CADERUS

2003-2013: 10 years of investment banking advisory

CHINESE ASSET MANAGEMENT INDUSTRY

Many years of economic growth, rapid wealth accumulation, regulatory liberalisation, growing international activity of Chinese private and institutional investors. Portfolio investment flows from China can change the landscape of any financial market.

Waiting for portfolio investment flows from China

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THE TIME IS SURE TO COME

With each year China is playing an increasingly more active and important role in the global economy, in international trade, in worldwide consumption and in investors' strategies and behaviour.

Some investors are looking for practical routes to gain access to Chinese financial instruments; others can hardly hide their excitement in anticipation of the forthcoming financial tide from China, just the news of which is bound to generate a sizeable rally.

However, despite the interest in the Chinese financial markets and the intuitive understanding of the rising financial power of the Chinese financial industry, there is a clear lack of knowledge even among professional financiers outside of China with regard to the current landscape and dynamics of the financial markets there, to the changing regulatory system for international direct and portfolio investments into and out of the country.

At the same time, investors in China, dissatisfied with the existing range of financial instruments available on the closed domestic market, are starting to consider overseas investment. In the meantime, as Caderus discovered during its research into the Chinese asset management industry (conducted in China during the summer of 2013), Russia is not on most Chinese investors' radars, despite the fact that the two neighbouring countries are also two of the largest in the world.

Barriers hindering the development of bilateral cross-border investment activity on both sides stem from linguistic and cultural differences and long-standing stereotypes. Even our common past, when the "big brother" USSR helped the younger Chinese "brother" build over 150 large infrastructure objects in the 1950s, does little to help overcome those barriers. While virtually nobody is aware of this fact nowadays in Russia, most Chinese remember and are still thankful for this.

This overview, which is the result of numerous face-to-face, over-the-phone, correspondence interviews and discussions with fund managers, trust managers, insurance fund managers, investment bankers, financial advisers, regulators, associations and high-net-worth individuals is designed to make a contribution toward breaking these barriers, helping our clients and partners take an important step towards understanding the financial markets and the asset management industry in China.

Chinese asset management research study

While working on this research, Caderus contacted close to 50 QDII fund managers, product development directors, international business development directors, trust managers, sunshine hedge-fund managers, insurance fund managers, research analysts and risk managers, senior management of stock exchanges, high-net-worth investors, investment bankers, advisors and regulators.

Most of these meetings and interviews occurred in the second half of June and in the first half of July 2013.

The first part of this overview gives a general understanding of the size of the Chinese financial markets, the landscape of the Chinese asset management industry, the general overseas investment regulatory framework.

The second part of this report presents the results of the study.

SCALE OF FINANCIAL ASSETS IN CHINA

Annual reports of numerous successful financial institutions in China do not cease to amaze one with the scale of their top line numbers, and their double-digit growth, despite their huge size.

BANKS

For example, aggregate assets of all Chinese banks reached USD23.6tn in July 2013, having demonstrated a 19.1% growth in 2012 in USD terms (17.9% RMB-terms growth and 1.01% CNY-to-USD growth). At the same time, Russian banks' assets amounted to RUR52.74tn as of July 1, 2013 (USD1.6tn, data from the CB of Russia).

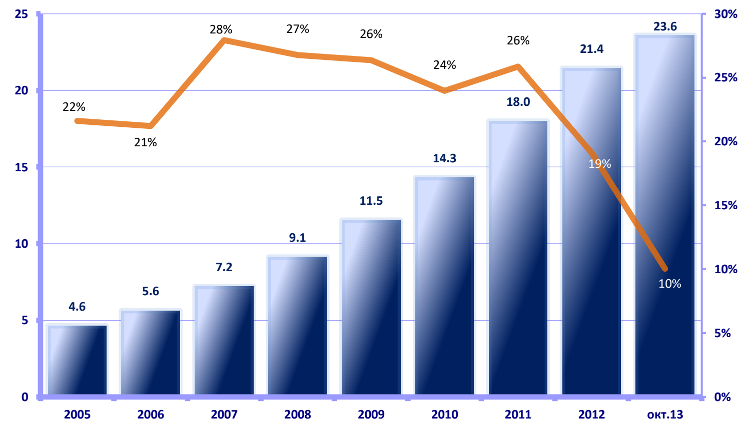
Total bank deposits in China reached USD15.1tn at the end of 2012, showing a double-digit annual growth, despite the regulatory upper limit on deposit interest rates (less than 110% of the PBOC's base rate, currently at 3%).

At the same time the shadow banking sector growth has been very impressive (the term "shadow banking" refers to credit and deposit activities outside of the commercial banking sector): according to various estimates, shadow banking assets in China have reached between RMB15tn and RMB36tn (USD2.4-5.85tn), making it comparable in size to the traditional banking sector.

EQUITY MARKET

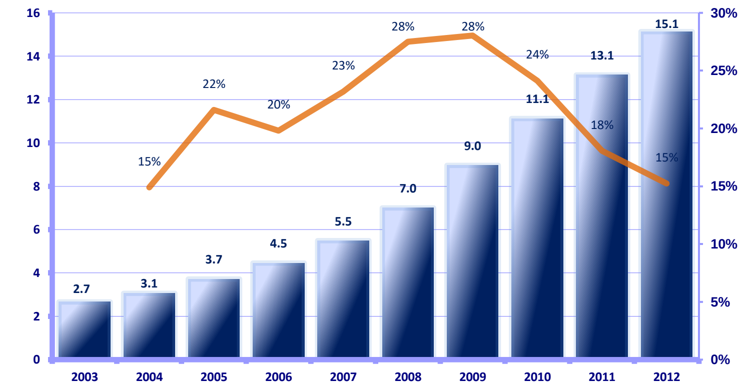
Shares of almost 2.5 thousand companies listed in the PRC (excluding Hong Kong) were worth a total of RMB23.62tn (USD3.84tn) at the end of October 2013, of which RMB15.2tn is the market capitalisation of shares on the Shanghai Stock Exchange, and RMB8.42tn worth of shares are listed in Shenzhen.

Aggregate Chinese banks assets (USD tn) and annual growth (%, rhs, YTD in 2013)



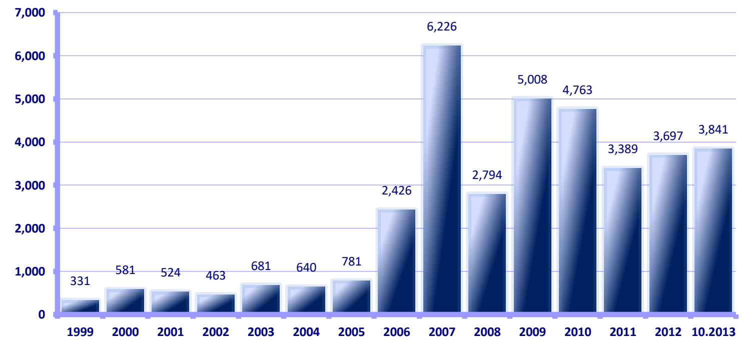
Source: PRC National Statistics Bureau, Caderus estimates

Aggregate Chinese banks deposits (USD tn) and annual growth (%, rhs)



Source: CBRC (China Banking Regulatory Commission) , Caderus estimates

Shanghai and Shenzhen combined equity market capitalization, USD bn



Source: Shanghai and Shenzhen Stock Exchanges, Caderus estimates

Ever since the re-opening of the Shanghai Stock Exchange in 1990, the market has been driven by individual investors. Up to 70-80% of daily trading volumes are generated by individual investors who are

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registered directly on one of the stock exchanges. Such a high level of dependency on individual investors has led regulators to focus on the development of institutional investor base in China, beginning with fund management companies (FMC).

Nevertheless, during the last few years the Chinese equity market has failed to attract additional investments: the total market capitalisation has been stagnating for the past few years, new IPOs have been frozen since the second half of 2012 (due to the fight for quality of corporate governance and the protection of minority shareholders' rights). At the very same time, other segments of financial markets, namely trusts, have seen stellar growth. This growth is actually one of the reasons for the lacklustre performance of the equity market, for investors have been attracted by trust product returns.

TOTAL SAVINGS IN CHINA

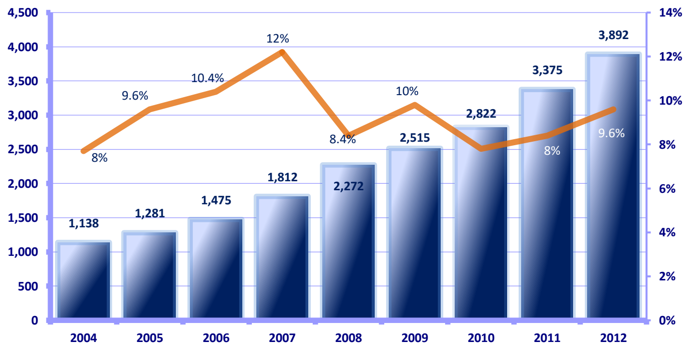
POPULATION

One of the direct results of market reforms started by Deng Xiaoping back in the late 1970s, is the steady accumulation of wealth by the Chinese population. Every component of disposable income has seen steady growth over the last 30 years: salaries and wages, social security payments, assets appreciation, etc.

Chinese private wealth research conducted jointly by the China Merchants Bank and Bain identified more than 700k wealthy individuals in China at the end of 2012 (those with investable assets of more than RMB10m, or USD1.6m, each). This is a noticeable increase from 500k in 2010. By the end of 2013 there will be 840k of HNWIs in China, as researchers have predicted. According to their research, one half of investable assets of those wealthy individuals is invested in bank deposits, equities and real estate.

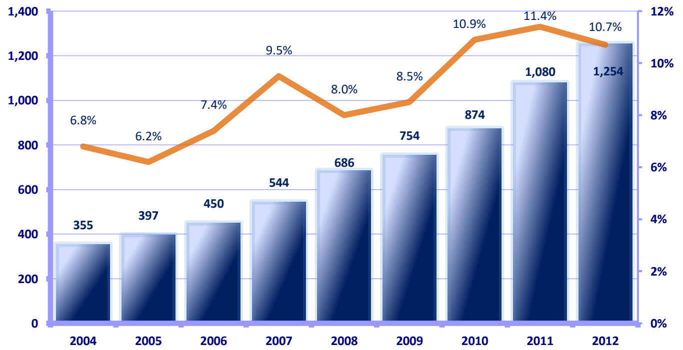
The research has also revealed a growing interest in overseas investment: more than 30% of HNWIs surveyed have already invested in overseas assets; most of the remaining 70% have started to consider this option.

Average annual urban per capita disposable income (USD) and real growth (%, rhs)



Source: PRC National Statistics Bureau, Caderus estimates

Average annual rural per capita disposable income (USD) and real growth (%, rhs)



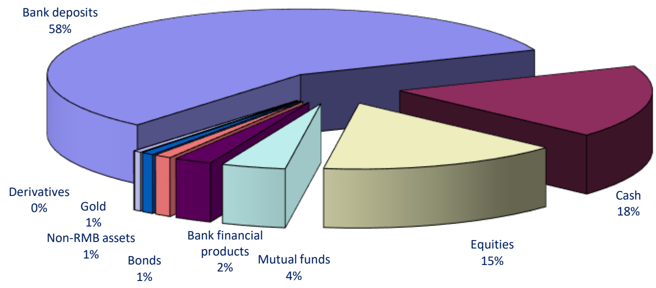
Source: PRC National Statistics Bureau, Caderus estimates

The China Merchants Bank and Bain came up with an estimate for total investable assets of the Chinese population at the end of 2012: RMB80tn (USD13tn), increasing to 92tn (USD15tn) by the end of 2013.

Major Chinese population related trends:

- Continued urbanisation and middle-class formation. Current estimates of the Chinese urbanisation rate are between 45% and 52% at the end of 2012.
- Population ageing trend.
- Nascent decline in working-age population, continued cost of labour growth.
- Relaxation of the one-child policy, with the ensuing consumption growth.
- Official strategic focus on growing consumption as a share of GDP.
- Further increase in HNWI numbers and growth of total Chinese savings and investable assets.
- Lowering of the tax burden, contributing to further increases in savings and consumption.
- Shifting of production from eastern to western Chinese regions, growing middle class population in the central and western China.

Asset class distribution of average Chinese household's investable assets



Source: AMAC (Asset Management Association of China) , Caderus estimates

ENTERPRISES

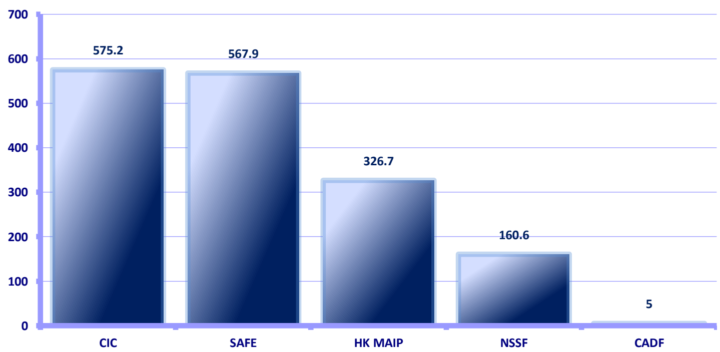
Both state and private enterprises have been accumulating vast amounts of unused investable cash. Some of them have set up investment companies, trusts and fund management companies, sometimes as joint ventures with international bulge bracket investment banks. Chinese enterprises' aggregate AUM is currently estimated at RMB10tn (USD1.63tn).

GOVERNMENT

The state is undoubtedly the largest owner of assets in China. Investable state assets are accumulated in sovereign wealth funds which continue to grow at a fast rate.

The participation of the government in the economy is still quite high: according to data from the CRS Report for US Congress (September 2013), state owned enterprises produce up to 50% of the ex-agriculture GDP in China.

Chinese sovereign wealth funds: AUM (2012), USD bn



Source: SWF Institute, Caderus estimates

This year the government has undertaken important steps to bring down the general tax burden, e.g. by giving a VAT exemption to small and medium enterprises. This will provide more resources to SMEs for their development however may also lower the sovereign wealth funds' AUM growth rate.

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State investable assets are managed by sovereign wealth funds at the national level, and by regional governments at the regional level (the main part of pension assets).

Largest PRC sovereign wealth funds:

CIC	China Investment Corporation	中国投资有限责任公司
SAFE	State Administration of Foreign Exchange	国家外汇管理局
HKMAIP	Hong Kong Monetary Authority Investment Portfolio, HKMAIP	
NSSF	National Social Security Fund	全国社会保障基金
CADF	China-Africa Development Fund	中非发展基金

WHO MANAGES CAPITAL IN CHINA

SOVEREIGN WEALTH FUNDS 1: CIC (China Investment Corporation)

One of the top five world largest sovereign wealth funds (together with SAFE), CIC was established on September 29, 2007, with an initial AUM (assets under management) of USD200bn. Further asset growth was driven by investment portfolio appreciation as well as periodic capital injections by the state.

Before taking the current position as head of CIC, Ding Xuedong, was Deputy General secretary of the PRC State Council. His predecessor at CIC, Lou Jiwei, was appointed Minister of Finance last year.

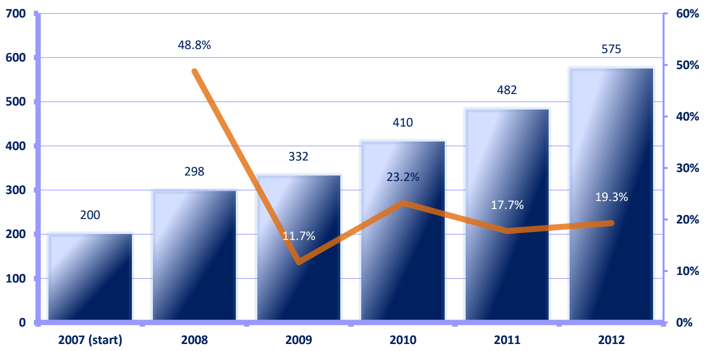
The majority of CIC's investment portfolio (63.8%) has been allocated to other funds, the balance (36.2%, down from 43% in 2011) is being managed by the CIC internal team.

CIC investment activity in international equities is primarily focused on the US market (49.2%, up from 43.8% in 2011), other developed markets (27.8%), and also developing markets (23%).

CIC investment portfolio consists of public equities (32%), alternative investments (45%), fixed income securities (19%), and cash-like investments (3.8%).

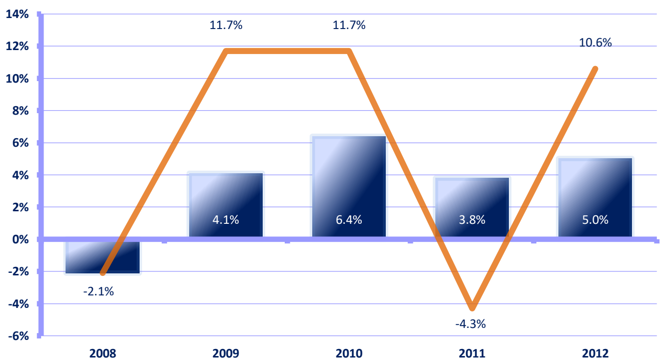
In 2012 the fund was investing in financials (22.3% of total equity portfolio), consumer stocks (21.1%), IT (11.6%), energy (10.2%), industrials (9.1%), and healthcare (8.2%).

CIC's AUM 2007-2012 (USD bn) and annual growth, % rhs



Source: CIC annual reports, Caderus estimates

CIC investment portfolio return (orange line) and average annual cumulative return since inception (blue columns)



Source: CIC annual reports, Caderus estimates

CIC investment portfolio's asset class structure dynamics, %

	2008	2009	2010	2011	2012
Equities	3.2	36	48	41	32
Fixed income	9	26	27	26	19
Alternatives	0.4	6	21	28	45
Cash and cash-like	87	32	4	6	3.8

Source: CIC annual reports, Caderus estimates

CIC is currently the biggest Chinese institutional investor in Russian assets, primarily as strategic long-term investments. Investment transactions in Russia include:

- acquisition of a 45% stake in Nobel Oil for USD300m in November 2009,
- USD100m participation in the VTB SPO (February 2010),
- acquisition of a 5% stake (less 1 share) of Polyus Gold for USD425m in May 2012,
- a joint Russian-Chinese PE fund set up with RDIF (June 2012, CIC's contribution – USD1 bn),
- subscription to Uralkali convertible bonds (November 2012), later converted into a 12.5% stake of the company, worth about USD2bn (September 2013),
- acquisition of a 4.58% stake in MICEX (the Russian exchange) for USD187m in December 2012,
- co-financing of Russian Far East infrastructure projects together with VEB.

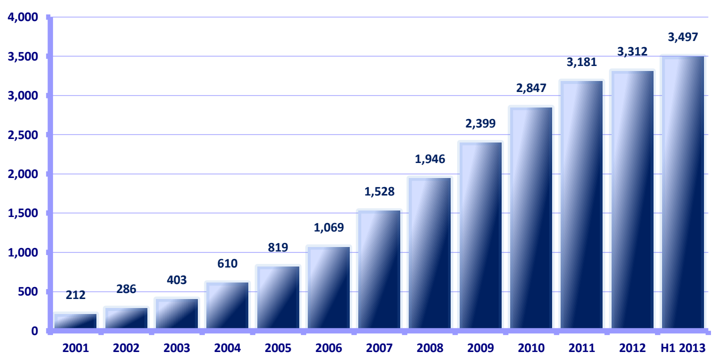
SOVEREIGN WEALTH FUNDS 2: SAFE (State Administration of Foreign Exchange)

Technically, SAFE is a department within the People's Bank of China, the Chinese Central bank. The head of SAFE is also deputy head of the PBOC.

The main objective of SAFE is to manage the country's foreign currency reserves, which totalled USD3.5tn at the end of June 2013.

SAFE is also responsible for allocating investment quotas to QFII, RQFII and QDII license holders.

Chinese foreign currency reserves, USD bn



Source: SAFE, Caderus estimates

SAFE has always been a very conservative investor. However, in recent years, with the rapid growth of the Chinese foreign currency reserves, SAFE has started investing into an increasingly broader range of asset classes.

A substantial part of SAFE's assets (USD1.28tn) is invested in US long-term Treasury securities. Since 2007 SAFE has gradually become an active global equities investor. SAFE had accumulated the largest US equities portfolio among all sovereign wealth funds by 2009 (Brad Setser from Roubini Global EM).

SAFE has also made substantial direct investments in world largest companies and banks: BP, Total, Rio Tinton, RD Shell, Barclays, Tesco, RBS, etc.

It is possible that SAFE will soon start increasing its share of infrastructure and other long-term foreign investments at the expense of its holdings of US Treasury securities.

SAFE has opened offices and branches in numerous cities of mainland China, and also in Hong Kong, London and New York.

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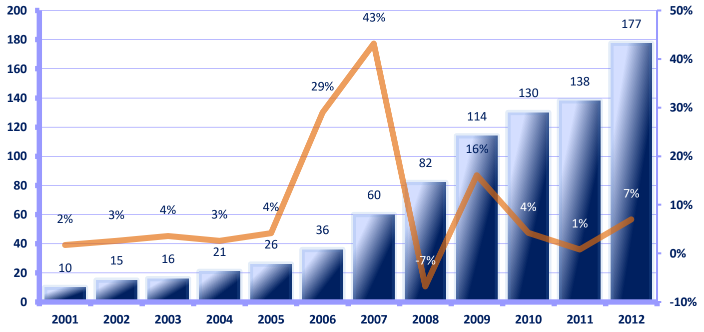
SOVEREIGN WEALTH FUNDS 3: NSSF (National Social Security Fund)

The NSSF is managed by the NCSSF (National Council for Social Security Fund). It was established in August 2000 as a strategic reserve fund to help resolve future problems related to the ageing of the population.

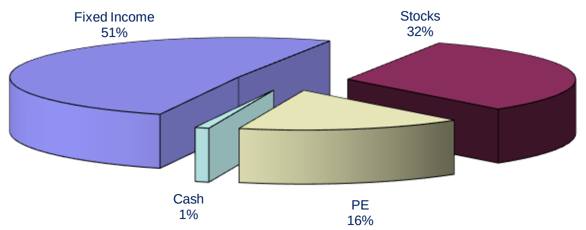
NCSSF is self-managing 59% of the fund' assets, the remaining 41% having been allocated to other funds, including private equity funds.

NCSSF's AUM (USD bn) and annual return (%, rhs)



Source: NSSF annual reports, Caderus estimates

NSSF assets distribution by asset class, 2011, %



Source: AMAC (Asset Management Association of China), Caderus estimates

The fund's rules allow NCSSF to invest overseas up to 20% of the fund's assets into equities, fixed income, other funds and derivatives. At the end of 2012, 7% of the fund's AUM was invested overseas.

Some domestic experts expect the fund's AUM to grow 4 times by 2020, and that its actual overseas investment allocation will grow substantially by then as well.

FUND MANAGEMENT COMPANIES

The Chinese fund management industry originated in 1990s and existed with minimal regulation up until the Asian crisis of 1997, when the CSRC (China Securities Regulatory Commission) was appointed as regulator of the sector. By October 1997, 72 small-scale closed-end investment funds were managing a total AUM of RMB6.6bn, while the equity market capitalisation was already at RMB520bn.

Five new FMCs were set up during 1998 according to new regulation from the CSRC: China Southern, Goutai, Bosera, China Asset Management, HuaAn Asset Management. By the end of 1998, the first year since the new regulation was introduced, each FMC was operating one closed-end fund. All funds combined raised a total of just RMB2bn.

Many major equity market players were actively resisting the new rules, collectively boycotting stocks that the new funds were buying, thus creating difficulties for them with investment returns, but also with corporate access. Management of public companies started to avoid any communication with the new investment managers, anticipating problems for their company's shares.

The regulator stepped in to protect the new asset management industry: a set of rules was introduced to allocate a minimum of 20% of all new IPOs to the new funds. At that time, IPOs guaranteed good returns. FMCs had been saved.

In September 2001 HuaAn (华安) registered the first open-end fund in China. In September 2002 HuaAn opened the first fixed-income fund, in November 2002 – the first index fund, and in December 2003 – the first money market fund.

FMCs are managing public funds, but they can also run Separately Managed Accounts (SMAs) for HNWIs and corporations (with a minimum investment of USD5-25m depending on the FMC), as well as sovereign wealth funds' and pension funds' assets.

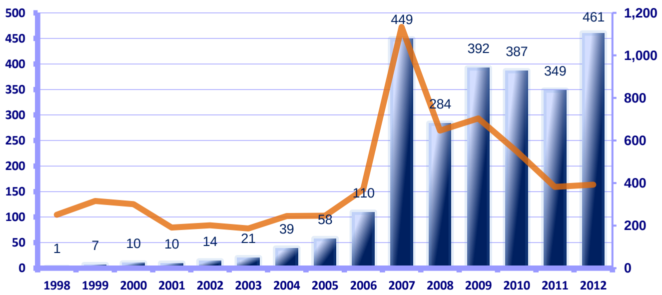
Data from the Asset Management Association of China shows that 21% of all assets under management of Chinese FMCs in 2012 were classified as "other assets", i.e. SMAs from private, institutional and corporate clients and other funds.

As of July 2013, there are 82 FMCs in China, with a total AUM of RMB3.7tn (USD602bn, including SMAs). Assets of all mutual funds globally reached USD27.86tn in Q1 2013, based on data from the International Investment Funds Association.

260 new funds were launched in 2012, raising a total of RMB645bn (USD 104.9bn) of investors' funds.

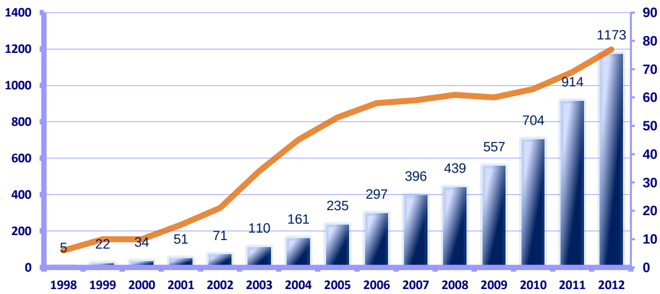
Despite the negative dynamics of domestic financial markets in China between 2010-2012, the mutual funds industry enjoyed some positive development, in terms of the number of FMCs (82 in 2013, up from 60 in the beginning of 2010), number of funds (1466 at the end of 2013, up from 557 in the beginning of 2010), and also in terms of AUM growth (USD461bn at the end of 2012, up from USD392bn in the beginning of 2010).

Combined NAV of all funds (USD bn), average NAV per fund (USD m, rhs)



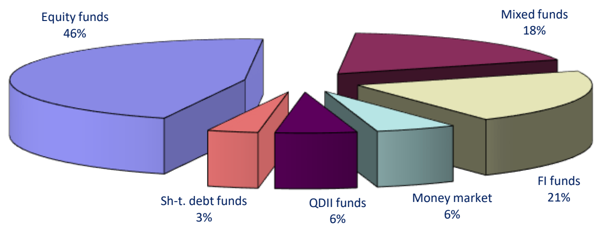
Source: CSRC, Caderus estimates

Total number of funds, number of FMCs (line, rhs)



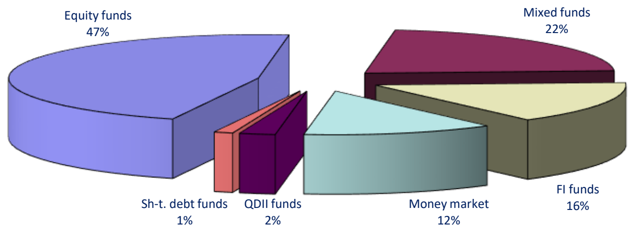
Source: CSRC, Caderus estimates

Number of funds breakdown by fund type, June 2013



Source: China Securities Regulatory Commission, Caderus estimates

Funds NAV distribution by fund type, June 2013



Source: China Securities Regulatory Commission, Caderus estimates

A major step in financial markets' liberalisation was the creation of the first overseas investment funds in 2006, with the expansion of the QDII program (Qualified Domestic Institutional Investor).

International investments became very popular with clients, both retail and high-net-worth. First QDII funds reached fund raising targets within just one or two days after launch. By the end of September 2007, FMCs, banks and insurance companies had received a combined QDII quota of USD42.17bn.

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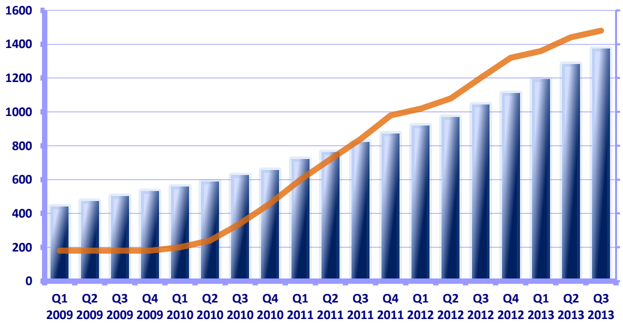
However, in 2008 QDII funds were hard hit by collapsing global equity markets and many clients became captives of those funds. Collective memory of the QDII funds 2008 debacle is one of the main reasons for subsequent low investor demand for any product bearing the QDII designation.

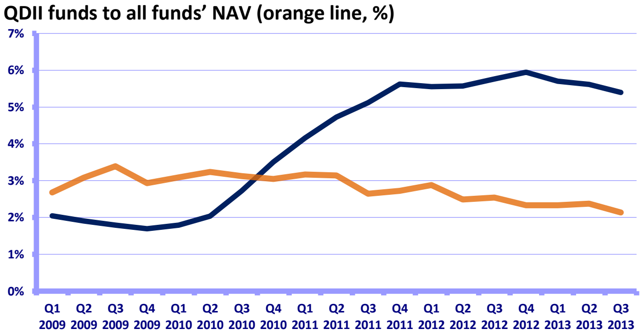
The track record of many international funds is nonetheless quite impressive: the average 2012 QDII funds return was 11.88%. In the first 8 months of 2013, QDII Offshore China Growth fund managed by Fortune SG returned 41%, and GF's Asia-Pacific (ex-Japan) Enhanced Equity fund grew by 31%.

Total number of mutual funds and QDII funds (line, rhs)



Source: China Securities Regulatory Commission, Caderus estimates

Number of QDII funds to all funds (blue line, %) and combined NAV of QDII funds to all funds' NAV (orange line, %)



Source: China Securities Regulatory Commission, Caderus estimates

The PRC law requires FMCs to register as limited liability companies. Foreign shareholders cannot own more than 49% of an FMC company. QDLP, the new type of license, gives more flexibility to international FMCs to develop their business in China.

FUND SALES CHANNELS, NEW FUNDRAISING METHODS

All FMCs raise new capital mainly by selling their products through banks' sales network, and to a lesser extent through brokers and via direct sales. FMCs can also source funds directly from companies and HNWIs in separately managed accounts.

According to PWC estimates, banks arrange about 75% of fund sales, 13% are direct sales by FMCs' own sales force, and about 8% is raised through brokers. The five largest banks control 60-70% of the bank channel sales.

By the middle of 2012, 157 entities were involved in funds distribution in China, of which 59 were commercial banks, 94 brokers and 4 independent distributors. Management companies are not focusing on direct sales to avoid conflict with their partner banks, their main sales channel.

There are innovative solutions as well: using direct access to a large pool of clients with their own fully integrated payment system Alipay, Alibaba (the biggest online marketplace in China) launched a special online money market fund management service "YuE Bao" a few months ago. During the first month, 2.5 million clients transferred idle cash sitting in their Alibaba accounts to purchase highly liquid Tianhong money market funds investing over RMB50bn (USD8.13bn). The combined value of all YuE Bao accounts grows by RMB500m daily and is expected to reach RMB100bn (USD16.3bn) by the end of 2013. By the end of September 2013, YuE Bao already counted more than 16 mln users, and in the first half of March 2014 there was a total of 81 mln users with over RMB500bn (USD81.5bn) in deposits.

Insurance asset management companies, having joined the mutual fund management club earlier this year, are bringing their tens of thousands of sales agents' network into the game, thus increasing the relative weight of the direct sales channel.

BANKS

Banks participate in managing assets of their retail and wealthy clients (private banking). The CBRC, regulator of the banking sector, is overseeing the distribution of asset management products to clients of banks: open-end funds, trust products, private equity funds and venture funds.

The main asset management product offered by banks to their clients is called the wealth management product (WMP). WMPs provide bank depositors with higher interest rates compared to the regulated bank deposit rate, although with a higher level of risk. For borrowers, WMPs provide access to debt financing, an alternative way to secure traditional bank loans, unavailable to many types of borrowers in China.

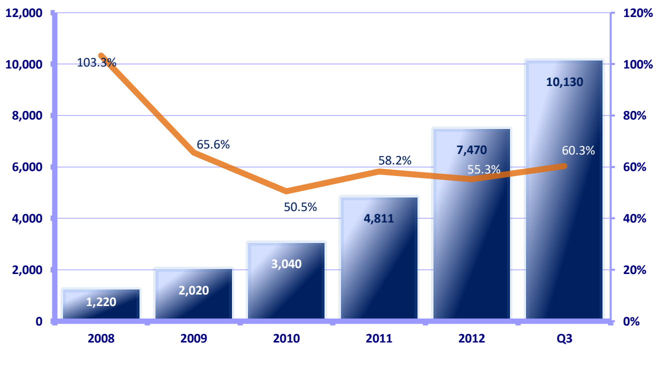
Besides banks, wealth management products are also being offered to their respective clients by trusts, insurance companies and brokers, private equity funds. Assets from many different clients, who purchased WMPs, are then pooled together to be invested in a wide range of financial instruments.

The CBRC estimates the total value of outstanding WMPs issued by banks by the end of 2012 to have reached RMB7.1tn (USD1.1tn). By the middle of 2013, the value of all outstanding WMPs grew further to RMB8.2tn (USD1.3tn).

TRUSTS

Chinese trusts have certain similarities with both banks and funds. The main difference is a much more liberal regulation regime for trusts, operated by the CBRC, due to the inaccessibility of trusts for retail investors: the entry ticket for clients starts from RMB1m (USD163k).

Total trusts AUM (RMB bn) and same-period growth (%, rhs)



Source: China Trustee Association, Caderus estimates

The rapid growth of the trust sector is one of the direct consequences of strict regulation of the banking sector: HNWI clients are looking for returns higher than the regulated deposit rate, often negative in real terms.

The regulation allows trusts to pay higher interest rates to their clients compared to bank deposit rates, and this difference can be fivefold. Compared to FMCs, trusts offer a wider range of financial instruments and more complicated investment strategies and solutions. Most trust assets guarantee a minimum rate of return, some trust products provide a fixed return.

Therefore, 67 trusts were managing RMB10.13tn (USD1.65tn) at the end of September 2013, up 60.3% during the previous 12 months.

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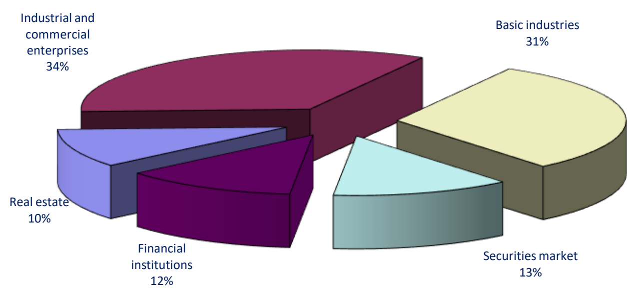
Combined revenues of 67 trust management companies in H1 2013 reached RMB35.1bn or USD5.7bn (annual growth of 35.4%), total profits were RMB25.78bn (USD4.2bn, annual growth of 35.69%).

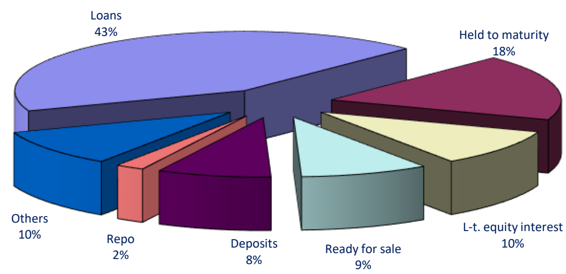
Foreign participation in the equity capital of a trust company is currently limited at 25%, and foreign shareholders cannot own more than 20% each. Nevertheless, greater participation in trust activity and profit distribution is possible by including a trust investment consulting advisory.

Trusts AUM breakdown by sector (June 2013)



Source: China Trustee Association, Caderus estimates

Trusts AUM breakdown by investment product (June 2013)



Source: China Trustee Association, Caderus estimates

INSURANCE ASSET MANAGEMENT COMPANIES

Companies managing insurance assets have total AUM of RMB7.27tn, or USD1.18tn (CIRC, end of August 2013), a growth of 6.07% YTD.

Insurance asset management regulation is following the general liberalisation trend. Until recently, insurance AM companies could only manage their parent company's assets without the right to manage third-party funds. Starting from June 2013 they have the right to set up mutual funds for retail investors.

At the same time, insurance asset management companies can invest in an ever larger range of financial instruments. At present this includes banking and fixed income products, equities, direct investment into non-public companies' equity, infrastructure products and real estate.

Foreign participation in insurance AM equity capital is currently limited at 25%.

Insurance assets distribution by asset class (August 2013)

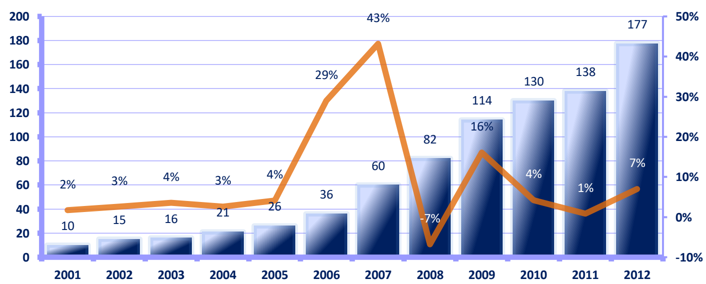
	RMB bn	USD bn	Доля
Fixed income	3,266	531	44.9%
Bank deposits	2,214	360	30.5%
Equities and funds	731	119	10.0%
Other	1,060	172	14.6%
Total	**7,271**	**1,182**	**100%**

Source: China Insurance Regulatory Commission, Caderus estimates

PENSION FUNDS

Chinese pension assets are grouped into three parts: the first part, worth about RMB2tn, is managed by regional governments; the second part is made up of enterprise pension funds, and finally, the reserve pension funds at the NSSF (National Social Security Fund, RMB1.1tn at the end of 2012).

NCSSF's AUM dynamics (USD bn) and annual return (%, rhs)



Source: National Social Security Fund, Caderus estimates

Most of the regional pension funds are allocated to low-interest rate bank deposits and state debt securities, earning less than the inflation rate. In the past few years many regional governments have transferred some of these funds to the NCSSF. Some part of the pension funds is also being managed by 52 Chinese FMCs, based on data from Z-Ben Advisors.

SUNSHINE HEDGE-FUNDS

There were more than 900 sunshine hedge-funds at the beginning of 2013, however their combined AUM was RMB138.3bn (USD22.5bn, data from the China Trustee Association). Sunshine funds are not limited in their choice of financial instruments, so they can offer very flexible investment strategies. Their goal is absolute return and not the outperformance of any particular index. They often use leverage.

Sunshine funds can only raise funds through private placement among qualified clients. Most often such funds cooperate with trusts using their legal platform to raise cash.

Due to the fact that sunshine fund managers only deal with sophisticated clients, they are not regulated by the CSRC, as opposed to FMCs. The new version of the Securities Investment Funds Law, effective since June 1 2013, requires such fund managers to register with the Asset Management Association of China (AMAC).

In contrast to traditional open-end funds, which charge their clients just the management fee (usually 1.5%-2%), sunshine hedge-funds' fee structure also includes the performance fee, an additional 20% of the portfolio's appreciation.

FAMILY OFFICES

In the last few years, many successful Chinese entrepreneurs decided to stop running their businesses in order to focus on managing their accumulated wealth. One of the Hurun's latest research reports on the Chinese HNWIs mentions Liu Yonghao (62), a member on the board of the New Hope Group, and also China's wealthiest private investor with assets worth RMB20bn (USD3.25bn). Hurun found a total of 22 entrepreneurs with investable assets of more than RMB5bn each and with combined assets of RMB212bn (USD34.5bn).

HNWIs invest primarily in venture projects, ranging from IT to financials. Many experts point out high risk tolerance of Chinese HNWIs compared to their western counterparts.

ASSET MANAGEMENT REGULATORS

The CSRC (China Securities Regulatory Commission) is the main regulator of the securities market and the asset management industry. It also looks after private equity and venture capital funds.

Trusts are being handled by the CBRC (China Banking Regulatory Commission). CBRC also regulates Chinese banks' wealth management activity.

Insurance asset management activity is controlled by the CIRC (China Insurance Regulatory Commission). Insurance companies' investments in FMCs are jointly regulated by the CIRC and the CSRC.

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RQFII license scheme is jointly run by the CSRC, the SAFE and the PBOC (People's Bank of China).

The National Development Reform Commission which had been responsible for the private equity and venture capital funds' regulation before June 2013, is still involved in managing the sector.

INTERNATIONAL INVESTMENT DEVELOPMENT

QFIIs and RQFII

QFII and RQFII licenses give foreign entities the right to invest their foreign currency (QFII) or offshore RMB (RQFII) directly into onshore yuan-denominated financial instruments: equities, bonds, funds and derivatives.

To begin investing, foreign investors have to obtain a QFII or an RQFII license from the CSRC and then a quota from the SAFE.

The RQFII license was first issued in December 2011, to allow investing offshore yuan (CNH) into Chinese financial products, primarily to be used by Hong Kong offices of mainland banks and FMCs. In July 2013 HSBC became the first international bank to get its own RQFII quota. And in October this year China and the UK agreed to extend the RQFII program and to provide a special quota of CNH80bn to UK-based institutions.

The QFII license can be granted to major foreign investment banks and brokers whose own capital exceeds USD500m and to foreign FMCs with AUM greater than USD500m. License formalities can last between 6 and 12 months.

In September 2013 the total number of issued QFII licenses reached 216, with 6 new licenses and USD1.05bn of new quotas issued in September alone, after two even more active months, July and August (8 and 10 new licenses respectively, USD1.5bn of new quotas in each month).

The total amount of RQFII quotas allocated before the end of September 2013 reached CNH134.3bn (a 5% m-o-m growth) of which 85% belonged to FMCs and 15% belonged to banks and brokers. At the start of this year that number was a mere CNH67bn, so the value of all RQFII quotas more than doubled in the first 9 months of this year.

The total QFII quotas potential value (combined upper limit set by the government) was increased in 2013 from USD80bn to 150bn. Currently, the RQFII quota ceiling, with the latest addition of the UK's CNY80bn, stands at CNH350bn.

By the end of September 2013, QFII and RQFII quotas actually allocated amounted to USD47.5bn and CNH134.3bn (USD21.8bn) respectively.

The combined total value of QFII and RQFII quotas actually allocated (USD69.3bn) is a mere 1.85% of the total Chinese equity market capitalisation of USD3.75tn (August 2013).

At the same time, QFII and RQFII investors are investing in equities and other asset classes, which means that the above ratio is even smaller in reality. Therefore, we believe that the on-going capital markets liberalisation will be leading to a continued growth in international investors' participation in the Chinese equity market capitalisation.

QDII

The license that is designed to allow domestic investors to invest overseas is called QDII (Qualified Domestic Institutional Investor).

This type of license was introduced in 2004. PingAn Insurance was the first company to obtain it, together with a quota of USD8.89bn. PingAn Insurance used the license alone for 1.5 years, until in April 2006 the QDII license became available for other players of the asset management industry.

Bank of China was the first bank to obtain the license and a quota of USD1bn in July 2006, and HuaAn was the first FMC to obtain a USD500m quota in September 2006.

In September-October 2007 4 newly launched QDII funds collected a total of RMB120bn (about USD16bn), some managed to reach their quota limit within the first day or two with substantial oversubscription. The actual combined demand for those funds (RMB280bn) exceeded more than twice their total allocated quota.

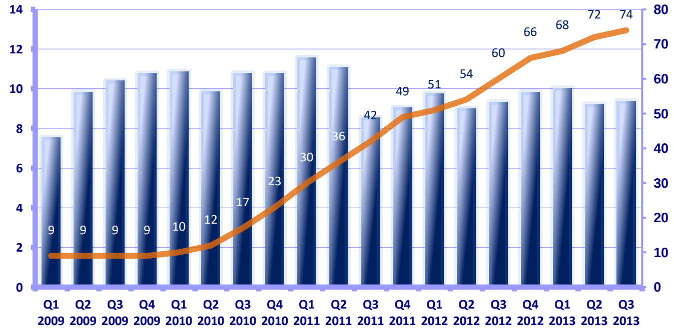
But in 2008 those funds suffered a painful setback with the sharp fall of global equity markets. Investors could not get out of the QDII funds without some serious losses. This had a large negative impact on the international investing for years to come.

However, despite the negative background, continued wealth accumulation was pushing domestic investors to diversify by investing overseas. So, in 2010 the number of QDII funds grew from 9 to 17, and each of them raised an average of RMB600 m (USD97.5m).

In 2011 many new QDII funds were launched, bringing the total QDII funds number to 42 by the beginning of 2012. Performance, on the other hand, was not stellar: -20% during that year, coinciding with the MSCI China performance (-20%), and performing slightly better than many local funds (-23% on average). Combined NAV for all funds declined by 21% to RMB58bn (USD9.3bn).

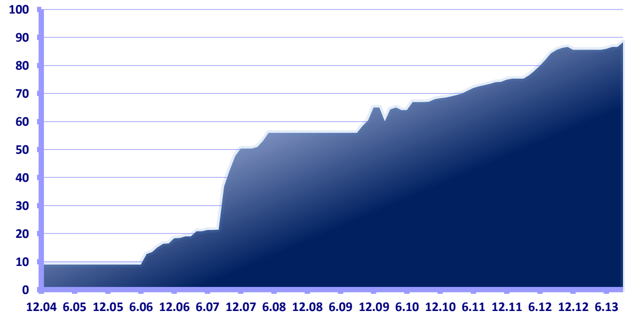
The following year was considerably more optimistic: QDII funds returned an average of 11.88% in 2012, which was a great achievement against a slightly negative performance of most domestic funds.

Total NAV (USD bn) and number of QDII funds (line, rhs)



Source: CSRC, Caderus estimates

QDII quota allocation dynamics, USD bn



Source: SAFE, Caderus estimates

By the end of September 2013, a total of 113 QDII licenses were issued with a total quota of USD88.3bn. However, there is some time lag between obtaining a QDII license and launching a first QDII fund. Currently, average QDII quota utilization rate does not exceed 15%, varying greatly from fund to fund.

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Some of the largest FMCs shared with us their plans to apply for an extension of their QDII quotas, having already approached the limit for overseas investment.

QDII license holders	Quota, June 10	Share, June 10	Quota, Feb 12	Share, Feb 12	Quota, Sep 13	Share, Sep 13	Number of licences
FMCs, brokers	39.2	61.2%	44.4	59.0%	45.2	51.2%	47
Insurance	16.3	25.4%	19.6	26.0%	26.9	30.5%	29
Banks	8.0	12.4%	9.5	12.6%	11.3	12.8%	29
Trusts	0.6	0.9%	1.8	2.4%	4.9	5.6%	8
Total	**64.0**	**100%**	**75.2**	**100%**	**88.3**	**100%**	**113**

Source: State Administration of Foreign Exchange, Caderus estimates

At the moment, almost all major and medium-sized FMCs, major commercial banks, investment banks, trusts, insurance companies and all sovereign wealth funds are QDII license holders.

Sometimes FMCs use their QDII license and quota to acquire stakes in international companies of a specific sector, acting as an agent for a major Chinese corporate.

QDII funds have often tended to invest in overseas equities related in some way to the mainland China, Hong Kong or Taiwan, and to a lesser extent to Singapore and Australia. Thus, many Chinese investors have not benefited from one of the major advantages of international investing: lower risks without decreasing portfolio returns by investing in markets uncorrelated with China.

LIBERALISATION OF REGULATION

Liberalisation of financial markets regulation is a long-term trend in China.

According to the new version of the Securities Investment Funds Law, effective since July 1, 2013, trusts, brokers, insurance asset management firms, can now launch open-end funds to raise retail investors' capital, which will inevitably increase competition in the asset management industry and push industry participants towards further product innovation.

Financial markets liberalisation also includes gradual relaxation of capital controls and full yuan convertibility, which is planned before the end of 2015. Many tight rules are being relaxed and new types of licenses are designed and launched to allow new business activities previously considered unacceptable.

QDII2 (Qualified Domestic Individual Investors)

The launch date for QDII2 has not been announced yet but it is expected within the coming months. First QDII2 licenses will be granted to clients of a couple of investment banks in Guangzhou and Shenzhen (2 major cities near Hong Kong), who will have the right to trade directly on the HK Stock Exchange. To become eligible, clients will be required to have at least 3 years' experience in equity investing and a minimum of RMB1.5m of assets. Each investor will be able to invest between RMB500k and 20m into foreign securities.

QDLP

QDLP (Qualified Domestic Limited Partner) was launched in the summer of 2012. It allows international FMCs to raise funds in the PRC into feeder-funds, to be converted, transferred into an overseas fund and then invested in international securities. QDLP funds can use traditional fund sales channels, they can also approach HNWIs directly.

In September 2013, first six foreign asset managers obtained the license to raise USD50m each, with a combined quota of USD300m.

SHANGHAI FREE ECONOMIC ZONE

The free economic zone in Shanghai, launched on September 29, 2013, allows qualified private and institutional investors from the mainland to invest in foreign securities, while foreign fund managers can liaise directly with Chinese investors.

One of the primary goals of the zone is to test interest rate liberalisation, free yuan convertibility, and other more liberal capital controls.

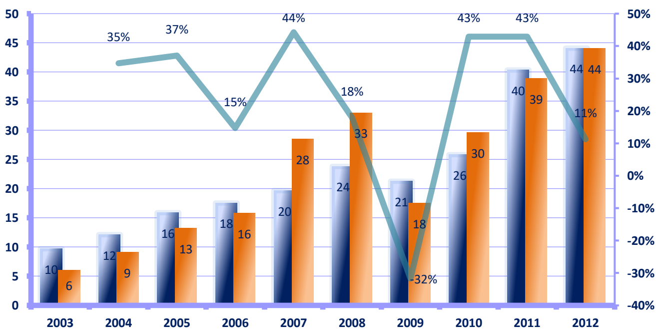
HONG KONG AM LICENSE EXTENSION TO MAINLAND

There are plans to allow FMCs with a license from the Securities and Futures Commission (Hong Kong) to raise funds directly from mainland individual investors. This should allow foreign-owned FMCs to have a greater freedom of action, and to avoid the current requirement to set up joint ventures with a maximum 49% foreign ownership.

BUSINESS ACTIVITY CHINA – RUSSIA

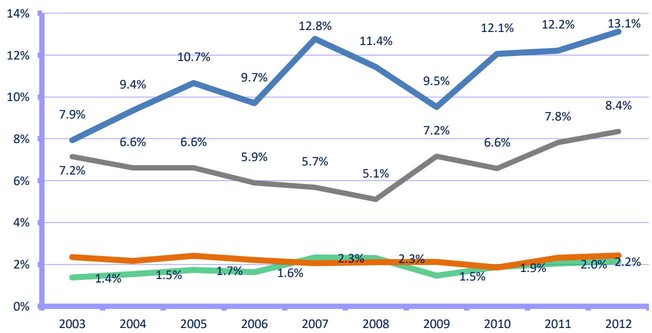
Bilateral trade between Russia and China has been growing both in absolute terms and also as a share of each country's foreign trade. It is not surprising that trade with China has a higher relative weight in Russia's cross-border trade than the other way around.

Exports from Russia into China (blue columns, USD bn), imports to Russia from China (orange columns, USD bn), bilateral trade growth (line, rhs, %)



Source: Russian Statistics Agency, WTO, PRC General Administration of Customs, Caderus

Imports from PRC to total imports to RU (blue line), exports to PRC as % of total exports from RU (grey l.); imports from RU as % of total imports to PRC (orange line), exports to RU as % of PRC exports (green line)



Source: Russian Statistics Agency, WTO, PRC General Administration of Customs, Caderus

Direct investment activity is also taking off.

Chinese OFDI into Russia (each year and cumulative, USD m), share of total Chinese OFDI (line, rhs, %)

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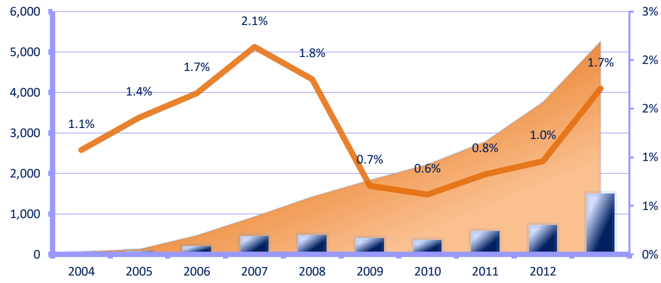
Ever since the 2008 financial crisis, Chinese FDI into Russia has been growing both in absolute terms, and also in terms of their share in total Chinese Overseas FDI. This, we believe, confirms our view that bilateral cross-border portfolio investment activity may be the next logical step in developing business activities between our countries.



Source: PRC Ministry of Commerce, National Bureau of Statistics, SAFE, Caderus estimates

OUR STUDY

During the summer of 2013 we conducted a study of the asset management industry in China in order to better understand the landscape and the dynamics of this sector, existing regulatory limitations on cross-border international investment, and the prospects for Chinese FMCs to play a more active role on international financial markets.

We met with representatives of about 30 major FMCs, trust managers, insurance asset managers, hedge funds, as well as with other participants of the Chinese asset management industry.

ASSET MANAGERS' VIEWS

ABOUT COMPETITION IN ASSET MANAGEMENT INDUSTRY

Many managers mentioned growing competition in the Chinese asset management industry. In the summer of 2013, trusts, insurance companies and brokers obtained the right to launch mutual funds.

Many market participants believe that these changes could shake the established balance of power, leading to a much higher level of competition.

Many professionals believe that the strongest future competitor for FMCs will be brokers, who have a direct contact with millions of clients, a sales channel dedicated for financial products.

Chinese banks have access to a greater pool of clients and their savings, and currently are the main sales channel for new funds. However, banks can offer investment products only to a part of their clients, since many of them are just interest in the deposit and payment services of their bank.

ABOUT OVERSEAS INVESTMENTS

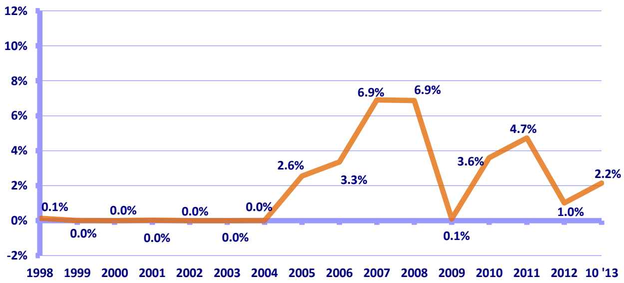
Many managers mentioned a growing interest from their clients, and primarily HNWIs, to investing overseas. They were greatly motivated by the rally in H1 2013, especially against the lacklustre domestic market performance in recent years.

The first stop for many investors starting to invest overseas is Hong Kong. Many mainland Chinese and also international companies' stocks are traded on the Hong Kong Stock Exchange, which makes it easier to begin investing overseas but helps fulfil the task of portfolio diversification only to some extent.

Main reasons against international investments affecting investors and professional fund managers in China:

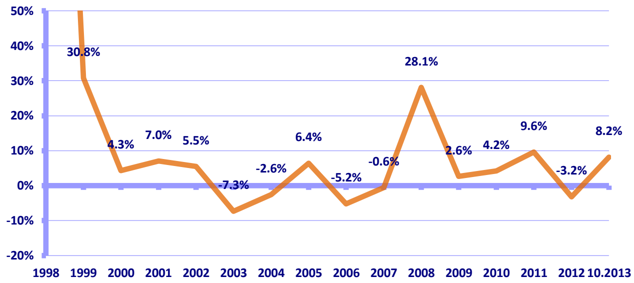
- Linguistic and cultural barriers,
- Higher information cost,
- The dearth of international markets experts and expertise. In the past, most funds used external advisors to invest overseas, however nowadays the trend is to develop in-house expertise.
- Steady yuan appreciation

RMB to USD yoy appreciation (YTD appreciation in 2013), %



Source: People's Bank of China, Caderus estimates

RMB to RUR yoy appreciation (YTD appreciation in 2013), %



Source: Central Bank of Russia, Caderus estimates

Main reasons for international investments:

- Investment portfolio diversification,
- Extension of business, trade, educational, cultural exchanges,
- Intensification of competition among asset managers in China, growing need for product innovation,
- Gradual relaxation of regulatory barriers,
- Danger of bubbles on domestic markets due to a rapid capital accumulation in a closed market,
- Growing expectations among some investors for possible yuan appreciation trend reversal.

INVESTMENTS INTO RUSSIA

Investing in Russia is still considered by many Chinese investors as too risky, both from in terms of price risks (high dependence on oil & gas), and in terms of low protection of ownership rights, inefficient legal and court systems.

Other negative factors that were raised by some managers included the 1998 default, overdependence on the opinion of one leader, and the political "castling" before the latest presidential elections.

Significant past events affecting some investors' attitude include the Cherkizovo market closure followed by substantial losses for some SME investors from China.

Reasons against investing in Russia:

- Most asset managers claim to have little knowledge of the Russian macro economy and individual companies. We heard about a lack of information on Russian investment environment. There is no established source of regular information on Russian macro economy and financial markets.
- Lack of managers and analysts with expertise on Russia.

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- Negative news flow regarding Russian business environment, investment climate, social trends.
- Doubts concerning overdependence on oil & gas.
- Concerns about the quality of corporate governance and country governance, administration efficiency.
- Lack of companies with substantial market capitalisation, trading volumes.
- Rouble rate stability concerns.
- Negative events in the past affecting Chinese investments in Russia.
- No major known Russian brands.
- Negative equity market dynamics over the last 2-3 years.

Nevertheless, many managers expressed their personal opinion that Russia could be quite interesting to many retail as well as HNWI clients, be it individually or as part of a portfolio product (e.g. regional ETF). The key success factor, they believe, is the correct positioning of such products.

Attracting factors:

- Low valuation levels of the equity market, based on the P/E ratio (5-6 on average)
- High FI interest rates level.
- Attractive real estate cap rates.
- Good dividend yield on individual stocks.
- Expectations for structural reforms. Introduction of a system-wide reform agenda may generate substantial interest to Russian financial markets.
- Russia is one of the few markets that has not yet been actively promoted to Chinese investors. Against the background of an ever increasing competition in the asset management industry, asset managers believe that correctly structured and positioned Russia-focused financial products can be very successful.

RESULTS AND CONCLUSIONS

1. A strong and steady growth of investable assets is happening, together with the growth in the number of HNWI investors from the mainland.

2. The government is focused on the PRC financial markets liberalisation, including giving domestic investors ever more freedom for overseas investment. Quality change is expected by 2015.

3. The asset management industry is developing very fast, both domestically and internationally. Many mainland FMCs have opened Hong Kong offices as a first step in their international development. In the coming years we expect the opening of regional offices of major Chinese FMC in world financial centres.

4. With the liberalisation of the financial markets regulation, competition grows and stimulates product innovation. Products focused on international and especially new markets investing will soon flourish.

5. Wealthy and retail clients have watched developed markets indices growth in H1 2013, and are re-considering overseas investing. Urge for higher returns makes them more willing to listen to their bankers and brokers recommendations.

6. New legal channels for international investment (e.g. QDLP) may become popular, since they have no negative history, as opposed to QDII funds fighting off negative associations with the 2008 debacle.
7. A key challenge is to correctly position Russia-focused financial products.
8. We have identified FMCs that are already investing in Russian traded securities.
9. We have identified FMCs that plan to start investing in Russia.
10. We have identified FMCs that would like to receive more information about Russian financial market and potentially liaise with a Russian fund management company to discuss partnership opportunities.

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