

Chinese Sovereign Wealth Funds: *A Changed Game: 2009-2014 Opportunities*

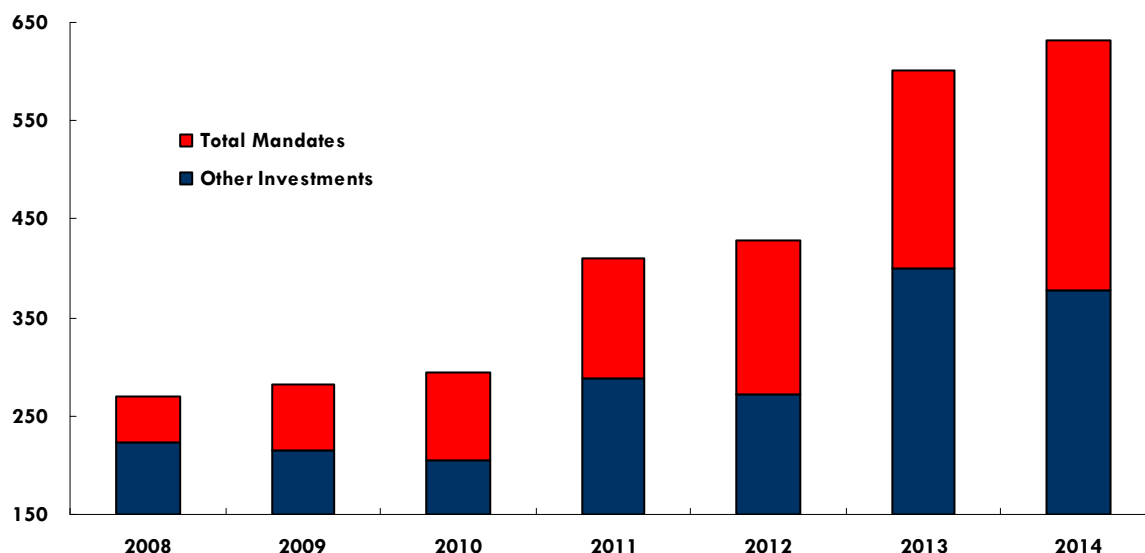
In our second annual forecast of the growth and third-party mandate needs of China's Sovereign Wealth Funds, Z-Ben Advisors has made a substantial reduction in both the volume of assets we project will be invested and the speed at which those funds will be deployed. Changes in market outlook and, more significantly, changes in funding dynamics mean China's SWFs enjoy less pressure to invest quickly and more time to seed their global investments programmatically.

Key findings from this year's report include:

- We expect total SWF assets to rise only to USD295bn by end-10, down from last year's prediction of USD729bn. The primary cause of this change: reduced accumulation of sterilized reserves.
- CIC will likely move more aggressively than NCSSF to appoint foreign fund managers, although it increasingly likely to do so through unpublicized private RFI/RFP rounds.
- Property, infrastructure and private equity investments, whether domestic (NCSSF) or foreign (CIC), remain high priorities as both SWF seek to exploit their tolerance for illiquidity.
- While the next two years will see smaller than expected government funding, we expect total SWF AUM to rise to USD631bn by end-14.

Many foreign asset managers have made NCSSF and CIC key elements of their China plans. While most have reassessed their expectations following the 2008 market downturn, some have yet to process its full implications for China's SWFs. Our message is unambiguous: expect substantially less activity and more measured advances than any estimate formed last year might have predicted.

Chinese SWF AUM Forecast (USD billions)



Source: Z-BEN ADVISORS

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Section Guide

Introduction	5
At a Glance	8
- Chinese SWF Basics	
• National Council for Social Security Fund	8
• China Investment Corporation	10
• China-Africa Development Fund	12
NCSSF	13
- The Domestic Giant	
• 2008 Activities	14
• 2009 Expectations	17
• 2010-2014: Asset Allocation	19
• 2010-2014: Domestic Mandates	21
• 2010-2014: Foreign Mandates	23
Reading the Rumors	25
- Assessing SWF Predictions in Print	
CIC	27
- The Global Investor	
• 2008 Activities	28
• 2009 Expectations	31
• 2010-2014: Asset Allocation	33
• 2010-2014: Foreign Mandates	35
SAFE	37
- Not a Sovereign Wealth Fund, Still an Opportunity	

Table of Exhibits

NCSSF Balance Sheet: 2008e-2014e (Table)	9
NCSSF Balance Sheet: 2008e-2014e (Chart)	9
CIC Balance Sheet: 2008e-2014e (Table)	12
CIC Balance Sheet: 2008e-2014e (Chart)	12
NCSSF End-08 Portfolio Allocations	15
NCSSF HK Portfolio: Listed Equity 2008	15
NCSSF HK Bank Recap Investment at end-08	16
NCSSF Infra/PE Fund Investment at end-08	16
NCSSF Balance Sheet: 2009 in Focus	17
NCSSF End-09 Foreign Mandate Allocations	18
NCSSF Balance Sheet: 2010-2014 in Focus	19
NCSSF 2010-2014 Domestic Mandate Allocations	21-22
NCSSF 2010-2014 Foreign Mandate Allocations	23-24
CIC End-08 Portfolio Allocations	29
CIC Overseas Direct Ownership Stakes	29
Central Huijin Direct Ownership Stakes	29
China Jiayin Direct Ownership Stakes	30
CIC Balance Sheet: 2009 In Focus	31
CIC End-09 Mandate Allocations	32
CIC Balance Sheet: 2010-2011 In Focus	33
CIC 2010-2011 Mandate Allocations	34
CIC Balance Sheet: 2012-2014 In Focus	35
CIC 2012-2014 Mandate Allocations	36

equity investments, in our view, and will instead focus on improving the quality and liquidity of its fixed-income portfolio, a subject we explore later in this report.

As transfers of funds are the single largest component of CIC's income, reduced expectations there translate directly to a reduced forecast for the number of mandate managers CIC might need to employ, regardless of how aggressive its plans for portfolio extension might be. Last April, we suggested that CIC might require as many as 103 external managers by end-10. This year, we project that only 62 will be required by end-14. Our forecasts of which asset classes and geographies CIC will likely prefer as it builds out its portfolio, however, are relatively intact, with strong biases towards equities, emerging markets and higher-volatility investments such as private equity and property.

KEY FORECASTS

NCSSF: USD5.1bn
annual new funding

CIC: USD100bn new
funding in 2011, USD
150bn in 2013

NCSSF to focus on
overseas equity,
property mandates

CIC favors FI mandates
early, shifts later to
equities, property

NCSSF strongly favors
domestic equities,
Infrastructure

CIC likely to diversify
industry mix of direct
stakes quickly

The effects of the global market downturn on CIC's existing portfolio, while unwelcome, were marginal: more than half of CIC's assets are tied up in inherited domestic assets held at cost. Another 40% is, according to our estimates, held in cash and money market funds. That leaves less than 10% of the total portfolio exposed to market moves - a percentage diminished further by CIC's investment in at least one private equity fund, also held at cost. CIC has ample room to increase its exposure to higher-yielding foreign asset classes and, in our view, little fear of doing so once it is convinced the dangers of capital destruction have receded.

At NCSSF, by contrast, many of our projections for overseas activity remain relatively intact. The Fund will continue incrementally to increase its foreign exposures - particularly to non-Hong Kong equities and global property - through mandates. Its inflows of funds from central government appear unlikely to be disturbed by changes in China's global trade positions. Moreover, as NCSSF has taken a lead role in domestic infrastructure investment, continued funding remains a politically astute move, improving infrastructure while creating high-quality assets for the nation's future pension needs. As at CIC, we believe that NCSSF's appetite for higher-volatility investments is increasing, which is good news for existing and potential domestic mandate managers, a group which includes JV and foreign-invested asset managers.

Many foreign asset managers have made NCSSF and CIC key elements of their China plans. While most have reassessed their expectations following the 2008 market downturn, some have yet to process its full implications for China's SWFs. Our message is unambiguous: expect substantially less activity and more measured advances than any estimate formed last year might have predicted. The key pressures on CIC have changed, while NCSSF's pragmatic conservatism will more likely lead it to a domestic investing focus in the near term. What 2008's SWF predictions suggested might happen in the next two years will now likely take five or more to occur.

Moreover, in Z-Ben Advisors' blunt view, only a small handful of global asset managers should see SWFs as cornerstones of their China plans, a point we made last year and continue to believe.

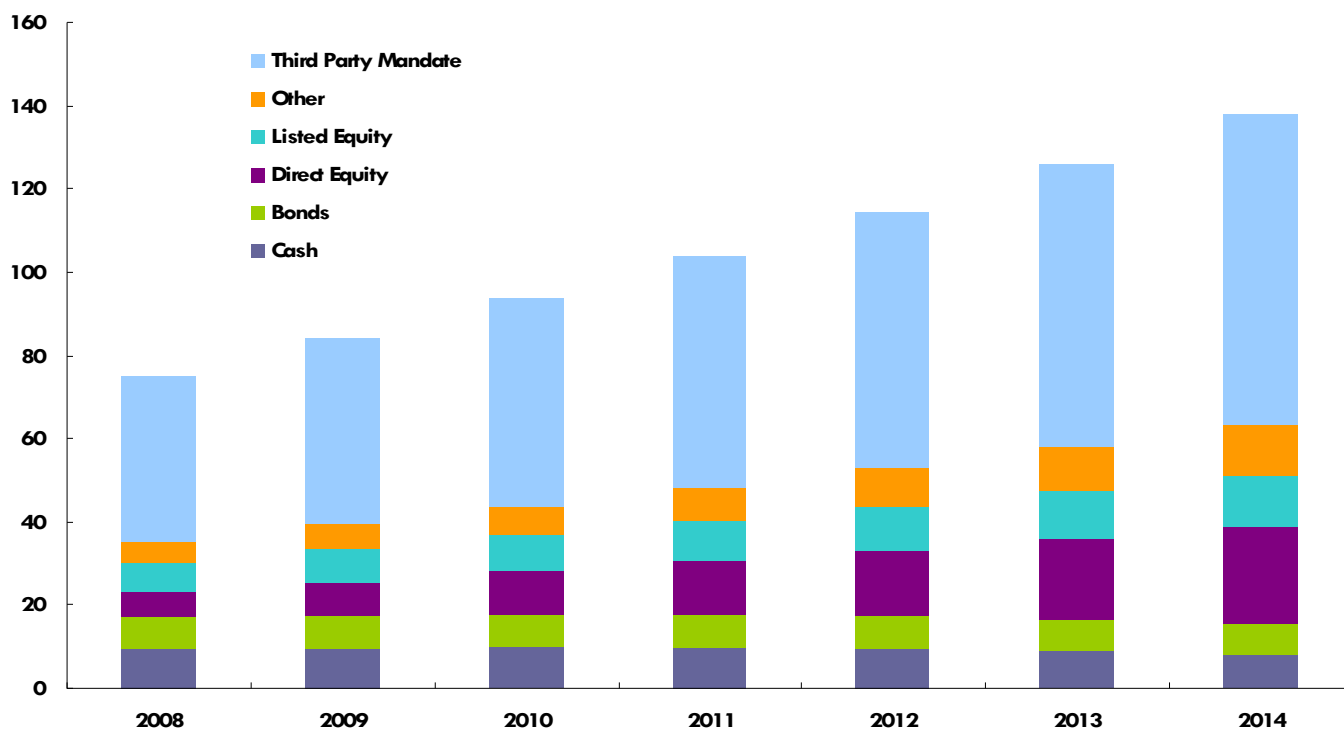
NCSSF Balance Sheet: 2008e-2014e (Table)

(USD Billions)

	2008	2009	2010	2011	2012	2013	2014
Income from Central Govt	5.1	5.1	5.1	5.1	5.1	5.1	5.1
Bank Deposits	9.6	9.8	9.9	9.7	9.5	9.0	8.3
Accrued Interest	0.4	0.4	0.4	0.3	0.3	0.2	0.1
Short Term Bonds	0.4	0.4	0.5	0.5	0.6	0.6	0.7
Long Term Bonds	7.0	7.2	7.2	7.2	7.0	6.7	6.2
Indexed Investment	0.6	0.7	0.7	0.8	0.9	1.0	1.1
Agency Bonds	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Equity Investment	6.2	8.2	10.5	13.1	16.1	19.5	23.4
Listed Stocks	7.1	7.9	8.7	9.6	10.5	11.4	12.4
Trust Investment	3.7	4.6	5.6	6.7	8.0	9.4	11.0
Third Party - Domestic	35.5	38.6	41.7	44.7	47.8	50.8	53.8
Third Party - International	4.5	6.3	8.4	10.9	13.7	17.0	20.7
TOTAL	75.1	84.1	93.6	103.7	114.4	125.8	137.9

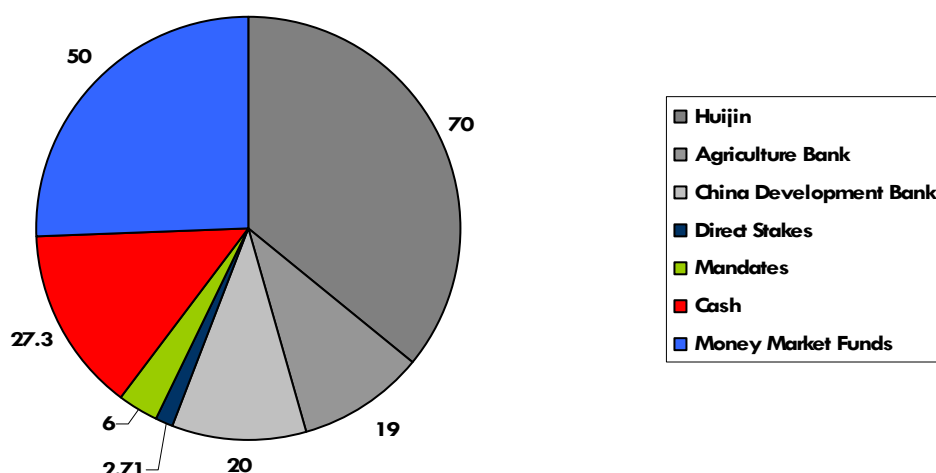
NCSSF Balance Sheet: 2008e-2014e (Chart)

(USD Billions)



Source: Z-BEN ADVISORS

CIC End-08 Portfolio Allocations (Estimated)



Source: Z-BEN ADVISORS

CIC Overseas Direct Ownership Stakes

	Cost	Current Value
Blackstone	3.00	0.60
China Railway Group	0.10	0.08
Morgan Stanley	5.58	1.84
Visa	0.20	0.19
TOTAL	8.88	2.71

Source: Z-BEN ADVISORS

Central Huijin Direct Ownership Stakes

	Cost	Stake
Bank of China	22.50	67.52%
China Construction Bank	13.64	48.22%
ICBC	15.00	35.40%
Import-Export Bank of China	5.00	n/a
China Jianyin Investment	1.00	100.00%
Everbright Bank	2.70	70.88%
Shenyin Wanguo Securities	0.31	37.31%
Guotai Jun'an Securities	0.13	21.28%
Galaxy Financial Holdings	0.67	78.57%
China Reinsurance Corp.	5.30	85.50%
New China Life	n/a	38.00%
<i>HK listed (at fair value)</i>	1.12	<75%
TOTAL	67.37	

Source: Z-BEN ADVISORS

SAFE: Not a Sovereign Wealth Fund, Still an Opportunity

Z-Ben Advisors does not consider the State Administration for Foreign Exchange (SAFE) to be a sovereign wealth fund. Few statements, among the many we have made about Chinese institutional investors, have attracted as much comment – or as many challenges – since last year’s edition of this report was published. Here we review the logic of our position for readers to consider and give, in outline, our expectations for the opportunities that SAFE may present for asset managers in 2009.

SAFE is not designed to include illiquid and volatile investments

SAFE was designed to be a fast-response currency management tool: one which ensured that highly-liquid and convertible investments could rapidly be deployed to meet the State’s FX needs. Its recent overseas purchases – among them minority stakes in banks and resource companies, along with a very illiquid private equity deal – all fit very poorly with that design. SAFE also plays a key role in managing the Renminbi’s foreign exchange rate. While most foreign governments accept that their peers will buy and sell their sovereign debt as an exchange management tool, they are unlikely to accept the danger that SAFE (or, indeed, similar investors) might also be tempted buy or sell company debt, shares, fund or index positions as part of that effort. Why, then, has SAFE strayed from its core currency management purpose? In Z-Ben Advisors’ view, it has been driven to such behavior because it has become vastly overfunded: with more than USD1.95tr under management in 1Q09, SAFE has little incentive to buy more sovereign debt, which neither reduces risk nor improves returns.

An overfunded SAFE is now using this excess capital to invest, in our view, primarily for higher returns. For many observers, this change in behavior has established SAFE as a new Chinese SWF. Such observers believe that SAFE will, in time, articulate a broader investment plan and incorporate its existing holdings into a diversified portfolio of the kind common to global SWFs, albeit with an outsize exposure to liquid, convertible sovereign debt and cash. We disagree. In fact, we strongly suspect that SAFE’s experiments with investing for higher return are likely to diminish, not increase, over time.

CIC was designed specifically to hold such investments

The foundation of our belief is a simple one: CIC was created specifically to prevent SAFE from engaging in this higher-return investing activity. China’s State Council, recognizing the likely political implications of sovereign wealth investing, ensured that such investment would not be made by the same body responsible for currency management. By creating a new, single-purpose SWF investor – CIC – they could transfer SAFE’s surplus into the hands of an institution designed to pass foreign regulatory tests, able to articulate a long-term investment plan and capable of attracting portfolio design and management talent who have strong relationships with global asset managers.

Although China’s forex reserves are no longer growing at anything like 2007-08’s pace, SAFE remains overfunded for its core purpose. Indeed, as recently as March, SAFE’s former chief and current vice-president of the National People’s Congress financial and economic affairs committee, Wu Xiaoling, publicly made the case for the size of the reserves to be reduced. In part, that

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