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Strategic Insight is pleased to present this inaugural issue of our new monthly, *Windows into the Mutual Fund Industry*, written by SI's diverse research teams. With planning for 2006 on all of our minds, this issue suggests opportunities to strengthen fund managers in the coming years.

We are grateful to Matt Fink for contributing historical background on our \$9 trillion US mutual fund industry's early legal foundations. Then and now, vision and leadership are critical.

In Strategic Insight's 20<sup>th</sup> year, our associates and I are looking forward to assisting our many friends and colleagues within the asset management industry in new ways, and to answering your questions and responding to your suggestions, at [Windows@sionline.com](mailto:Windows@sionline.com).

Joel Rosenthal, President

# Perspectives 2006



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## Assembled Advice Packaging Further Expands

Funds of funds, mutual fund wraps, multiple investment disciplines pooled within one fund or one transaction, global asset allocation tools, etc. For distributors and managers, this leads to even greater focus on:

- Style adherence, low tracking error within style; attribution analysis helping identify a finer peer group (than just the popular ‘style boxes’);
- For Alpha generating, but limited capacity investment processes, fine-tuning access and optimizing advisory fees;
- Adding more non-correlated strategies to packaged advice platforms;
- Falling interest in narrow sector, regional funds, (except the cyclically ‘hot’ area); and
- An expanding ETF role within the retail marketplace.

## Desire to Diversify Internationally

- Toward a 30% allocation to international equity funds (from current 18%; balance of 82% within US equity funds);
- US dollar rebound might reverse, triggering faster international rebalancing;
- \$100 billion-plus annual flows to international equity funds for years to come;
- High inflows and liquidity pressures—driven by demand by mutual funds as well as institutional accounts—further facilitate self-reinforcing price appreciation within emerging markets and other off-shore smaller-liquidity stock markets;
- International style box more often being used, international funds-of-funds expand; and
- Capacity management continues to be a problem, new partnerships of retail fund managers and institutional advisors in US and globally emerge.

## US Fund Managers Expand Globally

- **Demand for funds rises worldwide;** fund inflows internationally doubled US fund flows in 2005;

- In many foreign markets, a more transparent investment landscape and shifts from closed proprietary distribution to more open relationship windows to high quality, globally coordinated investment managers; and
- Japan emerges with a retail fund marketplace; high monthly dividend sovereign bond fund focus augmented slowly by funds with higher equity allocations.

## Board Relationships / 15 (c)

- Somewhat smoother sailing after the regulatory firestorms;
- Advisory vs. sub-advisory rationalization and conflicts persist;
- More discussions of cost of trading and providing liquidity lead at times to incorporating innovative liquidity solutions (e.g., like those offered by Ebb or ReFlow); and
- Possibly, further migration of institutional investment analytics (beyond at times simple, easy-to-understand trailing comparative returns) into the 15(c) process.

## Distribution Companies / Platforms: Investment Analyst Gatekeepers’ Expanding Powers Necessitate Even Greater Attention

- Continue to organize company to support increasing institutionalization of fund selection;
- Hire / train institutional wholesalers;
- Build, strengthen internal competitive analytical teams; link, match investment analytics under CIO with investment analytics under “sales”;
- Understand specific analytics used within top distribution partners; shadow / replicate such internally to proactively identify relationship opportunities;
- Fine-tune investment communication and data-update schedules to needs of investment analysts; and
- **Concentration of selection power by a small number of analysts, many using similar technologies and screening, will regularly trigger cash flow concentration within a small number of funds, forcing more frequent fund closures, and constantly leading to new openings for other highly rated funds.** Staying close to such investment analysts’ teams and analytical process will help to **proactively identify such opportunities and benefit from them.**

# US Fund FlowWatch



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Against a backdrop of surging consumer confidence and stock prices lately, **the mutual fund industry is well positioned for continued growth in 2006.** Themes such as **international equity** and **funds-of-funds**, both of which have posted record inflows in 2005, could remain key drivers of expansion. A **rebound of growth-style investing**, if materialized, could open **new opportunities**. Rising MMF yields revive this segment as a source of profit growth.

## 2006 New Sales Projections

Assuming **positive economic trends persist into 2006**, triggering a **modest rise of stock prices** but relatively stable long-term interest rates, our fund **sales projections for next year are as follows:**

### Open-End and VA Underlying Fund New Sales\* \$B

	Est. 2005	Proj. 2006	'05 vs '04	'06 vs '05
US Equity	744	796	-4%	7%
World Equity	210	252	20%	20%
Hybrid	101	96	-13%	-5%
<b>Equity / Hybrid</b>	<b>1,055</b>	<b>1,144</b>	<b>-1%</b>	<b>8%</b>
National Muni	35	36	6%	3%
State Muni Bond	21	22	18%	6%
<b>Muni Bonds</b>	<b>56</b>	<b>58</b>	<b>10%</b>	<b>4%</b>
Strategic Income	113	119	5%	5%
Corporate Bond	74	78	-5%	5%
Government Bond	45	45	-16%	0%
High Yield Bond	31	31	-22%	2%
World Bond	20	25	29%	25%
<b>Taxable Bonds</b>	<b>283</b>	<b>298</b>	<b>-4%</b>	<b>5%</b>
<b>Total Long-Term</b>	<b>1,393</b>	<b>1,500</b>	<b>-2%</b>	<b>8%</b>

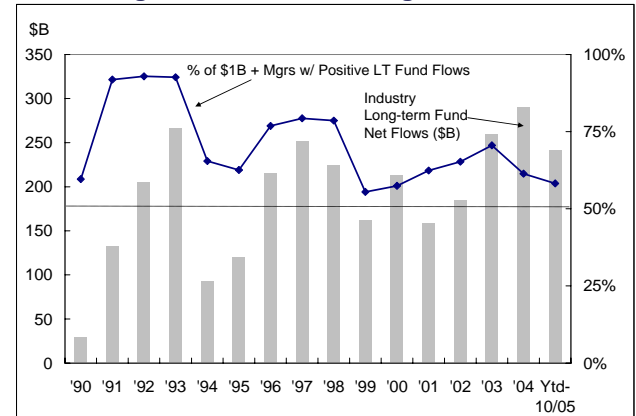
*For 2005 data, the first 10 months' data is actual; Nov.-Dec. projected. Sources: ICI Trends, SI projection; Exc. ETFs and closed-end funds*

- Equity / hybrid funds would control 76% of 2006 sales; despite gains, int'l equity funds share of all equity sales just one-quarter; FoFs replace some demand for balanced funds; and
- Stable rates and aging recovery lead to slightly higher bond fund sales; world bonds again used for defensive currency play; HNW investors interest in Muni bond funds persists.

## Small and Large Firm Success

The majority of fund management companies experienced positive net inflows year after year.

### % of Managers\* With Positive Long-Term Fund Flows



*\*Only managers with > \$1 B in long-term fund assets at end of each year. Source : Strategic Insight Simfund MF*

Many smaller players partake in the growth of our industry. The distinct investment focus of some such managers (value, int'l equity, and real estate, respectively, for the top-ranked firms below), demonstrates the expanding range of opportunities for smaller firms, especially with **increasing fund selections based on traditional institutional-type investment screens**, less on preferred partner agreements.

### 20 Fastest Growing Managers—2005 Through October\*

Stock / Bond Funds Only	Assets \$B 10/05	Flows \$MM Ytd	Flows As % of 12/04 Assets
Hotchkis & Wiley	10.3	4,159	70%
Causeway Capital	3.9	1,537	65%
Alpine Management	1.9	753	64%
Rainier Investment	2.5	870	59%
Schroder Investment	1.8	651	56%
Scout Investment	2.4	790	54%
CRM Advisors	2.7	889	50%
US Global Investors	2.2	632	50%
Muhlenkamp	3.0	934	47%
Third Avenue	13.0	3,816	47%
Julius Baer	16.0	4,580	45%
Hussman Econometric	2.3	641	40%
Princor	19.1	5,254	40%
Matthews Asian Funds	4.3	1,131	38%
AssetMark	2.9	689	32%
Barclays Global	151.0	31,751	28%
Highland Capital	2.5	525	27%
Touchstone	2.4	456	24%
American Beacon	8.8	1,633	23%

*\*Fastest YTD flows as % of beginning assets; managers with more than \$1 billion of long-term fund assets in December 2004. Source: Strategic Insight Simfund MF*

# New Fund Success



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## New Equity Funds

Among the new open-end equity funds launched in 2005 that raised the most assets were clones of successful international funds (to manage capacity); stand-alone institutional funds; non-market-correlated products using various absolute return or commodities-based approaches; strategic or tactical allocation funds-of-funds (FoFs) or standalone offerings; and global REIT or natural resource-based portfolios, reflecting the recent appeal of these sectors.

Beyond these broad strategies, we note, for example, that **Schwab** leveraged its proprietary equity ratings for its successful **Premier Equity** fund, raising **almost \$1 billion** by now. **PIMCO's** enhanced index **Fundamental IndexPLUS Total Return** fund launched in July seeks to outperform the S&P 500 Index by combining investments in derivatives linked to the Research Affiliates Fundamental (RAFI) 1000 Index, with an underlying actively-managed short-to-intermediate maturity fixed income portfolio. The RAFI 1000 Index weights companies by a blend of factors, such as sales, cash flow, book value and dividends, instead of weighting by capitalization. **(Derivative-based funds are also discussed in Global Horizons, p. 13).**

## New Bond Funds

Notable open-end bond funds launched in 2005 included "enhanced cash," international bond, inflation-indexed and alternative strategy products. An **absolute return fund** from **UBS** launched in April has raised **more than \$350 million** through October. (UBS has garnered \$1.2 billion within its January-incepted nontraditional **Dynamic Alpha** equity fund.) **Fidelity** just brought to market the **Strategic Real Return** offering, a blend of TIPS, Floating Rate loans, commodity-linked derivatives and REITs. Also noteworthy was the use by **Eaton Vance** of a FoF structure to combine three fixed

income sectors (high yield, floating rate, and US mortgage-backed) in its **Diversified Income** fund (FoFs not shown in table below); the fund has **raised \$195 million so far this year.**

### 2005 New Funds Raising Most Flows Lately\* Actively Managed Stock and Bond Open-End Funds \$MM

Fund Name	Assets 10/05	Net Flows	
		8-10/05	1-10/05
<b>Domestic Equity</b>			
Schwab Premier Equity	843	<b>155</b>	803
PIMCO Fundamental IndexPLUS TR	276	<b>96</b>	281
Federated Strategic Value	148	<b>80</b>	148
Van Kampen American Franchise	88	<b>64</b>	90
Schwab Large Cap Growth	58	<b>58</b>	58
ML Managed Acct Mid Cap Val Opp.	52	<b>53</b>	53
<b>International/Global Equity</b>			
Julius Baer Intl Equity II	421	<b>335</b>	424
UBS Dynamic Alpha	1,202	<b>288</b>	1,167
Fidelity Intl Small Cap Opportunity	211	<b>215</b>	215
SEI SIIT World Equity Exc. US	507	<b>204</b>	382
BlackRock All Cap Global Resources	246	<b>119</b>	233
Wm Blair Emerg Markets Growth	121	<b>91</b>	120
DFA Emerging Markets Core Equity	169	<b>58</b>	157
ML Mngd Acct Global Small Cap	52	<b>53</b>	53
TGIT Templeton Income	74	<b>52</b>	75
Cohen & Steers Int'l Realty	149	<b>50</b>	147
<b>Bond</b>			
Reserve Yield Plus	1,171	<b>1,059</b>	1,168
PIMCO Developing Local Markets	576	<b>333</b>	581
Hartford Floating Rate	278	<b>191</b>	276
UBS Absolute Return Bond	357	<b>144</b>	355
Evergreen IL Enhanced Income	379	<b>92</b>	379
JPMorgan Real Return	54	<b>55</b>	55

\* With trailing 3-month flows > \$50 mm; excludes funds just launched by John Hancock and selected new GMO institutional funds. Source: Strategic Insight Simfund MF

## New Closed-End Funds

**On the closed-end fund side, the covered call approach** that first emerged in mid-2004 was **pervasive** among new equity fund IPOs in 2005, and various versions of it were applied in association with US or global diversified as well as sector portfolios. Recently, **Merrill Lynch** even combined options-income strategies with a US government bond portfolio (in the **Enhanced Government** fund). **Eaton Vance**, one of the leading sponsors of option-income products, has filed two additional Rampart-subadvised tax-managed equity funds that will write index call options. **Closed-end bond funds** in the pipeline include a flexible "Credit Opportunities" fund from Eaton Vance, Enhanced Government II from Merrill, and funds with possible high allocations to high yield securities from **BlackRock** and **Regions Morgan Keegan**.

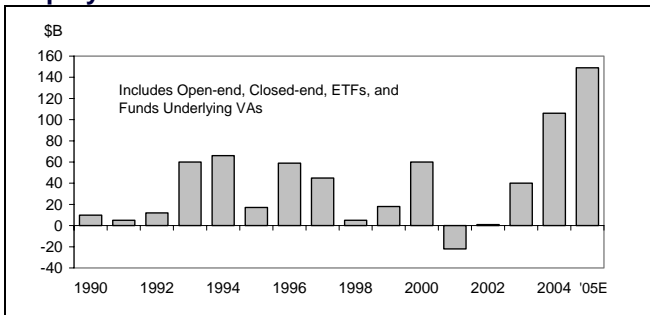
# International Funds



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**Net inflows to US-registered International / Global equity mutual funds are estimated to near \$150 billion this year, up some 40% from last year's record (stock / balanced open-end and closed-end funds, funds underlying variable annuities, and ETFs.) Assets in these international equity funds surged to eclipse \$1 trillion lately.**

## Flows to US-Based International and Global Equity/Balanced Mutual Funds



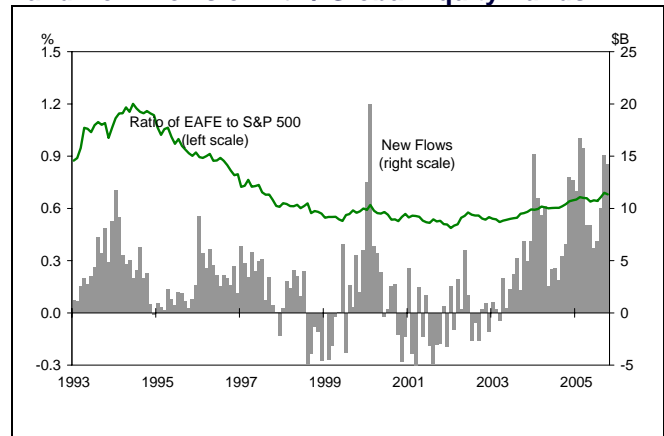
Source: Strategic Insight Simfund MF

## Opportunistic and Rational: High Demand To Persist

Surging international fund flows are driven in part by the **strong relative performance** of foreign stocks vs. US equities; such funds earned on average **33% over the past five years in total returns, vs. 11% for US-centered equity funds**, for example (such advantage also shows in trailing three and one year).

But **past (and future) sales gains** are also driven, importantly, by **increasing foreign allocation recommendations**; some are as high as 35%–50% of one's equity portfolio (for the fund industry in aggregate, the current allocation is just 18%). Thus, international fund **rebalancing would support high inflows for such funds for years, as they are structural in nature, somewhat independent of the near-term relative returns of foreign markets** (as well as discussion about dollar near-term valuations, Asian capital flows, relative P/Es, capital market correlations, meaning of \$525 per ounce of gold, etc.).

## Relative Performance of US vs. Foreign Stocks and New Flows of Int'l / Global Equity Funds



Sources: Strategic Insight Simfund MF, Standard & Poors

## International Fund Assets and Flows

Open-end, **actively managed international equity funds** accounted for **more than \$100 billion of 2005 inflows**, suggesting **expanding opportunities** for many investment companies. Diversified, multi cap growth-to-value styles gained the most; smaller cap, and regional funds, despite very large NAV gains, captured fewer new investments in aggregate.

### US Based Int'l / Global Equity Mutual Funds\*

	Assets \$B 10/05	Net New Flows \$B					2005E
		'00	'01	'02	'03	'04	
Open-End Active	800	45.4	-21.6	-0.9	27.3	71.6	103
Open-End Index	39	1.9	1.2	1.6	2.2	5.7	9
ETFs	53	0.7	1.3	3.8	5.7	15.3	19
Closed-End	24	0.0	0.0	0.0	0.3	4.4	7
VA Funds	103	12.1	-2.8	-3.3	4.8	9.2	11
	1,019	60.0	-22.0	1.0	40.3	106	149

\* Equity & Balanced Funds, Open-end, Closed-end, ETFs, VA Underlying Funds. Source: Strategic Insight Simfund MF

### Only Actively Managed Funds: 10 Largest Styles

	Assets \$B 10/05	Net New Flows \$B	
		YTD 10/05	Oct'05
International Multi-Cap Growth	149	13.5	1.4
International Multi-Cap Core	90	11.3	1.1
International Multi-Cap Value	71	16.6	1.2
Global Multi-Cap Value Funds	68	14.8	1.6
International Large-Cap Core	58	-4.1	-0.8
Emerging Markets Funds	56	8.0	0.7
Global Large-Cap Core Funds	47	-0.4	-0.1
Global Flexible Portfolio Funds	47	8.8	0.6
Global Large-Cap Value Funds	29	2.0	0.2
International Small/Mid-Cap Core	23	1.9	0.1

Sources: Strategic Insight Simfund MF, Lipper Inc.

# Assembled Advice



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The fund industry has witnessed in recent years an extraordinary increase in sales of “assembled” advice (multiple, diversified investment strategies within one investment vehicle), moving away from a too-often ill-fated dependence on the exciting “fund-du-jour” or the hottest investment style. Lessons from and post-bubble regrets, and, increasingly, compliance and liability concerns, have combined to trigger such a shift. Funds-of-funds (FoFs) and Lifecycle funds have been some of the biggest beneficiaries of such a transition, especially within DC plans, and thus are the focus of this article.

The two kinds of lifecycle funds—risk-based ones, which have a static allocation based on the investor’s risk tolerance, and target-date funds, which typically reallocate to become increasingly conservative as the target date nears—held combined assets of about \$180 billion at the end of October 2005. More than 85% of these assets reside within a FoF structure, wherein internally managed or subadvised funds are used to achieve asset allocation targets. The FoF design is even more common within the target-date variety, where virtually all series are composed of FoFs.

### Lifecycle Funds (Excludes Variable Annuities) All Investors (DC and Non-DC) \$ B

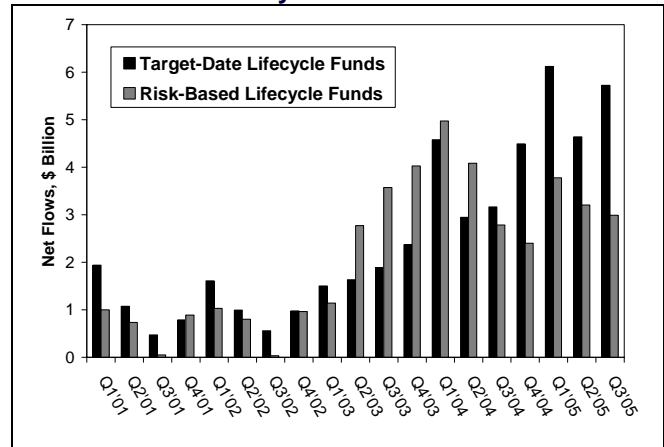
	Assets	Net Flows			
	10/05	2002	2003	2004	1-10/05
Target-Date	63.3	4.1	7.4	15.2	18.1
Risk-Based	117.6	2.8	11.5	14.2	10.9
<b>Total</b>	<b>180.9</b>	<b>7.0</b>	<b>18.9</b>	<b>29.4</b>	<b>29.0</b>

Source: Strategic Insight Simfund MF

Assets in the lifecycle category have nearly doubled since the end of 2003, and should continue to increase rapidly as these funds grow in importance in the Defined Contribution (DC) plan world. The percentage of DC plans that offer such funds on their investment menus has risen from 27% in 2000 to 39% in 2004 (Source: ICI), with this year showing further rapid gains. Participant adoption has also risen greatly (naturally, the percentage of overall plan assets invested in such funds may only slowly increase; these funds are positioned toward, and

more likely to be used by, novice and lower-balance participants).

### Net Flows Into Lifecycle Mutual Funds\*



\*All investors (DC ad non-DC); excludes variable annuities.

Source: Strategic Insight Simfund MF

Among plan providers and sponsors, target-date lifecycle funds are gaining favor over the risk-based ones, especially for less-engaged participants. Risk-based programs require participants at times to fill out questionnaires that help them “self-describe” their risk profile as aggressive, moderate or conservative etc., pick the appropriate fund, and take action to shift from one fund to another as their investing style changes. On the other hand, with target-date funds, participants need only choose the one that’s consistent with their expected retirement date. The growing body of behavioral finance research highlighting the need to set optimal default structure, and expanding acceptance of the behavioral approach has further shifted the focus toward the target-date area, which has seen at least 11 new providers enter the fray since 2004.

Compliance concerns could also favor target-date funds. The appropriate equity exposure among target-date funds, especially for older investors, varies across programs and could become an important differentiating theme.

### Largest Target-Date Lifecycle Fund Managers\* All Investors (DC and Non-DC) \$ B

	Assets	Net Flows		
	10/05	2003	2004	1-10/05
<b>Fidelity</b>	39.9	5.8	7.0	7.9
<b>Vanguard</b>	7.0	0.2	2.3	4.2
<b>T. Rowe Price</b>	6.7	0.5	2.8	2.9
<b>Princor</b>	3.1	0.5	0.8	1.3
<i>All Others</i>	6.6	0.4	2.2	1.8
<b>Total</b>	<b>63.3</b>	<b>7.4</b>	<b>15.2</b>	<b>18.1</b>

\*Excludes variable annuities. Source: Strategic Insight Simfund MF

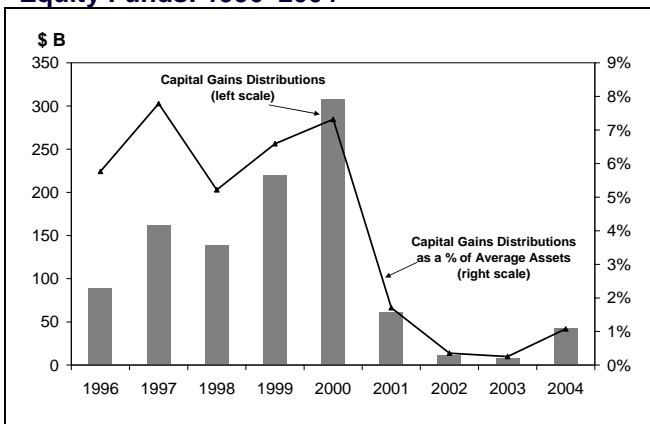
# Topic of the Month: Tax Managed Funds



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Among actively managed equity funds paying capital gains during October, the average payout ratio was 4.6% for international equity funds and 4.8% for US diversified funds (these ratios are asset weighted). Ratios among some large and visible funds were much higher than these averages. While October capital gain payments represented only a small group of funds, it is certain that capital gains distributions this year will be the highest since it peaked in 2000, before dropping off sharply during a lengthy period when realized capital losses shielded investors from the societal unfair burden of funds' capital gains taxation.

## Realized Capital Gains Distributions Equity Funds: 1996–2004



Source: ICI, Strategic Insight

Only a small share of equity fund shareholders is exposed to current taxes on capital gains distribution. With more than 60% of all equity fund assets in tax qualified accounts (e.g., IRAs, DC, VAs), and with some of the balance held by institutions (not individuals), **less than 30% of all equity fund assets held by individuals are affected by capital gains distributions.** Furthermore, some of these taxable investors reduce their exposure through the holding of index funds, ETFs, and tax-managed equity funds. This would suggest that only **roughly \$1 trillion of actively**

managed stock fund assets are held in individual taxable accounts.

Tax Managed Funds' Net Flows \$B					
	2001	2002	2003	2004	1-10/05
US	3.5	0.6	0.6	1.0	0.0
Int'l	0.7	0.9	1.0	1.9	0.9
Bond	1.1	0.5	0.9	-1.5	-0.4
<b>Total</b>	<b>5.3</b>	<b>2.0</b>	<b>2.4</b>	<b>1.3</b>	<b>0.5</b>

Source: Strategic Insight Simfund MF

## A Tax Managed Funds Rebound?

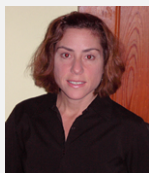
Inflows to dedicated tax managed funds, after peaking at \$10 billion in booming 1999, slowed steadily. Nevertheless, **in 2005 we counted 14 such funds with at least \$100 million of inflows** (led by institutionally oriented funds from DFA, AllianceBernstein, and Eaton Vance). Interestingly, **tax managed bond funds** (mostly Muni bond funds), which gained some traction during the recent falling cycle of interest rates (tax management sheltered some of the capital gains triggered by these declining rates) have been **redeeming lately**. Naturally, rising interest rates make these funds' advantages less attractive.

**Yet, tax managed equity funds may experienced a resurgence in coming months.** Reignited public discussion and awareness of tax-managed funds (and ETFs or index funds vs. tax-inefficient active funds), might be combined with a possible spiking interest in growth-style funds (a style used among many tax managed funds that underemphasize dividend income). This trend may suggest **a timely opportunity to emphasize tax-managed US and international equity funds in coming months. One area of focus could be the fast growing mutual fund wraps, where historically tax aware funds were underused.**

## Tax Managed Closed-End Funds Evolve

Tax management emerged as a closed-end fund theme in late 2003, when a new tax law greatly advanced the after-tax returns of qualified stock dividends. One tax managed closed-end fund raised \$1.3 billion in 2003. Then, in 2004, six such funds accumulated \$5 billion in their IPOs and subsequent leveraging. **So far in 2005, three tax-advantaged closed-end funds captured \$1.7 billion in their IPOs** (possibly, the short-term nature of option writing strategies popular among closed-end funds lately makes tax management strategies more complicated). Two more such funds from Eaton Vance are in registration.

## Inside FundFiling.Com



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### Disclosing Revenue Sharing

The Nov. 22, 2005 [NASD Member Alert](#) reminds NASD Members of their responsibilities regarding the sales of mutual fund shares and dealers agreements. *“Dealer agreements should adequately delineate the respective responsibilities of the parties in a manner reasonably designed to help ensure that the mutual fund sales and distribution process protects investors.”*

The on-going focus on fund management companies' relationships with distributions, including revenue sharing agreements, continues to be reflected in numerous refinements to SEC filed documents, as evidenced in a few recent filings, identified via SI's [www.FundFiling.com](http://www.FundFiling.com). [**Bolding are SI's**]

**Franklin Templeton** has added the following text to its funds, *“.. **compensate**...among other factors, **sales and assets levels, redemption rates and the level and/or type of marketing and educational activities provided by the dealer.** ... may include financial assistance to dealers that enable distributors to participate in and/or present at conferences or seminars, sales or training programs for invited registered representatives and other employees, client and investor events and other dealer-sponsored events.”*

**Morgan Stanley Advisors:** *“...may pay compensation, out of their own funds and not as an expense of the Fund, to Morgan Stanley DW and certain unaffiliated ... Intermediaries... in connection with the sale or retention of Fund shares and/or shareholder servicing. ... may pay additional compensation... for the purpose of promoting the sale*

*of Fund shares, maintaining share balances and/or for sub-accounting, administrative or shareholder processing services. Such payments are in addition to any distribution fees, service fees and/or transfer agency fees... payments may be based on factors, including level of sales (based on gross or net sales or some specified minimum sales or some other similar criteria related to sales of the Fund and/or some or all other Morgan Stanley Funds), amount of assets invested by the Intermediary's customers (which could include current or aged assets of the Fund and/or some or all other Morgan Stanley Funds), the Fund's advisory fees, some other agreed upon amount, or.. ... On Class D shares (other than shares held by participants in the Morgan Stanley Portfolio Architect...), ... annual fee of up to 0.05% of the average monthly net asset value of the Class D shares... On sales of Class A, B and C shares (except purchases through 401(k) platforms or shares... held by...) through Morgan Stanley DW's Mutual Fund Network: ...up to 0.11% of gross sales of Fund shares; and ... up to 0.03% of the total average monthly net asset value of such Fund shares in excess of \$9 billion.”*

**BlackRock:** *“Additional Payments may be made... in connection with the sale and distribution of Fund shares... the following Service Organizations are receiving such Additional Payments: Citigroup, Fidelity, Merrill Lynch, MetLife, UBS, Morgan Stanley, Linsco/Private Ledger and Wachovia Securities. The level of Additional Payments... normally will not exceed the sum of (a) 0.25% of such year's Fund sales by that Service Organization and (b) 0.12% of the assets attributable to that Service Organization invested in equity portfolios of the Fund and 0.11% of the assets attributable to that Service Organization invested in fixed-income portfolios of the Fund”*

**Lord Abbett** got specific with its revenue sharing language by adding a range from 0.02% to 0.10% of assets.

**(For full disclosure language on these revenue sharing modifications, and others, please contact the FundFiling.com team.)**

# Fees & Expenses



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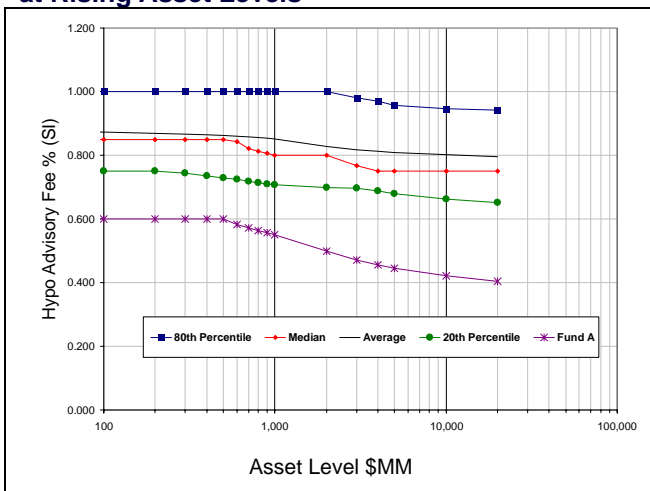
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Economies of scale shared with investors through advisory fee breakpoints (or other fee reduction arrangements) remains at the core of management companies' advisory fee considerations. Fee benchmarking for international funds can be even more complicated, with their higher costs and complexity of investment management, small portfolio size at times, the incidence of many small accounts (due to opportunistic one-time purchases and no follow-up investments), and their resultant high TA fee ratios, and higher custodian fees, to name a few.

## World Stock Funds' Advisory Fees

World Stock funds is one of the largest and fastest growing international segments (\$184 billion as of 10/05 and nearly \$15 billion of inflows this year). To illustrate the category fee ranges, we replicated a frequently requested analytic capturing an advisory fee breakpoint schedule in comparison to peers.

### World Stock Funds (Morningstar Category) Hypothetical Contractual Advisory Fee Ratios at Rising Asset Levels



Source: Strategic Insight Simfund MF

The very low fee structure of the largest fund in this Morningstar peer group—American Funds' Capital World Growth & Income—is captured above as Fund A.

### CHART EXPLAINED

Fees of all funds (with asset-based advisory fees) are included. For rising asset levels, the chart captures a median/average value of advisory fee ratios, high (80%) and low (20%) markers, and the relative position of a specific fund. A descending line equates to a lower contractual advisory fee due to the usage of breakpoints.

The Hypothetical Advisory Fee Ratio (y-axis) at rising Asset Levels (x-axis) is calculated using the current contractual advisory schedules of each fund in the Subject Fund's Morningstar Category.

SI is sometimes asked to narrow a peer group (e.g., only bank-sponsored funds, only a sub-advised peer funds' universe, only funds from retail-focused fund managers, etc.).

Lastly, for each investment strategy, the graph depicted above captures the size where economies of scale start to become meaningful, and a declining slope of advisory fee becomes more common (smaller cap, sector investing, and selected international styles would naturally trigger lower effective fees at higher asset levels than US Large Cap Core funds, for example).

Data behind the graphics presented above is often supplemented based on the newest advisory fee schedule filings (identified through SI's search engine FundFiling.com), which allows more accurate and timely peer fund data (a particular theme within our 15(c) assignments). This year, for example, we note 27 changes of advisory fee schedules within the World Stock category filed with the SEC.

### World Stock Funds (Morningstar Category) Fee-Related Changes Filed With the SEC in 2005

Change Type	No. of Funds	% of All Changes
Advisory Schedule	27	32%
Advisory Fee Waiver	19	22%
12b-1 and Shareholder Service Fee	16	19%
Sub-Advisory Schedule	9	11%
Sub-Advisory Fee Waiver	3	4%
Total / Other Expense Cap	11	13%

Source: [www.FundFiling.com/](http://www.FundFiling.com/) Daily Changes Section

# 15(c)



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## Contractual Advisory Fee Structures among Funds

- **Roughly 85% of open-end mutual funds** (controlling about 70% of fund assets) **charge an advisory fee based solely on fund assets** (the remaining 15% of funds incorporate a variety of contractual advisory fee structures such as performance-based fees, unified-fees (all-inclusive), total assets of management company / group fees, etc.).
- **Approximately two-thirds of such advisory fee based funds are structured with flat** (no breakpoint) advisory fees (of course, a much smaller percentage of assets resides in these funds, as suggested below). And, among the one-third of advisory fee based funds that do have break points, about half were too small to trigger their first breakpoint.

### Open-End Mutual Funds Assets—October 2005

Fund Type	Asset-Based Advisory Fee Structure		
	Flat Fee Structure	Breakpoint Fee Structure	Other Fee Structure
Domestic Equity	23%	37%	39%
Int'l Equity	31%	48%	21%
Tax-Free Bond	19%	47%	34%
Taxable Bond	40%	29%	30%
Taxable Mny Mrkt	58%	24%	18%
Tax-Free Mny Mkt	45%	25%	30%

Source: Strategic Insight Simfund MF

Many large funds, as suggested in the following table, are structured only with flat fees. This was most evidenced among money market funds. Clearly, many such large funds (and smaller ones) implement non-contractual fee waivers as a way to reduce shareholders' costs.

### Funds with Average Net Assets Over \$1 Billion Fiscal Year-End 2004

Fund Type	Flat Fee Structure	Breakpoint Fee Structure
Domestic Equity	41%	59%
International Equity	46%	54%
Tax-Free Bond	23%	77%
Taxable Bond	46%	54%
Taxable Money Market	65%	35%
Tax-Free Money Market	56%	44%

Source: Strategic Insight Simfund MF

## Realizing Scale Economies

- Investment management companies employ a range of strategies to deliver the benefits of economies of scale to shareholders. Beyond advisory fee breakpoints, many funds use non-contractual fee waivers.
- **Approximately 58% of fund assets had an advisory fee waiver during fiscal year 2004.**

### Funds with Average Net Assets Under \$250 Million—Fiscal Year-End 2004

Fund Type	Advisory Fee Waiver	Advisory Fee Recoupment	No Advisory Fee Waiver
Domestic Equity	53%	2%	45%
Int'l Equity	57%	1%	42%
Tax-Free Bond	54%	0%	46%
Taxable Bond	65%	1%	34%
Taxable Mny Mrkt	77%	0%	23%
Tax-Free Mny Mkt	77%	0%	23%

Source: Strategic Insight Simfund MF

- **The median domestic equity advisory fee waiver last year was 15.5 basis points.**

Most common type of non-contractual approaches:

- **Total Expense Cap**—the advisor agrees to waive its fees to the extent that the total expense ratio of the fund exceeds a set percent of average assets.
- **Total Expense Cap with Recoupment**—the advisor is allowed to recapture any fees waived in prior fiscal periods (typically a specified number of periods), within expense cap constraints.
- **“Scheduled” Total Expense Cap**—allows the cap to be set at different levels for different asset sizes.
- **Relative Expense Cap**—an expense cap at current fee ratios, not a predetermined amount.

## Contractual Advisory Fee Changes

Our preliminary analysis of contractual advisory fee changes suggests that such modification activity may have peaked in 2004 at about 7% of all fund assets, with 2005 witnessing a somewhat slower pace.

# Board Talk



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Selected topics commonly discussed by fund boards were analyzed in *Mutual Funds Insight* ([www.MutualFundInsight.com](http://www.MutualFundInsight.com)), SI's educational service for fund directors. In this issue we share a few observations from our 2005 published studies.

## 12b-1 Fees at "Closed" Funds

The appropriateness of 12b-1 fees among funds closed to new investors has been questioned increasingly as of late.

Our study identified 191 funds closed to new investors. Of those, only 16 also filed for changes in their 12b-1 fee lately, with all such filings set to reduce 12b-1 fees from a fee ratio of 0.30% or 0.35% (class A) to the more common 0.25% fee ratios typical of service fees. Even among "closed" funds, 12b-1 fees for certain share classes have not changed—e.g., 'B' or 'C' share classes, where 12b-1 fees need to continuously be paid to financial advisors or to amortize previously occurring distribution costs (*"The Use of 12b-1 Fees Among Funds 'Closed' to New Investors," MFI 2005 No. 17. The study is also posted on the Executive Insights section of sionline.com.*)

## Board Compensation at Small Fund Managers

Our examination of 17 fund complexes (\$1 billion–\$30 billion in stock and bond mutual fund assets, no more than 15 funds) found that, for a non-interested director / trustee, median total compensation per fund was \$10,750; median total compensation per complex was \$42,500. Within our peer group, the median annual retainer fee was \$30,000, the median in-person meeting fee was \$2,500, and the median committee chairman fee was \$4,250 (*see MFI 2005 No. 15*).

Our study also found that, of the 17 fund complexes:

- Thirteen had a majority of the directors / trustees owning greater than \$100,000 in fund shares;
- Nearly 65% have a nominating committee; and
- Nearly half have a valuation committee.

## Sarbox Ups Audit Disclosures

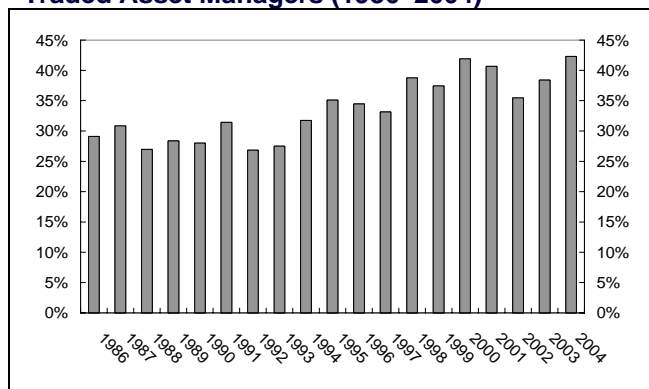
The Sarbanes-Oxley Act of 2002 prohibits public accounting firms from providing non-audit services to an issuer at the time of the audit, other than certain permitted services and provided these exceptions are disclosed to investors.

Our review of mutual funds' annual reports indicates that accounting firms continue to provide non-audit related services for some management firms. In our sample, non-audit fees averaged 18% of total audit and non-audit fees. No fund manager in our sample reported non-audit fees exceeding one-third of total fees paid to its accounting firm (*see MFI 2005 No. 16*).

## Management Company Profitability

Fourteen large management companies surveyed by Strategic Insight saw pre-tax operating margins hit an aggregate 42% of asset management revenues in 2004, a new 20-year high. The lowest profitability ratio among the public companies was 26% (*see MFI 2005 No. 19*).

### Median Pre-Tax Operating Margin for Publicly Traded Asset Managers (1986–2004)



Source: Company reports, Strategic Insight.

All but one of the 14 Public Companies experienced revenue growth in 2004's expanding fee environment and all but one saw its operating expenses rise in 2004.

### Asset Managers' Composite Annual Revenue and Expense Growth Rates

	2001	2002	2003	2004
<b>Fee Revenue Growth</b>	-3%	-6%	2%	17%
<b>Operating Expenses</b>	3%	-2%	0%	15%

Source: Company reports, Strategic Insight

# Global FlowWatch



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Investors around the world contributed more than €480 billion of net flows to mutual funds (excluding money market programs) in 2005 through September (**SI Global now tracks aggregate monthly fund flows for 25 of the largest capital markets around the world and monthly trends among more than 30,000 funds in Europe**). More than €160 billion was put in during the third quarter, reflecting increasing use of mutual funds by both retail and institutional investors, institutional switching activity, and lately in Europe by Swiss fund groups, new introductions of Sicav Part II funds outside the scope of the European Savings Directive. Net flows through September already match 2004 full-year results. Global mutual fund inflows could top €720 billion in 2005, by our estimate.

## Global Fund Flow Highlights

### Global Mutual Fund Net Flows January-September 2005, (€ Billion)

	Equity/ Balanced	Bond	Other	Subtotal Long-Term	Money- Market	Total
Europe	100	118	31	252	48	301
US*	150	33	-	183	-23	160
Asia	14	13	6	33	13	46
<b>World</b>	<b>267</b>	<b>174</b>	<b>37</b>	<b>481</b>	<b>38</b>	<b>519</b>

*US data includes open-end and closed-end fund flows estimated by Strategic Insight, plus variable annuities and other funds tracked by the ICI. Source: Strategic Insight, using converted 12-month average exchange rates through latest month.*

**Europe-domiciled funds so far gathered 60% of global net inflows, almost twice as high as US-based funds, and with positive flows for each asset class. Funds domiciled in Luxembourg and Dublin accounted for half of all net gains across Europe, in both roundtrip and cross-border products.** Yet, some of the large domestic markets added between €15 billion and €30 billion each as well, including Germany, France, Italy, Spain, and Scandinavia. Looking at the market share of the largest five fund distributors in terms of assets in selected markets, while in Germany and Scandinavia that number is still around 75%, for the other large markets it ranges from 28% in the UK to

60% in Japan, and has been coming down in recent years.

**Equity/balanced fund net contributions in the US totaled €150 billion, accounting for 80% of total flows in the US. Aggregate inflows in Asia reached €46 billion through September, mostly to long-term funds in Japan. Equity funds in India also gathered notable flows.** Total equity mutual fund assets in India have almost doubled in the past nine months, from \$9 billion in December 2004 to \$16 billion as of September 2005, and foreign managers are benefiting through India-domiciled funds such as Fidelity Equity Fund Growth Option and Franklin India Flexi Cap Fund Growth Plan.

## Europe Fund Flow Highlights

**Flows to Luxembourg- and Dublin-domiciled funds, which are sold on a cross-border basis, have been increasing in recent years.** Luxembourg and Dublin long-term investment funds (excluding money market funds and round-trip funds domiciled in Luxembourg or Dublin and sold back into countries such as Germany, Italy and Switzerland) accounted for 51% of all European flows to long-term mutual funds YTD.

### Europe Mutual Fund Net Flows January-September 2005, (€ Billion)

	Equity/ Balanced	Bond	Other*	Money- Market	Total
<b>Europe Total</b>	<b>100.2</b>	<b>118.0</b>	<b>30.6</b>	<b>48.3</b>	<b>300.7</b>
Luxembourg	48.9	49.2	10.3	11.9	120.2
Dublin	10.8	9.5	2.1	4.7	27.1
France	14.3	4.6	6.3	36.6	61.8
Germany	3.5	24.3	1.2	11.0	40.0
Denmark	10.5	5.3	-	-	15.8
Spain (Inverco)	4.2	7.2	4.9	-2.2	14.0
U.K. (IMA)	3.4	6.0	-	0.6	10.0
Italy (Assogestioni)	-5.2	14.3	7.7	-8.7	8.1
Sweden (Fond.Förening)	3.8	1.3	1.5	1.4	7.9
Finland (IRF)**	1.2	2.4	0.4	2.7	6.8
Norway (Verdi. Forening)	1.3	0.3	-	0.5	2.1
Switzerland (SFA)	2.3	3.3	1.1	-6.5	0.1
Greece (AGII)	-0.9	4.5	-	-10.0	-6.4

*Data for European countries excludes funds not reported to the local industry associations.*

*\*\*"Other" includes mostly guaranteed, real estate, and hedge funds in Luxembourg/Dublin; guaranteed funds in France and Spain; real estate and hedge funds in Germany and Switzerland; flexible and hedge funds in Italy.*

*\*\*Data through 08/2005*

*(a) Europe total does not equal sum of individual countries, as numbers have been adjusted for double counting;(b) Luxembourg net flows estimated by Strategic Insight based on data from Lipper Inc.'s Hindsight, and ALFI/CSSF data;(c) Dublin domiciled fund net flows estimated by Strategic Insight based on data from Lipper Inc.'s Hindsight;(d) Germany data excludes Spezialfonds. Flows converted into € using 12-month average exchange rates through latest month for Non-Euro-Zone countries. Source: Strategic Insight, Industry Associations, Lipper Inc., and EuroPerformance (France).*

Flows to offshore-domiciled funds mostly went to flagship equity funds of well-known asset managers such as Templeton, Capital International, and Fidelity. Popular fund introductions included absolute return and total return vehicles, guaranteed funds, diversified funds-of-funds, and other asset-allocation programs.

# Global Horizons



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In the wake of the UCITS III regulations in Europe, some mutual fund management companies are launching investment products that implement derivatives-based portfolios, further blurring the lines between “traditional” and “alternative” investment management. They include long/short vehicles, as well as other products that make use of derivatives, such as commodities funds and investment strategies based on overlays or portable alpha, and “absolute return” funds.

## Some Recent Alternative Mutual Funds Using Derivatives

One example is the **Merrill Lynch UK Absolute Alpha Fund**, a UK unit trust introduced in May that pursues long investments in equity but also allows “synthetic” short selling, aiming for a positive absolute return. The fund is not managed against any UK equity index. The positions taken by the fund will mainly be achieved by investing in Contracts for Difference (CFDs). In addition to synthetic short positions, the fund’s marketing and product literature mentions pair trades and the ability to invest up to 100% in cash as principal strategies. Some in the media have described the fund as a “cash plus” fund.

### Merrill Lynch UK Absolute Alpha Fund

<b>Source of return:</b>	Long equity
<b>Source of “absolute” return:</b>	Synthetic short selling + pair trading
<b>Investment vehicles:</b>	Contracts for Difference
<b>Leverage:</b>	No
<b>Risk monitoring:</b>	Yes – VaR
<b>Minimum investment:</b>	£10,000
<b>Distribution pattern:</b>	Financial advisors
<b>Management fee:</b>	1.75%
<b>AUM (as of October 2005)</b>	£25 million

Although the fund may be innovative and distinctive, those qualities have yet to translate the offering as a marketing success. Through October, the UK Absolute Alpha Fund had collected only £25 million in assets, a small amount even in the context of overall UK fund industry flows, which are low, compared to the rest of Europe.

Another “cash plus” fund that was heavily marketed earlier in the year is the **DWS RateBuster Fund**, a UK OEIC launched in April that collected in excess of £60 million in assets. An enhanced income fund targeting an annual return of 7.75%, Ratebuster invested in a range of deposit-based investments whose income provided the capital that was then invested in currency and bond markets through an alpha overlay portfolio using five currency and bond investment teams within Deutsche Asset Management. Although this fund also appeared distinctive at offer, in September it was announced that it would be liquidated in April 2006, following the transfer of Deutsche’s UK business to Aberdeen.

Nevertheless, other funds with derivatives-based strategies have found success in Europe. For instance, UBS has been very active in offering new derivatives-based products including **UBS Absolute Return Bond Fund** (using derivatives to actively manage duration of a diversified portfolio of bonds), followed up with the launch of **UBS Absolute Return Plus Fund** and **UBS Absolute Return Medium**. Other successful examples include funds from **Credit Suisse**, **Julius Baer**, and **Baring**. For further details please refer to our original study, *Fund alternatives, Risk management, and Commodity Investments*, published in June 2005.

Europe is not the only market where we are seeing such innovative products. In the US, the **UBS Dynamic Alpha** fund seeks an absolute return outpacing inflation regardless of market conditions, through global tactical asset allocation (GTAA). The fund adjusts its exposure to international stock, bond, and currency markets (beta), separately from the choice of individual securities (alpha). Introduced in January, the UBS Dynamic Alpha fund’s assets exceeded \$1.2 billion in October. See our report, *The Search for Alpha*, which provides details about GTAA and investment strategies involving the separation of alpha and beta.

# Variable Annuities



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## VA Business Net Flows Driven by Living Benefits, Funds-of-Funds

As is the case elsewhere in the fund industry, variable funds-of-funds are drawing in significant amounts of new cash: about \$1.4 billion in October and **\$17 billion year-to-date**. Assets in such FoFs have surged to nearly \$58 billion, up 38% from \$42 billion at year-end 2004.

Beyond the financial industry-wide focus on “assembled advice,” a specific driver of FoF growth within VAs has been the **requirement of many insurers that buyers of living benefit features invest only through FoFs** (to reduce the probability of a dramatic reduction in account value due to extreme concentration of investments in only one sector and subsequent poor stock market performance).

As of late, the VA feature with strongest demand has been the lifetime Guaranteed Minimum Withdrawal Benefit (GMWB). As researched and detailed on SI’s [www.AnnuityInsight.com](http://www.AnnuityInsight.com), 16 new or revised versions have been filed since July.

The five leading insurers gaining in net flows this year through October, as found by Simfund VA, either already have this feature, will be offering it soon, or have another very competitive benefit rider:

- **John Hancock** (Manulife) gained nearly \$1.4 billion in Q3 inflows, due to its lifetime GMWB, Principal Plus for Life, one of the most competitive out there;

- **AXA/Equitable**—much of its high sales are due to its Guaranteed Minimum Income Benefit (GMIB), but it will soon be rolling out a lifetime GMWB;
- **ING**—a mainstay in living benefit sales weighed in with a lifetime GMWB in November;
- **Lincoln National**—recent results fueled by i4LIFE *Advantage*, a variable annuitization feature with ample liquidity and guarantee provisions, now with more than \$1 billion in assets under management; and
- **Pacific Life**—rolled out its own lifetime GMWB in October.

## VA Int’l Equity Fund Flows Expand

As we observed elsewhere, international equity funds also show gains within variable insurance programs, with investors becoming more and more comfortable with such diversification. We do note, though, that international fund flow trends within this space grew at a somewhat slower pace than elsewhere in the industry during 2005.

### Int’l Equity Variable Fund Net Flows / Assets \$MM

Top M’str Categories	Ytd-10/05	Assets 10/05
Foreign Large Blend	3,751	<b>33,638</b>
World Stock	1,094	<b>31,930</b>
Foreign Large Value	1,339	<b>9,027</b>
Foreign Large Growth	651	<b>8,978</b>
Emerging Markets	1,442	<b>6,514</b>
Other Int’l Equity Funds	760	<b>12,533</b>
<b>Total Int’l Equity Funds</b>	<b>9,036</b>	<b>102,619</b>

Source: Strategic Insight Simfund VA

This year, fund families rapidly expanding their managed variable insurance fund assets include **Capital Group** (\$8.5 billion in net inflows year-to-date through October), **Franklin Resources** (\$4.1 billion) and **Morgan Stanley/Van Kampen** (\$1.9 billion). Gains within these managers’ international funds contributed to these overall inflows. Other investment managers with gains within their international equity funds were **Mellon, OppenheimerFunds, Alliance, Merrill Lynch, Harris Associates, JP Morgan, and Julius Baer**, to name a few.

## Guest Column



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*Matt Fink is the immediate past President of the Investment Company Institute. He is an independent director of the Oppenheimer Funds and guest lectures at law and business schools on the history of the investment company industry. Strategic Insight is grateful to Mr. Fink for the following article, which first appeared, in slightly different form, in the Fall 2005 issue of Financial History magazine, published by the Museum of American Finance.*

### Seventy Years Ago: A Regulatory Foundation Is Created

The year was 1935 and the leaders of the nation's investment companies were not a happy group. The country remained mired in depression and the stock market, though improving, was still well below its 1929 highs.

The predominant investment companies, closed-end funds, had been the darlings of the bull market of the 1920s, when their shares traded at large premiums over the actual values of their portfolios. Now they were villains, accused by some of having caused the 1929 crash by dumping securities into a falling market. Works like John T. Flynn's *Investment Trusts Gone Wrong!* excoriated closed-end funds. The steep decline in the stock market, exacerbated by closed-end funds' use of leverage, took a terrible toll on the value of the funds' portfolios. Total closed-end assets plummeted from more than \$2.6 billion in 1929 to \$765 million in 1932. And the funds' own shares moved from large premiums to deep discounts. From September 5, 1929 through October 5, 1932, American International Corp. fell from 84 to a low of 6, Goldman Sachs Trading Corp. from 110 to 2 ½, and US & Foreign Securities Corp. from 64 ½ to 1 ⅞.

The smaller boys on the block, mutual funds, introduced in 1924, also were hit hard by the bear market. Total mutual fund assets fell from \$140 million in 1929 to \$75 million in 1932. From September 30, 1929 through 1931, Massachusetts Investors Trust fell from 55 to 16, State Street Investment Corporation from 140 to 44 and Incorporated Investors from 67 to

17. But these declines were not as steep as those of closed-end funds. One reason was that, instead of trading at premiums or discounts, mutual fund shares were redeemable—a shareholder could put her shares back to the fund and receive a price based on the current value of the fund's portfolio.

The public was outraged by the losses they had suffered and the abuses that had been revealed. The Senate Banking Committee called for stringent federal regulation of investment companies. Others, like Frank A. Vanderlip, former president of National City Bank and author of *Tomorrow's Money*, wanted to go further and prohibit investment banks from managing investment companies. And others, like Bernie Winkelman, author of *Ten Years of Wall Street*, wanted to go even further and outlaw "every set-up which embraces the investment trust idea." In 1935, Congress put the ball in motion when it directed the Securities and Exchange Commission to study the industry and submit recommendations to Congress.

The leaders of the investment company industry could see that a major legislative battle was on the horizon.

### The Revenue Act of 1936

One bright spot for investment companies was the tax area. The federal income tax law provided a 100% exclusion for dividends received by one corporation from another corporation. Therefore, investment companies did not pay tax on dividends they received from corporations in which they invested.

But in June of 1935, President Franklin Delano Roosevelt proposed taxing inter-corporate dividends. In his message FDR stated that there might be an exemption for investment companies that submitted to "public regulation" and offered "small investors...the benefit of diversification."

Congress proceeded to reduce the inter-corporate dividend exclusion from 100% to 90%, and then to 85%, but did not, as FDR had mentioned, provide an exemption for investment companies. Therefore, investment companies became subject to tax on a portion of the dividends they received, and thus fund shareholders bore a tax burden that was not imposed on them if they held securities directly.

Investment companies feared that they would be taxed out of existence.

Then in March 1936, President Roosevelt proposed an entirely new tax scheme aimed at taxing undistributed corporate profits: corporate tax rates would be increased but there would be a full deduction for

dividends paid to shareholders. Corporate America and the financial community rose in vehement opposition to the proposal for fear it would pressure corporations to distribute all of their earnings.

But, in the words of Merrill Griswold, head of Massachusetts Investors Trust, the first mutual fund, mutual fund leaders saw the President's proposal as a "godsend" that could solve their tax problem. The President's proposal would tax only undistributed profits. Because mutual funds typically paid out all of their income to shareholders, the funds would not have any tax liability.

Griswold developed a theory under which an investment company is regarded as a mere "conduit" between fund shareholders and the securities in which the fund invests. Under this theory, the fund is ignored for tax purposes and fund shareholders are treated as though they own the securities directly. Griswold, Paul Cabot of State Street Investment Trust, and Tudor Gardiner of Incorporated Investors met with one of their Senators, David Walsh, a member of the Senate Finance Committee, to discuss a statutory exemption for mutual funds based on the "conduit theory." They then met in Washington with other members of Congress and officials in the Bureau of Internal Revenue and the Treasury Department.

On June 3, they saw President Roosevelt. Just as they entered the Oval Office, the President received an urgent phone call. When the 10-minute call ended, an aide entered the room to say the meeting was over because the President's next visitor had arrived. Cabot could not contain himself and blurted out: "Mr. President, this is a damned outrage. We've come all the way down from Boston on a very important matter and we haven't had a word with you." The President laughed and asked what the group wanted to discuss. They explained that, unlike most business leaders, they supported his proposed tax on undistributed profits. FDR was delighted and told an assistant: "Try to take care of these gentlemen."

The result of these efforts by the three mutual fund leaders was the Revenue Act of 1936, which provided that if a mutual fund met a number of tests, the fund would be exempt from tax and shareholders would be taxed on distributions they receive, thus putting fund shareholders on a par with direct investors in securities.

A number of the tests were of the type one would expect to find in a tax law. The Act sought to insure that a mutual fund would be an investment company, rather than an operating company, by mandating that it derive at least 95% of its income from dividends,

interest and gains on the sale of securities. To guarantee that fund shareholders would pay tax, the Act required that the fund distribute at least 90% of its income to shareholders as taxable dividends during the current year.

But the 1936 Act also contained tests that reflected New Deal regulatory concerns. *The Wall Street Journal* reported that "the law...seems to show what the New Deal wants in such [investment] corporations."

As indicated in President Roosevelt's 1935 message on inter-corporate dividends, one thing that the New Deal wanted was to provide small investors with the ability to diversify. Therefore the 1936 Act required that no more than 5% of the fund's assets could be invested in any one corporation.

As Griswold later wrote, the New Deal also wanted to "protect investors against speculative activities." Therefore the 1936 Act provided that not more than 30% of a fund's gross income could be derived from gains from the sale of securities held for less than three months.

Finally, Griswold stated that the New Deal "wished to prevent an investment company's acquiring control of companies in which it invested." Therefore, the 1936 Act provided that a fund could not own more than 10% of the stock of any corporation.

Thus, through the imposition of various tests, the 1936 Act was the first federal law to regulate mutual funds' activities, not simply in furtherance of tax policy, but also in order to address investor protection and economic concerns.

### **The Investment Company Act of 1940**

While the mutual fund tax issue was being resolved, the SEC continued work on its study of the industry, which was completed in early 1940. On March 14, a bill of more than 100 pages drafted by the SEC was introduced in both houses of Congress.

It seemed unlikely that closed-end funds and mutual funds would be able to put aside their long-standing rivalry and work together on the legislation. *Business Week* of May 1, 1940 reported: "Basic is the fact that the open-end and closed-end trusts have anything but identical interests....In fact, they went to Washington in two groups and stopped at different hotels. They were represented by different lawyers and had retained separate public relations counsel."

But the press also was unanimous in predicting that the bill was unlikely to be enacted into law, principally due to the expectation of strong industry opposition. The

headline in the March 18 edition of *Barron's* declared: "Investment Trust Law Unlikely This Year" and the story stated: "The bill's best chance of enactment lay in the possibility that the SEC and the investment trusts could agree on a bill which would provoke no controversy. The bill...made this possibility a thin one." Similarly, *The New York Times* of March 24 reported that "chances of passage of the bill in this session are said to be very slight."

Predictions grew even more pessimistic after the Senate concluded hearings. On April 27, *The Wall Street Journal's* story began: "Enactment of legislation for federal regulation of investment trusts is no longer considered as even a fair prospect."

It appears likely that had the industry opposed Congressional action, legislation would not have been enacted. By 1940, the New Deal had run out of steam, the SEC was under attack, the nation was focused on American defense preparedness and even supporters of legislation believed that the SEC's bill had gone too far.

Robert Taft, a leading Republican Senator, advised the industry to hang tough and not even to negotiate with the bill's sponsors: "If you think you can sit down with those Democratic bastards and get anywhere, well you're nuts."

But the investment company industry surprised Senator Taft, the press and other observers and worked aggressively for the enactment of legislation.

Why did an industry that apparently could have defeated legislation subjecting its members to stringent regulation instead seek its enactment?

The explanation is fairly clear in the case of the smaller segment of the industry, mutual funds. Mutual fund leaders long had been concerned about abuses. Paul Cabot had written a landmark article on problems in the industry before the 1929 crash. Mutual funds viewed federal regulation as a way to address abuse and restore public confidence. Mutual funds already were subject to a degree of federal regulation under the Revenue Act of 1936. Mutual funds became even more comfortable with legislation when the bill was revised to remove or modify provisions they found most objectionable, such as limits on size, segregation of management and sales functions and preventing an individual from organizing more than one fund. Massachusetts Investors Trust reported that the 1940 Act called for "very few changes in the business methods of our Company." In short, mutual funds had much to gain, and little to lose, by enactment of the revised bill into law.

The situation of closed-end funds was more complex. On the one hand, closed-end funds, like mutual funds, wanted to end abuse and saw federal regulation as a way to restore public confidence. But on the other hand, the proposed legislation focused heavily on closed-end funds, because that was the part of the industry where most abuses had occurred. When the SEC presented its bill to Congress, an estimated 80% of the SEC's testimony was devoted to closed-end funds. Weighing these factors, it is by no means clear why closed-end funds should have concluded that it was in their best interests to support legislation.

But there was an additional factor that helped lead closed-end funds to back legislation—the need for closed-end funds to become subject to "public regulation," in order to obtain special tax treatment.

Since the 1936 Act granted special tax treatment solely to mutual funds, closed-end funds found themselves at a disadvantage not only versus direct investors in securities, but also versus their long-standing rivals, mutual funds. And mutual funds, which had amounted to only 5% of managed investment company assets in 1929, were gaining an ever-increasing share, growing to 25% in 1936 and to 40% in 1940. Closed-end funds were convinced that a major factor contributing to this trend was the disparity in tax treatment. Closed-end funds concluded it was essential that they obtain special tax treatment. A closed-end witness at the Senate hearings declared: "The future tax treatment for closed-end investment trusts is most important."

Closed-end funds realized that, to obtain tax parity with mutual funds, they, like mutual funds, would have to become subject to "public regulation," and that the 1940 Act offered a vehicle to accomplish this result. Closed-end funds adopted a two-step strategy—first regulation via enactment of the 1940 Act and then tax relief. A closed-end witness at the Senate hearings stated: "We urge that the basis for this taxation be laid in this bill." Similarly a closed-end witness told the House committee: "we are very hopeful that with the passage of this bill and with these companies placed under regulation the Treasury will see fit to go into this problem."

Closed-end funds undertook a series of steps to implement their strategy. First, they put aside their rivalry with mutual funds, and the two groups formed a joint task force to work on the legislation. Second, closed-end funds obtained SEC support for their two-step approach. David Schenker, Chief Counsel of the SEC study, testified: "We... feel that if closed-end funds are supervised by a governmental agency...there

is absolutely no reason for that [tax] discrimination.” Third, closed-end funds urged that the Senate and House committee reports accompanying the legislation spell out the need for extending special tax treatment to closed-end funds.

With both mutual funds and closed-end funds supporting legislation, the two industries acted in concert to obtain enactment. First, closed-end and mutual fund witnesses testified in strong support of reform legislation while stressing specific defects in the SEC’s bill. Next, the joint industry task force prepared a detailed outline of suggestions for legislation within the structure of the original bill. Then the SEC and the industry task force reached agreement on the framework for a revised bill. The very first page of the SEC-industry framework stated:

The Commission and the Industry unite in the earnest suggestion to the Senate Committee that it call attention to the tax problem and to the desirability of providing special tax treatment not merely for certain classes of open-end investment companies as under the present law, but for closed-end investment companies as well.

The SEC-industry framework was used as the basis for a new bill that was reported out by the Senate and House committees, with the report of the Senate Committee on Banking and Currency stating:

Representatives of the Securities and Exchange Commission and of the industry ... called ... attention to the serious tax problem affecting investment companies. It appears that the nature of these companies in many respects, constituting a conduit for distribution of income to the smaller investor, is such that they should not be subjected to the same type of taxation as the ordinary business

corporation. This has already been recognized in respect of certain classes of open-end companies which receive special tax treatment under existing Federal tax laws. The record before the committee indicates that the tax problem is acute with respect to closed-end companies of the type classified in this bill as ‘diversified.’ If this bill is passed, the committee believes that the tax problem of these companies should receive prompt consideration. [The report of the House Committee on Interstate and Foreign Commerce contained similar language.]

The new bill was passed by both houses, and the Investment Company Act was signed into law by President Roosevelt on August 23, 1940.

And, as closed-end funds had hoped, the next major tax law, the Revenue Act of 1942, extended special tax treatment to closed-end funds.

## Conclusion

The Revenue Act of 1936 was the most important event in the history of the mutual fund industry:

- The 1936 Act accorded special tax treatment to mutual funds, putting fund shareholders on a par with direct investors in securities;
- It was the first time the federal government subjected mutual funds to regulation in the interest of investors; and
- Ironically, the 1936 Act’s failure to provide special tax treatment to closed-end funds helped lead to enactment of the Investment Company Act of 1940, the federal law that governs the structure and day-to-day operations of investment companies and that has played a critical role in the industry’s success over the past 65 years.

# Tools Time



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The new version of Simfund (**Version 4.0**) allows you to easily generate **Total Return Floating Graphs**. The Graph and the underlying data for each of the funds within the entire peer universe are exported to an Excel file; thus, **each fund can be highlighted and plotted**.

For a peer group, you can select **Morningstar Categories**, **S&P Style**, and, for the **Lipper Module** subscribers, **Lipper Classifications (official return data of each of these three firms is now available in Simfund)**. You may also **combine a specific fund outside the peer group** (to assess its relative ranking within such a peer group). Several time periods are available to choose from; trailing return periods and, for some data items, rolling periods can be selected.

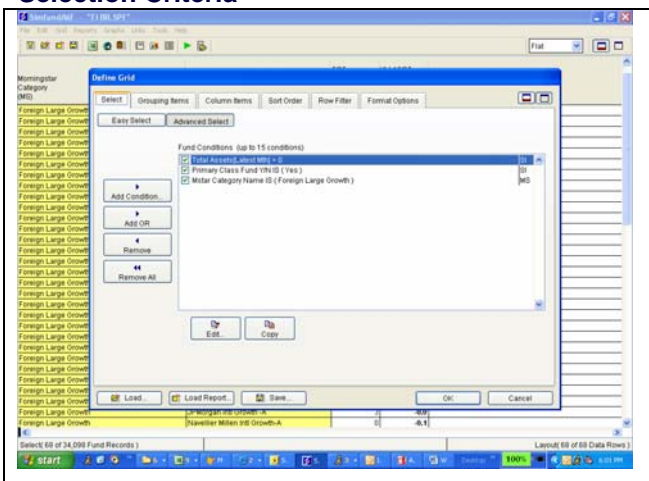
## An Illustration:

**Select Peer funds** = M'str Foreign Large Growth

**Select Primary Share Class** = Yes (to filter out the redundant share classes of the same portfolio)

**Grouping Items:** by Mstar Category and Fund Name

### Selection Criteria

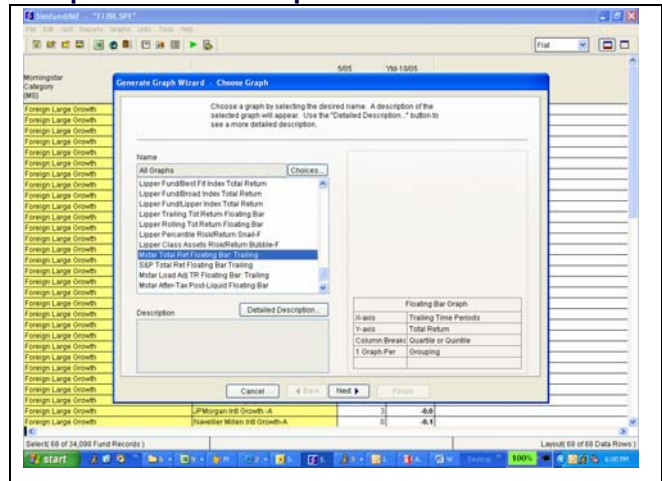


Source: Strategic Insight Simfund MF

**Run the grid**; all the funds will appear in your browser. Now you are **ready to generate a floating bar analysis** by following the graph wizard.

Click on the Graph Menu and Generate graph or the Graph Button on the tool bar. The wizard will start. Choose the Mstar Total Ret Floating Bar: Trailing. Follow the wizard.

### Graph Wizard Start-Up Screen

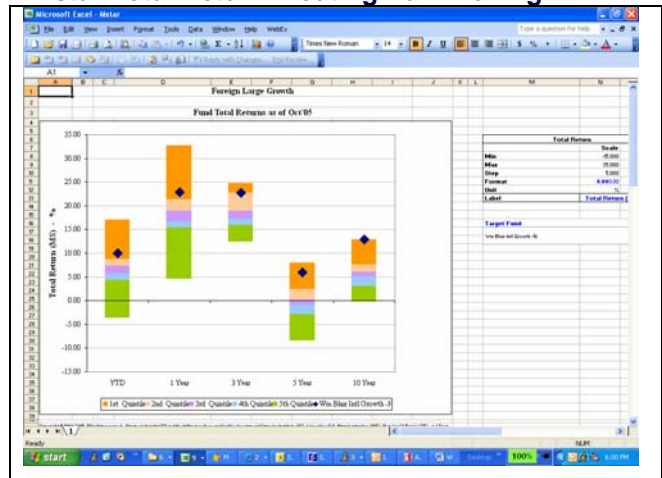


Source: Strategic Insight Simfund MF

Once you have taken these steps, the following **graph will be displayed in Excel** as seen below.

The diamond represents the fund chosen on the left hand side of the graph. **Scroll** on the drop-down box to **highlight any fund** you want displayed. Add Fund Name to Title.

### M'star Total Return Floating Bar: Trailing



Source: Strategic Insight Simfund MF



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