INTRODUCTION

China’s economic output has grown ten-fold over the last 20 years. Hundreds of millions of Chinese are now middle income earners and millions are wealthy. The asset management industry has grown along with the economy, but not as fast as might be expected. The bulk of China’s RMB 145 TN of financial assets are held in deposits. Only 3% are held in mutual funds. The Chinese remain savers rather than investors.

Yet, for reasons we explain in this report, this is set to change. We expect assets under management (AuM) to grow from RMB 4 TN today to RMB 24 TN by 2020. This will present a massive opportunity for Chinese fund management companies (FMCs) and, potentially, for foreign asset managers too.

But aggregate growth in AuM is not enough on its own to guarantee profitability for FMCs. Many of the funds that have proliferated in China since recent deregulation are now sub-scale and unprofitable. Equally foreign players have found it difficult to make forays into the Chinese market work.

Having described the current dynamics of the Chinese asset management industry and the drivers of growth, we look at the challenges for FMCs seeking to establish a sustainably profitable business model in China.
THE CHINESE ASSET MANAGEMENT MARKET TODAY

China’s GDP has surged from RMB 6 TN in 1995 to RMB 60 TN today¹, making it the world’s second largest economy. China’s asset management industry has also grown rapidly from RMB 0.5 TN in 2005 to RMB 4 TN² in 2013. While this growth rate is impressive, the industry is still well below its long term potential. Only 3% of China’s RMB 145 TN of financial assets are held in mutual funds.

Market liberalization has opened the scene to many new players. In addition to the incumbent firms, there are new FMCs affiliated with banks, securities firms, trust companies and insurance firms. Liberalization has broadened the range of products available across the investment universe, facilitating a proliferation of new fund launches.

Only 3% of China’s RMB 145 TN of financial assets are held in mutual funds.

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² Asset Management Association of China.
However, liberalization has not been entirely conducive to the healthy development of the industry. Many players have focused on “grabbing policy resources” (政策资源) for developing regulatory-driven products, knowing that there may be limited time before such opportunities lapse.

The result has been the creation of commoditized and sometimes poorly designed products with limited long term appeal to investors. Whilst the market has been growing, the median size of each fund has declined and with it product profitability. Over the last eight years the median fund size has declined from a peak of RMB 6 BN to around RMB 0.4 BN in 2013 (Exhibit 1).

As of year-end 2013, more than a third of China’s 90 fund management companies (FMCs) were loss-making, with most carrying sub-scale fund products that are struggling to break-even or, worse, failing to stay above the RMB 50 MM statutory minimum AuM. The situation is aggravated by distributor commission structures that encourage customer churn to new products. Interestingly the asset managers who have grown net new assets fastest over the past four years have done so by both keeping existing assets in established funds and acquiring new assets through new funds (Exhibit 2).

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*1 Total AuM include both mutual funds and segregated accounts of non-public-offering assets.
Source: Asset Management Association of China, Oliver Wyman analysis, WIND.
Exhibit 2: NEW INFLOWS GO TO NEW FUNDS, WHILST TOP PERFORMERS STEM OUTFLOWS FROM EXISTING FUNDS, 2010-2013

AUM GROWTH ATTRIBUTION
BY TOP 20/MID 20/NEXT 20, ATTRIBUTED AS A % OF 2010 AUM

<table>
<thead>
<tr>
<th>Tier Group</th>
<th>Performance Impact</th>
<th>Flow of Existing Funds</th>
<th>New Funds Issuance</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top 20 (12%)</td>
<td>-6% -4% 50%</td>
<td>(x%) Percentages showing the tier groups average annualized AUM growth rate from 2010-2013</td>
<td></td>
</tr>
<tr>
<td>Mid 20 (0%)</td>
<td>-25% -8% 34%</td>
<td>Flow of existing funds</td>
<td></td>
</tr>
<tr>
<td>Next 20 (5%)</td>
<td>-20% -6% 43%</td>
<td>Performance impact</td>
<td></td>
</tr>
</tbody>
</table>

*1 60 FMCs are selected due to data availability; FMCs established after 2011 are excluded from this analysis.
*2 Existing funds are funds that have been established for three years, and have reported data as of Q4 2010.
*3 New funds are those established during the period of Q1 2011 to Q4 2013.

Source: Asset Management Association of China, Oliver Wyman analysis, WIND.

Several of the fastest growing FMCs are affiliated to major banks. Given the retail orientation of the current market, these bank-affiliated FMCs have benefited from access to their parents’ distribution channels. Yet even these FMCs face internal competition from deposits, bank-trust wealth management products (WMPs) and insurance products. Recent liquidity challenges in the banking sector have seen some banks deprioritize mutual fund sales, instead favoring products that provide lendable funds. With the regulatory action to curb the practice of converting bank loans into interbank assets and bypass the loan-to-deposit (LDR) cap, this trend may accelerate, at least in the short term. WMPs from banks and securities firms have also grown significantly over the past four years to about RMB 20 TN, which is five times FMC assets. However, there is widely publicized concern that some customers do not understand the risks involved in some of these WMPs. As such regulation is being introduced to address these concerns (e.g. Circulars 99, 107 and 127) and is focused on increasing investor awareness, rather than, at this point, curtailing WMPs themselves.

Some FMCs have sought to take advantage of the Qualified Domestic Institutional Investor Programme (QDII) which permits Chinese investors to invest in international markets. However, QDII has had a difficult start. Since its introduction in 2007, about 35% of all funds still have not returned to their value at time of issuance and over 50% are underperforming their benchmarks, even pre-cost. There are three reasons. First, many of the QDII products have focused on China H-share equities (Chinese companies listed in Hong Kong) which offer little diversification from domestic markets. Second, RMB appreciation has been a drag on the returns of un-hedged international exposures. Finally, relative performance has often been poor because many FMCs are inexperienced investing in foreign markets.

That all said, given the recent outperformance of international vs. domestic markets from a Chinese investor’s perspective, we are seeing some renewed efforts to develop next-generation QDII products that seek to avoid the errors of earlier efforts.

As of Dec 2013.
A SHIFT FROM SAVING TO INVESTING

Over the next few years, we expect the Chinese asset management industry to enter the next phase of its development as institutional demand grows from its currently low base and the retail market matures.

As our “base case”, we estimate assets managed by FMCs will grow to RMB 24 TN by 2020 (see Exhibit 3). China will then be the second largest Asian asset management market after Japan. We project that about 60% of the growth will come from retail investors and 40% from institutional investors. This is a significant shift from the recent decade where nearly all the growth came from the retail segment.

The key drivers behind this dramatic growth will be the emergence of institutional investors, households’ evolution from saving to investing and RMB internationalization.

Exhibit 3: HISTORIC AND PROJECTED GROWTH IN CHINESE INVESTABLE ASSETS INCLUDING THOSE MANAGED BY FUND MANAGEMENT COMPANIES
2005-2020E, RMB TN

*1 Government linked funds include only estimated outsourced portion of NSSF, CIC and SAFE portfolios.

Source: PBOC, CBRC, CIRC, and annual reports of NSSF, SAFE and CIC; Oliver Wyman analysis.
Although institutional investors in China command over RMB 70 TN in assets (including cash deposits), the external asset management business for the institutional segment remains underdeveloped. FMCs manage only RMB 1.2 TN of institutional assets. The largest asset pools are in the hands of the three government-linked wealth funds, all of which have in-house capabilities and outsource only specific parts of their portfolios.

FMCs manage less than 2% of institutional investor assets because of regulatory restrictions and a tendency for vanilla investment strategies within those restrictions to be managed in-house. Except for the largest institutional investors, many still allocate more than 90% of their portfolios to cash and domestic government bonds. New regulation now allows insurance firms to allocate up to 15% of their investments to foreign securities, versus the current allocations of 1%-5% for most insurers. Similarly, most pension funds hold no more than 7% in foreign investments, well below the 20% regulatory limit.

We expect the institutional opportunity to improve, for three reasons:

1. **Relaxation of investment constraints**
   To encourage portfolio diversification, regulatory investment constraints on insurers have been relaxed. Since 2012, the China Insurance Regulatory Commission (CIRC) has issued a number of guidelines allowing insurance companies to invest in a wider range of exchange-listed and over the counter (OTC) products. The restrictions on overseas exposure have also been relaxed to include 25 developed markets and 20 emerging markets. It has also become easier for insurers to outsource to authorized external asset managers.

2. **Tax incentives**
   In December 2013 the SAT (State Administration of Taxation), MOF and MoHRSS announced the launch of a long-awaited tax-deferred pension investment scheme. This could direct RMB 0.3 TN of annual pension contributions into the asset management industry.

3. **Hunt for higher yield**
   After three consecutive years of declining returns, insurance companies finally improved average returns to 5% in 2013 (though this still fell short of the typical 5.5% model assumption). Reform of insurers’ investment portfolios has become a priority of CIRC. Similarly, with a rapidly aging population, below-inflation investment returns on retirement savings are a source of regulatory and social concern. Portfolio diversification and more sophisticated investment strategies are urgently needed. While the National Social Security Fund (NSSF) has become a more sophisticated institutional investor, much improvement is required in the local and provincial pension funds and for enterprise annuities.

Family offices are also emerging as key clients in the asset management business. Rather than reinvesting most wealth back into the family business, the next generations of rich families are starting to invest through professional managers via a family office model. FMCs can provide family offices with products that augment their in-house investment activities.

In the US and Europe, corporate treasurers have long used money market funds (MMFs) to manage liquidity and diversify counterparty risk. This is not yet the case in China, where MMFs are only 2% of total deposits (at around RMB 1.5 TN) despite the negative cash carry on many corporate treasurers’ books. Now that Chinese MMFs can be structured for same day settlement, which makes them a more conducive tool for liquidity and cash management, the corporate use of MMFs should grow significantly.

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5 Including private equity, unsecured bonds, hybrid and convertible bonds, real estate and direct equity investments in certain sectors.

6 Ministry of Finance.

7 Ministry of Human Resources and Social Security.

8 2009-2013 industry average returns were 6.41%, 4.84%, 3.6%, 3.39% and 5.04% respectively.

9 Source: Lesson from America, Anthony Carfang, The Treasurer, Sep 2013.
HOUSEHOLDS’ EVOLUTION FROM SAVING TO INVESTING

China’s household savings exceed RMB 45 TN with a national savings rate above 50%. However, saving is not the same as investing. Chinese households tend to keep their savings in low yielding bank deposits. Of the RMB 45 TN in household savings, mutual fund penetration is only 7%. This is behind both other Western and comparable Asian markets.

However, we believe that households are increasingly concerned about the threat of inflation eroding the value of their long term savings. Many households have kept the majority of their savings in bank deposits not necessarily by choice but because they have lacked alternative investment opportunities. As the Chinese financial system matures, we expect a gradual conversion of household savings into mutual fund-based investments. Moving towards the mutual fund penetration levels of other Asian markets on new savings, could alone deliver RMB 12 TN in new mutual fund assets over the coming years through to 2020.

However, many Chinese retail investors are still inexperienced, and have become wary of equity market investment. To win the confidence of these retail clients, asset managers need better designed products offering performance diversification. They also need more effective investor and distributor education to explain the virtues of diversification and their investment approach.

We expect the development of the fixed income and multi-asset funds to help draw savers away from bank deposits. Bond funds today account for only 20% of China’s funds and only 5% of AuM, which is far lower than in most other markets. On the supply side, the growth of corporate bond issuance will allow asset managers to create funds offering better risk-return characteristics.

Technology is also driving change in adoption and distribution of investment products. Tian Hong asset management has attracted over 80 MM investors and RMB 500 BN AuM for the Yu E Bao money market fund it manages within eight months since inception – now one of the largest money market funds in the world – through its partnership with Alibaba’s electronic payment affiliate Alipay. This is a good example of the power of the new technology-enabled distribution models.

Bond funds today account for only 20% of China’s funds and only 5% of AuM, which is far lower than in most other markets.
Over the coming years the RMB is expected to move to full convertibility. This should significantly increase both outward and inward investment. Yet, even ahead of this, several developments are supporting demand for Chinese assets.

By 2013, the People’s Bank of China (PBOC) had established bilateral currency swap agreements with 23 central banks and monetary authorities for over US$400 BN. The Chinese interbank bond market is now open to foreign central banks, monetary authorities and RMB clearing banks designated by the PBOC. Qualified Foreign Institutional Investor Program (QFII) and the RMB Qualified Foreign Institutional Investor Program (RQFII) participants can also access the bond market where over 90% of the domestic fixed income instruments are traded.

Although it is not yet fully convertible, some foreign central banks have announced that they have invested or will start investing in RMB fixed income assets as part of their reserves. While central banks typically invest directly as opposed to through funds, RMB fixed income based funds should benefit from the increased liquidity caused by central bank activity.

Foreign investors can currently access Chinese markets only through the QFII, RQFII and the Qualified Foreign Limited Partner (QFLP) programs. Given these access constraints, global and emerging market indices exclude the A-share markets from their calculations. For example, the MSCI emerging market index’s 18.9% allocation to China is largely H shares listed in Hong Kong11. When the market is eventually opened for foreign investors, removing all constraints on liquidity and repatriation, the MSCI EM Index is likely to be close to 30% weighted to China, including over 10% for the onshore A-share markets. This should trigger significant new inflows over time as fund managers around the world rebalance their portfolios according to the new benchmark weights. Similarly, the onshore fixed income market will see significant inflows as global fixed income benchmarks adjust to reflect the new weighting for China.

China is already taking steps to make it easier to invest between the Mainland and Hong Kong through the forthcoming Shanghai–Hong Kong exchange trading bridge and mutual fund recognition programs. Details are still being formalized, but this should allow for the sale of qualifying Hong Kong registered mutual funds into the Mainland through a new quota system. This may further create an entry point for China into Asian Region Funds Passport (ARFP) discussions.

11 As of Oct 2013, the 18.9% China allocation included 9.9% H share, 5.1% red chip, 3.8% p chip and 0.2% B share.
IS THERE A MEANINGFUL ROLE FOR FOREIGN ASSET MANAGERS IN CHINA?

Of the 90 FMCs in China today, 48 are joint ventures with foreign asset managers. Foreign shareholding ranges from 10% to 49%, which is the statutory ceiling. In most cases, the foreign shareholder plays a relatively small role in the day-to-day management of the JV. To gain direct access to the Chinese market, foreign players must operate through special programs, such as the QFII, RQFII, QFLP, QDII and QDLP (Qualified domestic limited partner), all of which come with lengthy and stringent licensing processes, quotas and capital flow requirements.

Challenging profitability, complex regulation and differences in management culture have created some disillusionment around the opportunity for foreign firms in China.

This disillusionment may be due to a mismatch of expectations right from the start. JVs are most successful when both parties bring specific value to the table and recognize each other as doing so. In many JVs, the Chinese partner has been looking for technical knowhow and association with an international brand name but ultimately has no intention yielding management or further equity control. Hence, the question remains: Is there a meaningful role foreign asset managers can play in China?

We think the answer is yes. Foreign asset managers should not dismiss the Chinese market as an opportunity, especially given how large the market will become. However, they need clearer strategies for participating in the market.

With regard to JVs, foreign firms must be confident that they can bring sufficient value to the table and that the JV has a credible strategy for turning asset growth into profitability. Or, if they see the JV as a “loss leader”, they need to be confident that what it teaches them about the Chinese market and the improvement of their market-position will be worth the investment. Some of the value may come from the advantages that presence in China gives them in serving the RMB investment needs of their global clients. But being the weaker partner in an unprofitable JV, in the blind hope that it will at some day turn good, is not a sensible approach.

Nor is a full joint venture the only option for entering the Chinese market. Alternatives include:

1. Co-operate with local firms on specific products or functions in order to develop knowledge and network access
2. Develop an onshore performance track record ahead of the curve, through participation in quota programs (such as QFII, RQFII) under own licenses or international mandates backed by client licenses’
3. Work with (alternative) distributors to build a strong suite of QDII products to capture investor needs on outbound, offshore allocation
4. Sale of Hong Kong registered funds into mainland China through the likely forthcoming mutual recognition scheme (however timing and specific details on participation requirements are not clear)

As market liberalization continues, we expect foreign share-holding limits to be ultimately removed. During such an interim period, WFOE (wholly foreign-owned enterprise) may also become an increasingly viable option for those who are prepared to invest ahead of the curve by building out functions within the legal remits of a WFOE (e.g. local research and risk management capabilities).

If foreign asset managers are eventually allowed to set up their own FMCs in China (and possibly starting with a full license serving just the institutional clients), those best positioned to succeed will have a proven local track record, a local management team, and the ability to convince the regulators that they will support the healthy development of the asset management market in China.
BUILDING A WINNING MODEL

There are many FMCs competing in the young Chinese asset management market. The experience of more mature markets suggests consolidation will occur, especially amongst retail client focused firms. There will likely be more room for asset specialist boutiques serving institutional clients, but only for those with strong track records, robust risk management and differentiated investment approaches.

To survive, we believe firms must have a clear target business model that plays to their competitive strengths. To this they must show great discipline in following a plan that develops their business towards that model.

Exhibit 4: SUCCESS FACTORS FOR WINNING MODELS IN CHINESE ASSET MANAGEMENT

<table>
<thead>
<tr>
<th>PLAYER TYPE</th>
<th>CLIENTELE TO FOCUS ON</th>
<th>SUCCESS FACTORS</th>
<th>CHALLENGES</th>
</tr>
</thead>
</table>
| Bank-affiliated asset managers | • Mass market  
 • Affluent  
 • Corporates | • Depth of distribution channel partnership (including advisor training, client ready materials and long term economic sharing model)  
 • Product design that creates complementary products to the bank’s liquidity needs, creates trust through predictable outcomes and delivers scalability | • Being prepared for new forms of guided or open architecture distribution models and being able to diversify distribution channels ahead of time |
| Security firm affiliated asset managers | • Affluent  
 • HNW  
 • Institutional investors | • Product innovation leveraging securities expertise and market access (e.g. ETF, smart beta, fixed income)  
 • Customer education and tools to encourage incorporation of funds into client portfolios | • Managing the appropriate balance between leveraging market access capabilities and avoiding conflicts of interests that could result in a backlash from either clients or regulators |
| Fixed income specialists | • Institutional investors (especially insurance and pension funds)  
 • Global investors (e.g. QFII/RQFII)  
 • Corporates | • Deep expertise in both Chinese public bond markets and private credit markets  
 • Scalability to deliver cost-effective outsourcing solutions for large investors  
 • Product innovation around liability defined investment and risk managed yield enhancement | • Convincing large investors to outsource rather than manage portfolios internally  
 • Liquidity and capacity management |
| Equity specialist managers | • Investment advisors (UHNW, family offices)  
 • Institutional investors  
 • Global investors (e.g. QFII/RQFII) | • Distinctive investment philosophy and supporting investment process discipline  
 • Effective sales & marketing to professional gatekeepers (e.g. international consultants)  
 • Active encouragement of professional market development | • Delivering sustainable economics whilst developing track record  
 • Liquidity and capacity management |
| Off-shore specialist managers for Chinese investors | • Institutional investors  
 • Investment advisors (UHNW, family offices, corporates with off-shore assets)  
 • Domestics FMCs (white-labeling)  
 • Corporates (off-shore liquidity) | • Global investment products designed for Chinese investor portfolios (e.g. RMB hedged)  
 • Customer training and tools to understand role of global investment in investment portfolio  
 • Effective on-shore representation and marketing partnerships | • Developing strong relationships with local stakeholders |

Becoming a leader in the Chinese asset management market will not be easy but the reward is potentially huge. By 2020, we expect that Chinese market leaders will be closing in on the top 50 of global asset managers. By 2030, we can expect they will be firmly in the global top 20. For leading foreign firms, China is too large to ignore. For the most ambitious domestic firms, China is a springboard to global leadership.