New Product Designs Lack Investor Focus

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The conventional wisdom on product development is no longer going to get the job done.

With an increasingly crowded and commoditized field forcing firms to reinvent, pressure to adopt institutional strategies may have unintended consequences.

Most firms base their product development decisions on a product-gap analysis, comparing the asset classes that are experiencing steady flows to their own lineup of funds. Shops also look at the latest fund filings to monitor what their competitors are rolling off the assembly line.

While this approach should not be abandoned, there needs to be a more integrated and acute focus on customer needs, according to a recent **Cerulli Associates** report.

New is not necessarily improved when it comes to unveiling fresh-baked funds. While shifting away from long-only strategies may be an increasingly popular move for mutual funds, firms need to reconsider if they are simply hopping on a bandwagon or if the alternative asset classes meet an expressed investor need.

Analysts and consultants say that product innovation has been largely unimpressive in recent years as firms have too often thrown resources around gimmicky, narrowly sliced or copycat products. And promises of guaranteed income, hedge-fund-like returns and the need for niche exposure have not lived up to their billing.

What is getting lost in the equation is how these products meet the needs and goals of their customers, both financial advisors and investors. "Fund companies get tangled up because they're selling through an advisor or a gatekeeper. This causes them to lose sight of how the product may be used in the client's portfolio," says Cindy Zarker, director at Cerulli.

Gatekeepers are the consultants tasked with making manager selections on behalf of the broker-dealers, who then put them on a recommended list for their army of advisors to sell.

This lack of investor focus has been an outgrowth of further convergence between institutional and retail markets. In an effort to curry favor with the gatekeepers, there has been a race to blend less traditional asset classes with core investments.

Indeed, more and more firms are adopting the blueprint used by college endowments. The success of **Yale University**'s chief investment officer, David Swensen, has turned a lot of heads. Swensen's secret sauce is said to be his decision to place 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.

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 he arrived in 1985.

Still, the instruments used by large pensions and endowments don't always translate well to

the mutual fund market, Zarker says.

The Investment Company Act of 1940 severely restricts a mutual fund's ability to use leverage. And the SEC requires funds engaging in the use of derivatives, forward contracts and short selling to cover their positions.

Zarker concedes that the innovation on the alternatives side is interesting but says it has to be designed in a way that matches the firm's distribution strategy. "There are some real disconnects," she says. "Some of the structured products out there have very small ticket sizes, suggesting they were sold to the wrong people."

She argues that firms need to synchronize their product development efforts across the entire organization. Targeting the right advisors with the right products is crucial. **Russell Investments**, for example, does a good job of marketing to advisors who want to delegate portfolio construction, she says.

Providing better client services and operational efficiencies is perhaps more prudent than building a better mousetrap, one consultant says. "We have so much duplicative product out there. What we need is a gigantic product rationalization," says Lisa Cohen, president of **Momentum Partners**.

Ultimately, more thought needs to be put into meeting specific investor needs or objectives. Fund companies must operate in the context of "their role in investors' portfolios, understanding sponsors' and advisors' approaches to portfolio construction and evaluating threats from investment banks and other product assemblers," Zarker says.

The fund managers that will beat out the competition will be the ones that identify new sources of growth that maintain desired levels of return. Some fund companies hope to accomplish this with long-short funds or ETFs. In terms of predictability of growth or income, managers must assess the competition from banks and insurers using structured products and come up with a more compelling offering.

For protection of principal or income, fund shops should keep working toward lower fees and expenses, Zarker says, adding that partnering with a bank or insurer might help make this process smoother. Lastly, "optimized portfolio construction" will be an integral part of manager success as shops decide whether to use model-only accounts, multi-manager funds, target-date funds and other embedded advice and outcome-oriented funds.

Most firms have fallen short in their attempts to offer guaranteed income due to the insurance restrictions mandated by the '40 Act. Still, one product Cerulli says shows promise in that area is the **DWS Scudder** Life Compass funds, which use a third-party "warranty" from **Merrill Lynch**.