China: The World’s Best Opportunity for Asset Managers?

Citi OpenInvestor®
Since ancient times, the Chinese have referred to their country as “Zhong Guo,” Mandarin for “Middle Kingdom.” Today, the meaning is quite appropriate, as turmoil in Europe and anemic growth forecasts for other developed markets leave many looking to China as the world’s central growth engine.

Yet, after a roaring start in the first decade of the millennia, the Chinese asset management industry has seen its growth stall, even as the local banking sector mostly avoided the issues that plagued developed markets during the financial crisis. While GDP growth has continued to grow at 8% in recent years, funds under management today remain some 30% below 2007 levels. At the same time, the number of funds has almost tripled, and no fewer than 71 fund management companies are competing fiercely for investors, many of whom prove quite fickle. Meanwhile, declining capital markets have reduced asset values, further straining the profitability of managed assets.

Citi is proud to partner with Z-Ben Advisors, an independent consultant, in closely examining the unique features of the Chinese asset management landscape and its prospects in coming years. Based in Shanghai, Z-Ben is focused solely on producing research on China, and as such, is well placed to explore the finer points of the local market.

Key findings of Z-Ben’s research show that while China’s asset management industry has taken a brief pause in terms of mutual fund growth, other sectors have flowered. Assets in private funds have tripled in less than two years’ time; monthly launches of short-term-oriented bank wealth management products number in the thousands; and on the institutional side, sovereign and retirement funds are growing with breakneck speed.

The future of asset management in China remains bright, Z-Ben notes, as the shift toward a financial industry more reminiscent of developed markets is under way. The pension and insurance sectors offer tremendous promise, given the need to rise to the challenge of providing for an aging population. Continued liberalization has increased the size and number of opportunities available to domestic and foreign players, as witnessed by the recent expansion of the Qualified Foreign Institutional Investor (QFII) program.

The long-term prospects of China are almost universally extolled, even if challenges remain in the short run. As a major provider of services to the investment community, by sponsoring this research Citi hopes to provide industry participants with fresh insights, making a complex market easier to navigate.

Neeraj Sahai, CEO
Citi Securities and Fund Services
Foreword: Z-Ben

You’ll never hear the word “easy” when describing the Chinese asset management industry. Still, the rewards for preparedness and effort can be at a scale and speed unmatched by any other country. For almost ten years, foreign firms have been the key beneficiaries of China’s financial renaissance, winning market share, mandates and positions as trusted partners to some of the world’s largest and fastest-growing financial firms.

Z-Ben Advisors’ research, as detailed in this report, finds that there has never been a better time for international firms to execute entry and expansion plans in China. However, preparedness and hard work will be required as never before. The relative ease of gathering assets and winning institutional mandates in the past has waned with success in the future accruing predominantly to those foreign asset managers having the skill and capabilities to exploit an increasingly unique set of opportunities.

That change isn’t solely due to market conditions. Regulators have made big changes to market development programs, allowing foreign participants ever-greater scope and flexibility in their operations. QFII, RQFII and QDII – China’s formal programs for cross-border investment – have all been expanded dramatically over the past year.

In addition, programs to encourage pension savings, insurance investment and cooperation between financial firms have all been boosted, providing foreign asset management companies new and potentially material institutional business prospects. Finally, overseas financial firms can now complement their representative offices with wholly foreign-owned enterprises (WFOEs), 100%-owned businesses offering enormous operational flexibility and the opportunity to take a direct role in China’s ongoing internationalization of capital flows.

The balance of risk and reward has changed in China as a result of these developments. Nevertheless, domestic markets can no longer be counted on to shower AUM on start-ups and speculative fund launches. Better targeting – of time, of personnel, of research and of strategic goals – is now the prerequisite for success in China.

That new environment has forced a hard truth on many foreign asset managers: China efforts can no longer be managed by remote control. The market is now too complex to be addressed by flying in C-suite occupants, senior sales and business development executives for periodic visits. To take full advantage of the rewards China offers, constant, detailed, on-the-ground research and monitoring are required. The payoff for that work, of course, remains unmatched growth.

Sincerely,

Peter L. Alexander
Managing Director
Z-Ben Advisors Limited
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Executive Summary

Key Findings:
Asset Management Overview
• Substantial growth in the mutual fund market should be expected. We forecast at least RMB6.8tr (USD1tr) in total assets by 2015, up from RMB2.3tr (USD360bn) today. Gains in equity markets and net inflows from new investors will be the cause. Even slight policy changes are set to increase retail fund participation.

• While AUM may improve, advancements in advice have yet to materialize. Domestic banks do not offer post-sale servicing, and with fund managers lacking in this area, investor loyalty is minimal.

• Personnel turnover remains a key concern. Competition from other segments – brokerages, private fund and insurance asset managers – has meant a slow but consistent outflow of the most skilled fund managers, with obvious consequences for performance, brand strength and reputation.

Institutional Investing
• Asset diversification needs will drive institutional investors into offshore markets, ready or not. The search for higher returns and lower correlations will lead institutions toward PE, equities and alts. Finding the right match for each new client, however, will prove extremely challenging.

• China’s institutional market will become much broader over the next decade as a large number of smaller players, including insurers and pensions, make their debuts. Targeting these will require a much more active approach, as few have experience dealing with global managers or markets.
• Insurers will be the key growth area among institutional investors. They are the stop-gaps for an incomplete and underfunded national pension system. Pension-linked policies are the major driver of their offshore and onshore investments.

Distribution Dynamics
• Although China has an open architecture for financial product sales, banks are by far the dominant channel and will remain so for the foreseeable future. Expect only narrow specialists to emerge as a distribution alternative in the next decade.

• In China, products are bought, not sold. Worse, buy-and-hold strategies are uncommon and considered unwise. As a result, marketing and reputation management are significantly less effective than in the West. Investors will remain extremely fickle and quick to churn.

• Foreign banks will become fund distributors in the near future, although most will have difficulty breaking into the retail market. To facilitate partnerships with fund managers, foreign banks will first need to attract much larger numbers of HNWIs, requiring considerable investment in relationship development.

Expanding Internationally
• Greater China will soon become its own distinct asset class, separate from “BRICS” or emerging markets. Global investment portfolios will shift to gain more exposure to this market. Chinese managers – with government support – enjoy the best position to exploit this change.

• Offshore subsidiaries of Chinese financial firms should be much higher on their global competitors’ radar screens. No foreign firm will be able to equal their access to the domestic Chinese market in the next ten years. Expect them to expand quickly from Hong Kong to control large portions of the Greater China investment market.

• Demand for foreign investment options, motivated by an acute need for diversification, is running far ahead of regulators’ control. Near-permanent Chinese interest in real estate, private equity and absolute returns should be assumed. Regulators will move quickly to create manageable channels for this money to reach qualified managers.

“Although China has an open architecture for financial product sales, banks are by far the dominant channel and will remain so for the foreseeable future.”
Asset Management Overview

China’s asset management industry – the public portion of it, at least – has been relatively stagnant over the past four years. Following the run-up in equities seen in 2007, even the most successful firms have struggled to simply maintain market share. There are numerous reasons for this state of affairs:

- Losses in equity markets over the period have made it very difficult for fund managers to maintain performance, and have limited general interest in the financial services industry.

- Insufficient product diversification among nearly all segments, and within all product categories, has meant that few firms have individually distinguished offerings.

- Investors have extremely limited loyalty for any given firm or product, and as a result, building client relationships is very difficult.

- Domestic distribution architecture and the dominance of banks as the primary sale channel has been a persistent problem, which has yet to lead to the creation of alternative outlets.

In China, funds are bought, not sold, and this has led to a situation whereby a limited number of investors are constantly churning their fund holdings between a handful of managers and products.

“...the future of asset management in China is bright, and the shift toward a financial industry more reminiscent of developed markets has already started.”
This setup means that China’s asset management industry has not managed to keep pace with broader economic growth: Fund managers would like nothing more than to see an 8% rise in inflows (China’s average GDP growth over the last several years) from new or existing investors. The disconnect between Chinese savers becoming wealthier, but not putting their money to work, means that every year long-term AUM growth projections are revised upward. As a result, there is keen interest from outside the industry both from foreign financial firms interested in establishing a foothold, and from large domestic corporations that simply want to hold a stake as passive investors. Some potential entrants have been deterred by an erosion in profitability across the fund management industry, with several of the smallest firms now consistently in the red.

However, the future of asset management in China is bright, and the shift toward a financial industry more reminiscent of developed markets has already started. Bearing this in mind, public fund (i.e., mutual fund) AUM is projected to reach RMB6.8tr (USD1tr)* by 2015. Considerable policy support is still required, but regulators, despite having different priorities, are keen to provide a stable environment for investors and to support more big-picture economic growth. The need for growth policies is compounded by less-than-ideal demographic trends, which will lead to considerable pressure on the pension system. The United Nations estimates that as much as one third of the Chinese population will be aged 65 or older by 2050. Lastly, emerging cross-border programs will translate into opportunities for international firms, but not necessarily along the avenues that most observers now expect.

Chinese Mutual Funds
The first mutual fund companies debuted in the late 1990s but did not realize significant amounts of inflows until 2004. Chinese investors were gradually moving into equities, and while outside observers likened this era to a Macanese casino, overall participation in the financial industry was relatively limited.

The run-up in equity prices in 2006 led to an explosion of interest in all segments. There was near universal interest in all things financial that permeated major cities. Of course, such zeal proved to be as sure a sign of a bubble as any, and the subsequent implosion of prices in 2007 left a mark on the financial industry that has yet to be removed. The global financial crisis in 2008 did little to boost confidence, even though many felt that China was, and still is, relatively immune from the underlying causes of the crisis.

All of this has led to a situation where the amount of wealth that is actually being put to work is well below what it would be, if the financial services industry had a more thorough

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*USD figures are based on exchange rates as of June, 2012. All estimates in this report are based on expected growth in assets in RMB figures. USD figures are provided as a reference only, and not intended to imply any change in exchange rates.
coverage of the country’s investors, particularly retail and mass affluent. The pace of policy development has had an impact as well. The China Securities Regulatory Commission (CSRC) is one of three major regulators for the financial services industry, but has traditionally been the least influential in creating the overall policy framework; its interests may at times have been put on the back burner in favor of maintaining stable national growth. China, for all of its success in the past several years, remains a developing country. The other two key regulators are the China Insurance Regulatory Commission (CIRC) and China Banking Regulatory Commission (CBRC), which have traditionally had significantly more pull than securities regulators. This is hardly surprising, given the importance of the banking system to the health of the broader economy.

Nonetheless, tides appear to be shifting, and over the past two years CSRC has taken an extremely aggressive stance on bringing China’s securities markets in line with global standards. This will not only impact equity players but also fund managers, which also fall under CSRC’s purview. Much of this has been motivated by Beijing’s recent push to internationalize its currency. While overall stability remains a top priority, convincing other countries to utilize the RMB to settle trades requires a much more complex institutional framework than currently exists. Liberalization of the asset management industry, to provide investment solutions for offshore holders, is just another part of this effort.

High-Risk, Low-Risk
Returning to the domestic market, it is important not to ignore the nontraditional segments of China’s financial industry. Some of these segments have seen extremely strong growth over the past several years. Private funds, China’s version of hedge funds, have witnessed robust expansion in AUM. Since 2010, “sunshine” private funds (those launched through trusts, with fundraising results disclosed) have seen AUM move from RMB46bn (USD7.2bn) in 2010 to 156bn (USD24bn) as of the beginning of 2012. Relatively strong performance and a certain exclusive cachet have caused Chinese high net worth investors to flock to the segment.

Banks have recently entered the (short-term) asset management game as well, through what are locally known as bank wealth management products. These are very short-term duration notes (one to six months, on average) with decent yields. Based on their association with China’s major banks, wealth management products are viewed as risk-free by domestic investors. Having been burned in the past by nearly every investment type imaginable (stocks in 2007 being the most recent example), many investors are leery of trusting any individual manager who could allocate a large portion of their wealth to any individual firm for an extended period of time. Bank wealth management products solve both concerns of investment type and duration, as well as provide short-term cash management in order to build up sufficient capital for what some are calling threshold investments – property in most cases. Despite concerns over unreasonably high prices in real estate markets, investors are still interested in the segment, and short-term, risk-free cash management has grown as a result.

This bifurcation demonstrates that demand for investment management is moving away from a medium-risk mean, and toward two opposite ends of the spectrum: higher-risk allocations, such as private funds and private equity among high net worth investors and institutions; and low-risk, short-term investments among retail buyers. So far, the fund management industry has struggled to provide solutions for either extreme, and clung to traditional equity-centric products. While more managers are beginning to offer bond funds that mimic the characteristics of bank products – early movers have seen strong results – but overall, these new assets still only account for a tiny portion of industry AUM, and are a fraction of what the banks are capable of drawing to their wealth

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The rapid growth of bank wealth management products seen over the past 18 months demonstrates that there is actually a considerable amount of demand for short-term wealth management solutions.

![Exhibit 3 Bank Wealth Management Product Launches, January 2007 – January 2012](chart.png)

Sources: Z-Ben Advisors, Wind
management products. Even more aggressive product diversification will be necessary to meet this changing landscape, if fund management companies are to see stronger growth.

Problems in Paradise
The lack of sufficiently diversified products has limited firms’ ability to access the lower end of the risk spectrum. Five years ago fund managers would have probably said that this was the result of restrictions on what they could actually do with raised funds, but since then, regulators have been relatively responsive and allowed fund managers to target non-traditional segments for investment. CSRC also allowed fund managers to offer segregated accounts, designed to appeal to high net worth or institutional buyers. Even with that platform, however, FMCs have struggled to compete effectively against the gains made by private funds.

Although there have been advances in product development over the last several years, variety is still lacking when compared with more developed markets. In general, there is also a distinct follow-the-leader approach where firms often mimic any instances of success. This has led to a series of product cycles, which means that at any given time, investors have a restricted selection of new product types available, limiting the appeal of the industry as a whole.

Case Study: Full Goal
Full Goal is a relatively large fund manager in China, and has been a good example of how a firm can utilize a consistent strategy while simultaneously adapting to market trends in order to draw new inflows. Traditionally, Full Goal was an equity-centric house, and began to slowly shift its focus towards fixed income offerings when equity markets began to sour. It did this not on a per-product basis, as it deliberately ignored several short-term trends but rather developed a well-rounded portfolio. Most recently, it has switched to offering absolute-return products.

Exhibit 4: Inflows from New Public Mutual Funds by Type (RMB bn)
Product demand tends to go in cycles, with early movers taking a large amount of AUM in their products

Personnel turnover has also been a major problem for fund managers. Fundamentally the result of a limited supply of experienced professionals, the industry has also suffered from an inability to properly incentivize key personnel. Fund managers are unable to list on a stock exchange, and additional rules make it difficult to provide direct equity stakes even to senior management. As a result of limited retention strategies, compensation for the top performers (both managers and analysts) has gradually increased. Less-than-robust corporate governance and firm management only compound this problem. Private funds therefore represent a natural exit for the best and brightest, and when well-known portfolio managers leave, they often take a sizable proportion of a firm’s AUM with them.

Turnover and salary inflation have also led to significant pressure on profitability at most firms. At most firms, only a small coterie of portfolio managers has extensive tenure. With salaries on the rise, immediate incentives favor moving between firms after a solid run of performance. This, of course, has a large number of ancillary effects: After solid performance, firms are at risk of losing their best people, which has an unsurprisingly negative effect on asset retention. Replicate this cycle enough times, and it is not a shock that the industry has struggled to retain buyers who are otherwise on the margin.

ETFs and Passive Products
The first exchange-trade fund (ETF) in China was launched in 2004, but it was not until recently that the infrastructure and trading system developed to allow sufficiently mature cross-market offerings between the Shanghai and Shenzhen exchanges. Two products have been launched under the new setup, from Harvest and Huatai-PineBridge, and collectively raised RMB50bn (USD8bn). Such a large fundraising take was primarily the result of having utilized a national network of brokerages, sidestepping the bank bottleneck that affects non-ETF funds. Their timing (at the beginning of 2012) also appears to have been ideal, as institutional investors felt that equity markets had finally hit a bottom, and were moving back into equities throughout the period.
More generally, **passive products have continued to grow in popularity, although they have not yet proven capable of drawing significant inflows away from other major segments.** Some analysts have previously suggested that passive funds provide an attractive structure in terms of liquidity and cost, features that have proven attractive elsewhere (such as the bank wealth management products described earlier). The major limiting factor for additional growth in passive products has been capital market performance. Between the strong fundraising seen from the two debut cross-border ETFs, combined with past demand trends, it appears that there is still considerable potential for gaining assets via new products, and the lack of growth has had more to do with insufficiently varied fund offerings, rather than a lack of interest among potential buyers.

**Offshore Allocation**

Much has been made over the lack of options for genuine diversification that are currently available for Chinese investors. To some extent this is true, but it is important to remember that product development, at least when considering what asset managers can actually create, has expanded considerably over the last several years. With that in mind, there still remains considerable interest in venturing offshore, if only to access returns that are not highly correlated with Mainland markets.

The Qualified Domestic Institutional Investor (QDII) program was created to address such demand by allowing institutional investors and asset managers to invest foreign currency in international markets. One obvious method of utilizing this quota was to construct mutual funds around the framework, to allow retail investors access to offshore markets.

The theory was more attractive than the eventual execution, however, as most fund managers have struggled to have their QDII funds break even. After the first wave of products in 2007 saw extremely strong inflows, the global financial crisis diminished demand for offshore allocations. Since then, only a handful of firms have seen success from their QDII offerings. Some of this, again, has to do with product design: The bulk of these funds invest in Hong Kong markets, which have been highly correlated with A-share markets over the past several years, diminishing the actual amount of diversification that any individual investor could realize. Some firms, such as Guotai Fund Management, have offered more genuine diversification (in their case, a NASDAQ index fund) but even these have failed to see strong inflows, despite above-average performance.

**Future Growth**

Longer-term growth in the asset management industry is therefore contingent upon firms implementing a host of changes to their business strategies. What choices are made depend upon a firm’s current position and areas of focus. For smaller firms, holding back on new product distribution – deliberately focusing on existing funds and accepting that no new money may come through fund launches – is one possible choice. Small firms can also refocus their efforts and specialize in a particular business line or product segment. Essence Fund Management, for instance, had its first product in the form of a segregated account. This allowed the newcomer to sidestep traditional distribution entirely, potentially drawing money from existing institutional contacts. Regardless, a change in the decade-old model will be critical for many firms to achieve healthy levels of revenue.

If these changes are implemented – and early evidence suggests that pioneers are already making the necessary shifts – we will likely see rapid growth in industry AUM, particularly as traditional investments for retail buyers becomes less attractive by comparison. **By 2015, the fund management industry could see upward of RMB6.8tr (USD1.1tr) in total AUM, a figure that could very well double by 2020.** This is, of course, to say nothing of nonpublic segments. Even present-day market estimates are difficult to come by, making forecasts all the more unreliable. Regardless, China’s regulatory landscape will continue to evolve, and segments that are now underregulated (such as private funds) will be brought into the open, potentially making it much easier for them to raise and manage funds. As it stands, these entities must rely on a relationship with trust companies.
to actually execute trades, an arrangement that exists only because it works and is not explicitly illegal. Such a setup does carry limitations, particularly regarding how accounts are dealt with in the event of a fund becoming insolvent and closing. While not a major barrier, these types of issues have certainly limited the segment’s growth, and the volume of inflows to the segment remains more of a testament to how desperate certain investors are to achieve stronger returns.

Competitive Landscape

There are several ways to examine the competitive landscape in China’s financial industry. Intersegment competition has become increasingly fierce over the past several years, with nearly all major players trying to position themselves as full-service providers. Banks are currently in the best position to do so, in no small part thanks to their extensive, and dominant, distribution networks (as will be discussed in detail in the “Distribution Dynamics” section on page 18 of this report). Fund management companies have tried to supplement their own physical and online distribution capacity in an effort to generate more sales leads and hopefully find more committed customers. Brokerages and insurers have both moved into asset management, utilizing their client base (in the case of brokerages) or substantial institutional asset base (in the case of insurers) as a base to develop expertise and broaden their reach.

All of these firms rightly forecast considerable unmet demand in the asset management space, and if Chinese buyers move out of their traditional portfolios – essentially cash under mattresses in multiple apartment properties – into active or passive products, considerable windfalls await those that have established the groundwork necessary to deal with large inflow amounts.

Within each segment, different competitive dynamics are at work. For fund management companies, the largest firms unsurprisingly have significant advantages. Fixed operations costs per unit of market share are fairly low, making their operations that much more competitive. Large-firm dominance will increase over the next several years as costs rise and turnover becomes an even more persistent and problematic issue. There is also the prospect that fund managers will be able to provide stock option incentives for employees, something that has in the past been resisted by existing shareholders. If such rule changes do in fact occur, and firms start to adopt such programs, turnover and corporate governance issues may not be as much of a problem, which would have an extremely positive impact on asset retention and general health of the fund management industry.

“Much has been made over the lack of options for genuine diversification that are currently available for Chinese investors. To some extent this is true, but it is important to remember that product development, at least when considering what asset managers can actually create, has expanded considerably over the last several years.”

Exhibit 6: Top 20 FMCs by Market Share and Sino-Foreign Stake Holdings Split (as of May 2012)

<table>
<thead>
<tr>
<th>FMC</th>
<th>Market Share</th>
<th>Domestic Ownership</th>
<th>Foreign Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>China AMC</td>
<td>9.12%</td>
<td>90%</td>
<td>10%</td>
</tr>
<tr>
<td>E-Fund</td>
<td>6.66%</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Harvest</td>
<td>6.13%</td>
<td>70%</td>
<td>30%</td>
</tr>
<tr>
<td>Southern</td>
<td>5.66%</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Bosera</td>
<td>5.27%</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>GF</td>
<td>5.18%</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Hua’an</td>
<td>3.36%</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Dacheng</td>
<td>3.08%</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Yinhua</td>
<td>2.85%</td>
<td>100%</td>
<td>0%</td>
</tr>
<tr>
<td>Full Goal</td>
<td>2.83%</td>
<td>72%</td>
<td>28%</td>
</tr>
<tr>
<td>China International</td>
<td>2.49%</td>
<td>51%</td>
<td>49%</td>
</tr>
<tr>
<td>ICBC Credit Suisse</td>
<td>2.43%</td>
<td>75%</td>
<td>25%</td>
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<tr>
<td>China Merchants</td>
<td>2.32%</td>
<td>67%</td>
<td>33%</td>
</tr>
<tr>
<td>Penghua</td>
<td>2.28%</td>
<td>51%</td>
<td>49%</td>
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<tr>
<td>China Universal</td>
<td>2.28%</td>
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<td>0%</td>
</tr>
<tr>
<td>Lion</td>
<td>2.09%</td>
<td>100%</td>
<td>0%</td>
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<tr>
<td>BoComm Schroders</td>
<td>2.00%</td>
<td>70%</td>
<td>30%</td>
</tr>
<tr>
<td>CCB Principal</td>
<td>1.92%</td>
<td>75%</td>
<td>25%</td>
</tr>
<tr>
<td>Rongtong</td>
<td>1.88%</td>
<td>60%</td>
<td>40%</td>
</tr>
<tr>
<td>INVESCO Great Wall</td>
<td>1.80%</td>
<td>51%</td>
<td>49%</td>
</tr>
</tbody>
</table>

Sources: Z-Ben Advisors, Wind
China’s Institutional Investors

In the near term, China’s major institutional players are even more promising than the retail market. Many large organizations find themselves with significant amounts of capital to work with, domestically and, increasingly, overseas. Many of these institutions either have foreign currency or face an increased need to add meaningful diversification to their portfolios, two factors that provide considerable impetus to the push into foreign markets.

China Investment Corporation

China Investment Corporation (CIC) is a major global sovereign wealth fund, charged with aggressively allocating a portion of China’s sterilized foreign currency reserves. With the bulk of these reserves currently invested in U.S. Treasuries, low rates of return mean that Beijing could actually be seeing depreciation on its foreign asset holdings, particularly when exchange rate fluctuations are taken into account. Established in 2007, CIC was meant to be a partial answer to the problem as well as a means for the foreign reserve authority to gain exposure to a much wider variety of assets. After all, when an investor is 80% or more beholden to a single geography (U.S. government bonds, in this case) the underlying need for diversification is crucial. CIC has therefore been extremely aggressive in deploying its assets, which currently total an estimated USD410bn.

There are few investors that can afford as long a time horizon as CIC, and the fund has used this fact to its advantage time and time again, by making major allocations toward long-term, direct equity investments. Many of these are handled internally but the fund has also proven to be one of the most important sources of institutional mandates for the foreign asset management community. At first, mandates appeared to encompass a wide variety of allocations but since 2008 CIC has tried to develop as much of its internal capabilities as possible and a considerable amount of decision making has been brought in-house. The remaining alternative allocations and specialist strategies still, however, need to be outsourced.
When that happens, a proven track record and commitment to areas that CIC is interested in will be most important in winning mandates. The best candidates may be those specialists with expertise in areas identified as important for the “China growth” narrative, including commodities and technology. These would likely include targets that enhance Chinese firms’ ability to expand offshore, or provide better access to commodities that are considered critical for the country’s continued development.

It is within this context that foreign asset managers need to maneuver when trying to develop mandate business with CIC. On the one hand, there are now additional funds which can be allocated externally along with the prospect of a more standardized funding mechanism moving forward. That being said, CIC is now working through a detailed review of those mandate managers first picked and funded back in 2009. The needs and objectives of CIC are, today, vastly different from what was the case three years ago. That then means the likelihood of a greater-than-expected turnover among those firms chosen to run money on behalf of CIC. There is still expected to be a bias in favor of alternative asset classes, but in the long-only space it is currently projected that CIC will favor those foreign asset managers with a strong performance track record or which operate in a highly specialized market niche.

At present, CIC is dependent on State Council for new asset injections, and it recently received another round of funding totaling a reported USD50bn. In its last annual report, the fund was very vocal about how it had drawn down all available cash and was fully invested, a clear signal to its overseers that it was ready for another injection.

CIC will soon transition from its first generation of managers. Since its inception, it has considerably improved its fund allocation capacity, improving its ability to both internally manage funds and competence to source and monitor mandates. Once returns stabilize, it is likely that State Council will establish a more normalized – and predictable – funding mechanism for the SWF. When that happens, a proven track record and commitment to areas that CIC is interested in will be most important in winning mandates. The best candidates may be those specialists with expertise in areas identified as important for the “China growth” narrative, including commodities and technology. These would likely include targets that enhance Chinese firms’ ability to expand offshore, or provide better access to commodities that are considered critical for the country’s continued development.

It is within this context that foreign asset managers need to maneuver when trying to develop mandate business with CIC. On the one hand, there are now additional funds which can be allocated externally along with the prospect of a more standardized funding mechanism moving forward. That being said, CIC is now working through a detailed review of those mandate managers first picked and funded back in 2009. The needs and objectives of CIC are, today, vastly different from what was the case three years ago. That then means the likelihood of a greater-than-expected turnover among those firms chosen to run money on behalf of CIC. There is still expected to be a bias in favor of alternative asset classes, but in the long-only space it is currently projected that CIC will favor those foreign asset managers with a strong performance track record or which operate in a highly specialized market niche.

State Administration of Foreign Exchange
The State Administration of Foreign Exchange’s (SAFE) official duties revolve around sterilizing as much of the foreign currency inflows into China as possible, in order to maintain a stable exchange rate regime. For the better part of the last decade, the country has relied on an export-heavy set of industrial policies to realize extremely strong rates of economic growth. Over the past several years, criticism both at home and abroad have brought to light the need to rebalance away from investment-and export-led growth toward a consumer-driven economy.
Regardless of the underlying reasons, SAFE, a regulator overseen directly by the People’s Bank of China, has found itself sitting on one of the largest hoards of foreign reserves in the world. Yet, the real value of these reserves has steadily declined as the need to increase purchasing power has increased. SAFE has therefore taken it upon itself to add slightly more aggressive exposure to the foreign currency reserve holdings, as an apparent stopgap effort between U.S. Treasuries and duties that are supposed to fall under CIC. On the whole, SAFE has historically been a conservative investor, with holdings focused on fixed income. More recently, however, SAFE has been provided with an expanded role and is now working to diversify foreign-currency holdings much like CIC does, providing global asset managers with a new (and sizeable) business opportunity.

For selection criteria, SAFE unsurprisingly has preferred managers with a track record of highly stable investments and will increasingly look to diversify its assets away from targets that are strongly correlated with its traditional holdings (developed market debt). Unfortunately for the fund, there are few asset classes that fit this description and offer risk-free returns, presenting a significant opportunity for asset managers that are able to provide this type of exposure.

National Council for Social Security Fund

The National Council for Social Security Fund (NCSSF) is the supervising body for the National Social Security Fund (NSSF), a fund created to oversee assets that will eventually be injected back into China’s pension system. It is a common refrain that China will grow old before it grows rich, and as a result of demographic shifts, the country’s public pension system will soon come under considerable pressure. At present, coverage is nowhere near universal, with only a portion of the population being covered. This means that if plans for expansion of the system go into effect, the need for additional funding becomes all the more acute. Foreseeing just such a problem, State Council established NSSF and NCSSF in 2000, with a mandate to develop its investment expertise and realize strong returns. Since then, the fund has been relatively conservative, with a significant portion of its assets put into fixed income holdings.

One complicating issue is that the national system’s pension assets are actually held at the provincial level, many of which are currently running deficits. Until recently, how these (mostly cash) assets could be managed was unclear. Payouts will soon surpass inflows to the system, straining the resources of even regions that now boast surpluses. Earlier this year, Guangdong province’s pension scheme allocated RMB100bn (USD15bn) in a mandate to NCSSF. While this is likely a trial scheme (Guangdong claims one of the largest provincial surpluses), if it is replicated it means that NCSSF may well become the dedicated manager for surplus funds in the nation’s pension system. Up until

Exhibit 9: Growth of SAFE’s Foreign Reserves, 2000 – 2011 (USD bn)
SAFE’s foreign reserves have compounded at an average rate of 30% since 2000

“For selection criteria, SAFE unsurprisingly has preferred managers with a track record of highly stable investments and will increasingly look to diversify its assets away from targets that are strongly correlated with its traditional holdings (developed market debt).”
now, it was unclear which entity would manage existing assets. Some saw the NCSSF as the natural candidate, as it already holds a large amount of assets and has a similar mandate—achieve the strongest returns possible while maintaining overall holdings for eventual deployment into the pension system. There was also the prospect that an entirely new organization would be created, allowing NCSSF to focus on the long-term stability of its assets, given the supplementary nature of the fund. The move by the Guangdong pension system is likely a first step in order to test feasibility.

Domestically, NSSF has been active in awarding mandates, typically for the portion of its portfolio dedicated to higher-return targets (at present, equities and a handful of alternative investments). To access these, a firm must have an onshore presence, preferably an experienced asset manager, and a track record in running large mandates. Looking ahead, one thing is certain: the sheer scale of the obligations facing the pension system means that significantly higher returns are an absolute necessity, not a luxury.

Beijing has no doubt realized this and, over the next several years, a windfall is heading toward firms positioned to capitalize on the shift.

NCSSF has also made forays offshore, although nowhere near as aggressively as CIC. The last RFP for international mandates that NCSSF issued was in 2011 and was arguably the most flexible to have been issued to date, allowing for a broader range of targets than historically permitted. These included offshore fund products and even derivatives—the institutional equivalent of a blank check for product designers. Over time, NCSSF’s preferences appear to have broadly mimicked CIC’s, as the fund is typically considered a model for other major domestic institutional investors. With inflation having made headlines several times over the past year in China, the need to enhance returns for one of the most important pots of capital in the country becomes all the more apparent. As a result, it would not surprise us if NCSSF shifted to become even more aggressive in the near future.

“It is a common refrain that China will grow old before it grows rich, and as a result of demographic shifts, the country’s public pension system will soon come under considerable pressure.”

Exhibit 10: NCSSF Portfolio Returns and AUM, 2001 – 2011 (RMB bn)

Caption: Since its establishment, NCSSF’s portfolio has only suffered one negative annual return

Sources: NCSSF, Z-Ben Advisors
Insurers
China's insurance companies have enjoyed extremely rapid growth rates over the past decade, so much so that many have had to find ways to increase their registered capital, as premium growth moved them beyond the threshold allowed by regulators for normal operations. With massive asset bases, the largest insurers have taken to establishing dedicated asset management subsidiaries to manage the funds of the parent company as well as those of other insurers (for a very small fee). Traditionally, insurers were important sources of mandates for asset managers and the establishment of asset management subsidiaries has represented a major shift in this setup. Nevertheless, insurers are still major sources of funds, especially for international asset managers.

Insurers are also set to benefit from the looming problems facing the pension system. As the primary alternative to the public pension income for retirees, insurance companies are set to more than double the amount of assets they have on hand over the coming decade. Whether insurers are targeted as a potential partner platform (the joint venture approach described earlier), or as a source of mandates, they stand to assume an important role in China's financial landscape. Additionally, with strong sales networks, many insurance asset management companies appear on the verge of seeing extremely rapid increases in their overall AUM.

If there is anything certain in the world of analytical forecasting, it is demographics, and the aging that China's population will undergo in the next 20 years is as sure of a bet as any. While growing assets from NCSSF are part of this, insurers are onshore, and this is where most of the action will be.

Exhibit 11: Insurance Asset Management Companies, Establishment Date and Historic AUM (RMB bn)
A number of insurers have launched asset management subsidiaries to manage internal and external funds

<table>
<thead>
<tr>
<th></th>
<th>Establishment Date</th>
<th>Registered Capital</th>
<th>2007</th>
<th>2008</th>
<th>2009</th>
<th>2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anbang Asset Management</td>
<td>May 2011</td>
<td>RMB300m</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>China Life Insurance Asset Management Co., Ltd</td>
<td>November 2003</td>
<td>RMB3bn</td>
<td>1,030</td>
<td>1,140</td>
<td>1,300</td>
<td>1,550</td>
</tr>
<tr>
<td>China Reinsurance Asset Management Co., Ltd</td>
<td>February 2005</td>
<td>RMB200m</td>
<td>69</td>
<td>62</td>
<td>64</td>
<td>72</td>
</tr>
<tr>
<td>Huatai Asset Management Co., Ltd</td>
<td>January 2005</td>
<td>RMB300m</td>
<td>36</td>
<td>N/A</td>
<td>40</td>
<td>42</td>
</tr>
<tr>
<td>New China Asset Management Co., Ltd.</td>
<td>May 2006</td>
<td>RMB100m</td>
<td>100</td>
<td>N/A</td>
<td>180</td>
<td>200</td>
</tr>
<tr>
<td>Pacific Asset Management Co., Ltd</td>
<td>June 2006</td>
<td>RMB500m</td>
<td>200</td>
<td>N/A</td>
<td>338</td>
<td>449</td>
</tr>
<tr>
<td>PICC Asset Management Co., Ltd</td>
<td>July 2003</td>
<td>RMB800m</td>
<td>70</td>
<td>106</td>
<td>184</td>
<td>270</td>
</tr>
<tr>
<td>Ping An Asset Management Co., Ltd</td>
<td>May 2005</td>
<td>RMB500m</td>
<td>470</td>
<td>452</td>
<td>570</td>
<td>700</td>
</tr>
<tr>
<td>SinoLife Asset Management</td>
<td>2011</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Sun Life Everbright Asset Management</td>
<td>N/A</td>
<td>RMB100m</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
<tr>
<td>Taikang Asset Management Co., Ltd.</td>
<td>January 2006</td>
<td>RMB1bn</td>
<td>146</td>
<td>200</td>
<td>204</td>
<td>300</td>
</tr>
<tr>
<td>Taiping Asset Management Co., Ltd</td>
<td>August 2006</td>
<td>RMB100m</td>
<td>40</td>
<td>54</td>
<td>70</td>
<td>100</td>
</tr>
<tr>
<td>Union Life AMC</td>
<td>N/A</td>
<td>RMB100m</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

Sources: Z-Ben Advisors, CIRC
How to Target Institutional Assets

Traditionally, China’s institutional market has been highly concentrated toward the three main sovereign wealth funds (CIC, NCSSF and SAFE). From a logistical point of view, this has been the easiest and most rewarding strategy to take. Foreign firms have simply needed to fly in and fly out, making presentations and ensuring that ample resources are in place to service these clients once a mandate was awarded. There is, however, growing evidence that this historic strategy will need to be radically amended as the three primary institutional targets increase their sophistication. Demand for a new approach is also evident given how new targets — insurers, pensions and even corporate investors — have different perspectives on where assets need to be allocated, and at what risk profiles.

To best access this segment, an onshore presence will help significantly, if only to coordinate the potentially complex logistics that are required to manage relationships with these new emerging organizations.

In specific terms of how best to approach the broadening and deepening Chinese institutional market, there are tactics that are recommended to be deployed as detailed below.

Foreign asset managers should now focus more of their business development attention on brand positioning and awareness. Local perceptions play a significant role, so knowing how your firm is viewed can prove critical. The same holds for a foreign firm’s suite of investment solutions. Attempting to have all solutions for all institutional clients in China is simply not possible. Core capabilities need to be identified and then communicated to differentiate one firm from another.

Exhibit: 12: Public Pension Fund Balance (RMB bn), 2007 – 2030e

The gap in the public pension system will need to be met by private alternatives, coming largely from insurance offerings.

There is then the issue of what sorts of local distribution platforms a foreign asset manager has access to along with any/all formed strategic alliances. Most foreign firms have spent a great deal of time and resources building local relationships, which must be fully leveraged to maximize distribution. At the same time, with a clearer understanding of how these variables come into play, a foreign asset manager must also properly communicate an ongoing value proposition through ongoing client interaction.

Not to be overlooked are internal issues such as resource availability and management of expectations. Over the past five years, foreign asset managers have had a relatively easy time when it came to securing business from one or more of China’s sovereign institutions. Moving forward, business will require far more resources than have been invested in the past. It’ll also take more time before growth in institutional mandates gathers speed, which will then require greater internal communication in setting and managing expectations. To the point, what had been easy in the past no longer will be.

With each passing day it becomes painfully clear that very few foreign asset managers have a definable China strategy when it comes to targeting institutional investors. The sooner this is recognized and eventually overcome, the better for the future prospects of developing real business.

“If there is anything certain in the world of analytical forecasting, it is demographics, and the aging that China’s population will undergo in the next 20 years is as sure of a bet as any.”
Distribution Dynamics

Throughout the last decade, China’s major banks – especially the four largest: Industrial and Commercial Bank of China (ICBC), Bank of China (BOC), Agricultural Bank of China (ABC) and China Construction Bank (CCB) – have been the preeminent means for accessing investors’ capital. Until recently, this has even been true of the high net worth and institutional markets. Sheer physical reach is the primary reason for this dominance: Banks are some of the few national institutions to have offices and staff in disparate parts of the country as well a high degree of concentration in population centers. Another reason is simply perception – most investors trust that offerings through banks are genuine and unlikely to be misrepresented.

Fundamentally, distribution problems result from supply and demand. There are 71 fund management companies active in China, all of which compete for access from the same four primary distribution channels. In truth, most managers don’t even consider all the commercial banks available, but instead focus on placing their products on the roster of just two – ICBC and CCB. There is the option to distribute via brokers – usually the largest 40 – but sales volumes remain constantly low.

Most retail investors are already committed to buying a particular product, or type of product, by the time they walk into the bank. Consequently, despite a large number of sales personnel, the bank’s role as a point of sale is simply transactional. For asset managers, this means that a decision has already been made even before a customer walks in the door, and as a result, effective marketing is of paramount importance, something that fund managers have yet to fully embrace (or pay for). For most FMCs, advertising has consisted of expensive billboards – Shanghai residents will be familiar with them on skyscrapers and subways – but whether these efforts have actually made a connection with buyers is still an open question. Trust companies, for instance, have taken to targeting high net worth investors: Shanghai International Trust earlier this year cosponsored an appearance of the Berlin Philharmonic, and cachet of that sort will not go unnoticed by the firm’s target investors.
With costs on the rise, numerous observers have wondered how exactly asset managers can move forward. Only recently have potential alternatives to the bank framework begun to emerge, and even these have been slow to develop. That said, the big four domestic banks still account for the bulk of most types of transactions for asset management.

We’ll be frank: Within the next several years it is unlikely that a reliable alternative sales channel will emerge, and for the foreseeable future, commercial banks will remain the dominant way to access end investors. This level of importance is not lost on CBRC, the chief banking regulator, which realizes that its charges are on top of one of the most profitable gold mines in China’s financial services sector. Fund managers that have a bank shareholder appear to be free, or at least insulated, from some of these pressures. All of the major banks in China have joint venture FMC partnerships with several foreign partners, and these companies have seen some of the best asset retention in the industry. While formally there is no direct relationship between the bank as a distributing agent and the joint venture FMC, available data suggests that bank shareholders often take that extra step to help push their subsidiaries’ products when new launches are conducted. Outperformance in fundraising among these firms also shows just how dependent fund managers are on having a reliable sales channel.

Finally, fund managers themselves have attempted to enhance their distribution capabilities. So far, this has revolved around opening wealth management centers and bringing in a dedicated sales staff. While there is no way most FMCs will be able to go toe-to-toe with banks on their own terms, this can provide a supplementary means of drawing in new AUM. Targeting high net worth investors by locating in China’s most populated cities has proven a popular technique. Whether or not this is any less expensive than simply utilizing the bank framework, however, remains to be seen.

Of course, there are more banks in China than just ICBC and CCB, and many fund managers have begun to engage so called nontraditional channels. China Merchants Bank has proven to be a reliable choice for firms interested in the high net worth segment, while a handful of regional banks provide support for mid-sized and small fund managers. At present, however, there is no substitute for

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**Exhibit 13: Costs and Revenues for Fund Managers**

Rising costs and declining profit, on average, have bitten into fund managers’ bottom lines.

<table>
<thead>
<tr>
<th>Year</th>
<th>Total Revenue (RMB m)</th>
<th>Total Cost (RMB m)</th>
<th>No. Funds</th>
<th>Average Revenue per Product (RMB m)</th>
<th>Average Cost per Product (RMB m)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2006</td>
<td>7,585</td>
<td>6,480</td>
<td>288</td>
<td>26.34</td>
<td>22.50</td>
</tr>
<tr>
<td>2007</td>
<td>36,944</td>
<td>22,656</td>
<td>365</td>
<td>101.22</td>
<td>62.07</td>
</tr>
<tr>
<td>2008</td>
<td>36,004</td>
<td>23,094</td>
<td>438</td>
<td>82.20</td>
<td>52.73</td>
</tr>
<tr>
<td>2009</td>
<td>33,995</td>
<td>22,831</td>
<td>556</td>
<td>61.14</td>
<td>41.06</td>
</tr>
<tr>
<td>2010</td>
<td>35,690</td>
<td>24,570</td>
<td>703</td>
<td>50.77</td>
<td>34.95</td>
</tr>
<tr>
<td>2011</td>
<td>33,110</td>
<td>24,750</td>
<td>914</td>
<td>36.23</td>
<td>27.08</td>
</tr>
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</table>

Sources: Z-Ben Advisors, Wind

These dynamics mean that distributing through banks is becoming an extremely expensive prospect. Trail fees (at, if not above, 50% of management fees) and custodian fees (a hefty 25bps per annum) rank as the highest-cost elements of fund managers’ business. Several years ago, fund managers even paid undisclosed incentive fees to bank staff, in order to get to the top of the distribution list. Since these sums were not made public, and were indeed of questionable legality in the first place, it is difficult to assess whether they were effective. Regardless, since regulators banned the practice outright, many fund managers have gradually seen their average fundraising results fall – and explicit trail payments increase – suggesting that lack of commitment by bank staff themselves may be a significant bottleneck. In the past, incentive payments may well have been an effective means to assure additional inflows. Whether or not this can be replicated in the future remains unknown – if so, banks are unlikely to be a major part of the equation. In principle, spending money on their own dedicated sales staff, with appropriate marketing efforts, appears to be one of the best routes forward for most asset managers.

Online sales have been touted as one possible solution. For general consumer goods, China is actually fairly developed in the percentage of transactions that occur online, even when compared to developed markets. Unfortunately, such behavior has not yet translated to the financial service sector, where online channels remain the exception rather than the rule. Part of this may be just a problem of execution: If only a handful of fund managers have websites that could be described as functional, fewer still could be categorized as “intuitive” or “user-friendly.” Nevertheless, the rewards for breaking into this market are potentially very high, and independent third-party platforms have begun to look into distributing fund products online. Regulatory barriers have so far made such a prospect difficult – CSRC must approve any fund distributor, and so far no single entity has been able to obtain all of the licenses necessary to create a functional funds supermarket. There is no lack of candidates trying to do so, however – a topic we will examine later in more detail.

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Rising costs and declining profit, on average, have bitten into fund managers’ bottom lines.

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<td>36.23</td>
<td>27.08</td>
</tr>
</tbody>
</table>

Sources: Z-Ben Advisors, Wind
having a place at the top of ICBC’s new product list, putting many smaller managers in a painful position when they seek to bring new products to market.

Making matters even more complicated, some of the major distributors have announced caps on the number of funds they intend to sell in 2012. This is likely the result of the success of their proprietary short-term wealth management products and the fact that the purchase of products for which the bank serves as custodian keeps the cash in-house. Investing in products typically involves a mere transfer of money out of a deposit account and into a fund product, all in the same bank. In the event of a liquidity crunch, many banks are able to earn more simply by having that money sit in their vaults or moving it to one of their short-term products.

Foreign Banks as Distributors
In our view, foreign banks will soon be given approval to sell mutual funds to domestic investors. Even the four largest foreign banks in China – Citibank, HSBC, Standard Chartered and Bank of East Asia – have nowhere near the reach of the domestic big four banks. Even many regional banks in China have more branches and staff than the foreign contingent. This is not to say that foreign banks don’t bring a value proposition to the table. For domestic distributors, any financial transaction is for the most part a fire-and-forget operation: Make the sale and provide minimal post-sale follow-up. After all, fees are earned only when the transaction is made, leaving fund managers themselves to foot the bill for post-purchase servicing.

Exhibit 14: Big 4 Banks’ Share of New Fund Distribution, 2007 – 2012
ICBC, BOC, ABC and CCB consistently account for the vast majority of fund distribution

Source: Z-Ben Advisors, Wind

Foreign banks, due to regulatory barriers on how they can take deposits, already have a client-based bias toward mass affluent and high net worth investors. With that in mind, international banks, once approved to sell funds, could offer an additional layer of servicing, which could include:

- Manager selection
- Use of investments within a full wealth management portfolio
- Additional post-sales support

While not entirely unknown in China, these types of practices remain relatively undeveloped, creating a real business opportunity and competitive advantage. Barriers to implementing such a business model are most likely to be found in developing the on-the-ground expertise and controls necessary to attract and retain clients.

With distribution as one of the most lucrative elements in China’s fund management industry, the rewards for a commercial bank that manages to get a solution right are significant. Bearing this in mind, we do not mean to suggest that the likes of Citibank or HSBC will be able to unseat domestic counterparts quickly. Nevertheless, with appropriate investments in personnel, even the initial business growth gains can greatly boost their onshore presence and market share, at least among foreign competitors. Such a shift is not without challenges, however. Getting all of the elements right ahead of domestic competitors has often proven to be a barrier in the past. Servicing, after all, can be learned and some smaller domestic banks have already been making investments in this area.

“With distribution as one of the most lucrative elements in China’s fund management industry, the rewards for a commercial bank that manages to get a solution right are significant.”
Churn, Churn, Churn
As a result of new product bias among both investors and the major sales channel, many of the redemptions of existing products are just recycled into the purchase of new funds. This might not be a serious problem if the overall industry was able to attract new investors, but up until now, it appears that most of the RMB2.3tr (USD363bn) in public funds is from the same group of investors. The beneficiaries, of course, are once again the banks. As the prime distributor, they are in a position to earn trail fees each time redemptions move capital out of an existing product and into an entirely new offering. Investors suffer the loss of redemption fees that eat away at the returns they are able to realize in the relatively short period of time that a fund product is actually held.

CSRC is well aware of this problem and eager to address it, especially as all of the major distributing banks are not under the regulator’s direct control. At present, however, its tools are limited. For its part, CSRC appears keen to allow its charges, asset managers and securities firms more flexibility in choosing their distribution options. Such a move is predicated on having additional options available and CSRC is well aware of this fact – while it will likely allow third parties to directly distribute funds, a certain amount of control will still be necessary to assure that providers of such services implement appropriate risk-control measures.

Some mutual fund managers have themselves chosen to alter their business strategies to overcome the distribution bottleneck. Over the past two years, one of the most effective ways that fund managers have been able to escape the trap has been to pioneer new products and preempt the competition. While ex-ante it is very difficult to determine what types of offerings will prove popular, there has been such limited diversity that almost any deviation from the norm has been handsomely rewarded. Lion FMC launched a wildly popular gold fund, utilizing QDII quota to purchase offshore gold funds. The fund saw extremely strong inflows – a testament to being able to hit the sweet spot in demand. While we realize it is not realistic to expect all asset managers to innovate consistently, the industry would benefit from any move away from the follow-the-leader behavior that seems to plague most managers.

Case Study: Haitong Securities
Haitong Securities is a prime example of how financial institutions within China have expanded rapidly into most available segments. Haitong has interests in a fund manager, a direct investment subsidiary, an offshore presence and a strong brokerage business. Many firms view having such a wide footprint as a means of overcoming some of the fundamental challenges within the industry, such as the bottleneck in reliable distributors.

Independent Advisers
To fix the distribution handicap on industry growth, there is interest in developing a more mature system within which financial advisors can operate. In China, there is essentially no equivalent for independent advisers to retail investors, and even high net worth investors find the most thorough servicing through – you guessed it – the banks.

This dearth of small-scale independent operations has as much to do with the perception of banks as the sole trustworthy outlet, as it does with regulatory barriers preventing third-party sales (or rather, the difficulty involved in obtaining a distribution license). There have been some exceptions – the most well known internationally being Noah Holdings, an overseas listed financial advisory firm. Even Noah Holdings, however, does not directly distribute funds, but rather serves as a sales agent and takes fees per client directed to asset management products. While the long-term sustainability of the practice may seem questionable, there is no doubt that Noah is occupying a necessary space in China’s investment management industry. It has also been one of the most aggressive firms in pursuing licenses for direct third-party distribution.

Case Study: Noah
Noah has been one of the most aggressive financial advisors within China, and has built its business upon targeting high net worth investors to buy into fund products, primarily those from trusts, private funds and private equity. It has also been relatively aggressive in its expansion, having opened a Hong Kong office early in 2012.

Foreign firms interested in capitalizing on this wide-open market space have only a handful of avenues for access. Aside from the joint venture platforms described earlier, a wholly owned advisory firm may soon be the best route to access investors. Such an operation alone may have difficulty generating business. However, when paired with another holding, be it a JV or an offshore manager, the possibility of realizing robust inflows will increase.
Expanding Internationally

At present, Mainland China represents approximately 9% of global GDP, with similar figures for total market capitalization. Yet when examining global portfolio allocations, the total amount of offshore money invested in China is nowhere near this amount. Even if Taiwan and Hong Kong are included, the figure is still very small (between 1% and 2% of total global portfolio allocation). This suggests that, even with normal growth assumptions for the region, a portfolio rebalancing will inevitably take place and translate into increased asset flows toward China. Given the disparity between China’s current 11% share of global market capitalization and investors’ 0.1% allocation to the country, global investors’ allocation to China could gradually increase by tenfold, or even more. Still, in the short term, a lack of viable investment channels have meant that international buyers have few actual means to access this type of exposure, regardless of the underlying demand.

With this in mind, it should be apparent that small changes in the access points, or new methods of buying into China-related holdings, will have a major impact on international portfolio flows, even if only major institutional investors are considered. To cite an obvious instance, most global pension funds try to diversify their holdings in such a way that underlying macroeconomic conditions are represented. For the most part they are successful, but as emerging markets have developed as an asset class, many traditionally successful managers have had to scramble to adjust their portfolio allocations proportionately. Add to that a global financial crisis that has led to developed markets comparatively less attractive, at least based purely upon returns available, and the shift to a wider variety of targets appears all but inevitable.

Fundamentally, we expect that in the coming decade Greater China will no longer be viewed simply as an element of emerging market exposure, but rather as a distinct asset class, with Chinese A-share investments making up a significant part of this allocation. The rest, of course, will come from regional exposure, primarily Hong Kong and Chinese firms cross-listed on other markets. If this sounds like a fantasy at present, one need only look to the
last ten years and consider the pace at which China has already developed its financial markets. Beijing has committed to making the renminbi (RMB) a more internationally relevant currency and this requires more flexibility in capital flows. When these types of changes occur, however, the rewards go to those most active in the market at the time. Anecdotal reports suggest that most major asset management companies are keen to gain additional China exposure, but the expenses needed to do so have so far served as a barrier, particularly for those not yet in the market. As global operating budgets begin to recover, we expect to see a renewed push into the region, with China as a focal point for rounding out the types of allocations demanded by global institutional investors.

For the past several years, the only direct method to gain A-share exposure has been through the Qualified Foreign Institutional Investor (QFII) program, a scheme that allows foreign firms to obtain RMB to invest directly in onshore markets. The securities regulator, CSRC, approves applicants and SAFE allocates quota, usually in the range of USD100 – 200m, which can then be transferred into RMB. One of the major goals of the program has been to provide liquidity to China’s capital markets, as long-term international investors are viewed as being a stabilizing element. While this is the case to some extent, the total amount of assets that come through the QFII program is still extremely small (accounting for barely 1% of A-share market capitalization). Asset managers that use QFII to create fund products have also had problems realizing strong returns (at least those that report their performance data). Part of this is likely due to the size of the individual awards. If a firm obtains only USD100m in quota, it becomes a fairly hard sell to set up a dedicated A-share research team, especially one based in China. Expense and inexperience in operating in the environment have meant that passive allocations are the preferred structure for QFII offerings. This factor, combined with limited specialization toward A-shares, has created an upper lid on returns.

Exhibit 15: China’s Fundamentals vs. Portfolio Allocations, 2010 & 2020 (estimate)
Significant portfolio rebalancing will be essential if asset allocations are to reflect macroeconomic realities compelling opportunities

<table>
<thead>
<tr>
<th>% of Global Market Capitalization</th>
<th>% of Global GDP</th>
<th>MSCI ACWI Weighting</th>
<th>Investors’ Actual Weighting</th>
</tr>
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<tr>
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<td>2010e</td>
<td>20%</td>
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<tr>
<td>11%</td>
<td>9%</td>
<td>2%</td>
<td>9%</td>
</tr>
</tbody>
</table>

Source: Z-Ben Advisors, MSCI

In actuality, QFII’s lifespan has encompassed an extremely volatile and arguably painful period for domestic markets. Demand may have been limited even if access channels were expanded. Should another run-up in equity prices occur (as happened in 2007), firms with existing QFII quota will find themselves in enviable positions.

It is with this in mind that the recent expansion of the QFII program is of considerable interest with the CSRC announcing nearly 30 new licenses to participate during the first four months of 2012, which is the same number awarded in all of 2011. At the same time, it was announced that the total permissible quota cap of USD30bn would be increased to USD80bn, indicating that CSRC and SAFE are set to continue with an aggressive opening up of the QFII program. For the first time since the QFII program was introduced in 2003, there is a real alignment of interest between the regulators and foreign assets managers. It is, however, worth noting that competition for asset flows will increase now that Chinese asset managers can target such flows through the recently introduced RQFII (“RMB Qualified Foreign Institutional Investor”) program.

“Fundamentally, we expect that in the coming decade Greater China will no longer be viewed simply as an element of emerging market exposure, but rather as a distinct asset class, with Chinese A-share investments making up a significant part of this allocation.”
By providing a Chinese subsidiary-only channel, regulators hope to create a space in which these firms can develop. However, results for the first wave of RQFII have been less than was first forecast, with barely half of the quota used up by the end of March 2012. Some of this is attributable to product homogeneity. The first batch of products was stipulated to invest in fixed income and equity, with a strict 80/20 split. Demand was also impacted by the fact that nearly all of the products were distributed by only the Bank of China (Hong Kong), creating a significant distribution bottleneck.

**Case Study: Harvest Global Investors**

Harvest Global Investors (HGI) was one of the earlier instances of a Chinese fund manager establishing an offshore subsidiary. The firm has been very active in launching products, most recently through the RQFII framework. A high degree of cooperation with Deutsche Bank, the foreign shareholder of Harvest FMC, a Chinese fund manager, has likely also contributed to business growth. It has also been one of the first offshore subsidiaries to develop alternative business.

Distribution efforts may have been further hindered by marketing efforts overly focused on retail investors. This limited the size of individual buy-ins and neglected institutional assets, which overall appear to be a much more interested set of buyers. Still, the issues currently at hand -- distribution and product development -- can be easily overcome and with that could lead to far more demand for RQFII products in the coming years. Once again, however, what is vital to take away at this point is the setting of a stage where foreign firms and their Chinese counterparts will go head-to-head (QFII vs. RQFII) in managing portfolios of onshore Chinese assets.

**Regional Competition**

Over the last 12 months, regulators have shown a preference for QFII managers that are either based within the region or have extensive operational experience in Asia and Greater China in particular. Many of these companies, particularly those based in Korea, Hong Kong and Taiwan, have been eager to develop their China capabilities in an effort to win new business from global investors. While the total amount of AUM that this group (defined as firms with headquarters in the region) is below that of truly global asset managers, their expertise and regional specialization has allowed them to grow more quickly when it comes to attracting global asset flows. While these firms are at a disadvantage when it comes to both branding and, more importantly, access to global distribution networks as compared to their larger rivals, they have proven better (on average) when it comes to generating performance. And it is with this one variable that Asian regional managers and Chinese subsidiaries have the real advantage.

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**RQFII**

RQFII was announced in late 2011, but was open solely to Chinese asset management companies and brokerages having a wholly owned subsidiary in Hong Kong. It was also a program that was quickly executed upon with 22 firms approved to operate and all of the initial RMB20bn (USD3.1bn) in quota already awarded with another RMB50bn (USD7.9bn) committed to expanding the program.

The basis of the RQFII program is to provide a more attractive investment channel for offshore RMB (known as CNH). These assets historically were low-yielding — securities of Chinese offshore fixed income — and extremely limited the size of individual buy-ins and neglected institutional assets. This limited the size of individual buy-ins and neglected institutional assets, which overall appear to be a much more interested set of buyers. Still, the issues currently at hand — distribution and product development — can be easily overcome and with that could lead to far more demand for RQFII products in the coming years. Once again, however, what is vital to take away at this point is the setting of a stage where foreign firms and their Chinese counterparts will go head-to-head (QFII vs. RQFII) in managing portfolios of onshore Chinese assets.

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Both of these competitive groups — Asian regional managers and Chinese subsidiaries in Hong Kong — are expected to become a significant force when it comes to attracting global asset flows. While these firms are at a disadvantage when it comes to both branding and, more importantly, access to global distribution networks as compared to their larger rivals, they have proven better (on average) when it comes to generating performance. And it is with this one variable that Asian regional managers and Chinese subsidiaries have the real advantage.
Of course, there is always the possibility that when demand emerges, global players will reverse course and put a large amount of resources into enhancing their China-specific research and execution abilities. Many firms already rely on their Hong Kong offices to provide such information – simply an expedient, in our view, as the firms that have an onshore research presence have demonstrated considerably stronger returns. Of course, data in this regard remains extremely limited, purely due to the small number of observations. Once again there is also considerable sample bias, as firms with an extensive onshore presence are also those that have been offering China exposure the longest, and as a result, have had a much longer time to develop their expertise. Regardless, over the next several years all global players will be facing additional competition from regional players for assets targeting China, and home-field advantage (for the assets sourced) will only go so far in assuring robust asset inflows. If offshore Chinese subsidiaries have preferential access to domestic markets and first crack at building their brands, inflows that would have otherwise gone to international heavyweights may instead fill the coffers of China AMC or Harvest.

Under the Surface
Tight liquidity within China, particularly over the last two years, means that there has been considerable demand for additional credit. Authorities have been reluctant to allow banks to extend additional loans, wary of potentially replicating the expansion that occurred in 2008, as a response to the global financial crisis. This has led to a sizable amount of under-the-radar financing schemes, which have understandably drawn the ire of regulators concerned about unsustainable macroeconomic expansion. Demand for better investment returns is the other side of the equation, and a handful of

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<tr>
<th>Company Name</th>
<th>Parent Company</th>
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<th>Date of Establishment</th>
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Source: Z-Ben Advisors, Hong Kong SFC
Many offshore firms, reluctant to commit to an onshore platform due to expense, utilize representative offices to monitor the market and provide a framework for developing the relationships necessary to consistently win mandates. The cost of a representative office has itself increased over the past several years, but still remains a key springboard to a more permanent holding within China.

Too often, representative offices are misused, and established without a clear goal in mind only in response to orders from headquarters that demand an increased China presence. As a result, for some companies, a Mainland representative office is little more than a glorified travel agent facilitating the moves of key personnel from other global offices as they pitch products and try to land assets from major institutional investors. Representative offices should not just be used as a convenient stopgap for establishing a more meaningful presence.

The process by which a representative office is opened can affect whether or not it serves effectively as a stepping stone for other types of business within China. Often a rep office simply functions as a personnel incubator, and is closed when a joint venture or other platform is established. This often ends up being a relatively short-sighted move, as a representative office provides a means to gather information on the investment – to conduct proper benchmarking and research post-transaction. Such information is extremely valuable within China, as too often a joint venture holding will itself serve as the only conduit for information, of potentially dubious reliability. In addition, as will be touched upon below, for those foreign firms willing to assume slightly more business risk, they are advised to forgo the rep office and, instead, establish a Wholly Foreign Owned Enterprise (WFOE).

Opening of additional channels, to allow for money to flow out in more easily monitored channels, has therefore become a priority in 2012. Several localities have authorized an increase on the per-person limit of international currency they may exchange annually, and Beijing appears highly supportive of a number of efforts – QDLP and the so-called “mini-QDII” (not yet the official designation) to enable an outlet for this swath of money.

The amount of attention paid to potential QDII sub-advisory arrangements is hardly commensurate with their actual importance in the cross-border landscape. Initially, numerous foreign firms viewed QDII as another platform whereby domestic asset managers would require additional management expertise, which they could charge for. While part of this assumption proved true – Chinese managers were indeed inexperienced when operating in offshore markets – many of them simply chose to focus their QDII offerings on Hong Kong, leveraging their expertise in the domestic markets to focus on cross-listed firms.

Such strategies have had the impact of making QDII an extremely unattractive segment, yet from the domestic asset managers’ viewpoint, the expense of developing expertise in other global markets, or paying for that expertise outright, means that the paltry amounts of AUM that QDII funds typically raise can hardly be expected to cover such costs.

At present only a handful of QDII funds utilize third-party advisors and barring a collapse in A-share markets, with rapid growth in other equity indices, we do not see this situation as likely to change in the near future.

One possible caveat is if domestic investors demonstrate an interest in diversified offshore holdings, to which fund managers are able to respond. The gold fund launched by Lion FMC is one example, as there may be strong reasons to invite specialist firms in to help with the development of highly nontraditional products. This, unfortunately, is only likely to occur on a case-by-case basis and as a result, is unlikely to transform the overall industry.

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access that an international firm can gain are therefore worth examining. So far we’ve covered the various segments of the industry without explanation of how they can be utilized to grow a firm’s onshore presence. For fund management companies, the maximum shareholding possible by a foreign firm is 49%. Today, however, this can only be achieved through setting up a “greenfield” (start-up) joint venture, which is a complicated endeavor. There is the option of buying a minority stake in a Chinese fund manager, but that comes at a price, with relative pricing typically in the range of 7% or 8% of AUM.

The only international firms that have higher percentages in their holdings are those that entered the industry relatively early; barring exceptional circumstances, positions above 25% appear unlikely in the next several years.

With fund managers becoming much more difficult access points to secure, many offshore players are considering investments in other platforms. Trusts have recently become much more popular, given their industry flexibility. Moreover, international firms are allowed to hold up to 20% of trusts’ shares. Valuing a trust company is much more difficult, however, given the variance in the firms populating the market. Some are well run, but many are still recovering from overexpansion and a reliance on bancassurance products. Due diligence is therefore an absolute necessity for any company considering acquisition of a trust platform.

Brokerages and insurers are also becoming more popular means of accessing China’s financial industry, with insurance companies likely to be the next wave of offshore acquisitions or partnerships. The handful of firms that are able to maintain a position in multiple ownership stakes and licenses will soon find themselves in enviable positions when developing their onshore platforms. Utilizing one platform to assist another has become an increasingly important method of overcoming some of the market challenges that currently exist.

The one platform that continues to be vastly underappreciated by the foreign asset management community is the Wholly Foreign Owned Enterprise (WFOE). While there is no debate whatsoever as to whether such an entity can be established, the debate rages on — facilitated by the international legal community — as to what activities a WFOE platform is actually allowed to undertake. A largely unexplored option is using a WFOE registration as a base for developing an asset management or advisory business. At present, the WFOE license does not allow beyond much more than setting up an office and providing a framework to hire employees directly as well as invoice within China, and transfer money back overseas. Such a setup provides an extremely flexible and potent platform when moving forward with business expansion within the Mainland.

A WFOE can be used as a stepping stone to developing an advisory business focused on asset management, or client servicing. As a result, it is highly complementary with having an ownership stake in a joint venture, as opportunities for cooperation between the two holdings become much easier.

**Best Foot Forward: Final Thoughts on Opportunities for Asset Managers**

When considering what approach to take to China’s financial markets, it’s important to remember that regulatory changes rarely benefit the newly arrived. While first movers typically have an extremely strong advantage, regulatory changes — one of the prime levers of growth — rarely occur in isolation or without warning. Major policy developments are typically implemented gradually, with geographic restrictions or a carefully selected set of first-run participants. For firms looking at one particular aspect of business development, it is possible to structure a market entry effort that maximizes the chance of success.

There are bound to be setbacks. Nonetheless, the need to further liberalize China’s financial industry is clear to central authorities. Without a more diversified set of options for investors, domestic buyers will
remain far too reliant on a very small set of holdings for their portfolios. Limited returns exacerbate the nation’s pension problems. A much more flexible and resilient system is absolutely necessary for the country to confront a decade of potentially lower GDP growth rates, and with this in mind firms interested in the China market need to keep several important elements in mind:

• International asset managers must focus their attention on enhancing their brand within China. Having a one-size-fits-all approach to any client is impossible, and has unfortunately led to a significant amount of wasted effort.

• Finding a way to overcome the distribution bottleneck is critical to realizing growth. This is true for domestic managers, and soon will also be the case for foreign firms operating investment platforms onshore.

• Once fund distribution by foreign banks is allowed in China, providing post-sales support and advice will be the best way to attract clientele.

• Growth of the market, along with further expected liberalization, will mean a host of opportunities for firms that already have operations in place and can hit the ground running.

• Additionally, demand for offshore allocation from Chinese investors has not been met by solutions provided locally. This means a significant amount of untapped capital awaits firms that are able to offer attractive products.

• Seeking China-sourced business has traditionally been possible without a local presence. Over the next several years, such an approach will become much less effective as the pool of possible institutional targets widens.

• All of these efforts are dependent on having direct access to a dedicated onshore platform.

China remains a highly complex market, and while continued liberalization offers hope, it does not necessarily bring simplicity. Though an on-the-ground presence is essential, it has become merely table-stakes. Many of those with an onshore presence have struggled to raise assets.

At the same time, China’s future is decidedly bright. For foreign managers negotiating the hypercompetitive North American market, or stuck in the doldrums of Europe, China seems to offer tremendous hope, managed assets and economic growth converge. While China is not a panacea, there is much to be gained by a thoughtful approach to the market. True success requires innovative solutions, a firm understanding of the distribution dynamics and above all, a long-term commitment.

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