Z-BEN ADVISORS

China Investment Management: Market Update

February 2010

# Works Every Time

Economic commentary through the looking glass

Remember what you were reading about China one year ago? A huge and risky stimulus plan was dominating headlines, kept in prominence by an (allegedly) unexpected and outsize bank lending spree that vastly amplified the program's effects. The overall tone of offshore commentary was a mix of suspicion and wonderment. Surely declining global trade levels meant China had no cards to play? Surely a massive expansion of the lending base would lead immediately to asset bubbles and runaway inflation? And even if the Chinese government somehow managed to keep all of its plates in the air, the growth target of 8% was now, of course, impossible, so what would China be forced to do to accommodate the new reality of slow economic progress?

One year later, with GDP growth of 8.7% achieved, wonderment and suspicion continue to prevail. Surely the cooling steps the government will need to take must, at last, explode the property and stock bubbles? Surely attempts to prevent inflation will come at the costs of jobs, investments or GDP itself? And no matter how good at juggling China's leaders have become, surely some of these plates are doomed to fall?

We doubted the hand-wringers then, we doubt them now. But, while holding the economic commentariat's feet to the fire is a healthy and character-building exercise for all involved, it's neither our purpose nor our point. What we hope to draw readers' attention to is the astonishing and growth-supporting policy continuity that has governed life for China's FMCs throughout this long cycle of outrageous economic turbulence. CSRC has, throughout the past three years, been slowly ticking its way down a list of clear and well-communicated requirements for the FMCs it regulates. That list is nearing its end and what CSRC has accomplished will, in our view, create significant new opportunities for current and future participants in China's fund management industry.

## Industry Assets Under Management (RMB Billions)

| | 4Q09 | Growth | 3Q09 | Growth | 2Q09 | Growth | 1Q09 | Growth |
|---|---|---|---|---|---|---|---|---|
| Total Industry Assets | 2,676.1 | 19.1% | 2,247.7 | -2.4% | 2,302.8 | 14.7% | 2,007.0 | 3.5% |
| Total Domestic | 1,490.9 | 18.0% | 1,263.7 | -1.3% | 1,280.8 | 14.4% | 1,119.4 | 5.9% |
| Total Joint Venture | 1,185.1 | 20.4% | 984.0 | -3.7% | 1,021.9 | 15.1% | 887.6 | 0.7% |

SOURCE: Z-BEN ADVISORS

The process of bringing shareholding structures into line with regulations is now almost complete. Those FMCs which have finished re-engineering their share registries are, without exception, receiving fund launch permissions, pilot program access, regulatory blessing for Hong Kong expansion and, in our view, tacit support for any attempt they might make to bring in new capital – foreign or domestic – or even begin preliminary plans for a public listing. Those still struggling to complete their restructurings are denied all of the above and have no opportunity to grow their business again until CSRC is happy: exactly the punishment the regulator threatened when the shareholding compliance issue was first raised.

For FMCs whose shareholdings were already compliant, CSRC has improved both the frequency of launch approvals and the ease of obtaining them, allowing a record number of firms to launch products into 2009's equity market rise, widening or deepening their fund ranges and breaking new ground with innovative funds, ETF feeders and more. These steps have preserved industry

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AUM over one of the most volatile market cycles the industry has ever known. Moreover, CSRC has managed to preserve competitiveness through a period when deep-pocketed giants could easily have picked off struggling smaller rivals.

CSRC's track record isn't perfect. Mechanisms for slowing the revolving door of portfolio managers have yet to show themselves effective and, as 30 – yes, you read that correctly, thirty – firms will now complain, more could be done to allow new entrants into the industry. The latter problem, we suspect, will be solved faster than the former, although likely not as fast as the 30 complainants would like.

**Unprecedented predictability from regulators**

CSRC's real gift, over the past three years, has been to introduce substantially greater predictability to the Chinese fund industry at a time when it has been reduced in almost every other market. That predictability is what allows us to forecast with such confidence the effects of margin trading and index futures on FMCs, the impact of insurers as FMC owners, the opportunities remaining for style funds, the pros and cons of launch vs post-launch management emphasis and every other topic considered in this report. If our forward view has been so greatly improved by the regulator' acts, it's fair to ask: has yours?

# Monthly Research Highlights

## Seismic Activity: Insurers Set to Enter the Mutual Fund Business — Page 9

On December 30th, 2009, China's third-largest insurer, PICC (Group), announced plans to acquire a 48% majority stake in Dacheng FMC, China's seventh-largest fund house, marking a major regulatory breakthrough for Chinese insurers, which are, so far, barred from entering the mutual fund industry. Barring an outright and visible regulatory objection, Z-Ben Advisors expects other insurers to view PICC's action as a greenlight for them to start finding a way to add a FMC to their own conglomerates. We forecast that it is just a matter of time before more insurers' name appear on the list of owners for local fund houses. Given insurers' formidable asset base, the potential distribution they might bring and, not to mention, their ambition for mega financial-service conglomerates, we attempt to sketch the full consequences of their entry into the fund business.

## Margin Trading & Index Futures: New Year's Present — Page 12

New year, new decade and a long-anticipated New Year's present from the State Council: hedging. Margin trading and index futures were approved by the highest authority in China in January. In our view, CSRC will facilitate their launches in the next two to three months, starting with carefully regulated pilot stages. According to the current management rules, margin trading and index futures will serve primarily as hedging tools in the A-share market. Z-Ben Advisors believes it unfeasible for FMCs to incorporate them into innovative products in the market for now. In the long run, however regulators are determined to expand both programs. Right now, hedging is within sight, although unlikely to arrive soon. Our advice: start planning today.

## Rmb19m Annually: The Real Cost of Losing a Portfolio Manager — Page 15

The losses caused by replacing a PM are sobering. By our calculations, losses in performance and shares in issue cost funds that changed PMs once between 2007 and 2009 Rmb2.67bn in total AUM, on average, compared to those that kept the same PM throughout the period. Assuming a typical fee of 150bps per year, that's as much an average of Rmb13m in annual revenues that were lost the moment a PM walked out the door. For funds which endured multiple PM changes, the numbers are even worse: Rmb4bn in AUM foregone and Rmb19m in annual fees, on average. We analyze the factors that make PM replacement such an expensive move and demonstrate that the loss of a strong performer can cost twice as much (or more) than the departure of an average PM.

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