#1 PRODUCT DEVELOPMENT

Four factors are shaping product development as we look toward 2017 and beyond:

1. Consolidated shelf space
2. Scarcity of returns
3. Pressure on fees
4. Control over portfolio construction

These dynamics drove new product development of mutual funds to its lowest level in at least 16 years. Only 316 mutual funds were launched in 2016, compared to more than 500 for four of the previous five years (493 in 2014).

- FUSE anticipates that new product development will continue at a moderated pace in 2017, with close to the same number of launches (~350 mutual funds) as 2016.
- Product development will remain central to asset managers’ growth, but new product proposals will be subject to more intense grilling by internal product committees.

Conversely, ETF product development has been very consistent.

- ETF product development exceeded 200 products for the third consecutive year (244 launches).
- Product development from established ETF players combined with new (or newish) entrants focused outside traditional beta (strategic beta, active, etc.) will drive product development of ETFs in the 250 range in 2017.

Control of Portfolio Construction

More than ever, asset managers will plot their product development strategy through the lens of investor outcomes, and which entity (i.e., home office, third-party, advisors) ultimately controls portfolio construction.

- The growth of fee-based business and model portfolios will force managers to cede control over to a growing slice of solutions, operating as only a component of the overall solution (e.g., single strategy mutual funds and ETPs) of their strategic partners.
- At the same time, managers will look to target advisors and platforms that don’t depend solely on home office models to distribute higher margin solutions to generate revenue.

Strategic Beta

Strategic beta strategies enjoyed a record year of growth in 2016, benefitting from a combination of factors that have intensified the focus on transparency and fees, favored ETFs over mutual funds, and indexing over active management. Implementation among financial advisors has increased with the majority planning to sustain or increase asset allocations over the next several years. In 2017, FUSE believes:

- Factor and volatility strategies will continue to drive growth, more heavily among ETFs as investors look for outperformance from low cost vehicles while fixed-income strategies will experience the greatest amount of product innovation.
- There is room for fee reductions with existing and new players bringing expense ratios downward.
#2 2017 NET FLOWS

2017 will continue the trend of solid industry net sales. Our projection calls for nearly $180 billion in net inflows across mutual funds and ETFs. We expect that the overall trend favoring passive strategies will continue to be quite strong with passive mutual funds and ETFs projected to receive $481 billion while their active counterparts experience net outflows totaling $301 billion. At the broad objective level:

- **Equity**—Domestic equity flows should remain fairly static with 2016 levels. However, passive strategies will continue to be the driver of this growth, and we expect active products in the aggregate to experience another year of net outflows ($214 billion out of active, $185 billion into passive). Global/international funds are expected to be a key driver of net sales in 2017 with slightly more than $59 billion of net inflows.
- **Fixed income**—After a big sales acceleration in 2016, we anticipate fixed-income flows will continue to be strongly positive in 2017, albeit a bit lower. While sales will be led by taxable categories ($103 billion net inflows), we expect municipal bonds to remain a contributing factor to overall fixed-income flows in 2017, experiencing another $30 billion of net inflows.
- **Alternatives**—2016 was another modest year for net sales of alternatives, and we are not anticipating a robust turnaround for 2017 with aggregate net sales across funds and ETFs remaining positive but likely less than $10 billion.

#3 BUSINESS INTELLIGENCE / SALES ANALYTICS

Business intelligence has been an increasing area of interest and focus for asset managers over the past few years. The ability to better target distributors and their advisors presents asset managers with the promise of optimizing sales and more effectively utilizing resources. As 2017 unfolds, the following three areas will be interesting to keep an eye on:

1. **Personalizing Advisor Engagement**—Segmentation around an advisor’s book of business, preferred method of communication, and business model continue to be key areas of synergy between sales and marketing. Personalizing a firm’s message and product focus are priorities for most asset managers.
2. **Sales Data Availability and Accessibility**—As distributors continue to expand their partnerships with asset managers and share their proprietary sales data, how will this impact the existing third-party aggregators of sales data? Asset managers’ ability to source the most transparent, highest-quality data will have to be balanced with the cost of potentially buying redundant data.
3. **Limitations of Distributor Intelligence**—With larger asset managers subscribing to essentially the same data and with smaller managers lacking the budget and internal resources to leverage such data, the promise of “big data” and distributor analytics may become viewed more as a perceived advantage versus a real “game changer.”

#4 INSTITUTIONAL ASSET MANAGEMENT

Institutional accounts domiciled in the U.S. recorded $123.6 billion in outflows in 3Q16, according to eVestment. Despite this trend, our outlook for asset gathering in the institutional channels is optimistic for the select group of asset managers with strong performance; staff committed to seamless, high
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value client interactions; and armed with relevant solutions that address institutional asset holders’ portfolio management challenges.

- Institutions face two major challenges—generating sufficient returns while controlling costs. We anticipate the counter trends of insourcing (e.g., State of Wisconsin Investment Board) and outsourcing or partial outsourcing (e.g., Harvard Endowment’s recent move) investment models will continue as institutions optimize their approach.
- Increased fee consciousness has redirected assets to low-cost index strategies and vehicles across institutional channels. We predict the growth of passive will be the most pervasive in the defined contribution channel in 2017, with more passive options added to retirement plan menus and the use of collective trust funds moving further down market. Moreover, RFP activity will increase in 2017, as plans sponsors attempt to validate the reasonableness of fees in their plans.
- Defined benefit plans will continue to grapple with funding issues. Liability driven investing will remain a meaningful business for some asset managers, and we also believe that that the high cost of maintaining the liability will prompt more pension fund buyouts in 2017.
- Institutions will be pressured to meet high return targets in a low return environment. This, combined with ongoing concerns about market volatility, will likely continue to benefit alternatives and low volatility equity strategies. Institutional AUM in low volatility equity topped $182 billion, an all-time peak, in 3Q16.

#5 DISTRIBUTION RESOURCES AND CHANNEL DEVELOPMENTS

The volume of investible assets solely directed by individual advisors will continue to contract in the coming years. Increasingly, decisions are being made, or heavily influenced, by “professional buyers” including broker/dealer research teams, financial advisor teams within broker/dealers, and large RIA firms that have their own internal research committees.

The impact to salesforce management in 2017 will include:

- A shift to smaller, more strategic distribution teams.
- Distribution leaders will require that top-tier wholesalers, those with the necessary combination of sales/relationship skills and investment acumen, focus only on their most sophisticated and profitable advisor relationships.
- Many firms will increase their reliance on National Accounts teams to face off against the research professionals. Already, we see more senior level National Accounts executives elevated to the ranks of Sales leadership, a trend that will continue.
- We expect greater use of investments specialists to assist in the due diligence process, particularly as traditional managers broaden their product offerings (private equity and other traditional alternative investments, ETFs, etc.).
- Distribution strategies will become less channel-centric and more advisor-centric with generalist wholesalers given responsibilities to cover financial advisors who fit the appropriate profile regardless of distributor type.

Channel Trends:

- The trend toward growth in the RIA channel, to the detriment of wirehouses, has already been established.
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- The new regulations will dampen overall growth in the independent broker/dealer channel. Increased costs to comply plus pressure on high producing advisors to seek the best capitalized firms will induce a shakeup in this segment, ultimately leading to mergers or closings among sub-scale distributors.
- The private bank/trust channel is better positioned for these changes. FUSE projects an 8.5% 5-year CAGR (based on 2016 data) which would push mutual fund assets in this channel past independents, and ultimately past RIAs.

#6 M&A ACTIVITY

For M&A activity in 2017, we reached out to true experts in the field who provided two perspectives. Darlene DeRemer, Managing Partner of Grail Partners, provided thoughts on the asset management industry and Dan Seivert, CEO and Managing Partner of ECHELON Partners, shared his wealth management view.

Darlene DeRemer: "We expect to see continued pressure on active management strategies, fee pressure, and distribution access challenges. In this environment, there will be big winners and losers. Scale will be more important than ever before. As a result, sub-scale firms with mediocre products and performance will continue to get squeezed, accelerating M&A in the asset management industry."

Dan Seivert:

1. **Wealth Manager M&A Activity**
   - In 2016, M&A activity in the RIA industry hit an all-time record of 138 transactions or roughly 13 deals per month. This represents a 10% increase over last year’s record level and a 16% compound annual growth rate since the business cycle trough in 2009. M&A activity has increased in six of the seven years leading up to 2016’s record level. Trend level growth would suggest M&A activity of approximately 160 deals in 2017.

2. **$1BN+ Transactions**
   - a. 2015 and 2016 represented a paradigm shift in the number of acquisitions and breakaways involving $1BN+ wealth managers. The volume in both of these years was about 2-2.5 times the volume in 2013 and 2014.
   - b. Given the seven year expansion of markets and enterprise values since the market downturn, and the increased number of advisors over age 60, many entrepreneurs have been motivated to secure their liquidity event and solidify their succession solutions.

3. **Average Deal Size**
   - The average M&A transaction moved over $1 billion in 2015 and pushed even higher in 2016. This represents the third time in the past five years that the average deal sizes have been in excess of $1 billion in AUM. Should deal volume hit 160 in 2017 with an average deal size of $1.5 billion, it would translate into more than $240 billion in AUM trading hands.

#7 FUTURE OF ADVICE

Advice

- **Traditional Advisors**—Unsurprisingly, advisors will continue to pour more money into fee-based relationships over transaction-based business in 2017. While this trend may be accelerating due to the impending DOL fiduciary rule, advisors have been shifting assets to fee-based for several
years. In addition, home-office research teams are seeing their influence grow within advisor portfolios for both investment selection and asset allocation. As the power of home-office models grows, asset managers will need to place even more emphasis on servicing the professional buyers at broker/dealers.

- **Robo Advisors**—2017 becomes the year for advice to come full-circle as hybrid models solidify their spot atop the digital advice food chain. The convergence of the digital and human aspects of wealth management has been inevitable as most wealth management shops have made strides toward improving their technology and tools available for their human advisors. Meanwhile, robo advisor models will look to bring in more human connections and enhance their digital offering with more human financial planning engagement. Whether this is done through more call centers, brick-and-mortar presence, or personal video connections, the line distinguishing a robo advisor will become more blurred. Asset managers seeking entry into the robo market must understand that it’s a matter of scale at this point. Reputation matters and firms might be capable of leveraging their brand to bring new offerings to market, a la T. Rowe Price ActivePlus Portfolios. Furthermore, creating a digital connection to younger clients will help create, drive, and lift brand recognition as younger investors mature and look for more beyond low-cost index investing, which requires an understanding of the investment level needed.
#8 BONUS PREDICTIONS

- **Super Bowl LI**—Patriots win their fifth Super Bowl since 2001 by defeating the Atlanta Falcons 34-27. Tom Brady wins his fourth Super Bowl MVP in the process by throwing for three touchdowns.
- **NBA**—In a rematch of 2016’s NBA finals, Golden State defeats the Cleveland Cavaliers in seven games. Kevin Durant is MVP of the series.
- **NHL**—Chicago Blackhawks defeat the Montreal Canadiens in six games to win their fourth Stanley Cup championship since 2010.
- **NCAA Men’s Basketball**—Kansas, Villanova, Kentucky, and Louisville make up the final four with Kansas beating Kentucky to win their fourth NCAA championship.
- **MLB**—Boston Red Sox win their fourth World Series led by dominant pitching from Chris Sale, David Price, and Rich Porcello by defeating the San Francisco Giants in six games.