

# Australian Investment Management Survey 2005



## Important Notice

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# 1. Foreword



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I am delighted to introduce the PricewaterhouseCoopers Investment Management Survey 2005.

While IFSA have sponsored the PricewaterhouseCoopers annual survey for a number of years, the format and depth this year has been enhanced to include more interpretation and analysis of the data, in what we hope will provide more meaningful intelligence for senior executives.

The survey comprised a questionnaire, initial discussions with CEOs and a chief executive roundtable meeting. The roundtable meeting was used to debate, challenge and expand the survey findings and was a key part of the survey process.

The survey findings provide an interesting insight into the major issues facing investment managers operating in Australia. Clearly after the last two years, a period of positive returns, the industry is buoyant and optimistic for the future. But the industry, perhaps only just coming out of its adolescence, continues to feel growing pains. The industry has responded diligently and at times innovatively to growth and change, and has done so profitably. However with markets expected to level out and staff numbers and costs rising and expected to continue to rise, cost containment is sure to re-emerge as a key plank for continuing profitability. Enlightened investment managers may need to re-check their strategies to ensure they can create truly scalable businesses, underpinned by the management of operational risk as a strategic priority to control growth, rather than a mechanism constantly playing catch up.

The PricewaterhouseCoopers investment management survey team would like to thank survey participants and in particular the executives who participated in our lively roundtable debates and one-on-one meetings. We appreciate their openness, insight and vision provided on key topics. I welcome feedback on the survey, particularly how it can be improved for the next edition. If you would like any further information regarding the survey, please do not hesitate to contact myself or your usual PricewaterhouseCoopers contact.

## 2. Executive summary – Key survey themes

The investment management industry continues to experience good growth levels and is meeting the changing needs of a more sophisticated client base. The industry has succeeded in managing the increased level of regulation while still being able to deliver innovative products and returns to their investors.

Our research, experience and discussion with industry leaders has uncovered the following key themes:

### Macro themes

- The industry needs to be better able to rationalise its product suites. Older products and their legacy systems are increasingly difficult and costly to manage. As legacy products continue to contribute to operational breakdowns and managers exercise their rights to pass these costs through to investors, the arguments for urgent legislative relief to facilitate product rationalisation are compelling.
- The legislative and regulatory framework governing investment management, product distribution and advice has become more comprehensive and the regulators have become more active in enforcing compliance.

### Business themes

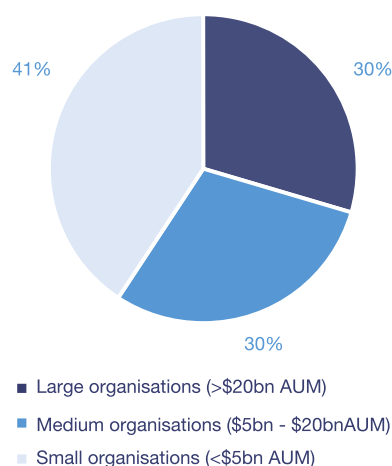
- Profitable times – but has asset-price-driven growth masked operational excellence and cost efficiency?
- “A good reputation is more valuable than money”. Regardless of the cost advantages of consolidations, mergers and distribution arrangements, negative publicity, adverse regulatory action or customer backlash may negate future financial gains.
- Capital management has been fairly rudimentary. We expect this issue will be of increased focus for investment managers. For those owned by banks, this may be stimulated by Basel II.
- Staff costs and numbers continue to rise. Emerging issues for investment managers seem to be resolved through labour intensive means. Headcount, once a key performance indicator of some importance, appears to be of little relevance in this growing market.
- As the industry becomes more complex and the drive for out-performance intensifies, the need for leadership skills and asset managers is an emerging issue. The boutiques, who are often led by renowned investment managers, may become even more attractive acquisition propositions.
- Organisations appear to have made their strategic decisions on what to outsource, and the momentum has slowed.

### Risk themes

- Unit pricing remains a major focus and errors can lead to large losses and reputational damage.
- Investment managers need to ensure they have equipped themselves with operational risk management systems that can cope with increased regulatory focus and be more preventative than detective.

# 3. About the survey

Figure 3.1 Size of organisations who responded to the survey



The PricewaterhouseCoopers Investment Management Survey 2005 was conducted in June and July 2005.

31 investment management organisations, representing assets totalling more than \$600 billion, participated in the survey and/or the chief executives roundtable meeting. The survey was conducted by an in-depth online questionnaire which was completed by 28 respondents at chief executive and chief financial officer level.

The survey covered five main areas:

- organisational profile
- growth and growth expectations
- industry trends and drivers
- client demand
- operational management

A key part of the survey process was to hold a series of interviews with CEOs prior to the survey launch to better understand the issues facing the industry. The survey was designed following this important input and a roundtable meeting with a number of CEOs followed the initial aggregation of the survey results. The roundtable meeting helped to consider those initial results and helped shape the analysis and interpretation. The meeting provided lively debate and extremely interesting and useful insights into the survey findings.

This report provides an overview of the survey findings, together with our analysis and interpretation of the results of the survey and the PricewaterhouseCoopers point of view on some of the important issues facing the industry.

Only survey respondents will receive in-depth feedback of the survey results, which we trust will deliver them valuable analysis for their future strategic considerations and just reward for their participation.

# 4. PricewaterhouseCoopers' point of view

Mandated superannuation contributions, strong domestic equity markets, continued penetration by the funds industry into the savings markets and a continuation of innovative product design to meet the needs of an increasingly savvy investing public and their advisers, all of these have added up to a period of growth by the Australian investment management industry.

And strong future growth is expected to continue – see Figure 5.1.

Hidden amongst all of the statistics however are some indicators that might need further consideration.

## Managing future growth by making operational risk management a strategic imperative

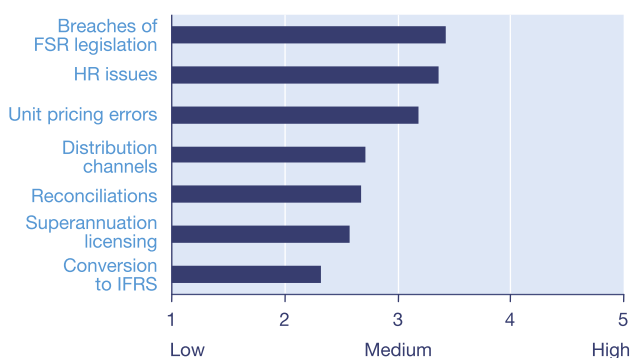
Our survey indicated leveraging brand and maintaining a good reputation were considered a big opportunity for organisations. The CEOs canvased were perhaps even more focused on ensuring the sound reputation of their organisations. This is not surprising as the Australian landscape is increasingly dominated by our largest domestic players, who tend to maintain a separate brand but are bank owned, and the international players, who often operate diverse businesses under one global brand.

Over the past decade the legislative framework governing investment management, product distribution and advice has become much more comprehensive. Further, the regulators have been more active and penalties for non-compliance have become significantly more public and severe.

Increasingly the Australian landscape is one in which a damaged brand is just one unit pricing error away.

Survey respondents were asked to identify what were the biggest risk management issues facing them.

Figure 4.1 What are the biggest risk management issues facing your organisation?



Clearly, the recent enacting of the FSR has increased the compliance effort required by the industry. Interestingly, over 45% of survey respondents indicated that the recent FSR legislation had not benefited the customer. This surprising result may be explained by the frustration of what is seen as a requirement that over-complicates disclosure and makes compliance difficult, even for the well intentioned. We received many comments seeking the simplification of Statements of Advice and clarification of legislation to allow distributors to explain product features without the fear of such explanations being construed as the provision of (unlicensed) advice.

Yet the CEOs, cognisant of the significant costs already incurred to bed down compliance regimes, see the FSR simply as the rules of the game they want to play, and would prefer interpretative change to the rules rather than more substantive changes. ASIC have issued an Information Release explaining that refinement may be on the way.

Managing HR risks has become a major issue and is discussed later in this report.

Unit pricing remains a major focus. Rightly so – it is to the Australian industry what market timing and late trading were to the mutual funds industry in the US (albeit without the wilful intent implicit in the US controversies).

Clearly there are many instances of good practice, but the weight and public evidence of unit pricing errors is too difficult to ignore.

The apparent simplicity of unit pricing belies its complexity. But how did it get so hard and how did these errors arise?

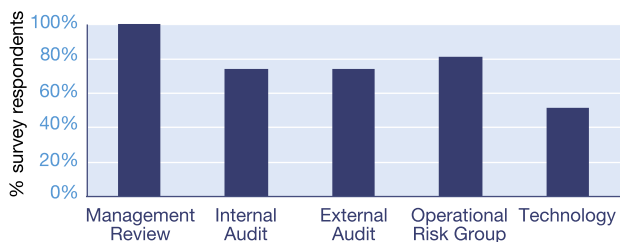
There is no one answer and each instance of such errors will have its own cause, but some factors that are complicating the ability to get it right, everytime are:

- an inability to rationalise older products (see further discussion later)
- taxation complexity
- an industry that operates under the requirement of finer tolerances than global competitors
- industry consolidation, resulting in managers with duplicate product suites and multiple unit pricing systems.

Despite these factors, the pursuit of growth has involved voluntary decisions to put on more products, to acquire competitors, to focus on newer offerings. Errors have resulted.

One question lingers – have investment managers equipped themselves with operational risk management systems that have coped, and can cope, with the demands of complex unit pricing requirements and an increasingly onerous regulatory regime?

Figure 4.2 How do you monitor operational risk?



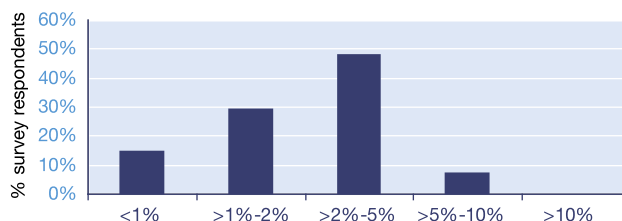
We asked the industry how they manage operational risk. We were surprised at the relatively low uptake of technology as an enabler to improve operational risk oversight. This may, however, have been consistent with a result which indicated that greater than 90% of respondents spend less than 5% of revenue in managing operational risk.

While there is no specific “right spend” as a percentage of revenue, investment managers simply need to question whether they have spent enough.

One chief financial officer of an investment management subsidiary of a bank commented that there is more operational risk in accepting people’s money than there is in lending to them. In today’s regulatory environment, this may be close to the mark.

But whether operational risk management has the same presence at an investment manager as at a bank is debateable.

Figure 4.3 How much do you spend on managing/monitoring operational risk as a percentage of revenue?



There are some other questions to ponder:

- Have investment managers been too focussed on growth, and underinvested in managing operational risk?
- Have investment managers been too reactive to problems?
- In a complex environment, where tolerance for error is low, why hasn't technology played a bigger part in operational risk management?
- Do investment managers imbue an appropriate organisational status to the head of risk?
- Is operational risk management considered

strategically to assist sensible decision making, or as a back office bastion to manage the fallout of flawed decision making?

The investment management industry is relatively young – there have been times when they have proudly defended a unique culture, importantly different from banks.

Perhaps now it is time for CEOs to reflect whether the unique culture of the past has been too shaped by growth objectives and whether they need to be more risk aware to sustain future growth.

## The need for product rationalisation

Over the past decades, investment managers have responded to changing market needs and developed new and innovative products to meet the needs of the day.

However, what appears a straightforward decision at the time can come back to bite, as today's innovative products become tomorrow's legacy.

For instance, in the mid 1990s, almost 75% of new managed funds were multi-sectors funds, catering for all tastes. More recently, the advisers have reclaimed that ground, preferring to undertake the asset allocation decisions client by client, opting for a blend of sector specialists in preference to multi-sector funds. This allows the adviser to select the best managers by asset class and to reduce style risks that may exist with particular managers.

Consequently, the multi-sector funds so in fashion in the 1990s, are out of favour today. Our survey indicated that multi-sector funds make up only 17.7% of asset classes with, this estimated to fall to 16.5% in three years time.

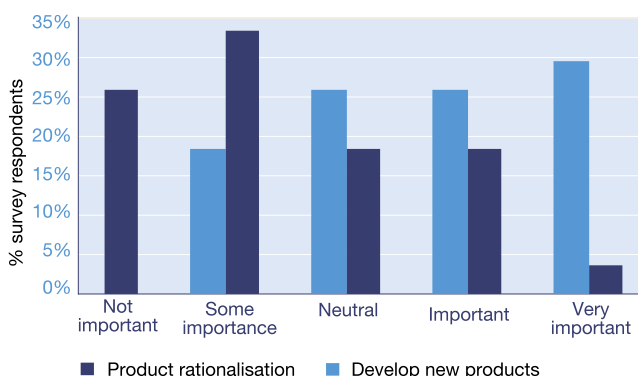
In addition to the proliferation of products, industry rationalisation has resulted in mergers and acquisitions that have the larger investment managers constantly considering how to manage duplicate product offerings.

In some instances, managers are striking more than 500 unit prices daily and managing multiple IT systems where, even with the best intent, knowledge of such systems fade as employees move on and the newer product suites demand greater attention.

Coupled with the discussion above in relation to the environment in which unit prices are struck, it is not hard to justify that managers need an ability to manage down their product suites. But current legislation inhibits the ability of managers to do this.

But does the industry see product rationalisation as a key strategic priority?

Figure 4.4 Key strategic priorities



While our survey indicated that new product development was seen as an important strategic issue and a key to revenue growth, there appears to be no solution to get efficiencies from the existing product base. Product rationalisation was not seen as a key strategic issue for a lot of our survey respondents. However, for our large fund managers, product rationalisation was seen as more important reflecting, the fact that a lot of these organisations have been

through mergers and acquisitions and have inherited a number of legacy systems.

There have been some suggestions that the industry’s push for product rationalisation will increase manager profitability but may not result in a benefit to investors. In our view, this is short sighted.

First, the legislators, who provide the system into which compulsory super is channelled, need to ensure that the market can reduce product numbers, where appropriate, to enable them to better manage their risks, not create an environment which adds to that risk. A rain tank with no valve to reduce the water level will eventually overflow. We acknowledge that operational risk management needs to play an important role in alerting management that the tank capacity has nearly been reached, but a more effective means to protect investors is to address all of the root causes – including an ability to rationalise products.

Secondly, those who argue that the cost savings will not necessarily flow through to investors miss a critical point. In the past five years managers have become much more informed about product profitability. Unprofitable products in other industries would be closed down. Where that is not possible, the supplier naturally looks to increase prices. The issue here is older products – where natural attrition has resulted in them becoming lower fee-earning, and compliance and maintenance costs are rising. In short, they are

becoming uneconomic. A prevalent feature of older products, however, is constitutions that allow fee rates which, if offered for the first time today, would appear unmarketable. But failing to be able to rationalise such products, manufacturers will look to other means to make them profitable – and with such access to higher fee flexibility, may well have the means to do so.

In short, the argument to facilitate legislative change to assist product rationalisation is not just about passing on savings to tomorrow’s investors, but how today’s investors are also protected.

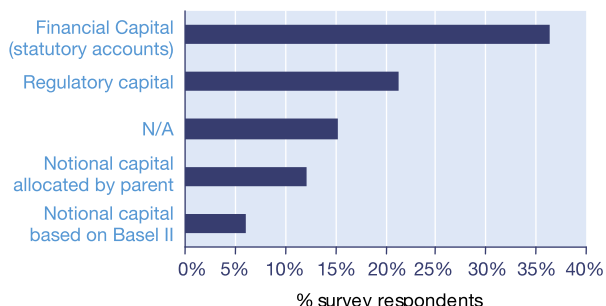
Clearly, protection of investors’ interests remains paramount and any principle underpinning such legislation would need to provide that. In our view, a set of consistent principles should be applied across managed investment schemes, superannuation and life products, and may require supplementary tax roll-over relief to protect investors from forced crystallisation of tax consequences.

While our survey results indicate a greater interest in continued product development compared to product rationalisation, in our opinion there is an urgent need at larger fund managers for legislation that allows for product rationalisation. Moreover, we would see such enabling legislation as a sensible planning step for the future of the industry and all of its participants – investors included.

## Capital management is growing in importance

Our survey asked respondents to select what capital measure their performance is measured against.

Figure 4.5 What capital is your performance measured against?



Our survey findings show that most organisations manage their capital based on statutory requirements. At best this is rudimentary. As the influence of bank-owned investment managers continues to grow and there is an increased focus on the operational risk area, we believe more organisations will take the strategic decision to implement capital management models - either those proposed by the Basel II framework or, internally generated models.

## The rise and buys of the boutiques (or how the quest for talent may play into their hands)

As the industry continues to grow and the fight for talent increases, we are seeing more organisations having to deal with people issues to ensure key personnel are retained and teams are managed properly. In recent times, we have seen more dramatic retention strategies as organisations tackle this important issue head on.

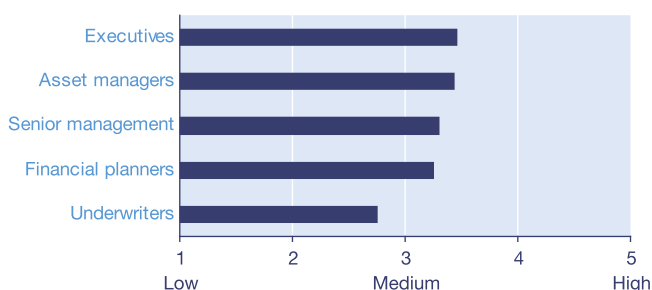
As the investment management environment becomes more complex, it raises challenges for those running investment companies and heightens the need for leadership skills to define and drive the strategy and to motivate co-operation throughout the organisation.

Australian organisations have shown they are good at managing these issues. This is demonstrated by the importance of quality of management as a key performance indicator (see Figure 5.17).

We asked survey participants in which areas staff shortages were likely to occur. With a constant push for more and more tied financial planners, we expected to see this area emerge with the most skill shortages. Results were fairly even and financial planning was an area of expected shortfall, but interestingly it was executives and asset managers that respondents

thought might have the greatest shortfall - which might be music to the ears of the personalities and industry icons who have driven the rise and rise of the boutiques.

Figure 4.6 Where will the skill shortages be in 3 years time?

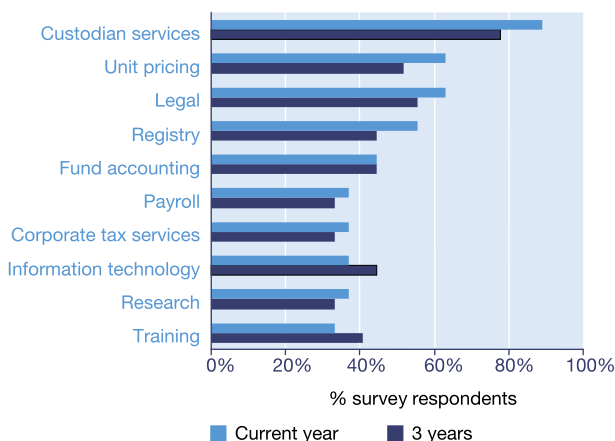


Some consolidation of the boutiques may be inevitable, for competitive reasons alone. But if the large institutions can entice these market leaders back into the fold, perhaps a key driver of that consolidation activity will be filling talent gaps – and of course the desire of the principals behind the boutiques to extract appropriate exit values from their businesses.

## Outsourcing momentum has slowed

The main areas for outsourcing are custodian, unit pricing and legal services. There is little change expected in the levels of outsourcing over the next three years and in fact some degree of decline in reliance on outsourcers is forecast.

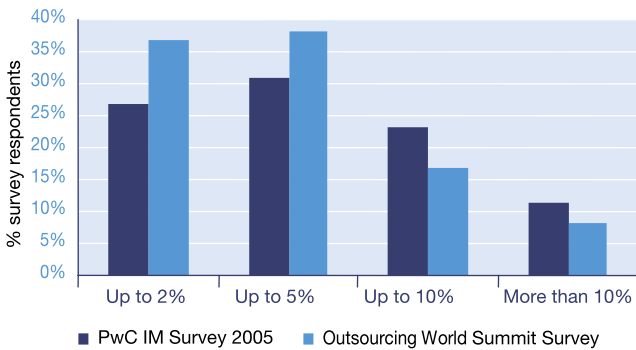
Figure 4.7 Outsourcing services used



Most organisations appear to have already made their decisions about what to outsource, and the momentum to outsource has slowed. This may change for the smaller players as they look to gain scale and meet the challenges of an increased compliance burden. While those working through unit pricing issues may have an impetus to re-assess their in house/outsource strategic decisions.

Our survey asked respondents to select how much they spend managing the outsourced relationship.

Figure 4.8 How much do you spend as a percentage of the total contract value managing the outsourced relationship?



When compared to results from the Outsourcing World Summit Survey 1999, the Australian investment management industry spends more on managing outsourced relationships than the global comparative group. While the Outsourcing Survey data may be from a few years ago, we do not believe it is time sensitive, and it reasonably demonstrates that investment managers place a great importance on actively managing and participating in their outsourced relationships.

## Most admired organisations

Our survey asked respondents to list which of their competitors they most admired and why. The results highlighted the following organisations:

Organisation	Main reasons given
Macquarie	Product innovation and profitable business
Barclays Global Investors	Strong investment offering
Maple-Brown Abbott	Innovation and focused business strategy
Colonial First State	Excellent execution
Perpetual Trustees	Proven investment performance and quality products

Our survey indicates that successful investment managers will be those who make customers feel as though they receive top-tier service through customer segmentation and multi-level offering, while providing product innovation with a focus on investment performance.

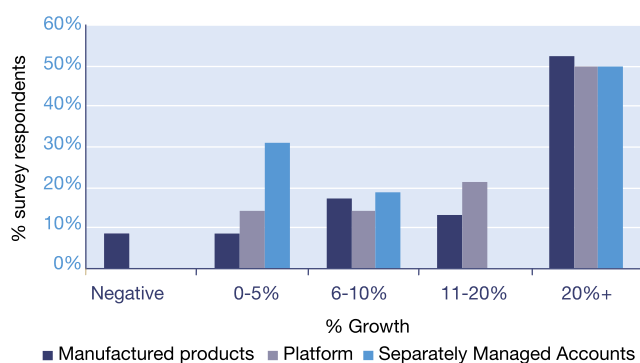


# 5. Detailed survey findings

## Growth and growth expectations

The investment management industry continues to experience good levels of growth. Assets under management grew by 15-18% in the current year. This compares favourably to international levels, with mutual fund assets worldwide increasing 15%\* over the year. The outlook for future growth is optimistic, with approximately 50% of survey respondents expecting growth of more than 20% in three years time.

Figure 5.1 Assets under management – 3 year growth



While market movements have contributed greatly to recent growth, our discussions with CEOs ratified their optimism to achieve these growth forecasts. Customer numbers have also increased, with over 40% of respondents expecting growth of over 10% in three years time.

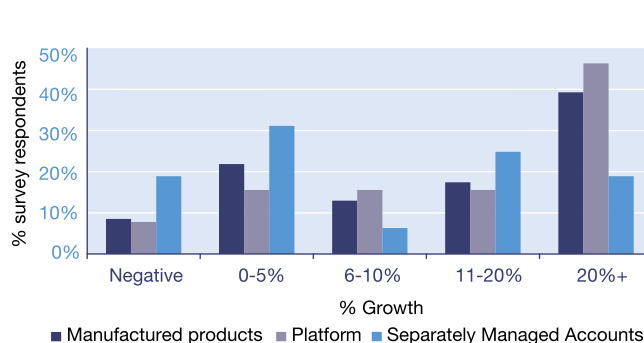
We believe this growth in assets and customer numbers will be driven by:

- new entrants availing themselves of administration efficiencies via platforms (particularly those who have been direct equity holders rather than fund investors)
- those who opt out of industry funds under the super choice regime
- increasing average superannuation holdings, driven not just by the growing impact of the uplifted compulsory superannuation, but also a workforce that is working longer and retiring later.

Of course, as always, the market may have the final say on whether these growth expectations prove to be realistic.

Profit growth has also been strong, with approximately 40% of survey respondents across most product groups experiencing growth in excess of 20% in the current year and over 50% of respondents expecting this level of growth to continue in the next three years.

Figure 5.2 Profit growth – current year



\* 2005 Investment Company Fact Book, Investment Company Institute

# Costs

Cost to income ratios (operating expenses/operating income) have fallen this year and the expectation of those surveyed is that this ratio will further decrease over the next three years.

Coming off record high domestic equity markets, a period of stagnation would significantly put the focus on cost containment strategies to achieve this. Other indicators suggest decreasing revenue margins, staff costs growing significantly, and the increasing costs associated with responding to evolving client needs and the associated compliance costs of managing these matters in a tighter regulatory regime.

Figure 5.3 Cost to income ratio – current year

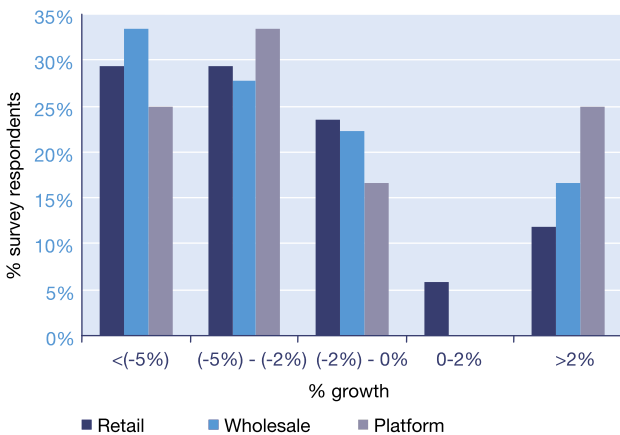
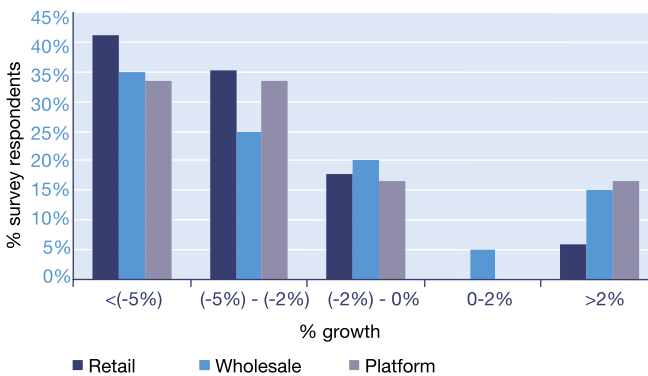


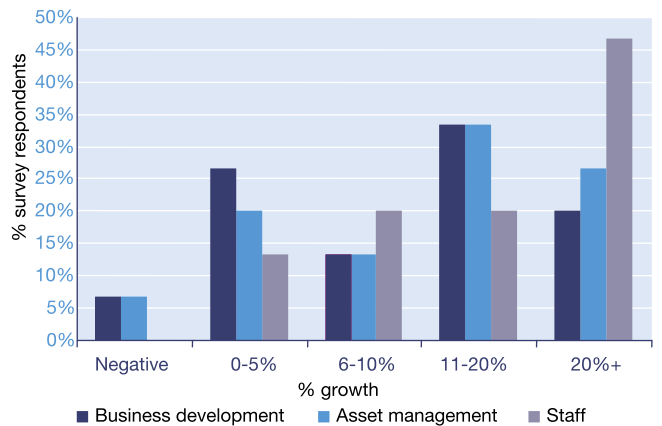
Figure 5.4 Cost to income ratio – 3 year



Our survey asked the industry to indicate the approximate level of growth across the major expenses in their cost base. Respondents indicated that the main

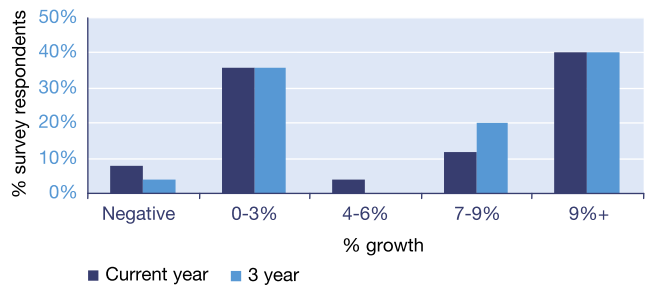
areas of cost increases are business development, asset management and staff, and this is expected to continue over the next three years.

Figure 5.5 Organisations cost base – 3 year growth



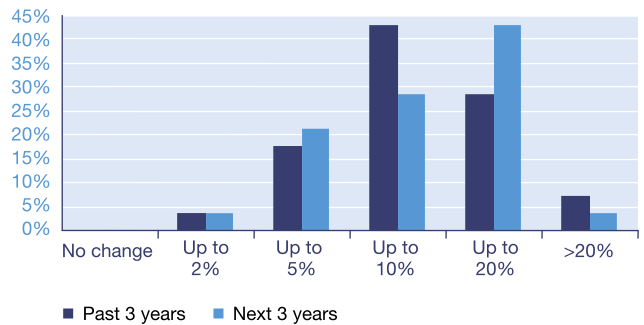
The expected increase in three-year staff costs is consistent with the current year findings, with 40% of respondents experiencing an increase in staff numbers of greater than 9% in the current year, and levels expected to continue to grow (see Figure 5.6). While a more recent focus on retention strategies may have played its part in this growth, staff numbers are also increasing as external recruitment continues to grow. Interestingly, when asked to list a maximum of 5 key performance indicators, only 2 of 27 responses included headcount, once a statistic of some importance (see Figure 5.17).

Figure 5.6 Employee growth



As well as staff numbers increasing, salaries have also increased, with over 75% of respondents experiencing salary cost increases of greater than 10% over the last three years and over 50% of respondents expecting salary costs to increase up to 20% or greater in the next three years (see Figure 5.7).

Figure 5.7 How much have your aggregate salaries increased?



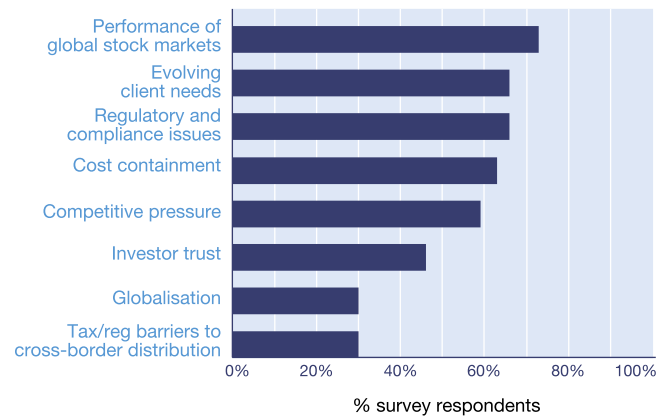
## Industry trends and drivers

So what are the major obstacles confronting investment managers? Clearly dealing with volatile markets still poses a major challenge. Other challenges include strategic issues such as responding to evolving clients' needs, but also matters such as regulatory and compliance issues, while staff and cost containment also looms large. Our survey asked the industry to rate a selection of 14 challenges with the top 10 challenges highlighted below.

Figure 5.8 What are the greatest challenges to investment managers over the next 3 years – Australia?



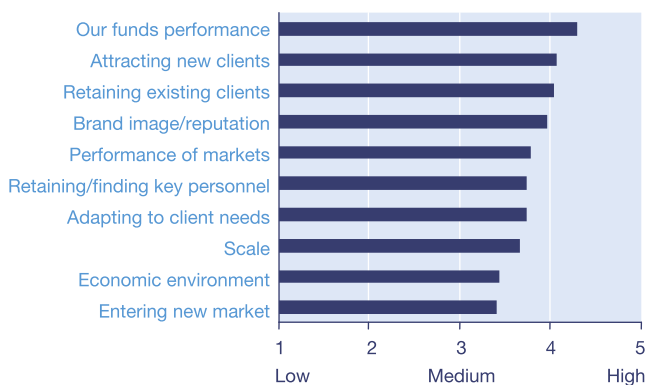
Figure 5.9 Which five of the following factors do you consider present the greatest challenge to the investment management industry over the next three years – Global?



When compared to results from our Global Survey 2003, the challenges are not dissimilar to those experienced by Australian investment managers.

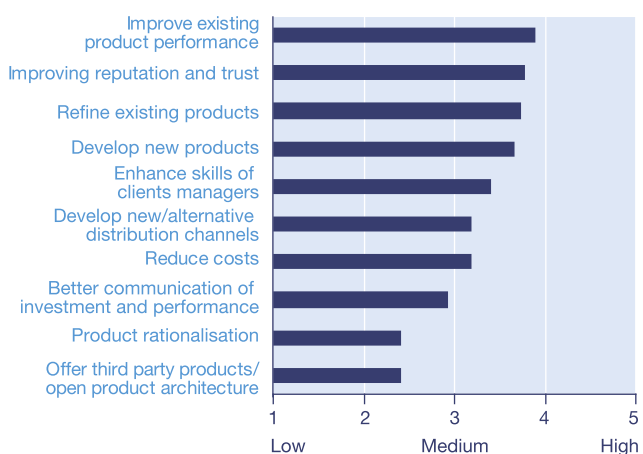
Our survey highlighted that some of these challenges are also the greatest opportunities to investment management organisations. Own funds performance and adapting to client needs were seen as important opportunities. In addition, attracting new clients and retaining existing ones were seen as important and are consistent with the growth objectives expected from the industry. Our survey asked the industry to rate a selection of 17 opportunities with the top 10 opportunities highlighted below:

Figure 5.10 What are the greatest opportunities for profit?



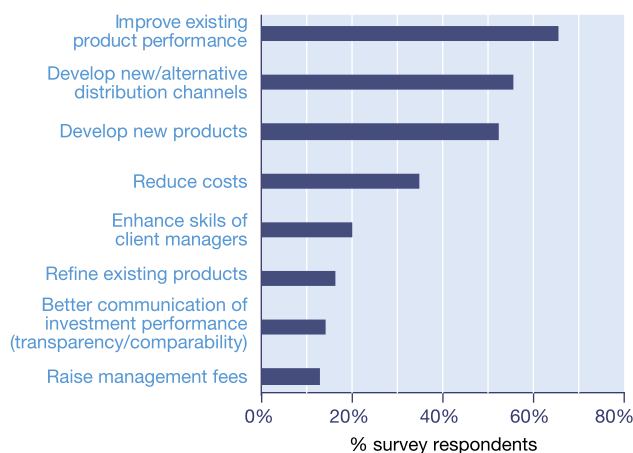
Our survey also highlighted key strategic priorities of investment managers. Clearly developing new products and improving their existing ones were important, but the issue of improving reputation and trust is seen as a key strategic priority. Our survey asked the industry to rate a selection of 12 key strategic priorities with the top 10 priorities highlighted below:

Figure 5.11 Key strategic priorities



Compared to global results, the issues facing global investment managers are consistent with Australian organisations, with perhaps the drive to reduce costs a greater issue globally than in Australia. As a point of comparison here, the Global Survey Results were undertaken in 2003, during a period of global stagnation or decreasing markets. In 2005, the Australian market has enjoyed two good years of equities performance which may have had the influence of masking the importance of cost management (in the short term). It might be reasonable to assume, however, that a slowing of performance domestically may bring about a return of greater focus on cost containment, and the comparative survey response may be a good leading indicator.

Figure 5.12 Which three of the following are the most important key strategic priorities for your organisation to increase its profitability over the next three years – Global?



# Client Demand

Figure 5.13 Factors for investors when choosing a fund manager

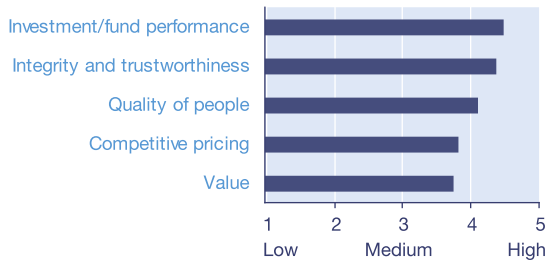


Figure 5.14 Factors for financial planners when choosing a fund manager

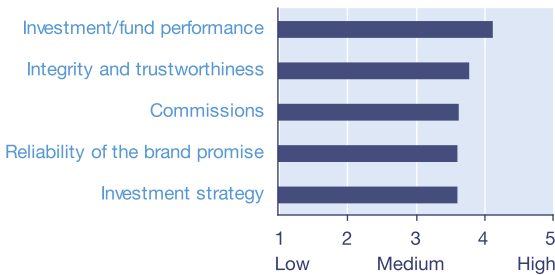
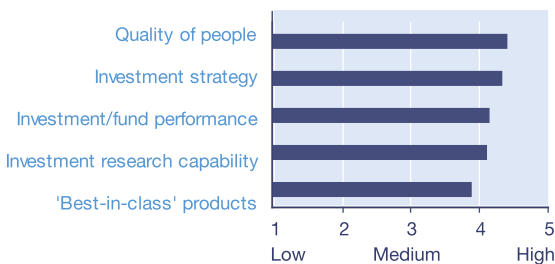


Figure 5.15 Factors for assets consultants when choosing a fund manager



Results from our survey show that along with investment/fund performance and price, investors also look to integrity and trustworthiness and the quality of people when choosing a fund manager. This further emphasises the need to protect the brand and deal effectively with legal and compliance issues that may cause it harm. Our survey asked the industry to rate a selection of factors that investors, financial planners and asset consultants considered when choosing a fund manager, with the five most important factors highlighted above.

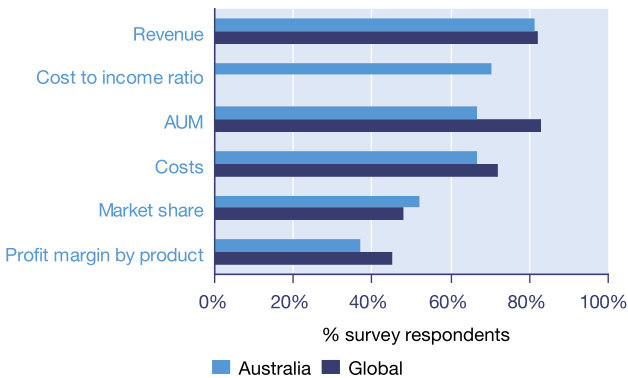
It is interesting to compare the results of financial planners (usually acting on behalf of retail customers) and asset consultants (usually acting on behalf of wholesale clients). At the retail end, financial planners appear to look more to the “here and now” (investment fund performance) for “you and me” (commissions ranking third in importance), compared with the asset consultants’ view of future investment performance sustainability (quality of people, investment strategy and investment research being three of the top four considerations).

# Operational Management

Although assets under management will continue to be the key benchmark to the outside world, internally, investment managers also concentrate on revenue and increasingly on measures such as cost to income ratios (reflecting the influence of bank ownership).

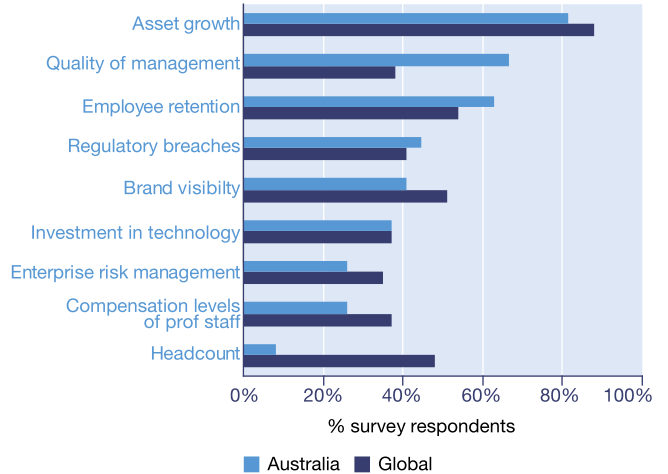
Participants were asked which financial measures they use to evaluate the performance of their business (and were given a selection of 11 measures to consider). The main responses, together with comparison to the Global Survey, are shown below (noting that cost to income ratio was not a selection offered in the Global survey).

Figure 5.16 Which financial measures do you use to evaluate the performance of your business?



As well as asset growth, the industry seems to concentrate on inward-looking measures such as employee retention and quality of management when evaluating the performance of their business. Our survey highlighted that few Australian investment managers focus on head count as a measure, in contrast to the global market, as evidenced by the graph below.

Figure 5.17 Which management issue measures do you use to evaluate the performance of your business?



If the markets do provide for a more challenging few years, it is hard to imagine that headcount will not again become an indicator of great relevance.

# PricewaterhouseCoopers

In addition to this survey, PricewaterhouseCoopers regularly produces surveys, newsletters, white papers and brochures on industry issues. These include:

- Investment Management Perspectives (Global publication – July 2005 just released)
- Global Investment Management Survey 2003
- 2005 Global Private Banking/Wealth Management Survey
- 2004 Global Trends in Performance Measurement
- Asia Pacific Investment Management Newsletter
- Focus on growth - striking the right value balance within financial services
- Protecting the brand – the evolving role of the compliance function in financial services

If you would like to receive any of these publications, please contact Carrie Smith, Australian Financial Services Marketing Manager on 02 8266 3481 or [carrie.smith@au.pwc.com](mailto:carrie.smith@au.pwc.com).



# Who to contact

PricewaterhouseCoopers ([www.pwc.com](http://www.pwc.com)) the world's largest professional services organisation, helps its clients build value, manage risk and improve their performance.

As a leading provider of professional services to investment managers, PricewaterhouseCoopers has a multi-disciplinary team of professionals comprised of business advisers dedicated to the industry.

Our specialist Insurance and Investment Management Group includes over 40 partners, supported by a global network of professionals, whose specialist knowledge and experience enable us to provide our clients with insights into marketplace developments and global opportunities. PricewaterhouseCoopers offer industry-focused solutions and strong implementation capability, providing a globally coordinated approach to the investment management industry's business needs.

Please go to [www.pwc.com/au/fs](http://www.pwc.com/au/fs) for electronic copies of the survey. For further information about the survey or to request a hard copy please contact Carrie Smith, Australian Financial Services Marketing Manager on 02 8266 3481 or [carrie.smith@au.pwc.com](mailto:carrie.smith@au.pwc.com).

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