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2015 Mutual Fund Outlook
Accelerating the quest for growth

Deloitte Center *for* Financial Services

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Foreword

Dear colleagues:

In many ways, the financial services industry is on more solid footing than it has been for quite some time. The US economy continues to improve, although concerns remain in both Europe and some emerging markets. Investors are generally seeing solid performance, and profitability in many sectors is quite strong.

But concerns — some new, some old — are keeping industry executives on their toes. Whether it's the evolving threat of cybercrime, the rising cost of regulatory compliance, or pressure from nontraditional competitors, financial services leaders have challenges aplenty. Agility, innovation, and collaboration will be important to capitalize on new opportunities for growth in 2015.

Our views on industry trends and priorities for 2015 are based on the firsthand experience of many of Deloitte's leading practitioners, supplemented by research from the Deloitte Center for Financial Services.

Producing industry outlook reports has the result of exposing the authors to second-guessing; hindsight is 20/20. Nevertheless, we believe it is important to reflect on what we said a year ago and put our prior prognostications to the test by analyzing what we got right — and perhaps not exactly right — in our 2014 outlook. You will find this "Looking back" analysis leading off this year's edition, followed by a "Looking forward" summary of our views on the coming year.

The bulk of the report explores a number of key issues of importance for the industry, each including a specific look at the "Focus for 2015" and a "Bottom line" that provides actionable takeaways for industry leaders to consider.

We hope you find this report insightful and informative as you consider your firm's strategic decisions for 2015. Please share your feedback or questions with us. We welcome the opportunity to discuss the report with you and your teammates.

Regards,

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Looking back

Product and investor demand

2014 was a year of market expansion, as envisioned in Deloitte's 2014 Mutual Fund Outlook. To do their part in driving growth, fund firms upped their game, by "Innovating Around the Edges"[1] and launching mutual funds and exchange-traded funds (ETFs) with liquid-alternative, advanced-beta, and managed-volatility strategies. These new products contributed to the growth of the industry to $15.5 trillion in mutual fund assets and $1.8 trillion in ETFs. Product demand was favorable as well, with mutual funds posting $124 billion in net inflows through late 2014, and ETFs experiencing $121 billion in net issuance.[2] Sales demand was concentrated in passive strategies, which experienced eight straight months of net inflows, while active stock funds experienced seven months of net outflows, amounting to $70 billion through the third quarter.[3]

The year was not without its challenges, however. Deloitte expected escalating compliance around retail alternative investments, and this was evident in the initiation of a national sweep exam by the US Securities and Exchange Commission (SEC).[4] A higher focus on specialized ETFs in 2014 was also anticipated, yet fewer fund companies launched active ETFs than expected. This was partly in response to the outstanding proposals for nontransparent ETFs that the SEC was reviewing. Given that one new type of exchange-traded product (ETP) was approved by the SEC, the exchange-traded managed fund structure,[5] it is anticipated that more firms will roll out active products in the next few years.

Risk management and growth

The goals of balancing risk management and driving growth required investment managers to be fast responders to market and regulatory events in 2014. Key themes included greater strategic focus on risk identification and risk resource allocation. In response, leading fund managers were anticipated to be more thoughtful about engaging risk-oriented talent and resources, and seek out higher involvement by risk and compliance departments during new business development. This occurred as expected. Risk oversight

Figure 1: Mutual fund industry 2014 focus

Product and investor demand	● (blue) Mutual fund industry grows at a respectable pace
	● (green) Increased focus on specialized ETFs — both active and indexed
	● (gray) Alternative investments challenge fund leaders from compliance perspective
Risk management and growth	● (blue) Fund leaders more strategic about risk and resource management
	● (blue) Higher involvement by risk and compliance leaders in new business development
	● (gray) Heightened attention on cyberthreats
Regulatory flux	● (blue) SEC rules on money market funds
	● (gray) Financial Stability Oversight Council (FSOC) aims to label mutual fund firms as systemically risky
	● (green) Spotlight on omnibus oversight, valuation guidance, and fiduciary rules

Key:
- ● (blue) Turned out as expected
- ● (green) Partially turned out as expected
- ● (gray) Did not turn out as expected or unresolved

Source: Deloitte Center for Financial Services analysis continues to be top of mind, with 59 percent of the fund groups responding to Deloitte's 2014 Fair Value Pricing Survey indicating that they have a risk function.[6]

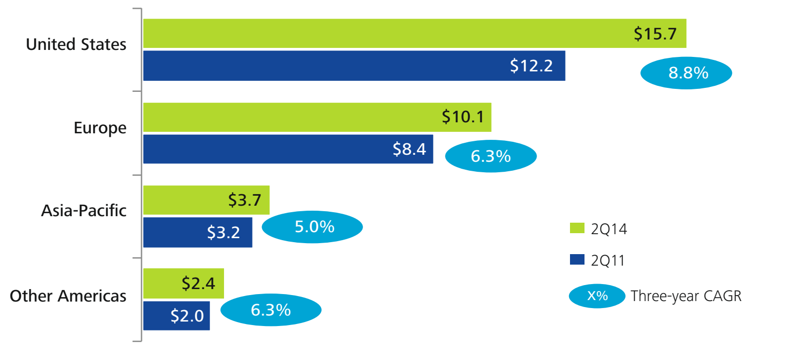
Cybersecurity was the one area where the fastest movement was expected. Surprisingly, the prediction that cybersecurity would be a substantial budgetary focus for investment managers in 2014 did not materialize. Given the overall escalation in cyberrisk incidents since that time, and the Office of Compliance Inspections and Examinations (OCIE) Cybersecurity Initiative currently under way, investment managers are likely to reprioritize their approach to this issue.[7]

Regulatory flux

The most significant regulatory development in 2014 was the SEC's adoption of money market reform rules,[8] fulfilling Deloitte's expectation this would be a "done deal" during the year. Though the outcome was viewed unfavorably by some in the industry, the upside was that investment managers could move forward into 2015 with some resolution. Valuation was a second area of anticipated movement — which did occur — yet the incorporation of valuation elements into the money market fund ruling was an unexpected twist.

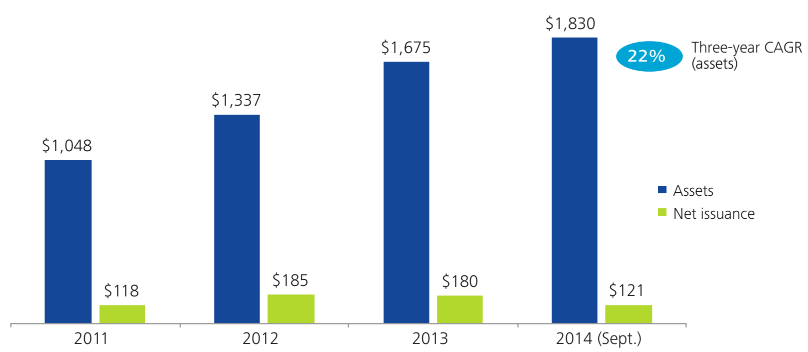
The regulatory flux from last year persists as it relates to systemic risk. Our 2014 Mutual Fund Outlook noted that the FSOC was reviewing the designation of a systemically important financial institution (SIFI). After much debate in the industry, the FSOC decided to focus on a firm's activities and products, rather than the firm itself, when looking for systemic risk.[9] In turn, the SEC has stepped up its focus on systemic risk with a goal toward implementing other monitoring requirements, such as stress tests. This could require significant resources on the part of larger fund companies.[10] Industry organizations, such as the Investment Company Institute are "vigorously opposing" SIFI designation with regard to regulated funds,[11] a position expected to carry over into 2015.

Figure 2a: Three-year growth of mutual fund assets worldwide ($ trillion)



Sources: Investment Company Institute, 2014. "Worldwide Mutual Fund Assets and Flows: Second Quarter 2014" (October) and Second Quarter 2011. For the most up-to-date figures about the fund industry, please visit www.ici.org/research/stats.

Figure 2b: Three-year growth of US ETFs ($ billion)



Sources: Investment Company Institute, 2014. "Exchange-Traded Funds: September 2014" (October). For the most up-to-date figures about the fund industry, please visit www.ici.org/research/stats. *2014 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry*. Available at www.icifactbook.org.

Looking forward

2015 will be a period of accelerating the quest for growth with continuation of a number of current trends — such as the focus on product development, regulation, and risk management. The difference in 2015 will be the redirection toward expansion and the speed at which growth-oriented strategies are executed.

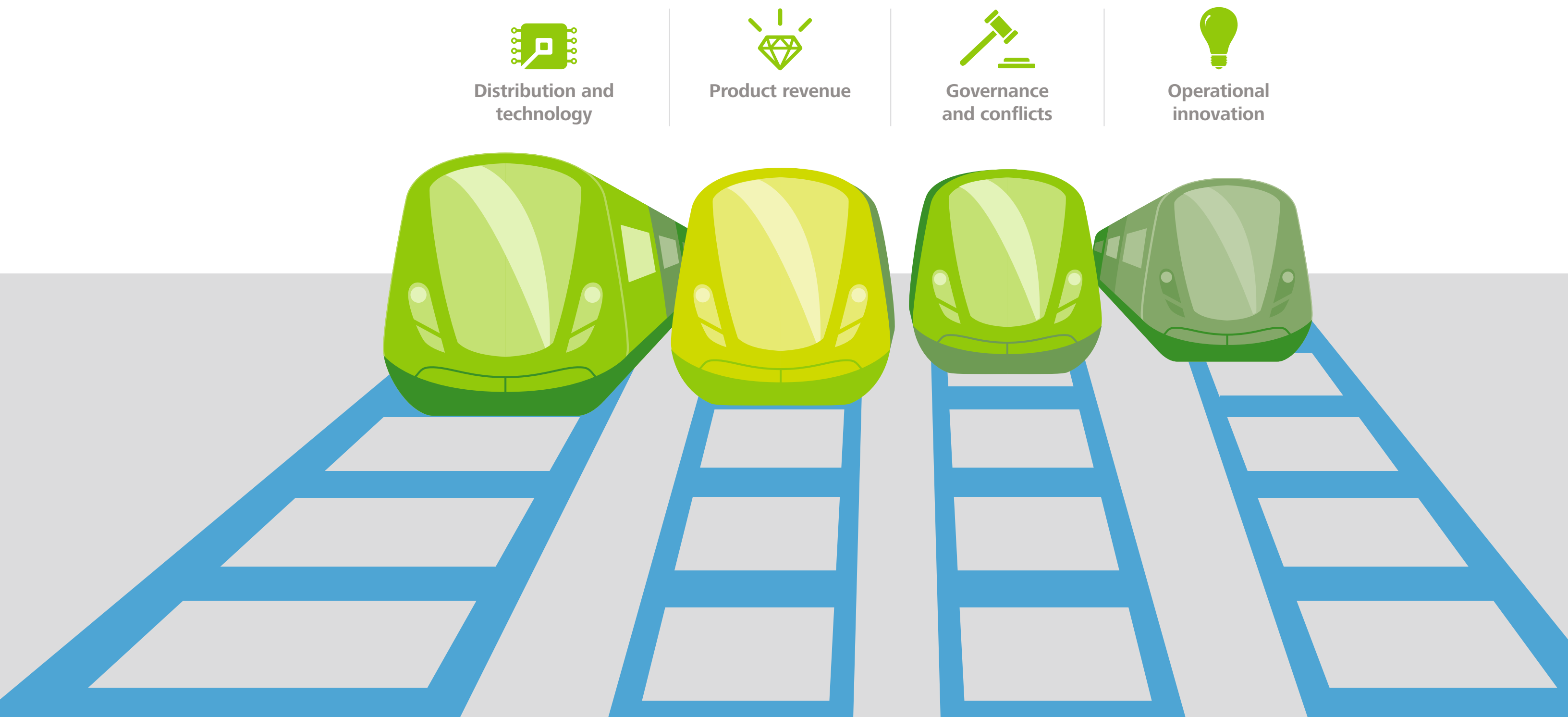
Acceleration of innovation by investment managers will be a critical driver of the movement toward growth, as firms work to cut through the complexity of distribution channels and product development. To make this happen, targeted sales, product differentiation, response to regulatory events, and operational innovation will need to happen at a faster and more efficient pace to gain competitive advantage.

Additionally, some investment managers will need to become more successful at unlocking revenue opportunities by introducing higher-fee products and gaining organizational efficiencies. In what may be viewed as "funding growth," organizations need to address cost structures, reassess product margins, and reallocate available resources to free-up back-office dollars for front-office spend.

Forward-looking managers will be reassessing their target-market approach in 2015 and executing on previously defined growth strategies. While demographic shifts are a longer-term evolution, investment managers that spend resources today on educating and capturing the loyalty of millennials — people born in the 1980s and 1990s — will position themselves solidly to manage the assets of this generation in the future.

Finally, growth over the next year will be supported by the economic environment. Bearing in mind that there is increasing concern about volatility and market corrections, the most probable scenario in Deloitte's US economic forecast is that real gross domestic product will rise through 2015, accompanied by increases in real disposable personal income and net household wealth. Interest rates are anticipated to rise incrementally in 2015, but with significant increases further out.[12] This indicates that the US market may continue to support investor retirement savings, drive demand, and remain a highly attractive domicile for investment.

Figure 3: Four focus areas for 2015



Leveraging technology to drive distribution

Years ago investment managers were able to grow their businesses by launching attractive, differentiated, high-performing products and having a strong direct or intermediated distribution strategy. That is no longer the case in a multitrillion-dollar marketplace. Now, winning the game requires increased distribution efficiency by leveraging the most advanced tools of 2015: data and technology. The innovative opportunity that data and analytics bring to the business will become a key differentiator for investment managers over the next few years and help to target globally focused distribution strategies to maximum advantage.

Focus for 2015

Distribution grows globally

Investment managers are taking on the world. With 51 percent of mutual fund assets now held outside the US[13] and new wealth being created overseas at record pace, the drive for global distribution by US managers remains high. At the same time, foreign managers continue to view the opportunity in the US as attractive. Of course, the flip side of increased global distribution is increased competition. With more than 75,000 mutual funds available worldwide and 7,800 in the US,[14] there are a lot of options for investors to consider. To grow global distribution amid this complexity, managers need to understand international markets and asset classes, at the same time as they focus on creating deep, local relationships and distribution networks abroad.

Complexity of distribution escalates

Distribution isn't getting any easier, especially for investment managers that want to grow geographic reach. Looking forward, there are four challenges that investment managers will need to address:

Rising global influence: Deloitte global economists are seeing modest global expansion accompanied by a lessening of systemic risk — all good signs for growth in 2015.[15] As the interconnectedness of global investment management grows, US managers need to gain a deeper understanding of how international influences affect fund distribution and how to take advantage of emerging opportunity. Developing countries such as China and India, and their emerging wealth, may provide opportunities for fund managers to benefit both from global distribution and rising domestic demand through wealth managers.

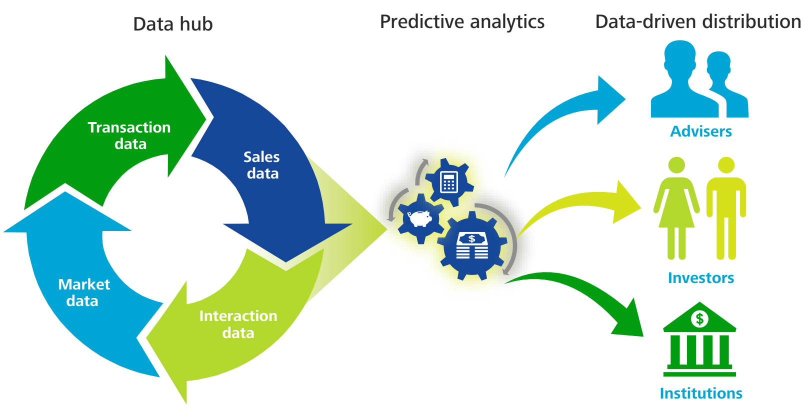
A commoditized US marketplace: A plethora of products in the marketplace creates a true challenge for managers seeking assets. With 7,800 US mutual funds and 1,400 ETFs currently in play,[16] and more on the way, there seems a limited amount of room left for managers to get the attention of advisers and investors. In that light, fund managers need to embrace the use of predictive analytics to optimize adviser and investor outreach, and target investment products using behavioral purchasing patterns. Turning the discussion toward achieving specific investing outcomes, rather than focusing solely on returns, may also help sales, particularly when followed up with compelling products.

Omnibus opacity: Pulling back the curtain on sales data is becoming even more challenging as omnibus account management increases. The good news is that underlying transaction data is becoming more widely available; yet managers are now struggling with the high volume of this data and how to glean insights for business decisions. It is anticipated that the value-add of omnibus data sets offered by broker-dealers will grow. At the same time, there will be more competition for omnibus data analysis by secondary data providers. These third-party aggregators take mutual fund and ETF sales data and break it down by distribution channel to bring some transparency to an opaque marketplace. The escalating race between consolidators will have a dual advantage of bringing more clarity to the sales process and product development strategy, while improving omnibus oversight capabilities. It will also support the alignment of sales efforts more closely to institutional and adviser purchasing behavior.

A fragmented approach: The combination of channel convergence and global expansion creates a kaleidoscope of challenges for investment managers. In 2015, investment managers will need to focus resources on areas of greatest return on sales efforts across the intermediary, institutional, retirement, and direct channels. At the same time, investment managers will continue growing assets by offering product structures outside their traditional lines, such as insurance-linked retirement income products;

by targeting new channels not adequately served (e.g., millennials); and by increasing the use of mobile devices as support, sales, and account management tools. A centralized data hub, discussed in the next section, may be the key to unifying data gathered from various distribution channels.

Figure 4: Analysis before action creates competitive advantage



Source: Deloitte Center for Financial Services analysis

Technology supports sales and service targeting by segment

Solving the distribution dilemma in today's complex environment requires a different approach — one that is informed and actionable. In 2015, that will parlay into a data-driven approach to distribution. The primary focus of sales strategists is anticipated to include the growing use of data and analytics to define, understand, and target multiple channels. For example, analysis of sales and redemption patterns of specific adviser segments can help investment managers with allocating wholesaler resources more effectively, while providing support for targeted marketing materials and advertising campaigns.

A greater use of data and predictive analytics will ultimately bring investment managers up to the level of banks and insurers. Toward this end, managers are expected to make significant investments in technology. In 2014, 39 percent of investment managers surveyed by Money Management Executive planned to increase their technology-related spend,[17] a trend which will carry over into 2015.

Though data is the driver, human touch will still remain significant. People are still very much a part of the fund sales process, and wholesaling will remain a people business. So accurate calibration of the digital/personal mix is imperative to capture the best of both worlds. To maximize revenue, the savviest managers will ensure that cost-revenue objectives are optimized. Translating this by channel means that when dealing with intermediaries, manufacturers need to focus on picking the right partners, particularly when launching products outside their traditional areas of expertise; understanding distributors in-depth; and creating effective personal touch points with wholesalers. In the direct market, cost-effective delivery of investor education and servicing may need to move more in lock step with a tech-savvy younger generation. Respondents to Deloitte's 2014 financial services consumer survey on mobility indicate that 98 percent of investors ages 21-29 use their smartphones to interact with their financial institutions. Additionally, 53 percent of respondents in all age groups would value a video call with their investment adviser.[18] This indicates there may be more room to blend digital/personal delivery for retail investors.

While specifics will vary across managers, data-driven distribution is generally headed toward enhanced use of data hubs and predictive analytics.

Data hubs: Data-gathering efforts may be in preliminary stages for some firms, yet investment managers need to look ahead 12 to 18 months, when merely capturing and reporting information will not be enough for winning at distribution. By that time, it is expected that fund firms will have started active construction of centralized hubs blending four types of data: transaction, sales, interaction, and market-related. An important step in this process is the selection and implementation of the right customer relationship management (CRM) tool for sales data analysis. Fund managers are planning to completely revitalize CRM capabilities, which, in legacy form, are often basic and superficial. For many, the answer is cloud-based platforms that offer significant extended capabilities. Going forward, it is likely that CRM systems will provide the underpinning of data-driven distribution, particularly for intermediary channels, which need a 360-degree view of the financial adviser.

Predictive analytics: With data hubs answering the "what is" question, the "what might be" question is next on the radar. Predictive analytics, the statistical analysis of historic data to make predictions, is already widely used for both product analysis and wholesaling. On the product side, predictive analytics may be used to track competitor products under stress, anticipate net redemptions, and plan approaches to seizing asset-gathering opportunities. For sales, it could be used by some firms to build profiles of their most productive advisers and then build predictive models to help identify advisers with similar profiles. Managers will also continue to use predictive analytics to identify high-producing geographies and territories to optimize sales through existing channels, while supporting the search for new target markets. As predictive analytics provides valuable information to the sales force about adviser practices, product selection, and sales trends, its use is expected to escalate in 2015.

The bottom line

"Analysis before action" characterizes the future of mutual fund distribution, and managers that start down this path early may gain a competitive edge. In 2015, investment managers need to take measured steps toward building their distribution intelligence through the use of data and analytics. When applied to a globally growing business, technology may help to cut through the complexity and direct resource utilization to the best advantage. Leading fund managers need to focus on streamlining big data into distribution data over the next year and leveraging predictive analytics to arm their sales forces with actionable information they can use to grow the business.

Unlocking revenue opportunity in a product-rich marketplace

To accelerate growth in a product-rich marketplace, investment managers need to continually evolve their approach. In 2015, product-development strategies for many managers will focus on unlocking the revenue opportunity. With low-cost passive products gathering a significant share of net asset flows, the search for higher-fee strategies is aggressively under way at some managers. Various revenue opportunities are being assessed, including the use of alternative product structures to enter new markets, a refocus on product profitability, an emphasis on actively managed strategies, and the exploration of newer investment strategies for fund portfolios.

Focus for 2015

Providers cross over, converge

There has been a multiyear evolution of mutual fund managers offering nontraditional investments within target-date and multi-managed funds. Hedge fund and private equity managers are also actively launching 1940-Act regulated investment products that replicate their alternatives expertise. Market entry for alternative managers through private-branded series trusts is a growing part of the business.

Likewise the connection between insurers and investment managers has the potential to become closer. In 2014, both the Treasury Department and Department of Labor (DOL) issued guidance that is likely to boost insurance-linked retirement products in the form of in-plan annuities or as part of target-date funds.[19] These products are intended to support lifetime retirement income by matching clients' current assets with their future liabilities. Long term, significant opportunity will be present via the convergence of investment management and insurance to support retirement goals throughout the investor life cycle. However, there are significant distribution challenges ahead for these products. Even after the products are designed and built, providers still need to convince retirement plan sponsors and participants to use them.

Revenue before cost drives innovation

Investment managers face a dilemma. Because low-fee, passive strategies have been so successful at capturing assets, product profitability has become a new objective for many fund organizations. As a result, it is expected that 2015 will be a year of "revenue before cost" for many organizations. Application of this concept, outlined in the book *The Three Rules*,[20] indicates that unlocking the revenue opportunity may be a key component of product innovation.

When translated to registered investments, this means higher-fee products will receive new attention at many managers, particularly in light of how they support revenue growth. This trend is observable in the launch of more retail alternative investment funds, active ETP plays, renewed vigor around marketing actively managed funds, and growing interest in insurance-linked retirement income products.

Reintroducing the value proposition of active management is another strategy that some managers are likely to consider in 2015 to support the growth of asset-based revenue. Telling the story of how a manager's active management strategy differs from peers is important, as is convincing advisers and investors of how active management can benefit their portfolios.

Another important task that investment managers will be focusing on is the need to better understand product profitability and the cost of managing investments in order to reduce and allocate expenses more accurately, particularly for larger product lines. Because usually one or two products drive asset growth, paring down products may reduce the cost, clutter, and confusion of simultaneously distributing many similar investment products.

Newer investment and product approaches upstage traditional strategies

The ABCs of investment innovation for 2015 include a number of products outside the scope of traditional stock and bond mutual funds. These are what might be classified as emerging investment options for mutual fund portfolios, as well as products that are still relatively new, but represent a more established market.

Emerging investments, for example, include newer or lesser-used strategies that fund managers are wrapping into mutual fund portfolios, such as business development companies (BDCs), catastrophe bonds, and master limited partnerships (MLPs). One appeal of these products is their diversification potential versus traditional strategies.

Evolving products, such as ETPs, guaranteed retirement income products, and retail alternatives may have more longevity in the marketplace. Demand for these products is growing, but liquid alternatives and active ETPs, in particular, have yet to successfully weather the storms of market fluctuations endured by traditional stock and bond funds — a requirement to proving their diversification and return advantages. Guaranteed retirement income products also need to mature, in terms of product development and market demand.

Both of these types of newer fund strategies are expected to grow in 2015, as managers make special efforts to satisfy regulatory requirements and provide adequate education to financial advisers.

Emerging investment opportunities

BDCs

BDCs, which are closed-end fund investment companies, are attracting attention for their high yield, diversification benefits, and three-year returns of 18 percent.[21] Currently between 8-10 percent of the BDC market cap is held in mutual fund and ETF investments, totaling less than $3 billion in assets; this leaves considerable room for growth.[22] To capitalize on this opportunity, investment managers will likely adopt three strategies toward the use of BDCs in 2015, some of which extend beyond their use as an investment: investing in BDCs as part of the mutual fund portfolio, merging an investment company into a BDC, or buying an entity that runs a BDC. The challenge BDCs and fund managers will face over the next year is to focus more on the need to manage the requirements associated with being regulated under the 1940-Act, particularly regarding disclosure of acquired fund fees. It is also anticipated that the regulatory focus on BDCs will grow along with investment levels.

Catastrophe bonds

Investment managers and financial advisers are now selectively using “cat bonds” — insurance-linked securities that transfer catastrophe or natural disaster risk from the issuer to investors — in their bond portfolio allocations, aiming to take advantage of their lack of correlation to traditional investments. While it is unclear how much of the $24 billion cat bond market[23] is represented in mutual funds, interest in these investments may grow based on their past performance (nine percent annualized increase over the past five years).[24] Some people predict that cat bonds may experience higher uptake by mutual funds due to the funds’ higher liquidity requirements.[25] At the same time, questions around suitability for investors will present challenges to growth. The Financial Industry Regulatory Authority (FINRA) issued a risk alert in 2013 on the topic,[26] and the SEC’s focus on risk disclosures and valuation may lead to operational and regulatory issues that need to be overcome.

Master limited partnerships

Viewed by many as a strategy that is too compelling to miss, MLPs look to be a strong contender for portfolio allocation by fund managers in 2015. Their attraction is exposure to the energy market and tax-favored yields. Currently, there is $46.1 billion in MLP assets held in mutual funds and ETFs.[27] Performance for the MLP index has been impressive over the past five years, with 24 percent in annualized returns, yet recently the category has been hard-hit with the decline in oil prices.[28] While this may exert pressure on MLPs, the long-term nature of contracts and the connection of revenue to volumes instead of price are factors in favor of investment.[29] The nuances of taxation for MLPs held in funds will be a growing challenge for fund managers to address as the market matures.

Evolving investment products

ETPs[30]

For a number of years the $1.8 trillion ETF market[31] has been crowded and on a growth trajectory. This will remain much the same in 2015, and will be further supported by the use of ETFs in model portfolios and anticipated presence within 401(k) plans. Even though fund managers are branching out toward more active strategies and incorporating derivatives, moving outside passive management will remain challenging. Active ETF strategies hold merely $14 billion in assets,[32] showing there is vast room for growth, yet also indicating the difficulty of charging higher fees for what is traditionally viewed as a low-fee product. Following the SEC approval of one exchange-traded managed fund structure, it is anticipated that active ETP rollouts will increase.

Guaranteed retirement income products
Target-date funds offering guaranteed retirement income via an annuity component have been available for a number of years,[33] but adoption rates by plan sponsors have been low. However, the ideal regulatory framework was previously not in place to enable this type of product to grow. Based on the recent guidance from the Treasury Department and the DOL for the use of insurance-linked products in retirement plan menus,[34] there is anticipation of a new round of product development in the area. However, the complexity of implementation and the newly issued guidance point to slow steps forward in the short term. Challenges include the fact that products will need to establish a track record, as many 401(k) investment policy statements require a three-year performance history; concerns about portability; and low participant demand. Despite the challenges, it is expected that investment managers will put significant resources behind these efforts due to the market's considerable potential. As this happens, these products have the potential to be a big factor in solving the retirement-income challenge.

Retail alternatives
Retail alternative mutual funds are growing in popularity and now hold roughly $150 billion in assets.[35] Institutional investors are increasing their allocations to retail alternative investments at the same time as plan sponsors are looking closer at these products as part of their retirement plan offerings. Despite recent outflows, it is expected that in 2015 liquid alternative investments will remain a growth market, with a focus on both communication of investment philosophy and transparency of holdings.[36] Concurrently, challenges will include uncertainty around performance under pressure, the use of derivatives, and time in the SEC spotlight.

The bottom line
The commoditization of the mutual fund marketplace requires a new approach in 2015. To stand out, investment managers need to seek revenue-oriented strategies in newer, high-growth areas. Performance is still king and having a stellar product is key. Yet in 2015 managers have to tell the story of what they are invested in and why. Education around investment philosophy and process — including the value proposition and continued relevance for active strategies, in particular — will help to create differentiation around mutual fund and ETF products, guiding advisers and investors through the maze of what has become a very complex investment landscape.

Managing reputation risk through growth in governance

Protecting a growing organization from risk-oriented events requires continuous evolution in identifying what these might be and facing them head-on. Over the past few years, investment managers have spent considerable resources in building general compliance and risk expertise, while addressing regulatory risk at large. In 2015, the risk focus will be targeted toward the integration of risk and compliance, governance and conflicts of interest, and how these issues influence firms' reputation overall.

Focus for 2015

Reputation risk rises

A quick perusal of a newspaper or industry websites will highlight one of the most important issues investment managers face today: reputation risk. Eighty-seven percent of the global executives responding to Deloitte's Reputation@Risk survey rate reputation risk as more important or much more important than other strategic risks their companies face. In addition, 88 percent say their companies are explicitly focusing on managing reputation risk.[37]

Reputation risk is so closely tied to the success of the organization that seemingly small missteps can become very large issues in the marketplace. How well reputation is regarded — or even perceived — by key stakeholders can have immediate and far-reaching impacts on an organization's overall success. Reputation can affect an organization in four powerful ways: for customers, reputation can have a positive or negative impact on sales; for potential recruits, it can attract or discourage career interest; for prospective shareholders and business partners, it can entice or repel investment; and for regulators, it can signal effective compliance or raise a red flag.[38] In implementing risk strategies, the tone at the top is an essential starting point for effective internal control and corporate governance.[39]

Top-down risk management centers on governance and conflicts

In 2014, corporate governance and conflicts of interest risk oversight were among the SEC's highest priorities.[40] These priorities will likely carry over into 2015 as well. Managing such a sweeping agenda requires fund leaders to focus first on growth in governance as an umbrella of protection — because, in essence, strong governance instills and monitors processes that protect an organization from risk. Risk from conflicts of interest is one of the top priorities to manage. Conflicts of interest is a consumer protection issue, and at its core, most SEC regulations deal with conflicts as a baseline of their inspection, disclosure, and enforcement programs.

> "Investment managers need to develop a view with respect to how they manage conflict of interest risk. Regulators are going to be actively targeting this topic for the foreseeable future."
>
> *— Mike Fay, principal, Enterprise Risk Management, Deloitte & Touche LLP*

To help mitigate conflicts of interest, the area of conflict must first be identified and understood. Many conflicts occur in the natural course of the investment management business, with the type of conflicts faced unique to each organization. These all must be managed, including conflicts with intermediary relationships, arbitrage, product allocations, and distribution; competition between business lines for deals; and the movement of alternatives managers into the registered space.

In 2015, investment managers also need to consider potential conflicts of interest related to valuation. Deloitte's 2014 Fair Value Pricing Survey indicated that 74 percent of survey participants revised their valuation policies and procedures over the last year.[41] In an emerging trend, nine percent of survey participants also indicated that their fund board added valuation risk dashboards or key valuation indicators over the last year to assist in their oversight of the valuation process.[42]

Multiyear evolution begins toward well-defined risk
Looking forward, a different, even more complex risk profile is anticipated to emerge, accompanied by a multiyear risk evolution. Drivers for risk escalation include the intricacy and sheer volume of laws and regulations around the world, the intensifying scrutiny of enforcement officials and the public, the rising cost of compliance breaches, and the underlying risk of reputation damage.[43] To manage this shift, managers should consider focusing on two key components in 2015: talent management and risk culture, and infrastructure.

- *Talent management and risk culture*: To address existing and evolving risks, three areas of talent management should be prioritized in 2015: roles, responsibilities, and accountability. Risk-based endeavors should become key-person dependent in a productive way, as people make risk management come to life. In addressing risk, fund managers need to focus first on the firm's culture, particularly the tone at the top, as per priorities of the SEC's National Exam Program. Regulators appear to be looking for institutions to adhere to more than the letter of the guidelines. A "risk intelligent culture" is the goal, meaning that employees understand the organization's approach to risk, take personal responsibility to manage risk at all times, and encourage others to embrace this culture. "Strong" institutions are those that embrace the spirit of risk management.[44] They have a strong risk culture and the ability to remain compliant.[45]
- *Infrastructure*: Effective governance and conflicts management requires infrastructure that spans the organization and its connection points to the external environment. When it comes to risk management, this means maintaining institutionalized processes to identify potential conflicts in light of the organization's business model and investment activities, as well as software tools, such as conflicts registers, to track and manage potential conflicts. The conflicts register is important as it may contain an inventory of potential conflicts, relationship maps to identify areas of concern, procedures to implement conflicts management policies, disclosure practices, and back-testing to confirm that controls were working as intended.

The bottom line

Acceleration toward growth is requiring fund companies to become increasingly creative in their risk-management strategies. Implementing new product structures, forming different business partnerships, and a changing external environment all have immediate impact on the types of risks fund managers must face and the speed at which they need to address these risks. To add to the complexity, external market risks are increasing rapidly at the same time as media attention has remained focused on investment managers' activities. As a result, risk management and regulatory oversight in 2015 will focus on managing a firm's reputation, primarily through ensuring that governance measures are firmly in place and continuously monitored — and that these measures start with a clear risk vision and supporting tone at the top.

Targeting growth through operational innovation

Classical themes are still top of mind for operations teams. Trying to do more with less, simplifying operations, increasing productivity, and remaining competitive are overarching goals that will still resonate in 2015. But there is change under way. As with other areas of the business, operational goals are moving toward supporting growth objectives, following a multiyear retrenchment. Key themes that will evolve over the next year include data management, cyberrisk, extended enterprise management, workflow analysis, books of record, and customer experience.

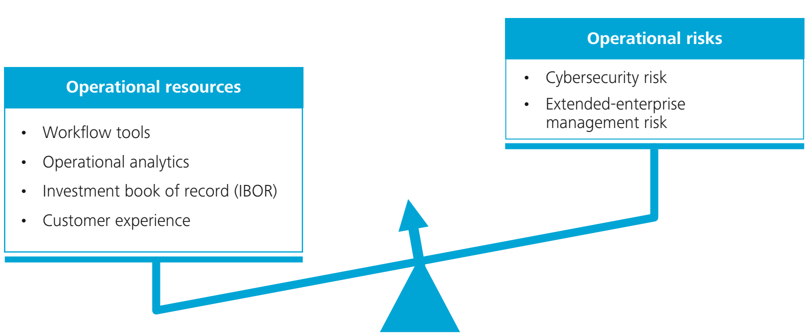
Focus for 2015

Operations is business as usual — with a twist

Subtle shifts are under way when it comes to operational efficiency. Though many operational objectives remain the same as in the past year, four themes have advanced: the maturity of compliance procedures, which frees up organizational resources; a venturing toward growth as seen through merger and acquisition activity; assessing product profitability by linking activity costs to products;[46] and a shift from cost-savings to enhancing the customer experience.

While just one of these shifts in focus may prove influential on operations budgets, the fact that they are all happening together means that fund managers entering 2015 may have more breathing room when it comes to meeting operational efficiency objectives and goals, risk management programs, and growth targets.

Figure 5: Operational objectives shift to favor growth-oriented resources



Source: Deloitte Center for Financial Services analysis

Emerging risks demand a fresh approach

With many regulatory requirements already addressed, fund managers may now refocus resources on other external risks — notably cybersecurity and extended-enterprise risk.

- *Cybersecurity risk*: Mutual fund managers are challenged to respond to the rising threat of cyberrisk and how it may impact both reputation and investments. In fact, managers should take cues from the OCIE Cybersecurity Initiative in order to gauge how seriously regulators are taking it. The risk of cyberthreats is intensifying, and investment managers also need to take this threat more seriously. Therefore it is important for organizations to establish a program to become secure, vigilant, and resilient — while at the same time focusing on the regulatory aspects of cybersecurity readiness.[47]
- *Extended-enterprise management risk*: The connections between manufacturer, distributor, and serviceprovider have become so close that risk to one is fast becoming risk to all. To prevent the domino effect of the potential reputation risk events discussed earlier, operations teams need to understand and enhance EEM risk management measures. Some organizations are still unprepared to face this risk. Forty-seven percent of companies surveyed by Deloitte in our global Reputation@Risk survey indicate that third-party/extended-enterprise risk is an issue for which they are least prepared.[48] Yet as extended-enterprise risk was a part of the SEC National Exam Priorities for 2014,[49] it is expected to be a primary area of focus in 2015 as well. Further, on May 14, 2013, the Committee of Sponsoring Organizations of the Treadway Commission (COSO) issued its updated Internal Control — Integrated Framework, which became effective in December 2014.[50] Specific enhancements to the 2013 framework include requirements for management to consider how outsourced service providers are monitored, and the need to focus on risk analysis as well as internal controls.

Data and tools deliver innovative edge and enhance customer experience

Operations teams have powerful tools at their disposal to help propel a fund organization toward growth. In 2015, these tools are anticipated to be a blend of technology and targeted customer support — similar themes to those being implemented by the broader organization.

- *Workflow tools*: Workflow management tools and processes provide investment managers with trade support, exception monitoring, and batch-cycle monitoring processes. Perfected on the investor side, but not yet on the investment-servicing side, the use of workflow tools needs to be prioritized in 2015. There is a strong argument to be made for the use of these tools to forecast, prepare for, and remediate operational events, even though they may be difficult to implement and optimize.
- *Analytics*: Both asset servicers and large fund managers sit at the intersection of unique and proprietary data sets, which, if effectively analyzed, could allow them to deliver actionable demographics to product teams, as well as to client and distribution channels to win and retain business. This supports intelligent management of a product portfolio and decision making. Fund managers need to translate the same data capabilities that are used in the front office for portfolio construction and alpha generation to bridge the gap to the back office. Operationally, data analysis may be used to help prevent cash breaks, avoid processing errors, or identify potential million-dollar mistakes — all before these events affect the organization.
- *IBOR*: An IBOR consolidates back-office portfolio accounting with middle-office events (such as corporate actions, etc.) for real-time use by portfolio managers in their trading decisions. Over the past several years, a number of investment managers have implemented an IBOR with a goal of improving their position data. At the same time, other organizations have begun to reassess the capabilities of their existing ABOR, or an accounting book of record, to see how it can be upgraded to play a similar role and to help with regulatory reporting. In 2015, companies should analyze their approach to their books of record for two reasons: the potential to improve operational efficiency, and the ability to craft an early response to the data and portfolio reporting proposal the SEC is considering.
- *Customer experience*: One of the best indicators that the fund industry has turned the corner toward growth is the repurposing of resources toward customer experience. To be successful, operational and back-office support is imperative. Leading global organizations are focusing on the following objectives: automation of lower-value transitional processes to free up time for the customer-facing staff to focus on experience, operations acting as customer consultant, and dialogue-based interactions using next-best-action insight.[51] Forward-thinking around the customer experience also needs to focus on a digital strategy and how to reach investors through mobile devices and social media.

The bottom line

When operations teams begin to align activities with growth as an objective along with the rest of the organization, it can be a true sign that the industry is turning the corner from cost-containment toward expansion. As a result, fund managers will be reassessing their global operating models accordingly. Looking forward, 2015 will likely be a year where operations may regroup, maintain the business, and support growth-oriented opportunities that have been sidelined for some time.

What’s next?

> “Investment managers have a number of emerging opportunities that can drive a dynamic growth trajectory in a strong mutual fund industry. Fund leaders must be able to tell their story to investors to rise above market challenges. Data-driven distribution and innovation will be paramount to delivering the right product set to retirement savers and the next generation of investors — enabling firms to win in an increasingly competitive industry.”
>
> *— Paul Kraft, partner, US Mutual Fund Investment Advisor practice leader, Deloitte & Touche LLP*

Investment managers are well-positioned to accelerate the quest for growth. Even though the mutual fund industry is mature, there is still a lot of opportunity for both large and niche managers to distinguish themselves. Because the challenges are so great, companies need to be more dynamic, innovative, and nimble than ever before.

At the end of the day, growth comes from investor demand — and retirement goals are the engine driving the fund industry train. Baby boomers are actively fueling growth at present, keeping the $24 trillion retirement market on a growth trajectory.[52]

To ensure that the fund industry remains on track to accelerate growth over the long-term, managers need to begin actively targeting the younger generation today. As millennials age, their rising incomes are likely to provide some of the fuel to keep the industry growing after baby boomers start drawing down their assets. Wealth transfer from inheritances may also support the growth of millennials’ investable assets. According to the US Trust Insights on Wealth and Worth® survey, 60 percent of respondents with investable assets of $3 million or more believe it is important to leave a financial inheritance to the next generation.[53] This indicates that millennials may be the largest beneficiaries of this wealth transfer.

Technology has been a primary theme running through our outlook, and this is a driver that will help capture the attention and loyalty of millennials as well. A recent survey by TIAA-CREF found that millennials are more likely than other market segments to want to connect with financial advisers online and attend webinars.[54] This reflects the growing interest in technology and financial advice, which may also drive the trend toward the use of “robo-advisers” — or technology-enabled advice platforms. From the distributor’s perspective, financial advisers and wholesaling efforts to reach them will also be increasingly technology-supported. Overall, investment managers that adopt cutting-edge technology in a cost-efficient manner may be able to benefit the most over time.

Looking ahead, it is anticipated that leading organizations will focus on creative approaches toward data-driven distribution, emerging asset classes, growth in governance, and operational innovation. With a combined strong customer-experience orientation and focus on involving the next generation of investors, the outlook for the mutual fund industry is full of potential.

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