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Search for growth in new landscape

Overview

Alternative strategies and new markets are on the agenda, writes **Andrew Greene**

The US mutual fund industry is in a state of flux as it searches for the next growth curve.

The competitive landscape is being reshaped, not just to target new assets and markets but also to satisfy investor demand for products that offer downside protection and uncorrelated returns. All this will be the topic of much discussion at the Investment Company Institute's annual general membership meeting in Washington this week.

Among recent developments, retail fund companies have been churning out asset allocation funds and products that offer alternative investment strategies at a fast pace.

Meanwhile, a number of hedge fund firms have launched funds that use alternative investing strategies in a traditional mutual fund structure. The likes of Permal Asset Management and AQR Investments have launched products that are registered under the Investment Company Act of 1940. Others, such as Viathon Capital and Akros Capital, have signed on to sub-advise mutual funds that seek to deliver absolute return.

Absolute return and hedge-like funds have been multiplying because they answer retail investors' desire for downside risk protection and uncorrelated returns. The transparency, liquidity and simple tax approach of so-called "alt-style" funds has also been a draw for some wealthy investors, advisers say.

Assets have started flowing into the products in the past two years, which has driven a steady proliferation of funds. Alt-style funds added $18.9bn in net new assets during that time, according to Morningstar data.

Meanwhile, data from Lipper show that, over the same period, about 42 new absolute return funds have made their debuts along with another 13 funds that include the term "tactical allocation".

What remains to be seen is how these funds will perform in a full market cycle. That lack of a performance track record will make gaining distribution through adviser networks difficult.

There is another question, says Jeff Tjornehoj, head of research for the Americas at Lipper: do retail asset managers have the necessary expertise to manage complex risk mitigation strategies involving derivatives and other instruments. "The use of derivatives is like a scalpel in a doctor's hand," he says. "In the hands of a novice it can lead to a lot of bleeding."

Vermont-based Sentinel Asset Management is among the firms that have ramped up their offerings of tactical asset allocation products. In recent months the firm, which has about $9.1bn in fund assets, launched a total return bond fund and reworked three existing funds' investment policies, enabling them to invest in derivatives and use hedging techniques to mitigate risk.

As a smaller niche player in the industry, the firm's strategy is to take a disciplined approach to asset allocation, says Christian Thwaites, chief executive. Sentinel wants to differentiate itself from its competitors by making investments based on the relative value of markets and moving assets around more tactically, he adds. The discipline comes by

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Mark Smith

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Pension funds take shine to ETFs . . .

Institutional buying

Chris Larson finds there are several advantages from using the securities

As exchange traded funds continue to grow in the retail space, managers say they are also seeing steady interest from pension funds and other institutional investors.

Some of the biggest managers are leveraging their firms' existing institutional relationships to introduce ETFs to pensions, while also educating investment consultants on what, according to managers, are the benefits of ETFs for institutional investors.

The exact size of the institutional market for ETFs is hard to nail down. Most managers will say that about half of their total ETF assets come from "institutional" investors – but that term encompasses not just pensions, endowments and foundations, but also hedge funds, other asset managers, insurance companies and other financial institutions.

Managers say they do not track exactly how much of their ETF assets come from pensions and similar institutional investors. A Greenwich Associates survey from last year, however, found that about 14 per cent of pensions, foundations and endowments use ETFs, and that figure is expected to grow.

ETF managers agree. "We've seen great adoption by PFEs [pensions, foundations and endowments]," says Liz Tennican, managing director and head of institutional sales for iShares, BlackRock's ETF unit.

Jim Ross, global head of SPDR ETFs at State Street Global Advisors, has similar words. "The engagement we have with institutions today on ETFs, compared to two years ago, is dramatically different," he says.

Managers do not like to disclose their clients but regulatory filings give some insight into institutional ETF holdings. Harvard University's endowment holds billions of dollars worth of ETFs from multiple providers. Raytheon's corporate pension had about $2.4bn in ETFs at the end of last year, while the University of Notre Dame's endowment held nearly $37m worth of ETFs at year-end.

ETFs bring several advantages to pensions and endowments, experts say, including their liquidity. "They like the idea of using ETFs for a liquid overlay," Mr Ross says. "They like that they can come in and out of the securities quickly" – a feature that makes ETFs a great vehicle for some of an institution's cash allocation.

Also, he says, ETFs are "used significantly during the transition management process" – that is, when a manager has been terminated, ETFs can be a great place to park the cash, and keep the exposure to an asset class, while the pension decides on a replacement manager.

Furthermore, because they are tradable securities, ETFs can be put to work in a pension's securities lending programme to earn a few extra points of return. And some institutions use ETFs for selected tactical exposure, Ms Tennican notes, to quickly and easily gain equity exposure to a certain country, sector or region, for example.

'The primary focus for us tends to be those clients with in-house asset management'

Liz Tennican
BlackRock's iShares unit

Winning ETF business from a pension differs from winning a traditional institutional account, as there will not be an RFP (request for proposal) process. For that reason, the playing field may be slanted toward the larger ETF managers, since their parent firm will have existing relationships with such clients all over the world – relationships the ETF unit can leverage.

"My team here at iShares works very closely with the broader BlackRock institutional team," Ms Tennican says. "The primary focus for us tends to be those clients with in-house asset management. Those that do more tactical trades, or that are transitioning more, tend to be heavier users of iShares."

SPDR takes the same tack with its parent, institutional giant SSgA. "Our approach has been to leverage our existing sales and relationship management people," Mr Ross says. "We partner with them to become an institutional ETF team. Instead of cold-calling their clients, we want to go in with them."

ETF providers also need to engage investment consultants, the gatekeepers that help institutional investors decide where to put their money.

But scepticism remains. "Some consultants still have very little interest," Mr Ross concedes. "Some say the cost is higher than a separate account, for example."

That may be true in one sense, but the real cost will depend on factors such as trading costs and how long a pension intends to hold the investment.

While ETF managers are understandably bullish about their products, not every gatekeeper is. "We don't have anyone with ETF-only mandates," says Jay Kloepfer, executive vice-president and head of capital market and alternatives research at institutional consultant Callan Associates. "We're not opposed to them. ETFs are simply a tool," he says. But, he adds, Callan has few if any clients with notable exposure to ETFs.

Mr Kloepfer does not expect that to change, and few experts see ETFs ever being a huge institutional play.

But slow, steady growth is expected: the Greenwich Associates survey last year found 61 per cent of respondents expecting to increase their ETF holdings over the next three years, with rises of between 1 and 4 per cent the most likely.

Just 16 per cent said they would reduce their ETF investments, while a third of respondents said they expected no change.

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Search for growth in altered landscape

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drawing clear lines between investment sleeves to ensure there is no crossover of investment themes or underlying issues. This ensures the fund is not unwittingly overallocated to any one particular stock or market.

Despite the numerous challenges, the market shake-out has presented something of a silver lining on the distribution front for smaller niche players such as Sentinel, says Mr Thwaites. Namely, the brokers and advisers that survived are more willing to look at smaller shops that bring a more focused, specialised investment approach.

The hurdle for active managers is outperforming benchmarks after fees in a way that is characteristically different than the index, he says.

That task has not become any easier in recent years. Investors have flocked to passive investments in an environment where anaemic returns have elevated the importance of fund fees.

Index funds and exchange traded fund providers have been pulling in assets at a rapid clip. Last year, Vanguard Group, BlackRock and State Street Global Advisors each posted gains of fund assets in excess of 20 per cent, according to Boston-based Financial Research Corporation.

Investors have increasingly given up on the idea of paying a fund manager to find outperformance in the markets in favour of taking what the market offers in more cost-efficient index and exchange-traded funds, according to Douglas Dannemiller of Dannemiller Analytics & Consulting.

Fees and expenses have become a central theme in the ETF market where distribution hubs Schwab and Scottrade have launched series of their own ETFs with bargain-basement fee ratios. Scottrade plans to charge just 5 basis points on the first series of ETFs it is planning to launch. That will make it the cheapest in the industry.

Index funds have gained strong traction in the retirement space where plan sponsors have grown increasingly sensitive to fees and expenses charged by plan administrators and providers.

Target date funds, in particular, reflect the rise of passive strategies in retirement plans. Index giant Vanguard, for example, posted the strongest first-quarter growth among all top-tier target date providers, posting a 7.2 per cent organic growth rate, according to Ibbotson Associates. Meanwhile, BlackRock is preparing a new series of target date funds that invest in index funds. The firm is also adding two new funds to its iShares ETF target date series.

'There is a much more mature industry in the west than in Asia'

Overall, the ETF market continues to attract new product development although the bulk of assets continue to be concentrated among the top three firms. BlackRock, SSgA and Vanguard held $470bn, $242bn and $164bn in ETF assets, respectively, according to March asset data from the National Stock Exchange. The next largest firm in terms of assets was Invesco Powershares, which held $60bn in ETF assets.

Profitability among fund advisers rebounded over the past year, but it was held in check, in part, by the price pressures brought to bear by ETFs, according to Merywick Payne, a senior partner with Management Practice, a consultancy that serves the fund industry. Based on a review of data from publicly traded asset managers, Management Practice estimates that the average return for fund firms after costs and expenses was about 30 per cent of revenue.

Meanwhile many US fund groups are looking to overseas markets, particularly Asian markets, where a growing middle class in places like India and China shows an attractive growth curve for years to come.

Firms such as Pimco, State Street, Janus and Legg Mason have either expressed an interest in, or have taken solid steps toward, building their presence in Asia. Goldman Sachs recently signed a deal to buy Benchmark Asset Management, the largest ETF provider in India.

Driving that trend are strong growth projections for those economies and populations with assets to invest. The savings and investment rates as a percentage of gross domestic product in those markets provide some clue as to why US managers are so keen to establish a beachhead there.

In 2009 India's savings rate, for example, was 43.6 per cent of GDP, while China's was 53.6 per cent, according to data from the McKinsey Global Institute. In the US, the savings rate in 2009 dropped to a 10-year low of 11 per cent.

Wealth creation and economic growth in those markets is what is driving the interest from US managers, says Mr Dannemiller. "I think one of the things western societies have to offer is professional management and there is a more mature industry in the west than in Asia, especially at the retail level."

. . . while providers feel pinch from fee wars

Pricing pressure

Jackie Noblett on how reduced ETF expense ratios are reshaping strategies

As exchange traded fund sponsors continue to whittle away expense ratios to generate flows and attention, the low-fee environment is playing a large hand in shaping firms' product and distribution strategies.

Low-cost players such as Vanguard and Charles Schwab have burst into the ETF market and rapidly attracted assets. The pricing pressure has become so strong in certain segments of US equities and emerging markets that firms such as FocusShares, the ETF arm of discount brokerage Scottrade, offer products with expense ratios of 0.05 per cent. The average annual expense ratio for an index-based ETF is 0.56 per cent.

Much of the pressure on expenses is coming from sponsors proactively cutting fees to attract assets, rather than from advisers or end-clients, says Benjamin Fulton, managing director and head of global ETFs at Invesco PowerShares. "Capitalism is working. At the end of the day people are pricing based on what it takes to attract assets and to maintain and grow their business at sustainable levels."

The firm evaluates expenses both when launching a product as well as periodically afterwards.

While the fee wars have been concentrated among the largest ETF sponsors and in the traditional, cap-weighted products, pricing pressure is trickling down to smaller firms looking to build a successful asset management business solely around the products. As assets continue to pour into ETFs, the question for sponsors is how to ensure that growth translates into steady profits.

ETF Top 10*
Assets under management ($bn)

Issuer	
BlackRock	470,649
SSgA	242,351
Vanguard	164,204
Invesco PowerShares	59,643
ProShares	26,161
Van Eck	21,899
Bank of NY	11,496
WisdomTree	11,284
Rydex	7,964
First Trust	7,291

* March 2011

Source: National Stock Exchange

"As a smaller business we want to charge a fair fee, but we also have to make sure we have the financial wherewithal of running a business at $73m in assets under management," says Noah Hamman, chief executive of AdvisorShares, an active ETF sponsor. "The big firms are always going to be able to price more effectively, but we know over time we'll be able to compete on all levels: performance, marketing and pricing."

While it is difficult to ascertain exactly how profitable the largest ETF sponsors are, a closer look at some of the smaller firms shows the challenges of turning the fast-growing products into profit engines.

For example, WisdomTree is the seventh-largest ETF sponsor with $11bn in assets under management as of March, according to Morningstar, and revenues in 2010 grew to $41.6m compared with $2.2m in 2006. Yet the firm has yet to cross the profitability mark, posting a net loss of $7.5m in 2010 according to regulatory filings.

"Day one we always knew Vanguard would be, at the end of the day, the dominant player in equities because their fee advantage in cap weighting was significant," says Jonathan Steinberg, WisdomTree's chief executive. "We envision WisdomTree to be able to comfortably coexist with Vanguard, to do equities differently and provide better after-fee returns."

Indeed, several ETF sponsors admit that the largest firms, most notably Vanguard, have the scale and flexibility to lead on price. Vanguard's mutual structure allows the firm to pass along all the economies of scale that come with larger ETFs as well as all the profits associated with securities lending, says Joel Dickson, principal and ETF investment strategist.

"When you have a third-party ownership structure, whether it is public shareholders or a private entity, you always have this tension between those that want more profit out of the business and investors that want more return," he says. The investor-owned structure, Mr Dickson argues, "is a better balance of the risk and return for investors".

As expenses dip precipitously close to zero as seen on some products in Europe, some firms are turning to practices such as securities lending for a larger part of revenue. Firms such as iShares and State Street divide lending profits between the firm and shareholders, and those shareholder profits go toward counteracting an expense ratio.

Rate wars also play a role in product development calculations, evaluating new markets on what fees clients will pay for access – and whether there are enough clients for the fund to reach a sustainable scale.

"There are markets, quite honestly, that we don't participate in because we don't think we can generate sufficient scale to make it work at a pricing that is competitive," says Bruno del Ama, chief executive of Global X, a New York-based ETF sponsor with $1.7bn in 26 different products, according to March data from the National Stock Exchange.

"You have to have the whole package. You can't just say, 'I'm not going to compete on price or I'm only going to compete on price.'"

Bruno del Ama: 'You have to have the whole package'

Education is key to making sense of latest offerings

Fishing for ideas: the Ivy Asset Strategy fund's daily meeting is known internally as the piranha tank Alamy

New-style products

The industry knows it must ensure clarity for advisers and investors, writes **Hannah Glover**

The financial crisis sent investors looking outside the traditional formats for solutions. And the industry responded with a slew of non-traditional products meant to smooth volatility and protect against market downturns, each with its own benchmark and strategy.

Now the challenge for investors is to make sense of the marketplace. Go-anywhere mandates and the unique strategies employed by these products mean that two seemingly similar products could be invested differently. Relatively brief track records mean few have been tested in a market dip or volatile environment like the one that spurred their creation, says Matthew Lemieux, a research analyst with Lipper.

"It's a new space, and we can't put a label on a lot of these products," says Jeffrey Cusack, president at Forward Management. Forward Funds, manager of the roughly 14-month old, $846.2m Tactical Growth fund, this month will join forces with AQR, Hatteras, Nuveen, Eaton Vance, JPMorgan and Rydex for a three-city roadshow where managers will sit side-by-side, describe their investment styles and field questions from advisers.

Product manufacturers must explain to intermediaries and investors what their products are designed to do and what they are not. "It is really incumbent on the industry to make sure we position these correctly," says Christopher Thompson, head of product management and marketing at Columbia Management.

It is no easy task. Between 2008 and the end of March, 42 new absolute return mutual funds hit the shelves. That compares with 19 for the seven-year span leading up to the crisis, according to data from Lipper. Together, the 61 funds represent about $30.6bn in assets.

Likewise, 13 funds with the term "tactical allocation" were launched between 2008 and 2010. Before that, the most recent launch occurred in 1999, according to Lipper data.

One challenge is explaining to advisers that untethering managers from tight mandates or limited asset classes can reduce risk. "It's a fine line between chasing a fad and embracing a strategy that over the long-term can improve the risk-return profile of your overall portfolio," says Douglas Beck, head of product management at DWS Investments.

The complexity of the products makes education critical. The $770m DWS Alternative Asset Allocation Plus, for example, comprises as many as a dozen underlying strategies, and uses a blend between the MSCI World (70 per cent) and the BarCap US Aggregate Bond index (30 per cent) as a benchmark. The S&P 500 serves as a secondary benchmark.

Education at DWS starts with the salesforce. In addition to in-person training several times a year, wholesalers are also tested on web-based modules. For advisers, aside from presentations, videos featuring fund managers and white papers, DWS also invites front-line advisers to due diligence meetings, typically attended only by broker-dealers' product analysts.

Columbia talked to distribution partners early in the process of designing its two new absolute return funds to ensure the new strategies meet their needs and expectations, says Mr Thompson. "What we can't come out with is a product with attractive goals, but limited transparency, or a confusing process," he says.

The result was the Absolute Return Multi-Strategy and Absolute Return Enhanced Multi-Strategy product, which each use a variety of asset classes and strategies. Both aim, "over the course of a normal market cycle," to outpace the historic rate of investment grade bonds and equities, respectively, with less volatility and low correlation to traditional benchmarks.

Manufacturers also must be ready to provide significant access to their investment team as part of the distributors' due diligence process. "[Distributors] brand is important to them, and they want solutions that are right for their investors," says Jeffrey Carney, head of global marketing and products at Putnam. "They'll know very quickly whether you have the investment skillset or not."

Putnam's absolute return suite includes four products that aim, over the course of a market cycle or about three years, to beat the annualised returns of Treasury Bills by 1 per cent, 3 per cent, 5 per cent or 7 per cent, respectively. Rather than a typical two-page product brochure, Putnam has a 20-page pamphlet outlining the suite. Other efforts include roadshows, a series of videos, and web-based materials "You need to keep telling the story over and over again to provide appropriate education to the marketplace," says Mr Carney.

While other firms have made the case that such strategies need not be relegated to satellites in advisers' portfolios, Putnam has injected its absolute return portfolios into its target date and retirement income products.

Putnam's leadership allows the firm to help define the category, says Mr Carney. The four funds launched in January 2009. Today they represent about $3.2bn, collectively.

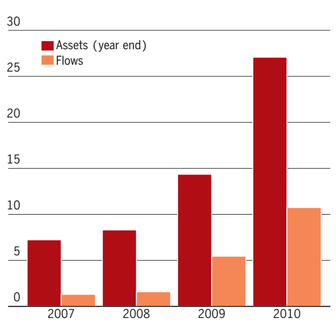
Advisers may be attracted to compelling cases for change, but what they want most is a strategy with a process that can be repeated. When the style-box defying Ivy Asset Strategy fund launched in 1997, its go-anywhere mandate befuddled some. With time, advisers saw the fund's flexibility as a big strength. A 10-year track record with an average return of 10.7 per cent, nearly triple that of the S&P, does not hurt either. Today, the fund represents about $27.4bn, according to Morningstar data.

A long track record alleviates the need to position the fund against newer entrants, but education "never stops", says Thomas Butch, chief marketing officer and executive vice-president at Ivy's parent, Waddell & Reed Financial.

At the core of that education is ensuring advisers understand the investment process and the 75 portfolio managers, analysts and traders that drive it. Each day the investment team convenes a 90-minute meeting, where they pitch ideas, share perspectives and challenge one another. Around the office, the meetings have been dubbed "the piranha tank".

"As the category widens . . . it's really important that advisers understand the nuances between how these products are managed," Mr Butch says. "It's important that our fund is not labelled as something it's not and that makes it incumbent upon us that we tell the story with great precision."

Absolute return
$bn



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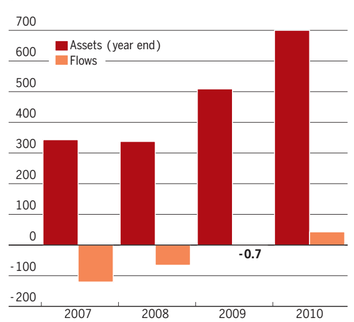


Source: Lipper, a Thomson Reuters company

Hedge funds consider the alternatives

Mutual trends

Managers are keen to help craft new retail products, writes **Tom Stabile**

Alternative investing-flavoured mutual funds are not only getting interest and asset flows from advisers spicing up portfolios that failed them in the downturn, they are also attracting hedge fund managers that smell opportunity baking.

Established hedge managers are moving into the regulated fund space by building their own operations or serving as sub-advisers to mutual fund market partners. Recent forays into the retail market by prominent hedge brands such as AQR Capital Management and Permal Asset Management have added to the segment's momentum.

Morningstar data show alternative-style mutual funds adding $18.9bn of net new assets in 2010 and $12.8bn in 2009, dwarfing the previous nine years, when annual inflows ran from $500m to no more than $5.6bn.

And the alternative segment – which Morningstar divides into bear market, long-short, market neutral, and currency funds – rose from a mere 1.6 per cent of the $294bn in net flows across the mutual fund market in 2006 to 7.7 per cent of last year's $246bn in inflows.

"It is still a very small slice of the pie, but quickly growing," says Nadia Papagiannis, alternative investments strategist for Morningstar.

The product proliferation is a response to demand from advisers, who no longer count on commodities, gold and real estate to act as non-correlated assets to traditional portfolios, says Matthew Lemieux, research analyst at Lipper.

Retail alternative funds that are regulated under the Investment Company Act of 1940 are even attractive to wealthy clients. Some have never dabbled in the asset class before and others may switch from higher fee structures such as funds of funds, says Neal Simon, chief executive of Highline Wealth Management, a Maryland-based independent adviser with more than $1bn in assets.

"I could see some investors moving out of funds of funds to the mutual fund versions for both simplicity of tax issues and the much greater liquidity for their investments," Mr Simon adds, noting that "gates" many hedge funds created to restrict withdrawals during the crash left investors frustrated.

Highline has about a third of its client assets in alternatives, and Mr Simon says a growing share is in mutual funds, including the Princeton Futures Strategy Fund, established by a managed futures fund of funds manager that his firm has used for seven years.

While retail products crafted by alternative firms seldom mirror their restricted funds for institutional and wealthy investors, the longer track record in trading complex securities, using shorting and leverage techniques, and managing counterparty risk gives these managers an edge, Mr Simon says. That is preferable to a long-only mutual fund manager trying its hand at new tricks, he adds.

Still, hedge managers entering '40 Act territory must be strategic, because mutual funds present their own operational challenges, says Marco Hanig, president of AQR Funds, the retail affiliate of Connecticut-based AQR Capital.

Building on core expertise in strategies such as managed futures, convertible arbitrage, and market neutral products, AQR added diversified arbitrage and managed futures mutual funds, as well as non-traditional risk parity and momentum funds, which all together have nearly $4.3bn in retail assets.

Permal's Josh Levine: new retail strategy

"We saw a significant opportunity to deliver something that was needed in the retail market," says David Kabiller, principal and head of client strategies at AQR.

The firm is limiting retail distribution to advisers, and plans additional strategies, Mr Hanig says.

Various hedge managers have taken the sub-adviser route, and their contributions are in demand from mutual fund managers aware they lack alternative investing expertise, says Lipper's Mr Lemieux. "A lot of mutual fund companies are looking to fill a gap, to be more flexible and have a wider investing mandate," he adds.

Lipper cites several examples of hedge managers sub-advising retail absolute return funds, including AQR on the Transamerica AQR Managed Futures Strategy, Akros Capital on the Quaker Akros Absolute Return Fund, and Viathon Capital on the Van Eck Multi-Manager Alternatives Fund.

Another prominent relationship is Permal sub-advising a mutual fund with about $115m in assets for its affiliate, Legg Mason. The retail strategy launched in 2009 is new for Permal, but derives from the same core research that fuels the fund of fund firm's products in areas such as global macro, long-short, and distressed securities, says Josh Levine, its co-head of global sales. The strategy can invest in unregistered hedge funds and use illiquid derivatives and short selling.

"We were looking for something different – a bridge between traditional and alternative investing, and we had a mutual feeling that we had the resources here to express it," Mr Levine says. The firm benefits from Legg's mutual fund operations and distribution engine, he adds.

He says the affiliates have more funds on the drawing board, with some set to launch in the coming year.

Funds find happy hunting grounds in overseas markets

No flagging of interest in Europe for US funds Reuters

Global expansion

Foreign advances exceed domestic growth, writes **Peter Ortiz**

While the financial crisis shook the confidence of asset managers, a few US mutual fund providers have since made huge advances in their global operations – experiencing success that outpaces their domestic growth.

Franklin Templeton *(see article below)*, JPMorgan and Pimco rose in the ranks of the top 15 European-domiciled funds from September 2008 to February 2011 for assets under management, according to Morningstar data. Pimco saw the most dramatic increase, rocketing from 46th in 2008 to 15th, while Franklin jumped from 18th to fifth and JPMorgan from 16th to eighth, respectively.

A combination of factors have helped US-based mutual funds gain a stronger distribution foothold in Europe, where forming relationships with gatekeepers at banks has been important for US fund managers looking to succeed there, says Syl Flood, product manager for fund flows at Morningstar. While developing those relationships is still important, they are becoming less crucial.

"A new generation of investors who are tech-savvy question things, unlike an older generation that may have trusted [European] banks," Mr Flood says. "So the model in Europe has changed; it has opened up more opportunities for American funds to do more business in Europe."

Meanwhile, a lot of flows into Asia are through European-domiciled funds, Mr Flood says. In some places, such as China and India, it is harder for US firms to gain a presence because of restrictions placed on foreign companies that do business there, but funds with a global track record continue to make inroads in Asia and other emerging markets.

As the European distribution model increasingly resembles its US counterpart, US asset managers are gaining better leverage with bank gatekeepers as well as the bank's clients who are demanding better-performing funds regardless of the sponsor's national origin, Mr Flood says. Firms with a long history and focus in global markets are seeing the greatest payoff. And the success of early pioneers also has helped relative newcomers with a solid US track record, such as Pimco.

"I think Europeans are certainly not new to getting exposure to US equities and Pimco took advantage at a time when they wanted exposure to US bonds," Mr Flood says.

"The market has gotten used to dealing with American companies and Pimco is the beneficiary of that." Overall, six US-based fund shops – BlackRock (second), Fidelity (third), Franklin Templeton (fifth), JPMorgan (eighth), Pioneer (11th), and Pimco (15th) – made it into the top 15 European-domiciled funds as of February 2011, according to Morningstar. That is up from just three – BlackRock (second), Pioneer (fourth), and Fidelity (fifth) in the top 15 in September 2008. (Pioneer is a US-based fund firm, but is owned by an Italian bank).

> 'The model in Europe has changed; it has opened up more opportunities'

The difference in organic growth a US firm can find overseas as opposed to back home highlights why so many are looking abroad. The organic growth rate is the percentage change in a firm's assets due to the net flows into the group's funds over the time period (measured by dividing cumulative flows by beginning net assets), Mr Flood says. Industry analysts use this rate as a measure of a firm's health.

Franklin Templeton, for one, posted an organic growth rate from 2008 to 2011 for its US-domiciled funds of 11 per cent. During the same time period, Franklin's Europe-domiciled funds growth rate was 108 per cent. Meanwhile, Pimco's organic growth rate for its US-domiciled funds stood at 66 per cent compared to 179 per cent for its Europe-domiciled funds during that three-year time span.

Vijay Advani, executive vice-president of global advisory services for Franklin Resources, says the financial turmoil in 2008 and 2009 has helped "separate the men from the boys" for asset managers that have had a foothold presence in foreign markets. His firm did scale back on resources in 2009, but it did not close any offices, nor did it cut back on the portfolio management side, he says.

For Legg Mason, non-US operations are only 30 per cent of the total but it has much bigger global aspirations, says Joe Sullivan, head of global distribution for the firm. The Baltimore-based asset manager is striving for a 50/50 balance in its US and foreign operations.

"I do think the financial crisis has changed things, particularly in Europe," where investors have become less provincial, Mr Sullivan says.

"So we actually think our opportunity in Europe is greater now than before the financial crisis because a lot of investors are looking beyond the local firms in their market."

Having a presence in Europe has also allowed Franklin Templeton to import some of its more successful funds for its US product line.

The Templeton Asian Growth fund, which started in Europe and was brought to the US late last year, "is a good recent example of a strategy that has gained traction in Europe and then, because of its success, has been introduced to US investors", Mr Flood says.

"The innovation doesn't just happen in the US and then gets cloned elsewhere," Mr Flood says. "Product innovation for these groups is happening everywhere."

Long view pays off for Franklin in Europe

Case study

CHRIS NEWLANDS

There are a number of blueprints available to any US investment manager wanting successfully to gather assets in Europe.

Obvious examples include Carmignac, Allianz, HSBC and Schroders. But US firms might feel most comfortable imitating California-based Franklin Templeton Investments.

In 2010, the US firm had Europe's best-selling bond and equity funds.

During the same period it also topped a Lipper list of the biggest-selling investment houses in Europe with some €31bn of net sales – significantly more than that of second-place Allianz (€17.9bn) and third-place Carmignac (€16.8bn). Achievements over the short term have been significant, but for Jamie Hammond, managing director of Franklin's European operations, the short term has had little to do with recent accomplishments.

"The seeds for this success were sown a long time ago," he says. "In Europe one of the best decisions we ever made, which was decided upon some 10 to 15 years back, was to open local offices in each of our target markets.

"We have had people on the ground for a very long time and that has proved invaluable."

Shiv Taneja, managing director at Cerulli Associates, is a fan of Franklin's approach.

He believes other US firms could learn a lot from its methods.

"US asset managers have a reputation of cutting and running at the first sign of trouble, but Templeton is part of a small number of US firms that have learnt how to play the long game and play it well – not just in Europe but in most markets it operates in," he says.

Jamie Hammond: people on the ground are invaluable

"A sufficiently wide product range obviously helps, as does above-average performance, but a sufficiently long-term commitment makes all the difference as it allows the firm to build its brand and reputation during good times, and then benefit from that when times are tough."

Mr Hammond admits that during the recent crisis the firm – like many others – had to reduce its staff count, but he is quick to point out that Franklin never cut back on any client-facing personnel.

"We thought it was very important that we left such staff alone, and we even in fact tried to add to those teams. This gave great comfort to the distributors we were trying to do business with."

Daniel Enskat, global head of consulting at Strategic Insight, believes Franklin is popular with distributors because it has a clear view on the markets and helps its clients understand the big themes – information they can then pass on to their own clients. "Distributors are looking for help and Franklin is good at providing that," he says.

Diana Mackay, former chief executive of Lipper FMI, who now heads fund market research company Fund Buyer, adds: "Franklin has a wide range of products covering all asset classes and this wide range appeals particularly to large distribution platforms that are looking for a small number of suppliers that cover every nuance of demand."

DC pension reformers facing a tough task

It's going to be a stretch: confidence in having enough money for a comfortable retirement is waning dreamstime

Retirement plans

The current system will not provide an adequate income and needs an overhaul, writes **Mariana Lemann**

The first wave of baby boomers reaching retirement age and the steady termination of defined benefit plans is shedding brighter light on the need for improving the defined contribution system.

Survey after survey has shown that retirees and pre-retirees are not well positioned to fund their golden years.

The 2011 Retirement Confidence Survey by the Employee Benefit Research Institute (EBRI) shows that the percentage of workers not at all confident about having enough money for a comfortable retirement grew from 22 per cent in 2010 to 27 per cent, which represents the highest level measured in the 21 years of the survey. At the same time, the percentage very confident shrank to the low of 13 per cent that was first measured in 2009.

"The defined contribution system was originally created to supplement defined benefit programmes. But many of those defined benefit programmes were frozen or terminated," says John Carl, president at The Retirement Learning Centre.

"A lot of people are talking about redesigning the current DC system or offering alternative plan designs that could have better outcomes for participants – that is, a plan that includes certain elements from traditional defined benefit plans and also retaining elements of today's DC system."

However, those looking at reforming the system appear to have more questions than answers. Regulators, plan sponsors and the industry are picking apart the current system in search of a way to increase workers' savings and stretch those funds over a longer period of retirement.

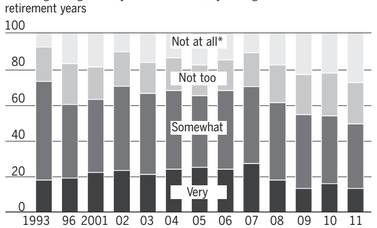
Questions include how to extend the coverage of retirement plans, how to incorporate income guarantees into retirement savings and how to align the expectations of investors in target-date funds with their actual design.

"Traditionally, the 401(k) participant experience has been narrowly focused on 401(k)s," says Don Hess, head of product innovation for JPMorgan Retirement Plan Services. "Plan sponsors are increasingly recognising that they can't look at the 401(k) by itself, but they have to look at it in the context of total financial wellness."

Within 401(k)s, which are the most prevalent type of defined contribution plan, much of the thought given to making improvements revolves around target date funds. The funds are a staple in retirement plans, with $373bn in assets at the end of March, according to Morningstar.

Worker confidence

in having enough money to live comfortably throughout their retirement years



∗ Includes 1-2% don't know or refused

Source: RCS

The funds' explosive asset growth is closely tied to their status as a qualified default investment alternative, which allows plan sponsors to default employees into those funds. The market meltdown raised many questions about the funds after some participants on the verge of retirement suffered huge losses because of heavy allocations to equities. Since then policymakers have been questioning their appropriateness as a default investment and the funds' exposure to risk.

"We have a joint task force with the DOL [Department of Labor] and SEC [Securities and Exchange Commission] scrutinising target date funds, but it is pretty clear that target-date funds will remain with their safe harbour status as qualified default investment alternatives," says Mr Carl. "They remain the easiest QDIA to implement for a plan sponsor, but I don't think necessarily they represent the best."

While several target date fund managers tweaked their funds' design and tried to communicate more clearly to investors what to expect, many still consider these adjustments insufficient.

"As they are structured today, target date funds are one-size-fits all," says Lou Harvey, president of consulting firm Dalbar. "Everybody gets exactly the same simply because of the role of their age.

> 'The single largest weakness in DC plans today is the contribution rate'
>
> **Lou Harvey Dalbar**

"That is a fundamentally flawed concept. I really do believe that target date funds could and should be reformed to simply consider factors beyond age in determining how investments are deployed."

Risk tolerance, income and other investment holdings and the nature of a participant's work, for example, are some of the factors that should be taken into account, he says. The reality, however, is that for the majority of plan participants, these factors are not considered.

Like it or not, target date funds seem to be here to stay because of participants' tendency not to act on their own behalf in saving for retirement, says Susan Czochara, senior product manager for defined contribution solutions in Northern Trust Global Investments.

"I do believe that target date funds will get the bulk of assets," she says. "Inertia can work against participants, but in the case of those invested in target date funds, it works in their favour. Participants in target date funds never left when 2008 and 2009 occurred."

Northern Trust's target date fund series, launched in October 2009, crossed the $1bn in assets threshold last month.

In fact, target date funds are expected to emerge as the largest asset class in defined contribution plans, capturing nearly 40 per cent of assets and the bulk of flows by 2015, according to McKinsey. "Most people are continuing to embrace target date funds as an appropriate solution as a default option for participants," JPMorgan's Mr Hess says. "Plan sponsors are drilling down to know what the composition of their target-date funds is."

This composition is changing across the board to include more passive strategies, leading to cost reductions, and alternative strategies, such as Tips, commodities, Reits, absolute and real return strategies aimed at reducing the volatility and downside risk.

Still, many say that even the optimal target date fund or any other construct will not address the fundamental pitfall of DC plans.

"The system needs reform primarily because, as projected right now, DC plans would not adequately fund the retirement of the participant," Mr Harvey says. The single largest weakness in DC plans today is the contribution rate. There is an over-reliance on market appreciation."

Fears over Dodd-Frank spur action

Regulation

Concerns grow on possibility of more Fed oversight, says **Beagan Wilcox Volz**

The US mutual fund industry's lobbyist, the Investment Company Institute, is tracking more than 100 rule-makings, studies and reports mandated by the Dodd-Frank Act, the sweeping financial reform law passed last July.

But the issue of "broadest and deepest concern" to the industry, says Paul Schott Stevens, ICI president and chief executive, is the Financial Stability Oversight Council's plan to designate non-bank financial institutions as systemically important, and thus subject to heightened oversight by the Federal Reserve.

Since money market funds are often cited as the focus of FSOC concern in the registered fund area, the industry is worried that managers of the funds – and/or the funds themselves – could be designated as systemic risks.

The ICI is "disappointed" that FSOC has not been more explicit about how it intends to carry out its designation duties, says Mr Stevens.

The council will meet again in May and may begin sending information requests to companies being considered for designation. It may look at assets under management, business models, whether the firm owns an insurance company, board members and other areas.

Another top concern, says Mr Stevens, is whether regulators will move forward with subjecting mutual funds that invest in commodity futures and options to oversight by the Commodity Futures Trading Commission. The ICI argued in its comment letter to the regulator that funds are already subject to comprehensive oversight in this area.

The Securities and Exchange Commission's proposed whistleblower rules are also a big source of anxiety in the industry. As proposed, the rules would allow would-be whistleblowers to bypass internal compliance programmes and go straight to the SEC. Firms believe this scenario is especially likely since Dodd-Frank provides that whistleblowers with original information leading to a successful enforcement action with sanctions of at least $1m can get 10 to 30 per cent of those penalties.

"I think the concern is accentuated by what seems to be an especially aggressive enforcement mentality on the part of the SEC," says Roger Joseph, partner at Bingham McCutchen.

Also high on the list of industry worries is the possibility that a uniform fiduciary standard will be imposed on broker-dealers.

'Just keeping tabs on the changing competitive landscape is essential'

It is unclear exactly how such a standard would change the structure and incentives that broker-dealers currently have in terms of selling funds. The SEC has said it will not move forward with any proposals on this issue until after the one-year anniversary of Dodd-Frank's passage.

Industry efforts to influence the outcome of regulation in these and other areas lifted securities and investment lobbying expenditures from $94.5m in 2009 to $103.3m last year. The ICI's lobbying costs decreased slightly from $5.5m in 2009 to $4.8m last year.

Meanwhile, Fidelity's lobbying costs went from $2.9m to $3.5m during the same period; BlackRock more than doubled its lobbying spend from $545,000 to $1.45m, as did Federated, going from $313,000 to $718,000. Vanguard remained at $1.2m in lobbying expenditures, according to OpenSecrets.org.

Beyond paying for lobbyists, the industry is also stepping up its internal and external resources to assess the onslaught of rulemaking and to prepare for it, to the extent possible.

"Just keeping tabs on the changing competitive landscape is essential," says Dan Crowley, partner at K&L Gates. Firms have to adapt to the new regulatory environment, because doing so is a necessary facet of their strategic business plans going forward, he says.

In addition to gaining a better understanding of how the regulatory environment may change, firms are also seeking to enhance their understanding of enterprise risk, says David Thelander, managing director of Promontory Financial Group. Having a strong understanding of their own businesses helps firms grasp how regulation could affect them, and in turn allows them to respond to rule proposals via comment letters.

As deadlines on final rulemaking and studies approach, the industry is keeping close tabs on the ongoing debate over the SEC's budget. The SEC gained about $74m in funding for the remainder of fiscal 2011. But whether Congress will approve an increased, decreased or flat budget for 2012 is unclear.

All smiles: Christopher Dodd (left) and Barney Frank Bloomberg

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