

Lawyers, Guns & Money: Nine Industry Predictions for 2009

The crystal ball may be a bit hazy, still the outlook for the coming year isn't all that bright. Even a rebound in equities could be a Catch 22 for fund managers. Fasten those seatbelts, it's about to get really bumpy.

2009 looks to be yet another challenging year for fund managers

Z-Ben Advisors would like to forecast a pleasant year ahead. We'd like to be a soothing voice, proudly – even smugly – anticipating the Chinese mutual funds industry's smooth and predictable progress, highlighting only unexpectedly good successes and happy endings. For the upcoming year, here's the best we can do: 2009 won't be as bad as 2008. AUM losses, while expected to continue, won't be on the order of 2008's 40%+ drop. Profitability, for at least a third of China's fund managers, should continue. A wide array of new products will be launched and failure to reach the magic Rmb200m minimum for a new product nonexistent.

Nothing will take away from the industry's long term trend

That's - as ugly as it is - the good news. Below is a list of mostly bad news, with a small sprinkling of opportunities that may, in Z-Ben Advisors' view, brighten the outlook for a subset of fund companies able to exploit them. It is a truism in fund management that the best firms outperform when everyone else is going backwards. We expect the best firms to be very easy to identify in 2009.

No matter how challenging 2009 may end up being, Z-Ben Advisors see little which will take away from the Chinese investment management industry's long term prospects. Volatility and uncertainty are the hallmarks of a developing marketplace. With that in mind, Z-Ben Advisors is advising all interested parties to keep at the ready their stiff upper lips. Everyone will be needing it.

Competition: Pressure with Fewer Lifelines

That the number of operational fund management companies in China will increase next year is not in doubt: three bank-led JV firms have already announced their planned debuts and a similar number of greenfield JVs could follow them. Their arrival will add to the competitive difficulties of smaller firms, who will face further struggles to attract assets from investors willing to give a lower-AUM firm's offerings a chance.

There will be a number of new (JV) fund managers approved

Perhaps a more serious destabilizing force affecting the middle and top tiers of the funds industry will be insurance asset management companies. In 2009, the number of insurance AMCs is unlikely to grow much past its current membership of nine. However, these companies

Profit margins will be severely squeezed

are likely to claw back some investments now held in funds to redeploy them in both directly-owned stock portfolios and other asset classes, such as trusts and property. This in turn will mean that fund managers, in Z-Ben Advisors' view, will need to adjust for a lessening in fund flows from insurers. We believe insurance AMCs are likely to devote a much smaller proportion of 2009's AUM to managed funds, preferring instead to seed their own portfolios and take advantage of the wider set of assets current law permits them to own.

Profitability: Slim Just Left Town

Fee income is being hit hard and the blows are coming fast and furious and from all directions. Industry AUM continues to decline and, within public mutual funds, retail and institutional investors alike are shifting assets from high fee-paying asset classes such as equities to lower (in some cases, much lower) fee-paying classes such as money market product alternatives. Segregated account customers are pressing for much lower fees from managers, often backing their demands with threats to jump to another manager. The pressure is also taking place at a time when market conditions make performance fees all but impossible for managers.

Fee income also looks as though it is deteriorating faster than cost containment. Stubbornly high HR costs, requirements for better IT and compliance systems, increasingly expensive fund launches and inadequate overall cost controls are inflicting as much pain to profitability as falling fee revenues. For all but the largest and strongest fund houses, 2009 could be a second consecutive year of falling profitability, if not outright losses.

QFII: More Players, Rules, and Money

The Qualified Foreign Institutional Investor (QFII) program continues to prove itself a reliable mechanism for equity demand stimulation and Z-Ben Advisors expects CSRC to, at a minimum, continue the steady flow of new approvals. With each new QFII investor receiving an average USD150m from the State Administration of Foreign Exchange (SAFE), a further USD3bn or more of fresh foreign funds could be injected into the domestic market by end-09.

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However, upheavals among existing QFII owners – changes of ownership, bankruptcies and government bailouts – are complicating the regulatory community's game plan. We expect more administrative measures to be promulgated in 2009, detailing what steps financially-troubled QFII owners must take if disaster does in fact strike. The current trend of favoring applicants who have long-term, buy and hold financial plans shows no sign of abating: look for more A-share funds to be launched on the back of QFII approvals in 2009, especially if the Chinese market begins to show more signs of life.

This is a greater risk of retail investors finally deciding to redeem

Retail Erosion: Like Acid on Limestone

For more than a year, Z-Ben Advisors has been commenting on Chinese investors' remarkable willingness to hold loss-making funds. It can't last. The primary reason for refusing to redeem is intrinsically irrational: selling acknowledges the loss. Given enough time, real-world needs such as rent and bill payments – even, dare we say it, other investment opportunities – will trump the irrational spirit, and investors will begin to sell. For 2009, Z-Ben Advisors predicts gently climbing redemption rates – even among funds trading below Rmb1 – with the worst performers in the 3-month and 6-month periods likely to be among the hardest hit. At a guess – hard numbers won't emerge until May's annual reports – most funds lost 5-10% of their retail investment base in 2008. We expect that rate of loss to increase, on average, to 10-15%+ in 2009, absent a market turnaround, with many, particularly smaller and newer firms, losing in excess of 30% of their retail clients.

QDII may be a bright spot although demand could be nonexistent

Fixed Income: A Safe(ish) Harbor

Z-Ben Advisors expects the share of total industry AUM taken up by bond and money market funds to increase by 50-100% in 2009 – from their current 16% of total AUM to 24-32% – with the gains coming exclusively at equity funds' expense (index funds may be the only equity segment to hold, if not gain, market share). Continued erosion in equity fund values is one contributor to this market share reallocation but, in Z-Ben Advisors' view, the homes that long-term investors are seeking for their money are contributing every bit as much to the realignment. Most of the new money being introduced to the domestic fund market isn't pri-

Banks will continue to have a strangle hold over end distribution

marily speculative in character – a marked change from 2007. Currently, these investors are looking for capital preservation above all else; a quality that is all but absent from funds in the equity space. The good news? These new investors will likely increase their equity exposure once a market bottom is in evidence, unlike the vast swathe of equity investors who are simply waiting for a well-priced chance to abandon fund investments entirely.

QDII: More Choices, Less Clarity

A raft of mutual funds under the Qualified Domestic Institutional Investor (QDII) program are likely to hit the market in 2009, regardless of market conditions. For the 17 companies which have received QDII approvals but not yet launched funds, "Use it or lose it" is likely to be the message heard. The latter "it," in this case, should also be understood to include the phrase "and our future favor." For bank-led QDII products, the absence of an obvious customer base has not deterred their desire to sell (regulatory obstacles aside), thanks to some astonishingly high trail rates paid by foreign fund manufacturers. For such managers, the marginal costs of attempting to have their products sold in China is essentially zero: paying a generous trail, at least in the early years, is better than no access at all. However, the result is an ever-growing hodgepodge of complex, specialized, poorly-marketed funds being marketed to Chinese HNW customers; customers who may not necessarily understand what they're buying. The risk of banks souring buyers on QDII products by failing to explain them properly will need to be addressed in short order.

Bank Distribution: Your Money Or Your Life

Every bank has customers; major fund distributing banks in China have hostages. To a very great extent, smaller fund houses' willingness to take on short-term institutional assets (in return for fee concessions elsewhere) when launching funds – one of many bad asset-raising habits formed in 2008 although perhaps nothing more than a legacy issue – is a consequence of banks' overstuffed distribution channels. Clogged channels, coupled with investors' widespread lack of interest in funds as investing vehicles, meant that those fund houses too small to insist on bank attention were all but cut off from retail

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Insurers could offer a distribution alternative to the banking channel

Institutional clients will assume even greater power of fund managers

Strategies to seed for the future:

- Fund marketing
- Customer service
- Product construction
- Better communication

2009 AUM Projections
Base Case = Rmb1.4tn
Best Case = Rmb1.7tn
Worst Case = Rmb0.9tn

investors in 2008.

Very little has changed. Major distributing banks, in Z-Ben Advisors' view, understand that they face no real competition for retail access and are pricing their efforts accordingly. Smaller and mid-sized fund management houses can expect to pay extortionate costs for bank attention in 2009 – even for hot products (should any emerge) and even when distribution channels are relatively uncluttered by other products. We expect greater interest in, and exploitation of, alternative distribution channels such as IFAs and DEDT in 2009. Recent reports have even surfaced suggesting that some managers are pressing for funds to be distributed by insurance companies. However alluring this may be, it remains that there is currently no alternative to the bank's dominate position. In turn this will mean no meaningful competitive impact on the fees banks will ask – and get.

Asset Retention: New Competitive Locus

In the absence of meaningful volumes of new investment, every fund manager's attention will be focused on client retention in 2009. For institutional clients, that means fee discussions are likely to be more frequent – and more painful – even than in 2008. Within that space, Z-Ben Advisors expects to see many more investors transferring their assets out of public funds and into segregated accounts. As an alternative, segregated accounts are designed to allow managers to extract higher fees in return for more precise investment targeting and better-quality reporting. However, Z-Ben Advisors expects investors, in this instance, to require all of those service improvements for lower fees than those paid in public funds.

More interesting, perhaps, will be competition to retain retail assets. Clearly, there is now some evidence that a greater proportion of retail funds investment is non-speculative than ever before: DEDT's success at the retail level, among other signs, makes this point. Turning the broader fund-buying public into long-term, non-speculative, goal-oriented investors will require, at a minimum, better fund marketing, better customer service, better fund construction and better communications between all participants and the public. Z-Ben Advisors can't honestly say we expect real progress on this wish list to be made in 2009. However, we expect many parts

of it to be attempted and the initial results to be of critical importance to the industry.

AUM in 2009: Expect Less

Z-Ben Advisors' base forecast for end-09 industry AUM is Rmb1.4tr – approximately 16% down from current levels – and, in our view, a volume of assets which represent both risk and opportunity in equipoise. On the minus side of the equation, we expect another 5-10% of retail assets to evaporate, mild clawbacks of institutional (primarily insurance) assets and fundraising to remain in its current trough. On the plus, we suspect that domestic equity markets may deliver a stronger 2009 than widely believed if GDP and core earnings growth beat current expectations; better linkages between fund managers and pension funds (private or, experimentally, public) may be established; and global allocations to Chinese domestic equities continue to rise. While many manager would take that outcome, if offered, right now, we would point out that AUM of Rmb1.4tr is below our estimate of the industry's profitability breakeven level.

Our best-case forecast assumes a marked rise in domestic equity indices – up perhaps 10% or more heading towards the second half of 2009 – and retail investors showing a willingness to remain in funds that is, at the moment, in doubt. It also assumes some renaissance in fundraising, along with higher levels of support from institutional investors than the base case. The outcome of these events; end-09 industry AUM of Rmb1.7tr. However, the upside of a market bounce, no matter if strong and sustained, to industry AUM is constrained, in our view, by the possibility of massive churning, in Z-Ben Advisors' view, of fund units that regain a par (Rmb1) price. Many of those sellers won't be coming back to funds investment for a long, long time.

Our worst-case forecast assumes a much higher rate of retail divestment, deep clawbacks from institutions, continuing poor market performance and fundraising all but impossible outside a narrow range of funds. Should the industry's luck turn that sour, we forecast end-09 AUM of Rmb0.9tr (and, in our view, insufficient assets with which to turn a profit for more than 50% of the industry's managers.) Try as we might, even the rosier of outlooks is still dim.