THE RISE OF REAL ASSETS

Tepid recovery drives institutional investors to alternative strategies

A report prepared by the Institutional Investor Custom Research Group in conjunction with AMP Capital / May 2013

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Welcome to the inaugural issue of the AMP Capital Institutional Investor Research Report.

This study provides institutional investors with benchmark information on asset allocation and investment trends through primary research among investment decision makers around the world.

This issue includes findings on:
- Movements in asset allocations in the first quarter of 2013
- Allocation intentions for the next quarter
- The Not-So-Great Rotation and the movements between cash, fixed income, and equities
- Structural institutional investment trends
- Listed versus direct investment
- External versus internal management
- Investors' mistakes and lessons from last year

We hope you find the results of this research useful, and we'd be pleased to hear your comments and questions.

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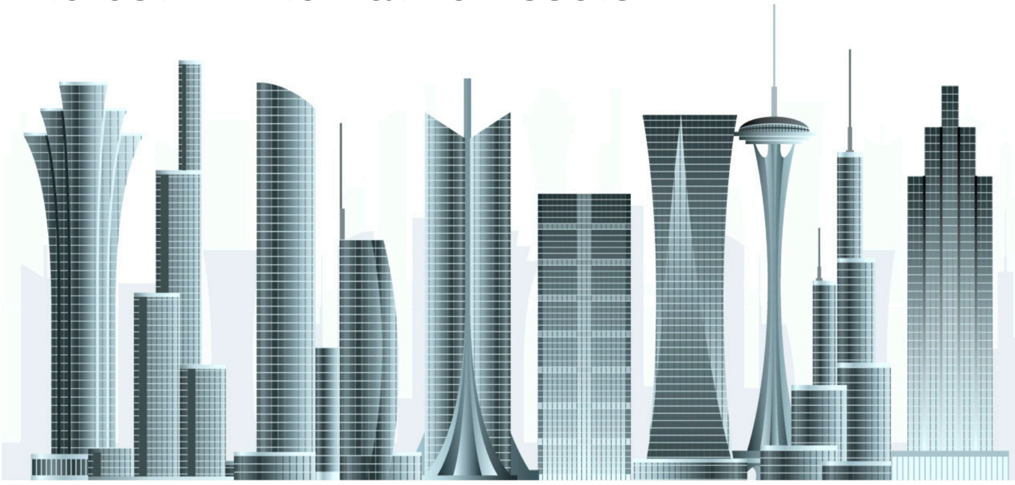
Gradual Recovery Drives Interest in Alternative Assets



Large institutional investors are most likely to have increased allocations to alternative asset classes in recent months, and are likely to continue to increase them in the future.

The global economy has recovered from the turmoil of recent years at a very gradual pace. On one hand, publicly traded equities have delivered handsome returns of 12%-25% in the United States, Asia, and Europe since the beginning of 2012. On the other, interest rates remain abnormally low, job growth has been weak, and fiscal policies in Europe and the United States have contributed to stagnant economic growth. Thus the good news is that, even if it is underwhelming and slow, the economic recovery appears to be gradual and persistent.

In response to this tepid recovery, institutional investors are increasingly seeking high returns through alternative investment strategies, according to the findings of this study of asset managers conducted by the Institutional Investor Custom Research Group and AMP Capital. We find that investment decision-makers at large institutional investor firms are most likely to have increased allocations to alternative asset classes in recent months, and that they are likely to continue to do so in the future.

Alternative assets—which in this study include listed and unlisted real estate and infrastructure along with private equity, hedge funds, and commodities, among others—are especially appealing to alpha-seeking investors. Survey respondents show a growing interest in alternative investments over publicly traded ones, but temper their enthusiasm for them by calling for clear-eyed analysis of investments at the asset level.

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Survey respondents from around the world represent large financial institutions, such as pension funds, foundations, endowments, sovereign wealth funds, and family offices.

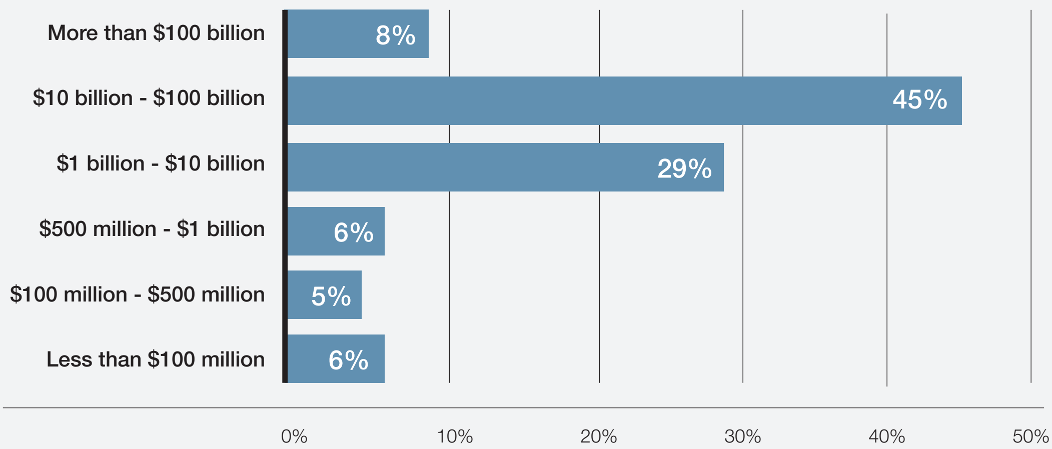
About this Research

In the first quarter of 2013, Institutional Investor Research was commissioned by AMP Capital to conduct a survey of senior decision makers at investing institutions in Europe, North and South America, and Asia (including Australia and Japan). Sixty-two individuals responded.

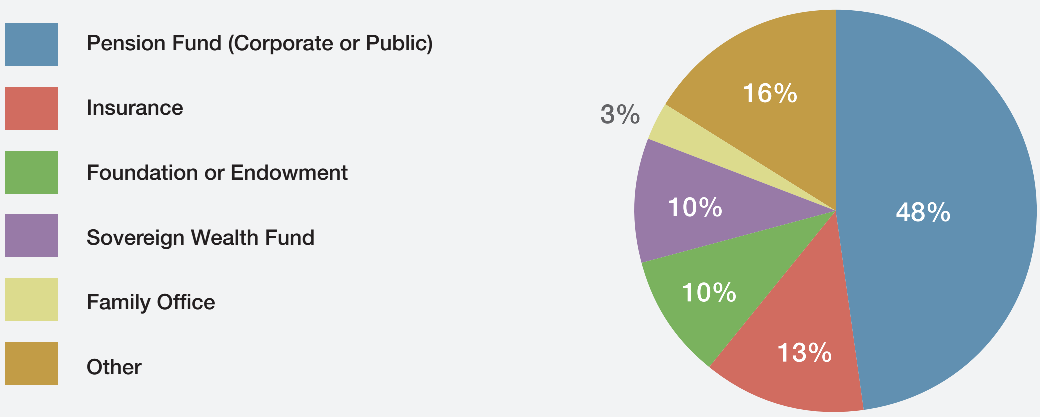
As shown in Figure 1 below, survey respondents represent large financial institutions—82% of them work for firms with $1 billion or more in assets under management—such as pension funds, foundations, endowments, sovereign wealth funds, and family offices. Eighteen percent of respondents are located in Asia, 18% are in Europe, and 65% are in North and South America. Collectively they manage an estimated $1.9 trillion.

Figure 1. Respondent demographics

What are your institution's assets under management?



What is your institution type?



Percentage of respondents. Values may not total 100% due to rounding.

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Asset Allocation Benchmarks

Asset allocations are a closely guarded secret among large investors of all types. They are both a source and an expression of investment strategy and therefore vary according to a fund's objectives, mandate, and historical performance. Nonetheless, our review of recently published allocations suggests that, in aggregate, institutional investors similar to those in this study have 35-52% of assets invested in equities, 13-34% in fixed income, and 18-35% in alternative investments, such as directly held real estate, real estate investment trusts (REITs), infrastructure, hedge funds, private equity, and commodities, as shown below.

In aggregate, institutional investors similar to those in this study have 35-52% of assets invested in equities, 13-34% in fixed income, and 18-35% in alternative investments.

	Consultant #1 Global Asset Allocation[1]	Consultant #2 Global Asset Allocation[2]	Country A 89 Institutional Investors[3]	Country A 's largest pension[4]	Country A's largest Sovereign Wealth Fund[5]
Equities	47%	41%	45%	52%	35%
Domestic			25%	29%	11%
Global			21%	23%	24%
Fixed income	34%	33%	20%	13%	17%
Domestic			13%		
Global			7%		
Alternatives	18%	22%	24%	30%	35%
Direct property		6%	8%	12%	6%
Listed property/REITs			2%		
Infrastructure	1%	1%	11%	14%	6%
Hedge funds	7%	7%	3%		
Private equity	5%	5%		4%	7%
Commodities	1%	1%			
Other alternatives	4%	2%			15%
Cash	1%	3%	9%	5%	13%
Other			1%		

Source: AMP Capital. Totals may not equal 100% due to rounding.

While asset allocations are often viewed as proprietary, we are able through this survey to gauge the dynamics of asset allocations in the past three months as well as investors' general plans for the quarter that lies ahead.

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1. Towers Watson Global Pensions Asset Study January 2013 (available online).
2. Russell Investment's 2012 Global Survey on Alternative Investing (available online).
3. Average allocation of 89 institutional investors in Australia from Peter Lee Associates as of end 2012 (used by permission).
4. AustralianSuper is Australia's largest superannuation fund. Balanced option allocation as of October 2012 (available online).
5. Australia's largest sovereign wealth fund is the Future Fund. Allocation as of 31 March 2013 (available online).

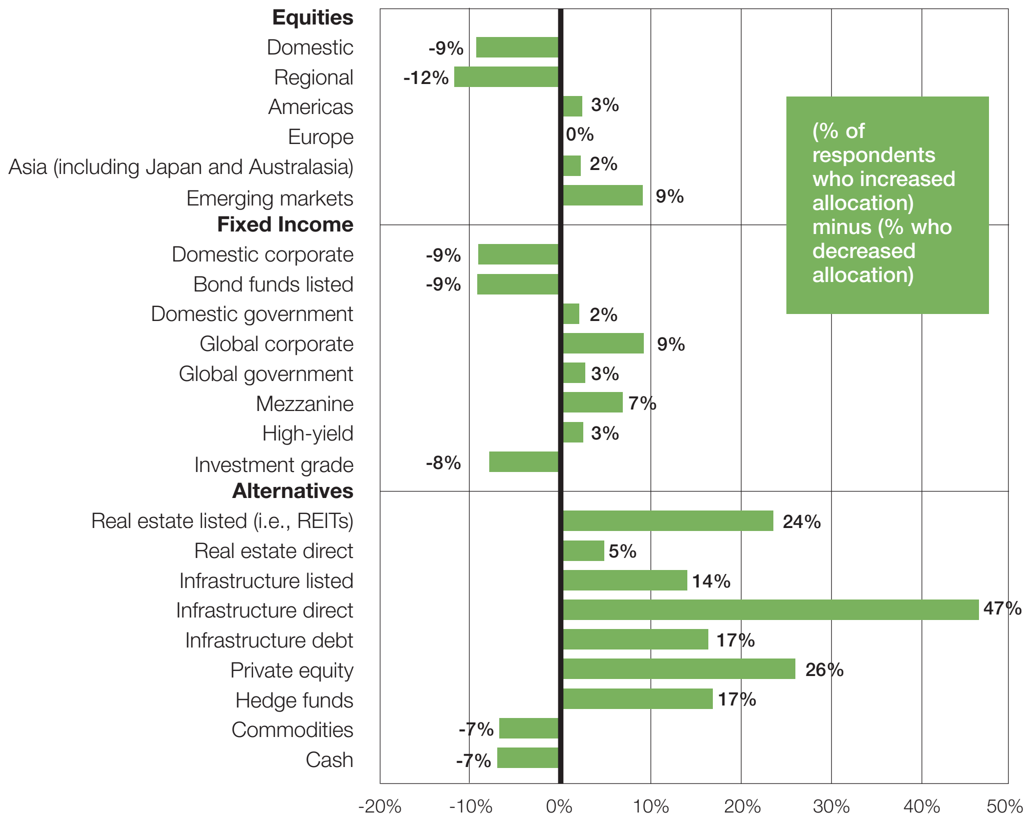
Movements in Asset Allocation

Investors are most likely to report an increase in alternative investment classes, especially direct infrastructure, hedge funds, private equity, and REITs. As Figure 2 shows, some respondents increased their allocations to fixed income and equity classes, while others decreased them. This allocation dynamic may well illustrate the normal course of business for investments in the two largest asset categories. Alternative investments, however, have seen a net increase, according to survey data. Indeed, no respondents in the survey report reducing their allocation to infrastructure—listed or direct—or infrastructure debt.

Alternative investments saw a net increase in allocation in Q1 2013, according to survey data Infrastructure—both listed and direct—and infrastructure debt were the only assets to show no reductions in holdings.

Figure 2. Investors increased allocation to alternative investments in Q1 2013

Has your firm increased, decreased, or left unchanged its investments in the following asset classes in the most recent quarter?



[1]"Domestic" refers to equity or debt investments in respondent's nation. [2]"Regional" refers to equity or debt investments in respondent's region.

Pension fund respondents were consistently more likely than their peers in other types of firms, such as endowments, foundations, insurance companies, and sovereign wealth funds, to leave their asset allocations unchanged, perhaps due to pension governance requirements and the stable flow of funds from participants' contributions and to pension beneficiaries. Similarly, in nearly all asset classes, pension respondents were less likely than their non-pension peers to increase their allocations, preferring to stay the course with their current mix of equity, debt, and alternative assets.

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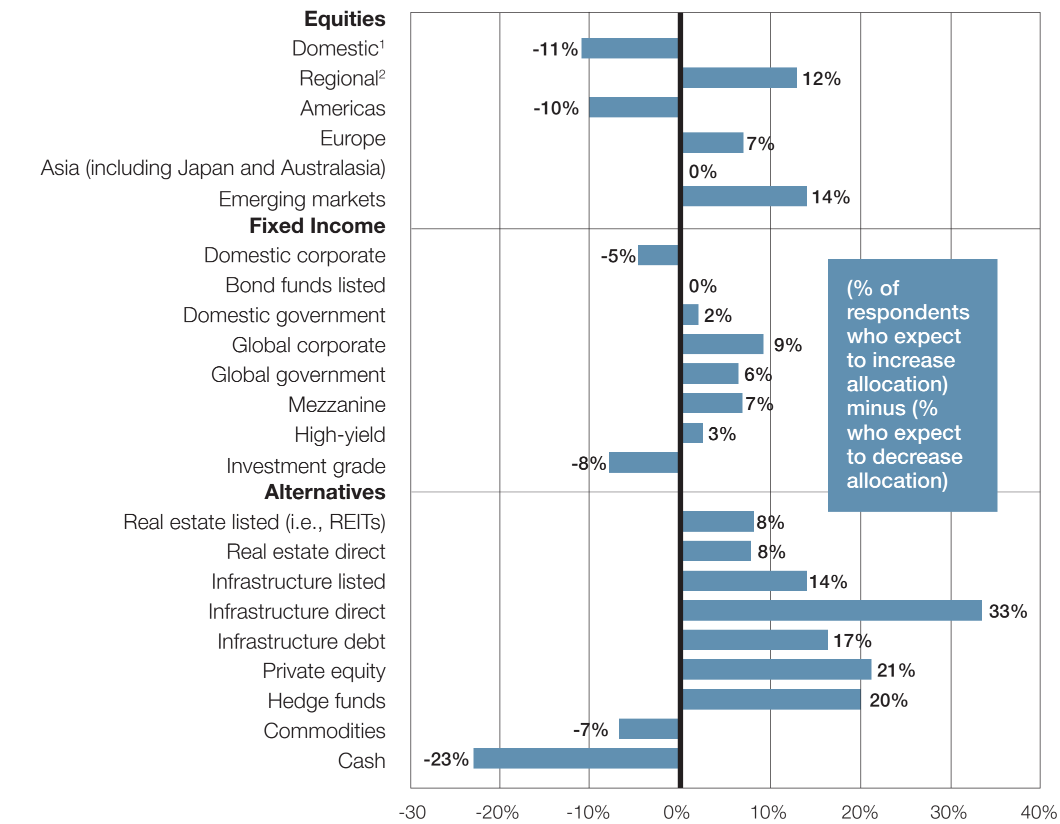
In the second quarter of 2013, investors will generally sustain their asset allocation strategies, according to survey data. As shown in Figure 3 below, the patterns of Q1 2013—in which increases and decreases in equity and fixed income allocations are approximately equal—are likely to continue, with a few notable exceptions. The percentage of respondents increasing their allocation to equities in the Americas falls from 28% in Q1 2013 to 13% in Q2, while increases in allocations to equities in Europe, Asia, and emerging markets remain unchanged at 23%, 17%, and 28%, respectively. Again, infrastructure is the only asset class that no investor intends to reduce.

Pension fund respondents were consistently more likely than their peers in other types of firms to leave their asset allocations unchanged, perhaps due to pension governance requirements and the stable flow of funds from participants' contributions and to pension beneficiaries.

Figure 3. Increase in allocation to alternatives is likely to continue

Do you expect your firm will increase, decrease, or leave unchanged its investments in the following asset classes in the next quarter?



[1]"Domestic" refers to equity or debt investments in respondent's nation. [2]"Regional" refers to equity or debt investments in respondent's region.

After segmenting the data according to whether respondents had or hadn't increased their allocations to equities, it becomes clear that those who increased their equity allocations last quarter are more likely to continue to increase their equity holdings in the next quarter compared to their peers who didn't increase equities in Q1 2013. The same pattern emerges among respondents who increased fixed income and alternative investment holdings when compared with respondents who didn't in Q1 2013.

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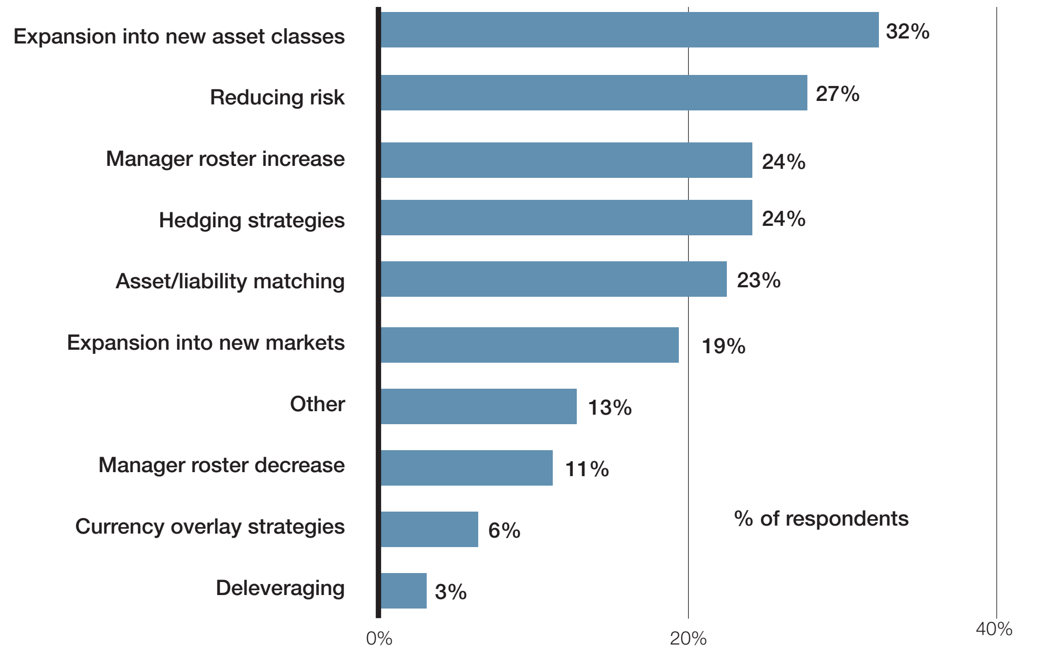
Strategies Focus on Delivering Higher Returns While Limiting Risks

While investors will fine-tune their asset allocations and selections in an effort to limit risk and to deliver high returns, they will also pursue other methods. When asked what structural changes they expect to make in the year ahead, survey respondents are more likely to say they will expand into new asset classes, limit risk in various ways, and increase their roster of managers. These choices appear to be closely linked with one another. For example, expansion into new asset classes is likely to require a larger roster of asset managers. Similarly, hedging strategies and duration matching are two effective tactics for reducing risk. (See Figure 4.)

Respondents' structural changes are closely linked with one another. Expansion into new asset classes is likely to require a larger roster of asset managers. Similarly, hedging strategies and duration matching are two effective tactics for reducing risk.

Figure 4. Institutional investors expect to focus on new asset classes and risk reduction

What structural changes to your investment portfolio do you expect to make this year?



Respondents from pension funds are especially likely to anticipate moving into new asset classes compared with their non-pension peers. Forty-three percent of pension respondents expect to expand into new classes of assets in the year ahead, but only 22% of non-pension respondents plan to do so.

These asset classes include:

- infrastructure
- private equity
- real estate
- renewable energy

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The Not-So-Great Rotation

The term "great rotation" has become a catch phrase for the expectation that today's historic low bond yields will prompt investors of all types to "rotate" out of bonds and into equities. The expectation that the great rotation will happen is not unfounded as low bond yields (high bond prices) mean that yields can't go any lower, and that they will eventually rise (and bond prices will fall). However, economic conditions today are still uncertain, and governments around the world are likely to continue to adopt a monetary policy that supports a low interest rate environment.

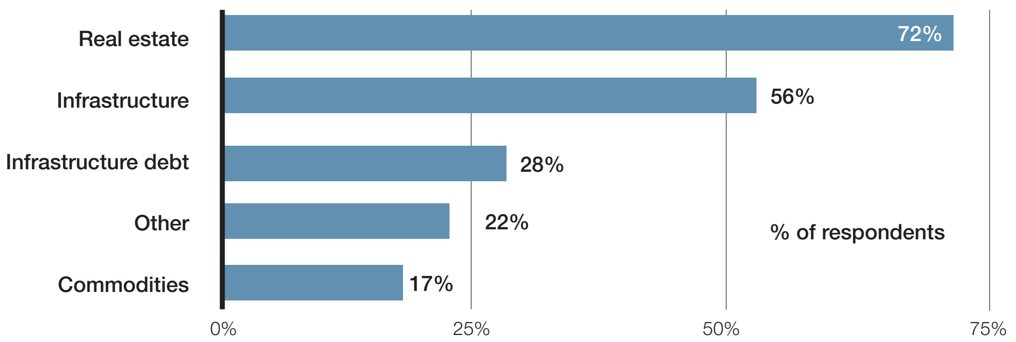
However, this rotation has not been widely adopted among institutional investors. Rather, we see them moving out of cash and into bonds and equities, and making shifts within their fixed income investments by, for example, moving away from sovereign bonds into high-yield corporate debt. Institutions with set, well-defined liabilities such as pensions and insurance firms need to invest in assets that have a steady rate of return with stable capital and thus they remain in fixed income.

We note some institutional investors are also expanding into the real asset sub-classes of infrastructure debt.

The "great rotation" theory is theoretically sound, but institutional investors have not embraced it, according to survey data.

Figure 5. Infrastructure and infrastructure debt are likely to see increased allocations in 2013

If you are increasing your real asset investments, which specific classes are you most likely to increase?



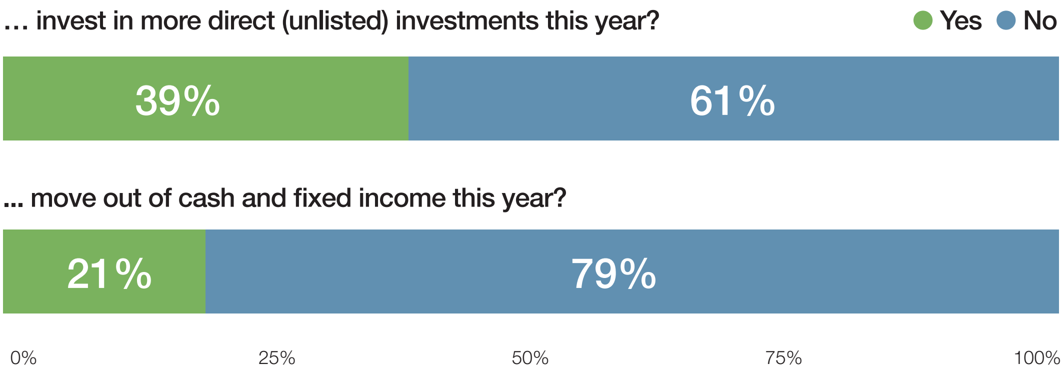
Seventy-nine percent of institutional investors polled said they did not plan to move out of cash and fixed income this year. Only 21% expected to make such a move, showing that this asset class remains very important for institutions. Global and domestic government bond holdings were increased by 29% and 28% of respondents, respectively, in the first quarter, and a significant part of this rise appears to be U.S. treasuries and selected European debt. Listed bond funds were sold down the most. In the future, high yield and global corporate bonds are among those expected to be most in demand.

Institutional investors are clearly moving more toward direct investments as they seek to avoid the volatility associated with public equity and bond markets. Nearly forty percent of respondents plan to increase their investments in direct/unlisted investments this year, despite the fact that direct investments, such as private equity, infrastructure and direct real estate, are often illiquid. We infer that managers increasingly see private, direct investments as less volatile than long-term equity and bond investments and also as a source of attractive returns.

We infer that investors see private, direct investments providing returns comparable to long-term equity and bond investments with less volatility.

Figure 6. Respondent show growing interest in direct investment while remaining committed to cash and fixed income

Do you plan to…



Real Assets: An Alternative to Public Markets

As the world economy moves gradually toward recovery, investors may well be prudent to take a similarly gradual “wait-and-see” approach toward investments. Pension respondents are especially likely to move cautiously in the near term, according to their responses to a question on their firm’s investment focus in 2013. “Status quo – we’ll try to get fully funded over the next few years,” says one pension respondent.

However, active investors seldom have the luxury of waiting until conditions are ideal for high returns; that is, they need to deliver performance despite the vagaries of public markets. Accordingly, many respondents in this survey will seek returns in non-public markets. Queried on his firm’s investment focus for 2013, one respondent from a sovereign wealth fund in North America said his firm will “continue [capital] deployment to support long-term targets, shifting away from an overweight of equities to income producing assets.” Similarly, another investor says his midsized pension fund is likely to “cut exposure to long-term rates and to continue to build out private markets.”

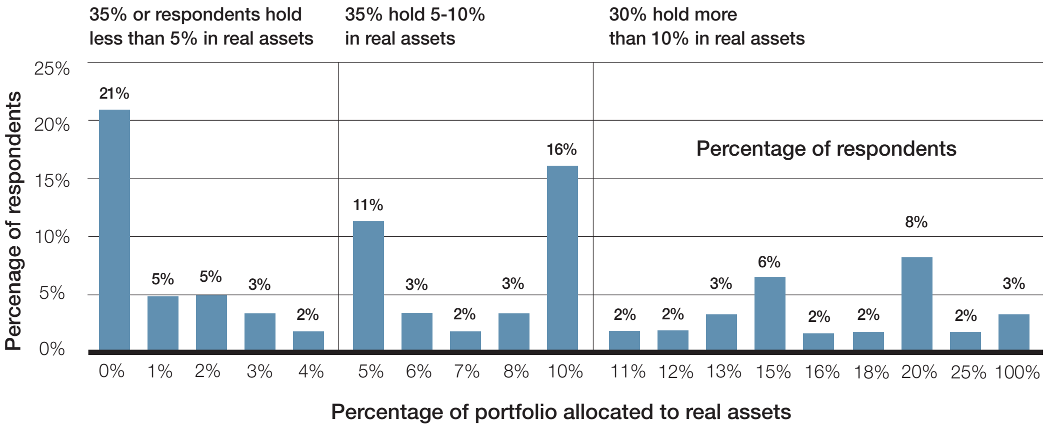
With $6.5 trillion in alternatives, institutional investors have placed the alternative asset class in the investment mainstream.

Investments in alternative asset classes doubled from 2005 to 2011, as AUM in alternative assets grew seven times faster than in traditional assets, according to McKinsey’s 2012 study, *The Mainstreaming of Alternative Investments*. Clearly, with $6.5 trillion invested in alternatives, this asset class has become part of the institutional investment mainstream.

Within the alternative class, listed and unlisted real estate and infrastructure make up one of the fastest growing segments. Survey respondents have included real assets in their portfolios to varying degrees, as shown in Figure 7. Approximately one-third have 5% or less of their holdings in real assets, another third have 5-10% invested in real assets, and the remainder holds more than 10% in real assets. In a separate question, 29% of all respondents in the survey say they anticipate increasing their allocation to alternative investments in 2013.

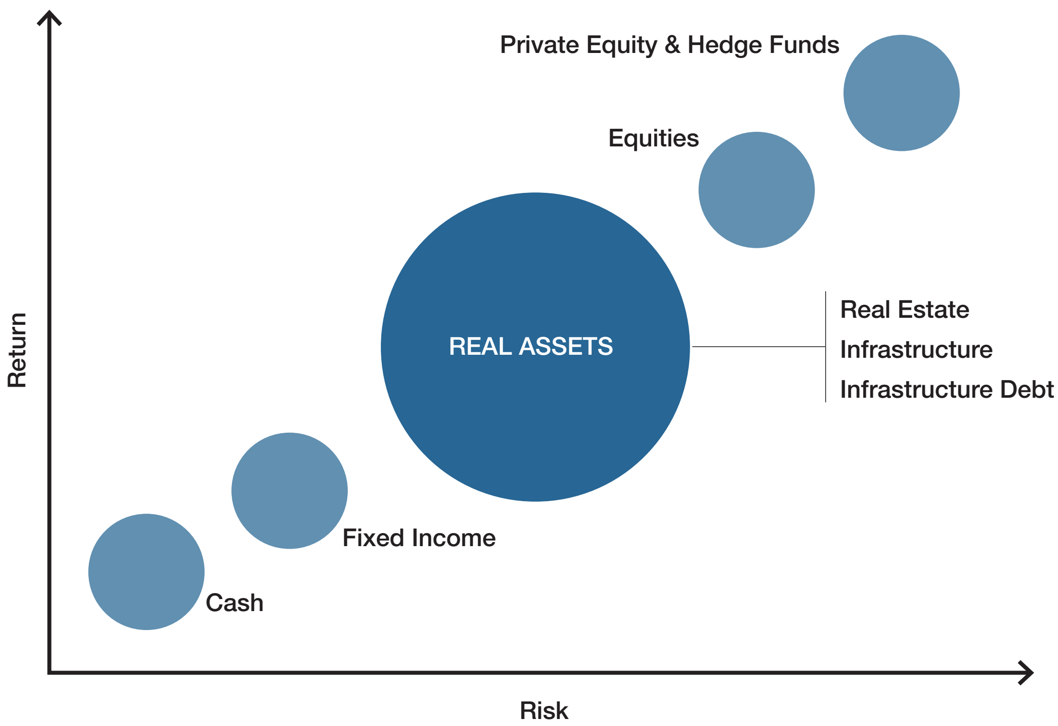
Figure 7. Real assets play a substantial role in respondents’ asset allocation strategies

What percentage of your assets is invested in real assets, such as real estate, infrastructure, infrastructure debt, and commodities?



One of the appeals of real assets is their tangibility, which offers a greater sense of stability and insulation from the systematic risk of public equity markets. A second appeal is that real assets' typical performance bridges the gap between fixed income and equity (see Figure 8).

Figure 8. Real assets sit on the risk-return curve above fixed income but below equities



Source: AMP Capital

More Assets Will Require More Managers

Pensions' expansion plans are likely to require more third-party asset managers, given that 40% of pension respondents expect to increase their roster of managers, compared with only 9% of non-pension respondents.

This expansion in manager bench-strength is confirmed by respondents' answer to another question, in which 50% of pension respondents say they anticipate conducting more manager searches in the year ahead, while only 19% of non-pension respondents say they hold such a view.

Almost 34% of all respondents expect to conduct more manager searches in 2013 than in 2012; whereas 48% expect to undertake a similar number of searches. Only 18% expect to conduct fewer searches this year. Interestingly, 31% of investors expect to increase their own internal asset management capability, but almost 70% do not.

Large institutional investors around the world call for balancing resolute investment decision making with a keen focus on the fundamental value of their investments at the asset level.

Investors' Lessons from Last Year

In response to a question on the greatest investment lessons from 2012, one respondent said, "Not moving fast enough. [We] need to incorporate innovative ideas in communication with our Board." Similarly, a pension manager regretted "not being more aggressive in removing bureaucratic impediments which slowed the implementation of asset changes," while another cited a need for "more timely rebalancing."

Other respondents temper this call for decisive action by affirming the value of active investment strategies. A respondent from South America calls for "staying true to the fundamentals regardless of price movements and forecasting the news flow." A foundation manager cites an important distinction between a sector's performance and the performance of actual assets, saying "emerging market fundamentals do not translate into faster growth from emerging market equities."

This focus on the asset fundamentals extends to alternative asset categories as well. In the poignant words of one respondent, "The biggest lesson learned from our investment experience in 2012 underscored the importance of making real estate investments that are well positioned at the asset-level. Simply owning real estate in markets with great fundamentals is not enough. Investments that are poorly positioned at the asset level will continue to face leasing challenges even if the submarket enjoys meaningful net absorption."

With these findings in mind, institutional investors would be wise to pursue their investment objectives by balancing an urge for decisive action with a well-informed, asset-level mastery of investment opportunities.

Institutional investors in Asia increased their investment in domestic government bonds, listed bond funds, global government bonds, mezzanine debt, and other debt instruments. This growth in fixed income allocations in Asia is likely to continue in the second quarter of 2013.

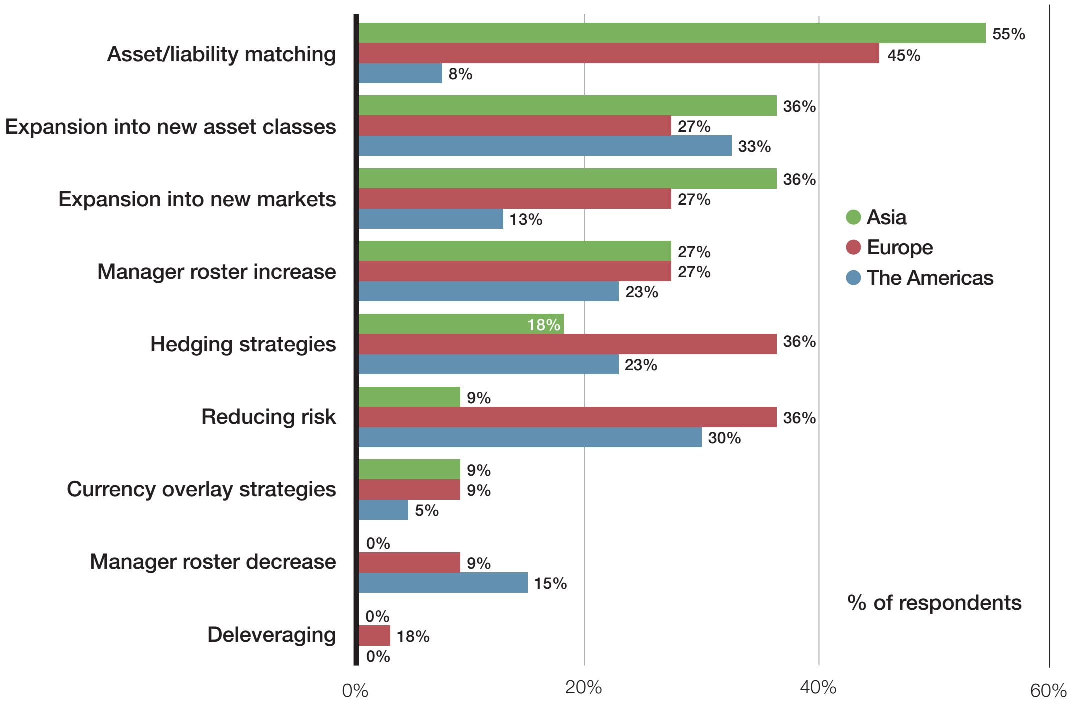
Topline Findings—Region by Region

Asia focuses on fixed income, risk management, and new assets

Institutional investors in Asia increased their investment in domestic government bonds and in listed bond funds, while those in the United States decreased theirs, according to a regional segmentation of the survey data. Respondents in Asia were also especially likely to increase their allocations to global government bonds, mezzanine debt, and listed and direct infrastructure holdings. This growth in fixed income allocations among institutional investors in Asia is likely to continue in the second quarter of 2013.

Respondents in Asia are likely to focus on asset/liability matching and to expand into new markets and asset classes.

What structural changes to your investment portfolio do you expect to make this year?



A separate question reveals that only 18% of respondents in Asia expect to conduct more manager searches this year, compared to 36% in Europe and 38% in the Americas.

Looking to the future, interest in direct, unlisted investment among respondents in Asia is nearly on par with respondents elsewhere. Thirty-six percent of respondents in Asia anticipate increasing their direct, unlisted investments in the year ahead, while 46% of those in Europe and 38% in the Americas foresee such a change.

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European respondents shed domestic and regional equities and move toward real assets

European investors decreased their domestic and regional equity holdings more than respondents from any other region during the first quarter of 2013. European respondents were also more likely to increase their high-yield bond holdings than their peers elsewhere.

Some 46% of European investors expect to allocate more funds to real assets in 2013, compared with only 18% in Asia and 28% in the Americas. Similarly, nearly half of the respondents from Europe expect to invest in more direct, unlisted investments. In Europe, institutional investors will focus on infrastructure and infrastructure debt, whereas in Asia, they are showing greatest interest in real estate, infrastructure, and infrastructure debt.

Institutional investors in Europe and the Americas are likely to continue to increase their investments in real assets, especially in infrastructure and real estate.

Portfolio rebalancing in Europe will not come at the expense of cash or fixed income allocations, according to survey data. Only 9% of institutional investors in Europe plan to move out of cash or fixed income compared with 23% in the Americas and 27% in Asia.

Respondents in the Americas expect incremental growth in real assets

Eighty percent of respondents in the Americas hold real assets in their portfolios, and 28% of them anticipate increasing their allocation to real assets in the year ahead. Real estate allocations are likely to grow among 82% of respondents in the Americas, followed by infrastructure which is expected to grow among 45% of them.

Investors in the Americas are the least likely to increase internal asset management, with only 28% planning to do so.

Contact information

For more information on AMP Capital and its offerings, visit www.AMPcapital.com.

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