

Strategic Insight

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WINDOWS

Into the
Mutual Fund
Industry
May 2011

		Page
2011 Perspectives	Perspectives	2
Domestic Funds: Q1 2011 In Review	US Fund FlowWatch	3
US-Based International Funds: Q1 2011 Update	International Funds	5
Global Trends: Asia Sends Mixed Signals to Fund Managers	Global Trends	6
ETF Update: Q1 2011 Rides Equities, Bonds	ETFs	8
ETFs: Gaining Ground in NBD Wraps, Slowly	ETFs	9
Product Innovation Post-Crisis: Global, Flexible, Non-Correlated	New Funds / Filings	10
US Style-Box Equity Demand Trends in Fee-Based Platforms	Distribution	12
The Growing Use of No Load Share Classes	Distribution	14
Variable Annuities: International VAs	Variable Annuities	15

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2011 Perspectives



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In this edition: 2011's 1Q flow trends in the US; a perspective on Asia's place in the global fund industry; product development trends post-crisis; an update on the growth of US ETFs; national broker-dealer fund distribution insights; and more. These developments are naturally impacted by the gradual recovery of fund investor sentiment and rising stock markets. By early May **the global mutual fund industry has reached about \$31 trillion of assets**, eclipsing its prior record. [Note: Some readers accessing our reports only electronically have requested we mail printed versions of them as well – Windows, Overviews, etc. Please contact Barita@sionline.com if you want the same.]

ICI General Membership Meeting this week: We look forward to seeing you, **booths #206 & #208**. Note **our pre-GMM seminar, Wed. 10:00-11:45 at the Lincoln Room**, SI experts will cover new research findings on **Fund Distribution and Share Class Pricing Evolution in the US** (including their implications for Rule 12b-2); **Distribution Opportunities in Asia and Europe**; and **Fee and Retrocession Benchmarking in Europe**. Also, we will **demo our new web-based Global database**. Seating is limited - reserve with rloeb@sionline.com.

Exciting news from our tech team: **the new generation of SI's Simfund database suite, Simfund Global on-the-web, is available. Covering European, Asian, and offshore funds, Simfund Global Focus** monitors the product landscape; benchmarks progress versus peers; observes competitors for opportunities or threats; gauges success of new products and marketing initiatives; and identifies product gaps and market-entry opportunities.

Simfund Global Focus offers professional, presentation-ready reports which can be produced quickly and easily each month. Reports can be saved and shared between users. Multiple reports can be placed into a print-ready Workbook, exportable to pdf, Excel, Word, and additional formats. Learn more [here](#), or for a demo reach SI teams in London, Hong Kong, or New York.

New research studies: We recently published three revealing studies of fund distribution, including the expanding use of ETFs by financial advisors. Selected observations are discussed on pages 9, 12, and 14. You may connect the reports' authors to learn more; Contact Dan Weinerman (dweinerman@sionline.com) for subscription to these for-sale studies.

The **SI 2010 Fund Sales Survey** (based on a detailed annual survey of fund managers selling mostly through financial advisors) is out. The report, analyzing sales by share class and by channel, is free to managers providing their confidential data to SI, and available to others for a fee; see [here](#). An excerpt, focusing on the growth of No Load share classes, is on Page 14.

Our latest quarterly study of **National Broker Dealer fund sales trends**, in collaboration with Coates Analytics, is also available (see [here](#)).

SI's new in-depth report, **How Financial Advisors Use ETFs**, examines ETF uses in NBD wrap programs and especially among FAs in Rep-as-PM Programs. See [here](#) for more information on this 36-page study, including ordering options. Read an excerpt on Page 9.

Shortly, SI's Global team will publish their **latest in-depth analysis of opportunities in Asia fund management and distribution**. Learn more on page 6.

SI Fund Trends 2011 conference: On June 27-28, Strategic Insight is holding a conference in New York City for senior fund industry executives. SIFT should draw 130+ senior mutual fund distribution, planning, retirement and product management executives, as well as key executives among BD distributors. The event aims to deliver insights regarding how to serve critical distribution channels, where product innovation is headed, and what works in the retirement plan markets. Find out more and register online here: [About SIFT](#).

Strategic Insight 25th Anniversary Gala Dinner: I am excited to announce Strategic Insight 25th Anniversary Gala on November 7th. We will host a gala black tie dinner celebrating the last 25 years of the mutual fund industry. We will be honoring individual "Visionaries" for their accomplishments and outstanding contribution to the foundation of our industry. **Save the date: November 7th in New York City. To learn more, book your table or seat, or find sponsorship opportunities, contact Allana Burke at (917) 664-3507 or aburke@sionline.com.**

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Domestic Funds: Q1 2011 in Review



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Fund Industry Overview (Excludes ETFs and VA Underlying Funds)

	Net New Flows \$B			
	2009	2010	Q4'10	Q1'11
US Equity/Hybrid	-26.7	-49.3	-13.1	36.6
Int'l Equity	<u>40.7</u>	<u>71.8</u>	<u>32.1</u>	<u>29.6</u>
Total Equity	14.0	22.5	19.0	66.2
Taxable Bond	280.9	213.4	19.6	40.3
Muni Bond	<u>69.1</u>	<u>10.5</u>	<u>-19.4</u>	<u>-19.9</u>
Total Bond	350.1	223.9	0.2	20.3
Total Equity & Bond	364.1	246.4	19.2	86.5
Money Market	-505.9	-509.4	7.7	-81.0
Total Industry	-141.9	-263.0	26.9	5.6

Source: Strategic Insight Simfund MF; Note: Flow figures exclude all funds-of-funds.

US Equity funds made a significant turnaround in fund flows during Q1 2011, drawing \$37 billion in net new flows – their first quarter of positive net flows since Q1 2010. (And April looks to extend the trend of positive flows to US equity funds.) Two years after the stock market's bottom of March 2009, US investors began returning return to the market amid signs the trauma of the global financial crisis had started to heal.

International/Global equity fund flows for Q1 2011 nearly matched their success of the previous quarter, despite a headline-filled quarter (Japan, Libya, etc.) (For more on international funds, see page 5.)

Long-term mutual funds drew \$87 billion in total inflows for the first quarter of 2011, led by equity funds (which already attracted greater flows in Q1 2011 than in all of 2010). Bond funds, while off the record pace achieved in 2010, continued to attract moderate inflows, partly in a search for yield and partly due to investors' cautious outlook. Meanwhile, continued worries about states' and municipalities' finances spurred

Q1 outflows from muni bond funds for the second consecutive quarter.

Following net inflows in 2010's fourth quarter, money market funds in Q1 experienced net outflows for the seventh time in eight quarters. Led by institutions, investors withdrew a cumulative \$81 billion from money market funds in Q1. Very low yields continued to push short-term investors elsewhere, including leveraged loan and multi-sector bond funds, as well and other investment strategies.

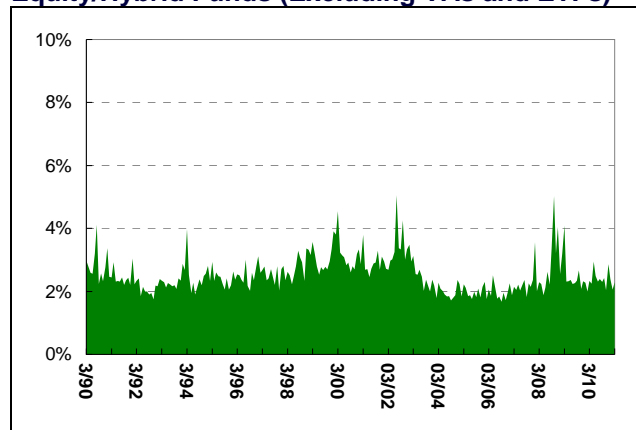
Active US equity funds' average asset-weighted return of 5.9% matched the S&P 500's 5.9% total return for Q1'11; active US smaller cap stock funds outperformed large cap ones, (For more on small cap vs. large cap, see page 4). Meanwhile, the MSCI EAFE index's 2.7% return was bested by the average international equity fund's 2.8% return over the same period.

	Average Asset-Weighted Annualized Returns %			
	2009	2010	Q4'10	Q1'11
US Equity *	31.1	16.7	10.8	5.9
Int'l Equity	40.2	13.0	7.1	2.9
Taxable Bond	18.3	8.5	0.0	1.4
Muni Bond	17.8	2.1	-4.4	0.0
Money Market	0.31	0.08	0.00	0.02

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

Although the worst of the economic crisis seems to be over, anxieties about economic and employment recovery have not faded. While the equity fund sales pace slowly rises, stock fund redemptions continued at their normalized, pre-crisis pace of around 2%, as the graph below shows.

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



Source: Strategic Insight Simfund TD (ICI Trends)

As we have noted before, and observed in past bear markets, redemption spikes tend to be short-lived.

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

	Net New Flows \$B		
	2010	Q4'10	Q1'11
Actively Managed Funds	-18.2	7.9	48.3
Index Funds (non-ETF)	37.3	10.3	16.2
ETF Open-End Funds	75.4	35.1	20.6
ETFs structured as UITs / Grantor Trusts / ETNs /Other	7.0	0.9	-1.9

Source: Strategic Insight Simfund MF

Equity index and open-end ETFs continued to draw investors' interest but trailed actively managed equity funds in 2011's Q1. On the bond side, actively managed funds also drew substantially greater net inflows.

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

	Net New Flows \$B		
	2010	Q4'10	Q1'11
Actively Managed Funds	192.6	-5.4	15.6
Index Funds (non-ETF)	27.4	4.4	4.1
ETF Open-End Funds	29.6	-0.5	6.8

Source: Strategic Insight Simfund MF

Growth vs. Value

Flows and returns among diversified actively managed US equity funds are summarized below.

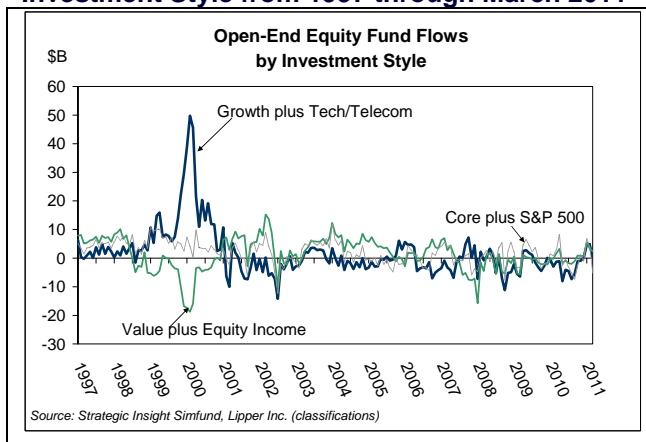
Actively Managed Diversified U.S. Equity Flows and Performance (excl. VAs)

	Flows \$B		Q1'11 Returns *
	2010	Q1'11	
Large-Cap Growth	-13.8	3.1	5.1%
Mid-Cap Growth	-2.1	1.0	7.7%
Multi-Cap Growth	-8.8	1.0	6.6%
Small-Cap Growth	-0.7	1.5	9.2%
Growth Funds	-25.5	6.7	6.4%
Large-Cap Core	-42.6	-9.1	5.1%
Mid-Cap Core	-1.0	0.9	7.1%
Multi-Cap Core	-6.4	0.9	6.3%
Small-Cap Core	0.0	2.6	8.0%
Core Funds	-50.0	-4.7	6.0%
Large-Cap Value	-11.3	-2.1	6.0%
Mid-Cap Value	1.5	1.1	6.7%
Multi-Cap Value	-1.0	0.4	5.5%
Small-Cap Value	1.8	1.4	7.7%
Value Funds	-9.1	0.8	6.1%

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

For Q1'11, value (including equity-income funds), core and growth equity fund styles each gained about \$7 billion in net inflows.

Open-End Domestic Equity Fund Flows by Investment Style from 1997 through March 2011



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

Q1 2011 Flows by Manager

The tables below present the managers making the most cash flow progress in 2011 in active, long-term funds. Noteworthy below is the rise of JP Morgan funds, and the many mid-size and small fund managers in the highest net inflow list.

All Equity and Bond Actively Managed Funds (excl. VAs): Highest Cash Flow Managers in Q1 2011

Manager	Flows (\$B)		Q1'11 Flow Rate*	3/11 Assets \$B^
	2010	Q1'11		
JPMorgan Funds	20.6	7.3	6.2%	128.0
BlackRock	13.9	5.2	3.2%	174.0
DFA	7.3	4.4	4.4%	121.9
T. Rowe Price	12.3	4.0	4.0%	267.0
Franklin Templeton	20.2	3.9	3.9%	349.4
First Eagle	4.1	2.8	2.8%	45.9
Eaton Vance	9.8	2.8	2.8%	104.5
MainStay Funds	2.1	2.6	9.0%	33.0
Thornburg	9.0	2.3	4.9%	50.8
Intl Value Advisors	4.4	2.1	23.2%	11.7
Lord Abbett	7.7	2.0	3.1%	69.4
DoubleLine Capital	4.0	1.9	46.0%	6.1
John Hancock	4.3	1.9	3.0%	67.7
TCW / MetWest	4.3	1.8	6.9%	28.7
Waddell & Reed	3.9	1.8	2.7%	70.8
Pacific Heights	3.8	1.7	16.5%	12.3
Harris Assoc	2.9	1.7	4.5%	40.0
Prudential Fincl	3.3	1.5	4.1%	40.5
Yacktman	2.9	1.5	27.6%	7.2
Manning & Napier	2.9	1.4	9.4%	17.5

*Flow rate = Q1'11 flows as a pct. of 12/10 assets; ^Active long-term assets only; Source: Strategic Insight Simfund MF

US-Based International Funds: Q1 2011 Update



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

Structure/Type	Assets	Net Flows, \$B			
	\$B 3/11	2009	2010	Q4'10	Q1'11
Open-end Active	1,582	33.1	56.0	23.0	23.9
Open-end Indexed	128	9.7	19.0	10.4	5.3
ETFs**	352	53.7	43.9	15.3	2.1
Closed-End	38	0.0	0.7	0.3	0.0
VA Funds	223	6.9	7.0	3.1	1.8
Total	2,323	103.5	132.1	52.1	33.1

Source: Strategic Insight Simfund MF / VA. *Includes Gold funds; ** UIT and other ETPs, as well as open-end ETFs

Despite tragic developments in Japan, political turmoil in the Middle East/North Africa, and continued global inflation fears, **US mutual fund investors added \$33 billion in net new cash to US-domiciled International / Global stock funds in the first quarter of 2011.** First-quarter demand for diversified emerging markets funds declined from Q4'10, especially among passive products, on a dip in EM performance and investor fatigue.

After outperforming domestic equity funds in 2009, Int'l/Global equity underperformed average US equity funds in 2010 and the first quarter of 2011:.

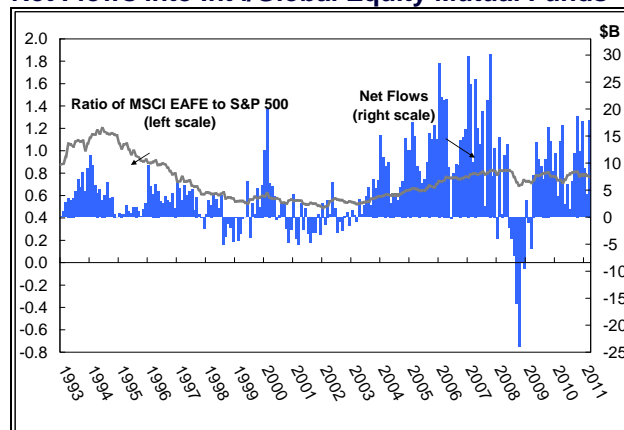
Int'l Equity , US Equity, and World Bond Funds Annual Average Total Returns (Asset-Weighted)

	2007	2008	2009	2010	Q4'10	Q1'11
U.S. Equity*	7.12	-37.89	31.52	16.82	11.24	6.19
Int'l/Glbl Equity	16.66	-41.91	40.45	13.62	7.24	2.84
World Bond^	8.86	-1.27	15.65	9.15	-0.22	1.61

Source: Strategic Insight Simfund MF; * Exc. Balanced/Hybrid, Int'l Equity includes Gold; ^ Morningstar category.

The relative performance of the EAFE (vs. the S&P 500) and the recovery of inflows since April 2009 are 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 MF, Standard & Poor's; Int'l flows include Gold funds

Actively managed emerging markets funds again topped the list of highest-flow classifications for Q1 2011 as well as for the full previous calendar year. Some of those flows reflected performance-chasing, but flows to international/global equity funds also stemmed from investors' search for more global diversification – a long-term shift in portfolios. Global asset allocation funds had greater Q1'11 flows than in Q4'10 as investor demand for flexible and unconstrained strategies rose; international equity funds also drew substantial inflows.

Actively Managed Int'l/Global Equity Funds 10 Highest Q1 2011 Net Flow Classifications

	Net Flows \$B		Assets \$B
	2010	Q1'11	3/11
Emerging Markets	27.68	4.79	196.3
Intl Multi-Cap Value	3.35	2.46	30.9
Intl Large-Cap Growth	0.81	1.99	302.6
Intl Multi-Cap Core	3.11	1.88	47.3
Global Multi-Cap Value	2.27	1.30	19.3
Intl Multi-Cap Growth	4.31	1.02	67.7
Intl Sm/Mid-Cap Core	0.11	0.57	16.5
Global Multi-Cap Core	-0.10	0.37	10.2
Intl Sm/Mid-Cap Growth	1.74	0.34	22.7
Japanese	-0.76	0.13	1.7

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

Asia Sends Mixed Signals to Fund Managers



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SI's Global team this month will publish their latest in-depth analysis of opportunities in Asia fund management and distribution. The study will address not just the fund industry in the region, but more broadly the growing importance of Asia investments and Asia-focused funds globally, including in the US and Europe. Expect more information from us soon about this report, including ordering options.

The Promise of Asia, Against the Challenge of Distribution, Regulatory, and Structural Change

Fund executives on the whole remain confident about the future of business in Asia. **However, investors in Asia contributed just 12% of the \$1 trillion of worldwide net flows** into long-term mutual funds in the past year. Has the promise turned into, at least for now, a problem?

This modest share underscores the very real challenges within Asia's fund industry region today, but also highlights the upside potential if the obstacles to investing can be addressed. Fortunately, many of the constraints appear to be event-driven, temporary, or resolvable. But some developments raise questions.

For instance, **in Korea, net redemptions have drained \$30 billion from equity funds since the start of 2009**, an amount corresponding to half the inflows achieved during 2007. Profit-taking activity by investors as they recouped losses is one reason for the outflows. However, some of the outflows were diverted into an expanding range of **individually managed accounts, called equity "wrap" accounts in Korea**, with asset-based annual fees ranging from 1% to 3%. In three years, the number of such accounts increased from under 200,000 to more than 800,000;

they now hold almost KWR 40 trillion in assets (US\$33 billion), about 20% of the size of the onshore fund industry. The question going forward is whether wraps will continue to grow, substituting for funds, or if funds can retake the lead.

Funds in India also suffered \$30 billion of net redemptions in the past year, mostly from money market, "liquid plus", and short-term bond funds, with the implementation of **mark-to-market** rules on shorter-maturity holdings. Equity funds have also been suffering outflows for nearly three years, though to a lesser degree than money and bond funds; a **ban on front-end load sales** charges in early 2009, making funds less attractive for advisors to sell, is partly blamed. Thus the disruptions within India's fund industry are in part **regulation-driven and transitional in nature**. The bigger question is whether the changes have introduced long-term structural constraints that will prevent mutual funds from growing, despite India's ascent as an emerging economic power and creator of wealth.

Leaving out Korea and India, Asia's share of global long-term fund flows gets bumped up, but only by a small amount, from 12% to 15%. Clearly, the issues permeate beyond those two markets. Elsewhere:

- Hong Kong fund sales recovered somewhat since the crisis, but not as much as hoped, as **regulatory compliance burdens** multiplied the time and cost of fund distribution, and also impacted the product mix;
- **In China, outflows have persisted** from both long-term funds and (to a greater extent) money market products, despite the success of certain individual funds and managers in the country;
- Investors in Taiwan contributed \$10 billion on a net basis to offshore international funds last year, a good amount, but the local industry has not grown, and **new rules on commission disclosure** are worrying some executives.

Japan's is the only fund local business to show meaningful expansion, with long-term flows rising from \$33 billion in 2009 to \$69 billion last year. But there, investors have heavily concentrated their risks into high-yield and emerging market bond funds.

Despite the apparent limitations in many Asia markets currently, a number of fund managers are growing their business in the region: the evidence suggests 10% to 20% of cross-border international UCITS fund sales and flows in the past two years were sourced in Asia. Cross-border UCITS collected more than \$500 billion in the past two years combined,

not including money markets, so the amounts are significant. For international companies with **strong brands, local presence, and distribution access, the percentages sourced from Asia can be higher.**

Asia, with \$2 trillion in mutual fund assets, represents 7% of the nearly \$30 trillion in worldwide AUM (12% including Australia). But the Asia-Pacific region already accounts for 25% of global GDP and 30% of worldwide stock market capitalization and is growing. Thus, a gap persists between regional mutual fund adoption and global wealth and economic trends. As the industry works together to bridge the gap, funds in Asia can benefit from quite a bit of catching up.

Asia's Hidden Role: Allocations Reach 40% of US Equity Flows

As the opportunities for fund managers on the ground in Asia expand over time, from an investment perspective the region has already become central to managers' activities, including in the US. **Worldwide, we estimate that portfolio managers are allocating around 40% of their incremental equity assets to Asia-centered asset classes.**

The explosion in emerging market investments in recent years plays a critical role in this trend but other factors are also tipping the scales. **In all, nearly \$100 billion of investments in the past year alone were directed to Asian equities through mutual funds, primarily in the US and Europe.** On a longer-run cumulative basis, the impact of such allocations on financial markets could be profound, encouraging further self-reinforcing investments to the region.

The magnitude of these allocations is hidden behind the blur of fund classifications. A cursory glance at the \$7 trillion equity fund business in the US, for instance, shows only \$70 billion, or 1% of total equity fund assets, within Asia-related investment categories. These funds registered negligible inflows last year (\$1.5 billion). Excluding index funds and ETFs, the segment looks even less impressive with under \$40 billion of active Asia fund assets in the US.

But analysis of fund holdings suggest that **Asia is of much greater importance, and becoming more so, for US money managers and within US investors' portfolios.** This is probably **good news for Asia investment specialists**, many of them previously focused on their home markets, but now expanding globally in search of Asia subadvisory mandates, fund distribution, and other partnership opportunities.

- Using regional allocation data, we estimate that over **\$700 billion of assets are invested through**

US mutual funds into Asia-Pacific equities; \$450 billion is allocated to core and emerging Asia markets excluding Japan and Australia.

- Leaving out the four Tiger economies (also referred to as the early industrializing four Dragons – Hong Kong, Singapore, Taiwan, and South Korea), **Asia's newer emerging stock markets have a total of \$230 billion allocated by US mutual funds.** This is 28% more than the amount allocated to emerging Latin America stocks. Overall, around \$500 billion is allocated by US funds to all Emerging Market stocks.
- **Emerging Market funds during 2010 captured \$56 billion of flows in the US; about half of this is allocated to emerging Asia markets (closer to 58% for emerging index products).** Another \$30 billion total went to diversified international and global products in the US, which allocate between 20% and 40% of assets to Asia. Global asset allocation funds got \$25 billion last year; 65% on an asset-weighted basis goes to equities, and of that roughly a quarter is channeled to Asia.
- **Combined with contributions through Asia-focused funds, at least \$45 billion of net cash were directed to Asia-Pacific stock markets last year by US equity funds.**
- Other remarkable facts: Nearly \$400 billion in assets reside within equity funds in the US whose top individual security holding is an Asia region stock. This group of funds collected \$50 billion of net inflows in 2010. Including equity funds whose #2 holding is an Asian stock further expands the pool to \$625 billion in assets with \$68 billion of inflows last year.

While much of this reflects the recent growth of Emerging Market funds, which are allocating around half of their assets to Asia, many diversified global and international funds are making bigger Asian bets, chasing economic and earnings growth in the region and the anticipated capital appreciation it could bring. Moreover, many non-international and non-global "US equity" (including Natural Resources) and asset allocation funds are also investing a small portion of their assets opportunistically in Asian stocks.

Meanwhile, **in Europe, roughly one-quarter of the assets managed within equity funds (excluding Europe Equity) is invested in Asia.** Doing the math, **around \$50 billion was net invested into Asia-Pacific stocks through Europe-based funds last year** (about \$35-\$40 billion to Asia ex-Japan/Australia).

ETF Update: Q1 2011 Rides Equities, Bonds



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Exchange-Traded Funds in the US drew net new flows of \$26 billion in the first quarter of 2011. Although down from the \$36 billion in net inflows that ETFs enjoyed in Q4 2010, it was a marked improvement over Q1 2010's \$8 billion in net inflows. **At the end of March 2011, US ETF assets (including ETNs) were \$1.074 trillion, up from \$1.005 trillion at year-end 2010.**

ETFs: By Investment Type					
	Assets		Net Flows \$B		# of Funds
	\$B				
		03/11	2009	2010	
US Equity					
Diversified	396.5	-14.1	16.7	3.2	288
Sector	126.2	13.2	13.9	7.9	273
Subtotal US Eqty	522.7	-0.9	30.6	11.1	561
Int'l/Global Equity					
Diversified	54.6	-1.0	2.6	2.6	29
Divrsfd Emrg Mkts	95.2	17.0	25.2	-8.7	38
Single Country	76.5	12.2	6.2	7.5	94
Regional	17.9	3.0	0.4	-1.2	32
Sector	18.2	4.1	2.2	2.6	88
Subtotal Int'l/Glbl Eqty	262.4	35.3	36.6	2.9	281
Subtotal Equity	785.1	34.5	67.2	14.0	842
Bond					
Taxable Bond	155.6	44.5	31.3	8.9	160
Muni Bond	6.7	3.6	1.1	-0.2	27
Subtotal Bond	162.3	48.1	32.4	8.7	187
Specialized					
Commodity	119.5	31.1	12.8	3.0	102
Currency	6.6	4.0	-1.7	0.6	36
Subtotal Specialized	126.1	35.1	11.2	3.6	138
Total	1,073.5	117.6	110.8	26.3	1,167

Source: Strategic Insight Simfund MF

The flows into ETFs in Q1 2011 were **driven by equity and, to a lesser extent, bond ETF inflows**, mirroring trends seen in the traditional mutual fund space. On the equity side, US equity ETFs (led by

Natural Resources Sector) had robust inflows and, echoing traditional mutual funds, US equity products had greater net inflows than international/global products. As the table at the left shows, this was partly due to a Q1 drop in demand for diversified emerging markets equity ETFs.

Taxable bond ETFs drew \$9 billion in Q1 2011 (led by Corporate Short Maturity), up from less than \$1 billion in Q4. As with mutual funds, worries about possible state/municipal defaults weighed on muni bond ETFs. Bond ETFs overall climbed to 15.1% of US ETF assets at March '11, up from 14.4% a year earlier.

Commodity ETFs saw net inflows in 2011's first quarter, as gold ETFs saw net outflows and other commodity products (including silver and agricultural commodity ETFs) drew net inflows.

The number of exchange-traded products continued to grow, reaching a record 1,167 at the end of March 2010, up from 1,080 at the end of 2009.

Actively Managed ETFs

Actively managed ETFs had \$4.2 billion in assets in 36 funds at the end of March 2011. This young segment of the ETF market drew \$1.1 billion in net new flows in 2011's first quarter, but 75% of that went to four ETFs.

Biggest Active ETFs of March 2011

Fund Name	Assets	Net Flows
	March'11 \$MM	Q1 2011 \$MM
PIMCO Enhncd ShortMaturity Strategy	1,190	403
WisdomTree Emergng Mkt Local Debt	729	161
WisdomTree Dreyfus Chin Yuan ETF	639	-5
WisdomTree Dreyfus Emerg Currency	450	151
WisdomTree Asia Local Debt ETF	173	173
WisdomTree Dreyfus Brazil Real ETF	171	36
Cambria Global Tactical ETF	145	74
iShares Diversified Alternative Trust	127	15
PIMCO Intermed Muni Bond Strategy	78	15
WisdomTree Managed Futures	73	72

Source: Strategic Insight Simfund MF

Despite this sector's small size, active ETFs are drawing increased interest based on developments that hint at grander potential: Eaton Vance and State Street Global received SEC approval earlier this year to launch active ETFs; Columbia Management acquired Grail Partners to use Grail's SEC exemptive relief to launch active ETFs; and PIMCO filed in April with the SEC to launch an **active-ETF version of its Total Return Bond Fund** – a likely bellwether active ETF. We continue to believe that the entry of more established fund managers and/or funds could redefine the active ETF market.

ETFs: Gaining Ground In NBD Wraps, Slowly

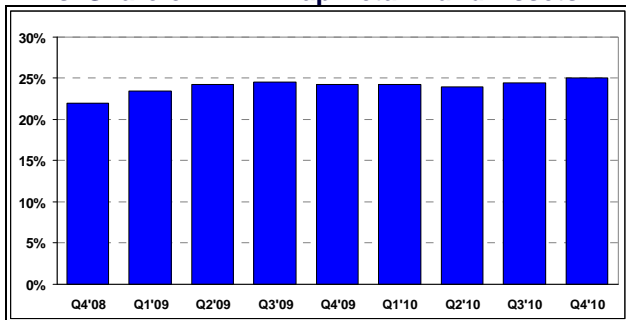


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This article presents some key observations about ETF use within National Broker Dealers (NBDs), drawn from our new 36-page, for-sale report, “How Financial Advisors Use ETFs.” The report combines SI’s ETF data and in-depth analysis with NBD assets, sales and flow data from Coates Analytics to provide an unprecedented view of how NBD financial advisors are using ETFs. For more information about purchasing this report, contact Allana Burke at aburke@sionline.com, or (917) 664-3507

ETFs have been gaining ground in National Broker-Dealers (NBDs) – firms such as Morgan Stanley Smith Barney and Wells Fargo – but growth has been at a modest rate in recent years. ETFs’ growth within NBD wraps has more or less matched the organic growth rate of mutual funds in wraps since mid-2009. That’s due, in part, to some of the heaviest ETF users in these wraps gravitating back to mutual funds as stocks recovered.

ETFs’ Share of NBD Wrap Retail Fund Assets*



*Mutual fund and ETF wraps tracked by Coates Analytics
Source: Coates Analytics DMS / SI Analysis

ETFs experienced only modest market share gains among National BD wrap programs in recent years, as the chart above shows. While ETF flows exploded in recent years industry-wide, their share within the universe we studied increased only modestly: from 22% of combined mutual fund and ETF assets (retail fund assets: cash and other holdings excluded) in our selected NBD wraps at the end of the fourth quarter 2008, to 25% share two years later, on December 2010.

Our new report, **How Financial Advisors Use ETFs**, found that ETF use is particularly heavy within Discretionary Rep-as-PM (Portfolio Manager) wrap platforms, programs in which the financial advisor maintains discretion to make account transactions on behalf of their clients, without prior client approval. At the end of 2010, within the two large NBDs that Strategic Insight studied, ETFs accounted for 54% of retail fund assets in Rep-as-PM programs tracked by Coates Analytics. FAs working in Rep-as-PM programs have a greater inclination toward early adoption of ETF use – in part because advisors working in Rep-as-PM programs don’t need to persuade clients to use ETFs, and because these programs tend to attract a select group of advisors. In this way, FAs in Rep-as-PM programs are most like independent RIAs.

FAs Working in Rep-as-PM Programs*

- Tend to be more experienced, select group of FAs
- Larger books of ETF business than in other wrap types
- ETFs = 54% of retail fund assets at year-end 2010
- More likely to use nontraditional mutual funds (and ETFs)

*Based on select, Coates-tracked NBD Rep-as-PM programs
Source: Coates Analytics DMS / SI Analysis

This is in sharp contrast to Non-Discretionary Rep-as-Advisor wrap programs, where the FA needs client approval of portfolio decisions. For example, the median FA in Rep-as-Advisor programs that we studied had \$98,000 in ETF assets at the end of 2010, while the median FA in analogous Rep-as-PM programs had \$191,000 in ETF assets at year-end.

However, as the recovery of the stock market progressed in recent quarters, mutual funds regained some market share within Rep-as-PM programs; the evidence suggests that the beneficiaries have been nontraditional and flexibly mandated mutual funds – implying that **unique active mutual funds have the potential to attract even the financial advisors most heavily invested in ETFs.**

For example, we tracked a group of 1,746 ETF-centric advisors working within two Rep-as-PM programs, including their ETF use based on actual assets and flows data. And we found that the percentage of these FAs who used all ETFs and no mutual funds declined from 21% of the group in Q3 2009 to 12.5% in Q4 2010 – a sign that mutual funds can draw the heaviest ETF users.

The report further explores trends in ETF use, flows and market share in Rep-as-PM programs, as well as ETF use and ETF brand preferences among the group of 1,746 ETF-friendly FAs, and other topics.

Product Innovation Post-Crisis: Global, Flexible, “Solution”- based Cores and Non- Correlated Strategies



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Advisors and investors alike have been rethinking traditional investment frameworks and asset allocation and portfolio construction priorities in the post-crisis environment. A confluence of factors has driven a review of the very cores of investment portfolios over the past two years, among them:

- The rise in asset-class correlations in 2008 brought about by extreme risk aversion (as in previous episodes of acute market stress)
- Continued episodic intense market volatility and some suggesting possible increased occurrence of outlier events
- US investors' realization of the need to invest in the intellectual capital and economic growth generated overseas, and
- Significant changes in the bond landscape.

The changes are impacting certain secular factors that drive fund innovation. **Reservations about traditional, essentially static, 60:40, US-focused balanced allocations achieved with the help of long-only style-box-confined or benchmark-oriented funds has led to the development and popularity of more flexibly managed global portfolio “cores.”**

These “new” cores include exposures to both developed ex-U.S. and emerging markets, on both the equity and bond sides of the equations. They typically have the ability to invest across style and market caps within equities, across the duration and quality spectrum within bonds, and can assume short positions or allocate to derivatives or cash to assume a more defensive posture in the face of enhanced market volatility. They may also include non-traditional asset

classes like commodities and currencies, and might seek to systematically manage tail-risk.

The much **greater complexity involved in assembling such global, risk-managed portfolio cores has led many advisers to seek out investment management firms that can provide “solutions” in the form of Global Tactical Asset Allocation mutual funds.** The portfolio managers of these types of funds run them as if they constitute an investor's entire portfolio rather than a single fund. Most recently, this solution-focused approach has been applied for the Emerging Market (EM) portions of portfolios in the form of new EM Asset Allocation funds.

Besides embedded-advice products looking to provide a total “solution,” **increasingly popular are single-asset class funds (equity, bond, alternative) with a similar, “unconstrained,” global approach** that advisers can use to populate the cores. Also growing in prevalence are funds providing exposure to **non-market-correlated strategies and non-traditional sectors**, such as merger arbitrage, commodities and managed futures, which can be used as “satellites”.

These trends have also affected the defined contribution world, where target-date and target-risk funds are diversifying beyond traditional, US-focused long-only stock and bond funds. Lifecycle funds are taking on more of a global and “absolute return” orientation by introducing or increasing their international exposure and adding alternative asset classes and volatility-management components. This has been an important factor driving fund innovation, as in many instances managers are launching innovative new funds that are solely or mainly intended to serve as underlying investments within their lifecycle and other packaged funds-of-funds.

Among equity funds, we have also observed the investor appeal of **high-conviction US and Global managers** offering relatively more focused or high-“active share” products. Many RIAs averse to the commoditization of their business will continue to appreciate the distinctive investment processes of boutiques. Several of the fastest-growing actively managed stock/hybrid fund management firms over the past year have been boutiques that together encompass a range of strategies.

On the bond fund side, the still historically low-interest-rate environment in the US today reached after a 30-year period of falling rates, the changes in the debt fundamentals of the government and corporate segments in the developed world, and the more secular deviation in the debt dynamics and economic growth

rates between developed and emerging wealth regions, is driving the design and investor acceptance of **innovative, flexible products that are “unconstrained” by traditional, cap-weighted benchmarks.** Also gaining traction are corporate floating rate, high yield and emerging market debt funds—individual strategies positioned to benefit from slowly rising interest rates, economic recovery or emerging market growth. Alpha-oriented, active management and security-level bets based on quality credit research have also been used by some value equity managers to build relatively concentrated bond portfolios.

In the closed-end fund area, a recovery in IPOs is underway. In the first quarter of 2011, six new closed-end funds made their debut and collectively raised a net \$2.3 billion (significantly more than the \$800 million raised—within four IPOs—in the first quarter of 2010). **The movement towards more global, flexible and non-traditional investment strategies is very much manifest in the income-focused closed-end fund world as well.**

An overarching trend of products that outsource asset allocation and portfolio construction to the investment manager also dovetails with many financial advisors’ inclination to reduce their reliance on distribution firms’ strategists and home-office models. Other advisors gravitating towards a more active role in building their clients’ portfolios may use unique, active strategies, as well as narrowly-defined ETFs, as they transition from centralized asset allocation guidance toward their own discretionary account management.

The recent recovery in investor sentiment and confidence (before a dip in March) may have prompted a slight uptick in new fund filings in the traditional, long-only core US and international stock fund area, an investment sector that experienced less demand post-crisis. However, we don’t expect this to displace the long-term trend in the direction of products that are more globalized, less benchmark- or style-box constrained, and non-market correlated.

New Open-End Mutual Fund Development (Excludes ETFs and VAs)						
	Number of New Funds Started					
	2006	2007	2008	2009	2010	1Q'11
U.S. Stock	118	114	105	76	120	28
Balanced Exc. World Allocation	74	95	87	65	41	4
World Allocation	6	7	11	9	32	8
International Stock Excl. Diversified Emerging Market	65	70	76	55	72	17
Div. Emerging Market	10	6	20	5	19	7
Subtotal Equity/Hybrid	273	292	299	210	284	64
<i>Int'l Stock and World Allocation as % of Total Eq/Hyb</i>	30%	28%	36%	33%	43%	50%
Alternative* / Commodities	16	13	23	28	52	21
<i>Alternative / Commodities as % of Total</i>	5%	4%	6%	9%	12%	20%
Taxable Bond: US	39	35	27	45	55	12
Taxable Bond: World / Emerging Market	7	12	13	5	16	6
Subtotal Taxable Bond	46	47	40	50	71	18
<i>World/EM Bond as % of Total Taxable Bond</i>	15%	26%	33%	10%	23%	33%
Municipal Bond	15	7	6	8	12	4
Total Above	350	359	368	296	419	107
<i>* Includes Market-Neutral, Long-Short, Bear Market, Equity Precious Metals, and Currency Funds</i>						
Source: Strategic Insight Simfund MF; Morningstar; SI Research						

US Style-Box Equity Demand Trends in NBD Fee-Based Platforms



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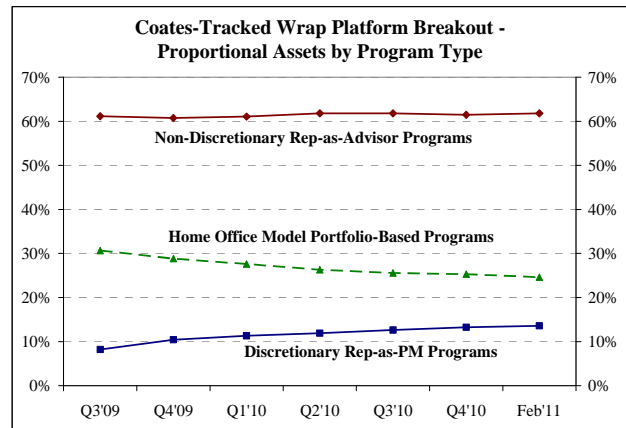
Over the past several years, investor demand for US Style-Box Equity funds (i.e. value, growth and blend strategies across each of large, mid and small cap US equities) has come under mounting pressure. The increasing diversification – including global diversification – of investors’ overall asset allocation portfolios, combined with two severe US equity bear markets over the span of less than a decade, have led many investors and FAs to rethink their traditional style-box-based model of portfolio construction.

The early part of 2011, however, saw the beginnings of rebounding investor sentiment toward US equity funds. Actively managed US Style-Box Equity funds attracted more than \$13 billion of net inflows during January and February – the highest pace of net deposits to such funds over the first two months of a year since 2004. Economic and geopolitical factors resulted in a pause in this demand during March, when such funds experienced \$4 billion of net outflows industrywide. But the renewed investor engagement of January and February (and April, we estimate) may mark an inflection point in the base of underlying investor sentiment toward US equity strategies.

Given these market dynamics, this article examines the post-crisis differences in relative sales trends of US Style-Box Equity funds across the three distinct mutual fund wrap platform structures at National Broker Dealers (NBDs) – Non-Discretionary Rep-as-Advisor, Discretionary Rep-as-PM and Home Office Model Portfolio-Based wrap programs. This commentary is based on recent analysis contained within SI’s ongoing quarterly report series focusing on the NBD space (leveraging data from Coates Analytics), *National Broker Dealer Product Strategy & Distribution Trends*. [For more information regarding subscription options for these quarterly studies, contact Dan Weinerman – dweinerman@sionline.com; 212-217-6897.]

Nat’l Broker Dealer Wrap Trends

Before examining US Style-Box Equity fund demand in wrap platforms, it is important to understand the evolving trends in such platforms’ growth. The graph below charts asset market share across each of Non-Discretionary Rep-as-Advisor, Discretionary Rep-as-PM and Home Office Model Portfolio-Based wrap programs within the Coates-tracked universe of NBDs.



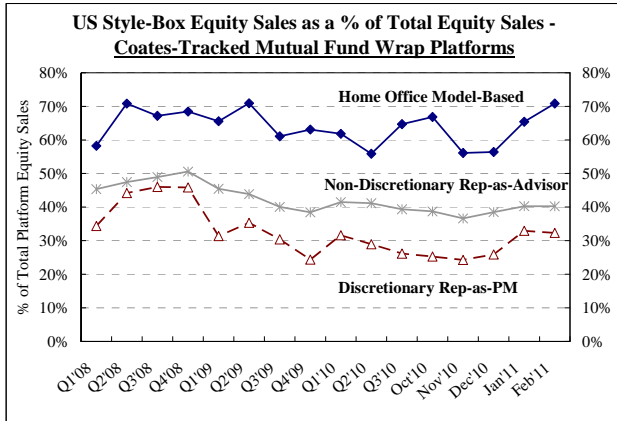
Source: Coates Analytics Distribution Management System / SI Analysis

Clearly, FA/investor-controlled programs account for a majority of assets within the NBD mutual fund wrap space (75% as of February 2011). Such programs have also been the main drivers of growth over the past two years – largely at the expense of Home Office Model-Based programs – as many FAs have shown increased desire to maintain (or expand) control over the decision-making process for their clients’ assets within their own office (rather than outsource such responsibility to home office research teams).

Differences in US Style-Box Equity Demand across Wrap Platforms

Within these evolving high-level platform trends, interesting differences can also be seen in the fund choices made by FAs within each wrap program. Such varying demand trends by wrap platform type (within US equity and also other investment styles) provide interesting insights into the shifting portfolio construction views of different FAs. At the same time, they also suggest which segments of the marketplace may be most receptive to certain strategies and where various parts of fund firms’ product lines may best fit across the scope of investor and advisor demand.

The following graph captures proportional sales to US Style-Box Equity funds as a percentage of total equity fund sales within each of Non-Discretionary Rep-as-Advisor, Discretionary Rep-as-PM and Home Office Model-Based wrap programs.



Source: Coates Analytics Distribution Management System / SI Analysis

The graph shows that US Style-Box Equity funds have remained an important component of overall equity exposure within Home Office Model-Based wrap programs, both pre- and post-crisis. Clearly, the home office research teams which construct such model portfolios have remained largely committed to the style-box-based foundation of asset allocation. Given such “pure-play” strategies’ relative predictability and repeatability of performance across market cycles (versus the more-unpredictable potential performance of more flexibly mandated products), these funds continue to serve as important building blocks within the context of the various investment sleeves that make up such home office-constructed portfolios.

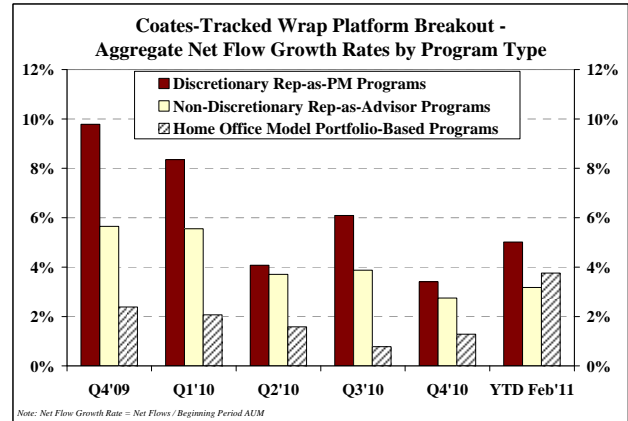
Within platform structures where the FA and investor control the fund selection process, US Style-Box Equity funds have been a smaller part of overall equity demand. Contributing to these lower relative sales has been the emerging portfolio construction trend within such platforms toward the use of more broadly mandated, single-product “solutions” to manage larger portions of investors’ ongoing portfolio diversification (i.e. global tactical asset allocation, etc.).

US Style-Box Equity funds have experienced particularly low traction within Discretionary Rep-as-PM programs. In addition, relative demand for alternative fund strategies has been higher among these more investment-centric FAs than in other wrap programs. Despite US Style-Box Equity funds’ declining influence post-crisis within such platforms, they did see an increase in their share of total Rep-as-PM equity sales during the early stages of 2011. While such funds still account for a smaller proportion of overall equity demand than in other programs, these strategies do hold the potential to remain a substantive piece of Rep-as-PM FAs’ overall equity allocations.

Impact of Investment Style Demand on Wrap Platform Trends

The characteristics of certain wrap platform structures naturally affect underlying fund demand within these programs. On the other side of this equation, overall fund demand trends can also have an impact on the growth patterns of the various wrap platform types.

The graph below charts net flow growth rates (defined as net flows divided by beginning-period assets) for each wrap platform structure discussed previously.



Source: Coates Analytics Distribution Management System / SI Analysis

Rep-as-PM programs have seen the highest organic growth over each of the periods captured above (partly due to the fact that such platforms are growing from a smaller base). Home Office Model programs, however, saw a significant increase in net flow growth for during the first two months of 2011. This coincided with the overall increased engagement within US equity funds – as discussed, an important part of Home Office Model program demand.

From a longer-term perspective, the trend toward FAs taking greater control over their clients’ portfolios (both at NBDs and elsewhere) figures to be an important secular trend within the intermediary-sold space moving forward. At some levels, however, the velocity of movement away from Home Office Models post-crisis may be based partly on cyclical investor demand trends – with open-architecture Rep-as-Advisor and Rep-as-PM programs proving more conducive to actively managing the over-weighted fixed income portfolios of many investors post-crisis. As investor demand for US equity funds improves, such Home Office Model programs should benefit from some level of increased engagement.

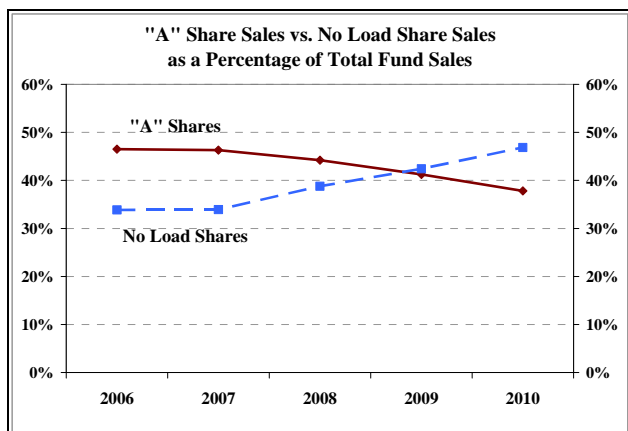
The Growing Use of No Load Share Classes



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The shift toward asset-based fees as the primary compensation structure within the intermediary-sold space has significantly affected many aspects of fund sales. One key effect: the rapidly growing importance of No Load share classes among traditionally advisor-sold fund firms. This was among the chief trends analyzed in *The Strategic Insight 2010 Fund Sales Survey: Perspectives on Intermediary Sales by Distribution Channel and Share Class*. The study was based on SI's proprietary survey of 40 fund firms that distribute primarily through FAs. Participants managed \$4.4 trillion in total U.S. open-end stock and bond fund assets at year-end 2010 (representing 56% of industry-wide long-term fund assets) and reported roughly \$800 billion in open-end, long-term fund sales in 2010. [Participants receive the report free; others may contact Daniel Weinerman, dweinerman@sionline.com, for information about purchasing the study.]

Among survey respondents, No Load shares (SI's definition: any class with no load and a less-than-50-basis-point 12b-1 fee) accounted for 47% of total sales in 2010, up significantly from 42% in 2009 and just 34% in 2007. Much of this growth has come at the expense of traditional "A" shares. As seen in the graph below, the relationship between No Load and "A" share sales have shifted:

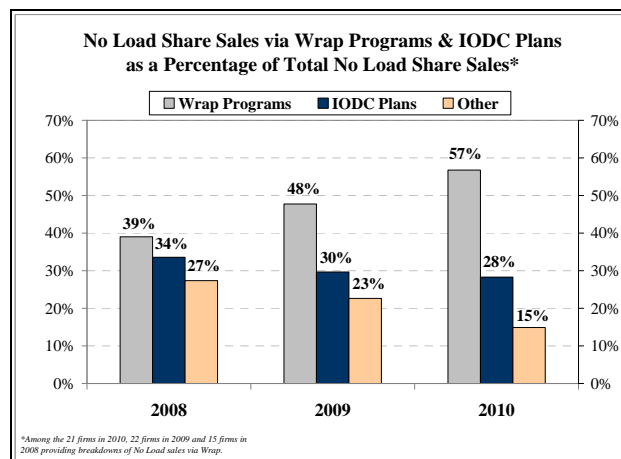


Source: 2010 Strategic Insight Fund Sales Survey

Even within this declining overall "A" share business, two-thirds of all "A" sales in 2010 were made at NAV (without a front-end sales load). Conversely, only 6% of total fund sales in 2010 were made via "A" shares with 4% or greater load.

Key Drivers of No Load Share Growth

Sales via fee-based programs have been a key driver of No Load share growth. The graph below charts the proportion of total No Load sales made through Wrap/Fee-Based Advisory Programs and also through Investment Only DC Plans.



Source: 2010 Strategic Insight Fund Sales Survey

Fee-based sales accounted for 57% of total No Load sales in 2010, rising substantially from just 39% in 2008. From the perspective of total sales made via Wrap/Fee-Based Advisory Program, No Load shares made up 60% of such sales in 2010, up from 41% in 2008. In addition, the vast majority of demand for No Load shares within fee-based programs over the past two years has been for those without 12b-1 fees (which have in the past assisted with distributor "cost-sharing" expenses). For many, this has forced a greater proportion of such expenses to come from net management fee profits.

For many firms, this escalating demand among distributors for the lowest-cost share class has led to increasingly "retail" use of traditional "I" shares (or other equivalent institutional classes) within such fee-based programs. These share class demands – and the subsequent squeeze on fund firm profit margins – appear unlikely to diminish soon. Potential regulation around uniform Fiduciary Standards may accelerate this trend, once put in place. As fee-based programs continue to grow and advisors are increasingly compensated via an externalized fee for advice, there is even greater demand to keep expenses as low as possible on underlying fund shares.

Variable Annuities: International VAs



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If the story for VAs with living benefits is so compelling that it has been the primary driver for growth in the U.S., what about the rest of the world?

The products need to be understood within the context of the local historical, regulatory, and social environments. For example, the tax deferral benefits enjoyed by American investors are not similarly available within other jurisdictions, such as Australia.

Canada is probably most similar to the United States, with a more conservative investing population and a smaller range of insurers. There, less-risky products have been embraced by investors and are also easier for insurers to support. Growth is likely to be slower but easier on manufacturer balance sheets.

Japan

A few short years ago, Japan was known as the land of the rising VA assets, thanks in part to their guarantees' appeal to risk-averse Japanese investors and to bank distribution of the products. However, the financial crisis hit that economy hard, and three companies, Mitsui Life, the Hartford, and ING, pulled up stakes from the market entirely within the first quarters of 2009. Some others suspended sales of particular products and many redesigned their products.

Despite the pre-crisis sense that the Japanese VA business was enjoying a boundless upward trajectory, in truth increasing competition was squeezing margins and making it more difficult for multi-nationals to manufacture sufficiently profitable products.

Japanese investors, quite conservative and tolerant of lower-yielding products, did provide demand. But between the hedging requirements and the fact that most domestic insurers weren't hedging at all, risk management became increasingly difficult. The reach

of VAs has expanded significantly due to regulatory changes that allow bank sales. And the needs of a rapidly aging population still demand more retirement-income options.

The opportunity in Japan remains ripe for companies with a strong risk management footing. Two insurers (JV Aegon Sony Life and Allianz) have entered the fray since the crisis, and two others, Dai-ichi Life and Credit Agricole, have picked up market share. Dai-ichi sees itself as a budding multi-national.

United Kingdom

VAs with living benefits were first brought onto the scene in 2005 by the Hartford, and within five years, the company that had introduced that contract pulled out of the market. Clearly, the Hartford's decision to back away from both the U.K. and Japan had less to do with the disposition of its international businesses than its need to regroup and take care of domestic matters.

Even so, manufacturers' interest in VAs in the U.K. remains sluggish, with few companies actively engaged there, and all of them from outside the U.K. The abolition of the requirement to annuitize at age 75 does expand product options for retirees, but some believe that investors remain tepid.

The CEO of U.K. insurer Prudential PLC opined that investors there have never demonstrated an inclination to pay for explicit guarantees. However, demographic pressure may shift investor sentiment and open up the market, at which point Prudential PLC will be ready.

Australia

The vast pool of superannuation funds has made Australia a target for any company with an interest in retirement assets. Pre-retirement guarantees are virtually unknown. Even fixed annuities, which are available upon retirement, are not used to accumulate assets.

There is a nascent VA industry in Australia. Three insurers currently offer VA products with living benefits: AXA, OnePath (formerly ING Australia) and Macquarie. However, a means-tested social security net (old age pension) means that retirees who run low on assets have a minimum guaranteed income stream, much like the benefit that GLWBs are intended to provide – thus lessening VA demand.

Manufacturers there expect the market to grow slowly but steadily, fueled by some demand from an aging population – but dampened relative to other countries.

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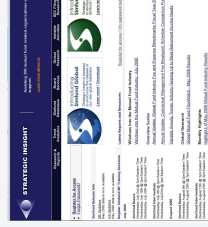
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