

Strategic Insight

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This latest edition of SI's Windows report include updates on recent industry developments and some ideas to help you plan for 2007. We encourage you to share the report with your associates. You can access past articles and future editions by simply registering on www.sionline.com.

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2007 Perspectives: New and Continuing Themes



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Some themes to consider in your planning for 2007:

- **How to participate (distinctively) in the financial services industry's transition to an "assembled" advice, asset-allocation focus?** e.g., by evolving funds-of-funds beyond simple risk-based or target maturity programs; higher equity allocations, adding international, alternative and real estate exposure; and deepening your link with distributors of fund "wraps" (whose further acceleration in 2006 increased their aggregate inflows to over \$70 billion.)
- **A corollary to the above: overcoming broker "fatigue" by articulating your distinctive way of providing diversification** (the transition away from "hot, exciting" ideas of the past has made it harder for some traditional brokers / advisors to overcome investors' fears and inertia)
- How will demand for value funds change considering such funds' multi-years of out-performance (vs. growth funds), including 2006? How long a delay in growth-style sales recovery? Large- vs. small-cap?
- How to **expand capacity to cater to the on-going very high demand for international equity funds?**
- **Role of quant funds for capacity management**, especially for core styles; **searching for "alpha";** and **the impact of hedge funds'** growing holdings on the availability of mis-priced investment opportunities
- **Bond funds:** converging all investment grade bond strategies into a "core-plus" approach to be used for asset allocation; value-added bond funds to address insatiable desire for income; considering the impact of a relatively flat yield curve, and the Fed's next interest rate move
- **The ETF reality:** while in our judgment so far most ETF purchases by individual investors and FAs are substitutions of stock, SMA, and sector bets, retail acceptance is gradually broadening. What role will ETFs play in the traditional mutual fund space in the coming years, and can a traditional long-biased active fund manager participate profitably in such evolution?
- What's next for **closed-end fund** innovation, IPO distribution windows, in light of sustained demand for international diversification and a more favorable interest rate environment?
- **Variable Annuities: sub-advisory relationships and fee management; new retirement income solutions** within VAs, elsewhere (e.g., income ideas, see page 4)
- **Non-market correlated alternatives** to funds and will they exhibit a greater traction in the retail fund business than in the past
- **Increasing institutionalization of fund selection** has implications for sales structure and wholesaling strategy—tomorrow's wholesalers are trained today. Need to understand investment gatekeepers' evaluation process, and enhance information flow to them; yet, without disregarding the importance of traditional wholesalers, coverage, and engagement
- Portfolio management and distribution teams' **consensus on how to articulate your investment process**, including through advanced analytics and your risk and style management
- Expansion, partnering opportunities in Europe, Asia, elsewhere
- Industry M&A implications; expanding opportunities for alpha-generating smaller fund managers; and intensified search and competition to portfolio management talent
- Continuing to help fund directors with active engagement, education; and responding to trustees' rising interest in understanding the changing distribution landscape and its implications.

2007 New Sales Forecast



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New Sales Trends 2006 - 2007

We project that for full-year **2006**, new sales of stock and bond funds would exceed \$1.7 trillion, **having risen 17% from 2005's pace** (the 2006 estimate is based on ICI actual new sales data through August, and SI's projection for the balance of the year, and is for open-end funds including VA funds, but excluding ETFs and closed-end funds.)

Mutual Fund Industry New Sales Forecast* \$Billion				
	2004	2005	2006 Est.	2007 Proj.
Equity Funds				
Growth / Aggressive Growth	510	537	639	734
World Equity	175	231	353	476
Grth & Income / Equity Income	269	266	274	301
Balanced / Flexible / Asset-Allocation / Income Mixed	116	108	101	96
Subtotal	1,070	1,141	1,367	1,608
Taxable Bond				
Multi Sector / Intermediate / Corporate	186	194	213	234
Government Bond	54	47	45	45
High Yield Bond	40	34	32	32
World Bond	16	20	24	28
Subtotal	295	296	315	340
Tax-Free Bond				
National Muni Bond	33	38	48	60
State Muni Bond	18	22	26	33
Subtotal	51	60	74	93
Total Long-term Funds	1,416	1,497	1,756	2,041

* Exc. ETFs, closed-end funds; Sources: ICI Trends; Strategic Insight estimate for 9-12/06 and 2007.

For the purpose of our **2007 sales forecast**, we **assumed stable investor confidence and fund choices**. This is based on stock prices fluctuating in a narrow trading range but in an up-trend next year, and only modest adjustments in the interest rate

environment and yield curve (its more likely rates would trend down).

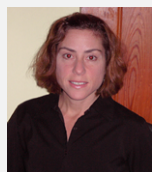
Note that ICI's equity sub-sectors in the attached tables do not correspond directly with the "growth vs. value" spectrum, but many value-tilted funds are included in the Growth & Income / Equity-Income segment, while most growth, small cap, and sector funds are captured in the Growth / Aggressive Growth segment.

Overall, we **project a 16% increase in long-term fund sales in 2007**, similar to 2006's increase; and for stock / balanced funds to capture 79% of the total sales next year, with bond funds capturing the balance 21%; large sales gains among international equity funds will continue (and will elevate the sales market share of such funds to over 30% of all equity fund sales); some substitution of balanced fund sales by funds-of-funds will re-occur, as was the case this year; and the (recently stalled) rebound of growth fund sales would resume, making sales gains of such funds slightly higher than those of large cap value funds. Muni bond fund sales will also increase, but such funds will again account for less than 5% of all open-end fund sales; and multi-sector and global bond funds would also experience year-to-year sales increases.

Mutual Fund Industry New Sales Forecast*				
	2007 Projected		% Change	
	\$B	% of Total	'06 vs. '05	'07 vs. '06
Equity Funds				
Growth / Aggressive Grth	734	36%	19%	15%
World Equity	476	23%	53%	35%
Grth & Income / Equity Inc	301	15%	3%	10%
Balanced / Flexible / Asset-Allocation / Income Mixed	96	4.7%	-6%	-5%
Subtotal	1,608	79%	20%	18%
Taxable Bond				
Multi Sector / Intermed. / Corporate	234	11%	10%	10%
Government Bond	45	2.2%	-4%	0%
High Yield Bond	32	1.6%	-5%	0%
World Bond	28	1.4%	19%	15%
Subtotal	340	17%	6%	8%
Tax-Free Bond				
National Muni Bond	60	2.9%	27%	25%
State Muni Bond	33	1.6%	18%	25%
Subtotal	93	4.6%	24%	25%
Total Long-term Funds	2,041	100%	17%	16%

* Exc. ETFs, closed-end funds
 Sources: ICI Trends; Strategic Insight estimate for 9-12/06 and 2007.

New Fund Filings



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Fund-of-fund development continues at a steady clip. We highlight below a few of the new series filed recently.

Russell is planning a trio of income-focused funds-of-funds (FoFs) as part of a new Retirement Distribution series under the **LifePoints** brand name. The **2007 Retirement Distribution**, **2007 Accelerated Distribution** and **2007 Extended Distribution** funds will invest primarily in affiliated funds in trying to provide “steady, predictable, but not guaranteed, distributions. The **Extended Distribution** offering will have a secondary aim of preserving a portion of the capital initially invested.

Russell LifePoints Fund	Annual	
	Distribution Term	Target Distribution*
2007 Accelerated Distribution	10 Years	\$1.20 (or 10%^)
2007 Retirement Distribution	10 Years	\$0.96 (or 8%^)
2007 Extended Distribution	20 Years	\$0.84 (or 7%^)

*Per share per year payable monthly based on an initial NAV of \$12. ^ Percent of initial NAV.

The Russell funds will use a dynamic asset allocation model that will take into account future distributions to be made by a fund, its per-share NAV, and the time remaining until the end of its 10-year or 20-year term. (Note: Russell’s LifePoints risk-based “Target Portfolio” series has accumulated about \$10.5 billion in assets since its inception in 1997, while its newer LifePoints “Target Date” series started at the end of 2004, holds \$50 million in assets.)

John Hancock filed its new **JHF II Lifecycle** series offering target dates numbered in five-year increments from 2010 to 2050 and a “Retirement” portfolio, each sub-advised by **MFC Global Investment Management** (a Hancock affiliate), with **Deutsche Asset Management** providing sub-advisory consulting services. The JHF II Lifecycle portfolios will invest

chiefly in affiliated funds, but may also invest in unaffiliated funds, including ETFs, and “other permitted investments” including various kinds of individual securities and instruments. (Note: John Hancock’s JHF II Lifestyle fund-of-fund series held \$19.7 billion in assets as of 8/06.)

TCW is preparing the “**LifePlan**” risk-based lifecycle affiliated FoF series, comprising of four options (their equity/bond allocation percentages indicated in brackets): **Conservative** (40/60), **Moderate** (60/40), **Aggressive** (80/20), and **Global Balanced Aggressive** (75/25). The equity underlying funds in which the various LifePlan funds invest will vary in their capitalization and/or geographical focus. The **Conservative** option will invest in US and non-US equity underlying funds with a large-cap focus; the **Moderate** option in US and non-US equity funds with a large- and mid-cap bent, and the **Aggressive** option in US and non-US equity funds investing in issuers of on any capitalization. The **Global Balanced Aggressive** fund’s underlying equity funds will invest principally in large- and mid-cap international securities.

Quantitative, market-neutral, multi-managed, real estate, international, and value-added bond funds were among the fastest growing new funds lately.

Funds Started in 2006 Raising Most Flows Lately* Actively Managed Stock and Bond Funds \$MM

Fund Name	Assets 8/06	Net Flows	
		8/06	6-8/06
Domestic Equity			
JPMorgan Highbridge Stat Mkt Neutl	609	151	473
Northern Multi Mgr Mid Cap	171	69	173
Northern Multi Mgr Small Cap	142	42	143
Rigel US Equity Large Cap Growth	123	0	125
Vanguard Structured Lrg Cap Eq	312	103	103
AIM Structured Growth	89	86	86
International Equity			
Northern Multi Mgr Intl Equity	465	175	456
DWS RREEF Gbl Real Estate Sec	200	184	200
M Stanley IL Global Real Estate	112	112	112
Fidelity International Value	130	26	83
Bond			
GMO Inflation Indexed Plus Bond	2,006	1,200	1,695
GMO Strategic Fixed Income	689	93	274
RiverSource Floating Rate	344	66	158
Am Century NT Diversified Bond	83	4	82

* With trailing 3-mth flows > \$75 MM. Source: Strategic Insight Simfund.

International Equity Funds



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The improvement in global stock markets since early September helped international equity funds to nearly 15% returns by mid-October, the fifth year in-a-row they out-earned US equity funds.

Trailing Average Total Returns, 8-06 (Asset Weighted)

	YTD	1 Year	3 Years	5 Years
Int'l Equity *	11.7%	22.2%	83.5%	90.0%
US Equity **	4.8%	8.5%	42.1%	38.1%

* Inc. Gold; ** Exc. Asset Allocation (AA)
 Source: Strategic Insight Simfund MF

Such performance trends, combined with persistent efforts by financial advisors and investors to increase worldwide exposure in their investment portfolios, have resulted in international equity funds attracting in excess of \$140 billion so far in 2006 (through September, including VA flows). High inflows should continue as long as financial market confidence and price levels are stable.

From the time that flows into international equity funds started to accelerate in 2H 2003, such funds have garnered over \$400 billion. Liquidity pressures due to demand from international equity mutual funds, US-focused funds increasing their international allocations, institutional accounts and hedge funds, and other investors, can partly explain the dramatic appreciation in international stock markets over this time period, especially those capital markets with lower supply of available securities, as well as emerging markets.

Yet, even with large inflows and out-performance, **international equity funds' share of all equity fund assets is still just 23%, below what we believe is prudent diversification allocation,** considering the very long-term horizon of most equity fund investors funding their retirement years through such savings.

Overall, high demand for international equity funds should persist. Interestingly, **international equity fund share of industry's gross sales (not net flows),**

while rising, was just 28% of all equity fund gross sales in 2006. SI's sales projection for 2007 (as discussed earlier in this Windows edition) suggests that international equity fund share of equity sales would rise further.

US-registered Equity Funds 2006 Flows: Domestic vs Int'l/Global (Inc. ETFs; Exc. VAs)

	Net Flows \$B					
	1-4/06	5/06	6/06	7/06	8/06	1-8/06
Domestic	44	-2	-3	-2	1	38
Int'l/Global	91	11	-1	8	10	118
Equity/AA	135	8	-3	5	11	155

Source: Strategic Insight Simfund MF

Note below the relationship between international and domestic equity share of assets and recent inflows.

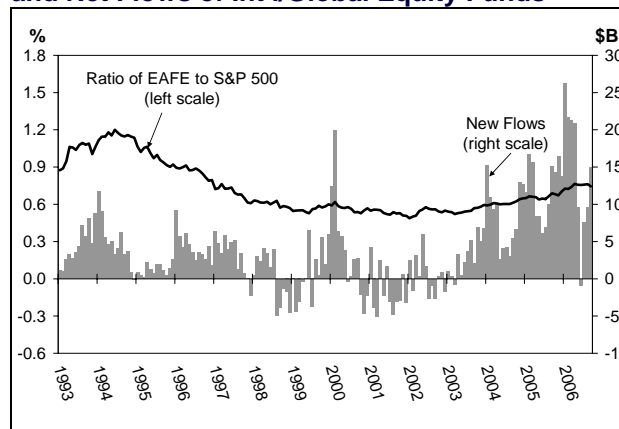
US-registered Equity Fund Asset and Flow Share: Domestic vs Int'l/Global (Inc. ETFs; Exc. VAs)

Fund Type	Assets 8/06		Net Flows Ytd-8/06*		
	\$T	Share	\$B	Share	% of Beg. Assets
Domestic	4.25	77%	38	24%	1%
Int'l/Global	1.25	23%	118	76%	12%
Equity/AA	5.50	100%	155	100%	3%

Source: Strategic Insight Simfund MF

The relative performance of international equity funds, represented by the EAFE Index vs. the S&P 500 Index is illustrated below, as is the dramatic acceleration of international equity fund flows.

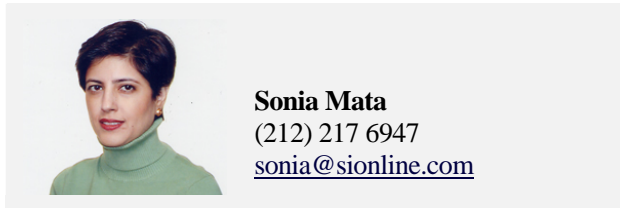
Relative Performance of US vs. Foreign Stocks and Net Flows of Int'l/Global Equity Funds



Source: Strategic Insight Simfund MF, Standard & Poor's

Further details on flows by investment style, showing the dominance of large cap, diversified funds, are available on sionline.com through our updated "[Key Forces Shaping the Fund Industry](#)" presentation.

401(k) Asset Allocation in 2005: Two-thirds in Equity



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Assets within 401(k) plans, the most common type of Defined Contribution (DC) plan, grew by 8% in 2005 to reach \$2.4 trillion. Mutual fund share of this DC plan segment has grown from less than 10% in 1990, to nearly 50% currently.

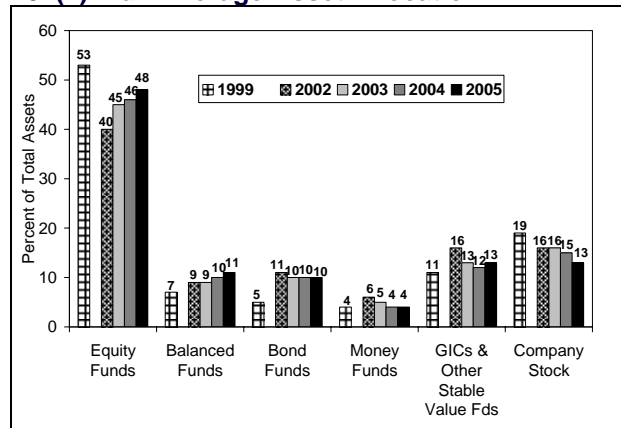
The Employee Benefit Research Institute (EBRI) and ICI recently published a study providing an update on asset allocation within 401(k) plans. The study used information from a joint EBRI/ICI database that at the end of 2005 contained around 47,000 plans with \$1 trillion in assets and 17.6 million participants. The database showed that the average share of equity/balanced funds in participant assets was 59%, up from 2004's 56% (see chart on right). Overall, equity securities, whether invested in through mutual funds (equity funds or the equity portion of balanced funds) or directly, accounted for roughly two-thirds of plan balances. This last proportion has actually never dipped below 62% over the past ten years despite the vicissitudes of the stock markets.

Beneath the broad averages, however, there are considerable differences in allocations. For instance, about one-fifth of participants held more than 80% of their balances in equity funds, while a third of participants held no equity funds at all. (Roughly half the participants holding no equity funds did, however, hold balanced funds or stocks, and get equity exposure that way.)

Balanced funds saw their share of plan balances inch up to 11% last year. Lifecycle/lifestyle funds, which have experienced accelerated growth in recent years, are included within the "balanced fund" category in the EBRI/ICI database. Among recently hired participants, a rising trend in balanced fund use is reflected in these numbers: nearly 43% of recently hired participants held balanced funds in 2005, as compared to 29% of their peers in 1998; about 19% of the plan balances of recently hired participants in their 20s was in balanced

funds in 2005, as compared to 7.4% among their peers in 1998, and 16% in 2004.

401(k) Plan Average Asset Allocation



Source: ICI

The overall proportion of company stock in plan balances continued to fall, reaching 13% in the 2005 database. The share of company stock is, of course, higher if we look at just those plans that do offer company stock as an investment option: among plans that offer company stock but no stable value funds, 23% of balances, on average, were in company stock.

Bond fund and money fund share of plan balances held steady at 10% and 4% respectively. The share of GICs / stable value, which had crept up somewhat during the equity bear market, has hovered at 12-13% since 2003.

DOL Proposed Rule on Default Investments

The share of stable value products may undergo some erosion as a result of recent legislative changes.

Traditionally, conservative options like stable value and money funds have been the most common "default" investment options in DC plans (the "default" is the option employed in the absence of participant investment direction; this issue typically arises in the context of automatic enrollment.) Although the use of lifecycle/balanced funds as default options has been growing, plan sponsors' fears of litigation should such hybrid investments sour in the short term, has held back more widespread application. The recently passed Pension Protection Act of 2006 laid the groundwork for overcoming these reservations by amending section 404 (c) of ERISA to extend its fiduciary relief to certain default investments, which the Department of Labor (DOL) was directed to identify. In September, the DOL proposed a rule that would provide fiduciary relief if assets are invested in a default option that is a "life-cycle" or "targeted-retirement date" fund, balanced fund, or managed account. Capital preservation vehicles have not been included in the proposed safe harbor.

Inside FundFiling.Com: Class Transitions



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The pace of change among pricing share classes remains high. Class B shares continue to be phased out, merged companies are generating class reorganizations, managers are consolidating for organizational purposes, and Class R and Institutional shares lead the way in the creation of new classes.

Reorganizing Shares

DWS Scudder began [an active reorganization program](#) over the summer, with the consolidation, for select funds, of Class I and Premier shares into Institutional Class shares, Class R merging into Class A, and finally, AARP, M and Investment shares all merging into Class S. **AIM** reorganizing included the [conversion of certain Class B shares](#) (those shares acquired by an exchange from the closed-end fund predecessor of **AIM Floating Rate** fund) into Class A shares.

Classes Opening/Closing (some related to merger actions)

The **Columbia Acorn**, **Acorn Select** and **Acorn USA** funds closed Class B shares to new investors, as did the [ING fixed income funds](#). **American Century** funds will no longer offer Class B shares through employer-sponsored retirement plans, and will *only offer* Class R shares through employer-sponsored retirement plans. Among many other changes, **BlackRock** closed Investor B shares to new/existing shareholders (with the **BlackRock Index Equity** fund closing Classes A, Service and Institutional). Four [Waddell & Reed](#) funds, and the [Legg Mason Partners Municipal Bond Florida](#) fund, closed Class Y to new/existing investors. The [Reserve](#) funds closed Class 8 to new/existing shareholders, and renamed Class 12 shares as Institutional shares. Class C shares of the **Merrill Lynch Municipal Short Term** and **Municipal Intermediate Term** funds closed to new investors. As

to the reopening of shares, the **Westport Select Cap** (Class I) and the **Alger Spectra** (Class N) funds reopened their shares to new investors on September 1st and September 22nd, respectively.

Renaming/Terminating Shares:

Vanguard funds renamed the long-standing Viper shares the more recognizable “ETF” Class.

[Wilmington](#) money market funds renamed Investor shares as Institutional shares, **M&T’s MTB Money Market** fund reclassifies its Institutional shares as Class A2, [WM Advisors](#) re-designated Classes R-1 and R-2 as Class A shares. Recent class terminations included **Dreyfus** money market funds’ [liquidation of E*TRADE shares](#) (whose assets moved elsewhere) and the liquidation by **ING Principal Protection** funds II, III and VI of their Class Q.

Introducing New Classes

Some new classes being introduced have been anything but the typical A, B and C shares. The [Columbia Large Cap Growth](#) fund introduced Classes E and F, shares designed for persons who wish to make an irrevocable gift to a child, grandchild or other individual. The shares are held in a trust until a specified date, at which time they pass to a beneficiary. Most, of the new class additions focus on the institutional investor. [Reich & Tang’s Institutional Daily Income Municipal](#) fund is adding broker/dealer account classes, F, O and T shares, with the [Institutional Daily Income Money Market](#) fund registering broker/dealer account classes, F, O, M and X. **Phoenix** also filed a Class X, a new class for institutional investors, for the [Phoenix CA Tax-Exempt Bond](#) and [Phoenix Strategic Growth](#) funds. [Vanguard](#) addressed the needs of smaller institutional investors by filing new Signal shares (which would have a lower minimum than existing institutional classes). The [Oppenheimer Champion Income](#) fund registered Class Y shares, available only to certain institutional investors that have a special agreement with the distributor. **Fidelity** added Institutional shares, as well as classes A, B, C, and T to its [Asset Manager](#) series. **RS** introduced Class I to many of its funds, along with a new Class K, which will be offered only through employee benefits plans. [SEI](#), [Artisan](#), [Excelsior](#), [Stephens](#), [Neuberger Berman](#), [DWS Scudder](#) and [Hartford](#) all registered new Institutional shares. Not to overlook new retirement shares: [BlackRock](#), [RiverSource](#) and [Legg Mason](#) put out a host of new Class R shares over the past few months.

Board Talk

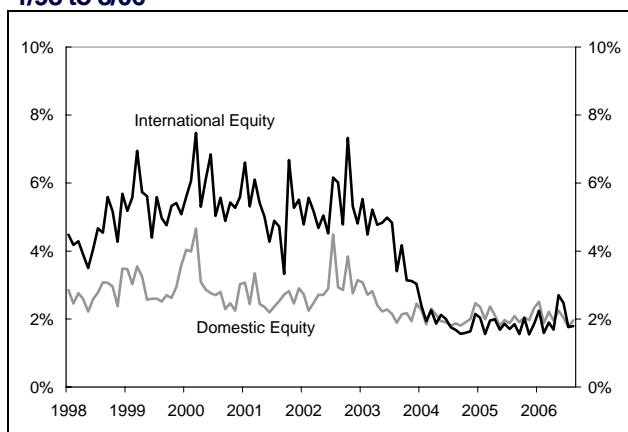


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22c-2: SEC New Timeline and Clarification; But Evidence that Abusive Market Timing Largely Gone

Corrective actions have resulted in the virtual disappearance of abusive time-zone arbitrage within international equity funds, as documented below.

Monthly Equity Fund* Outflow Rates, 1/98 to 8/06



* Excluding VAs. Source: ICI, Strategic Insight

Beyond international equity funds, asset velocity (as measured by outflow rates captured through N-SAR data filed by funds with the SEC and available in SI's Simfund) was stable and low in recent years among other investment strategies impacted at times by stale pricing (e.g., small cap equity, high-yield or international bonds.)

Morningstar® Investor Returns™ vs. Fund Returns

Morningstar just announced a new comparative performance measure, intended to measure how the average investor in a fund fared over a period of time. This ratio calculates dollar-weighted returns, to account for situations when investors add significant inflows sometimes towards the end of a particular period (possibly responding to a fund's terrific relative and absolute returns and high rankings), or, inversely,

to the timing of shareholders' redemptions. The subject of "investor returns", and how they differ from "fund returns" is already being introduced to the public discussion of funds delivering "better" or "worse" investor experience.

We look forward to studying this new measure once released, but also note some apparent limitations. For example, it appears that "investor returns" could largely lag the fund's return among very well-run funds which are appropriately benefiting from significant cash inflows; inversely, underperforming funds suffering redemptions (or funds closed to investors) may show "investor returns" equal or higher than the fund's total return. These observations are counter-intuitive and might be misunderstood.

Similarly, outperforming small funds that attract fast inflows (as a percent of assets) may demonstrate a wide gap between the fund returns and average shareholder returns. In contrast, large funds with steady, small flows as a percent of assets would be "praised" as providing a better investor experience.

Bottom line: the need to exercise prudence through asset allocation and avoidance of "hot" funds at the tail-end of their style's out-performance are well-recognized themes; it is unclear how this new measure of the average investor's experience would help beyond reinforcing such themes.

Performance Fee Miscalculations

In early September, the SEC settled five cases where fund companies' methods of computing performance fees did not match the required formula. For the purpose of calculation of performance fees, instead of averaging funds' net asset values during the same rolling periods as the performance periods, other methods were used (averaging asset values on the month or the quarter following the performance period, or just using latest assets.) In one case, the SEC commented on the fund's out-performance, rising assets, and too-high performance-fee incentives as miscalculated based on latest assets (not average during the past period); in another case, the SEC discussed the inverse situation: lagging returns, falling assets, and too small fee "penalty" based on latest, smaller asset value. (Note: an SI study published in early 2006, "[A Status Report on the Use of Performance-Based Fees in Mutual Funds](#)", is available on sionline.com.)

Variable Annuities



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ETFs in VAs: A Trend with Question Marks

Used by institutional investors, brokers, planners, RIAs, and some individual investors (so far mostly as stock / SMA substitution and sector bets), ETFs continue to grow fast. However, the extent to which this trend extends into the VA arena remains an emerging question. Relatively few ETF-devoted funds-of-funds (the only form of VA-based ETF investing allowed) are currently available. So far, Simfund VA tracks 14 such funds from three companies: MetLife, Phoenix and Touchstone. At the end of August, these funds held a total of \$517 million in assets.

VA ETF Fund Assets as of 8/06, \$ Million

Met Investors ST Cyclical Growth & Inc ETF *	186
Met Investors ST Cyclical Growth ETF *	210
Phoenix S&P Dynamic Asset Allocation Aggressive Growth	7
Phoenix S&P Dynamic Asset Allocation Growth	7
Phoenix S&P Dynamic Asset Allocation Moderate Growth	5
Phoenix S&P Dynamic Asset Allocation Moderate	2
Touchstone Aggressive ETF	17
Touchstone Conservative ETF	12
Touchstone Enhanced ETF	46
Touchstone Moderate ETF	24

Source: Simfund VA

* Assets in different share classes combined

The as-yet modest growth of VA ETF funds, the limitation of their design to funds-of-funds and the fact that ETF tax advantages are irrelevant in VAs, have not curbed interest in ETFs. **We have had numerous**

discussions with carriers that are considering using them. We have observed three important factors that influence the feasibility of implementing an ETF-based strategy: **(1) total cost; (2) hedgeability; and (3) access to sectors/specialties.**

Bright Future or False Start?

The use of ETFs in VAs most likely will increase over the coming months, but the degree to which these funds become popular with investors is still unknown. Given the tenor of our consultative conversations, cost now seems the stickiest factor in creating product designs that make sense for both clients and the carrier. Some carriers suggested that the overall low cost of ETFs and their specific pricing structure makes it challenging to price funds-of-ETFs such that a basic strategic allocation model can provide adequate product profitability. And at least one carrier concluded that traditional index funds were cheaper.

However, not all agree that cost will remain an issue limiting broad development of ETF funds in VAs. For example, XTF Advisors is a new firm that is banking on the growing popularity of ETF-based funds, and part of its business is devoted to constructing and managing ETF portfolios for VAs. The company asserts that the economics of ETF-based funds-of-funds can work for many carriers, further predicting that many new funds will get registered next year.

VA risk management is always a consideration, and ETF-based funds are easier to hedge. Although not the only factor, this did contribute to Integrity Life's decision to use its ETF funds as the basis for its first living benefit.

Another important factor in the usage of ETFs relates to the availability of a broad variety of specialty and sector options. The many existing offerings of sector ETFs could help in VA ETF developments. Not only does this facilitate further innovation for VA funds-of-funds, but it also means that non-ETF-focused funds are more likely to use ETFs incidentally as apt investment choices.

Generally speaking, the trend of ETFs in funds-of-funds follows along with the broader acceptance of FoFs, but ETFs also lend themselves to use in specialized strategies and in marketing directed to ETF-friendly (or, more generally, low-cost) advisers. For that reason, these funds represent not simply a subset of FoFs but are a distinct and evolving class of investment options.

Asia Highlights



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Despite a slowdown in inflows during July, **net contributions to mutual funds in a number of Asian mutual fund markets captured below approached \$90 billion year-to-date, already surpassing last year's full year flows and more than twice as high as full year results in 2004.**

Mutual Fund Net Flows in Asia, Selected Countries *, \$ Billion

	2003	2004	2005	1-7/06
Equity	24	42	47	74
Mixed	-10	0	4	5
Bond	-14	-5	16	-3
Other	6	1	11	7
Long-Term	6	38	78	84
Money Market	-15	15	-2	2

Source: Strategic Insight, Industry associations.
*Includes Japan, Korea, India, Taiwan and Hong Kong.

Contributions to equity funds, as shown above, remain the main driver of flows in Asia. Most of the money went to equity funds in Japan, but equity funds in Korea and India accounted for 20% and 10% of aggregate regional contributions, respectively.

Asia Net Flows by Country in \$ Billion, 1-7/06

	Japan**	Korea	India	HK	Taiwan	Asia Total
Equity	48	14	6	5	1	74
Mixed	-	6	0.1	-0.1	-0.5	5
Bond	1	-3	2	0.2	-3	-3
Other*	-	8	-	-2	1	7
Long-Term	49	24	8	4	-2	84
Money Mkt.	-3	-8	13	0.1	0.3	2
Total	46	16	21	4	-1	86

*Other includes mostly guaranteed funds and ETFs in Taiwan, and REITs, FoFs and commodity funds in Korea; **Japan data from JITA adjusted for certain bond funds in the balanced equity category. Source: Strategic Insight, Industry associations.

Equity fund flows in Japan so far this year (through July) approached \$50 billion, up from less than \$30

billion in 2005. Significantly, over half of that total went to funds-of-funds according to data from Japan's industry association. We also estimate that roughly 75% of flows went to funds-of-funds that invest in part or in whole in external/ unaffiliated investment managers. Note also the sharp decline in global sovereign bond fund inflows.

Mutual Fund Net Flows in Japan Equity vs. Bond, 2005-2006, \$ Billion

	2005	1-7/06
Total Equity Funds*	27	48
Domestic Equity	2	9
International Equity	8	7
Fund of funds	27	25
Index Funds	-7	7
Total Bond Funds	58	1
Global Sovereign Bond	44	19
Other Bond	14	-18

Source: Strategic Insight, JITA; *Includes certain investment products such as convertible bond funds and derivative funds, which are classified as equity funds by JITA and not shown in the table; thus total for equity funds is not the sum of the breakdown.

Funds-of-funds are especially prominent among "Mixed Asset" funds in Japan. A few notable examples, among both mixed and equity funds:

- **Nomura's MyStory Distribution**, a balanced FOF that combines multiple asset classes (stocks, highly rated bonds, and high yield/emerging market bonds), includes external fund investments, and pays dividends six times a year, attracted \$4 billion in flows to date.
- Also from the group, **Nomura Fund Masters Global Emerging Markets Equity** with \$1.6 billion of flows this year invests in external funds.
- **Nikko Mellon GW Select Best Nine Fund**, managed by Mellon Global Investments Japan and distributed by Nikko Cordial Securities Inc., was introduced in April and collected over \$5 billion through July. The **Best Nine product combines traditional with alternative investments across nine asset classes**, and is offered through two Cayman Islands domiciled investment options with different risk levels, **GW Select Fund Aggressive Type** and **GW Select Fund Moderate Type**. Selection and monitoring of underlying managers, funds, and asset allocation are carried out by both Mellon's fund of funds subsidiary (EACM Advisors) and Nikko Cordial Corporation's Global Wrap Consulting Group. The investment universe includes five Mellon subsidiaries, and Mellon Capital Management also provides a **Global Tactical Asset Allocation overlay** across the entire portfolio.

New Funds in Europe



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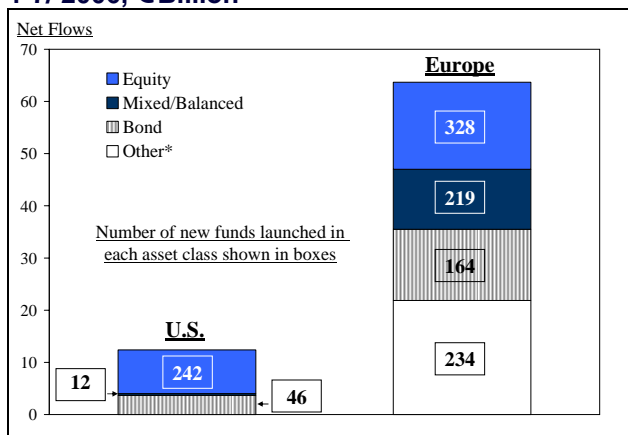
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Offering Access to Specialist Managers and “Stars”

Product development continues at a strong pace in Europe, with **nearly a thousand funds launched since the end of last year**, excluding money market programs. These new funds collected almost **€70 billion in assets and accounted on a net basis for 40% of total inflows** in the region to long-term programs. In contrast, in the more mature US fund market, new funds introductions, especially for core investment strategies, remain subdued.

Monitoring fund introductions and their successes in the context of evolving investor demand in various markets, especially in light of innovative products made possible by UCITS III, suggests current and future distribution and partnership opportunities.

New Long-Term Funds, Number and Flows 1-7/ 2006, €Billion



* “Other” asset class includes Guaranteed, Hedge and Real Estate Funds. Source: Strategic Insight, Lipper Inc; data includes all share classes of a fund.

In the inaugural issue of Global Windows, we had highlighted the top new fund offerings in Europe during the first half of this year, which included **absolute return products, guaranteed funds, institutional fund vehicles**, and various **equity and bond funds along with sector themes**.

New products featuring access to external fund managers, through **sub-advisory single- or multi-manager** formats, are also evident.

For instance, **Pictet & Cie** of Switzerland launched their Luxembourg-domiciled **Pictet Funds (LUX)-US Equity Selection** at the end of June, gathering close to €100 million. A concentrated portfolio, the fund invests in U.S. large-cap stocks. It is managed by **Waddell and Reed**, one of the oldest US mutual fund companies with over \$30 billion in mutual fund assets, and fast growing lately.

Also in mid-June, **Skandia Investment Management Ltd** – the U.K. asset manager focused on products for financial advisors and their clients through the selection and monitoring of specialist managers – introduced **Skandia Global Best Ideas**. The fund, which had €70 million in assets by July-end, brings together the best selections from **ten “star” managers** from different investment companies. It allocates 50% to five U.K. managers, and the balance to others. The fund will hold a portfolio of about 100 stocks. Each manager will contribute ten best ideas without any index constraints, and are free to hold large positions of up to 25% of their allocation in individual stocks or cash.

Skandia Global Best Ideas Fund Allocation as of June 2006

Region	Alloc.	Company	Manager
UK	50%	New Star	Stephen Whittaker
		Artemis	Mark Tyndall
		Merrill Lynch	Richard Plackett
		Gartmore	Ashley Willing
		AXA Framlington	Roger Whiteoak
US	17%	Martin Currie	Tom Walker
Europe	14%	Odey	Crispin Odey
Emerging Mkts	7%	First State	Angus Tulloch
Japan	6%	Schroder	Nathan Gibbs
Asia ex. Japan	6%	Aberdeen	Hugh Young

Source: Strategic Insight; Skandia Investment Management.

Guest Column



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Adoptions and Absorptions – More Common, Less Effective?

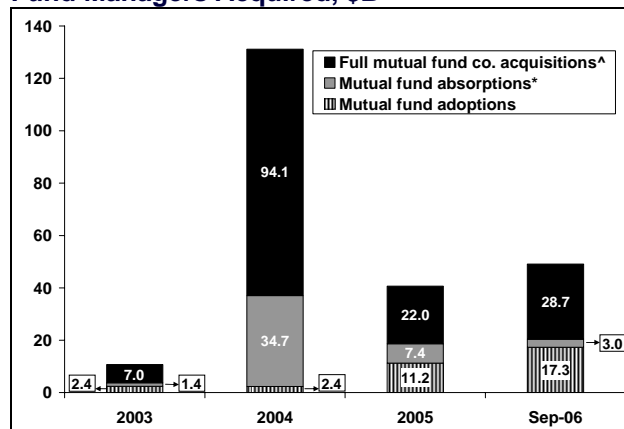
Mergers and acquisitions in the global fund management industry have reached a fever pitch in 2006, a year in which the level of transaction activity threatens to shatter records, at least in terms of assets under management changing hands. Beyond recent mergers of a number of large asset managers, fund adoptions and fund absorptions collectively represent an increasingly powerful theme side-by-side with traditional M&As. *Adoptions* describe transactions where a fund manager partners with another management company (often larger and with established retail distribution presence), who takes over fund management, legal, and distribution elements, while the investment advisor responsible for the fund’s historical results retains a sub-advisory agreement. Elsewhere, fund *absorptions* involve buyers folding purchased funds into existing products through tax-free transfers.

A wider array of large U.S., and even European, mutual fund complexes see these acquisition strategies as tools through which they can wring further efficiencies of scale from their administrative and distribution operations—as well as gain access in some cases to differentiated, if not superior, asset management product. Adoptions and absorptions also promise relief to firms operating smaller fund families, struggling with increasing compliance and distribution costs and longing to focus on managing money rather than deal with the infrastructure of retail fund provision. First used in the early 1990s and more commonplace today, fund adoptions and absorptions

certainly have become an effective way to strengthen both sub-advisor and manager. Yet, post-adoption accelerating sales, scale and investment capacity management, and performance results, for both existing shareholders and new shareholders, remain themes of importance for all parties involved in these relationships.

Six years after Vanguard Group’s absorption of Turner Investment Partners’ Growth Equity Fund—fund adoptions have swelled in size. The Phoenix Companies’ recent adoption of the 19-member Insight Funds family, representing \$10.5 billion in assets under management, from Bank of Montreal’s Harris Bank subsidiary, is the largest such deal cut to date. In fact, adoptions represented 35% of the assets changing hands in transactions focusing exclusively on U.S. mutual funds (*i.e.*, excluding deals involving diversified asset managers with both retail and institutional clients) during the first nine months of 2006.

Assets Under Management by Pure U.S. Mutual Fund Managers Acquired, \$B



* Includes \$29bn of AllianceBernstein money market funds absorbed by Federated.

[^] Statistics exclude mutual funds purchased as part of larger diversified fund managers with inst'l clients.

Source: Putnam Lovell NBF Securities

Absorptions are also becoming more common, although they often involve smaller, poorer-performing funds—products better suited for mergers into larger, more established portfolios—and therefore usually represent a smaller proportion of purchased assets. One sizable exception involves Federated Investments’ 2004 decision to buy AllianceBernstein’s cash funds, which held \$29 billion at the time.

Strategies

As industry forces continue to separate investment manufacturing and distribution, more adoption opportunities may unfold. Some institutionally-oriented managers with only small mutual fund operations may increasingly find the legal and distribution elements of mutual funds costly and distracting. Rising compliance and disclosure burdens, as well as the increasing costs of securing shelf space, have made it tougher for some smaller complexes to achieve sufficient profitability. For such organizations, adoption allows a fund advisor to focus on its core competency: managing money. While advisory fee ratios of an adopted fund are thinner—typically the adoptive parent retains 50% to 60% of the management fee, on average—the fund manager sheds the costs and headaches of thorny distribution issues better handled by bigger operations, but continues to participate in incremental asset growth.

The benefits to the fund complexes adopting the funds are clear. Families that already have covered many fixed costs of administration can derive more marginal profit from each additional fund. Adopting funds with attractive historical returns can provide tactical advantages by stimulating sales of such funds (and possibly others within the same family), as well as long-term advantages and differentiated strategies. Naturally, an adoption proves quicker and more cost-effective than waiting for start-up funds to gain attention.

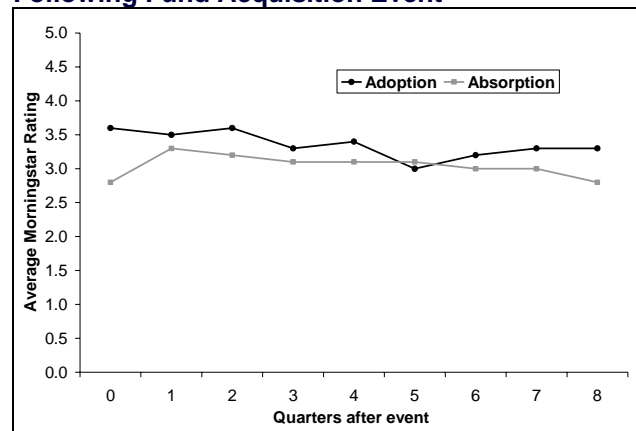
Several larger financial services companies besides Phoenix—which has overseen at least three adoptions—have emerged as champions of the adoption strategy. John Hancock Financial, now a unit of Canada’s Manulife Financial, was an early adopter of opportunistic rifle-shot adoptions—first in the early 1990s, then with a fund from Yeager, Wood & Marshall, and then with one from small-cap specialist Pzena Investment Management—before its decision to more strategically tackle international investments by adopting \$10 billion of GMO fund assets last year. Charles Schwab Corp., seeking an expansion of its proprietary product array, adopted AXA Rosenberg’s \$1.4 billion fund array in 2003. There were other successful adoptions in recent years, among them by Pioneer, Dreyfus, Touchstone, Evergreen, and more (SI: see Strategic Insight’s study “[Developing Subadvisory Relationships](#)” June 2004, pages 5-7.)

Performance

Adoptions clearly help build bigger and wider product arrays, but post-adoption performance results naturally vary. In one simple approach, we studied pre- and post-adoption rankings and their changes, as compiled by Morningstar (recognizing that such ratings carry the historical performance and tend to change only gradually as a result.)

The average composite Morningstar rating of 40 adopted funds fell nearly half a point during the two years following adoption. (Data for the third year, given the small sample of funds with such long post-adoptive histories, is inconclusive.) About one out of five funds in the sample lost the coveted four- or five-star rating that they brought with them when adopted (notably, most funds kept their above-average ratings); one in four lost at least one star, yet, nearly the same proportion, 18% of the funds, watched their ratings rise.

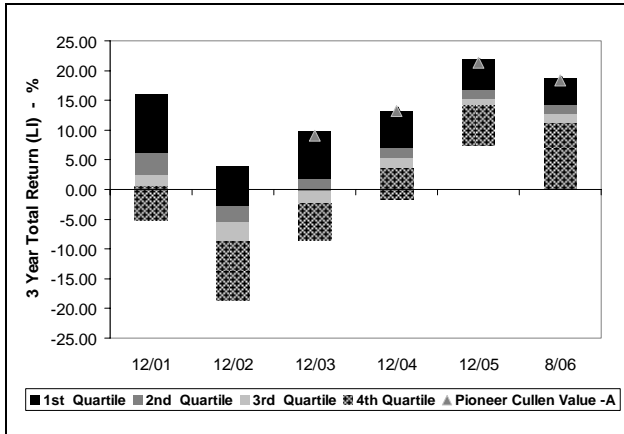
Average Composite Morningstar Ratings Following Fund Acquisition Event



Source: Strategic Insight Simfund, Morningstar, Putnam Lovell NBF Securities

Naturally, many highly rated adopted funds experience accelerated inflows post their adoption and may reach capacity limitations, choose to modify their strategy, and at times experience lower relative return. Other funds maintain their investment momentum and keep their ability to leverage a successful investment strategy over a larger asset base. For example, Pioneer Group’s Cullen Value, adopted with only \$45 million in its coffers, has garnered more than \$1 billion in net flows so far in 2006 and kept its five-star composite, as well as its superior risk-adjusted returns despite its spectacular growth, as captured below in its relative three-year rolling return ratings within its Lipper Large Cap Value classification.

Rolling 3-Year Annualized Total Returns
 Lipper Classification “Large Cap Value”: Relative Performance Ranking of Pioneer Cullen Value Versus its Peer Funds*



* Only primary share class.

Source: Strategic Insight Simfund

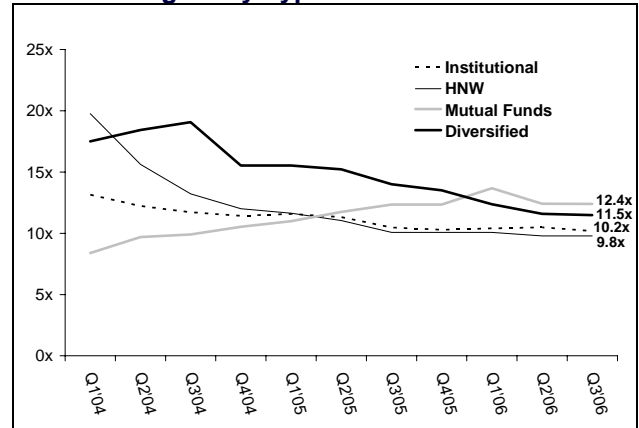
Some adopted funds maintain high ranking and sales; others reach capacity, experience deteriorating returns, or are simply in an out-of-favor category. Regardless of the reason, nearly half of the funds examined suffered net redemptions after adoption.

Conclusion

The success of selected adoptions over recent years has been remarkable. John Hancock, Pioneer, Schwab, and Evergreen are just a few fund complexes where adoptions significantly changed the dynamic of expansion. For example, with John Hancock as an adoptive parent, Pzena Investment Management’s value equity fund added \$6 billion in net inflows (with additional gains elsewhere for the advisor.) Schwab helped double the size of the AXA Rosenberg Funds, re-branded Laudus.

This evident growth potential will continue to fuel the number and size of adoptions and absorptions, as available opportunistically and tactically. As in the past, due diligence of investment processes and capacity management considerations will continue to be critical. Such selectivity will make stable, better-performing funds (with available capacity to manage more assets) even more desirable—and likely contribute to the already rising multiples buyers are paying for mutual fund complexes.

Rolling 3-Yr Median EBITDA Multiples for Asset Managers by Type



Source: Putnam Lovell NBF

Putnam Lovell NBF Securities Inc. is an investment banking firm focused on financial services, and a leading advisor of mergers and acquisitions involving the investment management industry. The firm serves a clientele comprised of global financial institutions, banks, private investment firms, broker-dealers, insurance, mutual fund vendors, and financial technology firms. Founded in 1987, Putnam Lovell NBF operates from offices in Boston, London, New York, and San Francisco.

Tools Time: Linking Simfund to FundFiling.com



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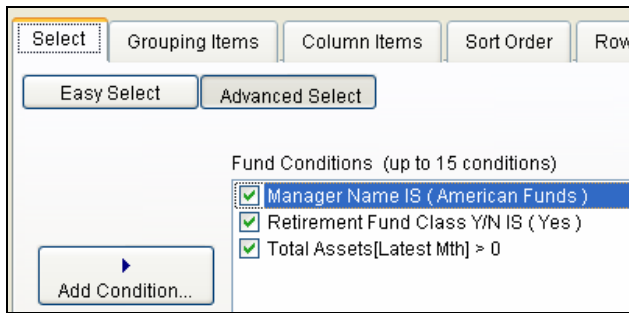


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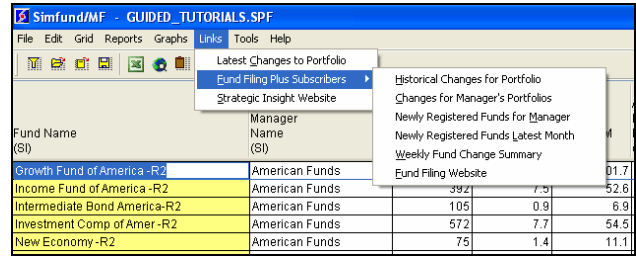
You can find answers to questions raised while using Simfund, through the instant link to SI's FundFiling.com library of the latest prospectus documents, or any changes to that fund (or by same manager). Below we walk you through a simple query to provide an illustration.

- In Simfund, click on the  "Define Grid" button or funnel icon on the tool bar to start building your query.
- In the "Select" tab, choose the following selection criteria.

American Funds
Total Assets Latest Month > 0
Retirement Share Class = Yes [in the advanced select]

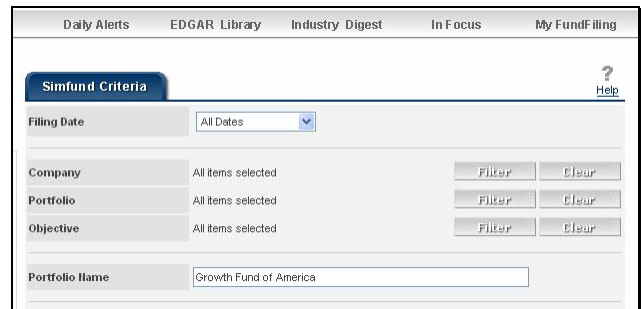


- In the Grouping Item tab, choose "Fund Name" as your grouping.
- Click OK in the Define Grid screen to run your query.
- Now place your cursor on the fund whose changes you wish to track, e.g. "Growth Fund of America – R2", then go to the main menu, and click on "Links" as seen in the next screen shot.



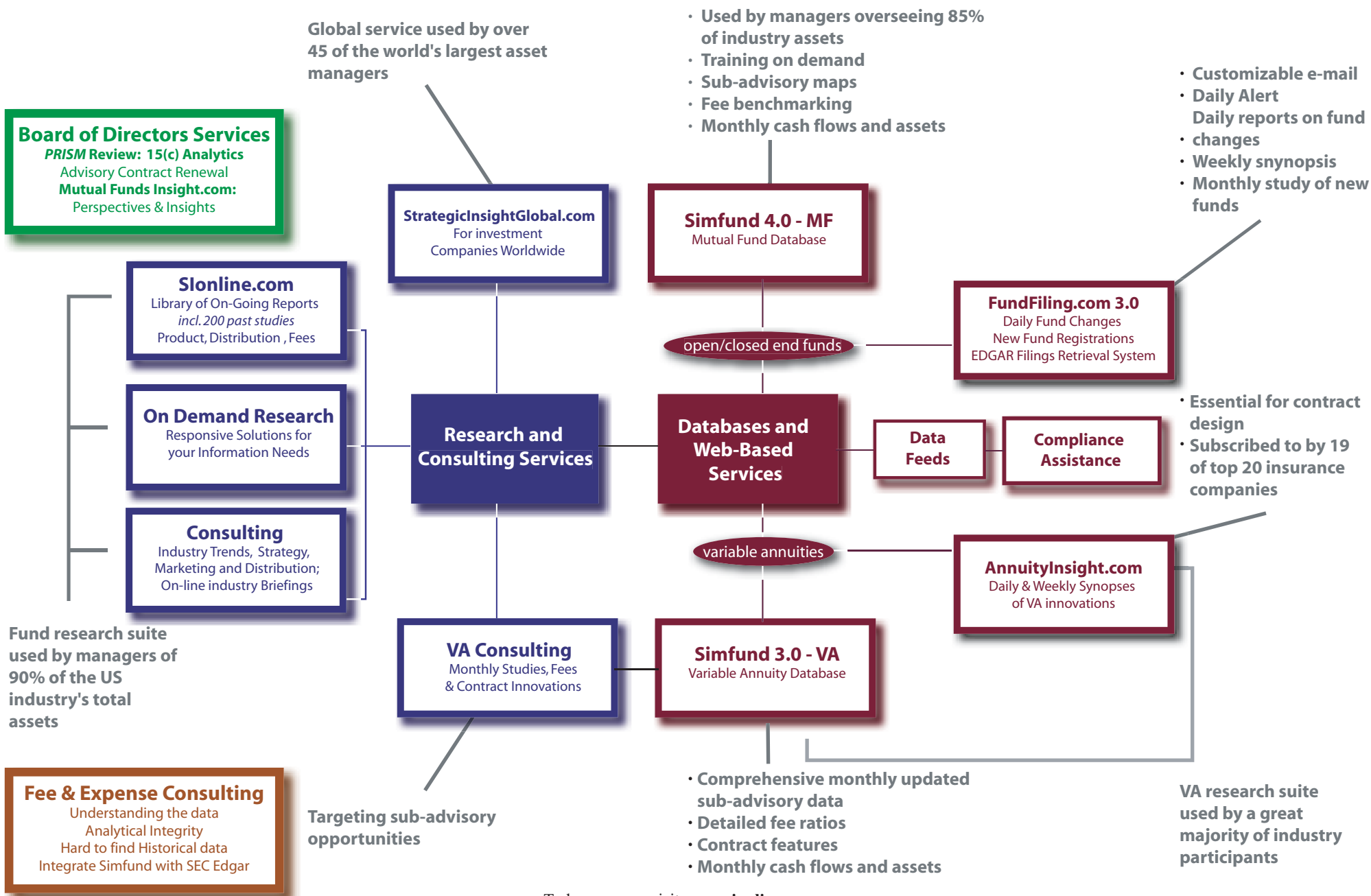
- There are multiple ways of linking up to FundFiling.com. Choose the middle option "Fund Filing Plus Subscribers" (some FundFiling.com features are open to all Simfund subscribers; advanced features are accessible only by FundFiling.com subscribers). Navigate to "Historical Changes for Portfolio" which will link you to all changes for the highlighted portfolio (which may or may not include changes to the R-shares.)

You can also access the latest prospectus for the portfolio, to study, for example, the fee structure of its retirement share classes. There are a number of ways to find the latest prospectus for the fund on FundFiling.com; you can use "Simfund Criteria" under the "EDGAR Library" menu as seen below. Search for the fund whose prospectus you're trying to access or simply choose its management company.



If you open the latest prospectus as an HTML document, for example, you can use the "Find" function to search for the term "Other Expenses" and then study the fees for this share class (popular in small retirement plans), which are paid to affiliated or unaffiliated entities providing services to the retirement plans.

	PAYMENTS TO AFFILIATED ENTITIES	PAYMENTS TO UNAFFILIATED ENTITIES
Class A	.05% of assets or \$12 per participant position*	.05% of assets or \$12 per participant position*
Class R-1	.10% of assets	.10% of assets
Class R-2	\$27 per participant position plus .15% of assets	.25% of assets
Class R-3	\$12 per participant position plus .10% of assets	.15% of assets
Class R-4	.10% of assets	.10% of assets
Class R-5	.05% of assets	.05% of assets



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