



Investment Management CEO Survey 2008

Insights from industry's leaders

Important Notice

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Setting the scene



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I am delighted to introduce the annual PricewaterhouseCoopers Investment Management CEO Survey 2008, and welcome the continued support of this initiative by IFSA. I would like to thank the survey participants (almost 40 in all), and in particular the CEOs who took part in our round table forum and one-on-one discussions. These discussions helped capture the themes, issues and opportunities in the industry and added a great deal of colour to the analysis.

Following a golden run over the last 10 years or so, 2007-08 proved to be one of the more challenging years on record for investment market returns, both here and overseas, with the average Australian balanced superannuation fund retreating by more than 5%.

However, this needs to be seen in perspective. Over the last 5 years balanced superannuation funds achieved an average return of more than 10% a year, compared with just under 5% for cash funds.

Nevertheless, the Australian investment management industry entered a new phase in 2007-08. Tailwinds were replaced by headwinds. Continued inflows into superannuation may have helped some managers maintain positive net inflows, but negative investment returns have reduced the asset bases on which revenues are collected.

Negative returns have been a global phenomenon, with both equity and debt markets hammered everywhere.

When the US subprime mortgage market collapsed in 2007, most observers expected a short-lived crisis with limited collateral damage. However, the US subprime crisis soon morphed into an extended global liquidity crisis – the ‘credit crunch’.

Cheap sources of debt dried up, and when companies had to refinance, some that had relied on short term debt to fund long term assets, ran into real trouble.

Concerns over credit and liquidity, not to mention fear of a US-led global recession, have dented investor confidence.

It is unclear how long it will take global credit markets to return to something like normality. More than 70% of CEOs responding to the survey believe that it will be at least 2 years before conditions start to improve markedly. There is also a view that credit risk spreads may never return to the extremely low levels seen before the crisis. Instead, conditions may eventually improve to a ‘new normal’ in which risk is given its proper price.

The outlook for equity markets is equally unclear – both here and globally. Will the market downturn continue and, if so, ‘how low’ and for ‘how long’ are the big questions being asked right now.

The headwinds currently buffeting the investment management industry may well continue to blow for some time.

The majority of Australian investors appear to be holding their nerve so far and focusing on the long term return from their investments. However, their confidence is currently being tested as they come to terms with this year’s statements, and the possibility of even further deterioration. This will figure heavily in the strategic thinking of CEOs.

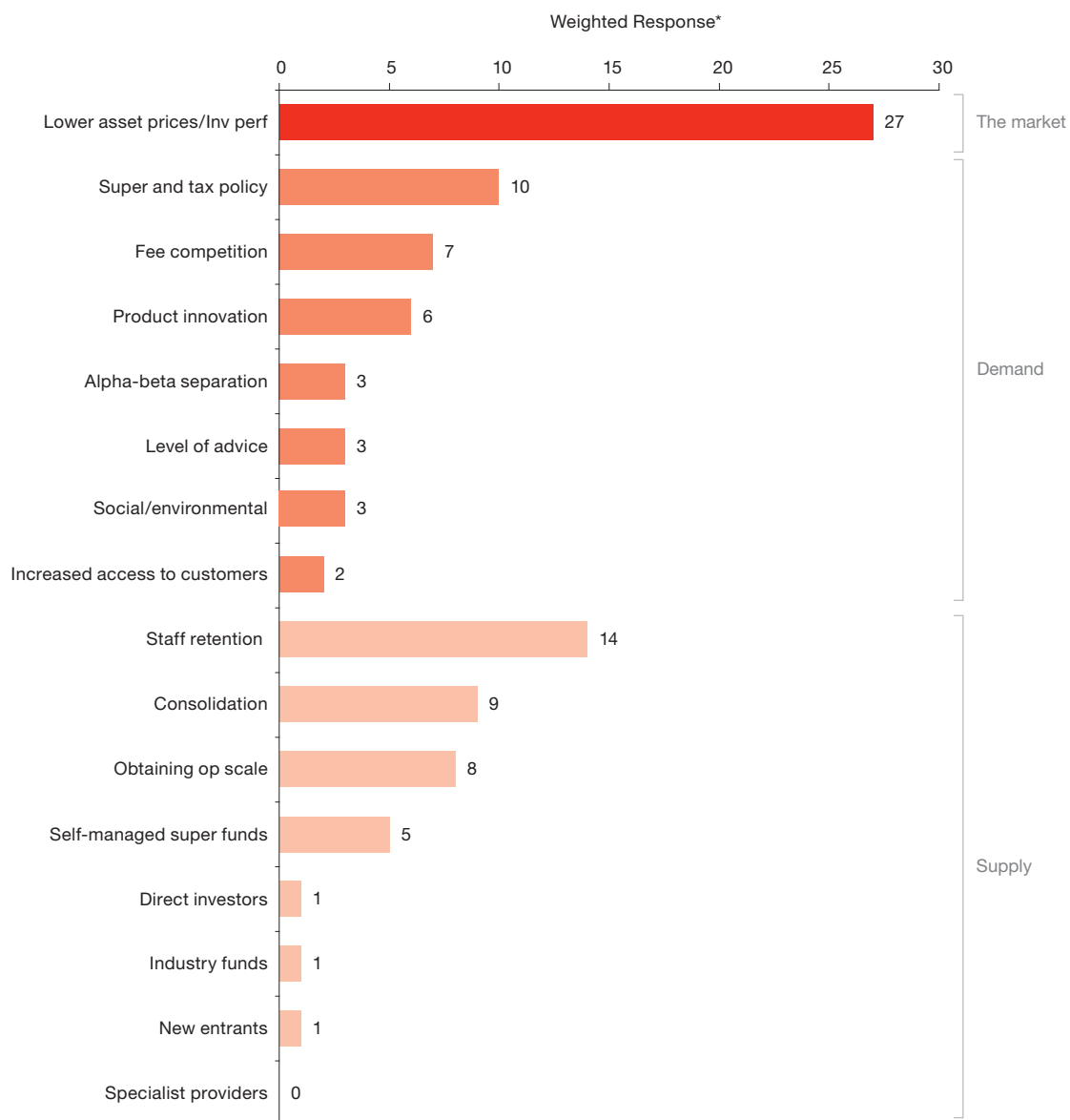


Following a golden run over the last 10 years or so, tailwinds have now been replaced by headwinds – asset values have fallen and investor confidence is being tested.

To date, investors have held their nerve and CEOs continue to focus on client service and growth. However, investor confidence is currently being tested as they come to terms with this year's statements.

The next 3 years – ‘make or break’ factors

What are the top 5 factors likely to impact the different parts of the industry over the next 3 years?



* This graph, and a number of subsequent graphs, indicate a 'weighted' response. A 'weighting' is used where respondents are asked to rank a number of options. Weightings are applied depending on the ranking given and then aggregated. The outcome demonstrates the relative importance of items.

Market conditions



Investment performance is always important, even in the best of times. Investment managers work hard and skilfully to produce performance for their customers. In rising investment markets absolute returns are strong, and the challenge for managers is to be better than one's peers.

These, however, are not the best of times – markets are down, the outlook is uncertain and investors are worried.

Under these conditions, absolute returns disappoint investors no matter how well a manager performs relative to a benchmark or its peers. At the same time, managers are hit by lower asset bases, flows and revenues.

While ups and downs in profitability are inevitable in this industry, going hand-in-hand with strong and weak investment markets, getting this message across to their shareholders can be difficult for CEOs.

In this environment, nerves are stretched – financial planners, call centre staff, the investment team, the finance team, not to mention CEOs – all come under pressure.

Indications are that investors are mostly holding their nerve so far. However, how they will react as they come to terms with this year's statements is yet to be seen.

The next 3 years – which factors

Ensuring efficient supply of investment management services

Staff retention

Number
2

As was the case in last year's survey, staff retention is a major issue.

Some larger investment managers, had been finding it increasingly difficult to win in the war for talented asset managers and other key specialists. Smaller players and the local offshoots of global investment managers were often able to provide more attractive workplace cultures: including, greater autonomy and access to decision makers.

But times are changing. Under difficult market conditions, with the momentum of investment managers stalling, the war for talent is no less intense, but the playing field is more even. How well an investment manager is weathering the storm becomes a key consideration that applies to all. In uncertain times, the stability of a larger organisation may have more appeal.

Consolidation

Number
4

Further consolidation is expected across all segments of the investment management industry over the next 3 years, with platform provision being the segment considered the most likely for consolidation.

Interestingly, the competitive threat posed by further new entrants or industry funds did not figure heavily in CEOs responses – this may be a sign of the maturing of the industry, with scale being a high barrier.

After significant growth in the number of participants in the investment management industry over the past few years, it is not surprising that consolidation is anticipated. The result should be an industry with fewer players, but they should have better scale and greater efficiency than is currently the case.

Obtaining scale

Number
5

In order to meet continued downward pressure on fees while continuing to deliver innovative products, the task of obtaining and holding onto operational scale is critical in most segments of the investment management industry. CEOs expect the industry to achieve this through both continuous improvement in efficiency and through acquisitions.

will most impact the industry?

Building demand for investment management services

Super and tax policy

For the last two decades, the framework for retirement savings and the associated issues of adequacy and coverage have been high on the political agenda. With the bulk of the investment management industry ultimately servicing superannuation savings, government superannuation and associated taxation policy will continue to drive strategic decisions within the industry.

Number
3

We note the recent proposal of a sweeping review by the Minister for Superannuation and Corporate Law, focusing on all areas of the industry, including self-managed, industry, public, retail and corporate funds. While formal terms have not been announced, reports suggest the review will cover the operations, structure and costs of the entire compulsory superannuation system, with the aim of reducing the fees ultimately paid by investors.

This review will be run alongside the government's income tax review, headed up by Treasury secretary Ken Henry, which amongst other things will take a look at the adequacy and coverage of superannuation and how to incentivise Australians to save more for their retirement through higher super contributions.

History has shown that periods of framework reform need to be followed by periods of stability for lasting change to the way Australians view saving for their retirement.

Consumers will need to be confident that concessions contained within the superannuation regime will remain before they put more discretionary savings into

superannuation. Similarly, providers will need to be clear on any proposed changes to legislation before they make substantial investments in product innovation or in operating systems and infrastructure.

Fee competition

Competitive pressures, growing asset balances and improved operational efficiency have led to constant downward pressure on fee rates paid by consumers in recent years. Aside from the government's proposed review, further reductions are expected, with platform fee rates coming under the most pressure.

Number
6

Product innovation

Continuing innovation of products to provide greater choice to investors, and to meet their needs, remains high on the strategic agenda. Product innovation is expected to focus on:

Number
7

innovations in product design, structure and packaging

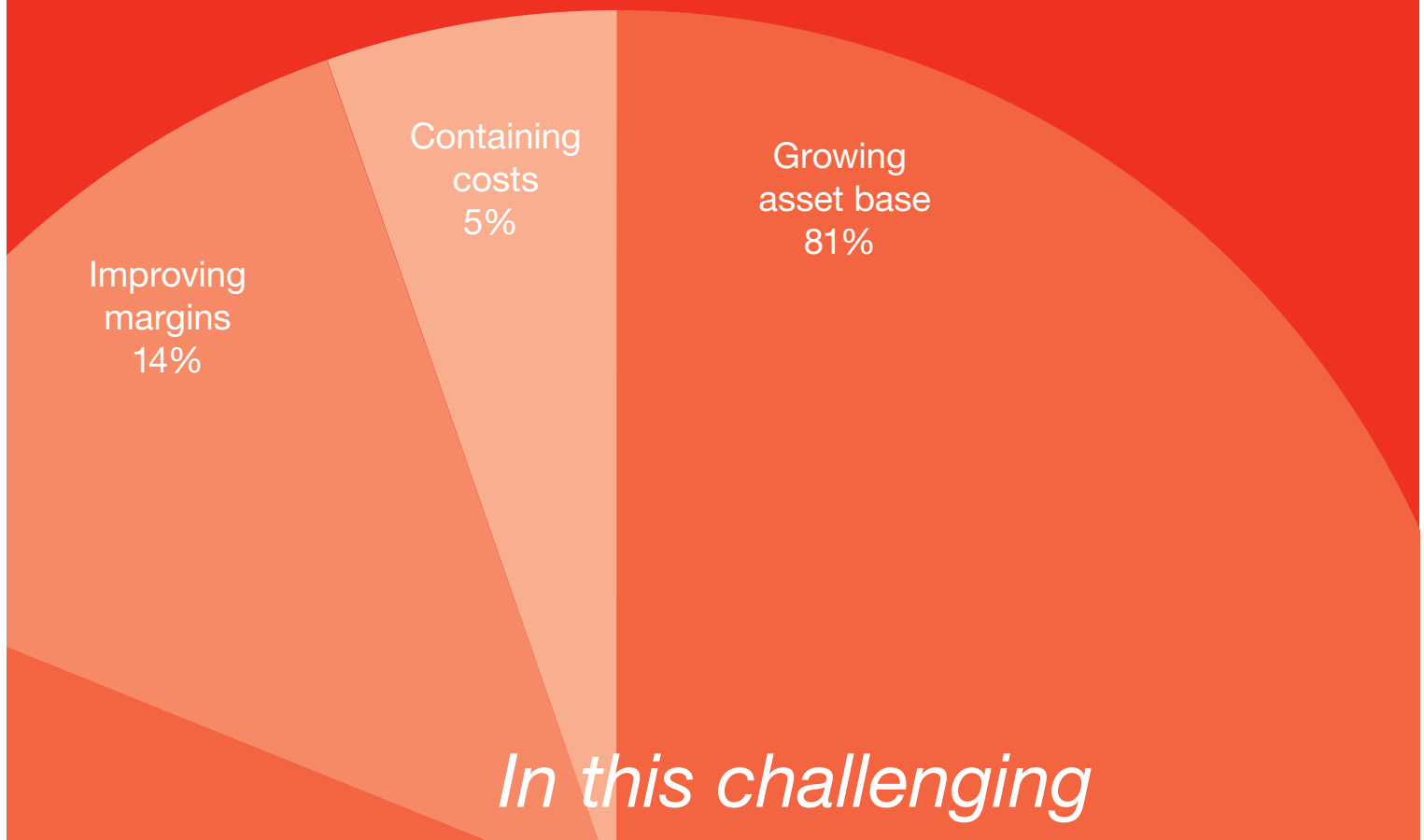
- platform offerings (such as term deposits)
- investment guarantees in superannuation
- transition to retirement
- access to pension savings
- offerings to self managed super funds

innovation in the base asset classes and investment styles employed

- global and emerging markets
- enhanced active management and high alpha techniques

The next 3 years – what will CEOs focus on?

Which one of the following measures will you concentrate on most to deliver growth in profit over the next 3 years?



In this challenging environment, 8 out of 10 CEOs still see winning customers and growing their asset base as the most effective way to deliver growth in profits

The next 3 years – most important strategies

What do you see as your organisation's most important internal management strategies over the next 3 years? (multiple open responses)

Internal management

Attracting and retaining staff **53%**
"Retain and align the interests of key talent"

Obtaining scale and growth **36%**
"Acquisition to grow scale"
"Positioning for growth"

Distribution reach **31%**
"Identify new distribution channels for existing products"
"Expand and diversify distribution including the opportunity to export"

Cost control **28%**
"Cost reduction through outsourcing and standardising of processes"

Efficient operations **25%**
"Increased operating leverage"

What do you see as your organisation's most important client/product strategies over the next 3 years? (multiple open responses)

Client and product

Product innovation **49%**
"Innovative approaches to traditional asset classes"
"Innovation – new products, long/short, hedge funds, thematic funds"

Separation of alpha and beta **29%**
"Alpha-beta separation, eg 130/30 market neutral"
"Smarter beta"
"Development of high alpha products"

Focusing on retirees **20%**
"Move to retirement products – dollars retained better than new money"
"Capital guarantees – performance protection and supporting regulatory environment"

Access to multiple managers **9%**
"Increased multi-manager diversity"

Current market conditions will surely serve to intensify the focus on each of these areas, while at the same time throwing up plenty of distractions to blur it. To understand how CEOs intend to achieve their strategic goals, we now consider how they plan to tackle each of the following areas:

1. doing more for customers – through innovative product, competitive pricing and valued advice
2. retaining key staff
3. obtaining operational scale and efficiency

Doing more for customers

On the demand side of the equation, accessing customers and providing them with quality advice and innovative and competitive product is the name of the game.

Doing more for customers – through innovative product

Continuing innovation in products to meet customer needs remains high on the strategic agenda. Product innovation in the investment management industry takes two forms: innovation in product structure design and packaging; and innovation in the base asset classes and investment styles employed.

(and other multi-manager structures) as increasing their already significant importance to revenue.

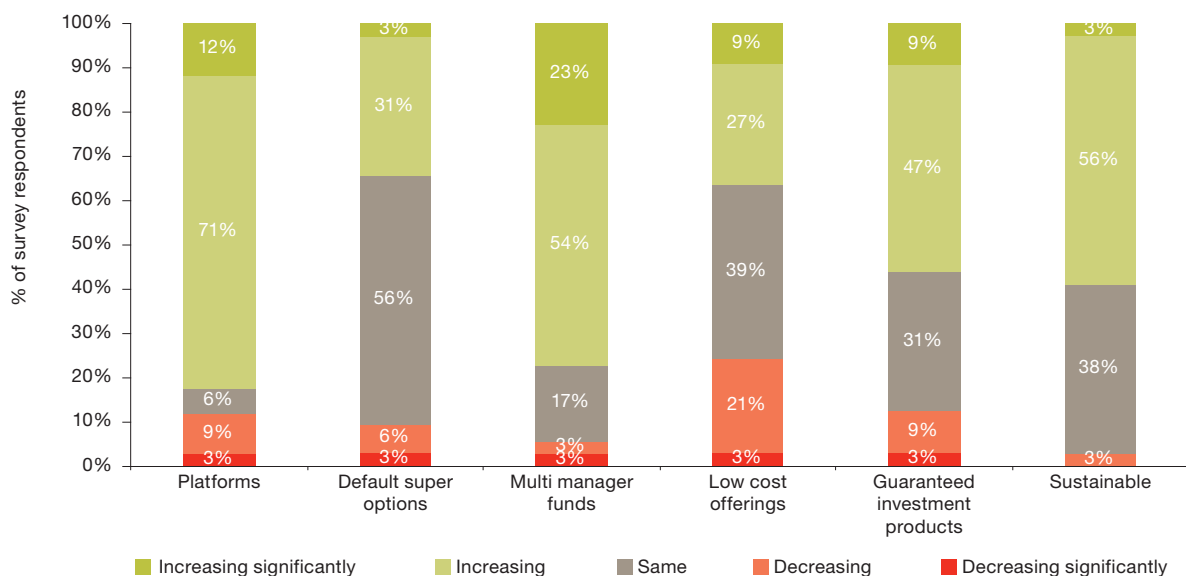
One reason for this is the ability of platforms to rapidly adapt to changes and innovations in the market. This speed was recently demonstrated with platform providers adding term deposits to their menu to satisfy customer demand for simpler products with more certain returns.

Product structure

The most successful product structure over the last decade has been the platform. Recent research has shown that over 80% of new money invested via financial planners was through platforms. Almost all CEOs saw platforms

Socially responsible and sustainable investments, while still viewed as becoming more important, have not risen as rapidly as earlier surveys predicted. The sentiment among CEOs was that while sustainability is important, in times of poor performance, investors may be more concerned with returns.

How do you see the relative importance of the following product offerings to your organisation's revenue changing over the next 3 years?



Self-managed super funds

Once the domain of only the well-to-do, self-managed super funds are now an attractive alternative to many Australians, representing approximately 25% of the market and growing.

SMSFs are often 'distributed' through suburban accountants, although increasingly financial planners are advising on SMSFs. They can offer a highly tailored product for what is seen as a relatively low fee.

Aside from the flexibility they offer with regard to investment options, they also offer the opportunity to tailor tax solutions that cannot always be achieved in managed superannuation funds.

SMSFs are not all bad news for the industry. They provide good opportunities for platform providers, with investors still wanting access to investments across many asset classes.

It will be interesting to see whether the trend to SMSFs continues, particularly given the recent market volatility.

Investment guarantees

A number of specialist investment products have hit the market over the last year including a range of highly geared products with a floor on investment losses, attracting a niche of private investors. These products focus on the tax advantages of high gearing, while protecting against the significant losses such a strategy could incur. However, with complex disclosure requirements, and additional contributions not possible, the appeal of such tax focused products may be limited in the broader market, especially with 'mum-and-dad' investors.

Market volatility has also put a focus on providing protection options that are suited to those near or in retirement. A new generation of guaranteed products has appeared on the horizon, aimed at providing more flexible protection by allowing investors to transact and vary their asset classes just as they would with regular super options. The market for flexible guarantees on retirement savings in the US has passed the \$US1 trillion mark, and local CEOs see this as the most important product innovation for retirees.

AXA is the first company in Australia to launch a 'next-generation' guarantee, allowing investors to choose from a number of investment options, while protecting their superannuation or pension balances. These types of products can work well under the existing regulatory framework.

A recent survey by Milliman shows rapid innovation in the US of new products offering guarantees for life, whereby retirees can withdraw a guaranteed percentage of their initial retirement balance for the rest of their lives (irrespective of market performance or how long they live).

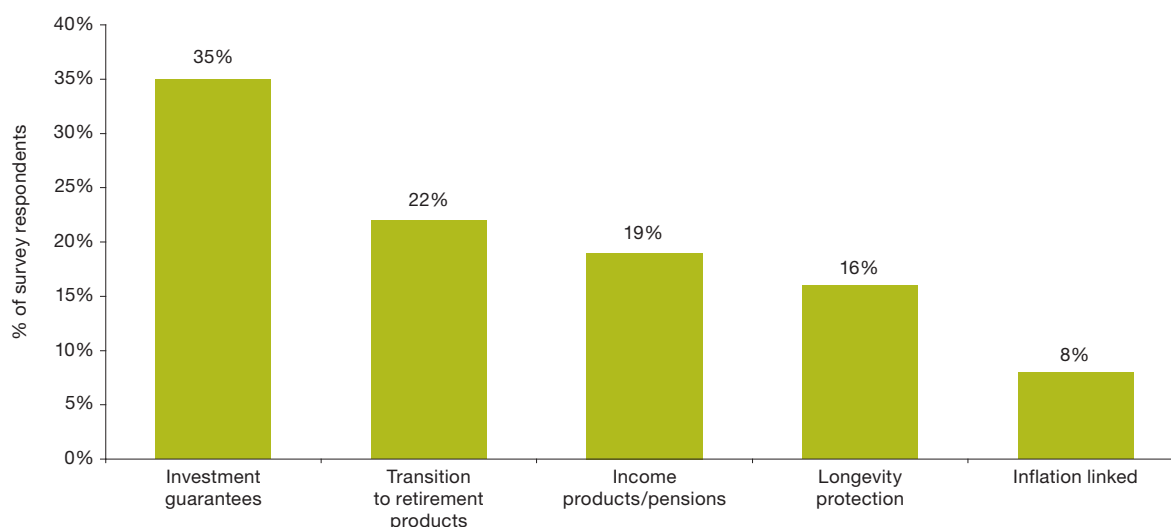
However, a number of hurdles need to be overcome if these types of life contingent guaranteed products are to ever achieve the success they have seen overseas. The current prudential regulatory framework for life insurers is viewed by many as a limit to innovation, and as seen in other markets, will need to adapt to support the advancement of the industry. Open dialogue between the regulator and industry is called for.

Products packaged for retirees

Up until now, the industry has primarily been focused on the accumulation phase of the superannuation life cycle, however, the Better Super reforms have opened the door to a wide range of innovations aimed at the transition to retirement, and during retirement itself. However, despite the reforms, many organisations still struggle to retain investors in retirement.

In an effort to increase retention, some organisations have launched products to take advantage of tax benefits when retiring, while others have looked for more integrated solutions.

What strategies and products do you think will profit most from an ageing population (i.e. what will you do specifically for retirees as opposed to savers)? (multiple open responses)



For example, rather than having separate saving and retirement products it is now possible that a single product can serve you while working full-time, ‘transitioning’ to retirement and during retirement. This simplicity may be the key to improving customer retention into retirement.

Another innovation that is making headlines is ease of access to account-based pensions. For example Westpac/BT and Russell/ANZ have recently launched integrated products allowing direct access to pension savings via everyday banking, with ATM access replacing the tiresome process of filling in forms.

Ultimately, the key to success in retaining customers through retirement is to understand the change in psyche of retirees – once retired, some see their standard of living as no longer in their own hands, but rather in the hands of their investment manager.

Asset classes and investment styles

Investment performance remains critical to retaining and winning business, but in past years when double digit returns were being achieved across many different asset classes and investment styles, investors were generally happy across the board. As such there was less focus than today on how different investment styles could add incremental value.

All that has changed – CEOs now need to be confident that their offering of fund options contains the asset classes that are most relevant to the current investment outlook, managed with a style that is appropriate in the new conditions. Some classes and styles will be winners for investors, and others will not.

Over the next 3 years, CEOs expect to see an increase in the relative importance of global asset classes over local asset classes. This is not entirely surprising with the invested assets in superannuation surpassing the market capitalisation of the Australian stock market.

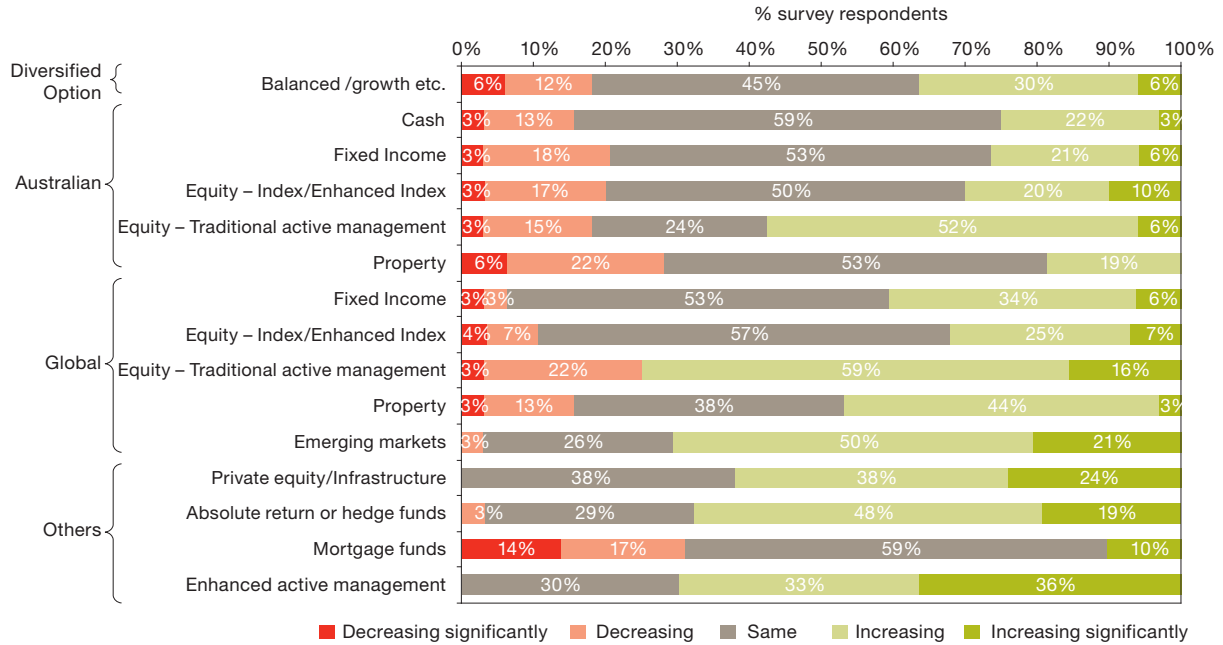
It will be interesting to see how this growth emerges – whether it be truly global funds or rather through regionally specific funds (where those regions that present the best opportunities in particular asset classes are sought out).

For equity markets, CEOs saw the US and emerging markets as undervalued and expected both of these markets to be in demand.

Within equities everywhere, CEOs see traditional active management styles increasing in relative importance compared to an index or enhanced index style.

Mortgage funds are seen as the asset class likely to reduce most in relative importance – the impact on returns of the blowout in credit spreads has hit this sector hard.

How do you see the relative importance of the following asset classes on your organisation’s revenue changing over the next 3 years?



Obviously, no one knows which asset classes and investment styles will outperform over the next few years – but two things seem clear – Australian investment managers are adapting to the new conditions; and Australian investors will continue to have a wide range of investment options to choose from.

Increasingly, providers are seeking to mix index and active management to achieve outperformance at a lower cost. This is achieved by investing the bulk of a fund in an index return (beta) at a lower fee, and paying significantly higher fees for out-performance (alpha) on a small part of a portfolio.

Depending on where an organisation sits in the wealth management value chain, the impact of this alpha-beta separation presents challenges or opportunities.

In the current investment climate, the ability of asset managers to achieve alpha will be crucial for their survival. CEOs saw that their search for alpha would continue with private equity infrastructure, absolute return or hedge funds and enhanced active management funds all increasing in importance.

What challenges/opportunities does alpha-beta separation present to your organisation?

Opportunities

- Value opportunity
- Growth
- Product innovation
- Effective beta
- Better use of fees
- Optimisation

Challenges

- Difficulty selling the concept
- Resource challenges
- Conflicts
- Pricing challenges
- Systems, skills, education

Doing more for customers – with competitive fees

In any period of low returns, investors will focus more on the fees they are paying. With lower absolute returns, a larger proportion of performance is taken in fees – a 2% fee is more significant when returns are zero or negative, and less of an issue with returns of 10% or more.

When considering the total fees paid by investors, it is not a case of simply adding up the component fees across the different wealth management service areas. In particular, a single investor will not utilise every service area, for example, consumers will largely either be invested through retail products predominantly offered by fund managers/life insurers or they will be invested via platforms.

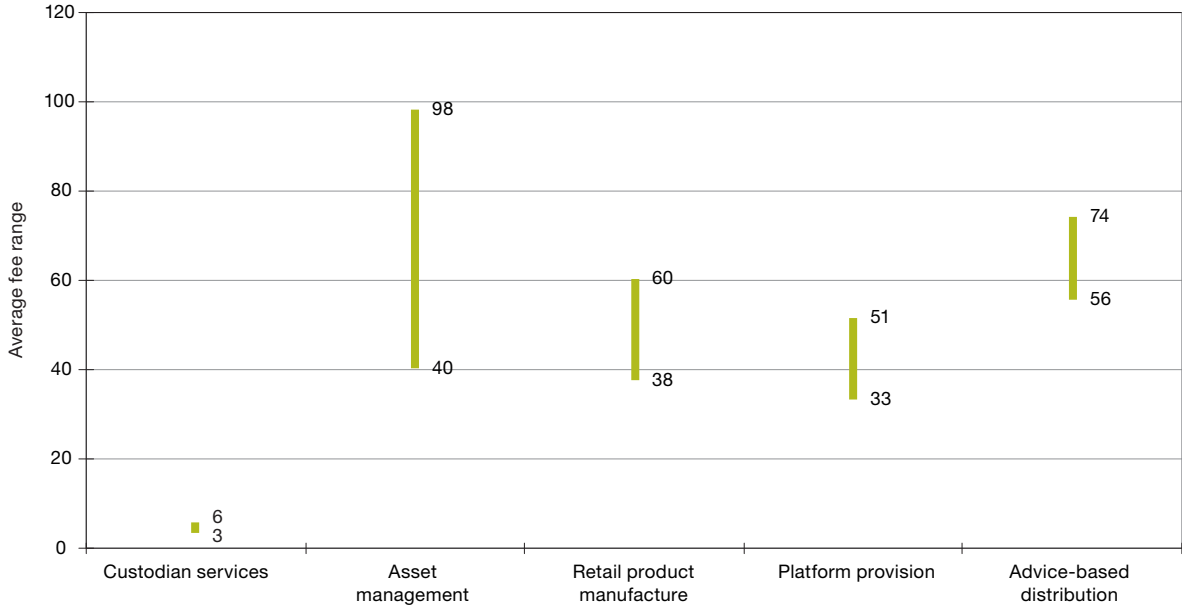
Overall the total fees paid by consumers vary widely, with large differences between non-super investments, personal superannuation, RSAs, ERFs, corporate superannuation, industry funds and public sector funds.

Treasury estimates that the average cost of the superannuation system is 125 basis points. This statistic, however, does not show the wide range of costs to consumers, resulting from:

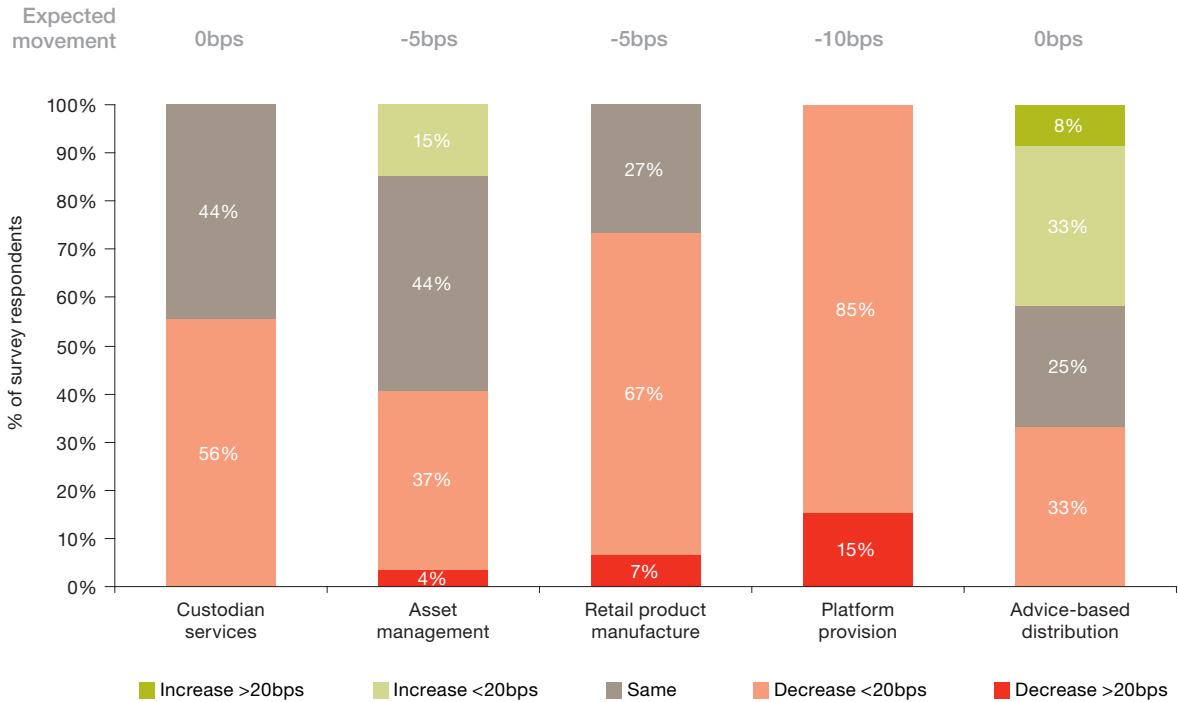
- variations within a provider: fees will vary between consumers depending on asset classes/ investment styles chosen, balance sizes, product features, level of advice etc
- variations between providers: small scale offerings average from 180 to 230 basis points of funds under management whereas large scale offerings average from 70 to 110 basis points of funds under management.

The traditional definitions of retail vs wholesale are now blurred, for example a small industry fund or master trust could have higher fees than a large scale personal super offering.

What is the approximate range of fee levels charged by your organisation for each wealth management service where you are a provider?



How do you think these fee components will change over the next 3 years?



Competitive pressures, growing asset balances and improved operational efficiency have all contributed to a constant downward pressure on fees rates paid by consumers in recent years.

Over the last 5 years, average fee rates have reduced by at least 10 to 15 basis points. This is most notable in corporate superannuation master trusts and personal superannuation products, where reductions have averaged in the order of 30 to 40 basis points.

CEOs believe that further reductions will come over the next 3 years. Reductions in fee levels are generally expected across all wealth management service areas, with an expected reduction in the total cost to customers in the order of a further 10 to 15 basis points (with smaller reductions expected in the large scale offerings, and perhaps larger reductions in offerings through platforms).

One of the main drivers of this has been the disaggregation of the wealth management value chain and the shift in power from each 'supplier' to their respective customers. For example, platform providers have exerted their significant buying power over asset managers.

However, under the current environment CEOs expect platform providers to come most under pressure while advice-based distribution is expected to be the most resistant – perhaps underscoring the importance and relative value of good financial advice.

As always, those providers that can best articulate and deliver value for money for their customers in terms of better returns, better service, more flexibility and/or better advice will be the most resistant to fee pressure.

Improvements in organisational efficiency and scale will continue to be required for the industry to obtain good margins.

It will be interesting to see the impact of the current environment on the growing trend toward performance fees – in a cheap beta environment, investors will only pay for outperformance. In addition, funds may also face tough times justifying fees for outperformance of a benchmark while an investor's funds are going backward.

Doing more for customers – through valued advice

In any industry, distribution can certainly be a make or break issue. In the investment management industry, providers seek access to customers, and importantly, many customers seek advice for their purchase. This is because investment products are financially important, generally complex, and there is a myriad of offerings and providers from which to choose.

Generally, CEOs consider that full advice will continue to be the most important form of advice-based distribution over the next few years.

Intermediaries will continue to be the predominant channel, rather than branch staff or a sales force.

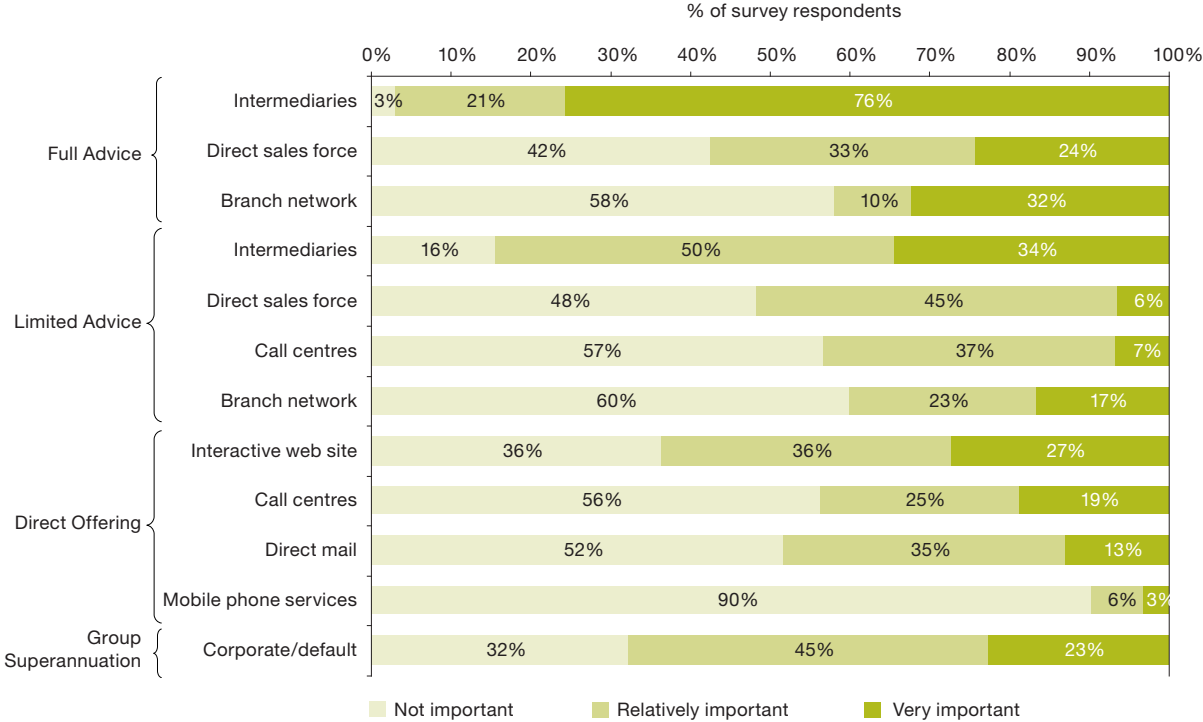
Demand for advisers is currently outstripping supply – seek.com data regularly shows over 1,000 financial planning positions in a month. Reports suggest that the number of financial advisers will need to double over the next

few years. Given the importance of advisers for distribution, increasing their number and quality is critical to growing both customers and asset bases.

Over half of the CEOs thought that organically growing the quality and number of advisers would be the primary approach to meeting this demand. They mentioned strategies such as training programs for existing and would-be advisers through academies and introducing accreditation standards. Other innovative approaches to attracting people to the industry, including recruitment from other professions, have not yet gained much traction.

35% of CEOs plan to acquire or form partnerships with adviser groups. For those fund managers without a financial adviser network, a presence on platforms and adviser approved lists is critical for effective distribution.

How important will each of the following types of distribution be to your business over the next 3 years?



The question of how advisers should be remunerated and how best this should be disclosed has long been a debated issue. The debate centres on how best the industry can ensure any potential or perceived conflicts of interests are minimised (so as to not adversely impact the end customer).

Elements of the debate were put back on the table recently with the announcements from the Minister for Superannuation and Corporate Law. One area of focus will be the use of commissions, particularly in a compulsory superannuation environment. The Minister is also concerned about the total fees paid by customers, which for many retail investors may include the embedded cost of advice.

Even before those announcements, over half of the CEOs that have advice-based distribution businesses saw their adviser incentivisation model changing over the next few years, often towards 'fee for service'.

When asked specifically about conflicts of interest, 43% of respondents felt that the best way to minimise conflict of interest was through proper disclosure, 50% felt that further attention is required and only 7% felt it was not an issue. However, of those CEOs with advice-based distribution businesses, 90% felt disclosure minimised conflicts of interest.

One thing is certain – the industry is clear that it needs to provide simple and clear disclosure that effectively addresses what the customer needs to understand.

What are your views on the potential for conflicts of interest? (open response)

“Any system that pays an adviser more for selling one particular product over another has the potential to influence the advice outcome and this may not be in the best interests of the investor”

“Disclosure is not enough... ongoing use of commissions as payment for advice means that perceptions of conflict remain”

“If commissions received are adequately disclosed to the end customer then conflicts are minimised”

“Disclosure needs to be easily understood”

“Disclosure is everything”

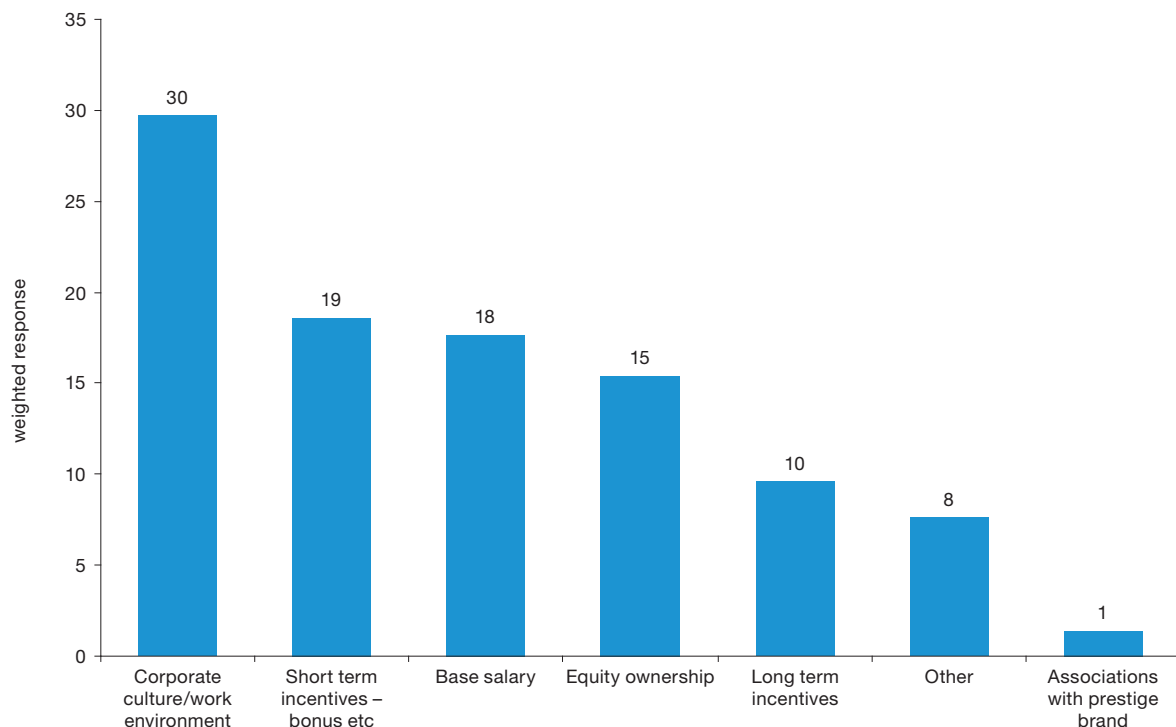
Retaining key staff

Over the past few years, the importance of staff attraction and retention has been a growing issue for the industry. This continues to be top-of-mind for CEOs, featuring as the second most important factor to impact the industry over the next few years.

Retaining existing staff

Active management for retaining staff is an ongoing necessity because top talent is in constant demand. Aside from the lost skills and knowledge, the cost of replacing a key staff member is estimated to be in the order of double that staff member's annual salary.

What are the 3 most important measures you consider in relation to recruiting, retaining and incentivising key staff members?



CEOs saw the most important measure for attracting, retaining and incentivising key staff members is the corporate culture and work environment.

Innovations that can build a more appealing work environment and culture include:

- access to the top (fewer layers in the organisational chart)
- freedom to move (less rigid structure)
- being in charge of own destiny
- self determination (excitement of working for a growing organisation, being able to make a difference) and
- shielding from corporate and administrative nuisances.

For some, a more structured approach to people strategies is necessary, including competency assessments, training and clear career mapping.

Good base salary together with attractive short term incentives assist with attracting talent at the recruitment stage, but it is the corporate culture and work environment that will determine whether an organisation can hold on to its key employees – there is only so much institutions can deliver on remuneration packages.

Also, short term incentive schemes can become problematic when market conditions are difficult and profitability comes under pressure. Some CEOs indicate that their schemes will be reviewed to ensure that their key people are rewarded appropriately even in challenging times, while others firmly believe that performance-linked incentives are just that – performance-linked.

On balance, it is likely that the structure of incentive schemes will be kept largely intact, but where necessary discretionary allocations will be made for key individuals at year end.

Another cloud looming on the horizon is the impact of the Baby Boomers retiring from the workforce. The risk of losing significant corporate memory and experience is a huge problem for some segments of the industry. In an attempt to retain this group of workers for as long as possible, some companies now provide the option for more flexible work hours, as well as attractive retention packages.

Attracting new staff

The principal method of recruitment in this sector is to poach from competitors. This is not a sustainable recruitment strategy. However, opportunities to attract staff are beginning to open up as expats may be seeking to escape the growing impact of the credit crunch in the UK and US markets.

Capacity constraints have been the watch-words in recent years, but with the current turbulence, some of the heat may be coming off this issue. Under difficult market conditions, with the growth momentum of all investment managers stalling, the war for talent is no less intense, but the playing field is more even. When trying to attract staff, how well an investment manager is weathering the storm, and the market's view of the long term prospects of a business become a key consideration that applies to all.

“The war on talent is already over – talent won”

Obtaining scale and efficiency

The investment management industry as a whole believes that gaining and holding onto optimal operational scale is critical. This requires not only continuous improvement in efficiency, but also consolidation. CEOs consider platform provision and custodian services to be the segments where consolidation is most likely. Each of these involves heavy capital investment in systems and technology, requiring considerable scale, and in the case of platforms, continuing success also requires innovation and adaptation.

There have been a number of significant adviser group acquisitions over the last few years by the large retail/platform providers. This trend is expected to continue.

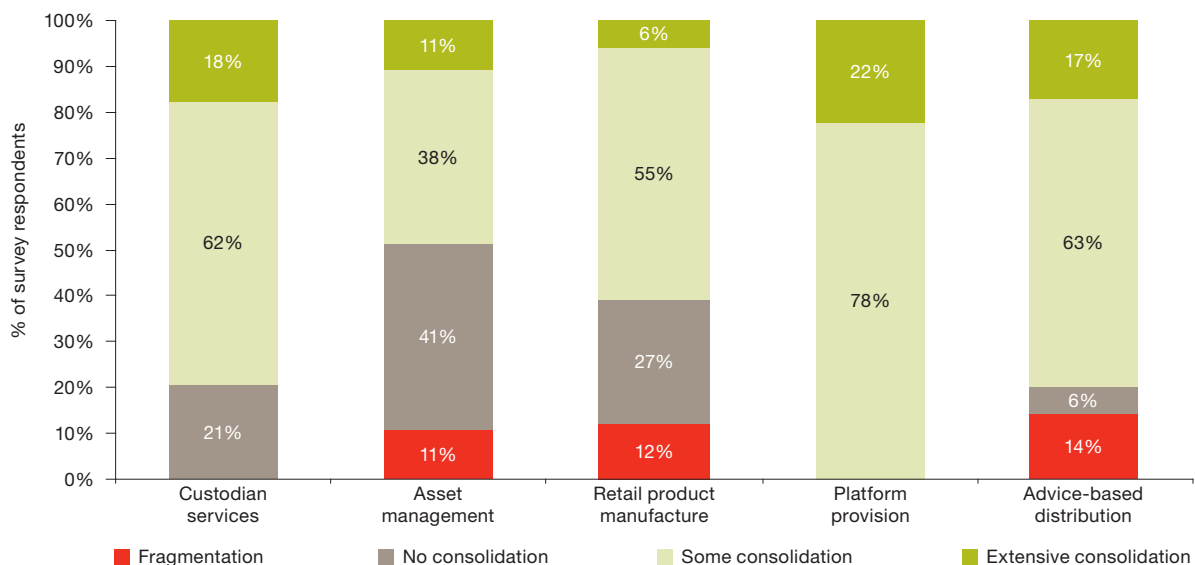
It is interesting to note the spread of responses in respect of consolidation among the asset managers. This may be partly explained by the life cycle of boutiques, with successful teams breaking off to become the next generation of

boutiques, and with the re-absorption of the not so successful by larger players.

Generally speaking, the imperatives for consolidation are to grow scale or to diversify into related industry segments. In the case of mergers of asset managers, whether such a step would pay dividends depends on the acquirer's ability to retain the reputation, clients and key staff of the firm it has taken over. If these are lost, any benefits quickly evaporate.

The global credit crunch, and the difficult investment market conditions it has triggered, have impacted some investment management businesses more severely than others and created opportunities for consolidation. The impact of reduced revenue from decreased asset values and inflows may force players to merge, acquire or be acquired to spread fixed costs over a larger base, reap synergies and restore profitability.

Over the next 3 years, what level of consolidation, if any, do you expect within the following areas of the investment management industry?



After significant growth in the number of participants in the investment management industry over the past few years, it is not surprising that consolidation is anticipated. Furthermore, current market conditions mean that success is less likely for any new players

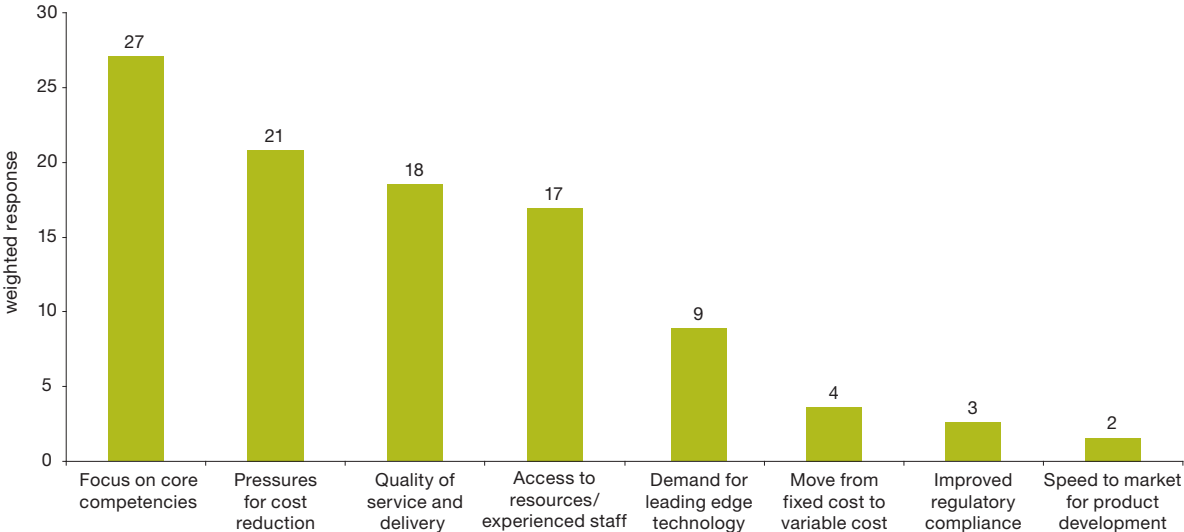
in the industry than was the case in recent years. The result in 3 years' time should be an industry with fewer players, but they should have better scale and greater efficiency than is the case now, at the end of a golden run.

Does the high level of disaggregation across the value chain give more CEOs the option of outsourcing and offshoring to solve key challenges?

The main driver of outsourcing is a desire to 'stick to one's knitting' and to farm out non-core activities to specialised players who have the right scale and expertise. When it comes to core activities, CEOs are engaged in a 'race to best practice', which also means giving consideration to offshoring some of a manager's standardised processes to more efficient operating units outside of Australia.

Does this further reflect the war on talent theme? Will the joint pressures of needing to attract and retain staff, innovate in the face of a limited talent pool and obtain scale and efficiency mean we will see more outsourcing?

What would be the top 3 drivers for any outsourcing and/or offshoring you might consider?



Rationalisation vs innovation

Investing, especially in superannuation, is a long term undertaking. Customers may hold products for many years, and expect their product to remain true to the initial offering. The industry, however, needs to keep innovating to comply with changes in legislation, to satisfy demand from customers and to respond to competitors. These opposing tendencies of the need for long term products and continuous innovation can and do create legacy products.

Growing numbers of legacy products not only generate additional complexity and cost, but potentially crowd an investment management company's capacity for innovation.

There have been several calls over recent years to remove legislative and regulatory barriers to rationalisation. Last year's Treasury discussion paper on a simplified mechanism for product rationalisation generated a lot of interest, and the industry still eagerly awaits its findings.

Until new regulatory enablement comes to the rescue, transferring, closing, or merging products will continue to be difficult. What then is the right balance between continued product innovation and rationalisation?

Many CEOs saw a focus on rationalisation as necessary before unhampered further innovation could take place:

“ Strategies to close legacy products are critical to creating opportunities for new products ”

“ The regulatory environment should facilitate the closure of legacy products ”

Others saw maintaining a balance as being important, through controlled innovation that ensures effective support of all products, old and new:

“ The rate of product innovation is moderated by the need to efficiently support all new products through advice channels ”

“ Key focus must be innovation to meet client/adviser needs rather than just for change sake ”

However, some CEOs asserted the prime importance of innovation regardless of legacy product issues:

“ Product innovation is central – need to keep innovating ”

“ Product innovation should always occur, should be encouraged and should not be hampered by onerous conditions applying to legacy products ”

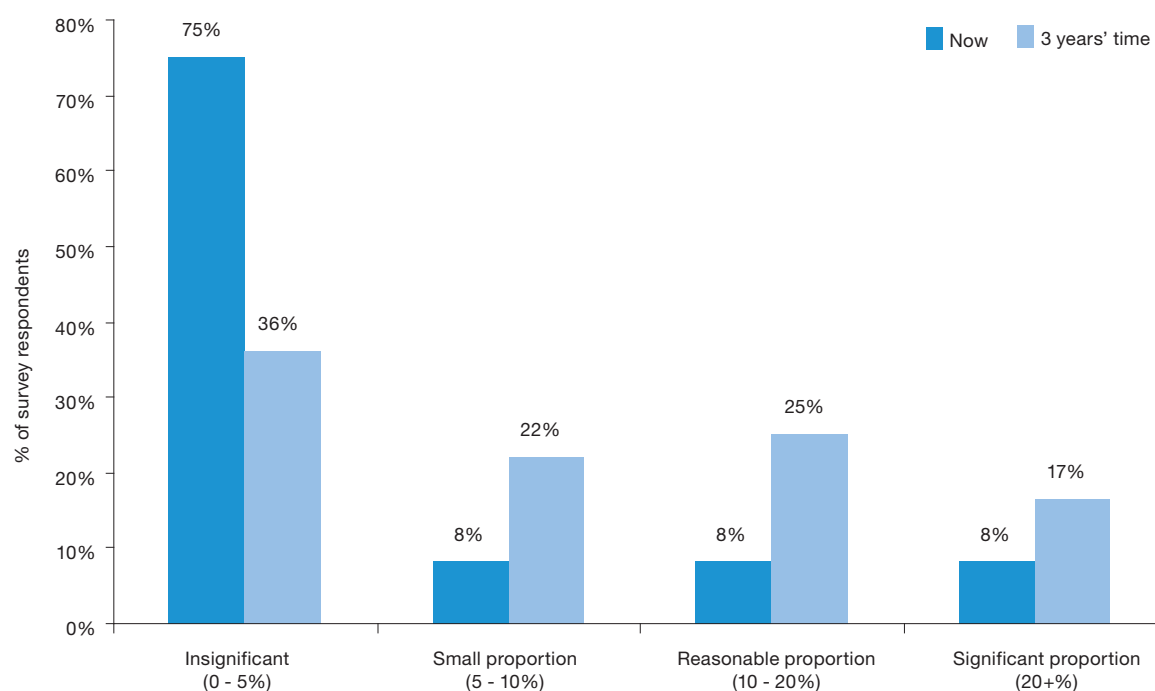
Australia as an FS hub

The Government has indicated its intention to develop Australia as a financial services hub for the Asia-Pacific region. The Australian investment management industry is well developed by global standards and presents a fantastic opportunity for ‘export services’.

The first step of this plan is the passing of amendments to withholding tax laws addressing what CEOs saw as the major barrier to attracting overseas investors. Under the new laws residents of certain countries will be subject to significantly lower withholding tax from investments in Australia, decreasing from 22.5% in 2008 to 7.5% after 2010. These reforms have been well received by the industry, and will surely make a difference to the amount of overseas investments attracted.

Currently, only 3 to 4% of CEO respondents’ funds under management (or administration) are sourced from overseas. Over the next 3 years, CEOs expect that this level will increase. While it is difficult to predict, on average, CEOs are expecting a 100 to 200% increase on this level. In broad terms the size of the prize over the next 3 years may be in the order of an extra \$50 to \$100 billion – more than enough reason for the industry to have a strong focus on these markets.

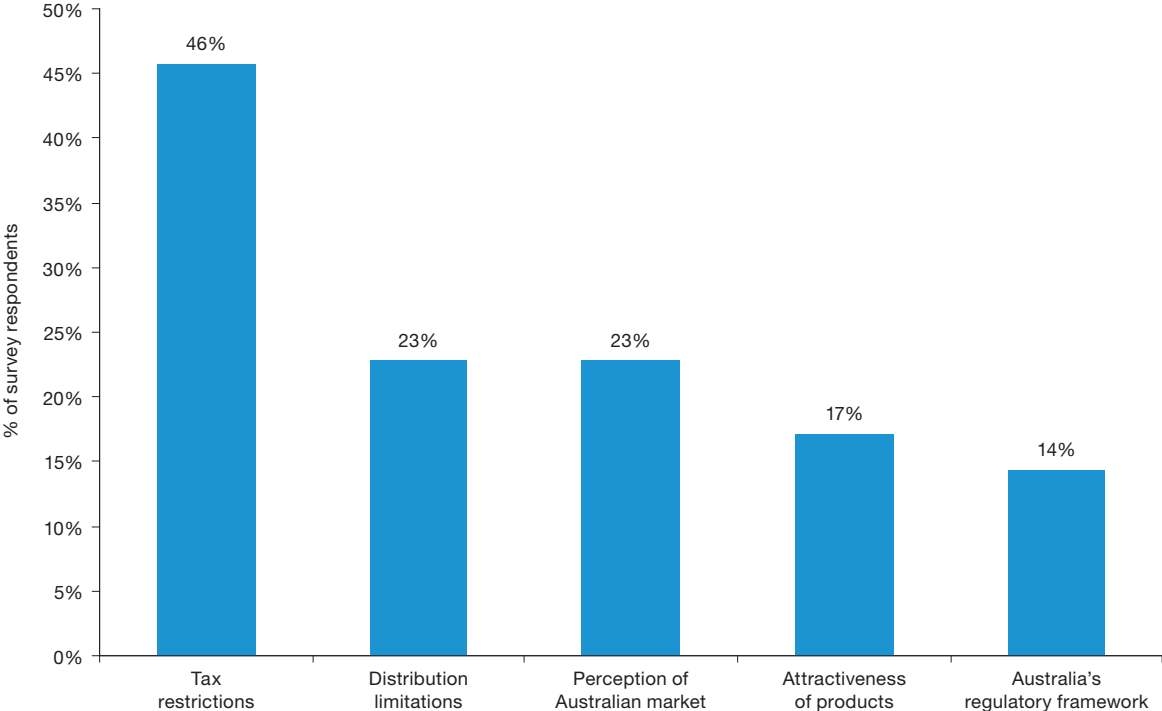
Approximately how much of your funds managed/administered is sourced from investors outside Australia now and how much do you expect in 3 years’ time?



Asia has an increasing and wealthy middle class and a relatively unsophisticated market. In our time zone, albeit not quite on our doorstep, it provides us with an opportunity to be the FS hub for the world's fastest growing region so that Australia can improve its balance of payments, provide employment opportunities for our young and not so young, and take pride in developing a world leading industry.

The industry stands ready to partner with the Government to make a success of Australia as an FS hub. However there are still significant barriers for overseas investors. CEOs saw creation of relevant products and access to investors as significant challenges. Furthermore there may be a perception that Australia is a niche market, with a lack of international presence.

What are the main barriers to attracting overseas investors to your products?



The industry plans to at least double the amount of funds sourced from overseas investors to over \$100 billion in the next three years alone

Contemporary issues

We asked CEOs to comment on a number of topical issues:

Illiquid assets

Many funds offered to investors contain illiquid assets such as direct property, infrastructure, private equity and other unlisted securities. Sometimes these assets are part of larger balanced funds, while some funds offer them as sector specific options. These exist both in a unit priced and a crediting rate environment.

While these asset classes represent valid investment options and help investors construct diversified portfolios, concerns have been raised with the difficulty of valuing such assets, especially when markets are turbulent.

As year-end fund performance numbers emerge, some strongly performing funds are coming under increased attention, especially where they contain a high proportion of illiquid assets. Any out-of-date or unrealistic valuations are potentially a serious issue. Investors exiting a fund at an incorrect valuation can leave the other investors at a disadvantage and, worse still, this can build into a liquidity problem for the fund. Most (but not all) funds allow full transactional liquidity, especially those that are subject to superannuation portability with member choice. Were investors to leave an incorrectly valued fund in significant numbers, the illiquid nature of the assets may mean that the fund could rapidly exhaust its supply of liquid assets.

Fund managers therefore need to be sure that valuations of their illiquid assets are always up-to-date and realistic, perhaps by considering the following questions:

- How frequently are the fund's illiquid assets valued?
- Are valuations appropriate given current movements in observable markets?

- Does the fund's valuation policy specify a basis to estimate the price in between valuations?
- The fund will require immediate revaluation if unit prices or credited values do not reflect the current realistic value of the underlying portfolio. How will transactions be suspended until updated valuations are available?

A repeat of the early nineties needs to be avoided, where a number of unlisted property trusts suffered severe liquidity problems. Should a run on a fund occur, swift and decisive action would need to be taken to prevent the early movers leaving the rest of the investors to suffer the consequences.

"In a member choice environment, liquidity of the investments should be aligned with the liquidity enjoyed by the member"

"The main issue with the current environment is one of volatility. This in turn presents a problem around the valuation of illiquid assets where there is no easy benchmark to value that asset"

There is no doubt that disclosure of a funds approach to illiquid assets is necessary. However, the nature of the investment also sets expectations in the minds of investors. For example, a daily unit priced option or a daily crediting rate option carries a strong message of transactional liquidity to the investor. Disclosure of its approach to the valuation of illiquid assets does not absolve a manager from providing realistic and fair prices every time an investor wishes and is able to transact.

Securities lending and short selling

CEOs are adamant that securities lending and short selling are, and have long been, a valid part of investment practice:

“Stock lending and short selling are efficient and effective value adding”

However, CEOs are equally adamant that in light of recent events improved disclosure and monitoring of these practices are necessary:

“Needs greater transparency for market cohesion and reputation”

Some CEOs express themselves even more strongly:

“Real issue is that regulators need to have access to more information and then do what they can to stamp out market manipulation”

The message is clear – when conducted properly and openly securities lending and short selling are valid practices, however they should not be allowed to be abused.

Unit pricing and compensation issues

The regulatory framework, industry guidance and industry practice in relation to these issues have all improved considerably in recent years.

The main area requiring better guidance relates to materiality, and in particular the threshold over which investors who have been impacted by a unit pricing error should be compensated.

We note that this is an aspect of unit pricing currently under attention by ASIC/APRA with more guidance expected to be issued shortly.

“We need to have a greater focus on materiality when it comes to unit pricing issues, particularly compensation of very small amounts”

“We are fixing too many small items. Cost benefit isn't justified”

Effectiveness of regulation

Many CEOs felt that regulators are not focusing on the things that matter, such as systemic weaknesses or unsound practices that have the potential to become serious problems:

“Regulators need to focus on the right things – connect to industry and identify risks before they happen”

“We don't see ASIC getting involved in many issues or making policy statements regarding significant issues”

“Insufficient commercial judgement and too much bureaucratic form over substance”

On the question of prescriptive regulation versus self regulation, most CEOs favour less of the former and more of the latter, depending on the purpose, but there is a spectrum of views around this:

“Need to limit further regulation, particularly in the area of advice”

“Disclosure should be self regulated, while other aspects require prescription e.g. capital adequacy”

“Self-regulation is completely ineffective”

Finally, on the question of consistency of regulations most CEOs thought that there were too many regulators, too many overlaps between them and too much inconsistency in the regulation of similar products. To quote the plea of one CEO – “One regulator, less regulation”.

Most admired

As in previous years, we asked CEOs to tell us who they most admired and why (multiple open responses)

Macquarie

31%

- Product innovation
- Time to market, adaptability
- Global presence

CFS

31%

- Integration of platform, advisers and other product offerings
- Fund flows, scale and margins

BGI

17%

- Client service/relationships
- Thought leadership/innovation
- Clear product positioning
- Investment performance and style

BT

17%

- Scale and resources
- Platform and product success

Platinum

11%

- Performance
- Brand/market position
- Business model not based on trail commission

Innovation, scale performance and the bringing together of investors and managers continue to define success

About the survey

The PricewaterhouseCoopers Investment Management CEO Survey 2008 was conducted in May 2008, with 37 investment management CEOs participating (including 9 out of the 10 largest wealth managers). Respondents were from a wide range of organisations covering all parts of the investment management industry.

A key part of the survey process was to hold one-on-one interviews and a roundtable meeting with a range of CEOs following the initial aggregation of the survey results.

This report provides an overview of the survey findings, together with analysis and interpretation of the results. The aggregated responses to individual questions from the CEO survey will be provided to survey participants in a separate Appendix.

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