

Money Management Executive

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Covering Mutual Funds, SMAs, 401(k)s, 529s & More

The Newsweekly of Insight & Strategies

At Deadline

American Funds Fined For Directed Brokerage

By Lee Barney

The NASD fined American Funds Distributors \$5 million on Aug. 30 for violating the NASD anti-reciprocal rule that precludes investment companies from directing trades to brokerage firms in exchange for preferential sales treatment for their funds.

In American Funds' case, the firm directed trades to 50 brokerage firms that were top sellers of its products, the NASD charged, paying more than \$98 million in trading commissions to the brokers between 2001 and 2003.

The NASD hearing panel concluded that

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Regulation & Compliance

DB(k) Plans to Offer Opportunity in 2010

Until Then, Companies Await Clarification

By Hannah Glover

Starting in 2010, millions of American workers could get the chance to have their retirement savings cake and eat it, too.

The 2006 Pension Protection Act allows for businesses with 500 employees or fewer to offer hybrid defined benefit/defined contribution plans. These so-called DB(k)s provide a low employer-paid guaranteed lifetime monthly retirement benefit that can be supplemented by voluntary tax deferred contributions from employees.

In an era when government and businesses have shifted the burden of preparing for retirement from employ-

ers to employees, these DB(k)s combine the security workers enjoy through traditional pensions, with the individual control over investments, straightforward approach and tax advantages that first made defined contribution plans so popular.

"It takes [out] some of the guesswork," said Tom Foster, national retirement plans spokesman for The Hartford in Hartford, Conn. "The income stream in a 401(k) defined contribution plan is predicated on how you've invested your funds," he said.

Although many people, at first, like the idea of picking their own investments, too often, they fail to participate

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Retirement

Affluent Fail to Consider Retirement Income

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Funds Flows on Track to Outpace 2005

By Jessica Papini

The mutual fund industry has seen strong inflows thus far this year, and the market outlook appears stable for the rest of the year, pointing to a generally promising outlook for 2006, according to a report from Strategic Insight of New York.

Over the past six months, stock and bond long-term funds have netted \$175 billion in inflows, according to the "State of the Mutual Fund Industry Mid-Year 2006" report.

"There has been a high level of investor

confidence in mutual fund vehicles even during the difficult past few years," said Avi Nachmany, director of research at Strategic Insight. Worldwide mutual fund net inflows neared \$1 trillion last year and more than \$400 billion in the past six months.

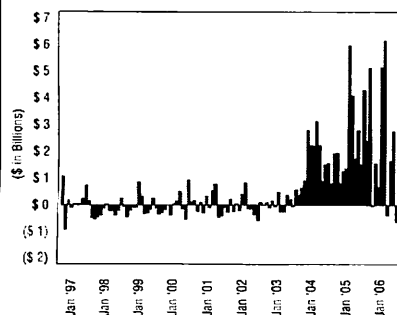
At this pace, net flows into U.S. long-term funds by the end of this year could surpass the nearly \$300 billion they took in during 2005, when they declined from the \$325 billion they took in during 2004.

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Mutual Funds

Data Points

Monthly Net Flows Into Natural Resource Funds



While the natural resources category includes items such as paper, wood and mining, it is oil that is responsible for a large volume of trading. The fund category has experienced returns in excess of 27% annually for the past three years. Oil prices are through the roof, and with improved fund performance, fund sales have risen significantly.

Source: Financial Research Corp.

New Director's Forum Exec Speaks Out

As the new executive director of the Mutual Fund Director's Forum in Washington, Susan Ferris Wyderko hopes to help independent fund directors do their job better and increase the not-for-profit organization's responsiveness to directors' needs. This is her first job out of public service in more than two decades, although she believes

her new role allows her to continue to indirectly serve the best interests of the investing public.

Wyderko is perhaps best known for her service at the Securities and Exchange Commission, having joined the top U.S. securities regulator in 1985 as a staff attorney. Most recently,

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Governance

FUND FLOWS

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However, due to stock market declines since early May, year-to-date returns of U.S. diversified funds through July are only slightly positive. The continued decline in stock prices and geopolitical concerns have brought economic confidence down with them and have recently slowed inflows to mutual funds, the report noted. However, once investment confidence rebounds, so will inflows to mutual funds. The possible peak in the interest rate cycle in the U.S. should help global economies and counter some of the economic fallout from the Middle East crisis.

"Notwithstanding the recent pause in investors' purchases, we believe that optimism about wealth management through mutual funds persists worldwide, suggesting new growth opportunities for money management over time," according to the report.

New products have been emerging and active product development will continue. While exchange-traded funds have moved to the forefront, they are not directly competing with flows to mutual funds, according to Strategic Insight. A majority, over 80% by some estimates, of ETF purchases by advisers and individual investors are substitutions of stock and separately managed accounts—not a replacement of buy-and-hold mutual funds.

Strategic Insight also said there has been a noticeable shift in investors creating more prudent asset allocation and increased diversification. Investors are increasingly gravitating to U.S. growth funds and shying away from value-orientated funds, which have dominated investment choices over the past four years. Additionally, there has been an increase in purchases of funds-of-funds and bond funds.

"It's a positive thing that people have learned lessons from the bear market and are becoming more effective in rebalancing their portfolio and asset allocation," said Mathew

Greenwald, president of research and consulting firm Greenwald & Associates of Washington.

Narrower sector funds, such as technology and real estate funds, have not seen large inflows of money. Emerging market funds experienced high returns and inflows in recent years, but their gains accounted for only about 15% of all international equity fund net flows last year and under 10% in 2005, Strategic Insight found.

On the other hand, investing in international funds has increased sig-

"Advisers are pushing solutions, not products."

—Owen Concannon
Analyst
Financial Research Corp.

nificantly. International equity fund inflows exceeded \$100 billion in the first half of the year. "There is greater focus on international funds, and people are realizing that they should have investments in non-U.S. funds," said Nachmany, who predicts the shift toward a higher allocation of portfolios to non-U.S. funds will continue. "Investors are realizing that they need more of an appropriate mix," he said.

Over the past five years, international funds have outperformed U.S. funds by 45 percentage points. "Investors are chasing returns, and globally the market has done better," said Niels Holch, executive director of the Coalition of Mutual Fund Investors of Washington.

Financial advisers and retirement planners are ensuring that investors are more diversified. Forces driving the asset allocation are compliance concerns, regulatory prudence, product innovation and distributor and financial adviser advice. "Advisers are pushing solutions, not products, said Owen Concannon, an analyst with Boston-based at Financial Research Corp. The model has changed and mutual fund wraps, SMAs, lifecycle funds and new products are being bought into the

mix, he said.

Inflows to mutual fund wrap accounts exceeded \$50 billion in 2005, and similar targets are expected this year, according to the report. "The process has become more institutionalized, and it's not the art of selling, now it's the science of selling," Nachmany said.

In recent years, fund ownership turnover has been low and stable, mirrored by redemption rates that are at the lowest levels experienced in modern history of the mutual fund industry. However, a majority of the money is in

retirement funds, which is usually not reallocated by investors, experts pointed out.

For large, actively managed equity funds, commission costs in recent years have generally declined, as fund sizes have increased and turnover has slowed. Between 2003 and 2005, 13 of the 20 largest actively managed funds saw their brokerage commission costs decrease by more than 30%, with the median decreasing 35%. Only one firm out of the 20 experienced a rise in its commission ratio for the two-year period. Commission rates will continue to fall as the cost structure changes and there is increased transparency in the market, experts said.

An increasing number of small money management firms that tout good performance and low fees are capturing more assets from the market. Low-fee stock and bond index funds secured \$81 billion in inflows last year. Many small managers that delivered high relative return, low relative risk and superior performance, grew rapidly last year, according to the report.

"Investors want to invest in sustainable, good performing funds, and smaller funds that perform well will attract assets," Holch said. 