

Russell Research

Russell Investments' 2010 Global Survey on Alternative Investing

Evaluation and re-commitment: The next phase for alternatives

Survey highlights in brief

Most investors are staying the course.

- › Most institutional investors are “staying the course” with alternative strategies and expecting increases in overall alternative allocations over the next few years. Few say they are cutting back.
- › The survey found that institutional investors are expecting to increase their allocation to alternative investments from 14% in 2009 to 19% over the next two to three years.
- › The anticipated increase in allocations to alternatives is expected to come from equities, as institutions continue efforts to mitigate total portfolio risk.

Institutions are placing significant emphasis on improving risk management and governance processes.

- › 84% of respondents have made or plan to make changes in their risk management approach, and nearly two-thirds are increasing the sophistication of their internal decision making and governance processes.
- › Alternatives remain attractive for potential risk-adjusted returns and reducing overall portfolio volatility; however, high costs and illiquidity continue to be viewed as obstacles.
- › Investors want more transparency. While larger institutions are trending towards separate accounts, virtually all who participate in alternatives will demand greater accountability from providers.

Expectations for new investments over the next two years.

- › **Private equity** allocations are expected to increase, especially in North America, based on a combination of valuation improvements and new commitments.
- › **Hedge funds** have survived the “stress test” of the financial crisis, and allocations are expected to rebound in most regions, although recovery may be slow in Europe.
- › **Real estate** allocations are expected to grow through 2012, partly due to rebalancing to policy weights, perceived opportunities due to the current stage of the economic cycle, and attractive inflation features.
- › **Infrastructure and commodities** are becoming more important to institutions around the globe. They are expected to represent an important share of overall growth in allocations to alternatives through 2012, though from a very low base.

Introduction

We can now divide the growth of alternative investing into three phases:

1. The initial era of increasing acceptance among institutional investors, culminating in 2007;
2. The global financial crisis of 2008 and early 2009, which heavily impacted alternatives; and
3. The recovery and evaluation period now underway, which we believe is leading to a re-commitment to alternatives for the future.

Russell Investments' *2010 Global Survey on Alternative Investing* offers one of the first comprehensive evaluations of trends and themes that will emerge in this third phase and beyond. It captures—in quantitative data and qualitative interviews—the experiences of individuals who are “on the front lines” of institutional investment decisions. It also documents the evolving changes in philosophies, policies, allocations and attitudes among diverse global institutions that participate in alternatives.

In normal economic environments, institutional asset management is a business that seeks to mitigate the risks associated with sudden changes or personal emotions, yet it is also susceptible to the market's trends and moods. The cataclysms of 2008-09 shook this industry in many ways—from Lehman to Madoff, from large-scale layoffs to record low interest rates. The professionals who are responsible for prudently investing billions of dollars today, to provide benefits such as pension payments or foundation grants tomorrow, were personally involved in this epic event. They have had to re-evaluate much of what they do and re-think a number of concepts, including alternative investing.

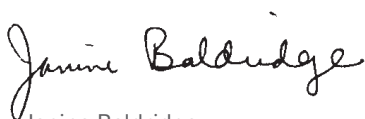
Our 2010 global survey offers a window into this process. In this report, we have summarised key survey findings in a way that allows readers to interpret data and commentary in the context of their own organisations and mandates. We believe you will find the nuances of the interview comments as revealing, and perhaps as useful, as the “headline data.” Together, the comments and data suggest a variety of ways institutional investors are changing their expectations, needs and requirements in this space.

We have deliberately chosen interview comments to help you understand the diversity of ideas uncovered by the survey, rather than to reinforce any generalisations and conclusions. To protect the confidentiality of respondents, all interview comments are anonymous.

We believe this survey confirms that alternative investments have survived the storm and are on the way to recovery. Although the financial crisis raised the bar for alternative providers in specific areas such as liquidity and transparency, awareness of alternatives' role in portfolio diversification and risk management has increased. Institutional investors around the globe remain committed to alternatives, and the majority view increased allocations to alternatives as probable in the years ahead.

Russell wishes to thank the many institutional investment executives who contributed time, efforts and insights to this survey. We hope you will find the results and our analysis valuable to your firm and useful in your work and decisions. Collectively, the results summarised herein are valuable to us as we continue to have conversations with global investors and offer thought leadership as well as innovative strategies and solutions.

Yours sincerely,



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Methodology

During the first month of 2010, 119 firms with a total of \$1.3 trillion of assets under management completed surveys by phone, e-mail and internet. Each represented organisations that utilise at least one form of alternative investment. For survey purposes, "alternative investments" comprise the following types of investments: hedge funds, private equity, real estate, infrastructure, commodities, and "other." Other includes: green investing, carbon investing, timber, portfolio catastrophic insurance, and non-specified alternatives. (Note: We will refer to these consistently as "types" in this report.)

Respondents were selected among broadly based, global organisations that manage institutional assets. In all cases, the individuals surveyed or interviewed were qualified to represent the investment activities, decisions and views of their organisations. The list included large institutions located in North America, Europe, Australia/New Zealand and Japan/Asia and the interview comments you will see throughout this report stem from our interviews with a sampling of these institutions. Live interviews were conducted with institutional investors in each region, mainly focused on those who sponsor defined benefit pension plans. You can see a

breakdown of the full survey participant list, by type, in the chart below.

Russell Investments was assisted in this endeavor by our research partner McKinsey & Company.

Note that the topic of alternative investments includes a considerable subjective component and, in some cases, is measurable only through limited samples. Therefore, the results of this survey should not necessarily be considered projectable to a larger population. Changes observed between two surveys may be affected by differences in the composition of the samples, such as the mix of types of organisations, or by changes in the investment behaviour of one or two very large institutions. The reader is advised to take a qualitative approach to the data, with a focus on the long-term trends and implications suggested.

The total sample was divided into smaller segments for reporting purposes on the basis of geography, firm size, firm types and major types of alternative investments. Readers are advised that data for relatively small segments may not be statistically significant. The tables below summarise each segment as a percentage of total completed interviews (119) and total respondent assets under management (\$1.3 trillion).

NOTE: We believe it is important to note that endowments and foundations represented 17% of total survey respondents but only 2% of total respondent assets reported. Based on other surveys and studies, including our own, we believe it is probable that endowments and foundations may have somewhat larger overall allocations to alternatives than most other investor types surveyed.

Survey respondent composition	Number of respondents % of total	Respondent assets % of total
By GEOGRAPHY		
North America	52%	17%
Europe	18%	55%
Japan/Asia	24%	26%
Australia/New Zealand	6%	2%
By INSTITUTION SIZE		
More than \$25 billion	9%	71%
\$5–25 billion	26%	21%
\$1–5 billion	43%	7%
Less than \$1 billion	22%	1%
By TYPE OF FIRM		
Corporate pension/DC plan	50%	12%
Public pension	16%	51%
Endowment & foundation	17%	2%
Insurance/other	17%	34%

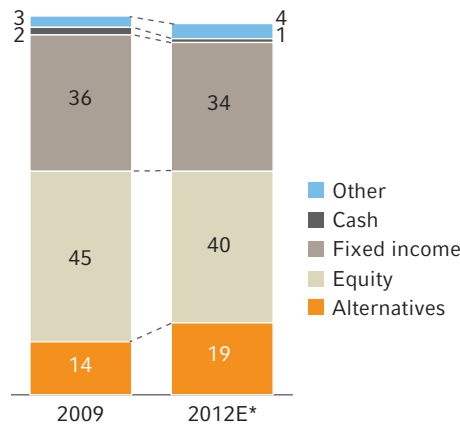
Overall observations

INTERVIEW COMMENT

“As we decrease the proportion of return-seeking assets, we certainly are not looking to decrease alternatives. It’s the equities that are taking the hit.”

The survey measured institutional exposures to alternative investments relative to total portfolio assets and among different types of alternatives for the year 2009. It then compared these exposures against the expected allocations for 2012 (“the next two to three years”). The graph below shows the results, based on a simple average of all responses.

2009 Allocation % to alternatives vs. expectations



*Expected next 2–3 years.

Our most recent comparable survey, conducted in 2008, revealed a 24% allocation to alternatives at the end of 2007, prior to the global financial crisis. Because the prior survey involved a different respondent sample, results are not directly comparable.

Results and interview commentary suggest that there was a reduction in alternative holdings from 2007 to 2009 driven by three factors:

1. the “denominator effect” caused in part by the strong rebound in equity markets in 2009, which caused alternatives to represent a lesser percentage of the overall portfolio; and
2. lower appraised values of some private market alternatives with appraised values which declined in 2009; and
3. some scaling back in alternatives due to specific concerns.

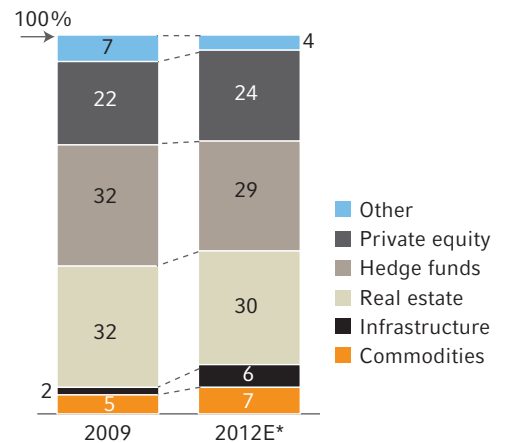
One significant finding is the expectation for a 5% increase (from 14% to 19%) in alternative allocation over the next two to three years. Most of this gain is expected to

be drawn from a reduction in existing equity allocations. Survey interviews revealed that the crisis has made many institutions more aware of risk management in general, and specifically in the systematic risk of global equities. The higher correlations between global equity sectors, styles and regions since 2008 have increased interest in alternative strategies that can help to diversify portfolios and reduce equity beta exposure.

Allocations by alternative investment type

The survey determined that real estate, private equity and hedge funds have remained the preferred alternative types, collectively accounting for 86% of 2009 alternative allocations. They are expected to remain dominant through 2012, although commodities and infrastructure will make meaningful gains from their current low allocations, as shown in the graph below.

Allocation % among alternative types vs. expectations



*Expected next 2–3 years.

NOTE: In all survey results, including the graph above, real estate may be slightly under-represented because Australian investors generally regard it as a core asset class, not an alternative.

Interviews confirmed that most institutions have not changed their fundamental alternative philosophy or commitments to different alternative types. If anything, the crisis has increased caution and the need for due diligence before implementing major changes.

Overall observations

INTERVIEW COMMENT

“Our investment team is dedicated to the hedge fund asset class, but there has been quite a lot of opposition from our board to go further with it. We have one primary fund of funds, where we have a 2% portfolio allocation, and it’s been doing well. But further allocations in the short-term will be difficult.”

INTERVIEW COMMENT

“While we believe in the concept of hedging interest rate risk, we think from an intermediate-term perspective now is exactly the wrong time to do it. So, we are looking to take more risk on that front. We’ve moved into an allocation of 10% in commodities, which is pretty aggressive for us. We think it will be a source of value in the coming inflationary environment.”

The majority of survey respondents must implement any significant policy changes through governance structures, including investment committees or boards. Now, the wheels of governance are turning more cautiously and decisions are taking somewhat longer.

Although we believe the increased expectations for infrastructure and commodities allocations are significant, several respondents indicated that these choices have been under consideration for years, without much action to date. However, among all alternative types, real estate, infrastructure and commodities stand to benefit from increased concerns over higher inflation and interest rates, and such concerns appear to be growing.

Surveys were conducted at a time when many hedge funds and public real estate investment trusts (REITS) had bounced back from the crisis with strong 2009 returns. However, because private equity and private real estate investments are priced on appraisals and lag values of transactions made in real-time, they were still declining in value.

Expected changes in “portfolio share” by type

If survey expectations are accurate, what will the alternative portion of institutional portfolios look like by 2012? The table below summarises the answer.

Alternative types as a % of total portfolio assets

Type	2009	Expected by 2012	2012 Expectations relative to 2009 (1.00)
Private equity	3.1%	4.9%	1.58
Hedge funds	4.2%	5.7%	1.36
Real estate	4.1%	6.6%	1.61
Infrastructure	0.3%	1.4%	3.67
Commodities	0.7%	1.1%	1.57
Totals	12.4%*	19.7%	1.59

*NOTE: The 12.4% total above is the sum of allocations to each type, and it is drawn from a different survey question than the 14% “total allocation” to equities discussed earlier. The 1.6% difference may be to un-categorised alternative allocations (not assigned to a specific type).

In summary, alternatives’ overall allocation are expected to increase by more than 7% of total assets, as all alternative types gain assets and “portfolio share.” Infrastructure is expected to increase share most meaningfully, relative to the rest, albeit from a very low base.

On the basis of global regions, the survey suggests that allocations to private equity, hedge funds and real estate will increase strongly in North America. In Europe, all three major types will experience more subdued increases. In Japan/Asia, growth may be confined mainly to real estate, although the region’s allocation to hedge funds (6.0% reported for 2009) is greater than in any other region.

Changes in investment philosophy and strategies

Portfolio allocations are objective, measurable realities. Institutional investors’ philosophies and strategies, on the other hand, are multi-faceted and not always easy to quantify. This is why the qualitative interviews included in our survey are useful in balancing survey data and illuminating changes in philosophies and strategies.

On the “top level,” we found that 58% of respondents agreed that their philosophies/strategies had not changed as a result of the financial crisis, vs. 28% who disagreed. Only 5% agreed that losses or liquidity constraints experienced during the crisis changed their view about the benefits of alternatives, or

Overall observations

INTERVIEW COMMENT

“We’re quite long-term investors in private equity. We make commitments every year so we don’t get a bigger J-Curve effect on the portfolio. We haven’t classified different managers as more liquid or illiquid. But we have decided that these asset classes can be quite illiquid as a whole. We’ve found out with some hedge funds, which we’ve chosen to exit, that there was more illiquidity than we expected.”

INTERVIEW COMMENT

“We’re trying not to have a kind of knee-jerk reaction in the time of downward pressure. Prior to the crisis, we already were very much on the de-risking path.”

INTERVIEW COMMENT

“The actuarial side, the board and different stakeholders are keen to look at our investment process. The documentation for introducing new managers or asset classes has increased within the last 24 months or so.”

caused reductions in allocations to them. Yet, 44% said that they already have or soon will differentiate alternative investments by liquidity risk. The interviews suggested that one of the most significant changes respondents have made is with respect to risk management and governance. (These changes will be covered in more detail later in this report.)

Three attributes were indicated as drivers for increasing allocations to alternatives, specific types of alternatives, or specific alternative providers:

- › Reducing volatility (83% agreed)
- › Improving returns (76%)
- › Better risk-adjusted performance (61%)

Two negative factors were indicated as drivers for reducing allocations:

- › Liquidity concerns (46%); and
- › High fees (34%)

An overarching factor in respondents’ ability to navigate the crisis was having a sound asset allocation policy in place prior to its onset. None of the respondents surveyed had excessive allocations to alternatives pre-crisis. Many indicated that they do not expect or require their alternatives to be a source of “duress-driven liquidity.”

Our interviews helped to add depth to these findings. For example:

- › Very few respondents reported that their funds faced liquidity pressures during the global crisis, and this was due to:
 1. adequate liquidity in traditional asset classes;
 2. diversification among alternative types and managers; and
 3. long-term liability profiles and sufficient contributions or cash flows to meet current liquidity needs. Liquidity concerns still relate more to risk management and portfolio flexibility than to cash flow pressures. 44% of respondents agreed that they have or will differentiate alternative investments by liquidity risk, compared to 15% who disagreed and 36% who were neutral.

- › Some defined benefit pensions made changes in philosophy or strategy during the crisis to reduce volatility and seek better risk-adjusted performance. These changes were driven not only by a review of portfolio performance and asset exposures but also by negative developments in liabilities—i.e., an acceleration in early retirements, increased longevity, and lower discount rates.
- › Liability-driven investing (LDI) was reported as a trend or area of interest in several cases. A few respondents are carving out an “LDI bucket” to increase liquidity and asset/liability-tracking, and it is possible that some institutions will use the 2009 market rebound as an opportunity to take portfolio profits, reduce risk exposures and increase LDI commitments.
- › The Madoff saga served as a catalyst for committing more institutional resources to manager due diligence. It was a cautionary tale that made virtually all levels of the institutional investment process, from board members to investment technicians, more aware of personal responsibilities. It also increased the focus on transparency, frequent manager reviews and operational due diligence.
- › Few respondents reported that they have yet achieved fee reductions with alternative providers, but many are trying. Some are planning on receiving fee breaks at designated thresholds based on assets under management, longevity of relationship and other factors. As alternative allocations expand, more institutions will increase their “fee negotiating clout.”
- › Even in billion-dollar-plus funds, resources are limited and are being strained by increased demands. As a constant refrain in interviews, we heard comments such as “there are only X of us” and “we use outside managers because of limited internal capacity.”

The trend is moving toward allocating scarce internal resources to evaluate and select hedge funds and private equity funds. In both alternative types, fund of funds (FOFs) are perceived by some respondents to add value in manager evaluation/selection. However,

Overall observations

INTERVIEW COMMENT

“As an institutional investor, there is no way you can invest into a black box.”

INTERVIEW COMMENT

“Sometimes we have to ask hard questions that can’t be answered immediately, to get the transparency we need. Once we ask these questions, managers are honest with us in terms of where and how they’re investing.”

* customised account examples include managed accounts, a hedge fund with one investor, or a separate account of multiple hedge fund allocations instead of a commingled hedge fund of funds structure.

other institutions prefer to use consulting firms or industry networks, in part because they perceive FOFs as being too expensive, less able to generate attractive returns, or less transparent. The trend is moving toward allocating scarce internal resources to due diligence, manager communications, and portfolio monitoring activities while outsourcing some asset allocation and manager screening tasks, virtually all hands-on investing, and most back-end performance analysis.

Separate account investing is fairly common in real estate (27% of respondents use) but less so in private equity (12%) and hedge funds (6%). The survey detected some desire to increase adoption of customised* account structures in accessing hedge fund managers, with expected usage increasing from 6% in 2009 to 12% by 2012. The benefits of separate accounts—especially transparency—are perceived to be attractive especially in the hedge fund area. The major obstacles appear to be:

1. insufficient assets in any one fund to have “separate account clout”; and
2. some separate account structures may add unacceptable fiduciary or operational risks for the sponsor. (Note: Interviews indicated that Japanese institutions are less likely than their counterparts elsewhere to be offered separate accounts.)

Regardless of account structure, the survey revealed increased demand from respondents and their auditors for increased transparency across all alternatives. However, what “transparency” means (and how it is achieved) varies among investment types. We believe that this development is a natural part of the growth and evolution of alternative investments, as well as a reflection of investment attitudes post-crisis.

Trends and themes in alternative types

INTERVIEW COMMENT

"We think the information advantage still exists so that good private equity managers should be able to do better by 3% to 5% annually than the public markets over a reasonable time period."

INTERVIEW COMMENT

"In the hedge fund space, we are quite comfortable with where we are. The hedge funds that we hold have performed better than equities, with better defensive characteristics. And over the past year, they have come back and delivered pretty decent and steady returns."

Private equity

Previous surveys have shown that North American respondents have held the strongest commitments to private equity, with consistent allocations of 6–8% of their total portfolio share from 2001 through 2007. The strong rebound in publicly traded equities in 2009 influenced a reported decline in private equity's share in 2009, to 4.3% (the "denominator effect"). However, 2010 respondents expect this share to increase to 6.8% by 2012. We believe the increase is driven by a combination of valuation improvement expectations and greater commitments/allocations.

Past private equity commitments, reported by 2007 respondents, ranged from 3–5% in Europe and 2–3% in Japan. In both cases, the declines reported in 2009 were of a magnitude proportionate to North America's. However, expectations for 2012 rebounds are not as robust in either Europe (3.7% share expected) or Japan (2.5%). In Australia, private equity had a 6.3% share at the 2007 peak, as reported by 2007 respondents, and 3.5% reported for 2009, with little increase expected by 2012.

Although North America remains "where the money is" for many private equity providers, the interviews suggest that interest is growing and new mandates likely will be emerging elsewhere around the globe, especially in Asian emerging markets.

Private equity essentially "froze up" at the height of the global crisis, but it may emerge from the downturn stronger than before, for three reasons:

- › Sponsors understood even before 2008 that private equity requires a long-term horizon and has limited short-term liquidity. The crisis produced few surprises.
- › The long holding periods and time horizons give sponsors more confidence that these investments can help to mitigate stock market systematic risk over time.
- › As markets froze, capital drawdowns for exits virtually stopped due to anemic levels of strategic acquisitions and/or IPO activity. Increased activity and previous investor commitments backed up in the private equity pipeline and are expected to

flow into the increased allocations over the next few years.

The survey indicates that private equity is considered a relatively expensive asset class in an age of increased fee consciousness, and also that private equity manager due diligence requires large amounts of scarce "staff bandwidth." For this reason, private equity fund of funds are a preferred solution for many respondents.

Hedge funds

Overall, 4.2% of survey respondents' portfolios were committed to hedge funds in 2009, and this allocation is expected to increase to 5.7% by 2012. Although allocations are expected to increase overall, interviews revealed mixed attitudes among individuals, such as:

- › "Our trustees want to see the waters clear a little before getting back into hedge funds."
- › "We are a little more nervous about hedge fund liquidity."

While some institutions have reduced or eliminated hedge fund allocations, we believe this cloud may have a silver lining. The financial crisis produced a "stress test" for how hedge funds perform under adversity, and it helped institutions better evaluate their expectations for market exposure, transparency and liquidity against reality. In the long run, this educational process may help many hedge funds adapt to client expectations, especially those that can meet today's higher due diligence standards. In general, institutions seem more selective in evaluating hedge fund providers, regardless of whether they invest directly in hedge funds or through FOFs.

Previous surveys showed that average allocations to hedge funds had increased to about the 7–8% range in North America and Europe and as high as 9–10% in Japan/Asia. These increases were driven by both the capital invested and increased leverage, which contributed to higher values in a rising market. Crisis-related disenchantment with hedge funds was greatest in Europe, and allocations there may not return to peak levels for some time. Hedge funds are expected to rebound in North America and Japan/Asia faster.

Trends and themes in alternative types

INTERVIEW COMMENT

“We think there are opportunities right now in global macro hedge fund strategies that invest across countries, interest rates and currencies. We’re not as interested in the relative value pieces, especially during times of extremes.”

INTERVIEW COMMENT

“Even though it’s illiquid, I think there’s enough of an incremental return available from real estate to compensate for the lack of liquidity.”

INTERVIEW COMMENT

“In our real estate portfolio we did some risk-modeling and came to the view that we had more exposure than we needed in core real estate. We are reducing that in favor of private equity or non-core real estate, which has private equity characteristics.”

* Source: Global Private Real Estate Market Overview, Russell Investments, February 2010

NCREIF = National Council on Real Estate Investment Fiduciaries

Indexes are unmanaged and cannot be invested in directly. Past performance is not indicative of future results.

The hedge fund universe remains divided between institutions that prefer to invest directly and those that favor FOFs. The FOFs are still viewed as a source of expertise in evaluating and selecting individual managers, especially by institutions that lack internal resources or expertise in this area. However, they also are associated with trade-offs such as additional costs, lower transparency, and limited direct access to the underlying hedge fund managers. A few respondents who have previously used FOFs indicated they are exploring other ways to evaluate and select managers, to reduce or eliminate these drawbacks.

Both long/short and global macro hedge fund styles are viewed as having some diversification benefits and the potential to reduce liquidity risk in other hedge fund styles. Respondents indicated less interest in styles such as mergers & acquisitions, arbitrage, and event-driven—given their relative illiquidity. (These views were investor and circumstance dependent, so they are subject to further evaluation.)

Real estate

Because real estate is more sensitive to geography-specific influences than global trends, the impact of the financial crisis on real estate allocations varied somewhat by region. For example, the NCREIF Property Index (NPI), which reflects the total rate of return of U.S. private commercial real estate (CRE), reflected a 31% negative appreciation since its peak in Q1 2008, through Q4 2009*, while CRE values were more stable across Australia and emerging Asia. This disparity has drawn more attention to strategies for globally diversifying real estate allocations—whether through real estate FOFs or directly into real estate funds.

All respondents reported an average 4.1% portfolio allocation to real estate in 2009, which for the vast majority was well below traditional pre-crisis levels. The average allocation is expected to increase to 6.6% through 2012. We attribute this outlook partially to an expected recovery in valuations over time and to perceived opportunities at this stage of the current private real estate cycle which, as is typical, is lagging the general economic cycles.

Opportunities are varied by region, and manager selection is of critical importance.

Traditionally, Australia and Europe have reported the highest allocations to real estate, with peaks of 11.5% (of portfolio assets) for Australia in 2003 and 9.8% for Europe in 2005, as reported by 2007 survey participants. Both allocations have declined from these peaks. Previous surveys show that in North America (7.3%) and Japan (4.7%) allocations peaked later, in 2007, and then fell. All regions experienced declines in 2009, with Australia’s drop being the least steep, to a reported 8.7%. We think Australia’s allocation held up best because its institutional investors have mostly domestic exposure, and the nation’s real estate valuations were not as negatively impacted as those in North America, Japan or Europe.

For 2009, real estate’s average portfolio share stood at 4.0% in North America, 4.9% in Europe, and 2.7% in Japan. Respondents are expecting valuation-driven increases by 2012 in each of these regions.

Some institutions expect to increase allocations to real estate because it aligns with their outlook on inflation. Others see opportunities to add core real estate allocations or view the asset class more opportunistically, due to significant value declines. In addition, the survey has captured more interest in diversifying real estate exposures outside investors’ home countries.

Infrastructure

Infrastructure investment in projects such as highways, airports, pipelines, ports, and water/sewer systems is booming all over the world. It is laying the groundwork for the growth of emerging and frontier economies in Asia, Eastern Europe, South America and Africa, and helping stimulate developed economies post-crisis in North America and Europe. Institutional investors are attracted to this type of alternative for three main reasons:

1. increased diversification potential;
2. potential inflation and interest rate hedging; and
3. cash flows that match well with long-term liabilities.

Trends and themes in alternative types

INTERVIEW COMMENT

"Infrastructure investments have a fixed cash flow and that cash flow is being indexed by a consumer price index as well. That's very positive, because we have similar liabilities on the other side of the balance sheet of our pension fund."

INTERVIEW COMMENT

"We used to have a portable alpha strategy in commodities, meaning a benchmark allocation to an index manager of commodities along with an overlay to add alpha. We have changed that to two separate commodity managers who are trying to add value compared to the commodity index."

Many infrastructure investments are viewed as having government support or backing not only of capital costs but also future rate structures and revenue streams. In Australia especially, infrastructure investing has been embraced by institutional investors for some time, and often for lengthy time horizons.

The drawbacks of infrastructure investing are viewed by respondents mainly as:

1. lack of liquidity, especially in private investments (as opposed to listed); and
2. lack of knowledge and evaluation expertise. The global financial crisis took a toll on several Australia-based leveraged public infrastructure funds, which lost substantial value from the peak, and this also increased concerns.

Infrastructure accounted for only 0.3% of all respondents' portfolio allocation in 2009, and this is expected to rise to 1.4% by 2012—a more than four-fold increase. However, we should note that several participants have been evaluating this class for some time, without yet buying into it, so acceptance may be slower than expected. For publicly supported projects, increased pressures on government budgets or limits on tax-raising ability might be perceived as negatives and could further slow acceptance.

Commodities

Although commodities have not been a mainstream alternative type, institutional investors can obtain some exposure to this area through equities and listed futures (which may not be perceived or reported as alternatives). Some institutions have overweighted the materials and energy sectors or equity allocations, purchased stocks of integrated oil companies, or participated in drilling master limited partnerships.

Respondents reported an allocation of 0.7% of portfolio assets to commodities in 2009, with expectations for growth to 1.1% by 2012. For those respondents investing in commodities, the survey suggests a preference for investing on a passive basis via indices and/or ETFs (37%). For those taking an active approach, long-only commodity funds (23%) and long/short commodity funds (20%) are the primary methods. A few respondents expressed concerns about excessive valuations in some commodities contracts, driven by speculative trading. The major advantages perceived in a commodities allocation include liquidity, inflation protection and the track records of some successful managers in generating alpha. Significantly, despite inflation concerns, the survey revealed no special interest in precious metals.

Looking forward

INTERVIEW COMMENT

"We operate two plans, each of which has trustees, and only one trustee overlaps both plans. So, educating all the trustees, and keeping them informed, is a huge job. Many trustees have full-time job responsibilities elsewhere, outside the financial or investment world. The level of education they need to feel comfortable about making investment changes, particularly in alternatives, can't be underestimated."

INTERVIEW COMMENT

"We are moving to meet the Basel II Solvency requirements, and that also increased our focus on risk management."

Russell Investments' *2010 Global Survey on Alternative Investing* is designed to help our clients, Russell and the alternatives industry decipher emerging trends and anticipate changes. This section summarises our analysis of a few important forward-looking issues and trends the 2010 survey has brought to light:

Response to the market environment

A major variable in shaping alternative investment commitments and strategies will be the future direction of global economies and financial markets. We have seen a rising tide of risk-consciousness among survey respondents. There is increasing acceptance that alternatives are an integral part of a defensive portfolio, and different types of alternatives offer diverse benefits in down or chaotic markets. For example, the long-term nature of private equity and private real estate investments helps to dampen short-term volatility swings in public securities. Some types of hedge funds are expected to act as diversifiers to equity and credit markets, while commodities and infrastructure may temper inflationary forces.

We also observed that respondents' concerns over market volatility are no longer focused only on equities. The 36% share of respondents' total portfolios committed to fixed income (2009) also is viewed as vulnerable to rising interest rates, as well as potential ratings downgrades or increased default rates. If another economic storm lies on the horizon, alternatives are well positioned to balance both equities and fixed income allocations.

Risk management and governance

A striking 84% of respondents have made (or plan to make) changes in their risk management approach, and nearly two-thirds are increasing the sophistication of their internal decision making and governance processes. In regard to alternatives, 44% said they are increasing the depth and frequency of reporting, and 39% indicated they are providing more active education and briefings to boards or senior management. At

the same time, interviews revealed challenges in meeting board or management requests to stay current on alternative investment holdings, managers and risks.

A number of respondents said they are reviewing governance structures, and in some cases the process began before the financial crisis. Clearly, events of the past two years have brought risk management and governance concerns into sharper focus.

The survey also showed that respondents are attempting to meet this challenge with a variety of initiatives, including reliance on investment sub-committees of the board, more frequent board meetings, and an increase in the frequency or depth of communications.

Among the 84% of firms who plan to make changes to their risk management approach, over one-third said they are increasing proprietary research on asset class or asset allocation strategies, or on specialised investments. Also, 21% are increasing the frequency and depth of risk reporting; 17% are relying more on risk-budgeting; and 15% are implementing risk management systems.

LDI + alternatives

The global financial crisis has rippled through institutional investors' governance structures, in some cases triggering thorough reviews of portfolio risks, fiduciary responsibilities, and liability-side actuarial assumptions. In defined benefit (DB) plans, sponsors' attitudes toward LDI are changing, with a gradual increase in acceptance of its potential to smooth interest rate risk. For some respondents, however, LDI is not being implemented as an overriding philosophy but rather as another "bucket"—in some ways similar to the alternatives allocation. We believe more DB plan sponsors will recognise that an appropriate combination of LDI strategies and alternatives can produce risk-management synergies.

We also observe that some sponsors believe their plan's current funded status is not yet favorable for implementing LDI. Not all DB plans are yet able to afford the potential "sleep-at-night" benefits of LDI.

Looking forward

INTERVIEW COMMENT

"I don't think over the long term that the 20% part of profits that a lot of hedge funds get is going to be a sustainable structure. I think there are too many alternatives, and there's also a lot of competition that probably will reduce costs."

Fees and separate accounts

Alternatives have survived the storm with their fee schedules and pooled structures largely intact. Few survey respondents reported that they have managed to negotiate lower management fees, although several have tried. Two big barriers to reduced fees appear to be size and relationship. Respondents believe they need to reach size thresholds to have fee bargaining clout, and they don't believe they have much negotiating leverage with established manager relationships. On the other hand, the survey clearly shows increased awareness of fees and more motivation to lower the cost of investing.

We think the ability to influence terms is slowly becoming more balanced between providers and investors, and this trend is likely to have the most impact (at least initially) in hedge funds. The hedge fund industry is dynamic and global, with new styles and managers constantly emerging, and more institutions are diligently identifying new talents. As allocations to hedge funds have stabilised and even increased recently, more institutions have begun to achieve the asset thresholds required to have bargaining clout with established relationships, especially as hungry new managers wait in the wings.

We see the concept of fee "breakpoints" arising in hedge funds, similar to the tradition of mutual funds. Several survey respondents are anticipating achieving such a breakpoint in hedge funds over the next year or two, although the pace of progress is difficult to measure, as hedge fund returns were strong in 2009 and continue to improve in 2010. In general, hedge fund terms seem to be more aligned with underlying strategies now than before the crisis, especially in regard to lock-up periods and other liquidity-related features. Our conversations with respondents clearly reflect an increased level of sophistication in evaluating and comparing terms. We think this can be attributed to experience and the evolution of the alternative investment landscape.

As allocations rise, hedge funds also will compete for mandates by offering the

transparency of separate or managed account structures. Gradually, we think investor demand will force many hedge fund managers to offer increased transparency through managed accounts or single-client fund structures for allocations above a given threshold level. This may vary among alternative types and regions. The survey has revealed some concerns that a separate account structure would expose institutions to increased fiduciary responsibilities and additional demands on limited internal resources. We believe this issue may require further exploratory analysis, which should lead to increased comfort with the industry's "best practices" for accessing talented hedge fund managers through different account structures.

Internal vs. external resources

The 2010 survey has confirmed the trend toward increasing resources available to evaluate, select and monitor managers. In particular, more respondents are anticipating increased reliance on a combination of internal resources and external consultants. In 2009, only 10% of real estate assets (among all respondents) were internally managed, while that percentage dropped to 5% for hedge funds and zero for private equity. No change in these percentages is expected through 2012.

Alternatives have accelerated the trend toward external management because most institutions do not have alternative manager selection expertise in-house, although they may have considerable competence with traditional investments. Also, the dynamic nature of the alternatives industry requires institutions to keep evaluating, looking and screening for the best emerging concepts and talents.

Among institutions with less than about \$5 billion of portfolio assets (or roughly \$1 billion committed to alternatives), the emerging "best practice" is to use alternatives consultants for:

1. filtering the manager universe based on custom investment policies, objectives and needs; and

Looking forward

2. monitoring institutional portfolios and individual managers, maintaining allocation guidelines, and advising on rebalancing and maintaining risk and liquidity guidelines. This model frees internal staff to focus on due diligence, fiduciary responsibilities, manager interviews, and communications with internal committees and boards.

Additional interview insights:

- › The global financial crisis has increased internal and external responsibilities, across-the-board. While changes in global regulation of alternatives remain uncertain, they could become complex and further increase the need for qualified external consultants who represent the institutional investor's interests.
- › While political and regulatory changes may impact alternative strategies in various ways, expect institutional investors and managers to adapt to take advantage of new opportunities.

Summary

Russell Investments' *2010 Global Survey on Alternative Investing* has provided a valuable window into the practices and attitudes of institutional investors around the world toward alternatives, at a pivotal time in the evolution of these investments. We can confidently say from the survey results that alternatives have survived the storm of the global financial crisis and we believe they are poised for recovery, re-evaluation and increased allocations in the coming years. We also believe that if the current global recovery falters at some point, alternatives have gained enough "critical mass," as portfolio-diversifiers and risk-mitigators, to maintain and gain momentum.

Additional details from the survey are available to the institutions that assisted Russell Investments and our partner in this project, McKinsey & Company, with their time and thoughts.

If you are interested in participating in Russell Investments' next *Global Survey on Alternative Investing*, please contact Russell Investments at russellinvestmentgroup@russell.com. Please put Global Survey on Alternative Investing Participant Interest in the subject line of your email.

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