

## Strategic Insight

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## Year-End Perspectives



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### Looking ahead to 2010:

- This past year has been a remarkable period for all throughout our industry. With 2010 at our doorstep, **Happy Holidays** to you and your family from the Strategic Insight's family.
- This week you'll also receive SI's **2010 Forecast**; a summary of the nearly 60 reports and webcasts offered this past year and some of our 2010 publishing schedule; and a "State of the Industry" PowerPoint update.
- **Also this week:** on December 18<sup>th</sup> **SI will be moving to its new headquarters** in midtown Manhattan located at 805 Third Avenue (on 50<sup>th</sup> Street). This modern office accommodates our expanding staff, which should grow to over 80 associates during 2010. This new facility enables us to accelerate our client roundtables, seminars, training, webcast, video conferencing, studio presentations, and industry's community events.
- SI in 2010 will continue to increase its capabilities as the gold-standard in competitive intelligence technology and research globally. SI will be expanding its domestic and global reach – opening a **London office** in early 2010, introducing a **Web-based** version of our **Simfund** database, and developing deeper **retirement-focused research** and services in conjunction with our sister organizations PLANSPONSOR / PLANADVISOR. We are excited that **Simfund Global is increasingly used by investment managers around the world**, and that the US version, **Simfund MF, is now available** to subscribers – collectively responsible to over 85% of the industry's assets – **by the ninth business days after month-end** and soon even earlier.
- In this issue: **US, European, and Asian mutual fund developments, ETF evolution**, update on **Lifecycle mutual funds and new fund innovations** including **closed-end funds**.

- **National broker-dealers:** The latest data from our joint research initiative with **Coates Analytics** show that gross sales of bond funds dominated Q3'09 commission-based sales, while equity funds were better represented in wrap program sales.
- **SI Forum:** Our Nov. 2 event drew 72 executives from 45 fund firms. Among the key takeaways, distributors still see mutual funds as core products and see wholesalers as important partners; and FAs are questioning long-term, 'buy-and-hold' models. Watch for announcements on our 2010 conferences.

### Reflections:

- **2009 inflows to bond mutual funds will come in at an all-time record of more than \$400 billion.** These flows have been spurred by demand for income as cash yields remain near zero. We project that 2010 will continue to witness further intermediation from cash in banks and MMFs, with bond fund sales (led by corporate bonds and multi-sector funds) likely to rise by nearly 20% next year, after gaining 50% in gross sales this past year from 2008's pace. **Are bond funds the next bubble?** A slow economic recovery and very slowly rising short-term rates suggest that by the time longer-term interest rates start to rise, safety- and income- seeking investors will have added \$1 trillion-plus to their bond fund portfolios – setting up possible disappointments when bond fund NAVs decline. Meanwhile, **demand for stock funds has been subdued.** US equity/hybrid funds will have redeemed over \$30 billion in all of 2009, under 1% of their assets. In contrast, inflows to international stock funds will have exceeded \$40 billion in 2009. Overall, fund investors' appetite for risk remains low. **Search for income and low risk tolerance will likely dominate the fund landscape in early 2010**, and maybe beyond.
- **Despite the dramatic rise of stock prices in 2009, stock fund investors (especially in US-based funds) have barely increased their purchasing. Many investors are waiting for economic and employment signals of recovery, not just stock price gains.** In past bear markets, it has taken stock investors 12-18 months after a stock market trough to significantly re-engage. Beyond the passage of time, **more FAs and investors are looking for funds and wealth management tools with greater investment flexibility**, as discussed below.

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# Domestic Funds: Trends in 2009



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## Fund Industry Overview (Excludes ETFs and VA Underlying Funds)

	Net New Flows \$B			
	2007	2008	1H'09	7/09-11/09
US Equity	-34.0	-138.6	-2.3	-15.1
Int'l Equity	175.9	-58.8	-1.2	35.6
<b>Total Equity</b>	<b>142.0</b>	<b>-197.4</b>	<b>-3.5</b>	<b>20.5</b>
Taxable Bond	92.3	17.5	105.0	155.5
Muni Bond	9.2	4.6	27.7	36.9
<b>Total Bond</b>	<b>101.5</b>	<b>22.1</b>	<b>132.7</b>	<b>192.5</b>
<b>Total Equity &amp; Bond</b>	<b>243.5</b>	<b>-175.3</b>	<b>129.2</b>	<b>213.0</b>
Money Market	653.2	609.3	-175.8	-336.0
<b>Total Industry</b>	<b>896.6</b>	<b>434.0</b>	<b>-46.7</b>	<b>-123.1</b>

Source: Strategic Insight Simfund MF; historical assets and flows have been restated and may not match past reports

In 2009, equity funds enjoyed modest net inflows, thanks to flows into international funds. As suggested above, US equity funds continued to see outflows in the July-November period, as confidence remained muted after the bounce that led to inflows into such funds in Q2. In that five-month period, meanwhile, international equity funds experienced a rebound in inflows. (For more on international funds, see page 7.)

**Bond fund inflows hit an all-time monthly high** in September, exceeding \$50 billion, as bond fund inflows strengthened in the five months through November. Including VA funds, **total bond fund inflows should easily surpass a record \$400 billion for all of 2009.**

Of taxable bond fund net inflows through October, \$136 billion, or 59%, went to short, short-intermediate, and intermediate portfolios – as many investors sought higher-yielding investments than in money funds.

Muni bond funds also saw robust inflows of nearly \$60 billion in 2009's first 10 months.

Investors withdrew a cumulative \$512 billion from money market funds in the first 10 months of the year, including \$220 billion just in Q3, as institutions and 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 2009. Although the S&P 500 index gained a robust 24.1% through the first 11 months of 2009, **the average domestic equity fund investor surpassed the benchmark index with a 26.9% gain** on an average asset-weighted basis through the first 11 months of 2009 (the performance advantage of just Large Cap Blend funds was a more modest roughly 1%).

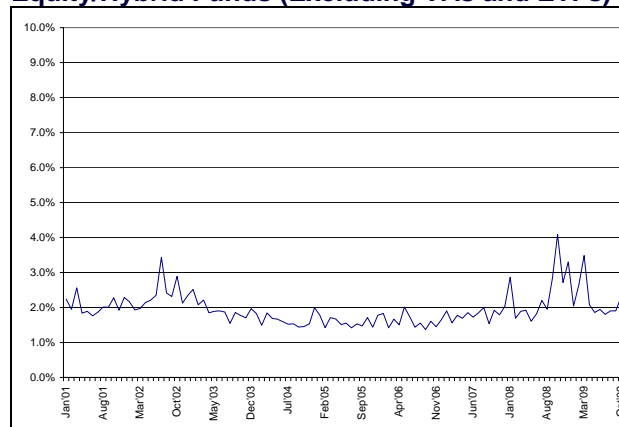
## Average Asset-Weighted Annualized Returns %

	2006	2007	2008	YTD-11/2009
US Equity *	14.1	7.2	-37.0	26.9
Int'l Equity	24.3	16.4	-41.9	37.2
Taxable Bond	5.5	5.7	-5.0	17.4
Muni Bond	5.2	1.2	-9.0	15.4
Money Market	4.4	4.7	2.3	0.3

\* 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 fund industry have not abated. Consequently, the pace of new equity fund investments has been slow. 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	YTD-10/09
Actively Managed Funds	73.3	-237.5	-12.1
Index Funds (non-ETF)	45.1	40.0	28.0
ETF Open-End Funds	90.6	96.1	40.6
ETFs structured as UITs / Grantor Trusts / ETNs /Other	43.4	56.9	-9.4

Source: Strategic Insight Simfund MF; historical assets and flows have been restated and may not match past reports

Equity index and open-end ETFs continued to draw investors' interest. On the bond side, both active and passive bond funds 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	YTD-10/09
Actively Managed Funds	80.8	12.4	270.5
Index Funds (non-ETF)	16.6	9.6	18.4
ETF Open-End Funds	13.1	13.1	38.9

Source: Strategic Insight Simfund MF; historical assets and flows have been restated and may not match past reports

**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 10 months 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). Trailing relative performance may soon be even more significant in marketing funds.

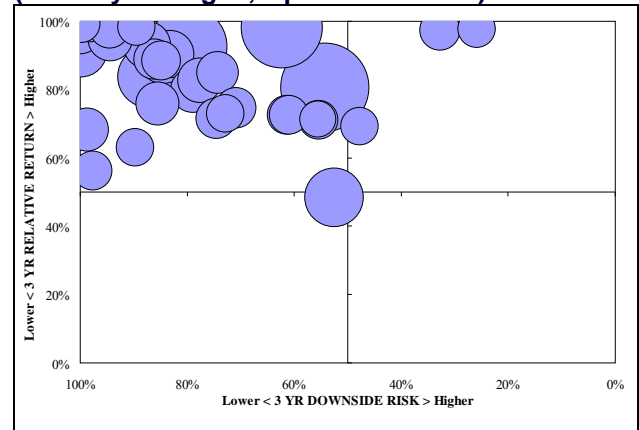
As an illustration of cash flow results through the first 10 months of 2009, we capture below the "trailing three-year risk-return vs. cash flow bubbles" of the industry's 40 highest cash flow funds in the year to date through October '09 (risk and return measured

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 YTD-10/2009 net inflows.**

The funds in the charts clearly share appealing risk-return characteristics for the 36 months ending Oct. 2009. The few outliers are funds from respected managers benefiting from a "halo" effect, hard-to-classify funds, or those reflecting strong performance in earlier periods. In the bond area, some funds with high relative yields (but below-average relative returns) saw high net inflows in the first three quarters of 2009.

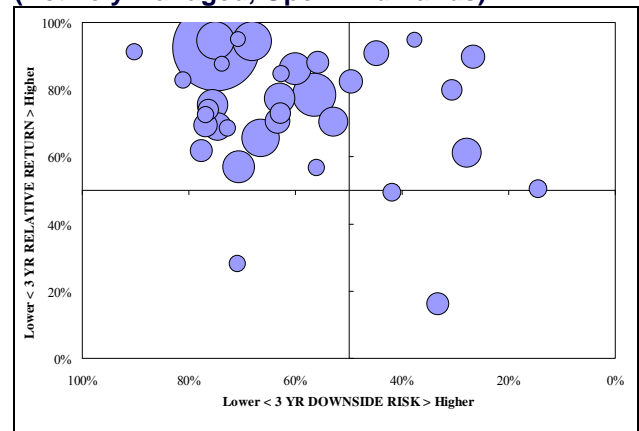
**Risk-Return Characteristics of Best Selling Mutual Funds in YTD-10/2009**

**Highest Net Inflow Equity Funds in YTD-10/09 (Actively Managed, Open-End Funds) \***



\*YTD-10/09 Flows and 3-Yr. Risk/Return Analysis within Lipper Classifications; Source: Strategic Insight Simfund MF

**Highest Net Inflow Bond Funds in YTD-10/09 (Actively Managed, Open-End Funds) \***



\*YTD-10/09 Flows and 3 Year Risk/Return Analysis within Lipper Classifications; Source: Strategic Insight Simfund MF

# Global Trends: No More Excuses



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## Carmignac, a Study in Success

There is much discussion in the industry these days about Carmignac. The French boutique asset manager was founded by Edouard Carmignac in 1989 and after decades of existence with less than \$1 billion in assets, it has seen more than \$11 billion of inflows to its flagship Patrimoine fund this year alone. In September, the firm’s total assets topped out at roughly \$42 billion.

Carmignac’s phenomenal success has stretched the industry’s concepts about what is possible for funds today. One implication is that fund managers no longer have many excuses for marketing failure, particularly in Europe. **Through September, Carmignac captured over \$18 billion in net flows, with more than \$2 billion coming in every month for the past five. If they can do it, why can’t others?** Some excuses included distributors preventing scalable progress by focusing too much on commissions and short-term churning. While there’s some evidence of that in various channels, Carmignac nevertheless overcame the obstacles and built a meaningful asset management business with, ironically, a steadfast commitment to the longer term. They achieved their gains in part by going beyond retail bank distribution, focusing instead on private banks and IFAs/ RIAs with a one-fee-for-all-channel approach. In a recent *Financial Times* article, Mr. Carmignac described the firm’s success as occurring “by default,” noting that “it’s not so much that we’re so clever, it’s that other people are not doing what they should.”

## A Product Perspective

Management group gains are in many cases driven by a few flagship funds. For Carmignac, the Patrimoine fund has accounted for 62% of the management company’s flows this year and represents roughly half of the assets held in the firm’s offerings. The table that

follows highlights other top-selling funds in Europe, many of them current flagships for their companies.

### Europe/Offshore: Top-Selling Long-Term Funds, YTD Thru 9/09, in US\$ Billion

Portfolio	Domicile	Flows
Carmignac Patrimoine	France	11.4
BlueBay Invnt Grade Bd Base	Lux	7.4
Schroder ISF Euro Corporate Bd	Lux	5.2
AllianceBernstein-Global HY	Lux	3.9
M&G Corporate Bond	UK	<u>3.2</u>
<b>Total Above</b>		<b>31.1</b>

Source: Strategic Insight Simfund GL

Carmignac’s flagship fund is a balanced strategy spun around an “absolute performance” message. Through September, the fund averaged 15.2% returns for the year (in local currency terms) and in June became the largest long-term product in Europe. A year ago it was barely in the top 40. The dramatic pop in ranking attests to the major restructuring of the fund business in Europe in a short period of time. Carmignac met the occasion by signaling the fund now has “critical mass,” thus helping to make it “an essential product for covering investors’ strategic long-term savings needs, particularly with a view to funding retirements.” Active management, balanced approach, international scope, and protection of assets are all served up as hallmarks of suitability for this purpose.

In March, the group put another foot into the absolute return waters by converting its Market Neutral portfolio into a UCITS vehicle (the track record dates back to 2006). But assets as of September stood at roughly \$112 million, a fraction of the roughly \$21 billion managed by the flagship. Market Neutral’s modest progress serves as a gauge for the prospects of long/short approaches in the fund industry, as a number of companies seek to bring alternatives into the mainstream.

## Carmignac in Context

Across Europe, traditional strategies were top-sellers thus far in 2009. (Nearly half of Carmignac’s long-term product offerings fell into the region’s top-selling categories; its Patrimoine fund was among the region’s fourth highest-selling category, which garnered \$5.2 billion in flows.) Across the region, investors continued to show aversion to certain higher-risk vehicles, with hedge products experiencing over \$14 billion in redemptions. Net inflows to Europe’s top-selling categories outpaced outflows by roughly \$1 billion.

### Best & Worst Selling Long-Term Categories in Europe by Net Flows, YTD Thru 9/09

<b>Best Selling</b>	<b>Net Flows, \$B</b>
Equity Europe	19.2
Bond Europe	15.8
Mixed Balanced Flex	8.3
<b>Total Above</b>	<b>43.3</b>
<b>Worst Selling</b>	<b>Net Flows, \$B</b>
Hedge	-14.1
Guaranteed/Protected	-12.5
Mixed Conservative	-4.3
<b>Total Above</b>	<b>-30.9</b>

Source: Strategic Insight Simfund GL

In Asia, Bond and Equity Asia Pacific categories continued to see positive flows – over half of the \$20.7 and \$17.3 billion in respective gains to date were made in July and August. Bond High Yield products have captured \$12.1 billion this year, with all but \$1.2 billion going to Nomura's high yield strategies in Japan (more details to follow). Inflows to the region's top-selling categories outpaced its worst by some measure.

### Best & Worst Selling Long-Term Categories in Asia by Net Flows, YTD Thru 9/09

<b>Best Selling</b>	<b>Net Flows, \$B</b>
Bond High Yield	12.1
Equity Asia Pacific	11.1
Real Estate	8.8
<b>Total Above</b>	<b>32.0</b>
<b>Worst Selling</b>	<b>Net Flows, \$B</b>
Bond Global	-7.8
Mixed Conservative	-5.4
Mixed Balanced Flex	-0.9
<b>Total Above</b>	<b>-14.1</b>

Source: Strategic Insight Simfund GL

The renewal of spirits across Europe these days has rubbed some of the sparkle off Asia, but locally domiciled funds in the East are still outpacing those in the West. Through August, long-term Asia funds collected \$55 billion of inflows as compared to \$38 billion into their local European counterparts. (Cross-border international products pulled in \$88 billion and long-term strategies in the US captured an impressive \$282 billion for the same period.)

Among the top-selling long-term funds in Asia, there has been dominance by India fund managers like HDFC, Birla Sun Life, and Kotak Mahindra. Their

Bond Asia Pacific funds advertise liquidity for short-term investors (with a horizon as brief as seven days in the case of Kotak Floater Long Term Growth). The funds invest in securities and money market instruments and though offered to retail and institutional investors, they seem to attract most flows from institutional clients.

China also remained prominent. The July launch of CSI 300 Index by ChinaAMC gathered \$3.6 billion in a mere three days. Though the fund is now closed to new investment, it still ranks among the highest-selling funds in Asia in 2009. Also notable in the table below are sustained high inflows to Nomura's second ("new") US High Yield fund. Combined inflows this year to both Nomura US High Yield products have exceeded \$6 billion.

### Asia: Top-Selling Long-Term Funds YTD Thru 9/09, in US\$ Billion

<b>Portfolio</b>	<b>Domicile</b>	<b>Flows</b>
Nomura New US High Yield Bond Fund	Japan	5.8
Birla Sun Life Savings Fd-Retail Growth	India	4.2
ChinaAMC CSI 300 Index Fund	China	4.1
HDFC Cash Mgmt Fd-Treasury Adv	India	2.8
E Fund CSI 300 Index Fund	China	<u>2.5</u>
<b>Total Above</b>		<b>19.4</b>

Source: Strategic Insight Simfund GL

### The Future—a Broader Scope

Along with local and international fund industry recovery, cross-border product distribution through Asian hubs is also rebounding. Data from the Hong Kong Investment Funds Association shows that the ratio of gross sales to redemptions has risen from 90% in Q1 (net redemptions) to over 100% in Q2 (flat), and over 130% in July and August (inflows), while the pace of gross sales has more than doubled since the first quarter. **Most of that activity is going to international products.** From the data we also know that the emphasis in the hub continues to be on Greater China and other regional equity and sector funds. One beneficiary has been Fidelity – our Simfund Global database reveals over \$1 billion of inflows to the firm's China Focus fund in 2009 from all sources worldwide.

Edouard Carmignac has not been shy in stating his desire to turn his firm into "the next Fidelity". With Carmignac's 19 products being widely sold across the major markets of Europe, Asia seems a possible next step. For more details on Carmignac's strategy, see "The Seven Secrets to Carmignac's Success" on [www.GlobalFundDistribution.com](http://www.GlobalFundDistribution.com).

# International Funds: 2009 Update



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

Structure/Type	Assets		Net Flows			
	10/09	2005	2006	2007	2008	YTD-10/09
<b>Open-end Active</b>	<b>1,183</b>	<b>116</b>	<b>147</b>	<b>138</b>	<b>-69</b>	<b>23</b>
Open-end Indexed	82	9	13	18	11	6
ETFs*	230	26	31	51	27	42
Closed-End	33	7	3	19	0	0
VA Funds	173	13	22	20	4	5
<b>Total</b>	<b>1,701</b>	<b>171</b>	<b>216</b>	<b>248</b>	<b>-26</b>	<b>76</b>

Source: Strategic Insight Simfund MF / VA. \*ETFs include UIT and open-end ETFs; Int'l Equity includes Gold; historical assets and flows have been restated and may not match past reports.

**Flows into US-domiciled International / Global equity funds continued to be strong, adding \$76 billion through October '09 (and November brought an additional \$13 billion).** Domestic equity funds, meanwhile, saw net outflows in 2009.

A large part of international funds' success at capturing flows was fueled by ETF flows. The inclusion of, (mostly non-US invested) Gold funds to the International universe, as is our new methodology, strengthened this trend; gold ETFs saw net inflows of more than \$14 billion through October 2009 (see more on ETFs on page 8).

Superior returns for international/global funds persisted in 2009, with these funds outperforming domestic funds by a 10% margin (on average) so far this year.

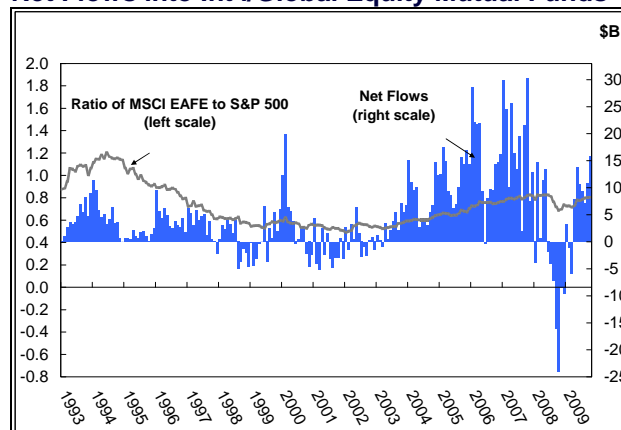
## Int'l Equity, US Equity, and World Bond Funds Annual Average Total Returns (Asset-Weighted)

	'04	'05	'06	'07	'08	Ytd-10/09
U.S. Equity*	12.70	7.94	14.08	7.20	-37.95	20.79
Int'l/Glbl Eqty	18.37	16.23	24.33	16.43	-41.83	31.70
World Bond^	8.96	-2.09	6.62	8.93	0.16	13.56

Source: Strategic Insight Simfund MF; \* Exc. Balanced/Hybrid, Int'l Equity now includes Gold; historical data may not match prior reports. ^ Morningstar category.

The trend of the outperformance of the EAFE and the recovery of inflows since April 2009 continued through October as captured in the chart below.

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



Source: Strategic Insight Simfund, Standard & Poor's; Int'l flows include Gold funds

Actively managed emerging markets funds, like their ETF counterparts, top the list of highest flow classifications for the year thus far, with over three times the net inflows of the next closest style; some of those flows resulted from performance-chasing. Overall, flows to international/global equity funds also reflected a return to the global diversification of investors' portfolios that we saw in years prior to 2008.

## Actively Managed Int'l/Global Equity Funds 10 Highest YTD Net Flow Classifications

	Net Flows \$B		Assets \$B
	3Q 2009	YTD-10/09	10/09
Emerging Markets	4.48	12.42	117.6
Intl Large-Cap Growth	2.19	3.36	96.7
Pacific Ex Japan	0.97	3.12	16.6
Intl Multi-Cap Core	2.25	2.75	42.4
Intl Multi-Cap Growth	1.70	2.10	33.7
China Region	0.77	2.09	8.0
Intl Multi-Cap Value	1.12	2.01	35.0
Gold Oriented	0.09	1.94	19.4
Latin American	0.11	0.80	8.6
Intl Sm/Mid-Cap Core	0.60	0.70	9.9

Source: Strategic Insight Simfund MF; Excludes index funds and ETFs, as well as VA funds; historical assets and flows have been restated and may not match past reports.

# ETF Update: Growth Continued



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ETF growth continued through the first 10 months of 2009, with US net inflows of \$71 billion (and inflows of \$15 billion in November). Echoing trends in the traditional fund space, bond ETFs accounted for 55% of net inflows year to date through October. **At the end of Oct. 2009, US ETF assets (including ETNs) were \$699 billion (and \$746 billion by November-end).**

## ETFs: By Investment Type

	Assets		Net Flows \$B		# of Funds
	\$B			YTD-10/09	
	10/09	2007	2008	10/09	10/09
<b>US Equity</b>					
Diversified	263.8	62.0	87.4	-32.2	227
Sector	80.2	16.7	32.6	11.4	218
<b>Subtotal US Eqty</b>	<b>344.0</b>	<b>78.6</b>	<b>120.0</b>	<b>-20.8</b>	<b>445</b>
<b>Int'l/Global Equity</b>					
Diversified	51.6	16.2	9.0	-0.9	47
Divsfd Emerg Mkts	55.3	14.0	9.3	12.9	27
Single Country	51.5	6.6	-0.4	10.6	54
Regional	15.6	4.4	-0.8	2.4	25
Sector	10.3	5.1	2.4	3.1	74
<b>Subtotal Int'l/Glbl Equity</b>	<b>184.3</b>	<b>46.2</b>	<b>19.5</b>	<b>28.1</b>	<b>227</b>
<b>Bond</b>					
Taxable Bond	94.2	12.5	20.8	36.0	61
Muni Bond	5.4	0.6	1.7	3.1	18
<b>Subtotal Bond</b>	<b>99.7</b>	<b>13.1</b>	<b>22.5</b>	<b>39.1</b>	<b>79</b>
<b>Specialized</b>					
Commodity	65.3	9.2	13.5	23.7	66
Currency	5.2	2.2	0.4	1.2	35
<b>Subttl Specialized</b>	<b>70.5</b>	<b>11.4</b>	<b>13.9</b>	<b>24.9</b>	<b>101</b>
<b>Total</b>	<b>698.5</b>	<b>149.3</b>	<b>175.8</b>	<b>71.4</b>	<b>852</b>

Source: Strategic Insight Simfund MF

The robust flows into ETFs in 2009 were impressive. Indeed, while ETF inflows may not experience the market-crisis-induced surge of 2008, when a record \$175 billion flowed into US ETFs, we estimate that ETFs should easily top \$100 billion in full-year 2009 net inflows. The year should end with US ETF assets over \$760 billion, a record.

The number of exchange-traded products continued to grow, reaching 852 at October 2009, up from 818 at the end of 2008 and 654 at the end of 2007. However, product rationalization also continued: as of October, there were 69 ETPs with less than \$5 million in assets, versus 145 under-\$5 million ETPs at the end of 2008.

The continuing momentum in 2009 marks a maturing of the ETF space, as the diversity of the ETF marketplace allows for growth under conditions of market decline and also market recovery. Note that ETFs were essentially vehicles for US equity exposure until five years ago, but this year's net inflows were driven by non-domestic equity funds. At October 2009, US equity represented only about 49% of total US ETF assets and roughly 55% of exchange-traded products.

## Most Popular ETFs YTD 2009

The table below lists the highest cash-flow ETFs of 2009 through October. Seven of the top 15 were fixed-income ETFs, not surprisingly, as ETF investors mirrored the income-seeking activities of fund shareholders at large.

## Highest Cash Flow ETFs YTD Thru 10/2009

Fund Name	Start Year	Assets		YTD-10/09 Net Flows	Rate*
		\$B	10/09		
SPDR Gold Shares	2004	36.9	<b>12.3</b>	57%	
iShares Barclays TIPS Bond	2003	17.2	<b>7.6</b>	88%	
Vanguard Emrg Mkts Stk Index	1994	15.5	<b>6.7</b>	132%	
iShares iBoxx \$ Invst Grd Idx	2002	12.9	<b>4.9</b>	70%	
US Natural Gas	2007	3.8	<b>4.6</b>	658%	
iShares MSCI Emerging Mkt Idx	2003	35.0	<b>4.2</b>	22%	
UltraSh 20+ US Trsy ProShares	2008	4.5	<b>3.4</b>	222%	
iShares Barclays 1-3yr Crd Bd	2007	4.1	<b>3.2</b>	399%	
UltraSh S&P 500 ProShares	2006	3.6	<b>3.1</b>	137%	
Vanguard Total Bond Mkt Index	1986	5.8	<b>2.6</b>	88%	
PowerSharesDB Cmmnty Indx	2006	3.7	<b>2.2</b>	185%	
iShares MSCI Brazil Index	2000	10.3	<b>2.2</b>	62%	
SPDR Barclays Cpt HiYld Bd	2007	2.9	<b>1.8</b>	266%	
Vanguard Short Bond Index	1994	3.1	<b>1.8</b>	159%	
Direxion Daily Finl Bear 3X	2008	1.2	<b>1.8</b>	2,058%	

\*YTD-10/09 Net Flows as a % of 12/08 assets.

Source: Strategic Insight Simfund MF

**Three of the 15 highest-cash-flow ETFs invested in emerging markets**, thanks to those markets' relative outperformance in 2009 and driven in part by strong October inflows (the iShares MSCI Emerging Markets fund and the Vanguard Emerging Markets fund were, respectively, the highest and second-highest cash-flow ETFs of October). And three were linked to commodities or commodity sectors; the SPDR Gold Shares was the big winner, taking in a net \$12.3 billion year to date.

Among the more interesting phenomena in 2009 was the growth and then halt of **leveraged and inverse ETFs**. Following the dramatic growth of these ETF types since the start of 2008, FINRA issued a warning in late June about the suitability of investing long-term in leveraged/inverse ETFs, given their daily tracking goals. Then, several national broker-dealers placed restrictions or outright bans on the sales of these products, and FINRA raised margin requirements on leveraged ETFs effective December 1.

#### Leveraged & Inverse ETFs, YTD-9/2009

Net New Flows, in \$B, First 6 Months 2009	<b>\$13.7 B</b>
Net New Flows, in \$B, in Q3 2009	<b>-\$2.7B</b>
Total Assets, in \$B, at Sept. 2009	<b>\$30.0B</b>

Source: Strategic Insight Simfund MF

As we'd predicted, these developments depressed sales of leveraged/inverse ETFs in Q3. Leveraged/inverse ETFs saw net outflows of \$2.7 billion in the third quarter, after strong inflows of more than \$13 billion in the first half of 2009. The entire leveraged/inverse ETF universe didn't freeze, however, as 64 out of 138 such products experienced net inflows in Q3'09 – and, notably, fixed-income leveraged/inverse ETFs (a small product set of only seven ETFs/ETNs) captured net inflows of \$750 million in Q3'09.

#### New ETF Launches YTD 2009

Through the first 10 months of 2009, 85 new exchange-traded products launched, drawing an aggregate \$4.5 billion in net inflows – including 13 new products that each took in \$100 million or more in net inflows.

What's notable about the 10 most successful new ETFs of 2009 is the diversity of them: no one sector or strategy dominates the list. The Barclays-issued iPath ETN investing in short-term futures on the CBOE volatility index has been the standout launch of 2009, taking in just under \$800 million in inflows. But other interesting new successes include JP Morgan's ETN investing in master limited partnerships, the iShares convertible bond ETF and a Direxion ETF offering 300% daily long exposure to the MSCI U.S. REIT index.

#### Top New ETFs YTD-10/2009, By Flows

	Assets	Net New
	\$MM	Flows \$MM
	10/09	Ytd-10/09
iPath S&P 500 VIX ShrtFtrs ETN	665	<b>798</b>
Van Eck MktVector BrzlSmCp ETF	498	<b>449</b>
JPMorgan Alerian MLP Index ETN	448	<b>399</b>
Vanguard FTSE AW ExUs SmCp	283	<b>257</b>
ETFs Silver Trust	197	<b>196</b>
UltraPro Shrt S&P500 ProShares	161	<b>179</b>
Van Eck MktVector Indonesia ETF	188	<b>176</b>
PIMCO 1-3yr Treasury ETF	166	<b>166</b>
SPDR Barclays Cpt Cnvt Bd ETF	145	<b>132</b>
Direxion Daily RealEst Bull 3x	107	<b>108</b>

Source: Strategic Insight Simfund MF

Other notable launches in the first 10 months of '09: The ETFs Silver Trust marked the first US launch by Europe's ETF Securities; expect more cross-border activity in this space. Also, PIMCO's first ETF, a short-duration Treasury product, took in a respectable \$166 million in its first five months. At the end of October, PIMCO had \$300 million in seven ETFs. And Van Eck saw success with ETFs that provide exposure to individual emerging-markets countries.

Launches and year-to-date flows resulted in some changes in market share among ETF sponsors; notably, InvescoPowerShares and ProFunds switched places (fourth and fifth) since June, and PIMCO (not shown) entered the top 20 in assets and market share.

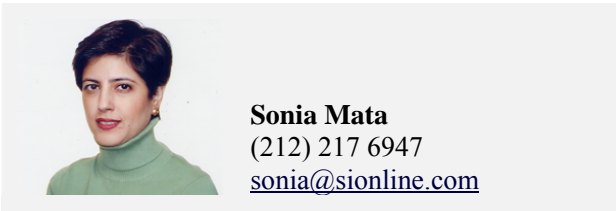
#### Top 10 ETF Managers as of Oct. 2009

Manager	Assets	Market	Net New	# of
	\$B	Share	Flows \$B	Fnds
	10/09	10/09	Ytd-10/09	10/09
Barclays/BlackRock	<b>348.8</b>	49.9%	35.0	207
State Street Global	<b>159.9</b>	22.9%	-15.1	88
Vanguard	<b>78.6</b>	11.3%	20.4	39
InvescoPowerShares	<b>30.0</b>	4.3%	1.9	102
ProFunds	<b>25.2</b>	3.6%	8.6	89
Van Eck	<b>10.0</b>	1.4%	3.2	21
DB Commodity Svcs	<b>9.1</b>	1.3%	5.1	11
Bank of New York	<b>7.6</b>	1.1%	-0.5	1
US Commodity Funds	<b>6.0</b>	0.9%	3.5	6
Rydex Investments	<b>5.6</b>	0.8%	0.8	40

Source: Strategic Insight Simfund MF

The US ETF market remains concentrated, with the three biggest sponsors controlling 84% of the assets. The industry awaits the continued growth of PIMCO and Charles Schwab (which launched its first ETFs in November and raised \$144 million), and other new players and trends.

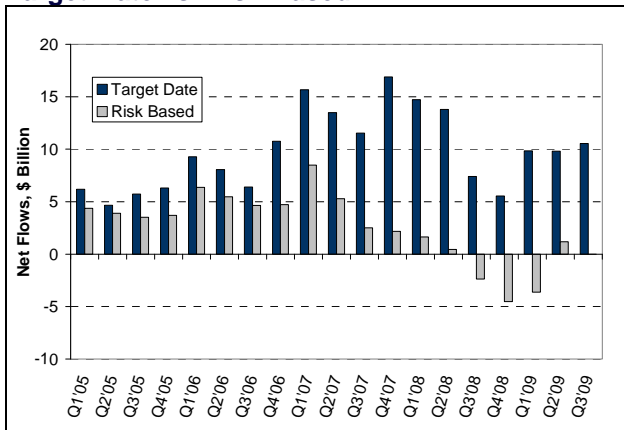
# Lifecycle Mutual Funds – An Update



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**Target-date lifecycle funds** have seen steady and strong net inflows this year, with no individual month’s volume dropping below the \$2.5 billion mark, and the average monthly flow volume for the year through October equaling \$3.2 billion, not much below the \$3.7 billion monthly average over January-October 2008. The three fastest-growing target-date lifecycle fund managers so far this year through October (among firms that managed at least \$500 million in target-date fund assets at the end of 2008) were **American Century**, **TIAA-CREF**, and **American Funds**.

## Quarterly Lifecycle Mutual Fund\* Net Flows Target-Date vs. Risk-Based



\* Retirement and non-retirement investors, excluding 529 plan funds and variable annuities.

Source: Strategic Insight Simfund MF

**Risk-based lifecycle funds**, which had shown less stability in flows in the aftermath of the recent financial crisis, have experienced an improvement in recent months—in the form of net outflows largely stemming. The top ten cash-flow managers in this segment over the trailing three months as of 10/09 collectively garnered \$2 billion. The three fastest-growing risk-based lifecycle fund managers in the ten-month Jan-Oct’09 period (among firms that managed at least \$500 million in risk-based fund assets as of 12/08) were **Manning & Napier**, **Franklin Templeton** and **Thrivent Financial**.

## Highest Ytd-10/09 Cash Flow Lifecycle Fund Managers

Manager Name	Assets \$B	Net Flows \$B			Flow Rate Ytd-10/09
		2007	2008	Ytd-10/09	
<b>Target-date</b>					
Vanguard	50.2	14.0	13.0	9.7	29%
Fidelity	92.4	19.2	11.0	8.6	13%
T Rowe Price	38.2	11.5	6.8	5.6	22%
Principal Funds	13.7	4.0	3.0	2.1	22%
American Funds	5.6	1.6	2.6	1.7	54%
TIAA-CREF	3.5	1.0	1.1	1.2	63%
American Cent.	1.9	0.2	0.2	0.9	120%
Wells Fargo	5.4	0.9	0.7	0.9	37%
John Hancock	2.9	0.8	1.4	0.8	48%
Barclays Gbl Inv	2.7	0.6	-0.2	0.5	25%
<b>Risk-Based</b>					
John Hancock	26.1	3.6	1.7	1.1	6%
Manning&Napier	2.0	0.3	-0.1	0.5	40%
Franklin Tmptn	2.4	0.2	0.4	0.4	24%
Putnam	4.9	0.7	-0.6	0.4	10%
JPMorgan Fds	5.3	-0.1	-0.4	0.3	8%
Thrivent Fin'l	2.8	0.9	0.5	0.2	11%
Nationwide Fds	4.3	0.3	0.1	0.1	4%
Vantagepoint	4.1	0.3	0.0	0.1	4%
Pacific Life	1.4	0.4	0.1	0.1	11%
DFA	2.2	0.5	0.3	0.1	6%

Source: Strategic Insight Simfund MF

In the [Sep'09 issue of Windows](#) (see pages 11-16 of that issue), we referred to the ongoing evolution in TDF glide paths. That process is continuing. For instance:

- In late September, **Fidelity** announced it would raise the target international equity fund exposure of its **Freedom and Freedom Advisor fund series** as a percentage of their targeted total equity fund exposure, to 30% from 20%. The Freedom funds will also introduce commodities and TIPs into their asset mix.
- Also, **John Hancock** has extended the glide path for its **TDF series** by another 20 years. Previously, the “dated” funds in the series reached their most static allocations at retirement at which point their goal/strategy and investment policies became similar to the series’ “Retirement Portfolio.” As of Nov’09, the dated funds have changed their strategies such that they will continue to become more conservative for another 20 years after retirement, at which point the equity allocation will be 25%; the “Retirement Portfolio” has been eliminated.
- **Vantagepoint** is another sponsor that has filed (the change is not effective yet) to extend the glide path of its **TDF series** so the equity “landing point” will be reached 10 years after the year in the name of its TDFs rather than during the year in the fund’s name as is currently the case.

# National Broker-Dealer Distribution Trends in Q3'09

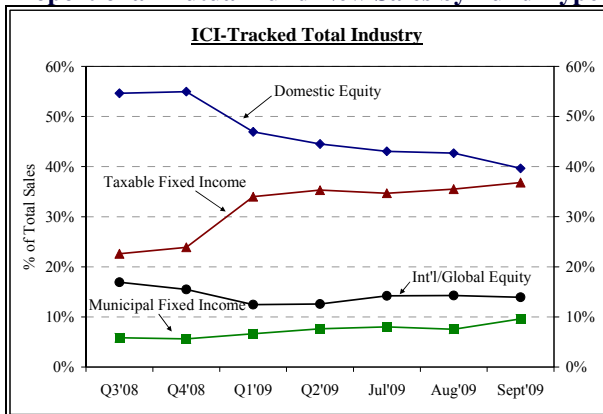


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Bond funds' high pace of demand persisted during the third quarter of 2009, on its way to a record of nearly \$400 billion in inflows for all of 2009. In contrast, equity fund buying (particularly domestic stock funds) has remained relatively flat.

From a proportional gross sales perspective, as depicted in the graph below, demand for both taxable and municipal fixed income funds has trended consistently upward as 2009 has progressed, at the expense of equity funds. As of September, equity funds still held a slim *gross* sales advantage over bond funds. However, a major source of these equity sales were likely via qualified retirement accounts, and this edge in gross sales over bond funds was down significantly from a year earlier.

## Proportional Mutual Fund New Sales by Fund Type



Source: Strategic Insight Simfund TD / ICI

Within the framework of this overall industry picture, interesting differences have emerged across various segments of the fund distribution landscape. In SI's continued joint quarterly research with Coates Analytics, combining the distinctive sales and

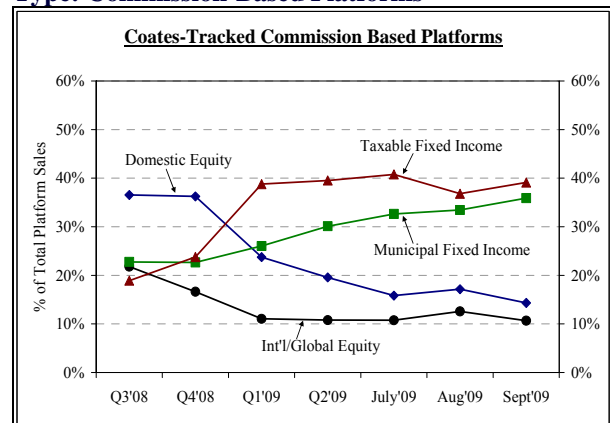
distribution data in Coates Analytics' Distribution Management System™ with the industry perspective and expertise of Strategic Insight, we have observed significant trends in investor and financial advisor demand at national broker-dealers – trends that vary from commission-based to mutual fund wrap platforms.

In this article, we summarize some of the important macro-level findings from the Q3'09 version of our National Broker-Dealer Distribution Opportunities report series. [This new **subscription-based quarterly report series** provides important competitive benchmarking, peer group analysis, and actionable information regarding the National BD distribution marketplace. For more information regarding subscription options for this quarterly report series, contact Dan Weinerman – [dweinerman@sionline.com](mailto:dweinerman@sionline.com); 212-217-6897.]

## National BD Sales Trends

In the context of the continued explosion in bond fund sales industrywide during Q3'09, the commission-based platform structure continued to be a primary distribution vehicle for FAs in supporting this demand. As can be seen in the graph below, proportional gross sales of bond funds, both taxable and tax-free, accelerated to an overwhelming 75% of long-term commission-based fund sales during September'09 within national broker dealers.

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



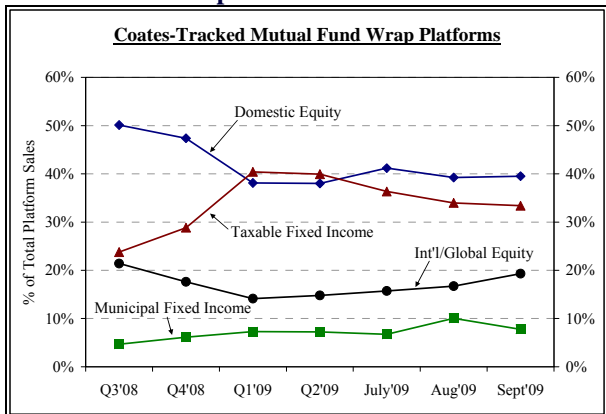
Source: Coates Analytics Distribution Management System

While sales of taxable bond funds remained relatively steady on a proportional basis within commission-based platforms during Q3, the key driver of the continued rise in total bond fund sales were tax-free fixed income investments. Proportional sales into

municipal bond funds rose more than 6 percentage points, from 30% during Q2'09 to 36% in September, as FAs and investors continued to a large extent to use shorter-duration municipal funds as an income substitute for zero-yielding money market and cash-equivalent products.

Contrary to the continued dominance of fixed income investing within commission-based platforms, mutual fund wrap programs within national broker dealers did experience a thaw in equity fund sales during Q3'09.

**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. After tracking at basically a 50/50 proportional split between equity and bond sales for the first half of 2009, equity funds increased over the course of Q3 to 60% of total wrap platform sales during September. This rise in proportional sales of equity funds within wrap platforms was spurred primarily by steadily increasing demand for International / Global Equity funds. As these funds outpaced their US equity counterparts by 250 basis points in asset-weighted total return during Q3'09 (18.3% vs. 15.8%), they also added 4.5 percentage points to their proportional sales total within wrap programs over the course of the quarter, as compared to only a 1.5 percentage point gain for US equity funds.

In fact, a clear trend toward non-US diversification can be seen in the fastest-growing investment styles within each of commission-based and wrap platforms via national broker-dealers during Q3. Each of International and Emerging Markets Equity, as well as Global and Emerging Markets Fixed Income registered in the top-10 fastest growing styles in Q3'09 via each platform structure (with Global Fixed and the two Emerging Markets styles repeating the feat for the

second straight quarter). Clearly, this demand for non-US focused investments was based not only within the equity portion of investors' portfolios, but also in the fixed income piece as well. Given the evolution of fixed income markets abroad and the recent weakness in the US dollar, this shows investors' desire for geographic diversification within the fixed income portions of their investment portfolios (in addition to the equity side), and also perhaps indicates a maturing of 2009's steep run up in investor demand for exposure to domestically invested taxable fixed income funds.

**National Broker-Dealer Competitive Landscape**

The evolving differences in investor demand by asset class between commission-based and mutual fund wrap platforms during Q3'09 also produced auxiliary effects on the competitive landscape for asset managers within each respective platform structure. As commission-based sales continued to accelerate toward bond funds during Q3'09, many firms with strong fixed income capabilities continued to experience sales success. Within commission-based platforms, nine of the top 10 selling firms in Q3'09 were also among the top-10 sellers during Q2'09.

Conversely within wrap platforms, five new firms made the top-10 sellers during Q3'09, as the previously discussed shift in asset class sales mix within wraps back toward equity-based asset allocation spurred opportunity for several managers to gain traction within the equity portion of their product lines.

At the same time, only three firms were able to score among the top-10 fastest growing managers via both commission-based and mutual fund wrap programs during Q3'09. This again showed how the differences in opportunity sets across each platform structure offer unique opportunities for managers with appropriate investment and product strengths.

With investor demand for risky assets still evolving in the post-crisis economic environment, the competitive landscape within the fund industry will also continue to change and evolve. Given the differences in sales trends observed across subsections of the national broker-dealer marketplace during Q3'09, the ability of fund firms to manage their product and distribution strategies in parallel could play an important role in fund sales success moving forward.

## Variable Annuities: Gearing Up for RIAs



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Amid profound changes in the variable annuity marketplace, manufacturers now seem ready to mount a concerted effort to focus more on the needs of Registered Investment Advisers. The earlier reluctance of companies to target RIAs was unsurprising in the context of an industry that had an active and competitive mainstream market.

Now, with lower demand among those advisors who have been selling richly priced Living Benefit VAs over the past decade, manufacturers are exploring new ways to bring VAs to RIAs, who are themselves more interested in guaranteed retirement income solutions.

In fact, **many advisors now recognize that the absence of such products represents a gap in their practices and a disservice to clients.** Simply driven by fiduciary duty alone, they are compelled to research and understand guaranteed retirement income better and how such products might help their clients.

While some insurers have attempted to woo RIAs with simple and low-cost products, the industry has still fallen short in identifying the keys to success with this notoriously independent crowd. Add to this the fact that the term “registered investment advisor” broadly refers to advisors with widely divergent practices, and one can easily grasp why most annuity manufacturers have so far failed to crack the RIA code.

### A Marriage of Convenience?

In general, RIAs are looking for straightforward, uncomplicated guarantees and low price tags. Similarly today, insurers are looking to manufacture products with a lower risk profile. This combination lends itself well to the **development of simple, less rich guarantees that are lower-cost costly and less-worrisome for manufacturers.**

Although creating suitable products is a necessary first step, it is not the only change that must take place to win over RIAs. For one thing, **these advisors conduct business differently from their less-independent counterparts.** Generally, they are happy to learn how to use a new solution, and then they don’t want to be bothered by a wholesaler. In fact, the bulk of support is likely to be in the back office, to help fill out applications properly.

### Case Study: The *AnnuityNote VA*

**John Hancock** is making its way into the RIA market with the *AnnuityNote VA*, an extremely simple contract that includes a guaranteed lifetime withdrawal benefit (GLWB) and only a single investment option. The GLWB is a single life guaranteed withdrawal of 5% of contract value, with withdrawals beginning five years after issue. The design is available in different share classes, although each class is filed separately, maintaining the simplicity of a given prospectus.

Although there are few elements to *AnnuityNote*, John Hancock is coming out with slight variations. For example, one contract that is currently in registration offers a slightly more equity-focused fund than the earlier iterations. The basic insurance fees, which include the charge for the living benefit, are also higher than that of their less-risky brethren.

According to **Marc Cosantini**, who runs the domestic VA business for John Hancock, the philosophy behind *AnnuityNote* is to constantly issue new “series” of the contract in an effort to easily adapt to the RIA market and the company’s understanding of that channel’s needs. The availability of a profusion of different, simple contracts also offers choice without complexity internal to the product.

While the economic crisis has cracked open the door to reach RIAs, this opportunity does not represent a slam dunk for manufacturers. The changed environment will certainly feature a trial-and-error period, a fact that companies like John Hancock fully recognize as they ready themselves to present a new generation of solutions to RIAs – and John Hancock is only targeting the 20% of advisors who are already dually licensed and can sell VAs.

The jury has been out as to whether the victory goes to the swift or the steady. Who will win: the companies that put in the effort to “figure out” the RIA market, or those that follow in their shadow but execute well? The answer may be a bit of both, but we certainly see a new battle brewing in an industry that is acclimated to more than a bit of competition.

# Some Key Themes in Recent New Fund Successes



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## “Unconstrained” Investing: Outside the Style Box?

In an environment of depressed demand for equity funds, by and large, two of the three actively managed equity funds to have drawn the most cash flow year-to-date through November are flexible global asset allocation portfolios. **Waddell & Reed’s Ivy Asset Strategy** and **BlackRock’s Global Allocation**, which have drawn in the neighborhood of \$6 billion each in net flows over the period, invest in stocks, bonds, cash and commodities around the world. The two are examples of an important theme in new product innovation of late: funds investing in a wide range of asset classes worldwide and managed with “unconstrained” / tactical / hedged approaches in a bid to provide downside protection and “absolute” returns during further episodes of extreme market volatility (and which may appeal to more risk-averse investors).

The table on the right side of this page lists all actively managed open-end funds started after Sept. 2008 that have raised \$75 million+ over the trailing three months to 10/09. Note that the equity/hybrid fund portion of the list is dominated by funds offering exposure to global / international / emerging markets or alternative asset classes/strategies, and some of these are flexible global allocation products. Among the funds in the list, for instance, are the following:

- **International Value Advisors’** immensely successful **IVA Worldwide** fund managed by Charles de Vaulx and Chuck de Lardemelle, which employs a less constrained approach to value investing through its ability to decide how much in assets to hold in the US versus outside the US,

invest across the capitalization spectrum (small to large), and to hold, in addition to equity securities, bonds, gold bullion and cash. The manager’s IVA International fund has a similarly flexible, non-benchmark-hugging mandate except it invests exclusively outside the US.

- **PIMCO’s Global Multi-Asset** fund, which seeks to outperform traditional balanced funds, engages in global strategic and tactical asset allocation that incorporates hedging to limit downside risk during systemic shocks (like 2008’s). The fund invests in other PIMCO funds, as well as in unaffiliated ETFs (it can invest also in unaffiliated regular funds) and in securities and derivatives. Launched last October, the fund’s year-to-date through November net intake totaled \$1.2 billion.

### Actively Managed Long-Term Open-End Funds Started since 10/08 with Highest Trailing-3 Month Ended 10/09 Flows

Portfolio Name	Start Date	Assets \$MM 10/09	Net Flows \$MM	
			Ytd-10/09	3 Mth-10/09
<b>Equity / Hybrid</b>				
IVA Worldwide	10/08	2,575	1,898	765
American Intl Growth & Inc	10/08	2,907	922	510
PIMCO Global Multi Asset	10/08	1,242	991	506
Northern MultiMgr EM Eqty	11/08	1,289	899	443
AQR International Equity	8/09	324	316	316
IVA International	10/08	529	366	142
Fidelity Commodity Strategy	10/09	130	130	130
Putnam Absolute Return 500	12/08	239	216	106
JHF II Technical Opport.	8/09	407	102	102
AQR Diversified Arbitrage	1/09	148	147	90
Fidelity Gbl Commodity Stk	3/09	196	183	87
ASG Global Alternatives	10/08	134	107	87
Putnam Absolute Return 700	12/08	185	153	85
Forward Tactical Growth	9/09	82	82	82
RVS Recovery & Infrstrcture	2/09	333	273	76
<b>Bond</b>				
JPMorgan Strategic Inc Opp	1/09	3,334	3,210	2,227
PIMCO Long Term Credit	3/09	1,397	1,276	568
Lord Abbett Short Tax Free	12/08	1,016	1,005	553
GMO US Treasury	4/09	555	554	335
Third Avenue Focused Credit	9/09	279	277	277
PIMCO Gbl Advtg Strat Bd	2/09	594	497	260
Northern MultiMgr HiYldOpp	9/09	223	219	219
EatonVance Tax Adv Bd Strg	3/09	250	248	135
Northern TxAdv Ult Sht FxInc	6/09	168	167	131
Putnam Absolute Return 300	12/08	246	236	130
DFA Short Term Ext Qual	3/09	378	364	118
Goldman Sachs Credit Strats	6/09	271	261	115

Source: Strategic Insight Simfund MF

- **Putnam’s Absolute Return 500** and **Absolute Return 700** funds started at the end of 2008 combine Global Tactical Asset Allocation (GTAA) with active security selection and other alpha strategies. The offerings have an explicit prospectus-stated absolute return targets (though not guarantees). They seek to outperform inflation as reflected by the return of US Treasury Bills, by 5%, and 7% respectively, over a “reasonable period of time”; elsewhere the prospectus for the series notes that the funds are designed for investors with longer-term investment horizons — generally at least three years or more. Both funds have together attracted \$450 million year-to-date through November.

Some other managers that have launched funds in the past year or so that similarly engage in some form of a GTAA strategy include **USAA**, **Legg Mason** (in partnership with its Hedge FoF subsidiary **Permal**), **Invesco AIM** and **Van Kampen**. **Goldman Sachs**, **MassMutual**, **Thornburg**, **SEI**, and **FAF Advisors** are among fund companies that have new global allocation offerings in the pipeline.

Another fund in the previous table that is noteworthy for its investment flexibility is **John Hancock’s Technical Opportunities**, which **Wellington** sub-advises using a bottom-up approach driven by technical analysis. Besides having no limitations on the percentage of assets held in any capitalization range, sector, region or country, the fund has the leeway to hold large cash stakes (up to 100% of net assets).

Some relaxation of traditional portfolio management constraints by deviating from benchmarks at one end of the spectrum and “go anywhere” mandates with wide discretion in adjusting duration and allocating across sectors on the other are also significant elements in several of the new **bond funds** that investors have found appealing lately. For instance:

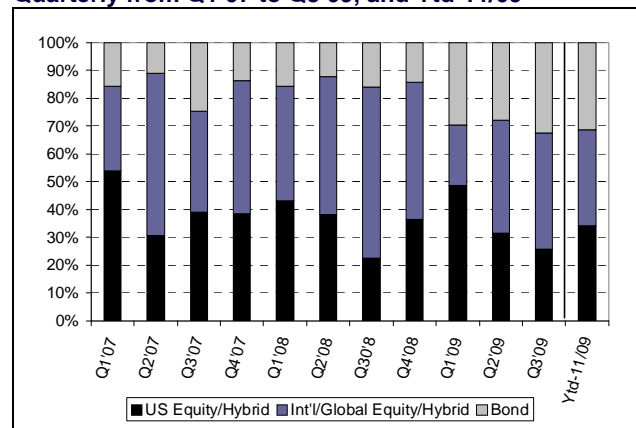
- **JPMorgan’s Strategic Income Opportunities** fund adopts an opportunistic approach in its attempt to reduce interest rate sensitivity – it can invest globally in both developed and emerging markets, has the flexibility to devote as much as 100% of its assets to high yield securities (at the end of October, high yield represented 31% of fund assets), the ability to hold a sizable liquid position (53% of fund assets were in cash as of 10/31/2009), and to assume short positions. The fund has captured a huge \$2.9 billion over the trailing three months ending Nov’09, and has brought in \$4.2 billion year-to-date through November.

- **Goldman Sachs’ Credit Strategies fund** launched this June is an interval fund (\$25,000 minimum initial investment) that tactically allocates to various corporate credit segments including investment grade, high yield, bank loans and convertible, in pursuit of its total return goal.
- **Putnam’s Absolute Return 300** is a global opportunistic multi-sector bond offering that combines top-down and bottom-up strategies with currency positioning and derivative use in seeking to achieve its return target (outperform inflation as reflected by US Treasury Bills by 3%, over a “reasonable period of time). The fund can allocate substantial assets to cash equivalents (and lately did – 57% at the end of October 2009).
- **Third Avenue’s Focused Credit** fund (launched this September), the deep value manager’s first bond mutual fund, invests in its best credit ideas across the capital structure - in bank loans, high yield bonds and convertible securities. The fund may also hold significant positions in equities that it receives as part of a reorganization process and can hold them until such time as their disposal is most gainful.

\* \* \*

**New fund filing data for 2009 by asset class** reflects the avid demand on the part of still equity-shy investors for income, besides the ongoing asset-allocation-driven need for various bond fund sleeves. **Bond funds have accounted for a growing proportion of total long-term fund filings** in recent quarters (as the chart below shows). After a distinct slowdown in 2008, there has also been a resurgence in new closed-end (primarily bond) fund filings and issuance in 2009.

**New Funds\* Filed with the SEC: By Asset Class Quarterly from Q1’07 to Q3’09, and Ytd-11/09**



\* Includes open-end and closed-end funds, and open-end ETFs. Source: [www.SimfundFiling.com](http://www.SimfundFiling.com)

# Closed-End Funds: Signs of Rebound

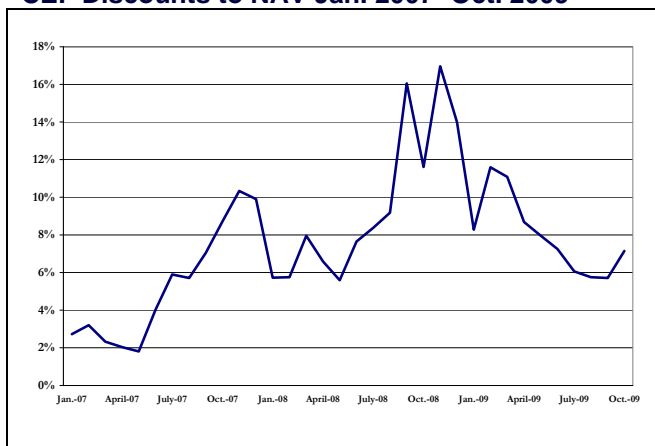


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After weathering the financial crisis of 2007-09, including a freeze in the market for Auction-Rate Preferred Securities (ARPS), the US closed-end funds market shows signs of recovery in 2009. In 2008, just two closed-end funds went public, raising a combined \$250 million – the worst year for closed-end fund IPOs since 2000. But through the first 11 months of 2009, 14 CEFs came to market, raising a total \$2.5 billion, a third of which was collected in November.

Sentiment toward closed-end funds has improved, as seen by contractions in market-price discounts to NAV (which average around 2%-3% prior to the 2007-2009 crisis); wide discounts to NAV result in fewer IPOs, and CEF discounts have dropped from 10%+ in late 2008 and early 2009 to around 7% in October.

## CEF Discounts to NAV Jan. 2007- Oct. 2009



Source: Lipper

Some of the improvement in CEF sentiment reflects the gains registered by all closed-end fund sectors in the first 10 months of 2009 – fixed income CEFs were up an average 34% on an NAV basis and equity CEF NAVs up an average 33%, according to Lipper. Also, investors have been less concerned about the perceived riskiness leverage in closed-end funds. Leverage now accounts for less than 22% of CEF assets, down from 31% in February, according to Morningstar.

The decline in leverage stems at least in part from the ARPS problems had been clouding closed-end funds. According to Bank of America, CEFs had issued some \$63 billion of floating-rate ARPS for added leverage (to boost yield). But the shutting of the ARPS market starting in February 2008 created extraordinary concerns among many as ARPS shareholders were denied liquidity. As of November, more than two-thirds of assets in closed-end ARPS were redeemed, with most of the remaining ARPS held by broker-dealers. Going forward, CEFs are searching for new vehicles for leverage. Nuveen has sold some fixed-rate, 5-year preferred issues. But until pricing normalizes, the market will wait for broader ARPS substitutes that include liquidity guarantees – new vehicles that BlackRock and other CEF sponsors have discussed.

## Closed-End Funds: \$231B in Assets at Nov. '09

	Total Assets Nov. '09 \$B	Total Assets Dec. '08 \$B	Net Inflows YTD-10/09 \$B
Domestic Equity	53.9	46.8	0.4
Int'l Equity	33.3	26.9	-
Taxable Bond	62.1	51.6	1.1
Muni Bond	82.2	73.2	1.0
<b>Total</b>	<b>231.5</b>	<b>198.5</b>	<b>2.5</b>

Source: Strategic Insight Simfund MF

The 14 closed-end fund IPOs to date in 2009, all but two have been fixed income. Of these 12 bond funds, eight were in the beaten-down muni sector. A more diversified slate of closed-end funds are potentially in the pipeline, however. Legg Mason, Guggenheim Partners (which now owns Claymore) and Nuveen, for instance, are among the firms that have filed for CEFs aimed at investing opportunistically in all areas of the fixed-income market, including mortgage-backed securities. And ETF provider InvescoPowerShares has filed for its first three CEFs which, under certain conditions, could convert to ETFs (in order to limit discounts to NAV).

Strategic Insight tracks \$231 billion in closed-end funds as of November, and this remains an intriguing area of the industry with much potential. As some of the proposed opportunistic funds suggest, CEF product innovation is ready to offer interesting alternatives to investors. Closed-end funds are good at investing in less-liquid securities, a key point as investors rethink diversification. And **the general demand for income should also help closed-end funds, possibly setting them up for an even bigger year in 2010.**

# Sustainable Investing: Now with ‘Legs’ for the Long Term



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In business development, a big idea with significant long-term potential is described as having “legs.” Sustainable investing is at an important inflection point in its development and it definitely has “legs.”

First, there’s a need to agree on a common vocabulary. **The term ‘sustainable investing’ is newer than SRI (socially responsible investing), and reflects an evolution in thinking about the industry.** It describes an investment approach that uses a financial framework that incorporates environmental, social, and corporate governance issues to evaluate investment opportunities. This differs from values-oriented strategies that include or exclude particular companies based on alignment with social objectives (i.e. benefits for same sex couples) or religious objections (i.e. companies that manufacture birth control products). Values-oriented strategies have generally been described as SRI, faith-based, or ethical investments.

While SRI products hold significant potential, they continue to be challenged by questions about their ability to deliver superior returns. Sustainable investing, on the other hand, is in a different position. Intuitively and empirically, well-run companies are better long-term investments. Today, being well-run means addressing issues of climate change (risks and opportunities), running a sound and honest organization, and managing the corporate governance process effectively. Sustainable investing may be a more accessible idea to more investors, and we anticipate that it will support the growth of both SRI and sustainable investing managers.

That said, classification in major fund databases is a problem. The labels for US funds are not the same for international funds (where SRI/sustainable investing is a bigger business), and no distinction is made between funds that screen proactively versus excluding certain investments, for example. Establishing a global vocabulary and classification system would be very

helpful in tracking this sector’s growth (and helping individual managers in marketing).

## The ‘Sustainable’ Connection

Besides delivering long-term benefits, sustainable investing and SRI can also meet a variety of more personal investor needs across the investment and social values spectrum. Because so many investors (and advisors) are struggling with trust in the industry – and because people are so much more aware of climate, social and corporate governance issues – **we believe that funds incorporating a robust screening process for good corporate citizenship or a personal, values-based connection may have a sales advantage in the current environment.**

There’s a reason that sustainable investing funds in the US have seen total net inflows since 2006 (excluding one anomalous fund from American Funds), and net inflows in three of the last four years.

Socially Conscious Long-Term US Funds Net New Flows in \$Million				
	2006	2007	2008	YTD- 10/2009
Domestic Equity	347	138	-73	1,476
Int'l Equity	434	344	632	200
Taxable Bond	330	475	-613	771
<b>Total</b>	<b>1,104</b>	<b>956</b>	<b>-54</b>	<b>2,447</b>

Source: Strategic Insight Simfund MF

Witness, too, the growth of the upstart 401(k) provider Social(k): the firm offers a screened list of nearly 150 sustainable mutual funds, and offers several thousand traditional funds in total. Assets under administration grew 187% from 2007 to 2008; as we might expect growth has slowed in 2009. Currently the firm oversees \$45 million in 401(k) assets.

Sustainable investing is global and local. More than 600 firms around the world have signed the UN-backed [Principles for Responsible Investing](#). The investment manager signatories to these principles represent more than \$18 trillion in AUM. While the total numbers are significant, it is important to note that the sustainable investing and SRI market is fairly fragmented, with many firms managing \$1 billion or less. We would expect to see that dynamic change as the sector matures, sales momentum increases, and funds and firms consolidate. **The sustainable investing sector is actively engaged in product development, having launched 65 funds just since the start of 2005.**

“Sustainable” approaches vary, and funds may use a number of screens, and may either seek or avoid a number of variables including treatment of the environment, impact on climate change, human rights,

weapons and more. There are also several funds – and one large portfolio run by American Funds – that simply avoid alcohol, tobacco, and gambling and thus fall into the sustainable/SRI categories, but we don't view those as true “sustainable investing” products.

At the end of October, 60 firms in the US were categorized in SI's Simfund MF database as socially conscious managers. In aggregate, these firms managed about \$38.5 billion, excluding American's \$49 billion Washington Mutual portfolio mentioned above. The top 10 sustainable investing funds housed \$15.8 billion in assets, or 41% of the group's AUM.

**Largest Socially Conscious US Long-Term Funds, as of Oct. 2009**

	Assets \$MM	Net New Flows \$MM
	10/09	YTD-10/09
PIMCO Total Return III	2,763	231
Parnassus Equity Income	2,200	357
Pax World Balanced	1,865	-67
Ariel Fund	1,630	113
Amana Growth	1,377	450
GuideStone Intl Equity	1,330	-55
Ariel Appreciation	1,200	-70
GuideStone Growth Equity	1,181	-33
GuideStone Value Equity	1,131	1
Calvert Social Investment Equity	1,115	54

Source: Strategic Insight Simfund MF

Another category of investment strategy has emerged recently: funds that invest in clean energy, alternative energy, or investments based on potential opportunities around climate change. By their nature, though, these are not as values-driven as other SRI funds, and so we see this group as having a slightly different (and more sector-like) orientation – but no less opportunity, as they focus on macro social and economic change.

The bottom line? Sustainable investing is a growing movement that's still emergent, with opportunities for firms to position their unique value proposition.

**Prescriptions for Manager Growth**

We recommend a number of specific strategies for sustainable investment managers wishing to grow.

1. **Manage product lines aggressively.** Many firms in the sustainable/SRI investing space have flagship funds that capture the bulk of flows. Use this as a starting point for product line rationalization and new product development. Build on core competencies and expand into new investment areas based on client and market feedback. This level of

product line management requires putting a schedule together for evaluating your offerings in context, and then another game plan for continual evolution and implementation.

2. **Effectively position products relative to competing offerings.** This is a competitive space with much confusion about labeling and categorization. Each manager must clearly articulate a specific and differentiated approach to sustainability and to investment management, and to how those work together. Be clear about where you fit and why.
3. **Sell the darn things.** “If we build it they will come” is not a distribution strategy. Determine the costs of distribution through the various channels and models, and how that cost structure will affect you. Build, rent, or buy what you need, and stay flexible. We find that advisors today are more alike by business model (i.e., fee-based advisors are more like one another) than by traditional channel labels.
4. **Focus.** Build on core competencies that offer long-term opportunity and low volatility. Active management faces greater skepticism these days, and sustainable managers often have investors' personal attachment to investment strategies to consider. Active managers need to ensure that funds don't hurt trust by stretching the boundaries of prudence.
5. **Carefully evaluate your approach to ETFs.** Today most managers are working to understand how ETFs fit into their product line, either by adding them or working around them. Build an ETF (or non-ETF) strategy.
6. **Highlight strategies that generate income.** If your core strengths involve sustainable investing strategies that support the need for income, you're in the sweet spot, so take advantage of it. Income generation (along with capital preservation) is a hot topic now, especially for Boomers and their advisors.

Sustainable investing managers are no longer waiting for the world to believe that an idea like this makes sense. Rather, they need to take advantage of this unique period and implement strategies for growth.

# Observations from Our Nov. Conference



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*Strategic Insight's third live conference, "SI Forum: Fund Distribution & Product Innovation 2010" in New York on November 2, drew 72 executives from 45 fund organizations. Major highlights of the conference were two panels – one of executives from fund distribution firms discussing distribution-related issues and one of executives from fund management firms discussing product development. This article summarizes some of the key observations from the two panels. Look for more SI Forum conferences in 2010!*

## The View From Distributors

Our panelists – senior heads of distribution from Morgan Stanley Smith Barney, Merrill Lynch, Edward Jones, and Raymond James, together representing over 50,000 FAs – agreed that mutual funds remain core parts of their businesses, whether in rep-as-portfolio manager programs, traditional commission-based programs, mutual fund wraps, or Unified Managed Accounts (UMAs). Panelists have seen more business flow to fee-based programs, and agreed that adoption of a fiduciary standard for all advisors (if it happens) would speed the shift to fee-based platforms. Also:

- All four distributors have seen advisors question the traditional model of 'buy-and-hold.' This means an increasing emphasis on dynamic or tactical allocation, including shifting assets into cash and/or greater use of global allocation funds.
- Panelists noted that financial advisors need more flexibility in their portfolio selection. This means more 'alternative' strategies, as well as products for hedging. Some distributors are actively looking for more outside-the-style-box strategies.
- The panelists have all observed flows into shorter-duration bond funds (especially when sold as cash equivalents) and worry that investors will experience disappointment when interest rates

begin to rise and these funds' risks become more evident. Speakers agreed that fund firms should help provide more education about building truly diversified portfolios.

- Distributors continue to see wholesalers as extensions of their own sales forces. Beyond influencing platform placement (one distributor noted a preference for funds with bigger wholesaling forces behind them), wholesalers are seen as crucial in helping advisors with training and in understanding investment products.
- While mutual funds are core products, ETFs are going to be bigger parts of the brokerage business – as FAs seek to use ETFs in 'active' portfolios and to reduce costs. One panelist predicted ETFs and mutual funds will co-exist in UMAs.

## Challenges of Product Innovation

The panelists – representing Putnam Investments, AllianceBernstein, and ReFlow Management – believe that the industry is in a new, post-crisis era; they agreed with the distribution panelists that the long-term, 'buy-and-hold' model needs some tweaking – notably by mixing it a greater awareness of short-term market dynamics, risk management and diversification. Other highlights:

- There is too much focus on product structure (funds, ETFs, collective trusts) and the fund industry needs to see investment solutions in ways that defer less to product silos, the panelists agreed. In the future, products may even be developed for specific distribution channels.
- Panelists agreed that there is untapped potential in active management and greater diversification. Some products should allow portfolio managers more discretion, and products need to be designed with more of an eye to outcomes, not processes.
- The industry needs to re-think what constitutes 'core' investments, the panelists said. This can include combinations of low-risk and higher-risk strategies. Also, while more portfolios may include passive products, alternative and less-liquid products can be bigger parts of portfolios.

As 'best-of-breed' continues to grow as an industry theme, more firms will outsource or use subadvisors (possibly echoing the DB world). Other firms will resist giving up control over the product, however. An important consideration will be how many investment cultures a product manufacturer can manage.

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