

Russell Research

Russell Investments' 2012 Global Survey on Alternative Investing

The importance of diversification and alpha

Introduction

In recent years, alternatives have become an even more prevalent aspect of multi-asset investing. Because we believe alternatives can play a unique role in helping organizations achieve their desired investment outcomes, we expect this trend to continue.

The purpose of the Russell Investments 2012 Global Survey on Alternative Investing ("Survey") was to assess the primary factors that influence institutional investors as they evaluate and make decisions about alternative investments, within the context of their objectives for their institutions.

Russell has published the Survey biennially since 1992, which gives it one of the longest tenures of any survey of its kind in the financial services industry. Over the years, we have captured themes, trends and the perspectives of thousands of institutional investors around the globe. In this dynamic industry, we believe our surveys provide a clear lens through which to view the changing nature of alternative investments in a growing multi-asset investment landscape.

In this year's Survey, questions were developed around the following perspectives: assessing the demand for alternative investments, defining barriers to investing in alternatives, understanding key influencers and gaining insight into key implementation issues.

What is the Survey telling us? Participants have confirmed:

1. **SIGNIFICANT DEMAND, EXPANDING USE.** Survey respondents are making significant allocations to alternative investments—on average, 22% of total fund assets. The majority of respondents expect to maintain their existing exposures. More importantly, 12% to 32% of respondents plan to increase their allocations to one or more categories of alternatives over the next one to three years (percentage varies by strategy).
2. **INVESTOR-DRIVEN IMPLEMENTATION.** With greater experience and expanding allocations, respondents are driving implementation approaches. For example, in hedge funds, 63% of the Survey respondents are obtaining customized solutions to complement existing exposures, pursuing niche opportunities, and accessing strategy-specific expertise.
3. **THE DYNAMIC NATURE OF THE ALTERNATIVE INVESTMENT MARKETPLACE.** Participants are using alternative investments in multiple ways to support their investment objectives, which include diversification and potential alpha generation. Importantly, as the alternative investment industry continues to change and evolve, 36% of respondents indicated that additional education about alternatives is needed within their organizations.

Consistent with our practice in past editions, we have incorporated selected comments gathered from one-on-one interviews of Survey respondents. These comments are meant to illustrate the diversity of perspectives uncovered by the Survey, rather than to reinforce any specific conclusions. To respect the privacy of those interviewed and our commitments to them, none of the comments are attributed.

In this *Executive Summary*, we have expanded the picture developed from our analyses of data and interviews by including insights from Russell's alternative investment experts, who share a global investing background and the perspectives gained by working with a variety of Russell clients daily.

We have summarized key Survey results in a way that enables readers to interpret data and commentary within the context of their own organizations' objectives. Moreover, we trust that our research will give readers valuable insights they can apply to their portfolios.

We wish to thank the many institutional investment professionals who contributed their time, efforts and insights, and we hope the Survey results and our analysis will prove valuable to your organizations.

Yours sincerely,



Darren Spencer,
Director, Alternative Investment Consulting
Americas Institutional



Julia Cormier,
Director, Alternative Investments
Investment Division



JULIA CORMIER



DARREN SPENCER

Methodology and summary statistics

Between January and March 2012, 146 institutional investors, representing 144 organizations with a total of \$1.1 trillion in assets, completed an online survey that aimed to understand their use of alternative investments. The Survey was conducted in English in all markets except Japan.

Invitations to participate in the Survey were sent to a broad group of institutional investors—representing corporate and public pension plans and/or non-profits. Participation was voluntary, and in all cases the individuals surveyed and/or interviewed were qualified to represent the investment activities, decisions and views of their organizations. ORCInternational provided assistance with Survey structure, programming and data integrity, as well as with assuring confidentiality to respondents who requested it.

Each respondent represents an organization that utilizes (or is evaluating) at least one type of “alternative investment”—hedge funds,

private real estate, private infrastructure, private equity, commodities, public real estate, public infrastructure and/or “other,” which may include timber and alternative energy, etc. A total of 94% (by number) of Survey respondents currently have exposure to at least one type of alternative investment.

Because the topic of alternative investments includes a considerable subjective component, and given that sample sizes are in some cases limited, Survey results may not necessarily be representative of a larger population. Nonetheless, we believe the quantitative and qualitative interpretation of the data provides some indication of trends and implications for a broader investor base.

Tables 1 to 3 below, provide a breakdown of the total sample set by country/region, fund size and type, as well as by the percentage of total completed surveys by category. Data for relatively small segments may not be statistically significant.

Table 1: Respondent composition by geography

Respondent composition by country/region	% of total included	Number of responses
United States	45%	64
Canada	11%	15
United Kingdom	8%	12
Europe	6%	8
Australia/New Zealand	14%	20
Asia, including Japan	16%	23
Totals	100%	142

NOTE: Four responses are not included in the table to the right because respondents did not provide this information.

Table 2: Survey composition by total fund size

Survey composition by total fund size	% of total included	Number of responses
Less than \$1 billion	25%	34
\$1 billion to \$4.99 billion	42%	59
\$5 billion to \$9.99 billion	19%	27
\$10 billion or more	14%	19
Totals	100%	139

NOTE: Seven responses are not categorized by total fund size because respondents did not provide this information.

Methodology and summary statistics

NOTE: Four responses are not categorized by type because respondents did not provide this information.

Table 3: Respondent composition by type

Respondent composition by type	% of total included	% of total respondent assets
Corporate DB pension plan	46%	66
Corporate DC/profit sharing/savings plan	3%	4
Public DB pension fund (government retirement plan)	19%	27
Non profit (e.g., endowment or foundation)	13%	18
Superannuation fund	9%	13
Other (i.e., asset pool, insurance unions, multi-employer, hospital, etc.)	10%	14
Totals	100%	142

High-level observations

The overall mood reflected by institutional investors responding to the Russell Investments *2012 Global Survey on Alternative Investing* (the “Survey”) is significantly different than in 2010, when our last Survey was published. Research for that edition was conducted in the fourth quarter of 2009, when the aftershocks of the dislocations caused by the 2008 global financial crisis were still reverberating. As institutional investors around the world were still assessing the impact of those events, their perceptions of, and attitudes about, alternative investments were in flux.

Results of the *2012 Survey* reflect a greater sense of calm, mixed with prudent caution. We believe the increasing interconnectedness of world markets becomes more apparent every day, and that several key macro themes affect markets globally. During the period of our data collection for the *2012 Survey*, respondents were managing portfolios affected by events and developments as varied and far-reaching as geopolitical tensions; U.S. political gridlock and 2012 presidential election prospects; the European debt crisis; potentially slowing economic growth in China; nuclear threats in Iran and North Korea; and concerns over global climate change.

It is clear that respondents are trying to shepherd their portfolios in an environment that is no longer positioned to offer protection against the risk of every short-term market trend. Instead, respondents expressed greater acceptance that shocks to portfolios will continue, and that volatile and uncertain markets are the new normal. Respondents reflected a sophisticated understanding that portfolios should be structured to prudently manage risk, even as they also seek to achieve returns in a variety of potential market environments.

Our goal for the Survey is to focus on the current thinking of institutional decision

makers on the following perspectives, as they relate to alternative investments:

1. **Drivers:** The most critical investment issues facing the total portfolio, and the assessment of demand for alternative investments to help meet total portfolio objectives.
2. **Influencers:** Factors in the decision-making process that are influential in shaping how organizations invest in alternatives.
3. **Barriers:** The key factors involved in including or excluding certain alternative investment categories and the specific challenges institutions must address or overcome.
4. **Implementation:** The approach, rationale and advantages/disadvantages of different implementation options.

Based on Survey results and the work we do with clients, it is clear to us that institutional investors are successfully using alternatives to pursue specific investment objectives. At the same time, investors face myriad challenges in assessing the range of alternatives across an expanding spectrum of opportunities and implementation choices.

The data shows that for those who responded to our Survey, alternative investments, which increasingly include global exposures, are a dynamic and developing component of total portfolios. In fact, the term “alternative” may no longer be as meaningful as it has been in the past, because many institutions now regard some of these investments as mainstream holdings firmly rooted in investment policies and portfolio allocations.

Although the approach to alternative investing continues to evolve, readers may be surprised by the trends the *2012 Survey* illuminates, including a more deliberate approach to multi-strategy portfolio allocation, trustee education, transparency and risk management processes.

Survey details

Diversification potential is the primary reason for investing in alternatives.

PERSPECTIVE—DRIVERS: *These are the most critical investment issues facing the total portfolio and the assessment of demand for alternative investments to help meet total portfolio objectives.*

The clearest message was that respondents are driven to alternative investments for their diversification benefits. We asked investors to rank their top three reasons for investing in alternatives. As shown in Exhibit 1, 90% of respondents indicated diversification as a primary reason. Closely aligned with that theme is alternatives' lack of correlation to traditional assets and the consequent reduction in portfolio volatility that may be achieved; 64% of Survey respondents indicated that these were significant reasons for including alternatives in a portfolio.

While diversification and volatility reduction are most important, returns are also critical. Alpha generation and the long-term return

potential of alternative assets were deemed very important, with both highlighted as being among the top three decision drivers by 45% of respondents.

The results of the Survey reflect that current and expected future allocations to alternatives support these drivers.

Exhibit 2 confirms the relevance of the Survey questions: 94% of respondents invest in some form of alternatives. A majority of respondents hold private real estate (66%), private equity (64%) and hedge fund assets (59%). The allocations to private real estate and private equity are not surprising, given that investors have historically been relatively comfortable with these strategies when first investing in alternatives. With more than half of respondents utilizing hedge funds, the data confirms our experience with clients—namely, that hedge funds are increasingly becoming a standard choice for the alternative investments component of a total portfolio.

Exhibit 1: Reasons investors utilize alternative investments, as % of respondents (more than one reason was permitted.)

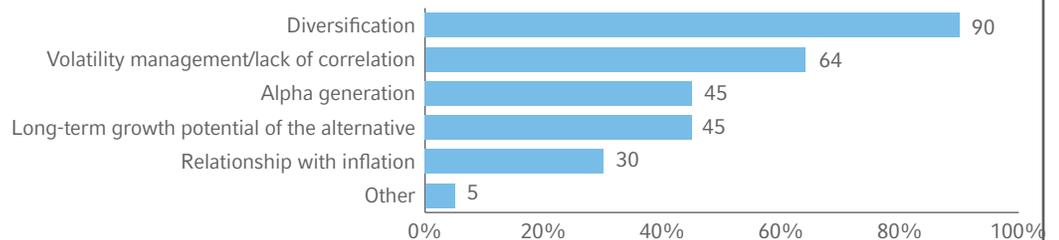
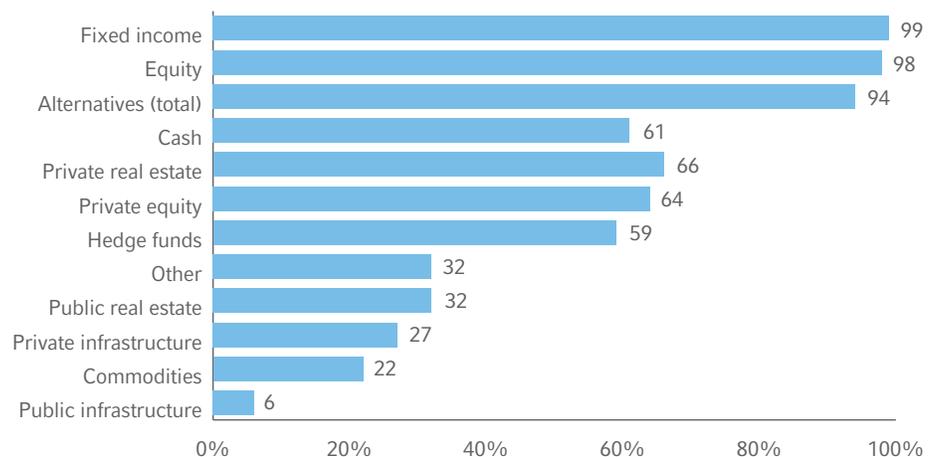


Exhibit 2: Percentage of respective asset classes held by Survey respondents



Survey details

COMMENT

In Russell's 2010 Survey, respondents projected that by 2012, 20% of their total assets would be in alternatives. The data collected for the 2012 Survey shows that this year's respondents hold approximately 22%. Although the two surveys had a different base of respondents, the 10% growth in allocations to alternatives between the 2010 and 2012 survey periods suggests that alternatives continue to be an important portfolio allocation, moving slowly but surely into the mainstream. It also indicates that many institutions are broadly aligned in utilizing alternative investments to help meet their objectives.

COMMENT

Cash is over target for 45% of respondents. This may be an indication that institutions responding to the Survey are cautious about taking risk, and they appear to be waiting for the right time to reposition cash. It is interesting to note that respondents are under target mainly in private real estate (38% of respondents), private equity (35%) and hedge funds (32%). Alternatives that are under target could potentially be recipients of excess cash in the future.

Exhibit 3 shows the combined asset allocations of all respondents, which we call the "Survey Portfolio." It shows that over 22% of total portfolio assets, on average, are allocated to alternative investments. Of that total, over 16% (roughly three-quarters of the 22%) is allocated to hedge funds (6%), private equity (5%) and private real estate (5%).

Target allocations and anticipation of increased use of alternatives

The 2012 Survey data reflects the potential for increased allocations to alternatives. We base this observation on: 1) comparison of each respondent's current allocations

to target allocations; and 2) exploration of respondents' anticipated increased use over the next one to three years. Results are shown in Exhibits 4 and 5.

CURRENT VS. TARGET ALLOCATIONS:

Traditional investments—cash, fixed income and equities—were more frequently over-than under-target. However, at least 30% of respondents indicated they were below their target weights in private equity, private real estate and hedge funds.

Exhibit 5 shows where respondents expect to increase allocations, keep the same allocations, or decrease allocations over the next one to three years. Hedge

Exhibit 3: "Survey Portfolio"—combined allocations of all Survey respondents, by asset class

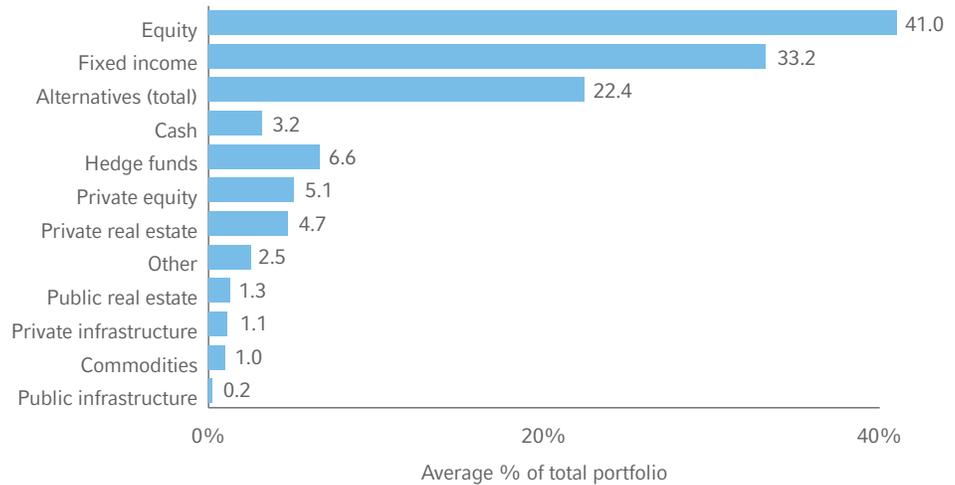
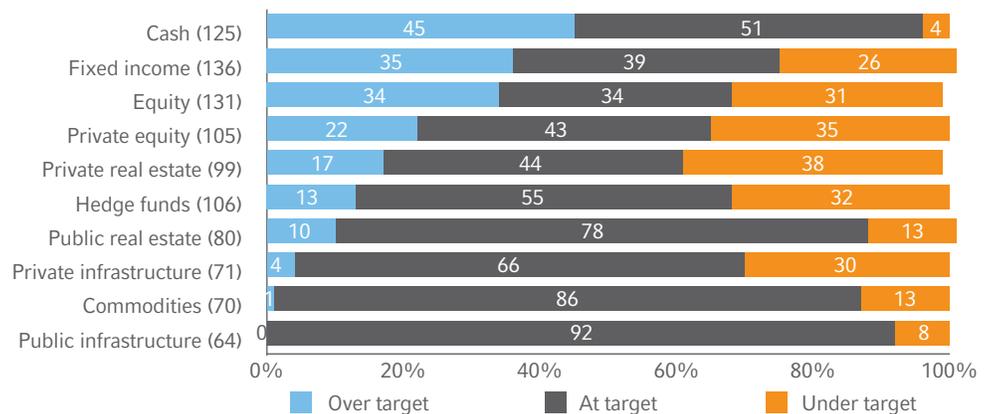


Exhibit 4: Current asset allocations: percentage of respondents over-target, at-target and under-target



Numbers in parentheses are numbers of respondents.

Survey details

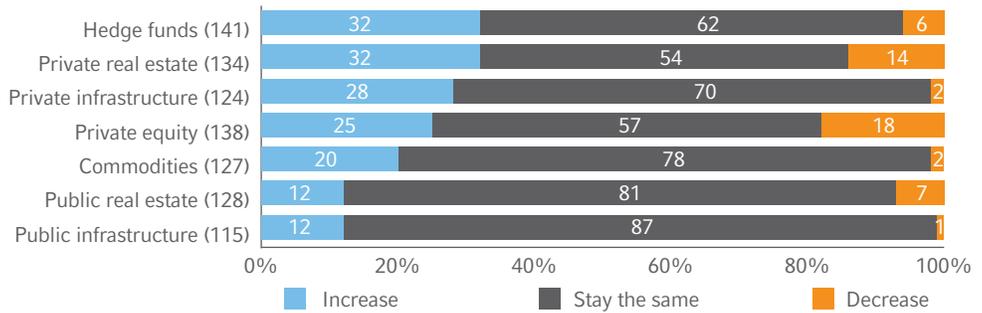
COMMENT

In 2012 Survey data and interviews, liquidity was a theme in regard to private equity. Nevertheless, 25% of respondents indicated that they expect to increase their allocations to private equity over the next one to three years.

INTERVIEW INSIGHT (CANADIAN ENDOWMENT FUND):

“Our goal is to invest in infrastructure in order to earn a much better yield compared to what our fixed income portfolio is giving us at the moment.”

Exhibit 5: Percentage of respondents anticipating changes (if any) to alternative investment allocations over the next 1–3 years, by investment type



funds and private real estate lead the way, with 32% of respondents indicating they may make increased allocations. Other categories targeted for meaningful anticipated allocation increases were private infrastructure (28% of respondents) private equity (25%), and commodities (20%). It is interesting to note that all of the investment types projected to receive increased allocations are expected to provide diversification benefits and lower correlations to traditional investments.

Fewer respondents expected to increase their allocations to listed investments in real estate and infrastructure (12% of respondents for each). This may be due, in part, to the fact that respondents are already at their targeted allocations for those investment types. Also, due to these investments’ high correlations to traditional equities, respondents may be looking to increase allocations to alternatives investment types with lower correlations.

Some investors are over target in private equity, in part because of the relatively slower pace of exits over the last few years. However, significant cash positions on the balance sheets of many corporations, generally improved equity markets in the first-quarter 2012 were indications that increased IPO and/or strategic acquisitions could increase, and that the capital overhang in private equity could subside. However, with the more recent return of market volatility in the second quarter, the timing of private equity exits through IPOs or strategic sales may be extended.

The funded status of defined benefit plans is a critical determinant in decisions related to asset allocation. For those unable to accept the relative illiquidity of private equity in return for higher return potential, private equity commitments may need to be reduced.

Combined public and private infrastructure investments currently account for only about 1% of the Survey Portfolio allocations. (See Exhibit 3.) Although Australian and Canadian respondents have higher allocations here, the other regions represented in the Survey have not yet made significant allocations to this segment, which brings down the alternatives total in the Survey Portfolio. The demand for infrastructure investments remains high globally—driven by developing economies’ need for infrastructure, and developed economies’ need for increased capital to repair or replace aging infrastructure.

PERSPECTIVE—INFLUENCERS: *Several factors are influencing/shaping the decision-making process for institutions investing (or not investing) in alternatives.*

The 2012 Survey probed to uncover perceptions of the alternatives’ value proposition across different criteria. To determine how strongly investors felt about various elements, the level of agreement/disagreement with certain statements was measured by use of the scale below.

Disagree			Neutral	Agree		
1	2	3	4	5	6	7
Completely disagree						Completely agree

Survey details

COMMENT

Additional education and improvements in transparency are gradually reducing the most significant barriers. Our interviews with Survey respondents indicated that they have sought out and embraced the ongoing education of board members, investment committees and investment staff. The degree to which education is needed is very specific to the organization and the composition of the respective committees.

INTERVIEW INSIGHT (U.S. CORPORATE PENSION PLAN):

“When we decided to add a Tactical Trading allocation to our portfolio, it required education for the investment committee. When the time comes to make a specific recommendation, not for the allocation, but for the investment manager, I will have to again educate committee members.”

INTERVIEW INSIGHT (U.S. ENDOWMENT FUND):

“With increased demands for data from auditors, I rely more heavily on the resources and data provided by my managers. In many cases, I couldn’t provide this information on my own. The key to our whole process is the transparency that we now get into portfolios through expanded reporting.”

The three strongest levels of *agreement* (as reflected by the combined percentages of respondents selecting #6 or #7 on the scale) were as follows:

1. Alternatives meet our expectations as to the role they play in our portfolio: 47%.
2. There is sufficient risk premia in unlisted investments to accept their relative illiquidity: 40%.
3. The current low return environment in traditional assets is an important factor in our allocation to alternatives: 32%.

The strongest levels of *disagreement* (as reflected by the combined percentages of respondents selecting #1 or #2 on the scale) were as follows:

1. Peer group activity in alternatives influences what we do in that space: 50%.
2. We intend to increase our use of passive investments for traditional assets so we can increase our allocation to active strategies through alternatives: 45%.

PERSPECTIVE —BARRIERS TO INVESTING:

The key factors involved in including or excluding certain alternative investment categories, and the specific challenges that institutions must address or overcome.

Relative to 2010 Survey results, it appears that many of the obstacles investors have faced in the past are now less imposing. This is particularly true in the areas of risk budgeting, communication with investment committees and boards, and increased awareness of relevant exposures. The results of the 2012 Survey show that the majority of respondents are getting what they need. For example:

- › 51% of respondents indicated that lack of liquidity in their portfolios is not preventing them from increasing allocations to alternatives.
- › 41% of respondents indicated that the complexities of alternatives and their ability to get comfortable initiating or increasing exposure is not a barrier.
- › 34% of respondents indicated that their risk budgeting approach incorporates alternatives well.

- › 33% of respondents have sufficient internal governance or risk management processes to monitor these types of investments.

Although these are encouraging data points, it is important to note that there is still room for improvement.

As the range of alternative strategies adapts to changing market opportunities, education is an ever-evolving process. In the hedge fund space, for example, many investors are relatively comfortable with understanding long/short equity strategies, whereas strategies such as Tactical Trading and Opportunistic Credit are less familiar. As they represent potentially significant opportunity, education is an integral part of making an allocation to these strategies.

Increased transparency has been an important consideration for investors across alternative investments for a number of years, particularly in private markets. Although transparency has been slowly increasing, based on investor and auditor requirements, the global financial crisis has made this issue a priority for many other reasons, and results have continued to improve. A number of interview participants said their views into underlying holdings are better than ever.

PERSPECTIVE —IMPLEMENTATION:

The approach, rationale, and advantages/disadvantages of different implementation options.

Due diligence

Making allocations to alternative investments is a resource-intensive activity, and there is no question that due diligence is an essential component of successful investing. Survey results show that respondents increasingly require comprehensive due diligence from both the investment and operational perspectives. Yet, in many cases, their organization’s internal resources are not sufficient to handle these tasks.

- › **Agreement with survey question:** We require comprehensive due diligence to be completed before making any new investment: 68% of respondents.

Survey details

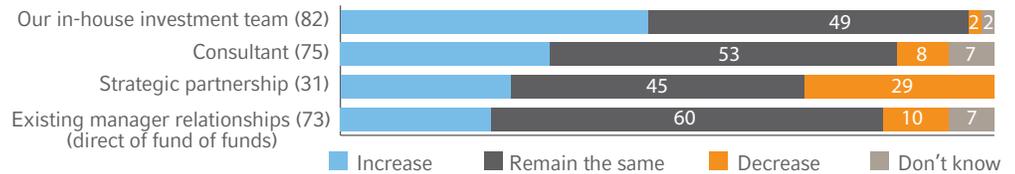
INTERVIEW INSIGHT (EUROPEAN PUBLIC PENSION):

“We are a lean and mean organization in terms of personnel and resourcing. Currently, we have 20 different mandates and we’re comfortable with monitoring those and exercising what we think is the appropriate level of due diligence. But if we were upping the ante and getting into more private equity or hedge funds directly, it would raise issues of delegation and governance.”

INTERVIEW INSIGHT (U.S. CORPORATE PENSION):

“We’ve maintained separate accounts for private equity, infrastructure and real estate. We’re considering folding these into partnerships with a discretionary manager, so that we can rely on the expertise of that manager to monitor the underlying valuations of each of the partnerships, among other activities.”

Exhibit 6: Percentage of respondents anticipating changes (if any) to how they perform due diligence over the next 1 to 3 years



› **Disagreement with survey question:** Our investment staff can effectively manage direct investments: 33%.

In Russell’s experience, most institutional investors have increased their operational due diligence resources since the *2010 Survey*—whether through in-house staff or outsourced consultants—because they recognize potential operational challenges as being an uncompensated risk. Multi-strategy

approaches, with managers vetted through consultants with deep resources and expertise, are being recognized as an attractive solution.

In the *2012 Survey*, 74% of respondents indicated that their investment and operational due diligence is being performed by the same entities; 46% said the due diligence roles of in-house investment teams will increase over the next one to three years, and 32% said consultants’ roles would increase.

Trends and themes by alternative strategy

COMMENT

The ability to obtain customized solutions is a bigger factor for corporate and public pension plans (58%) than for other types of investors (32%). As we will explore in the “Looking

Forward” section of this Executive Summary, customized solutions often go hand in hand with investor-specific goal attainment, increased fee-negotiation ability, consultant due diligence and multi-strategy manager selection.

INTERVIEW INSIGHT (U.S. CORPORATE PENSION):

“I think hedge funds have done what we expected them to do. It doesn’t mean the performance was great, but then I don’t have the expectation that hedge funds will always give us a positive return. I look at what is expected in terms of return distribution potential, and from that standpoint hedge funds have had a bad couple of years. Is it unpleasant? Yes. Is it surprising? No. That’s what happens sometimes. If you take risks, you sometimes end up on the wrong side of the distribution.”

Hedge funds

The fund of funds structure remains the most commonly used approach to hedge funds, with 49% of those respondents who participate in hedge funds currently utilizing this approach. This is more than double the percentage of that for any other hedge fund implementation method, including direct hedge funds (20%); a blend of fund of funds and direct hedge funds (14%); single-strategy/style-specific (5%); and multi-strategy (5%). However, this year’s Survey shows that participants anticipate making significant shifts away from the traditional fund of funds model. Only 17% of respondents using hedge funds expect to be using the traditional structure for implementation over the next one to three years. While fund of funds are anticipated to lose ground, all other implementation methods are expected to gain.

The major drivers of hedge fund investment decisions have remained somewhat constant in Russell surveys over time, and there are no big surprises here. Agreement was high that the following drivers are important in selecting funds:

- › Pedigree of investment team managing the hedge fund—63% agree (levels 6 and 7).
- › Liquidity terms—51%.
- › Risk-adjusted performance history—49%.

- › Fee structure—43%.
- › Consultant recommendation—37%.
- › Ability to obtain customized solutions—29%.

Interestingly, the assets under management (AUM) of hedge fund managers does not rank very highly as a selection driver (only 20% agree).

Because the trend of hedge fund customization clearly has momentum, the Survey explored the reasons why customization is important.

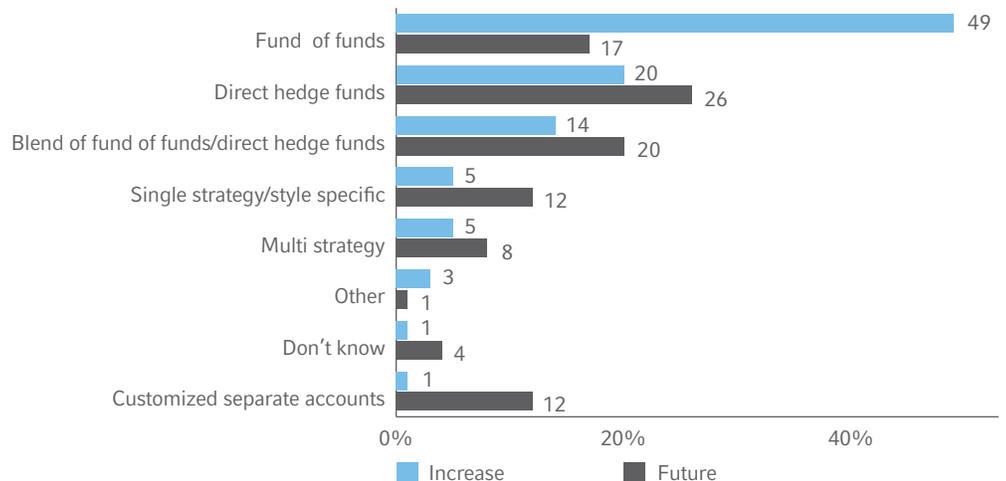
Although investors have diverse reasons for pursuing hedge fund customization, the “power balance” is changing to give investors more leverage and choice, and gain more flexible and negotiated terms.

Today’s attitudes toward hedge funds are colored by the disappointing performance some institutions reported in 2011, relative to equity benchmarks. This sentiment appears to be more common in the U.S. than in Europe.

Private equity (PE)

Consistent with previous surveys, private equity (PE) is more prevalent in North American portfolios, although Europe is not far behind. Commitments to private equity are lower in emerging markets, Asia Pacific and Japan. The liquidity constraints of negative

Exhibit 7: Hedge funds—current and anticipated future implementation methods



Trends and themes by alternative strategy

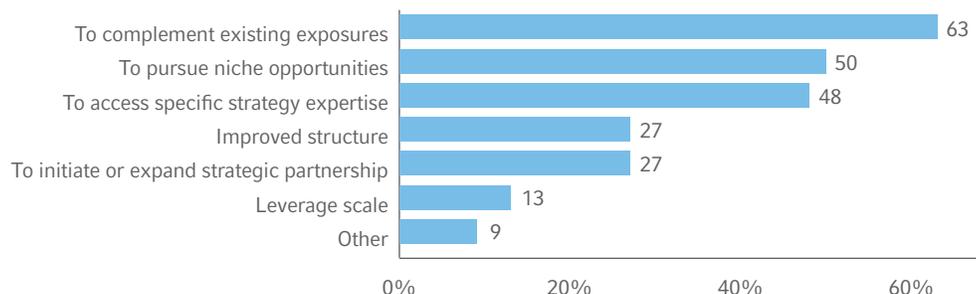
COMMENT:

Investors with long-term allocations to PE have typically watched investments run their course and in some cases produce attractive returns. However, latecomers to PE who entered at valuation peaks preceding the 2008 crisis feel frustrated by the lack of liquidity and exit opportunities. A common theme is the inability to make new PE commitments until legacy investments generate cash or are written off. Several respondents said they will be focusing their “illiquidity budgets” on private infrastructure investments in the future, rather than PE.

INTERVIEW INSIGHT (U.S. PUBLIC PENSION):

“Making any new commitments to PE is hard right now because we’re so over-allocated to it. Our target is 16% and we’re roughly 23% to 24%. Within the first half of 2011, we saw liquidity in the market and had more capital calls than disbursements. But then, as the market started to get more volatile, there were fewer exit opportunities. For a stable PE program, you want to have as much unfunded in the ground as your fair market value. Right now, we have probably twice as much fair market value as unfunded. Eventually, our money will come back, but we just need exits.”

Exhibit 8: Why customize hedge fund exposures?



cash flows are making PE less attractive for Japanese defined benefit pension plans.

In both North America and Europe, more investors are currently committed to small/medium buyout funds than to larger funds. Significantly, both North American and European investors expect small to modest decreases in their current PE commitments over the next one to three years.

Among current PE investors (93 in number), 85% are currently committed to small/medium buyout funds, 75% to venture capital funds, 72% to large buyout funds and 70% to distressed asset funds. Co-investments and alternative energy are expected to show the largest increases in commitments over the next one to three years.

Investors identified two main benefits of PE commitments:

1. Potential for investments to generate attractive returns—69% agreement (levels 6 and 7).
2. Potential benefits of active management—53%.

Some respondents did not foresee increasing their commitments to PE in the future, and no single significant barrier appeared to be driving this view. Some respondents support the idea that four obstacles exist:

1. Limitation of investing in illiquid assets—23%.
2. Legacy issues and unfunded commitments with existing portfolios—22%.
3. The ability of firms to retain key investment staff—21%.
4. The current level of capital overhang—20%.

Real estate

Listed Real Estate Investment Trusts (REITs) and unlisted private real estate funds continue to dominate as implementation choices, with 51% of the respondents (who hold real estate currently) using them. However, only 38% of these respondents said real estate funds will continue to be an implementation choice over the next one to three years. Allocations to direct property investments (23%) and customized separate accounts (15%) are expected to increase in the near future.

The most important drivers of real estate decisions continue to be income (46% agreement, levels 6 and 7) and portfolio diversification (42%). Some respondents viewed high amounts of leverage (28%) and the volatility of REITs (26%) as barriers to investing.

Commodities

Even with inflation-sensitive characteristics, commodities remain a niche solution and future possibility (more than a current reality) for most institutional investors—except in Australia, where commodities are familiar and mainstream. If global inflation were higher, some respondents say, the appeal of commodities would rise.

Among the small sample of Survey respondents (32 in number) who hold commodities, long futures exposure is the most popular type of investment (63%), with private equity (44%) and hedge funds (28%) trailing. Long/short strategies and funds have not yet made much of an impact (23%), but interest in them is rising, with 46% of current commodity investors expecting to add long/short over one to three years.

Trends and themes by alternative strategy

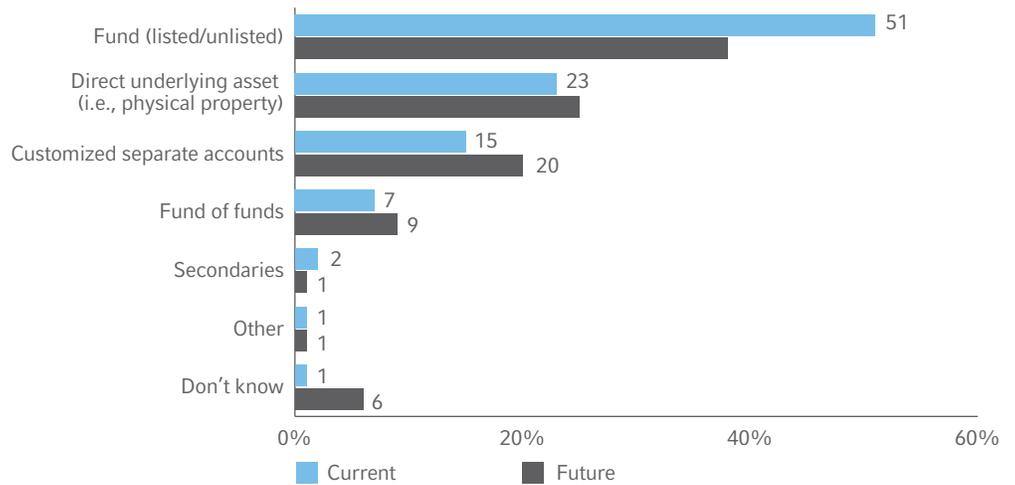
COMMENT:

Russell is seeing a gradual shift among some investors toward using private infrastructure and natural resource investments, in addition to private real estate, for inflation protection potential. Some characteristics of private real estate produce an income stream that may look attractive in the current low-yield environment.

INTERVIEW INSIGHT (U.S. PUBLIC PENSION):

“Commodities and infrastructure have been the two investments that we’ve spent some time on in recent years. When we initially were looking at commodities several years ago, I think the view was that we’d already seen a fairly big rise in prices, so we were hesitant to sign up at that point. With the 2008 slowdown, commodity prices fell off pretty sharply, and we moved to take advantage of them. Since then, it’s been a journey for us, with quite wide swings.”

Exhibit 9: Real estate—current and future implementation methods



Leading strategies include collateralized commodity futures funds (58%), natural resources private equity funds (42%), physical commodities (21%), and natural resources listed equities (19%).

Respondents who hold commodities indicated that the drivers of their commodities decisions include: the relationship to inflation (71% agreement, levels 6 and 7); low/negative correlations with traditional assets (54%); potential benefits of active management (41%); and the potential for investments to generate attractive returns (38%). Major barriers include the negative roll yield due to contango in futures contracts (22%) and price volatility (20%).

Infrastructure

Infrastructure investment in projects such as highways, airports, pipelines, ports and water/sewer systems is booming all over the world, laying the groundwork for the growth of emerging and frontier economies in Asia, Eastern Europe, South America and Africa. Institutional investors are attracted to infrastructure alternatives for three basic reasons: 1) increased diversification potential; 2) inflation and interest rate protection; and 3) public/private cooperation.

Although infrastructure still commands a small share of institutional assets (just 1% of the Survey Portfolio), many signs point to growth. Private infrastructure investments appear to be attracting a growing portion of institutions’ illiquidity budgets, perhaps taking share away from private equity.

Among current private infrastructure users (39 in number), the most common structure is a private closed-end fund (68%). A minority of current users are invested in all other structures, including private open-end funds (34%), global listed securities (27%), infrastructure debt instruments (20%) and co-investments (18%).

The most important drivers of infrastructure investments are portfolio diversification (66% agree, levels 6 or 7); income (61%); relationship to inflation (57%); the long duration of the investment (46%); and monopolistic pricing power (39%).

Barriers to investment include the fees associated with private equity infrastructure funds (31%), the volatility of listed infrastructure (19%) and the relative maturity of the asset class (17%).

Trends and themes by alternative strategy

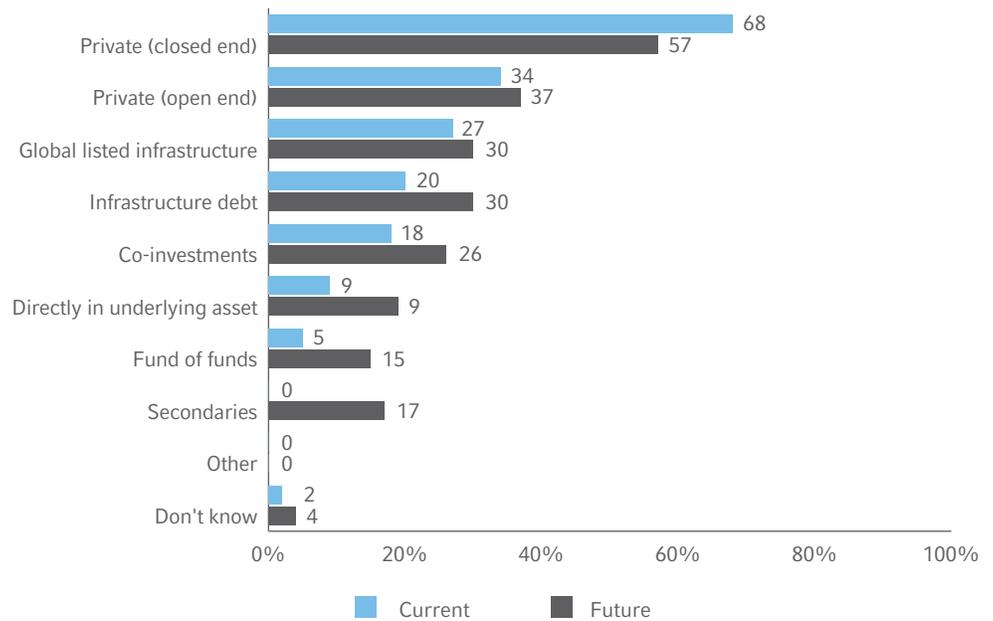
COMMENT:

Russell has observed that investors in infrastructure funds are attracted by investment cash flows, which can rival those of real estate. In fact, cash flow is more important to some infrastructure investors than either growth potential or inflation hedging. However, the supply of quality private infrastructure funds is an obstacle in some regions—especially Japan, where it is limited by legislation and regulation. Also, some investors feel challenged by the due diligence and education requirements that new infrastructure investments will impose.

INTERVIEW INSIGHT (CANADIAN PENSION):

“When we started down the road to implementing Canadian infrastructure investments, there was a strong recommendation that we had to increase the staff available, because these are very time-consuming investments. Everyone in fund management understood that, and while there was approval to go forward with the investments, there was no approval to go ahead with any additional staffing. So, we’ve now got ourselves in a position where we’ve taken on additional work.”

Exhibit 10: Infrastructure—current and future implementation methods



Regional trends and perspectives

Due to smaller sample sizes by region, the “level of agreement” includes levels 5, 6 and 7 responses and “level of disagreement” includes level 1, 2 and 3 responses.

There can be significant differences in use and beliefs about alternative investments based on regional, fund type and individual perspectives. This section summarizes regional trends reflected in 2012 Survey results along with relevant perspectives from Russell’s regional alternatives consulting leaders.

Japan

Survey respondents indicated that hedge funds are the alternative type most likely to grow AUM in Japan over the next few years, while allocations to private real estate are expected to shrink. The key drivers of alternative investment selection in Japan will be diversification and volatility management. As expected, inflation is of minimal influence, which explains the low interest in commodities and infrastructure. In Japan, more than in other regions, investors are de-risking by reducing their exposures to equities. This trend, combined with low expected returns in traditional asset classes, is driving increased allocations to alternatives.

Two recent developments have impacted alternatives:

1. Many of Japan’s defined benefit pensions have already (or soon will have) moved into negative cash flow positions, with benefits paid out exceeding contributions coming in. This requires more focus on cash management in their portfolios, which increases pressures to maintain liquidity. Negative DB plan cash flow is being driven primarily by the aging of Japan’s population. With average life expectancy at 83 years, according to the United Nations, Japan’s population is living longer than that of any other developed nation.
2. The scandal involving Tokyo asset management firm AIJ Investment Advisors, which broke in February 2012, is expected to cause large investment losses and will affect various pension plans and their beneficiaries directly and indirectly. As a result of this experience, the focus on operational due diligence in Japan has increased. Japanese investors are now questioning how far and deep they need to do their own due diligence. They are reflecting on their responsibilities more closely than ever,

and the industry also continues to seek answers for the hard problem.

In Japan, there was less pressure on hedge fund managers to negotiate fees, and this is partly due to cultural traditions of courtesy and partly due to pension plan’s hedge fund investment structure in which investors usually purchase offshore funds as they are. This will likely change over time as large Japanese investors lead the trend toward customized investments in cooperation with their advisers.

Australia, New Zealand, Asia Pacific (ex-Japan)

Eighty-five percent of Asia Pacific investors (ex-Japan) say alternatives are meeting their expectations for the role they play in portfolios, compared to just 70% globally. However, compared to alternative investments available elsewhere around the globe, Asia-Pac alternatives appear to be less sensitive to low-returns risks or global economic/geopolitical risks than are traditional investments. Fee-consciousness is rising in the Asia-Pac region, with 68% of respondents saying fees make it hard to justify initiating or increasing alternatives exposures (compared to 47% globally).

Under Australia’s “MySuper” regulation, which takes effect in mid-2013, a superannuation fund must offer its default fund (typically, a balanced fund) as a “low-cost, no-frills” investment option. In response, superannuation funds are reconsidering their current allocations to alternatives, especially those with high fee structures.

Europe, Middle East and Africa (EMEA)

Most of the responses from organizations in EMEA regions align with global themes. Some, such as education barriers, were marked a little higher. EMEA investors are also transparency-conscious, with 70% saying the relative lack of transparency is a barrier to investing (vs. 50% globally). On the other hand, of those who invest, fewer say they aren’t getting sufficient risk reporting from providers (20%, vs. 34% globally). Certainly, investors are demanding and getting more from their alternative providers.

Regional trends and perspectives

The discovery that fund-of-funds structures retain a role may be initially surprising (only 19% of respondents say they are unlikely to make these investments after reaching a certain size, vs. 37% globally). This reflects a more discriminating approach to the use of funds of funds and to the role of their providers, as well as to the value added. There is a movement toward a full rethink of the fund of funds model including fees, a focus on strategies that have delivered, and the creation of customized (“fund-of-one”) mandates to fulfill their specific investment objectives rather than generalized commingled multi-strategy funds.

Liquidity is a significant issue in Europe, particularly for corporate defined benefit pension plans. The vast majority of such plans are closed to some degree and are considering an endgame. For many, the endgame will involve transferring liabilities to insurance companies, which, if targeting is for less than 10 years, makes investment in longer-term illiquid vehicles difficult. However, many larger plans appreciate that they are likely to continue investing for 20 or 30 years and thus can continue to invest in long-term vehicles.

Finally, EMEA had the strongest net interest in increasing infrastructure assets against fairly neutral net positions for hedge funds and private equity.

North America (NA)

In the post-Madoff years since our last survey, Russell has observed a growing respect among North American (NA) investors for comprehensive due diligence. In the *2012 Survey*, 91% of NA investors said they require comprehensive operational due diligence before making new investments (vs. 83% globally). In many cases, the AUM size of NA mandates can support the cost of internal staff due diligence expertise. Forty-five percent of NA respondents said they are unlikely to make fund-of-funds investments after reaching a certain AUM size (vs. 37% globally). Forty-three percent said their investment staff can effectively manage direct investments (vs. 35% globally).

There seems to be a trend in investors’ approach to the “internal staff vs. external resource” decision. Even some sophisticated investors who appreciate the benefits of alternatives have decided they don’t have the internal resources to manage multi-strategy alternatives.

Looking forward

The *2012 Global Survey on Alternative Investing* is designed to help Russell Investments, our clients, and the alternatives industry decipher emerging trends and anticipate changes. This section summarizes our analysis of a few of the important forward-looking issues and trends the *2012 Survey* brings to light.

Customized Separate Accounts: The fund-of-one

Russell is working closely with global institutions to evaluate and implement a concept that represents a fundamental shift in alternative implementation—customized separate accounts. Investors have greater opportunities to utilize external fiduciary providers who will customize solutions. This can range from establishing separate accounts where the investor holds 20 or more direct hedge funds, or holds those underlying funds in a dedicated “fund of one”. While both result in investment customized to the investor, the second typically shifts more of the implementation activities and accountability to the external fiduciary provider. They invest in underlying hedge funds, held in the investor’s name and based on the investor’s specific allocation, but their money is not commingled with other investors in a traditional fund of funds structure.

These relationships and related developments support greater investor-driven success with fee negotiation and term flexibility.

Global macro-stress and cash levels

Compared to our last survey, the *2012 Survey* indicates that institutional investors are feeling more optimistic and breathing easier. At the same time, one 2012 finding stands out: respondents held relatively high levels of cash, above targets for the asset class. In the Survey Portfolio, cash represented 3.2% of holdings, and 45% of all respondents said their current cash holdings were over target allocations.

Based on Survey results and client conversations, Russell believes cash levels

above target are mainly an indication of caution, as well as more deliberate and time-consuming investment processes. Investors have some cash on the sidelines, and based on what survey responses indicate, part of it is expected to move into alternatives.

Education and transparency

Since our *2010 Survey*, demand for education has grown significantly.

In Survey results and interviews, clients indicate that their boards and trustees are more demanding of education about alternatives and more receptive to proposals that have education attached. Investment staffs are increasingly focused on connecting decision makers to quality education and expanding communication and reporting related to alternative investments. As a result, risk reporting has evolved from flat data sets to broader information and deeper views on real-time exposures.

Liability-driven investing (LDI)

Our *2010 Survey* indicated strong interest in liability-driven investing (LDI) among defined benefit (DB) plan sponsors. We indicated then that: “Russell believes more DB plan sponsors will recognize that an appropriate combination of LDI strategies and alternatives can produce risk-management synergies.”

Although low interest rates have been a deterrent to LDI implementation, the concept is very much alive and well in 2012. A significant amount of Russell’s corporate U.S. DB clients have adopted LDI on some level. We measure LDI allocations based on designations of specific assets managed to match projected liabilities. We estimate that Russell’s U.S. corporate DB clients with LDI overlays are currently allocating about 30% of AUM in this way, and we expect a gradual increase to about 40% over the next few years.

We think LDI and complementary alternative investment strategies stand to benefit from de-risking through reduction of equity commitments and increases in global interest rates.

Summary

The 2012 *Global Survey on Alternative Investing* has provided valuable perspectives on the practices and attitudes of institutional investors around the world in regard to alternatives. As one picture of a growing alternatives industry, viewed within the context of the biennial surveys Russell has conducted since 1992, it helps to illuminate trends and recent changes.

The current environment is one of increased stability from 2010, with alternatives widely viewed by the 2012 Survey respondents as an area that will continue to increase in visibility, allocations and importance. The Survey has helped to define the key drivers, barriers, influencers and implementation methods that are shaping alternative investment strategies. Its one-on-one interviews address key questions and issues

that we believe will have continuing impact for institutional investors globally.

As Russell continues its commitment to help our clients achieve their desired outcomes, the results of our biennial surveys help clarify investor expectations and requirements.

We encourage readers to discuss with us any questions or comments they may have about the Survey.

Additional details from the Survey are being provided to the institutional investors who, with their time and thoughts, assisted Russell Investments and our partner in this project, ORCInternational.

If you are interested in participating in our next *Global Survey on Alternative Investing*, please contact Russell Investments.

If you are interested in participating in our next *Global Survey on Alternative Investing*, please contact:



Janine Baldridge



Jiro Shimpo



Nicolle Connolly



Darren Spencer



Julia Cormier



Nick Spencer



Vic Leverett

This material is for your private information, and we are not soliciting any action based upon it. Nothing contained in this material is intended to constitute legal, tax, securities or investment advice, nor an opinion regarding the appropriateness of any investment, nor a solicitation of any type. The general information contained in this publication should not be acted upon without obtaining specific legal, tax and investment advice from a licensed professional. The material is based upon information that we consider reliable, but we do not represent that it is accurate or complete, and it should not be relied upon as such. In particular, we have not undertaken any independent review of the information, including expected future returns, reported by respondents. Opinions expressed are current opinions as of the date appearing on this material only. We do not undertake to update the information discussed in this material. We may be in a position to benefit, as an investor or manager, advisor or other service provider, from increased interest in investments of the type described in this report.

Information contained in this report includes information developed by and/or supplied under license by Russell Investments. In particular, the methodology and data in this survey are the exclusive property of Russell Investments, and any use without the prior express written permission of Russell Investments is strictly prohibited. Data from 2010 and earlier referenced in this report is drawn from previous surveys. Surveys prior to 2003 were conducted jointly with Goldman Sachs International.

Some opinions expressed in this material are not necessarily those held by Russell Investment Group, its affiliates or subsidiaries. While all material is deemed to be reliable, accuracy and completeness cannot be guaranteed. The information, analyses and opinions expressed herein are for general information only and are not intended to provide specific advice or recommendations for any individual or entity.

Nothing in this publication is intended to constitute legal, tax securities or investment advice, nor an opinion regarding the appropriateness of any investment. This is a publication of Russell Investments Canada Limited and has been prepared solely for information purposes. It is made available on an "as is" basis. Russell Investments does not make any warranty or representation regarding the information.

Copyright © Russell Investments 2012. All rights reserved. This material is proprietary and may not be reproduced, transferred or distributed in any form without prior written permission from Russell Investments. It is delivered on an "as is" basis without warranty.

Russell Investments Canada Limited is a wholly owned subsidiary of Frank Russell Company and was established in 1985. Russell Investments Canada Limited and its affiliates, including Frank Russell Company, are collectively known as "Russell Investments".

Russell Investment Group is a Washington, USA corporation, which operates through subsidiaries worldwide, including Russell Investments, and is a subsidiary of The Northwestern Mutual Life Insurance Company.

The Russell logo is a trademark and service mark of Russell Investments.

First used: June 2012

USI- 13474-06-14

For more information about Russell Investments and our products and services, please go to www.russell.com