

China Cross-Border Report

The End of the Beginning

QDII program expansion is back on track with seven FMCs receiving quota approval from SAFE and one – E-Fund – receiving launch permission from CSRC, then raising a disappointing Rmb592m. A further two FMCs were granted quota by SAFE in early Q1. China Merchants and China Universal are expected to launch their funds after Spring Festival.

Given the speed at which SAFE and CSRC are moving, expect the entire current queue of QDII applicants to be cleared by 3Q10, with 25 or more QDII products approved by year end. Elsewhere, CIC appears to have completed the investment of its initial funding with a series of mandate funding and direct investments and now stands ready to receive additional funds – perhaps USD250bn or more, likely by Chinese New Year. Expect 60%+ of these new funds to be devoted to third-party mandates as CIC enters new territories and asset classes. At the opposite end of the spectrum we find that SAFE is continuing to hold the QFII tap open, granting an additional six overseas firms investment quota in Q4. A strong preference for long-term, retail fund-oriented investors and Asian fund manager continues to be strongly in evidence and will likely remain so over the course of 2010.

QDII Key Developments

A flood of new FMC quota approvals hit in Q4, with nine fund houses receiving initial quota grants in the USD500m-1.0bn range: no USD5bn mega-funds appear likely in 2010. Expect more approvals to follow early in 2010.

Fast track quota-to-launch transit is now possible for prepared FMCs: order of quota approval may not determine order of launch. While FMCs are on the move, the bank channel remains all but closed to new QDII products.

QFII Key Developments

The backlog of quota applicants is now projected to be more than 200. Lower-priority applicants (i.e. not pensions, endowments or FMCs hoping to launch China retail funds) are unlikely to be served in 2010.

Passive China fund manufacturers are not yet showing up on quota recipient lists and quota rental, although banned, is not dying quickly. Expect SAFE to begin bringing quota-renting index funds under the QFII umbrella in 2010.

QDII Fund Developments

Redemption rates continue to be significantly higher within funds launched in the second wave of the QDII program's expansion, regardless of their performance relative to the original four.

Performance was relatively strong in Q4, with QDII funds delivering an average return of 8.72%. However, this figure was overshadowed by the double-digit gains of domestic equity funds, dampening enthusiasm for offshore investing.

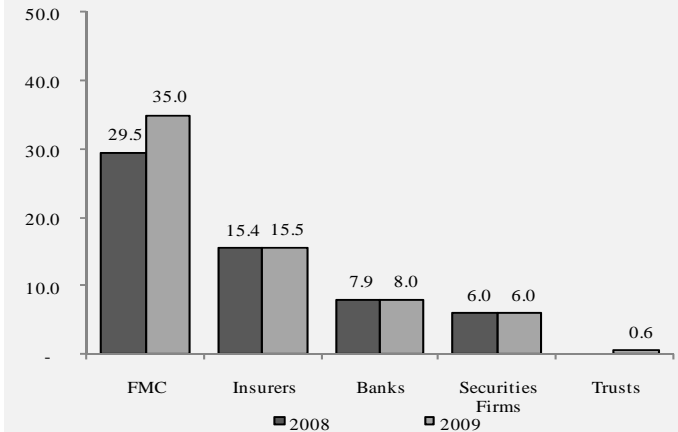
Institutional Key Developments

CIC has likely spent all of its initial USD110bn free cash (save a reserve of perhaps 10-15%) and may receive a further USD200bn+ to invest in Q1. Expect more than 60% of new monies to be invested in third-party mandates.

NCSSF has restated its commitment to increasing offshore allocations but will likely move first to take advantage of new PE opportunities at home. The NDRC-approved list of PE was greatly expanded in Q4.

FMCs' slice of the pie grows

QDII quota by recipient type, (USD bn)



SOURCE: SAFE, Z-Ben Advisors

Performance ramps up

QDII funds' selected 2009 data, ranked by 2009 return

QDII Manager	AUM (Rmb m)	Q4 Fund flows	Q4 Return	2009 Return	Factsheet Page no.
Fortis Haitong	517.4	-16.4%	11.2%	83.5%	33
BoComm Schroders	400.4	-18.0%	10.6%	72.3%	34
ICBC Credit Suisse	1,881.6	-5.4%	9.7%	64.9%	30
China International	16,171.7	-3.4%	4.7%	58.5%	29
Harvest	17,072.6	-3.5%	10.0%	58.0%	28
China AMC	20,267.3	-3.4%	7.7%	56.7%	27
Fortune SGAM	140.7	-17.8%	11.7%	54.1%	31
Southern	17,014.0	-3.1%	6.9%	39.6%	26
Yinhua	128.3	-3.3%	6.0%	29.9%	32

SOURCE: Company reports, Z-Ben Advisors

Introduction to the *China Cross-Border Report*

Welcome to the new *China Cross-Border Report*, the successor to our popular *QDII: Quarterly Review*, re-designed to meet readers' requests to provide more detailed and more regular coverage of the activities of China's regulators, sovereign wealth funds and largest institutional investors, who represent a far larger volume of outbound investment than that captured within the QDII scheme. Thanks to the recent jump-start of the QDII program itself, we have also expanded our analysis of the program's participants, their products and their progress.

Expect this report to grow substantially larger over the course of 2010 as the ten QDII funds we now track in detail (which can be reviewed individually in the second section of this report) grows to 20, 25 or more. Larger won't necessarily mean wordier, however. In response to our subscribers' requests, we've increased the number and variety of charts in the report, attempting to make both key trends and subtle environmental changes more immediately clear. In that spirit, we have also given greater attention to fund flows, a key topic that bedeviled many FMCs in 2009 and will, we suspect, remain a key concern in 2010.

With a larger number of QDII funds entering the market, investors will (fingers crossed) also be given a broader choice of geographies, sectors and fund styles to choose from. To better understand their preferences, we have also begun to assess fund flows and performance by region and sector, an analytical exercise that will only grow more complex over the course of the year but one we hope will help FMCs answer the question: what do Chinese investors really want from their QDII funds?

To round out the changes in our QDII coverage, we have also begun to assess the fortunes of QDII funds by, for lack of a better term, birth cohort. The first wave of funds - those created by Harvest, China International, China AMC and Southern - has always behaved differently, especially in how they retain assets, than the second wave - funds created by Fortis Haitong, Fortune SGAM, ICBC Credit Suisse, Yinhua and BoComm Schroders. The third wave - the one that begins to wash ashore in Q1 with E-Fund as the first rider - will also, we expect, display its own peculiar characteristics and may affect the behavior of its predecessors. Tracking the waves, we believe, will shed more light on who is and isn't affected by changes in investor preferences.

While QDII will remain at the core of the report, we have expanded our coverage to include a number of other investing segments and regulators whose choices often influence, or are influenced by, developments in the QDII program. In our view, it is always unwise to consider the QDII program outside the regulatory context and often difficult to understand the choices that QDII PMs make without seeing some of the moves that Chinese institutional investors - especially SWFs - are making with their offshore portfolios. Beginning in this report, we will devote analytical coverage to both NCSSF and CIC, with additional commentary on SAFE and, when applicable, larger institutional investors such as insurers, groups finance companies and SASACs.

We will also bring our coverage of the QFII program under this report's umbrella. Cross-border investing, of course, runs in two directions and many of the readers of this report have as keen an interest in events in the QFII program as they do in QDII. Over the course of this year, our QFII coverage will expand to track a representative sample of publicly-reporting QFII-backed A-share funds to help readers better understand the dynamics of investing through the program.

Expect this report to get fatter as 2010 rolls on. We have redesigned our coverage of individual QDII funds to allow a better at-a-glance view of their fortunes from quarter to quarter. We're covering ten now and that number may rise as high as 25 by the end of the year. And, with a broader range of ambits encompassed by those funds, expect to see wider range of PM views expressed as well - always a useful clue to the thinking of FMC leadership as they advance into Hong Kong and beyond.

In redesigning this report, we were pleased by and impressed with the quantity and quality of advice and suggestions we received from our readers. If there are further changes we can make to help you grasp the important themes, events and forecasts affecting China's cross-border investment flows, please don't hesitate to get in touch.

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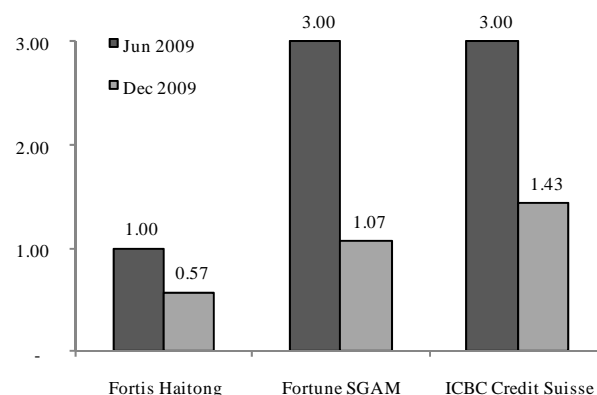
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QDII Program: Q4's key developments

Exhibit 2.02: SAFE taketh away

FMCs with QDII quota reduced by SAFE (USD bn)

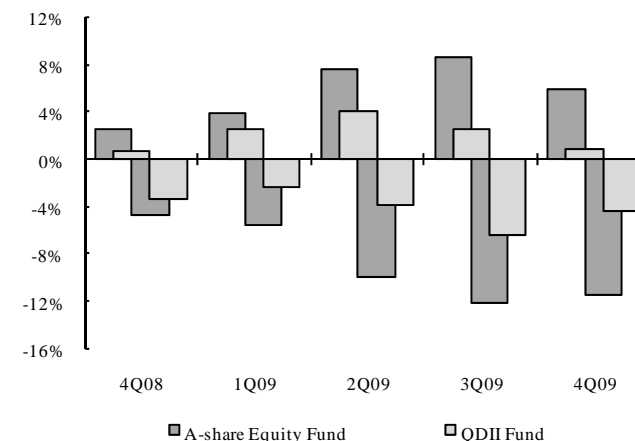


SOURCE: Company reports, Z-Ben Advisors

- Three funds endured quota clawbacks in the second half of 2009, likely in Q3, although not formally confirmed until Q4. The three, all members of the second wave of QDII funds, were among the hardest-hit by investor redemptions and even aggressive dividend marketing tactics failed to return shares in issue to anything near launch levels.
- SAFE's willingness to claw back quota is a genuinely worrisome problem for new QDII entrants, particularly those such as E-Fund, which failed to raise significant sums at launch. How long will SAFE stand by, waiting for post-launch marketing to take effect, before clawing back quota? We doubt that the two years' grace given to the second wave funds will become the rule.
- Our gut response: where redemptions are caused by market cycles, SAFE will allow at least a year post-trough before cutting quota. Where marketing tactics are to blame for poor usage, SAFE will put FMCs on a tighter leash.

Exhibit 2.03: Where's the upside?

Gross subscriptions/redemptions for QDII vs onshore equity funds (%)



SOURCE: Z-Ben Advisors

- Despite many FMCs' volatility woes in the QDII sector, share churn is typically less of an issue offshore than on. Both gross subscriptions and gross redemption tend to peak with the market cycle, as the chart above shows.
- The key differences between on- and offshore fund flow behavior, in our view, are in timing and subscriptions. In the chart above, we can see QDII funds, to some extent, lagging onshore equity funds in both the growing (4Q08-2Q09) and shrinking (3Q09 on) parts of the cycle.
- However, while QDII redemptions are relatively range-bound, typically between 3-7% of AUM, so are subscriptions, and in a much lower range (1-4%) than for onshore funds. The replacement rate for departing QDII investors remains lower, through a full market cycle, than for domestic equity funds, which find it much easier to attract new buyers during market upswings. More funds will need to attempt the dividend-based marketing strategies used to bolster QDII shares in issue in Q2 if this inequality is to disappear.

Appendix III: Quarterly Factsheet

Fund Return

4Q09	7.71%
1YR	56.65%
ITD	-17.60%

Basics

(As of 12/31/2009)

	4Q09	Δ Q-Q
AUM (Mil Rmb)	20,267	4.17%
Shares (Mil)	24,583	-3.39%
NAV	0.8240	

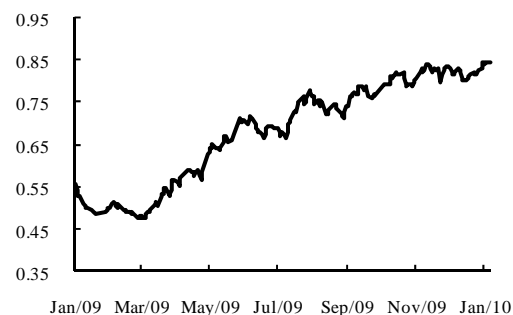
Benchmark: MSCI All Country World Index

Portfolio Manager: Mr. Yang Changheng
Mr. Zhou Quan

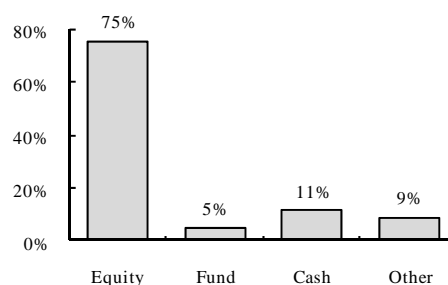
Foreign Advisor: T. Rowe Price Group, Inc

Advisory Team: Robert N. Gensler

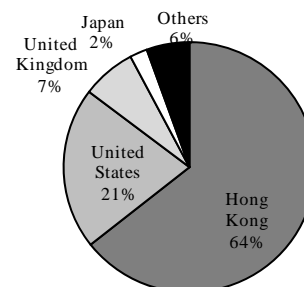
NAV Analysis



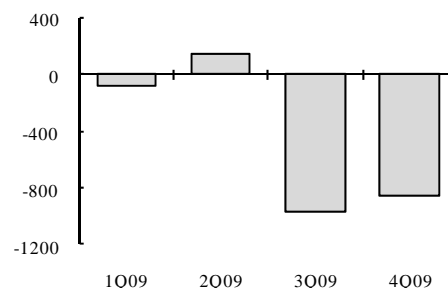
Asset Allocation



Geographic Allocation



Fund Flow Analysis



China AMC Global Enhanced Equity Fund

Product Assessment

- The fund's performance in 4Q09 was unimpressive, only slightly better than the worst performer (FoF excluded).
- The fund manager turned conservative in asset allocation this quarter, reducing equity exposure to 75% from 80%. A 3% higher "other asset" allocation is due to increasing settlement accounts receivable of securities.
- Hong Kong and United States got 85% of AUM in 4Q09, no real change from last quarter, while equity exposure to the Japan market was raised slightly to 2.25%. The manager emphasized prudence, keeping most of equity positions pat and adding 1.39% more AUM to iShares ETFs.
- 4Q09 saw yet more net outflows of the fund assets, but at a lower rate than last quarter. Although the net redemption ratio fell to 3.39%, more pressure will arrive when the fund's NAV approaches Rmb1.00.
- The fund manager forecasts a moderate recovery trend in next quarter with portfolio holdings benefiting from consumption in emerging markets. New energy generators will also be a hot point in 2010.

Top 10 Equity/Fund Positions

Name	Market Value (Mil Rmb)	Portfolio Allocation
ICBC	1,315.67	6.49%
China Petroleum & Chemical	1,242.32	6.13%
Bank of China	1,158.13	5.71%
Petro China	771.47	3.81%
iShare Asia ETF	635.90	3.14%
Belle International Holdings	598.36	2.95%
Vale SA-SP	592.19	2.92%
Gazprom OAO-Spon	510.91	2.52%
Bank of Communications	444.65	2.19%
China Resources	435.89	2.15%

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