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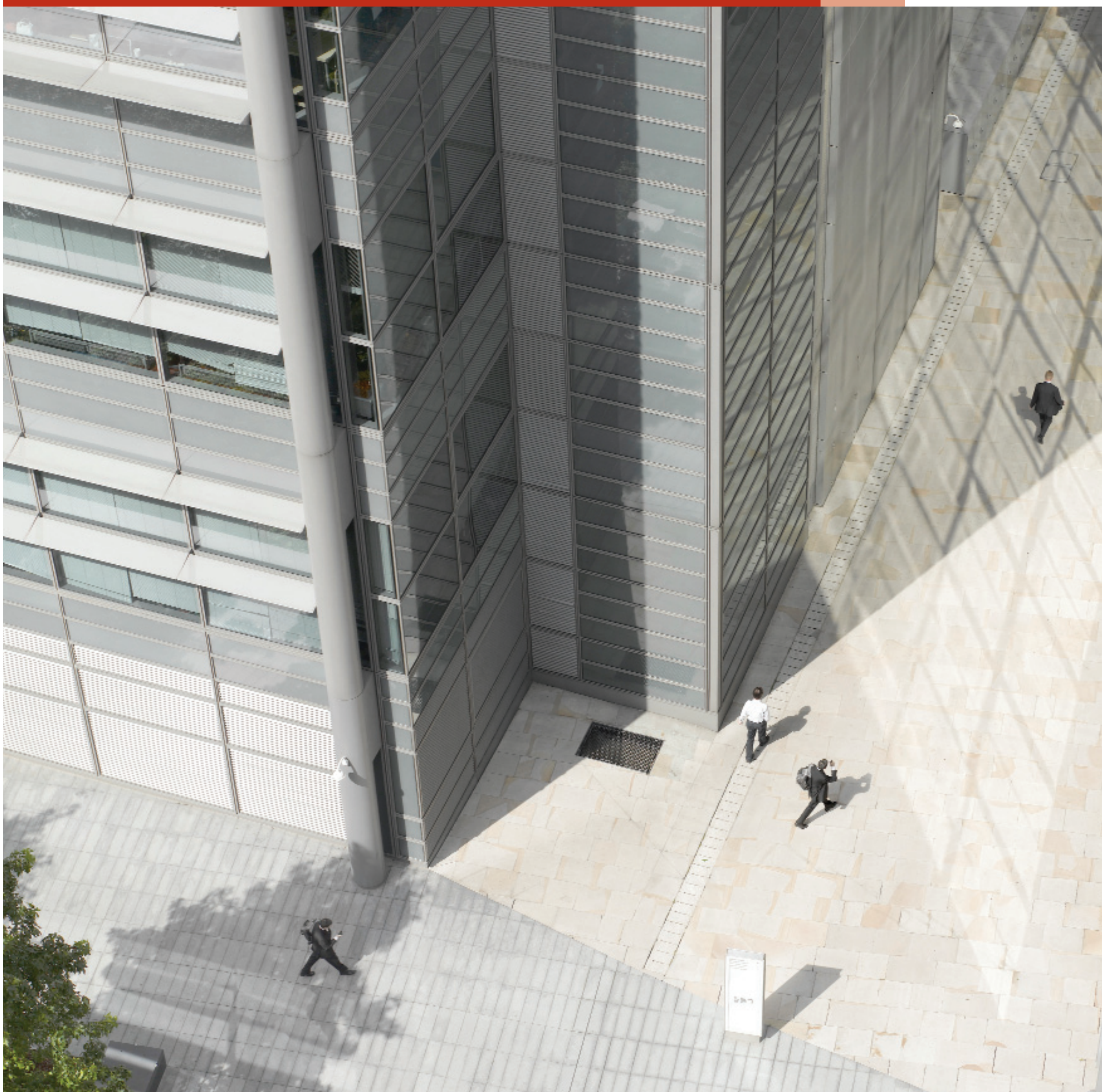
US Asset Management The State of the Industry

June 2011



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Contents

Executive summary

The chaos of 2008 and early 2009 yielded to relative financial stability and modest economic recovery in 2010; however, market volatility and regulatory reform continue to pressure asset managers in 2011.

Nevertheless, key industry findings from PwC's recent *Global CEO Survey* revealed that "asset management CEOs are among the most optimistic" of the executives surveyed, though their confidence is "tempered by a keen awareness of the challenges of increasing regulation, competition for talent and evolving investor expectations."[1]

Faced with recovering but volatile markets and regulatory change, asset managers are striving to maximize the performance parameters they can control. With asset flows generally improving, firms are focused on operational excellence, growth, performance, people-related issues, governance, risk and compliance.

The Dodd-Frank Act has ushered in a new regulatory framework designed to identify and mitigate systemic risks in the financial system and prevent future crises. The asset management industry has begun to assess the impact of the new regulations. Responding to growing demands from investors, asset management firms are strengthening their focus on transparency and risk management.

The Foreign Account Tax Compliance Act of 2009 (FATCA) will also have a significant impact on the asset management industry. FATCA adds a new chapter to the Internal Revenue Code that is focused on strengthening information reporting and withholding compliance with respect to US persons who invest through and/or in non-US entities. For many organizations, the Act will require extensive modification to internal customer information and reporting systems.

Product innovation has become an important priority as a generation of Baby Boomers approaches retirement and their focus shifts from asset accumulation to asset preservation and payout. New investment vehicles such as exchange traded funds (ETFs) continued to grow in popularity and are now considered to be viable alternatives to traditional mutual funds.

Mergers and acquisitions (M&A) remain an avenue of growth for asset management firms. The recent focus is on acquiring organizations that specialize in certain client segments or particular products.

With the media and investors scrutinizing the industry's tax practices, many asset managers recognize the need to incorporate global tax risk management into their investment strategies. They also continue searching for ways to optimize tax processes to enhance after-tax returns and minimize investors' potential future tax exposures.

In the aftermath of the financial crisis, regulators and asset managers are focused on the use of standardized, transparent performance metrics. Alternative fund managers are pursuing Global Investment Performance Standards (GIPS) as a way to build investor trust.

As the economy recovers, firms are investing heavily in talent management. A stricter regulatory environment and greater investor scrutiny is causing asset managers to rethink their traditional reward systems. Firms may have to promote non-monetary rewards in order to recruit and retain top talent.

1 PwC, "Gearing up for renewed growth: Asset management industry summary," *Key industry findings from 14th Annual Global CEO Survey*. Available at http://origin-pwc.pwc.com/ca/en/investment-management/publications/gearing-up-renewed-growth-asset-management-industry-summary-2011-03-en.pdf.

Topical issues in asset management

The asset management industry continues to grapple with a number of difficult issues, from regulatory change to talent management. Following are what we believe to be among the key challenges facing the industry.

Product innovation and management

With a wave of Baby Boomers approaching retirement, many investors are shifting their focus from accumulating assets to asset preservation and payout. Impending retirement and the erosion of portfolio values in recent years has increased investors' demand for a renewed focus on risk management and guaranteed minimum payouts.

In this environment, product innovation has become increasingly important. New investment products, notably ETFs, are being developed to meet investors' shifting needs and investment preferences. As demand for overseas investment opportunities increases, US-based asset managers are identifying opportunities to expand their global footprint through local products and offices.

With retirees drawing down assets and firms under continuous pressure to reduce their fees, asset managers are struggling to maintain a baseline of assets under service and compensate for declining fee revenue. Some asset managers have expanded their servicing capabilities to take advantage of asset flows into new product lines, such as ETFs.

Asset managers also continue to focus on product management. Significant consolidation in the industry since 2000 has led to the elimination of many redundant funds, through merger activity or shutdown. Firms that have grown through acquisition will want to consider how the products acquired will fit into their existing brands. Further, they will have to close or consolidate redundant funds post-merger, a process that can be challenging, time-consuming and costly.

Evolving investor demands

The complex demands of the global marketplace and financial turmoil of recent years have bred a new awareness and sophistication among investors and other stakeholders. Some investors in traditional funds are expecting fee reductions to offset diminished returns. Regulators and investors also are demanding greater fund transparency, assurance of reporting accuracy, and better accountability and governance from fund managers.

In this environment of changing investor demands, asset managers have the opportunity to strengthen their brands by proactively addressing stakeholder concerns. Asset managers that provide additional reporting (including third party assurance reporting), offer greater transparency, and change their policies and procedures to meet the new requirements of investors and regulators have the opportunity to gain an advantage in an increasingly competitive marketplace.

Mergers and acquisitions[2]

M&A continues to be an avenue for growth for asset management firms. Growth in M&A activity in 2010 was driven primarily by the desire of acquiring companies to grow their products and asset bases as well as to expand their geographic footprints. Both deal volume and values improved by 20% compared to the previous year (excluding BlackRock's landmark acquisition of Barclays Global Investors in 2009, for $13.3 billion). While diversification activity by banks and insurance companies has slowed, independent asset managers are gradually returning to the market in hopes of finding buyers to help them with distribution capabilities and with management of the increasing cost of compliance.

M&A activity has been focused on pure play asset managers looking to acquire small to medium size firms that serve a specific client segment or specialize in a particular product. Alternative asset managers have continued to drive M&A volume, particularly in the hedge fund, fund of hedge funds and collateralized loan obligation/collateralized debt obligation spaces.

Deal activity started out slow in the first quarter of 2011. While we see an increasing number of interested buyers and sellers, the gap between buyers' and sellers' valuations created by differing expectations of future asset flows and fund performance is resulting in failed deals. In addition, regulatory uncertainty and the impact of new tax regulations may continue to depress deal activity in the remainder of 2011. However, continued recovery in the economy, improving deal valuations and an increasing number of willing buyers and sellers should offset these negative trends.

For companies that are interested in doing acquisitions, it is important to have a clear understanding of why a potential target is a good fit with the existing business. Implementing a well coordinated due diligence effort that uncovers risks, particularly around quality of assets under management (AUM) as well as tax and regulatory compliance issues, will be critical to avoid overpaying for an acquisition. Realizing the potential efficiencies identified before a deal is completed will require rapid, seamless integration of the acquired company post transaction, with service lines working together to integrate operations.

*Snapshot: M&A activity**

Deal environment firming: Deal volume in 2010 increased over the levels of 2008 and 2009, with 117 transactions completed (an 18% increase over the previous year), but activity remained well below 2005-2007 levels. With the global economy beginning to stabilize, deal activity is expected to accelerate.

Fewer megadeals announced: One megadeal was closed in 2010—the UK-based Man Group's acquisition of GLG Partners for $1.5 billion. This was a decline from the three megadeals completed in 2009, including BlackRock's landmark acquisition of Barclays Global Investors for $13.3 billion.

Deals for alternative investment manager targets drive activity: Approximately three-fourths of deal activity related to alternative investment manager targets, with the largest share of activity relating to hedge fund managers.

Valuations improve: Both EBITDA multiples and overall EBITDA levels helped to improve valuations compared to the levels of 2008 and 2009. However, valuations remained depressed relative to pre-financial crisis levels as well as against public company multiples. In order to address valuation gaps, potential acquirers are developing creative structures.

Cross-border activity aids in the recovery: Cross-border M&A accounted for 61% of total deal value in 2010, with the UK, UAE, India, Switzerland and Hong Kong being the dominant cross-border investors. US-based investors continue to eye emerging markets such as Brazil, India and China, and investors from those countries are looking to enter the US market.

*Source: Thomson Reuters

2 PwC analysis, based on data from Thomson Reuters.

Managing global tax risk

Governments worldwide are introducing legislation and standards that require funds to provide greater transparency in their financial reporting, and they are focusing on tax strategies to minimize taxes in their jurisdictions. The media and investors also are scrutinizing asset managers' tax practices. Major newspapers have run front page headlines about funds targeted for tax avoidance, and investors are asking more sophisticated questions about how funds invest internationally and manage their global tax risk exposures.

In this environment, the tax function can no longer focus solely on tax compliance. Fund managers may want to proactively consider current and potential future tax risk management as a key component of the fund's overall investment strategy. The way in which an asset management firm manages its global tax risk can affect not only its financial performance but its reputation.

In response to increased scrutiny, senior executives of funds are attempting to gain deeper insight into tax exposures that could have a material impact on financial statements and the investment firm's reputation. Increasingly, CFOs are requiring their tax leadership to take ownership of tax risks and internal tax controls globally. A systematic approach, with strong information and communication procedures, will be needed to manage global tax risks. We view this as one of the more serious challenges for the tax function over the next few years.

Global sourcing

For asset management firms, the recent financial crisis resulted in poor investment performance, which led to declining AUM. The reality of dwindling resources has led to underinvestment in technology infrastructure. Now firms are evaluating their infrastructure options, and deciding whether to pursue significant internal development or outsourcing. Many are choosing the latter option, as outsourcing allows firms to leverage third party service providers' technology investments, reduce costs and receive high quality, specialized levels of service.

Some firms are moving in-house functions to third parties, establishing or expanding their existing offshore locations, and/or consolidating select business operations into shared service centers known as "centers of excellence."

The potential for outsourcing extends beyond back office operations to include core functions such as product development and research. Asset managers that choose to outsource these functions can tap into significant talent, particularly in Asia and to a lesser extent, in Latin America, but will require changes to existing operating models.

Tax optimization

Competitive pressure has forced asset managers to optimize their operations by implementing technology, workflow and process integration solutions. As part of this effort, tax departments have been given optimization responsibilities, ranging from redesigning inefficient processes to managing the complex tax risks associated with multinational funds. The goal of tax department optimization is to support and enhance a fund's after-tax returns and minimize investors' potential future tax exposures.

The tax optimization process will vary considerably among funds, depending on factors such as the fund's strategy and types of investors, where the fund manager is based, and where investment strategies are deployed throughout the world.

When determining how to optimize a fund's tax position, asset managers can begin by analyzing how much time the tax function spends on identifying and delivering value-enhancing strategies, how to improve the efficiency of tax calculations and compliance processes, and how to better integrate the tax team into the business. Asset managers may want to consider devoting resources to keep up with the rapidly changing global tax landscape.

Topical issues in asset management

Product innovation and management:
Many investors are nearing retirement and shifting their focus from accumulation of assets to asset preservation and payout. This shift is spurring the development of new products, such as emerging market funds and other alternative investment vehicles.

Evolving investor demands:
Investors in traditional funds are demanding fee reductions to offset diminished returns and are expecting greater transparency of financial information. Firms that proactively address investors' growing demands will be better positioned to succeed in a highly competitive environment.

Mergers & acquisitions (M&A):
Deal activity improved over 2009 but remained well below the levels experienced between 2005 and 2007. Growth was driven primarily by asset managers seeking to expand their product lines and global footprints. We believe that asset management M&A is poised to gain momentum, despite the fact that activity in the first quarter of 2011 started out slow. Continued uncertainty related to new regulations and a valuation gap between buyers and sellers continue to slow down the pace of recovery in deal activity.

Managing global tax risk:
In an era of heightened government scrutiny, the tax function can no longer focus solely on tax compliance. Fund managers may want to be proactive in considering current and potential future tax risk management as a key component of the fund's overall investment strategy. The way in which an asset management firm manages its global tax risk can affect not only its financial performance but its reputation.

Global sourcing:
Coming out of the market downturn, asset managers are investing less in their in-house support infrastructure. Many are turning to outsourcing to reduce costs while leveraging the scalable technology investments and expertise provided by third parties.

Tax optimization:
Asset managers, feeling competitive pressure to optimize their operations, are giving tax department directors responsibility for optimizing their operations, from redesigning inefficient processes to managing complex tax risks. The goal is to increase the efficiency of the department while enhancing the fund's after-tax returns and minimizing investors' potential future tax exposures.

Performance measurement:
The latest version of GIPS became effective in January 2011. While many mutual fund managers have long complied with the standards, managers of alternative investment funds also are considering GIPS compliance as a vehicle for building investor trust and assuring independence of performance reporting.

Talent management:
As signs of market recovery continue, asset managers are once again investing heavily in recruiting and retaining talent. They face many challenges in this area, from dealing with regulatory, investor and media scrutiny over compensation to preserving shareholder returns in the face of increasing payroll expense.

Regulatory change:
A number of new laws affecting asset managers were enacted in 2010. For many organizations, the passage of legislation such as Dodd-Frank, FATCA and the RIC Modernization Act will require extensive changes to operational processes and governance models.

Performance measurement

In the wake of the financial crisis, managers and regulators continue to focus on the use of standardized, transparent performance metrics in the asset management industry. The most widely recognized and commonly used tool is the Global Investment Performance Standards (GIPS). Asset managers leverage GIPS to calculate and report on their performance.

Most traditional managers have long complied with GIPS. More recently, managers of alternative investment funds have become interested in GIPS compliance as a source of independent assurance of performance reporting.[3] Compliance with GIPS standards can help alternative funds to reinforce investor trust and build new relationships with prospective clients. Compliance also can help to establish a more consistent set of procedures for calculating and reporting on investment performance.

The latest version of the standards, GIPS 2010, became effective January 1, 2011. Some provisions of the revised standards, including changes to valuation practices and reporting of carve-out returns, will require some asset managers, including smaller firms, to modify their operations to accommodate new valuation practices and reporting requirements.

Talent management

As the market continues to recover, asset management firms are once again investing heavily in attracting and retaining talent. The changing regulatory environment, which demands a greater focus on risk management and increasing transparency, will have significant implications for talent management.

With pressure to increase base salaries, asset managers are challenged to preserve shareholder returns in the face of rising payroll costs. They also are searching for ways to redefine the overall compensation package, taking into account pressure from employees and scrutiny from shareholders, regulators and the public over incentive outcomes.

Regulatory guidance on incentive compensation arrangements has spread from the banking and capital markets sector into asset management as a result of the Capital Requirements Directive III in Europe and the Dodd-Frank Act in the US. Guidance issued to date will require greater disclosure of incentive compensation and governance processes. The largest firms (over $50 billion in balance sheet assets) also may be subject to specific rules on deferral of incentives and the use of performance adjustments during the deferral period. The evolving regulatory environment will accelerate efforts to evaluate overall compensation mix (base salary, annual incentive, long-term incentive) for key positions within asset management firms.

Regulatory restrictions (e.g., prohibition of proprietary trading and increased demands for transparency) could drive talented risk seekers to set up their own investment or private equity firms or even choose to leave the asset management industry, impacting the supply of top talent in the industry. In addition, the “Volcker Rule” prohibiting banks from sponsoring or managing hedge funds will have an impact on human resources, as banks spin off their alternative investment operations.

The more restrictive regulatory environment will require a rethinking of traditional reward systems. To recruit and retain top talent, asset managers may have to promote non-monetary rewards, such as opportunities for professional development and global deployment as well as cross-functional experience.

Regulatory change

The speed of regulatory change has asset management firms struggling to assess the impact of anticipated new requirements and expectations from regulators and investors. Asset managers are rethinking their operational processes and governance models in response. A number of key regulations impacting the asset management industry are highlighted below.

Dodd-Frank

Among other things, Dodd-Frank imposes new oversight of firms and activities deemed “systemically important” and impose entirely new

3 There are other paths to third party assurance as well, including independent examination of a manager’s investment performance, performed under the attestation standards of the American Institute of Certified Public Accountants (AICPA) and International Standards on Assurance.

regulations over derivatives trading. It also requires advisers to private funds—previously exempt from registration—to register with the SEC as investment advisers, comply with requirements of the Investment Advisers Act of 1940, and to file new information with regulators. For advisers to private funds, becoming registered requires adopting and implementing a formal compliance program, designating a chief compliance officer, performing testing and ensuring strong compliance controls.

Dodd-Frank contains other new requirements that may have a collateral impact on asset management firms, including requirements related to incentive compensation, asset-backed securities, credit rating agencies, and incentives for whistleblowers. The Act also provides for a potential new standard of care for broker-dealers and the possibility of a changed regulatory oversight structure.

Dodd-Frank requires that regulators propose and adopt a myriad of rules for implementing the Act. Asset management firms have been working hard to assess the potential impact of Dodd-Frank on their organizations, provide comments to regulators, and make plans to comply with its many provisions. That requires, among other things, determining how best to organize the cross-functional resources needed to implement the new regulations. Having a dedicated capability that is empowered and accountable for implementation on an ongoing basis can help to ensure continued compliance.

FATCA

This regulatory framework was enacted in March 2010 as part of the Hiring Incentives to Restore Employment (HIRE) Act. Beginning January 1, 2013, FATCA will impose a 30% US withholding tax on any US-sourced dividends, interest, rents and other investment income, gross proceeds from the sale of US stocks and securities, and payments on certain US equity swaps paid to foreign financial institutions (FFIs) and non-financial foreign entities (NFFEs) that fail to disclose US ownership.

FATCA has significant business and tax implications for asset management firms. It imposes new operational requirements and costs on offshore funds with underlying US investments, their service providers and counterparties. For many organizations, the Act will require extensive modification to internal customer information and reporting systems.

FATCA's tax provisions will compel most offshore funds that have meaningful direct or indirect US investments, including certain synthetic investments (e.g., through equity derivatives), to enter into FFI agreements. Otherwise, the 30% tax on gross proceeds from the disposition of investments, regardless of whether received directly through withholdable payments or deemed to have been received indirectly through passthru payments, will make most US investments uneconomical. If a fund has any material turnover, the tax could readily exceed the fund's net asset value.

Every asset manager will need to understand the legal, tax, regulatory and systems implications of FATCA. While final guidance has not yet been issued by the IRS, the timeline for compliance is aggressive, leading many organizations to plan ahead for compliance. Offshore funds with underlying US investments, and their service providers, can begin by assessing the business and tax risks arising from FATCA and outlining a plan to limit risk exposure and implement a comprehensive compliance solution.

FBAR

On February 24, 2011, the federal government published new regulations related to Form TD F 90-22.1, Report of Foreign Bank and Financial Accounts, commonly referred to as "FBAR." The new regulations, which became effective March 29, could affect a significant number of US persons with a financial interest in, or signature authority over, foreign financial accounts (FFIs) reported on FBAR. Changes to the FBAR rules may require officers and employees who previously had no FBAR reporting obligation with respect to their employer's foreign financial accounts to file an FBAR by June 30, 2011.

RIC Modernization Act

The Regulated Investment Company Modernization Act of 2010 was passed into law in December 2010. It is the culmination of efforts by the mutual fund industry in recent years to modernize various tax rules applicable to regulated investment companies (RICs). The Act contains 17 provisions that collectively are among the most significant to affect RICs since the Tax Reform Act of 1986.

Prior to passage of the RIC Modernization Act, RICs faced a number of potentially severe tax consequences for inadvertent compliance oversight errors. The Act modifies some of these rules, reducing the tax risks faced by RICs. For instance, it will allow RICs to pay financial penalties rather than lose RIC tax status for qualification violations. The Act also presents new opportunities. Among other things, funds of funds will be able to own international and municipal bond funds and pass through foreign tax credits and tax-exempt income from those funds to fund of funds shareholders.

For tax service provides, a first step in complying with the RIC Modernization Act involves managing transition risk—understanding how and when funds are impacted, assessing state tax consequences, and keeping current on emerging questions and uncertainties. Other compliance activities include assessing the changes required to existing policies and procedures, managing calculation risk, and coordinating with and educating other impacted parties.

A broad range of groups that provide services to RICs will see their responsibilities affected by the RIC Modernization Act. That includes not just fund management and tax service providers, but also personnel in the fund reporting, marketing, transfer agency, information technology and compliance functions. Management may want to consider assembling a task force to analyze the Act and assess its impact on the fund's various service providers.

Other proposed or enacted regulatory change

Distribution and management

The SEC has proposed new rules to replace the existing regulations governing mutual fund distribution and marketing fees, including so-called "12b-1 fees." The proposal calls for capping fund sales charges, improving transparency through disclosure, encouraging retail price competition, and modifying the oversight role of directors. The new rules, if adopted, will have far reaching consequences on how distribution deals are negotiated and how much can be charged. The SEC has indicated its intent to address distribution issues in 2011.

Revised SEC Custody Rule

The SEC revised the "Custody Rule" (Investment Advisers Act Rule 206(4)-2) effective in March 2010, to provide greater transparency to clients and regulators, improve oversight through independent testing, and increase the controls for registered advisers that maintain custody of client assets. Those private fund advisers that must register with the SEC face new reporting and audit requirements under the Custody Rule.

"Pay to play"

New rules adopted by the SEC prohibit an investment adviser from providing advisory services for compensation (directly or through a pooled investment vehicle) for two years, if the adviser, or certain of its executives or employees, makes a political contribution to an elected official who could influence the selection of the adviser (Rule 206(4)-5 under the Advisers Act). These new requirements create significant recordkeeping and compliance obligations.

Mutual fund industry overview

Recovering from the financial crisis, the mutual fund industry has seen continued growth in AUM, while investors continue to look for ways to maximize returns. Following are highlights of the state of the mutual fund industry.

Market size

US AUM increased during 2010 across all fund types except money market funds, which have experienced significant declines since 2009. Investors appear to be globalizing their allocation models, given the increase in demand for international and emerging market equities as well as global/international fixed income funds.

Competitive environment

The mutual fund industry remains highly competitive, despite a significant amount of M&A activity over the past few years and a long-term consolidation trend. Through the financial crisis, a number of firms reduced operating expenses while shoring up their balance sheets, emerging with an improved financial position. Now firms are looking to make strategic acquisitions in order to boost market share, create synergies, and expand their investment capabilities.

Product offerings

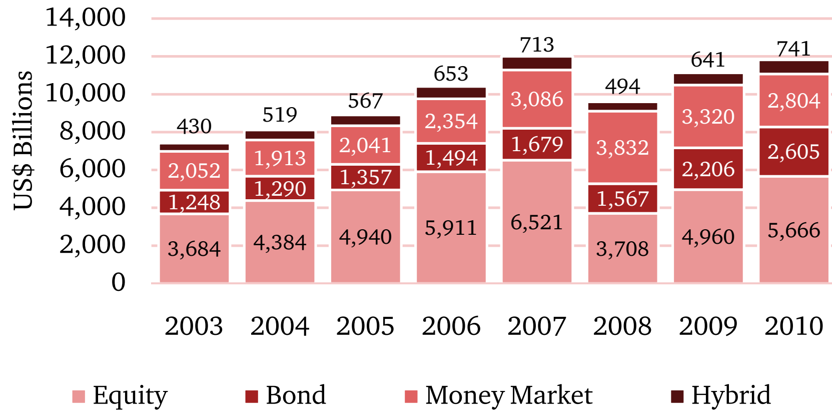
Mutual fund offerings continued to decline in 2010, while the number of other investment vehicles, especially ETFs, increased in response to changing investor demands. The main drivers behind the decline of mutual fund products were mergers and liquidations of funds as managers attempted to create economies of scale, cut costs, and reduce the overlap in their fund line-ups. Product innovation continues in response to increased investor interest in ETFs, absolute return funds, and alternative investments.

Earnings drivers

AUM continues to be the key driver of earnings. While mutual fund assets remain below pre-crisis levels, other fund assets continue to reach new highs. Since the crisis, mutual fund AUM increased 15.9% and 6.2% in 2009 and 2010, respectively. Through the end of 2010, equity fund assets increased 14.2%, bond fund assets grew 18.1%, and hybrid fund assets increased 15.6% from the prior year. Money market fund assets declined 15.5% through the end of 2010, as investors sought out higher-yielding asset classes. Assets invested in other investment vehicles, such as ETFs, UITs, and closed-end funds, continue to reach new highs, primarily due to the growth of ETFs.[4]

Achieving top-line growth requires asset managers to capture investor flows and consider the makeup of AUM. Earnings are driven by the optimal mix of asset classes and related fee structures. For instance, equity products are associated with higher fees and margins relative to fixed income and money market products.

Mutual Fund Net Assets by Category

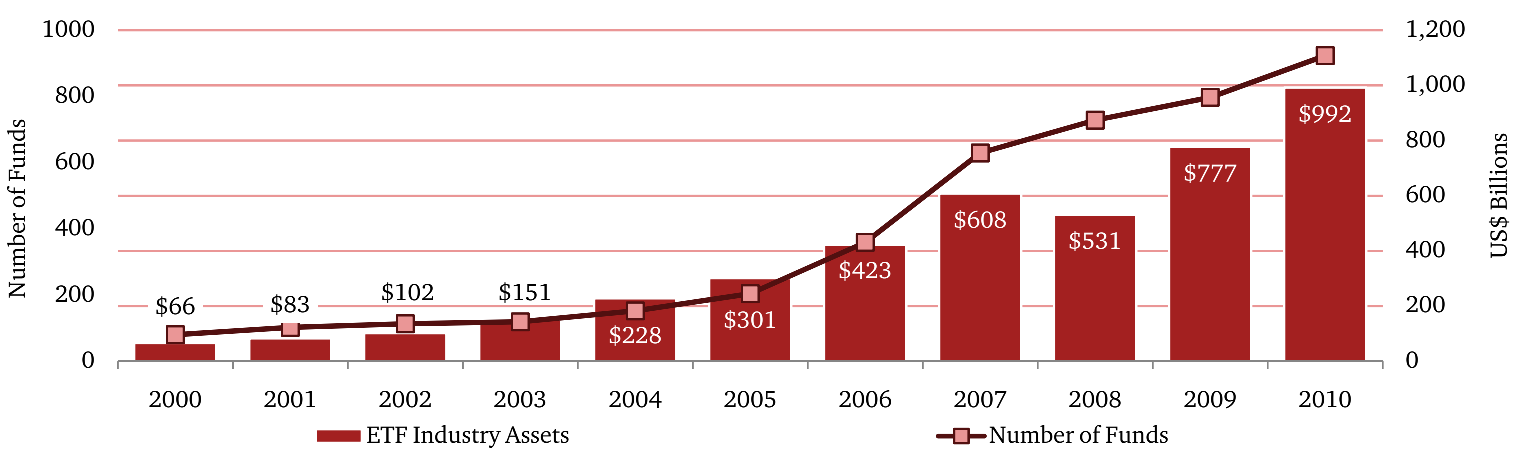


Source: Investment Company Institute

Exchange traded funds

With close to $1 trillion in AUM as of December 2010, the ETF sector has experienced tremendous growth in the last decade, becoming a strong competitor to traditional mutual funds. Competition in the ETF market remains highly concentrated, with the top five managers controlling approximately 90% of assets.[5] As new ETFs with lower fees are introduced to the market, existing ETF products face the risk of downward pressure on fees.

ETF Assets and Number of Funds



Source: Investment Company Institute, Strategic Insight, Simfund

4 Investment Company Institute.

5 Investment Company Institute, Strategic Insight, Simfund.

Money market redemptions

In 2008, the Federal Reserve reduced short-term interest rates to essentially zero. In response, investors sought alternative ways to earn higher yields, primarily by redeeming or exchanging their money market funds for alternatives such as short-duration and intermediate-term fixed income funds. Money market net outflows through the end of 2010 totaled $511 billion, slightly surpassing the total amount of net outflows in 2009 ($507 billion).[6]

For the better part of 2010, fixed income funds continued to capture the majority of long-term fund flows. However, in the fourth quarter of 2010, investors shifted toward equity funds. For the year, net new flows into equity funds totaled $134 billion—a sharp increase over the 2009 level of $15 billion.[7]

Expense ratio pressures

Fees and expenses continued their downward trend in 2010 due to industry competition and investors' migration to cheaper funds. Expense ratios vary by fund type, with higher ratios for equity funds, especially those which focus on a particular sector or on international equities. Larger mutual funds generally offer funds with lower expense ratios, as they benefit from significant breakpoint fee reductions.

Regulatory challenges

Regulators and market participants are continuing to evaluate the regulatory framework for money market funds. New regulations for these funds went into effect in 2010, including rules related to enhanced credit quality and new filing requirements for public disclosure of shadow pricing. Under Dodd-Frank, regulators are also evaluating ways to reduce reliance on credit ratings. If new rules are adopted as proposed, money market funds and other funds and their boards of directors would not be able to rely upon credit ratings in making assessments of creditworthiness.

FATCA will also change the way that mutual funds operate. To comply with the new regulation and avoid the 30% withholding penalty for nondisclosure of US ownership of certain investments, many funds will have to make significant modifications to their customer data gathering and reporting systems.

Mutual funds may also be impacted by possible changes to distribution requirements under Rule 12b-1 that would limit fund sales charges and increase fund disclosure about distribution fees, among other things. In addition, mutual funds and other asset managers that have distribution relationships with broker-dealers may be impacted by a potential change to the standard of care owed by broker-dealers to retail investors. Finally, regulators have signaled a greater focus on enforcement efforts related to the mutual fund industry, particularly with respect to fund fees, insider trading, risk disclosures and compliance programs.

Snapshot: Mutual fund industry

Market size: US AUM increased during 2010 across all fund types except money market funds, which have experienced significant declines since 2009, as investors sought to earn higher yields elsewhere.

Competitive environment: The mutual fund industry remains highly competitive despite significant M&A activity over the past few years. The long-term trend of consolidation is expected to continue.

Product offerings: Mutual fund offerings continued to decline while the number of other investment vehicles, notably ETFs, increased. The ETF sector remains highly concentrated and continues to accumulate assets.

Earnings drivers: AUM continues to be the key driver of earnings. While mutual fund assets remained below pre-crisis levels, other fund assets reached new highs.

Money market redemptions: In the low interest rate environment, investors pursued higher-yield alternatives to money market funds, such as short-duration and intermediate-term fixed income funds.

Expense ratio pressures: Mutual fund expenses were pushed lower due to increased industry competition and investor demand for lower fees.

6 Strategic Insight, Simfund.

7 Ibid.

Alternative fund industry overview

Driven by market performance and investor inflows, hedge fund assets reached $2.47 trillion by the end of 2010. The demand by investors and regulators for more oversight, transparency, and enforcement will have a significant impact on alternative fund managers. Following are highlights of the state of the alternative fund industry.

Regulation

Alternative asset managers will soon have to comply with new regulations, oversight, and enforcement actions in the United States and abroad. The following pieces of legislation (among others), in the US and Europe, will have a significant impact on the industry:

Dodd-Frank

As a result of Dodd-Frank, a significant number of private fund advisers, including advisers to hedge funds, private equity funds and real estate funds, are subject to the oversight of the SEC for the first time. Dodd-Frank requires advisers to private funds, which previously were exempt from registration, to register with the SEC as investment advisers, comply with requirements of the Investment Advisers Act of 1940, and file new information with regulators.

For advisers to private funds, becoming registered requires adopting and implementing a formal compliance program, designating a chief compliance officer, performing testing, and assuring strong compliance controls. For many alternative fund managers, becoming registered requires significant changes to operations, controls, staffing, recordkeeping and disclosures. While no conclusive numbers are available, thousands of advisers, including those based in the US and advisers based elsewhere that have US investors, will be impacted.

FATCA

FATCA compliance by offshore funds focused on alternative investments will present substantial business and operational challenges, from the identification and documentation of investors, to the fund's portfolio and IT systems, which may affect multiple functions (tax, legal, back-office administration, operations, IT, etc.)

AIFM Directive

The EU Directive on Alternative Investment Fund Managers (AIFM Directive) will bring about sweeping changes to the alternative asset management industry. The Directive will impact hedge funds, private equity and venture capital funds, real estate funds, and investment trusts. It would regulate all AIFMs distributing in the EU, whether they manage funds within the EU or in other countries. Complying with the new regulations will require stronger controls, reporting and recordkeeping.

Hedge funds: Market size and performance

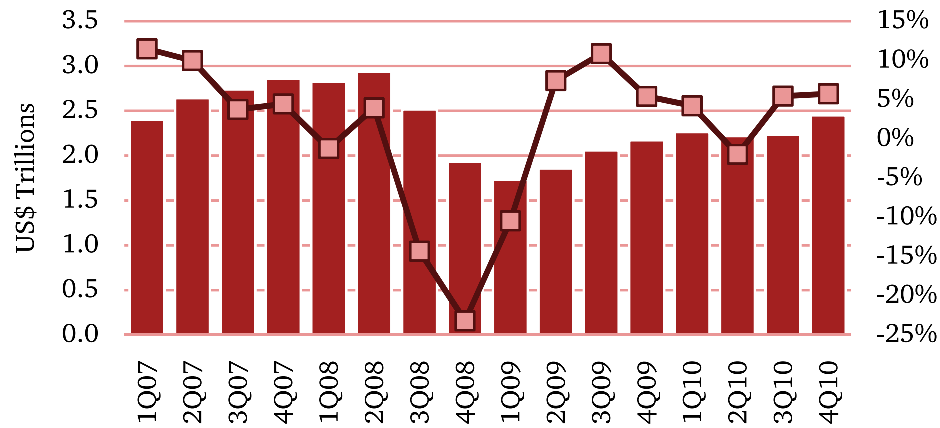
Hedge fund assets reached $2.5 trillion by the end of 2010, a slight increase from the beginning of 2010, driven by market performance and investor net inflows. Fund of hedge funds assets were $948 billion at the end of 2010, an increase of approximately $62 billion from the start of the year.[8] The change in asset levels in 2010 was driven primarily by performance rather than positive net flows.

The Hedge Fund Aggregate Index and Fund of Funds Aggregate Index were positive through the end of 2010. As in 2009, emerging market country averages, with the exception of China, outperformed the US.

Institutional investors account for more than half of hedge fund industry assets. These investors remain optimistic.[9] They continue to increase their allocations towards hedge funds to meet the need for higher returns and diversification. In 2011, 85% of institutional investors plan to increase or maintain their allocations to hedge funds.[10]

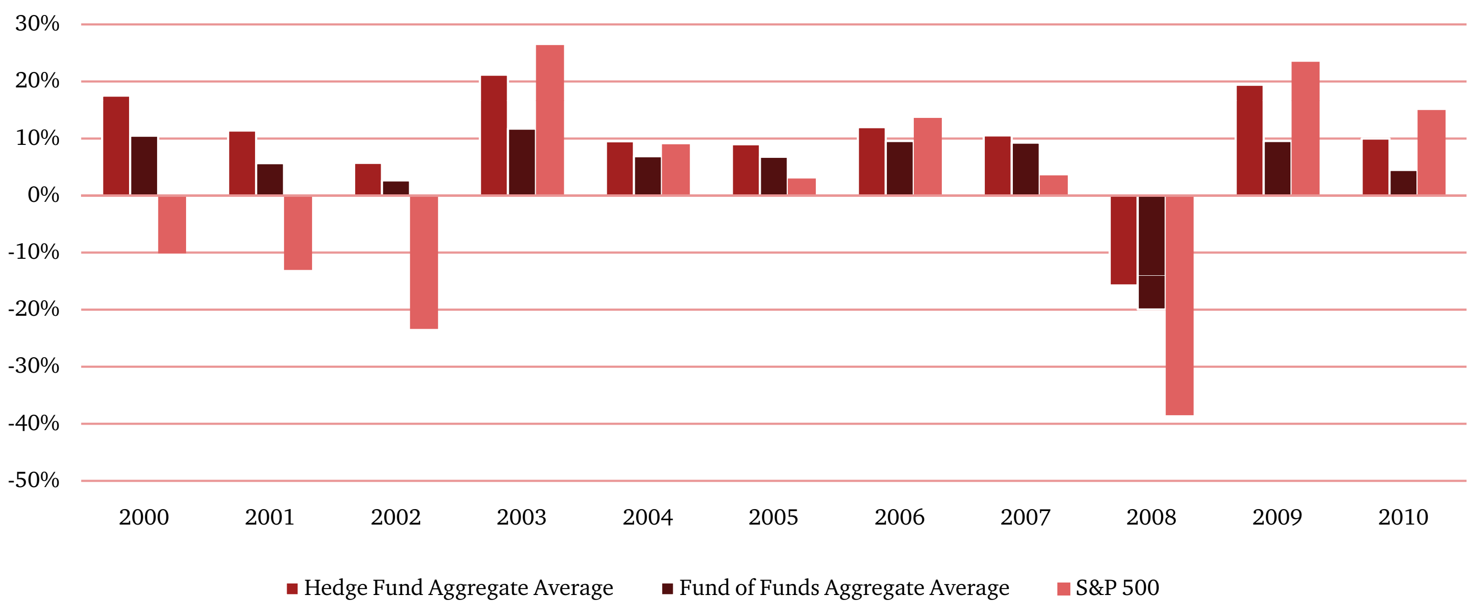
While institutional investors are optimistic, many countries are reconsidering their regulatory requirements for alternative funds. Asset managers will likely face stricter rules in the coming years and would do well to prepare for a more restrictive environment.

Single Manager Hedge Fund Assets



HedgeFund.net (HFN), Channel Capital Group Inc.

Hedge Funds and Fund of Funds Annual Returns



HedgeFund.net (HFN), Channel Capital Group Inc.

8 HedgeFund.net (HFN), Channel Capital Group Inc.

9 Preqin Research Report, "Are Interests Aligned? Fund Terms Investor Survey Results," September 2010.

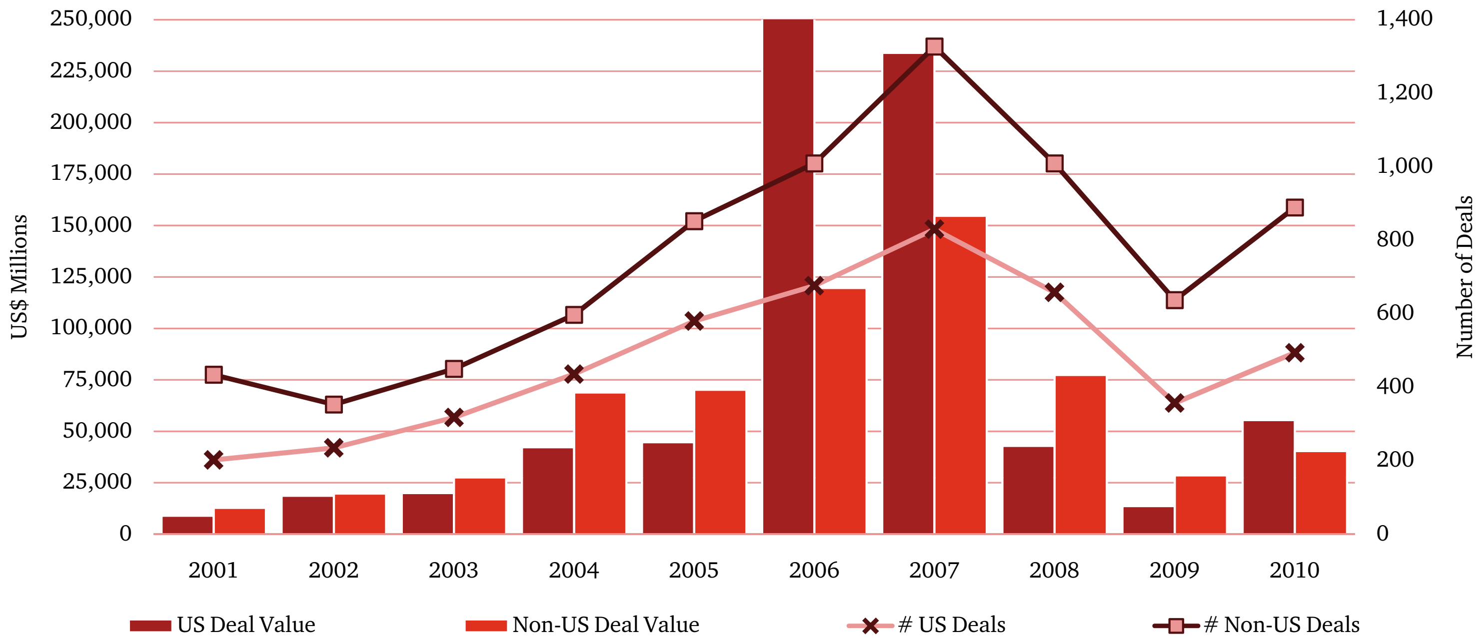
10 Preqin Research Report, "The Next 12 Months: Institutional Appetite For Hedge Funds," August 2010.

Private equity deal activity

The global private equity market is beginning to show signs of improvement, but it remains well below pre-crisis levels, as measured by deal activity and values. In 2010, the number of US deals increased 38% and the number of non-US deals increased by almost 40%.[11]

Fundraising declined over the previous year. The fundraising market continues to be challenging for asset managers currently seeking commitments. A number of firms are exploring new fundraising methods and are offering more favorable terms to attract investors.

Private Equity Deals



Source: Thomson Reuters

Snapshot: Alternative fund industry

Regulation: Alternative asset managers face new regulatory requirements in the US and Europe. Dodd-Frank and the AIFM Directive will have a significant impact on the industry.

Market size: Hedge fund assets stood at $2.5 trillion at the end of 2010, up slightly from the start of the year. Fund of hedge funds assets increased by $62 billion during the year, reaching $948 billion.

Performance: The HFN Hedge Fund Aggregate Index and HFN Fund of Funds Aggregate Index were positive through the end of 2010.

Institutional investors: These investors, which account for more than half of hedge fund industry assets, remain optimistic and continue to increase their allocations towards hedge funds, to meet the need for higher returns and diversification.

Private equity deal activity: The global private equity market is beginning to show signs of improvement, but deal activity and values remain well below pre-crisis levels. Fundraising declined in 2010 and the fundraising market continues to be challenging for firms currently seeking commitments.

11 Thomson Reuters.

Commercial real estate industry overview

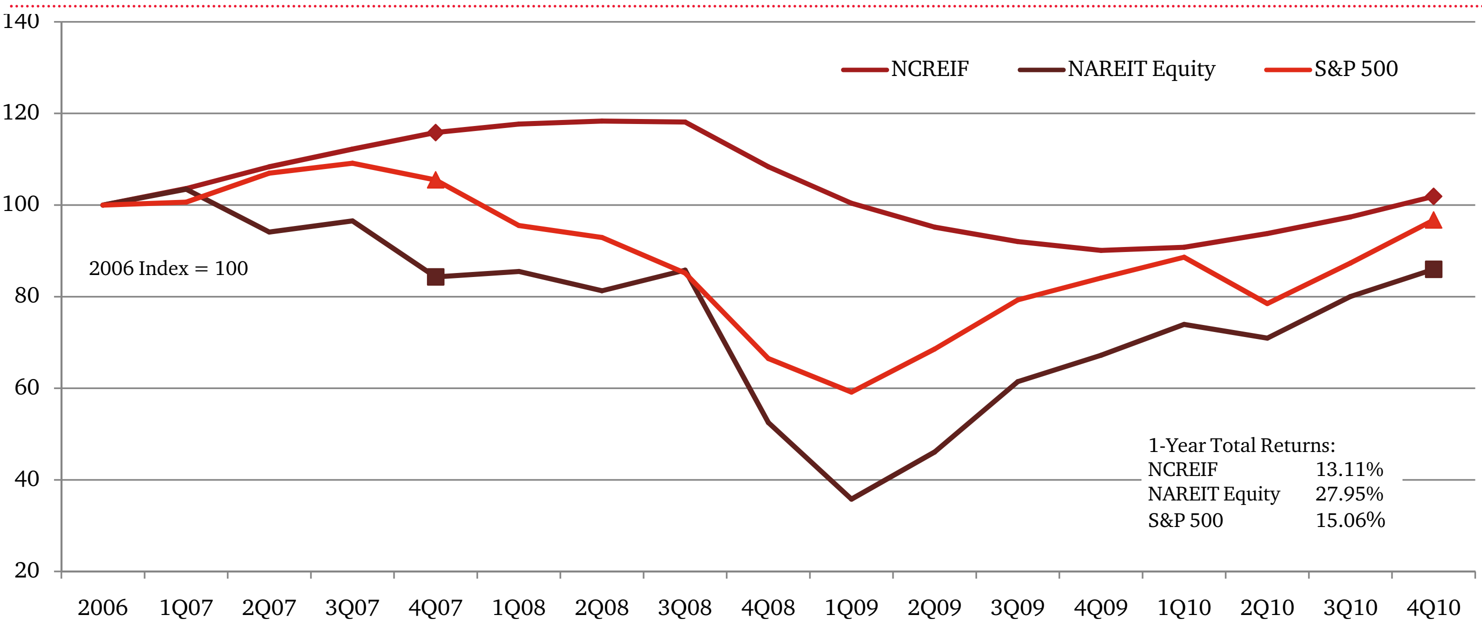
Commercial real estate markets showed signs of recovery in 2010, but the fragile state of the economy continues to create uncertainty about the future of the industry. Following are highlights of the state of the industry,

Performance, fundamentals and pricing

Both direct and indirect real estate investments have shown strong signs of recovery since the credit crisis. Equity REITs were the top performers in 2010, exceeding pre-recession levels in the fourth quarter. The National Council of Real Estate Investment Fiduciaries (NCREIF) benchmark was only 12% short of its pre-recession peak.

Rental rates for office properties have begun to show signs of recovery in select prime markets. Other property types continue to struggle. For the near term, the priority is to maintain occupancy—at almost any cost. As a result, owners and managers are focused on cementing tenant relationships. More tenants have begun to renew and extend their leases, signaling confidence that they can sustain their businesses and have a desire to take advantage of lower rates. Forecasts do not show any upward pressure on commercial rents until 2012, and few expect rents to spike anytime soon.

Index Total Returns



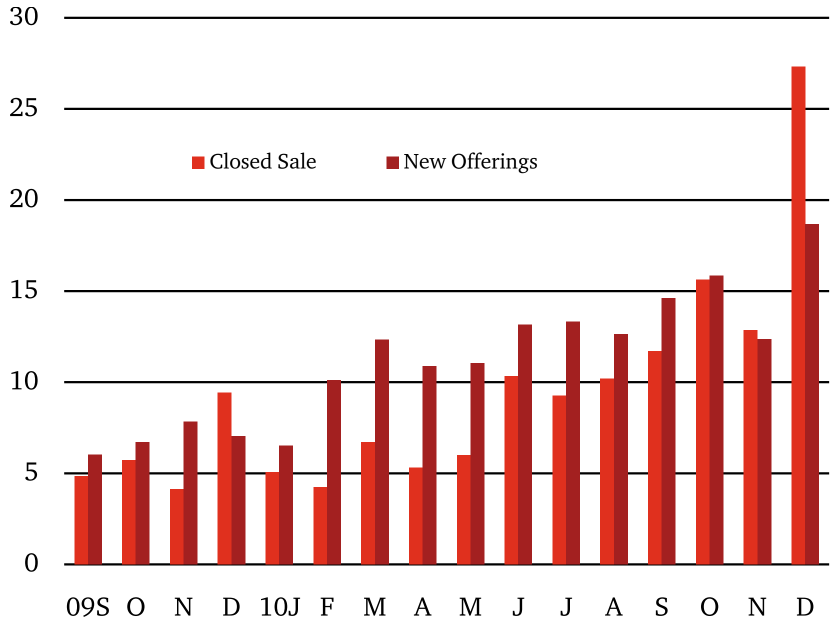
Source: NCREIF, NAREIT, Standard & Poor's

Real estate transactions

Transaction activity in 2010 was a story of quality over quantity. For healthy properties—those in attractive sectors with high tenant interest located in strong markets—pricing trends exceeded the average for the commercial real estate sector. Pricing trends for distressed properties, in contrast, were weaker due to oversupply, limited availability of financing, high vacancy rates and general investor caution.

Transaction activity lagged at the start of 2010, but for the year, the volume of transactions was double the number for 2009. Prices fluctuated throughout 2010, and this pattern is likely to continue until investors have a clearer vision of where the economy is headed. In 2011, money has been flowing into REITs, which raised the most capital in the first quarter.

Commercial Real Estate Transactions (US $ Billions)



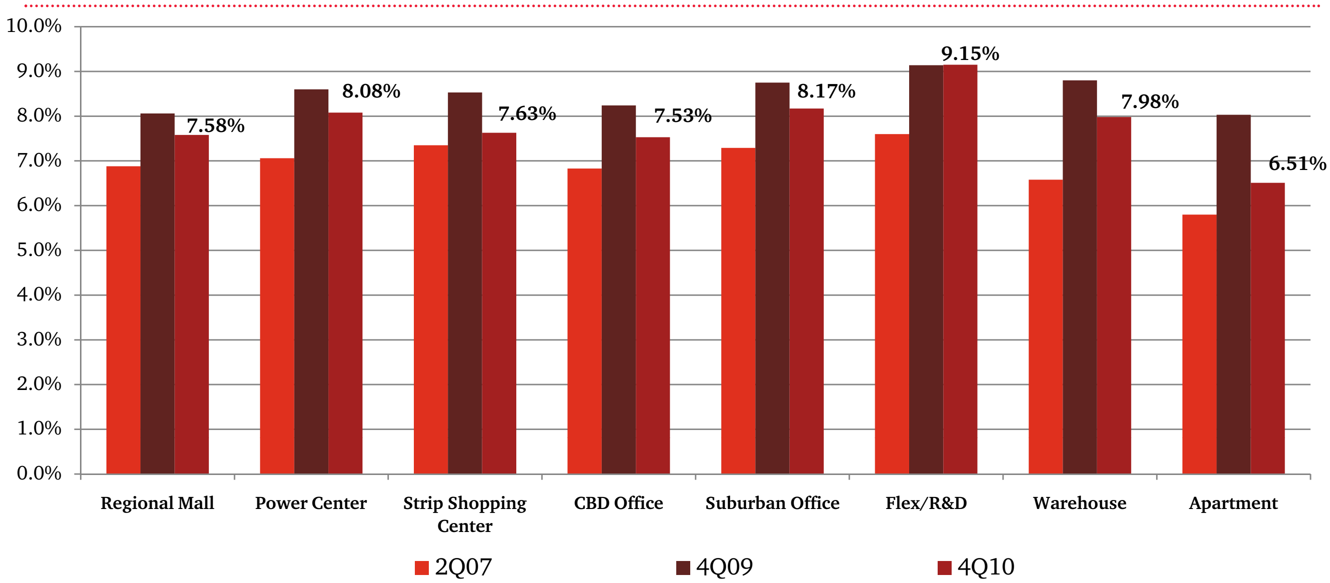
Source: Real Capital Analytics http://www.rcanalytics.com. Based on properties and portfolios $5 million and greater

Capitalization rates

With signs of a strengthening US economy evident in declining initial jobless claims, rising business and consumer confidence, and growing employment figures, the fundamentals of the commercial real estate industry are improving and attracting much attention from investors, who are eager to deploy capital as the industry moves past the bottom of the cycle.

Strong buyer interest, combined with the reopening of the debt markets and interest rates that remain low, continues to put downward pressure on overall cap rates, especially for core, stabilized assets. The first quarter 2011 issue of the *PwC Real Estate Investor Survey* reports that the average overall cap rate, a reflection of an investment's anticipated ownership risk, decreased in 27 of the 31 markets surveyed. The highest quarterly decreases occurred in regional apartment markets, where average cap rates compressed between 39 and 73 basis points this quarter.

Capitalization Rates – Commercial Real Estate Markets



Source: *PwC Real Estate Investor Survey*

Real estate capital markets

Debt and Equity Forecasts

More than 55% of respondents to the PwC *Emerging Trends in Real Estate 2011* survey[12] see equity capital as moderately to substantially oversupplied for 2011—a reaction to the recent investment surge into a few 24-hour cities and into the multifamily sector. Survey respondents view this activity as a leading indicator of the depth of sidelined equity that is slowly making its way back into the market.

Real Estate Investment Trusts

US REITs raised $47.5 billion in 2010, in more than 170 IPO, initial debt, and equity capital offerings.[13] Total capital raised during the year exceeded the record setting pre-crisis levels of 2007.

Investor appetite for both REIT equity and debt deals remains strong. Many REITs are still offering attractive yields relative to US ten-year Treasuries and providing a liquid allocation for real estate investments.

Commercial Real Estate: CMBS Market

As of March 2011, year-to-date CMBS issuance had reached $8.9 billion, well on track to surpass the 2010 total of $11.6 billion. While market activity has accelerated in 2011, issuance is not expected to reach the peak level seen in 2007. Underwriting standards remain tight, with most loans in the 60-65% loan-to-value (LTV) range and lenders enforcing stricter underwriting standards.[14]

Lodging sector

Hotel operating performance remained cyclically depressed in 2010, but the sector made substantial strides toward recovery. Performance gains were strongest in major markets, particularly Boston, Denver, Miami, New York, and New Orleans. Meanwhile, national supply growth slowed. This combination sets the stage for improvements in pricing, which are important to complete the recovery of revenue per available room (RevPAR) to its long-term, inflation-adjusted average.

Snapshot: Real estate industry

Performance, fundamentals and pricing: Economic drivers continue to depress underlying fundamentals and rents. The apartment sector and REITs are on track for the quickest recovery. The multifamily sector is showing signs of improvement in select prime markets, but performance in the retail sector continues to lag.

Real estate transactions: Transaction activity lagged at the start of 2010 but for the year, the volume of transactions was double the number for 2009. Pricing trends for healthy properties (those in attractive sectors with high tenant interest located in strong markets) were better than the industry average.

Capitalization rates: Overall capitalization rates continue to trend downward for deals in better performing markets and for the best, well leased assets in the industry. This is due to strong buyer interest, debt availability, and low interest rates. Some of the cap rate compression is related to apartment assets.

Real estate capital markets: Capital markets continue to improve, but more flow is coming from the equity side than from the debt side in 2011. We expect lenders to increase their activity in 2011, but low LTV ratios and a dry CMBS market will remain major concerns for the market.

Lodging supply and demand: Hotels are experiencing a stronger than expected rebound in demand, and further growth is anticipated. Occupancy recovery is expected to help drive pricing gains in 2011, which will be particularly important for hotels in the upper tier segments. Supply growth remains suppressed.

12 Available at http://www.pwc.com/us/en/asset-management/real-estate/publications/emerging-trends-in-real-estate-2011.jhtml.

13 NAREIT.

14 Commercial Mortgage Alert (CMAlert.com).

Conclusion

The US asset management industry is facing a new and more challenging environment of stricter government regulation and greater investor scrutiny. The major regulatory changes of 2010, from Dodd-Frank to FATCA, are fundamentally reshaping the industry and their impact will be felt for many years. The growing demands from regulators, investors and the general public for greater transparency, accountability, and risk management represent a new fact of life for asset managers. "Business as usual" has been redefined.

The brave new world of asset management presents significant challenges but also offers a major opportunity for firms to differentiate themselves. How quickly and effectively asset managers adapt to the new environment will help to determine whether they lead or lag in the coming years.

www.pwc.com/us/assetmanagement

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For more information about any of the issues discussed here, please feel free to contact your local PwC representative, or any of the Asset Management practice leaders and partners listed here. Thank you.

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