

On the Characteristics and Development of Hedge Funds in China

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Abstract: With the steady development of China's economy and the support of China's opening-up policy, China's financial market has gradually opened to the outside world, the internationalization of RMB has accelerated, and more and more new trading means have entered China's financial market. Hedge fund stands out in a variety of trading products with its high return, complex and novel operation methods, and is sought after by investors and fund managers. In the international market, hedge funds have developed more mature, but in China, hedge funds are still in the early stage of development. In order to make the hedge fund market expand and develop steadily, it is necessary to deeply understand the connotation, characteristics and development trend of hedge fund, find out the existing problems in the development of hedge fund, and put forward constructive suggestions in view of the problems, so as to effectively prevent and face the possible risks in the development of hedge fund and promote the development and maturity of China's hedge fund market.

1. Introduction

Hedge funds are issued through private placement and pursue high returns by using complex and flexible investment strategies. They have the characteristics of less information disclosure, greater leverage effect, high risk and high return. This makes hedge funds attract a large number of investors, at the same time, they face the risk of improper supervision, unauthorized manipulation of large assets and financial market turbulence. In addition, China's hedge fund market started late, the market regulation is not perfect, the investment strategy is relatively single, the risk dispersion degree is limited and so on, which restrain the further growth of China's hedge fund market. In view of the above, this paper proposes to establish and improve the regulatory system, control the leverage ratio, increase information disclosure, and improve the access threshold of fund managers, so as to expect the steady development of China's hedge fund market.

2. Characteristics and development trend of hedge fund

In a sense, hedge fund is an investment strategy. Understanding and summarizing the characteristics and development trend of hedge fund is conducive to correctly defining and deeply understanding hedge fund, grasping the trend of hedge fund, seizing investment opportunities, doing well in risk prevention and response measures, and steadily developing China's hedge fund market step by step.

(1) An overview of the characteristics of hedge funds

1) Raising funds by private placement

Public funds refer to the funds obtained through public offering to the general public. In order to protect the interests of investors, most countries have strict restrictions on the number of public funds, issuance methods, investment direction, etc. In contrast, private equity fund financing to specific investors, usually for institutional investors or individual investors with capital strength and investment experience, has small use restrictions, high risk-taking ability of investors, strong capital

strength, and effectively meets the use requirements of hedge funds. Raising funds through private placement is conducive to the smooth implementation and development of hedge funds

2) Make full use of leverage effect

Hedge funds manage their investments in a radical and active way, and their investors are "risk seeking" investors. Hedge funds are good at using leverage effect to leverage large amount of capital with less capital to obtain huge profits. But correspondingly, if investors misjudge the market or misoperate the investment, investors will face huge losses. Therefore, the investment of hedge funds has the characteristics of high return and high risk. There are two ways to use leverage, one is to set up leverage artificially by means of lending, the other is to invest in financial derivatives with leverage, the right on schedule, based on its margin system to make full use of leverage effect to obtain excess return.

3) Hedge funds are subject to less supervision and restriction, with high investment risk and return

Hedge fund investment belongs to alternative investment. At present, it seems that each country, relatively speaking, has a low degree of supervision over alternative investment industry, low level of internal supervision and industry transparency. The disclosure of important management investment indicators of hedge fund companies, such as historical risk and return, is limited. These investment characteristics make the investment of hedge fund get high return, at the same time, it is not conducive to well protect the interests of investors, is not conducive to the control and supervision of the market, increases the opportunity to manipulate the market and obtain high return, and has the characteristics of high risk. Most hedge funds adopt the way of centralized investment, and the degree of risk dispersion is limited. In addition, the full use of leverage also increases the investment risk.

4) Flexible investment strategy

With the emergence of hedge funds, the neutral investment strategy gradually prevails, and with the change of market demand, more and more new investment strategies come into being. Compared with the traditional long holding securities, which rely on the gains when the securities rise, hedge funds allow short selling, and hold both long and short, so as to cope with the uncertainty of returns caused by market fluctuations, so as to achieve "absolute returns".

5) High investment management fees charged

Hedge fund's investment management fee collection mode is unique and the collection fee is high. Investment management fee is divided into fund management fee (based on capital scale) and incentive fee (based on investment performance). Generally speaking, the management fee of hedge fund is 2% of its total assets under management per year, and the performance is divided into 20%. The investment of hedge funds is highly professional and requires excellent strategic analysts and traders. High performance returns and wages are conducive to attracting excellent talents and promoting the development of the industry. On the other hand, the high returns of hedge funds also make the high investment management fees have the basis of payment.

(2) An overview of the development trend of hedge funds

In the past decade, the scale of global hedge fund is still in a state of rapid growth. Hedge fund is accepted and introduced by more and more countries. The market share of big fund countries such as the United States and the United Kingdom is still leading. But in the past two years, due to the financial crisis and trade war, the fund market is not very good. However, in emerging markets such as Russia, Brazil and China, there are still strong potential markets for hedge funds. Countries pay more attention to the liquidity management of hedge funds, the transaction strategy is more complex and advanced, and the quantitative funds which are analyzed through big data and machine learning develop rapidly.

Originally, hedge fund investors were mainly high net worth clients and institutions, but due to the emergence and development of hedge fund funds (FOFs) and structured financial products related to hedge fund performance, more and more individual investors can also participate in investment. FOFs has developed rapidly in recent years. It is a new type of investment fund. Different from the fund that invests in individual stocks, the fund of hedge fund is selected from the fund. It divides different kinds of funds with different profitability together and finds out the

dominant ones. Then through the strategic allocation, it can achieve the purpose of dispersing investment, avoiding risks and obtaining stable returns. FOFs has become a new force in investment funds because of its low access threshold, high risk dispersion, high quality redemption terms, detailed due diligence and other advantages (the structure diagram of FOFs is as follows).

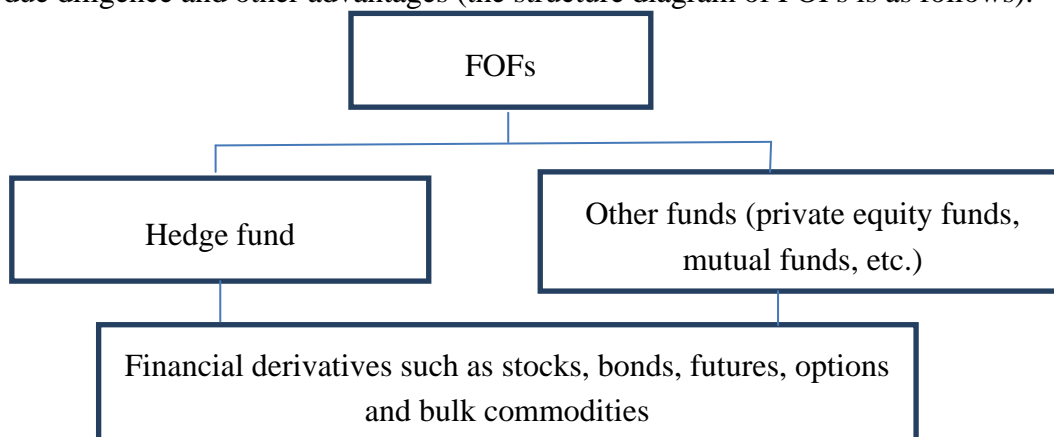


Figure 1. Structure diagram of FOFs

3. The development of hedge fund in China

Compared with European and American countries, China's hedge funds have just started and have huge market potential. Hedge fund is the product of the development of financial market, which can provide investors with diversified investment opportunities, new capital management methods and profit-making methods, attract excellent financial talents, and promote the development of China's financial capital market. But in recent years, due to the impact of trade war, the hedge fund market is not very prosperous, coupled with the current situation of China's hedge fund market is not perfect, leading to the development of hedge fund market is hindered to some extent. This paper mainly explains from the following aspects:

(1) There is no perfect hedge fund supervision system

In recent years, China's economy has developed rapidly and steadily. With the increase of people's wealth and the advancement of RMB internationalization, China's hedge fund market has great potential. However, due to the late start of China's securities market, the immature market background of the development of hedge funds, and the characteristics of hedge funds, such as high risk, high return, limited information disclosure, etc., China needs to strictly supervise the emerging hedge funds to prevent the financial market turbulence caused by the improper use of hedge funds. At present, China is gradually exploring the hedge fund market, but there are no clear laws and regulations on the issue of hedge funds, investor access conditions, disclosure restrictions and other aspects of detailed description and specification. Investors ignore the high risk and blindly pursue the high return, and managers consciously manipulate the market in order to pursue the high profit and other phenomena happen from time to time, which has laid the unstable factors for the financial market of our country. Therefore, it is urgent for China to establish a perfect hedge fund supervision system to prevent risks and provide a good and standardized development environment for hedge funds.

(2) Hedge fund managers operate against rules and disrupt the market

The management of hedge funds has the characteristics of professionalism. The managers of hedge funds are usually financial talents with many years of investment experience, who are familiar with the financial market and various financial operations. China's hedge fund market is in the initial stage of development, industry self-discipline and external supervision are not strict enough, coupled with the characteristics of less disclosure of hedge fund management information and low transparency. Professionals are vulnerable to the temptation of high-value interests, against the wishes of investors, misappropriating capital assets or using undisclosed internal information and complex trading means to manipulate the market and other phenomena happen from time to time,

which undoubtedly has laid a hidden danger for the healthy development of China's financial market. The existence of these phenomena proves that the professional moral quality of fund managers needs to be strictly standardized, and the prevention and accountability system of market irregularities needs to be further improved.

(3) The risk of hedge fund is large, which is easy to cause financial market turbulence

Hedge funds make full use of leverage effect to leverage large amount of capital with less capital, which will increase profits and increase losses at the same time. In our country, the standard and monitoring of leverage are not strict enough. When the forecast is biased, it is easy to lead to the phenomenon of insufficient fund solvency and falling into the vicious circle of additional margin and asset price decline, resulting in huge losses. In addition, the information disclosure requirements are low and there is no strict monitoring and regulation. Due to the limited disclosure of trading information such as risk position, counterparty, trading strategy and risk control standard, hedge fund is not conducive to the adjustment of trading position of all parties. In addition, investors are mostly institutional investors, which are easy to lead and move the whole body, undoubtedly aggravating the generation and transmission of risk. With the rapid changes of the market, huge capital investment and risk transmission, the hedge fund market is prone to lead to financial market turbulence and financial crisis.

(4) The investment strategy is relatively simple, and the degree of risk decentralization needs to be improved

China's hedge fund market is still in the initial stage of development and exploration. Due to the traditional concept of operation and supervision of other financial products and the lack of innovation of hedge fund operation strategy, the investment strategy of China's hedge fund is relatively single, most of which use the multi empty strategy, while the event driven, trend oriented, convertible arbitrage and other investment strategies are rarely involved. The degree of risk diversification is limited, and investors have limited choice. In contrast, a variety of investment strategies in Europe, America and other countries have given investors unlimited choices, which is convenient for investors to choose the right hedge fund, which can effectively disperse risks and generate positive returns in different market environments, thus injecting strong vitality into hedge funds. Therefore, China should actively learn from foreign advanced experience and fully develop China's hedge fund market.

4. Suggestions on the development of hedge funds in China

China's hedge fund market is developing rapidly. In order to promote its stable and orderly development and take risk prevention measures, this paper puts forward improvement suggestions from the aspects of internal and external control, market supervision and personnel training, respectively, according to the characteristics and problems encountered in the development process of hedge fund.

Table 1. Legislative documents of countries or regions with advanced hedge fund development

Country or region	Legislative literature on hedge funds
America	<i>Securities law; Securities exchange law; Investment consulting law; Investment company law</i>
Germany	<i>Investment law; Investment tax law</i>
Hongkong, China	<i>Hedge fund guidelines; Hedge fund reporting requirements</i>

(1) Establish and improve the supervision system of hedge funds

China is in the early stage of hedge fund development, the laws and regulations are not perfect, and the supervision is relatively low, so we cannot prevent and deal with the risks brought by hedge fund. Therefore, China should learn from advanced management experience at home and abroad in time (Table 1 shows the legislative documents of some countries and regions with advanced hedge fund development), and establish a perfect regulatory system for hedge funds. It is suggested to

clarify the main body of hedge fund activities, main behaviors, regulatory agencies and regulatory responsibilities through laws, regulations and normative documents, so as to protect the legitimate interests of investors, regulate the operation of hedge fund, maintain the stability of financial market and prevent systemic risks.

(2) Training and introducing high quality fund management talents

Facing the emerging investment strategies and tools, the market needs hedge fund managers with high professional ethics. China needs to create a high-quality financial market environment, attract foreign professionals to guide the development of hedge fund market, and actively formulate and implement the domestic professional training plan. It is necessary to establish the access examination system and investment behavior supervision system for fund managers, review their credit situation and historical investment situation, and supervise their daily investment behavior and investment quality, so as to avoid the occurrence of damaging the interests of investors due to the information asymmetry between investors and managers.

(3) Fund companies should strengthen internal control, strictly control leverage, and improve information disclosure requirements,

Hedge fund managers should strengthen internal control. First of all, we should set strict access standards for investors and managers, and register the identities and access conditions of investors and managers of hedge funds. In addition, the capital flow should be strictly monitored, the leverage ratio of the company should be controlled, a certain risk reserve should be set, and the risk should be monitored in real time. Finally, we should actively learn advanced investment management methods, innovate investment management technology, and use diversified investment strategies to avoid investment risks. Through the above methods, enterprises effectively improve the requirements of information disclosure, enhance the strength of information disclosure, make the operation of hedge funds more transparent, and reduce the occurrence of illegal market manipulation.

(4) Strengthen the verification of hedge fund credit allocation

One of the most significant characteristics of hedge funds is to make full use of leverage effect, to obtain high returns while also bearing high risks. The institutions that issue loans should strengthen the verification of hedge fund loans, and set up appropriate lending rates and credit mortgage systems. After the loan is issued, the use way and utilization degree of the loan shall be strictly monitored.

(5) Active learning and innovative investment strategies

Continuous innovation and introduction of new investment strategies can inject vitality into the hedge fund market. In order to promote the development of the hedge fund market, China should actively introduce the world's advanced investment strategies, learn advanced investment knowledge and innovate investment methods, so as to better disperse investment risks and provide diversified services for customers.

5. Conclusion

At present, the contradiction between the rapid development of Chinese hedge funds and the imperfect hedge funds regulatory system makes the hedge fund market not transparent enough, and the illegal operation events occur frequently, which cannot prevent and face the risks brought by hedge funds. Therefore, China should learn from the advanced experience of foreign countries, introduce and cultivate high-quality talents, establish and improve the supervision system of hedge fund as soon as possible, regulate the operation of hedge fund market, effectively crack down on illegal and criminal phenomena, and promote the prosperity of China's economy.

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