Study on Portfolio Strategy of FOF Funds

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Abstract: FOF, as an emerging financial model, diversifies fund products and gives investors a new investment experience. This paper analyzes the following aspects: Firstly, it gives an overview of the investment status of FOF funds at domestic and overseas; secondly, it introduces the development history and status of domestic FOF funds; then, it elaborates on the characteristics and mode of operation for FOF funds; finally, it puts forward the management principles of FOF funds and analyzes the advantages and disadvantages of FOF funds with empirical data. Moreover, the study above shows that China is still lagging behind in the development of FOF funds. However, with the continuous opening of the financial market, more and more foreign investors are entering our market. Therefore, it is necessary to strengthen the understanding of FOF funds, actively explore new investment models and improve our own investment level.

Keywords: FOF; Portfolio; Strategy research.

1. Introduction

China's financial markets have changed dramatically in recent years, with a dramatic increase in the number of institutional investors, resulting in a continued improvement in the efficiency of China's financial markets. However, this has also led to an increasing reduction of arbitrage space for various assets. With the improvements in market efficiency and the extensive participation of countless experts and academics, it is difficult for investment institutions to capture excess returns on a single stock or bond alone. Moreover, this situation will also persist due to the numerous factors affecting the securities market and the possibility of unexpected situations occurring at any given time. The instability of long-term market changes makes it impossible for investors to make precise investment decisions. Therefore, the development of asset allocation techniques and strategies by fund management companies will be a pivotal factor in future investment returns, where specialized funds such as FOFs can drive the development of asset management.

2. Overview of FOF Fund Portfolios

2.1. Concept of FOF funds

FOF funds are an investment strategy that invests in other funds, which is not only limited to 80% of the fund's total assets but also includes purchasing funds with derivative nature and holding other FOF funds.[1] In China, the Securities Regulatory Commission requires FOF funds to adhere to investment restrictions to protect investors' interests strictly. Moreover, the market value of a FOF fund's holdings shall not exceed 20% of its total assets to ensure its long-term stable growth.[2]

2.2. Characteristics of FOF funds

2.2.1. FOF funds can risk reduction

FOF funds can effectively reduce unsystematic risk by combining multiple assets together so that changes in a single asset have minimal impact on its net worth, thus making the fund more steady.

2.2.2. Yield of FOF may be low

FOF funds cannot invest all of their capital in stocks and commodity futures and thus cannot rely on dramatic increases in a single security to achieve high returns.

Figure 1. Investment ways of FOF funds[3]

2.2.3. FOF funds are more suitable for institutional holdings

Since FOF funds can control risk effectively while carrying large amounts of capital, it is suitable for institutional investors and high-net-worth individuals, especially pensions, who desire long-term steady returns. However, for general investors, the high risk-return rate of FOFs does not make them feel too tempted, which is why they prefer to buy money funds, equity funds, or index funds that have higher returns.

2.3. Classification of FOF funds

FOF funds can be classified into different categories depending on the type of investment fund, its affiliation, allocation strategy, and other factors, as shown in Table 1.
Table 1. Classification of FOF funds[4]

<table>
<thead>
<tr>
<th>Classification standards</th>
<th>Post-category name</th>
<th>Meaning</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sub-fund types</td>
<td>Equity FOFs</td>
<td>Sub-funds investing in purchased shares</td>
</tr>
<tr>
<td></td>
<td>Fixed income FOFs</td>
<td>Sub-funds investing in purchased bonds</td>
</tr>
<tr>
<td></td>
<td>Alternative FOFs</td>
<td>Sub-funds investing in various categories, regardless of the asset class</td>
</tr>
<tr>
<td></td>
<td>Hybrid FOFs</td>
<td>Invests primarily in sub-funds that are actively managed</td>
</tr>
<tr>
<td></td>
<td>Actively managed</td>
<td>Invests in various categories, regardless of the asset class</td>
</tr>
<tr>
<td>Sub-fund strategy</td>
<td>Passive managed</td>
<td>Invested sub-funds are all company-owned funds</td>
</tr>
<tr>
<td></td>
<td>Internal FOFs</td>
<td>Invested in sub-funds from the whole fund market</td>
</tr>
<tr>
<td>Sub-fund affiliation</td>
<td>External FOFs</td>
<td>Adopt a relatively flexible broad asset class allocation, and select funds</td>
</tr>
<tr>
<td></td>
<td>Hybrid FOFs</td>
<td>Select funds with excellent historical performance and strive to outperform</td>
</tr>
<tr>
<td></td>
<td>Absolute return FOFs</td>
<td>the average market return.</td>
</tr>
<tr>
<td>Profit strategy</td>
<td>Relative return FOFs</td>
<td>Adopt a relatively fixed asset allocation.</td>
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<td></td>
<td>Fixed allocation FOFs</td>
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3. Analysis of the Advantages and Disadvantages of FOF Funds

3.1. Advantages of FOF

3.1.1. More professional investment

FOF funds are a way for investors to select the best portfolio for a higher risk-return ratio through various methods, such as qualitative analysis, quantitative analysis, interviews, etc.

3.1.2. Excellent risk diversification

FOF funds reduce investment risk by investing in various financial instruments, such as stocks, commodities, bonds, and futures. Moreover, if the market experiences significant economic fluctuations, the FOF fund's portfolio can remain stable and avoid significant losses.

3.1.3. More professional in asset allocation

FOF funds have the advantage of having good asset allocation ability and coping with the complex and changing market environment, thus achieving higher returns. However, managers of equity funds and hybrid funds are often experts in the financial industry, who often lack knowledge of macroeconomic analysis and in-depth macro-strategic analysis, and it is difficult to obtain sustainable returns just by relying on market gaming. Conversely, FOF funds have the unique advantage of adjusting the direction of capital flows according to macroeconomic changes, thus achieving effective returns.

3.2. Disadvantages of FOF

3.2.1. Limited disclosure of fund information

Currently, the lack of adequate information disclosure makes it difficult for fund researchers to obtain pivotal information from public sources, which leads to difficulties in maintaining fund pools and hinders fund research and screening. In addition, investors also find it difficult to determine the best investment strategy based on the announced information because of the lag in information disclosure, which does not reflect the fund's position in a timely manner.

3.2.2. Unclear benchmark for FOF fund comparison

FOF funds have distinctive performance benchmarks, varying investment objectives, and short investment horizons and are rarely experienced by the market, which makes their performance benchmarks difficult to predict, thus causing their investors to face significant challenges when making investment decisions.

3.2.3. Double charge

With the development of the financial market, the yield of FOF funds has increased significantly, and investors can benefit from it. Moreover, compared to before, investors do not need to pay subscription fees, management fees, and custodian fees whether they buy a single fund or a FOF fund, thus making investors' returns effectively protected. In addition, investors do not have to worry about the turnover of the management team, thus avoiding a significant loss of capital.

3.2.4. Other issues

The FOF funds usually have a very limited investment scale, which may lead to control by the mother fund, thus causing negative consequences for the sub-fund investors. In addition, the double fees of FOF funds and their market share make them more popular, bringing more opportunities and challenges to small and medium-sized funds.

4. Development Status of FOF Funds

4.1. Development of foreign FOF funds

In 1978, the U.S. launched the world's first FOF fund and has maintained a leading position in the decades since, continuously improving and perfecting fund-related laws and attracting investors from around the world, which has made the U.S. the leader of the global FOF market and has provided an important reference for the development of China's FOF market. Moreover, Europe's FOF funds are developing rapidly, and institutional and individual investors generally welcome their public FOF products. Taiwan, Japan, and South Korea have a market share of over 10% for FOF funds, which benefited from their refined management in the investment process, thus enabling investors to receive consistent, stable, and high returns.

4.2. Development of China's FOF funds

Wind data shows that by the end of January 2020, a total of 86 global FOF funds have been issued, of which 69 have been reviewed. In addition, in terms of fund scale, the total amount of global public FOF funds has reached RMB 41.831 billion, of which the total amount of each fund is RMB 481 million, while the overall amount is RMB 249 million. Among these funds, Minsheng Royal Fund has the largest scale of RMB
4.595 billion, while Huaxia Jufeng Fund's steady target A has the smallest scale of RMB 0.01 billion, with a variance of 73.74. Moreover, the scale of these funds is between 0 - 200 million, which is significantly more compact than other types of funds, as shown in Figure 2.[5]

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**5. Selection of Portfolio Strategies for FOF Funds**

**5.1. Principles of selecting portfolio strategies for FOF funds**

When selecting a portfolio strategy for a FOF fund, certain principles need to be followed. Firstly, it is important to consider the balance between risk and return. The portfolio of a FOF fund should have a high rate of return, but at the same time, it should not be too risky, or it may lead to losses. Therefore, when selecting the bid qualifications, the balance between its risk and return needs to be considered comprehensively. Secondly, attention should be paid to the diversity and stability of asset allocation. The portfolio of a FOF fund should cover different types of assets, such as stocks, bonds, real estate, etc., to reduce the risk of a single asset. Concurrently, asset allocation also needs to pay attention to the degree of diversification to avoid over-concentration in a particular asset. Finally, it is important to pay attention to changes in the market environment. The portfolio of a FOF fund should be able to adapt to changes in the market and adjust the investment direction and ratio in a timely manner. In addition, it is also necessary to pay attention to the impact of policies and regulations to ensure that the selected investment targets comply with relevant regulations. In conclusion, selecting a portfolio strategy for a FOF fund requires careful consideration of various factors, including risk, return, asset allocation, and other factors. Only in this way can we achieve a long-term and steady investment goal.

**5.2. Methodology for selecting portfolio strategies for FOF funds**

When selecting a portfolio strategy for a FOF fund, various factors need to be considered. Firstly, one should clarify one's risk tolerance and return expectation target. Secondly, one should analyze the market situation and understand the current market trends and directions to grasp the opportunities better and avoid the risks. In addition, it is necessary to pay attention to the interrelationship between different types of assets and their respective volatility. Finally, factors such as the fund manager's experience level and management style should be considered. Moreover, for the specific selection method, fundamental analysis or technical analysis can be used to assist the decision. Among them, the fundamental analysis method mainly determines the value of the stock by studying the company's financial situation and industry outlook, while the technical analysis method mainly predicts future stock price changes based on historical price movements. Concurrently, other indicators, such as the PEG ratio and P/E ratio, can also be combined to evaluate a fund's performance comprehensively. In short, choosing the right portfolio strategy is one of the keys to the success of a FOF fund.[6]

**5.3. Steps for selecting portfolio strategies for FOF funds**

When choosing a portfolio strategy for a FOF fund, there are certain steps to follow. Firstly, one should clarify one's risk appetite and return objectives to determine the appropriate strategy better. Secondly, an in-depth market study should be conducted to understand the performance of different asset classes and their relationship with the macroeconomic environment. Moreover, based on this, a corresponding portfolio plan can be developed. Specifically, different investment styles can be selected to build the portfolio of a FOF fund. For example, some investors may favor equity funds that seek high returns; while others focus more on steadiness and allocate their funds to bond funds or hybrid funds. In addition, one may also consider risk reduction through diversification, namely allocating funds to different products from multiple fund companies. Finally, it should be
noted that the portfolio strategy of a FOF fund needs to be constantly adjusted and optimized to adapt to changes and trends in the market. Therefore, it is also necessary to constantly keep an eye on market dynamics and make timely decisions accordingly in the actual operation process. In conclusion, choosing the right portfolio strategy for a FOF fund is one of the keys to achieving long-term steady returns.

6. Common Portfolio Strategies for FOF

6.1. Target period of investment strategy

The target period strategy is an investment strategy based on the risk-return characteristics of investors at different ages. Moreover, the aim is to help investors achieve higher returns and provide better investment returns for their pensions. FOF funds in the U.S. are one of the best examples of this strategy.

By adopting a new strategy that gradually reduces portfolio risk as investors age and seeks higher returns from the outset, and then gradually increases holdings in lower-risk bonds and other products. This strategy meets investors' retirement needs while effectively enhancing their pensions' value.

6.2. Yale fund management strategy

The Yale strategy is an optimization of Markowitz's mean-variance model applied in practice. By analyzing historical risk and return data, combined with investors' subjective experience, institutional investors can more accurately allocate assets, thus achieving higher investment returns. Moreover, Yale University's campus fund is an important example because it is committed to balancing annual returns with long-term investments. By managing its funds over the long term, the Yale Fund is able to effectively avoid missing out on undervalued opportunities in the market, thus yielding greater returns. Over the past two decades, the Yale Fund has grown at an average annual rate of 13%, and the fund's net worth has increased 12-fold, which far exceeds the returns of other university funds.

6.3. All-weather strategy

The all-weather strategy aims to allocate different types of assets to different portfolios through the principle of risk parity to achieve optimal returns and losses. Moreover, taking stocks and bonds as an example, the ratio of the two asset classes can reach 50% if equal weighting is adopted. In addition, considering the risk of stocks, the all-weather strategy can effectively reduce investors' losses. By adopting a risk parity strategy, Bridgewater Associates, over two decades, the fund has been able to achieve the same risk contribution between equities and bonds, thus minimizing risk exposure. The fund has delivered a compound annual return of over 8% over two decades and has never experienced any retreats. The success of this strategy stems from its ability to maintain a more consistent commitment over decades. It has consistently earned the same rate of return as the global stock market since the 1970s, and it has had half the maximum retracement rate of the stock market, resulting in excellent volatility and Sharpe ratios.

7. Conclusions

For investors of FOF funds, it is very important to understand and master the portfolio strategy of FOF funds. Firstly, it is important to clarify that a FOF fund is a pooled fund, which consists of multiple independent funds that different fund companies or fund managers usually manage. Moreover, since the FOF fund is composed of several independent funds, it has a much higher degree of risk diversification than a single fund. In addition, FOF funds can achieve better asset allocation results, thus improving the risk-return ratio for investors. Therefore, to better understand the portfolio strategy of FOF funds, in-depth research, and analysis are needed. Specifically, it can start from the following aspects: Firstly, selecting suitable independent funds as the basis of FOF funds; secondly, reasonably allocating the proportion of funds; thirdly, reasonably screening and evaluating different types of independent funds; fourthly, adjusting and optimizing the portfolio in time during the investment process. In conclusion, the portfolio strategy of FOF funds is a complex process that requires adequate research and thought to get the best results.

References


