

2012 - regulations, scale, multi asset in ascendant

Regulation moves up the agenda

We think that regulatory change is becoming a powerful factor in the development of the asset management industry. As well as increasing costs, we think that a focus on transparency in the retail market could put pressure on overall fee levels.

Business models start to evolve

Partly as a consequence, we think that business models are starting to evolve, having been pretty static until recently. Firms will measure their businesses against a yardstick calibrated to competitive advantage and profitability.

Product trends - secular and cyclical

There is a lot of cyclical noise in fund flows and product development. The flight from European assets in 2011 is an example of this, we think. However, we also see well established secular trends. We think index management will continue to gain share at the expense of core, beta-ed mandates.

Multi asset still growing

We think the growth in advanced onshore investing, and in multi asset, has much further to go. Overall, these styles have delivered for investors in difficult times, and match the current need for risk managed, cash plus investments.

2011 - revenues under pressure

We think run rate revenues were lower in 2011 than the previous year, due to the difficult end to the year. Mainstream management seems to have retained a share of around two thirds of overall revenues. So far, 2012 looks to be a better year, although this is contingent on markets remaining decent.

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Bank of America Merrill Lynch

Philip Middleton >> Research Analyst MLI (UK) philip.middleton@baml.com	+44 20 7996 1493
Jonathan Richards >> Research Analyst MLI (UK) jonathan.t.richards@baml.com	+44 20 7995 0460
Martin Price >> Research Analyst MLI (UK) martin.price@baml.com	+44 20 7996 4389

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Refer to important disclosures on page 51 to 53. Link to Definitions on page 50.

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Ground shifting

There are a number of themes in this note, our eighth annual review of trends in asset management.

Regulation is becoming increasingly important. It is creating opportunities for some, but is also leading to higher costs. This is one of a number of forces which will, we think, increasingly encourage managers to adopt business models which play to their strengths. We see a decline in the number of firms automatically opting for broad, undifferentiated business models.

We continue to see growing market share for index funds, and for alternative/advanced asset management, including multi asset investment. SRI is still spreading as an investment style, although the emphasis is shifting more towards integration than we expected.

Before discussing these themes, this note looks in some detail at the industry. We start with an overview of top down data for 2010, the latest date for which we have solid numbers. We then look at developments in hedge funds and private equity, and make some estimates for the industry at the end of 2011. This provides a platform for the forward looking sections of the report.

Setting the scene

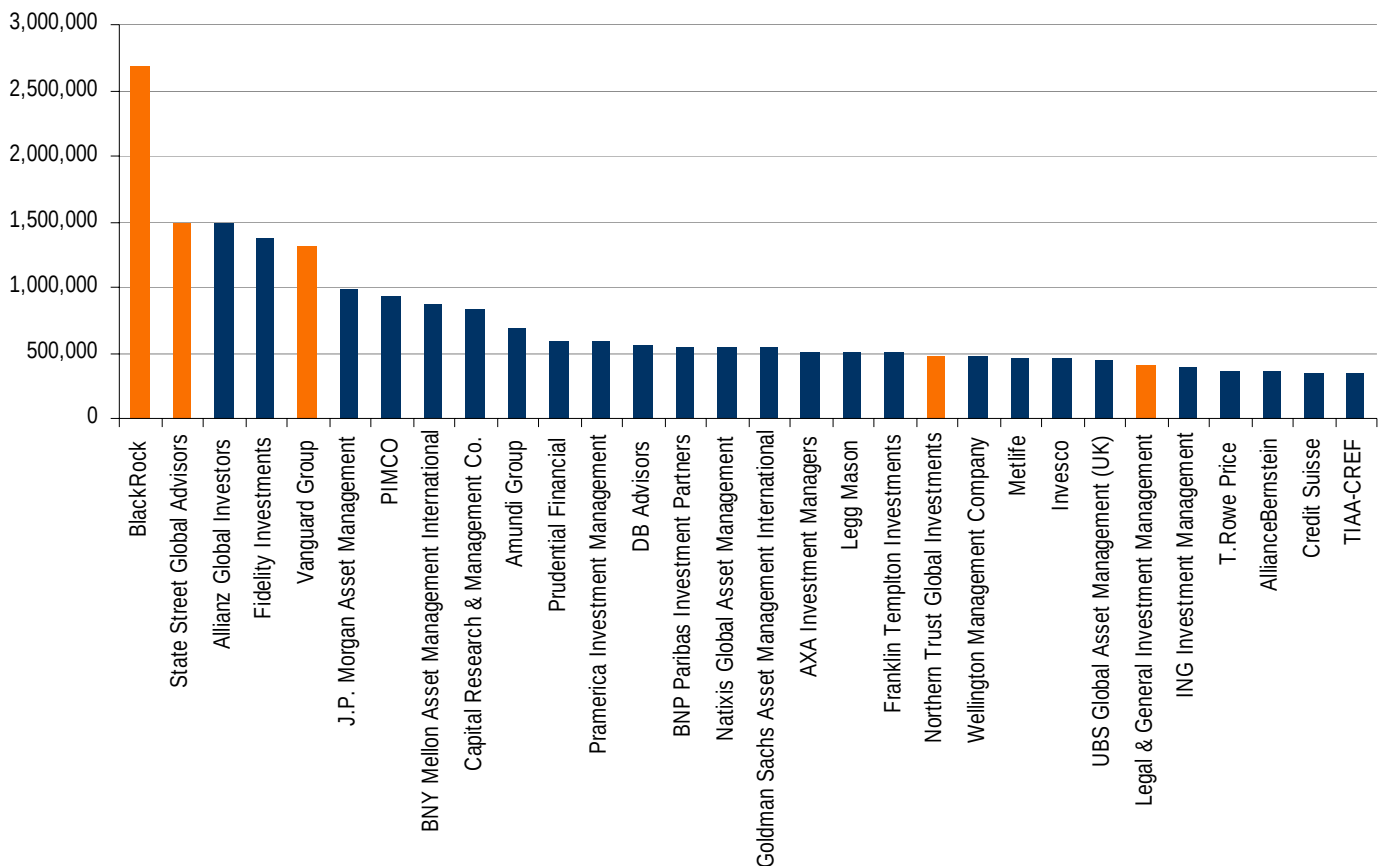
To start, we review the data we have for AUM at the end of 2010. This provides a solid basis for discussing the industry in 2011 and 2012, we think.

AUM 2010

Each year, in a sector note, we have tried to start with a picture of how the industry shapes up in terms of AUM, starting with the mainstream managers.

We stress each year that this is a simple question to pose, but a difficult one to answer. So, to come out with as accurate an analysis as possible, we have combined two useful industry surveys, IPE and P&I¹. The data only appears in the second half of the following year. We have taken their data, tried to resolve conflicts where they exist, and as a final check compared our 2010 data with data for 2009. This produces the following chart. We have, to make a point, shown companies which boast a considerable proportion of index funds (>50%, according to our best estimates) in ochre.

Chart 1: Global asset management industry - end 2010 by AUM (€m)



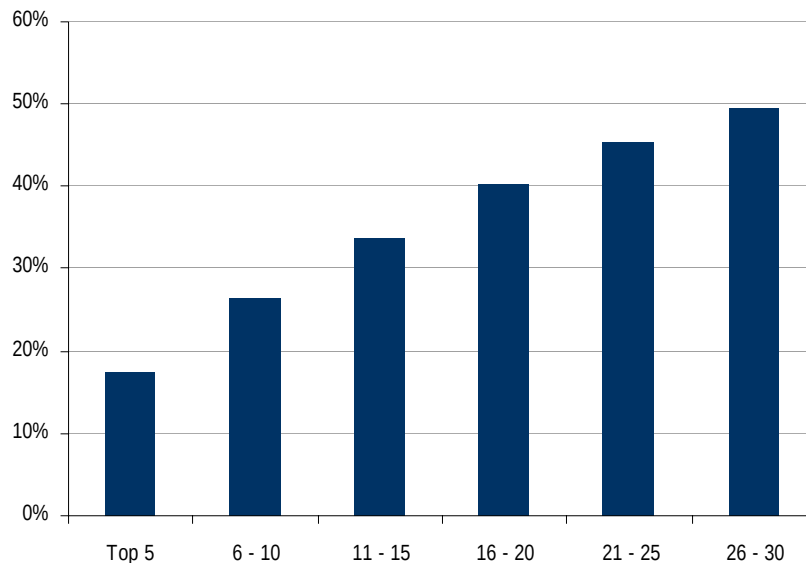
Source: IPE/Pensions&Investments, BofA Merrill Lynch Global Research

¹ We thank Abhijeet Sakhare for his work here

BlackRock stands out as a scale provider. We also think it is significant that three of the top five asset managers by AUM have significant index businesses.

One way of presenting this is to look at revenue concentration. We show this below.

Chart 2: Revenue Concentration - 2010



Source: IPE/Pensions&Investments, BofA Merrill Lynch Global Research

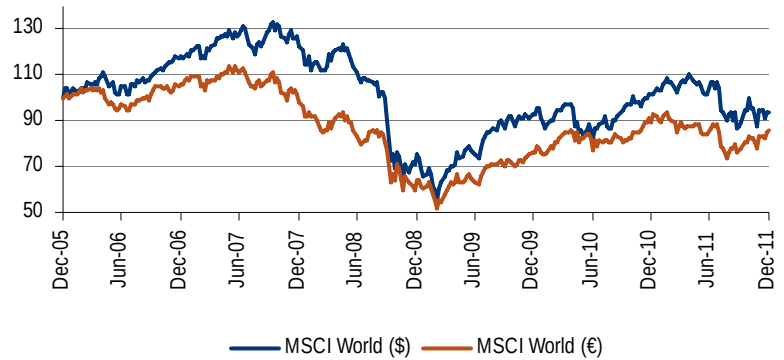
Concentration seems to have fallen a fraction since 2009. We have no particularly good explanation for this. Overall, 2010 was a good year for the asset management industry, with total AUM increasing by 25% in Euros. Some of the larger firms actually beat this growth (Allianz, Vanguard and PIMCO are clear examples), others lagged a bit. We continue to think that over time concentration will increase, something we discuss later.

Rolling forwards

Given that 2010 is a long time ago, we have updated our survey, as much as possible, to take account of events in 2011. To do this, we have applied market movements to our data for the end of 2010. We show data for this in a later chapter.

Although 2011 was a volatile year, it was actually not as grim as it felt. We show the performance of the MSCI World Index below. There are additional exhibits in the Appendix.

Chart 3: MSCI World - \$ and € (indexed)

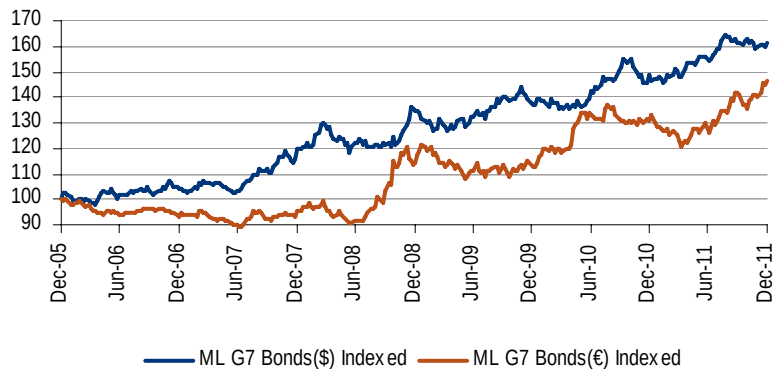


Source: Datastream/ BofA Merrill Lynch Global Research

World equities fell a bit, but saw nothing like the precipitate declines of 2008. We suspect that people remember the second half, where markets were negative, to the exclusion of the first half, which was very decent.

Government bonds overall were strong in 2011, somewhat to the surprise of some high profile investors.

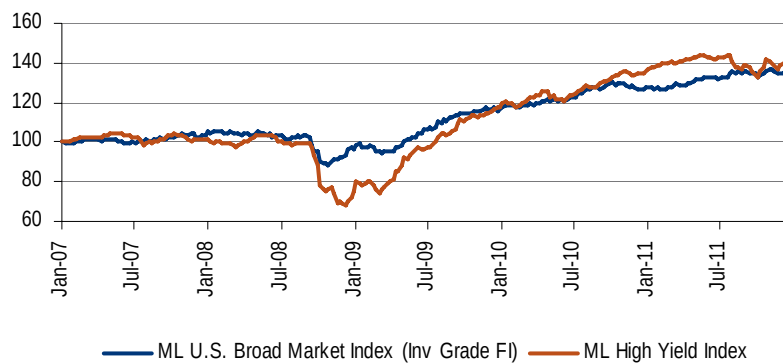
Chart 4: ML G7 Bonds - \$ and €



Source: Datastream/BofA Merrill Lynch Global Research

Both high yield and high grade US bonds were also positive, although high grade performed better.

Chart 5: High grade and high yield bonds (\$)



Source: Datastream, Bloomberg, BofA Merrill Lynch Global Research

Hedge funds had a mediocre year in terms of returns, as discussed later.

Hedge Funds

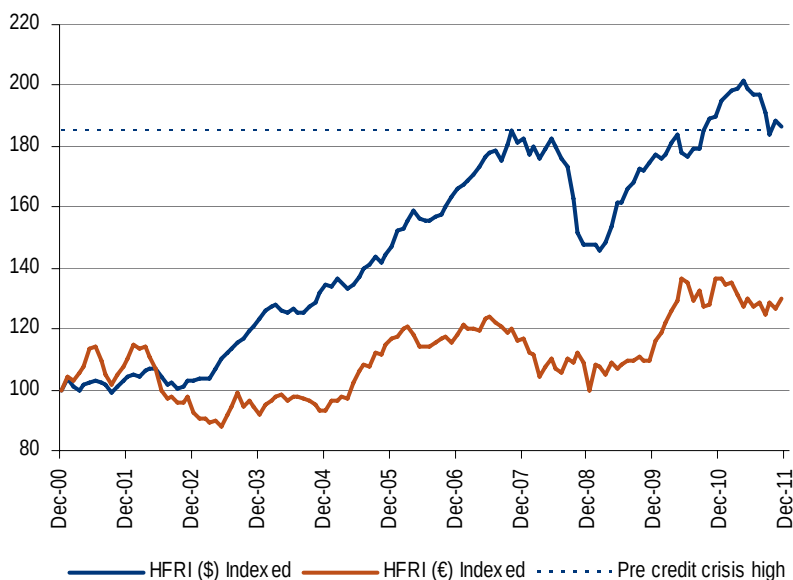
2011 was a patchy year for hedge funds. The broad indices made new performance fee highs in the middle of the year, but gave this all back in the second half. The HFRI overall performed in line with global equities, albeit with lower volatility.

Flows were decent for the year, but again the first half was better than the second. Technically, Q4 11 broke a nine quarter streak of inflows, although it was for all intents and purposes flat.

Performance

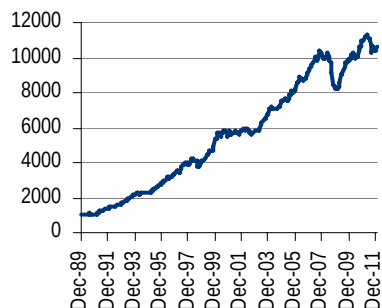
We show below the performance of the HFRI composite index since the start of 2000.

Chart 6: HFRI Composite (in \$, and converted into €)



Source: HFR, Datastream, BofA Merrill Lynch Global Research

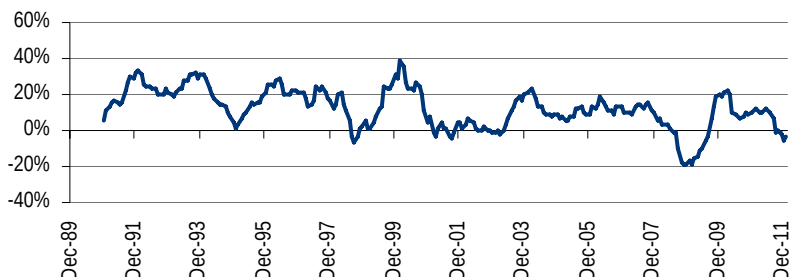
Chart 7: HFRI Composite



Source: HFR, BofA Merrill Lynch Global Research

Below, we show the annual performance of this index for as long as we have data.

Chart 8: HFRI Composite - 12 Mth Perf.

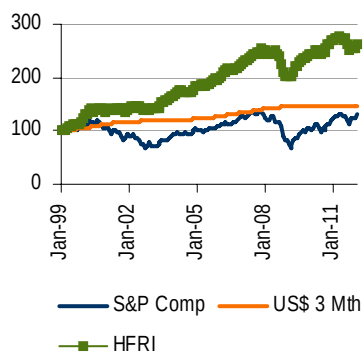


Source: HFR, BofA Merrill Lynch Global Research

The end of 2011 was not a great one for the industry, although this will hardly come as a surprise given how difficult the period was for risk assets overall. However, the amount of time this series spends in the plus column represents a major bull case for the hedge fund style, we think.

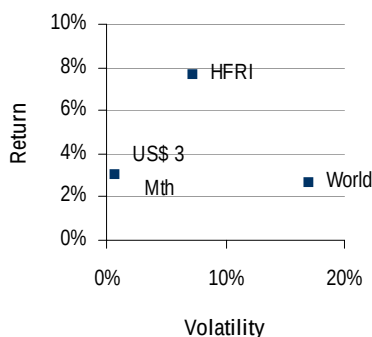
We show below three charts that to us sum up the attractions of hedge funds as an investment.

Chart 9: Total Return



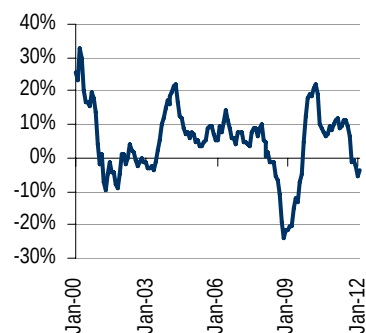
Source: BofA Merrill Lynch Global Research, Datastream

Chart 10: Risk/Reward



Source: BofA Merrill Lynch Global Research, Datastream

Chart 11: HFRI - Spread over 3m\$



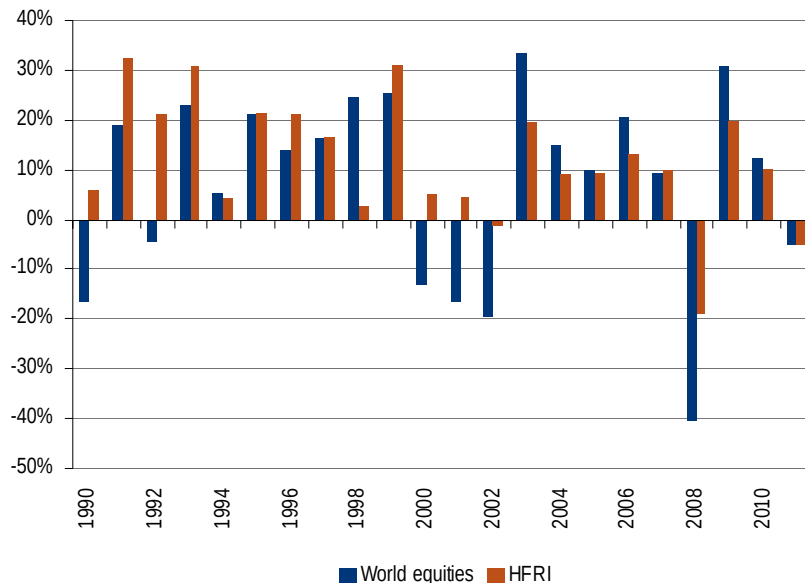
Source: BofA Merrill Lynch Global Research, Datastream

The industry has shown its ability to manage risk, showing less than half the risk of the MSCI World, for instance. It also has a good record of beating cash. Given we see considerable desire for cash plus products among investors, this is a positive.

Hedge vs beta

Although basic, it is interesting to look at how hedge funds have performed against world equities by calendar year. We summarise the data below.

Chart 12: Hedge funds relative to world equities (MSCI World in US\$)



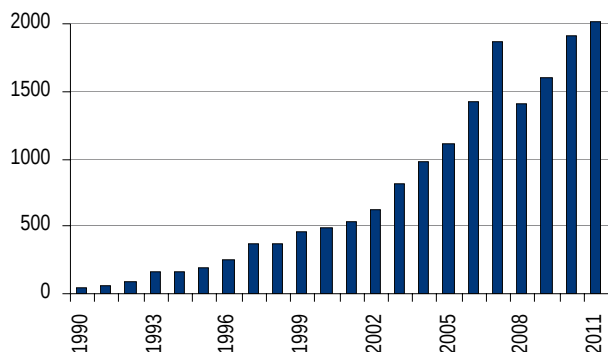
Source: Datastream, HFR, BofA Merrill Lynch Global Research

Although 2011 was really a dead heat, technically hedge funds did a **bit** better than world equities. As a result, we would point out that hedge funds, as measured by the HFRI, have always outperformed equities when equities are negative. 2008, the year when hedge funds took the most media flak for supposed poor performance, was actually the year of the greatest outperformance. Like the triptych of charts above, we think this is a pretty compelling argument for hedge funds as a style

Flows

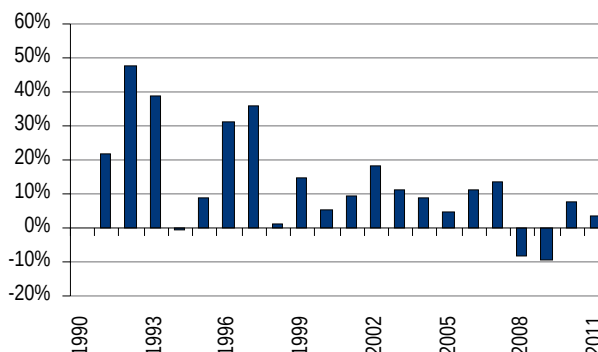
It seems from the data that overall, investors share our view on the hedge fund industry, as it has seen decent flows over the past couple of years, especially when compared to other asset classes.

Chart 13: Hedge Fund Universe (\$ Bn)



Source: HFR

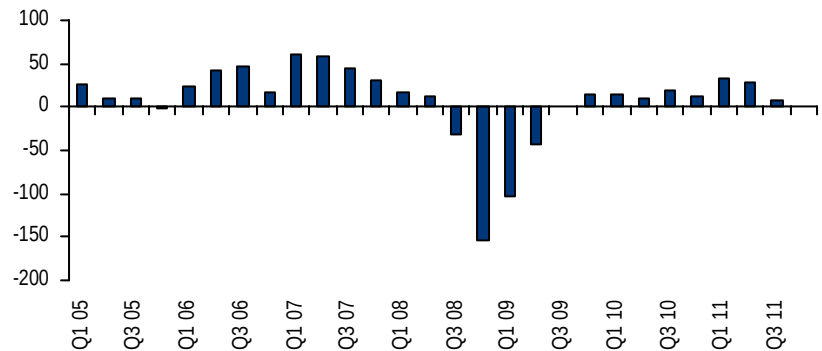
Chart 14: Hedge fund flows vs starting assets



Source: HFR

We show the same data by quarter below.

Chart 15: HFR - Quarterly Flows (\$bn)



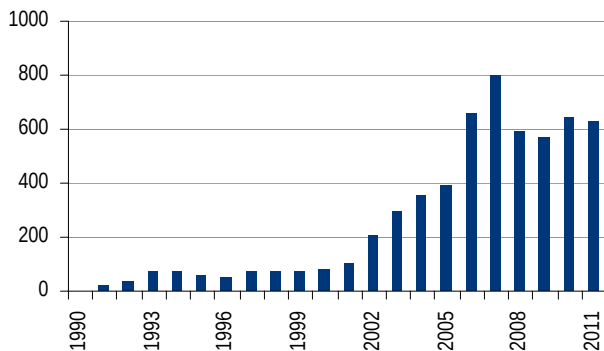
Source: HFR/BofA Securities Merrill Lynch research

The industry has been seeing pretty steady inflows for the past couple of years. Q4, according to HFR, saw outflows of \$127m, essentially flat flows for an industry of around \$2tr. By segment, macro and relative value saw noticeable inflows whilst equity hedge saw largish outflows and event driven somewhat lower net outflows. AUM at the end of Q4 was split roughly equally between these four categories (equity hedge is fractionally the largest of the four, macro the smallest).

Fund of funds

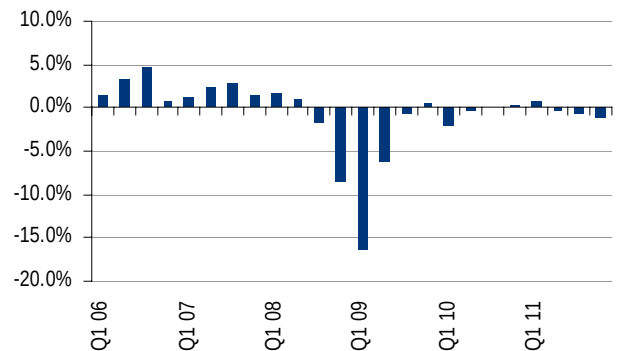
The picture is less happy with fund of funds.

Chart 16: HFR - Fund of fund assets (US\$ bn)



Source: HFR

Chart 17: HFR - Fund of fund flows vs assets



Source: HFR/BofA Securities Merrill Lynch research

The fund of funds industry arguably was the largest sufferer of the credit crisis, as the European industry especially suffered from a “dash for cash” which spread malaise through the single manager industry. Arguably, this is why redemptions were so large, and will in our view have been clearly negative for performance. Whatever, fund of funds have not returned to their past glory. We think they provide useful access vehicles to hedge funds, but investors are also looking at other ways of gaining exposure to advanced investment styles. These include managed accounts, multi strategy funds and onshore alternatives.

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GlobeOp data

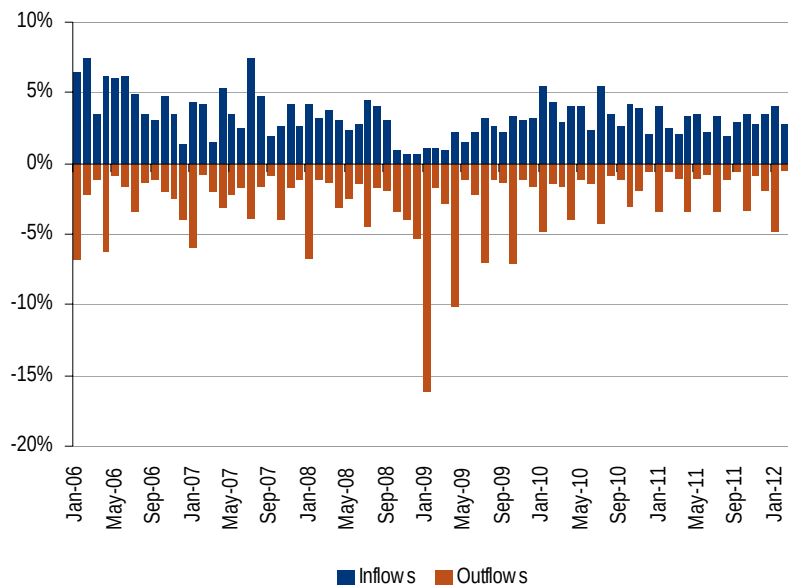
We always like a new data source, and GlobeOp has obligingly started providing what we regard as a very helpful brace of data series.

Capital movement index

This looks at gross outflows and inflows into funds administered by GlobeOp. This highlights the plusses and minuses of the series. On the plus side, because GlobeOp administers flows for its clients, it knows in a precise and timely matter exactly what is happening. Other hedge fund series are either much less timely, based on surveys and so on. On the minus side, it represents its clients, not the whole industry. With about \$175bn of assets under administration, not all in hedge funds, GlobeOp represents high single digits of the whole industry. Anecdotal, it also has something of a tilt away from equity long/short. So, we think this provides very solid directional data rather than all you need to know about hedge fund flows. Typically, the GlobeOp data moves in the same way as the (much later) HFR data, but in a more extreme way. This is exactly what you would expect with a smaller sample.

Anyway, we show below the GlobeOp flow data.

Chart 18: GlobeOp Capital Movement Index



Source: Company/BofA Merrill Lynch Global Research (nb Jan 09 = -15%)

There are a couple of interesting features here. Firstly, especially over the last couple of years, the seasonal nature of hedge fund redemptions is extremely clear. There is a strong three monthly cycle being imposed on monthly flows here. Secondly, the end of 2008 and start of 2009 was characterised by not just outsized redemptions but by nugatory subscriptions. Subscriptions picked up in 2009 rather sooner than redemptions normalised.

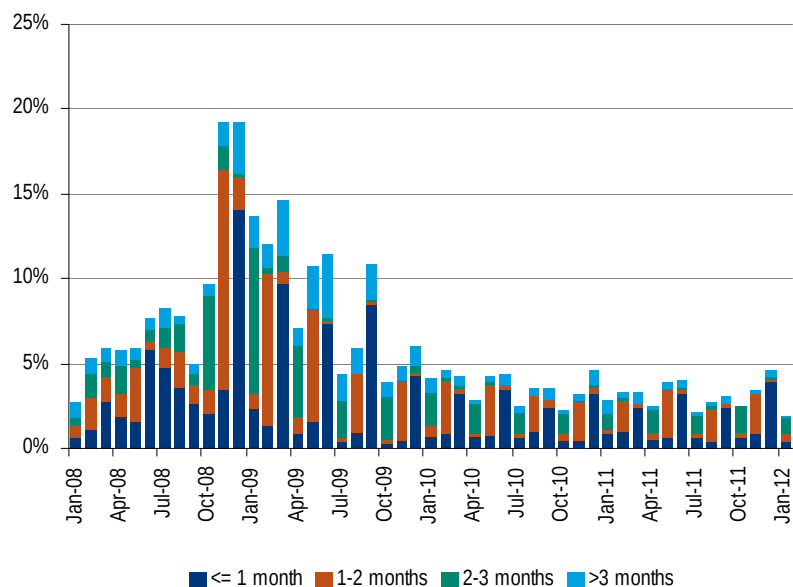
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At the moment, on this data the industry is ticking over, with capital being reallocated but overall, positive flows. Anecdotally, these are largely coming from US institutional investors. We see no reason why this should not continue. Certainly, a wide range of surveys we see about investing intentions suggest that allocators are looking to increase hedge fund exposure.

Forward redemption indicator

The company also provides a series that looks at notified redemptions. Most hedge funds (as opposed to regulated onshore absolute return products) have notice periods of 1-3 months, with some having longer lock-ups. So, at any one time an administrator will know of redemptions in the pipeline. This therefore provides a warning of stormy weather ahead. For example, this measure peaked in November and December 2008 whereas actual redemptions peaked in January 2009.

Chart 19: GlobeOp Forward Redemption Indicator



Source: Company/BofA Merrill Lynch Global Research

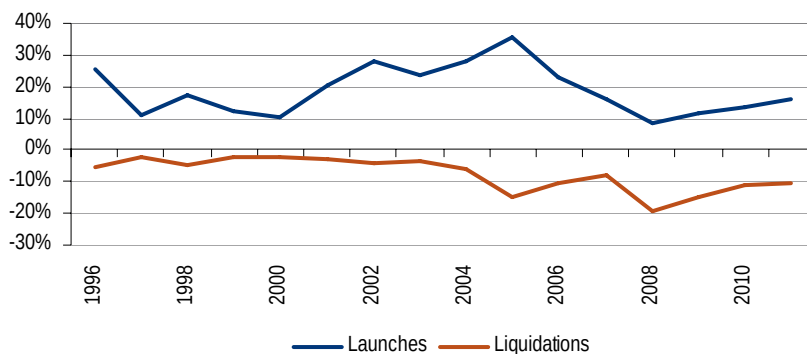
Currently, this measure is very normal-looking, suggesting there is no reason to expect a flood of redemptions over the next few months.

Launches

Hedge fund launch numbers provide a decent indicator of the perceived health of the hedge fund industry, we reckon. We show below how launches and liquidations have moved in relation to the total number of funds. Broadly, liquidations seem to be running around the 10% level, while launches have ticked up, although are still below pre crisis levels. This suggests to us that there must be funding available for new funds. Anecdotally, this is the case if the new entrants have a plausible track record and are decently institutionalised.

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Chart 20: Hedge fund industry - demographics



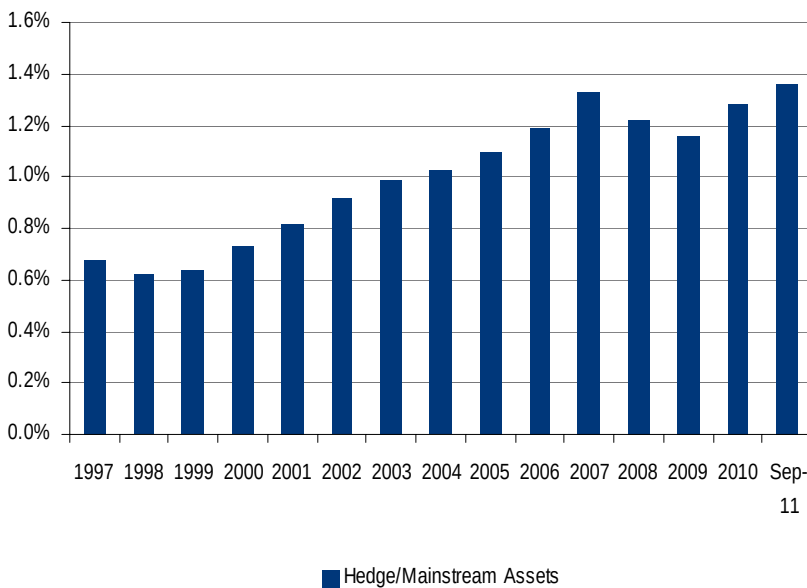
Source: HFR, BofA Merrill Lynch Global Research 2Q11 data annualised

The number of hedge funds is, according to HFR, close to its peak value (around 3% down) whereas the number of fund of funds is 21% below peak level. Fund of funds numbers have been falling pretty steadily post crisis, although they still number well over 2,000.

Market size, hedge fund “bubble”

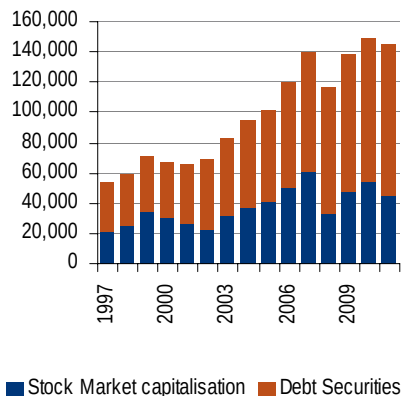
We have for some while contrasted the size of the hedge fund universe with mainstream assets. We have updated our work here. To start with, we show our calculation of the hedge fund world as a percentage of the mainstream world.

Chart 21: Hedge Fund Assets vs Mainstream Assets



Source: HFR, World Federation of Exchanges, BIS, Tremont, BofA Merrill Lynch Global Research

Chart 22: Conventional Assets - \$bn



Source: World Federation of Exchanges, BIS

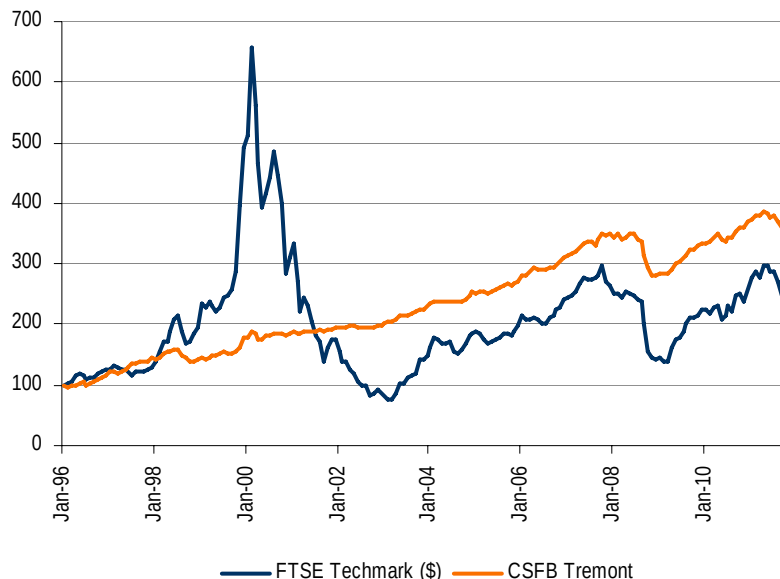
In the margin, we show the data on which this is based.

We have only taken this to the third quarter of 2011, as we do not have more up-to-date data for debt securities. The industry seems to have reverted to its historical pattern of modest annual growth. Here, we are missing the “dark matter” of the regulated/onshore absolute return area, where we expect to see continued growth.

Bubbles?

Another longstanding chart of ours is the comparison of hedge fund performance with that of the FTSE Techmark, a sensible proxy for European technology. This is rhetorical, in the sense that people used to call hedge funds a “bubble”, and we thought it would be interesting to compare it to another asset class that has been accused of being the same thing. The Techmark is down 61% from its all time high, whilst the hedge fund industry, represented here by the CSFB Tremont index², is relatively close to its highs.

Chart 23: Hedge Funds - the Bubble Continues?



Source: DataStream/CSFB Tremont/Merrill Lynch research

Revenues in 2011

We have oscillated between looking at global performance and performance by broad style in calculating hedge fund performance fees. The latter is helpful where one style performs well, but is swamped by others. This year, the issue is more the shape of hedge fund returns. The HFRI peaked mid-year, and then fell away. The HFRI peaked at 3.2% ahead of high water mark, before ending the year 8% below its new peak value. If you weight the four broadest hedge fund styles, the picture is very similar. We have therefore opted to use 3.2% as the basis for our estimation of performance fees. We have multiplied AUM by 25% of performance (after fees) to arrive at an estimate of total hedge fund performance fees, as set out in our chapter on 2011 revenue estimates.

² The CSFB Tremont differs fractionally from the HFRI, referenced earlier. It has a longer history, which is why we sometimes use it.

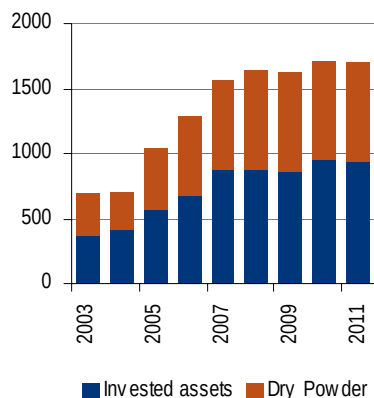
Private equity

The private equity industry is in the midst of a period of adjustment, in our view. Returns have been decent, and sizeable funds continue to be raised. However, asset gathering is well below peak levels, and deal volumes are relatively subdued.

AUM, Revenues

As for last year, we have relied on Preqin data for AUM. The private equity industry is something of a law unto itself, in that it operates with committed capital that expires after a number of years, leading to ubiquitous discussions of “dry powder” for investment. The industry charges for maintaining dry powder as well as for invested funds.

Chart 24: Private equity AUM (€bn)



Source: Preqin, BofA Merrill Lynch global research estimates

Data for 2011 is an extrapolation from data for earlier in the year and flow data (we are lacking full Q4 data here).

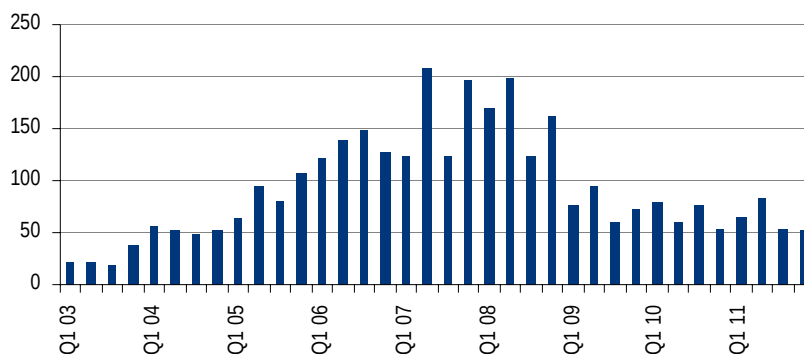
Overall, we think AUM in private equity has remained pretty static over the past year. Asset gathering has been difficult not impossible, realisations have remained decent and investing has been slow.

Revenues probably increased somewhat due to realisations and performance was, overall, also OK. Although transparency here is not the finest, according to Preqin, the median fund in the 2004-6 area, which are those which are most likely to be in realisation and distribution mode, is offering a money multiple of between 1.64x (for 2004) and 1.15x (for 2006). In other words, these funds have offered reasonable IRRs, which over time determine carry paid to managers.

Fund raising

Fund raising has been plodding along over the past few quarters.

Chart 25: Private equity fundraising by quarter (\$bn)



Source: Preqin

Like so much to do with our sector, this is pretty cyclical (if we tried hard enough, we could probably retrofit it to the GFSI, BofAML's proprietary risk index, as we like to with most things we look at). The good news is that even in the very difficult Q4, funds continued to hold final closings. The largest was EQT's €4.75bn buyout fund, according to Preqin. Of course, private equity fund raisings are elephantine affairs, so one quarter's data needs to be taken with a pinch of salt. The twelve month average fundraising is currently around

\$250bn, roughly where it's been for a few quarters now and well down on peak levels of almost \$700bn a year.

So, it seems that it is possible for private equity firms to gather assets at present, but at a significantly reduced rate. It seems a reasonable assumption that 2012 will see similar trends. Again according to Preqin, 35% of private equity investors they surveyed at the end of last year are below their target allocations, against 16% who see themselves as over allocated. This should provide a tolerable backdrop for asset gathering. Given private equity is, we think, economically cyclical, improved macro new and increased risk appetite should also be helpful.

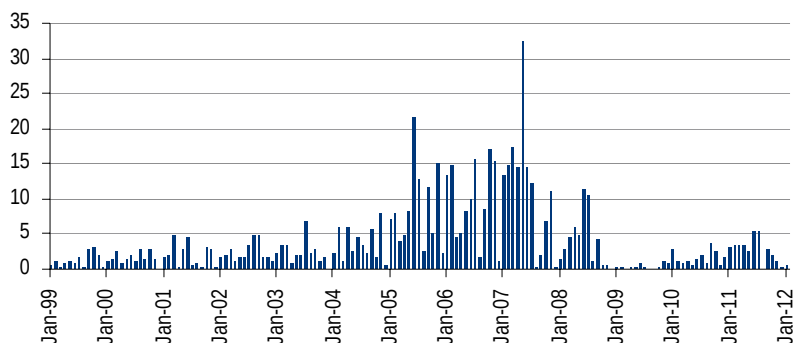
Preqin's H1 12 "Investor Outlook" document contains some more granular data on LP intentions. For example:

- Geographically, more US investors are above their target allocations than European investors suggesting geographical diversification in distribution is helpful.
- Overall, investors are satisfied with the performance of their private equity portfolios. Three quarters of LPs surveyed said their investments had met expectations. Given how difficult 2011 was for investing, we think this is a positive outcome.
- LPs are open to new GP relationships (84% said they would consider this over the next year), although first time funds may find "tougher challenges" in the face of some investor scepticism.
- Investors seem increasingly willing to coinvest alongside GPs. 33% of LPs said they were happy to do this. Emerging markets "continue to attract strong interest".
- Mid market buyout funds were the most favoured type of investment (mentioned by 49% of LPs), followed by distressed (26%) and secondaries (16%).

Investment

We show below European leveraged loan issuance, a useful measure of private equity volumes.

Chart 26: Senior Leveraged Loans: Monthly Volume (€bn)



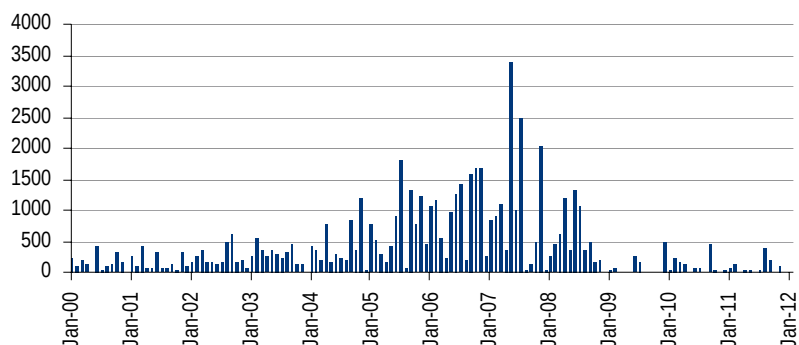
Source: S&P LCD

This suggests that deal volumes are:

- cyclical
- better than in the aftermath of the credit crisis, but
- nothing to write home about.

Roughly the same pattern can be seen in mezzanine volumes.

Chart 27: Mezzanine: Monthly Volume (€m)



Source: S&P LCD

There are a range of reasons for this pattern. Firstly, availability of credit has shrunk. Many in the industry (especially members of the “shadow banking system”) argue that it is in the process of shrinking further, as an increasing number of CLOs structured in the “good old days” come to the end of their investment periods. Again, the volatility we have seen over the past few years is unlikely to encourage an active two-way market. In particular, sellers tend to dry up when markets are dull and misery is high. This leads to the time-honoured complaint that private equity investors do not invest enough at market bottoms. This is at once true and unfair, in our view. Vendors have to be either distressed or extremely gloomy to sell decent assets at such times. Lastly, M&A is usually regarded as positive for private equity volumes, as managements tend to sell divisions which don’t fit into the new corporate strategy post merger.

On our central assumption – sentiment improves a bit – it would be reasonable to expect deal volumes to edge up over the next year.

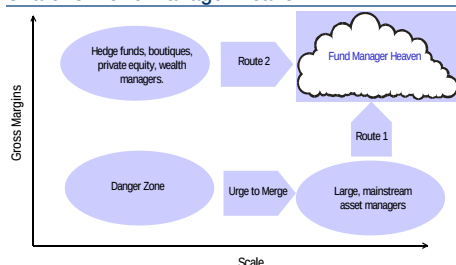
Overall

We think the private equity industry is in the midst of adjusting to the “new normal”. The industry did not have a bad credit crisis overall. Although performance dispersion is high, the median fund has actually provided respectable returns (source: Preqin performance monitor). As with hedge funds, though, we would expect to see an increasing emphasis on institutionalised firms, with an element of the big getting bigger. Against a tolerable economic backdrop, we expect to see AUM and revenues rise somewhat.

Industry estimates for 2011

In this section we pull together estimates for the various segments of the asset management industry. Dull markets have eroded revenues compared to 2010, as have reduced hedge fund fees. The first half of the year was good for revenues, the second less so.

Chart 28: Fund Manager Heaven



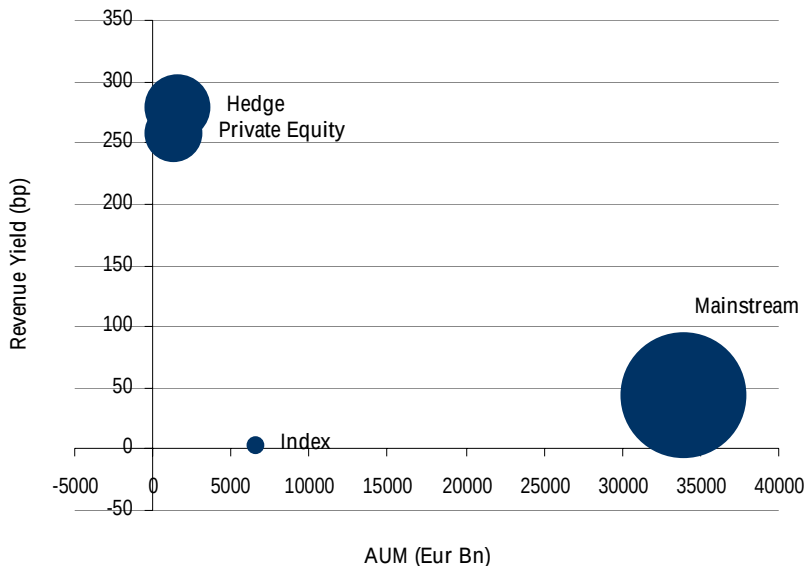
Source: BofA Merrill Lynch Global Research

Fund manager heaven

Adding together our estimates for mainstream, index, hedge and private equity managers produces our beloved “fund manager heaven” bubble chart. This marries the idea between our old diagram, shown in the margin, which argues conceptually that managers should be aiming for a combination of scale and margins if they want to maximise revenues, with some facts.

We show this below. We have used the estimates for the various buckets as described earlier.

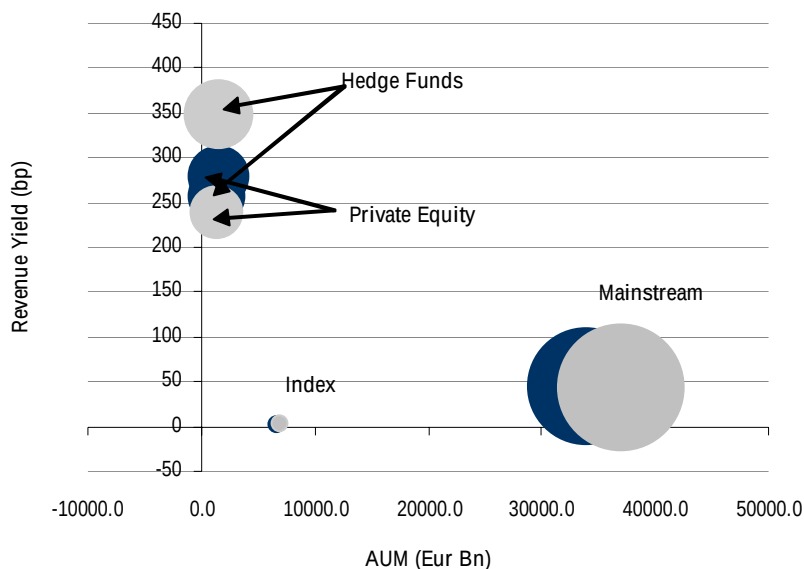
Chart 29: Asset Management World - end 2011 (Estimates)



Source: IPE, P&I, HFR, Prequin, BofA Merrill Lynch Global Research

We compare this with our numbers for 2010 in the chart below. 2010 has been slightly revised, on the basis of more accurate data.

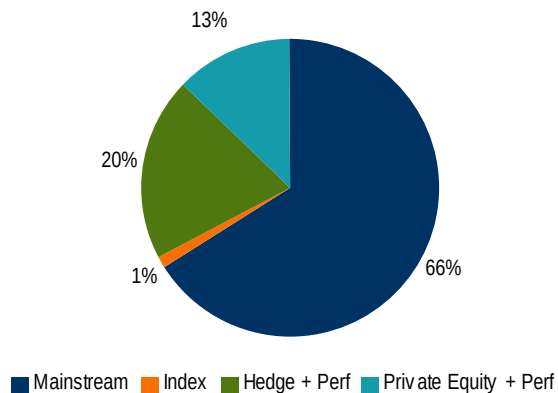
Chart 30: Total Industry - 2010 (gray) and 2011 (navy) Compared



Source: IPE, P&I, HFR, Prequin, BofA Merrill Lynch Global Research

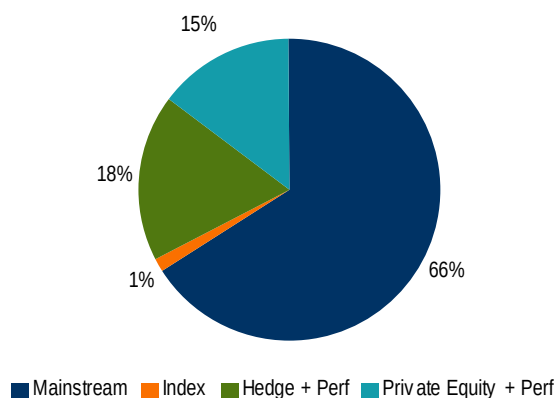
Overall, both AUM and revenues fell by something like 7% between 2010 and 2011, although it felt much worse, as 2011 was very much a year of two halves. Hedge funds will have seen a more significant fall in revenues due to weaker performance fees. This is reflected in the split shown below. Private equity actually saw a decent 2011, as realisations were relatively plentiful, although weighted towards H1. Realisations are a significant determinant of revenues, as “carry”, the private equity analogue of performance fees, needs realisations.

Chart 31: Asset Management Revenues by Product - End 2010



Source: IPE, P&I, HFR, BofA Merrill Lynch Global Research

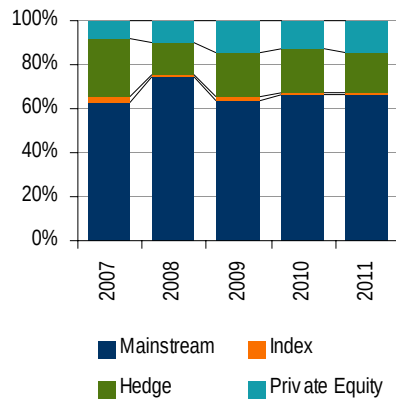
Chart 32: Asset Mgmt. Revenues by Product - End 2011



Source: IPE, P&I, HFR, Prequin, BofA Merrill Lynch Global Research

The mainstream industry's revenue share has been maintained at around two thirds of the total.

Chart 33: Revenue Share by Style



Source: IPE, P&I, HFR, BofA Merrill Lynch Global Research

We make the same point in a different way in the margin chart. The mainstream saw its wallet share expand during the credit crisis, crudely because it typically has a linear charging structure whilst the alternative styles have a performance component, and because it suffered less badly in terms of flows than hedge funds. Overall, though, the revenue share seems fairly static, in the mid 60% area.

2012?

Applying the same methodology would suggest a useful uptick in run rate revenues, as equity markets have been strong, as have hedge fund returns, with bonds and commodities also positive.

Fund flows

Our commentary on flows has been pretty extensive over the past year, thanks to Jonathan Richards' monthly notes.

This section highlights key trends within recent fund flows. Overall, we have seen a clear move out of risk assets over the second half of 2011. Within this, products with "Europe" in the title have received especially severe treatment. We think this is partly structural, partly cyclical. We still think that we are in the midst of a secular migration away from unhedged beta mandates, but think that the second half of last year was dominated by unusual levels of risk aversion.

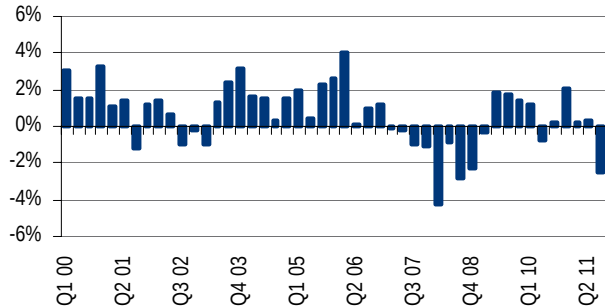
Key data - retail

The best data here is retail. For Europe overall, data collection is far trickier than you would assume. This is partly down to Luxembourgish and Irish funds, which are typically sold cross border and where there seems not to be a trade body with especially good visibility.

EFAMA

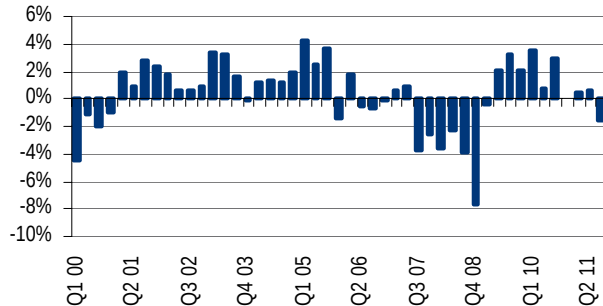
The longest run data on the European fund industry comes from EFAMA, the Europe-wide trade body. It is quarterly, and a bit of a lagging indicator. We show the four most obvious asset classes below.

Chart 34: Equity Flows - UCITS Funds



Source: EFAMA/BofA Merrill Lynch Global Research

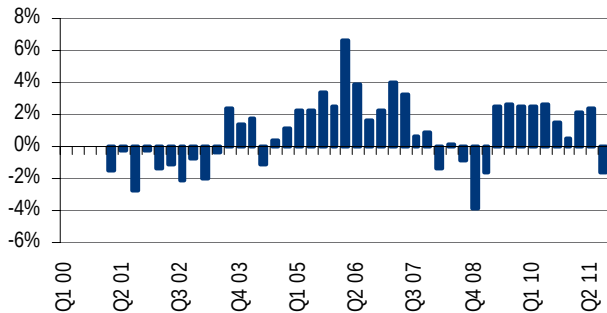
Chart 35: Bond Flows - UCITS Funds



Source: EFAMA/BofA Merrill Lynch Global Research

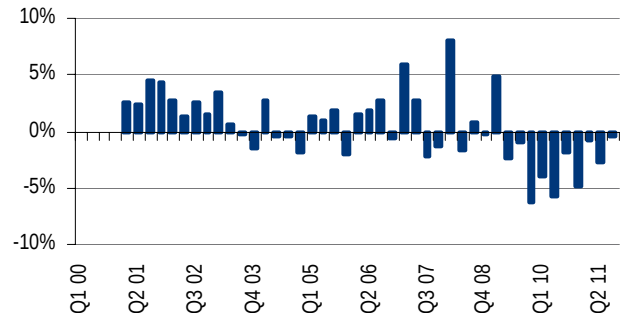
16 February 2012

Chart 36: Balanced Flows - UCITS Funds



Source: EFAMA/BofA Merrill Lynch Global Research

Chart 37: Money Mkt. Flows - UCITS Funds



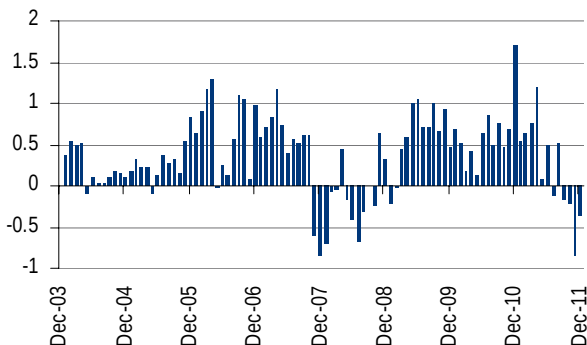
Source: EFAMA/BofA Merrill Lynch Global Research

There is a clear pattern here. Risk assets saw overall flows at their most negative in Q4 08; outflows fell in the first part of 2009 before turning positive in Q2 09 and remaining positive until the last part of 2011. Money market flows have been more eccentric, but have seen outflows since Q2 09.

UK, US

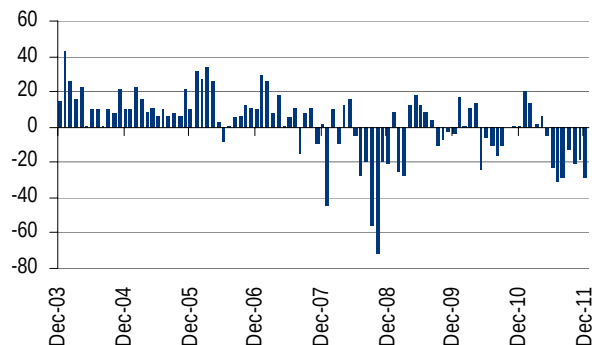
Whilst on the subject of national association data, we also show equity flows from the UK and US markets, as these are arguably the most mature mutual fund markets globally.

Chart 38: UK Equity flows (£bn)



Source: IMA, BofA Merrill Lynch Global Research

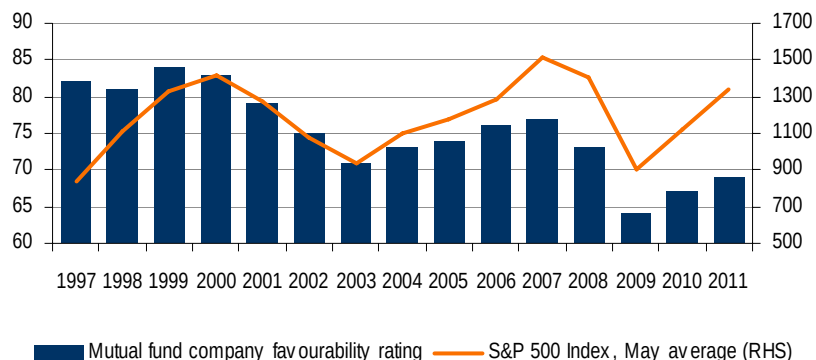
Chart 39: US equity flows (\$bn)



Source: ICI, BofA Merrill Lynch Global Research

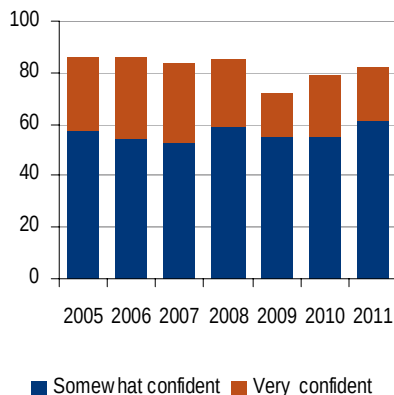
The ICI, the US trade body, produces an entertaining data series, which tracks investor perceptions of mutual funds, and shows how this relates to index levels.

Chart 40: Mutual fund favourability rises and falls with market performance



Source: ICI, Bloomberg

Chart 41: Mutual shareholder confidence



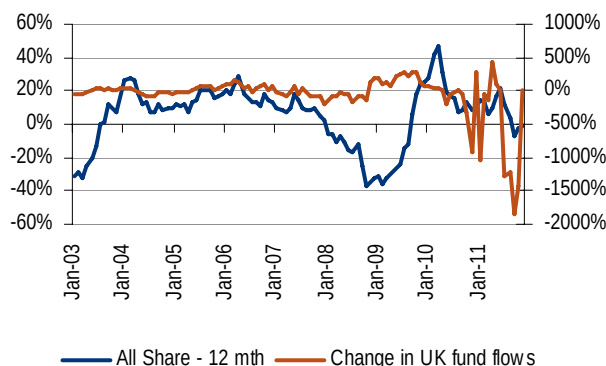
Source: ICI

It is easy to forget that the US market was actually pretty strong until mid year. When this survey was taken, the S&P was nearing the end of an impressive, multi year rally. This had its expected impact on favourability rating of mutual fund companies. We would hazard that the same survey now would come up with a less ringing endorsement of the industry.

In the same vein, the ICI also provides data for the "Percentage of all mutual fund shareholders by level of confidence that mutual funds can help them meet their investment goals". We summarise this in the margin. As you might guess, rising equity markets are good for confidence, and especially good for being "very confident". People were most confident (or at least most "very confident") in mid 2007.

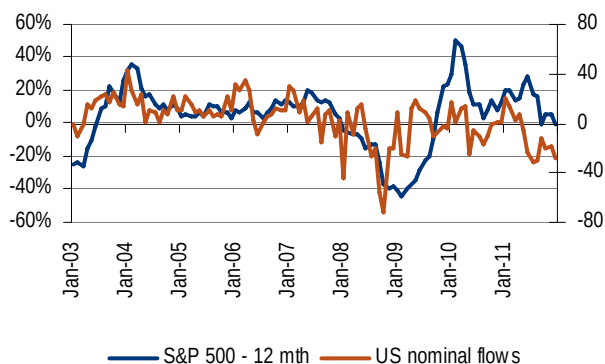
This relationship is yet another example of something we regard as a core truth about mainstream asset management; flows in the past have reflected lagged performance. We show below a couple of our favourite charts here. Again, looking at the strength of markets, we think you would have expected more of a move into equities were the old relationships still to hold good.

Chart 42: UK - change in flows vs. market



Source: IMA/DataStream/ BofA Merrill Lynch Global Research

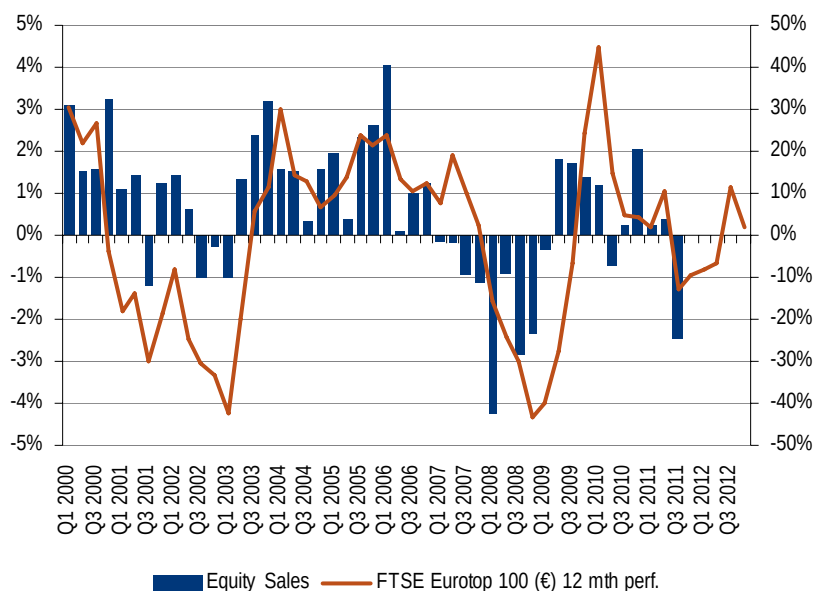
Chart 43: U.S. - equity flows vs. market



Source: ICI/DataStream/BofA Merrill Lynch Global Research

We show below another old favourite of ours, a chart which shows European equity flows against market performance. We have rolled forwards the spot market to provide our data for future performance here.

Chart 44: Equity Sales vs Lagged Market Performance - Quarterly



Source: EFAMA/Datastream/BofA Merrill Lynch Global Research

Once again, there seems a decent directional relationship between sales and markets. We continue to think the key change over the past few years is the magnitude of sales when in a bull market.

Strategic Insight data

In the second part of 2010 we began providing relatively detailed monthly breakdowns on fund flows, using data derived from Strategic Insight, a data firm which essentially aggregates data from fund statistics companies like Morningstar and Lipper. We reproduce a few charts from our latest monthly³.

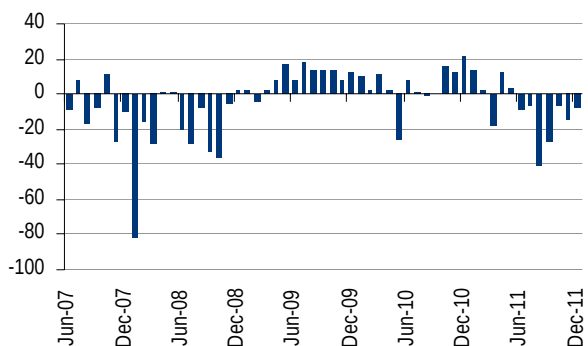
Europe/International

We show below data for European and International⁴ funds, as categorised by Strategic Insights.

³ December 10 – Out of Europe (10 February 2012).

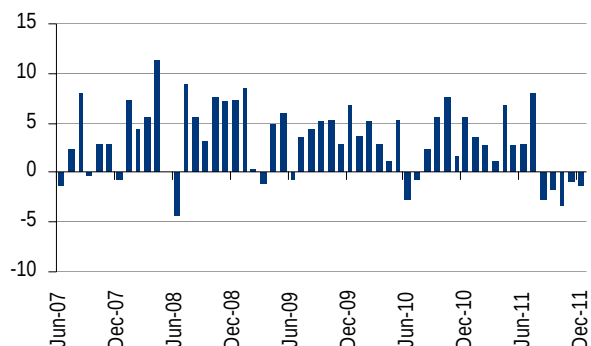
⁴ "International" is funds sold into multiple domiciles. Typically, these are Luxembourg or Dublin funds sold across Europe. The data does not allow us to show exactly where these flows are originating from.

Chart 45: Active equity flows (\$bn)



Source: Strategic Insight Simfund GL/BofA Merrill Lynch Global Research

Chart 46: Passive equity flows (\$bn)

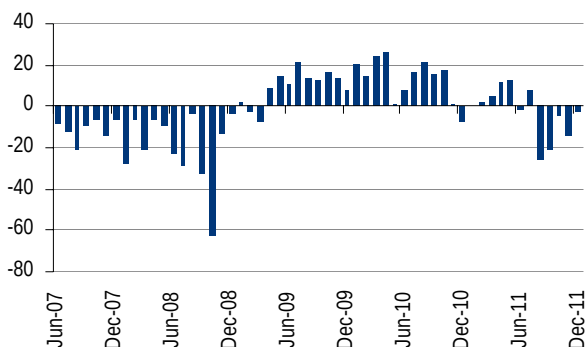


Source: Strategic Insight Simfund GL/BofA Merrill Lynch Global Research

This data highlights the cyclical nature of active equity flows as well as the relatively steady demand for indexed equity products.

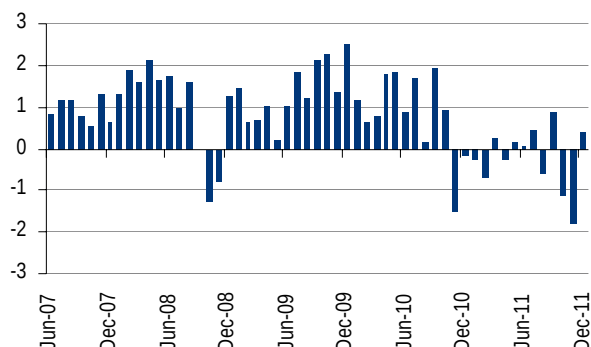
We show similar data on bonds below.

Chart 47: Active bond flows (\$bn)



Source: Strategic Insight Simfund GL/BofA Merrill Lynch Global Research

Chart 48: Passive bond flows (\$bn)

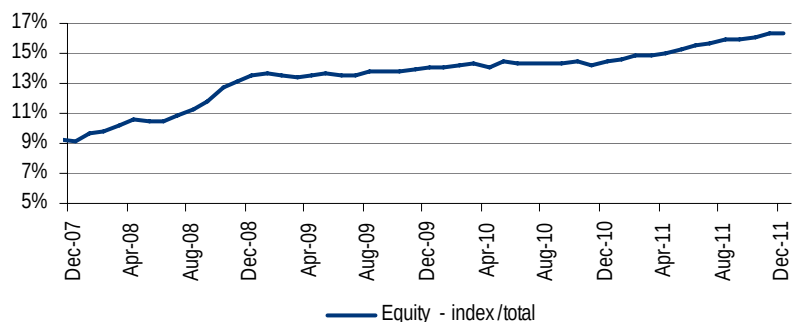


Source: Strategic Insight Simfund GL/BofA Merrill Lynch Global Research

Bond funds, which were one of the winners of investors' equity aversion since the end of 2008, have also been out of favour of late. Within this, the bulk of outflows have come from European bond funds, with areas like emerging markets and global bonds proving more popular. Historically, indexation has not been as big a factor in fixed income, but a number of managers are aiming to increase their representation in this area. Blackrock, for instance, has been vocal here.

We show below the growth of indexation.

Chart 49: Equity - index/total



Source: Strategic Insight Simfund GL/BofA Merrill Lynch Global Research

Indexation has continued to gain ground as an investment style. It is something of a “frog in boiling water” effect. Because indexation’s share has tended to be remorseless but incremental, people maybe have not paid it enough attention. However, indexation seems to us to be a key factor in determining the medium term direction of the asset management industry.

Looking forward

The key issue here is not what flows have been (pretty grim overall in 2011) but what they will become. Our overall views are as follows.

More indexation

To start with our highest conviction view, indexation will continue its upwards path in equities. In fixed income, indexation has yet to make as much progress. We have heard a number of explanations for this. These include there being a plethora of fixed income indices, making indexation problematic, active fixed income being a lower cost style than active equity, making the potential savings less, and fixed income being in a multi year bull market. We know that a number of managers are investigating indexed fixed income.

More alternatives

We expect flows to remain decent into both offshore alternatives (hedge funds, PE) and onshore alternatives – multi asset products, regulated absolute return vehicles and the like. We think multi asset is rapidly becoming established as another asset allocation “bucket” alongside equities, bonds and cash. We talk more about this later.

Bonds - vulnerable?

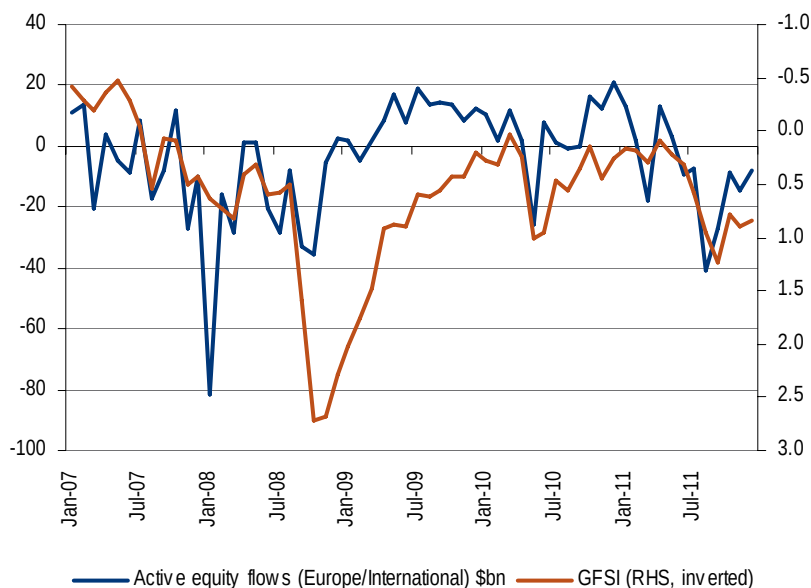
We continue to see bond flows as vulnerable to yields retreating. To be fair, this moment has been a long time a-coming, especially amongst US, UK, German etc sovereign bonds.

Equities - cyclical risk asset

Equity flows represent flows into the ultimate risk asset. We have already suggested that flows correlate with historic market movements. We show below a chart that looks at equity flows into European and international equity funds, set against the GFSI, a BofAML proprietary measure of financial risk to which we

have become very attached. Directionally, the two correlate very well⁵, suggesting that this index can potentially be looked on as a proxy for fund flows. An optimist would point out that this risk measure has been falling of late.

Chart 50: Equity flows correlate with financial risk



Source: Strategic Insight Simfund GL/BofA Merrill Lynch Global Research

We think that equity flows are firmly into the “risk on-risk off camp”. Our general view (or maybe “hope” would be more accurate) is that perceived riskiness will fall over the next few months. This would help equity flows, but we continue to believe that we are in the midst of a secular shift out of unhedged equities. Without wanting to look as if we are randomly quoting people who agree with this position, we recently saw the following comment from Liz Ann Sonders the chief investment strategist of Charles Schwab “The stock market has effectively doubled since the March '09 low, and we're still in redemption territory for equity funds. That's never happened⁶.”

⁵ We have inverted the scale of the GFSI to make the relationship clearer.

⁶ Quoted in Bloomberg story “Stocks least loved since '80s as U.S. scales wall of worries (6 Feb 2012)

Demographics revisited

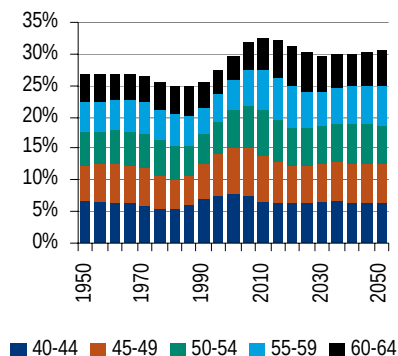
The problem with demographics is that it is unusual for you to be able to come up with something new on an annual basis. All that has happened over the past year, as far as we are aware, is that we have moved a year along the various population distribution curves we show.

We have reproduced a few of these simply because although they are not fast moving, they are important.

Large fund markets ageing

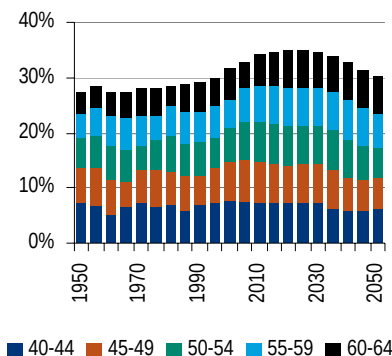
We have taken data from the UN population database. Overall, the message is that although globally demographics looks good for the asset management industry, when you look at large fund markets – the US, Europe and Japan – you find a less favourable picture. Global data is driven by large areas such as Africa, India and Latin America, where fund markets are overall much smaller (although the Indian market and LatAm do seem interesting ones). China's demographics can be seen as explaining a lot of its behaviour, in that whilst it is now reaping a significant "demographic dividend", this is likely to go into reverse pretty dramatically as the century progresses. We show below three charts which encapsulate this.

Chart 51: USA - age structure



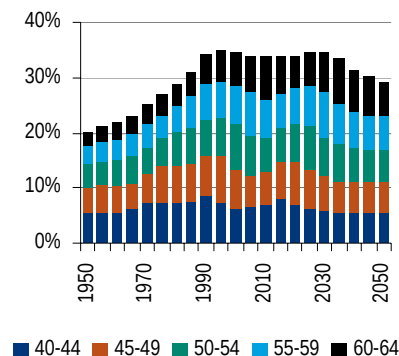
Source: UN World Population Prospects 2008 Revision/BofA Merrill Lynch Global Research

Chart 52: Europe - age structure



Source: UN World Population Prospects 2008 Revision/BofA Merrill Lynch Global Research

Chart 53: Japan - age structure



Source: UN World Population Prospects 2008 Revision/BofA Merrill Lynch Global Research

In the US, the "boomer" generation is retiring, and the risk taking age segment is shrinking. In Europe, this is further off, and a bit less dramatic, but still a powerful long term trend – the greatest risk-taking segment here has already peaked. Japan is ahead of its time – the risk-taking cohort peaked in 1990.

So what?

We still think that the overall shift in the population from accumulation to "decumulation" in the jargon is a significant factor in the overall move we are witnessing towards more risk controlled, income producing investment products.

Emerging trends: 1. increasing regulation

In the next two sections we have tried to pull together some of the trends which we think will influence industry structure over the next few years. We believe that the rise in indexation and the rise in risk-controlled management styles are both established trends. They therefore do not feature here, although we talk about them elsewhere in this note.

Post the credit crisis we have seen a sharp increase in the amount of financial regulation being proposed⁷. Regulations affecting the asset managers break down into two types, we think. First, there are regulations which directly affect the business and second there are those which have an indirect effect.

Indirect

To start with the last, first, there are number of areas where regulation has implications for asset management, albeit at one step removed.

Dodd-Frank, MiFID

The various regulations updating OTC trading will have significant implications for the asset management industry, as it is likely that a significant number of firms will be included in the "major swap participant" category of Dodd-Frank, and so will have to clear clear-able OTC securities. This is one of a number of issues which feels as if it is largely technological and administrative, but which could easily prove time consuming and expensive for managers. We imagine some will opt to clear directly, and others to clear via a third party (presumably a large bank). Either process, though, will require operational investment, as will the potential need regularly to post variation margin. The European equivalent regulations are lagging somewhat behind the US (though Dodd-Frank implementation has lagged its own putative timetable!). However, they are likely to move in the same direction.

FTT/choice of domiciles

Various forms of financial transactions taxes are sporadically discussed in Europe. Most recently, both of the leading candidates to be the next president of France have supported a FTT, in France only if needs be. We think that such a measure would be complex to implement successfully, but such talk certainly focuses attention on how asset managers have structured their businesses. Does an asset manager need structures in a range of tax domiciles? Does it need perhaps a non domestic European centre, a non EU centre (Switzerland and Singapore are often mentioned) and an offshore centre (such as the Cayman Islands)? These decisions again add complexity to the business, without it being obvious that they are adding any revenues.

Direct

There are some important regulatory developments which directly impact the industry.

⁷ Clearly, we are not lawyers, and are offering neither legal advice nor legally complete summaries of mooted regulations in these comments. We are picking out some high level themes and issues.

FATCA

This is a measure aimed at the taxation of assets held outside the US by US taxpayers. It imposes a 30% withholding tax on inter alia US interest dividend payments as well as gross proceeds of sales of investments unless the so-called “foreign financial institutions” in essence collect all the information necessary to reassure the US IRS that all due tax is being paid by US clients. This will require managers to invest in IT, to change data management systems and so forth. The US has recently announced some proposals which may make the process more do-able for managers. It has agreed to explore a system whereby the UK, France, Germany, Italy and Spain will collect the necessary information, which will be shared with the US IRS on a reciprocal basis. There is, we suspect, some water to flow under the bridge here.

US Money Market reform

The US is also close to proposing new regulations for money market funds. Our US colleague Cynthia Mayer has written on this topic as it concerns Federated Investors. The immediate reason for the proposals is the desire to avoid a repeat of the issues around the Lehman, when the large “Reserve fund” “broke the buck”. This is US money market speak for seeing your fund's NAV drop below one. The SEC has been reported in the print media to be considering offering funds the choice between a floating NAV (which would be anathema to the industry) and a combination of capital buffers and restrictions on investor withdrawals. In Cynthia's words “Stay tuned, the process is likely to be a long one⁸”.

Short selling rules

Likely to be implemented in November 2012, the European short selling rules are likely to disclose net short positions in equities and sovereign debt. So-called “naked short selling” will be banned, requiring managers to have procedures in place to make sure they comply with the regulations.

Solvency II

Solvency II is a long-running issue, which seems still to have much further to run. However, barring a major volte face, it will require asset managers managing insurance money to provide a wealth of data to help feed insurers' solvency calculations. Again, there are IT issues here.

Solvency II has, we think, already played a major role in encouraging insurers to de-risk their investment approaches, although given market performance this may have been pushing at a relatively open door. It is hard to be categorical about the ultimate effect of the regulations, given they are still in a state of flux, but we can envisage a mini-industry growing up, dedicated to providing insurers with “solutions” to the requirements of Solvency II. This could well have implications for product development.

Sections of the industry are also fretting about a European consultation about extending Solvency II to pension schemes. The buzz-word for this is IORP (i.e. potential changes to the directive on Institutions for Occupational Retirement Provision). Those involved in the consultation occasionally take to the press to reassure people that the intention is not to transplant Solvency II lock stock and barrel into pensions regulations. However given the implications of doing exactly

⁸ See Cynthia's note of 10th February 2012 “Federated Investors – Lowering to Neutral on greater regulatory risk” for more details.

this on the asset/liability mix of pension schemes, we suspect that there will remain chatter on this topic until the ink is finally dry.

Solvency II interacts with Basel III. At present, the two regimes do not fully align, adding on the one hand complexity and on the other opportunity. Both of these, though, spell to us “cost”.

RDR/MiFID

We wrote on the UK's RDR just over a year ago. This process continues to grind forward, with a mooted start date of the beginning of next year. To recap, the RDR, amongst other things, bars the payment of sales retrocessions to advisors by fund management companies. We are still waiting for a concerted response by the industry, but current consensus wisdom is that managers will offer RDR share classes (effectively reducing the management fee by the retrocession). This would allow distributors to add a charge on top whilst keeping the investors' position as before. In addition, the increased focus on fees that this is likely to bring seems set to increase the appeal of indexation. The argument here is that advisors who provide a holistic service to their clients will aim to reduce the manufacturing charge, partly as a way of safeguarding their own economics. The suggestion is that the market will either determine some kind of “going rate” for a total fee load, or compete on fees as well as service quality.

We will talk in this note about RDR more than the UK's share of the European industry suggests is necessary, simply because we think it is an interesting example of the likely changes which will occur more broadly.

Asset management industry responses

We have seen two concrete asset management industry responses.

“Clean” share classes

Schroders has been early in launching share classes that simply charge a manufacturing fee “on all UK domiciled funds, with the exception of a few such as those which are soft closed”⁹. The consensus view is that this is a route that everyone will have to follow eventually. There are a couple of complexities, though. First, the treatment of platforms remains unclear under RDR, though Schroders point out that they were simply responding to the demand from some platforms, such as Cofunds, which claims on its website to have introduced “a new ‘unbundled’ pricing model”. Second, some people have mentioned the fact that some distributors are reputed to receive a fraction more rebate than the norm. Will they have their own share classes?

Regardless, it seems logical to envisage that all players attacking the UK market will register similar share classes. There will be a one off cost, and presumably higher running costs overall, but this will be the cost of doing business in the UK.

Low fee units

The second approach is to launch low fee units. These are typically mutual fund versions of institutional products. They therefore are unlikely to cannibalise a company's higher fee offerings. They are aimed at two objectives. First, feeding the post RDR desire for lower cost products. Second (and in a way, this is the same point) providing a response from active managers to the growth of indexation. The idea is to position a fund as a slightly higher fee alternative to an

⁹ James Rainbow, Schroders' head of UK marketing, quoted on Citywire(24/10/11)

index fund, but with some alpha (but not as much alpha as the higher fee products). Whilst clean share classes are in essence administrative, this approach is more interesting. The issues with it are clear. How can a fund manager position its products accurately enough to ensure that investors are being charged the right amount? Will investors understand the various positionings? Will people genuinely be prepared to pay an extra fee for a possible outperformance of index products, when this outperformance is uncertain?

We shall see. Certainly, this is a development which we did not expect a couple of years ago, but which seems to have built up a head of steam at present.

Distributor responses

The UK advisor community is highly disparate, making it harder to comment about its response to the RDR. However, we have heard people suggest that the industry will look for:

- more indexation, to help reduce the overall fee load, as discussed earlier; and
- more multi asset (including multi manager) to reflect a desire to outsource management, focusing on planning.

MiFID/PRIPs

MiFID appears to be pointing in a similar direction. For example, Article 24 of the MiFID Directive is proposed to say that:

When the investment firm informs the client that investment advice is provided on an independent basis, the firm:

(i) shall assess a sufficiently large number of financial instruments available on the market. The financial instruments should be diversified with regard to their type and issuers or product providers and should not be limited to financial instruments issued or provided by entities having close links with the investment firm,

(ii) shall not accept or receive fees, commissions or any monetary benefits paid or provided by any third party or a person acting on behalf of a third party in relation to the provision of the service to clients¹⁰.

These two provisions mirror closely the RDR language about independent advisors having to survey the “whole market” and not receive commissions. To be fair, this is a “Directive” not a “Regulation”. Confusingly (at least to us), “Directive” is EC-ese for “suggestion” or “something member states may ponder at their leisure”. Regulations are things that have to happen. So, for example, provisions about OTC trading, clearing and trade reporting are contained in a Regulation.

PRIPs

The EC is also in the midst of considering its approach to “PRIPs” – packaged retail investments products. We expect to see some firm developments here this year. At present, the Commission has published a paper on the topic¹¹, and

¹⁰ EC COM(2011)656/4 P 77

¹¹ EC COM(2009) 204 final

undertaken some consultations and cost benefit analysis. The idea here is that there should be some harmonisation of the treatment of various retail products such as funds, life products and structured products.

The PRIIPs paper looks pretty much like a high level version of MiFID. It stresses suitability – a very big topic now, we think. The EC paper talks about investors receiving “clear and effective disclosures of remuneration arrangements and all charges, commissions or fees paid” on products¹². This is not exactly what is proposed in MiFID, but seems to be heading in the same direction. The paper also talks about extending the MiFID rules to all relevant products¹³.

Suitability

There is also an increased emphasis on product suitability. For example, the UK’s FSA is in the midst of a consultation about this area. This was launched by its January 2011 paper “Product Intervention”¹⁴. In the words of the FSA’s Chair, Lord Turner:

This Discussion Paper is different in scope to many of the papers we publish. It proposes a quite new and more intrusive approach to the regulation of retail financial services, aiming to ensure that potential consumer detriment problems are identified and offset at an early stage.

At present, the FSA focuses on regulating the point of sale. The FSA argues that empirically, it has seen waves of regulatory issues rising to the surface, often centred around one set of products at a time. The agenda therefore appears to be moving towards a system of regulation which heads these issues off at the pass by “intervention earlier in the value chain”¹⁵. This is still work in progress in the UK. In Europe, the same topics are current (this was, for example, topic in the MiFID review).

We are, in our view, a long way from clarity on this topic. However, it is worth at the very least noting that it appears to be a new stream in the regulatory workflow.

Overall

Overall, it seems as if regulation across Europe is moving in the direction of greater openness on fee and commission payments, and a greater stress on suitability. It seems reasonable to us to assume that the RDR will provide a guide to how these debates will evolve elsewhere. Overall, we see over the medium term:

- increased use of index products;
- increased use of third party products;
- increased fee sensitivity among investors, leading to more discussion of value for money when looking at investment products.

¹² P 11

¹³ P 10

¹⁴ DP11/1, available on the FSA website

¹⁵ P 18

Increased cost base, new opportunities

We think that the current spate of regulatory reform is causing a material increase in asset managers' costs. Direct compliance costs are likely to rise, and any of these developments are also likely to call for infrastructure investment. We see this as being one of the forces which is encouraging managers to focus their strategy closely on profitability and competitive advantage. Aviva, discussed later, is in our view an early visible sign of this.

We definitely think that regulatory change is increasing the focus on management and distribution costs, at the same time as increasing costs for product providers. Without wanting to sound too Pollyanna-ish, though, these changes also create opportunities. Specifically, we think that opportunities are progressively opening for managers who are able to produce products with attractive risk/reward properties. We also think that the increased regulatory complexity will increase scale benefits, presumably increasing industry concentration.

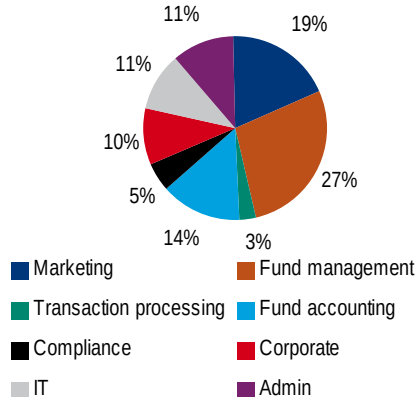
Emerging trends: 2. Manufacturing/distribution split

Business models have not evolved materially over the past decade or two, in our view. However, there are signs that this may be starting to change, with companies taking a more eclectic view of the appropriate mix of manufacturing and distribution in their businesses.

Another trend we are beginning to see discussed more often is the balance between manufacturing and distribution. In most cases, this involves some shades of grey. The only manufacturing only models we can think of would be proprietary traders, individual investors and the odd family office. These businesses have no interest at all in gathering third party assets. They have captive assets and seek to manage these. There are also some distribution only models. Platforms can fall into this category where these simply sell themselves as efficient administrators of assets.

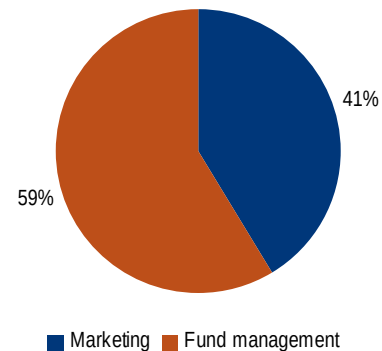
Most of the mainstream asset managers look like manufacturing only models, but in reality, they spend a significant amount of money on distribution. We show below some data from the IMA, which breaks its respondents' employees down by function. Note that this represents headcount not overall compensation. You would probably guess that fund managers overall earn more than the average employee here, but distribution professionals can be pretty well paid as well, we suspect.

Chart 54: Distribution of staff by activity (direct employment only)



Source: IMA, 2010-2011 Annual survey

Chart 55: Marketing vs. fund management



Source: IMA, 2010-2011 Annual survey

It is perhaps striking that only 27% of the people employed by members of the "Investment Management Association" actually **Manage Investments**. In our view, this in part highlights the increasing costs associated with participating in the industry at all. Within this, though, manufacturing represents around 50% more headcount than distribution. Distribution is the second largest employer of people in the industry¹⁶.

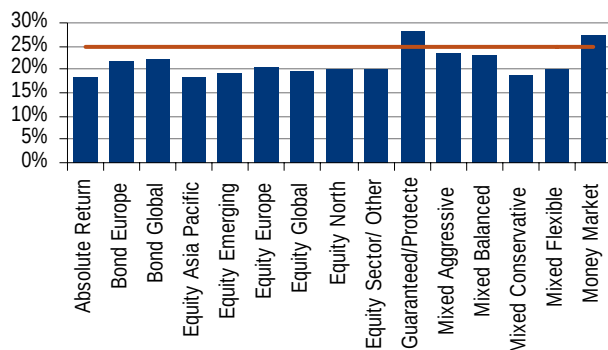
This ties in with our quantitative analysis of the industry. In our note "Winner takes it all"¹⁷, we showed that performance has a demonstrable impact on fund sales.

¹⁶ Well, the UK industry, but the IMA sample is a pretty broad one, and so likely to be representative.

¹⁷ 5th September 2011

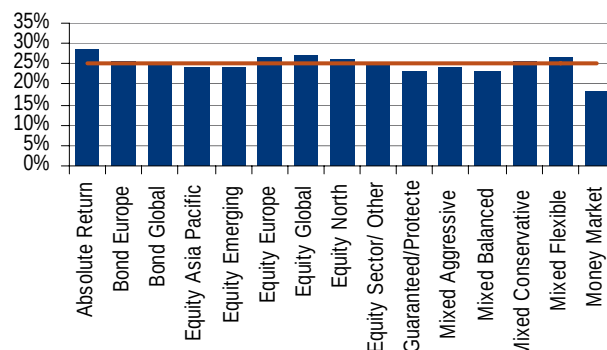
The note is full of data. We have just reproduced here two charts. These summarise the results of one of the tests we used – whether a fund had spent one year in the bottom quartile over the previous three or four years, depending on the length of record for the sector. We looked at what percentage of funds which had experienced this found themselves in the first and fourth quartile for fund sales.

Chart 56: Top 15 sectors - Fourth quartile in last three years - top quartile sales



Source: Strategic Insight SIM fund Global/BofA Merrill Lynch Global Research

Chart 57: Top 15 sectors - Fourth quartile in last three years - bottom quartile sales



Source: Strategic Insight SIM fund Global/BofA Merrill Lynch Global Research

For thirteen of the fifteen large sectors we focused on, the common-sense relationship “fourth quartile year = dull flows” worked. Overall, the best selling funds were under represented in the set of funds which had experienced a year of disappointing performance. The data for the fourth quartile of sales is patchier (see the note for more discussion of this), but overall we took our data to confirm that performance does impact flows. This is a relief to us, it has to be said.

However, a significant amount of variability remains. Most of the bars in the left hand chart are in the 20% zone. That is, around 20% of the top selling funds have had a year in the bottom quartile. The same pattern was on show for the other tests we devised. This variability has, we think, to be down to the “soft” factors such as distribution, client service, brand name and luck. This is probably why managers spend so much effort on distribution.

So, if you are aiming to make a living by managing other people’s money, you cannot do without some kind of marketing. In “the good old days”, many hedge funds came as close as any, with marketing being a pretty small part of the overall business. Even these, though, made some nod towards distribution, even if it was only being nice to the big fund of funds groups, attending a few PB events and sending out a monthly letter.

Can you do without manufacturing? If by “manufacturing” you mean working to provide the end clients with products which meet their needs, we hope the answer is “no”. If, though, you mean picking individual assets directly, we think the clear answer is “yes”.

The increase in complexity which the asset management industry is seeing is progressively increasing the fixed costs of asset management. At the same time, technology and regulation is making performance ever more transparent. In our view, this is shifting the cost/benefit balance from aiming to be all things to all people towards a greater use of third party products. If you were, say, a financial

institution with a strong customer franchise, it might well make sense to focus on asset gathering, product design and risk management/asset allocation, at the expense of direct manufacturing.

Private banks and wealth managers have been doing this for decades. They have become increasingly sophisticated and demanding assemblers of financial products. These can include mainstream mandates, index products, hedge funds, regulated absolute return funds, some more exotic vehicles and some hedging. There is a clear skill to doing this well, and it is highly valuable to client. It is simply not a traditional manufacturing activity. We think that over the next few years, a range of companies will move from being fully vertically integrated to more hybrid business models.

Although this trend might take on new forms, it has been happening for some years, with the share of third party products growing across Europe.

Aviva - focusing on areas of advantage

We may, therefore, see more announcements like Aviva's. There are a few different strands to this, so it is interesting to have a look at the company's statement.

"Aviva Investors, the global asset management business of Aviva, is proposing to streamline its business, leveraging its strengths in key asset classes and prioritising its distribution effort towards the institutional market...the conclusion of the review was that the business strategy is sound but that greater focus in core areas of strength would improve profitability and enable Aviva Investors to continue to invest in the development of its global infrastructure.

Aviva Investors therefore proposes to streamline its business to concentrate manufacturing activity in Fixed Income, Real Estate and Multi-Asset Solutions, where the business sees growth potential and already has a strong competitive position. In addition the economic downturn has been the catalyst for a change in client behaviour across the asset management sector, with a reduced appetite for riskier assets such as equities, notably in Europe.

As a result Aviva Investors is proposing to reduce the scope of active equity management in London, focusing on the core market in each of its four regions and eliminating duplication by removing London based European, Emerging Markets, Global and Sustainable Responsible Investments (SRI) equity desks. Aviva Investors plans to retain its strong indexing and quant capability, and to have one active portfolio management capability in each of the main markets, retaining all the expertise required for multi asset solutions¹⁸."

In other words, the company has decided to streamline manufacturing to focus on areas where it sees a mix of superior profitability, good client demand and competitive strength.

Same idea, different implementations?

Other managers are likely to choose different products. Some, especially the heavily retail facing ones, might decide to opt out of direct manufacturing at all. In the US market for instance, subcontracting is relatively common. Vanguard, for example, subcontracts direct asset selection to a range of third party entities.

¹⁸ Company press release, 30th January 2012

This does not seem to have held back its progress. We would not be surprised to see people in the European market moving in the same direction.

Mutual fund proliferation

In this vein, it's worth revising another fact from our "Winner takes it all" note. In this, we looked at over 28,000 funds. Of these, 20,000 had net flows of less than \$100m in either direction over the previous five years. The 100 largest represented around 15% of total assets, the next 100 6.4%, then 4.6%. 300 funds, a fraction over 1% of the total, represented over a quarter of total assets.

We know that this is all more complex than it appears. Some of these funds are aimed for specific markets, which is necessary due to different tax rules, local preferences and so on. Others will be being incubated. It is much more difficult and expensive to close and merge funds than it sounds. All these are potentially perfectly valid arguments for fund proliferation. However, we still struggle to see that we need 28,000+ European/International registered funds, or that it is financially sensible for the industry to be managing this number of vehicles.

So, to sum up, we see increasing differentiation of businesses. Some will remain "waterfront" managers, offering all things to all people, or an approximation of this. Others will focus on areas of excellence. Others still might emphasise their distribution operations. The upshot, we think, is likely to be more consolidation at the manufacturing level.

M&A?

Industry M&A has largely been the dog which has not barked. Whilst deals have been done, these are small compared to the amount of deals that have been talked about. We think this is probably down to a few different reasons.

- It is easier to identify sellers than buyers. At the right price, many capital-hungry businesses would be willing to dispose of their asset management businesses. The list of potential buyers which tend to be mentioned is a select group.
- It is easier to make deals work in theory than in practice. This is due to the "soft" issues involved, as well as to the typical client response to ownership changes.
- It is far from easy to value bank-owned businesses. These tend to have a significant distribution component, but this is linked to the bank infrastructure.

We still think these represent significant hurdles. Over time, though, it would be logical for M&A to form a part of the process whereby industry concentration increases. The widely flagged sale of Deutsche's asset management businesses (excluding the DWS mutual fund unit in Germany) will be an interesting test case here.

Regulated absolute return/multi asset products

We continue to expect market share gains from onshore alternatives, and multi asset products. Overall, these have, we think, provided better risk adjusted returns for investors than the core, beta-ed asset classes. They also provide a potential answer to what investors will buy when they don't want to buy bonds.

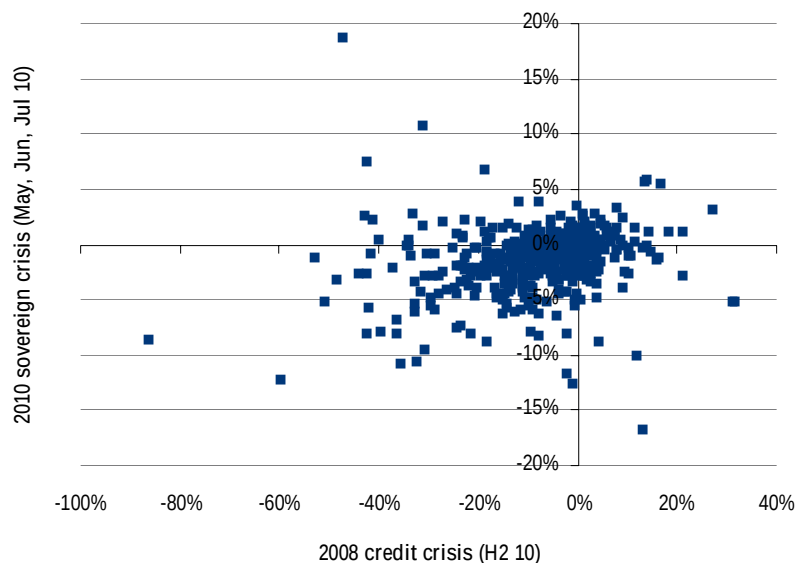
A few facts

Our derivatives research group has undertaken some helpful work on the European regulated absolute return universe. This is easier said than done, because the industry has developed more quickly than the data providers' classifications. Therefore, it takes a lot of manual work to arrive at a proper dataset. Multi asset products represented around 40% of the total AUM identified at the end of August 2011, coming in at \$86bn. Overall, the regulated absolute return sector has more than doubled AUM since the end of 2008.

How has the universe performed?

We show below the performance of the regulated absolute return universe through two periods of stress, the credit crisis and the sovereign crisis. We think it is interesting to look at times of stress, as this should put the risk management skills of the managers to the test. We show some data covering the credit crisis and the 2010 sovereign crisis below.

Chart 58: Returns of European regulated alternative funds, credit and sovereign crises

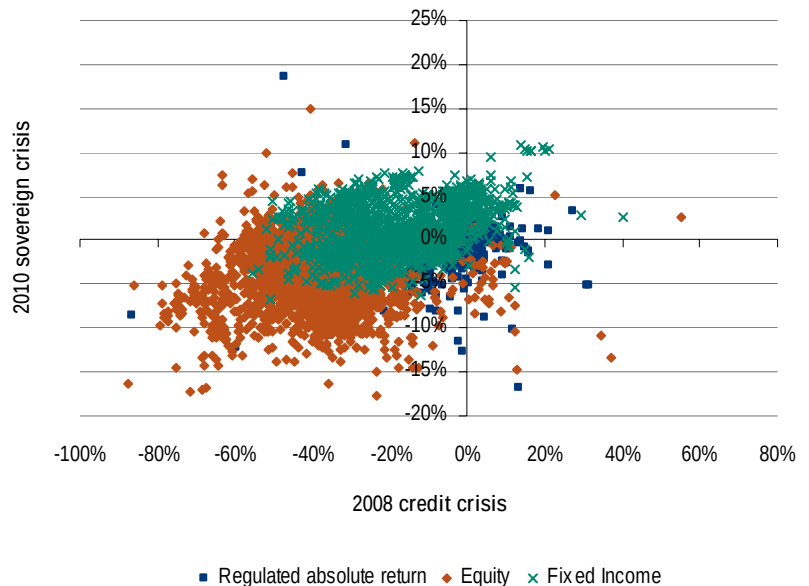


Source: BofA Merrill Lynch Equity Derivatives Research

A number of reactions are possible here. One is to say "that's not very absolute, is it?". Indeed, it is not. Only a minority of funds managed to be positive in both periods.

However, we think this lacks perspective. We struggle to think that it is reasonable to expect risk investments to be positive through two such difficult eras, especially given the high correlations between asset classes on display. A more realistic question is whether the universe has provided investors with a better experience than the beta-ed asset classes. We show some data on this below. It is hard to interpret this over precisely, as the data series overlap, but it seems pretty clear that the equity universe underperformed the regulated absolute return sector significantly in both periods. Fixed income also had a worse credit crisis, although it is hard from this display to tell how it fared in the sovereign crisis.

Chart 59: Absolute return vs. unhedged equity, fixed income



Source: BofA Merrill Lynch Equity Derivatives Research, Strategic Insight SIMfund Global

In other words, we think that the onshore advanced funds performed as well as they could realistically have been expected to do. Overall, the universe protected clients from the worst of the drawdowns in both periods. If you use the median to summarise the performance of the three categories, you find that the regulated absolute return universe clearly dominated equities, and materially outperformed fixed income in the credit crisis. Fixed income did a bit better in the sovereign crisis, overall. When you consider that fixed income is in the throes of a multi year bull market this is not a bad outcome.

So, we would conclude that so far, the onshore advanced funds have delivered for their investors. It is increasingly important that the industry makes sure that investors understand this! If you believe our argument that regulators are set to focus increasingly on product suitability, it is important that investors understand the difference between a product which aims to manage risk and provide non benchmark related returns over time with one which aims never to go down. In our view, the latter is a money market fund.

Multi asset major area for growth

That said, we continue to think that multi asset will be a major focus of both product development and investor interest over the next years. We could easily

see a situation where multi asset becomes another bucket into which investors allocate assets, alongside equities, fixed income and cash.

There are a number of themes at work here.

- Firstly, as our (admittedly brief) section on demographics argues, Europe and the US are both experiencing a transformation of their **demographic footprints**. Overall, we are moving from risk taking mode to risk managing mode. Multi asset products offer this.
- At the same time, they offer a tempting answer to the question “what will people buy when they **stop buying bonds**”. Given that a range of sovereign bonds have enjoyed multi decade bull markets, it seems reasonable at least to consider the issue of what acts as a replacement product here.
- Also, multi asset products form a way of reintroducing **asset allocation** into the mix. By and large, traditional beta-ed products had left the asset allocation component to the investor. The desire to bring back asset allocation holistically into the investment process also is, we think, a factor in the rise of global equity and bond mandates.
- Lastly, multi asset products also provide a way of bringing **advanced risk control** into the equation. By packaging together the ability to invest across geographies and through the capital structure with an ability to use derivatives to hedge, multi asset products provide investors with access to sophisticated risk control.

In the institutional market, varieties of multi asset investing are being used alongside liability hedging in LDI type approaches.

None of this makes multi asset a “with one bound, they were free” solution to the issues in the asset management industry. It is a skill based style. Managers have the opportunity to manage in the style well and badly, and this will no doubt be a major factor in determining who manages the “category killer” funds here. However, it marks another development of two product themes we have talked about before.

- Firstly, we have been perplexed by the disconnect between technical innovation in asset management and a striking lack of product innovation. Multi asset represents a clear example of innovation moving into the product area.
- Secondly, allied to this, it represents a kind of democratisation of multi strategy or macro hedge fund styles.

It also enables managers to move away from the core beta mandates which are vulnerable to index fund substitution.

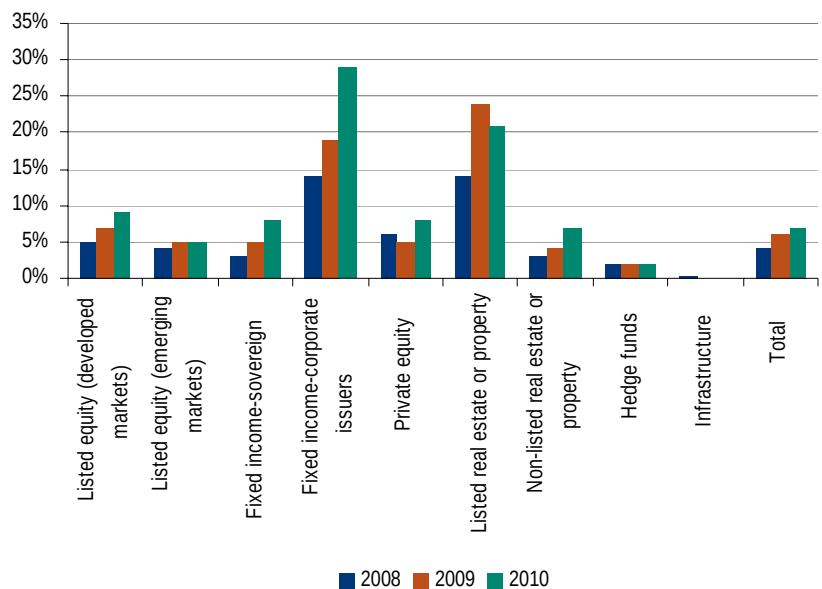
SRI - growing but changing?

Since we last wrote on SRI¹⁹, there has been some good news and some mixed news for aficionados of the style.

Progress

To start with the good news, adoption of the style seems to be increasing. The only new data we have seen has come from the UN PRI, covering 2010. This shows that the number of managers signed up to the PRI has increased as a percentage of the total investible universe pretty much across the board. The chart below shows the progress here.

Chart 60: UN PRI - signatories by specialism



Source: UNEP Finance Initiative/UN Global Compact Report on progress 2010, 2011

Some recent signatories of the PRI include PIMCO and Man.

Pimco

PIMCO has published an interesting Q&A on its approach to ESG analysis, arguing that this is an integral part of the company's process. For example:

"PIMCO's secular processes and our long-standing emphasis on medium to long term sustainability as opposed to unsustainable short-term performance underpin our focus on the longer term dynamics that are at the core of ESG issues²⁰."

In other words, for PIMCO ESG analysis is a core part of their overall investment approach.

Man

Man's Pierre LaGrange was pointing in the same direction when he said of Man's signing the PRI "Investing sustainably enhances long-term value and reduces risk

¹⁹ In "Landscape moving fast: risk moves centre stage", 11 Feb 2011

²⁰ Source: PIMCO, December 2011

which is clearly good for all concerned: investment managers, their clients, society and the environment". Man points out that it is "already working in line with the PRI" by, amongst other things "investing in technology and training to enable investment managers to take ESG factors into account and encourage listed companies to improve on ESG criteria"²¹.

Debatable

The less good news is the demise of two longstanding SRI teams, both London based. At the end of last year, Henderson decided to close down its SRI team, whilst Aviva's team was one of the casualties of the company's refocusing, discussed earlier.

The specialist SRI press has not reacted well to these announcements²². This is understandable, as both have been seen as standard bearers for socially responsible investing. However, whilst clearly disappointing for both the individuals involved and their clients, the picture may be more complex than the headlines suggest.

The debate boils down to an issue we discussed last year, the difference between engagement and some kind of purer SRI mandate. The growth of SRI over the past few years has been driven by integration, which "involves managers viewing information about non-financial aspects of a company as input into decision-making" as we put it last year.

It is integration which PIMCO and Man talked about when commenting on their signature of the PRI, and integration which has led to the dramatic increase in SRI assets in mainland Europe. Again as we argued last year, core SRI is a slightly land-locked strategy, whereas integration can appeal to a much broader group of investors. Whilst we would not seek to argue that losing high profile core SRI teams is good for the movement, paradoxically, it probably reflects an increasing acceptance that incorporating ESG criteria in investing can form part of, and enhance, a mainstream investment process.

Our view

Our view remains unchanged. We think that demand for investment management which integrates ESG analysis into decision taking will continue to increase. For example, the UN 2011 survey suggested that 77% of asset owners surveyed included ESG criteria in RPFs, up from the mid 60s in 2010. This will add to the complexity, and potentially cost base, of asset managers. However, it is important both in safeguarding a competitive position, and enabling a manager to pitch for new business.

²¹ Source (both): Man press release, 30th Jan 2012

²² See, for instance "RIP Henderson, but what now?", Ethical corporation 9/12/11 and "Henderson was a canary in the coalmine, Aviva is an explosion in the SRI business..." (Responsible Investor, 2/2/12)

Prospects by segment

So what does the next year hold for the various segments of the asset management world?

Index managers

Broadly, life remains good for this select group. There is some squabbling about synthetic versus physical ETFs in Europe, but aside from that, the sky is blue. Regulatory trends in European retail seem to favour index management. The recent uptick in interest in asset allocation and risk management amongst both retail and institutional investors has also shifted focus towards beta.

The physical/synthetic debate is an interesting one. The proponents of synthetic ETFs point out that in Europe, most physical managers earn a lot of their returns from stock lending, which has issues with collateral just as synthetic ETFs do. Others point out that in the US, ETFs don't engage in stock lending. Our view is that the debate about collateral is a real one, and that a bit more clarity would not go amiss. However, most European ETFs are UCITS products, and the UCITS regulations place significant limits on investors' exposures.

Anyway, this is a little local difficulty, we think. Indexation should continue to grow, which is good for index fund managers, probably modestly good for advisors, and a continued source of angst for active managers.

Mainstream managers

The mainstream industry is facing a number of issues. The cost of doing business is increasing, as is business complexity. At the same time, the growth of indexation has, logically, to equate to a shrinking of "activation". Finally, we think that client demand is moving away from traditional beta-ed asset classes, towards hedged, risk managed or multi asset products, and towards "solutions". Although this is not a word that especially appeals to us, it is being used increasingly. Crudely, it means that the industry should move away from answering the questions it wants to (such as "what stocks do you think will outperform the benchmark?") to the questions the client wants answering – how do I achieve a certain level of income, how do I protect myself against inflation, and so on.

That said, the mainstream industry still possesses a number of strong strategic advantages. These include:

- extremely powerful distribution,
- a large existing book of business and
- investment talent.

The mainstream agenda has been for some time that of shifting its business away from core, beta-ed mandates towards more advanced management styles. Overall, it has done a decent job of this. The success of Standard Life's "GARS" products is a clear example of this, as are the Amundi volatility funds. However, other managers have also made consistent progress. This can be in terms of more eclectic fixed income products, or multi asset, equity long/short, commodities, agriculture, and so on. Scratch what looks like a traditional manager, and you will probably find some relatively un-traditional products.

The challenge for the mainstream community is continuing this process against a backdrop of rising costs. The opportunity is twofold. Firstly, by migrating assets towards more advanced styles, the industry can potentially avoid direct competition with the index community. Secondly, it can potentially market higher fee products, increasing revenue yield to compensate for market share losses to indexation.

We also believe that mainstream managers who rise to this challenge have the potential to boost AUM by benefitting from others' desire to streamline their business, and stress product assembling and distribution.

Hedge funds

The hedge fund industry is overall in reasonable health. AUM is close to peak levels, although 2011 was a difficult year for performance. Regulation has no doubt been a hindrance for the industry, with short selling bans, some registration requirements and the like, but the backdrop still seems tolerable.

At the same time, start-ups seem to be increasing again. This is, in our view, an important measure of the health of the hedge fund sector. One of the successes of hedge funds, in our opinion, is the way the industry continues to rotate capital from funds which have not met performance expectations to stronger funds. This is all fine, but needs an environment in which new funds are constantly being created. 2011 was a year when seeding seems really to have taken off again as an investment approach. This both encourages new start-ups and also imposes some quality control.

2012 will probably be a "more of the same" year for the industry. In our view, the key challenge for hedge funds will be accessing onshore AUM. This has typically proved to be a difficult thing for the vast bulk of funds to achieve, as they still tend to lack onshore distribution.

Overall

On a one quarter view, the asset management industry is in many ways a cork bobbling on the surface of capital markets. There are, we think, strong correlations between market movements, risk measures, flows and asset management ratings. Asset management stocks are "risk on" investments, and profitability will wax and wane along with market levels.

Longer term trends

On a longer term basis, we think that there are some definite trends which provide a following wind for some.

- We think that **index** and **advanced management styles**, including various forms of multi asset investing, will gain market share.
- By definition, something has to lose share, and we think this will be **mainstream active mandates**.
- We think that we will see increasing **differentiation between business models**, with some opting to increase focus on distribution and product assembly.
- **Regulation** is likely to play an increasing role in the industry over the next few years. In particular, we think that regulation will increase the **focus on costs** in retail management.

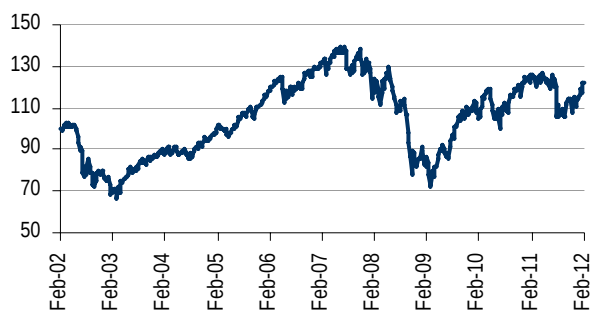
- **Scale** will become more important. Capacity management will remain key to investment success. However, we think the increased complexity of the asset management industry now, in terms of regulation, distribution and product, is tipping the scales towards size.

2012 so far has smiled on the asset management industry, as market moves will drive revenues up. However, we feel the pace of change remains significant. We suspect this will become increasingly clear over the next year or two.

Appendix - Background charts

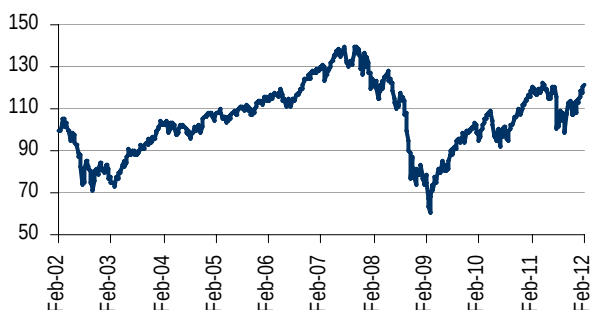
We show below the performance of some key local markets. All are in local currency aside from Asia, which is in US\$.

Chart 61: FTSE All Share



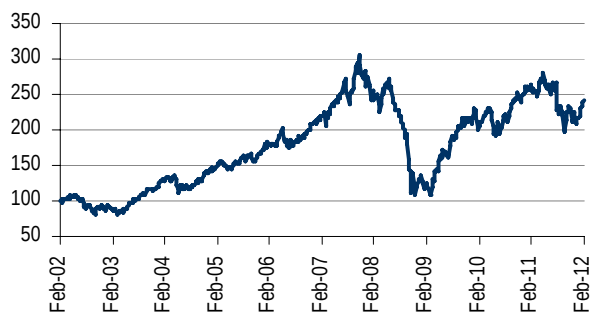
Source: DataStream/BofA Merrill Lynch Global Research

Chart 62: S&P Composite



Source: DataStream/BofA Merrill Lynch Global Research

Chart 63: FT World Asia Pac ex Japan



Source: DataStream/BofA Merrill Lynch Global Research

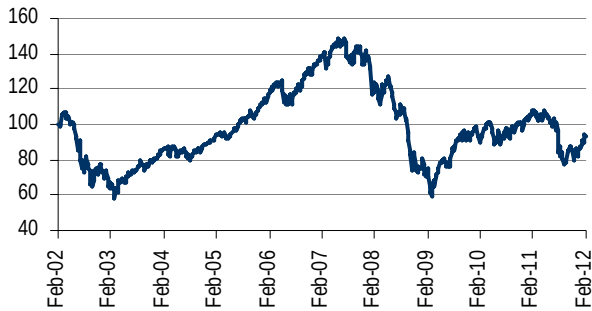
Chart 64: Nikkei 225



Source: DataStream/BofA Merrill Lynch Global Research

16 February 2012

Chart 65: FT World Europe ex UK

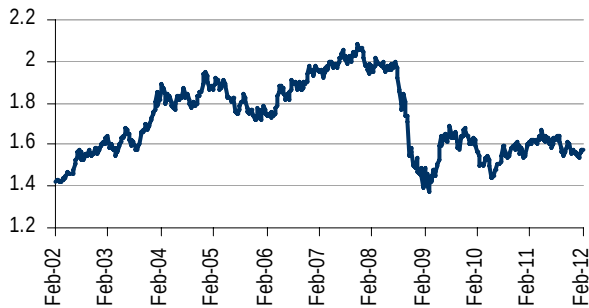


Source: DataStream/BofA Merrill Lynch Global Research

Currencies

Below, we show the Sterling exchange rates with the US\$ and the Euro.

Chart 66: \$/£



Source: DataStream/BofA Merrill Lynch Global Research

Chart 67: £/€

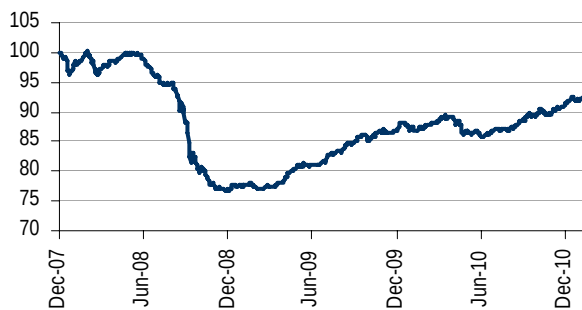


Source: DataStream/BofA Merrill Lynch Global Research

Hedge Funds

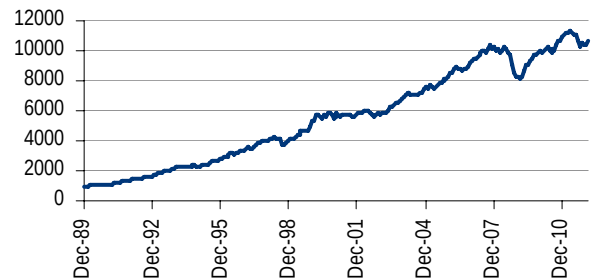
Finally, below we show the HFRX, the HRF daily investible index, and the HFRI.

Chart 68: HFRX



Source: HFR/Banc of America Securities-Merrill Lynch research

Chart 69: HFRI Composite



Source: HFR, BofA Merrill Lynch Global Research

Link to Definitions

Financials

Click [here](#) for definitions of commonly used terms.

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Investment rating	Total return expectation (within 12-month period of date of initial rating)	Ratings dispersion guidelines for coverage cluster*
Buy	≥ 10%	≤ 70%
Neutral	≥ 0%	≤ 30%
Underperform	N/A	≥ 20%

* Ratings dispersions may vary from time to time where BofA Merrill Lynch Research believes it better reflects the investment prospects of stocks in a Coverage Cluster.

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