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WINDOWS

Into the

Mutual Fund Industry

September 2009

Q4 2009 & 2010 Perspectives, Strategic Insight 2.0

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- **In this edition:** Improving sentiments among investors in US and international mutual funds; evolution in lifecycle mutual funds; fund advisory fee structures and investment management firm profitability; distribution trends among national BDs, RIAs, and the IODC channel; the dynamic ETF marketplace; a brightening mood in the VA space; and the unique process behind Simfund's cash flow data – these are just a few of the themes in this expanded Windows edition.
- **SI recent initiatives:** Expanded and **frequent Webcasts;** a nationwide travel **schedule to visit many of you in the coming months; continuing to hold live client conferences that provide opportunities for ideas and networking;** and a new **joint research initiative with Coates Analytics –** see a preview of this unique, **subscription-based quarterly report series** on Page 17, offering competitive benchmarking and actionable information on the $200 billion+ sales opportunities in National BDs.
- **Planning ahead to 4Q and 2010:** a few highlights:
    - **Bond fund net inflows could exceed $300B in 2009. High demand for bond funds should persist into 2010,** thanks to very low short-term interest rates, a steep yield curve, corporate bond investment opportunities, incorporating global income into bond vehicles, and more. There is $10 trillion+ in near zero-yield cash instruments that will be searching for income enhancements over the coming years
    - **If we assume that modest economic improvements continue, then diversification into international equity funds (and away from US Dollars) will accelerate in the coming year**. From 2003-07, investors shifted $2 trillion+ from US securities to international stocks. That trend – which paused in the past year – is resuming, as evidenced in recent months.
    - Active fund management has benefitted from the dramatic dislocations lately, as "active" funds have drawn more flows in 1H 2009 than passive products. We assume **the advantage of actively managed stock funds (and credit analysis in bond funds) continues in the coming year.** That said, packaging of passive funds and ETFs also will expand.

Strategic Insight 2.0:

Many of you congratulated us on the recent partnership we have established with a new parent company, Asset International ("AI"). SI joined AI's other prominent industry brands, including PLANSPONSOR, PLANADVISER, Global Custodian, ai5000, and The Trade. This relationship will help SI grow further and provide more resources to help your organizations succeed and become stronger in the coming years. AI's CEO Jim Casella became the new CEO of Strategic Insight, succeeding our pioneering founder Joel Rosenthal, 71, who has announced his retirement.

What this means for you:

- SI's entire staff continues with the firm, and will be led by the same dedicated management team you have come to depend on, including more than a dozen executives who have spent 10 years or more at SI.
- The growth-oriented transaction will result in additive synergies. The combined organization will leverage the retirement-plan expertise of PLANSPONSOR and PLANADVISOR for valuable retirement-focused services for fund firms. The SI Global research presence will expand to Europe and Asia in 2010, to better serve non-US clients and the non-US arms of US clients.
- SI has modestly expanded its staff in the past year, which now number more than 70, and will continue to invest in people and technological resources to ensure the quality of our service to you is improved.
- SI remains an independent unit of AI, headquartered in New York City. Strategic Insight retains its distinctive brand identity, as well as our core mission of helping each of our clients in the US and globally, while also supporting the mutual fund industry overall.

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Trends in the First Half of 2009

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Fund Industry Overview
(Excludes ETFs and VA Underlying Funds)

	Net New Flows $B			
	2007	**2008**	**Q1'09**	**Q2'09**
US Equity	-33.1	-137.7	-30.0	25.1
Int'l Equity	176.9	-57.2	-15.3	16.6
Total Equity	**143.8**	**-194.9**	**-45.3**	**41.7**
Taxable Bond	94.2	17.1	39.4	65.2
Muni Bond	8.9	4.2	11.1	16.7
Total Bond	***103.1***	***21.3***	***50.4***	***81.9***
Total Equity & Bond	**246.9**	**-173.6**	**5.2**	**123.6**
Money Market	650.5	604.4	-17.2	-159.9
Total Industry	**897.4**	**430.8**	**-12.1**	**-36.3**

Source: Strategic Insight Simfund MF

During the first half of 2009, equity fund flows registered modest net redemptions. But, as suggested above, the flow recovery in Q2 was dramatic, and the small inflows to stock funds persisted in most summer weeks. The Q2 equity inflows were split about 60/40 domestic to international equity funds, a change from most of the past six years. In recent months and through August, international equity funds once again outdrew US stock funds in net flows. (For more on international funds, see page 7.)

Bond fund inflows hit all-time monthly highs in both April ($25.2 billion) and again in May ($30.2 billion). In 1H 2009, a cumulative $133 billion poured into taxable bond funds. If one includes July and August flows, and adds inflows to VA bond funds, bond fund aggregate net inflows so far in 2009 have eclipsed $200 billion, and could easily exceed $300 billion for all of 2009. Of 1H 2009 net inflows, $51 billion, or 39%, went to short, short-intermediate, and intermediate investment grade portfolios – as many investors sought stable but higher-yielding investments than available in money funds. Municipal bond funds also enjoyed record inflows so far this year; as with taxable bond funds, most muni flows, or 71% in 1H 2009, went to short/intermediate muni funds.

Investors withdrew a cumulative $247 billion from money market funds from February to June (excluding January's $ 69 billion inflow), as individuals sought higher-yielding asset classes.

Following the stock market/economic turmoil of the past year, high-tracking-error investments proved superior to index funds in '09. With a slightly positive 3.16% total return for the S&P 500 in 2009's first half, **the average domestic equity fund investor handily beat the index with a 6.8% gain** on an average asset-weighted basis in 1H'09. Through the end of July, actively managed US equity funds outperformed the S&P 500 by about 500 basis points.

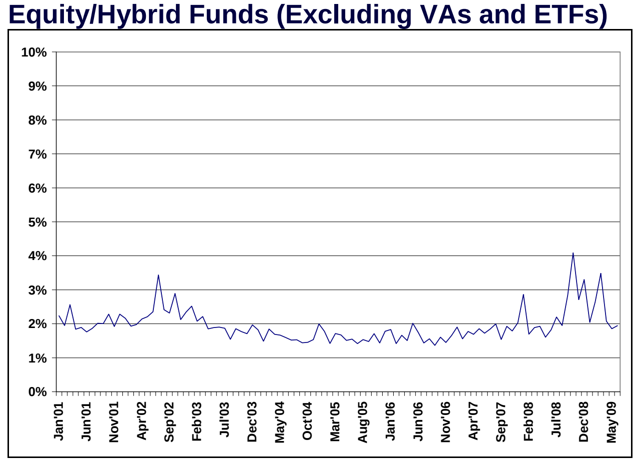
Average Asset-Weighted Annualized Returns %

	2006	**2007**	**2008**	**1H 09**
Domestic Equity *	14.1	7.1	-36.9	6.8%
Int'l Equity	24.2	16.3	-41.9	12.7%
Taxable Bond	5.4	5.7	-5.1	7.6%
Muni Bond	5.1	1.2	-9.0	8.4%
Money Market	4.4	4.7	2.3	0.2%

** Includes hybrid/allocation funds. Sources: Strategic Insight Simfund MF; Morningstar. Data excludes Funds of Funds*

Although the worst seems to be over, financial pressures on the middle-income investors that anchor the mutual fund industry have not abated. Worries about the economy, employment and inflation remain. Naturally, the pace of new equity fund investments has been slow, only modestly picking up in recent months. While the sales pace remains moderate, the pace of stock fund redemptions fell to its normalized pace. As we have noted before, redemption spikes, as recently evidenced, tend to be short-lived.

Redemptions as a Percentage of Assets Equity/Hybrid Funds (Excluding VAs and ETFs)



Source: Strategic Insight Simfund TD (ICI Trends)

Equity / Hybrid Funds: Active vs. Passive (excl. VAs)	Net New Flows $B		
	2007	2008	1H 09
Actively Managed Funds	98.7	-235.0	-22.5
Index Funds (non-ETF)	45.1	40.1	18.7
ETF Open-End Funds	90.9	96.3	22.5
ETFs structured as UITs / Grantor Trusts / ETNs /Other	43.4	56.9	-12.1

Source: Strategic Insight Simfund MF

Equity index and exchange-traded funds continue to draw institutional and individual investors' interest. On the bond fund side, both actively and passively managed bond funds have attracted high inflows, though actively managed funds to a far greater degree.

Bond Funds: Active vs. Passive (excl. VAs)	Net New Flows $B		
	2007	2008	1H 09
Actively Managed Funds	85.1	11.0	125.0
Index Funds (non-ETF)	18.0	10.4	7.7
ETF Open-End Funds	13.1	22.5	24.5

Source: Strategic Insight Simfund MF

Funds with Highest Inflows: Some Risk-Return Characteristics

While the decision to invest in a particular fund or with a particular fund manager is the result of numerous factors, SI has observed that **trailing three-year rankings, within the fund's investment style and on both relative-return and relative-risk dimensions, offer explanatory and predictive value for 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. **The first half of 2009** was another period for which the top-left quadrant of such graphs housed the highest-inflow funds (even when many such funds experienced losses during the trailing three years). Beyond relative performance, we note that with the fund industry starting to recover, trailing three- and five-year performance may soon be even more significant in marketing funds.

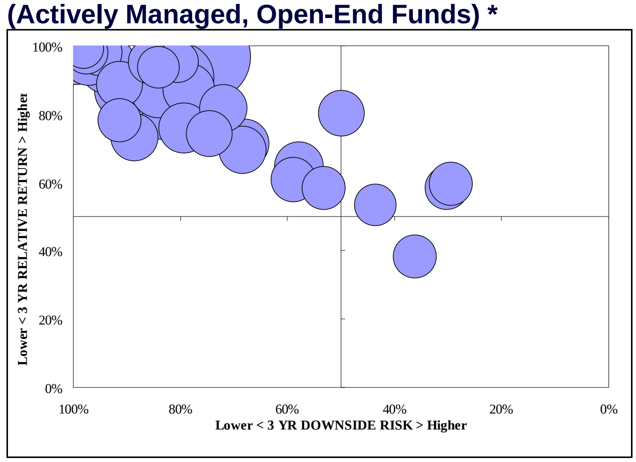
As an illustration of 1H 2009 cash flow results, we capture below the "trailing three-year risk-return vs. cash flow bubbles" of the industry's 40 highest cash flow funds during 1H 09 (risk and return measured within each fund's Lipper investment classification).

Simfund subscribers can easily replicate these graphs for their peer funds (and can run such graphs within the funds' Morningstar category as well). Note that **bubble size corresponds to 1H 09 net inflows**.

The individual funds in the bubble charts clearly share appealing risk-return characteristics for the 36-month period ending June 2009. The few outliers are funds offered by well-respected managers benefiting from a "halo" effect, somewhat unique hard-to-classify funds, or those reflecting strong performance in periods prior to recent years. In the bond area, some funds with high relative yields (but below-average relative returns) experienced high net inflows in 1H 2009.

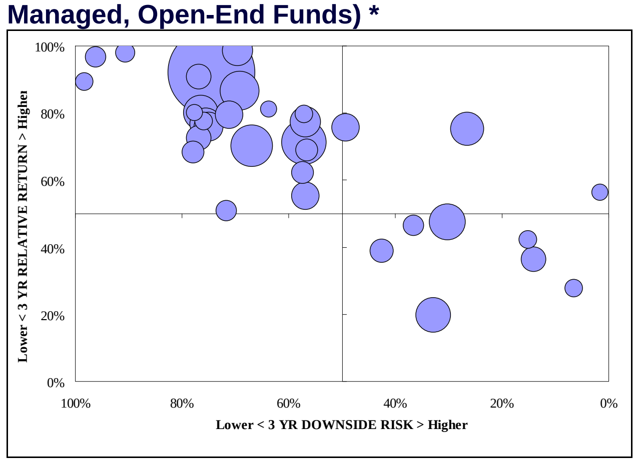
Risk-Return Characteristics of Best Selling Mutual Funds in 1H 09

Highest Net Inflow Equity Funds in 1H 09 (Actively Managed, Open-End Funds) *



**YTD 06/09 Flows and 3-Yr. Risk/Return Analysis within Lipper Classifications; Source: Strategic Insight Simfund MF*

Highest Net Inflow Bond Funds in 1H 09 (Actively Managed, Open-End Funds) *



**YTD 06/09 Flows and 3 Year Risk/Return Analysis within Lipper Classifications; Source: Strategic Insight Simfund MF*

Global Trends: Industry Rebound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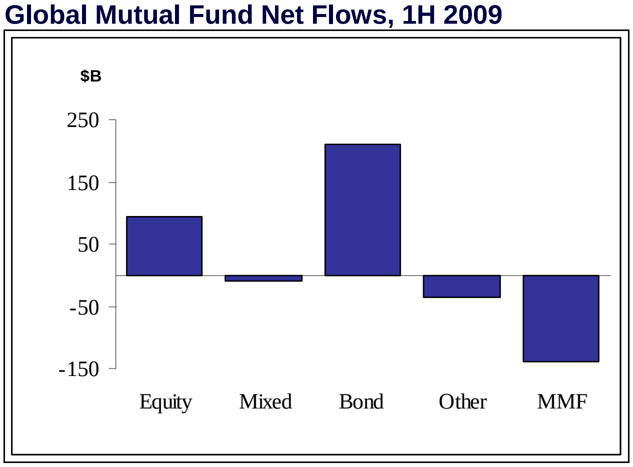
Best Global Net Inflows in More Than Two Years

The first half of 2009 saw the global mutual fund industry stage a dramatic rebound, as $295 billion flowed to stock and bond funds in the US, Europe and Asia. The best performance for stocks in any quarter since the late 1990s helped draw investors cautiously back into investments, resulting in the highest net inflow numbers for stock funds in over two years. Yet, a little more than two-thirds of positive flows globally went to bond funds. Money Market mutual funds were in net redemptions.

Global Mutual Fund Net Flows, 1H 2009



Source: Strategic Insight Simfund GL, MF, VA.

While investors remain cautious, Simfund Global data shows steady demand for bond funds and stand-alone balanced funds. We assume traditional sales of stand-alone equity and bond funds will persist globally in 2H'09 and into 2010, as the secular transition to asset allocation wrapped solutions only slowly returns.

Yet, over time, a greater focus on **asset allocation, portfolio construction and advice** globally provides opportunities for innovative independent asset management firms that commit to expansion and international diversification.

Categories: Bonds & Back to Basics

In Asia and Europe, fixed-income funds did well (not surprisingly), and there was also a shift to "back to basics" products, such as regional equity and bond funds, away from more complex fund categories.

In Asia, flows to the best-selling categories easily outpaced outflows from the worst-selling. Asia Pacific equity and fixed income, including high yield, garnered $20 billion, compared with $12 billion in outflows from the weakest flow styles.

Best & Worst Selling Long-Term Fund Categories in Asia by Net Flows, 1H 2009

Best Selling	Net Flows, $B
Bond High Yield	8.7
Bond Asia Pacific	5.8
Equity Asia Pacific	5.3
Total Above	**19.8**
Worst Selling	**Net Flows, $B**
Bond Global	-7.0
Mixed Conservative	-4.0
Mixed Balanced Flex	-0.7
Total Above	**-11.7**

Source: Strategic Insight Simfund GL.

Contrastingly, in Europe, $61 billion in outflows from the worst three categories (mostly hedge and guaranteed themes) were nearly one-third higher than the roughly $46 billion going to Europe fixed income, emerging markets equity and Europe equity.

Best & Worst Selling Long-Term Fund Categories in Europe by Net Flows, 1H 2009

Best Selling	Net Flows, $B
Bond Europe	17.9
Equity Emerging Markets	14.3
Equity Europe	13.4
Total Above	**45.7**
Worst Selling	**Net Flows, $B**
Hedge	-43.6
Guaranteed/Protected	-11.3
Mixed Conservative	-6.2
Total Above	**-61.1**

Source: Strategic Insight Simfund GL.

The Billionaires' Fund Club, Updated

The top selling products in Europe and Asia encompass a range of funds and managers succeeding thus far in 2009: As shown in the following tables, the top five long-term funds raised $14 billion in Asia and $20 billion in Europe, respectively. Worldwide (including the US), 85 long-term funds were part of this year's 1H Billionaires' Fund Club: those funds with over $1 billion in 1H inflows. They included diversified investment solutions, balanced products, guaranteed investments, fixed-income, and thematic products.

High-profile fund launches dominate Asia success stories: Among the best selling new funds were two installments of the Nomura US High Yield Bond Fund—the newest of which is sub-advised by JP Morgan and, like its predecessor, was recently closed to new investments over liquidity concerns stemming from high inflows since its May launch. (Nomura is said to be considering a third installment.)

Beyond Nomura in Japan and China's Changsheng Tongqing Divisible Fund, we saw greater activity in Southeast Asia from India managers like Birla Sun Life and IDFC. Those two managers pulled in roughly $3 billion and $2 billion in flows to their Bond Asia Pacific funds, respectively. The funds invest in securities and money market instruments, advertising liquidity through brief investment horizons. Though they are offered to both retail and institutional investors, they seem to attract most flows from institutional clients.

Asia: Top-Selling Long-Term Funds 1H 2009, in US$ Billion

Portfolio	Domicile	Net Flows
Nomura US High Yld Bd Fnd*	Japan	**4.4**
Nomura New US High Yld Bd Fnd*	Japan	**2.7**
Birla Sun Life Svgs Fnd-Rtl Growth	India	**2.7**
Changsheng Tongqing Divisbl Fnd	China	**2.2**
IDFC Money Mgr Fnd-Treasury	India	**1.9**
Total above		**13.9**

**Combines the various currency-linked versions of the fund*

Source: Strategic Insight Simfund GL

In Europe (including offshore-domiciled funds), boutiques and corporate UK fixed income products led European flows. Europe offered a distinct picture with magnet products from Carmignac, BlueBay, Schroder, M&G and PIMCO in the top five. Carmignac epitomizes the high-profile boutique fund firm with cross-border appeal and well over $6 billion in net flows this year alone (after more than a decade of existence with less than $1 billion in AUM). Holding the fifth slot in the below table, PIMCO (whose Total Return Fund was by far the best-selling fund in the U.S. in the first half of 2009) is extending its brand in Europe with its GIS series.

Europe/Offshore: Top-Selling Long-Term Funds 1H 2009, in US$ Billion

Portfolio	Domicile	Net Flows
Carmignac Patrimoine	France	**6.6**
BlueBay Investment Grade Bd Base	Lux	**5.3**
Schroder ISF EURO Corporate Bd	Lux	**3.2**
M&G Corporate Bond	UK	**2.9**
PIMCO GIS Global Inv Grade Crdt	Dublin	**2.1**
Total above		**20.1**

Source: Strategic Insight Simfund GL

In all, some 128 funds in Europe and Asia drew over $500 million each in net new flows in 1H 2009. Among the managers of these funds, Nomura had success with its US High Yield Bond series and equity sector funds; Prudential PLC saw particular success with UK fixed income funds; DWS saw flows to guaranteed/protected and target-maturity funds; and four of Barclays' five bestsellers were Dublin-domiciled ETFs.

Characteristically, new product development played a greater role for asset gathering in Asia than in other regions. Out of the 31 funds launched in 2009 that each drew $500 million or more in net new flows year-to-date, 20 were domiciled in Asia. Within June launches alone, nine new funds drew $500 million or more in net new flows—all were from China, Japan, or Korea, and eight of which were fixed-income funds.

Product introduction and innovation will continue to affect industry direction and evolution, and will in turn be shaped by the many changes now taking place to better meet client needs. In recent years, the clear majority of annual global fund flows have gone to less than 1% of investment vehicles worldwide, often new products with an appealing investment theme and story. The financial crisis has accelerated the concentration of contributions to fewer products and a loss of investor confidence in banking has triggered a shift back to basics and emphasis on independence and simplicity. How companies rationalize existing product lines and, even more importantly, which funds are being introduced now will influence the future of the fund industry globally.

International Funds: 1H 2009 Update

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US-Based International/Global Equity Mutual Funds $ Billion

Structure/Type	Assets 6/09	Net Flows 2005	2006	2007	2008	1H 2009
Open-end Active	**1,001**	**118**	**148**	**140**	**-69**	**-2**
Open-end Indexed	67	9	13	18	11	3
ETFs*	145	23	27	46	19	15
Closed-End	28	7	3	19	0	0
VA Funds	1,021	23	34	36	-14	4
Total	2,263	180	225	261	-53	19

*Source: Strategic Insight Simfund MF / VA. *ETFs include UIT and open-end ETFs*

International / Global equity funds outdrew domestic equity funds in the first half of 2009, with net inflows, excluding VA funds, of $15 billion. That flow advantage for international funds over US stock funds grew in the July-August period.

As the table above shows, in 2008 and continuing into 1H 2009, passive products, principally ETFs, dominated the flows for US-domiciled international equity funds. In recent months, though, "active" international equity fund flows dominated.

Through 1H 2009, international equity funds again out-earned US equity funds (on average), a pattern displayed from 2003-07. Such outperformance is likely to persist if the dollar declines further, and with inflows once again propelling international stock markets (especially emerging markets) higher.

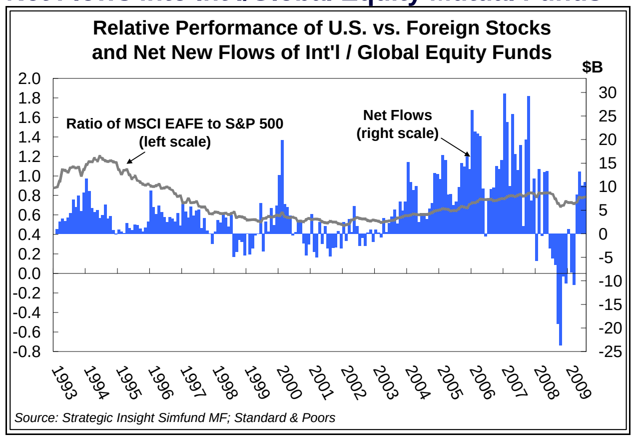
Int'l Equity , US Equity, and World Bond Funds Annual Average Total Returns (Asset-Weighted)

	'04	'05	'06	'07	'08	1H 2009
U.S. Equity*	12.37	7.87	14.08	7.21	-37.96	6.79
Int'l/Glbl Eqty	18.52	16.01	24.20	16.27	-41.95	12.69
World Bond^	8.95	-2.09	6.62	8.93	0.27	4.92

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

Flow trends, and the relative performance of the MSCI EAFE Index vs. the S&P 500 Index are captured in the chart that follows. Note the outperformance of the EAFE and the recovery of inflows since April 2009.

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



Source: Strategic Insight Simfund, Standard & Poor's

Recent returns in international markets helped spur net inflows to international/global equity funds. A rise in confidence in Q2 also encouraged US investors to resume the international diversification of portfolios that we have seen in the past few years.

Several of the top actively managed international/ global equity styles for 1H 2009 were emerging markets-like in nature, suggesting some rise in investor confidence. Other popular styles were diversified international funds of varying market caps and styles. Notably absent were diversified global styles.

Actively Managed International/Global Equity Fds 10 Highest YTD Net Flow Classifications

	Net Flows $B 1Q 2009	Net Flows $B 2Q 2009	Assets $B 6/09
Emerging Markets	0.68	5.17	94.3
Pacific Ex Japan	-0.40	2.36	13.5
Global Flex Port	-0.40	1.87	56.1
China Region	0.08	1.09	6.1
Intl Large-Cap Growth	-0.50	1.14	83.1
Latin American	-0.06	0.53	6.6
Intl Multi-Cap Growth	-0.57	0.82	26.8
Intl Multi-Cap Value	0.21	0.02	32.2
Intl Sm/Mid-Cap Value	0.02	0.03	9.4
Pacific Region	-0.11	0.00	2.0

Source: Strategic Insight Simfund MF; Excludes index funds and ETFs, as well as VA funds

ETF Update: Beyond Equities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ETF growth continued in 2009's first half, with US net inflows of $35 billion. Echoing trends in the traditional mutual fund space, fixed-income ETFs accounted for 70% of net inflows in 1H'09 (a notable leap from their 13% of net ETF inflows in '08). **At the end of June '09, total assets in US-registered ETFs (including ETNs) were $596 billion**.

ETFs: By Investment Type

	Assets $B 6/09	Net Flows $B 2007	2008	1H'09	# of Funds 6/09
US Equity					
Diversified	235.6	62.0	87.4	*-33.2*	219
Sector	69.6	17.3	32.9	*7.6*	186
Subtotal US Eqty	***305.2***	***79.2***	***120.3***	***-25.6***	***405***
Int'l/Global Equity					
Diversified	42.3	16.2	9.0	*-2.9*	**44**
Divsfd Emerg Mkts	41.2	14.0	9.3	*6.2*	**25**
Single Country	42.1	6.6	-0.4	*8.3*	**52**
Regional	11.6	4.4	-0.8	*1.0*	**24**
Sector	7.5	5.0	2.1	*1.6*	**66**
Subtotal Int'l/Glbl Equity	***144.6***	***46.1***	***19.2***	***14.3***	***211***
Bond					
Taxable Bond	78.6	12.5	20.8	*22.8*	**52**
Muni Bond	4.0	0.6	1.7	*1.7*	**17**
Subtotal Bond	***82.6***	***13.1***	***22.5***	***24.5***	***69***
Specialized					
Commodity	59.6	8.7	13.5	*21.8*	**91**
Currency	4.0	2.2	0.4	*0.3*	**35**
Subttl Specialized	***63.6***	***10.9***	***13.9***	***22.1***	***126***
Total	**596.0**	**149.3**	**175.8**	**35.3**	**811**

Source: Strategic Insight Simfund MF

The robust flows into ETFs in the first half of 2009 were impressive. Indeed, while ETF inflows may not experience the market-crisis-induced surge of 2H 2008, which led to a record $176 billion intake for 2008 as a whole, the net inflows of $35 billion in 1H 2009 were ahead of the $26 billion in net inflows that ETFs enjoyed in 1H 2008.

This year marked an important advance in acceptance of bond ETFs for a product that was entirely an equity vehicle until 2002; the broadening of ETF use beyond equities could encourage more financial advisors to build whole or partial portfolios from ETFs. Bond ETFs accounted for 14% of US ETF assets at mid-year. Besides bond ETFs, commodity ETFs (such as Gold, Energy, Diversified), Emerging Market Equity ETFs (Diversified, China, Brazil) and inverse US equity ETFs all saw significant net flows in 2009's first half.

Most Popular ETFs in 1H 2009

The table below lists the highest cash-flow ETFs in the first half. Only one was a long US equity ETF (iShares S&P 500 Index fund); meanwhile, five of the top 15 were fixed-income ETFs, three were linked to commodities or commodity sectors, four to emerging markets equity, and two provided inverse exposure to US equity diversified or sector indexes. The SPDR Gold Shares was the big winner, as investors using it as a safe haven poured a net $12 billion into it in the first quarter (in Q2 this ETF actually saw small net outflows); use for inflation-hedging helped the iShares TIPS fund to become the No.2 ETF in 1H'09 inflows.

Highest Cash Flow ETFs in 1H 2009

Fund Name	Start Year	Assets $B 6/09	1H'09 Net Flows $B	Rate
SPDR Gold Shares	2004	33.7	***11.9***	55%
iShares Barclays TIPS Bond	2003	14.2	***5.0***	57%
iShares iBoxx $ Invst Grd Idx	2002	12.1	***4.8***	69%
US Natural Gas	2007	3.6	***3.3***	464%
iShares MSCI Brazil Index	2000	8.6	***2.8***	80%
UltraSh S&P 500 ProShares	2006	4.4	***2.7***	121%
iShares MSCI Emerging Mkt Idx	2003	28.4	***2.6***	14%
UltraSh 20+ US Trsy ProShrs	2008	4.0	***2.6***	166%
Vanguard Emrg Mkts Stk Index	1994	9.5	***2.5***	50%
iShares S&P 500 Index	2000	18.4	***2.2***	14%
iShares FTSE/Xinhua HKChn25	2004	9.9	***1.8***	31%
PowerShrsDB Cmdty Idx Track	2006	3.0	***1.6***	136%
iShares Barclays 1-3yr Crd Bd	2007	2.4	***1.5***	194%
Vanguard Total Bond Mkt Index	1986	4.4	***1.4***	48%
Direxion Financial Bull 3X	2008	1.7	***1.4***	804%

** 1H'09 Net Flows as a % of 12/08 assets.*
Source: Strategic Insight Simfund MF

Emerging markets ETFs saw a resurgence of interest after those markets exhibited recoveries starting in March. Thus, Q2 saw accelerated flows to ETFs investing in emerging markets (including China).

Among the more interesting phenomena in 1H 2009 was the continued growth of inverse ETFs, which had combined net inflows of about $13 billion in 1H, the bulk of which actually came in 2Q. These ETF types, offered by ProShares, Direxion and others, have grown dramatically since the start of 2008, and now hold more than $19 billion in assets. While these products are not aimed at "average" investors, they may have found a sizeable audience among investors (especially active traders) looking to benefit from the increased volatility in financial markets in recent quarters.

FINRA issued a warning in late June about the suitability of investing long-term in leveraged/inverse ETFs, given their daily tracking goals. This was followed by several national broker-dealers placing restrictions or outright bans on the sales of these products starting in July. In September, FINRA raised margin requirements on leveraged ETFs effective December 1.We expect these actions, combined with the ensuing negative publicity, to depress sales of leveraged/inverse ETFs in Q3.

New ETF Launches in 1H 2009

In the first half, 54 new exchange-traded products launched, drawing an aggregate $1.1 billion in net inflows. As the table below shows, 12 of them drew $25 million or more in flows.

Top New ETFs of 1H 2009 By Flows

	Assets $MM 6/09	Net New Flows $MM 1H '09
iPath S&P 500 VIX ShrtFtrs ETN	163	**166**
JPMorgan Alerian MLP Index ETN	176	**164**
Vanguard FTSE AW ExUs SmCp	126	**124**
Van Eck MktVector Hi Yld Muni	81	**76**
Direxion 30 Yr Treas Bear 3X	62	**63**
Van Eck MktVector Brazil SmCp	48	**48**
SPDR Barclays Cpt Cnvt Bond	44	**43**
PIMCO 1-3yr Treasury ETF	40	**40**
SPDR Barclays Cpt IntmCred	27	**29**
WisdomTree Dryfs EmgCurrcy	27	**27**
Van Eck MktVector PreRefMuni	27	**26**
IQ Hedge Mlt Strtg Tracker ETF	26	**25**
Direxion Mid Cap Bull 3X	23	**21**
Van Eck MktVector Indnesia ETF	22	**20**
iPath S&P 500 VIX Mid Ftrs ETN	25	**19**

Source: Strategic Insight Simfund MF

Three of the 1H'09 ETP launches attracted $100 million-plus flows in the first half: these included two ETNs (JP Morgan's product investing in master limited partnerships, and a Barclays-issued iPath ETN based on an S&P VIX Futures index) and Vanguard's all-world ex-US small cap fund.

Among the exchange-traded products launched in 1H 2009, the two Barclays iPath ETNs based on VIX futures are interesting examples of using the exchange-traded product structure to provide exposure to a barometer of investor sentiment: volatility. Similarly, IndexIQ, which launched a mutual fund tracking hedge fund returns in June 2008, is pioneering the use of ETFs for hedge fund replication. Other notable launches in 1H 2009 included:

- PIMCO's first ETF, a short-term Treasury product started in June (the manager has since launched four other bond ETFs –- another Treasury fund and three TIPS products).
- Municipal bond ETF innovation by Van Eck (the first-ever high yield and pre-refunded muni products)
- The paired ("Up" and "Down") MacroShares Major Metro Housing exchange-traded products, benchmarked to the S&P/Case-Shiller Composite 10 Home Price Index. These are the first exchange-traded products linked to US housing prices;
- The Grail American Beacon Large Cap Value ETF, a multimanager actively managed ETF that's a step forward in resembling traditional active mutual funds;
- More development focusing on emerging markets, including ETFs from Van Eck, BGI, ProFunds, the ALPS / Emerging Global Advisors partnership and from Global X.

ETFs by Manager

Recent launches and 1H'09 flows resulted in some changes in market share among ETF sponsors. Notably, flows into its 3X long and inverse ETFs enabled **Rafferty/Direxion** to enter the Top 10 in market share in less than nine months from the manager's entry into the ETF market ETFs drew 11% of net inflows to ETFs in the first half of '09, although mid-year assets gave them a market share of just 0.9%. Also, **Van Eck Global** rose slightly in the ETF manager rankings thanks to robust 1H 2009 net inflows to its commodities-oriented ETFs in particular; Van Eck's Market Vectors Agribusiness ETF, investing in global companies that derive 50%+ of their business from agriculture, alone took in $532 million in 1H 2009, including $400 million in Q2.

Growth opportunities continue to attract new sponsors; in 1H 2009, four new sponsors entered the marketplace: PIMCO, Grail Advisors, IndexIQ, Global X Management – bringing the total number of managers to 38. The business remains highly concentrated, however, with the 10 largest sponsors accounting for 98% of assets at mid-2009.

Top 20 ETF Managers as of June 2009

Manager	Assets $B 6/09	Market Share 6/09	Net New Flows $B 1H'09	# of Fnds 6/09
Barclays Global	295.10	49.5%	*18.50*	215
State Street Global	141.46	23.7%	*-17.42*	86
Vanguard	59.56	10.0%	*9.97*	39
ProFunds	27.54	4.6%	*9.53*	86
Invesco PowerShares	25.55	4.3%	*0.55*	105
Van Eck	7.81	1.3%	*2.21*	19
DB Cmmdity Svcs	7.32	1.2%	*3.67*	11
Bank of New York	6.35	1.1%	*-0.82*	1
US Cmmdity Funds	6.20	1.0%	*2.65*	5
Rafferty/Direxion	5.13	0.9%	*3.75*	20
Rydex Investments	4.60	0.8%	*0.33*	39
WisdomTree	4.03	0.7%	*0.58*	51
Claymore Advisors	1.64	0.3%	*0.46*	34
Deutsche Bank	1.41	0.2%	*0.62*	24
First Trust Adv	0.96	0.2%	*0.15*	39
Swedish Export Cr	0.56	0.1%	*0.28*	7
Greenhaven Cmmdty	0.14	0.0%	*0.12*	1
XShares Advisors	0.14	0.0%	*0.01*	5
VTL Associates	0.13	0.0%	*0.06*	6
Fidelity	0.11	0.0%	*0.02*	1

Source: Strategic Insight Simfund MF

Some detail on the three biggest ETF sponsors:

BGI maintained its lead in the marketplace with a 50% share of the US market. Its ETF assets grew by about 14% in the first half of 2009 and reached $295 billion by mid-year. The manager's net issuance rose to nearly $19 billion in 1H '09; those flows fed a diversity of products, led by its taxable bond ETF lineup and emerging market equity and commodity/specialty funds/notes.

The other first-half big news for Barclays Global Investors/iShares was the June announcement that BlackRock agreed to acquire BGI from parent Barclays PLC. The merger is expected to close in Q4 2009. It will have implications for the entire ETF industry, in large part because we've seen the success and brand-building efforts of larger ETF sponsors help spread general awareness of ETFs in ways that benefit all participants in the ETF sector:

- In explaining the transaction, BlackRock CEO Laurence Fink predicted a rise in the number of investors using a mix of passive and active products in their portfolios. The combined organization could increase this trend.
- The greater resources that a merged BlackRock-BGI could bring to bear could help ETF penetration into DC plans, where they have been held back by a mix of operational issues (traditional DC platforms are not set up to use ETFs). This could spur even greater growth of ETFs in general.
- BlackRock's expertise in active management, which it has packaged in a variety of vehicles (open-end funds, closed-end funds, institutional portfolios, etc.) could eventually mean the introduction of more actively managed ETFs. This could bring more publicity and flows to the emerging category of "active" ETFs.

SSgA saw net outflows of $17.4 billion in the first half of 2009, despite its SPDR Gold Shares topping ETF inflows in the first half with $11.9 billion in net issuance (as mentioned before, most of these flows came in Q1). The manager's net outflows were largely concentrated in its primarily institutionally-held S&P 500 SPDR, for which volatile swings in flows are not uncommon. That ETF experienced $30.5 billion in 1H net outflows, partly as a result of early-year portfolio rebalancing/tax tactics following $24 billion in net inflows in Q4 2008 and $69 billion for all of 2008 (but July '09 saw net inflows of nearly $3 billion).

Vanguard continued its steady growth in 1H 2009, drawing net inflows of $10 billion. Echoing the overall market, most of Vanguard's ETF inflows went to its Emerging Markets ETF and Total Bond Market ETF. The firm's ETF assets market share rose to 10% at June 2009 from 8.5% at the end of 2008.

The US ETF market remains heavily concentrated, but with continued innovation and new entrants, such levels of concentration may not last in the long run.

Evolution of Lifecycle Mutual Funds

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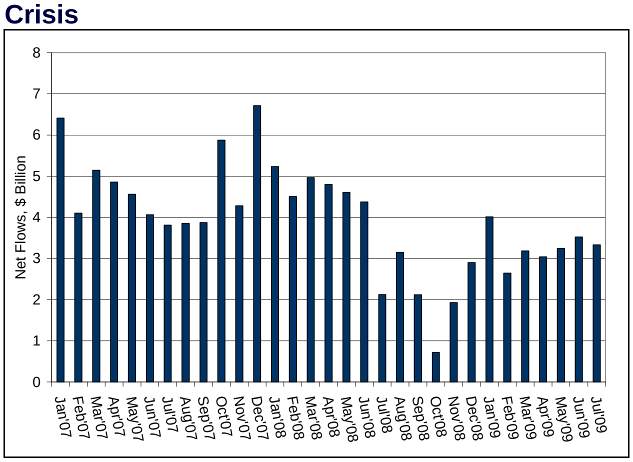
Despite the extreme market volatility and investor anxiety experienced last year, and the resultant widespread flow weakness affecting both stock and bond funds, **target-date lifecycle mutual funds (TDFs)** attracted sustained new commitments on a net basis. Although flows fell in the third and fourth quarters of 2008, the category as a whole has not experienced net outflows in any single month post-crisis. And TDF assets had crossed the $200 billion mark by the end of July.

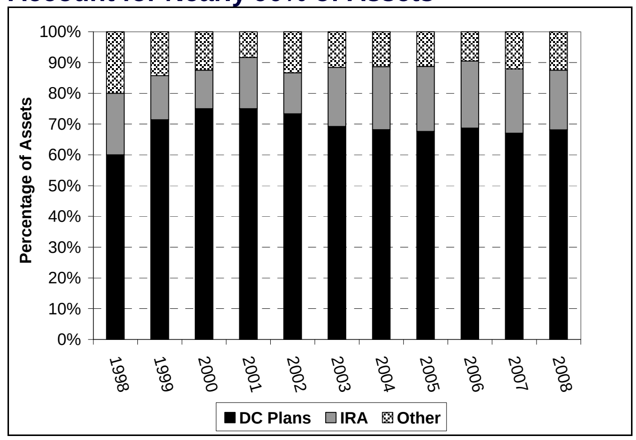
Monthly Net Flows into Target-Date Mutual Funds*: Resilient During the Recent Financial Crisis



* Retirement and non-retirement investors, excluding 529 plan funds and variable annuities.
Source: Strategic Insight Simfund MF

The resilience of flows into TDFs can be attributed to the important role and ubiquity of such products in retirement plans, which has led to as much as 88% of TDF assets at the end of 2008 being held in some kind of tax-advantaged retirement account (DC/IRA). Steady dollar-cost averaging investments into DC plans, where 68% of TDF assets are held, and the long-term investment horizon of retirement investors in general factored into the relative stability of TDF flows in a time of great turmoil.

Target-Date Mutual Funds: DC/IRA Investors Account for Nearly 90% of Assets

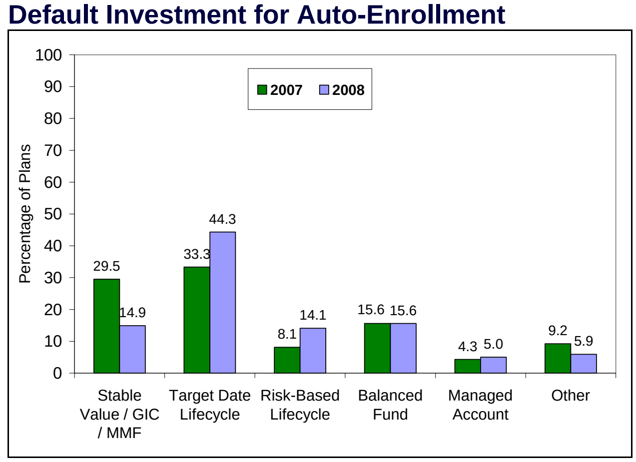


Source: ICI

Driving TDF growth in the DC area in recent years has been the expanding adoption of automatic enrollment and TDFs' preferred status as a Qualified Default Investment Alternative. (The Pension Protection Act of 2006 made it easier for plan sponsors to automatically enroll new workers in a DC plan, and target-date funds were one of three types of funds the DOL designated as a QDIA or a "default" investment eligible for fiduciary relief under automatic enrollment arrangements, if the participant does not "elect" a choice.)

According to PLANSPONSOR magazine's 2008 Defined Contribution survey, target-date lifecycle funds were a default investment for auto-enrollment in 44% of plans in 2008 (the proportion would be even higher in larger plans), up significantly from 33% in 2007. The growth in the use of TDFs and other diversified investments as defaults has come at the expense of capital preservation options such as stable value funds or money market funds that traditionally held this role.

Target-Date Mutual Funds: Growing Use as Default Investment for Auto-Enrollment



Source: PLANSPONSOR

TDFs have been the subject of greater regulatory scrutiny of late as a result of the investment losses that such funds (including near-term ones primarily held by retirees and pre-retirees) sustained in the aftermath of the credit crisis, which affected a wide range of asset classes. Asset allocation overall as a theme is also being debated and reassessed, but we expect the concept to be reinforced in the balance of 2009 and beyond, with some adjustments.

Among lifecycle funds, target-date funds had clearly taken over the lead in popularity from **risk-based lifecycle funds** in DC plans in recent years.

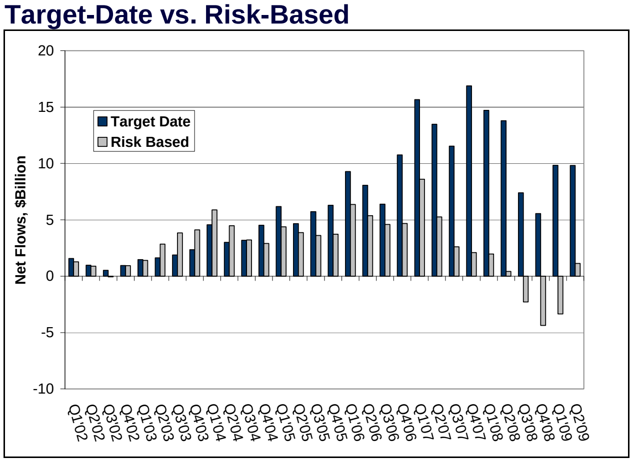
Lifecycle Funds
Retirement and Non-Retirement Investors
Excluding 529 Plan Funds and Variable Annuities

	Assets	Net Flows			
	7/09	2006	2007	2008	Ytd-7/09
Target-Date	207.4	34.5	57.5	41.4	23.0
Risk-Based	159.0	21.0	18.5	-4.3	-1.9
Total Lifecycle	***366.5***	***55.5***	***76.1***	***37.2***	***21.0***

Source: Strategic Insight Simfund MF

For risk-based funds, a diminishing asset share from DC plans in turn has contributed to comparatively lesser asset stability. Risk-based lifecycle mutual funds (some refer to these as "lifestyle" funds) experienced a distinct flow slowdown starting in the latter half of 2007, and saw their net new intake dip into negative territory in 2H08 as the crisis deepened, with outflows persisting in Q109. In Q2 2009, however, the net outflows from risk-based lifecycle funds have stemmed as markets and investor confidence recovered.

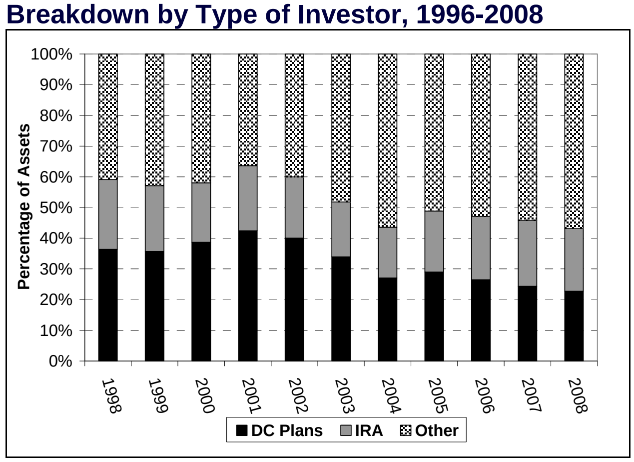
Quarterly Lifecycle Mutual Fund* Net Flows, $B
Target-Date vs. Risk-Based



* Retirement and non-retirement investors, excluding 529 plan funds and variable annuities.
Source: Strategic Insight Simfund MF

A much smaller proportion of risk-based mutual fund assets are sourced from DC plans (23% at the end of 2008, versus TDFs' 68%). Conversely, risk-based funds have a relatively greater presence in non-retirement markets where they appeal to the intermediary-driven channel; risk-based funds provide advisors a greater role in helping investors determine risk attitudes and appropriately choose among funds within a series (such as Conservative, Moderate, Aggressive) and in moving investors between funds over time as their needs and risk profiles change.

Risk-Based Lifecycle Mutual Funds: Asset Breakdown by Type of Investor, 1996-2008



Source: ICI

The use of risk-based lifecycle fund as automatic enrollment defaults, although smaller than for TDFs, is growing nonetheless (from 8% of plans in 2007 to 14% in 2008, as per the PLANSPONSOR survey mentioned before). In light of how the recent unprecedented volatility affected TDFs, and as plan sponsors reevaluate plan defaults or choose their QDIA for the first time, more plans may opt for risk-based lifecycle funds, many of which also have longer track records. (We're also seeing a slight recent pickup in filings of new risk-based series after product development activity in this area had languished for more than a year.)

An innovative, new risk-based series started last year was the **Putnam Absolute Return** funds (100, 300, 500, 700), which adopt a flexible approach in their attempt to outperform inflation as measured by US Treasury Bills (by 1%, 3%, 5%, and 7% respectively, over a period of three years or more).

Putnam Absolute Return Funds			
	Assets $MM	Net Flows $MM	Total Return %
Portfolio	7/09	Ytd-7/09	Ytd-7/09
Putnam Absolute Return 100	53	48	2.10
Putnam Absolute Return 300	113	106	4.10
Putnam Absolute Return 500	124	111	5.00
Putnam Absolute Return 700	82	68	7.70

Source: Strategic Insight Simfund MF

Besides targeting retail investors and advisors, Putnam also appears to be positioning these funds as a possible qualified plan default. Investors have found the non-correlation and low-volatility aspiration of these dynamic, multi-asset Putnam products appealing in a volatile market environment—the funds have drawn $330 million in net flows year-to-date through July, helping Putnam jump to the number two spot in the risk-based segment (see table below listing highest YTD-7/09 cash flow risk-based lifecycle fund managers; Putnam's other risk-based series saw small net outflows YTD bringing the manager's *total* risk-based lifecycle flows down somewhat).

Fund design as well as investor education and expectations management will be crucial elements in determining the success of these and other attempts at delivering more stable returns within lifecycle funds. But alternative strategies or asset classes (such as TIPS, Emerging Market Debt, Frontier Market Equity, Commodities / Natural Resources, Market-Neutral, Long-Short) are already finding their way into lifecycle fund glidepaths, although allocations to them are still generally small.

Highest-Flow Risk-Based Lifecycle Fd Managers, Ytd-7/09
Retirement and Non-Retirement Investors
Excluding 529 Plan Funds and Variable Annuities

	Assets $B	Net Flows $B			Flow Rate*
Manager	7/09	2007	2008	Ytd-7/09	Ytd
John Hancock	24.2	3.62	1.72	**0.66**	3.3
Putnam	4.5	0.74	-0.58	**0.23**	6.6
Franklin Tmpltn	2.1	0.22	0.36	**0.22**	13.4
Thrivent Fin'l	2.6	0.94	0.47	**0.17**	8.3
Manning&Napier	1.5	0.30	-0.06	**0.10**	8.7
OppenheimerFd	3.5	1.55	0.76	**0.10**	3.4
Nationwide Fds	4.1	0.25	0.08	**0.08**	2.2
Vantagepoint	3.9	0.27	0.00	**0.06**	1.7
JPMorgan Fds	4.8	-0.14	-0.40	**0.05**	1.3
Pacific Life	1.3	0.43	0.14	**0.04**	3.5

** Ytd-7/09 net flows as a % of 12/08 Assets.*
Source: Strategic Insight Simfund MF

The Target-Date Fund Landscape

The target-date mutual fund area remains dominated by the bundled DC plan providers as the table below shows. But the space attracted many new entrants in recent years looking to capitalize on the growth potential in the area, including through the Investment-Only DC business. Overall, the number of fund companies with offerings in the target-date fund area has almost doubled since the end of 2005, to more than 40 at the end of July 2009. A corollary of the rapid, recent expansion in manager population, however, is that many providers are still emergent in terms of investment track records and assets gathered.

Highest-Flow Target-Date Lifecycle Fd Mgrs, Ytd-7/09
Retirement and Non-Retirement Investors
Excluding 529 Plan Funds and Variable Annuities

	Assets $B	Net Flows $B			Flow Rate*
Manager	7/09	2007	2008	Ytd-7/09	Ytd-7/09
Vanguard	44.5	14.0	13.0	**6.2**	18.5
Fidelity	85.5	19.1	11.0	**5.9**	8.7
T Rowe Price	34.7	11.5	6.8	**4.1**	16.2
Principal Funds	12.6	4.0	3.0	**1.7**	18.6
American Funds	4.8	1.6	2.6	**1.1**	37.5
TIAA-CREF	3.0	1.0	1.1	**0.7**	40.0
Am. Century	1.6	0.2	0.2	**0.7**	89.9
Wells Fargo	3.2	0.9	0.7	**0.5**	23.4
John Hancock	2.5	0.8	1.4	**0.5**	33.3
USAA	0.5	-	0.2	**0.3**	158.8

** Ytd-7/09 net flows as a % of 12/08 Assets.*
Source: Strategic Insight Simfund MF

New entrants as well as existing providers have tried to differentiate themselves in an increasingly crowded field through their glide path philosophy and fund design and composition.

- A key differentiator among TDFs has been the equity "glide path" of the funds: What is the equity (and equity sub-asset class) allocation in the early years and at what rate does that change? What's the funds' equity allocation at and after the retirement date? Some series glide "to" the retirement date, minimizing exposure to risky assets as participants approach retirement age (liquidating or transforming the funds into "Income" funds at that date), while others glide 20 or 30 years into retirement, seeing a role for the funds not only in the accumulation years but also in the decumulation phase. Some firms such as **Old Mutual** and **Great West** have offered target-date funds with multiple glide paths aimed at offering a choice of risk preferences within each target date. (In general, irrespective of the overall approach taken, fund companies can be expected to further step up the focus on investor education and related materials to communicate their particular strategies.)

Target-Date Mutual Funds
Retirement and Non-Retirement Investors
Excluding 529 Plan Funds and Variable Annuities

Morningstar Category	Assets $B 7/09	Net Flows, $B 2007	Net Flows, $B 2008	Net Flows, $B Ytd-7/09	Avg, Allcn % Stock
Retirement Income	8.4	1.6	0.9	0.6	29.9
Target Date 2000-2010	28.7	7.8	1.7	-0.1	42.6
Target Date 2011-2015	24.8	7.5	5.2	2.3	47.5
Target Date 2016-2020	43.1	11.4	7.2	3.7	55.4
Target Date 2021-2025	24.5	7.4	6.4	3.5	69.2
Target Date 2026-2030	32.0	8.9	7.0	4.1	70.3
Target Date 2031-2035	15.9	4.7	4.7	2.8	80.4
Target Date 2036-2040	19.4	5.3	4.8	3.3	78.0
Target Date 2041-2045	6.6	1.8	2.2	1.6	85.2
Target Date 2050+	3.9	1.2	1.5	1.2	78.9
Total above	***207.4***	***57.5***	***41.6***	***23.0***	

Source: Strategic Insight Simfund MF

- There is also a greater focus now on both the equity and bond sub-allocations. The number and distinctiveness of asset classes and sub-asset classes used (including non-traditional or "alternative" asset classes, and inflation hedges such as TIPs and commodities) is an area of ongoing TDF innovation, as is the frequency of rebalancing between them.

- Is the asset allocation implemented primarily through actively managed (e.g. at Fidelity and American Funds) or indexed underlying investments, (e.g. at Vanguard) or a blend (e.g. at Invesco AIM) and are direct securities investments part of the mix. Active management within TDFs could also be in the form of "volatility management" through more tactical adjustments to the glide path in response to market conditions, and, given recent experience, attempts to hedge "tail risk". And passive management could be at the TDF level itself, with the funds attempting to track target-date indexes provided by a third-party provider (such as the Wells Fargo and XShares/TD Ameritrade series.)

- Is the asset-class and underlying-fund allocation performed internally or is a sub-advisor or external "consultant" used for the same?

- Do the TDFs invest exclusively in proprietary, internally managed underlying funds, or do the underlying investments include also external managers or non-proprietary funds?

- Some managers emphasize the approaches they use for underlying manager selection and optimization (to lessen stock holdings overlap and allow for greater diversification).

In the aftermath of the 2008 crisis, a spotlight has been placed on TDFs. Firms have been reevaluating the asset allocation glide paths and other aspects of these funds, and some have made changes as a result. Some illustrations of recent changes in TDF strategies and fees, based on filings and other research:

- **Schwab** has made multiple recent alterations to its target-date mutual fund series. In January this year, the firm indicated in a prospectus-supplement that the "Retirement Income Fund" option within its Target Funds series would be merged away (into the "Schwab Monthly Income Fund — Enhanced Payout" fund; the merger took place in June). And in April, the manager announced an adjustment of its TDFs' rolldown to make it more conservative: the funds added more fixed-income exposure beginning 10 years from target date, in order to offer more potential downside protection and periodic income to pre-retirees and retirees; the adjusted rolldown also added equity exposure in the early years with the aim of building more wealth before target date; moreover, the rolldown was extended by an additional five years to continue 20 years after target date. Schwab also added some passive strategies and third-party-advised funds to its underlying investments, and announced a cut in expense ratios in its TDFs by 13 to 23 basis points.

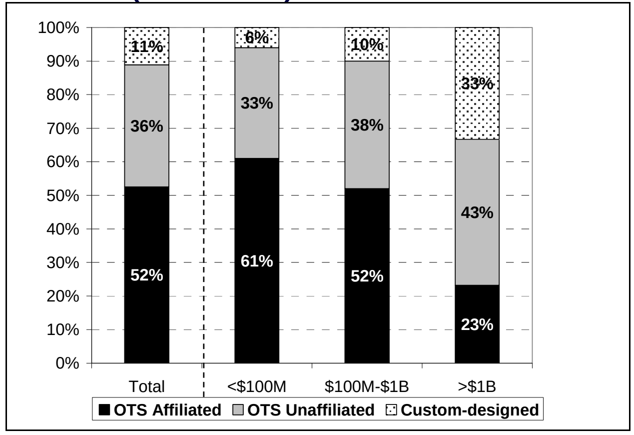
- **RiverSource's** *Seligman Target Horizon ETF Portfolios*, which invest primarily in ETFs, in August 2009 added a risk management overlay: funds in the series that are fewer than 11 years from their target date will write covered call options on an ongoing basis, while all funds in the series may purchase protective put options tactically. (Note: RiverSource acquired this fund-of-ETF series via its acquisition of Seligman; it also has a target-date series that invests in regular mutual funds – "RiverSource Retirement Plus".)

- In November 2008, **TIAA-CREF**'s TDFs added, among other funds, enhanced index US and international equity funds to its roster of primarily active underlying funds (as per June'09 allocation data, meaningful portions of the TDFs' equity exposure is now achieved through these newly added enhanced index underlying options.) The TDFs also simultaneously revised strategies so that besides investing in affiliated funds, they could invest also in unaffiliated mutual funds and other investment products or pools, which may include ETFs and ETNs. (ETFs and ETNs may be used to gain exposure to particular market sectors or securities in order to implement the TDFs' asset allocation strategies, or for cash management, hedging or defensive purposes.)

- Effective February 2009, **MFS** introduced more sub-asset classes into its *Lifetime* TDF series by adding international style-based (growth, value), emerging markets equity, emerging markets debt, global real estate, and absolute return funds as underlying investments.
- **Principal** lowered the overlay management fees on its *LifeTime* affiliated fund-of-fund portfolios from 0.1225% to 0.03% effective July 1st.
- **Putnam** removed the overlay management fees it previously charged (0.05%) on its *RetirementReady* series of affiliated funds-of-funds starting August 1st. Also at the end of August, it comprehensively altered the fund options for the series—going forward, instead of investing in regular (non-lifecycle) funds, the TDF series will invest in funds in Putnam's two risk-based series – the older Asset Allocation Portfolios (Equity, Growth, Balanced and Conservative) and the newer Putnam Absolute Return funds (mentioned before), all of which are structured as standalone funds. (Note: Risk-based lifecycle fund veteran Manning & Napier is one other manager that uses a similar approach – its 2008-incepted target-date funds invest in its risk-based funds.)
- Effective August 24, 2009, **Columbia's** target date funds-of-funds broadened the range of eligible investments, permitting added flexibility particularly in asset classes with low market correlation: they expanded the security types to include ETFs, TIPS and commodity-related and other derivatives, and introduced several additional Columbia equity and bond funds as possible underlying investments for added diversification. The funds now also have the ability to invest in third-party-advised funds as part of their principal investment strategies.
- Effective May 1' 2009, **Payden & Rygel** reduced the fees for each fund in its Payden/Wilshire TDF series from 1.40% to 1.15%.

More DC plan sponsors, especially in the large plan segment, are today looking beyond off-the-shelf (OTS) proprietary, single-manager TDFs delivered by the plan recordkeeper and considering unaffiliated providers and custom open-architecture solutions, in some cases created from core options on the menu or otherwise offered by a TDF provider. According to a target-date retirement fund survey by consulting firm Casey Quirk and the Profit Sharing / 401k Council of America, 33% of plans with more than $1 billion in assets have already implemented custom TDFs, as compared with 11% of *all* plans (March 2009).

Type of Target Date Retirement Fund Provider by Plan Size (March 2009)



Source: Casey Quirk / PSCA survey

Some of the motivations behind TDF customization include: diversifying away manager concentration risk; obtaining best-in-class expertise and the ability to easily replace underperforming managers without disrupting the entire fund; desire for a more diverse asset allocation; acquiring the ability to tailor the glide path to plan demographics (and whether or not participants have access to a Defined Benefit plan); and addressing potential conflicts from having a single provider do both glide path management and underlying investment selection.

In case core options are used to build custom TDFs, conceivably an eventual greater scale may in turn lead to lower costs through lower investment management fees, besides facilitating the use of institutional vehicles and recruitment of the same managers as on a company's DB plan, counterbalancing some of the costs of customization. Recent market volatility and intensified regulatory scrutiny of TDFs, besides pending legislation for more DC plan fee disclosure, are factors in greater interest in third-party and custom solutions.

Overall, plan sponsor cost and fiduciary concerns are also promoting interest in institutional vehicles such as collective trusts and in incorporating passive strategies to an extent (some of the latter is being considered cyclical though) within the mega- and large-plan areas.

Such competitive pressures are among factors that – beyond triggering strategy changes in existing TDFs – are influencing new product development in the space. **Fidelity**, a leader in the target-date mutual fund space, in July launched a new **"Freedom K"** series of TDFs, a lower-cost version of its retail Freedom funds intended only for plans where the manager serves as recordkeeper. Also, in June the manager filed the Fidelity **Freedom Index** series, which will primarily use indexed underlying Fidelity funds. Soon after Fidelity's Freedom Index filings, and in the same month, **TIAA-CREF**, the seventh-largest manager of target-date mutual funds, registered a Lifecycle Index series.

In addition to Fidelity's Freedom K, many of the **new target-date mutual fund series coming out since the beginning of 2008** have been reflective of the above-mentioned trends. Some have been from providers that, like some of the existing TDF sponsors, use a "Manager-of-Managers" or sub-advised approach for their entire fund family, which in turn creates multi-managed TD affiliated fund-of-funds (USAA, Harbor). Also, others have designed an open-architecture TDF solution by using underlying investments that are a combination of their own proprietary funds and those of an unaffiliated mutual fund complex (Van Kampen's series that uses also Russell funds, and a now defunct Allstate series, which invested in both Allstate and unaffiliated funds) or been products that use low-cost ETFs exclusively or partly (BGI's series of ETFs-of-ETFs and Legg Mason's Clear Partners Target Retirement funds).

Another emergent area of TDF innovation is through the integration of guaranteed income – some asset managers and insurers are designing hybrid solutions that combine target-date portfolios with annuities. The structures some of these firms have come up with embed annuities into the glide path, with exposure to the annuities increasing as participants approach retirement. There are variations in philosophies as to the optimal mix of investments and annuities over time, and different ways of dealing with the challenges or considerations such as product complexity, administrative/guarantee costs, liquidity/portability, and diversifying insurer risk.

New Lifecycle Mutual Fund Series Started 2008-09

Series Name	Inception	Assets $MM 7/09	Net Flows $MM Ytd-7/09
Target-Date			
USAA's "Target Retirement"	8/08	512	**272**
Harbor Capital's "Retirement Strategy"	1/09	89	**74**
Manning & Napier "Target" series	3/08	87	**72**
Van Kampen's "Retirement Strategy"	10/08	35	**27**
Fidelity's "Freedom K"	7/09	6	**6**
Legg Mason Partners "Target Retirement"	8/08	12	**4**
PIMCO's "RealRetirement"	4/08	17	**2**
Allianz Global Investors' "Solutions"	12/08	21	**1**
Old Mutual "Target Plus"	3/08	4	**0**
BGI's iShares S&P Target Date	11/09	25	**-2**
Allstate's ClearTarget Retirement*	4/08	1	**-6**
Risk-Based			
Putnam "Absolute Return"	12/08	372	**332**
BGI's iShares S&P Allocation	11/08	75	**21**
Allianz Global Investors "Solutions" Allocation	4/09	188†	**4**

** Liquidated in August. † AGI's existing Multi-Style fund with about $150 million in assets was reorganized in May 2009 into the "Core" fund in the lifecycle series.*

Source: Strategic Insight Simfund MF

National Broker-Dealer Distribution Opportunities in '09

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The delivery of advice to investors through financial intermediaries is only growing in importance. And despite recent market turmoil, Strategic Insight research shows that National Broker Dealers still account for the largest proportion of mutual fund sales (over 30%) of any distribution channel among fund firms that sell primarily through intermediaries.

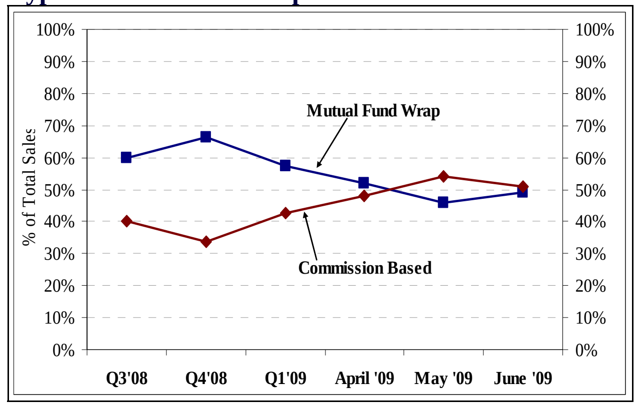
As SI continues to expand its focus on fund distribution, we have embarked on an exciting **new joint research initiative with Coates Analytics**. Combining the distinctive sales and distribution data in Coates Analytics' Distribution Management System™ with the industry perspective and expertise of Strategic Insight, this new **subscription-based quarterly report series** will provide important competitive benchmarking, peer group analysis, and actionable information regarding the National Broker Dealer distribution marketplace. [To download the 40-page Q1'2009 version of this report series as a free sample, click here; for more information regarding subscription options contact Dan Weinerman – dweinerman@sionline.com; 212-217-6897.]

In this article, we summarize some of the important macro-level findings of our research in this space.

National BD Sales Trends

The following graph charts the aggregate trends of new sales between the two mutual fund-centric National BD platform types – mutual fund wrap and commission-based platforms. In recent years, the shift toward fee-based investing has been an overarching trend in fund distribution. As can been seen in this chart, however, during the first half of 2009 this trend was (temporarily) reversed, with sales via point-of-sale, commission-based platforms outpacing sales within mutual fund wrap programs in the Coates-tracked National BD universe during both May and June (although trending back toward wraps in June).

Proportional Mutual Fund New Sales by Platform Type: Mutual Fund Wrap vs. Commission Based*

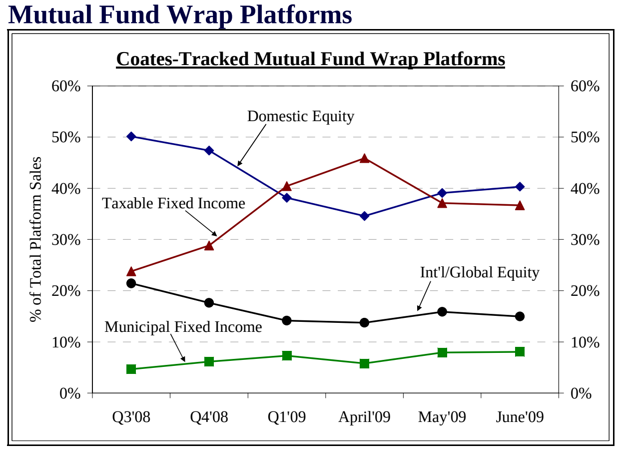


Source: Coates Analytics Distribution Management System
**Note: Reflective of data from national broker dealer firms with both commission-based and wrap platform data captured in Coates Analytics Distribution Management System.*

Understanding this shift holds implications for strategic decision-making around wholesaling efforts, share-class pricing, and other distribution areas. We don't see the 2009 dip in wrap market share as a fundamental movement back toward commission-based models as the preferred method of fund distribution by financial advisors. Rather, this temporary trend reversal is likely attributable to market conditions and investor sentiment during 1H 2009. In particular, as investors and financial advisors moved away from equity funds and toward fixed income, some sales momentum shifted away from asset-allocation-rooted and equity-biased wrap programs and towards commission-based platforms, whose structures can be more conducive to opportunistic style shifts (toward fixed income, for instance).

An analysis of sales trends by fund type across platforms provides important insights into the overall relationship between commission-based and wrap program sales.

Proportional Mutual Fund New Sales by Fund Type: Mutual Fund Wrap Platforms

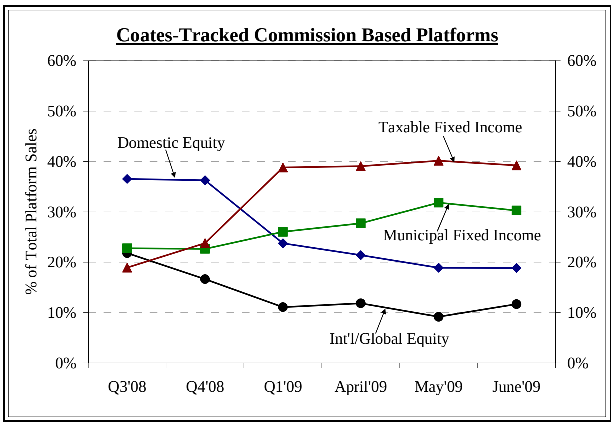


Source: Coates Analytics Distribution Management System

The graph above charts sales trends by fund type within **mutual fund wrap platforms**. By their fundamental structure, mutual fund wrap programs are generally an equity-biased method of investing, where structured asset allocation sleeves are used to create a diversified investment portfolio. The sales trends above depict this dynamic, although also they also show the effects of defensive reallocations in early 2009 away from equities and toward lower-volatility fixed income investments. While at their peak during April. taxable and tax-free fixed income funds made up a combined 52% of wrap program sales, proportional sales trended back toward equity funds as stock markets rallied during Q2.

In contrast to mutual fund wrap programs, sales trends by fund type within **commission-based platforms** offer a distinctly different picture.

Proportional Mutual Fund New Sales by Fund Type: Commission-Based Platforms



Source: Coates Analytics Distribution Management System

As depicted above, sales into fixed income funds (both taxable and tax-free) have constituted a majority of commission-based fund sales within Coates-tracked National BDs throughout the first half of 2009. **In commission-based platforms, bond fund sales made up a full 70% of new sales during Q2'09**. Of note within this overall movement toward fixed income within the commission-based space is the added prevalence of municipal bond funds, which made up 30% of Q2'09 sales within commission-based platforms, compared with just 7% within wraps.

This large-scale movement into fixed income funds within the commission-based space likely reflects a combination of several factors, including:

- Overall defensive investor sentiment, combined with sales substitution by FAs of commission-based bond funds to offset downturns in asset-based fees within their fee-based business;
- Opportunistic buying during the early part of 2009, as many fixed income categories posted solid gains while equity markets remained uncertain;
- Search for yields among taxable accounts, and substitution of high-quality, short-duration municipal bond funds replacing near zero yielding money market investments.

Together, these forces influencing both investors and financial advisors helped to spur bond fund sales through the commission-based platform structure, while proportional sales via structured asset allocation-based wrap programs temporarily lagged.

National BD Trends Moving Forward

While still a dominant share of commission-based sales, taxable and municipal fixed income began to flatten as a percentage of total sales as Q2'09 progressed, even trending slightly downward during June on a proportional basis as the rally in global equity markets began to turn investor sentiment. At the same time within wrap platforms, domestic and international equity funds rose to a combined 55% of total sales in June, reversing the sharp run up in taxable bond fund sales during the first four months of 2009. This slowdown in commission-based fixed-income sales and the simultaneous thawing of equity sales within wraps also corresponded with the overall uptick in proportional sales back toward wrap programs at the expense of commission-based platforms during June.

With commission-based platforms' advantage in sales over wraps attributable largely to short-term dynamics, the proportional shift back toward wraps should become more pronounced as investors become focused once again on equity-favored asset allocation programs. Yet, with more than $10 trillion in cash held in the banking system and in money market mutual funds, SI projects that demand for income mutual funds throughout the yield and quality spectrum will last for an extended period, offering distribution opportunities for managers of narrowly-invested bond funds, as well as those offering multi-strategy bond funds, during 2H 2009 and into 2010.

The relationship between equity and fixed income sales across platform types offers valuable insight into factors influencing fund sales, and the subsequent opportunities within these subsections of the National BD marketplace. The ability of managers to differentiate these opportunities with regard to product strategy, wholesaling efforts and FA engagement can be important drivers of fund sales success.

Understanding Investment-Only DC Market Opportunities

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*Strategic Insight hosted in July its second live **SI Forum** conference, for which we invited several outside industry observers to present. This article is adapted from Chris Brown's presentation (the full set of slides is available to SI clients here at our Web site). Brown, who founded Sway in 2007, is a leading expert on the DC investment-only market, among other topics.*

Even after experiencing more than a decade of strong growth, investment-only assets continue to expand share of the defined contribution market. Sway Research projects investment-only market share will rise to 49% of DC assets in 2012, up from 47% at the end of 2008. However, due to a range of competitive, legislative, and market-based challenges, it is more difficult now than ever before for asset managers to achieve success in this market.

For example, the global financial crisis hit the DCIO market hard. Among 17 investment managers surveyed by Sway Research in January 2009, the 2008 market crash resulted in an average decline of 26% for DCIO assets. Not surprisingly, DCIO sales and marketing budgets have been slashed. Despite this, nearly half of managers increased 2009 DCIO sales goals, forcing DCIO executives to do more with fewer resources.

DCIO: Potentials, Pitfalls

To effectively capture assets and increase productivity in the DCIO space, managers must implement a carefully thought-out and targeted approach to establishing and growing relationships with DC consultants, recordkeepers, and retirement-advisors.

A chief problem faced by DCIO leaders is to determine how to best utilize their resources across a large and diverse group of constituents, including the following: DC Plan sponsors and participants; DC platform gatekeepers, wholesalers, and due diligence teams; Retirement-focused advisors, including brokers, RIAs, and TPAs; and consultants, as well as model-builders such as Morningstar and Ibbotson.

With all of these important groups to potentially serve, where should a DCIO sales executive allocate his or her resources? Sway's most recent in-depth DCIO study revealed that the average DCIO sales and marketing budget was only $3.2 million in 2008, and this is expected to decline by 19% in 2009. We also found wildly differing sales-force productivity levels, ranging from less than $300 million of DCIO gross sales per external salesperson to $1.5 billion per external. And those differences in productivity levels are not primarily product-related.

Considerations for success

Much of the difference stems from the approach taken by the DCIO sales leader, and the experience level of DCIO sales staff—a very important, but often overlooked, ingredient to a successful effort. Those firms achieving exceptional productivity levels have vision and well thought-out plans driving their DCIO effort. Components of this plan usually include:

- The firm's heritage and other distribution efforts, which can be leveraged in the DCIO space. For example, making sure the firm's portfolios are offered through the top-selling DC platforms at key retail distribution partners, thereby enhancing opportunities to leverage retail wholesalers.
- Focus on a small group of preferred partners, and build a deep understanding of their needs. Really get to know and support key outlets: 80% to 90% of DCIO sales are usually from 10-12 key partners.
- A cohesive, clear message to the market about the firm's strengths, reinforced through marketing collateral, value-add programs, and, most importantly, the caliber of field sales personnel. Firms with ordinary product generate extraordinary DCIO sales as a result of greater investment in highly experienced and knowledgeable sales people and leading-edge value-add programs.
- A willingness to adapt, carefully, to changing market conditions – while also keeping a keen eye on maintaining margins. For example, firms should be open to offering new product structures, such as collective investment trusts, but also be careful not to act too fast, or be too amenable to recordkeeper demands for lower management fees; this may result in unprofitable products/relationships.

Now that the worst of the market crash is over, it's an opportune time for asset managers to review and fine-tune DCIO efforts, as manager-switch activity is likely to heat up in the second half of 2009.

Mutual Fund Distribution to the RIA Channel

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*Strategic Insight hosted in July its second live **SI Forum** conference, for which we invited several outside industry observers to present. This article is adapted from Richard Sincere's presentation (the full set of slides is available to SI clients here at our Web site). Sincere, who founded Sincere & Co. in 1997, serves as an expert conduit between fee-based advisors and the fund companies that serve them.*

Mutual fund distribution to the Registered Investment Advisor (RIA) channel is a difficult business. The RIA channel resists the tactics that work for the retail and broker-dealer markets.

What fund firms need to serve the RIA market:

Product/Portfolio Manager – *Good product is key; a great portfolio manager (PM) is critical.* The major challenge is that most PMs believe RIAs will flock to their fund if it has strong performance. Experience, however, suggests that most funds have "pimples" (high expense ratios, short track record, changes in management, etc). The marketer must clear them up, or at least explain why the fund will be successful.

Audience – *RIAs are entrepreneurs, and objectivity is one of their most important assets.* Most RIAs have at some time in their career risked their net worth to start their business. If that business is successful, they aren't willing to risk investing in a fund that could "blow up" or, at the very least, under-perform against its peer group. Part of the RIA's due diligence process is their use of proprietary screens to find a fund. If a fund doesn't hit their radar, it won't get their attention. The fund firm's job is to get the fund inside the screens or to explain why it is appropriate to go outside the proprietary model.

Relationships – *RIAs focus on two types of relationships - clients and employees.* If there is a choice between meeting a PM vs. a current or prospective client, the PM will likely be the second choice, unless the PM/wholesaler/firm has a special relationship with the RIA. The same holds true for RIA employees who serve as the gatekeepers between the client and the firm. Product providers must gain trust with those relationships to get past the gate.

Manager Meetings – *Even the best PMs need to learn how to communicate with RIAs.* Before investing a significant amount in a fund, most advisors want to meet the PM: in person, at a conference, lunch and learn, by phone, etc. PMs who are shy or aren't great speakers do well with RIAs as long as they are smart and insightful. Still, the PM may need some coaching on public speaking.

RIAs Have Varied Practices

Wealth Manager	**Transitioning RIA**
- Institutional Fee/Hybrid	- Broker/fee hybrid
- Multi-faceted business	- 'Breakaway' broker
- Family office model	- Platforms facilitate move
Asset Manager	**Financial Planner**
- Money manager only	- Focus on client life goals
- Provides services for other RIAs	- May outsource investment management

Source: Sincere & Co.

Materials – *Quantity without quality doesn't fly.* Marketing to RIAs isn't about inundating them with glossy marketing pieces, promotions and premiums, but creating product materials that are truly useful. Without a compelling story, supported by attribution analysis that clearly shows the differences between the fund and its peers, intelligent white papers, fact sheets, blogs, etc., RIAs can't get a clear understanding of why they should invest in a firm's product.

Integrated Marketing – *Earning RIAs' trust takes more than booth duty.* "Integrated marketing" in the RIA channel employs a combination of events, advertising, direct mail, in-person meetings, conference calls, and public relations. Many advisors are active in professional associations such as the FPA (Financial Planning Association), NAPFA (National Association of Personal Financial Advisors) and others, and so it can be wise to support these organizations beyond a few conferences a year.

Serving the RIA marketplace is a long-term proposition; firms need to invest a minimum of three years just to get started. Strong product and committed services makes the task easier.

Money Management Profitability in '08

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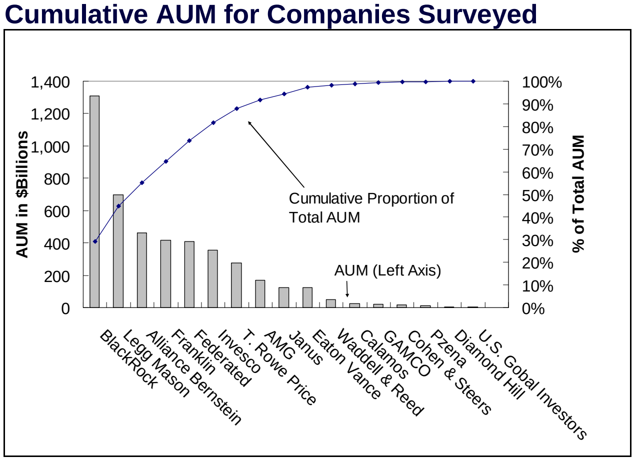
The 2008 Financial Results of Publicly Held Money Managers

Last year saw asset managers under increased pressure due to contracting asset levels and lower corresponding fee revenue. The 17 money managers with publicly held equity surveyed this year by SI *("Public Companies")* saw a 24% decrease in year-end assets under management. Yet, because most of the declines in AUM and fee revenues occurred late in the year, the average pre-tax operating margin for the group dipped just 2%, to 42% from 44% in 2007. (Naturally, 2009 results are weaker). The public companies generated profit of $2.6 billion on collective revenue of $26 billion and AUM of $4.5 trillion. [SI clients can access the full, 40-page report on 2008 money manager finances here.]

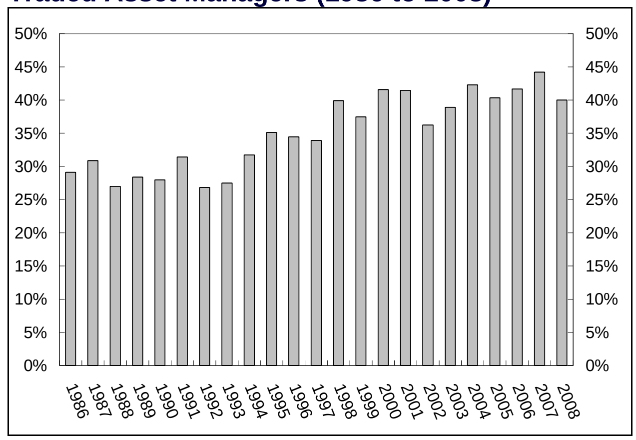
Cumulative AUM for Companies Surveyed



Source: Company Reports, Strategic Insight

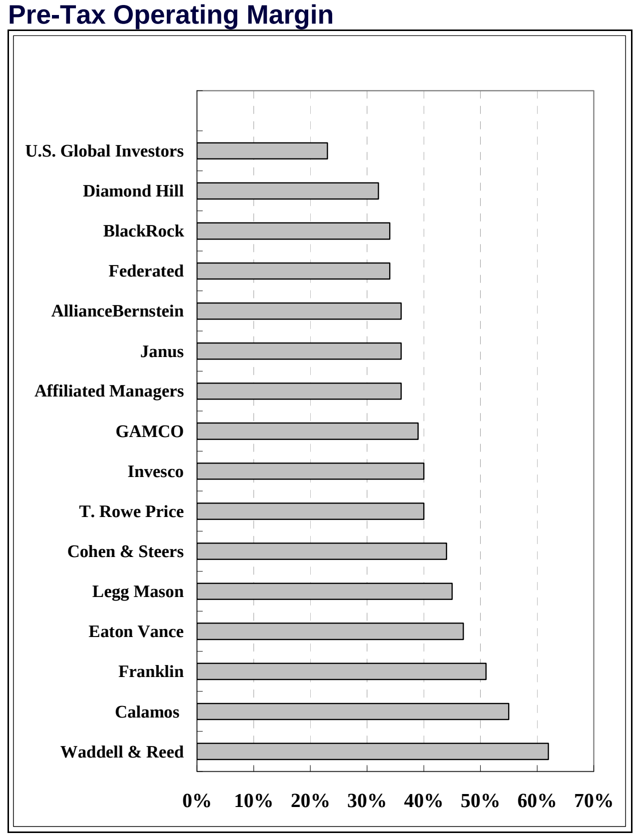
The median pre-tax 2008 operating margin for the group stood at 40% (slightly below the average margin). Although Q4 2008 and Q1 2009 proved especially challenging, the ability of many firms to cut expenses with flattening revenues was clear, as only two companies (Federated and Diamond Hill) witnessed operating expenses rising faster than operating revenues from 2007 to 2008. It's important to note that both of these managers were also the only members of the group to benefit from positive AUM growth in '08.

Median Pre-Tax Operating Margins for Publicly Traded Asset Managers (1986 to 2008)



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

Pre-Tax Operating Margin



Source: Company Reports, Strategic Insight

Six out of the 17 companies experienced slightly higher margins in ’08 as compared to ‘07. Only BlackRock, Alliance Bernstein and Pzena (not shown in the graph above) registered margin increases of more than 2%.

More telling were the results of the companies that *did* suffer from declining margins, as seven were able to control the downturn in operating efficiency by keeping the profitability shortfall (fee revenues minus operating expenses as a % of managed assets) to a maximum of 5%.

Public Managers’ 2008 Revenues

Assets Under Management were battered, as 10 out of the 17 public companies lost more than 30% of their ending AUM from 2007. Aside from Federated and Diamond Hill growing in AUM and BlackRock declining only slightly, revenues were off in most cases.

In aggregate, group revenues retreated 8%. But not all results were discouraging, as five companies experienced revenue growth, including BlackRock, which continued to enjoy impressive progress amid a slight 4% decline in AUM. The combination of its expanding risk management/investment system solution area and cash management business propelled the company’s revenues to a 10% jump from 2007.

Public Managers’ Composite Annual Revenue Growth Rates

	2004	2005	2006	2007	2008
Operating Revenues	20%	21%	28%	28%	-8%

Source: Company reports, Strategic Insight

… And Their Expense Trends

Intense scrutiny to keep costs in check resulted in a 7% drop in operating expenses among the group. Only T. Rowe Price, Federated, Eaton Vance, Waddell & Reed, and Diamond Hill saw an uptick in their costs due to higher compensation and technology expenditures. T. Rowe and Eaton Vance each saw a 3% rise, with Eaton Vance incurring higher costs associated with its new corporate headquarters.

Public Managers’ Composite Annual Expense Growth Rates

	2004	2005	2006	2007	2008
Operating Expenses	14%	19%	25%	25%	-7%

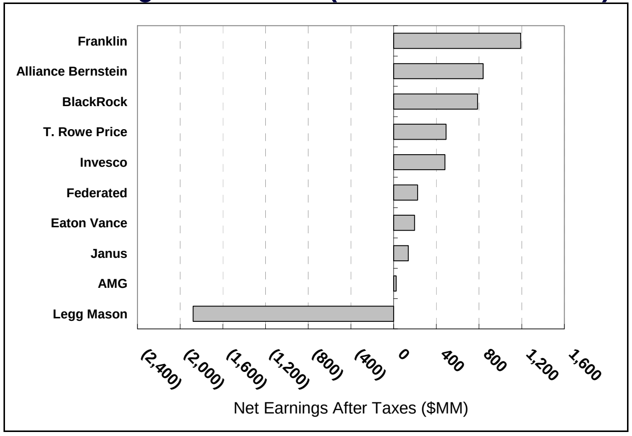
Source: Company reports, Strategic Insight

Public Managers’ 2008 Net Income

Excluding Legg Mason’s nearly $2 billion loss, net income for the group would have been $4.5 billion. For the second straight year, Franklin reached the $1 billion mark in net income.

Larger Asset Managers

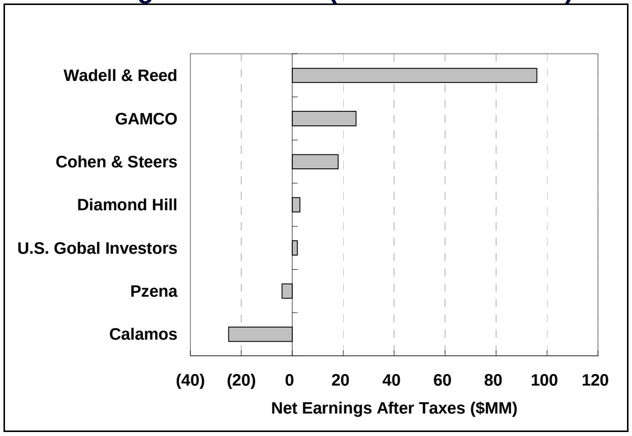
Net Earnings After Taxes (AUM $100B or above)



Source: Company Reports, Strategic Insight

Smaller Asset Managers

Net Earnings After Taxes (AUM under $100B)



Source: Company Reports, Strategic Insight

Fees & Expenses: Breakpoint Analysis

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Analysis of Structures & Schedules

For well over 10 years, Strategic Insight has been benchmarking and advising clients on mutual fund pricing, fee/expense benchmarking, and other mutual fund board-related concerns. Our Fee and Expense Benchmarking studies are on www.sionline.com.

- The first report, *Mutual Fund Industry Fee and Expense Benchmarks*, presents fee and expense benchmarks for actively managed open-end funds.
- The second report, *Contractual Management Fee Breakpoint Schedule Comparison*, provides contractual management fee breakpoint schedule statistics for actively managed open-end funds.

In light of recent market volatility and intensified regulatory attention, we have further expanded our board services staff and research agenda. Additionally, we recently published a third Fee and Expense Benchmarking study focusing on contractual advisory fee structures and schedules. SI clients can see this study here on our Website.

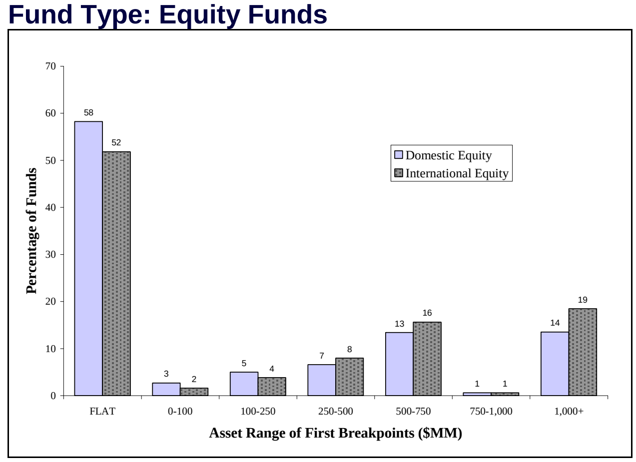
During the second half of 2009, we expect to publish reports on mutual fund transfer agent contracts/fees, small account policies, and sub-advisory fees.

The recently published study focuses on open-end **equity and bond mutual funds that have advisory fee contracts based solely or largely** (e.g. performance adjustment fees, income component, etc.) **on assets**. As of December 31, 2008, 85% of open-end equity and bond funds, representing about 67% of total open-end equity and bond fund assets, had contractual advisory fee schedules based solely or partly on assets. Exclusions exist and are detailed in the published study.

Key Observations

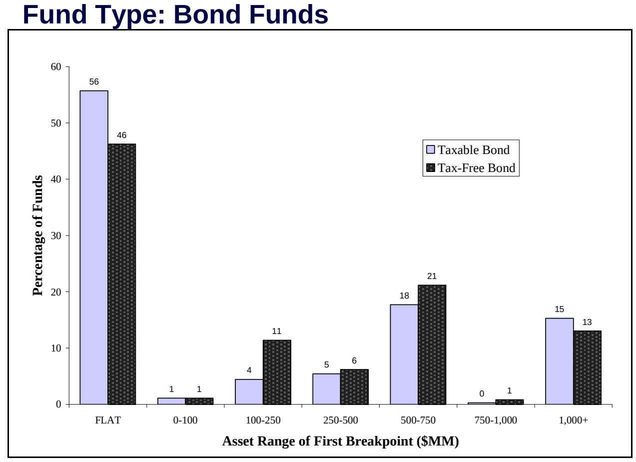
- **Nearly 60% of the domestic equity funds that have fees based solely or largely on assets have a "flat" contractual advisory fee,** which means they do not have breakpoints (some of these funds offer non-contractual advisory fee reductions).
- Among equity and bond funds with advisory fee breakpoints, **$500 million and $1 billion are the two most common first breakpoints.**

2008 Contractual Advisory Fee Breakdown By Fund Type: Equity Funds



Source: Strategic Insight Simfund MF

2008 Contractual Advisory Fee Breakdown By Fund Type: Bond Funds



Source: Strategic Insight Simfund MF

- Among diversified US equity funds that have a contractual advisory fee schedule with breakpoints, roughly 35% are currently large enough to trigger the first breakpoint.

Is self-financing B&C shares worth the risks?

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SG Constellation LLC is a wholly owned subsidiary of Société Générale's Corporate & Investment Banking and is integrated within the firm's newly created Global Markets division. SG Constellation is an expert in deferred sales charge financing, and supports its clients in the U.S (B& C shares), Canada (DSC and Low Load shares), as well those offshore (B shares). SG Constellation, based in New York, also provides hedging solutions to life insurance companies.

Aren't B Shares supposed to be dead?

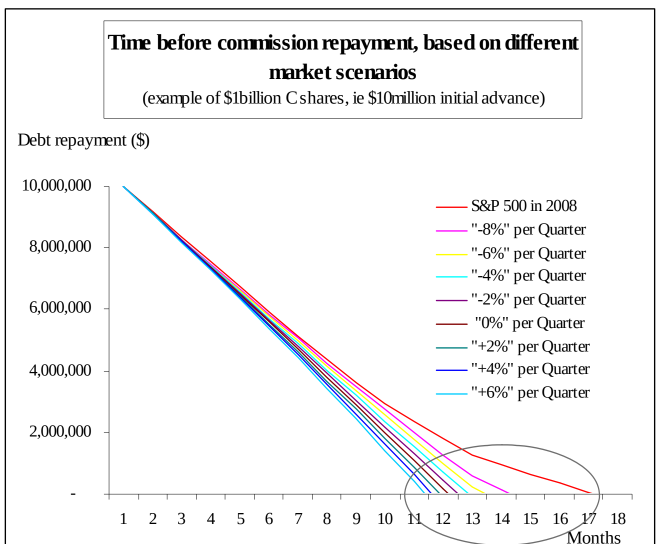
B and C shares continue to account for a rather substantial portion of mutual fund managers' assets (nearly $450 billion). While it is true that over the past five years, B shares have gone out of favor in the US largely due to **concerns about their lack of breakpoints,** they can still represent up to 10% of AUM and may comprise a significant share of new retail sales for those choosing to participate in this share class. Those who opt to stop selling B shares still have significant amounts of deferred commission assets (explained later) on their books that can be monetized. **It is also worth noting that there is a growing appetite for B shares in the Asian markets,** and particularly in Japan, where B shares have proven to be a very successful way for large asset managers to partner with local distributors.

C shares also remain a significant source of new sales within the retail distribution channel, especially through major wholesale programs and financial advisor networks. For instance, the one-year CDSC feature not only makes C shares appropriate for short- to medium-term portfolio reallocations, but also helps avoid front-end loads for investors. For many platforms, the C share product accounts for 10% to 20% of total AUM.

Does it still make sense to self-finance B&C shares?

To support the sale of B and C shares, distributors face some unique challenges. Distributors must pay a sales commission to the broker on day one, only to be repaid over time through uncertain flows of asset-based fees. This flow of fees is usually referred to as a DCA (Deferred Commission Asset). At times, unusually high redemption rates and diminished AUM have often triggered substantial write-offs of DCAs, putting the distributor at further risk. And, **where previously we have seen conventional term financing being employed to finance the upfront commission payments, we can no longer be sure that future fees will cover debt service,** thus leaving the distributor vulnerable to ensuing liquidity issues.

As illustrated by the graph below, adverse market conditions may substantially delay the repayment of the initial commission for C shares if they are self-financed and un-hedged. For example, it would take around 17 months to pay down an advance payment made on Jan. 1, 2008 on an S&P 500 fund; essentially five more months than the standard 12-month period anticipated for C shares. Also, taking into account the 12b-l fee of 1% that is typically paid to the broker beyond the 12-month period demonstrates that C shares can very well be unprofitable to finance in difficult market conditions, especially on funds paying high dividends.



Source: SGCC analysis
Assumptions: 12b1 of 1% in year 1 and 75bps after, 5% interest rate, 10% redemption rate in Y1

From a treasury standpoint, DCAs are similar to a working capital situation with an immediate financing need and a delayed collection of receivables. Working capital is typically financed through a combination of cash and short term debt, with receivables collected within one accounting year. With DCAs, however, the reality is much more complex:

- Financing is medium to long-term (12 months for C shares, 7 years for B shares);
- Receivables are unpredictable in terms of time, magnitude, and duration, and are also subject to a complex combination of portfolio performance and investor-behavior risks;
- As a result, accounting treatment of DCAs is unusually complex and subject to write-offs.

DCAs are not a standard type of working capital, and they combine complex financing and risk management issues.

From a CFO/CEO standpoint, self-financing of DCAs should be part of a strategic discussion on the best allocation of capital resources, cash and debt, in a highly constrained environment. Now more than ever, cash appears to be the “king” for asset management companies. If available, cash has significant opportunity cost that is commonly measured by the WACC (“Weighted Average Cost of Capital”). Simple Net Present Value calculations show that self-financing DCAs is not easily a break-even investment, even under quite optimistic assumptions. Moreover, risks related to DCAs remain significant and difficult to properly hedge.

SG Constellation believes that DCAs have a very poor risk/reward profile when compared to other strategic opportunities.

In today’s market, the transfer of a financier’s risks via securitization is no longer a viable solution. As a result of this, SG Constellation has developed an efficient and sustainable way of managing these risks internally through the use of market instruments such as index options and ETFs. **SG Constellation typically assumes any risk that can be effectively hedged. SG Constellation’s expertise in financing and risk management has allowed it to effectively manage these risks since 1995.**

Solutions

1- Monetizing existing DCAs – SG Constellation’s unique position in managing risks can help a distributor that has DCAs on its books, stemming from B or C shares. SG Constellation can monetize these illiquid assets by estimating their value through the use of proprietary technology. Partnering with SG Constellation provides many benefits, such as:

- Immediate cash
- No risk of debt service shortfalls, etc.

2- Financing program - SG Constellation finances commissions (B or C shares) as sales are made.

- SG Constellation funds the full sales commission.
- In exchange, SG Constellation receives all the 12b-1 sales charges and CDSCs for an agreed term.
- A variety of financing structures are available, including on- and off-balance sheet, and recourse and non-recourse debt.

3- Delta hedging for life insurance companies

SG Constellation can act as a hedging agent and provide a basket of indices and ETFs to replicate large exposures that life insurance companies may have to mutual funds. SG Constellation typically uses 15 projectors or more across various asset classes and rebalances the weights every three months to adjust the replication. Based on its proprietary replication technology, and supported by Societe Generale’s global index and basket trading expertise, SG Constellation is very well positioned to implement such hedging strategies in an efficient way.

Conclusion

Self-financing DCAs, as well as financing B and C shares, poses many risks that SG Constellation can help mitigate. SG Constellation’s expertise in managing DCAs’ complex risks can provide invaluable guidance in financing platforms of B and C shares.

Lastly, SG Constellation’s technology can also be applied to life insurance companies to finance commissions on variable annuities or simply delta hedge large exposures to specific mutual funds.

Variable Annuities: Tide Turning for VAs?



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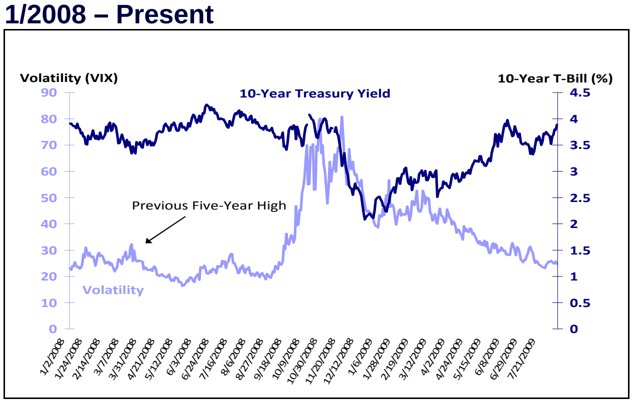
The recent rise in major stock indices, coupled with reduced volatility, has created a sense that the financial crisis is on the mend. However, whether or not the worst is over, the world of finance is certainly changed.

The realm of VAs has witnessed a dramatic series of changes at every level, touching manufacturers and distributors. Two of the key factors in managing living-benefit risks are interest rates and volatility. Looking at these elements charted from the beginning of 2008 (see the accompanying graph), we see that long-term interest rates are roughly in the range they had been prior to October 2008. However, volatility, which has been steadily trending down in recent months, is still higher than it had been before the October crash. Note that even early in 2008, elevated volatility invoked actuarial anxiety about the adequacy of benefit pricing.

Volatility (VIX) and 10-Year Treasury Bill Rate, 1/2008 – Present



Source: CBOE, US Treasury Dept., Strategic Insight

The market plunge in October was the anvil that broke the camel's back. Starting then, change came quickly and companies no longer worried overmuch about how their competitors were going to react. The tumultuous months that followed led to widespread suspension of living benefits, radical alterations, and new releases of benefits with toned-down features.

Today's economic environment may provide some breathing room, yet not enough to spur another cycle of competitive benefit designs. Pricing volatility remains high, elevating hedging costs. For now, the more-conservative product designs and pricing are likely to remain intact, though they may soften a bit.

But Enhancements Continue

As discussed in our tracking of VA trends on SI's AnnuityInsight.com, despite the "rationalization" of guarantees, we are seeing more companies adopting the next generation of the 200%-after-10-year-benefit-base guarantee. **Prudential** will continue to include a guarantee of 400% of the benefit base after 20 years in its latest offering, though the highest percentage version (600% after 25) is falling by the wayside for now. **Jackson National** will also be including a 400% after 20 year guarantee in its newest GLWB.

These guarantees are appealing because they are simple to explain and understand, and because they encourage the delay of the use of benefits (reducing the chance that the policyholder will need the benefit). Given concerns about the actuarial supportability of features today, it follows that companies will pursue enhancements that encourage deferral of withdrawals.

Guarantees that are fundamentally fixed income in nature are easier for the carrier to manage, and we expect more innovations in this area. Consumers may yearn for equity returns, but they often seek guarantees that offer stable and reliable payments. Thus, insurers have a new opportunity to create guarantees that bridge the gap between variable and fixed components.

Moving Ahead

Many questions remain about how the industry will move forward, and whether some insurers will exit the VA business. We anticipate continued innovation, but with a renewed focus on rational guarantees that reflect both consumer demand and sound economics for insurers. This will lead carriers toward less-rich versions of features similar to those sold in recent years and fixed income style guarantees within VAs.

While early signs of economic recovery may not be enough to turn back the clock for the VA industry, this period at least serves to encourage insurers to forge ahead with innovation. Also, as the industry's concern about the sustainability of guarantees settles, we may see renewed interest in other products, such as SALBs (Standalone Living Benefits).

Tool Time: Understanding Estimated Net New Flows



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Flow data is at the core of SI research, and has been for two decades. **Flow data is in our DNA**; for some other data providers it is just one of many services. SI's gold-standard flow data is used in internal analysis, reports to the CEO and Board, in regulatory filings, and in other arenas. Simfund and SI research is used by managers of 90% of our industry's assets, as well as by many equity research analysts, M&A firms, distributors, auditors, the ICI, the SEC, and others.

SI invented cash flow analytics 20 years ago. SI's Simfund cash flow methodology is unique, proprietary, and unrivalled. Our fund-level adjustments each month result in (cumulative) differences of some $10-$30 billion monthly compared to other data providers. For example, during May 2009 alone, adjustments and refinements totaled nearly $20 billion (July adjustments exceeded $17 billion). **Cumulatively, over the past five-to-10 years, share-class level flow differences (between Simfund and other vendors' data) may have reached $1 trillion.**

How Does SI Assure Its Cash Flow Data Integrity?

- **Actual Cash Flows**: Increasingly, fund managers provide SI with actual cash flow data for inclusion in Simfund. Currently Simfund captures actual flows for roughly $1.3 trillion in AUM and a high share of industry's flows; we welcome your interest in providing actual data. No other data provider capturers actual flow data.
- **TNAs Collected from three sources**: SI collects Total Net Assets data directly from nearly all mutual fund companies of size. Month-end TNAs are also received from Lipper and Morningstar.
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- **Cross-Checking**: Each month SI's data universe is matched against the universe captured by Morningstar and Lipper to identify new funds and new share classes. Thus, SI is assured of capturing the largest universe of funds.

We also use a sophisticated **Intelligence Exception Report and Adjustment Algorithm:**

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- An **'intelligence exception report'** is run, checking whether the cash flows for a fund make sense based on past monthly results, investment sector trends, and SI's knowledge of the fund and its management company. Exceptions are reviewed, including **direct inquiries with the management company**. This data assurance process, which runs with multiple and repeated screens, is administered by SI data assurance analyst with 10+ years of experience.
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We encourage your inquiries into our flow methodologies. Upon request, we can share an extensive document detailing our data collection and assurance methodologies.

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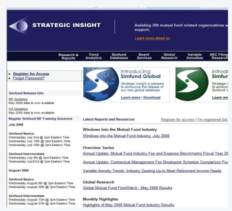

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