

Strategic Insight

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Special Edition: Inaugural SI Forum Wrap-Up “Opportunities in the Current Fund Environment”

This edition of ‘Windows’ is based on the first SI Forum, held April 6, 2009 in New York City.

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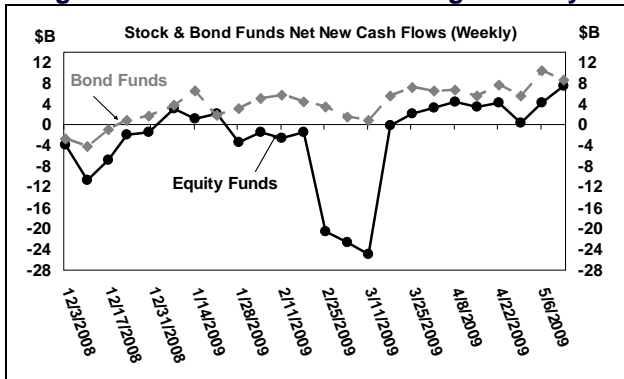
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The Mutual Fund Industry in Transition



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Long-Term Fund Flows Rebounding Recently



Source: ICI

April 2009 was the best flow month for our industry in over two years (bond and stock fund inflows exceeded \$40 billion, not including ETFs). The beginning of May marked an even stronger recovery for investor sentiment, with both US and international equity funds attracting inflows, and bond fund inflows accelerating. And the industry’s managed assets have expanded by about \$500 billion since March-end.

In the context of a somewhat improving but still very challenging business environment, we continue to witness our industry’s leadership addressing some of the current vitally important and transformative questions for our industry, such as the structure of MMFs. Similarly, to stimulate greater engagement among fund executives, SI introduced its new live client event series, the **SI Forum**, in early April at the Harvard Club in New York. Despite the inclement weather, 65 executives from 43 companies in the investment management business attended, including heads of distribution, strategy and product development, as well as CEOs. The Forum provided an

opportunity to step back, take a measure of where we are, and talk about crucial issues that we all face as firms adapt to a changing environment. SI will conduct similar but more intimate roundtables, bringing together executives among SI clients in other cities, throughout 2009.

This issue of ‘Windows Into the Mutual Fund Industry’ offers select findings from the inaugural SI Forum. The articles are adapted from presentations that SI analysts made at the event; they address a range of topics reflecting the breadth of SI research.

Importantly, this Forum was a new way for all of us in the Strategic Insight family to reach out to our community. SI, like our industry in general, has been adapting rapidly to the necessities of today. Whether through technological enhancements (Simfund Express, Simfund on-the-web, SimfundFiling.com), client roundtables, major studies in critical areas of industry innovation, timely reports, regular Webcasts, or responding one-on-one to your research needs, Strategic Insight remains committed to using every avenue to be of service in these difficult times.

Since SI’s founding 23 years ago, our core mission has been to strengthen the industry overall, and to help each of our clients succeed, in the US and throughout the global marketplace. This is the ongoing discussion that we are eager to take up with you, and the first SI Forum was just one step in that journey.

* * *

To start, it is helpful to provide some context. Stock and bond fund sales have declined from their previously extraordinary levels, but they are still projected to near \$2 trillion for full year 2009. Fund redemptions spiked in the past year, but they’ve been trending lower lately. Some helpful data is available from the *Hewitt Associates 401(k) Index*, which captures the daily activity of nearly 1.5 million investors in 401(k) plans, and thus provides a granular perspective on investor sentiment. According to Hewitt’s 401(k) Index, even during the days of highest anxiety in early October, the portion of balances transferred was just \$3 out of every \$1,000 invested (equal to 0.3% of assets), with the direction of transfers strongly fixed income-oriented.

During extreme market volatility and heightened anxiety, some defensive switches are likely. Then,

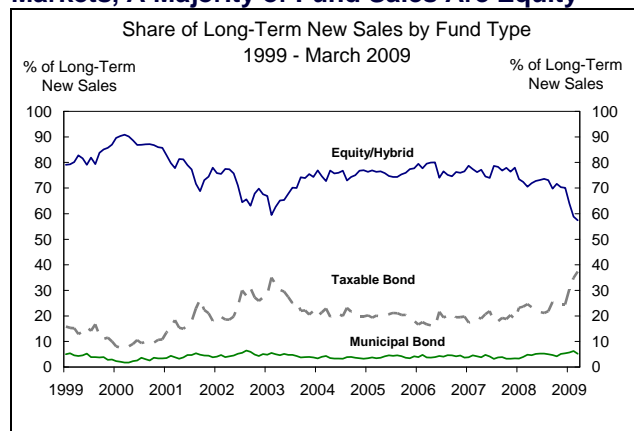
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weeks afterwards, redemption activity tends to subside, a phenomenon we have observed over many decades. Stock fund assets in our industry, over two-thirds of which are in a retirement account of some kind, are increasingly held within an asset allocation framework. Some shareholders, due to loss aversion or just inertia, stick to “buy-and-hold” and take short-term volatility in stride, even during anxious times.

The chart below shows the percentage of monthly long-term fund sales going to equity funds vs. bond funds. Not surprisingly, bond fund sales have increased in importance. **But nearly 60% of fund sales are still of equity funds**, with a lot of those sales representing dollar-cost-averaging into 401(k) plans or elsewhere.

Due To Retirement Goals, Even During Bear Markets, A Majority of Fund Sales Are Equity



Source: Strategic Insight Simfund TD (ICI Trends)

Note: Our PowerPoint, [The Mutual Fund Industry: In Transition - May 2009](#), offers many more data updates.

Our industry’s core appeal remains as a means of saving for retirement, and over the past decade, three-quarters of equity fund inflows have been sourced within retirement accounts. Excluding the portion that is automatic savings for retirement from the fund sales data above would yield an equity/bond fund sales ratio lately of probably closer to 50/50 (or even one tilting somewhat more towards bond funds).

It is reasonable to assume today’s heightened risk aversion will not go away quickly. What does that mean in terms of management of existing products, and for product development/innovation? And, as an industry, how do we ensure that the next generation of fixed-income vehicles will have the appropriate level of disclosure and suitability so FAs know what they’re selling and investors understand what they are buying?

Looking at these changes, we’re clearly in a new era – one that raises some profound issues for the investment

industry, and yet, in our view, leads to an even greater dependency on mutual funds going forward:

- Who can I trust with my financial affairs? Mutual funds offer transparency and liquidity within an essentially unleveraged and soundly regulated vehicle.
- In an era of financial seriousness, investors will pay a premium for investment convictions, most clearly articulated by investment boutiques or a visible investment team in larger organizations.
- The structure of the mutual fund business: What will stay the same? What will change?

Our global research team, in its work with managers and distributors globally, has found strong affirmation for the sentiment that mutual funds are the preferred investment vehicle for the coming years. Other vehicles were tried but many distributors realized the inherent benefits of mutual funds are here to stay.

In times of great uncertainty, investors want to listen to someone with strong convictions. This creates an opportunity for PMs at investment boutiques to become more visible. The prospects are strong for boutiques with convictions and clarity about their investment process, and access to fee-based platforms.

Lastly, everyone in the business is going through financial trauma. So it’s worth thinking about the mindset of investors, and of financial advisors. SI published a report on financial trauma 20 years ago, an adapted version of which is available in our October 2008 Executive Insights report, “*Mutual Fund Industry Strategies for Uncertain Times*,” available to clients [here](#). We looked at the psychological literature around trauma in general and found that there are four steps that every person needs to go through to deal with trauma. These steps can be adapted to create a communication framework to help investors, employees, wholesalers, and financial advisers:

1. Stimulate communication; encourage talk about anxieties, perception. Listen and help pull the customer (FA) out of the spiral of self-esteem collapse.
2. Once the FA is open: provide perspective, framework, facilitate coping. Separate stock-market chaos from the FA’s life.
3. Help investors restore a sense of mastery through facts, and alternative actions that they can take that help them feel back in control.
4. Finally, find ways to enhance self-esteem, and emphasize what can be learned from the experience.

Evolving Fund Distribution, Pricing

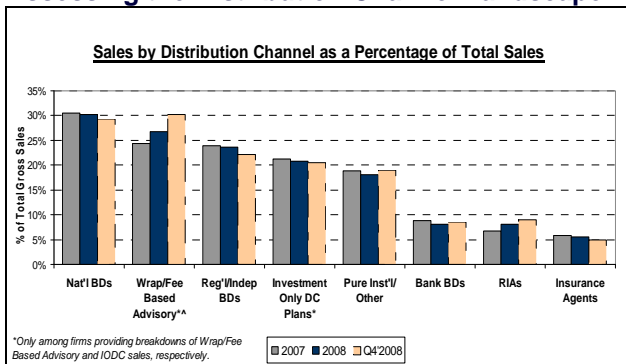


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SI continues to expand its focus on fund distribution, and has embarked on a number of new initiatives that will be shared with you later this year. In this article, we summarize the findings of our recent survey of firms that sell primarily through intermediaries; participants in our survey in aggregate manage about half of U.S. open-end stock and bond fund assets and included nearly all of the larger firms historically focused on FA distribution. Detailed results of this second annual fund sales survey were published in our recent *Executive Insights* report, [Perspectives on Intermediary Sales: Trends in Fund Sales by Distribution Channel and Share Class](#). SI clients can access the 16-page report by via the link (or going to the Executive Insights section on Sionline.com).

Distribution Channel trends. The graph below presents sales by distribution channel, broken down by percentage of total gross sales. The bars at the far left represent 2007, the darker bars in the middle are 2008, and the lighter-colored bars on the right are the separate breakouts of the fourth quarter of 2008. Thus, national broker/dealers (NBDs) accounted for 31% of fund sales in 2007, 30% in 2008 and 29% in Q4 2008.

Assessing the Distribution Channel Landscape



Source: Strategic Insight 2008 Fund Sales Survey

National broker/dealers and the regional/independent broker/dealers made up over 50% of the U.S. distribution landscape for the firms surveyed. NBDs'

and IBDs' share of sales remained relatively flat from 2007 to 2008, but in 4Q experienced some drop-off, in part due to a broad paralysis that gripped FAs and investors.

At NBDs and IBDs, wrap/fee-based advisory programs increased their share of sales last year and in 4Q. Conversely, stand-alone fund sales shrank faster than asset-allocation-driven sales. It's notable that wrap/fee-based programs gained relative momentum in the fourth quarter of 2008.

The Investment-Only DC (IODC) channel and the pure institutional channel each represented roughly 20% of total sales in 2008 for survey participants (but individual company experience varied greatly).

Our survey's results with regard to the RIA channel in particular are worth noting. The survey participants had historically underemphasized RIAs, where sales have been growing off a small base of 8% of total fund sales in 2008. However, RIA-driven sales have been for the past two years the fastest-growing standalone distribution channel in our sales surveys. (Note that many other firms, including smaller investment boutiques and legacy "no-load" firms, not included in our survey, have benefitted from RIA distribution for years.) With the selective migration of FAs – most of them heavy users of mutual funds – to independent RIAs, the managers already working with such migrating advisors would find new expansion opportunities among RIAs.

Essentially, our survey quantified and confirmed that fund distribution is shifting even more towards asset allocation and the on-going fee-for-advice model. Fee-based relationships and channels, such as RIAs and wraps, continued to gain sales market share.

National broker/dealers. NBD consolidation, whether a Morgan Stanley-Smith Barney partnership, a Merrill Lynch / BofA merger, etc., allows fund managers to concentrate key resources (key account people, wholesalers, value-add programs) over a consolidated base of NBD platforms. This coincides with NBDs experiencing budget constraints, which make them more reliant on fund firms for value-added programs. Such consolidation, though, also triggers increased competition for platform access, and for the investment strategies being selected.

At the same time, the NBD channel continues to feature capacity limitations for lower-liquidity strategies, changes in which funds are identified as offering excellent performance, and the ability of wholesalers to make a difference in which fund is

actually used among the ‘selected’ funds. Taken together, these factors keep open opportunities for a wide range of investment managers, small and large.

National Broker-Dealers

Opportunities

- Accounted for largest portion of '08 fund sales
- Recent industry consolidation increases ability to focus key resources and personnel (key account, wholesalers)
- Wholesalers' scale and reach important in engaging FAs disappointed with poor results of centralized asset allocation guidance
- Less reliance on SMAs open more growth opportunities within mutual fund wraps

Weaknesses

- Consolidation leads to increased competition for platform access and greater pricing power for distributors
- Asset allocation mindset within unified accounts leads to greater use of low-fee investment approaches (index funds, ETFs, “model” portfolios institutionally priced), allowing the BD to retain higher % of asset-based fees

Our survey results revealed a slightly lessening reliance on the NBDs. Those fund firms in our survey that garnered more than 30% of their total sales via the NBD channel fell from 38% of firms in 2007 to 27% of firms in 2008. Naturally, more fund firms are focusing away from retail distribution through NBDs, or find it harder to compete profitably within this channel.

The implications of the increasing role of fee-based platforms are exemplified at Edward Jones. In Jones's traditional, transaction-based business, it is assumed that American Funds used to account for more than 50% of mutual fund sales, thanks to a strong, long-lasting partnership. But we believe that on Jones's first fee-based platform, launched in 2008, American Funds accounted for just about one-tenth of sales.

This mirrors the expansion of opportunities for fee-based platforms throughout the industry. One question we've pondered is the “relationship risk” that may emerge when a distributor becomes *too* reliant on a strategic partnership with one fund firm, brilliant though that firm may be. At the SI Forum, it became clear that one of the largest distributors discussed internally the issue of this strategic relationship risk, and concluded that industry trends will only make this question more important in the future.

RIAs are big beneficiaries of the trend towards fee-based distribution. On top of that, some of the technology advances and back-office advances by the RIA custodians, such as Schwab, Fidelity, and TD Ameritrade, have been serving to ease the traditional barriers to entry into this space, and make it easier for advisors to transition to an RIA status (we do believe that such migration has been limited though, and fewer FAs than commonly assumed have made such a transition lately).

The RIA Channel

Opportunities

- Fastest growing stand-alone channel
- Tech advances by custodians (Fidelity, Schwab, TD) should foster growth
- Effects of financial crisis and proposed regulatory overhaul of the alternative investment space could lead to increased use of mutual funds

Weaknesses

- Geographic dispersion presents wholesaling challenges
- Traditional allegiances with “direct” no-load investment boutiques

RIAs are at times heavy users of alternative investments. It will be worth watching how their client experiences around the alternatives space during the financial crisis – either due to liquidity concerns or other issues – affect their thinking about the use of mutual funds (which are gradually making alternatives easier to access). This could be an opportunity for mutual funds to penetrate further into the space. One possible direction for hedge fund managers launching mutual funds could be to focus on RIAs.

Obviously with RIAs, geographical dispersions and small books of business are a business challenge. Also, RIAs have in the past tended to have allegiances with the legacy direct, no-load managers (or with specialized firms such as DFA). But with more RIAs migrating from a more traditional NBD or IBD where they have learned to use and appreciate fund managers active within such a BD, these new RIAs offer expansion opportunities to more fund managers.

Mutual fund wraps. Also riding the growth in the fee-for-advice compensation model, mutual fund wraps, which cross fund distribution channels, experienced sales share growth that outpaced that of any standalone channel in 2008. And the growth (from 24% of fund sales in 2007 to 27% of sales in 2008) only accelerated

into the fourth quarter of 2008 (when wraps accounted for 30% of sales).

There has been an acceleration not only in the aggregate scale of wrap sales, but also on a manager-by-manager basis. Based on our survey data, wrap sales are becoming larger components of sales at more managers.

Mutual Fund Wraps

Opportunities

- Growth far outpaced that of any stand-alone channel
- Accelerating further in Q4'08
- Prevalence only expanding in scale and scope

Weaknesses

- Intense competition for platform positioning requires new level of resource allocation
- Pricing pressures from distributors
- Share class breakdown: 56% "A" at NAV, 44% No-Load shares in 2008

With the movement towards more fee-based investing, though, comes an increasing competition for space on the different fee-based platforms – and that means a new level of resource allocation around these platforms.

Within wrap programs, because of an externalized fee structure, pricing pressure impacts choices of share classes used. And in our survey results we saw that 56% of wrap sales were made via "A" shares sold at NAV, with the remaining 44% being through no-load shares (but with the proportion of no-load, and often no-12b-1 fee, classes rising lately).

To delve further into broker/dealer platforms, we looked at data from Coates Analytics (www.coatesgroup.com). Many of our clients work with Coates, which collects fund distribution data from the broker/dealer level. Coates Analytics' data show that, for those select NBD platforms tracked by Coates, wrap sales grew 18% (in dollar terms) over the course of 2008, while both SMA and retail fund sales declined by 38% over the same period. And wrap sales exceeded SMA and retail sales in every month of 2008. This provided yet more confirmation that fund wraps had greater growth and momentum than either SMA or commission-based retail programs last year.

Similarly, we looked at Coates data on concentration: the percentage of total sales within each platform type going to the top five and top 10 fund managers. We found that in mutual fund wraps, the top five fund managers made up only 30% of total sales. But that jumps to 41% in commission-based (often one-fund-at-a-time) retail sales. Similarly, the top 10 fund managers

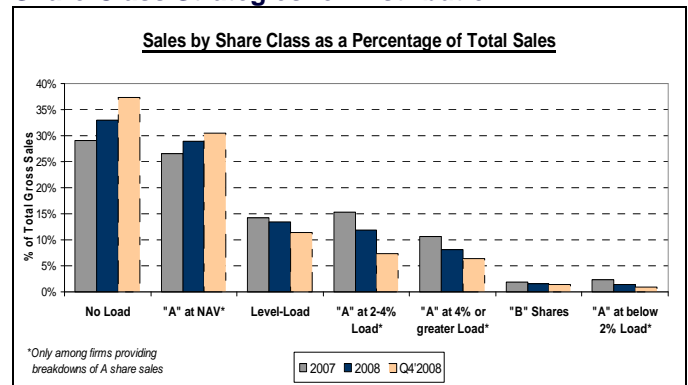
accounted for 59% of retail platform sales, versus just 46% in wraps, indicating a more open competitive environment in fee-based wrap programs.

As brokerages expand their wraps and other fee-based programs dependent on fund selection units, one question is whether financial advisors will become more dependent on home-office model portfolios, or instead cling to portfolio management. At the Forum, a knowledgeable attendee suggested that both trends are occurring: some FAs are using the wraps' model portfolios more, and some FAs are still building their own models, although they use the fund selection units' ideas and research.

Share class pricing. Just to touch on share-class pricing, the chart below breaks out 2007, 2008 and Q4'08 gross fund sales by share class, again from SI's fund sales survey. More than 60% of gross sales in 2008 were made in share classes without front-end loads.

What you also see is that "A" shares at NAV and no-load shares were the only two share classes that actually increased in prevalence as we moved from 2007 to 2008 and then further into the fourth quarter of 2008. Meanwhile, "A" shares sold at all commission levels made up just 19% of sales in 2008, and commissionable "A" sales declined as a portion of sales from 2007 to 2008, and then further in 2008's fourth quarter.

Share-Class Strategies for Distribution



Source: Strategic Insight 2008 Fund Sales Survey

Similar to our survey's findings regarding distribution channels, the sales by share class saw a Q4'08 rise in share classes used in fee-based programs. So the fourth quarter, the height of the financial crisis, only served to reinforce the underlying trend of sales shifting towards fee-for-advice structures. Obviously, budget pressures in the industry will make the allocation of distribution resources even more important as we move forward. We hope our recent research, and the new initiatives we plan, will help fund firms in that exercise.

Exchange-Traded Funds: Growth & Opportunity

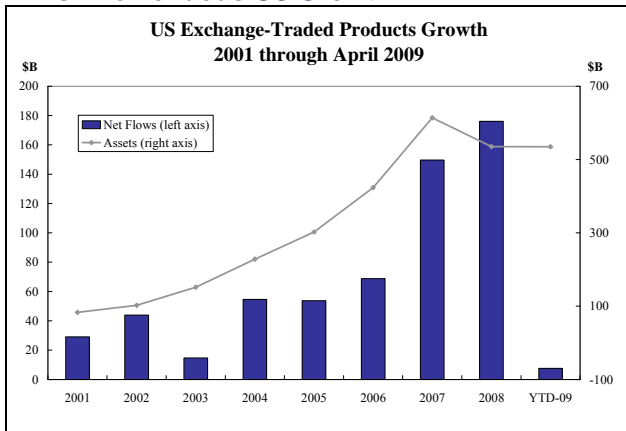


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Should investment management firms focused on active management pay attention to ETF growth?

ETF Expansion. There are many signs of ETF widening appeal. We're seeing gradual adoption of ETFs in packaged asset allocation products such as wraps or as alternatives to SMAs. Some VA providers are looking to substitute active funds with ETFs (or passive funds) due to their lower management fees and more accurate (and cheaper) hedging. Fee-only RIAs, early adopter of ETFs, are increasing their use of exchange traded products for their retail clients. New managers and distributors (e.g., PIMCO and Schwab) are planning to enter the ETF space. Slowly being introduced, actively managed ETFs may look more like traditional actively-managed funds. For some fund managers, ETFs look like a threat; for others, an opportunity.

ETFs' Tremendous US Growth



Source: Strategic Insight Simfund MF

The chart above shows the growth of ETFs (including ETNs) in the US since 2001. In 2008, we saw a record \$176 billion in ETF inflows, and in the first four months of 2009 an additional \$7 billion were (net) added to ETFs, as they held their flow gains in the very

volatile first few months of the year. At the end of April '09, US ETF assets topped \$534 billion.

Recapping why ETFs took in money in 2008: During stock and bond markets' extreme volatility last year, ETFs' flexibility, intraday trading, and shorting (or long) bets within a wide range of strategies, including non-stock market correlated ETFs, were very much in demand. The intraday tradability became more appealing amid the rise in market volatility. ETFs' tax efficiency, particularly for HNW clients in non-qualified accounts, and low fees, were appealing.

One of the reasons for ETF growth lately is the tremendous diversity of asset classes and strategies to which ETFs allow exposure. Three in four ETFs were launched since the beginning of 2006. These include a wide range of fixed-income ETFs, as well as ETFs providing leveraged exposure, commodity exposure, currency exposure, and more. For example, in just the first quarter of 2009, leveraged long and inverse ETFs took in a combined \$5.7 billion in net inflows. Today investors can build truly diversified portfolios out of just ETFs in a way impossible three or four years ago.

More opportunities. With the flowering of new ETFs and new strategies over the last few years, there was also a slight change in the market leadership. Since early 2006, Barclays Global's iShares has lost some market share, while new players focused on innovations joined in the top echelons of the ETF space (e.g., ProFunds, Van Eck). As the ETF market grows and diversifies further, it will become less concentrated over time, enabling a larger number of firms to become players of scale.

The Evolving ETF Competitive Landscape

April 2006 Market Shares		April 2009 Market Shares	
Firm	Market Share	Firm	Market Share
Barclays Global	59.3%	Barclays Global	49.4%
State Street Global	24.5%	State Street Global	24.9%
Vanguard	4.6%	Vanguard	9.6%
Bank of New York	2.9%	ProFunds	4.7%
PowerShares	2.0%	InvescoPowerShares	4.4%
Rydex	0.7%	Bank of New York	1.3%
First Trust	0.3%	Van Eck	1.2%
Total ETF Assets: \$345.6 Billion		Total ETF Assets: \$534.7 Billion	

Source: Strategic Insight Simfund MF

SI expects ETF assets to double over the next five to six years, eclipsing the \$1 trillion mark in the US alone. It is plausible for ETF flows in the coming five-plus years to reach half a trillion dollars, providing plenty of expansion opportunity for existing players, as well as possibly new players and new, innovative strategies. (SI offers many more details on ETF

competitive issues in our recent, for-sale report, [ETFs: Growth, Innovation, Competition](#). You can find out more about this comprehensive, 200-page study, including a Table of Contents, by clicking that link.)

Retail penetration. One of the factors driving ETFs' recent and future growth is a broadening of ETF distribution. These products started in the mid-1990s as mostly institutional vehicles. But now, based on our conversations with distributors, as well as big ETF providers, our best sense is that a little less than half of ETF assets are in institutional hands, including pension funds, hedge funds, and proprietary trading desks (as well as mutual fund PMs). Inversely, a little more than half of ETF assets are held by retail investors, which include self-directed individual investors as well as those investing in ETFs with the help of a financial advisor. New ETF sales seem to be skewing a little more heavily towards retail than to institutional.

Broadening of ETF Distribution	
▪	Our best estimate: 40% to 50% of ETF assets reside with institutions, including pension funds, hedge funds, prop trading desks, and mutual funds.
▪	Now: 50% to 60% of ETF assets reside with retail users, including FAs and the direct retail channel.
▪	But new ETF sales are skewing a little more heavily toward retail.
▪	We think about 70% of retail ETF use = substitute for individual stocks, SMAs

Even today, we estimate that maybe 70% of retail ETF ownership is mainly a substitute for investing in individual stocks or SMAs. But over the long run, we see ETFs becoming a little bit more of a substitution to actively-managed funds, and the recent financial trauma is going to accelerate that trend. Already some investors and financial engineers of asset allocation solutions are rethinking alpha versus beta, using ETFs for beta exposure. The same investors may use ETFs to diversify their portfolios with alternative strategies and reduce correlations to the stock market (ETFs offer easier access to alternative asset classes than a lot of other investment products do).

To take a different view on the fee-only RIA role, as part of our for-sale ETF report, we surveyed 85 RIAs who use ETFs. Of these ETF-friendly RIAs, 73% see a further increase in ETF use over the next two years. If you look in the table below, one-quarter expect *much more* use of ETFs over the next two years. Of course, the fee-only RIA world was early to adopt ETFs. But this may be another leading indicator of an investment management universe that continues to shift towards a

compensation model of fees-for-advice and away from point-of-sales compensation.

SI Proprietary Survey of ETF-Using RIAs

Over the next two years, you plan to use ETFs:		
	Response Percent	Response Count
Much more	24.1%	20
A little more	49.4%	41
The same amount	21.7%	18
A little less	2.4%	2
A lot less	2.4%	2
Total responses		83

Source: Strategic Insight Research

There are many trends that benefit passive funds, both traditional index funds and ETFs. Index funds use among DC plans is still much more widely spread than ETFs. ETFs do offer a wider array of investment choices (roughly 800 ETFs versus maybe 240 traditional index funds). There's some overlap of the index-fund and ETF audiences, but a larger portion of ETF use remains institutional and tactical. In terms of product diversity, it's more difficult to find index funds that provide exposure to commodities or currencies or frontier markets, for instance.

And the flow of new ETFs will only continue. We've recently seen the launch of more emerging markets ETFs, as well as leveraged fixed-income ETFs. In 2009, we saw actively managed ETFs take a step forward from rules-based/quant strategies to an approach more closely resembling traditional active fund management. "Active" ETFs could be a real hot spot, with Barclays Global, Claymore, PIMCO, and other firms filing with the SEC for the exemptions necessary to launch these products. If they prove successful, actively managed ETFs could be attractive vehicles for traditional fund firms to deliver active-management expertise in a different structure (which could appeal to new bases of investors).

Is the ETF world – in the US or globally – mature and product-saturated? Or, will there be opportunities for new players in the space as it grows to \$1 trillion and eventually much more?

Retirement Income, Insurance Guarantees & VA Development

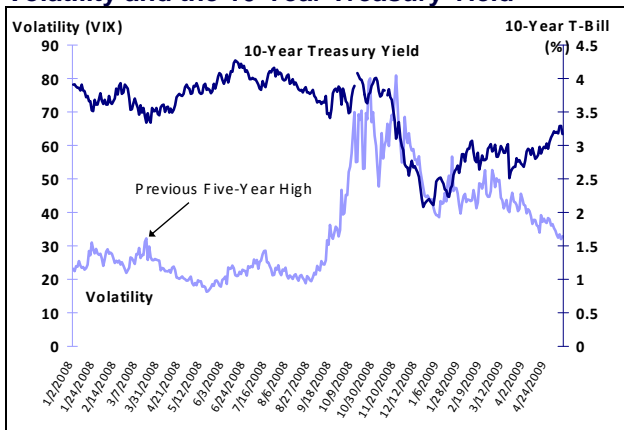


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Turmoil in the VA Market

The variable annuity market is in extreme turmoil. And for many people it's easy to misunderstand what's going on. What many advisors see is prices on variable annuity guarantees going up, and VA benefits getting scaled back; that's another opportunity for folks to say, 'Oh, it's the insurance companies and they're just trying to jack up the rates because they can.' But the insurers really do have to make those moves, because of what's been going on in the financial markets.

Volatility and the 10-Year Treasury Yield



Source: CBOE, U.S. Treasury Dept., Strategic Insight

The above graph illustrates the dilemma pretty well: The 10-year Treasury rate, which is the top line, had been relatively high and it dipped down. It's recovered somewhat, but it's still much lower than it had been. Meanwhile, volatility (as measured by the CBOE Volatility Index, which measures expected volatility in the S&P 500 index), the line at the bottom, has soared. It hit its previous five-year high, what seemed like a reasonable peak, in early 2008. But since around Sept. 21, volatility has left that previous five-year high in the dust. And volatility has yet to drop down to the level of

the previous five-year high. So it's been more than two quarters of such elevated levels of volatility.

But understand that in early 2008, when volatility was at its previous five-year high, insurance companies were saying, 'Our guarantees are not priced correctly for this market.' And it's true; they were not priced for an indefinite period of inflated volatility and sinking interest rates. We saw a lot of profit compression even back then.

So you can imagine what's happened to those profit margins lately, with volatility so much higher. Which leads to a major point: guaranteed retirement income is necessary, but it's very, very expensive to deal with.

Of course, things will return to normal at some point. But we will always remember this time. Actuaries have a very long memory. And we are seeing fundamental changes to the way the insurance business is being operated that is going to affect every product moving forward that contains a guarantee.

Economic Challenges

The cost of hedging the portfolios in VAs is related to the earlier Treasury yield/Volatility graph. Interest rates are low and they're volatile, and that makes swaps more expensive. The other thing is that we have protracted very high volatility, which drives up the cost of the options that underlie the hedging.

Economic Challenges of Equity Guarantees

- Basis risk:
 - Discrepancy between a portfolio's benchmark index/indices
 - Correlation spread tends to be worse during market drop vs. rise
 - Greater/different scrutiny of actively managed portfolios
 - Inclination to select index/ETF-based portfolios
- Cost of hedging:
 - Low/volatile interest rates → expensive swaps
 - Protracted very high volatility → expensive options

Another important challenge related to these equity-based guarantees is "basis risk." This is a problem because, as you may know, actively managed funds have a discrepancy between the benchmark index or indices and the actual performance of the funds.

Basis risk acted dramatically differently in how it materially affected many insurance firms. As a result, we are seeing increased interest in ETF-based or index-

based portfolios in the VA world. ETFs and index funds are predictable vehicles, and they can be hedged much more accurately than companies can hedge actively managed portfolios. We see that as a continuing trend as it's just much easier from a risk management standpoint to manage. Now, the industry may be overly conservative right now in pursuing passive investments and the pendulum may eventually swing back some. And certainly there are some options for adding more active management that is well hedged. But the greater use of index funds and ETFs is a permanent shift, even though we're not sure where the ultimate balance of passive and active will end up.

As for portfolios that will continue to use actively managed funds, insurance companies will view portfolio management of those differently. They may have much tighter restrictions on what's in them. Plus, the insurers are looking at a lot of turnover right now.

Then there will be long-term effects on the insurance industry. One of these longer-term effects is that there will be a smaller "active management" portion of the funds in a lot of cases. We're already seeing the beginnings of that in the new contracts coming out.

Economic Challenges of Equity Guarantees: Long-Term Considerations

- Underlying/associated investment composition
 - Less active management in some cases
 - More stringent constrictions on eligible portfolios
 - New approaches to investment limitations
 - More insurers may implement asset transfer programs (Prudential, for example) that shift some hedging to policyholders
- Guarantee design changes
 - Less rich
 - Focus on delaying use of benefits
- Renewed interest in life annuitization

There will be more stringent restrictions on the portfolios that are available. At the same time, the companies will have new ways of restricting the investments.

We'll also see more insurers adopt Prudential's "Highest Daily" guarantees' style of asset transfer, which shifts a certain degree of the hedging onus from the insurance company directly on to the investor. Prudential's approach uses an algorithm to determine the percentage of a portfolio that must shift into a fixed or a bond account. This reduces the amount of capital

that the insurance company has to hold. It allows Prudential to offer a richer benefit in one sense, because there is that hedging trade-off.

We haven't seen much of this so far. The only other asset transfer program of note is from Transamerica, in its *Retirement Income Choice 1.2*; for policyholders who don't use one of the available asset-allocation options, under certain circumstances funds move into a *ProFunds UltraBear* fund. But we think we'll see more asset transfer programs in the future.

As mentioned, guarantees are also changing. It's tempting to look at the sort of daily and weekly changes that we're seeing and assume they'll be temporary. But a lot of these changes are going to be permanent, or semi-permanent. There will be reduced percentages of guarantees. Insurance companies are simply not able to put as much risk out there, and that will affect benefits. We have noted more de-risking of benefits (reduction of the richness of features), increases to fee, and the removal of some benefits from the market. We've also seen the filing of new, simpler benefits.

In particular, we think there's going to be a lot more emphasis on delaying policyholder use of VA benefits, which is very helpful in terms of reducing the overall obligation. And insurers may introduce dynamic pricing, which allows the price to change without a step-up, new contribution or excess withdrawal.

Finally, we also see that there's a renewed interest in life annuitization (turning an accumulation of assets into a guaranteed-for-life income stream) among a lot of insurance companies – partly because of the relative risk of life annuitization. Previously, the growth of living benefits held back demand for life annuitization. But in the wake of the last few quarters, there's going to be some more thinking around life annuitization and different ways of integrating that model with the equity portion of investing.

The Future of Guaranteed Retirement Income

The industry is talking a lot today about the future of retirement income. Everybody is worried about what's going to happen. Frankly, having a financial collapse in a number of different sectors at the same time is pretty helpful in terms of reminding people that things can go disastrously bad and that there is a value to actual guarantees.

Also, longevity is a big deal. There's a lot of industry chatter about the fact that the retirement age of 65 is an artifact of a time when the average longevity was

actually 47 years. Set in motion many years ago, you were supposed to receive retirement benefits starting at age 65 (when people on average died at 47). Translate that 18-year difference into today’s life expectancy and no one would get retirement benefits well after they actually retire....

We can’t change the retirement age, but the entirety of retirement income solution is changing. That changes the appeal of various products, including the ability to turn on and off benefits, or to turn on and off withdrawals based upon changes in your life. Investors may not necessarily be retiring from work entirely, but they may just be shifting gears.

The current retirement-income solutions are not adequate to meet investor needs. And that doesn’t mean that the products today are inadequate to reach that goal. We actually could meet everybody’s needs with the products that are currently available. It’s a matter of preference, and a lot of advisors just don’t want to sell annuities for various reasons. A lot of smart people have developed some great products that are on the market today. But still, there’s a need to meet people where they are.

<p>The Future of Retirement Income</p> <ul style="list-style-type: none"> ▪ Heightened investor concern about risk: need for guarantees ▪ Increased longevity = continued need for equity investment ▪ Current solutions not adequate to meet all investor needs <ul style="list-style-type: none"> ▫ Adapt existing products to other realms (Standalone Living Benefits, or SALBs) ▫ Innovate new solutions
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That’s precisely why we’ve seen the adaptation of the existing benefits that are available on VAs to products outside of this retail market. Strategic Insight recently published a for-sale report on this trend, [Guaranteed Retirement Income Beyond Annuities: Standalone Living Benefits](#) (click on the link for more information, including a Table of Contents). Our 160+-page report is all about taking those living benefits off of annuities, and applying them to non-annuity assets, in particular individual mutual funds or managed accounts.

To briefly explain the Standalone Living Benefit (SALB): The most popular of the secondary guarantees on VAs right now is the Guaranteed Lifetime Withdrawal Benefits (GLWB), which allows the investor to withdraw a certain guaranteed amount every year, and if your portfolio gets completely

depleted, then you still get that guaranteed annual withdrawal. The SALB just attaches the GLWB to a mutual fund or separately managed account.

In the case of the SALB, the base that you’re working off of is an actual account that is held by the investor under the full control of the investor/advisor. So that money can be changed or moved or they can do different things. With SALBs, you withdraw money from your account, and once that account balance nears or reaches zero, that’s when you start to get your guaranteed payment. And people tend to like the flexibility and the fact that you can control the amount that you take out or don’t take out.

<p>Standalone Living Benefits (SALBs)</p> <ul style="list-style-type: none"> ▪ AKA “synthetic” or “unbundled” annuities ▪ Guarantee is insurance, “contingent deferred” annuity or certificate <ul style="list-style-type: none"> ▫ Registered and filed with both SEC and states, similar to VAs ▪ Insurance contract is separate from asset management <ul style="list-style-type: none"> ▫ Individual mutual funds or managed money, either managed portfolios using underlying mutual funds/ETFs, or SMA/UMAs

The SALB is not the most efficient way of providing lifetime income guarantees. Annuitization is more efficient because it leverages mortality credits, which are the benefits of pooling together the money of the people who die prematurely and those who continue living. The appeal of GLWB is related to control and liquidity, though, which people prefer with these benefits as opposed to typical annuitization.

We’ve had a lot of interest in SALBs from our clients, both on the asset management side and on the insurance side on these products. The SALB is not a price play. The potential appeal of this emerging product is more about reaching a different set of advisers, reaching advisers who won’t necessarily sell annuities. This is particularly salient in the RIA and independent broker/dealer markets.

The SALB is just one example, though, of how the industry is always innovating new solutions. There’s a lot of work that financial engineers can do to package products in a way that’s going to be powerful for the consumer and provide the lifetime income guarantees that they really need.

Fee-Related Analysis, 15(c) Considerations & Board Relationships



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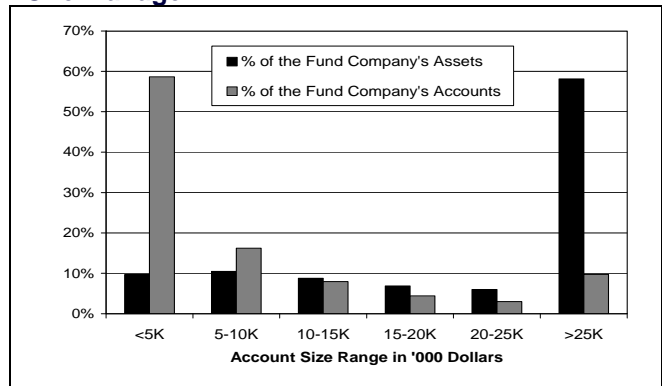
The stock market's sharp declines cut average account sizes dramatically for many retail stock funds, triggering a spike in such funds' TA fee-ratios and thus overall total expense ratios (TERs). To put the 2009 rise in equity funds' fee ratios in context, asset levels of many such funds are half the size they averaged in 2008. The S&P 500 Index was down about 37% last year and down another 11% in 1Q (by late May it had recovered to yield about flat returns for YTD 2009). The stock market's decline lowered the average retail equity fund account size to about \$10,000, down from around \$16,000 before last summer (the median equity fund account size today is significantly smaller).

Beyond the impact of shrinking shareholder accounts (triggering an increase in TA fee ratios), 2009 also witnessed a rise in other non-management fee ratios (as fixed dollar costs were spread over much smaller fund assets, or AUMs). Also, for funds with management fee breakpoints in place, a small increase in TERs has also been observed in the past year due to falling AUMs and breakpoints 'working in reverse'.

Some of this material is also covered in our recent *Executive Insights* report, [Emerging Considerations in Fee-Related Analysis and Advisory Contract Renewal 15\(c\) Discussions in 2009](#), which is available to SI research clients by clicking on the link.

The following chart presents a profile of average retail account sizes for one fund manager. A similar pattern of high proportion of tiny accounts may occur also at some other firms. This example's distribution of account sizes and high proportion of tiny accounts, though, is atypical in the industry; most fund managers have, on average, a larger proportion of bigger accounts. But this example shows one truism of mutual funds – the "mutualization" of fund fees – whereby larger accounts subsidize the high costs of the smaller-sized accounts.

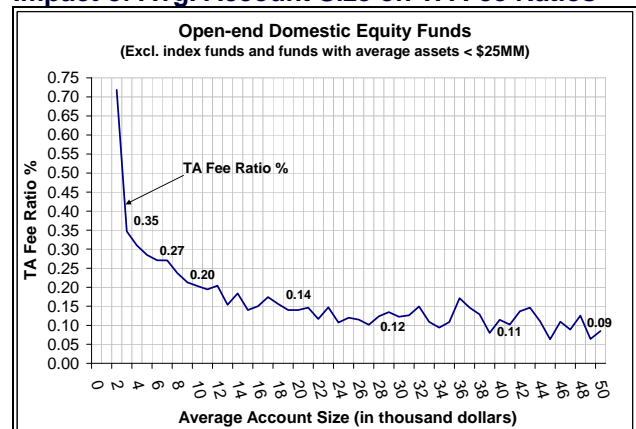
Distribution of Fund Account Sizes: Pattern at One Manager



Source: Strategic Insight Research

In the example above, only 10% of company assets were held among almost 60% of accounts. For these small accounts, costs were subsidized by the larger accounts represented by the bar on the far right showing the prevalence of account sizes greater than \$25,000.

Impact of Avg. Account Size on TA Fee Ratios



Source: Strategic Insight Research

Transfer Agency Fees. Because average account sizes of actively managed equity fund accounts have gone from roughly \$15,000-\$16,000 to about \$9,000-\$10,000 today, the effective TA fee ratios have spiked. Using such account size averages would imply TA fee ratios on average rose from 16 basis points to 21-22 bps; for many funds with higher proportions of smaller accounts, the spike could have been noticeably higher.

The line chart above illustrates the rise of TA fee ratios triggered by the drop in average account size. Many funds experienced lately 5-6 bps increases in TA fee ratios (others funds' fees rose even more), which in turn pushed total expense ratios higher.

Some fund firms focus on the excessive costs of tiny accounts by charging a small account fee (which is paid back to the fund itself). For example, Vanguard may charge a \$20 fee for accounts holding less than \$10,000 (the fee gets waived if the shareholder meets various requirements, such as receiving all communications electronically, or having a total of \$100,000+ invested across all Vanguard accounts). At other firms, certain individual funds charge small-account fees even though their fund complexes do not. Often the advisor has the option to liquidate the account if it is very small (some funds have explicit prospectus language allowing them to shut down tiny accounts).

The rise in TA fee ratios, in other non-management fee ratios among small funds, and the small increase in management fees for funds with breakpoints in place, all add up to expense ratios at many retail-focused equity funds in 2009 rising by 10 bps or more above their average TERs in 2008.

Rising TERs and Expense caps. There are many funds that have expense caps, usually on total expense ratios but sometimes on TA fees. Other funds with all-inclusive fees have in effect a cap on TERs. Still other funds who try to keep their 2009 TERs at the “median” of a peer group’s TERs, based on latest available (but somewhat stale) 2008 data also in effect have to deal with a capped TER.

Thus, many funds’ management and Boards are wrestling with how to manage expense ratio caps through reimbursements, on top of having AUMs, fee revenues, and advisor profitability cut dramatically.

Funds with Expense Caps:
<ul style="list-style-type: none"> ▪ On TERs, or TA Fee Ratios, in all-inclusive fee ratios; or managing 2009 fund TERs to be in-line with the median of 2008, ‘stale’ TERs within an expense peer group ▪ Collapsing equity fund AUMs reduced profitability dramatically; fee reimbursements on top of such decline worry virtually every advisor and trustee ▪ Expense caps add to profitability pressures; an extra 10-15 bps reimbursement is very costly (esp. for a large fund) ▪ Early responses, by some advisors and Boards: remove or relax expense caps, recapture arrangement; more to come

Should the advisor reimburse money to the fund in this environment – reimbursing what may amount to 15 bps – to stay at the expense caps? In some cases, and especially with small managers, maintaining existing

expense caps through reimbursements may force the advisor into running its business at too-low profitability or even at a loss.

One example of a manager dealing with this issue is American Funds. American had been waiving 10% of their management fee on an ongoing basis, and now they have stopped waiving those fees.

We’re seeing a number of funds where the board has concluded that a relaxing of the expense caps or the eliminations of expense caps altogether is appropriate. In a few cases, some boards have introduced language enabling “recapture” of expense waivers.

Expense Peer-Group Benchmarking. The expense-cap issue is made thornier for the many advisors (and fund boards) that use expense caps to position their funds’ expenses to be at the “median” charged by peers. This approach may work out when fees don’t really change that dramatically and assets are relatively consistent year-over-year. But this year, funds are dealing with having to compare their own spiked current expense ratios with peer expense ratios using 2008 data (based on much higher AUMs during all of last year or even during late 2007). So the timing lag in available data creates another challenge.

This is an issue that is cropping up in 15(c) reviews this year, because they traditionally look at latest (and audited) data available, which is updated through fiscal-year 2008. Funds are benchmarked versus similarly invested funds with comparable assets under management “on average” during the funds’ latest fiscal year – averaging the previous year’s total net assets. But the current asset levels of most funds are dramatically lower than what they averaged during the funds’ latest fiscal year.

As a result, SI created analytics providing a “hypothetical TER” for 2009 for a “target” fund’s peers (using peer funds with AUMs during their fiscal 2008 similar to the target fund’s AUM today; and tweaking such peer fund TERs by “adding back” to each an estimate of the likely increase in that fund’s TA fee ratio.) For some advisors and fund boards we suggest the consideration of a supplemental fee analysis – outside of the actual 15(c) report, and along the parameters just outlined – in particular for funds that have shrunk dramatically in size (and, for these funds, we propose using current assets and current realized management and non-management fees).

Global Perspective: A World of Ideas & Opportunities for Funds



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Why 'Global' Matters to US Firms

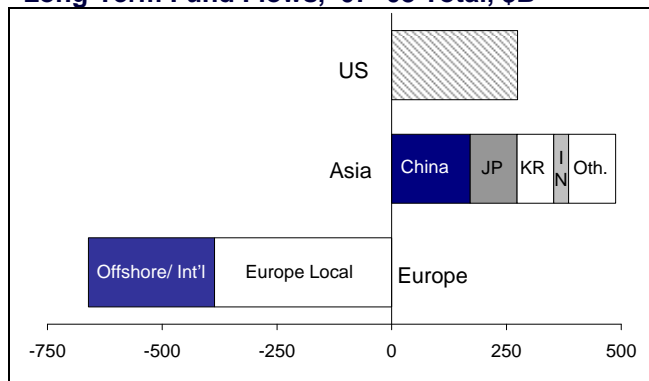
The larger mutual fund world is quickly becoming more important to US managers who in the past benefited from ample growth avenues at home. Gains are now harder to come by domestically, while new product, distribution, and asset gathering opportunities are arising elsewhere.

Globally, the biggest new fund launch in 1Q09 was in Japan (the Nomura US High Yield Bond Fund, which raised \$3 billion). The fact that it was a *US bond* vehicle suggests that other US bond specialists might find new audiences in Japan and elsewhere in coming years. Japan has already proven to be one of the largest yet unrecognized and misunderstood marketplaces. For all the talk of Japan being a challenge for foreign firms, we found \$100 billion in assets raised by international money managers in Japan in recent years, through fund-of-funds, subadvisory, and other conduits.

The global opportunities vis-à-vis the US are not an aberration or a recent phenomenon. The biggest fund launch of 2008 was in Germany, with the second-largest being in Japan. In fact, among the top new fund launches worldwide last year, funds in the US were hardly visible. In 2007, the world's biggest fund launch was a \$6 billion fund in China, and many of the (smaller!) \$4 billion QDII Chinese products that year were advised by international and US-based money managers. China has shown better than expected resilience in the past year, and many new funds there continued to gather assets through Q1 '09, followed with a \$2 billion offering from Changsheng in May.

While some US managers continue to benefit from global expansion, others have barely participated up to now. Beyond new funds, the overall direction of net inflows has shifted significantly to Asia. Combining 2007 and 2008 flows shows half a trillion dollars going into funds in Asia, exceeding US flows considerably.

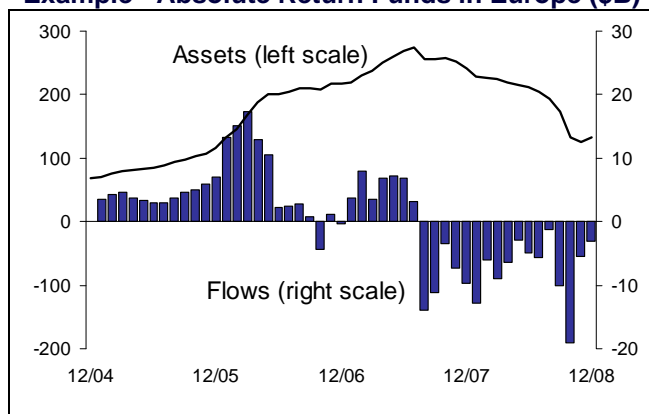
The Shifting Global Mutual Fund Map: Long-Term Fund Flows, '07-'08 Total, \$B



Source: Strategic Insight Simfund GL/MF

Beyond the sheer volume of business globally, another reason for money managers to think more broadly are lessons and innovations that can be applied in one's home markets. An example is **the absolute return story**. SI has tracked this category for the last several years in Europe. It has not been a theme in the US mutual fund space until some buzz about the concept emerged in recent months (with some concerns from regulators about mis-selling of such funds). Absolute return funds in Europe drew assets through 2006, but experienced net outflows since early 2007.

Avoiding Mistakes and Adapting Ideas: Example - Absolute Return Funds in Europe (\$B)



Source: Strategic Insight Simfund GL/MF

What are some of the lessons from the experience in Europe? Most absolute return fund managers faced severe challenges when the return expectations embedded in such

products proved unrealistic, as implicit promises failed to deliver. This hurt many money managers’ brands (although some have found renewed appeal with “absolute return” in the current environment, especially in the UK).

Another change: in the past, it was believed that developments in the US industry would later appear in Europe and Asia. Now at times the reverse occurs; ideas, products, and strategies get rolled out across multiple markets worldwide by firms with a global footprint. Successful elsewhere, these are later introduced in the US. In addition to the absolute return funds mentioned above (which may soon be appearing in the US), other examples include a climate change fund by DWS and an allocation fund by UBS “imported” from Asia and Europe.

A third point on why “global” matters: Nearly everyone we talk to expects that Asia will be the center of gravity for asset management in the future. What are the investment implications of that? What kinds of funds are Asian investors buying? And how will the money flow impact investment returns and money managers everywhere?

Blockbusters Still Exist

Fewer managers are experiencing extraordinary inflows lately. Yet, amid lower industry-wide flows, many themes *are* still working around the world, from Nomura’s recent launches in Japan, to cross-border international funds on distribution Select Lists, to PIMCO’s Total Return Fund in the US (and elsewhere in part due to the influence of the firm’s leadership).

The Billionaires’ Fund Club: Funds That Gained Over \$1 Billion During 2008

No. of Funds (Underlined) and Flows (\$B) by Region & Type, 2008					
<i>Excludes Money Market Funds</i>					
	Equity	Mixed	Bond	Other	Total L-T
Europe (Local)	<u>7</u> 12.9	<u>3</u> 5.0	<u>8</u> 22.3	<u>11</u> 17.2	<u>29</u> 57.4
Offshore	<u>16</u> 31.1	<u>1</u> 3.3	<u>5</u> 8.1	<u>1</u> 1.1	<u>23</u> 43.6
Asia	<u>8</u> 16.4	-	<u>18</u> 31.9	<u>1</u> 1.2	<u>27</u> 49.4
US*	<u>79</u> 205.4	<u>2</u> 2.3	<u>30</u> 85.9	-	<u>111</u> 293.7

* US data exclude ETF UIT/Other and all 529 Funds of Funds

Source: Strategic Insight Simfund GL/MF

The observations in the table above are just a few of the many blockbuster funds out there still in great demand. While aggregate flow numbers are modest, these aggregates should not be used as an indication of poor opportunities for all. Note, for example, that during the extraordinary 2008, 190 long-term funds each attracted more than \$1 billion in net inflows.

Those funds together collected nearly \$450 billion in inflows.

Being Proactive, Using Data

Fund executives and board members in some cases are now at odds over what to do and how much of their resources to commit internationally. A needed reaction for some firms (in the US and Europe) is to pull back, focus on core businesses, and preserve resources. Yet some companies instead are stepping forward and being more assertive and opportunistic.

Recently at a conference, a CEO from Asia made the point that too often firms make the mistake of launching at the peak (when costs of people, operations, and real estate are highest) and then pulling out just when it matters most to distributors and the overall relationship. An example suggested was China, where many firms entered in 2007. Yet today, while some firms are pulling back, many talented people with desired skills are available, and costs of operations are lower.

By understanding the shifting landscape better, and **by embracing granular data and research with a strategic time-horizon in mind, firms can gain an advantage which could serve as a foundation for future expansion.** Some of SI Global’s clients actually undertake a deeper research commitment and are seizing openings around the world by leveraging such information.

One way for your firm to facilitate such organizational knowledge and opportunistic action is by breeding “creative data analysts”, a data-driven team working closely with global sales and the CEO to provide fresh and innovative ways to monitor and use data and competitors.

(For a more in-depth discussion on these themes, see SI Global’s book on Global Fund Distribution and our ongoing detailed international commentaries on www.GlobalFundDistribution.com)

SI Forum Photos

Strategic Insight's own Jeffrey Hutton, who works in our Annuity Insight team, is also an accomplished photographer. Here are a few of the photos he took during our SI Forum in New York on April 6, 2009.



(L-R): Andrea Trachtenberg of Ivory River Group, Steven Miyao of kasina and Beth Segers of Empirical Research talk during a break at the SI Forum.



Richard Hein of Eaton Vance and Marco Hanig of AQR Capital share a laugh.



William Rittling of MFS and SI's Tamiko Toland, Editor of Annuity Insight, talk during a break.



Avi Nachmany, EVP & Director of Research, addresses the Forum, reviewing key industry trends.



SI Research Analyst Dennis Bowden presents.