

# Z-BEN ADVISORS

## China Investment Management: Market Update

November 2009

### Target Rich Environment

It's that time of year again. All over the globe strategic plans are being vetted and budgets thoroughly worked over. The process is what the process is, but Z-Ben Advisors offers a word of caution: when it comes to the Chinese market, success will accrue to those foreign firms which plan (and allocate ample resources) accordingly for growth. At this very moment, more opportunities are being created for partnership, client acquisition, mandate management and market entry in China than we have seen in the past five years. Not to sound too melodramatic, but all of the activity taking place right now, and carrying through into next year, may offer the last best chance for foreign firms to plant a flag and really start to mix it up. Bluntly put, 2010 in Z-Ben Advisors' view, is going to be remembered by global asset managers with great nostalgia and fond memories of "you really had to be there". Here's why.

CIC, Z-Ben Advisors predicts, will run through its entire current USD110bn foreign investment budget by year-end followed by additional funding of USD200bn+ by Chinese New Year. Unlike 2007's allocation, roughly half of which was directed to domestic investments (read: Central Huijin), all of these new funds are expected to be deployed abroad for investment. For two years, we have been referring to CIC's initial USD1bn+ third party manager mandates as seed funding. Beginning in 2010, we expect to begin seeing CIC's real portfolio take shape, with a total value that will likely exceed USD550bn by end-12, although probably sooner. Think of CIC as an organization

Plan Accordingly:

Opportunities galore in China throughout 2010

More funding for CIC and sooner than you think

### Industry Assets Under Management (RMB Billions)

	3Q09	Growth	2Q09	Growth	1Q09	Growth	4Q08	Growth
Total Industry Assets	2,247.7	-2.4%	2,302.8	14.7%	2,007.0	3.5%	1,938.9	5.2%
Total Domestic	1,263.7	-1.3%	1,280.8	14.4%	1,119.4	5.9%	1,057.5	0.4%
Total Joint Venture	984.0	-3.7%	1,021.9	15.1%	887.6	0.7%	881.4	11.5%

SOURCE: Z-BEN ADVISORS

whose global equity investments will be roughly as large as Fidelity's equity mutual funds AUM in three years and you're probably being conservative. If you're not planning, in fine detail, how to manage some of those assets, start.

CIC may be the richest seam of gold appearing in China but they are far from the only institution worth mining. Their domestic progenitor, NCSSF, has lately been plotting ways and means of both increasing foreign exposure (up to 20% from the current 7%) and restructuring its investment department to allow faster reactions and a deeper understanding of alternative assets. While NCSSF's projected Rmb1tr (USD146bn) in assets is dwarfed by CIC's expected war chest, USD500m third party mandates are well worth winning. The number of such jackpots NCSSF will offer to global managers is all but guaranteed to increase next year.

Already past the Rmb trillion mark for AUM are China's group finance companies (GFCs), which are rapidly streamlining their idiosyncratic approaches to global investment. Contrary to widespread belief, every single GFC in China is or represents a fully-qualified foreign investor, with no meaningful limit on the proportion of total AUM that can be devoted to offshore assets. Z-Ben Advisors went to great lengths in our recent *China Executive Series 2009: Institutional Market Sizing Report* to show how GFCs have undoubtedly become key middlemen in arranging offshore fund and securities investments for domestic companies. Z-Ben Advisors now expects these institu-

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tions to follow the lead of sovereign wealth funds and insurers (another giant institutional group determined to make 2010 the year they more aggressively globalize their investments) when assessing whether and when foreign third-party mandates should be assigned. These bushes may be tangled, compared to the straight-gated RFI/RFP processes of China's SWFs, but well worth beating for the game they conceal (not to mention, far less competitive).

As memorable as 2010 promises to be for those seeking Chinese assets to manage, it will also deliver a large number of opportunities to buy into a healthy, established fund managers. There's China Merchants Securities which recently completed its divestiture of Boser, China Ocean Shipping Company (COSCO) is now auctioning of its 20% stake in ICBC Credit Suisse, and BNP Paribas is moving ever closer to finishing the sale - second time's a charm - of ABN Amro TEDA with either Fortis Haitong or SYWG BNP Paribas next in line for disposal. Lots of M&A activity is already on the books and yet there are upwards of another half-dozen properties Z-Ben Advisors expects could change hands in the coming 12 to 18-months, including 800-pound gorilla China AMC. For those foreign firms truly committed to the Chinese market our recommendation is simple: hit 'em hard, hit 'em fast and whatever you do don't necessarily balk at the price.

A land of possibilities, to be sure, but it is also a land where nothing comes easy or quick. There is no secret sauce. And for those firms which believe they have a short cut we say hogwash. The time has come for those truly committed foreign firms to leave ad hoc China strategies in the dustbin. Focus on what you want, allocate the resources and reap the rewards.

If you want direct access and a stake in a fund manager the time is now

Nothing will be quick or easy!

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## Monthly Research Highlights

### Q3 Industry Review: Drifting with the Markets

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After a bumpy quarter in the stock market, industry AUM declined slightly in Q3, by 2.5% to Rmb2.25tr. Weak stock market performance and continued outflows from seasoned products were the causes to blame. Fixed-income products, in particular, saw heavy asset losses again last quarter. Fund managers assumed a conservative and defensive stance in the quarter. Thus nothing really changed both in terms of manager behavior and industry trends. The only surprise came from the strong new product offerings of passive funds. With Rmb128.1bn pulled in, total shares-in-issue rose by 0.8%, despite the decline in AUM.

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### CIC's Direct Investments: The End of the Beginning

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CIC is gearing up for another USD200bn+ mandate, which Z-Ben Advisors expects to come early next year. This report examines a recent spate of dealmaking that suggests the sovereign wealth fund is keen to reduce its cash on hand. In the third quarter CIC has moved quickly to increase the number of direct, passive stakes it holds. CIC's raison d'être – overseas investment – is again coming to the fore. This is not the beginning of a new trend, but rather the resumption an older goal, temporarily derailed by deteriorating global markets throughout 2008 that forced CIC to pull back, especially after the results of several strategic investments made in financial firms. Now that market sentiment has broadly turned, we expect CIC to continue to be involved in a wide range of deals.

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### At Last!: SAFE Kick-Starts the QDII Program with New Quota Grants

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On 24 October, at long, long last, SAFE resumed granting quota to FMCs in the QDII queue, allowing the creation of the first new public offshore funds in more than 17 months. E-Fund (USD1bn in quota) and China Merchants FMC (USD500m) are expected to launch their debut QDII funds before the end of 2009. A further four FMCs are understood to have been selected as the next to be granted quota and we believe that SAFE may attempt to clear the entire backlog of QDII quota applications – 20 FMCs in total – by the end of 2010. We assess the funds that look likely to be next out of the starting gates and identify the first new opportunities for foreign asset managers to gain a QDII foothold.

**A New Distribution Model CSRC to Standardize Distribution Fees Page 18**

CSRC recently introduced a new regulation designed to rein in sales practices that have incentivized distributors to churn fund assets. Among other stipulations, the regulation calls for limiting all sales-related compensation between FMCs and sales institutions into a single contract, one solely based on share-retention basis. Additional incentives, including direct sales commissions, will be barred. Needless to say, CSRC is proposing nothing less than a complete overhaul of the current distribution system. The result: fund managers may have to shift their growth strategy away from the current new-product driven model to one that is based on organic growth with regular and robust inflows.

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**Identifying the Fittest: Small-tier Doesn't Always Mean Small-Time Page 21**

Surprising results from the small-tier segment of the funds industry resulted in two relatively unknown firms - New China and Golden Eagle - growing AUM by over 400% and over 100%, respectively. At the same time, two older small tier-firms - China Nature and Galaxy - have suffered a steady flow of redemptions and finished the first three quarters of the year down in both AUM and shares. Good performance, timely product launches and successful organic growth has helped turn two of the weakest fund manager's in terms of revenue profitable. In this update we take a look at the opportunities and challenges for the fund industry's smallest participants and draw out lesson's that can be applied for success universally.

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**Paradise Lost, Paradise Found: A story of Two Fund Managers Page 24**

The battle between arch-rivals Bank of Communications Schroders and ICBC Credit Suisse, which have jockeyed for position since their inception, has finally come to a head. At the end of 2008, both firms made widely different strategic decisions: Bank of Communications Schroders allocated a large amount of funds towards equity, while ICBC Credit Suisse focused on fixed income products to rapidly grow AUM. With the arrival of positive market sentiment in 2009, Bank of Communications Schroders' choice was vindicated (no without pain felt elsewhere) as the firm rapidly overtook ICBC Credit Suisse, resulting in a massive shift in competitive positioning. This report examines the underlying causes for this change, and draws several recommendations for firm-level strategy that managers would do well to consider in the future.

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**Passive-Aggressive Behavior: A Glut of CSI 300 Index Funds Page 27**

If 2008 was the year of the fixed-income fund, 2009 has undoubtedly been the year of the CSI 300 index fund. Fifteen such funds now clutter the landscape: one CSI 300 tracker for every four fund houses, with the promise of more to come. Their growing population begs two obvious questions: given the rarity with which US and European active managers set foot on in passive territory, why are so many Chinese FMCs jumping in, and why are so many landing on the same spot? We assess the drivers of demand and supply that have created one of the most interesting - and fastest-growing - segments of the Chinese mutual funds industry.

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**JV REVIEW: A Case for Product Diversity Page 21**

Over the past two years, A number of leading Sino-foreign managers witnessed considerable volatility in AUM as markets gyrated wildly, portfolio manager came and went and historic performance proved difficult to repeat. One firm, Full Goal, may be bucking this trend through a rebalancing of its product mix away from equity funds. The firm will be heading into 2010 and beyond with a well balanced-offering, including equity, bond, index funds, several of which embedded with small, but critical, innovations that easily differentiate its products. If the markets stabilize in 2010, as Z-Ben Advisors expects to be the case, Full Goal is very well positioned to capitalize on any market movements - an enviable competitive position.

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**Corporate Action: Search for Senior Executives, Globally**

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The number of corporate actions decreased last month but the implications of each event may not. First, two managers believed to be preparing for their QDII products redeemed their in-house fund investments, perhaps to some support to their forthcoming product launch. There were fewer portfolio manager resignations, while the number of total hiring increased, with more firms recruiting globally. Hua'an, for its part, is recruiting for the firm's new General Manager position globally, possibly to turn around its international business. China International saw significant changes in its senior executive team, with a deputy GM resigning and the GM reported to be close behind.

**Monthly Performance Review: A Small Recovery**

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Supported by improving economic data and corporate earnings, stock markets recouped earlier losses in October with the CSI 300 Index gaining 9.2%. A raft of GEM IPOs did not shake investors' confidence and fund managers are putting cash to work quickly. Only not quickly enough. Only 10% of actively-managed products delivered excess return for the month. Performance of QDII products lagged behind their domestic peers but still finish the month as the only class registering net return for the last three months. On the other hand, competition for the champion of 2009 is getting heated, as most of the top ranking funds are running with equity exposure close to 90%.

## Analytical Quick Hits

**A 20% Stake in ICBC Credit Suisse to Be Sold.** COSCO is selling its 20% stake in ICBC Credit Suisse for Rmb258.2m. Since ICBC owns the preemptive right, and only domestic commercial banks having experience in asset management are permitted to buy the stake, it's probably that ICBC purchase the stake at last.

**AXA to Exit Investment in Chinese Insurer.** AXA is reported to be looking to raise around USD1bn from the sale of its 15.6% stake in Taikang Life Insurance. AXA also holds a 51% stake in an insurance JV with China Minmetals Corp, founded in 1999. AXA could be feeling pressure to sell the stake because of possible regulatory concern over its investment in two separate life insurers.

**China Pacific Insurance to Set up a HK Asset Management Subsidiary.** China Pacific Insurance Group received CIRC approval to launch an asset management firm in with Pacific Asset Management Co. The Group and its domestic AMC will hold 49% and 51% stakes, and has HKD50m in registered capital.

**New Regulations on Fund Sales Fee.** CSRC recently proposed regulations on open-end funds' sales fees. The new rules encourage a back-end charge model, guide long-term investment and introduce a redemption fee charge for short-term transactions to restrict their usage and regulate trailing commission.

**New Rules on Insurance Companies' Bond Investment.** CIRC amended the regulation on insurance companies' bond investment last month. The cap on insurers' corporate bond investment has been raised from 30% to 40% of gross assets at the end of the previous quarter. Bonds that insurers invest in must be rated BBB and above.

**New QDII License Approved.** Changxin FMC was granted a QDII license recently, becoming the 30<sup>th</sup> fund management company to join the QDII program. According to the people from Changxin, their first QDII product may mainly focus on the U.S. market.

**New QDII Quota Granted.** E-Fund, which was approved by CSRC to launch a QDII product last year, obtained USD1bn in quota from SAFE. The new QDII quota should allow the company to launch its first open-end overseas mutual fund. China Merchants FMC also obtained USD500m in QDII quota.

**One More QFII License Issued.** CSRC granted a QFII license to Ashmore Investment Management Limited. Its domestic custodian bank is ICBC. So far, a total of 88 QFII license have been granted. According to SAFE disclosures, at the end of September, USD15.72bn has been granted to 78 firms. The latest was DWS Investments, with USD200m QFII quota granted on September 2009.

**NCSSF Expected to Reach Rmb1tr in 2010.** At the end of June, NCSSF had total AUM of Rmb660bn, with around 10% investment return. According to Mr. Dai Xianglong, Director-General of NCSSF, the Fund is expected to grow to Rmb750bn by the end of the year and Rmb1tr next year. About Rmb100bn may be invested in PE and VC in 2010.

**ChiNext Opened on October 30.** ChiNext (GEM) opened for trading on October 30. First batch of 28 companies were listed collectively. After the jump on the first day, the total market value of ChiNext reached Rmb25bn, and the average P/E was about 78X. All listed enterprises are requested to report intended use of the collected capital within 60 days after being listed on ChiNext.

**Penghua Preparing Passive Products.** Penghua was approved to develop ETF products based on Shanghai-based index and index fund based on CSI 500 Index. The company also signed a series of indices using agreements with MSCI BARRA, and plans to launch a series of global ETF products.

**New Bond Fund Approved.** CSRC resumed the approval of bond funds after three-months hiatus to Morgan Stanley Huaxin. It's the second new fund from Morgan Stanley Huaxin in less than three months. The new product will probably be launched in November.

## Analytical Quick Hits

**Dacheng Failed to Raise Enough Capital for MCSA.** After two months' intensive offering of MCSA products, end demand decreased visibly. Dacheng -Guangdong Development Bank Flex Allocation No. 1 MCSA product failed to reach Rmb50m in a one-month subscription period, becoming the first MCSA product to fail.

**China AMC (HK) Hired as Sub-Advisor by Taiwan Firm.** China AMC HK subsidiary signed an exclusive deal with Taiwan Cathay Securities Investment Trust to advise Cathay's upcoming Greater China fund. China AMC's Beijing head office will not play an official role in the fund.

**Hua'an Hiring New GM in Global Market.** Hua'an released a public recruiting notice on October 30 for finding a new GM. Mr. Yu Miaogen still acts as the GM during the recruitment. After that, Mr. Yu will focus on the job of Chairman. In 2008, Full Goal also had public recruitment of GM.

**Former Senior Officer of Lombarda China Moves to Private Fund.** Ian Midgley, former Deputy GM and CIO of Lombarda China, recently set up a private fund management company of his own, called Xin Zhi Investment Management. The new company will focus on the secondary market.

**Hopu's First Overseas Investment.** Hopu, the Beijing-based private equity fund, has acquired a 4.9% stake in Lippo Karawaci, an Indonesian-listed real estate and hospital developer. Hopu is planning to branch out into fast-growing regional economies such as Vietnam and Malaysia.

**CIC Invested Again in Natural Resources.** CIC plans to invest up to USD1.2bn in two Mongolia-focused natural resources companies - Iron Mining International and SouthGobi Energy Resources. Previously, CIC invested in other resources companies from Canada, Russia, Kazakhstan, and Indonesia.

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

DOMESTIC FUND MANAGERS				SINO-FOREIGN FUND MANAGERS			
	AUM				AUM		
	RMB Bill	Share	RANK		RMB Bill	Share	RANK
Baoying	10.86	0.48%	42	ABC-CA	14.02	0.62%	37
Bosera	138.33	6.15%	2	ABN Amro TEDA	25.96	1.15%	30
Changxin	22.39	1.00%	32	AEGON-Industrial	37.55	1.67%	24
China AMC	232.21	10.33%	1	AIG-Huatai	19.28	0.86%	33
China Nature	5.01	0.22%	52	AXA SPDB	1.64	0.07%	60
China Post & Capital	37.67	1.68%	23	Bank of Communications Schroders	67.99	3.02%	9
China Universal	56.10	2.50%	12	BOC <sup>1</sup>	25.28	1.12%	31
Dacheng	82.69	3.68%	7	CCB Principal	32.43	1.44%	27
E-Fund	127.88	5.69%	3	Changsheng <sup>2</sup>	40.90	1.82%	21
First Trust	12.40	0.55%	39	China International <sup>1</sup>	57.43	2.56%	11
Galaxy	12.07	0.54%	41	China Merchants <sup>1</sup>	31.12	1.38%	28
Golden Eagle	4.38	0.20%	54	CITIC-Prudential	12.71	0.57%	38
Great Wall	40.13	1.79%	22	Everbright Pramerica	33.63	1.50%	26
Guangfa	91.08	4.05%	6	First State Cinda <sup>1</sup>	7.69	0.34%	47
Guotai	41.68	1.85%	20	Fortis Haitong	35.43	1.58%	25
Harfor	5.26	0.23%	51	Fortune SGAM	46.77	2.08%	18
Hua'an	76.42	3.40%	8	Franklin Templeton Sealand	17.50	0.78%	35
Huashang	9.95	0.44%	43	Full Goal <sup>2</sup>	53.69	2.39%	14
Lion	42.62	1.90%	19	GTJA Allianz	9.45	0.42%	45
New China	5.49	0.24%	50	Harvest <sup>2</sup>	127.62	5.68%	4
Orient	9.49	0.42%	44	HSBC Jintrust	8.06	0.36%	46
Soochow	6.50	0.29%	49	ICBC Credit Suisse	46.99	2.09%	17
Southern	109.94	4.89%	5	INVESCO Great Wall	49.89	2.22%	16
Tianhong	3.56	0.16%	56	KBC-Goldstate	3.85	0.17%	55
Wanjia	14.25	0.63%	36	Lombarda China	3.41	0.15%	57
Yimin	6.79	0.30%	48	Lord Abbett China	4.78	0.21%	53
Yinhua	58.57	2.61%	10	Minsheng Royal	2.05	0.09%	59
<b>TOTAL</b>	<b>1,263.7</b>	<b>56.2%</b>		Morgan Stanley Huaxin	2.57	0.11%	58
				Penghua <sup>2</sup>	51.84	2.31%	15
				Rongtong <sup>2</sup>	53.71	2.39%	13
				SYWG BNP Paribas	12.28	0.55%	40
				UBS SDIC	27.90	1.24%	29
				Zhonghai <sup>2</sup>	18.61	0.83%	34
				<b>TOTAL</b>	<b>984.0</b>	<b>43.8%</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.