Enhancing the distribution network and broadening investor participation in Hong Kong

Asset and Wealth Management

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Executive Summary

The fund distribution landscape in Hong Kong SAR (Hong Kong) is at a turning point and while the asset and wealth management (AWM) industry has been in a state of continuous metamorphosis for some time, the development of more diversified distribution channels in the city is only starting to gain traction. In recent years, we have seen a new breed of technology-driven actors such as digital wealth advisors and platforms, enter the market with new business models and provide new avenues for product manufacturers to distribute their products. Overall, these exciting developments are likely to have a positive net effect as new entrants entering the market enable investors to gain exposure to a wider variety of asset classes and niche markets. With this, market incumbents such as retail banks and insurance companies have also been augmenting distribution efforts to ensure they remain fit for purpose in a shifting landscape that challenges current operating models and raises new decisions on how to reach the end-investor.

The speed of change in the fund distribution landscape is picking up as the ever-evolving shift in investors' mindsets, a profound shift in the demographics of the investor base and technological innovation accelerate the pace of change. This will impact all stakeholders, from the asset manager, the distributor, right down to the end-investor.

Longer term, as the AWM industry matures and demand grows for more sophisticated products, investor education will be key for industry players to win new business. A collaborative effort by all industry stakeholders to educate the investing public is critical to moving investors away from a 'stock picking mentality' towards an 'investment mind-set'. With this, product manufacturers and distributors could look at their client servicing model and re-evaluate how to play a more prominent role in investor education.

Linked to this is the investment and retirement planning landscape, whereby Hong Kong's privately managed Mandatory Provident Fund (MPF) System is currently undergoing its biggest digital transformation journey to date and this will inevitably catalyse how some investors make informed investment decisions.

The increasing need for control of distribution and the client relationship is likely to catalyse new product strategies and distribution tactics. Today, we are seeing various strategic alliances and partnerships come to fruition as industry players pivot their fund distribution business model and create new value propositions. Moreover, in the midst of monumental change, the 'retailisation' of private markets and alternative assets sweeping the industry in more mature markets could start to take some form in Hong Kong. While innovation has provided pathways for a broader range of investors to access alternative assets which includes private equity, hedge funds, real estate and private credit, this has so far not trickled down to the masses in Hong Kong.

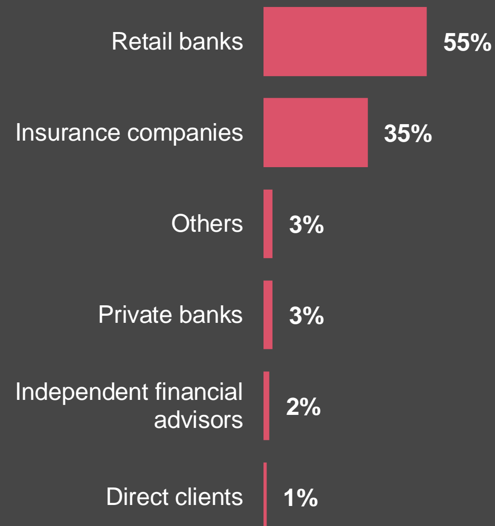
This publication aims to set the stage for discussion on the future of the distribution environment in Hong Kong and is based on research and insights gathered within the PwC network and qualitative interviews with key market participants – including asset managers, retail banks, digital wealth advisors and platforms and industry associations – to identify emerging trends and forces reshaping the distribution landscape and operational infrastructure.

The lay of the land

Retail banks – the giants of fund distribution

Hong Kong has a rather concentrated fund distribution market, with retail banks accounting for the lion's share of the market. Banks (both retail and private) represent around 60% of retail fund sales (compared with around 78% ten years ago) with insurance companies being the other main player. Given the market concentration, this has led to some concerns that competition or innovation may be hindered, leading to limited investment choices to retail investors.

Retail banks have actively distributed funds to their client base since the inception of the market. Initially, they focused on selling their own in-house products, but they soon learnt that adopting an 'open architecture' approach to fund selling provided infinitely more opportunities to increase sales.



Source: Hong Kong Investment Funds Association (HKIFA). Data as at the end of June 2022

If the retail bank has its own fund range, it might favour the use of those. However, retail funds from third party asset managers were also included ensuring investors had a choice across investment styles and geographies, and ultimately getting the products available to suit their needs.

There are clear differences among the retail banks when considering their relative success at fund distribution, but given the concentration of the market, it is evident banks are able to maintain some influence on the type and range of products available to investors and to a certain extent, the fees and costs to the end-investor.

The priority of most asset managers is to get onto the fund distribution lists of the leading retail banks. However, this is not an easy undertaking and there are some fundamentals that must be considered when seeking to get on the shelf space of banks and to promote products. For a bank to consider including any retail fund onto its distribution list, it will have multiple considerations to take into account. The following is the usual list of criteria but different banks may vary these according to their own circumstances and may occasionally waive them for say, depending on the existing relationship with the asset manager.

Stability of portfolio management team	Investment style	Consistency of performance	Size and scale of fund	Repeatable processes to achieve results	Level of trailer fee

The lay of the land

Current status quo of selling retail funds

Across the globe, an era of full transparency is evolving with investors and regulators asking for complete disclosure of costs and fees. Greater transparency is revealing where asset managers and intermediaries add value, allowing investors to evaluate which product and service is suitable to their needs. While the exact form of regulations differs from one jurisdiction to another, some focus on enhancing transparency and disclosure, while others opt for an outright ban on fees paid to intermediaries and distributors. Generally, this has significantly reduced fees as industry economics are altered and a client-focus approach is promoted as opposed to a product-focused approach.

In Hong Kong, the commission-based model of selling retail funds is dominant and intermediaries play a key role in the value chain. Intermediaries selling retail funds receive an ongoing trailer fee from the asset managers which are often opaque to the investor and this practice raises questions of whether this is in the best interest of investors and if a high fiduciary standard of care is taken.

How are distributors in Hong Kong remunerated?

Front-end load + Trailer Fee

- **Front-end load:**

  The typical front-end load on retail funds offered in the market can be as high as 300 bps and banks as major distributors, expect to receive most of this.

- **Trailer fee:**

  For the typical retail share class, banks as distributors would expect to receive over half of the management fee (for the life of the fund holding) in the form of trail commission.

Characteristics of select markets

Market	Initial charges Use in retail market	Ongoing commissions Use in retail market	Distribution Primary Channel
Australia	Banned	Banned	Large Distributors
Mainland China	Medium	High	Banks
Hong Kong SAR	**High**	**High**	**Banks**
India	Banned	High	Banks, Brokerage
Japan	Medium	High	Banks, Brokerage
Korea	Low	High	Banks, Brokerage
Singapore	High	High	Banks
Switzerland	High	High	Independent Advisers, Banks
Thailand	Medium	High	Banks
United Kingdom	Low	Banned*	Independent Advisers
United States	Low	Medium	Independent Advisers

Source: Morningstar, Global Investor Experience Study: Fees and Expenses
*Ongoing commissions are banned going forward, but certain existing share classes were grandfathered.

Investor perspective – the fees and costs

Can a fee-based advisory model take off?

A fee-based advisory model has yet to truly take off in Hong Kong, but there are green shoots emerging. New entrants to the market such as digital wealth advisors and platforms, looking to deliver an advisory proposition that is goals-based charge a fee based on assets under management, usually with no fees for entry (front-end load), performance (performance fee) or exit (back-end load). The proliferation of the aforementioned fee-based model reflects the growing demand for investors' rising demand for transparency and value-added advisory. While the concept of advisory has been around for some time, its appreciation has not been in Asia.

Retail investors are generally averse to paying for advice and preferring to trade on their own given the 'stock picking mentality' as opposed to 'investment mind-set'. Nevertheless, market developments in other jurisdictions are worth watching, in particular large and mature markets as they can potentially influence a shift in Hong Kong. For example, the Retail Distribution Review (RDR) which was implemented in the United Kingdom more than ten years ago and was designed to end the potential conflict of interest that arose when investors used independent financial advisors to buy funds. The review resulted in increased transparency by making firms outline the fees that an adviser was charging a client. The RDR served to unbundle fees and charges from commissions paid to distributors - a measure aimed to reduce costs for investors once they realised how much they were paying.

Recently in Mainland China, the regulator in its ongoing mission to urge the fund industry to better uphold investor interests, ordered all asset managers to trim up to 30 basis points off annual management fees charged to retail investors for certain products. This move is expected to be part of wider industry reforms to be introduced in the coming years that will aim to enhance fee transparency and hasten the shift of aligning investor and advisor interests, in addition to enhancing market competition.

How could distributors be remunerated outside of the current status quo?

An all-in-one advisory / platform fee

The single figure presented as an all-in-one fee based on assets under management (AUM) could facilitate investors to improve their comparability, leading to more informed investment choices as transparency becomes absolute.

Performance fees

Potentially a means to achieve better investment outcomes by aligning the interests of asset managers, distributors and end-investors, and an incentive for asset managers to generate positive returns.

As the market matures and assets grow, investor education will be key to ensure retail investors make appropriate decisions in building a diversified portfolio, especially for new types of investment products emerging which will require greater attention. The onus will be on product manufacturers and distributors to further engage in dialogue with investors and revisit their client servicing model to play a more prominent role in investor education. Rather than looking at this as simply a compliance exercise, it is vital to bolster investor education and understanding, with content geared to new cohorts of investors or those unfamiliar with the product suite.

A new breed of technology-driven actors

Digital wealth advisors and platforms coming to the fore

The proliferation and ongoing specialisation of online digital wealth advisors and platforms have been apparent, enabling retail investors to purchase investment funds and acquire investment advice in an efficient manner from the click of a button.

Generally, digital wealth advisors and platforms come in many forms, but have evolved significantly from the early days when they were merely perceived as a 'funds supermarket'. Previously, their core offering was an online marketplace that allowed investors to buy, sell and store investments in one place. However, the new breed of market players are armed with big data and market analytics, enabling them to offer investors holistic wealth management advice and portfolio management services, which can be fully delegated or assisted. While the array of new incumbents and their value propositions vary considerably, many offer market insights, deliver investment advice and ultimately curate tailored portfolios and rebalance over time, based on the investors financial targets and goals.

The increasing use of social media as a source to compare financial products and services is also altering the rules of the game. Social media is gradually becoming a key nexus of the marketing strategy of companies and advisors that aim to better understand their clients' needs and preferences, enabling them to fine tune their offerings accordingly. Moreover, market analytics and new technologies are becoming fundamental tools in order to integrate insights derived from various sources into product development initiatives and marketing efforts.

Overall, technology innovations have catalysed the growth of independent advisory services and investors can now navigate a suite of products through user-friendly interfaces. The advisory business is ripe for revolution especially with the potential to scale up exponentially in a cost efficient manner to reach the high-volume mass affluent market and also younger cohorts of investors who have a greater appetite for information and 'finance at their fingertip' which enables them to research and transact with a few clicks.

Virtual Banks – exploring new opportunities

In recent times, more than half of the virtual banks in Hong Kong have obtained a license from the Securities and Futures Commission (SFC) to launch asset and wealth management related services as they move in the direction of providing their client base access to investment products. Capitalising on the rising trend of online distribution, virtual banks have generally established partnerships with product manufacturers.

Virtual Bank	Licenses obtained
Bank A	-
Bank B	-
Bank C	**Dealing in Securities** (Nov 2022) **Advising on Securities** (Nov 2022)
Bank D	**Dealing in Securities** (Jan 2023)
Bank E	-
Bank F	**Dealing in Securities** (Jun 2023)
Bank G	**Dealing in Securities** (Apr 2022) **Advising on Securities** (Apr 2022)
Bank H	**Dealing in Securities** (Jan 2022)

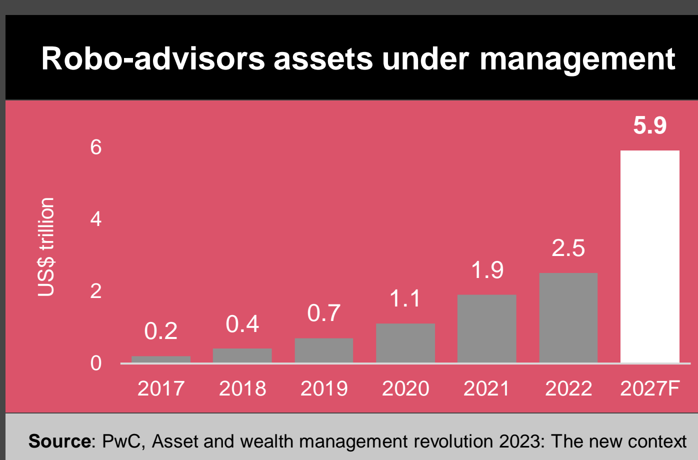
Source: Securities and Futures Commission (SFC)
Data as at the end of June 2023

A new breed of technology-driven actors

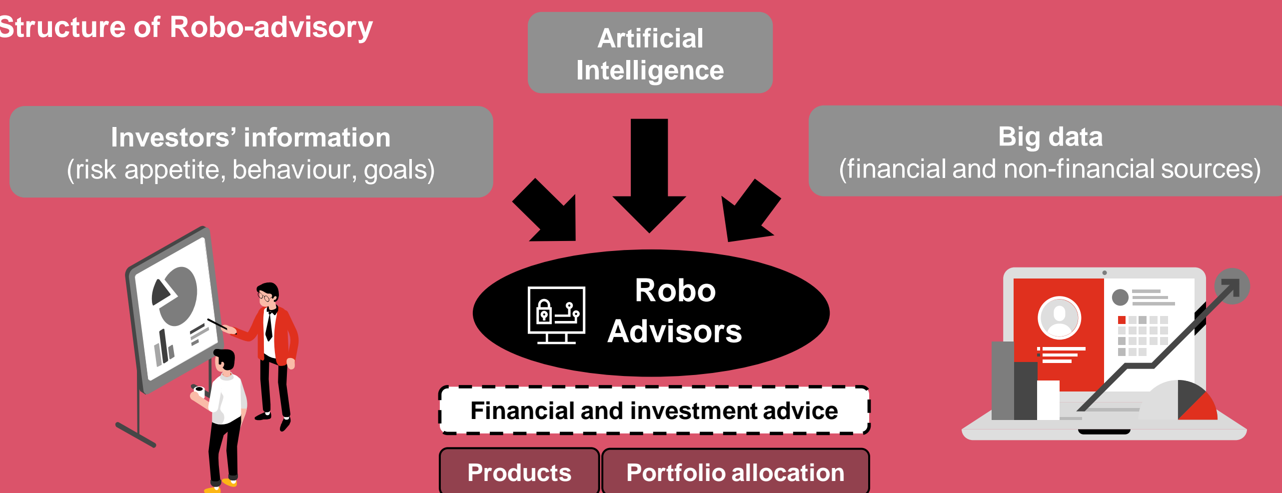
Tailored advice – robo-advisors

As part of the wave of technologically enhanced asset and wealth management services, there has been a surge of robo-advisors globally capable of providing tailored advice to individual investors. These robo-advisors have the potential for better performance and help manage risks while minimising transaction costs through optimal portfolio creation with some robo-advisors even having integrated trade execution capabilities. Moreover, the influx of robo-advisors has made investing more accessible to retail investors, particularly the new generation of investors, as they provide a simplified interface and lower fees compared to human advisors. As a result, the proportion of assets being handled by robo-advisors has been increasing steadily.

Assets under management managed by robo-advisors globally reached US$2.5 trillion in 2022, up from US$200 billion in 2017. Our predictions show that assets managed will reach US$5.9 trillion by 2027, more than double the figure of US$2.5 trillion in 2022. However, in some markets, adoption has been slower, suggesting that more work is needed to make this model viable.



Source: PwC, Asset and wealth management revolution 2023: The new context



In the context of Hong Kong, a number of robo-advisers have launched their business, offering investors more options to access lower-cost and digital financial advisory services. This has enabled product manufacturers to leverage robo-advisors to grow their asset base. Going forward, the proliferation of robo- advisors raises some interesting questions - how do the robo-advisors maximise their impact as disruptors in an industry in Hong Kong which has generally lagged digital trends and what role can they play in a competitive fund distribution environment. With regulators receptive of the adoption of fintech and the development of digital channels to create alternative distribution channels, digital-first platforms will likely grow in stature.

Fit for the future

Digital fund services of banks and insurance companies

Against the backdrop of a new breed of technology-driven actors disrupting the fund distribution landscape, market incumbents (retail banks and insurance companies) are also undergoing a digital transformation journey in response to increasing competition and are ramping their use of technology to distribute products. With investors now having more options than ever before to buy investment funds, as online digital wealth advisors and platforms increasingly offer them alternative channels, market incumbents are also strengthening their digital capabilities and value proposition to compete with new rivals and maintain their leadership position. In short, market incumbents are similarly looking at serving their investors more efficiently, and at greater scale, with one eye on the younger cohorts of investors who have a greater appetite for digital channels.

In recent years, a host of retail banks and insurance companies have launched online services that enable its client base to invest in investment funds managed by either an asset management affiliate or third party asset manager. In addition, these new online services generally provide investors with product information as well as content focused on improving financial literacy and investment planning, such as learning more about one's own risk tolerance and investment needs. To make the investment funds more accessible and appealing to investors, the minimum investment amount can be as low as HK$1.

Market incumbents are also thinking carefully on investor segmentation as they look to identify clients with the highest profit potential. While online channels can enable market incumbents to service investors at greater scale, retail banks still have many bank branches and insurance companies still leverage a vast agency force, as the human touchpoint is considered indispensable in some areas. I.e. physical meetings restricted to the high-fee generating clients or investors who seek value add services such as advisory.

Direct distribution for asset managers

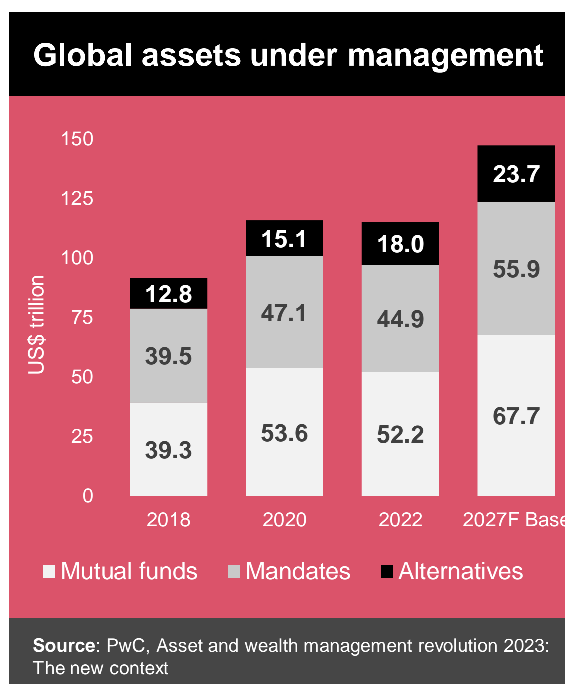
While asset managers can distribute products to investors directly through their own platforms, only a handful have made an attempt to diversify their distribution channel since 'The Guidelines on Online Distribution and Advisory Platforms' published by The Securities and Futures Commission (SFC) in 2019, paved the way for asset managers to set up online distribution channels. To date, only a few asset managers have a platform for direct sale.

With direct distribution, besides building a user friendly portal for the digital age where investors can transact seamlessly and rebalance their portfolio, asset managers would be required to invest further in their compliance and regulatory infrastructure to take into consideration additional protective measures such as suitability requirements.

‘Retailisation’ of private markets

Making alternative assets less alternative

As alternative assets continue to grow as an impactful portion of the industry and in conjunction with greater investor sophistication, the asset class has slowly but surely been broadening its access to a wider investor base, outside of institutional investors. Harder to access and often confined to institutional investors such as large pension funds and endowments, alternative assets have become a mainstay for these investor groups. Historically, retail investors were unable to invest in alternative assets for a number of reasons, most notably the regulations in place regarding investor protection, the significant complexity of such investments, illiquid product structures, investment time horizon associated with products, as well as the tremendous capital requirements involved.



Source: PwC, Asset and wealth management revolution 2023: The new context

Times are changing as the focus of some individual investors are increasingly shifting towards alternative investments. With innovation in technology, increasing receptiveness from regulators and greater interest from asset and wealth managers to offer the asset class in a format accessible for individual investors, alternatives are expected to become less alternative in the future. This trend is already playing out in various jurisdictions across the globe as innovation and product structuring have provided alternative assets an avenue to reach a larger base of investors.

Retail investors are able to gain exposure to alternative investment strategies through liquid alternatives in some parts of the globe. Liquid alternatives provide exposure to alternative assets and private markets through publicly available fund vehicles, such as mutual funds, Undertakings for Collective Investment in Transferable Securities Directive (UCITS) and Exchange Traded Funds (ETFs). Asia-Pacific is yet to truly follow in this regard, but it is envisaged these trends will emerge in the region sooner rather than later.

More common in Asia-Pacific though are innovative fintech platforms opening up alternative assets to a broader audience, mainly ‘accredited investors’ or ‘professional investors’ which meet certain criterions. Investment minimums to subscribe to alternative funds can be as low as US$10,000 assuming the individual can meet the aforementioned criterions. The development is a step in the right direction for the ‘retailisation’ of alternatives in the region. It is only a matter of time until an alternative investments product is developed for the masses at a price point that makes sense in a retail structure. Exposure to alternative assets and private markets will give retail investors more options at a time when public markets remain choppy and more companies opt to stay private for longer.

‘Retailisation’ of private markets

New avenues of growth for alternative asset managers

Although institutional investors will remain the key investor group for private market assets, some alternative asset managers are increasingly seeking to broaden their investor base and explore how best to capitalise on growth opportunities within the retail space.

Exploring products suitable for retail investors would enable alternative asset managers to access new sources of capital and fundraising options - something that is a constant as managers look to set up new funds and grow. While it might lead to a different mode in operations and adhering to a new set of regulations, the amount of capital they can potentially gather is vast and potentially worth it.

Globally, mass affluent investors which can be a proxy for the upper-end of the retail market is expected to amount to 29% of total client assets by 2027. Expanding amounts of client assets from the mass affluent segment provide opportunities for alternative asset managers to service this growing client segment, which is expected to grow to over US$100 trillion by 2027. The retail market offers vast and still largely untapped openings for growth and mass affluent investors are looking for more differentiated products.

While the ongoing ‘retailisation’ of private markets will provide opportunities in the fund distribution space, a whole new set of risks, expectations and operational challenges will also enter the mix. This has led to many alternative asset managers finding it difficult to extend access to private markets in practice, and the operational challenges are compounded by other complexities. Even with many individual investors reconsidering their asset allocation and seeking access to private markets, it will be some time before investors access alternative assets in a frictionless manner in the form of a retail structure in Hong Kong.

The retailisation of private markets is a trend that is to pick up further steam around the world and more alternative assets managers will head into this direction. While the regulatory landscape is far from conducive from unlocking private markets to retail investors in Hong Kong, it is an interesting development to watch as retailisation of private markets presents both opportunities and challenges for regulators. Regulators will need to strike a balance between giving impetus to the private markets and protecting investors from risks and this is not an easy feat, as there are technical as well as operational challenges when it comes to broadening private markets access to a wider investor base.

Clients’ assets (US$ trillion)

Clients	2018	2020	2022f	2027f	CAGR 2018-2022	CAGR 2022-2027
Pension assets	46.0	56.8	54.4	64.9	+4.2%	+3.6%
Insurance companies	31.2	35.9	33.9	40.6	+2.0%	+3.7%
Sovereign wealth funds	8.4	9.9	11.4	14.5	+7.8%	+5.0%
HNW individuals	73.5	103.5	107.3	139.6	+9.9%	+5.4%
Mass affluent	64.6	88.5	84.5	107.1	+7.0%	+4.8%
Total client assets	223.7	294.6	291.5	366.7	+6.8%	+4.7%
Total AUM	91.6	115.8	115.1	147.3	+5.9%	+5.0%
Penetration rate	40.9%	39.3%	39.5%	40.2%	N/A	N/A

Source: PwC, Asset and wealth management revolution 2023: The new context

Forecast using base case scenario

Looking forward

The pace of change reshaping the distribution landscape cannot be understated. Profound shifts in investor expectations and technological developments has impacted how industry players distribute their investment products and has been a catalyst for new value propositions in the market. With this, a new breed of technology-driven actors such as digital wealth advisors and platforms have emerged as potential challengers to incumbents such as retail banks and insurance companies.

Disruption is already underway. Emerging trends are prompting a rethink in how funds are distributed, challenging the concept that 'funds are bought, not sold'. Fund distributors are now required to deliberate meticulously on many considerations from investor segmentation, client experience, brand loyalty and trust, and most importantly how to distribute products. Fund distribution is no longer a linear single-step process, but has evolved into a multi-faceted one with many fundamentals to consider.

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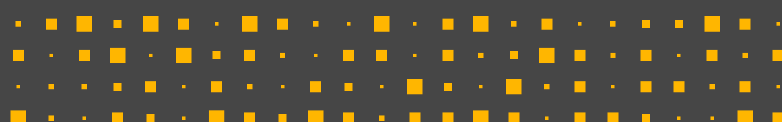

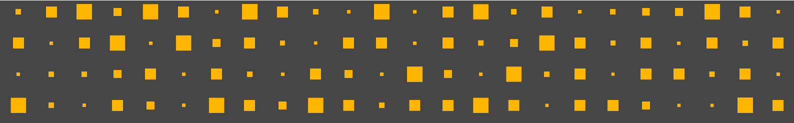

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