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Advisory Relationship with Chinese Asset Managers in the New Age

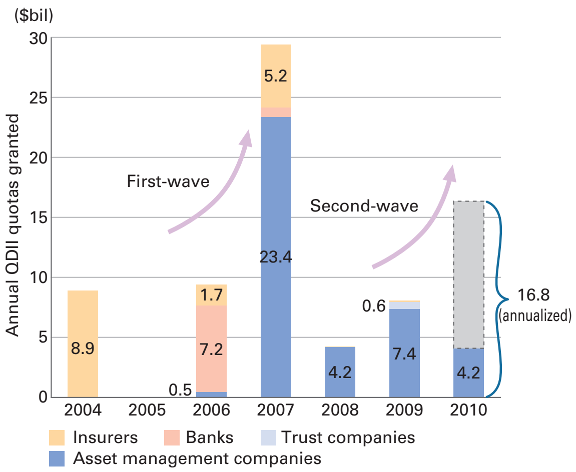
Nomura Research Institute, Ltd.

With China's 2007 QDII fund boom still fresh in memory, QDII funds are showing signs of renewed growth in 2010 following a multiyear lull. Offshore advisory services provided to QDII funds by foreign asset managers are becoming increasingly specialized against a backdrop of diversification of investor preferences and a pickup in QDII approvals by Chinese authorities.

Chinese financial authorities step up QDII approvals

To invest in oversea markets, Chinese domestic institutional investors must obtain the approval of the Chinese Securities Regulatory Commission (CSRC) by undergoing a CSRC examination of their business operations and financial capability. Those that have obtained such approval are called Qualified Domestic Institutional Investors (QDIIs). As of March 2010, 76 institutions has been granted QDII licenses. The CSRC granted QDII licenses to banks and insurers at the beginning of the program. In recent years, however, the vast majority of newly approved QDIIs have been asset management companies. Asset management companies account for 62%, or US$40 billion, of the aggregate QDII quota[1)] granted to date. So far,22 QDII funds[2)] have been approved and distributed in the market, and 11 of which are launched in the “second wave” since November 2009.

Exhibit 1. A new boom in the making?



Note: (1) 2010 QDII quota is an estimate derived by annualizing the quotas granted in the first quarter.
(2) Converted to US dollars at an exchange rate of 6.8 renminbi to the dollar.
Source: NRI America, based on CSRC data

With investor risk appetite still subdued in the wake of the recent financial crisis, these second-wave funds have accumulated only about US$500 million of assets at market value, but industry sources report that an additional 20 QDII funds, roughly equivalent to the number of existing QDII funds, are awaiting approval. A bevy of new QDII funds is likely to hit the market by year-end.

First wave: strained alliances with foreign asset managers

When the first wave of QDII funds was approved around 2007, inexperienced Chinese asset management companies faced a quandary as they prepared to venture into the world of overseas investing. Most choose to seek assistance from existing JV partners. Six of the 11 first-wave funds adopted a China-themed investment style, which refers to the strategy of limiting the investment universes to Chinese companies listed in Hong Kong and other overseas markets, thereby keeping their investment mandates within the scope of their expertise.

However, tensions arose between Chinese asset managers and their offshore advisors. Of five QDII funds that had hired JV partners as offshore advisors, three have already terminated their investment advisory relationships for a number of reasons. One reason was fundamental incompatibility with respect to investment horizon. Chinese asset managers (and Chinese retail investors) tend to be trend followers with a short-term orientation, whereas foreign asset managers generally tend to pursue medium- to long-term investment returns. This difference in time horizons was a source of substantial discord and distrust in the investment decision making process. Another reason was that Chinese asset managers were hoping to gain incidental know-how (e.g., research, investment knowledge, skills, IT) from their investment advisory partners, but they were reportedly dissatisfied with the level of cooperation, other than investment recommendations, that was forthcoming. At the same time, some major Chinese asset managers (e.g., ICBC Credit Suisse Asset Management) have been steadily expanding their in-house capabilities to obviate their former reliance on outsiders by hiring personnel with previous work experience at European or US asset management companies. Other than these, some structural changes from foreign partner side also partially contributed to the failure of the collaboration. Some alliances with foreign asset managers were terminated due to exogenous factors, such as acquisition of the foreign asset manager or bankruptcy of the foreign asset manager's parent company.

In response to the financial crisis's onset and sharp increase of volatility and risks in oversea markets, the CSRC temporarily stopped issuing QDII licenses in August 2008, ending the first wave of QDII fund boom.

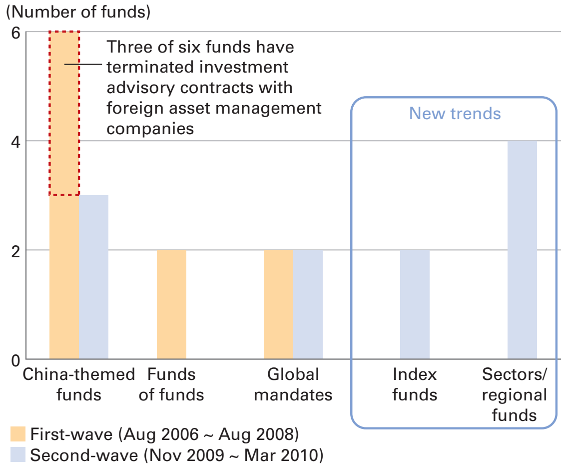
Second wave: foreign asset managers' advice sought amid shift to sector/regional specialization

After a 15-month hiatus, the CRSC resumed approving QDII applicants. Two new trends have since emerged in terms of Chinese asset management firms' investment style.

The first is a trend toward in-house portfolio management. QDIIs that have recently launched new China-themed funds are managing the funds utilizing in-house capabilities without any assistance from external asset managers. Meanwhile, some QDIIs have recently launched foreign index funds that require little issuer-specific research, enabling them to manage the funds utilizing in-house resources only.

The second trend is specialized investment. Some QDIIs have launched funds that invest exclusively in specific regions or sectors to differentiate themselves from their competitors, and improve upon the inadequate geographic diversification available from China-themed funds. As a result, we can see funds focusing on specific regions (e.g. emerging markets, Australia), or sectors (e.g. energy sectors), being launched very recently. However, such

Exhibit 2. Evolution of QDII funds' investment strategies



Source: NRI America, based on information disclosed by Chinese asset management companies

specialty investment strategies require skills that are largely lacking at Chinese asset management firms. Chinese asset managers are therefore likely to continue to require advice from foreign asset managers for the time being. In fact, all four specialized QDII funds launched in the first quarter of 2010 are utilizing offshore advisors. Two of the four are receiving investment advice from their JV partners. JV partners thus appear to still have an advantage in terms of winning offshore advisory mandates from these second type of QDII funds.

The QDII playfield are continuously changing, and relationship between Chinese asset managers and offshore advisors is evolving accordingly. Whenever there is demand, there is supply. When demand shifts, supply will follow. Chinese asset management companies recognize that advice from foreign asset managers is still important to ensure the quality of new specialized and other QDII funds. And meanwhile foreign asset management companies realized they must keep abreast of the QDII industry's ongoing evolution by understanding the investment styles preferred by Chinese investors and assets managers and providing the requisite specialized investment skills and research capabilities. The two parties are gradually exploring and optimizing the relationships in the second wave.

Some within the asset management industry have expressed concern that QDII funds will face headwinds for as long as speculation about renminbi revaluation (foreign currency depreciation) persists. However, others see economic recovery and the recent pickup in QDII approvals by Chinese authorities as long-term tailwinds for the QDII industry's growth. While the industry's future is fraught with unknowns, such uncertainties represent business opportunities for QDIIs and associated players.

Note

1) A QDII quota is the maximum amount of money that a QDII is authorized to invest in foreign markets. Quotas are set by the CSRC for individual QDIIs.

2) A QDII fund is a foreign investment fund sponsored by an asset management company with QDII license. Individual funds also must be approved by the CSRC.

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