THE CERULLI EDGE
U.S. ASSET MANAGEMENT EDITION

SEPTEMBER 2007 ◆ GATEKEEPERS & PRODUCT IMPACT ISSUE

10TH ANNIVERSARY ISSUE

*As we celebrate the 10th anniversary of The Cerulli Edge—U.S. Edition, Cerulli Associates is pleased to announce that effective with this issue, the publication's name will change to **The Cerulli Edge—U.S. Asset Management Edition**. This name better reflects the content and focus of the publication—trends and new developments in the U.S. asset management industry—and further helps to differentiate this flagship publication from the five distinct editions of The Cerulli Edge it inspired over the last decade (Global, Managed Accounts, Advisor, Asia-Pacific, and Retirement).*

The perspective in The Cerulli Edge—U.S. Asset Management Edition will continue to be based upon the same repeatable, two-pronged proprietary research process (interviews and surveys) that has served as the foundation of our published research since 1994, providing subscribers with the necessary context, intelligence, and key implications to navigate today's market environment.

Paramount Product Solutions

The art of successful product development today

It may be a given that gatekeepers are highly influential, but getting them to buy into an investment manager's product is more elusive. As always, generating superior investment performance is quite helpful, yet turning out competitive returns year in and year out is exceedingly difficult.

Developing unique products can also grab the attention of gatekeepers, yet product development is challenging in a mature marketplace. Product development decisions have historically been based on investor demands and competitive research. While fund firms still need to study demand trends and conduct competitive analysis, the implementation of these results may be quite different from in the past.

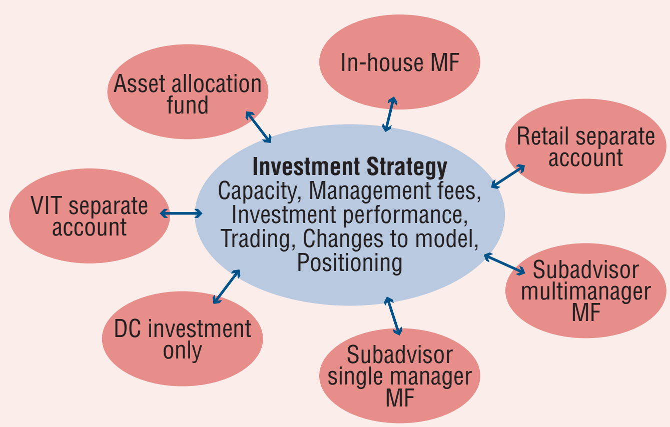
By concentrating on their own priorities of developing and rolling out products utilizing their core competencies and clientele preferences, for example, firms may come to the conclusion that the paramount product solution is to partner with a competitor in a subadvisory—even a multimanager subadvisory—arrangement.

In this issue we take a close look at product development in the context of portfolio construction. We evaluate the changing institutional landscape, and we examine what the industry—asset managers and professional buyers themselves—believes is most vital for getting, and staying, on the good side of gatekeepers.

Our quantitative section, built from our latest intermediary research, reveals trends in product usage by financial advisors. ◆

MULTI-VEHICLE, MULTI-CHANNEL DISTRIBUTION

Multi-vehicle, multi-channel distribution offers the opportunity to fully exploit investment strengths; however, asset managers must manage their capabilities and resources judiciously.



Analyst Note: This diagram defines the ways an asset manager might leverage its investment expertise through different channels and vehicles. Source: Cerulli Associates

PORTFOLIO CONSTRUCTION

Beginning with the End in Mind

Fresh thinking is influencing portfolio construction

Asset managers must develop their product and distribution strategies in the context of their role in an investor's comprehensive portfolio solution.

A convergence of forces in the financial services industry is having a meaningful impact on portfolio construction. These changes are influencing asset managers in almost every element of their business, from their manufacturing strategies (and related merger and acquisition strategies) to their product and distribution strategies. This discussion examines asset management product strategy and distribution in the context of retail advisor-built portfolios, highlighting Janus's Modular Portfolio Construction (MPC) program, and presenting 130/30 funds as a case study of incorporating alternatives in an investor's portfolio construction.

Defining portfolio construction

The phrase *portfolio construction* is often tossed around casually, applied as both noun and verb, and it is sometimes difficult to distinguish from portfolio management. Cerulli describes portfolio construction as more holistic and investor-outcome-focused than portfolio management, which we view as less encompassing and principally investment-centric.

There is also a meaningful nuance, that of timeline—portfolio construction refers to how a portfolio is built and how all the pieces, or building blocks, fit together to achieve an institutional or retail investor's desired outcome. Portfolio construction

INSIDE THIS ISSUE

The Cerulli Edge™—U.S. Asset Management Edition is dedicated each month to a specific financial services industry theme. **In October, we publish our annual Readers' Choice issue.** The annual subscription price is US$11,000 per client firm and is available in hard copy and 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 CAmarketing@cerulli.com for login details.

also refers to the financial engineering of structured products. Portfolio management refers to the long-term monitoring and oversight of a portfolio, based on a specific investment strategy (*e.g.*, small-cap growth), as well as the ongoing rebalancing, involving the buying or selling of certain securities or products.

In many situations—for example, target-date/lifecycle funds—an asset manager acts as both portfolio constructor and manager. The portfolio construction elements involve the decisions around the optimal blend of strategies and vehicles, as well as the most efficient glide path to meet the fund's objective, which is tied to a specific target date. The portfolio management elements include the selection of specific securities within each of the underlying funds or sleeves that make up the product.

Portfolios are constructed by a cast of contractors, including asset managers, overlay managers, advisors, and investors. Model portfolios constructed for managed account platforms are a frequently discussed area of portfolio construction. Model portfolios hard code—to varying degrees—portfolio construction with the advisor ceding some or all of the allocation decisions to the platform. This article focuses on asset managers working with advisors in situations where the advisor retains control of the portfolio construction.

The implications of portfolio construction

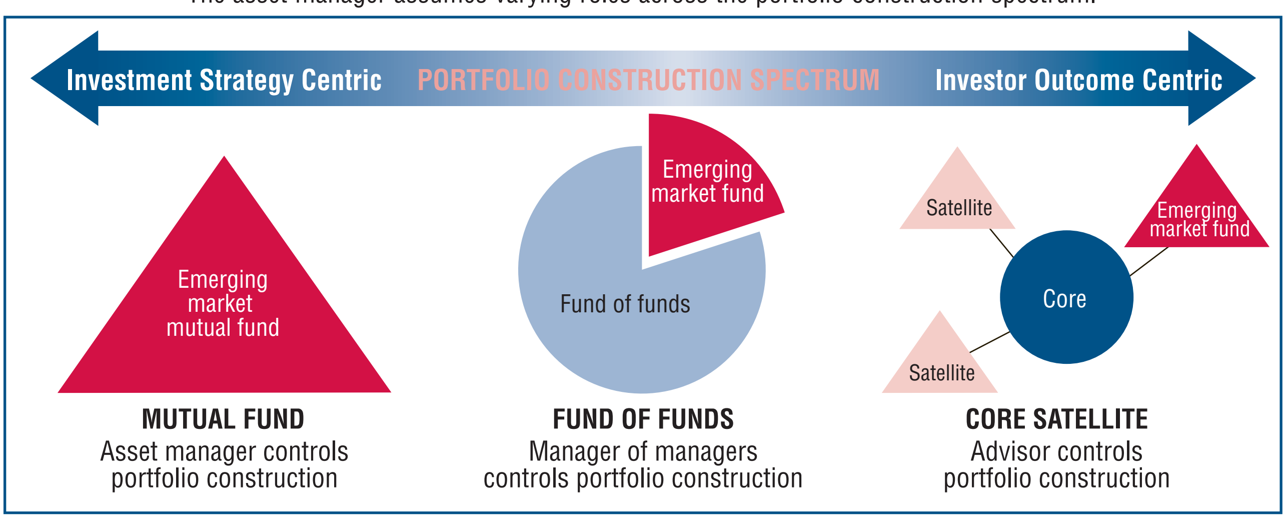
Not long ago the average retail investor's long-term investments comprised one or two mutual funds and perhaps some individual securities. Even today many investors' portfolios consist of only a couple of products, which, in the end, may or may not meet their desired outcome.

As they have accumulated greater wealth (or in some situations found themselves with a potential retirement funding shortfall), and subsequently accumulated more financial products, many investors have begun to focus on whether their portfolios will meet their desired outcome. A growing number of investors has chosen to "set it and forget it" by directing their defined contribution (DC) or 529 contributions to embedded-advice solutions, mostly target-date/lifecycle funds. Many have chosen to work with an advisor to create a more comprehensive plan.

This shift is having meaningful implications on asset managers. If an investor holds one or two mutual funds, portfolio construction is less relevant to the asset manager. In this scenario, the asset manag-

THE PORTFOLIO CONSTRUCTION SPECTRUM

The asset manager assumes varying roles across the portfolio construction spectrum.



Source: Cerulli Associates

er is managing its mutual funds to optimize performance against the fund's peer universe. If the asset manager has strong performance, it stands in a reasonable position to control a sizable piece of the investor's portfolio. If an investor holds more than a few mutual funds, the asset manager's strategy and performance remains important, but may also be viewed in the context of the overall portfolio.

At the same time, advisors' approach to portfolio construction is being influenced by a number of factors, including retail managed account platforms, the popularity of alternative investments, and fresh thinking in portfolio theory.

During the end of the 20th century, the introduction of modern portfolio theory (MPT) moved the investment management industry beyond a two-dimensional process of risk-and-return analysis at an individual security level. MPT compelled investors to assess a portfolio more holistically and add a third dimension—asset allocation among uncorrelated markets.

A number of factors are influencing portfolio theory and compelling some in the industry, particularly in institutional circles (which often trickles down to retail channels), to apply fresh thinking about MPT, and test new ideas about how portfolios should be constructed. MPT is rooted in the idea that markets are efficient, and while the marketplace hasn't exactly rebuffed MPT, there is wider acceptance of MPTs limitations.

The controversy is intensifying with the expansion of alternative investments, as well as the reorientation among both institutional and retail investors to managing toward specific outcomes, beyond merely the risk-reward characteristics of a portfolio. Amid the sometimes frivolous discussion around the separation of alpha and beta, there have been important developments in investment theory and portfolio construction—with potentially far-reaching implications. In pension circles, liability-driven investing has been a central discussion as firms have sought to address underfunded pensions.

At the same time, behavioral finance has come to the fore as money managers have attempted to understand the irrational nature of investors, which sometimes makes markets less than efficient.

Core-satellite

The nine-style-box system of asset allocation that is rooted in MPT and was popularized by Morningstar, and even led to a generation of style box "pure" new products, has become less applicable as advisors incorporate "go anywhere" non-style-box-pure products and alternative investments in their clients' portfolios.

One framework that advisors apply to portfolio construction is a core-satellite approach (see chart at bottom of page 17). Core-satellite is not new, particularly in the institutional marketplace, but it is becoming more top-of-mind in the retail marketplace, while at the same time it is evolving. Traditionally, asset allocation has been defined as a way to reduce portfolio risk by allocating assets among a diverse group of asset classes, in particular those that demonstrate low correlation. Core-satellite approaches employ diversification as one tool, but also distinguish between the alpha and beta components of a portfolio, recognizing that certain markets are more efficient and offer less opportunity for active managers to consistently derive benchmark-beating returns.

The definition of "core" varies somewhat—strictly interpreted, core represents the passively managed component of the portfolio. The core has sometimes been described as the tortoise, or workhorse, of the portfolio. The "satellite" component of the portfolio complements the core by seeking alpha. These slices of a portfolio may include individual stocks, a hedge fund or 130/30 fund, a structured product, real estate, emerging markets, commodities, precious metals, and other nontraditional investments.

The concept of core-satellite is vehicle agnostic, but certain product structures tend to fall under the core or satellite components. Low-fee passively managed mutual funds and exchange-traded funds (ETFs) that track mainstream indexes are deemed ideal core holdings. One of the arguments for core-satellite is that by using low-fee vehicles for the core, it boosts returns because of the savings on fees and taxes.

Product strategy: Building blocks versus complete solutions

Asset managers must consider whether they want to operate as a building block of a portfolio, deferring 100% of allocation decisions to the portfolio constructor, develop products with embedded advice, or straddle both. Acting in this multi- dimensional capacity poses a challenge for marketers as they seek to establish brand recognition and convey the brand's attributes.

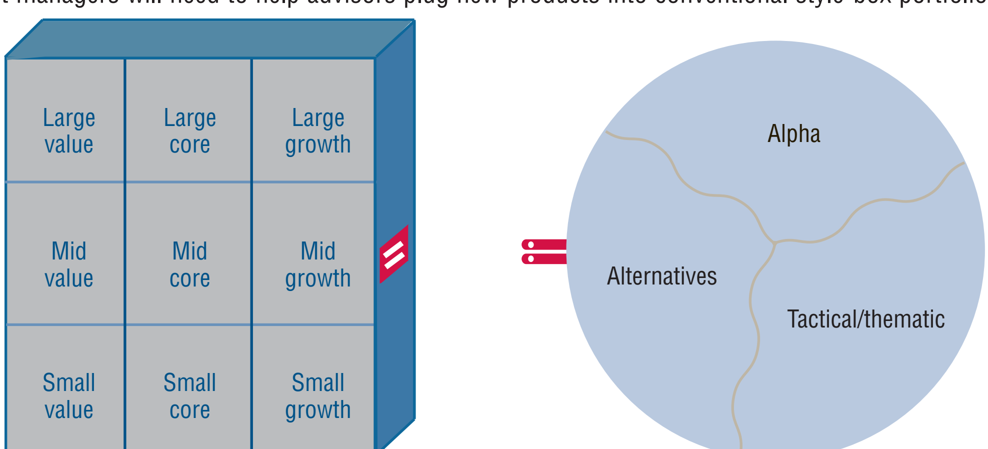
As product developers conceptualize and design the next iteration of retail investment product solutions, Cerulli counsels asset managers to define their strategies in the context of what role they play in investors' overall portfolio construction. There has been abundant discussion in the industry of the need, and the opportunity, for asset managers to develop outcome-focused products. Yet the opportunity for asset managers to manage only one or two, or even several, slices of a retail advisor-built portfolio remains meaningful.

When operating as a building block, asset managers must approach product development and positioning with the end in mind. While it will remain important for them to convey attributes such as their integrity and solid investment performance, they must also communicate how a particular product fits into an investor's overall portfolio and help advisors more effectively construct portfolios that meet a desired outcome. The building blocks that an asset manager markets may be ideally suited to be the core of a portfolio, or better suited as a satellite component.

Some of this can be accomplished through branding and the use of taglines. Asset managers are balancing the traditional mindset, which reflected portfolio construction through the lens of the nine Morningstar style boxes and measured performance in relative terms, with an emerging and evolving mindset that views portfolio construction through a more holistic lens. Taglines such as "we have the style boxes covered" and product names

NEXT-GENERATION PORTFOLIO CONSTRUCTION

Just as asset managers helped educate advisors about the importance of moving from commission-based to fee-based business, asset managers will need to help advisors plug new products into conventional style-box portfolio construction.



Source: Cerulli Associates

including The Small Cap Value Fund reflect how, in the recent past, asset managers often positioned their product lines within the nine-style-box framework. These approaches contrast with more contemporary taglines—from MFS' "Choose what fits in your client's portfolio" to Rydex's "Essentials for Modern Markets."

Providing education on portfolio construction, both within their own organizations, as well as with their third-party advisors, and offering tools that support this effort, will be even more imperative.

130/30 funds

Product development in the area of 130/30 and other similar strategies offers a textbook example of the importance of asset managers approaching product strategy in the context of how advisors construct their clients' portfolios. The quest to bring hedge fund qualities to the retail investor is most evident in the number of 130/30 funds that have been filed or are on the drawing board.

Asset managers must determine how their organizations will position—and teach advisors to employ—modern products such as 130/30 funds (establishing whether these products should be considered core or satellite components of a retail investor's portfolio).

A number of asset managers have 130/30-type strategies on the drawing board. BNY Mellon Asset Management recently tapped its affiliate, quantitative manager Mellon Equity, to launch its Extended Alpha Large Cap Core Strategy, and also registered the Dreyfus Premier 130/30 Large Cap Growth Fund. While some of this proliferation is a reflection of the herd mentality that shapes much of new mutual fund product development, some of it reflects the latest theory that the ability to employ both long and short strategies is a better way to invest.

Asset managers need to deliberate about the appropriate positioning for these products in retail investors' portfolios, as well as whether they possess the investment aptitude to successfully manage a 130/30 or similar product. Fundamental equity managers may face an uphill battle convincing gatekeepers that their process will uncover fruitful opportunities to short stocks. Some gatekeepers insist that they will not add 130/30 funds to their platforms unless they are run by quantitative shops. Even then, the portfolio managers will have to prove that their "black box" mathematical models will produce meaningful short-selling opportunities over the long term.

Among the other challenges, including trading conflicts among portfolios, that asset managers will encounter as they consider launching these products is whether these funds are truly a retention tool, or actually a training ground for portfolio managers to acquire the needed skills to depart for the seemingly greener pastures in the hedge fund arena.

The question of how 130/30 funds should be deployed—within the context of an investor's portfolio construct—is also being debated. Because this cohort of investment products is largely untested, and there is some confusion around the distinctions between these strategies and absolute-return strategies, these products are sometimes deemed niche products that should be delegated to the satellite component of an investor's portfolio. Others view these products as a superior approach to long-only investing, and appropriate as core investments. Asset managers must determine how their organizations will position—and teach advisors to employ—these modern funds (*i.e.*, establishing whether they should be considered core or satellite components of a retail investor's portfolio).

CASE STUDY
JANUS INVESTMENTS

Modular Portfolio Construction

Janus Investments and its affiliate Intech have developed a range of value-added programs targeted to retail advisors that they market under the moniker Janus Labs. The financial engineering segment of Janus Labs is an innovative program aimed at helping advisors navigate the evolving landscape of investment options and construct portfolios that optimally meet their clients' desired outcomes. An in-depth discussion of asset managers' advisor-focused value-added programs will appear in the October issue of *The Cerulli Edge—U.S. Asset Management Edition*.

Within its Janus Labs framework, the Denver-based manager has developed an original tool it promotes to third-party advisors, labeled Modular Portfolio Construction (MPC). The idea was conceived more than two years ago as a result of the research and focus groups that Janus conducted to evaluate how it could help advisors navigate the evolving landscape of investment products, including "go anywhere"-type mutual funds and alternative investments that don't fit squarely into the nine-style-box allocation model.

Janus' MPC offers a next-generation approach to the core-satellite portfolio construction. Instead of presenting the traditional approach of a core surrounded by satellites, Janus' model encircles the core with three modules: alpha, alternative, and tactical. The core may be comprised of ETFs and index funds as well as actively managed large-cap funds, while the alpha component might include mid- or small-cap funds, international strategies, or even "go anywhere"-type strategies. The alternative slice might comprise gold mining or other natural resource stocks or funds, hedge funds, or 130/30-type strategies. The tactical piece provides a structure for incorporating more thematic opportunities; an investor might overweight growth or infrastructure, for example.

MPC was not designed to directly promote Janus products; it is a value-added tool meant to assist the segment of advisors that can benefit from further education in the area of portfolio construction. This tool is not targeted to the sophisticated cohort of RIAs that already possesses in-depth investment knowledge in this area. This is also a program that helps Janus make their mark in the industry, in an area where it leverages its investment expertise, without going head to head with its competition in an already crowded arena such as retirement income.

Cerulli believes that the asset managers that are able to produce superior investment returns, but also show advisors how to effectively construct outcome-oriented portfolios for their own clients by using the asset managers' products as some of the building blocks, will be able to successfully differentiate themselves from the rest of the competition.

Distribution: Piecing it all together

Changes in the financial services landscape have reenergized product development, spawning innovation in 130/30 funds, structured products, and other newfangled products—yet many advisors do not know how to optimally deploy these vehicles within investors' portfolios. Asset managers can help advisors think more relevantly about portfolio construction, and should think about which advisors will be receptive to their message. A boutique asset manager that does not assemble any embedded-advice solutions and focuses on investing in emerging markets needs to identify advisors that are constructing portfolios for their clients that include emerging markets.

Advisors have varying degrees of influence over portfolio construction. Some of their level of expertise aligns with their channel, with RIAs generally deploying more sophisticated approaches. There are many approaches within each channel, however, and even within advisors' own practices they may apply different levels of portfolio construction depending on a client's needs, net worth, stage of life, and risk tolerance. A young client who is just beginning to build their portfolio may be steered to an embedded-advice fund, while a client with a larger nest egg may be guided into a managed account solution where the portfolio construction is controlled by the overlay manager.

The core expertise of Russell Investments, a West Coast-based global multimanager, is in manager selection and portfolio construction. In its strategic planning, Russell Investments has conducted extensive segmentation analysis and split advisors into three principal groups: wealth managers, who take a holistic view of an investor's portfolio, portfolio constructionists, and money managers. Russell has chosen to target wealth managers, as they are the most receptive to Russell's approach because these advisors want to outsource the portfolio construction component of their business. Portfolio constructionists, on the other hand, focus on portfolio assembly—building an investor's portfolio through the selection and allocation of the investor's assets to a group of packaged products, such as mutual funds, and would be less likely to utilize Russell's products.

As new products come to market, product providers must invest time and effort teaching advisors how to effectively use these products within an investor's portfolio construction. Cerulli points to Janus' Modular Portfolio Construction (MPC) as a solid example of the newest generation of portfolio construction initiatives that we anticipate asset managers will create (see case study on page 7). ◆

PROFESSIONAL BUYERS

Making the Grade

Vital factors for fostering relationships with professional buyers

Recognizing the importance of professional buyers is a given, but what does the industry—asset managers, and the buyers themselves—say is most vital for fostering these relationships?

Investment managers have come to appreciate that professional buyers—gatekeepers such as investment consultants, multimanagers, subadvisory selection committees, and managed account research analysts—influence an ever greater percent of sales. Getting on the good side of these gatekeepers means not only making the grade, but being repeat winners, and in some cases, being hard-coded into asset allocation models.

Recognizing the importance of professional buyers is a given, but what does the industry—asset managers, and the buyers themselves—say is most vital for fostering these relationships? Cerulli research reveals that three key ingredients are contact management, prioritizing product, and knowing what pro buyers want—and delivering it.

Contact management

Effectively managing gatekeeper relationships—rapport with the actual individuals involved—is one of the key factors for investment management success among professional buyers. Without question, the day-to-day contact is essential.

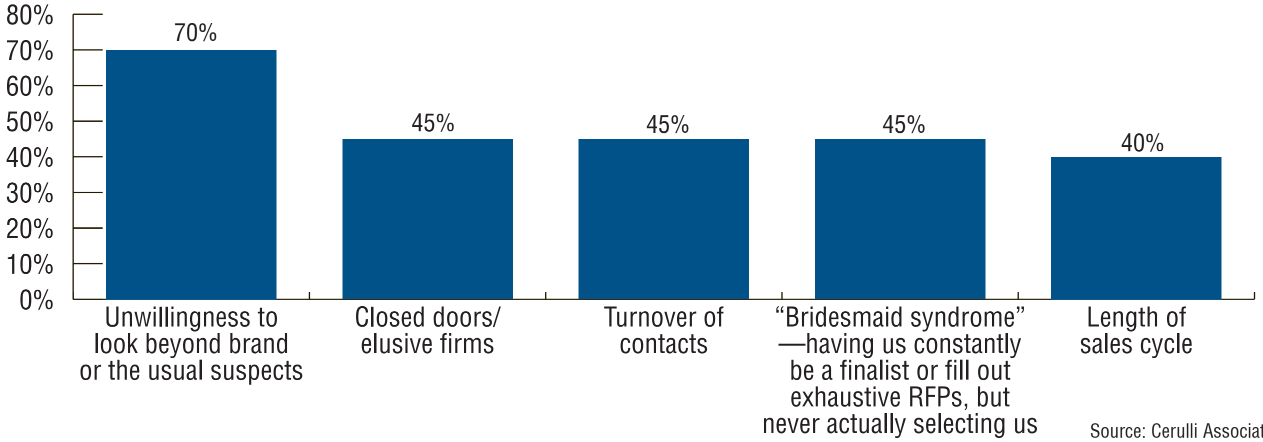
Among professional buyers, two common arrangements include a research professional assigned to cover the entire asset management firm, or a research professional assigned to a particular asset class. The arrangement will dictate the nature and complexity of the relationship. While from the asset manager's perspective, having gatekeepers segmented by firm is beneficial (the manager can theoretically discuss the entire product line in one visit), it is also less common: roughly half (48%) of professional buyers surveyed segment their analysts by asset class, while less than 15% focus on particular asset management firms regardless of asset class.

An important item on any asset manager's to-do list is to identify influential secondary players beyond the initial point of contact. This could include the backup analyst dedicated to the firm, product, or asset class in question. Recent data from managed account surveys shows that there are approximately eight analysts per managed account group. In many cases, there is a formally defined backup procedure.

This task is significant, as turnover is a major problem. The problem is a bit ironic

GREATEST SOURCES OF FRUSTRATION WITH THE CONSULTANT COMMUNITY, PART I

While professional buyers don't appreciate portfolio manager turnover at their investment management partners, they experience quite a bit of turnover themselves—to the frustration of investment manager partners.



Source: Cerulli Associates

because while professional buyers don't appreciate portfolio manager turnover at their investment management partners, they experience quite a bit of turnover themselves. A Cerulli survey of multimanagers cites portfolio manager turnover as the most common reason for terminating a relationship with an investment manager. At the same time, 45% of institutional investment managers named turnover at the professional buyer (in this case, investment consulting firms) as a major source of frustration. Adding to their frustration, turnover of professional buyers is quite frequent and likely much more common than portfolio manager turnover. This creates a most unpleasant scenario: perhaps the investment manager has spent months, if not years, trying to forge a strong relationship with the distributor/intermediary, only to have it disrupted by turnover.

Cerulli analysts believe that turnover will continue to be prevalent at gatekeepers. One reason for this is the gatekeepers—whether broker/dealer (B/D) research arms, or even investment consulting firms—tend to be operations run with thin margins. Thus, undercompensation is a continued issue for research professionals. As these individuals pursue and complete the Chartered Financial Analyst (CFA) program, they become ideal candidates for other, higher-paying jobs, such as portfolio management.

So what can asset managers do about this? To the extent that they can forge relationships with other professionals, the effects of turnover can be mitigated. At the start of the relationship, the investment manager should ask, who is the main point of contact? Who is the backup? To whom does the professional buyer report? To whom does the research group report into within the greater parent organization (*e.g.*, B/D firm), if any?

Having answers to these questions does not immediately solve the problem. Note that in the chart below, 45% of institutional managers cited that certain professional buyers can be elusive. Consider the case of consulting firms: such firms often have in-house research staffs, which may be centralized and specialized, dedicated to research and research alone (they do not meet with clients). Meanwhile, it is the responsibility of field consultants to go out and visit with existing and potential clients. Usually (though not always), field consultants rely on centralized research, and as such, will have less direct influence over what product gets sold to clients. Some are actually forbidden from recommending any

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INSTITUTIONAL ASSET MANAGEMENT

Paradigm Shift

Broad changes usher in different opportunities

The demand for stable returns and moderate risk; understanding future liabilities; and a quest for low correlation with both equities and bonds are fueling institutional demand for a new method of investing assets.

The institutional landscape is changing. The demand for stable returns and moderate risk; understanding future liabilities; and a quest for low correlation with both equities and bonds is fueling institutional demand for a new method of investing assets. Here we examine what types of managers are poised to capitalize on these changes.

The institutional marketplace stood at $14.3 trillion at year-end 2006. These assets are managed on behalf of any non-retail investor. This includes defined benefit (DB—both public and private), defined contribution (DC—public, private, and union), endowments, foundations, insurance general accounts, and subadvisory (both mutual fund and variable annuity).

Notably, many high-net-worth investors and family offices start to achieve quasi-institutional status, due to the size of their accounts and the depth of services required. Nonetheless, Cerulli chose to classify these investors as retail, even though they may be more complicated and demanding than an ordinary retail investor. Despite the high-net-worth client's wealth, such investors usually do not carry the heavy burden of fiduciary duty, whereas institutional clients make decisions every day that impact the lives of others.

LARGEST INSTITUTIONAL ASSET MANAGERS, 2006 ($ millions)

Though there is some crossover from the retail world—in some cases under a different but related brand—the managers that dominate the institutional space are largely a different cast of characters.

Rank	Manager	Total Assets	Marketshare
1.	State Street Global	$1,690,881	11.8%
2.	Barclays Global	1,457,745	10.2
3.	Fidelity	930,442	6.5
4.	Legg Mason Partners	744,816	5.2
5.	Mellon Financial	744,534	5.2
6.	BlackRock	680,265	4.8
7.	AIG Global	677,549	4.7
8.	Northern Trust Global	606,534	4.2
9.	Wellington Management	574,117	4.0
10.	Vanguard	563,247	3.9
11.	PIMCO/Allianz Global	548,064	3.8
12.	JPMorgan Asset Management	535,440	3.7
13.	AllianceBernstein Institutional	455,105	3.2
14.	Prudential Financial	424,565	3.0
15.	ING	411,324	2.9
16.	UBS Global Asset Management	387,013	2.7
17.	TIAA-CREF	376,814	2.6
18.	Goldman Sachs	367,167	2.6
19.	Deutsche Asset Management	328,880	2.3
20.	Morgan Stanley	316,869	2.2

Sources: *Pensions & Investments*, Cerulli Associates

The players

Historically, the attributes sought by retail investors have diverged somewhat from the institutional audience. True, both camps prefer managers with successful track records as measured by investment performance, both in absolute terms and relative (versus peers or benchmarks). But in the case of institutional investors, attributes such as brand are deemphasized in favor of investment process and firm ownership structure.

This is important for asset managers with a historical focus in the retail space: the brand name they have forged may translate into little value on the institutional side. Indeed, success on the retail side can be viewed as a stigma on the institutional side. The perception is that such managers are "too retail," can't create customized solutions, and generally do not understand the specific needs of institutional clients. It is not surprising that firms such as Fidelity Investments create new branding messages for their institutional investment management arm, Pyramis Global Advisors.

Though there is some crossover from the retail world—in some cases under a different but related brand—the managers that dominate the institutional space are largely a different cast of characters. For example, while Fidelity and Vanguard are represented on both lists, other well-known fund retail-oriented managers such as Franklin Templeton and Columbia Funds fail to crack the list of the 20 largest tax-exempt institutional managers.

Shifting times

Increased regulation in the form of the Statement of Financial Accounting Standards 158 (SFAS 158) and the passage of the Pension Protection Act (PPA) of 2006 have reduced smoothing capabilities (*smoothing* refers to the ability to amortize gains and losses on assets and liabilities over a number of years, rather than recognize their market values, called "mark-to-market") in calculating asset and liability values in DB plans, the segment in which the largest amount of institutional assets resides. These changes have led to an increase in liability-driven investing (LDI).

LDI refers to the process of managing investments with explicit reference to a specific set of liabilities. In order to be able to meet liabilities regularly, asset allocation in the plans will likely move to more conservative investments, as well as spark an increased demand for long-duration products, derivative products, and low- to medium-volatility investments that can offer equity-like returns with bond-like risk. Alternative asset classes will enjoy increased inflows.

The institutional marketplace stood at $14.3 trillion at year-end 2006.

These changes represent new opportunities for many Wall Street firms, such as Goldman Sachs, J.P. Morgan, Citigroup, and others that have experience using derivatives and structured products in their proprietary trading accounts. Niche managers who can provide portable alpha solutions, hedge funds, and quantitative management competencies are also likely to benefit.

With some uniquely positioned firms, the lines are blurring between asset management and investment consulting. Cerulli analysts believe that the changes in the DB marketplace have led the way for the adjustments just beginning to show in other institutional market segments, such as in the endowment and foundation segments, where there are similar concerns regarding liabilities.

Wake-up call

In that vein, Cerulli reiterates the importance of appreciating changes in the institutional marketplace. We believe that changes in the role of investments and the investment managers are long term, rather than trends likely to reverse. Similar transitions are taking place in the DC market, where embedded-advice funds (*e.g.*, lifecycle/target-date, lifestyle/target-risk, asset allocation, and balanced funds) offered by large asset managers (*e.g.*, Fidelity, Vanguard, and American Funds) dominate inflows. Almost 66% of DC net inflows went to lifestyle and lifecycle funds in 2006.

In the future, rather than employing managers in each of the style boxes, institutions will be more likely to look to two to three multi-asset, multi-strategy primary managers who will give advice, make asset allocation decisions, and look to deliver both alpha and beta. These primary managers will control the bulk of assets, and be selectively augmented by secondary niche managers. Further, the primary managers are positioned to oversee the transition to different secondary asset managers.

Also in the future, we expect more customized embedded-advice funds that will take into account total investor wealth. Next-generation embedded-advice funds will go beyond the predetermined asset mix that is offered today. Currently, they are limited in their construction and their rebalance mechanisms. These embedded-advice funds will eventually become more open and employ multiple managers. Longevity solutions will be introduced to DC plans in order to help create the inherent promise of a DB plan for participants. ◆

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product which has not been pre-approved by the central research group.

Nonetheless, field consultants may still wield a considerable amount of power. Even when they must stick to pre-approved investment managers, they may have some freedom as to which of these approved managers to recommend. They may also have some influence over the client's asset-allocation policy. This can obviously impact which products get chosen and which products do not.

Though less evident, it can be quite beneficial for asset managers to make non-research contacts at the professional buyer (if applicable). For example, if the asset manager is hoping to make inroads on a defined contribution platform, we suggest that the firm attempt to make contacts beyond the manager research group, such as the head of client service, or even the president of the retirement division. This can have multiple benefits, including developing an understanding of the broader mission of the firm, gaining an appreciation for the firm's typical client (and by extension, the asset manager's indirect clients), and knowing how the research group fits into the firm (is quality research a source of differentiation, or is it a secondary consideration?).

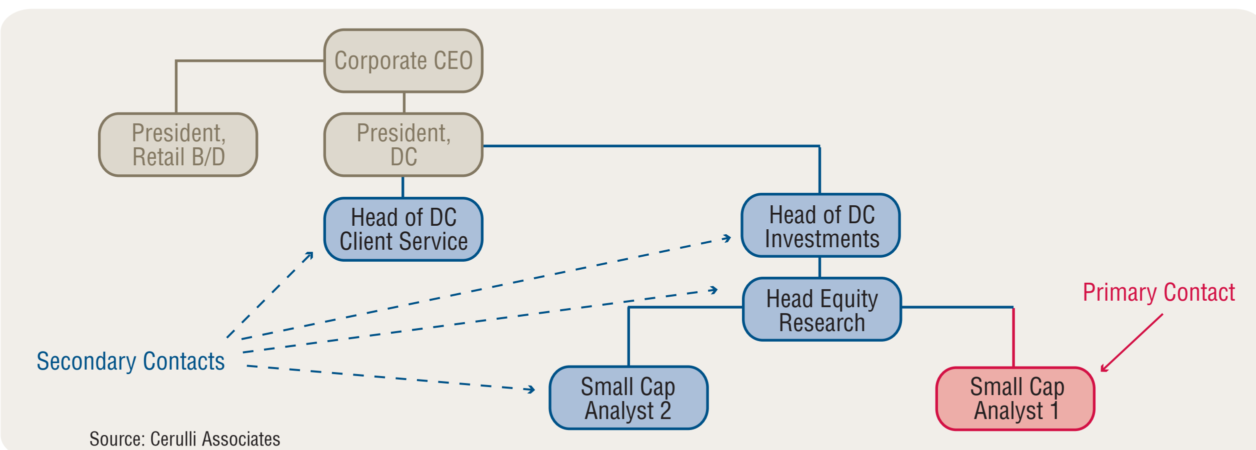
One account relayed to Cerulli analysts by an asset manager sheds light on the effectiveness of this practice. This reputable investment shop had struggled with their relationship with a particular investment consulting firm for which they provide many services (*e.g.*, asset liability modeling and plan design) beyond simple manager selection. Despite top-notch performance, the asset manager had seen little or no flows through the consulting firm.

At an industry conference, a senior sales executive from the investment house ran into the head of the consulting firm's retirement practice. Quite spontaneously, they had a long discussion concerning the relationship between their firms and why it was not working. The sales executive agreed to make some changes, including meeting more frequently with the central research group (CRG) and being more responsive to requests to meet with portfolio managers. It's important to note that these concerns were never raised by the CRG. The meeting ended on a positive note, and the head of the consulting firm's retirement practice put in a good word on behalf of the asset manager with the research professionals. Such an example shows that the centers of influence within a firm are not always readily apparent, and need to be managed appropriately.

Finally, it should be noted that while asset managers need to look beyond their

PRIMARY AND POTENTIAL SECONDARY CONTACTS

To the extent that asset managers can forge relationships with other professionals, the effects of gatekeeper turnover can be mitigated.



Source: Cerulli Associates

main professional buyer contact, they should do so carefully. First, the primary contact is just that—the person who needs to be the main source of attention. Though ancillary conversations may add value, going behind the back of a primary contact or violating directives can backfire, alienating both primary and secondary contacts. Second, some field consultants do not want to be bothered by asset managers, and will refer them back to the CRG. Nonetheless, a balanced approach should set the stage and gently push the limits. Establish a backup and attempt to reach centers of influence. While it's not necessary to have daily contact with field consultants, it might still make sense to reach out to these professionals periodically. Performance reversions in the market or significant changes (good or bad) to the portfolio management team or process might provide grounds for an occasional special conversation.

Prioritizing product

Asset managers today operate in a highly competitive business. No longer is it sufficient to have a strong brand name, top-quartile performance, or marketplace longevity. Indeed, even within the large-cap mutual fund universe, having a top-quartile three-year return might only place a manager in the "select" company of 500 other managers. Thus a major challenge for managers is to find other ways to differentiate their product. This could include focusing on why the investment process is superior, or the firm's history of low turnover.

For larger asset managers, an important issue is how to manage the discussion of a wide product range. Firms should recognize that, with rare exceptions (perhaps when professional buyers are segmented by firm), gatekeepers will not want to hear about every last product. Paradoxically, some sales and relationship professionals are compensated for selling as many products as possible, rather than meeting clients' needs. As noted earlier, some professional buyers will be very hard-pressed for time, so lest they offend the hand that feeds them, investment managers should learn to prioritize the product discussion.

While there are no set rules for product prioritization, there might be two broad approaches. The first is to have an ongoing dialogue with the professional buyer about the types of products clients are using. This should include an appreciation for the balance of active versus passive, and traditional versus alternative managers. Even within asset classes, professional buyers may have firmwide beliefs regarding the types of managers they use. For example, a managed account group might want to recommend diversified managers (*i.e.*, those who run portfolios of 100 securities or more) within the small-cap space; conversely, a subadvisory sponsor might prefer a concentrated manager (particularly if the sponsor employs multiple subadvisors). Meanwhile, an investment consultant working with large pension plans might prefer a "smid" manager (one that invests in both small- and mid-caps) for the additional liquidity and reduced volatility common with this strategy. Another obstacle that comes up occasionally is that some pro buyers may have a bias against team-managed portfolios. Their belief is that with such arrangements, it is hard to understand who adds the most value and, therefore, impossible to monitor and digest the importance of turnover among those managers.

Getting this type of information from pro buyers is not always easy. Some manager research groups are protective with regards to their biases and selection methodologies. Often, they believe that their methodology is superior, and do not want to give up their edge or have the secret recipe fall into the hands of a competitor. Equally important, some pro buy-

HYPOTHETICAL POOL OF AVAILABLE PRODUCTS/STRATEGIES, XYZ CAPITAL MANAGEMENT

For larger asset managers, an important issue is how to manage the discussion of a wide product range.

Filter	# passing
Entire product range	25
Top quartile for 3-year period	11
Actively managed	8
Manager tenure of at least 3 years	5
Assets >$100 million	3
Add back compelling 130/30 strategy	4

Result: Manager should lead with the three products passing all screens & consider fourth if appropriate

Source: Cerulli Associates

ers don't want asset managers to know all the details of the selection methodology, because they don't want managers to then retrofit their sales pitch or investment process to the selection methodology. Rather than rehearse a series of commonly asked interview questions, they prefer that investment managers simply be themselves and act naturally.

Even if pro buyers play it tight-to-the-vest with their selection methodology, there are ways for investment managers to glean some information. Industry rags often publicize recent manager searches, particularly within the institutional arena. It may be possible to see not only which managers are being hired, but which consultant firm is giving the recommendation. From this information, and from the website of the selected asset managers, firms can build a mosaic of the desired attributes. Networking with peer firms (*i.e.*, other asset managers) can also be helpful to paint a picture of industrywide demand—just don't expect very detailed information or a full client list.

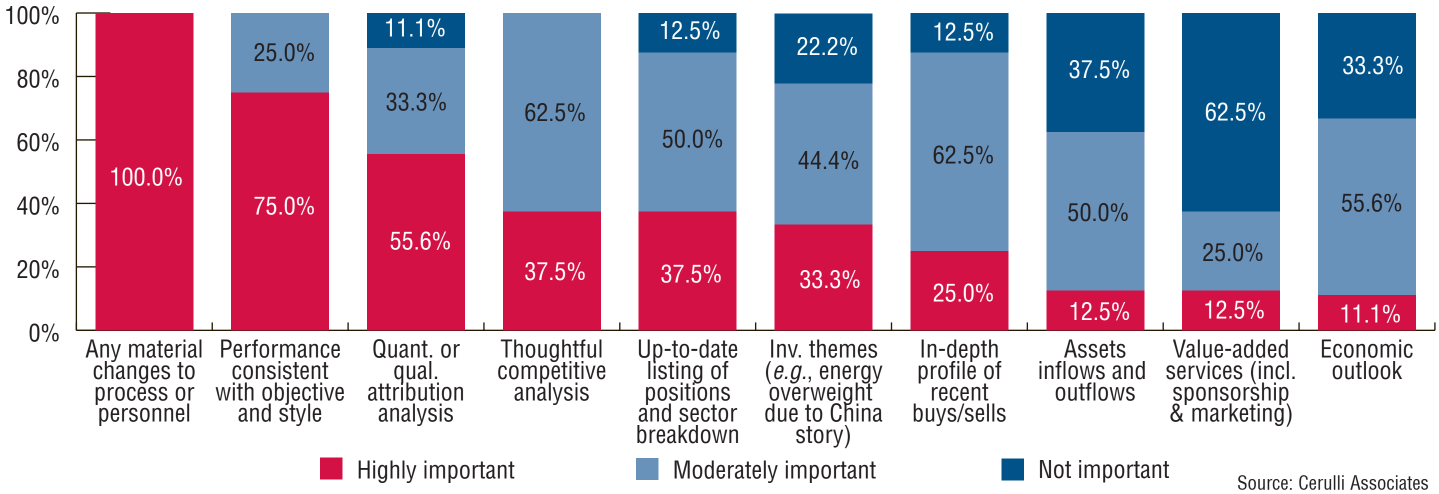
Cerulli analysts also recommend that investment managers have a good handle on other trends in the industry. In baseball, good general managers will use publicly available information (*i.e.*, the divisional standings) to determine which teams are out of contention, and thus, more likely to concede the race and become "sellers" (*i.e.*, willing to part with talented but expensive players). Similarly, investment managers should track the performance of other asset managers, good and bad. Using databases (such as Morningstar for mutual funds or PSN for separate account managers), one can identify managers who have stumbled. This can be particularly useful when large, widely held managers hit a rough patch. If the thoughtful asset manager integrates this analysis with the above-discussed search analysis, one might properly anticipate which professional buyers are likely to make manager changes.

Cycling through these queries should significantly narrow the range of appropriate products for discussion with professional buyers. While investment managers will want to lead with the short list (perhaps as few as one or two strategies) of products meeting these criteria, Cerulli believes it is acceptable and desirable to also raise awareness of any "near-threshold" products or strategies. For example, when working with an investment consultant who only looks at strategies with track records of at least three years, asset managers may want to introduce viable products with two-plus years of performance. Similarly, when a research group for a recordkeeping platform says that operational limitations preclude consideration of hedge fund products, it may be possible to discuss the merits of '40-Act 130/30 strategies.

Discussion of such near-threshold products is important, as some professional buyers confess that, despite their best efforts, they can't possibly cover every manager and every strategy under the sun. To the extent that an asset manager can broach a subject that might not otherwise be brought up, they may be doing the pro buyer a favor—particularly with products near capacity, and strategies designed to overcome the limitations of competing products.

MOST IMPORTANT DELIVERABLE QUALITIES IN AN ASSET MANAGER

While 75% of investment consultants expect performance to be consistent with the manager's objective and style, even professional buyers can be performance chasers.



Source: Cerulli Associates

Deliverables: What pro buyers want

Having identified the appropriate centers of influence, investment managers need to have a firm grip on the deliverables that will keep professional buyers content. Here, we see both overlap and conflicting information across various types of professional buyers. It should come as no surprise that the overlap manifests itself in the importance of manager performance in both channels. For example, when asked to rate the relative importance of asset manager deliverables, 75% of investment consultants expect performance to be consistent with the manager's objective and style. Similarly, 91% of managed account sponsors point to performance as the most important deliverable for asset managers.

Performance Pressures

Performance is a tricky issue: at a minimum, it is what it is (positive or negative). In addition, investment results are largely out of the purview of sales professionals at the asset management company. Though the industry has improved, Cerulli analysts still hear repeatedly from asset managers that even professional buyers can be performance chasers.

While the industry has improved with regards to grace periods for existing managers, potential new managers with performance issues are treated like misfits and are rarely invited to the dance. In the mutual fund world, four- and five-star products dominate inflows, with one-, two-, and three-star funds all suffering net redemptions in each of the past five calendar years. Similarly, 20% of institutional managers surveyed cited "short-term orientation" as one of their greatest sources of frustration with the consultant community.

Anecdotal evidence from investment consultants corroborates this data: one representative from Mercer recently remarked that, despite his own involvement in "hundreds of manager searches," he couldn't remember a single case in which an institutional client agreed to hire a manager with poor recent results, no matter how highly rated that manager was in qualitative terms.

To be sure, this phenomenon reflects the behavior of clients—that is, the end-user who is represented and intermediated by the professional buyer. Sometimes recommendations to stick with an underperforming manager, or to take a chance on an unrated manager, are shot down by clients. This is not purely a retail phenomenon: in our recent survey of institutions, 50% cited strong performance as the key factor underpinning their best relationships with asset managers. What can sales and relationship professionals do about performance chasing? Though old habits die hard, Cerulli believes managers can at least influence such behavior at the margins. First and foremost, it is important for asset managers to alert pro buyers to any negative developments as quickly as possible. In the case of performance, managers should not wait until quarter end to discuss any blowups that occur early in the period. Managers should make an effort to explain why the underperformance occurred and whether or not it is expected to be prolonged or reversible. Even if this proactive approach does not prevent termination, it will build trust with pro buyers.

In addition, investment managers should do more to educate the investment public on the slippery nature of rear-window investing. Such efforts can be industry-level or firm-specific. For example, the consulting firm DiMeo Schneider recently published research revealing that 90% of managers rated top-quartile for a 10-year period also ranked in the bottom half of peers for at least one 3-year period. In other words, everybody has a bad day (or 1,095 of them). At the firm level, individual asset managers might report their returns to clients both on a time-weighted and dollar-weighted basis to better demonstrate the effects of performance chasing.

Value-added materials and services

If performance is an area of commonality between professional buyer groups, there are also areas of difference between these camps. While 50% of managed account sponsors point to value-added materials and services as one of their greatest needs, only 13% of consultants offered a similar response. This is somewhat expected: managed account sponsors' attitudes reflect prevalent practices across major B/D firms. Since investment consultants work for large institutions with pricing power, there is more pressure to focus strictly on manager searches. Moreover, a series of industry scandals earlier in the decade has reduced the importance (and indeed, the acceptance) of certain value-added programs in the consulting space.

Finally, while there are some structural differences across professional buyer groups by type (*i.e.*, managed account vs. investment consultant), Cerulli also highlights the fact that there are differences within each segment. Though our analysis may summarize average or typical responses, such top-line data can obfuscate micro-level information. For example—in spite of the chart on page 15—we did find investment consultants who place importance on value-added services. One consulting firm in particular is hungry for any research on client tendencies (*e.g.*, pension funds' hedge fund usage) so as to make its clients more comfortable with asset allocation recommendations. Asset managers should not confuse the general with the specific. Said differently, the trick is not merely to know what the average pro buyer thinks, but to know instead what each is thinking.

Putting it all together

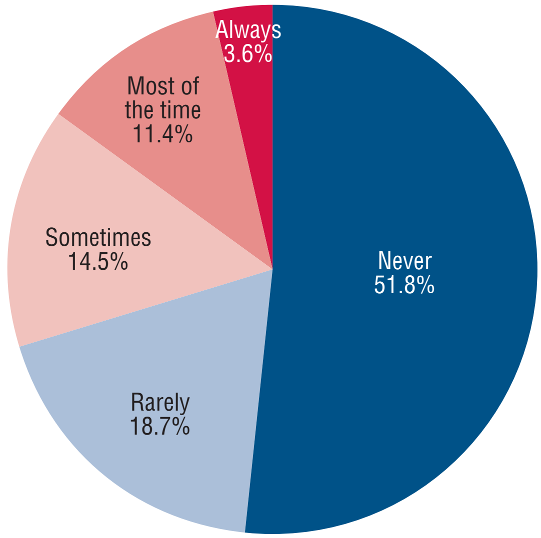
Professional buyers can be a complex and demanding group of clients. However, with the right mix of ingredients—contact management, product prioritization, and meeting deliverables—investment managers can provide excellent service and increase the chances of winning mandates. Admittedly, incorporating these ingredients is more akin to making a complex and delicate soufflé than baking chocolate chip cookies: having the right ingredients alone won't solve anything. However, with the right execution, investment managers can get more out of their relationships with professional buyers. ◆

QUANTITATIVE UPDATE

DISTRIBUTION STRATEGIES

PORTFOLIO CONSTRUCTION

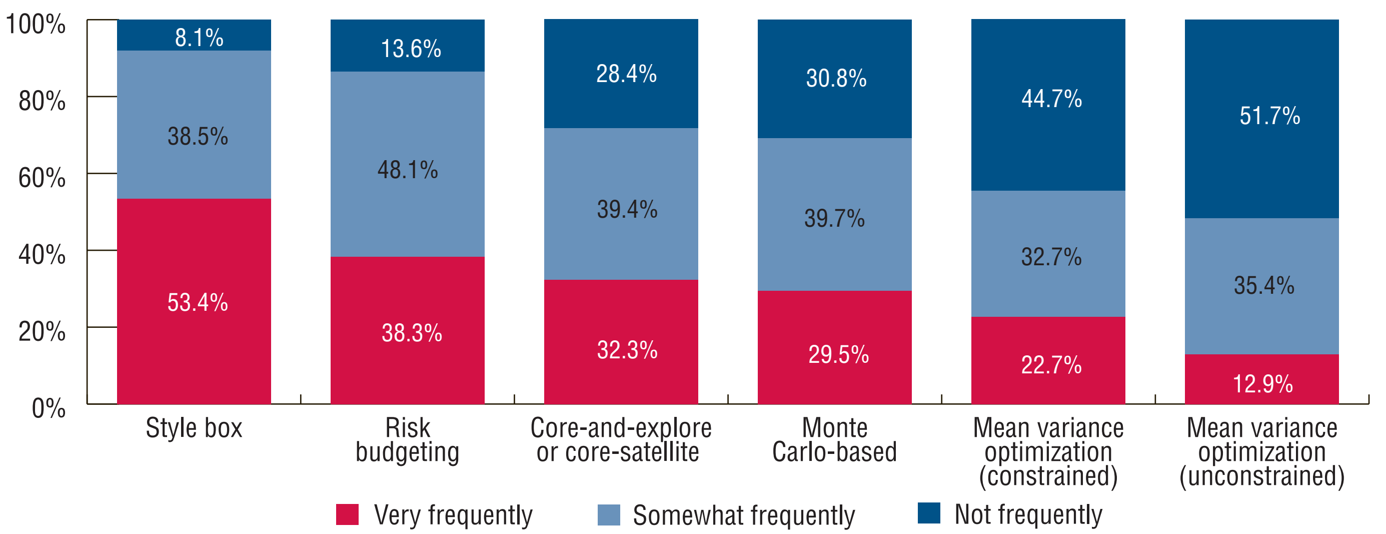
FREQUENCY WITH WHICH ADVISORS OUTSOURCE PORTFOLIO CONSTRUCTION, 2007



Source: Cerulli Associates-Financial Planning Association Advisor Surveys

More than half of advisors (51.8%) never outsource the portfolio construction process, and 15% of advisors always outsource or outsource most of the time. Armed with outside software and home-office and academic research to complement their own, advisors are still frequently involved in portfolio construction (to varying degrees). However, Cerulli analysts believe the number of advisors outsourcing portfolio construction will continue to grow in the long run. Best-practice advisors realize that the most valuable use of their time is not researching investments, but spending time with existing and prospective clients. As a result, more and more advisors will realize they are well served to hand off this duty to an unbiased third party.

FREQUENCY WITH WHICH ADVISORS USE VARIOUS PORTFOLIO CONSTRUCTION METHODS, 2007

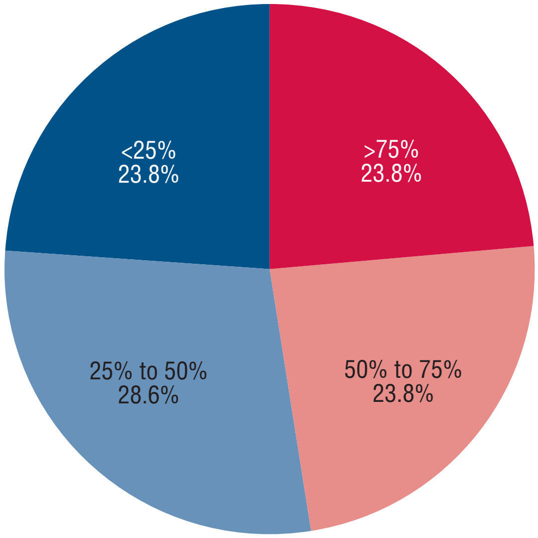


Source: Cerulli Associates-Financial Planning Association Advisor Surveys

Advisors employ a range of tools to construct and test portfolio solutions. One common model that advisors apply to portfolio construction is a core-satellite approach. It is not new, particularly in the institutional marketplace, but it is evolving and becoming more top-of-mind in the retail marketplace. This provides an opportunity for asset managers to help advisors with the portfolio construction process (in situations where the advisor retains control of the portfolio construction) by teaching them how to optimally deploy vehicles and strategies within investors portfolios.

PROFESSIONAL BUYERS

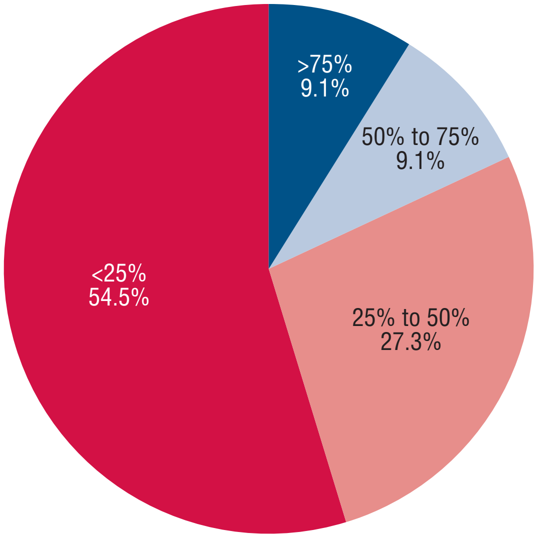
ASSET MANAGERS: PERCENTAGE OF MUTUAL FUND AND SEPARATE ACCOUNT SALES INFLUENCED BY THE PROFESSIONAL BUYER AT BROKER/DEALERS, 2007



Sources: Advanced Sales Corporation,Cerulli Associates

Among survey respondents, there is wide variation on the true influence of the professional buyer at the broker/dealer (B/D) firm. Estimates of their impact on sales range from as low as 10% to as high as 100%. Cerulli analysts believe the influence of the professional buyer at B/D firms will only increase as more advisors see the time savings and revenue opportunity associated with fee-based managed accounts. Many managed account programs, with the help of the professional buyer, shorten the list of recommended managers, but still allow the advisor to make the final selection. In addition, product providers must partner with B/D firms to provide education to their advisors. Although advisor education does not necessarily directly result in sales, if well executed, it can deepen the product provider-B/D firm relationship.

ASSET MANAGERS: NATIONAL ACCOUNT MANAGER TIME SPENT WITH THE PROFESSIONAL BUYER IN BROKER/DEALERS, 2007

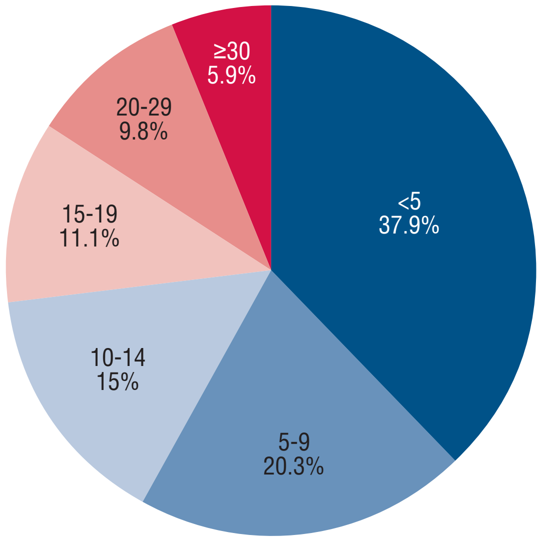


Sources: Advanced Sales Corporation, Cerulli Associates

The majority (55%) of national account managers spend less than 25% of their time with professional buyers at B/D firms. It is unclear whether these low results are the impact of neglect or the nascent trend of separate teams to work with the professional buyer. Regardless of the reasons, the results demonstrate the increasing difficulty of the national account manager's role. In addition to quarterbacking information flow to the professional buyer (whether they are directly responsible or not), they must also be working with a number of other roles inside the B/D firm including sales, marketing, compliance, and legal. With many B/D firms becoming increasingly selective about their product partnerships, Cerulli analysts believe that product providers must develop relationships at every possible level of the B/D firm in order to firmly entrench themselves as a key partner.

ADVISORS

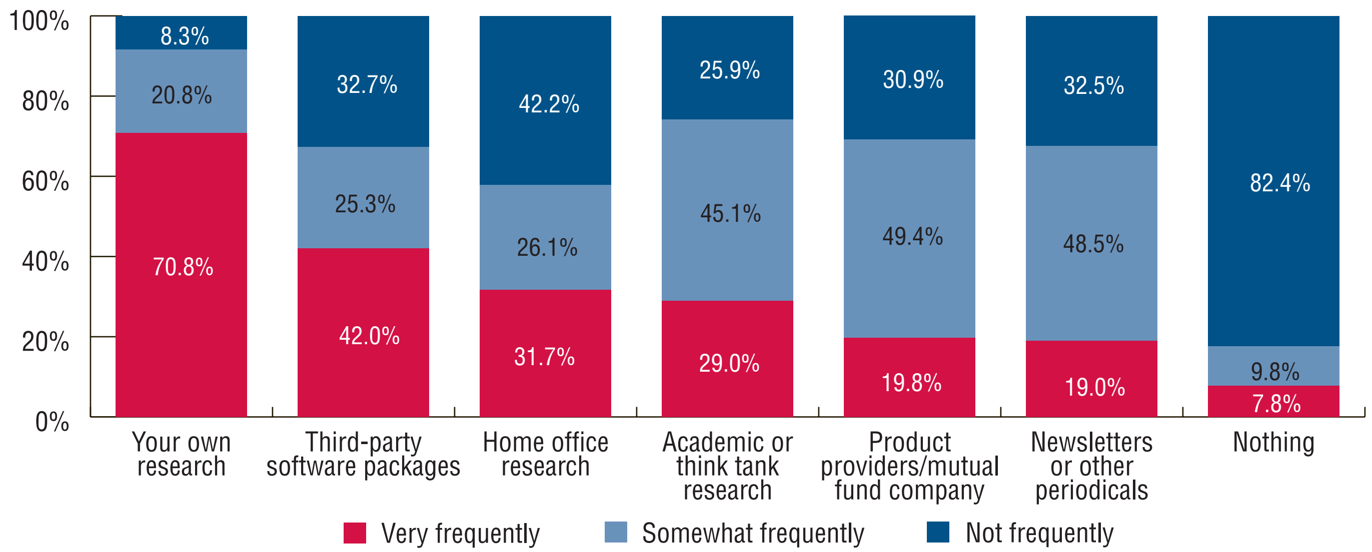
NUMBER OF ASSET MANAGERS USED BY ADVISORS, 2007



Source: Cerulli Associates-Financial Planning Association Advisor Surveys

More than 15% of advisors use 20 or more asset managers for their clients' assets. Most advisors, however, use far fewer managers. Almost 60% of advisors use fewer than nine asset managers. On average, advisors reported using 10 asset managers. A number of contrary trends appear in this chart. On one hand, advisors who sell loaded mutual funds have been forced to trim their partners as regulatory scrutiny around breakpoints and sales charges increase. However, as other advisors shift to fee-based managed account programs, taking advantage of open-architecture and best-of-breed asset managers, the number of asset managers used increases. Cerulli analysts expect the average number of asset managers used by advisors to slowly drift upward as the popularity of managed accounts continues to rise in channels outside the wirehouses.

FREQUENCY OF METHODS USED BY ADVISORS FOR DETERMINING ASSET ALLOCATION, 2007

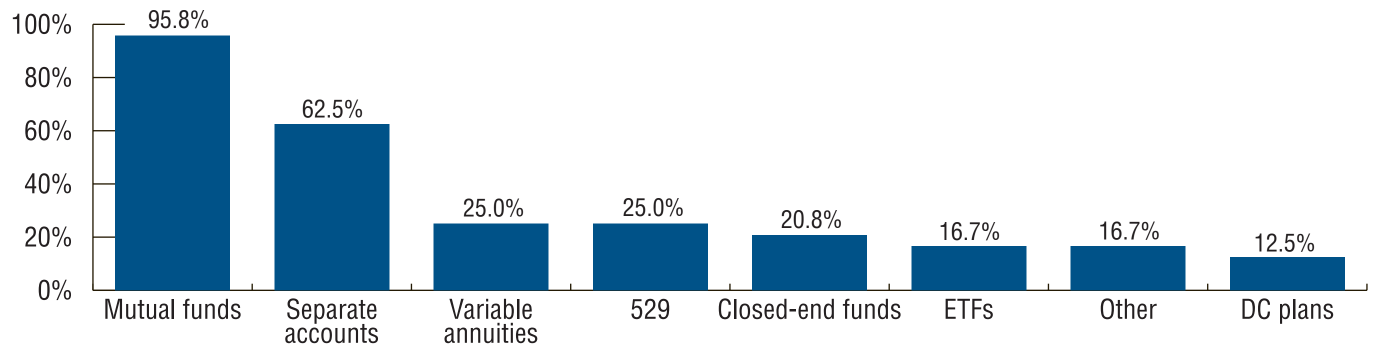


Source: Cerulli Associates-Financial Planning Association Advisor Surveys

An advisor's own research is the most popular method of determining their clients' asset allocation, with 71% reporting frequent use of their own research. Third-party software packages rank as the next most popular, followed by home-office and academic research. Advisors ultimately feel responsible for their clients' asset allocation. When an issue arises with a client portfolio, the advisor will be held responsible, even if they relied on a third party for asset allocation. Advisors often function as "validators," and will continue to rely on a variety of third-party sources for some portion of asset allocation.

ASSET MANAGER SALESFORCES

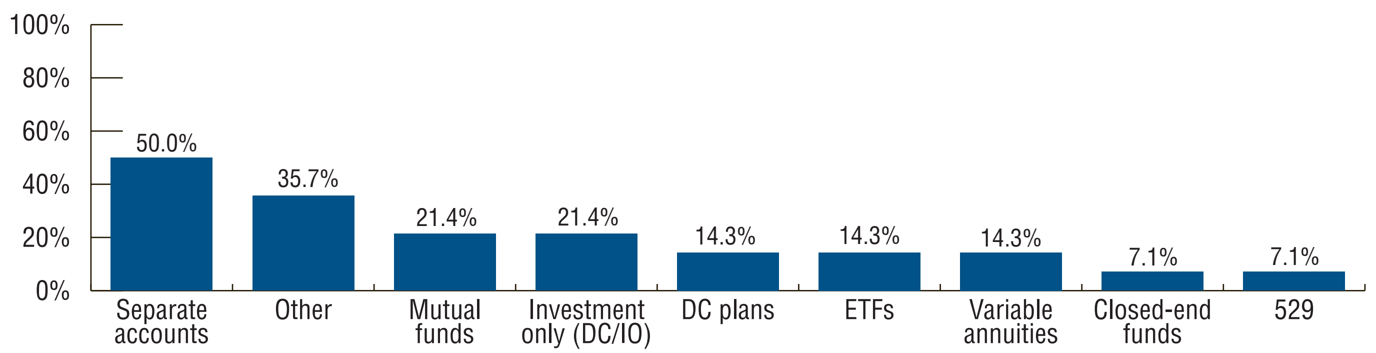
ASSET MANAGER SALESFORCES: GENERALIST WHOLESALER PRODUCT LINE RESPONSIBILITIES, 2007



Sources: Advanced Sales Corporation, Cerulli Associates

Generalist wholesalers almost always have sales responsibility for mutual funds (96%) and retail separate accounts (63%). They dabble in other product lines, but there are no clear-cut winners as many asset managers do not universally distribute these products. Asset management wholesalers' responsibilities are typically limited to only mutual funds and separate accounts. As more asset managers look to opportunities in the closed-end fund and ETF space, they must consider whether their salesforce has the bandwidth to handle additional product lines without jeopardizing existing business and relationships.

ASSET MANAGER SALESFORCES: SPECIALIST WHOLESALER PRODUCT LINE RESPONSIBILITIES, 2007



Source: Advanced Sales Corporation, Cerulli Associates

The most common use of specialist wholesalers is for retail separate accounts (50%). Separate accounts are used for higher-net-worth clients and are, therefore, sold by higher-end advisors. The result is that the sale tends to be more institutional in nature, where the focus is on the investment manager process, not just performance. As asset managers consider whether to use specialist wholesalers, they must also consider how they will compel their salesforce to work cooperatively. Specialist wholesalers work best in cooperation with generalists, so as not to create the confusion of multiple wholesalers from the same company operating independently. However, these wholesalers must be strongly encouraged to work together and share intelligence on advisors so that the right wholesaler with the right skill set is addressing the best opportunity.