

Investment Management Review

A Quarterly Update for the Investment Management Industry

Insight

A close-up, angled view of a microchip or circuit board. The chip is dark blue/black with intricate, glowing orange and yellow circuit traces. The background is a lighter blue gradient.

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- The Future of Risk Management
- Hybrid Funds: An Increasingly Attractive Opportunity for Credit Investors
- Pension Plans: A New Strategic Paradigm
- Hedge Fund Trends for 2010 and Beyond: Prospering in a Polarized Marketplace
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IMR UP FRONT

Insight

In this issue of *Investment Management Review*, we focus on one of the key issues for international asset managers looking to broaden their distribution footprint. The biggest growth opportunities are widely viewed as being in emerging markets. The challenge, however, is to keep pace with regulatory changes. We assess recent developments in four of the most exciting markets and the impact they have for both inward and outward investment flows. In all these markets, clients can call on Citi's highly developed fund servicing capabilities to support their expansion strategies.



We also look at what the future holds for Gulf Cooperation Council countries now emerging from the Dubai debt crisis. We ask what the GCC needs to do in order to revive inward investment flows. The growth of a regional debt capital market is a first, and highly encouraging, step.

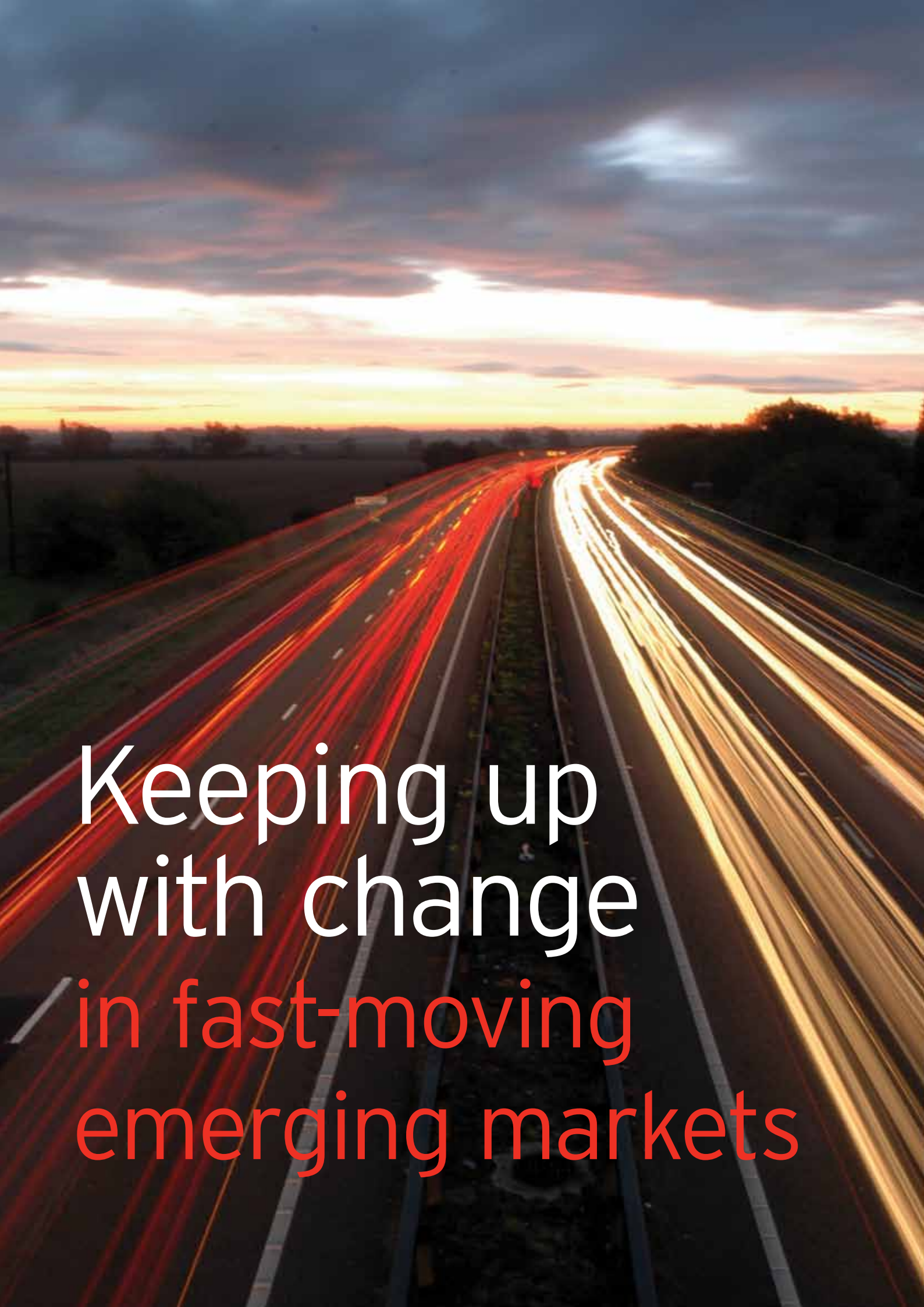
Regulatory reform is not confined to emerging markets. Recent months have seen momentous changes in the U.S., most notably with the passage of the Dodd-Frank act. This recasts the landscape for financial institutions for years to come and has major implications for investment advisers. We look at the impact of this and other recent developments in the U.S. market.

Since the events of 2008, managing risk has been top of the agenda for investment firms of all kinds. We talk to risk managers and specialists in the area of cash and collateral management about the new approaches being adopted and the challenges posed by the introduction of central counterparty clearing for standardized OTC derivatives.

In all these areas and more, we at Citi are committed to helping our clients confront change, deliver the efficiencies that guarantee competitiveness and make their growth plans a reality.

Lastly, we encourage you to take part in our readership survey. It is important that this publication remains relevant to our readers. Please take a moment to complete the survey and return it to our offices. We look forward to continuing to bring you information and insight that assists your growing business.

Richard Ernesti
Managing Director
Global Head of Client and
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Global Transaction Services, Citi



Keeping up
with change
in fast-moving
emerging markets

For international asset managers, emerging markets present rare growth opportunities. Rapidly growing economies, an expanding savings base and increasing liberalization – all these factors make the major markets of Asia, the Middle East and Latin America prime destinations for leading brand names. That said, little is simple in international fund marketing. These markets are moving targets.

While most are opening up to foreign firms, the pace of change is far from even and subtle shifts in regulation can have a significant impact on the products firms sell and the channels through which they can distribute them. Keeping abreast of these changes is vital if asset managers are not to be left behind.

In this article, we take a look at developments in some of the most exciting markets – China/Hong Kong, India, the Middle East and Brazil – and assess what they mean for asset managers keen to tap inward and outward flows in these territories and position themselves for the growth each market promises for the future.

China and Hong Kong: Internationalization of RMB Throws Up New Opportunities

With the signing of a memorandum of understanding between the Hong Kong Monetary Authority and the People's Bank of China in July 2010, the long-awaited opening up of an offshore market in Hong Kong in renminbi-denominated (RMB) securities and funds is at last becoming a reality. "Chinese currency funds are the hot topic right now," says Cheeping Yap, Hong Kong Head of Securities and Fund Services for Citi's Global Transaction Services: "Until the memorandum of understanding (MoU), firms were only allowed to open RMB accounts for trade-related purposes. Now financial institutions can develop RMB products."

Mr. Yap says there is a major mismatch at present between the scale of RMB deposits in Hong Kong and the size of the RMB-denominated corporate bond market. "There is a total of around US\$12 billion of RMB deposits in Hong Kong earning around 0.2% but

only US\$3.5 billion of RMB corporate bonds. More issues are scheduled for the second half of the year." In an encouraging sign, McDonald's recently raised a \$29 million RMB-denominated bond while the Hong Kong-based toll road operator, Hopewell Highway Infrastructure, announced plans to raise \$150 million in RMB-denominated bonds. Previous issues had all been by mainland banks, onshore subsidiaries of foreign banks or the Chinese government.

The next step is expected to be the launch of RMB-denominated equity funds. "We expect regulation shortly to allow Chinese securities firms and fund managers to offer offshore RMB equity funds in Hong Kong," says Mr. Yap. Moreover, permission for the Qualified Chinese Institutional Investor (QCII) funds could come anytime in the next six months.

Alvin Goh, Director, China Securities Country Manager for Citi's Global Transaction Services, says the moves are part of a wider strategy on the part of the Chinese authorities to establish the RMB as an international currency within the Asia region. "Hong Kong is likely to be the offshore center, but the People's Bank of China has signed swap agreements with six other countries, too.

"We also expect non-Chinese corporations to be allowed to come to China to issue RMB debt which will be traded in the Chinese interbank market. This market is outside the scope of the existing Qualified Foreign Institutional Investor (QFII) program – through which foreign investors are allowed to invest in mainland stocks – and only selected investors are likely to be allowed in," he says.

There has been a slowdown in new QFII approvals of late, which Mr. Goh puts down to two likely causes: "It is to allow both QFII regulators to sync their approval process and balance the capital flows given China's current situation." Only three new QFII investors were approved in the first half of 2010, compared with ten in the same period last year. Total new QFII approvals increased the quota by US\$1.15 billion to over US\$17 billion in total. When the QFII scheme was set up in 2003, it was with a US\$30 billion ceiling.

The development of the Chinese markets continues apace. In April 2010, the China Financial Futures Exchange started trading futures on the China Securities Index 300. QFII investors have in principle been given approval to trade the futures but the detailed regulation is still

awaited. The point to note, says Mr. Goh, is that QFII fund managers launching in Asia can now include the opportunity to trade Chinese equity futures in their prospectus.

The opening up of the RMB market and Hong Kong's increasing role as China's favored offshore center both add a new dimension to the China growth story. Hong Kong is also seeing a boom in private wealth management, says Mr. Yap, as a wave of Chinese IPOs throws off a new generation of mega-wealthy individuals. Taken together with the progressive broadening of the QFII program, recent developments have only served to underline China's position as the number one target destination for international asset managers.

India: Best Is Yet to Come

With foreign inflows of more than US\$10 billion over the year to date, 2010 is shaping up to be the best year since 2007 for net inflows into India's securities markets. "The money is not just coming from Asian funds," says Sundaresan Naganath, President and Chief Investment Officer of India's DSP BlackRock Investment Managers. "It is largely allocations from global portfolios. That reflects the anticipated high growth rates in the Indian economy over the next three to five years and even higher rates of corporate earnings growth," he says.

At present, some 38 asset managers compete in the Indian market. "Another half dozen are either in the process of setting up or applying to enter the market," says Mr. Naganath. DSP BlackRock, which was set up 13 years ago, currently manages around US\$4.7 billion of locally sourced funds in addition to advising US\$1.7 billion of international money invested in India.

The newcomers may find distribution more of a challenge than in the past. In 2009, the Securities & Exchange Board of India (SEBI) banned the practice of front-end loading – the payment by investors of entry fees charged to mutual funds. Now distributors, including independent financial advisors (IFAs) must either charge their retail clients a fee for their advice or negotiate separate payments from asset managers.

"Long-term, the move is a good one – introducing more transparency for retail investors and buying them more units for the same investment," says Debopama Sen, Director, India Securities Country Manager, Global Transaction Services, Citi. "And India has often led the

way for paradigm changing regulation. But the feedback from asset managers is that the industry needs more time to adjust to the change," she says. There are newspaper reports suggesting many IFAs have decided either to switch to selling unit-linked insurance products or private equity products, where there are attractive commissions, or have closed down. Clearly, only the serious players who are able to add value to the investor may be able to survive.

Therefore, after an initial hiccup, mutual fund sales are picking up again. "The market has rebounded in an intelligent manner," says Mr. Naganath: "In May 2010 we launched the DSP BlackRock Focus 25 Fund and raised approximately US\$143 million. We expect the market to continue to improve over the next 12 months."

The key now is to find distribution channels not only in the big cities but in the smaller ones, too. "Sophisticated bank distribution is concentrated in the main cities," says Ms. Sen: "Asset managers need to cast their net more widely." Mr. Naganath agrees: "DSP BlackRock has over 20,000 distributors, made up of banks, national distributors and IFAs. The industry has historically derived around 80% of its assets from the top ten cities. Now the biggest growth rates are in the smaller cities and towns."

The key now is to find cost-effective distribution channels in the smaller towns. "Major distribution networks are concentrated in the main cities," says Ms. Sen: "Asset managers need to cast their net more widely." Mr. Naganath agrees: "DSP BlackRock has over 20,000 distributors, made up of banks, national distributors and IFAs. The industry has historically derived around 80% of its assets from the top ten cities. Now the biggest growth rates are in the smaller cities and towns."

In one interesting development, says Ms. Sen, investors can now use the stock exchange platform to subscribe to or redeem mutual fund units – charging negotiated brokerage fees. "The change was only introduced a few months back and these are early days yet," she says: "But maybe there is an opportunity here for asset managers to effectively penetrate the market, given the far reaching network of the exchanges."

India is a market where asset managers must invest for the long term. Given the capital requirements to set up, many international managers have set up joint ventures with local firms. "Six Asset Management Companies (AMCs) entered the market in the last two years with their

mutual fund offering and Citi supports the infrastructure needs for four of these firms," says Ms. Sen. Most of the international managers either market domestic funds or local feeders into their overseas funds. "There is no sign of a change in regulation in the immediate future to permit offshore funds to sell their products directly," adds Ms. Sen, "and there has been limited interest among investors in overseas funds. The returns in India have been positive over the past year and the rupee remains generally firm. But that should change over time as diversification becomes increasingly important."

But with a fast-growing middle class, and only around 8% of retail investable surpluses currently allocated to stock markets, including mutual funds, India is a market of huge potential. "Asset managers have to be in this market to take advantage of the rise in savings over time," says Mr. Naganath. "Without doubt," he says, "the best is yet to come."

Brazil: Window Opens for International Managers

No asset management market provides such tantalizing prospects right now as Brazil. Regulatory changes in the past two years first allowed authorized investment funds and then pension funds to invest a proportion of their money abroad. While 40% of the US\$830 billion-plus of domestic assets under management is still invested in government bonds, that could be changing. "The long-term trend is for interest rates to fall," says Mr. Veronese, Director for Securities and Fund Services in Brazil for Citi's Global Transaction Services: "Institutional investors are starting to look for different instruments."

The large numbers of international asset managers now descending on Rio and São Paulo will be hoping international securities make it onto the "watch" list. Pension funds alone could have US\$40 billion to US\$50 billion to invest overseas. "Very few domestic asset managers have genuine international expertise, which presents a real window of opportunity for international managers," says Mr. Veronese.

It is not all plain sailing. Offshore funds cannot be sold in Brazil so asset managers are obliged to set up locally domiciled "international investment funds" as feeders. Asset managers must also register locally and are required to maintain a substantial presence in Brazil. The market is highly regulated, with firms obliged to provide data to the regulator on a daily basis. To minimize the

initial investment, many firms are turning to third-party administrators.

It is a mark of how far the Brazilian market has come that it is no longer just the top names from the U.S. and Europe – be it asset managers or investors – that are looking to enter the local market. Asian names now figure prominently in the mix, among them Mirae Asset Management, the big Korean asset manager. "Mirae already had an allocation to the country," says Mr. Veronese. "A couple of years ago they opened their Brazil office. This meant they could position themselves as the only true Brazilian expert in Asia.

As the Brazilian authorities open up the international markets to domestic investors, so they are endeavoring to bring more of the international markets to Brazilian exchanges through the creation of Brazilian Depositary Receipts (BDRs). Telefonica, the Spanish telecoms company, and Dufry Group, a Swiss retailer, were among the first to list local BDRs.

"Investment in a BDR is counted as an investment abroad," says Mr. Veronese: "The Brazilian exchange requires some of the dealing from the new outflow. It is part of an attempt to transform the Brazilian market into a worldwide hub by bringing more liquidity and more instruments into the country."

The authorities have also been encouraging the creation of exchange-traded funds (ETFs).

One other area that is highly active at the present time, says Mr. Veronese, is the private equity market. "The main investment channel is via private equity mutual funds," he says "With the soccer World Cup in four years' time and the Olympics in six, there is going to be a lot of money flowing in via the capital markets. Brazil is an exciting place to be."

Middle East: Long-Term Growth Story Remains Intact

The growth of a regional asset management industry in the Gulf Cooperation Council (GCC) countries remains a work in progress. Five years of disappointing returns since the last equity bubble burst in 2006, concerns about the world economy in general and the outlook for Dubai in particular, as well as a generally short-term outlook on the part of local investors – all continue to frustrate asset managers in the key territories.

“Regional managers do win business from international firms, with global mandates, who wish to tap into the local markets, and international fund managers continue to take assets out to invest internationally,” says Abdul Kabir Hussain, Head of Asset Management at Mashreq Asset Management, part of the UAE’s largest private bank. “But raising local money for local investment remains challenging,” he says.

He says his own firm represents a microcosm of the region’s asset management industry. “We were one of the first to launch a family of equity funds and one fixed income fund in 2005 and 2006, and almost instantly had US\$1 billion under management,” he says. “That is now down to around US\$450 million.”

The one area of recent growth is in debt funds. According to Mr. Hussain: “A variety of debt funds have been launched since the start of last year. Prior to that, Mashreq’s fund had been the only one to survive the 2008 credit crisis,” says Mr. Hussain. “We launched a Sukuk fund in June 2008, which has since returned more than 10%. The market is still dependent on international demand,” stresses Mr. Hussain.

There are encouraging signs, however. Richard Street, Director and Head of Securities and Fund Services for the Middle East and Pakistan, Global Transaction Services, Citi, says sovereign wealth funds and other public sector funds are beginning to allocate more of their assets within the Middle East region. “Importantly, they are moving money away from direct investment toward portfolio investment,” he says.

He also points to the arrival of a number of international firms: “Ten years ago, no international companies would have been managing money investing into the Middle East from the Middle East. Now a number are doing so – either directly themselves or through joint ventures.”

In many cases, international firms look to enter the region by partnering a large regional bank with established distribution. One problem they face, says Mr. Street, is that the partner bank may not have the anti-money laundering, “know-your-customer” or other key processes in place that are generally expected in more developed markets.

The region’s long-term fundamentals remain robust, says Mr. Hussain, who stresses the role regulators must play in helping the markets achieve their potential: “There is a lot of talk about the development of domestic bond markets and the consolidation of exchanges. The regulators realize there has to be a move to improve transparency and liquidity. But it will not happen overnight.”

Mr. Street agrees: “The biggest change is going to come from the opening up of markets. Saudi Arabia represents about half of the GCC markets, but remains closed to non-GCC investors – other than through mutual funds or swap arrangements. The opening up of these markets, when it comes, will mark a sea-change in their evolution as the influence of international investors and asset managers increasingly makes itself felt. The potential here remains huge.”

Markets in Transition

While the fund markets of China, India, Brazil and the GCC are clearly evolving at different speeds, they share many of the same characteristics. There is mounting private wealth – both among a growing middle class and a super-wealthy elite. There is an emerging equity culture, which in most cases remains domestically focused. By and large, too, the regulatory environment is improving. Market liberalization is either moving ahead or firmly on the agenda.

Most of these markets have shown extraordinary resilience to the credit crisis and the economic malaise that has affected OECD nations. Even in the GCC, which has been afflicted by some of the same credit issues faced by the U.S. and Europe, huge reserves of oil wealth have been mobilized to sustain spending and growth. That these economies still march to a different drumbeat cannot be disputed.

All of which reinforces the case for asset managers to be actively involved in all four markets. The rewards will not be immediate. Distribution and market access issues will remain a challenge for some time to come and firms will need both patience and invention to make the most of the opportunities on offer. ■



The Future of Risk Management



Jervis Smith

Managing Director
Global Head of Client Executive
Global Transaction Services, EMEA, Citi

The crisis events of 2008 exposed a number of flaws in the investment management industry's approach to risk. Now risk managers and regulators alike are developing a new set of principles and practices to master risk wherever it arises.

Nothing demonstrates better the change in attitudes since the collapse of Lehman Brothers than the intense interest now being shown in risk issues. “Before the fall of 2008,” says Wylie Tollette, Senior Vice President, Investment Risk and Performance at Franklin Templeton, “we would have meetings with clients and prospects once a quarter. Now it’s once a week. That gives you a sense of how much interest there is in this topic.”

Worldwide, regulators are recalibrating their approach to risk. In Europe, investment managers face big changes with the advent of the Alternative Investment Fund Managers Directive (AIFMD) and UCITS IV. On both sides of the Atlantic, regulators are committed to reducing the risk in over-the-counter (OTC) derivatives by moving trading onto exchanges and clearing into central counterparties (CCPs). In market after market, reporting requirements for institutional investors are being tightened.

“Even without the pressure from regulators,” says Christian Skylar, Global Head of Risk and Performance at Marshall Wace, “there is pressure from investors. Not only do they want more information and more transparency, but they want improved reporting and new metrics. The industry needs to develop more adequate risk indicators. What drives correlation between assets? How can we be protected when there is a sudden jump in volatility? Liquidity risk is now a big deal – but there is no universal model to measure it. All of this needs building into a new model,” he stresses.

Right across the investment management world, risk professionals are groping their way toward a new set of tools for analyzing and measuring market risk. “The key is to find tools that are forward-looking, that can be more useful to managers,” says Mr. Skylar: “The capital allocation pricing model on which everyone depended for measuring expected volatility and returns is no longer relevant. Take the Sharpe ratio. Before the crisis people were assuming an average risk-free rate of return of around 4%. Now it is clear the risk-free return is zero.”

At Franklin Templeton, Mr. Tollette says that while risk models have a role to play they are just a “starting point for the discussion.” It is possible, he says, to go in a lot of different directions with risk modeling: “But unless it improves your knowledge of the risks and results in something that is actionable by the investment managers it is not much help,” he says. “The real problem in the past

was that risk managers failed to get their message across in a way that was intelligible to the average human. The communication element is crucial to the risk management function.”

The key, he suggests, is the way in which risk management relates to the investment management process. “There are a lot of different approaches,” says Mr. Tollette. “Risk management can be seen as compliance – a type of risk police – where the risk managers sit at the back and send reports out to the traders telling them they’ve reached a certain exposure limit.” Such a reactive approach, however, falls short of the mark, he insists.

“Risk management should be integral to the investment process. We believe in getting risk built into the process in advance. We work with the investment analysts, getting them to think about risk in the portfolio construction process. We call it the ‘three Rs.’ We believe in taking risks that are recognized, rational and rewarded,” he says. “If you understand the risks you are taking, they cannot surprise you. If you are rational you will avoid pitfalls such as overconcentration. And if you run a performance attribution exercise you will be able to tell whether you have been properly rewarded for the risks taken.”

Complexity and Illiquidity

The increasing complexity of the markets – particularly in derivatives – poses an extra challenge. Mr. Tollette says Franklin Templeton has a cross-functional complex securities committee, which includes legal, tax and investment experts, to evaluate new strategies and securities. “It helped us avoid leveraged ETFs and auction-rate securities,” he says.

The crisis demonstrated that when complexity went hand-in-hand with illiquidity it could be especially damaging. “For the first time people started to ask what the assets were really worth,” says Jervis Smith, Head of Client Executive, Global Transaction Services, EMEA, Citi. “Valuation has become one of the key issues,” says Mr. Skylar: “In particular, the link between risk and OTC valuations is now a big subject.”

Market illiquidity poses a big challenge to the pricing of complex OTC instruments. Investors have become wary of relying on counterparties for their pricing while modeling often fails to take account of the quality of the underlying

instruments. Increasingly, they are turning to specialist valuation services to minimize risk. "It can make the difference between being sued and not being sued," says Mr. Smith.

Counterparty and Collateral Risks

The biggest fallout from the Lehman affair clearly concerned counterparty risk – and in particular issues of collateral ownership and valuation. Prompted by the scale of these issues in an OTC derivatives market put at around US\$600 trillion (and nearly three times the size of the world's bond, equities and exchange-traded derivatives markets combined), legislators and regulators are now moving to force all trading of "standardized" OTC derivative instruments onto exchanges or electronic trading facilities and require them to be cleared through CCPs. The move is effectively supported by every country in the G20, which has set a deadline of end-2012. Interest rate swaps will be the first instruments to be affected.

"Unquestionably, CCPs will reduce risk," says Rajen Shah, Global Head of Collateral Management, Global Transaction Services, Citi, "but there are a number of problems, too." First, he says, for users there is the issue of cost: "Initial margin will be required. With existing bilateral contracts, there is only variation margin to put up. And since CCPs will restrict the type of collateral they take to cash or government securities, many buy-side institutions will have to sell assets to raise cash for their initial margin."

The post-CCP landscape will also be highly complicated since only "standardized" OTC instruments will be centrally cleared. Many other OTC derivatives will continue to be traded and cleared on a bilateral basis and firms will still have to manage those transactions as they do now. At the same time, says Mr. Shah, other regulatory changes are likely to increase the need for regular reporting.

"In many ways, these reforms make life more, not less, complex for buy-side firms," he says: "There will be as many as eight different CCPs and there will be multiple clearing agents for each one. In many cases, investment managers and pension funds will want more than one clearing agent per CCP – so there is a lot to manage." The changes are expected to give added impetus to a trend that has been apparent for some time as buy-side firms outsource collateral management.

Managing Cash

In the wake of the Lehman collapse, counterparty risk was also perceived to be a major issue for depositors. The sense of panic over what to do with cash may not currently be as intense as it was at the peak of recent market turmoil, but good risk management still requires a structured approach to cash. Hugo Parry-Wingfield, Head of Liquidity and Investments, EMEA, Global Transaction Services, Citi, says there is a three-step process investors should adopt to drive out risk from the cash management process.

The first, he says, is to enhance the visibility of cash: "It is critical investment managers know where their cash is. As they move into ever more markets and instruments, there is likely to be a growth in number of accounts. It also becomes more difficult to track where cash is in the settlement chain. But without perfect information, how can you hope to manage your counterparty exposures, manage your currency requirements or mobilize your cash to maximize efficiency?"

The key, says Roger Brookes, Cash Client and Sales Management, Global Transaction Services, Citi, is quality of information. "Clients are often dealing with out-of-date information. The important thing is to know where cash is now, not where it was yesterday. Firms need to get SWIFT 942 intraday messages, which are triggered every time there is a movement. Real-time information is vital," he says.

The second step is to consider one of the automated techniques developed for corporate treasuries to concentrate or notionally pool multiple cash holdings so that they can be managed on an aggregated end-of-day basis to extract full value from them. This can be especially important for multicurrency investors where unexpected spikes can occur and long positions in one currency can be used to offset short positions in another. An automated service also ensures that where sovereign or other issues arise in a particular market, cash can be moved out quickly.

The third step, says Mr. Parry-Wingfield, is for firms to revisit their cash investment practices. “The focus must be on concentration risk,” he says. The problem is that diversification brings its own challenges, particularly where investors are restricting themselves to highly liquid, short-term options. There is the issue of evaluating and monitoring counterparties and determining limits with each. And a lot of operational time and effort can be taken up booking and settling trades where liquidity is retained on a short basis.

Managing Brand Risk

With the increasing convergence of long-only and alternative funds and the advent of UCITS IV and the AIFMD, investment firms face greater regulatory challenges than ever before. The mushrooming growth of “newcits” has been described as “an accident waiting to happen,” with many retail investors unclear as to the risk profile of the funds they invest in.

“Not all hedge fund managers have experience of the reporting requirements of UCITS,” says Robert Hennessy, EMEA Head of Fiduciary Services, Global Transaction Services, Citi, “and it is vital they get good advice before launching newcits products.” And all firms, he stresses, including existing UCITS promoters, will have to look again at the way they measure and monitor derivative risk once UCITS IV takes effect next July.

This is because the new regime does away with the distinction between sophisticated and non-sophisticated funds currently part of UCITS III. That, in turn, means that Value at Risk (or an equivalent advanced risk measurement methodology) will need to be used where UCITS engage in

complex investment strategies which represent more than a negligible part of their investment policy; or have more than a negligible exposure to exotic derivatives; or where the commitment approach does not adequately capture the market risk of the portfolio. Otherwise, the less costly commitment approach will be adequate. This will require firms to be more cognisant of their derivative risk and to tailor their derivative risk measurement methodologies accordingly.

“The Committee of European Securities Regulators has recently published guidelines on risk measurement for UCITS,” says Mr. Hennessy. “They are tightening the rules and requiring stress tests to be carried out on a regular basis, at least once a month and more frequently for rapidly changing portfolios. That compares with a quarterly frequency at present.”

There is upside to all this. In a recent industry survey conducted by the consultancy CREATE-Research, and sponsored jointly by Citi Global Transaction Services and Principal Global Investors, one theme to emerge was that “the winning model of this decade will have a fiduciary overlay.” That overlay would better align the interests of asset managers, their professionals and their clients – by, for instance, countering behavioral biases that have cost clients dear in the past, stopping asset managers from selling products that are not fit for purpose and ensuring that the gains and the pain are shared equitably.

“Success in the future may require firms to go beyond what they are legally obliged to do,” says Mr. Hennessy, “by applying an extra level of due diligence. This implies a new philosophy in which duty of care is paramount.” ■



Hybrid Funds: An Increasingly Opportunity for

As the alternative investment industry continues to evolve in the wake of the global financial crisis, the use of closed-end fund structures to manage investor liquidity is increasingly prevalent in less-liquid trading strategies. These investment vehicles – called hybrid funds – directly address the investor/investment liquidity mismatch by taking advantage of longer capital lockups and certain features from a typical private equity fund structure while retaining hedge-fund-style trading strategies.

Attractive Credit Investors

Jeffrey Law

Vice President, Global Head of Hedge Fund Bank Debt Services
Citi

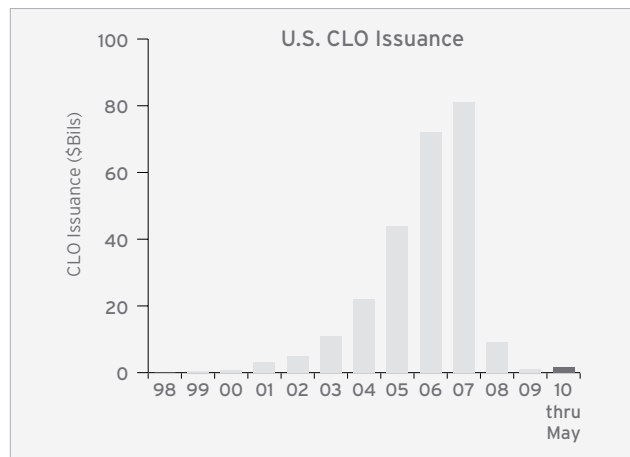
Michael Saulnier

Vice President, Head of Hybrid Fund Services
Citi

Hybrid funds are optimal to access a variety of illiquid asset types, from fixed income to real estate to private equity. To a great degree, hybrid funds have been concentrating in distressed and intrinsic value strategies where managers have recognized the opportunities to acquire investment assets at prices at attractive levels.

Transformed Landscape

The landscape for credit investors in the global markets has undergone massive change as a result of recent financial events. As evidence of this transformation, the collateralized loan obligation market is only now beginning to see signs of life after issuance of CLOs in the U.S. collapsed from nearly \$80 billion in 2007 and has remained under \$10 billion for the last two years. (See accompanying chart.) In addition, new legislation and regulation around the world will very likely move credit derivatives to exchanges and risk retention requirements will impact securitization going forward.



Source: LSTA

In this altered economic environment, one of the emerging trends is a marked move in the alternative investment industry for credit investors away from traditional hedge funds to a more private-equity-like structure that combines the benefits – and the operational/administrative challenges – of the two structures into a unified entity.

Hybrid Funds: A Definition

Hybrid fund structures are becoming increasingly popular in alternative investment strategies. Because these funds each have specific, individual nuances, they are difficult to define as a group. However, the following is a summary of the three major hybrid classes we see credit managers using today. The partnership accounting complexities created by these structures, coupled with the investment accounting and pricing challenges that bank loans and distressed credit strategies present, have created a new set of operational issues for credit fund operators, administrators and auditors to handle. Hedge fund managers have been moving into the illiquid distressed credit market by using side pockets. Because most funds limit the use of side pockets to between 10% and 30% of portfolio assets, managers have sought innovative solutions to take advantage of the price and demand displacement in the credit markets. For example, the drive for outsized returns and investment opportunities has led to structures in which lengthy rolling lockups of investor capital are employed. In some cases, managers have structured these funds to employ capital commitments in order to manage the inflow of capital for investment as well. At the other end of the spectrum is a more traditional closed-end private equity structure where the hedge fund manager will diversify into more illiquid strategies (e.g., bank loans, distressed credit and real estate). In all cases, the manager's primary objective is to match investor liquidity with investment liquidity.

Side Pockets

Hedge fund managers use side pockets to hold illiquid investments because, in many respects, they have similar characteristics to private equity funds. The primary attributes are:

- Investor capital is locked in until a realization event occurs, eliminating the mismatch between investor and investment liquidity.
- The manager's incentive compensation is charged based on realization of investment, which may take several years to occur. Given the longer time horizons needed to deploy these strategies, this type of back-end fee structure aligns the manager's compensation with the strategy.

Capital Lockups

The use of capital lockups was a natural progression for managers looking to take advantage of distressed credit prices created by the market events of 2008. Capital lockups prevent fund investors from being able to redeem capital for an extended period of time. Prior to 2008, it was common for managers to require an initial one-year lock. Today, the initial lockup period required by many managers, especially those trading distressed credit strategies, has lengthened to two to three years and sometimes as long as five years. The concept of the rolling lockup is also becoming more common as well. Here the investors can redeem on their designated redemption date but will remain locked up for an additional period of time should they decide to forfeit their right to redeem.

The use of capital commitments has also been employed with this capital lockup structure, giving the manager additional control over capital inflows, which better correlates capital inflows with the manager's ability to make investments. This fund structure looks more like a private equity fund than a traditional hedge fund that uses side pockets but still typically charges a traditional mark-to-market incentive fee.

Closed-End Structure

Closest to the private equity end of the spectrum is the closed-end structure. This type of fund setup uses investor capital commitments and does not allow for redemption until the fund is wound down, usually after five to seven years. After a defined investment period, managers will typically make capital distributions usually consisting of current income generated and investment realization proceeds. The manager compensation model in a closed-end structure is realized on the back end and is typically subject to an 8% preferred return and clawback provisions.

This closed-end fund structure allows credit managers to focus on long-term strategies without having to manage investor liquidity.

Impact on Managers

The combination in a hybrid fund of two very different asset classes with two different economic streams requires a solid infrastructure of people, processes and

policies. Managers considering developing a hybrid fund structure should be aware of the following considerations:

The hybrid structure brings with it new partnership arrangements to manage, support and market.

The time horizon needed for investing in bank loans and other distressed credit assets is much longer than normal hedge fund investing in equities, bonds and derivatives. The skills required to execute the investments are very different. While hedge funds attract professionals who thrive in a trading environment, private equity attracts people focused on research and analysis.

The difference in time horizons and types of investments has a major impact on liquidity. Hedge funds are used to providing monthly or quarterly liquidity to their investors, based on a calculation of net asset values. Net asset values are easily determined when the underlying assets are publicly traded securities. However, bank loans and other distressed credit securities are hard-to-price, illiquid assets since there is often no market price for them.

The two economic models inherent within a hybrid fund also give rise to different tax liabilities coming from the difference between capital gains and trading income, where investors are domiciled and whether investors are taxable or tax-exempt. Hybrid credit funds also have to develop a legal structure that accommodates both types of investors and the tax liabilities arising from bank loans, loan origination and other credit assets including foreign investments. The complex structures will include the use of Luxembourg SARLs and Cayman Blocker entities for purchasing certain investments in a tax-efficient manner.

A hedge fund that has a large portion of its assets in credit and illiquid investments will encounter complexities in accounting for those investments and managing the fund's investor liquidity cycle. Accounting for two economic streams can be complex, especially when investments in illiquid and hard-to-price securities become a larger part of the manager's strategy. This trend is pushing managers more and more toward the longer capital lockups and closed-end structures.

Impact on Investors

Investors, too, should be cognizant of a new consideration-set when investing in hybrid funds.

These credit strategies more typically fall in the hedge fund world, but closed-end structures make hedge fund allocators question whether the product is a hedge fund or private equity fund.

Investors need to take the time to understand the new hybrid fund structures, especially around manager compensation. It is important for investors to comprehend the manager's ability to side pocket investments, as it will impact their ability to manage their own investment liquidity. In a closed-end fund structure, the manager's compensation will differ from the hedge fund model in that a preferred return is typically used as a hurdle for charging fees, and the investor gets the benefit of a clawback provision should the final fund liquidation not result in a cumulative preferred return for the fund's life.

Hybrid funds – with different credit investment strategies and complex accounting, legal and tax considerations – are, by definition, complicated. Yet because of investors' demands for increased transparency, they have a clear preference for new investment proposals structured on a simple and transparent basis with offering documents plainly disclosing all investment risks.

The voluminous and highly complex documentation developed for rated securitization transactions is giving way to the hybrid fund that can be more easily set up and marketed. The slowdown in the securitized transaction market will likely lead to a new group of investors looking to access the alternative investment market. As a result, it is very important for fund managers with private structures to be very clear and transparent with their investors if they want to acquire those allocations from the securitized market.

Going Forward

In our view, hybrid funds, which have become more and more established as investment vehicles in illiquid trading strategies, will be increasingly utilized for the benefit of fund managers and their investors in the credit space. However, managers considering developing these vehicles should recognize the operational and administrative complexities inherent in these vehicles, and look to experienced service providers to deliver the knowledgeable support necessary for them to be successful. ■



Pension Plans – A NEW STRATEGIC PARADIGM



With more than \$23 trillion AUM worldwide, pension funds represent the largest asset class in the global financial marketplace. Managing this massive amount is the responsibility of pension plan sponsors who, supported by investment managers and other service providers, are charged with delivering results to plan participants within an ever-changing and ever-challenging economic environment.

Investment Management Review spoke with Patrick Curtin, Citi's North American Head of Investor Client Management, about the dynamics that are driving the pension fund marketplace, the evolving role pension plan sponsors play in this shifting landscape and the new strategic paradigm he foresees transforming the space.

Investment Management Review: The pension landscape around the world has been changing for over a decade. Can you recap those changes and what have been the key drivers to explain where the industry is today and where it is headed?

Patrick Curtin: The principal reason for the changing landscape of the pension arena has been the shifting economic and capital markets environment.

In relative terms, the last couple of decades have seen a significant amount of interest rate volatility. Because the present value of a pension fund's liabilities is partly – one could even say largely – a function of long-term interest rates, we've watched pension funds frequently vacillate between overfunded and underfunded positions. If you layer on top of that the global capital markets environment, uncertain regulatory conditions and dislocations in the asset side of their portfolios, you create an almost perfect storm within which pension plan sponsors have operated over the last several years.

What have been the macro market factors that affected the asset side of pension fund sponsors' business?

On the asset side, several factors – including the tremendous financial crisis of 2007/2008 – gave major headaches to pension plan sponsors: the relative underperformance of traditional long-only active managers; alternative investments, which in some cases did not fully deliver on what they were intended to do; and the breakdown of the correlation between different asset classes that were supposed to have added diversification to pension plan sponsors' portfolios in periods of high volatility.

This combination of market conditions is giving rise to a different paradigm in the way pension plan sponsors look to achieve their investment objectives. And as a result, their service providers – investment managers and other service providers alike – have had to and will continue to adapt their business model to accommodate this shifting paradigm.

Can you describe the new paradigm you see for pension plan sponsors and their service providers?

For the better part of the last ten years, pension plan sponsors and their consultants and advisers have been talking about separating the manufacture of their beta, which is their market returns, from their alpha, which is their ability to add value above an appropriate benchmark. In the new paradigm, pension plan sponsors will form a small handful of key strategic relationships with outside firms that they will depend on for their manufacture of alpha and beta, and the infrastructure necessary to facilitate that.

This shift will require a fundamental change in the working relationship between plan sponsors and their service providers – from a conventional buyer/vendor association to a strategic partnership.

That's not to say that sponsors will have only two or three or four fund managers. Certainly there will be pension plan sponsors with dozens and dozens of relationships, and who will be able to do so very successfully. However, there are others that may find greater value in managing a smaller, more strategic group of investments managers and other service providers. Importantly, this concentration of strategic relationships isn't about getting the best price. It's really about developing the strongest possible relationships with firms that understand the culture of a particular pension fund.

The new paradigm includes being able to efficiently and cheaply get access to beta. The most fundamental way to accomplish that is through passive investment management by indexing portfolios in developed equity and fixed income markets around the world. In the new paradigm, plan sponsors have the ability to access beta returns through ETFs or other passive structures, and efficiently manufacture beta exposure with derivatives.

Finally, in the new paradigm, plan sponsors may manufacture beta themselves, which does require some investment in technology to build or strengthen an infrastructure that may or may not exist in-house. Several market studies indicate that over the next three to five years more plan sponsors may well consider doing that, particularly the larger public pension plan sponsors – less so in the corporate pension plan space – and even in the endowment and foundation space.

How and where will pension fund sponsors attain alpha in this new paradigm?

The conventional answer has always been in the AI space. Alternative investments will still play a meaningful part in how and where plan sponsors get alpha, but it won't be the whole story. Going forward, it will be more about the way pension plan sponsors manage the business of being a pension plan sponsor.

Of course, alpha generated from portfolio performance will continue to contribute to a fund's overall returns. But there will also be something I call "organizational alpha." Citi recently sponsored a CREATE-Research study that indicated that investment managers with strong back- and middle-office infrastructures are correlated to those that tend to outperform their benchmarks and create alpha. If you transfer that concept to the beneficial owners of the assets (i.e., the pension funds), you could argue that organizational alpha will become critically important for pension funds, particularly those that manage their business relationships and their strategic partnerships in-house.

Besides this paradigm shift toward strategic relationships between pension plan sponsors and a select number of service providers, what other changes do you see in the pension fund marketplace over the next five years?

Interest rates, at least in the United States, are at historical lows. And the consensus among economists and other market watchers is there's a good likelihood they will head higher over the next five years. Rising interest rates actually lower the present value of pension liabilities. If asset values were to stay the same, which is not realistic, rising interest rates would improve the funding position of many pension plans in the country.

To me, a pension plan is the ultimate exercise in asset/liability management. And I believe the science of asset/liability management will increasingly weave its way into pension management over the next five-plus years. The reason is straightforward: Pension plan sponsors – particularly those whose sponsoring entities are cash-strapped or earnings-strapped – have to minimize the contribution that the sponsoring organization has to make to keep funding levels where they need to be. As a result, the science of asset/liability management will become more and more important in the pension arena over the coming several years.

Also, macro-economic changes such as rising or falling interest rates or increasing or decreasing asset prices are factors that pension funds can't control. There is, however, another issue that pension plan sponsors can manage and will increasingly focus on – their tail, or downside risk. I believe that sponsors, given their worst-case-scenario experience of the recent financial crisis, might be willing to give up some upside returns for protection on the downside. So we may see products being developed that are aimed at helping pension plan sponsors put a collar around the potential return distribution. I'm not saying this is going to be universal or transcend all pension funds, but I think that it will be considered by many sponsors of defined benefit plans, particularly in the public space.

What will be different about the way pension plan sponsors view their asset allocations within the context of this new paradigm?

In the traditional model, pension plan sponsors typically speak about their asset allocations as the percentage allocated to equities, to fixed income, to cash and perhaps to alternative investments. They might also talk about the percentage allocated in their domestic market or globally, or the percentage allocated to large-cap versus small-cap equities, or their investment style – how much of the allocation was for value investing versus growth. Those are all vectors in the traditional model pension plan along which sponsors talk about their asset allocations.

Going forward, I think the model might emphasize the allocation to beta returns and the allocation to alpha returns. I'm not saying that the traditional approach is

going to disappear overnight. But I am suggesting that it's going to be supplemented by – and maybe even heavily supplemented by – this alternative view of measuring asset allocation.

What risks will pension plan sponsors be most concerned about?

The single biggest risk that pension plan sponsors are concerned about is not having enough cash to meet their liabilities and therefore needing to infuse cash from the sponsoring organization. This is particularly worrisome in today's budget-constrained environment. To mitigate that risk, pension plan sponsors should embrace this new paradigm I've outlined.

What about risk managers? What risks are they facing in the pension fund space?

Investment managers that most quickly adapt to the fundamental shift in the mindset and needs of the pension plan sponsor will be the most successful. Those that don't adjust to the changing paradigm might do so at their peril.

Why have alternative investments been a growing part of pension portfolios? Will that growth continue and how might AI investing be viewed differently going forward?

The primary reason alternative investments have been a growing component of pension portfolios has been the promise of alpha. In certain cases, they've achieved it. Yet, if we're completely honest, in plenty of instances the promise of alpha on a risk-adjusted and fee-adjusted basis has not been delivered. Even so, private markets still offer a tremendous potential to outperform public markets. Going forward, alternative strategies that utilize long/short techniques as well as relative value plays between different markets, different securities and different asset classes will offer the potential for material alpha generation. Those opportunities will therefore continue to be heavily utilized for both defined benefit and defined contribution plans – and certainly in endowment and foundation portfolios. For asset managers in the AI space, it will all be about continuing to manufacture alpha in an efficient way that pension plan sponsors need to attain their performance objectives. ■

Hedge Fund Trends

Prospering in a Polarized Marketplace

Institutional money has come to dominate hedge fund inflows over recent years, though until 2008 most hedge funds were still able to dictate terms with their big investors. Not anymore. Investors now call a lot of the shots. The impact of this shift in power is far-reaching.

Marion Mulvey

Managing Director, EMEA Head of Alternative Investments
Global Transaction Services, Citi

for 2010 and Beyond:



With a new set of demands and requirements, institutional investors are obliging the hedge fund industry to open its books. They are demanding a ringside seat so they can track what their managers are doing. Transparency is paramount. A more risk-averse investor base is also proving a barrier to entry for newcomers to the hedge fund industry and making life more difficult for smaller players.

At some undocumented moment in the last two years, the terms of trade between hedge funds and their investors changed. The shift was hardly seismic but it is nonetheless apparent to most in the industry. Investors are demanding, and getting, more transparency and liquidity. They are undertaking much more due diligence before investing. Some will now only invest in onshore vehicles. And because the events of 2008 put so many hedge funds on the back foot, the hedge fund industry is, by and large, responding positively to these new demands.

The shift in power reflects a trend that has been under way for much of the past decade: the increasing institutionalization of the hedge fund marketplace. Many in the industry see this leading to an increasing polarization of the marketplace. The bigger hedge fund managers – with institutional-grade infrastructure already in place – are winning an ever-bigger share of the cake. Smaller firms are losing out.

Capital raising has become a major challenge for all but the leading names. Institutional investors are often unwilling to invest until a fund has a 12-month track record. Apart from specialist seeding platforms, most funds of funds are also stepping back until a fund has six months under its belt.

Hedge Fund Success Factors

So what are the keys to success? What do hedge funds need to prosper in the new world? As already noted, size and scale are important factors – underlined by Man Group's proposed US\$1.6 billion acquisition of GLG Partners to create a company with more than US\$63 billion under management. Economies of scale have

become ever more crucial to success. Operational complexity is increasing as managers offer an expanding range of products spanning both offshore and onshore domiciles and managed accounts.

The launch of UCITS funds brings new marketing and other costs and requires the maintenance of distributor relationships. Yet many of the “newcits” launched to date have been only limited successes. Anecdotal evidence suggests hedge fund managers are rethinking their onshore strategy and turning instead to the more liberal non-UCITS structures available in both Luxembourg and Dublin. However, the advent of the Alternative Investment Fund Managers Directive (AIFMD) will reduce some of the flexibility even in these products.

Transparency Is Core

Meanwhile, institutional investors are clamoring for more disclosures. They want more clearly defined and written policies. And they are conducting more thorough due diligence before investing. As the added regulatory costs implicit in the AIFMD become reality, so they will intensify the need for scale.

But flexibility – and in particular the ability to offer managed accounts – is also becoming critical. In a survey of leading European hedge fund managers conducted by Citi Hedge Fund Services in the spring of this year, institutional demand for managed accounts was keenly highlighted. Most managers said they were happy to provide them in return for a substantial investment. Occasional instances were reported where large investors had redeemed from a main fund investment and asked to be “rehoused” in an individual managed account.

The Rise of Managed Accounts?

There is mounting evidence, too, that funds of hedge funds are being pressed by their institutional investors to convert as many of their underlying fund holdings to managed accounts as practicable. Funds of funds that have been quick to read the signs have managed to convert around half of their fund holdings into dedicated managed accounts. Clearly, this is only really possible where the managers in question are operating liquid strategies.

Funds of funds that go down this route have to demonstrate to their investors that they are deconstructing the mass of information they receive from each managed account and making good use of it. Some are building out sophisticated management operations to deal with the information they are getting, often using a third-party risk manager. Others are setting up what amounts to a hedge fund front office to interpret the data. Clearly, managed account sponsors are on the line with nowhere to hide if things go wrong.

Kite-marks

One trend apparent from the survey was increasing acceptance of the need for best practice kite-marking. More and more managers have been signing up to the Hedge Fund Standards Board's best practice standards. These cover 15 key issues in the areas of disclosure, valuation, risk management, governance and shareholder conduct. At the last count, some 58 firms, with a combined US\$215 billion of assets under management, had signed up.

Given the increasing institutional focus on hedge fund managers' internal processes, some managers are also contemplating generating an SAS 70-style report on their internal procedures and related controls in order to provide additional comfort to investors. SAS 70 reporting originated in the U.S. banking industry and involves an external audit of the stated controls either at a particular point in time (a Type I report) or over a set time period (a Type II report). SAS 70 reports are expensive to generate, but they could become a valuable quality mark in the competition for institutional money.

The ability to match the due diligence expectations of institutional investors is vital. The Citi survey highlighted a new trend. The focus of much due diligence has shifted to funds' operational processes. Due diligence visits now typically involve a "deep dive" into operational and risk management processes. Many investors expect to be walked through specific trades and valuations, taking the process through to the records held by the administrator and prime broker.

No Substitute for Experience

The entire operations team may be involved as investors analyze every procedural step around trade flow, reconciliation, risk management, portfolio pricing and counterparty exposure management. The external administrator is also now contacted in many cases – sometimes for a face-to-face interview. Many institutional investors have recruited new, experienced people to manage the due diligence function, but specialist consultants are also much in evidence.

Ongoing information disclosure has also assumed new importance. More investors are reportedly requesting access to a full portfolio breakdown – effectively seeking much the same information as they would get from a managed account. Some look for supporting FAS 157-type portfolio classifications. Feeds to consolidated risk reporting tools, as offered by specialist market vendors, are also being requested on a more regular basis.

The ability to deal effectively with these demands is essential if managers are to retain the trust of their institutional investors. One hedge fund manager contacted in the survey reported that the firm had set up an internal transparency committee to cope with the rise in information requests from investors.

All of these pressures reinforce the need for effective and highly automated operational structures and processes that deliver the real-time and customizable data on which internal controls (and by extension portfolio disclosures) rely. There is increasing need for daily trade confirmation, settlement and reconciliation with counterparties, all supported by centralized reporting and delivered in an STP environment that maximizes automation and minimizes human intervention. Cost containment reinforces the case for an integrated, end-to-end solution that spans the complete trade operating life cycle.

As the hedge fund industry increasingly polarizes between big and small players, the winners will be those firms with the scale and operational resources to accommodate the needs of an ever-more-demanding client base – yet do so within an operational environment that is cost-effective and scalable. ■

Spotlight:

Back on a growth path in the Gulf

After the upsets of 2009, what does the future hold for the Gulf economies? *Global Investment Management Review (IMR)* interviews Farouk Soussa, Chief Economist for the Middle East, Citi, to find out.





Saudi Arabia is a good example. In 2008, despite a fall in the oil price from over US\$140 a barrel to just over US\$40, the Kingdom was still prepared to lift 2009 budgeted spending by almost 20%, resulting in a 3% deficit. With huge reserves parked within sovereign wealth funds, Saudi Arabia could afford to fund a deficit of that scale for another 20 years without having to borrow in the markets.

Investment Management Review: **What is the general outlook for the Gulf Cooperation Council (GCC) countries?**

Farouk Soussa: The headline story is that the GCC is set to outperform other parts of the world. We believe the region as a whole will grow at almost double the global average over the next five years. The main driver of economic growth will be government expenditure. Reserves of oil wealth are now being drawn on to fund infrastructure spending. Governments are also working hard to boost employment. Given their demographic profile, with more than 50% of the population under the age of 21, most GCC countries continue to view job creation as a priority, and growth remains a key policy objective.

How important is the oil price in sustaining growth?

Over the past 30 years, there has been a strong correlation between oil prices and government expenditure. But that boom/bust cycle has been detrimental to long-term economic growth. In the past couple of years, governments have demonstrated that they are willing to prioritize growth and push on with large deficits.

Saudi Arabia is a good example. In 2008, despite a fall in the oil price from over US\$140 a barrel to just over US\$40, the Kingdom was still prepared to lift 2009 budgeted spending by almost 20%, resulting in a 3% deficit. With huge reserves parked within sovereign wealth funds, Saudi Arabia could afford to fund a deficit of that scale for another 20 years without having to borrow in the markets.

Clearly, there are consequences to all this. With interest rates effectively linked to those of the U.S. through the dollar peg, the GCC is currently a low-interest-rate environment. The combination of high government spending, low interest rates and external inflationary pressures is bound to put upward pressure on prices. In Saudi Arabia, strong government expenditure is driving a recovery in nonoil economic growth, which we expect will be in the order of 4.5% in 2010. But rising housing and food costs are driving up inflation, too. We recently lifted our forecast for the Consumer Price Index from 5% to 6% for 2010, and believe risks are on the upside. Policymakers face something of a conundrum: How do you maintain economic growth without stoking inflation when you have a passive monetary policy that is linked to that of the U.S.?

What about the debt problems in Dubai? Are they a potential obstacle to regional growth?

There is certainly a massive debt overhang, particularly among state-owned enterprises, while the correction in the property market has proved a double whammy for many of these companies. Unquestionably, the debt overhang will be a drag on the economy for some time to come as it reduces the incentive for lenders to supply credit and deters investment inflows.

But despite this, we see compelling reasons for optimism. The recovery in the global and regional economy is set to benefit Dubai as the premier regional hub. Dubai's non-real-estate sector accounts for about 75% of the economy and has the potential to lead a strong recovery in the near term. In our view, the property market correction has boosted Dubai's competitiveness in at least two ways. It has eliminated some of the supply bottlenecks that had developed in the boom years and reduced the cost of living and working in the Emirate. The key point is that there is a lot of surplus infrastructure. The economy can grow without having to sustain infrastructure spending at 2003 - 2008 levels. The underlying fundamentals are sound.

Despite a continued fall in investment in the medium term, we see GDP growth returning to positive in 2010 and increasing steadily to over 6% by 2012. The main beneficiaries of this growth will likely be sectors related to external demand – such as tourism, trade, logistics and transportation – and to domestic consumption.

What have these markets to do in order to encourage the return of positive investment flows?

After the Dubai World/Nakheel debt moratorium and issues affecting investment companies and banks in a number of GCC countries, you would expect some retrenchment by international investors – particularly at a time of evident derisking. But as debt issues from Qatar and Abu Dhabi last year and from the Dubai Electricity and Water Company in the spring of this year testify, there is still appetite for regional issues among international investors.

Local equity markets have grown substantially over the past decade – though some have more to do in terms of their market structure in order to lose the “frontier markets” tag. The primary problem is the lack of liquidity in the debt capital markets. Government issuance has been low, so there is little in the way of benchmark securities. Historically, demand from local investors has been low and local state pension funds have invested the bulk of their money overseas.

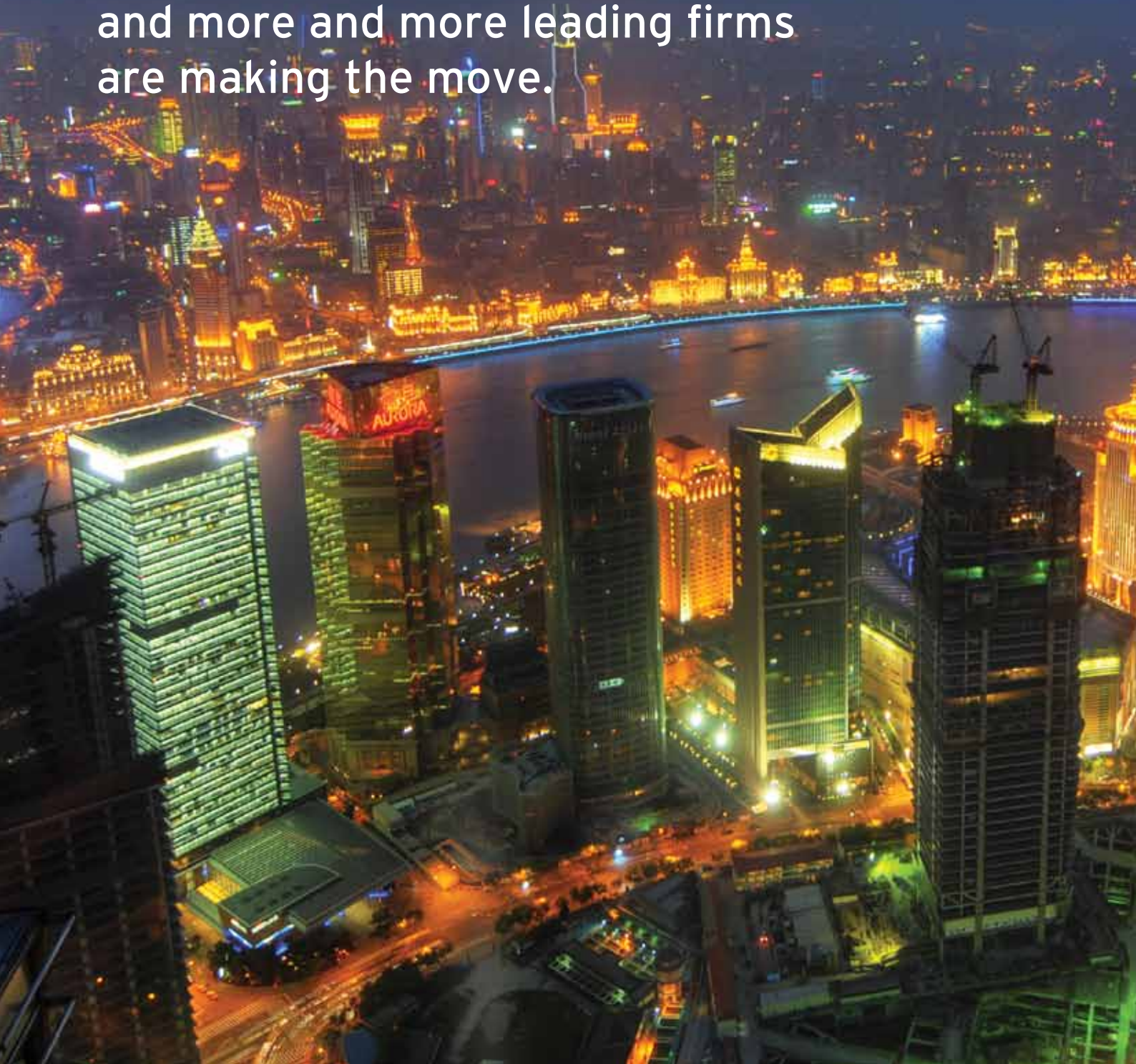
This may be about to change. In the past, the main source of finance for local companies has been the banking sector. That has been badly hit and credit growth will likely be flat at best. Local companies have recognized the need to diversify their funding sources. There is a very strong call for local debt issuance. At the same time, there is pressure on state pension funds to invest more of their assets in the local markets. These two factors should be a catalyst for the growth of the region's debt capital markets going forward.

So the long-term outlook is positive?

Very much so. There is one other factor to bear in mind. Iraq's post-war reconstruction represents a particularly strong opportunity for long-term growth in the GCC. The country is targeting a growth in oil production from around 2.5m barrels of oil a day to 12m by 2016. This may be ambitious, but achievement of anything like that target would put Iraq on par with Saudi Arabia as the world's largest producer and exporter of oil. Its current account surplus would make it a net exporter of capital, similar to Saudi Arabia or Abu Dhabi. Ultimately, Iraq's ascendance represents opportunities and challenges to the GCC region. ■

Back-Office Outsourcing in the Funds Industry

About 20% of international managers in Asia have already chosen to outsource substantial parts of their back offices, and more and more leading firms are making the move.



Chris Ryan

Senior Advisor, Asia Pacific, Securities and Fund Services
Citi

Investment fund companies advertise their performance, their research and their attention to client needs and security, but rarely do they boast about their back-office operations. That is because much of the back-office function has become a commodity, and indistinguishable from one firm to another. The capability of a firm's back-office operations generally does not enter the decision process when a client is looking for a new investment vehicle.

Smooth back-office operations, however, are a key part of the value chain between the fund's customers and their investments. Despite being near invisible, they are necessary for investment companies to operate efficiently. But the back office can become a weak link if it is inefficient or high-cost, affecting a firm's ability to grow, react to market downturns or run at maximum efficiency.

The setting up and running costs for an in-house back office can be quite substantial once the expense of floor space, technology and staffing are taken into account. Once that infrastructure has been put into place, it can also be costly to adjust according to shifts in the market. For example, a large investment firm with two floors of back-office operations in a prime office tower in the central business district of a major city will find it very difficult to cut overhead costs when business goes through a downturn. This was the experience of many firms during the 2008 global financial crisis.

Thirty years ago investment firms had little choice but to maintain large departments of back-office staff that added no strategic value but were vital to operations. Back then, firms did their own custody of assets and accounting, keeping all the important papers in fireproof safes and accepting costs as an unavoidable part of the business.

Today, investment firms do have a choice. They can relieve themselves of the cost and inflexibility of a large in-house back office by outsourcing all or part of these operations. This option leaves them free to manage money, deal with clients and carry out other activities that can differentiate them from their competitors.

The Rise in Back-Office Outsourcing

The global trend toward outsourcing parts of the investment fund business, from legal to accounting and marketing services, has been gaining momentum for decades. Back-office outsourcing, however, is relatively new and has developed in response to the changing nature of the fund industry and market conditions.

Since the 2008 crisis, the level of compliance costs in the financial services sector has risen sharply as regulators are demanding increased transparency and monitoring due to eroded investor confidence. This in turn has led to

longer sales processes for distributors and added to the administrative burden of fund companies as they struggle to do what is required of them for the same fees they were receiving before the new regulations were imposed.

At the same time, over the years fund products have also become more complex, again adding to the back-office workload and requiring more expertise. A decade ago many firms offered simple domestic equity and bond products; nowadays, they may be offering derivative and structured product funds that raise the level of sophistication required by their back-office teams. Naturally a fund that requires a higher level of servicing can quickly absorb more than its share of administrative resources, making it unprofitable on an individual basis.

Adding to the complexity is that, whereas 30 years ago many investment funds were priced on a monthly basis, the industry standard has now moved to daily pricing. In addition, there is less tolerance for unit pricing discrepancies and other errors. All of these things can be easily handled with today's technology, but fund companies must own this technology – and not only is it expensive, but it is constantly changing, creating a moving target for the firm and the fund manager.

Another major issue is the investment company business and operating model. While fund managers and sales staff are exclusively on variable compensation plans linked to the firm's profitability, most back-office staff are paid fixed salaries with low variable bonuses. This means that even as the market softens and revenues fall, the operational cost of the back office (salaries, the cost of floor space and so on) remains largely the same. As investment companies found during the recent crisis, there are just too many fixed costs associated with the back office. With little room for raising gross fees in the foreseeable future, following the 2008 crisis, the only option for fund companies that want to maintain their margins is to become more efficient. The challenge is how to achieve this without cutting corners and increasing operational risk.

The ideal solution would be to outsource everything from the dealer screens back to the origin of the assets. Whereas previously there was resistance to this idea – the fear being the loss of control – back-office outsourcing is increasingly being seen in terms of the advantages it brings. Although in practical terms, fund companies

should only outsource as much as they feel comfortable (as regulators will still hold them accountable for the funds they manage and any errors that may occur), there are now a whole range of back-office outsourcing options available in the market. As well as daily support services, a sophisticated outsourcing provider can offer custody, securities lending, transfer agency, fund accounting, investment accounting and cash management functions. In some cases where clients have large existing back offices, a complete “lift-out” may be possible in which some of the client’s staff and technology is incorporated into the outsource provider’s own operation to create a smoother transition.

It is estimated that the activities that can be outsourced account for up to 40% of the overhead costs of running a fund, with savings made in cost of office space, salaries and technology investment. But even if back-office outsourcing does not result in substantial savings on a day-to-day basis, it still makes the business more scalable, provides enhanced operational efficiency and integrity, as well as improving the general quality of operational services.

Coming Now to Asia

The outsourcing of back-office operations has become standard practice in the United States and the United Kingdom over the past two decades, with continental European firms also rapidly turning to outside providers. Asia Pacific, however, has been slower to make the transition due to regulatory hurdles. However, with regulations easing and local firms increasingly adopting international best practices, there are more reasons than ever for Asian firms to consider back-office outsourcing.

According to Citi’s estimates, up to 20 international managers are expected to enter the Asian funds market over the next two to three years. They are entering a market on the cusp of significant growth fueled by a rising middle class, high savings rates and steady growth in universal pensions across the region. Outsourcing their back-office operations from their initial move to the region could greatly enhance their success as they tackle new markets. By paring down the administrative workload, they can better focus on the aspects of business that truly make a difference. And with the global financial crisis fresh in their minds, they will be keen to avoid the costs of setting up a large in-house back office,

together with the inflexibility and risks that this involves. Creating flexibility in this area is particularly relevant in Asia, which has a long history of highly cyclical economic activity.

Another reason why back-office outsourcing is pertinent to Asia is that many investment firms in Asia serve several jurisdictions in the region. From Hong Kong to Taiwan, Singapore and Korea, each market has its own rules and requirements. But despite their significant growth potential, many of Asia’s markets remain small in comparison to the major western markets. Building in-house back-office operations to meet the needs of each jurisdiction would involve considerable costs, with little scope for scalability due to the limited market size. Outsourcing to a provider with expertise in compliance in multiple jurisdictions overcomes this challenge. Some outsourcing service providers use third-party subcustodians in smaller jurisdictions, trusting client assets to a local bank. However, a larger provider would be able to provide proprietary custodian services, allowing its clients to be assured of consistency of servicing across the region.

Conclusion

About 20% of international managers in Asia have already chosen to outsource substantial parts of their back offices, and more and more leading firms are making the move. Established fund managers with existing in-house back offices are outsourcing them to reduce operational risk and increase efficiency while lowering fixed costs, while smaller companies establishing new offices are choosing outsourcing in order to allow them to focus on managing funds and finding new clients. As more Asian fund managers embrace outsourcing for its advantages, the business of providing such services will attract new entrants. This increased competition will, in turn, result in better pricing and another added benefit for investment firms.

Chris Ryan recently joined the Fund Services team within Citi’s Global Transaction Services in Hong Kong in a senior advisory role. With more than 30 years of experience within the fund industry, which includes running some of the largest fund operations in Asia Pacific, he has expert insight into the challenges and potential opportunities facing investment funds today. ■

2nd Quarter 2010

Regulatory & Update

U.S. Mutual Funds



Legislative

The second quarter was dominated by an event that actually culminated shortly after the end of the quarter, the passage of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Act"), which was signed into law by President Obama on July 21, 2010. The Act is the result of almost two years of negotiation, debate, research and hard work involving elected officials and their staffs, regulatory agencies, the financial services industry and consumer advocates. It most certainly changes the landscape for all financial institutions for many years to come. Most pertinent for investment firms, the Act includes several provisions affecting investment advisers. First, investment advisers to certain unregistered investment products, including hedge funds and private equity funds having assets under management of \$150 million or more, will be required to register with the Securities and Exchange Commission ("SEC") no later than July 21, 2011. In addition, all SEC-registered investment advisers will be subject to new filing, record-keeping and examination requirements related to these unregistered pools. Also, funds relying upon Regulation D under the Securities Act of 1933 are immediately subject to an amended definition of an accredited investor. The amended definition no longer allows an investor to include the value of their primary residence in their net worth.

Another event that could have a large effect on the registered fund community also occurred shortly after the end of the second quarter. On July 21, the SEC voted to propose amendments to Rule 12b-1 under the Investment Company Act of 1940 (the "1940 Act"). The proposed amendments are intended to improve regulation of fund distribution fees and allow for improved investor disclosures. The proposal would limit ongoing sales charges that an individual investor could pay to the total they would have paid in a class of the fund that charges a front-end sales charge. Funds could continue to use up to 25 basis points for "marketing and service fees" outside of the ongoing sales charge limitation. However, offering documents would no longer refer to these amounts as Rule 12b-1 fees. Rather, they would be referred to as marketing and service fees. Funds would have to disclose any ongoing sales charges and any marketing and service fees in their prospectus, shareholder reports and in confirmations. The proposal would also create a fund exemption that would permit broker-dealers to establish their own class-specific sales compensation structure to encourage competition among financial intermediaries. A fund relying on the exemption would not be permitted to deduct other asset-based sales charges for that class of shares. Finally, the rule proposal would eliminate the requirement for a fund's board to approve, or annually reapprove, fund distribution plans.

There was also movement on several other fronts. Notably, the SEC staff released two sets of responses to questions about the new amendments to the rules governing money market funds which went into effect on May 5. The first, issued by the staff on May 25, covered compliance dates and implementation, liquidity, stress testing, quality and website posting. The second, issued on June 25, concentrated on questions regarding the scope of Rule 30b1-7 under the 1940 Act and Form N-MFP (shadow pricing, multiple classes, investment categories, capital support agreements, master feeder funds and money market funds that do not use amortized cost or penny-rounding methods of valuation). The Q&A releases did not provide any major surprises; however, they did provide money market fund managers with greater comfort in their approach and interpretation of the amendments' provisions.

The “flash crash” of May 6 also led to some quick revisions to the market exchange circuit breaker rules. Regulators were quick to implement a new single-stock circuit breaker rule that would suspend trading for five minutes anytime a stock (currently limited to stocks in the S&P 500) drops by more than 10% during a five-minute period during the trading day. In addition, plans are to expand the rule to cover stocks in the Russell 1000 and exchange traded funds. Regulators are also considering revisions to the market-based circuit breaker rules, which were not activated during the May 6 market drop because it occurred after the last trigger point (2 p.m. EST) for the day.

In other news during the second quarter, the SEC staff posted a new technology infrastructure and taxonomy on the SEC’s EDGAR filing website. The new taxonomy, validation and document preview tools are intended to provide the filing support necessary for a fund’s

submission of XBRL risk/return and investment objective information. The compliance date for these XBRL filings is currently slated for January 1, 2011. Finally, the requirement for funds to implement identity theft prevention programs (the “Red Flag Rule”) was delayed again, this time until December 31, 2010. This marks the fifth compliance date delay for the Red Flag Rule. It is unlikely that funds will receive any sympathy from regulators if they are not ready by the new compliance date.

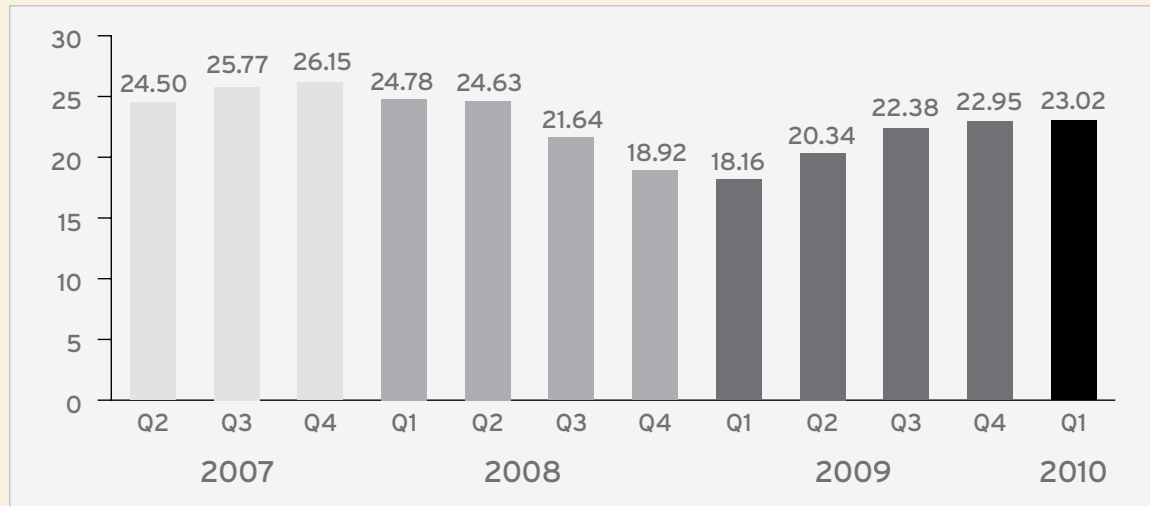
In conclusion, the Act was the biggest story of the quarter. As we all know, the implementation work is just beginning and, to a certain extent, is reliant upon SEC and other regulatory agency rulemaking initiatives. Firms will need to remain vigilant in their monitoring of industry news as they navigate these new and uncharted regulatory waters. ■

The Industry by the Numbers

Mutual Funds

Worldwide Mutual Fund Assets

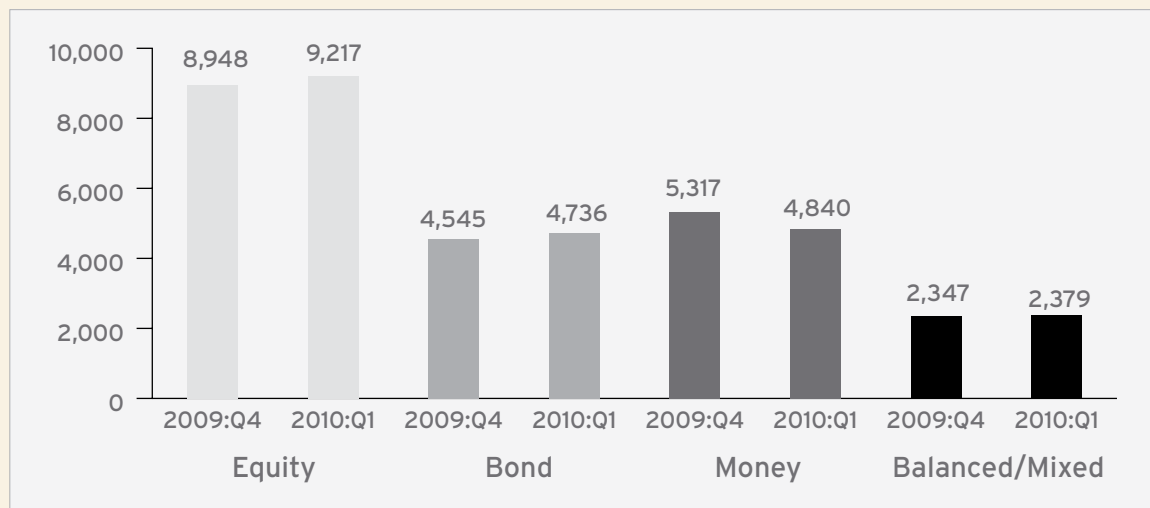
Trillions of U.S. dollars, end of quarter



Source: Investment Company Institute, Washington, DC, 2010

Worldwide Assets of Equity, Bond, Money Market and Balanced/Mixed Funds

Billions of U.S. dollars, end of quarter

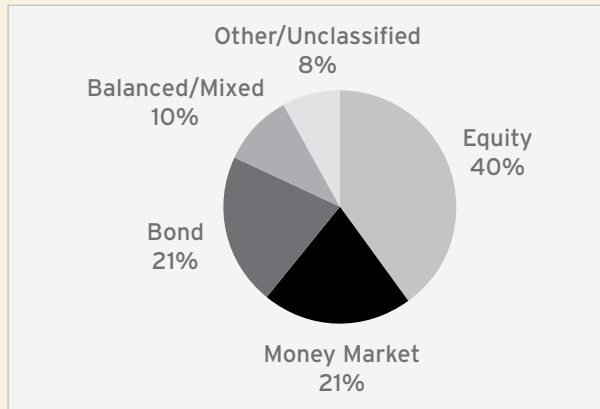


Source: Investment Company Institute, Washington, DC, 2010

Percent of Worldwide Mutual Fund Assets by Type of Fund, 2010:Q1

Note: Other/unclassified includes the total net assets of Ireland and Netherlands.

By region, 55% of worldwide assets were in the Americas in the first quarter of 2010, 32% were in Europe and 12% were in Africa and the Asia and Pacific region.

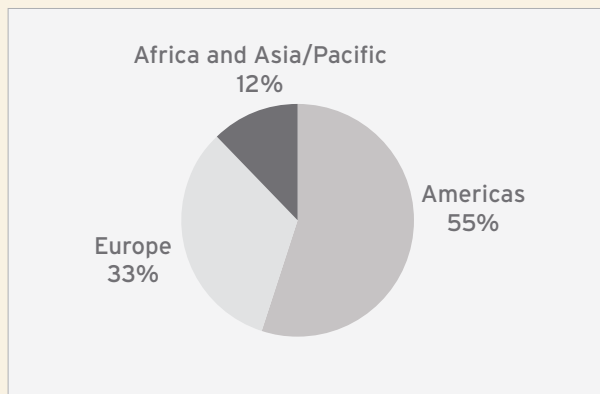


Source: Investment Company Institute, Washington, DC, 2010

Percent of Worldwide Mutual Fund Assets by Region, 2010:Q1

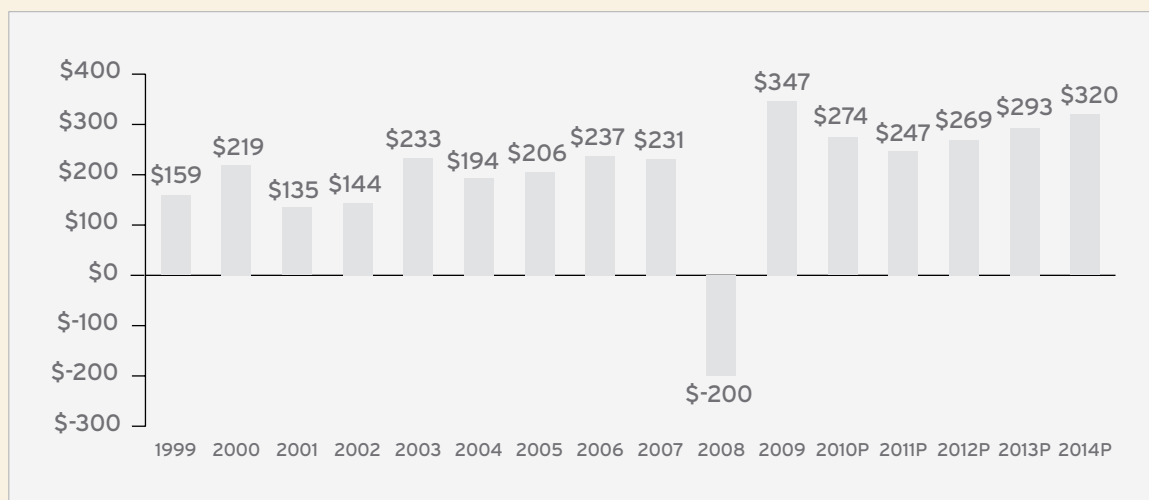
Note: Components do not sum to 100% because of rounding.

The number of mutual funds worldwide stood at 65,971 at the end of the first quarter of 2010. By type of fund, 39% were equity funds, 23% were balanced/mixed funds, 19% were bond funds and 5% were money market funds.



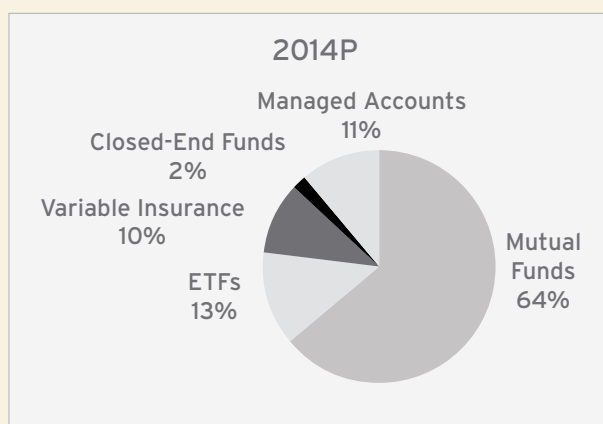
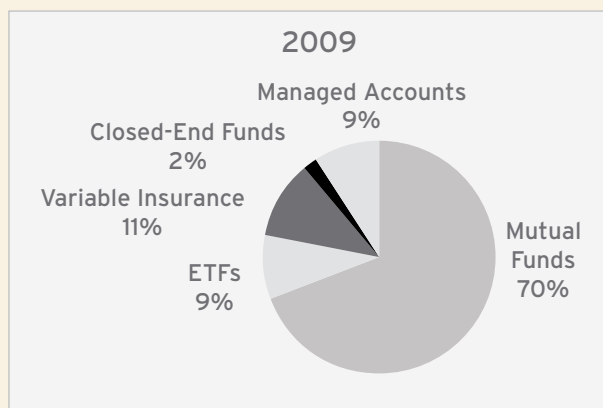
Source: Investment Company Institute, Washington, DC, 2010

Net New Cash Flow of Long-Term Mutual Funds (\$B)



Source: Financial Research Corp. (FRC) 2010

Asset Breakdown: Retail Investments



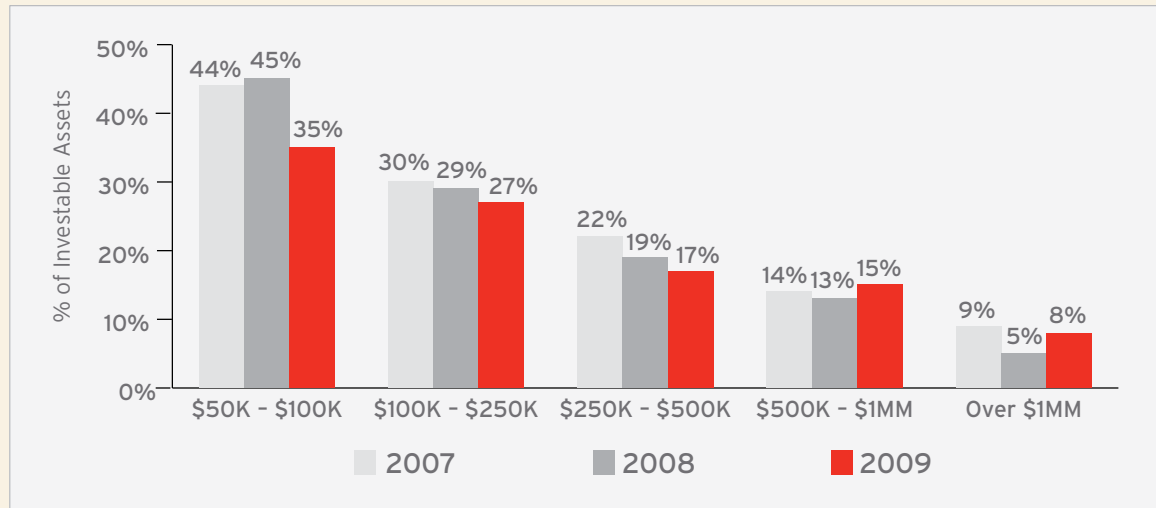
Source: Financial Research Corp. (FRC) 2010

Projected Mutual Fund Sales and Asset Growth by Broad Distribution Channel

| | 2009 | 2010p | 2011p | 2012p | 2013p | 2014p | 5 yr CAGR |
|---|--------------|--------------|--------------|--------------|---------------|---------------|------------|
| Gross Sales Projections, 2010 – 2014 (\$ Billions) | | | | | | | |
| Intermediary-Assisted | 1,205 | 1,331 | 1,464 | 1,627 | 1,808 | 2,008 | 11% |
| Direct-to-Investor | 266 | 266 | 293 | 325 | 362 | 402 | 9% |
| Retirement & Institutional | 572 | 621 | 683 | 759 | 844 | 937 | 10% |
| Total | 2,043 | 2,218 | 2,440 | 2,712 | 3,013 | 3,347 | 10% |
| Net Sales Projections, 2010 – 2014 (\$ Billions) | | | | | | | |
| Intermediary-Assisted | 205 | 164 | 148 | 161 | 176 | 192 | -1% |
| Direct-to-Investor | 45 | 33 | 30 | 32 | 35 | 38 | -3% |
| Retirement & Institutional | 97 | 77 | 69 | 75 | 82 | 90 | -2% |
| Total | 347 | 274 | 247 | 269 | 293 | 320 | -2% |
| Asset Projections, 2010 – 2014 (\$ Billions) | | | | | | | |
| Intermediary-Assisted | 2,427 | 2,728 | 3,045 | 3,397 | 3,788 | 4,222 | 12% |
| Direct-to-Investor | 899 | 996 | 1,100 | 1,213 | 1,339 | 1,476 | 10% |
| Intermediary-Assisted | 3,462 | 3,821 | 4,185 | 4,582 | 5,014 | 5,484 | 10% |
| Total | 6,789 | 7,546 | 8,330 | 9,193 | 10,141 | 11,183 | 10% |

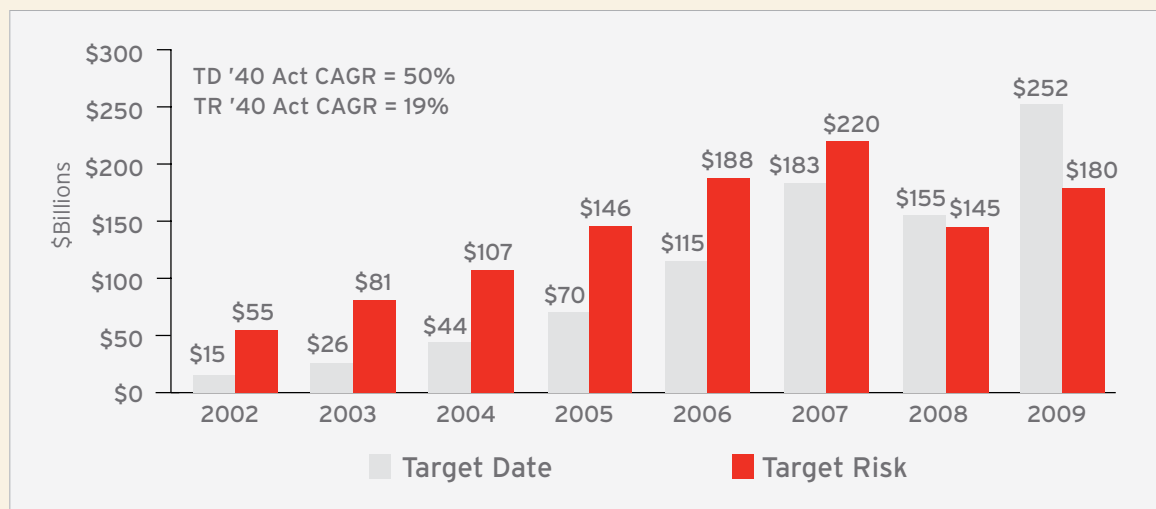
Source: Financial Research Corp., 2010

Defined Contribution as a Percent of All Investable Assets



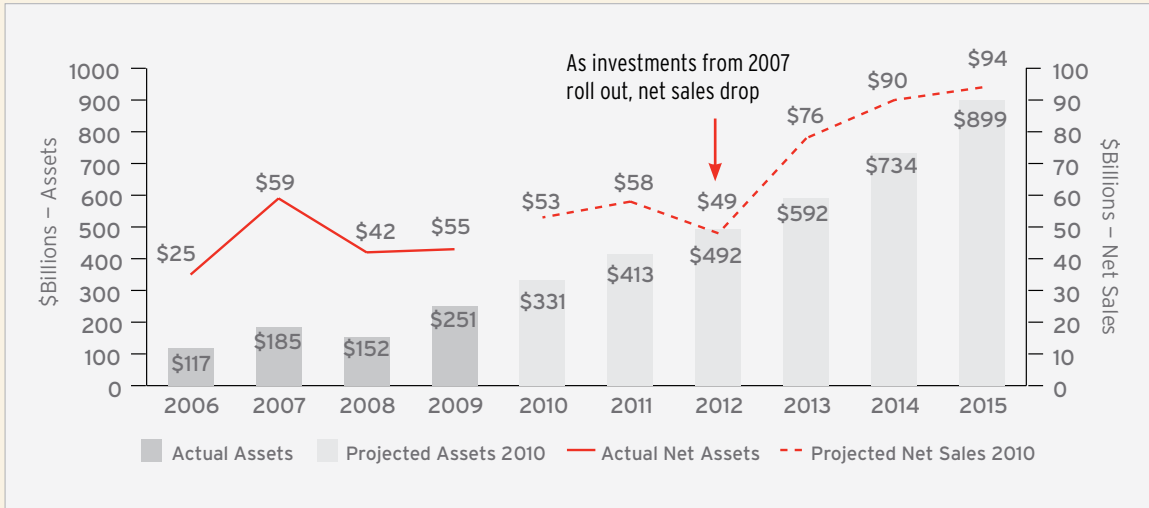
Source: BAUFRC 2009 Retirement Benchmark Survey
 Investable Assets include Mutual Funds, ETFs, Hedge Funds, Private Equity Funds, etc.

Target-Date Asset Growth Outpaces Target-Risk



Source: '40 Act data Financial Research Corporation (FRC)

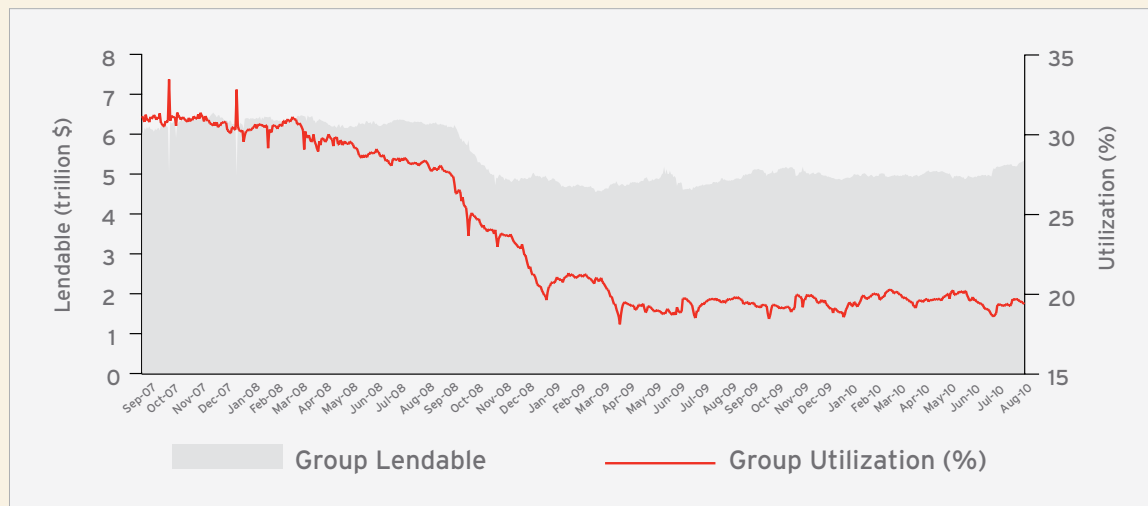
Target-Date Market Growth to Be Robust with 26% CAGR (2010 - 2015)



Source: FRC IMPACT Database

Securities Lending

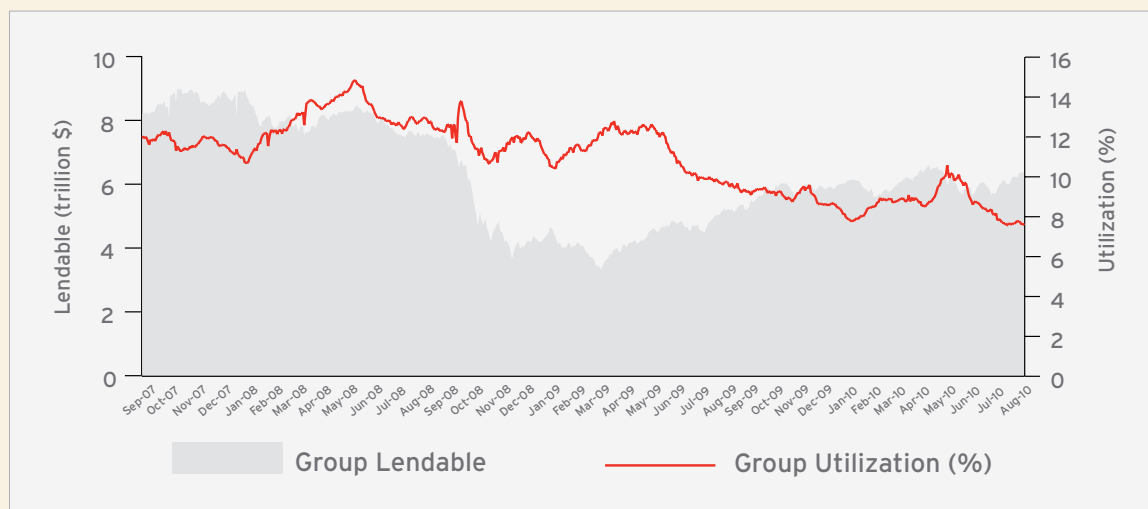
All Bonds



Source: www.dataexplorers.com

Post September 2008, Global Bond lending availability has settled down to around USD 5 trillion and lending utilization to around 20%. The current levels clearly show the effect of the deleveraging that has taken place over the past two years.

All Equities



Source: www.dataexplorers.com

The decline in lending utilization over the past few years can be partly explained by the reduction in asset values but is mostly due to the reduction in hedge fund demand. Lendable assets, after suffering a big decline in September 2008, have now recovered and have leveled off at around USD 6 trillion.

Investment Management Review



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Comments: _____

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| <input type="checkbox"/> Collateral management | <input type="checkbox"/> Distribution | <input type="checkbox"/> Emerging markets | <input type="checkbox"/> Outsourcing |
| <input type="checkbox"/> Regulation | <input type="checkbox"/> Alternative investments | <input type="checkbox"/> Asset pooling | <input type="checkbox"/> Foreign exchange |
| <input type="checkbox"/> Securities lending | | | |

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|--|---|--|---|

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Calendar of Events

SEPTEMBER:

- 16 Hedge Funds Care "Cocktails on the Sound"
Stamford, CT, USA
- 23 No Greater Sacrifice (NGS) Charity Dinner Program
New York, NY USA
- 26 – 29 Investment Company Institute Tax & Accounting
Conference
Phoenix, AZ, USA
- 27 – 29 *Institutional Investor's* 16th Annual Hedge Fund
Institutional Investment Conference
San Francisco, CA, USA
- 28 – 29 Dow Jones Private Equity Analyst Conference
New York, NY, USA
- 28 – 29 ALFI/NISCA Investment Management Conference
Luxembourg

OCTOBER:

- 3 – 7 Fund Forum Middle East
Bahrain
25% off delegate pass (code: KN2248CITPDF)
- 12 – 15 RMA Conference on Securities Lending
Boca Raton, FL, USA
- 14 Citi Business Process Outsourcing (BPO) Client Forum
Toronto, Canada
- 15 ALFI Transfer Agency Conference
Luxembourg
- 17 – 20 Super Return Middle East
Abu Dhabi
25% off delegate pass (code: KR2249CTEM)
- 20 – 21 Beneficial Owners
London, UK
- 28 – 29 ALFI NISCA Funds Forum
Luxembourg

NOVEMBER:

- 1 Asia Pacific Investors Roundtable
Hong Kong
- 1 – 3 ICBI Fund Forum USA
Boston, MA, USA
25% Off Admission with Citi Passcode KN2254CITIEM
- 2 – 3 AR Symposium
New York, NY, USA
- 4 Mutual Funds Against Cancer (MFAC) Charity Wine Event
Boston, MA, USA
- 8 – 9 Investment Management Consultants Agency (IMCA)
Advanced Wealth Management Conference
San Francisco, CA, USA
- 8 – 9 Canada Life and Health Insurance Association (CLHIA)
Conference
Toronto, Canada
- 11 – 12 Money Management Institute (MMI)/Fall Solutions
Conference
New York, NY, USA
- 18 Hedge Funds Care
Boston, MA, USA
- 22 – 24 World Islamic Banking Conference
Bahrain
- 24 – 25 ALFI Alternative Investment Conference
Luxembourg

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