



2014 Mutual Fund Outlook
Championing growth
Innovating around the edges



Deloitte Center
for Financial Services

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Foreword

Dear colleagues:

"It was the best of times; it was the worst of times..." So begins Charles Dickens' *A Tale of Two Cities*. In many ways, this describes the environment that the financial services industry is facing as we start 2014. The economy is showing some signs of life, balance sheets are stabilizing, and investors' confidence is trending toward the positive. That said, this year likely will be one of continued challenges for industry executives to realign business models, adjust to increasing regulation, and attempt to innovate for growth.

The investment management industry certainly is seeking to balance opportunity and challenge. Many parts of the business have seen growth in assets under management and profitability. We also note a renewed investor tolerance for risk-based returns, and firms are responding in a number of ways, including the launch of new products and by exploring global expansion. At the same time, these new forays are confronting industry participants with a more complex array of risks, and they will need to account for these as they react to regulators who are enforcing rules with renewed vigor. Nevertheless, many investment managers are poised to take advantage of increased opportunities for growth in 2014.

We are pleased to share with you this outlook for 2014, based on original research combined with the insights and first-hand experience of many of Deloitte's leading investment management practitioners. We hope you find this report insightful and informative as you consider your strategic decisions this year.

Regards,

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Overview

2014 finds the mutual fund industry in an enviable spot. Mutual fund firms have steadily added new assets while navigating a slippery regulatory terrain. Having grasped this balance, mutual fund firms are now looking to up their game. Much like speed skaters in search of the extra edge that will put them ahead of the pack, mutual fund leaders are innovating around the margins by experimenting with new products to help them develop a competitive advantage.

These new forays are placing additional importance on oversight and compliance frameworks as slips in execution could prove costly. We are seeing a first wave of mutual fund firms embracing risk-based resource models in order to gain a holistic view of risk within their organizations and to align resources accordingly. At the same time, risk and compliance leaders are increasingly taking part in business development and other planning discussions, adding valuable insight into strategic decisions.

Of course, mutual fund firms will have to manage their growth-related risks while they remain responsive to regulators who are ratcheting up their enforcement efforts and standing on the cusp of imposing new requirements. Missteps are not an option, and mutual fund firms will need to keep a close eye on Washington as some key issues remain unsettled.



Creating new products to meet investor demands

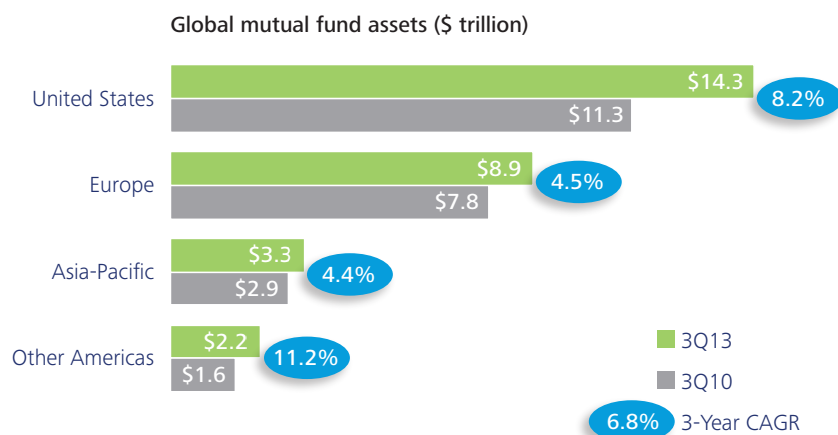
As the mutual fund industry looks ahead, it has solid asset growth at its back. Driven by increased inflows and improvement in investor sentiment, mutual fund assets have grown at an impressive 6.8 percent compounded annual growth rate over the past three years. U.S. mutual funds now hold \$14.3 trillion in assets, representing nearly half of total global mutual fund assets (see Figure 1).¹

The industry's persistent growth is a testament to its staying power over the years as a diversified choice in retirement planning. This past year marked the twentieth anniversary of the launch of the first target-date fund, and today these retirement investment products are offered by up to 80 percent of defined contribution plans.²

At the same time, investor tastes continue to change, prompting mutual fund leaders to consider new products to meet investor demands. In the aftermath of the financial crisis, one prevailing theme is that retail investors are seeking the downside protection that alternative investments offer, particularly now that U.S. equities have extended their three-year bull run and bonds face downward pressure from the expected easing of monetary policy.

Market events are thus contributing to the convergence of Main Street fund offerings with Wall Street alternatives that grant investors more leeway to pursue tactical strategies. Hedge fund and private equity managers have begun to investigate registered mutual fund offerings to entice retail investors. At the same time, mutual fund firms are partnering with hedge funds — either through outright acquisitions or bringing them on as sub-advisers — to give investors access to more flexible investment strategies implemented by hedge fund managers who are used to tactical maneuvering.

Figure 1. Three-year growth of mutual fund assets worldwide



Source: Investment Company Institute, Worldwide Market 3Q10, 3Q13

Alternative offerings may challenge mutual fund leaders from a compliance perspective, as well as when it comes to setting investor expectations. Because hybrid funds will have to work within the confines of the Investment Company Act, they won't be able to employ traditional hedge fund strategies such as the use of "go anywhere" type of investing that may insulate investors from volatility. How these early alternative funds perform in the year ahead against investor expectations will likely decide whether long-term demand for such offerings accelerates or retreats.

¹ Investment Company Institute, "Worldwide Mutual Fund Market Data, Third Quarter 2013," January 7, 2014.

² Sue Thompson, CIMA, "It Was Twenty Years Ago Today," *The Blog*, November 1, 2013, BlackRock, <https://www.blackrockblog.com/2013/11/01/twenty-years-today/>.

Exchange traded funds (ETFs), on the other hand, have certainly proven their staying power with investors based on their lower costs and ability to trade throughout the day. While the number of new ETFs declined for the second year in a row in 2013, ETFs continue to grow assets and remain one of the strongest selling retail products.³ If anything, the decline in launches suggests that industry participants are simply taking a more measured and strategic approach to new offerings.

We believe that the industry still has ample elbow room to create successful products that meet investor tastes, and we expect to see an increased focus on specialized ETFs — both active and indexed — in 2014. Another important development could come from the Securities and Exchange Commission (SEC), which appears poised to allow investment managers to introduce straightforward index-based ETFs pursuant to an upcoming ETF rule.⁴ The agency currently grants such ETF exemptions on a case-by-case basis, and the process can take up to three years or more, proving a real deterrent for new ETF entrants.

With consistent demand from investors for traditional fund products, new offerings already underway, and innovations on the horizon, the mutual fund industry appears set to “go” for 2014 and the foreseeable future.

Industry asset growth could also get a boost soon from the launch of re-engineered active ETFs. Advancements appear to be underway that will leverage pricing proxies and other innovations to provide investors with real-time share prices while safeguarding the confidentiality of portfolio investments. This is one trend we will watch with keen interest in the year ahead, as these new active ETFs could prove a real juggernaut if their innovations take root.

The bottom line

The rise of ETFs has enabled the industry to meet investor demands for lower fees and greater flexibility, bringing additional assets to the table without cannibalizing traditional mutual fund offerings. Their success is encouraging some industry participants to try their hand at more complex offerings, such as alternative funds and new types of active ETFs. Given the complexity involved in these new products, this year will likely bring a fair share of hits and misses. This aside and assuming the market cooperates, we see industry growth continuing at a respectable pace in 2014.

³ Investment Company Institute, “Exchange-Traded Funds Net Issuance,” September 2013.

⁴ Trevor Hunnicutt, “U.S. SEC Mulls Streamlining Launch of Exchange-Traded Funds,” Reuters, June 6, 2013, <http://www.reuters.com/article/2013/06/06/us-wealth-summit-etfs-idUSBRE9551AU20130606>.

Balancing risk management and growth

In 2014, we expect to see mutual fund leaders being more strategic about identifying and weighing risks when deciding what actions to take and where to allocate resources. In a global risk management survey of financial services firms conducted by Deloitte last year,⁵ a full 94 percent of respondents said their boards and/or executive management teams are spending more time on the oversight of risk compared to five years ago.

Mutual fund firms are very much a part of this shift in focus towards risk management. The fact is the industry's global expansion and new product forays involve complex execution and operating model support. There are important differences, for example, between running a mutual fund and an alternative fund, including valuation frequency, investment constraints, tax mandates, and not to mention compliance oversight. Low-cost ETFs, meanwhile, exert downward pressure on margins while also requiring additional operational support to facilitate intraday pricing and trading. And, of course, global expansion means multiple locations involving different time zones, regulatory requirements, and cultures.

Mutual fund leaders are increasingly accounting for this greater level of complexity when they consider new business ventures. In 2014, we expect that more industry participants will involve risk and compliance leaders in new business development efforts so they can better understand the risk implications of specific new business ventures.

We see the engagement of risk and compliance leaders as a positive development. When these key positions have a seat at the table, organizations are positioned to effectively understand how revenue-generating opportunities will impact the firm's overall risk profile and exposure. Elevating the risk function to become a strategic partner empowers the overall decision-making process and allows for a more balanced go-to-market strategy.



At the same time, risk resources are under considerable pressure given that risk is now being tasked to contribute to growth and restructuring initiatives while staying on top of a mounting array of emerging risks. This is a widely felt pressure point as evidenced by the 71 percent of respondents in our global risk management survey indicated that resourcing is a challenge.

As a result, we are seeing a shift to risk-based resourcing where mutual fund firms are utilizing risk assessments to allocate resources to key focus areas inside the organization. For example, inside most firms there is almost always the potential for decisions on resources to be unduly influenced by the loudest or most persuasive voice in the room and the prospects for revenue generation. Allocating resources based on risk assessments counteract these internal tendencies and allows for better prioritization of resources and more active management of significant risk areas.

⁵ "Global Risk Management Survey, Eighth Edition," July, 2013.



Mutual fund firms are also growing more sophisticated when it comes to managing risks outside their walls. The extended enterprise is comprised of a host of third-party providers, including custodians, transfer agents, administrators, brokerage counterparties, and technology firms among others. Albeit to different degrees, each of these partners is opening up firms to service provider risks such as potential business disruption, regulatory breaches, counterparty credit risk, service failure, and the theft or inadvertent dissemination of personal identification information or intellectual property.

One risk area where we expect to see heightened attention in 2014 is cyber threats. The specter of a cyber breach is top of mind for many in the industry, and while steps may have been taken to address the internal dimensions of cyber risk, the extended enterprise still represents a potential soft spot. The reality is cyber threats represent a complex array of possible breaches that can be many times removed from the fund company itself. For example, a cyber attack may not target the service provider directly, but potentially cripple a third party vendor the service provider utilizes, with damaging consequences nonetheless. Leading mutual fund firms now regularly conduct cyber threat assessments to better understand not just their own potential exposure to cyber attacks but their service providers' as well.

The bottom line

After a prolonged period of cost retrenchment following the financial crisis, mutual fund firms are beginning to take up discretionary spending again to better manage risks in support of new growth initiatives. At leading mutual fund firms, risk and compliance leaders are increasingly participating in strategic growth discussions and this is allowing organizations to get a better handle on how to allocate oversight responsibilities both internally and outside the firm. We suspect more mutual fund firms will embrace these models for weighing new business opportunities against downside risks and related cost implications.

Staying in front of regulatory flux

The industry will need to balance its growth objectives with the need to stay on the right side of regulators who are enforcing existing rules with renewed vigor. SEC Chair Mary Jo White has clearly emphasized the agency's intent to bring forth enforcement cases when it finds compliance violations. Mutual fund firms also have to contend with added complexity brought on by the increasing involvement of the Financial Stability Oversight Council (FSOC) and the Department of Labor (DOL) in industry rulemaking. The interplay of these agencies will be important to watch in 2014 as regulators appear ready to move on long-standing regulatory initiatives.

Changes for money market funds seem the clear frontrunner on the regulatory landscape for 2014, as industry participants and regulators continue to debate structural changes for these products. A number of industry participants see the potential combination of a floating net asset value (NAV) and liquidity fees and gates as a highly undesirable outcome that will sway investors to other vehicles for their short-term investments. It remains unclear whether the SEC will employ the liquidity and gating features as tools to address systemic risks or whether it will seek to broaden the floating NAV requirement to all money market funds or some combination of foregoing. With the FSOC watching closely in the wings, the industry may not be waiting long for the SEC's decision on its money market proposals.

The FSOC is also keenly interested in the potential connection between mutual funds and systemic risks, as evidenced by a recent report from the Office of Financial Research.⁶ The industry has challenged the report, which seeks to highlight certain concerns regarding the "herding threat" and other risks posed by fund groups. Whether one or more mutual funds firms will be pinned with systemically important financial institution designations remains to be seen. The stakes are high as any such action would likely present competitive implications for the affected fund companies.

Another top concern with high stakes is the potential for new fiduciary duty requirements in the retirement distribution channel. The fiduciary rule, which was first proposed by the DOL in 2010, may be reintroduced by the agency this year after making its 2014 priority list. While it is unclear how significantly the requirements might change, one possibility is that IRA sales and rollovers could be subject to the new fiduciary standard. Fund distribution in the retirement arena will also be affected if the DOL initiative focuses on prohibited transactions for affiliated broker-dealers, permissible fee arrangements, and conflicts of interest disclosure.

Some in the industry and in Congress want to see the SEC establish a fiduciary requirement for broker-dealers before the DOL acts. The SEC's last formal action in the area concerned a 2011 staff study on the harmonization of broker-dealer and investment adviser requirements. That study triggered a fair amount of controversy, as it opened the door to not only applying a fiduciary duty to broker-dealers, but also applying certain broker-dealer requirements — such as capital standards, new recordkeeping obligations and/or self-regulatory oversight — to investment advisers.⁷ The industry will need to stay tuned as SEC Chair White has pledged to consider fiduciary harmonization, without committing to specific timing.

⁶ Office of Financial Research, "Asset Management and Financial Stability," September 2013.

⁷ SEC, "Study on Investment Advisers and Broker-Dealers," January 2011.

Omnibus intermediary oversight will be another issue to watch as the SEC inspection staff has continued its focus on “payments for distribution in guise” in its 2014 National Exam Priorities.⁸ The agency is keeping close tabs on the potential misuse of fund assets to indirectly finance distribution outside of a Rule 12b-1 plan. With the attention the SEC’s inspection staff is giving to this area, we would not rule out an SEC enforcement action in 2014 related to omnibus oversight and/or servicing payments. On the omnibus oversight front, we expect 2014 to witness the continued debut of Financial Intermediary Controls and Compliance Assessment reports, which the industry can use to evaluate and gain comfort around an omnibus intermediary’s internal controls.

The SEC’s settlement last year with the former directors of a mutual fund firm regarding their fair valuation oversight practices was a watershed event for the industry.⁹ In Deloitte’s 2013 Fair Value Pricing Survey, 78 percent of mutual fund firms reported changing their valuation policies and procedures over the last year, likely in response to this enforcement action.¹⁰ The ramifications of the settlement will continue to unfold in 2014, as questions persist about whether or not the SEC will issue formal guidance in the valuation area. The SEC staff has been moving in this direction for years, but there is still significant skepticism that any guidance can appropriately reflect the industry’s diverse valuation practices. There is also concern around the likelihood that any guidance sanctioning or proscribing particular valuation practices will quickly become outdated due to the pace of change in this area.

“The SEC certainly has the industry’s attention,” said Elizabeth Krentzman, the leader of Deloitte’s Mutual Fund practice. “Events over the last year have cast a significant spotlight on fund valuation efforts. It was the strongest signal yet that the SEC has fund directors firmly in its sights and will hold them responsible for fair valuation decisions.”¹¹

The bottom line

With a new governing body in the picture and long-standing regulators flexing their muscles, the regulatory landscape is as unpredictable as ever. Industry leaders recognize it will be tough to act in advance to account for the unknowns associated with potential turf battles and the growing array of pending proposals. But, in the meantime, they can work to ensure that their compliance regimes adequately address the areas we know are in enforcers’ sights.

⁸ SEC, National Exam Program, “Examination Priorities for 2014,” January 2014.

⁹ SEC, Administrative Proceeding File No. 3-15127, filed June 13, 2013, <http://www.sec.gov/litigation/admin/2013/ic-30557.pdf>.

¹⁰ Deloitte, “Fair Value Pricing Survey, Eleventh Edition: Finding the Formula that Fits,” September, 2013.

¹¹ Deloitte, “Deloitte Report: Mutual Fund Directors on Alert Over Fair Valuation Oversight,” news release, September 23, 2013, <http://www.prnewswire.com/news-releases/deloitte-report-mutual-fund-directors-on-alert-over-fair-valuation-oversight-after-morgan-keegan-case-224860312.html>.

Conclusion

Mutual funds have conditioned themselves to excel within the confines of an extensive regulatory framework, and we expect them to remain resilient in the face of regulatory uncertainty. Year in and year out, the industry's diverse base of investment offerings has continued to attract investors of all walks of life and investment sophistication. With mutual fund leaders now innovating around the edges to build new product offerings, the industry's adaptability will surely come in handy. We believe the industry's success will likely be determined by how much it continues to mature in managing the risks and other unique challenges that these new endeavors bring.



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