Private Banking

China Reforms

January 2014

Overview

- Key points of the China's 3rd Plenum reforms
- Will President Xi succeed?
- Re-rating potential
- Will China's local government debt de-stabilise the macro?
- Reform winners and losers

China’s Third Plenum reforms are significant

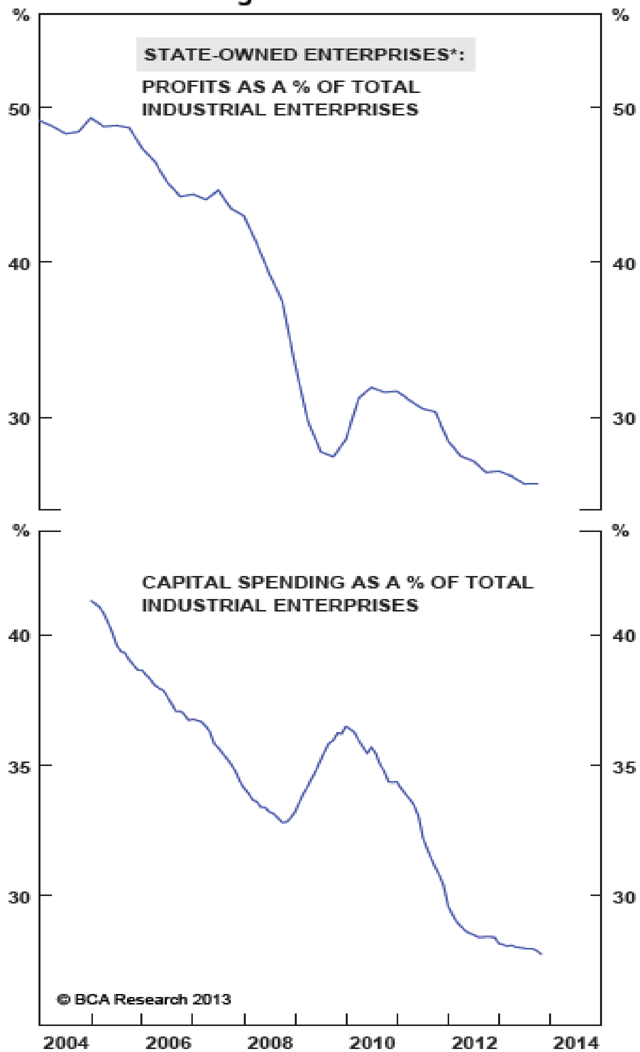
- The reform agenda is arguably the most ambitious blueprint in several decades, with 60 measures covering economic, political, social, cultural, and military reforms…

Economic reform
Set up market-based resource price system (e.g. utilities)
Promote “mixed ownership” of SOEs (crossholding)
Opening up to the private sectors
Increase SOE dividend pay-out to the gov’t to 30% by 2020
Set a fair, open and transparent market regulation system
Establish unified rural/urban land market
Support the Free Trade Zones
Strengthen protection of intellectual property
Impose property tax, luxury tax, close loopholes
Promote urbanization (relax the Hukou system)
Improve the natural resources assets property rights system
Reform environmental protection management system
Accelerate RMB convertibility & capital account opening
Accelerate the financial market reforms

Political reform
New standards to evaluation officials
Strengthen anti-corruption efforts
Improve government budget and taxation systems
Reform the judicial system
Social reform
Relax one child policy
Strengthen social security & healthcare system
Strengthen education and vocational training
Cultural reform
Improve the culture market system
Build a modern public cultural service system
Military reform
Deepen structural and organizational reform of the army
Promote civil-military integration

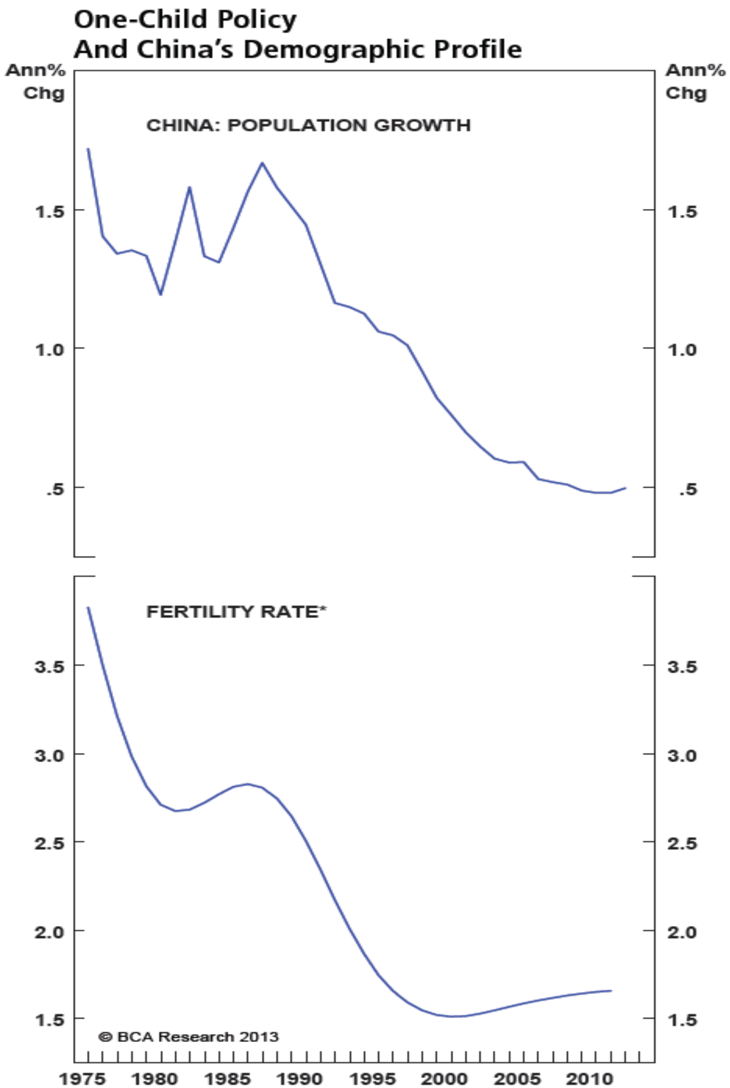
The changing role of the government

Further Reducing The Role Of The State Sector



- The gov't will promote a "mixed" ownership structure in SOEs (i.e. increase private ownership or a cross holding).
  => SOEs will pay more attention to improving **return on capital**
- SOEs will pay 30% of net profits to state coffers by 2020 (versus 10-15% currently) to fund social security and welfare
  => should improve **consumption**
- **Capital spending** projects should increase as the currently complex approval procedures will be eliminated
- **Financial reforms** include further interest rate liberalization, RMB internationalization and IPO, etc
- **Market-driven resource allocation** (e.g. utility prices)

Some other key reform measures



- The "**hukou**" system (household registration) will be relaxed in smaller cities.
  => Extend social welfare to rural migrant workers and promote **urbanization**
- The **"one-child" policy** will be relaxed, allowing families to have two children if one parent is an only child.
- **Fiscal reform** will reduce the mismatch of resources & responsibilities between the central government and local governments
- **Rural land reform** enables monetization of rural land => positive low-end consumer
- **Legal system reform** => crucial for the market-oriented economy

Will President Xi Jinping succeed?

- President Xi Jinping has quickly consolidated his power base in the party, government and military apparatuses. He is ready to push through his reform agenda.

- A central "leading team" will be set up to spearhead reform efforts. The team will report directly to the top leadership, rather than to the government.

- Recent reform developments
  - Anhui province has begun a pilot program on rural land reforms
  - China Securities Regulatory Commission (CSRC) announced a reform plan for IPOs (e.g. IPO resumption, preferred shares introduction, cash dividend promotion and backdoor listing)
  - Zhou Xiaochuan, Head of the PBoC pledged further flexibility in interest rates and exchange rates.

Implications for RMB & rates

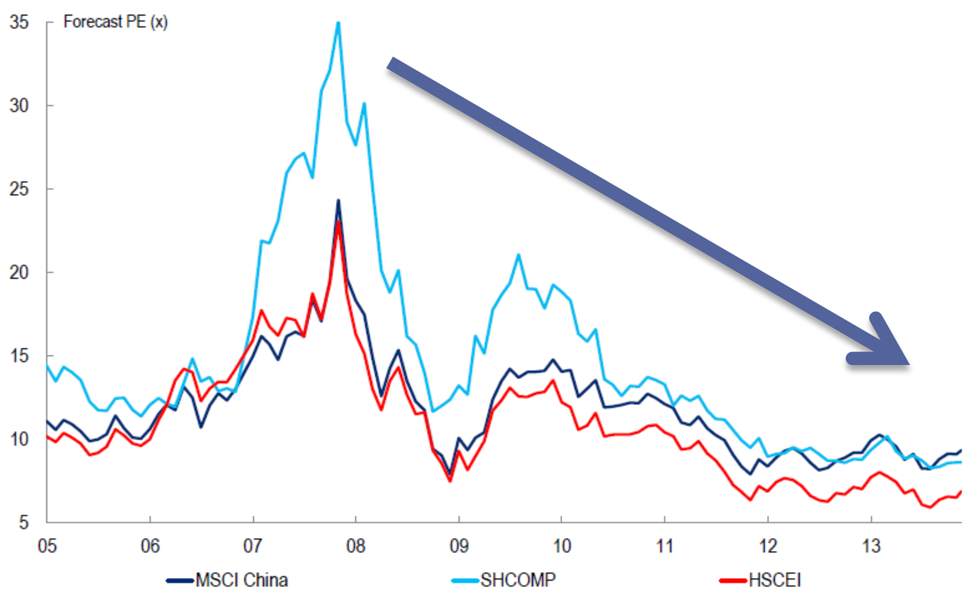
USD-CNY spot price

Source: Bloomberg

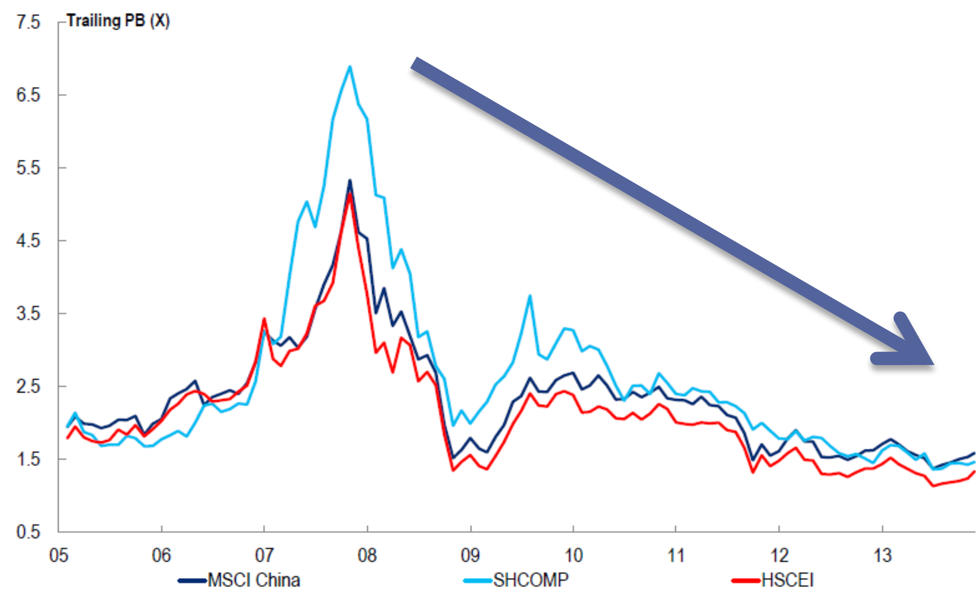
- With gradual capital account liberalization and interest rate de-regulation, **RMB** and Chinese **rates** are likely to become more closely tied to the market
  => **further RMB appreciation**

Valuations are deeply depressed

Forward PEs for China markets



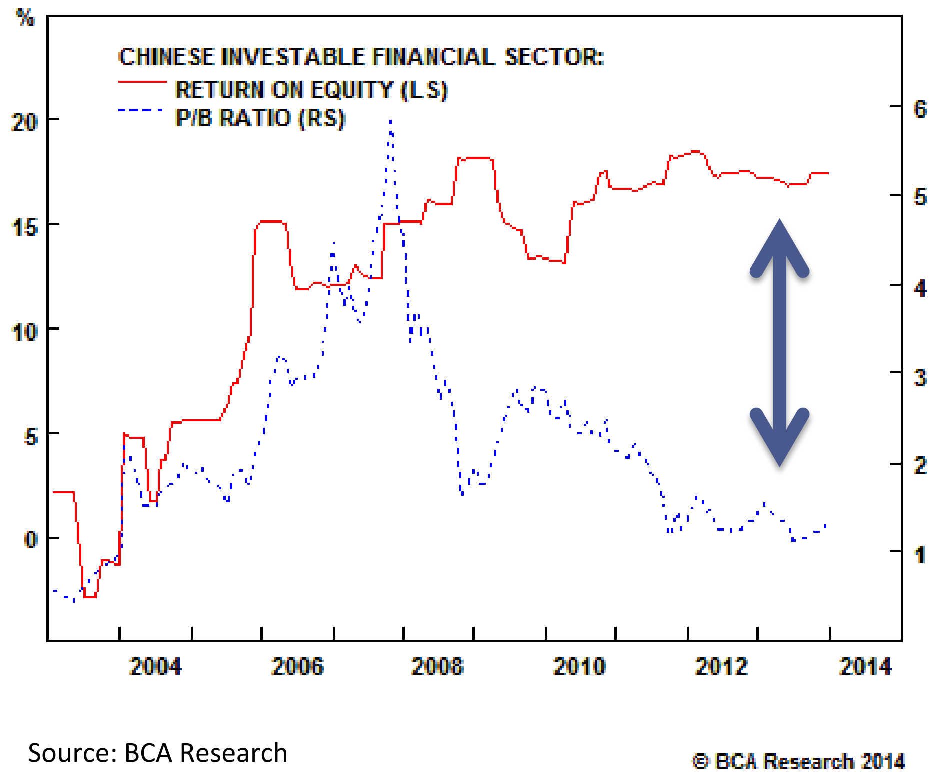
Trailing PBs for China markets



Source: Factset and Citi Research

- Concerns over Chinese growth have led to lower PEs and PBs
- Worries over NPLs in the banking sector and overcapacities in cyclical sectors

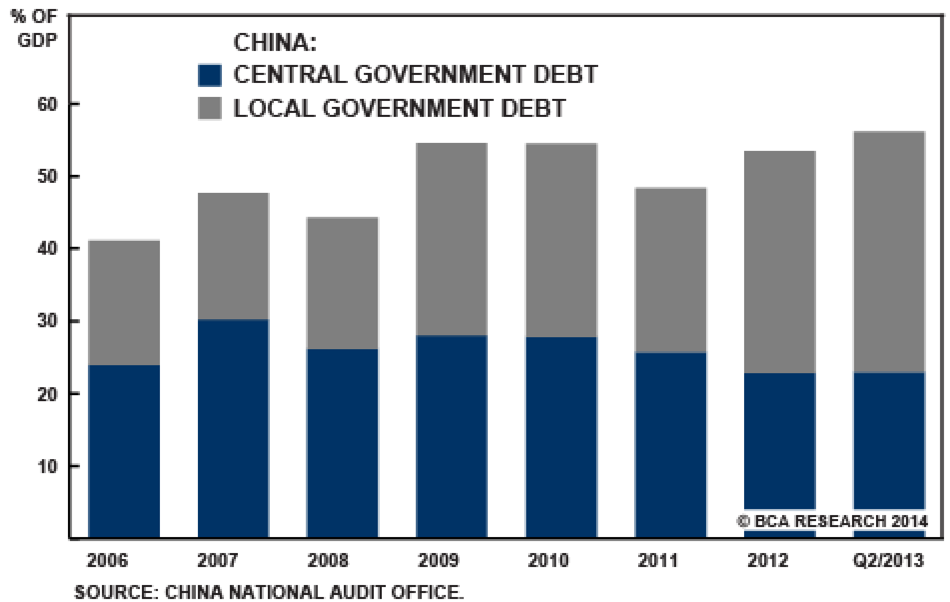
Chinese banks suffer the most



Source: BCA Research

- Concerns of a ‘debt bubble’ have undermined investor confidence on Chinese banks’ asset quality
- PB has declined sharply but ROE has stayed elevated => a lot of bad news is priced in

Will China's local government debt de-stabilise the macro?

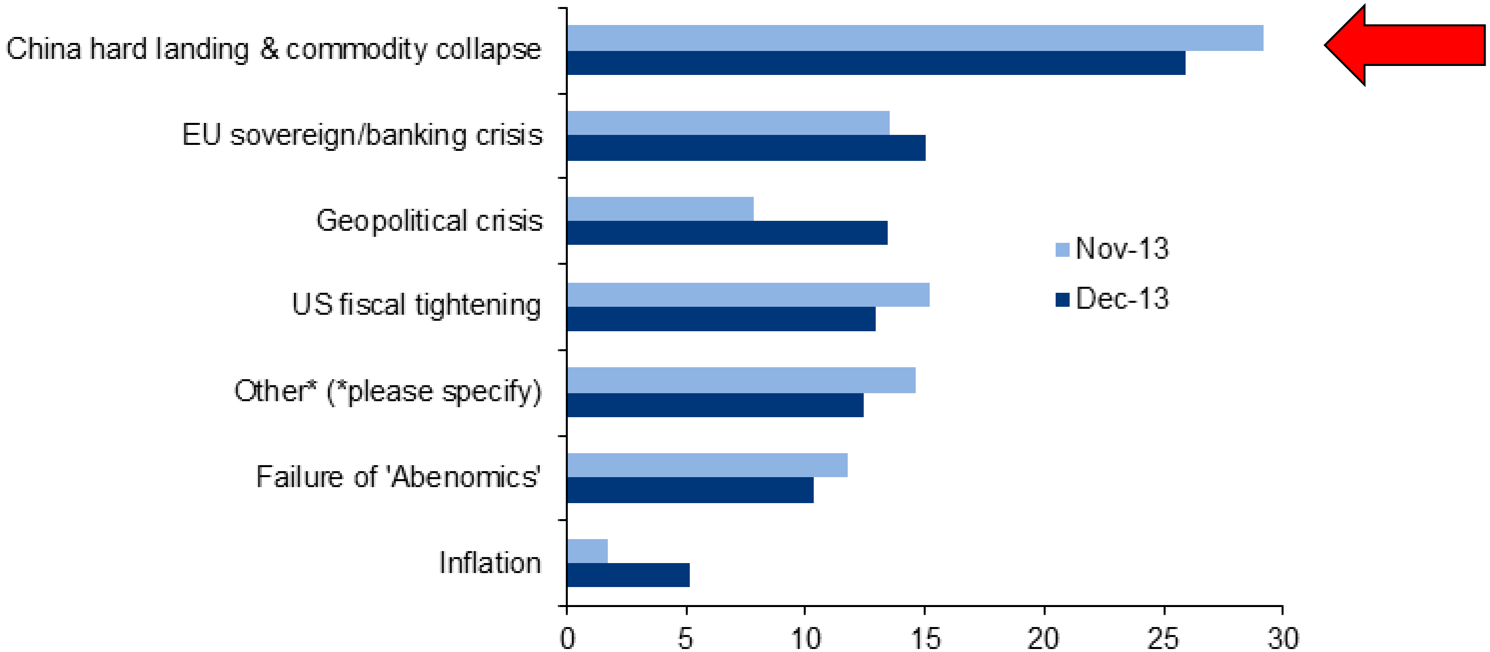


Source: BCA Research

- Chinese local gov't debt surged from RMB10.7trn at end-2010 to RMB17.9trn at Q2/2013. This has occurred in tandem with deleveraging at the central government level
- Overall, the total public sector debt increased from 47.7% of GDP to 56.2% between 2007 and mid-2013. The increase is rather mild compared to other major economies
- One should also consider China's high national savings rate (~50% of GDP)
- The build-up of local gov't debt is addressed through **financial and fiscal reforms**

Chinese stocks are out of favour

What do you consider the biggest 'tail risk' :



Source: BofAML Global Fund Manager Survey

- Investors remain most worried about a China hard landing & a collapse in commodity prices
- The latest reforms hold the promise of lifting the economy’s long-term potential. Plus stronger external demand => **re-rating potential**

Private companies > State-owned enterprises

MSCI China P Chip Index vs. MSCI China Index

Source: Bloomberg

- Policies are designed to favour the private sector and make the public sector more efficient
- In the long term, **private enterprises** should outperform SOEs.
- Most China equity indices are SOE-heavy. Recommend investing in **specific reform beneficiaries** rather than index-linked ETFs

Reform winners and losers

- Key beneficiaries
  - + **Brokers** (IPO reform/preferred shares, capital market reform)
  - + **Insurance** (social security reform, healthcare reform)
  - + **Healthcare** (social security reform, public hospital reform, and one-child policy easing)
  - + **Utilities** (tighter pollution control favors clean energy and environmental protection plays)
  - + **Railway construction** (high-speed rail lines opening, urbanization)
  - + **Mass market consumption** & **IT** (Hukou reform and one-child policy relaxation)

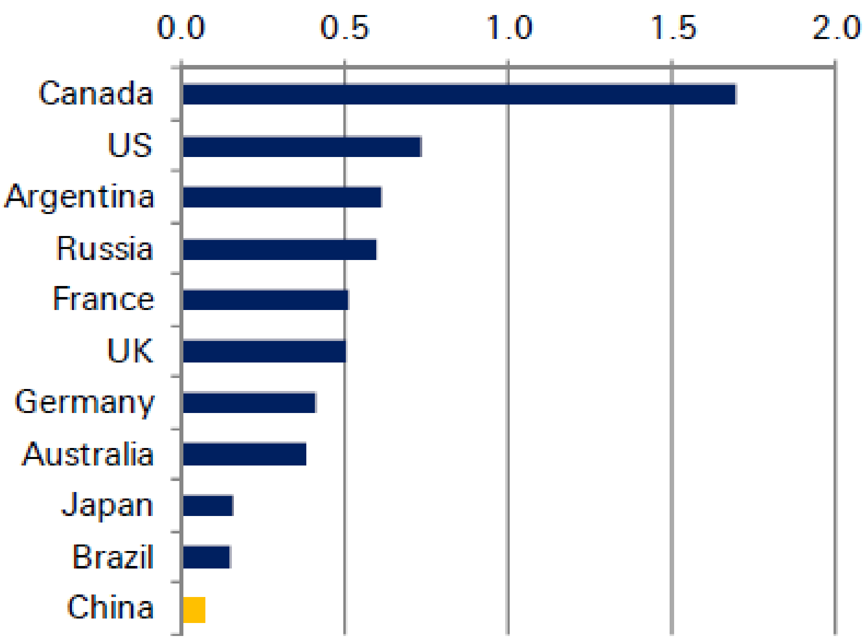
- Who will suffer?
  - – **Banks** (removal of entry barriers to banking, tightening regulations on interbank and WMP businesses, structural problems in asset quality and interest rate deregulation)
  - – **Materials** and **Coal** (tightening regulations on environmental protection, the levy of resource taxes and environmental compensation fees)
  - – **Real estate** (tightening policies launched by more than a dozen tier-1 and tier-2 cities)
  - – **Luxury spending** (anti-corruption)

China Reform Beneficiaries & Sector Strategy

Under-capacity/Under-investment

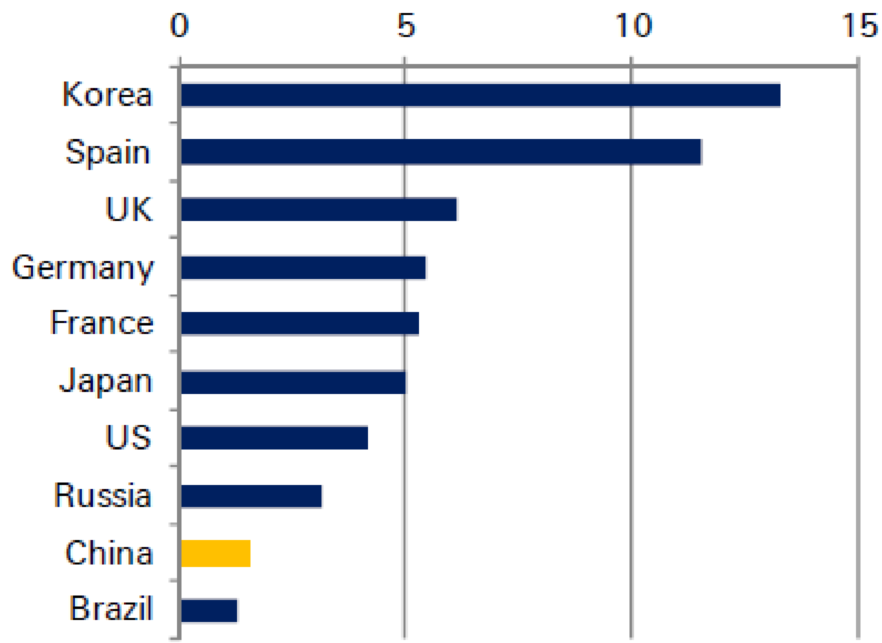
- Reform package will deregulate the economy in certain areas and permit private investment into many areas, including some that were historically dominated by SOEs.
- Some sectors are in shortage, and we expect these to see more sustained growth, including railway/subway, healthcare, clean energy.

Railway Density (km/1000 people, 2011/12)



Source: Deutsche Bank, WDI

Subway Density (km/mil people, 2012/13)

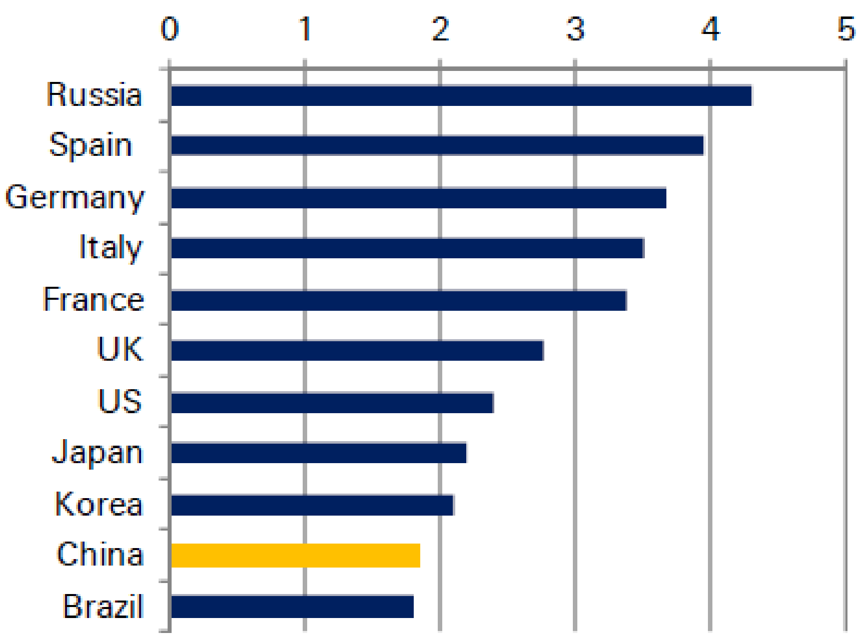


Source: Deutsche Bank, Urbanrai.com, company reports

Under-capacity/Under-investment

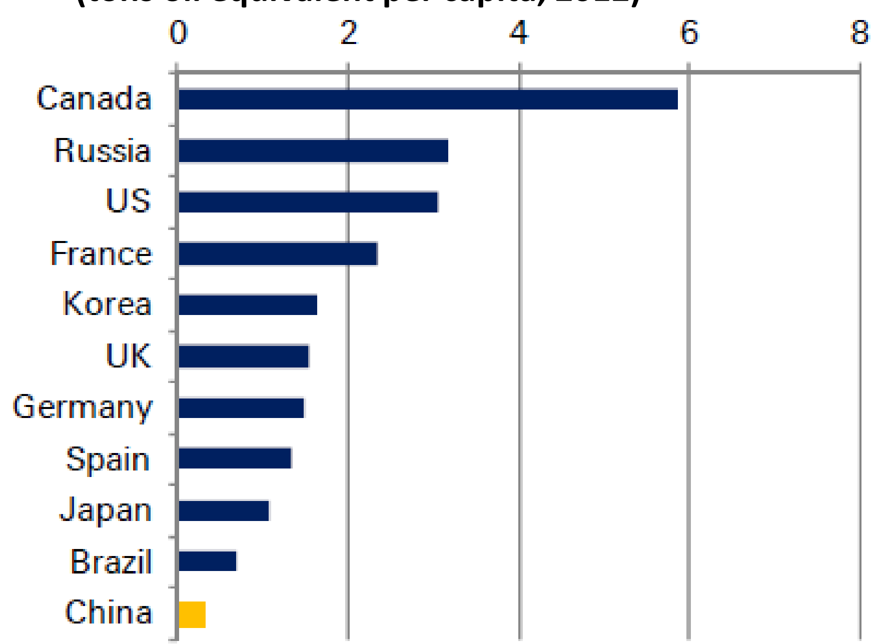
- Under-investment in part due to policies that favored SOEs, and penalized private capital.
- In Healthcare, the government is going to relax controls on market access.
  – One of largest pharmaceutical companies, Fosun, is planning to invest in 500 hospitals.
- For New Energy, likely subsidy increases are coming for gas fired power, solar, wind, and high-quality shale gas.

Physician Density (per 1000 people, 2010/11)



Source: Deutsche Bank, WDI

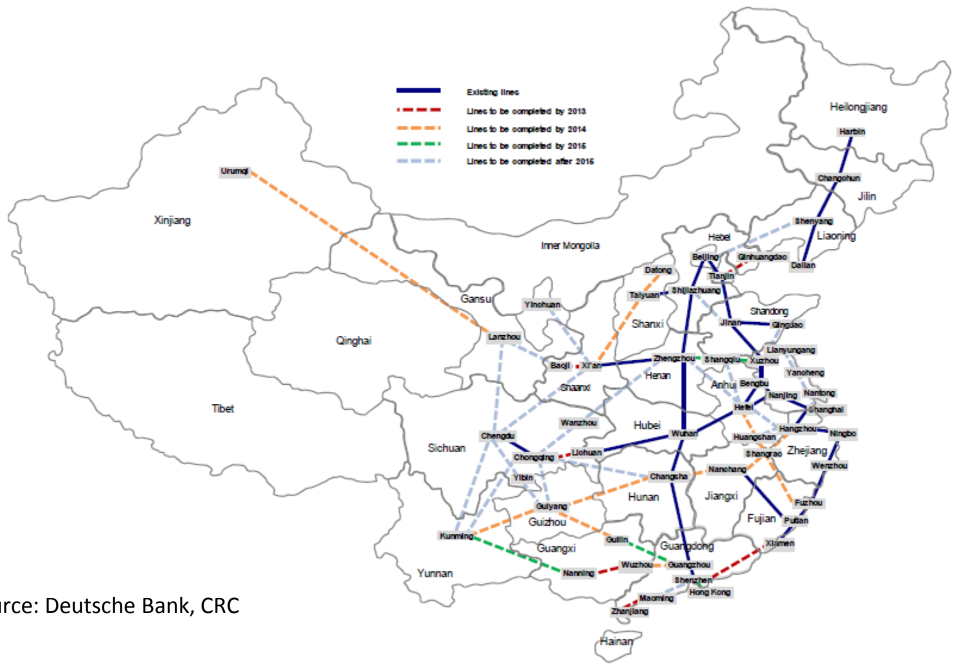
Clean Energy Consumption
(tons oil equivalent per capita, 2012)

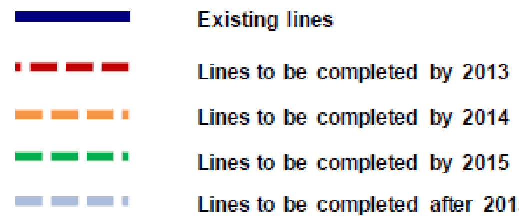


Source: BP Statistical Review of World Energy 2013, Deutsche Bank; Note: Clean energy include gas, wind, hydro, solar, nuclear and other renewable

Railway

Map on high-speed railway lines in China





- More than 10,000km of high-speed railway line will be launched in 2014-2015 (vs. +7,000km in 2011-2013)

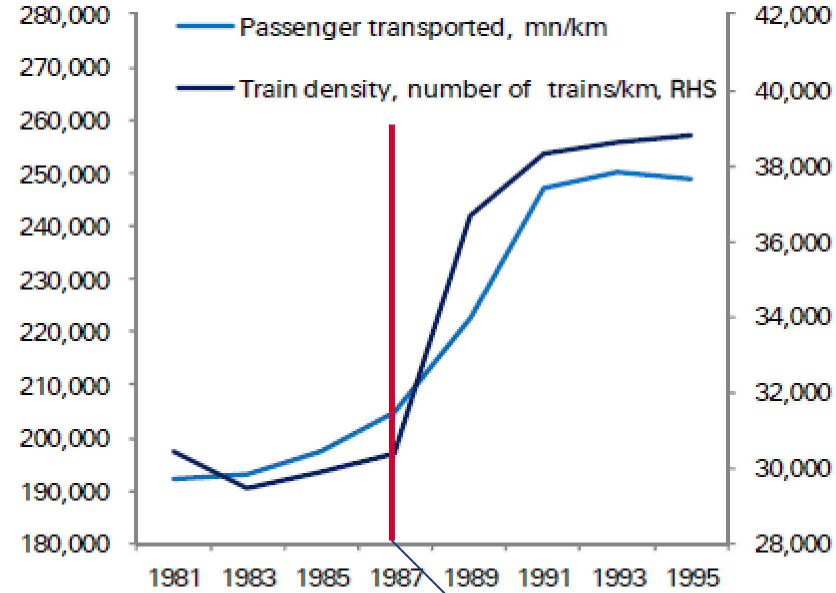
Source: Deutsche Bank, CRC

- Political interference, slow decision, heavy debt, lack of profit motivation due to SOE ownership, and low labor productivity were major reasons that drove railway reform. Recent “Plenum reform” and “383 plan” also imply government determination on progressing railway reform.
- To enhance efficiency, Ministry of Railway (MoR) just went thru restructuring. All administrative function has been consolidated to Ministry of Transport (MoT) and operational function is now executed by a newly established China Railway Corp (CRC). The purpose is to separate government functions from enterprise management and will result in a fast growing and more profitable sector.

Railway and Subway

- Japan Railway reform as a precedence for China.
  - In 1987 Japan split up and privatized the JNR.
  - Result was a huge jump in pax, increase in efficiency through higher train density on the network.
- For China, reforms should boost total investment in the sector.
  - Increase in government spending to build out.
  - Policy support for private investment in the sector.
    - Freight transportation tariffs too low, likely to see 20% increase in pricing, to improve efficiency and investment.

Impact of 1987 Reform/ Privatization of the JNR

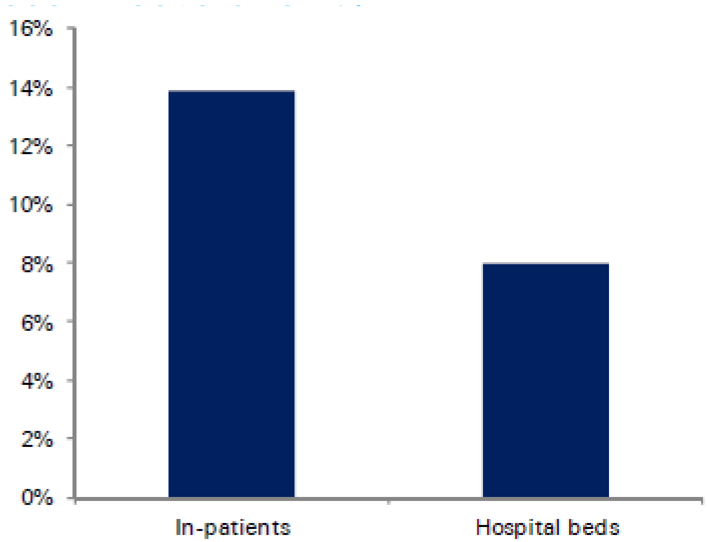


Source: International Union of Railways' (1997) statistics, Deutsche Bank

- Acceleration of subway development to reduce road traffic congestion and to support anti-pollution efforts.
- Railway equipment and construction companies should be the biggest beneficiaries as a result of potential freight tariff hike, rise in traffic volume, and stronger investment in the sector.

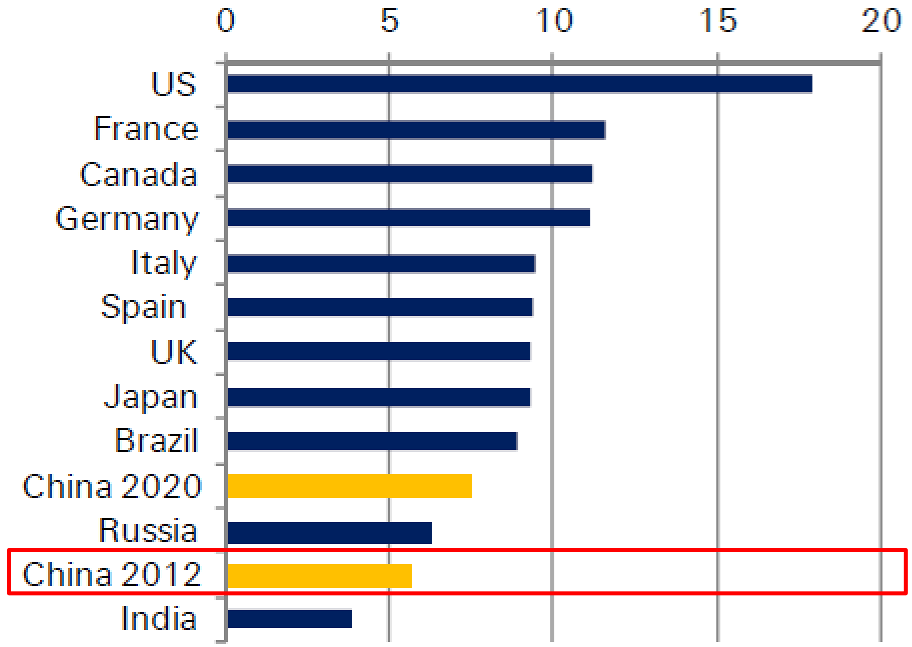
Healthcare

China: growth of in-patient visits vs. number of hospital beds



Source: Deutsche Bank, NBS

Global healthcare expenditure in 2012 (as % of GDP)

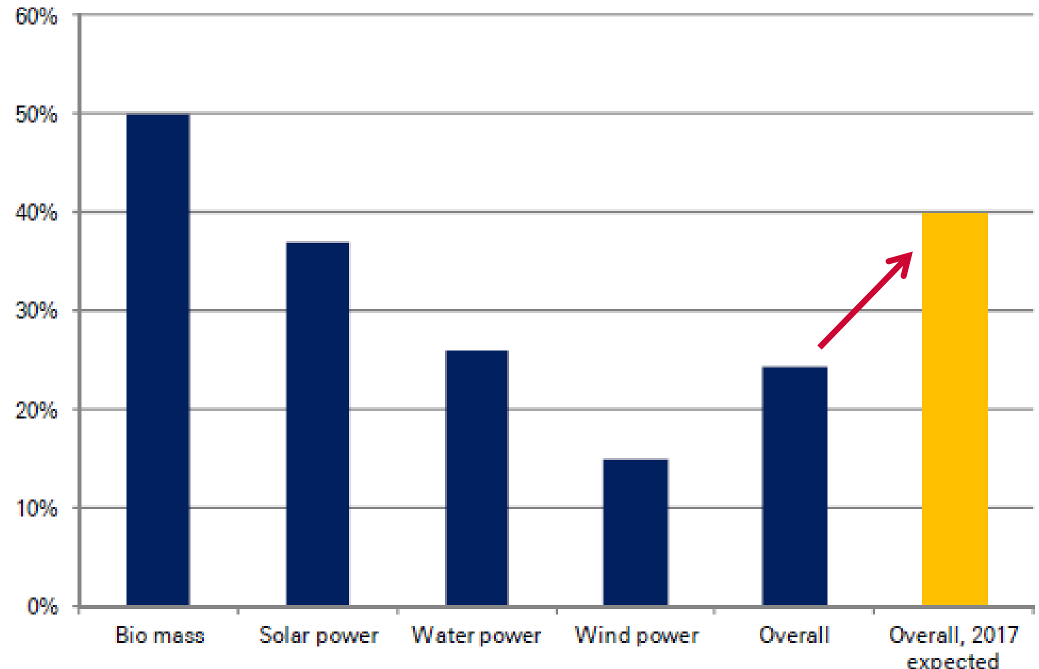


- Healthcare service providers' revenues and total expenditure in China increased 20% CAGR in 2008 - 2012. However, expenditure as % of GDP remains low. We believe China's healthcare sector still has significant growth potential due to:
  - Rapidly ageing population + supply growth not catching up with demand (as shown above)
  - Increasing disposable income
  - Increasing / Extending coverage of medical of insurance to private hospitals
- Expect more aggressive policies to be rolled out as the Decision at the 3rd Plenum laid an unprecedented emphasis on encouraging private capital to health sector.

New Energy / Environment

- Fact: Pollution is terrible in China.
- Through policy incentives, likely to see:
  - New and/or higher government subsidies for Gas, Wind, Solar, etc.
    - China at 0.2% of fiscal budget subsidizing new energy vs. 0.4% US, 0.7% Germany.
  - Deregulation of the national power grid, and oil sectors.
    - Likely break up of grid monopoly to level playing field, enabling private IPPs to have stable access to the grid to sell power.
  - Private sector only 24% of new energy generation. Expect rise to 40% over next 3-4 yrs, with removal of policy bias towards SOEs.

Share of Private Enterprises in Renewable Energy Production in China



Source: Deutsche Bank, NBS

New Energy / Environment

- Natural gas consumption may see +15% CAGR, over the coming years, supported by:
  - Relaxation of controls on gas importing rights
  - Further spin-off of gas pipelines
  - Promotion of gas fired power
  - Greater penetration of gas as fuel for transportation and industrial usage.

Exhaust gas emission comparison between different fuel types

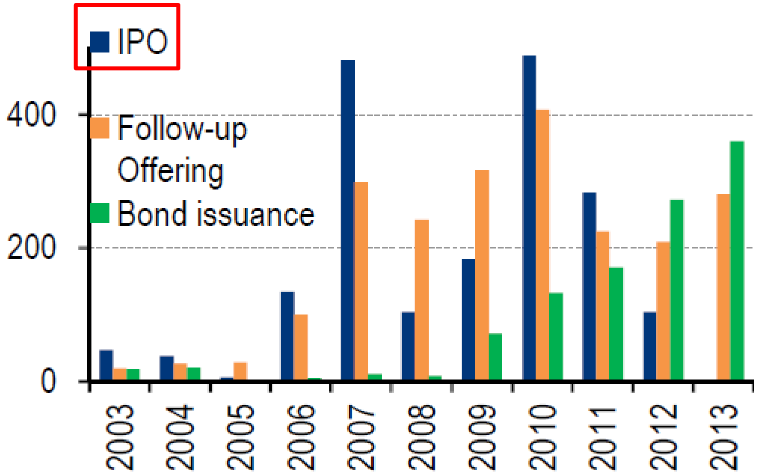
Type	Unit	Gasoline	Diesel	LPG	CNG	LNG
Hydrocarbon	ppm	<10,000	<300	<5,000	125	112
NOx	ppm	~2,000-4,000	~1,000-4,000	~1,000-2,200	~980-1,960	~800-1,800
Pollution particulate	mg/cu. m	0.01	0.5	No	No	No
Sulphur dioxide (SO2)		Yes	Yes	Tiny	Minimal	No

Source: Deutsche Bank, Kunlun Energy, ENN Energy

- Natural gas to play larger role in replacing gas/diesel as transport fuel.
  - Environmentally friendly, to improve air quality with much lower emissions.
  - Cost effective. LNG is 20-30% cheaper than diesel/gasoline on an equivalent caloric value basis.
    - Higher cost of vehicle can be recouped from fuel savings in a little over a year (i.e., 14 months).
- Natural Gas plays are strong beneficiaries.

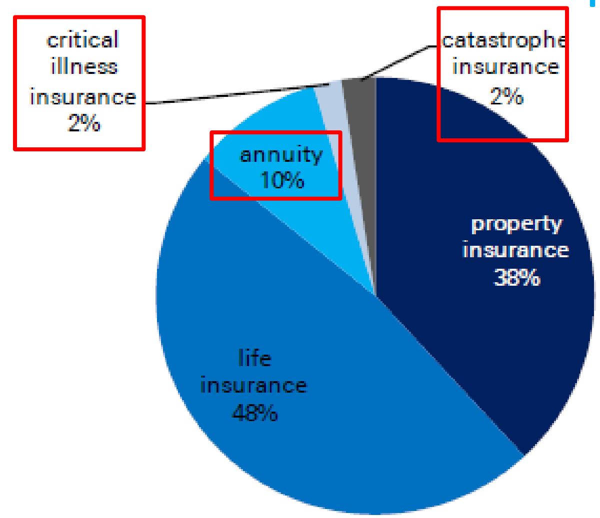
Brokers and Insurance

Fund raising from A-share market (RMB b)



Source: BOAML, CSRC

More diversified sources of insurance premium by 2020



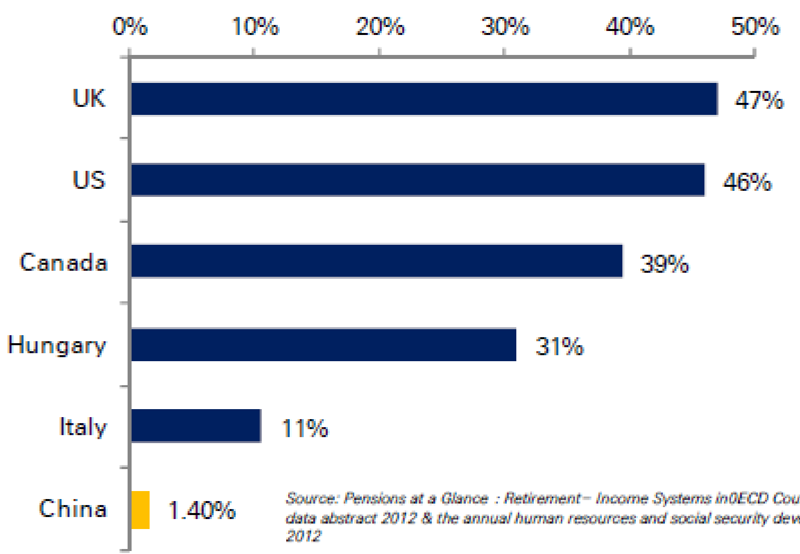
Source: Deutsche estimate

- Brokers will be key beneficiary as a result of relaxation of restrictions on cross-border RMB flows under capital account, increased demand for innovative business (such as margin financing, share pledges, asset management, preferred shares issuance). The resumption of A-share IPO will also boost brokers' earning. (Some expect 2014 total IPO fundraising to be RMB250b, close to 2010 level.)
- Insurers will directly benefit from potential new business lines. As part of the healthcare insurance reform, government decided to develop critical illness and catastrophe insurance.
- Expect current critical illness insurance pilot programs in 120 cities to be expanded to nationwide by end of 2014. The room for expansion is huge because current trails cover only 200m people and ultimate coverage should be 1.1b.

Brokers and Insurance

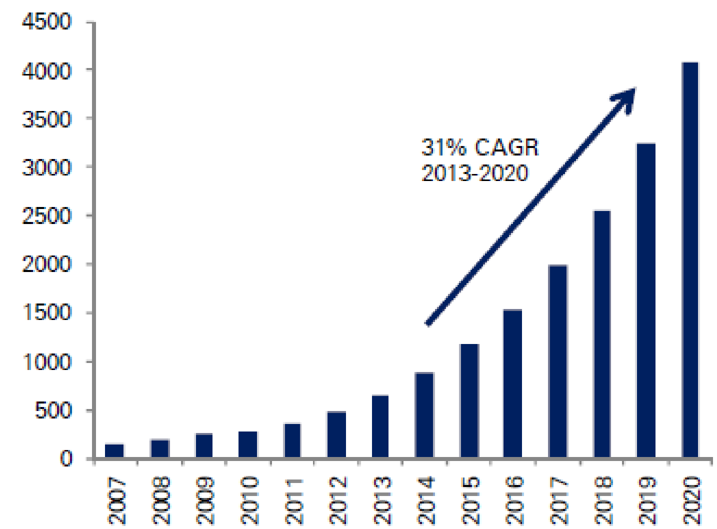
- In the past, post-disaster reconstruction relied only on the national fiscal budget and donations. Less than 5% of the economic losses were covered by insurance. Coverage ratio in developed countries is usually 20%-40%.
- Insurance will also directly benefit from:
  - New business from Annuities, as well as potential upside in Chinese equities.
    - Only 0.4% of PRC companies participated in the annuities program (company sponsored pensions) in the 2H 2013. Only 1.4% of working population covered.
    - Possible 30% CAGR from 2013-2020, with support from recently announced tax deferral policies (of up to 4% of annual average salaries being tax exempt).

Coverage of Annuity Plans (% working pop.)



Source: Pensions at a Glance : Retirement– Income Systems in0ECD Count, The national annuity fund data abstract 2012 & the annual human resources and social security development statistics bulletin 2012

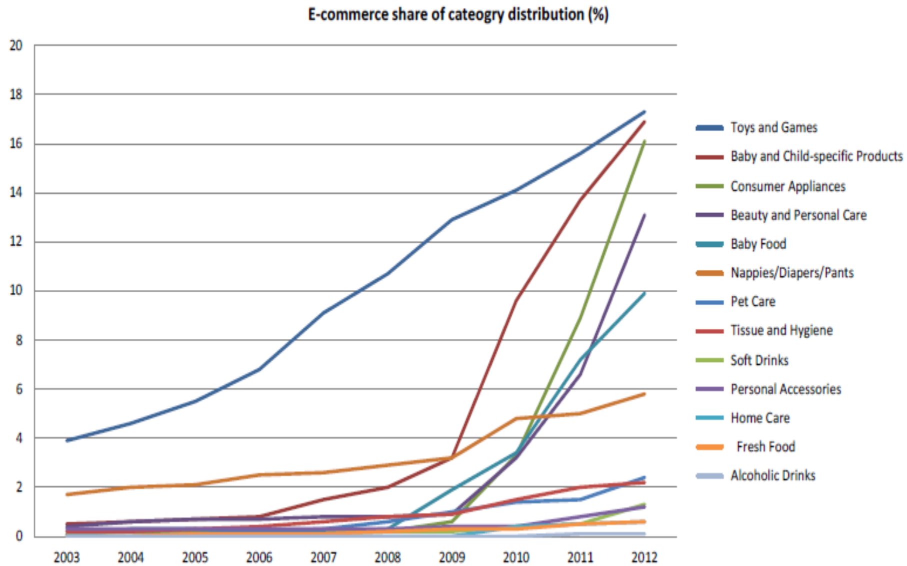
Total Annuity Assets Projection (RMB Bn)



Source: Deutsche Bank estimate

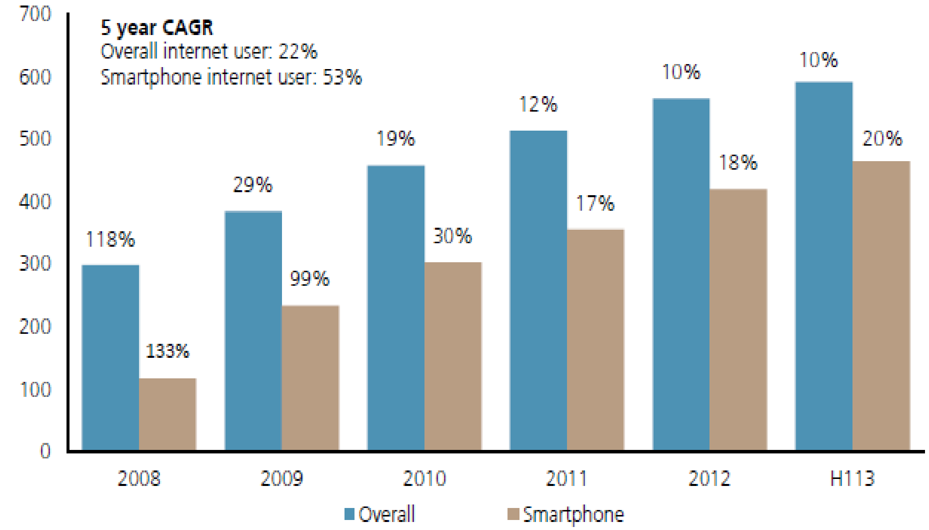
Mass Market Consumption & IT

E-commerce share of category distribution (%)



Source: Citi Research, Euromoniotor

China Internet Users (m) (YoY %)



Source: CNNIC

- China's tissue paper consumption per capita p.a. is much lower than that of developed markets. Accelerating urbanization and rising living standards continue to be catalyst for the growth of the sanitary napkin market. Relaxation of one child policy should also drive demand for baby disposable diapers and dairy products. In addition, popularity of SUVs should also increase.
- With the deregulation of value-added service and increasing penetration of smartphone users in China, internet companies with very large client base and innovation ability will benefit.
- E-commerce in China has also grown rapidly, with penetration looking to surpass that of the US this year. The growing no. of online shoppers, competitive pricing, and the improvement of payment system (Alipay, Tenpay) as well as logistics have been the key growth factors.

Conclusions

- As a result of the Third Plenum reforms, “hard landing” fears are subsiding.
- Improved sentiment will drive a **re-rating** in the medium to long term.
- The focus on reducing the role of state-owned enterprises (SOEs) should benefit the **private sector**
- By contrast, SOEs will face increased competition
- Suggest **avoiding ETFs** which are typically SOE-heavy. Recommend investing in stocks that benefit from the reforms:
  + **Brokers**
  + **Insurance**
  + **Healthcare**
  + **Clean Energy** & **Environment Protection**
  + **Railway Construction**
  + **Mass market consumption** & **IT**

Risk Disclosures

Issuer risk (credit risk)

Any deterioration of the issuer's solvency or insolvency on the part of the issuer could mean a loss of the assets involved, or at least part thereof.

Counterparty risk

There is a risk that the execution of trades entered into for the account of the fund assets may be jeopardized by liquidity problems or insolvency/bankruptcy on the part of the relevant counterparty.

Inflation risk

Inflation may reduce the asset value of the investment. The purchasing power of the invested capital is reduced if the inflation rate is higher than the income generated by the investments.

Economic risk

This is the risk of price losses resulting from the economic development not being taken into account to a sufficient degree, or not accurately, when making the investment decision, resulting in securities investments being carried out at the wrong time or securities being held during an unfavourable phase of the economic cycle.

Country or transfer risk

Country risk refers to the situation that arises when a foreign debtor, although not insolvent, is unable to fulfill its obligations on time, or unable to fulfill them at all, as a result of the fact that the country in which the debtor has its registered office is either unable or unwilling to permit transfers (e.g. due to currency restrictions, transfer risks, moratoriums or embargoes). This may, for example, result in the non-receipt of payments to which the sub-fund is entitled or in payments being received in a currency that is no longer convertible as a consequence of currency restrictions.

Settlement risk

Particularly when investing in non-listed securities, there is a risk that settlement via a transfer system is not effected as planned due to delayed or non-compliant payment or delivery.

Liquidity risk

The sub-fund may also acquire assets that are not admitted to an exchange or included in any other organised market. However, the acquisition of any such assets entails the risk that problems may arise, particularly when on-selling these assets to third parties. With regard to small caps (second liners) there is a risk that the market may be temporarily illiquid. This may result in securities not being tradable at the desired time and/or not in the desired quantity and/or not at the targeted price.

Risk Disclosures

Possible investment spectrum

In compliance with the investment principles and limits set forth in the UCITS Law and the unit trust agreement in conjunction with the special investment policy provisions, which provide for a very wide scope for the UCITS and its sub-funds, the actual investment policy may also be geared towards purchasing assets primarily from a small number of industries, markets or regions/countries, for example. This focus on a few select investment sectors may offer special opportunities but may also give rise to special risks (e.g. market constraints, high fluctuations during certain economic cycles). The annual report informs the Investors about the investment policy of the past financial year.

Concentration risk

Further risks may arise if investments are concentrated on specific assets or markets. In these cases, the sub-fund would be highly dependent on the development of any such assets or markets. Market risk (price risk) This is a general risk linked to all investments and entails the risk that the value of an investment changes to the detriment of the sub-fund.

Psychological market risk

Sentiments, opinions and rumours may trigger significant price slumps, even if the earnings situation and prospects of the companies invested in have not changed considerably. The psychological market risk has a particularly strong effect on equities.

Settlement risk

This is the loss risk of the sub-fund which occurs if an executed trade is not fulfilled as expected, as a counterparty fails to pay or deliver, or that losses may occur as a result of operational errors in connection with the settlement of a trade.

Legal and tax risks

The buying, holding or selling of investments of the sub-fund may be subject to tax provisions (e.g. withholding tax) outside of the UCITS's country of domicile. Moreover, the legal and tax treatment of the subfund may change in an unforeseeable fashion, and the sub-fund may have no control over any such 21 changes. Amendments to the sub-fund's tax bases for previous financial years as a result of a tax audit determining that such tax bases had been incorrectly applied, may lead to a correction that is disadvantageous to the Investor from a tax perspective. As a consequence, the Investor may have to bear the tax burden resulting from an amended tax assessment for previous financial years, even if the Investor was not invested in the sub-fund at that time. Conversely, the Investor may be faced with a situation where a favourable amended tax assessment for the current and previous financial years, in which the Investor was invested in the sub-fund, does not benefit the Investor as a result of the Investor having redeemed or sold the Units before the amendment took effect. Furthermore, the correction of tax data may result in taxable profits or tax benefits actually being assessed in a different tax assessment period from the correct one. This may have a negative impact on the individual Investor.

Risk Disclosures

Company risk
Equity investments are a direct participation in the economic success or failure of a company. In the worst case scenario (i.e. in the event of bankruptcy), this may result in the total loss of any amount invested.

Currency risk
Where the sub-fund holds foreign currency assets, such assets are exposed to a direct currency risk, unless its foreign currency positions are hedged. Falling exchange rates would lead to a decrease in the value of foreign currency investments. Conversely, the foreign currency market also offers profit opportunities. In addition to direct currency risks there are also indirect currency risks. Companies with international operations are exposed to exchange rate developments to a greater or lesser degree. This may also have an indirect impact on the price development of investments.

Changes in investment policy
The risk associated with the sub-fund may also change if the investment policy changes within the legally and contractually permissible investment spectrum. Within the scope of the applicable unit trust agreement, the Management Company may materially alter the investment policy of the sub-fund by amending the prospectus at any time.

Amendments to the unit trust agreement
Under the unit trust agreement, the Management Company reserves the right to amend the terms and conditions of the unit trust agreement. Moreover, the Management Company has the right under the unit trust agreement to completely liquidate the sub-fund or to merge it with another sub-fund. For the Investor, this entails the risk that the Investor may not achieve the holding period as planned.

Risk of suspension of redemption
As a rule, Investors may request that the Management Company repurchase (redeem) their Units in accordance with the valuation interval of the sub-fund. However, the Management Company may opt to temporarily suspend the redemption of Units if extraordinary circumstances exist, and only redeem the Units at a later time at the price then applicable (for further details see "**Suspension of Calculation of the Net Asset Value and the Issuance, Redemption and Conversion of Units**"). This price may be lower than the price prior to the suspension of redemption.

Key personnel risk
Sub-funds whose investment performance is particularly positive during a certain period owe this success, among other things, to the skill of their specialists and thus to the correct decisions of their management. However, the composition of the fund management may change. It may be that new decision-makers are less successful in their endeavours.

Interest rate risk
To the extent that the sub-fund invests in interest-bearing securities, it is exposed to an interest rate risk. If the market interest rate level rises, the market value of any interest-bearing securities that are part of the fund assets may rapidly fall. This applies even more so if the fund assets also include interest-bearing securities having a longer residual term and a lower nominal rate of interest.

Risk Disclosures

Market Risk
Customers are exposed to the political, economic, currency and other risks related to the synthetic ETF’s underlying index.

Counterparty Risk
Where a synthetic ETF invests in derivatives to replicate the index performance, customers are exposed to the credit risk of the counterparties who issued the derivatives, in addition to the risks of the derivative issuers should be taken into account (e.g. since derivatives issuers are predominantly international financial institutions, the failure of one derivative counterparty of a synthetic ETF may have a “knock-on” effect on other derivative counterparties of the synthetic ETF). Some synthetic ETFs have collateral to reduce the counterparty risk, but they may be a risk that the market value of the collateral has fallen substantially when the synthetic ETF seeks to realise the collateral.

Liquidity Risk
A higher liquidity risk is involved if a synthetic ETF involves derivatives which do not have an active secondary market. Wider bid-offer spreads in the price of the derivatives may result in losses.

Tracking Error
There may be a disparity between the performance of the synthetic ETF and the performance of the underlying index due to, for instance, failure of the tracking strategy, currency differences, fees and expenses.

Trading at a Discount or Premium
Where the index/ market that the synthetic ETF tracks is subject to restricted access, the efficiency in unit creation or redemption to keep the price of the synthetic ETF in line with its net asset value (NAV) may be disrupted, causing the synthetic ETF to trade at a higher premium or discount to its NAV. Investors who buy a synthetic ETF at a premium may not be able to recover the premium in the event of termination.

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Picture description

"The Liechtenstein Garden Palace in Vienna", 1759/60

BERNARDO BELLOTTO
1721–1780

As in "the Liechtenstein Garden Palace in Vienna Seen from the East", Bernardo Bellotto also depicts here the proud Prince Joseph Wenzel standing in front of his surburban palace. These two paintings, while epitomising the spirit of Roman grandezza in Vienna, are recorded in a manner that is topographically accurate. The documentary value of these pictures is considerable, not only with regard to the appearance and colour of the palace and its relation to the Belvedere as of 1760, but also in recording, for the last time, the extensive Baroque garden with its statuary. Starting in 1773, the sculptures and vases were auctioned off and work was begun on an English-style landscape garden. In 1787 Joseph Hardtmuth appeared on the scene (he was to be appointed architect to the prince in 1790) and, both at the suburban palace and at numerous other locations, was responsible for an upheaval that would introduce Neoclassicism, in the strict sense of that term, to the House of Liechtenstein.