

# Z-BEN ADVISORS

## China Investment Management: Market Update

October 2009

### Hard Knock Life

Intense competition is only just beginning

Last year it was the stock market that delivered kicks, instead of kisses, to China's FMCs. This year, increased competition for assets that FMCs traditionally regarded as their own has dished out almost as many tricks as the market has provided treats. Worse, that competition can't be relied upon to fade away: head to head competition for assets between FMCs, insurance asset managers, private fund managers and even securities companies is more likely to intensify than decrease over the next five years. The early effects of this competition are already being felt on the bottom line.

FMCs, as a group, were less profitable in 1H09 than a year ago. That margins fell as equity markets decimated AUM is no surprise. However, FMCs were, until this year, better insulated against AUM declines by the amount of revenue they could raise from investment activities not directly connected with public funds: segregated accounts, advisory fees, proprietary investment and the like. In H1, the correlation between AUM and margin tightened, as those extra sources of income became more difficult to tap. Why? Competition.

Z-Ben Advisors has long argued that public mutual funds management is usually one of the least profitable activities (per asset managed) undertaken by China's FMCs, despite often high annual management fees and innovative methods of passing running costs on to investors that might raise eyebrows in other markets. To find the marginally accretive contributors to most FMCs' income statements, one must look to their institutional clientele, from whom FMCs have extracted rich

### Industry Assets Under Management (RMB Billions)

	3Q09 <sup>1</sup>	Growth	2Q09	Growth	1Q09	Growth	4Q08	Growth
Total Domestic	1,236.5	-3.6%	1,282.7	14.6%	1,119.4	5.9%	1,057.5	0.4%
Total Joint Venture	979.7	-4.2%	1,023.2	15.3%	887.6	0.7%	881.4	11.5%
Total Industry Assets	2,216.1	-3.9%	2,305.8	14.9%	2,007.0	3.5%	1,938.9	5.2%

SOURCE: Z-BEN ADVISORS, 3Q09 AUM IS AN ESTIMATE

fees for services that range from the highly-tailored to the highly-scalable. As their performance records for such clients are not publicly available, Z-Ben Advisors acknowledge the possibility that FMCs have delivered superb returns for these fees. However, another possible explanation for this fee-extracting success may be that these clients had nowhere else to go: for large-scale asset management, there had, until this year, been few options in China other than FMCs.

In 2009, a slew of new, credible non-FMC asset managers began pressing FMCs' clients for business. Insurance asset management companies, securities firms and private asset managers all now have approvals, to varying extents, to manage institutional and multi-client segregated accounts. All can boast respectable track records and investment structures designed to produce repeatable returns. Most importantly, all have proven very willing to compete on price. Even if traditional FMC customers have not defected, the presence of these new competitors has already extinguished the fee premium such clients were once willing, however grudgingly, to pay.

Clearly, more choice (and choice among credible, tested asset managers) combined with lower fees is no bad thing for institutional investors. Arguably, it's not entirely a bad thing for FMCs either, as their business models relied, perhaps unhealthily, on a mixed diet of the ultra-fat and the ultra-lean. Inarguably, it's what CSRC wants and insight into the regulator's plan is perhaps the best

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The local industry  
converging to  
international norms

Tougher competitive  
environment will bring  
out the best

illuminator of the new conditions under which all Chinese FMCs should expect to operate.

As a thumbnail guide, Z-Ben Advisors expects China's asset management industry, 30 years from now, to be indistinguishable from any other developed market. Entry, sales and localization of products and services, then, will be no more difficult than it is in Singapore, Rome or Chicago today. Five years from now, by contrast, we expect the industry to be almost as baffling to the inexperienced as it is today. The reason is simple: CSRC wants, in Z-Ben Advisors' opinion, China's FMCs to be as ready to face global competition as humanly possible. To accomplish this, it intends to toughen them by exposing them to ever-increasing amounts of local (and, to a lesser and controlled extent, foreign) competition. Each year, just as we have seen in 2009, CSRC will allow more and more competition for a larger and larger number of products, clients and asset pools. Call it a hardening off of budding FMCs prior to exposing them to the frosts of global competition.

By forcing FMCs to out-compete ever more able rivals before, sometime in the next 30 years, throwing the doors open to all comers, CSRC expects to breed the toughest cockroaches in the kitchen: FMCs which can ably defend their home turf against foreign entrants. These will also, CSRC hopes, be FMCs ready to turn globalization to their advantage, using their scale and experience in China to drive hard into foreign markets. FMCs should expect more hard knocks. Large-scale public mutual funds appear to us to be the only business line where CSRC will brook no competition, at least in the next few years. For every other form of asset management, FMCs should expect more and better-armed competition, with CSRC's blessing, on a schedule as fast as the regulator believes is consistent with industry survival. It's going to remain a hard knock life.

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## Monthly Research Highlights

### Going, Going, Gone: The Last of the Red-Hot FMC Bargains

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Regulatory non-compliance of ownership stakes has been a key driver for much of the M&A activity since mid-2008. Though many of the high-profile deals are complete, there is still a rapidly closing window of opportunity for foreign fund managers to buy into Chinese FMCs at relatively low prices. Simultaneously, CSRC is unlikely to approve any new JV launches until near-total regulatory compliance is achieved. As a result, future JV applicants will join an already long queue. In our view, this makes the few remaining opportunities especially crucial for those interested in entering China's fund management industry within the next several years.

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### Mid-Year Profitability: Grinding It Out

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Despite the H1's 74% market rally, a large number of fund managers saw their profit margins decline noticeably: for the sample of 16 firms that we were able to collect profit and revenue figures, the average profit margin fell from nearly 39% one year ago to 32%. Even in the best case scenario, FMCs may only generate two thirds of last year total revenue from mutual funds. The same is true of other revenue opportunities such as segregated accounts, enterprise annuities and advisory services. And, FMCs are likely to incur more costs as new products and platforms, such as multiple-client accounts, come online. For fund managers to recreate margins as high as 2008, or 2007 for that matter, would be a challenging exercise indeed.

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### Bank Distribution: Cracks in the United Front

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A distribution void left by big banks over disagreements regarding performance fee sharing arrangements in the newly-launched multiple-client platform are being filled rather quickly by small and mid-tier banks. And the same is true when ICBC, for whatever the reason, stopped selling mutual funds. Given that fund distribution is a highly lucrative business, many banks, big or small, are increasingly willing to compete for distribution mandates with friendlier terms. This, of course, is a godsend for fund managers and they may soon enjoy a much more competitive and efficient distribution architecture going forward.

**QFII Update: Restrictions on the Quota Rental Model****Page 19**

On September 4, 2009, SAFE released a new set of (draft) measures for the Qualified Foreign Institutional Investor scheme and specifically to address a number of long outstanding issues. Much of what was included in the draft was widely expected, but Z-Ben Advisors was taken aback by the terminology used which takes direct aim at the transfer or resale of investment quota (the QFII rental business). We believe the possible impact of this has, thus far, been dramatically overlooked. As a consequence, the decision was made to assess how a far more restrictive QFII rental market could affect all parties as well as the QFII landscape as a whole. All parties should take heed: players who breach or potentially breach opaquely worded clauses are advised to reassess how they employ quota and their strategies of accessing the Chinese A-Share markets.

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**The New New Thing: Multiple-Client Accounts Squeeze Shelf Space****Page 24**

Barely a month since multiple-client segregated accounts (MCSAs) were green-lit for sale and the program may have already reached the Rmb10bn AUM mark. Demand proved to be stronger than expected, with even regional banks, in cooperation with mid-tier fund managers, easily meeting their sales targets. In fact, strong demand for MCSA products, along with banks' distribution bias for these newly-launched products, may be drawing new assets away from new mutual funds. With leading fund managers and top-tier banks just entering the fray, intense competition is just starting.

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**Born to Run: Fuel-Injected Private Fund Managers Step Out****Page 28**

Private funds experienced very rapid growth in the past two years, especially in 2009. Not only have they outperformed mutual funds in general, but they have managed to accelerate new product offerings in the first eight months of this year as well. In addition, they have also realized fast geographic expansion through the cooperation with various trust companies throughout the nation. However, their challenges are also growing quickly, especially with the opening of multi client segregated accounts business offered by mutual fund managers. Facing the challenges, some private fund managers are actively developing alternative solutions to best meet growing competitive forces head on.

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**Brokerage Asset Management: Tomorrow's Problem?****Page 31**

Securities firms are pushing their way into the domestic asset management industry, launching more structured investment products in 2009. Although not yet direct competitors to mutual fund companies, securities firms are creating innovative investment strategies and learning how to target potential investors from their already impressive list of brokerage clients. With 7 JV securities companies currently in operation, there is a lot of buzz that this will provide more foreign firms with an alternate strategy to penetrate the domestic asset management industry. Z-Ben Advisors has set out to define the opportunities they may post to domestic firms and the challenges securities firms will present to foreign asset managers.

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**Joint Venture Review: One Smiling Customer At a Time****Page 34**

China International and Fortis Haitong both possess exceptional fundraising skill and superior asset retention, critical elements of any well functioning and profitable fund. These measures are particularly impressive when considering both firms' decidedly mid-tier AUM. This report explores how, entirely through non-dividend policies, these two firms have performed better on critical measures of performance. As a result of their strong efforts in direct marketing and building proper customer relations systems, these firms have won an amount of customer loyalty not usually found among FMCs. Bearing this in mind, we recommend that fund managers reevaluate the costs and benefits of engaging in similar customer relation efforts, potentially using these two firms' practices as a model.

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**Corporate Action: M&A Activities set to Rise****Page 37**

Firms turned cautious and defensive both in terms of dividends and proprietary trading due to the recent stock market correction. Portfolio management changes continued in high frequency last month, especially with a sharp rise in the number of resignations. With a massive flooding of MCSA products recently, the competition of investment talent is only set to increase. However, a new trend seems to be looming on the horizon, which involves FMCs such as China AMC and Bosera starting to hire professionals from the international marketplace.

**Monthly Performance Review: Reclaiming Lost Grounds****Page 54**

Starting from August's lows, the first half of September saw modest gains in equities, reaching 17% by the 17th, before gradually falling thereafter, with September ending with a 6.2% monthly gain. Equity funds finished at the top with 6.26%, followed by QDII funds. High volatility throughout the market has made skilled management even more important, as only a third of the actively managed equity products managed to deliver absolute returns during this period. Investors remain concerned with overall market conditions, especially as the listing of large cap stocks and the launch of the Growth Enterprise Market (GEM) may impose further liquidity stress on the market.

## Analytical Quick Hits

**Harvest Ends QDII Sub-Advisory Agreement with DWS.** Harvest ended an overseas investment consulting agreement with DWS Finanz-Service GMBH on September 1, 2009. Harvest will manage the QDII fund internally. It was the third fund house this year that stopped hiring overseas consultant for QDII products. The other two were ICBC Credit Suisse and Southern.

**BoComm Got Approval to Buy China Life CMG.** The bank got approval from CBRC and CIRC to buy a 51% stake in the JV insurance company, China Life CMG Insurance, from China Life. BoComm also became the first domestic commercial bank investing in insurance firms. The insurer's foreign shareholder, Commonwealth Bank of Australia, will keep the remaining 49%.

**Capital Injection by Huijin.** The State Council has selected Central Huijin to inject funding into the Export-Import Bank of China and China Export & Credit Insurance Co. Details of the fund injection plan for the two firms have yet to be determined. The move will enhance Huijin's role as a government vehicle to control equity stakes in key financial institutions.

**Customized QDII Products were Allowed.** Three FMCs - Harvest, Fortune SGAM and Fortis Haitong - have been allocated a new batch of FX quotas for the new products. These quotas are separate from the existing quotas they have already received for their mass-market-oriented QDII funds.

**Merchants Securities Sells Bosera Stake.** Merchants Securities has agreed to sell the 24% stake in Bosera FMC at the base price to four unidentified buyers. The 24% stake was divided into four parts before put up for sale, with each part sold at a base price of Rmb657m. The deal would be worth Rmb2.628bn provided that the holdings were auctioned as a whole.

**First Batch of IPOs Approved for GEM.** CSRC has granted conditional approval to ten companies for listing on the Growth Enterprise Market in Shenzhen. These ten companies began subscription on 25 September, and are expected to raise Rmb6.9bn from the listing.

**One More QFII License Issued.** CSRC granted a QFII license to Baring Asset Management in August. Its domestic custodian bank is HSBC (China). So far, a total of 87 QFII licenses have been granted.

**Bosera Plans to Set up HK Subsidiary.** Bosera recently announced that the company planned to set up a solely owned subsidiary in Hong Kong. The company will have registered capital of HKD100m. The subsidiary will provide QDII consulting service.

**New Century Fund Management Renamed.** The fund house is renamed New China Fund Management. The new name corresponds with the name of its largest shareholder - New China Trust. The fund names from the house are also renamed correspondingly.

**BEA to Buy Stake in Golden Eagle.** BEA plans to buy about a 10% stake in Golden Eagle FMC from New Hope Group, which currently holds one fifth of the fund house. The investment will be done by BEA's JV subsidiary - BEA Union Asset Management. BEA may increase its stake in the small fund house at a later stage.

**Mirae to Establish China JV with Huachen Trust.** Mirae Asset Financial Group and Huachen Trust are planning for a mutual fund joint venture. Mirae, the largest asset management firm in South Korea, plans to invest about USD3.8m for a 25% stake in the new JV.

**HK Listing Plan of CPIC Approved.** CIRC approved China Pacific Insurance's Hong Kong listing plan. China Pacific will issue no more than one billion H shares. It will become the third insurer that lists both in A Share and H Share market. The first two are China Life and Ping An.

## Analytical Quick Hits

**PICC Shift to a Shareholding Company.** People's Insurance Company of China has restructured itself into a state-controlled shareholding insurer, after the Ministry of Finance approved the change in its status. The new company is set up with a registered capital of Rmb30.6bn.

**New Draft Rules on QFII.** SAFE issued the draft *Regulations on Domestic Securities Investment of QFII* to solicit public opinions. SAFE plans to increase maximum quota for a single QFII from USD800m to USD1bn and shorten the lockup period for some medium and long-term QFII funds such as pension and insurance funds to 3months.

**Ping An Securities Launching U.S. Dollar PE Fund.** Ping An Securities plans to raise USD200-400m with its new U.S. dollar denominated PE fund. The fund will be invested in growth companies with possibilities of listing in three years. The brokerage's wholly owned subsidiary, Ping An Bright Fortune Investment will manage this fund.

**Goldman Sachs Gaohua Securities Wins Asset Management License.** GS Gaohua Securities will soon set up a domestic asset management team. Recently, many securities companies are reported to prepare for their asset management subsidiaries, including CICC.

**CCB International Launched Healthcare PE Fund.** CCB International, a subsidiary owned by CCB, has launched a healthcare PE fund which raised Rmb2.6bn for the initial phase. This is the first RMB-denominated PE fund that focuses on China's healthcare sector. 70% of the capital raised came from institutional investors including Jianyin Investment, Yangtze Power and so on.

**Mutual Funds Allowed to Invest in GEM.** CSRC clarified that stocks listed in GEM are also investment choices for mutual funds. For individual product, it will depend on the prospectus. Most fund houses have announced their funds may invest in GEM stocks.

### INDUSTRY AUM & MARKET SHARE SEPTEMBER 30, 2009 (ESTIMATE)

DOMESTIC FUND MANAGERS				SINO-FOREIGN FUND MANAGERS			
	AUM				AUM		
	RMB Bill	Share	RANK		RMB Bill	Share	RANK
Baoying	10.67	0.48%	42	ABC-CA	17.93	0.81%	35
Bosera	137.19	6.19%	2	ABN Amro TEDA	23.70	1.07%	31
Changxin	19.64	0.89%	32	AEGON-Industrial	35.32	1.59%	25
China AMC	222.71	10.05%	1	AIG-Huatai	18.42	0.83%	34
China Nature	4.91	0.22%	52	AXA SPDB	1.90	0.09%	60
China Post & Capital	36.62	1.65%	24	Bank of Communications Schroders	63.76	2.88%	9
China Universal	52.00	2.35%	15	BOC <sup>1</sup>	25.34	1.14%	30
Dacheng	86.27	3.89%	7	CCB Principal	32.90	1.48%	27
E-Fund	122.21	5.51%	4	Changsheng <sup>2</sup>	40.10	1.81%	22
First Trust	13.20	0.60%	39	China International <sup>1</sup>	58.96	2.66%	10
Galaxy	11.45	0.52%	41	China Merchants <sup>1</sup>	32.36	1.46%	28
Golden Eagle	4.76	0.21%	53	CITIC Prudential	13.30	0.60%	38
Great Wall	40.57	1.83%	20	Everbright Pramerica	33.08	1.49%	26
Guangfa	89.15	4.02%	6	First State Cinda <sup>1</sup>	8.17	0.37%	47
Guotai	40.48	1.83%	21	Fortis Haitong	39.44	1.78%	23
Harfor <sup>4</sup>	5.19	0.23%	50	Fortune SGAM	46.71	2.11%	17
Hua'an	72.60	3.28%	8	Franklin Templeton Sealand	17.54	0.79%	36
Huashang	8.83	0.40%	46	Full Goal <sup>2</sup>	54.53	2.46%	12
Lion	43.47	1.96%	19	GTJA Allianz	9.05	0.41%	44
New China <sup>5</sup>	4.32	0.19%	55	Harvest <sup>2</sup>	126.49	5.71%	3
Orient	9.66	0.44%	43	HSBC Jintrust	8.90	0.40%	45
Soochow	7.23	0.33%	48	ICBC Credit Suisse	44.74	2.02%	18
Southern	110.85	5.00%	5	INVESCO Great Wall	47.13	2.13%	16
Tianhong	3.54	0.16%	57	KBC-Goldstate	4.67	0.21%	54
Wanjia	14.18	0.64%	37	Lombarda China	3.74	0.17%	56
Yimin	6.96	0.31%	49	Lord Abbett China	5.01	0.23%	51
Yinhua	57.81	2.61%	11	Minsheng Royal	2.84	0.13%	58
<b>TOTAL</b>	<b>1,236.5</b>	<b>55.79%</b>		Morgan Stanley Huaxin	2.63	0.12%	59
				Penghua <sup>2</sup>	52.03	2.35%	14
				Rongtong <sup>2</sup>	52.47	2.37%	13
				SYWG BNP Paribas	12.51	0.56%	40
				UBS SDIC	25.58	1.15%	29
				Zhonghai <sup>2</sup>	18.47	0.83%	33
				<b>TOTAL</b>	<b>979.7</b>	<b>44.21%</b>	

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; BLACK ROCK 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. LA COMPAGNIE FINANCIERE EDMOND DE ROTHSCHILD BANQUE OWNS A 15.385% OF ZHONGHAI.

4. ORIGINALLY HUAFU FUND MANAGEMENT. 5. ORIGINALLY NEW CENTURY FUND MANAGEMENT

# Z-BEN ADVISORS

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