

Strategic Insight

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Innovations to Help Your Company Grow



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Mutual fund fees, and innovation, have been high on my mind lately, and are the common theme of this Windows edition.

Fees: 12b-1, and SI Monitoring Tools

I was fortunate to have taken part in the SEC's June 19th hearings on Rule 12b-1. In preparation for the panel "*Looking Ahead: What Are Our Options?*", moderated by the Director of the Division of Investment Management, SI put together a 20-page study ("[Rule 12b-1: Looking Back, Looking Forward, in the Context of a \\$12 Trillion Mutual Fund Industry](#)"), which was shared with my fellow-panelists and the ICI ahead of time, and later shared with you and submitted to the SEC.

Lately, SI has intensified its focus on mutual fund fee research. One important development we are excited to announce is the inclusion within the newest version of Simfund MF, its version 5.0, of the entire range of fee data available in funds' most current prospectuses (more than 50 data items; see details in our SimfundFiling sections on pages 9 and 10-11).

Simfund 5.0 now offers a complete mapping of fund fees, combining Annual Report disclosure with fee information from the latest Prospectus; plus a hyperlink to each fund's SEC filings intelligently organized on SimfundFiling.com (SI's library of all SEC fund filings). Together, these enhancements greatly expand your ability to benchmark fees, critical for competitive advantage.

Who are My Peers? Out-of-the-Box Innovative Solutions

Like many others, we have been wrestling with the appropriate way to categorize funds and create refined peer groups. We concluded it would be competitively essential for managers to see themselves through the prisms of both leading fund trackers—Morningstar and Lipper. The new Simfund 5.0 allows you to do just

that. Now you can access all the key data from both organizations and view it side-by-side; plus, we added a **third peer group analysis dimension**, the fund's prospectus-stated benchmark.

We are also intrigued by research conducted by AthenaInvest Inc. on **peer selection founded on Strategy-Based Investing**. Such an approach may free Portfolio Managers from the limitations of being "**stuck-in-the-box**", and facilitate a forward-looking portfolio construction with likely favorable results. We encourage all of you to **review a Guest Column in this issue describing AthenaInvest's approach**.

Innovations to Reduce Tax, Trading, and Liquidity Costs

On the oft-discussed topics of the **costs of securities trading, fund liquidity, and taxes on capital gain distributions**—important innovation for the industry allowing a sharp reduction in each of these costs is offered by ReFlow Management, a San Francisco-based technology firm that recently added OppenheimerFunds as a client. A second **Guest Column in this Windows issue describes these important innovations and is another must-read**.

Major SI Innovations for You, and a Source of Great Pride for Us

The just-released Strategic Insight Simfund MF 5.0 greatly expands your ability to support sales, board and fee reports, product management, and investment management benchmarking. **The industry finally has, in one integrated database, all the key publicly-available business intelligence data.**

What's in 5.0? Comprehensive performance, ratings, and portfolio information, from both Lipper and Morningstar; SI-calculated market shares and fund flows; **comprehensive and more timely fee and expense data**; and smart, instantaneous hyperlinks to a sister SI web site facilitating additional research of all SEC filed documents; **additional links connect each fund in Simfund to its Lipper Fund Fact Sheet.**

Simfund, first offered 14 years ago, is already used by fund managers overseeing more than 80% of the industry's AUM, and, among others, the ICI, and the SEC (via a datafeed). SI looks forward to helping each of you uncover how version 5.0 can benefit different business units inside your firm; **email simfund5@sionline.com to invite us to present these many new capabilities to senior management, on location, as well as train your analysts.**

Fund FlowWatch: First Half 2007 and Beyond



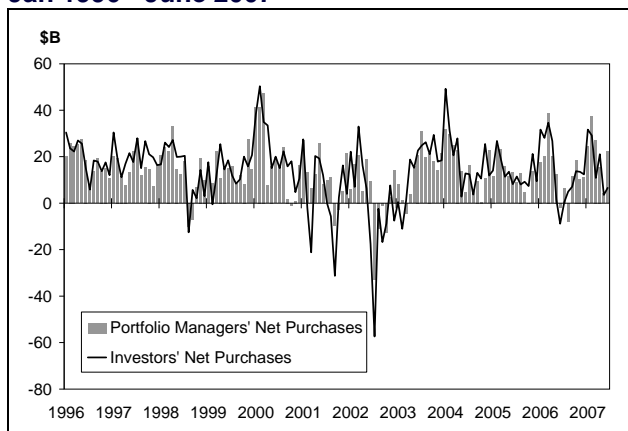
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Recent Performance in Perspective

After peaking around July 19th, stock markets fell sharply. A rebound in early August was followed by further sharp corrections. These market corrections have nearly wiped out year-to-date gains for most US equity funds. Although the pullback was global, some international equity categories—Asian, Latin American and Emerging Markets—still show sizable year-to-date gains.

Concerns about the future direction of stock and bond markets, and about the impact of market volatility on mutual fund flows and on net demand by portfolio managers, are inevitable. In that context, we share a reminder from many past SI studies: redemptions spikes are **always limited in scope, short-lived, and non-recurring, and fund portfolio managers always “buffer” net redemptions spikes, as illustrated in the graph below. Of course, small pockets of high redemption activity are also evidenced at times.**

Equity Fund Net Purchases: Portfolio Managers vs. Investors Jan 1996 - June 2007



Source: Strategic Insight Simfund, ICI Trends

First Half 2007 Highlights

Some first half highlights: more than \$180 billion in net flows into actively-managed stock and bond funds (if the market stabilizes in the second half, full-year active long-term fund flows will establish a dramatic all-time record), persistent demand for international diversification, a very high level of bond fund flows despite a flat yield curve, a record \$24 billion amassed by closed-end fund IPOs, accelerating fund-of-fund (especially target-date FoF) flows, greater investor awareness of long-short and market-neutral funds, and ongoing ETF development.

Mutual Fund Flow Trends; Exc. VAs and ETFs

	Assets		Net Flows \$B		
	\$T	6/07	Q1'07	Q2'07	1H07
US. Eqty / Hybrid	4.8	35.8	-2.9	32.9	
Int'l / Gbl Eqty	1.6	59.2	45.7	104.9	
Taxable Bond	1.2	34.8	39.3	74.1	
Tax-Free Bond	0.5	8.4	5.1	13.5	
Money Market	2.5	0.0	0.1	0.1	
Total above	10.5	160.3	151.1	311.3	

Source: Strategic Insight Simfund MF

Fund-of-Fund Flow Trends (Excludes 529 Plans)

	Assets		Net Flows \$B		
	6/07 \$B	1Q'07	2Q'07	1H'07	
Target-Date	151.0	15.3	13.4	28.7	
Risk-Based	169.0	8.3	5.3	13.6	
Other	142.1	6.5	5.4	11.8	
Total Above	462.0	30.1	24.1	54.2	
VA FoFs	135.7	8.6	9.5	18.2	

Source: Strategic Insight Simfund MF / VA

Asset-Weighted Average Total Return % Trailing Periods, as of 6/07

Fund Type	1H07	1 Yr	3 Yrs	5 Yrs
US Equity / Hybrid	8.09	19.14	44.85	77.71
Int'l/Global Equity	11.77	29.07	89.06	140.63
Taxable Bond	1.53	6.76	15.51	33.18
Tax-Free Bond	0.23	4.67	14.61	24.02

Source: Strategic Insight Simfund MF

Some Notable New Closed-End Funds Being Readied



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A few of the closed-end funds filed in July 2007:

Eaton Vance registered the **Risk-Managed Equity Income Opportunities** fund, which will combine a US-focused dividend-capture approach with a range of options strategies. The fund will (i) invest in stocks that pay qualified dividend income, (ii) write put options on stocks considered attractive for purchase, and (iii) write stock index call options with respect to a portion (initially roughly two-thirds) of its stock portfolio. To lessen downside risk due to an equity market decline, the fund will buy index put options against a sizable part of the value of its common stock holdings and stocks subject to written put options. **Rampart Investment Management** will implement the options strategy.

Evergreen filed the **Diversified Income Opportunities** fund, which will seek a high level of current income through a diversified portfolio built using a mix of “top-down” and “bottom-up” approaches, with at least 25% in equity securities. After identifying geographical/industry sectors that it believes are likely to benefit from favorable growth rates, Evergreen will analyze specific companies, and the securities those companies offer – **common and preferred stocks, convertibles, and debt**. A portion of the fund’s debt investments will likely include mortgage-backed securities, including collateralized mortgage obligations, and various structured products, chosen by the sub-advisor, Evergreen affiliate, **Tattersall Advisory Group**.

DWS Scudder filed the **Dreman Enhanced Total Return** fund. Sub-advisor **Dreman** will use a value

approach to invest chiefly in equity securities of U.S. and foreign companies with a capitalization of \$5 billion and higher. The fund plans to write covered call options on stocks that meet the sub-adviser’s sell criteria, and to write covered put options as a way of acquiring potential investments while also earning option premiums.

Federated’s proposed **Enhanced Treasury Income** fund will normally invest at least 80% of its total assets in US Treasury securities, and up to 20% of its total assets in US Gov’t Agency securities. It will seek to generate current earnings by actively managing its core portfolio and by implementing an options strategy. **Dix Hills Partners**, in which Federated acquired a minority interest earlier this year, will sub-advise the fund.

Funds Started in 2007 Raising Most 2Q Net Flows* Actively Managed Stock and Bond Open-End Funds \$ Million			
Portfolio Name	Assets 6/07	Net Flows	
		Q2'07	Jun'07
Stand-Alone Funds			
Domestic Equity			
Fidelity Small Cap Opportunities	950	934	67
Goldman Sachs Commdty Strgy	207	196	19
LSV Conservative Value Equity	53	52	35
Plumb Balanced	51	51	10
JHF II Mid Cap Intersection	339	51	3
International Equity			
Schwab Global Real Estate	288	293	36
JHF II Emerging Markets Value	472	144	144
Aberdeen Emerging Markets	109	106	25
Russell Global Equity	995	96	22
Oberweis Intl Opportunities	105	80	19
Bond			
PIMCO Emerging Local Bond	1,511	866	245
CreditSuisse Instl Asia Bond	330	332	10
TA Idex Loomis Sayles Bond	266	107	72
RVS Strategic Income Allocation	71	71	16
Price Instl Intl Bond	66	66	7
Weitz NE Tax Free Income	52	52	3
Wm Blair Bond	52	52	6
Funds-of-Funds			
PAS Intl Fidelity FOF	439	330	44
PAS US Opportunity FOF	153	84	57
GuideStone MyDestination 2015	115	84	23
American Target Retire 2020	95	75	27
American Target Retire 2015	91	73	30
American Target Retire 2010	90	68	23
American Target Retire 2025	67	55	19
GuideStone MyDestination 2025	73	54	18

Funds with 2Q'07 net flows > \$50 MM.
Source: Strategic Insight Simfund.

International Funds: 1H 2007 Trends



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Demand for global diversification remained remarkable in the first half, with total flows to funds investing all or most of their assets overseas nearing \$130 billion (flows slowed in 2Q, though, and naturally since then). Since the second half of 2003, US-registered international / global equity funds have garnered over \$600 billion in net inflows.

US-Based International/Global Equity Mutual Funds \$B

Structure/Type	Assets		Net Flows			
	6/07	2003	2004	2005	2006	1H'07
Open-end Active	1,460	27.3	71.6	104.8	131.2	74.8
Open-end Indexed	85	2.2	5.7	8.9	11.3	11.4
ETFs	141	5.7	15.3	23.0	26.6	16.5
Closed-End	54	0.3	4.4	6.7	2.7	18.1
VA Funds	198	4.9	9.3	12.3	18.8	9.9
Total	1,938	40	106	156	191	130

Source: Strategic Insight Simfund MF / VA

Beyond huge purchases made by international equity funds, demand also originated from global rebalancing by portfolio managers of US-centered funds and by institutional pools and hedge funds. And European money managers similarly transferred large holdings into developing countries, as reported in SI's Global FlowWatch studies.

Int'l Equity, US Equity, and World Bond Funds Annual Average Total Returns (Asset-Weighted) %

	'02	'03	'04	'05	'06	1H'07
Int'l/Glbl Eqty	-15.4	37.5	18.5	16.4	24.0	11.8
U.S. Equity*	-20.5	30.9	12.5	7.9	14.1	8.3
World Bond	13.3	13.2	8.9	-2.1	6.7	2.1

Source: Strategic Insight Simfund MF; * Exc. Balanced/Hybrid,

In 1H07, combining stock gains and currency appreciation, **international / global equity funds returned 11.8% (asset weighted), on average, or nearly 4 percentage points above the 8.1% returns of US equity funds.** As mentioned on the previous page, the July-August market corrections nearly wiped out year-to-date gains for most US equity funds, but

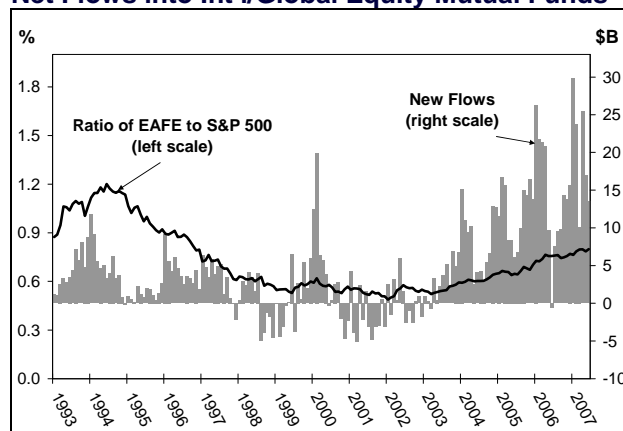
some international equity categories—Asian, Latin American and Emerging Markets—still show large year-to-date gains.

The performance advantage of Int'l / Global equity funds over the trailing five-year period (as of 6/07) is extraordinary—they returned 126% on average (asset weighted) over the period vs. 68% for US equity funds. World bond funds also slightly out-earned US taxable bond funds and pulled in \$12 billion in the first half.

Strong demand for international funds should persist, despite the recent stock market turmoil, thanks to the momentum and trailing performance of such funds, as well as due to concerns about the US Dollar, awareness of globalization, the domestic nature of the sub-prime mortgage market problems, and portfolios still under-exposed to international wealth creation.

Flow trends, and the relative performance of the MSCI EAFE Index vs. the S&P 500 are captured below.

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



Source: Strategic Insight Simfund, Standard & Poor's

Actively Managed International/Global Equity Funds Highest 2Q 07 Net Flow Classifications

	Net Flows \$B		Assets \$B
	2Q'07	1H'07	6/07
Intl Multi-Cap Value	9.1	17.5	132.3
Real Estate (Global)	5.9	10.4	25.0
Global Multi-Cap Val	5.4	11.6	137.1
Intl Multi-Cap Gro	5.2	12.5	258.9
Intl Multi-Cap Core	3.3	8.3	206.1
Intl Large-Cap Value	1.6	3.4	20.9
Emerging Markets	1.5	3.3	130.3
Global Funds	1.3	11.6	19.8
Pacific Ex Japan	1.2	1.7	19.6
Intl Sm/Mid-Cap	0.9	1.5	12.8

Excludes closed-end funds, index funds and ETFs, as well as VA funds
Source: Strategic Insight Simfund MF; Lipper Inc. (Classifications); new funds not yet classified by Lipper are assigned to likely classifications

Some Noteworthy FoFs Launched or in Registration



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Retirement Income

In May, **Fidelity** registered the “**Income Replacement**” affiliated fund-of-fund series. The [series](#) will comprise of 11 funds, with horizon dates set in two-year increments from 2016 until 2036. Funds in the series will aim to convert accumulated shareholder assets into a regular payment stream. Each fund’s asset allocation strategy will become progressively more conservative over time, and will aim to support a payment strategy to be executed through shareholder participation in the “Smart Payment ProgramSM”, an optional account feature. The filing states:

“A participating shareholder’s monthly payment for a given month will consist of an Income Replacement Fund’s dividends for that month and, if such dividends are less than the dollar amount of the shareholder’s monthly payment, the proceeds from the automatic sale of the appropriate number of shares of the Income Replacement Fund required to pay the monthly payment. Shareholders who elect to participate in the Smart Payment Program authorize the automatic sale of their shares for this purpose... A shareholder’s participation in the Smart Payment Program will result in the gradual liquidation of the shareholder’s entire investment in an Income Replacement Fund by its horizon date. It is expected that each Income Replacement Fund will be liquidated (that is, will distribute its remaining assets to shareholders) shortly after its horizon date.”

Elsewhere, the filing clarifies: “Principal preservation is not guaranteed; in fact, your investment will be returned to you over time if you participate in the Smart Payment Program.” **The funds’ expense ratios will range from 0.54% for the 2016 fund to 0.65% for the 2036 fund.** The Income Replacement funds will also be offered in **Advisor** versions, which will have “A”, “T”, “C”, and “Institutional” share classes.

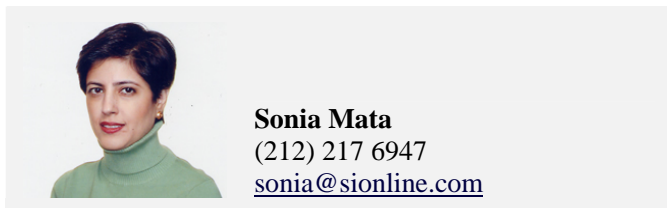
Global Tactical Asset Allocation and Other Non-Traditional Strategies

In July, **UBS** launched the **UBS Global Frontier** fund, which will actively allocate across seven US and non-US equity and fixed income sub-asset classes, by investing directly in securities, or indirectly through investments in open-end funds, including affiliated funds “to the extent permitted by an exemptive order received by the fund”. This new fund’s **active asset allocation** will be combined with **active bottom-up security selection** and a **currency strategy**. Also, the fund would generally seek to increase its global market exposure through the use of **leverage**. Although it is currently invested in affiliated UBS “Relationship Funds” (which are not “publicly” offered), the fund is expected to increase its direct securities investments as it grows. It offers retail class “A” and “C” shares, and institutional class “Y” shares. *(Note: UBS’s \$5.2 billion Global Allocation fund, which has a similar strategy except it doesn’t use leverage, has been the manager’s highest cash flow long-term fund in 1H07, attracting nearly \$400 million, on top of about half a billion dollars captured last year. The Global Allocation fund is currently invested mostly in securities and only in a limited way in affiliated UBS funds.)*

DWS introduced in July the **DWS Alternative Asset Allocation Plus** fund, which will invest in other **DWS** funds, certain other securities, and derivatives. Designed as a complement to an investor’s traditional portfolio, the fund will focus on alternative asset categories such as market neutral, inflation-protection, commodities, real estate, and emerging markets, and has plans to use a **global tactical allocation overlay** once assets have reached \$50 million. Offered in “A”, “C”, “Institutional”, and “S” share classes, the fund has a management fee ratio of 0.30%. Its “A” shares bear a net expense ratio of 1.90% (including underlying fund fees).

Schroders is preparing the [Schroder All Asset](#) fund, which will **seek a rate of long-term total return that, after investment advisory fees, is above the rate of inflation.** The fund will adopt a flexible global approach. It will: a) allocate to various traditional as well as alternative asset classes (obtaining such exposure directly or through investment in other funds or private pools or through derivatives); b) use cyclical asset allocation across markets and asset classes; and c) use active management (Schroders and non-Schroders) within certain asset classes where it consider markets to be inefficient. Fund managers will also stress control of risk and volatility, including through the use of derivatives to gain downside protection.

Closed-End Fund Expansion and Innovation

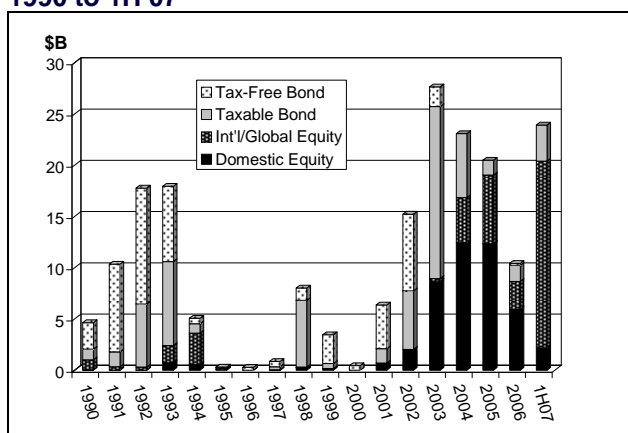


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Closed-end fund IPO activity, which had been subdued for much of 2006, recovered dramatically starting in November last year. Thirty one new closed-end funds have come to market over the November'06 – June'07 period, and have raised an average of nearly \$900 million each. (For comparison, the first ten months of 2006 had seen just 18 IPOs, with much smaller average net proceeds of \$300 million.)

In 2007, new closed-end funds have raised a collective \$24 billion in net proceeds in the first six months alone. Although IPOs in July proved to be a tougher sell due to the month's market pullback, the full year's volume could still be expected to best the record of \$27 billion set in 2003, when accelerating innovation, an influx of new sponsors, and new distribution partnerships had energized this industry segment and set the stage for some big IPO years.

Closed-End Fund IPO Net Flows 1990 to 1H'07



Source: Strategic Insight Simfund MF

Closed-End Fund Initial Public Offerings Trailing 12 Months, as of 6/07

Manager	Net Proceeds* \$MM	# of IPOs
Eaton Vance	8,327	2
Alpine Woods Capital	6,154	3
BlackRock	4,596	4
Nuveen	1,683	4
Morgan Stanley	1,450	2
Van Kampen	1,355	1
DWS Scudder	1,082	2
IQ Investment Advisors	1,049	3
Evergreen Inv Mgmt	829	1
Calamos Advisors	802	1
ING Investments	657	2
Claymore Advisors	549	1
First Trust Advisors	495	3
PIMCO/Allianz Global	484	1
Cohen & Steers	461	1
Gabelli	357	1
Kayne Anderson	233	1
Delaware	224	1
Seligman	212	1
Pioneer	174	1
Dividend Capital Inv	143	1
RMR Advisors	91	1
Total above	31,409	38

* Proceeds net of brokers' commissions. Source: Strategic Insight Simfund MF

Historically, a low short-term interest rate environment has been an attractive one for closed-end fund issuance. As short-term interest rates crept up in recent years, lowering spreads, leverage became a less attractive technique to boost yields. Alternatively, new closed-end funds coming to market have tended to feature greater equity participation, more global exposure, and investments in derivatives to augment yields. Several of the most recent equity closed-end fund offerings use “**dividend capture**” techniques for portions of their portfolios to target high distribution rates for yield-seeking investors (many of whom are at or near retirement), but without resorting to leverage. This yield enhancement method has been used alone or in conjunction with **covered call option writing**, which has already figured in a big way in many new equity closed-end funds launched since 2004. Dividend Capture funds' appealing distribution rates, typically 6% to above 10%, and potential for investment gains, has drawn a lot of interest from income investors. Two very large closed-end fund IPOs this year feature dividend harvesting techniques: **Eaton Vance's Tax Managed Global Diversified Equity Income** fund

(EXG), which raised \$5.8 billion in net proceeds in February, a record for a closed-end fund IPO in the US, uses both dividend-capture and option-income strategies, while **Alpine Woods' Total Dynamic Dividend fund** (AOD), which gathered \$3.9 billion in January, concentrates on dividend-capture trading to boost yields.

Largest Closed-End Fund IPOs in 2007

Fund Name	Start Month	Strategy	IPO Net Proceeds† \$MM
Eaton Vance Tax Mgd Gbl Div Eq Inc	Feb	Gbl Eq / Div Capture* / Option Inc*	5,802
Alpine Total Dynamic Dividend	Jan	Global Eqty / Div Capture*	3,852
BlackRock Intl Growth & Income	May	Intl Eqty/ Option Inc*	1,910
Alpine Global Premier Properties	Apr	Real Estate/ Div Capture*	1,908
Van Kampen Dynamic Credit Opportunities	Jun	Senior Loans/High Yield	1,355
M. Stanley Emerg Mkt Domestic Debt	Apr	Emerging Mkt Debt	1,218
Evergreen Global Div Opportunities	Mar	Gbl Eq / Div Capture*, Option Inc*	829
Calamos Global Dynamic Income	Jun	Gbl Hybrid / Option Inc*	802
BlackRock Global Equity Income	Mar	Gbl Div focus/ Option Inc*	764
Nuveen Multi-Crncy ShtTerm Govt Inc	Apr	Int'l Govt Debt	764

* Strategy used for at least a portion of fund assets. †Proceeds net of brokers' commissions. Source: Strategic Insight Simfund.

Dividend-Capture Trading

A dividend capture strategy involves trading to receive more than the general four dividends a year for US stocks, and the typical one or two dividends a year for international stocks. Specifically, it entails buying a stock just before a dividend is paid, holding it just until the dividend is received, and then using the proceeds to buy another stock expected to pay a dividend in the near future. Given the potential to generate large tax bills, dividend capture trading became a more attractive candidate as a fund investment strategy only after a tax law change lowered the top rate for dividends in the US to 15%, substantially reducing the tax on this type of income at the individual level. (Previously, dividends were taxed as ordinary income, up to a high 38.6% maximum rate.) The period for which a stock is held by the fund is dependent in part on what percentage of the fund's distributions is targeted to be "tax-advantaged" or "qualified" dividend income (QDI). To qualify for the lower 15% rate, funds must hold the stock for at least 61 days during the 120-day period surrounding the ex-dividend date. Funds seeking to maximize QDI may

hold the stocks for only 61 days, just long enough to qualify for the reduced rate, typically buying the stock in advance and selling it soon after the dividend is declared. By such "rotation" among stocks, they may collect up to six "tax-advantaged" dividend payments in any 12-month period. (In order for qualified dividend income paid by a fund to a shareholder to be taxed at the reduced 15% rate, the shareholder needs to satisfy certain holding period requirements as well.)

International stocks, typically account for a significant part of dividend capture funds' portfolios because of their large single or two dividends. Dividend-capture funds also seek out "special" or one-time dividends.

One of the risks of dividend-capture trading is NAV erosion as a result of the stock price, which typically declines by the amount of the dividend after the dividend is paid, not rebounding during the time the stock is held; such erosion could intensify in a falling market.

Eaton Vance was among the first to use dividend capture trading in the closed-end fund area, coming out with its Tax Advantaged Dividend Income fund (EVT) soon after the dividend tax cut in 2003, and adding another two QDI-focused funds in 2004. These first three Eaton Vance QDI funds used leverage, and yield around 6%-7%; the most recent dividend-capture offerings from Eaton Vance (EXG and ETY; data as of 6/07) do not use leverage currently, but combine dividend harvesting with covered call writing, and have achieved higher current distribution rates of 9%-10%. (A "buy-write" strategy, while providing income in a flat market, and some cushion in a falling one, may limit the upside in a sharply rising market though.)

Alpine Woods first used the dividend harvesting approach within an open-end offering. The attractive track record the sponsor was able to build up in its 2003-incepted open-end Alpine Dynamic Dividend fund (ADVDX), helped it make its first foray into the closed-end fund world in 2006 with the Alpine Global Dynamic Dividend fund (AGD), which raised about \$400 million. Alpine followed that fund up with the huge AOD IPO mentioned earlier, and then raised another large amount (close to \$2 billion) in its real estate-focused Global Premier Properties fund. Alpine's closed-end funds emphasize "paired rotation", involving rotating between similar companies with different dividend dates while remaining positioned within the same sector.

Other managers that have either already come to market with, or are readying funds that use dividend-capture as one of their strategies include **Evergreen, Cohen & Steers, First Trust, RMR and Old Mutual**.

Simfund Filing.Com Major Innovations



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There are many new ways to strengthen your business using SimfundFiling.com; connect to Simfundfiling@sionline.com to request a demo or training on the newest features of this service, which could be valuable to additional teams (sales, board relationship, PM benchmarking) within your firm.

SimfundFiling.com: New Data, Links, Features, and Name

Simfund MF 5.0 and SimfundFiling.com (previously FundFiling.com), with functionality hyper-linked, now facilitate a unique 360-degree view of every single fund's competitive position.

SI Fund Prospectus Profile (see illustration on page 10): A new one-page-per-fund **summary showing** the most current fee and expense data, hyperlinked to Simfund, **updated on a real-time basis** (data previously available in Simfund only once a year from the fund's Annual Report filing).

Latest prospectus data: More than 50 new data points, all extracted directly from the latest prospectus:

- Fee tables (management, 12b-1, other, waivers, expense caps)
- Prospectus-stated performance benchmarks
- Redemption rates and policies
- Portfolio manager name, tenure details
- Fund-of-funds' underlying funds' fees
- Contractual advisory fees, type
- Advisory fee asset and fee breakpoint schedules

- Performance fee details
- Contractual fees for each sub-advisor in funds with multiple sub-advisors, sub-advisory contract types, asset and fee breakpoints or sub-advisory percent of advisory fee
- Specialty investment flags.

The integration of the prospectus information into SimfundFiling's functionality enables time-saving analytics, and allows your analysts to suggest tactical ideas to help stimulate sales (e.g., negative developments among peer funds identified quickly).

Peer group study: Beyond the ability to monitor one fund at a time, you can now **identify a multi-fund peer group in Simfund and then search for specific SEC filings for all funds in that group**. Simfund users can hyperlink to SimfundFiling, research what they need, and then return to Simfund.

E-Mail Alerts to monitor relevant changes: Simfund users are able to **create SimfundFiling e-mail alerts** (for **competitively important fund changes**, newly-registered funds, and prospectus or annual report filings by predefined groups of peer funds or companies) in a one-step process.

Monitoring the success of the newest funds: Simfund users can now link to SimfundFiling and check whether a previously registered fund has become active. They can observe cash flows of such a new fund, as well as current prospectus-based data.

New peer group: Prospectus-stated-performance benchmarks now available in SimfundFiling and in Simfund 5.0; compare and create peer groups using these benchmarks.

Peer group refinement: Create relevant peer groups, whether among ETFs, FoFs, Market Neutral, Socially Conscious, Tax Managed, Target Date, Focused Funds, etc. With one click, select a peer group of funds with an identical structure or strategy, and then zoom to the latest legal documents, check fund changes for the group, and run a Fund Prospectus Data Profile—all from within the new SimfundFiling library.

Finally, our **News Makers** feature covers fund events that were significant enough to be reported in the media; now you have quick links to the SEC filings underlying such news. Separately, we will be highlighting changes for important funds (high cash flow, large asset size, very fast growing, or unique).

Fund Prospectus Profile on SimfundFiling.com



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A One-Page Summary of Key Prospectus Data

The newly added Fund Prospectus Profile web page allows you to review many key data points from the current prospectus, with updates done continuously—see the icon next to a fund name, click on it to view the latest Profile. (If the icon is dimmed, it means the fund does not yet have a fund prospectus profile; for example, for a newly registered fund not yet available to the public.) **Fee data is available for each fund class; click in the drop-down box next to the fund's name to choose a particular share class.**



Top Section of Profile

UBS Pace Lg Co Growth Equity	
Manager	UBS Global Asset Manage
Advisor(s)	UBS Global Asset Manage
Sub-advisor(s)	Wellington Management
Benchmark	Russell 1000 Growth
Last Update as of	6/1/2007

- Fund Name: SI's fund name
- Manager: Business entity that manages and distributes the fund
- Advisor(s): Legal entity that manages the portfolio
- Sub-advisor(s): One or multiple sub-advisors
- Benchmark: Prospectus-stated performance benchmark; uniquely available in a database format
- Last Updated: Date of the latest available prospectus or prospectus amendment from which data has been extracted; the date has an embedded hyperlink to the actual prospectus document.

Fees and Expenses Section

Fees and Expenses	
UBS Pace Lg Co Growth Equity-A	
Management	0.59%
12b-1	0.25%
Other	0.44%
Total Expense	1.28%
Waivers	0.05%
Underlying Expense	None
Fee Notes	Read >>
Redemption Fees	Days 90

Access prospectus fees for each share class (use the drop down box next to the fund name to choose the pricing class); management and/or operating fee waivers are further explained in detail in the Fee Notes section; redemption fee rate and period are also available.

Advisor Contractual Fees Section

Advisor Contractual Fees	
UBS Global Asset Management	
Start Date	
Effective Date	
Asset Based	<input checked="" type="checkbox"/>
Performance Based	<input type="checkbox"/>

Zoom into advisory contract details; read asset-based fee schedules (up to \$500 MM, 0.60%... above \$2 billion, 0.525%, etc.)

Asset Start (\$MM)	Asset End (\$MM)	%
\$0	\$500	0.60
\$500	\$1,000	0.575
\$1,000	\$2,000	0.55
\$2,000	-	0.525

Click on the “Read>>” link next to the Notes for more textual details about the contract; it includes the start date and effective date of the contract, when disclosed in notes.

Sub-Advisor Contractual Fees Area

Study in detail the sub-advisor(s) contracts; fee approach; and dollar values at the bottom of the section in the case of fixed-dollar-amount contracts.

Sub-Advisor Contractual Fees

Dreman Value Management

Start Date	Effective Date	Asset Start (\$MM)	Asset End (\$MM)	%
8/1/1997		\$0	\$250	0.24
		\$250	\$1,000	0.23
		\$1,000	\$2,500	0.224
		\$2,500	\$5,000	0.218
		\$5,000	\$7,500	0.208
		\$7,500	\$10,000	0.205
		\$10,000	\$12,500	0.202
		\$12,500	-	0.198

Asset Based
 Performance Based
 Income Based
 Other Fund Based
 Cap or Waivers
 Paid Directly

If there are multiple sub-advisors, click on the drop-down box to choose the sub-advisor for which you’d like to view the information. (Note that at times, the sub-advisory fees may not be disclosed.)

Sub-Advisor Contractual Fees

- Wellington Management Company
- Wellington Management Company
- Marsico Capital Management
- SSgA Funds Management

Fund Manager Section

Here you will find details of the portfolio managers: their names, tenure with the fund and with the company. In the case of sub-advised funds, the details are for the sub-advisor’s portfolio manager.

Things to Remember about the Fund Prospectus Data Profile

- The “Last Update” date in the Profile’s top section has an embedded hyperlink that takes you to the latest fund prospectus, or prospectus amendment for the fund (so either a 485 BPOS or 497 document)—

once in that document, you will be able to see a dropdown menu on the top, that will allow you to choose from among all the documents filed for the fund in that prospectus cycle, as can be seen in the following illustration:

Prospectus History: 20070601 - 497
 Format: 20070601 - 497, 20061129 - 485BPOS
 Portfolio Name: UBS PACESM Select Advisors Trust
 Manager: UBS PACE Municipal Fixed Income Investments

- If a fund is not sub-advised, the related area will be blank including the header
- Data from the SI Fund Prospectus Data Profiles web page will at a future date be exportable to Excel
- Simfund MF 5.0 includes the data points discussed above. You can Select, Display, and Export to Excel from the Simfund grid, and navigate from the Portfolio Grouping level through hyperlinks to SimfundFiling.com, and to the SI Fund Prospectus Profile, instantly**
- In SimfundFiling, you can access the SI Fund Prospectus Profile by clicking on the icon in the following sections:
 - Prospectus Changes – Search screen
 - New Registration – Search Screen
 - SEC Filings – Search Screen
- See an illustration below of a search screen result with the Fund Prospectus Data Profile icon showing next to the fund name

Manager	Portfolio
AllianceBernstein	AB Balanced Share
AllianceBernstein	AB Global Value
AllianceBernstein	AB Intl Value

- As mentioned before, if the icon is dimmed, it means the fund does not yet have a Fund Prospectus Profile; this could be the case, for example, for a newly registered fund not yet available to the public.

Email SimfundFiling@sionline.com for additional guidance, training, or suggestions.

Fund Selection Units: Focus on Asset Allocation



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The emerging role of Fund Selection Units (FSUs) in advisor-sold or institutional (such as DC or variable annuity) platforms is putting **even more emphasis on asset allocation as the backbone of advisors' fund selection**. This is no surprise, as asset allocation has been a developing theme in the industry overall.

FSUs are growing in significance, a notable trend discussed in SI's February 2007 Windows article, "Fund Selection Units: Accelerating Focus in the US and Internationally" (available online [here](#)). As that study noted, FSUs influence 30% to 50% of sales today or more. At one major broker platform, for example, two-thirds of assets follow the FSU analyst group's recommendations.

The typical retail FSU might be choosing funds for five or more model portfolios, with each portfolio slicing assets up into three, four or more asset classes; some FSUs may allocate among as many as 30 different asset classes. For each asset class, the FSU might identify eight to 10 funds to choose from.

New product searches usually involve looking to fill an opening in a specific asset class. (Many FSUs organize their analysts by asset class.) Naturally, **FSUs are less likely to find slots for multi-asset-class funds**; thus, making the case for such 'flexible' funds is not impossible, but requires more work explaining the fund's (unique) strategy.

Similarly, once a fund is chosen for a recommended list/model portfolio, the FSU monitors its style consistency as well as its performance. **Strategy and Style drift (and critical changes in personnel) are the quickest way to get a fund dropped from a recommended list (and be put on "watch")**; FSUs may be even less patient about style drift than about underperformance.

The Search Process: What Counts

Among the large retail platforms, the FSU process of searching for new product starts with a **quantitative screen**, either using proprietary software or third-party programs from Zephyr, MPI, etc. FSUs assess a fairly similar mix of risk-return data, such as:

- Absolute and relative returns
- Historical alpha, beta and volatility
- Upside/Downside capture (how well the fund does in up or down markets)
- Sharpe Ratio, Information Ratio, and other measures comparing return to risk
- Performance attribution (from securities selection, sector weighting, other factors).

FSUs may ask funds for some of this information, but generally they have independent access to analytics and run quant screens on their own.

A crucial part of the fund search process is discussion about the "past-quant-screen" fund's investing process. It is believed that **FSUs spend at least 70% of their time on this people-intensive step**:

- Investment strategy, and how buy/sell decisions are made
- Portfolio manager experience, training, and philosophy
- Reputation/stability of fund management firm.

The qualitative stage may involve several meetings, including in-person with the portfolio manager(s).

Looking Ahead

Because FSUs take a disciplined, metrics-based approach to asset allocation, their broadening influence could mean more opportunities for process-driven funds as opposed to "opportunistic" ones. Already, highly-rated but low brand-awareness funds are gaining traction on B/D platforms, mirroring FSU analysts' influence. The institutional process behind FSUs already impacts product development in stimulating greater interest in "quant" funds and in alternative asset classes.

Among the issues still being debated: peer group selection for traditional long-equity or bond funds (which "box" or benchmark is the right one? see article on "strategy-based" peer groups on pages 29-35); how to fit non-correlated strategies within a platform of FoFs (especially where unique funds are offered); and dynamic portfolio construction for generating income at retirement.

Money Management Profitability



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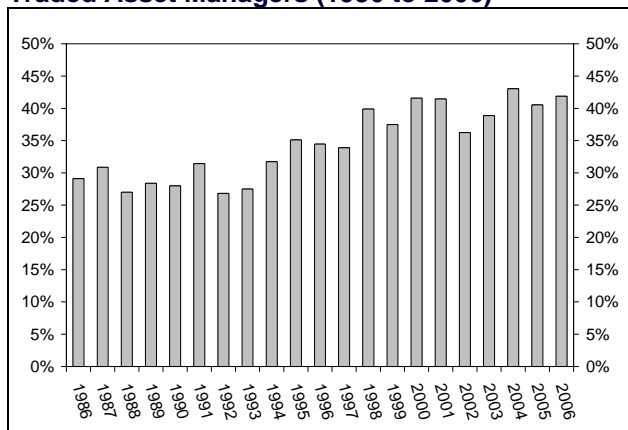
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2006 Financial Results of Publicly Held Money Managers

The seventeen management companies with publicly-held equity surveyed by Strategic Insight (“Public Managers”) managed \$5.2 trillion at year-end 2006. Their combined mutual fund assets under management exceeded \$1.8 trillion. The group collectively generated over \$27 billion in revenues and roughly \$5.5 billion in profits.

The group’s money management pre-tax operating margins (as calculated by SI) averaged **42% during 2006, two percentage points higher than the previous year’s (40% in 2005)**. Operating margins among the Public Managers ranged from 19% at the low end to 64% at the high end.

Median Pre-Tax Operating Margins for Publicly Traded Asset Managers (1986 to 2006)



Results for each year include the historical data of Public Managers during that year, based on SI’s past surveys; Sources: Company reports, Strategic Insight

More than two-thirds of the Public Managers delivered steady or improving margins last year, and one-third had, by our computation, all-time highs in pre-tax operating margins in 2006.

Public Managers’ 2006 Revenues

The aggregate operating revenues of the Public Managers rose 28% from 2005 levels, outpacing the 24% rise in aggregate expenses as compared to 2005.

Fee revenues increased, naturally, as a result of year-to-year asset gains from equity market appreciation. This was supported in many cases by organic cash flow growth for stock, bond, and cash programs, and expanding internationally-based revenues.

Public Managers’ Composite Annual Revenue Growth Rates

	2002	2003	2004	2005	2006
Operating Revenues	-6%	11%	19%	21%	28%

Source: Company reports, Strategic Insight

... And Their Expense Trends

Large, diversified publicly held asset managers focusing on the mutual fund marketplace generally maintained their ability to reinvest in their businesses so they could stay competitive, despite overall rising costs and an intensified focus on mutual fund fees. (We have noted in our research that contractual and non-contractual advisory fee reductions have remained limited in scope and breadth; fee waivers are used instead, as suggested on page 18.)

The flexibility of many asset managers to invest in their businesses (and incur higher costs) in parallel with gains in assets and fee revenues may support their attractive valuations. Such flexibility, both in good and bad times, is typical of the reliable profitability of this industry. As a reflection of this, we note a number of managers have had consistent year-to-year profitability, with operating margins fluctuating by only 4%-6% over recent years.

Public Managers’ Composite Annual Expense Growth Rates

	2002	2003	2004	2005	2006
Operating Expenses	-1%	9%	19%	14%	24%

Source: Company reports, Strategic Insight

ReFlow's 3 Solutions for Increasing Fund Returns, Reducing Costs



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ReFlow Management (Reflow.com) provides a unique set of cash management services to the mutual fund industry to lower the "invisible" cost of fund flows (transactions, cash management, and taxes). Among its US mutual fund management company clients are OppenheimerFunds, Bridgeway Funds and Forward Management; among its Luxembourg clients is Pictet.

ReFlow was founded in 2002 by Gordon P. Getty and is led by J. Alan Reid, Jr., CEO and President.

(Avi Nachmany: While this Windows Edition highlights explicit mutual fund costs measured through Total Expense Ratios, there are other implicit costs, such as those generated by trading, by liquidity provision, and by realized capital gains, that distinctly disadvantage mutual funds and our industry overall. The ReFlow technologies that Alan Seigerman discusses below offer important solutions.)

Reducing Trading Costs and Capital Gains Realizations and Accommodating Shareholder Flow

The explicit and implicit costs of portfolio transactions have been discussed often, and such costs significantly reduce the attractiveness of high-turnover, actively managed funds (past research suggested that trading costs alone could exceed 1% annually for low-liquidity investment styles).

Similarly, the treatment of realized capital gains among mutual funds puts the industry at a significant disadvantage versus securities. Equity funds distributed more than \$250 billion in capital gains in 2006, roughly a third of which went to investors in taxable accounts. Among funds paying capital gains, the median pay-out ratio last year was around 4.5% of

assets (according to SI research), but, of course, many paid out significantly more in realized capital gains. Such large distributions are likely to persist.

ReFlow offers two techniques to help funds reduce capital gains distributions:

- One lowers fund turnover by minimizing the need to trade in response to daily shareholder redemptions and subscriptions. The service cuts back on such "operational" trades, helping reduce trading costs and postponing the realization of capital gains without interfering with the fund's investment strategy, and enabling the portfolio manager to harvest gains or losses at the fund's discretion
- Another aggregates outflow and provides for the efficient and anonymous disposition of fund positions via in-kind transactions. Like ETF in-kind transactions, this can remove low-cost-basis shares from the portfolio.

Accommodating Shareholder Flow

Unrealized capital gains, and any income or realized capital gains that have not been distributed, create the fund's total tax overhang. While this number can reflect how effective the fund has been in generating capital appreciation or at postponing realization of capital gains, it is also a measure of the future tax liability owed by the fund's taxable-account investors.

Funds with higher turnover rates are more likely to realize their capital gains. Thus, reducing unnecessary turnover is one tax-management tool that can help portfolio managers (as long as it doesn't hurt the returns to investors in tax-deferred accounts who are unconcerned with distributed capital gains).

ReFlow's approach focuses on the operational trades that arise from daily net shareholder flows. Shareholders' redemptions force the fund at times to realize capital gains, and those liquidations also shift the tax consequence of these realized gains (if not matched against realized losses) onto the remaining and future shareholders.

ReFlow provides two services that enable funds the flexibility to balance out flows over time:

- **ReFlow's Redemption Service (RS)**
- **Client Tailored Equitization (CTE)**

ReFlow's Redemption Service (RS) helps reduce the need for operational trades by providing the capital to meet investors' redemptions and net subscriptions. ReFlow provides just-in-time capital by purchasing

shares in the fund when it experiences net redemptions, thereby avoiding the need to liquidate securities. In the ensuing days when the fund experiences net subscriptions, ReFlow automatically sells its holdings back to the fund, thus reducing the need for the fund to reinvest new shareholders' capital. This helps lower realization of gains and losses, and assists the manager in planning for the timely disposition of investment positions. **ReFlow received a no-action letter in July 2002 to receive a fee for its liquidity service.**

To accommodate shareholder flows without having to sell stocks, most funds hold some cash. To earn higher returns, portfolio managers may temporarily invest the cash in ETFs, equitize the cash using futures to capture beta, or use total return swaps to capture both the beta and the fund's alpha.

For managers who prefer holding cash, **ReFlow provides a custom equitization tool, Client Tailored Equitization (CTE)**. CTE is a total return swap in which ReFlow provides a market return on the fund's cash based on the portfolio's performance (i.e. change in NAV) in exchange for the LIBOR return on the cash plus a spread.

Using CTE, the mutual fund keeps its cash and captures both the market beta and the alpha exposure the portfolio manager has created. CTE can be set up to automatically adjust to changes in a fund's cash without incurring additional transaction fees, taking full advantage of the portfolio manager's investment strategy. Daily shareholder redemptions and subscriptions can now be met with a reduction or an increase in the cash plus CTE without creating additional operational trades and taxable events.

In-Kind Transactions and Unrealized Gains

Reducing turnover postpones realization of taxes, but cannot eliminate the fund's future tax liability. However, disposition of low-tax-basis securities for investment strategy purposes via in-kind transactions can reduce future tax liability without triggering the recognition of the capital gains.

ReFlow's Redemption In-Kind (RIK) service aggregates shareholder redemptions and helps in the efficient, anonymous reduction in undesired holdings to meet the fund's cash needs—while potentially avoiding the realization of embedded capital gains via in-kind redemptions.

To illustrate the benefit of in-kind transactions, you can review how ETFs manage the "redemption unit". ETFs transact in-kind with the institutional investors,

specialists and market-makers that deal directly with the ETF. The in-kind redemptions, i.e. exchanging ETF units for baskets of securities, are an important source of ETF tax-efficiency. They enable ETFs to distribute appreciated holdings without realizing any capital gains. Furthermore, designating low-cost-basis stocks in the redemption process reduces the embedded capital gains that can affect future shareholders. (SI: similarly, Vanguard's patented technique uses its ETFs to remove low-cost-basis stocks from the paired conventional index fund.)

Using in-kind transactions, ReFlow offers the potential for ETF-like accounting treatment to mutual funds. ReFlow acquires shares in the fund through its Redemption Service (RS), as described above, buying shares when the fund experiences net redemptions.

Afterwards, the fund may request that ReFlow redeem some or all of its holdings in the mutual fund. For those clients with whom we have established in-kind transaction operations, we intend our redemptions to be met with securities held in the fund's portfolio. The portfolio manager selects the stock tax lots in which he or she wants to reduce the fund's exposure, and **delivers the shares directly to ReFlow without any incremental commission, spread or market impact.**

At the end of the transaction, the fund will have delivered a basket of securities in exchange for an equivalent value of its mutual fund shares. Small differences between the value of the basket and the shares delivered are corrected with a cash wire between ReFlow and the fund. Typically, in this kind of transaction, the portfolio accounting assigns the lowest-cost share lots to the transaction and does not recognize the capital gains.

Conclusion

Mutual funds' unrealized capital gains are in the trillions of dollars, and each year, realized capital gains trigger billions of dollars in tax payments by fund investors. Furthermore, the unfair tax treatment of mutual funds (vs. direct securities) has facilitated the promotion of SMAs as an alternative to funds as well as made ETFs and index funds more attractive to taxable account investors.

The three return-enhancement and tax-reduction tools summarized above can assist in managing unrealized capital gains and lowering tax liabilities, helping mutual funds improve shareholders' realized total returns, and become more appealing to a broader group of more tax-sensitive investors.

Fees & Expenses: 2006 Trends



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Our two detailed Fiscal 2006 Annual Fee and Expense Benchmarking studies are posted on www.sionline.com.

- One report captures in detail [fees by investment style and portfolio size](#).
- The other illustrates [management fee breakpoint schedules](#) throughout the industry within 30 distinct investment strategies.

With industry assets rising, triggering breakpoint implementation and other fee reduction arrangements, and cash flows concentrated in lower-fee, high performance funds and management companies, the industry’s effective fee ratios (asset-weighted ratios paid by the “average investor”) have been inching downwards in recent years.

Average Total Expense Ratio % (Asset-Weighted) Actively Managed Open-End Funds; Excluding VAs

	2002	2003	2004	2005	2006
US Eqty / Hybrid	1.06	1.05	1.00	0.95	0.92
Int'l Equity	1.25	1.25	1.20	1.14	1.10
Taxable Bond	0.80	0.78	0.77	0.75	0.71
Tax-Free Bond	0.68	0.68	0.67	0.66	0.65
Taxable MMFs	0.47	0.44	0.43	0.42	0.43
Tax-Free MMFs	0.50	0.47	0.45	0.42	0.41

Source: Strategic Insight Simfund, SI Research

Note that the table above weights the total expense ratio by the average size of each fund during the particular year, to capture **the experience of the average investor** (and thus reduce the statistical influence of many small funds that are more expensive but held by just a few).

To help in “apples-to-apples” comparison, **the table also excludes passively managed funds (index funds and ETFs)**. It also excludes closed-end mutual funds and variable annuity mutual funds, both of which have somewhat different expense structures.

To exclude the impact of 12b-1 fees (competitive marketplace trends discussed in another section of this Windows edition are reducing the industry’s use of 12b-1 fees), the following table shows **trends in fund fees excluding 12b-1 fees**.

Average Total Expense Ratio %, Exc. 12b-1 Fees (Asset-Weighted) Actively Managed Open-End Funds; Excluding VAs

	2002	2003	2004	2005	2006
US Eqty / Hybrid	0.81	0.81	0.78	0.73	0.71
Int'l Equity	1.00	1.02	0.97	0.92	0.89
Taxable Bond	0.60	0.58	0.57	0.55	0.54
Tax-Free Bond	0.51	0.51	0.50	0.49	0.48
Taxable MMFs	0.36	0.34	0.34	0.33	0.32
Tax-Free MMFs	0.41	0.39	0.38	0.35	0.35

Source: Strategic Insight Simfund, SI Research

Underlying the steady decline in total expense ratios is the steady reduction in advisory fees charged to the average investor, as captured below.

Average Advisory/Administrative Fee Ratio % (Asset-Weighted) Actively Managed Open-End Funds; Excluding VAs

	2002	2003	2004	2005	2006
US Eqty / Hybrid	0.608	0.597	0.586	0.564	0.554
Int'l Equity	0.737	0.742	0.742	0.716	0.708
Taxable Bond	0.470	0.454	0.439	0.435	0.429
Tax-Free Bond	0.424	0.424	0.416	0.405	0.394
Taxable MMFs	0.276	0.260	0.248	0.238	0.228
Tax-Free MMFs	0.328	0.304	0.286	0.264	0.258

Source: Strategic Insight Simfund, SI Research

Fund Fees within DC Plans Lower Than Average



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A majority of mutual fund shareholders are introduced to mutual funds via DC plans. Afterwards, many expand their investment portfolios, for both retirement savings and other purposes. Reflecting on the importance of DC plans in seeding the investment process, we note that over the past decade, fund investors net purchased \$700 billion within their DC accounts; in addition, they earned about \$1 trillion due to appreciation.

In IRA accounts, where most flows in the past decade originated from DC plan rollovers, investors have experienced similar results.

With our industry seen as the “guardian of the nation’s retirement savings,” a greater oversight of fund fees is emerging, including some congressional effort on additional fee disclosure. In that context, we wanted to share our observations, based mostly on ICI research.

Total expense ratios (TER) paid by fund investors (measured by asset-weighting such TERs) have declined significantly over the past decade. **From 1996 to 2005, ICI research has suggested that equity fund average TERs fell 11 basis points, from 1.02% to 0.91%; bond fund average TERs declined from 0.92% to 0.71%, a much greater 21-basis-point decline.**

For investors in 401(k) plans also, who generally own lower-than-average-expense funds (mostly larger portfolios, core strategies, etc.), average TERs declined sharply and remain well below industry averages. **For investors in DC plans, over the 1996 to 2005 period, equity fund average TERs fell from 0.82% to 0.72%, and bond fund average TERs declined from 0.71% to 0.58%, according to the ICI.**

The trend of declining fees persisted over the past two years, amid a rise in industry assets (and the impact of advisory fee breakpoints), as well as cash-flow concentration among low-fee funds and below-average-fee management firms. This was evidenced for both fund investors overall and investors owning funds within 401(k) plans, as per SI estimates shown below.

Mutual Fund Average Total Expense Ratios, Asset-Weighted					
	2005 (ICI)		2007 (SI Estimate)		
	401(k) ¹	Industry ²	401(k) ³	Industry ⁴	401(k) Minus Industry
Stock Funds	0.76	0.91	0.71	0.85	-16%
US Stock	0.72	0.87	0.67	0.81	-17%
Int'l Stock	1.01	1.10	0.94	1.02	-8%
Hybrid	0.65	0.82	0.56	0.70	-21%
Bond Funds	0.58	0.71	0.58	0.71	-18%
HY / World	0.89	1.00	0.87	0.97	-11%
Other	0.55	0.64	0.56	0.65	-14%
Money Mkt	0.42	0.41	0.41	0.40	2%

¹The 401(k) average expense ratio is measured as a 401(k) asset-weighted average; ²The industry average expense ratio is measured as an asset-weighted average. ³SI estimate reached by applying an identical 2007 vs. 2005 percentage decline as in industrywide average expense ratios. ⁴The industry average expense ratio is measured as an asset-weighted average, at 6/07. SI 2007 data includes funds-of-funds but excludes ETFs. Sources: ICI, Strategic Insight Simfund, SI estimates

One of the reasons for the decline in fund expenses charged to 401(k) investors is the steady shift towards no-load and institutionally-priced share classes, and away from retail, loaded share classes, as suggested by ICI research. Furthermore, note that most owners of A Shares (Front-Load funds) actually purchased such funds at NAV (and did not pay sales commissions upon purchase).

401(k) Mutual Fund Assets by Share Class		
% of Assets ¹	1996	2005
Load Share Class	41%	26%
A Shares/ others	37%	21%
B Shares	3	1
C Shares	(*)	1
Retirement Shares	(*)	3
No-Load Shares	59	74
Institutional	14	19
Retail	45	51
Retirement Shares	(*)	4
Total	100%	100%

¹ May not add up to the total because of rounding; (*) = less than 0.5%; Source: ICI

Advisory Fee Waiving Trends



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The Increasing Usage of Fee Waivers among Open-end Funds

While the percentage of funds using some form of fee waivers has increased over the past five years, the median fee waiver has been declining.

Our analysis of fee waivers over the fiscal years 2002-2006 indicates that fee waiver usage has increased by 5.7 percentage points over the period. In 2002, 44.1% of all open-end funds waived fees, while in 2006 the percentage was 49.8%.

Percentage of Funds ¹ with Fee Waiver / Reimbursement by Fiscal Year					
Fund Type	2002	2003	2004	2005	2006
Domestic Equity	40.3%	40.3%	42.9%	44.7%	45.1%
Int'l Equity	43.1%	43.5%	47.0%	49.0%	45.5%
Tax-Free Bond	45.0%	48.8%	51.8%	58.4%	54.7%
Taxable Bond	53.1%	55.7%	60.9%	62.0%	60.9%
Overall	44.1%	45.5%	48.7%	51.0%	49.8%

Source: Strategic Insight Simfund; Footnote: ¹includes open-end, long-term funds with at least \$50 million (excludes money market funds, index funds, funds-of-funds, and ETFs).

In 2006, Taxable Bond funds had the highest proportion of funds with usage of fee waivers at 60.9%, a 7.8 percentage point increase as compared to 2002. Tax-Free Bond funds witnessed the largest increase over 2002-2006 in the proportion of funds with fee waivers—9.7 percentage points, while International Equity funds saw the smallest—2.4 percentage points.

The fee waiver analysis on this page excludes funds with portfolio assets less than \$50 million. (It is very common for new fund offerings or small funds to waive fees to align the total expense ratios with more established funds that benefit from economies of scale.)

Median Fee Waivers among Open-End Funds

Over the past five years, the median domestic equity fund fee waiver for funds with assets of \$50 million to \$500 million each has decreased 35% to 6.3 basis points (bps). The median international equity fund fee waiver has decreased from 15.4 bps to 6 bps.

Stock market gains, especially internationally, have generated a record level of fund flows and attractive market returns. For many mutual funds, **surging assets have triggered advisory fee breakpoints** (substituting the need for waivers), **resulting in greater economies of scale for fund investors**. Another possible reason for the shift to lower median fee waivers could be the effects of the product line rationalization that occurred over the past five years. Post-bear market, many mutual fund families closed or merged away under-performing or small funds. (Since 12/01, over 2,300 portfolios have been closed.)

Median Fee Waiver % Funds ¹ with Assets Between \$50MM - \$500MM				
	Domestic Equity	Int'l Equity	Tax-Free Bond	Taxable Bond
2002	0.097	0.154	0.184	0.165
2003	0.100	0.140	0.150	0.142
2004	0.066	0.100	0.130	0.130
2005	0.067	0.073	0.122	0.127
2006	0.063	0.060	0.142	0.147

Source: Strategic Insight Simfund; Footnote: ¹includes open-end, long-term funds with at least \$50 million (excludes money market funds, index funds, funds-of-funds, and ETFs).

A similar trend is observed among funds with assets of \$500 million to \$1 billion each, and those with assets of over \$1 billion each. Among the four fund types, Taxable Bond funds continue to have the highest median waivers. Median waivers declined across all four fund types over the five year period (except for int'l equity funds with assets between \$500 million - \$1 billion each).

Median Fee Waiver % Funds ¹ with Assets Over \$1 Billion				
	Domestic Equity	Int'l Equity	Tax-Free Bond	Taxable Bond
2002	0.012	0.029	0.020	0.081
2003	0.009	0.035	0.007	0.054
2004	0.012	0.032	0.008	0.033
2005	0.016	0.030	0.010	0.033
2006	0.012	0.028	0.006	0.031

Source: Strategic Insight Simfund; Footnote: ¹includes open-end, long-term funds with at least \$50 million (excludes money market funds, index funds, funds-of-funds, and ETFs).

Performance-Based Fees in Mutual Funds: An Update



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The use of performance-based fees in fund advisor compensation has grown only slightly in recent years. As of June 2007, SI has identified 234 equity funds with \$790 billion in assets (87% of which are funds from Fidelity and Vanguard) that use performance adjustments in their fees. The number of such funds was just modestly above the roughly 200 such funds identified and analyzed in our study on performance-based fees in early 2006 (see SI's Executive Insights 2/06 posting on sionline.com, "[A Status Report on the Use of Performance-Based Fees in Mutual Funds](#)"). **Such funds account for less than 5% of all equity funds offered today.**

Interestingly, over the last 18 months, the funds that we have identified with performance-based fee adjustments, in aggregate, suffered modest net redemptions. This, naturally, varied by their relative performance results and the positioning of each fund; some captured high inflows, while others experienced large withdrawals.

Among the few funds that added performance-based fees as of late we note some **Janus** funds and eight **Dunham** funds.

Overall, performance-fee use remains a niche strategy in mutual funds. Including fixed-income funds, just over 250 funds with \$800 billion in assets used performance-based fees. That represented just 7% of total fund industry assets, with **five fund families—Fidelity, Vanguard, RiverSource, USAA, and Janus—accounting for 96% of performance-linked assets.**

Fee Structures

When performance-based advisory fees are used in a mutual fund, the advisory contract is set up with a base fee and then a sliding scale of increases or decreases in the fee ratio depending on the fund's returns over a pre-determined performance period. Performance is universally measured as returns against a benchmark

(sometimes a composite of two or more indexes). **The most common performance period measured is a rolling 36 months**, although funds differ in the periods used. When Janus adopted performance-based fees on some funds, it used a rolling 36-month period of performance—similar to the practice at Fidelity and Vanguard. But alternative rolling periods are also used; Dunham & Associates used a rolling 12-month period for assessing performance-based fees for its funds' sub-advisors when it adopted the structure for 11 of its funds, effective last July.

Mutual funds by law require performance adjustments to follow a "fulcrum" structure, where the percentage for rewards and penalties are equal. So a fund might see its advisory fee rise 1 basis point for every 0.10% it outperforms its benchmark, and see its fee drop 1 basis point for every 0.10% it underperforms its benchmark. Funds typically **cap performance adjustments** in either direction; some funds (but not all) create a **buffer zone of a minimum out- or under-performance** before fees are adjusted.

By law, **performance fees are assessed on an average of the fund's assets over the same rolling period used in the comparison to performance benchmarks** (36 months, 12 months, etc.). The incorrect calculation of "average assets" was the trigger of a number of SEC actions in recent years.

Additions, Subtractions

Since January 2006, a number of mutual funds have decided to add performance adjustments, while others, which used to have such fee adjustment, inversely eliminated such fees and have moved to asset-based advisory fees.

- **Janus** shareholders voted in November 2005 to adopt performance-based fees on 11 of its retail funds. The change went into effect starting in January or February 2006, depending on the fund. The change affected funds that now have \$25.4 billion in aggregate assets.
- In June 2006, shareholders of 11 Dunham & Associates funds voted to adopt performance-based fees. The change affected funds that now have \$467 million in total assets.
- In December 2006 and February 2007, trustees of 19 Fidelity Advisor funds (which now have a total of \$45.7 billion in assets) voted to adopt performance-based fees. Depending on the fund, shareholders have either voted on the switch or are slated to vote on it in November. If approved, it

would give Fidelity 68 funds with performance-based fees.

- In March 2006, **Touchstone** eliminated performance fees on 18 of its funds, switching to flat fee structures. Touchstone still has four fixed-income funds that use performance-based fees.
- In October 2006, shareholders of the **Stratton Small Cap Value Fund** voted to eliminate performance adjustments in favor of a flat fee of 0.90%.
- Also last October, trustees of the **Putnam Research Fund** voted to eliminate performance-based fees and switch to flat fees.

Pros and Cons

Supporters of the idea of performance-based fees argue that it aligns the interests of the investment management company with that of the fund's shareholders. They also point out that the structure benefits shareholders with a fee reduction when their funds under-perform.

Critics have raised some concerns. One is whether the introduction of performance-based fees would result in a higher risk-profile by portfolio managers. Another is the potential asymmetrical nature of performance-fee dollar adjustments.

Due to the nature of fund flows, the fulcrum structure of fee ratio adjustments might not always result in equal gains and losses in pure dollar amounts—as we explained in last year's "[A Status Report on the Use of Performance-Based Fees in Mutual Funds](#)." Because funds outperforming for a lengthy period are likely to gain inflows and increase their assets, performance-based bonuses are levied on growing asset bases.

For such attractive funds, while asset calculations may average the latest 36 months, large inflows, especially occurring towards period-end, result in high fee adjustment paid by investors who have not benefited from such outperformance. Clearly, due to their backward-looking nature, newer shareholders may be paying the advisory fee bonuses for past performance they never enjoyed.

Similarly, underperformance coincides with fund outflows, and so performance-based penalties may be applied to smaller asset bases.

Another argument in favor of linking fees more closely to performance is that fees just based on a percentage of assets are not an incentive to maximize fund performance; rather it is solely an incentive to gather more assets. One may counter that argument by the

reality that without risk-adjusted return excellence, funds may lose, due to just normal attrition, 15%-20% of assets each year. And, an industry truism is that notable periods of outperformance in funds tend to be followed by significant new assets.

For example, of the 30 actively managed funds that attracted the most in net new assets in 2006, SI found that 18 were in the top quartile of performance in their Morningstar categories in both 2005 and in 2004. Clearly, fund managers have long had strong incentives to maximize risk-adjusted performance.

It is not always clear, though, what behavior is encouraged by performance-based fees. An academic study ("Incentive Fees and Mutual Funds") published in April 2003 in the *Journal of Finance* suggested that funds with performance adjustments tend to take on more risk than funds without such fees, and concluded that this was done in an effort to generate excess returns.

A recent article on the legal aspects of performance fees (F. Scott Thomas and John C. Jaye, "Compensating Mutual Fund Advisors," *Journal of Investment Compliance*, Vol. 7 No. 4, 2006) concludes that performance-based fees may be more suitable for funds aiming purely for high returns than for funds aiming for a mix of returns, risk management, and other factors.

Clearly, generalizations about risk and performance are difficult to make given that the universe of funds using performance fees is so small and so concentrated among just a few funds and managers: the 25 largest such funds account for 74% of assets tied to performance fees.

Overall, SI continues to believe that performance-based fees will only be used by a small percentage of mutual fund managers, but it is an important concept worth ongoing monitoring.

Partly “Closed” Funds and 12b-1 Fees



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In view of the recent focus on Rule 12b-1 fees, we updated our past research on the use of such fees among funds partly closed to investors. We found that, **for the many reasons we detail in the following section, 12b-1 fees continue to be implemented and charged among funds “closed to new investors”.**

Over the past four years, very few funds closing to new investors reduced their 12b-1 fees. The only funds that *did* reduce 12b-1 fees upon closing were those that charged 12b-1 fee ratios of over 0.25% (generally 0.30% or 0.35% in class ‘A’) prior to “closing”—once closed to new investors, these funds reduced fees to the 0.25% ratio typical of service fees among such funds open to new investors.

Even among “closed” funds, 12b-1 fees for certain share classes have not changed. With ‘B’ or ‘C’ share classes, 12b-1 fees need to be continuously paid to financial advisors, or used for amortizing previously incurred distribution costs. (Of course, many ‘closed’ funds had not charged a 12b-1 fee before closing.)

Funds’ Partial Closing to Investors: Some Background

Among the many reasons, some inter-related, that funds temporarily close are:

- Investment capacity constraints, especially among smaller cap or specialized strategies
- A portfolio management team’s persistent inability to find new investments priced within the fund’s valuation model
- A large and growing cash hoard

- Inflows that come in too large and too quickly to be invested
- Too many investors flocking to a fund at the wrong phase of its investment cycle
- Organizational “stress” due to “hyper-growth” throughout a management company, not just in one of its funds (companies where fast growth within mutual funds is often paralleled by large institutional investments within the same style).

Since many attractive funds may experience a surge in new accounts and investments once their future closing is announced, some funds exercise a sudden, “hard” close, where no additional investments are permitted after the “closing” announcement. Such “hard” closes can be very disruptive, though, especially for: (i) investors focusing on prudent dollar-cost averaging; (ii) retirement plans; and (iii) financial advisors using the fund to manage their clients’ ongoing, dynamic asset allocation needs.

Thus, most “closed” funds remain open for many of their existing shareholders or other types of investors. Some steady inflows into the “closed” funds are actually often to the advantage of existing shareholders, since they balance regularly occurring redemptions, running at roughly 1%-3% of fund assets each month. Such balancing inflows lessen the need to liquidate securities to meet redemptions, as well as allow some opportunistic buying without the need to liquidate attractive stocks and needlessly realize capital gains.

Overall, even a “soft” close continues to necessitate some ongoing marketing and sales efforts. And since a large share of the assets of “closed” funds (whether they exercised a “soft” or “hard” close) is held in omnibus accounts, at Schwab or Merrill Lynch, for example, **most “closed” funds continue to require ongoing service expenses for the majority of their assets, and the sharing of the costs of such services. Such needs do not decline or ‘disappear’ once a fund’s closing is announced.**

To illustrate the “open” nature of “closed to new investors” funds, note one highly-rated fund that closed to new investors three years ago, and remains closed: **the Dodge & Cox Stock fund closed to new investors in January 2004. Since then, it has drawn \$15 billion in net cash flows (gross sales to existing investors were even higher).**

Rule 12b-1: A Reality-Check



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The following discussion is excerpted from SI's recent study on Rule 12b-1, prepared for the SEC's 6/19 Hearings on this topic.

Competitive Forces Have Been Reducing 12b-1 Fee Use

- **“B” Shares Going Away, Slowly:** The use of high 12b-1 fee “B” share classes has been shrinking rapidly, and such share classes are likely to largely disappear in the coming five years. Of all stock and bond fund sales through financial advisors in recent years, “B” share classes possibly accounted for just 3%. Minimal new sales, naturally occurring redemptions, and automatic conversions to “A” shares with lower-12b-1 fees, led assets in “B” shares to fall to about \$240 billion, or roughly 2% of the industry's total. In aggregate, “B” share classes lost nearly 20% of their assets due to net redemptions in each of 2005 and 2006, and such liquidations have accelerated in 2007.
- **“A” Share Sales Less Often Involve Payment of Point-of-Sales Commissions:** In parallel with the decline in the use of “B” shares, fewer investors today pay point-of-sales commissions (“loads”) when buying “A” shares. It is estimated that 80%-85% of “A” share sales today are at NAV. With lower commissionable “A” share sales and hardly any “B” share sales, only one-fifth of fund sales today generate point-of-sales compensation for the financial advisor, implying that most advisors selling mutual funds today receive fee-based compensation, either through 12b-1 fees, or “externalized” fees paid outside the fund.
- **“C” shares,** which charge and pass on to the financial advisor 12b-1 fees equal to about 1% of the fund's assets, account for possibly one-tenth of fund sales through financial advisors today. “C” shares are often used as an alternative to account-based fees—such as within mutual fund wraps that

charge more than 1%, or in Registered Investment Advisors' (RIAs) fee-based accounts.

- **Other competitive forces have also been reducing the use of 12b-1 fees** among mutual funds. In an increasing number of mutual fund “platforms”, more lower-fee institutional share classes (without 12b-1 fees) are being used, replacing “A” or “Adviser” shares (purchased at NAV but carrying 0.25% 12b-1 fees). And among mutual fund “supermarkets,” which service self-directed investors, as well as RIAs managing mutual fund investments for their clients, the fastest expansion has been observed at the “transaction fee” platforms, where lower-fee and no-12b-1 fee funds are sold.
- **Overall, mutual fund total fee ratios** (combining advisory, operational, and distribution fees) **have declined significantly in recent years.** Notably, for investors using mutual funds in their Defined Contribution (DC) plans, fund fee ratios in aggregate have not only been significantly lower than fund fees elsewhere, but have been falling too (see discussion on page 17).

Most Fund Accounts Small and Most Households' Total Fund Ownership Modest

- Given the extraordinary growth of the mutual fund industry, which is already responsible for \$12 trillion in assets, and investment management capacity limitations at many funds today, closing funds to some investors is at times advisable. Such “closed” funds, however, are rarely truly closed, as they continue to be open to existing individual and institutional investors, and therefore, maintain sales and ongoing services to existing investors. Our study suggests that, **among such “closed” funds, the continuation of 0.25% 12b-1 fees post their “soft” close has been well within the industry's best practices and regulators' recommendations.**
- One reason to keep some access open to “closed” funds is to help the smaller fund accounts grow. **Most fund accounts are very small and quite expensive to administer. Industrywide, the average stock fund account size is about \$20,000, suggesting that possibly half of all equity fund accounts are smaller than \$10,000 or \$12,000** (the likely median value). Funds with too many small accounts can become much more

expensive for all shareholders. (Such additional costs due to “mutualization” can annually reach 0.30% of assets in some cases.)

- **Modest ownership of mutual funds pervasive:** The dollar value of mutual fund ownership among most investors remains modest, reflecting the middle-income characteristics of most fund shareholders. For example, in 2004, half of all American households investing in mutual funds owned less than \$48,000 in total across all of their funds’ accounts; among fund-owning households, half owned four funds or fewer.
- Only 14% of fund-owning households have mutual fund assets in excess of \$250,000; another 13% have mutual fund assets of \$100,000 to \$250,000; thus, about 70% of fund-owning households held mutual fund assets of less than \$100,000 (2004 data).

Investors Expect Advice, but “Externalized” Models Expensive

- **Most fund investors expect personalized advice:** roughly four out of five fund investors seek personalized advice. Should fees for financial advice be “externalized” by replacing 12b-1 fees taken out of a fund’s value with fees charged directly to investors’ accounts? To examine the impact of such “externalization,” we analyzed a number of areas of the investment management industry where such practices have been in place for many years, and looked at the price being charged there for advice.
- **Separately Managed Account (SMAs):** Many financial advisory firms offer SMAs to their wealthier investors. While SMA account minimums are often \$100,000 (twice the median mutual fund holding of fund-owning households), many SMA accounts are of a much larger size. The **average SMA** (“subadvisory separate account consulting program”) **account held \$336,000** (in 1Q 2007), according to Cerulli Associates.
- “Externalized” fees charged in **smaller SMA accounts are generally 2.5%-3% of assets.** For all SMAs, large and small, Cerulli estimates that the average **effective fee** (asset-weighted, thus adjusted for the greater contribution of the lower fees charged to the very large accounts, such as those holding \$250,000 or \$500,000 or more) was **1.69%** (2Q 2006). Cerulli also suggests that such fees have not declined much since 2002 (despite the more than doubling of assets managed in SMAs).
- **SMA investors are among the wealthiest, most informed, and most able to negotiate the cost of financial advice. Yet, the fees they are charged (which also include investment management fees) have been set at an economic equilibrium much higher than the advice cost to fund investors embedded in the form of 12b-1 fees** (and fund investors generally have fewer financial assets, sophistication, and bargaining power than SMA investors).
- **Mutual fund advisory “wrap” programs** charge an additional fee on top of the underlying mutual funds’ expenses. The average mutual fund wrap account held \$143,000 during 1Q 2007. Here again, the average account size is many times the size of most households’ aggregated mutual fund holdings within a single financial institution. Cerulli estimates the average wrap fee at 1.17% of assets.
- **Cost of “externalizing” fees for advice:** Comparing the equivalent cost of financial advice under the “externalization” option, to paying for such advice through 12b-1 fees, suggests that repealing Rule 12b-1 and “externalizing” fees paid for advice could result in a dramatic increase in the cost of advice to low-balance investors.
- **Loss of tax benefits:** Another inevitable cost of “externalization” is the loss, in many cases, of the tax-benefits of paying for advice through 12b-1 fees. (Fees based on a fund’s value result in a reduction in taxable fund distributions and in the shareholder’s reported taxable earnings, and thus, lower tax payments.) In comparison, when fees for advice are paid in out-of-pocket cash, tax benefits are generally available only when the investor is able to report such expenses under “miscellaneous itemized deductions” subject to the 2% of Adjusted Gross Income (AGI) limitations. Yet, less than 5% of all households are able to deduct such expenses.
- While the tax disadvantage of “externalizing” varies by circumstance, **even a small annual shortfall becomes meaningful over a 20-30 year investment horizon, and can cumulatively exceed 5% of the original investment value.**

Externalizing Advice Creates Operational Issues, Related Costs

- **“Externalization,” disclosure, and transparency:** Beyond funds’ fee tables, 12b-1 fee ratio data is already instantly available on many web sites (e.g., on the free site Morningstar.com,

four clicks are all that's needed to observe any fund's fee data.) No such transparency will be available post-"externalization."

- **Other issues to consider:** Operational costs of "externalization," both for initial conversion and ongoing; operational problems when each FA becomes a "collection agent" (and not all FAs have superior technology). Will FAs transition from mutual funds to other, less transparent yet more expensive investments? Will the elimination of 12b-1 fees reduce availability of small DC plans or significantly increase their costs, especially considering the opportunities and expectations from the Pension Protection Act of 2006?
- **Competition and consolidation:** Since December 2002, more than 150 fund management companies have either been merged with others or have chosen to exit the fund business. About 2,000 individual funds have been merged away. Structural changes reducing access for fund investors may accelerate the industry's consolidation, especially during the inevitable down markets in the coming decade. (Even today, a small number of fund managers account for a very large percentage of the industry's incremental cash flows.)
- **High-fee funds and risk management:** Do some funds with multiple share classes, including some classes with high 12b-1 fees, take higher investment risk to overcome the additional expenses? Given that "B" share sales have declined significantly, and that a majority of multi-share class funds' assets are in low- / no-12b-1 fee share classes, the incentive to reach out into the risk spectrum is uncertain today. For example, of 652 very large funds, each with \$1 billion-plus in assets, that offer "C" shares as one of their pricing classes, just four have more than 50% of their total assets in "C" shares. Thus, taking undue risk to stimulate the ranking and sales of some share classes, but at the expense of the risk-adjusted ranking of all share classes, appears imprudent. Even in the bond fund area, where there is a greater focus on "total returns" today (and not just on yields) and with ranking services zeroing in on risk-adjusted returns, such investment approaches may be rare.

Externalizing Advice Costs will Hurt Small Fund Investors

- **Who can afford to advise the small investor?** Eliminating 12b-1 fees and their tax-related and operational efficiencies in paying for advice would force many financial advisors (FAs) to rationalize and limit access to any investor with limited wealth (a process already in evidence at the larger financial institutions). Many FAs who find themselves unable to efficiently service 200-300 relationships (averaging at least \$200,000-\$300,000) in fee-based assets will not be able to maintain their employment; thus, such FAs will have to dismiss some existing low-wealth relationships and curtail, or eliminate, new lower-wealth accounts.
- **"Externalizing" mutual fund fees charged for advice would result, over time, in a significant increase in what the average mutual fund investor would pay for advice. It would, in our view, most likely end up doubling the annual cost, and even more than double the out-of-pocket costs, when also accounting for the tax benefits lost as compared to charging 12b-1 fees through the mutual fund.**
- **Over a lifetime of investment, such higher costs could add up to a penalty, in some circumstances, of 20-30% of the account's current value.** Furthermore, many lower income and wealth investors using mutual funds would be shut out completely from access to affordable personal advice.
- **In summary: "Externalization" of fees for advice has been in place for many years, with such fees transparent to wealthier, more sophisticated investors with much greater economic negotiating power. Yet, the economically equivalent fees for advice in these circumstances are much higher than fees embedded in Rule 12b-1.**

Global Horizons



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Asia Fund Industry Flows more than Double in First Half

It is difficult to understate the growth taking place in Asia; by all measures, the funds business is ramping up with remarkable strength, benefiting many international money managers that have established a presence there, along with local providers.

More than \$200 billion in net inflows went to mutual funds domiciled in the key markets of Asia during the First Half of 2007, as business in the region accelerated rapidly. Moreover, this number does not include Australia, and also does not include an increasing proportion of flows going to offshore funds (mostly Luxembourg- and Dublin-based) that are benefiting from opportunities in the region. During all of 2006, the comparable net flows number was \$180 billion; thus, the pace is running double that of last year, which also was more than twice as much as in 2005. **Adding Australia and offshore funds sold in the region, net flows in Asia likely approached a quarter trillion dollars in the First Half of 2007.**

Strategic Insight’s global research team tracks more than 18,000 local funds in Asia and thousands of offshore funds registered for sale in the region, including monthly net flows, assets, performance, and other details; it also works with nearly 60 companies active internationally, providing research, analytics, perspective, and ongoing commentary (through the **Windows into Global Asset Management** series) on opportunities and developments globally, and in particular in Asia. Highlights and topics discussed in-depth in past editions and forthcoming:

- **Japan remains a center of opportunity for international money managers**, as investors for the most part purchase **Fund-of-Funds** and **Global Allocation** vehicles that either invest in underlying funds of foreign managers, or represent multi-

subadvised and single-subadvised vehicles. We estimate that **at least 50% of the (massive) net flows to locally-domiciled funds in Japan ultimately benefited underlying international money managers, local funds of foreign managers, or foreign managers offering a co-branded investment product with a local provider or distributor.**

- China is exceeding most expectations by far. **During Q2’07, funds in China collected close to \$50 billion in net flows**, more than double the amount in all of 2006, and triple the flows in the First Quarter. To put that in perspective, the number is just a touch higher than flows to all funds in Luxembourg during the same period. As the table below shows, **three of the ten top selling funds in Asia during 1H’07 were in China (the rest in Japan).** Yet concerns remain around the stability of investor demand through weak markets, asset turnover and longevity, preferences for low NAVs, and managing new product introductions against asset quotas.
- The expanding growth in Asia, while widening the opportunity set for fund providers, is also coming with more business complexities and uncertainties; in past Global research reports we discussed tax rulings in Korea which put offshore providers at a disadvantage; amendments to China’s QDII scheme that will allow investment in offshore funds in Hong Kong; the terrific take-up of infrastructure and global REITS programs in Korea, against a backdrop of M&A and new entrants to the market; plus many other issues within the region.

Highest Cash Flow Funds in Asia, 1H’07 \$ Billion

Fund Name	Category	Flows
Pictet Global Income Equity	Equity Global	5.8
Nomura MyStory Distribution	Mixed Asset	5.5
Nikko Nikkei 225 Index	Equity Japan	4.7
Nomura Nikkei 225 Index	Equity Japan	4.7
ChinaAMC Blue Chip Core Fund*	Mixed Asset	4.1
Nomura Gbl High Yld Dividend Stock	Equity Global	4.0
E Fund Value Growth Fund*	Mixed Asset	3.4
Daiwa Resona World Asset Allocation	Mixed Asset	2.6
Nomura Global All-Stars	Mixed Asset	2.6
Bosera FTSE/Xinhua A200 Fund*	Equity China	2.5
Total Above		39.9

Sources: Strategic Insight; Lipper, Inc.; *China-domiciled funds; the rest are in Japan

Introducing the Asia FlowWatch

Companies building their business in Asia need timely information and intelligence on what investors are buying, and what is working, in each market. To support that process, **Strategic Insight has introduced a new analytical series—the monthly Asia FlowWatch—providing far greater visibility on the most important details behind the Asia funds industry.**

We are the only research firm integrating net flows, assets, performance, and other essential information on over 18,000 funds across the Asia region in a way that supports efficient and ongoing analysis, planning, and decision-making for product development, marketing and distribution, and strategy. The Asia FlowWatch provides CEOs, investment managers, product and distribution heads, and other executives and analysts with a detailed view on the major activities in the fund industry in Asia. Among its features:

- **Tracking the specific funds that investors are buying in Asia, in all key markets:** How well can you implement your strategies in the region without knowing what investors are purchasing? The Asia FlowWatch every month identifies the **20 highest-cash-flow products in each major market—Japan, Korea, India, China, Taiwan, Hong Kong, and Singapore, plus others (Malaysia, Thailand, Indonesia, and offshore ranges exclusively sold in Asian markets)**. Our unique analytical templates combine net flows with assets, performance, volatility measures, investment categories, and other fund information, to provide a detailed view of the top-selling products in Asia.
- **Highlighting the most successful new products in Asia:** Product development is central to success in the region, as a large proportion of industry net flows continue to go to new launches. The Asia FlowWatch lets you know exactly **which new products are raising the most money in each market**—helping you to stay abreast of industry innovation, deeply understand product developments, identify the different themes that are working in various markets, and providing a foundation for ongoing monitoring of product trends to enhance and support your own development and expansion efforts.
- **Management company progress:** How well is your company doing versus the competition in the region? The Asia FlowWatch answers that with

net flows and asset growth by company and asset category for the major providers. This can help you better understand your position and market share in a particular market, monitor the direction of overall industry progress and that of your peers, and identify segments where certain companies are finding particular success (or challenges), and thus serve as a starting point for more in-depth research and understanding of your business and its true achievement in the region.

- **Flows by investment category in each major market:** What type of funds are investors buying in Japan (or China, etc.) this month? During the past three months and trailing year? How does this compare with your own product range and investment competencies? Where are the opportunities for product development or additional marketing efforts to supply investors with the type of investments they are demanding? These are just a few of the questions that the Asia FlowWatch and its sales monitoring by detailed investment category can help answer.
- **Monthly net sales over time for each market by investment category:** A summary of progress over the past year, helping analysts, fund promoters, and distributors better **grasp the direction and pace of growth in each market**, the types of funds growing in importance and demand, and the evolution of investor purchasing patterns.

The Asia FlowWatch includes additional views on funds, including aggregate analysis of the region, to help you build your business in the fastest growing segment of the industry globally. To learn more about how to get this resource, contact Jag Alexeyev at jag@sionline.com / +1-212-944-4456.

Strategic Insight's In-Depth Analysis of the Asia Funds Industry

In the fall, SI Global will publish the first comprehensive study on the Asian mutual fund industry, combining its unique on- and offshore data coverage with the key distribution dynamics for the region and case studies on asset managers that successfully entered the region. Some of the questions addressed in the Asia study include: Will Asia dominate the global fund industry in five years? Is a Pan-Asian strategy possible or will markets stay fragmented? What are the most successful market-entry and sales approaches fund managers can take? What are the key drivers in each of the local markets? Which are the most promising markets for foreign managers? How will regulation impact growth in Asia?

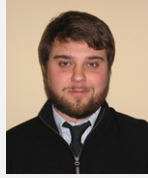
VAs: Life-Time Income Guarantees



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VA Guarantees... Outside of VAs

The annuity industry has long spoken of its “franchise” on lifetime income guarantees. However, with the overwhelming popularity of guaranteed minimum withdrawal benefits (GMWBs) has also come significant interest in expanding this feature to non-annuity products.

Although we have heard queries about applying GMWBs to mutual funds, this is not the area where we have seen the earliest development. So far, three carriers, **Allianz**, **Genworth** and **Phoenix**, have filed with the SEC to release products that would add a GMWB guarantee to investment advisory accounts not managed directly by the insurer. Like GMWBs on VAs, these guarantees offer a different set of features and benefits, varying in the guaranteed lifetime percentage and other aspects.

How the Guarantee Works

Generally speaking, **each product guarantees lifetime payments in the event that the policyholder’s investment account value reaches zero** through an individual or joint spousal certificate in a group fixed annuity. The idea is that the policyholder spends down the investment advisory account, where assets are directly held, according to the conditions typical to GMWBs in VAs.

The guarantee and annuity payments come into play in case the investment account value falls to zero. This concept is not in itself novel, as some GMWBs already use a similar mechanism where the policy terminates once the cash value is depleted and a separate immediate annuity then funds the income guarantee.

These filings used SEC form S-1 in separate accounts (generally used for market value adjusted or registered fixed index annuities, but not VAs).

Allianz Contingent Annuity, [CIK 1403082](#)

Original S-1: [July 13, 2007](#)

Genworth Group Guaranteed Income Annuity Certificate, [CIK 1156124](#)

Original S-1: [June 4, 2007](#)

Phoenix Guaranteed Retirement Income Solutions, [CIK 1031223](#)

Original S-1: [October 4, 2006](#)

Pre-Effective Amendment #1: [March 20, 2007](#)

Pre-Effective Amendment #2: [July 2, 2007](#)

These contracts are basically deferred single premium annuities whose life-only payments begin only under a particular contingency. Even though the guarantee is on a fundamentally variable investment, the brokerage account, the guarantee itself is for a fixed lifetime payment (or a fixed payment with COLI adjustment).

Bear in mind that, as of this writing, these policies have only been filed, not approved, and may assume significantly different forms when released onto the market. Even so, it is worthwhile to examine the carriers’ approaches in designing this coverage. So far, two of the three are associated with specific investment advisory programs.

In all three products, policyholders are also able to cash out the remaining value of their brokerage accounts in exchange for a fixed life-only annuity. To provide any value, policyholders must elect this option well before the account value reaches zero. The carrier guarantees a certain payment rate stated in the certificate.

General Observations

While these products do resemble the essential blueprint of standard GMWBs commonly found on VAs, certain aspects of the guarantees are different from what is offered so far. For instance, the fee structure is necessarily different, as it is for the guarantee alone and not the guarantee on top of a comprehensive contract with other asset-based fees.

Also, the separation of the control of investment management and the guarantee poses an interesting dilemma for carriers: as with GMWBs within VAs, they must assess some control over the assets in order to properly manage the risk. However, they have no direct control over assets and their ability to even monitor adherence to assumed programs is predicated on the relationship with the investment manager, program manager and/or broker dealer. As a result of

this situation, **the guarantees can potentially be nullified by actions outside of the control of the policyholder.**

Taxation of Guarantee Payouts

Because these are novel products, the tax status of payouts from the guarantee is not clearly established, and the prospectus includes disclaimers to that effect (Allianz's prospectus does not even include the tax-related information yet). However, Phoenix and Genworth both include an interpretation of tax law for non-qualified accounts by which the payouts are treated as life annuity payments, taxed partially as income and partially as non-taxable returns of aggregate policy fees. Once the policy fees are returned, the remaining balance is taxed fully as income.

Policyholders who opt to purchase a life-only single-premium immediate annuity with the remaining account balance would also pay taxes according to annuity treatment; in this case, however, the investment base is the amount of the brokerage account balance liquidated to purchase the supplemental policy.

Implications

These are the first registrations we are aware of involving a lifetime GMWB guarantee applied outside of an annuity, and the existence of multiple such filings reflects considerable interest in the area. Nevertheless, none of these products has gone live, so the view of regulators, both on the federal and state level, of this type of guarantee, remains untested.

Furthermore, it is unclear how producers and buyers will take to this line of products, given the relative prevalence of more common VAs. Generally, the investment restrictions on VA GMWBs allow more investment options than we see on this set of products. Because these guarantees require the use of monitored investment regimens that remain static among a large pool of clients, they are not likely to attract extremely high end clients, but those are also not individuals who have a need for this kind of downside risk protection.

With preliminary filings from three carriers already, we may see more entrants into the market. Perhaps the biggest question is how long it will take for this line of development to proliferate. The taxation uncertainty may be a hurdle that some carriers and distributors are unwilling to vault until those questions are resolved by the Treasury Department. **However, earnings withdrawals from the account itself, in all probability constituting the bulk or entirety of payments, likely will be taxed at capital gains rates.**

This alone represents a noteworthy improvement for high-tax-bracket policyholders from the tax status of GMWB withdrawals, which currently have FILO treatment at the income tax rate. Furthermore, as the account balance goes down (and the guarantee gains more value to the customer), the account can reap capital losses, unlike a VA account. Finally, in non-qualified accounts, policyholders can take withdrawals prior to age 59½ without a penalty, although such withdrawals can reduce the guaranteed income amount (depending on which carrier is providing the guarantee).

Competition or Complementary?

Perhaps the most important question is whether this new area of product development provides more competition or more opportunity for VA manufacturers. **With widespread speculation that a similar product applied to mutual funds will emerge, the market reach of GMWB guarantees will potentially expand further.**

VA writers are obviously in the best position to support these benefits and will likely have some hand in them, But carriers will be sailing into new waters by offering the guarantees only without collecting any other asset-based fees or providing other contract services.

The absence of income diversification that standard VAs provide exposes the cost and value of the bare guarantee and puts such carriers solidly in the business of selling insurance as opposed to selling securities products with insurance properties. Therefore, **the pricing of these products is a novel exercise that analysts, rating agencies and regulators will certainly scrutinize closely.** Additionally, **it may add to questions about the current pricing methodology of GMWBs within VAs,** debated both in the financial press and from the NY State Insurance Department.

However, **writing this new business potentially provides some market access to producers and clients who would otherwise eschew VAs.** Not only can carriers benefit by selling such policies and adding to their books of business, but **it may make some producers and customers more interested in annuities themselves.** Certainly, the industry will keep a keen eye on the new developments that are likely to come down the pike in this area over the coming months and years.

Strategy Based Investing: “Out of the Box”



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For more information regarding Strategy-Based Investing, visit us at www.athenainvest.com or email us at info@athenainvest.com or call us at (877) 430-5675 ext. 1.

Executive Summary

We believe that the two most important pieces of information regarding an active investment manager are **1) the investment Strategy being pursued and 2) how consistently it is being pursued.** We refer to this approach as Strategy Based Investing or SBI for short. For the equity version of SBI, we have identified **10 Strategies for managing equity portfolios.**

Methodology: The 10 equity Strategies were identified using a three stage process. As part of this process, managers who manage or have managed a wide variety of equity funds were interviewed in order to expand and refine the key aspects of the proposed identification system. Then, detailed Strategy information was gathered resulting in 22,000 pieces of Strategy information. This information was organized into 40 elements which were, in turn, assigned four each to a particular Strategy. Based on the specific information provided by the manager, primary and secondary Strategies were identified for each fund using a proprietary, carefully structured, objective algorithm.

SBI Designation and Manager Review: The resulting Strategy profile for a typical fund is comprised of **primary and secondary Strategies**, as well as a number of elements, some associated with the primary

and secondary Strategies and others not. As a final step, the fund's **Strategy profile will be made available to fund management companies** and AthenaInvest will request manager feedback regarding how AthenaInvest has interpreted the manager provided Strategy information.

The equity investment world can be viewed through Strategy lenses once fund primary and secondary Strategies are known. We provide an initial look through Strategy lenses in this report.

Finally, a Meaningful Peer Group: By using the SBI Strategy identification process, we believe it is **possible to finally categorize managers to allow for the formation of meaningful peer groups.** Our continuing SBI research reveals that Strategy optimization and consistency lead to superior performance in the range of the 300 basis points that we first unearthed in our “20,000 foot” Strategy consistency research published in the Winter 2005-06 issue of the *Journal of Investment Consulting* (IMCA).

Portfolio Construction Using SBI: We have also developed an easy to use **application that allows the advisor, consultant, or investor to categorize, restructure an existing portfolio, and track performance using SBI concepts.**

Our research shows that **a portfolio that is strategy optimized and is invested in a number of strategy consistent mutual funds has an excellent chance of outperforming the market index.**

Strategy Based Investing: Introduction

In a series of articles in the *Journal of Investment Consulting* (Winter 2005-06), *Investment Advisor* (Sept 05, Feb 06 and March 06), and elsewhere we have made the case that **constraining managers to boxes, defined by market capitalization and value-growth characteristics, costs about 300 basis points per year in underperformance.** There are other studies, covering the time period from 1984 through 2007, that find similar results. The six studies reported in Table 1 approach the question from different directions, but basically come to the same conclusion: **staying in a box or hugging an index is detrimental to a fund's performance.** We have also shown that characteristic boxes are not asset classes and that **diversifying among boxes provides minimal, if any, risk reduction beyond what can be obtained by randomly selecting funds.** Thus we conclude that

boxes hurt performance and provide few if any risk reduction benefits.

Table 1: Performance Advantage of Drifters versus Box Huggers

Author	Date Published	Focus	Sample Period	Drifters Minus Huggers
Wermers	2002	Style Drift	1985-2000	2.93%
Teo & Woo	2004	Style Rotation	1984-1999	9.80%
Kacperczyk, et. al.	2005	Industry Concentration	1984-1999	1.84%
Howard & Callahan	2006	Strategy Consistency	1995-2003	3.39%
Cremers & Petajisto	2007	Active Share	1990-2003	3.26%
Howard	2007	Style Drift	1997-2007	4.40%

**Annual risk adjusted returns. Sources: Wermers, Russ. 2002. "A Matter of Style: The Causes and Consequences of Style Drift in Institutional Portfolios" (July) Working Paper, University of Maryland. Teo & Woo, "Style effects in the cross-section of stock returns", November 2004, Journal of Financial Economics. Kacperczyk et. al. "On the Industry Concentration of Actively Managed Equity Mutual Funds", August 2005, Journal of Finance. Howard and Callahan, "The Problematic 'Style' Grid" Journal of Investment Consulting, Winter 2005-06. Cremers and Petajisto, January 2007. "How active is Your Fund Manager? A New Measure That Predicts Performance" Yale School of Management Working Paper. Research conducted by Tom Howard based on the April 2007 Zephyr data base.*

We have also established a distinction between value-growth and market capitalization characteristics and "style", where style is the Strategy a manager uses to analyze, buy, and sell stocks. Large-cap value, for example, states nothing about how a manager selects stocks. It simply states that a manager is currently purchasing stocks with specific characteristics.

Categorizing and constraining managers by characteristics not only hurts performance and provides minimal risk benefits, but it also provides no information regarding the investment Strategy being pursued by a manager.

Strategy Based Investing

We have identified 10 Strategies for managing equity portfolios. ("Style" might have been a suitable word, but, as it has been used incorrectly for almost 20 years, we chose "Strategy" instead). Here are the ten equity Strategies we have identified:

- Competitive Position
- Economic Conditions
- Future Growth

- Valuation
- Profitability
- Market Conditions
- Social Considerations
- Quantitative
- Opportunity
- Risk.

Competitive Position managers seek companies with traits such as high quality management, defensible market position and a track record of innovation.

Economic Condition managers start with macro economic forecasting and work their way down to favored industries and stocks.

Future Growth and **Valuation** are fairly obvious although it should be noted that they are not limited to what have been labeled "growth" and "value" stocks.

Profitability managers favor companies with impressive margins and/or return on equity.

Momentum and technical analysis might be used by the **Market Condition** managers

Risk managers favor companies with below average business risk among, other similar traits.

Social Considerations managers focus on companies that are socially responsible, ecologically aware, or invest based on religious tenets.

Opportunity managers seek market imbalances that are driven by events such as earnings surprises.

Finally, statistical and mathematical modeling are the focus of the **Quantitative** Strategy. (Complete definitions can be found in the Appendix.)

The Identification Process

We identified 10 equity Strategies in a three stage process extending over a two year period. After completing the initial identification process, equity managers, who manage or have managed a wide variety of equity funds, were interviewed in order to expand and refine the key aspects of the proposed identification system. Then detailed Strategy information was gathered from public manager statements. Over 22,000 pieces of Strategy information were obtained for 2012 funds (ignoring share classes) covering 85% of the actively managed open end equity funds covered by Lipper. For the other 15%, managers

did not provide enough information to permit Strategy identification.

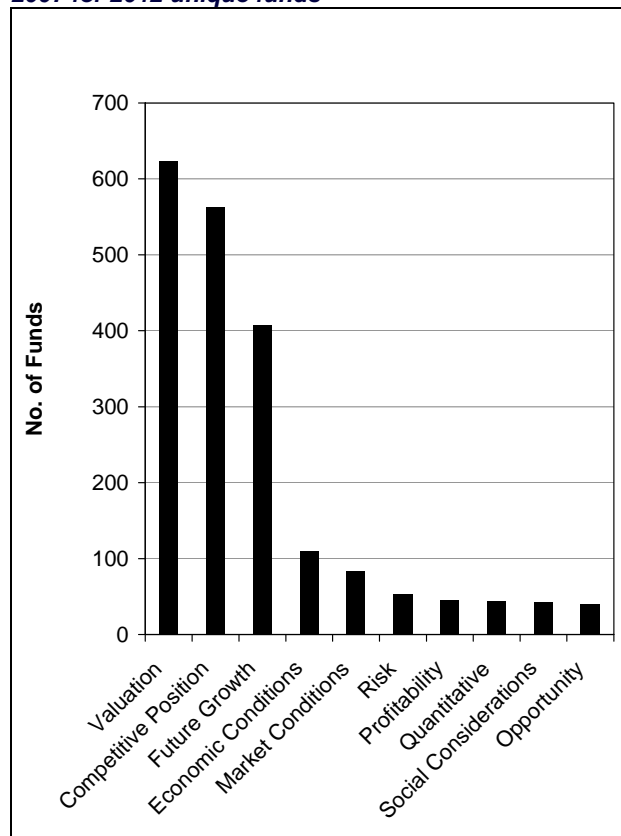
We then organized the Strategy information into 40 elements which were, in turn, assigned four each to a particular Strategy. An element represents a specific item focused on by the manager while pursuing a Strategy. Once this data organization process was complete, we identified the primary and secondary Strategies for each fund using a proprietary, carefully structured, objective algorithm. The resulting Strategy profile for a typical fund is comprised of primary and secondary Strategies, as well as a number of elements, some associated with the primary and secondary Strategies and others not.

As a final step, the fund’s Strategy profile will be made available to each manager and AthenaInvest will request feedback from the manager regarding the profile. This feedback will be limited to how the fund’s public statements have been interpreted by AthenaInvest. The accuracy of public statements will not be directly verified, however. AthenaInvest is developing several objective measures that will allow investors to judge whether the manager is indeed pursuing the stated Strategy. Thus strategy identification is based on public statements, and interpretive help, if offered by the fund manager.

The Equity World through Strategy Lenses

As described above, 2012 US equity open-end funds have been identified as pursuing one of 10 equity Strategies. Table 2 shows the frequency of the ten different Strategies. Valuation is the most popular, practiced by managers of 622 funds. Competitive Position and Future Growth are the second and third most popular Strategies.

Table 2: US Equity Open-End Funds by Primary Strategy
Based on AthenaInvest and Lipper data as of April 2007 for 2012 unique funds



Source: AthenaInvest

Notice that of the three most popular Strategies, none has a primary focus on the economy. Instead, they just look for bargains, high quality companies, or future growth, respectively. Economic Conditions, is the fourth most popular approach, but is practiced by only 5% of the managers in our sample. It is interesting that all day long on financial TV the economy is debated for entertainment purposes, but 95% of the professional managers we surveyed do not focus primarily on the economy when making investment decisions.

Table 3 shows YTD (period ending April 30 2007), 1-, 3-, 5- and 10-year returns for all ten Strategies sorted by the 10-year return. Market Conditions, Valuation, and Competitive Position stand out as being the most productive Strategies over various time periods. For the year-to-date (YTD) time period, Competitive Position, Future Growth and Market Conditions have been the top performers. Opportunity, Future Growth, Economic

Conditions and Profitability stand out as producing poor relative returns over a number of the time periods.

Table 3: Annual Strategy Returns Sorted by 10yr Returns

	Fund Count	YTD	1yr	3yr	5yr	10yr
Market Conditions	83	6.13	9.50	13.60	9.86	10.32
Valuation	623	5.65	12.00	13.91	10.10	10.09
Competitive Position	563	6.15	9.63	12.82	9.29	9.57
Social Considerations	43	5.66	9.37	12.40	8.57	8.98
Quantitative	44	5.59	9.43	12.69	8.48	8.91
Profitability	46	6.05	9.67	12.12	8.88	8.78
Risk	53	5.51	10.70	12.34	8.51	8.71
Future Growth	407	6.14	8.02	11.60	7.73	8.39
Economic Conditions	110	5.93	9.07	12.75	9.19	8.38
Opportunity	40	5.21	9.38	11.94	8.58	8.24
Total/Avg.	2012	5.92	9.97	12.83	9.12	9.31

Source: AthenaInvest and Lipper, April 2007. Fund returns are net of management, administrative, and 12b-1 fees, but not of sales, load, or other charges. The number of funds in each sample declines with the length of the time period. PAST PERFORMANCE IS NO GUARANTEE OF FUTURE PERFORMANCE

These latter results lead to some interesting speculation. Are the lagging strategies just not productive Strategies? Intuitively appealing, but perhaps not useful approaches? Or, are the disappointing results of these strategies unique to the specific time periods shown in the table above? Perhaps in different economic and financial settings they might be productive. Or, are these potentially productive Strategies, but the managers using them may not be good at applying them? For example, maybe Future Growth is a potentially productive Strategy, but managers are not good at assessing growth. Or, are there so many managers pursuing these Strategies that, due to competitive forces, Strategy benefits are negated? Or, perhaps the managers in the lagging Strategies have been characteristic constrained. After all, the evidence is clear that characteristic constraints and performance are inversely related. It should be noted that the results reported in Table 3 are averages. In each category there are managers who are Strategy consistent and, as a result, produce strong results.

Some might argue that the differences among Strategy returns are simply the result of differences in risk or due to the well known small firm and low PE effects. We adjusted returns for these factors and the relative

performance among the Strategies changed little. Thus, the performance differences among Strategies are determined by something above and beyond risk and the small firm and low PE effects.

Primary and Secondary Strategies

In addition to a primary Strategy, each manager's Secondary Strategy was also identified. As an example, let's consider two Competitive Position managers, A and B. They both screen for and favor high quality companies. Manager A then selects the ones with the highest potential growth (Future Growth) while manager B favors the cheap ones (Valuation). Manager A would be a Competitive Position primary Strategy with a Future Growth secondary Strategy, whereas manager B employs a Valuation secondary Strategy to complement his Competitive Position primary Strategy.

Table 4 shows the top five performing primary Strategies on the vertical column, and the top five performing secondary Strategies horizontally. These boxes represent the superior performing combinations as measured by the trailing three-year risk adjusted returns as of April 30, 2007. The table entries are the number of funds pursuing these Strategy combinations. Generally, some combination of Valuation, Quantitative, Opportunity, Risk, and Market Conditions has been productive.

Table 4: Number of US Equity Open-End Funds Pursuing the Top Performing Primary and Secondary Strategies

Primary	Quantitative	Opportunity	Risk	Market Conditions	Valuation
Valuation	20	32	12	51	
Quantitative			4	3	6
Opportunity	7		6	1	13
Risk	2	3		2	6
Market Conditions	5	1	1		9

Note: Strategies ranked by 3yr risk-adjusted returns for the period ended April 30, 2007. Source: AthenaInvest

Table 5 shows the bottom performing primary and secondary Strategies over the same three year period ended April 30, 2007. It is interesting to note that the combination of Future Growth and Competitive Position in either primary-secondary sequence is not productive, yet it is used by over 300 funds. It is also apparent that fewer funds, in general, are using the most productive combinations in Table 4 while many more funds in Table 5 are using unproductive Strategy combinations. These two tables in combination reveal

both opportunity and overcrowded spaces in the equity mutual fund arena.

Table 5: Number of US Equity Open-End Funds Pursuing the Bottom Performing Primary and Secondary Strategies

Primary	Competitive Position	Economic Conditions	Profitability	Future Growth	Social Considerations
Social Considerations	7	2		6	
Economic Conditions	34		3	19	5
Competitive Position		127	38	171	4
Profitability	7	6		7	1
Future Growth	144	27	18		3

Note: Strategies ranked by 3yr risk-adjusted returns for the period ended April 30, 2007. Source: AthenaInvest

Looking Ahead

Given fund distributors’ focus on structuring portfolios using non-correlated investment strategies, and the need to align product management, peer review, and new product innovation to such asset allocation considerations, the limitations of the style-box investment strategies are becoming more apparent.

Using SBI for peer fund evaluation, identifying the best funds within each strategy, and constructing an efficient-frontier portfolio with such highly-rated funds (see further AthenaInvest research), suggest a superior, yet practical application of *Strategy Based Investing*.

AthenaInvest looks forward to collaborating with mutual fund managers in the introduction and communication of SBI to the marketplace. For more information regarding Strategy-Based Investing, visit us at www.athenainvest.com or email info@athenainvest.com or call us at (877) 430-5675 ext. 1. Or, call Tom Howard, 303-204-4621, tom.howard@athenainvest.com.

Appendix to “Strategy Based Investing: ‘Out of the Box’”

Strategy and Constraint Definitions

Competitive Position

The manager focuses on business principles, including quality of management, market power, product reputation, and competitive advantage. Important considerations are the sustainability of the business model and a history of adapting to market changes.

Economic Conditions

The manager follows a top down approach based on economic fundamentals. These may include employment, productivity, inflation, and industrial output. The manager gages the overall health of the economy, trying to ascertain where it is in the business cycle, the resulting supply and demand situation in various industries, and, ultimately, the best stocks to purchase.

Future Growth

The manager focuses on companies poised to grow rapidly relative to others. The Future Growth and Valuation Strategies are not mutually exclusive and it is plausible for a manager to deem both important in the investment process.

Market Conditions

The manager considers the stock's recent price and volume history relative to the market and similar stocks. The manager may consider overall stock market conditions as well.

Opportunity

The manager focuses on unique opportunities that may exist for a small number of stocks or at different points in time. May involve combining stocks and derivatives and may also involve use of considerable leverage. Many hedge fund managers are characterized as following an opportunity Strategy, but a mutual fund manager may also be so classified.

Profitability

The manager focuses on company profitability, as measured in a variety of ways, such as gross margin, operating margin, net margin and return on equity.

Quantitative

The manager focuses on mathematical and statistical inefficiencies in the market and individual stock pricing. Typically involves mathematical and statistical modeling with little or no regard to company and market fundamentals.

Risk

The manager focuses on controlling overall risk, with increasing returns a secondary consideration. A wide range of risk measures may be considered including beta, volatility, company financials, industry and sector exposures, country exposures, and economic and market risk factors.

Social Considerations

The manager focuses on social considerations, including the company's ethical, environmental, and business practices as well as an evaluation of the company's business lines in light of the current social and political climate.

Valuation

The manager focuses on stocks selling cheaply compared to peer stocks based on accounting ratios and valuation techniques. The Valuation and Future Growth Strategies are not mutually exclusive and it is plausible for a manager to deem both important in the investment process.

Constraints: Capitalization

The manager focuses on stocks falling into a specific market capitalization category.

Industry & Sector

The manager limits investments to a particular industry and/or sector. This does not include industry/sector bets that are a residual of pursuing a particular Strategy.

Disclosures

The Strategy Based Investing methodology is based on the concept of constructing portfolios along the strategy dimension, the elements, and the ratings, one of which is consistency. This entire system also looks at managers this way, assembling peer groups, allocates among them, and analyzes the sources of alpha as a result. This methodology is currently patent pending.

Opinions and forecasts regarding industries, companies, countries and/or themes, and portfolio

composition and holdings, are all subject to change at any time, based on market and other conditions, and should not be construed as a recommendation of any specific security.

Expressed in percentage terms, Lipper's calculation of total return is determined each month by taking the change in monthly net asset value, reinvesting all income and capital-gains distributions during that month, and dividing by the starting NAV.

Reinvestments are made using the actual reinvestment, and daily payoffs are reinvested monthly. Lipper does not adjust total returns for sales charges (such as front-end, deferred or redemption fees). The total returns do account for management, administrative and 12b-1 fees and other costs automatically taken out of fund assets.

SI Innovation: The New Simfund MF 5.0



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Comprehensive Lipper Data added to Data from Morningstar, ICI, SEC Filings, and SI

Multiple data sources, one seamlessly integrated Database: For the first time, all Simfund users have access to a wide range of Lipper data, including performance (trailing, monthly, etc.), survivorship bias-free rankings, Lipper Leader scores, classifications, portfolio statistics, risk measures, and more. Of course, Morningstar performance data continues to be available too.

You may already have been using Lipper data in other parts of your firm—now you can use those same peer groups in Simfund. As organizations distributing your funds use both Morningstar and Lipper for benchmarking and screening, the **simultaneous availability of mutual fund data from both of these sources in Simfund MF 5.0 offers an efficient way to compare and contrast the results of these alternative ranking services**, and communicate a deeper understanding of a fund's relative performance to investors, financial advisors, gatekeepers, and fund trustees.

Each firm will use this unique integration differently. One possible area of focus could be sales of funds ranked highly by one ranking service, but less so by the other. For example, **we identify more than 1,700 stock and bond fund share classes (in over 1,000 portfolios) that are currently awarded the highest Lipper Leader score for Consistent Returns but only four-stars or less by Morningstar.** Can your sales be stimulated using Lipper ranking data, now timely and easily accessible, in combination with the many other business intelligence tools in Simfund?

Simfund-enabled Lipper data can also be used to focus on refined peer groups for tracking business trends, new funds, peer fund sales (when you have access to such data based on the ICI's confidential sales report available to ICI members), net flows, and more.

Also of significance: **Simfund 5.0** will allow all users to **download Lipper's performance data for each month on around the 10th day of the following month**, 10-12 days before the release of fully-refreshed Simfund (note though that this early release of Lipper performance data will not include updated cash flows, month-end assets, etc.). SI also intends to offer Morningstar data updates earlier in the monthly cycle than before—such an option may become available later in 2007.

Most Complete, Timely Fee Data

Version 5.0 adds a range of fee data from fund prospectuses, updated monthly (based on our daily monitoring of every newly-filed prospectus and prospectus amendment).

Prospectus-based data fields include management fee ratios, 12b-1 fees, other fees, waivers, total expense ratios, performance benchmarks, contractual advisory fees, including contract type, fee breakpoint schedules, performance fee details, contractual fees of each sub-advisor in funds with multiple sub-advisors, sub-advisory contract types and asset and fee breakpoints or sub-advisory percent of advisory fees, etc.

Beyond these new fields in Simfund, **clients that also subscribe to SimfundFiling.com can use the many instantaneous links from Simfund to SimfundFiling.com** to study additional fee details in any of the fund's SEC filings (see further details below).

Funds-of-funds: Simfund 5.0 now includes a field showing **each fund-of-fund's underlying fund fee ratio** (which FoFs are now required to report as a separate line item in prospectus fee tables, pursuant to new SEC disclosure requirements that became effective earlier this year).

Newest Funds: For the first time, Simfund also shows fee ratios and schedules (from current prospectuses) for the newest funds.

Taken together, Simfund MF 5.0 and SimfundFiling.com and comprehensive fee tracking solutions they offer (current prospectus, historical Annual Report-based fee ratios for the past five years, and instant links to each fund's SEC filings),

make for an unparalleled source of fee data for internal or board reporting.

Unique Resources to Target and Monitor the Sub-Advisory Business

Simfund MF 5.0 offers **expanded data and analytics on sub-advised funds, including complete sub-advisory detail on funds with multiple sub-advisors.** In the near future, we will add the ability to identify (“select”) **all funds (including multi-managed funds) for which a particular company serves as a sub-adviser** (not just funds where it is the sole sub-adviser).

For funds with multiple sub-advisors, Simfund 5.0 includes the **sub-advisory breakpoint schedules for each sub-advisor, when disclosed.**

In combination with related enhancements in the **soon-to-be-launched 5.0 version of SI’s Simfund VA module** for the Variable Annuity business, and **daily tracking of all filed sub-advisory changes through SimfundFiling.com**, SI’s Simfund suite of products represents **an unparalleled, timely data resource for sub-advisory monitoring.**

Peer Selection, Benchmarking in Complementary Ways

New to Simfund, the **version 5.0 offers as a data field the prospectus-specified performance benchmark of a fund** (Russell, MSCI, S&P, FTSE, Lipper, Lehman, etc.), **allowing, for the first time, the use of such indices for funds’ peer comparison purposes.**

This additional field may assist you as you deal with important questions related to business benchmarking and performance measurement: How do investment analysts in the increasingly influential fund selection units construct peer groups for evaluating your funds? What is the appropriate peer group for internal reporting purposes? What peer group refinements are needed to ensure an “apples-to-apples” comparison?

For example, only a third of funds classified as “Large Blend” by Morningstar are classified in the equivalent “Large-Cap Core” category by Lipper (some of the alternative groupings into which Lipper places funds include multi-cap, large-cap value or growth, and S&P 500 Index funds). Similarly, less than half the funds Morningstar classifies as “Mid Blend” are assigned a “Mid-Cap Core” classification by Lipper, etc.

Funds benchmarked to the same prospectus-stated index are at times assigned different styles by Lipper and Morningstar.

Of course, certain investment strategies are more tightly defined and tend to be classified more uniformly.

Besides quickly and easily defining peer groups by using just one of these three criteria (Lipper Classification, Morningstar Category, or prospectus-stated Benchmark Index), you can **use various other specialized flags and screening tools available in Simfund** (P/E, P/B, distribution channel, focused funds, fee criteria, tax managed, open to new investors, etc.) to identify the most appropriate peer group for a variety of distinct purposes.

Thus, **beyond the “style box,”** additional data and flags in Simfund allow you to identify sub-groups within the same style, “save” such selections and filters, and efficiently re-run comparisons each month using “batch” features.

These easy-to-reproduce reports should help generate sales ideas, assess portfolio manager performance, monitor prospectus changes filed with the SEC, facilitate reports for trustees, etc.

Lastly, Simfund may incorporate at a future date some additional data along the lines of the analytics discussed in the Guest Column on pages 29-35; strategy-based peer groups should offer a completely new dimension away from the limitation of “boxes.”

Links from Simfund to SimfundFiling.com (formerly Fund Filing.com) have been greatly expanded. Users that subscribe to both products can now **run a query in Simfund** using any of its flexible screens for **defining peer groups** and then in one step, **link to the SEC filings of the entire group of funds on SimfundFiling.com. This facilitates time-efficient monitoring of SEC filings and peer fund changes.**

You can also set up e-mail alerts or watch lists for multiple peer funds or managers in order to monitor for fund closures, portfolio manager changes, new funds filed, fee modifications and other changes with important competitive implications.

New links also provide access from within Simfund to a fund’s latest prospectus, as well as a **continuously-updated SI Fund Prospectus Profile**, which contains important details extracted from the prospectus, including fees, performance benchmarks and portfolio manager information. See a sample [Profile](#) on SimfundFiling.com’s Connect section, and read pages 10-11 of this Windows issue for illustration of this innovation.

Lipper Fund Fact Sheet Hyperlink

From within Simfund MF 5.0 (while at the Fund Grouping level), **you can link instantly to Lipper's Fund Fact Sheets** providing rankings, historical returns, Leader scores, top holdings, risk ratios, best and worst quarters, and more, facilitating further research, sales ideas, and peer evaluation.

Expanded ETF Data and Resources

Simfund MF 5.0 offers comprehensive data and analytical tools to track the fast-growing ETF business, which now holds **half a trillion dollars** in assets in more than 500 funds, and is marked by rapid new product development activity. **Enhanced software allows you to quickly and conveniently zoom in on this segment** of the marketplace and view ETFs of all legal structures (including UITs, grantor trusts/ETNs etc.). You can also choose to see an industry "view" that shows all the different types of ETFs alongside conventional mutual funds.

The **5.0 version also offers for the first time a wide range of ETF data from Morningstar**, including Morningstar categories (adding to already-available Lipper classifications) and **Morningstar's ratings, returns, risk measures and portfolio statistics**. Plus, Simfund offers an array of assets, net flows (actual and estimated), returns and fee data on ETFs. The data and software enhancements in the 5.0 version, together with **access through SimfundFiling.com to the latest prospectuses, one-page SI Fund Prospectus Profiles, and daily tracking of new ETFs filed with the SEC**, provide clients an unmatched resource for staying abreast of trends in this part of the business.

Software Enhancements

New software enhancements allow you to conveniently **isolate for further study some fast-growing areas of the fund business**, such as funds-of-funds and ETFs, or use a unified "view" to **compare all types of funds**—open-end, closed-end, ETFs, and funds-of-funds—at the same time.

Also part of version 5.0 are:

- **Alternative industry "views" and new graphs, scorecards, and datasheets**
- **New data on funds-of-funds, including each FoF's underlying fund fee ratio**
- For **asset allocation funds** (fund-of-fund or standalone) that have hybrid performance benchmarks, Simfund will include data on the **weight of each component index in the blended benchmark**.

More to Come

- Addition of **Market Indices** for benchmarking in reports and graphs
- 10 Years of **Monthly Total Return** data
- **Closed-End Fund data** from Lipper including returns and rankings. (Lipper Classifications for closed-end funds are already available in Simfund 5.0.)
- And much more.

Invite Us to an On-Location Presentation and Training

Simfund, first offered 14 years ago, **is already used by fund managers overseeing more than 80% of the industry's assets under management**, and by consulting and service firms, investment and commercial banks, the ICI, and the SEC (via a datafeed).

We anticipate that, as a result of Simfund MF 5.0 innovations, use within our clients will broaden to the CIO and investment management area, to the legal and board relationship group, and also further expand within the sales and product management area.

All of us at SI are looking forward to helping each of you uncover how version 5.0 benefits different business units inside your firm.

We encourage you to invite us, and recommend the scheduling of two separate meetings:

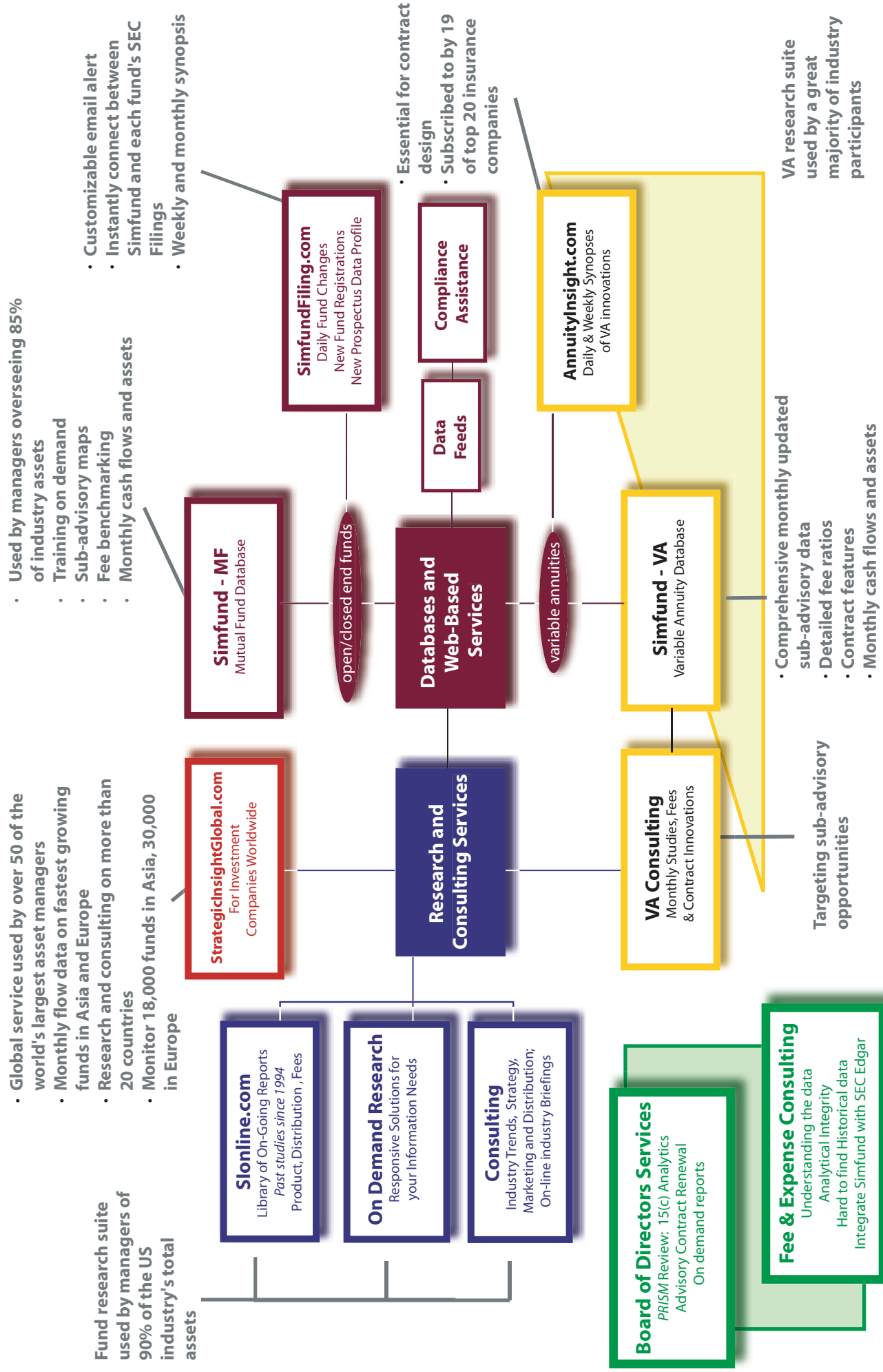
1. One for SI to present to your senior management how the new Simfund MF 5.0 can help address the specific data needs of your firm
2. A second, to train your analysts, one-on-one
3. Note also that we now offer, daily, WebEx sessions on the new features of version 5.0.

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