanese investors who constantly seek for active investments to beat the passive benchmarks.

IV. PROMOTING ONSHORE FUND BUSINESS

The master agent mandate introduced by earlier policy allows offshore funds to flourish without having to be physically involved in establishing the costly distribution channels in Taiwan. Ideally, local regulators would like offshore fund houses to contribute to the development of the mutual fund industry in Taiwan by offering their commitment to build their businesses and distribution networks in Taiwan.

In addition, the high concentration of investments in the high yield bond funds in the offshore fund market has raised serious concerns after the painful experiences learnt from the subprime crisis in 2007 and the recent European debt crisis. The desire of Taiwanese investors for regular dividend payments offered by high yield bond products also presents a concern to the regulators as to whether the dividend payment represents income from fund performance or erosion of principal.

With the intention to balance the competitiveness of onshore versus offshore fund houses and lessen the overreliance on the investments in the high yield bond sector, the Taiwanese regulators began to tighten the policies governing the registration and operations of offshore fund houses in recent years. Some of the most important policies implemented to restrict offshore fund operations and promote onshore fund businesses are summarized below (Aldcroft, 2014; Fulco, 2015):

- In 2013, the FSC reduced the number of offshore funds permitted to be included in a single registration application from three to one. This creates a barrier for new entrants to gain their market share in the Taiwanese mutual fund industry.

- Effective from 1 January 2016, the percentage of a fund’s asset permitted to be sold to Taiwanese investors has been reduced from 70% to 50%.

- Onshore funds are allowed to launch multiple high yield bond funds while offshore funds are only allowed to distribute one high yield bond product per year. In addition, fund houses offering high yield bond funds are required to disclose the source of income in offering and marketing documents.

- An incentive scheme was introduced in 2013 to reward offshore fund houses that devote effort in establishing their business and network in Taiwan. Some of the incentives include faster approval for retail launches, waivers of restrictions on operations and distributions, permission to launch new products, etc.

- Since 2012, onshore funds are permitted to invest 100% of AUM in China A-shares, while only 10% of AUM at the maximum is permitted for offshore funds. In addition, only local asset managers are permitted to issue renminbi-denominated funds in Taiwan.

V. OPPORTUNITIES AND THREATS AHEAD

From the measures listed above it is apparent that the restrictions imposed to cramp the offshore fund businesses outnumber the incentives offered to promote the devotion of offshore fund houses in building their businesses onshore (Fulco, 2015). Despite the restrictive policies that present headwinds to existing offshore fund houses and new entrants to the market, the large population of Taiwanese people now working or doing business in China (more than 2 million) has created a large demand of exposure to China by Taiwanese investors that offers ample growth opportunities to global fund houses (Aldcroft, 2014).

After the new cross-strait service trade agreement as a follow-up to the Economic Cooperation Framework agreement (ECFA) entered by China and Taiwan in 2010, Taiwan is expected to be included in the Renminbi Qualified Foreign Institutional Investor (RQFII) program that grants permission to overseas investors to deploy offshore yuan investments in China (Hung, 2013). Without membership in the RQFII program, any investment in the Chinese financial market will have to go through a costly exercise of remitting foreign currencies to China and converting them to yuan first (Liu, 2015). In addition, the central banks of China and Taiwan entered into a clearing agreement for yuan transactions in Taiwan in 2012. The interbank trading of the yuan currency is now possible in Taiwan, which lessens the currency exposure of Taiwanese companies when moving their yuan-denominated assets back to the mainland (Wong and Chang, 2012). The progressive partnership development between China and Taiwan in recent years has surely made Taiwan an important location to grow the business of global fund houses. The FSC’s “China is for Taiwan” policy means that onshore fund houses will be promoted as the first choice to offer Taiwanese investors opportunities to invest in the Chinese financial market (Aldcroft, 2014).

Aldcroft (2014) also points out that the increased longevity and declining birth rates in Taiwan have led to increased savings as a preparation for retirement costs. The pension reform plan in Taiwan aims at stimulating a greater number of individual pension plans that make use of the defined contribution schemes to offer members a wide variety of choices in overseas investments. In addition, major national pension schemes such as the Labor Pension...
Fund, Labor Insurance Fund, National Pension Insurance Fund and Public Service Pension Fund also outsource part of their assets to international fund houses.

The prosperous growth opportunities highlighted above also brought fierce competition to the market. The Roland Berger report points out that while the largest offshore players continue to grow at the expense of smaller players, the onshore fund houses have actively engaged in acquiring rivals to enhance their capabilities and competitiveness in the Taiwanese mutual fund industry. By the same token, offshore fund houses have also resorted to mergers and acquisitions (M&As) to gain their presence in the market. Thus, it becomes very difficult for onshore or offshore fund houses to compete in the market without having critical scale in their networks and product offerings. The smaller fund houses are likely to become takeover targets as the market is dominated by the presence of well-established fund houses.

CONCLUSION

Over the past decade, the offshore fund houses flourished the mutual fund industry in Taiwan, which presents a threat to onshore funds. The local regulatory body has since imposed measures to promote onshore fund business and encourage offshore fund houses to establish their business onshore. Despite the regulatory headwinds, the island remains an attractive location for the global mutual fund houses to grow their business. The progressive partnership development and lessened political tension between China and Taiwan also makes Taiwan a perfect location to grow the businesses of global fund houses. The growing pool of idle funds in preparation for retirement needs represents potential source for financial market growth in Taiwan.

Going forward, the competition in the fund market becomes quite intense with many onshore and offshore funds resorting to M&As to maintain their competitive edge as it leaves no room for fund houses to compete without having critical scale in the market. The short-termism of Taiwanese investors that results in active trading of mutual funds with very short holding periods also poses a potential challenge to fund houses. For offshore fund houses, although the use of a master agent agreement presents a cost effective marketing channel, the commitment to build significant onshore presence is important for long-term growth and to remain competitive in a restrictive regulatory environment.

REFERENCES


