

Industry Review & Analysis

The global credit crises has ravaged every single stock market. Next up: collateral damage to the real economy. China will not go unscathed, but don't expect a major reduction in economic activity.

Q3 AUM dropped to an estimated Rmb1.7tr

Fund managers ended up stumbling across the finish line in Q3 as initial estimates for industry assets under management (AUM) again declined by double digits, falling from Rmb2.1tr to Rmb1.7tr. Not all that surprising a result given market conditions: it could easily have been worse. The outlook for the remainder of the year isn't pretty. There are few positive influences in view and fund managers are now hoping that some hard bottom can be reached in the equities market.

Redemptions are still expected to be slight for the period

However, it is important to remember that global events are overshadowing just about everything else. In our view, little collateral damage is being done to the Chinese economy. Market commentators are now suggesting that the jig is finally up for China. The virtuous cycle, so their argument goes, has turned vicious. No longer will American consumers be ferocious buyers of

this time any different? Perhaps, but as frequent readers of Z-Ben Advisors' reports are well aware, we think it is dangerous to bet against China. The government's policy quiver is chock full of stimulative arrows, the first - and, arguably, least significant - of which have already been loosed. However, before exploring what can be done to keep China's economy and markets ticking over, it would be best to begin by assessing the current size and state of China's fund industry - the market participants whose health is our prime concern.

The AUM Give Back

When assessing the fund industry's Q2 results earlier this year, Z-Ben Advisors noted that the industry had witnessed a sharp contraction in AUM. We also noted at the time that this could be viewed as simply a give-back of 2007's

Industry Assets Under Management (RMB Billions)

	Current ¹	Share	2Q08	Share	1Q08	Share	4Q07	Share
Total Industry Assets	1,741.6	100.0%	2,086.7	100.0%	2,612.7	100.0%	3,272.2	100.0%
Quarterly Δ	-16.5%		-20.1%		-20.2%		5.2%	
Total Domestic	985.4	56.6%	1,190.4	57.0%	1,553.1	59.4%	1,951.3	59.6%
Total Joint Venture	486.8	28.0%	575.3	27.6%	678.164	26.0%	838.5	25.6%
Total Foreign Invested	269.4	15.5%	321.0	15.4%	381.405	14.6%	482.4	14.7%

SOURCE: Z-BEN ADVISORS. Footnote 1—Estimate as of September 30, 2008

Chinese products, rerouting foreign currency to the People's Bank of China. In turn, these funds will no longer be redirected back to the States and invested into treasury and agency securities. In their view, the unwinding of the Chinese export boom means time is running out for the Chinese economy.

Today's the focus is on how China's economy will be impacted by the global credit crises

Such predictions have been made before and they will most certainly be made again. However, a bit of perspective in assessing the near term outlook - recognizing that Z-Ben Advisors is by no means an expert in the dismal science - can go a long way, especially a perspective that takes account China's recent economic history. Claims of China's economic death are nothing new and, as events have proven, have exaggerated the economy's problems time and again. Is

gains. In our view, current events are little more than a continuation of that trend. The industry contracted yet again in Q3 although it is not yet clear to what degree. Z-Ben Advisors' in-house estimates have AUM for the period declining by around 16.5%.

The simple reason Z-Ben Advisors can be so certain about a third consecutive quarterly drop in industry AUM comes from the performance of the domestic equities market (down 20% for the three month period ending September). So too did assets remain highly concentrated - well over two thirds of total AUM - in equity oriented mutual funds.

On the bright side, it once again appears that investors decided not to sell out. Redemption

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China has been here before:

1998: Asian Financial Crises

2003: SARS

rates are expected to be moderate at worst with the quarter possibly registering net new inflows due to newly issued products.

This is perhaps of little solace to the hordes of retail investors who drove into funds last year. Even the best performing mutual fund year-to-date (once again the China AMC Large Cap Enhanced Fund) is down 34%. Impressive, compared to the 58% drubbing suffered by the CSI 300 Index, but down enough for investors to feel the sting.

Z-Ben Advisors had been expecting the clouds to part at some point in the second half or, at worst, a bottom in the equities market to be found. That view now looks to have been too optimistic. As elsewhere, equity prices in China have continued to slide since the week long National Day holiday. An additional 15% has been knocked off the CSI 300 Index, taking industry AUM down in the process.

Some Perspective

Surreal seems to be the most common description of the ongoing global financial crises. Certainly many of our fundamental beliefs about markets in action are being tested. Events are also playing out so quickly that we go from bad to worse in a single news cycle: global equity prices in developed markets declined by more than 20% after the American government finally passed a USD700bn financial rescue package, despite a globally coordinated reduction in interest rates, including China's.

Markets will find a bottom. That may be a glib comment to make in light of the pain suffered by investors but it may well be the case that the faster share prices decline, the faster that bottom can be reached. In our view, better a quick sell off than a thousand small cuts. What is key from our specialist perspective is how the global credit crisis might end up impacting the Chinese economy and its mutual fund industry in particular.

The consensus now projects that GDP growth in China will slow. Slow, yes. Crater and implode? We doubt it. We expect there to be many more pundits claiming an end to the Chinese economic juggernaut. Indeed, that case can plausibly be argued. For better or for worse, Z-Ben Advisors' institutional memory has made us all but immune to that kind of argument: we've heard it too many times over the past decade.

Of course, this time is supposedly different. But is it really? A key difference, often overlooked in these judgments, is that, for once, China's problems aren't local. This is not to say China won't be impacted. It most certainly will, but the risks, in our view, are indirect and imported. Imported, in China, usually means containable.

Again, there is the need for some perspective. Just over a decade ago China was faced with considerable risk when the '97-98 Asian Financial Crisis tore a hole in the regional economic "miracle". Much like today, calls were made that the fallout would directly impact China and that the country's export machine would be humbled in the process. Under the assumption that the local economy was highly dependent on exports to support economic growth, some pundits went so far as to project a devaluation in the Renminbi down to 10 to the dollar. Both the assumption and the prediction proved incorrect. In fact the opposite took place: GDP growth held steady throughout the year-long economic contagion before moving higher in the middle of the next decade. And the Renminbi? By 2005 policy makers in Beijing made the decision to scrap the de facto peg to the US dollar. Since then the local currency has appreciated by +20%. (Attentive readers will by now have noted that many of that period's most fervent doomsayers are back in the headlines today...)

Then there was SARS in 2003; in Z-Ben Advisors' opinion, the event that posed the most serious threat to China's exporters. Here was an unknown plague ravaging all of China which, at one point, appeared to become a global epidemic. Equities markets throughout the region sold off with Hong Kong taking the brunt of the punishment. Once again, pundits insisted that China's economic growth would be derailed. Once again, these calls were proven wrong. In fact, the annual rate of GDP growth expanded each year following SARS.

Today's events are eliciting a similar brand of negativity from the commentariat. Enormous wealth has been wiped out in recent weeks and it remains uncertain when investors (especially those in the credit markets) will regain much-needed confidence. The impact on global economic growth will be real and we are happy to yield to expert views on the fate of developed markets. However Z-Ben Advisors disagrees with those expecting a downturn in China on that downturn's likely extent. Slower economic

The death of China's economic miracle has been errantly called before

Economic growth will slow, but not implode

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growth for the mainland is all but certain. That decline should, however, be manageable.

To make that statement, in our view, is not to dismiss those factors which will act to slow China's GDP growth. Exports are a key factor in China's GDP growth and certainly one of its most visible and discussed components. Now China's two largest markets, the United States and European Union, are expected to contract (potentially deeply and for years) which, without doubt, should adversely affect China's rate of economic growth. Continued appreciation in the Renminbi (at least against the USD and EUR) - a second factor in most commentators' forecasts - should further depress margins for China's exporters. Z-Ben Advisors acknowledges the impact of both of those factors and agrees that domestic GDP growth will slow. However, we are not persuaded that these factors will combine to produce a catastrophic pullback in GDP growth. In our view, a much more likely scenario is a return to the longer-term rate of growth.

Perhaps this belief stems, from our refusal to see China's recent GDP growth as "normal". Z-Ben Advisors views the 11% to 12% rate of growth recorded over the past several years as an anomaly. Over the past decade, economic growth of 8-9% a year has been more normal in China. Dropping back to this level will certainly cause pain for a great many. However, we might say all of the following about such a drop in GDP growth: it's what China's government has long been working to produce, through restrictive monetary policies and non-regulatory means; it's far closer to the growth rate that has been achieved by non-exporting sectors of the Chinese economy; and it's a much smaller and easily endured drop than that likely to be sustained by the majority of developed nations.

It may also be worth recalling the Law of Large Numbers here. China ended 2007 with total economic output totaling approximately USD3.5tr. At that size, 12% growth is simply unsustainable and leads to an increasing number of economic stresses, as was seen earlier this year when the specter of inflation took the spotlight. Z-Ben Advisors believes that Chinese policy makers would probably welcome a moderation in the rate of growth so long as the process of getting from point A to B wasn't overly disruptive.

As we frequently point out, we're not econo-

mists. However, we do feel able to point out assumptions widely held by economists who comment on China that aren't shared by either the Chinese government or the Chinese market participants to whose thoughts we are privy.

Chief among these, in our view, is the notion that a pullback in GDP is a bad thing for China. If we assume, for a moment, that the economic downturns we listed above are capable of reducing China's GDP growth from 12% pa to 8%, we find it difficult to imagine who, within the Chinese government would consider that a wholly bad thing: much of the legislation, new central bank guidance and moral suasion we have seen brought to bear over the past two years has been aimed at bringing about that exact result. In fact, such a call would come when many measures of monetary tightening - central bank rates and reserve requirements particularly - are, by Chinese standards, at very high levels. In fact, in contrast to most developed markets' central banks, China's has taken only slight and incremental steps to loosed monetary controls. This, in our view, is a sign that PBoC has not dismissed expansionary/inflationary risks as fully as developed market peers.

Secondly, China is currently implementing new market regulations that will, inevitably, increase volatility. These include the introduction of short-selling and margin trading, along with new guidance on the disposal of former G-shares. These changes are not only another visible contrast to the volatility-damping regulatory changes in evidence in developed markets, but are also, in our view, a sign that neither China's government, nor the market participants who have lobbied for such changes, believe that changing domestic conditions are likely to add to the equity market's woes.

There is, in our view, a widening disconnect between foreign expectations for China's growth trajectory and those entertained at home. We cannot advise readers who is, at this point, more likely to be proven right, although our own bias is domestic. Our readers know that domestic expectations are the ones which will be informing the strategies, tactics and operational decisions of domestic mutual fund owners in coming months. That perspective is, for now, much less pessimistic that the typical Western pundit's, and is also the one that will determine both the market's near-term level and mutual fund companies' aggression.

Pundits now argue that exports will be severely curtailed

Z-Ben Advisors looks for a return to the long term growth rate (8% to 9%)

Increasing disconnect between Western/ Chinese expectations

Analytical Quick Hits

QFII License Approval at a Peak

In August, there were six foreign investment institutions approved for QFII licenses. They were ACE INA International Holdings Ltd, Caisse de dépôt et placement du Québec, President and Fellows of Harvard College, Samsung Investment Trust Management Co., Ltd, AllianceBernstein Limited, and Oversea-Chinese Banking Corporation Limited. This is the most QFII licenses that CSRC has granted in one month since September 2004. At the end of August 2008, CSRC has approved 65 institutions' QFII applications in total.

Hua'an's QDII Fund Hit by Lehman

Hua An International Balanced Fund may suffer losses due to the bankruptcy of its business partner Lehman Brothers. The fund has suspended redemptions. Hua An Fund Management announced it would assume responsibility for payment of principal on the QDII fund that had been guaranteed by Lehman Brothers. The investment bank's failure will make domestic fund managers more cautious when looking for foreign business partner.

F&C and Hua Xia Bank Plan JV

U.K. based F&C Asset Management, which manages GBP96.5bn, disclosed that it is planning a joint fund management company with Hua Xia Bank. This means another Chinese commercial bank intends to enter into the fund industry. Detailed information for the potential JV fund house wasn't provided.

Huijin Increased Bank Stakes

To shore up investors' confidence and stabilize share prices, Central Huijin bought about RMB250m shares of three major state-owned commercial banks on the secondary market. The banks included Industrial and Commercial Bank of China, the Bank of China and China Construction Bank. Huijin will continue to increase its stake in the three banks on the secondary market over the next twelve months.

Bosera Cooperates with Fullerton

Singapore-based Fullerton Fund Management and China's Bosera Asset Management have formed an investment partnership to work jointly under the QDII and QFII schemes. Bosera plans to launch a conventional QDII fund which will mainly invest in Asia-Pacific market. Fullerton which has more than 18 years of investment experience in managing Asian investments will be its consultant.

Central Huijin Reforms Its Securities Firms

Central Huijin will reform the firms under its subsidiary Jianyin Investment. The firms include China Jianyin Investment Securities, Hongyuan Securities, China Securities, Southwest Securities, UBS Securities, Qilu Securities, and China International Capital Co. The primary plan is that Jianyin Investment will keep controlling Hongyuan Securities and hold stake in China Securities. The other four securities firms and CICC will be transferred to Central Huijin.

More Closed-end Funds Conversion

CSRC has approved E-fund Kehui Fund to convert into open-ended status. E-fund Kexiang Fund and Full Goal Handing Fund will be also converted into open-end funds this year. After the three funds' conversion, there will be 28 closed-end funds.

NCSSF Invests into CDB

China's National Social Security Fund will invest into the China Development Bank, NCSSF chairman Dai Xianglong said. Mr. Dai didn't disclose the investment amount. The CDB is undergoing a shareholding transformation to turn itself into a commercial bank. Its current shareholders are Ministry of Finance and Central Huijin. NCSSF will directly purchase shareholding from Central Huijin as it did when investing into BOC and ICBC.

Analytical Quick Hits

New Accounting for Suspended Stocks

China's fund management companies adopted new methods promulgated by CSRC to value suspended stocks from September 16. The move was aimed to prevent abnormal high prices for suspended stocks which resumed trading amid a market slump. Many equity funds' NAV was reduced after the adjustment and the fund ranking also changed. Soochow Value & Growth Fund's NAV fell most: down by 12.59%.

QDII Funds Suffered Heavy Losses

Struck by the U.S. subprime loan crisis and economic slowdown, QDII products were suffering heavy losses. The most serious case was China International's QDII fund, whose NAV fell to RMB0.52. The total losses made by the earliest four fund company-backed QDIIs amounted to RMB70bn. Meanwhile, 95% of bank QDII products had negative returns as well.

Insurance Protection Agency Set Up

CIRC has set up a nonprofit State-owned corporation to manage its insurance protection fund, amounting to at least RMB7bn. The entire assets of the insurance protection fund, including its 38.8% stake in New China Life Insurance, will be transferred to the newly established company. CIRC also broadened the range of products the protection fund can invest in.

26th QDII License Awarded

Franklin Templeton Sealand Fund Management was granted a QDII license by CSRC. It is the 26th fund manager possessing QDII qualification.

Morgan Stanley Cuts JV Stake

Morgan Stanley sold 6% stake in Morgan Stanley Huaxin Fund Management to Huaxin Securities. Thus, its shareholding was decreased from 40% to 34%, and Huaxin Securities became the largest shareholder with 36% stake. The shareholding transfer has been approved by the regulator.

First Innovative Closed-end Bond Fund

Full Goal Tianfeng Optimized Bond Fund was approved to launch. Different from a conventional bond fund or closed-end fund, it is a closed-end bond fund. The close period will be three years. After three years, the fund will be converted to a listed open-end fund. Currently, there are 31 conventional closed-end equity fund and six innovative closed-end equity fund. Full Goal Tianfeng will be the first innovative closed-end bond fund.

INDUSTRY AUM & MARKET SHARE

SEPTEMBER 30, 2008: ESTIMATES

DOMESTIC FUND MANAGERS

	AUM		
	RMB Bill	Share	RANK
Baoying	10.1	0.58%	38
Bosera	111.5	6.40%	2
Changxin	17.8	1.02%	32
China AMC	172.4	9.90%	1
China Nature	4.1	0.23%	52
China Post & Capital	28.3	1.63%	23
China Universal	38.9	2.23%	17
CITIC	9.0	0.52%	40
Dacheng	64.9	3.73%	6
E-Fund	88.6	5.09%	5
First Trust	12.4	0.71%	36
Galaxy	11.7	0.67%	37
Golden Eagle	1.6	0.09%	58
Great Wall	31.7	1.82%	20
Guangfa	64.6	3.71%	7
Guotai	26.0	1.49%	26
Hua'an	60.3	3.46%	8
Huafu	4.1	0.23%	53
Huashang	5.9	0.34%	48
Lion	35.1	2.02%	19
New Century	1.2	0.07%	59
Orient	6.1	0.35%	47
Soochow	7.0	0.40%	43
Southern	97.7	5.61%	4
Tianhong	3.8	0.22%	55
Wanjia	8.0	0.46%	42
Yimin	6.5	0.37%	46
Yinhua	40.4	2.32%	14
Zhonghai	15.8	0.91%	33
TOTAL	985.4	56.58%	

JV FUND MANAGERS

	AUM		
	RMB Bill	Share	RANK
ABC-CA ⁴	6.8	0.39%	44
ABN Amro TEDA ⁵	19.0	1.09%	31
AIG-Huatai	15.6	0.90%	34
AXA SPDB ⁴	1.1	0.06%	60
Bank of Communications Schroders	39.0	2.24%	15
BOC ¹	19.4	1.11%	30
CCB Principal	26.6	1.53%	25
China International ¹	56.3	3.23%	9
China Merchants ¹	29.9	1.72%	21
CITIC-Prudential	8.6	0.49%	41
Everbright Pramerica	25.0	1.44%	27
First State Cinda	6.6	0.38%	45
Fortis Haitong	28.5	1.64%	22
Fortune SGAM	44.8	2.57%	11
Franklin Templeton Sealand	14.9	0.85%	35
GTJA Allianz	5.3	0.30%	49
HSBC Jintrust	5.0	0.28%	50
ICBC Credit Suisse	43.5	2.50%	12
INVESCO Great Wall	47.1	2.70%	10
KBC-Goldstate	4.3	0.25%	51
Lombarda China	2.3	0.13%	56
Lord Abbett China	3.8	0.22%	54
Morgan Stanley Huaxin ³	1.8	0.10%	57
SYWG BNP Paribas	10.1	0.58%	39
UBS SDIC	21.6	1.24%	28
TOTAL	486.8	27.95%	

FOREIGN INVESTED MANAGERS ²

	AUM		
	RMB Bill	Share	RANK
AEGON-Industrial	26.9	1.55%	24
Changsheng	21.2	1.22%	29
Full Goal	40.7	2.34%	13
Harvest	103.3	5.93%	3
Penghua	38.9	2.23%	16
Rongtong	38.4	2.20%	18
TOTAL	269.4	15.47%	

SOURCE: Company Data, Z-BEN ADVISORS

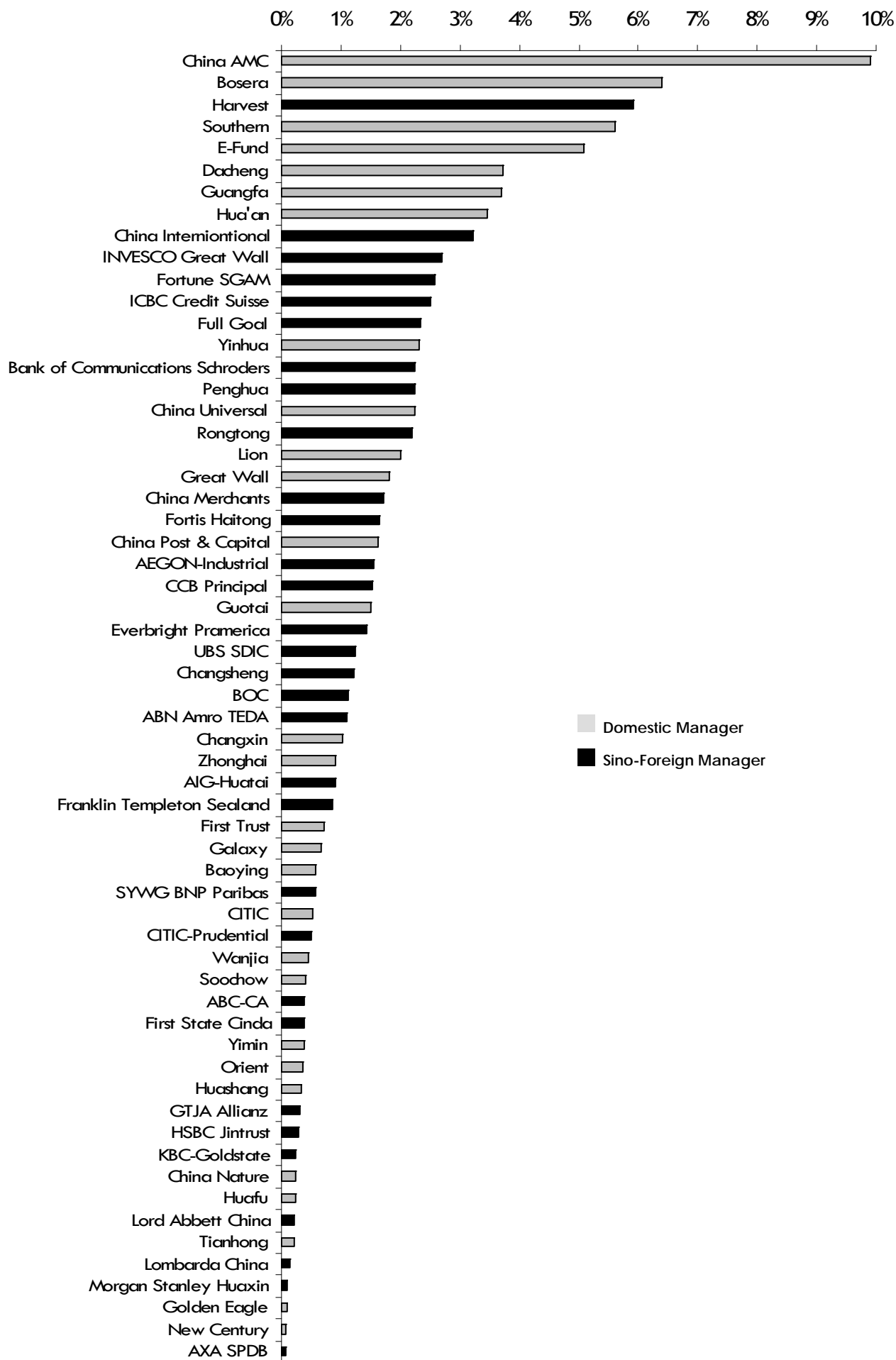
¹ - ING INVESTMENT MANAGEMENT OWNS A 33.3% EQUITY INTEREST IN CHINA MERCHANTS; JP MORGAN FLEMING ASSET MANAGEMENT OWNS A 49% EQUITY INTEREST IN CHINA INTERNATIONAL; MERRILL LYNCH OWNS A 16.5% EQUITY INTEREST IN BOC; COLONIAL FIRST STATE GROUP OWNS 46% IN FIRST STATE CINDA.

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 - AXA-SPDB AND ABC-CREDIT AGRICOLE BOTH RECENTLY FINISHED RAISING ASSETS FOR THEIR RESPECTIVE MAIDEN PRODUCTS.

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: Sept 30, 2008 (Estimate)

SOURCE: Z-BEN ADVISORS