2006 EUROPEAN INSTITUTIONAL ASSET MANAGEMENT SURVEY

NOVEMBER 2006

European Institutional Asset Management Survey 2006

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European Institutional Asset Management Survey 2006

a FOREWORD

This is the seventh edition of the European Institutional Asset Management Survey. The survey sets out to gain insights into the thinking of institutional investors in Europe. Our definition of an “institutional investor” includes any organisation that manages balance sheet assets. Pension funds and Insurance type companies are obviously a significant focus and make up half of the sample we have polled. But we have made a significant effort to include Banks, and 'other' types of investors such as Foundations and Corporations. The survey is based on respondents in France, Germany, Italy, and Belgium/The Netherlands (who we have grouped as The Benelux Countries). We also have a small representation for the first time from Switzerland.

Our respondents vary in size from very large to very small. This survey is not intended to reveal the behaviour of the super-large institutions as many other surveys are successfully doing. We want to show what the thinking is among what could be called the small and medium size institutions. For many in the investment community this world is under-researched. And we can now show that it is easy to misunderstand.

A continuing feature of this study is that it shows results not just by country, but also by the sector and size of each respondent. One of our core conclusions last year was that it was a mistake to look at European institutional investment behaviour purely through the prism of regional differences. This year we show again how, in many key areas, it is not the nationality of investors that drives their behaviour so much as their sector or size.

In previous years we have tended to focus our insights on product demand. Last year, for example, we were able to show how demand for structured products (and other 'alternative alternatives') was emerging. The theme of this year's study is to understand investment objectives better. We have looked in detail at issues like Absolute versus Relative Return, and we have explored demand for Alpha and Beta and what these terms mean for institutions. We have also looked at the possible emergence of Liability Driven Investment, and how Core/Satellite approaches are interpreted.

What we have discovered will surprise many market commentators. The institutions outside the super-large zone have quite independent ways of thinking, and are less influenced by the so-called fashions that continue to capture the attention of some market commentators.

We are very grateful to the respondents for providing their time and views for this survey. To thank them for their participation, we have provided each respondent with a confidential tailored benchmark showing how their responses compared to those of similar institutions.

We are grateful also to Magnus Spence of Spence Marketing Intelligence for having carried out the analysis of this year’s findings. Lastly, we are most grateful to the sponsors of this study: AFG (Association Française de la Gestion Financière), Af2i (Investisseurs Institutionels) Euronext, SSG Management Consulting, and BVI.

I hope you find this survey of interest. I invite you to contact me or Magnus Spence (mas@magnus-spence.demon.co.uk) with any questions or feedback.

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Life outside the super-large zone is quite different

This survey is consciously looking at institutions that fall outside what might be called the super-large zone. We have set out to understand the thinking and behaviour of the large number of medium and smaller investment institutions which exist across Europe. There is a temptation to assume that whatever happens in the super-large arena, will also happen among the medium and small institutions. In this study we show that this temptation should be avoided. The medium and small institutions have minds of their own. Here are three examples. Relative return is still very much in demand among our respondents, when to judge by the market commentators in recent months and years, you might think that the whole investment community was solely focused on absolute return. Secondly, institutions who participated in our study perceive and define the concepts of alpha and beta in such a varied way that one might even suggest that these terms have no meaning at all. Many institutions told us that these terms are not useful to them, and are not part of their investment vocabulary. Thirdly, investment approaches such as Core/Satellite and Liability Driven Investment have significantly less impact than might be expected from looking at the behaviour of the super-large institutions - this is particularly true of Liability Driven Investment.

It's not where you are that matters, it's who you are, or how big

Institutions in this survey come from different countries, sectors and are of varied sizes. We continually ask the question: what is driving their behaviour, is it where they are, or is it what they are, or how big they are that matters. Our conclusion is that looking at Europe purely through a regional prism has its limitations. Investment behaviour is, yes, often driven by region - there seems to be a French love affair with hedge funds, for example. But it is driven equally often by other factors, two of which we track in this survey: sector and size. Institutions do what they do because of what they are, or how big they are, as much as they do it because of where they are. Here are some examples of what we mean. Pension funds and Insurance companies tend to have dramatically different investment horizons, irrespective of what country they come from. Pension funds tend to focus more on relative return than others in our sample, while insurance companies are notably more absolute return-focused. Smaller institutions in our study are much more attracted to hedge funds and real estate than the larger ones, whilst larger institutions place a larger proportion of their assets than the smaller ones in private equity.

Alternatives are growing, but which ones?

We have identified growth overall in alternative investment. Indeed last year we predicted just this. But we are surprised at how small the growth seems to be. We have identified last year and this that hedge funds are much more popular in France than in any other country. Growth in hedge funds does seem to be occurring in both France and Italy in terms of number of users and in terms of assets allocated to this class. But elsewhere - in Germany and Benelux countries - there is negligible growth among our respondents. Structured products, which we tipped last year as one of the growing 'alternative alternatives' have not taken off quite as we had thought they would. The real alternative asset growth story we predict this year based on what our respondents are saying, is Real Estate. This slightly unglamorous asset class attracts a very high proportion of alternative assets year after year, and many of our respondents predict growth in coming months.

Other important conclusions

Our 2006 survey has generated a number of other interesting insights. Here are three examples:

Performance fees are in hot demand

The demand for performance fees was growing last year, but this year it is much more pronounced. For example, 18% of respondents are currently paying performance fees for equity mandates, but 48% would like to be doing so in future. The most persistent demands for performance fees come from Germany.

Institutional investors are big fund users

Over half of the respondents, and maybe many more, are fund investors. This is a very difficult area to research, for example because of the danger of double counting, so we cannot be sure, but it is possible that the proportion of the institutions' assets that is invested through funds may be far greater than many currently think it is.

There may be signs of stable or even increased client loyalty

Those in this survey appear to be less likely to break relationships than was the case in any of our surveys since 2003.

1 *Investment Objectives* Page 12	**Absolute return matters most, but relative return matters too.** The most important two objectives that are pursued when setting investment policy are the same as last year: 'Absolute Performance' and 'Level of Risk'. But this year we explore what matters for each of internally and externally managed assets. What emerges is that relative performance is still in great demand for externally managed assets, especially among pension plans. In the current rush to service absolute return objectives, asset management firms should not ignore this continuing need for relative return among their clients. There are significant differences between what is wanted for internally and externally managed assets. For example, Insurance companies see their internally managed assets as having a long term horizon, while pension plans give this characteristic to their externally managed assets. Respondents to this year's survey are less long term than in the previous year.
2 *Sources Of Absolute Return* Page 15	**Absolute and relative return mean different things to different institutions** Both absolute and relative returns are achieved using a variety of strategies, involving a variety of asset classes. Investing institutions develop unique strategies to suit their unique needs, and have told us that they do not feel they need to be beholden to a specific set of industry standard norms. For example we have looked in detail at how institutions who seek both absolute and relative return strategies at the same time, do this, and have found that there are at least nine different combinations of approaches used. Pension funds are particularly varied in how they seek absolute return. It would be sensible for asset management firms offering services to these institutions to listen carefully to each institution's own individual definition, rather than try to impose their own.
3 *Sources of Alpha And Beta* Page 20	**Alpha and Beta also mean different things to different people** Just as there are varied sources of absolute and relative return, there seem to be a wide variety of sources of Alpha and Beta. We have observed many different approaches to achieve them. Overall, equity appears the most popular route to both alpha and beta, followed by fixed income, but in fact this varies widely by respondent. Alternative investments are not often seen as a source. Confusingly, we have found little relationship between the desire for Alpha and Beta on the one hand, and Relative return on the other hand. Institutions, whilst well aware of their meaning, use the two terms very little in their everyday conversations. Institutions in this survey retain the right to define the terms in ways that are meaningful to them, but which are not necessarily shared across the industry.

4 Liability Driven Investment Page 22	**Liability driven investment techniques are not popular** One might think, to judge by the amount of press and asset management company coverage on this issue, that liability driven investment techniques are very popular among all institutional investors. But of the respondents to this survey only 6% told us they used them. Our conclusion is that Liability driven investment is new, so a low percentage is not a surprise. It is quite possible that Liability Driven Investment Techniques will never be in great demand outside of the highly resourced super-large institutions.
5 Core/Satellite Approach Page 23	**The Core/Satellite approach is widely used, but interpreted in varied ways** A Core and Satellite approach is used by a third of the institutions in our sample. Respondents conform broadly to the expected norms of Core/Satellite approach. But there is much variety in what different respondents do, showing that the Core/Satellite approach can be adapted significantly to suit individual needs. Equity was used as the predominant satellite category by nearly half of those responding, but Hedge Funds and Fixed Income were named as Satellite asset classes by a quarter of the respondents. It appears that usage of a Core and Satellite approach is a function of size - nearly half of the larger companies used it, but only one in four of the smaller ones.
6 Investment Assets Page 25	**Investment allocation is driven less by size, and more by type of institution** Among the institutions in our survey, there is over twice as much investment in bonds than equity, three times as much investment in Government bonds as in Corporate bonds, and ten times as much in large cap as in small cap. There is little size related difference in the structure of the portfolios we have observed. But there is great variety by sector - pension funds and Other institutions (which includes foundations) are likely to be three times more focused on equity, than are insurers or banks. Equity investment appears to have grown in France, Italy and to a lesser extent Germany. Fixed income investing appears to have fallen in Italy. In the coming year approximately one in five of respondents predict they will increase weighting in Real Estate. A strong regional shift towards Asia is also predicted. Emerging markets may also see growth.
7 Alternative Assets Page 28	**Real estate is the real alternative** Among the firms who make up this survey, the most prominent alternative investment is real estate which remains as popular as ever, particularly among Pension funds, and is said to grow strongly again this year. Hedge funds in our last survey were most popular in France, and it is true again this year. Hedge fund assets have grown as a proportion of assets in France and Italy. Only in Germany have we seen little in terms of hedge fund asset growth. Private equity is a very rare asset class among smaller institutions, but unlike last year, we can now see usage among larger firms in our survey. Commodity investing, apparently a fashionable activity according to some market commentators, is very small among respondents to this survey.

8 Hedge Funds

Page 30

Institutions access hedge funds through funds of funds

The most popular hedge fund products are funds of funds. After this in terms of popularity come funds that are equity long/short, market neutral. Pension funds are enthusiastic users of funds of funds, but they don't like single hedge funds. Larger investors are less likely to use stand alone (i.e. not funds of funds) funds, which it seems are more attractive to the smaller institutions. French investors are interested in hedge funds because of the high performance they offer, whilst Italian investors are particularly attracted to the fact that hedge funds are uncorrelated.

9 Structured Products

Page 32

Structured Products are mostly capital protection vehicles

The most popular type of structured product are capital protection vehicles, followed by yield enhancement structures. We thought that structured products would grow more in 2006 than they have. Overall a third of institutions use them, but this means that the number of users of structured products in our survey is similar this year to 2005. It is difficult to be sure, but the indications are that around 3% of assets are in this category across our sample. Most of the usage of structured products is in cash and enhanced cash products, and in fixed income.

10 Exchange Traded Funds And Passive Investing

Page 34

Evidence only of limited growth in ETFs

Overall passive investment probably represents 15% of the value of respondents' average portfolios, and ETFs make up only a small part of this passive investment. As with structured products, we had expected to see increases in usage of ETFs in 2006 which does not appear to have happened. We are aware that there have been reports of significant growth in ETF investing - we think our findings may reflect different ETF demand patterns among smaller institutions. ETFs remain popular in our survey in France and Italy, but growth of these assets is not visible in Germany, at least not in this survey. The usage of ETFs is greatest among Insurance Companies, and among larger firms in our sample, and again this was our experience in last year's survey. Most of the ETF usage in our survey is in Equity based Regional products. Sector and commodity ETFs have not caught the imagination of our respondents.

11 Investment Though Funds

Page 36

Over half of the respondents, and maybe many more, are fund investors

This year we have attempted in a systematic way for the first time to collect data on the way in which investment is made through fund structures. We still have not succeeded in securing robust data - this is a very complex area to research. The number of fund users is above 55% of the institutions, and may be higher, which is surprising. It is growing. We cannot be sure, but it is possible that the proportion of the institutions' assets that is invested through funds may be far greater than many currently think it is. There are plenty of other factors which can cause problems of definition here. For example, institutions in France to ease the administrative burden, often structure their own internally managed assets as funds in certain circumstances.

12 Performance Attribution Page 39	**Performance attribution is supplied increasingly by investment managers.** Performance attribution is used by a similar number of respondents to last year. This service is supplied increasingly by investment managers.
13 Investment Consultants Page 40	**Use of consultants has not grown** Usage of consultants has been one in three of our respondents for four years. Where they are used it is mostly by the pension funds, but 'Other' types of investors also use them. There seems to be a big change in the way consultants are used - much less for management selection, and slightly more for asset allocation. Across all users of consultants, only 38% of respondents now ask for help with manager selection. This is down from 61% in 2004.
14 External Managers: Usage and Change Page 42	**More mandates coming, but probably smaller** As we reported last year, it is the German institutions that delegate least to external managers. Also as reported last year it is the Pension funds which delegate most. On average each respondent to this survey has 13 relationships with external managers, mostly for either segregated mandates or pooled funds. On average each respondent delegates five mandates to external managers. More external managers are being used for segregated mandates (and the same may be happening for pooled funds). This in turn suggests a mild trend towards fragmentation: more, but smaller mandates.
15 External Managers: Asset Allocation Page 46	**Pensions delegate most equity and Insurers most fixed income** Internally managed assets tend to be more heavily focused on fixed income, and cash. Externally managed assets are more focused on equity. Pension funds delegate equity more than other sectors, while insurers delegate more fixed income. French institutions continue to delegate much cash, and German respondents delegate the most fixed income.
16 External Managers: Selection Page 47	**Performance matters most yet again as a selection criteria** Performance is the most important selection criterion, again. Criteria for selecting managers have stayed very similar in other respects too. Clarity of the investment process continues to be of great importance to institutions, but this should not be an excuse for sales teams to "talk and talk about their process". Instead institutions ask for managers to talk a little less, and listen a little more to their specific needs. Level of fees continues to be relatively unimportant. Selection processes can be unstructured - 'long lists' of candidate firms can be based around who is known best to that institution. There is scope for boutiques to win business here. Investment funds are selected using similar techniques to suppliers of traditional mandates. Investment fund managers are selected using similar techniques to suppliers of traditional mandates.

17 External Managers: Fees

Page 50

Performance fees are now in great demand
We received a very clear message: respondents to our survey want more performance fees and less fixed fees. The demand for performance fees was growing last year, but this year it is much more pronounced. For example, 18% of respondents are currently paying performance fees for equity mandates, but 48% would like to be doing so in future. The most persistent demands for performance fees come from Germany. There are also strong views against performance fees.

18 External Managers: Constraints

Page 52

Managers must expect directives and constraints
External managers must expect to be told what to do, and must learn to live with constraints to their investment freedoms. Nearly 9 in 10 institutions give detailed directives or constraints in delegating to an external Investment manager. Banks appear to give most constraints. When they give constraints to their external managers, most do so with benchmarks, and they gave us a wide ranging list of the ones they use.

19 External Managers: Evaluating

Page 54

Managers are delivering excellent team experience, and improving their performance, but delivery does not always match needs.
The feature of external managers which is rated the most highly by institutions in this survey is Management Team Experience, as last year. Also judged to be high quality aspects of external managers business was their focus on asset management, and the transparency and rigour of their management processes. Sales Team stability, or lack of it, was judged their least impressive aspect. In the past year the quality of external managers has shown an improvement in Performance and in Quality of Reporting, which continue to get better. Overall, there are confusing signals here about Performance - it is not an area of excellence, but it is improving. By comparing what we have discovered about the needs of institutions to what we have been told here about what they are being delivered, it seems there are several gaps - institutions are not always getting what they want.

20 External Managers: Breaking Relationships

Page 57

There may be signs of stable or even increased client loyalty
There were an average of one relationship terminated in the past year by each respondent, and nearly two in the previous two years. But there may be stable or even increased client loyalty shown by our respondents - those in this survey appear to be less likely to break relationships than was the case in any of our surveys since 2003. Pension Funds and insurance companies are the most likely to have broken relationships, while German institutions stand out as the most loyal clients. When looking at reasons why relationships are broken, it seems that the importance of performance is common to most respondents, but any attempt to generalise about other factors may be unwise.

Absolute return matters most, but relative return matters too.

The most important two objectives that are pursued when setting investment policy are the same as last year: 'Absolute Performance' and 'Level of Risk'. But this year we explore what matters for each of internally and externally managed assets. What emerges is that relative performance is still in great demand for externally managed assets, especially among pension plans. In the current rush to service absolute return objectives, asset management firms should not ignore this continuing need for relative return among their clients. There are significant differences between what is wanted for internally and externally managed assets. For example, Insurance companies see their internally managed assets as having a long term horizon, while pension plans give this characteristic to their externally managed assets. Respondents to this year's survey are less long term than in the previous year.

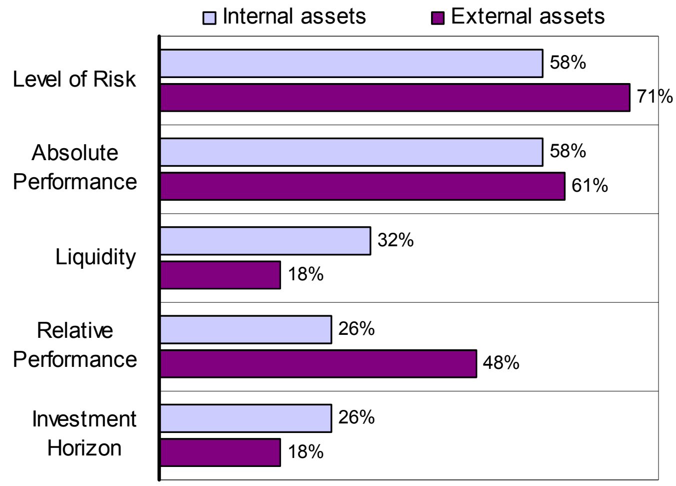
The most important objectives set by institutions in our survey are Level of Risk and Absolute Performance, followed by Liquidity, Relative Performance and the Investment Horizon, as shown in Figure 1.1.

This year we have uncovered very interesting differences in the investment objectives between Internally and Externally Managed assets. Last year and in previous years, we had asked only about the objectives of the investment portfolio as a whole.

Absolute performance is an objective for both internal and external assets, but more respondents mentioned level of risk as an important investment objective for their external assets (71%) than for their internal assets (58%). Most significantly of all, nearly twice as many mentioned relative performance in relation to externally managed assets (48%) than mentioned it in relation to internal assets (26%).

Compared to 2005, level of risk appears to be an objective with growing importance, as shown in Figure 1.2. This year it ranked as the most important objective in both internally and externally managed assets in 2006, whilst only being the second most important objective in 2005. Absolute performance was ranked most important objective in 2005, but is the second most important in relation to externally managed assets in 2006.

1.1 **Most important Investment Objectives**
% of those responding to question *(82 respondents)*



"Twice as many mentioned relative performance in relation to externally managed assets than in relation to internal assets"

1.2 **Most important Investment Objectives 2005-2006**
Ranking: 1= highest *(82 respondents)*

Objective	2006 Internal assets	2006 External assets	2005 all assets
Level of Risk	1=	1	2
Absolute Performance	1=	2	1
Liquidity	3	4=	5
Relative Performance	4=	3	3
Investment Horizon	4=	4=	4

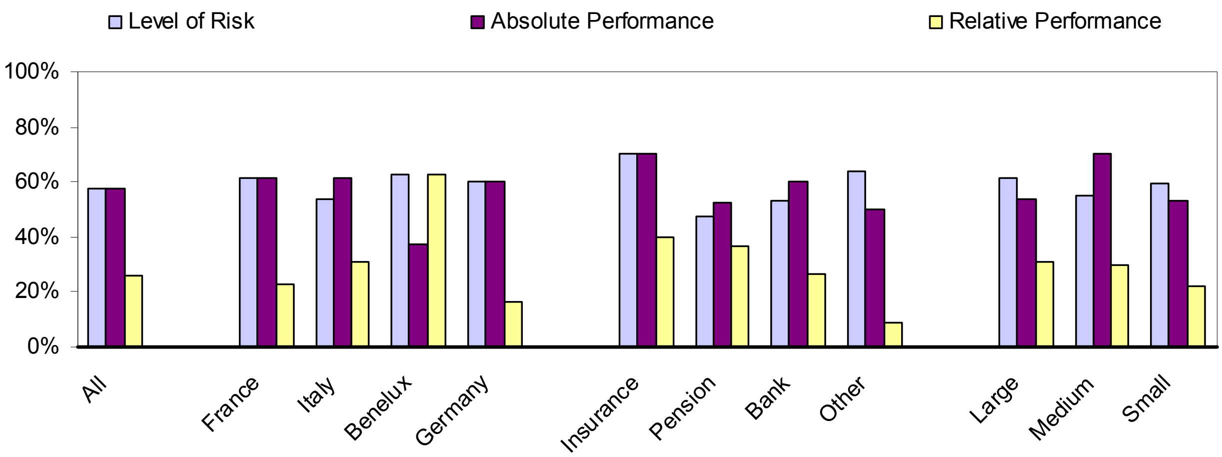
Liquidity was ranked 5th most important overall in 2005, but is rated much more important than this by the 2006 respondents, who rank it third and fourth for internal and external assets respectively.

Level of risk and absolute performance are two internal objectives that matter for all types of investors except those in Benelux, where absolute performance seems of less importance than relative, as can be seen in Figure 1.3. When they think about their externally managed assets, French investors in our survey place least importance on the Level of Risk.

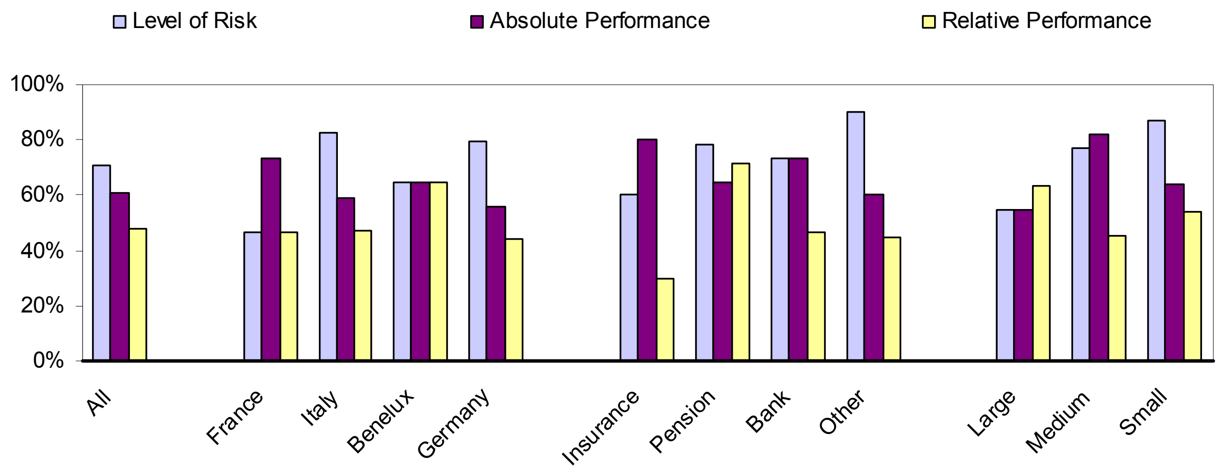
What is striking is the variance in importance of relative return, which is shown in both Figures 1.3 and 1.4. Benelux investors rate it as a highly important investment objective. But in terms of externally managed assets, the most striking is the extent to which Pension funds place importance on this objective. 71% of them mentioned this, compared to only 30% of the insurance companies.

When we asked about their investment objectives, investors revealed to us a complex combination - there can be quite

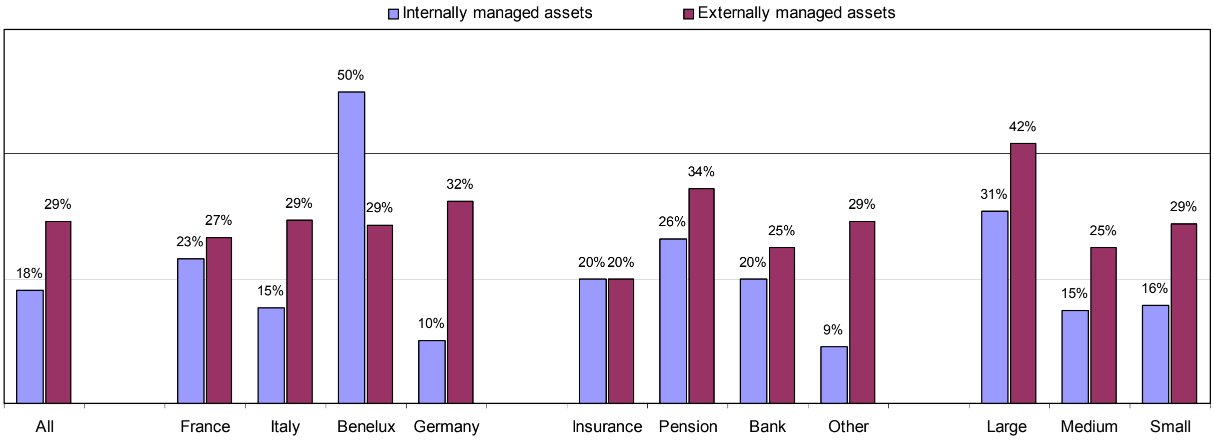
1.3 **Important Internally Managed Assets Investment Objectives by country, sector, and size category**
% of those responding to question *(66 respondents)*



1.4 **Important Externally Managed Assets Investment Objectives by country, sector, and size category**
% of those responding to question *(82 respondents)*



1.5 **Most important objectives: Those mentioning only Relative Return, by country, sector and size category**
% of all respondents



different goals for different parts of each investor's portfolio. Therefore conflicting objectives, such as absolute and relative return, can both exist for the same portfolio at the same time.

At an overall portfolio level, absolute performance is still key for most institutions, but when looking at specific alpha sources, relative performance comes more into play. This is the conventional wisdom, and it certainly applies to most of the institutions in our survey. One large pension fund told us: "Relative return is the cherry on the cake - but we expect lower absolute returns in coming years, which means that the cake is shrinking, and the cherry becomes more important".

But what is also true is that there are institutions who have revealed to us that relative return alone is key for them. This is shown in more detail in Figure 1.5. The figures in this chart exclude those who mention both absolute and relative return, and looks only at those who, when asked what their most important investment objectives are, mention only relative return.

As one would expect relative return is more important for most when it comes to externally managed assets, but it is also vital for internally managed assets as well. For externally managed assets, 29% of the institutions say that relative return is important and absolute is not. 8% on average say this for their internally managed assets.

"Relative return is the cherry on the cake - but we expect lower absolute returns in coming years, which means that the cake is shrinking, and the cherry becomes more important"

This average varies widely - 34% of Pension funds and 42% of the larger institutions have Relative Return as an objective rather than absolute return. Investors in Benelux seem highly motivated by relative return, especially for their internally managed assets, but this measure is based on a small number of responses than the other countries, so should be treated with caution.

We have explored the correlation between hedge fund usage and investment objectives. We have shown the result in Figure 1.6, which focuses on just externally managed assets. Hedge fund usage is sometimes associated with absolute return objectives, so we had expected to find that those who use hedge funds most ('Big HF Users'), would be most inclined towards an absolute return objective. But in fact the opposite seems to be the case - big Hedge Fund users are more inclined to have an exclusively or partially relative return objective, and less inclined to take an exclusively absolute stance. This is perhaps not so surprising, since large hedge fund users are often sophisticated, and can use hedge funds as a carefully controlled device for achieving alpha, and higher relative returns.

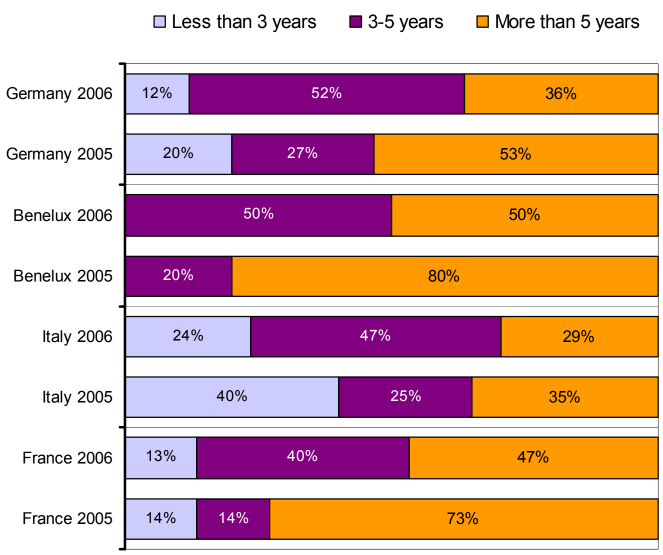
We have identified a change in investment horizons this year compared to previous years. Figure 1.7 shows that the respondents to this year's survey are less long term then in previous years. In order to counter sample variations as much as possible, we have shown the data by country. French and Benelux respondents were the most long term in outlook in both 2005 and 2006, contrasting with Italian and German respondents who were the most short term in both years.

1.6 **Summary of most important investment objectives analysed by Hedge Fund (HF) User category (externally managed assets only)**
% of all respondents

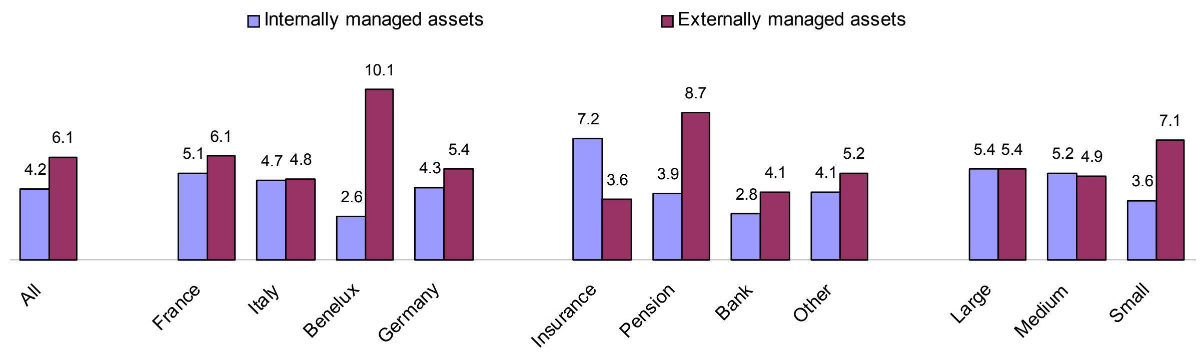
	Big HF users	HF Users	Non HF Users
Absolute and Relative	33%	28%	13%
Just Absolute	22%	50%	43%
Just Relative	33%	22%	32%
Neither	11%	0%	13%
	100%	*100%*	*100%*

"Big Hedge Fund users are more inclined to have an exclusively or partially relative return objective."

1.7 **Investment horizon 2002-2006**
% of those responding to question *(81 respondents)*



1.8 **Investment horizon by country, sector and size category**
Average number of years *(81 respondents)*



But in all countries there appears to have been a shift towards the shorter term. The Benelux, French and Germans respondents in 2006 have shifted their focus from the long to the medium term compared to 2005. The contrary Italians are however moving the other way: they are more focused on the medium term at the expense of the short term.

There are considerable differences in investment horizon between internally and externally managed assets. Overall, externally managed assets appear to have an average horizon of 6.2 years, compared to internally managed assets with just over 4 years as shown in Figure 1.8.

But there is much variety in this response. Benelux investors in our survey suggest their horizon is four times longer for their externally than their internally managed assets. As you would expect, for pension funds it is twice as long. Not surprisingly, for insurance companies it is the other way round, with externally managed assets having a significantly shorter horizon than the internal assets. Larger companies have longer time horizons than smaller ones for internal assets, but smaller companies suggest the longest horizon for externally managed assets.

"There appears to have been a shift towards the shorter term."

Absolute and relative return mean different things to different institutions

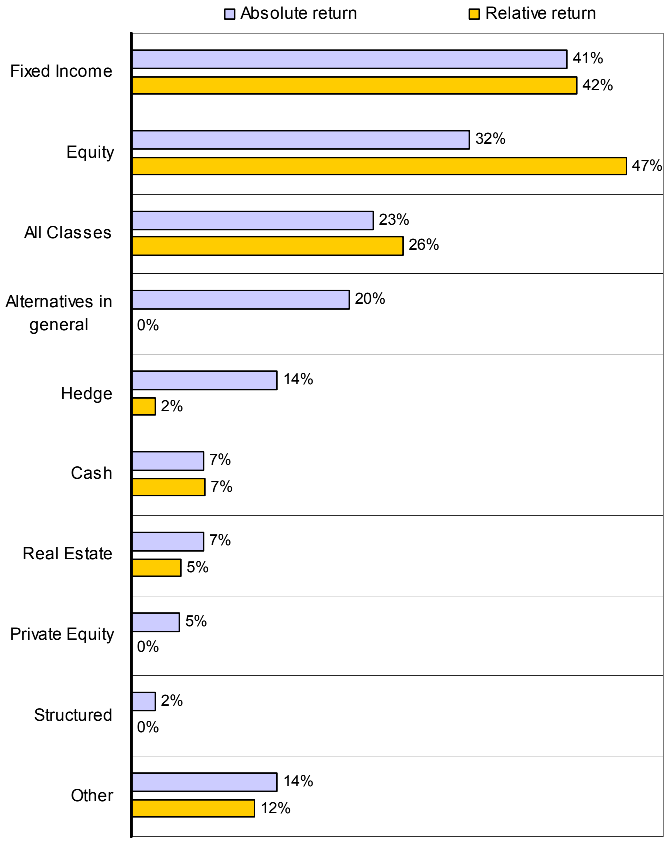
Both absolute and relative returns are achieved using a variety of strategies, involving a variety of asset classes. Investing institutions develop unique strategies to suit their unique needs, and have told us that they do not feel they need to be beholden to a specific set of industry standard norms. For example we have looked in detail at how institutions who seek both absolute and relative return strategies at the same time, do this, and have found that there are at least nine different combinations of approaches used. Pension funds are particularly varied in how they seek absolute return. It would be sensible for asset management firms offering services to these institutions to listen carefully to each institution's own individual definition, rather than try to impose their own.

There has been a well documented shift towards absolute return in recent years, particularly among pension funds. "Positive absolute return is vital" one told us. Several of our respondents told us they had switched recently from having a relative to an absolute return objective. Many told us that they seek both. For example, one Belgian pension fund told us "We use absolute return objectives for our internal assets and the portfolio overall, but we use relative return as a way of measuring how well our managers are doing." Others told us they persist with just relative measures.

There is another group, who told us they find the terms absolute and relative unhelpful, One Belgian fund told us that "absolute and relative are not terms that mean anything to us; the danger is that you pay active fees for passive results." "Instead", this institution went on, "we just want to invest in the best ideas."

We wanted to understand what these terms meant to our respondents, and where they 'source' it. We did so by asking if they had absolute or relative objectives, and if so in which parts of their portfolio (for example certain asset classes /regions /types/vehicles) do they tend to look for these things?

2.1 Sources of Absolute and Relative Return
% of those responding to question (61 respondents)



The source of absolute and relative return most mentioned are fixed income and equity classes, as is shown in Figure 2.1. Fixed income assets are a source of absolute return according to 41% of respondents. Fixed income classes that were mentioned in this respect included European bonds, Global Convertible bonds, and other respondents who included all types of fixed income products: government and corporate bonds, high yield, and emerging market bond.

> *"Absolute and relative are not terms that mean anything to us"*

Fixed income assets are also a source of relative return according to 42% of respondents. They look for them in a range of types of fixed interest products, some for example bonds by region (mostly Europe, but also Emerging Markets), while others mentioned bonds in terms of risk levels: government bonds, corporates, high yield, and so on. Equity is seen as a source of relative return by nearly half of the respondents. They mostly refer to European equity, but also to US.

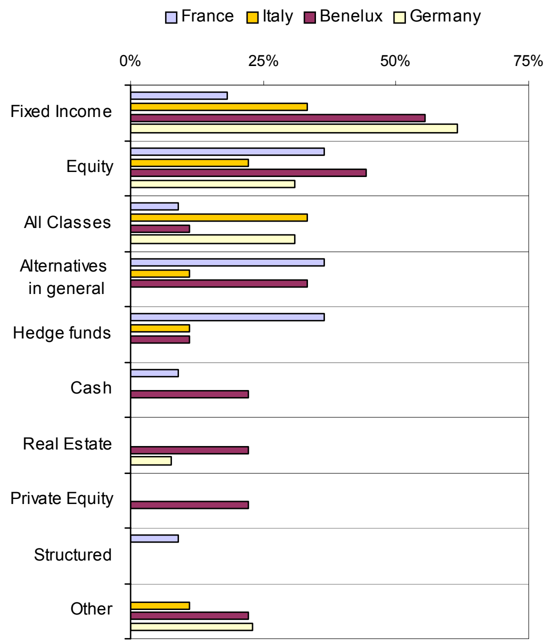
Absolute return is an objective which is achieved by different investors in quite different ways.

Figure 2.2 shows how absolute return is sourced in each of the countries we have polled. It is the French respondents who show the greatest enthusiasm for alternative investment in general in this context, with half of them saying that this was their route to absolute return, with hedge funds the particular asset class of choice for a further third. German investors in contrast see the route to absolute return being primarily through their fixed income portfolio.

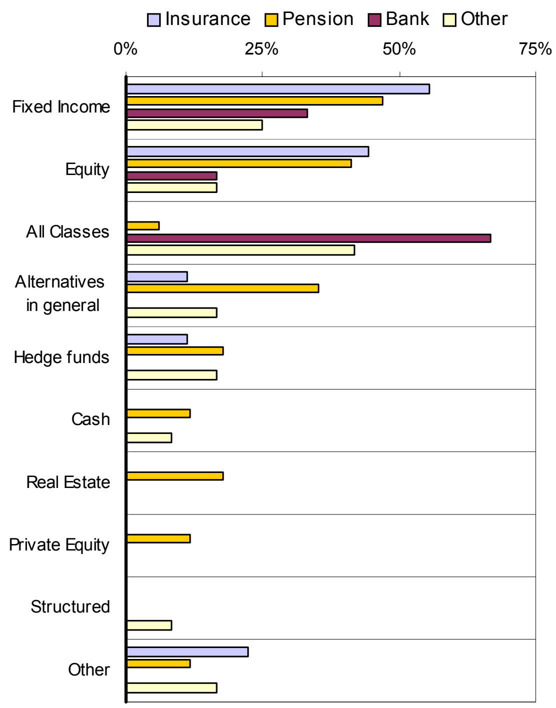
In Figure 2.3 we see that fixed income and/or equity are the most popular responses by insurers and pension funds, but banks and other types of respondents tend to refer rather more vaguely to 'all classes'. Pension funds are particularly varied in how they seek absolute return - respondents of this type told us that they sought absolute return through a combination of every one of the asset types that were mentioned, except for structured products, which were mentioned as a route to absolute return only by 'other' respondents.

"Pension funds are particularly varied in how they seek absolute return"

2.2 Sources of Absolute Return by country
% of those responding to question (44 respondents)



2.3 Sources of Absolute Return by sector
% of those responding to question (44 respondents)

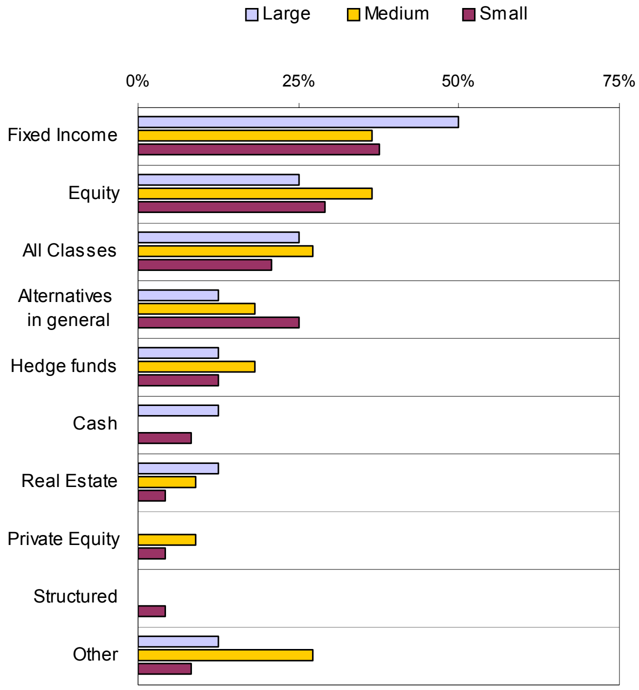


It does not seem to be size which drives variance on this subject - the large medium and small investors all have a similarly diverse set of responses on this issue, as is shown in Figure 2.4. There is one exception - it seems that the larger investors are more inclined to use fixed income than others as their route to absolute return.

"Just as institutions have a wide variety of needs so they have developed a wide variety of strategies."

These charts reveal that there is no norms in the industry on what the route to absolute return is, and this applies even to investors of similar size, region and sector. Just as institutions have a wide variety of needs so they have developed a wide variety of strategies.

2.4 **Sources of Absolute Return by size category**
% of those responding to question (44 respondents)



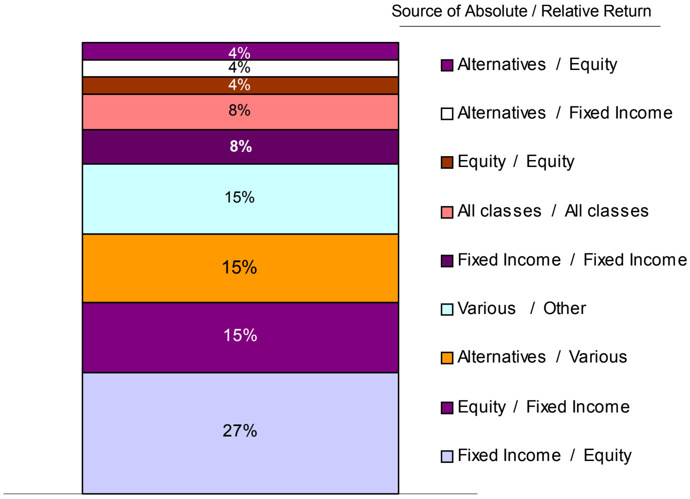
When asked whether they pursued absolute and/or relative strategies, 26 (43%) of the 61 respondents to this question told us that they seek both at the same time. We have summarised the strategies adopted by this group of 26 respondents to achieve these two aims in Figure 2.5.

Of these nine summaries of the combinations, the most popular (mentioned by 27%) is Fixed Income (Absolute Return) combined with Equity (Relative Return). But the second most popular (mentioned by 15%) is the exact reverse of this: Equity (Absolute Return) combined with Fixed Income (Relative Return). Alternatives (Absolute Return) combined with various assets (Relative Return) is the third most popular. Those shown selecting 'various' classes means that they selected a mixture for example of equity and bond, and those shown selecting 'other' refers to other types of investment altogether, including funds.

Our conclusion is that institutions in our survey each have a clear rationale for their strategies, driven by their own circumstances and individual needs. The variety of sources of absolute and relative return that exist when you look at the market overall suggests that some caution needs to be used when generalising on this subject.

It would be sensible for asset management firms offering services to these institutions to listen carefully to each institution's own individual definitions and strategies, rather than try to impose their own. This suggestion is indeed offered by the institutions themselves in various ways. For example the fourth most important criteria used in this survey when selecting between managers (see section 16) was that managers should 'Understand the organisation's particular goals and needs'.

2.5 **Variety of combinations of sources of Absolute / Relative Return**
% of respondents looking for both Absolute / Relative Return (26)



"Managers might want to listen carefully to each institution's own individual definitions and strategies, rather than try to impose their own"

Alpha and Beta also mean different things to different people

Just as there are varied sources of absolute and relative return, there seem to be a wide variety of sources of Alpha and Beta. We have observed many different approaches to achieve them. Overall, equity appears the most popular route to both alpha and beta, followed by fixed income, but in fact this varies widely by respondent. Alternative investments are not often seen as a source. Confusingly, we have found little relationship between the desire for Alpha and Beta on the one hand, and Relative return on the other hand. Institutions, whilst well aware of their meaning, use the two terms very little in their everyday conversations. Institutions in this survey retain the right to define the terms in ways that are meaningful to them, but which are not necessarily shared across the industry.

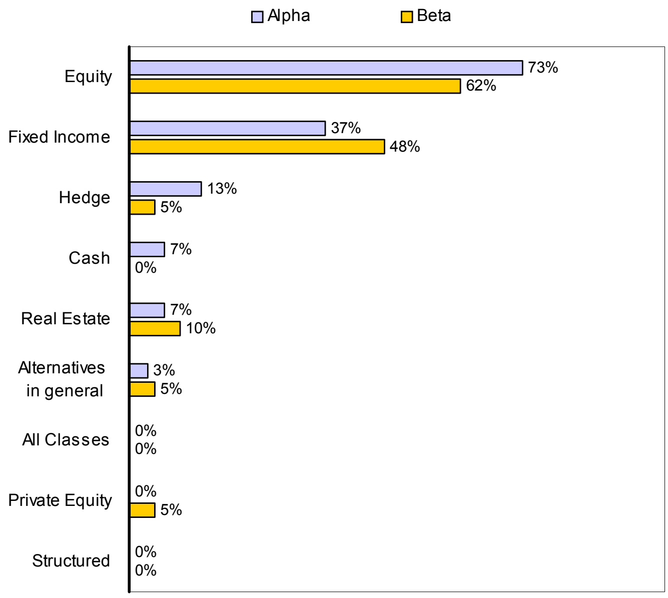
Just as we concluded that there was a very wide variety of sources of Absolute and Relative Return, so we have concluded that there seem to be a wide variety of sources of Alpha and Beta. Each institution seems to have a clear idea of how it will set about achieving its own Alpha and Beta related goals. But what we can also say is that looking at the institutions as a whole, no norm or standard exists on how alpha and beta can achieved.

Perceptions of what Alpha and Beta mean vary so much from institution to institution that they become almost meaningless. This conclusion is reinforced by feedback from many institutions who, whilst well aware of what they mean, do not find these terms useful and do not use them in their internal conversations. Typical was one Dutch pension fund which told us: "We know what these terms mean, but we don't use them." Another said: "what is more important than alpha and beta is our asset liability ratio (assets divided by liabilities)".

We wanted to find out how the thinking behind these terms is embedded in investment objectives. It is very difficult to measure the extent to which alpha and beta strategies are used by institutions. It is even more difficult to measure how these terms are interpreted by their users. But we have attempted both of these things.

To our surprise, only 34% of the respondents said that they look for Alpha, and 23% said that they look for Beta. 20% look for both. We asked the question: 'If you look for Alpha and/or Beta in your investments, please describe which elements of your portfolio you make responsible for generating these.'

3.1 **Sources of Alpha and Beta**
% of respondents looking for Alpha or Beta *(33)*



Of those that do look for either alpha and/or beta in their investment strategies, equity was the most popular route to both alpha and beta, followed by fixed income. This is shown in Figure 3.1. Alternative investments are not often seen as a source of Alpha and Beta. Other asset types apart from equity and fixed income were mentioned as a source of either Alpha or Beta by a small number of respondents, including cash, real estate investing, and alternative investments, particularly hedge funds.

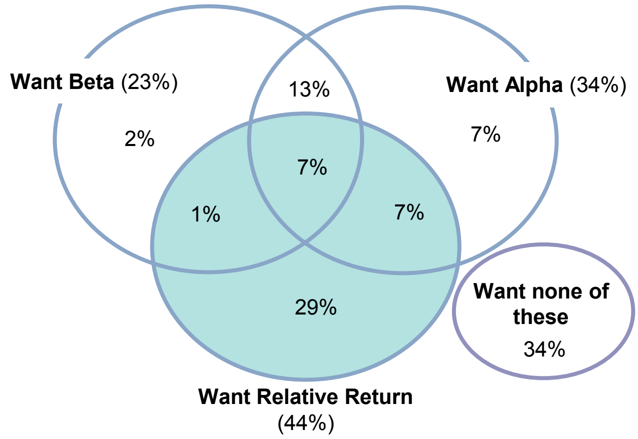
So at first glance it may appear that consensus exists on the source of Alpha and Beta. But this is not the case. The sources of alpha vary widely by respondent. Most do see Alpha coming through equity, but a significant minority of Insurers and Other types of investors see it coming through Fixed Income. Some Italian investors told us they source it through hedge funds. Cash was particularly mentioned by French respondents, and real estate particularly mentioned by those from Benelux countries. Only pension funds mentioned Private Equity as a source of Alpha. Pension fund investors are the only sector to mention Real Estate as a source of Alpha.

The sources of beta also vary by respondent. Italians tend to look for beta through equity, but German respondents did so more through Fixed income. In Benelux a significant minority do so through Real Estate. Insurers look for Beta in equity, but Other types of investors tend to look for it through fixed income.

Perceptions of what Alpha and Beta mean vary so much from institution to institution that they become almost meaningless. If these terms were to be abandoned or replaced by something else, it would cause little problem for the institutions we spoke to, many of whom told us that whilst they believe they are well aware of what the terms mean, they use them very little in their everyday conversations.

We have further doubts about what Alpha and Beta mean to institutions based on how these terms are used in conjunction with the term relative return. We had expected to see that those who pursue either Alpha or Beta would also pursue relative return, since Alpha and Beta are, put simply, measures of performance relative to a benchmark. But we have found little relationship between the desire for Alpha and Beta on the one hand,

3.2 **Relationship between Alpha, Beta and Relative Return**
% of all respondents



and Relative return on the other. 23% of respondents wanted Beta and 34% want Alpha, as we have already mentioned. But only 15% of these also want Relative return as an investment objective, as is shown in Figure 4.2. There are 29% who want relative return who do not seek either Alpha or Beta returns. There are a further 34% who do not look for any of Alpha, Beta, or Relative Return.

> *"We have found little relationship between the desire for Alpha and Beta on the one hand, and Relative return on the other"*

Our conclusion is that few in this part of the industry place as much importance on looking at the investment world through the prism of Alpha or Beta, or if they do, they retain the right to define the terms in ways that are meaningful to them, but which are not necessarily standard across the industry.

Liability driven investment techniques are not popular

One might think, to judge by the amount of press and asset management company coverage on this issue, that liability driven investment techniques are very popular among all institutional investors. But of the respondents to this survey only 6% told us they used them. Our conclusion is that Liability driven investment is new, so a low percentage is not a surprise. It is quite possible that Liability Driven Investment Techniques will never be in great demand outside of the highly resourced super-large institutions.

We encountered very little usage of liability driven investment techniques among our sample. Only 5 respondents (6%) of the sample told us they used this. This small group were a mixture of types of investors, including pension funds, insurers and other types. Three of this group were German, but one each came from Italy and the Netherlands.

"One institution told us: 'there is a lot more talk than action on this subject, we think'. "

They gave varied reasons for using liability driven investment techniques, one saying that it amounted to a "reduction of reinvesting risk". Another told us it was a route to Absolute Return.

It is quite possible that Liability Driven Investment Techniques will never be in great demand outside of the highly resourced super-large institutions. The lack of enthusiasm for Liability Driven Investment is often based on some strongly held investment views. One institution for example, told us Liability Driven Investment was a product only for 'weak' pension funds: "We don't think Liability Driven Investment is the best solution for pension funds like us. The way we will meet our liabilities is to make good returns, and the way you do this is to take risks. Weak pension funds are trying to avoid risks with techniques like Liability Driven Investment, but as a direct result they will not get good returns."

One institution told us: "there is a lot more talk than action on this subject, we think". This amounts to the suggestion that Liability Driven Investment is an investment product which has greater energy in its supply than in its demand, at least among our survey respondents. Liability Driven Investment Techniques are being strongly promoted by many asset management firms, but it may be sensible for these same firms to stop and listen carefully to the demand for this service (or lack of it) before they engage with institutions like those in our survey.

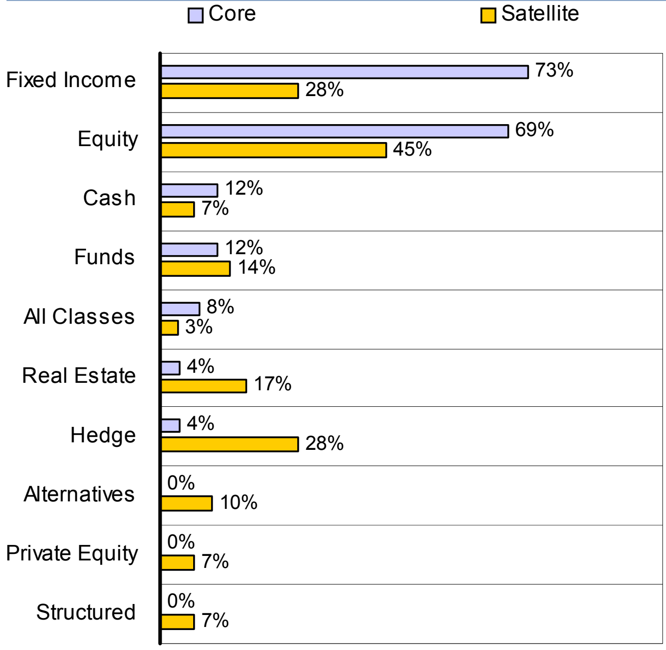
The Core/Satellite approach is widely used, but interpreted in varied ways

A Core and Satellite approach is used by a third of the institutions in our sample. Respondents conform broadly to the expected norms of Core/Satellite approach. But there is much variety in what different respondents do, showing that the Core Satellite Approach can be adapted significantly to suit individual needs. Equity was used as the predominant satellite category by nearly half of those responding, but Hedge Funds and Fixed Income were named as Satellite asset classes by a quarter of the respondents. It appears that usage of a Core and Satellite approach is a function of size - nearly half of the larger companies used it, but only one in four of the smaller ones.

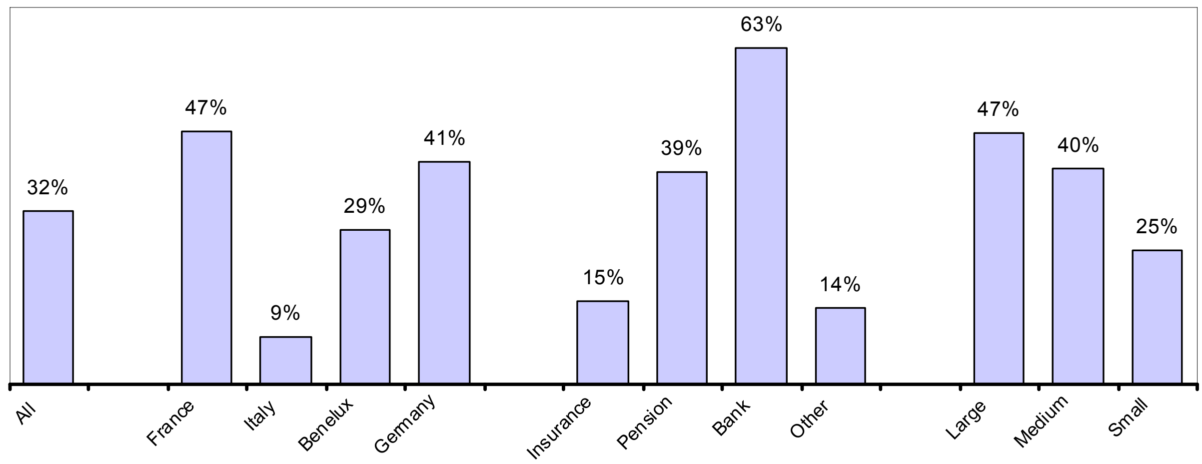
A Core and Satellite approach is used by a third of the institutions in our sample, a shown in Figure 5.1. It appears that usage of a Core and Satellite approach is a function of size - nearly half of the larger companies used it, but only one in four of the smaller ones. The Core and Satellite approach is particularly popular among the banks who took part in our survey, 63% of which used it, compared to only 15% of the insurance companies. It is least used in Italy, where only 9% of the respondents used it, compared to 47% in France and 41% in Germany.

When they do use a Core and Satellite approach, institutions tend to use fixed income or equity as the core and equity, fixed income or hedge funds as the satellite. 73% saw fixed income assets as belonging to their core, and only 28% put this class in its satellite category. This is shown in Figure 5.2. Equity was used as the predominant satellite category by nearly half of those responding, but Hedge funds and Fixed Income were named as Satellite asset classes by a quarter of the respondents.

5.2 **Core Satellite Approach by asset class used**
% of respondents using Core Satellite Approach *(29)*



5.1 **Usage of Core Satellite Approach by country, sector and size category**
% of all respondents



As well as offering the summaries above, we have shown below in Figure 5.3 and 5.4 a selection of the responses we were given when we asked which asset classes/regions/types/vehicles the respondents considered to be Core and Satellite.

These detailed answers help to make two main points. Firstly that the respondents conform broadly to the expected norms of Core/Satellite approach, with their Core asset classes tending to be traditional, close to home, or capable of being managed in a passive form. The Satellite asset classes are, as might be expected, less close to home, more likely to require active management, or capable of generating alpha type returns.

The second point is that the variety of responses to the question helps to show the variety of ways in which the Core Satellite Approach can be adapted to suit individual needs. Some see hedge as Core assets, most see them as Satellite. Many see European equity as a Core asset, a few see it as a Satellite one. Core/Satellite is an approach that can mean widely different things to different investors.

5.3 **Selected Examples of 'Core' assets**

- All that is fixed income, Equities, Europe
- Balanced segregated account
- Bonds / equities
- Bonds/Equity Euro Zone
- Cash and Fixed Income
- Dedicated Funds Euro Zone (All class of assets)
- Equities / all zones / open-ended mutual funds / hedge / all zones / funds of fund
- Equities and fixed income Europe
- Equities Europe, fixed income
- Equity / Fixed Income
- Equity Euro zone
- Equity Europe
- Euro Equity / Fixed Income / Mutual Funds / Cash
- Euro Government Bonds, Mandate
- Euroland
- Euroland->FX, Equities, Corp.
- European bonds, European equities, US equities
- Fixed income Europe
- Fixed income Europe, equity Europe
- Fixed income, real estate
- Holdings which are not considered as fixed assts
- Inland: covered fixed-income security
- Large cap.; Gov. Bonds; Coll. Bonds (German covered bond)
- Mixed
- Passive and Enhanced; US and Europe and UK Large Caps; European and Corporates; Global inflation linkers
- Private assets fixed income
- Traditional investments

5.4 **Selected Examples of 'Satellite' assets**

- All that is not fixed income, Equities, Europe
- Alternative investments
- Commodities, equities Asia + emerging marked
- Corporate Bonds / Hedge Funds
- Diversification on area, sector, class of assets
- Emerging / Hedge
- Emerging market debt+equity; US High Yield; US + European Small Caps
- Equities, Hedge Funds
- Equity Eastern Europe, Asia, Japan; fixed income, high yield, emerging market bonds, convertibles
- Equity EM
- Equity emerging
- Euro Zone Equity, Euro Zone Credits, World-ex-Eurozone Equity and European Real Estate Equity Mandates
- Foreign: uncovered fixed-income security
- Global convertible bonds, Real estate
- Hedge / all zones / single fund manager
- Hedge / Private Equity / Real Estate
- Hedge funds
- Investment stiles: value, growth, small, mid cap egn., corporate bonds
- Open-Ended Funds
- Convertible bonds, quantitative mandate
- Real estate / alternative assets
- Small + Mid Caps - Commodities - Emerging Markets / High Yields/ ABS
- Small caps, equities / fixed income outside Europe
- Specific funds, mutual funds, portfolio management
- Structured Products + Hedge + Equities (USA and developing countries) + Enhanced Cash
- USA; Japan

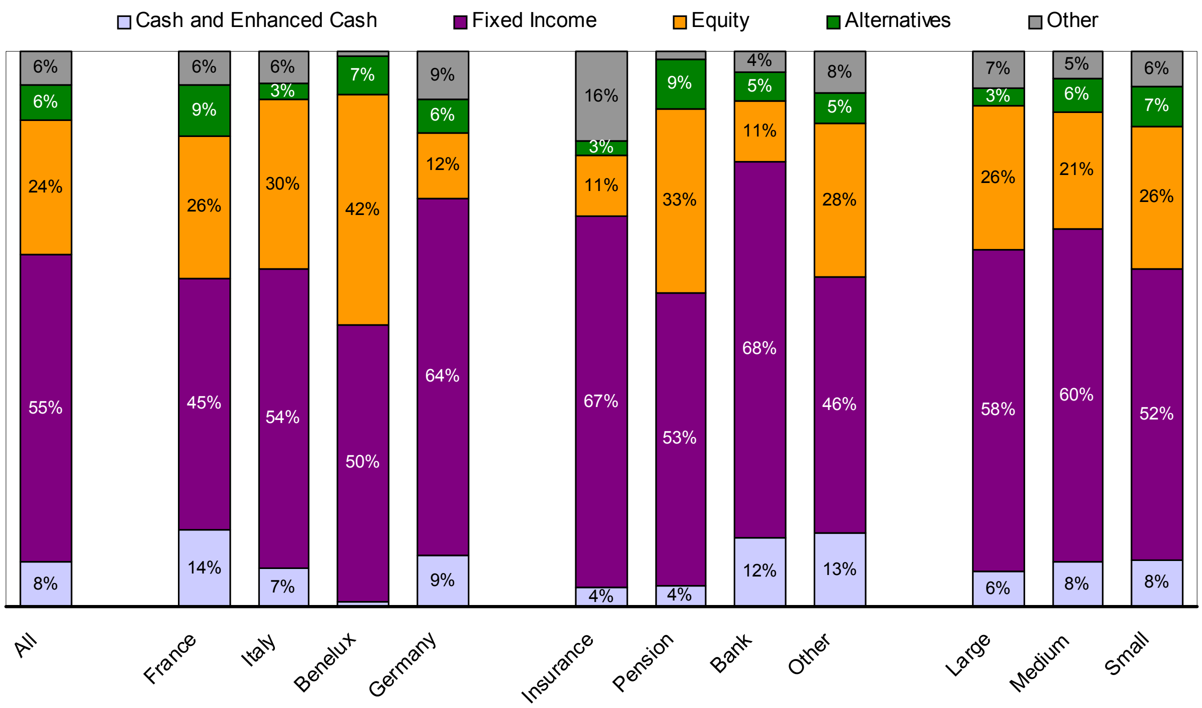
Investment allocation is driven less by size, and more by type of institution

Among the institutions in our survey, there is over twice as much investment in bonds than equity, three times as much investment in Government bonds as in Corporate bonds, and ten times as much in large cap as in small cap. There is little size related difference in the structure of the portfolios we have observed. But there is great variety by sector - pension funds and Other institutions (which includes foundations) are likely to be three times more focused on equity, than are insurers or banks. Equity investment appears to have grown in France, Italy and to a lesser extent Germany. Fixed income investing appears to have fallen in Italy. In the coming year approximately one in five of respondents predict they will increase weighting in Real Estate. A regional shift towards Asia is also predicted. Emerging markets may also see growth.

An average of 55% of the assets in this survey were invested in fixed income, and 24% in equity. Investment allocation among the sample in this year's survey appears to be driven by their type and region, and less by their size. As can be seen in Figure 6.1 there is little size related difference in the structure of the portfolios we have observed.

But there is great variety by sector - pension funds and other institutions (which includes foundations) are likely to be three times more focused on equity, than are insurers or banks. The largest equity investors in this survey are in Benelux, and the most heavily weighted towards cash are in France.

6.1 Investment asset allocation by country, sector and size category
Average % of assets *(82 respondents)*



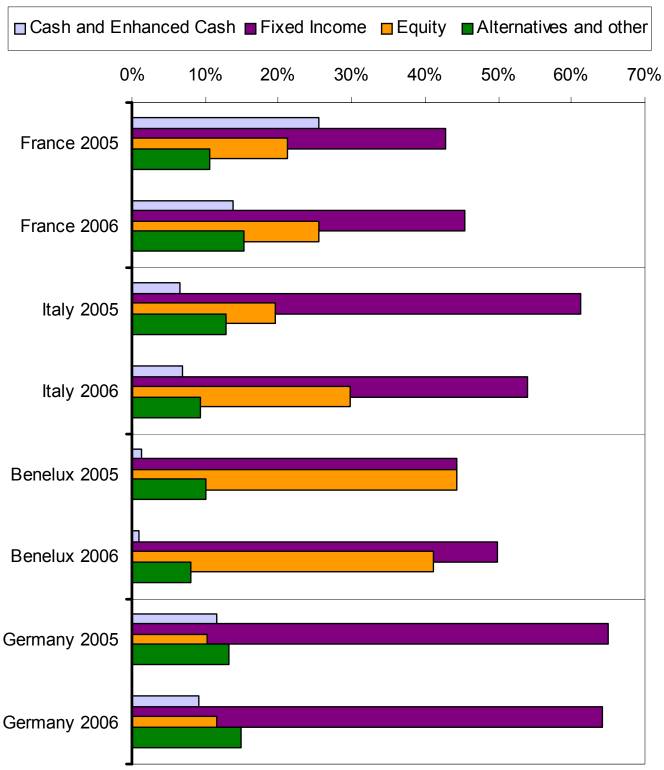
6.2 **Detailed investment asset allocation**
Average % of assets *(82 respondents)*

	Own country	Rest of Europe	*Europe*	Rest of World	Global	*All assets*
Cash and Enhanced Cash	6.8%	1.0%	*7.7%*		0.2%	*8%*
Fixed Income						
Government Bonds	15.3%	15.6%	*30.9%*	0.3%	2.3%	*35%*
Corporates Bonds	4.9%	5.4%	*10.3%*	0.1%	2.5%	*12%*
Bank Loans, ABS/MBS	5.9%	2.0%	*7.9%*	0.0%	0.4%	*7%*
Convertible bonds	0.3%	0.3%	*0.6%*		0.6%	*1%*
Equity						
Large Cap	6.7%	8.8%	*15.5%*	0.4%	5.0%	*22%*
Small Cap	0.8%	1.2%	*2.0%*		0.5%	*2%*
Private Equity	0.2%	0.1%	*0.3%*	0.0%	0.0%	*0%*
Real Estate	3.2%	1.0%	*4.2%*		0.4%	*4%*
Commodities	0.1%		*0.1%*	0.0%	0.1%	*0%*
Hedge	0.5%	0.5%	*0.9%*		1.0%	*2%*
Other	5.1%	0.8%	*5.8%*		0.2%	*6%*
Total	*50%*	*36%*	*86%*	*1%*	*13%*	*100%*

A more detailed breakdown of the total is shown in Figure 6.2, which reveals that 86% of the assets were invested in Europe, 13% were globally invested, and only 1% were invested specifically outside Europe. There is three times as much investment in Government bonds as in Corporate bonds, and ten times as much in large cap as in small cap.

Equity investment appears to have grown in France, as shown in Figure 6.3. Italy and to a lesser extent Germany. Fixed income investing appears to have fallen in Italy. Cash appears to be less prominent as an asset class in France, but this is likely to reflect changes in the sample from 2005 to 2006 as much as it reflects any underlying trend.

6.3 **Investment asset allocation by country 2005-2006**
Average % of assets *(82 respondents)*



In the coming year the respondents to our survey predicted that they would make a range of changes in their portfolio allocation, as shown in Figure 6.4. Most changes were expressed either in terms of asset class or region.

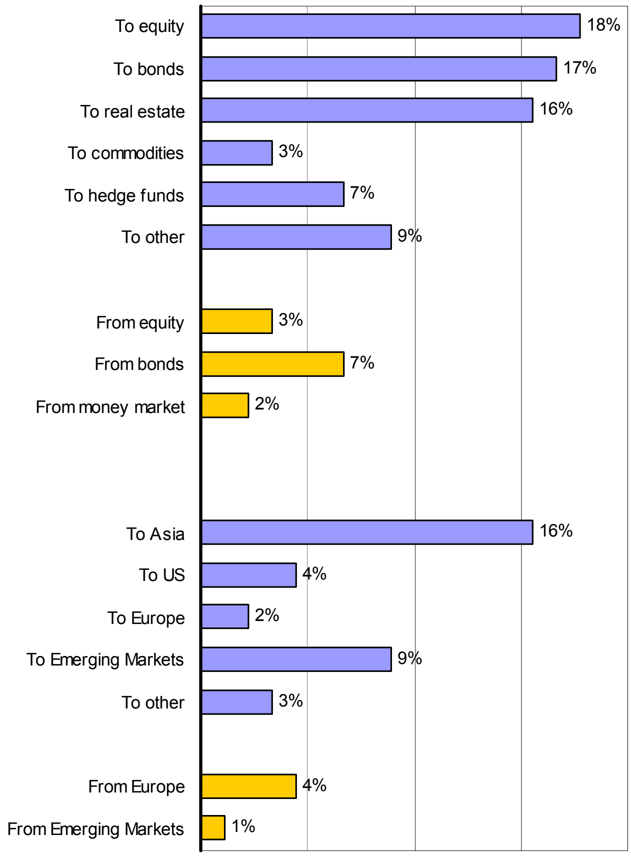
In terms of asset class, 18% of respondents predicted that they would make shifts two percentage points or more to equity, and 17% predicted shifts of the same scale to bonds. 16% saw growth in their real estate portfolios, double the number who predicted growth in hedge funds.

"A regional shift towards Asia is also predicted. Emerging markets may also see growth."

A strong regional shift towards Asia is also predicted, with 16% telling us this. Emerging markets may also see growth from 9% of the institutions.

We were given more predictions on what would be bought, and few predictions on what would be given less weight in portfolios, but those that did tell us saw bonds being the main asset class that would reduce, and Europe was the most often mentioned region.

6.4 **Those predicting changes >2% points in investment asset allocation**
% of all respondents

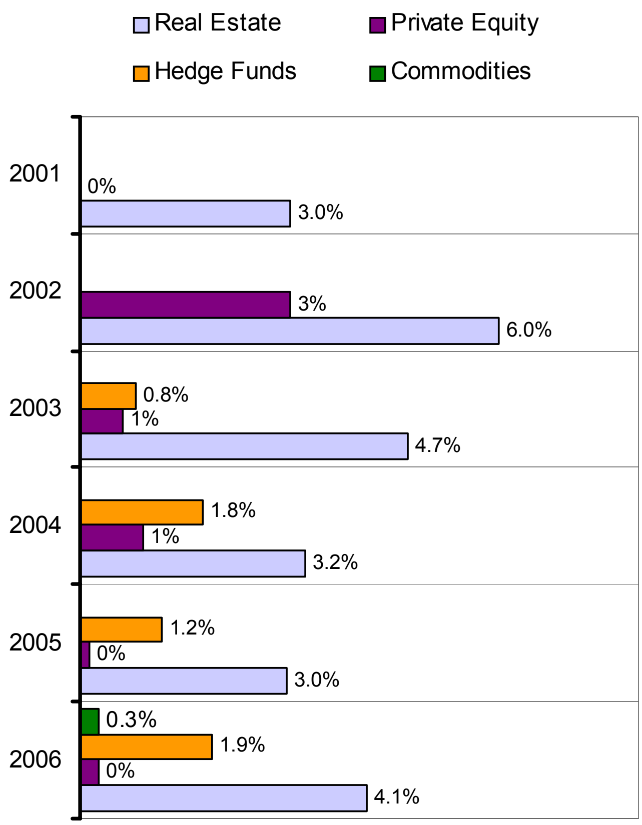


Real estate is the real alternative

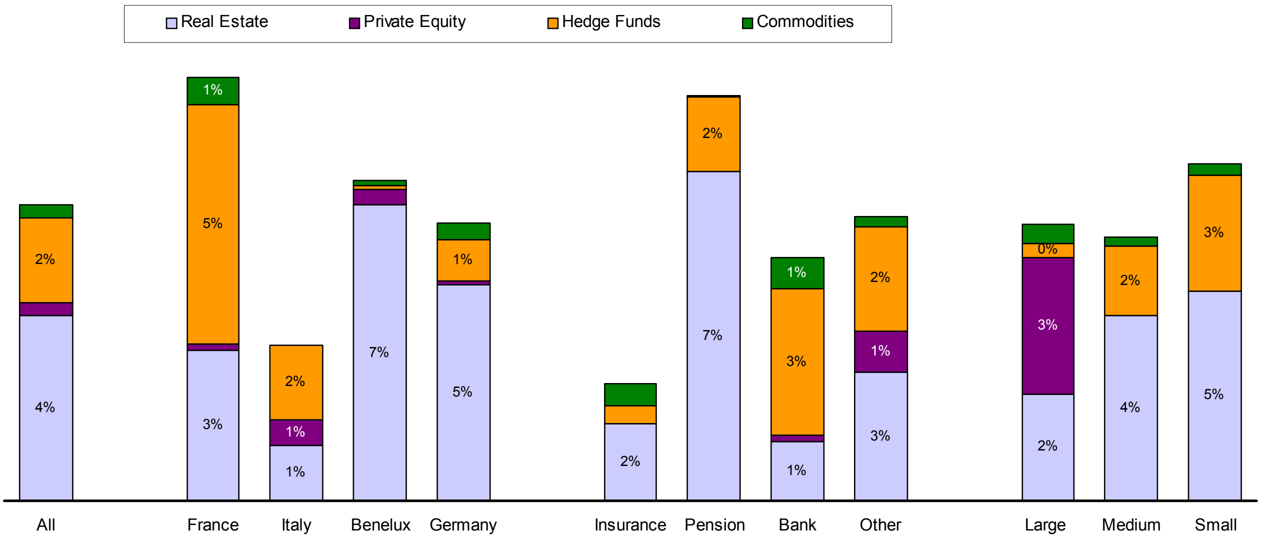
Among the firms who make up this survey, the most prominent alternative investment is real estate which remains as popular as ever, particularly among Pension funds, and is said to grow strongly again this year. Hedge funds in our last survey were most popular in France, and it is true again this year. Hedge fund assets have grown as a proportion of assets in France and Italy. Only in Germany have we seen little growth in terms of hedge fund asset growth. Private equity is a very rare asset class among smaller institutions, but unlike last year, we can now see usage among larger firms in our survey. Commodity investing, apparently a fashionable activity according to some market commentators, is very small among respondents to this survey.

The EIAMS survey has tracked the growth of selected alternative assets since 2001, as summarised in Figure 7.1. We have to be careful in concluding what changes are the result of actual trends, and what are the result of changes in the samples we have polled. What we believe is true, after taking account of sample variances, are the following main conclusions: real estate investing remains as popular as ever; hedge fund growth is greater than it may appear

7.1 **Selected Alternative Assets 2001-2006**
Average % of assets *(82 respondents)*



7.2 **Selected Alternative Assets by country, sector and size category**
Average % of assets *(82 respondents)*



from looking at the charts; private equity is a very rare asset class among smaller institutions; and commodity investing, apparently a fashionable activity according to some market commentators, is very small among respondents to this survey.

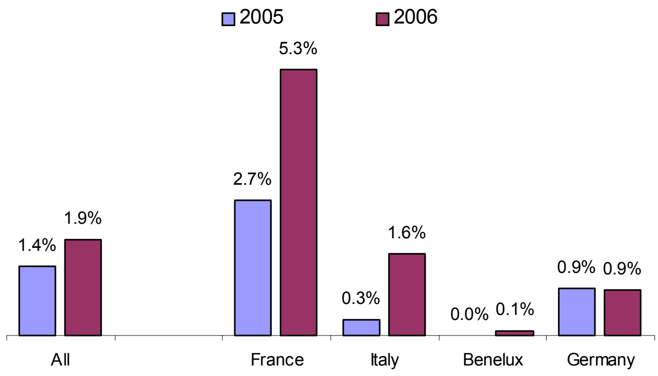
Real estate investing is very popular with pension funds, where in our survey in 2006 it represents an average of 7% of assets, compared to only 1% for banks, as shown in Figure 7.2. It was said by our respondents to be the third most likely category to grow in the coming year, after equities and bonds. Real estate also appears to be popular among smaller institutions, rather than larger ones.

Hedge funds in our last survey were most popular in France, and it is true again this year - they average 5% of assets in this year's survey, compared to only 1% or below in Germany and Benelux. These assets were also most popular among smaller investors in the 2005 survey, and the same is true this year - they were 3% of assets at the smaller firms in this survey, and less than 1% of the larger ones as shown in Figure 7.2. What is also now becoming very clear is that hedge fund assets used by pension funds and insurance companies covered by this survey remain low.

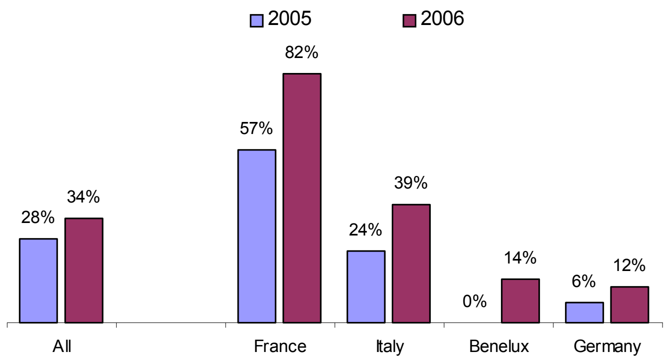
Private equity has represented 1% or below of average assets for each of the past four years in the EIAMS survey. The reason seems clear: it is popular this year only among the larger institutions in our survey, for which it represents an average of 3%. Last year even the larger investors had not taken to this class, so it is possible we are seeing a growth in private equity among larger institutions, but to be sure we need more evidence of this.

It may appear from Figure 7.2 that hedge funds have grown very little in recent years. However we think that this chart disguises some strong underlying trends. In fact, as we show in Figure 7.3, hedge fund assets have grown as a proportion of assets in France and Italy. Only in Germany have we seen little asset growth.

7.3 Hedge Fund Assets by country 2005-2006
Average % of assets *(82 respondents)*



7.4 Hedge Fund Users by country 2005-2006
% of all respondents



Asset growth is difficult to measure from one survey to another. More reliable as an overall (if not so precise) indicator of growth trend is growth in the number of users. As we predicted last year, hedge fund growth overall would not increase much - Figure 7.4 shows that 34% of the respondents used hedge funds in the 2006 survey, only a slight rise from 2005. But in fact there has been noticeable growth in the number of users in certain countries, particularly France and Italy. Many respondents told us they were just beginning to use this asset class.

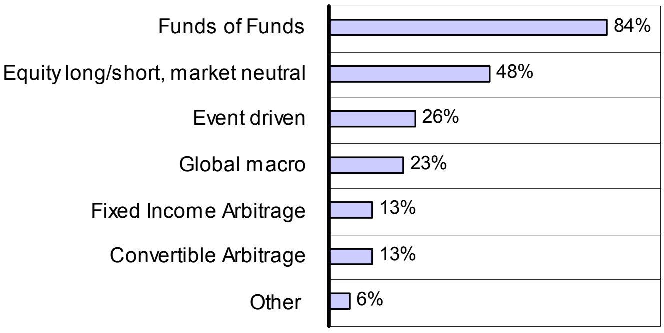
We explore hedge fund demand in more detail in section 8.

Institutions access hedge funds through funds of funds

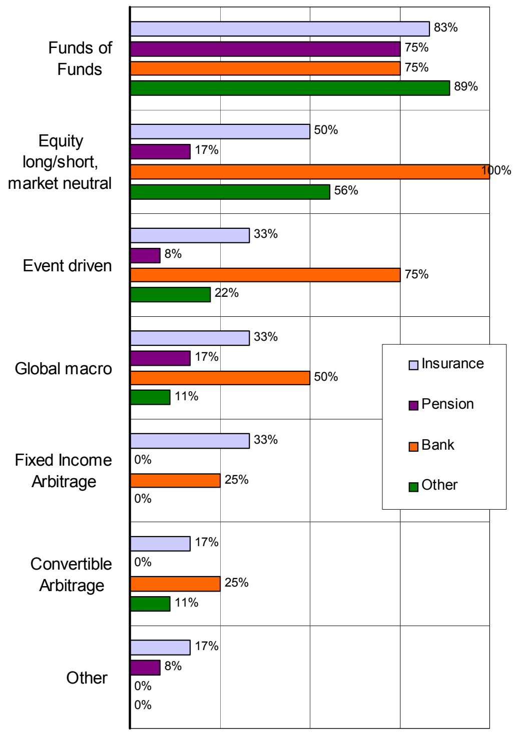
The most popular hedge fund products are funds of funds. After this in terms of popularity come funds that are equity long/short, market neutral. Pension funds are enthusiastic users of funds of funds, but they don't like single hedge funds. Larger investors are less likely to use stand alone (i.e. not funds of funds) funds, which it seems are more attractive to the smaller institutions. French investors are interested in hedge funds because of the high performance they offer, whilst Italian investors are particularly attracted to the fact that hedge funds are uncorrelated.

The most popular hedge fund products are funds of funds, which are used by eight out of ten of those who use hedge funds in this years survey. After this in terms of popularity come funds that are equity

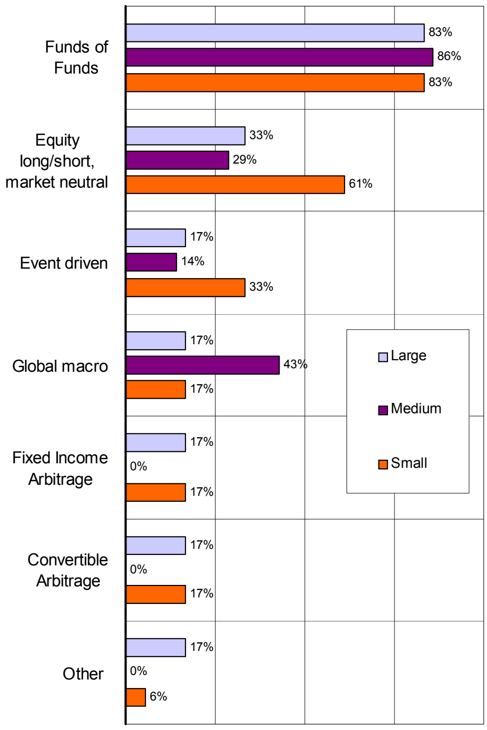
8.1 **Users of different Hedge Fund Products**
% of users of hedge funds *(28)*



8.2 **Hedge Fund Products by sector**
% of users of hedge funds *(28)*



8.3 **Hedge Fund Products by size category**
% of users of hedge funds *(28)*



long/short, market neutral, used by nearly half. Other lesser used products include Event driven funds (28%) and Global macro (23%). Fixed Income Arbitrage, and Convertible Arbitrage were used by less than 15% of hedge fund users in our survey.

All the sectors are interested in funds of funds. But Pension funds are unusual in only wanting this type of fund - they do not seem to want single strategy funds (i.e. not funds of funds), as can be seen in Figure 8.2.

Larger investors are less likely to use single strategy funds, which it seems are more attractive to the smaller institutions, as can be seen in Figure 8.3. While all sizes of institution are keen on funds of funds, over half of smaller institutions are attracted to equity long/short, market neutral funds, compared to only a third of the hedge fund users at the larger respondents.

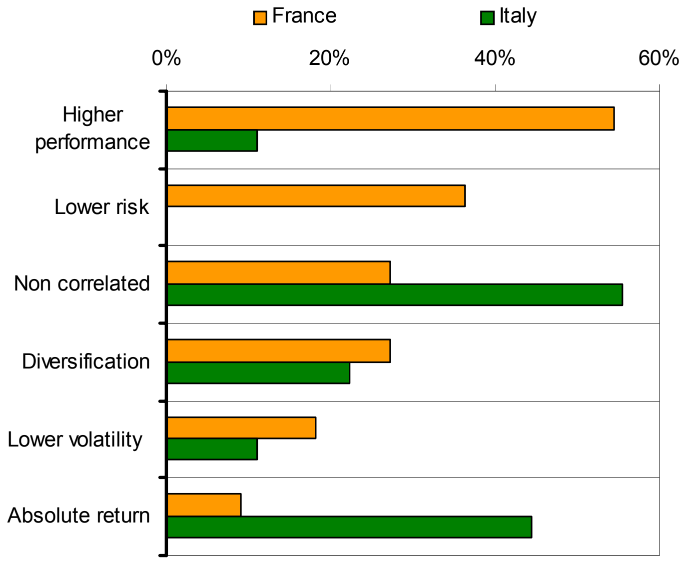
> *"Hedge funds are used more by smaller respondents to this survey"*

We asked the users of hedge funds to tell us the reasons they use hedge funds. Last year they told us it was risk control and diversification that attracted them to hedge funds. Now it tends to be performance and non correlation that attract them.

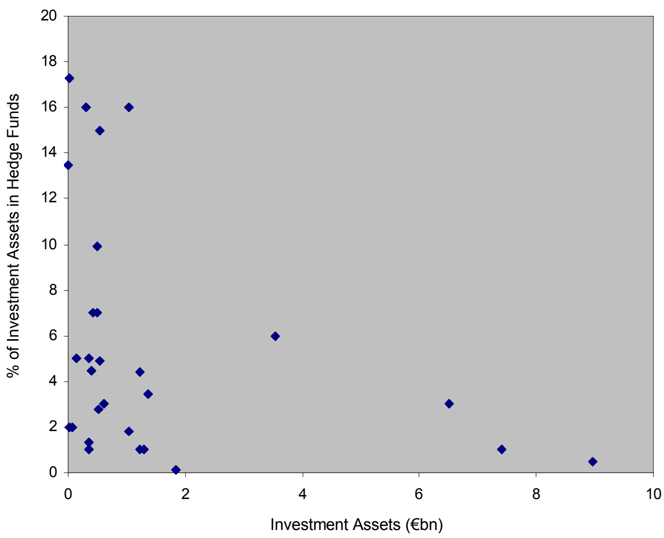
The reasons why the French and Italian respondents, the most numerous hedge fund users in the survey, use hedge funds are quite different, as can be see in Figure 8.4. French investors are interested in the high performance offered by hedge fund products, whilst also attracted to the lower risks they offer. Italian investors however, are particularly attracted to the fact that hedge funds are uncorrelated, and provide an absolute return.

Hedge funds are used more by smaller respondents to this survey. 28 hedge fund users in this survey are represented in Figure 8.5, showing their hedge fund usage as a proportion of assets mapped against their assets. The smaller respondents tend to have the highest exposure. It is not a direct correlation, of course, and it is based on a small sample, but it mirrors a similar finding last year.

8.4 **Reasons for use of hedge funds**
% of users of hedge funds *(28)*



8.5 **Hedge fund usage vs. Investment Assets**
Users of hedge funds *(28)*



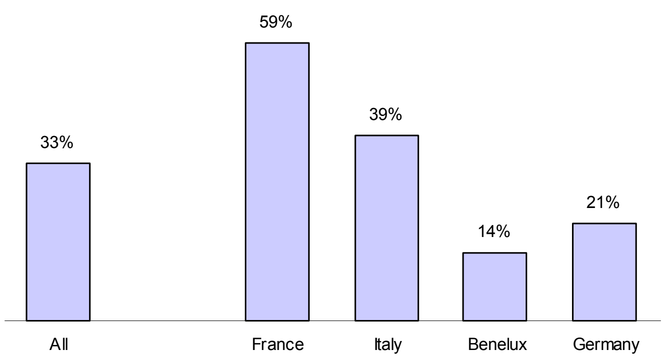
Structured Products are mostly Capital Protection vehicles

The most popular type of structured product are capital protection vehicles, followed by yield enhancement structures. We thought that structured products would grow more in 2006 than they have. Overall a third of institutions use them, but this means that the number of users of structured products in our survey is similar this year to 2005. It is difficult to be sure, but the indications are that around 3% of assets are in this category across our sample. Most of the usage of structured products is in cash and enhanced cash products, and in fixed income.

33% of respondents to this survey told us they use structured products as can be seen in Figure 9.1. This is similar to last year's findings. 59% of the French respondents told us they used them, which suggests a growth from last year, and 39% of the Italian respondents, and this is also a growth from last year. The numbers of users were lower in Germany and Benelux.

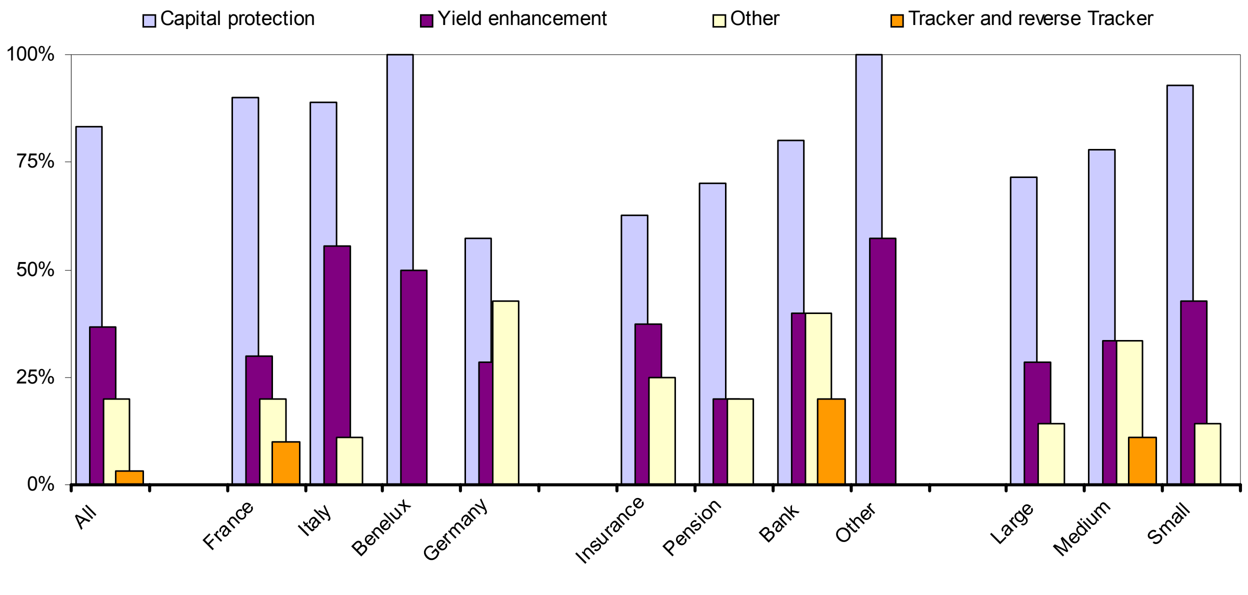
We have attempted to measure the value of assets in structured products, whilst being aware of the dangers of double counting. Given the small numbers of respondents, it is difficult to be sure, but the indications are that around 3% of assets are in this category across our sample.

9.1 **Structured Product Users by country**
% of all respondents



"33% of respondents use structured products. This is similar to last year's findings."

9.2 **Users of Structured Product types by country, sector and size category**
% of respondents using Structured Products *(30)*



Most of the usage of structured products was in cash and enhanced cash products, and in fixed income.

The most popular type of structured product are capital protection vehicles (used by 87% of users of structured products), followed by yield enhancement structures (37%), Tracker and reverse trackers (3%) and other types (20%). These are shown in Figure 9.3.

Of those that use Structured products, most use only one product, but 40% of them use two or more. Three in four of these multi-users use both capital protection vehicles and yield enhancement structures.

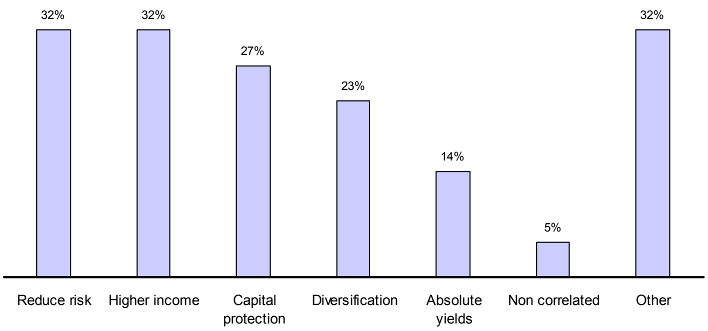
Size seems to be a strong driver of demand for different types of structured product: the smaller institutions are more attracted to capital protection and yield enhancement. Banks are the only sector which uses structured trackers.

Users of structured products were asked the reasons they used these products. Overall we were told that they wanted to reduce risks, and they were attracted to higher incomes offered by structured products, as is shown in Figure 9.3. The need for capital protection is also strong. Structured products also offer a route to product and regional diversification, and are also a way of securing absolute yields.

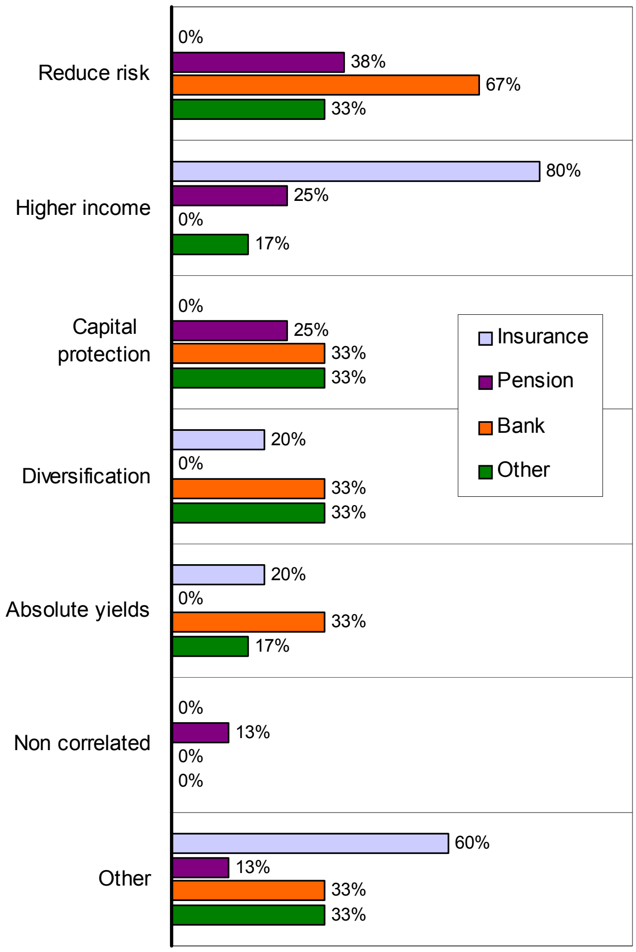
Other reasons were given for using structured products. One large pension plan told us that investing in this way had been "demanded by the investment board". Another told us that structured products offered the possibility of using index-ratings which otherwise wouldn't be available on the market. A third said that structured products offered a safer way of making investment in very risky assets.

The reasons for using structured products vary according to the sector of institution, as is shown in Figure 9.4. The insurers are most keen on higher income benefits of structured products, while the banks like to use them to reduce risk.

9.3 Reasons for using Structured Products
% of users of structured products *(30)*



9.4 Reasons for using Structured Products by sector
% of users of structured products *(30)*



Evidence only of limited growth in ETFs

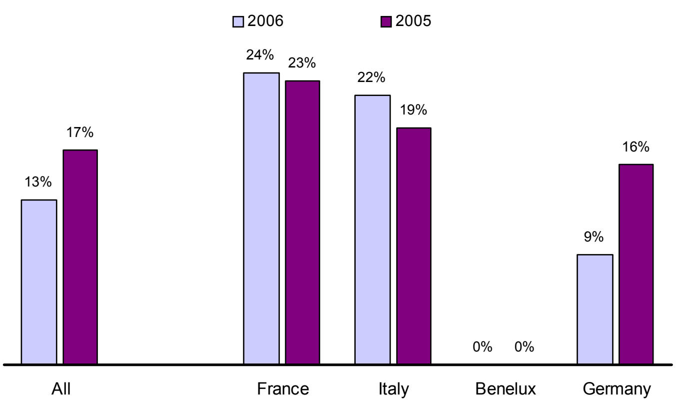
Overall passive investment probably represents 15% of the value of respondents' average portfolios, and ETFs make up only a small part of this passive investment. As with structured products, we had expected to see increases in usage of ETFs in 2006 which does not appear to have happened. We are aware that there have been reports of significant growth in ETF investing - we think our findings may reflect different ETF demand patterns among smaller institutions. ETFs remain popular in our survey in France and Italy, but growth of these assets is not visible in Germany, at least not in this survey. The usage of ETFs is greatest among Insurance Companies, and among larger firms in our sample, and again this was our experience in last year's survey. Most of the ETF usage in our survey is in Equity based Regional products. Sector and commodity ETFs have not caught the imagination of our respondents.

We have not encountered much growth in ETFs this year. As last year, usage of ETFs also continues to be prominent in France, and Italy, as is shown in Figure 10.1. Also as last year, we have encountered very little usage of ETFs in Benelux countries. Based on this survey there may even be evidence of a slight decline in usage in Germany among our respondents, but sample variations may account for this.

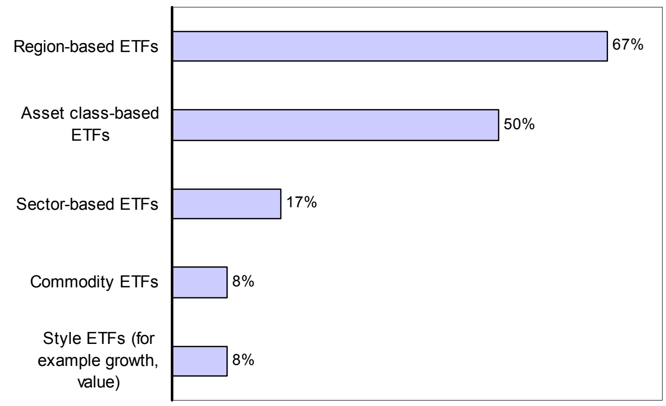
The usage of ETFs is greatest among Insurance Companies, and among larger firms, and again this was our experience in last year's survey.

Most of the ETF usage in our survey is in Equity based products. When asked to describe the product characteristics they are attracted to, we were told that region based ETFs are the most popular, with two thirds of ETF users selecting these, a shown in Figure 10.2. Asset class focused ETFs were used by half the respondents. Sector-based, commodity, or style focused products are not used much.

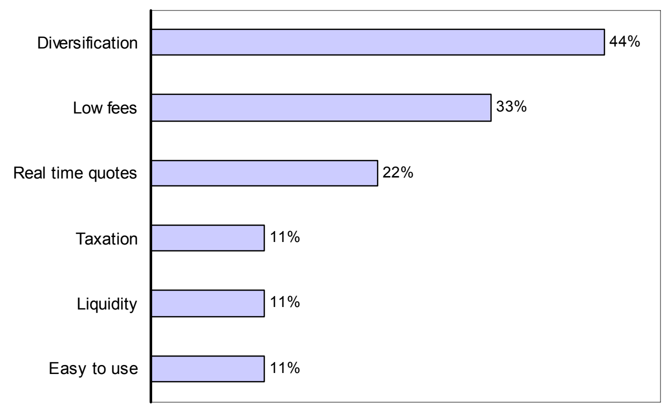
10.1 **Exchange Traded Funds (ETF) users 2005-2006**
% of all respondents



10.2 **ETF products used**
% of users of ETFs *(12)*



10.3 **Reasons for usage of ETFs**
% of users of ETFs *(12)*



Those that use ETFs say that they do this primarily for diversification, which means mainly regional diversification, but may also refer to diversification across asset classes. This is shown in Figure 10.3. The real time quotes of ETFs are important to one in four users, and the ease of use, tax benefits, and liquidity were also mentioned.

When they invest in ETFs, the respondents to our survey in France most frequently use Euronext, as in 2005. This is shown in Figure 10.4. In Italy institutions continue to favour Euronext and other stock exchanges. In Germany usage is shared between Deutsche Borse (75%) and Euronext (25%). These measures are based on small samples, and should be used with caution.

We have attempted to measure the value of assets in ETFs, whilst being aware of the dangers of double counting. Given the small numbers of respondents, it is difficult to be sure, but the indications are that less than 0.5% of assets are in this category across our sample. The largest allocation we observed was in one of the Swiss respondents, who had 7% of its assets in ETFs.

What we have seen however, is evidence of investment in 'other types of passive funds'. While some 12% of respondents are using ETFs, 19% are using these other

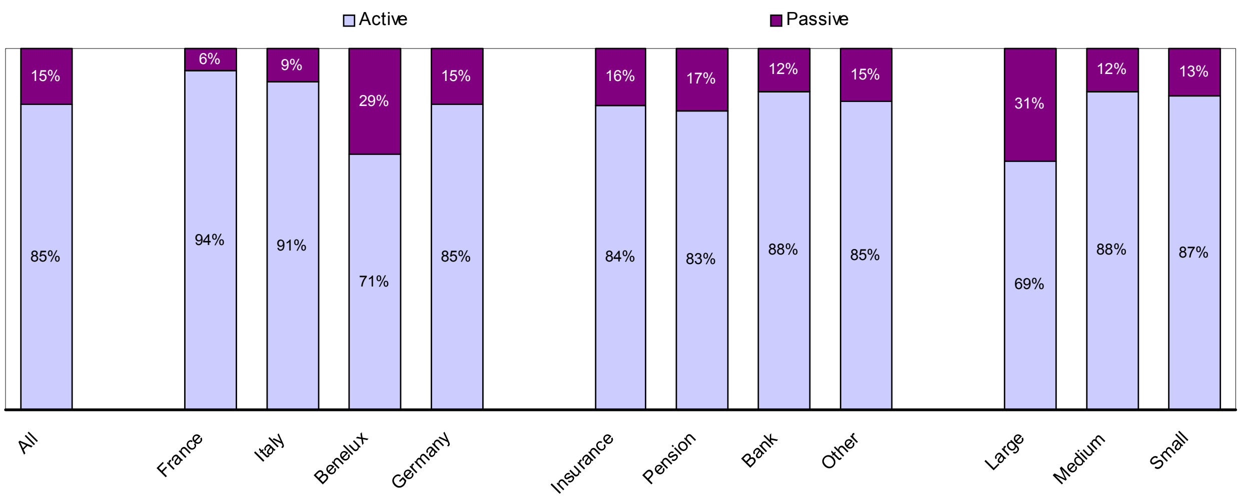
10.4 **Exchanges used to purchase ETFs**
% of users of ETFs *(12)*

	France		Italy		Germany	
Exchange used	*2006*	*2005*	*2006*	*2005*	*2006*	*2005*
Euronext	100%	90%	50%	60%	25%	
Other European stock exchanges	25%	10%	50%	40%		
Deutsche Borse					75%	100%
USA		10%	50%			
Asia (including Japan)				20%		

passive funds, pension funds and smaller institutions in particular. When ETFs, investment in other passive funds, and what we have called 'any other passive investment' is taken together, it suggests that overall passive investment represents 15% of the value of respondents' average portfolios. This is shown in more detail in Figure 10.5. The largest passive investors on this basis are the larger firms and those in Benelux.

We are aware that there have been reports of significant growth in ETF investing, and offer this suggestion as to why such high growth is not reflected in our sample. We think ETFs are probably most popular with super-large institutions that fall outside our scope. In the small-medium institutions, we think our findings may reflect different ETF demand patterns.

10.5 **Active and Passive Investment by country, sector and size category**
Average % of assets, excluding 'other' investments *(66 respondents)*



Over half of the respondents, and maybe many more, are fund investors

This year we have attempted in a systematic way for the first time to collect data on the way in which investment is made through fund structures. We still have not succeeded in securing robust data - this is a very complex area to research. The number of fund users is above 55% of the institutions, and may be higher, which is surprising. It is growing. We cannot be sure, but it is possible that the proportion of the institutions' assets that is invested through funds may be far greater than many currently think it is. There are plenty of other factors which can cause problems of definition here. For example, institutions in France to ease the administrative burden, often structure their own internally managed assets as funds in certain circumstances.

This year we have attempted, more systematically than we have been able in the past, to collect data on the way in which investment is made through fund structures. This is complex issue to research since it raises significant issues of double counting. However carefully the questions are phrased, it seems there is scope for misunderstanding in the minds of respondents. As we admit below, we are still working to resolve this problem. Our findings here must be read accordingly.

Two thirds of those in the survey gave us data on this topic. Of these, virtually all (90%) told us they were users of at least one of the types of fund we had nominated. It is possible that our question caused confusion - some respondents may define terms differently, for example by thinking that a segregated mandate and a fund are the same thing.

There are plenty of other factors which can cause problems of definition here. Institutions in France to ease the administrative burden, often structure their own internally managed assets as funds in certain circumstances. German institutions invest through Spezialfonds, which are more akin to mandates than to traditional fund vehicles, but which may quite often be defined as funds.

We spoke to several respondents to check, and they reassured us that they had not used this alternative definition, but we cannot be sure that all respondents understood the question in the same way.

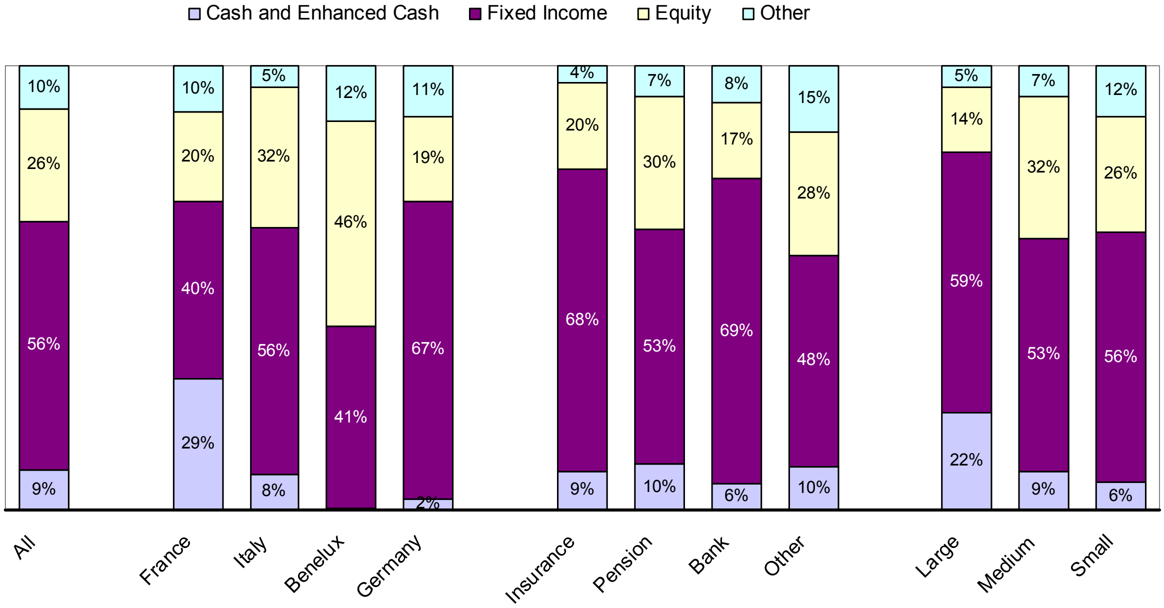
But we were further confused when we asked the same question in a slightly different way later in the survey, and got a different, lower, answer. When asked if they used 'Pooled or co-mingled funds' eight in ten of the respondents gave an answer, and of these 55% said they used funds according to this definition.

> *"Over half of the institutions are users of funds"*

So, what we can say with confidence is that the number of fund users lies somewhere between 55% and 90% of the institutions. This is not a very satisfactory degree of precision. But even the possibility that over half of the institutions are users of funds seems in itself a surprising and interesting conclusion.

And we have been told that use of funds will grow. We asked respondents whether investment in funds would increase, and 12% said they planned to make a significant shift of 2 percentage points or more, in favour of fund investment in the near future.

11.1 Asset class of fund investment by country, sector and size category
Average % of assets of those investing through funds *(66 respondents)*



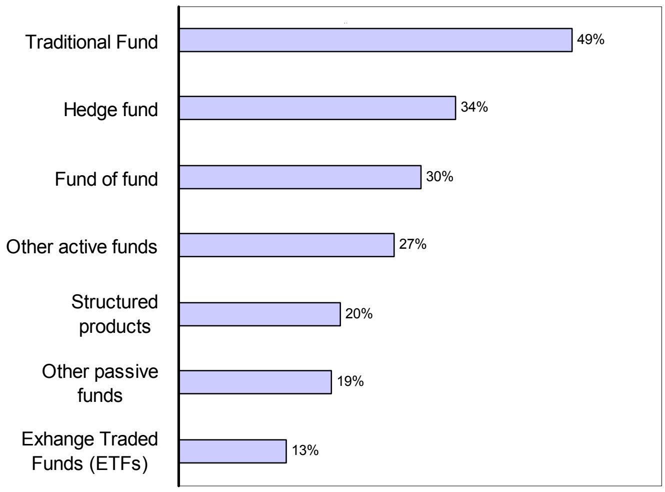
The respondents to this survey use funds for all asset classes. As is shown in Figure 11.1, 56% of fund investment is fixed income, 26% is equity. The remainder is cash or 'other' classes.

Pension funds use funds primarily for fixed income. They are also proportionately the biggest users of equity funds, 30% of their fund investment being in this class. French institutions use funds for cash more than any other country, while Benelux investors use them more for equity than do the respondents from other countries.

We have identified seven types of fund vehicle, as shown in Figure 11.2. Half of the respondents to the survey tell us that they invest through what we have called traditional funds, by which we mean long only active funds that are not funds of funds. One third invest in hedge funds (including in some cases, stand alone hedge funds) and 30% invest through funds of funds (both hedge and long only). We have included structured products as funds in this analysis, since many are structured in this way - 20% use

"One third invest in hedge funds"

11.2 Types of fund vehicles used
% of all respondents



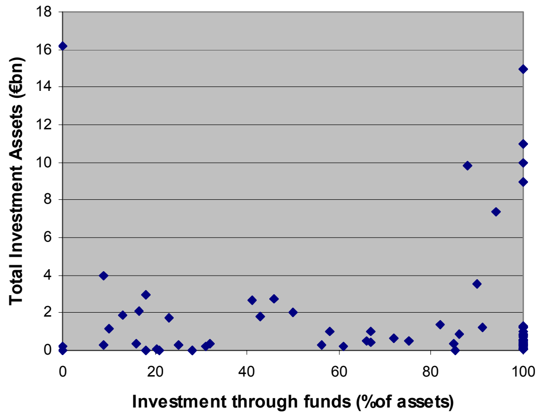
them. As we have already noted in section 10, ETFs are invested in by 13% and other passive funds by 19% of the respondents.

We tried to capture a picture of what value is invested through funds. We have shown the responses in Figure 11.3, which compares the proportion of assets that respondents told us were invested through funds, to their total investment assets. On average they said that 65% of their assets are in funds vehicles, but this does not sound right.

We have assumed that our question must have been phrased in a way which misled some respondents, causing them to give misleading answers. However, we have shown the results in order to make the following point: a significant proportion did not misunderstand us (we checked), and if even some of them are right, this finding is likely to be the case across small, medium and large institutions.

So what we **can** say is that a significant proportion are telling us that a significant proportion of their assets are in funds. We aim to turn this sentence into something more precise next year. In the meantime we are left with the possibility that the proportion of these institutions' assets that is invested through funds may be greater than many currently think it is.

11.3 **Investors through fund vs. Total Investment assets**
Those investing through funds *(66)*

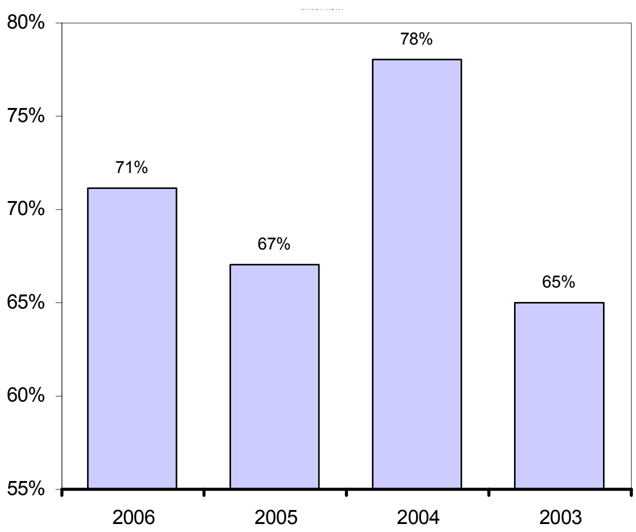


Performance attribution is supplied increasingly by investment managers.
Performance attribution is used by a similar number of respondents to last year. This service is supplied increasingly by investment managers.

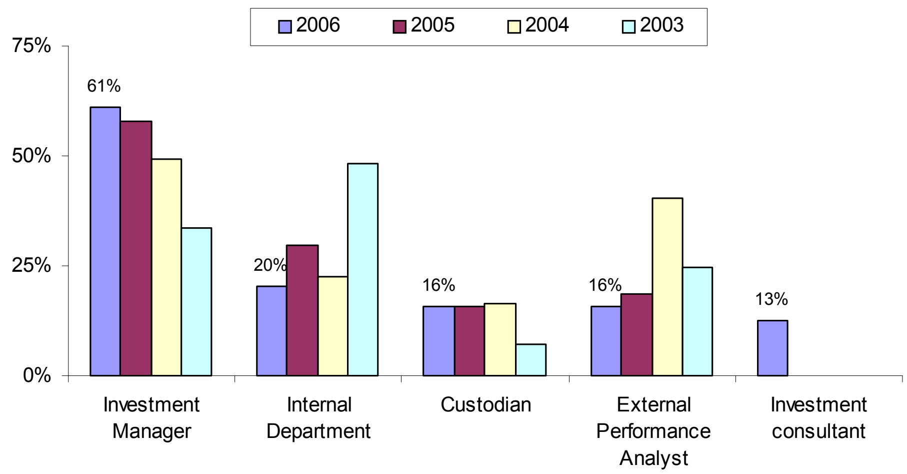
Performance attribution is used by 71% of the respondents to this year's survey, which is slightly higher than last year, as shown in Figure 12.1.

It is supplied increasingly by investment managers, who now supply this service to 61% of those that receive performance attribution, up from 34% in 2003, as shown in Figure 12.2.

12.1 **Users of Performance Attribution 2003-2006**
% of all respondents



12.2 **Suppliers of Performance Attribution 2003-2006**
% of users of Performance Attribution *(64)*



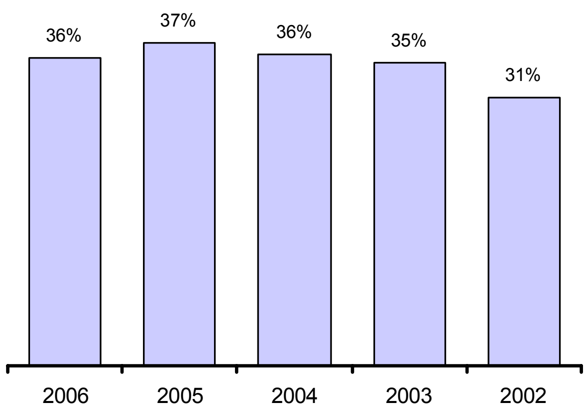
Use of consultants has not grown

Usage of consultants has been one in three of our respondents for four years. Where they are used it is mostly by the pension funds, but 'Other' types of investors also use them. There seems to be a big change in the way consultants are used - much less for management selection, and slightly more for asset allocation. Across all users of consultants, only 38% of respondents now ask for help with manager selection. This is down from 61% in 2004.

Usage of consultants has been one in three of our respondents for four years, as shown in Figure 13.1. If there is growth, it is slow. There may be a limited 'shelf-life' for consultants at some institutions - we have heard from some that they have used consultants in the past, but have now stopped using them, one telling us: "we used consultants in order to get help in designing our selection process, but once the process was designed, the consultants were no longer needed".

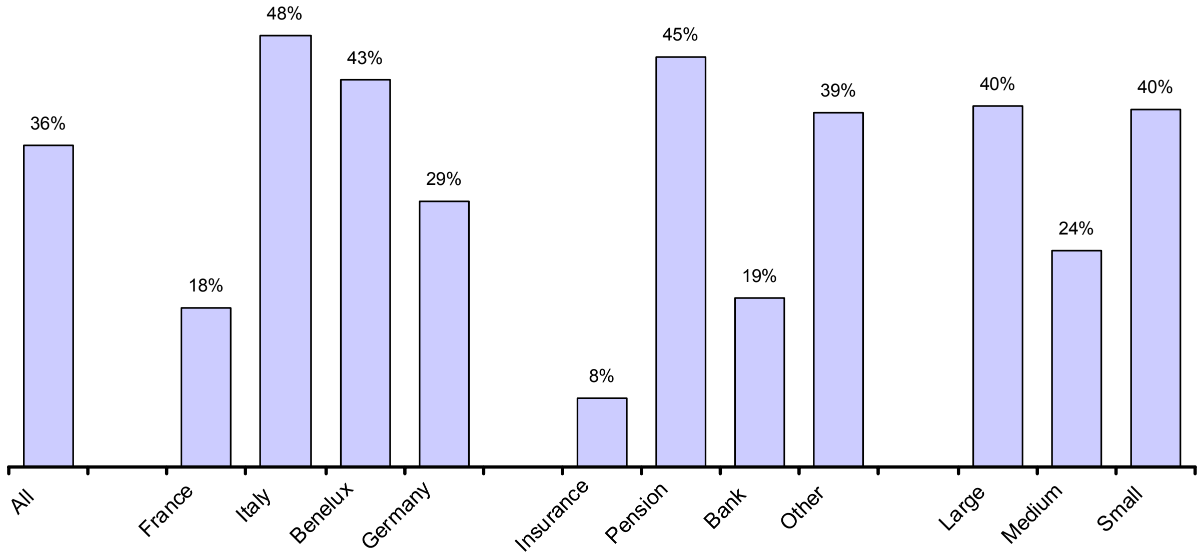
The consultants are used much more widely among the pension plans than they are among the other types of institutional investor that we track - these include

13.1 **Users of consultants 2002-2006**
% of all respondents



"There may be a limited 'shelf-life' for consultants at some institutions "

13.2 **Users of consultants by country, sector and size category**
% of all respondents



insurers, foundations, banks, and corporations. Half of pension plans in our survey use consultants, as is shown in Figure 13.2. But their penetration among the other types is only one institution in four.

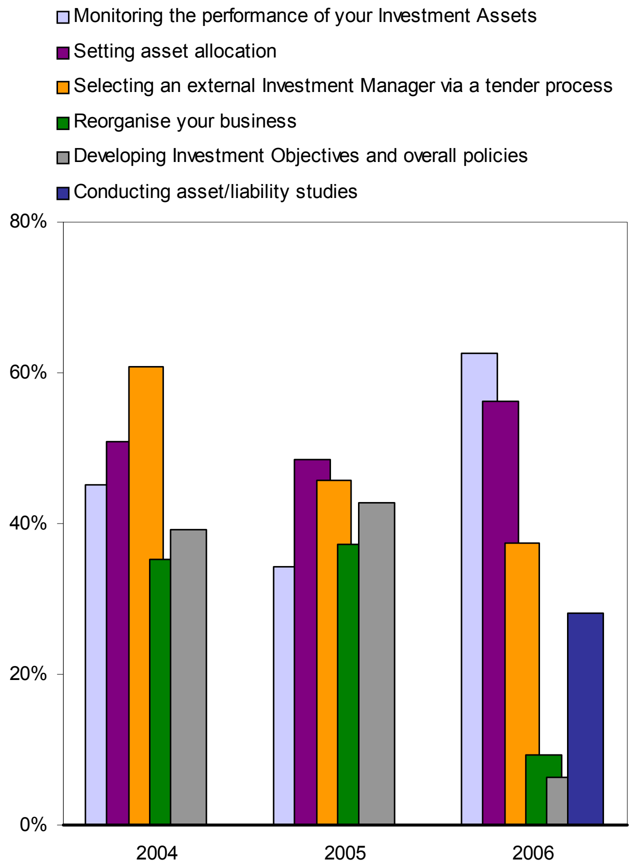
The pattern of usage by country varies from survey to survey, and no overall conclusion can be drawn. Figure 13.2 shows that Italian institutions are much more likely to use a consultant than those of other countries. The French institutions were the least likely to use a consultant, although last year it was German respondents who were least likely to use them.

Consultants are used most by our respondents in 2006 to monitor the performance of their investment assets. 63% of those that used a consultant said this, as shown in Figure 13.3. 56% use them for asset allocation, an increase from previous years.

This year we asked for the first time whether consultants were used for conducting asset liability studies, and 28% said they were - it was probably the appearance of this new option that prompted a big decline compared to previous years in responses saying that consultants were used for 'reorganising your business', and 'directing investment objectives'.

Only 38% of users ask consultants to help with manager selection. This is down from 61% in 2004. Put another way (38% of the 35% who use consultants =) only 13% of the institutions in our survey as a whole use consultants for manager selection. And even then, some firms that use consultants for selection only give the consultant a very defined, and limited, role in the process. One institution for example, told us that "when we selected a Corporate Bond fund recently, we looked at a long list of 50 that we chose. The role of our consultant was simply to provide comparative performance measures between the funds." Another said they used consultants in management selection, but "only for very specific cases, such as Global Corporate Debt, where we lack the experience to do it on our own."

13.3 **Reasons for usage of consultants**
% of respondents who use consultants *(2006 - 32)*



A word on the meaning of the word 'consultant'. Experience from previous surveys, and from conversations with some respondents, suggests that the consultants they refer to here are a widely diverse group ranging from multi-national actuarial firms, through to small local one-person management consultancies.

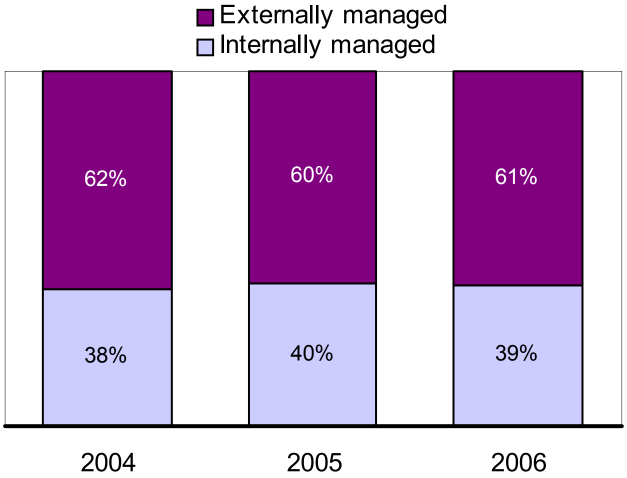
More mandates coming, but probably smaller

As we reported last year, it is the German institutions that delegate least to external managers. Also as reported last year it is the Pension funds which delegate most. On average each respondent to this survey has 13 relationships with external managers, mostly for either segregated mandates or pooled funds. On average each respondent delegates five mandates to external managers. More external managers are being used for segregated mandates (and the same may be happening for pooled funds). This in turn suggests a mild trend towards fragmentation: more, but smaller mandates.

39% of assets were managed externally for the institutions in our survey. This proportion has not changed for three years, as is shown in Figure 14.1

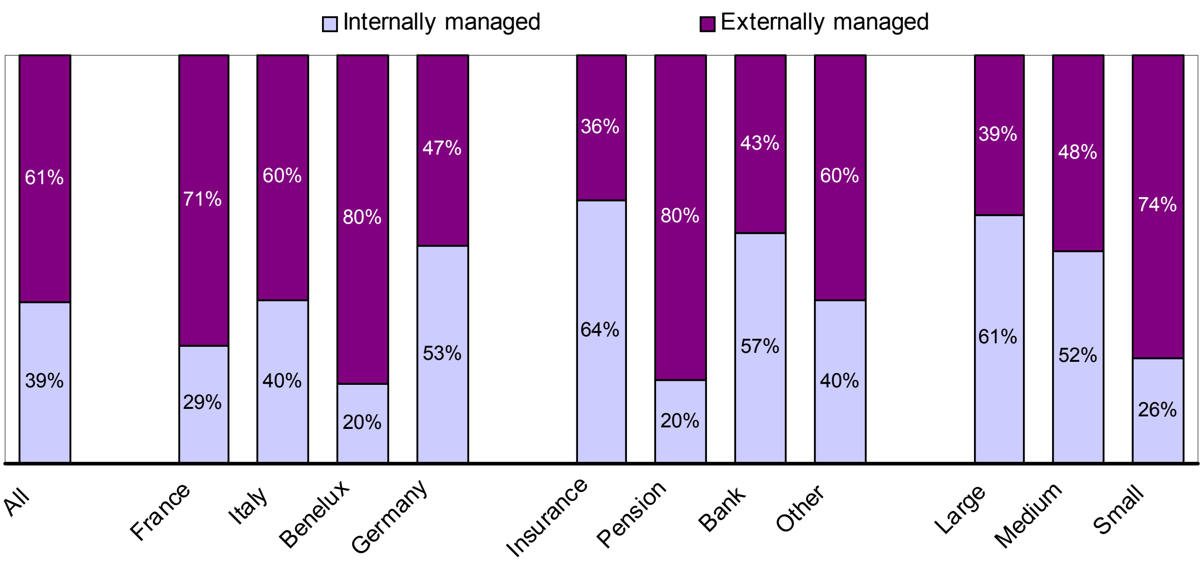
As we reported last year, it is the German institutions that delegate least to external managers. Also as reported last year it is the Pension funds which delegate most. Also similar to last year is the finding that it is the smaller firms who delegate most to external managers. The findings for 2006 are shown in Figure 14.2.

14.1 **Users of external Investment managers by vehicle**
% of those responding to question *(76 respondents)*



"As we reported last year, it is the German institutions that delegate least to external managers."

14.2 **Assets delegated to external investment managers by vehicle, by country, sector and size category**
Average % of assets of those responding to question *(76)*



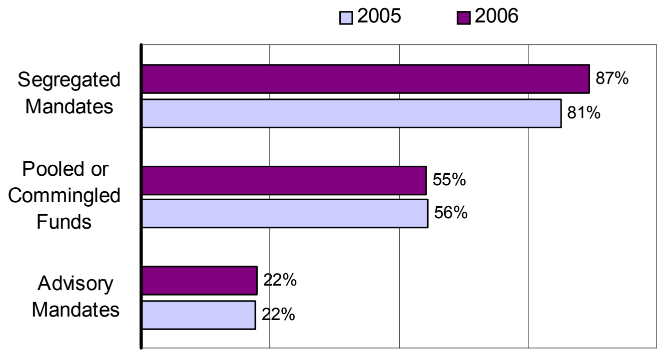
We have explored demand for the various investment services provided by external managers: segregated mandates, pooled or commingled funds, and advisory mandates. 93% of the respondents to our survey in 2006 use one or other of these services. The proportions for each service have changed little from last year. 87% of our respondents use segregated mandates in 2006, compared to 81% in 2005, as shown in Figure 14.3.

These numbers are not designed to reflect the proportions that use these services in the wider universe of institutions beyond our survey, but since the basis for selecting respondents remains consistent each year, any significant changes in demand for these services would show themselves in these figures.

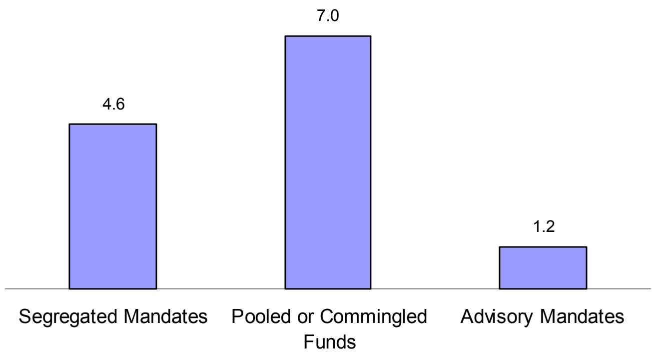
We have observed a total of 975 known manager-institution relationships through this survey. On average each respondent to this survey has 13 such relationships, of which five tend to be segregated mandates, as shown in Figure 14.4.

The numbers of mandates do not vary very much by country, but as might be expected, the larger the firm, the more mandates it tends to have, as shown in Figure 17.5. We identified this same finding last year.

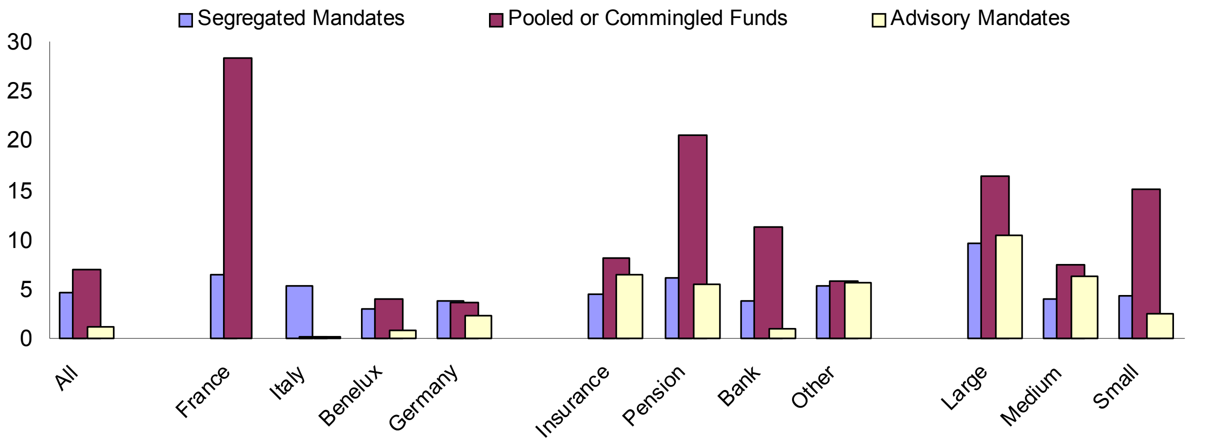
14.3 Users of external Investment managers by vehicle
% of 76 responding to question



14.4 Number of external Investment managers used
Average of those responding to question *(76)*



14.5 Users of External Investment vehicles, by country, sector and size category
Average of those responding to question *(76)*



What does vary by country is the number of funds used, where the French respondents are users of many more managers than respondents in other countries through pooled funds. 13 French respondents told us how many managers they use - they averaged 28 managers each, with four of them using more than 50. In other countries the average number of Pooled Fund Managers did not exceed 4.

It is noticeable that the number of advisory mandates is also driven by size, with large institutions in our survey using them four times as much as smaller ones.

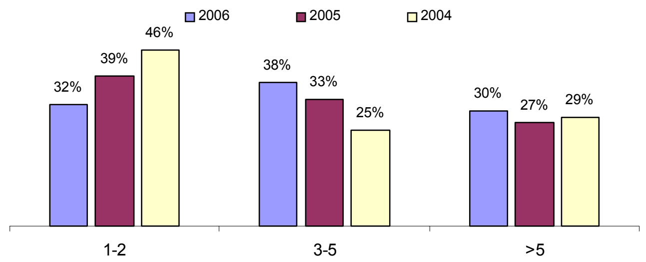
More external managers are being used for segregated mandates as shown in Figure 14.6. In 2004 nearly half of the respondents used 1 or 2 managers, but in 2006 less than one third do. Instead there has been growth (25% to 38%) of the number that use between 3-5 managers. What should also be noted is that there is little change in the number of institutions using 5 or more managers.

Since we have also noted that the overall proportion of assets delegated to external managers has not gone up, this means that delegated assets are being fragmented into mandates of smaller size, or which grow only in line with stock markets.

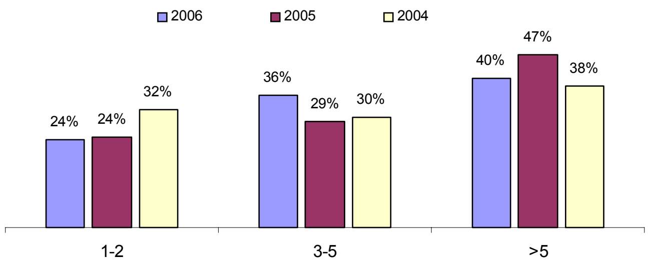
The same may be happening for pooled funds, as shown in Figure 14.7. There are more using 3-5 managers in 2006 compared to previous years, and fewer using 1 or 2. There is no obvious long term trend in the number using 5 or more.

Equally there is no obvious longer term trend in the numbers of managers used for Advisory Mandates as shown in Figure 14.8. The majority of those that use this service rely on 1 or 2 managers. This data is based on small samples, so cannot be relied on as much as for the other two offerings above.

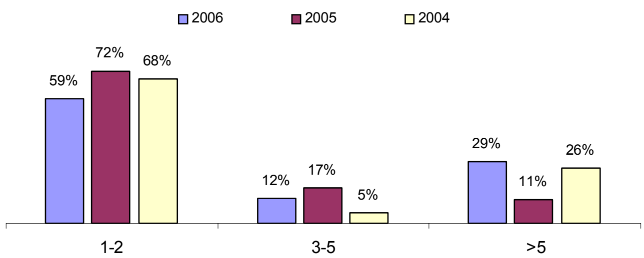
14.6 Number of external Investment managers used for Segregated Mandates
% of those that use Segregated Mandates *(66)*



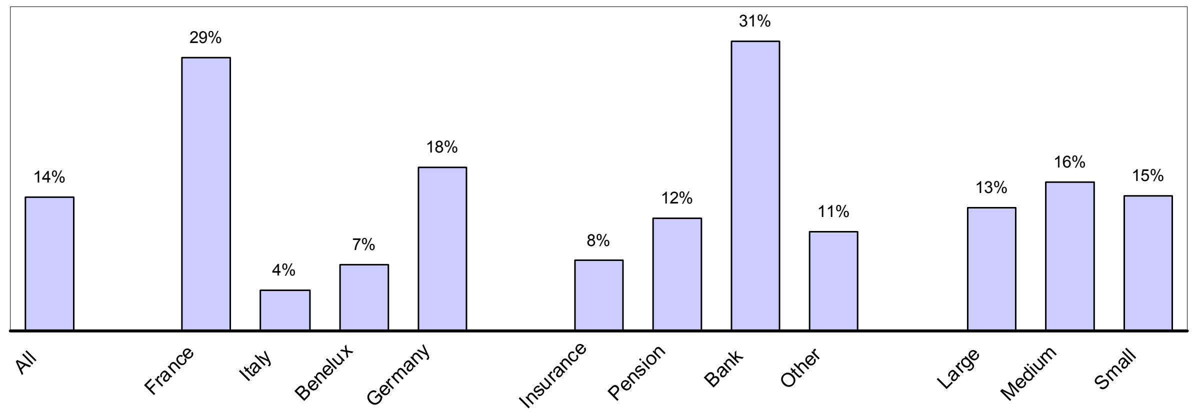
14.7 Number of external Investment managers used for Pooled/Commingled Funds
% of those that use Pooled/Commingled Funds *(42)*



14.8 Number of external Investment managers used for Advisory Mandates
% of those that use Advisory Mandates *(17)*



14.9 Institutions predicting growth in use of external Investment managers by country, sector and size category
% of all respondents



14% of the institutions in the survey told us that they would be delegating an additional 2% points or more of their assets to external managers in the near future, as shown in Figure 14.9. 29% of the French institutions said this, and 18% of the Germans, compared to only 4% of the Italian. It was the Banks who were the most enthusiastic: 31% of them said they would be using external managers more, and only 8% of insurers. There were no obvious differences driven by scale.

"14% of the institutions told us that they would be delegating an additional 2% points or more of their assets to external managers"

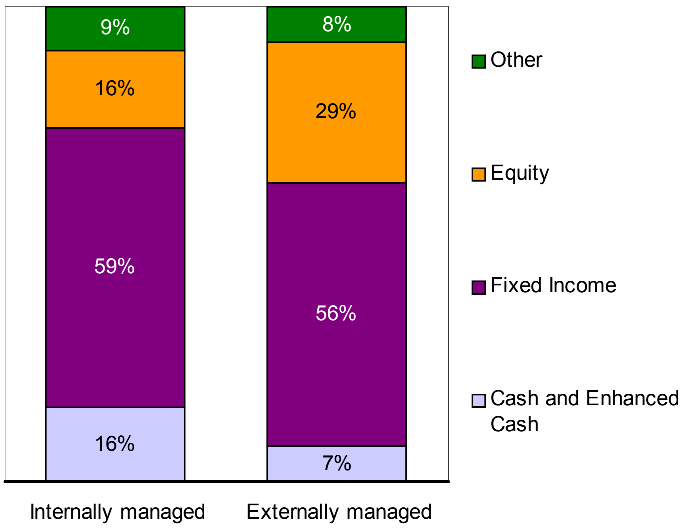
Pensions delegate most equity and Insurers most fixed income

Internally managed assets tend to be more heavily focused on fixed income, and cash. Externally managed assets are more focused on equity. Pension funds delegate equity more than other sectors, while insurers delegate more fixed income. French institutions continue to delegate much cash, and German respondents delegate the most fixed income.

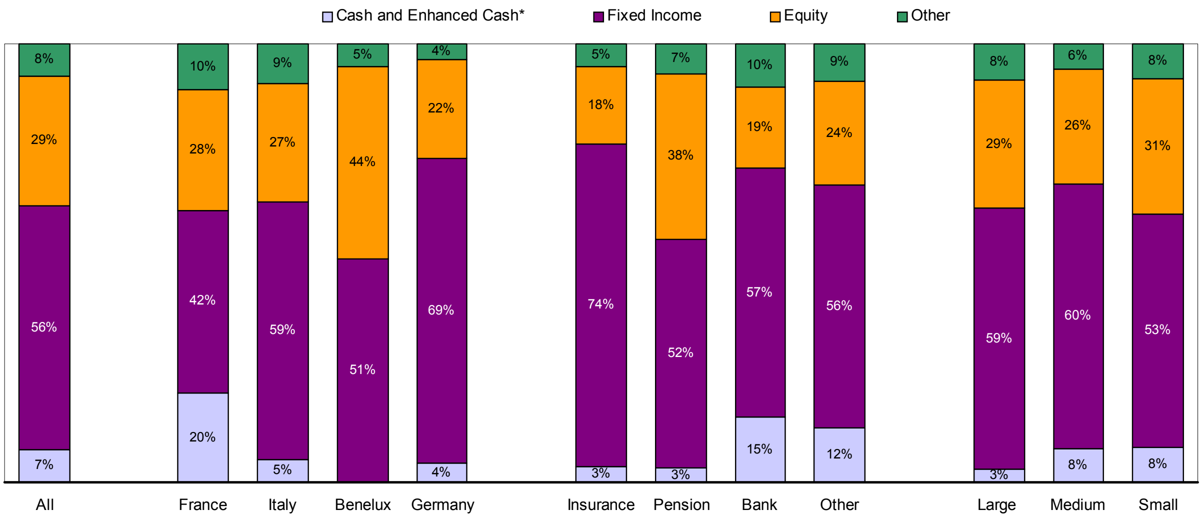
Internally managed assets tend to be more heavily focused on fixed income, and cash. Externally managed assets are more focused on equity. The differences are not huge, but they are noticeable, as can be seen in Figure 15.1 29% of externally managed assets are in equity, compared to only 16% for internal assets.

The highest proportions of equity that we have seen among externally managed assets are in Benelux, where the average equity component is 44%, as shown in Figure 15.2. Externally managed assets of Pension funds are on average 38% equity, compared to 18% with insurers, who tend to delegate fixed income assets more than any other sectors. As in our study last year, French institutions and Banks and Other Institutions are unusual in delegating cash assets to external managers.

15.1 Asset allocation by internal and external management
Average % of assets (84 respondents)



15.2 Asset allocation by internal and external management, by country, sector and size category
Average % of assets (84 respondents)



	All	France	Italy	Benelux	Germany	Insurance	Pension	Bank	Other	Large	Medium	Small
Other	8%	10%	9%	5%	4%	5%	7%	10%	9%	8%	6%	8%
Equity	29%	28%	27%	44%	22%	18%	38%	19%	24%	29%	26%	31%
Fixed Income	56%	42%	59%	51%	69%	74%	52%	57%	56%	59%	60%	53%
Cash and Enhanced Cash*	7%	20%	5%		4%	3%	3%	15%	12%	3%	8%	8%

Performance matters again as a selection criteria

Performance is the most important selection criterion, again. Criteria for selecting managers have stayed very similar in other respects too. Clarity of the investment process continues to be of great importance to institutions, but this should not be an excuse for salespeople to "talk and talk about their process". Instead institutions ask for managers to talk a little less, and listen a little more to their specific needs. Level of fees continues to be relatively unimportant. Selection processes can be unstructured - 'long lists' of candidate firms can be based around who is known best to that institution. There is scope for boutiques to win business here. Investment fund managers are selected using similar techniques to suppliers of traditional mandates.

Performance continues to be ranked as the most important selection criteria by the respondents of this survey. As last year, it stays as the most important factor, as can be seen in Figure 16.1, which shows all 23 of the factors which respondents were invited to score. The only change from last year is that Risk control has moved to third, and Clarity of the Investment Process has moved to second. Level of fees continues to be a factor outside the top five, as it has been since 2003.

Importance is measured by respondents between 1 and 5, and this year the average score for Performance has risen, slightly, as it has done every year since 2003, as is shown in Figure 16.2. Risk control has slightly receded in its average score. But clarity of the investment process is an issue of great importance to institutions, who have scored this factor more highly than in any year since 2003. Rating the process as important does not mean that managers should place all their sales energy into this. One institution told us: " Most people who visit us just want to talk and talk about their process."

16.1 Criteria when selecting an external Investment Manager 2003-2006
Degree of importance (Ranking) (84 respondents)

	2006	2005	2004	2003
Performance	1	1	2	2
Clarity of investment process	2	3	3	3
Risk control	3	2	1	1
Understanding of your organisation's particular goals and needs	4	4	6	6
Stability of investment team	5	5	4	4
Client service	6	7	10	8
Level of investment management fees	7	8	8	9
Quality of reporting	8	6	5	5
Segregation of fund management function	9	12	9	10
Ability to provide advisory service	10	10	12	13
Financial strength of external manager	11	9	7	7
Product innovation	12	14	17	19
Presence in your country: sales office presence	13	13	13	11
Reputation of asset manager (brand)	14	15	14	14
GIPS/AIMR compliance	15	18	15	16
Professional rating of external manager	16	11	11	12
Total size of AuMs of external manager	17	16	16	15
Presence in your country: investment team presence	18	17	19	17
Non-competitor	19	21	21	20
Fitch asset manager rating	20	19	18	18
Existing commercial relationship (banking, insurance)	21	20	20	21
Parent group is domestic	22	22	22	22
Parent group is international	23	23	23	23
Other	24	24	24	24

16.2 Top five criteria when selecting an external Investment Manager 2003-2006
Degree of importance (Average scores) (84 respondents)

16.3 Top 10 criteria when selecting an external Investment Manager by country, sector and size category
Degree of importance (Ranking) *(84 respondents)*

		By Country				By Sector				By Size of Institution		
	All	France	Italy	Benelux	Germany	Insurance Companies	Pension Funds	Banks	Other	Large	Medium	Small
Performance	1	1	1	3	1	1	1	1	1	1	1	1
Clarity of investment process	2	8	3	1	2	7	2	2	2	2	3	2
Risk control	3	5	2	2	6	2	3	6	4	3	4	3
Understanding of your organisation's particular goals and needs	4	6	5	6	3	3	6	3	3	8	2	4
Stability of investment team	5	7	8	4	4	4	4	5	7	4	6	6
Client service	6	3	11	7	5	5	7	4	5	5	5	5
Level of investment management fees	7	14	4	5	7	8	8	10	6	7	10	7
Quality of reporting	8	2	10	9	8	6	9	9	8	6	8	8
Segregation of fund management function	9	12	9	8	11	9	5	12	14	11	7	10
Ability to provide advisory service	10	4	14	10	12	10	11	11	9	15	12	9

What institutions want is a little less talking from managers, and a little more listening. The clue lies in the next most important criteria: 'Understanding of our organisations needs' which remains in fourth place. We asked one institution what it meant by this, and it gave us this example: "Some of our external managers, those from the US in particular, don't seem to understand, however much we tell them, that they have to help us fulfil our regulatory requirement to deliver certain figures regularly to the Bundesbank." This institution went on to say that this need was now being understood and met more regularly now.

In Figure 16.3 we show the top 10 criteria when selecting an external Investment Manager by country, sector and size of institution. This reveals that there are significant differences in the importance by country. Clarity of the investment process is the most important factor for Benelux countries, while it is not even in the top 5 for French respondents, which reflects the same finding as in 2005. Italian respondents do not care much about the stability of the investment team as they do about fees, and this is again the same finding as last year. Italians again place a high score on risk control.

It comes as a surprise that insurers rank Clarity of the investment process as low as 7th, since last year it was the second most important to them. However, in other respects the scores of the various sectors are very similar to last years.

The votes of the large medium and small institutions are remarkably similar, although large institutions give a lower ranking to the importance of Understanding of the organisations needs, as they did last year. This is the second most important factor for medium sized institutions.

When they select managers for segregated mandates many of the respondents told us that their selection process was relatively unstructured. Most select a long list of names, often 10 or so, from which they select a short list of 3-4 or so. But we did encounter institutions who invite bids from 30 or more external asset managers. Long lists are not always the result of very structured processes. One insurance company told us that "everyone in the office can put in names - there is no magic". The lists of firms who are scanned for inclusion in the long list can be small. One firm said that they only search among the firms they know already.

Several of the firms told us that there was nothing to stop boutiques being included in the list of candidates, but "we would have to know them first", which suggests that what is faced by boutiques in getting accepted is often more of a publicity challenge than just a performance-related one. A German bank told us "we often get information on new managers from other savings banks". The route to being well known is not so much about putting adverts in newspapers, but is more about having a few key people talking about you at the right moments.

"When selecting between funds, the institutions in our survey often use a similar process to that which they use when selecting for segregated mandates"

Investing in funds represents a significant part of their process, as we have shown in section 11. When selecting between funds, the institutions in our survey often use a similar process to that which they use when selecting for segregated mandates. They make a long list of between 10-50 firms (we observed a wide range here), usually based on an external data source such as FERI (Germany) or S&P, and then invite typically 3-4 short-listed firms to visit them for more discussions. They usually want to meet the managers themselves when they interview the short listed fund candidates.

European Institutional Asset Management Survey 2006

Performance fees are now in great demand

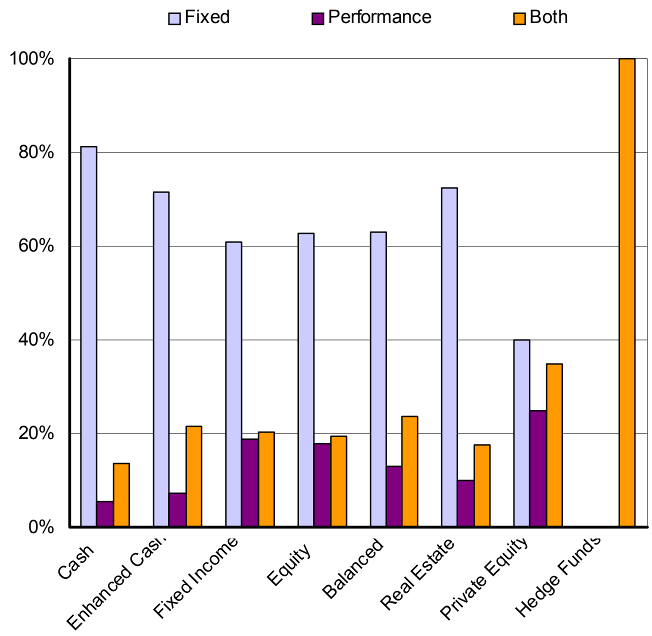
We received a very clear message: respondents to our survey want more performance fees and less fixed fees. The demand for performance fees was growing last year, but this year it is much more pronounced. For example, 18% of respondents are currently paying performance fees for equity mandates, but 48% would like to be doing so in future. The most persistent demands for performance fees come from Germany. There are also strong views against performance fees.

Institutional investors in this survey currently pay most of their fees to their external managers in the form of Fixed Fees, as shown in Figure 17.1. 81% of those that pay fees for Cash mandates and who answered this question, pay fixed fees. 61% of fixed income fees are fixed, and 63% of equity mandates are fixed. Only 40% of Private Equity fees are fixed, however, and all hedge fees paid by this survey's respondents are a mixture of both fixed and performance fees.

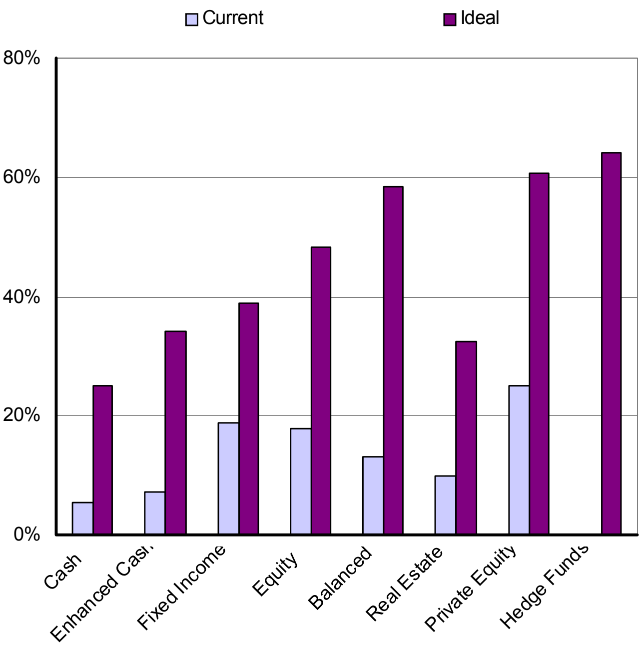
That describes what the current status is. We went on to ask what the respondents would ideally like the compensation structure of their external managers to be in future. We received a very clear message: they want more performance fees and less fixed fees. Figure 17.2 below shows the extent of the difference.

It reveals how many respondents currently pay performance fees (the same numbers as in Figure 20.1), and compares this to the number of respondents who would like to see performance fees in future. 18% are currently paying performance fees for equity mandates, but 48% would like to be doing so in future. 21% are currently paying performance fees for Private equity, compared to 61% who want to do so.

17.1 **Current compensation of External Investment managers**
% of respondents to each question (67 respondents)



17.2 **Current and ideal Performance compensation of External Investment managers**
% of respondents to each question (67 respondents)



The desire for performance fees seems to have grown recently. This is the conclusion we draw from comparing the ideal compensation structures as described in 2006 and 2005, shown in Figure 17.3. Only 17% said they wanted performance fees for Fixed Income products in 2005, but now in 2006 it is 39%. 36% said they wanted performance fees for Balanced mandates in 2005, but now it is 59%.

The most persistent demands for performance fees come from Germany, as is shown in Figure 17.4. 59% of German respondents to this question want performance fees for equity, compared to only 25% in France. On fixed income, 52% of German respondents want performance fees, compared to only 13% of those from France.

We spoke to a number of managers to explore in more depth their view on fees. There are strongly held views on both sides of this debate. Those in favour of performance fees see "a need for managers to be more aligned to our interests" as one pension fund told us. Another said: "Performance fees, as long as they involve tight risk budgets, work well, they tend to make managers more committed to us".

> *"Performance fees tend to make managers more committed"*

Many performance fee arrangements are a mixture of lower than normal fixed fee plus a performance element. There seem to be extreme performance fees being developed which offer managers a greater upside for performing well, but also a greater downside for underperformance in the form of having to repay some of its fee.

But we should note the equally passionate arguments on the other side of the debate. "We used to like performance fees", one pension fund told us, "but now we see that they give incentives to managers to take unnecessary risks with our money." "Performance fees", said another "mean that managers take risks they should not".

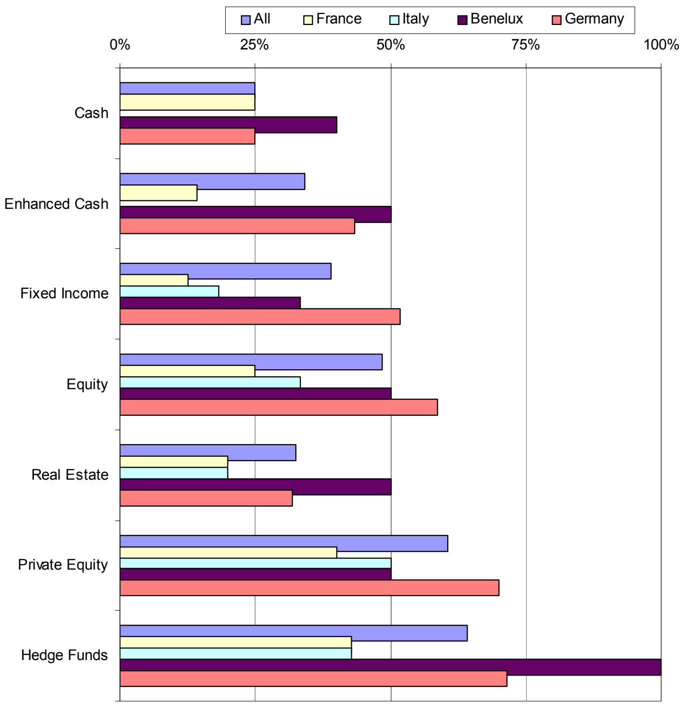
17.3 Ideal compensation of External Investment managers 2005-2006

% of respondents to each question *(2006 - 67 respondents)*

	Fee type	2005	2006
Cash	*Fixed*	82%	64%
	Performance	13%	25%
	Both	5%	11%
Enhanced Cash	*Fixed*	67%	45%
	Performance	23%	34%
	Both	9%	21%
Fixed Income	*Fixed*	74%	44%
	Performance	17%	39%
	Both	9%	17%
Balanced	*Fixed*	52%	20%
	Performance	36%	59%
	Both	12%	22%

17.4 Ideal performance compensation of External Investment managers by country

% of respondents to question *(67)*



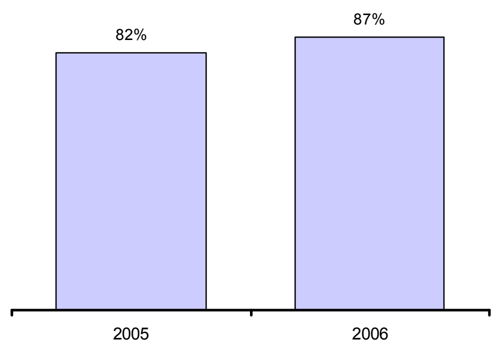
Managers must expect directives and constraints

External managers must expect to be told what to do, and must learn to live with constraints to their investment freedoms. Nearly 9 in 10 institutions give detailed directives or constraints in delegating to an external Investment manager. Banks appear to give most constraints. When they give constraints to their external managers, most do so with benchmarks, and they gave us a wide ranging list of the ones they use.

Nearly 9 in 10 of the respondents give detailed directives or constraints when delegating the management of their investment assets to an external Investment manager. There may be a slight increase (from 82% to 87%) in this tendency since 2005, as is shown in Figure 18.1.

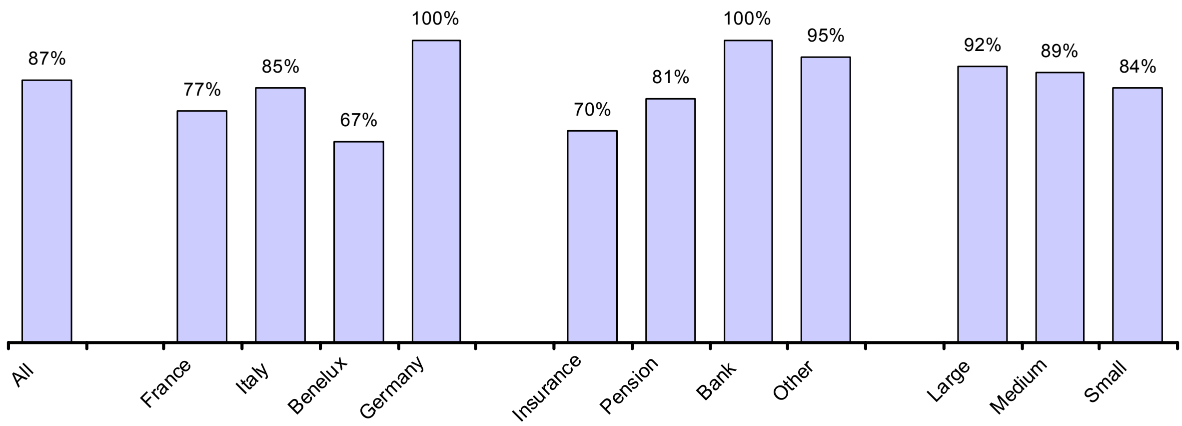
Banks appear to be the most prone to giving constraints to their managers, as shown in Figure 18.2. The least likely to do so are those in Benelux and in France, which is what we found last year as well. Insurance Companies are the least likely sector to give constraints. It is possible that the smaller the firm, the less likely it is to give constraints.

18.1 Detailed directives or constraints given to managers
% of respondents to question (70 respondents)



"Banks appear to be the most prone to giving constraints to their managers"

18.2 Detailed directives or constraints given to managers, by country, sector and size category
% of respondents to question (70 respondents)



As is shown in Figure 18.3, when they give constraints to their external managers, 79% do so with benchmarks - we have explored this in more depth below.

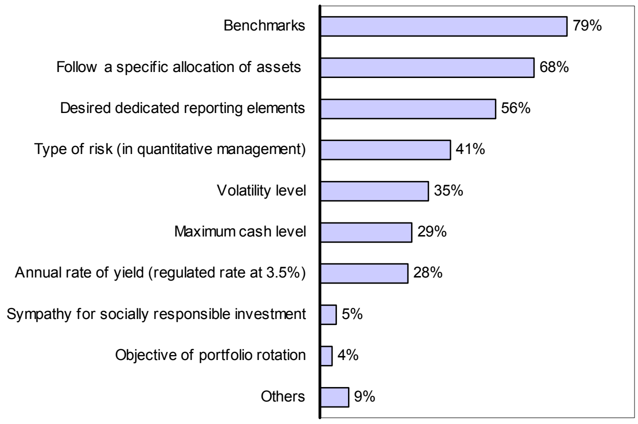
The second most frequently mentioned constraint is to Follow a specific allocation of assets (68%), followed by Desired dedicated reporting elements (56%). The Type of risk (in quantitative management) is used by 41%. The respondents impose on their managers an average of between 3 and 4 of the constraints on our list.

> *"The respondents impose on their managers an average of between 3 and 4 of the constraints on our list."*

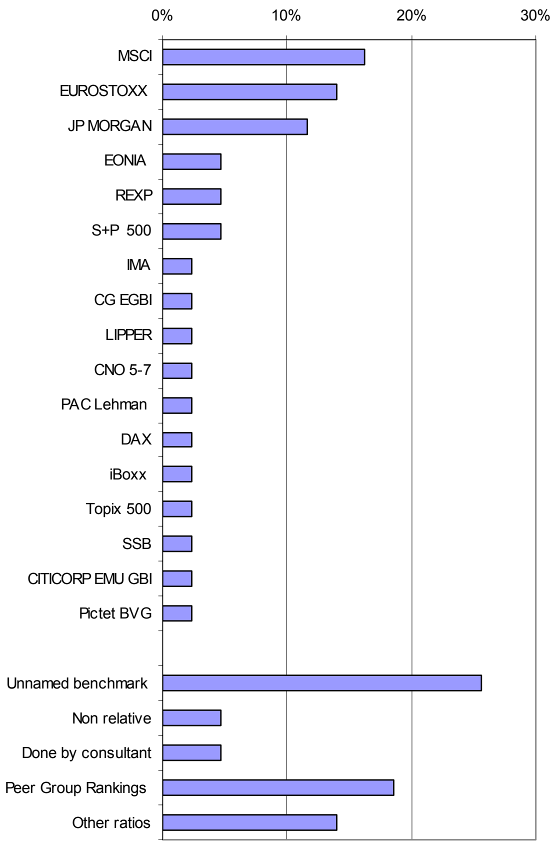
The benchmarks that they use when evaluating the performance of managers are varied. We were supplied with a list of 22 them, reproduced as Figure 18.4.

The most frequently mentioned was the MSCI, by 16%. followed by the Eurostoxx indices, and various of the JPMorgan benchmarks, including its EMU and Government Bond Indices. Another 14 indices were mentioned. Others did not name their benchmark, or said they used peer group rankings.

18.3 Types of constraints given to managers
% of those applying constraints (73)



18.4 Benchmarks used to evaluate managers
% of respondents to question (43)



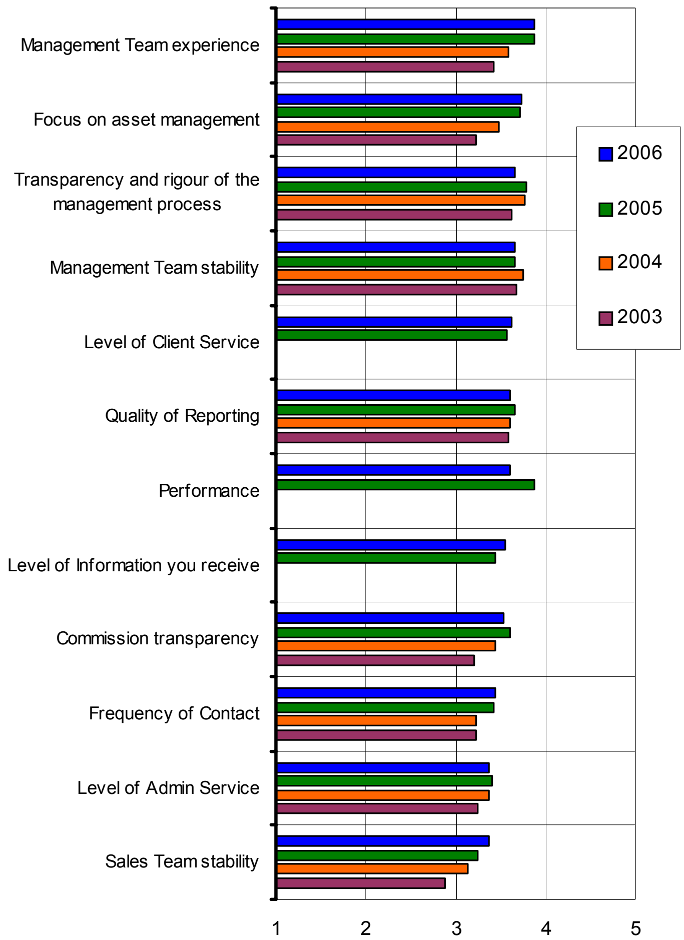
Managers are delivering excellent team experience, and improving their performance, but delivery does not always match needs.

The feature of external managers which is rated the most highly by institutions in this survey is Management Team Experience, as last year. Also judged to be high quality aspects of external managers business was their focus on asset management, and the transparency and rigour of their management processes. Sales Team stability, or lack of it, was judged their least impressive aspect. In the past year the quality of external managers has shown an improvement in Performance and in Quality of Reporting, which continue to get better. Overall, there are confusing signals here about Performance - it is not an area of excellence, but it is improving. By comparing what we have discovered about the needs of institutions to what we have been told here about what they are being delivered, it seems there are several gaps - institutions are not always getting what they want.

The quality of current External Managers was scored by the respondents, and is shown as Figure 19.1. Management Team Experience was the feature which scored the highest, with an average of 3.9 (maximum was 5), the same score it achieved last year. The focus on asset management of their external managers was said by respondents to be a high quality feature, and this scored second highest. The transparency and rigour of the management process scored third, but at a lower score than last year, possibly a warning that this could improve. Management team stability has also slightly declined according to our respondents.

There are confusing signals about Performance, which as we have noted in section 19, is a key criteria for starting, and then terminating relationships with managers. Here performance is said on the one hand to be a feature of external firms that is not impressive (Figure 19.1), but on the other hand it is improving (Figure 19.2).

19.1 **Assessment of qualities of current External Managers**
Score: 1= Very low quality, 5= Very high quality *(80)*



"There are confusing signals about Performance"

The lowest quality features of external managers are their Commission transparency, Frequency of Contact, Level of Admin Service, and worst of all, their Sales Team stability, or lack of it. However, this does appear to be achieving an improved quality score each year.

In the past year the quality of External Managers has shown an improvement in Performance and in Quality of Reporting, as shown in Figure 19.2. Improvement is shown by positive scores, and decline by negative.

Both Performance and Quality of Reporting had improved in 2005 as well this year, and in the case of Quality of Reporting, where we have collected this data on this heading for longer, there has been improvement every year since 2003. This can also be said about Transparency of the Management Process.

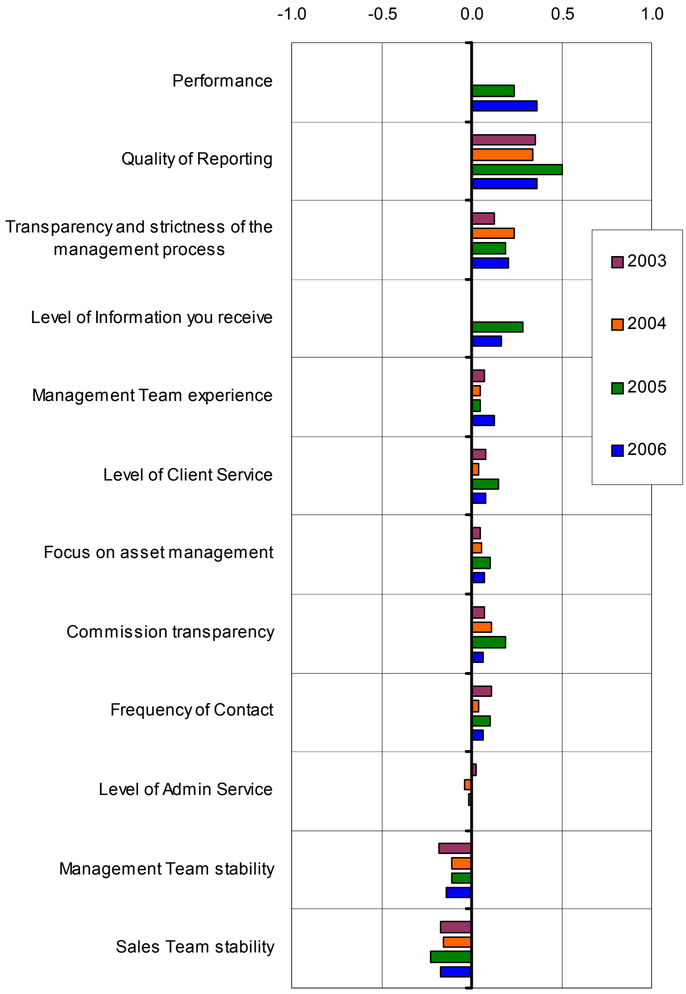
"The lowest quality feature of external managers is their Sales Team Stability"

Many categories are in danger of falling into decline, such as Level of Client service, and Frequency of contact. There has been consistent lack of improvement in Management and Sales team stability, based on this measure.

Communication is vital to many institutions. Several in conversations with us mentioned the word transparency, which usually meant that they wanted to trust their managers to tell them everything, good and bad. Continuity is also important in this context, and several institutions told us they wanted to deal with the same person on a long term basis. When describing the forms of communication they wanted to receive, one institution told us that they did not want to put pressure on the managers with incessant demands. "We don't want to put pressure on managers, they need to be relaxed enough to deliver, but deliver they must!"

19.2 **Assessment of Improvements in past year in quality of current External Managers**

Score: 1= improvement, 0= neutral, -1=decline (78)



By comparing what we have discovered about the needs of institutions to what we have been told here about what they are being delivered, it seems there are several gaps - institutions are not always getting what they want.

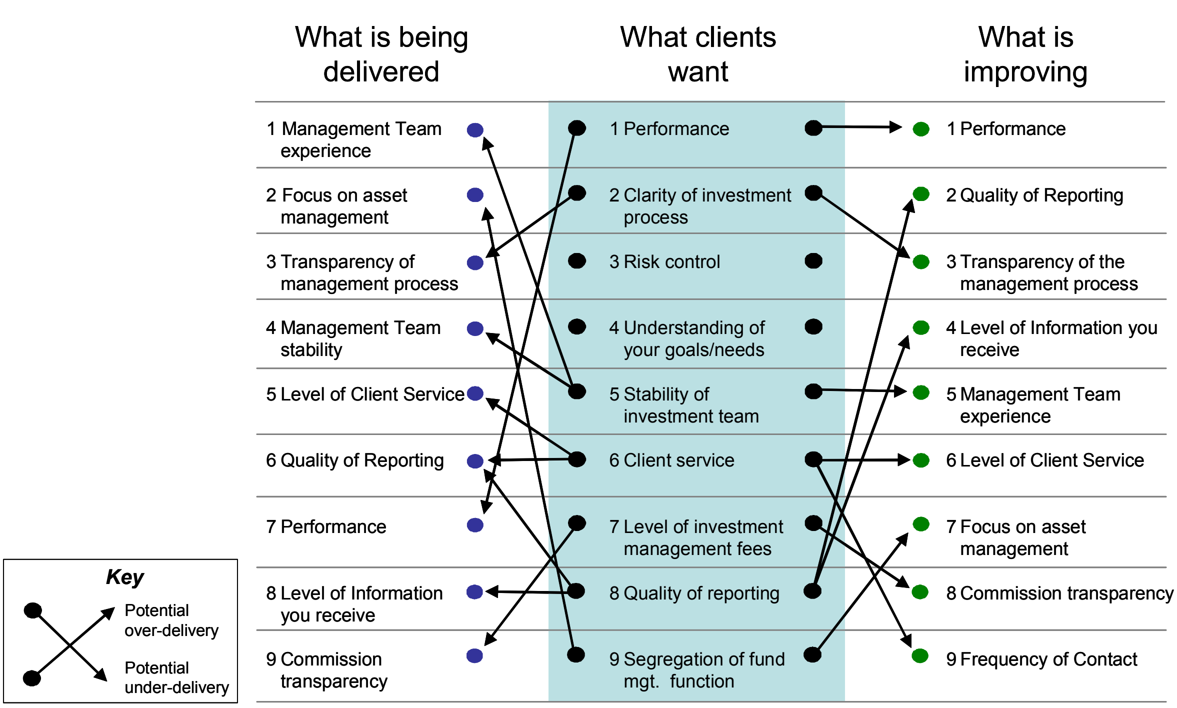
In this and a previous section we have collected three sets of perspectives from respondents to this survey. We have their criteria when selecting an external investment manager (Figure 16.1), their assessment of qualities of current external managers (Figure 19.1), and their assessment of Improvements in past year in quality of current external managers (Figure 19.2). We can translate these as 'What Clients want', 'What is being delivered', and 'What is improving', respectively.

We have mapped these three sets of perspectives against each other in Figure 19.3, to show where the needs of institutional investors are being met by the delivery or potential delivery (i.e. improvements) of the managers. If a feature ranks high on the list of institutions' needs, then in theory this feature should also be found high in the list of what it is delivering well now, or seeking to deliver well in future.

In the event that specific features are lower or higher on one list than another, this implies that managers are either over-delivering (i.e. being good at something that is not needed), or under- delivering (i.e. not being good at something that is needed). This map can only be an approximation, an indicator.

What it indicates is that managers are significantly over- and under-delivering in certain key areas. For example managers are delivering and improving in the area of quality of reporting, but this is not a vital area of need. And it is possible that managers are not addressing two of the needs that were mentioned: high skill in risk control, and understanding clients goals/needs.

19.3 **Reconciliation of institutional needs with manager delivery**



There may be signs of stable or even increased client loyalty

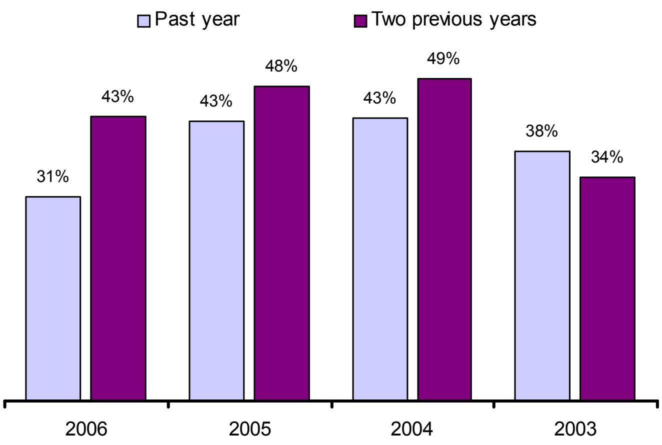
There were an average of one relationship terminated in the past year by each respondent, and nearly two in the previous two years. But there may be stable or even increased client loyalty shown by our respondents - those in this survey appear to be less likely to break relationships than was the case in any of our surveys since 2003. Pension funds and insurance companies are the most likely to have broken relationships, while German institutions stand out as the most loyal clients. When looking at reasons why relationships are broken, it seems that the importance of performance is common to most respondents, but any attempt to generalise about other factors may be unwise.

In 2006 31% of respondents told us they had broken a relationship with at least one manager in the past year, and the equivalent figures for both 2005 and 2004 was 43%, as shown in Figure 20.1.

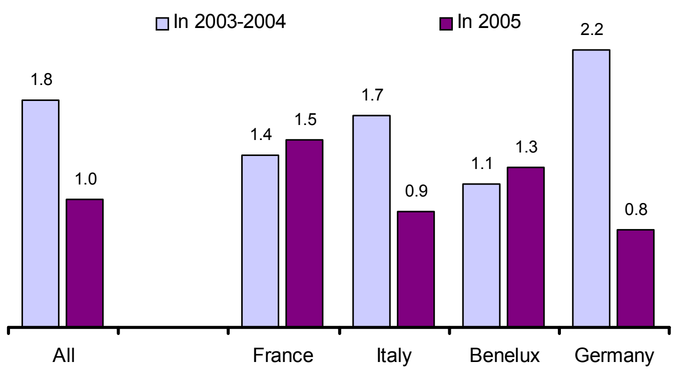
Each year we have asked respondents to tell us whether they have terminated a relationship with an external investment manager, both in the past year and in the previous two years. Looking back in time to the previous two years, institutions told us in both the 2004 and 2005 surveys that they were more likely than in 2006 to have broken relationships in the past. Only in 2003 have we recorded greater stability in manager/institution relationships.

For the first time we have captured the number of relationships that have been terminated by respondents to our survey. There was on average one relationship terminated in the past year by each respondent, and nearly two in the previous two years. This varies by country as shown in Figure 20.2. German respondents have each broken fewer relationships in the past year than others (average 0.8 relationships), but they have broken more in previous two years (average 2.2).

20.1 Relationships with a Manager terminated 2003-2006
% of all respondents

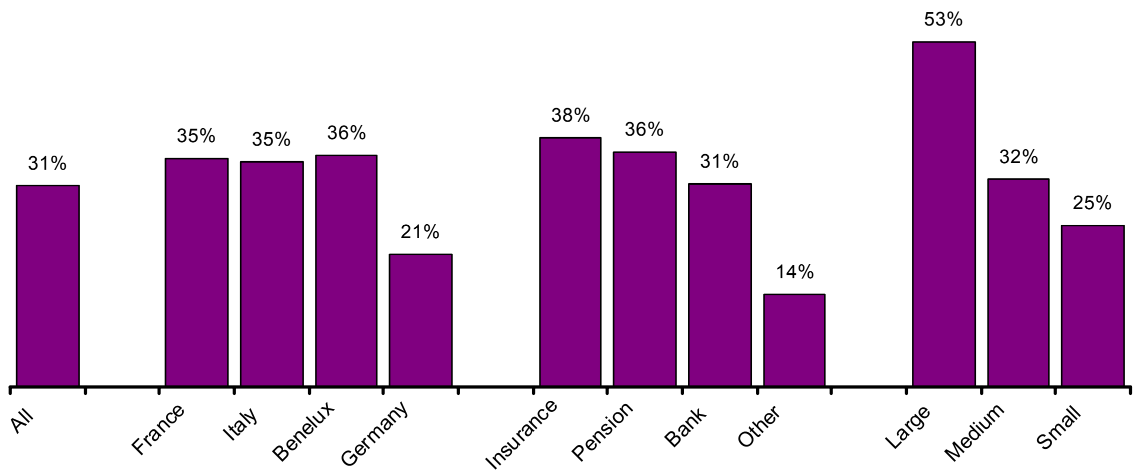


20.2 Relationships with a Manager terminated this year and in previous two years
Average number of relationships (48 respondents)



"Only in 2003 have we recorded greater stability in manager/institution relationships."

20.3 **Relationships with a Manager terminated in the past year, by county, sector and size category**
% of all respondents



This year we have found that Pension funds and Insurance companies are the most likely to have broken relationships, as is shown in Figure 20.3, while last year it was pension funds alone that stood out for the frequency of terminations. As we saw last year, it is clear that the larger firms have broken more relationships in the past year than smaller ones. German institutions stands out as the most loyal clients on this measure.

"Pension funds and Insurance companies are the most likely to have broken relationships"

We asked the respondents to tell us what played a role in their decision to break a relationship with an external manager. We were told that the four important factors were, unsatisfactory performance, lack of clarity in fund management policy, deviation from investment constraints or mandate, and inadequate reporting/contact.

There are differences to the scores we were given last year, as shown in Figure 20.4. Only one factor has changed significantly: excessive turnover of portfolio managers, which was the second most mentioned factor in 2005, is now the 8th most mentioned.

Of the four most frequently mentioned factors this year, overwhelmingly the most important was the first, unsatisfactory performance. All types of respondent, ranked this as their first or second most important factor, as can be seen in figure 20.5. But after this there is a wide diversity in the responses given, by country, sector and size category.

As last year, insurance companies were the only sector to see *level of costs* as a top 5 relationship breaking issue. But there is also wide variations in the 2005 and 2006 responses, which tends to suggest that there are few patterns in this area apart from the importance of performance, and that any attempt to generalise may be unwise.

20.4 Factors which play a role in the decision to remove an External Manager 2005-2006
Degree of importance (Ranking) *(48)*

	2006	2005
Unsatisfactory Performance	1	1
Lack of clarity in fund management policy	2	3
Deviation from Investment Constraints or mandate	3	4
Inadequate reporting/contact	4	5
Reorganisation of Investment Manager's group	5	8
Failure to control risk	6	11
Change of investment strategy or asset re-allocation	7	6
Excessive Turnover of Portfolio Manager	8	2
Excessive Turnover of Contact personnel	9	10
Level of Costs	10	7
Inability of Investment Manager to advise on investment strategy or asset allocation	11	9
Lack of clarity in portfolio related investment guideleines	12	0
Internal reorganisation of your group	13	12

20.5 Factors which play a role in the decision to remove an External Manager, by country, sector and size category
Degree of importance (Ranking) *(48)*

		By Country				By Sector				By Size of Institution		
	All	France	Italy	Benelux	Germany	Insurance Companies	Pension Funds	Banks	Other	Large	Medium	Small
Unsatisfactory Performance	1	1	1	1	8	1	1	2	1	1	2	1
Lack of clarity in fund management policy	2	2	5	2	9	3	2	8	5	2	3	5
Deviation from Investment Constraints or mandate	3	4	3	6	12	2	4	4	13	4	1	12
Inadequate reporting/contact	4	12	6	7	7	8	8	9	2	8	7	4
Reorganisation of Investment Manager's group	5	3	9	9	4	6	7	1	12	7	5	6
Failure to control risk	6	9	10	10	1	13	9	5	3	12	10	2
Change of investment strategy or asset re-allocation	7	10	4	4	3	11	6	3	7	13	8	3
Excessive Turnover of Portfolio Manager	8	8	7	3	10	10	3	13	4	5	4	7
Excessive Turnover of Contact personnel	9	5	12	5	6	4	5	10	8	3	9	10
Level of Costs	10	7	11	12	5	5	10	7	11	6	11	11
Inability of Investment Manager to advise on investment strategy or asset allocation	11	6	8	13	11	9	11	11	6	9	13	8
Lack of clarity in portfolio related investment guideleines	12	13	13	11	2	12	12	6	9	10	12	9
Internal reorganisation of your group	13	11	2	8	13	7	13	12	10	11	6	13

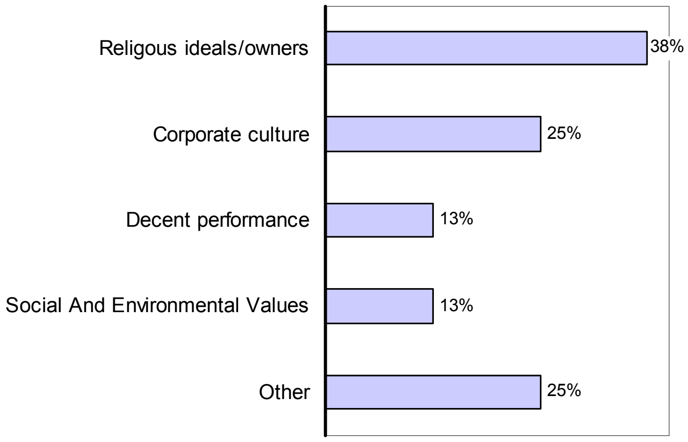
Socially Responsible Investing is often driven by moral corporate cultures

Socially Responsible Investing is done by one in 20 of our sample, mainly those whose corporate culture was morally driven in some way, as one might expect. Insurance companies in our survey do not do it at all.

We have explored the area of Socially Responsible investment for the first time this year. 9% of the respondents use this form of investment. These were a mixture of Pension funds, banks and other types of institutions (including foundations). There are no users of Socially Responsible investment in our survey among the insurance companies.

When they do use them, users told us they like of Socially Responsible investment because it corresponds to their religious ideals or ownership structure, as shown in Figure 21.1. A similar reason was that it fitted their corporate culture - this was a reason given by foundations for example. The social and environmental values were also mentioned, and one respondent also said that it selected Socially Responsible investments when they offered decent performance. These findings are based on small samples and should be treated with caution.

21.1 **Reasons for usage of Socially Responsible Investments**
% of users of Socially Responsible Investments (8)



"There are no users of Socially Responsible investment in our survey among the insurance companies."

Again, few have voting policies
As last year, very few institutions in our survey have defined voting policies, although the number may have increased from last year.

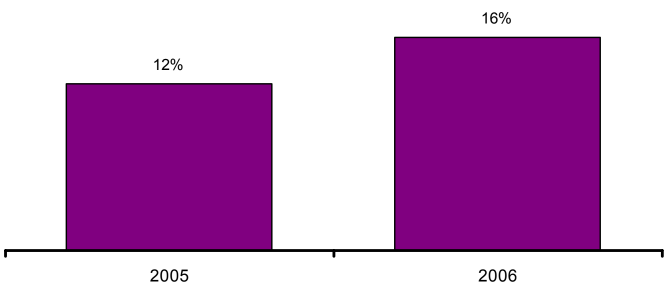
Defined voting policies are absent at 84% of the respondents to this year's survey, a similar number to last year, as is shown in Figure 21.2.

The least likely to have a voting policy are French institutions, of which three in ten had no such policy, as shown in Figure 21.3.

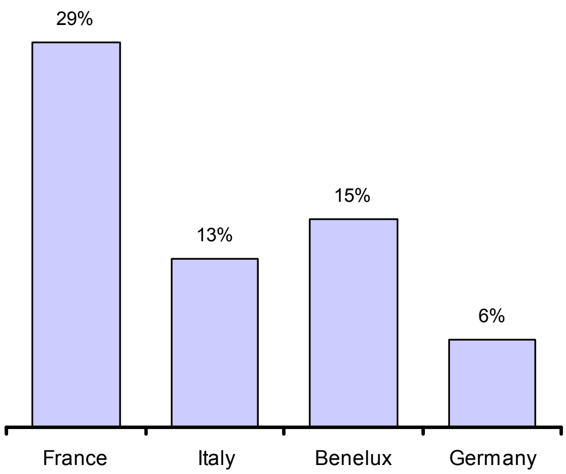
"Defined voting policies are absent at 84% of the respondents"

Last year we identified that large firms were more likely to have voting policies than others, but this year there is little difference in voting policy between different sized firms.

21.2 **Frequency of voting policies 2005-2006**
% of all respondents



21.3 **Frequency of voting policies by country**
% of all respondents



Securities lending is mostly allowed against equities

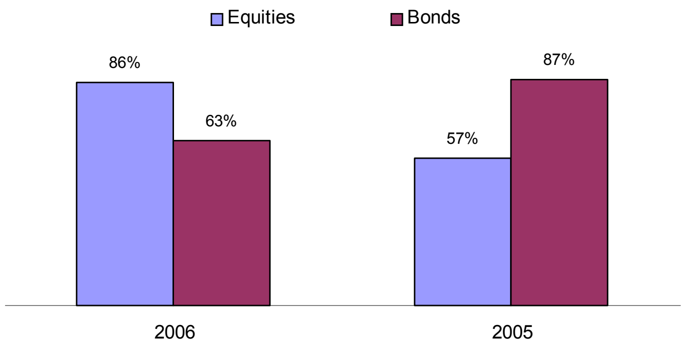
Securities lending is mostly allowed against equities, we were told this year, in a reverse of what we heard last year. This may represent a shift in the way securities lending is being carried out, but this finding relies on a small sample and should be treated with caution.

19% of the respondents told us they did securities lending in 2006. More lent against fixed income securities than equity. Equity limits were either 50% or 100%, and averaged 86%.

Fixed income limits ranged from 5% to 100%, with the median being 50%, but the most frequent limit used is 100%.

The average for fixed in come securities is 63%. These are shown in Figure 21.4. They are in contrast to our observations in 2005, when we saw almost the opposite measures, with restrictions being greater on equity than on bonds.

21.4 **Asset classes used for securities lending 2005-2006**
% of respondents to question *(17)*



"19% of the respondents told us they did securities lending in 2006."

The sample was spread well

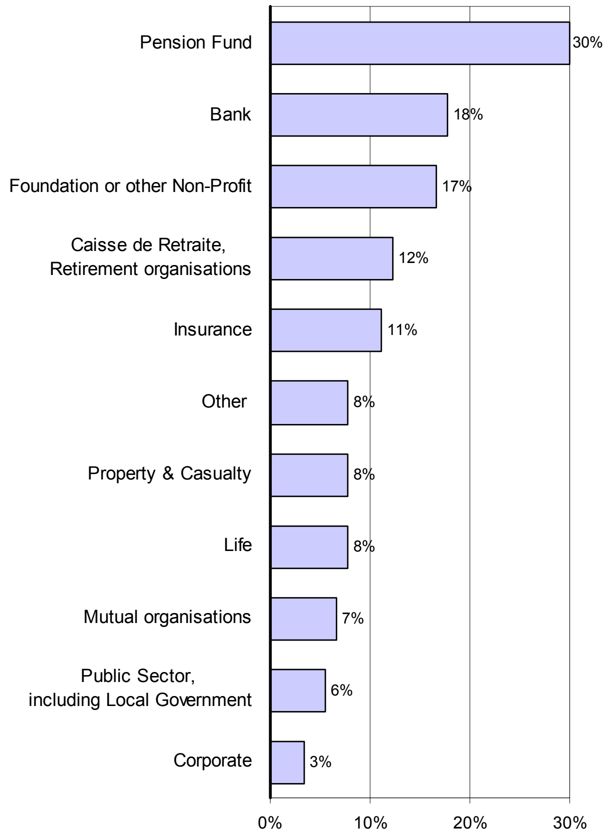
There were 90 financial institutions, mainly from France Germany and Italy, Belgium and the Netherlands that acted as respondents to this survey. They are insurance companies and Pension funds, banks and other types of institutional investor. In total the respondents had Investment Assets of €311bn, or an average of approximately €3.5bn per respondent and a median of €0.7bn. The survey was conducted between May and August 2006.

The intention was to identify and interview a cross section of different types, country and size of institutions in a way that was comparable to the five previous annual surveys in this series. However, the sample should not be taken as being an accurate representation of the market as a whole.

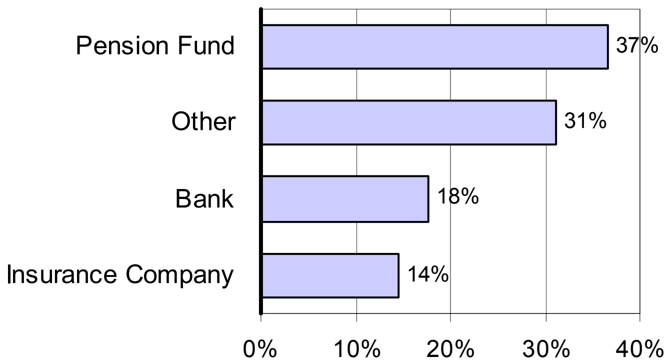
17 of the respondents came from France, 34 from Germany, 23 from Italy, and 14 from Belgium and The Netherlands ('Benelux') as shown in figure 22.3. We also had two respondents from Switzerland who contributed to the findings in all respects except when analysed by country. The French sample size is significantly smaller than in 2005, so we have borne this in mind when making comparisons between years.

The respondents came from a range of sectors as shown in figure 22.1. Many institutions described themselves as being more than one type, some being several. We have summarised the sample by type of institution in various places in the study. Where an institution was more than one type, we have assessed its likely predominant type in order to assign it to one group. As shown in Figure 24.2 we have grouped them as Pension Funds (33 of the 90 in the sample), Banks (16), Insurance Companies (13) and 'Others' (28). This last category included foundations, charities, corporations and local governments. Last year we grouped Banks into Others, but have separated them out this year.

22.1 **Sample by type of institution**
% of all respondents, two or more categories could be chosen



22.2 **Sample by sector category**
% of all respondents



22.3 Sample AuM and numbers of respondents

	All[1]	France	Italy	Benelux	Germany	Insurance	Pension	Bank	Other	Large[2]	Medium	Small[3]
Respondents	90	17	23	14	34	13	33	16	28	12	21	55
Total Investment Assets (€bn)	311	92	76	32	110	154	46	40	70	250	46	15
% of Total Investment Assets	100%	30%	24%	10%	35%	50%	15%	13%	23%	80%	15%	5%
Avge AuM (€bn)	3.5	5.4	3.3	2.3	3.2	11.9	1.4	2.5	2.5	16.7	1.8	0.3
Median AuM (€bn)	0.7	0.6	0.9	0.3	1.0							

[1] *Also includes respondents from Switzerland* [2] *>€5bn* [3] *<€1bn*

In various places in the study we have categorised the institutions by size. We did this using their total investment assets. Those with less than €1bn were classed as small (55 of the 90 in the sample), those with more than €5bn were large (12) , and remainder were medium (21).

When looking at analysis by sector and by country, it should be borne in mind that a high proportion of Benelux respondents were Pension Funds, and a high proportion were also small institutions. This makes it difficult to rely on findings for that country. In other respects, there was a satisfactory spread of respondents by country, sector and size categories.

> *"There was a satisfactory spread of respondents by country, sector and size categories."*

Where there are averages or totals shown, these are all simple averages. We have not weighted the responses in any way, (i.e. the responses of a small institution are given as much weight as those of a large one.). However we have shown results by size category, which ensures that the behaviour of large and small institutions can be properly compared.

The number of respondents who contributed to the data in each chart is shown in the title bar of each. Where it refers to 'all respondents' this means all 90 of those who took part in the survey.

This is the seventh edition of EIAMS. One must be careful in comparing the outputs of surveys from different years because however hard one may try to make them similar in structure they inevitably have different samples. We have not ignored this risk, but have chosen to make comparisons from year to year only when we feel that this risk is acceptable, or where our use of language is carefully geared to making this risk clear.