

Z-BEN ADVISORS

China Investment Management: Market Update

March 2010

Plant and Equipment

January and February experienced a dearth of sales and marketing action in the fund industry, which will likely continue into March, even after the National People's Congress meetings conclude. Managers should take this opportunity to do a bit of spring cleaning and begin the endless process of making incremental improvements to internal operating processes. In Z-Ben Advisors' view, there is considerable room for improvement of these policies on a number of fronts at nearly every JV.

We appreciate how difficult it is to actually affect operational changes in any context, particularly when the counterparties themselves are speaking a foreign language (both literally and figuratively). Now is the time, however, to begin spending whatever political capital the foreign partner has to move forward with operational changes. On a similar note, it is also an ideal period to build more political capital. Learn your vintage *baijiu* brands and invite partners over for dinner. You will likely need more cooperation (and need to work harder to win it) than you think in order to effect change. Above all, remain strategically persistent, and tactically humble, in order to gradually build influence to affect operational changes.

Influence should be used to communicate possible changes in strategy to all members of investment teams, after harmonizing these goals with mainland JV partners. For some, this may mean defining new goals by re-evaluating benchmarks, conducting in-depth competitive analysis, and reassessing the market. For others, it may only be a matter of communicating these goals clearly to other stakeholders. If only it were that simple, as the solutions to these types of problems are rarely obvious. This may be a matter of establishing effective rapport and building trust, or spreading influence

Industry Assets Under Management (RMB Billions)

	Current ¹	Growth	4Q09	Growth	3Q09	Growth	2Q09	Growth
Total Industry Assets	2,200.8	-17.8%	2,676.1	19.1%	2,247.7	-2.4%	2,302.8	14.7%
Total Domestic	1,234.9	-17.2%	1,490.9	18.0%	1,263.7	-1.3%	1,280.8	14.4%
Total Joint Venture	966.0	-18.5%	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 FEBRUARY 28, 2010

and persuading other stakeholders of the importance in a change in overall direction. Persuading the domestic stakeholder to act as the proponent (and enforcer) of change is an especially effective strategy, although one of the most difficult to engineer.

There are important benefits that might be derived from something as simple as adjusting individual fund benchmarks, in order to set a higher bar, and better match PM style. Doing so may have short-term costs but will benefit long-run marketing efforts. Six months from now, a firm that can point to honest and transparent asset allocation will be in a much better position to launch an aggressive product than those firms which continue to communicate internal management practices to their clients in opaque and exclusively qualitative terms.

Such changes should not be attempted at the expense of losing focus on core business. Performance continues to be extremely important, perhaps even more so now that the market rests comfortably in a range-bound middle ground. Delivering above-average performance now will produce important gains when, in several months' time, investors begin re-opening their wallets, ready to shell out for new products. Preparing for that day, however, should not simply mean preparing to push as

Downtime should be used to build influence and redefine strategy

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many products out the door as CSRC allows, and calling up institutional partners to buy up large portions of these new products at launch, only to watch this AUM disappear months later.

Instead, the focus must be on incremental growth and building brand awareness. Short-term strategy shifts can help with progress on these fronts but are no substitute for a consistent approach in delivering sustained long-term growth. Dividend payments, as a fast-shifting strategic example, are abused by many fund managers who blithely assume that payouts will lead to share inflows, regardless of market conditions and perceptions of performance.

Synthesizing these changes, and making them a normal part of firm operation, is a very difficult process and will likely require much more than a few months of downtime. Yet that is all most FMC management teams now have to work with. Firms should move to have honest discussions about weaknesses and be ready to take responsibility for past problems. Many funds, for example, were slow to capitalize on 2009's rebound. This may have been a problem of misdiagnosis, though for some firms, it surely was a problem of lack of communication from the investing frontline to top management, who may have been reluctant to allow managers to move aggressively into equities.

Being the last firm to catch onto a trend – in any business – will diminish possible gains. At the risk of playing to clichés, investing in China requires an appreciation and understanding of subtle shifts in market conditions. PMs have access to this tacit knowledge, though they may be hesitant about taking considerable risk for limited upside, if losses are punished much more severely than gains are rewarded. Communication between management, portfolio managers, and analysts may then mean reorganizing firm structure in order to better transmit this type of data rapidly.

Remove communication barriers so that data can flow rapidly

Monthly Research Highlights

China 2020: The Shape of Things to Come

Page 9

At Z-Ben Advisors, the difficult is our daily bread but the impossible sometimes takes a little longer. While fully acknowledging the fact that few things are certain and fewer are stable in China's financial markets, we have labored to forecast the shape, size, and structure of China's fund management industry in 2020. We provide our baseline projections for China's asset management industry, along with an overview of where we see major opportunities for global asset managers in China over the next ten years.

CIC's US Disclosures: Reading Between the Lines

Page 12

CIC recently disclosed USD9.6bn of American holdings in its first-ever 13-F filing for the US Securities and Exchange Commission. In Z-Ben Advisors' view, however, this is but a small sampling of CIC's total US holdings, and is likely the least aggressive portion. Through a combination of other tools, primarily special purpose vehicles and investment mandates, CIC has made numerous strategic, long-term bets in American securities, which are less apparent than publicly available information suggests. We give our analysis on the results of CIC's first-ever US filing and help fund managers to prepare for new RFI/RFPs as they present themselves.

Private Managers at Large: Charting the Star Map

Page 15

Private fund managers in China utilize a greater variety of styles than many observers have previously thought. This, along with a wide divergence in management skill, has resulted in huge differences between short-term and long-term performance rankings. Industry leaders for two-year returns, in particular, have seen triumphs from distinctive style choices, such as absolute return or alpha strategies. Recognition of these features will enable investors to select private funds whose styles work for the investment targets and outlook. Z-Ben Advisors segments a large sample of private funds and provides the first ever detailed analysis into the strategies that are working and failing for managers in the private fund industry.

Blinded by the Light: Dividends Lose Their Luster**Page 19**

Dividends are a very effective strategy for share retention, though only when paid in periods of positive market sentiment, especially when the paying fund demonstrates strong underlying performance. Z-Ben Advisors' analysis demonstrates that, over the past several years, dividends paid during market downturns have been ineffective at share retention, and in some cases, even harmful to firm AUM. This is not to say dividends are useless – far from it – though they are far more effective as an offensive tactic, used to draw inflows during periods of rapid growth. We give our insight into how firm's should be positioning their dividend strategy and what will work best to achieve growth.

Modern Warfare 2: Rethinking Launch Strategy**Page 22**

Z-Ben Advisors has a controversial theory about launch strategy. In the second part of a two-report set on the strategies FMCs need to employ in order to increase market share, we take a closer look at the typical fund manager launch culture. While the vast majority of the industry is still operating under the assumption that more fund launches equates to better AUM growth, our research shows the opposite. For firms which lack strong brand or distribution advantage, exercising a prudent strategy (one new product every 12 months) can help to cut cost and increase the amount of AUM raised per product launch. We detail a new strategy firms can employ to help build brand and sustain AUM growth over the long term.

Slam Dunk in a Low Hoop: How to Abuse Benchmarks**Page 25**

Only a handful of active equity funds feature what we characterize as aggressive allocations, with the remainder using conservative hedges that do not reflect current levels of equity allocation. Aggressively benchmarked funds consistently realize higher performance, though do not have similar levels of benchmark outperformance as their conservative peers. The vast majority of fund managers have set the bar intentionally low, while simultaneously marketing high risk (and high return) funds to their customers. Instead, they manage only to deliver outperformance on an intentionally handicapped and conservatively hedged benchmark. We assess the impact these strategies have on their products and give our advice on how to manage benchmark selection to a fund's advantage.

QFII vs. Local A-Share Funds: Lost in Translation**Page 28**

Z-Ben Advisors' analysis of the 2009 performance of QFII-backed A-share funds reveals that performance, while in line with the average domestic fund's, was uninspiring. Our diagnosis of the causes: insufficient breadth of company research - an essential in rising markets, when smaller and mid-sized companies tend to lead the charge - and stodgy asset allocation which favors index heavy-weights. Intriguingly, the QFII fund which performed best in 2009 was also the one which avoided these traps to the greatest extent, taking a more Chinese (that is, flexible and broad) approach to equity investing. We may be seeing a hint of things to come if smart QFII managers abandon Western fund construction habits and adopt Chinese techniques for obtaining outperformance.

Joint Venture Review: Eastern Promises**Page 31**

For Western firms, a stake in a Chinese FMC means convenience, reputation, and the promise of vast future returns. For Japanese, Taiwanese and Korean asset managers, expansion into China will soon become a matter of life or death, as these firms face low-growth home markets that are becoming increasingly saturated with financial service specialists. Firms from these three countries possess several inherent advantages over their American and European counterparts when it comes to navigating deals in China. More importantly, their pockets are now deeper, since the financial crisis led to implosion of many major Western financial conglomerates' balance sheets. With the resources and the will, firms from Asian countries will soon become fierce competitors in M&A deals.

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