

The Future of Product

Asset allocation and Alternatives are considered two of the hottest areas in product right now. Research covering aspects of these topics continues to be produced by asset managers, consultants, and other organizations. In addition to a number of recent research reports included in this Synthesis, recent market conditions have served to make prescient a number of slightly older observations regarding asset allocation philosophies and products as well as alternative products. Where appropriate we have included these as well.

Asset Allocation

Broad Asset Allocation Trends

- Putnam Lovell argues that there will be a growing concentration on asset-allocation products globally, but especially in the United States, where recent pension reform places such vehicles squarely in the middle of 401(k) plans as an obligatory default option. Assemblers building such lifecycle and multi-asset portfolios increasingly style themselves as professional buyers. This allows an assembler to claim it is adding significant value through the asset allocation, often citing the famous Brinson and Ibbotson studies that attribute 90% of portfolio gains to the asset mix. It also allows the distributor to jettison poor performing managers quickly.
- In a DC-oriented publication penned by Mercer, the consultant covers trends in the lifecycle industry from both a North American and European perspective.
 - In North America, investors utilize funds that correspond to their expected retirement date, whereas in Europe investors choose from a menu of funds customized for their current age. Europeans must switch from fund to fund as they age.
 - North American lifecycle options transition from equity exposure as the fund reaches the mature state of its glidepath. In the UK and Ireland, equity exposure remains fairly static – given the reliance on target-risk options – until 5 to 10 years before retirement, when more conservative options are tapped.
- Casey Quirk advocates “combining the strategy and execution components of the investment process” under one entity. They argue that target-risk and target-date funds will look more sophisticated and account for \$920B in new flows in the next five years.

Glidepaths

PIMCO comments on the inherent deficiencies in the glidepaths of many target-date offerings in the current market.

- Most glidepaths available in the market today need to be more diversified (both in absolute terms and relative to a person's other taxable wealth) and be more focused on the effects of inflation. Accordingly, these first generation glidepaths are likely to create many winners, but also many losers, due to their extremely wide range of real expected outcomes.
- DC participants need to include equities in their asset allocation, but need to be mindful that the equity risk premium (the excess returns of equities over bonds) is very unpredictable. Including equities raises the mean expected return for DC participants over long periods of time, but also widens the range of expected outcomes between all participants. It is prudent to reduce equities as the investor's time horizon shortens in order to prevent an unrecoverable loss in purchasing power from an equity bear market.
- First generation glidepaths provide little explicit protection against inflation.
- As investment risk has shifted to the individual participant in a DC plan, we believe the optimum investment strategy should take into account that each participant must ensure their own retirement income floor, without the benefit of being able to pool risk with others. As such, the primary strategy for DC plan participants who must derive a significant portion of their retirement income from their 401(k) should be to preserve and enhance purchasing power. As such, optimizing an asset allocation against a real liability stream is more likely to provide for retirement income with meaningful purchasing power.
- Plan sponsors should concentrate on maximizing the number of people who can achieve their goals into retirement, not the total amount of wealth created. Narrowing the range of real investment outcomes is a key to maximizing utility among a population of participants. The best way to do this is to improve diversification through the use of real assets.
- Lastly, while we are not forecasting a return to significantly higher inflation, an effective asset allocation will still hedge this possibility. As expected, glidepaths that focus on real future values, like the second generation glidepaths, are typically more effective in this regard.

Wilshire argues that many of the first generation lifecycle/glidepath products have fallen short by lacking the necessary sophistication to model a participant's most important liability - the need for retirement income.

- Advocates incorporating surplus optimization to address investor liabilities and funding ratio. Surplus optimization refers to Wilshire's process of designing a glidepath that incorporates an investor's risk of not meeting their retirement income needs.

Wilshire builds its glidepath around asset classes that are more likely to track the "liability return".

- Blend traditional asset and surplus frontiers to manage investors equity glidepath.
- Dynamically model investor's life expectancy in conjunction with surplus optimization to manage their account through retirement.

Plan Sponsors Use of Target-Date

- Mercer identifies four main decisions that Plan sponsors have to make when choosing lifecycle funds for their DC plans. Certainly, the types and variety of funds available in each country will vary but the key considerations remain the same:
 1. Target-date/age versus target-risk funds.
 2. Customized target date/risk using the plan's core funds versus an off-the-shelf product.
 3. Actively managed versus index underlying strategies.
 4. With or without a tactical asset allocation component.
- Employee Benefit Research Institute (EBRI) reported nearly 66% of 401(k) plans included target-date offerings at the end of 2007, representing a 9% increase over the prior year.

Chatham Partners recently released a study focused on the criteria and usage trends within the QDIA market.

- Two-thirds of plan sponsors have selected a QDIA despite limited understanding of QDIA regulations and alternatives. Among plan sponsors that have selected a QDIA, target date funds are the most frequently cited option, followed by risk-based / balanced funds, and managed accounts. However, plan sponsors who have not selected a long-term QDIA do not demonstrate a strong preference for one alternative compared to another.
- In fact, almost 40% express uncertainty as to which option they will ultimately choose, suggesting that opportunities remain to convince them of the merits of target-date, risk-based balanced funds, or managed account approaches.

The manner in which plan sponsors have historically evaluated target- date or risk-based / balanced funds is consistent with the risk managed nature of these products. Accordingly, plan sponsors commonly cite pricing /fees, performance-related attributes, fund

diversification, and risk / return characteristics as some of the more important attributes they took into consideration when selecting a fund.

Overall, 19% of plan sponsors indicate that they use an index manager to run their QDIA. However, almost two thirds of plans that chose index managers had plans of at least \$250M in assets. Sponsors that chose index managers primarily did so because the products are low-cost, avoid security selection and market risk, and are easy to explain to plan participants.

Large plan sponsors are more likely to want to customize their QDIA fund to meet plan-specific criteria or objectives. Common rationale for customization include tailoring the risk profile to be reflective of employee risk tolerance and demographics, a desire to actively play a role in underlying manager selection, and minimizing fiduciary risk.

Alternative Products

Alternative Products will drive Product Development and Bottom Lines over the next five years. Offering investors choices beyond the traditional equity and fixed income strategies continues to be a priority at many asset managers looking to expand their product offerings while betting on the future of portfolio construction.

Deloitte takes a forward looking perspective on issues impacting the investment management industry.

- Alternative investments undergo growing pains. Assets continue to flood into hedge funds and private equity funds, and increasingly these come from institutional investors, which demand much greater transparency. In addition, some hedge funds will need to respond to investor concerns that their risk management processes may not be strong enough to handle the risks they have assumed.

Alternatives Market Share and Asset Growth

- In a September 2007 report, Casey Quirk recommended that asset managers "liberate the efficient frontier" by adopting more products that utilize shorting, derivatives, short-extension and focused-equity strategies. CQ went on to predict a doubling of AUM in "illiquid direct" investments such as private equity, venture capital, and real estate within the next five years. Within

the institutional space, CQ predicts hedge fund beta products will continue to gain recognition and eventually capture 10% (\$330B) of global institutional allocations to alternative strategies by 2011. Several hedge fund beta products have already been launched at the retail level by managers such as ING and NATIXIS.

- Putnam Lovell confirms the trend towards a greater usage of alternative strategies. In their view, alternative assets will become mainstream via extension strategies and transparent long-short portfolios. Combined, products labeled as "alternative" will represent slightly more than 50% of industry revenue within five years.

Alternatives Related M&A Activity

- Asset managers with existing alternative capabilities have recognized their value in the marketplace and have sought to cash in. According to Berkshire Capital's 2008 M&A review, 2007 represented a record year with 29 hedge fund transactions representing an average deal size of \$290M. Drawn to the high margins and recurring revenues of the asset management business, private equity investors looking to deploy capital, rushed to enter bids on available properties. Madison Dearborn Partners completed 2007's largest deal with its \$5.8B acquisition of Nuveen Investments.

Alternatives Usage

- The Financial Planning Association (FPA) found in its 2008 member survey that nearly 20% of respondents reported allocations to alternative investments in 2007, with commodities, real estate partnerships and international/global real estate funds used most frequently. The average alternative asset allocation reported by FPA members was roughly 7 percent.

Types of alternative investments most frequently used	Percentage of respondents*
Commodities	54
Real estate partnerships	54
International/global real estate funds	41
Hedge-like mutual funds	35
Private equity funds	26
Hedge fund-of-funds	24
Futures	22
Structured products	
Options	17
Currencies	15
Hedge funds	13

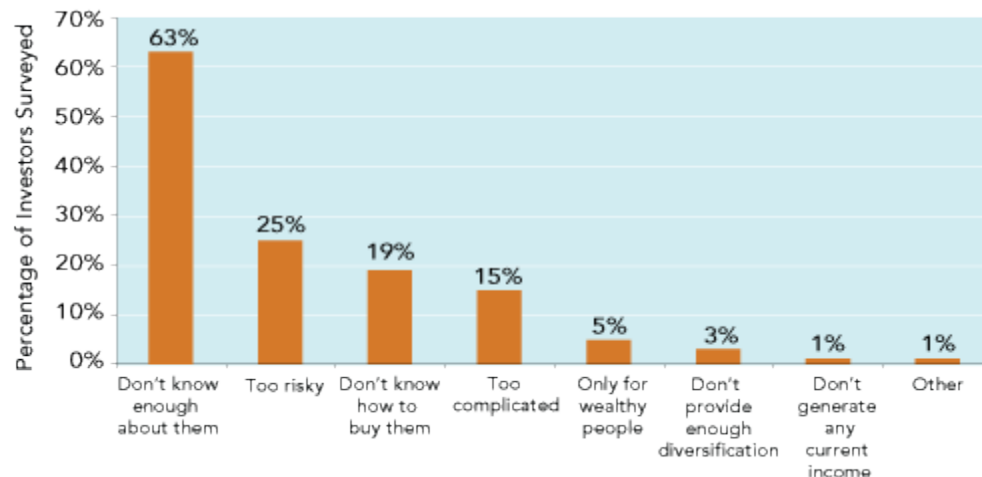
**Only asked of respondents who indicated use of alternative*
<http://www.nuwireinvestor.com/articles/alternative-investment-use-growing-financial-planner-survey-finds-51795.aspx>

Rydex Advisor Benchmarking Survey
Using Alternatives as a Client Retention Tool
April 2008 - Report Excerpt:

It's no surprise that advisors are increasingly using alternative investment products to enhance returns and mitigate risks. In fact, more than half (55%) of advisors estimate they will increase their use of alternatives by up to 25%, while 13% believe they will boost their use of alternatives by more than 75% (see *Practice Edge* January, 2008). However, many investors are not familiar with these investment products. According to a recent Rydex survey of individual mutual fund and ETF investors, 75% of investors don't

know what alternative investments are and less than 1% consider themselves very knowledgeable about alternatives. What's more, 40% of investors don't feel that enough information on alternative investments is available to them. And the number one reason investors don't invest in alternatives is that they don't know enough about them. But, they want to know more. Half of investors surveyed (50%) indicate a desire to receive more information about alternative investments via an investment advisor. When presented with a description of alternative investments, 60% of investors said they would consider investing in alternatives if their advisor recommended doing so.

Main Reasons Investors Don't Invest In Alternatives



Creative Product Development

CQ identifies some new products that asset managers will develop to remain relevant and help solve the retirement income dilemma that many retirees will face:

- **Collateralized pension obligation** – Essentially transferring a pension sponsor's funding gap to the market in the form of a structured finance vehicle where risk profiles would be spliced among various tranches.
- **Home Pensionization** - Managers will provide private pension plans in which homeowners receive a pension in return for a portion of the equity on their homes. On average, we estimate that a 65-year old homeowner should expect to receive roughly .5% of his or her home equity value per month as income.

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May 2008

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http://www.advisorbenchmarking.com/practice_value/pe_april2008.htm

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http://www.deloitte.com/dtt/cda/doc/content/me_asset_mngmt_outlook_040407.pdf

Chatham Partners

September 2008

And They're Off! – The Race to Gather QDIA Assets - An Assessment of Selection and Evaluation Criteria of QDIA Options by Plan Sponsors and Their Intermediaries”.