



State of the Investment
Management Industry in Asia Pacific
April 2008

FINANCIAL SERVICES

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Introduction

Following the dramatic developments in global financial markets since late 2007, the investment management industry is entering a potentially turbulent period. Higher interest rate levels have created pressure to deleverage investments and inflation is threatening to become a more permanent fixture in the world economy.

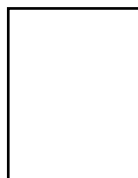
As investment returns fall in many mature markets, these developments may in turn lead to greater attention upon Asia Pacific where the longer term outlook is still bright. If indeed that is the case, it will further highlight the significant challenges that exist in many markets around the region, which we touch upon in this report. These include differing regulatory environments, staffing shortages and the need for more sophisticated distribution strategies.

For the purposes of this report, the investment management industry refers to entities that are actively engaged in the management of pooled assets. This includes traditional mutual fund managers and life insurance companies, as well as managers using alternative investment strategies through vehicles such as hedge funds.

The scope of this report extends across the entire Asia Pacific region, including Australasia, South Asia and Northeast Asia. There is a particular focus on the most developed economies – such as Australia, Hong Kong, Japan, Singapore, Taiwan and South Korea – as well as the two most significant developing markets in the region – China and India.

In the course of researching this thought leadership, we have undertaken interviews with KPMG professionals and investment management executives based around Asia Pacific, to gauge their views on the market.

We hope you find this report insightful and would welcome the opportunity to discuss the findings with you.



Jacinta Munro

Partner

Head of Investment Management
KPMG Australia



Bonn Liu

Partner

Head of Investment Management
KPMG China

1. Executive summary



KPMG extends its thanks to Robert Agnew of Matrix Services Ltd., for his assistance in the research and development of this report. Matrix Services is an emerging market research and corporate advisory firm specialising in Asia related transactions, with offices based in Hong Kong, Shanghai, Bangalore and London.
www.matrixserviceslimited.com

By any significant measure, the investment management industry in Asia Pacific has grown and developed at an impressive pace in recent years. The regulatory environments of many jurisdictions present challenges, but successful Asian investment managers have learnt to respond quickly to this dynamic market.

Asia Pacific's demographic and economic fundamentals point to an even brighter future. With levels of middle class wealth rising, the limited existing penetration of structured or managed products in many markets points to opportunities for continued growth and further sophistication.

Another factor affecting the Asia Pacific region is the increased influence being exerted by global investment trends. Foreign mutual firms seem to be recognising the need for local presence and many now have managers, research analysts or distribution operations in the region. The global trend of polarisation of the market between large, branded fund managers and niche institutional investors, such as hedge funds, is also mirrored in Asia Pacific.

A caveat, however, is that pension reforms and continued liberalisation of financial markets previously closed to foreign capital and institutions will be necessary to sustain this development. Some examples of prevailing regulatory constraints include the imposition of currency and capital controls, quotas or qualifying criteria for foreign institutional investors, conflicts or obligations arising from a multiplicity of regulatory bodies, and the obligation to form a joint venture with a local firm.

The varying rules and regulations are the biggest hurdle when entering the markets of Asia Pacific, but challenges also exist in many other areas, which are addressed in this report. These include staff retention, distribution, communication and technology.

Likewise, Asia Pacific's diversity of cultures and languages has very real and specific implications for companies seeking to develop or grow in different markets around the region. Regional fragmentation is an unavoidable reality when doing business across Asia Pacific. There is no Asian equivalent to the European supra-national reform process to help drive standardisation across the region.

Forces shaping the investment management industry in Asia Pacific

- Growing wealth and prosperity among the middle class
- Regulatory reforms opening up previously closed markets
- Polarisation of the market between large, branded fund managers and niche institutional investors
- Difficulties in attracting and retaining key staff
- Asia Pacific's diversity of cultures and languages, which has implications for market entry and distribution strategies.

Some executives hope that common standards will evolve more informally, for example through the common acceptance of the Chartered Financial Analyst (CFA) designation or the adoption of Global Investment Performance Standards. However, this is unlikely to be a satisfactory alternative to region-wide reforms driven by regulatory bodies.

This fragmentation and diversity suggests that while the outlook is bright, many investment managers are most likely to achieve competitive advantage through a careful allocation of resources and talent to certain markets, rather than taking a truly region-wide strategy.

This investment management report complements a series of similar KPMG thought leadership reports on the investment management industries of Europe and the United States. We would welcome the opportunity to discuss the findings with you further.

Market overview

This overview of the largest Asia Pacific investment management markets show Japan and Hong Kong dominating in terms of the numbers of funds and fund managers, with Japan and Australia having the highest quantum of assets under management due to the significance of pension assets under management in those jurisdictions.

In the tables and charts below, assets under management are defined as those assets which are pooled and actively managed by fund managers, life insurance or hedge funds. Australia and Japan are the only markets where significant volumes of assets are

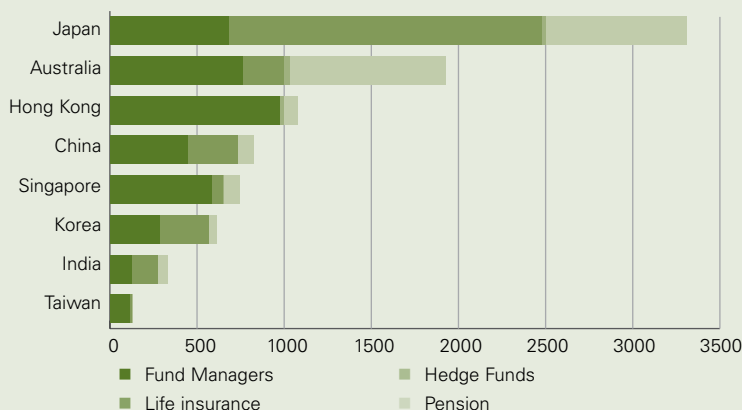
managed by pension funds. In addition to Australia and Japan, China and Korea also have a high proportion of assets managed by life insurance companies. Equities continue to dominate as the preferred medium for investment.

The following table summarises the number of companies and the assets under management for each of the markets under review in fund management (pension and non-pension), life insurance and hedge funds.

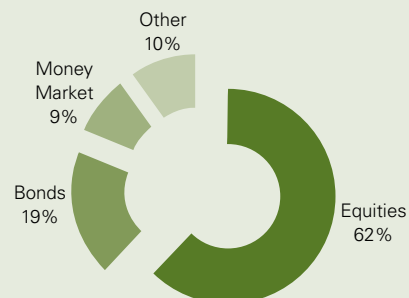
Country	Number of Companies, 2007			Assets Under Management (US\$b), 2007			
	Fund Managers	Life Insurance	Hedge Funds	Fund Managers	Life Insurance	Hedge Funds	Pension
Australia	175	34	66	763	236	31	900
China	58	46	-	477	284	-	92
Hong Kong	280	61	118	791	23	20	62
India	33	13	14	122	150	3	59
Japan	129	38	270	679	1,800	22	809
Korea	50	22	-	286	280	-	46
Singapore	109	11	190	581	66	6	94
Taiwan	50	10	-	111	15	-	4

Sources: Matrix, CIA, APRA, AMFI, CSRC, CRIC, IRAsia, SFC Hong Kong and Taiwan, FSS South Korea, MAS, FSA Japan

Assets Under Management (USD bn), 2007



Asian Assets by Investment Type



2. Demographic trends: A market of vast potential



Asia Pacific accounts for more than 60 percent of the world's 6.5 billion population, but remains underdeveloped in terms of penetration of investment management services.

This is set to change, however, as the pressures created by ageing populations, along with the growth in middle class income and wealth, are helping to drive pension and market reforms in many parts of the region.

The greying of Asia Pacific

Many regions around the world are responding to the challenges of an ageing or greying population and Asia Pacific is no exception to that trend. In many countries, the issue is exacerbated by falling birth rates. Japan and Korea are both expected to see a fall in their populations between 2005 and 2015.¹ In the case of China, the falling birth rate has been engineered with the imposition of the 'one child'

policy, while in other countries it is a product of increased affluence and urbanisation.

The following chart details the growth in the percentage of people over 65 years of age in six Asian countries where the statistics were readily available. It clearly illustrates the demographic position confronting some of these large economies. In

¹ www.global-dem.com

most countries, the percentage of people aged over 65 will make up a significant proportion of the total population by 2025. Asia Pacific, unlike other regions, is dealing with this issue in the space of one generation, in other words over a period of 25 years. The speed at which this demographic shift is occurring is underpinning the pension and market reform agenda in many jurisdictions in the region.

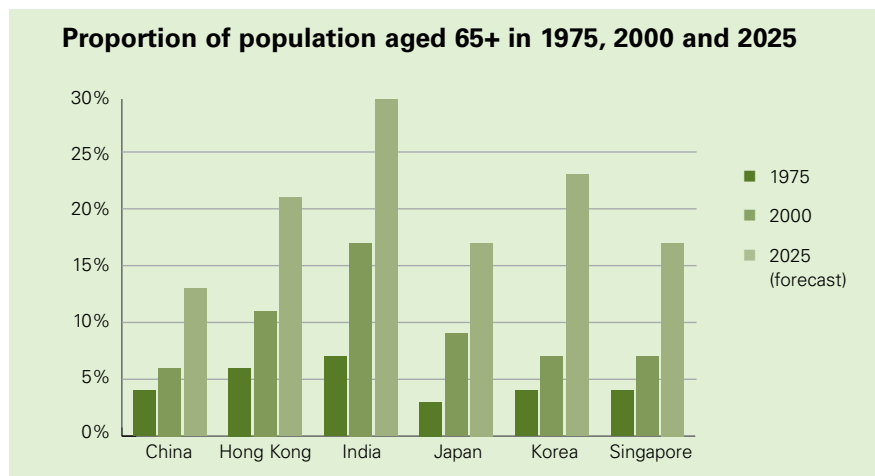
With a diminishing workforce paying into the pension coffers, 'pay-as-you-go' state social security programmes cannot be relied upon indefinitely as the primary provider of pension benefits. The importance of this trend, in the context of the development of the investment management industry within Asia Pacific, is that the deteriorating demographic position around the region is spurring governmental programmes of pension reform and market liberalisation. This creates, and should continue to create, new pools of capital for the industry to manage.

Growing wealth

The ongoing process of urbanisation in Asia Pacific is supporting explosive growth in the affluent middle class. The key issue for the investment management industry will be how much of this new wealth can be translated into actively managed assets under management and not just left idle in bank accounts or invested directly by the individual.

Since the 1970s, East Asia (comprising Greater China and Korea) has experienced the largest proportional increases in wealth of any region in the world, averaging growth in gross domestic product (GDP) of 8 percent per annum.²

As a measure, urban population levels are seen as a good proxy for the growth of middle class populations. The



Sources: UN Population Department, US Bureau of Census.

biggest absolute wealth increase has been in China, where it is expected that at least 200 million more people will move into urban areas in the next 10 years.³ If India achieves similar levels of urbanisation then it would mean even larger numbers migrating from the countryside.

The growth in wealth is of course not only limited to the middle class but is also evident in the high net worth individual (HNWI) segment. In a recent report on Asia Pacific wealth, Merrill Lynch estimated that the region's HNWI population - defined as those with more than USD 1 million of investable income - grew to 2.6 million in 2006, an increase of 8.6 percent on 2005.⁴

On this basis, Asia Pacific accounts for 27.1 percent of the global HNWI population. The wealth of Asia Pacific HNWIs totaled USD 8.4 trillion in 2006, an increase of 10.5 percent over 2005. Asia Pacific is home to five of the 10 fastest growing markets for HNWIs, namely Hong Kong, India, Indonesia, Singapore and South Korea.

This strong growth in wealth has been driven by high levels of GDP growth, strong stock market performance around the region and in many areas a strong savings ethos. China, Singapore and Hong Kong all have domestic savings rates in excess of 40 percent,

according to the Merrill Lynch report.

Much of the wealth in Asia Pacific is held in unstructured or unmanaged assets such as shares, real-estate and particularly bank deposits. Bank deposits in Asia Pacific are estimated to be at least USD 12 trillion, with bank deposits in China alone exceeding USD 2.5 trillion.⁵ This provides some illustration of the scale of opportunity facing the investment management industry, as it seeks to expand the relatively small amounts of wealth currently being held in managed products such as mutual funds, unit trusts and life insurance.

Therefore, while growth in the investment management industry will be determined by growth in the overall levels of wealth, there are other factors that will determine how much of this unstructured pool of savings can be drawn into, and retained within, the investment management universe. Product innovation and more effective strategies covering sales, marketing and service, and increased investor education are all needed to facilitate this development.

² www.worldmapper.org

³ United Nations Population Division (UNPD)

⁴ Merrill Lynch and Cap Gemini second annual Asia Pacific wealth report, October 2007.

⁵ InvestAsia and China Banking Regulatory Commission



3. Regulatory developments: A kick-start for the industry

Changing regulations and new market structures are being put in place around the region to stimulate more orderly involvement in capital markets.

Pension reforms

Reforms to pension systems have been occurring throughout the region, driven by the demographic and economic trends mentioned earlier in this report. While there are some variances, there

is also a great deal of commonality in terms of what is taking place and its potential to drive broader development of the investment management industry.

Around the region, savings schemes are being implemented to move the burden of pension provision from the state to the individual. Many of these emerging savings schemes are

mandatory, with defined contribution structures generally preferred to defined benefit structures such as the Central Provident Fund in Singapore, the Mandatory Provident Fund schemes in Hong Kong and the New Pension System in India.

While there are exceptions, private institutions are typically used to manage the invested assets. The

development of a strong domestic fund management industry has been supported by many governments in the region as they seek to establish orderly, liquid domestic capital markets. A robust and sophisticated buy-side is an integral part of capital market development.

The table below provides a summary of the key characteristics of the various pension schemes operating in Asia Pacific, as well as the total assets under management for each scheme.

The oldest and most successful of the mandatory savings programmes in the region is Australia's Superannuation Scheme, which was established in 1992. The scheme obliges employers to make contributions to the employee's designated superannuation fund at least once every three months. These superannuation contributions are invested over the period of the employee's working life and the sum of the compulsory and voluntary contributions, plus earnings, less taxes and fees, is paid out to the person upon retirement, generally as a lump sum payment.

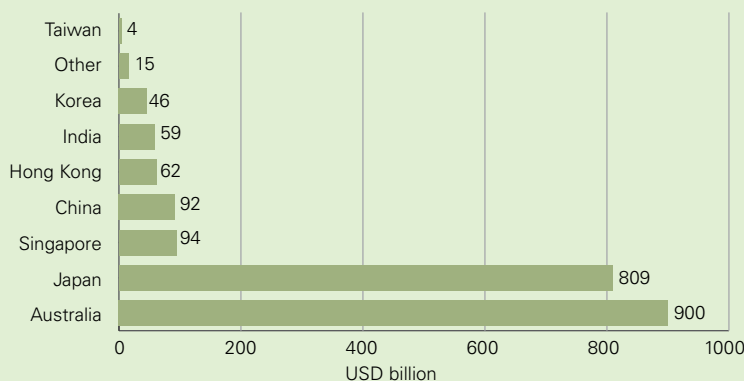
Today, Australian workers have over AUD 1 trillion (USD 900 billion) in superannuation assets.⁶ As a result, they now have more money invested in managed funds per capita than any other economy in the world. Compulsory superannuation, combined with buoyant economic growth, has helped Australia develop a strong shareholder culture, where most workers are now indirect investors in the stock market. Consequently, a lively personal investment marketplace and a significant domestic fund industry have developed.

The Australian experience proves that a greying population is not an insurmountable challenge and that substantial assets can be accumulated in a relatively short space of time, provided the scheme is compulsory.

Other markets in Asia Pacific are following suit in raising levels of investor education, creating stronger and more transparent domestic fund management companies.

The issue in Asia Pacific, however, is not always one of design, but rather the level or extent of funding. For example:

Relative size of pension assets, 2007



⁶ Australian Prudential Regulatory Authority (APRA)

	Public Social Security	Private Pensions			Assets Under Management
		Mandatory	Voluntary	Scheme Name	
Australia	Yes	Yes		Superannuation	USD 900 bn
China	Yes		Yes	Enterprise Annuity	USD 92 bn
Hong Kong		Yes		Mandatory Provident Fund	USD 62 bn
India		Yes	Yes	New Corporate Scheme	USD 59 bn
Japan	Yes		Yes	New Corporate Pension System	USD 809 bn
Korea	Yes		Yes	New Corporate Pension System	USD 46 bn
Singapore		Yes		Central Provident Fund	USD 94 bn
Taiwan	Yes	Planned	Yes	New Labour Pension Scheme	USD 4 bn

Sources: Matrix, Allianz Dresdner Economic Research and Individual Country Regulators

- The Chinese pension system is well designed and has three distinct elements, or pillars, which are in line with the World Bank's recommendations. The first public pillar consists of a state-sponsored pay-as-you-go scheme and funded individual accounts. The second pillar is a voluntary occupational pension in the form of enterprise annuities and the third pillar is based on the voluntary use of private savings.
- Hong Kong's mandatory defined contribution scheme, called the Mandatory Provident Fund (MPF), was introduced in 2000. In addition, there are also legacy voluntary occupational schemes and a small social safety net for the elderly. The MPF system may be fully funded, but the levels of mandatory funding are also relatively modest when compared against the territory's increasingly high costs of living.
- India's pension system is fragmented, with a very limited social security net for the elderly, although there is a well developed defined benefits pension system for civil servants. Employees in the organised private sector are covered by mandatory plans operated by the Employees Provident Fund Organisation.

As a first step, the introduction of mandatory schemes has been viewed as a success, but they need to go further. South Korea enacted legislation to unify its corporate pension system in 2005. It has two basic distinctive plans, funded and unfunded. Prior to the legislation, there were three sub-plans under the funded plan: 'Retirement Pension', 'Retirement Insurance' and 'Retirement Trust'. However, the legislation outlawed the use of 'Retirement Insurance' and 'Retirement Trust' so that the 'Retirement Pension' plan will be the only option for the funded corporate pension system



when the legislation becomes fully effective in 2011. The current unfunded plan is not affected by the legislation. Tax-favourable private pensions are also available and still represent a significant portion of the assets under management in South Korea.

The Japanese system has undergone a series of reforms in recent years. Automatic changes to benefits were introduced to allow for greater flexibility and new corporate pension plans were introduced. The current system consists of the flat rate National Pension System and employment-related pensions for public and private employees. Voluntary private pensions take a wide variety of forms.

The following table provides an overview of the current pension scheme environments of six key

investment management markets within Asia Pacific. The final column in the table shows Matrix's estimate of how large the individual country pension assets under management are likely to grow to by 2015.

Market liberalisation

Another regulatory development has been the opening up of previously closed financial markets to foreign capital and institutions. This has been a positive development for economies and for the Asia Pacific investment management industry in particular, as it has:

- created new opportunities for both Asian and international companies
- facilitated the exchange of ideas, knowledge and know-how across the region

Forecast growth in assets under management			
	AUM, 2007 (USD bn)	Forecast AUM in 2015 (USD bn)	Compound growth rate
China	USD 92	USD 640	27.4%
Hong Kong	USD 62	USD 140	10.7%
India	USD 59	USD 230	18.5%
Japan	USD 809	USD 890	1.2%
Korea	USD 46	USD 290	25.9%
Singapore	USD 94	USD 150	6.0%
Taiwan	USD 4	USD 56	39.1%

Sources: Allianz Dresdner Economic Research, Matrix Services Ltd.

- put direct competitive pressure on previously moribund state enterprises to improve their performance and effectiveness
- promoted the need for better transparency and corporate governance
- created new pools of (international) capital
- created more choice and greater opportunities for diversification for the end consumer.

There is another trend that is less universally evident around the region but nevertheless highly significant. This is the drive to open up markets to foreign participation.

While it is difficult to generalise over the entire region, there is a consensus building across many parts of Asia Pacific that a controlled opening up of markets to foreign participation should be welcomed.

Competitive liberalisation, where jurisdictions compete for foreign investment with tax and regulatory incentives, has been particularly evident across East and Southeast Asia. The ongoing competition between Hong Kong and Singapore as regional financial centres in fund management, hedge funds and private wealth management is the most directly relevant example of this phenomenon.⁷

Many regulators are understandably concerned about speculators undermining their currencies or capital flight hitting key strategic industries, but this concern merely adds to the drive for pension and market reform.

There is, however, a crucial difference between the process of liberalisation now and the market liberalisation which was evident prior to the Asian financial crisis of the late twentieth century. Regulators are increasingly motivated

China's Qualified Foreign Institutional Investment scheme

When UBS purchased local currency domestic shares in four listed Chinese companies on 9 July 2003, it marked a significant new phase in China's path towards opening its financial markets to the outside world – the Qualified Foreign Institutional Investor (QFII) scheme had commenced. QFII refers to the process of licensing international financial institutions and allowing them to invest in the domestic Chinese markets.

QFII has widened the opportunities available to foreign investors. The rules allow for foreign investor participation in the following areas:

- direct trading in the "A" share market
- buying and selling treasuries, convertible bonds and enterprise bonds listed on China's stock exchanges in Shanghai and Shenzhen (but not via the inter-bank market)
- investing in both closed and open ended funds
- participating in IPOs.

However, in line with the patchy nature of the reform process referred to above, the QFII scheme remains tightly controlled. Investors need to apply for licences (some 40 institutions are licensed) and most importantly the investors can only invest a limited amount of funds set by a strict quota.

As a result, QFII forms a small portion of the total assets under management in the China investment funds industry. The total quota amount granted under QFII has been USD 10 billion (or less than 2 percent of the total). However it is our contention that QFII has had a disproportionately large (and positive) impact on China's capital markets. The following is a summary of how QFII has had an impact:

- **Creation of stocks that are seen as a barometer of market sentiment:** Companies with a large QFII investor base and to varying degrees 'bell weather' status. In particular domestic unregulated funds and individual mainland investors who do not have their own research capabilities see the QFII as market movers and hence closely track foreign investments.
- **Development of research and market valuation tools:** QFII market participants have made good quality research and valuations a central pillar of their research approach.
- **Stabilising influence:** QFIIs have turned out to be less speculative than other institutional investors in China. They tend to keep stocks for longer periods and their investment style is relatively stable.
- **Support for mutual investment funds:** China's mutual funds are favourable investment channels for QFIIs, and the QFII investment in turn will help mainland fund managers to attract more domestic investors.

Source: *A Capital Guide to China's Investment Management Industry*, written by Robert Agnew and published by ISI Publications, 2008

⁷ For more on competitive liberalisation, see Asia Pacific Financial Deregulation, by Gordon De Brouwer, Wisarn Pupphavesa, 1999

to take liberalisation steps because of their stated aim of attracting long-term, quality foreign investors while at the same time keeping speculators safely at arm's length.

The result, in some parts of Asia Pacific, has been a somewhat cautious, 'two-steps-forward-one-step-back' reform process. For example, the introduction of qualified foreign institutional investors or QFIIs in both India and China is characterised by clear licence application procedures, high entry requirement levels and predetermined quotas on the amount that can be invested.

Liberalisation is not a universal process across Asia Pacific. Many markets are characterised by currency controls, obligations for foreign firms to form joint ventures and areas of regulatory overlap. Others, such as Hong Kong, are considered among the freest in the world.⁸

KPMG's report *State of the Investment Management Industry in Europe*, published in July 2007, spotlights the role of European regulations, specifically the Markets in Financial Instruments Directive (MiFID) and the Capital Requirements Directive (CRD), in investment firms' decision making processes. MiFID requires firms to demonstrate an effective control environment is in place that takes into account the nature, scale and complexity of the business.

There is a key point to be made about MiFID and other European regulations, from the perspective of this report. Essentially in Europe there is a supra-national body (the European Commission) which is pushing pan-continental regulations driving standardisation across the continent. There is no equivalent in Asia Pacific and little evidence of coordination between the regulators in other areas, with the one exception being the coordination of anti-money laundering initiatives.



However, there are a number of non-regulatory practices which are beginning to have an impact in driving common standards and practices across the Asia Pacific region. The Chartered Financial Analyst (CFA) designation is now a global *de facto* industry qualification and is being pursued by investment managers widely throughout Asia Pacific.

Global Investment Performance Standards (GIPS) have also been widely adopted as a set of industry-wide ethical principles, providing investment firms with guidance on how to calculate and report their investment results to prospective clients.⁹ Much like the CFA designation, the GIPS approach has been enthusiastically adopted in the United States, however there has only been limited traction so far in Asia Pacific.

Nevertheless, when issues of language and culture are added to the mix, it is clear that many factors are reinforcing the disjointed and fragmented nature of the Asian marketplace. The result is that it has been difficult for investment management companies to develop a truly pan-Asia strategy. A more common approach has been to identify key markets and to develop a series of individual, and often relatively separate country level plans.

One of the direct consequences of the opening up of Asian stock markets to foreign investment is the growth in cross border institutional funds flow. This is one of the key trends identified in the KPMG report, *The State of the Investment Management and Funds Industry*, published in the US in 2007. Opportunities exist for institutional funds to invest more easily in the region than they could previously. The report discusses how a variety of North American institutional investors wish to globalise their holdings in response to poor performance in their home market and a desire to manage risk with international diversification. In particular, the report observed that many US institutions were aggressively pursuing higher returns through an emerging market strategy that included a focus on Asia Pacific.

⁸ Hong Kong has been ranked as the world's freest economy by the Heritage Foundation and The Wall Street Journal for the 13th consecutive year in the 2007 Index of Economic Freedom.

⁹ www.gipsstandards.org

4. Polarisation in the market: Room for growth at the extremes



Though the investment management industry in Asia Pacific may have seen less merger and acquisition activity than elsewhere, it has become apparent that the industry is going through a process of polarisation. By this we mean that investment managers, who are responsible for the 'manufacturing' element of the industry, are moving towards two distinct and quite opposite approaches.

The first approach is the 'bulge bracket' players who are focused on beta and gain their competitive advantage through economies of scale. While they may seek to develop new products and diversify into new investment strategies that are outside their normal sphere of expertise, the driving aim remains growth of their assets under management. Size is the name of

the game for these players and more often than not they trade on a strong brand.

By contrast, there are smaller specialist or boutique managers who are more focused on alpha returns. While they are also concerned about their absolute assets under management, they are also intent on charging higher fees (and very often a split of the profits or performance fee, often referred to as 'carried interest' or 'carry') for specialist investment advice. These companies trade on the name and expertise of specific successful managers, but are relatively light in their back office with many of these functions outsourced.

The process of polarisation has many implications for the investment management industry and related segments, including:

- the introduction of new business models, such as the funds 'supermarket' concept, into Asia Pacific
- pressure on mid-market players to adapt, as they have neither the economic muscle of the bulge bracket firms nor the innovation and specialist knowledge of the alternative companies

- support functions, such as administration and custody, have had to review their own strategies. The support and technology requirements of the two poles of the market are quite different. This has led, for example, to the advent of bureau services for the alternative, specialist providers and to some consolidation in the administration market
- bulge bracket players engaging the services of the specialist managers as they adopt a fund of funds approach.

The message for investment managers, it would seem, is to avoid getting "stuck in the middle," lacking neither the scale to compete with the bulge bracket players nor the ability to rapidly innovate and achieve superior returns.

Hedge funds

The specialist or alternative pole of our spectrum would include managers in asset classes such as private equity, infrastructure, real estate and other structured products. However, it is in the hedge funds segment where the industry has seen explosive growth.

The number of hedge funds in Asia

Pacific has increased substantially in recent years. The specialist hedge fund consulting firm GFIA, using data from Asiahedge and EurekaHedge, estimated in 2007 there were 900 dedicated Asia Pacific hedge funds with USD 200 billion of assets under management, representing an annual growth rate of 25 percent. They further estimated that the number of Asian hedge funds is likely to exceed 1,000 in 2008.

These numbers suggest that Asia now accounts for slightly more than 10 percent of total assets under management in the global hedge fund industry. Therefore, while the region is growing in importance it still punches beneath its weight on the world stage.

At present, the Asian hedge funds market is characterised by the following:

- The market is now dominated by institutional investors and the global allocators are becoming increasingly important. This has meant that Asia Pacific hedge funds have had to adapt their marketing offerings, market communication strategies, client reporting procedures and internal systems (such as risk management) to a predominately institutional client base.
- The individual hedge funds themselves are getting bigger and have larger asset bases. GFIA has estimated that more than 60 percent of Asian hedge funds have more than USD 50 million of assets under management. This is up from 40 percent in 2003.
- More global funds are establishing a physical presence in Asia, because of the increasing need to be on the ground to identify opportunities. In particular, Hong Kong and Singapore offer a well developed regulatory environment, advantageous tax arrangements and relatively low barriers to entry.

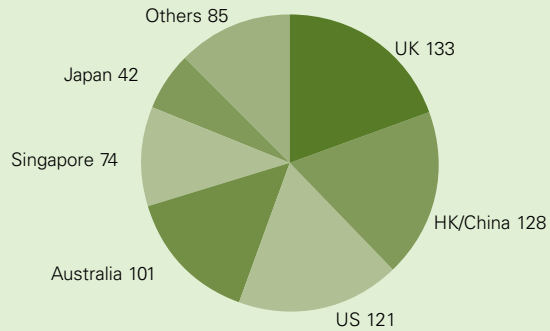


However, there remains a strong presence of funds focusing on Asia Pacific from locations outside the region (specifically in the United Kingdom and the United States) as is evident in the following chart.

Long-short equity investments continue to dominate in the region, with a majority of Asian hedge funds adopting it as a strategy. One fund manager commented that there simply are not sufficient people to develop more complex strategies, adding, "People find Asian equities have enough upside potential as it is, so there is limited interest in going into new product areas that they don't understand."

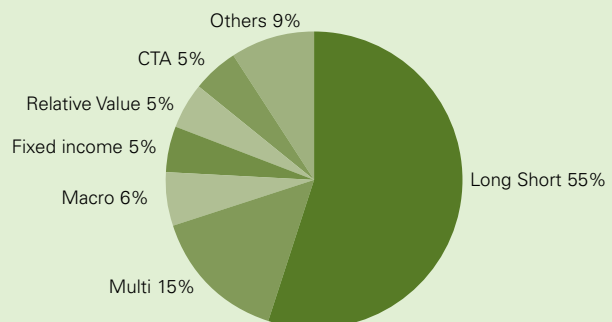
This fund manager believes that for most markets, including China, it may be too early to talk about the environment for alternative investments. "I believe a long-only approach will still beat alternative investment structures most of the time. The banks have made money on structured products through higher fees, but the level of complexity puts the client at a disadvantage."

Location of hedge fund decision making centres for funds with an Asian-focused strategy (September 2006)



Source: Eurekahedge and GFIA

Hedge fund strategies in Asia Pacific



Source: Eurekahedge and GFIA

5. Challenges ahead: The keys to success



The early months of 2008 have proved challenging for investment managers, as credit has tightened and many stock markets have sagged. The Asia Pacific region has not found itself immune to this phenomenon. Several governments have responded with specific measures, one example being China's temporary introduction of tax exemptions on mutual funds.

The longer term outlook for the investment management industry may still be favourable, but there are many other challenges and potential constraints to growth.

In September and October 2007, Matrix Services Ltd. surveyed 62 investment managers around the region on the biggest restrictions they are facing. Respondents were asked to grade,

from zero (unimportant) to five (very important), a list of factors that could constrain their future growth. The survey revealed that regulation is the most important consideration, while a lack of certain skilled staff, poor investor education and limited product distribution options were other significant issues facing the industry.

The following table is a summary of the top five constraining factors from similar surveys undertaken in 2003, 2005 and 2007.

While regulatory considerations have been the predominant concern for the last several years, attracting, training and retaining skilled local talent has steadily increased in importance.

Talent management

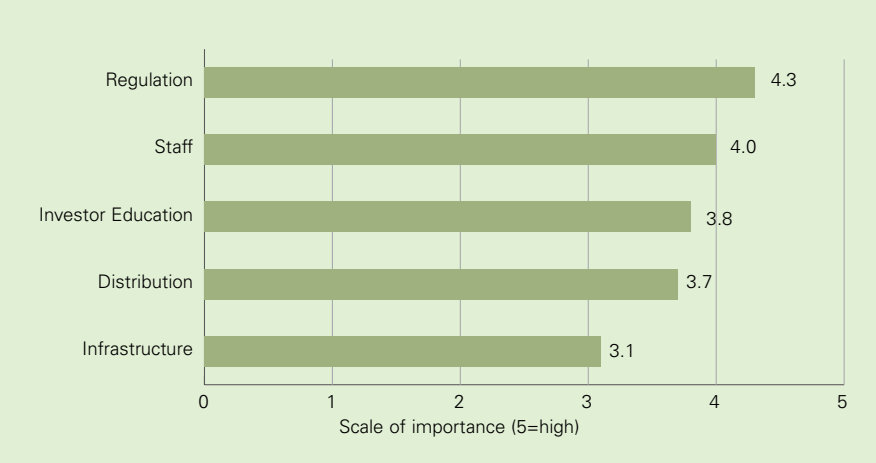
The 2007 survey suggested that staff turnover rates vary considerably across the region but are averaging between 10 and 20 percent in most countries and can be as high as 30 percent in some locations and for some specific positions.

Skills shortages are particularly acute in the following areas:

- mutual fund and life insurance sales people in China
- fixed income analysts
- private bankers in Singapore and Hong Kong
- mid and back office staff with good capital markets experience.



Market constraints



Source: Market constraints survey by Matrix Services Ltd., 2007

Changing importance of factors affecting investment management companies

	2003	2005	2007
First	Regulations	Regulations	Regulations
Second	Investor education	Investor education	Staff
Third	Distribution	Staff	Investor education
Fourth	Staff	Distribution	Distribution
Fifth	Bond Market	Competition	Infrastructure

There is a more general shortage of professionals with language skills and experience working in large institutional environments. As one executive in a large international fund management company put it, "Trying to find a good accountant with the right knowledge of the workings of the capital markets and the local language skills has been all but impossible."

This is having an impact on the ability of investment managers to grow their businesses around the region and there is anecdotal evidence to suggest that spiralling wages are having an effect on costs and hence profitability.

Finding and rewarding talent in the front office is a fundamental challenge for the smaller specialist companies. One respondent in a boutique investment house commented that "Demand for good alpha-focused managers will always outstrip supply.

The huge turnover of funds means there will always be new opportunities."

Investor education

Many markets around Asia Pacific are characterised by a general lack of understanding of product risk and a resistance to pay for "advice" on the part of the investing public. These expose significant problems for the industry as a whole.

This issue was highlighted last year in a KPMG report entitled *China's fund management joint ventures: The growing flow of wealth*, produced in conjunction with Reuters. Chinese investors make little distinction between their approach to fund investment and direct stock market investments. There is poor knowledge of the concept of buying and holding for the long term. Investors will sell poor performing products to mitigate losses as readily as well-performing

products to 'lock in' profits. As a result, the investor often disregards the underlying asset valuation, the fund's investment approach and the skill of the fund manager in favour of a short term need.

In 2007 Matrix interviewed six fund management and life insurance companies to describe the characteristics of a 'typical' retail investor. A summary of the common characteristics mentioned include:

- short time horizon
- price sensitive and a real resistance to paying for advice
- require a "hands on" approach and they value a "relationship"
- often family money being invested as a pool
- little understanding of structured products or of the role of institutional investors
- brand is important to them.

As a result, the Asian investor base needs additional resources to service their needs. In private banking for example an account manager in United States can handle up to 100 clients. In Asia the number is nearer 50.

Distribution

A successful investment funds industry is dependent on a robust distribution network. Ideally, the distribution network would have multiple channels to market including: independent financial advisors; brokers and agents; direct or employed sales forces; bancassurance and new technologies.

Limited distribution options are a significant issue facing Asia Pacific fund management companies in securing reliable channels to market. This lack of options is a particularly acute problem for smaller players. Improving distribution and building trust will be key factors in bringing the unstructured savings of Asia Pacific's middle classes

into managed investment products.

Bancassurance has rapidly become an important distribution channel for investment companies. As a result, overdependence on the bank channel is a significant issue facing the industry in many markets in the region. An error often made by new entrants is to look only to the size of a bank's branch network as the key indicator. However, relationships with larger banks are often more difficult to manage and these institutions will typically expect a larger slice of the fees, possibly a percentage of the management fee.



Distribution: The success of technology in Korea

The countries of Asia Pacific exhibit a range of levels of technical sophistication, which have implications for the development of products and distribution strategies. Korea has some of the most advanced IT infrastructure in the world and has been one of the first markets to see joint venture cooperation between telecoms companies, technology companies and financial institutions. In 2008, SK Telecom agreed to set up a joint venture with Citigroup to sell mobile banking and payment solutions across Asia and also in major American cities.

Mobile commerce in Korea is growing at a remarkably fast rate. Three Korean mobile firms - SK Telecom, KTF and LG Telecom have collaborated with banks to develop mobile commerce services. The number of mobile banking transactions in Korea increased from 140,000 per day in 2004 to 720,000 in 2007. Several major banks including KB, Woori, Shinhan, Hana and CKI (Citibank Korea) have been offering services which enable customers to view fund products and transfer money through a mobile device. Woori customers are even able to redeem their funds through the mobile banking system. It is estimated that 4 percent of the total number of financial transactions per day occur over mobile networks and these percentages are expected to grow dramatically.

As of December 2007, on a daily basis, approximately 60 percent of financial transactions in Korea were conducted over the internet. As Digital television (IP TV) gains in popularity, it will also help to expand the web and mobile banking population.

The implications for financial institutions are clear. An understanding of web and mobile based technologies will be important to compete effectively in banking and fund industries, especially when it comes to distribution channels. Further strategic alliances between telecoms companies and financial institutions are likely.

Independent financial advisors have a strong presence in Australia and India and with the expatriate markets in Hong Kong and Singapore, but are relatively less developed as a channel in most parts of Asia Pacific. One reason cited for this is the general reluctance of Asian investors to 'pay' for advice. The growth of this distribution segment could help in addressing the issue of investor education.

Because of the talent management issue discussed above, building a direct sales channel, either by employing a sales force or by building a tied agency/broker network, has become increasingly expensive in Asia Pacific.

When poor levels of investor understanding are combined with a weakly regulated intermediaries sector, the potential for mis-selling increases. The potential for mis-selling scandals to surface in Asia Pacific within the next few years cannot be discarded. Any such incident could have a short to medium-term impact on the flow of funds into the industry in that market.

Performance management

Though it did not appear as an issue in the 2007 research by Matrix, it has become increasingly obvious since the early months of 2008 that performance management will be a significant issue for the investment management industry.

Some non-Asian institutional investors will not have the appetite for the increased volatility of Asian equity markets and this could lead to some repatriation of funds out of the region. One hedge fund manager described this as the 'hot money' problem. However, this phenomena is likely to be more than offset by new money seeking better performance in

emerging markets. Therefore this may be more of an issue at the individual fund level but not disrupt the overall trend of increased international institutional fund flows.

Decreased liquidity due to the credit crunch and poor performance could lead to fund withdrawals or the closure

of some smaller funds. For many of the newer funds this is their first experience of a downturn. The 'churn rate' in some emerging markets, such as China and India, may well increase as retail investors cut their losses.

Available distribution channels				
	Independent Financial Advisors	Banks	Agents/ Brokers	Direct Sales
Australia	Yes	Yes		Yes
China		Yes	Yes	Yes
Hong Kong	Yes	Yes	Yes	
India	Yes	Yes		
Japan		Yes	Yes	
Korea		Yes	Yes	Yes
Singapore	Yes	Yes		

Reliance Mutual Fund: Local strength in an emerging market

Reliance Mutual Fund is one of India's leading mutual funds companies, with assets under management of USD 19.4 billion (as on January 2008) and a base of over 4.6 million investors.

Reliance may be an established name within India, but it is one that was traditionally associated with heavy industries and telecoms, rather than investment management. Established in 1995, Reliance Mutual Fund is now the largest fund of its kind in India according to assets under management and continues to grow rapidly thanks to consistently high returns on investment levels.

Reliance Mutual Fund is proof that a domestic Asian firm can build a brand and a significant presence, without foreign involvement. The fund is domestically-owned and only recently gained a foreign shareholder when US-based Eton Park took a 5 percent stake.

A critical factor in the growth of Reliance Mutual Fund has been the support of its parent company, the Anil Dhirubhai Ambani Group. The corporate group has been a large contributor to the debt portion of the fund. With the benefit of this additional scale the fund has been able to exert more bargaining power over distributors, thereby achieving competitive advantage through lower-than-average fees.

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Contact us

Australia

10 Shelley Street
Sydney NSW 2000
Australia

China

8th Floor, Tower E2
Oriental Plaza
1 East Chang An Avenue
Beijing 100738
China

Hong Kong SAR

8th Floor, Prince's Building
10 Chater Road
Central
Hong Kong

India

KPMG House
Kamala Mills Compound
448, Senapati Bapat Marg
Lower Parel
Mumbai 400 013
India

Indonesia

35th Floor WISMA GKBI
28, Jl. Jenderal Sudirman
Jakarta 10210
Indonesia

Japan

Marunouchi Trust Tower North
8-1 Marunouchi 1-chome
Chiyoda-ku
Tokyo 100-0005
Japan

Malaysia

Wisma KPMG
Jalan Dungun
Damansara Heights
50490 Kuala Lumpur
Malaysia

New Zealand

18 Viaduct Harbour Avenue
Auckland 1
New Zealand

Philippines

22nd Floor, Philamlife Tower
8767 Paseo de Roxas
Makati City 1226, Metro Manila
Philippines

Republic of Korea

10th Floor, Star Tower
737 Yeoksam Dong
KangNam-gu
Seoul 135-984
Republic of Korea

Singapore

16 Raffles Quay #22-00
Hong Leong Building
Singapore 048581
Singapore

Taiwan

68th Floor, Taipei 101 Tower
No.7, Sec. 5, Xinyi Road
Taipei 11049
Taiwan, R.O.C.

Thailand

48th Floor, Empire Tower
195 South Sathorn Road
Yannawa, Sathorn
Bangkok 10120
Thailand

Vietnam

10th Floor, Sun Wah Tower
115 Nguyen Hue
District 1
Ho Chi Minh City
Vietnam