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The opportunity in **asset management** in China

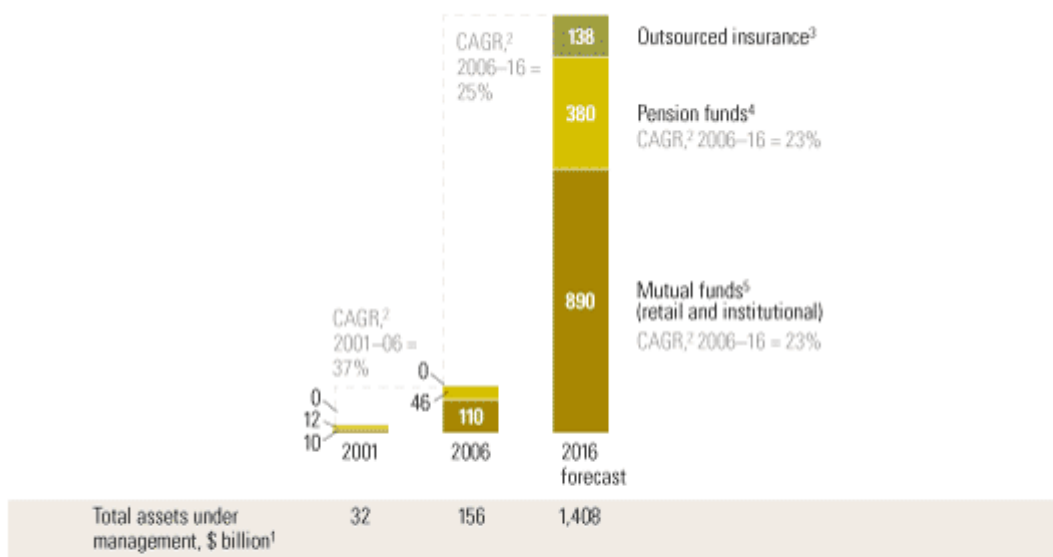
The country's asset-management market will grow by 24 percent annually for the next ten years, but the multinational companies attempting to serve it face vastly increased competition.

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Of all the financial-services opportunities in China, none is more tantalizing than asset management. Fueled by the investment, retirement, and insurance needs of increasingly affluent Chinese consumers, the sector has grown at a rate of more than 60 percent annually for the past three years. We estimate that assets under management will rise at a rate of 24 percent annually for the next decade, making it the fastest-growing segment of financial services in China—and the world (Exhibit 1).

Distribution of funds available to asset managers in China, \$ billion¹



¹\$1 = 8 renminbi in 2006.

²Compound annual growth rate.

³Excludes investments in mutual funds (currently not allowed; projections assume deregulation by 2010).

⁴Includes both national social-security funds and corporate pension funds.

⁵Includes both retail and nonretail (eg, insurance companies).

Multinational financial-services companies can't ignore this market, but capturing a large share of it won't be easy. More than 27 foreign asset managers have entered China in the past five years, through joint ventures and minority stakes, but most face significant challenges despite the recent high returns. (Chinese law restricts foreign participation to partnerships with Chinese companies, and foreign ownership in an asset manager is limited to 49 percent.) For one thing, Chinese investors are extraordinarily fickle: many shift their holdings out of any given mutual fund within six months. In fact, almost all funds lose the bulk of their assets under management after two years, so companies must constantly launch new funds to win investors.

High churn rates and the low fees resulting from strong competition have until recently made it hard to turn a profit. In 2006 only half of all active foreign joint venture asset managers had enough assets under management (about \$700 million to \$800 million) to break even. But with the market offering upward of 100 percent returns in 2007, more than two-thirds of the asset managers have been making money. High churn rates and competitive fees seem here to stay, however, so profitability is a continuing challenge. To compete successfully, foreign asset managers will have to tailor their operations to meet the capriciousness of Chinese investors more effectively. Building a strong brand and a competitive distribution system will help companies to showcase their offerings.

The state of the market

As millions of Chinese climb the income ladder, they are likely to seek alternatives to low-yielding bank accounts, which currently make up almost 79 percent of all personal financial assets (Exhibit 2). Mutual funds are the probable beneficiaries of that change, though they accounted for less than 3 percent of household assets in 2006. To be sure, a large-scale shift will take time: investors in other Asian economies, such as Japan, have taken years to embrace mutual funds. But forces now under way in China—the increasing number of workers preparing for retirement, much-reduced government pensions, creeping inflation, and a booming stock market—have inspired consumers to seek higher returns from their savings.



¹\$1 = 8 renminbi in 2006.

²Compound annual growth rate.

Source: *Almanac of Banking and Finance Industry, China, 2006*; *Almanac of China's Insurance Industry*; Global Demographics (formerly Asian Demographics); China Banking Regulatory Commission (CBRC); Datamonitor; Economist Intelligence Unit; Global Insights; McKinsey analysis

Government efforts to build the financial-services sector will also boost the asset-management business. Recently, the China Banking Regulatory Commission (CBRC) permitted local insurers to establish wholly owned asset-management subsidiaries, making them the third type of business—in addition to securities companies and banks—that can operate in this market. Some signs also suggest that investment trust companies (uniquely Chinese entities that resemble a cross between private-equity firms and syndicated-loan companies) will be allowed to participate in the sector by managing third-party assets in the form of closed-end trusts.

Asset managers should benefit from growth not only in retail demand but also in pension-related assets—not least, the state's \$40 billion National Social Security Fund (NSSF). In addition, the government is pushing companies to provide pension coverage through voluntary corporate schemes. In ten years, the assets under management of these enterprise annuities are expected to reach \$150 billion, from today's \$15 billion—partly as a result of their increasingly favorable tax treatment. To date, the government has licensed more than a dozen asset managers, including several foreign joint ventures, to manage these annuities.

The government's Qualified Domestic Institutional Investor (QDII) program, which permits Chinese nationals to invest overseas through authorized Chinese asset managers, should also help buoy the sector. QDII has been slow to take off because the government restricted it to fixed-income assets. In May 2007, however, the CBRC began permitting local commercial banks, through QDII, to invest in a wider range of asset classes, including equities, as part of the wealth-management business. There are already indications that this more flexible QDII program is attracting significantly greater interest: China Asset Management and China Southern Fund Management each raised up to \$4 billion for their QDII funds in a single day, for example.

But the flip side to this mostly positive outlook is that major improvements in the underlying capital markets will be critical to the future growth of the asset-management business. So far the vast majority of mutual funds in China have offered strikingly similar compositions: a limited number of attractive companies listed on the Shanghai and Shenzhen stock exchanges. This makes it difficult for fund managers to differentiate themselves, let alone hedge against the market through other asset classes.

Meanwhile, asset managers, including the companies that manage foreign investments, face stringent

regulations influencing when they can launch new funds. The regulator—concerned about the risk of a stock bubble if too many funds launch at the same time, driving up stock prices—dictates the timing to ensure a steady flow. These limitations hinder the asset managers' ability to capitalize on market trends.

Such issues will take time to resolve, but there are some encouraging signs. The government, for instance, recently announced plans to deregulate the corporate-bond market by removing a kind of quota system that allowed only a handful of giant state-owned enterprises to issue bonds. The new regulations also let the market rather than the regulator set bond prices and interest rates. In addition, the government recently announced that it will soon lift a two-year ban that prevented foreign securities companies from taking minority stakes in local securities companies.

The continued focus on raising standards for accounting, financial transparency, and corporate governance, as well as other anticipated developments (such as the launch of a covered-warrant market in Shanghai) will further buttress the capital markets.

Overcoming the challenges

The task facing foreign joint venture asset managers is how to carve and sustain a niche in the market. For most of them, China presents an unusual investing environment. Retail trading can be whimsical at times, raising volatility (Exhibit 3). And government investigations into insider trading are common. Foreign managers lack the risk-management tools available to managers elsewhere, because China is an equities-based market with few derivative instruments available for hedging strategies. Furthermore, foreign asset managers may find that their Chinese partners' experience and mind-set in risk management and compliance differs from their own.



¹\$1 = 8 renminbi in 2006.

Source: China Securities Regulatory Commission (CSRC)

One of the biggest challenges foreign companies face is differentiating themselves from local competitors—a task made more difficult in a market where all funds generate high returns. Yet because these won't last forever, fund managers will increasingly have to rely on their reputations, on consistently high performance compared with the competition, and on strong distribution networks to build sustainable franchises over the longer term. What's more, local early movers have an advantage: some wholly Chinese-owned fund managers, such as Southern Fund Management and E Fund Management, have already developed strong reputations by building steadily high-performing funds.

Brand recognition

McKinsey research shows that consumers in China put a high value on brand names, which suggests that asset managers coming there with long-established global brands would have a leg up over nascent local companies in luring business. But since most investors in China are new to mutual funds, a manager's international recognition doesn't translate immediately into local success. Today Chinese companies still control about 60 percent of the assets under management in the market (see sidebar, "[Managing local partners](#)").

To build brand recognition, foreign joint ventures will need to have all the attributes that appeal to Chinese investors: a wide portfolio of funds, frequent launches of new ones, and strong short-term performance. They must also actively cultivate and educate individual investors through effective marketing campaigns. These efforts should help win over China's growing class of affluent people, most of whom, according to a recent McKinsey survey on personal financial services in China, believe that shopping around for financial products is worth the effort.

Asset managers can start by leveraging the Internet, for many Chinese investors obtain information through Web sites that discuss equities and mutual funds. Joint venture managers can tap into this network by offering free commentary on the market's direction and answering investors' questions—and in this way drawing attention to their high level of experience in other markets. They might also consider providing investment advice to clients.

Many asset managers offer investor education seminars, which are likely to become more popular as retail investors seek financial advice. A recent McKinsey survey found that they are increasingly willing to pay for it. China International Fund Management, JPMorgan's asset-management joint venture with the Shanghai municipal government, already offers more than 100 free investor seminars a year throughout China, sometimes in collaboration with a major bank that also distributes the venture's funds to retail customers. Similar programs, which require little investment, are likely to help bolster a company's brand image—help that will be particularly useful once returns start to fall.

These programs will also help China to develop a more sophisticated pool of retail investors; the market is just emerging, so most of them now have only a rudimentary understanding of the industry. They often believe, for example, that a fund whose shares start at 1 renminbi is cheap. They view funds that have appreciated in value, thereby raising share prices, as expensive. And they act according to the logic of "buy low, sell high," cashing out of funds with higher values in order to buy into cheaper ones. Many high-performing funds, having witnessed this trend, now distribute large dividends to lower their share prices, thus aiming to stem the outflow of capital to supposedly cheaper funds.

Distribution

To make the most of a marketing effort, foreign asset managers must use distribution channels effectively. The primary distributors are China's four largest (and state-owned) banks, since they have tens of thousands of branches around the country. These and most other banks, as well as securities companies, use an open-architecture model to distribute the asset managers' funds. In this approach a bank resembles a supermarket, selling several brands of funds for a fee, as well as its own funds.

Banks are eager to distribute the asset managers' funds because of the income that distribution and custody fees generate—combined, they equal about 1 percent of all assets under management. During the first half of 2007, many new funds were oversubscribed by the end of the first day of offering; retail investors lined up outside bank branches hours before they opened.

As the market matures, however, fund managers will find it increasingly important to diversify their distribution beyond the big state banks. They can do so by working more closely with other distributors and by developing their own branches. To this end, they should identify and collaborate with more sophisticated distributors to have greater influence over the quality of the selling process and to develop a stable investor base. For example, China Merchants Bank, widely regarded as one of China's most successful retail-focused banks because of its strong brand and large retail customer base, has shown that it can distribute funds as effectively as China's largest state-owned banks. Several foreign joint venture asset managers already work closely with China Merchants, training its sales managers in order to get priority "shelf space."

Asset managers should also consider building proprietary distribution channels to reduce their dependency on the powerful banks. Such channels will become even more important as these institutions build their own asset-management arms, since thereafter they may eventually change their terms for distributing third-party funds or even drop such funds altogether. Proprietary distribution could also promote brand building by helping asset managers to get faster feedback from customers about product trends and preferences. JF Asset Management (formerly known as Jardine Fleming) and Fidelity Investments, for example, have both created a strong direct retail presence in many other Asian countries through their own retail outlets. A wide network of outlets, complemented by a strong Internet offering, may prove to be a powerful differentiator for asset managers in the longer term.

Finally, a proprietary network may be an innovative way for asset managers with affluent- or private-banking ambitions to create a distinctive wealth-management business. Retail-oriented asset-management branches may give such players a head start, since today's regulations make opening a bank branch expensive and time consuming for foreign companies.

In these early and heady days of asset management in China, companies riding the market's surge may be tempted to delay building their brands, establishing proprietary distribution networks, or developing specialized services. But as the market matures, the differences among fund managers will become more apparent, and those that move early to carve niches in the market will have a secure foothold when the shakeout occurs. 

Managing local partners

Foreign fund managers seeking to enter China face a particularly challenging environment: the most obvious opportunities to partner with domestic securities companies and banks have almost all been taken, and the few remaining strong possibilities are already in advanced discussions with potential partners. Also, many local companies see little value in a foreign partnership, since they are more experienced than the multinationals in navigating the turbulent waters of China's stock market and have proved that they can outperform foreign players. Indeed, eight of China's ten largest fund managers are local.

A small number of local companies are unprofitable, however. Given the dire prospects that some of them face, investing in these asset managers might give foreign fund managers greater management control than would otherwise be possible.

To attract partners, foreign companies should emphasize their established investment processes, better corporate-governance models, experience in other emerging markets, and proven product design capabilities. As the stock markets mature, these qualities will probably attract Chinese managers. In addition, foreign asset managers with experience in derivatives or in certain asset classes (such as property) can highlight their skills to attract Chinese partners that lack this specialized knowledge.

Would-be foreign entrants might also look at new kinds of partnerships. One option could involve insurance companies. Many insurers aspire to develop a substantial third-party asset-management business, especially in the institutional realm—a segment poised for tremendous growth driven by corporate annuities and the national social-security fund. Franklin Templeton, for example, has partnered with China Life Insurance, the country's largest life insurer, to help manage its foreign-denominated assets. For the foreign company, a Chinese insurer brings to the table important advantages, such as large and stable assets under management, as well as established institutional relationships.

Foreign asset managers that aren't prepared to jump directly into the market should stay involved on the fringes. They can, for example, work with local institutions to develop and manage products for the Qualified Domestic Institutional Investor (QDII) program or participate in the Qualified Foreign Institutional Investors (QFII) scheme, which allows approved foreign institutions to invest in stocks listed in China. All of these strategies would allow foreign asset managers to gain experience investing there.

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