



INVESTMENT
& PENSIONS
EUROPE

IPE European Institutional Asset Management Survey 2009

Research supported by Invesco



Contents

Section	Page	Scope
Foreword	2	Introduction from survey's lead sponsor
EIAMS Executive Summary	3	Main points from the survey
1. Sample	5	Methodology of this survey
2. Investment objectives	6	How institutions prioritise objectives
3. Investment of assets	9	Overall asset allocation by institutions
4. Sources of absolute versus relative return	14	Strategies used to achieve these objectives
5. Alternatives	16	Further analysis of this asset class
6. Portfolio tools and instruments	19	
a) Structured products	19	Further analysis of this product
b) Exchange Traded Funds	20	Further analysis of this product
c) Fundamental indexing	20	Usage of this strategy
d) Interest rate and inflation rate swaps	21	Usage of these strategies
e) Index exposure	21	Techniques used
7. Duration	22	How countries compare
8. Performance attribution	23	Users and suppliers
9. Consultants	24	Users and tasks they are set
10. External managers: usage	26	Extent of usage
11. External managers: asset allocation	28	Asset classes delegated
12. External managers: selection criteria	30	How they are chosen
13. External managers: fees	32	How are they rewarded
14. External managers: constraints	35	Constraints placed on them
15. External managers: breaking relationships	36	Overview of terminations
16. Other findings	38	SRI/ESG/Securities lending
17. List of charts and tables	40	

FOREWORD

It is hard to believe that this is the ninth edition of the European Institutional Asset Management Survey (EIAMS) and Invesco is proud to have been the sponsor of this unique research throughout this period.



This is the second year of our partnership with Investment & Pensions Europe (IPE) which undertook the survey and analysed the results on a completely independent basis. We believe this co-operation has worked out extremely well.

IPE's reach into the institutional investing community in Europe has resulted in a broad-based and robust set of findings, which we hope will be beneficial to investors and those advising them.

We believe that this year when the institutional investment sector (as well as the retail sector) has gone through such testing times, the results will be of even greater significance. There are certainly some conclusions in this EIAMS that could point to some fundamental changes in investors' attitudes and practices.

As heretofore, we have tried to have as broad a perspective as we could with responses from some 24 countries. There was a small increase in the number of participants but a significant jump in the size of investors responding. While we are delighted with the increased participation by the large funds this year, we are equally pleased that over half of the funds responding are under €1bn in assets.

It was never our intention to have the focus of the survey on the larger investors only. It has always been our contention that the small to medium-sized players are the under-

researched part of the marketplace.

While the emphasis has shifted to include more pension fund participants, we have asked the same broad-based questions, so there is a consistency and continuity that comes from having investors from one sector, even though the actual sample changed significantly between last year's respondents and this year's. We did approach last year's participants and did what we could to have them take part again.

We would like to thank most sincerely all those investors who took the time and trouble to take part in the survey. We know it is quite a daunting questionnaire, even though we do everything we can to make it as easy as possible to complete. But we like to think therein lies EIAMS's value: that it asks the questions other surveys do not and has done so for the past nine years!

We were delighted that a number of this year's respondents were able to join us to discuss the results at the recent IPE 360 Event for Pension Funds, held in Barcelona in June.

Our deep gratitude goes to the think-tank members of this study and the help they gave us: Association Française de la Gestion Financière (AFG), Euronext and the BVI in Frankfurt. We give our special thanks to AFG for their assistance in promoting the survey among the French investor community.

This year, we have improved how the survey looks, which we hope will help those studying it, especially those who need to do so in depth.

We are starting to look at how we develop the EIAMS survey in the coming year and would welcome any feedback that you may have as to how we can improve and extend it.

*Yves Van Langenhove
Head of Institutional Sales, Invesco
June 2009*

EIAMS Executive Summary

1. Survey parameters

This year's survey covered 117 investors in 24 countries, with total assets invested of €477bn. Over half the funds were small, under €1bn, while 21 were large over €5bn and 38 were in between. Some 27 of the funds responding came from Benelux countries and 26 from Britain & Ireland. Around three quarters of the sample described themselves as pension funds, and 8% were insurers.

2. Investment objectives

Focus on the horizon

Investment horizon is now in the foreground for internal assets as investors struggle to address recent damage to portfolio worth, but relative performance still rules for external assets. Relative returns are now seen as more important than absolute returns. Relative risk is second most important for external assets, and liquidity is seen as more important than a year ago for internally managed assets.

3. Investment of assets

Back to the future

The need for safer havens encouraged investors to invest twice as much in bonds as equity, reversing the previous trend, with the overall allocation to cash almost doubling. The large funds have been most aggressive in reducing their equity holdings. There has been a pronounced domestic bias in asset allocation, and only twice as much is now invested in government bonds as in corporate bonds, compared with three times as much last year. Going forward, investors are evenly split between increasing and decreasing their equity holdings, but with broad consensus in shifting more equity investments to the US market. The big winners are commodities, followed by real estate and private equity.

4. Sources of absolute versus relative return

Hedge funds clipped

Hedge funds, previously seen as the main source of absolute return, are now regarded as one of the least likely sources. Fixed income and real estate are now the main drivers for absolute returns, while equity and fixed income, with cash now a respectable third, continue to be seen as the main sources of relative return. For absolute returns, the larger investors have switched from alternatives to fixed income and the smaller investors from hedge funds, but both are also interested in real estate.

5. Alternatives

Reports of demise exaggerated

Alternative portfolios have shrunk in size, halting their previously inexorable rise, but large net increases in allocations are being predicted by investors for next year in both real estate and private equity, together with massive increases in commodities. Real estate maintains its position as by far the most sought after alternative asset apart from commodities. Previously, most popular with the Swiss and British & Irish, the latter have now been displaced by Benelux investors.

6. Portfolio tools and instruments

In investors' toolkits

- a) Structured products: Overall, there has been a steady decline in usage, down to one-fifth this year, from a quarter last year and a third before that. Capital protection is again key, but is now followed by diversification, in place of higher income.
- b) Exchange traded funds: In a reversal of fortune, ETF usage by investors surveyed has fallen significantly, but this might just be a by-product of current market conditions. ETFs now being used by some three-quarters of large investors compared with one-half a year ago.
- c) Fundamental indexing: Another dramatic decline in usage with little prospect of recovery to last year's levels for at least another year.
- d) Interest and inflation rate swaps: A low response rate indicated that managing liabilities was by far the most important reason for implementing both interest and inflation rate swaps.
- e) Index exposure: Futures and ETFs remain the most popular techniques to gain index exposure, but with ETFs failing to justify last year's speculation that they were set to supplant futures.

7. Duration

Bridging the gap

Overall, the duration gap has widened but this camouflages wide variations by country. While the gap has widened significantly for British & Irish, Benelux and CEE countries, the reverse is true for the Germans and French. But the significance of the duration gap depends on the structure of the pensions industry in the country.

8. Performance attribution

Knowledge is power

Performance attribution continues to gain users and is close to universal adoption. Investment managers remain the single largest provider and have made

small inroads into the significant ground they lost last year. Internal investment departments' share has grown for the third consecutive year and has made the largest gains.

9. Consultants

A case of the curate's egg

Use of consultants has continued to grow, albeit marginally compared with last year's quantum leap. Investment advice has replaced asset allocation as the prime reason for their use. The Italians remain the biggest users and the French the greatest converts, with big falls being experienced by the Nordics, British & Irish and Swiss.

10. External managers: usage

Big swings to in-house

Overall, there was a considerable decline in the use of external managers compared with last year, and is at its lowest for three years, in the cases of the larger and smaller institutions, with just medium-sized investors making marginally more use of external managers. Benelux and British & Irish investors made modest increases in usage, with dramatic falls elsewhere, particularly among the Germans, Italians and Swiss.

11. External managers: asset allocation

Fixed income on the up-swing

Last year's reported sea-change of more fixed income assets being switched to external managers has not only continued but has also overtaken equities as the largest externally managed asset class. Benelux, GB & Ireland and Italy delegate the most fixed income, with GB & Ireland, Benelux and France delegating the most equity. The larger funds have made the biggest switch from external to internal management.

12. External managers: selection criteria

More clarity demanded

For the first time in four years, clarity of investment process is now most in demand, relegating performance to third place behind risk. Corporate governance and SRI, both first-time questions, did not rate highly. The Germans appear most interested in quality of reporting, with the French regarding client service as one of their prime requirements.

13. External managers: fees

Performance-related fees on back-burner

Performance-related fees remain the ideal but the reality of the times is that, across all asset classes,

there have been increases in levels of fixed fees. Performance-related fees are again most in demand from smaller institutions.

14. External managers: constraints

Business as usual

Benchmarks, tracking error and following a specific allocation of assets again form the top three constraints. In fact, while there has been no change in the order of the 10 constraints identified, investors are more active in their demands for both maximum cash levels and maximum portfolio turnover.

15. External managers: breaking relationships

No wholesale dismissals

Year on year, a small increase has been reported in the incidence of dismissals, but most countries reported little or no change. It was only the French and Swiss who doubled their terminations. The key overall factors triggering a dismissal remain unchanged from last year, and are failures in the areas of performance, risk, strategy or asset allocation and clarity. However, change of investment strategy or asset re-allocation was only driven up by the importance given to it by the Benelux and Nordic countries; and the French and Germans were less swayed by any failure to control risk.

16. Other issues: SRI & ESG/Securities lending

SRI/ESG: now part of the landscape

Social and environmental values, rather than just owners' beliefs, have taken over as the prime reason to pursue SRI/ESG policies. Corporate governance policies are now in place among three-quarters of respondents, a dramatic increase on the two-fifths reported last year, and the incidence of all other written policies have shown impressive gains.

Securities lending: Lending on the slide

The impact of the ban on financial stock shorting, together with the emergence of counterparty risk, have significantly reduced investor involvement in securities lending. However, some one-third of those responding to the question said that they had only temporarily ceased lending.

1. Sample

Pension funds take lion's share

This year's survey brought altogether a response of 117, a marginal increase on the previous year's 115, spanning a range of investing institutions based in 24 countries. A feature of this year's response is that only around 38% of last year's respondents participated – anecdotally, this was attributed in most cases to difficult market conditions rendering completion of the questionnaire impossible.

So we are very appreciative of the time and effort put into undertaking this year's questionnaire by those who responded. Undoubtedly, the EIAMS questions are challenging as to the range and depth of the issues that are put to investors, but we do believe that it is the resulting information that justifies the effort involved.

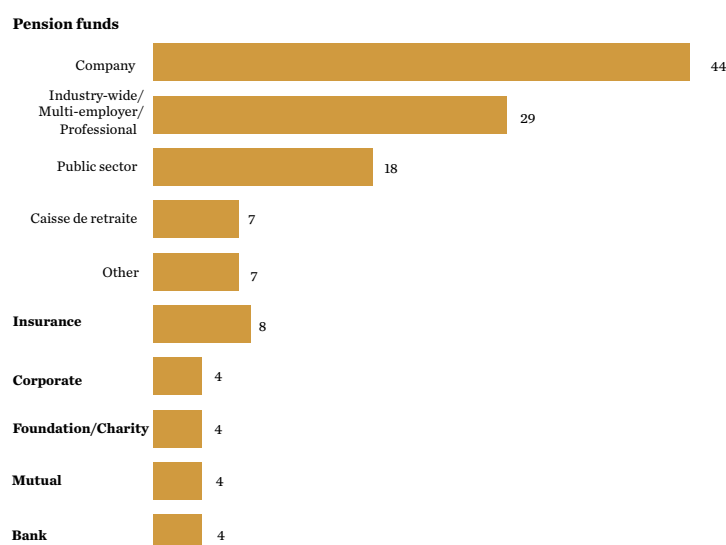
As last year, pension funds make up most of the respondents. Our breakdown as to the different types of pension funds shows that there is a good representation from across the industry, particularly by including under the umbrella Caisse de retraite, the uniquely French institution, which often includes more than retirement provision in the range of benefits provided to members. The insurance sector is at the same level of participation as last year and other respondents by type of institution are at much the same levels as in previous years, comprising banks, corporates, foundations and charities and mutual organisations.

We have seen a considerable jump in the asset levels of participating funds – these increased by half to €477bn, thanks to more large funds responding. While this brings the average size of fund responding to €4.1bn, this does not reflect the distribution of sizes of funds, as a high proportion of participants do come from small funds (see below).

The table (Fig 1.2) shows the spread of assets across the different country participants and this year we have been able to follow exactly the same format as last year, enabling comparisons to be made on a much more consistent basis. In a period of significant changes in investor behaviour, this has proved to be very important. Thanks to the help from our colleagues at Association Française de la Gestion Finan-

1.1 Sample by type of institution

% of respondents (total 117). Two or more categories could be chosen



cière (AFG), we are able to report a much better response from the French market, which has improved the reliability of the data emanating from there.

27 of the respondents came from Belgium and The Netherlands (Benelux), 9 from France, 12 from Germany, 8 from Italy, 14 from Croatia, Czech Republic, Estonia, Latvia, Lithuania and Romania (Central & Eastern Europe), 8 from Denmark, Iceland, Norway and Sweden (Nordic countries), 26 from Great Britain and Ireland, and 6 from Switzerland.

We have also had a number of respondents from other countries Austria (2), Cyprus (1), Portugal (1) and Spain (3). These respondents' numbers were not sufficient to report individually, but they did contribute to the findings in all respects, except when analysed by country.

A feature of the EIAM survey has been a breakdown of the results according to the size of the investing institution using, as our criteria, the total assets under management. Those with less than €1bn were classed as small (58 of the 117 in the survey), those with over €5bn were large (21) funds, with the remainder classed as medium. There has been a significant increase in the responses this year from large funds – last year 14 were large, 34 medium and 67 small.

1.2 Sample AuM and number of respondents

	All	Benelux	France	Germany	Italy	Nordic	GB & Ireland	CEE	Switzerland	Large	Medium	Small
Respondents	117	27	9	12	8	8	26	14	6	21	38	58
Total invest assets (€bn)	477	80	73	53	7	32	93	8	120	362	94	21
% of total invest assets	100%	17%	15%	11%	1%	7%	20%	2%	25%	76%	20%	4%
Average AuM (€bn)	4.1	3	8.1	4.4	0.8	4	3.6	0.6	20	17.2	2.5	0.4
Median AuM (€bn)	1	0.7	5.1	0.9	0.6	2.3	2.2	0.6	9.8	12.3	2	0.3

2. Investment objectives

Rational investors

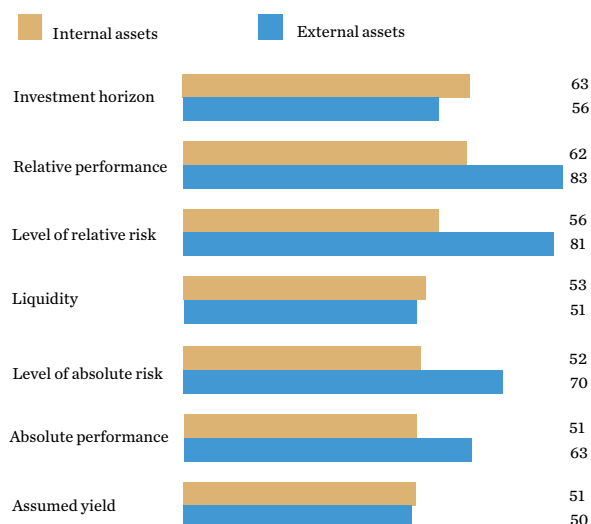
Are we seeing not a portmanteau but a portfolio revolution this year? When it comes to investors' objectives, there is a palpable sea-change. Of all candidates for pole position, investment horizon would not be one to spring to mind – but investors now see this as the critical criterion as they work out how to rebuild their portfolios. The dethronement of performance – though not for external managers – and the enthronement of risk, both absolute and relative – all are signs of investors determined to get a grip on their portfolios

For anyone managing pension fund and other institutional portfolios investing over the long term, the investment horizon is now to be the key objective in looking at internally managed assets.

'Investment horizon' has jumped from its ranking of

2.1 Most important investment objectives

% of 94 respondents answering question



fifth position in last year's survey to first this year (Fig 2.1), replacing absolute performance, which has now fallen to sixth place – the lowest in our survey.

Key takeaways

- ➔ investment horizon now the most important objective internally
- ➔ investors now seeing relative returns as much more important than absolute returns for both internally and externally managed assets
- ➔ for externally managed portfolios, relative performance ranked as most important, but with relative risk a close second
- ➔ new category of 'assumed yield' was ranked low both internally and externally
- ➔ liquidity has now risen in importance

2.2 Most important investment objectives 2007-2008

Objective	2008 (07)	2008 (07)
	Internal assets	External assets
Investment horizon	1 (5)	5 (5)
Relative performance	2 (2)	1 (1)
Level of relative risk	3 (4)	2 (3)
Liquidity	4 (6)	6 (6)
Level of absolute risk	5 (3)	3 (4)
Absolute performance	6= (1)	4 (2)
Assumed yield	6= (n/a)	7 (n/a)

Compared with our previous surveys, the ascendancy of investment horizon is a development that has bucked the trend of the previous two years' findings, which put performance, whether absolute or relative, at the top of priority lists of investors (Fig 2.2). This is certainly the case no longer.

Key takeaways

- ➔ investment horizon has become much more important internally (up to 1 from 5)
- ➔ relative risk creeping up in importance both internally and externally
- ➔ absolute performance crashed internally (down to 6 from 1) and also much less important externally

Such a reversal does make sense for investors, who have seen their expectations about returns dashed comprehensively by the savage conditions of the financial markets. To set your investment objectives in these conditions by the absolute returns you can produce from the assets under your control can only be done by reconsideration of the investment period over which asset values can be rebuilt. Thus the 'investment horizon' becomes a main focus.

This year, we introduced the choice of the 'assumed yield', hoping to elucidate some of investors' attitudes to the returns being obtained, as against the yields required by the fund to meet its longer-term objectives. In the general tumult of crashing markets, assumed yield is clearly not a current priority, being allocated sixth place, along with 'absolute performance' for internally managed assets. For externally managed assets, assumed yield is ranked lowest in seventh place.

But that does not mean that performance yardsticks have been overthrown by investors, as when it comes to relative performance, they clearly want to know how portfolios have performed against their benchmarks. For externally managed portfolios (Fig 2.4), it remains the number one objective, while for internal assets it is investors' second most important (Fig 2.3).

Not surprisingly in these market circumstances, liquid-

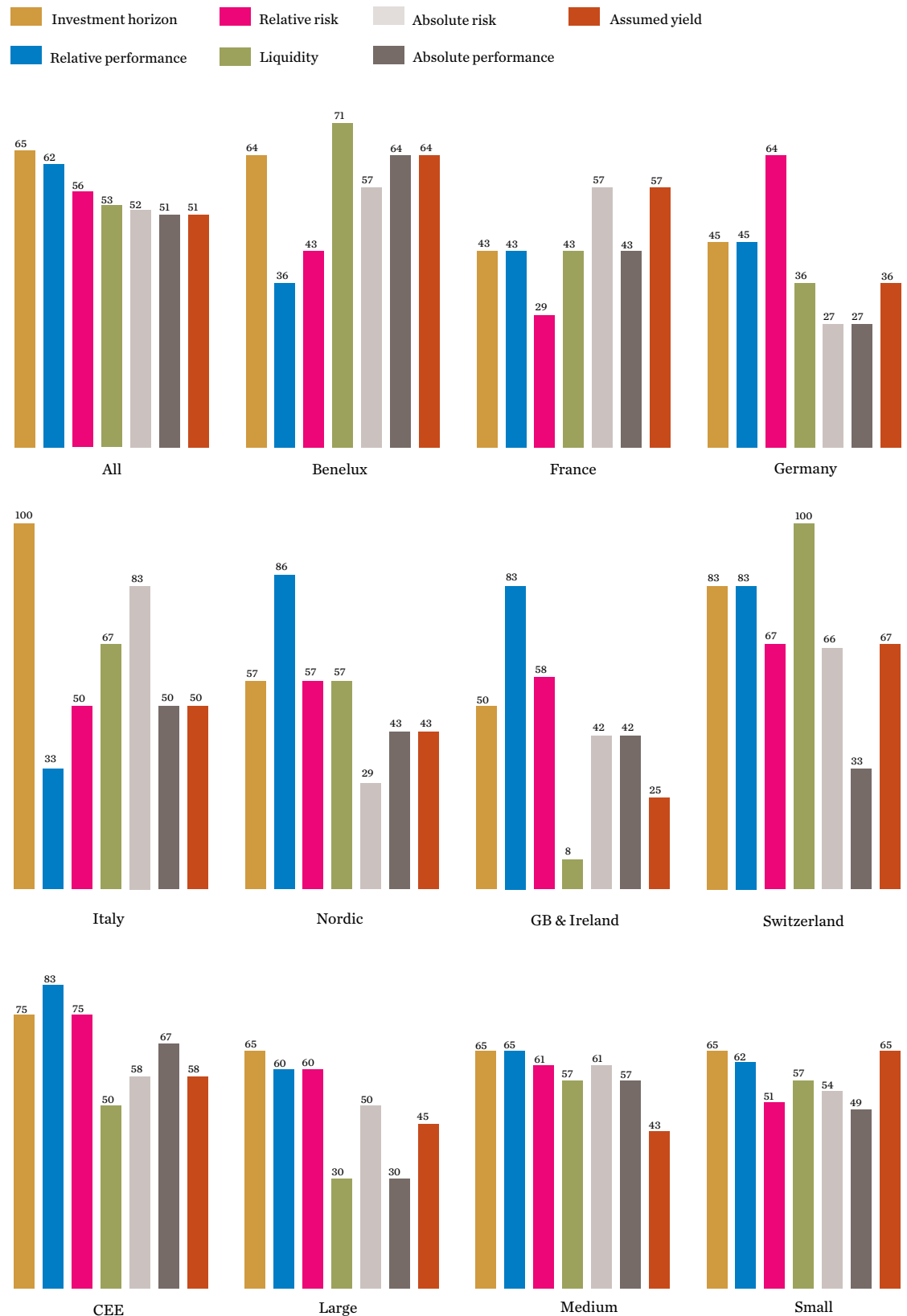
ity has moved up the spectrum when managing assets in-house. However, investors appear not to have the same degree of concern about the liquidity of their external assets, perhaps seeing that as part and parcel of what they have outsourced, and that the external managers have to manage liquidity issues.

Investors put ‘investor horizon’ at the top of their lists irrespective of fund size. Both large and medium investors continue to identify both relative performance and risk, as being important to them for both internally and externally managed assets. Smaller investors seem to need the compass of ‘assumed yield’ when it comes to assets looked after internally, but expect to scrutinise externally managed assets by the chosen benchmarks. Even in bad times, they expect their assets to have performed according to what the mandate dictated – there has been no suspension of the rules of the game.

Looking at the results from a country perspective, the message from this year’s results is that investment horizon and relative performance are the internal assets objectives

2.3 Important objectives for internally managed assets by country and size category

% of 80 respondents



that now matter most across the board, although Benelux investors stubbornly hold to their belief that relative performance seems of much less importance than absolute. Investors in Germany are much less addicted to absolute

performance, which traditionally has been a very strong driver in that market.

Despite the prioritising of ‘investment horizon’, it is important not to lose sight of the fact that risk, both relative and absolute, together with relative performance, are the main objectives for all sizes of investor. This holds good across the board in country terms, except for Italy, where absolute risk was more important to the investors responding to the survey.

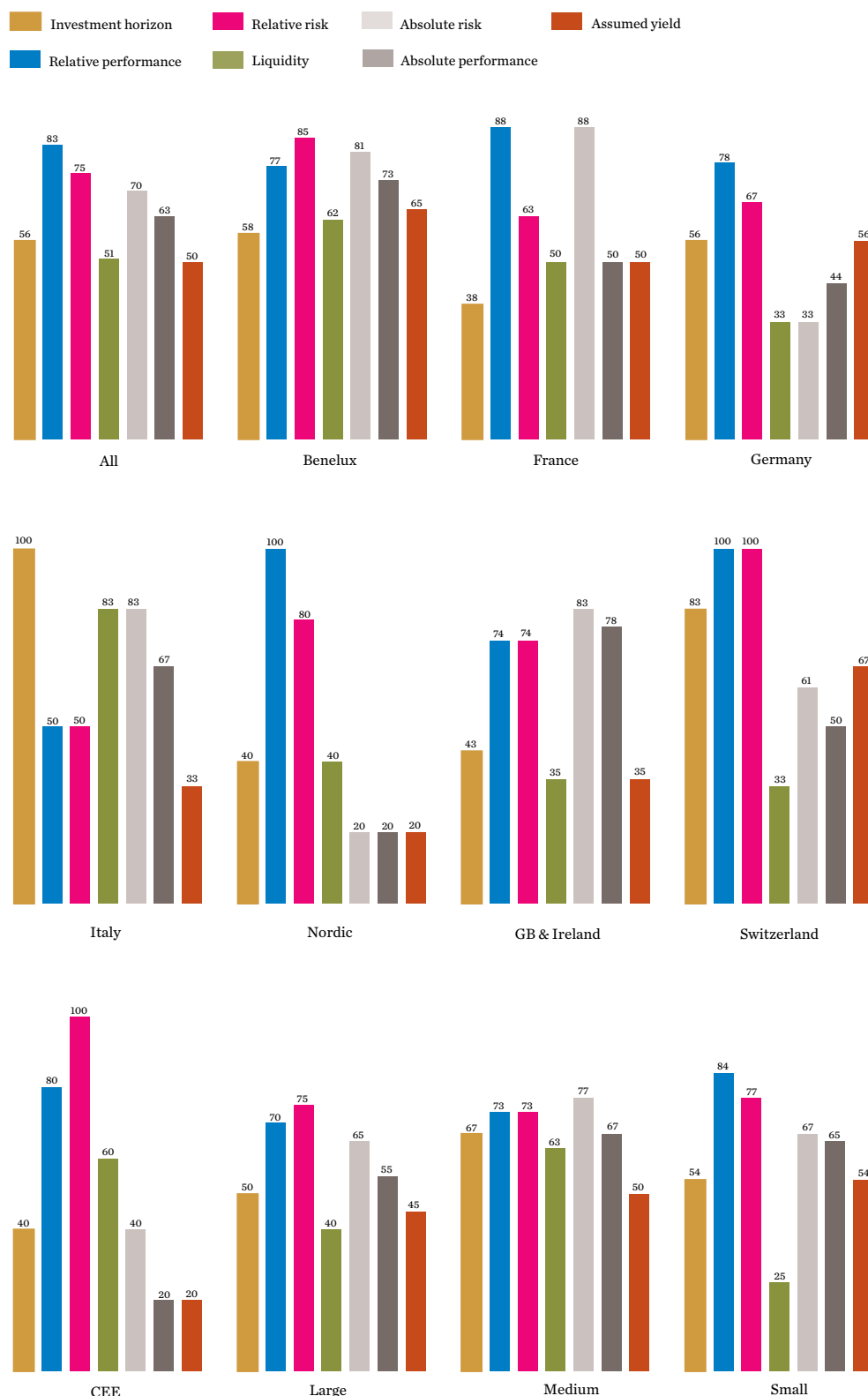
Last year, the results showed that performance was the key goal for all investors. While relative performance continues to be prioritised, the objective of absolute performance has been all but jettisoned for internal portfolios and fallen down the wish list for external portfolios. This seems to be a recognition of the current investment climate and how far we are from normal longer term investment considerations.

Key takeaways

- ➔ all sizes consider investment horizon as most important for internally managed assets
- ➔ both large and medium investors continue to identify both relative performance and risk as very important for both internally and externally managed assets
- ➔ smaller investors favour assumed yield internally, and relative performance externally

2.4 Important objectives for externally managed assets by country and size category

% of 94 respondents



3. Investment of assets

Overall composition of portfolios

As the dust from the market turmoil settles, we are getting a clearer picture of how European pension and other institutional portfolios are positioned. All funds had to bow before the gales that howled through the markets and the resulting allocations may have had less to do with investors' own prescience and desires than the enforced allocation of the marketplace

Figure 3.1 gives as clear a summary as possible as to where portfolios are positioned: equities now form some 25% of portfolios, so we are now back to where we were in 2006, with twice as much fixed income in portfolios as equity. Compared with last year's survey, the proportion of equities has declined by over a fifth from 32%.

Fixed income accounts for 54% now compared with 51% in 2007. The question facing investors has to be whether this is what they really want to hold looking forward?

While real estate makes up around 5% of portfolios, it takes time for the impact of lower valuations of property to work through portfolios so that investors know precisely where they are on a marked to market basis, where funds are subject to these requirements.

Similar considerations may apply to alternatives. In particular, illiquid private equity holdings will be hard to value in these times of illiquidity.

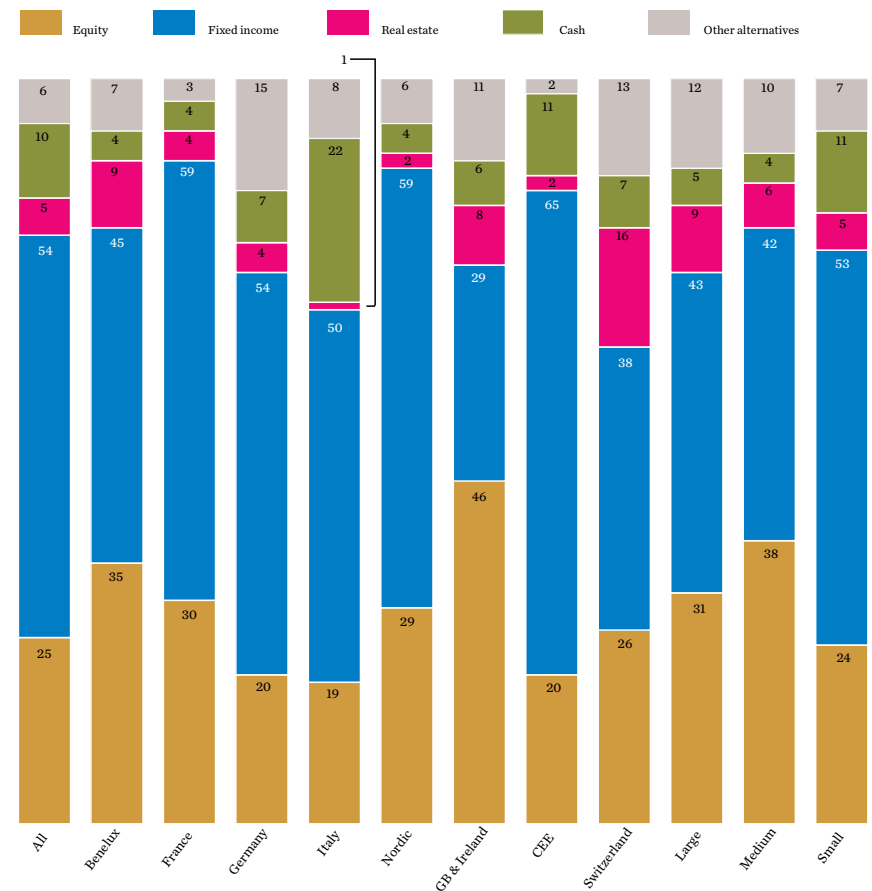
Cash is now king, accounting for 10% of assets of funds surveyed, up from last year's 6% allocation. While many investors will have made a conscious decision to hold a greater proportion in cash, it is important to remember that, while many other assets have shrunk in value, cash is one asset that will not have done so and, with diminishing portfolio values, the share of cash assets will have grown.

But the figures for an 'all countries' allocation is somewhat meaningless when it is presented in a disembodied way from what is happening at a country level, where investor allocation behaviour is honed by regulation, common approach, peer groups or attitudes to risk, among other factors (Fig 3.3).

Here there have been some seismic shifts, with Irish and British investors seeing their equity portfolio share slip from 55 to 46%. The Swiss are down from 32 to 26%, while the equity in Benelux investors' portfolios has slipped from 40 to 35% and that of Nordic players is now at 29%, compared with 37% in last year's survey.

3.1 Investment allocation by country and size category

Average % of assets



Key takeaways

- ➔ reversion to 2006 position with over twice as much investment in bonds than equity
- ➔ no change in level of investment in real estate – but cash deposits have grown by some 60%
- ➔ equity investment has declined across the board except in France where, as in the previous year, there was marginal growth. Most countries are near the average allocation, except Benelux and GB & Ireland, which are significantly above
- ➔ there was a small overall increase in fixed income investing, attributable mainly to France and Nordics. Italy experienced the steepest decline and last year's pattern repeated itself, whereby it was most sought after by CEE and least by GB & Ireland
- ➔ allocation to cash has increased significantly overall, Italy and GB & Ireland showing a five-fold increase (albeit the latter from a very low base). There has also been significant increases from Nordics, CEE and Switzerland
- ➔ by size, there has been an across-the-board reduction in equity holdings, of which only some 50% has been re-allocated to fixed income
- ➔ medium funds almost halved their holdings in real estate, while the larger and smaller funds made small increases and decreases, respectively.
- ➔ medium and smaller funds are seeking significantly more refuge in cash

There is certainly a narrower dispersion between countries' equity holdings now than in the past. Some of the countries not associated with a heavy equity predisposition also took some hits, with Germany down to 20 from 27% and Italy from 26 to 19%. CEE investors' average exposure fell heavily from 29 to 20% in the market turbulence.

France is the exception, reporting some growth, albeit marginal, up from 27% in 2007 to 30% currently. This may be due more to a marked increase in the participation from French funds this year over last year as the changed profile of the investors may have favoured equity investment.

Every country has a greater allocation to fixed income than a year ago, except for Italy, which has stashed 22% of assets into cash (up from 4% in the previous survey) and Benelux investors with exactly the same proportion of fixed income, but they have boosted their alternatives and real estate holdings. CEE countries have the highest fixed income holdings, at 65% (62% in 2007), but they have also boosted their cash positions to 11% (5%).

The flight to cash is a real feature of this year's allocation figure, as some countries which in the past had the merest cash exposures have had these boosted significantly. British & Irish, and Nordic investors, who in the previous survey had only 1% of assets in cash, now hold 6 and 4%, respectively. While the German and Swiss investors each now have a substantial 7% in cash, the Germans had this proportion in the previous survey, while the Swiss have moved from a 4% exposure.

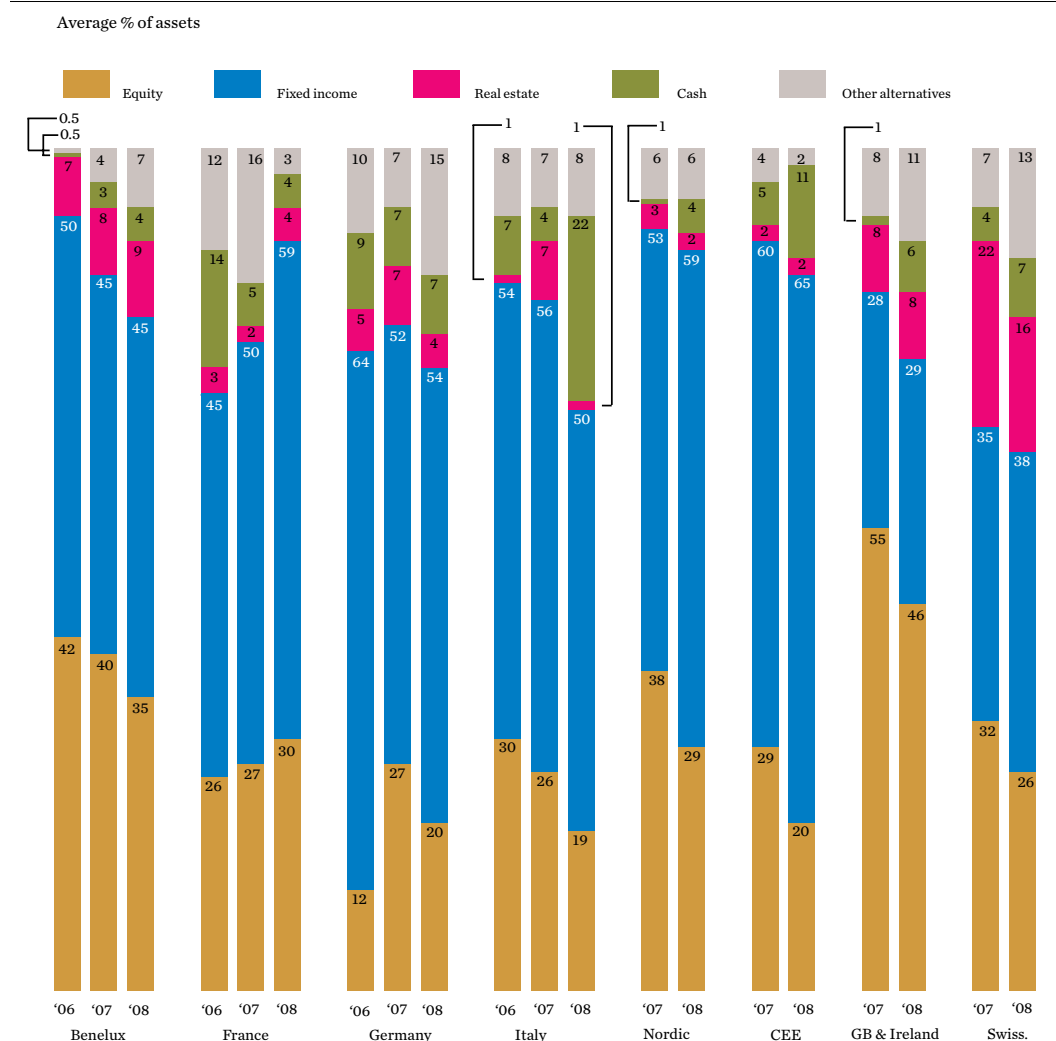
Swiss investors now have a massive 16% dedicated to real estate, albeit a sizeable reduction from last year's 22%. It

3.2 Detailed investment asset allocation

Average % of assets

	Own country	Rest of Europe	Europe	USA	Asia (inc Japan)	Other markets	All assets
Equity	7.0	8.8	15.8	4.6	1.7	3.4	25.5
Fixed income:							
Government bonds	18.8	10.4	29.2	1.3	0.2	1.3	32.0
Corporate bonds	8.9	7.2	16.1	0.8	0.1	1.1	18.1
Other	3.1	0.6	3.7	0.1	0.0	0.5	4.3
Real estate	2.4	1.8	4.2	0.1	0.1	0.3	4.7
Cash	9.2	0.4	9.6	0.2	0.0		9.8
Private equity	0.4	0.5	0.9	0.4	0.1	0.3	1.7
Hedge fund	0.2	0.4	0.6	1.0			1.6
Commodities	0.1	0.2	0.3	0.1		0.3	0.7
Other alternatives	0.4	0.4	0.8	0.1		0.7	1.6
Total	50.5	30.7	81.2	8.7	2.2	7.9	100.0

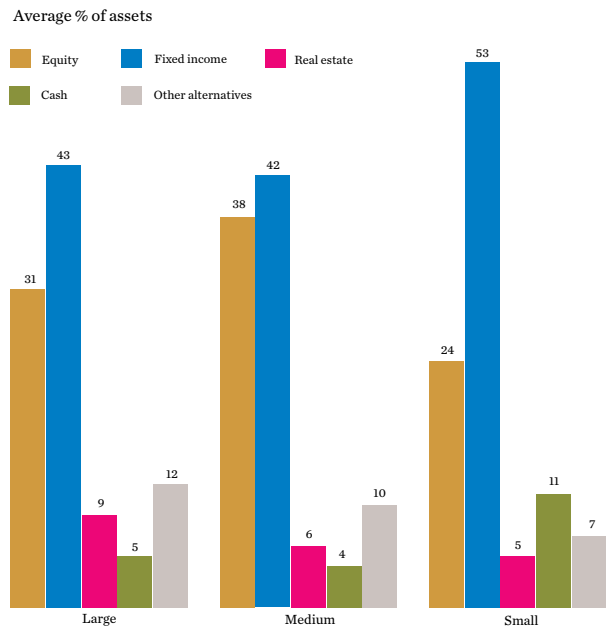
3.3 Investment asset allocation by country 2006 to 2008



Key takeaways

- ➔ equity investment has declined across the board, except in France where it has increased marginally. It is highest amongst GB & Ireland and Benelux investors
- ➔ fixed income investing is broadly unchanged but has increased significantly again in France, with the largest allocation in CEE, France and Nordic countries
- ➔ real estate unchanged overall: small but steady increase in each of past three years in Benelux, a doubling in France, with steep declines in Germany, Italy and Switzerland

3.4 Investment asset allocation by size



will be interesting to see whether this level, extremely high by European standards, will persist as property markets become more liquid. Their exposure to alternatives has also leapt to 13% of assets, compared with 8% in 2007. Again, this may be in part due to illiquid portfolios growing in weight, or some seriously mistimed moves into these newer assets.

Irish and British investors have seen alternatives exposures rise from 8 to 11%, as did players in the Benelux, where involvement moved up from 4 to 7%. While there had been increased interest by German investors in alternatives in recent years, their exposures appear to have moved quite dramatically from 7 to 15%, while their real estate exposure has declined from 7 to 4%.

When the data is sliced according to investor size (Fig 3.4), for large and medium investors the shift from equities to fixed income shows up as is to be expected. Medium-sized funds are more heavily into equities than the large funds, although their fixed income allocations are identical. In fact, the large funds allocate more to alternatives and real estate than medium-sized investors do but, in this survey compared with the previous, the drop in equity has been more pronounced for the large (down from 41 to 31%), compared with the medium-sized (43 to 38%).

With the across-the-board reduction in equity holdings, only 50% has been re-allocated to fixed income. Medium-sized funds reduced significantly their holdings in real estate, while the larger and smaller funds made small increases and decreases, respectively. With the medium and smaller funds seeking more refuge in cash.

Small funds have always had a higher propensity to be in

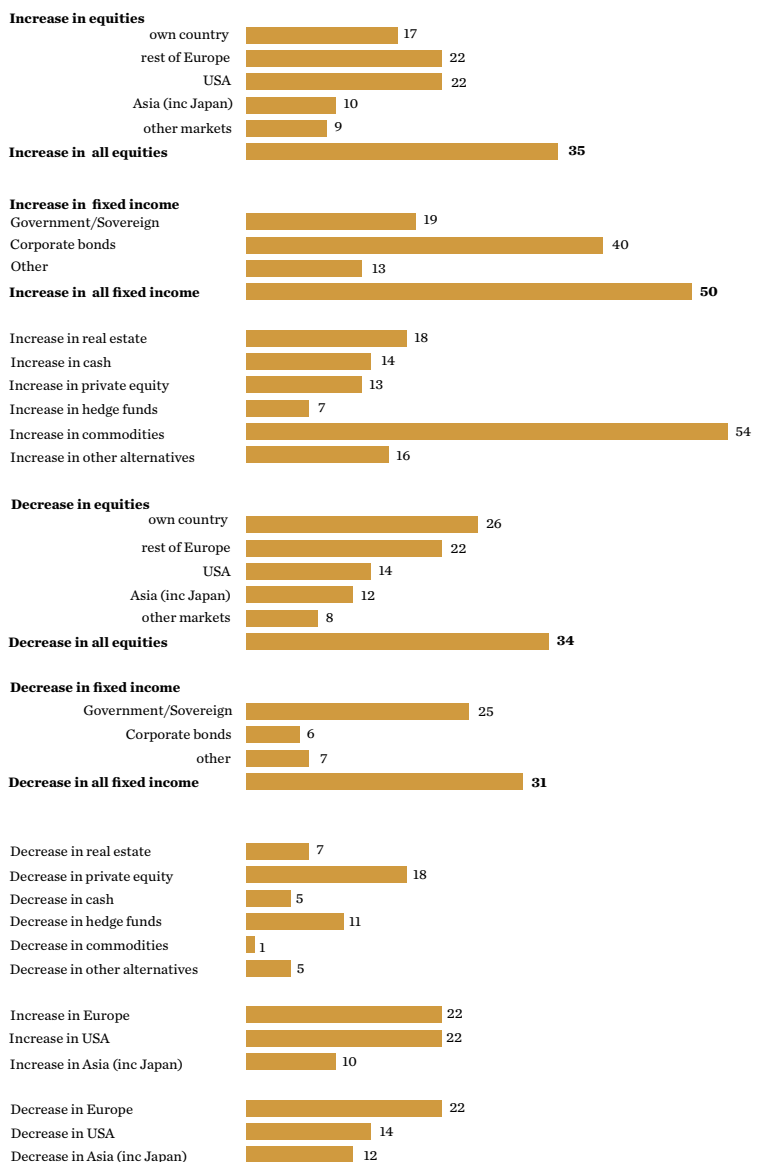
Key takeaways

➔ investment allocation pattern for large and medium-size investors has diverged with the large funds making a much more significant reduction in their equity holdings. Both holding some 10% in real estate last year, large funds have made only a small reduction, whereas medium funds have almost halved theirs. And both are looking much more to 'other alternatives' for their returns

➔ small investors still holding, on average, some 10% less in equities, 10% more in fixed income, but have made a small increase

3.5 Changes planned to strategic asset allocation in 2009

% of 110 respondents to question



cash and this has continued with an allocation of 11% currently, as against 7% previously. Their equity holdings have been cut back to 24% (30%), while fixed income only went up to 53% (51%), the cash element making up the balance.

While Europe is still the dominant place where investors invest their assets (Fig 3.2), accounting for 81% (80%),

there has been a pronounced rise in domestic bias, with 51% of assets now being allocated to ‘Own country’ – last year this was 47%.

Again this might be a technical factor as a result of the rebalancing achieved by the market revaluations, but the higher proportions in cash, which currently rides at 9.2%, compared with 4.9% last year, accounts very clearly for this shift – as cash will normally be held in local as opposed to foreign accounts.

The rise in interest in corporate bonds is another demonstration of the shift in investor focus. While there is nearly twice as much invested in government fixed income as in corporate bonds (CBs), the fact that some 18% of all assets is now allocated to CBs is something of a sea change – last year their share was 12.9% of the total. But while domestic investment at 8.9% (6.1%) has increased, a greater proportion has been allocated to the ‘Rest of Europe’ at 7.2% (4.5%).

Of the 19% invested outside Europe, the USA still takes the lion’s share with over half in equities, giving European investors a 5% portfolio stake in the market there. ‘Other markets’ at 8% (7%) have increased their share slightly at the expense of Japan’s 2% (3%). Again, equity investment is the main component.

Changes in strategic asset allocation

Investors in two minds

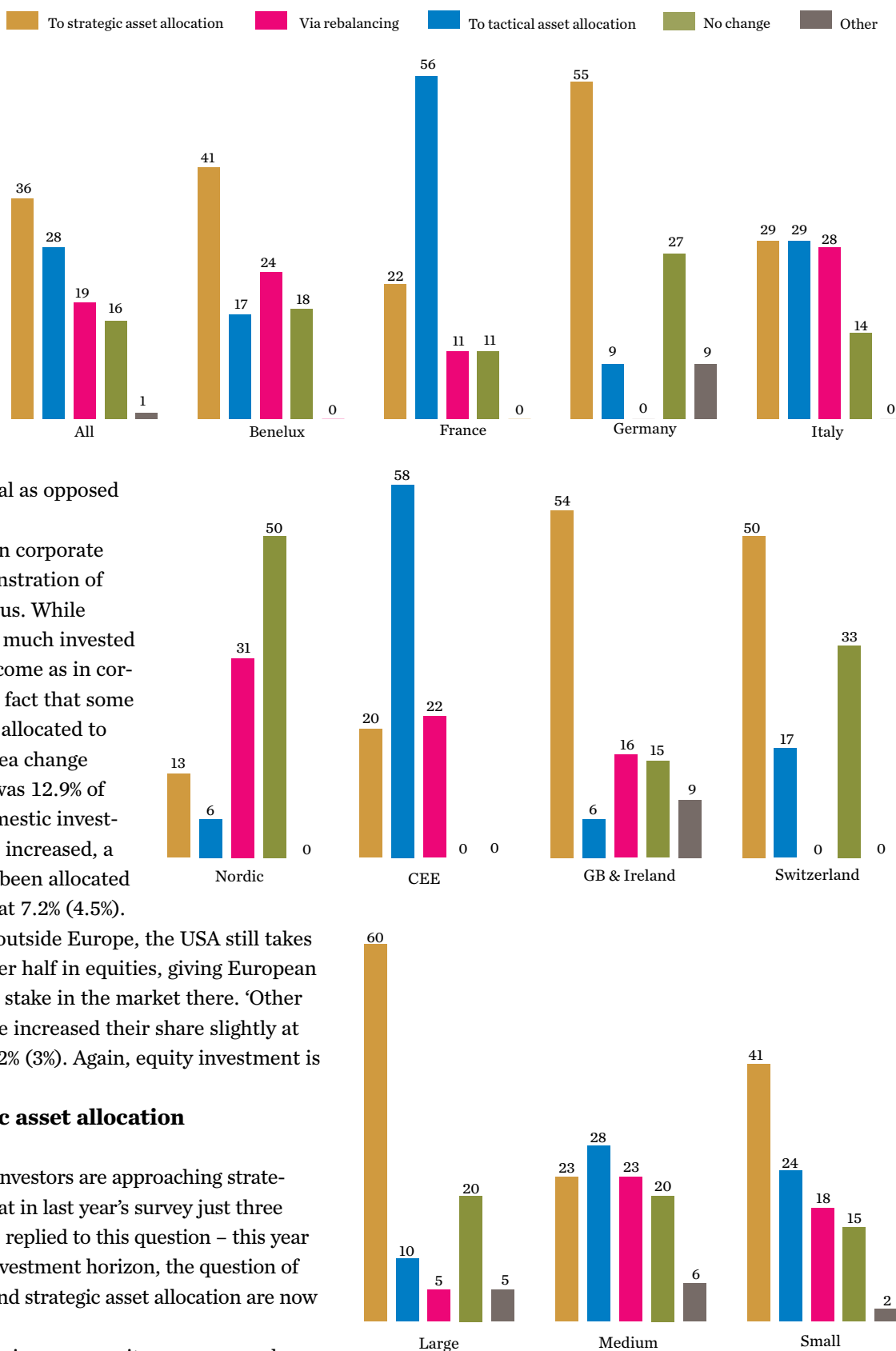
A key indicator of how investors are approaching strategic asset allocation is that in last year’s survey just three quarters of respondents replied to this question – this year over 90% did. As with investment horizon, the question of portfolio composition and strategic asset allocation are now top of the agenda.

With 35% planning to increase equity exposure and 34% bent on reducing it (Fig 3.5), investors are much in two minds, but the overall impact is neutral for the equity market outlook.

Even with the individual categories of equities, there

3.6 Changes planned to asset allocation as a result of current market conditions by country and size

% of 109 respondents



seems to be remarkable consensus with matching scenarios for ‘Rest of Europe’, Asia and other countries – the only pronounced trend on the equity side is those investors moving from their domestic markets to the USA.

The long-term trend to fixed income, however, is even more pronounced this year, as 50% expect to increase their exposure compared with 31% reducing; last year the respective figures were even more visible with 69% increasing and 39% decreasing exposures. The interest in corporate bonds continues to look very strong.

Key takeaways

- ➔ with as many investors increasing as decreasing their equity holdings, might this indicate some cautious optimism that worst of the recession is seen as over?
- ➔ sentiment has moved significantly against hedge funds
- ➔ sizeable net shift to real estate and private equity, and seismic shift to commodities
- ➔ previous big shift to Asia halted and replaced with predicted large movement to USA

But how long before investors decide to come out of cash? In last year's survey 12% expected to increase cash, as against the 31% who planned to move from cash. Now 14% intend to increase their cash holdings, while only 18% plan to move from cash – a much more subdued stance in just 12 months.

Another striking commentary of the times is the degree to which investor attitude has moved against hedge funds, with only 7% moving into and 11% moving out – last year 25% and 1% were the respective figures. Commodities appear to have weathered the roller-coaster ride of the past year or so, with a massive 54% declaring their intentions (12%) to invest, with just 1% divesting (1%). In addition, there has been a sizeable net shift to real estate and private equity. We give a snapshot of where investors are overall regarding 'Alternatives' in the future on page 18.

4. Sources of absolute versus relative return

Some leopards change their spots

In a period of investment where many of the accepted assumptions about the merits of different assets have disappeared into the melting pot, investors are still left with the issue of trying to build portfolios on the basis of expected returns and diversification of risk. They are clearly much less certain as to the role the different asset classes can play in delivering returns currently

Investors' perceptions of where returns come from in their portfolios seem to be less dispersed than last year, where the biggest changes have been in relation to both fixed income and equities as the sources of relative returns.

In the current survey (Fig 4.1), 15% of respondents see fixed income as a source of relative return and 18% on the equity side – the respective figures for the previous survey were 45% and 54%. When it comes to absolute returns, the position this year is much closer to last year – in the case of fixed income 16% (17%) and of equity 13% (14%).

But perhaps the greatest turnaround has been in hedge funds, which were seen last year as the greatest source of absolute returns by 25% of investors, with a minimal 1% contribution in terms of relative returns. The volte face means that a mere 5% now expect absolute, while 9% see them as a source of relative returns.

While alternatives in general are still regarded as producers of absolute returns by 9%, down somewhat from last year's 13%, they are now seen as a source of relative returns by 9%, compared with a zero contribution expected from them last year.

So where are investors sourcing their absolute returns?

Real estate is the answer, as it is an asset where 15% of investors see absolute returns coming from, ranking just behind fixed income in this regard.

More investors are expecting contributions to their returns to come from commodities, currency investing and cash and, judging by this year's survey findings, all of these asset classes are seen as sources for both absolute and relative returns by an increasing proportion of investors.

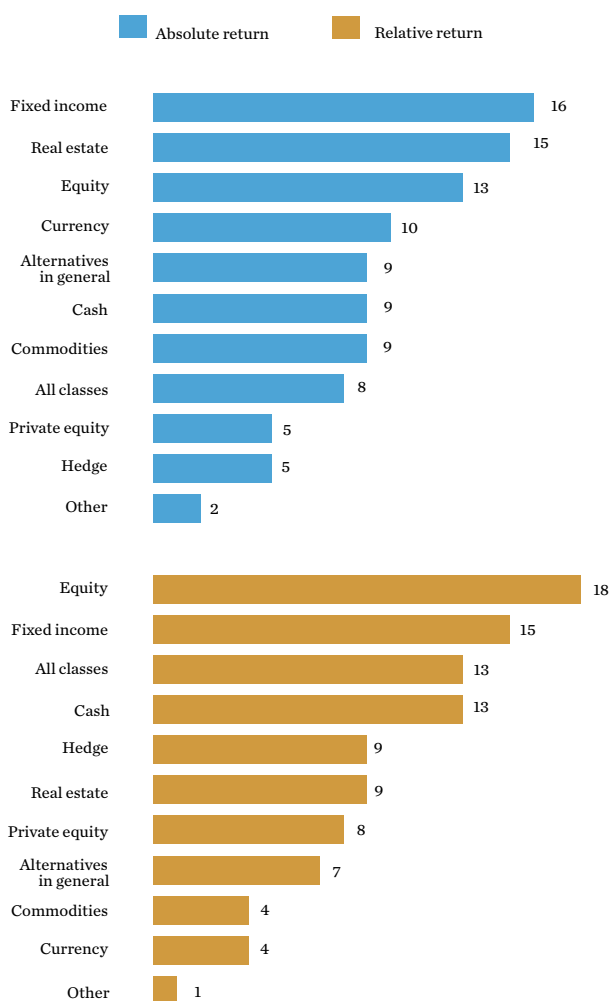
Interestingly, none of these three areas of investment have seen a switch in the predominance of absolute versus rela-

Key takeaways

- ➔ fixed income, closely followed by real estate, largest single source of absolute return
- ➔ fixed income, real estate and equity broadly equal, and same as in 2007, as sources of absolute return at average of 15%
- ➔ currency and commodities now seen as much more important sources of absolute return
- ➔ equity and fixed income remain the main sources of relative return, but at significantly lower levels than last year, at 18% and 15%, respectively

4.1 Sources of absolute and relative return

% of 109 respondents answering question



tive returns, as has happened in the case of hedge funds and private equity, where more investors currently see both as sources of relative returns than absolute, when compared with last year's findings.

Country perspective

As might be expected, investors in different countries take their own views about their own portfolios and in particular about where they expect their returns to come from (Fig 4.2). For the purpose of this analysis we just look at absolute returns.

Countries where the pension system provides some hurdle or guaranteed rate of return are likely to favour the absolute return approach, as may be evinced from the 'all classes' analysis.

The strong interest of Nordic countries in absolute returns could emanate from this, particularly so in the case of Danish funds. German funds can operate under similar constraints; in Italy and some of the CEE countries, some funds may have to meet such expectations.

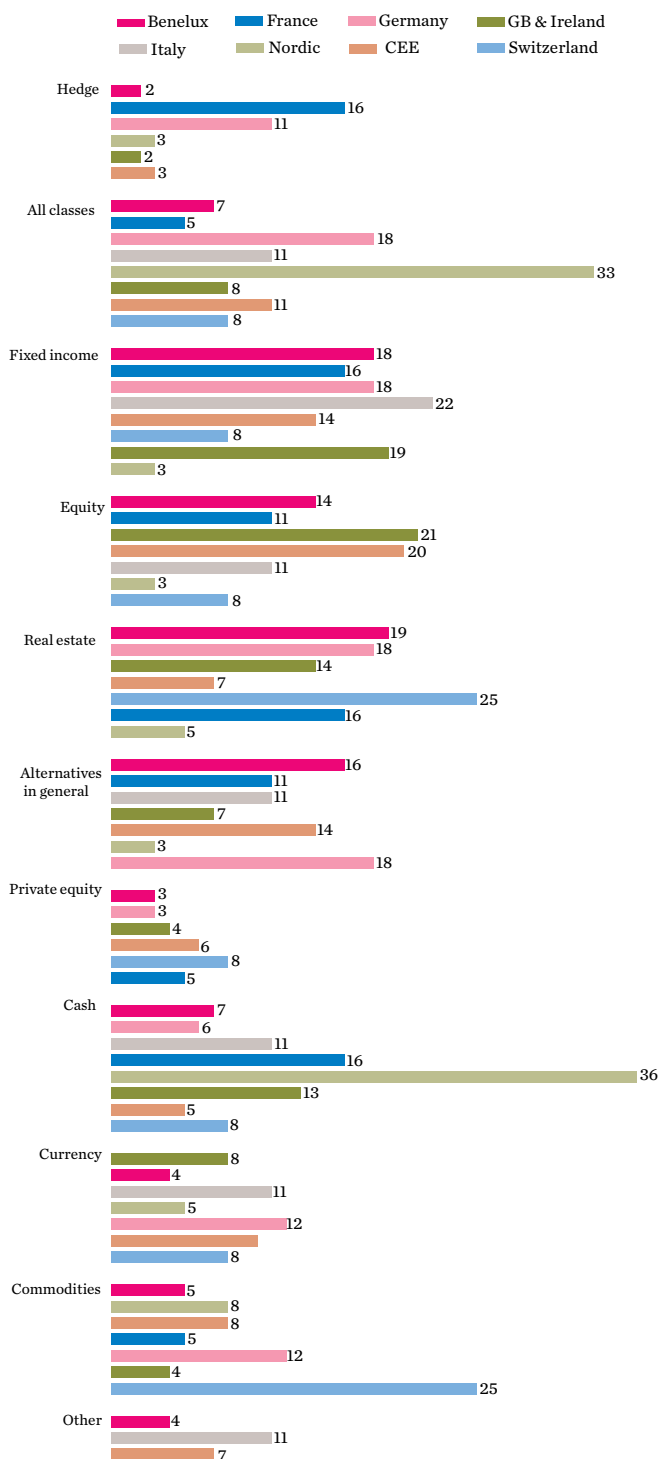
In the other overall grouping of 'alternatives in general', where absolute returns are normally expected to be gener-

ated within portfolios, Nordic investors are not focusing on alternatives, which is borne out when looking at the funding for hedge funds, private equity and real estate. Cash is king for these investors when it comes to ensuring absolute returns and commodities seem to be an area where they are seeing opportunities.

While British & Irish investors rank highest among those looking to equities for their returns, they see these coming to practically the same extent from fixed income. They also see real estate as a potential provider, as do Benelux and

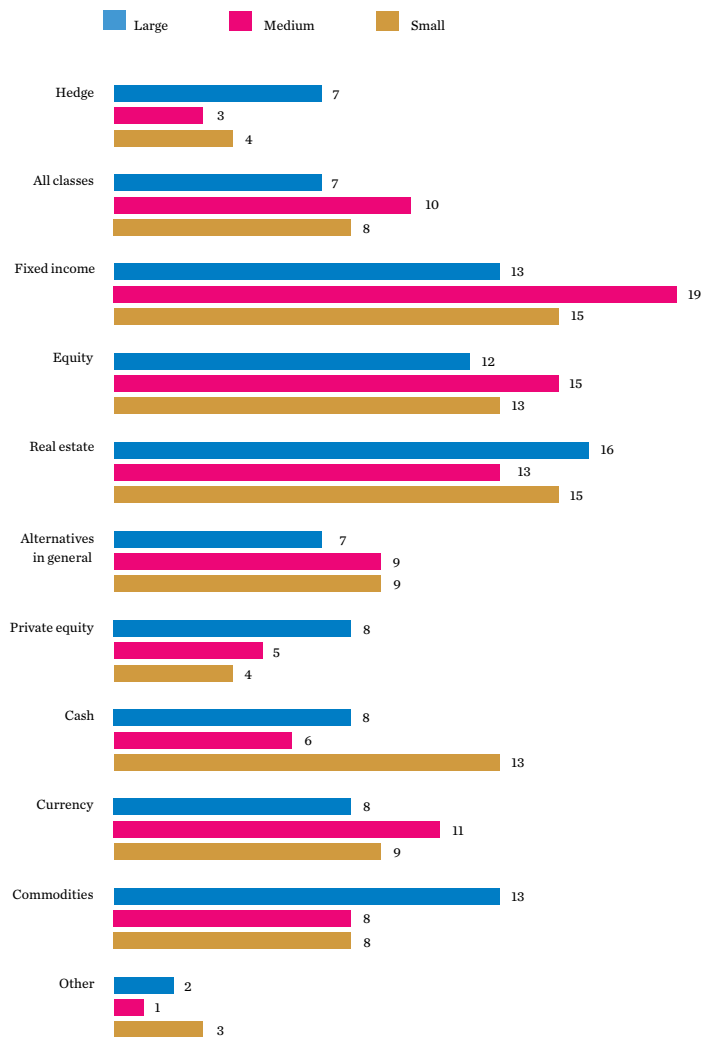
4.2 Sources of absolute return by country

% of 89 respondents answering question



4.3 Sources of absolute return by size category

% of 90 respondents answering question



German investors to an even greater extent.

But it is the Swiss who see the real estate as a key source of absolute returns, with 25% of investors giving it this rating, the same response rate as for commodities. They are relying to a lesser degree on private equity this year, although they are ahead of others in their estimation of its contribution.

Large funds seem to be looking less to alternatives than their smaller brethren for their absolute returns (Fig 4.3), although they seem to be more expectant of obtaining of these returns from hedge funds and private equity than other investors. Commodities appear to be their alternative of choice in this regard.

Key takeaways

- ➔ Nordic countries still have the biggest overall commitment with 33%, with main focus now on cash
- ➔ German preferences now also include the same levels of real estate and alternatives in general as fixed income
- ➔ GB & Ireland and CEE most focused on equity
- ➔ Larger investors have switched back into fixed income and away from alternatives

5. Alternatives

At a crossroads

The state of alternatives investing in Europe is one of the key issues that this survey highlights. Do European investors still believe in the alternatives story – the need to diversify portfolios into non-correlated assets – or has that belief been dented by the financial turmoil they have been living through?

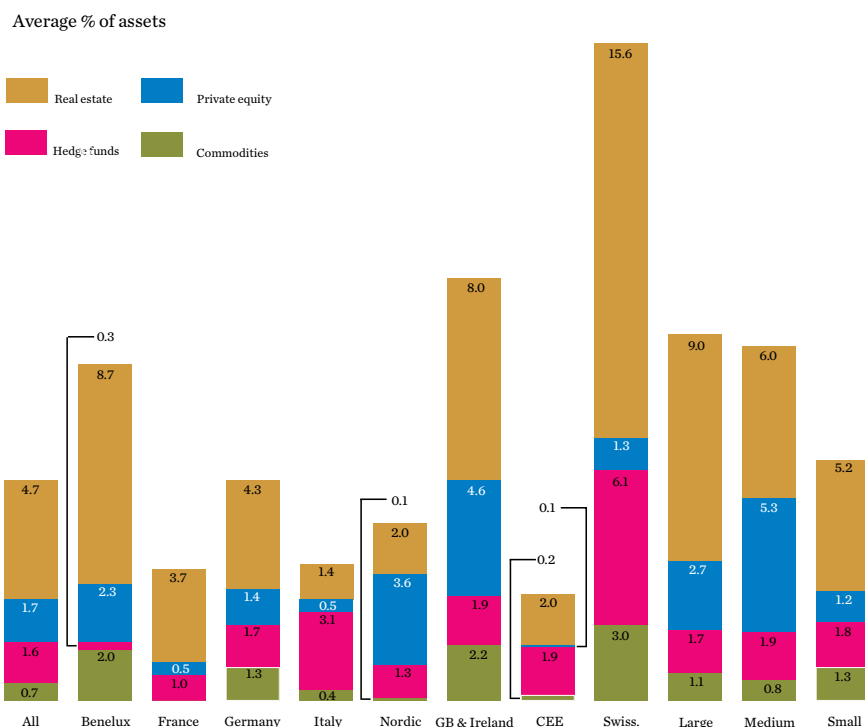
Certainly, looking at the overall ‘All countries’ figures (Fig 5.1), alternative portfolios are now a smaller proportion than they were a year ago. In the 2008 survey, they accounted for 10% of assets – currently this figure is down to 8.7%. So although investors’ faith may not have been destroyed, it certainly has been dented.

And this is across the spectrum of alternatives, with real estate at 4.7% (5%), private equity 1.7% (2%), hedge funds 1.6% (2%) and commodities 0.7% (1%). While this is no bloodbath it is a check in what could have been regarded as the almost inexorable rise in the alternatives share (Fig 5.2) since 2003.

It is clear from the survey responses, the situation facing investors can vary from country to country very markedly.

Real estate has been the core element of all alternatives - but the impact of the market downturn has affected

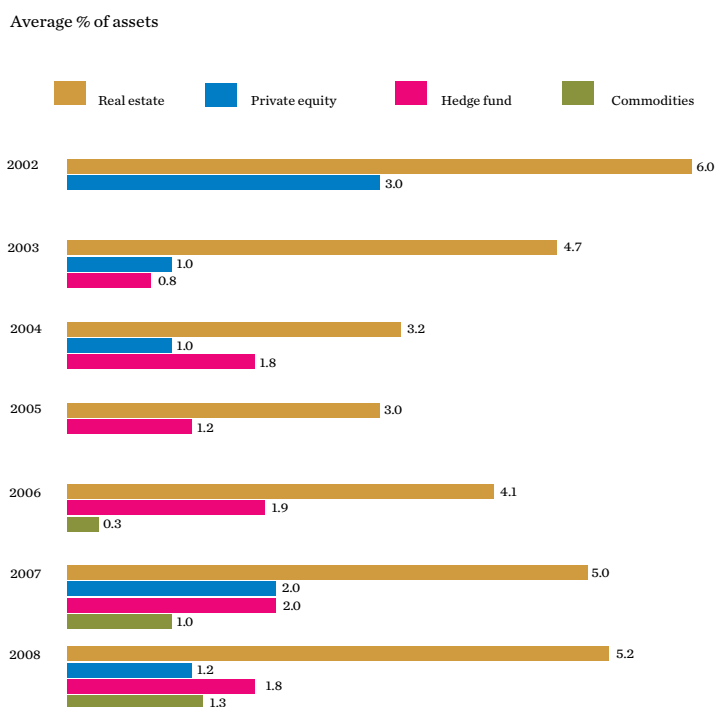
5.1 Selected alternative assets by country and size category



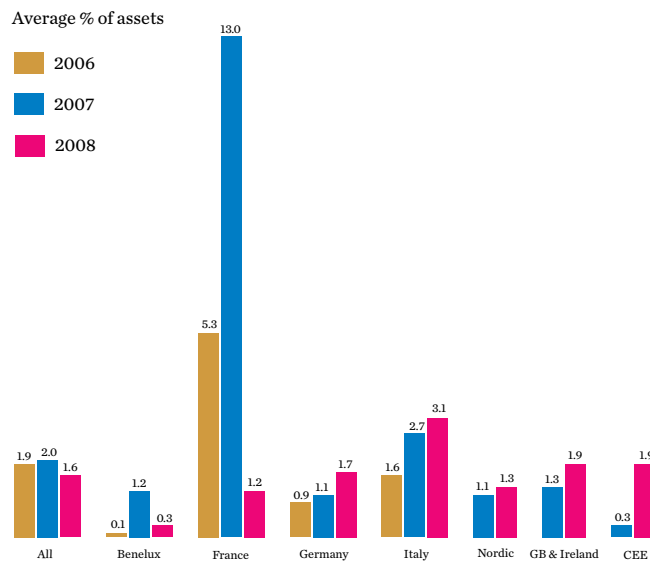
individual countries very differently. Swiss investors have seen the real estate component reduce to 15.6 from 22.1% - this is a dramatic reduction. No other markets have seen their proportions slashed in such a chastening way, though Italian and German funds are down from 7.3 to 1.4% and 4.3%, respectively.

Others hit by the decline include CEE investors down from 4.4 to 2%, Nordic 3.3 to 2%, and British & Irish funds a marginal decline from 9 to 8%. French investors seem to have bucked the trend by increasing the real estate exposure, up to 3.7 from 1.3%, but this could be

5.2 Selected alternative assets 2002-2008



5.3 Hedge fund assets by country 2006-2008

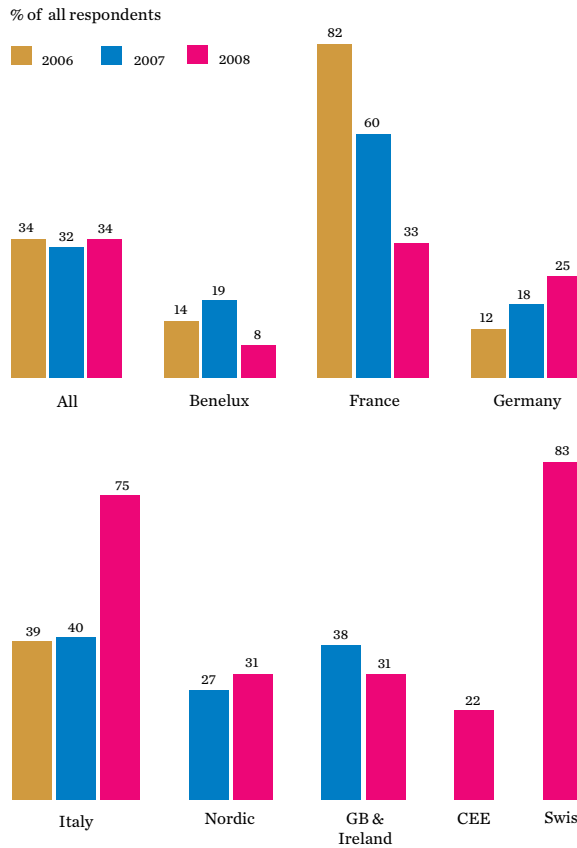


a reflection of the wider sample from that market participating in this year's survey. Benelux countries also showed a rise from 7.4 to 8.7%.

While private equity is just ahead of hedge funds as the second most popular alternative among survey respondents, there is not much air separating the two at a European level. Exposure is minimal in some countries, such as the CEE, where the structure, regulation and maturity of the pensions area would make it difficult to incorporate the asset class. France and Italy are also still marginal players, with an exposure of less than 1%.

The strongest players are Irish and British funds, which reported a significant 4.6% average involvement with private equity, up from the previous survey's 3.4%. Benelux investors also allocated more, with 2.3% of investments in the area, a slight increase of 0.2 percentage points. German

5.4 Hedge fund users by country 2006 -2008



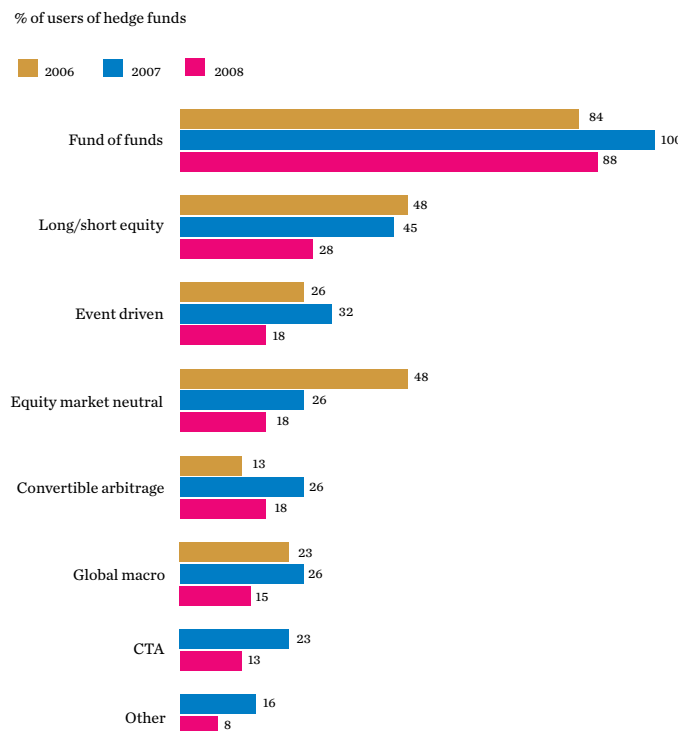
investors are concerned? At a European level they hit their peak of a 2% allocation last year, only to see this slip to a marginal 1.6% this year. With all the negative feedback in the marketplace, will it be possible for them to crawl their way back into investor acceptance? The Benelux, France and Nordic investors have seen their allocations slip (Fig 5.3), but a serious caveat has to be entered as to the reliability of the figures for the French market for 2006 and 2007 – the current figure of around 1% is likely to be nearer the mark for this market.

In some countries, notably Switzerland, they seem to have made considerable inroads, reaching a 6.1% allocation. Italy may strike some as an unlikely market for hedge fund investing to take off, but it has the second highest exposure in Europe and, as Fig 5.3 shows, it has been building up its allocation gradually over the past three years. Germany has had a similar growth pattern, although at considerably lower absolute portfolio proportions. Irish and British investors and, somewhat surprisingly, CEE, also show increased commitment to the asset.

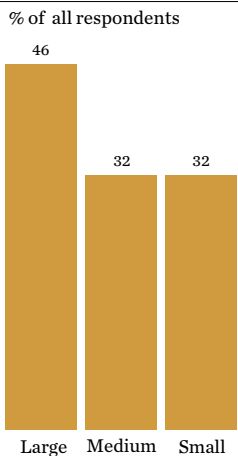
As to the future – the investor intentions response relating to alternatives (page 18) shows that hedge funds could well be in for a rougher ride.

In relation to investor size, the bigger the fund the bigger the allocation to all alternatives is what might be

5.6 Users of different hedge fund products 2006 - 2008



5.5 Hedge fund users by size 2008



and Swiss investors posted a higher percentage to up to 1.3% and 1.4% from a lowly 0.2% and 0.3%.

Have hedge funds shot their bolt as far as European

expected, but there are some exceptions here, with commodities appearing to be a higher proportion of smaller funds than that of the largest or medium-sized. Private

equity seems to be particularly prized by medium-sized funds.

Hedge fund investing, according to this finding, has not just held its own, but increased marginally in the past year to the levels of two years ago (Fig 5.4). There has been a steep decline in Benelux investors, reversing the trend of the previous two years. The French decline has been dramatic, but caution needs to be exercised, due to changes in the investor sample relating to this country. Falls also occurred among British & Irish funds.

The declines contrast with a big uptake by Italian funds, with almost twice as many funds investing as in the previous year. But the numbers of German and Nordic investors have also increased. Swiss investors now hold the top slot, with over 80% of investors using hedge funds.

When it comes to size factors (Fig 5.5), medium funds have pretty much held firm, with one-third saying they invest currently, the same proportion as the smaller funds which have substantially increased their use. Almost one-

Key takeaways

- ➔ 34% of respondents used hedge funds in 2008, or a steady one-third in each of the last three years
- ➔ large funds have increased their commitment to hedge and almost half are investors
- ➔ funds of funds still the most favoured investor approach, but its popularity has fallen

half of the large funds are now saying they employ hedge funds, up from one-third previously.

Looking at how investors use hedge funds (Fig 5.6), fund of funds are still the most popular, although now only used by 88% of those that use hedge funds, down from 100% last year. Equity long/short strategies were the second most popular but their use almost halved. Convertible arbitrage and equity market neutral have both moved up one place to equal third, while global macro has fallen in popularity, moving from fourth to sixth place.

Investors’ intentions regarding alternatives

The trend to the adoption of the ‘Alternatives’ culture across the different markets seemed to be an inevitability and the gradual increase in exposures virtually in all alternatives tracked by the survey confirmed anecdotal market information.

But this year, the train hit the buffers and the inexorability of the trend has to be questioned. Can alternatives survive the body blow the market has dealt? Does the charge stick that alternatives do not do what they say on the tin; they do not provide the diversification claimed? Obviously, with all asset classes seeing downward revisions in valuations due to the recession gripping the worldwide economy – the proponents of alternatives say that these are extraordinary conditions when virtually all assets become correlated.

Any asset that is illiquid will be penalised in such markets – by their nature a number of alternatives are illiquid – but part of their return comes from their illiquidity, which

has long been seen as an attractive feature for long-term institutional investors.

But the detractors of alternatives are in a strong position to preach a lesson of the need to return to the traditional assets. All their warnings of the drawbacks in alternatives have been confirmed by the events of the past 12 months.

So alternatives investing must be something that is due for critical review in the boardrooms and committees of investors across Europe. It is a debate where the jury must still be out and the case for each alternative has to be judged individually.

But what do investors say their plans are for alternatives – deriving information from the previous section 4, we give below a table we have updated from last year’s report with this year’s responses, but also give last year’s responses in parenthesis to show the shifts in thinking that are happening about alternatives.

Apart from commodities and hedge funds where the message is clear, the reckoning about alternatives is much more subdued, but by no means is their place within portfolios jeopardised, although investors’ expectations and intentions appear more muted.

European investors’ planned changes to their allocation to alternatives

Alternative	To 2008(07)	From 2008(07)	Difference 2008(07)
Real estate	18% (26%)	7% (5%)	11% (18%)
Cash	14% (12%)	18% (31%)	-4% (-19%)
Private equity	13% (22%)	5% (0%)	8% (22%)
Hedge funds	7% (25%)	11% (1%)	-4% (24%)
Commodities	54% (12%)	1% (1%)	53% (11%)
Other alternatives	16% (26%)	5% (0%)	11% (26%)

6. Portfolio tools and instruments

In the toolkit

The changing investment climate is definitely impacting how investors are approaching techniques that in the pre-recession climate looked as if they had an extremely bright future. Structured products have run into problems in a number of their manifestations, but certainly not all. Exchange traded funds usage has declined overall, but this may reflect a diminution in portfolio activity. Is fundamental indexing as a concept past its ‘sell-by’ date – investors seem much less convinced by the case in a declining market? Are current interest rate levels damaging the prospects for interest and inflation swaps usage?

a. Structured products

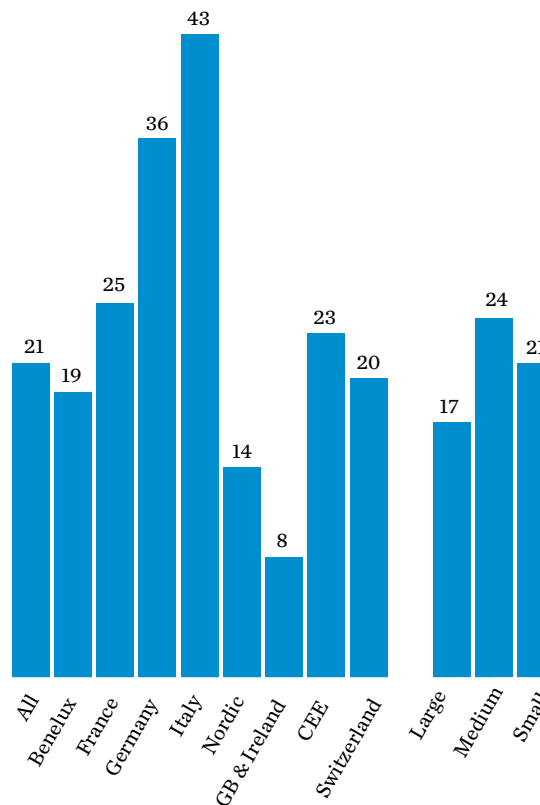
As in previous years, we defined these as instruments, including those with non-standard features, such as capital protection, warrant and loan gearing, commodity hedge arbitrage and share index style investment. But, of course, the term covers more than those mentioned, not least some highly engineered and complicated structures.

There certainly has been a fall off in investor use with the proportion falling to 21% on an ‘All country’ basis compared with 28% the previous year (Fig 6.1). The year before that (2006) it had been as high at 33%, when a higher proportion of insurance companies figured among the survey sample.

With the structured products and vehicles blazoned in headlines across Europe, it might be thought that investors would shun being associated with such investments, but not all or even most structured products can be looked on in this way. Portfolio capital protection insurance is very popular in Ger-

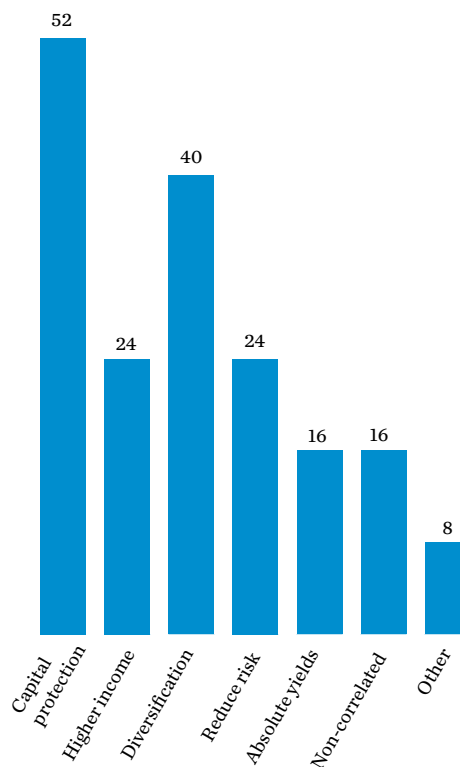
6.1 Structured product users by country and size

% of 108 respondents



6.2 Reasons for using structured products

% of 25 users of structured products who responded to question



many, for example, particularly in investment downturns and is a well established and reputable structured product.

German investors are favouring them even more this year compared with last, with up to 36% (30%) using them. But it is Italian investors who have moved to occupy the numero uno slot, with 43% of funds indicating their usage.

France, which has been a stronghold of structured investment, no doubt due to the French market’s strongly developed financial engineering expertise, saw investor interest drop to 25% from 40% in the previous year’s survey. Nordic investors have been players in this arena, but also have cut back their involvement to just 14% from 36% in the previous survey. Other countries that have reduced their exposure include the CEE down to 20% (28%).

The Swiss have maintained a steady course, with 20% investor involvement, the same level as the year before. British & Irish funds appear to have been never more than lukewarm with regard to structured products, as the number of funds taking them up declined to 8% from a mere 9%.

The chart also shows how fund size impacts and it is quite dramatic in the case of the large funds, with currently less than half the number of funds previously active – but perversely, more medium and small sized funds have become players, albeit marginally.

Although less than a quarter of respondents gave their reasons, of the 25 that did (Fig 6.2), over half (52%) were doing so for capital protection, much higher than the previous year’s 30%. Similarly, ‘diversification’ as a reason was used by 40% (24%), while only 24% (24%) were seeking higher income, often seen as the key reason for using

these products. A similar number wanted to use these products to reduce their risks.

But one of the most glaring contrasts with the previous year is that those who had other reasons had fallen from 30% of respondents to just 8%, perhaps indicating a clearer, more focused approach to what these products can offer institutional investors.

b. Exchange Traded Funds

There has been a significant fall in numbers of investors using Exchange Traded Funds (ETFs) between this year and last year, down to 30% for 'All countries' from 44% a year ago. There is no reason to think this reflects investor distrust or change in attitude to the product, rather it may be due to a slowdown in portfolio activity owing to the uncertain investment climate. Within the investment marketplace, the acceptance of ETFs has been widespread.

French investors have been ardent proponents with last year some 100% of respondents using ETFs. While this has slipped, still two thirds (67%) are using the instruments, although this may also be a consequence of year on year sample differences. The CEE countries have been highly active users, down to 50% this year (83%). In Italy, where two thirds said they invested in ETFs in 2007, this has slipped this year to 57%.

Benelux investors saw a heavy fall in use down by almost a half to 14% from 27%, while British & Irish funds managed to push up their use against the trend with around a quarter of funds using ETFs as against 18%.

Fig 6.4 indicates that the large funds are the strongest champions of ETFs, where the penetration has been very pronounced – currently three quarters of the large funds are employing them, compared with 50% a year ago. Where the fall-off has been most noticeable is among the medium-sized funds, where usage fell to 24% (28%).

The small funds, where the ETFs' non derivative credentials must be a plus point, also saw a take up in use last year with the number of funds active moving from just under a quarter (23%) to well over a third (36%).

As portfolio reconstruction gets underway across Europe, it will be fascinating to see how the next stage in the ETF story unfolds.

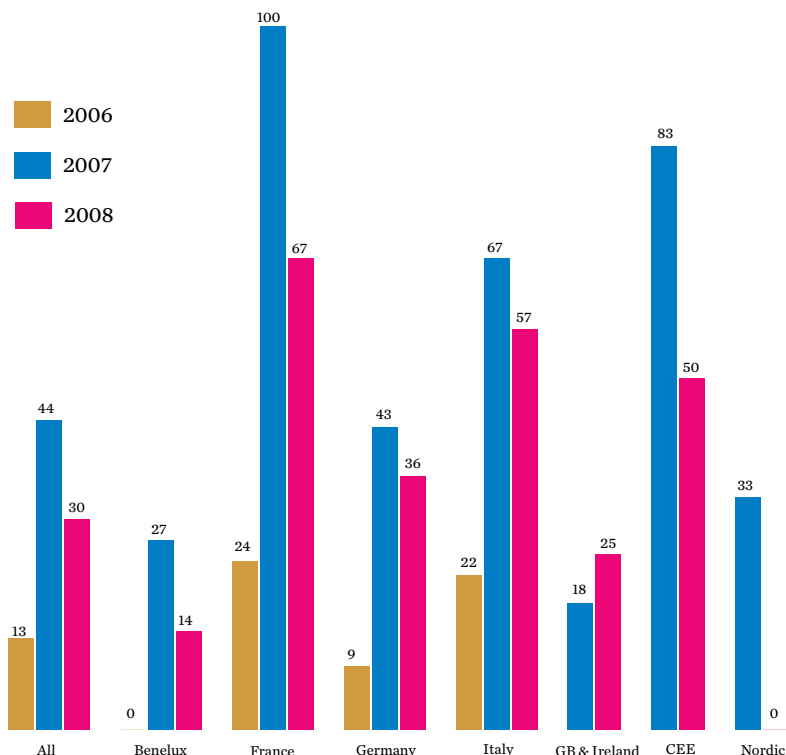
c. Fundamental indexing

The jury still has to be out as to whether fundamental indexing is a concept that has weathered the storm of markets conditions.

The definition we used was the same as the previous survey's glossary: 'An index where the weighting of individual stocks is composed using factors such as level of sales, cash

6.3 Exchange traded funds (ETF) users 2006-2008

% of 113 respondents



flow, dividends and book value rather than using market capitalisation as with traditional indices'.

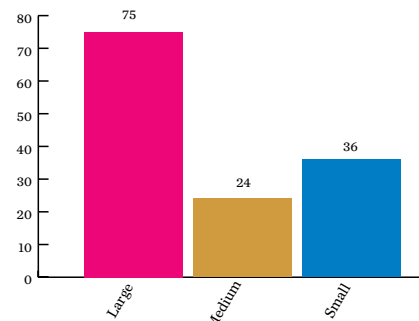
With a concept such as 'fundamental indexing', there have to be concerns that the definition was in accord with the respondents own understanding of the term. But the response rate was even higher than last year, with 112 out of 117 replying to the question.

While the same percentage as last year, 11%, confirm (Fig 6.5) that they are considering employing fundamental indexing in their portfolios, those who say they are has slumped from 24% to 7%.

This is a dramatic decline in usage for a methodology that was just beginning to make its impact in the market.

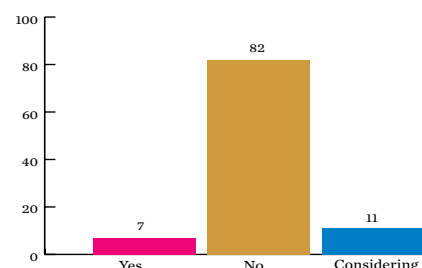
6.4 Exchange traded funds (ETF) users by size

% of 113 respondents



6.5 Use of fundamental indexing strategies

% of 112 respondents to question



Even if all the 11% ‘considering’ did decide ultimately to use it, the total user population would then only be 18%, well below the 24% actively involved last year. The proportion of those responding ‘no’ increased from 70% to a resounding 82%.

d. Interest rate and inflation rate swaps

The number of respondents to this question at 23 is considerably less than the 30 replying in the previous survey. While it is impossible to draw any conclusions from this fact, it may indicate a lesser degree of interest in these techniques than previously, perhaps related to the current levels of interest rates (Figs 6.6 and 6.7).

Last year we integrated the question we asked to include both interest rate and inflation rate swaps, but this year we separated the two questions. (There were only 7 who responded to the inflation rate question).

In the survey, two thirds indicated they used interest rate swaps to manage liabilities, a quarter (24%) to manage guarantees, while the balance (8%) included just ‘additional returns’ and ‘managing duration’ – a much narrower range of reasons than provided last year.

Managing liabilities was pre-eminent (86%) as the rationale for interest rate swaps, with just 14% quoting ‘additional returns’ as the other reason, with no requirement at all for managing guarantees.

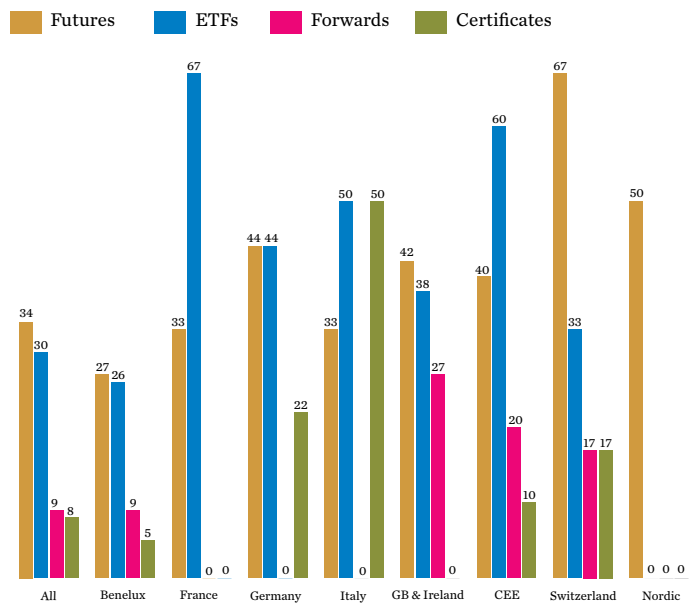
e. Index exposure

When we asked what techniques were used to gain index exposure, overall, futures and ETFs remain most popular, but at reduced levels compared with last year.

According to Figure 6.8, futures were ranked just ahead of ETFs, at 34% and 30%, respectively, this was well down on the previous survey’s 51% and 54%, though there does

6.8 Techniques used to gain index exposure

% of 102 respondents



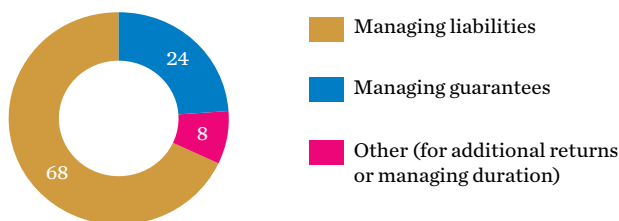
not seem to have been much difference in the relative ranking of the two. Last year, it was speculated that we could see ETFs usurp futures’ leadership.

Nordic and German investors maintain their pole position in relation to use of futures, with 51% and 44%, respectively, well down on last year’s corresponding values of 83% and 86%. CEE were the lowest users of futures, although this year’s 40% is more than double last year’s.

ETFs have their strongest proponent as last year in the CEE countries, while certificates have very limited exposure, being confined to CEE, Germany and Switzerland.

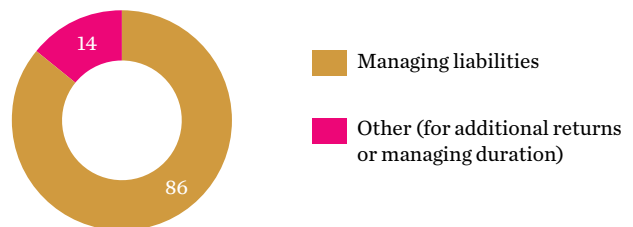
6.6 Reasons for implementation of interest rate swap approach

% of 23 respondents



6.7 Reasons for implementation of inflation rate swap approach

% of 7 respondents



7. Duration

Bridging the gap

For pension funds and insurance companies, the re-emphasis that has been put on liabilities and meeting them has reawakened the traditional investment approach of matching liabilities and immunising them by fixed income investment. That liabilities have bond-like characteristics has become almost a mantra of the business. The scenario has been complicated by the longevity issue which is ever increasing the sum of the liabilities and their duration – the other is the lowering of interest rates by governments, which has had the effect of increasing the value of the liabilities, but not necessarily, of course, their duration. While we measure how investors state the gap in terms of years, we question the value of such a measure on a pan-European basis, rather than using it for country level analysis alone

Measuring the duration gap has become for some markets a key figure to judge how well positioned the pensions and insurance investors are to matching the two.

In last year's survey, we examined for the first time what investors' 'duration gap' might be – knowing that a figure out of the blue would not in itself be very significant for investors. We recognised then that it would only be a snapshot at any particular moment and that its real value would be over time.

Tracking the gap between the overall duration of fixed income portfolios and investors' actual liabilities over time will provide some indicators as to how countries are keeping their investment portfolios in line with their liabilities.

But it has to be recognised that this measure is a very crude approximation and is subject to a whole raft of 'other things being equal' caveats. Its usefulness and relevance will also very much depend on the country being considered. It has most significance for countries with defined benefit type liabilities, but will also be of interest to those with other guarantees within their liabilities profiles.

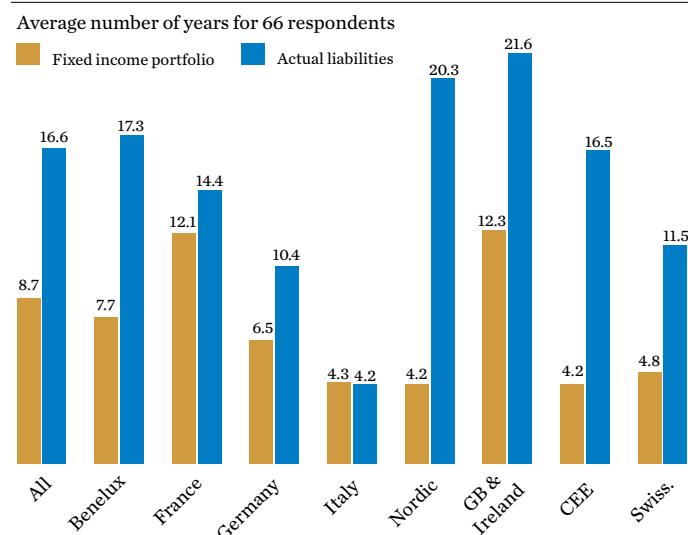
We limited the responses we considered for inclusion to those funds that gave responses for both the liabilities and the fixed income duration. Last year this reduced the number of respondents to 64 investors and this year to 66.

So for British & Irish funds, where their liabilities have increased to 21.6 years (previously 19.8) and the fixed income duration has reduced to 12.3 (13.5), the situation has deteriorated (Fig 7.1) and this is picked up in the table in the panel, where the difference has increased from 6.3 to 9.3.

In the case of Benelux investors, liabilities have moved out significantly to 17.3 years from 13.6, while the duration of the fixed income portfolios stayed static at 7.7; it saw the gap in years crystallise at 9.6, up from 5.9.

With a strong contingent of Danish investors, Nordic funds also find themselves with a wide gap between the

7.1 Overall duration of fixed income portfolio and actual liabilities, in years, by country



two measures, though their difference narrowed from 17 to 16.1. They saw their liabilities fall slightly from 20.3, while the duration of their fixed income portfolios increased slightly by from 3.9 last year to 4.2 years. This could be the result of successful hedging and risk management techniques exercised by investors in Denmark.

Both Swiss and German funds do certainly have defined benefit type liabilities as part of their occupational provision, but the position seems to be very much more under control here – Germany with a 3.9-year gap and Switzerland with one of 6.7 years, both lower than the table.

The Italian funds are in negative territory, but in this context this has positive connotations as it means the duration of the fixed income portfolio covers the liabilities,

Country/region	Difference in years	
	2008	2007
Benelux	9.6	5.9
Germany	3.9	5.1
GB & Ireland	9.3	6.3
France	2.3	6.1
Switzerland	6.7	7.5
Italy	-0.1	3.5
Nordic	16.1	17.0
CEE	12.3	5.8
All countries	7.9	6.7

so they are extremely strong from that perspective. France too has seen its ratio narrow and the gap is now 2.3 years against 6.1 in the previous survey.

Key takeaways

➔ in all cases, except Italy with -0.1 years, the duration of the liabilities again exceeded the fixed income portfolios duration

➔ the overall average for fixed income duration lengthened by almost one-half year, and that for actual liabilities by just over one and one half years. The overall difference in years increased by just over one year

8. Performance attribution

Knowing where it comes from

Sound information is the cornerstone of running any organisation – attribution analysis gives the ability to investors to examine critically the sources of returns within their portfolios

The steady upward adoption of performance attribution within portfolios as a trend continues unabated – unimpeded by any ripples in investment market conditions. That this practice is almost universally adopted has to be welcomed, as it is critical that investors know precisely what is under the bonnet when it comes to the investment engine. With 87% usage we must be near market saturation (Fig 8.1).

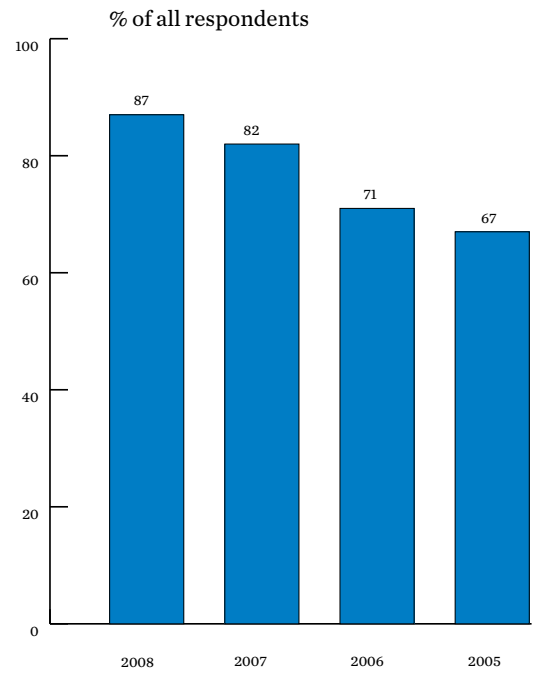
As heretofore, investment managers continue to be the main providers of attribution services and seem to be recovering from the precipitous fall between the 2006 and the subsequent survey. At the same time, funds’ own internal departments are making rapid strides, though this proportion may be due in part to the greater number of large funds participating in this year’s survey (Fig 8.2).

For other players, this could be something of a commodity product making it hard to win market share. Custodian banks and investment consultants appear to be making marginal inroads into the territory of specialist external analysts.

Key takeaways

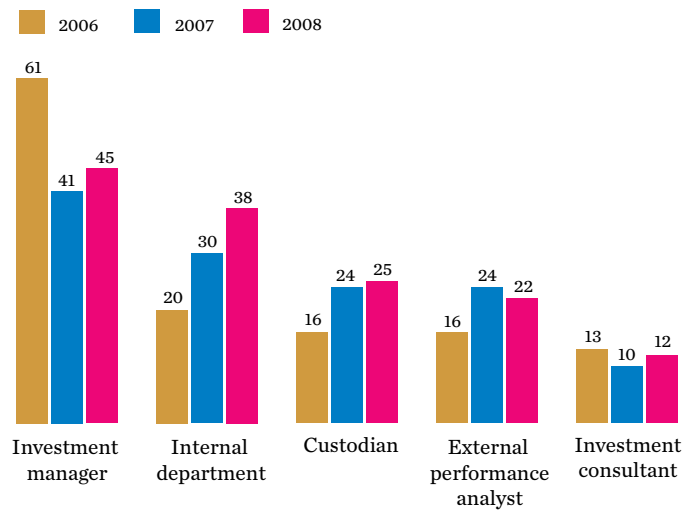
- ➔ used by 87% of respondents, showing a steady increase in each of the past four years
- ➔ investment managers are still the single largest providers of performance attribution, improving slightly on their market share last year, although still far behind their 2006 position of 61%
- ➔ internal departments are still in second place but have made the largest gains

8.1 Users of performance attribution 2005-2008



8.2 Suppliers of performance attribution 2006-2008

% of users of performance attribution



9. Consultants

What price advice?

Consultants often say that tougher times are good for business – but the lessons from this recession are not so clear-cut. While demand for their services in a number of countries continues to grow, in some of their traditional markets the fall-off in usage has been very significant. Certainly, the demand for investment advice has grown from investors and is now ranked first in the reasons for approaching consultants. Such a consequence is entirely consistent with recessionary times, but in keeping with other findings of the survey, asset allocation advice and manager selection have both seen declines in their use. The question has to be whether investors will learn to live without these services in the long term or whether the growth will bounce back in the traditional markets?

This year has seen the continuation of the penetration of the pensions markets by the consultancy firms. The breakthrough in spread of consultancy was really picked up in the 2007 findings, which showed that consultants had broken through the 50% barrier (Fig 9.1) as to the proportion of investors using their services across Europe.

While the big jump may be in part attributable to the increased proportion of pension funds featuring in the 2007 survey, our current findings do confirm this trend. But will we ever reach the situation where two-thirds of investors will engage external consultants as the trend in the figures might suggest?

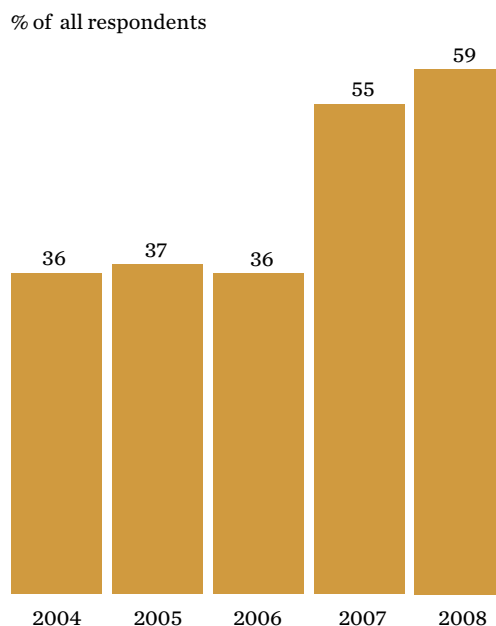
A clearer picture of what is happening on the ground comes from the country-by-country analysis, where the message is much more mixed (Fig 9.2). There has been a sizeable swing to using consultants in France, where 89% of investors responding are involved. This may be due, in part at least, to changes in the sample of respondents but, even in the previous survey's findings, the increase had been up from 18 to 40% in 2007.

The Benelux investors have also increased their usage as have the German and CEE countries, so it is they and the French between them that have driven this year's increase.

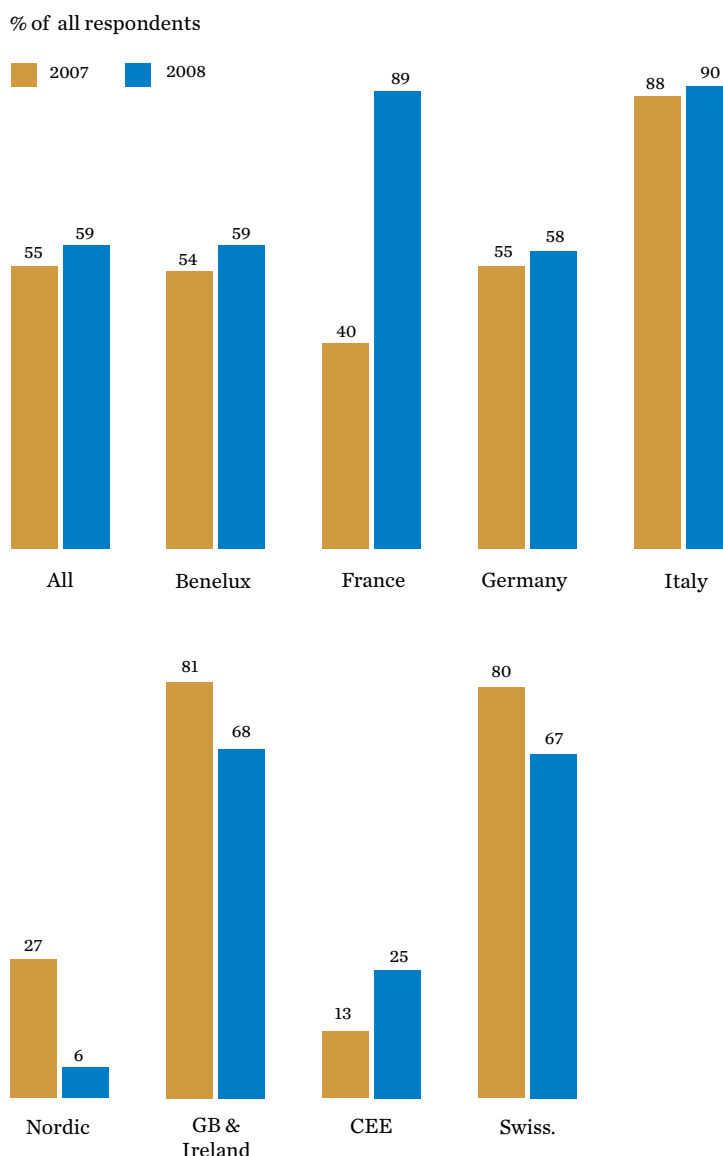
It is what is happening in the two strongholds of consultancy use, the Swiss and British & Irish investors, that may prove to be of greater long-term consequence to the penetration by consultants. Here we see that in both marketplaces there has been a slide in usage, roughly of the same magnitude to two-thirds from 80% or over.

The precipitous fall in Nordic markets usage from 27% penetration to 6% may well reflect the Danish influence, where labour-market and other funds have a very high level of in-house capabilities, which has

9.1 Users of consultants 2004 - 2008



9.2 Users of consultants by country 2007-2008



stultified the development of consultancy in the country along the lines that has happened elsewhere.

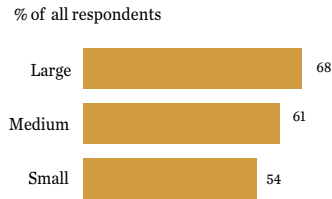
When it comes to considerations of size (Fig 9.3), there is not much that separates the groupings, nor has there been much movement since last year. Large funds usage has increased to 68% (64%), medium funds are down slightly to 61% (65%) and small funds increased marginally their use to 54% (52%).

Some explanation as to why the previously heavy users have trimmed back may be gleaned from the analysis as to the reasons why consultants are used (Fig 9.4). Obviously, as the recession bites, there has been a diminution in the level of portfolio activity, with a fall-off in external manager hires and less active portfolio allocation changes.

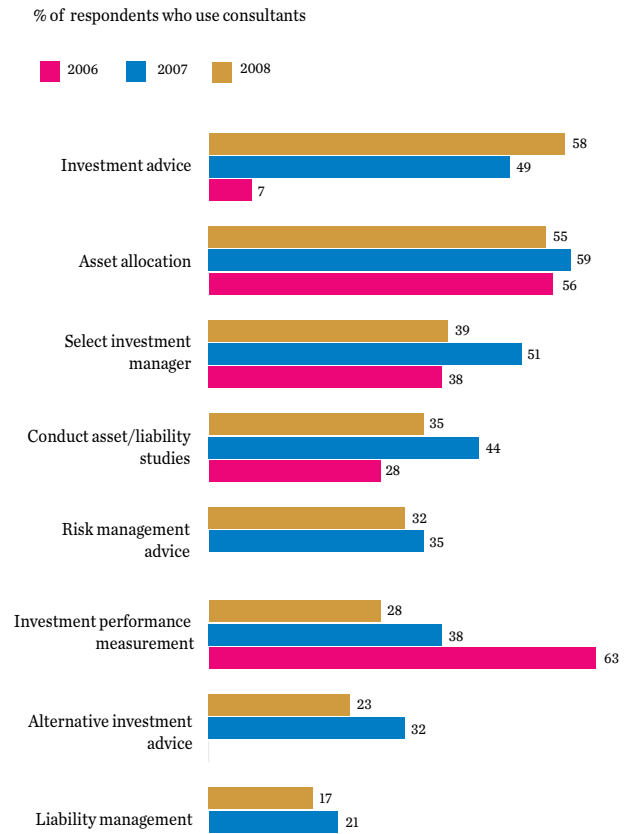
The figures show a fall right across the board in the 'reasons' why investors use consultants' services. In fact, all categories are down except for investment advice. It is probably safe to say that this decrease could be attributed largely to the Swiss, British & Irish and Nordic markets.

As to the services in demand, there has been some change in the relative positions as to the reasons why investors use consultants. 'Investment advice' at 58% (49% previous year) now ranks highest, dethroning 'asset allocation' at 55% (59%). 'Manager selection' had to yield position

9.3 Users of consultants by size



9.4 Reasons for usage of consultants 2006-2008



down from 51% to 39% , a clear indicator of quieter investor activity. 'Risk management advice' has moved up the ranks, even though its 'score' slipped back to 32% (35%).

Key takeaways

- ➔ use of consultants has continued to grow, albeit only by a small amount compared with the large hike in 2007
- ➔ the French seem the greatest converts to using consultants, appearing to have doubled their usage in each of the past three years
- ➔ from a much lower base, the CEE countries have also doubled their usage, while GB & Ireland and the Swiss, whilst still big users, have fallen back significantly from the

- highs of last year
- ➔ the Italians remain the biggest users
- ➔ consultants were most used for their investment advice, rather than asset allocation which had been in first place for the previous three years but now second by a small margin
- ➔ moving down from second to third place is manager selection

10. External managers: usage

Swing to in-house

While there has been a swing to internal management, it has been most significant among small funds, although the large funds are going that way too. In some countries the in-house shift has been very pronounced

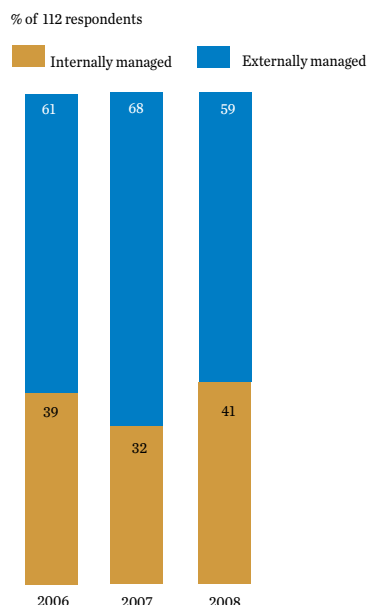
Compared with the previous survey, there has been a discernible swing to in-house management of assets by investors, with 41% of assets now being managed internally, compared with 32% last year (Fig 10.1). This is a complete reversal of the previous trend with a seemingly inevitable progression to external management at the expense of in-house activity.

While this move has been noticeable among the large funds, which saw externally managed funds fall to 53% from 59% (Fig 10.2), it has been most significant with the smallest funds, which saw their share of in-house managed assets grow from 34 to 43% this year. Medium-sized investors marginally decreased the in-house allocation, but by a marginal 1 percentage point to 32%.

On a country basis, there have been some reversals of the external/internal balance, with investors in Germany now managing 60% in-house compared with 43% in the previous survey. Nordic investors now only outsource 45% of their assets to external managers, compared with 32% last year. This could be due to the presence of more Danish funds in the sample with a greater propensity to invest using internal resources. The Italian funds are also notable for making a similar switch.

Among the traditional outsourcers, we see the Benelux countries going even further down this route, with just 13% managed internally as against 15% last time around. It is a similar story for British & Irish investors where the external

10.1 Users of external investment managers by vehicle

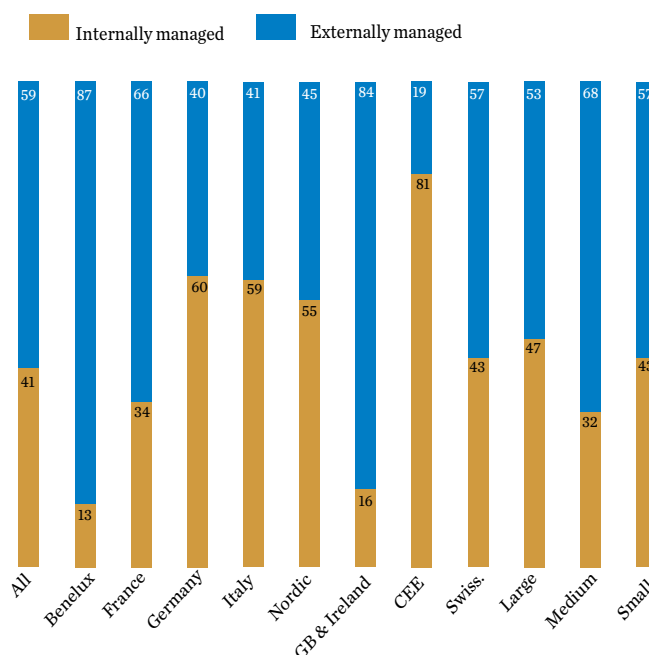


proportion grew to 84 from 81% last year. Switzerland, which has always been open to external management, reversed the trend over the past year and has now 57% of assets in external hands down from 81% in the previous survey.

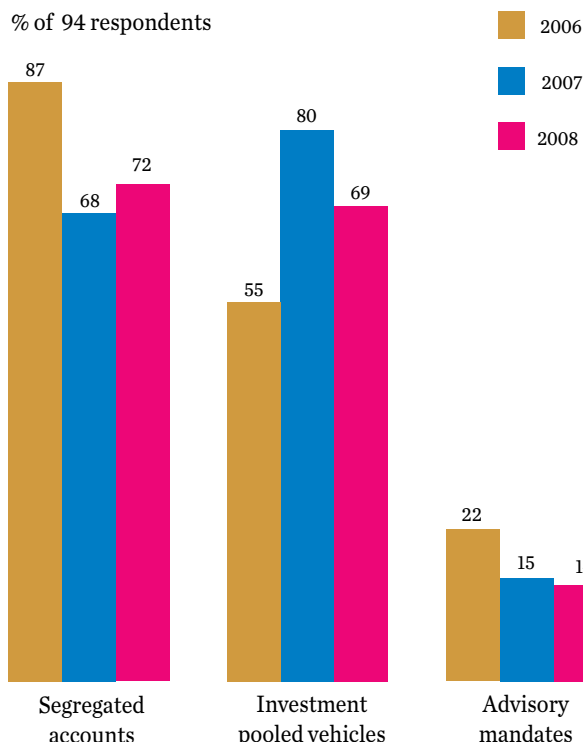
The CEE countries have always been firmly in the internal camp and they have kept exactly the same ratios of internal to external as in the previous survey. This reflects the situation

10.2 Assets delegated to external investment managers by country and size

Average % of assets of 112 respondents to question



10.3 Users of external investment managers by vehicle



in many of these countries where the big financial institutions provide the pensions vehicles and undertake in-house the bulk of the management.

Using a vehicle

Here we looked at how investors hold the assets they place with external managers, which have traditionally been mainly in segregated accounts. There had been some signs

Key takeaways

- ➔ small recovery in use of segregated accounts to 72% (from 68%)
- ➔ significant fall in use of investment/pooled vehicles to 69% (from 80%)
- ➔ no change in use of advisory mandates remaining very much out of favour
- ➔ segregated funds used most by French and Nordics, and least by CEE and Benelux
- ➔ pooled vehicles used most by Nordics and GB & Ireland, and least by French and Swiss
- ➔ segregated accounts used most by larger funds who have increased their usage to 62% from 53% last year
- ➔ pooled vehicles most popular with smaller funds and least by larger funds

that the arrival of funds catering for the special requirements of institutional investors would make their presence felt on the marketplace.

In the 2007 survey we found major jump in the proportion of investment/pooled vehicles being used, which perhaps was confirmation of this trend. But as a trend, it appears to have petered out. A substantial 69% are users of investment funds of one type or another (Fig 10.3), according to this year's survey, but the figure is well down on the 80% recorded the previous year. And any trend looks like it is in check currently.

We have seen some swing back to segregated accounts from the very major fall noted in 2007, where users declined in just one year to 68 from 87% in the previous year's survey. Advisory mandates seem to have found their place.

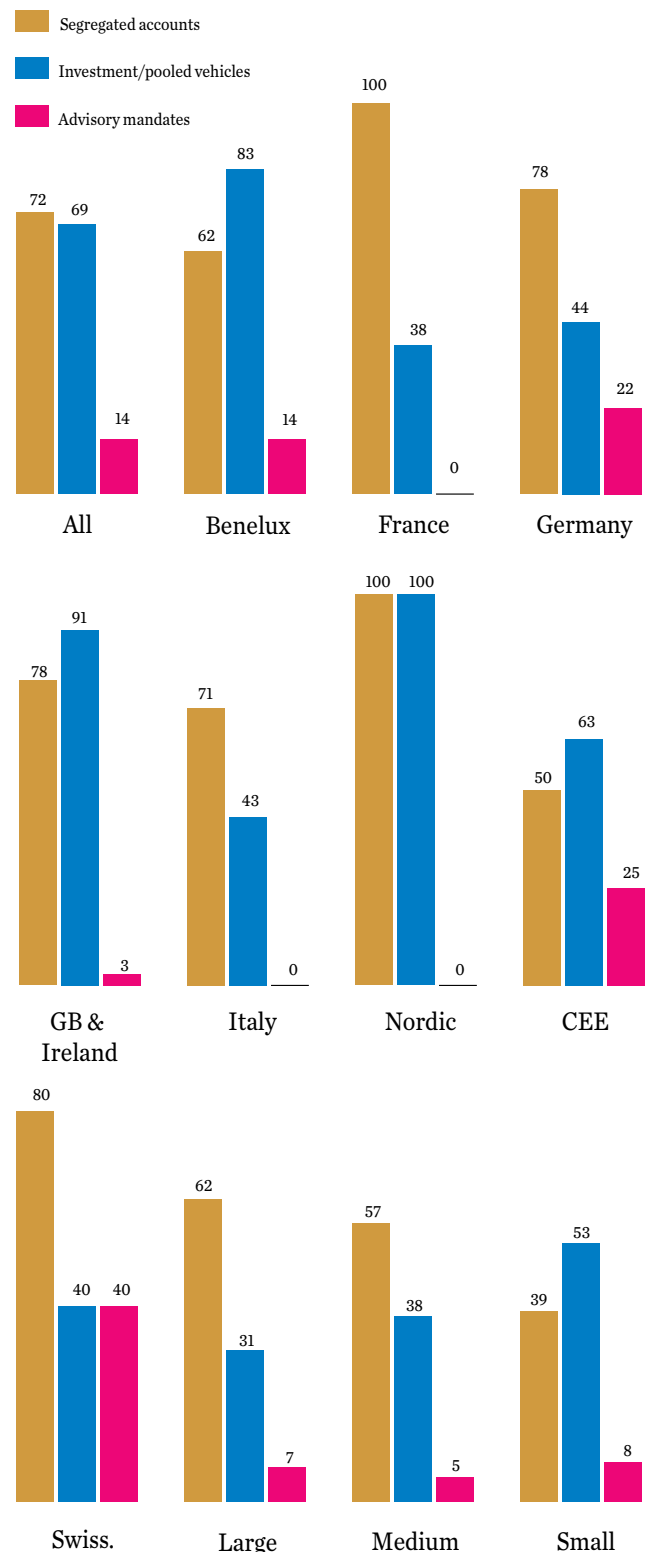
On a country spectrum, the practice varies, with Belgian funds large users of investment funds due to tax considerations, while Dutch are heavy users of segregated accounts (Spezialfonds).

Key takeaways

- ➔ previously, what was being seen as an 'inexorable' trend towards external managers has been halted, reducing to 59% from 68% last year (the lowest figure for at least three years)
- ➔ medium investors now delegate most to external managers, with larger and smaller investors tied when apportioning between internal and external managers. However, smaller investors have increased their allocations to internal managers by about one-third whilst the larger investors have only done so by a relatively small amount
- ➔ previously possibly distorted figure for French last year of 100% external, may now be more representative with 66% externally managed
- ➔ CEE unchanged and then Germans maintain their position of delegating least to external managers
- ➔ Italy has almost halved its allocation to external managers, and the Nordics have reduced their combined allocation by about one-third

10.4 Users of external investment vehicles by country and size category

% of 94 respondents



The use of advisory mandates seems to be more prevalent among smaller than larger funds (Fig 10.4), a feature picked up in the previous year's survey, when 11% of small funds said they used these mandates. Generally, they are still the biggest users of investment and use even more this year 53% (50%).

11. External managers – asset allocation

In traditionally outsourced countries equity generally forms the bulk of outsourced assets, but the fixed income proportion has burgeoned

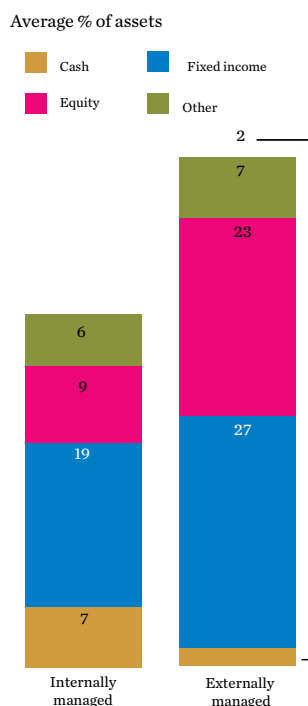
As discussed in Section 10, compared with the previous survey, there has been a discernible swing to in-house management of assets. The interesting, but unanswerable, question is whether this was a deliberate move by investors or just the end result of market adjustments on their portfolios?

With the internal cash portfolio moving up to 7 from 6%, and the internally managed fixed income proportion moving from 17 to 19% this year and the internal equity falling to 9 from 11%, market movement alone could be responsible for this restructuring. The jump in ‘other’, covering alternatives is more likely to have been caused by the illiquidity of the asset resulting in these classes increasing their share of internal portfolios, from 4 to 6% this year.

Where a large swing has occurred is in relation to large investors which now manage more internally than externally, with the in-house proportion now running at 53% (Fig 11.1), compared with 41% internally, according to the previous survey. This jump would be much harder to explain in terms of market movements alone.

Their external fixed income portfolios in the 2007 survey comprised 30% of assets, while the equity element came to

11.1 Asset allocation by internal and external management



How the balance has changed

	2008		2007	
	Int	Ext	Int	Ext
Benelux	14	86	22	78
France	34	66	0	100
Germany	60	40	41	59
GB & Ireland	16	84	31	69
Italy	59	41	32	68
Nordic	55	45	36	64
CEE	81	19	86	14
Switzerland	43	57	19	81
All countries:	41	59	38	62

23%. This year these figures were down to 18% and 20%, respectively. Internal fixed income rose to 23 from 9% and in-house equity was just 11% this year compared with 21% previously.

For medium-sized investors, the net effect was an increase in the amounts externally managed from 66 to 68%. But the shape of their external portfolios changed substantially, with the fixed income component increasing to 29 from 17% and the equity falling to 30 from 35%.

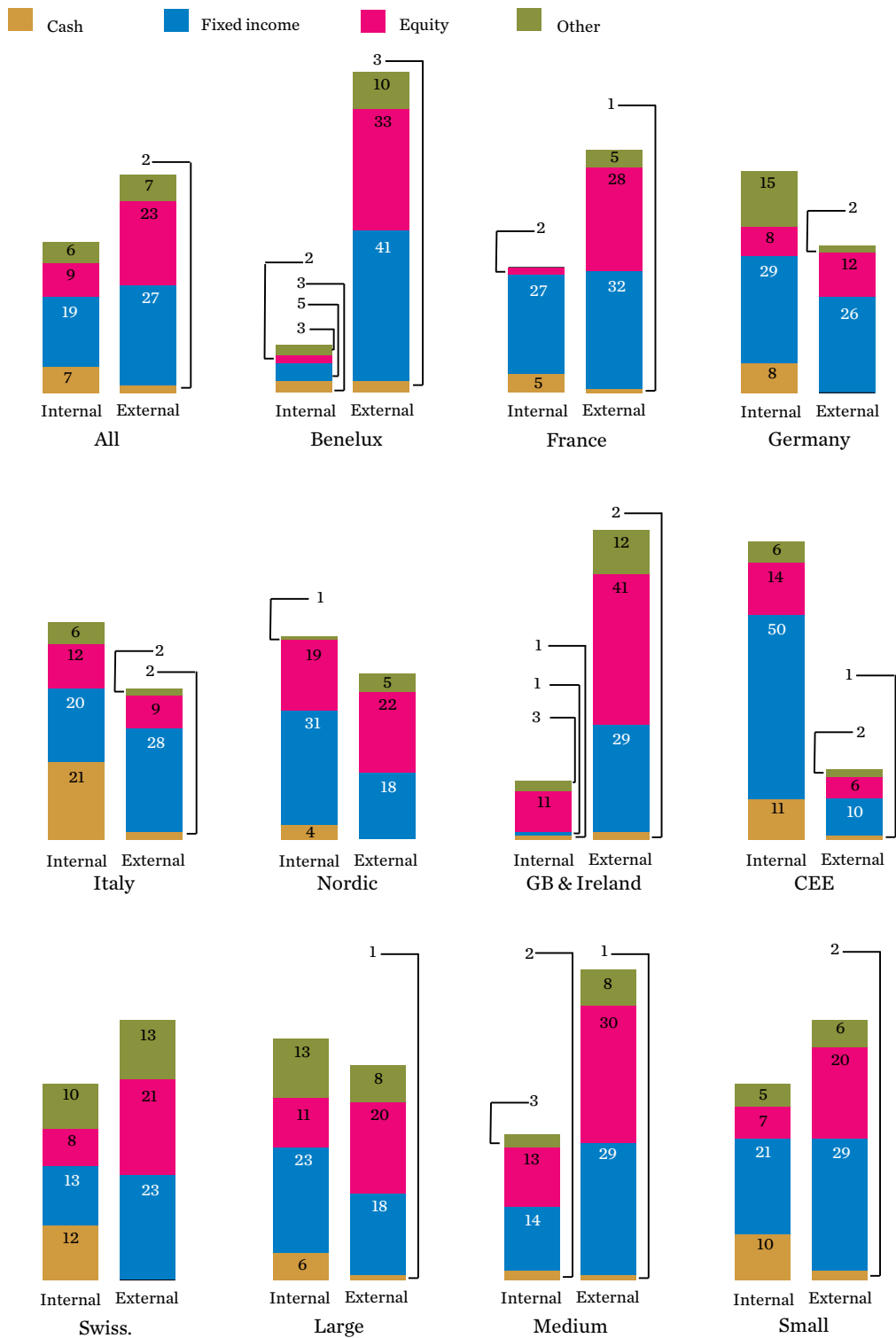
But for smaller investors internal portfolios grew to 43 from 40%. The main changes externally were a small fall in equities to 20 from 23% a year ago and in fixed income a rise from 28 to 29% in 2008.

Key takeaways

- ➔ internally managed assets again more heavily focused on fixed income, and by marginally more than last year
- ➔ externally managed assets now more focused on fixed income than equity (2007 = 25% & 27%; 2008 = 27% & 23%)
- ➔ small increase in amount of cash managed internally, and doubling of that managed externally but still very small at 2% so still little evidence of cash being delegated
- ➔ Benelux, GB & Ireland and Italy delegate most fixed income
- ➔ GB & Ireland, Benelux and France delegate most equity
- ➔ GB & Ireland again have highest proportion of equity among externally managed assets
- ➔ medium and smaller investors have the most allocated to fixed income, with medium investors now allocating twice as much to external managers as is managed internally; and large funds have made a large switch from external to internal management

11.2 Asset allocation by internal and external management by country and size

Average % of assets



12. Criteria when selecting an external investment manager 2004-2008

Questions of choice

Although external manager selection activity has diminished significantly in the current year, it is clear that investors still have a very sharp focus on this activity. Also, the difficulties of the times seem to be ensuring that investors are clearer in their own minds about why they are choosing managers, and no longer is it the case, as in previous surveys, that the issue of 'performance' numbers was the prime criterion for choosing a manager

There should be three cheers that investors have moved away from being wedded to performance as the number one factor in selecting an external manager. That 'Clarity of investment process' has emerged as the number one consideration is a reflection not just of the increasing maturity and seriousness of investors, but also a determination to reduce the chances of making mistakes by relying on past performance numbers – as all health warnings say, 'past performance

is no guide to future performance'.

Not that 'performance' has disappeared from the rankings – nor should it. It is still a very important component and has been ranked constantly within the top three yardsticks investors use as is clear from Figure 12.1. Risk control has remained in second place throughout.

Another change in the rankings is that transparency of manager fees has moved further up the chart to fourth place (only introduced in last year's survey). This might be a reflection of the fallout from the crash in alternatives, with hedge fund fees and those of the private equity industry drawing unflattering attention in the past year or so.

The level of investment management fees is dealt with separately and has long featured in the survey and been ranked this year, much as in previous surveys, as being of concern but not of the utmost priority. It seems investors are quite level-headed about managers' fees – despite what might be gleaned anecdotally.

That the 'stability of the investment team' continues to be scored highly by investors is very much in keeping with the focus on investment process, as delivery of the process is inextricably bound with the manager's team. Any significant changes there can impact the process and eventually the returns.

Client servicing maintains its ranking as in previous years – as is to be expected, but the position of the importance of using asset managers who have been externally rated, which was focused on last year as of reasonably strong interest in eleventh position, fell back to fourteenth in this survey. Is it a concept that the current difficult times will either make or break?

This year, we inserted among the criteria those of 'Corporate governance' and 'SRI', bringing the total to 28. It seems that investors consistently place a higher emphasis on corporate governance issues than on SRI, which are ranked eleventh and twenty-third, respectively.

On the basis of the size of funds, the clarity of process

12.1 Criteria when selecting an external investment manager 2004-2008

Degree of importance (Ranking)

	2008	2007	2006	2005	2004
Clarity of investment process	1	3	2	3	3
Risk control	2	2	3	2	1
Performance	3	1	1	1	2
Investment management fees: transparency of fees	4	5	n/a	n/a	1
Stability of investment team	5	4	5	5	4
Client service	6	7	6	7	10
Understanding of your organisation's goals & needs	7	8=	4	4	6
Quality of reporting	8	6	8	6	5
Investment management fees: level of fees	9	8=	7	8	8
Financial strength of external manager	10	10	11	9	7
Corporate governance	11	n/a	n/a	n/a	n/a
Reputation of asset manager (brand)	12	13	14	15	14
Segregation of fund management function	13	14	9	12	9
Asset manager rating	14	11	20	19	18
Professional rating of external manager	15	12	16	11	11
GIPS/AIMR compliance	16	15=	15	18	15
Ability to provide advisory service	17	19	10	10	12
Ownership/structure	18	18	n/a	n/a	n/a
Product innovation	19	15=	12	14	17
Total size of AuMs of external manager	20	17	17	16	16
Existing commercial relationship (banking, commercial)	21	20	21	20	20
Presence in your country: investment team presence	22	22	18	17	19
SRI	23	n/a	n/a	n/a	n/a
Presence in your country: sales office presence	24	21	13	13	13
Parent group is domestic	25	26	22	22	22
Parent group is international	26	24	23	23	23
Non-competitor	27	23	19	21	21
Other	28	25	24	24	24

12.2 Top 10 criteria when selecting an external investment manager by country and size

Degree of importance (Ranking)

	All	Benelux	France	Germany	Italy	Nordic	GB+Ire	CEE	Swiss.	Large	Medium	Small
Clarity of investment process	1	1	3=	5=	1	1	1	4	2	1	1	1
Risk control	2	2	1=	2=	2	5	3	6	1	2	3=	3
Performance	3	3	3=	7=	3=	2=	2	1	6=	3	2	2
Investment management fees: transparency of fees	4	4	5=	7=	3=	2=	4	5	4=	4	3=	4
Stability of investment team	5	7=	5=	2=	6=	4	5	8	8	6=	3=	6
Client service	6	10	1=	5=	5	6	7	7	3	5	7	5
Understanding your organisation's goals & needs	7	6	8=	2=	6=	10	9=	3	10=	9	9	9
Quality of reporting	8	7=	7	1	10	8	6	10	6=	6=	8	7
Investment management fees: level of fees	9	5	10	10	9	7	8	2	4=	8	6	8
Financial strength of external manager	10	9	8=	9	6=	9	9=	9	10=	10	11	10
Segregation of fund management function											10	

issue was ranked first across the board, as it was in most countries and regions, apart from Germany, France, the CEE and Switzerland.

Risk control was ranked either second or third by funds looked at from a size perspective, although on a country

basis, the Nordics and the CEE ranked this fifth and sixth, respectively. While performance was in the second or third position, it was marked down at seventh by German investors and at sixth place by the Swiss.

Key takeaways

- ➔ 'clarity of investment process' ranked first for first time, with 'risk control' second for the second year and 'performance', having been first for the previous three years, now displaced to third place
- ➔ nevertheless, the top three above have been in the first three places, just jockeying for position, during the last five years
- ➔ 'transparency of fees' has moved up to fourth place, swapping places with stability of investment team' which is now fifth
- ➔ on a country basis, broad concurrence that 'clarity of investment process' is most important, except for the

Germans who favour 'quality of reporting', which is lowly placed everywhere else

- ➔ for the first time, we asked about 'corporate governance' and 'SRI' which registered only in 11th and 23rd places, respectively
- ➔ French also bucking the trend by jointly favouring 'risk control' and 'client service', the latter being a quality which is also ranked quite highly only by the Swiss
- ➔ broad agreement by size on the top four criteria. Medium and smaller funds have again ranked clarity and performance in their top two, but performance for the larger funds has now taken on much more significance

13. External managers: fees

It may be a real sign of the times and the difficulties investors are having, but performance related fees is certainly not the topic at the top of agendas this year

The much-heralded shift in the basis on which fees are paid to managers from fixed to performance or a mix of both does not seem to have occurred. In fact, more fees are on a fixed basis this year than last, according to the survey's findings.

While this year's sample is different, there is no reason to think this should impact this year's results. But in a year where performance has been negative across a range of asset classes, other than cash, it may be that in reality the current compensation of managers is in the

form of fixed fees, as little will be coming from performance-related fees agreements.

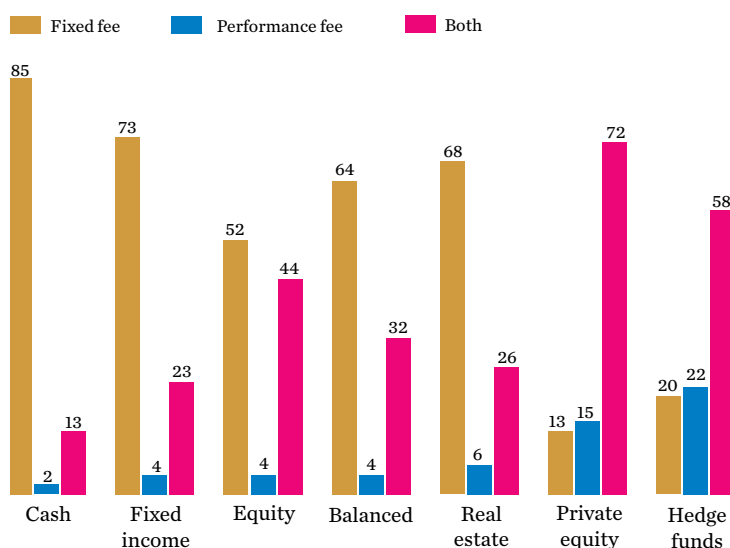
Figure 13.1 shows performance fees in fixed income are being paid by 4% of investors (compared with 9% last year), in equity also by 4% (12%), in real estate by 6% (5%), and balanced by 4%

Key takeaways

- ➔ most remuneration again fixed fees with increases across the board for all asset classes
- ➔ fixed fees have increased significantly for fixed income 73% (61%) and private equity 13% (8%)
- ➔ fixed fees of 68% (65%) suggests it continues to be regarded more as a mainstream asset than alternative
- ➔ private equity and hedge funds again predominately a mixture of fixed and performance fees

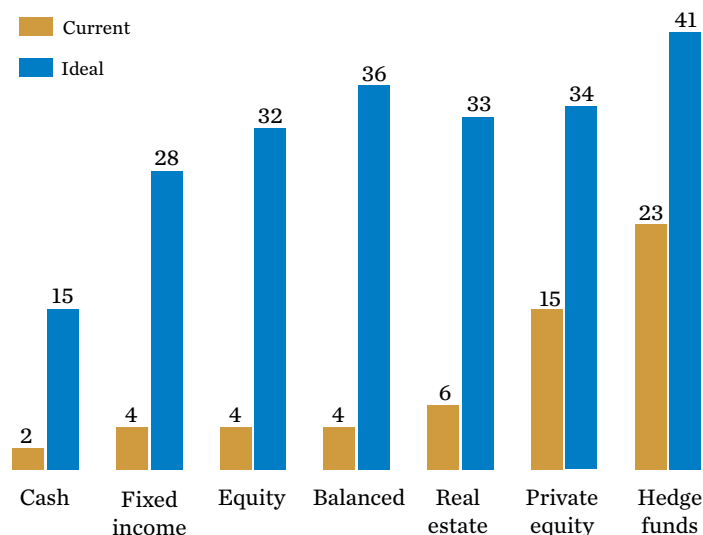
13.1 Current compensation of external managers

% of respondents to question



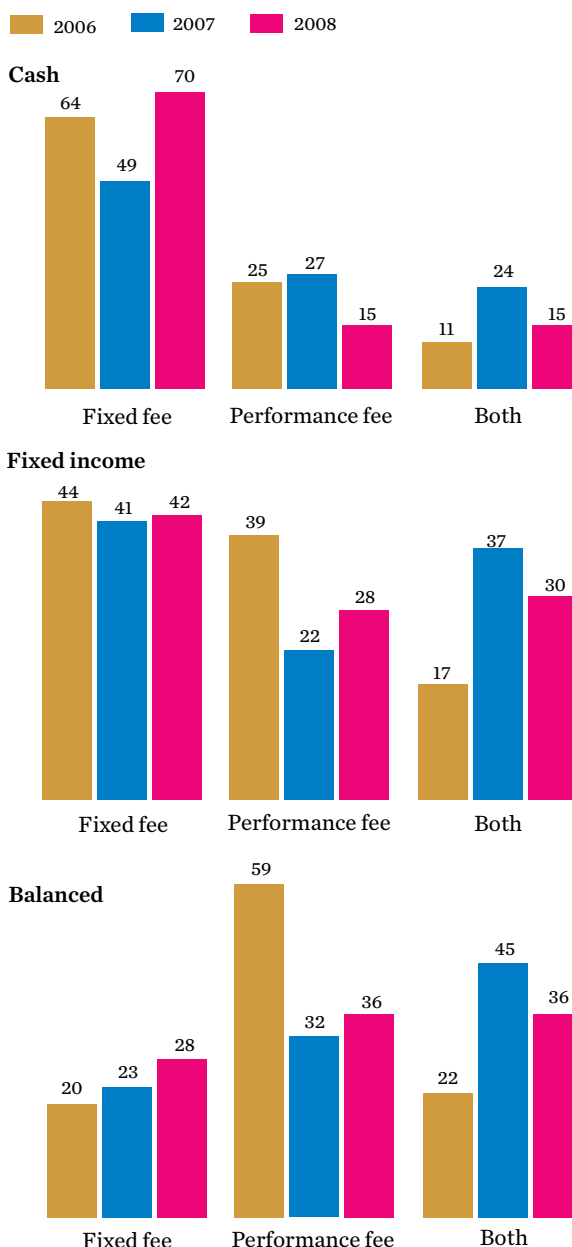
13.2 Current and ideal performance fee usage for external investment managers by asset class

% of respondents to question



13.3 Ideal compensation of external investment managers 2006-2008

% of respondents to question



(8%). In the alternative classes, where performance fees play a more important part than in traditional classes, there is a slight increase in private equity to 15% (from 14%) and hedge funds 22% (14%).

In fact, in 2008, right across the board in all asset classes, more investors were paying fixed fees than were paying last year. Also for most types of assets, apart from fixed income, private equity and hedge funds, a combination of both types of fees has become more popular.

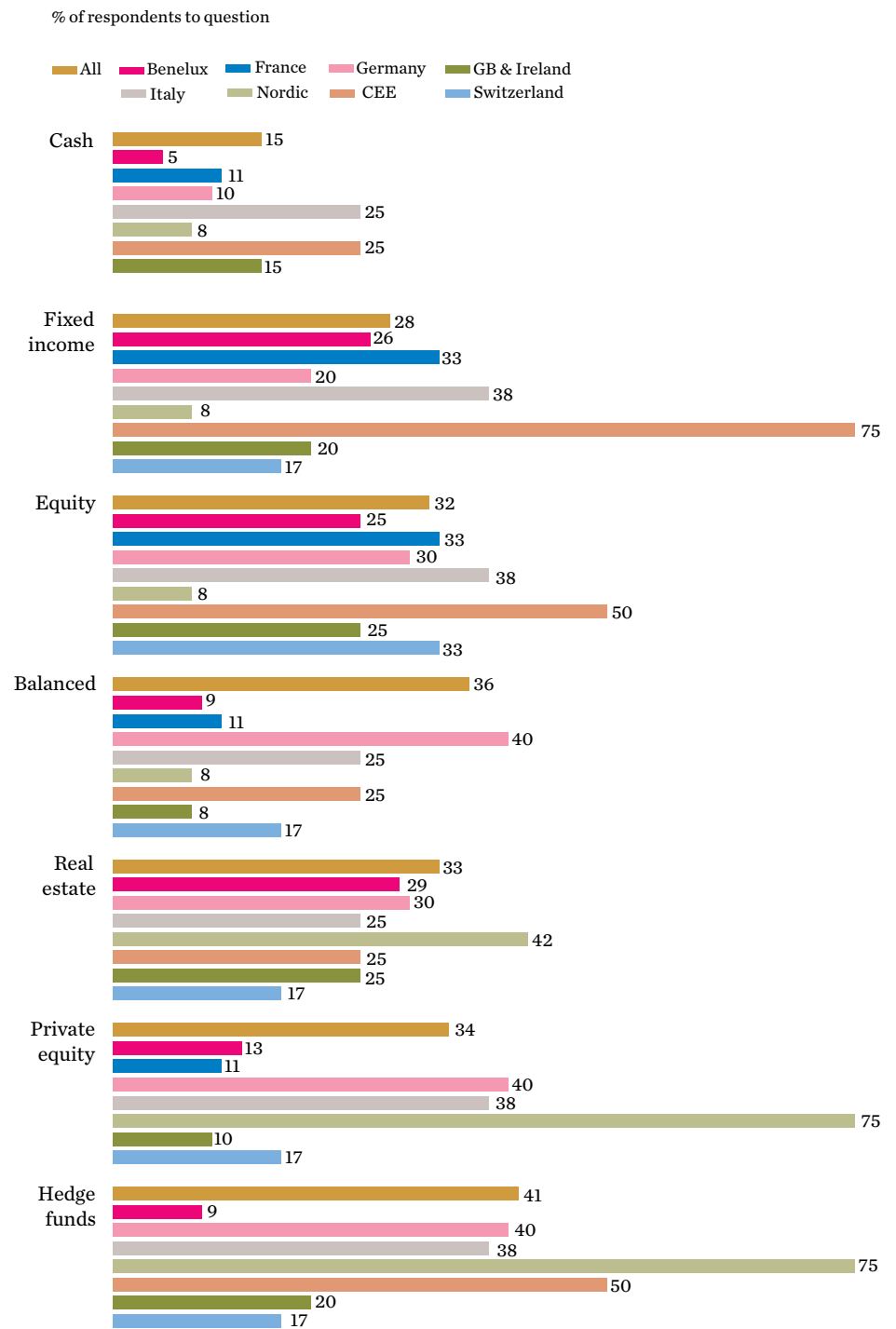
Key takeaways

- ➔ more performance fees are desired for all classes
- ➔ current performance compensation is showing significant falls on last year, exceptions being marginal increase for real estate and private equity and a 50% increase for hedge funds 23% (14%)
- ➔ gap between current and ideal has grown significantly for fixed income 24% (13%) and equity 28% (19%), and less so for balanced 32% (24%)
- ➔ gap has shrunk only for cash 13% (20%) and hedge funds 18% (21%)
- ➔ last year's results suggested that increasing numbers of respondents' aspirations were being met, but this trend appears to have been short-lived

But what would investors really like to see as their ideal compensation arrangement, contrasted with the current practice? Figure 13.2 shows how many respondents currently pay performance fees (the same number as in 13.1) and how this compares with the number responding who would like to see performance fees in the future. Just 4% of equity investors pay these fees currently, while 32% would like to do so.

When it comes to private equity and hedge funds, the ideal is seen as performance fees, with hedge funds

13.4 Ideal performance fee usage for external managers by country



Key takeaways

- ➔ ideal of fixed fees for cash have increased dramatically to 70% (49%) while performance has almost halved to 15% (27%)
- ➔ little change in sentiment for fixed fees for fixed income, but small increase for performance
- ➔ balanced showing steady increase for fixed, small increase for performance and decline for mixture of both

at 41%, compared with 35% last year. At 36%, even more investors would like to see performance fees for balanced mandates than was the case last year (32%), while 33% would like these for real estate, compared with 29%.

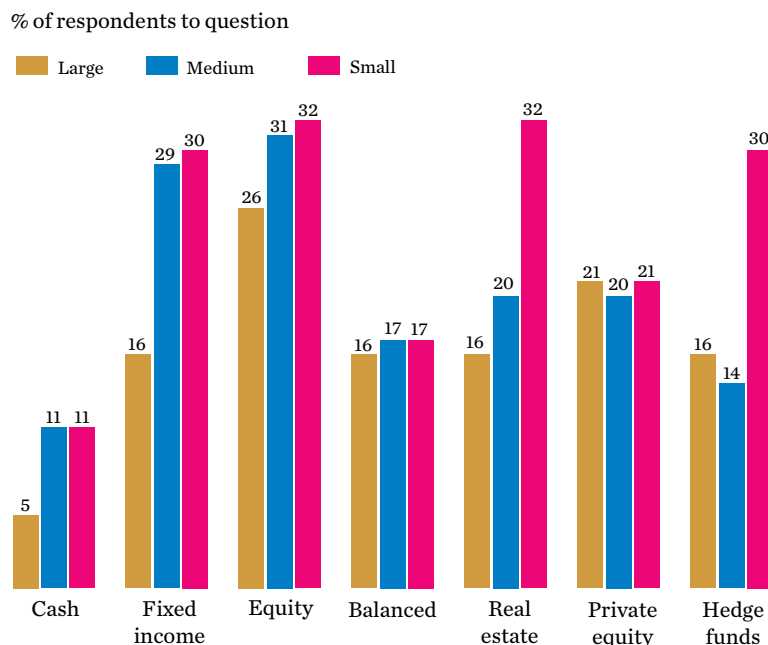
Investors definitely regard fixed fees as being the ideal basis for manager remuneration for cash, but are more evenly split between the options when it comes to fixed income (Fig 13.3). For balanced mandates, investors see the value in a stronger performance-related component, but appear to be of equal mind as to whether this should be pure performance-related or a mix of both.

Investors in Britain & Ireland and in Germany were those pushing most for performance-related fees in the 2007 survey, but this year Italy and the CEE countries are those most interested (Fig 13.4). Germany is still interested in performance fees for balanced mandates and for private equity, while British & Irish still favour them for equity and real estate.

Nordic investors clearly like the performance basis for real estate, private equity and hedge funds, where they are strongly in favour. But when it comes to the more traditional classes, their interest is minimal.

On a size of fund-related basis (Fig 13.5), smaller funds continue to be most interested in performance fees, which might seem to be counterintuitive. The larger funds seem to be more keen on these fees for real estate and balanced mandates as in 2007 their interest was almost non-existent, although they are keener this year about seeing these fees for private equity than last year (10%), the opposite is the case for hedge funds, where interest was at the 30% level, compared with 16% currently.

13.5 Ideal performance fee usage for external managers by size category



Key takeaways

- ➔ most persistent demands for performance fees, previously from Germans, now coming from Italians and CEE
- ➔ 75% of CEE and 38% of Italians want performance fees for fixed income, compared with 8% for Nordics and 17% for Swiss
- ➔ 50% of CEE and 38% of Italians want performance fees for equity and, with the exception of Nordics (again at 8%), other respondents fall in range of 25 to 33%
- ➔ performance fees are again most in demand from smaller investors. For hedge funds, larger investors have halved their expectations while smaller investors have doubled theirs

14. External managers: constraints

Constraining at the limits

Investors' relationships with managers require that mandates deliver what is expected within the agreed terms. The constraints these impose on managers play a key role in determining performance. Compared with previous years, it appears a case of business as usual regarding constraints imposed, although this year changes are occurring as to the extent to which investors are placing limitations on managers

This year's responses confirm that where investors have a relationship with external managers, they continue to impose the same constraints as before. Also, the survey finds that the constraints are ranked in much the same order of importance, although there is some reshuffling.

Benchmarks and tracking error still head the list of techniques used in mandates (Fig 14.1), but they are being used by a smaller proportion of investors, reducing to 88 from 94% in the case of benchmarks and to 52 from 68% for tracking error.

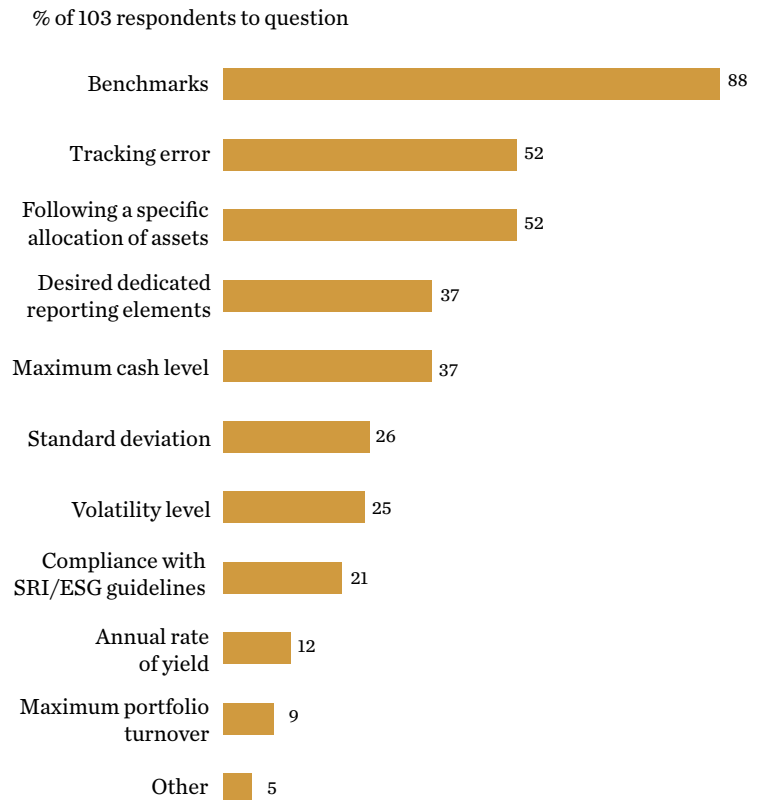
The constraint 'Follow a specific asset allocation' has moved to equal second in the rankings, from its third place last year, although its use has slipped to 52 from 56%. Slightly more investors are requiring 'Dedicated reporting elements', with the increase being marginal, from 36 last year to 37%.

'Maximum cash levels' is another portfolio constraint where investors are being more active, up to 37% from 34%. Investors will be looking more closely at the cash elements of portfolios in the current climate, but normally this constraint is imposed to ensure that managers do not sit on excessive cash positions and are fully invested.

'Standard deviation' is a constraint that also seems to be less in favour by investors, with the proportion of respondents using this reducing to 26% from 28%. 'Volatility' has remained at the same level as last year.

It may come as a surprise that fewer investors are imposing requirements by way of SRI/ESG guidelines, as the number declines to 21% from 24% last year.

14.1 Types of constraints given to managers



The 'Annual rate of yield' appears to be very much less a constraint than previously, as this has fallen to 12 from 18%. However, investors do seem to be more concerned about the degree of portfolio turnover, as there has been a significant jump to 9 from 6%.

Key takeaways

- ➔ benchmarks remain the predominant measure of satisfaction, albeit down to 88% from 94% last year
- ➔ the pecking order remains unchanged from last year, although tracking error and following a specific allocation of assets are now in joint second place with 52% each
- ➔ although still at a low level, expectations have risen in respect of maximum portfolio turnover, up to 9% from 6% previously

15. External managers: breaking relationships

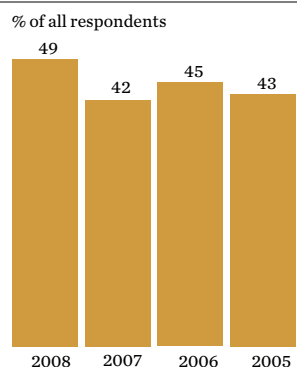
In the firing line

The ultimate weapon in the hands of those using external managers to manage mandates is to terminate the arrangement when they believe it is not working to their advantage. Despite the tough market conditions, there is not much sign of investors dismissing managers wholesale, although it does vary by country. The reasons why managers are fired seem to be in the area of performance – the traditional stumbling block

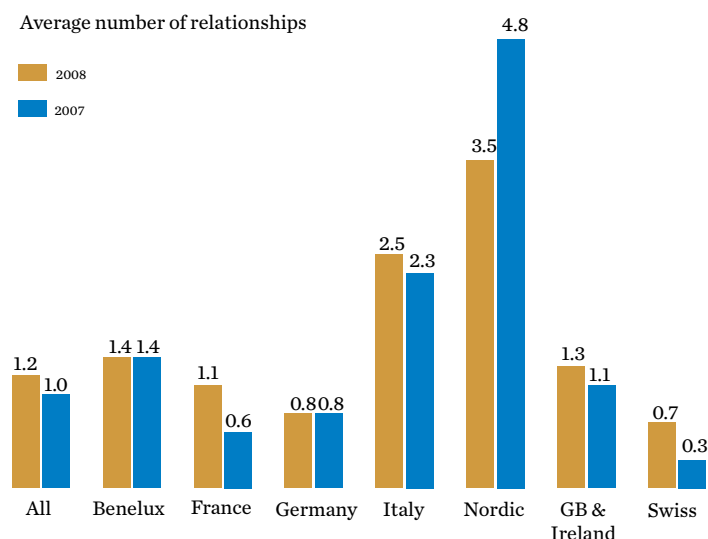
There has been a noticeable increase in the termination by investors of their agreements with external managers in the current survey's findings, which asked respondents about their firings in the past two years. Compared with other findings in the survey, the responses for 2008 and 2007 comes from the same sample population of investors.

The figures for 2006 and 2005 (Fig 15.1) refer to last year's and the prior year's sample. While all sets of responses show that there has been a degree of fluctuation, in general terms the relationships seem pretty stable when regarded from an 'All country' perspective. However, when the figures are looked at from a country point of view (Fig 15.3), there are considerable differences as to what is happening over the two-year

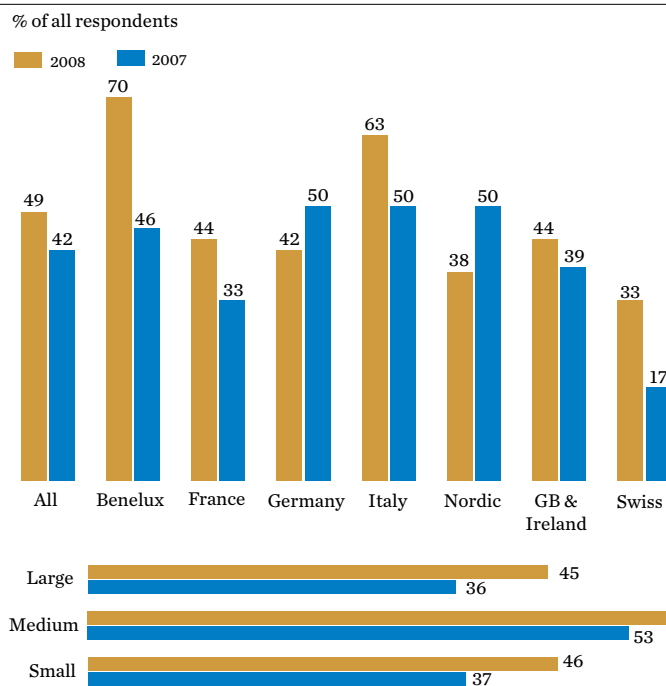
15.1 Relationships with a manager terminated 2005-2008



15.2 Relationships with a manager terminated in 2008 and 2007



15.3 Relationships with a manager terminated in the past two years by country and size category



period, with 70% of Benelux investors terminating managers in the current survey, as against 46% in the previous, almost a 30% increase.

The Swiss marketplace is another that reported a sharp increase, almost doubling the number of firings in the period. Italy also recorded a jump from 50 to 63% last year, as did France, although at a lesser rate. While the proportion of British & Irish investors grew, the rate was quite modest.

Some countries registered a drop in the number of manager sackings, with the proportions for investors falling, as in the case of Germany to 42 from 50% and the Nordics, from 50 to 38%.

On a size-of-fund basis (Fig 15.3), medium-sized funds have been terminating strongly, with 58% of investors going that way, compared with 53% the previous time round. For larger and medium investors there were also more ending of relationships.

The numbers of relationships that were ended averaged out at 1.2 on an 'All country' reckoning, up to an extent on the previous year's score of 1 (Fig 15.2). This could be looked on as 'stable', and certainly for some countries, such as Benelux, Germany, Italy and Great Britain & Ireland, this appears to be the case. In the Nordic countries, life seems to be a bit more hectic for external managers. Here the average was 3.5 in 2008, down from a murderous 4.8 in 2007.

Even though samples are not comparable, the termination figure for 2007 for the Nordic countries in the previous EIAMS report was well above the average.

On the influential factors when deciding to dispense

with managers' services, respondents were very definite in their assessment, which was exactly the same as the previous year both as to the factors and their ranking (Fig 15.4). Of the complete list of 13 criteria, those that have moved up the ranking scales are 'Reorganisation of the investment manager's group' and 'Inadequate reporting/contact'.

Looking at these factors on an across country basis (Fig 15.5), unsatisfactory performance is certainly the key factor in dismissals. This might appear at odds with the move away from performance as a key investment objective for investors' portfolios as outlined in Section 2 of this report, although the high priority given to controlling of risk does fit in with the ranking given in the objectives section.

15.4 Factors which play a role in the decision to remove a manager 2007-2008

Degree of importance (Ranking)	2008	2007
Unsatisfactory performance	1	1
Failure to control risk	2	2
Change of investment strategy or asset allocation	3	3
Lack of clarity in fund management policy	4	4
Strategy or asset allocation	5	5
Reorganisation of investment manager's group	6	9
Inadequate reporting/contact	7	11
Excessive turnover of investment team	8	7
Level of costs	9=	8
Inability of investment manager to advise on investment	9=	12
Breach of investment constraints	11	6
Internal reorganisation of your group	12	10
Excessive turnover of contact personnel	13	13

Compared with last year's responses, lack of clarity in fund management policy has moved up the rankings in most countries' response.

Key takeaways

- ➔ last year's pattern has repeated itself exactly with the top five factors remaining in the same order
- ➔ breach of investment constraints has fallen sharply to 11th from 6th, whereas inadequate reporting/contact has gone in almost the mirror image, up to 7th from 11th
- ➔ all countries give precedence to unsatisfactory performance. French hold less store in failure to control risk, marking it down to 5th. The Swiss place much more store in breach of investment constraints, placing it third, whereas it is out of the top 10 for most of the others

- ➔ at least 49% have broken relationships, 7% increase on previous year
- ➔ average of just over one termination per year, slight increase on previous year
- ➔ Swiss and Germans most loyal with about 0.8 broken relationships; Nordics and Italians most ruthless with 3.5 and 2.5, respectively
- ➔ Benelux and Swiss have been much more aggressive than previously, while the Germans and Nordics were more tolerant than last year, or have had better experiences
- ➔ medium funds broke the most relationships, breaking the tradition of this being a larger investor monopoly

15.5 Factors which play a role in the decision to remove an external manager by country

Degree of importance (Ranking)	All	Benelux	France	Germany	Italy	Nordic	GB & Ireland	Swiss.
Unsatisfactory performance	1	1	1	1	1	1	1	1
Failure to control risk	2	2=	4=	5=	2	2=	2	3=
Change of investment strategy or asset re-allocation	3	2=	6=	4	6	2=	5	7=
Lack of clarity in fund management policy	4	4	2	3	3	6	3	3=
Strategy or asset allocation	5	8	6=	11	5	8=	4	9=
Breach of investment constraints	11	11=	11=	9=	13	8=	7=	3=
Excessive turnover of investment team	8	10	6=	5=	9=	11	9	2
Level of costs	9=	5	11=	5=	9=	4	10	9=
Reorganisation of investment manager's group	6	6=	3	12=	9=	5	7=	6
Internal reorganisation of your group	12	13	13	12=	4	7	11	7=
Inadequate reporting/contact	7	6=	4=	2	8	12=	6	13
Inability of investment manager to advise on investment	9=	9	9=	5=	7	8=	13	9=
Excessive turnover of contact personnel	13	11=	9=	9=	9=	12=	12	12

16. Other findings: SRI/ESG/Securities lending

On the move

The signs are encouraging for SRI (Socially Responsible Investing) or ESG (Environmental, Social and Governance) criteria within the institutional world. But not all investors are in a position to climb on board yet, with almost two-thirds of respondents indicating that they do not have plans to up their SRI/ESG assets

That SRI/ESG issues are moving up investors' agendas are clear from the responses to this year's survey. This appears to be because the message about this aspect of portfolios is coming through more strongly.

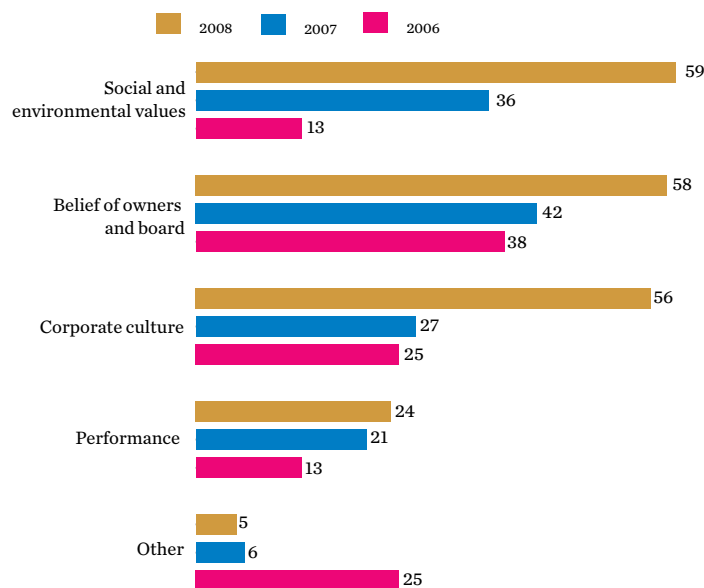
Probably, the most clear-cut indicator is that 'Social & environmental values' now heads the list of reasons for pursuing these strategies, rather than the 'Beliefs of owners and boards' (Fig 16.1). This demonstrates that SRI values are at last being given recognition in their own right. The fact too that both of these reasons have attracted a much greater response rate than in the previous survey is also indicative of the greater attention these issues are receiving.

But it is certainly not going to be a smooth road ahead. We put a supplementary question this year, asking if respondents planned to increase the percentage of assets governed by SRI during the next year (Fig 16.2). Of the respondents, 8% said all their assets were already governed by SRI policy, but 30% were planning some increases while 62% had no forward plans in writing.

Having written policies for these areas is also a step forward confirming the commitment of investors to the area. Compared with last year, written policies for corporate governance strategy is now in

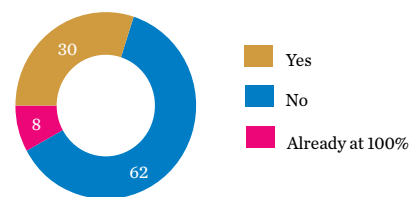
16.1 Reasons for pursuing SRI/ESG strategies

% of pursuers of SRI/ESG strategies



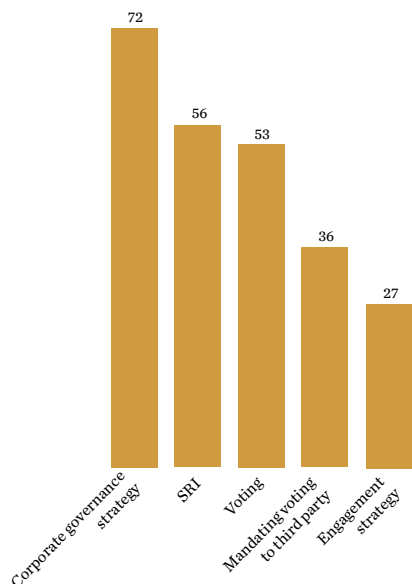
16.2 Plans to increase assets percentage governed by SRI policy in next year

% of all respondents to question



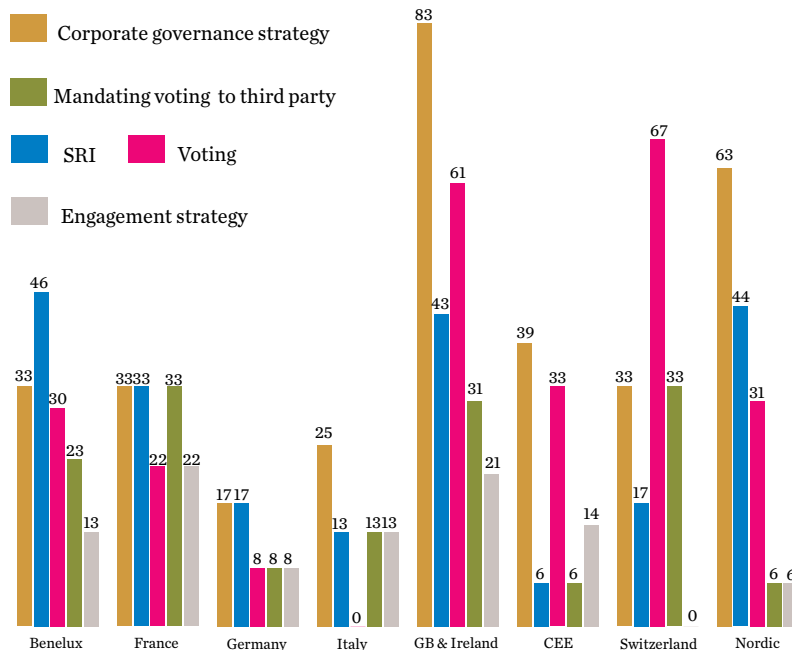
16.3 Frequency of written policies

% of all respondents to question



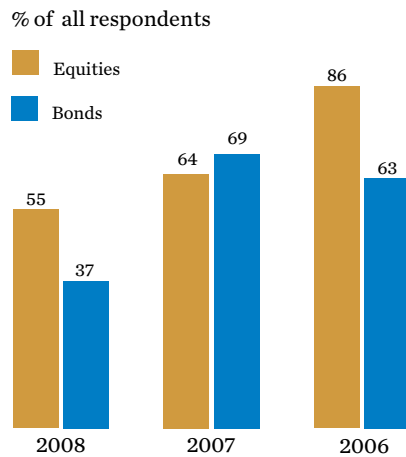
16.4 Frequency of written policies by country

% of all respondents



place by nearly three quarters of respondents (72%), a big rise on the 41% of last year (Fig 16.3). SRI policies are in place with over half of funds (56%), also up from 41%. Having voting policies also took a significant step forward and are now operational with 53% of investors, up from 29%.

16.5 Asset classes used for securities lending 2006-2008



Again, British & Irish investors, as well as those from the Nordic region, are the keenest regarding corporate governance strategy, with 83% and 63%, respectively, having these, well ahead of where they were last year. In fact, across the board, there seems to be more commitment to the different areas. With 46% of Benelux investors active in SRI, they are well ahead of most countries, other than Nordic at 44% and British & Irish at 43%, while over two-thirds of Swiss investors have written policies on voting (Fig 16.4).

Never a lender be?

The established practice of securities lending, long regarded as a low-risk additional source of income, showed its darker side, with the ban on financial stock shorting and the emergence of counterparty risk, among other features that put lending under a cloud. The survey finds there has been a marked change in attitude to the area

This year, investor involvement in securities lending seems to have taken a downward step, with only 15% saying they lend. Compared with last year's findings when 21% lent, this is a significant drop and is a reversal of the previous upward trend, as 19% had been lenders the year before.

When it comes to what proportion of assets are permitted to be used for securities lending (Fig 16.5) – equities are limited to 55% and bonds to 37%. Not only are those figures a severe reduction on the previous year's results, when equities were 64% and bonds 69%, but there has been quite a reversal of the position of bonds versus equities.

This year, we asked investors an additional question as to whether there had been any changes to their stock lending policy, to which 60 responded. Of these, just over half (53%) said they never lent stock (Fig 16.6). Almost a third said they had taken action in light of the market disquiet about shorting of financial stocks,

Key takeaways

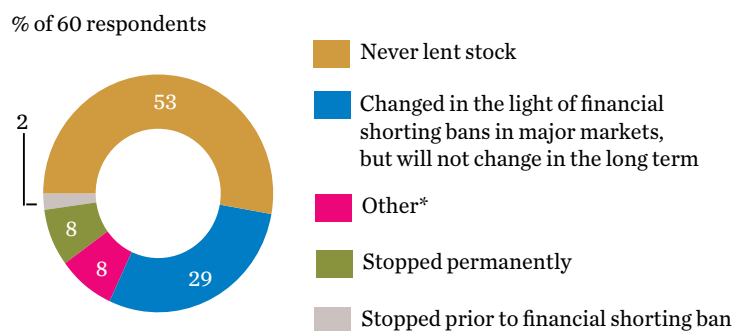
- ➔ main reason now social & environmental values ahead of belief of owners and boards, but by narrowest of margins, and corporate culture now also almost equally regarded
- ➔ percentages of those providing the above three reasons has increased significantly in all cases and, for corporate culture, has more than doubled
- ➔ written policies continue to gain ground with three-quarters saying they have policies for corporate governance strategies and over one-half for SRI. Mandating voting to a third party, at over one-third, and engagement strategy, at one-quarter have both doubled since last year
- ➔ written policies continue to be most popular with British & Irish and Nordics. France and Germany now starting to register some interest so interesting to see how that develops

but they expect to resume in the longer term – this figure includes two investors that just said they had ceased temporarily.

Nearly a tenth (8%) said they had stopped permanently, while one fund indicated that it had stopped before the bans on shorting financial stocks. The 8% that gave a range of other reactions included those saying 'no change', 'stricter guidelines', 'counterparty risk'.

The limits allowed to be loaned of the equity portfolio range from 2 to 100%, compared with 10 to 100% in last year's survey. The fixed income limit ranged from 3 to 100%. The most frequent limit is up to 100%, for both.

16.6 Recent changes to stock lending policy



* Responses included: no change; stopped temporarily; stricter guidelines; liquidation and counterparty risk

Key takeaways

- ➔ fall in interest with just 15% saying they lend (21% last year)
- ➔ equity limits range from 2% to 100%
- ➔ fixed income limits range from 3% to 100% (average 55%)
- ➔ most frequent limit for both is again 100%
- ➔ in response to a new question over one-half (32 funds) or 53% of respondents said that they had never lent stock
- ➔ 29% said that the financial shorting bans had changed their policy in the short-term
- ➔ 8% said that they had permanently stopped lending

17. List of charts and tables

- 1.1 Sample by type of institution
- 1.2 Sample AuM and number of respondents
- 2.1 Most important investment objectives
- 2.2 Most important investment objectives 2007-2008
- 2.3 Important objectives for internally managed assets by country and size
- 2.4 Important objectives for externally managed assets by country and size
- 3.1 Investment allocation by country and size
- 3.2 Detailed investment asset allocation
- 3.3 Investment asset allocation by country 2006-2008
- 3.4 Investment asset allocation by size
- 3.5 Changes planned to strategic asset allocation in 2009
- 3.6 Changes planned to asset allocation as a result of current market conditions by country and size
- 4.1 Sources of absolute and relative return
- 4.2 Sources of absolute return by country
- 4.3 Sources of absolute return by size
- 5.1 Selected alternative assets by country and size
- 5.2 Selected alternative assets 2002-2008
- 5.3 Hedge fund assets by country 2006-2008
- 5.4 Hedge fund users by country 2006-2008
- 5.5 Hedge fund users by size 2008
- 5.6 Users of different hedge fund products 2006-2008
- 6.1 Structured product users by country and size
- 6.2 Reasons for using structured products
- 6.3 Exchange traded funds (ETF) users 2006-2008
- 6.4 Exchange traded funds (ETF) users by size
- 6.5 Use of fundamental indexing strategies
- 6.6 Reasons for implementation of interest rate swap approach
- 6.7 Reasons for implementation of inflation rate swap approach
- 7.1 Overall duration of fixed income portfolio and actual liabilities, in years, by country
- 8.1 Users of performance attribution 2005-2008
- 8.2 Suppliers of performance attribution 2006-2008
- 9.1 Users of consultants 2004-2008
- 9.2 Users of consultants by country 2007-2008
- 9.3 Users of consultants by size
- 9.4 Reasons for usage of consultants 2006-2008
- 10.1 Users of external investment managers by vehicle
- 10.2 Assets delegated to external investment managers by country and size
- 10.3 Users of external investment managers by vehicle
- 10.4 Users of external investment vehicles by country and size
- 11.1 Asset allocation by internal and external management
- 11.2 Asset allocation by internal and external management by country and size
- 12.1 Criteria when selecting an external investment manager 2004-2008

12.2 Top 10 criteria when selecting an external investment manager by country and size**13.1** Current compensation of external managers**13.2** Current and ideal performance fee usage for external investment managers by asset class**13.3** Ideal compensation of external investment managers 2006-2008**13.4** Ideal performance fee usage for external managers by country**13.5** Ideal performance fee usage for external managers by size**14.1** Types of constraints given to managers**15.1** Relationships with a manager terminated 2005-2008**15.2** Relationships with a manager terminated in 2008 and 2007**15.3** Relationships with a manager terminated in the past two years by country and size**15.4** Factors which play a role in the decision to remove a manager 2007-2008**15.5** Factors which play a role in the decision to remove an external manager by country**16.1** Reasons for pursuing SRI/ESG strategies**16.2** Plans to increase assets percentage governed by SRI policy in next year**16.3** Frequency of written policies**16.4** Frequency of written policies by country**16.5** Asset classes used for securities lending 2006-2008**16.6** Recent changes to stock lending policy