

Z-BEN ADVISORS

China Investment Management: Market Update

February 2009

Back in the Ring

There is an unmistakable - and unfamiliar - sense of optimism in the air in China's markets at the moment: perhaps, more accurately, a rising belief that the worst economic, profitability and trading news may now be behind us. We're not immune to such moods at Z-Ben Advisors, although our natural contrarian instincts are fighting our emotional response.

2009, in prospect, just doesn't look as bad to us as it does to many commentators abroad. GDP looks set to roll on at a pace few other nations can dream of; early domestic company reports have, for the most part, satisfied or exceeded expectations; and policymakers have, so far, dodged every bullet from inflation to deflation to credit crunches. That said, we're not economists: our optimism stems in large part from some familiar patterns we see emerging in mutual fund investing, fund manager behavior and demand for access to Chinese domestic assets.

The table below shows an unexpected jump in industry AUM during Q4, the overwhelming majority of it made up of flows into money market funds. Elsewhere, we'd call that evidence of negative sentiment: investors pulling out of anything with a hint of risk. In China, interest-rate cuts and once-in-a-decade money market yields notwithstanding, such moves are often a sign of a staging area being built. Institutional investors who are preparing for a large move into equities often stockpile cash in money market funds first, readying the war chest for an attack. That's our first sign of hope for 2009.

Enthusiasm for China's equity markets may be more than a passing fancy

Industry Assets Under Management (RMB Billions)

	4Q08	Share	3Q08	Share	2Q08	Share	1Q08	Share
Total Industry Assets	1,938.9	100.0%	1,843.3	100.0%	2,086.7	100.0%	2,612.7	100.0%
Quarterly Δ	5.2%		-11.7%		-20.1%		-20.2%	
Total Domestic	1,057.5	54.5%	1,052.9	57.1%	1,190.4	57.0%	1,553.1	59.4%
Total Joint Venture	551.3	28.4%	508.5	27.6%	575.3	27.6%	678.2	26.0%
Total Foreign Invested	330.1	17.0%	281.9	15.3%	321.0	15.4%	381.4	14.6%

SOURCE: Z-BEN ADVISORS,

The second sign is re-equitization. Equity and balanced funds are moving back - albeit cautiously - into equities, an asset class they couldn't abandon fast enough in 2008. China's equity markets, in addition to delivering a helpful lift over the past six weeks, have been deepening for more than a quarter. For the first time in a year, stockpicking has a meaningful ability to influence returns for more than a handful of managers. Where returns are possible, they will be sought and this leads us to expect more support for equity markets from equity-centric funds.

Finally, demand for access to China's domestic markets appears to be running at all-time highs. QFII applications - either submitted or in preparation - are running high and global equity managers are devoting ever-increasing proportions of their portfolios to China. To a very great extent, this is the natural consequence of lifeless markets elsewhere, added to global managers' hopes (we can't quite bring ourselves to say conviction) that China will be the first market to emerge in 2009, thanks to its early and substantial battering in 2007-08.

A launching pad for equity buying may now be under construction

We're not in the business of predicting stock market levels (a fact of which we remind you every time we get such predictions wrong), but our confidence is growing that a number of events appear more likely to occur in 2009 than they did even three months ago.

First among these events will be increased competition for stakes in existing fund managers. At least six such stakes, as a consequence of global consolidation or domestic intent to find foreign partners, should come to market in 2009. The market for such stakes looks significantly deeper than it did during the September global market crashes and sellers can reasonably hope to achieve substantially better prices (and, in some cases, auction prices) for their stock.

Second is a greater willingness to take risks in launching funds. The QDII program, consigned to the coma ward as recently as six months ago, may soon sit up and take a bowl of soup. Domestically, the recent focus on bond and money market launches may shift not only to equity products but higher-risk or higher complexity products issued through the newly-opened innovative funds Green Channel.

Finally, retail investors may, in 2009, remove their hands from under their seats and begin to abandon underperforming funds. Too many funds have been rewarded with loyalty for lackluster performance and, in a market where the best equity managers are better able to separate themselves from the worst, that loyalty may (and should) be tested. We could spend equal space detailing the negatives facing the fund industry: poor profitability, homogeneous products, rudderless management. But there are some green shoots showing today; that's a change worth noting.

Prospects are brightening for fund managers on both growth and valuation grounds

Monthly Research Highlights

A Faintly Positive Note: 2008 Year-End Assessment

China's fund managers ended 2008 with AUM declining 41% for the year. During the final weeks of the year, however, demand reappeared to such an extent that the AUM growth rate turned slightly positive in Q4. Although welcome, this demand was all but completely centered on money market funds and to the point that total industry AUM in fixed income products reached 30%. Elsewhere, every established equity mutual fund finished the year deep in negative territory, although their returns look strong when compared to the benchmark CSI 300 Index.

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The Rmb1.00 Dilemma: Better Performance, Worse Redemptions?

Fund managers may be facing a dicey situation heading into 2009. The equities market is showing clearer signs of a recovery but this could end up raising the risk of higher rates of redemptions. Retail investors have been sitting on significant unrealized losses and could use any material rally as a point at which to exit. The threat of such a scenario playing out increases the closer a highly retail exposed fund's NAV nears Rmb1.00. History shows that this strong relationship does in fact exist. Not all fund managers are at risk. In this article, Z-Ben Advisors identifies the funds and managers most likely to suffer Rmb1.00-driven redemptions in coming months.

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Mid-Tier Firms: Well Camouflaged Success

The battle over market share is heating up and especially among those fund managers ranked in the middle. A great deal of jostling took place in 2008, yet many firms succeeded solely on the support of well timed new product offering or sudden demand for a money market fund. Adjusting for these two factors shows that certain fund houses have in place a far stronger long term business platform than rivals. Others are found to be more lucky than good. The relationship which hasn't changed is that between relative-to-peer performance and a firm's success in gathering and retaining assets. An important relationship to be mindful of as assets are expected to slosh around the industry throughout 2009

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Subtlety When Seducing Angels: Product Innovation in Focus

At the end of 2008, CSRC decided to open a new path for any product application deemed as being truly innovative. The details of what actually constitutes “innovation”, however, were left to the imagination of fund managers. A positive development, to be sure, but Z-Ben Advisors’ research finds that attempts to create innovate products in the past has been met with mixed results. It is unclear to what extent retail investors either want or understand such products. Institutional investors will want evidence that innovations aren’t simply designed to extract for their fees.

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AUM vs FEES: 2008’s Key Trade, for Better or for Worse

The first blow suffered by fund managers last year was a sharp contraction in AUM. That was followed by an equally sharp blow in the average fee extraction rate as investors rushed into bond and money market funds. This confluence of events led every fund manager facing a stark (and sometimes involuntary) choice: accept enormous dilution of fee extraction or watch AUM drop like a stone. It was, ultimately, a trade off whereby some fund managers came out the other end relatively unscathed and others were left battered and bruised by the development.

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O REITS, Wherefore Art Thou: The View from the Balcony

The one topic on everyone’s mind these days is the inevitable introduction of Real Estate Investment Trusts (REITs). For developers, REITs are the answer to every prayer. For policymakers, they appear to be a valuable development tool. For investors, REITs may yet prove too rash, too unadvised and too sudden. We review both supply and demand for REITS, identifying the most likely offerings and their buyers. Our conclusion: don’t expect a particularly liquid REIT market any-time soon.

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Private (Hedge-Lite) Funds in 2008: Success but Little Stability

Over the past two years, the funds industry has been plagued by the defection of “star” fund managers who saw greater glory (and remuneration) running their own shops than in the public eye. While their performance in relative terms typically exceeded public mutual fund managers’ by some distance, positive absolute returns remained out of reach for most in 2008. In this article, we explore the dynamics of private funds’ returns and assess investors willingness to stay the course with - for now - money-losing funds.

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JV Manager Review: On the Rise but Under the Radar

The slosh of new cash into money market funds masks, to a surprising extent, the success of JV managers in retaining and attracting AUM in recent months. While JVs as a group are taking more market share from competitors, new launches and reclassifications account for much of the obvious gain. The situation looks likely to become even less stable in 2009, as industry consolidation outside China may force a number of domestic stake sales. We review a number of current sale candidates and suggest the likely drivers of JV market share growth in coming months.

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Corporate Actions: Hitting the Brakes

After a rather active December, fund managers closed the month of January with little in the way of announced corporate actions. This was especially true when assessing the number of firms declaring a dividend: 34 mutual funds announced a payout in December versus just three in January. On changes made to senior management, China AMC disclosed that it had strengthened its bench by bringing in new portfolio managers. The same too at both Harvest and Fortis Haitong. There were, however, no noticeable defections to speak of. But then again most portfolio managers stay put at least until year-end bonuses are paid out. The merry-go-round should pick up momentum beginning next month.

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New Product Review & Analysis: Safer but Harder to Measure

Seven new products are reviewed this month, a relatively low number but unsurprising given an attenuated selling period before the advent of the Year of the Ox. Balanced and bond funds dominate the lists, as managers attempt to meet investors' need for cautiously-managed funds which limit exposure to volatile equity markets. Complicated benchmark splits may make managerial performance difficult to assess for shareholders of many of these new funds - even we're having trouble comparing apples to oranges among the balanced sector's newest funds. However, the selling message for many of these funds is a simple one: lower risk, and a better chance of positive returns.

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Monthly Performance Review: Up, Up and Away?

A month of positive index performance has already been much celebrated by China's investors. Among managers, however, the good cheer isn't quite so evenly distributed. In a familiar pattern, those managers who have proven themselves to be flexible and - when the time is right - aggressive outperformed by a wide margin. Laggards, as always, failed to capitalize fully, although buoyant markets translated to some gains for even the worst-served fund investors. Cap rotation towards smaller and mid-sized companies is becoming more pronounced, a result of better market depth than has been seen in China for more than a year.

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Analytical Quick Hits

Private Fund Compensates for Losses. After recording losses greater than 15% in 2008, the private (hedge) fund, Shanghai Cyndi Investment paid more than Rmb12m to investors as compensation. This was the first time that a private fund compensated for investment loss.

Guangfa Gets QDII Qualification. Guangfa was approved to invest in offshore markets under the QDII program. To some extent, this shows the regulator still supports the program in a volatile overseas economic environment.

Ban on Investment-Linked Insurance. CIRC will stop sales of investment-linked insurance products at deposit counters starting in March. Banks will be allowed to sell only at their financing centers. New rules aim to standardize insurance sales and reduce bad advice.

E-Fund Sets Up Branch in Hong Kong. The firm set up a wholly owned subsidiary in Hong Kong. The subsidiary has licenses for both securities consulting and asset management. Since CSRC allowed domestic fund houses to establish branches in Hong Kong last May, four houses have entered into Hong Kong including China AMC, Southern, Harvest and E-Fund.

Four More QFII Licenses Issued. In December of 2008, CSRC granted QFII licenses to Abu Dhabi Investment Authority, Allianz Global Investors Luxembourg S.A., Capital International and Mitsubishi UFJ Securities. By the end of 2008, 76 foreign institutional investors were approved to invest in the domestic capital market under the QFII program.

AEGON-Industrial Approved for Segregated Account Business. AEGON-Industrial Fund Management won approval to offer segregated account services. Currently, 30 fund houses have segregated account qualification.

Lion Secured Segregated Account Contract. The listed Beijing Mainstreets Investment Group announced a Rmb50m segregated account contract with Lion Fund Management. Lion is one of the first fund houses to achieve segregated account qualification.

First Fund of Minsheng Royal. The newly-established JV fund house, Minsheng Royal Fund Management, was approved to launch an equity fund, which will mainly focus on blue chips.

China Life's CIO Left for CITIC Securities. China Life announced that CIO Mr. Liu Lefei resigned to move to CITIC Securities. It's reported that Mr. Liu may be assigned to manage Mianyang Industrial Fund, which was established by CITIC Securities. China Life is a shareholder of CITIC Securities.

Measure for Fund Rating Institutions. CSRC may promote measures for mutual fund rating institutions to improve and standardize China's mutual fund rating system. CSRC will grant license to qualified rating institutions.

Citibank Launched QDII Product. Citibank launched a new QDII product, a structural guaranteed fund, as the first bank QDII product of 2009. Investors

Analytical Quick Hits

will receive fixed return in the first year. Considering the economic situation, capital preservation will be the main objective of investors in 2009.

Breakthrough in 3rd Party Distribution. Tianxiang Investment Consulting will cooperate with Minsheng Bank for fund distribution. Minsheng Bank will take responsibility for capital clearing and supervision. This is a significant breakthrough in third party fund distribution as capital clearing has long been a problem.

China AMC Finally Takes over CITIC. CSRC approved China AMC to take over CITIC FMC's four funds. China AMC officially became those four funds' manager. After manager and staff rearrangement and other changes, the merger will be finished soon.

E-Fund Bought Index Fund. E-Fund announced proprietary trading of Rmb200m. This capital was invested in its own fund, E-Fund Shanghai 50 Index Fund. Previously, E-Fund's proprietary

trading was mostly in closed-end funds. Investing in an index fund may show the manager's confidence in the market's rebound.

Divided Paid Despite NAV Below Rmb1.00. ABN Amro Teda Optimized Stable Fund paid a dividend of Rmb4.4 per ten shares, lowering NAV from Rmb0.95 to Rmb0.50. The dividend payout may have been made to shield the fund from Rmb1.00 redemption pressures.

INDUSTRY AUM & MARKET SHARE DECEMBER 31, 2008: ACTUAL

DOMESTIC FUND MANAGERS				SINO-FOREIGN FUND MANAGERS			
	AUM				AUM		
	RMB Bill	Share	RANK		RMB Bill	Share	RANK
Baoying	9.2	0.48%	42	ABC-CA	9.7	0.50%	40
Bosera	125.7	6.49%	3	ABN Amro TEDA	20.8	1.07%	31
Changxin	23.4	1.21%	28	AEGON-Industrial	25.1	1.29%	27
China AMC	188.9	9.74%	1	AIG-Huatai	12.7	0.66%	37
China Nature	6.2	0.32%	47	AXA SPDB	1.7	0.09%	58
China Post & Capital	25.8	1.33%	26	BoComm-Schroders	48.4	2.50%	12
China Universal	47.2	2.44%	15	BOC ¹	22.3	1.15%	30
CITIC	9.2	0.47%	43	CCB Principal	37.8	1.95%	20
Dacheng	70.7	3.65%	7	Changsheng ²	27.3	1.41%	25
E-Fund	87.6	4.52%	5	China International ¹	49.0	2.53%	11
First Trust	12.6	0.65%	38	China Merchants ¹	39.7	2.05%	18
Galaxy	15.9	0.82%	33	CITIC-Prudential	9.4	0.48%	41
Golden Eagle	1.9	0.10%	57	Everbright Pramerica	23.3	1.20%	29
Great Wall	29.0	1.50%	24	First State Cinda	5.9	0.30%	48
Guangfa	66.9	3.45%	9	Fortis Haitong	38.5	1.99%	19
Guotai	31.7	1.63%	23	Fortune SGAM	48.2	2.48%	13
Hua'an	69.5	3.58%	8	Franklin Templeton Sealand	13.6	0.70%	35
Huafu	4.8	0.25%	51	Full Goal ²	40.3	2.08%	17
Huashang	4.8	0.25%	52	GTJA Allianz	5.2	0.27%	50
Lion	33.2	1.71%	22	Harvest ²	137.5	7.09%	2
New Century	1.0	0.05%	60	HSBC Jintrust	6.3	0.32%	46
Orient	7.4	0.38%	45	ICBC Credit Suisse	75.2	3.88%	6
Soochow	7.5	0.39%	44	INVECO Great Wall	41.8	2.15%	16
Southern	102.9	5.31%	4	KBC-Goldstate	3.9	0.20%	53
Tianhong	3.4	0.17%	54	Lombarda China	2.1	0.11%	56
Wanjia	12.8	0.66%	36	Lord Abbett China	3.4	0.17%	55
Yimin	5.7	0.29%	49	Morgan Stanley Huaxin ³	1.7	0.09%	59
Yinhua	52.4	2.70%	10	Penghua ²	47.7	2.46%	14
TOTAL	1,057.5	54.54%		Rongtong ²	36.7	1.89%	21
				SYWG BNP Paribas	10.5	0.54%	39
				UBS SDIC	20.5	1.06%	32
				Zhonghai ⁴	15.5	0.80%	34
				TOTAL	881.4	45.46%	

SOURCE: Company Data, Z-BEN ADVISORS

1 - ING INVESTMENT MANAGEMENT OWNS A 33.3% EQUITY INTEREST IN CHINA MERCHANTS; JP MORGAN FLEMING ASSET MANAGEMENT OWNS A 49% EQUITY INTEREST IN CHINA INTERNATIONAL; BLACKROCK OWNS A 16.5% EQUITY INTEREST IN BOC; COLONIAL FIRST STATE GROUP OWNS 46% IN FIRST STATE CINDA.

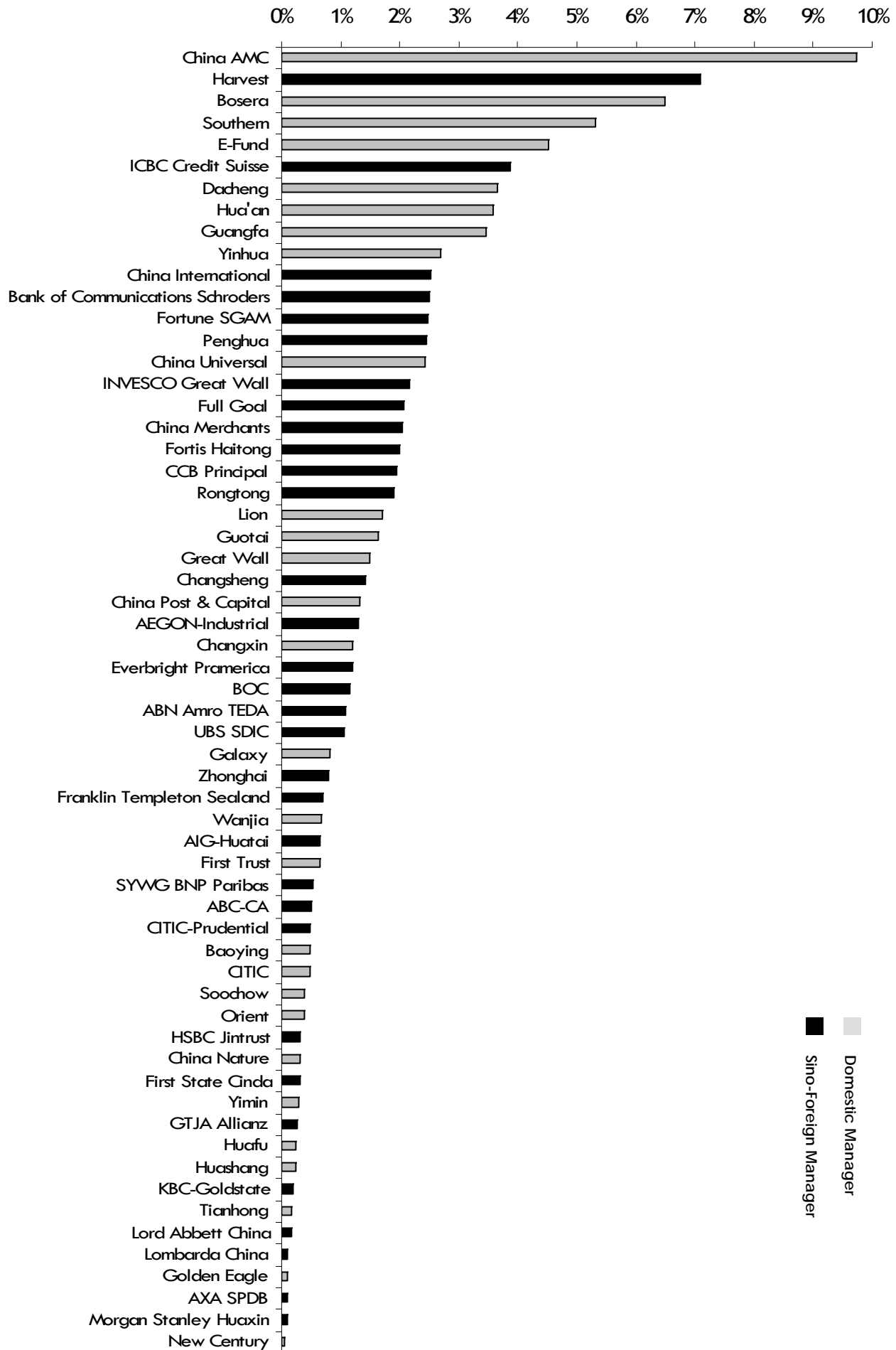
2 - BANK OF MONTREAL BOUGHT AN EQUITY INTEREST IN FULL GOAL THAT CURRENTLY STANDS AT 27.775%; DEUTSCHE ASSET MANAGEMENT PURCHASED 30.0% EQUITY INTEREST IN HARVEST. DBS ASSET MANAGEMENT ACQUIRED A 33% STAKE IN CHANGSHENG WITH NIKKO ASSET MANAGEMENT BUYING A 40% POSITION IN RONGTONG. EURIZON FINANCIAL GROUP OWNS A 49% STAKE IN PENGHUA.

3 - FORMERLY JUTIAN FUND MANAGEMENT

4 - ZHONGHAI AND LA COMPAGNIE FINANCIERE EDMOND DE ROTHSCHILD BANQUE COMPLETED THEIR MERGER IN DECEMBER 2008.

5 - FORTIS GROUP HAS AGREED TO SELL ITS POSITION IN ABN AMRO TEDA TO UK-BASED OLD MUTUAL ASSET MANAGEMENT. THE DEAL HAS YET TO BE APPROVED BY THE CHINESE SECURITIES REGULATORY COMMISSION.

INDUSTRY MARKET SHARE: December 31, 2008



SOURCE: Z-BEN ADVISORS