THE CERULLI EDGE
GLOBAL
EDITION

NOVEMBER 2007 ◆ PRODUCT STRATEGY ISSUE

ASIA

Portfolio Optimization

Asians' short-term view of mutual funds is hurting the industry

Future product strategies should be guided more by portfolio than product development needs.

Fund managers in Asia, whether already well entrenched, or simply skirting around the industry edges, face a similar problem—how to implement a retail product strategy capable of growing assets and revenues over the long term, despite the very short-term nature of retail mutual fund investing in the region.

In addition, best-selling asset classes in each of the major Asian markets also tend to differ from each other, negating the notion of a single pan-Asian product capability (see chart on page 4). While there is some overlap in terms of offshore-registered funds, differences in local rules and market maturities have given rise to a divergence in investment emphases and a large number of domestically structured funds across the region.

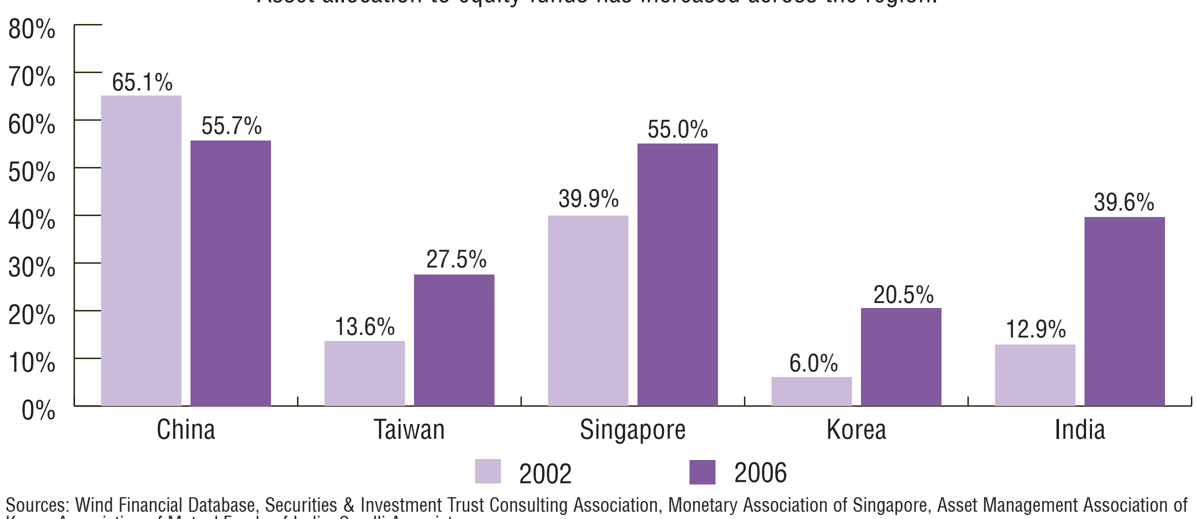
Both of these factors leave managers scratching their heads when tasked to map out a product strategy for Asia. While many struggle to see how many new funds they can support with limited resources, the answer may lie not in the construction of particular products, but in the construction of client-specific portfolios.

Falling net flows

It has long been a concern of fund managers that Asian investors tend to take a short-term view of their mutual fund

EQUITY FUND ASSETS AS A PERCENTAGE OF TOTAL MUTUAL FUND ASSETS, 2002 VS. 2006

Asset allocation to equity funds has increased across the region.



Sources: Wind Financial Database, Securities & Investment Trust Consulting Association, Monetary Association of Singapore, Asset Management Association of Korea, Association of Mutual Funds of India, Cerulli Associates investments, that distributors are too dependent on commission-based revenues, and that regulators do too little either to stem churning practices or to encourage longer holding periods through tax and other incentives.

As a result of these trends, asset retention is alarmingly low in the Asia-Pacific region. In response to a Cerulli survey on Asian retention rates in the first quarter of 2007, all bank respondents in Hong Kong and Taiwan said that they experienced mutual fund outflows of $70 or more for every $100 of inflows. Despite positive equity markets in the first quarter, only about 10% of survey respondents across the region said that their outflows amounted to less than half of their total inflows.

Supporting these survey results is countries' net inflow data. In Hong Kong, annual net flows fell from HK$35.8 billion in 2002 to HK$9 billion in 2005. Although net flows recovered in 2006 and the first half of 2007 as a result of renewed interest in Chinese equities, they have not returned to the highs of 2002.

Equities focus

This slowdown in net flows coincides with a significant increase in equity fund assets in the region. In many Asian markets, equity funds as a percentage of total mutual fund assets have doubled or, as in the case of Korea and India, tripled from 2002 to 2006 (see chart on page 1). However, this greater exposure to equities is leading to a higher turnover of assets, for a number of reasons.

First, although still small in relative terms, the growth of assets in higher-risk, specialized, and exotic products has outpaced the asset growth of more traditional equity funds. Both retail and institutional investors tend to hold these funds for even shorter periods than they hold traditional funds. A closer look at the fund flows in

INSIDE THIS ISSUE

The Cerulli Edge™—Global Edition is a monthly periodical designed to update the firm's clients about the most recent events and trends in the 20 asset management marketplaces Cerulli Associates covers worldwide. A Quantitative Update each month highlights the most current data for global mutual fund marketplaces. The annual subscription fee is US$15,000 per client firm and is available in hard copy or electronically. Subscriptions may include copies sent directly to key executives (up to 15 copies). Each additional recipient beyond 15 copies is $1,000. We suggest heads of key business units be included, as well as CEOs, and directors of marketing, strategy, product development, and sales. **Your subscription also gives you access to all archived issues via our web-based client access service. Contact us for details.**

Hong Kong and Singapore clearly demonstrates this trend (see chart on page 5).

The chart shows how over an 18-month period, certain asset classes are able to quickly gain—and just as quickly lose—favor with investors. Real estate investment trusts (REITs) and emerging-market equity funds, for example, can move from being one of the top-selling asset classes to one of the worst in a matter of a few months.

Redemption drivers

This chart also points to another driver of outflows in Asia—profit-taking. In situations where fund returns are not only rising, but rising fast, there is a tendency for investors to regularly pocket their profits in the same way as they would for direct stock investments. The high cost of doing so is often ignored, given that net profits remain reasonable, and many Asian investors appear willing to sacrifice some returns in order to avoid capital losses, wherever possible.

A third driver of flow volatility is the increasing rate of fund launches. Across the region, new funds are being launched to capture "hot" investment themes, whether property, commodities, or greentech. However, many of these fund launches do little to increase the mutual fund penetration rate. Investors often move into these new theme-based funds by liquidating their existing funds, rather than investing additional assets.

Role of managers

However, while it is to be expected that, according to Cerulli's survey, fund managers identify the "churning of mutual funds" as their most important market issue in Asia, managers are often contributing to the problem. Product differentiation continues to dominate Asian managers' time and attention, despite the already large

EDITORIAL

SOLUTIONS, NOT PRODUCTS

On the face of it, managers may deem any attempt at a global product strategy laughable, given that product trends appear to clash even within a single region, let alone across regions. However, some surprisingly similar patterns exist across the global market, and these alignments are more likely to strengthen than to weaken.

First, the pressure to launch new products is unlikely to go away, whether in the United States, Europe, or Asia. However, new product launches should not be confused with innovation. While there is clearly a demand for innovative responses to investor needs, many new "me too" products add wholesaling costs with limited asset-retention potential.

Second, returns net of costs will likely become a more prominent issue for investors around the world, even though starting points may differ. Fee pressure has long dogged the U.S. industry, but it is already a feature in Asia as distributors focus increasingly on high-net-worth individuals, and in Europe, where the likelihood of even greater risk aversion makes net performance all the more crucial.

Third, investor demand for advice may not be as linear across investor asset bands as some have assumed. On the one hand, investors, even high-net-worth ones, have shown themselves increasingly attracted to both very high-risk and very low-risk assets, for which advisory services are fairly redundant. On the other hand, even mass retail investors appear willing to pay for advice when it comes to their longer-term retirement assets.

In combination, these developments point to some future directions for providers to consider. Important to bear in mind is the fact that it is possible after all to construct globally relevant product strategies and programs. However, these have to be based not on the ability to identify a set of common products across the world, but rather on a set of investment solutions to common investor needs, even though the actual products may differ.

This requires providers to take a greater interest in the actual portfolios held by different investor segments, and to be open-minded about helping the industry develop the most appropriate solutions for each segment, regardless of whether these extend beyond individual providers' existing capabilities.

RANKING OF NET NEW INFLOWS BY FUND TYPE, 2006

	First	Second	Third
Hong Kong	Greater China Region Funds	Emerging Markets Funds	Sector Funds
Singapore	Equity Funds (India)	Equity Funds (Emerging Markets; Far East)	Equity Funds (Sector; Basic Industries)
Taiwan	Equity Funds (International)	Fund of Funds	Real-Estate Securitization (Property Funds)
Korea	Equity Funds	Balanced Funds	Derivative Funds
India	Bond Funds (Income)	Equity Funds (Growth)	Liquid/ Money Market Funds

Sources: Hong Kong Investment Funds Association, Lipper/IMAS Singapore Fund Flows Insight Report, Securities & Investment Trust Consulting Association, Asset Management Association of Korea, Association of Mutual Funds of India, Cerulli Associates

choice of funds. Especially for managers new to the region, a foot in the distributor's door often means offering products not already on the distributor's product shelf. This has the tendency of introducing ever more exotic products into the marketplace, and at the same time fuelling investors' short-term forays in and out of funds.

More established managers are under similar pressure to build out their product range at a pace that can be difficult to maintain. They are often required to design exclusive products for their local and regional distributor partners, and to offer substantial product variety. These factors explain why in the Hong Kong market alone, each of the top 10 managers by number of funds has more than 100 funds registered with the Securities and Futures Commission (see table on page 5). The 10 managers with the largest fund numbers in Taiwan and Singapore average 100 and 60 funds, respectively.

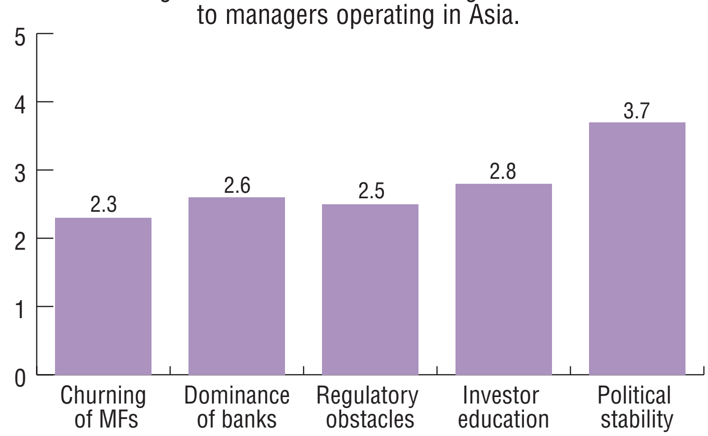
Portfolio construction

It may therefore be time for managers to take a step back from this unrelenting product proliferation and consider instead what would make for an "optimal" fund range—that is, one that avoids becoming overextended in terms of wholesaling and maintenance, while still meeting the needs of distributors.

Creating such an "optimal" range requires managers to adopt an "optimal" and compelling client portfolio, customized to various client segments and in consultation with distributors. The problem of wild market swings and asset turnover (discussed above) can be overcome—to some extent—by ensuring that these assets stay with the same manager, if not the same funds. To do this, managers must be able to offer clients and distributors a product range that is substantially, but not necessarily wholly, applicable to such portfolios.

CA SURVEY RESPONDENTS' VIEWS ON IMPACT OF MARKET ISSUES IN ASIA, 2007

Churning is still one of the issues of greatest concern to managers operating in Asia.



Note: 1 = Most important; 5 = Least important

Source: Cerulli Associates

SELECTED ASSET CLASS RANKING BY NET SALES IN HONG KONG, 1Q 2006–2Q 2007

Net fund flows into emerging markets, Asian regional, and REITs funds can vary greatly from quarter to quarter.

Rank	1Q 2006	2Q 2006	3Q 2006	4Q 2006	1Q 2007	2Q 2007
1	Emerging Markets	Greater China Region	Greater China Region	Greater China Region	Greater China Region	Asia Regional (excl. Japan)
2	Japan	Emerging Markets	Balanced/Managed Funds	REITs-related	European Regional Market	Greater China Region
3	Greater China Region	European Regional Market	Global Bond	Global Bond	Asia Regional (excl. Japan)	Global Bond
4	European Regional Market	Asia Regional (excl. Japan)	European Regional Market	North American Equity	REITs-related	Balanced/Managed Funds
5	Global Bond	Global Bond	Asia Regional (excl. Japan)	Balanced/Managed Funds	Balanced/Managed Funds	European Regional Market
6	Hedge Funds	Japan	Emerging Markets	Hedge Funds	North American Equity	North American Equity
7	North American Equity	Balanced/Managed Funds	Japan	European Regional Market	Global Bond	Hedge Funds
8	REITs-related	Hedge Funds	REITs-related	Asia Regional (excl. Japan)	Hedge Funds	REITs-related
9	Balanced/Managed Funds	REITs-related	Hedge Funds	Japan	Japan	Emerging Markets
10	Asia Regional (excl. Japan)	North American Equity	North American Equity	Emerging Markets	Emerging Markets	Japan

Sources: Cerulli Associates, Hong Kong Investment Funds Association

Unfortunately, in the past, managers promoted unsatisfactory portfolio constructs composed solely of their existing product range. These have largely been discredited for being too subjective and not sufficiently in tune either with client needs or distributors' sales processes.

Rather, the new constructs must help investors move from a piecemeal to a comprehensive view of their investments, including, therefore, investment products not manufactured by the individual manage (*e.g.*, direct securities, structured products, ETFs, and alternative assets).

A "Goldilocks" strategy

It is this portfolio construct that should underpin managers' product build-out and rationalization of existing products. Clearly, managers with a long-term view of their business in Asia should aim for a product set that is not too concentrated in either high- or low-risk mandates. The latter has led, in some instances, to a terminal bleeding away of assets.

On the other hand, managers cannot possibly hope to fulfill all the elements of an adopted portfolio construct, even in the mutual fund wedge. A portfolio-driven product strategy can therefore define for a manager the maximum number of products needed to realize all sectors of the portfolio, and a minimum number that still allows the manager to play ball with its distributors. ◆

TOP 10 FUND MANAGERS IN HONG KONG BY NUMBER OF FUNDS (AS OF OCT 2007)

Rank	Mutual Fund Company	# of Funds
1.	BlackRock Merrill Lynch Investment Managers	243
2.	Fidelity Investments Management (HK) Ltd.	172
3.	INVESCO Hong Kong Ltd.	149
4.	Hang Seng Investment Management Ltd.	145
5.	Pioneer Investment Management S.A.	131
6.	Schroder Investment Management (Hong Kong) Ltd.	125
7.	Baring Asset Management (Asia) Ltd.	120
8.	Franklin Templeton Investments (Asia) Ltd.	118
9.	AllianceBernstein Hong Kong Ltd.	105
10.	Morgan Stanley Investment Management Ltd.	102

Sources: Morningstar, Cerulli Associates

UNITED STATES

Peaceful Co-Existence

The demand for low-cost investment products is growing

ETFs do not spell the end of mutual funds, but do require managers to review their product strategies.

Much as some managers would like to bury their heads in the sand and hope they go away, low-cost investment products, and exchange-traded funds (ETFs) in particular, are here to stay. Their rise over the last few years has coincided with three key and likely lasting trends in the U.S. asset management industry: the increased sensitivity to the impact of fees on investment returns; the separation between passively managed beta and actively managed alpha; and the wildfire proliferation of new retail registered investment advisor (RIA) firms.

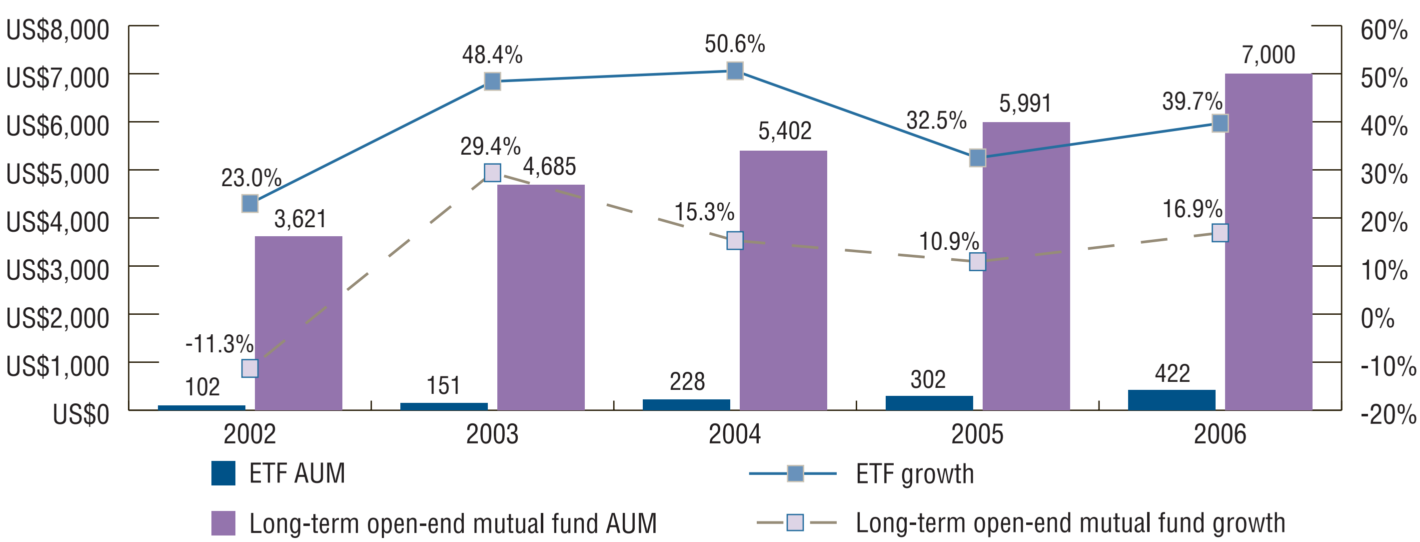
Cause for concern?

The combination of all three trends has resulted in more than 30% year-over-year growth of U.S. ETF assets since 2000, reaching US$422 billion as of year-end 2006, which was almost three times its 2003 size. The United States currently dominates the global ETF markets, and as of the second quarter of 2006 commanded close to 70% of the world's ETF assets. Despite this, ETFs do not seem, on the face of it, to be the cause of much concern for U.S. fund managers. ETF assets are still a long way from the United States' US$7 trillion in mutual fund assets, and account for only about 5% of advisors' client portfolios.

At present, growth forecasts for ETFs are also fairly conservative, given that the low margins associated with ETFs make them less palatable to traditional fund managers. In fact, Cerulli's 2007 survey revealed that close to three-quarters of all respondents deemed ETFs to be "not attractive" as a vehicle to pursue future business opportunities, while fewer than 13% said that they had any plans to develop and launch ETFs.

TOTAL ETF VS. LONG-TERM OPEN-END MUTUAL FUND ASSETS AND GROWTH, 2002–2006 (US$ billions)

Mutual funds dwarf ETF assets, but mutual fund growth is only half that of ETFs.



Sources: Strategic Insight, Cerulli Associates

Sobering

On the other hand, there are reasons for fund managers to sit up and pay ETFs more attention than perhaps they have been. Regardless of whether ETFs present a viable business option, it is sobering to note the growing correlation between management fees and net flows. In the period between 2000 and 2006, the majority of net new flows (61%) went into funds with the lowest total expense ratios (less than 0.1%). During the same period, net flows into funds charging total expense ratios of 1.5% or higher were negligible, and in some cases, negative.

In tandem with this is the fact that, although open-end index mutual fund flows have continued to grow (although not as strongly as ETFs), equity mutual funds, and especially domestic equity funds, are experiencing a severe slowdown in fresh flows. According to Lipper, monthly net new flows into equity funds have fallen to levels not seen for 13 years, and net flows into U.S. equity funds currently average about zero, with outflows matching inflows. Lipper analysts say that these assets are being redirected into alternative investments and ETFs, and agree with Cerulli analysts that this trend is not a short-term blip, reflecting instead a long-term shift in investor fund allocation.

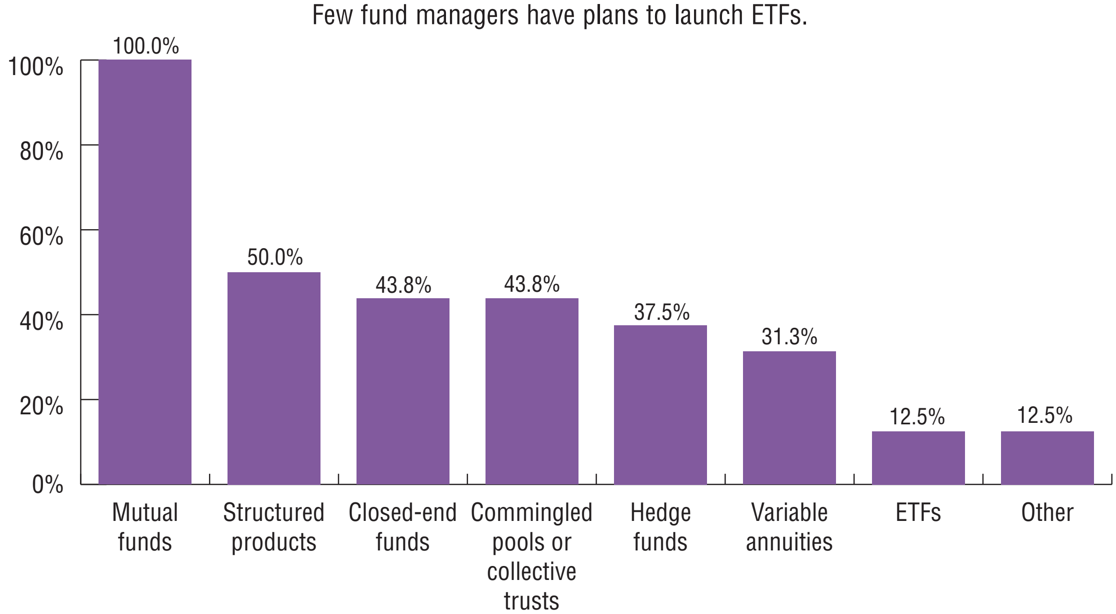
More entrenched

Not everyone agrees with this assessment, but few can deny that ETF providers are moving even more aggressively into the retail arena and appealing more directly to the investor through a series of high-profile campaigns. Retail investors already account for the bulk of ETF assets, thanks to their financial advisors, although the exposure to ETFs is currently not evenly spread. The higher the individual's net worth, the more likely their RIA is to recommend ETFs as part of their investment portfolio. Going forward, not only are the number of RIAs likely to continue their rapid rise—with ETFs very much a part of their product arsenal—but also, more RIAs are likely to include ETFs in smaller accounts.

The production line of new ETFs and new indices also appears to be working overtime. In 2006, 166 new ETFs were introduced into the U.S. market (compared

ASSET MANAGERS' PLANS FOR PRODUCT LAUNCHES BY VEHICLE OR STRUCTURE, 2007

Few fund managers have plans to launch ETFs.



Source: Cerulli Associates

with 153 new in-house mutual funds), and these are increasing in scope and diversity. TD Ameritrade even introduced a set of "target-date" ETFs in October this year, aimed at retirees and longer-term investors. And while a number of recent ETF launches have been based on "research-intensive" indices and charge fees as high as 0.95%, many ETF providers have also entered a price war, cutting back their expense ratios to ultra-low levels of between 0.1% and 0.3%.

On the sidelines

Clearly, many fund managers are unable or unwilling to play in this very challenging space. While some have turned a blind eye to the ETF phenomenon, others have tried to come to terms with it by seeking approval from the U.S. Securities and Exchange Commission (SEC) for a new range of actively managed ETFs that tracks a manager's stock or bond picks instead of tracking an index. Vanguard and Bear Stearns are vying to be the first in the market to offer these actively managed ETFs, but have yet to receive the SEC's approval.

It is therefore still to be determined whether such products will be the ideal amalgam of competitive fees and active management that will take investors by storm. Many in the industry are holding their breath and are expected to pounce once the SEC finally signals its approval. However, despite the apparent appeal, it is possible that the loss of transparency and relatively higher fees may produce less favorable results than imagined.

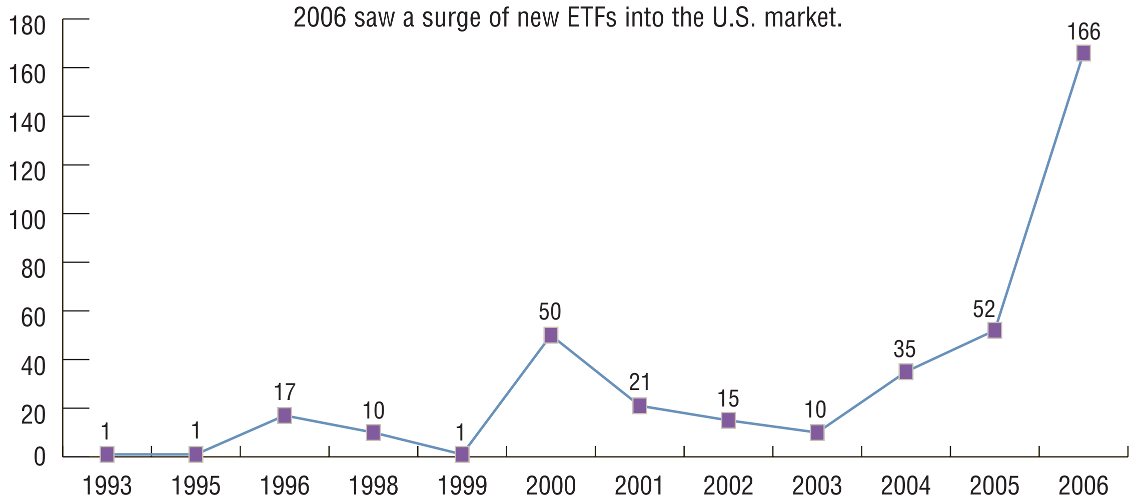
Enhanced portfolios

Whether or not managers eventually decide to join the ranks as manufacturers of ETFs or ETF-like products, there is nevertheless the need to better understand ETFs' place in investor portfolios. Underpinning the recent growth of ETF assets is their increasing use as a low-cost and tax-efficient vehicle with which to populate the "core" of investment portfolios, within the now increasingly popular core-satellite approach.

Such passively managed products may not have sat well with investors in the past, but the growing availability of alpha-generating products, using a variety of alternative investment techniques, asset classes, and vehicles, has helped investors to achieve a balance of active and passive management, while containing costs. Upgraded models of the core-satellite approach give these new vehicles even

NUMBER OF NEW EXCHANGE-TRADED FUNDS, 1993–2006

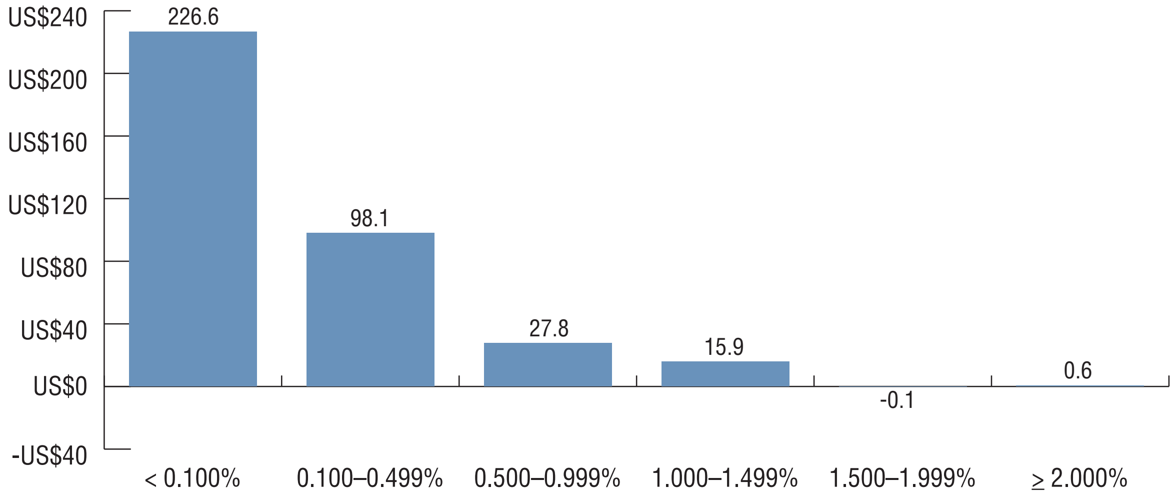
2006 saw a surge of new ETFs into the U.S. market.



Note: There were no new ETFs in 1994 and 1997.

Sources: Strategic Insight, Cerulli Associates

CORRELATION OF TOTAL EXPENSE RATIOS TO NET NEW FLOWS OF FUNDS, 2000–2006 (US$ millions)
High-cost funds are increasingly unpopular with investors.



Sources: Strategic Insight, Cerulli Associates

more intellectual credibility and practical application.

For this reason, too, ETFs are becoming an increasingly common feature of unified managed accounts (UMAs) and platform providers' separate account consultant programs. More than half of the platform providers we surveyed said they were already using or planning to use ETFs in their programs or wrap accounts. Many are simply waiting to upgrade their infrastructure in order to support ETF vehicles. Increas-ingly redundant within these portfolio constructs, however, are the traditional broad-based and long-only funds.

ETFs are becoming an increasingly common feature of unified managed accounts and platform providers' separate account consultant programs.

Complementary

Despite these advances, many fund managers continue to downplay the threat that ETFs pose to their current mutual fund range. Fund managers would do better to understand how their funds can sit side by side with ETFs, rather than in direct competition. Cerulli analysts contend that while mutual funds will continue to occupy an important segment of an investor's portfolio, these will have to be actively structured to harmonize with ETFs and other low-cost, passively managed vehicles.

It is not the case that ETFs will only be used for core investments, nor will mutual funds be increasingly relegated to the outer reaches of an investor's portfolio. As the number of niche and comparatively more expensive ETFs become available, these are likely to be employed more customarily for tactical purposes. Similarly, for less sophisticated investors, embedded-advice products such as lifecycle, lifestyle, and balanced funds may be better candidates for their core investment holdings than single-asset-class ETFs.

For the advisor, the challenge of creating and rebalancing portfolios that are customized to meet diverse investor needs, amid a bewildering choice of investment products, is like attempting to complete numerous jigsaw puzzles simultaneously. Fund manufacturers who embrace, and even champion, portfolios that include non-mutual-fund offerings are in a better position to define to advisors what these puzzles should look like, how their funds fit in, and where to find the missing pieces. ◆

EUROPE

X-treme Investing

Risk polarization of European investments is set to increase

Investors are abandoning their safety nets in some cases, and reinforcing them in others.

As financial market crises go, the collapse of the subprime lending market in the United States is like no other. Crises, including the Russian and Asian currency crises of the late 1990s and the bursting of the dot-com bubble in 2000, tend to be met by investors clamoring for the relative safety of cash and bonds. The current global credit crunch, however, has had the opposite effect—rendering demand for these seemingly bulletproof investment vehicles all but negligible in many European marketplaces.

No mean feat, given the long-standing risk aversion of rank-and-file European investors and the preponderance of fixed-income securities on offer, even amid the rally in global equity markets. Yet, in the summer of 2007, retail investors turned their backs on those products reliant on cheap debt to provide the very capital protection they had so craved. As many vehicles and institutions with broad exposure to the credit markets continue to teeter on the brink of collapse, fund managers are having little success stemming the drop in returns and inflows to previously highly sought-after guaranteed funds and assembled packages containing these products.

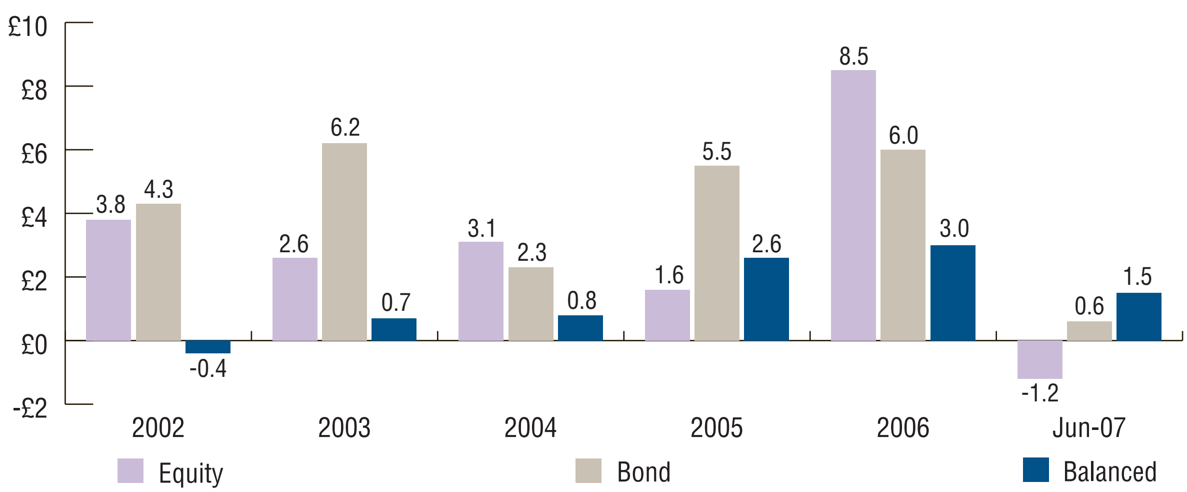
Poles apart

These developments increase the pressure on product development teams whose new launches over the past 24 months have provided the bulk of net new inflows. Lipper-FERI sales data show that new launches accounted for more than 90% of fund inflows in Europe's major markets through the first six months of this year. Cerulli analysts predict that 2008 will continue to be driven by this already overworked product launch engine.

As such, fund providers would do well to consider carefully what other products they should add to their existing product range, especially given the opportunities—but also

U.K. MUTUAL FUND NET NEW INFLOWS BY INVESTMENT OBJECTIVE, 2002–JUNE 2007 (£ billions)

Balanced funds saw the highest net inflows in 1H 2007 amid a subdued sales environment.



Sources: IMA, Cerulli Associates

challenges—of the new MiFID (Markets in Financial Instruments Directive) rules. One potential source of new money in the year ahead is likely to come from tapping investor interest in products at the opposite ends of the risk spectrum. The implementation of the UCITS III regime in 2007, by providing manufacturers with an opportunity to increase their use of derivatives in vehicles carrying the UCITS passport, is not only increasing the choice of products, but also extending the risk scale to include ultra-conservative and ultra-aggressive investment options.

More risk

The result is that promoters of traditional, long-only funds—especially those based on risk-weighted securities—have suffered. In addition, legacy vehicles have struggled to retain assets in this era of increasing competition and broadened investment horizons. On the other hand, now that even once-safe investment havens are under intense scrutiny, the providers of more risk-weighted vehicles possess an opportunity to attract investors—especially those offering diversification—away from traditional asset classes. Already, even the higher-risk hedge funds and real estate investment trust (REIT) funds have enjoyed surprising support among both European retail and institutional investors.

In the United Kingdom, retail hedge funds attracted £4.4 billion in 2006, while property funds attracted a further £3.6 billion. In combination, these two sectors accounted for more than 50% of the year's net retail sales. That they still comprise only about 5% of total U.K. assets under management, and are only just starting to reap the benefits of French and German reforms, suggests that there is much room for growth.

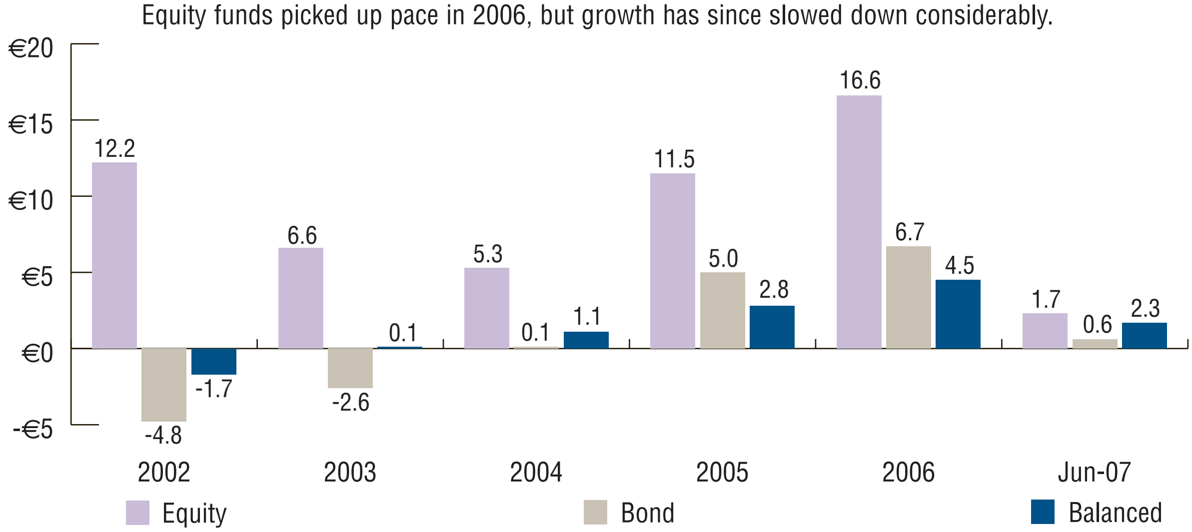
Packaging sells

Not all is lost at the center of the risk spectrum. As yet another sign of European investors' readiness to consider higher-risk products under certain conditions, sales of single-premium, unit-linked insurance policies with long-dated tenors, and multi-asset, multi-manager funds are booming in a number of European marketplaces.

The trend toward longer investment terms and lifestyle product provision is also helping to fuel demand for these products. A desire by governments in aging European countries to reduce reliance on overburdened social security infrastructures is at last manifesting itself more in policy measures. In particular, retail investors are

FRENCH MUTUAL FUND NET NEW INFLOWS BY INVESTMENT OBJECTIVE, 2002–JUNE 2007 (€ billions)

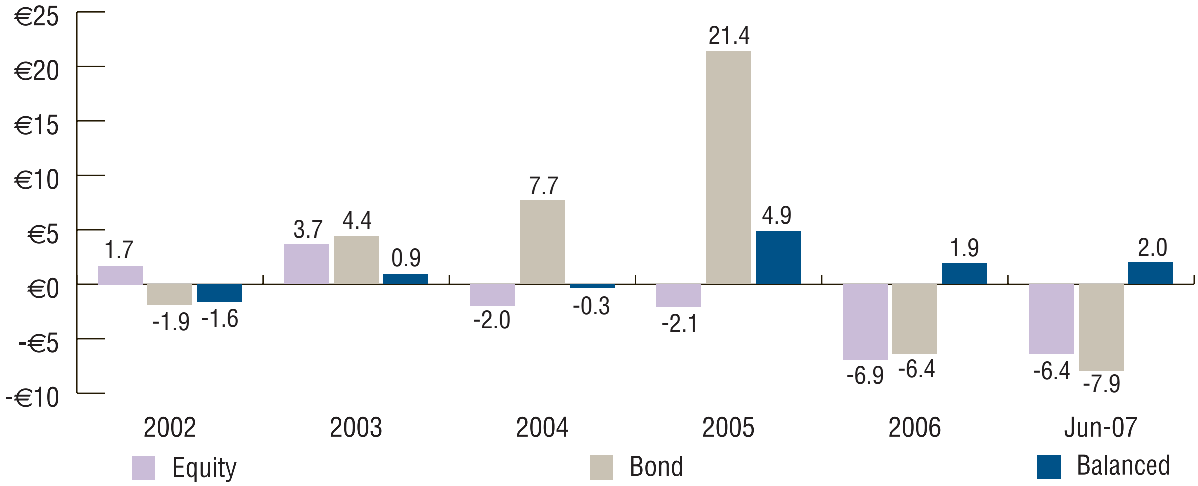
Equity funds picked up pace in 2006, but growth has since slowed down considerably.



Sources: FERI-FMI, Cerulli Associates

GERMAN MUTUAL FUND NET NEW INFLOWS BY INVESTMENT OBJECTIVE, 2002–JUNE 2007 (€ billions)

Bond funds saw negative net flows in 2006 and the first half of 2007.



Sources: FERI-FMI, Cerulli Associates

starting to enjoy tax breaks in exchange for taking more personal responsibility for their retirement.

The assembly of investment portfolios into shape-shifting lifestyle products—which has the added advantage of allowing investors to move assets among instruments without incurring tax—is also taking pride of place in retirement schemes and advisor-led personal financial plans.

Making a difference

This is not to suggest, however, that risk aversion has evaporated in Europe. To the contrary, risk appetites in most European retail marketplaces are still relatively small and the demand for low-risk products, even ultra-low risk products, is expected to continue (see article on page 13).

Whether managers decide to play in the high- or low-risk extremes of the newly expanded risk scale, or even in the center, manufacturers and assemblers are still looked upon to root out tax-efficient, risk-adjusted performance. And this is going to be even more difficult to achieve in coming years because, as the credit crunch has laid bare, they must do so without an over-reliance on mispriced assets. On the plus side, MiFID has laid the groundwork for more cross-border sales opportunities, and successful product strategies possess the potential to grow sales by orders of magnitude.

Some innovative structures seen in 2007 that show strong potential for the year ahead are index-linked hedged vehicles that enable investors to grab a broader spectrum of exposure with less risk than in single-manager funds or funds of hedge funds. In line with these are total-return products based on 130/30 long/short ratios that have proved popular with high-net-worth investors in a number of marketplaces.

As managers venture even further into the realm of risk, there will be a strong temptation to capture the growth in emerging markets, not only those like China and India where markets have already climbed precipitously, but also such relatively uncharted territory as the Middle East and Africa. Equally, funds that have adopted social responsibility and ecological biases as their theme show promise as investors eschew traditionally focused funds or flee the market altogether.

Whatever their structure or theme, the product innovations in the year ahead are sure to be replicated *en masse* by competitors keen not to lose share in a market that is dominated by structured products. ◆

Less Risk, More Choices

Regulatory reforms pave the way for new product designs

Opportunities exist to appeal to bond-heavy investors caught up in the subprime crisis.

The global subprime crisis, while forcing many Europeans to consider higher-risk products, has also brought risk aversion in the region to new heights. The previous article dealt with some of the higher-risk products that manufacturers will be considering for the year ahead. Here, we look at the opportunities at the more conservative end of the scale.

Vehicles such as money market and Libor-plus funds have been prime beneficiaries of not only the increased interest in the safer asset classes, but also recent legislative changes. These changes have potentially widened the client base for these portfolios and better enabled their use in other product designs.

Money market

The sale of money market funds, for example, has been, until recently, largely limited to institutional clients and high-net-worth individuals. However, the rules governing capital adequacy of European banks currently being implemented into national law in various countries might just change that going forward.

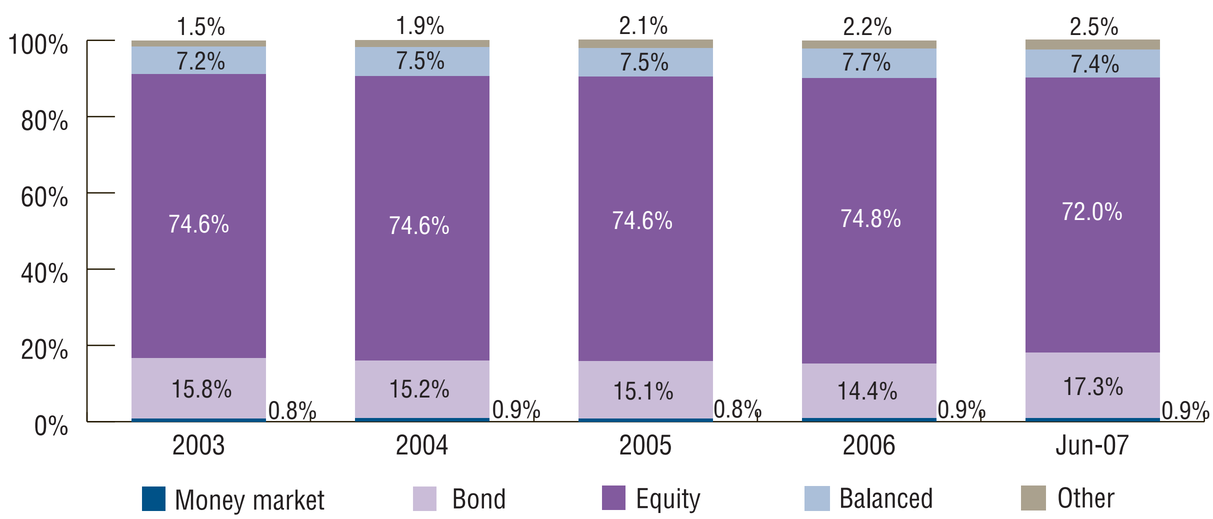
The Basel II Accord, which replaces the original 1988 Basel I Accord and is implemented via the Capital Requirements Directive, appears on the surface to be irrelevant to product development. Its explicit goal is to strengthen the soundness and stability of the international banking system, and to reduce the probability of consumer loss or market disruption as a result of prudential failure.

Old rules

Under the old rules, banks across the European Union were required to set aside a certain amount of capital to cover the risk of investments they make. The amount set aside was dependent on the risk assigned to the investment; so the higher the risk, the higher the amount that needed to be set aside. Under these rules, money market funds—despite the fact that they invest in

U.K. MUTUAL FUND ASSETS UNDER MANAGEMENT BY INVESTMENT OBJECTIVE, 2003–JUNE 2007

Money market assets are less than 1% of the market currently.



Sources: IMA, Cerulli Associates

cash-like instruments and are extremely liquid—were considered high risk.

The capital required to be set aside to cover investments in this area were prohibitively high—100% in some cases, or even more if the bank intended to invest in the underlying holdings directly. This is because the original Basel Accord made no distinction between a money market fund and an equity fund, treating all pooled investment vehicles the same. The result was to make mutual funds essentially an unrealistic investment for banks.

New rules

Under Basel II, this is now changing. A risk rating can be given to the fund, so a money market fund would therefore likely be given a lower risk rating than a pooled-equity portfolio. That is not to say that the rules under Basel II are a whole lot clearer when it comes to funds, as many of them are subject to interpretation. In general, however, the new rules do afford greater flexibility and are expected to open the door to the banking industry as potential new clients for European funds. And by making it easier for investment banks to use these portfolios, there is the possibility that banks could then use them to structure other products, by using money market funds as backing instead of other forms of collateral.

However, while the need and demand for these products may exist, the ability to actually deliver what investors are seeking through them is now in question. Money market funds, having been impacted by the liquidity crisis that has already seen one U.K. mortgage bank require emergency funding, have been received with some mistrust by potential buyers.

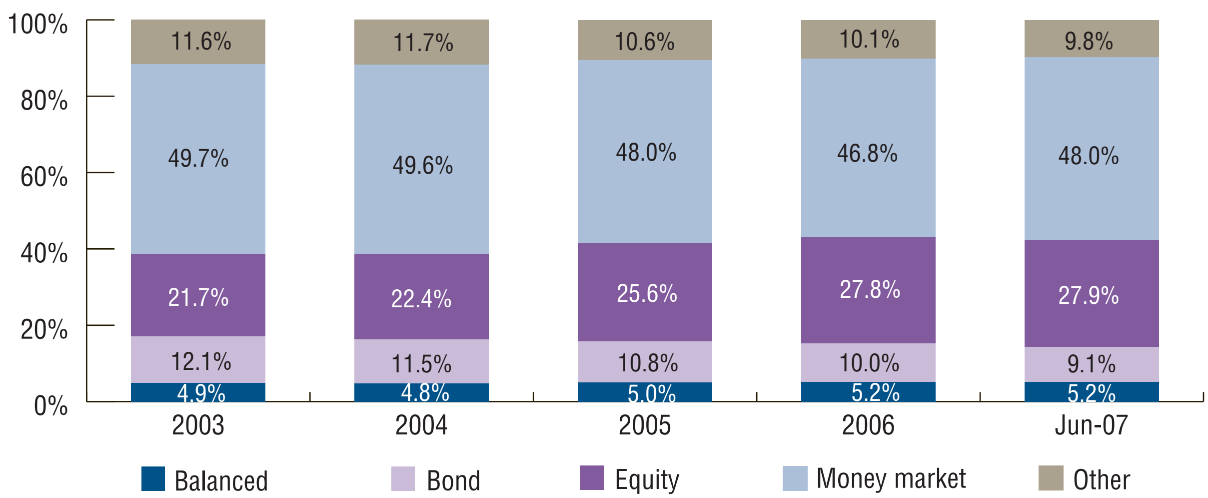
Bond saturation

There are other roadblocks to cross-border sale and distribution of other low-risk products. While bond funds are also contending with the fallout from the credit crunch, they face an additional problem. Much of Europe is already heavily overweighted with fixed-income investments, leaving little room for externally managed bond funds from outside their own regions.

German investors, for example, have always been large buyers of domestic fixed income, and the same can be said for the United Kingdom, which, despite a stronger equity appetite, has some 238 onshore bond funds. In some other European countries, Austria for example, tax benefits help

FRENCH MUTUAL FUND ASSETS UNDER MANAGEMENT BY INVESTMENT OBJECTIVE, 2003–JUNE 2007

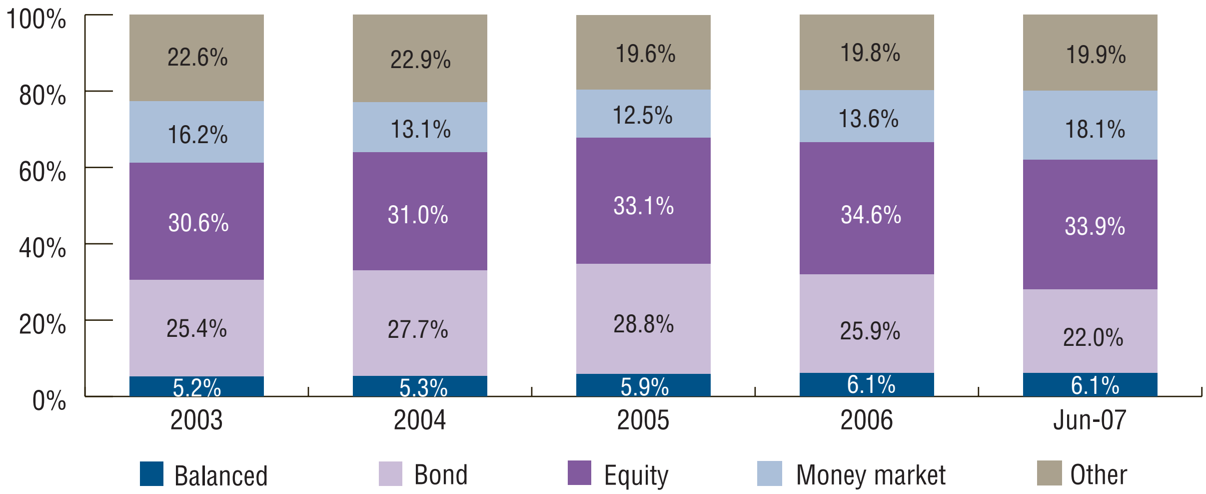
In contrast to the United Kingdom, money market assets make up about half of France's mutual fund assets.



Sources: FERI-FMI, Cerulli Associates

GERMAN MUTUAL FUND ASSETS UNDER MANAGEMENT BY INVESTMENT OBJECTIVE, 2003–JUNE 2007

Money market assets grew significantly in the first half of 2007.



Sources: FERI-FMI, Cerulli Associates

to support a domestic bias toward bond portfolios.

Structured allure

Structured products with capital guarantees have also seen considerable growth in recent years, a beneficiary of this drive toward quality and need for protection. However, performances of late have seemed lackluster amid robust markets, while long maturity periods (above three years) have failed to garner sufficient interest among Continental Europeans. As a result, providers have been forced to create more complicated products, or ones tied to more esoteric indices, in an effort to attract attention.

Nevertheless, Cerulli believes that the flows to these products will continue and even accelerate. Unlike cash funds, which have been hurt by the recent market turmoil, structured products should benefit from the high interest rates and market volatility, enabling the creation of more flexible and interesting structures. Even a limited upside may be more palatable in an environment where it seems many assets are falling.

Hedge-like funds

Another area of potential demand that could come from a more "creative" use of derivatives within retail portfolios is the development of "hedge fund-lite" structures. Using a mutual fund vehicle, managers can use derivatives to apply short-selling and leveraging techniques, but these do not operate at the same level as true hedge funds.

Derivatives can also provide such vehicles with a floor for losses (and a ceiling for gains), widening the appeal for the more conservative investor. In addition, managers of such vehicles are also using option premiums as additional income, which again should help lower-risk buyers and retirees to fill the income gap left by the demise of income-paying bond funds.

Running with the ball

Developments are only really starting in this area and there is little uniformity in the existing offerings across individual countries, let alone Europe as a whole. Although the race is on, a front-runner in this area has not been established—yet. The way is still clear, therefore, for players to leave their mark on their region by making the most of regulatory changes, both in terms of innovative product design and aggressive cross-border sales. ◆

JAPAN

New Era of Transparency

New investor protection laws have just come into effect

Their impact on future product strategies could be significant and long lasting.

Even ahead of the implementation of the Financial Instruments Exchange Law (FIEL) at the end of September, mutual fund sales in Japan had already started to show signs of slowing down. In fact, net new mutual fund flows have fallen from the year-to-date high in June of nearly ¥1 trillion, to a net outflow of ¥690 million in August. Although market volatility is thought to be a factor, many also attribute the steep drop in net flows to preemption of the FIEL. Now that the law has come into effect, some are concerned that even a short-term cooling off may not be good for an industry just getting back on its feet.

Few dispute the fact that the FIEL, aimed at introducing a higher level of risk disclosure and profiling into existing sales processes, is a positive development for the industry in the long run. However, preparations for compliance with the new law, especially by the banks and brokers with large distribution networks, have been at the expense of normal sales activity.

New challenges

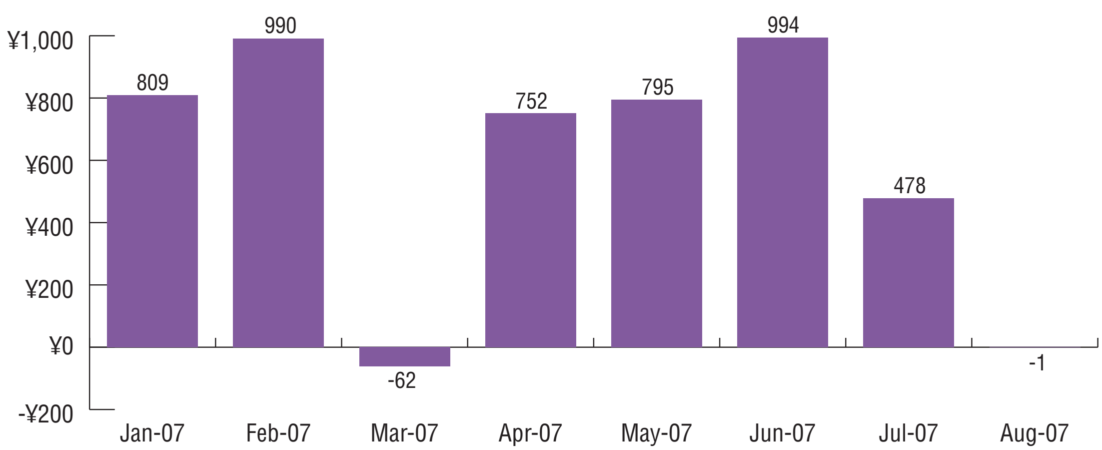
Going forward, financial institutions are also concerned with achieving the right balance between meeting all the necessary requirements of the FIEL, while maintaining a time- and resource-efficient sales process. There is also a worry that investors will become "spooked" simply by the lack of familiarity with these new disclosure requirements, rather than a previous lack of understanding of the products concerned.

However, while Cerulli anticipates a fairly severe, if short-term, impact on domestic bank sales, other channels are likely to get off more lightly. Brokerages tend to have more risk-tolerant and sophisticated clients, who are less likely to suffer any adverse effects from brokerages' compliance with the new law.

The same can be said of foreign banks, and many were already applying high disclosure standards in accordance with home-office practices. Furthermore, the Citibank scandal in 2000 caused many foreign banks

JAPANESE LOCALLY DOMICILED MUTUAL FUND NNI, JANUARY–AUGUST 2007 (¥ billions)

Mutual fund net flows fell in July and August ahead of the introduction of the FIEL.



Source: Investment Trusts Association of Japan to review their sales compliance procedures and tighten up on risk disclosures.

Nevertheless, given the large number of new fund launches in recent years, fund numbers in Japan have reached colossal proportions—more than 5,300 locally domiciled funds were available as of August 2007—putting an enormous strain on sales staff. Extensive product training can be expected to take on a new and urgent importance in the new FIEL era, especially where sales staff are dispersed across a wide geographical area. Although the result presumably will be a larger pool of highly skilled staff, this will not happen overnight.

New era of product development

Although the FIEL is not expected to have a long-term impact on sales, its impact on product development initiatives is likely to be more enduring. In particular, distributors, and the domestic banks in particular, are expected to make stronger demands on managers to provide products that are simple and easy to explain. Lower-risk products are also likely to be in vogue as these can be offered to a wider range of potential investors.

As such, many expect the growing interest in well-diversified funds of funds and balanced funds to pick up even more steam. These vehicles not only carry less risk than equity funds, but also they offer prepackaged advice, thereby reducing the pressure on already stretched sales staff to provide portfolio services.

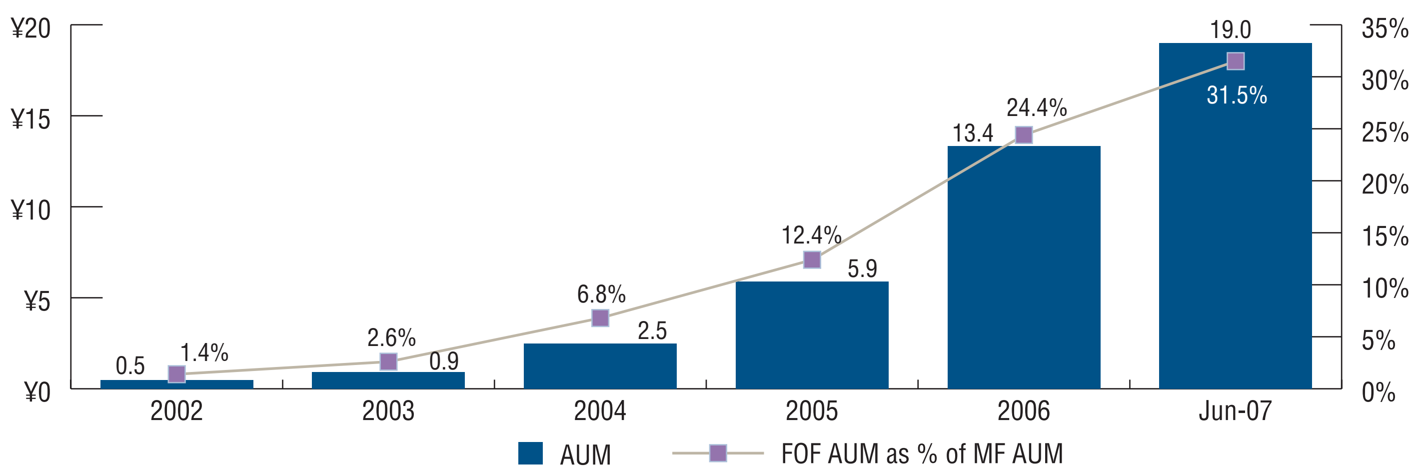
Citibank, for example, has started to sell Nikko Asset Management's new fund-of-funds range, called "Professional Stage." These invest in four different asset classes, including real estate and alternative assets, provided by 13 managers, including some new to the Japanese marketplace, such as Clarinvest Asset Management and GRT Capital Partners. The bank plans to sell this range as a core investment holding for the majority of its clients, including the large number of Baby Boomers on its books.

Value added

In a tougher mutual fund sales environment underpinned by FIEL, distributors can be expected to resist any downward fee or margin pressure, but to offer more value to investors through packaged or unpackaged advice. Banks are already charging a higher sales commission—up to 4.5%—for their funds of funds, compared with approximately 3% for single-manager funds. Fund managers acting as assemblers of such products are less enthused by funds of funds' growing

JAPANESE FUND-OF-FUNDS AUM AND AS A PERCENTAGE OF TOTAL MF AUM, 2002–JUNE 2007 (¥ trillions)

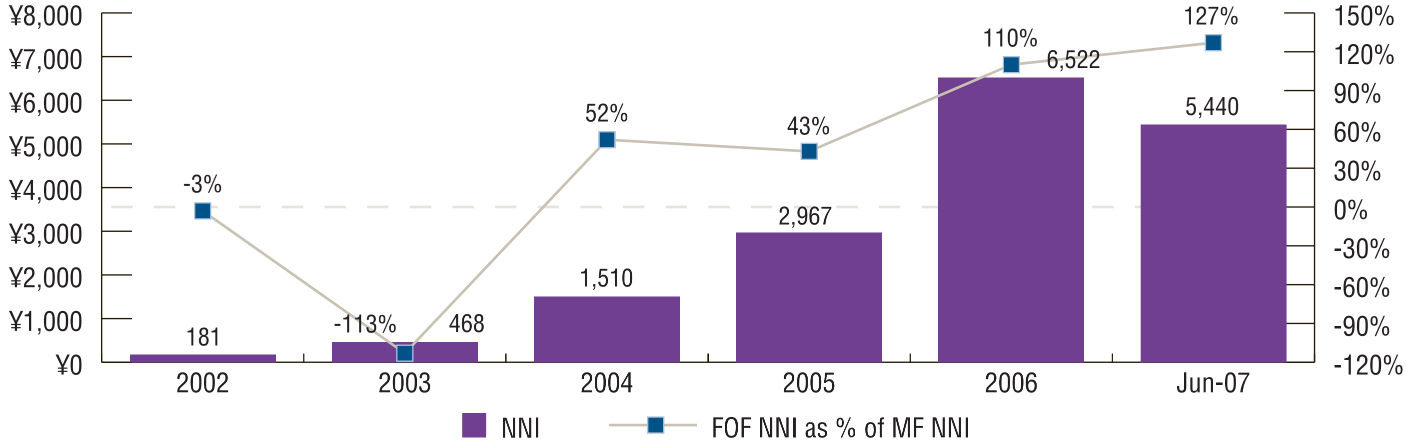
Funds of funds have been growing strongly in both absolute and relative terms.



Sources: Investment Trusts Association of Japan, Cerulli Associates

JAPANESE FUND-OF-FUNDS NNI AND AS A PERCENTAGE OF TOTAL MF NNI, 2002–JUNE 2007 (¥ trillions)

Net flows into funds of funds have exceeded total MF net flows since 2006.



Sources: Sources: Investment Trusts Association of Japan, Cerulli Associates

popularity, given investors' resistance to high management fees.

Managed accounts also contain the element of prepackaged advice, transparency, and a good revenue stream, and on the face of it, should be better-received going forward. However, to date, Japanese managed account programs are far from satisfactory. While these programs have grown since deregulation in 2004, driven largely by brokerages and lately, the trust banks, managed account assets have yet to cross the ¥700 billion mark.

FIEL: Regulating Sales Conduct

The new Financial Instruments and Exchange Law (FIEL) expands the scope of previous financial regulations. Its new Rules of Conduct for financial firms include the following:

- Delivery of written documents before making a contract, which should include fee disclosures and any "possibility of incurring loss."
- Restrictions against engaging in "the delivery of false information" and "solicitation by providing decisive judgments on uncertain matters."
- Ban on solicitation of customers who have not requested such solicitation or indicated that they do not wish to enter into a contract.
- Ban on engaging in inappropriate solicitation, in light of a customer's knowledge, experience, assets, and purpose for concluding a contract.

Alongside the FIEL is the need to reform outdated regulations separating brokerages and banking, if products targeting more conservative, high-net-worth individuals are to take off. Japan's regulator, the Financial Services Agency, appears to be in support of such a move, and the Financial Council, which advises the Prime Minister on financial matters, has already started discussions to abolish these firewalls. Once in place, the industry can expect a more concerted shift from deposits to high-alpha investments, supported by a robust and credible sales process.

Comeback kings

While the temptation for managers in the near term will be to focus on brokerages and foreign banks that are less likely to be hobbled by the new disclosure requirements, it would be a mistake to take their eyes off the domestic banks. Once the necessary sales and training procedures have been put in place, domestic banks can be expected to bounce back fitter and stronger. And investors too, although likely to remain wary of investing in the early days of the FIEL, can be expected to return with greater confidence in their financial institutions. ◆

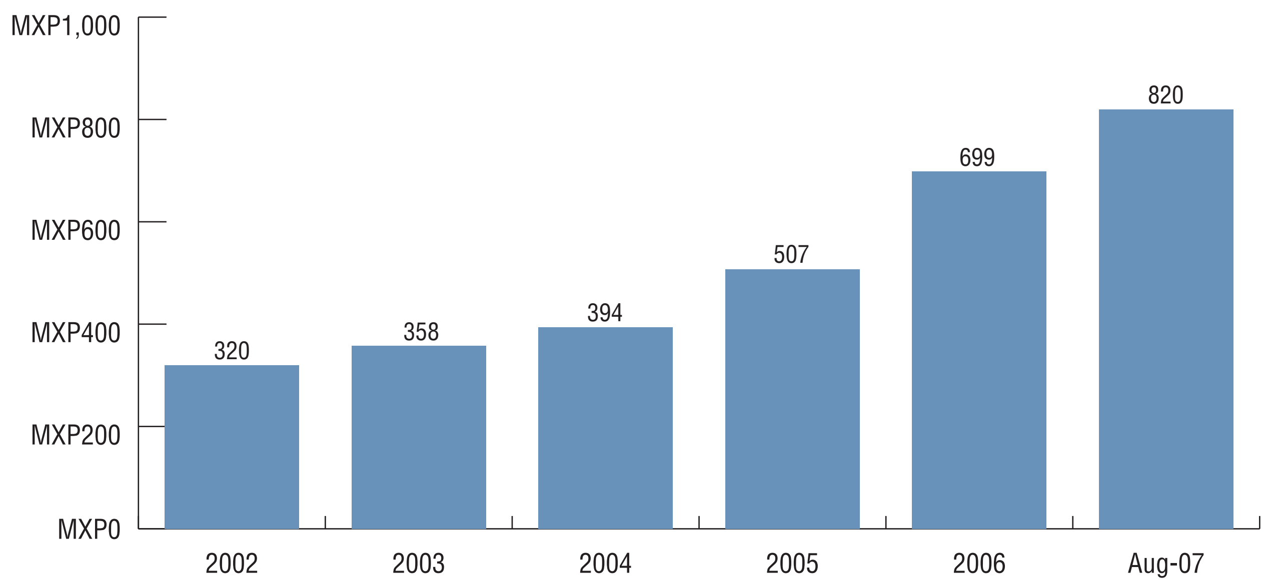
QUANTITATIVE UPDATE

MEXICO

Mexico's mutual fund market is the second largest in Latin America, far behind Brazil but with a great deal more flexibility for international investment. A major overhaul of the industry culminated earlier in the decade with the issuance of a new Investment Company Law that paved the way for independent distribution, global diversification, fund-of-funds investing, and independent oversight. Since then, the industry has grown increasingly robust and competitive as well, with new players and products entering the fray. Cerulli Associates and strategic partner Latin Asset Management have been tracking Mexico since 2001, and what follows is an assessment of key mutual fund marketplace metrics.

Industry Summary

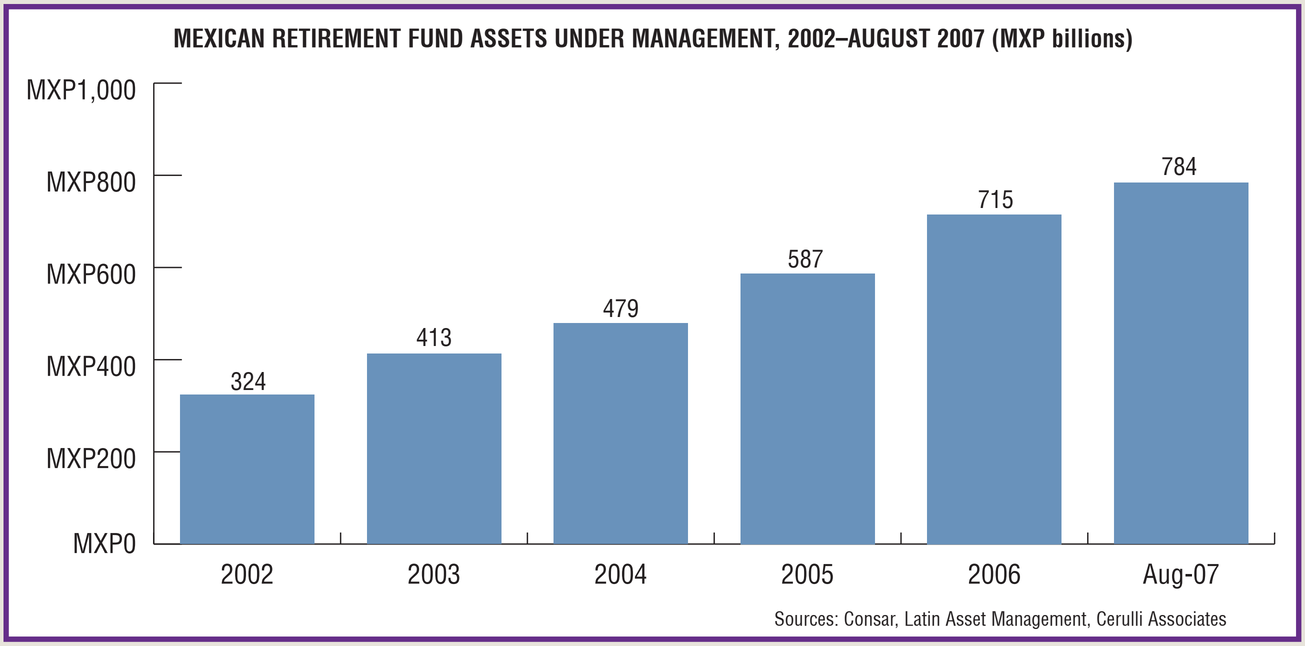
MEXICAN MUTUAL FUND ASSETS UNDER MANAGEMENT, 2002–AUGUST 2007 (MXP billions)



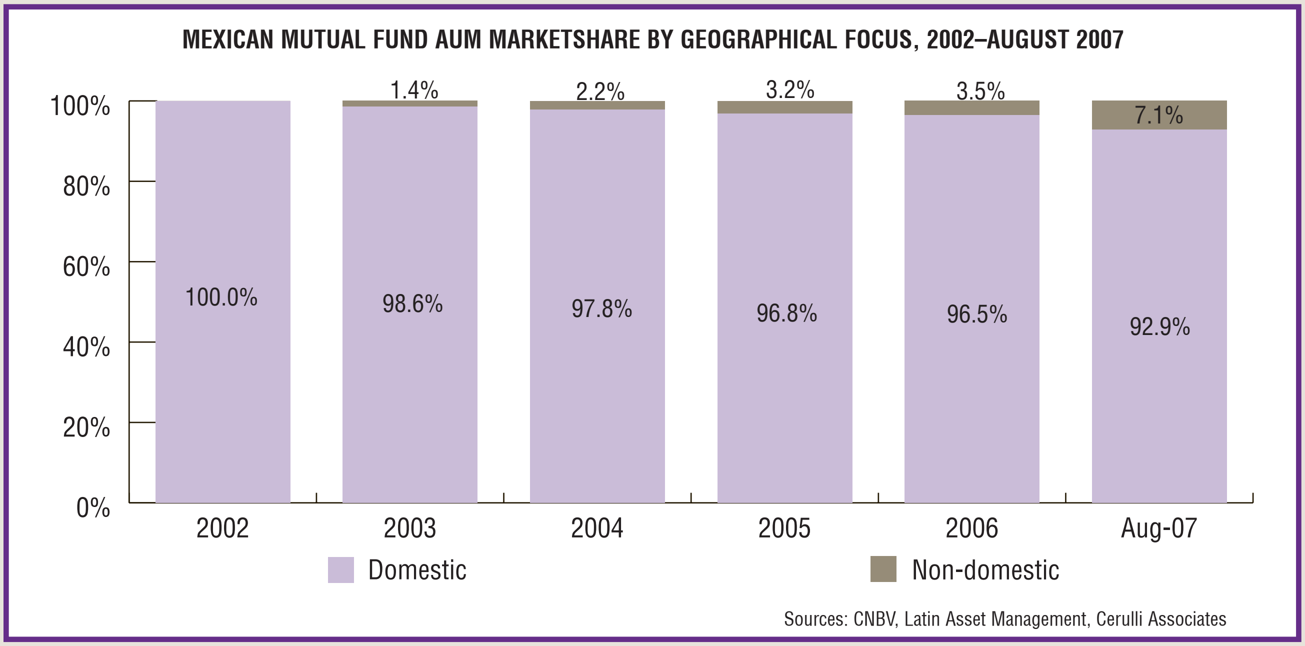
Sources: CNBV, Latin Asset Management, Cerulli Associates

- Industry assets, which have more than doubled since the close of 2004, are on course to rise more than 25% in 2007. Shrinking interest rates and demand for higher yields have forced banks to increase their emphasis on mutual funds.
- Overseas investment options are entering the Mexican marketplace. Local mutual funds may invest 100% of their portfolios in cross-border funds domiciled in major markets. Banamex recently launched a global fund of funds that allocates to cross-border funds.
- Also positive is the opening up of alternative avenues of distribution. The growing influence of fund supermarkets and the corporate pension market means that independent managers' reliance on large banking firms for distribution is dissipating.
- Regulatory moves to streamline the outsourcing of all back-office activities will allow global managers to focus on product development, investment management and distribution. In addition, local managers will be allowed to set up trusts, facilitating the development of separate account and subadvisory businesses.

MARKET SIZING

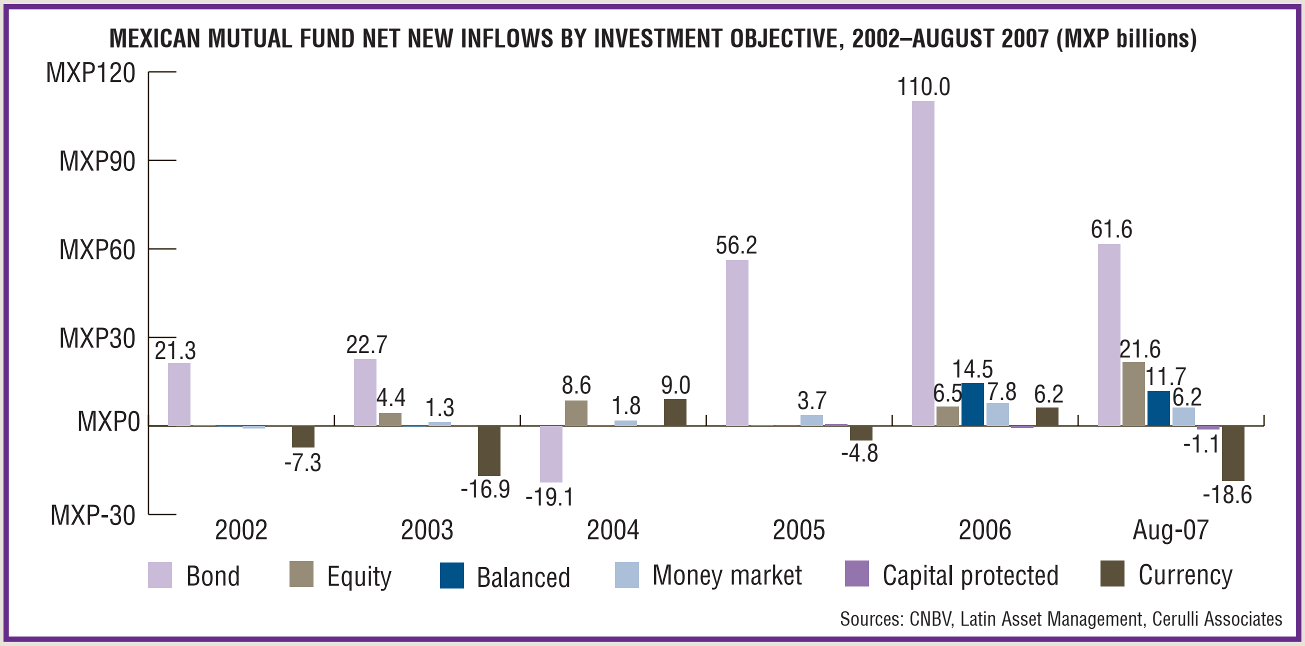


◆ Assets under management (AUM) of Mexican Sociedades de Inversión para el Retiro, or Siefores, have been doubling every four years, and the industry finished 2006 with about MXP715 billion, a 24% jump in 12 months. AUM is on track to rise about 15% to 20% in 2007. Strong flows have been fostered by new plan participants, as well as new pension fund managers joining the fray. A total of 10 Administradoras de Fondos para el Retiro (Afores) have entered the business in the last three years, reversing a consolidation trend that began shortly after the system's launch in 1998.

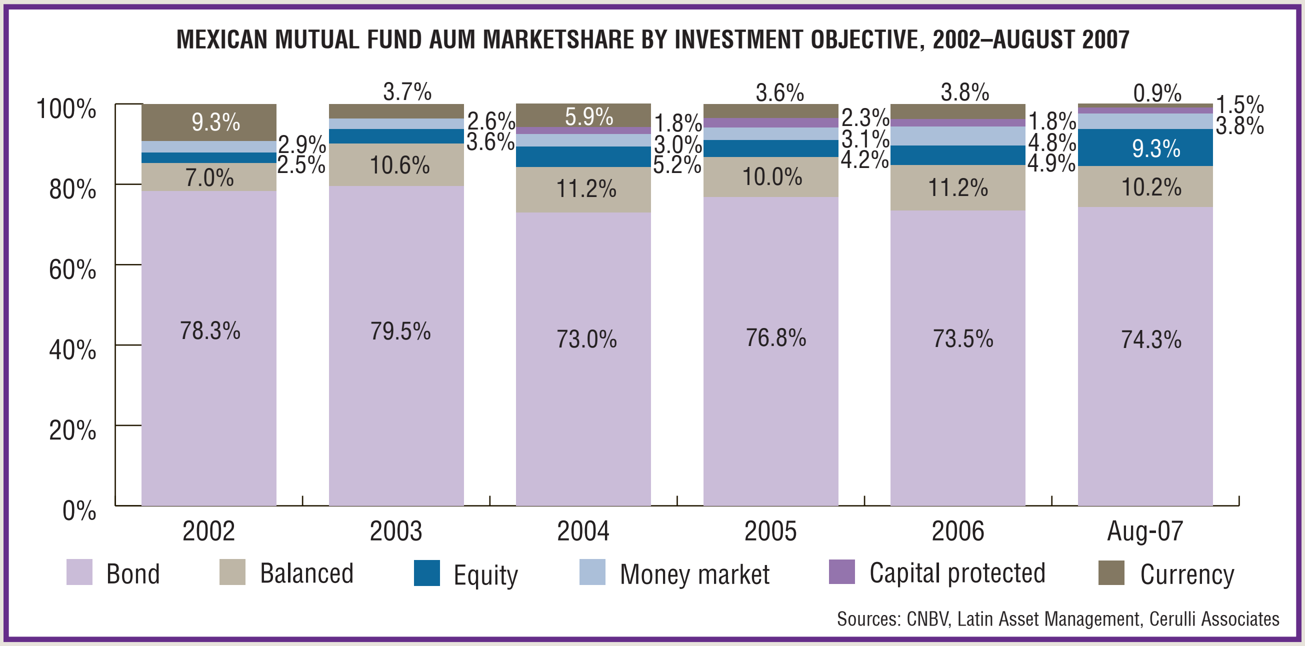


◆ Once 100% allocated to domestic vehicles, Mexican mutual funds have slowly gained some international exposure. The door to international markets has been open since 2003, when regulations facilitated the investment in foreign securities or funds. Nevertheless, only recently have local distributors begun to promote international funds, in the face of declining yields in traditional, local fixed-income vehicles.

PRODUCT DEVELOPMENT



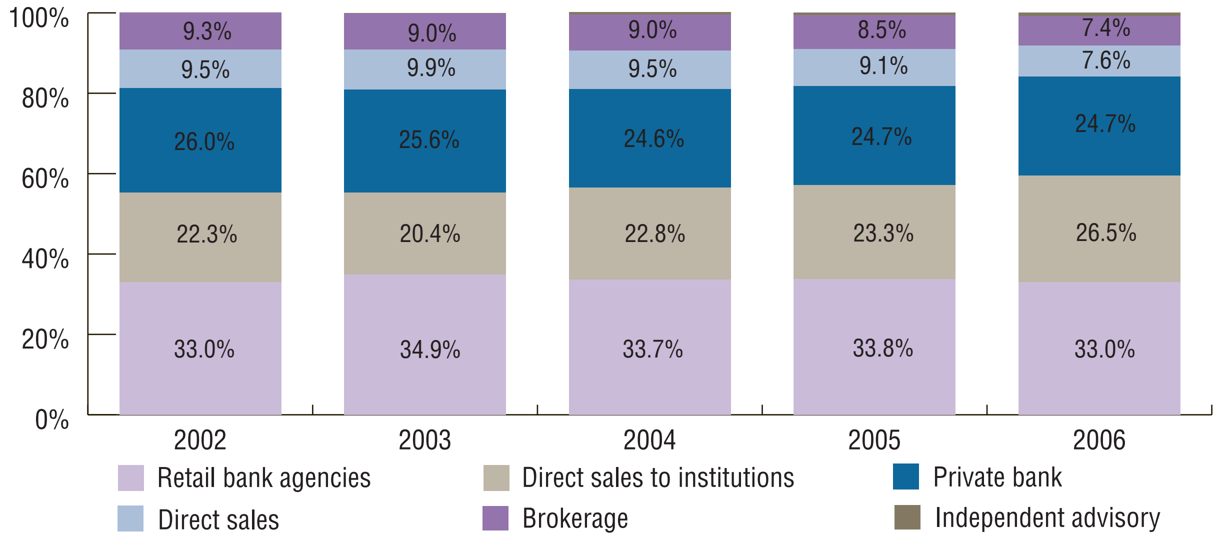
◆ In a healthy sign for the industry, equity and balanced funds are finally getting more attention. While investors may have already missed out on the steepest rises in the local stock market, at least it appears that the message of investing for the long term is seeping into the minds of the public. Flows overall have been very healthy, and the industry has managed to hold on to most of the inflows made in 2006.



◆ While fixed-income funds remained the principal target of retail and corporate investors, equity funds gained more than four points of marketshare in the first eight months of 2007. Together with balanced funds, vehicles with equity exposure accounted for more than 20% of total AUM, compared with 9.5% in 2002. Meanwhile, currency funds, which help to hedge against a declining peso, have fallen out of favor as the dollar has weakened.

DISTRIBUTION

MEXICAN MUTUAL FUND AUM MARKETSHARE BY DISTRIBUTION CHANNEL, 2002–2006



Sources: CNBV, Latin Asset Management, Cerulli Associates

◆ The institutional channel was hot in the runup to the 2006 election, as many corporate treasuries and corporate pension funds took refuge in short-term, fixed-income mutual funds. This channel includes the institutional areas of major financial services firms such as Banamex and Santander.

◆ The retail areas of these same banks now account for 33% of total AUM. Small investors have found new alternatives to bank branches: the independent advisory channel. These consist of mutual fund supermarkets and independent firms such as Prudential, Principal, Actinver and Skandia, which offer a much higher level of service to the public.

COMPETITIVE ANALYSIS

LARGEST 10 MEXICAN MUTUAL FUND MANAGERS, 2006 AND AUGUST 2007

Manager	AUG-07		DEC-06	
	AUM (MXP b)	Marketshare	AUM (MXP b)	Marketshare
BBVA Bancomer	MXP176	21.5%	MXP146	20.8%
Santander	144	17.5	120	17.2
Banamex	142	17.4	132	18.9
HSBC	46	5.6	41	5.9
Inbursa	42	5.2	37	5.4
Scotia	39	4.7	28	4.1
Banorte	35	4.2	26	3.7
GBM	23	2.8	14	2.0
Actinver	22	2.6	18	2.6
Ixe	20	2.5	18	2.5
Others	131	16.0	118	16.9
Total industry	**MXP820**		**MXP699**	

Sources: CNBV, Latin Asset Management, Cerulli Associates

◆ The top three mutual fund managers in Mexico—all bank-owned—control 56% of the market, and the top seven firms claim more than 75% of the total. Of the banks that control these managers, only Banamex and HSBC have opened up their platforms to allow third-party funds to compete alongside proprietary products. This chart underscores the stepping-up of sales efforts on the part of large banks BBVA and Santander in response to competitive challenges on multiple fronts.

QUANTITATIVE UPDATE

MUTUAL FUND AUM BY DOMICILE, AUGUST 2007 (US$ billions)

Country	Domicile	Most recent data	2004	2005	2006	Aug-07	% change (2007)
Australia	local	Aug-07	$352.1	$403.2	$474.8	$541.1	13.9%
Brazil	local	Aug-07	195.7	279.7	325.2	369.9	13.8%
	cross-border	Aug-07	20.4	18.6	22.5	27.6	22.5%
Canada	local	Aug-07	498.6	574.1	661.1	656.9	-0.6%
Chile	local	Aug-07	12.6	13.2	18.0	22.9	27.3%
	cross-border	Dec-06	21.1	27.6	35.5	*35.5*	N/A
China	local	Jun-07	42.1	61.3	109.2	*236.0*	116.1%
France	local	Aug-07	800.6	924.7	1,047.1	1,213.6	15.9%
	cross-border	Aug-07	4.4	3.3	3.4	4.1	18.3%
Germany	local	Aug-07	381.6	409.6	398.4	418.9	5.1%
	cross-border	Aug-07	207.2	270.1	312.5	371.6	18.9%
India	local	Aug-07	37.0	48.9	79.4	113.5	42.9%
Italy	local	Aug-07	503.2	506.7	479.7	417.9	-12.9%
	cross-border	Aug-07	202.0	254.3	303.0	334.8	10.5%
Japan	local	Aug-07	297.0	387.5	442.9	470.2	6.2%
	cross-border	Aug-07	50.6	64.6	70.6	65.4	-7.4%
Korea	local	Aug-07	203.7	223.7	245.1	274.1	11.8%
	cross-border	Jul-07	4.2	6.6	13.9	*13.7*	-1.7%
Mexico	local	Aug-07	36.5	46.9	64.7	75.9	17.2%
	cross-border	Dec-06	11.6	13.1	15.5	*15.5*	N/A
S. Africa	local	Jun-07	43.2	58.7	77.3	*87.8*	13.6%
	cross-border	Jun-07	6.5	9.4	13.4	*14.8*	9.8%
Spain	local	Aug-07	335.5	377.5	393.3	401.9	2.2%
	cross-border	Jun-07	24.0	45.3	59.4	*60.8*	2.3%
Sweden	local	Aug-07	107.2	141.8	172.4	181.2	5.1%
	cross-border	Aug-07	13.9	16.2	17.7	14.2	-20.0%
Switzerland	local	Aug-07	84.1	95.2	97.1	112.6	15.9%
	cross-border	Aug-07	267.0	336.7	397.1	388.6	-2.1%
Taiwan	local	Aug-07	73.3	56.2	53.9	61.0	13.2%
	cross-border	Aug-07	25.8	30.8	41.5	54.7	31.9%
U.K.	local	Aug-07	551.9	695.9	821.6	912.8	11.1%
	cross-border	Aug-07	N/A	N/A	32.8	32.3	-1.7%
U.S.	local	Aug-07	7,529.3	8,247.9	9,619.7	10,641.9	10.6%
Luxembourg & Ireland[1]	hub cross-border	Aug-07	949.2	1,408.4	1,762.4	1,962.1	11.3%

Notes: June 30, 2007 exchange rates used. Italics indicate countries where current month data has not been reported.
[1]Total, excluding cross-border fund assets reported in other domiciles

Sources: Cerulli Associates, Latin Asset Management, EFAMA, Strategic Insight/SIMFUND, www.planforlife.com.au, Europerformance, IFIC, BVI, AMFI, DFIA, Assogestioni, Investment Trusts Association, ALFI, AMAK, ACI, Inverco, CNMV, Fondbolagens Forening, SFA, SNB, SITCA, IMA, FERI FMI

Quantitative Update aims to provide summary information about global mutual fund industries. Further information can be found in **Cerulli Quantitative Update: Global Markets,** formerly **Cerulli Global Update**.

QUANTITATIVE UPDATE

GLOBAL MUTUAL FUND STATISTICS, AUGUST 2007 (US$ billions)

	Assets Under Management			Net New Inflows		
Country	**2006**	**Aug-07**	**% change**	**2006**	**Aug-07**	**YTD Aug-07**
Australia	$474.8	$541.1	13.9%	N/A	N/A	N/A
Brazil	347.7	397.5	14.3%	0.4	1.5	17.5
Canada	661.1	656.9	-0.6%	21.2	-1.5	25.3
Chile	53.5	58.4	9.2%	4.1	2.4	3.9
China	109.2	236.0	116.1%	N/A	N/A	N/A
France	1,050.6	1,217.7	15.9%	79.1	-39.1	46.5
Germany	710.9	790.5	11.2%	2.0	-11.3	37.7
India	79.4	113.5	42.9%	23.8	-4.0	31.1
Italy	782.7	752.7	-3.8%	-34.6	-5.5	-49.1
Japan	513.5	535.6	4.3%	48.7	38.6	197.1
Korea	259.0	287.8	11.1%	26.4	*5.8*	*22.9*
Mexico	80.2	91.4	13.9%	24.0	0.9	7.5
S. Africa	90.7	102.5	13.1%	*9.0*	*1.7*	*5.9*
Spain	452.8	462.7	2.2%	-3.5	-0.5	-3.2
Sweden	190.1	195.4	2.8%	4.1	0.3	-1.7
Switzerland	494.2	501.1	1.4%	7.1	-2.4	-0.5
Taiwan	95.4	115.7	21.3%	-4.2	0.6	0.2
U.K.	854.4	945.1	10.6%	38.0	1.6	5.3
U.S.	9,619.7	10,641.9	10.6%	452.2	154.6	542.5
Luxembourg & Ireland	1,762.4	1,962.1	11.3%	273.4	-33.7	136.1
Sum of above	**$18,682.3**	**$20,605.7**	**10.3%**	**$971.3**	**$109.9**	**$1,025.0**
Other	864.5	953.5				
Total	**$19,546.8**	**$21,559.1**	**10.3%**			

Notes: June 30, 2007 exchange rates used. New data often triggers restatements. Country AUM levels include local holdings in cross-border funds where such data is available. Such funds have been removed from the Luxembourg and Ireland total; removed assets may actually reflect assets held in other domiciles.

Sources: Cerulli Associates, Latin Asset Management, EFAMA, Strategic Insight/SIMFUND, www.planforlife.com.au, Europerformance, IFIC, BVI, AMFI, DFIA, Assogestioni, Investment Trusts Association, ALFI, AMAK, ACI, Inverco, CNMV, Fondbolagens Forening, SFA, SNB, SITCA, IMA, FERI FMI