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WINDOWS
Into the
Mutual Fund Industry
FEBRUARY 2006

Investments within $1.3 trillion of mutual fund assets are run by investment companies unaffiliated with the fund manager. This issue focuses on themes related to such sub-advisory relationships. We welcome your suggestions for other single-theme issues of future *Windows'* editions.

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Perspectives

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Transitioning Into 2006

Fund inflows reflect the acceleration of several recent trends. Notably, flows into international equity funds jumped to an all-time monthly record of nearly $30 billion during January, a monthly pace almost double the prior record. Among US-centered funds, the slow rebound in growth-style fund inflows, partly at the expense of value-style funds, continued. And, pausing for a moment of reflection, our industry has just reached the $10 trillion milestone for assets under management.

$1.3 Trillion in Sub-Advisory Relationships, and Growing

The search to offer highest quality investment advice takes many forms. Naturally fund managers focus on strengthening their internal portfolio management teams, by attracting experienced investment personnel, including lift-outs; expanding PM teams in parallel to bigger size funds; concentrating resources on a smaller number of funds (about 20% of all portfolios in existence at year-end 2002 have since been liquidated or merged); or adopting funds with distinctive investment processes and track records.

But many funds also outsource the investment management function. They enter into partnerships with sub-advisers to differentiate their products, build or maintain investment superiority and, at times, penetrate new channels of distribution. Some of these providers have developed product lines for which the entire family of funds is sub-advised (sub-advising, for the purpose of this article, refers to the outsourcing of investment management to a firm other than the fund manager; generally these investment managers function independently and do not reside under a common corporate ownership).

Sub-advised open- and closed-end mutual funds (excluding variable annuities) accounted for a total of **nearly $900 billion** in assets as of January 2006 (roughly 10% of total fund assets) and **attracted more than $130 billion in net flows in the past three years. Approximately one in six mutual funds is sub-advised.** For equity funds, 14% of assets and one-in-five portfolios are sub-advised. **Within active international equity funds, one in every four is sub-advised**.

The importance of sub-advisory relationships within the variable annuities / life (VA/L) business is even greater. As of last count, approximately one-third of all VA/L fund assets, or $386 billion, are sub-advised, and these funds dominate new sales and flows for VA/Ls.

Sub-advisory relationships considerations include, among others:

- Articulating one's core expertise; outsourcing investment management beyond core.
- Identifying an investment manager to partner with, establishing a relationship, monitoring the sub-adviser and, at times, replacing it.
- Setting and benchmarking sub-advisory fees.
- Single vs. multiple sub-advisers and their economics (retained advisory fees after paying for sub-advisory). Managing and monitoring a single sub-adviser is easier than working with multiple sub-advisers. Also, sub-advisory fee breakpoints will be reached earlier with a single sub-adviser; this will allow the manager to recoup its introductory expenses at a smaller asset size (about one-third of sub-advised funds have less than $100 million in assets under management).
- Addressing board of directors' issues related to sub-advised funds, including selecting and replacing sub-advisers, monitoring procedures, the sub-adviser's culture and resources, fees and economies of scale, including those pertaining to retained advisory fees, and more.
- Managing the conflict, disclosure, and rationale for the different advisory fees, when an investment team offers sub-advisory services at institutional level fees and in parallel runs a retail fund with a similar investment process at a higher level of advisory fees.

This issue of *Windows* focuses on the many aspects of sub-advisory relationships among mutual funds. We discuss leading participants, newly launched sub-advised funds, changes among established sub-advised funds, fee and expense and Board considerations, the special case of VA/L sub-advised funds, the process of developing sub-advisory relationships, and some suggestions on using SI's Simfund and FundFiling.com tools as prospecting tools for new sub-advisory opportunities.

Sub-Advised Funds (Excluding VA Funds)

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Sub-advised long-term funds experienced a **record $57 billion in flows in 2005**, exceeding the previous record of $51 billion set in 2004. As of January 2006, sub-advised equity and bond funds represented about 16% of long-term funds and **close to 13% of long-term fund assets**.

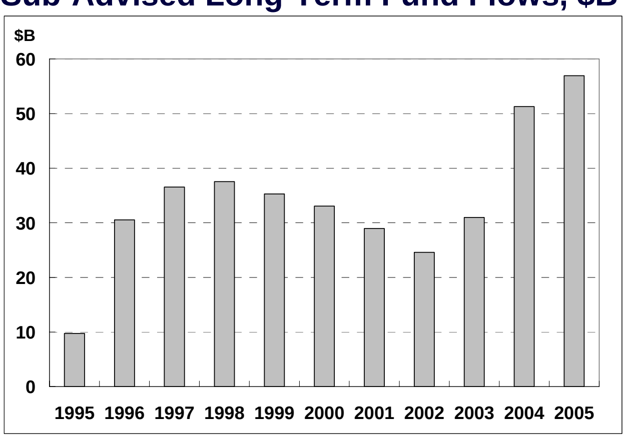
Sub-Advised Long-Term Funds (excl. VA) $B

	Flows 2004	Flows 2005	Assets 1/06	# of Port 1/06
Domestic Equity	38.6	37.8	608.7	675
International Equity	7.9	11.6	124.8	199
Total Equity	***46.5***	***49.4***	***733.4***	***874***
Taxable Bond	5.0	7.5	116.0	170
Tax-Free Bond	-0.2	0.0	6.6	30
Total Bonds	***4.8***	***7.5***	***122.6***	***200***
Long-Term Fds Total	**51.3**	**56.9**	**856.1**	**1,074**

Source: Strategic Insight Simfund MF

Most funds use a single sub-adviser but **about one-quarter use multiple sub-advisers;** often these are larger funds, but at times smaller. These multiple-sub-adviser funds control $350 million in assets and gained $26 billion in net flows in 2005.

Sub-Advised Long-Term Fund Flows, $B



Source: Strategic Insight Simfund MF

The managers with the highest inflows into their sub-advised funds over the past three years are listed below.

High Inflow Managers: Sub-Advised Actively Managed Open-End Funds

Manager Name	Assets $B 1/06	Flows $B Latest 1 Yr	Flows $B Latest 3 Yrs	No. of Funds 1/06
Vanguard	315	11	**31**	31
John Hancock	25*	13*	**15***	44
Princor	13	4	**8**	28
Harbor Capital	28	4	**7**	13
Russell	25	2	**6**	20
The Hartford	28	1	**5**	27
MassMutual Fin'l	10	1	**4**	18
American Beacon	9	2	**4**	8
Waddell & Reed	5	2	**4**	8
Diversified	10	1	**3**	16

**Mostly due to internal reorganization of managed investments.*
Source: Strategic Insight Simfund MF

Other managers, not listed above, with significant such inflows among their sub-advised funds in recent years were TA Idex, AssetMark, RiverSource, Delaware (LPL's Optimum line), and Touchstone.

Vanguard, SEI, The Hartford, Harbor Capital, John Hancock, Russell, Scudder, Princor, USAA, and Mass Mutual Financial are the managers with the greatest assets of sub-advised actively managed funds.

Investment managers with significant gains serving as sub-advisers in recent years include Wellington, Merrill Lynch, PRIMECAP, Northern Cross and Earnest Partners (Harbor Capital sub-advisers), T. Rowe Price, GMO, Dreman, Mackenzie, Gateway, AllianceBernstein, and PIMCO.

Some fast growing sub-advisers benefited significantly from their 'adoptions,' notably Pzena and Sustainable Growth (gaining almost $5 billion and $1.5 billion, respectively, over the latest three years due to their partnerships with John Hancock).

New Fund Filings



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Some Recently Filed Sub-Advised Funds

UBS Global Asset Management has registered the UBS Pace Alternative Strategies Investments fund, which intends to invest globally in stocks, fixed income securities, and derivative instruments. UBS expects to allocate fund assets among **two investment advisers** that will each adopt strategies that seek capital appreciation while trying to keep a low correlation to traditional equity and fixed income asset classes. **Analytic Investors** (a subsidiary of Old Mutual) will employ long/short global equity, global tactical asset allocation, and index option strategies, while **Wellington Management Co.** will take a "diversified total return" approach. *(**Note:** UBS's alternative strategy **Dynamic Alpha** and **Absolute Return Bond** funds have together attracted $2 billion in net flows since their inception last year.)*

Managers Funds (a subsidiary of Affiliated Managers Group) plans to add a **First Quadrant sub-advised fund** to its lineup. The proposed Managers AMG FQ Global Alternatives fund will make extensive use of derivatives for **"total return from investments in the global equity, fixed income, and currency markets, irrespective of market direction."** The fund's investment process will incorporate an analysis of returns based on the (a) relative returns derived from global asset class performance; (b) relative returns within the equity asset class based on country; (c) relative returns within the fixed income asset class based on country; and (d) currency risks. *(**Note**: First Quadrant already sub-advises Managers' AMG FQ US Equity and AMG FQ Tax Managed US Equity funds, and a portion of the affiliated Fremont Global fund..)*

American Beacon Advisors filed the Small Cap Value Opportunity fund, sub-advised by **Panagora Asset Management**, a Boston-based quantitative specialist co-owned by **Putnam** (majority owner) and **Nippon Life Insurance** (minority owner). This proposed fund will seek long-term capital appreciation and current income by investing primarily in equity securities of small cap US companies (generally those with market caps of $3 billion or less) by applying a blend of quantitative techniques and fundamental analysis.

Phoenix Investments filed the Phoenix Institutional International Equity and Phoenix Institutional Emerging Markets Equity funds; both will be sub-advised by **Vontobel Asset Management**. *[Note: Vontobel already sub-advises the Phoenix Focused Value and Phoenix Foreign Opportunities funds, funds originally sponsored by Vontobel (under different names) and subsequently "adopted" (first by Janus and subsequently by Phoenix).]*

New Actively-Managed Funds With Highest Cash Flows (Industry-Wide, All Funds)

Funds Started in 2005 Raising Most Flows Lately*
Actively Managed Stock and Bond Funds $MM

Fund Name	Assets 1/06	Net Flows 3 Mths-1/06	Net Flows 2005
Domestic Equity			
Schwab Premier Equity	1,159	**217**	911
PIMCO Fundamental IndexPLUS TR	495	**194**	461
Steward Multi Manager Equity	165	**165**	--
International Equity			
Julius Baer Intl Equity II	1,074	**547**	742
Fidelity Int'l Small Cap Opportunity	843	**526**	459
UBS Dynamic Alpha	1,760	**512**	1,481
SEI SIIT World Equity EX US	835	**231**	580
NB International Institutional	316	**216**	165
Lazard Int'l Strategic Equity	189	**176**	132
Matthews India	168	**159**	79
BlackRock All Cap Glbl Resources	462	**147**	294
Merrill Lynch Glbl Equity Opportunity	152	**144**	116
Wm Blair Emerging Markets Growth	292	**120**	225
Cohen & Steers Intl Realty	322	**113**	282
Bond			
PIMCO Developing Local Markets	1,673	**1,024**	1,215
Hartford Floating Rate	567	**284**	445
Fidelity Strategic Real Return	628	**133**	139

** With trailing 3-month flows > $75 mm; excludes funds launched by John Hancock, GMO and DFA.*
Source: Strategic Insight Simfund MF

Sub-Advised International Funds

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International equity funds have experienced dramatic gains as of late, capturing over $200 billion of inflows since December 2004. So far, however, sub-advised international funds—accounting for one in four international equity funds—garnered less than 10% of these fund flows lately.

Sub-Advised Equity Mutual Funds

Share of:	Fund Count	Assets 1/06	Net New Flows 2005	Net New Flows 1/06
Domestic Equity	21%	15%	39%	49%
US-Based Intl/Global	25%	12%	8%	7%

Source: Strategic Insight Simfund MF

Popular Sub-Advised Int'l Styles

Each international/global classification, as defined by Morningstar, has at least one fund that uses an external adviser (with the exception of Latin America). The most prevalent use of external investment advisers occurs in the diversified foreign categories, both in terms of number of funds sub-advised and in assets under management.

US-Based Sub-Advised International/Global Equity Mutual Funds

Category	1/06 Funds Count	1/06 Funds Share	1/06 Total Assets $MM	1/06 Total Assets Share	Net New Flows 2005 $MM	Net New Flows 2005 Share
For Large Blend	67	39%	52,005	22%	5,129	21%
For Large Growth	20	29%	6,833	7%	900	10%
For Large Value	16	26%	30,770	22%	490	3%
World Stock	19	20%	6,975	3%	584	3%
Div'fd Emerg Mkts	14	20%	4,421	5%	34	0%
Pac/Asia ex-Jp Stk	6	18%	583	5%	43	2%
For Sm/Mid Gwth	4	13%	3,657	13%	223	5%
Europe Stock	4	11%	1,874	6%	475	16%
Div'fd Pac/Asia	1	11%	211	6%	-39	-7%
For Sml/Mid Value	2	8%	242	1%	20	0%
Japan Stock	1	5%	548	3%	-17	0%

Source: Strategic Insight Simfund MF, Morningstar

The largest sub-advised funds in this space are shown in the table below. Note that six of the 10 largest funds use more than one sub-adviser.

10 Largest Sub-Advised US-Based International/Global Equity Mutual Funds

Fund	Category	Actual Adviser (Sub-adviser)	1/06 Total Assets $MM
Harbor Intl	For Lg Val	Nrthn Cross Inv	13,081
Vanguard Intl Gwth	For Lg Blnd	Multi Ad/Sub-Ad	12,407
Vanguard Intl Val	For Lg Blnd	Multi Ad/Sub-Ad	4,728
ING Intl Val	For Lg Val	Brandes Inv Part	4,411
Columbia Intl Val	For Lg Val	Brandes Inv Part	3,721
SEI SIT Intl Equity	For Lg Blnd	Multi Ad/Sub-Ad	3,422
Vanguard Gbl Eq	World Stk	Multi Ad/Sub-Ad	3,084
Russell Intl Sect	For Lg Blnd	Multi Ad/Sub-Ad	2,867
Amer Beacon Intl Eq	For Lg Val	Multi Ad/Sub-Ad	2,602
Vanguard Intl Expl	For Sm/Md Gth	Schroder Invest	2,477

Source: Strategic Insight Simfund MF, Morningstar

Selected Large Managers: Sub-Advised Actively Managed International Open-End Funds

Manager Name	Assets $B 1/06	Flows $B 2004	Flows $B 2005	No. of Funds 1/06
Vanguard	22.7	2.1	**2.5**	4
John Hancock	3.8*	0.0	**1.8***	7
Harbor Capital	13.3	1.1	**1.1**	2
Russell	5.2	0.6	**0.5**	3
US Global Investors	1.5	0.3	**0.4**	2
Waddell & Reed	1.3	0.4	**0.4**	3
RiverSource	2.4	0.4	**0.4**	4
Princor	0.7	0.2	**0.3**	2
Schwab	1.4	0.3	**0.3**	1
USAA	3.4	0.1	**0.3**	5

**Mostly due to internal reorganization of managed investments.*
Source: Strategic Insight Simfund MF;

Wellington sub-advises numerous international funds (all or part). Northern Cross, which manages only one fund for Harbor International, tops the list of sub-advisers, with more than $13 billion in sub-advised international assets under management.

Reviewing data in SI's FundFiling.com, we note that **in the past six months, 46 sub-adviser changes have been filed with the SEC**. Alliance picked up the most new business, being named sub-adviser to seven funds, including two funds each from Delaware, Pacific Life, and SEI.

Looking ahead, we note that **many of the better performing international equity funds are now closed** to new investors**.** With demand for international diversifications remaining high, **capacity management** will continue to be **a challenge. New sub-advisory partnerships, possibly with European and Asian investment managers, are thus likely.**

Use of Sub-Advisers in Lifecycle Funds

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Several new players have entered the lifecycle funds arena in recent years. Of these, some have chosen to outsource investment management or asset allocation to **unaffiliated sub-advisers** or **third-party consultants.** In the case of lifecycle funds structured as funds-of-funds (FoFs), such outsourcing may have been driven by compliance concerns (such as avoiding conflicts of interest), or for marketing / branding purposes. For lifecycle FoFs, the functions performed by the sub-adviser / consultant may be one or more of the following: **asset allocation**, **underlying fund analysis and selection** (most sub-advised lifecycle FoF series are based on multi-managed underlying fund platforms), and **portfolio construction**.

One firm with a significant presence in the lifecycle fund consulting / sub-advising area is **Ibbotson Associates**. With its long track record as a consultant to the pension and investment community, Ibbotson is a well-respected brand in the institutional marketplace, and is currently working with several lifecycle fund sponsors. Another important player is **Morningstar**—although Morningstar has several allocation roles on the VA side (e.g., Met Life, US Allianz, and American Skandia to name a few), its highly visible and successful relationship elsewhere has been with **Transamerica Idex.** This manager leveraged Morningstar's credibility as well as on-going analysis and portfolio "ownership zone" optimization, and has accumulated $5.4 billion in assets within its risk-based Asset Allocation Portfolios in a little more than three years.

Within risk-based lifecycle **FoFs**, Morningstar's relationship with Transamerica Idex and Ibbotson's with Pioneer are among the very few formalized as **sub-advisory** ones. Besides having a different legal structure, sub-advisory relationships generally warrant a greater level of involvement and risk for the investment manager than the **consulting** ones, in which they may only be providing non-binding recommendations.

On the **target-date fund** side, **Barclays Global Investors** (BGI) is a prominent sub-adviser, managing a total of $2.5 billion in assets as of January 2006. BGI's partners have distinctive distribution capabilities that complement its own within the institutional retirement plan space (State Farm in the insurance channel and Wells Fargo on the bank fund side), providing it platforms for retail distribution.

Selected Sub-Advised Lifecycle Funds (Excluding VAs)

Name of Lifecycle Series	Sub-adviser	Assets $B 1/06	Net Flows $B 12 Mths to 1/06
Risk-based			
TA IDEX Funds AA*	Morningstar	5.43	0.90
Prudential Strategic Partners	Multiple	1.07	0.06
Pioneer Ibbotson AA*	Ibbotson	0.55	0.18
Old Mutual AA†	Multiple	0.27	0.27
SunAmerica Horizon	Trajectory	0.00	0.00
Subtotal Risk-based		***7.98***	***1.29***
Target-date			
State Farm Lifepath*^	BGI	1.26	0.46
Wells Fargo Outlook	BGI	1.18	-0.06
SunAmerica HighWatermark	Trajectory	0.49	0.25
Subtotal Target-date		***2.92***	***0.66***
Total		**10.91**	**1.95**

** Structured as funds-of-funds; ^ Invests in BGI portfolios;*
† Allocation by Ibbotson.
Source: Strategic Insight Simfund MF

Selected Lifecycle Funds (Excluding VAs) Using Third-Party Consultants

Name of Lifecycle Series^	Consultant	Assets $MM 1/06	Net Flows $MM 12 Mths to 1/06
John Hancock *(JHF II Lifestyle)*	Deutsche *	17,225	900
Gartmore		3,590	1,006
Investor Destinations	Ibbotson	*3,530*	*963*
Optimal Allocations	Ibbotson	*60*	*44*
Hartford		1,308	675
Allocation	Ibbotson	*1,307*	*674*
Target Retirement	Ibbotson	*1*	*1*
Pac. Life *(Portfolio Optimization)*	Ibbotson	558	215
AXA Enterprise *(Allocation)*	Ibbotson	144	10
Jennison Dryden *(Asset Alloc.)*	Ibbotson	104	32
Calvert *(Allocation)*	Ibbotson	30	29
Janus *(Smart)*	Wilshire	20	21
Total above		***22,980***	***2,889***

^ All series in this table are structured as FoFs; all series in this table except Hartford Target Retirement are risk-based.
** Deutsche Asset Management furnishes "sub-advisory consulting services" to sub-adviser MFC Global.*
Source: Strategic Insight Simfund MF, SI research

Developing Sub-Advisory Relationships

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The Many Reasons for Establishing A Sub-Advisory Partnership

Among the reasons for establishing a sub-advisory partnership are the following:

- For sponsors, sub-advising may be a way to broaden product offerings and expand into areas in which they lack internal investment expertise, without having to build products from within. In this case, hiring external managerial talent would be used to complement internal investment management.
- Sub-advising gives sponsors the ability to use open architecture to design a product, including the selection of investment managers.
- Sub-advising enables the strategic decision to concentrate on core competence of relationship management and distribution. Some firms have concluded that investment management may not be a lasting value differentiator for them, and that their core competence perhaps resides in the skills and knowledge base that allows them to build and maintain strong customer relationships. Hence, some fund lines, including those of some insurance companies, banks, affinity groups, and brokerage firms are largely or completely sub-advised.
- Some sponsors may seek to acquire distribution effectiveness by hiring other distributors as sub-advisers.
- Sub-advising may be a way to boost sales momentum by hiring a star manager.
- Some sponsors have sought to build an "embedded advice" multi-manager product solution that aims at risk-reduction by bringing together a number of specialist sub-advisers within a fund, each managing a different style or sector.
- For the sub-advisers, the assignments are asset-gathering opportunities that make use of their existing capacity and spread business risk. The opportunities could be in product platforms the sub-advisers have not participated in before, including open-end and closed-end mutual funds, separate accounts, wrap programs, variable annuities, etc.

Of course, excessive dependency on sub-advisory relationships can also have its downsides. Capacity considerations conflict with fee revenue optimization. The friction between retail and institutional account fees may intensify due to heightened oversight. Some sub-advisers, faced with stagnant fees yet little growth, and with growing demands for handholding and support, will inevitably question the viability of the model.

The Product Development Phase of New Sub-Advised Funds

Important considerations are:

- What are the investment merits of such an offering? How can it help in asset allocation efforts?
- What is the likely demand curve for such a new fund?
- Evaluating the investment area into which you contemplate introducing the product—are current valuations low or is this style at the end of its outperformance cycle; is there a proliferation or deficiency of funds in that space; are there opportunities you can take advantage of?
- Should such a style be managed by one sub-adviser or multiple ones? (The intuitive advantage of multiple sub-advisers conflicts with the greater complexity involved, as well as the greater difficulty in securing economies of scale of net retained advisory fees.)

The Manager Search Process

- Investment companies that wish to secure sub-advisory mandates often do so by directly marketing to prospective clients.
- Fund managers generally use a request for proposal (RFP) process, especially for institutional mandates.
- The **evaluation, selection and monitoring of investment managers involves the use of both quantitative and qualitative measures.** Investment process and performance and, in some cases, other factors that may help in asset gathering—such as the asset manager's brand,

reciprocal distribution, and marketing and sales support—are evaluated. On the traditional mutual fund side, brand may be somewhat less critical today than in the past, as funds are combined with others within an asset allocation model, and distributors depend on their own strong relationship brands. In the VA space, brand awareness may have remained an advantage.

- The search process is largely similar for both retail and institutional mutual funds, with only small differences.
- The search begins with the **identification of the investment objectives of the particular search assignment**. For instance, large cap value, international emerging market equity, market-neutral, corporate high yield, or other asset class or style, along with any constraints that the search may be subject to, resulting from the fund's policies or regulatory requirements.
- Typically, the universe of managers in a particular discipline is first distilled based upon a **quantitative screening** of managers in the various databases (such as Lipper, Morningstar, Mobius, PSN, helped at times by attribution software). The consistency of returns, rankings among peers over a number of years, and risk-adjusted returns are some of the variables examined. At this stage, sometimes as many as the top half of the managers resulting from the screens would be looked at, since performance is only one of several criteria for selection. **Investment companies with which the fund manager has had prior experience may also be considered**, even if such managers do not figure in the databases. **For multi-managed products, additional analysis evaluating how the different managers work together is necessary.**
- By themselves, quantitative screens are insufficient. They must be supplemented with **qualitative screens**—an **assessment of the manager's investment process; knowledge and skills; history; and the assets of the firm overall, as well as within the strategy that needs to be outsourced.** The fund manager would prefer not to account for too large a share of the sub-adviser's overall assets or the sub-adviser's specific-strategy assets. At the same time, in some investment categories, such as the smaller capitalization ones, sponsors may want to find out if there is room for growth, or **whether the firms are already nearing capacity.**
- Once the field has been narrowed down to a few candidates and the interest of those candidates in the mandate ascertained, a detailed **Request for Proposal** (RFP) is sent out. The RFP generally covers details of the firm, personnel and asset turnover, strategy, investment management team, trading, client service, and compliance. Clearly, **investment companies active in the sub-advisory space have detailed, up-to-date firm descriptions appropriate for potential searches and ready to be shared at any time**. As of late, a part of the intensified due diligence process may be a supplemental questionnaire on sub-advisory policies.
- The proposals received in response to the RFP are evaluated, and any clarifications needed from the portfolio managers obtained. The next step is for the sponsor to **visit and conduct on-site interviews** of the selected finalists. Before the visit, the sponsor may again run performance attribution analysis to uncover the drivers (and potential concerns) of the manager's risk-adjusted outperformance.
- Manager visits include a review of the organization and involve not only an in-depth discussion with the portfolio managers and research analysts, but also meetings with senior management and the compliance, trading, marketing, and client services teams. The manager's investment process is scrutinized and risk controls assessed—for instance, if the manager follows a quantitative method, the sponsor's team may want to learn about the models used for research, portfolio construction, and trading.
- Following the site visits, the proposals are reevaluated, and one or more managers selected, based on capacity constraints and the success of the RFP process in finding good manager candidates.
- A mandate is assigned to the selected manager(s), or the firm(s) added to a list of potential replacements for current sub-advisers. **Identifying emerging manager talent and ensuring that there are alternatives to existing selected managers is important, should a manager switch become necessary.**

Sub-Adviser Marketing And Sales Assistance

- In many cases but not always, money managers that can offer superior marketing support and distribution assistance—over and above investment performance and product—will be preferred as sub-advisory allies. This tends to favor retail-focused firms.

The Role of External Consultants

- Although larger fund managers with investment management expertise often have an internal team conducting searches (for both potential sub-advisers and at times, funds to 'adopt'), some smaller firms as well as those relatively new to sub-advising use external consultants in their search.
- The perspective and knowledge of an internal team becomes more important for companies looking to go beyond the outsourcing of investment management, to secure reciprocal distribution and marketing and sales support.

Manager Monitoring

- Effective monitoring requires that investment and business expectations (marketing support, fees, compliance, ethics, and people management) be clearly spelled out at the very start of the relationship.
- The managers employed should be continuously monitored for performance, business, and staff developments at their firms, to identify early any potential performance problems.
- The monitoring process seeks to assure conformity with performance measurement, capitalization, style, compliance requirement guidelines, etc.
- Sub-advisers with 1940 Act experience are generally valued owing to the associated familiarity with mutual fund compliance needs. Institutional managers that do not have such experience initially may require closer compliance oversight.
- It is important to note here that, in October 2003, the SEC proposed a new rule, 15a-5, which would enable the "principal advisers" of funds, under certain conditions, to hire and discharge sub-advisers without the cost and delay of a shareholder vote. Currently, sponsors of manager-of-manager funds can enter into and materially amend contracts without a shareholder vote only if they obtain special exemptive relief for this purpose from the SEC (such exemptive relief was
- first granted in 1995). The new rule, if adopted, would make the relief available to all manager-of-manager funds. The proposed rule would also permit a manager-of-managers fund to disclose only the aggregate amount of advisory fees that it pays to sub-advisers as a group (instead of having to disclose the amount paid separately to each sub-adviser). For more details of the proposed rule, see the document on the SEC web site.
- Clearly, key information about portfolio managers, organizational changes, regulatory concerns, or other "bad news," should be communicated to sponsors effectively and quickly.

The Termination Process

This is really "hiring in reverse." Multiple deficiencies, such as the ones listed below, could be a reason for termination:

- Weak performance;
- Lack of service, marketing support;
- A key portfolio manager or managers leaving, and insufficient confidence in the remaining members of the team due to absence of a track record; or
- Shifts out of style of expertise.

In such a situation, the firm doing the outsourcing would need to consider whether it wants to stand behind the sub-advisory firm in hard (but maybe temporarily so) times. If the decision is to terminate, some believe it is advisable to communicate it quickly—"with one phone call."

Terminations are linked to the hiring process of a replacement team. Some managers use index funds or ETFs as a temporary holding before re-assignment of mandates.

As alluded to earlier, under appropriate circumstances, the sponsor currently has the flexibility to quickly replace a sub-adviser, without incurring the cost of a shareholder vote, using a manager-of-managers exemption.

Inside FundFiling.Com: Sub-Advisory Changes

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Enriching, Changing Sub-Advised Funds and Their Fees

FundFiling.com identified 87 sub-advisory fee changes since the end of last September, some of which increased fees, while others reduced them. Eleven of the 87 changes were made due to sub-advisory relationship changes; in each case the sub-advisory fee was reduced.

Since last September, SI's Fund Filing flagged 177 sub-advisory relationship changes; 65 of these changes were in funds sub-advised by multiple sub-advisers. A number of these changes were made by one of the industry's largest 25 managers, including:

Vanguard Windsor II added **Armstrong** to a long list of sub-advisers already in place for the fund, and **Vanguard Mid Cap Growth** added **Provident** as a sub-adviser (joining **Chartwell**, making the fund a newly multiple sub-advised fund).

Prudential Strategic Partners Equity Income added **T. Rowe Price** to **Alliance**, and **Prudential Strategic Partners Small Cap Growth** added **RS Investment** and **Transamerica** to **Deutsche**, producing two new multiple sub-advised funds.

J.P. Morgan Multi-Manager Small Cap Value, in October, replaced **ICM Asset Management** with **First Quadrant; t**he following month, the fund removed **Advisory Research**, leaving **First Quadrant**, **Vaughan Nelson,** and **Earnest Partners** sub-advising the fund.

Transitioning Out of Multiple Sub-Adviser Relationships

Diversified Intermediate Government Bond terminated **Stephens Capital Management**, leaving **Allegiance** to sub-advise the fund.

Constellation International Equity fund approved **AXA Rosenberg Investment Management** as sub-adviser, and terminated the sub-advisory agreements with **Boston Company Asset Management**, **Brandywine**, and **Oechsle**.

Forward Management, the **Forward Sierra Club Stock** fund's investment adviser, took over management of the portion of the fund that **Harris Bretall Sullivan & Smith** sub-advised, leaving a portion to **New York Life Investment Management**, the remaining sub-adviser to the fund.

Transitioning Into Multiple Sub-Adviser Relationships

Numerous funds shifted from either a single sub-adviser, or no sub-adviser, to become a multiple sub-advised fund since October 1, 2005.

Twenty multiple sub-advisory relationship changes were made by **SEI Investments**.

Old Mutual restructured many of its funds, introduced multiple sub-advisers to the following funds: **Old Mutual Large Cap Growth**, **Large Growth Concentrated**, and **Select Growth** (added **CastleArk** and **Turner**), **Small Cap** (added **Liberty Ridge** and **Eagle Asset Management**), **Growth** (added **Munder** and **Turner**), and **Old Mutual Strategic Small Company** (added **Liberty Ridge**, **Eagle Asset Management** and **Copper Rock**).

Mellon Equity joined **J.P. Morgan** in sub-advising the **Princor PIF Partners Small Cap Value I** fund. **T. Rowe Price** joined **Alliance** in sub-advising the **Prudential Strategic Partners Equity Income** fund. **RS** and **Transamerica** joined **Deutsche** in sub-advising the **Prudential Strategic Partners Small Cap Growth** fund.

Lastly, Diamond Hill, a fast-growing Columbus, Ohio firm, joined **Turner** in sub-advising the **Constellation Small Cap Value Opportunities** (**Touchstone Investment** of Cincinnati recently acquired **Constellation**).

Fees & Expenses

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Advisory Fee Economies of Scale: Consistency Across Styles And in VA Underlying Funds; The Case of Sub-Advised Funds

Economies of scale in advisory fee ratios are witnessed throughout the fund industry, as suggested in the table that follows. Not surprisingly, in areas of specialized expertise, advisory fee ratios tend to be higher, as is the case among international equity funds or small cap US funds. Elsewhere—within large cap diversified US funds, for example—fee ratios are lower. Similar patterns exist among bond funds, where higher-yield corporate bond fund fees are higher than among less specialized programs.

Advisory fees, of course, are identical across all share classes of the same portfolio. Thus, in the comparative analysis of advisory fees we use the size of the "portfolio" (all classes combined), not the size of a single class in a multi-class portfolio, during the fiscal year. Note that the data presented in the following table excludes funds under $100 million, as fee waiving tends to distort comparative results for such small funds.

On average, advisory fee ratios among sub-advised funds (partnering with unaffiliated sub-advisers), **which are sponsored generally (but not always) by smaller management companies with more limited resources, tend to be somewhat higher than among funds run by portfolio managers affiliated with the management company.**

This adds another facet to the debate about the "proper" level of fund management fees, a debate focused on arms-length selection of qualified money management talent hired for sub-advised funds, the competitive marketplace pricing of such talent, and the costs of fund management services beyond securities selection. Note that unaffiliated sub-advisers manage about one-third of all actively-managed equity funds in the VA business, but a smaller 14% of traditional actively managed equity funds.

Comparative Advisory/Admin Fee Ratios: Actively Managed Funds, 2004/2005 Fiscal Year Data *

	Open-End Funds		VA Funds	
Portfolio Avg. Size 2002 Fiscal Year ($MM)	Not Using Sub-Adviser	Using ** Unaffiliated Sub-Advisers	Not Using Sub-Advisers	Using** Unaffiliated Sub-Advisers
US Large Cap				
$100-250	0.758	0.773	0.723	0.793
$250-500	0.721	0.799	0.700	0.743
$500-1000	0.649	0.720	0.660	0.752
$1000-3000	0.491	0.698	0.610	0.716
> $3,000	0.455	0.626	0.453	0.566
Industry	0.508	0.695	0.559	0.687
US Small Cap				
$100-250	0.946	0.917	0.828	0.916
$250-500	0.866	0.972	0.827	0.868
$500-1000	0.927	0.819	0.800	0.828
$1000-3000	0.866	0.929	0.704 (1 Fd)	0.800 (1 Fd)
> $3,000	0.840	1.134 (1 Fd)	--	--
Industry	0.863	0.902	0.803	0.853
Int'l Large Cap				
$100-250	0.840	0.954	0.852	0.910
$250-500	0.809	1.015	0.857	0.821
$500-1000	0.788	0.921	0.820 (3 Fds)	0.786
$1000-3000	0.804	0.875	0.723	0.913 (3 Fds)
> $3,000	0.683	0.750	0.526 (1 Fd)	--
Industry	0.718	0.833	0.733	0.858
Intermediate Term Bond				
$100-250	0.434	0.464	0.579	0.620 (3 Fds)
$250-500	0.452	0.575	0.475	0.540 (2 Fds)
$500-1000 MM	0.484	0.528	0.557	0.609
$1000-3000 MM	0.416	0.435	0.464 (1 Fd)	0.596
> $3,000	0.366	0.331 (2 Fds)	0.464 (1 Fd)	--
Industry	0.420	0.454	0.505	0.585
High-Yield Corp. Bond				
$100-250 MM	0.619	0.689 (2 Fds)	0.584	--
$250-500 MM	0.597	0.730 (3 Fds)	0.652	0.603
$500-1000 MM	0.580	--	0.593	0.797 (2 Fds)
$1000-3000 MM	0.545	0.680	0.571	0.654 (3 Fds)
> $3,000	0.484	--	--	--
Industry	0.551	0.713	0.595	0.674

** Advisory/Administrative fees. All values asset-weighted; latest available Fiscal Year data (2004 or 2005); excludes funds with one-all-inclusive fee structure; investment style as was defined by Morningstar on 12-05 for open-end funds;*
*** Only when the sub-adviser/adviser is unaffiliated with the parent company of the fund manager, to measure arms-length relationships*
Data cells with less than four observations with applicable data are noted.
Source: Strategic Insight Simfund MF and Simfund VA

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Economies of Scale in Sub-Advised Mutual Funds

As suggested in the table on the previous page, advisory fees (on average) among sub-advised funds are similar or slightly higher than those among funds not having sub-advisers, often driven by the reality than many managers using sub-advisers are relatively small. Thus, at certain times peer group selection for benchmarking advisory fees (and their breakpoint patterns) should be limited only to other sub-advised funds; at other times a larger universe would be more appropriate.

The graphs below exemplify the three dimensions of advisory fees within sub-advised funds (in this example, actively-managed Large Cap equity sub-advised funds):

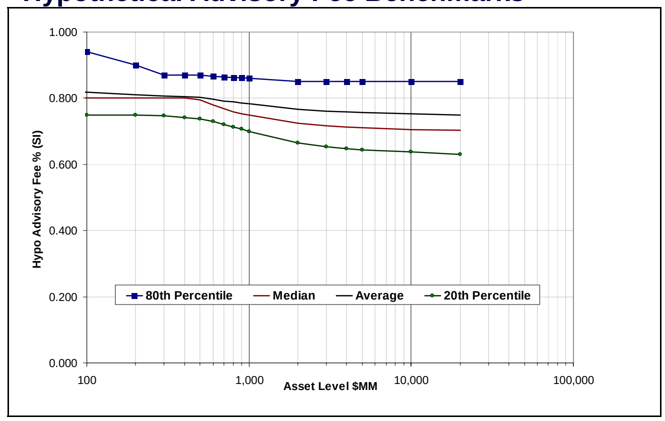
- Advisory fees (collected by the manager);
- Sub-advisory fees (paid to the investment team); and
- Retained advisory fees (the difference).

For each screen, we compute the hypothetical advisory fee breakpoints, hypothetical sub-advisory fee breakpoints, and the spread (hypothetical advisory minus hypothetical sub-advisory breakpoints) between advisory and sub-advisory fees at various asset levels.

(Sub-advised funds whose advisory and sub-advisory fees were based either on variables other than portfolio assets, or on portfolio assets and other variables such as complex (group) assets, performance relative to benchmark, or income were excluded.)

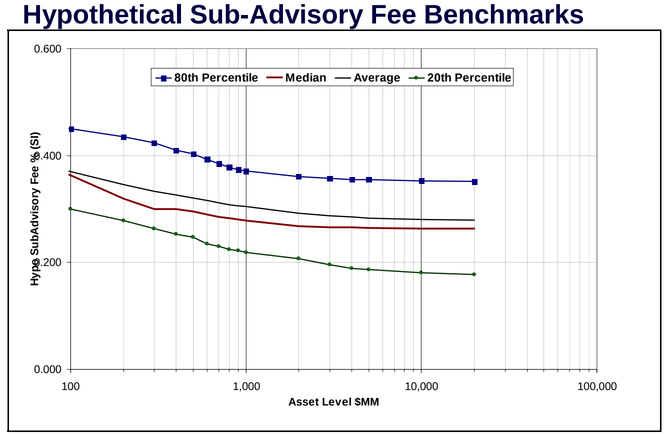
The third graph shows that, typical of sub-advised funds, the ratio of retained fees increases somewhat as the fund grows, a structure set up partly to allow the manager to recoup its initial expenses of establishing such funds. Sub-advisory fee breakpoints are most noted at funds of less than $1 billion; retained fee ratios flatten with funds of more than $1 billion (other than Vanguard's funds, we identify only 48 such larger funds vs. more than 200 smaller sub-advised large cap funds).

Large Cap Actively Managed Sub-Advised Funds—Hypothetical Advisory Fee Benchmarks



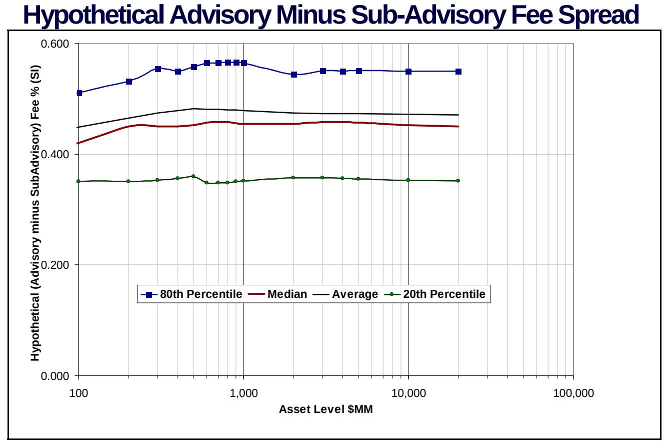
Source: Strategic Insight Simfund MF

Large Cap Actively Managed Sub-Advised Funds—Hypothetical Sub-Advisory Fee Benchmarks



Source: Strategic Insight Simfund MF

Large Cap Actively Managed Sub-Advised Funds—Hypothetical Advisory Minus Sub-Advisory Fee Spread



Source: Strategic Insight Simfund MF

Board Talk

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Boards Look at Sub-Advisory Pacts

As we discussed in last month's Board Talk column (*Windows*, January 2006, p. 11), a 2004 SEC rule mandated more explicit disclosure regarding the material factors on which fund Boards of Directors base their approval of advisory contracts, and specified that these disclosures be published in various fund shareholder reports.

The SEC rule also explicitly states, **"investment advisory contracts covered by this item include sub-advisory contracts** [emphasis added]." Moreover, the rule adds that "If any factor … is not relevant to the board's evaluation of an investment advisory contract, note this and explain the reasons why that factor is not relevant." The SEC clarified in the text of the rule release that this latter stipulation is intended to address **the concerns of those commenters who wanted less or different disclosure to be allowed for advisory contracts with an unaffiliated sub-adviser or "non-sponsor adviser"** [emphasis added].

Our sample review of fund disclosures, using Strategic Insight's daily-updated SEC Edgar filing monitoring service (http://www.fundfiling.com) suggests that mutual fund boards are addressing the issue of sub-advisory contracts in ways mirroring the new rules. Below we share some relevant disclosure language.

The board members of one fund, according to its disclosure, "received information from the Fund's manager … to assist them in their consideration of the Fund's management agreement … and **sub-advisory agreement** …. The Board received and considered a variety of information about the Manager … the Fund's **sub-adviser** … , as well as the **sub-advisory** and distribution arrangements for the Fund….

The Board concluded that, overall, the nature, extent and quality of services provided (and expected to be provided) under the Management Agreement and **the Sub-Advisory Agreement** were acceptable."

In discussing management fees and expense ratios, "The Board noted that the compensation paid to the **Sub-adviser** is paid by the Manager, not the Fund, and, accordingly, that the retention of the **Sub-adviser** does not increase the fees or expenses otherwise incurred by the Fund's shareholders."

In some cases, disclosures indicate that boards have had to consider a change of sub-advisers. For example, according to another recent disclosure, "In the case of … Fund, the Trustees considered that the Adviser had recommended a change in **sub-adviser** and that in recommending [New Sub-adviser] to replace [Old Sub-adviser], the Adviser had conducted an extensive search for a mid cap growth investment adviser which indicated that [New Sub-adviser] had the expertise and resources to add value for that Fund's shareholders. Specifically, the Trustees received a presentation by the Adviser concerning its search and the finalists resulting from that search and the rationale for the Adviser's recommendation of [New Sub-adviser]. The Trustees considered [New Sub-adviser's] breadth and depth of experience with aggressive mid cap growth portfolios. They also specifically considered [New Sub-adviser's] historical investment results in managing client portfolios in this strategy and having aggregate assets of $973 million as of June 30, 2005.

Following a review of "the historical performance of the Fund during [Old Sub-adviser's] management, relative to that of a universe of similar funds compiled by Lipper …" the disclosure then indicates that "As a result of these deliberations, the Trustees agreed that the then existing sub-advisory agreement should not be continued, and voted to approve the new Sub-advisory Agreement with [New Sub-adviser]."

The board also had to consider a case of underperformance at a different fund of the same manager, noting, "In consideration of … Fund (inception date November 1, 1993), the Trustees noted its underperformance in relation to its peers and universe medians for the one-year, three-year, and five-year periods ended June 30, 2005. The Trustees considered the Fund's longer-term record and noted that the Fund had underperformed its benchmark, the MSCI EAFE® Growth Index, for the one-year, three-year, five-year, 10-year and since inception periods ended June 30, 2005.

In this case, however, the conclusion was to give a new sub-adviser additional time. The disclosure indicates, "The Trustees acknowledged that most of the unfavorable record was generated prior to the change in sub-advisers for … Fund on March 1, 2004, but noted that the record had not improved significantly under [Sub-adviser]. The Trustees concluded that it was too early to assess whether any action would be required to improve long-term performance."

Global FlowWatch



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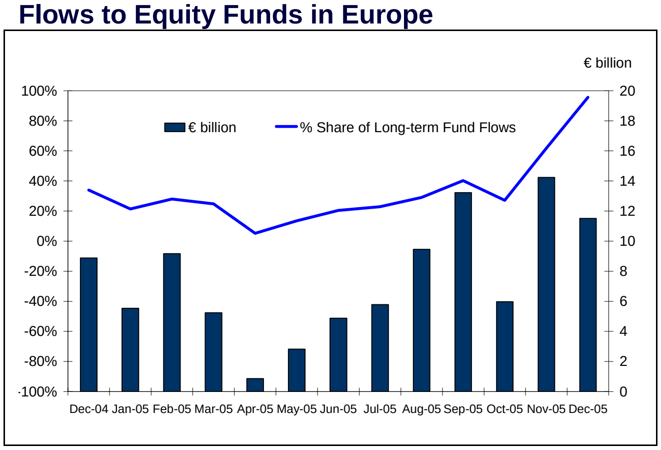
Global Fund Industry Results—2005

Mutual funds around the world gathered €750 billion in net flows in 2005 (about $1 trillion, using average exchange rates for 2005**), up from €450 billion in 2004 and €300 billion in 2003.** Global mutual fund assets grew to €17 trillion ($20 trillion) worldwide, rising from €13 trillion the prior year.

Equity/mixed funds worldwide gathered €400 billion in 2005, or 55% of all global fund flows. Bond fund contributions more than doubled from €90 billion in 2004 to €200 billion in 2005, or 30% of all flows across asset classes, while money market funds took in €100 billion in 2005 after two consecutive years of outflows.

Flows to Equity Funds in Europe



Source: Strategic Insight estimates, based on data from Lipper Inc.

European fund flows were the highest since 2000, on aggregate growing two-thirds year over year, to a total of €360 billion in 2005. In particular, contributions to equity funds in Europe since April have notably increased their share of overall long-term fund flows on a monthly basis, of late contributing the majority of long-term fund flows.

The Evolving Distribution Landscape

Against the backdrop of expanding inflows and AUM, asset managers are seeing **greater distribution opportunities, as banks, wealth managers, and other intermediaries seek to access external investment expertise** and to work more closely with fund providers and partners through third-party fund sales, sub-advisory and private-label agreements, and multi-fund/manager vehicles.

Offshore fund flows to Luxembourg- and Dublin-domiciled funds improved across asset classes in 2005. Luxembourg-based net flows grew by almost three-quarters, compared to 2004, totaling €170 billion for 2005. Equity and bond fund flows combined accounted for 75% of that total.

Luxembourg-Domiciled Mutual Funds Estimated Net Flows (€ Billion)

	Equity	Mixed	Bond	Other[1]	Subtotal Long-Term	Money Market	Total
2004	48	4	39	8	99	0	99
2005	62	17	62	12	154	11	165
% change	29%	358%	58%	45%	55%	NA	67%

1) "Other" includes mostly guaranteed, hedge and futures/options funds.

Note: AALFI/CSSF reports €236 billion net flows in 2005.

Source: Luxembourg flows based on Strategic Insight estimates using fund-level data from Lipper Inc.

Successful cross-border distribution agreements helped JP Morgan capture more than €20 billion in net contributions in 2005, making it the highest cash flow manager in Europe, by SI estimate. Of that amount, €13 billion went to equity funds, with five funds taking in more than €1 billion each. The five funds, US Dynamic, Global Capital Preservation (an absolute return offering), Euroland Equity, Europe Strategic Value, and Emerging Markets Equity collected more than €8 billion in net new money combined.

Global Horizons

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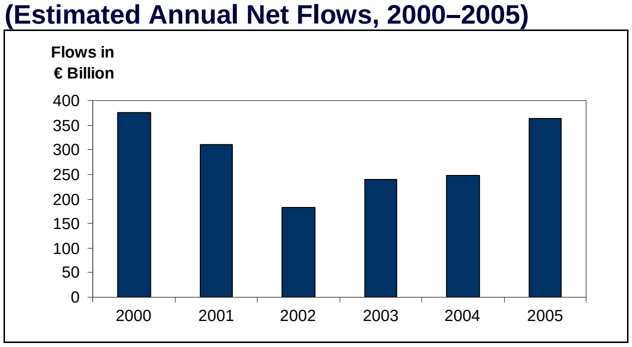
Exceptional Growth in Europe

European mutual funds collected €360 billion in net flows in 2005, two-thirds greater than in 2004 and the highest level in five years. I**nvestment funds in the region accounted for roughly half of total flows to mutual funds around the world last year**.

Europe Domiciled Mutual Funds (Estimated Annual Net Flows, 2000–2005)



Source: Strategic Insight estimates, based on data from Industry Associations, EFAMA, Europerformance, and Lipper Inc.

Driven by net inflows and NAV growth, **assets in Europe-domiciled funds increased by €1.3 trillion (25%) to €6.6 trillion** (including UCITS and non-UCITS funds) last year. This is more than double the increase in either 2003 or 2004; indeed, it is the **largest annual asset gain ever for Europe-based funds**, just slightly exceeding record 1999 volume (albeit not as a percentage of beginning assets; in 1999, the industry grew nearly 40% off a smaller base).

Europe's Top-Selling Funds

Many funds benefited from inflows in Europe, but gains remained fairly concentrated among a few top products. **Net flows to the 100 highest cash flow funds, excluding money markets, exceeded €130 billion, representing roughly 40% of all net money** captured by long-term funds in the region in 2005. The top-selling funds reflected the needs of a wide range of investors and included dividend-oriented equity funds, total return concepts away from traditional benchmarks, balanced/asset allocation strategies, regional/emerging markets, guaranteed funds, money market funds including institutional and enhanced offerings, other institutional funds and mandate switching, tax-related movements (Sicav II funds), and progress by international fund groups through expanding distribution agreements.

Highest Cash Flow Funds in Europe, 2005 (€ billion) Excludes Money Market Funds (SI Estimates)

Fund Name	Type	2005 Flows
1. dit-Euro Bond Total Return	Bond Euro	3.4
2. Intesa Premium	Mixed Asset	3.0
3. Activest Total Return	Bond Global	2.7
4. Pioneer Funds Euro Bond	Bond EuroZone	2.5
5. dit-Allianz Flexi-Rentenfonds	Mixed Asset	2.2
6. AXA Rosenberg Jpn Eqty Alpha	Equity Japan	2.2
7. Fidelity Funds—India Focus	Equity India	2.1
8. Dexia Total Return Bond	Bond Global	2.0
9. JPMF Europe Equity	Equity Europe	2.0
10. MLIIF World Energy	Natural Res	1.9

Source: Strategic Insight, Lipper Inc. Flows includes all shares classes of a fund

Reflecting the trend toward open architecture and transparency, relative performance and rankings were strongly correlated with sales success. Our research shows that i**n every major European market, funds with a top ranking received the vast majority of net flows in 2005** (we used Lipper Leaders scores for consistent return and total return for this analysis, but expect that the pattern would be very similar using ratings from Standard & Poor's or Morningstar). In nearly all cases, f**unds ranked in the bottom three tiers experienced aggregate outflows**; also, funds ranked in the second-tier received either negligible flows or, in many cases, suffered from aggregate net redemptions. We saw a similar pattern in the US in the 1990s.

Funds offering a balance of return, income, protection, and diversification also found demand, especially funds of funds and other "assembled advice" solutions. For example, **Intesa's Premium and Bouquet 2 Profilo Conservativo combined gathered €4.6 billion and Dexia Total Return Bond raised €2 billion.** The Intesa funds are third-party FOFs combining in-house and external mutual funds; the Dexia Total Return Bond fund is a proprietary FoF.

Variable Annuities



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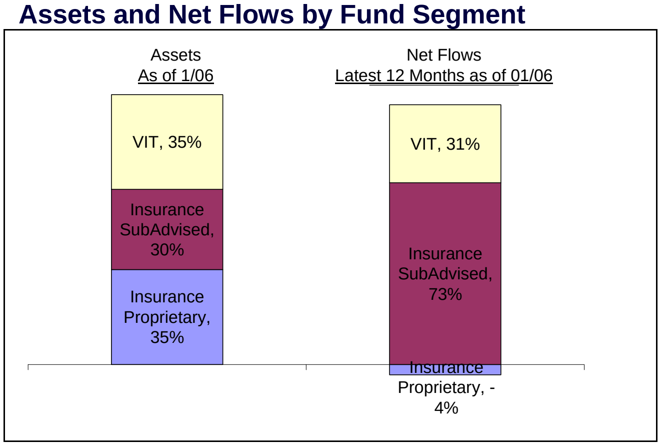
Sub-Advised Funds Dominate

The variable annuity/life (VA/L) industry has experienced a remarkable increase in sub-advised fund inflows in recent years. For example, in the past year, (to January 2006), insurance sub-advised funds captured 73% of industry net flows, a share more than double their market share of assets. During this same period, Variable Insurance Trusts (VITs) captured a 31% share of industry net flows—more than $5 billion; insurance proprietary funds suffered net redemptions.

Assets and Net Flows by Fund Segment



Source: Strategic Insight Simfund VA

Drivers of Sub-Advised Fund Growth

Sub-advised funds offer many benefits to VA/L providers over insurance proprietary funds and VITs. Some factors fueling the growth in the sub-advised funds include:

- Brand name investment managers;
- Multi-manager diversification;
- Ability to add a unique investment approach;
- Flexibility in replacing underperforming managers;
- Increased control over fees; and
- Economic advantages of outsourcing.

Single Sub-Advised Funds Gain

Nearly $400 billion of VA funds are sub-advised by an unaffiliated money manager. Of these assets, almost 90% use a single sub-adviser; only one-eight employs multiple-sub-advisers (in aggregate, these multiple sub-advised funds had little in inflows in the past year). Multiple sub-advised funds are clearly more complex to manage and monitor, and are less profitable to the manager (at a small asset base) than single-sub-advised funds, partly due to the slower economy of scale (net advisory fee) realizations in such funds.

Among sub-advisers gaining within single sub-advisory relationships in the past year, we note:

- Mellon / Dreyfus captured net flows of more than $2.5 billion in the latest 12 months (mostly due to its Jackson National relationship; JNL's Perspective II contract has been the major driver).
- OppenheimerFunds offers sub-advisory to a broad number of VA/L provider platforms; much of their recent inflows came from ING, Pacific Life, Met Life, and Allianz relationships.
- PIMCO / Allianz's inflows of more than $2 billion were helped by Pacific Life, AXA Equitable, and John Hancock.
- Merrill's $2 billion-plus flows occurred within programs of AXA Equitable, Pacific Life, Aegon, and ING.
- T. Rowe's $2 billion in flows were supported by numerous sub-advised relationships; much of 2005 growth occurred at John Hancock, ING, American Skandia, and Penn Mutual programs.
- Morgan Stanley / Van Kampen—$2 billion (AXA Equitable, ING, Allianz, Pacific Life).

Single Sub-Advised Funds Only: Top Sub-Advisers by Net Flows, $B

Single Sub-Adviser Only Sub-Adviser	Net Flows Trailing 1 Yr 1/06	Assets 1/06
Mellon / Dreyfus	**2.5**	9.6
OppenheimerFunds	**2.3**	10.8
PIMCO / Allianz	**2.2**	17.9
Merrill Lynch	**2.1**	10.5
T. Rowe Price	**2.0**	21.1
M Stanley / Van Kampen	**1.9**	12.6
BankAmerica / Marsico	**1.5**	8.5
Lazard Freres	**0.8**	7.9
Pioneer	**0.8**	1.0
NeubergerBerman	**0.7**	3.8

Source: Strategic Insight Simfund VA

Newly Launched VA Sub-Advised Funds

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In January 2006, many of the 23 new variable insurance funds registered were from sub-advised insurance company trusts. These include small cap equity, diversified international and emerging markets portfolios; funds-of-funds, and some target-term strategies.

The **Gartmore Variable Insurance Trust (GVIT)** filed four funds-of-index portfolios; some of these had three share classes, others more. The sub-adviser is **Fund Asset Management, a division of Merrill Lynch Investment Management**.

Advisory fees on these new funds range from 0.20% of assets (US Small Cap Index) to 0.27%, for an international index fund; and for the bond programs, from 0.22% of assets (Bond) to 0.35% (Enhanced Income). Operating fees range from 0.11% to 0.21%, depending on share class; 12b-1 fees range from 0% to 0.40%; and a small fee waiver is also disclosed.

GVIT funds, over time, have come to be used well beyond **Nationwide Financial**, Gartmore's parent. The funds are appearing in variable contracts from **Prudential-American Skandia**, **Transamerica**, **People's Benefit** and **Hartford**.

(Note that Gartmore's risk-based fund-of-funds program, using its regular index funds, has already amassed $3.5 billion and captured $1 billion in each of the past two years.)

In January, Jackson National registered six new portfolios, sub-advised by the likes of **Mellon Capital (**which already has benefited greatly from JNL programs—see previous page), **Franklin Templeton**, **Goldman Sachs**, **Lazard,** and **PIMCO**. All have two share classes, A (sporting a 0.20% 12b-1 fee) and B. Lazard is handling an emerging markets fund (Lazard will receive a portion of the 1.15% advisory fees). The PIMCO fund invests in inflation-indexed bonds. Of the two Mellon offerings, one invests in a target basket of 24 securities (a subset of the S&P 500) purchased just once over a given year. The other Mellon fund spreads its assets among five strategies, investing in common stocks of companies that are identified by a model based on five separate specialized strategies such as NASDAQ, Value Line, European, and Global.

ING filed six portfolios, each with four share classes; the sub-advisers include **Columbia**, **UBS**, **Fidelity** and **Franklin**. Some of these funds are structured as enhanced index funds.

Pacific Life filed two sub-advised funds, one from **Batterymarch Financial Management** (a manager affiliated with **Legg Mason** that we have not seen before in the variable space) that invests in international small cap issues, while **JP Morgan** will manage a diversified bond fund.

Fidelity filed four **VIP FundsManager** funds-of-funds, invested in Fidelity's funds and subadvised by affiliate **Strategic Advisers**, which uses an asset allocation format based on indexes created by Fidelity for each fund. These indexes monitor, hypothetically, the level to which underlying funds correspond to a set of commonly-used benchmark indexes, based on asset class.

The new VIP fund-of-funds from Fidelity is offered with a 0.2% advisory fee (on top of the underlying fund fees), and with 12b-1 fees ranging from 0% to 0.25%. According to the filings, the combined total expense ratios after expense reimbursements and expense reductions for each portfolio will vary by share class, ranging from 0.97% for certain Investor Class shares to 1.28% for Service 2.

The fund with the highest equity exposure—**Fidelity VIP FundsManager 85%—will have at least 85% of assets allocated to equity funds**. Its initial target allocations are projected to be 70% in US Equity Funds, 15% in international equity funds, and 15% in fixed-income funds.

The underlying fund holdings will be actively managed to achieve portfolio characteristics similar to that of the **VIP FundsManager 85% Composite Index**, which is a hypothetical representation of the performance of the asset classes in which the underlying Fidelity funds invest, based on combinations of the following unmanaged indices: Dow Jones Wilshire 5000 Composite Index (equities); Lehman Brothers Universal Bond Index (bonds); and Lehman Brothers 3-Month T-Bill (short-term investments). Clearly, setting such a benchmark should allow Fidelity to address the difficulties of using only traditional classifications for FoFs investment rankings.

Tools Time: Sub-Advisory Prospecting

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Simfund VA as a Sub-Advisory Prospecting Tool

With persistent gains among sub-advised VA funds, investment managers are increasingly looking for new tools and analytics to understand the competitive dynamics in the VA/L business, identify new sub-advisory opportunities, and monitor their existing sub-advisory relationships for emerging risks. Such efforts are mirrored in the increasing use of SI's Simfund VA; more than 70% of Simfund VA clients now use it as a prospecting tool (beyond fee or competitive analysis, market share, or performance reporting).

Simfund VA allows investment managers to analyze sub-advised funds as well as Variable Insurance Trust (VIT) funds in detail. As discussed before, insurance sub-advised and VIT funds are both growing segments in VA/Ls (insurance sub-advised funds captured 73% of net flows in the 12 months ending in January 2006; VIT funds captured 31% of net flows; Insurance Proprietary funds suffered net redemptions).

Sub-Advisory Analytics

Among Simfund VA automated reports and frequently used analytics are:

- Scorecard report for gap analysis;
- Risk-return report for replacement analysis.

The Scorecard report maps the sub-account lineup. You may choose a VA/L provider and screen based on Morningstar's style box, or Lipper's style/cap grid. Gaps in the sub-account lineup can be easily identified. In the sample Scorecard below, the Mid Cap Value space does not yet offer an investment solution, while the Large Cap Blend box uses only an index fund and the Small Cap Blend box has an underperforming fund. Performance details and rankings of sub-accounts are

Gap Analysis—Scorecard Report
Insurance Company Sub-Accounts, Morningstar Domestic Equity Funds, January 2006

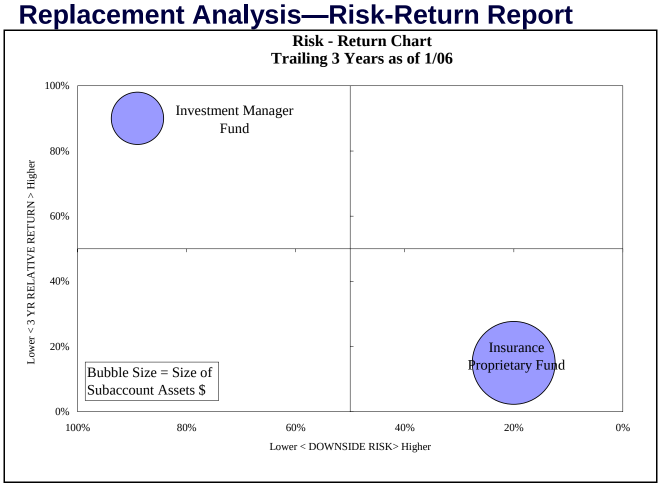
Cap	Style	Fund	Mstar Rating	Ann Returns as of 1/06: 1 Year	3 Year	5 Year
Large	Value	Large Cap Value	3	12.78	17.91	1.49
Large	Value	Growth & Inc	2	11.80	16.90	1.71
Large	Value	Main Street Core	1	10.40	10.54	
Large	Value	Equity Income	3	18.34	12.54	
Large	Blend	Equity Index Fun	4	10.13	16.12	0.09
Large	Blend	**No Actively Managed Funds**				
Large	Growth	Blue Chip Stock	4	12.45	21.75	2.85
Large	Growth	Growth	5	34.41	30.70	4.13
Large	Growth	Research Fund	3	12.45	19.93	-8.90
Large	Growth	Focused 30	5	32.98	34.15	-4.74
Mid-Cap	Value	**No Offering**				
Mid-Cap	Blend	Mid Cap Blend	4	15.50	22.93	11.04
Mid-Cap	Blend	Special Opportur	3	12.36	8.84	7.51
Mid-Cap	Growth	Mid Cap Growth	3	14.96	17.32	-1.86
Mid-Cap	Growth	Aggr Growth	4	27.80	25.65	-4.47
Mid-Cap	Growth	Growth Opport	2	7.26	3.51	-9.84
Small	Value	Small Cap Value	3	15.55	18.21	3.54
Small	Blend	Small Cap Blend	1	2.58	-8.52	4.35
Small	Blend	**Underperforming Fund**				
Small	Growth	Small Cap Growt	4	26.81	19.60	13.72
Small	Growth	New Discovery	3	20.54	12.36	

Source: Strategic Insight Simfund VA

offered when available (Simfund VA will also show performance of the underlying funds, if newer sub-accounts have not yet reported performance).

The analysis above is supplemented by Risk-Return analytics, at times used for replacement opportunities (naturally combining more detailed investment analytics). The graph below compares a fund's performance / risk relative to its category (the upper left quadrant suggests higher relative return / lower relative risk vs. peers). Investment managers can use this type of report to identify replacement and sub-advisory opportunities.

Replacement Analysis—Risk-Return Report



Source: Strategic Insight Simfund VA

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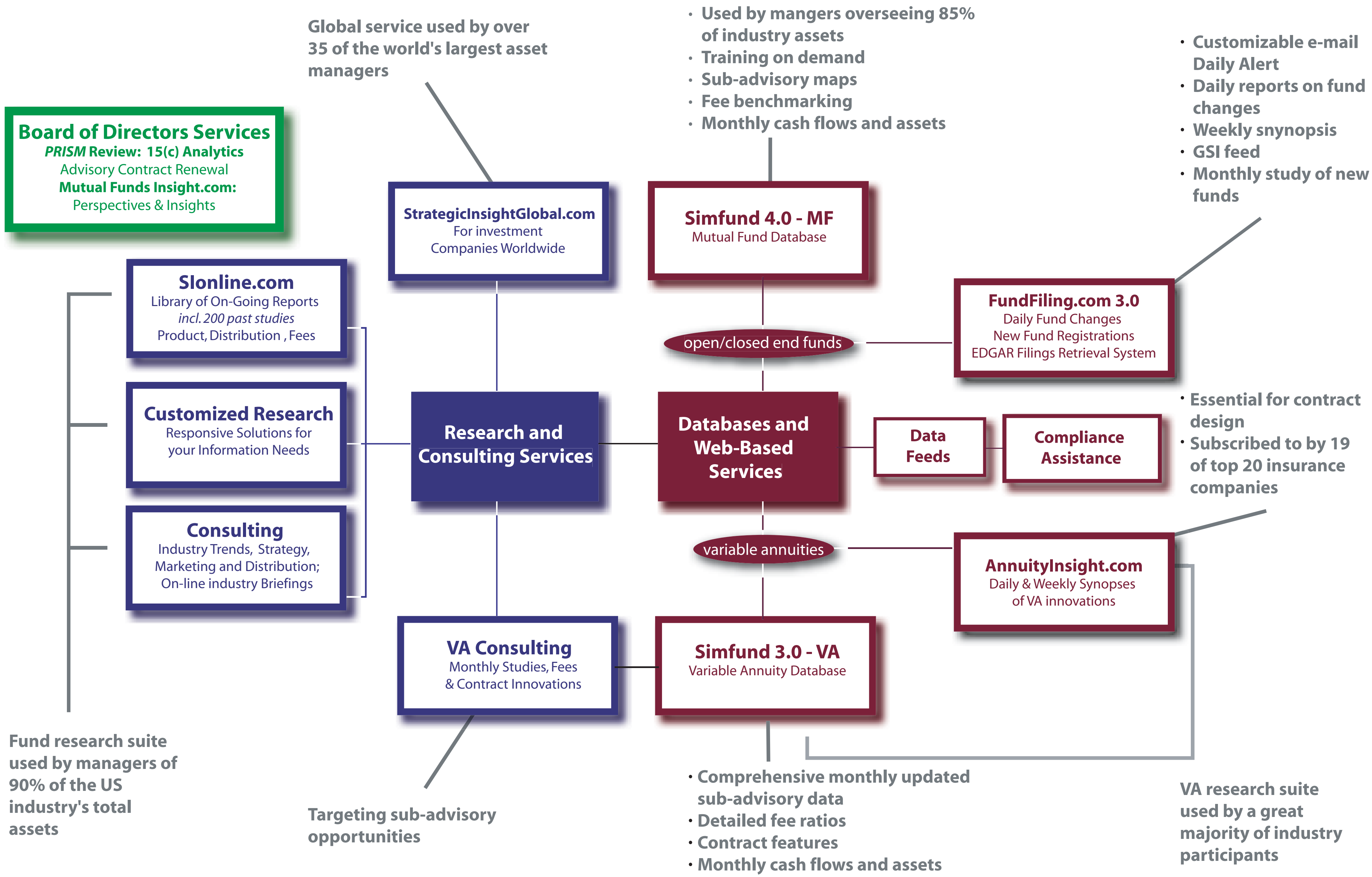

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