

Z-BEN ADVISORS

China Investment Management: Market Update

April 2010

Roll Up Your Sleeves

Don't be lulled asleep

Ignore the objects in the rear-view mirror. We see the same things you do: a flat stock market, slumping fundraising results and more than a few nay-sayers calling for China's imminent economic collapse. This is not an environment that rewards hesitation and anxiety. Foreign firms with a China strategy are advised to doubledown their efforts in the region and prepare to take aggressive steps to ensure short-term growth. Here, market regime change happens fast. While a long-term conservative bet that China will grow is still the right call, firms need to be thinking about charging ahead more aggressively in the present. Whether you have an established China platform or are planning to set one up, now is the time to go full throttle ahead and lay a foundation for fast-paced growth. Groups which question their China commitment and attempt to use short-term market trends as a basis for strategy will find likely themselves on the sidelines when the next growth phase begins.

If you want to succeed in China, it is a crucial time to target business opportunities. Whether it is meeting with institutional investors or working with domestic FMCs expanding into Hong Kong, the slower-paced corners are where the winners make their move. It may seem somewhat contradictory to call for aggressiveness when the market itself is anything but. That is the nature of the China beast. A slowly moving market here almost guarantees a break-neck pace on the horizon. Yes, fund flows have slowed down and the current product cycle is waning. The stock market is flat and growth in the funds industry is hard to come by. QDII funds have had underwhelming results thus

Industry Assets Under Management (RMB Billions)

	Current ¹	Growth	4Q09	Growth	3Q09	Growth	2Q09	Growth
Total Industry Assets	2,202.6	-17.7%	2,676.1	19.1%	2,247.7	-2.4%	2,302.8	14.7%
Total Domestic	1,227.8	-17.7%	1,490.9	18.0%	1,263.7	-1.3%	1,280.8	14.4%
Total Joint Venture	974.8	-17.7%	1,185.1	20.4%	984.0	-3.7%	1,021.9	15.1%

SOURCE: Z-BEN ADVISORS, CURRENT AUM IS AN ESTIMATE AS OF MARCH 31, 2010

far in their new launch cycle. At the same time, M&A deals have gone (temporarily) quiet. That will not last. Call it the calm before the storm, now is the time for groups to put even more focus on China and build a footprint that will catch opportunities when they return.

We know the temptation is strong at the moment to pull back. Many rep offices and HK branches will be under pressure from impatient home offices wondering why their China investments aren't meeting expectations. In some cases, there will be requests to redeploy assets or go after other global opportunities in the inbox. But remember, this is always the way the market looks in China right before it takes off. Z-Ben Advisors believes the investment industry is on the verge of another flourish. We are confident a number of big-name M&A deals will be approved in the immediate future. At the same time, domestic FMCs are aggressively expanding abroad, bringing with them a rush of new opportunities for HK-based asset managers. The product cycle looks slow but it only takes a small spark to reignite. If the stock market turns suddenly, which we believe is possible, fund flows will pick up even faster and firms looking backwards will be caught unprepared.

We'd love to know when and how Chinese markets will pick up. We only know they will and that should be enough for now. China is too long-term and too big to ignore. However, it is often the short-term trends that decide the winners and losers. There are any number of events or market

For more information,
please contact:

Derek Wang
Director, Research
derek.wang@z-ben.com

Ms. Peggy Xu
Associate, Sales
peggy.xu@z-ben.com

Z-BEN ADVISORS, LTD
Tongsheng Tower, 5/F
458 Fushan Road
Pudong New Area
Shanghai, China 200122
Email: info@z-ben.com
Phone: 86-21 6876-1650
86-21 6876-1651
Fax: 86-21 6876-1652

trends on the horizon that may spark a sudden turn of sentiment. The lull that always accompanies the annual National People's Conference and government budgeting exercise in Beijing is now behind us. Earnings season is picking up and is one possible driver of a stock market move. As mentioned earlier, high-profile M&A deals are likely to emerge soon, breathing life into the deals landscape in China. NCSSF, an important bellwether for all institutional investors in China, looks to be showing an increased risk appetite, a good sign for Chinese FMCs. And, there are countless more unknowns that could spark a sudden torrent of activity in China that we have little ability to predict.

If we haven't been clear by now, we probably need to hire new writers. As silly as it may sound, this is Z-Ben Advisors' call-to-arms for global players. Senior staffers should plan a China trip as soon as their schedule permits. If there is a China office already established they should be on full alert, combing their contact lists and connections for short-term opportunities. In addition, long-term relationships, particularly the ones that look like they will lead to big deals or inflows down the road, should be reaffirmed now. One thing we have learned is that the firms which show a dedication to China, particularly in the slow periods, are rewarded when the climate changes. Acknowledge that the market has slowed but don't put too much thought into it. More importantly, acknowledge that China is a major part of your firm's global growth strategy and prioritize accordingly.

China's markets can
turn on a dime

Monthly Research Highlights

Dreams that HK Stuff is Made of: FMC Subsidiaries Update

Page 9

When we last reviewed the activities of Chinese FMCs' Hong Kong subsidiaries, what we observed was little more than a (possibly) promising start. Eight months on, the raw numbers haven't changed much – eight subsidiaries established, six licensed and four with products – but the trends have. Two interesting operational models have been established for HK-bound firms to follow (along with one less-than-impressive alternative) and the possibility of acquisition-led growth has leapt in prominence. Expect serious M&A, JV and distribution firepower to be trained on HK in the next year as Chinese FMCs test-drive their first offshore toys.

Rookie Portfolio Managers: Looking for the Young Schumi

Page 12

Promotions of inexperienced rookie PMs have become much more frequent over the last two years. Driven by a deepening shortage of portfolio managers, the mutual fund industry now relies heavily on rookie promotions to substitute for the continued departures of PMs and persistent new product offerings. However, this strategy may cause damage to funds' quality because the some rookie PMs had only limited experience in the securities and investment industry and none in managing portfolios. Our survey of the rookies' first-year performance reveals that the scores are largely decided by the team and the company. The best-performing rookies come from FMCs with strong research and investment abilities. Z-Ben Advisors suggests that FMCs need to improve their CIO posts to secure the success of future rookie PM promotions.

The Name's Bond: The Next Bond Fund Cycle

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The next cycle of (drum roll) bond fund inflows may be coming sooner than you realize. Z-Ben Advisors reviews the first cycle of bond funds, now at least two months behind us, and gives our strategic insights into what fund managers can do to prepare for the upcoming cycle. One key finding is a massive shift in end demand for bond funds, which now boasts almost two-thirds retail participation. While simply launching new bond funds may be attractive for certain FMCs looking to grab AUM, Z-Ben Advisors argues for an alternative approach. As boring as the segment may seem, it is worth your attention purely based upon market share that it commands. Fund managers, in our view, should review their current bond fund offerings and do a better job of positioning their products into investment strategies that can be marketed and sold to retail investors.

Catching Your Second Wind: Take Classified Funds Seriously **Page 18**

With the current market uncertainty and fundraising results low, launching new classified funds is a solid strategic move for fund managers. In addition to the fact that each of these products can offer at least two risk/return profiles for investors, demand is relatively strong and the product category is also underdeveloped vis-à-vis other segments, giving fund houses plenty of room to expand. We outline a compelling demand case for classified funds and, more importantly, strategies fund managers can take to expand aggressively into this relatively young, yet promising, product category.

Foreign Private Equity Funds in China: A Fortress Half-Opened **Page 21**

Chinese regulators issued legislation last year to expand foreign PE institutions' entry into the mainland and more are expected to come. A considerable number of foreign GP managed funds have finished domestic registration, many of which are conducting Rmb fundraising right now. Unfortunately, the Chinese private equity fund industry is like a half-opened fortress for global PE managers. Although entry has become easier, investment remains difficult, because the investment space in China for foreign investors is restricted. Giant and powerful industrial funds with government backgrounds have monopolized PE investment throughout a large part of national economy. Z-Ben Advisors identifies three sets of possible opportunities for the future. And makes three suggestions for global institutions: short-term action, patience and long-term perspective.

In Search of Zhou Schmo: The Changing Face of Distribution **Page 24**

Today's distribution architecture is a vestigial result of 2007's explosion in market performance and is poorly suited to the current environment. Previously, all a fund manager needed to do was land a product on a major bank's distribution sheet and be subsequently rewarded with massive inflows. The results now are much more random, and less enriching. Z-Ben Advisors' in-depth analysis demonstrates that all but the largest fund managers are being forced into situations where they must pay higher and higher fees for increasingly poor access to, at best, marginal investors. Whether fund managers are able to break this stranglehold will depend more on commercial forces than regulatory reforms, which may instead hurt smaller firms. Seizing these opportunities will be critical for survival as the landscape continues to change.

The Rat Pack: The True, Untold Story of China's First Six FMC JVs **Page 27**

The Rat Pack in China's fund industry are the six original greenfield JVs. 2010 marks the seventh year anniversary of their inception into the funds industry and Z-Ben Advisors assesses their performance over that period. These firms are both the six most successful JVs in China and the most disappointing ones. With an early-mover advantage and aggressive initiative, many of these firms saw their market share rise rapidly, only to come crashing back to reality in recent years. Now, most of them are mired in a slow regression as their brand name has taken a considerable battering. We investigate what factors caused this behavior and determine what it means for other JVs.

JV Review: When to Pull Your Starter **Page 30**

JVs which made the decision to allow the domestic shareholder to appoint the general manager are faring well relative to their competitors. A trend we first noticed in 2008, many JVs have removed a foreign-appointed GM and allowed the domestic shareholder to place a mainland Chinese national in the crucial leadership role. To assess the results of this trend, Z-Ben Advisors has analyzed seven firms which made this move between 2007 and 2008. The results teach all JVs an important lesson: giving up some control can often lead to a turnaround for their platform, especially when things aren't going well. We take a closer look at the reasons why domestically-appointed GMs have done better than their foreign-appointed counterparts.

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Ms. Peggy Xu

Marketing Associate

Tel: (86-21) 6876-1119

peggy.xu@z-ben.com

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Z-BEN ADVISORS

Tongsheng Tower, 5/F
458 Fushan Road
Pudong New Area
Shanghai, China 200122

Tel: (86-21) 6876-1650

(86-21) 6876-1651

Fax: (86-21) 6876-1652

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