Bank of America Merrill Lynch
Capital Introductions

Institutional Investor Survey
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Kevin E. Lynch, CFA
Bank of America Merrill Lynch Capital Introductions
kevin.lynch@baml.com
1.646.855.1707

Professor Osman Kilic, Ph. D.
Quinnipiac University School of Business
osman.kilic@quinnipiac.edu
1.203.582.8267

SPECIAL THANKS TO:
Executive Summary

The Bank of America Merrill Lynch (BofA Merrill Lynch) Capital Introductions Group recently conducted an institutional investor survey in conjunction with the Alternative Investment Institute at Quinnipiac University and the Connecticut Hedge Fund Association. The purpose of the survey was to better understand the views of major institutional investors on a range of topics including allocation intentions, various asset class trends and alternative investments. One hundred seven (107) investors participated, representing the US, EMEA and Asia Pacific markets and representing approximately $2.1 trillion in assets under management. The following are highlights from the survey respondent results:

- Institutional investor respondents are considerably more bullish about alternative investments than traditional equities and fixed income—by a large margin. Reflecting this bullishness, respondents expect to allocate a considerably higher amount of capital to alternatives than to any other major asset class. In fact, almost two-thirds (63%) of respondents plan to increase their asset allocation targets for alternatives over the next 12–24 months.

- The percentage of public pension respondents intending to increase the amount of their traditional equity and/or fixed income allocations managed passively (i.e., indexes and ETFs) is almost twice as large as the rest of the survey respondents.

- Since the market crisis of 2008, 17% of respondents have implemented systematic tail-risk management programs, while another 33% are considering doing so.

- Forty-one percent of plan sponsor respondents fell below the 80% funded level while about one-third (32%) of pension plans indicated funding levels in excess of 90%.

- Institutional investors intend to invest in hedge funds directly versus through funds of funds. The percentage of respondents that intend to increase their direct allocations to hedge funds is 55%; in contrast, only 5% of respondents intend to increase their allocations to funds of funds.

- The percentage of institutional investor respondents that intend to increase their allocations to hedge funds over the next 12–24 months is almost six times the amount of respondents expecting to redeem from the space.

- Survey results indicated that strategies expected to gain the most from anticipated inflows over the next 12–24 months are Global Macro/CTAs, Long/Short Equity, Credit Long/Short and Event Driven strategies other than merger arb and distressed.

- Our study indicates that the Asia Pacific Rim is expected to attract the highest percentage increases of money flowing into the hedge fund space over the next 12–24 months.

- Respondents continue to believe that a lack of alignment of interests between themselves and their managers is the biggest impediment to raising capital in the current environment.
Survey Respondents

The chart below provides the breakdown of survey respondents by type of institution.

![Chart showing the breakdown of survey respondents by type of institution]

Source: Bank of America Merrill Lynch

As illustrated by the chart above, the survey had strong representation from the plan sponsor community, with pension funds making up about 54% of total respondents. In terms of the breakdown between public and corporate pensions, publics were the largest contributors to the survey, representing 30% of respondents. However, the survey had broad representation from the institutional investor community, with respondents from the endowment and foundation community, government/central banks, sovereign wealth funds, insurance companies, union (Taft-Hartley) plans and consultants.

From a regional perspective, the majority of respondents were U.S. investors (78%). However, as illustrated in the following chart, institutional investors from Europe, Japan, the Asia Pacific Rim and the Middle East/Africa participated.

The survey was conducted on-line and supplemented by phone interviews with several large institutional investors.

As noted above, we estimate that the survey respondents represent approximately $2.1 trillion in assets under management, and include some of the most recognized institutional investor names in the world. The AUM of the funds represented in the survey were fairly evenly distributed at the lower asset ranges (from $0 to $20 billion); the exception was at the top range of assets, that is, for funds with more than $20 billion in assets under management. That category had the largest number/percentage of respondents (32%) and was heavily populated by large public/corporate pensions, insurance companies and sovereign wealth funds. This aspect of the results allows us to identify the major trends among large institutional investors on a global basis.

QE2 will be positive for equities in the short-term, but not in the long-term.

- endowment
The following chart shows the breakdown of respondents by their assets under management.

<table>
<thead>
<tr>
<th>Total Assets Under Management</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>&gt;$20B</td>
<td>20%</td>
</tr>
<tr>
<td>&gt;$10B to &lt;$20B</td>
<td>10%</td>
</tr>
<tr>
<td>&gt;$5B to &lt;$10B</td>
<td>10%</td>
</tr>
<tr>
<td>&gt;$1B to &lt;$5B</td>
<td>20%</td>
</tr>
<tr>
<td>&lt;$1B</td>
<td>20%</td>
</tr>
</tbody>
</table>

Source: Bank of America Merrill Lynch

With regard to equities, 60% of respondents were neutral, possibly reflecting uncertainty as a result of the mid-term elections in the U.S. and pending tax and regulatory changes globally. The broader equity markets have performed well for the year-to-date period as market participants anticipated the impact of additional quantitative easing from the Fed. Approximately 29% of respondents were bullish on the equities market.

Who wants to lend money to the U.S. Government for 10-years at 2.5%?
- endowment

In contrast, a recent Barron’s poll indicates that 62% of respondents think that stocks will be the best performing asset class over the next 12 months while 53% of respondents think that the U.S. stock market is undervalued.

Alternatives play a diversifying role in our asset allocation.
- sovereign wealth fund

For fixed income, survey respondents were almost evenly split between neutral and bearish, with less than 5% of respondents bullish on the category. This most likely reflects the view that rates don’t have much further to fall, before additional monetary and fiscal stimulus leads to higher inflation and rates. Respondents in the aforementioned Barron’s poll indicated that the stampede into bond funds would end in the next six months.
The results of our question on the investment climate are shown in the following chart.

<table>
<thead>
<tr>
<th>Asset Class</th>
<th>Bearish</th>
<th>Neutral</th>
<th>Bullish</th>
</tr>
</thead>
<tbody>
<tr>
<td>Equities</td>
<td>11%</td>
<td>60%</td>
<td>6%</td>
</tr>
<tr>
<td>Fixed income</td>
<td>29%</td>
<td>5%</td>
<td>46%</td>
</tr>
<tr>
<td>Alternatives</td>
<td>54%</td>
<td>40%</td>
<td>6%</td>
</tr>
</tbody>
</table>

Source: Bank of America Merrill Lynch

In a positive sign for hedge funds and other alternative asset providers, almost two-thirds of respondents anticipate increasing their target allocations to alternatives, with 63% responding in favor of an increase.

Our asset allocation has been heavily influenced by the Yale endowment model, that is, we have a heavy emphasis on alternatives.

- sovereign wealth fund

Less than 6% of respondents indicated that they are anticipating a decrease in their target allocation to alternatives, while 31% indicated that they expect no change. Among plan sponsors, 65% of publics indicated that they would increase their allocation to alternatives, versus 60% for corporates. Endowment investors (80%) and European-based investors (89%) registered the highest responses to this question.

Forty-one percent of respondents anticipate reducing their target allocations to equities over the next 12–24 months, with only 22% expecting to increase equities. The numbers were higher among the pension community as 50% of corporates and 48% of publics anticipate reductions in their equity portfolios. This corresponds to a trend that the BofA Merrill Lynch Capital Introductions team has seen playing out since the market crisis, where plan sponsors have been de-risking their portfolios via reductions to traditional equities and re-investing active risk dollars in fixed income and alternatives.

A Wall Street Journal (WSJ) article dated October 16th, 2010 indicated that corporate pension managers were fleeing stocks for the safety of bonds. After growing their stock allocations to almost 70%, pension plans as a group reduced their exposures to stocks to 45% by July 2010. It is estimated that the decline in the value of corporate stock portfolios...
from the market peak of October 2007 to March 2009 was about $1 trillion. The article also cites a study by Towers Watson from mid-2009 that found that corporate pensions were planning to move 10% of assets this year out of stocks and into bonds and alternative investments.

As for fixed income, 48% of respondents anticipate making no change to their target allocation, with the balance of respondents fairly evenly split between increasing and decreasing their fixed income allocations. The same WSJ article cited earlier also referred to the dilemma that pension managers face in today’s low rate environment. As mentioned in that article, low interest rates are a disaster for pension plans in two regards. First, pensions are loading up on fixed income at a time when low rates are providing historically low yields; secondly, falling rates increase the present value of pension liabilities, resulting in higher funding gaps, which is particularly problematic for corporate pensions whose discount rates are tied directly to corporate bond rates.

In an attempt to highlight another trend amongst institutional investors, we asked if respondents planned to increase the percentage of traditional equity and/or fixed income allocations that are managed passively, using index products or ETFs. To our surprise, only 14% of total respondents planned to increase the use of passive products in lieu of active management. However, another 19% reported that they were considering such an increase. Interestingly, the percentage of public pensions planning to increase their use of passive products was 26%, almost twice that of the aggregated results. And although only 5% of corporate funds indicated that they planned to increase the use of passive products, another 25% indicated that such increases were under consideration. According to our results, this appears to be a trend that is exclusive to U.S. investors.

These results are also somewhat in line with a recent survey by Pyramis Global Advisors that indicated that 34% of public pensions will increase their passive holdings while 31% of corporate pensions would do the same.

The results are reflected in the following chart.

Another trend that we attempted to capture through the survey was whether institutional investors were implementing systematic tail-risk programs, in the wake of the market crisis of 2008–09. Although only 17% of institutions responded affirmatively to our question, another one-third of respondents indicated that tail-risk type programs were currently under consideration. So, fully one-half of respondents had either implemented a systematic tail-risk program or were considering implementing such a program. Interestingly, 24% of corporate pensions indicated that they have already implemented a tail-risk program, while another 33% of corporates are considering one. (see chart on following page)
We have had discussions around tail-risk, but have not implemented a formal program. We currently deal with tail-risk by dialing risk up/down via tactical asset allocation. When you want it (tail-risk), it’s too expensive.
- public pension

The survey also asked if investors were anticipating changes to their currency overlay, enhanced overlay or currency alpha programs over the next 12–24 months. Two-thirds to three-quarters of investors indicated that they had no allocation to such programs, while those that did mostly indicated that there would be no change to their programs over the specified timeframe.

Tail-risk hedges are too expensive; our fund doesn’t want to give up any upside.
- public pension

Currency overlays are becoming more important in a world where currency wars are breaking out.
- endowment

**Plan Sponsor Questions**
We directed five questions specifically to the plan sponsor community to understand the dispersion of assumed rates of return, funding levels and liquidity of defined benefit plans. Additionally, we asked some questions relative to specific trends and/or strategies being pursued by plan sponsors.

In terms of assumed rates of return, roughly 60% of respondents indicated that their return assumption fell within the range from 7.5% to 8.5%. The prevalent trend this year amongst plan sponsors
Much has been written over the past several months about the crisis in plan sponsor funding levels, particularly within the public space, so we asked plan sponsors to provide their current funding ratios. Almost one-third of respondents indicated that their funding ratio exceeded 90%. Another 23% of respondents fell into the 80% to 90% funded range. However, 26% of respondents fell into the 70% to 80% range and another 15% were below the 70% funded ratio threshold. Many actuaries make the argument that a fund’s assets should be able to cover at least 80% of their liabilities. Many of these lesser-funded plans face difficult choices ahead in order to improve their funded status.

We recently lowered our actuarial rate of return for the first time in several years. The expected return drives the asset allocation but is also a factor in the computation of our discount rate.

According to the Milliman 2010 Pension Funding Study, pension fund assets at the 100 largest corporate pensions covered more than 100% of liabilities in 2007. By the end of 2008, that percentage was down to about 79%, resulting primarily from losses in their equity portfolios. More recently, Milliman reported that the funded status of the largest 100 corporate defined benefit pensions increased to 78.3% in October 2010.

Although the average of returns across plan sponsors is 8%, the dispersion of expected returns is fairly wide. Some major plan sponsors have reduced their return expectation to below 7%, while others maintain their return expectation at or above the 8.5% level.

The responses to this question are shown in the chart below.

For Plan Sponsors: What is your fund’s assumed rate of return? (select one)

<table>
<thead>
<tr>
<th>Rate of Return</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>&lt;7%</td>
<td>10%</td>
</tr>
<tr>
<td>&gt;7% to &lt;7.5%</td>
<td>20%</td>
</tr>
<tr>
<td>&gt;7.5% to &lt;8.0%</td>
<td>15%</td>
</tr>
<tr>
<td>&gt;8.0% to &lt;8.5%</td>
<td>15%</td>
</tr>
<tr>
<td>&gt;8.5%</td>
<td>20%</td>
</tr>
</tbody>
</table>

Source: Bank of America Merrill Lynch
The results from this question are shown in the following chart.

Almost three-quarters of respondents characterized the liquidity level of their funds as “strong,” with the remaining one-quarter of respondents indicating that their fund’s liquidity was “adequate.” None of the respondents said that their fund had poor liquidity.

Despite these results, reports suggest that some funds in the public sector, in particular, have been forced to sell off large amounts of assets in order to meet benefit payments or issue pension bonds to improve their funding status and liquidity. For example, Pensions & Investments (P&I) recently reported that the Kentucky Employees Retirement System was selling $30 million in investments in order to raise money to pay pension benefits.16 The fund was about 45% funded at June 31st, 2009.17

This news came just a few days after Fundfire reported that the five major pension systems representing Illinois state employees are considering selling off assets worth more than $5 billion, or 10% of their assets, to meet benefit obligations in the current fiscal year.18

We will most likely expand the amount of assets managed by internal staff as they’ve done a great job, and such a move would reduce the overall costs of the fund.

- public pension

Another trend that we’ve seen over the past year, particularly in the public space, is pensions increasing the percentage of traditional assets managed internally versus that managed by external asset managers. Slightly more than one-quarter of all respondents indicated that they intend to manage more of their assets in-house, while an additional
12% were considering doing so. The numbers were higher among public pensions, as 32% of plans indicated that they would increase the amount of assets managed internally and another 10% were considering such a move. Corporate pensions were less likely to move in this direction, with only 20% indicating that they planned to increase internal management and another 13% considering it.

Our fund has taken more assets in-house, particularly in the liquid spaces.
- public pension

In early September, it was reported on Fundfire that the State of Wisconsin Investment Board was moving almost $4 billion of externally managed international equity assets in-house, a move that will mean terminations or loss of assets for several international equity firms.\(^{19}\)

This move follows the announcement of other large public pensions like CalSTRS and Florida State Board of Administration bringing more of their assets in-house.

The results from this question are shown in the following chart.

According to the chart below, only about 12% of plan sponsor respondents in aggregate have implemented a Liability-Driven Investing (LDI) program, with another 18% indicating that it was currently under consideration at their funds. These results include both public and corporate funds; it should be noted that LDI is not a concept that has gained much traction with public funds, as they generally don’t manage their assets in order to immunize their portfolios against growth in plan liabilities. When corporate pension respondents are separated out, about 27% of plans have already implemented LDI, while another 33% indicate that LDI is currently under consideration at their funds. In contrast, 95% of publics had no plans to implement LDI.

We’ve recently dismantled our LDI program.
- corporate pension

For Plan Sponsors: Do you plan on adopting a Liability-Driven Investing (LDI) program? (select one)

According to the chart below, only about 12% of plan sponsor respondents in aggregate have implemented a Liability-Driven Investing (LDI) program, with another 18% indicating that it was currently under consideration at their funds. These results include both public and corporate funds; it should be noted that LDI is not a concept that has gained much traction with public funds, as they generally don’t manage their assets in order to immunize their portfolios against growth in plan liabilities. When corporate pension respondents are separated out, about 27% of plans have already implemented LDI, while another 33% indicate that LDI is currently under consideration at their funds. In contrast, 95% of publics had no plans to implement LDI.
Hedge Fund Questions

We posed a number of questions (14) that dealt with respondents’ hedge fund exposure. According to HFR’s Third Quarter 2010 Industry Report, hedge funds reported the largest quarterly asset jump in over three years, with total capital increasing by $120 billion.20 The increase in capital resulted from a combination of performance and new capital inflows, bringing industry assets up to $1.77 trillion.21 Through the end of the 3rd Quarter, the HFR Fund Weighted Composite was up 4.80% for the year; however, fund-raising remains difficult, as year-to-date new inflows amounted to $42.3 billion, with most of the new capital flowing to the larger managers (> $5 billion) in the space.22

In order to get a feel for how investors invest in the hedge fund space, we asked about direct vs. indirect investing. Thirty-eight percent of respondents indicated that they invested in hedge funds directly, another 12% were fund of funds investors, and about 35% invested both directly and in funds of funds. Just 15% of investors reported no exposure to the hedge fund space.

Hedge funds can deliver higher risk-adjusted returns and will become more popular over the long-term.

- public pension

The chart below illustrates the responses to our question on how respondents are invested in the hedge fund space.

If you are a hedge fund investor, how are you currently invested in the space? (select one)

<table>
<thead>
<tr>
<th>Option</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Directly</td>
<td>38%</td>
</tr>
<tr>
<td>Fund of funds</td>
<td>12%</td>
</tr>
<tr>
<td>Both directly and FOFs</td>
<td>35%</td>
</tr>
<tr>
<td>Don’t currently invest</td>
<td>15%</td>
</tr>
</tbody>
</table>

Source: Bank of America Merrill Lynch

As a follow-up to the question above, we asked how the mix between direct and fund of funds investments would change over the next 12–24 months. The good news for hedge fund managers is that 55% of respondents indicated that they would be increasing their direct investments into hedge funds; only 5% of respondents indicated that they would be increasing their investments in funds of funds. Interestingly, among public plans, none of the respondents indicated that they would increase their allocations to funds of funds over the next 12–24 months.
The fund of funds space continues to struggle to raise capital in the post-crisis environment. HFR reports capital outflows for the 3rd quarter year-to-date of $13.6 billion. In contrast to some post-crisis forecasts that suggested that funds of funds could benefit from the market crisis and Madoff scandal, that scenario doesn’t appear to be playing out.

The old fund of funds model was about access; the new model is about unbundling services and being an extension of the client’s investment team.

- corporate pension

We asked respondents about their primary portfolio objective for investing in hedge funds. As noted in the chart above right, the highest percentage of responses (43%) favored absolute returns as a primary portfolio goal. Thirty-two percent of respondents indicated that diversification/uncorrelated returns was the primary rationale for their investments in the hedge fund space. A distant third place in terms of a portfolio rationale was reduction of portfolio volatility (11%).

We asked several questions related to investors’ investment processes and thresholds that they established for selecting hedge fund managers. The first of those that we asked related to the length of the due diligence process, post-crisis.

Reputation should not replace due diligence.

- fund of funds

The chart below shows these results.

The investment process for many institutional investors has become more protracted since 2008. How long, on average, does your process take from sourcing to final investment recommendation? (select one)

- Less than 3 months
- 3 months to 6 months
- 6 months to 12 months
- 12 months to 18 months
- More than 18 months

Source: Bank of America Merrill Lynch
Past research has suggested that the due diligence process has become more protracted since the market crisis. However almost two-thirds (63%) of investor respondents reported that they can complete an investment decision on a manager in three to six months from sourcing to final recommendation. Based upon anecdotal information and discussions with investors and managers alike, we expected to see results skewed more towards the 6 to 12 month and 12 to 18 month categories.

We also asked respondents about the minimum AUM they require before investing with a hedge fund manager. Twenty-six percent of respondents indicated that a hedge fund manager needed assets between $100 and $500 million, while another 26% indicated that a manager should have between $500 million and $1 billion. Another 25% said that they required no minimum amount of assets under management before investing in a manager. (see chart below)

To help understand decision making criteria around hedge funds, we asked how long a track record was required before investing with a hedge fund manager. Thirty-eight percent of the aggregate responses indicated that a three-year track record was required; nineteen percent of respondents said that they were day-one investors. Among corporate pension investors, 54% said that they required a three-year track record, considerably higher than the aggregated results.

The following chart shows these results.

![Chart showing required minimum AUM for investment in a hedge fund manager]

In order to get a feel for investors’ allocation intentions, we asked how much investors anticipated investing/redeeming from the hedge fund space on a net basis over the next 12 months. (see chart on following page)
We don’t invest in new launches as we’re always concerned about headline risk. The fund is restricted from being more than 20% of a fund’s assets and typically wants at least $1 billion in assets under management.

The highest percentage of responses (37%) came from respondents anticipating investments in excess of $100 million in the space over the next 12 months. In fact, the percentage of respondents that plan to add to their hedge fund allocations over the next 12 months is almost 6 times the number of respondents that plan to redeem from the space. These results dovetail nicely with the earlier finding that indicated investor bullishness towards alternatives and their propensity to increase allocations to alternatives.

Public plan sponsors were more likely to write bigger tickets as 53% of public plan sponsor respondents indicated that they would allocate between $25 and $50 million to the space, while 30% indicated an allocation of more than $100 million.

The following table shows the net flows into hedge funds over the past several quarters:

<table>
<thead>
<tr>
<th>Assets ($ bn)</th>
<th>Flow</th>
</tr>
</thead>
<tbody>
<tr>
<td>2nd Qtr 2008</td>
<td>$1,931</td>
</tr>
<tr>
<td>3rd Qtr 2008</td>
<td>1,722</td>
</tr>
<tr>
<td>4th Qtr 2008</td>
<td>1,407</td>
</tr>
<tr>
<td>1st Qtr 2009</td>
<td>1,332</td>
</tr>
<tr>
<td>2nd Qtr 2009</td>
<td>1,431</td>
</tr>
<tr>
<td>3rd Qtr 2009</td>
<td>1,535</td>
</tr>
<tr>
<td>4th Qtr 2009</td>
<td>1,600</td>
</tr>
<tr>
<td>1st Qtr 2010</td>
<td>1,668</td>
</tr>
<tr>
<td>2nd Qtr 2010</td>
<td>1,648</td>
</tr>
<tr>
<td>3rd Qtr 2010</td>
<td>1,769</td>
</tr>
</tbody>
</table>

As reported by HFR, the 3rd quarter net inflow of $19 billion into the hedge fund space was the largest quarterly capital inflow since the 4th quarter of 2007. Although net inflows dipped in the 2nd quarter of this year, investor intentions, as evidenced by our survey, may bode well for the industry.
Uncertainty Over Regulatory Impact

Institutional investors seem to harbor high levels of uncertainty about the impact of new financial regulations on their hedge fund investments. Fully 60% of survey respondents indicated that they were not sure how the new financial sector regulations would impact their hedge fund investments. The remaining 40% of respondents were evenly split, with 20% saying that the new financial regulations would have a positive impact, and 20% saying that they would impact their hedge fund investments negatively.

All these new regulations are causing more uncertainty.

- corporate pension

In terms of plan sponsor responses, corporates were in line with the aggregate results, while publics were considerably higher in terms of the level of uncertainty, with 81% saying that they were unsure of the impact of the new financial regulations.

Strategy Priorities

We asked respondents to tell us how their hedge fund allocations would change by strategy over the next 12–24 months. Survey respondents reported that the largest increases by strategy are expected to be in Global Macro/CTAs (46%), Long/Short Equity (41%), Credit Long/Short (35%), Distressed (35%) and Event Driven—Other (35%). The largest decrease is expected to be in funds of funds (23%). It would appear from the responses that new capital will flow primarily into the strategies listed above, with few strategies suffering any significant capital outflows, with the exception of funds of funds.

Global macro is the main driver of our alternative investment strategies.

- sovereign wealth fund

Corporate pensions appear particularly focused on Global Macro/CTAs with 54% of respondents indicating that they would increase their allocations.
to the strategy, while 46% indicate an interest in increasing allocations to Long/Short Equity.

Publics also are mostly focused on Global Macro/CTAs with 47% of respondents saying that they will increase allocations to the strategy.

Classic long-only equity strategies will be viewed as insufficient.

- public pension

As for endowments and foundations, endowment respondents are particularly focused on increasing their allocations to the Emerging Markets (56%) and Global Macro/CTAs (50%). Foundations in our survey appear to be particularly focused on the Long/Short Equity space (50%). Insurance companies are focused on Distressed Securities (75%) and Long/Short Equity (50%).

As a matter of interest, consultant respondents were the most focused on the Long/Short Equity space (82%) and Global Macro/CTAs (73%).

Regional Allocation Intentions

The biggest winner, in terms of the aggregate responses, was the Asia Pacific region with 46% of respondents indicating that they would increase exposure there over the next 12–24 months. Thirty percent of respondents intend to increase allocations to European funds, while another 28% intend to increase their allocations to Latin America.

Interestingly, 46% of corporate pension respondents intend to increase their allocations to Asia Pacific, Europe and Latin America. Fifty-six percent of endowments intend to increase their allocations to the Asia Pacific region and 44% indicate that they will increase allocations to the Middle East/Africa. Insurance companies are more focused on increasing allocations to Europe (75%) and North America (50%). Consultants are also highly focused on the Asia Pacific region with 73% indicating that they would increase allocations to that region.

The chart below breaks down the allocation intentions by market/region.
Hedge Fund Capital Raising

The industry continues to find itself in a tough capital raising environment. We asked survey respondents what they thought was the biggest challenge faced by hedge fund managers in raising capital in the current environment.

The most popular response was that hedge fund managers need to align their interests with those of their investors on issues such as fees, liquidity terms and transparency. This choice garnered 43% of the responses and is consistent with studies done post-crisis by firms such as Casey Quirk and Bank of New York Mellon.

It is also consistent with a Bank of America Merrill Lynch whitepaper from March 2010 entitled “The New Hedge Fund Environment: Attracting Institutional Capital in a Post-Crisis World”. In that whitepaper, it was stated, “Of all issues, alignment of interests is evolving into one of the most, if not the most important criteria for investors”.

Fees and liquidity are something that hedge fund managers should address; they should be more client-centric.

- corporate pension

About 25% of respondents chose poor/mediocre performance as the biggest challenge faced by hedge fund managers in the current capital raising environment. About 11% of respondents cited investors’ preference for bigger, brand name funds; this is particularly relevant in the current capital raising environment, as HFR has reported that roughly 75% of net inflows in the 3rd quarter 2010 have flowed to managers with more than $5 billion in assets under management.

The responses to this question by the plan sponsor community are even higher than the aggregate responses in favor of better alignment of interests. From the survey, public (47%) and corporate pensions (46%) both indicated that the need to align with
investor interests was the biggest challenge in raising capital. Endowments (56%) and foundations (60%), however, had the highest percentage of responses in favor of the need to align with investor interests.

The final three questions in our survey were meant to take a pulse on certain trends in the hedge fund space. The first of those three questions asked investors if they would be investing in hedge funds through separately managed accounts (SMAs) over the coming 12–24 months. The results were not surprising in that we believe that this particular trend has been somewhat isolated amongst the larger institutional investors that have the ability to write large tickets and also have the operational bandwidth to deal with the additional administrative and compliance issues (and costs) that arise from these vehicles. Only 17% of respondents indicated that they would be investing in separately managed accounts, while 45% said that they would not be investing in SMAs. The remaining 38% of respondents indicated that they weren’t sure if they would invest through SMAs or not.

Drilling down by investor type, corporate pensions (31%) and endowments (22%) were more likely to respond in the affirmative regarding SMAs, while foundations were unanimous in rejecting the concept. Consultants were also more likely (27%) than the aggregate to recommend SMAs to their clients.

The results are shown in the chart below.

<table>
<thead>
<tr>
<th>Will you invest in hedge funds through a separately managed account over the next 12–24 months? (select one)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Yes</strong></td>
</tr>
<tr>
<td><strong>No</strong></td>
</tr>
<tr>
<td><strong>Not sure</strong></td>
</tr>
<tr>
<td>45%</td>
</tr>
<tr>
<td>38%</td>
</tr>
<tr>
<td>17%</td>
</tr>
</tbody>
</table>

Source: Bank of America Merrill Lynch

Some challenges for SMAs are: a continued state of low returns will make investors more sensitive to their costs, and the trend towards more transparency could also retard growth.

- corporate pension
The next question asked investors if they anticipated investing in a hedge fund product in a UCITS III structure over the coming 12–24 months. Not surprisingly, almost two-thirds of respondents answered in the negative, while another 20% said that they were not familiar with UCITS III structures. The reason that we are not surprised at these results is that the survey is still heavily concentrated amongst U.S. institutional investors (78%). Many U.S. investors are still not familiar with the UCITS III structure. In fact, five times the number of European investors responded affirmatively to this question versus investors in North America. Additionally, 29% of Asia Pac Rim investor respondents are considering UCITS III products.

The results of the UCITS III question are shown on the following chart.

Finally, the last question we asked attempted to find out how much investors were relying on advisors to help them with their hedge fund investments. So we asked investors if they employ a general or specialist consultant to assist them with their hedge fund allocations.

More than one-third (35%) of respondents indicated that they don’t use any type of consultant to help them with their hedge fund allocations, while another 14% checked the NA box.

The responses show that 27% use a specialist consultant in conjunction with their hedge fund portfolios, while 20% use a traditional general consultant. A small percentage of respondents (4%) indicated that they use a combination of a general and specialist consultant to help them with their hedge fund allocations.

The use of specialist consultants to assist with hedge fund portfolios was more likely amongst the plan sponsor community with 47% of public pensions and 39% of corporate plans reporting the use of specialists, versus 27% for the aggregate.

The chart below illustrates the responses to the question regarding consultants.
Summary

In summary, the BofA Merrill Lynch Fall 2010 Institutional Investor Survey found that, from its pool of respondents:

- Institutional investors are more bullish on the alternatives space than on traditional equities and fixed income, by a large margin.

- The percent of public pensions that are increasing the amount of assets managed passively is almost twice the amount of the aggregate results.

- Seventeen percent of respondents have implemented systematic tail-risk management programs since the market crisis began, with another 33% considering doing so.

- Forty-one percent of plan sponsor respondents fell below the 80% funded level while about one-third (32%) of pension plans indicated funding levels in excess of 90%.

- Institutional investors intend to invest in hedge funds directly versus through funds of funds.

- The percentage of institutional investors that intend to increase their allocations to hedge funds over the next 12–24 months is almost six times the amount of investors expecting to redeem from the space.

- The strategies expected to gain the most from anticipated inflows over the next 12–24 months are Global Macro/CTAs, Long/Short Equity, Credit Long/Short and Event Driven strategies other than merger arb and distressed.

- The Asia Pac Rim area is expected to garner the highest percentage increases of money flowing into the hedge fund space over the next 12–24 months.

- Investors continue to believe that a lack of alignment of interests between themselves and their managers is the biggest impediment to raising capital in the current environment.
Notes

1 All quotes come from phone interviews conducted in conjunction with our on-line survey
2 “Barron’s Fall 2010 Big Money Poll”, Barron’s, November 1st, 2010
4 Ibid
5 Ibid
6 “2010 Global Defined Benefit Survey”, Pyramis Global Advisors, September 2010
7 “Pension Gaps Loom Larger”, The Wall Street Journal, September 18th, 2010
8 Ibid
9 Ibid
10 Ibid
11 Ibid
12 Ibid
13 “Milliman 2010 Pension Funding Study”, Milliman Inc., April 2010
14 Ibid
15 Ibid
16 “Kentucky Employees sells off $30 million to pay benefits”, Pensions & Investments, August 31st, 2010
17 Ibid
18 “Illinois to Sell Billions in Pension Assets”, Fundfire, August 25th, 2010
19 “Managers to Lose as Fund Moves $4B In-House”, Fundfire, September 1st, 2010
21 Ibid
22 Ibid
23 Ibid
24 Ibid