

Strategic Insight

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WINDOWS

Into the
Mutual Fund
Industry
August 2011

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Strategic Insight’s Visionaries of the Fund Industry



At our 25th Anniversary Gala to be held November 7th, and with the guidance of an Advisory Board of esteemed industry leaders, SI will be acknowledging many of the influential “visionaries” of our community. The Strategic Insight Visionaries of the Modern Era of the Mutual Fund Industry include those individuals who have helped create the foundation of the industry and have led and protected it in the past quarter century.

[To learn more visit our website.](#)

The list includes notable company leaders, product innovators, path-breaking investment managers, legal and regulatory influentials, and technology pioneers. So many have helped envision, build, and protect the mutual fund industry that touches nearly every American today and serves as an inspiring example to many outside the US.

Strategic Insight's Visionaries of the Modern Era of the Mutual Fund Industry

Charles "Ted" Bauer	Carl Frischling	Peter Lynch	Bob Reynolds
Bruce Bent	Joel Goldberg	Ron Lynch	Jim Riepe
Ed Bernard	Mike Goldstein	Joe Mansueto	Joel Rosenthal
Jim Bodurtha	Robert L. Gould	Chip Mason	Chuck Schwab
Jack Bogle	Bill Gross	Tom McDonnell	Roger Servison
David Booth	Blake Grossman	John McGonigle	David Silver
Jack Brennan	Paul Haaga	Syd Mendelsohn	Launny Steffens
Marsh Carter	Edward "Ned" Johnson III	Allan Mostoff	Howard Stein
Bruce Crockett	Charles Johnson	John Neff	Paul Schott Stevens
Jack Donahue	David Kelly	William Nutt	Gary Strum
Andrew "Buddy" Donohue	Lee Kranefuss	Dick Phillips	John Templeton
Jack Dreyfus	Arthur Levitt	Don Phillips	Frederick Werblow
Dawn-Marie Driscoll	Michael Lipper	Robert Pozen	Al West
Larry Fink	Jon Lovelace	T. Rowe Price	Steve West
Matt Fink	Jonathan Bell Lovelace	George Putnam	Arthur Zeikel

We will be recognizing the mutual fund industry’s Visionaries at Strategic Insight’s 25th Anniversary Gala Dinner on **Nov. 7 in New York**. The gala’s audience will comprise senior fund company executives and other industry leaders, and the program will feature a keynote speech from Paul Schott Stevens, CEO of the ICI, with an additional presentation by Matt Fink. For more information on attending or sponsoring this event, please visit our site [here](#).

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1H 2011 and Looking Ahead



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Leadership matters: Watching the federal budget ceiling debate, we are all reminded that forward-looking, insightful, and resilient leadership, as our industry has been blessed with, is one of the pillars helping our industry succeed. Thanks!

SI's 25th Anniversary Gala Dinner will be held on **November 7th**, with the opening presentation given by Paul Schott Stevens, the ICI's CEO and President. **During the event we will be honoring individual "Visionaries of the Modern Era of the Mutual Fund Industry" for their contribution to the foundation of our industry. In the opposite page you can review the list of these remarkable individuals**, selected by our esteemed [Advisory Board](#).

Matt Fink, the ICI's past president and the author of "The Rise of Mutual Funds: An Insider's View" will offer his historical perspective. **To book your seat or a table for your firm, contact Allana Burke at (917) 664-3507 or aburke@sionline.com.**

In this edition: 2011's 1H flow trends in the US; a perspective on Latin America funds; observations about fund innovation and ETFs; profitability benchmarks; the evolving consensus on the need for Rule 12b-2; NBD distribution insights; and more.

Increasing economic uncertainty in the US and elsewhere and price volatility hampered demand for stock funds during Q2 and in July. Yet, during the first half, stock funds captured about half of the about \$140 billion of net inflows to long-term funds (excluding ETFs, which added more than \$50 billion of net flows).

Simfund Global web version is expanding its use in the US and internationally. Covering European, Asian, and offshore funds, Simfund Global DASH (renamed from 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 DASH 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 out to SI teams in London, Hong Kong, Boston, or New York. Separately, an **Australian version of Simfund**, benefitting from the unique data of our sister company, **Plan For Life**, is under development.

New Simfund data: SI is exploring significant data additions, in late '11 or in early '12. Stay tuned!

New fee research studies: SI recently published a number of our annual fee benchmarking reports (detailed fee ratios by style, size of fund, and fee component, [available here](#); advisory fee breakpoint structure by style, [available here](#)) as well as our annual review of [profitability](#) of investment companies that are publicly held. For more information you may connect to Kevin Shine at kshine@sionline.com, who heads our fee research and Board services, including our expanding 15(c) analytics area.

Webcasts: Recent and coming webcasts include fee trends (attended by over 100 executives and analysts from over 60 firms); ETFs' expanding use; new research discussing retention considerations and asset stability by the various BD platforms; and more.

Our revealing study of NBD fund sales trends, powered by Coates Analytics, is available (see [here](#)).

Global research and advisory: In Q2, SI's Global team **expanded its research staff** in London, Hong Kong, and Melbourne. Its senior analysts recently published **two books about fund distribution in Asia, as well as articles covering Brazil, Chile, and Switzerland**, among others. To learn more about the two consultative books, *Building Bridges* and *Capturing the Promise*, go [here](#).

Boston office: During Q2, SI has opened a Boston office on 255 State Street. This will allow us to serve our Boston and nearby clients with greater frequency.

Lastly, SI Fund Trends, our annual client conference in late June, attracted 160 fund and BD executives from 85 organizations. We were encouraged by the at-capacity attendance and would incorporate your suggestions to make our 2012 conference even more informative. **Read more about the event's key observations in this issue** and be on the lookout for our announcement of the dates of SI Fund Trends 2012.

Domestic Funds: Q2 2011 in Review



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Fund Industry Overview (Excludes ETFs and VA Underlying Funds)

	Net New Flows \$B			
	2009	2010	Q1'11	Q2'11
US Equity/Hybrid	-26.7	-48.9	36.6	-13.0
Int'l Equity	<u>40.7</u>	<u>71.4</u>	<u>29.8</u>	<u>15.9</u>
Total Equity	14.0	22.5	66.4	2.9
Taxable Bond	280.9	213.3	40.3	51.2
Muni Bond	<u>69.1</u>	<u>10.5</u>	<u>-20.0</u>	<u>-3.0</u>
Total Bond	350.1	223.9	20.4	48.1
Total Equity & Bond	364.1	246.4	86.8	51.1
Money Market	-505.9	-509.5	-80.9	-58.0
Total Industry	-141.9	-263.1	5.8	-6.9

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

After healthy inflows in the first quarter, US equity funds saw a significant reversal during Q2 2011 as uncertainty over the economy rose. US Equity funds' aggregate 1H 2011 inflows of \$23.6 billion surpassed 1H 2010's \$2.8 billion of inflows. Some 176 actively managed, open-end US equity mutual funds each attracted over \$100 million of net inflows in 1H'11 compared with 205 in 1H'10.

International/Global equity funds in Q2 2011 enjoyed continued net inflows, although they have seen some of the wind come out of their sails in part because of sovereign debt concerns in Europe. (For more on international funds, see page 6.)

Long-term mutual funds drew \$51.1 billion in total inflows for the most recent quarter, led by taxable bond funds, on pace to exceed total long-term flows from 2010. Taxable bond funds attracted a robust \$91.5 billion in first-half inflows, partly in a search for yield and partly due to investors' cautious outlook. Meanwhile, fears of widespread municipal defaults

eased, so muni bond funds saw smaller net outflows in Q2 than in Q1 (and modest net inflows in June).

While money market funds continued to realize net outflows through the first half of 2011, the current pace of redemptions has slowed substantially from 2009 and 2010. Led by institutions, investors withdrew a cumulative \$139 billion from money market funds in 1H'11. Very low yields continued to push short-term investors elsewhere, including leveraged loan and multi-sector bond funds.

Active US equity funds' almost flat return for Q2'11 bested the S&P 500 index's -0.4% return over the same period. Similarly, international equity funds' 0.6% gain in Q2 outdid the MSCI EAFE's 0.3% return.

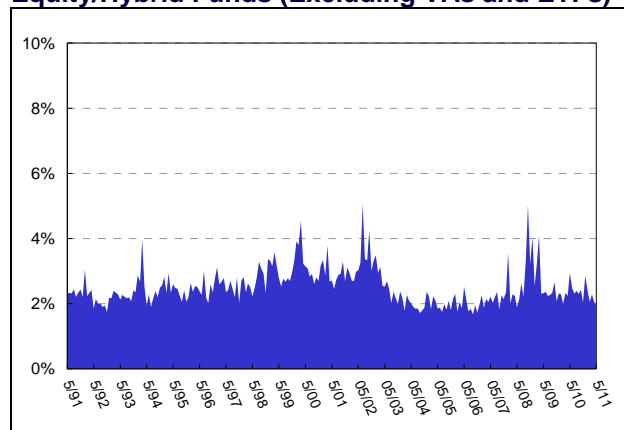
Average Asset-Weighted Annualized Returns %

	2009	2010	Q1'11	Q2'11
US Equity *	31.1	16.7	5.9	-0.2
Int'l Equity	40.2	13.0	2.9	0.6
Taxable Bond	18.3	8.5	1.4	1.7
Muni Bond	17.8	2.1	0.0	4.2
Money Market	0.3	0.1	0.0	0.0

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

Although the worst of the economic crisis is over, investors continue to worry about the progress of economic and employment recovery. As a result, the pace of new equity fund investments, especially in Q2, has been slow. While the sales pace remains moderate, the pace of stock fund redemptions continued at its normalized, pre-crisis rate 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		
	2009	2010	1H'11
Actively Managed Funds	-15.4	-18.2	37.5
Index Funds (non-ETF)	29.0	37.3	29.1
ETF Open-End Funds	57.5	75.4	37.8
ETFs structured as UITs / Grantor Trusts / ETNs /Other	10.0	6.7	-3.9

Source: Strategic Insight Simfund MF

Equity index funds continued to draw investors' interest but trailed actively managed funds and open-end equity ETFs in the first half. On the bond side, actively managed funds drew substantially greater net inflows than index funds or ETFs.

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

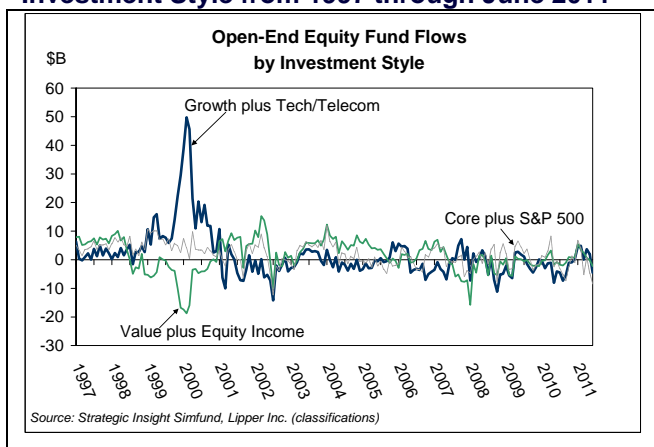
	Net New Flows \$B		
	2009	2010	1H'11
Actively Managed Funds	322.1	192.6	61.1
Index Funds (non-ETF)	27.4	4.4	6.6
ETF Open-End Funds	29.6	-0.5	16.8

Source: Strategic Insight Simfund MF

Growth vs. Value

For Q2'11, value and core styles recognized net outflows while growth (including tech) realized the most new dollars.

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



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

Flows and returns among diversified, actively managed US equity funds are summarized in the next table.

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

	Flows \$B		1H'11 Returns *
	2010	1H'11	
Large-Cap Growth	-11.4	4.2	5.4%
Mid-Cap Growth	-3.0	0.7	7.9%
Multi-Cap Growth	-7.4	2.4	7.5%
Small-Cap Growth	-0.6	1.6	9.8%
Growth Funds	-22.4	8.9	6.8%
Large-Cap Core	-41.8	-24.4	5.0%
Mid-Cap Core	1.0	0.2	7.1%
Multi-Cap Core	-6.3	-1.3	5.5%
Small-Cap Core	-0.1	1.5	6.7%
Core Funds	-47.2	-23.9	5.5%
Large-Cap Value	-12.5	-5.9	5.7%
Mid-Cap Value	-2.1	-0.2	6.8%
Multi-Cap Value	-0.7	-3.6	4.5%
Small-Cap Value	2.0	1.0	4.6%
Value Funds	-13.3	-8.6	5.4%

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

Funds with Highest Inflows: Some Risk-Return Characteristics

The decision to invest in a particular fund or with a particular fund manager is based on numerous factors, but SI has observed that **trailing three-year rankings, within the fund's investment style and on both relative-return and relative-risk dimensions, offer predictive value for flows.** Relative total returns remain the chief determinant for fund selection.

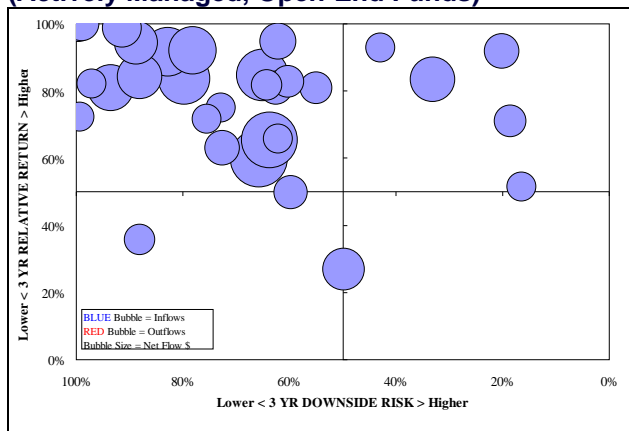
SI's "Bubble" charts, generated in Simfund, plot funds on a relative risk/return basis versus similarly invested peers. Funds in the top-left quadrant have superior positioning relative to peers, displaying below-average risk (defined as cumulative monthly losses over 36 monthly observations) while achieving above-average returns. And **Q2'11** was another period for which the top-left quadrant of graphs housed the highest-inflow funds.

As an illustration of cash flow results for Q2'11, we capture below the "trailing three-year risk-return vs. cash flow bubbles" of the industry's 40 highest cash flow funds in 2011 (trailing 3-year risk and return as of quarter-end 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 Q2'11 net inflows.**

The funds in the charts clearly share appealing risk-return characteristics for the 36 months ending June 2011. 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.

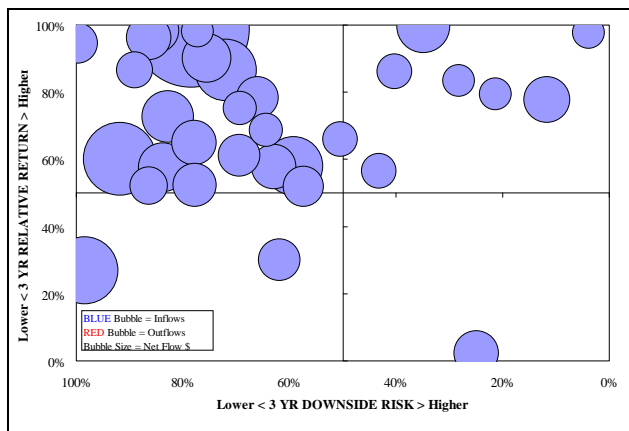
Risk-Return Characteristics of Best Selling Mutual Funds in 2011

Highest Net Inflow Equity Funds in Q2'11 (Actively Managed, Open-End Funds) *



*Q2 2011 Flows and 3-Yr. Risk/Return Analysis within Lipper Classifications; Source: Strategic Insight Simfund MF

Highest Net Inflow Bond Funds in Q2'11 (Actively Managed, Open-End Funds) *



*Q2 2011 Flows and 3 Year Risk/Return Analysis within Lipper Classifications; Source: Strategic Insight Simfund MF

2011 Flows by Manager

The tables below present the managers drawing the most cash flows in 2011's first half in active, long-term funds.

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

Manager	Flows (\$B)		1H'11	6/11
	2010	1H'11	Flow Rate*	Assets \$B^
PIMCO LLC	55.5	15.3	4%	414.3
JPMorgan Funds	20.7	14.3	12%	136.0
Franklin Templeton	20.2	10.0	3%	360.3
DFA	7.3	8.1	7%	124.4
BlackRock	13.9	7.9	5%	177.6
T. Rowe Price	12.3	7.9	3%	271.6
MainStay Funds	2.1	4.9	17%	35.3
First Eagle	4.1	4.6	11%	48.3
Thornburg	9.0	4.4	10%	53.3
DoubleLine Capital	4.0	4.4	107%	8.8
Lord Abbett	7.7	3.7	6%	71.2
John Hancock	4.3	3.5	6%	69.3
Eaton Vance	9.8	3.5	4%	105.7
Waddell & Reed	3.9	3.4	5%	72.5
Pacific Heights	3.8	3.2	31%	13.9
TCW / MetWest	4.3	3.2	12%	30.4
Virtus Invst Ptnrs	1.4	3.0	18%	20.0
Intl Value Advisors	4.4	2.7	30%	12.5
Prudential Fincl	3.3	2.7	7%	41.6
Yacktman	2.9	2.7	50%	8.6

*Flow rate = 1H'11 flows as a pct. of 12/10 assets; ^Active long-term assets only; Source: Strategic Insight Simfund MF

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

Manager	Flows (\$B)		1H'11	6/11
	2010	1H'11	Flow Rate*	Assets \$B**
DoubleLine Capital	4.4	4.4	107%	8.8
Cambiar	0.0	1.2	81%	2.8
Stone Harbor	0.8	1.0	72%	2.5
TFS Capital	0.2	0.7	62%	2.0
Yacktman	2.9	2.7	50%	8.6
AQR Capital Mgmt	2.4	1.4	44%	4.8
Driehaus Capital	0.9	1.4	39%	5.2
Pacific Heights	3.8	3.2	31%	13.9
Intl Value Advisors	4.4	2.7	30%	12.5
Brown Capital Mgmt	0.1	0.3	29%	1.4

^\$1B+ in AUM at 12/10; *Flow rate = 1H'11 flows as % of 12/10 AUM. ** Active long-term assets; Source: Strategic Insight Simfund MF

US-Based International Funds: Q2 2011 Update



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

Structure/Type	Assets \$B 6/11	Net Flows, \$B			
		2009	2010	Q1'11	Q2'11
Open-end Active	1,603	33.1	55.6	24.1	10.1
Open-end Indexed	134	9.7	19.0	5.3	4.6
ETFs**	361	53.9	43.4	2.2	12.4
Closed-End	38	0.0	0.7	0.0	0.4
VA Funds***	232	7.0	7.6	1.8	0.4
Total	2,368	103.8	132.4	33.3	27.9

Source: Strategic Insight Simfund MF / VA. *Includes Gold funds; ** UIT and other ETPs, as well as open-end ETFs. *** VA data through May 2011.

Notwithstanding continued political turmoil in the Middle East/North Africa, global inflation fears and economic uncertainty within the EU, **US mutual fund investors added \$28 billion in net new cash to US-domiciled International / Global stock funds in the Q2 2011.** Demand for global allocation funds slowed from Q1'11 but still outpaced Q4'10.

While Int'l/Global equity funds underperformed US equity funds in Q1 2011, they eked out a slight advantage over their domestic peers in Q2'11.

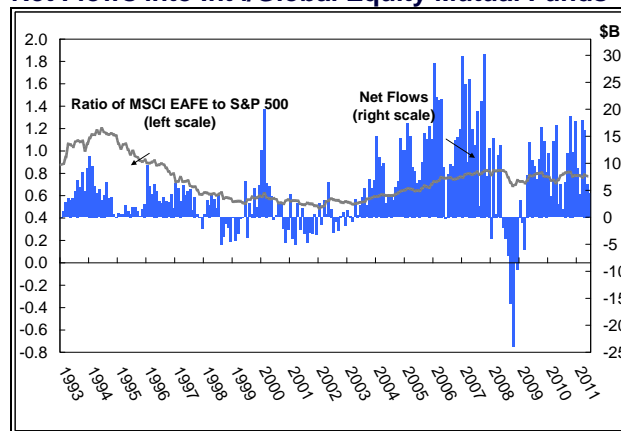
Int'l Equity, US Equity, and World Bond Funds Annual Average Total Returns (Asset-Weighted)

	2007	2008	2009	2010	Q1'11	Q2'11
U.S. Equity*	7.15	-37.87	31.48	16.82	6.19	-0.23
Int'l/Glbl Equity	16.66	-41.90	40.47	13.64	2.84	0.46
World Bond^	8.86	-1.27	15.65	9.15	1.61	2.55

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 1H 2011 as well as for the full previous calendar year. Some of those flows reflected performance-chasing, but flows to international/global equity funds in general also stemmed from investors' search for more global diversification – a long-term shift in portfolios. Multi-cap funds continued to have strong Q2'11 flows as investors demanded flexible and unconstrained strategies.

Actively Managed Int'l/Global Equity Funds 10 Highest 1H 2011 Net Flow Classifications

	Net Flows \$B		Assets \$B
	2010	1H'11	6/11
Emerging Markets	27.44	10.84	198.6
Intl Multi-Cap Value	3.35	3.76	32.7
Intl Multi-Cap Core	3.21	3.19	48.7
Global Multi-Cap Value	2.55	2.16	14.6
Intl Large-Cap Growth	1.18	1.00	305.3
Intl Multi-Cap Growth	4.84	0.61	66.4
Intl Sm/Mid-Cap Growth	1.74	0.58	23.3
Intl Sm/Mid-Cap Core	0.11	0.43	16.4
Global Multi-Cap Core	-0.52	0.30	15.4
Global Multi-Cap Growth	0.74	0.17	9.2

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

Emerging Markets Bridges: Latin America in Global Asset Management



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Brazil: Gateway to a \$1.2 Trillion Latin American Fund Market

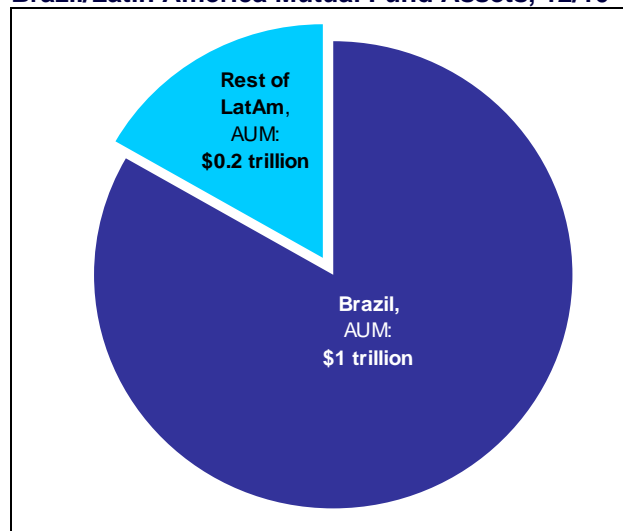
The Latin American mutual fund industry had \$1.2 trillion in total assets under management at year-end 2010, three times higher than in 2005. **Brazil, the largest country in the region with 200 million in population and \$2.1 trillion in GDP, dominated the industry with almost 90% of total Latin American assets** (shown in the graph at right).

Partly due to strong appreciation of the Real against the US dollar in recent years, Brazil is now among the five largest mutual fund markets in the world. (And with growing opportunities in markets like Chile or Peru, as well as Brazil, Strategic Insight plans to offer more in-depth analysis of Latin America later this year.)

Bond funds form the largest asset class in Brazil, totaling \$450 billion as of Q1 2011. Furthermore, **90% of private pension funds (Fundos de Previdencia Privada) in Brazil are fixed income products, adding another \$100 billion in bond assets.**

Equity and mixed funds account for \$115 billion and \$240 billion in assets, respectively. From a classification perspective, it is important to note that Brazilian “mixed funds” refer to Brazil’s regulated “multimercado (multi-market) funds,” sometimes also called “Brazilian absolute return” or “Brazilian Hedge Funds.” These invest in multiple asset classes such as fixed income, commodities and currency. Unlike hedge funds in other markets, multimercado funds are highly regulated, with mandatory daily redemption policies and extensive monthly investment reports, and have strict mark-to-market accounting requirements.

Brazil/Latin America Mutual Fund Assets, 12/10

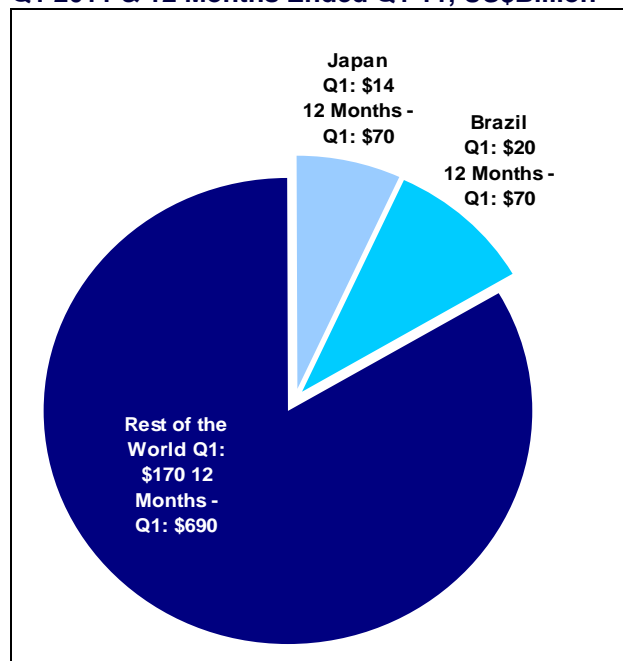


Note: Source: Strategic Insight, ICI, FIAFIN, ANBID

Brazil – Japan Bridge

Japan and Brazil, the two largest mutual fund markets in Asia and Latin America, respectively, combined attracted almost **20% of aggregate global mutual fund flows both in Q1 2011 and in the last twelve months through Q1**, as seen in the graph below.

Brazil/Global Long-Term Fund Net Flows, Q1 2011 & 12 Months Ended Q1'11, US\$Billion



Note: Japan flow data exclude Money Reserve and Money Management Funds; Brazil includes private pension funds). Source: Strategic Insight, Industry Associations

Interestingly, with Japan in recent years moving to exotic new fund themes distributed by brokers, (a shift from the diversified global portfolios distributed by banks pre-crisis), many Brazil country and Brazil-themed funds gathered billions in flows.

The largest single country Brazil funds in Japan in fact doubled in AUM each year since 2007, **with Q1 2011 assets now ten times its 2007 figure: from \$3 billion to \$30 billion.** Due to the appeal of higher yields and relatively lower risks, most Brazil funds for now are fixed income products. However, equity funds are gradually picking up as well.

Latin America: Mutual Fund Assets By Market

Market	Dec.'08 US\$B	Dec.'09 US\$B	Dec.'10 US\$B
Brazil	479	784	980
Mexico	60	70	99
Chile	18	34	38
Colombia	9	13	16
Peru	2	5	6
Argentina	4	4	5
Costa Rica	1	1	3
Bolivia	1	1	1
Total	573	913	1,148

Source: Strategic Insight, ICI, FIAFIN, ANBID

Chile as an Example of DC Retirement Investing

The Chilean pension scheme, a mandatory public retirement system with 10% monthly salary contributions, currently has about **\$150 billion in total assets, and nearly 50% of it in offshore investments.**

Furthermore, 70% of assets are currently *allowed* to be invested overseas: **this ceiling increased to 75% in Q2 2011 and will rise to 80% in Q3 2011** – a reverse home bias that has benefited foreign fund managers and put the country in the spotlight for the region as a **DC model similar to 401(k) plans in the US or Superannuation in Australia.**

- Of the \$148 billion total in Chilean pension fund assets, **\$68 billion are invested offshore.**
- Offshore equities with \$46 billion are the second-largest allocation in Chilean pension funds on aggregate, directly following domestic fixed income (\$54 billion).
- One third of total assets are allocated to domestic bonds, one-third are allocated to offshore equities, and the remaining third are divided between domestic equities and offshore fixed income.

A wide range of international fund managers have gathered meaningful assets and flows:

- **The top 10 offshore equity funds in Chilean pension funds as of Q1 2011 accounted for over \$16 billion in total assets,** led by Franklin Templeton and Fidelity and also including JPMorgan, Vanguard/SSgA, Schroders and Gartmore.
- Concentration of assets to flagship products: **Total assets for the top 10 equity funds account for close to 25% of all offshore investments and slightly over 10% of total pension fund assets.**

Chile as the Hong Kong of Latin America: Hong Kong along with Singapore and Taiwan are the leading UCITS hubs for asset managers to expand into Asia. However, the number of UCITS registered for sale in Chile slightly exceeds those in Hong Kong.

Cross-Border UCITS Assets, Q1 2011

Market	Assets
Europe	\$2.5 Trillion
Asia-Pacific	\$0.5 Trillion
<i>Hong Kong</i>	1,345 UCITS funds
Latin America	\$0.2 Trillion
<i>Chile</i>	1,361 UCITS funds
Middle East	\$0.1 Trillion

Source: Strategic Insight Simfund GL

While UCITS historically were meant to be a facilitator of cross-border business in Europe – a passport – the brand is increasingly becoming global in nature. Some \$3.3 trillion in global UCITS assets are cross-border. The contribution from Asia now stands at \$0.5 trillion and is growing quickly.

Many fund managers targeting non-domestic expansion have to decide whether to go to after the big AUM markets, such as China and Japan, or Brazil and Mexico. As discussed in our recent research, this involves a long-term commitment locally and heavy investments with a long-term horizon. Such an approach can make sense for large, international fund managers, but often this is beyond the scope of mid-size firms or smaller boutiques – at least initially.

But just as international fund houses have benefited from growth in the smaller Southeast Asian markets in recent years (for more information, please see our in-depth Asia report, *Building Bridges*), Latin America also offers a “small is beautiful” concept: **less upfront investment, leveraging existing relationships, more scalable, and, in the case of Chile, a stream of mandatory flows.**

ETF Update: Assets Approach \$1.1 Trillion



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Exchange-Traded Funds in the US drew net new flows of \$53.6 billion in the first half of 2011, ahead of the \$39 billion in net inflows they gathered in 2010's first half. First-half 2011 flows included \$27.3 billion in the second quarter. **At the end of June 2011, US ETF assets (including ETNs) totaled \$1.094 trillion** in 1,267 different products.

ETFs: By Investment Type

	Assets \$B 06/11	Net Flows \$B			# of Funds 06/11
		2009	2010	1H 2011	
US Equity					
Diversified	379.0	-19.2	12.1	4.8	251
Sector	148.8	16.2	17.7	15.2	272
Subtotal US Equity	527.8	-3.0	29.8	20.0	523
Int'l/Global Equity					
Diversified	72.3	0.5	4.7	6.3	54
Divrsfd Emrg Mkts	97.5	16.1	24.9	-3.7	37
Regional	17.7	2.6	0.7	-1.0	27
Single Country	74.2	12.0	6.0	7.8	94
Sector	4.6	0.8	0.9	1.2	18
Subtotal Int'l/ Global Equity	266.3	32.1	37.3	10.6	230
Bond					
Taxable Bond	140.1	38.6	25.0	15.1	106
Muni Bond	7.2	3.6	1.1	0.1	28
Subtotal Bond	147.2	42.2	26.1	15.1	134
Specialized					
Alternative Strategy	3.2	1.5	2.5	1.1	40
Commodity	105.6	29.0	12.2	-0.4	94
Currency	7.6	3.7	-2.2	1.9	29
Leveraged/Inverse	36.0	12.3	4.8	5.1	217
Subttl Specialized	151.9	46.4	17.2	7.7	380
Total	1,093.7	117.7	110.5	53.6	1,267

Source: Strategic Insight Simfund MF

The inflows into ETFs in 2011's first half followed four straight years of \$100B+ in net inflows, as they have consistently drawn capital from individuals,

advisors and institutions through varying market conditions. US equity ETFs drew \$20 billion in net inflows in 2011's first half, led by large cap ETFs and sector ETFs. International and Global equity ETFs saw \$10.5 billion in net inflows in 1H 2011, thanks to strong flows into diversified international funds and single-country ETFs. Diversified Emerging Markets ETFs took in net flows of \$5.2 billion in the second quarter, but that wasn't enough to make up for Q1 outflows – resulting in 1H net outflows of \$3.7 billion.

Bond ETFs drew \$15.1 billion in net inflows in 1H 2011. Short- and intermediate-term bond ETFs accounted for \$6.5 billion of first-half net inflows, including \$3.5 billion of inflows in Q2.

Commodity ETFs saw small net outflows in the first half. Meanwhile, leveraged and inverse ETFs enjoyed \$5.1 billion in net inflows in 1H 2011, driven mainly by flows to inverse ETFs (which seek the inverse of an index's daily return). Alternative strategy ETFs, including volatility-related, market neutral, long-short and managed futures products, saw net inflows of \$1.1 billion in the first half. We expect such alternative types of ETFs to grow both in number and in popularity as retail investors become increasingly comfortable with alternative-type strategies in general.

Most Popular ETFs in 1H 2011

The table below lists the highest cash-flow ETFs of 2011's first six months. The list is dominated by iShares (BlackRock), the #1 ETF sponsor by assets, and Vanguard, the #3 ETF sponsor; the Select Sector SPDR Technology ETF from State Street, the #2 ETF sponsor, came in 11th. The list is also dominated by established ETFs – the three newest ETFs, including Van Eck's AgriBusiness ETF, debuted in 2007.

Highest Cash Flow ETFs in 1st Half 2011

Fund Name	Assets \$B 06/11	1H 2011 Net Flows	
		\$B	Rate*
Vanguard MSCI Emerg Mkts Stock	50.4	5.3	12%
Van Eck MktVector AgriBusiness	5.5	2.9	111%
iShares MSCI Japan Index	7.2	2.7	54%
Vanguard Dividend Appreciation	6.7	1.8	39%
iShares S&P US Preferred Stock	8.0	1.7	29%
iShares MSCI Germany Index	3.8	1.6	87%
Vanguard Tax Managed Int'l	7.2	1.5	28%
iShares MSCI EAFE Index	39.4	1.5	4%
iShares MSCI Brazil Index	12.7	1.4	12%
iShares S&P Mid Cap 400 Index	11.5	1.4	15%

*1H 2011 Net Flows as a % of 12/31/10 assets.

Source: Strategic Insight Simfund MF

The most popular ETFs reflected a range of investment themes: income (the dividend appreciation and preferred stock products); news-related international plays (Germany and Japan ETFs); emerging markets (the diversified EM and Brazil ETFs); diversified developed international markets (the tax-managed international and EAFE products); commodities industries (agribusiness) and US midcap stocks (a segment that theoretically should benefit from any economic rebound). This diversity among the Top 10 draws in ETFs speaks to the broad range of asset classes and strategies available in ETF structures.

Excluding offerings from the Big Three (iShares, State Street and Vanguard), other ETFs that drew large inflows in 1H 2011 included the UltraShort 20+ US Treasury ProShares ETF (\$1.2 billion of inflows in 1H 2011); the PowerSharesDB Commodity Index Tracking Fund (\$0.7B of inflows); the Ultra Silver ProShares (\$0.6B) and the Alerian MLP ETF (\$0.5B).

Actively Managed ETFs: A note on “active” ETFs. This small but high-profile segment saw \$1.6 billion in net new flows in the first half of 2011. At the end of June, there were 44 active ETFs managing a total of \$4 billion. That’s less than ½ percent of the ETF market, and the three biggest funds held 63% of all active ETF assets. This market awaits new funds and new managers.

New ETF Launches 1H 2011

The pace of ETF launches seems to be accelerating. The first half of 2011 saw **189 new ETFs launch, drawing an aggregate \$2.8 billion in inflows**. By contrast, in 2010’s first half, 107 new ETFs launched and raised \$2.1 billion in net inflows, and in 1H 2009 46 new ETFs launched, raising \$1 billion.

Top New ETFs of 1H 2011, By Flows

Product	Strategy	Net New Flows \$MM 1H 2011
WisdomTree Asia Local Debt	Emrg Mkt Bond	474
WisdomTree Managed Futures	Mangd Futures	195
PowerShares Senior Loan	Floating Rate	181
Schwab US REIT ETF	Real Estate	131
iShares High Dividend Equity	Income/Growth	80
Schwab US Mid Cap ETF	Midcap Equity	74
VIX ShortTerm Futr ProShares	Volatility	59
IndexIQ GI Agribusiness SmCp	Nat Resources	56
ETFS Physical Asian Gold Shr	Gold	53
Active Bear ETF	Short-Selling	52

Source: Strategic Insight Simfund MF

Of the 10 most successful debuts in 2011 (not surprisingly, all 10 launched in Q1), only one was from the Big Three managers. Instead, 2011’s biggest debuts continued a trend of success among smaller managers and with ETFs that, in terms of core/satellite portfolio construction, would be considered satellite strategies.

Among the most successful newly launched ETFs in the first half, the biggest debut was WisdomTree’s Asia Local Debt ETF, an Asia-centered sequel to the firm’s \$900 million Emerging Markets Local Debt ETF, which launched in 2010. Alternatives were a big theme among the top 10, seen in: the first managed futures ETF, from WisdomTree; the Active Bear ETF, an all-short fund managed by AdvisorShares and subadvised by Ranger Alternative Management; and an ETF investing in futures on the VIX (CBOE Implied Volatility Index), another product expanding ProShares’ footprint beyond leveraged/inverse ETFs and into alternative strategies.

Biggest ETF Managers

The US ETF market is concentrated: as of June 30, **BlackRock, State Street and Vanguard together controlled 82% of the assets**, down from 83% a year earlier. The Top 10 ETF managers run 95% of the assets, down from 96% at the midpoint of 2010.

Top 10 ETF Managers as of June 2010

Manager	Assets June'10 \$B	Market Share June'10	Net Inflows 1H 2010 \$B
BlackRock (iShares)	473.8	43.3%	11.2
State Street Global	248.2	22.7%	0.0
Vanguard	175.0	16.0%	20.3
InvescoPowerShares	44.2	4.0%	0.6
ProFunds	27.2	2.5%	4.3
Van Eck	22.9	2.1%	4.2
DB Commodity Svcs	13.1	1.2%	1.3
WisdomTree	12.9	1.2%	2.9
Amer Stck Exchange	11.1	1.0%	-2.1
Rydex Advisors	9.2	0.8%	1.3
Top 10 Total	1,037.7	94.8%	44.0

Source: Strategic Insight Simfund MF

The ETF market is gradually fragmenting as it grows larger and more of the assets are flowing to newer, smaller managers. The surest sign is the position of BlackRock’s iShares ETF line: its assets grew by 35% from \$362.9 billion at June 2010 to \$473.8 billion at June 2011, but its market share dropped from 46.2% at June 2010 to 43.3% over that 12-month period. We expect further fragmentation as the US ETF market heads toward \$2 trillion in size.

Natural Resource Funds: Growth and Innovation



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Advisors and investors have added roughly \$20 billion in net flows to Natural Resources and Gold funds and ETFs/ETNs in the first half of 2011, on top of \$50 billion and \$40 billion, respectively, in full years 2009 and 2010. The elevated volumes have been driven by a desire to capitalize on the potential for higher returns (including through indirect exposure to emerging market growth), add diversification in investment portfolios (including within target-date and target-risk fund-of-funds), and hedge against potential inflation and macroeconomic and systemic risk. Notably, investors have shown greater inclination to use conventional funds rather than ETFs to gain exposure to the Natural Resources area.

Natural Resources & Gold						
Open-End Funds, Closed-End Funds, ETFs and ETNs						
	Assets		Net Flows \$B			
	\$B					
	6/11	2007	2008	2009	2010	1H'11
Natural Resources						
Open-End Funds	117.4	3.7	-2.7	15.3	17.2	11.7
ETFs/ETNs	68.4	10.2	9.6	17.3	5.1	7.7
Closed-End Fds	14.4	0.6	-	0.1	2.9	2.1
Subtotal Natural Resources	200.1	14.5	7.0	32.7	25.2	21.5
Gold						
Open-End Funds	32.6	0.2	0.7	2.2	4.0	-1.3
ETFs/ETNs	77.4	5.3	8.0	16.6	10.3	-0.5
Closed-End Fds	1.2	-	-	-	-	-
Subtotal Gold	111.2	5.5	8.6	18.8	14.3	-1.8
Total Above	311.4	20.0	15.6	51.5	39.5	19.7

Source: Strategic Insight Simfund MF

The bulk of the 1H 2011 flows into **Natural Resources** funds (we include here both stock-focused; and derivatives-based or “commodities” funds) came in the first quarter, when there was an uptick in demand for energy-focused stock funds after political unrest in some

countries in the Middle East and North Africa caused uncertainties about energy supplies from the region, contributing to upward pressure on oil prices. Aggregate flows into the sector slipped into negative territory in the second quarter under the impact of the sharp pullback in commodities markets in May as they adjusted to scaled back expectations for global growth.

Gold funds experienced small net outflows in the first half overall, largely due to the \$3.8 billion in net redemptions in January, when improved investor sentiment had lowered demand for the use of the metal as a “safe haven.” However, the rise in market volatility and macro concerns since then, including escalation of the sovereign debt crisis in the eurozone, led to a resumption of inflows that was interrupted only in May, the month of the commodities market “sell-off.”

Natural Resources / Gold: Highest 1H Flow Funds						
	Structure*	Start Year	Net Flows \$B			
			2010	1H'11		
Van Eck Market Vectors Agribusiness ETF	ETF	2007	0.2	2.9		
JPMorgan Highbridge Dynamic Commodities Strategy	OE	2010	0.7	1.8		
PIMCO Commodity RealReturn Strategy	OE	2002	3.6	1.4		
iShares Gold Trust	ETF	2005	1.6	1.3		
CreditSuisse Commodity Return Strategy	OE	2004	1.5	1.0		
RS Global Natural Resources	OE	1995	0.5	0.9		
BlackRock Resources & Commodities Strategy	CE	2011	-	0.8		
Prudential Jennison Natural Resources	OE	1987	0.9	0.8		
Van Eck Global Hard Assets	OE	1994	1.2	0.7		
PowerShares DB Commodity Index Tracking	ETF	2006	0.2	0.7		
Alerian MLP ETF	ETF	2010	0.6	0.5		
ClearBridge Energy MLP Opportunity†	CE	2011	-	0.5		
DWS Enhanced Commodity Strategy	OE	2005	0.4	0.5		
Nuveen Energy MLP Total Return	CE	2011	-	0.4		
United States Commodity Index Fund	ETF	2010	0.1	0.4		

* OE – Open-end Fund; CE – Closed-end Fund; ETF - Exchange Traded Fd
† Advised by Legg Mason, sub-advised by Legg subsidiary ClearBridge
Source: Strategic Insight Simfund MF

The three leading cash-flow funds in the Natural Resources / Gold area in the first half:

- The \$5.5 billion **Van Eck Market Vectors Agribusiness ETF (MOO)**, which seeks to provide exposure to a broad spectrum of companies involved in agribusiness by passively

tracking the DAXglobal Agribusiness Index, led with 1H net flows of \$2.9 billion. Notably, it was the second-highest flow gatherer among all ETFs and ETNs over the period (first being Vanguard’s MSCI Emerging Market Stock Index ETF.)

- **JPMorgan’s Highbridge Dynamic Commodities Strategy** fund, started last year, was next in the flow rankings with a \$1.8 billion net intake in the first half. The surge in flows led this open-end actively managed conventional fund to close to most new investors in May. Its commodity derivative investments are made using a long-biased style with the flexibility to short. The fund targets a specific long-term volatility level which it can reduce during extreme events or periods of portfolio underperformance. JPMorgan’s wholly-owned hedge fund subsidiary, **Highbridge Capital Management, LLC** manages the fund’s commodity investments in the capacity of a sub-adviser.
- Third among Natural Resource funds in terms of 1H flows was **PIMCO’s \$25 billion Commodity RealReturn Strategy**, one of the older commodity-derivatives based strategies in the fund area, and currently the largest Natural Resources (excluding Gold) offering by far. This fund follows an enhanced-index approach, investing in commodity index-linked derivatives backed by an actively managed TIPS portfolio. It drew \$1.4 billion in 1H.

Besides dedicated Natural Resources and Gold funds, some other equity/hybrid funds, such as **Pacific Heights’ Permanent Portfolio** and **First Eagle’s Global Fund**, have significant allocations to natural resources and precious metals.

Product Innovation

In the **conventional (non-ETF), open-end Natural Resources** fund area, new launches since the end of 2009 have comprised almost entirely of commodity derivatives-based offerings or funds that seek exposure to Master Limited Partnerships (MLPs)—the following table shows launches since the start of 2010 that have gathered the most net new money in 1H 2011.

As the commodities (derivatives-based) asset class develops in the fund world, we are observing the emergence of more active strategies than used in the past. Examples include the top three funds in the following table: (i) The **JPMorgan HighBridge Dynamic Commodity Strategy** fund (its active approach has already been described above) (ii) **PIMCO’s CommoditiesPLUS Strategy** fund, which actively manages its commodities derivatives investments as well

as its underlying short-term fixed income portfolio; and (iii) **Eaton Vance’s Commodity Strategy** fund, whose sub-adviser, **Armored Wolf**, uses active strategies for commodity-linked derivatives as well as global inflation-linked bonds, and emerging market bonds.

Natural Resources Funds Started over 2010-1H’11* that Drew the Most Flows in 1H’11 Open-end Funds (Excluding ETFs)

Portfolio Name	Morningstar Category	Net Flows \$MM	
		2010	1H’11
JPMorgan Highbridge Dynamic Commodities Strategy	Cmmdty Brd Bskt	684	1,794
PIMCO CommoditiesPLUS Strategy	Cmmdty Brd Bskt	793	299
Eaton Vance Commodity Strategy	Cmmdty Brd Bskt	207	280
SteelPath MLP Alpha	Equity Energy	198	265
SteelPath MLP Select 40	Equity Energy	326	191
Russell Commodity Strategies	Cmmdty Brd Bskt	934	139
DFA Commodity Strategy	Cmmdty Brd Bskt	113	108
SteelPath MLP Income	Equity Energy	124	97
ALPS / Jefferies Commodity Strategy Allocation	Cmmdty Brd Bskt	34	91
Cushing MLP Premier	Equity Energy	5	83

* All funds in above list were started in 2010. Source: Strategic Insight Simfund MF

On the **closed-end** fund side, Natural Resources offerings have accounted for nearly half of the total \$11 billion raised in IPOs since the beginning of 2010 (through June 2011). In an indication of the attractiveness of the MLP niche for income-hungry investors, about 70% of the total \$5 billion that has flowed to natural resource closed-end IPOs over the one-and-a-half-year period has gone to funds providing exposure to such energy partnerships.

Natural Resource / Gold Closed-End Fund IPOs: Jan 2010 to June 2011

Portfolio Name	Start Year	IPO Net
		Proceeds \$B
ClearBridge Energy MLP*	2010	1.1
Tortoise MLP Fund	2010	1.0
BlackRock Resources & Commodities Strtgy	2011	0.8
ClearBridge Energy MLP Opportunity*	2011	0.5
Kayne Anderson Midstream/Energy	2010	0.5
Nuveen Energy MLP Total Return	2011	0.4
Gabelli Natural Resources, Gold & Income	2011	0.4
ING Infrastructure, Industrials & Materials	2010	0.4
Salient MLP & Energy Infrastructure	2011	0.1
Total above		5.1

* Advised by Legg Mason, sub-advised by Legg subsidiary ClearBridge Source: Strategic Insight Simfund MF

Post-Crisis Mutual Fund Launches



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Since the S&P hit a low in March of 2009, fund firms have introduced 748 new active, open-end mutual funds to market. These portfolios have aggregately demonstrated success so far in net flows relative to more established peers – as of June 2011, post-crisis funds captured \$82B of the \$213B in net flows that investors put into all active, long-term funds in the 12 months ended June 2011. **Strong net flows into these new funds signify investors’ appetite for more sophisticated ideas and strategies, even absent a three-year track record, particularly products offered by managers with a solid institutional background.**

Domestic Equity. Although nearly half of the 228 Domestic Equity launches since Q2’09 reside within the Large Cap style box (such as the Brandywine Large Cap Value fund in the table), new US Equity funds tend to go beyond traditional style-box strategies. Domestic equity products with flows success are characterized by a combination of non-traditional features such as: application of technical analysis; tactical management; use of options; highly concentrated portfolios; and benchmark agnosticism. For example, JPMorgan Income Builder is a hybrid strategy that tactically manages across high-income asset classes such as global REITs and emerging markets debt. Additionally, a number of the Domestic Equity flows leaders among new product launches employ one or more subadvisors.

International Equity. Prevalent themes of successful International Equity funds launched post-crisis include less constrained investment approaches, total return, and the continuation of the emerging markets and global growth story lines. PIMCO’s EqS Pathfinder and EqS Emerging Markets funds (part of the firm’s new push into equity funds) take flexible investment approaches combined with tail-risk hedging. Emerging Markets Equity funds continue to be popular, with 34 such funds launching since Q1’09.

Top Mutual Funds* Launched After Q1 2009, By Net New Flows 12 Months Ended June 2011

Fund	Morningstar Category	Assets 6/11 \$B	Net Inflows 12 Mos.- 6/11 \$B
JPMorgan Income Builder	Conservtv Alloctn	1.9	1.6
Transamer WMC Qlty Val	Large Value	1.4	1.4
LM BW Dvsfd LgCap Val	Large Value	0.3	0.3
Total US Equity (228 Funds)		22.3	9.4
PIMCO EqS Pathfinder	World Stock	1.5	0.9
Russell Gbl Infrastructure	World Stock	0.9	0.8
Wells Fgo Avg EmgMkt	Divsfd Emrg Mkts	2.1	0.7
Total Intl Equity (176 Funds)		30.4	17.1
DoubleLine Total Return	IntermTerm Bond	8.2	6.8
GS Strategic Income	Multisector Bond	2.3	2.3
RS Floating Rate	Bank Loan	1.6	1.4
Total Taxable Bond (154 Funds)		59.4	30.7
JPM Hibridge DynComm	Commodities Broad Basket	2.5	2.2
American Gbl Balanced	World Allocation	2.1	2.1
Virtus Prem AlphaSector	Large Blend	1.9	1.9
Total Alternatives/ GTAA (161 Funds)		35.8	23.5

* Excludes ETFs, funds-of-funds, closed-end funds, VA funds
Source: Strategic Insight Simfund MF

Taxable Bond. Among the successful Taxable Bond funds launched after Q1’09 were flexible/opportunistic funds such as DoubleLine Total Return, launched in 2010 and focused on mortgage-related securities, and Goldman Sachs Strategic Income. Floating Rate strategies, such as those offered by RS Investments and BlackRock, topped sales as well.

Alternatives. Many successful post-crisis fund launches reflect flexible, multi-asset class mandates, supporting the rationale for ongoing product development centered around a global, go-anywhere philosophy. Exemplifying these trends are American Global Balanced fund, launched in February 2011, which has grown to \$2.1B; and Virtus Premium AlphaSector, which shifts its weighting among sector ETFs and T-Bills.

Early success of new fund launches by no means indicates continued success. But it’s clear that the demand for flexibility and non-correlation that has generated much industry buzz – and which we believe are long-term, secular trends – is showing up in recent net flows.

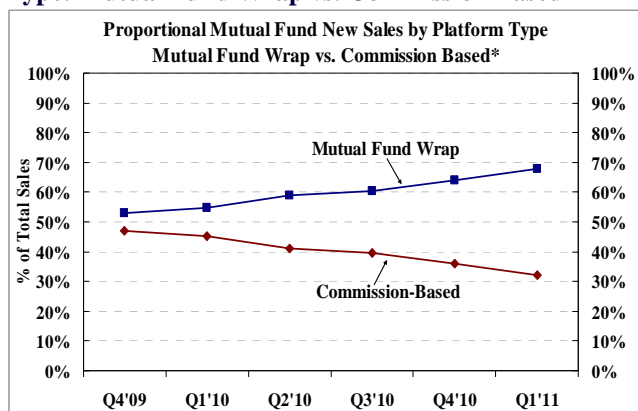
Trends in National Broker Dealer Platform Sales Q1 2011



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The fee-for-advice compensation model continues to accelerate as the preferred business structure for financial intermediaries. As seen in the graph below, fund sales via mutual fund wrap platforms accounted for nearly 70% of total fund sales within the Coates Analytics-tracked universe of National Broker Dealer (NBD) firms during Q1'2011.

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



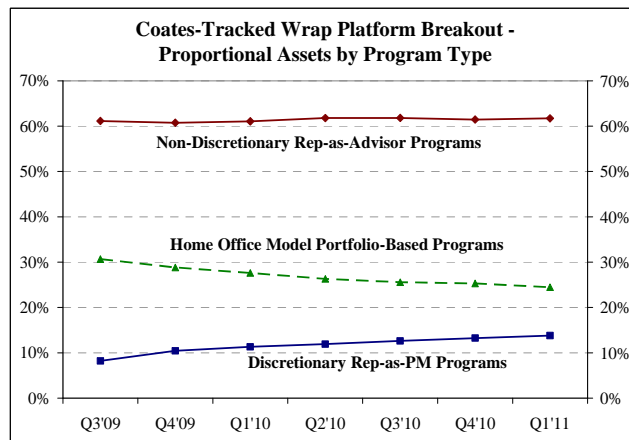
Source: Coates Analytics Distribution Management System / SI Analysis
*Note: Reflective of data from national broker dealer firms with both commission-based and wrap platform data captured in Coates Analytics Distribution Management System.

Within this overarching trend, however, important evolving shifts continue to emerge in the influence of different types of wrap programs (Non-Discretionary Rep-as-Advisor vs. Discretionary Rep-as-PM vs. Home Office Model-Based) among financial advisors (FAs) at NBDs.

In this article, we summarize some of the important macro-level findings from the Q1'2011 version of our joint research series with Coates Analytics – *National Broker Dealer Product Strategy & Distribution Trends*. [For more information regarding subscription options, contact Dan Weinerman – dweinerman@sionline.com; 212-217-6897.]

Wrap Platform Growth Trends

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

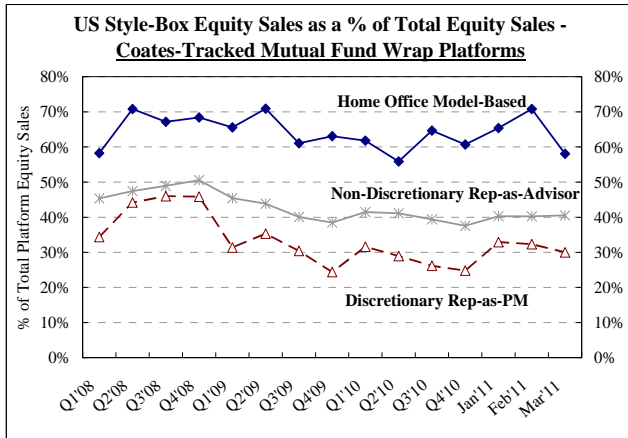
Over the past several years, the growth of Discretionary Rep-as-PM platforms (within NBDs and many Independent and Regional BDs), along with the increasing influence of the RIA community, have been important trends the intermediary-sold fund marketplace. While home office research and recommendations clearly maintain a role for many advisors within the portfolio construction process, it is also clear that a growing number of FAs are exerting more direct control over their clients' assets.

These trends continue to have an expanding influence on many fund firms' overall distribution strategies – from sales force composition, to product design, and more. They also emphasize the importance of understanding the product demand traits and business needs of different FAs in influencing fund selection decisions.

Evolving Asset Allocation Mindset

The growth in Rep-as-PM platforms has spurred an increasingly rapid shift in portfolio construction mindsets across expanding portions of the intermediary-sold space. As the fund demand picture among investors and FAs continues to evolve with regard to the composition of the “core” portfolio, notable differences in sales trends across platform structures have emerged.

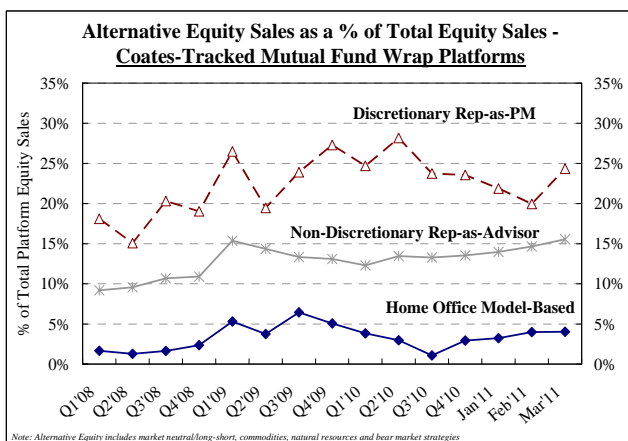
The following graphs show how FAs are constructing their clients' equity fund positions within each of the three wrap platform types. The graph below charts sales of US Style-Box Equity funds (i.e. value, growth and blend strategies across each of large, mid and small cap) as a percentage of equity sales for each platform.



Source: Coates Analytics Distribution Management System / SI Analysis

Clearly, Home Office Model-Based portfolios have remained largely committed to US Style-Box Equity funds as the core of their asset allocation portfolios – such funds accounted for more than 60% of total equity sales during Q1'08 – Q1'11. **Within Rep-as-Advisor and particularly Rep-as-PM programs, sales to US Style-Box Equity funds have decreased post-crisis,** as many FAs have looked to less-correlated strategies to make up larger portions of their clients' exposure.

To this end, the graph below charts Alternative Equity sales (encompassing market neutral, long-short, commodities, natural resources and bear market strategies) as a proportion of total equity fund sales.



Source: Coates Analytics Distribution Management System / SI Analysis

Alternative strategies have clearly been an important theme throughout many areas of the fund industry over the past several years – from product development and strategy to distribution. As seen in the previous chart, the growing demand for such strategies has been strongest among Rep-as-PM advisors (echoing trends among independent RIAs). Alternative Equity funds have clearly become a substantive part of overall equity exposure within Rep-as-PM platforms (and, to a slightly lesser extent, Rep-as-Advisor programs), as many advisors have looked beyond traditional US Equity strategies while shifting toward a greater absolute return focus for larger portions of their clients' portfolios. At the same time, such Alternative strategies have seen relatively low engagement within Home Office Model-Based platforms.

This disconnect between the portfolio construction practices of Home Office Model-Based platforms and FA/investor-controlled programs (both with regard to the trends captured here, as well as the greater use of more flexibly mandated, “solution-based” offerings within Rep-as-Advisor and Rep-as-PM programs) offers valuable insights to fund firms as to where certain segments of their product line might be most effectively positioned.

More broadly, this correlation between non-traditional funds and FA/investor-controlled platform structures may offer insights into the sustainability of future growth across platform structures. As many FAs have moved toward business models which allow them greater direct control over their clients' portfolios, they have also begun to rethink the composition of such portfolios.

As product preferences continue to broaden among a growing number of FAs, the expansion of FA/investor-controlled wrap programs should continue to spur increased engagement within “non-traditional” products. At the same time, the greater availability of such strategies within FA/investor-controlled platforms should contribute to the continued expansion of these programs. Moving forward, the continued disconnect or potential convergence between portfolio construction practices and product use within FA/investor-controlled platforms and that within Home Office Model-based programs carries significant implications for both distribution strategies and overall fund demand.

Money Management Profitability in 2010



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The 2010 Financial Results of Publicly Held Money Managers

In 2010, the economy and asset levels recovered from the lows of early 2009, generating broadly positive financial results for asset managers. For our annual study of money management profitability, SI surveyed 19 asset managers with publicly-held equity (“Public Companies”), up from 18 last year (Artio Global Investors having gone public in September 2009). We found that 15 of the 19 increased year-end assets under management 2010, and eight of the managers saw AUM rise by 20% or more over year-end 2009 levels. (Clients can access the full, 46-page report [here](#).)

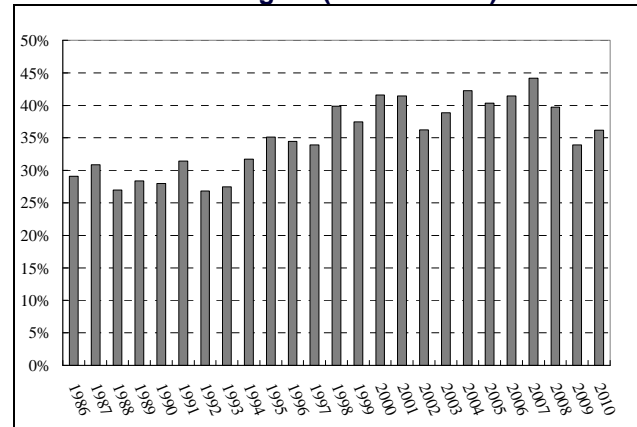
The Public Companies managed \$7.8 trillion at the end of 2010. Collectively, year end assets were up 10%, and the increase would have been even higher if not for outflows in money market funds.

Average assets, on which fee revenue is based, also rose significantly in 2010. In aggregate, average assets increased an impressive 41.5%, partially due to BlackRock’s December 2009 acquisition of Barclays Global Investors (BGI), which managed \$1.85 trillion in AUM when acquired. But the increase also reflected strong overall performance among the companies. Even excluding BlackRock entirely, average assets rose 15% for the Public Companies in 2010.

With AUM and fee revenue rising, the average pre-tax operating margin for the group (as calculated by SI) was 38% in 2010, up from 34% in 2009. The median pre-tax operating margin was 36%, up from 34% in 2009 but still below the high of 44% reached in 2007. Operating margins increased at 15 of the 19 Public Companies, and no company had a decline of more than three percentage points.

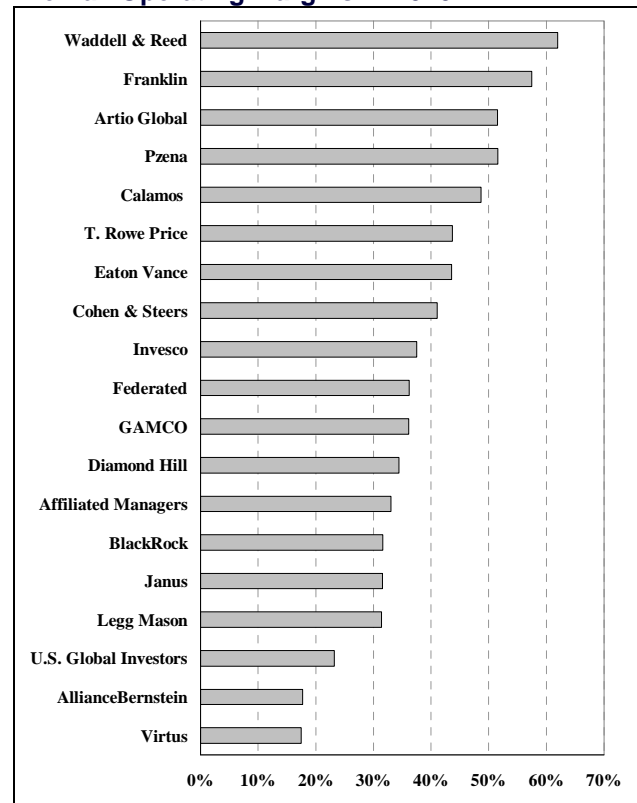
Margins ranged from 17% at Virtus to 62% at Waddell & Reed (which also had the highest margin last year). BlackRock and Cohen & Steers posted double digit increases in margins, and six other managers saw increases of 5% or more.

Median Pre-Tax Operating Margins for Publicly Traded Asset Managers (1986 to 2010)



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

Pre-Tax Operating Margins in 2010



Source: Company Reports, Strategic Insight

Collectively the Public Companies generated over \$34 billion in revenues in 2010. Profits totaled \$6.6 billion, up significantly from \$3.0 billion in 2009, but again below the peak of \$7.1 billion in 2007.

Public Managers' 2010 Revenues...

In 2009 operating revenue declined for every one of the Public Companies. In 2010 this trend reversed, and **18 of the 19 companies saw an increase in operating revenue**. Due to increasing assets, aggregate operating revenues for the Public Companies grew 35% in 2010.

BlackRock led the group with a 94% increase in operating revenue, reflecting a significant jump in AUM due to the BGI acquisition. Operating revenue at AMG rose by 61%, partially due to acquisitions but also as a result of strong organic growth. Eight other companies posted increases of 25% or higher.

Public Managers' Composite Annual Revenue Growth Rates

	2006	2007	2008	2009	2010
Operating Revenues	49%	30%	-9%	-19%	35%

Source: Company reports, Strategic Insight

...And Their Expense Trends

After aggressive cost cutting in 2009, operating expenses rose in 2010 as companies began to grow again. Public Companies spent more on compensation, administration, and often on sales and marketing. In aggregate operating expenses grew by 25% in 2010.

BlackRock and AMG saw the highest increases in operating expenses, at 70% and 64% respectively, again reflecting the costs of new acquisitions. Most of the other companies saw more modest increases, and Federated managed to reduce its operating expenses by 24%, partly due to lower distribution costs for its money market funds.

Public Managers' Composite Annual Expense Growth Rates

	2006	2007	2008	2009	2010
Operating Expenses	45%	26%	-8%	-8%	25%

Source: Company reports, Strategic Insight

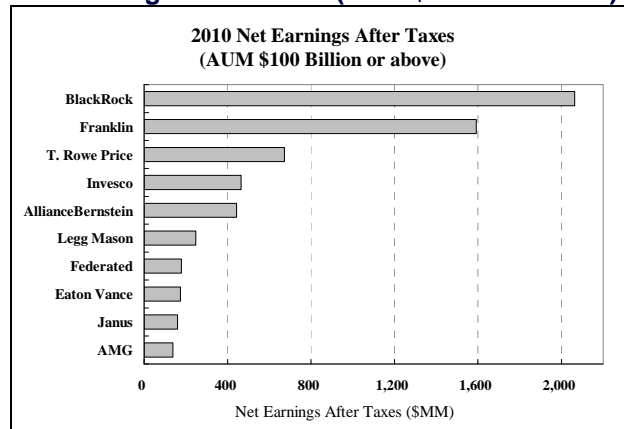
Public Managers' 2010 Net Income

Revenue growth generally outpaced increases in costs in 2010, and net income rose at 17 of the 19 Public Companies. Aggregate net income was \$6.6 billion, up from \$3.0 billion in 2009. Net income ranged from \$2.1 billion at BlackRock to \$6.0 million at US Global Investors. BlackRock's net income was double the

figure for 2009 (partly due to the BGI acquisition), the highest income among the companies studied. Franklin's net income topped the \$1 billion mark for the sixth straight year.

Larger Asset Managers

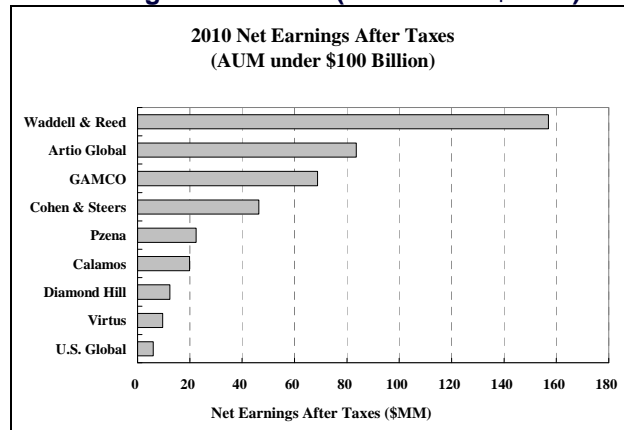
Net Earnings After Taxes (AUM \$100B or above)



Source: Company Reports, Strategic Insight

Smaller Asset Managers

Net Earnings After Taxes (AUM under \$100B)



Source: Company Reports, Strategic Insight

While the results for 2010 were generally reassuring, competitive pressures remain. These include a continuing focus on lowest-fee share classes, costs for US and global distribution, and the investments in technology, compliance and talent necessary in an intellectually driven industry. A weakening stock market and persistent near-zero short term interest rates could pressure many investment management profits and margins.

Rule 12b-2: An Emerging Consensus?



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- Marketplace forces continue to reduce, if not eliminate, the need for the radical reform of Rule 12b-1 that was suggested by the detailed and thoughtful Rule 12b-2 proposal from the SEC last year. Although some fine-tuning of Rule 12b-1 would be beneficial (such as simplifying directors' responsibilities, clarifications and education, etc.), a complete remake of the rule in the form of Rule 12b-2 has become unnecessary in the view of many.
- Consider this: less than 10% of stock and bond mutual fund assets today are held in share classes with over 0.25% in 12b-1 fees. Over the past 30 months, such funds, in aggregate, experienced modest net redemptions. In contrast, over the same period, funds free of 12b-1 fees garnered over \$800 billion in net inflows.

Equity and Bond Mutual Funds*

Share Class	Assets 6/11 \$Trillion	Estimated. Net Flows '09-H1'11 \$B
Zero-12b-1 Fees	5.6	~ \$850
0.01-0.25% 12b-1	2.1	~ - \$55
Over 0.25% 12b-1	0.7	~ -\$15
Total	8.3	780

Memo:

ETFs / ETPs 1.1 277

Source: Strategic Insight Simfund MF *Exclude ETFs, VA underlying funds, fund-of-funds, closed-end funds and MMFs

- Within sales made via Wrap/Fee-Based Advisory Programs, No-Load shares had a 60% share in 2010, up from 41% in 2008 (the share of "As" sold at NAV is falling), according to our research. Nearly all No-Load shares selected lately for use within fee-based programs are those without 12b-1 fees (83% in 2010, presumably higher in '11), leading to increasingly "retail" use of traditional "I" shares within such fee-based programs.

- Overall, market forces have stimulated more than \$1 trillion in net inflows to zero-12b-1 fee funds and ETFs in the past few years, while use of 0.25% 12b-1 fee share classes is declining and "Bs" are becoming extinct.
- Funds charging a small 12b-1 fee (0.25% or less) have also experienced in recent years, in aggregate, negative cash flows, as more FAs and BDs shift towards fee-based accounts and share classes carrying no 12b-1 fees at all. Such fee-based accounts typically charge an asset-based fee of 1.0-1.5% in addition to underlying mutual fund TERs. For example, an April 2011 study, summarized in [Investment News](#), capturing more than \$850 billion of assets managed by about 15,000 advisers, found, that "for accounts between \$1 million and \$2 million in assets, the average fee was 1.17%." Naturally, smaller accounts were charged a higher fee.
- We continue to observe (but not agree with) the advocacy that wrapped fee-based accounts are always advisable even when their total shareholder costs are at times significantly higher, and their accessibility for investors lower, than within programs funded with Rule 12b-1 "C" shares. And cost transparency, often argued to be greater in fee-based accounts, has yet to result in a meaningful reduction in the fees of such accounts.

Overall, the industry is facing an increasing use of "T" share classes where no Rule 12b-1 fees are available for BDs' (rising) expectations of revenue / cost-of-access sharing. This puts increasing pressure on fund management profitability. This rising cost of asset acquisition is coupled with falling duration of ownership, in particular in the fastest-growing segment of the fee-based business, Rep-as-PM programs. Fund managers often observe much shorter holding periods in Rep-as-PM programs relative to commission-based platforms. In total, these trends add up to a significant squeeze on fund firms' profit margins.

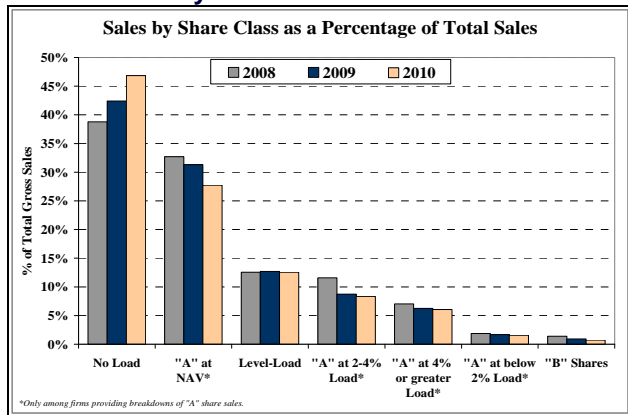
Such changes in profitability dynamics would accelerate once uniform Fiduciary Standards are set. In that context, the significant costs for investment firms and BDs to implement Rule 12b-2 – if its framework stays as originally conceived – need to be thoughtfully considered.

Notably, the focus on a careful analysis of costs vs. benefits was an important undertone in the criticism at the US Court of Appeals in its July 22, 2011, ruling against the SEC in the Proxy process ruling (see the

ruling [here](#)). Similarly, a recent DOL hearing regarding Fiduciary Rule before the U.S. House Education and Workforce Committee has focused on quantifying costs vs. benefits.

Back to the steady shift in share-class use: The asset data summarized above is mirrored in the sales data in the graph that follows.

Share Class Sales Trends Among Firms Relying on Intermediary Sales



Source: Strategic Insight Fund Sales Survey

Level-load share classes (“Cs”) remain very important to financial advisors and their clients and have captured roughly one in eight dollars sold. Yet, such share classes, while offering flexibility and an advantageous (tax-adjusted) way to pay for advice, are lagging the growth of other fee-based programs. And, in a reversal of the positive net inflow in ’09-’10, level-load shares are experiencing, in aggregate, modest net redemptions in 1H’11, suggesting some slowdown in their use.

Looking ahead to the future of “C” shares, one of Rule 12b-2’s core concepts – to stop charging “asset-based fees” in “C” share classes beyond a certain future point post-purchase (for example, at the 85th month post-purchase) – may affect only the 15%-20% of “Cs” assets still held in the original “tax lot” seven years post-purchase; this also assumes FAs would not transition such holdings to fee-based accounts where the FA/BD benefits from a 1%-1.5% trailing fees.

Thus, there is maybe \$50 billion of aging “Cs” where, for some investors, some Rule 12b-1 fee reduction is likely. In quantifying the potential (not certain) reduction in costs for investors in such funds, we guesstimate it may add up to, at most, \$200-300 million annually, a savings of just 2%-3% of currently charged Rule 12b-1 fee dollars. Furthermore, this group of investors represents

just about 1% of the fund assets held by BDs and serviced by FAs.

In summary: we acknowledge the concerns about the (potentially) perpetual nature of “C” shares with 12b-1 fees in excess of 0.25%. Yet, most likely the investors impacted would be less than 1% of the total number of investors being served by financial advisors and such savings may only occur in the very distant future.

As suggested above, Rule 12b-2 proposal may save at most 2%-3% of the total Rule 12b-1 fees permitted to continue under Rule 12b-2, yet such savings may be accompanied by implementation costs in excess of \$1 billion by some estimates, as well as enormous business disruption.

On reflection, mutual funds have a number of price “imperfections,” partly due to their “mutualization” nature, such as the cross subsidies where holders of large investments subsidize the costs to small account holders. This is part of the “social contract” that mutual funds offer, one of the reasons our industry has grown to \$14 trillion in assets under management in the US.

To delve into SI’s past research on Rule 12b-1, you can review the studies mentioned (and linked) below:

- [June 2007 SI Overview on Rule 12b-1](#)
- [July 2008 Article on Rule 12b-1 Excerpted from Windows](#)
- [October 2010 Presentation: Preliminary Comments on Rule 12b-2 Proposal](#)

Benefits Driving VA Fund Flow Changes



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If living benefits drive VA sales, then they also drive VA flows. One change that the financial crisis has brought is tighter control of eligible investments in order to reduce risks. These types of changes are less tangible to most investors than price increases and, ultimately, more effective at reducing risk. In order to understand VA fund flows, it is critical to understand the different risk management tools out there and how insurers use them.

Investment Limitations

Before the financial crisis, most insurers were employing some form of investment limitation related to their living benefits. Today, it is virtually ubiquitous. These programs range between a strict list of particular funds (in some cases, investors must place 100% of assets in a single asset allocation fund; in others, they may invest freely among a selection of such funds) to an open allocation structure, essentially a *prix fixe* menu of different categories.

Passive Investing

One of the first weaknesses immediately identified in VA hedging was that of basis risk, which is the difference between the performance of a fund and its related index. This difference is greatest in actively managed funds, and it also tends to be exacerbated during downturns. Thus, when markets go down, actively managed funds' tracking error tends to widen.

Because hedging is based on the use of indexes, many otherwise robust hedging programs were subject to performance gaps between their hedging instruments and the funds they were designed to hedge. Many ended up infusing additional reserve capital as a result and have shifted to greater use of passive investing (indexes or ETFs) as a result.

Asset Transfer Programs

At one time, **Prudential's** Highest Daily living benefits and their associated asset transfer program were an anomaly. Daily roll-up calculations are used to ratchet the benefit value higher but also to determine whether assets need to be shifted from the variable funds into a fixed income fund according to a stated algorithm. Money moves out of the safe fund when markets recover.

A key benefit of asset transfer is that it potentially preserves the actual contract value, even if the explicit guarantee applies only to the withdrawal benefit base. While Prudential has touted its franchise's unique capacity regarding daily asset transfers, other manufacturers are following suit with programs that include less frequent step-ups.

Nationwide, Protective Life, and John Hancock all have recently registered and released benefits that include an asset transfer component. Whether the transfer program dictates a shift into a single designated fund (the more standard design) or reallocates among the remaining eligible options (Protective's feature), **asset transfer triggers can be responsible for significant flows to the receiving funds.** In most cases, insurers create designated low-volatility funds that are able to handle abrupt inflows and outflows.

Portfolio Volatility Management

Volatility management within funds is very similar to the idea behind asset transfer programs. In this case, however, a fund incorporates a mechanism that is intended to reduce volatility. Typically, such funds use dynamic asset allocation and also invest in derivatives, magnifying the effect of reducing equity exposure at times of high volatility.

One advantage of having this mechanism inside of a fund is that it provides more control and flexibility to the insurer than it does to have it within the contract. In addition, the availability of derivatives is a useful tool that is quite different from a simple shift of assets into a fixed income fund.

Usually, insurers have been using either an asset transfer program or fund-based volatility management. In truth, we are likely to see a variety of solutions evolve in the marketplace. While it is easy to paint these strategies with a broad brush, they are in fact as different as the manufacturers that use them.

Volatility-managed funds have the advantage of capturing assets through good times and bad.

Observations from Our June Conference



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On June 27-28, 160 investment management executives from 85 organizations gathered in for the **Strategic Insight Fund Trends 2011** conference. The sold-out, one-and-one-half-day event probed key distribution, product development, and retirement strategy issues. Panels and presentations covered major topics such as what fund trends broker-dealers are seeing, rethinking asset allocation, effective wholesaling, DCIO opportunities, and more. This article summarizes just a selection of key observations from the panel discussions.



The View from Broker-Dealers

Our conference featured two panels of key decision-makers from broker-dealers. The independent/regional BD panel, made up of senior executives from Ameriprise Financial Services, MetLife Broker Dealer Group, LPL Financial and Commonwealth Financial Network, emphasized that their advisors are taking a bigger role in trying to manage clients' risks, often using more complex products to do so. This means many more FAs are using "alternatives" and alternative-strategy funds (long-short, global tactical asset allocation, etc.), and, therefore, increasingly educating their clients on alternatives. One panelist said that of the 30 top-selling funds at his BD, only six were traditional, style-box type funds. Also:

- FAs are focusing on their strengths, and so many are outsourcing some or all of their portfolio construction duties. As one panelist put it: "Advisors are saying, 'We're better suited for selling than portfolio management'." This involves more use of funds with advice embedded in them, including asset allocation products.
- Advisor teams have become more important. As the business becomes more complicated, FAs are

looking to add team members with particular expertise in areas such as annuities or derivatives.

- Income is a big theme, and is driving demand for bond funds, but also for REITS, BDCs, and floating rate/bank loan products.
- As more FAs transition to fee-based business, fund firms can gain an advantage by being set up to accommodate that shift – by having the appropriate share classes, for example.

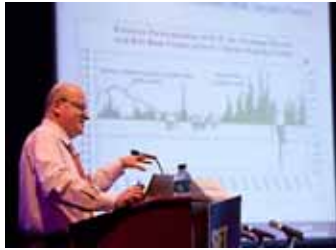
The national broker-dealer panel consisted of senior distribution execs from BofA Merrill Lynch, Morgan Stanley Smith Barney, UBS and Wells Fargo Advisors. All of them have been seeing increasing flows of capital to fee-based, advisory programs (as opposed to commission-based). They agreed that the need for non-correlation is driving the growth of alternative products in advisors' portfolio construction, but that this secular trend has sparked a flood of products and so risk management is a concern (and the possibility of this shift turning into a fad if go-anywhere and alternative products don't deliver is another concern). Also:

- Discretionary Rep-as-PM programs (where the FA doesn't need client approval of portfolio moves) are growing quickly, partly because they're efficient. But FAs in Rep-as-PM are using both home-office ideas and their own ideas, and are tending to be more asset allocators than stock/fund pickers.
- ETFs are gaining traction in some separately managed accounts, including all-ETF portfolios. But ETF use seems largely tactical. And BDs are thinking about beefing up their research on ETFs, which get less coverage than stocks yet are increasing the complexity of their offerings.

Effective Wholesaling

Distribution chiefs and national sales managers from Columbia Management, Putnam Investments, Delaware Investments and the CEO of consultancy kasina made up this panel, and all said that it's crucial to prioritize the FAs an external wholesaler must target – typically starting by firm and then identifying the target advisors within each firm; one panelist noted that influential non-producers at firms can also be important contacts for externals. Also:

- Firms are prioritizing training their externals on what to do once *in* an advisor meeting – engage with the FA's business concerns, but don't forget how to ask for the order. Understanding the high-impact advisors beyond CRM data is also important and under-emphasized.



SI's Avi Nachmany



Richard Bernstein



LPL's Bill Dwyer



Hartford's Jyoti Ladden



SIFT 2011 Cocktail Party



The DCIO Panel



The SIFT 2011 Audience

- kasina's latest annual study of compensation shows that external wholesaler comp hasn't risen but comp *has* gone up dramatically for internals and hybrid wholesalers (who spend some time on the sales desk and some in the field) because internals are playing bigger roles in making the sales. Panelists agreed that simplicity is an advantage in any comp plan, so wholesalers know what they're being incentivized to do and can easily figure out how they are doing versus their goals.

The View from LPL

Our Keynote Speaker was Bill Dwyer, Managing Director, President, National Sales & Marketing, LPL Financial. He said that in the new, post-crisis market environment, clients are coming back to the market with a more conservative, "I can't lose money" mindset. With returns likely to be closer to 5% a year (rather than the 14% a year that FAs enjoyed in the 1980s and 1990s), advisors won't be rewarded as much for returns. This translates into time management: the FAs at LPL growing 5% a year or less spend 30% of their time on portfolio management, but the fastest-growing FAs spend 2% of their time on portfolio management. This creates big opportunities for fund management firms in terms of product (like asset allocation solutions) but also in terms of providing practice management help.

Managing Operational Issues

This panel included executives from service providers Gemini Fund Services and Brown Brothers Harriman, and product development executives from fund managers Goldman Sachs and ALPS Advisors. Panelists agreed that the lines between retail and institutional products are blurring, and this is leading to more complex '40 Act products being launched (including many tactical asset allocation, managed futures and absolute return funds). Also:

- There can be benefits to getting a custodian/service provider involved early on in the product development process. The service provider can identify potential red flags that might upset clients (thus leading to a better product) and act as a subject-matter expert based on past experiences with other funds. Early involvement can also reduce the amount of legal work in designing a fund.
- Service providers said fund firms often underestimate the tax and compliance issues that come with new product launches.
- One challenge is deciding which strategy can be launched in more than one country (which often requires different regulatory design). Some service providers can, for example, show what a UCITS version of a US mutual fund looks like because there are key differences in regulations.

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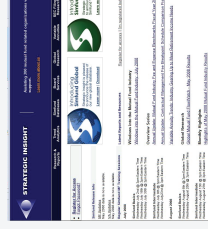
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