China: The new frontier for foreign asset managers

New trends and fresh insights to best navigate one of Asia’s largest asset management markets
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make China an attractive Asset Management market
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Despite a recent economic slowdown and high market volatility, China shows robust long-term fundamentals to support a growing asset management market.

**FAVORABLE MACROECONOMICS FOR ASSET MANAGEMENT IN CHINA**

China’s recent economic slowdown has attracted significant attention from investors and the media alike: China’s GDP growth has slowed from 10.6% in 2010 to 6.9% in 2015. However, a rate of 6.9% is still very healthy, if not arguably more sustainable, relative to its international peers (for example, Japan and the US grew at 0.4% and 2.4%, respectively). Also, given the current size of China’s GDP, a 6.9% GDP growth rate in 2015 (according to the National Bureau of Statistics of China) corresponds to a 26% growth rate from the 2012 baseline in absolute term or a 8.2% Compound Annual Growth Rate (CAGR) between 2012 and 2015.

Furthermore, with income per capita increasing by 34% over the last five years, the number of households with income above USD 30,000 doubled over the same period. The same is true for the number of high-net-worth individuals (HNWIs): Capgemini’s World Wealth Report 2015 published estimates that China is home to 890,100 HNWIs, or one HNWI per 1,000 citizens (by comparison, India’s ratio is 0.2/1,000 and the US’s 14/1,000). Slowly undergoing a shift from saving to investing, Chinese people are looking for new investment opportunities.

Faced with historically low yields in the savings market (currently 1.5% for a one-year deposit), many Chinese investors are willing to shift their portfolio toward riskier asset classes such as stocks. Recent market volatility has highlighted the need to diversify investments toward new geographies and asset classes. As a result, the volume of outbound investment is on the rise, a sweet spot for global asset managers.
A

CHINESE HNWI POPULATION IS GROWING AT A 14% CAGR, INCREASING CHINA'S INVESTABLE ASSET POOL [#HNWI]


B

CHINA'S SAVING RATE REMAINS HIGH [Savings; GDP%]

Source: International Monetary Fund, 2015
In addition, the structural aging of the Chinese population is also impacting the asset management market positively. By 2050, senior citizens will make up more than 30% of China's total population. This structural change underlies the government's efforts to set up a sustainable retirement savings system: from the first modern welfare reforms of the 1990's to the civil servant Occupational Annuity program (OA) launched in April, 2015, the government's commitment to universal pensions has been unwavering. Of course, the unprecedented opportunities created by the country's aging population have also sparked the interest of the private sector, including asset managers in the private-pension market.

**ONGOING DeregULATION PROVIDES FOREIGN COMPANIES WITH INCREASINGLY FAVORABLE MARKET-ENTRY OPPORTUNITIES IN CHINA**

Increased international prominence and recognition have been key agenda items for the Chinese government over the past decade, and these objectives have resulted in a number of deregulation initiatives. Essentially, the new measures allow for the easing of existing quotas as well as the introduction of new types of quotas and access channels.

Over the past two years, Chinese regulators have unveiled significant liberalization measures, and addressed concerns over capital markets accessibility to encourage capital inflows and offset the drop in foreign exchange reserves.

The series of reforms (in March, 2015, December, 2015 and early February, 2016) have provided greater flexibility for participants in the Qualified Foreign Institutional Investor (QFII) program in two ways: firstly, by easing the application process (quotas were previously granted on a pre-application basis only, but now firms will only need to seek further quotas once the cap limit is reached) and lifting the USD 1 billion quota ceiling; and secondly, by simplifying the rules for setting and awarding quotas, which will now be determined on a combined basis with the quotas set by the Renminbi Qualified Institutional Investor (RQFII) program. At the same time, the new rules allow earlier repatriation of invested funds by reducing the lock-up period and relax certain other restrictions on the inbound and outbound remittance of funds.

These measures make it easier to move money out of China with simplified application process, wider usage, greater liquidity and flexibility; in addition, these changes signal the willingness of the Chinese government to push for renminbi convertibility.

Asset managers – the biggest quota holders – will directly benefit from such changes. Overall, QFII quotas are now extended to 279 institutions (up from only 93 in 2010) and have quadrupled in size to about USD 81 billion since 2010.

In addition to deregulation measures, new types of quotas, such as Shanghai’s Qualified Domestic Limited Partner (QDLP) and Shenzhen’s Qualified Domestic Investment Enterprise (QDIE) quotas, were implemented in 2013 and late 2014, respectively, allowing wealthy investors to make alternative investments offshore. Invesco Great Wall Asset Management, Ping-An UOB and Ping An Trust have already received QDIE approval, while BlackRock and China International Fund Management received QDLP approval in late 2015. These additional quotas give asset managers new ways of making cross-border investments.

On top of the traditional and newer quota schemes (QFII, RQFII, QDLP, QDIE, etc.), the Chinese government has also been introducing new access channels to China’s capital markets. Several key milestones have been reached in the past few years, including the Shanghai-Hong Kong Stock-Connect (launched in November, 2014), the Mainland-Hong Kong Mutual Recognition of Funds (MRF) scheme (launched in July, 2015), the relaxation of quotas (in December, 2015), and the opening-up of the onshore Interbank Bond Market (IBB; in February, 2016). These developments are setting the scene for a new environment of cross-border investments, in and outside of China, characterized by a move away from quota restrictions.

In addition, in July, 2015, the IBB was opened to only a few foreign institutions (central banks, sovereign wealth funds and supranational institutions). In February, further liberalization came to meet rising demand from foreign investors. The PBOC announced, ahead of the G20 meeting, that it would also remove the quota system for commercial banks, insurance companies, securities firms and asset managers.

Practically speaking, this means that all institutions based in Hong Kong, Taiwan and Macau as well as members of the QDII scheme can trade in the Chinese bond market, thereby creating many opportunities for direct investments in China. A total of 27 foreign institutions are directly benefitting from the
**RECENT REGULATION CHANGES ARE IMPACTING FOREIGN PLAYERS**

<table>
<thead>
<tr>
<th>Setup options</th>
<th>Channels</th>
<th>Accelerated pace of deregulation in the past few years, enlarging the opportunities for foreign players to access mainland China AM market</th>
</tr>
</thead>
<tbody>
<tr>
<td>JV (% of ownership)</td>
<td>RMB quotas</td>
<td>First 33% and then 49% stakes allowed to foreign players since 2007</td>
</tr>
<tr>
<td>WFOE</td>
<td>MF recognition</td>
<td>September, Aberdeen to be granted the first WFOE license enabling Investment Management activities</td>
</tr>
<tr>
<td></td>
<td>Stock connect</td>
<td>July, start of MF recognition scheme with RMB 600 bn total quota</td>
</tr>
<tr>
<td></td>
<td></td>
<td>November, launch of Shanghai Stock Connect</td>
</tr>
<tr>
<td></td>
<td></td>
<td>December 2011, RQFII established with aggregate investment quota of RMB 20 bn</td>
</tr>
<tr>
<td></td>
<td></td>
<td>November, the quota is raised to RMB 270 bn</td>
</tr>
<tr>
<td></td>
<td></td>
<td>July, RQFII scheme significantly expanded and revised including new hubs (e.g., London, Taipei &amp; Singapore)</td>
</tr>
<tr>
<td></td>
<td></td>
<td>As of December, RMB 444 bn RQFII quota granted to 156 institutions up 48% YoY</td>
</tr>
<tr>
<td></td>
<td></td>
<td>November 2002, QFII scheme launched with aggregate quota limit of USD 30 bn</td>
</tr>
<tr>
<td></td>
<td></td>
<td>April, QFII quota raised to USD 80 bn</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Aggregate QFII quota limit raised to USD 150 bn</td>
</tr>
<tr>
<td></td>
<td></td>
<td>As of December, USD 81 bn had been approved up 21% YoY</td>
</tr>
</tbody>
</table>

1) Aggregated quota, split in each direction

deregulation, which constitutes a major step forward for foreign asset managers.

China’s onshore bond market stood at roughly RMB 47 trillion (USD 7.4 trillion) at the end of 2015, growing at 30% and providing higher yield than those elsewhere (ten-year mainland government bond yield was at 2.87% vs. -0.04% and 0.17% for Japan and Germany, respectively, at the end of February, 2016). Many expect the Chinese bond market to surpass the Japanese USD 11 trillion one and become the world second largest in the next four-to-five years, trailing only the American USD 35 trillion market.

In summary, even though foreign firms might not be immediately rushing to invest in the mainland’s bonds (mainly due to uncertainty about the transition from CNH to CNY), foreign firms now have more channels through which to meet their global investors' appetites for Chinese underlying assets.

With the stock connect and the IBB market liberalizations, quotas are becoming less important in accessing the mainland’s stocks and fixed-income assets. Although it is still not clear how foreign firms should proceed with their QFII and RQFII quotas, the quota system is likely to become obsolete as China continues to open up further. AllianceBernstein, for instance, has already decided to return its QFII and RQFII quotas and to invest in Chinese bonds through the IBB instead of the investment quota scheme (announced at FinanceAsia’s Borrowers and Investors Forum in March, 2016).

While the media focus on China’s economic slowdown and market volatility, international asset managers should keep their sights on the China market. In fact, asset-management opportunities in China continue to grow, nurtured by strong long-term economic fundamentals, increasing sophistication and deregulation, as well as positive cross-border trends. We estimate that China’s asset management market will double in the next five years, hence advise foreign firms to position themselves to secure their share of the pie. ➔ D

"Previously, the market was only open to a handful of foreign investors, and there was a strong bias toward public-sector investors; now it's been opened up to nearly all investors"

Global researcher at Standard Chartered Bank, Bloomberg

2020 FORECASTS SHOW STRONG GROWTH FOR BOTH RETAIL AND INSTITUTIONAL SEGMENTS [AuM; USD tr]

<table>
<thead>
<tr>
<th>Year</th>
<th>Retail</th>
<th>Institutional</th>
<th>CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>2013</td>
<td>0.7</td>
<td>1.2</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>1.2</td>
<td>1.9</td>
<td>+14%</td>
</tr>
<tr>
<td>2015</td>
<td>3.2</td>
<td>2.7</td>
<td>+12%</td>
</tr>
<tr>
<td>2016</td>
<td>4.2</td>
<td>5.3</td>
<td>+16%</td>
</tr>
<tr>
<td>2020F</td>
<td>8.5</td>
<td>3.2</td>
<td></td>
</tr>
</tbody>
</table>

Source: Roland Berger analysis, 2015
Opportunities and challenges international players should be aware of

**Areas with growth potential**
The advent of digital technology, combined with increasing sophistication and an inherent need for diversification, has put the following opportunities on our “watch-list” for asset managers in both domestic and cross-border markets.

1) Domestic market
Within China’s domestic market, the client and product mix keeps evolving. We have therefore investigated the recent shifts from a product perspective on the one hand and from a client perspective on the other.

1a) Product innovation
In the past, insufficient product diversification among all segments (both retail and institutional) and within all asset classes has made it difficult for Fund Management Companies (FMCs) – with or without JV partners – to differentiate their offerings. Over the past few years, the asset management industry in China has been shaped by a number of interesting product innovations.

Money market funds: a China-specific trend
Since the early 2010s, offerings from Internet giants such as Alibaba’s Yu’E Bao (the largest Money Market Fund (MMF) with USD 95 billion of AuM at the end of 2015 and managed by Tianhong Asset Management), Baidu’s Baifa (China Asset Management) and WeChat’s Licaitong (multiple managers) disrupted the traditional market with the launch of online – and mobile – MMFs. These funds promised annual returns as high as 8%. The attractiveness of these funds raised awareness for mutual funds among Chinese retail investors, highlighting the funds’ role as an alternative to direct securities investments.

In 2015, Chinese mutual fund assets nearly doubled, hitting a new high of USD 1.5 trillion, according to our projections and recent estimates by the Asset Management Association of China (AMAC). This increase was mostly driven by inflows into MMFs, especially in the second half of the year. This trend is expected to continue amid the stock-market turmoil, as booming online distribution has enticed mass-retail investors to switch deposits into relatively safe products with higher yields. Most Chinese MMFs offer an annualized yield of eight-to-ten times the bank deposit rate.

A booming MMF segment is in fact the most striking example of China’s unique growth pattern. Indeed, China’s mutual fund market differs significantly from mature markets (2010-2014 CAGR of MMF: 94% in China vs. -1% in the US and -3% in Japan) and is expected to undergo further structural adjustments across several dimensions including product segmentation.

Alternatives and fixed-income funds: potential rising stars to come
As the Chinese capital market matures, demand for sophisticated strategies is expected to increase. Asset classes such as quantitative products, private debt, hedge funds and private equity are still of limited supply domestically but are highly sought after by HNWIs, Ultra High Net Worth Individuals (UHNWIs) and institutional investors. With developed alternative asset management franchises in other international markets, there is ample room for foreign asset managers to leverage their expertise and capture market share as the alternatives investment market grows in China. For example, Société Générale and Deutsche Bank are leveraging their expertise abroad and their Chinese asset
**MONEY MARKET FUNDS ARE GAINING MORE WEIGHT AMONG MUTUAL FUNDS**

<table>
<thead>
<tr>
<th>Year</th>
<th>Others 1</th>
<th>MMF (Money Market funds)</th>
<th>FI (Bond 2) funds</th>
<th>EQ (Equity funds)</th>
<th>Balanced funds</th>
</tr>
</thead>
<tbody>
<tr>
<td>2011</td>
<td>13.6%</td>
<td>53.1%</td>
<td>6.8%</td>
<td>23.9%</td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td>19.9%</td>
<td>46.5%</td>
<td>12.6%</td>
<td>18.5%</td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td>25.1%</td>
<td>41.2%</td>
<td>14.5%</td>
<td>17.1%</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>46.8%</td>
<td>30.2%</td>
<td>9.7%</td>
<td>12.1%</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>54.2%</td>
<td>10.0%</td>
<td>8.5%</td>
<td>25.0%</td>
<td></td>
</tr>
</tbody>
</table>

1) Others includes commodities and guaranteed funds.
2) Includes short-term wealth management products.


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**CHINA STILL SHOWS DIFFERENT ASSET CLASS MIX AND TRENDS FROM MATURE MARKETS – ASSET CLASS MIX IN MUTUAL FUNDS**

<table>
<thead>
<tr>
<th>2014 mutual funds asset class mix</th>
<th>2010-14 CAGR by asset class</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>US</strong></td>
<td><strong>Japan</strong></td>
</tr>
<tr>
<td>15,851</td>
<td>769</td>
</tr>
<tr>
<td>9%</td>
<td>2%</td>
</tr>
<tr>
<td>17%</td>
<td>17%</td>
</tr>
<tr>
<td>22%</td>
<td>28%</td>
</tr>
<tr>
<td>52%</td>
<td>81%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>2010-14 CAGR by asset class</th>
<th>Japan</th>
<th>US</th>
<th>China</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Total</strong></td>
<td>9.7%</td>
<td>7.6%</td>
<td>16%</td>
</tr>
<tr>
<td><strong>EQ</strong></td>
<td>10.1%</td>
<td>10.4%</td>
<td>-3%</td>
</tr>
<tr>
<td><strong>FI</strong></td>
<td>9.9%</td>
<td>7.5%</td>
<td>23%</td>
</tr>
<tr>
<td><strong>MMF</strong></td>
<td>-3.0%</td>
<td>-0.7%</td>
<td>94%</td>
</tr>
<tr>
<td><strong>Mixed</strong></td>
<td>12.6%</td>
<td>-4%</td>
<td></td>
</tr>
</tbody>
</table>

1) Qualified Domestic Institutional Investors
2) Excluding UK

Chinese investors have growing demand for alternative assets both within the country and in overseas markets. With the gradual opening of the capital markets and yuan liberalization, two-way, cross-border investment becomes possible.

Bloomberg
management JVs to launch Fund of Hedge Funds and primary private equity products, respectively.

With investors still reeling from the impact of China’s equity market downturn since June, 2015, retail and institutional investors have quickly come to understand the need for more balanced investment portfolios, causing them to seek greater diversification in the domestic market. Therefore, demand for non-equity, high-yield products is on the rise.

At the same time, losses in equity markets in 2015 made it very difficult for fund managers to maintain their past performance. This has led local asset managers to increasingly push for product innovation and start developing more sophisticated fund portfolios to compensate for the decreasing margins of traditional products. This means that product offerings are also likely to evolve.

Regulation-wise, new schemes such as the Qualified Domestic Limited Partnership (QDLP) and Qualified Domestic Investment Enterprise (QDIE), are now allowing investments in alternative products (e.g., real estate and infrastructure), opening the door for further product sophistication in China’s domestic market. In addition, a variety of new asset classes is emerging, such as Asset-Back Securities (ABS) based on Chinese banks’ mortgages.

Overall, product innovation keeps increasing in China, nurtured by deregulation and market fluctuations. In this context, alternatives and fixed-income products appear much more appealing than in the past, especially for the more sophisticated institutional clientele. Well-positioned foreign players, actively marketing their fixed-income or alternatives funds to local financial institutions, should quickly benefit from this trend.

1b) Client mix dynamics
Looking forward, the institutional clientele is likely to generate most of the growth in China. For pension funds, increasing awareness of Enterprise Annuity programs (EA) in corporations leads to substantial growth in the EA asset pool. For insurers, most players are willing to outsource mandates to achieve higher investment returns.

Massive growth of pension funds
China’s pension system is still at a nascent stage of development. Funds from the National Social Security Fund (NSSF) and Enterprise Annuity Funds (EAP), however, have seen significant growth: from 2013 to 2014, EAP’s AuM increased by 50%, driven by retirement saving needs. Among all institutional investors, pension funds appear to be an attractive client segment to serve.

In 2015, China set up an occupational pension scheme (OA) for government employees – a type of supplementary pension similar to the 401k in the US that includes payments by both government departments and employees. It is estimated that this new scheme will add RMB 150 billion (USD 24.12 billion) annually into the pension industry from 2015 to 2020.

At the end of last year, the NSSF awarded its first batch of mandates to four foreign players (Vanguard, Amundi and the Hong Kong subsidiaries of DaCheng Fund Management and China Universal Asset Management). In addition, the it is expected to soon expand into overseas alternatives, including private equity.

Given the level of uncertainty in Chinese financial markets today, the government’s pension funds are increasingly willing to outsource management to professional fund managers. We estimate the outsourcing ratio to be 25% for the NSSF and 95% for EA.

Although the pension fund segment is still dominated by local players, government mandates are increasingly allocated to JVs. Hence, Chinese pension funds are an opportunity not to be missed for foreign players as well.

Insurance mandates
The insurance asset management sector in China has experienced substantial growth since 2012. Research indicates that insurers’ mandates are expected to grow at a CAGR of 69% from RMB 5 billion in 2013 (USD 812 mn) to RMB 200 billion in 2020 (USD 31 bn). This rise is mainly driven by the sector’s intrinsic growth and efforts to improve investment returns on prop account business. Today, we estimate insurers’ outsourcing ratio at roughly 1%, still small but on a massive asset base. Although this is positive news for all asset managers in China, foreign players should be particularly interested: insurers tend to require sophisticated products and to be open to offshore investments.

Along with Ping An and PICC, China Life completed an external mandate process late 2014 for both its domestic and offshore investments. Thirteen FMCs (including Harvest, Fullgoal, BoCom, Schroders and Invesco Great Wall) received local mandates, and eight global players (J.P.Morgan, Schroders, SSGA, Goldman Sachs, Neuberger Berman, BlackRock, America Centuray and Franklin Templeton) shared USD 800 million in offshore investments (out of a pool of assets of USD 60
billion available for offshore investments).

More recently, Ping An Insurance announced its plan to add external fund managers for equity and bond investments and to boost its exposure to foreign and property assets. Out of the group’s RMB 1.8 trillion (USD 260 billion) of investable assets, some RMB 50 billion (or 2.9%) are managed externally, and the group is increasingly moving into new instruments and asset classes such as convertible bonds, preferred shares and mezzanine debt funds, where foreign firms have a competitive edge.

Going forward, global asset managers may well be insurers’ first port of call for sophisticated offshore investment options.

2) Cross-border market
The cross-border market is a two-way street: outbound (Chinese investors investing outside of China) and inbound (global investors investing in Chinese assets). Different dynamics are at play in each.

2a) Demand for offshore investments from Chinese investors
Over the past few years, overarching public policies, such as “Go Abroad” (2007), “One Belt, One Road” (2013) and “Stock Connect” (2014), have been launched by the Chinese government to push for the deployment of Chinese capital offshore. Also, with domestic equities markets at home delivering a disappointing performance and the volatility of China A-shares at its highest, Chinese retail and institutional investors are now looking overseas for investment opportunities.

According to the P2P (peer-to-peer) lending platform CreditEase, in the past four years the proportion of mainland HNWIs’ holdings of foreign assets has doubled from 20% to 40%, and that of UHNWIs has risen from 50% to 60%, sparking the growing demand for offshore investments.→1

Foreign asset managers, in Hong Kong and mainland China, are best positioned to capture this growing demand. For example, UBS AM is continuing to build its China business. Following in the footsteps of BlackRock, UBS AM set up an outbound investment entity (with an initial quota of USD 100 million) in November, 2015, to capture the increasing offshore demand from HNWIs and institutional clients. Mainland investors are often a lucrative segment to serve: the average transaction size is 20-30% bigger than that of their Hong Kong counterparts.

In addition to these robust outbound trends, two regulatory relaxations (among a series of others) are creating exciting opportunities for offshore asset managers. Firstly, China’s central bank approved the launch of QDII-2 late last year, an improved Qualified Domestic Individual Investor program in the Shanghai free-trade zone, whereby HNWIs are allowed to directly invest in overseas real estate, financial assets and other investments under a certain foreign exchange quota. This may well lead to a surge in the volume of offshore investments. Secondly, industry insiders believe that, sooner than later, it will become feasible for Chinese institutions to invest in an offshore RMB pool without the need for an onshore entity. This will be a historical milestone for Chinese investors (both retail and institutional) and may well further increase domestic investors’ familiarity with offshore markets.

2b) Demand for investments in Chinese assets from global investors
Over the past several years, the only direct method to gain China A-share exposure has been through the Qualified Foreign Institutional Investor (QFII) program, a scheme launched in 2002 that allows foreign firms to obtain RMB to invest directly in China onshore markets. Asset managers were holding a total of USD 36 billion in quotas by end of 2015, making asset management players the biggest channel through which to access China’s domestic capital markets by far. By comparison, commercial banks held only USD 17 billion in quotas.

Despite China’s volatile equity market, several players have recently sought out higher quotas. For example, Vanguard, Wellington Management and Hyundai Investments have gathered RMB 20 billion (USD 3 billion), RMB 2.5 billion (USD 0.4 billion) and RMB 3 billion (USD 0.5 billion), respectively, during the first two months of 2016.

Vanguard said its mega-quota (USD 3 billion), the largest single RQFII quota handed out by the SAFE, would offer global clients more access to onshore securities and greater product diversification. Indeed, the main function of the quota will be to add A-share exposure to its emerging-market funds (Vanguard Emerging Markets Stock Index Fund is the largest in the world, with USD 49.8 billion).

In an effort to counterbalance the downward stock market cycles and further liberalize China’s capital markets, Chinese regulators significantly relaxed quota rules in February of this year, making it easier for foreign players to operate in China. For example, li-
China: The new frontier for foreign asset managers

Demand from Chinese Investors for Offshore Products [AuM; USD bn]

CAGR 2013-2019F
- Mutual Recognition & Bank QDII +8%
- Insurance companies +40%
- CIC +55%
- NCSSF +1%
- SAFE +55%
- SAFE -2%

Licensed investors, under the QFII or RQFII scheme, are now assigned quotas based on a percentage of their Assets under Management (AuM) rather than a per-application basis. Consequently, additional inflows from global investors are expected as China demonstrates more flexibility with its QFII scheme.

The same is true for the bond market. Bond-based mutual funds have enjoyed major inflows since the third quarter of 2015 (as fixed-income-based products accounted for up to 60% of all products, up from 30% at the beginning of the year). On top of this, two announcements made the demand for RMB assets surge: the IMF’s announcement in November, 2015 (to include the RMB in the Special Drawing Rights (SDR) basket), and the removal of quota controls on the mainland interbank bond market (IBB) in February this year. These developments were significant game changers for foreign investors and foreign asset managers.

Asset managers may now increase the proportion of Chinese bonds in their global fixed-income benchmarks. J.P. Morgan, Citi and Barclays hold the biggest emerging market global bond indices. J.P. Morgan GBI-EM is said to be the first of its peers to have made the move.

On both A-shares and Chinese bonds, foreign investors are moving quickly to trade in China. The mutual fund market is no exception to the trend. Foreign firms with a presence in Hong Kong (and mainland China) are likely to be the first to benefit from this booming two-way traffic. Indeed, the Mutual Recognition (MR), introduced in July, 2015, is making Hong Kong a fund manufacturing center. Despite a slow start (only three approvals, including J.P. Morgan Asset Management, out of 17 applications), there is great optimism for northbound (Hong Kong to China) MR funds. On the other side, southbound MR funds are also on the rise: for instance, Franklin Templeton’s Shanghai JV is launching its first China product in Hong Kong in March, 2016.

In the same spirit, HK Exchange also plans to launch a series of initiatives to broaden access to Chinese markets (e.g., the upcoming HK-Shenzhen Stock Connect, a Bond Connect, a scheme for foreign investors to subscribe to initial public offerings of A-shares through a new Primary Equity Connect Structure, etc.).

Fundamentally, in the coming decade, the “greater-China” region will no longer be seen as a source of exposure to emerging markets, but rather as a distinct asset class, with Chinese A-share investments making
up a significant part of this allocation. The rest will come from cross-border exposure, primarily Hong Kong and Chinese firms cross-listed on each other’s markets.

In such an environment, foreign players with a presence in both the mainland and Hong Kong should be able to access a large range of Chinese assets (on top of their global product offerings), thereby maximizing portfolio construction and product offerings to both Chinese and global investors.

While opportunities are on the rise for foreign asset managers in China, they continue to face a number of challenges.

**CHALLENGES FACED BY FOREIGN ASSET MANAGERS**

1) **Evolving legal entity status requirements put foreign asset managers in front of strategic choices on current vs. future local setup**

With 45 of the 101 FMCs in China existing as Sino-foreign joint ventures (JVs), setting up a JV with local Chinese partners has long been the status quo for foreign asset managers seeking to access the Chinese market. However, with Aberdeen and Fidelity launching Wholly Foreign-Owned Enterprises (WFOEs) in China in 2015, incumbent foreign players have started to take some interesting new paths. Russell Investments, for example, disposed of its stake in its JV, preferring a shift toward a standalone WFOE model while Franklin Templeton has voiced its intention to set up a new WFOE in addition to its existing local JV.

Setting up a WFOE seems to be the new trend as it provides foreign players with the ability to finally access market opportunities with a full-ownership setup. From the launch of the Shanghai free-trade zone in 2013 to the Sino-US talks in 2015, the Chinese government has accelerated the pace of reform, laying out more favorable setup conditions for foreign players. As part of the Sino-US talks, the Chinese government has agreed to grant newly licensed WFOEs the ability to invest in China’s domestic capital markets, i.e., not limiting WFOEs to investment advisory, consulting and client servicing only, but allowing them to manufacture and market their own funds. Aberdeen Asset Management was the first foreign player to obtain a WFOE license in September, 2015; Schroders established a WFOE in Shanghai at the end of 2015, and in February, 2016, Schroders’ WFOE itself set up a subsidiary in Beijing, so as to strengthen client services in both cities. Last year, at
Half of the ten largest FMCS in China are wholly Chinese-owned while the other 50% are sino-foreign JVs [AuM; RMB bn]

Foreign players are adjusting their local setups to maximize their penetration of Mainland China

1. Several foreign asset managers (e.g. State Street Global Advisors) are abandoning their JVs with local players after rather limited success.
2. With already a JV in China, several foreign AM players (e.g. Principal Global Investors) are setting up a WFOE.
3. Some foreign FMCS sold their stake in their JV (e.g. Russell Investments' with Ping An) to shift to WFOE.
4. New entrants (e.g. Aberdeen) choose WFOE instead of JVs.
5. New WFOE license that enables investment Management activities (September, 2015)

Source: Roland Berger, 2016
least 13 foreign asset managers set up WFOEs in China, and many others such as Franklin Templeton may also be considering this option.

The same push is being witnessed in other product channels: foreign players are currently leading a series of initiatives to prepare for and rapidly seize market opportunities in mainland China. J.P. Morgan, Amundi, Schroders were among the first movers to get products approved to sell HK domiciled funds in China through the Mutual Fund Recognition scheme. UBS, Nomura, Deutsche Bank and BlackRock applied early for Qualified Domestic Limited Partnerships (QDLPs) in two batches – the first in September, 2013, and the second in March, 2015. Although the majority of the main global players, such as Invesco Great Wall and Nikko's Rongtong, still operate in China as JVs, WFOEs may well replace the JV option, or complement it.

Despite the recent relaxations, players should not expect smooth sailing in China’s asset management market.

2) The distribution conundrum
Throughout the last decade, China’s major retail banks have been, by far, the predominant distribution channel for retail fund products. Over the past few years, new channels (e.g., online/direct sales and independent financial advisors) have started to emerge, generating new opportunities but also adding complexity to China’s distribution dynamics. Foreign asset managers need to carefully consider their options, as each comes with a set of advantages and disadvantages.

Distribution issues are fundamentally issues of supply and demand. At present, there are 101 active FMCs in China as well as 45 JVs and other indirect competitors, such as insurance asset management companies, all of which are competing to make large banks their primary distribution channels, especially Industrial and Commercial Bank of China (ICBC), China Construction Bank (CCB), Agricultural Bank of China (ABC) and Bank of China (BOC).

Indeed, many in the industry believe that being listed at the top of ICBC’s top-product list is critical. This distribution constraint puts many smaller managers who were hindered by a limited track record or low regional brand recognition in a difficult position when trying to introduce new products onto the market. In the past, incentive payments and expensive marketing campaigns may have been effective means to secure inflows, but pressure from regulators and increasing competition have made it harder to win shelf space.

On top of this, bank distributors have been applying caps on the number of funds they intend to sell, favoring their proprietary short-term wealth-management products (WMPs). The CSRC, well aware of this bottleneck, has been allowing non-bank distribution channels to compete. While banks remain dominant and account for 60% of fund sales, their share is shrinking in favor of online and IFAs.

Online distribution of funds is often seen as the solution to the challenges of fund distribution in China. Recent events, such as the rise of online fund supermarkets in other Asian markets, tend to suggest that the near-term potential for online distribution is far greater than previously assumed. Online distribution of funds can be divided into two categories: the online platforms of fund companies and online distribution over third-party platforms, which comprises 101 registered players in China in March, 2016.

Following the successful partnership of Yu’E Bao (an e-commerce platform launched by Alibaba Group as part of Alipay) with Tianhong Asset management, the third-party, e-platform distribution option has become increasingly popular. New digital players are flocking to the market from a wide range of industries. These new market entrants come with sky-scraping ambitions as well as large pre-existing user bases and solid digital platforms.

For example, Eastmoney, the owner of Tiantian Fund Sales – China’s largest online fund sales platform – has received approval from the CSRC to set up a mutual fund company. The resulting wholly-owned company, to be called Tiantian Fund Management, will leverage its digital platform to sell Tiantian’s products, which already account for 90% of fund sales by online third-party platforms in China.

The good news for foreign asset managers is that the CSRC’s legal requirements for other distribution channels also apply to e-commerce platforms. This means online platforms need to comply with clearing requirements, internal controls necessary to safeguard investor interests, investor post-trade services, etc. Many of these requirements demand capabilities that digital players may not have yet. On top of these regulatory obligations, the key challenge for online companies will be to offer more sophisticated products as the market develops and trends shift. This is where distri-
China: The new frontier for foreign asset managers

Chinese FMCS’ market has recently become significantly more competitive. [#FMC]

"The sudden success of the online marketplaces has made clear that managers can raise an impressive amount of assets in China even without a brick-and-mortar distribution network."

Dechert LLP

"Competitiveness in developing services and products will – at least initially – depend on the personnel at all levels of the organization."

Cerulli

bution partnerships between foreign fund managers and Chinese third-party platforms could be a “win-win” solution.

The trend also holds true for Independent Financial Advisors (IFAs). Noah, one of the most aggressive IFAs in China, built its business by advising HNWIs and enterprises to buy into fund products, primarily those from trusts, private funds and private equity. Noah then established a private fund company, got listed on the NYSE in 2010, opened an office in Hong Kong in 2012 and began offshore expansion. Other IFAs and private fund companies are also eager to broaden their scope of activities in this expansion phase, and foreign firms may have an interesting role to play.

Finally, P2P lenders with online wealth management platforms are reaching out to asset management firms in search of products. Standard Life Investments, which was in talks with China P2P firms at the end of last year, is an example of an asset management company seeking new partnership opportunities.

3) Talent acquisition and retention

One of the major difficulties faced by foreign asset managers when building a “China strategy” is talent acquisition. Indeed, domestic players’ competitiveness (both in the digital and traditional domains) has increased significantly over the past few years, making talent acquisition and retention even more challenging.

Aside from competitive fees and intense marketing efforts, the rapid market penetration of Chinese players has been propelled by aggressive talent acquisition initiatives at all levels. Talent retention, already a major challenge in China, has become the No. 1 priority for many AM players.

The liberalization of private funds through deregulation has added more fuel to the flames. Motivated by the prospect of higher compensation and greater flexibility, many well-connected fund managers have leveraged their close relationships with HNWI clients to leave their asset management employers and start their own private funds.

To address this talent shortage, foreign asset managers have come up with new strategies for different stages of the talent life-cycle. For talent acquisition, companies are slowly transitioning from hiring “the best people” to hiring “the right people.” Employer branding has become more critical, as the new workforce starts to look for jobs with a purpose. New competencies, such as resilience during difficult times and loyalty are becoming more highly sought after and tested in the recruiting process.

To overcome the shortage of home-grown talent suitable for multinational companies, foreign fund managers have developed a number of creative initiatives, such as sending employees on international assignments, enrolling them in frequent training sessions and offering customized retention plans. Equity incentives are often offered to key investment and marketing personnel which include adjusting remuneration to international market levels or offering expat positions in Hong Kong.

In summary, foreign asset managers interested in China can now explore a variety of ways to capitalize on China’s large and growing market, where regulations seem to be relaxing faster than in other financial services industry segments.
RECENT EXAMPLES OF SUCCESS

A number of international players in China have already taken bold actions to boost growth. Some have achieved considerable success. These examples may well give some food for thought to other foreign players reviewing their options in this challenging but exciting market.

PRODUCT INNOVATION

Fortune SG launched Fortune SG MMF, its first money market fund product, in 2005. Responding to investors’ demand for riskier assets in the early 2010s, the JV launched Fortune SG Tianyi in December, 2012. Fortune SG Tianyi, a fund that leverages the arbitrage between primary and secondary money markets, became the first MMF listed on the Shanghai Stock Exchange. Faced with aggressive pricing competition in 2014, Fortune SG created a bespoke “T sub-class” which offers lower fees after the first 90 days. This retention strategy proved to be the right move and led to massive AuM growth – a 400% increase in Fortune SG MMF’s AuM between 2014 and 2015, from USD 10.3 billion to USD 41.8 billion.

One interesting feature of Fortune SG’s MMF is that most assets came from institutional investors who had switched to the fund from equities (from the third trimester and onwards in 2015) because of its status as an exchange-traded product. With this strategy, Fortune SG managed to adjust its mix of institutional and retail business to 40/60, up from 20/80 two years ago.

Fortune SG, a JV between Société Générale and China’s Baosteel, has become one of the fastest growing asset managers in Asia Pacific in 2015 and is ranked 56th in Asian Investor’s 2015 ranking of the top-100 firms by Asia Pacific-sourced assets. It will continue to launch six-to-seven funds per year, targeting a range of assets between RMB 130 and 200 billion (USD 20 to 30 billion).}

FORTUNE SG MMF’S RECENT GROWTH [AuM; RMB bn]

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</tr>
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Source: WIND, Roland Berger analysis, 2015
MULTIPLE LEGAL VEHICLES

Aberdeen was the first global manager to be granted a WFOE license in China, which was announced in September, 2015. This enables it to operate fully as a private domestic securities firm in the Shanghai free-trade zone. Instead of working with a local partner, the license allows Aberdeen to conduct investment management as well as to manufacture and market its own products. These advantages amount to a higher degree of autonomy, client ownership and flexibility, a key cornerstone to building up an onshore presence in China.

Since then, Fidelity has also established a WFOE, and other international players such as Franklin Templeton have made similar applications in the Shanghai free-trade zone. New and incumbent international players can easily assess the benefits of such setups and evaluate whether they would make sense alongside a co-existing onshore JV.

Several asset managers, such as UBS, have made the Chinese market a key priority and are therefore concentrating on multiplying their access points to mainland clients. UBS now has a local JV with SDIC Trust and WFOEs in Shanghai and Beijing. UBS has also unveiled its plan to register both WFOEs as so-called "sunshine" private securities managers (the equivalent of hedge funds) once the regulator confirms the details of the WFOEs’ business scope.

In addition, UBS AM holds USD 100 million in quota under the QDLP program and has received QDIE quotas through UBS SDIC’s segregated account (SA) subsidiary, UBS SDIC Capital Management. Both QDIE and QDLP allow domestic investors to invest in UBS AM’s alternative products (PE funds, fund of hedge funds, etc.).

UBS’s Beijing WFOE was the first mainland WFOE to be registered as a private manager with the AMAC, which at present allows investments in alternatives only. Chinese authorities are, however, expected to further relax the regulations and potentially allow WFOEs to operate as private securities managers. If this happens, UBS and other foreign firms down the road will be free to participate in the domestic capital market and manufacture private products. Such products can then be distributed in partnership with a mainland firm, such as a trust company, or through other channels.

China is now UBS AM’s third-largest market by AuM after Switzerland and the US.

DISTRIBUTION INNOVATION

In August, 2015, Schroders disclosed that it was engaged in discussions with Ant Financial, the financial arm of Alibaba, on collaboration opportunities in China. While this collaboration is expected to be initially focused on the digital distribution of Schroders’ mutual funds, Schroders also expressed its intention to become more active in digital investment advisory, which is currently still at a nascent stage of development.

Like many other firms, Schroders has set up WFOEs in the Shanghai free-trade zone and Beijing to boost its local presence and develop opportunities in China’s fund industry. Schroders started offering two Chinese funds managed by the firm’s offshore JV, BoCom-Schroders, under the Mutual Recognition scheme. Other HK-registered funds are likely to be distributed through the JV’s distribution network, which will provide onshore contacts and client support.
CATERING TO OUTBOUND CHINESE INVESTMENT NEEDS

With increasing interest in overseas expansion, many Chinese asset managers (e.g., E-Fund, Caitong and Universal Funds) as well as institutional investors are in the process of setting up offices outside of mainland China: for instance, CIC is establishing offices in New York and China Pacific Insurance in London. Hong Kong is still a popular first choice for expansion, but many firms now have a presence in Europe and the Americas too.

According to DTZ/Cushman & Wakefield (real estate services firms), Chinese insurers have set aside a war chest of USD 73 billion in aggregate for overseas investments. Aside from direct real estate investments (e.g., Sunshine Insurance’s USD 401 million purchase of the Sydney Sheraton Hotel), more than 40 Chinese insurance companies and asset managers jointly established an investment firm in January, 2016, targeting overseas investments outside the real estate sector with an initial pool of USD 6 billion. While such large investors may prefer direct investments, many other investors, particularly second-tier insurance companies, may wish to partner with international asset managers for overseas fund products. To satisfy this demand for sophisticated asset classes, international asset managers could set up dedicated “China desks” with Mandarin-speaking relationship managers. The backgrounds and insights of such teams can also help drive foreign interest in inbound investments in China.

MANY CHINESE ASSET MANAGERS AND INSTITUTIONAL INVESTORS ARE SETTING UP OFFICES OUTSIDE OF MAINLAND CHINA

Source: Roland Berger analysis, 2016
Conclusion

With strong underlying macro fundamentals and supportive public-sector initiatives, the asset management industry in China presents foreign players with promising long-term growth potential. Although performance track record still remains the key differentiation factor for asset managers, foreign players should also holistically assess how to position themselves to benefit from increasingly favorable regulations, changing product offering and distribution dynamics and opportunities in two-way, cross-border investments in the short term. ◆
ABOUT US

Roland Berger, founded in 1967, is the only leading global consultancy of German heritage and European origin. With 2,400 employees working from 36 countries, we have successful operations in all major international markets. Our 50 offices are located in the key global business hubs. The consultancy is an independent partnership owned exclusively by 220 Partners.

FURTHER READING

ASIA ASSET MANAGEMENT: Consider Taiwan

“Taiwan is not typically seen as one of the ‘giants’ of Asia,” says Alain Le Couédic, a Partner at Roland Berger Strategy Consultants in Asia and one of the authors of the study. “But its asset management market offers significant opportunities that others do not.” The study credits Taiwan’s attractiveness to a growing appetite for foreign assets, a large pool of relatively low-debt investors who hold most of their wealth in financial assets, and an asset management market that has grown 10% per annum for the past six years straight.

The study also finds that Taiwan’s regulatory and competitive environment is more friendly than those of other regions or countries to foreign players that want to establish a footprint in Asia.

PLAN D – DIGITAL ALL THE WAY: How financial service providers can protect their livelihood with end-to-end digitization

New, technology-driven providers (online platforms, FinTechs) are cornering certain segments of the market with customer-friendly digital services, while the established financial service providers are falling behind the competition or even being forced out of the market. Finance brokers’ share of the market for mortgage lending has more than doubled since 2010, rising from 17 to 35 percent. This is one of the findings of a new study, “Plan D – Digital all the way: How financial service providers can protect their livelihood with end-to-end digitization”, in which experts from Roland Berger analyze the industry and present the steps the established financial service providers need to take now in order to successfully achieve digital transformation.

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