

Strategic Insight

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	Page
<u>Looking Back, and Ahead to 2008</u>	Perspectives 2
<u>US Mutual Funds: 2007 Highlights</u>	US Fund FlowWatch 3
<u>Asia and Europe Trends: Year-End Recap: Watching 2008 Unfold</u>	Global Trends 9
<u>New Fund Successes in 2007</u>	New Funds 10
<u>International Funds: 2007 Records</u>	International Funds 11
<u>Funds-of-Funds and Lifecycle Programs: An Update</u>	Assembled Advice-I 12
<u>Funds-of-Funds: Income-at-Retirement Solutions Expand</u>	Assembled Advice-II 14
<u>The ETF Advance in 2007</u>	ETFs 15
<u>Closed-End Funds: Growth and Advisors' Views</u>	Closed-End Funds 18
<u>Inside SimfundFiling.Com: Funds-of-Funds Evolve</u>	Inside SimfundFiling 19
<u>Path to Fee-Based Relationships</u>	Distribution 20
<u>Trends in Use of Fund Share Classes</u>	Share Class Pricing 21
<u>Star Rating of "A" Share Classes: Change Due?</u>	Fund Ratings 22
<u>Share Class Pricing: Looking Ahead</u>	Share Class Pricing 23
<u>Benchmarking the Management Fees of Sub-Advised Funds</u>	Fees and Expenses 24
<u>The Year in Variable Annuities</u>	Variable Annuities/Life 26
<u>Technology and Research Innovations Ahead</u>	Tools Time 28

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Looking Back, and Ahead



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- **2008:** Stock market declines triggered concerns. Overall, during **January**, equity funds net redeemed about 0.5% of beginning assets. (Actively managed US equity funds saw nearly 1% of beginning assets flow out, on a net basis, over the month.) Over \$20 billion in positive flows were captured by bond funds; money funds added \$140 billion. So far, the retreat in investor activity has been quite small considering the magnitude of economic and financial anxieties.
- **2007:** Just a few weeks into 2008, and last year seems like a distant memory. Yet, 2007 was a remarkable year for our industry. Industrywide **assets gains neared \$1.8 trillion**, up from a \$1.6 trillion expansion in 2006, and by year-end 2007 assets managed within open-end (including VA funds and ETFs structured as mutual funds) and closed-end mutual funds reached \$13 trillion. Equity investors, on average, earned about 10% in 2007 (much of that has been given back so far in 2008), following an average of 16% earned in 2006. US growth style outperformed value in '07 by 12%.
- **International equity funds attracted record annual flows of nearly \$250 billion in 2007.** Rising purchases and the performance advantage of international funds over the past five years brought such funds' share of all equity fund assets to 30% (up from 10% five years earlier). The **secular worldwide desire to diversify away one's "home bias" is a strong force that, despite late 2007's and this year's corrections, will continue to drive international exposure demand by US investors, counterbalancing negative sentiment overall.**
- **Asset allocation by default:** Increasing focus on asset allocation and pre-packaged advice was in place last year and should continue this year. Funds-of-funds, mutual fund "wraps," and other allocation strategies garnered flows of over \$250 billion in 2007. **Transition from one-fund-at-a-time to "assembled asset allocation" should continue to grow.**
- **Bond funds:** Bond fund flows approached \$150 billion in 2007, as core bond fund use within asset allocation programs, US dollar plays, and specialized strategies helped propel demand.
- **Money market fund inflows:** \$630 billion last year, and so far in 2008 a remarkable \$300 billion!
- **Closed-end funds:** IPOs garnered a record \$28 billion in high distribution-rate offerings, but activity virtually halted in the second half.
- **Fund Selection Units:** Increasing institutionalization of investment management selection is in evidence. (Our "2006 In Review" report provided suggestions and observations on the intensifying engagement of fund management companies with FSUs.) **But relationships still matter and given the range and diversity of FAs, wholesaling coverage continues to be very important. Many firms have actually expanded their wholesaler staffs.**
- **ETFs** garnered \$150 billion in 2007 inflows, with growth driven by a surge in institutional demand, and expanding use by financial advisors, RIAs, and individual investors. Institutional use and advisors / investors using ETFs as substitutes to individual stocks continue to drive much of ETF growth.
- **Fees, 15(c), and Trustees' questions:** SI continues to focus on and support management company and Board interests. For example, one of our just-published studies addressed alternative fee peer group selection methods for sub-advised funds.
- **Challenges abound:** The uncertainty in 2008 notwithstanding, demand for mutual funds remains strong both in the US and abroad, with a large number of fund managers, small and large, benefiting. Yet, providing investment excellence in an increasingly competitive wealth management business is ever-challenging. In 2007, nearly half of all fund managers experienced net redemptions among their long-term funds.
- **Strategic Insight:** In our 22nd year, we continue to expand the range of services offered to over 200 financial services client organizations in the US and over 70 globally. **Simfund Asia and Simfund Europe will be released in the Spring—for the first time, business intelligence on the entire world of mutual funds will be available through one platform.**

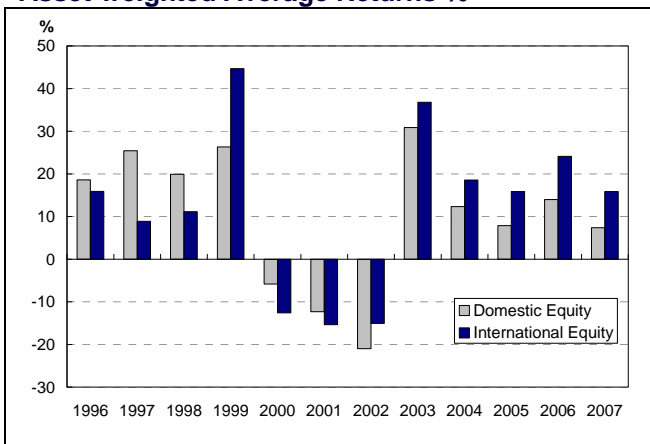
US Mutual Funds: 2007 Highlights



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The average equity fund investor gained nearly 10% during 2007, with international/global equity funds returning 16% and investors in US-centered equity funds earning 7% (these ratios are asset weighted to capture the experience of the “average investor, “not simply the “average” fund). It was the **sixth year in a row that international/global equity funds fared better than domestic equity funds.**

Domestic Equity vs. International Equity Asset-weighted Average Returns %



* Does not include hybrid funds or VA-underlying funds
Source: Strategic Insight Simfund; Morningstar (Returns)

Despite overall positive returns, **flows into US equity funds dropped significantly** in 2007 as uncertainty loomed over the US economy. Aggregate flows into US equity funds in 2007 were the lowest since 1988, a year of negative flows for the category. There were many bright spots, however, among individual asset managers, including several smaller players. (Manager ranking tables start on page 6.)

Fund Type	Average Asset-Weighted Annualized Returns %		
	Trailing Periods, as of 12/07		
	1 Year	3 Year	5 Year
Domestic Equity *	7.2	9.6	14.1
International Equity	15.8	18.6	22.4
Taxable Bond	5.4	4.5	5.5
Tax-Free Bond	1.2	3.4	3.9

* Includes hybrid/allocation funds.
Source: Strategic Insight Simfund MF; Morningstar (Returns)

Meanwhile, **internationally investing equity funds continued to gain momentum**, garnering \$220 billion in flows in 2007 (an additional \$20 billion came into VA-underlying international funds), the largest ever annual inflow to the asset class. Interest in global diversification should persist as **asset allocation programs continue to grow** and investors increasingly recognize **the need to diversify their “home biased” portfolios.**

Indeed, the growth of asset allocation programs continued to support bond funds as well despite rising interest rates in 2007. **Taxable bond funds saw the largest inflow since 2002**, mainly due to strong flows into corporate and multi-sector bond funds. Municipal bond funds took in roughly \$9 billion last year.

A safe haven for institutional investors (and some individual investors) following the credit crisis, **money market funds brought in a stratospheric \$630 billion** in 2007 (including in VA funds) with most of the flows coming in during the second half of the year. The record annual flows seen last year have extended into 2008—so far this year, nearly \$300 billion has been added in MMFs.

Fund Industry Overview (Active Funds Only, Excluding ETFs, Index, and VA Funds) \$B

	Net New Flows			Assets
	2005	2006	2007	12/07
U.S. Equity	40.3	-4.2	-65.0	3,574
Hybrid/Allocation	12.1	-3.7	1.3	401
Int'l/Global Equity	123.6	149.8	159.3	1,714
Total Equity/Hybrid	176.0	141.9	95.6	5,689
Taxable Bond	20.6	38.4	75.7	1,117
Muni Bond	1.3	12.8	8.7	465
Total Bond	22.0	51.2	84.3	1,582
Total Equity / Bond	197.9	193.1	179.9	7,271
Money Market	60.8	221.4	622.1	3,051
Total	258.7	414.5	802.0	10,322

Source: Strategic Insight Simfund MF

Passively managed funds (both index funds and ETFs) **captured significant flows** in 2007. Within ETFs structured as UITs/Grantor Trusts/Other, flows jumped to over \$40 billion; just a few funds—the S&P 500 SPDR and gold-oriented ETFs—were the principal drivers of flows in this category.

Equity / Hybrid Funds: Active vs. Passive (excl. VAs)

	Net New Flows \$B		
	2005	2006	2007
Actively Managed Funds	176.0	141.9	95.6
Index Funds (non-ETF)	21.5	27.8	44.4
ETF Open-End Funds	46.9	62.5	90.9
ETFs structured as UITs/ Grantor Trusts / ETNs /Other	0.5	-0.1	43.3

Source: Strategic Insight Simfund MF

Both actively- and passively-managed bond funds gained last year. Low cost multi-sector bond funds continued to fare well, as did international/global bond products.

Bond Funds: Active vs. Passive (excl. VAs)

	Net New Flows \$B		
	2005	2006	2007
Actively Managed Funds	22.0	51.2	84.3
Index Funds (non-ETF)	7.2	9.7	18.0
ETF Open-End Funds	6.3	5.1	13.1

Source: Strategic Insight Simfund MF

Equity Funds: Additional Details

US vs. International Funds

U.S. Equity / Hybrid Funds: Active vs. Passive (excl. VAs)

	Net New Flows \$B		
	2005	2006	2007
Actively Managed Funds	52.4	-7.9	-63.7
Index Funds (non-ETF)	13.0	16.6	26.9
ETF Open-End Funds	24.1	35.8	46.4
ETF (UITs / Grantor Trusts / Other)	0.2	-0.3	42.0

Source: Strategic Insight Simfund MF

Continued prudent diversification by investors and lessening of their “home bias” resulted in aggregate outflows for actively-managed diversified US equity funds during 2007. Weakness for US equity fund flows might persist in the near term given the market environment.

Int'l / Global Equity Funds: Active vs. Passive (excl. VAs)

	Net New Flows (\$B)		
	2005	2006	2007
Actively Managed Funds	123.6	149.8	159.3
Index Funds (non-ETF)	8.5	11.3	17.5
ETF Open-End Funds	22.7	26.6	44.6
ETF (UITs / Grantor Trusts / Other)	0.3	0.2	1.3

Source: Strategic Insight Simfund MF

Growth vs. Value

Flow trends and total returns among diversified actively managed US equity funds are summarized below. Growth style funds outperformed both core and value styles funds significantly in 2007.

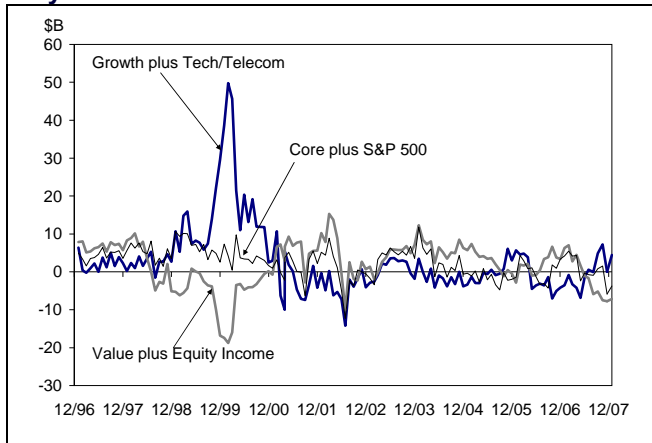
Actively Managed Diversified U.S. Equity Flows and Performance (excl. VAs)

	Flows \$B		2007
	2006	2007	Returns *
Large-Cap Growth	-31.9	-32.1	14.7
Multi-Cap Growth	24.2	16.6	14.7
Mid-Cap Growth	-4.7	5.8	20.8
Small-Cap Growth	-5.7	-6.9	10.3
Growth Funds	-18.2	-16.6	15.2
Large-Cap Core	-20.4	-19.6	6.2
Multi-Cap Core	11.3	6.6	7.7
Mid-Cap Core	0.7	-1.7	6.7
Small-Cap Core	5.7	-4.7	2.2
Core Funds	-2.7	-19.5	6.1
Large-Cap Value	-0.7	-11.1	4.0
Multi-Cap Value	10.3	-2.2	0.1
Mid-Cap Value	0.5	-0.7	4.6
Small-Cap Value	0.8	-2.4	-2.6
Value Funds	10.9	-16.5	3.0

* Weighted by ending assets; Source: Strategic Insight Simfund MF; Lipper Inc. (Classifications and Returns)

As can be seen in the following chart, **growth style funds experienced a surge in flows during the second half of 2007, triggered by their performance advantage, while value-oriented fund flows saw flows slowing over the same period, after a number of years of return and flow leadership.**

Open-end Equity Fund Flows by Investment Style from Jan '97 to Dec '08



Source: Strategic Insight Simfund MF; Lipper Inc. (Classifications)

Other Highlights of 2007

- **Total Assets:** As of year end 2007, assets in **US registered mutual funds (including VAs) reached \$13 trillion.** The breakdown: traditional open-end funds \$10.8 trillion; VA underlying funds \$1.4 trillion; open-end ETFs \$440 billion; other types of ETF products \$170 billion; and closed-end funds over \$300 billion.
- **Flows (including in VA funds and all ETFs): Total industry cash flows eclipsed \$1.0 trillion** for the year 2007. Money market funds drew \$630 billion, while bond fund inflows totaled \$150 billion. Equity funds captured \$290 billion, primarily through international equity programs.
- **Funds-of-Funds:** In 2007, flows into traditional fund-of-fund programs exceeded \$100 billion (with an additional \$39 billion into VA FoFs), in comparison to \$84 billion in 2006 and \$65 billion in 2005. The gains in flows can be attributed mostly to **target-date lifecycle funds whose flows jumped from \$35 billion in 2006 to \$57 billion last year.** Flows into risk-based lifecycle funds (\$19 billion) and non-lifecycle fund of funds (\$22 billion) were largely stable relative to 2006. Out of the \$39 billion that VA funds-of-funds drew last year, risk-based lifecycle funds accounted for \$34 billion.
- **New funds:** Roughly 930 new funds and ETFs were launched in 2007. Among common themes were target-date FoFs, non-lifecycle FoFs, real

estate sector funds (many with a global focus), flexible funds, some non-correlated strategies, and as can be expected, international equity funds. New bond funds included international bond, floating rate, TIPS, multi-sector, short duration, cash+, and some bond ETFs.

- **Sector-based funds in 2007: Natural Resources** funds once again led in flows among sector funds (\$9.5 billion). Flows into real estate funds differed widely between those focused domestically and those focused globally. US focused real estate funds redeemed about \$8.8 billion while **global real estate funds garnered \$13.9 billion.** Other notable gainers were financial sector funds (\$3.1 billion) and precious metal funds (\$2.8 billion).
- **Capital Gain Distributions and Tax-Managed Funds:** In December 2007, equity funds distributed at least \$318 billion in capital gains (equal to about 6.5% of assets among actively-managed funds which distributed in December.) Additional December capital gain distributions among equity funds underlying VAs, as well as capital gain distributions earlier in 2007, suggest that last year's capital gain distribution were the largest ever. (According to the ICI, the highest annual amount ever—\$326 billion—was paid out during the boom-and-bust year of 2000; in 1999, \$238 billion was paid.)
- While **only about a third of 2007's capital gain distributions were collected within households' taxable accounts,** the remarkable (and unfair vs. alternative stock investments) taxation of mutual funds will likely be a topic of intensified debate and may trigger further innovation in tax-managed investing. (While, in aggregate, tax-managed fund flows were modest last year, we count **16 individual tax-managed funds that received at least \$100 million each in net inflows in 2007.**)

Funds with Highest Inflows: Some Risk-Return Characteristics

The decision to invest in a particular fund or with a particular fund manager, as well as retention choices, are the result of many analytical and ranking methodologies and qualitative considerations. Yet, SI has observed that **trailing three-year rankings, within the fund's investment style and on both relative-return and relative-risk dimensions, offer**

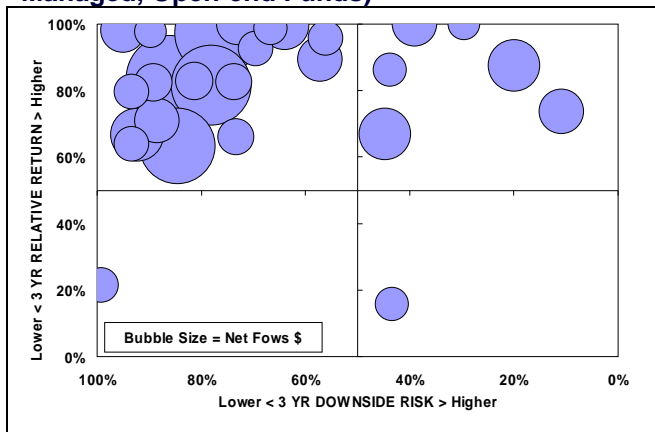
very strong explanatory as well as predictive value for fund flows.

SI's "Bubble" charts generated in Simfund, plot funds on a relative risk/return basis versus similarly invested peers. Funds in the top-left quadrant have superior positioning relative to peers, displaying below-average risk (defined as cumulative monthly losses over 36 monthly observations) while achieving above-average returns. 2007 was another period for which the top-left quadrant of such graphs housed the highest-flow funds. Beyond relative performance, we note that with the fund industry having climbed out of the depths of the 2000-2002 bear market, the impact of trailing three- and five-year look-back performance would be even more significant, and should help fund managers in presenting and marketing their funds.

As an illustration of 2007 cash flow results (we presented a similar analysis with very similar results last year summarizing 2006 flows), we capture below the "trailing three-year risk-return vs. cash flow bubbles" of the industry's 30 highest cash flow funds during 2007 (risk and return measured within each fund's narrow Lipper investment classification). Note that **bubble size corresponds to 2007 net inflows**.

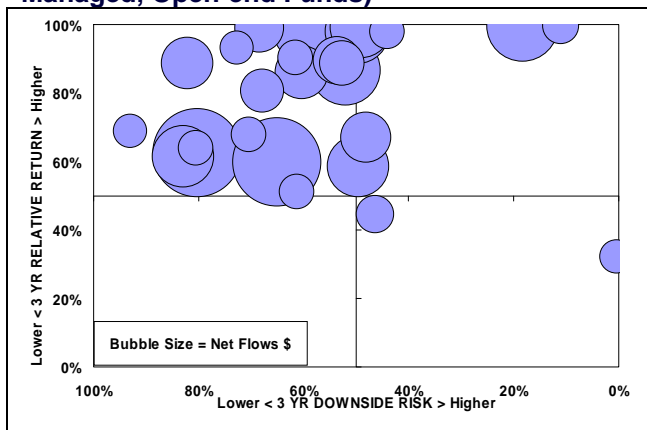
While we have not identified the individual funds in the bubble charts, they clearly share very appealing risk-return characteristics for the 36-month period ending December 2007. The few outliers are funds offered by well respected managers benefiting from a "halo" effect, or unique and thus hard-to-classify funds, or those reflecting strong performance in periods prior to last year.

Highest Flow Equity Funds in 2007 (Actively Managed, Open-end Funds) *



* 2007 Flows and 3 Year Risk/Return Analysis w/in Lipper Classifications; Source: Strategic Insight Simfund MF

Highest Flow Bond Funds in 2007 (Actively Managed, Open-end Funds) *



* 2007 Flows and 3 Year Risk/Return Analysis w/in Lipper Classifications; Source: Strategic Insight Simfund MF

2007 Flows by Manager

The following series of tables summarize, for each investment area, the managers making the most cash flow progress last year. Note that **for clarity we show actively managed funds separately from index funds (including ETFs); detailed ETF data can be found later in this annual review.**

Int'l / Global Equity Actively Managed Funds Highest Cash Flow Managers (excl. VAs)

Manager	Flows (\$B)		2007	12/07
	2006	2007	Flow Rate*	Assets \$B
American Funds	43.4	44.6	12.4%	464.6
Dodge & Cox	12.4	18.3	59.1	53.5
Fidelity	18.8	8.7	7.8	140.6
Thornburg	4.6	7.4	60.3	23.2
Alpine Woods	0.8	7.1	482.5	8.0
AllianceBernstein	5.3	6.7	21.5	41.0
Eaton Vance	0.5	6.0	57.6	17.9
BlackRock	3.0	6.0	20.0	41.1
DFA	6.2	5.8	18.6	42.6
Waddell & Reed	2.5	5.4	74.4	15.4
Julius Baer	2.6	4.8	18.7	35.1
Harbor Capital	2.9	4.6	24.1	28.3
T Rowe Price	2.4	4.6	20.0	33.8
Vanguard	5.0	4.5	14.2	40.1
Goldman Sachs	2.8	3.4	53.5	10.9
Janus	0.1	2.7	19.0	20.0
Henderson Global	1.4	2.6	84.7	6.3
Cohen & Steers	1.8	2.6	80.9	5.4
ING Investments	1.2	2.2	15.4	16.9
Principal Funds	1.1	2.0	50.7	8.1

* 2007 Flows as a percentage of 12/06 Assets Source: Strategic Insight Simfund MF

**US Equity Actively Managed Funds
(excl. VAs and Hybrid Funds)
Highest Cash Flow Managers**

Manager	Flows (\$B)		2007	12/07
	2006	2007	Flow Rate*	Assets \$B
American Funds	21.6	16.4	3.3%	550.6
T Rowe Price	4.8	7.5	5.7	149.8
Columbia Funds	2.8	6.5	11.3	69.6
The Hartford	3.5	4.1	13.8	38.0
Janus	-1.5	3.6	6.2	72.9
Thornburg	1.8	3.3	68.4	8.6
Davis-Selected	5.0	3.3	5.2	68.4
Eaton Vance	4.2	3.1	8.1	44.6
American Beacon	2.6	3.1	35.4	11.6
Kinetics	1.6	2.4	85.3	5.9
Fairholme Capital	1.8	2.3	59.8	6.7
Keeley Asset Mgmt	2.1	2.2	60.2	6.0
DFA	2.7	2.1	16.6	14.2
Alger	0.2	1.9	45.3	7.4
Rainier Investment	1.6	1.9	40.4	7.7
TIAA-CREF	-0.3	1.9	32.3	8.0
Baron Asset	0.7	1.8	11.6	18.5
CGM Funds	0.5	1.3	30.3	8.1
Russell Investment Grp	1.7	1.3	9.1	15.2
Waddell & Reed	0.4	1.2	5.7	27.0

* 2007 Flows as a percentage of 12/06 Assets
Source: Strategic Insight Simfund MF

**Taxable Bond Actively Managed Funds
(excl. VAs)
Highest Cash Flow Managers**

Manager	Flows (\$B)		2007	12/07
	2006	2007	Flow Rate*	Assets \$B
Fidelity	9.1	11.0	13.2%	96.7
American Funds	5.3	10.9	21.1	63.8
Loomis Sayles	4.4	9.7	84.5	22.2
Western Funds	4.6	5.4	26.4	27.3
OppenheimerFunds	2.3	4.6	19.3	30.0
Natixis Asset Mgmt	3.7	4.5	65.4	11.9
PIMCO/Allianz Global	4.3	4.5	2.6	186.6
Franklin Templeton	0.6	4.0	18.5	26.5
T Rowe Price	2.0	3.7	22.2	21.1
Dodge & Cox	1.9	3.5	28.9	15.9
Vanguard	-3.3	3.4	4.1	91.3
Metropolitan West	1.3	3.2	74.5	7.7
DFA	2.0	3.0	31.6	12.9
SEI	1.3	2.5	16.3	18.9
Principal Funds	1.4	2.0	23.0	10.7
AllianceBernstein	0.8	1.9	11.8	18.1
Grantham Mayo	2.2	1.7	17.5	11.9
Calvert	1.3	1.6	26.6	7.8
Van Kampen	-0.7	1.6	18.9	9.6
John Hancock	0.9	1.5	10.3	16.4

* 2007 Flows as a percentage of 12/06 Assets
Source: Strategic Insight Simfund MF

**Hybrid / Balanced Actively Managed Funds
(excl. VAs and FoFs)
Highest Cash Flow Managers**

Manager	Flows (\$B)		2007	12/07
	2006	2007	Flow Rate*	Assets \$B
Franklin Templeton	5.5	6.9	13.1%	61.7
Vanguard	0.4	1.3	1.9	78.3
American Funds	-1.5	1.0	1.8	60.7
Calamos Advisors	0.6	0.6	12.9	5.1
Leuthold Weeden	0.4	0.5	27.5	2.8
Lord Abbett	0.0	0.5	37.8	1.8
T Rowe Price	0.1	0.3	5.9	5.5
Snow Capital Mgmt	0.1	0.2	170.3	0.3
John Hancock	0.0	0.2	104.1	0.4
Wilmington Trust	0.3	0.2	35.1	0.6

* 2007 Flows as a percentage of 12/06 Assets
Source: Strategic Insight Simfund MF

**Tax-Free Bond Actively Managed Funds
(excl. VAs)
Highest Cash Flow Managers**

Manager	Flows (\$B)		2007	12/07
	2006	2007	Flow Rate*	Assets \$B
Vanguard	2.6	4.1	8.0%	57.0
OppenheimerFunds	7.2	3.2	10.3	32.0
Eaton Vance	2.8	2.3	15.0	17.1
American Funds	1.6	1.6	14.7	12.4
Franklin Templeton	0.3	1.4	2.6	55.8
AllianceBernstein	0.8	1.0	8.5	13.1
Northern Trust	0.1	0.5	28.2	2.2
Nuveen	1.6	0.4	0.8	50.1
Schroder Invest	0.2	0.4	87.8	0.9
Fidelity	-0.5	0.4	2.1	18.5

* 2007 Flows as a percentage of 12/06 Assets
Source: Strategic Insight Simfund MF

**Index Funds other than ETFs (excl. VAs)
Highest Cash Flow Managers**

Manager	Flows (\$B)		2007	12/07
	2006	2007	Flow	Assets
			Rate*	\$B
Vanguard	30.2	48.4	10.3%	550.3
Fidelity	6.5	9.4	14.7	81.8
DFA	4.1	2.9	8.1	36.2
T Rowe Price	1.2	2.5	27.6	12.0
Northern Trust	0.4	2.4	58.0	6.7
Schwab	-1.0	0.6	2.7	26.1
TIAA-CREF	0.1	0.3	12.3	2.4
Principal Funds	0.2	0.2	14.6	1.8
Vantagepoint	0.1	0.2	7.9	2.6
Nationwide Funds	1.4	0.2	1.8	7.0

*2007 Flows as a percentage of 12/06 Assets
Source: Strategic Insight Simfund MF

**All Equity and Bond Actively Managed Funds
(excl. VAs)
Highest Cash Flow Managers**

Manager	Flows (\$B)		2007	12/07
	2006	2007	Flow	Assets
			Rate*	\$B
American Funds	70.5	74.5	7.6%	1,152.1
Dodge & Cox	19.1	17.8	13.0	159.6
T Rowe Price	9.7	16.1	8.8	218.2
DFA	11.1	11.1	20.6	70.6
Thornburg	6.1	10.5	53.5	34.2
Loomis Sayles	4.5	10.1	79.2	24.2
Eaton Vance	6.9	9.4	11.1	97.3
Franklin Templeton	6.6	8.9	2.9	328.1
AllianceBernstein	5.2	8.7	10.8	94.0
Vanguard	4.5	8.5	1.9	492.6
Alpine Woods Cap	0.9	7.3	204.7	10.2
Waddell & Reed	2.6	6.7	20.0	47.8
Janus	-2.0	6.2	8.1	97.8
PIMCO/Allianz Global	6.9	6.1	2.8	243.6
The Hartford	5.8	5.7	14.2	50.1
Western Funds	4.6	5.4	26.4	27.3
Julius Baer	3.0	5.3	20.2	36.4
Columbia Funds	1.3	5.3	5.4	110.3
Goldman Sachs	7.9	5.2	10.6	58.5
OppenheimerFunds	10.6	4.8	3.2	164.0

*2007 Flows as a percentage of 12/06 Assets
Source: Strategic Insight Simfund MF

**Fastest Growing Managers: Actively Managed
Long-Term Funds (excl. VAs) ^**

Manager	Flows (\$B)		2007	12/07
	2006	2007	Flow	Assets
			Rate*	\$B
Alpine Woods Cap	0.9	7.3	205%	10.2
Kinetics	1.6	2.4	87.8	6.0
Henderson Global	1.4	2.7	86.5	6.5
IQ Investment Adv	0.1	1.0	80.8	2.3
Loomis Sayles	4.5	10.1	79.2	24.2
Metropolitan West	1.3	3.2	71.7	7.9
Quantitative Advisor	0.3	0.7	64.7	1.9
Keeley Asset Mgmt	2.1	2.2	60.2	6.0
Fairholme Cap Mgmt	1.8	2.3	59.8	6.7
Thornburg	6.1	10.5	53.5	34.2
Robert W Baird	0.2	0.5	49.2	1.7
Alger	0.2	2.0	43.8	7.7
Van Eck	0.1	0.4	43.2	1.9
Natixis Asset Mgmt	3.5	4.2	42.3	14.9
Rainier Investment	1.5	1.9	38.7	7.8
TIAA-CREF	-0.3	3.4	30.2	15.5
Leuthold Weeden	0.4	0.6	28.4	3.0
Transamerica Fin'l	0.2	0.4	26.9	2.2
Western Funds	4.6	5.4	26.4	27.3
CGM Funds	0.5	1.2	26.3	8.7

^ Over \$1B in AUM as of 12/06; * 2007 Flows as % of 12/06 assets; Source: Strategic Insight Simfund MF

**Money Market Funds (excl. VAs)
Highest Cash Flow Managers**

Manager	Flows (\$B)		2007	12/07
	2006	2007	Flow	Assets
			Rate*	\$B
Fidelity	45.1	89.2	32.7	376.1
Goldman Sachs	0.7	61.4	75.3	147.8
Dreyfus	14.7	59.9	55.4	171.3
Federated	5.5	47.5	31.9	203.9
JPMorgan Funds	16.4	43.6	25.4	224.1
Schwab	19.4	41.5	31.0	181.9
BlackRock	0.1	38.4	23.1	212.4
Vanguard	26.4	28.2	19.2	182.3
The Reserve	1.9	25.4	78.6	60.0
Wells Fargo	7.7	22.7	28.6	106.1
UBS Gbl Asset Mgt	5.4	15.0	42.8	52.2
Morgan Stanley	12.6	14.9	39.7	54.6
Legg Mason Ptnrs	3.1	13.9	16.7	101.1
NeubergerBerman	2.0	13.8	171.9	22.5
Columbia Funds	10.1	12.5	9.4	152.2

*2007 Flows as a percentage of 12/06 Assets
Source: Strategic Insight Simfund MF

Global Trends



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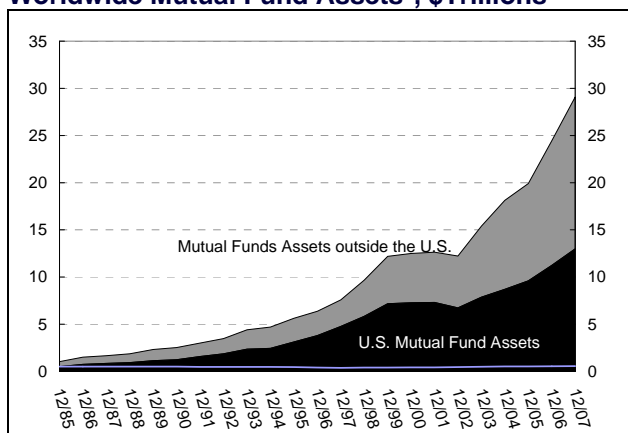


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Asia and Europe: Year-End Recap, and Watching 2008 Unfold

Recent market declines have raised the level of apprehension felt by industry participants, making it difficult for some to appreciate that **2007 was a record year for mutual funds globally. At year end, worldwide mutual fund assets had grown to \$29 trillion (only about 45% of that total is held in US-based investment companies). Unsurprisingly, 2008's stock market retreat has reduced such assets.**

Worldwide Mutual Fund Assets*, \$Trillions



* Non-US coverage in the 1980s-1990s incomplete
 Source: Strategic Insight Simfund MF, Industry Associations.

Mutual Fund Net Flows in Asia (ex Australia) 2004-2007, US\$ Billion

	2004	2005	2006	2007
Equity/ Mixed	59	52	169	377
Bond	1	25	31	31
Other	12	27	17	13
Long-Term	72	104	217	421
Money Market	25	21	-17	14
Total	97	126	199	435
<i>Offshore Cross-Border in Asia</i>			35	60
<i>Total from Investors in Asia</i>			234	495

Source: Strategic Insight.

Most remarkably in 2007, Asia's mutual fund industry underwent a dramatic boom, collecting around \$500 billion in net flows (this number includes about \$60 billion that flowed into cross-border funds already counted in Europe and other offshore centers). **China's expansion was most prominent, with \$175 billion in net inflows last year, 35% higher than net flows into Japan's fund industry.** Korea (\$64 billion) and India (\$33 billion) came next.

The speed and magnitude with which the Asian mutual fund industry has emerged as the major opportunity for international fund managers in the coming years is unparalleled. Flows quintupled from 2004 to 2007. Furthermore, the major themes of equity investing and internationalization have shifted the focus for most international money managers to Asia and how to participate meaningfully there. Our landmark study on the region, *"Asia Fund Management and Middle East Opportunities: Investing in the Future,"* published recently, was broadly subscribed to, and an updated version will be offered this year.

In Europe, on the other hand, flows into long-term funds went from \$200 billion to \$300 billion in each of the last three years to net redemptions in 2007.

Mutual Fund Net Flows in Europe 2004-2007, € Billion

	2004	2005	2006	2007
Equity	83	95	110	-19
Mixed	12	51	65	-1
Bond	64	133	-4	-58
Other	39	35	43	64
Long-Term	199	314	214	-14
Money Market	22	46	98	104
Total	221	360	312	90
<i>Offshore Cross-Border Portion in Asia</i>			25	40
<i>Total from Investors in Europe</i>			287	50

Source: Strategic Insight.

In Europe, equity and bond funds suffered €80 billion in net redemptions last year (Italy experienced the worst redemptions). However, flows into the "other" long-term fund category (which includes guaranteed, real estate, and certain alternative and registered hedge funds-of-funds) expanded to more than €50 billion. As you would expect given the month's market pullback, negative investor flows in Europe persisted in January 2008.

The SI Global research team, already assisting more than 70 organizations globally, continues to develop its resources to assist in the expanding, and challenging, global mutual fund marketplace.

New Fund 2007 Successes



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Notable New Open-End Actively Managed Funds

The table on this page lists funds started in 2007 that raised \$100 million or more over the year.

New equity funds: Among **US centered funds** in the table, we note the recurring themes of quantitative strategies, alternatives (real estate, market-neutral, commodity/natural resources), and some product line extensions. Overall, the list of US equity funds started last year that raised significant assets during the year is relatively short. Among **international equity funds**, we observe a greater diversity and a longer list of new funds raising significant assets. Global real estate, Emerging and Frontier Markets, funds focusing on “Climate Change” and its implications, and a small- cap orientation were a few repeated themes.

New bond funds: The list of new bond funds that raised significant assets in 2007 is relatively short, as the scale of existing funds helps them benefit from investment opportunities, low fees, and acceptance among asset allocators.

Funds Started in 2007 Raising > \$100 MM in '07: Actively Mgd Long-Term Open-End Funds, \$MM

	Assets		Net Flows	
	12/07	2007	2007	Q4'07
Domestic Equity				
Fidelity Small Cap Opport	1,248	1,330	176	
Fidelity Large Cp Core Enh Idx	782	807	767	
GS Commodity Strategy	377	307	28	
LSV Conservative Value Equity	194	192	59	
Nuveen NWQ Sm/Mid Cp Val	181	181	-1	
SEI SIMT Sm/Mid Divrsfd Alpha	129	135	9	
RVS Disciplined Large Cap Gro	124	124	47	
TA Idex Blackrock Natrl Res	158	120	3	
GuideStone Real Estate Sec	97	119	3	
TA Idex Mellon Mkt Neutral Str	115	108	2	
Price Instl US Structured Res	103	103	103	

	Assets	Net Flows	
	12/07	2007	Q4'07
International Equity			
Old Westbury Global Opport	709	713	713
DFA Intl Real Estate Sec	346	363	90
SEI SIIT Real Return Plus	303	290	23
Delaware PT Gbl Real Est Sec	260	264	-31
Russell Global Equity	1,142	244	60
Schwab Global Real Estate	244	240	-48
Price Africa & Middle East	235	222	197
Aberdeen Emerging Markets	238	218	31
Munder Intl Small Mid Cap	198	218	190
TA Idex UBS Dynamic Alpha	210	204	3
GS Structured Intl Small Cap	176	198	198
Allianz RCM Global EcoTrends	191	185	57
Munder International Core Eqty	156	165	135
JHF II Emerging Markets Value	538	153	0
SunAmerica Focus StarALPHA	149	143	12
Driehaus Intl Small Cap Growth	143	139	28
UBS Global Frontier	137	138	35
Calvert Global Alternate Energy	132	127	97
EII Global Property	110	121	19
Kensington Global Infrastructure	116	114	78
Thornburg International Growth	115	104	47
Davis Global	106	103	47
Oppenheimer Baring China	107	102	29
Taxable Bond			
PIMCO Emerging Local Bond	1,203	1,041	-1,085
CreditSuisse Instl Asia Bond	747	735	326
TA Idex Loomis Sayles Bond	595	583	133
SEI SIIT Enhanced LIBOR Opport	224	218	53
Schwab Premier Income	191	188	188
PIMCO Income	176	173	81
RVS Strategic Income Alloc	156	154	36
Hartford Strategic Income	132	131	75
GuideStone Global Bond	125	119	-1
Rydex High Yield	103	103	61
Tax-Free Bond			
DFA CA Short Term Muni Bond	143	142	33
Northern Short Intrmd TaxEx	121	119	43
Funds-of-Funds			
PAS Intl Fidelity FOF	452	424	10
PAS US Opport Fidelity FOF	419	398	5
Hartford Checks and Balances	395	392	224
American Target Retire 2020	314	312	110
American Target Retire 2015	287	286	102
American Target Retire 2010	265	264	95
American Target Retire 2025	231	230	84
American Target Retire 2030	180	179	66
GuideStone MyDestination 2015	171	168	27
PAS US Opport FOF	168	156	4
American Target Retire 2035	123	123	41
GuideStone MyDestination 2025	107	105	19

Source: Strategic Insight Simfund MF

International Funds: 2007 Records



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Both in the US and abroad, demand for global diversification has been remarkable in recent years. Since the second half of 2003, US-registered international / global equity funds have garnered over \$700 billion in net inflows. It is conceivable that a similar amount was net purchased by portfolio managers of US-centered equity funds and of institutional investment pools and hedge funds. And European money managers similarly transferred large holdings away from Europe and into other developed markets and emerging countries.

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

Structure/Type	Assets		Net Flows			
	12/07	2003	2004	2005	2006	2007
Open-end Active	1,660	35.0	79.1	116.9	147.0	140.5
Open-end Indexed	94	2.0	5.4	8.5	11.3	17.5
ETFs	178	5.7	15.3	23.0	26.8	45.8
Closed-End	54	0.3	4.4	6.7	2.7	19.4
VA Funds	218	4.8	9.7	12.8	21.7	20.4

Source: Strategic Insight Simfund MF / VA

In 2007, combining stock gains and currency appreciation, **international / global equity funds returned 15.85% (asset weighted), on average, or nearly double the returns of US equity funds.** World bond funds also out-earned US taxable bond funds last year by almost 3%, the outperformance partly a result of US Dollar depreciation.

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

	'02	'03	'04	'05	'06	'07
Int'l/Glbl Eqty	-15.4	37.5	18.5	16.4	24.0	15.8
U.S. Equity*	-20.5	30.9	12.5	7.9	14.1	7.4
World Bond^	13.3	13.2	8.9	-2.1	6.7	8.4

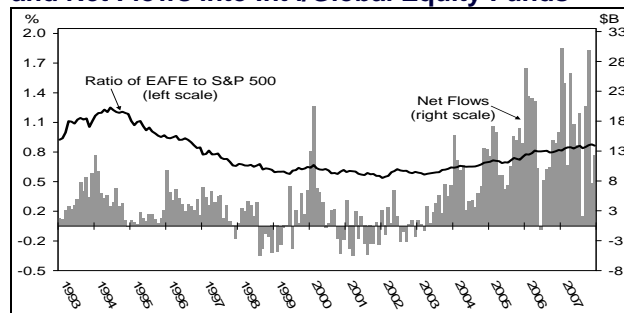
* Excluding balanced/hybrid funds.

^ Morningstar category.

Source: Strategic Insight Simfund MF

Flow trends (including the 2H'07 slowdown), and the relative performance of the MSCI EAFE Index vs. the S&P 500 Index are captured in the chart below.

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



Source: Strategic Insight Simfund, Standard & Poor's

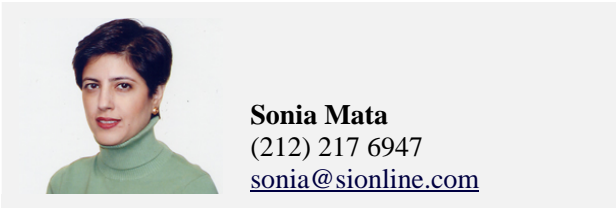
The following table summarizes international investment strategies that recorded positive flows in 2007. Note that the data is only for actively-managed funds, and thus excludes the fast-growing international ETFs and index funds. Also excluded are closed-end funds (a segment in which some sizeable IPOs in 1H 2007 benefitted from global strategies) and VA funds.

Actively Managed International/Global Equity Fds 20 Highest 2007 Net Flow Classifications

Lipper Classifications	Net Flows \$B		Assets \$B
	2006	2007	
Int'l Multi-Cap Growth	30.7	25.0	283
Int'l Multi-Cap Value	21.9	21.8	128
Global Multi-Cap Value	19.5	20.9	151
Emerging Markets	10.5	7.3	147
Int'l Large-Cap Value	4.3	5.5	22
Int'l Multi-Cap Core	13.4	5.3	205
Pacific Ex Japan	1.8	4.7	21
Int'l Large-Cap Core	2.1	4.0	98
Int'l Small/MidCap Value	2.0	3.2	13
China Region	1.7	2.7	10
Global Multi-Cap Growth	0.9	1.9	8
Global Small/Mid Growth	1.4	1.7	30
Latin American	1.4	1.2	12
European Region	2.6	0.9	21
Global Multi-Cap Core	-0.1	0.2	20
Gold Oriented*	1.5	0.2	20
Global Large-Cap Value	2.0	0.1	41
Global Small/Mid Growth	0.1	0.1	2

Excludes index funds and ETFs, Closed-end, and VA funds;* Investing mostly in non-US stocks. Source: Strategic Insight Simfund MF; Lipper Inc. (Classifications)

FoFs and Lifecycle Funds: An Update



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In 2007, lifecycle and other types of fund-of-fund programs continued to see large and growing inflows, as a result of a persevering emphasis on diversification on the part of fund investors, advisors, and retirement plan sponsors, an emphasis that was reinforced by the 2006 Pension Protection Act’s (PPA) support of diversified default investment alternatives. We expect growth in demand for packaged asset allocation products to be sustained in 2008 as a result of rising DC plan adoption of lifecycle (especially target-date) funds, growth in actual participant use of such funds when available on the menu, and a migration to diversified (lifecycle or other blended) default plan options from stable value or other capital preservation options. Also fueling the trend are financial services companies’ ongoing attempts to manage their own compliance and fiduciary liability concerns, as well as better manage investor expectations and promote long-term asset retention.

Net new flows into funds-of-funds totaled nearly \$100 billion in 2007 (including \$43 billion in the difficult second half of the year), up from \$76 billion in full year 2006. Lifecycle programs accounted for four out of every five dollars in net new money captured by funds-of-funds last year. (More on lifecycle funds in the following section.)

Funds-of-Funds Retirement and Non-Retirement Investors Excluding VAs and 529 Plans

Fund-of-Fund Type	Assets				Flow Rate 2007*
	\$B 12/07	Net Flows \$B			
Target-Date Lifecycle	180.1	22.7	34.5	56.6	49.4
Risk-Based Lifecycle	176.7	17.0	22.1	19.1	13.0
Other	150.9	19.3	20.1	21.6	18.2
Total above	507.6	59.0	76.8	97.3	25.6

*2007 net flows as a percentage of 12/06 assets.
Source: Strategic Insight Simfund MF

As shown in the table below, aggregate net flows into **non-lifecycle FoF allocation strategies** (usually a single fund and not offered as part of a series) were

large and stable at \$22 billion. Nearly half of those flows were garnered within single international equity FoFs focused on strategic allocation among international sub-asset classes. More tactical global asset allocation strategies, however, saw a decline in flows persisting as compared to the elevated levels experienced over the 2004-2005 period.

Non-Lifecycle Funds-of-Funds Retirement and Non-Retirement Investors Excluding VAs and 529 Plan Funds

	Assets \$MM	Net Flows \$MM			Flow Rate
	12/07	2005	2006	2007	2007*
US Equity/Hybrid	41.1	1.4	3.1	3.6	10.1
Int'l Equity	46.9	4.0	7.9	9.4	29.2
Global Asset Allocn	51.2	12.9	8.3	7.3	17.5
Other Global Equity	6.1	1.3	1.4	0.7	14.4
Bond/Money Market	5.5	-0.3	-0.5	0.6	12.7
Total Above	150.9	19.3	20.1	21.6	18.2

*2007 net flows as a percentage of 12/06 assets.
Source: Strategic Insight Simfund MF

New non-lifecycle FoF development in 2007 concentrated on international and income-focused products; and on niches like alternative strategy FoFs that can serve as a “satellite” or complement to an investor’s traditional portfolio. A fast-growing new FoF addition in 2007 was **Hartford’s Checks and Balances fund**, which divides up assets equally among the manager’s Capital Appreciation, Dividend and Growth, and Total Return Bond funds, rebalancing assets back to one-third each “as soon as reasonably practical.” Introduced in June, the fund had grown to a \$400 million size by year-end.

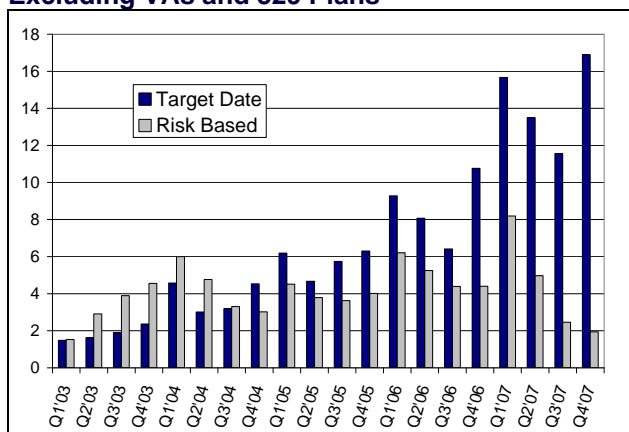
Lifecycle Funds: Target-Date Funds Pull Away

Net flows into target-date lifecycle funds are **growing rapidly year-over-year**. With interest and adoption boosted by the PPA, **target-date funds drew \$58 billion in aggregate in 2007**, representing a 67% increase over the net intake in 2006.

Although the PPA was passed in 2006, it was only in October 2007 that the Department of Labor (DOL) finalized its rules on fiduciary relief with respect to default options under DC plans. But more employers had already started automatically enrolling workers in DC plans, with target-date funds being the default option of choice (preferred over the two other types of “Qualified Default Investment Alternatives” the DOL approved: Balanced funds and Managed Accounts; managed accounts also have a distinct approach and

target audience). Fidelity recently reported that the number of its record-kept plans with automatic enrollment grew nearly five times over 2006, to nearly 1,700 plans at the end of 2007; a large majority of these plans adopted, in addition to automatic enrollment, automatic contribution increases, and lifecycle investment defaults.

Lifecycle Mutual Fund Flows, \$ Billion Retirement and Non-Retirement Investors Excluding VAs and 529 Plans



Source: Strategic Insight Simfund MF

Fund companies offering target-date funds are trying to differentiate themselves by fine-tuning equity/bond “glidepaths” (including equity allocations at target-date and in retirement years), the number and distinctiveness of asset classes used (including non-market correlated or “alternative” asset classes such as TIPs, global real estate and commodities); the frequency of rebalancing; whether they use active or indexed underlying funds or ETFs, or a blend; the management structure of the funds—are they internally managed or use external best-of-breed managers; and what approaches are used for underlying manager selection and optimization (to lessen stock overlap).

The glide paths of target-date funds vary significantly, (for instance, in the 22 target 2035 date funds we currently track, stock allocations varied from 75% to 93% as per Morningstar data), and we expect fund providers to continue to re-evaluate them. Also, more providers are looking into offering multiple glide paths for the same date. Multiple “roll-downs” could be aimed at offering a choice of risk preferences (aggressive, moderate, conservative) within each target-date—**Old Mutual** has already filed a [series](#) blending target-date and target-risk elements. Multiple glidepaths are also being explored as a way to adjust for the adequacy, or lack thereof, of a participant’s funding as he/she approaches closer to retirement. So an “accelerated” 2020 option, might be offered in

addition to a regular, more conservative “2020” option. One consideration in the offering of such additional alternatives is the need to retain product simplicity, the factor that drove use of target-date funds by more novice DC plan participants and those facing a “choice overload” in plans.

Although target-date funds appear to have taken a clear lead in the lifecycle fund business, **target-risk funds** have also been attracting meaningful inflows. In 2007, risk-based funds attracted \$18 billion. And while the target-date area remains dominated by bundled DC plan providers, risk-based funds are more broadly used. (According to the ICI, at the end of 2Q07 about 47% of the assets in target-risk funds resided in DC plans or IRAs; the corresponding proportion was 89% for target-date funds.)

2007: Highest Cash Flow Lifecycle Fund Managers Retirement and Non-Retirement Investors Excluding VAs and 529 Plans

Manager Name	Assets	Net Flows \$MM			Flow
	\$MM	2006	2007	Q4'07	Rate 2007*
Target-Date					
Fidelity	88,304	14,985	19,155	5,206	30.1
Vanguard	31,955	6,692	14,017	4,651	85.0
T Rowe Price	30,050	7,271	11,528	3,626	66.8
Principal Funds	11,066	2,534	4,040	760	60.4
American Fds	1,578	-	1,570	567	0.0
TIAA-CREF	1,464	366	978	314	230.2
Wells Fargo	2,324	21	928	345	72.1
AllianceBrnstein	1,299	300	897	213	262.6
John Hancock	854	25	826	341	3,288.9
Barclays Global	2,802	131	604	231	28.0
<i>Other Mgrs</i>	<i>11,294</i>	<i>2,211</i>	<i>3,069</i>	<i>643</i>	<i>38.6</i>
Risk-Based					
John Hancock	27,796	3,999	3,624	735	16.0
Goldman Sachs	8,446	2,428	3,038	434	61.2
AllianceBrnstein	7,628	1,762	1,815	299	33.0
Vanguard	29,568	1,896	1,796	-19	7.0
OppenheimrFds	4,421	1,771	1,554	163	57.1
Russell Inv Grp	13,974	1,861	1,308	250	11.0
TA IDEX Funds	9,125	1,526	1,179	317	16.1
Thrivent Fin'l	2,491	1,004	937	180	65.0
AIM Invsmts	2,248	446	751	71	54.3
DFA	2,179	467	538	136	34.1
<i>Other Mgrs</i>	<i>95,135</i>	<i>3,085</i>	<i>1,026</i>	<i>-622</i>	<i>1.2</i>

* 2007 net flows as a % of 12/06 Assets.

Source: Strategic Insight Simfund MF

Funds-of-Funds: Income-at-Retirement Solutions Expand



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Over the past several months, the industry's focus on income-at-retirement solutions has been energized by the launch/filing of **mutual funds promising predictable distributions for investors who want to turn their accumulated assets into steady income.** These open-end funds echo the structure of the 80+ closed-end funds (CEFs) with "managed" distribution policies that target set distribution levels but don't offer the income guarantees available in insurance-wrapped products. (Vanguard explicitly likened its product, explained below, to managed-distribution CEFs.) And like managed-distribution CEFs, these funds may return capital in distributions.

Here are some "managed payout" products of note:

Fidelity Investments has launched 14 Income Replacement funds, 11 in August and three in December. These funds of Fidelity funds have asset-allocation models set by target date, ranging from 2016 to 2042 (with a fund at each two-year interval). The funds grow more aggressive with later target dates, so, for example, the Income Replacement 2016 fund allocates 33% to domestic stocks and the 2042 fund allocates 52% to domestic stocks.

The funds' annual payouts fluctuate depending on performance, but the annual payout is distributed in equal monthly portions. To receive the "managed" monthly payouts, investors must opt for the "Smart Payment Program," which gradually returns principal to investors until the investments liquidate in the horizon year. Target annual distribution levels begin at 5.1% of the NAV at the end of the previous year when the target date is 30 years away, and increase toward 100% as the target date approaches. The funds have total expenses ratios ranging from 0.54% to 0.67%. Fidelity's offerings are still in launch mode and had only \$28 million in assets at the end of January 2008.

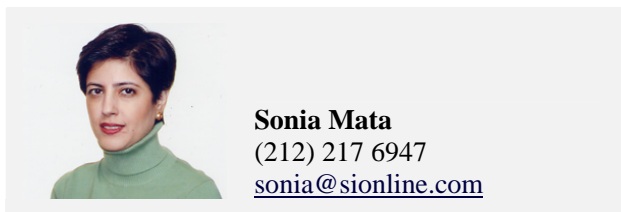
Vanguard filed in October to launch the Managed Payout Growth Focus Fund, the Managed Payout Growth and Distribution Fund, and the Managed Payout Distribution Focus Fund. These three FoFs invest in other Vanguard equity and fixed-income funds and are geared toward producing level monthly distributions to investors (totaling 3% annually of NAV for the Growth Focus fund, 5% for the Growth and Distribution fund and 7% for Distribution Focus). Unlike Fidelity's offerings, these do not offer a self-liquidating option. The funds will carry a total operating expense ratio of 0.58%.

John Hancock launched in January 2008 the JHF II Retirement Income and JHF II Retirement Rising Income funds, which aim for quarterly distributions at set annual rates (the Rising Income fund will increase its distribution rate annually by the rate of inflation). These FoFs invest 90% of assets in John Hancock funds, and may invest the rest in unaffiliated funds. Initially, the Income fund will target an annual distribution of \$0.60 per share and the Rising Income fund will target a distribution of \$0.40 per share. "A" share expense ratio is set at 1.35%.

Russell Investments plans to add retirement-income distribution funds to its LifePoints series of target-date FoFs (they are for *decumulation* of assets during retirement," the prospectus says). In July, the multimanager specialist filed to offer three funds with set annual distribution rates: a Retirement Distribution Fund (7% of initial NAV for 10 years); an Accelerated Distribution Fund (10% of initial NAV for 10 years); and an Extended Distribution Fund (6% distribution rate for 20 years). These funds will invest in a mix of 10 Russell equity and fixed-income portfolios. The funds may alter their distribution rates in the future, and may liquidate or merge the funds on reaching the end of their 10- or 20-year terms.

The financial industry's language continues to progress, from individual stocks, to managed pools (through funds, ETFs, and SMAs), to asset allocation, and now, to income-at-retirement. The transition from a product-centered dialogue to a planning discussion for a 20-30 year timeframe can make investor's choices more challenging. One company simplifies the solution by offering dozen of options; another, by offering just a few. **Can the industry find a solution for investors already feeling ambivalent about the distant future, so that income-at-retirement truly evolves beyond just another permutation of the "systematic withdrawals" available for many years already?**

ETF Advance in 2007



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ETF growth gathered momentum in 2007. An increase in institutional demand, and rising use by financial advisors, RIAs, and individual investors contributed to **ETF net issuance in 2007 more than doubling as compared to 2006. Total assets under management in ETFs had crossed the \$600 billion mark at year-end.**

2007 also proved to be prolific in terms of new product development: new fund starts during the year totaled 290, almost doubling the ETF universe, although some of the new offerings face challenges that are touched on later in this article. At the same time, the number of ETFs with a \$1 billion-plus size grew from 53 at the end of 2005, to 96.

ETFs					
Legal Structure	Assets				# of Fnds
	\$B	Net Flows \$B			
	12/07	2005	2006	2007	12/07
Open-End Fund	440.9	53.2	67.5	104.0	593
UIT	139.2	-2.5	-8.7	33.9	8
Grantor Trst / Ptnrshp	28.6	3.1	8.5	8.9	28
ETN	4.7	0.0	1.1	2.8	25
Total	613.4	53.7	68.5	149.5	654

Source: Strategic Insight Simfund MF

Unlike on the traditional fund side, where domestic equity programs were in net redemptions in aggregate in 2007, US equity ETFs drew \$80 billion last year (including \$31 billion in one fund, the S&P 500 SPDR). International equity products attracted another \$45 billion or so, with year-over-year growth strongest among diversified emerging market products. The bond segment of the ETF marketplace, which has so far been less developed, saw \$13 billion in new money collected within an expanding number of products, including in new areas like muni bond, corporate high yield and global bond. And specialized commodity- / currency-based products continued to be an important area of expansion, seeing net issuance of \$11 billion.

ETFs: By Investment Type					
	Assets				# of Funds
	\$B	Net Flows \$B			
	12/07	2005	2006	2007	12/07
US Equity					
Diversified	302.3	15.1	17.0	62.0	210
Sector	66.0	6.2	10.1	18.0	173
Subtotal US Eqty	368.3	21.3	27.1	80.0	383
Int'l/Global Equity					
Diversified	61.4	7.0	10.3	16.6	36
Divrsfd Emerg Mkts	37.6	5.1	3.5	13.9	14
Single Country	53.1	8.1	8.5	6.6	37
Regional	19.2	2.2	3.7	4.4	26
Sector	6.9	0.6	0.8	4.2	62
Subtotal Int'l/Glb Eqty	178.2	23.0	26.8	45.7	175
Bond					
Taxable Bond	34.1	6.3	5.1	12.5	37
Muni Bond	0.6	-	-	0.6	12
Subtotal Bond	34.7	6.3	5.1	13.1	49
Specialized					
Commodity	28.5	3.0	8.5	8.5	33
Currency	3.7	0.1	1.1	2.2	14
Subttl Specialized	32.2	3.1	9.6	10.8	47
Total	613.4	53.7	68.5	149.5	654

Source: Strategic Insight Simfund MF

Although growth opportunities continue to attract new sponsors (last year eight new sponsors entered the marketplace bringing the total number of managers to 28), the business remains highly concentrated: the largest 3 sponsors (BGI, SSgA and Vanguard) accounted for 84% of assets at the end of 2007.

BGI maintained its lead in the marketplace: its ETF assets grew by about 30% in 2007 and reached \$334 billion by year-end. But although the manager's net issuance rose to nearly \$60 billion last year (up from roughly \$48 billion in the prior year), its flow *share* fell from 70% to 39%, as a result of the strong recovery staged by SSgA.

SSgA's net new intake of \$44 billion in 2007 exceeded its cumulative flows over the prior six year period (2001-2006). Seventy percent of the manager's 2007 net flows were, however, gathered within one fund, the S&P 500 SPDR, which saw a surge in institutional activity, including for shorting purposes. In terms of new product development, SSgA was focused on

filling out the international equity and bond fund gaps in its lineup—it added 11 funds within each of these categories last year.

Vanguard continued to make steady inroads—it garnered \$17 billion in total ETF flows last year and rose to the number three spot in terms of ETF assets at year-end. (Helping Vanguard advance in the rankings was the divestment by the Bank of New York, last year’s number three, of five of the six ETFs it managed to PowerShares.) Vanguard started 10 new funds in 2007, including its first bond funds, two broadly diversified international equity offerings, and three mega-cap US equity funds. Two of its new funds, the FTSE All World-Ex US-ETF and the Total Bond Market Index-ETF, were the most successful new launches of 2007, each gathering net flows in excess of a billion dollars over the year.

ETF Managers					
Manager	Assets		Net Flows \$B		# of Fnds
	\$B		2005	2006	
Barclays Global	334.40	42.69	48.04	58.97	170
State Street Gbl	141.73	1.66	0.41	44.07	64
Vanguard	42.12	4.71	8.33	17.47	37
ProFunds	9.82	-	2.24	7.93	58
PowerShares	37.00	1.24	0.98	5.03	100
World Gold Trust	16.88	2.61	3.72	4.29	1
WisdomTree	4.56	-	1.44	2.88	39
Van Eck	3.60	-	0.50	2.77	8
DB Cmmidity Svcs	3.60	-	0.80	2.22	11
Rydex Global Adv	5.48	0.71	1.90	1.55	31
Claymore	1.96	-	0.42	1.37	38
XShares Advisors	0.26	-	-	0.27	31
Bank of New York	9.40	0.08	-1.09	0.26	1
Goldman Sachs	0.15	-	-	0.14	2
Swedish Export	0.12	0.00	0.00	0.11	5
Victoria Bay	1.10	0.00	0.81	0.10	3
First Trust Adv	1.01	0.04	0.05	0.07	36
FocusShares	0.02	-	-	0.02	4
SPA ETF	0.02	-	-	0.02	6
Deutsche Bank	0.01	-	-	0.01	2
Ameristock	0.01	-	-	0.01	5
Ziegler Cap Mgmt	0.01	-	-	0.01	1
Fidelity	0.11	-0.01	0.01	-0.04	1
Total	613.39	53.73	68.54	149.54	654

Source: Strategic Insight Simfund MF

ProFunds, which entered the business in 2006, has quickly built up a large line of inverse, inverse leveraged and long leveraged funds (primarily US equity—diversified and sector) and the manager is among the fastest growing in the ETF segment.

ProFunds saw its flows accelerating to \$8 billion last year, supported by traders seeking to exploit market swings. In the last quarter of 2007, ProFunds started its first international equity funds. It also has inverse bond funds in the offing.

Van Eck is another sponsor growing at a fast pace through sector and single country approaches. The manager also has a budding muni bond fund line—it has already started two funds, one intermediate-duration and another long-duration; others are in the works.

Highest Cash Flow ETFs in 2007

Fund Name	Start Year	Assets		
		\$B	2007 Net Flows \$B	Rate
S&P 500 SPDR	1993	98.2	31.0	48%
iShares MSCI EAFE	2001	51.9	10.5	28%
iShares MSCI Emerging Mkt Idx	2003	28.9	9.4	60%
iShares Russell 1000 Growth	2000	15.6	6.9	90%
streetTRACKS Gold Shares	2004	16.9	4.3	46%
Select Sector SPDR Financial	1998	5.1	3.6	155%
iShares Lehman 1-3 yr Treasury	2002	9.5	3.5	62%
Vanguard Tot Stk Mkt Idx-ETF	2001	10.3	3.0	43%
Vanguard Emrg Mkt Stk Ix-ETF	2005	6.0	2.7	131%
iShares Lehman Aggregate	2003	7.8	2.7	55%
iShares MSCI Brazil Index	2000	7.6	2.1	72%
iShares S&P 500 Growth Index	2000	6.6	1.9	44%
DJIA DIAMONDS	1998	8.6	1.7	26%
Vanguard Growth Idx -ETF	2004	3.2	1.6	123%
iShares MSCI South Korea Indx	2000	3.7	1.6	97%

* 2007 Net Flows as a % of 12/06 assets.
Source: Strategic Insight Simfund MF

New ETF launches last year were appreciably up from 2006 levels. (2006 itself had marked an acceleration point in new ETF additions; prior to the 2006-2007 period, new starts had never exceeded about 50 in any particular year.) New ETFs started in 2007 raised a collective \$20 billion in net flows. Broadly-diversified international equity, broadly-diversified and short duration bond, agricultural commodity-based / agribusiness, currency (Japanese Yen), leveraged inverse, and funds based on the single emerging markets Russia and China were among the most successful in 2007.

The bond area was an important one for progress—it saw new development taking place for the first time since the 2002-2003 period during which BGI had come out with six taxable bond offerings. 2007 witnessed Barclays further extend its taxable lineup and also add muni funds. Vanguard, SSgA,

PowerShares, and **Ameristock** were others that entered the taxable bond space. In the muni bond area, BGI and SSGA set the ball rolling in September, and PowerShares and Van Eck followed. In a promising sign for continued growth of bond ETFs, which are more complex from an operational point of view, thirteen of the 43 bond funds that made their debut in 2007 had crossed the \$100 million mark in assets by year-end.

Future new product explorations are likely to center on the bond, international equity, alternative (such as long/short), allocation/hybrid, and commodity/currency areas.

Although several of the equity/bond/specialized launches of 2007 were quite successful, many others are still struggling to raise assets. Overall, the rapid pace of new fund introductions in the last two years, has led the average ETF size to fall from \$1.47 billion at year-end 2005, to about \$940 million. Already some of the products targeted at overly fine slices of the market and others that for whatever reason have been unable to build sufficient traction and trading volume are being reconsidered. In one such move, Claymore liquidated 11 of its funds in February.

In this challenging environment in which to bring to market new funds, aspiring new entrants to the business are looking to differentiate themselves with innovative approaches, such as active management, ETN structures, ETFs-of-ETFs, products based on differentiated indexes, or by bringing to bear other distinctive strengths. For instance, **Northern Trust** is readying a large line of mostly international equity funds based on unique indexes, investment bank **Lehman Brothers** will explore opportunities in the ETN sector of the market, and **CCM Partners** plans funds based on credit default swaps. And **Dreyfus** is looking to jointly market with **WisdomTree** a line of cobranded foreign bond and cash products that Dreyfus will sub-advise. (Dreyfus's parent, Bank of New York Mellon, already sub-advises WisdomTree's ETFs.)

Active ETFs

Sponsors have until now struggled with finding workable solutions to the conundrum of providing enough transparency to facilitate the arbitrage process and yet prevent front-running. Lately, there have been some indications that the industry may be closer to obtaining regulatory approval of actively managed ETFs, which would represent a new generation of products. In early February, SEC issued notices regarding exemptive relief applications filed by PowerShares, Bear Stearns, BGI, and WisdomTree for

active ETFs. The notices indicate that the Commission will grant the exemptive relief sought unless it decides to hold, or other interested parties request, a hearing on the matter.

ETFs Started in 2007 - Sorted by 4Q Cash Flows

	Assets		Net Flows \$MM
	\$MM	2007	
	12/07	2007	4Q07
US Equity			
UltraSh Oil & Gas ProShares	265	313	194
Ultra Financials ProShares	208	235	174
PowerShares DWA Tech Leaders	317	311	139
Van Eck MktVector GI AltEn ETF	238	206	128
UltraSh Financials ProShares	1,000	804	114
Other US Equity ETFs	3,772	3,521	1,002
Total US Equity	5,800	5,391	1,752
Int'l/Global Equity			
Van Eck MktVector Russia ETF	800	769	604
Vanguard FTSE All WrldExUS	1,322	1,302	542
Van Eck MktVector AgriBsn ETF	706	641	527
Vanguard Europe Pacific ETF	653	666	470
UltSh FTSE/Xnha China25 ProShrs	382	378	378
Other Int'l/Global Equity ETFs	2,824	2,760	1,509
Total Int'l/Global Equity	6,688	6,517	4,031
Commodity/Currency			
PowerSharesDB Agriculture	1,109	941	384
United States Natural Gas	593	654	230
PowerSharesDB US Dollar Bull	100	146	91
CurrencyShares Japanese Yen Tr	988	938	71
iPath DJ AIG AgrcTotRtnlx ETN	68	63	63
Other Cmdty/Currency ETFs	869	785	323
Total Cmdty/Currency	3,727	3,527	1,163
Bond			
Vanguard Tot Bd Mkt Idx -ETF	1,095	1,074	606
SPDR Lehman Intl Treas ETF	189	189	189
iShares iBoxx \$ Hi Yld Corp Bd	296	320	166
Vanguard Short Bond Idx -ETF	407	396	120
iShares Lehman 1-3 yr Credit	211	210	80
Other Bond ETFs	2,640	2,603	860
Total Bond	4,839	4,792	2,020
Total	21,053	20,226	8,966

Source: Strategic Insight Simfund MF

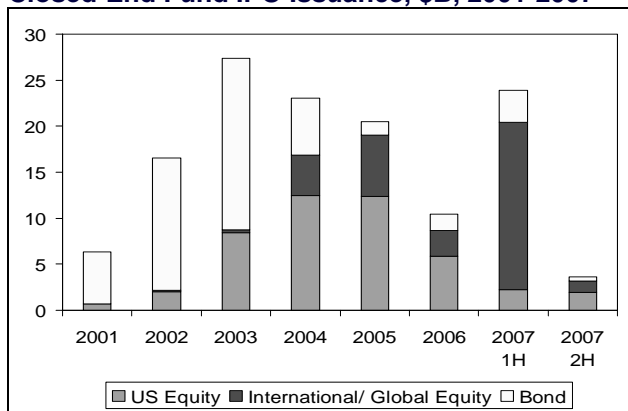
Closed-End Funds: Growth and Advisors' Views



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Closed-end fund (CEF) initial public offerings raised a record \$27.6 billion in 2007 (net of commissions), just surpassing 2003's \$27.4 billion. However, most of the IPO activity occurred in 2007's first half: during that time funds came to market sporting attractive distribution yields of 9% and higher. **The second half of 2007 saw IPO momentum stall in the face of subprime-related market volatility**, which shook investors' confidence and led to a widespread sell-off of CEF shares. Additional deterioration in NAV occurred in January 2008, and investor anxiety about recession and the markets continued to be the dominant influence on CEFs. (SI's just-published, detailed study on CEFs, "Closed-End Funds: Prospects for Growth Amid Challenges," is available online [here](#).)

Closed-End Fund IPO Issuance, \$B, 2001-2007



Source: Strategic Insight Simfund MF

Against this backdrop, it's helpful to recall that the **factors that drove 1H 2007 CEF IPOs (as well as the growth in 2003-2006) continue to be present. Investors' hunger for income-producing vehicles is becoming clearer with income-at-retirement a more**

visible industry theme. Thus, some industry participants expect regular IPO activity to return later this year, barring a major recession. In the meantime, fund sponsors agree that more should be done to educate investors about CEFs in order to fuel the long-term broadening of the CEF investor base.

Closed-End Funds Misunderstood

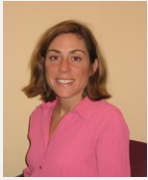
To get a sense of what advisors think can be done to support the CEF market, we interviewed at length 25 financial advisors across the U.S. who were listed with the Closed-End Fund Association (CEFA). Advisors we spoke with agreed that the general public has little understanding of closed-end funds. Most of the advisors' comments were variations on one complaint, "The industry doesn't explain them well." But concerns about the lack of clear information are fading, as two online resources have emerged with searchable databases that provide price, portfolio holdings, performance and other data on all CEFs, as well as some educational brochures and articles. The CEFA makes such data available on **CEFA.com**, along with data on IPOs and distribution policies; and Nuveen Investments runs **ETFConnect**, which contains information on all CEFs and ETFs (not just Nuveen's).

When asked what fund sponsors could do to support their use of CEFs, advisors said the fund firms should provide: better **phone support**, with quick answers to questions about CEFs from knowledgeable specialists/internal wholesalers; **thorough Web sites**, updated daily with CEF prices, NAVs and other information; and **conference calls and/or wholesaler visits** to update advisors on CEF managers' views and performance.

While advisors criticized the CEF industry in general, most were able to name specific firms that they believe do a good job with education and support. Within SI's limited market survey, Nuveen was referred to most often, with many advisors mentioning their brochures, phone support, and sponsorship of ETFConnect. BlackRock was mentioned second-most frequently, with several advisors praising its phone support and brochures. Eaton Vance, Cohen & Steers, Claymore, and First Trust also were highlighted for their marketing and educational support.

Looking ahead, CEFs' unique advantages to generate high distribution for income-at-retirement investors will expand the CEF investor base and change how CEFs are owned and perceived. Eventually, the focus may shift from opportunistic CEF trading and fluctuating discounts to NAV, to CEFs being a suitable income-at-retirement vehicle.

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Funds-of-Funds Modify and Adjust

During 2007, funds-of-funds (FoFs) captured about **\$140 billion in net flows** (in open-end and VA-underlying funds, not including 529 Plans), up from \$110 billion the prior year. More investors embraced this one-stop investment strategy. **The popularity of such packaged advice products encouraged close to 160 new FoF registrations with the SEC in 2007 alone (110 FoF portfolios were actually launched last year).** SimfundFiling.com's Prospectus Research team had a front row seat to watch the evolution of these funds. Below are just a few such transformations.

Traditional to Fund-of-Funds

This year saw a number of funds make the move from a traditional asset allocation fund to a FoF: **Northern Institutional Balanced** and the four funds of the **Old Mutual Asset Allocation** series (with **Schwab Viewpoints** joining this group in early 2008).

Expanding FoF Investment Strategies

Modifications in target asset allocations and changes in eligible underlying fund lists (removal of certain underlying funds or inclusion of new ones) were, unsurprisingly, common. e.g., the **Wells Fargo WealthBuilder Allocation** funds modified their allocation to include investment in funds that use alternative investment strategies.

Pricing of FoF Management Fees

The greater visibility of the composite fees of a FoF's underlying funds (you can now see these in both SimfundFiling.com as well as in Simfund MF), may lead to an enhanced focus on FoF fees. Yet, last year modifying FoF fees was not that common. One FoF series changing its fees was the [Legg Mason Partners](#)

[Lifestyle Allocation](#), which removed their overlay management fees in November.

FOF Portfolio Management Changes

Changes made to the people (and teams) that manage FoFs were significant in 2007. A complete list of portfolio management changes for FoFs can be found on [Simfund Filing's Prospectus Changes](#), under "Search All Changes" (on the toolbar). Narrow your search by filtering under "Special Strategies," as well as for Portfolio Management changes using the "Category of Change" filter.

Simfund Filing Re-launched

In 2007, the nearly 10 year-old Fund Filing service was re-branded as **Simfund Filing**, combining multiple enhancements and links to and from SI's **Simfund** system. Some of these changes included the addition of **Special Objective** tags such as for "Funds-of-Funds" (along with tags for ETFs, Focused Funds, Market-Neutral/Long-Short funds, etc.). A big addition to our research tools was the new **Fund Profiles** (which include fee tables, performance benchmark indexes, advisory/sub-advisory contractual data, and more). And finally, the easy-to-use **Selected Portfolio Email Alerts, Quick Searches, and the News Makers Archives** rounded out 2007's enhancements.

SI Fund Prospectus Profile: A new one-page-per-fund **summary showing** the most current fee and expense data, hyperlinked to Simfund, **updated on a real-time basis.**

Latest prospectus data: More than 50 new data points, all extracted directly from the latest prospectus, including fee tables, Prospectus-stated performance benchmarks, redemption rates and policies, portfolio manager name, tenure details, fees of **funds-of-funds' underlying funds**, contractual advisory fees type, advisory fee asset and fee breakpoint schedules, performance fee details, and for each sub-advisor, contractual fees.

The integration of the prospectus information into SimfundFiling's functionality enables time-saving analytics. Also, you can now **identify a 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. And E-Mail Alerts will keep you abreast of **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.

Path to Fee-Based Relationships



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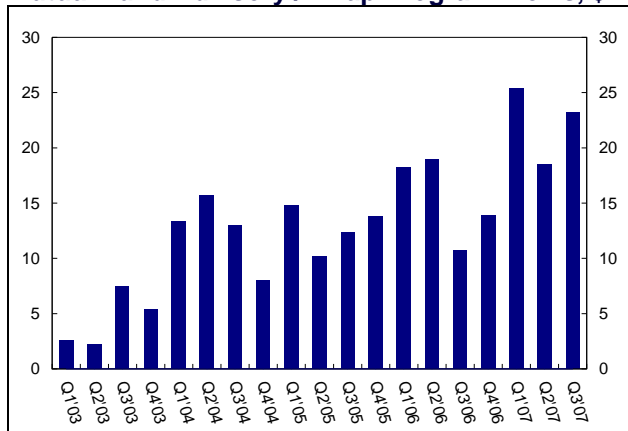
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Mutual fund sales data clearly shows a persistent shift towards asset-based fees for financial advice, and away from point-of-sales (POS) compensation. In recent years, the use of fund share classes that enable the payment of POS commissions has greatly declined, as many broker-dealers (BDs) have migrated from a business model based on “transaction-based compensation” to one built around “asset-based fee compensation”. Further evolution of Unified Managed Accounts (UMAs), currently estimated to hold less than 5% of managed account assets but growing quickly, supports such a trend.

There are many manifestations of the shift of the financial services industry towards an asset-based fee model, which is already applied to over \$2 trillion in “managed assets,” including mutual fund “wrap” accounts, separately managed accounts, other fee-based relationships, and fee-only RIA administered assets.

The expansion in mutual fund advisory wrap accounts documented in the following chart, is just one illustration.

Mutual Fund Advisory / Wrap Program Flows, \$B



Source: Cerulli Associates

Annual flows into fund wrap programs rose in 2007 (as per Cerulli Associates) to an estimated \$85-\$90 billion, up from about \$60 billion in 2006 and lower volumes in prior years. Note that such programs use fund share classes bought at NAV (load-waived “A” share classes, and increasingly, a share class without 12b-1 fees).

Another sign of the trend was the increase in the 2007 sales of “C” shares, which are often used as a substitute for fee-based accounts (and which offer a greater flexibility to switch out of under-performing funds than is possible in some asset-based fee accounts). We estimate that sales of “Cs” experienced a 19% increase in 2007 relative to the pace in 2006, and “C” shares accounted for about 13% of aggregate 2007 sales among fund managers focusing on distributing through intermediaries.

In contrast, the share of POS compensation “B” shares in BD fund sales has declined to just 2%-3%. In 2007, “B” share sales shrank by about 10% from 2006 levels.

As for POS compensation “A” shares: In 2007, sales of A share classes structured with high (over 4%) sales commissions grew by just half the overall rate of year-to-year mutual fund sales expansion, and are falling in importance.

Irrespective of the kind of fee-based account, such accounts offer many advantages to the BD. Transaction-based sales revenues can shrink significantly during periods of stock market declines, as happened in the early 2000s and is likely in 2008. **Investors tend to reduce the turnover of their financial assets during such periods, as inertia and anxiety take hold. In contrast, fees paid based on assets under management, held in well-diversified portfolios of stocks and bonds, decline much less during a bear market.**

Besides greater revenue stability, an asset-based fee model provides the BD control over the level of fees charged, and ability to modify them based on particular services offered (or adjust them to cover costs in a falling market). Instead of being subject to stock market unpredictability, fluctuating transaction volume, and sales commission levels determined partly by outsiders (such as fund managers’ “load” structure), a BD is in total control of fees charged in an asset-based fee account.

Emerging UMAs can be an attractive alternative for BDs and some of their wealthier clients due to the flexibility they offer in combining funds, ETFs, securities positions, SMAs etc. (at times with a tax-management overlay) as well as UMAs’ fee-based pricing. Thus, UMAs will continue to increase the popularity of asset-based fee accounts, lessening the use of commissionable “A” / “B” share classes, as well as “C” share classes.

Trends in Use of Fund Share Classes



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Fund managers distributing through broker-dealers have seen a transition to share classes used in asset-based fee accounts, and away from share classes that facilitate point-of-sales (POS) compensation (such as “A” shares sold with POS commissions or “Bs” where commissions are up-fronted). **Sales of “A” shares with POS commissions have declined in importance (and “B” share sales have almost disappeared).** **An SI survey of firms focusing on intermediary distribution (the firms’ collective sales of stock and bond funds in 2007 totaled over \$600 billion) found:**

“A” Share Classes

1. “A” shares sold at NAV accounted for about **55% of all “A” share sales in 2007.**
2. “A” shares sold at NAV, plus other no-load (retail or institutional) share classes outsold commissionable “A” shares by a **3:1 ratio in 2007.**
3. Commissionable “A” share sales (at low or high commissions) accounted for **just one-fifth of 2006 and 2007 aggregate new sales.**
4. “A” shares sold at high commissions made up **just about half of all commissionable “A” share sales;** the remainder of sales were of “A” shares sold at lower than 4% commissions, often driven by right-of-accumulation ownership discounts.
5. **Thus, just roughly 10% of long-term fund “A” share sales (of managers focusing on intermediary distribution) were at high (over 4%) POS commissions in the past two years.**

“B” Share Classes

“B” shares are down to 2%-3% of sales. 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 \$200 billion by year-end 2007, or roughly 2% of the industry’s total. Net liquidation of “B” share classes equaled 22% of “B” share assets in 2007.

“C” Share Classes

“C” shares, often a substitute for asset-based fee accounts, are of increasing importance among some BDs. Our survey suggested that “Cs” accounted for about 13% of intermediary-distributing fund manager sales last year (with slightly above-average YTY sales growth in 2007). But at some BDs, “Cs” were more important; at Merrill Lynch they accounted, we believe, for more than half of retail sales through traditional “commissionable A/B/C” classes.

“R” Share Classes

Retirement share classes have greatly expanded in recent years (nearly 1,700 of these are now available). It is generally assumed that such share class pricing options are essential for participation in many DC plans. Most retirement business flows go to “R” share classes with zero to 0.25% 12b-1 fees (American Funds controls the great majority of this segment; note that its effective total expense ratio, before 12b-1, is just 0.41% of assets).

Demand for 0.50% 12b-1 fee R-shares is in evidence but growing only slowly; just seven of the managers offering R-shares with 12b-1 fee ratios of about 0.50% garnered \$200 million or more in ‘07 net inflows (excluding such funds from American Funds); only 10 such individual funds (excluding American Funds) gained over \$100 million in ‘07 flows.

Little flow activity is being seen in “R” share classes with 0.75% or 1.00% 12b-1 fees (excluding gains at American Funds).

Open-End Stock and Bond Funds (Actively-Managed)

	Assets				
	\$B	Estimated Net Flows \$B			
	12/07	2004	2005	2006	2007
No Load	4,119	128	152	159	152
Front Load (“A” often sold at NAV today)	2,252	64	60	56	27
Level Load (“C”)	390	24	20	22	23
CDSC / Back Load (“B”)	206	-44	-54	-54	-50
Total above	6,966	172	177	183	152

Excludes passively managed funds (index funds and ETFs); also excludes closed-end mutual funds and variable annuity mutual funds. Source: Strategic Insight Simfund MF

“A” Share Class Star Ratings: Change Due?



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In fee-based accounts that use NAV share-class mutual funds, overlay (“externalized”) fees are charged outside the mutual fund structure. For some investors, this increases total fee transparency (of fund fees and external fees), helping them better understand the fees that are charged. Yet, in our view, this greatly reduces the ability to compare costs across BDs (BDs vary in the quality and depth of services they provide). Also, some discounts may be given to very large accounts (albeit, we believe, these apply only in accounts holding hundreds of thousands of dollars, many times the size of a typical mutual fund household account position).

Overlay fees charged in asset-based fee accounts are not explicit (they are not included in a fund’s expense ratio) and are thus not measured by ranking services such as Morningstar or Lipper. Not taking into account such overlay fees, while computing all expenses (**including sales commissions**) in “A/B/C” share class rankings has the potential of being misleading.

For example, no-load share classes of a fund held in an asset-based fee account are at times rated higher than an “A” share class of the same fund (which in its load-waived version is often held in a similar asset-based fee account). Morningstar adjusts the “A” share fund ratings by subtracting the maximum sales commission from the fund’s return. **But more than 80% of “A” share class sales done today are at NAV or at commissions well under the load used by Morningstar in its calculation.** Thus, this ranking methodology, designed many years ago when loaded “A” share sales were more prevalent, is outdated.

Furthermore, there are over \$2 trillion in “A” share class assets. Investors in these funds, many of whom acquired the fund shares decades ago, observe ratings for their funds that are, at times, misleadingly lower than deserved.

While Morningstar recognized this situation by introducing a load-waived rating, we believe the great majority of financial advisors and investors focus on the most common Morningstar Ratings™ (star ratings), without giving sufficient attention to the subtlety of load adjustments.

The impact of reducing a fund’s return by its maximum sales commission (a commission that hardly anyone pays today) can be meaningful, especially for relatively young equity funds, and in the case of bond funds extremely significant. Note: For funds started after 2003 that have the highest (Five) Lipper Consistent Return Score, half are awarded only two or three Stars by Morningstar! Such often undeserved low rankings may be both misleading to many, and harmful for new fund innovation.

We compared Lipper Consistent Return Scores to Morningstar’s star ratings. (Unlike Morningstar, Lipper doesn’t account for sales commissions in its risk-adjusted, within-classification ratings.) **For “A” share classes, at year-end 2007, Lipper awarded the highest risk-adjusted ratings to 601 funds collectively holding \$835 billion in assets. For the same universe, only 89 funds with a collective \$346 billion in assets received Morningstar’s five-star rating!**

Many fund industry observers argue that, with the persistent decline in maximum commission “A” share sales (and, inversely, the explosive increase in sales of “A” shares sold at NAV) investors would be better informed by a less misleading ranking methodology, with a load-waived rating becoming the default used by Morningstar.

Modifying the default ranking methodology for “A” shares addresses one ranking deficiency.

Another concern is that a “B”/“C” share class structured with a 1% 12b-1 fee used to compensate the financial advisor, is rated lower than an alternative share class, where an “overlay management” fee of 1% (or higher) is charged outside the fund’s expense ratio. Furthermore (and ignored by most observers), the payment of fees-for-advice within the expense ratio is cheaper, by 0.3%-0.4% on a tax-adjusted basis.

Overall, the opaque nature of fees charged in asset-based fee accounts paradoxically make share classes sold through such programs appear “better” than “A/B/C” share classes of the same investment vehicle.

Share Class Pricing: Looking Ahead



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- Rule 12b-1 changes:** The S.E.C. has suggested that its 2007 focus on Rule 12b-1 may lead to some changes this year. Beyond rule clarification and changes in directors' responsibilities, one idea floated about 12b-1 asset-based fee changes was to limit the time (thus the cumulative charges) an investor would pay while owning B/C shares. If adopted, it may further reduce, if not completely eliminate the use of the nearly extinct "Bs." It is not clear how "A" share class pricing may be impacted by such a change; depending on how it is set, a limited-duration "C" may make, from an investors' costs viewpoint, "Cs" always better or equivalent to "As", thus greatly reducing the ability to distribute commissionable "A" shares. Lastly, some BD users of "Cs" may be encouraged into an even faster transition to **fee-based accounts (where no caps based on holding periods are in place).**
 - Broker-Dealer Emerging Unified Managed Accounts (UMAs):** Some BDs increasingly expect to be offered a stripped-down share class (no 12b-1; sub-TA fees to just cover costs of account administration) for their UMAs. In such UMAs, externalized asset-based fees (set by the BD) would be used to cover all costs other than account administration. Of course, UMAs do not use "A/B/C" share classes. Among distributors adopting such UMA programs UMAs could replace mutual fund-only wrap accounts.
 - Challenges abound:** Launching a no 12b-1 fee retail share class to support UMAs may create a number of business model conflicts at other BD distributors (who may expect, as a fiduciary, a "most favored nation" access to the same share class, yet also still need much higher compensation and distribution support.)
- Being left with fewer options to influence the sales and retentions of their funds, having fewer financial resources to finance BD support, and rising pricing conflicts with other BD distributors are just a few of the reasons for elevated concerns expressed by fund managers in regards to this particular development among UMAs.
 - Increasing dependency on "platforms" and fund quality evaluation by the BD Investment Analyst / Fund Selection Units (FSUs):** This further distances the mutual fund managers from their ultimate clients and makes traditional wholesalers less effective (and point-of-sales compensation even less prevalent). Supporting "platform" sales, FSUs naturally focus on NAV share classes and do not enable sales of commissionable "A" shares.
 - Some may argue that regulatory and market pressures are transitioning fees for advice or other costs paid through pre-tax, largely transparent 12b-1 fees, to post-tax, at times opaque and impossible to benchmark externalized asset-based fees.**
 - Cost of "externalizing" fees for advice:** Comparing the equilibrium cost of financial advice under the "externalization" option, to paying for such advice through 12b-1 fees, suggests that **"externalizing" fees paid for advice is a very expensive option for low-balance investors.**
 - Lastly, 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**
 - An in-depth discussion of many 12b-1 fee related issues can be found in SI's report of last year, **"Rule 12b-1: Looking Back, Looking Forward, in the Context of a \$12 Trillion Mutual Fund Industry,"** available online [here](#).

Benchmarking the Management Fees of Sub-Advised Funds



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Peer Group Selection of Sub-Advised Funds

Sub-advised funds in the U.S. held a total of over \$1.7 trillion in assets at year-end 2007 and many such funds continue to grow rapidly today. In the traditional fund business, sub-advised funds control more than \$1 trillion. Vanguard, The Hartford, John Hancock, Harbor, American Beacon, TA IDEX, Principal, Russell, and SEI are just a few of the fund management companies that are growing their open-end fund lines through actively-managed sub-advised offerings. A number of closed-end fund managers have also successfully employed sub-advisors in venturing into new investment areas in which they did not have internal expertise.

The prevalence and importance of sub-advisory relationships is even greater in the variable annuity (VA) business. Sub-advised funds represented as much as 40% of total VA fund assets under management (or \$540 billion) as of year-end 2007, and accounted for the bulk of incremental growth in VA funds in recent years. Sub-advised VA funds contributed four in every five dollars of net new money that VA funds drew in total in 2007, and many fast growing VA funds-of-funds use a sub-advised underlying fund lineup.

Falling stock fund asset levels so far in 2008 and the possibility of further pressures on management company revenues from lower management fees may lead some organizations to more seriously consider sub-advisory relationships. Interestingly, expansion in

sub-advisory relationships and related permutations is in evidence not just in the US fund industry but internationally—our global research has observed increasing opportunities for advisory partnerships in many countries.

With numerous management companies endorsing the sub-advisory model, either for their entire fund line or for selected funds, the fees associated with such relationships are drawing greater attention. The benchmarking of (i) sub-advisory fees and the extent of economies of scale realized in such fees, (ii) the portion of advisory fees retained by the fund manager after paying the sub-advisor, and (iii) the total of management fees charged to investors within sub-advised funds, are just a few of the areas SI in which has provided guidance and data—to management companies, and at times, at the request of management companies, to fund boards.

Fee structures outside the US vary significantly from those in the US. Yet, SI's global research team has observed on occasion the emergence of worldwide partnerships between global distributors and investment managers, where there is a desire on the part of the distributors to harmonize sub-advisory fee levels paid in different international markets for similar investment management styles. Detailed knowledge of and the ability to benchmark sub-advised relationships may therefore have implications beyond the US fund market.

In a recent [SI Study](#), we looked at the total management fees (the sum of advisory and administrative fees) of funds that use a sub-advisor and how they compare to the management fees of funds that do not use a sub-advisor.

For the purposes of our study, a “sub-advised” fund was defined as a fund having a “sub-advisor” or “advisor” that was unaffiliated with the fund’s manager, in order to exclude the possible special considerations in affiliated relationships.

Management Fees: Sub-Advised Funds Experience Somewhat Higher Fees than Internally Managed Funds

We computed the median management fee ratios of sub-advised and non-subadvised funds for selected Morningstar Categories grouped together (Large-cap, Mid-cap, Small-cap, Foreign Large-cap, and Specialty Stock). **The results of our analysis, which combined**

data for traditional open-end actively managed funds as well as VA-underlying actively managed funds, are presented in a summary table in the detailed report.

In the majority of cases, sub-advised funds were found to carry a higher management fee, on average, than non-subadvised funds. The differential in fee ratios between sub-advised and non-subadvised funds varied, but its median value for our sample was 0.10%. (Of course, not all individual sub-advised funds charge a management fee higher than their peer group's median.)

The generally consistent, modestly higher management fees of sub-advised funds our analysis found can be balanced against the belief that, in many cases, the value sub-advised fund lines and their “best-of-breed” proposition offer far exceeds the small additional costs; and if a sub-advised fund’s performance excellence propels a growth in assets, economies-of-scale can subsequently deliver lower total expenses.

fund fee differential, whether in the context of a general comparison, or within the specific framework of a 15(c) review where even a small basis-point differential above the “median” can, at times, raise Board concerns.

What is the Appropriate Peer Group for a Sub-Advised Fund?

Picking the appropriate peer group to compare sub-advised funds against is an exercise fraught with increasing complexity. In that context, one question raised is **whether a sub-advised fund’s peer group for fee comparison and benchmarking should include only sub-advised funds.**

Another area of intricacy is the appropriateness of inclusion of both open-end and VA-underlying sub-advised funds within such a management fee comparison peer group. (The more common industry practice is to separate open-end traditional funds from VA funds in creating peer groups used for 15(c) analysis or business benchmarking.)

Overall, the question of how best to define the expense peer group of a sub-advised fund is receiving increasing attention. The decision at times to evaluate a fund’s management fees by how closely they “hug” the peer group median fee ratio, needs to take into consideration the reality that sub-advised funds’ roughly 0.10% higher management fees put them at a disadvantage in a comparison to a peer group consisting of all funds.

The choice between a peer group of all funds and one including just sub-advised funds also influences judgment as to the “materiality” of the sub-advised

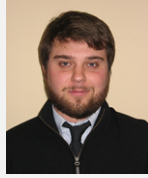
Variable Annuities 2007



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The Year in Variable Annuities

VA sales increased in 2007 [total sales through the first three quarters of the year rose to \$134.4 billion, 15% higher than the corresponding period in 2006 (source: NAVA and Morningstar)].

During 2007, mutual fund assets held by VAs rose by \$130 billion, combining an average appreciation of 7.2% (asset weighted) with modestly rising flows (these figures as well as the data below exclude over \$250 billion in fixed accounts, not structured as mutual funds, held within variable annuity contracts.)

	Net Flows			Assets
	2005	2006	2007	12/07
U.S. Equity	5.2	-11.2	-17.3	877
Hybrid/Allocation	-3.6	-2.9	0.5	86
Int'l/Global Equity	12.3	18.8	20.4	218
Total Equity/Hybrid	13.9	4.6	3.6	1,181
Taxable Bond	6.9	11.5	22.5	182
Total Equity/Bond	20.7	16.1	26.1	1,363
Money Market	-0.9	5.8	8.1	52
Total	19.8	21.9	34.1	1,415

Source: Strategic Insight Simfund VA

Asset expansion during 2007 reflected above-average returns and flows for international equity funds, as witnessed elsewhere in the industry. International equity fund assets rose 26% while US fund asset expansion was moderate.

(While the data above is sourced from SI's Simfund VA—more on the new version to be released soon on page 28—the comments below incorporate observations from AnnuityInsight.com, where SI tracks VA contract innovations daily.)

Non-VA Guarantees

Can non-VA products offer living benefits or other income guarantees? One type of these came to fruition during 2007 and the other is still on the drawing board.

There are several mutual funds that offer some kind of retirement income, although generally without an explicit guarantee. **Fidelity, DWS, John Hancock, Russell and Vanguard** all launched or announced mutual funds designed to generate regular distributions.

Still in the works, among others, are products from **Allstate, Allianz, Genworth, and Phoenix** that offer a GMWB type guarantee to cover either a unified managed account (composed of mutual funds or ETFs) or mutual fund. None of these products has been launched, although all are eagerly anticipated, as they potentially serve clients that are not keen on VAs but are interested in the guarantees.

Volatility Concerns

Large stock market fluctuations are a double-edged sword for VA marketers. On the one hand, the higher cost of volatility increases hedging costs and tests the efficacy of hedging programs. On the other, it further proves the desirability of VA guarantees and makes a product that used to sail in the winds of the equity markets suitable in times of greater uncertainty.

Feature costs, which some have viewed as potentially underpriced, may have to rise if volatility continues and risk management costs remain high for an extended period of time. Although this could raise the ire of both new and old policyholders, the price increase would take place during a period in which the value of the guarantees was evident.

The ride is not over yet, and with ample talk of a present or future recession, carriers may depend even more heavily on the appeal of insurance.

International Perspective

The US is not the only market for VAs with living benefits. Japan now hosts a lively market for VAs that includes both domestic and international insurers looking to meet that aging population's longevity concerns with products.

The UK is the newest arena for the VA business, with Aegon and Hartford offering GMWBs there and more companies sure to follow. It comes as no surprise that Canada, which typically lags several years behind the US but surely follows, has its own successful GMWB products.

During the coming year, **we expect to see expansion of the growing VA markets abroad, such as Germany, the rest of the EU, and beyond.**

VA Product Trends

Most of the changes during 2007 came in the form of **new or updated versions of Guaranteed Minimum Withdrawal Benefits (GMWBs).**

Living benefit elections continue to rise. All but a handful of contracts sold offer a living benefit as an option. More significantly, survey results suggest that three-quarters of policyholders elect a living benefit when one is available.

GMWBs remain the most popular living benefit, but GMIBs continue to be important and are not poised to fade into obsolescence. Standalone GMABs are not capturing strong sales, but this trend may reverse in 2008 with increased carrier attention to such products.

First, GMABs are components of a number of GMWBs, such as **Prudential's Highest Daily Lifetime Five** and the newer *Highest Daily Lifetime Seven*, both available in spousal versions. Each has a return of premium guarantee after ten years. Furthermore, both **Prudential** and **Allianz** have **new and updated standalone GMABs** that were released in early 2008.

Wrap structured products seem to be coming into their own, with a plethora of new products filed during 2007. These range from retirement plan to RIA-focused VAs, but they are all indicative that carriers are making structural changes to contracts to suit new distribution channels and adapt to distribution demands. While some products are lower fee (less than 1.00%), others strive towards no M&E.

One strategy is to charge a flat monthly fee, which **Jefferson National, Old Mutual** and **Phoenix** (through a joint venture with Jefferson National) all offer. Similar is the **Security Benefit EliteDesigns** five-year VA with no M&E. **The key development in this market is the inclusion of living benefits,** especially simple ones, as mentioned below. Jefferson National, which has not ventured into living benefits on its own, partnered with Phoenix to marry its low-cost administration system (and existing product chassis) with a basic GMWB.

GMWB Updates During 2007

Incremental changes across the board have amounted to a significant shift in product development in GMWBs. We have seen a variety of enhancements to non-withdrawal bonuses. Today, unlike a year ago, these are more likely to be in effect in any year with no withdrawal rather than stopping once the first withdrawal is taken. Also, we often see provisions that extend or restart the non-withdrawal bonus period.

Compared with a year ago, **the non-withdrawal period itself has generally gotten longer** through one of two mechanisms. One type of extension is through resets that also reset the bonus. Instead of an extension, the bonus period is sometimes the greater of ten years or until a certain age.

For non-withdrawal bonuses, **seven (and even ten) is becoming the new five,** with many bonus percentages on the newest features now higher than 5% with either simple or compound interest. Other subtle nuances include how bonuses and additional premiums are included in compounding.

One new feature of GMWBs that has emerged over 2007 is the concept of a distinct 10-year guarantee separate from the non-withdrawal bonus that is a set amount, such as 200% of initial premium. Mathematically, this amounts to just over 7% compounded over 10 years. **AIG SunAmerica, Allianz, AXA, John Hancock, MassMutual, Minnesota Life, and Prudential/Allstate** all offer this type of guarantee in at least one of their GMWBs.

GMWB-related death benefits are another common enhancement. These can be either integrated into the benefit or separate and may come at a higher charge. Usually, the covered amount on the death benefit mirrors the GMWB itself, but it can also be a more basic death benefit such as return of premium.

In contrast with product enhancements, **some new GMWBs are especially simple.** Simple benefits are often cheaper, thus appealing to cost-conscious consumers and advisors, especially RIAs. They are also apt for simplified retirement plan and rollover contracts. We have seen simplified riders for these markets on contracts filed this year by **AXA, Fidelity, Nationwide, Old Mutual, and Phoenix.**

SI's AnnuityInsight.com site will continue to monitor and share with you observations and interpretations of VA innovations as they emerge through the coming months.

Technology and Research Innovations Ahead



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Strategic Insight continues to expand the range of technological services we offer now to nearly 300 financial services client organizations in the US and internationally.

In 2007, the technology team at Strategic Insight introduced an expanded version of Simfund MF 5.0, and an enhanced (and re-branded) SimfundFiling.com.

In the coming year, we will **roll out new versions or enhancements to our Simfund databases, including:**

- **Simfund VA version 5.0**
- **Simfund Asia**
- **Simfund Europe.**

Upcoming Simfund VA (Variable Annuities) 5.0

This latest version represents a major advancement by providing users with a **more comprehensive database** and **robust reporting tools to analyze the variable annuity industry**. New features include:

- Over **350 Morningstar data fields**: returns, risk, official rankings, quartiles, quintiles, portfolio information, etc.
- Over **150 Lipper data fields**: returns, risk, Lipper Leaders, official rankings, quartiles, and much more
- Side-by-side Lipper and Morningstar comparisons

- Fees and expenses: funds, sub-accounts
- Prospectus Data: fund expenses, investment benchmarks, fund-of-funds expenses
- Over 100 performance graphs and reports
- Improved user interface
- Data dictionary
- Annuity Insight Link to Fund Prospectuses (subscription to Annuity Insight required).

You can learn more about Simfund VA 5.0 by connecting to Kevin Ng at kng@sionline.com or 212-217-6922.

To be Offered in Spring: Simfund Asia and Simfund Europe

SI's expanding **global research team** already assists **over 70 of the more dynamic managers and distributors worldwide, benefiting from monthly tracking of over 50,000 funds internationally, including from many fast growing fund markets in Asia.**

(The team's landmark study: *"Asia Fund Management and Middle East Opportunities: Investing in the Future"* published recently was broadly subscribed to, and an updated version will be offered this year.)

Strategic Insight will soon release an initial version of its Simfund database and analysis tool to include data on 30,000 portfolios in Europe and 20,000 in Asia.

The global databases will include a wealth of data from Lipper, Morningstar, as well as SI's research teams.

Later on we will align our global Simfund versions with the US Simfund tools. **This way, financial service companies in the US and internationally could have access to a powerful industry analysis tool that, for the first time, covers flows, assets, performance, portfolio characteristics, and other data on all funds across the major markets of the world.**

Please call Jag Alexeyev (+1-212-944-4456, jag@sionline.com) or Daniel Enskat (+1-212-944-4455 daniel@sionline.com) to discuss details and to register your interest in being among the first users of the Simfund Asia/Europe version.