



Go Niche or Get Left Behind: Consultants

Article published on January 16, 2008

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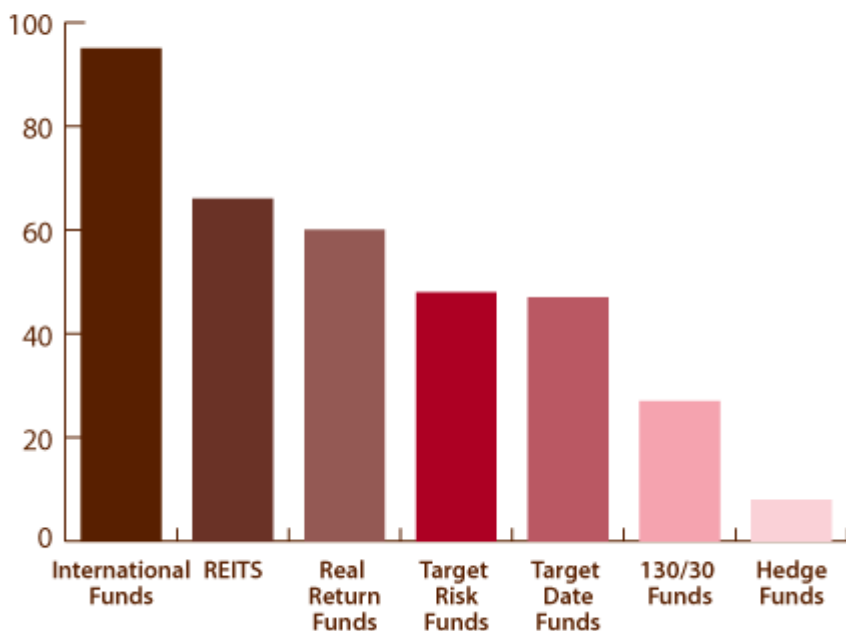
Mounting interest in alternative investments among financial advisors is putting pressure on fund companies to offer more niche products, albeit with varying levels of success, industry consultants say.

"Advisors' allocation to the core equity category will diminish," says Bruce Harrington, managing director of **Cogent Research**. Instead, registered reps are looking to international funds, target-date and target-risk funds, real-return funds and, surprisingly, real estate investment trusts (REITs). To a lesser degree, reps are showing an interest in hedge funds and 130/30 strategies.

"For those fund companies that don't have products in these categories, this should be a wake-up call," Harrington says. He sees niche products as an area ripe for growth within the next two years.

Niche Party

Financial advisors are increasingly looking to less traditional asset classes for diversification and frothy returns. Here's a breakdown of the percentage of advisors who will sell each product by the end of 2009.



Source: Cogent Research Advisor Product Forecast

The move toward greater diversification in investment vehicles and increased usage of more esoteric asset classes stems from the success endowments have had in generating strong returns, says industry consultant Burt Greenwald.

Indeed, **Yale University's** chief investment officer, David Swensen, positioned nearly half of the Ivy League school's endowment in illiquid, alternative investments, reducing exposure to U.S. equities to less than 25% of the portfolio at times.

His unconventional methods led to a 28% gain for the fiscal year ended June 2007. Furthermore, Yale's endowment has averaged a 15.6% annual return over the past 20 years and assets have grown to \$22.5 billion, from \$1.3 billion when Swensen arrived in 1985. The average endowment and foundation returned 10.2% over the same 20-year period, according to **Wilshire's** Trust Universe Comparison Service.

These outsize returns can hardly be ignored, and firms that are unwilling to stray from traditional asset allocation models may find themselves at a tremendous competitive disadvantage.

"Actively managed core mutual funds are in a dangerous place right now," says Lisa Cohen, president of sales consulting firm **Momentum Partners**. "There are packaged products that can deliver better returns and there are ETFs that can reliably replicate the benchmark."

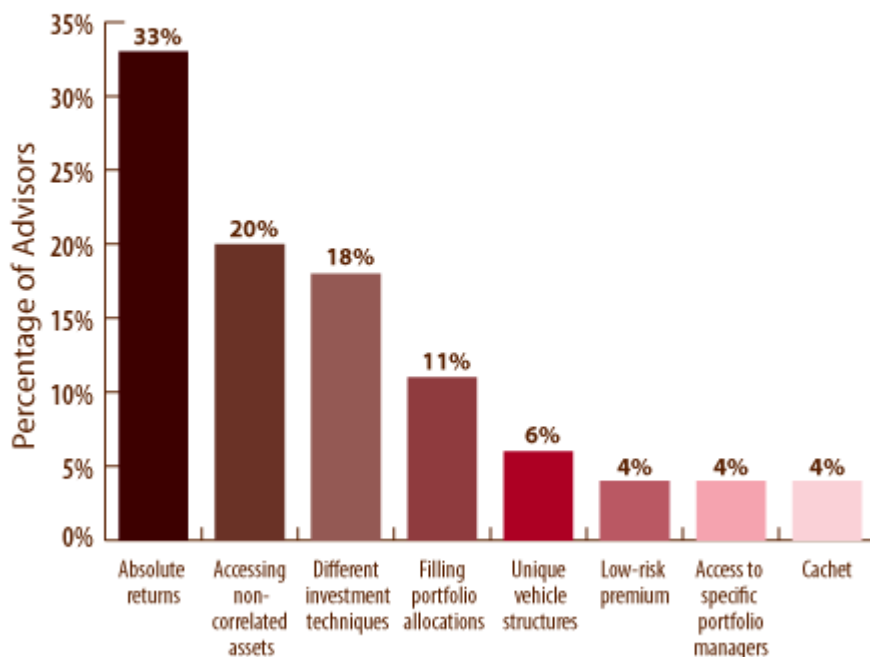
This increased competition is fueling the search for excess return above the benchmark through niche products. Ninety-five percent of advisors polled by Cogent Research said they plan to sell international funds by the end of 2009, citing "a solid opportunity for growth and diversification in an increasingly global economy."

Another 66% said they anticipate selling REITs down the road due to their negative correlation to equity markets, valuation and high rates of return. Many advisors see REITs as a viable option two years from now, when they expect a recovery in the real estate market, Harrington says.

As a hedge against inflation, some 66% of advisors surveyed said they plan to sell real-return funds. Nearly half expressed a keen interest in selling target-date and target-risk funds as a core holding in a retirement income plan.

Alternative Thinking

Top drivers of advisor demand for alternative investments.



Source: Winter 2008 Semiannual Rydex AdvisorBenchmarking Study

Some fund companies are responding to such demand by acquiring smaller boutique shops or entering into subadvisory agreements. Still others are launching proprietary market-neutral or 130/30 funds that aim to generate alpha using hedgelike strategies.

Natixis acquired Cincinnati-based money manager **Gateway Investment Advisers** in June 2007 to fill a product gap. Gateway's strategy is to invest in a broadly diversified stock portfolio and manage risk and volatility by buying and selling index options. "We'll continue to see more of that — firms looking to acquire expertise they don't possess," Greenwald says.

But while a lot of firms have recognized this trend, very few have taken action, Cohen says. That's because wholesaling is very entrenched at this point and changing the old-school sales mentality is going to take years.

"The question for mutual fund shops is whether to niche or not to niche," Harrington says. In order to compete he suggests they offer these products. To do so, they need to acquire, develop or focus intently on a particular niche. Doing so will also give smaller, more nimble firms the chance to focus in on what they do best, he says.

Outside of the largest asset gatherers like **American Funds** and **Franklin**, the second-tier firms are going to have a hard time staying competitive unless they create or acquire niche products that will resonate with advisors, Momentum's Cohen says.

"What ultimately creates and maintains market share is performance," Greenwald says. He cites **Dodge & Cox** as the prime example of a fund family that grew from obscurity to one of the top dogs in less than a decade on the strength of its track record and without spending much on marketing and advertising.

While Greenwald concedes that the timing is right for innovative new products that have merit, he questions whether many firms have really put a lot of thought into the funds that have hit the market of late and makes a prediction that could prove troubling for some. "There's a tremendous urge to differentiate for the sake of differentiating without much thought to whether it is a viable product or not," he says.

"Five years from now the mutual fund landscape will be littered with the corpses of alternative investments such as 130/30 funds."