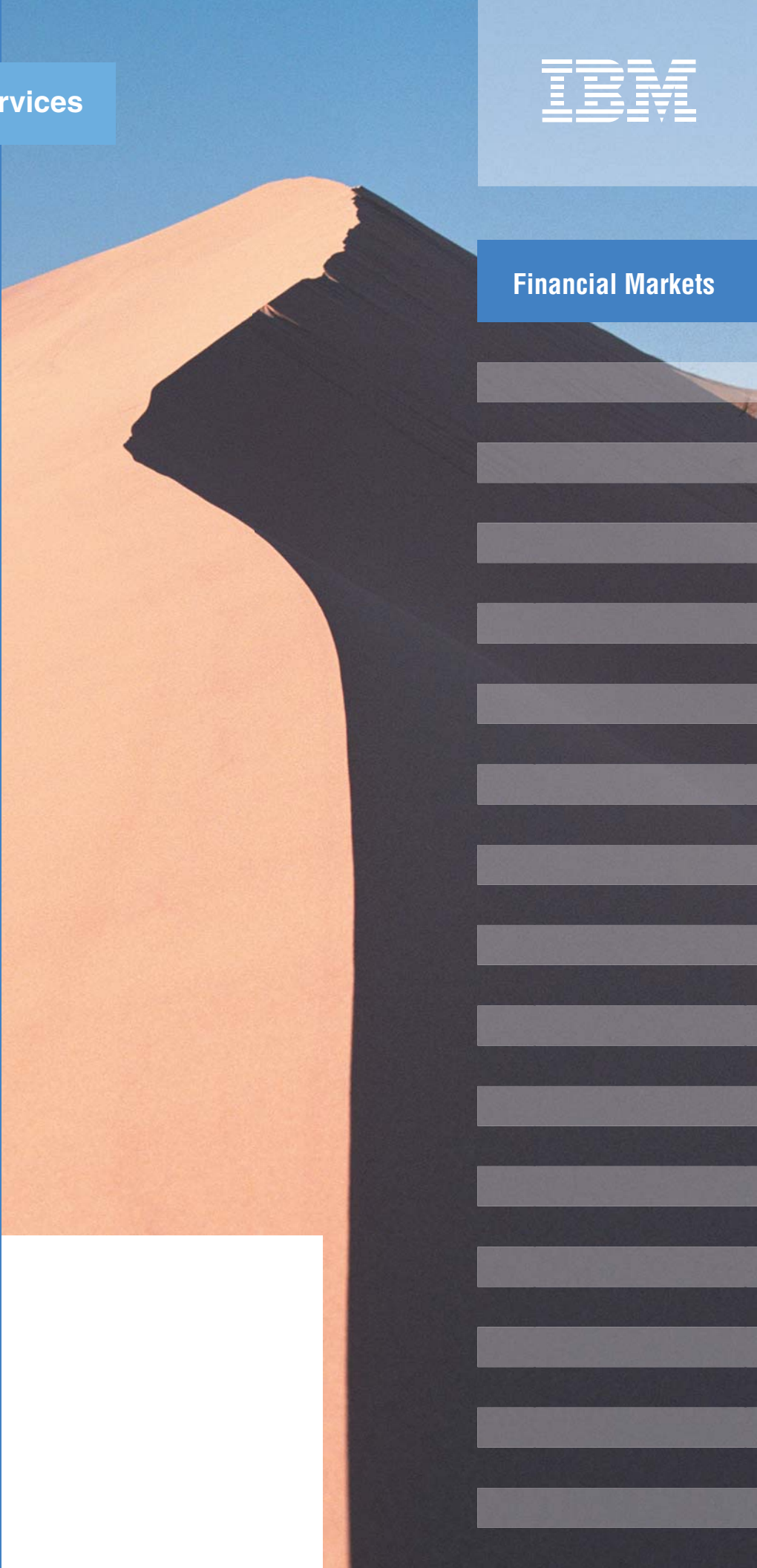


IBM Institute for Business Value

Asset managers turning up the heat

Creating differentiated
value under uncertainty

Financial Markets



IBM Institute for Business Value

IBM Business Consulting Services, through the IBM Institute for Business Value, develops fact-based strategic insights for senior business executives around critical industry-specific and cross-industry issues. This executive brief is based on an in-depth study by the Institute's research team. It is part of an ongoing commitment by IBM Business Consulting Services to provide analysis and viewpoints that help companies realize business value. You may contact the authors or send an e-mail to iibv@us.ibm.com for more information.



Asset managers turning up the heat

Creating differentiated value under uncertainty

Executive summary

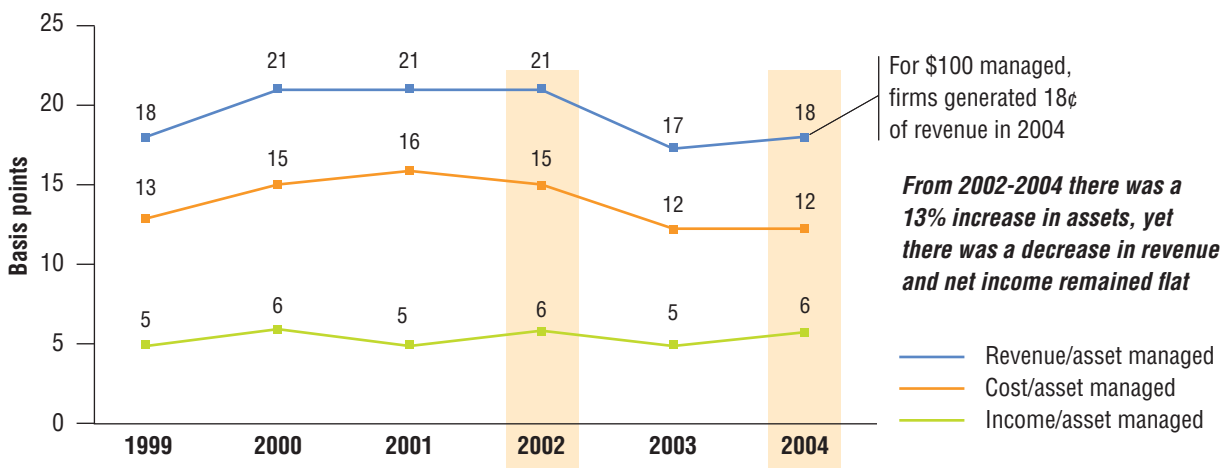
Just what is the current temperature of the asset management industry? On a positive note, the bear market has given way to impressive growth, as evidenced by the rocketing growth in global assets under management (AUM) of open-end investment companies, from US\$10.9 trillion in 2002 to US\$13.4 in 2004.¹ With such a sizeable jump in AUM, expectations of strong financial performance seem reasonable. Instead, many large, global buy-side firms have been dismayed to experience lower revenue and flat income per asset managed (see Figure 1).

The struggle for higher returns stems from persistent inefficiencies, coupled with fee pressures arising from a flight out of traditional, actively managed funds. Further compounding this struggle, analysts are pressuring the industry for double-digit growth over the next five years.²

Clearly, buy-side firms need a new approach. Asset managers must be able to respond more effectively to multiple forces shaping the industry:

- *Increasing revenue and cost pressures* – Top-line and bottom-line growth are not keeping pace with AUM growth
- *Tightening regulation* – Closer scrutiny is increasing compliance costs and uncertainty while diverting attention from revenue generation
- *Advancing technology* – Recent innovations are enabling infrastructure automation, connectivity and trade internalization
- *Demanding clients* – Investors are diversifying their asset mix while prioritizing reputation, advice and consistency
- *Intensifying competition* – The industry is consolidating, power is shifting to intermediaries and new product alternatives are emerging.

Figure 1. Revenue, cost and income per dollar managed for selected global firms,^A 1999-2004.



Note: ^A Selected asset management companies are largely institutional and include: UBS, SSgA, Barclays Global Investors, Citigroup and Mellon Financial.
Source: IBM Institute for Business Value analysis.

Consequently, buy-side firms are being forced to rethink their traditional strategies. To create value in this uncertain environment, asset managers will have to:

- *Seize growth opportunities at the edges* – Identify opportunities to gain share at the expanding edges of the buy-side product spectrum, such as hedge funds on one extreme and passive investments on the other
- *Unleash the potential of compliance investments* – Use required expenditures to build operational effectiveness and resiliency, and to further strategic goals
- *Recalibrate the business* – Rationalize workflows and capabilities and selectively partner to increase efficiency and flexibility
- *Give clients and intermediaries what they need* – Develop the ability to seamlessly and profitably meet the needs – not just the “wants” – of both clients and intermediaries.

Industry climate: Avoiding a cool spell

The once-staid asset management industry is changing dramatically in response to a host of emerging forces: some of these are obviously beneficial, while others may initially seem like obstacles. Ongoing technology advances, for example, offer the chance to fine-tune or fully transform infrastructures and processes while reducing costs from inefficiency and redundancy. But the impact of other marketplace forces – revenue and cost pressures, tightening regulations, demanding clients and intensifying competition – is potentially less positive unless firms understand how to adapt appropriately.

Increasing revenue and cost pressures

Put briefly, disappointing asset management industry performance is due to the inability to increase revenue and income per asset managed, coupled with persistent operational inefficiencies.³ Revenue and income are under pressure because assets keep flowing away from traditional asset managers, toward boutiques (featuring alternative products) and large-scale passive managers because of growing investor preference for alternative products, index products and exchange-traded funds (ETFs).

Cost pressures are the other major cause of poor industry performance. For asset managers, *compensation and benefits* comprised the largest expense between 2001 and 2004, though it remained relatively flat at around 29 percent of total revenue.⁴ But the second highest expense, *marketing and distribution*, nearly doubled during those same four years,⁵ largely due to paying more fees to independent financial advisers (IFAs) as more and more funds flow through them instead of through internal sales channels.

Tightening regulation

Closer scrutiny of the buy-side industry is simultaneously increasing compliance costs and diverting firms' attention from generating revenue. Meanwhile, pending regulations are creating uncertainty and limiting the ability of asset managers to plan ahead.

Increased transparency is emerging as the common objective of most regulations. For example, top of mind now in Europe are the Undertaking for Collective Investment in Transferable Securities (UCITS III) Directive and International Account Standards (IAS) asset/liability matching; U.S. firms are adjusting to the National Market System (NMS), as well as pending soft dollars and Securities and Exchange Commission (SEC) regulations addressing abuses like late trading, market timing, stale pricing, selective portfolio disclosure and inadequate compliance procedures. All of these regulatory changes require significant investment in systems or process changes.

Advancing technology

TowerGroup research shows that technology spending for the asset management industry is outpacing all other financial markets areas (e.g., retail and institutional sales and trading) with a projected compound annual growth rate (CAGR) of 7 percent between 2004 and 2008.⁶ Recent technology innovations are enabling asset managers to overcome the chronic inefficiencies within their siloed infrastructures. Globally, a growing share of this IT investment is being spent on software and services from external providers.

For example, to address suboptimal client and intermediary front-office integration, U.S. firms are beginning to automate workflows and improve connectivity,⁷ while Asian firms are taking advantage of improvements in data analytics and warehousing to improve the ability to segment clients.⁸ Europe's top priority is middle office outsourcing,⁹ to replace manual business processes within the middle office by partnering with highly efficient processing firms that can leverage scale across multiple clients.

Firms in all these regions are increasing their focus on technology improvements (such as data analytics, order management systems, and architecture and data standardization) to connect directly to the markets more than ever before – in some cases, eliminating the "middleman" broker. By strengthening these competencies through technology, buy-side firms are reducing their dependency on sell-side firms and passing savings on to the investor through lower fund expenses.

Demanding clients

Recent industry scandals, coupled with uncertainty on the heels of a bear market, led to considerable investor anxiety. Though signs of skittishness remain, investors are returning to the market. However, the requirements of both retail and institutional clients have changed quite dramatically in recent years.

Not only are their requirements changing, but they are asking for more than ever before and they are determined to get it somewhere, even if traditional channels do not

suffice. Transparency is in high demand as investors seek evidence of integrity and stability, such as risk management and regulatory compliance, in firms' processes and infrastructures.

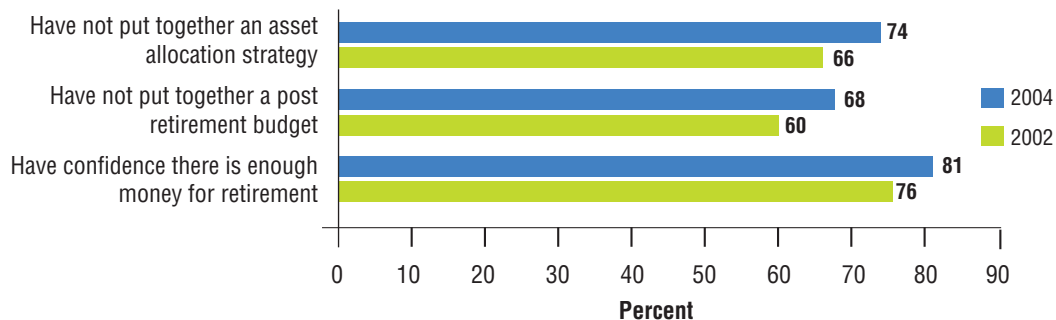
Overall, retail investors are savvier than ever before, noticing that most asset managers aren't beating the returns of the market. In fact, between 1993 and 2004, only 29 percent of active funds beat the 10.6 percent annualized return of the Morgan Stanley Capital International (MSCI) U.S. Broad Market 2500 Index.¹⁰

Such lackluster results have fueled the ongoing movement from active to passive investments. New demand for ETFs is shifting from the institutional investor to the retail investor.

In addition, the onus of funding retirement is shifting from employers to employees and profoundly affecting the needs of retail clients. From 1985 to 2004 in the U.S., assets in defined benefit pension plans grew at a CAGR of 8.8 percent.¹¹ For the same period, the CAGR of defined contribution plans was 13.6 percent.¹² Worldwide, the number of defined contribution retirement plans also continues to rise.

As a result, individual investors have more control of their retirement funds, whether or not they want it. Despite this additional investment responsibility, for the most part they are alarmingly unprepared to handle the associated investment planning. Surveys show that baby boomers – those closest to retirement age – greatly overestimate their preparedness while underestimating their need for advice (see Figure 2).

Figure 2. Pre-retiree planning and confidence (survey results).



Source: 2005 Fidelity Investments Retirement Transition Study, December 2004; survey conducted of 749 pre-retirees in the U.S. that are 1 year from retiring from a company with more than 5,000 employees and hold a DB or DC plan from that employer; IBM Institute for Business Value analysis.

In contrast to retail investors, institutional investors are shifting toward riskier, "hyperactive" products, in an attempt to make up losses they incurred in the bear market.¹³ *Hyperactive* is meant to signify an asset class that is necessarily a step beyond "active," due to the high trading volume and potential volatility of product performance.

Still another change is how investors choose their asset managers. Although *fund performance* remains the single most important factor for individual investors, it is shrinking in importance. Fund performance was cited by 24 percent of those surveyed in 1998 and only 21 percent in 2004.¹⁴ Over time, investors are placing more weight on criteria other than performance. In particular, factors contributing to *reputation* and *advice* were deemed important by 48 percent of those surveyed in 2004.¹⁵

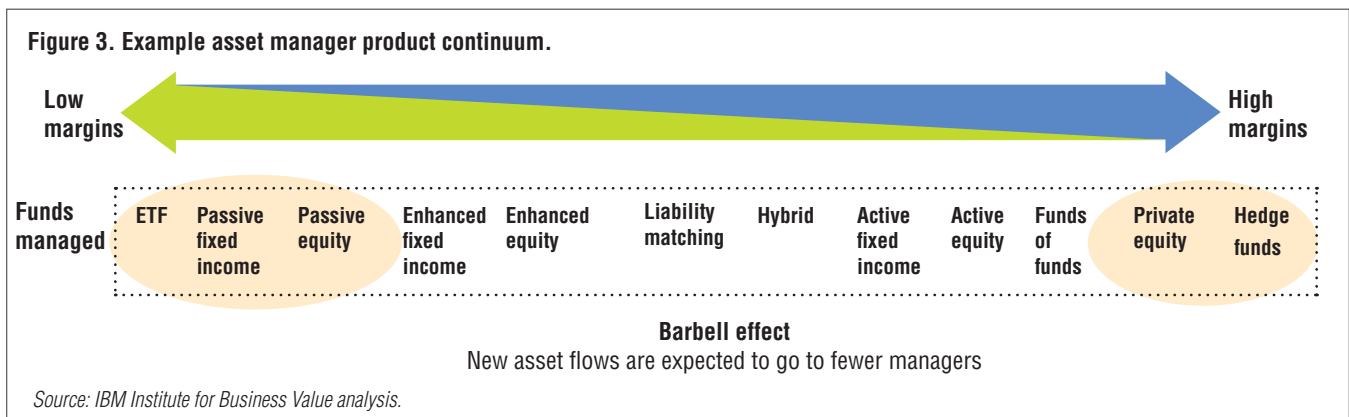
Before hiring an asset manager, institutional investors are screening much more rigorously than before. Besides *reputation, performance, investment strategy* and *experience*, advanced screening criteria can include an evaluation of *quality of support team, employee retention, investment processes, risk levels;* and *style*. To conduct this stringent selection effort, nearly half of institutional investors continue to hire external consultants.¹⁶

Intensifying competition

Because client requirements for the buy-side industry have evolved significantly, so has the competitive landscape. More and more, assets are flowing to passive and alternative products at the opposite ends of the buy-side continuum, to the detriment of traditional active funds in the middle (see Figure 3).

At one edge of the asset continuum, as a percentage of net inflows into equity funds, *net inflows into passive funds* as a percentage of net inflows into equity funds have grown from 0.3 percent in 1993 to 30 percent in 2004.¹⁷ ETFs have grown from less than 1 percent of total worldwide equity assets in 1998 to over 5 percent at year end 2004.¹⁸

Over the same period, U.S. institutional assets flowing into riskier products at the other edge – including real estate equity, private equity, balanced products and hedge funds – grew 17 percent in one year, from US\$416 billion in 2003 to US\$487 billion in 2004.¹⁹ Growth here reflects how institutional investors are now demanding alternative products. As a percentage of total U.S. defined benefit assets, alternatives (defined as hedge funds and private equity) have doubled, from less than 2 percent in 2003 to over 4 percent at year-end 2004.²⁰



This movement toward the edges means that fewer managers are likely to receive the new asset flows. Asset managers strong in traditional areas may not have the scale to provide products like passive fixed income or ETFs; similarly, most lack the investment expertise and trading technology to offer private equity or hedge funds. New leaders are emerging and the large number of acquisitions is creating a more concentrated industry.

Between 1995 and 2004, the largest players have grown through acquisition, mainly European firms purchasing U.S. firms. Many of today's industry leaders – some new market entrants among them – have emerged from managers of large-scale passive investments and niche alternative investments.

Meanwhile, a massive wealth transfer continues in the U.S. – from rollovers out of defined contribution plans into individual retirement accounts. This reallocation of wealth is not expected to end soon. Between 2003 and 2010, a US\$2.4 trillion asset opportunity is projected.²¹ The race is on to see which competitors will be positioned to take a greater share.

Third-party intermediaries, like IFAs and consulting firms, add yet another dimension to the competitive challenge. As retail investors search for lower cost and unbiased advice, they are increasingly working through direct and IFA channels. Though manufacturers do gain assets in this way, there are serious drawbacks. The fees paid to IFAs cut into profits and their direct customer contact weakens the ties between asset managers and clients.

Consulting firms are another type of intermediary that is limiting asset managers' direct interaction with clients. Institutional plan sponsors continue to turn to consultants for help in selecting fund managers. These rigorous searches tend to commoditize the asset managers, pitting them against each other as they try to sell themselves to consulting firms.

Cranking up the heat

With so many changes and challenges confronting asset managers, it's clear that traditional strategies will not be enough to offer differentiated value. While firms have begun to respond to industry challenges, there are still major opportunities for additional value creation. So how can asset managers take steps to start heating things up? We recommend the following:

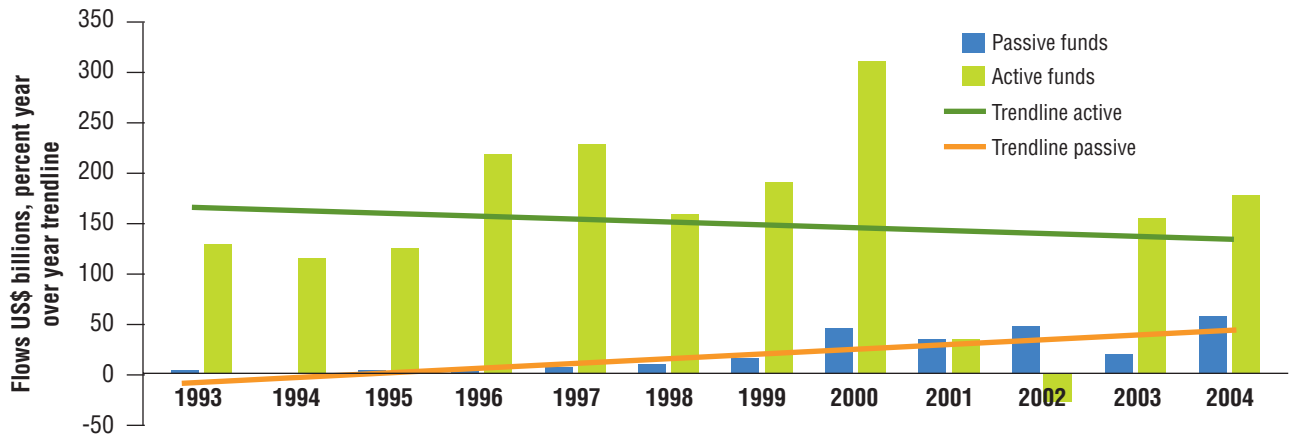
- Seize growth opportunities at the edges
- Unleash the potential of compliance investments
- Recalibrate the business
- Give clients what they need, not just what they want.

Seize growth opportunities at the edges

Because the traditional revenue base is being threatened, asset managers need to pursue targeted growth opportunities – an undertaking that requires matching a firm's specific strengths with the emerging sources of industry value, as well as assessing whether to continue to participate in areas of declining value.

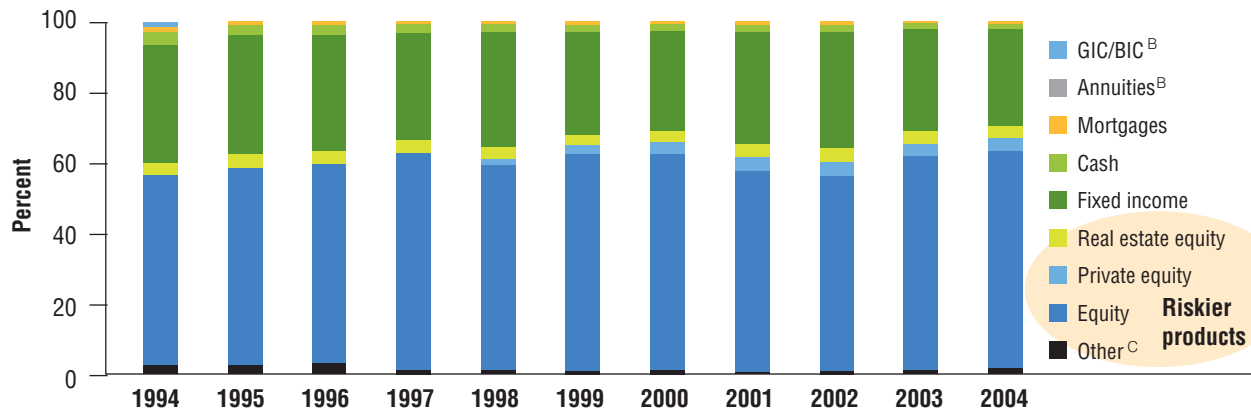
To be successful, firms need to design and implement a focused strategy that aligns delivery and IT capabilities and resources across LOBs. With strongest growth occurring at the edges of the product continuum (see Figure 4), the implications for each individual firm will vary.

Figure 4. Net inflows into U.S. equity funds: active vs. passive, 1993-2004.



Source: ICI; IBM Institute for Business Value analysis.

U.S. institutional assets,^A 1994-2004.



Note: ^A Defined as the top 1000 employee/benefit funds; ^B Guaranteed, benefit income and annuity assets are less than 2 percent; ^C Other: balanced products and hedge funds.
 Source: Pension and Investments; IBM Institute for Business Value analysis.

These trends toward heaviest investment at the edges could lead an asset manager to address the growing demand for passive strategies, or to trigger investment in the launch of nontraditional products. Each end of the spectrum presents its own challenges. Large asset managers, for example, will need the benefit of scale to succeed in the passive fund market with its razor-thin margins. And, successful hedge fund managers require a greater depth of expertise in hedge fund strategies, quantitative models and more advanced trading technologies.

ABN Amro: Focusing on higher demand for hedge fund products²²
 ABN Amro, based in Amsterdam, experienced significant demand for hyperactive products in 2004, when its total hedge fund assets increased by more than US\$500 million. The firm plans to organically grow its hedge fund business by launching a new hedge fund every six months, starting in 2005 and continuing over the next three years. By building on its extensive distribution capabilities, the firm sees further expansion into hedge funds as a way to attract and develop its investment talent while boosting fee income.

Figure 5. Self-assessment: Seizing growth opportunities at the edges.

<i>Progress</i>			
<p>1. How well do you pinpoint areas with untapped value and those with diminishing returns? How do you decide where it makes sense for you to compete?</p>	<p>Capital allocation^a decisions are based on a "gut feel" from your existing client base</p>	<p>The capital allocation process uses varying degrees of automation, depending on the particular LOB and product</p>	<p>Capital is dynamically allocated to high-potential areas via a consistent market intelligence process</p>
<p>2. Do you use meaningful metrics to monitor performance of new and existing LOBs, and to shut down underperformers?</p>	<p>Analysis of business performance is largely based on current client metrics, without consideration of external environment fluctuations</p>	<p>Business performance and external environment fluctuations are analyzed, but not on a consistent basis</p>	<p>A dashboard presents a unified view of data built on flexible rules that are based on internal performance and external environment metrics</p>

Source: IBM Institute for Business Value analysis.

Note: A Capital allocation refers to how firms apportion investments, including earmarking funds for new services and technologies, expanding into new geographies and the like.

Unleash the potential of compliance investments

Regulatory burdens – and archaic infrastructures – can slow time to market, limiting innovation and constraining capital. Yet firms that fully leverage the investments required for compliance can shore up their efforts to improve performance. Tomorrow’s leaders will no longer simply operate under the mindset of staying out of “regulatory jail.”

Instead, successful firms will learn to leverage regulatory investments in a way that drives revenue. Asset managers can use the required expenditures to improve operational effectiveness and resiliency, and to further strategic goals.

The harvest awaits: Reaping the benefits of transparency

Asset managers seem to be overlooking a golden opportunity to gain from compliance investments. It seems that firms remain mostly in "react mode" when it comes to verifying regulatory compliance, merely responding to requests for information as required by law. But, the "intelligent" part of data intelligence means reaping the benefits of such transparency mandates. The vast amount of data that must be gathered and reported for compliance purposes can be leveraged as part of a financial firm’s sales strategy. Using the results of analytics like client profitability analysis, asset managers can improve service and cross-sell, based on known client preferences.

Figure 6. Self assessment: Unleashing the potential of compliance investments.

<i>Progress</i>			
<p>1. How well do you reduce risk by using data effectively and eliminating redundant capabilities?</p>	<p>Separate teams enter and cleanse data; decentralized data distribution and limited understanding of data process flows</p>	<p>Data is created, maintained and shared for explicit risk management purposes, but not shared enterprisewide, with planners and other managers</p>	<p>A shared services model is used to centralize data cleansing and distribution for reference, market and client data</p>
<p>2. How do you demonstrate integrity while enhancing existing systems and processes?</p>	<p>Post-trade compliance checking verifies that trades do not violate client, firm or prospectus guidelines</p>	<p>Some geographies and LOBs perform post-trade compliance checking, others do it pre-trade, but data is not shared</p>	<p>Pre-trade compliance checking is consistently performed, with processes and IT/HR resources integrated enterprisewide</p>
<p>3. Are you able to reinforce business resilience and lower costs by using resources beyond your firm’s boundaries?</p>	<p>Multiple costly, dedicated data centers exist across your geographies; reliance on legacy, proprietary systems and processes hinders integration with shared services environment</p>	<p>Different LOBs approach outsourcing inconsistently, e.g., some outsource network monitoring while others outsource server management</p>	<p>Data center management performed by external partner, leveraging self-correcting technology and providing monitoring services</p>

Source: IBM Institute for Business Value analysis.

Recalibrate the business

In this uncertain environment, top-line growth alone cannot keep up with analysts’ performance expectations. As it becomes ever more difficult to grow revenue fast enough, firms will find that they have to keep an eye on cutting costs. Persistent operating inefficiencies – often as a result of silos and inefficient distribution – present a significant cost-cutting opportunity for firms. Achieving leadership (and meeting analyst expectations) will require not only revenue growth, but a substantial reduction in costs. By addressing distribution inefficiencies, asset managers can reduce costs as they streamline the operating model (see Figure 7).

Figure 7. Cost reduction required as a percentage of base cost.

		Required rate of earning growth		
		12%	14%	16%
Anticipated rate of revenue growth	8%	8%	13%	18%
	10%	4%	8%	13%
	12%	0%	4%	8%

Note: Model assumptions

- Operating margins of 60 percent stay constant before expense reductions
- Pretax margins = 25 percent, before expense reductions
- Tax rate = 40 percent
- Expense reductions applied to operating expenses only.

Source: IBM Institute for Business Value analysis.

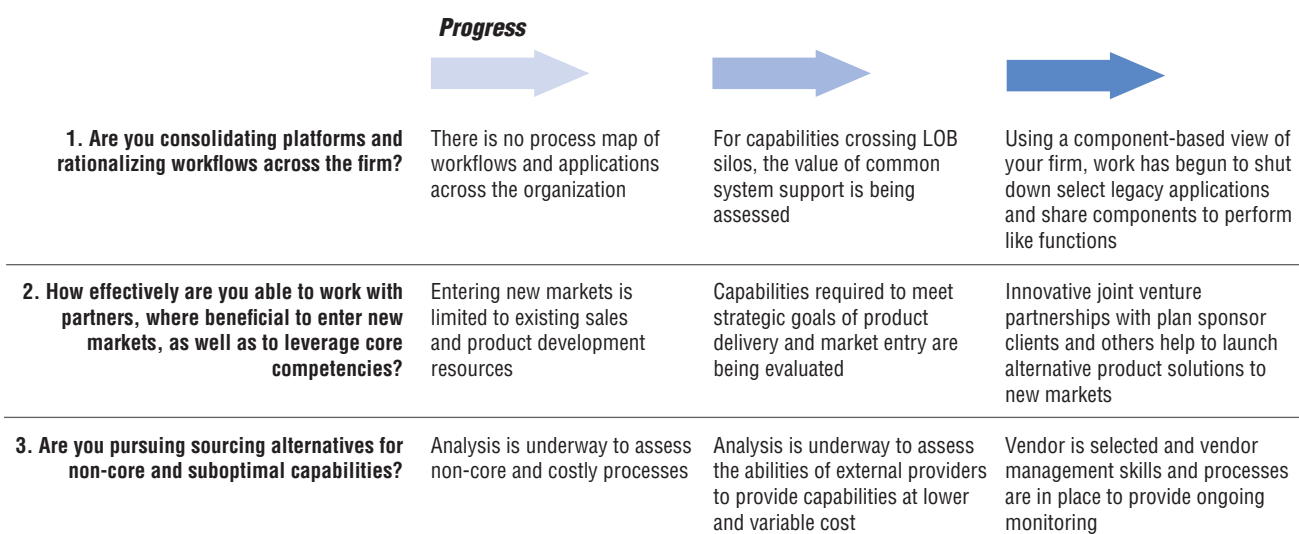
For example, if revenue grows at 10 percent and earnings are targeted at 14 percent growth, a typical asset management firm would have to reduce costs by 8 percent to achieve the expected growth rate for the period. This relationship between cost reduction and analyst expectations illustrates that long-term survivors will focus not just on excelling in managing client assets, but on managing a complete portfolio of operations.

Reducing costs and rejuvenating the business ecosystem requires an optimized operating model that encompasses sharing best-in-class capabilities across the firm while leveraging third-party offerings where it makes financial sense. Regardless of the chosen technology solution, buy-side firms are expected to continue turning to external providers and making significant IT investments, especially to purchase software solutions. By rationalizing capabilities, asset managers can increase efficiency and flexibility, and support growth strategies across LOBs.

ING: Increasing efficiency through outsourcing²³

ING, a global bank of Dutch origin, wanted to reduce costs and increase its focus on core asset management activities. To accomplish this, it outsourced middle office post-execution trade processing and settlement to the Bank of New York’s proprietary outsourcing business, BNY SmartSource. ING sought a provider with “superior technology and service” and now expects to benefit from BNY SmartSource’s “strong platform and thorough support for our business processes.” Implementation is expected to be complete within 12 months.

Figure 8. Self-assessment: Recalibrating the business.



Source: IBM Institute for Business Value analysis.

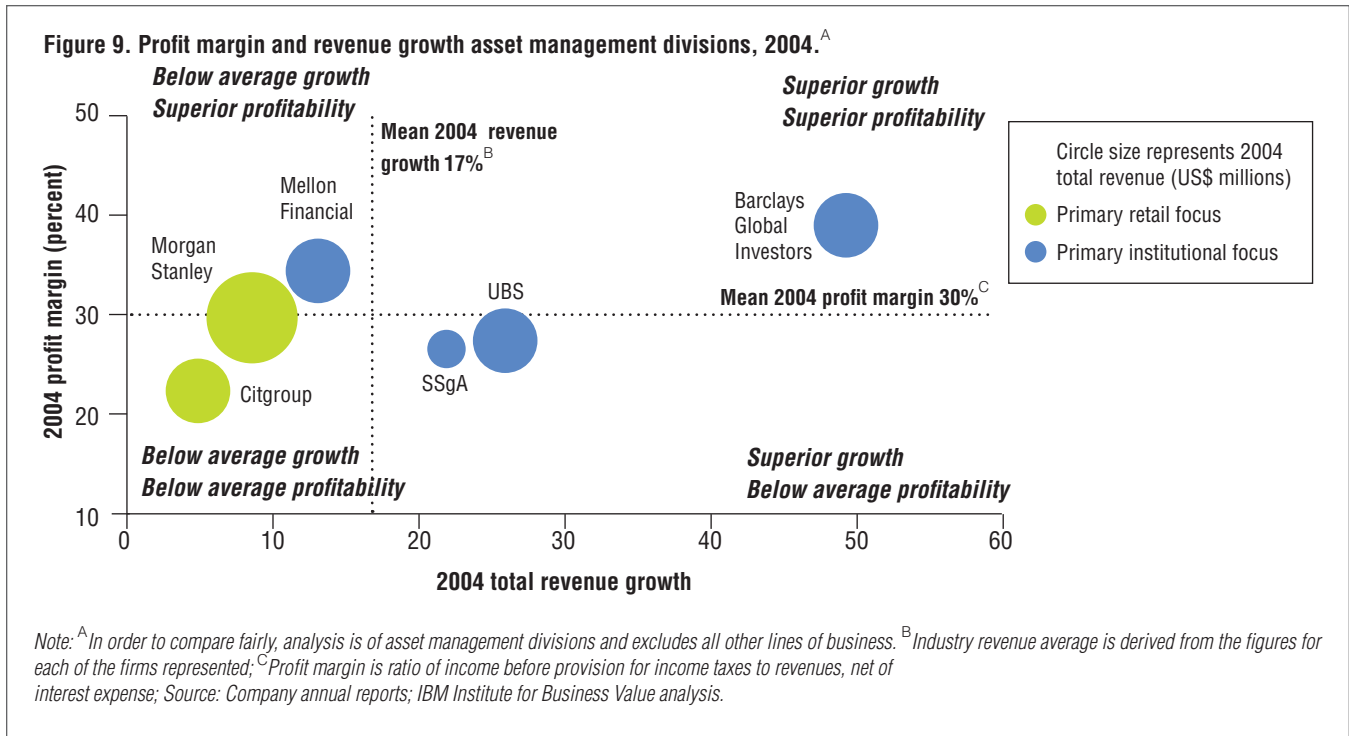
Give clients and intermediaries what they need

For successful asset managers, the ability to seamlessly and profitably serve retail and/or institutional clients – as well as intermediaries – is critical. Improved servicing depends on truly understanding and then meeting client needs by leveraging resources and delivery across LOBs. One important first step is segmenting intermediaries and clients based on their needs, history and overall value to the firm.

Once the firm is able to consistently segment, it will be able to facilitate an ideal client user experience: the ultimate objective is to provide access to a range of advice and products through multiple channels. All customer-facing channels, internal or external, need to operate consistently to build client trust and satisfaction.

Asset managers can provide clients, IFAs and consultants with sophisticated, yet simple-to-use tools to customize reporting or analyze historical “if, then” scenarios – allowing them to analyze their own hypothetical financial returns if, for example, they had invested in popular products like hedge funds or ETFs.

For retail clients, the shift from the defined benefit to the defined contribution market is causing a growing need for advice and investments. Yet, retail managers underperformed institutional managers in 2004, largely due to higher distribution costs (see Figure 9). Distribution costs are attributable to fees that are paid to distributors, high compensation costs associated with employing their own financial advisors, as well as direct marketing costs.



Retail asset managers need to consider the cost, regulatory pressures and perceived conflicts of interest associated with managing and selling their own funds. It may be advantageous to focus on either managing money or distribution. The Citigroup/Legg Mason deal is illustrative of this type of separation.

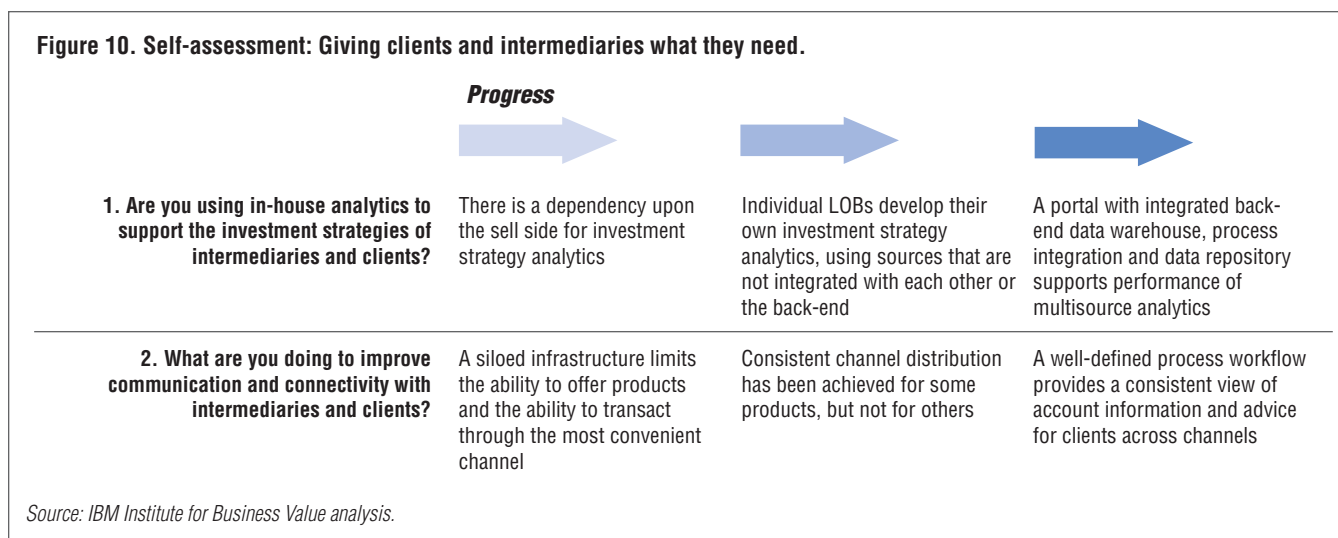
On the institutional side, improving service to intermediaries will benefit asset managers through increased business. A balanced approach is recommended. Institutional managers should consider creatively partnering with consultants – above and beyond what they are doing today. One approach is to provide consultants with sophisticated analytics and intelligence about new product offerings or changes to investment strategy or process in real time, for example, providing alerts through the Web as these changes occur. This need to build bridges with consultants can also help improve direct client contact by offering the same types of highly intelligent tools directly to clients.

Another approach is financial partnering directly with clients, such as forming joint ventures to start a hedge fund. By partnering, asset managers can increase their value proposition for winning new business directly from clients. Above all, asset managers' ability to create and demonstrate more transparency within their organizations can positively influence these decision makers and bring in more business.

Fidelity: Giving institutional investors what they need²⁴

Fidelity, based in Boston, is seeking to capitalize on its fastest growing segment, institutional investors, by increasing capacity and flexibility and improving its client servicing. It plans to spend more than US\$100 million and hire more than 100 investment professionals over the next 24 months – all to launch a company with portfolio managers, research analysts and traders focused exclusively on pension plans, 401(k) plans, endowments and foundations. By separating institutional business from its mutual funds business, Fidelity's goal is to grow assets to US\$2 trillion by "early next decade."

Figure 10. Self-assessment: Giving clients and intermediaries what they need.



Heating things up

Setting the thermostat for success requires tomorrow’s buy-side industry leaders to focus on providing the differentiated value for which their customers are willing to pay. Non-valued tasks should be performed at a level that is acceptable, whether internally or externally provided. With a robust set of capabilities at hand, asset management firms can leverage solid value creation opportunities and be better prepared to weather current and future industry challenges.

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