

Z-BEN ADVISORS

China Investment Management: Market Update

March 2009

The new mood of optimism is becoming entrenched

In Like a Lion

A second consecutive month of equity market gains has contributed to continued growth in industry AUM, by Z-Ben Advisors' estimate, and is tempting a greater number of investors away from the ultra-low-risk positioning in which they found shelter for the bulk of 2007. Perhaps the best indicator of this change in sentiment is the variety of concerns that Chinese investors are currently willing to shrug off. Disappointing earnings? Sure, but look at the growth potential. Declining exports? Domestic consumers are more important anyway. Loan-fuelled, short-term investment? Anything that gets the ball rolling will do for now.

It's been fashionable to characterize China over the past two years as a binary market: it does up, it does down, it doesn't do sideways. In our view, that statement's about half true but the half it doesn't cover seems like the important one. China did a lot of sideways before the majority of international investors arrived. Then (and, we suspect, now), market depth – the cross-sectional volatility (CSV) of individual stock returns – was typically a better measure of market health than overall index direction in China. Certainly, shallow but rising markets found it harder to maintain their upward momentum than deep ones.

Overall, CSV has risen substantially from its 2008 depths and, in spurts, added to market depth in February. That, combined with an equity market that, at time of writing, is 43% up from its November lows, leads us to the view that 4Q07 was likely both an equity market and fund AUM bot-

Industry Assets Under Management (RMB Billions)

Fear of equity markets retreating to 2008's lows has abated

	Current ¹	Share	4Q08	Share	3Q08	Share	2Q08	Share
Total Industry Assets	2,030.1	100.0%	1,938.9	100.0%	1,843.3	100.0%	2,086.7	100.0%
Quarterly Δ	4.7%		5.2%		-11.7%		-20.1%	
Total Domestic	1,109.0	54.6%	1,057.5	54.5%	1,052.9	57.1%	1,190.4	57.0%
Total Joint Venture	578.8	28.5%	551.3	28.4%	508.5	27.6%	575.3	27.6%
Total Foreign Invested	342.3	16.9%	330.1	17.0%	281.9	15.3%	321.0	15.4%

SOURCE: Z-BEN ADVISORS, CURRENT AUM IS AN ESTIMATE AS OF FEB 28, 2009

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tom. The recovery that has since been built – haphazardly, haltingly, and, at times, on unlikely foundations – is certainly a result of widespread agreement among domestic investors that a retracement to CSI 300 lows in the 1600s is unlikely.

This change in behavior and belief, especially visible among institutional investors, is pushing fund managers into territory they haven't seen for more than a year. New product offerings are winning AUM in sizes not seen in 2008 outside the fixed income sector. Outflows from equity funds appear to have all but ceased. Salesforces are finding a more attentive audience when pitching higher-risk products.

Such changes will force some obvious – and some more subtle – changes in fund management, in fund house strategy and in the overall industry competitive balance. The fastest-moving fund managers began upping their equity exposure as early as 4Q08. That the rest will follow, we have no doubt, but when? Laxity in seeking shelter was enormously destructive to AUM for the majority of

equity-oriented fund managers in 2008. We suspect that they will be quicker to embrace opportunity this year than they were to abandon money-losing holdings last year. However, speed is still going to matter: institutional investors learned a useful lesson in the value of a fast-moving manager over the past 12 months. We can expect them to judge their managers' flexibility more coldly as a result.

Fund houses with more conservative or fixed income-heavy ranges are beginning, again, to look very badly positioned for asset retention. Those whose flagship equity fund's performance has lagged rivals' will find it difficult to retain those clients who are sheltering, temporarily, in bond and money market funds. Other firms, who were shut out of the fixed income action but have maintained relative performance and bench strength in their equity offerings, are now attacking hard and we expect them to show steady gains in AUM that are as much due to inflows as performance.

Those are the obvious changes; here's the more subtle one. After range breadth, the next-best determinant of any firm's market share stability in 2007 was asset-raising ability. In Z-Ben Advisors' view, fundraising ability will matter more than anything else – even performance – in coming quarters. CSRC's launch window is wide open and salesforces, for the first time in months, are having their calls returned. Bank-backed fund houses appear best-placed to take advantage, just as they did last year, and maintain the upward trajectory of their market shares. Indeed, a few judicious launches could propel some of these firms far up the ranking tables, and quickly.

Expect enormous volatility in coming months but with it, the possibility of substantial gains in industry AUM and, as importantly, a recovery in fee income as investors move back to equities.

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

Monthly Research Highlights

Competitive Threats: Who's Eating My Lunch and Why?

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We don't expect the current equilibrium in competitive pressures to survive. Indeed, there are already signs that firm-level market share is becoming more volatile and that the speed and sharpness of market share changes will accelerate. We review the pro- and anti-competitive forces we expect to come more fully into play in 2009 and assess which firms are likely to win, lose or draw. We also highlight a number of defensive and attacking strategies that look much more likely to succeed in 2009 than they could in prior years, and give our tips on tactics for best execution.

Insurance Investments: Poised to Move

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Insurance industry AUM reached Rmb3.34 tr. by end-08, surpassing the mutual funds industry. Credit should be given to the industry's strong product sales, especially its bancassurance business. Insurers have also benefited from investors looking for a safer alternative to mutual funds. Regulatory changes may alter the insurance investment landscape significantly. Not only can bancassurance products no longer be sold at deposit counters, small and mid-sized firms will also be allowed to invest in A-shares directly, potentially challenging the stranglehold that big insurance asset managers have on insurance investment.

QDII Review: Breaking a Starvation Diet

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No QDII quota has been issued since July 2008. Although some may argue that the government is too concerned about capital flight to issue any more quota and that the QDII program is on its last legs, we beg to differ. We argue that SAFE is trying to avoid past mistakes and is timing the market. Central authorities are still in favor of the program. On another note, Group Financial Companies (GFCs) also look set to participate in the QDII program, though not in the near future. It would behoove a foreign institution looking to gain QDII mandates to develop a working relationship with such companies. The same would also apply for Chinese insurers and trust companies as well.

NCSSF 2008 Overview: Parsing the Numbers

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A preliminary statement from the National Council for Social Security Fund at the conclusion of its annual conference has given us our first clues about the Fund's 2008 performance. While substantially worse than in previous years, the Fund appears, at first, glance, to have delivered an overall gain. We look more deeply into the handful of figures announced at assess how and where the money was made. We also examine changes in the Fund's current holdings, its plans for portfolio development in 2009 and suggest the likely consequences for current and future mandate managers.

Big Tier Firms: Uneasy Lie the Heads that Wear the Crowns?

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The industry is still dominated by the five biggest firms, accounting for one-third of total industry AUM. They remain the most profitable and own the most diverse fund ranges in the industry. These top tier firms have significant advantages over smaller rivals and their major concern is market share preservation. However, the next ten largest firms are in a fierce battle to climb the ranks. We segment this group into three categories and determine the future prospects for each. There is now a strong possibility that a JV may be able to crack the top tier in the next two to three years.

In 2009, The Search for Talent Intensifies

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Market uncertainties may not be enough to deterred fund managers' plans for business expansions. All in all, the mutual fund industry is hiring in excess of 500 additional professional. The usual suspects such as investment professional and back office staffs are on the list. But interestingly enough, a quarter of the positing are for client relations managers and other sales professionals, coinciding with CSRC's relaxation on the Segregated Account requirements. It seems, under the circumstances, that fund managers are finally jumping with both feet into the wealth management space.

Segregated Accounts Platform: A Year Old Experiment In Progress

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One year has passed and with a total of 34 Segregated Account licenses issued, the program remain an experiment with a Rmb3.0bn end-2009 AUM. Both regulators and fund managers having to fine tune the requirements and products to give in some traction which, among other things, include lowering initial investment and increasing the number of accounts for each plans. If approved, fund managers may be in a better position to compete with other wealth management programs but it could come at the cost of increased competitive pressure amongst the fund houses as well.

JV Manager Review: A Tour of the Minor Leagues

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2008 was a rough ride for everyone, but especially so for the smaller fund houses. Smaller JVs face unique challenges such as access to quality distribution channels and scalability issues. We focus on the bottom four joint venture fund managers – Morgan Stanley Huaxin, AXA SPDB, Lombarda China and Lord Abbett China and find that there is room for improvement in terms of performance, asset retention and product diversity. For internal as well as external reasons, these firms have not developed according to expectations. 2009 may well be the year where they can get back on track.

Corporate Actions: Managers on the Move

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With a rebound in capital markets, corporate actions picked up momentum last month. February was probably the first month we have seen concentrated redemption in proprietary trading, as one manager pulled out from four of it funds. Dividend declarations rose sharply, primarily from fixed income products. Portfolio manager changes accelerated within fund houses while it remained low between firms. Some smaller firms have also announced changes to their senior management and executive teams. CITIC-Prudential, for example, finally nailed down a candidate for its general manager position, which had been vacant since early last year.

New Product Review & Analysis: Safer but Harder to Measure

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Only one new product finished fundraising in February, making it difficult for us to assess how much end demand has recovered with rising equity markets. The new product pipeline was far more crowded, with a total of 14 products that started fundraising, and end-March results may hold more explanatory power. Equity-oriented products take up the majority of the pipeline, a sharp contrast to the past six months. However, new funds also have to face a jammed distribution channel, a situation similar to that in the middle of last year.

Monthly Performance Review: Up, Up and then ...

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The rally in January continued into February with CSI 300 Index gaining more than 20%. However, profit-taking activities halted the rise during the last week of February and forced the market to retreat somewhat. Overall, equity-oriented products were dragged by their defensive asset allocation strategy and thus under-performed the market. Most of the equity products that reported significant gains since last November were lowering equity exposure again in February. Fixed-income products barely posted any return for the month. And, the worst performing asset class is once again the QDII products, due to the slide in the United States and Hong Kong.

Analytical Quick Hits

Shanghai Financial Industry Fund. Shanghai Financial Industry Investment Fund Management Company has been approved. CICC and Shanghai International Group will hold each 40% stake. They are still looking for another partner to take the other 20% stake. This Financial Industry Fund, which is expected to raise Rmb20bn, has started a primary fund raising of Rmb8bn. It will mainly invest in financial institutions such as banks, fund management and trust firms.

CAAM and SGAM to Combine. Crédit Agricole and Société Générale announced that they have signed a preliminary agreement to combine their asset management firms. Crédit Agricole will own 70% of the new firm and Société Générale 30%. CAAM and SGAM are the foreign shareholders of ABC CA and Fortune SGAM Fund Management, respectively. The combination is likely to affect the two Chinese JVs' shareholding.

Institutional Investors Opened New Accounts. According to statistics from China Securities Depository & Clearing, 34 new accounts were opened by institutional investors in January. NCSSF opened 16 accounts, QFII opened six, and Funds opened 12. Up to January, investors under QFII scheme opened 128 accounts and NCSSF 148 accounts in total.

Changxin Got Segregated Account. CSRC approved Changxin Fund Management to provide segregated account services. So far more than half fund houses have got segregated account qualification.

New LOF Index Fund. Penghua CSI 300 Index Fund was approved to launch. It is the first listed open-ended index fund since August 2005, when Harvest CSI 300 Index Fund debuted. The new index fund is also the third CSI 300 Index fund approved this year.

Local Government Bonds May be Approved. China's central government may approve local governments to issue bonds to finance the Rmb4tr stimulus package. Total local bond quota may be around Rmb200bn. The local governments are applying for issuance quota. Such bonds will be issued via the central government.

NCSSF Had First Loss in Eight Years. NCSSF lost about Rmb39bn on its equity investments in 2008, which was the first loss in eight years. The loss resulted in a 6.75% loss, in contrast to 10.7% annual return from 2003 to 2007. The loss was mainly due to the volatile market, with the benchmark CSI 300 Index down by 65% in 2008.

Insurers to set up PE Investment Subsidiary. PICC finished the preparatory work for its PE investment subsidiary. After insurance companies were approved to invest in PE, CIRC required companies to have a separate subsidiary for PE investment. Ping An Group also has submitted the application to set up a PE investment firm.

QFII Consultancy by China Life AMC. China Life Insurance Asset Management has entered into a QFII securities investment consultant agreement with DAIWA Asset Management. China Life will provide A share investment recommendations, research reports, and analysis reports of investment portfolios. In 2006, China Life Insurance Asset Management signed an agreement with AMP Capital Investors to become the first insurance asset management company entering the QFII investment consultancy business.

Guidelines for Trust Companies. CBRC recently issued guidelines for trust companies to operate trust equity investment businesses. CBRC affirmed the cooperation mode between trust companies and privately offered funds. In the Guidelines, CBRC issued requirements and thresholds for privately offered funds and PMs. The Guidelines are intended to better regulate the trust investment market.

Analytical Quick Hits

Tax Rule for QFII. QFIIs are required to pay 10% corporate income tax of dividends, bonuses and interest income gained in China. Previously, QFIIs were exempted from business tax, but regulations on income tax payment were not stated clearly.

ICBC Credit Suisse Left Credit Suisse Asset Management as Its QDII Consultant. ICBC Credit Suisse FMC ended an overseas investment consulting agreement with Credit Suisse AMC. According to the firm's statement, ICBC Credit Suisse will manage the QDII fund internally henceforth.

Amended Insurance Law Approved. The Chinese legislature approved the amended Insurance Law. The amended law expanded investment channels for insurance companies from government bonds and financial bills to stocks, securities-investment funds and properties. It strengthened the supervision on the industry to better protect the insured. The Law will be effective from October 1, 2009.

Direct Stock Investment by Small Insurers. According to the CIRC, small and medium-sized insurance companies may be allowed to invest directly in the

domestic stock market. Since currently they can only invest in the stock market through third-party asset management firms, this move could help those insurers reduce investment costs. In addition, CIRC will increase categories of bonds that insurers can invest in and promote asset securitization.

Guotai FMC bought NASDAQ-100 Index. Guotai FMC signed an agreement with NASDAQ OMX Group and it will design an ETF product linked with the index. The product may become the first domestically traded fund that is linked to foreign index.

INDUSTRY AUM & MARKET SHARE FEBRUARY 28, 2009: ESTIMATES

DOMESTIC FUND MANAGERS				SINO-FOREIGN FUND MANAGERS			
	AUM				AUM		
	RMB Bill	Share	RANK		RMB Bill	Share	RANK
Baoying	10.04	0.49%	40	ABC-CA	9.35	0.46%	43
Bosera	131.27	6.47%	3	ABN Amro TEDA ⁵	21.71	1.07%	32
Changxin	23.77	1.17%	30	AEGON-Industrial	27.32	1.35%	27
China AMC	194.53	9.58%	1	AIG-Huatai	13.80	0.68%	36
China Nature	6.16	0.30%	49	AXA SPDB	1.68	0.08%	59
China Post & Capital	30.15	1.49%	25	Bank of Communications Schroders	53.46	2.63%	11
China Universal	47.97	2.36%	15	BOC ¹	23.23	1.14%	31
CITIC	9.56	0.47%	42	CCB Principal	38.44	1.89%	21
Dacheng	75.26	3.71%	6	Changsheng	28.58	1.41%	26
E-Fund	94.10	4.64%	5	China International ¹	50.77	2.50%	13
First Trust	12.81	0.63%	38	China Merchants ¹	39.37	1.94%	20
Galaxy	15.85	0.78%	34	CITIC-Prudential	9.74	0.48%	41
Golden Eagle	2.05	0.10%	57	Everbright Pramerica	25.77	1.27%	28
Great Wall	31.98	1.58%	24	First State Cinda ¹	6.62	0.33%	46
Guangfa	72.08	3.55%	9	Fortis Haitong	39.43	1.94%	19
Guotai	33.95	1.67%	23	Fortune SGAM	52.07	2.56%	12
Hua'an	73.28	3.61%	8	Franklin Templeton Sealand	14.41	0.71%	35
Huafu	4.95	0.24%	52	Full Goal ²	41.74	2.06%	17
Huashang	5.69	0.28%	50	GTJA Allianz	5.69	0.28%	51
Lion	35.90	1.77%	22	Harvest ²	138.37	6.82%	2
New Century	1.16	0.06%	60	HSBC Jintrust	6.32	0.31%	47
Orient	8.02	0.40%	44	ICBC Credit Suisse	73.98	3.64%	7
Soochow	7.58	0.37%	45	INVESCO Great Wall	45.00	2.22%	16
Southern	103.29	5.09%	4	KBC-Goldstate	3.74	0.18%	53
Tianhong	3.44	0.17%	55	Lombarda China	2.33	0.11%	56
Wanjia	13.10	0.65%	37	Lord Abbot China	3.62	0.18%	54
Yimin	6.29	0.31%	48	Morgan Stanley Huaxin	1.81	0.09%	58
Yinhua	54.79	2.70%	10	Penghua ²	50.59	2.49%	14
TOTAL	1,109.0	54.63%		Rongtong ²	39.75	1.96%	18
				SYWG BNP Paribas	11.06	0.54%	39
				UBS SDIC	25.39	1.25%	29
				Zhonghai ⁴	15.91	0.78%	33
				TOTAL	921.1	45.37%	

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.

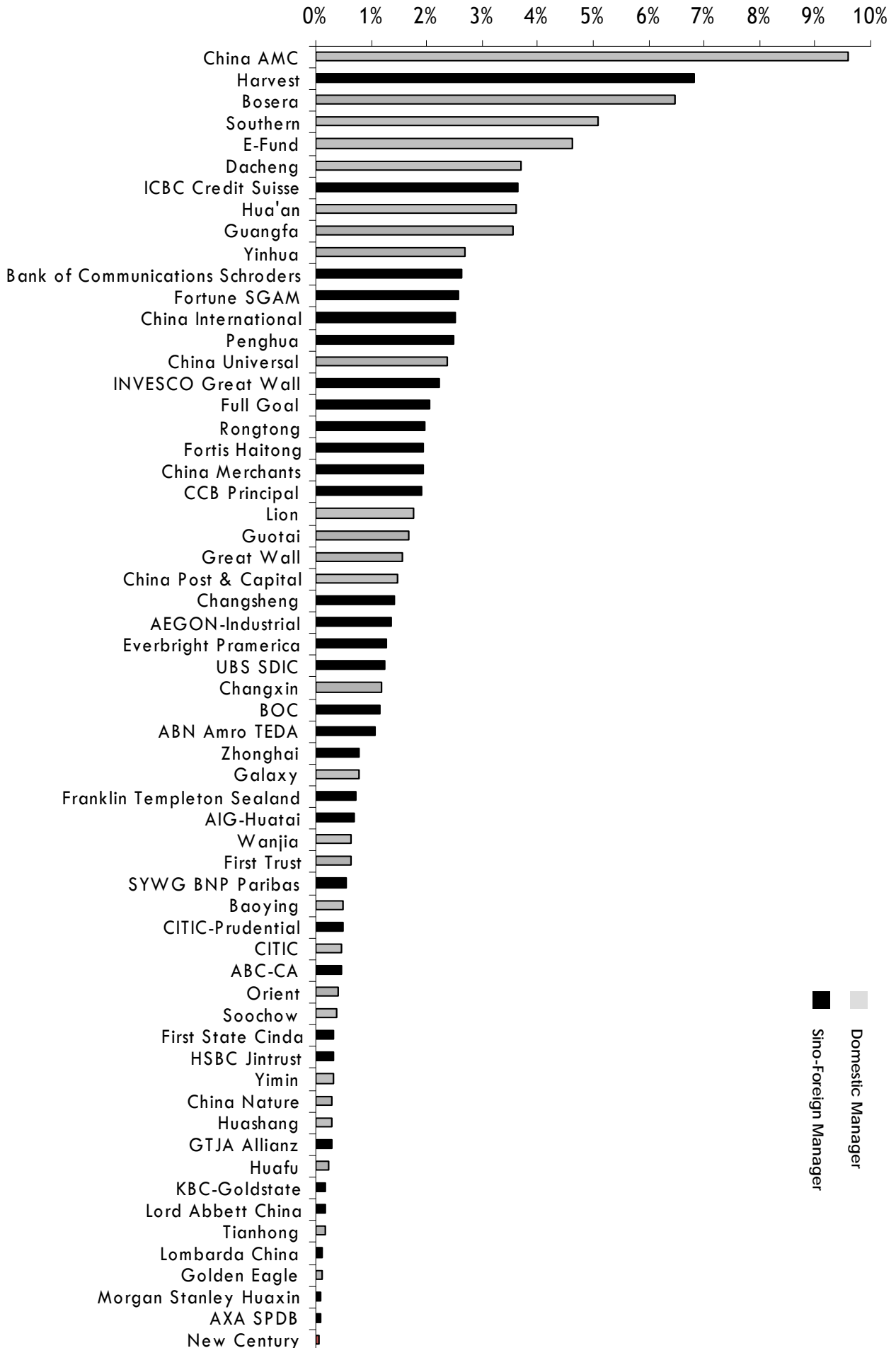
2 - BANK OF MONTREAL BOUGHT AN EQUITY INTEREST IN FULL GOAL THAT CURRENTLY STANDS AT 27.775%; DEUTSCHE ASSET MANAGEMENT PURCHASED 30.0% EQUITY INTEREST IN HARVEST. DBS ASSET MANAGEMENT ACQUIRED A 33% STAKE IN CHANGSHENG WITH NIKKO ASSET MANAGEMENT BUYING A 40% POSITION IN RONGTONG. EURIZON FINANCIAL 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: February 28, 2009 (Estimates)



SOURCE: Z-BEN ADVISORS