



CFA Institute Shenzhen Seminar

Investment of Pension Funds and Sovereign Wealth Funds in China

BY

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Demographic Dynamics in China



PRC Population

- Total: 1.37bn
- Rural Population: 674mn
- Urban Population: 666mn

Population Ages:

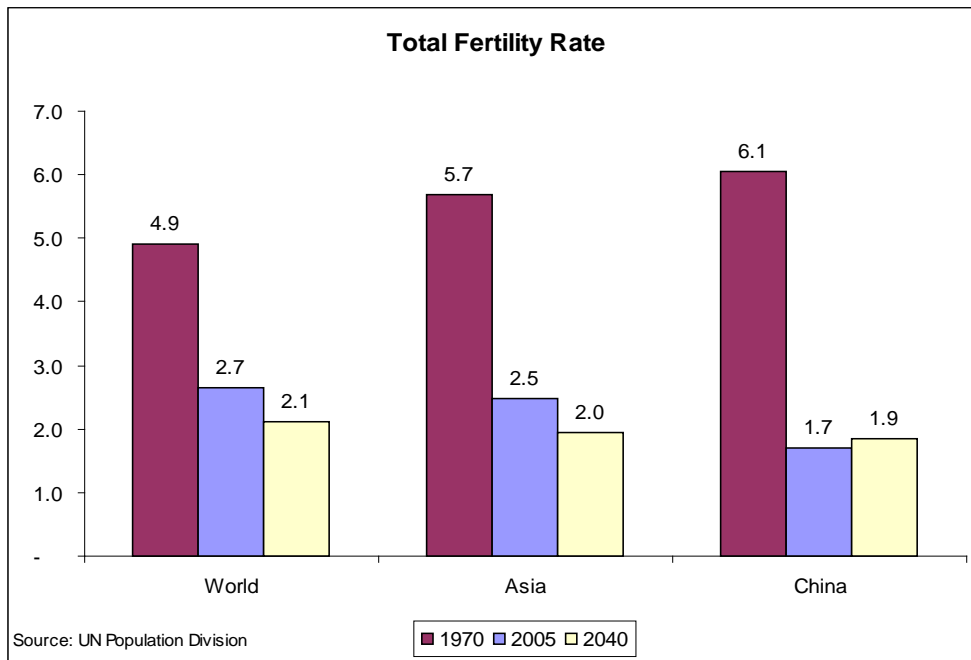
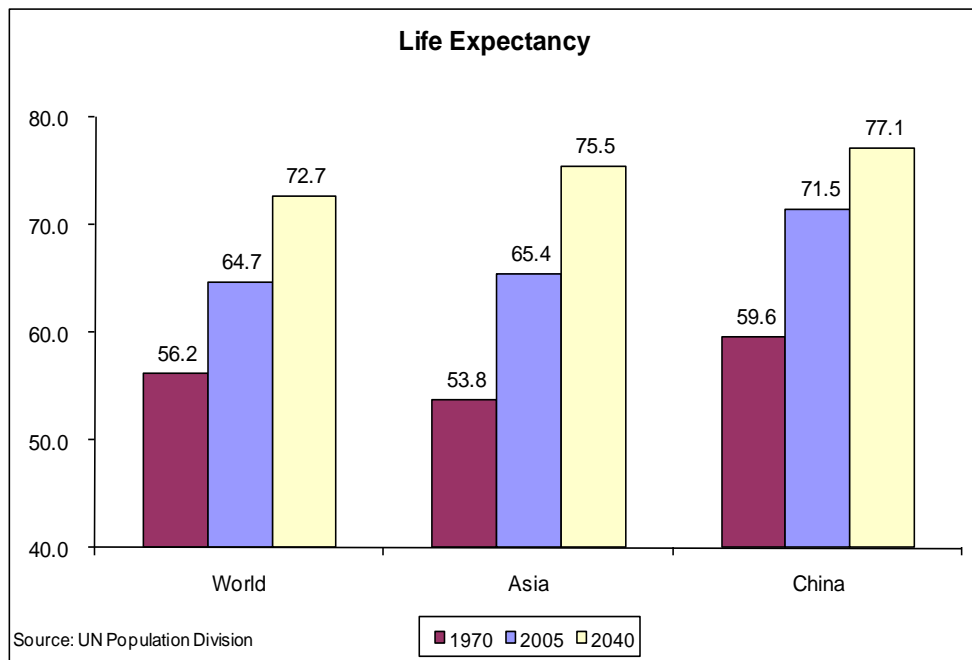
- | | | |
|---------|-------|---------|
| ■ 0-14 | 222mn | – 16.6% |
| ■ 15-59 | 940mn | – 70.1% |
| ■ 60+ | 178mn | – 13.3% |

Source: The Sixth National Population Census (2010)

Consider:

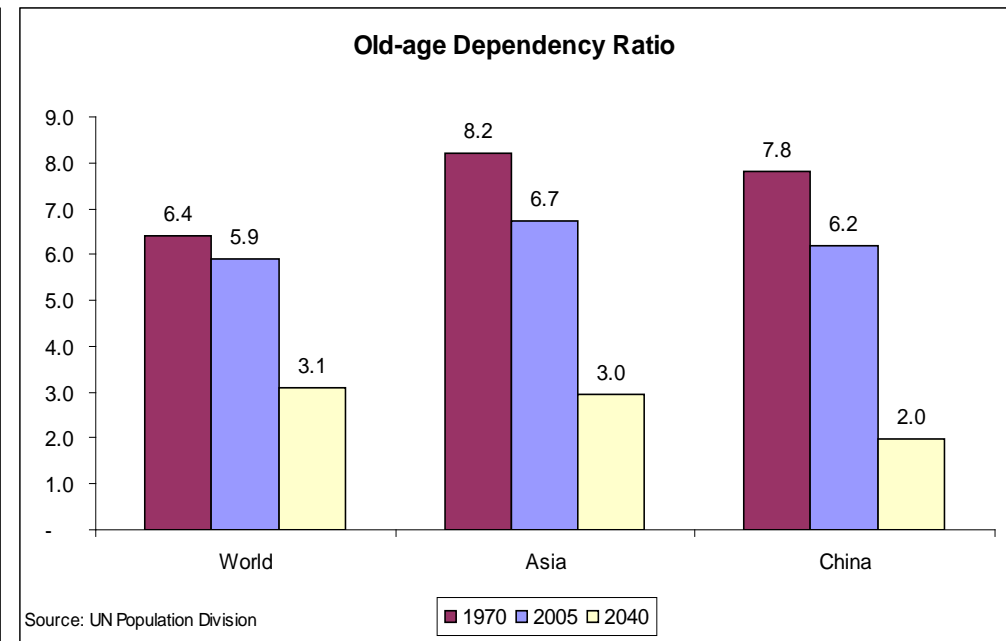
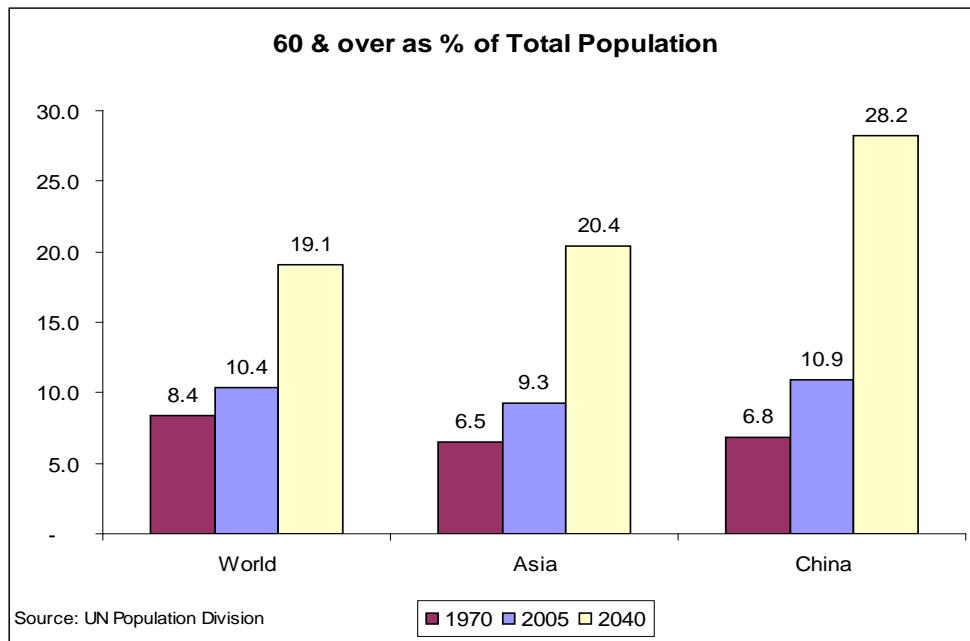
- One child policy
- Greatly improved life expectancy
- Dependency ratio deteriorating rapidly
- Population Sex Ratio up to currently 118 males born for each 100 females
- Solve population problem through migration? – NO!
- 400mn people over age 60 in 2040

Demographic Changes Pose Challenges



Source: UN Population Division

Demographic Changes Pose Challenges (Cont'd)



Source: UN Population Division

Pension Reforms

and

Enterprise Annuities



Old Pension System

- Urban employees typically worked for SOE for life
- Wages very low, but total security
- Retirement at 60 (males), 55/50 (females)
- Pension from SOE of 80-90% of final salary
- Pension increases each year
- Pensions paid out of cash flow alongside wages
- In 1950s not many pensioners, low life expectancy
- By 1980s very many pensioners, improved life expectancy
- Then SOEs became under pressure to downsize and get efficient



Pension Reform

- New unified pension system reform
 - Document 26 – July 1997
 - Document 38 – December 2005
 - Expand coverage to all urban employees

- National Social Security Fund (NSSF) established in 2000 as a strategic reserve

- Regulations for Enterprise Annuity (EA) plans in 2004

- Rural population to be covered by 2020

Urban Pension System

Pillars (World Bank)		Chinese Terminology	Contri- butions	Benefits	Funded Status
State	Zero	Zero: Minimum guarantee (Di Bao)	n/a	Varies	From Government
	I	Ia: Mandatory Social Pool Old Age Pension	ER: ~20% of salaries	Monthly pension based on average local monthly wage, indexed individual wage and years of employment	PAYG
	II	Ib: Mandatory Individual Account (IA) Pension	EE: 8% of salary	Monthly pension of 1/139 of IA balance at the time of retirement provided at least 15 years' contributions	Should be funded
Private	III	II: Voluntary Enterprise Annuity (set up by eligible employers)	ER; EE	Lump sum or annuity benefit	Funded
		III: Other Voluntary Benefits, e.g. Insured Group Pension Plans	ER; EE	Lump sum or annuity benefit	Funded
Private & State	IV	IV: Family support; subsidised healthcare and housing	n/a	Varies	From Government or Family

Source: Stirling Finance research. ER – employer; EE – employee.



Urban Pension System (Cont'd)

	Equities/ Linked products	Financial/ Corporate Bonds	G-bonds / Deposits
Pillar 1a (state)	-	-	100%
Pillar 1b (state) (IA)	-	-	100%
Pillar II (EA)	< 30%	< 50%	> 20%
Pillar III (non-EA)	< 20%	< 20%	< 100%

Source: Stirling Finance research

Notes:

- State pensions increase each year by an amount between price inflation and earnings escalation
- Investment return for IA: 2% p.a. in the past 10 years



Enterprise Annuities (EAs)

- Voluntary supplementary plans set up by employers according to MoHRSS Regulations
- Tax regulations (December 2009) and supplementary regulations (January 2011)
 - EE contribution - not tax deductible when calculating personal income tax
 - ER contribution - subject to personal income tax
- Conversion of non-EA supplementary plans to EA format, e.g.: after Shanghai Scandal
- Total of 58 licenses have been awarded to 38 institutions in two batches (in 2005 and 2007)
- Rapid expansion (as at end-2010)
 - total # of EA plans: 35,000
 - total # of members: 14mn
 - total AUM : RMB300bn

EA Service Providers– Who Can Do What?

Provider	Regulatory Body	Trustee	Administrator	Investment Manager	Custodian
Trust company	CBRC	√	√	√	-
Commercial bank	CBRC	√	√	-	√
Fund management subsidiary of commercial bank	CBRC	√	√	√	-
Fund management co.	CSRC	√	√	√	-
Securities co.	CSRC	√	√	√	-
Life insurance co.	CIRC	-	√	-	-
Pension insurance co.	CIRC	√	√	√	-
Fund management subsidiary of insurance co.	CIRC	-	√	√	-
Non-financial services co.	N.A.	-	√	-	-

Source: Stirling Finance research



EA Investments

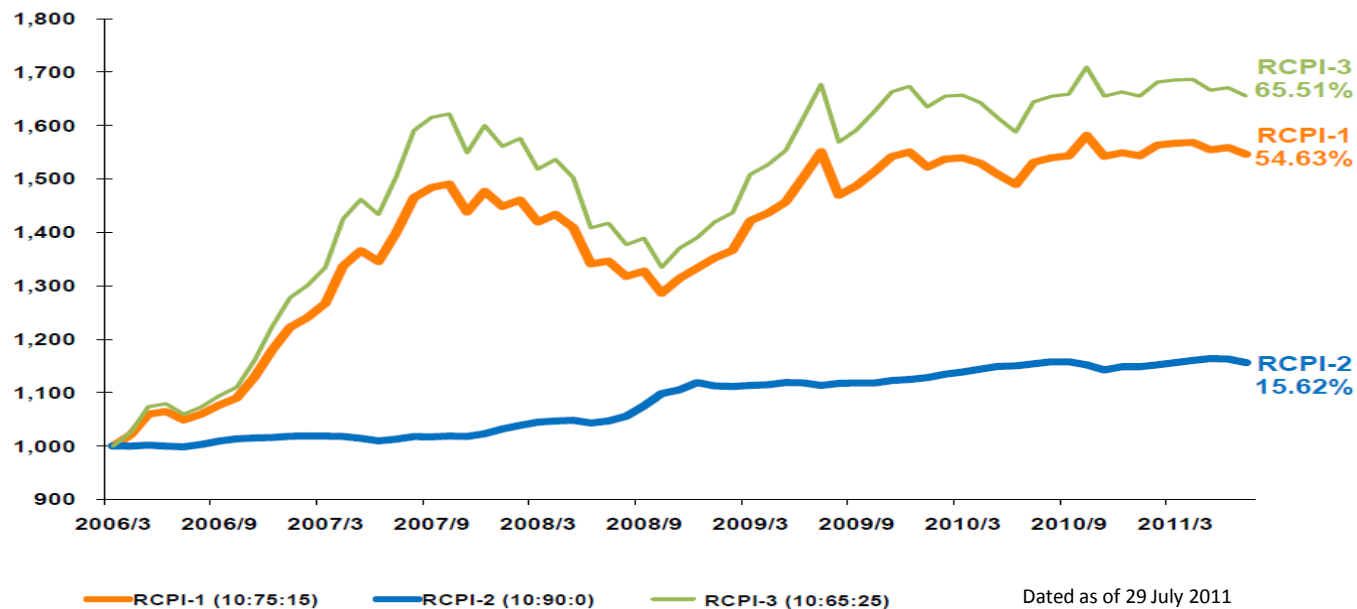
- All domestic
- Investment return
 - 2006-2008: 10.5% p.a. on average
 - 2009: 7.8%
 - 2010: 3.6%
- New Investment Measures take effect on 1 May 2011

	Old Rules	New Rules
Liquid assets	≥20%	≥ 5%
Fixed income	≥20%	≤95%
Equity products	≤30%	≤30%
- stocks	≤20%	

Source: Stirling Finance research

EA Investment Performance

- Reuters China Pension Index (RCPI)
 - Designed to provide performance benchmarks for China's Enterprise Annuities
 - Launched on 31 March 2006
- 3 versions reflecting different asset proportions between cash: fixed income: equities.



Source: Reuters.



New Rural Pension System

- Over 50% of residents in China are rural (674mn population)

- New rural pension system introduced in late 2008
 - Initially on a voluntary basis
 - Eligibility: Rural residents aged 16 and above who are neither students nor currently participating in the urban system
 - Pension age: 60 for M & F
 - Achievement: Scheme introduced to 23% of counties by end-2010;
Aiming to cover 50% by end-2011
 - To cover entire rural population by 2020 on compulsory basis



New Rural Pension System (Cont'd)

Terminology	Contributions	Benefits	Funded Status
Basic Social Pool	100% from government budget	No less than RMB 55 per month	Unfunded
Individual Account	<p>Individuals</p> <ul style="list-style-type: none"> - RMB 100 / 200 / 300 / 400 / 500 per year <p>Government</p> <ul style="list-style-type: none"> - No less than RMB 30 each year <p>Other sources</p>	<p>Monthly pension benefit of 1/139 of IA balance at pension age assuming at least 15 years' contribution; otherwise, lump sum payable</p>	<p>Funded (accumulated in accordance with 1-year bank deposit rate)</p>

Source: Stirling Finance research



Sovereign Wealth Funds



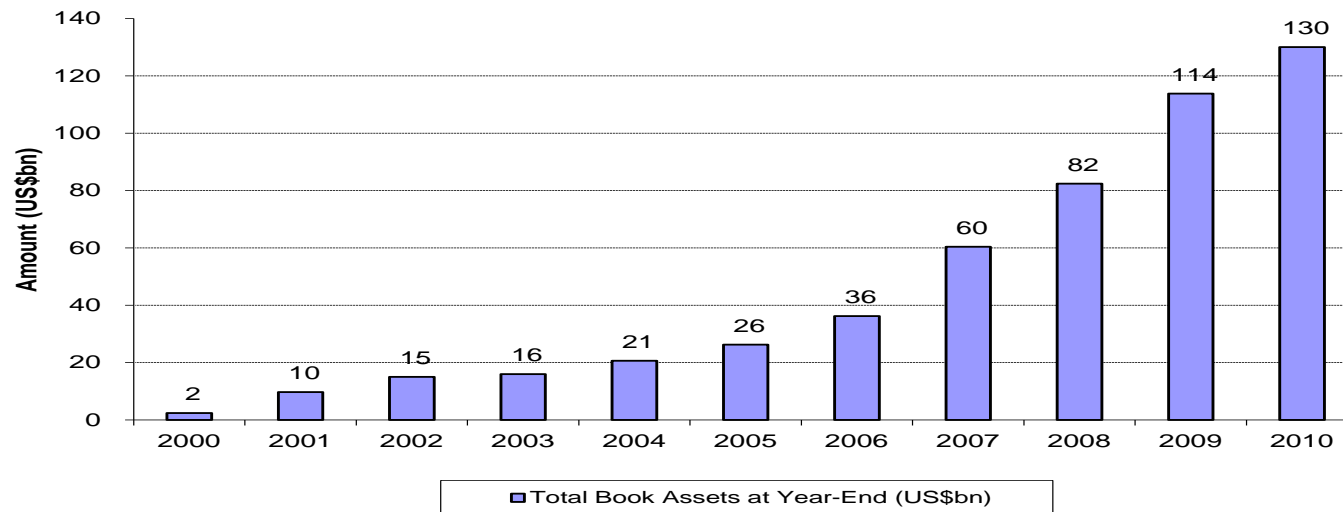
National Social Security Fund (NSSF)

- Established in 2000
 - A strategic reserve fund
 - A solution to the ageing problem
 - Pension fund of last resort - to help provinces with pension financing difficulties
- Source of funds:
 - Allocations from central government
 - State Shares equal to 10% of IPO proceeds
 - Lottery licence fees
 - Investment returns
- Growing significantly in size, stature and influence
- Acting like Sovereign Wealth Fund

NSSF Assets

■ Assets:

- Known as the biggest institutional investor in China's pension sector
- US\$130bn total assets as of end 2010
- Aiming to reach RMB1.5trn (US\$231bn) by 2015



Source: NSSF; Stirling Finance research



NSSF Investment Portfolio

- Well diversified Portfolio

Geographical Allocation	Execution	Permitted investments	Cap
Domestic	Direct	Bank deposits	>= 50%
		Government bonds	
	Appointment	Equities	= < 40%
		Fixed income	= < 10%
		PE funds	= < 10%
International	Appointment	Equities	= < 20%
		Fixed income	

Source: Stirling Finance research

Appointment of Domestic Fund Managers

- 2001 – 2002
 - direct investments only
 - modest returns:
 - 2% - 3%

- Domestic appointments
 - 6 in 2003
 - 4 in 2004
 - 8 in 2010

2003	China Southern
	Boshi (Bosera)
	Huaxia (China AMC)
	Penghua
	Changsheng
	Harvest
2004	CICC
	China Merchants
	E Fund
	Guotai
2010	Dacheng
	Fullgoal
	ICBC Credit Suisse
	Guangfa
	HFT
	China Universal
	Yinhua
	Citic Securities

Source: NSSF



International Investments

- Permitted by State Council to use its own FX to invest abroad in 2006
- Appointed international investment managers in November 2006
 - 5 mandates
 - 10 winners selected in November 2006
 - Selection of 2 global custodians in July 2006
- Second batch of mandates issued in May 2008
 - 5 mandates
 - 12 fund managers selected in 2009
 - Winners announced in March 2010
- Current allocation: 7%



First Batch of Overseas Investment Initiatives

Mandate	Index	Target Net-of-Fees Excess Return p.a.	Tracking Error	Managers
Global (ex-US) Equities	MSCI World (ex USA)	+ 200 bps	Within 8% p.a.	Allianz; Invesco; UBS/CICC
US Equities	S&P 500	+ 50bps	Within 2% p.a.	AllianceBernstein; AXA Rosenberg
Hong Kong Equities	FTSE China Hong Kong	+ 300 bps	Within 8% p.a.	JanusINTECH; T. Rowe Price
Global Fixed Income	Barclays Capital Global Aggregate Bond	+ 100 bps	Within 2% p.a.	AllianceBernstein; Blackrock; PIMCO
Cash	6-month LIBOR	0	N/A	Blackrock

Source: NSSF



Second Batch of Overseas Investment Initiatives

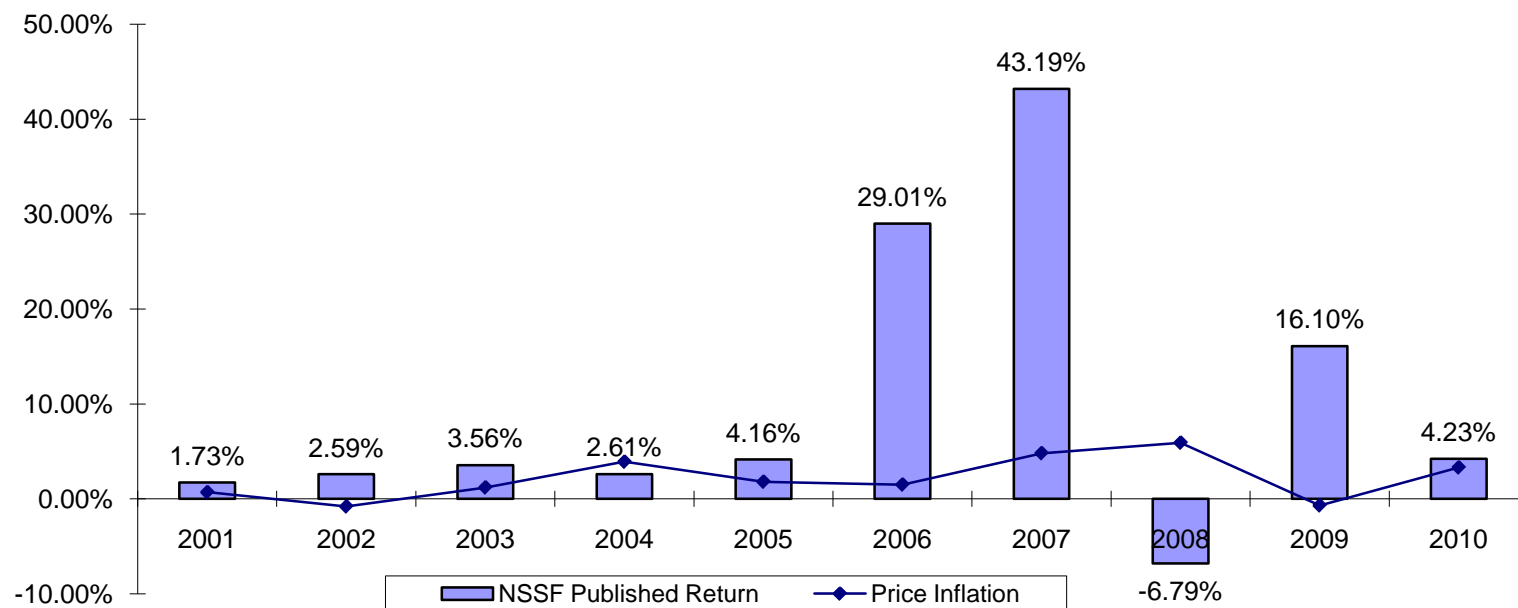
Mandate	Benchmark	Appointed Fund Managers
Active China Overseas Equity	MSCI China Index	Schroders; Boserá; Baring
Active Asia Pacific (ex Japan) Equity	MSCI All countries Asia Pacific ex Japan Index	Martin Currie; JF; Principal
Active Emerging Market Equity	MSCI Emerging Market Index	Batterymarch; Morgan Stanley; Schroders
Active European Equity	MSCI Europe Index	Newton; Fidelity
Active Global Equity	MSCI World Index	Prudential (UK); Wellington

Source: NSSF

- No target return or tracking error was specified

NSSF Investment Returns

- Investment returns as of 31 December 2010
 - 9.2% p.a. since inception vs. inflation rate of 2.1% p.a.



Source: NSSF; Stirling Finance research.



Sovereign Wealth Funds – CIC

- China Investment Corporation (CIC)
 - Established in September 2007
 - 5th largest SWF in the world
 - Mandated to manage a portion of China's foreign exchange reserves
 - Asset size increased from initially US\$200bn to US\$410bn as of 31 December 2010
 - Domestic investments
 - US\$67bn to acquire Central Huijin
 - US\$50bn to recapitalise ABC and CDB
 - International investments
 - Blackstone (US\$3bn), Morgan Stanley (US\$5.6bn+1.2bn)
 - Investments in PE funds, money market funds, natural resources and high-tech companies etc.
 - Two batches of selected international fund managers – not public
 - For international investments, annual total return of 11.7% in 2010, and return of 6.4% p.a. since inception
 - HK subsidiary (November 2010) and Toronto office (January 2011) set up



CIC – First Batch of International Mandates

- Equity-oriented
- Made public in December 2007

Mandate	Benchmark	Target Rate of Return (Annual, net-of-fees)
Global Equity Active	MSCI All Country Index(USD), dividends reinvested	+ 300 bps
MSCI EAFE Active	MSCI EAFE(USD), dividends reinvested	+ 200 bps
Emerging Market Active	MSCI Emerging Market Index(USD), dividends reinvested	+ 300 bps
Asia ex Japan Equity Active	To be provided by applicants	N.A.

Source: CIC; Stirling Finance research.



CIC – Second Batch of International Mandates

- Fixed income
- Made public in February 2008

Mandate	Benchmark	Target Rate of Return (Annual, net-of-fees)
Active Global Fixed Income	GDP weighted customized global bond index (composed of Barclays Capital US, Euro Zone, Japan, UK Treasury indices), measured in USD, dividends reinvested	+ 150 bps
Active Emerging Market Debt	JP Morgan EMBI Global, measured in USD, dividends reinvested	+ 200 bps

Source: CIC; Stirling Finance research.



CIC - Asset Allocation and Investment Returns

Year-end	2008	2009	2010
Equity	3.2%	36%	48%
Fixed income	9%	26%	27%
Alternatives	0.4%	6%	21%
Cash	87.4%	32%	4%
Total Return on international investments (US\$)	-2.1%	11.7%	11.7%
Overall return (US\$)	6.8%	12.9%	N/A (No disclosure from CIC)

Source: CIC; Stirling Finance research.



CIC – Future

- Consideration for restructuring?
 - Strip out all bank holdings?
 - CIC to focus on overseas investments?
 - Central Huijin to concentrate on state-owned financial assets?

- Another USD50bn may be obtained this year?

- Given its size and potential to sway the markets, every move of the CIC is closely watched



Sovereign Wealth Funds – SAFE

- State Administration of Foreign Exchange (SAFE)
- China's FX reserves as of 31 June 2011: USD3.2trn
- 5% of the assets are allowed for overseas equity investments
- Hong Kong subsidiary ("SAFE Investment Company Limited") established in June 1997
 - Asset size: ~USD568bn as of 31 December 2010
 - 4th largest SWF in the world
- Deals done through SAFE Investment or other nominee accounts
- Quietly built up stakes in over 50 European companies, Australian banks and PE funds



Sovereign Wealth Funds – CADFund

- China-Africa Development Fund (CADFund)
- Launched in June 2007 as the largest PE fund in China
- Also the largest fund invested in Africa
- Aims to enhance China-Africa strategic partnerships in various areas
- Initially US\$1bn provided by China Development Bank
- Will increase to US\$3bn by 2013 and eventually US\$20bn
- Operating independently based purely on market economy principles
- Have invested in over 30 projects in Africa
 - Energy, infrastructure, agriculture, manufacturing, mining etc.
e.g., glass plant (Ethiopia); electric power plant (Ghana); chrome plant (Zimbabwe)
Suez Economic and Trade Park (Egypt)



Investment Opportunities

and

Future Outlook

Opportunities for International FMs

Pillars (Chinese)		Opportunities?
Pillar Ia		No
Pillar Ib	Short Term	No
	Medium Term	Outsourcing by Social Security Bureaus
	Long Term	Like MPF or 401(k) plans?
Pillar II		Need EA License
Pillar III		Via insurance companies
NSSF		Yes
CIC		Yes

Source: Stirling Finance research



Possible Future Developments

- Improvements needed to further refine the urban system
 - Individual Accounts
 - Broaden investment scope?
 - Outsource to private sector?
 - EA: permit overseas investments?
- Rural pension system to follow
- More clearly defined objectives necessary for NSSF



Possible Future Developments (Cont'd)

- Under 12th 5-year plan, CSRC will aim to support investment industry
- CSRC + MoHRSS now studying 401(k)
- 401 (k) : Savings for retirement

+

Member choice of investment

+

Tax incentive

- Chinese 401(k) and Enterprise Annuity to merge?
- Could be very powerful stimulus to fund management industry
- Also CIRC permitting trial of Variable Annuities



谢谢!