Fund Investment: Your Questions Answered

HONG KONG INVESTMENT FUNDS ASSOCIATION

CONTENT

Basics

What is a UNIT TRUST or a MUTUAL FUND?

A unit trust or a mutual fund refers to a collective investment scheme under which professional fund managers pool money from individual investors and manage it according to pre-set investment objectives.

The investment objectives can range from maximising capital gains to maintaining a stable stream of income, and from beating inflation to preserving capital. Based on the designated objectives, the fund manager will invest the money in equities, bonds, currencies or other relevant investment instruments in a specific market or different markets around the world.

Why should I INVEST IN FUNDS? WHAT are the PROS and CONS?

Pros:

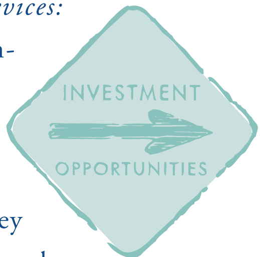
Low minimum investment, but with many choices: With a minimum investment, usually of US$1,000-US$2,000, you can invest in a wide array of securities through funds. For instance, an equity fund usually holds at least 40-50 stocks, and for some funds which have larger asset sizes, they may hold over a hundred stocks. If you buy all the individual stocks direct, especially the blue-chips, you would probably need a substantially larger outlay of capital. For bonds, you may find it extremely difficult to invest in individual bonds because the principal value is usually much higher.

Access to global investment opportunities: Through funds, your investment horizon can be broadened because there are different types of funds which can provide you with a very convenient and cost-effective way to capitalise on both local and overseas investment opportunities, and to avoid being bogged down in a particular market or by a particular type of instrument.

Diversification: Diversification may take different forms, e.g. along geographic or industry lines, or amongst different securities or issuers. The essence is that by investing in securities that have a low correlation, a portfolio can help you spread out the risks and achieve a better risk-return behaviour than individual securities.

The Code on Unit Trusts and Mutual Funds issued by the Securities and Futures Commission ("SFC") (read the Section on "Investor protection") has detailed requirements to ensure sufficient spread of investments. For example, a fund cannot hold more than 10% of its net asset value in securities issued by a single issuer. Also, a fund cannot hold more than 10% of the ordinary shares issued by a single issuer.

Access to professional investment management services: Through funds, you can enjoy the services rendered by fund managers. Fund managers will help you research and analyse the markets and securities for the funds. Fund managers will determine which securities to hold, when to buy or sell. They make decisions based on extensive research into the performance of individual stock or other security issues, as well as the fundamentals of the economies and market trends.



If you invest direct in a particular stock, you may need to spend a lot of time to monitor the performance and the latest development of individual stocks. However, with funds, you are relieved of these often onerous and time-consuming tasks of studying and picking specific securities. You can concentrate on your own occupation and other pursuits because there is a team of professional fund managers who will monitor the investment full-time.

Convenience: If you invest in individual stocks directly, you have to handle the custody and administration for each and every single stock. However, with funds, you enjoy a "one-stop" service as you can invest in a range of stocks, but can dispense with the tedious task of arranging payment, settlement and other related administration work for each individual stock.

Also, it is relatively easy to buy funds. You can buy through banks, independent financial advisors or direct from fund houses.

Cons:

Unable to PICK STOCKS?

Some people do not like to invest in funds because they enjoy the stock-picking process and they think that fund investment deprives them of the decision-making power to choose stocks.

It should be noted that it is here where the value-added of fund investment lies: funds allow an investor to focus on his own work and let fund managers, who have the professional expertise and skills, take care of his investment on a full-time basis.

Riskier than bank deposits?

Relatively speaking, most fund types (except probably money funds) would be riskier than bank deposits. However, risks go hand-in-hand with returns, i.e. higher risks go with higher returns and vice versa.

Over a longer term, you have the opportunity to get better returns from most fund types than from a normal bank savings account.

Unable to KNOW THE FUND PRICE REAL-TIME?

Unlike stocks, when you buy or sell funds, you won't know the price at which you buy or sell real-time.

Most funds are dealt on a daily basis (though some specialist funds may deal on a weekly or monthly basis) using a forward pricing basis. This means that when you buy or sell or switch in or out of a fund, you do not know the buy/sell price at which the transaction will be executed until the next dealing day.

The reason for this is that unlike an individual stock or bond, each fund holds a basket of securities. The price is calculated based on the net asset value of all the securities held and the number of outstanding units. The key benefit of using the "forward pricing" approach is that it is fair to all investors, as unit prices calculated after the dealing cut-off time on a particular day reflect the market value of the underlying investments more accurately.

Are UNIT TRUSTS DIFFERENT FROM MUTUAL FUNDS?

From an investment perspective, there are no major differences between unit trusts and mutual funds. Both are governed by the SFC Code on Unit Trusts and Mutual Funds. Both are professionally managed portfolios which invest in a wide variety of financial instruments.

The key difference between the two lies in the legal structure:

	Unit Trusts	**Mutual Funds**
Form of establishment	Trust	Limited liability company
Beneficiary	Unitholder	Shareholder
Governing law	Trust law	Company law
Legal document in which the rules are laid down	Trust deed	Company's articles/ bye laws & custodian agreement
Who protect investor interests	Trustee	Custodian (but according to the custodian agreement and articles/bye laws).
Who owns or holds the fund assets	Trustee holds the assets for the benefit of the investors.	The mutual fund company owns the assets and investors are shareholders of the company.
Who is liable	Trustee	The company has limited liability; directors can be liable.

Categories of funds

What TYPES of FUNDS are AVAILABLE?

Funds are commonly divided into the following categories, based on their investment objectives and policies:

- asset allocation
- equity
- fixed income/bonds
- money market
- warrants or derivatives
- others

What is an ASSET ALLOCATION FUND?

It refers to a balanced portfolio that aims to provide both capital gains and income. This type of fund may invest in global equity, fixed interest and money market instruments; and usually the investment in a particular asset class does not exceed a certain percentage.

What is an EQUITY FUND?

It refers to a fund that primarily (usually not less than 70%) invests in equities with the aim of maximising capital gains. The type of equities invested can range from domestic to international; and from blue-chips to small companies shares.

What is a BOND FUND?

It refers to a fund that invests predominantly (usually not less than 70%) in bonds and other fixed income securities which can be issued by governments, municipal states, corporations, or other issuers.

What is a MONEY MARKET FUND?

It refers to a fund that invests in short-term money market instruments (usually less than one year), such as government securities, term papers, bank deposits; and other assets denominated in different currencies.

It is sometimes called cash fund, currency fund or reserve fund.

What is a WARRANT or DERIVATIVES FUND?

A warrant fund typically invests in excess of 70% in warrants or related instruments and these funds may be highly geared.

Apart from warrant funds, there are other derivatives funds that invest in geared financial instruments, such as futures, forward contracts and options to maximise capital appreciation.

What are the OTHER TYPES OF FUNDS?

Examples include:

- convertible bond funds - "convertible bonds" refers to an instrument which has an option to be converted into equities at some pre-determined date in the future. Convertible bond funds invest predominantly – usually not less than 70% – in convertible bonds and preference shares.

- guaranteed funds - it refers to funds that usually limit investors' loss over a certain period, by way of a legally enforceable guarantee.

- fund of funds - this refers to a fund that invests in other funds, rather than investing directly in stocks, bonds or other securities.

What sort of risks and returns can I expect for equity, bond and money market funds?

General - risk and return:

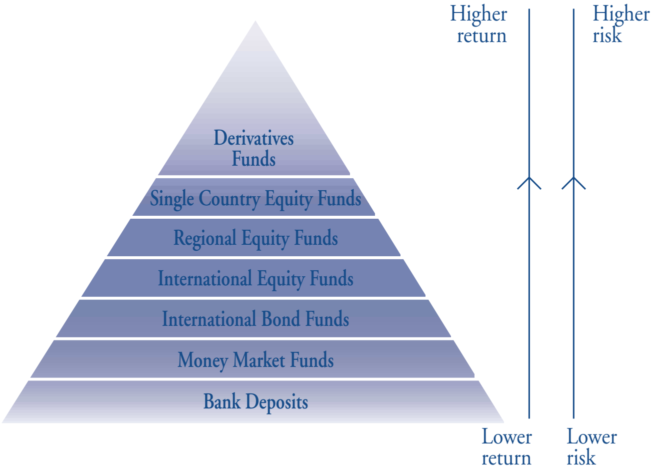
In making any investments, you should estimate both the returns and risks of the investment, bearing in mind that there is a trade-off between the two.

In layman terms, risk is the chance of not achieving your objectives of your investment. This may mean losing money, failing to beat inflation, or underperforming a certain benchmark. This is very personal as different people have different objectives.

From a more "objective" basis, you can probably look at the volatility of your investment, through the standard deviation ("S.D."). Usually, an investment with a higher S.D. is riskier.

Risks for each fund type:

Risks and returns vary with the types of funds. Generally speaking, higher risks go with higher returns and vice-versa; and risk appetites vary with an investor's age, income and financial position, as well as his investment objectives and risk tolerance level.



a) Equity funds:

If you invest in an equity fund, you are basically exposed to the same type of risks of the underlying equities.

The risks of a stock can be:

- unsystematic: company-specific (e.g. a competitor introduces an innovative product, which boosts its market share substantially); and/or
- systematic: applicable to the overall market (e.g. stock market crash of 1987)

Through diversification, a fund portfolio can reduce the unsystematic risks substantially.

In addition, like investing in any types of funds, you may be exposed to foreign currency fluctuations if the funds invest in overseas securities or are not denominated in your home currency.

b) Bond funds:

In essence, the risks you are exposed to in a bond fund are similar to that you would face if you invest in an individual bond:

- interest rate risk - when interest rates go down, bond prices usually go up and vice versa.
- default risk - this relates to the possibility of an issuer failing to pay interests or repay the principal.
- inflation risk - while bond funds may offer more stable returns than equity funds, their total returns may fail to keep pace with the inflation rate.
- prepayment risk - this happens when interest rates fall and the issuer may prepay before the bond matures.

The key difference between a bond fund and an individual bond is that the former does not have a maturity date and that its dividend payments are not fixed.

To choose a bond fund, you should check whether the fund focuses more on:

- maximising regular income streams (e.g. funds that invest in bonds issued by US or other more developed markets);
- maximising capital value rather than regular income inflows (e.g. high yield bonds); or
- striking a balance between the two.

c) Money market funds:

Compared with an equity or a bond product, money funds tend to provide a relatively high degree of safety. They are managed with the objective of maintaining the net asset values constant; whereas for other asset types, the net asset values may fluctuate.

Typically, a money market fund invests in short-term and high-quality deposits and debt securities. In other words, they are basically lending money only for brief periods to organisations such as banks, governments, and major corporations. As such, the risk of loss is relatively low.

However, a money fund can be "risky" as it may fail to beat inflation in the long-run. This will mean that your money is worth less and less.

Due to its relatively stable characteristics, it is often used as a cash management account where you can earn money rates on the money you need to use very soon.

Also, investors very often use money market funds as a "parking place". This is especially common when there is much uncertainty about the investment outlook and they haven't decided what investment options they should take up and when to invest; or when they feel that other options may look too risky.

Distribution channels

Where can I buy funds?

There are several channels through which you can buy funds:

- Direct:
  - retail outlets of fund houses (e.g. investment centres).
- Intermediaries:
  - banks (retail banks - primarily bank branches; and private banks - usually for high-net-worth individuals)
  - independent financial advisors
  - discount brokers
- Others:
  - insurance/accounting firms
  - securities firms

Which channel should I use?

There is no hard and fast rule as it depends on what types of investment services you would like to obtain; and how familiar you are with the different types of instruments and the markets.

- If you have already determined which market or sector to invest in and you know which fund house you would go for, you may wish to approach the relevant fund house direct or go through an execution-only broker.

- If you only know the market or sector you would like to go for, but you don't know which fund house to choose from, you may wish to approach an independent financial advisor ("ifa") or a bank.

- If you have some money for investment, but have no idea about which sector, market or fund house to go for, you may wish to approach an ifa, a bank or a few fund houses.

If you buy direct from a fund house, you would of course be able to buy that fund house's products only.

If you go through an ifa, you would be able to choose from a wider range of fund products as ifas usually represent products from different fund houses. Similarly, banks will also offer a wider range of fund products.

Despite the difference in the variety of products offered, fund houses, ifas as well as some banks that sell funds would provide professional investment advisory services. They will usually help you perform an assessment so as to understand your risk and return profile as well as your financial background. Based on the analysis, they will help you structure a portfolio that can cater for your needs. The fees charged by the various channels are also similar.

If you buy through an ifa, a bank or a discount broker, you will usually get a monthly or a quarterly consolidated statement, which itemises your holding with the various fund houses. If you buy from a fund house, you will also get a regular statement showing the funds you invest in through that particular fund house.

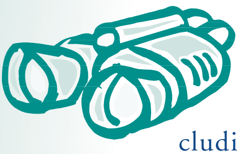
It would be advisable to shop around so as to compare the services provided by different channels. You should also try to consider the quality of services, but not just the prices.

Are fund companies, IFAs, banks or other intermediaries distributing funds reliable? Will they run away with my money?

Proper registration: These entities and their representatives must be properly registered with the SFC before they can distribute funds.

Depending on the functions undertaken, they may need to be registered as a securities dealer, or as an adviser, or be declared an exempt dealer. You can easily check whether a distributor possesses a dealer or an advisor licence because the certificate of registration should be displayed in a prominent place at their principal place of business.

If an entity is licensed, it means that it has met SFC's "fit and proper" criteria and complies with the basic requirements on capital, professional experience and expertise.



Licensees are obliged to comply with the SFC's Code of Conduct for Persons Registered with the SFC, which set out a number of principles including a duty to behave honestly and fairly, to provide information to investors, to know clients' investment objectives so that advices given are suitable and to avoid conflicts of interest. In particular, fund managers are also required to comply with the SFC's Fund Manager Code of Conduct.

However, assessment at the point of entry is based on the licensee's past behaviour, so a SFC licence is not a guarantee of future behaviour or quality of service.

Fund assets: No matter whether you buy through an ifa, a bank or a fund house, they can't lay hands on your assets as the assets are ringfenced and safely protected under trust law. (For details, see the Sections on "Investor protection" and "Trustees or custodians")

What kind of INFORMATION (MATERIALS) CAN I GET FROM A FUND HOUSE/INTERMEDIARY?

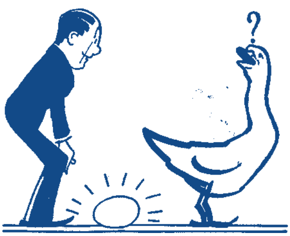
When you ask for information on a fund, a fund house or an intermediary will provide you with the following:

- prospectus or explanatory memorandum,
- latest audited annual report;
- latest unaudited semi-annual report;
- application form; and
- other pertinent information which the fund house or intermediary deems as appropriate.

Once you invest in a fund, you will receive regular statements (monthly or quarterly) providing you with the latest status of the portfolios (including valuation as well as number of units).

You may also receive regular newsletters or reports which will usually provide market views, news on products/services, as well as activities.

All these materials are required to obtain prior approval from the SFC.



Selection of funds

How can I choose which fund to buy?

It is important to do a 3-part homework before you decide on what type of funds to invest in:

Part A - Self assessment of your own financial background

First of all, list out the following:

- Your monthly income and expenditure position
- Your assets (e.g. properties, stocks, unit trust, etc.)
- Family obligations (e.g. funding for children's education)
- Other financial obligations, e.g. mortgages, pensions and insurance agreements

Part B - To select the appropriate fund sector

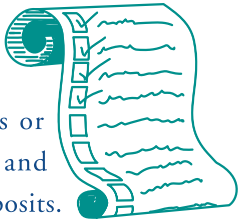
Then do a self-assessment on the following aspects:

Investment objectives: What is your investment objectives (income or capital growth) - if your objective is to maximise capital growth, you may consider allocating a higher percentage of your portfolio to equities. However, if you aim to obtain a stable stream of income, you should focus on fixed-income funds, money funds or other products that can provide you with steady income or dividend payout.

Risk/return expectation: Generally, investment must offer higher potential returns to compensate for increased volatility. Thus, if you are going to invest in instruments with higher potential returns, be prepared to accept more short-term price volatility.

If you are close to retirement or if you don't like to experience much volatility, you may wish to choose products that focus on income growth, e.g. bond funds or other products whose objectives are to provide a steady stream of income.

Time frame: Another factor you should ask yourself is how long you can put aside the money for investment. If you are going to use it in the next few days, weeks or even months, liquidity will be the key consideration and you should probably consider putting your money in deposits.



If the money can be put aside for a longer time frame, say over half a year, you may consider taking up some form of investment. If you can put aside the money say for 3-5 years, you are in a better position to invest in equities.

Usually a long-term investor who is ready to wait for a longer time and can accept more risks can invest a higher percentage of their assets in equities. However, an investor who is probably more conservative, and needs to redeem his investments in the short-run, should keep a larger portion of his investment in bonds or cash.

Part C - How to select a fund

Once you have identified the type of funds to invest in, e.g. you would invest in a balanced fund, you should try to obtain more information on funds within this sector. You can do so by reading the relevant funds' explanatory memoranda and financial reports, as well as call the SFC to check the funds' authorisation status.

Also, you have to:

- check if the fund's investment objectives specifically match your own and note that risk and returns always go hand-in-hand.

- compare the fund's performance and volatility against:

  - ➢ the peers (say via the sector median); and
  - ➢ the relevant benchmark.

  You should remember that past performance may not be indicative of future performance.

  (For details, read the Section on "Performance/Returns".)

- also, you can ask how long the fund manager has been with the fund, and whether the fund manager who has contributed to strong performance of the fund, is still with the fund.

- the volatility of the fund - a factor that investors always omit. As mentioned before, this is the standard deviation of the monthly returns of the fund from its average; or how much it deviates from its average, and usually the larger the number, the higher the volatility.

  You can check the volatility rating, which measures the variability of the fund's performance over the previous few years, usually three years.

  Usually the riskier the type of investment involved, the longer you need to put the fund aside. Generally speaking, it is three years for a mixed equity fund and at least five years for a single-country equity fund.

- fund size - a fund whose fund size is below a certain size may mean that you are bearing a disproportionate share of the overhead expenses. It is generally noted that if the asset size of a fund is below US$5 million, it may not be economical.

- investment details - these include fees and charges, as well as purchase, redemption, switching as well as other dealing procedures.

Why should I read the explanatory memorandum?

You should read the explanatory memorandum or the prospectus before investing because it is a legal document that provides you with details of a fund's objectives, investment strategies, fees and charges as well as other important investment information.

What information can I find in the explanatory memorandum?

You can find the following information in the explanatory memorandum:

- investment policies and objectives
- investment restrictions and guidelines
- characteristics of units, e.g. minimum investment, certification
- valuation and pricing of assets
- transaction procedures, including purchase and redemption of units, switching between funds
- suspension and deferral of dealing
- fees and charges
- accounting period and meetings
- distribution policy
- taxation
- base currency
- means by which modifications to the documents can be effected
- contact details of the providers: names and addresses of operators and principals including the trustee, the management company, Hong Kong representative, and distributors etc.
- procedures for termination of schemes

Selection of fund companies

Where can I get a list of authorized fund managers?

The HKIFA maintains a list of member fund companies. However, the list only covers fund managers that are members of the Association and represents about 70-80% of the active fund managers registered with the SFC.

Which fund manager should I use?

There are several factors that you may take into consideration before choosing a fund manager:

- *its corporate background:* you can look at its history, client base, strength as well as total assets under management (both in Hong Kong and worldwide, if applicable);

- *the types of products and services offered:* you can check whether the company offers a full-range of products or whether it is a niche player. The former usually allows you greater flexibility to switch amongst different products to capitalise on different investment climate; while the latter may provide you with more specialised services and product types.

- *its investment philosophy and approach:* this is important because a fund manager with a more aggressive approach may do better in a bull market. However, a more conservative fund manager may maintain more resilience in a market downturn.

- *point-of-sales:* this will affect how easy you buy, sell or switch funds. The point-of-sales usually include the outlets (can be physical premise or through electronic means) through which you can place an order.

Fees/Prices

WHAT TYPES OF FEES DO I HAVE TO PAY? WHEN DO I HAVE TO PAY?

When you invest in a fund, there are basically two types of fees you have to pay:

- initial subscription charge or the front-end fee; and
- annual management fee

In addition, some funds may charge a redemption fee (especially for no-load funds) and performance fees (mainly for funds that invest in very sophisticated instruments.) Moreover, each fund would have fees charged by service providers, e.g. the trustee/custodian, administrator, etc. There are also other out-of-pocket expenses directly charged to the fund.

HOW MUCH ARE THESE FEES?

Type of Fees / Type of Funds	Initial charge	Annual management fee	Redemption charges/ Performance fee
Money Market Bond Equity Warrants	0%-2% 3%-5% 5%-6% 5%-7%	0.25%-1% 0.5%-1.5% 1%-2% 1.5%-2.5%	Varies: the more sophisticated the instrument, the higher the fee levied
Note:	Already included in the offer price	Allocated from the fund on a daily basis. Will not constitute as an out-of-pocket expense for investors.	Only very few companies or fund types charge these fees.

The fees are generally computed based on the net asset value of the fund. The table is for reference only and investors should refer to the fund prospectus for detailed costs.

When do I have to PAY?

The initial subscription charge is paid up-front, i.e. you have to pay when you subscribe. For example, if you invest US$1,000 in a fund, the fund company will either:

- deduct 5% from your investment, and the net investable amount would be US$950;

or:

- gross up the amount so that the total you have to pay would be US$1,050; and your investable amount would be US$1,000.

On the annual management fee, you don't have to pay out-of-pocket separately. The fund will accrue it on a daily or a weekly basis, and deduct it from the pool of the money before the returns are divided amongst investors. The net asset value quoted is already net of the annual fee.

As for redemption fees, they are usually computed based on the NAV, and are charged on exit, based on a sliding scale. This fee is usually charged if no-front-end is levied. Usually, the longer you invest, the lower the redemption fees you will have to pay.

Why do fund companies CHARGE 5% SUBSCRIPTION FEE? What is it for?

Similar to any other services, you have to pay a fee for the services received from fund investment. This is just like having a meal at a restaurant where you have to pay a 10% service charge.

Fund companies charge the subscription fee, which primarily covers the expenses incurred for rendering the services to you. These include amongst other things, the cost of setting up your account, supplying you with updated market information, as well as paying a fee to professional intermediaries.

What are NO-LOAD FUNDS?

No-load funds refer to funds that do not require a payment of front-end charges.

However, if an investor redeems before a certain period, there would usually be a redemption charge.

Performance/Returns

Where can I find the fund performance data?

Fund performance data are compiled by Standard & Poor's Fund Services, Lipper Asia, and other independent companies that track fund performance.

The HKIFA website (http://www.hkifa.org.hk) carries performance data supplied by Standard & Poor's Fund Services. In addition, major print media, some electronic media, as well as marketing materials of fund managers or investment advisors also provide selected performance data. Performance data can also be found in the annual reports of funds.

How should I compare fund performance? What time frame should I look at?

When comparing the performance data, you should ensure that you are comparing like with like. Thus, you should only compare funds that are within the same sector or funds with the same investment objectives.

Usually, you can use two factors to evaluate fund performance:

- peer groups: you can compare a fund's performance against funds that have similar investment objectives and invest in the same asset class. In making the comparison, you can look at the sector median, which can give you an idea of the overall performance of funds within the sector.

- benchmarks: benchmarks refer to well-established and commonly used indices that are representative of the markets in which the securities invest. To a certain extent, a benchmark can give you an indication of the value-added brought by the fund managers.

It would be advisable to look at the peer group performance as well as the benchmarks because there may be some funds which appear to perform relatively poor against the relevant benchmark, but actually outperform the peers.

Also, when you look at performance, you should look at how the fund performs over different time frames (including 1-year, 3-years, 5-years and 10-years) so as to have a better understanding of how the fund has performed under different investment environments.

For example, usually it may not be advisable to invest in a single-country equity fund on the basis of its one-year performance. What you should try to do is to look at how it performs over other time periods to see if the fund has consistently performed reasonably well.

It should be noted that past performance is not indicative of future returns and that you should not focus just on performance, but should consider other factors in selecting a fund.

Are the RATES OF RETURN shown in the performance table GROSS or NET OF CHARGES? HOW are DISTRIBUTIONS TREATED?

The most common methods used for computing the performance data are offer-to-offer, or NAV-to-NAV, though other methods are also used.

Irrespective of which methods are adopted, the fund manager has to, under the SFC Code, spell out the source of data, the time period covered and computation basis alongside the performance data.

In computing the returns, it is generally assumed that all distributions are re-invested into the fund on the date on which such distributions can first be invested.

Can I rely on the performance data shown in the advertisement?

All adverts of authorized funds have to obtain prior approval from the SFC.

In vetting the adverts, the SFC's primary focus is to ensure that a true and fair picture is provided to investors and no misleading information or data is provided. The SFC will also see to it that the performance claims quoted in the adverts are verifiable, and that there is no forecast of fund performance.

How can I make money out of fund investment?

Investors can usually make money out of fund investment in two ways:

- *dividend/income growth:* this refers to income paid out from the fund, which can be regularly or irregularly. Very often, dividend or interest income represents the main source of income for money market funds and bond funds. It also represents a source - though less significant for equity funds, which in general focus more on capital appreciation.

A money fund receives interest payments from the governments, banks or other corporations to which it lends money. These payments will be passed onto investors as dividends.

Similarly, interest earned on a bond fund is passed onto investors as dividends. Dividends, less fund expenses, is the "yield" of the fund. It should be noted that not all bond funds will pay dividends and for those which make dividend payout to shareholders, the payout can vary from month to month.

Dividends can be taken in cash or be reinvested in the fund. You should check the prospectus for the distribution policy of the fund. The fund manager will usually specify whether he is going to make any distribution, and if yes, the frequency and timing.

In general, the default option for most equity funds is that the distribution will be reinvested rather than be paid out.

- *capital growth:* if the stocks, bonds or other securities held by a fund increase in value, the value of the fund portfolio will increase. As a result, the value per unit or per share will rise correspondingly. Similarly, if the total value of the portfolio decreases, the unit value will drop.

Capital growth/losses are usually associated with stocks, though bond products also can have capital appreciation/depreciation potential because bond prices are constantly changing in response to changing interest rates and other market factors.

Dealing and Valuation

WHAT IS NAV AND HOW IS IT ARRIVED AT?

NAV (Net asset value) is derived by subtracting the liabilities of a fund from its total assets, and then divided it by the number of shares outstanding. Valuation of a fund is usually calculated daily and the NAV will fluctuate in line with the securities that the fund holds.

HOW CAN I CALCULATE THE NUMBER OF UNITS THAT I AM ENTITLED TO?

Example :

Gross amount of investment	: US$10,000
Front-end load	: 5.5%
Net amount invested	: US$10,000 - (5.5% x US$10,000)
	= US$9,450
Price of the unit	: US$10
Units to which I would be entitled	: US$9,450/US$10
	= 945 shares

IN WHAT CURRENCIES ARE FUNDS USUALLY DENOMINATED?

Most funds are denominated in US dollars, though some are in HK-dollar, Euro, sterling or Yen, etc. When an investor considers an investment, it is important to note the currency in which the fund is denominated, because it may have a positive or a negative impact on the returns, due to exchange rate movements.

Why is a fund DENOMINATED IN A PARTICULAR CURRENCY?

The majority of unit trusts and mutual funds in Hong Kong are denominated in US dollars, primarily because this is the most widely available currency and accepted internationally as such.

The currency of denomination of a fund is a point of reference, and can be used as a basis of measurement, but as the assets of internationally invested funds are held in the currencies of the countries in which they are invested, it is the combined effects of these movement that then affect the dealing price for each fund.

Can the DENOMINATION, DEALING AND QUOTATION CURRENCIES OF THE SAME FUND all be DIFFERENT?

This can happen, but it causes additional administrative issues for the fund company. It is usual for deals in and out of the fund to be accepted in the local currency of the location where the fund is sold, i.e. Hong Kong dollars in Hong Kong, but the fund denomination and pricing will be a single currency, usually US dollars.

What exchange rates are applied in the PURCHASE AND REDEMPTION OF UNITS? Is it a UNIFIED RATE? If not, will the fund manager POCKET THE SPREAD or is the SPREAD CREDITED TO THE INVESTORS?

According to the SFC Code, fund managers have to execute orders on the best available terms, and he cannot pocket the spread.

Some companies have pre-arranged agreements with their bankers to provide "wholesale" i.e. institutional exchange rates, rather than "retail" rates offered at bank branches.

On currencies, what other issues should I be aware of?

You should check with a fund company whether the fund in which you wish to invest "hedges" the currency of the assets back to the currency of denomination. Hedging can be effective in reducing currency risk if it is got right, but can increase losses and be expensive if got wrong.

Do prices published in the newspapers and other media include charges?

It depends on the methods of quotation. At present, there are primarily two methods of quotation, namely by net asset value ("NAV") or by bid/offer.

Under NAV, fund prices are shown net of the subscription charges. You would redeem at NAV, and if you subscribe for the fund, you have to add the subscription charge to the NAV.

As for bid and offer, the spread between the bid and offer prices represents the subscription charges. You would buy at the offer price and sell at the bid price.

Example:

Assume that for a fund:

- net asset value of the fund: US$50 million
- outstanding number of units: 10 million

- net asset value per unit: US$5
- initial charge: 5%

then:

- bid price is US$5
- offer price is US$5 x 1.05 = US$5.25

Switching and redemption

What is SWITCHING and HOW will I be CHARGED?

Switching means that you move out from a sub-fund, say X to another sub-fund, say Z, within the same umbrella fund.

An umbrella fund comprises a number of sub-funds which are invested in a wide array of international markets. Each sub-fund is an independent unit trust and is separately managed, with its own investment objectives.

An umbrella fund offers investors a wide range of investment opportunities together with a simple method of switching from one sub-fund to another.

Usually, if you invest in a fund, say Z, you have to pay a subscription fee in full. However, if you switch from X to Z, you will very often not be charged the full subscription fee for Z, but only at a discount rate.

Sometimes, you may also be entitled to a discount rate if you switch from a single fund (not a sub-fund) to another single fund within the same fund group.

As to what switching discounts you will be entitled to, this will depend on the value of your investment, and you have to check with the fund houses in question.

Can I redeem at any time?

Yes, basically investors may redeem their funds within the trading hours on any business day, details of which are stated in the prospectus.

Is it possible that I am unable to redeem even within the trading hours?

Yes, it is possible that you may be unable to redeem even within the official trading hours.

However, this is the exception rather than the norm.

One possibility is where there is exceptional market situation, which will make accurate pricing difficult or impossible. For instance, if a market in which the fund invests suddenly announces measures on capital controls, or closes because of political upheavals.

However, suspension is to be used sparingly and the SFC Code requires that any suspension should:

- be in the best interest of shareholders;
- receive prior approval from the SFC; and
- be published in the newspapers in which the fund prices are normally published.

Notices may have to be sent to investors if the period of suspension is long.

Also, a fund can suspend dealing if on a dealing day, redemption requests exceed 10% of the total number of units in issue. Then the requests above the 10% will be deferred to the next dealing day.

When should I REDEEM?

There is no hard and fast rule on this because it goes back to the objectives of your investment.

Usually, investors would redeem if they have already achieved their objectives.

However, under some circumstances, investors redeem to cut loss or if they are aware the long-term market outlook is not altogether positive.

Irrespective of the reasons, it is always advisable to monitor your investment regularly (say monthly or quarterly, depending on the type of funds you invest in) and consult your investment advisors on the course of actions to be taken.

After I have made a REDEMPTION REQUEST, HOW LONG DOES IT TAKE before I GET BACK THE MONEY?

Under the Code on Unit Trusts and Mutual Funds, the maximum period between the redemption request and the payment of redemption money may not exceed one calendar month. In practice, fund companies usually take seven to ten business days to pay back the redemption money.

Can a fund be CLOSED? If so, WHAT will HAPPEN to my investment?

Yes, a fund may be closed, liquidated or merged. The conditions under which this happens are set out in the prospectus.

Common reasons are as follows:

- the fund size drops below a certain level and becomes uneconomical to manage;
- a fund is to be merged with another fund, with similar investment objectives; or
- other business decisions of the fund managers.

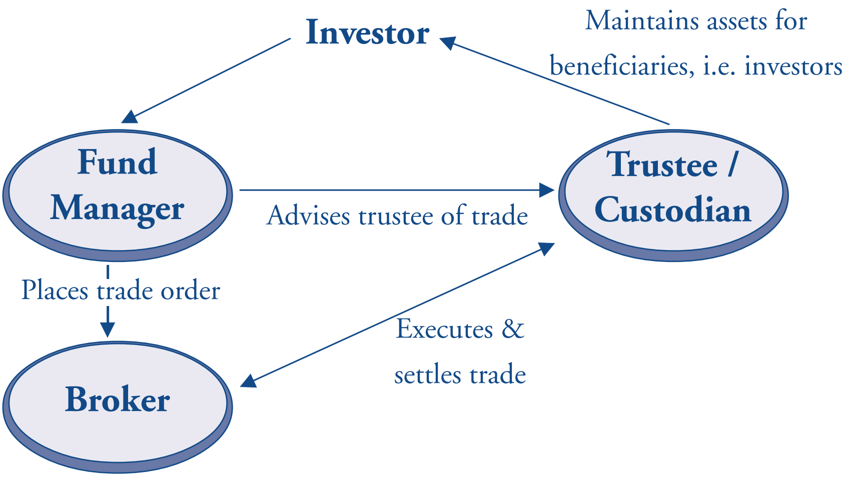
To close a fund (unless the means of termination are already set out in the prospectus), an EGM has to be called. And the termination can usually proceed if the resolution to do so has been passed by at least 75% of voters (in person or by proxy).

When you receive a notice of termination, you can choose to redeem your holdings before the EGM or remain in the fund.

When a fund is finally determined to be closed, the fund will be liquidated and you will be paid back according to the number of units/shares you have at the current market price. However, if at all possible, you would also be offered the choice of an alternative fund in the fund manager's portfolio, at no extra charge.

The fund manager will give notice of a decision to terminate and the notice period is normally three months, though it may be shorter if circumstances demand.

What parties are involved in the operation of a fund?



Regulation

Which piece of legislation governs the offering of authorized unit trusts and mutual funds?

The most important piece of legislation in relation to the marketing of investment products is the Protection of Investors Ordinance. The Ordinance prescribes that unless authorized by the SFC, no advertisements can be issued in Hong Kong. Selling unauthorized funds to the general public will constitute an infringement of law which involves fines and/or imprisonment.

What ROLE does SFC ASSUME in the regulation of funds?

- Investment products:
  - ➢ approves fund managers, in connection with authorized funds
  - ➢ authorizes funds

- Licensing:
  - ➢ licenses financial intermediaries (including fund managers) which carry on a business of dealing in or advising on securities in Hong Kong

- Intermedaries supervision:
  - ➢ inspects the activities of licensed financial intermediaries (including fund managers) in Hong Kong

What are AUTHORIZED FUNDS and WHY should I BUY authorized funds? What PROTECTION do I get?

You should buy authorized funds because these funds have been approved by the SFC and they satisfy certain minimum standards, in terms of operation, disclosure, investment, policy and promotion.

To be "authorized", a fund must satisfy the following requirements:

- *Clear and full disclosure in English and Chinese:* This aims to ensure that investors are given adequate information in relation to the fund before making an investment decision. Every authorized fund must provide an offer document, in both English and Chinese. It should set out important information such as the operators, investment policy and objectives, and investment details. No application form can be distributed without the accompaniment of an offer document.

- *Appropriate safeguards:* The fund must appoint an independent and qualified trustee or custodian which holds the fund's assets in trust for investors, and monitors the investments made by the fund managers.

  Also, the SFC will check the background of the fund manager to ensure that he has the necessary expertise, experience and is "fit and proper" to manage the funds.

- *Presence of a Hong Kong representative:* If a fund is promoted or managed by an overseas fund manager, it must appoint a Hong Kong representative with which Hong Kong investors can deal.

- *Diversified investment policy:* To be authorized, the fund must adhere to certain investment restrictions and guidelines. The basic principle is that the fund must be liquid and diversified.

- *Accurate adverts and marketing materials:* All adverts and marketing materials have to be vetted by the SFC before publication. The SFC will ensure that they do not contain false, biased or misleading information.

- *Other structural requirements:* There are other structural and operational requirements imposed on a fund, e.g. preparation of semi-annual and audited annual financial reports, and limitations on the types of fees which may be charged to a fund.

However, though you will have the protection of the regulatory framework by investing in an authorized fund, a fund which obtains the authorized status does not mean that it is being endorsed by the SFC. You still need to "do your homework" by reading the fund documentation.

To an investor, what is the MAJOR DIFFERENCE between a FUND DOMICILED IN HONG KONG AND a fund domiciled in OVERSEAS JURISDICTIONS?

Over 95% of the authorized funds are not domiciled in Hong Kong, but in other jurisdictions such as Luxembourg, the Channel Islands, Cayman Islands, Bermuda or Bahamas. The reason for these locations are either because they tend to be tax-free places or places where a fund, once established, can be widely marketed around the world.

SFC allows non-HK domiciled funds to be authorized here, but they still are required to meet the SFC standards as would apply to a locally domiciled fund. Most of the jurisdictions referred to above have their own securities commissions, and apply high standards to the fund before it is allowed to be offered to the public.

Does it mean that HONG KONG-DOMICILED FUNDS will be subject to the OVERSIGHT OF SFC only; while OVERSEAS-DOMICILED FUNDS to DUAL REGULATORY OVERSIGHT?

There is no a straight yes or no answer to this question because even amongst overseas-domiciled funds, the degree of supervision varies. Supervision would depend more on the domicile of the fund manager more than the fund domicile.

What HAPPENS if the LEGISLATION of the two places has DIFFERENT REQUIREMENTS? WHICH would PREVAIL?

Usually, if the regulatory requirements differ significantly, it is not possible for a fund to be authorized in Hong Kong as well as the place of its origin.

What other IMPLICATIONS WOULD DOMICILE HAVE to Hong Kong investors?

An advantage of having funds established in other jurisdictions is that the distribution of the fund may often be to a far larger market place. For example, funds registered and domiciled in Luxembourg may be sold in many of the European markets, as well as in Hong Kong, thus enabling the size to be much larger, if it is successful. Large-sized funds may enjoy economies of scale, resulting in lower expense ratios.

Fund managers/fund management companies

Are there any SPECIFIC QUALIFICATIONS before one can become a FUND MANAGER?

Strictly speaking, there are no professional qualifications that fund managers have to meet and there are no professional examinations to be taken. Most fund managers are university graduates, usually having a background in banking, accounting, or research; or have worked in the financial field for at least 3-5 years. Also, they are required to obtain licences from the SFC before they can deal in funds or provide investment advice to investors.

The SFC evaluates fund managers under the following criteria to ensure that they are "fit and proper" to engage in financial and securities business:

- financial status
- educational qualification and relevant experience
- reputation, character and financial integrity
- honesty and fairness

How are FUND MANAGEMENT COMPANIES being MONITORED? by WHOM?

Fund management companies are required to comply with ordinances and codes governing securities activities. In particular, they have to follow the Code of Conduct for Persons Registered with the SFC and specifically, the Fund Manager Code of Conduct.

To ensure compliance, the SFC will conduct inspection of locally-based fund managers on a rotation basis. Apart from routine check, the SFC may also carry out "special" or "theme" inspections.

On a day-to-day basis, it is the fund's trustees/ custodians which are responsible for monitoring the operation of the fund managers and the fund. The role of the trustees is to ensure that fund managers comply with the funds constitutive and offering documents and that the interests of the beneficiaries, i.e. investors, are best protected.

How CAN I KNOW IF A FUND IS AUTHORIZED OR THE PERSON I DEAL WITH IS LICENSED?

You can check this information from the SFC website: http://www.hksfc.org.hk or call up the SFC on (852) 2840-9333 to check if a fund is authorized or if a person is licensed or not.

All licencees are required to display their Certificate of Registration prominently at their place of business. If the SFC has imposed any conditions or restrictions relating to the types of services that can be offered, this will appear on the Certificates.

However, please note that there are no separate certificates for authorized funds.

Trustees or custodians

What are the ROLES of a TRUSTEE/CUSTODIAN in a fund and how do they DIFFER?

Both trustees and custodians have fiduciary responsibilities, meaning that they are entrusted to properly represent the interests of investors by standing between the fund manager and the investors.

Under law, a trustee owes a higher degree of care than a custodian in that it is responsible to perform a supervisory role in overseeing the fund operation. The trustee must ensure that the fund manager is fit and proper to act in its capacity, that the fund is being administered in accordance with the trust deed and any other regulations, that the assets are under the trustee's control, that the fund is being priced correctly and that distributions made to investors are properly handled and monitored.

The custodian's primary responsibilities include safekeeping of the fund's assets, settling of trades and collecting dividends.

In Hong Kong, the SFC requires the custodian of an authorized mutual fund to provide the same level of care as a trustee. Therefore, investors in authorized funds are offered the same level of protection whether investing in a unit trust or a mutual fund.

Who can be a TRUSTEE/CUSTODIAN?

For a Hong Kong authorized fund, (i.e. a fund which is subject to Hong Kong regulation and can be marketed to persons in Hong Kong) a trustee/custodian must meet the following criteria:

- a bank licensed under the Banking Ordinance;
- a trust company which is either a subsidiary of a bank or registered under the Trustee Ordinance;
- a banking institution or trust company incorporated outside Hong Kong which is acceptable to the SFC;
- must be independently audited and have a minimum issued and paid-up capital and non-distributable capital reserves of HK$10 million or equivalent; and
- subject to supervision on an on-going basis or be subject to an external audit on terms of reference agreed with the SFC.

What GUIDELINES exist with respect to RESPONSIBILITIES EXPECTED OF TRUSTEES/CUSTODIANS of Hong Kong authorized funds?

The Code on Unit Trusts and Mutual Funds issued by the SFC outlines the duties and responsibilities of trustees/custodians of funds authorized in Hong Kong. A trustee/custodian is strictly accountable to the SFC for any failure to comply with the requirements laid out in the Code.

How does a TRUSTEE/CUSTODIAN PROTECT INVESTOR'S ASSETS?

Fund assets are safekept under the trustee's/custodian's control. These assets are either kept by the trustee/custodian itself or by its appointed agents who are normally registered licensed banks. A fund's assets are segregated from the trustee's/custodian's own assets. Securities and cash held by a trustee/custodian are reconciled on a regular basis to ensure full control and protection.

Are TRUSTEES INDEPENDENT from fund managers? Can they be COMPANIES FROM THE SAME GROUP?

The SFC Code requires that the trustee/custodian and the management company of an authorized fund must be independent of each other.

If they belong to the same holding company, they can only meet the "independence test" if, among other things:

- no person is a director of both the trustee/custodian and the management company;
- neither the trustee/custodian nor the management company is a subsidiary of the other;
- the trustee/custodian and the management company sign an undertaking that they will act independently of each other in their dealings with the scheme.

What HAPPENS if a TRUSTEE/CUSTODIAN goes BANKRUPT? Will a trustee/custodian run away with my money?

The fund's assets do not form part of the trustee or custodian's personal assets and thus are recorded separately from their own financial statements. Similarly, the trustee/custodian cannot use the fund's assets for its own benefit. As a result, if the trustee/custodian goes bankrupt, investors' assets will not be affected.

On the subscription and redemption documents, one usually finds the name of the trustee/custodian, apart from the fund manager. WHY is it so? What is the relationship between an investor and a trustee/custodian (if something goes wrong, can an investor sue the trustee/custodian?)

Not only is the trustee/custodian responsible for protecting the fund's assets, but it may also be responsible for other administrative tasks such as maintaining the fund's register of shareholders. It is common for investors' subscription and redemption transactions to be handled directly by the trustee/custodian, rather than the fund manager itself.

The SFC effectively monitors authorized funds in Hong Kong and the parties involved in their management and administration. This is to ensure investors' interests are properly served.

If a trustee/custodian is in breach of the terms of the fund's constitutive documents (i.e. prospectus and/or trust deed), it may be liable to actions brought against them by investors or other parties.

How many stocks does an equity fund hold and how many bonds does a bond fund hold?

To achieve diversification, a fund portfolio will invest in a range of securities.

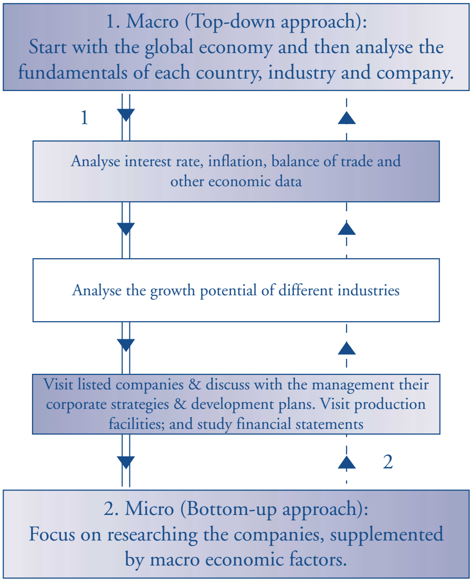
The number of stocks or bonds will depend on the size of the fund. It can range from 40-50 stocks for smaller funds to over 100 stocks for larger funds. For bonds, it also varies with fund sizes.

Can I determine which security the fund holds?

No, the decision of which security to buy is vested with the fund managers. It is here where the value-added of fund management lies - professional management services. As mentioned above, fund managers will perform in-depth analysis and determine which securities to invest.

How do fund managers pick securities?

Usually, the fund manager will either adopt a top-down or bottom-up approach.



A top-down approach means that he will study the macro economic conditions and then goes down to micro corporate factors. The reverse will happen for a bottom-up approach. Some fund managers use the former, some the latter, while others adopt a mixture of both.

WILL FUND MANAGERS CHURN THE PORTFOLIOS SO AS TO RECEIVE REBATES FROM STOCKBROKERS?

The SFC Code forbids a fund manager nor any of its connected persons to retain cash or other rebates from a broker for directing any transactions in relation to the fund. However, "soft dollars" (i.e. goods and services) may be retained if they:

- are of demonstrable benefit to the investors;
- are in line with best execution standards; and
- make adequate prior and periodic disclosure.

What is the KEY DIFFERENCE if I REGISTER my investment UNDER A NOMINEE NAME and if I register under MY OWN NAME?

At the point of purchase, you will have to indicate on the fund's subscription form the name under which you want your shares/units registered.

Usually, if you subscribe through a third party, such as a bank, investment advisor or custodian, it may be possible to have your holding registered in a nominee name. Nominee registration will provide you with confidentiality and convenience since the fund manager will look to the registered owner (i.e. the bank or trustee's nominee) to handle and authorize all activities relating to the beneficial owner's investment.

Such activities may include signing subscription/redemption forms, collecting dividends, voting at meetings, and receiving monthly statements.

The nominee service offered by an intermediary is an integral part of the business of the latter; and since the registered investment advisor is subject to the regulation and monitoring by the SFC, there should always be sufficient mechanism to protect investor interest.

However, since a nominee is an independent company, and strictly speaking, the business of this company is not under the oversight of the SFC, the SFC has only limited power over it. e.g. the SFC cannot inspect its accounts, and is also not empowered to restrict its businesses.

The pros of using a nominee account is that you can do away with a lot of administration work and can save a lot of time and administrative procedures. However, even though you are the ultimate beneficiary of the units, you are not the holder in a legal sense. The fund company has no direct legal obligations to the investors. Thus, if something goes wrong, you can only take it up with the nominee company, but not the fund company.

Also, you also need to pay service charges for opening and closing the nominee accounts.

Before you open a nominee account, you should check with the intermediary to see when you place an order, whether the ifa will forward the fund company's contract note to you or whether the ifa will issue its own consolidated statement for you.

What is the KEY DIFFERENCE IF I HOLD CERTIFICATED OR UNCERTIFICATED UNITS?

At present, most units are un-certificated. Usually, the administrator will not issue a share certificate to you, unless you request in writing. For an investor, a certificate is not a must because the contract note is already legally binding. Irrespective of whether you hold a certificate or not, if you have a contract note, the administrator will have your name in the register of unitholders or shareholders.

Will INVESTMENT in AUTHORIZED UNIT TRUSTS and MUTUAL FUNDS give rise to TAX EXPOSURE in Hong Kong?

In Hong Kong, a Hong Kong resident is not subject to tax, either on income arising, or the capital gains made from investing in authorized unit trusts, unless the acquisition and realisation of units is or forms part of a trade, profession or business carried on in Hong Kong.

For detailed tax implications, you should check with your financial advisors or accountants.

What is the difference between lump-sum and monthly investment? What are the respective pros and cons?

Lump sum investment is made when you invest a sum of money at one time into a specific fund or a few selected funds. With lump sum investment, investors must carefully time his/her purchase of the fund.

Monthly investment is when you make regular contributions into the fund. Through monthly investment, the dollar-cost averaging effect can smooth out the volatility throughout the investment period.

You do not have to be concerned with the short-term ups and downs of the market. This approach may reduce the average share cost to an investor over the long-term: when the price of units rises, you will buy fewer units; but when it drops, you will buy more.

This booklet has been prepared to help you understand how authorised funds work. The information given is for reference only and is not a substitute for professional advice, which you should seek before you make any investment decisions.

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