

SEC Narrows Definition of Research Fund Directors Examine Soft-dollar Expenses

“May Day” changed everything about brokerage commissions. Three decades later the Securities and Exchange Commission (SEC), directors of mutual funds and registered investment advisors—all express concern that commissions take too much out of investors’ pockets.

The issue first emerged on May 1, 1975, when the SEC ended a 200-year tradition of fixed brokerage commission rates. This fostered competition, reflecting a strongly held ideal of the American economic system. However, the lowering of commission rates also produced fears that brokers could no longer afford to provide useful services such as research.

In response to this concern, Congress enacted Section 28(e) to protect research-related items that could be covered by transactions. In effect, the SEC permitted brokers to offer research by charging higher commission rates. In 1986 the SEC reaffirmed this principle. This led, over the

years, to an expanded interpretation of what items were directly applicable to research activities by brokerages, mutual funds and advisors.

The Shrinking Safe Harbor

The definition of “research related” may have been elastic but it was not open-ended. In 2006 the SEC put its foot down, expressing concern that mutual funds continue to pay higher commission rates than necessary. It no longer considers valid for soft-dollar purchase such items as telephone lines and utilities, computer terminals and peripherals, office supplies, and membership dues for professional organizations. Attendance at meetings, seminars and conferences can be paid for with soft dollars, the SEC ruled, but travel, meals and entertainment cannot.

Mutual fund directors have taken the SEC’s new position to heart. They now cast a sharp eye on transactions through which their funds pay for items with soft dollars. Directors increasingly recognize that many items formerly associated with research represent overhead and should be paid for with hard dollars from the mutual fund’s operating budget. Failing to do so forces their investors to overpay for fund research and reduces fund performance.

Maintaining Efficiency and Transparency

Alan Reid, president of ReFlow, points out, “If all of a mutual fund’s trading incurs higher commissions related to paying for research, something’s wrong.” Reid cites the two types of trading in which funds engage: alpha-related and flow-related. “There’s no research component to flow-driven trades, so a mutual fund ends up buying a lot more research than it ever uses. It overconsumes. What’s more, flow-driven trades aren’t necessary. To that end ReFlow eliminates them, enabling mutual funds

From the President

By J. Alan Reid, Jr.

ReFlow and Knight Capital Partnership



No one succeeds alone. Every company’s success is built on relationships with other outstanding organizations. That’s

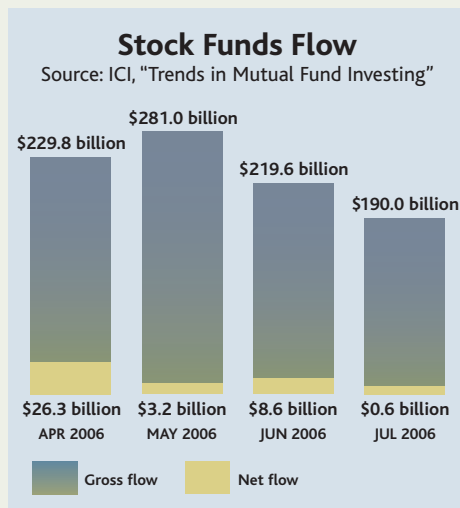
why I’m delighted to inform you that ReFlow and Knight Capital Group have entered into a strategic partnership.

You’ll find details on page 3. But I do want to state how pleased I am that ReFlow and Knight will work so closely together. As our previous issues of *Flow Matters* have explained, the mutual fund industry is undergoing significant change.

continued on page 4

FLOW BAROMETER

Each issue of *Flow Matters* reports on the most recent available four months’ gross and net industry flow. Gross flow generates total flow-induced trading and the costs related to it.



IN THIS ISSUE

Fund Directors Examine Soft-dollar Expenses 1

ReFlow Client Profile: Pictet Funds Europe 2

ReFlow Can Save Investors \$40 Billion per Year 2

Behind the Curtain: What We Know About Flow 3

Perils of a Fund Manager: Operational Cash Devours Alpha 3

Knight Capital Group Partners with ReFlow 3

News from ReFlow 4

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continued on page 4

Pictet Funds Europe



Background. Pictet Funds Europe is part of Geneva-based Pictet & Cie, founded in 1805. Pictet Funds Europe offers 80 different funds and a comprehensive range of investment strategies to banks, portfolio managers, insurance companies, financial intermediaries, pension funds, charitable institutions, corporations, individuals and other types of investors internationally. Net assets under management for Pictet Funds Europe as of August 31, 2006, were more than US\$41.8 billion.

Experience with ReFlow. Pictet Funds Europe became the first European mutual fund company to sign an agreement with ReFlow's

Luxembourg office. Pictet Funds made two ReFlow transactions in September 2006.

Summary. Pictet Funds Europe is very determined not only to maximize and protect

alpha for its clients but to minimize costs. This plays an equally important role in providing the highest possible return for investors. Pictet Funds Europe saw the importance of the ReFlow solution early on and has expressed great satisfaction with the results of its initial transactions. The firm saved money for its clients while enabling its fund managers to devote more of their time to making outstanding investment decisions.

Cutting Flow Trades Can Speed Retirement

ReFlow Can Save Investors \$40 Billion per Year

“ReFlow can help American investors add more and better years to their retirement, and that’s as real as it gets.”

— Alan Reid
President
ReFlow

The late Illinois senator Everett Dirksen once said, “A billion dollars here, a billion dollars there; soon you’re talking about real money.” American investors now lose real money to flow-driven trades—\$30 billion to \$40 billion annually. Save that money, and many could retire years earlier.

According to estimates, the mutual fund industry brings in \$100 billion to \$200 billion in new savings and investments each year. But the cost of mutual funds’ flow-driven trades comes to \$30 billion to \$40 billion. “As a result, mutual fund investors are losing up to 25% of their investment dollars yearly,” comments Alan Reid, president of ReFlow. “They aren’t coming close to saving what they think they are.”

Speeding Retirement

Many investors look 10, 20, even 30 years out to retirement. Funds that eliminate flow-driven trades and their costs can raise investors’ returns and help them retire earlier.

Reid points out, “The average fund saves 50 basis points or more by using ReFlow. The math isn’t very complicated, but it is quite powerful.” Say a 40-year-old wants to retire before age 60. She wants to add \$2 million to her portfolio to do it. She invests \$15,000 per year. If her mutual funds

produce a net return of 6.5% annually, she’ll have that additional \$2 million by age 64.2. But if her funds produce a return of 7% annually, that higher return enhanced by compounding will enable her to reach her goal by age 60—4.2 years sooner!

“It’s not just the money,” Reid emphasizes, “it’s a question of lifestyle. Whether investors will want to retire completely, enter a new career or keep working with more time to travel and enjoy life, a higher return offers more choices.”

How to get there? Investors and their advisors tend to look at funds’ expenses. Among these expenses, however, transaction costs are less transparent and often go unnoticed. That’s changing as investors learn that flow reduces the average fund’s annual return performance by 1.4%, according to Roger Edelen, a research consultant with ReFlow.

“ReFlow can help American investors add more and better years to their retirement,” Reid concludes. “And that’s as real as it gets.”



BEHIND THE CURTAIN: What We Know About Flow

Research Analysis by Dr. Greg Kadlec



Greg Kadlec, Ph.D., is an R. B. Pamplin professor of finance at Virginia Tech in Blacksburg, Virginia.

Shareholder flow has been the subject of considerable scholarly research. For the most part, this research has addressed two questions: How does fund return performance affect investor flows and, conversely, how do investor flows affect fund return performance?

The Thrill of the Chase

Studies show that investors chase past returns. This conclusion dates back to Ippolito (1992) but received more-detailed analysis in Chevalier and Ellison (1997) and Sirri and Tufano (1998). This brings us to ask: *what* returns do investors chase? They look more to past *total* returns than to past *alpha*, according to Del Guercio and Tkac (2002) and Evans (2006).

The upshot? To a large extent, mutual fund flows depend on factors like the return of the fund's asset class over the past three years, which lie outside of management's control. Flows tend to be cyclical. When a fund's asset class is doing well, flows tend to be positive. When other asset classes hold the spotlight and the fund's asset class is in the doghouse, flows tend to be negative.

Is the investor chase of past returns sensible? The evidence is mixed. Gruber (1996), Zheng (1999) and Edelen and Warner (2001) find that flows are positively associated with future returns over short horizons. This suggests that fund investors choose well. However, Frazzini and Lamont (2006) find that flows are negatively associated with future returns over longer horizons, suggesting that fund investors choose poorly.

The Negative Impact of Flow on Performance

Funds provide three basic services to investors: diversification, portfolio management and liquidity. Portfolio management aims to improve return

While fund managers have a positive impact on returns through portfolio management, investors have a negative impact on fund returns.

performance. Diversification provides risk management. Both are good. But providing liquidity (accommodating shareholder flow) represents a deadweight cost. Not good. Thus, while fund *managers* have a positive impact on returns through portfolio management, *investors* have a negative

impact on fund returns. They force fund managers to trade when they otherwise wouldn't or to hold cash instead of the targeted asset class.

Several studies confirm this logic. Shareholder flow reduces the average fund's annual return performance by 1.4%, according to Edelen (1999). In fact, controlling for flow, the average mutual

continued on page 4

Perils of a Fund Manager:

Operational Cash Devours Alpha

Consider Joe Sharpe, a hypothetical active fund manager who achieves 100 basis points (bp) abnormal fund returns (alpha) per year. Compounded over a 10-year period, such performance would put Joe's fund in a very high percentile of all equity funds.

Now consider the effect of imposing a 5% operational cash balance on Joe's portfolio when cash earns 4%. And note that the market typically rises or falls by about 15% over a 12-month span (S&P 500, 1950–2006).

In seven out of 10 years (69% probability), operational cash erodes Joe's 100 bp alpha. In four of those years, half of Joe's alpha—six months' work—is lost. In two years operational cash consumes all of Joe's efforts, with alpha eliminated entirely. In spite of high-quality management, the corrosive effects of operational cash are substantial.

BOARD SEAT, ADDED FUNDING, SALES ROLE

Knight Capital Group Partners with ReFlow

The Knight Capital Group has entered into a strategic partnership with ReFlow. Knight will also become a lead investor in ReFlow, expanding the private capital that enables ReFlow to purchase and redeem shares of mutual funds as an alternative to standard transactions. Thomas M. Joyce, Knight's chair and chief executive officer, will also join the ReFlow management board.

Additionally, Knight will enter into a sales relationship with ReFlow to market the ReFlow solution to its mutual fund clients. In turn, the ReFlow option will add value to the services Knight offers to funds seeking maximum efficiency when executing trades.

Alan Reid, president of ReFlow, comments, "Our strategic relationship with Knight Capital provides even greater strength to ReFlow. We've made significant progress

in moving forward the conversation about reducing mutual fund costs through our innovative approach, and this is one more step in that direction."

Alan Seigerman, ReFlow's chief operating officer, adds, "Our relationship with Knight offers further proof that the ReFlow concept is winning strong support and will propel our growth appreciably."

continued from page 1

From the President

The management at Knight fully understands this. Together we can do much to help mutual fund boards and managers, financial advisors and investors adapt more quickly and bolster their own successes.

The theme of success continues throughout this issue of *Flow Matters*. I invite you to see how the use of ReFlow can speed mutual fund investors toward their retirement and other financial goals. Higher fund performance can provide us with more quality time in our later years.

You'll find an informative article on ReFlow's operations in Europe as seen from a client's perspective. We've also included a review of academic studies demonstrating the terrible blow that flow-driven

trades can deliver to fund managers' alpha-generated efforts—the numbers may shock you—and more.

As always *Flow Matters* seeks to present new insights on key issues. Success in the mutual fund industry requires that we first adopt an agile approach to new challenges and concerns and then turn them into powerful new opportunities.

We encourage your input. Feel free to e-mail or call with your comments and suggestions: flowmatters@reflow.com or 1-866-473-3569. Your participation in this critical dialogue is of great interest not only to us but to mutual fund companies, financial advisors and investors worldwide.

News from ReFlow

- **The Wall Street Journal's Aaron Lucchetti** interviewed ReFlow president J. Alan Reid, Jr., regarding Knight Capital Group's investment in ReFlow (see page 3). The item appeared in "The Buzz" column in the *WSJ's* September 9 weekend edition.

- **Save the date: 2007 ReFlow Symposium.** Pencil in February 14–16 at the PlumpJack Squaw Valley Inn in Olympic Squaw Valley, California. Join mutual fund industry leaders and colleagues to share ideas and strategies for improving overall fund performance. You'll find a warm welcome on the slopes as well. Go to www.reflow.com/symposium2007.



- **World Business Review**, hosted by Gen. Alexander Haig, has produced a three-minute video on the issue of flow and mutual fund performance. ReFlow president Alan Reid and COO Alan Seigerman appear in the piece, which aired on CNBC and Bravo as paid programming. The report will also appear in-flight on select airlines. Go to www.reflow.com to view the report.
- **Upcoming conferences** continue to attract ReFlow's senior executives. They will attend ICI Small Funds Conference,* October 18–20, in La Jolla, CA; ICI Industry Academic Conference, October 26–27, in Washington, DC; Investment Company Directors Conference,* November 1–3, in San Francisco; Investment Company Directors Conference,* November 14–16, in Washington, DC; and the New York Financial Writers' Annual Awards Dinner, November 17, in New York.

* ReFlow executives will speak.

continued from page 1

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to reduce their expenses and provide higher performance to investors.”

Soft-dollar trades also veer from today's emphasis on transparency in business conduct, according to Mary Curran, ReFlow's general counsel. “Mutual funds have an obligation to make clear exactly what they purchase on behalf of their clients and the cost for each item. Soft-dollar trading as it has been sometimes practiced over the past 30 years blurs the lines. Shareholders can't always track how much commission goes to trades

and how much commission goes to research items, let alone what research items are involved. In this regard soft-dollar trading, unless it is done very carefully, is something of a dinosaur.”

Soft-dollar trading will likely continue because no one doubts the value of research in making alpha-related trading decisions. But the definition of what constitutes research will likely undergo strict scrutiny and yield changes in the way mutual funds approach commissions, particularly on flow-driven trades.

continued from page 3

BEHIND THE CURTAIN: What We Know About Flow

fund's net return (after fees) matches its benchmark. Thus shareholder flow is a primary reason why mutual funds underperform their benchmarks.

Fund managers perform substantially worse when making flow-motivated trades than when making value-motivated trades (Alexander, Cici and Gibson, 2006). Moreover, shareholder flow can have substantial tax consequences. Dickson, Shoven and Sialm (2001) find that redemptions force a fund to distribute unrealized capital gains, playing a key role in determining a fund's after-tax performance. Finally,

the negative impact of flow on performance is particularly severe for funds with narrowly defined investment objectives, such as small-cap growth, sectors and emerging markets (Coval and Stafford, 2005). Why? Funds with narrow investment objectives tend to buy and sell the same assets in response to shareholder flow, which creates higher trading costs due to aggregate, simultaneous price pressures.

While this research reveals layers of complexity, it can be summed up in two words: *flow matters*.