

Strategic Insight

805 Third Avenue, New York, NY 10022
Tel: (212) 944-4455, Fax: (212) 730-7730
Available at www.sionline.com

WINDOWS

Into the
Mutual Fund
Industry
November 2011

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Perspectives



Avi Nachmany
(212) 944 4451
avi@sionline.com

In this edition: Q3 and YTD flow trends; survey-based perspective on what global asset holders want from investment managers; ETF innovation; Fund-of-funds and retirement share class updates; heterogeneity of redemptions patterns among BD platforms; National BD distribution insights; and more.

2012 Around the Corner: More than in past years, planning for 2012 poses a number of challenges.

Investors have collapsed their planning time horizons. Thus, even for financial assets designated to be used in 10, 20, or 30 years, risk aversion has dramatically increased. The extreme price volatility as of late, loss of faith (for some) in the political process, crises around the world, and local economy, real estate, and employment uncertainties, in total, are proving “too much.”

Thus, near-term sentiment contrasts with investing for longer-term rewards: for financial assets not needed in the next three-five years, high quality stocks are likely to outperform – and by a wide margin – bond and cash investments. Yet, since 2008, bond funds garnered nearly \$1.4 trillion of net inflows globally, while demand for stock funds lagged, and reversed in recent months (the dramatic price recovery in October did little to reverse stock funds’ negative sentiment, at least for now). Similarly, savings and cash earning near zero in US banks grew by \$2 trillion since the 2008. Some 2012 assumptions:

- The US interest rate yield curve, plus lingering risk aversion, economic uncertainty, and election politics making Americans even more anxious suggest that **the insatiable search for income and safety persists in 2012**
- **Bond fund NAV risk in a rising interest rates:** the longer investors are lulled in today’s historically low interest rate environment, the greater the risk of a future NAV shock

(hurting the mutual fund brand, not just individual funds or managers). Bond funds’ \$3 trillion of assets pose an enormous education task. This also necessitates a thoughtful evaluation of the investment mandate flexibility each bond fund has now and during periods of rising rates. Fund managers and Boards should continue to focus on this issue

- **High stock dividends vs. low bond dividends:** an theme to develop further
- **Fund innovations:** a continued and unprecedented wave of new funds, away from benchmark-centric, long-biased strategies. How successfully will they meet investors’ expectations? If extreme price volatility is a secular reality, what can each fund company do to help its “out of comfort zone” investors?
- **America 2020:** We expect more investment firms to stress the need to **compartmentalize financial investments into: those to be used in 2020 and beyond; and those needed for emergency or consumption by 2015.**

Webcasts: We began a series of Webcasts on “Planning for 2012” with a Nov. 1 presentation on Strategic Insight’s services, planned product enhancements and research content; that Webcast is archived on our Website [here](#). Join us Nov. 17, 1 pm EST and on Dec. 1 for two more planning-oriented webcasts: “**Assessing Investor Demand & Fund Distribution Trends**”, and “**Assessing the Product Landscape**”, which will focus on fund and ETF innovations. Watch for the Webcast invitations.

Ground-breaking New SI Research on European Fund Fees: Commissioned by the European Fund and Asset Management Association (EFAMA), this report was recently published. SI analyzes investment management fees, distribution retrocessions, and total expense ratios in Europe. Some of the key findings of this report are excerpted in this newsletter on Page 7.

A Pause to appreciate SI’s 25th Anniversary and to recognize many of our industry’s founders and leaders: on November 7, 300+ senior industry executives joined SI to honor the “Visionaries of the Modern Mutual Fund Industry”. To our many colleagues and friends – a heartfelt thank you!

Strategic Insight US Fund Research Editorial Board

Avi Nachmany, avi@sionline.com, (212) 944-4451
Sonia Mata, sonia@sionline.com, (212) 217-6947
Loren Fox, lfox@sionline.com, (212) 944-4460
Dennis Bowden, dbowden@sionline.com, (212) 217-6895

US-Based Domestic Funds: Q3 in Review



Adam Feldstein
(212) 217 6935
afeldstein@sionline.com



Susan Belle
(212) 217 6948
susan@sionline.com

Fund Industry Overview (Excludes ETFs and VA Underlying Funds)

	Net New Flows \$B			
	Q1'11	Q2'11	Q3'11	YTD-9/11
US Equity/Hybrid	36.5	-13.3	-53.7	-30.5
Int'l Equity	29.9	16.1	3.5	49.5
Total Equity	66.4	2.7	-50.2	19.0
Taxable Bond	40.5	51.2	2.0	93.7
Muni Bond	-20.0	-3.0	0.5	-22.5
Total Bond	20.5	48.2	2.5	71.2
Total Equity & Bond	87.0	50.9	-47.6	90.2
Money Market	-80.9	-58.1	-55.3	-194.3
Total Industry	6.0	-7.2	-103.0	-104.1

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

Volatile market conditions in the third quarter of 2011 (the S&P 500 Index fell 13.9% in Q3, its largest quarterly drop since 2008) spurred an increase in risk aversion among investors. This led to net outflows of \$54 billion from US Equity mutual funds in the quarter.

Meanwhile, \$3.5 billion flowed into International/Global Equity mutual funds, led by Emerging Markets funds. For more on international funds, see page 6.

(In the first five weeks of Q4, equity fund net redemptions moderated to \$16 billion, as US Equity fund redemptions persisted despite a recovery in the stock market.)

Long-term mutual funds drew \$90.2 billion in total inflows for the first three quarters of 2011, led by bond funds. While off the pace that bond fund inflows achieved in previous years, fixed income programs continued to attract inflows, partly in a search for yield and partly due to investors' cautious outlook.

Meanwhile, worries about states' and municipalities' finances seem to have abated resulting in positive flows for muni bond funds in the third quarter.

While flows from money market funds continued to be negative, redemptions (mostly by institutions) through the first nine months of 2011 were significantly smaller than in the year-ago period. Near-zero yields continued to push income-seeking investors elsewhere, including high quality short-duration bonds funds as well as global income investment strategies.

Thanks largely to smaller cap stock funds outperforming large cap stock funds, active US equity funds' average return of -10.5% bested the S&P 500's -13.8% return for the first nine months of 2011. Similarly, the MSCI EAFE index's -19.6% return was bested by the average international equity fund's -16.1% return for 2010. (Note: stock market recovery in early Q4 brought YTD 2011 US stock funds' returns to about flat while international equity funds' YTD 2011 returns remained negative.)

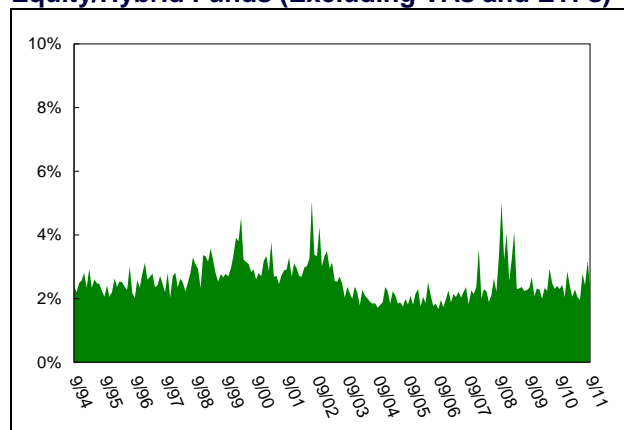
Average Asset-Weighted Annualized Returns %

	Q1'11	Q2'11	Q3'11	YTD-9/11
US Equity *	5.9	-0.2	-15.2	-10.5
Int'l Equity	2.9	0.6	-18.9	-16.1
Taxable Bond	1.4	1.7	-0.6	2.6
Muni Bond	0.0	4.2	3.5	7.9
Money Market	0.0	0.0	0.0	0.0

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

Overall, anxieties about economic and employment recovery have not faded. As a result, the pace of new equity fund investments for most of 2011 has been slow. While the sales pace remains moderate, stock fund redemptions continued at an above-average pace, following a spike in August, as the graph below shows. (As we have noted before, and observed in past bear markets, redemption spikes tend to be short-lived.)

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



Source: Strategic Insight Simfund TD (ICI Trends)

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

	Net New Flows \$B		
	Q1'11	Q2'11	Q3'11
Actively Managed Funds	48.6	-10.6	-60.6
Index Funds (non-ETF)	16.2	12.0	9.3
ETF Open-End Funds	21.2	18.2	2.4
ETFs structured as UITs / Grantor Trusts / ETNs /Other	-2.3	-1.1	4.2

Source: Strategic Insight Simfund MF

Equity index and open-end ETFs continued to draw investors' interest, as were bond ETFs.

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

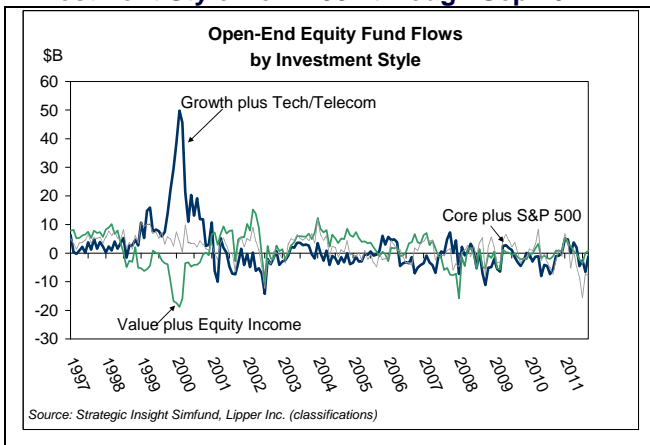
	Net New Flows \$B		
	Q1'11	Q2'11	Q3'11
Actively Managed Funds	15.8	45.9	5.6
Index Funds (non-ETF)	4.1	2.1	-3.1
ETF Open-End Funds	6.8	10.2	12.5

Source: Strategic Insight Simfund MF

Growth vs. Value

For the first nine months of 2011, returns of growth styles, benefitting from tech stocks, were a bit stronger than value funds. While both categories suffered redemptions on aggregate, naturally **many individual higher-performing value and growth funds continued to attract significant inflows.**

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



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

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		YTD-9/11 Returns *
	2010	YTD-9/11	
Large-Cap Growth	-11.0	2.6	-9.4%
Multi-Cap Growth	-1.8	-2.7	-13.0%
Mid-Cap Growth	-10.7	-0.3	-9.9%
Small-Cap Growth	-0.5	0.8	-13.1%
Growth Funds	-23.9	0.1	-10.5%
Large-Cap Core	-42.5	-46.6	-10.4%
Multi-Cap Core	2.2	-2.6	-15.9%
Mid-Cap Core	-2.2	-2.2	-12.8%
Small-Cap Core	-0.9	-3.7	-14.5%
Core Funds	-43.5	-55.0	-11.7%
Large-Cap Value	-10.5	-9.5	-12.2%
Multi-Cap Value	-3.9	-2.5	-13.1%
Mid-Cap Value	-0.3	-7.4	-15.4%
Small-Cap Value	2.0	-0.3	-18.3%
Value Funds	-12.7	-19.7	-13.8%

* 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.

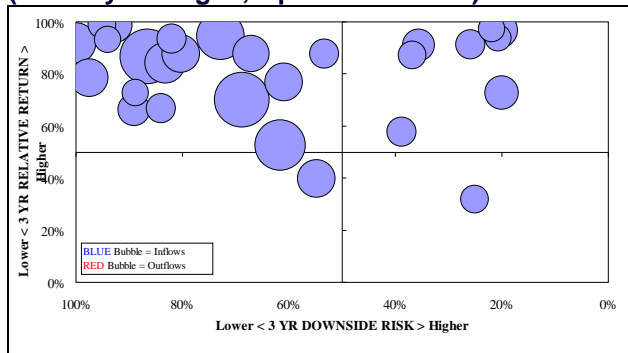
SI's "Bubble" charts, generated in Simfund, plot funds on a relative risk/return basis versus similarly invested peers. Funds in the top-left quadrant have superior positioning relative to peers, displaying below-average risk (defined as cumulative monthly losses over 36 monthly observations) while achieving above-average returns. And thus far, the first nine months of 2011 was another period for which the top-left quadrant of graphs housed the highest-inflow funds.

As an illustration of cash flow results for 2011, we capture below the "trailing three-year risk-return vs. cash flow bubbles" of the industry's 40 highest cash flow funds in Q3 2011 (trailing 3-year risk and return as of year-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 third quarter 2011 net inflows.**

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

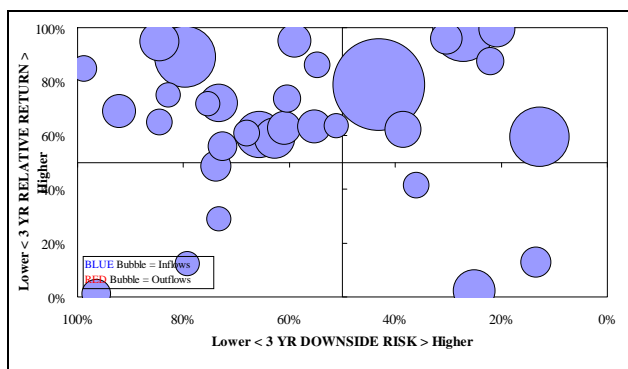
Risk-Return Characteristics of Best Selling Mutual Funds in Q3 2011

Highest Net Inflow Equity Funds in Q3 2011 (Actively Managed, Open-End Funds)*



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

Highest Net Inflow Bond Funds in Q3 2011 (Actively Managed, Open-End Funds)*



*YTD 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 making the most cash flow progress in 2011 in active, long-term funds.

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

Manager	Flows, \$B		YTD-9/11 Flow Rate*	9/30/11 Assets \$B^
	2010	YTD-9/11		
PIMCO	55.5	18.8	4.9%	414.5
JPMorgan Funds	20.7	14.8	12.5%	126.7
Franklin Templeton	20.2	11.1	3.3%	329.3
DFA	7.3	10.8	9.7%	100.8
BlackRock	13.9	8.3	5.1%	161.1
DoubleLine Capital	4.0	7.8	189.5%	12.5
MainStay Funds	2.1	7.2	24.8%	33.2
T Rowe Price	12.3	6.6	2.6%	234.1
First Eagle	4.1	5.8	13.8%	44.7
Thornburg	9.0	5.8	12.5%	46.1
TCW / MetWest	4.3	5.3	20.2%	31.5
Pacific Heights	3.8	4.8	46.9%	14.6
Virtus Investment Ptnrs	1.4	4.6	28.4%	20.1
Lord Abbett	7.7	4.1	6.3%	64.2
Prudential Financial	3.3	3.8	10.3%	36.9
Waddell & Reed	3.9	3.6	5.5%	60.1
Yacktman	2.9	3.6	66.7%	8.7
Manning & Napier	2.9	3.6	23.2%	16.3
Int'l Value Advisors	4.4	3.0	31.9%	11.4
American Century	2.8	2.9	4.2%	69.7

*Flow rate = 2011 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		YTD-9/11 Flow Rate*	9/30/11 Assets \$B**
	2010	YTD-9/11		
DoubleLine Capital	4.0	7.8	189.5%	12.5
Stone Harbor	0.8	1.4	101.5%	2.7
Cambiar	0.0	1.1	74.1%	2.0
Yacktman	2.9	3.6	66.7%	8.7
AQR	2.4	2.1	62.7%	5.0
TFS Capital	0.2	0.7	62.5%	1.8
Pacific Heights	3.8	4.8	46.9%	14.6
Driehaus Capital	0.9	1.4	37.8%	4.6
Brown Capital Mgmt	0.1	0.4	36.0%	1.2
Int'l Value Advisors	4.4	3.0	31.9%	11.4

^ \$1B+ in AUM at 12/10; * Flow rate = 2011 flows as pct. of 12/10 assets; ** Active long-term assets; Source: Strategic Insight Simfund MF

US-Based International Funds: Q3 2011 Update



Adam Feldstein
(212) 217 6935
afeldstein@sionline.com



Susan Belle
(212) 217 6948
susan@sionline.com

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

Structure/Type	Assets		Net Flows, \$B		
	\$B 9/11	Q1'11	Q2'11	Q3'11	YTD -9/11
Open-end Active	1,310	24.2	10.3	-1.6	32.9
Open-end Indexed	110	5.3	4.6	4.2	14.2
ETFs*	311	1.9	12.7	4.3	18.1
Closed-End	32	0.0	0.4	0.9	1.2
VA Funds	180	2.0	2.0	-3.0	1.0
Total	1,942	33.1	29.7	5.0	67.4

Source: Strategic Insight Simfund MF / VA. Data include Gold funds and ETFs; *ETFs include ETPs, UITs and open-end ETFs.

Inflows into US-domiciled International / Global equity funds in the third quarter, albeit positive, were significantly lower than in Q1 and Q2. This pullback in demand stemmed from a rise in caution among fund investors and losses for in International / Global funds, partly driven by the US dollar's recovery versus the euro.

Emerging Markets, as well as International and Global Multi-cap programs, benefitted from inflows.

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

	2007	2008	2009	2010	YTD-9/11
U.S. Equity*	7.16	-37.88	31.48	16.83	-11.01
Int'l/Glbl Eqty	16.66	-41.91	40.49	13.64	-16.07
World Bond^	8.86	-1.27	15.65	9.15	-0.29

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

Through the first nine months of 2011, international / global funds underperformed US equity funds by roughly 500 basis points – a sizable margin. This gap remained by early November.

Again, actively managed emerging markets funds topped the list of highest-flow classifications for Q3 2011, as well as through the first nine months, with almost quadruple the net inflows of the #2 classification (see below). Flows to international/global equity funds continue to be helped by investors' search for more global diversification.

Actively Managed Int'l/Global Equity Funds 10 Highest YTD-09/2011 Net Flow Classifications

	Net Flows \$B		Assets \$B
	2010	YTD-9/11	9/30/11
Emerging Markets	3.1	14.0	157.4
Intl Multi-Cap Value	0.7	4.9	33.3
Intl Multi-Cap Core	0.7	3.8	38.3
Global Multi-Cap Value	-0.1	1.4	20.9
Global Multi-Cap Core	0.6	1.2	8.2
Intl Sm/Mid-Cap Growth	-0.3	0.3	19.3
Intl Sm/Mid-Cap Value	0.1	0.3	9.3
Pacific Region	0.09	0.2	7.7
Japanese	0.1	0.2	1.7
Intl Sm/Mid-Cap Core	-0.2	0.1	11.3

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

The table below provides a more in-depth look at flows into emerging markets equity funds, including diversified, regional and single-country funds. Demand in active open-end funds and ETFs moderated in Q3 from Q2, especially among diversified EM equity ETFs.

US-Based Emerging Markets Equity Mutual Funds* First Nine Months 2011, \$ Billion

Structure/Type	Assets	Net Flows, \$B			YTD-9/11
	\$B 9/11	Q1'11	Q2'11	Q3'11	
Open-End Active	167	4.9	4.6	3.8	13.4
Open-End Index	13	-0.1	0.0	-0.4	-0.4
ETF	100	-9.5	4.9	-2.9	-7.4
Closed-End	92	0.0	0.0	0.0	0.0
Total	283	-4.6	9.6	0.6	5.5

Source: Strategic Insight Simfund MF. *Includes Diversified Emerging Mkts and relevant Regional and Single-Country Funds

Fees & Expenses: Fund Fees in Europe



Kevin Shine
(212) 217 6941
kshine@sionline.com

On October 4, the European Fund and Asset Management Association (EFAMA) published research by Strategic Insight (SI), “[Fund Fees in Europe: Analyzing Investment Management Fees, Distribution Fees, and Operating Expenses](#)”, that analyzes investment management fees, distribution retrocessions, and total expense ratios (TERs). The study showed that, after accounting for retrocessions (or revenue sharing) with distributors, retained management fees in Europe are not that dissimilar to those in the U.S.

Today shareholders have access to mutual fund expense information via point-of-sale documents, prospectuses, fund company websites and external data providers. Yet, for European fund investors, deconstructing TER to fees collected by distributors, administrators and custodians, and what is retained by fund management, is not possible through current disclosure. The need to cover distribution costs through retrocessions from fund management fees, a model that is not unique to Europe but seen in many markets around the world, reflects the realities of how funds are offered to retail investors. Yet the bundling of distribution and investment management fees in European TERs has made it more difficult to understand the costs charged by the various types of organizations in the fund value chain, and at times led some market observers to mischaracterize fees allocated to investment management.

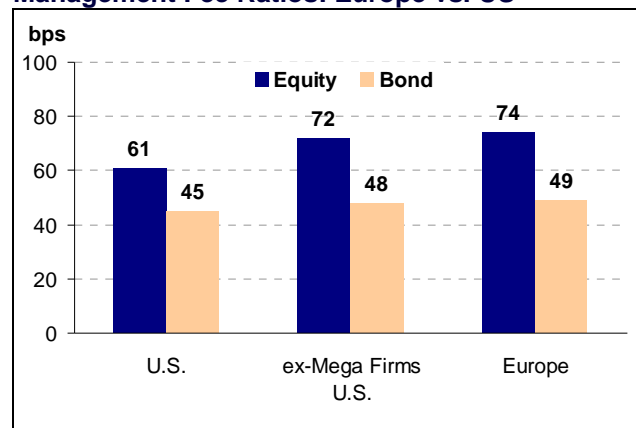
The report presents an SI survey of 17 EFAMA corporate members, accounting for more than €1 trillion in EU-domiciled equity and bond funds as of year-end 2010. These larger companies all distribute cross-border and operate in multiple jurisdictions. SI analysis benchmarks how much of European funds’ TER are paid to investment managers, fund distributors and other service providers (e.g. fund administrators, custodians). The data are aggregated by fund type and distribution channel. And European fund fees are compared to U.S. fund fees.

The study shows that, on average, UCITS fund managers retain just 42% of TERs. Through retrocessions, distributors are paid 41% of the total expense ratio. The balance of 17% is used for operating services such as custody, administration, transfer agency, etc. Fund managers still must assume the cost of marketing, supporting and servicing distribution organizations, all paid out of the remaining net management fees. On average, managers retained a little less of the TER on funds distributed through banks and insurers than via platforms and IFAs.

When studying the difference in TER between European and U.S. retail funds, SI suggests that the disparity may be explained by economies of scale as well as by taking into account the increasing use of “wrapper” fees in the U.S. that are charged in addition to the TER.

The study shows that asset-weighted average net investment management fees in Europe are only about 3 basis points greater than management fees in the U.S. – when excluding the three largest “mega” U.S. fund managers (managing \$600 billion to \$1 trillion each), which distort the composite results.

Management Fee Ratios: Europe vs. US *



*Fees are asset-weighted. European fund management fees: based on SI survey, estimated net of retrocession and operating fees; US data: management fees, as reported to SEC;

Sources: Strategic Insight / EFAMA / Simfund MF

Many forces will impact fees in Europe in the future including rising demands for transparency, the need to distinguish between investment and distribution fees, regulatory change (MiFID review, RDR, UCITS IV, PRIIPs, etc.), market competition, the rise of ETFs and index funds, the creation of low-fee active funds, the growing complexity of investment management, a shift to more sophisticated products and alternative strategies, and the increasing use of UCITS in Asia, Latin America, and other markets worldwide.

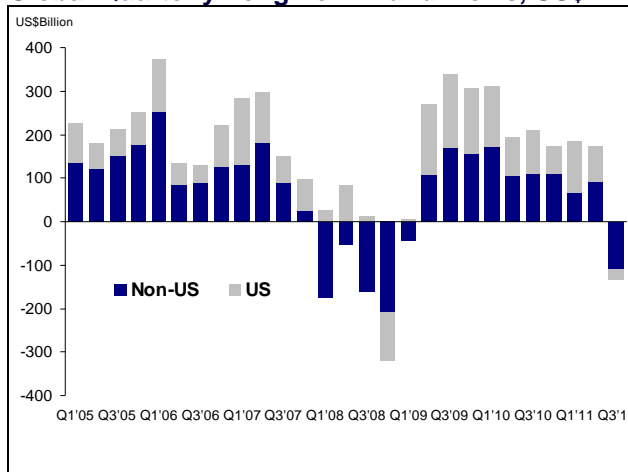
Global Trends: Q3 and Rising to the Challenge



Jag Alexeyev
 (212) 944 4456
jag@sionline.com

A complex period for fund providers with many changes: Asset declines, investor losses, and net redemptions are just a few facets of the tough environment for investment firms and distributors. Regulatory changes such as MiFID II and the UK’s Retail Distribution Review (RDR) are influencing how funds will be priced and sold, how advisers can be compensated, and what kind of products may be engineered for retail buyers. These will have a big impact on structure and competition in the industry over the long-term, and are already adding layers of complexity and cost to fund business strategy, management, and planning.

Global Quarterly Long-Term Fund Flows, US\$B



Source: Strategic Insight Simfund MF/GL; Excludes money market funds

Yet the current focus is on the market’s impact. Investors within European-domiciled equity funds during the third quarter experienced losses averaging 13% to 20% depending on currency, on an asset-weighted basis. These price dislocations helped trigger **\$70 billion of net redemptions in Q3’11 from European and cross-border stock funds.** Another \$37 billion were net withdrawn from bond funds. Adding mixed assets and other categories, total outflows reached \$140 billion (€100 billion) during the

quarter in Europe. Though significant, these amounted to less than 2% of long-term fund assets. They were however among the highest net outflows on record, close to those in Q3’08 (€17 billion), and roughly 70% of the amounts in Q1 and Q4 of 2008.

The sharp price declines, high ongoing intraday volatility, and the weight of three major global financial market crises within one painful decade continue to shape investment attitudes. Investors and advisers are seeking products with better management of volatility, a higher degree of downside protection, and less correlated returns. This supports the continued expansion of absolute return and alternative strategies (hedge fund-style, long/short, market neutral, global macro, etc.). **Alternatives captured \$27 billion or nearly 40% of total flows to actively-managed UCITS in the first half of 2011.**

Although UCITS III flexibilities gave birth to a new range of products, the expanding use of derivatives by such funds and their associated risks has raised concerns among regulators and industry leaders. European securities regulator ESMA recently consulted the industry on the risks of synthetic ETFs and structured funds, and the discussion has turned to proposals for **separating UCITS into non-complex versus complex products.** The EC’s MiFID II review further supported the delineation of structured UCITS as complex instruments, which would place certain restrictions on their availability to retail investors.

MiFID II will also bring a ban on trail commissions to independent advisers (similar to, but not as broad as, the RDR’s), which will have a significant impact on the European industry.

Meanwhile, the focus on risks of swap-based and leveraged exchange-traded products has put **synthetic ETFs between the crosshairs.** Swap-based approaches account for 65% of the European ETF industry, but flows have begun to shift towards “physical” products, and Blackrock’s share of total European ETF net flows rose from less than 40% in Q1 to over 80% in Q3.

Regulatory fatigue: The combination of MiFID, RDR, UCITS IV, PRIIPs, FATCA, Basel III, Solvency II, AIFMD, and other initiatives has even EC officials admitting to “regulatory fatigue”. For asset managers it has become a fact of life, along with the rising cost of compliance. But as the business changes, outcomes will be determined by how managers respond.

*For more details please see SI Global’s forthcoming **Global Fund Review: Rising to the Challenge.***

Global Trends: Asset Holders' Priorities



Daniel Enskat
(212) 217 6859
daniel@sionline.com

As part of its consulting work, Strategic Insight has conducted **1,200 interviews since 2008 with professional fund buyers** in Europe, Asia, and Latin America, alongside regular discussions with fund and wealth management executives. Discussions centered on changes in manager and fund selection, best practices for leading firms, and selection criteria in a back-to-basics and guided architecture framework with fewer firms as strategic partners.

The combined results provide details for numerous operational aspects and perceptions affecting a firm's success, including holistic brand post-crisis, competitive benchmarking, flagship funds on recommended lists and key mandates, client relationship management, operational and investment support, marketing, and tailored information delivery.

While universal principles and regional trends can be identified, firms are faced with multi-local regions encompassing numerous languages, regulatory frameworks, asset sizes, cultures, investment mindsets, business practices, and local idiosyncrasies.

The table below shows the rating on a scale of 1 to 10 of the importance of various criteria of fund management, based on our surveys of about 1,200 fund buyers.

Local, Global and "Glocal": Difference and Similarities Across Channels

Success Factor	Wholesale	Institutional
Performance	9.6	9.0
Organizational Stability	9.4	8.3
Client Services	9.0	7.3
Understanding of Needs	8.4	5.5
Brand	8.0	6.0
Product Range	7.5	5.3
Marketing & Communications	7.2	5.2
Product Innovation	6.5	2.1
Online Presence	4.1	2.1

Source: Strategic Insight

Organizational stability, service, and brand on par with performance post-crisis: Our survey of key asset holders worldwide since the crisis shows that priorities for both institutions and distributors have been significantly altered.

Performance remains the key selection criterion for managers and products. But organizational stability, service, and brand (especially among distributors) have moved front and center:

- Organizational stability:** In conjunction with proactive communication, the uncertainties in the financial markets and the public blowups of firms and outright fraud have raised the importance of the perceived stability of the organization. This includes turnover of investment and relationship/sales staff, senior executives, as well as the commitment to specific regions, products, or markets. Some firms hired staff during the crisis and increased their market share in addition to getting good, loyal people inexpensively and showcasing local commitment. Those firms that fired employees are dealing with the backlash — and in some cases are blacklisted.
- Client service:** Performance can get a product on the radar, but relationships determine how long it stays; and service excellence, unlike many aspects of performance, can be controlled. Global asset holders value the speed and quality of responses, as well as the support staff's level of technical knowledge. Satisfaction with service from asset managers is slightly higher on the institutional versus the intermediary side: 73% of institutions are satisfied with the service levels provided compared to 56% on the intermediary side. This is partially due to institutions having more specific needs and being less demanding compared to distributors (rating client services 7.3 versus 9.0).
- Product:** Product innovation is near the bottom of the list for all asset holders. Instead of the ability to crank out new themes every month, asset holders are focusing on the clarity of product positioning and the investment process. In all, this represents a paradigm shift for the industry.

*For more details please see SI Global's recent **State of the Global Investment Management Industry** study.*

ETF Update: Bonds Drive Q3 ETF Flows



Loren Fox
(212) 217-6912
lfox@sionline.com

Exchange-Traded Funds in the US drew net new flows of \$18.7 billion in the third quarter of 2011. Through the first nine months of 2011, ETFs netted \$74.6 billion, equal the \$75 billion in net inflows they drew in the first nine months of 2010. **At the end of September 2011, US ETF assets (including ETNs) totaled \$970 billion** in 1,321 different products. Market declines in September caused ETF assets to drop below \$1 trillion for the first time since November 2010.

ETFs: By Investment Type

	Assets \$B 09/11	Net Flows \$B			# of Funds 09/11
		2010	YTD- 9/11	Q3 2011	
US Equity					
Diversified	326.6	23.1	15.7	2.4	268
Sector	124.5	18.0	14.2	-2.8	280
Subtotal US Equity	451.1	41.1	29.8	-0.4	548
Int'l/Global Equity					
Diversified	66.6	5.8	12.1	4.2	82
Divrsfd Emrg Mkts	74.0	24.9	-5.1	-0.9	40
Regional	42.5	7.1	-0.2	-3.8	79
Single Country	25.3	-0.3	2.8	-0.9	46
Subtotal Int'l/ Global Equity	208.5	37.5	9.5	-1.4	247
Total Equity	659.6	78.6	39.4	-1.8	795
Bond					
Taxable Bond	153.2	7.2	27.9	13.0	109
Muni Bond	7.5	1.1	0.2	0.2	29
Subtotal Bond	160.7	8.3	28.1	13.2	138
Specialized					
Alternative Strategy	3.5	3.4	0.8	-0.3	51
Commodity	107.5	12.2	-0.1	0.7	98
Currency	7.6	3.7	-2.2	1.9	29
Leveraged/Inverse	31.4	4.7	8.6	5.0	210
Subtotl Specialized	150.0	23.9	7.1	7.4	388
Total	970.3	110.7	74.6	18.7	1,321

Source: Strategic Insight Simfund MF

The inflows into ETFs in 2011's first nine months followed four straight years of at least \$100 billion in net inflows, as they have consistently drawn capital from individuals, advisors and institutions through varying market conditions. In Q3, bond ETFs were the main driver of net inflows, taking in \$13 billion, or roughly 70% of Q3 net inflows. Leading the way were short- and intermediate-term bond funds, with combined Q3 net inflows of \$6.3 billion; the demand for alternatives to money market funds has been a trend in the overall fund industry since March 2009.

Equity markets were buffeted by both losses and extreme volatility in the third quarter. Investors responded by net redeeming \$1.8 billion out of equity ETFs. But the market volatility spurred net inflows of \$5 billion into leveraged and inverse ETFs; these tactically oriented products had their best quarter since drawing \$7.9 billion in inflows in Q2 2009.

Commodity ETFs saw small net inflows in Q3, thanks to strong inflows to precious metals ETFs.

Biggest ETF Managers

The US ETF market is concentrated: as of September 30, **BlackRock, State Street and Vanguard together controlled 82% of the assets.** The Top 10 ETF managers run 95% of the assets.

Top 10 ETF Managers as of September 2011

Manager	Assets	Market	Net Flows
	9/30/11 \$B	Share Sept.'11	YTD-9/11 \$B
BlackRock (iShares)	410.3	42.3%	13.5
State Street Global	231.8	23.9%	7.1
Vanguard	152.6	15.7%	26.5
InvescoPowerShares	39.2	4.0%	1.3
ProFunds	26.0	2.7%	7.3
Van Eck	21.5	2.2%	5.9
DB Commodity Svcs	12.3	1.3%	1.7
WisdomTree	11.2	1.2%	3.0
Amer Stck Exchange	7.8	0.8%	-3.2
Rydex Advisors	7.4	0.8%	0.4
Top 10 Total	920.1	94.9%	63.6

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. An example is BlackRock's iShares ETF line: its market share was a commanding 42.3% at the end of September 2011, but that was down from 58.6% five years earlier. We expect further fragmentation as the US ETF market expands and newer entrants gain traction.

The “Big 3” ETF providers – iShares, State Street and Vanguard – have a large hold on ETF assets. However, while these three firms have significant market share in the total ETF market (and especially in traditional “core” equity and bond asset classes), they do not dominate all categories of ETFs. The table below presents three examples of this:

ETF Categories Not Dominated by the ‘Big 3’ ETF Sponsors: Examples, Top 3 Firms in Each

Category	Manager	Assets \$MM 9/30/11	Category Market Share 9/30/11
Currency	Rydex	3,057	47.7%
Currency	DB Commodity	2,017	31.4%
Currency	WisdomTree	1,194	18.6%
Broad Commodities	DB Commodity	5,433	48.5%
Broad Commodities	Barclays Capital	2,570	22.9%
Broad Commodities	BlackRock	1,264	11.3%
Emerging Mkt Bond	BlackRock	3,062	48.3%
Emerging Mkt Bond	WisdomTree	1,493	23.6%
Emerging Mkt Bond	InvescoPowerShrs	1,223	19.3%

Source: Strategic Insight Simfund MF

As the table illustrates, there are ETF categories where smaller players dominate, and plenty of categories that are open to competition. To avoid competing with the Big 3, the best bet, though, is to pioneer a new category. Product innovation is accelerating and becoming increasingly important in the US ETF market. We examine this point with more depth in our upcoming Executive Insight report, *Product Innovation in ETFs*, which will be published in November.

Actively Managed ETFs

Actively managed ETFs – those ETFs not aiming to exactly match an index – is a high-profile but small segment of the ETF market. At the end of September, there were 40 active ETFs managing a total of \$3.7 billion. That’s less than ½ percent of the ETF market, and the three biggest funds held 66% of all active ETF assets (up from 63% three months earlier).

As shown in the table that follows, there are not many sizeable active ETFs. And many of the biggest ETFs are not very “active” – the three biggest are a money-market alternative and two currency-trackers. The active ETF market is waiting for new products and new entrants (drawn from the many traditional fund firms that have filed with the SEC for the necessary exemptions). Many market participants, for example, are waiting to see the new flows and the performance of PIMCO’s announced active ETF version of its Total Return Bond fund.

10 Biggest Actively Managed ETFs, Sept. 2011

ETF	Strategy	Assets \$MM 9/30/11	Net Flows \$MM YTD-9/11
PIMCO Enhanced ShortMaturity Strategy	Corp. Short Maturity	1,519	741
WisdomTree Dreyfus China Yuan ETF	Currency	521	-124
WisdomTree Dreyfus Emerging Currency	Currency	383	92
WisdomTree Managed Futures Strategy	Gbl Asset Allocation	238	257
Cambria Global Tactical ETF	Gbl Asset Allocation	166	116
WisdomTree Dreyfus Brazil Real ETF	Currency	144	9
iShares Diversified Alternatives Trust	Multi-Alternative	127	20
PIMCO Intrmed. Muni Bond Strategy	Muni Nat'l Intermed	103	35
Active Bear ETF	Growth	96	96
Peritus High Yield ETF	High Yield	59	47

Source: Strategic Insight Simfund MF

New ETF Launches YTD-Sept. 2011

The pace of ETF launches slowed a bit in the third quarter. After 189 new ETFs debuted in the first half of 2011, **59 new ETFs launched in Q3**. In all, ETFs listing in the first nine months of 2011 drew \$5 billion in total net inflows.

Top New ETFs in 2011 YTD-9/11, By Flows

Product	Strategy	Net New Flows \$MM 1H 2011
WisdomTree Asia Local Debt	Emrg Mkt Bond	419
iShares High Dividend Equity	Large Value	375
PowerShares S&P 500 Low Volatility	Large Value	348
WisdomTree Managed Futures	Mngd Futures	257
PowerShares Senior Loan	Bank Loan	166
Schwab US REIT ETF	Real Estate	159
MAXIS Nikkei 225 Index ETF	Japan Stock	156
Schwab US Aggregate Bond	Interm Bond	102
Northern FlexShares TgtTIPS	Inflation	98
Active Bear ETF	Bear Market	96

Source: Strategic Insight Simfund MF

Of the 10 most successful debuts in 2011, the MAXIS, Schwab and Northern Trust ETFs all debuted in Q3. And only one of the 10 was launched by a member of the Big Three. These top 10 debuts display a range of strategies/asset classes, from bank loans to emerging markets bonds and managed futures to real estate. As more new ETFs launch, there will be an even greater diversity of asset classes, strategies and managers.

Fund-of-Fund Packaging: Beyond Lifecycle Programs



Sonia Mata
(212) 217 6947
sonia@sionline.com

There has been a distinct acceleration in flows since 2010 into funds-of-funds (FoFs) implementing asset allocation concepts other than “target-date lifecycle” and “risk-based lifecycle” which both typically comprise series of funds. The residual “non-lifecycle” category of FoFs houses products implementing numerous variations on tactical and strategic allocation among single or multiple asset classes or strategies, for a variety of investment goals, typically within single funds that are not part of a series.

Funds-of-Funds*						
	Assets		Net Flows \$B			
	\$B					Ytd-9/11
	9/11	2007	2008	2009	2010	9/11
Lifecycle						
Target-Date	328	56.6	40.9	39.2	42.9	31.2
Risk-Based	160	19.5	-2.0	-2.0	-0.2	1.6
Subtotal above	488	76.1	38.9	37.2	42.7	32.8
Other FoFs	176	16.3	2.8	7.8	45.0	21.3
Total FoFs	665	92	42	45	88	54

* Excludes Variable Annuities and 529 plan funds.
Source: Strategic Insight Simfund MF

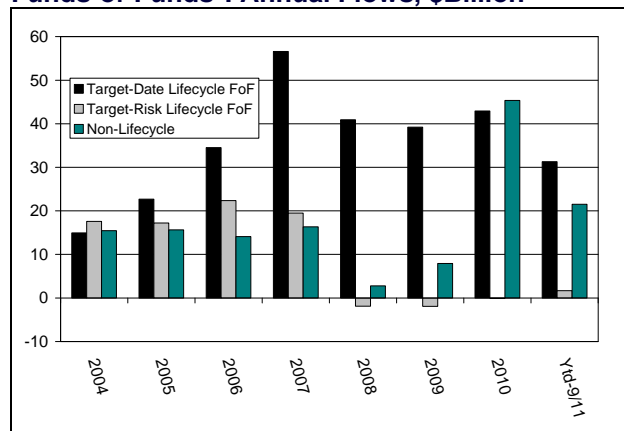
The sharp step-up in the pace of flows into the non-lifecycle FoF area in 2010 (to \$45 billion from just \$8 billion in 2009) and the slower, but still elevated (relative to pre-crisis) levels this year despite heightened market volatility and global economic uncertainty have been largely driven by two factors:

- The overall popularity of the more **risk-managed and tactical asset allocation approaches** that have gained traction post-financial crisis and have also benefited existing as well as new fund-of-fund structure products from several managers (the hybrid “Global Asset Allocation” and Flexible US”

funds have captured nearly 50% of year-to-date flows into the non-Lifecycle FoF area.)

- Strong flows (especially last year) into **Fidelity’s Strategic Advisers FoFs**. These eleven funds are used exclusively as “sleeves” within Fidelity’s “Portfolio Advisory Services” (PAS) discretionary mutual fund wrap program offered by the firm’s FAs to its clients

Funds-of-Funds*: Annual Flows, \$Billion



* Excludes VAs and 529 plan funds.
Source: Strategic Insight Simfund MF

The **Strategic Advisers (SA)** FoFs together held \$48 billion at the end of September. They have the flexibility to invest in Fidelity and non-Fidelity funds (including ETFs) available on Fidelity’s *FundsNetwork* supermarket platform, as well as directly in securities (through affiliated and unaffiliated sub-advisers), making them quite “open-architecture” in terms of both managers and vehicles.

The SA FoFs, as well as the PAS program itself, are run by **Strategic Advisers, Inc. (SAI)**, Fidelity’s registered investment adviser affiliate. Net flows into the SA FoFs approached nearly \$30 billion last year, but have moderated to about \$8 billion this year through September, with “Core Income” (\$2.5 billion), “International” (\$2 billion) and “Growth” (\$1.7 billion) fund offerings in the lead (see following table).

Fidelity's "Strategic Advisers" Funds-of-Funds

Fund Name	Start Year	Assets		
		\$B 9/11	Net Flows \$B	
			2010	Ytd-9/11
US Equity				
Strategic Advisers Core	2009	7.2	6.3	0.9
Strategic Advisers Growth	2010	6.6	4.9	1.7
Strategic Advisers Value	2008	5.9	5.0	0.1
Strategic Advisers US Opp	2007	2.5	1.3	0.2
Strategic Advisers Sml-Mid Cp	2007	2.2	1.2	-0.1
Strategic Advisers US Opp II	2007	0.5	0.0	0.0
International Equity				
Strategic Advisers International	2006	10.5	5.2	2.0
Strategic Advisers Emerg Mkts	2010	1.5	1.6	0.3
Strategic Advisers Int'l II	2007	0.7	0.0	0.0
Bond				
Strategic Advisers Core Income	2007	7.4	2.5	2.5
Strategic Advisers Income Opp	2007	2.5	1.0	0.8
Total Fidelity SA FoFs		47.6	28.8	8.4

Source: Strategic Insight Simfund MF

Excluding the Fidelity *Strategic Advisers* funds, which are not available to retail investors, the list of the ten non-lifecycle FOFs with the highest year-to-date (through September) cash-flow is dominated by Global / US flexible allocation products targeting one or multiple asset classes or sub-asset classes, as can be seen in the following table.

Highest Ytd-9/2011 Flow Non-Lifecycle Funds-of-Funds (Excluding Fidelity's "Strategic Advisers" FoFs)

Strategy		Assets		
		\$B 9/11	Net Flows \$B	
			2010	Ytd-9/11
PIMCO All Asset All Auth	GTAA	13.5	5.8	4.7
PIMCO All Asset	GTAA	23.0	3.3	4.5
Virtus Prmium AlphaSctr	TAA	2.2	0.4	1.9
PIMCO Globl Multi Asset	GTAA	4.8	1.5	1.6
BlackRock Strtg Inc Opp	Flex Glb Bd	2.9	1.4	1.6
RivrNorth/Dblline Strlnc	Flex Glb Bd	0.5	0.0	0.5
Free Market Fixed Inc	Global Bond	0.8	0.2	0.2
Stadion Managed Portf	TAA	1.2	0.7	0.2
GS Satellite Strategies	GTAA	0.9	0.3	0.2
DFA Glbl Real Est Sec	Glb RE Alloc	0.8	0.0	0.2

Source: Strategic Insight Simfund MF; SI Research

Three of the leading cash-flow funds in the first nine months of 2011 are GTAA offerings from **PIMCO**. The firm's \$13.5 billion *All Asset All Authority* and \$23 billion *All Asset* funds have been sub-advised since inception (2002-03) by **Research Affiliates**. RA allocates both funds' assets among underlying PIMCO funds in pursuing long-term return goals of CPI plus 6.5%, and CPI plus 5%, respectively. The third PIMCO fund in the list, the \$4.8 billion *PIMCO Global Multi-Asset*, is internally managed at the firm. Launched at the peak of the financial crisis in October 2008, this fund uses tail risk hedging as part of its investment process. It

invests in affiliated funds; unaffiliated and affiliated ETFs; directly in securities; and in derivatives.

The table includes two **funds-of-ETFs** that use quantitative models to try to participate in stock markets when they are up, and de-risk into fixed income or cash when they appear less favorable. **Virtus's Premium AlphaSector**, launched last year, is sub-advised by **F-Squared Investments**, and a Virtus affiliate, **Euclid**. It passively tracks an F-Squared index that allocates to a blend of Select Sector SPDR ETFs and a short-term Treasury ETF. Athens, Georgia-based **Stadion Funds' Managed Portfolio Trust** uses broad market ETFs augmented by sector/region ETFs, but was 100% invested in cash equivalents at the end of September.

An interesting instance of post-launch (and post-crisis) evolution within a FoF's strategy and structure is provided by **BlackRock's** \$2.9 billion unconstrained bond fund, **Strategic Income Opportunities**. At inception in 2008, this fund was called the "BlackRock Strategic Income Portfolio," sought "high current income, with a secondary objective of capital growth," benchmarked itself against the Barclays Capital US Aggregate Bond Index, and normally invested at least 65% of its assets in other BlackRock fixed income funds. In March 2010, when the fund still had less than \$80 million in AUM, it was renamed "BlackRock Strategic Income Opportunities," changed its objective to "seeking total return *as is consistent with preservation of capital*" (italics added), changed its benchmark to the Barclays Capital U.S. Universal Index, and was given the leeway to invest in BlackRock funds or to make direct purchases of individual securities to any extent. As the fund grew in size after these strategy changes and wider distribution (it has garnered \$2.9 billion in net flows since March 2010), it made use of its added structural flexibility to start a migration away from investing in BlackRock funds and towards building customized sleeves through direct securities investments.

Another fund in the table and an example of innovative use of the "mixed" FoF structure is **RiverNorth's RiverNorth/DoubleLine Strategic Income**. The fund, started last year, tactically allocates to three strategies: a sub-portfolio managed by RiverNorth itself that invests in closed-end funds in a bid to take advantage of pricing discrepancies in that space; and two sleeves ("Core Fixed Income" and "Opportunistic Income") run by sub-adviser **DoubleLine** by investing directly in securities. Also of note is **Goldman Sachs' Satellite Strategies** FoF started in 2007, which allocates to affiliated funds providing exposure to asset classes that GS believes be less correlated to traditional market exposures such as large cap equities and investment grade fixed income. At September-end, it was allocated to high yield debt; EM debt, international small cap equity, EM equity, real estate securities and commodities.

Developments in Retirement Shares



Bridget Bearden
(212) 217-6907
bbearden@sionline.com

As of September 2011, Strategic Insight designated 3,580 fund share classes from 81 asset managers as available for sale only through qualified retirement plans. Retirement shares – which at times use 12b-1 fees (and sub-TA fees where applicable) to help offset costs of plan administration and distribution—represented \$366 billion in assets, netting \$27 billion in flows in 2011's first nine months. "R" shares comprised 3.5% of open-end mutual fund assets, excluding ETFs. These figures include funds-of-funds (FoFs), which represent a sizeable portion of DC assets (both target-date and target-risk funds are QDIAs).

Fund Shares Designated for Qualified Plans

Share Class Designations	Assets \$B 9/30/11	YTD-9/11 Flows	Manager Count
K	95.2	21.4	5
R6	50.1	10.4	4
R4	46.8	-2.3	7
R3	43.9	-1.8	14
R5	43.5	-3.2	9
R	26.5	1.2	49
R2	21.0	0	12
Rtrm	12.6	-1.0	8
GS4	9.7	-0.2	1
R1	4.9	0.7	12
N	3.9	0	2
W	2.6	1.7	1
I	1.7	-0.2	2
P	0.8	-0.3	1
Q	0.4	0.3	1
IR	0.4	0.2	1
Total	365.9	27.2	81

Source: Strategic Insight Simfund MF

Recent registrations have renewed interest in R shares. In 2011, First Eagle registered nine R6 share classes; JPMorgan registered an additional eight funds as R2, R5, or R6; and John Hancock registered R6 classes of virtually all of the JHF II series. Outside of these registrations, 188 retirement-designated fund share

classes have been launched through 3Q2011, on track to be near par with the 245 launches of 2010.

The largest retirement share series are offered by American Funds (R1 through R6; \$162 billion combined) and Fidelity (K and W; \$96 billion combined). American Funds' retirement shares benefited from sizeable transfers of assets residing in other share classes prior to the launch of its R-series. Recordkeeper Fidelity has demonstrated sustained growth in its dedicated retirement share classes since first converting large plans from the Investor shares to K-shares in 2008. Fidelity's W share class is offered through its Freedom Index Fund series.

Top 10 Managers of Retirement-Designated Mutual Fund Share Classes by AUM

Manager	Total R Share Assets \$B 9/30/11	Percent of Firm's Total MF AUM*
American Funds	161.6	19%
Fidelity	96.3	7%
JPMorgan Funds	13.3	3%
TIAA-CREF	11.2	28%
GuideStone Capital	9.7	83%
MFS	9.6	11%
Thornburg	7.0	15%
Principal Funds	6.6	8%
T Rowe Price	5.6	2%
OppenheimerFunds	3.9	2%

*Open-end, long-term mutual funds, excl. ETFs and VA funds
Source: Strategic Insight Simfund MF

FoFs accounted for roughly 64% of R share net inflows in the first nine months of 2011; excluding FoFs, net flows into R-share funds were \$9.7 billion. Pure-play asset managers that netted positive flows in 2011 through September include Thornburg with \$1.3 billion and MFS with \$1.1 billion.

From an asset class perspective, the bulk (61%) of non-FoF retirement-designated assets resides in the larger-cap Growth, International Growth, and Growth & Income objectives. Leading 2011 R share net inflows were International Growth (\$4.4 billion), Small Company Equity (\$2.1 billion), and Growth & Income (\$1.6 billion) funds.

According to the ICI, about \$2.6 trillion of DC assets resided in mutual funds as of Q2'11, meaning that R-shares represent roughly 16% of DC mutual fund assets. As such, R-share trends in terms of asset classes and pricing structures provides a partial view of the direction of the DC marketplace. This view will broaden given the push towards transparency with Rule 408(b)2, which will most likely result in further proliferation of retirement-designated share classes.

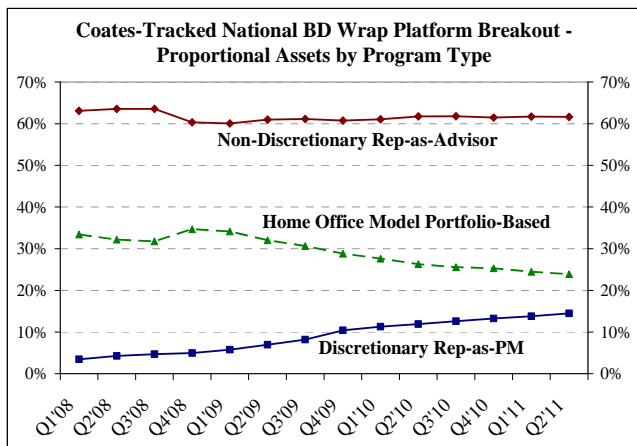
Trends in National Broker Dealer Wraps



Dennis Bowden
(212) 217-6895
dbowden@sionline.com

As heightened global economic uncertainty and increased market volatility have again reinforced elevated levels of investor and financial advisor (FA) anxiety, the trend toward greater discretionary portfolio management by FAs has also continued. This article summarizes some of the important macro-level findings from the Q2'2011 version of our joint research series with Coates Analytics – *National Broker Dealer Product Strategy & Distribution Trends*. [For more information on subscriptions, contact Dan Weirnerman – dweirnerman@sionline.com; 212-217-6897.]

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 Analytics-tracked universe of National Broker Dealer (NBD) firms.



Source: Coates Analytics Distribution Management System / SI Analysis

The influence of Discretionary Rep-as-PM platforms within the NBD space (as well as overall intermediary-sold fund distribution) has increased rapidly during the post-crisis period. Rep-as-PM programs have increased their share of total mutual fund wrap assets within the Coates-tracked universe from just 3.5% in Q1'2008 to 14.5% as of Q2'2011. Over the same three-and-a-half year period, Home Office Model-Based programs have seen their share

of total wrap platform assets decline from 33% in Q1'08 to 24% at the end of Q2'11.

This growth in discretionary portfolio management continues to significantly impact the intermediary-sold marketplace in many ways. One important result – influenced, too, by the effects of heightened market volatility – has been a rise in tactical management of client assets across broadening segments of the FA-sold universe. This trend has shaped FA product choices, as well as asset velocity features within the intermediary-sold space (as discussed in another article in this issue of Windows).

The table below charts the top-selling equity funds during H1'2011 across each of Rep-as-Advisor, Rep-as-PM and Home Office Model Portfolio-Based wrap programs within the Coates-tracked universe of NBDs.

Top Selling Equity Funds - H1'2011 via Coates-Tracked Mutual Fund Wrap Platforms		
Non-Discretionary Rep-as-Advisor Wrap Platforms		
Fund	Style	% of H1'11 Total Program Equity Sales
First Eagle Global	Global Equity	3.1%
Oppenheimer Developing Mrkts	Emerging Mrkts Equity	2.7%
BlackRock Global Allocation	Global Equity	2.6%
Ivy Asset Strategy	Global Equity	2.1%
Thornburg International Value	International Equity	1.8%
Discretionary Rep-as-PM Wrap Platforms		
Fund	Style	% of H1'11 Total Program Equity Sales
PIMCO All Asset All Authority	Asset Allocation	2.5%
Permanent Portfolio	Asset Allocation	2.4%
Oppenheimer Developing Mrkts	Emerging Mrkts Equity	2.3%
Ivy Asset Strategy	Global Equity	2.3%
First Eagle Global	Global Equity	2.2%
Home Office Model-Based Wrap Platforms		
Fund	Style	% of H1'11 Total Program Equity Sales
Eaton Vance Large Cap Value	Large Cap Value	3.9%
American Century Growth	Large Cap Growth	3.5%
Growth Fund of America	Large Cap Growth	3.2%
JPMorgan Intrepid Value	Large Cap Value	2.5%
Janus Forty Fund	Large Cap Growth	2.0%

Source: Coates Analytics Distribution Management System / SI Analysis

During the first half of 2011, a majority of the top-selling equity funds within both Rep-as-Advisor and Rep-as-PM programs featured flexible and tactical investment strategies. This suggests an interesting mix with regard to FAs' greater tactical management of investor portfolios. Clearly, some FAs (particularly within Rep-as-PM programs) are increasingly managing their clients' ongoing portfolio exposure more tactically on their own – through rapid movement between asset classes and funds. These H1'11 (as well as FY 2010) results, however, suggest that many FAs also continue to look to asset managers to help them manage more tactical exposure *within* solution-based fund offerings. For fund firms, these dual trends highlight the importance of not only effective investment management, but also effective product packaging in adding value to FAs' portfolio construction and management processes.

Redemption Patterns Across Intermediary-Sold Platforms

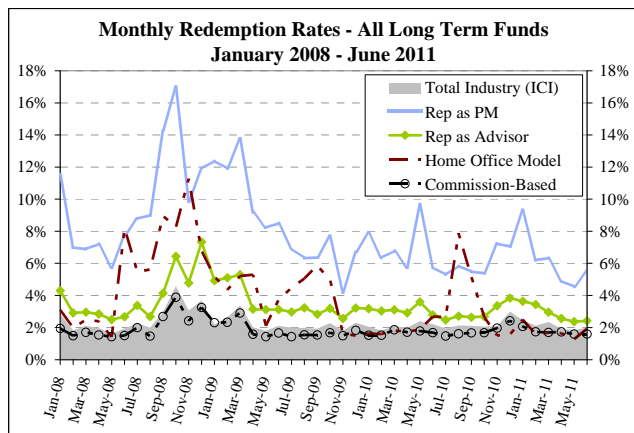


Dennis Bowden
 (212) 217-6895
dbowden@sionline.com

Fund distribution through financial advisors (FAs) continues to take on increasing complexity. Factors such as the expanding movement toward fee-based accounts, rapid shifts in share-class pricing demand, and ongoing changes in FA business models have created many challenges – including in asset stability.

In particular, the rapid growth of Discretionary Rep-as-PM platforms (as well as RIAs) has brought higher redemption rates to broader segments of the market. While Rep-as-PM programs may offer attractive new sales traits, they also carry the highest asset stability pressures. These trends and their impact on the economics of fund distribution play a crucial role for fund firms in shaping product focus, sales force compensation, and other aspects of distribution strategy. Our recent Executive Insight report, "[Perspectives on Redemption Patterns Across Intermediary-Sold Distribution Platforms](#)," from which this article is adapted, looks at the issue in depth.

The graph below charts aggregate monthly redemption rates (defined as gross redemptions divided by average assets) for all stock and bond funds across the industry as a whole (as tracked by the ICI) and within various Coates Analytics-tracked National BD platform types.



Source: Coates Analytics Distribution Management System / SI Analysis

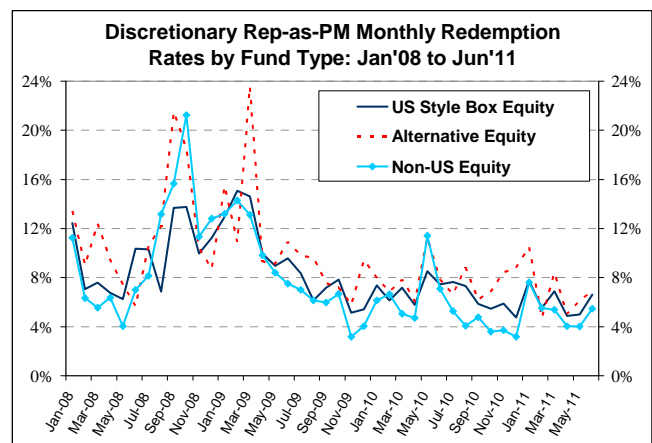
Rep-as-PM programs have clearly exhibited significantly higher ongoing redemption rates than other FA-sold platform types – often registering more than double the monthly rate of redemptions of any other platform captured.

This higher asset velocity within Rep-as-PM platforms (and similarly via many RIAs) stems from a combination of factors, including such FAs’ greater tendency to tactically manage client assets. In addition, such advisors have the ability to use full discretion to quickly adjust their clients’ portfolio exposure (with technology advances increasingly allowing them to easily make such trades across a broad number of client accounts with a single action).

Redemption Trends Across Equity Fund Categories

These aggregate redemption characteristics help to create important insight around asset stability features across platform types. More granular analysis of redemption rates across investment categories, however, can offer valuable perspective on the drivers of overall asset velocity pressures within each platform, as well as the applicable asset stability implications for fund managers across various portions of their product lines.

The graph below charts monthly redemption rates across three distinct pieces of the equity fund landscape – US Style Box, Non-US and Alternative Equity – within Coates-tracked Rep-as-PM wrap programs.



Source: Coates Analytics Distribution Management System / SI Analysis

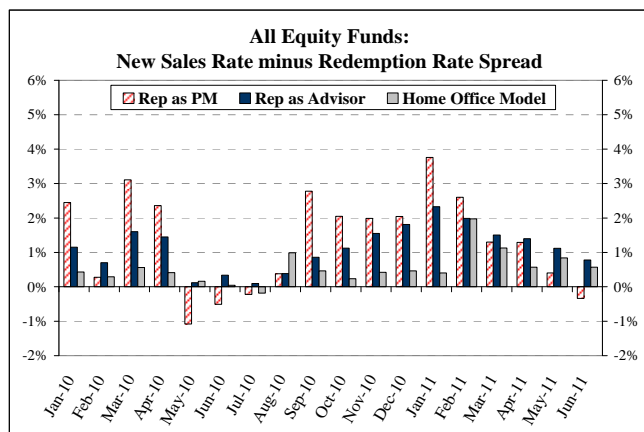
Within the overall higher asset velocity environment of Rep-as-PM platforms, Alternative Equity funds (represented by the dashed line above and defined as commodities, natural resources, market neutral, long-short and bear market funds) have exhibited the highest and most volatile redemption rate features of the investment categories charted. In Rep-as-PM

programs, such funds registered a redemption rate above 8% during 10 of the 25 months from June 2009 through June 2011 – more than double such high-redemption occurrences of US Style Box and Non-US Equity funds combined. While clearly highest on an absolute basis, redemption rates of Alternative Equity funds are also most disproportionately high on a relative basis within Rep-as-PM platforms as compared to Rep-as-Advisor programs. Rep-as-PM redemption rates of Alternative Equity funds surpassed Rep-as-Advisor rates by over 5% during more than one-third of the months from June 2009 through June 2011.

Given the greater demand for Alternative Equity funds among Rep-as-PM advisors – as well as many RIAs – the increasing use of these strategies has the potential to create a self-reinforcing circle of greater aggregate redemption pressures within expanding segments of the intermediary-sold marketplace. At the same time, however, such high-velocity use may suggest additional opportunities in this evolving segment to educate FAs and investors around the benefits of long-term alternative asset class exposure and management.

Assessing Holistic Opportunity Sets Across Platforms

As increasing asset stability concerns continue to impact the economics for fund firms distributing within the FA-sold space, holistic analysis of the opportunity set offered within each platform type is critical. While redemption patterns within Rep-as-PM programs are generally higher than those of other platforms, it is important to weigh such considerations in combination with sales growth characteristics. The graph below charts the monthly difference between the new sales rate and the redemption rate for all equity funds within each respective wrap platform type from January 2010 through June 2011.



Source: Coates Analytics Distribution Management System / SI Analysis

Rep-as-PM programs registered an average positive spread (new sales rates exceeding redemption rates) of 1.4% in equity funds over the 18 months from January 2010 through June 2011. Rep-as-Advisor platforms followed with an average monthly spread of 1.1%, while Home Office Model-Based programs averaged 0.5%.

At a more granular level within the equity fund universe, US Style Box Equity funds recorded their highest average opportunity set spread within Rep-as-Advisor programs (0.5%) and Non-US Equity experienced their highest average spread via Rep-as-PM platforms (1.5%). Interestingly, Alternative Equity funds scored a 2.8% average monthly spread within both the high asset-velocity environment of Rep-as-PM programs, as well as within the more stable asset-velocity atmosphere of Rep-as-Advisor platforms.

Implications Moving Forward

The increasingly converse relationship across different advisor avenues between new sales growth and the long-term stability of assets creates a growing number of variables that fund firms must weigh in shaping their overall distribution strategies. While aggregate Rep-as-PM redemption patterns are alarming, such advisors – with their significant recent growth and high-net-worth client bases – can still represent important relationship opportunities for fund firms.

These redemption statistics highlight the increased importance of FA segmentation around both growth and asset stability features (particularly within high-velocity segments such as Rep-as-PM and RIA). The ability to identify segments of these advisor bases (either among existing clients or prospects) with strong asset stability characteristics in applicable investment strategies has become even more critical, given the high asset-stability risks associated with many FAs in these spaces. In addition, revenue sharing arrangements with distribution partners clearly become less economically attractive as asset holding periods decrease. Given these dynamics, fund firms may find it valuable to begin to discuss redemption rate or holding period metrics as larger factors in revenue sharing negotiations – over time, potentially even resulting in some type of variable payment arrangement based on ongoing redemption characteristics.

As new business and asset stability considerations continue to converge, more detailed and thoughtful analysis on the balance between these two dynamics will continue to become an increasingly important factor in shaping effective long-term strategies related to intermediary-sold distribution.

Implications of Solvency II for VAs



Kevin Ng
(212) 217 6922
kng@sionline.com



Tamiko Toland
(212) 217 6949
tamiko@sionline.com



Jeffrey Hutton
(212) 217 6954
jeff@sionline.com

U.S. variable annuity providers can easily get so caught up in what is happening on the home front that they ignore what may seem like irrelevant developments in Europe. However, impending changes to insurance regulation in Europe in the form of the E.U.'s Solvency II Directive could have important implications here in the United States, and not just for multinationals.

Of course, there are many insurers in the U.S. that are part of European parent companies, and there is a possibility that they will ultimately have to conform to the European requirements for their U.S. businesses. In addition, U.S. companies with a European presence will have to deal with similar issues in order to continue to operate over there. However, even for purely domestic insurers, Solvency II may have an enduring effect on the regulation of insurance at home.

What is Solvency II?

Solvency II is a modernization of the regulatory system for insurance companies and products in Europe that will begin to take effect starting in 2013, with new capital requirements coming into play at the beginning of 2014.

The new system imposes **more rigorous enterprise risk management requirements** and it changes the treatment of various products. Solvency II requires analysis of group risk rather than simply looking at each individual subsidiary. This is perhaps the biggest fundamental difference in the two systems and it is a key element to modernization.

The other big issue from across the pond has to do with the **comparison with U.S. capital requirements**. Under Solvency I, which did not require a capital calculation for the entire group, this difference did not matter; under Solvency II, European insurers are

required to wrap their U.S. subsidiaries into the new calculation.

This means that **purely U.S.-based companies will have a short-term pricing advantage over their European counterparts** because they are not required to comply with the E.U.'s capital requirements. Pricing benefit or not, some actually believe that the market advantage will swing the other direction and that **companies bound to the more rigorous requirements of Solvency II will tout the superiority of that regime.**

Dragged into the Modern Age

Solvency II includes a provision that allows foreign jurisdictions to request regulatory equivalence, which regards non-E.U. regulatory systems as equivalent to Solvency II. Equivalence allows the foreign units of European insurers to operate under the local regulatory regime and vice versa.

However, the U.S. hasn't even made the top of the list of countries being considered for equivalence (instead, Bermuda, Switzerland and Japan are in the first wave). Furthermore, "transitional equivalence," for which the U.S. does qualify, would buy another five years at most and so is only a stop-gap measure. In order to achieve permanent equivalence, the U.S. needs to be considered equivalent in the area of either group supervision or group solvency.

The larger and more lasting effect of the adoption of Solvency II is that it will, like it or not, pull U.S. insurance regulation along in its wake. **Equivalence will only come about if the U.S. makes significant changes to its system**, and the country cannot afford to stubbornly stand by its own practices while others in the international community point to the U.S. as a regulatory backwater.

The diffuse regulatory structure in the U.S. gets in the way of international relations such as those involved in Solvency II. The NAIC (National Association of Insurance Commissioners) is doing its part to try to move regulatory practices forward. The Solvency II issue may generate greater impetus to either give the NAIC more power to effect change or create a bona fide federal insurance regulator, both to establish consistent solvency oversight and serve as a negotiating body in international relations. Thus, **Europe's insurance modernization initiative inexorably, if haltingly, draws the United States into a new era.**

A Wider View of Publicly Traded Fund Managers with SI Data



Tony DiSanzo
(212) 217 6951
adisanzo@sionline.com

Increasingly, industry analysts benefit from Strategic Insight's global coverage of funds; we now track via Simfund about \$25 trillion of fund assets.

Understanding an investment firm that operates globally poses a particular challenge, and publicly held asset managers are special cases. At times, equity research firms use SI's Simfund global data, in addition to our US data, to track mutual fund flows, asset, performance, and fees of investment firms with publicly traded equity. For some of these managers, US-domiciled traditional 1940 Act funds represent all or nearly all of their mutual fund assets. Others have a significant presence in international/offshore and VA underlying funds, and they lend themselves to a broader view to gauge AUM and flows firm-wide.

Strategic Insight's three databases (Simfund MF, Simfund VA, and Simfund GL) track, respectively, US domiciled funds; VA underlying funds; and Europe, Asia, and cross-border funds. Using data from all three gives a more complete picture of a manager's AUM composition and mutual fund lineup. For example, over 9% of Waddell & Reed's assets are in VA underlying funds, and the variable annuity counterpart to its popular Ivy Asset Strategy fund had over \$1.3 billion in assets at the end of August.

Fund Mix of Selected Managers' Registered Assets in US, Asia, and Europe – August 2011

Manager	US Domiciled	VA Underlying	Europe & Asia
AMG*	65.5%	0.2%	34.2%
AllianceBernstein	60.9%	4.0%	35.0%
BlackRock	66.2%	1.4%	32.4%
Franklin	64.6%	5.5%	29.9%
Invesco*	60.7%	4.6%	34.7%
Janus	85.4%	6.9%	7.6%
Legg Mason	74.0%	3.3%	22.7%
Waddell & Reed	90.9%	9.1%	-

*AMG and Invesco include subsidiaries. Sources: Strategic Insight Simfund MF, Simfund VA, Simfund GL

Trends among Europe, Asia, and cross-border funds captured in Simfund GL are at times quite revealing for both public (and non-public) US asset managers. The preceding table compares assets of some of the publicly traded managers.

Franklin Resources (BEN), for instance, has had well-documented success outside the US, evidenced by two of its Luxembourg-domiciled funds. The Templeton Global Bond fund had over \$11 billion in net inflows through the first eight months of the year, which almost kept pace with its hugely popular US counterpart, which had net inflows of \$14.3 billion during the same period. Similarly, over the same period the Luxembourg-based Templeton Global Total Return fund saw net inflows of \$10 billion, easily surpassing the net inflows of \$1.5 billion for its US counterpart. In 2010, BEN captured an estimated \$40 billion of long-term mutual fund net inflows outside the US, making it #1 of all global fund managers in term on non-US mutual fund inflows.

The table below lists flows for some of the publicly traded managers' other notable ex-US registered funds:

Flows for Selected ex-US Domiciled Funds, YTD-August 2011, in US\$ Billion

Portfolio	Domicile	Net New Flows \$B
iShares DAX	Germany	10.3
AllianceBernstein Global High Yield	Lux.	3.5
iShares S&P 500	Dublin	1.5
Legg Mason Brazil Govt Bond Fund	Japan	1.4
BlackRock Emerging Markets Index	Dublin	1.4
Genesis Emerging Markets [AMG]	Lux.	1.1
Templeton Asian Bond	Lux.	1.0
Templeton Emerging Markets Bond	Lux.	0.9
Invesco Euro Corporate Bond	Lux.	0.8
Invesco Perpetual High Income	UK	0.7

Source: Strategic Insight Simfund GL

At times, an international presence helps diversify its sources of growth and cushion a manager from the weakness in one market. Through the first eight months of 2011, for instance, Legg Mason saw net outflows from its long-term US products but inflows of \$2.4 billion in Europe and Asia.

Global perspectives through our Simfund databases also highlight higher-level trends. For example, sometimes demand for Emerging Market funds slows in the US but stays strong outside the US. Such a perspective helps identify opportunities for both public and private money managers.