



Celebrating 20 years of asset management in China

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Introduction

China's asset management industry came into being in 1998. The establishment of commercial institutions tasked with professionally managing third-party assets was a major landmark in the development of the country's financial system. It marks a transition away from a seemingly unregulated environment toward a system where specialist companies started to operate according to a defined set of standards and regulations.

The 20th anniversary of the industry's creation provides an opportunity to assess the immense progress that has taken place over the last two decades. The growth in assets under management (AUM) captures the scale of transformation — from six Fund Management Companies (FMCs) managing RMB10.4 billion (USD\$1.27 billion) in 1998 to RMB12.6 trillion (USD\$2.0 trillion) held by 132 firms today. Long-term growth will continue into the next decade, with KPMG China forecasting total AUM to hit RMB36.3 trillion (US\$5.6 trillion) by 2025, which would make it the second-largest asset management market in the world.

In addition to profound quantitative growth, there has also been significant qualitative change. The definition of the industry has broadened to include a wider range of participations such as private fund managers, securities firms and the asset management arms of banks and insurers. The range of products evolved too — the first FMCs were limited to closed-end funds, but nowadays there is a vast range of products in the market including ETFs, balanced funds, and QDII funds.

All of this growth has been fuelled by a number of factors that will continue to exert a positive influence over the coming years. Economic growth creates personal wealth among the population, who have become increasingly sophisticated consumers of financial products. At the same time, institutional investors — including sovereign wealth funds, insurers, pension funds and endowments —

are not only growing in size, but also looking for more professional management for their assets.

Although individual consumers and institutional investors are very different in terms of their needs, they both prompt the asset management industry to innovate in product design, channel development and operational capabilities.

The evolving structure of the financial system is another factor that will help nurture further growth among asset managers. Besides an accommodative regulatory framework, China's markets are becoming increasingly linked with the outside world, creating opportunities for FMCs to provide an international platform for their clients.

In this report, we provide an overview of the asset management industry in the world's second largest economy. We highlight the themes that will dominate the industry's next stage of growth, focusing on the competitive landscape, the importance of technology, as well as the ever-important issue of regulation.

We hope that this publication will help asset managers understand the importance of China as a market, how it should fit into their development plans, and how their current operational model might need to be adapted to reach the right opportunities. All of these are long-term considerations that require substantial planning. The rewards that come from getting it right, however, will also be durable, as it will allow asset managers to write two more decades of fruitful history in this thriving industry.

China's asset management industry — 20 years at a glance

A timeline highlighting the major events over the last 20 years.



At a glance

	1998	2008	2018Q1
Number of FMCs	6	60	132
Number of products	11	515	6,943
Total AUM of the industry in billions (RMB)	10.4	2,032.0	12,619.2
Total AUM of the industry in billions (USD)	1.27	297.3	2,011.0

Source: Wind and KPMG Analysis, KPMG China 2018



Competitive landscape — diversity is coming



Foreign FMCs are nothing new — joint ventures already hold more than half of the country's mutual fund assets, but a continued loosening of regulations means more foreign companies will start establishing local businesses.”

China's asset management industry is dominated by a relatively small number of FMCs, with 10 firms controlling 51.0 percent market share.¹ These companies are the primary beneficiaries of the industry's explosive growth in recent years, but their dominant status will be shaken in the next phase of expansion, as new forms of competition enter the market — offering new products and services to clients with increasingly sophisticated demands.

The largest FMCs will face competition from within the financial sector, as banks and insurers both look to leverage their solid brand and extensive distribution channels to cater to a large client base. These companies enjoy extensive support from their parent company, which will likely be willing to subsidize a loss-making venture in its early stages, as the value chain advantages of the business take hold.

Local incumbents will also face greater pressure from international asset managers who are drawn to China due to its attractive growth prospects. Foreign FMCs are nothing new — joint ventures already hold more than half of the country's mutual fund assets, but a continued loosening of regulations means more foreign companies will

start establishing local businesses. It will be difficult for a Chinese FMC that has primarily invested domestically to compete with the international expertise of a global firm.

Yet, competition will not only come from the financial sector, as China's home-grown technology giants have set their sights on asset management as an area to expand into. These companies are also enjoying strong distribution channels and have large amounts of capital at their disposal with innovative business cultures that reward creativity. Additionally, technology companies have a good understanding of how the asset management industry works — with years of industry experience providing mid and back office solutions to fund managers.

So if we look ahead to the next decade, we can foresee an asset management industry that is very different from how it is today. Banks, insurers, and technology companies will all be competing alongside traditional FMCs for assets to manage. Increased diversity is clearly a good development as it will stimulate innovation, but it will also mean that everyone will be required to work harder to capture a meaningful share of the growing pool of assets.

¹ Source: Wind and KPMG Analysis, KPMG China 2018





Client base — The challenging retail market



Setting up a direct retail business is therefore costly for many Chinese FMCs. But the growing wealth of the Chinese population will become too large to ignore.”

Over the last 20 years, retail investors have played an important, albeit changing, role in China’s asset management industry. They were the dominant segment of the market up until 2007, when volatility in stocks prompted individual investors to seek less risky assets. The retail market only started to pick up again in 2013, when Tianhong FMC, backed by Alibaba launched Yuebao — a FinTech platform that has quickly grown into the world’s largest money market fund.

The success of Yuebao is a clear demonstration of the growing importance of technology as a distribution channel for asset managers, while at the same time acting as an enabler for retail investors, as it allows them to compare products more effectively.

Another factor that is bringing retail investors back into the market is the demand for complex strategies that

require professional assistance to execute — such as global allocation, and multi-asset strategies.

Although the retail segment is growing in significance, asset managers should be aware of the challenges associated with establishing a business that targets individual investors. Building a brand can take an extremely long time, and a company will likely make a loss as it develops its sales channels and creates a loyal consumer base. Only when the FMC has reached a certain scale will it be able to make a profit.

Setting up a direct retail business is therefore costly for many Chinese FMCs. But the growing wealth of the Chinese population will become too large to ignore. As the industry matures, we expect that more FMC will try to build proprietary sales and client servicing platforms.



Client base — The rise of the institution



The private sector contribution comes from enterprise annuities, while the existence of cross-border investment channels means that more institutional money can come from overseas.”

Away from the mass market, institutional investors and high net worth individuals compose the other main segment that asset managers need to address. At the end of 2017, institutional investors held approximately 50 percent of all public mutual fund assets.² The figure will likely be higher if we include products typically sold only to the institutions, such as segregated accounts.

The growth of investable assets held by institutions can be explained by a variety of factors. In the public sector, the National Social Security Fund is a notable pool of capital that is delegating to third-party managers. The private sector contribution comes from enterprise annuities, while the existence of cross-border investment channels means that more institutional money can come from overseas.

But the story of institutional funds is not just simply driven by the abundance of capital, since asset

managers and security companies have worked hard to seize emerging opportunities. They did this by taking advantage of regulatory developments that expanded their business scope and creating innovative products that cater to institutional needs.

For a long time Chinese managers were serving their institutional clients in the same way as they serve the retail ones. But things are changing quickly as institutional investors now require an increasingly higher level of customization. The institutional business remains more profitable in relation to the retail, but it requires flexibility and agility. Providing a bespoke service requires investment in skilled professionals in order to cover the wide range of assets that an institution might be interested in. FMCs are therefore required to optimize, if not redesign their client strategy, as well as transform their middle and back office accordingly.

² Source: Wind and KPMG Analysis, KPMG China 2018



Channels — banks, here to stay

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...we foresee a situation where banks transform themselves in such a way that they become the main online distributor of mutual fund products, and more generally, asset management services.”

China's astonishing progress in the digital arena is often at the forefront of conversations about the world's second largest economy. It is only natural to think that high-tech solutions might play a major role in the future of the asset management industry. The extraordinary success of Yuebao demonstrates that there is clearly strong demand among retail clients for convenient and innovative products.

We believe that there is huge potential for technology to improve the industry's ecosystem. But we also think that the future role of technology is often overstated when people say that new online channels will disrupt traditional channels out of existence. The banks, according to this way of thinking, are destined to be eliminated by technological upstarts.

The banks are here to stay. In fact, we foresee a situation where banks

transform themselves in such a way that they become the main online distributor of mutual fund products, and more generally, asset management services. Some of the largest banks in China have already enacted aggressive plans to revamp their online strategy, which will likely consolidate their market dominance.

The reason for all this is simple. Online sales channels only work effectively with simple investment products — such as money market funds. Sophisticated products require a level of sales and after-sales support that an online channel might not be able to provide. The other factor at play here is that banks are at the top of the financial value chain, while FinTech start-ups operate at a much lower level. What is likely to happen, is that some of the start-ups will be acquired and absorbed into larger financial institutions.





Channels — widening your options

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Looking further into the future, there is a real possibility that banks will stop being partners to asset managers and become competitors.”

If banks remain the dominant distributors of investment products, asset management will remain dependent on banking partners to sell their products. This is problematic, as banks are imposing a greater level of scrutiny on their collaborators before they start selling their products. Banks are also increasing their fees and signing more exclusive distribution agreements with FMCs that lock out the products of competing firms.

Looking further into the future, there is a real possibility that banks will stop being partners to asset managers and become competitors. This will become more likely as China transitions to a universal banking model where banks will be able to own asset management services directly. If that happens and FMCs are still reliant on banks for distribution, there is a risk that the asset managers could be limited in their sales channels.

FMCs should start thinking about their distribution strategy before that happens. The most costly option is for asset managers to build their own distribution platform — something that is only really possible for the largest companies. Another possibility is to take advantage of emerging channels, such as independent financial advisors and online distribution.

Perhaps the most feasible solution for many asset managers is to enter into strategic partnerships with the banks. Traditional lenders know that it will take years for them to establish their own portfolio of investment products, so there is a compelling case for banks to work with carefully chosen third-party asset managers to speed up their entry into the industry.





Products — ETFs, fixed income, and offshore investments



We expect that index funds and ETFs will become a greater part of local portfolios as asset managers create products that are differentiated from each other by a powerful value proposition.”

The range of products that China’s asset managers can sell has come a long way from the closed-end funds that were the only option in 1998. In recent years, the biggest developments have been the introduction of exchange traded funds (ETFs), fixed income funds, and funds that provide offshore exposure. Going forward, these products offer the greatest potential for the industry in the coming decade, though asset managers will need to develop a strategic vision to ensure new products meet consumer needs.

ETFs have grown rapidly in popularity, both in terms of AUM and product numbers. But despite the rapid rise of ETFs, the product category remains in relatively early stages of its development, as asset managers have launched these funds to capitalize on regulatory windfalls rather than create value for investors. This is why we are yet to see specialize passive managers enter the market. We expect that index funds and ETFs will become a greater part of local portfolios as asset managers create products that are differentiated from each other by a powerful value proposition.

The growth of fixed income products is even more impressive, with bond funds accounting for approximately 63 percent³ of the asset management industry’s total AUM. Once again, there is a lack in strategic thinking behind this development, as asset managers were releasing fixed income funds in times when the appetite for stocks

was weak. Furthermore, the vast majority of the money going into fixed income funds goes to money market funds, which are primarily marketed to retail investors. Asset managers will need to innovate away from relatively simple money market funds in order to develop a fixed-income portfolio that appeals to institutional investors and high net worth individuals (HNWIs).

The other product category that is developing quickly is funds that provide offshore assets, which is partly the result of increased demand for international exposure, as well as regulatory reforms that make it easier to make cross-border investments — most notably, the Mutual Recognition of Fund and the Stock Connect programs.

Offshore allocation in China is far from optimal levels, something that holds true for both institutional and retail investors (though the Qualified Domestic Institutional Investor program (QDII) has made it easier for individuals to get exposure overseas). The demand is there however, which will prompt local asset managers to launch more products. Creativity will be driven by global asset managers setting up their wholly-owned platforms onshore. Perhaps the most rewarding products will be those that provide an interesting range of global investment options to retail investors, which at the same time are acceptable to the regulators.

³ Source: Wind and KPMG Analysis, KPMG China 2018



Human capital — meeting the demand for talent



“...the asset management industry needs to focus on nurturing and retaining talent.”

Asset management is a complex industry that requires a wide range of professionals to operate effectively. The problem in China is that as the industry's AUM has tripled over the last five years, the availability of human capital has failed to keep up. The shortage of experienced fund managers is made worse by the fact that retention rates are extremely low — the result of short-term evaluation methods that judge managers on a quarterly or even monthly basis, as well as the lack of an effective incentive scheme. In 2015, the departure rate for fund managers reached the highest level since 2007.

Some portfolio managers leave their employers to start their own funds, but many leave the industry to go and run funds for the asset management arms of banks and insurers — a trend that speeds up the development of new competitors.

More generally, the talent shortage hinders the range of products available in the market, since there are not enough people with the necessary skills to design and market innovative funds. Adequately staffing both the back and middle office is also a problem, as the growth of the industry creates the need for administration professionals.

Looking ahead, the asset management industry needs to focus on nurturing and retaining talent. Training people internally takes time — something that FMCs lack in the rapidly growing market. Sourcing professionals from other industries, such as banking and insurance, is an option, so too is importing talent from overseas. It is unlikely, however, that these sources will be enough to meet immense demand for experienced people. How the industry deals with the talent shortage will be of crucial importance over the coming years.





Foreign ownership — at the forefront of financial liberalization



Setting up a direct retail business is therefore costly for many Chinese FMCs. But the growing wealth of the Chinese population will become too large to ignore.”

When it comes to foreign ownership, the asset management industry is at the forefront of China’s drive to liberalize and open up its financial markets. In 2017, the country relaxed restrictions on foreign companies becoming majority shareholders in FMCs — allowing overseas investors to hold a 51 percent holding, up from the previous cap of 49 percent.

If foreign companies take advantage of the relaxed ownership rules, Chinese consumers will benefit from relatively inexpensive wider and more cost-efficient access to the products of global asset managers. More foreign participants in the market will increase competition, resulting in greater efficiency among local firms.

Foreign companies are nothing new in China’s asset management industry, as joint ventures between local and overseas partners have operated for many years. The easing in ownership

rules could result in a renegotiation of the terms of their partnership. The articles of association for some joint ventures explicitly state that the foreign partner is allowed to take control of the company if there is a regulatory change that allows such a move. If this happens, both sides will be required to determine valuations, design new holding structures, and implement new corporate governance and management control systems.

Not all Chinese asset managers will be interested in a foreign party taking a controlling stake in the joint venture. Ever since the global financial crisis in 2008, there is a growing sense of disillusionment among local FMCs with their global partners, which sparks a desire to fully own the business. They are no longer looking for capabilities from their partner, but more market access and client resources — factors that will become increasingly important as the cross-border business develops.

Conclusion:

The last twenty years has been a period of immense change for China’s asset management industry. It has grown from a small part of the country’s financial system when it was at its early stages of development, into an important part of the world’s second largest economy.

The next decade could be another period of enormous transformation. Technology creates new opportunities for managers to expand their client base within China — both with individual and institutional clients. The gradual integration of China’s financial markets into the global

system means that local companies can start to look overseas to expand.

There will be challenges along the way, but the growing levels of wealth in China means that its investment needs cannot be ignored. The asset management industry will develop new products and operational methods to meet evolving demands. Any forward-thinking asset managers should be looking at how they can be part of this exciting market.

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