Z-BEN ADVISORS

China Investment Management: Market Update

June 2010

Whirling Dervish

The punditry is, once again, forgetting the lessons of the past

Without focusing too much on mythical dancing (a favorite pastime to be sure), it is useful to remember the purpose of the dervish ritual: emptying oneself of all distracting thoughts. Perhaps no better advice can be offered, especially given all that has taken place over the past 30 days, as investors here and abroad have been bombarded with nothing but (important though they may be) distracting thoughts.

Amusingly enough, when assessing China, what we find is that the punditry (at least for the most part) has let loose once again and decided to shift its prognosis which, only weeks ago, claimed that the Chinese economy was on the verge of overheating. Today the talk is focused almost entirely on the growing prospects of a hard landing. It is as though no one actually learned anything from the 2008-2009 cycle. Then, the very same arguments were being made and yet, were not only without merit but were ultimately proven incorrect. For this reason among others, Z-Ben Advisors, in our previous report, strongly recommended that everyone now focused on the Chinese market ignore all of the current noise. All we can say for now is that we have peered down the coalmine and have seen the canary. We are pleased to report that he is chirping away quite happily, thank you very much.

All well and good but what of the potential negative ramifications of a serious change made by senior Chinese policy makers to address asset inflation? It is here that there is perhaps no better example than that of last month's proposed – and hotly debated – introduction of a property tax. For the better part of the past month this one single variable (talk about distracting thoughts!) has exerted a significant drag on local share prices. That said, Z-Ben Advisors – dancing on the knife's edge though we may be – would go so far to say that the likelihood of such a tax being introduced is, at worst, limited and probably not even in the cards. A strong statement to make, no doubt, but here again we need only look to the past to guide our analysis. It wasn't all that long ago – if you'll remember – when China's equity markets were soaring high, reaching the point where policy makers were believed to be considering the introduction of a capital gains tax. And what was the final outcome? Nothing. Zilch. Nada.

Industry Assets Under Management (RMB Billions)

	Current [1]	Growth	1Q10	Growth	4Q09	Growth	3Q09	Growth
Total Industry Assets	2,166.5	-10.9%	2,431.7	-9.1%	2,676.1	19.1%	2,247.7	-2.4%
Total Domestic	1,213.2	-12.0%	1,378.2	-7.6%	1,490.9	18.0%	1,263.7	-1.3%
Total Joint Venture	953.3	-9.5%	1,053.6	-11.1%	1,185.1	20.4%	984.0	-3.7%

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

There are a number of very good reasons to straighten your shoulders and press ahead vigilantly but there is none more important than the considerable profits firms can generate from managing money in China. Over the past two months, Z-Ben Advisors has been reviewing both top- and bottom-line 2009 financial results of the fund management industry with a summary of our findings included in this month's report. For all of the volatility that has been present, FMCs, on average, continue to post net margins around 35% and, based upon Z-Ben Advisors' analysis, EBITDA margins that easily exceed 40%. Granted these are just the average numbers but for even most smaller

For more information, please contact:

Mr. Francois Guilloux
Director, Regional Sales
francois_guilloux@z-ben.com

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

Z-BEN ADVISORS, LTD
GC Tower, 21/F
1088 Yuanshen Road
Pudong New Area
Shanghai, China 200122
Email:info@z-ben.com
Phone: 86-21 3857-1320
86-21 3857-1321
Fax: 86-21 3857-1322

FMCs profitability has been attained.

With profits come greater competitive pressure

With such profits, as to be expected, comes greater competition. This we find represented in the sheer numbers of new FMCs attempting to push their way into the market with Z-Ben Advisors' research identifying upwards of 18 new firms at some stage of entering the market. Still a slow burn but expect to see the number of FMCs fighting over AUM to rise in the next three years. Then there are the number of alternative platforms to manage other people's money – not to mention potentially lucrative institutional mandates – which are also on the rise. To start, there are securities companies which are once again assessing what role they can play in the asset management industry. That role is now increasing in potential scope with regulatory allowance for securities firms to totally incorporate their in-house asset management divisions.

We remain skeptical as to the real extent of the competitive threat these firms could post to FMCs. This isn't the first time securities firms have attempted to break into the asset management space and, thus far, their efforts haven't been adequately rewarded. The same, however, isn't the case for trust companies, especially if we consider their close working relationship with the rapidly-growing ranks of private investment advisory firms. For foreign firms the trust platform, even though it is limited to 20% ownership, offers the most open and unfettered prospects for developing new products. What insurers, banks and FMCs can't do is fertile ground for trust companies. And, while foreign participation may be capped at a less attractive level, the price to buy in (at least for the time being) won't break the bank.

For the near term, FMCs must effectively address a lack of demand

But it is the near-term outlook which may very well plague all firms in the money management business. While investment success may still be possible, it makes little difference if there isn't any material demand among investors. A truism if there ever was one. What history has taught us once again is that times such as these, especially in China, tend to be the most opportune in which to scale up exposure to risk. Or, at the very least, it's a good time to assess more closely what new steps can be taken to build a real competitive advantage. Some FMCs appear already to have embarked on such enterprises. As Z-Ben Advisors was finishing our latest report and sending it out to clients, Bosera Fund Management disclosed that its latest new domestic product launch finished with Rmb3.4bn in assets raised, among the best takes so far this year from an independent fund manager.

Recent launch results may point to renewed retail interest

Z-Ben Advisors recognizes that a single data point does not make a trend. We will need to closely monitor over the coming weeks just how strong demand is among other firms now finishing up their own new product asset raising activities. But, the signs from the recent Bosera launch are positive not only for the sheer amount of assets raised. Perhaps, even more importantly, is the fact that the firm announced very strong retail demand with just over 100,000 accounts opened at the time of launch (again, one of the top draws among Chinese FMCs so far in 2010). For FMCs, we see this as an unequivocally positive sign for growth. This holds true for the average retail investors gauging whether or not to buy shares of funds. It is also true for foreign firms reviewing the prospects for buying a minority stake in a fund manager or trust company or even allocating resources to initiate a local representative office.

Intestinal fortitude, yes, but recall that fortune tends to favor the bold

Notwithstanding the lessons which history can teach nor the long-term prospects for fund management in China, Z-Ben Advisors will be the first to state that market conditions can just as easily spiral out of control and so quite quickly and without much forewarning. China remains an emerging market and such volatility is par for the course. However, in our firmly-held view, this volatility is the ultimate distracting thought: the growth it often obscures is the real prize for asset managers in China. So have a twirl and put the short-term noise of out of your mind. Instead, focus on the products, the positioning and the internal processes which maximize your firm's chances of participating in that growth. That may not be the true path to ecstasy but it is, we can assure you, the fastest route to the money.

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Ms. Peggy Xu
Marketing Associate
Tel: (86-21) 3857-1321 x235
peggy.xu@z-ben.com

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Z-BEN ADVISORS
GC Tower, 21/F
1088 Yuanshen Road
Pudong New Area
Shanghai, China 200122

Tel: (86-21) 3857-1321
(86-21) 3857-1321

Fax: (86-21) 3857-1322