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CHINA

Outsiders No More

New rules open the door to stand-alone foreign fund managers

But the banks will still dictate who comes, and who stays.

In China, things can change in the blink of an eye. On May 10, 2007, offshore fund managers were given the fillip that they had not even dared dream. They will now be able to participate in the Chinese market without establishing independent or joint venture operations there. All they need to do is register their funds in Hong Kong, or in the future, any approved jurisdiction.

For now, this rule change is likely to be mutually beneficial for Hong Kong and mainland China. On the one hand, it further enhances Hong Kong's position as an international financial center, by giving it the green light to play a more active role in the development of China's commercial banks, and in particular their overseas investments businesses. On the other hand, it opens up new opportunities for retail banks on the mainland.

Although these new rules represent a dramatic development for foreign fund managers, they are actually an extension of existing legislation for mainland banks. Those wishing to offer foreign investment to their affluent clients were able to do so in a limited fashion under the QDII (Qualified Domestic Institutional Investor) quota-based scheme introduced by the China Banking Regulatory Commission (CBRC) in 2006.

However, this latest announcement,

which only applies to banks, gives local and foreign industry players the ability to sub-contract and market a far wider range of overseas investments. As such, they have a substantial head start over local fund managers who have not yet been allocated a QDII quota, and therefore are not able to offer any foreign-invested products. (The exception is Huanan Fund Management, which received approval to launch an experimental foreign currency-denominated fund with a global investments mandate, the first ever in China.)

A banking precedent

This extension of the QDII rules effectively allows Chinese investors, for the first time in modern Chinese financial history, relatively unfettered access to overseas-registered equity funds via their local banks, so long as these are approved by regulators that have an existing agreement with their Chinese counterpart, the CBRC.

This is where the recently signed Memorandum of Understanding (MOU) between the CBRC and Hong Kong's Securities and Futures Commission, comes in. The MOU makes the Hong Kong regulator the only one to date to have secured the necessary agreement with the CBRC. Mainland banks can therefore make any



Hong Kong registered mutual fund available to their customers, albeit repackaged to meet QDII criteria. However, the CBRC has imposed a RMB300,000 (US\$39,000) minimum for the purchase of such products.

QDII's limitations

Besides helping to firm up the financial industry, this latest liberalization by the CBRC is clearly also a response to the larger economic forces at play in China. The swelling of its foreign exchange reserves, always a worry, has reached untenable proportions. Already the world's largest at US\$1.2 trillion, continuing trade surpluses and investment inflows, especially into its manufacturing and property sectors, is expected to push these reserves even higher, further fuelling inflation and elevating the renminbi to export-impairing heights. In addition, speculative interest in the Chinese stock market has many stocks teetering at levels many agree are unsustainable.

The CBRC's attempts to resolve this

problem through the launch of the initial QDII scheme in 2006 has not yielded the required results. Faced with the wall of liquidity described above, the QDII scheme has barely made a mark, and not surprisingly. Given that these schemes were largely limited to overseas money market and fixed income, returns were miniscule compared to local stock market returns, and could in no way offset the appreciation of the RMB. As a result, banks and insurance companies have used up only US\$800 million to US\$900 million, or approximately 5% to 6% of the US\$14.8 billion QDII quota they were granted. The CBRC is said to be holding off any new or additional quota allocations until this amount is exhausted.

Lurching forward

This latest announcement serves to address some of the most important limitations and uncertainties of the earlier QDII scheme, and on the face of it, deserve to be welcomed by foreign managers with cartwheels and champagne. In theory, foreign

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The Cerulli Edge™—Asia-Pacific Edition is a quarterly periodical designed to update the firm's clients about the most recent Cerulli research initiatives regarding the eight major asset management marketplaces the firm currently covers in the Asia-Pacific region. Articles outline various trends in the Asia-Pacific asset management marketplace and provide relevant global context for analysis.

The annual subscription fee is US\$5,000 per client firm. The publication is available in hard copy and electronic format and includes copies sent to as many as 15 key executives. Each recipient above 15 copies is \$500. We suggest including heads of business units, CEOs, and directors of marketing, strategy, product development, and sales. **Your subscription also gives you access to all archived issues via our web-based client login service.** Please contact CAmarketing@cerulli.com for details. *The Cerulli Edge—Asia-Pacific Edition* ©2007 is published quarterly by Cerulli Associates, One Exeter Plaza, Boston, MA 02116; edge@cerulli.com; in Singapore, contact staneja@cerulli.com. Phone: 617-437-0084. Fax: 617-437-1268. Website: www.cerulli.com. Restricted and confidential; not to be duplicated or distributed; reproduction in whole or part in any media is prohibited except by permission. Analysis is based on data from extensive interviews, proprietary surveys, financial reporting services, periodicals, and other sources deemed to be reliable; although believed to be accurate, this information is not guaranteed and may be incomplete.

EXAMPLE OF A QDII FUND

The Bank of China fund was one of the first to be launched under QDII rules.

Product Name	Bank of China Steady Growth Fund
Type of product	Open End / Balanced
Manager	Bank of China
Guaranteed return	No
Main investments	<ol style="list-style-type: none"> 1. Open-end stock funds <ul style="list-style-type: none"> China H-Shares Red Chips Fidelity China Focus Fund Credit Agricole Greater China Fund 2. Bond type assets 3. Cash type assets

Source: Cerulli Associates

managers will now be able to tap into China's \$2 trillion worth of bank deposits without the painful task of setting up, operating, and managing joint ventures with local partners.

In practice though, the massive outflow of Chinese money into overseas investments may not happen as initial reports had so enthusiastically touted (although speculation about the rush by Chinese investors to buy H-shares, that is, Hong Kong-listed Chinese company stocks and H-share funds, did help boost the Hong Kong stock market recently). H-shares aside, for as long as the Chinese financial markets remain upbeat, and the RMB continues to trend upward, there appears little incentive for locals to seek returns elsewhere.

And while foreign fund managers may be able to do away with joint ventures, breaking into the Chinese market may not become substantially easier in the near term. Many local and joint-venture managers have worked hard over recent months to court the local banks and win them over. Foreign managers without Chinese joint venture partners will still find the task of building links with the banks an uphill battle, although of course, foreign banks with QDII quotas may be easier to penetrate (see chart at right).

Even among the local banks, there are

signs that things are already on the move. The Bank of China (BOC) has managed to preempt the CBRC's latest announcement with the launch of its Steady Growth Fund in February (see above). This fund includes direct Chinese equity investments as well as two Hong Kong-registered equi-

BANKS IN RECEIPT OF QDII QUOTAS

Although US\$14.8 billion has been allocated for overseas investing, only US\$0.9 billion has been used up.

No. Bank	Quota (US\$ millions)
1. Bank of China	\$2,500
2. ICBC	\$2,000
3. China Construction Bank	\$2,000
4. Bank of Communication	\$1,500
5. China Merchants Bank	\$1,000
6. Agricultural Bank of China	\$500
7. China Citic Bank	\$500
8. China Everbright Bank	\$500
9. China Minsheng Bank	\$500
10. Citibank N.A	\$500
11. HSBC	\$500
12. Industrial Bank	\$500
13. Standard Chartered Bank	\$500
14. Bank of Beijing	\$300
15. Bank of China (Hong Kong) Limited	\$300
16. Bank of East Asia	\$300
17. Credit Swiss Shanghai Branch	\$300
18. Hang Seng Bank	\$300
19. Nanyang Commercial Bank	\$300
Total	\$14,800

Sources: State Administration of Foreign Exchange (SAFE), Cerulli Associates

ty subfunds, the Fidelity China Focus Fund and the Credit Agricole Greater China Fund. Although the BOC could have chosen China funds from one of the many existing Chinese joint ventures, it appears that Fidelity's and Credit Agricole's significant fund size and investment expertise helped to sway the BOC in their favor.

The Industrial and Commercial Bank of China (ICBC) is also set to launch a wealth management product that can invest as much as 50% of its portfolio in Hong Kong-listed mainland stocks including red chips, H-shares, and new offerings. JF Asset Management, the Asian arm of JP Morgan Asset Management, has been designated as the overseas investment manager of this new product.

The Steady Growth fund has managed to raise more than RMB793 million (US\$103 million) to date, and it remains

to be seen how well the ICBC fund will do, especially given the new RMB300,000 minimum investment imposed by the CBRC. Cerulli Associates believes that while such products are likely to be better received than previous QDII products, the take-up will not be rampant in the near term. However, the current tepidity of retail interest in overseas markets could reverse very quickly, given the volatility of the Chinese stock market and its already lofty levels.

The new rules have leveled the playing field for foreign managers, and the winners will be the ones that have the best relationships with the banks, and can wield a solid reputation and product capabilities, rather than those who were first in the market or who have established amicable joint ventures with local counterparts. ♦

OVERSEAS WEALTH MANAGEMENT PRODUCT CRITERIA

The overseas wealth management products offered by Chinese commercial banks have to meet the following conditions:

- ◆ For overseas wealth management products that invest in foreign equities, the equities to be invested in should be listed on an overseas stock exchange.
- ◆ The total value of the investment in listed equities shall not exceed 50% of the total net asset value of each product.
- ◆ The value of investment in an individual equity shall not exceed 5% of the total net asset value of each product.
- ◆ The minimum initial investment by a single client in such a product shall not be less than RMB300,000 (or its equivalent in foreign exchange).
- ◆ The commercial banks are required to conduct due diligence in the selection of investment managers, and ensure that they continue to maintain the relevant qualifications.
- ◆ The commercial banks can only invest in overseas stock markets supervised by the regulatory authorities which have already signed an MOU with the CBRC.
- ◆ Investment in commodities-based derivative products, hedge funds, and debt securities with credit ratings below BBB as assigned by an international credit rating agency is not allowed.
- ◆ For mutual funds, the commercial banks are to select public funds duly approved, registered, or authorized by the regulatory authorities which have already signed an MOU with the CBRC.
- ◆ For structured products, the commercial banks are to select those structured products issued by authorized financial institutions with a credit rating of A or above as assigned by an international credit rating agency.
- ◆ The commercial banks may use the main types of derivatives instrument such as forwards and swaps, which are commonly used in the financial markets, for hedging purposes, but are not allowed to use them for speculation purposes or to magnify transactions.
- ◆ The commercial banks must completely segregate the client assets from their own or the relevant parties' assets and open separate custody accounts for each wealth management product in the name of the product.

Source: China Banking Regulatory Commission

Shopping for M&As

Australians are acquiring a taste for private equity funds

With returns finally coming through, more are expected to pile in.

Ever since private equity bids started coming in for blue chip names such as Coles Myer and Qantas, private equity investing has stopped being the preserve of the financially savvy and has become what Australian media call the barbeque-stopper: a subject on which everyone has an opinion.

Like all big investment themes in Australia, private equity has quickly found its way to the retail investor; but those who have tried to participate in the M&A trend through listed vehicles have so far had very mixed experiences. Most who got in at the earliest opportunity were badly burnt, but some may finally be rewarded for doing so. It would be reasonable to expect a new clutch of offerings this year, probably with the same results, and twice the retail interest.

Current offerings

While Qantas, as the country's most iconic company, really put private equity in the headlines this year, the fact is that many investors have had exposure to the asset class for several years. The Australian Stock Exchange tracks 10 different listed vehicles in Australia under the heading of private equity.

The biggest ones, by assets, are a cluster of cashbox listings that came in a flurry at the end of 2004 and early 2005 from financial companies such as Allco Finance Group, Babcock & Brown, and Macquarie Bank. These three companies raised A\$2.35 billion in the initial launch.

These were controversial listings at the time and remain so today, although this has not stopped them from acquiring their tar-

geted minimums with plenty of demand to spare. The managers involved issued minimal guidance on what exactly would be done with the funds. The money raised basically represents a leap of faith in the managers being able to make sensible investments in unspecified assets within an equally unspecific time frame. The performance fees were particularly unpopular among professional investors: the Allco product is allowed to take performance fees on its good investments, without being penalized for any duds.

Performance issues

While the backers timed their launches well, from the investor perspective it has not been plain sailing. At a time when the Australian stock market was undergoing one of its most sustained ever upward surges, all three listings initially dropped well below their issue price.

However, as the cashboxes have begun to make purchases, the picture has brightened. Macquarie Capital Alliance Group, for example, having put much of its funds into European telephone directories, was up 24% in the year to March 31 to reverse previous declines. Babcock & Brown Capital, after buying into Irish telco Eircom, has at least started to close in on its original listing price; and the Allco Equity Partners fund, while also below its issue price, is improved dramatically since making investments in credit scoring agency, Veda Advantage, among others.

Aside from these offerings, a series of some smaller listed private equity vehicles appeared around the same time in 2004 and 2005. ING launched a vehicle called PEAL

PRIVATE EQUITY LISTED MANAGED INVESTMENTS, MARCH 2007

Private equity investing is likely to receive a boost from improved performances.

	Size (A\$ millions)	1-Year Return (%)	3-Year Return (%)
Advent Limited	A\$18	-8.69%	-2.97%
Allco Finance Group	3,882	12.56	54.44
Babcock & Brown Capital	842	-0.70	N/A
Charter Pacific Corporation	32	-10.71	8.36
Colonial Private Equity	106	35.29	17.57
CVC Limited	261	33.96	22.44
ING Private Equity Access	42	27.25	N/A
Macquarie Capital Alliance	1,026	24.04	N/A
Macquarie Private Capital	95	11.00	N/A
Souls Private Equity	131	4.88	N/A

Source: Australia Securities Exchange

(Private Equity Access Limited), and Macquarie a product called Private Capital Group. These are both fund-of-funds products, with Macquarie putting money into such private equity groups as Crescent Capital Partners, GS Private Equity, and Ironbridge Capital; and ING announced in May its second commitment to Quadrant Private Equity.

Both of these groups have a track record of launching unlisted funds in private equity—ING having launched four wholesale private equity funds of funds, with A\$480 million currently in private equity assets under management. Macquarie too has put out four wholesale funds of funds under the MAIT series, accompanied by a number of retail structured products investing

in those wholesale funds. These, too, have been able to reverse weak post-listing results: ING PEAL was up 27.25% in the year to March 31, while Macquarie Private Capital was up 11%. Both, though, trade at a significant discount to their net tangible assets (NTA): 17% on a pretax basis for Macquarie. An older listed private equity fund run by Colonial First State has a much longer track record, and a good one too, delivering an annualized 10.09% over five years.

Alongside these are a handful of listed private equity companies, among them CVC, Charter Pacific, and HGL. The mixed fortunes of these securities can be starkly illustrated by the five-year numbers, with CVC up an average of 24.87%, and Charter Pacific down an average of 10.28% a year over that period. Other products from AMP Capital Investors and Goldman Sachs JBWere allow investors into the debt side of private equity. Some other groups, including Gresham Private Equity and Hastings Private Equity, actively involve mainstream participation.

Retail interest

So what's next for private equity retail funds? The fact that the existing product range can now point to decent short-term

**PREMIUM/DISCOUNT TO NET TANGIBLE ASSETS (NTA)
OF LISTED PRIVATE EQUITY FUNDS**

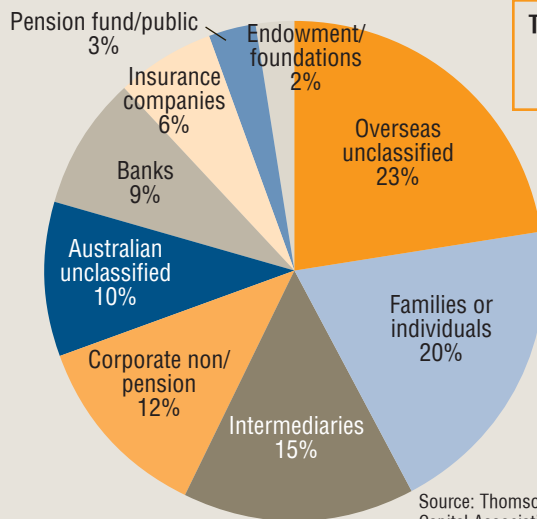
Private equity funds currently trade at a discount to NTA.

Fund	Pretax NTA* (A\$)	Prem/Disc % Pretax NTA
Colonial Private Equity	A\$0.82	-3.66%
ING Private Equity Access	1.32	-25.38
Macquarie Private Capital	1.06	-16.75
Souls Private Equity	0.28	-7.14

Notes: *NTA is the value of the underlying investment portfolio held in a listed fund on a per share basis. Funds may trade at a discount to the NTA due to excess supply.
Source: Australian Securities Exchange as of April 30, 2007

SOURCES OF PRIVATE EQUITY CAPITAL UNDER MANAGEMENT, JUNE 2006

Foreign pension funds and other institutional investors accounted for the largest share of capital committed.



TOTAL CAPITAL UNDER MANAGEMENT = \$22.4 BILLION

Source: Thomson Financial & Australian Venture Capital Association Ltd survey, June 2006

performances makes it much more likely that Australian asset managers will attempt to repeat the trick, taking advantage of the flurry of interest generated by the recent jumbo bids. Already, ING is believed to be planning another vehicle, and it would be no surprise if other promoters built fund-of-funds products by capitalizing on the growing profile of underlying private equity managers such as Quadrant, Gresham, and Ironbridge. Expect Macquarie to come up with another private equity play this year too.

It is likely that managers and promoters will persist with the listed model, at least if they want to involve retail money in the funds, since this gets around the liquidity problem. This approach has its challenges, though, because retail investors expect swift and consistent returns, whereas private equity, done properly, requires patience—the right opportunities can take years to come along—and is rarely conducive to regular dividends.

In any case, such products do not generally give retail investors exposure to the biggest bids, since they have tended to involve American private equity funds: KKR in the case of Coles, Texas Pacific in the case of Qantas.

Beyond retail

As in other countries, the very wealthy are able to sidestep managers altogether and are usually invited to invest alongside banks using their principal finance. Merrill Lynch and Deutsche are among the banks in Australia believed to be taking this approach. And it has been interesting to watch big Australian superannuation funds approach the asset class. Two, Westscheme and MTAA, are known for putting a very high proportion of their assets into alternative asset classes, which includes private equity (note however that they share the same asset consultant, Access Economics).

Another superannuation fund, Sunsuper, committed \$200 million to a private equity partnership with the investment banking boutique Carnegie, Wylie & Company, taking a stake in the private equity manager itself and becoming a cornerstone investor into two funds in the process. By becoming an owner, rather than merely a client of the firm, Sunsuper is able to save on fees while gaining much better access to new opportunities. Not many however, have the risk appetite or the liquid cash to do so. ♦

Annual Fees: Possibility or Pipedream?

Managed accounts offer a new revenue model for Japanese providers

Third-party managers have limited opportunities to date, but much to play for.

The Japanese managed accounts industry may still be small, but its potential for change is enormous. Brokerages keen to move from commission-based to fee-based revenues see managed accounts as the primary tool to help them do so, even though, as of December 2006, current programs had only amassed about ¥608 billion (US\$5 billion) in AUM, of which ¥473 billion were in discretionary assets.

Revenue considerations

Although managed accounts, broadly known as *rappu kouza*, were first admitted in 1999 as part of financial Big Bang, very few saw the light of day until 2004. Strict lines segregating a firm's asset management operations from its brokerage business, and prohibiting the exchange of information between them, served to dissuade many financial institutions from pursuing such programs, the exception being Nikko Cordial Securities. Deregulations that came into force in 2004 removed these barriers, and gave many brokerages the incentive to include managed account programs

in their product lineup.

However, in tandem with other matured and maturing markets, it is downward fee pressure that has been the more persuasive factor favoring managed accounts. In recent years, the demand for lower brokerage commissions has accelerated, as have the availability of cheaper channels, forcing brokerages to investigate new revenue models.

Today, online brokerages charging low sales commissions, or omitting trading-based commissions altogether, are currently estimated to represent close to 90% of all direct retail equity purchases. Large brokerage houses, including Nomura and Daiwa Securities, have established their own online channels, albeit belatedly, and still worry about cannibalizing client assets. Nevertheless, it seems only a question of time that these big players will mirror their smaller online counterparts by offering a wider array of investment products, including investment trusts. New revenue sources to replace sales commissions are no longer nice-to-haves, but rather, a matter of survival.

Brokerages in the front seat

It is therefore no coincidence that, bar one trust bank, managed accounts are almost wholly offered by the large brokerages such as Nomura, Daiwa, and Nikko. As such, third-party fund managers have not entered the fray in large numbers, as these brokerages have tended to look to their own affiliates for the management of such programs. Smaller brokerages offering externally managed programs have not

DISCRETIONARY AND NONDISCRETIONARY ASSETS UNDER MANAGEMENT

Managed account assets comprise only about 1% of Japan's AUM.

Asset Manager	AUM (¥ billions)
Nikko	¥236
Shinko	107
Daiwa	200
Others	65
Total	608

Source: Cerulli Associates

yet been able to raise assets of any significant size.

Contrary to Cerulli's initial assessment that the banks, with their strong retail brand name and reputation as long-term advisors, would be the most likely providers of managed accounts in Japan, few have taken up the challenge. In fact, after a serious examination of the managed account proposition, most have decided to pass for now, except Mitsubishi UFJ Trust Bank. Based on its belief that managed accounts are a good fit for its older, more affluent, and more long-term oriented clients, Mitsubishi says it is willing to go it alone.

There are several reasons underlying the banks' reticence with regards to a managed account offering. The most compelling is a concern that such programs could engender dissatisfaction and disgruntlement among bank customers who are traditionally low-risk-oriented and have a strong preference for principal-guaranteed investments. However, banks are also wary of the fact that many of their customers lack the necessary understanding of these sophisticated products and draw on the banks' reputation for their investment choices—a reputation that could so easily become tarnished once losses are incurred.

Major banks, including Sumitomo Mitsui Banking Corporation (SMBC), the leader in Japanese investment fund distribution with close to ¥3 trillion in assets, favor low-risk products with relatively simple features, while offering high-risk options via their brokerage partners or subsidiaries, especially since the separation of banking and securities businesses became more porous in 2004.

However, this arrangement may not last much longer. Client referrals from banks to their brokerage partners result in intermediary commissions that are much lower than direct fees, and more fundamentally, the banks risk losing their best investment

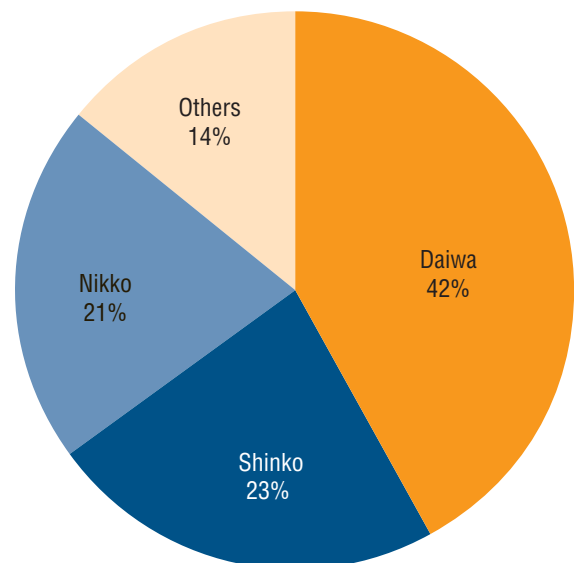
clients to the brokerages altogether. As investors' risk appetites increase, the banks are likely to seek out higher-risk but more stable product ranges, a bill that managed accounts would fit nicely.

The "mass affluent" conundrum

Two categories of managed account programs currently exist in the Japanese retail marketplace—separately managed portfolios of underlying stocks (sometimes involving a small number of investment trusts), and a broader portfolio of investment trusts that meet the criteria for Cerulli's Mutual Fund Advisory Program segment. The majority are in the former category, although there are several providers, such as Nomura Securities and Nikko Global Wrap Ltd., offering both program types.

In stock-oriented programs, Cerulli's survey reveals that many of them invest entirely in Japanese equities—hardly surprising given that the principal providers are local brokerages. Third-party managers are brought into play for mandates that affiliated managers cannot or do not cover,

MARKETSHARE OF DISCRETIONARY MANAGED ACCOUNT ASSETS
 Discretionary assets make up 77% of total managed account assets under management.



Source: Cerulli Associates

DAIWA'S PERFORMANCE-BASED FEE SCHEDULE FOR MANAGED ACCOUNT ASSETS UP TO ¥500M

	Advisor's fee (% of assets)	Sales commission (% of assets)	Tax (% of assets)	Total (% of assets)
Equity-focused	0.500%	1.500%	0.100%	2.100%
Equity/ bond mixed	0.500	1.000	0.075	1.575
Bond-focused	0.500	0.000	0.025	0.525
	Net annual return		Additional fee (% of profits)	
Performance fees (inclusive of tax)	Below 10%		10.50%	
	10-20%		15.75%	
	Above 20%		21.00%	

Source: Daiwa Securities

such as foreign REITs or commodities. Cross-border funds are not yet popular due to the brokerages' reluctance to include more complicated investment products, although many agree this could change with greater investor sophistication.

Daiwa Securities' main managed account program comes at a minimum investment amount of ¥50 million, but one of its programs does have a ¥1 billion (approximately US\$8 million) minimum requirement, based on Daiwa's conviction that such a product is viable. On the other hand, Nomura Securities' program, even with a lower ¥300 million minimum, did not generate much interest, and the firm now offers a cheaper but more popular alternative, based on minimum investment assets of ¥10 million. Shinko, the fourth largest brokerage in Japan, is proving to be a dark horse, having launched a minimum ¥20 million program that has gone down well with its mass affluent clients. It is now the country's second largest provider of discretionary accounts.

Fee schedules for managed accounts vary as much as minimum investment amounts, especially given the added complication of performance-based fees. On the whole, it appears that the highest fee in the marketplace is a fixed 3% pa for assets less than ¥100 million. However, Japanese investors seem to favor a combination of fixed and performance-based fees, where the priority is short-term performance

rather than the objectivity of the program managers.

No turning back

Will the Japanese managed accounts industry trace the success of its U.S. counterpart? Although many players agree that there is room for the industry to grow, the current pace is perhaps slower than might be expected.

However, Cerulli believes that several factors are in place for a stronger push forward. Japan's Financial Services Agency has launched further deregulation initiatives, in particular, the ability of brokerage staff to conclude managed account program sales without requiring the presence of an investment advisory bureau staff. Participation from providers other than the current 10 or so brokerages, extending to the banks and insurers, will also help invigorate the market in the longer term. However, more important than an increase in the number of players is the growing recognition among existing providers that adequate systems support and an improved product range are crucial prerequisites for success.

Perhaps most telling of all are domestic fund managers' own positive perceptions of the managed account industry. Where last year a Cerulli survey uncovered a "wait and see" approach, a similar survey this year shows that most managers are preparing to participate in its upcoming growth. ♦

Can I Give You Some Advice?

Independent advisors are holding their own against the banks

But they need to keep upgrading their advice quality to stay in the game.

Mark Twain's quote, "Rumors of my death have been greatly exaggerated," would be an appropriate slogan for Singapore's non-banking sector and in particular, its financial advisors (FAs). Five years since the introduction of the Financial Advisors Act, and in the face of widespread cynicism, Singapore's platform (*i.e.*, non-bank) mutual fund assets now comprise about 10% of the island's total, proving not only that the non-bank sector is here to stay, but gaining ground in this highly competitive and tightly regulated mutual fund market.

Despite the banks' hegemony of mutual fund distribution, platform mutual fund assets under administration (AUAs) in 2006 grew by a phenomenal 95% to cross S\$3 billion. This exceeds even Cerulli's own prediction of S\$2.7 billion for the same period, and has caused us to adjust our assumptions about this sector. In our latest survey, platform AUAs appear to

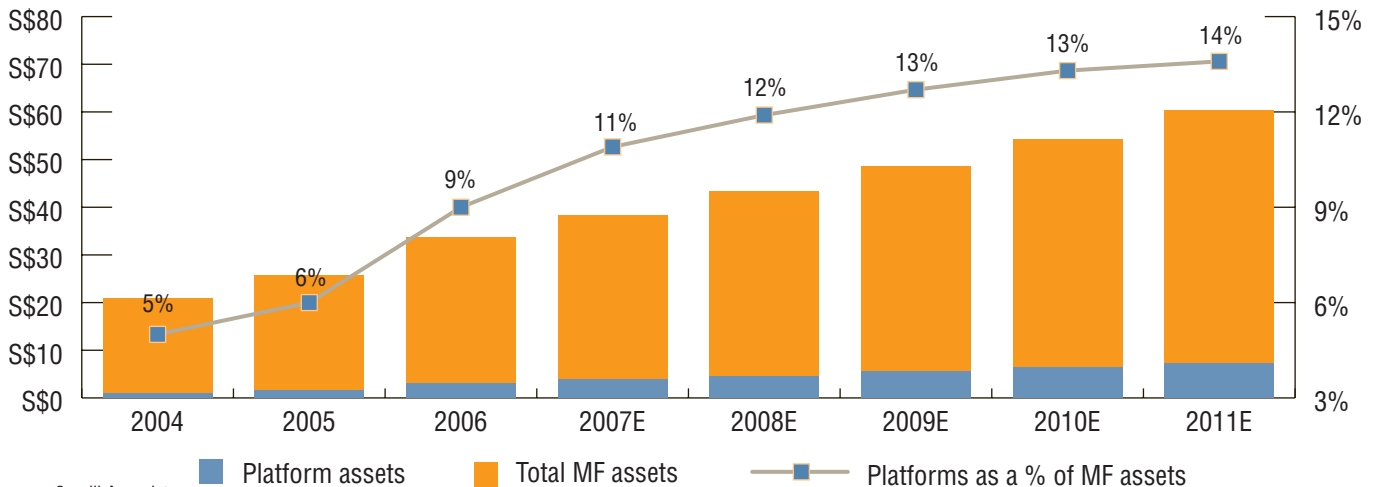
have reached S\$3.4 billion as of April 2007, well ahead of the industry growth average.

Advisory services change color

FAs accounted for 81% of this non-bank sector in 2006, compared to only 67% in 2005, and 52% in 2004, demonstrating their appeal relative to other non-banking channels such as online brokers. Cerulli attributes this success to the fact that, at a time when more of Singapore's mass affluent are warming to the idea of paying for investment advice, advisor firms have been able to cast off their image as glorified insurance agencies and reinvented themselves as advisory-based professional bodies. However, as part of this remodeling, three types of financial advisory groups have emerged.

At the top end of the scale are the boutique firms with the private banks and private banking clients very much on their radar. These firms tend to be small and

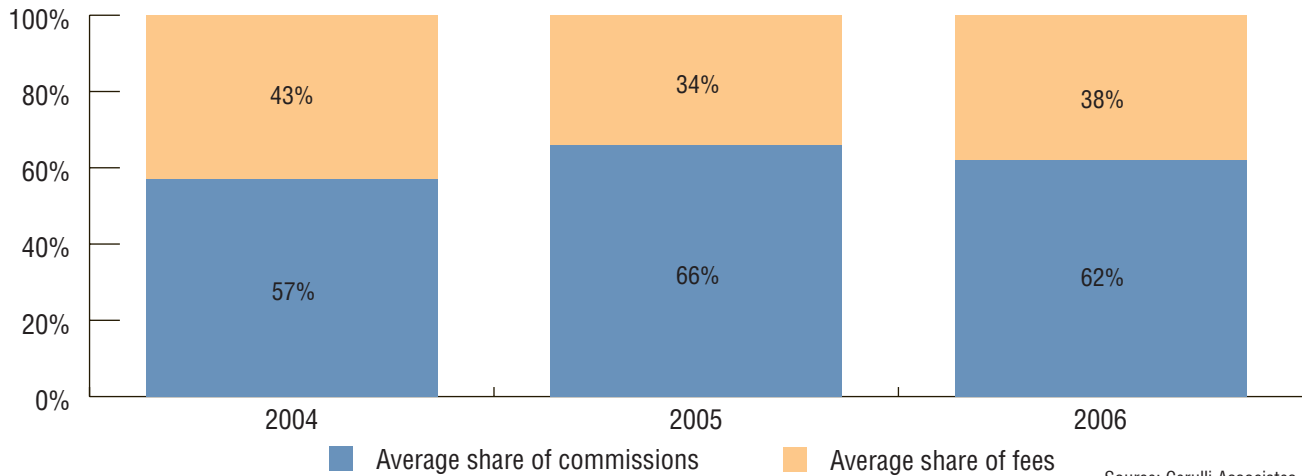
PLATFORM ASSETS UNDER ADMINISTRATION AND SHARE OF TOTAL MUTUAL FUND ASSETS (S\$ billions)
 Platform assets are expected to comprise a bigger share of total mutual fund assets in the years to come.



Sources: Cerulli Associates

SHARE OF REVENUE BY SOURCE

Average share of commissions has increased as a source of advisor revenues, despite a focus on advisory fees.



Source: Cerulli Associates

often sole proprietorships or partnerships with only a select number of high-end clients on their books. Attempts are made to provide a well-rounded financial advisory service, for which an advisory or wrap fee of 1% to 2% is charged. However, these fees are usually supplemented with sales commissions. These firms are a rarity and unlikely to proliferate in the face of the many private banks setting up shop here.

At the other end of the scale are the firms that are still purely commission-based and largely product-centric, often specializing in either insurance or mutual funds. These firms have not evolved greatly from their transactional roots, even if their marketing brochures say otherwise. Like many of the banks, these firms suffer from substantial revenue volatility and could be threatened by Asia's next big market correction.

It is in the middle of this range that Cerulli sees the greatest chance of long-term success. The firms in this group provide advisory services to the mass affluent market, and based on our tracking, have grown substantially in terms of the number of financial advisors employed, the number of new accounts, and the size of these accounts. These firms operate a fee model based on a combination of advisory fees

and commissions. Some have done well enough to implement strong operational systems. As banks continue to grow their mass affluent segment, it is this group of firms that is most likely to lure customers who desire a more personalized service away from the banks.

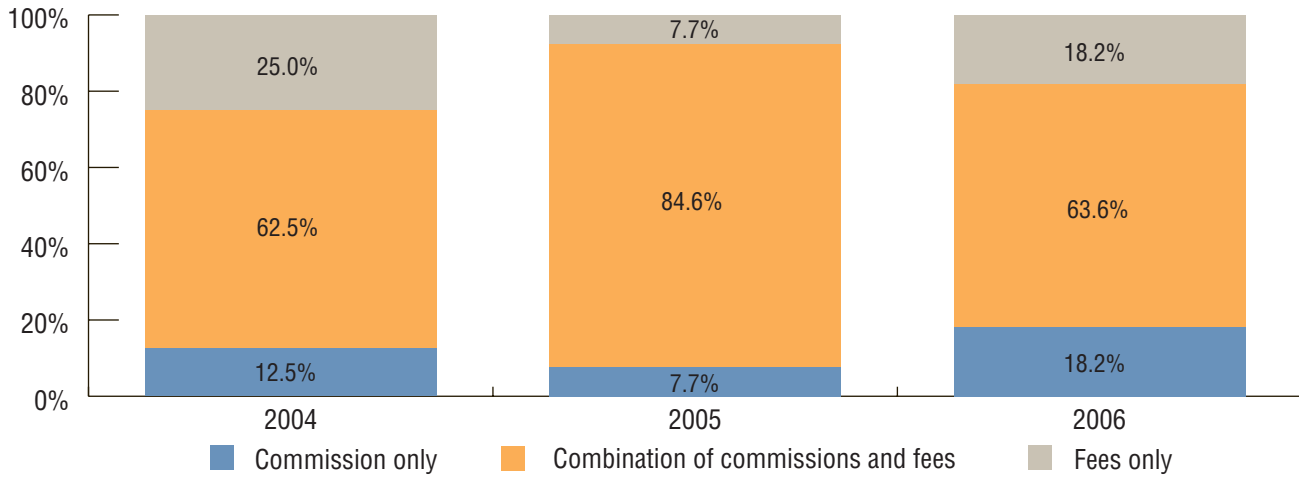
Advisory vs. transactional fees

When asked, many of these firms say that their advisory services are the key to their recent growth and therefore expect a higher percentage of their revenues to come from advisory fees over the next five years. That said, Cerulli's survey of advisor revenues in 2006 suggests that advisors actually increased their share of commission-based revenue, a symptom perhaps of the bullish Asian markets and high level of speculative transactions. However, it cannot be denied that the acceptance of advisory fees is still limited, and advisor firms find it difficult to raise their advisory fees, even in rising markets.

Nevertheless, advisor firms are looking to enhance their advisory offering in a variety of ways, the most interesting being some advisors' proposed use of foreign banks' offshore fund platforms. At present, Singapore's advisors utilize one of two main competing operational platforms in

ADVISOR FIRMS BY FEE MODEL

A combination of fees and commissions is still the preferred model for most advisor firms.



Source: Cerulli Associates

order to book their mutual fund trades on behalf of clients. Foreign banks' platforms will allow advisors access to a broader range of private banking products, such as hedge and private equity funds, and similar arrangements to use insurance companies' investment-linked product platforms are also currently being considered.

For the foreign banks, usually those relatively new to the Singapore marketplace and without an entrenched distribution network, "renting out" their platforms allows them to tap into alternative channels. However, the fees charged by the foreign banks are thought to be still too prohibitive for many advisor firms. A cheaper option for these firms is to offer prepackaged portfolios of products on a nonproprietary basis, although less than half of respondents to Cerulli's survey expressed an interest in doing so.

Looking forward

These differences in outlook are reflected within the industry in the form of a widening disparity of earnings and profits. While some advisor firms interviewed by Cerulli seem to have built up steam over the year, others appear to have lost their way somewhat. Some of the more profitable companies are starting to implement plans for offshore ventures. As Cerulli had

cautioned previously, overseas expansions, while to be encouraged given the limitations of the domestic market, must be deemed long-term commitments. Most other neighboring Southeast Asian markets are still some way from the level of investor sophistication needed for advisory services to pay off.

On the other hand, new CPF rules that will cap mutual funds' sales charge to 3% due to start in July this year is likely to introduce a downward pressure on fees that could shake up the entire industry. Advisors are unlikely to escape the turmoil and are more vulnerable than most. Coupled with the likely influx of new players in both private banking and independent financial advisory services, who are attracted to Singapore's increasing numbers high-net-worth individuals, advisor firms would probably do well to diversify their revenue base.

Over the next five years, Cerulli analysts will be monitoring Singapore's financial advisor community to see whether they are able to expand their operations, improve on their advice delivery and make use of better and more sophisticated product platforms. These three factors are likely to help determine whether advisors continue to gain foothold in Singapore's fund distribution landscape. ♦

Unbolting the Latches

After a hiatus, Malaysia is back in the financial services game

Islamic finance could be the country's trump card.

There is an unfamiliar movement underway in Malaysia at the moment—liberalization—and it is a trend that has extended to the fund management industry. Now, 10 years after the country acquired a reputation for insularity with a clutch of capital controls, it has removed nearly all of them, most recently the abolition of a cap on onshore banks undertaking foreign currency business. Equally significant but somewhat lost in the hullabaloo was another important shift in the financial industry: unit trusts can put up to 50% of their funds in foreign currency assets, up from 30% previously. This is going to have an interesting impact on its domestic managers.

It doesn't sound like much, but it is worth remembering that overseas funds have only been permitted in any form since 2005. Since then more than 40 funds have been launched to take advantage of this deregulation, and have taken in 10 billion ringgit between them. According to the Securities Commission, which oversees the industry, there were 426 unit trust products overall in Malaysia as of February, with MYR130 billion (US\$37.7 billion) invested in them, so the current shift to global assets is hardly a revolution. But it is believed that most global funds have hit their 30% limit and are expected to move up quickly to absorb the 50% allocation.

Most who have so far ventured overseas have not done all that well from it yet. Malaysia's stock market is one of the best performing in the world this year, and by May was second only to China among major Asian markets year-to-date. The CEO of one local fund manager calculates that last year alone Malaysian investors in

foreign funds would have lost MYR1 billion between them compared to the profits they would have made by staying at home. The rising ringgit hasn't helped, either.

Deregulation benefits

But for Bank Negara, Malaysia's central bank, there's more to it than retail investors' short-term returns. The backdrop is Malaysia's ambitions to join some of its Asian neighbors as a global financial center. Bank Negara is willing therefore to allow its institutions to invest externally in exchange for greater access to foreign players' knowledge base and experience in overseas markets, ultimately allowing local asset managers to become globally competitive.

However, this is just part of a broader theme in Malaysia. Having assisted ethnic Malays (Bumiputras) with positive discrimination legislation that requires them to be given 30% of the jobs and equity in Malaysian commerce, some senior-level legislators now feel the country has become less competitive compared to its increasingly aggressive Asian counterparts.

Recent developments, such as the extension of Khazanah's mandate from being a passive buy-and-hold investor for the Malaysian state to being an active agent of reform in the country's many powerful government-linked companies (GLCs), and the forced mergers in the banking sector, are attempts to address this lag.

Growing confidence

In that context, the shift in the rules for Malaysian fund managers reflects a growing confidence in their ability to move up the curve. Many managers have started by

launching regional funds: CIMB-Principal Asset Management has an Emerging Asia Fund investing in nine Asian markets from India to South Korea, the Asia Pacific Adil Fund buys Shariah-compliant stocks around Asia alongside two global equity products, while AmInvestment Services, part of AmBank group, offers seven offshore equity products, including an Asian income and Asia-Pacific property equities fund. In addition, HLG Unit Trust, part of the Hong Leong group, offers the Asia Pacific Dividend Fund; and Hwang-DBS Investment Management offers the Greater China Structured Fund.

Although regional funds dominate, there is evidence of broader tastes in some of the more esoteric global equity products recently put on offer. Hwang-DBS has launched a global emerging markets and global banks structured fund; HLG has global equities products focusing on health-care and resources; and OSK-UOB Unit Trust Management offers a global emerging leaders fund called Global New Stars and a capital-guaranteed BRIC fund.

Growth of outsourcing

However, instead of building the expertise themselves, managers are outsourcing the portfolio management to third parties or affiliates, and in many cases it is the managers with global or regional affiliations that are leading the way in offshore innovation. Hwang-DBS and OSK-UOB are linked to Singaporean banks, and AmBank's European equity product is run in association with Schroders, for example.

This should hardly have been a surprise—even in an asset management market as sophisticated as Australia's, most global equity funds outsource their offshore portfolio management—and there are clear marketing benefits too in being able to tout an international name around a product. However, this may not have been what the Securities Commission had in mind, hoping instead that managers would build the expertise themselves. Now with the increased limits, it is thought that some leading houses in Malaysia may be prompted to gain a better internal understanding of regional and international securities, and to

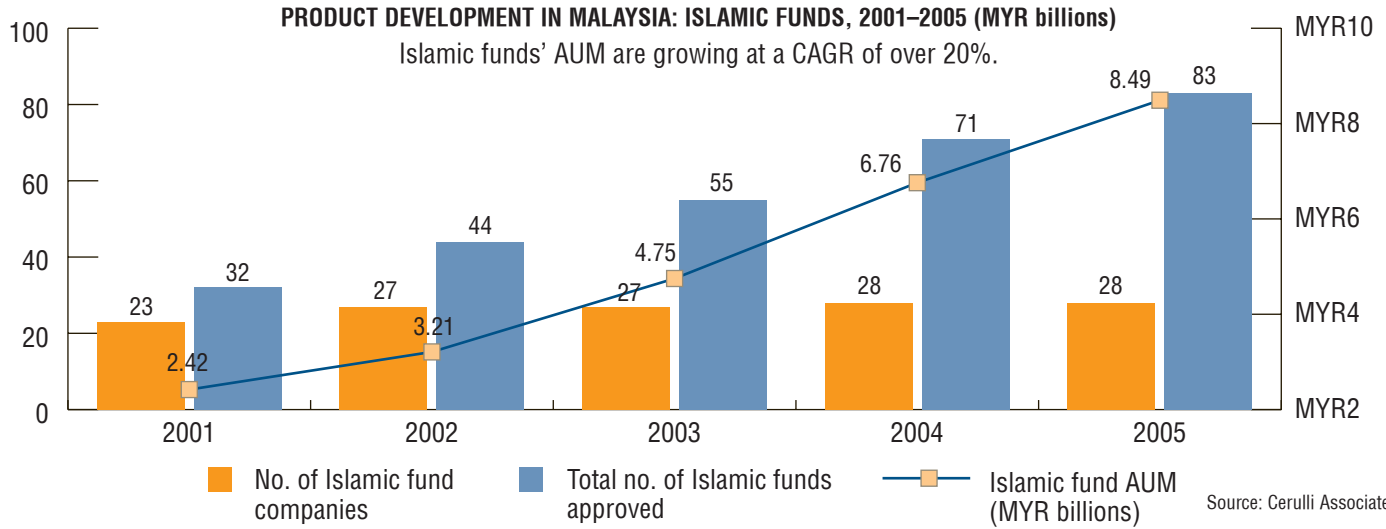
MALAYSIAN OVERSEAS FUND AUM BY FUND MANAGER, DECEMBER 2006 (MYR millions)

More than half of overseas fund AUM is outsourced.

No.	Manager	Total AUM ¹	AUM outsourced to external managers	Share of Total AUM
1.	Public Mutual	2,781	-	25.9%
2.	AmInvestment Management	1,319	1,319	12.3
3.	Prudential Fund Management Berhad	1,257	1,257	11.7
4.	HLG Unit Trust Bhd	939	482	8.7
5.	Hwang-DBS Investment Management	752	752	7.0
6.	SBB Mutual Berhad	724	414	6.7
7.	ING Funds	666	666	6.2
8.	OSK-UOB Unit Trust Management Berhad	578	200	5.4
9.	Pacific Mutual	487	384	4.5
10.	CIMB-Principal Asset Management	458	458	4.3
11.	RHB Unit Trust Management Berhad	308	236	2.9
12.	MAAKL Mutual Berhad	143	143	1.3
13.	TA Investment Management Berhad	104	104	1.0
14.	Alliance Unit Trust	92	92	0.9
15.	CMS Unit Trust	88	88	0.8
16.	Pheim Unit Trust Berhad	42	-	0.4
	Total	10,739	6,595	

¹Total AUM includes direct investment made by fund manager

Sources: Cerulli Associates, company websites



manage some of these funds in-house before too long.

Islamic funds

Fitting into this emerging confidence is Islamic finance. The development of the Malaysian International Islamic Finance Centre, MIFC, is the clearest example yet of Malaysia's desire to take on the world in this niche yet lucrative field. Although it allows outsiders to set up wholly owned Islamic finance businesses in banking, insurance, or asset management, the idea is to nurture local fund management specialists in this field.

One of the incentives of MIFC is that it allows fund managers who manage Islamic funds for foreign investors to claim a 10-year tax exemption on management fees. Existing Malaysian Islamic banking players can also get approval to set up something called an International Currency Business Unit, a dedicated division permitting

Islamic banking services, including for non-residents, in international currencies—again with a 10-year exemption.

Issuers and investors too will find it easier to participate. Malaysia already has the most sophisticated regulatory and legal framework for Islamic finance, and MIFC is a very clear pitch to make Kuala Lumpur a global center for it, even taking an agnostic approach to differing interpretations of Shariah law across the Islamic world. In the longer term, this should mean a healthy two-way flow not only of capital but of expertise, with Malaysian institutions increasingly able to target foreign funds for investment in their Islamic products, and foreign groups sharing their latest investment practices.

Today it's difficult to imagine Malaysian managers being acknowledged on a global scale. But recent developments show increasing determination in the Malaysian state that they can be. ♦

For more about Malaysia's Islamic funds and asset management industry, refer to The Cerulli Report entitled *Asset Management in Southeast Asia*



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