

China Cross-Border Report

Keys to the Kingdom

Future historians of China's fund industry (be they starving graduate students or eccentric fund consultants) will surely regard 2007-2009 as an anomalous period. The global financial crisis rattled nerves worldwide, including those of mainland regulators who, up until then, had no reason to craft financial policy in direct response to global events. During much of this period, however, CSRC and SAFE put overseas programs largely on hold. Now, at the beginning of 2010, the regulatory push has resumed in earnest.

This has not been accompanied by a return of underlying demand, however. Retail investors first purchased QDII funds at what was arguably the height of a global asset cycle, and were burned by the ensuing tumble. At present, they consider all overseas funds as one asset class, regardless of the actual investment targets of fund portfolios. Likewise, overseas buyers have become extremely interested in a still-resilient China, even if available QFII funds are demonstrating decidedly lackluster performance, compared with domestic equity funds. Overcoming these and other challenges will be a matter of further integration – a process that CSRC and SAFE seem more and more committed to.

QDII Key Developments

It isn't often in China that regulators' intentions are so eminently clear. CSRC and SAFE appear committed to gradual, predictable levels of quota granting for the QDII program in nearly every channel.

This is particularly evident in the variety of avenues that QDII is now being used for, such as expanded MCSA accounts, as well as quota awarded to a larger variety of institutions, such as insurers and brokerages.

QFII Key Developments

Quota and license grants in 1Q10 slowed, though this was primarily the expected result of seasonality (or the regulatory equivalent thereof) given the Spring Festival and National People's Congress meetings.

This will likely turn out to be an outlier, as QFII awards are expected to pick up pace while remaining predictable and stable overall. Whether more competition will improve performance, however, is an open question.

QDII Fund Developments

For the first time in recent memory, numerous QDII products are on bank shelves, testing what is no doubt tepid demand. The results so far are not encouraging for AUM-hungry fund managers.

The segment has finally begun to see more innovative products offering real diversification, however, and if recent improvements to performance are sustained, QDII's attractiveness for retail investors may improve significantly.

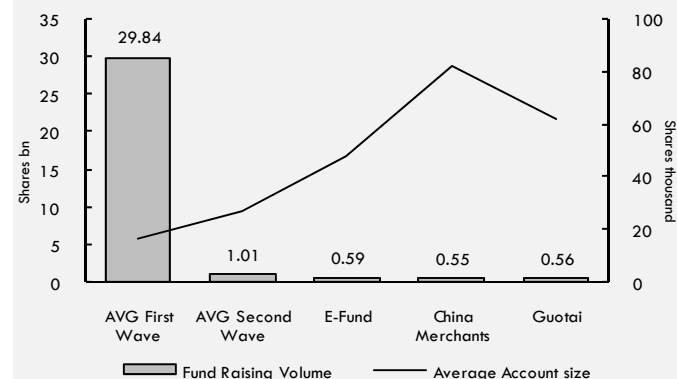
Institutional Key Developments

Incremental shifts in QDII and QFII stand in stark contrast to rather significant changes now being witnessed at the institutional cross border level. Major investors, including CIC and NCSSF, are set to move aggressively overseas.

SAFE's priorities now appear clear: find reliable methods for scalable diversification, while allowing a small amount of funds to be directed towards potentially higher earning, alternative investments.

Frontloading

QDII product fundraising results since inception



SOURCE: Wind, Z-Ben Advisors

Old Boy's Club

List of NCSSF's new mandate advisors

PORTFOLIO	MANDATED MANAGER
Chinese Equities Listed Overseas	Schroders Investment Management
	Bosera Asset Management
	Baring Asset Management
Asia Pacific ex-Japan Equity	Martin Currie Investment Management
	J.P. Morgan Asset Management
	Principal Global Investors
Emerging Market Equity	Batterymarch Financial Management
	Morgan Stanley Investment Management
	Schroders Investment Management
Europe Equity	Newton Investment Management
	Fidelity Investments
Global Equity	Prudential Group
	Wellington Management

SOURCE: NCSSF, Z-Ben Advisors

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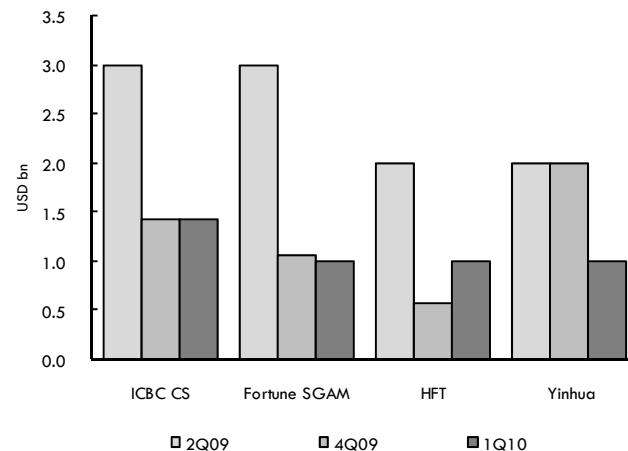
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QDII Program: Q1's key developments

Exhibit 2.02: Use It or Lose It

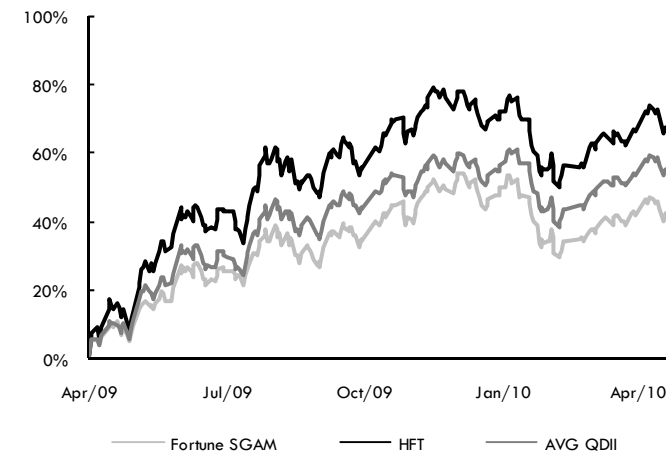
Total available quota, based on SAFE figures



- According to official figures, SAFE has continued to readjust available quotas from some FMCs but, for the first time, HFT saw SAFE reissuing previously reduced quota, showing the adjustments are not just in one direction. Admittedly, we see no rhyme or reason behind these adjustments, with only a few data points available so far.
- The adjustments only show that SAFE is increasingly watchful of how quota is being used but Z-Ben Advisors would refrain from jumping to the conclusion that the foreign-exchange regulator has adopted a “use it or lose it” attitude to excess quota.
- ICBC-Credit Suisse, HFT and Fortune SGAM have deployed their excess quotas through the segregated account platform for selected clients. Therefore, we are of the opinion that regulators are increasingly flexible on how quota is being used for qualified clients.

Exhibit 2.03: Variety, the Spice of Life

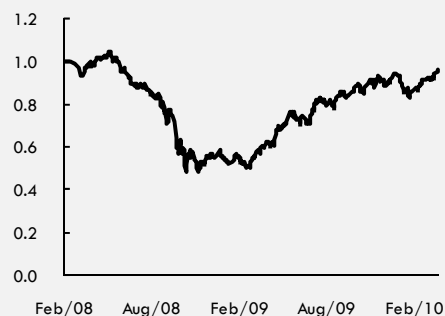
Return comparison of the best and worst QDIIs, on 12-months basis



- After nearly three years since the program's inception, performance of QDII funds has begun to diverge, and the spread of performance between the best and worst QDII funds widened significantly in Q1 although their overseas investment targets are relatively similar.
- HFT Enhanced China Oversea Fund consistently outperformed its peers while the reverse is true for Fortune SGAM China Overseas Growth Fund. Performance of the remaining seven funds remain highly volatile on a q-to-q basis, especially with China International Asia Pacific Advantage Fund moving up and down the rankings rather quickly and unpredictably.
- Historically speaking, strong and consistent outperformance doesn't automatically translate into significant inflows. Therefore, FMCs should keep robust marketing campaigns, such as strong dividend payments and secondary offerings, at the ready for the right time to start selling better returns.

QDII: New Product Launch – Special Focus: The first, second QDII product

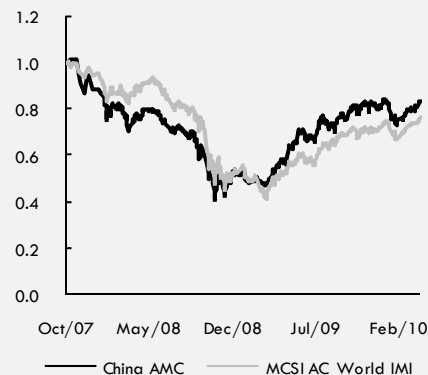
Exhibit 2.14: ICBC Credit Suisse Maiden Product Performance



Firm Level

- ICBC Credit Suisse will task Mr. You Linfeng, PM of the firm's maiden QDII product, with stewardship of the second. We therefore suspect performance trends to be broadly in line with this already established record.
- Performance for this fund was not unlike other first-wave QDII products, which were launched at what was arguably the peak of global equity sentiment.
- Fortunately, investors interested in ICBC Credit Suisse Global Enhanced Equity Fund will have a very good idea of what they are getting into: Mr. You's record, in the past several months, has been considerably better than the QDII average.

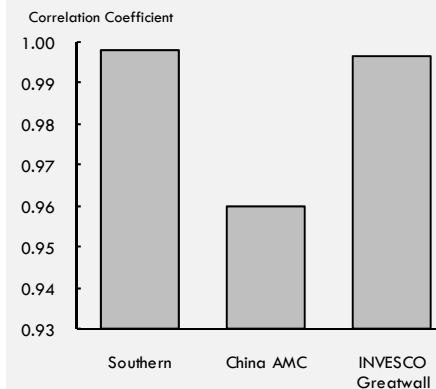
Exhibit 2.15: China AMC Maiden Product Performance



Investment Level

- ICBC Credit Suisse's Global Enhanced Equity Fund will utilize MSCI World Index as a benchmark. The index will provide considerable flexibility for precisely how new funds are allocated.
- This index has already been employed by China AMC Global Enhanced Equity Fund. Presumably, ICBC Credit Suisse did not draw any inspiration at all from their rival.
- Hopefully they will draw lessons for investment techniques: it took China AMC a full year to match their benchmark, presumably the result of an unfamiliar operating environment, with considerably more extensive selections.

Exhibit 2.16: Multiple Products, One PM



Operational Level

- Since ICBC Credit Suisse is using a new benchmark for its new fund, there is an argument that Mr. You Linfeng will manage the fund in a completely different style, and generate sufficiently uncorrelated returns to satisfy exceptionally discriminating investors.
- Analysis of other multiple fund PMs, however, suggests that in these instances, performance is typically highly correlated, with little differentiation between the actual investments and returns.
- Though we prefer to be optimistic, we doubt that there will be significant distinction between these two funds after the second launches.

Appendix III: Quarterly Factsheet

Bank of Communications Schroders Global Value Fund

Fund Return

1Q10	-3.88%
1YR	63.43%
ITD	61.14%

Basics

(As of 3/31/2010)

	1Q10	Δ Q-Q
AUM (Mil Rmb)	387	-3.45%
Shares (Mil)	256	0.47%
NAV	1.5100	

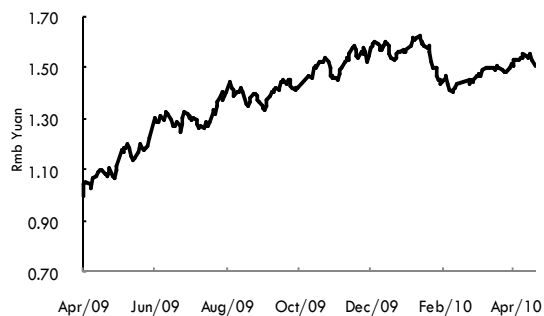
Benchmark: 70% S&P Global Large Mid Cap Index+ 30% Hang Seng Index

Portfolio Manager: Mr. Zheng Weihui

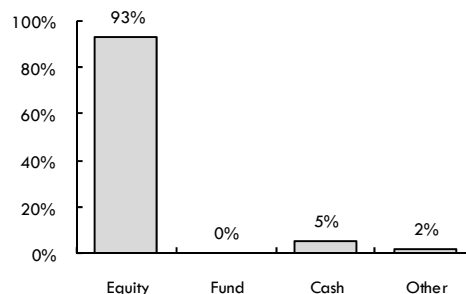
Foreign Advisor: Schroder Investment Management Limited

Advisory Team: Ms. Virginie Maisonneuve

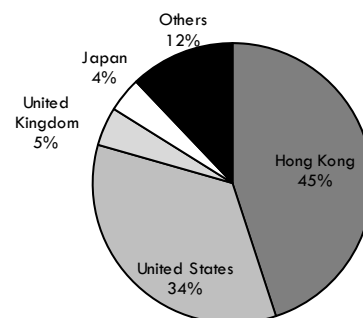
NAV Analysis



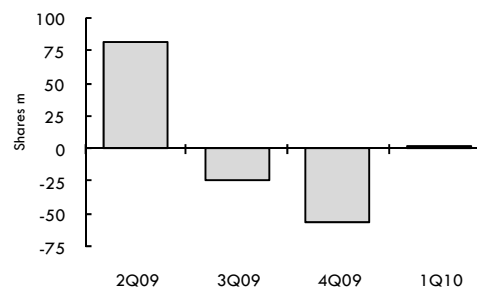
Asset Allocation



Geographic Allocation



Fund Flow Analysis



Product Assessment

- Quarterly returns for Bank of Communications Schroders Global Enhanced Value Fund turned negative in 1Q10, placing the fund among the worst QDII performers during the period
- The manager remained aggressive with a high equity exposure level of 93%, the same as the last several quarters, and moved 200bps from cash to other assets, slightly increasing total risk to the portfolio.
- Geographic allocation changed little during 1Q10, with only 300bps of assets being shifted from Hong Kong to other developed markets, such as the United States, Japan, and the UK. Equity investment was also further diversified as the top-ten holdings occupied 21.39% of total AUM, which was more than 24% in 4Q09. Even more new exposure was added to IT companies, though in smaller incremental amounts.
- Fund flow was relatively stable this quarter, with 1m total net share purchases into the fund. Investors seemed patient towards volatility, likely due to the sound performance record of the product.
- The manager will implement a more balanced and flexible investment strategy in the coming months by allocating more assets to developed markets and focus on undervalued companies concerned with domestic consumption, IT service, and renewable energy.

Top 10 Equity/Fund Positions

Name	Market Value (Mil Rmb)	Portfolio Allocation
ICBC	12.40	3.21%
Tencent Holdings	11.85	3.07%
China CITIC Bank	10.85	2.81%
China Merchants Bank	8.10	2.10%
Ctrip.com	7.49	1.94%
China Life	6.87	1.78%
Orange Sky Golden Harvest Entertainment	6.61	1.71%
Focus Media	6.23	1.61%
Giant Interactive	6.23	1.61%
BOC	6.01	1.55%

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