INVESTMENT
& PENSIONS
EUROPE

IPE European Institutional Asset Management Survey 2010

Research supported by Invesco

Contents

FOREWORD

This is the tenth edition of the European Institutional Asset Management Survey (EIAMS). It is with pride and a certain amount of self-congratulation that we at Invesco can say that we have sponsored this initiative throughout this period. It is the third year that we have partnered with Investment & Pensions Europe (IPE), which undertook the survey and analysed the results on an independent and confidential basis.

We believe that EIAMS is one of the most widely used survey 'windows' on what is happening within European institutional investment portfolios. There were almost 6,000 downloads of the 2009 survey over the past 12 months from the IPE.com website. Significantly, these downloads were well-spread throughout the year.

We expect much the same reaction to the survey this year, as things have not become any easier for those managing institutional portfolios. The 2010 survey results certainly pick up the drive to recovery and reversion to 'trend' by investors, as they rebalance their portfolios by reducing their cash holdings, outsourcing more and showing an increased appetite for alternatives, among other actions.

But at the same time, investors' appreciation of risk is at the same levels as during the crisis period covered in the previous survey. It is only since the survey closed to responses mid-April 2010, the full extent of the problems with government debt are hitting markets and investors' future decisions.

As in recent years, with access to IPE's database, we have had responses from 25 countries and a small increase in the number of investors responding overall. This year, the responses at the lower end of the scale have grown, among medium-sized funds (€1bn to €5bn in assets) and small-sized investors (under €1bn).

With 88% of respondents number coming from the medium and small categories, the survey focus is on those investors with assets under management of €5bn or under. These investors make up the bulk of the European pension community. As last year, pension funds are predominant in the sample, at 98%.

Around 60% of the previous year's respondents participated in this year's survey, which Invesco are very pleased with. Without knowing who the participants are, of course, we would like to thank very much all respondents to the questionnaire. Answering it can be challenging in some of the detail it seeks from investors.

With around 80% of the questions remaining unchanged from year to year, the survey has built up a unique perspective on the development of relationships of investors with their external managers, consultants and other providers, as well as the allocation of portfolios and the trends affecting this.

Our gratitude, as always, goes to the think-tank comprising the Association Française de la Gestion Financière (AFG) and NYSE Euronext for their extremely helpful input when putting the questionnaire together and at the stage of analysing the preliminary findings.

Lastly, we thank IPE for its work in collecting and analysing the EIAMS data and for promoting the survey on the IPE.com website.

As always, we welcome your feedback and would be delighted to hear from you as to how useful you found the results and any suggestions for improvements.

Yves Van Langenhove
Head of Institutional Sales, Invesco CE
June 2010

EIAMS Executive Summary

Survey parameters

This latest survey received responses from 121 investors from 25 countries, with total assets under management of €333bn. 60% of the previous year's respondents completed the survey. Over half the funds were small (under €1bn), 14 were large (over €5bn) and 38 were in between. The greatest number of responses again came from Benelux and Great Britain & Ireland with 30 and 23, respectively. With two or more categories to choose, almost 98% described themselves as pension funds, and 9% as insurers.

1. Investment objectives

Recession continues to influence thinking

Investment horizon remains at the forefront for internal assets, as damage limitation to portfolios stayed key. Relative performance still holds sway for external assets. Relative returns continue to be seen as more important than absolute returns, but now only marginally so for internal assets. Relative risk is again in second place for external assets, whilst absolute risk for internal assets has risen dramatically in importance.

2. Investment of assets

Green shoots of equities seen

Fixed income remains the safe haven of choice for investors, but equities and alternatives are showing signs of recovery as the drivers to rebuild portfolios. However, it is only the smaller funds leading the way here. The overall allocation to cash has halved. Any increase in equity holdings is seen as occurring most in home markets and outside Europe. All the alternatives are now much more attractive going forward with cash being the big loser.

3. Sources of absolute versus relative return

Hedge funds sprouting

Hedge funds have emerged from last year's frost to be seen once again as one of the main sources of absolute return. They are now joined, with cash at the top, by alternatives in general and real estate. Equity and fixed income, with all classes in third, are the main sources of relative return. For absolute returns, all sizes of investors have kept faith with fixed income and returned to alternatives, although the smaller investors, not unexpectedly, less so for real estate,

4. Alternatives

What a difference a year makes

Alternative portfolios have more than regained last year's retrenchment, so fulfilling the predictions made by investors in last year's survey, except for commodities which only grew sparingly from a low base. Strong growth is predicted for real estate, its overall share of portfolios having increased for the eighth year in succession, but strong growth is also anticipated for private equity, hedge funds and commodities. Real estate remains most popular with the Swiss, with Benelux now being displaced by the Italians.

5. ETFs and Indices

Back on track

ETFs showed a small recovery on the previous year, with Benelux and Nordic investors leading the way. The smaller funds have taken over as the largest users of ETFs. Fundamental indexes were by far the most popular type of index used, and by more than twice the use of market cap modified in second place. Open-ended mutual funds were the most favoured technique to gain index exposure, displacing futures from last year's first position.

6. Duration & LDI

The gap narrows

While the overall duration gap remains unchanged, the average for both fixed income duration and actual liabilities shortened by almost 11 months. Except for the French, where the gap doubled, all other countries and regions saw a significant narrowing. LDI strategies were the most popular, being used by over half of investors.

7. Performance attribution

Down but not out

Use of performance attribution has fallen back slightly but remains at a very high level. Investment managers continue to dominate and have increased their market share, together with custodians and external performance analysts, mainly at the expense of internal departments and investment consultants.

8. Consultants

One man's meat

Use of consultants has reduced, but remains at over 50%. The French, converts to the cause last year, have fallen dramatically by the wayside, and the Italians have also shown a big fall in usage. Conversely, the British & Irish have resumed their position as the most committed users. Medium funds are now the largest users of consultants, with much reduced involvement by both the larger and smaller funds. Investment advice remains the prime reason for their employment.

9. External managers: usage

Normal service resumed

External managers more than recovered the ground lost last year, the increased take-up coming from the larger and smaller funds, with just the medium funds showing a small decline. Most countries moved further towards external managers, with some retrenchment being shown only by Benelux and France.

10. External managers: asset allocation

Equities gain ground

There has been a small decline in the switch of fixed income assets to external managers so that it now only marginally exceeds the total for equities. Benelux, GB & Ireland and Switzerland delegate the most fixed income and equity. The larger funds have reverted to preferring external managers, but it is the medium and smaller funds that remain the biggest users, with the latter now narrowly the biggest users.

11. External managers: selection criteria

Keep making it clear

Clarity of investment process remains most in demand, followed by performance and risk control, all having shared the top three places for the last six years. More conformity was in evidence on a country basis, although the Germans were more influenced by transparency of fees than performance, and the French valued client service very highly.

12. External managers: fees

The gap shrinks

The ideal of fixed fees has grown substantially for both fixed income and balanced funds, while the clear preference for equities and real estate was for a combination of fixed and performance-related fees. However, the gap between current and ideal has shrunk, mostly for balanced and fixed income. Medium funds have now replaced the smaller funds as being keenest on performance-related fees.

13. External managers: constraints

Recession cuts restrictions

The constraints most in demand are again benchmarks, tracking error and following a specific allocation of assets. Fewer constraints were rated but the fact that compliance with SRI/ESG guidelines moved up to fifth place, followed by a new question on adherence to UNPRI, suggest that responsible investment may be taking on more importance.

14. External managers: breaking relationships

For better, for worse

Reported dismissals were the lowest for at least five years, perhaps reflecting the need for stability during difficult times. The French and Italians were the most loyal, with the British & Irish taking the most scalps. Medium funds, followed closely by the larger funds, have again broken the most relationships. The three most critical factors triggering a dismissal remain failures in performance, risk control and clarity, the latter replacing investment strategy or asset re-allocation. However, for both the Swiss and CEE, strategy or asset allocation and cost competition played a much more decisive role.

15. Other findings: SRI/ESG/Securities lending

SRI/ESG: Green agenda hangs on

Social and environmental values, owners' beliefs and corporate culture were again the main drivers behind the pursuit of SRI/ESG strategies. However, all three indicated declining interest, compared with the previous year, possibly due to the emergence of governance, an option included for the first time, which was supported by one-third of respondents. Corporate governance strategies remain the most popular, but slightly less so than last year; a pattern followed by all other written policies except engagement strategy, which witnessed a sharp decline.

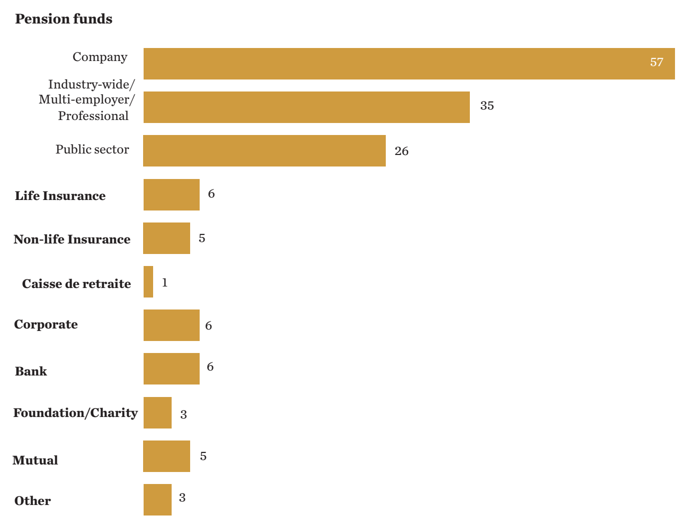
Securities lending: in free-fall

The continuing repercussions of the ban on financial stock shorting, together with counter-party risk, have meant that both equities and bonds used for securities lending fell by about one half of the previous year's already reduced position.

1. Our Respondents

1.1 Respondents by type of institution

% of respondents (total 121). Two or more categories could be chosen



Numbers participating increase

The European Institutional Asset Management Survey again saw a small rise in responses this year, with 121 completions compared with 117 in 2008 and 115 in 2007. These responses came from a total of 25 countries, which is one more than last year. The proportion of the previous year's respondents again completing the survey was a great improvement on last year, increasing to 60% from 38%.

This year's questionnaire was modified in places to improve ease of completion, while still retaining the core features of the survey to enable good comparison with earlier surveys.

The Nordic region (Denmark, Finland, Iceland, Norway and Sweden) produced 18 respondents, 10 more than last year and the largest increase of any country or region in comparative terms. Benelux (Belgium and The Netherlands) accounted for 30 respondents, 23 came from Great Britain and Ireland, 11 from Central and Eastern Europe (Croatia, Czech Republic, Estonia, Latvia, Lithuania and Romania), eight from Switzerland, and seven each from France, Germany and Italy.

There were also respondents from Austria (2), Cyprus (1), Greece (1), Liechtenstein (1), Portugal (2) and Spain (3). As last year, these countries did not have enough respondents to be meaningfully listed in the country breakdowns, but the respondents' data was taken into account in all other areas of the survey.

The asset figures reported relate to 30 June 2009, the survey having been undertaken between January and April 2010.

Although there was an increase in the overall number of survey respondents, the total value of assets fell by 30% from €477bn to €333bn, in part attributable to the decline in asset values. This also meant the average size of respondent was down to €2.8bn (€4.1bn in the previous survey).

Respondents with assets under management of more than €5bn are considered to be large (14 of the 121 respondents), those with €1-5bn are classified as medium (38) and those with less than €1bn as small (69). Therefore, although the average respondent asset size falls within the medium class, the vast majority of respondents are from the small category. Numbers of respondents by size followed a similar pattern to last year in that small funds comprise the most and large funds the least. However, small funds have increased from 58 last year and large funds have decreased from 21.

Pension funds again make up the large majority of respondents. The split by different pension fund types corresponds with last year, except for Caisse de Retraite that has decreased significantly. Other levels of respondent type are similar to last year, and made up of insurance companies, banks, corporates, foundations and charities, and mutual businesses.

Where a 'zero' is shown in some charts, this indicates either that no respondent answered the question, or did actually indicate a 'zero'; this of course will reflect, in the case of some countries, the small sample size.

Key takeaways

- **responses from 121 institutions across Europe**
- **they are pension funds, insurance companies and other types of institutional investor**
- **respondents had total investment assets of €333bn, or an average of some €2.8bn, less than two-thirds of the previous year's total**
- **30 of the respondents came from Belgium and The Netherlands (Benelux), 11 from Central & Eastern Europe, 7 from France, 23 from GB & Ireland, 7 from Germany, 7 from Italy, 18 from Nordic countries, and 8 from Switzerland**
- **we also had respondents from other countries who contributed to the findings in all respects except when analysed by country**

1.2 Breakdown of respondents

	All	Benelux	CEE	France	GB & Ireland	Germany	Italy	Nordic	Switzerland	Large	Medium	Small
Respondents	121	30	11	7	23	7	7	18	8	14	38	69
Total invested assets (€bn)	333	144	6	26	53	13	7	47	23	230	75	27
% of total invested assets	100	43	2	8	16	4	2	14	7	69	23	8
Average AuM (€bn)	2.77	4.98	0.54	3.78	2.29	1.40	0.99	2.59	2.92	16.45	1.98	0.40

2. Investment objectives

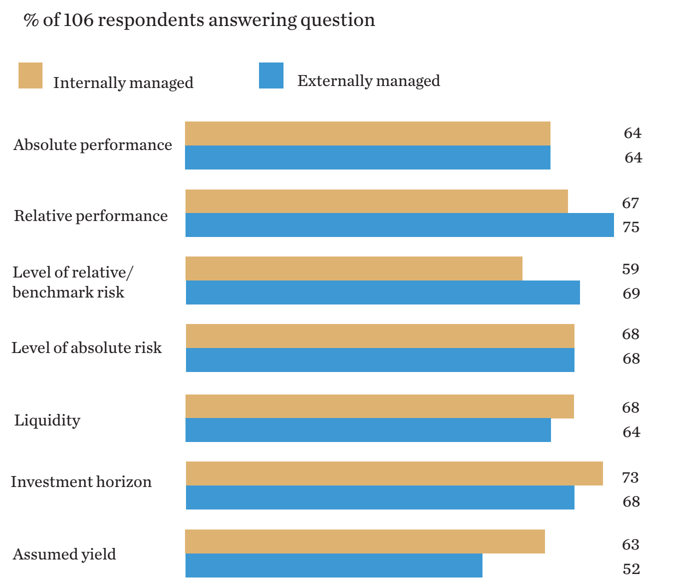
Nobody is relaxing yet

One year further into the aftermath of the financial crisis and we are continuing to see its impact. Last year investment horizon still dominated as the prime objective of our investors for internal assets and with risk objectives being pushed even further to the fore. For external assets, relative performance is still the first objective. But the differences as to how investors rank their objectives vary with the size of investors and their country or region.

Investment horizon has remained in pole position as the most important investment objective for institutions managing their internal assets. In last year's survey, it jumped to being the major consideration from fifth position the year before, marking a considerable shift in investors' preoccupations.

Absolute return had been their main objective until the 2009 survey when it was ranked sixth and this year there has been a slight move upwards to fifth position. Probably little has occurred in the intervening 12 months to make investors adjust their priorities here.

2.1 Most important investment objectives



Key takeaways

- investment horizon again most important objective internally, with its perceived importance significantly up on the previous findings
- pattern continues whereby relative performance seen as more important than absolute, and particularly so for externally managed funds
- for externally managed portfolios, relative performance and relative risk again ranked in first and second places, respectively, but now much more daylight between the two compared with last year
- 'assumed yield' again marked very low
- 'liquidity' continues to climb up the rankings

2.2 Most important investment objectives 2008-2009

Ranking: 1 = highest Objective	2009 (08) Internal assets	2009 (08) External assets
Investment horizon	1 (1)	3= (5)
Liquidity	2= (4)	5= (6)
Level of absolute risk	2= (5)	3= (3)
Relative performance	4 (2)	1= (1)
Absolute performance	5 (6)	5= (4)
Assumed yield	6 (6)	7 (7)
Level of relative/ benchmark risk	7 (3)	2 (2)

Investors' ranking of investment horizon as the prime aim for funds directly under their own control was commented on last year as being of seismic proportions. At the same time it can be seen as a comprehensible reaction to what has been happening in financial markets when they responded at the end of 2008 or early in 2009. The investment horizon has to be the cornerstone when rebuilding internal portfolios.

In the current survey results, investment horizon is ranked more important for externally managed portfolios than in the previous year, coming in third place as against fifth. With external portfolios usually being managed within a time frame of an agreed period of years, relative performance against the stipulated benchmark still ranks as the prime objective of investors when consigning assets to third parties for management.

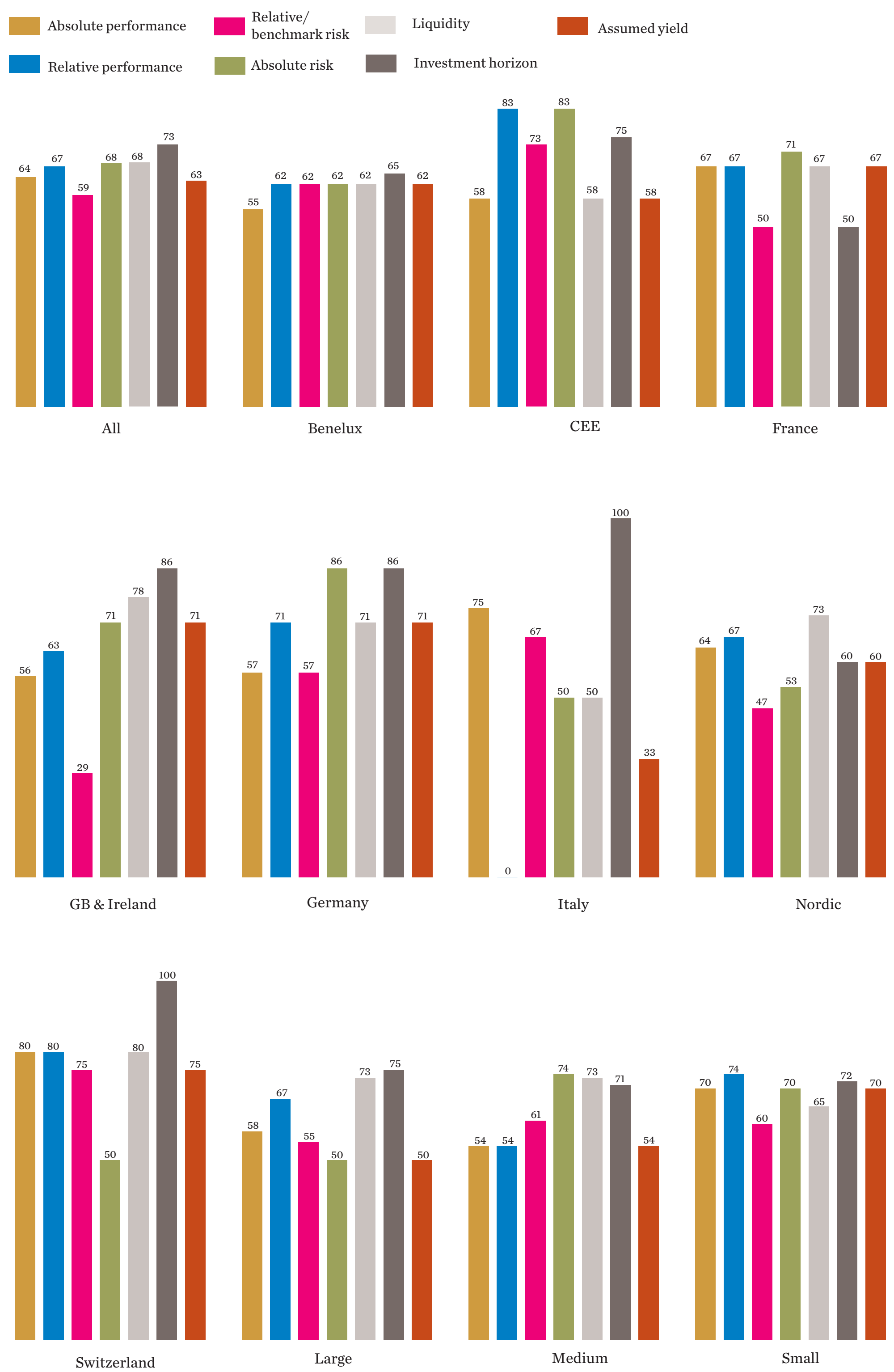
For internal portfolios, this year relative performance is down the list of objectives – in fourth place from second in the two previous surveys. Absolute performance languishes pretty well down the list of investors' priorities, in fifth place for both internal and external portfolios, probably still reflecting the bloodbath experienced by those assets which were used in expectations of achieving absolute returns.

With absolute risk and liquidity both ranked equal second in importance by institutions for their internally managed assets, the picture comes across of portfolios being managed very cautiously indeed, by close control of their risk exposures and tight management of their liquidity positions. For external portfolios a sharp eye is being kept on risk too, with the relative level of risk being deemed the second, and absolute the third, most important objectives. Nobody is relaxing quite yet.

But where investors are more relaxed is perhaps where they might be expected to be so. The degree of relative risk within internal assets is their least most important consideration, while liquidity within externally managed portfolios is regarded as being well down the list of priorities – that's the external managers' problem!

2.3 Important objectives for internally managed assets by country and size

% of 82 respondents



Key takeaways

- investment horizon is still the internal objective that matters most, and now by a much greater margin, except in France and Nordic countries where it is of much less importance
- absolute risk and liquidity are now key, although absolute performance appears to be re-emerging from last year's doldrums
- absolute risk and relative performance are now broadly most important, except in Italy where relative risk and absolute performance are reported as most prized
- less commonality this year between sizes of investor, with large leaning towards liquidity and relative performance, medium favouring absolute risk and liquidity, and small demanding first relative performance and then both absolute performance and absolute risk in equal measure
- last year, investment horizon mattered most to all sizes, but that now applies only to large funds, with medium and small funds now leaning most towards absolute risk and relative performance, respectively
- again, assumed yield matters much more to the smaller funds, but so too now does relative performance

For the large funds, investment horizon is the clear topmost objective for internally managed assets. But it has moved down from first to third place for medium-sized funds, coming after absolute risk and liquidity, and is now ranked second by the small funds, coming after relative performance, whereas previously it was in first place.

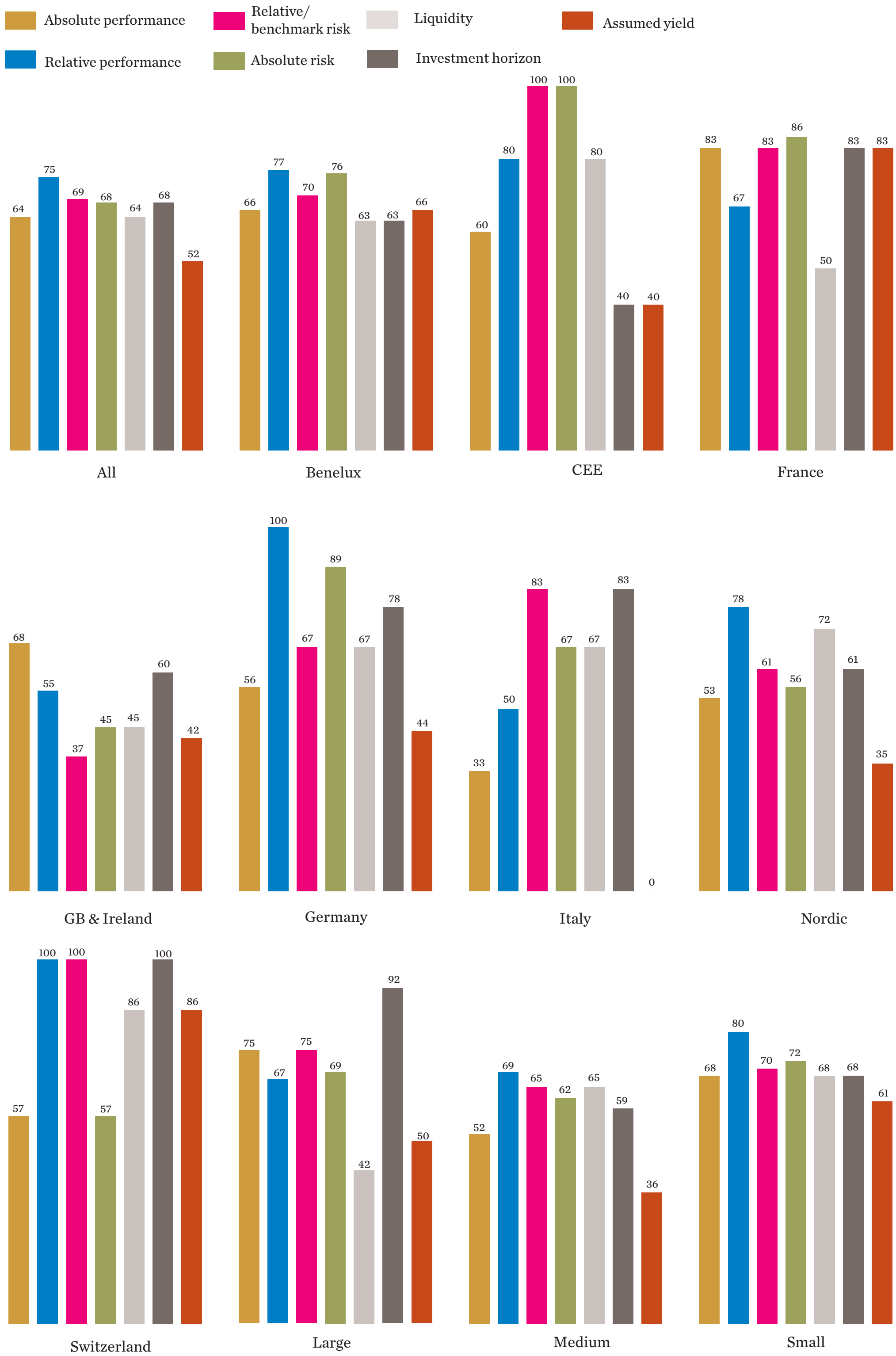
On a country/region basis, there is a range of responses, with Great Britain and Ireland, Germany, Italy and Switzerland seeing investment horizon clearly as their prime objective. While the Benelux countries still rank this as first, the emphasis is not so pronounced. For French investors, managing absolute risk is their key objective, while investment horizon is relegated to least important, sharing the same ranking as relative risk.

When it comes to externally managed portfolios, investment horizon still dominates in the case of large funds, with relative performance, the first objective for 'all funds', being put well down their priority list. As medium and small-sized funds are likely to have a higher proportion of their asset management outsourced, having relative performance as their key objective is understandable.

This is very much the case for investors in Benelux, Germany, Nordic countries and Switzerland, while those in Great Britain and Ireland are now focused on absolute performance and investment horizons as the key objectives, perhaps indicating a more structured approach to their portfolios and their resulting expectations from external managers. Investors in the CEE countries have risk as their priorities when externalising assets.

2.4 Important objectives for externally managed assets by country and size

% of 106 respondents

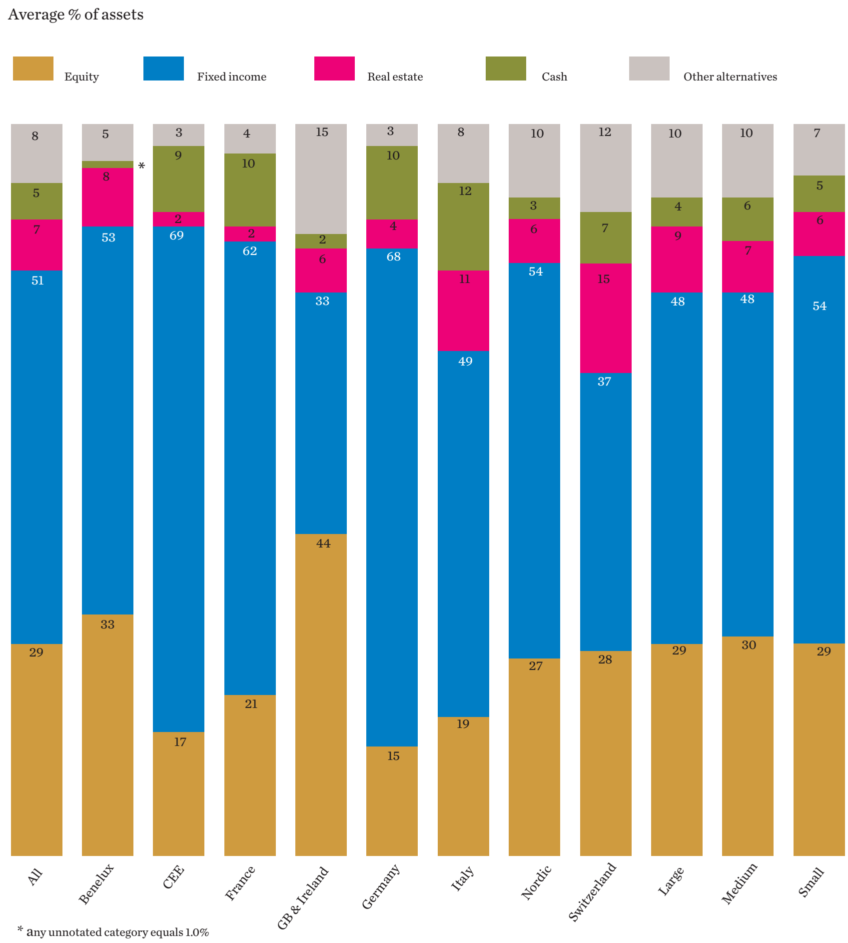


Key takeaways

- relative performance and relative risk remain the two most important external objectives, although there is now little space between relative risk and absolute risk
- the exception is GB & Ireland where relative risk is seen as least important
- medium and small funds appear to agree that relative performance is most important to them, whilst absolute performance is much more important for large funds

3. Investment of assets

3.1 Investment allocation by country and size



Reverting to trend

Are we seeing a return to familiar patterns or has the world changed out of recognition post the economic crisis? There are signs of the reassertion of reliance on equities to be the driver when rebuilding portfolios, accompanied by the reduction in liquidity. Investors' plans in relation to allocation show a rekindling of interest in Asian and other markets, and a willingness to re-engage with alternatives right across the spectrum. But the huge weight of portfolios is increasingly in fixed income – is this then the permanent home for the bulk of European institutional assets?

The effects of the financial crisis and the subsequent upsurge in equity markets that has helped investors dig themselves out of very black holes are reflected in Fig 3.1 if we take the panoramic 'all markets' view and compare this with the year before.

Equities have recovered from the four-year low point of 25% of asset allocation in institutional portfolios recorded in last year's survey to 29% currently. This increase reflects both the rebound in markets plus whatever fresh allocations investors made to the asset class.

There has been a consequent trimming back of the proportion allocated to fixed income to 51% (the level it was in 2007, incidentally) from 54%. This again could be the result of market movements and not deliberate asset reallocations by investors. With the level of risk in portfolios still being of such concern, as shown in the previous section, it is hard to see that any dramatic move will be made from fixed income for some time.

Real estate may have come through the worst of the recession with its overall allocation rising to 7% from the previous year's 5%, again helped by a degree of recovery in values. Similarly, 'Other alternatives' (ie other than real estate) have seen their share rise over the year to comprise 8%, as against 6% a year ago.

There was a significant drop in the proportion of cash holdings, which have fallen from a crisis level of 10% to half that in the current year's survey. Indeed, some of that drop in cash will have fed the increase in equities, real estate and alternatives.

But the real allocation story is at country and regional level, where the different investor preferences, regulation and history are played out. How allocations have changed at a country level over the past three years is set out in Fig 3.3.

The Benelux has not followed the overall trend in equi-

Key takeaways

- bonds remain the dominant asset class, but to a lesser degree than last year
- increased allocation to both real estate and other alternatives, while cash deposits have halved compared with last year
- equity holdings have broadly increased, but only three countries are near the average; GB & Ireland far in excess, with CEE, France, Germany and Italy significantly below
- despite a small year-on-year drop in overall fixed income investing, it has risen considerably in Benelux and Germany
- largest equity investors were GB & Ireland and Benelux, but with Germany bucking the trend most dramatically by divesting itself of 25% of its holdings
- most countries reduced their cash holdings, some dramatically so, like Italy, whereas France more than doubled its holding
- the large and medium funds have again reduced their equity holdings while the small funds increased theirs. All sizes invested more in fixed income. Real estate and other alternatives witnessed little movement. Medium funds increased their cash deposits by 50%, albeit from a very low level, with small funds moving in the opposite direction with more than a 50% reduction

ties, with its proportion falling from 35% in the previous survey to 33% in the current one. With the large contingent of Dutch fund respondents, it might be that the hand of the regulator, which forced funds to dispose of equities at the low point of the markets, can be seen here. Certainly, the increased allocation by Benelux investors to fixed income by 8 percentage points to 53% of portfolios will have done little to enhance returns and rebuild asset values.

Other countries where there was also a drift from equities include the 'cult of the equity' countries, Great Britain and Ireland, which had shown a seismic decline from a 55% allocation in 2007 to 46% in 2008, but then only declined by a mere two points last year to 44%. The Nordic countries were down to a similar extent, while Switzerland moved its allocation upwards, again by two percentage points over the past year, but is well below the 32% equity proportion of three years ago.

More significant declines occurred in France and Germany, from the 30% and 20% respectively reported in the previous survey. Germany's fixed income percentage is now 68% compared with 54% formerly, but part of that can also be attributed to a dramatic fall in alternatives in portfolios from 15% to just 3%.

While Italian investors' equity allocations remain unchanged at 19%, their cash holdings, at 12%, are still higher than all others, even though they are well down on last year's crisis level of 22%. Fixed income holdings have remained practically static.

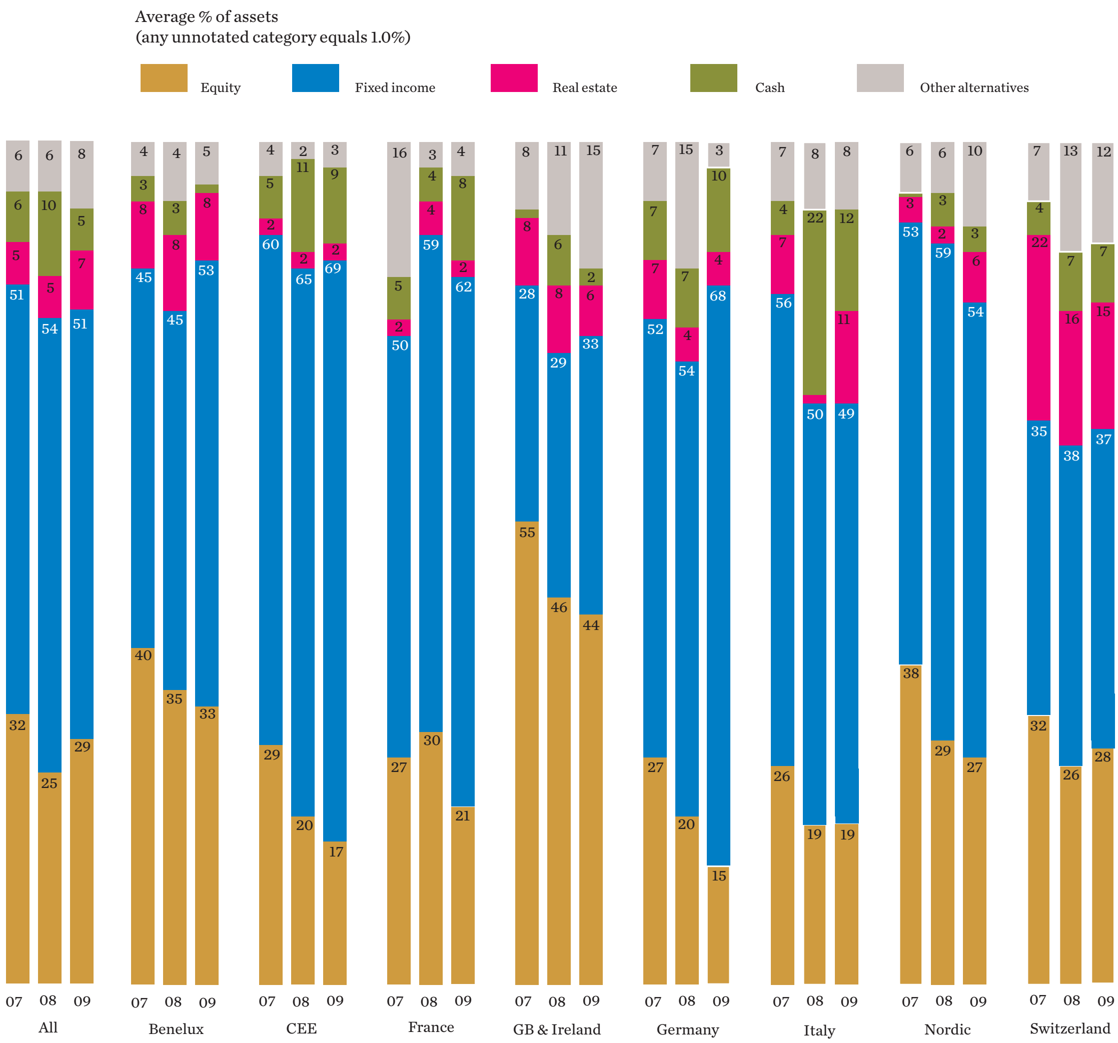
Alternatives have had something of a recovery, with some noticeably bigger allocations occurring in this year's results in the British and Irish markets at 15% (11% in the previous survey) and in the Nordics 10% (6%); other coun-

3.2 Regional investment asset allocation

Average % of assets

	Domestic	Rest of Europe	Rest of World	Total
Equity	23.5%	34%	42.5%	100%
Fixed income	49.2%	39.4%	11.4%	100%
Real estate	60.7%	30.1%	9.2%	100%

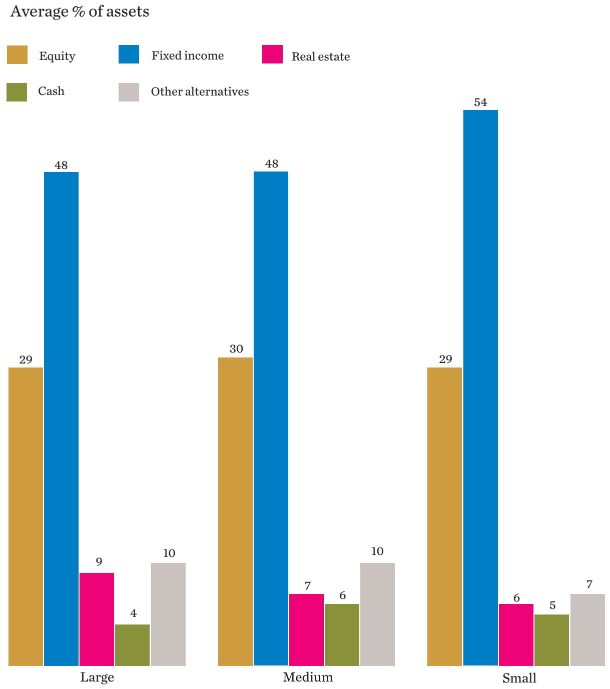
3.3 Investment asset allocation by country 2007-2009



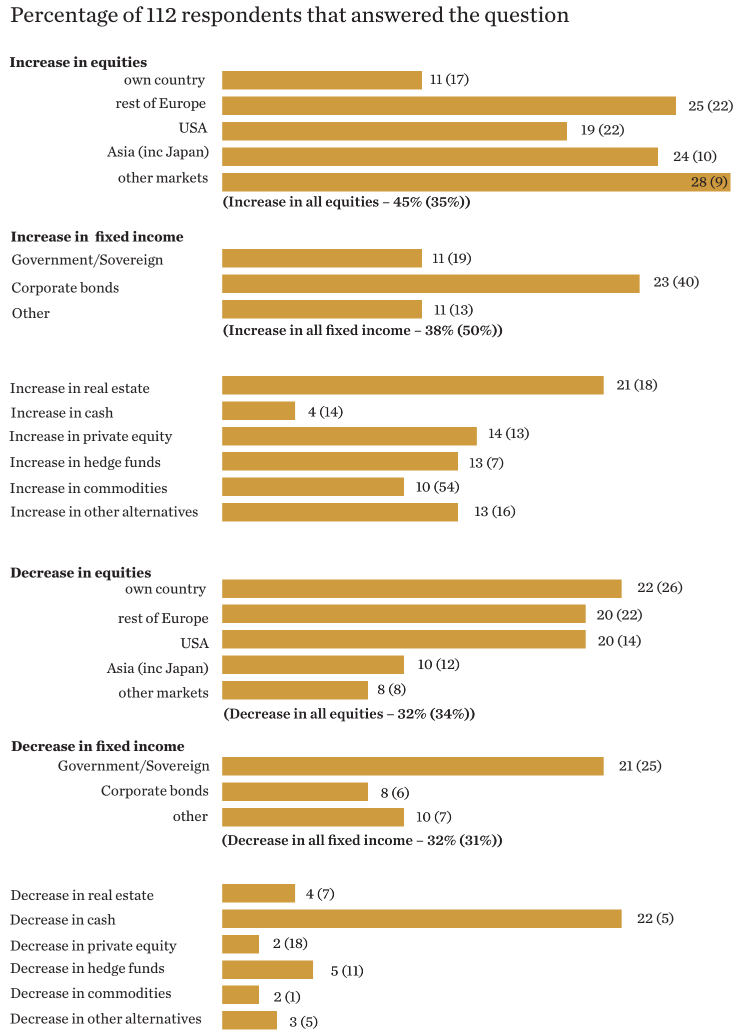
Key takeaways

- equity investment continues to decline across the board, except in Switzerland where it has increased marginally. It is again highest among GB & Ireland and Benelux investors. The broad overall trend over the past three years is for a steady, if largely undramatic, decline
- over the same period, investment in fixed income has risen sharply in Benelux and Germany, with only Nordic countries making a significant reduction. The largest allocation is in CEE and Germany, the least being in Switzerland
- while most countries' allocations to real estate have changed little over the last three years, the overall increase is most attributable to Italy (up from 1% to 11%) and Nordic countries (a three-fold increase to 6%)

3.4 Investment asset allocation by size



3.5 Changes planned to strategic asset allocation in 2010 (2009)



3.6 Differences in strategic asset allocation 2010 (2009)

Percentage of 112 (110) respondents that answered the question

Category	To 2010 (09)	From 2010 (09)	Difference 2010 (09)
Equities	45% (35%)	32% (34%)	13% (1%)
Fixed income	38% (50%)	32% (31%)	6% (19%)
Real estate	21% (18%)	4% (7%)	17% (11%)
Cash	4% (14%)	22% (5%)	-18% (9%)
Private equity	14% (13%)	2% (18%)	12% (-5%)
Hedge funds	13% (7%)	5% (11%)	8% (-4%)
Commodities	10% (54%)	2% (1%)	8% (53%)
Other alternatives	13% (16%)	3% (5%)	10% (11%)

tries' exposures remained more or less where they were: Benelux 5% (7%), Switzerland 12% (13%), Italy 8% (8%) and CEE 3% (2%).

When it comes to the impact of fund size, equity allocations are much more in line across all funds than they were previously. Smaller funds do have a higher fixed income allocation than the medium and large ones, much in line with last year's findings. And they have reduced the cash element in portfolios quite substantially from 11% to 5%.

The real estate component has remained basically comparable, with the large funds static at 9% and the medium and small both showing a 1% increase. For alternatives, the picture is exactly the same for the two years, except that larger funds' proportion has slipped from 12% to 10%.

What about investors' plans to change their asset allocations? Fig 3.5 shows how investors are changing the composition of their equity portfolios, with the domestic markets likely to face net outflows. While other European countries look like being the net recipients of new money, the flows of money to and from the US could well be in balance. But by contrast the Asian and other markets appear to be strongly in favour as the preferred destinations. Last year, investors were much more muted about these markets.

The determination to move out of cash is clear as investors expect to run down their positions, in sharp reversal of last year's plans to hoard cash. As to where it will go besides the Asian and emerging equity markets, corporate bonds appear to be in demand but to a lesser extent than last year.

Key takeaways

- confidence in equities continues to grow, with a corresponding decrease in the perceived need for bonds
- significantly less forward interest in the need to hold cash
- confidence in both private equity and hedge funds now much more in evidence
- shift to real estate continues to show large growth

4. Sources of absolute versus relative return

Hedge funds are back

In an era when anything can and does happen throughout national and global financial systems, investor preferences for sourcing returns remain fairly fluid, particularly in the case of absolute returns. Here, a flight to safety is blended with a greater use of alternatives. For relative returns, however, investors are using the different asset classes in many respects as last year.

In the current survey (Fig 4.1), cash is definitely king, with 15% of respondents seeing it as a source of absolute return. Last year, cash was in fifth place but has now ousted fixed income from the top spot, possibly because of the perceived vulnerability of the bond markets.

Fixed income – the most popular single source of absolute return in last year's survey – is now ranked only sixth in the list, with a mere 9% of respondents expecting it to produce returns, compared with 16% last year.

The second-placed source of absolute returns is alternatives in general, which includes real estate and hedge funds but these are shown separately in the bar chart (Fig 4.1).

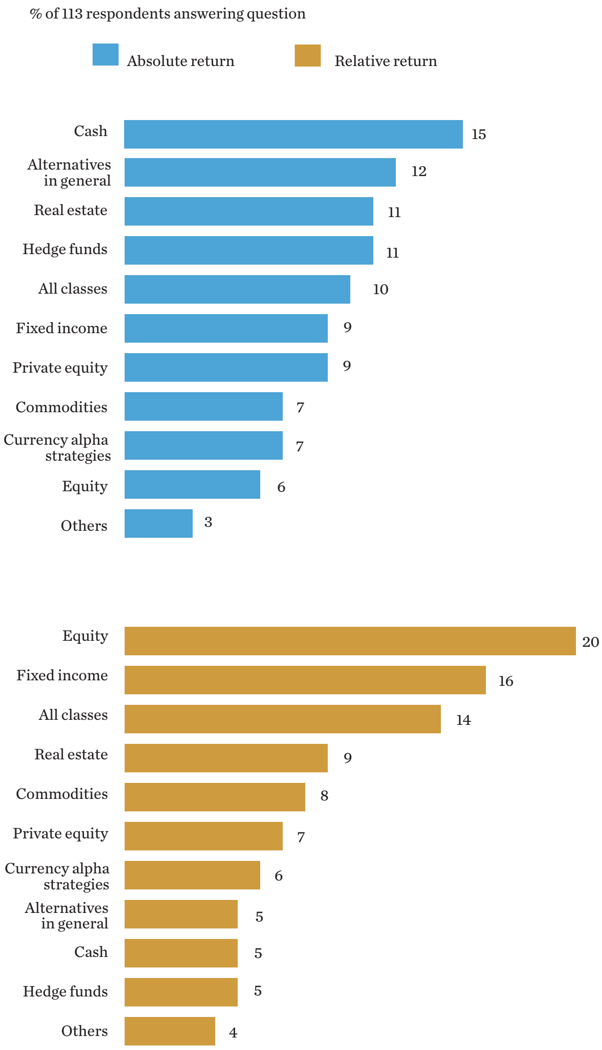
Meanwhile, real estate, which was last year's runner-up with 15% of respondents then seeing it as a source of absolute return, has slid to third, with only 11% of respondents now expecting it to make a contribution.

Another striking change is that investors now perceive hedge funds more as a source of absolute than of relative returns, a situation last seen two years ago.

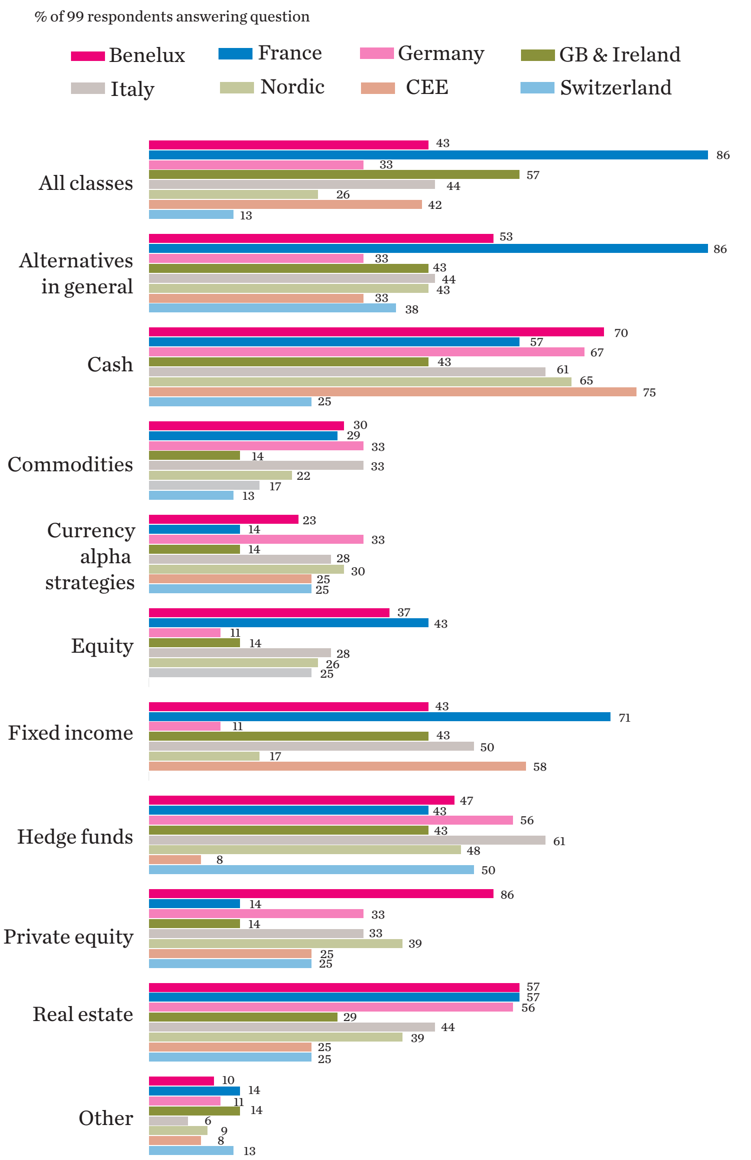
In last year's survey, hedge funds were the fifth most popular source of relative returns, mentioned by 9% of respondents. But only 5% of respondents saw them as producers of absolute returns, leaving them next to the bottom of those rankings.

This in itself was a reversal of the 2007 figures and, once again, hedge funds are now favoured for producing absolute returns, ranking joint third with 11%, while in the relative return rankings, they are almost bottom with 5%.

4.1 Sources of absolute and relative return



4.2 Sources of absolute return by country



Key takeaways

- currency, followed by alternatives in general, including real estate and hedge funds, largest sources of absolute return
- currency has moved up from 5th place last year
- fixed income now only seen as source of absolute return by 9% of respondents, compared with 16% previously
- equity and fixed income remain the main sources of relative return, and at slightly higher levels than last year, at 20% and 16%, respectively

Currency alpha strategies – which last year ranked above cash, in fourth place with 10%, have now dropped to ninth spot, with only 7% of respondents seeing them as a source of absolute returns.

For sources of relative return, the changes at the top this year are not quite as dramatic.

In 2008, the longstanding predominance of equity and fixed income as the main sources of relative return had severely declined. Although still clinging on as the most popular sources, they were mentioned by only 18% and 15%, respectively, of respondents.

The 2009 results see their status bolstered slightly. Still in pole position, they are rated at slightly higher levels (20% and 16% respectively). However, while the all classes category is still the third most popular source of relative return, real estate – rated by 9% of respondents, the same percentage as last year – has replaced cash in fourth place.

Meanwhile, cash's supremacy in the absolute returns rankings contrasts sharply with its slump to ninth place in the relative returns table, with 5%, compared with 13% in the previous survey.

There are, predictably, wide variations between different European countries in terms of sourcing returns. These are shown in Fig 4.2, which analyses sources of absolute returns by country. France has now overtaken the Nordic countries as having the biggest overall commitment – 86% – to absolute returns, focusing mainly on alternatives in general.

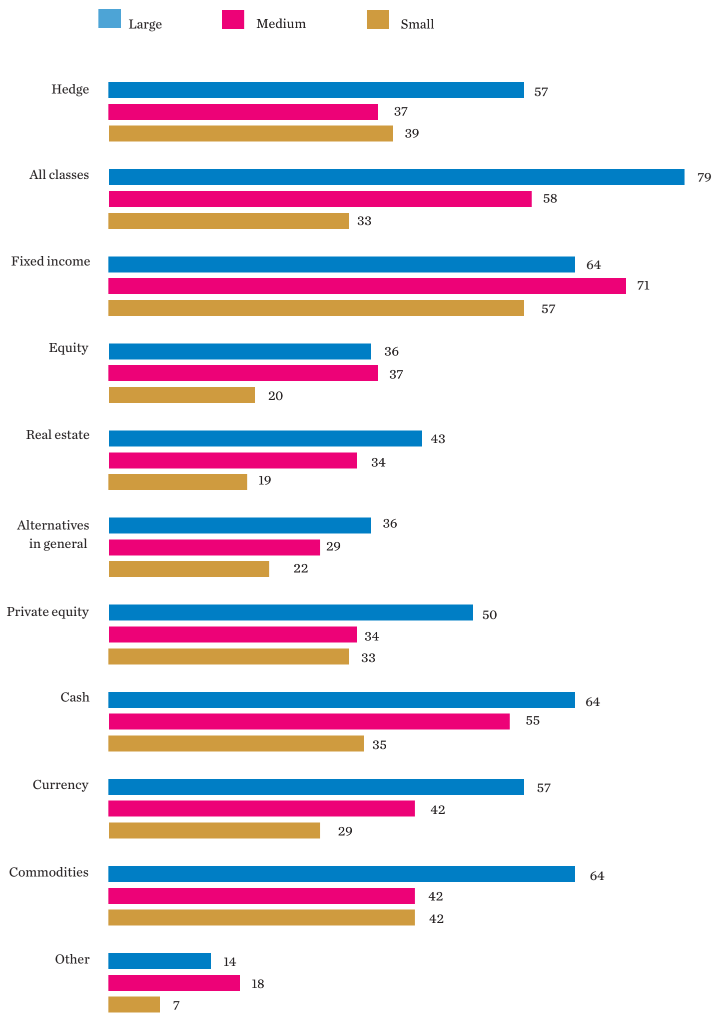
Germany's main preference has switched from fixed income last year to cash this time around, followed by real estate and hedge funds in equal proportions. Meanwhile, Great Britain and Ireland have shifted their focus from equity to fixed income and alternatives.

The Swiss are also looking mostly towards hedge funds, reflecting a general overall swing towards the asset class, along with private equity and real estate. Currency alpha strategies are most popular with the Germans, and least popular in France and Great Britain and Ireland.

According to this year's survey, the size of a fund now seems to be the main driver in determining the need for absolute returns (Fig 4.3).

4.3 Sources of absolute return by size

% of 100 respondents answering question



All sizes of investor are concentrating most on fixed income, although the larger funds are also the keenest on alternative asset classes as a whole. But it is the larger investors who are much more focused on the need for absolute returns.

Key takeaways

- France (previously Nordic countries) now has the biggest overall commitment to absolute returns with 86%, the main focus being on alternatives in general
- German main preference for cash (previously fixed income), followed by real estate and hedge funds in equal measure
- GB & Ireland have shifted their focus from equity to fixed income and alternatives
- Germans expressed most interest in currency alpha strategies, and least by France and GB & Ireland
- Swiss now look mostly to hedge funds, reflecting a general overall swing towards that asset class, private equity and real estate

5. Alternatives

Coming in from the cold

Despite their relatively exotic nature, alternative assets can provide something of a haven in times of turmoil as they are not generally correlated to the mainstream financial markets. However, even institutional investors can be somewhat wary of the asset class, especially in an uncertain climate. But, the worst seems to be over, with investors' faith restored in what alternatives can deliver to their portfolios.

Last year's survey reported a retreat from the sector as the economic crisis dented confidence in a big way, with the asset class reduced to 8.7% of portfolios overall, from 10% the previous year.

In 2009, however, European institutional investors appear once more to have embraced alternative assets. So much so that over the year, alternatives bounced back to make up 11.7% of respondents' portfolios (Fig 5.1), which is even bigger than the percentage of two years ago (10%).

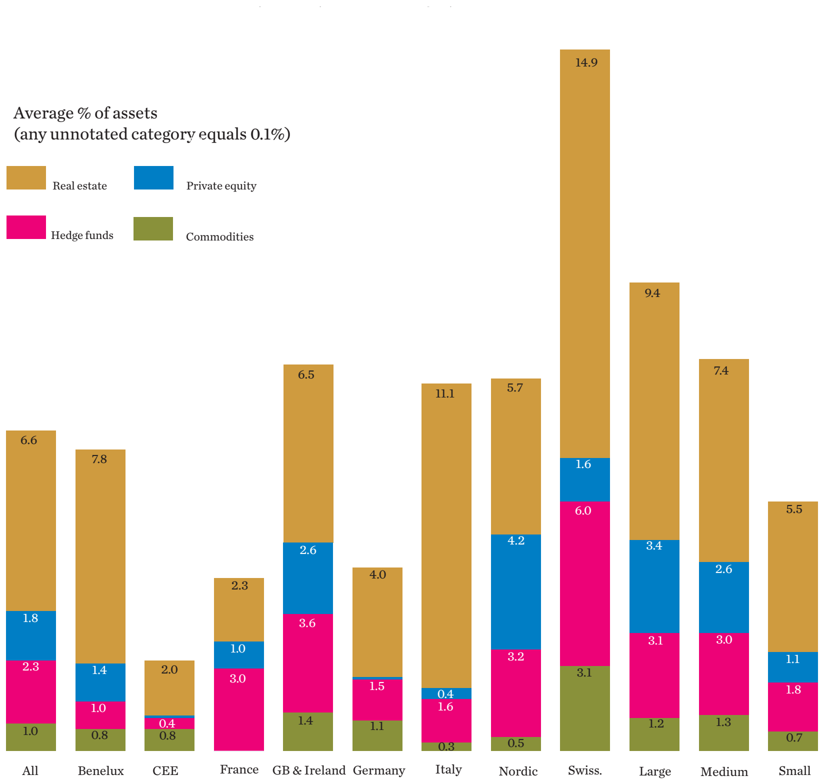
Like last year, real estate forms the lion's share of this allocation, with 6.6% of investors' total assets – over half the percentage held in alternatives – in this category, compared with 4.7% in 2008. Indeed, real estate is now at its highest level for at least eight years (Fig 5.2).

While real estate remains the cornerstone of alternatives investing, the overall increase in allocation masks the fact that most countries have made small reductions in their allocations. However, this has been more than outweighed by the fact that Italy has shown an eightfold jump (from 1.4% to 11.1%) and the Nordic countries a threefold increase (from 2.0% to 5.7%) over last year.

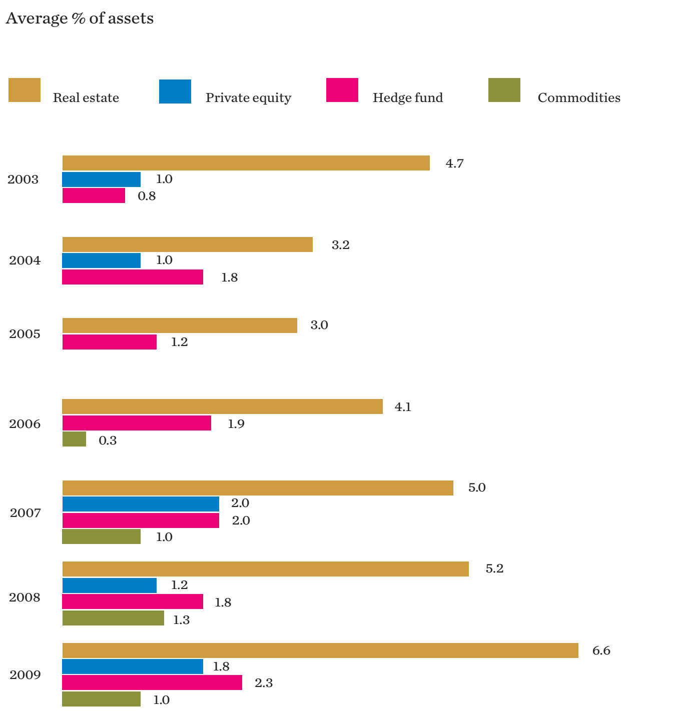
The big movers were hedge funds, which surged past private equity in importance, increasing by 50% over last year – from an admittedly low base of 1.6% – to make up 2.3% of total asset allocation.

Private equity roughly remains the same

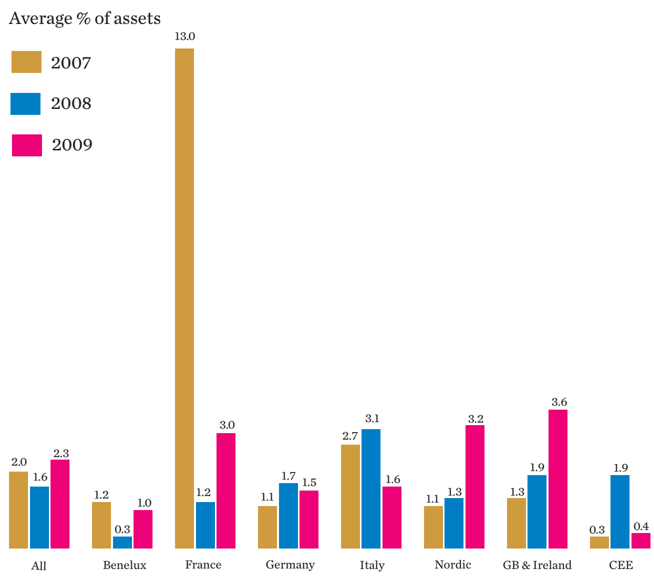
5.1 Selected alternative assets by country and size



5.2 Selected alternative assets 2003-2009



5.3 Hedge fund assets by country 2007-2009



Key takeaways

- real estate remains by far the single largest alternative investment, and is now at its highest level (6.6%) for at least eight years
- the overall increase masks the fact that most countries have made small reductions in their real estate allocations, whereas Italy and Nordic countries have shown an eight and three-fold increase, respectively
- hedge fund assets are showing a 50% increase on last year, the overall total still remaining small. The largest year-on-year increases have come from Benelux, France, GB & Ireland and Nordic countries
- private equity remains broadly unchanged, but with GB & Ireland showing a large reduction to 2.6% (from 4.6%)
- commodities has recovered all of the ground lost last year, but remains on the floor at 1%
- all sizes of investors have increased their allocations to real estate, medium investors making the largest increase, so perhaps starting to redress the significant reductions made the previous year.
- Large and medium investors have shown more faith in hedge funds (now at 3%, up from under 2% last year). The large and medium funds have diverged on private equity, the large making a small increase and the medium a 50% reduction.
- Large and medium funds have made small increases to their commodities allocations, but small funds have halved their allocation

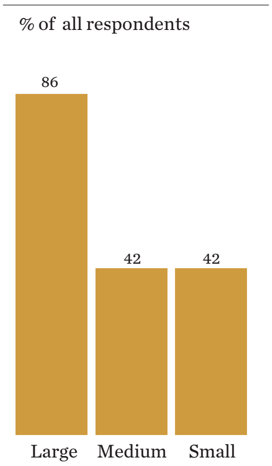
in percentage terms at 1.8% (from 1.7%), but with Great Britain and Ireland showing a large reduction in allocation, from 4.6% in 2008 to 2.6% in 2009.

The biggest player here is now the Nordic countries, overtaking the British and Irish funds with an allocation which has risen from 3.6% in 2008 to 4.2% this year.

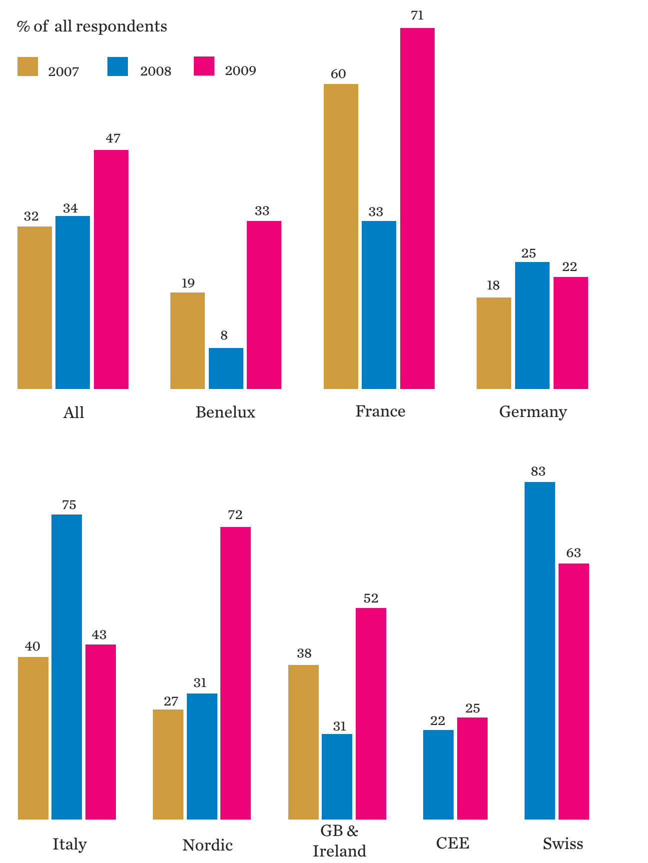
Meanwhile, commodities have recovered all of the ground they lost last year, but still remain the least considered important alternative asset class, making up just 1% of portfolios (0.7% last year).

The popularity of each of the four alternative classes varies according to the size of the investor. While funds across the size spectrum increased their allocations to real estate, the biggest rises were made by medium-sized investors. But perhaps all funds were making an effort to redress the significant reductions made the previous year.

5.5 Hedge fund users by size 2009

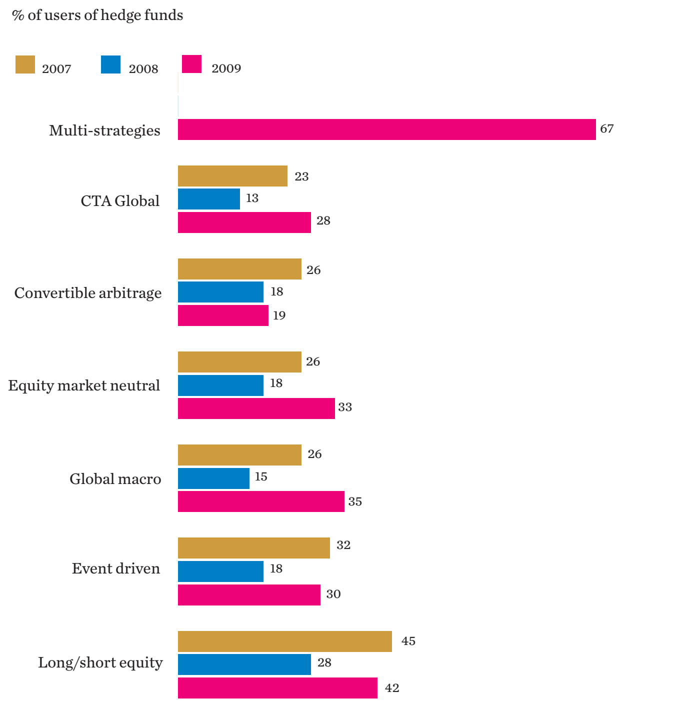


5.4 Hedge fund users by country 2007-2009



However, large and medium-sized investors have shown more faith in hedge funds than have smaller investors; the former now both have at least a 3% allocation, up from less than 2% last year, while the smaller investors have stuck with last year's 1.8% allocation.

5.6 Users of different hedge fund products 2007-2009



As for private equity, however, while the large funds made a small increase in their allocations, medium funds halved their exposure.

Similarly, large and medium-sized funds slightly increased their commodities allocations, while small funds reduced their exposure by 50%.

The survey highlights the use of hedge funds by country (Fig 5.3), giving some insight into the rise in popularity of this asset class. Switzerland remains the biggest investor in hedge funds, although the average allocation declined slightly from 6.1% in 2008 to 6% in 2009.

The Benelux, France, the Nordic countries and Great Britain and Ireland all increased their allocations, but all from very low bases.

The British and Irish funds are now the second biggest average investors in hedge funds (as a percentage of their portfolios), with a 3.6% allocation.

Italy – last year's most significant investor after Switzerland, with an average 3.1% in the asset class – halved its allocation this year to 1.6%.

While individual allocations to hedge funds have increased, there was also a rise in the percentage of investors using them (Fig 5.4). In 2009, 47% of respondents were holding hedge funds, compared with one-third in each of the previous three years.

Again, there were significant increases in uptake by Benelux, France, the Nordic countries and Great Britain and Ireland, but a steep decline in user numbers in Italy (from 75% to 43%) and Switzerland (from 83% to 63%).

In terms of the size of institutional investors, hedge funds have seen increased usage across the board (Fig 5.5).

Key takeaways

- **hedge fund assets have grown by some 50% from last year's very low base**
- **Benelux, France, Nordics and GB & Ireland have increased their allocations, but all from very low bases, while Italy has almost halved its allocation to 1.6%**
- **47% of respondents used hedge funds in 2009, compared with one-third in the previous three years**
- **significant increases in uptake by Benelux, France, Nordics and GB & Ireland, contrasting with steep declines in Italy and Switzerland**
- **funds of all sizes have increased their use of hedge funds, medium and small funds at the same level of 42%. Large funds have almost doubled their use at 86%**
- **multi-strategies is most popular at 67%**
- **equity long/short second for third year at 42%, but a significant increase in 2008 usage (28%)**

However, while 42% of both medium and small funds now use them, it is the larger funds where their popularity is rocketing. The numbers using hedge funds have almost doubled since last year, from 46% in 2008 to 86% in 2009.

Turning to the ways in which the different hedge fund products are used, the survey asked, for the first time, about multi-strategy products (Fig 5.6). These are now employed by 67% of hedge fund investors in this survey, which investors will access through fund of funds.

Long/short equity is the second most popular product for the third year running, but with a significant increase in usage (42%, compared with 28% in 2008).

6. ETFs and Indices

Back on track

After being ignored for several years and then seeing a flurry of interest and activity in 2007, institutional investors seem to have settled into using ETFs – if relatively sparingly. About one-third of respondents report using them in 2009, little changed from 2008. The sector itself goes from strength to strength, attracting record assets as ETFs gain popularity, with retail investors attracted by low fees and commission. For institutional investors, however, the bread-and-butter ETF market offers much less compelling cost savings next to alternative solutions like segregated passive accounts or derivatives like forwards, futures and options.

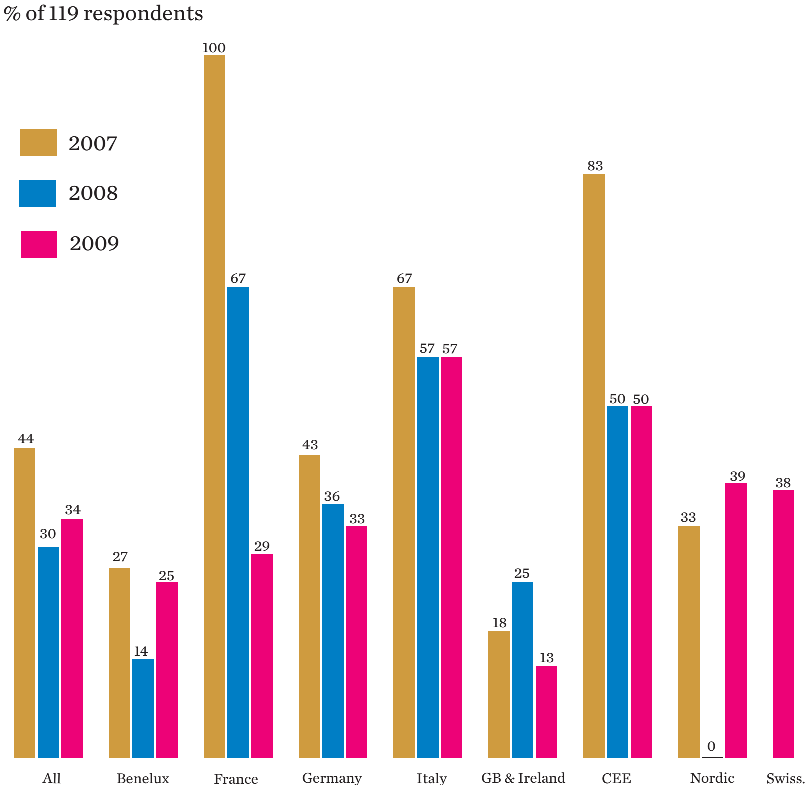
Index-tracking mutual funds remain the favoured way to get passive exposures, particularly among Nordic, French and CEE investors. Only German and Italian investors tend to go for futures instead, and the only other country group that does not rank mutual funds top is Switzerland, where investors overwhelmingly prefer another traditional way in – the segregated index-tracking account.

Exchange traded funds (ETFs) have come back a little during 2009 after a slump in 2008 (Fig 6.1), and have again edged futures into second place, 36% to 34% (although forwards are also used by 12% of all European investors, and are particularly favoured in Great Britain and Ireland). The CEE like them the most, with 60% putting them to use – a result consistent with previous years' findings. Futures tend to be used more in Benelux, Germany, Italy and the Great Britain and Ireland.

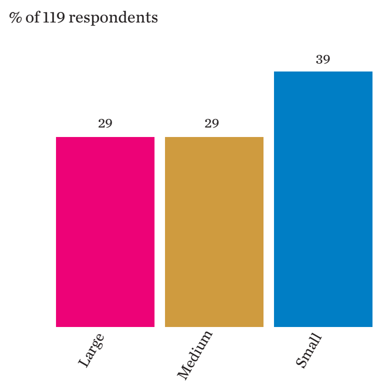
Although ETF use across Europe in general has gone up slightly from 2008, 34% of investors now report using them, up from 30% (Fig 6.1). Benelux and the Nordics are the only regions where they have become more favoured. Although French investors seem to have turned against ETFs, the small size of the sample may be a factor – in 2007 every single respondent indicated that they were using ETFs – by 2009 that had fallen to less than one-third.

In 2007, it was the larger funds which tended to use ETFs – perhaps because they were among the first movers into a relatively new technology (Fig 6.2). By 2009, a larger proportion of smaller funds report using them, a result more consistent with the fact that they are a more expensive but arguably a less governance-intensive index

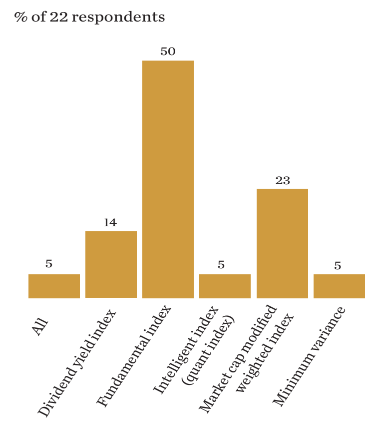
6.1 Exchange traded funds (ETF) users 2007-2009



6.2 Exchange traded funds (ETF) users by size



6.3 Use of new types of indices



Key takeaways

- **overall usage of ETFs has shown small recovery from 30% in 2008 to 34% in 2009**
- **Benelux and Nordic countries have made the biggest increases in their usage, with the largest reductions coming from France and GB & Ireland**
- **previously used most by the larger funds (75% in 2008), their usage has now reduced to 29%, the same as for medium funds. Smaller investors are now the biggest users at 39%, although at a similar level to the previous year.**
- **Use of ETFs based on new indices (2009 ~ only 5% of the 22 respondents said they used ETFs based on one or more new indices). Of those fundamental indexes were most popular at 50% followed by market cap modified at 23%**

exposure solution than derivatives like futures or forwards.

Among larger funds, one suspects that ETFs are most useful for tactical asset allocation and, increasingly, for quick and easy exposure to niche sectors or geographies, alternative asset classes like commodities, hedge fund indices and foreign exchange, and even quasi-asset classes like dividends, volatility or inflation.

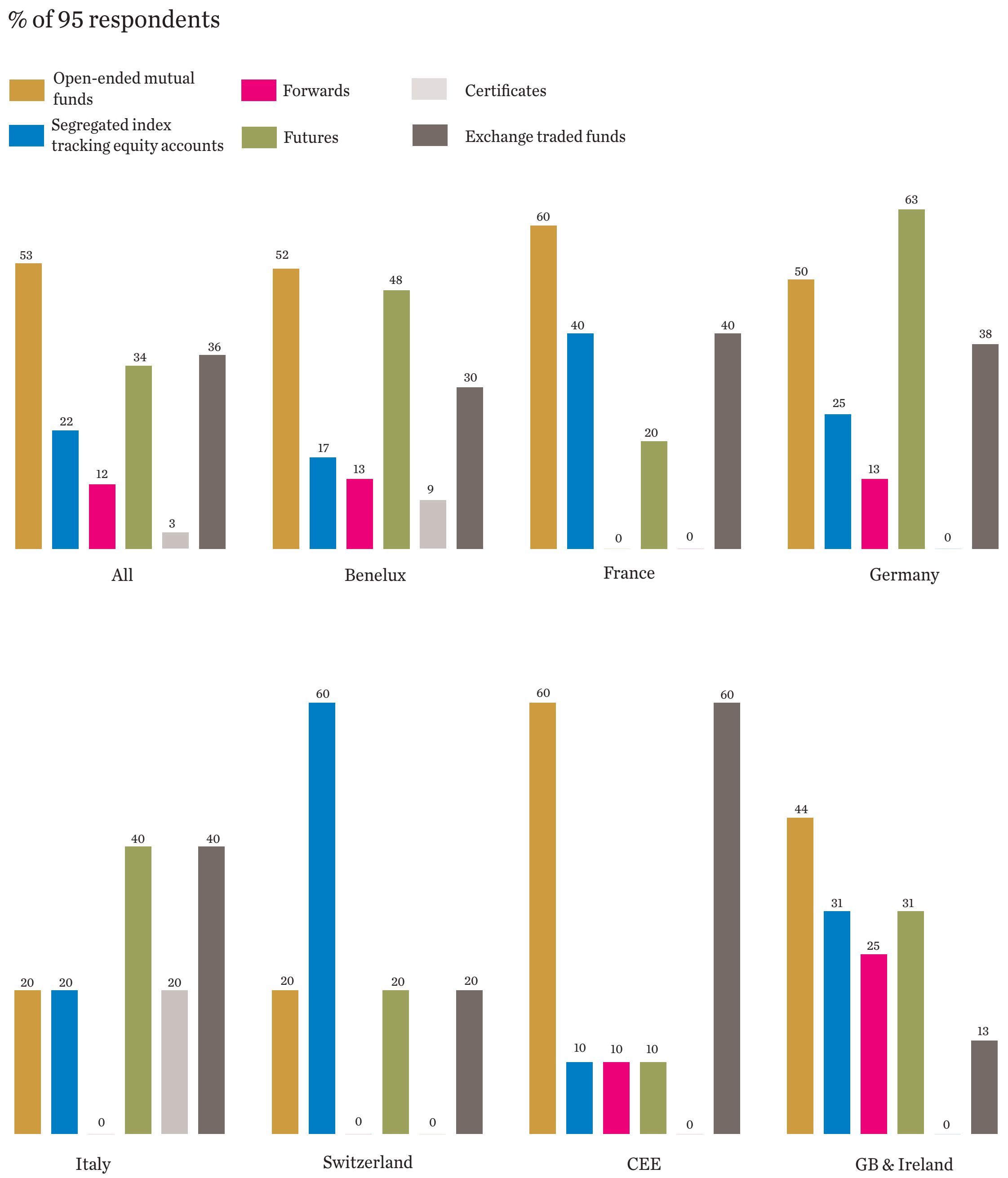
In addition to an increasing array of alternative asset class ETFs, in the last few years there has been an inevitable rise of ETFs tracking alternative equity indices – the most notable of which have been the family of fundamentally-weighted indices (Fig 6.3). Although European institutional investors have certainly been experimenting with segregated mandates based on various fundamental and/or equally-weighted indexation methodologies, they appear not to be interested in the ETF versions. This is not wholly surprising: those that have looked at alternative indexation tend to be large, sophisticated funds focused on optimising big beta exposures – not the natural constituency for ETFs (only 29% of large investors report using them at all).

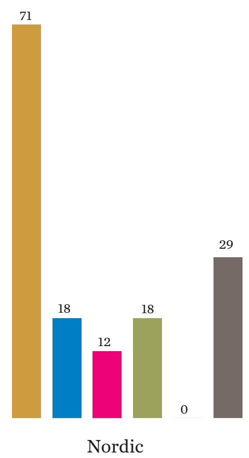
On the wider question of development of indices (Fig 6.3), investor take-up is understandably limited. Of the more recent newcomers, fundamental indexing is the most established now among investors.

In all, 11 respondents report using fundamental index ETFs, which is three more than last year but still not much to write home about (though that could be regarded as a 37% surge!).

Five respondents said they used market-cap modified weighted indices while three reported using dividend

6.4 Techniques used to gain index exposure





Passive and tactical

Passive core holdings are one side of the index investment coin: their popularity has increased for pension funds, particularly in equities. The other side of the passive coin is the use of techniques to take a tactical position in the portfolio through instruments such as forwards, futures and certificates.

Bearing in mind that survey respondents could select multiple options to reflect the strategies they deploy (Fig 6.4), 53% said they used open-ended mutual funds for passive exposure, 36% used exchange traded funds, while 22% used segregated accounts for this purpose. No less than 34% used futures, 12% used forwards and only 3% used certificates.

The use of ETFs has increased by six percentage points compared with last year's survey, when 30% of respondents used them. The use of futures is the same, at 34% in both years, use of forwards is up three percentage points, at 12%, while use of certificates has decreased by five percentage points from last year, when 8% of investors said that they used them.

Use of the various techniques and vehicles varies significantly across the countries and regions covered in the survey, with as few as 20% of Italian and Swiss respondents using open-ended mutual funds for passive exposure. However, while only 20% of Italian investors use segregated accounts, for Swiss investors the figure is 60%. In the Nordic region, a total of 71% of investors use open-ended mutual funds, while only 18% use segregated accounts.

Investors in the CEE region are the biggest users of ETFs – at 60% – with mutual funds also used by 60% of investors in the region and only 10% using segregated accounts. British and Irish investors are the lowest users of ETFs, at 13%, perhaps representing some consultants' hostility to the vehicle.

Futures are deployed in all countries and regions – with usage varying from 10% in the CEE region to 63% in Germany. No investors made use of forwards in France, Italy and Switzerland. The highest users are British and Irish investors, whose deployment totals 25%. The use of certificates is highly patchy, with the 3% average rate masking large discrepancies. The only users were Benelux investors, where the rate was 9%, and Italian investors, where usage reaches 20%. No investors from other regions use them in this year's survey.

Key takeaways

- **Nordics, France and CEE are biggest users of open-ended mutual funds; Italy and Switzerland use it least**
- **France has reduced its use of ETFs to 40% (67% in 2008)**
- **increased but still limited use of forwards and certificates, except in Italy, where they are virtually unused**

7. Duration and LDI

Gaps remain

The maturity of many defined benefit pension funds has led to an increasing focus on liabilities, and the ability of investors' bond portfolios to broadly match future commitments to pensioners. This is why the EIAMS survey measures the duration of participants' fixed income portfolios.

Sensitivity to interest rates is a particular issue at the moment, and might be a factor helping to drive down the overall duration of fixed income portfolios in the most recent study. The historic low interest rates that we currently see have meant that taking risk at the long end of the interest rate curve represents a less attractive proposition in terms of risk and return.

It should also be noted that many investors' bond portfolios have changed in the past two years or so. Strong dislocations in fixed income markets since the market crash of autumn 2008 prompted many investors to take investment risk in other areas of debt than just straight home market government bonds. The yawning yield gap between government bonds and credit represented a compelling opportunity for institutional investors in particular in late 2008 and early 2009. In short, credit has become more of a risk asset than one that can be deployed broadly to match pension fund liabilities over time, albeit one that has enjoyed attractive risk-return characteristics.

As last year, with the exception of Italy, the duration of investors' actual liabilities exceeds the duration of their actual fixed income portfolios. All countries and regions represented in the survey have seen a very slight decrease in the duration of liabilities: on average, this was 15.7 years in 2009 and 16.6 years in 2008. The actual duration of the fixed income portfolio, on average for all participants in the survey, has also decreased – in this case from 8.7 years to 7.8. The overall gap is therefore 7.9 years in this survey and has remained constant. In the previous survey it was also 7.9 years.

Differences are to be found in the various countries and regions covered in the survey, reflecting local conditions, debt issuance and investors' preferences. In the case of British and Irish investors the duration of liabilities was down from 21.6 years in 2008 to 20.9 in 2009 and from 20.3 years in 2008 in the case of the Nordic region to 18.5 years in 2009. These two represent the markets with the longest duration of liabilities. The widest gap is again in the Nordic region, at 10.9 years – down from 16.1 years in the last survey.

In Great Britain and Ireland, the duration of the average investor's fixed income portfolio has increased from 12.3 years to 13.2 years. For the Nordic region there was a spike in the duration of the bond portfolio of 4.2 years to 7.6 years.

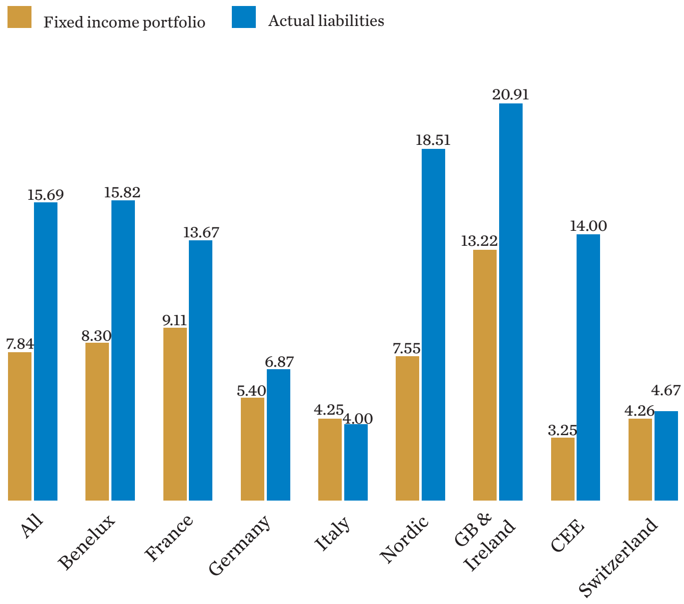
The most recent sample of Swiss investors has a much shorter liability duration than last year, at 4.7 years compared with 11.5 years in 2008. The largest duration gap is measured in the CEE region, although it has decreased from 12.3 years to 10.8 years between the most recent two surveys. The smallest – and only negative – gap is in Italy, at -0.25 years. In the last survey this gap was -0.1 years.

Key takeaways

- in all cases, as last year, except Italy with -0.25 years, the duration of the liabilities exceeded the fixed income portfolio duration
- the overall average for both fixed income duration and actual liabilities shortened by almost 11 months. The overall difference in years remained unchanged
- last year's reported negative gap for the Italians has widened further, widened for the French and narrowed for all others

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

Average number of years for 105 respondents



Country/region	Difference in years	
	2009	2008
Benelux	7.5	9.6
Germany	1.5	3.9
GB & Ireland	7.7	9.3
France	4.6	2.3
Switzerland	0.4	6.7
Italy	-0.3	0.1
Nordic	11	16.1
CEE	10.8	12.3
All countries	7.9	7.9

Liability driven investing

Maturing pension funds, the closure of defined benefit pension schemes, mark to market regulations and historic low current interest rates, in combination with the market crash of autumn 2008, have all led to an even more increased focus on the management of liabilities.

Asset managers have developed so-called pooled liability driven investment vehicles in recent years, which have attracted many smaller investors. Larger investors have preferred to deal directly with investment banks to implement interest rate swap strategies or alternatives, such as swaptions.

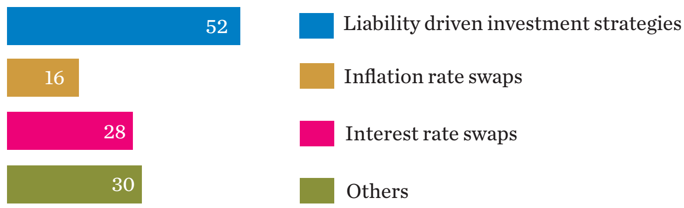
This is in combination with an increased focus on counterparty strength and the robustness of standard agreements. UK funds, which are obliged to increase benefits in line with inflation up to a 5% cap, have also become users of interest rate swaps.

Accordingly, we have asked investors in the last three surveys to tell us about their liability management policies and the techniques used to achieve this. In total, 79% of investors said they used some kind of liability management approach. Bearing in mind that survey participants could select multiple options to reflect their strategy, this year some 52% of investors told us that they used liability driven investment strategies – which could include a pooled LDI fund or a duration lengthening strategy for the bond portfolio.

A total of 28% used interest rate swaps and 16% used

7.2 Use of LDI and other approaches

% of 134 answers, from 106 respondents



Key takeaways

➔ liability driven investment strategies used by 52% of respondents, forming the predominant technique to manage liabilities/guarantees. Almost twice the next preferred single technique of interest rate swaps at 28%

inflation rate swaps. A total of 30% used another form of strategy. This could include a combination of derivative strategies or other forms of interest derivative, such as swaptions, which are an option on an interest rate swap.

8. Performance attribution

Victim of circumstances

A key portfolio backroom function, performance attribution seems to have suffered a small decline in usage, maybe as a result of economising in the aftermath of the crisis or it may reflect a greater number of smaller funds among this year's respondents.

This year sees a slight fall in overall use of performance attribution services at 83% (Fig 8.1) – which represents the first fall recorded by the EIAMS survey since 2005. In the 2008 exercise, market penetration reached 87%, up from 82% of respondents in 2007, 71% in 2006 and 67% in 2005.

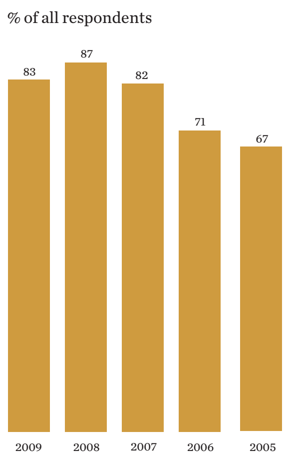
Recent surveys have seen an increase in the proportion of pension funds using investment managers to provide performance attribution up from 41% in 2007 to 45% in 2008 and 49% in the 2009 exercise (Fig 8.2).

Previous surveys have tracked a corresponding increase in the share of investors' internal departments providing this information, but this has dropped back to 30% – the same as in 2007. In 2008 the figure for internal departments was 38%.

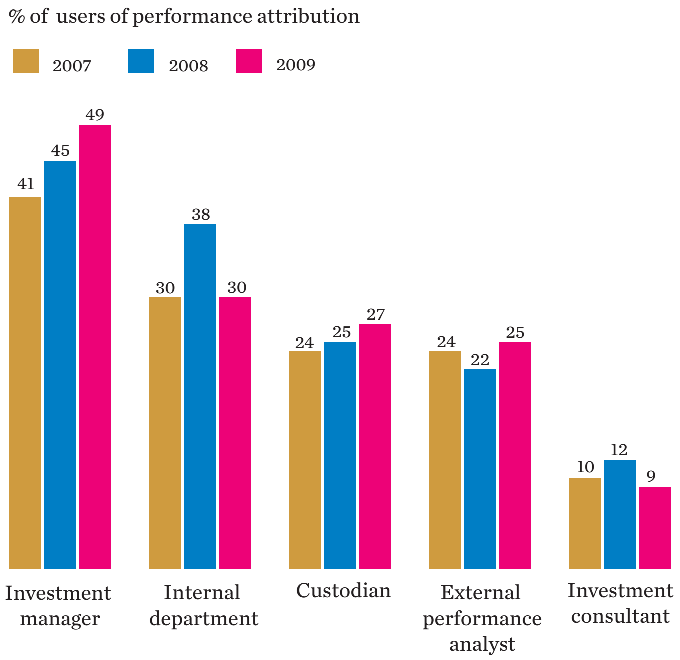
Other providers are less used when it comes to this important function.

Custodians have been increasing their share over the years and now come in at 27% usage, having increased their share from 24% in 2007 to a 25% market share among the respondents in 2008. Specialist external providers now have a market share of 25% – the figure has remained steady in the early 20s – while investment consultants have the smallest share among the providers, at 9%. This had hovered just above the 10% mark since 2006.

8.1 Users of performance attribution 2005-2009



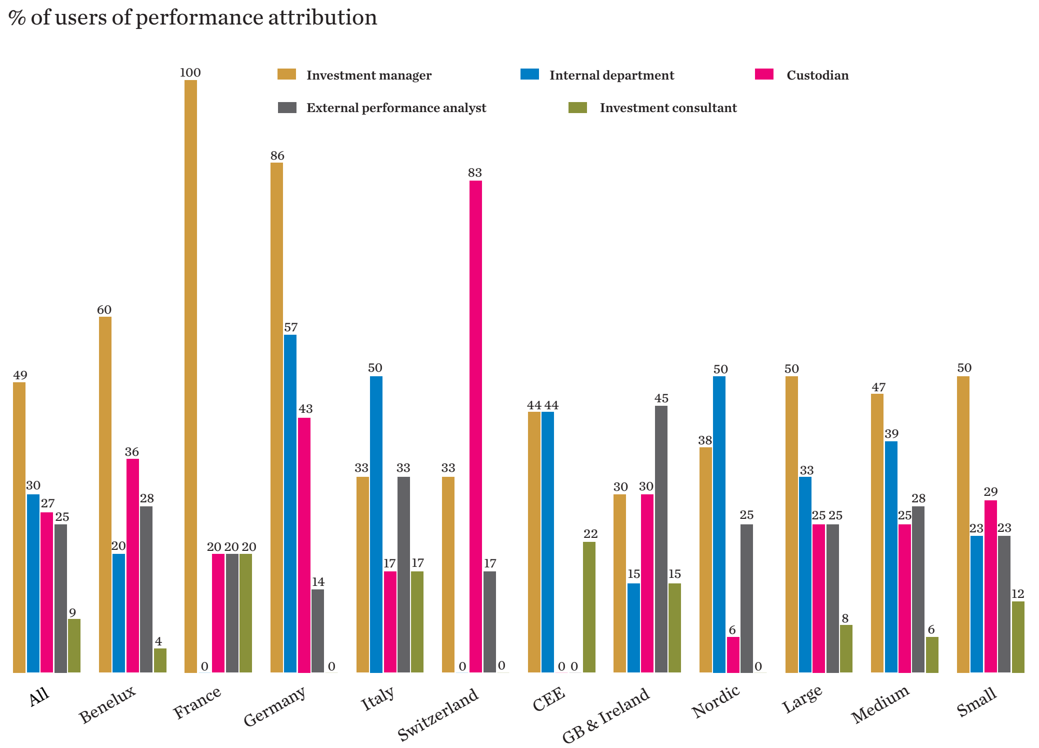
8.2 Suppliers of performance attribution 2007-2009



Key takeaways

- **investment managers remain the single largest providers of performance attribution, improving again on their market share, but still far off their 2006 position of a 61% share**
- **internal departments have kept their second place but**

8.3 Suppliers of performance attribution by country & size



9. Consultants

Times are a-changing

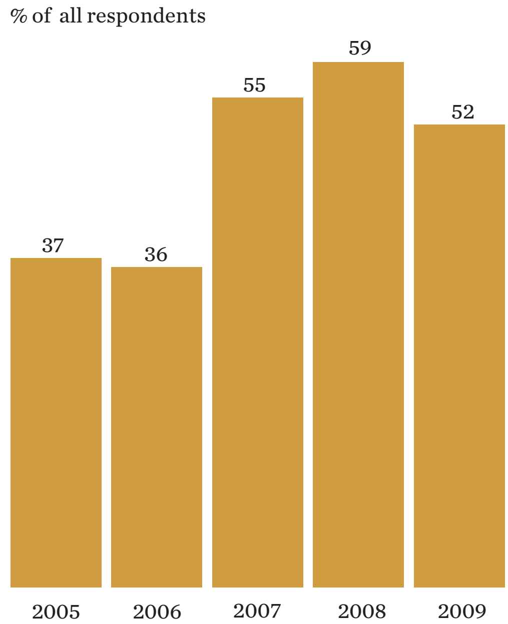
Tougher times may be good for the business of consulting but the fall-off in the use of consultants as a result of the recession in a number of countries is notable. The top reason for hiring consultants remains the need for investment advice, which is entirely consistent with recessionary times, but other findings in the survey show that almost all other types of advice have declined. Having said that, while the traditional consultant roles such as asset allocation and manager selection may be declining, a new breed of advisers and new areas where investors need advice seems to be on the rise. Implemented consulting and fiduciary management as well as reorganisation of businesses have for the first time been mentioned by the participants in the survey as reasons for approaching a consultant. The question is whether those providing traditional services will be able to adapt to the changing environment quickly enough?

This year, there seems to be a break in the continuation of the penetration of the pensions markets by the consultancy firms for the first time since 2007, when the breakthrough in the spread of consulting really picked up and broke the 50% barrier as to the proportion of investors using their services across Europe (Fig 9.1). Although the use of consulting remains above that level, this year's survey shows a decline to below 2007 levels, at 52%. Despite the new types of services provided by the consulting industry, it seems likely that it will be some time yet before the two-thirds barrier, in terms of proportion of investors using their services, is broken.

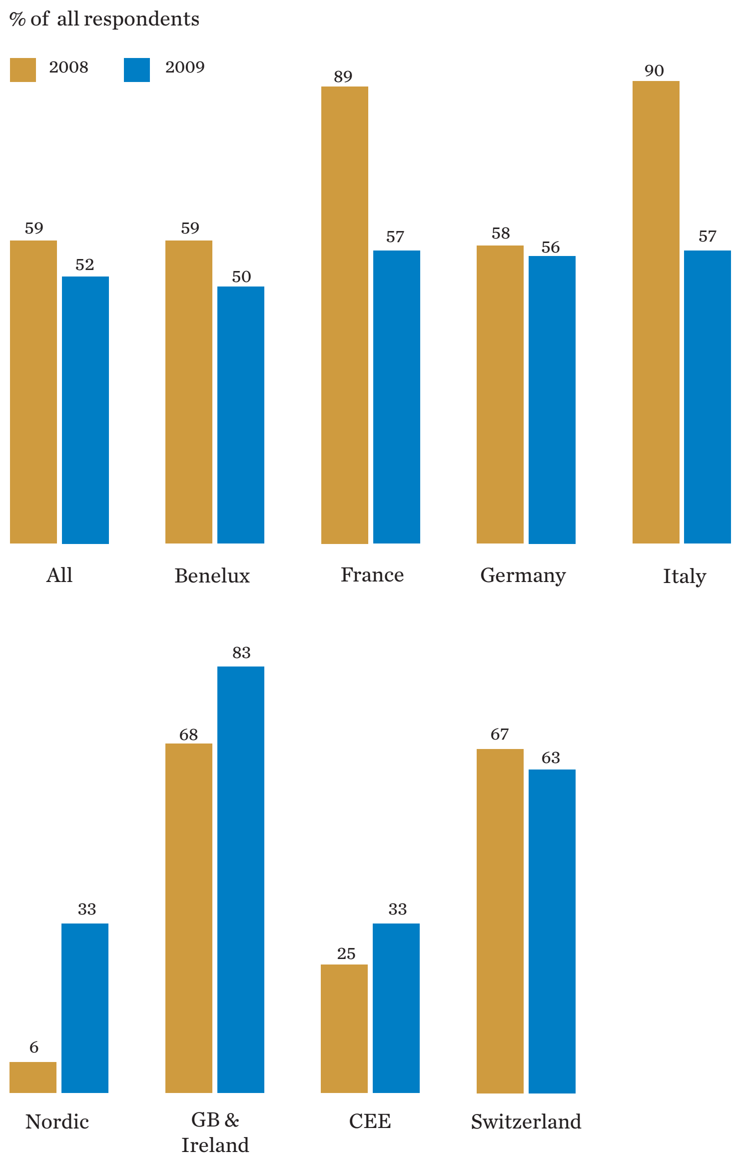
Looking at the country and region-specific statistics, the majority have seen a decline in the overall use of consultants (Fig 9.2) and France again shows a sizeable swing down. In part, this might be a reflection of the changes in the sample of respondents in this year's survey compared with last year. The overall fall in usage has been driven not only by the French but also by Italy, which has seen a similarly significant fall from 90% to 57%. In addition, Switzerland, which is traditionally one of the most well-penetrated consultants markets, is down and significantly so compared with 2007.

On the other hand, Great Britain and Ireland, another stronghold of consultancy use, is now back up and beyond 2007 levels of usage, showing that the fall last year may have been a short-term reaction to the recession. British and Irish investors are now the biggest users of consulting services, having dethroned Italy. A similar scenario is apparent in the Nordic region, which has seen a swing back and beyond 2007 levels. Again, this may be the reflection of the sample

9.1 Users of consultants 2005-2009



9.2 Users of consultants by country 2008-2009



of respondents compared with last year which was influenced by Denmark, where labour-market and other funds have a very high level of in-house capabilities, which has hindered the development of consultancy in the country. In addition, the CEE countries continue to increase the usage of consultants, with a third of respondents now using their services, equaling that of the Nordic countries.

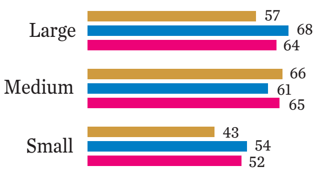
When it comes to the consideration of size (Fig 9.3), the separate groupings are beginning to show some distinctions and both large and small funds are using consultants to a much lesser extent. In the case of smaller funds this may be a reflection of limited resources and with the larger players it might be an effect of the recession and a need to curb costs. It may also be the timing of the survey, ie, regular reviews might not be annual. However, medium-sized funds buck the trend and continue to increase usage of consulting services. Some explanations to the changes may be gleaned from the analysis as to the reasons why consultants are used (Fig 9.4).

As the recession eases, portfolio activity is slowly increasing again, with selection of external managers up to 40% (39%) on last year but remains down compared with 2007 (51%). In fact, most reasons as to why investors use consultants' services show increases, albeit small, with the exception of liability management which is the only category with a significant increase. Now 24% (17%) of respondents say they use consultants for liability management.

Investment advice remains the top reason for using consultants, followed by asset allocation advice. Investment performance measurement and alternative investment advice show a sharp decrease compared to 2007, which may be a reflection of the recession and the rise of the new types of advice such as implemented consulting which is used by 10% of respondents. Two other categories, fiduciary management and reorganisaiton of businesses are also new for this year.

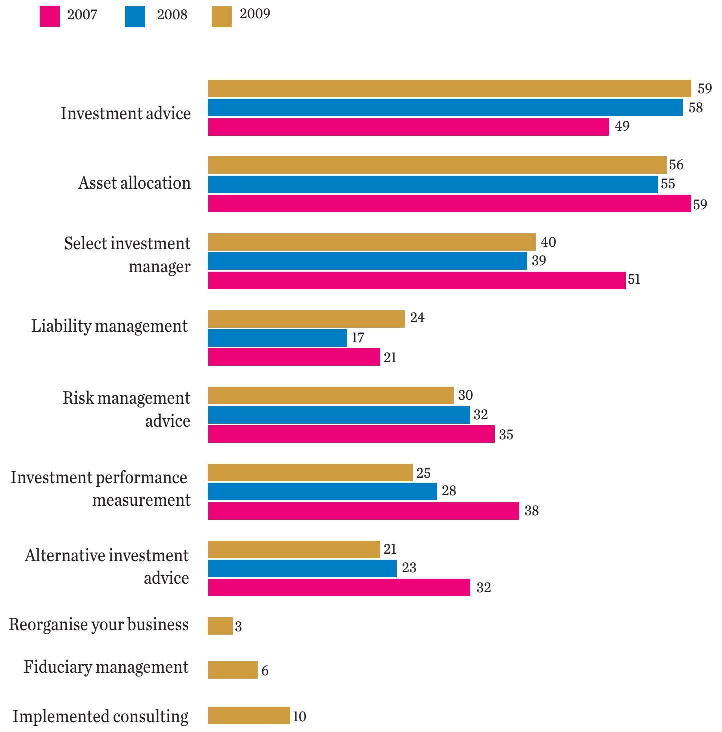
9.3 Users of consultants by size 2007-2009

% of all respondents



9.4 Reasons for usage of consultants 2007-2009

% of respondents who use consultants



Key takeaways

- use of consultants has fallen back from last year and is now just below that reported in 2007
- on a country basis, there has been a general fall in the use of consultants, and particularly so by France and Germany, each with a reduction of some 35%, albeit perhaps as a result of sample changes.
- the main exceptions are GB & Ireland with an apparent increase of some 20%, and Nordic countries with an increase from 6 to 33%
- GB & Ireland now stand out alone as by far the biggest users
- medium funds have now replaced large funds as the biggest users, with both the large and small funds substantially reducing their take-up
- consultants were most used for their investment advice for the second year and with virtually no change in the level of that usage. Asset allocation and selecting investment managers also kept their positions of second and third place, respectively

10. External managers: usage

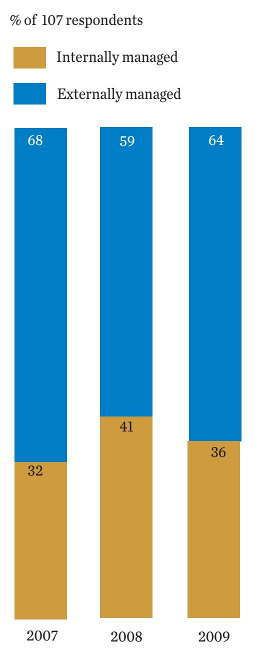
External trend resumed

The survey finds a swing back to the use of external managers after the sharp upsurge in internal management the previous year, perhaps prompted by the problems of the day, although this reversal is not completely across the board. The use of pooled funds is also increasing after a setback.

The long-term trend towards external managers over in-house management of assets was resumed in 2009, following a brief reversal in 2008. The previous year's survey saw the proportion of assets managed externally fall for the first time in several years, from 68% to 59%, but in 2009 it jumped back up to 64%, suggesting that 2008 was a blip, not a permanent reversal (Fig 10.1).

This can be seen clearly for both small and large investors. The proportion of assets managed externally for small investors returned to 2007 levels, up from 57% in 2008 to 66% (Fig 10.2). Similarly, the proportion of assets managed for large investors increased from 53% in 2008 to 56% in 2009, although this was still below the 2007 level of 59%.

10.1 Users of external investment managers



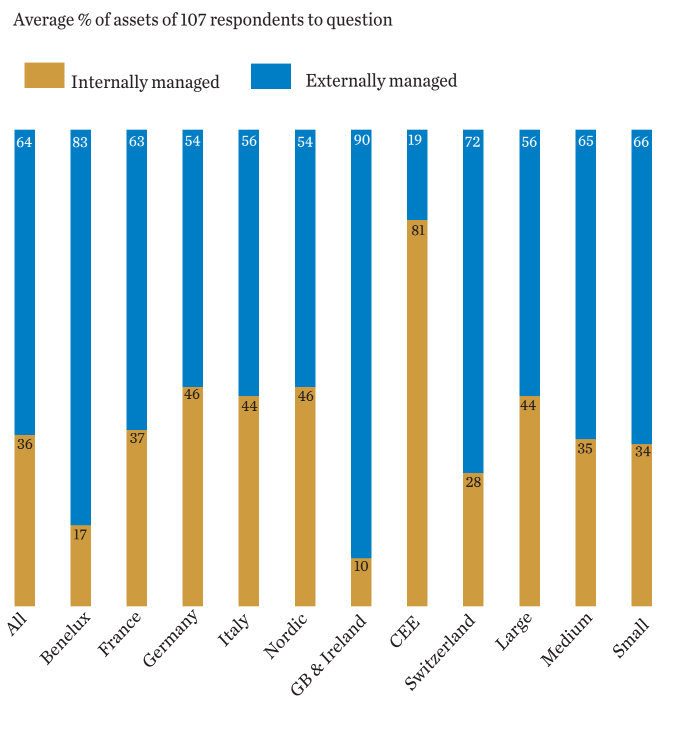
Only the medium-sized investors bucked the trend – as they did marginally last year – with externally managed assets actually decreasing from 68% to 65%. As a result, small investors have now supplanted medium-sized investors as the biggest users of external managers, albeit by a small margin.

The trend was played out across the majority of countries included in the survey. For example, Swiss assets managed internally dropped from 43% to 28%. Similarly, in the Nordic countries the proportion fell from 55% to 46%, while in Italy it dropped from 59% to 44%.

Key takeaways

- **the inexorable trend towards the use of external managers, briefly halted last year at 59%, has now apparently resumed normal service and, at 64%, is almost back where it was in 2007**
- **by a narrow margin, small investors have now replaced medium investors as the biggest users of external managers, although large investors have also increased their usage**
- **GB & Ireland remain the largest users of external managers, and have increased their usage since last year. Benelux is a close second but has made a small reduction**
- **CEE remains the lowest user, followed by Germany although it has significantly increased its usage**
- **the Swiss and Italy, both relatively low users last year, have made significant increases in their allocations**

10.2 Assets delegated to external investment managers by country and size



Outside the CEE region, German investors have historically been the smallest users of external managers, but they significantly increased their share, rising from a 40% minority in 2008 to a 54% majority in 2009.

British and Irish investors, which have historically outsourced more of their assets than any other investor region, saw their proportion of internally managed assets fall from 16% to 10%.

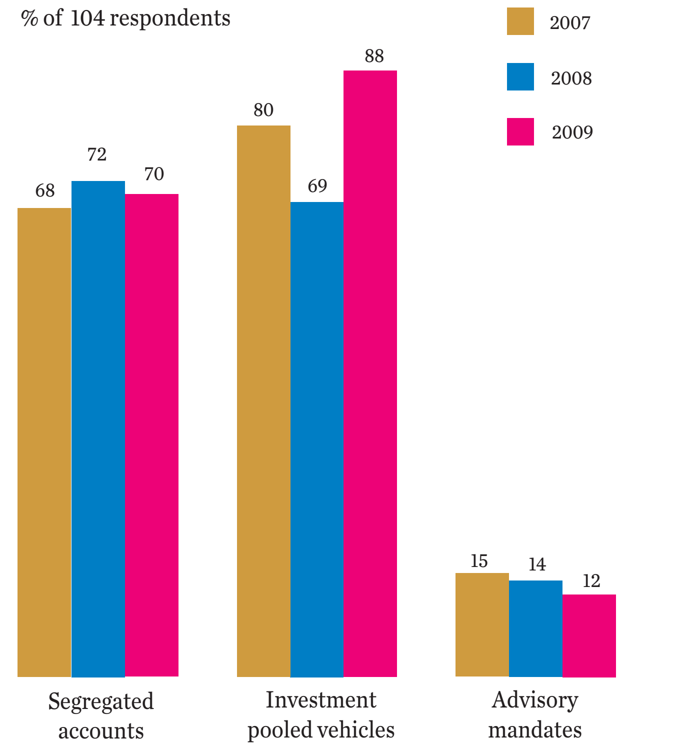
The CEE countries have always been firmly in the internal camp and they retained their place as the lowest users of external managers in terms of proportions of assets. In fact, their in-house/external manager split remained constant between 2008 and 2009 at 81/19.

Two other countries bucked the trend: the proportion of French assets managed internally actually increased from 34% to 37%; in the Benelux countries it rose from 13% to 17%.

Using a vehicle

Here we looked at how investors hold the assets they place with external managers, which have traditionally been held mainly in segregated accounts, although the arrival of funds catering for the special requirements of institutional

10.3 Users of external investment managers by vehicle 2007-2009



investors in recent years have showed signs of becoming the most popular investment structure.

After initially surging in popularity in 2007 to become the most widely used structure (used by 80% of investors versus 68% for segregated accounts), pooled investment vehicles dropped significantly in 2008 (to 69% versus 72% for segregated accounts). In 2009, pooled funds reclaimed their dominance with 88% of investors using them, versus 70% using segregated accounts (Fig 10.3). Advisory mandates continued their steady, if marginal, decline from a high of 22% in 2006 to 12% in 2009.

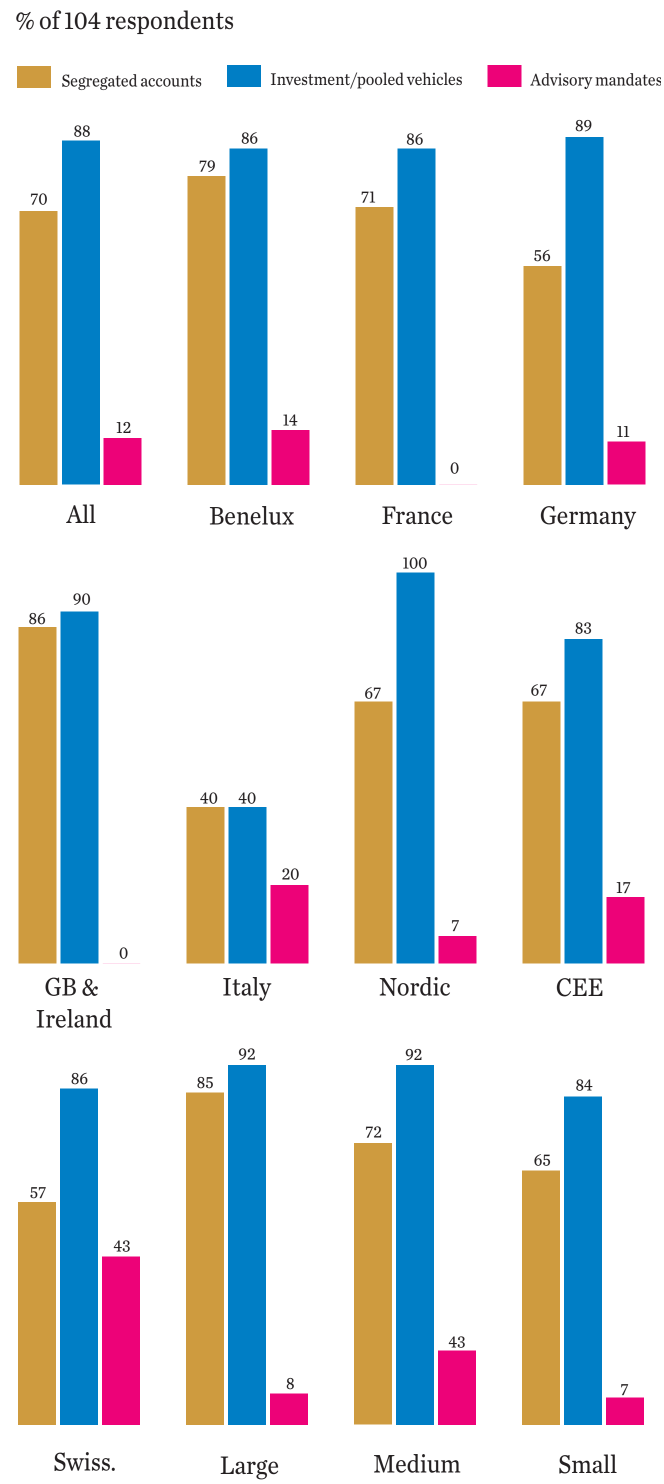
As highlighted in previous surveys, Nordic investors and those based in Great Britain and Ireland are the biggest users of pooled funds, at 100% and 90%, respectively (Fig 10.4). Pooled funds are least used by investors in Italy at 40%. As last year, Swiss investors are the only significant users of advisory mandates (43%).

The preference for pooled funds over segregated man-

Key takeaways

- use of segregated accounts has fallen back slightly
- investment/pooled vehicles now the most used, having recouped all and more of last year's losses at 88% (from 69%)
- advisory mandates continue to trend downwards and are little used at 12%
- segregated accounts used most by GB & Ireland and Benelux, and least by Italy and Germany
- pooled vehicles used most by Nordics and GB & Ireland (as last year) and least by Italy and CEE

10.4 Users of external investment vehicles by country and size



dates can be seen across the size spectrum of investors: 92% for both large and medium investors (versus 85% and 72%, respectively, for segregated accounts), and 84% for small investors (versus 65% for segregated mandates). Last year, only small investors showed such a preference for pooled funds (53% versus 39%). Segregated accounts remain the most popular with large funds.

The recovery in the use of pooled funds by investors generally may be seen as a greater recognition of their convenience compared with segregated accounts.

11. External managers: asset allocation

Reversing the trend

Investors continue to increase the proportions of their fixed income portfolios that they manage internally, while for equities the part that is managed externally continues to grow and now almost equals the assets in external fixed income managers' hands. This seems to be pretty well across the board

As discussed in Section 10, after a brief reversal in 2008, the long-running trend towards the use of external managers resumed its course in 2009. Only 36% of assets were managed internally in 2009, the biggest portion of which was fixed income. The dominance of fixed income for in-house investments is in keeping with previous years, although the proportion has continued to grow each year: last year it was 19%, this year 21% (Fig 11.1).

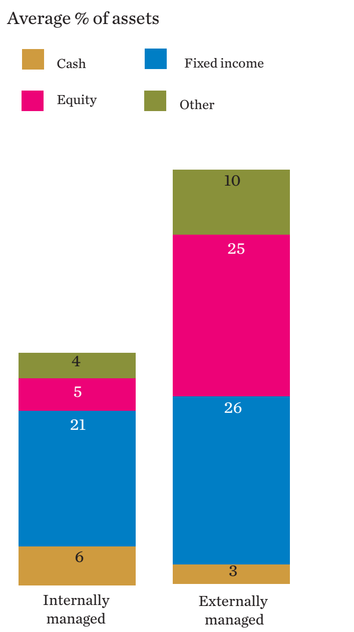
Fixed income also continues to make up the largest segment of assets managed externally (26%), although externally managed equities have grown in size each year to the point that they were almost as large in 2009 (25%). The gap was wider in last year's survey, with external fixed income at 27% and external equities at 23%.

Investors in Great Britain and Ireland, Benelux and Switzerland outsourced their fixed income investments the most, with the former not choosing to run any in-house. Meanwhile, 39% of Benelux investors' portfolios were externally managed fixed income, compared with 8.7% internally managed fixed income. The equivalent figures for Switzerland are 29.7% and 4.4%, respectively. British and Irish investors also had the highest proportion of equities run by external managers, at 43.6% of assets, versus 2.3% for in-house equities (Fig 11.2).

According to last year's survey, large investors were managing more assets in-house (53%), but in 2009 they returned to outsourcing the majority of their investments (55.7%). One of the biggest factors in this shift seems to be a reduction in internal equity investments (from 11% to 6.38%), while external equities have effectively remained constant from 20% to 19.8%). Cash management seems to have been largely outsourced, with external cash increasing from 1% to 4.6%, while internal cash has dropped from 6% to 2.9%. Alternative investments, falling under the 'Other' category, are now managed roughly 50-50 externally and internally: in 2008, alternatives were managed 13% in-house and 8% externally; in 2009, they were managed 9.2% in-house and 9.9% externally.

The proportion of assets managed internally at small investors reduced significantly in 2009, down from 43% to 34.2%. The biggest factors seem to be equity and cash portfolios. Only 5.1% of cash was managed internally in 2009 compared to 10% in 2008; meanwhile, externally managed cash increased from 2% to 2.9%. In-house equities shrunk from 7% to 4.5%, while external equities rose from 20% to 26.3%. Other investments managed in-house also fell from 5% to 2.6%, while those outsourced increased from 6% to 9.2%. Fixed income stayed relatively stable in comparison, with internal investments rising from 21% to 22%, and external holdings dropping from 29% to 27.4%.

11.1 Asset allocation by internal and external management



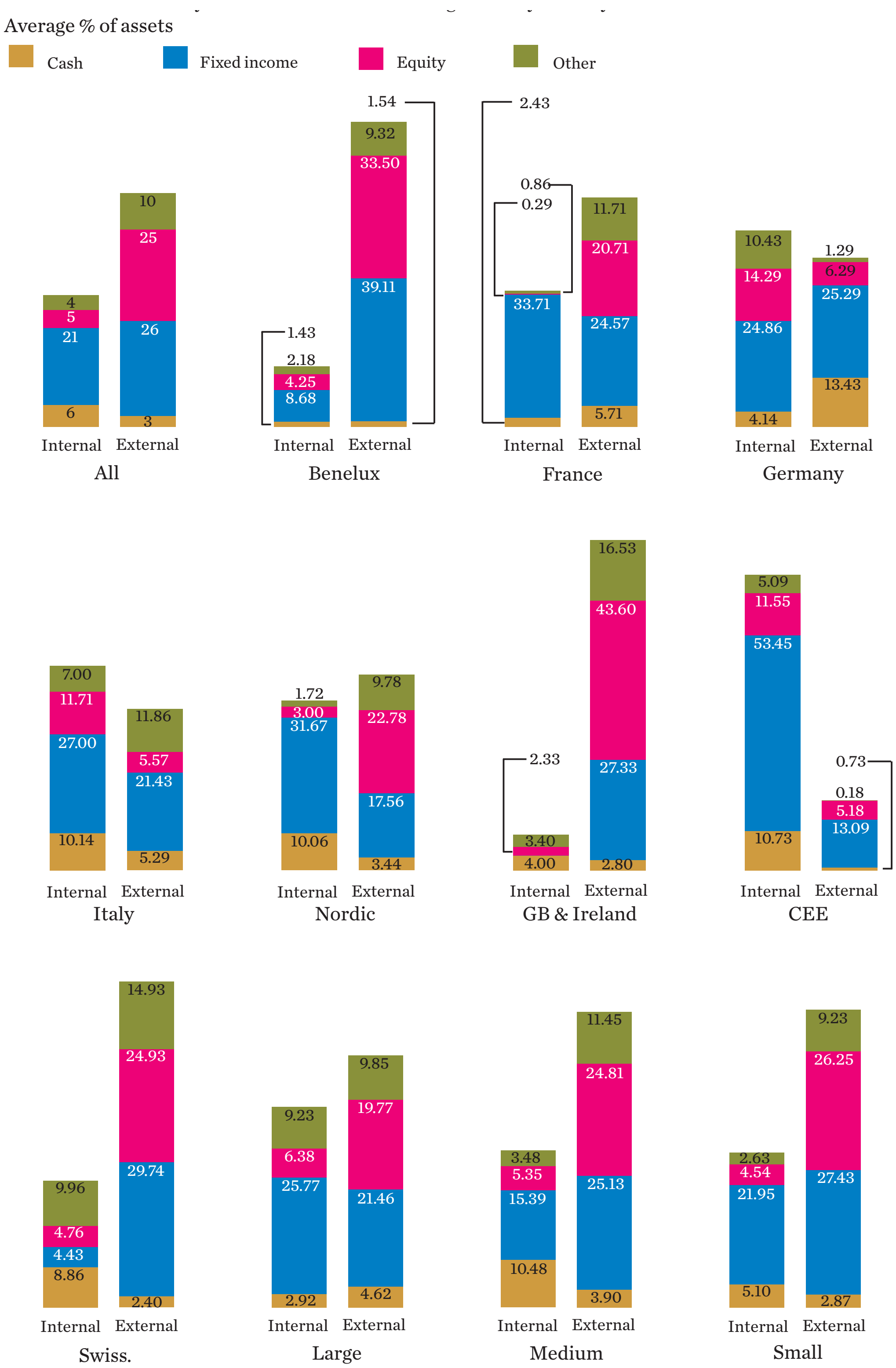
How the balance has changed

	2009		2008		2007	
	Int	Ext	Int	Ext	Int	Ext
Benelux	17	83	14	86	22	78
France	37	63	34	66	N/A	N/A
Germany	54	46	60	40	41	59
GB & Ireland	10	90	16	84	31	69
Italy	56	44	59	41	32	68
Nordic	46	54	55	45	36	64
CEE	81	19	81	19	86	14
Switzerland	28	72	43	57	19	81
All countries:	36	64	41	59	38	62

Key takeaways

- **internally managed assets continue, for at least the third year, to be most heavily focused on fixed income and by an increasing proportion**
- **externally managed assets, for the second year, are more focused on fixed income than equity, but now by the narrowest of margins (2008 – 27% & 23%; 2009 – 26% & 25%)**
- **cash still remains delegated at very low levels**
- **Benelux, Switzerland and GB & Ireland delegate most fixed income**
- **GB & Ireland, Benelux and Switzerland delegate most equity**
- **GB & Ireland continue to have highest proportion of equity among externally managed assets**
- **medium and small investors, as last year, have the most allocated to fixed income**
- **all fund sizes now allocate more to external than internal managers, medium and small funds both allocating two-thirds of their assets to external managers. Large funds have reversed last year's position by allocating over one half to external managers**

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



12. External managers: selection criteria

Perhaps the most notable results from this year's survey of attitudes towards selection criteria for external managers are that 'client service' remains stubbornly stuck outside the top five and that 'understanding of your organisation's goals and needs' has slipped the furthest – from seventh place in 2008 to 11th in 2009, after being a top-four criterion in 2005 and 2006. The two findings may be connected. Both these things are undoubtedly nice – but arguably luxuries. Priorities appear to have changed: investors are less concerned with the niceties of "What is it that you can do for me, specifically?" and more focused on the fundamental question, "How can I be sure that your industry is treating mine fairly?"

Backing up this speculation, we see 'corporate governance' jumping two places to ninth. Where investment banks are shedding their asset management divisions, minds once again become concentrated on the question of whether they were built up to deliver performance to clients or to gather assets and mitigate the cyclical nature of of the parent business, not to mention their strengths as stand-alones. Similarly, as merger and acquisition makes a big comeback, clients have to wonder whether synergies and cost-cutting will be passed on to them via lower fees and better performance – or whether the seemingly inevitable value destruction will be passed on to them instead.

The allegations around the mis-selling of synthetic CDO tranches to institutional investors, and a wilful lack of transparency at the heart of certain well-established business models, came too late to influence the survey responses – but we use 'well-established' advisedly: certain practices and conflicts of interest have long been a cause for concern for both asset owners and asset managers alike.

Informing against this sense that investors are concerned that the industry is not getting the basics aligned are the rankings of the two fees-related criteria. 'Transparency' of fees still outranks 'level' of fees, but the relative ranking has narrowed from fourth versus ninth last year to fifth versus seventh this year. Perhaps this indicates that investors have got to grips with the increasingly standardised fee and carried interest structures (form of profit share for managers in private equity and hedge funds) in the alternative investments world, and that they will be more demanding of better value from their managers in future surveys.

Investors' top-five criteria seem to be consolidating, and 'clarity of investment process' is tightening its grip on the number-one spot. This is both heartening and unsurprising: having gone through the mother of all tail events in 2008, the importance of understanding the true risk inherent in an investment process – and the folly of relying solely on volatility-based quantitative screening – is clear. Furthermore, as investors focus more intently on whole-portfolio risk sensitivities, unwanted, unexpected or style drift-related risks imported by external managers become a more obvious liability.

The same issues might

12.1 Criteria when selecting an external investment manager 2004-2009

Degree of importance (Ranking)

	2009	2008	2007	2006	2005	2004
Clarity of investment process	1	1	3	2	3	3
Performance	2	3	1	1	1	2
Risk control	3	2	2	3	2	1
Stability of investment team	4	5	4	5	5	4
Investment management fees – transparency of fees	5	4	5	n/a	n/a	1
Client service	6	6	7	6	7	10
Investment management fees – level of fees	7	9	8=	7	8	8
Financial strength of external manager	8	10	10	11	9	7
Corporate governance	9	11	n/a	n/a	n/a	n/a
Quality of reporting	10	8	6	8	6	5
Understanding of your organisation's goals and needs	11	7	8=	4	4	6
Reputation of asset manager (brand)	12	12	13	14	15	14
Other criteria	13	28	25	24	24	24
Segregation of fund management function	n/a	13	14	9	12	9
Asset manager rating	n/a	14	11	20	19	18
Professional rating of external manager	n/a	15	12	16	11	11
GIPS/AIMR compliance	n/a	16	15=	15	18	15
Ability to provide advisory service	n/a	17	19	10	10	12
Ownership/structure	n/a	18	18	n/a	n/a	n/a
Product innovation	n/a	19	15=	12	14	17
Total size of AuMs of external manager	n/a	20	17	17	16	16
Existing commercial relationship (banking, commercial)	n/a	21	20	21	20	20
Presence in your country: investment team presence	n/a	22	22	18	17	19
SRI	n/a	23	n/a	n/a	n/a	n/a
Presence in your country: sales office presence	n/a	24	21	13	13	13
Parent group is domestic	n/a	25	26	22	22	22
Parent group is international	n/a	26	24	23	23	23
Non-competitor	n/a	27	23	19	21	21

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

Degree of importance (Ranking)

	All	Benelux	France	Germany	Italy	Swiss	Others	CEE	GB + Ire	Nordic	Large	Medium	Small
Clarity of investment process	1	1	1=	1	4=	1	2	2	1	1	1=	1	1
Performance	2	4	1=	6	2	2=	4	1	2	2	1=	3	2
Risk control	3	2	2=	2	1	2=	1	5=	4=	3	1=	2	3
Stability of investment team	4	3	5=	4=	6=	4=	7	3	4=	4	2=	4	4
Investment management fees: transparency of fees	5	5	4	3	4=	4=	3	4=	7	5	2=	5	5
Client service	6	6	2=	5	5	3=	6	4=	9	7	3	7	6
Investment management fees: level of fees	7	7	6=	8=	6=	3=	8=	5=	8	6	6=	6	7
Financial strength of external manager	8	10	5=	8=	6=	6=	5=	8=	5	9	4	8=	9
Corporate governance	9	8	6=	9	8=	5	5=	7	10	10=	5	9	10
Quality of reporting	10	12	3=	7	8=	6=	8=	6	11	8	6=	10	8
Understanding of your organisation's goals and needs	11	11	6=	4=	3	7	9=	8=	6	11	7	8=	11
Reputation of asset manager (brand)	12	13	3=	11	7	6=	9=	5=	12	10=	8	12	12
Other criteria	13	9		10		8	10		3	12	6=	11	13

help explain the (perhaps surprising) switch between 'risk control' and 'performance' between 2007 and 2009. When 'performance' is about how much a manager outperforms its (gently rising) benchmark, it is not strange that it should outrank 'risk control', as it did in 2006 and 2007. With the disaster that then struck, the signal went out that 'risk control' be taken pretty seriously. In the aftermath, the more profound recognition dawns: for a long-term investor trying to compound returns from risk premia over decades, outperforming spurious benchmarks is less crucial than avoiding big losses. When you are focused on protecting your downside, there is not much difference between 'risk control' and 'performance' –they go together.

Country-and size-specific samples showed few outliers against the aggregate results, with the exception of one result that suggests that sometimes national stereotypes may contain a kernel of truth: German investors rank 'clarity of investment process', 'risk control', 'transparency of fees', 'stability of investment team' and 'client service' above 'performance' in sixth place.

Key takeaways

- **'clarity of investment process' retained its first place, followed by 'performance' and 'risk control' in second and third places, respectively, reversing their positions of the previous year**
- **those top three have kept the first three places, just not always in the same order, for the past six years**
- **'stability of investment team' has moved up to fourth place, swopping places with 'transparency of fees' which is now fifth**
- **'level of fees', 'financial strength of external manager' and 'corporate governance' have all moved up two places to seventh, eighth and ninth, respectively**
- **responses should have a sharper focus as we removed some 15 criteria that had never been highly rated**
- **on a country basis, again broad concurrence that 'clarity of investment process' is most important, except for the Italians, who favour 'risk control'**
- **France is much more focused than others on 'quality of reporting', and Italy on 'understanding goals and needs', both in third place**
- **'performance', in overall second place, was considered less important by the Germans (sixth) and Benelux (fourth)**
- **there is now broad agreement by size on the top five criteria. 'Performance' continues to dominate the minds of larger funds, moving in the past three years from seventh to third to first place**

13. External managers: fees

Closing the gap

There seems to be a degree of convergence of fee structures across asset classes. Historically, managers of fixed income, equities and real estate have more commonly charged investors fixed fees than, for example, private equity fund managers. While this remained largely true in 2009, the gap seemed to be closing significantly.

Performance fees on their own remained largely unpopular in 2009, outside private equity and hedge funds (Fig 13.1). But the survey responses also reveal that the proportion of fixed income investors paying only fixed fees fell by eight percentage points to 65% in 2009, while the proportion of those paying a combination of fixed and performance fees increased by the same percentage.

Similarly, the number of equity investors paying both fixed and performance fees actually outgrew those paying fixed fees only (50% versus 49%) in 2009 – a reversal of the previous year's situation when 52% of investors paid fixed fees and 44% paid a combination of both. Real estate investors followed this trend, with the proportion of investors paying fixed fees dropping nine percentage points to 59% and paying a combination of fees climbing by 10 percentage points to 36%.

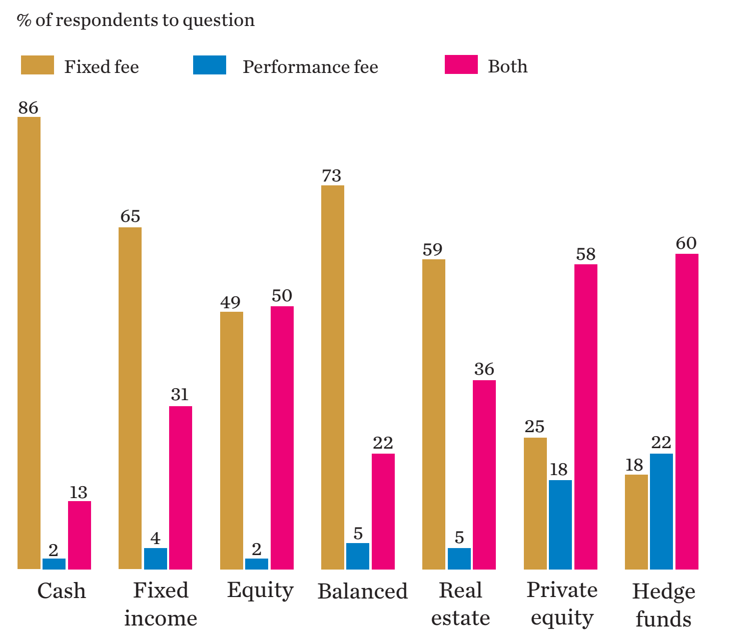
The only two asset classes where the opposite trend was true was for private equity and balanced funds, where the proportion of investors paying only fixed fees increased by 12 percentage points to 25% and nine percentage points to 73%, respectively. Hedge funds remained fairly stable, only shifting by two percentage points to 60% in favour of a combination of fees versus fixed fees.

Overall, these findings imply that hedge funds are seen as best suited to a combination of fixed and performance fees, while fixed fees are the most appropriate for managed funds. All other asset classes seem to be converging somewhere in the middle, suggesting a variance of opinion among investors over fee structures depending on the type of asset.

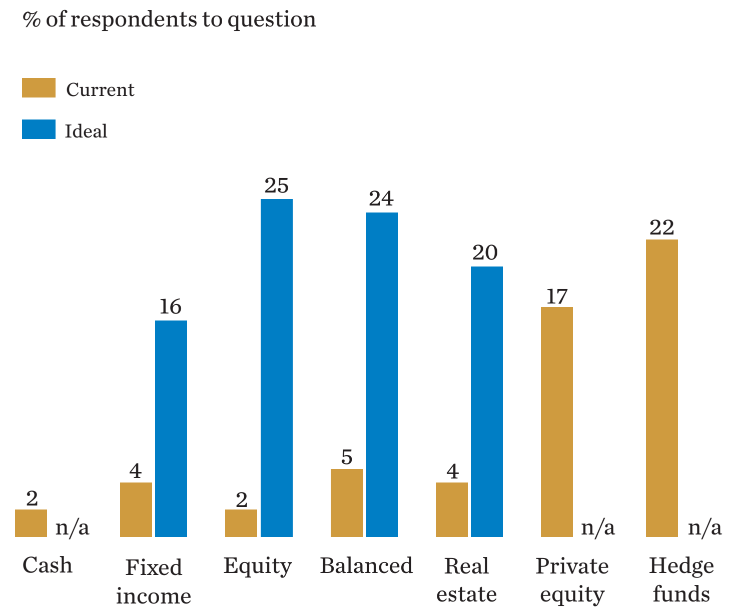
However, a large proportion of investors (Fig 13.2) perceive that more fixed income, equity, balanced and real estate funds should have performance-related fees in place. This is particularly significant for equity and balanced funds, with ideal performance fee usage of 25% and 24%, respectively, outstripping current performance fee usage of 2% and 5%.

While the majority of investors over the past four

13.1 Current compensation of external managers



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



Key takeaways

- **most remuneration again fixed fees, but with reduced requirement for fixed income 65% (73%) and real estate 59% (68%)**
- **a mixture of fixed and performance fees is now mostly sought for equities 50% (44%); and this continues to be true also of private equity and hedge funds**
- **where responses provided, more performance fees are desired for all classes**
- **current performance compensation has declined for equity and real estate, with a marginal increase for balanced**
- **gap between current and ideal has shrunk across the board, most significantly for balanced (by 13%), followed by fixed income (12%), real estate (11%) and equity 5%**
- **last year's results suggested that increasing numbers of respondents' aspirations were not being met, but this trend appears to have been halted**

years believed fixed fees were the ideal form of compensation for managers, this reached a high in 2009 at 49% (Fig 13.3). Performance fees on their own have lost their popularity over the same period, dropping from 39% in 2006 to 16% in 2009, although a combination of both has remained a relatively popular structure over the past three years, staying in the region of 30-37%.

Investors seem to disagree more over the ideal fee structures for balanced funds, although performance fees seem to have lost a great deal of appeal for investors in these funds over the past four years, from a high of 59% in 2006 to a low of 24% in 2009. This year's survey respondents are split on fixed fees (37%) and a combination of both (39%).

This question of ideal compensation has been extended in this year's survey to include equity and real estate managers. The data shows that currently a combination of fixed and performance fees is the most popular structure for both, at 41% for equity and 42% for real estate. That said, fixed fees are a fairly close second, at 34% for equity and 38% for real estate.

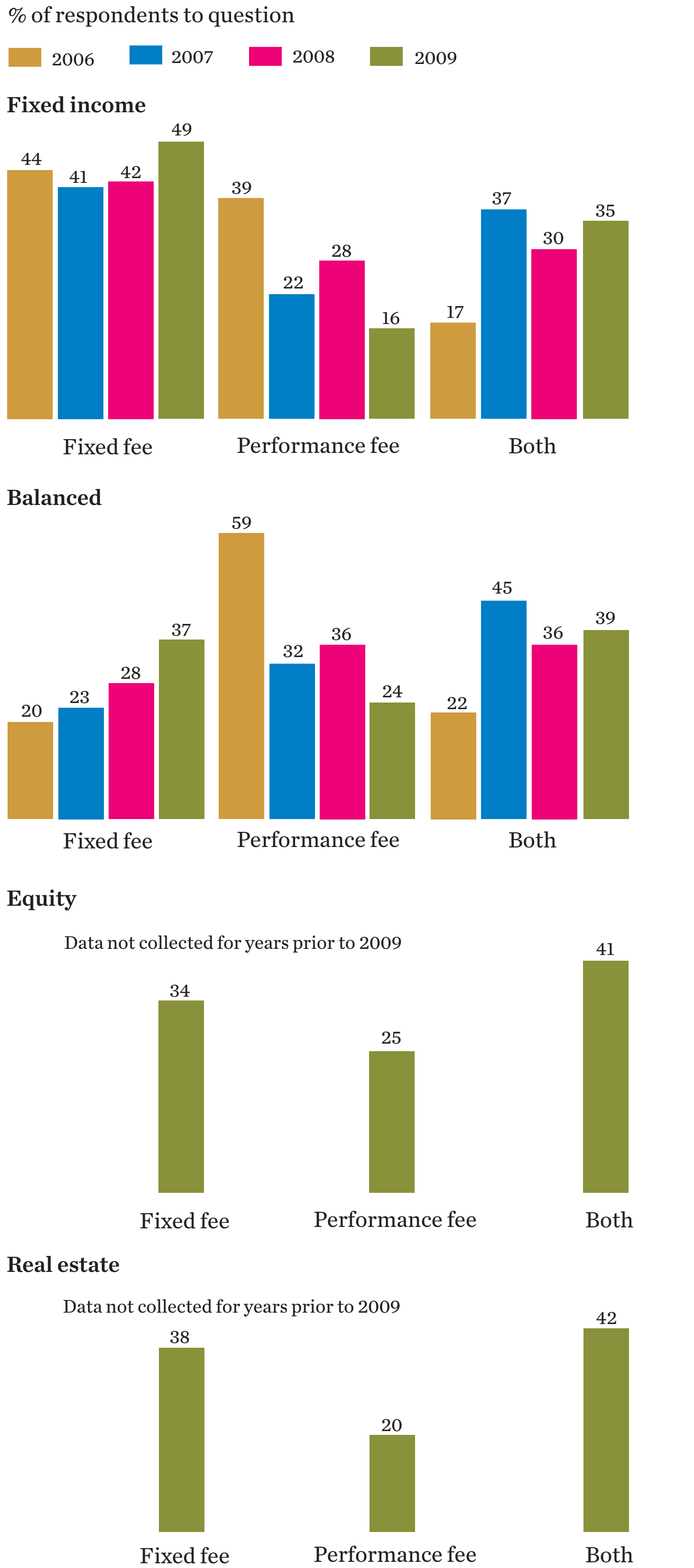
Investor opinion over ideal performance fee usage across different asset classes appears to vary from country to country (Fig 13.4). For example, investors in Great Britain and Ireland were those pushing the most for performance-related fees for fixed income managers at 29%, with German investors less concerned at 25%; the picture was reversed for equity managers with German investors pushing the most at 38% and British and Irish investors less concerned at 14%.

Investors in Italy were the most consistently in favour of performance fees across all four asset classes: 21% for fixed income; 32% equity; 38% balanced; 25% real estate. At the other extreme were CEE investors who did not respond to the question for any of the four asset classes. German investors were a close second behind their Italian counterparts (25% for fixed income; 38% equity; 29% balanced; 14% real estate). After CEE investors, the Swiss were particularly averse to performance fees, with the compensation method only showing appeal for equity (20%) and balanced funds (25%).

In terms of investor size, medium investors are the most in favour of performance fees across the asset classes, particularly for equity and balanced funds at 38% and 37%, respectively (Fig 13.5). Small investors were the least in favour of performance fees, with only 12% showing interest for fixed income and real estate, for example. Balanced funds were the only category where small investors were more in favour of performance fees than large investors, at 21% versus 19%.

It becomes apparent there was a significant shift away from performance fees by small investors when the numbers are compared with last year's survey results. Fixed income fell from 30% to 12%, equity fell from 32% to 19%,

13.3 Ideal compensation of external investment managers 2006-2009



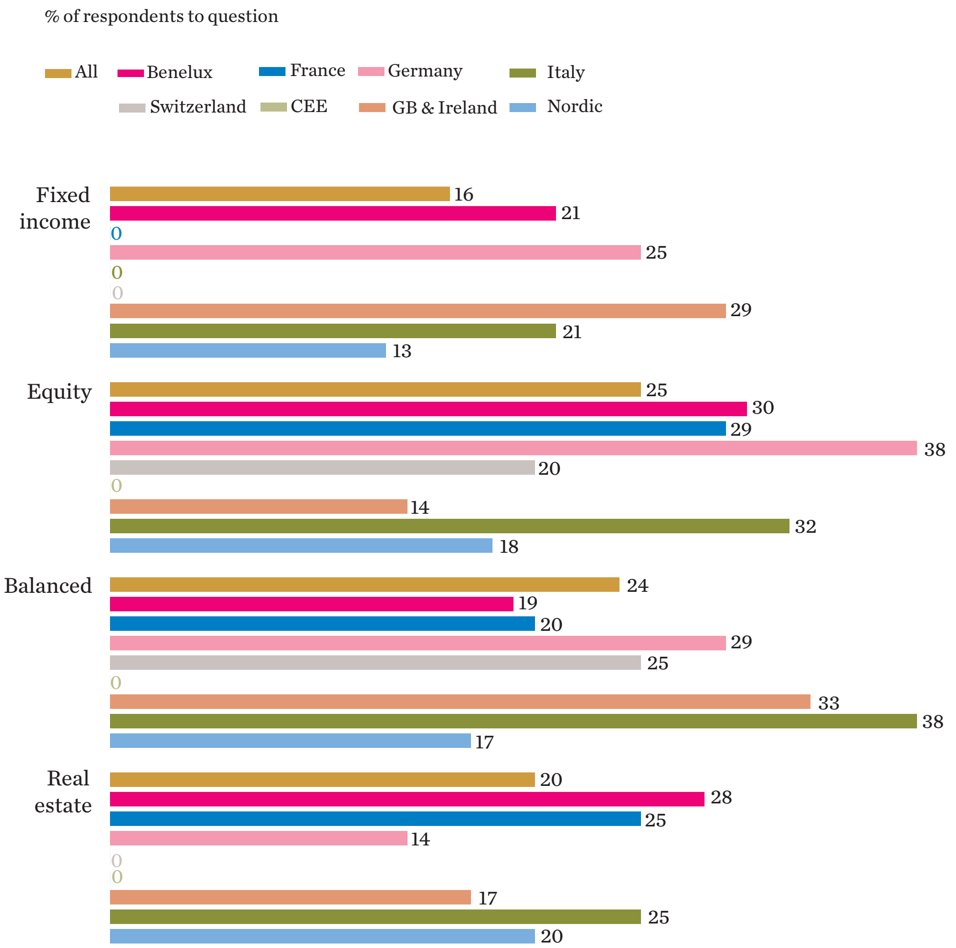
and real estate fell from 32% to 12%. By contrast, balanced funds actually increased from 17% to 21%.

Interestingly, the percentages for large and medium investors did not move anywhere near so much from last year, possibly revealing less of a knee-jerk reaction to poor performance figures. But the one exception was real estate where large and medium investors showed an increased appetite for performance figures: large investors jumped from 16% to 27%, and medium investors rose from 20% to 30%.

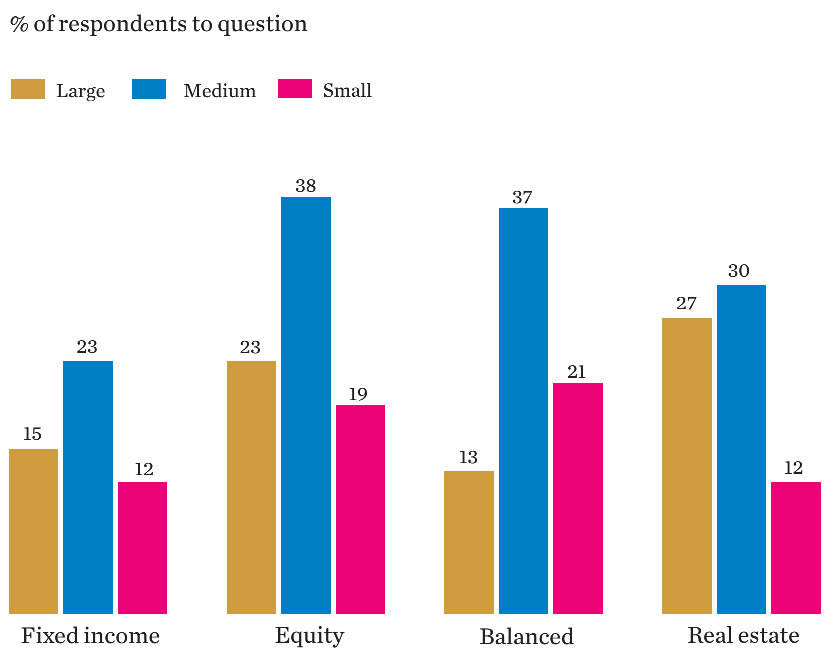
Key takeaways

- ideal of fixed fees for fixed income has increased in each of the last three years, now at 49%; sharp drop by almost one half for performance fees to 16% (28%), but recovery of interest in combination of fixed fees and performance to 35% (30%)
- balanced indicating a steady increase over the last three years for fixed, a marked reduction in interest in performance fees at 24% (36%); and a move towards a combination of both at 39% (36%)
- the ideal for equities is a combination of both (41%) followed by fixed fees (34%)
- real estate follows a similar pattern with both leading at 42% and fixed fees at 38%
- most demand for performance fees for fixed income comes from the Germans (25%) and Benelux (21%), with zero interest being recorded for the French, Italians and Swiss
- 38% of Germans and 32% of Italians want performance fees for equity and, with the exception of GB & Ireland at 14% (excluding CEE at zero), other respondents fall in the 18% - 30% range

13.4 Ideal performance fee usage for external managers by country



13.5 Ideal performance fee usage for external managers by size



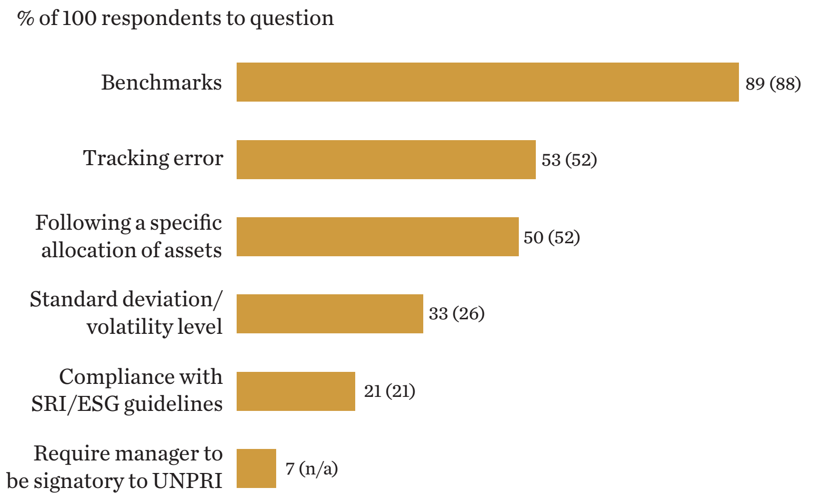
14. External managers: constraints

Fewer types of constraints

In the aftermath of the greatest recession seen for decades it might have seemed inevitable that investors would impose more restrictions on managers, because these constraints play a vital role in determining performance. However, compared with previous years, it appears that the number of restrictions imposed has been reduced.

This year's responses confirm that where investors have a relationship with external managers, their top constraints remain the same as before. However, there are fewer types of constraints ranked and some further reshuffling has occurred as well as new constraints included.

14.1 Types of constraints given to managers 2009 (2008)



Benchmarks and tracking error still head the list of techniques used in mandates (Fig 14.1), but they are being used by a slightly larger proportion of investors, increasing to 89% from 88% in the case of benchmarks and to 53% from 52% for tracking error. The constraint 'Follow a specific asset allocation' has now fallen back to number three in the rankings, from its joint second place last year, and its use has slipped to 50% from 52%.

In this year's survey there are no respondents who are requiring 'Dedicated reporting elements', or 'Maximum cash levels' constraints, compared with 37% for both categories in last year's survey. In previous years, and in particular during the recession, investors have been looking more closely at the cash elements of the portfolios, ensuring that managers do not sit on excessive cash positions and are fully invested.

Other portfolio constraints that no longer seem to be as much of a concern for investors are 'Annual rate of yield' and 'Maximum portfolio turnover' at 12% and 9%, respectively, last year. 'Standard deviation' is a constraint that seems to be more in favour by investors, with the proportion of respondents using this increasing to 33% from 26%. This year the 'Volatility level' category has been merged with 'Standard deviation'.

This year the constraint 'Compliance with SRI/ESG guidelines' remains at the same level as last year, at 21%. However, new for this year is whether investors now 'Require manager to be signatory to UNPRI', with 7% using this constraint. That this new category has appeared, in addition to 'Compliance with SRI/ESG guidelines' shows perhaps that the UN Principles for Responsible Investment is gaining momentum and that institutional investors are further specifying their responsible investment activities.

Key takeaways

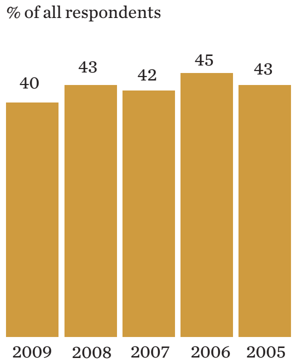
- **benchmarks remain the favoured constraint at 89%, marginally up on 2008**
- **tracking error stays in second place, narrowly ahead of following a specific allocation of assets (previously in joint second)**

15. External managers: breaking relationships

Breaking up is so hard to do

Perhaps it is simply a case of sticking to the tried and tested during difficult times, but the past year has brought a new stability to relationships between investors and external managers, with less appetite for sackings. However, while unsatisfactory performance is still considered the most significant factor in the decision to remove a manager, lack of clarity in fund management policy is gaining in importance as investors become keener to analyse the story behind the investment returns.

15.1 Relationships with a manager terminated 2005-2009



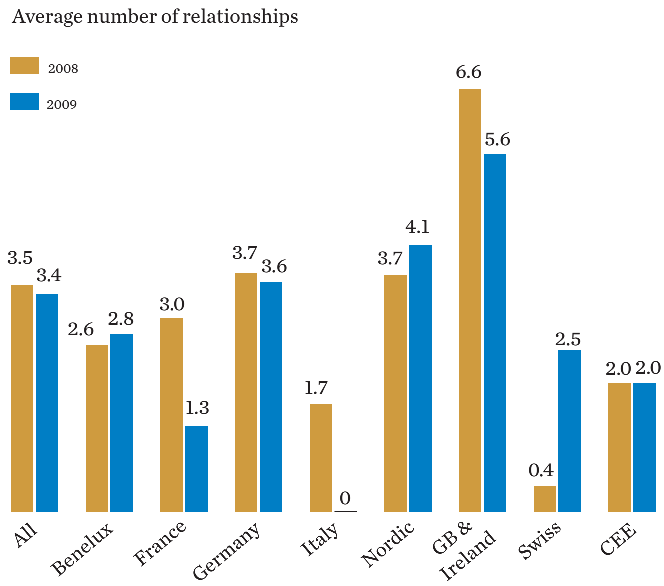
Overall, the proportion of investors who terminated their agreements with external managers in 2009 is the lowest it has been – 40% – in the past five surveys (Fig 15.1).

And while this figure has fluctuated only within a few per cent over the five-year period, the breakdown on an individual country or region basis (Fig 15.3) shows an even more striking trend towards stability.

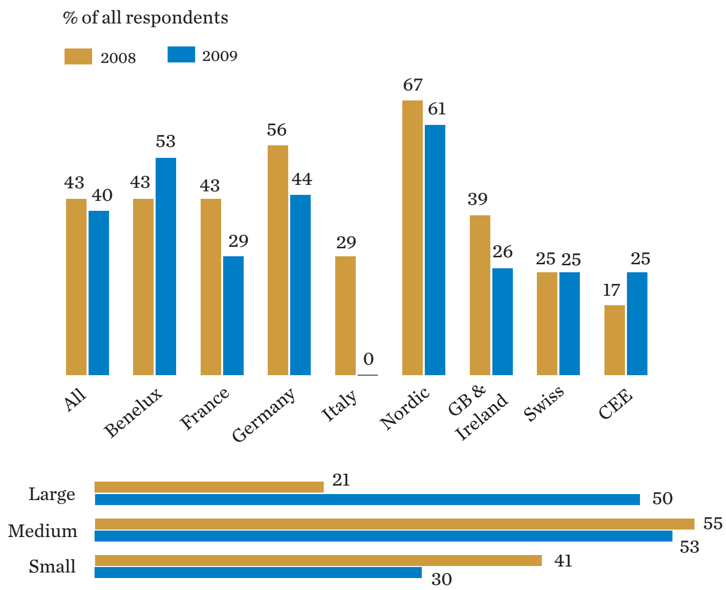
There were just two regions where manager dismissals increased between 2008 and 2009. In the Benelux countries, 53% of investors ended their relationship with a manager during 2009, compared with 43% in 2008, while sackings were made by 25% of CEE investors in 2009, compared with 17% the year before.

While the Swiss maintained equilibrium at 25% of investors firing managers in both years, everywhere else there were fewer investors ending relationships.

15.2 Relationships with a manager terminated in 2009 and 2008



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



The most significant result was in Italy, where no investors terminated management contracts in 2009, compared with 29% the year before. But there were also large falls in Great Britain and Ireland (from 39% to 26% of investors) and France (43% to 29%).

However, there was a huge difference in the treatment of managers between large investors on the one hand, and small and medium-sized investors on the other.

Key takeaways

- **40% have broken a relationship, a small reduction on the previous year (43%) and the smallest amount for at least five years**
- **the average number of terminations has decreased slightly to 3.4 per year (3.5 in the previous year)**
- **Italians and French most loyal, with 0 and 1.3 broken relationships, GB & Ireland and Nordics most ruthless with 5.6 and 4.1, respectively**
- **Benelux and CEE have increased their rate of aggression, with the French and Italians being much more tolerant (or satisfied) than the previous year**
- **medium funds have again broken the most relationships, although at a lower rate than the previous year, followed very closely by the larger funds**

While both small and medium investors recorded a drop in the number of sackings – for small funds these were down by more than a quarter, from 41% to 30% of investors – the proportion of the largest investors that had shown managers the door more than doubled over last year, from 21% to 50%.

On an 'all country' basis, the number of fractured relationships averaged out at 3.4, down slightly from 3.5 last year (Fig 15.2). Predictably, Italy was the exemplar of new-found bliss, with no relationships terminated in 2009, compared with an average 1.7 in 2008. France, Germany and Great Britain and Ireland also experienced fewer relationship splits.

However, Great Britain and Ireland has now taken over from the Nordic region as the most fickle in Europe, by sacking the largest average number of managers – 5.6 – last year.

As in the previous year, however, the most compelling reason for sacking a manager was unsatisfactory performance, while failure to control risk again came second (Fig 15.4).

But lack of clarity in fund management policy has now increased in importance, moving up to third place from fourth last year. Next comes strategy or asset allocation, while change of investment strategy or asset reallocation has slipped back to fifth.

Of the dozen factors listed, breach of investment constraints is the only other which has moved up the scale.

On an 'across country' basis (Fig 15.5), there are signs that failure to control risk is growing in importance, with Benelux and Germany now rating it more important as a sacking offence than unsatisfactory performance. Again, lack of clarity is also a more important factor this year than last, with only Switzerland and the Nordic region ranking it lower than third place.

15.4 Factors which play a role in the decision to remove a manager 2007–2009

Degree of importance (Ranking)

	2009	2008	2007
Unsatisfactory performance	1	1	1
Failure to control risk	2	2	2
Lack of clarity in fund management policy	3	4	4
Strategy or asset allocation	4	5	5
Change of investment strategy or asset re-allocation	5	3	3
Reorganisation of investment manager's group	6	6	9
Breach of investment constraints	7	11	6
Inadequate reporting/contact	8	7	11
Excessive turnover of investment team	9	8	7
Inability of investment manager to advise on investment	10	9=	12
Cost competition	11	n/a	n/a
Internal reorganisation of your group	12	12	10

Key takeaways

- **unsatisfactory performance remains the most important factor overall to trigger a removal, except for Benelux and Germany where it is failure to control risk, and Italy which looks most to strategy or asset allocation**
- **Swiss and CEE also give much more importance to strategy or asset allocation, placing it second**

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

Degree of importance (Ranking)

	All	Benelux	France	Germany	Italy	Switzerland	CEE	GB & Ireland	Nordic
Unsatisfactory performance	1	2	1	2	2=	1	1	1	1
Failure to control risk	2	1	2	1	2=	4	2=	2	2
Change of investment strategy or asset re-allocation	5	5	4=	5	n/a	5	4=	5	3
Lack of clarity in fund management policy	3	3	3	3=	3	6=	3=	3	4
Reorganisation of investment manager's group	6	4	7	6	n/a	6=	4=	7=	5
Strategy or asset allocation	4	6	6=	8	1	2	2=	4	6
Internal reorganisation of your group	12	10=	9	11	n/a	9	2=	10	7
Excessive turnover of investment team	9	9	4=	9	n/a	6=	5=	8	8
Breach of investment constraints	7	7	6=	3=	n/a	7	6	9	9
Inadequate reporting/contact	8	8	5	4	n/a	8	4=	6	10=
Cost competition	11	11	8	7	n/a	3	3=	7=	10=
Inability of investment manager to advise on investment	10	10=	6=	10	n/a	6=	5=	7=	10=

16. Other findings: SRI/ESG/Securities lending

Governance leads the way

Last year the attention of institutional investors was directed at the ongoings of markets and financials rather than extra-financials. After increasing interest in socially responsible investment (SRI) or environmental, social, governance (ESG) in previous years, these issues seem to have taken a step back in respondents' minds. The environment, particularly climate change, took centre stage again in the public eye in 2009 and, because of this, environmental concerns could have been expected to be the main drivers behind SRI/ESG.

'Social and environmental values' were indeed cited as the number one reason (Fig 16.1) why respondents follow these types of investment strategies. However, compared to the previous year's survey, fewer respondents named this factor as a reason for pursuing SRI/ESG strategies.

More than half of respondents attributed their ESG strategy to the belief of owners and the board and more than a third to the corporate culture but again those reasons fell behind compared to previous years.

However, 30% of respondents indicated that governance was the main driver behind their pursuit of SRI/ESG strategies, the first time this option was included in the survey.

The survey confirms the widespread belief that the majority of institutional investors are essentially driven to SRI/ESG by other than performance-related reasons although this undoubtedly remains an important factor for many respondents.

Most respondents have no plans to increase assets governed by SRI/ESG in 2010 (Fig 16.2), although just under half of respondents are planning on doing so.

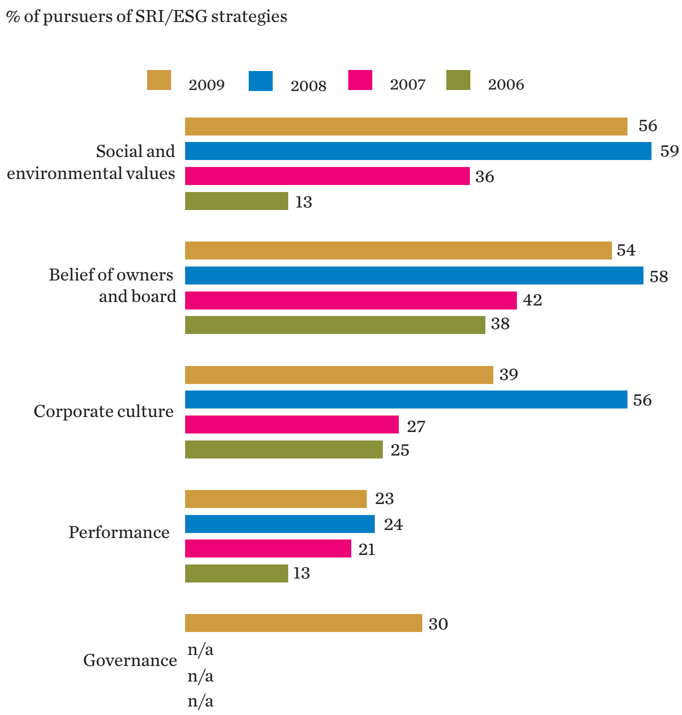
Fewer written SRI/ESG policies in place, compared to the previous year, testified that SRI/ESG took a backseat for many investors in 2009. However, again the written policies most respondents had in place were corporate governance strategies, at 70%, though these were also down by 2% on 2008 (Fig 16.3).

Corporate governance strategies are also the most common written policies used to gain index exposure with the exception of the Benelux and Nordic countries, where SRI leads the way (Fig 16.4).

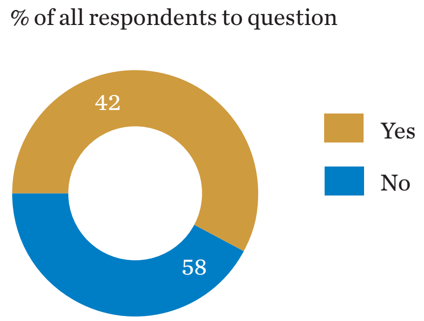
Written corporate governance policies were slightly lower in number on the previous year in France, Italy and the Nordics – however, those policies generally continue to make their foray among institutional investors across Europe. In Switzerland and Germany, corporate governance strategies by respondents almost doubled from 33% in the previous year to 63% and from 17% to 33%, respectively. In Great Britain and Ireland, they continue to be as popular as they were in the previous year at 83%.

Engagement strategy continues to be country-specific,

16.1 Reasons for pursuing SRI/ESG strategies



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

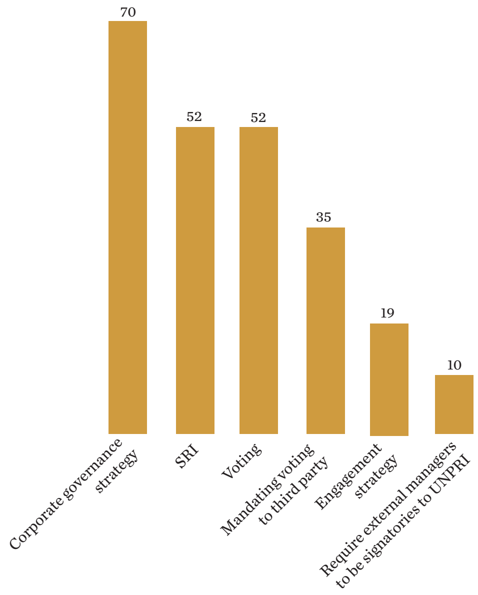


Key takeaways

- **main reason, for second year, is social and environmental values ahead of belief of owners and boards, but by a very narrow margin compared with the previous year's findings; corporate culture remains in third place but now by a large margin**
- **respondents planning to increase percentage of assets governed by SRI increased to 42% (30%), with 58% having no such forward plans, although the assumption is that a proportion of that 58% is already fully governed by SRI principles**
- **incidence of written policies has lost some ground on the previous year, but corporate governance strategies in place for 70% of respondents (72%), and over one half for SRI and voting (both 52%, compared with previous year's 56% and 53%, respectively). Engagement strategy has fallen back considerably to just 19% (27%)**
- **new question of requiring adherence to UNPRI found little interest at 10%, with most interest being shown by French and British & Irish investors**

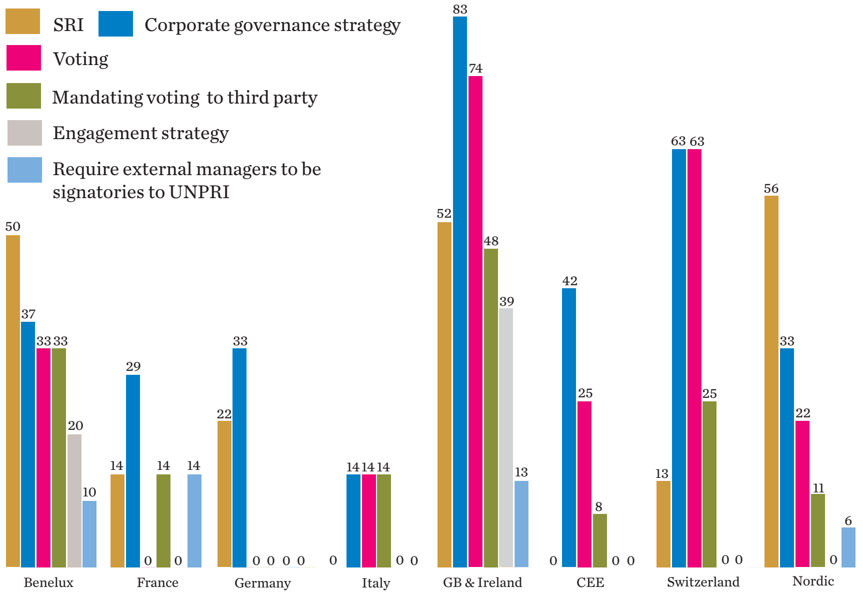
16.3 Frequency of written policies

% of all respondents to question



16.4 Frequency of written policies by country

% of all respondents



Key takeaways

➔ written policies continue to be most popular with British & Irish. The first signs last year of blossoming interest in written policies by the French has largely withered this year, except for corporate governance strategies, with the Germans now only expressing interest in SRI and corporate governance

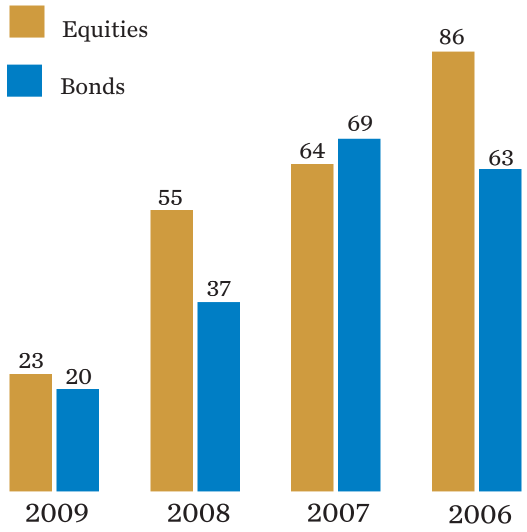
being applied only by respondents in the Benelux, Great Britain and Ireland.

Membership of the UN Principles of Responsible Investment (UNPRI) continues to grow but at this stage it only occasionally appears to make it into written policies.

Securities lending

Following the emergence of counterparty risk and the ban on financial stock shorting in 2008, the asset classes used for securities lending dropped substantially in 2009 compared to previous years. Equities used for securities lending plummeted by more than half, while bonds used for securities lending fell by 17% on 2008 among respondents, a decline of more than two thirds on the peak of 2007 (Fig 16.5).

16.5 Asset classes used for securities lending 2006-2009



Key takeaways

➔ equities and bonds used for securities lending have fallen by about one half to 23% and 20%, respectively, and dramatically from the highs reported in 2006 of 86% and 63%, respectively

17. List of charts and tables