RUSSELL RESEARCH

THE 2005-2006

Russell Survey on Alternative Investing

A SURVEY OF ORGANIZATIONS IN
NORTH AMERICA, EUROPE, AUSTRALIA, AND JAPAN

EXECUTIVE SUMMARY OF KEY FINDINGS

Russell

Looking for Answers

In 1992, Russell Investment Group saw a common trend—the need for meaningful insights into alternative investing around the world. So we went looking for answers, and we're pleased to present the seventh edition: The *2005–2006 Russell Survey on Alternative Investing*. Russell previously partnered with Goldman Sachs to conduct the survey, but with increased focus and growth in alternative investments, Russell this year is excited to be the sole sponsor of the survey.

About the Survey

A total of 327 large organizations responsible for managing tax-exempt assets responded on their use of private equity, hedge funds, and real estate. By directly surveying these institutions on their views and methodologies regarding alternatives, we hope to provide investors with a valuable and easily understandable overview while also identifying specific trends in the alternative investing universe. This biennial survey is unique because it covers multiple alternatives across multiple regions globally. Each successive report offers a broader perspective by accumulating progressively longer streams of historical data.

Identifying Trends

The survey asked in-depth questions designed to extract useful information and insights. The results help generate a clearer picture of what lies ahead for alternative investing:

- ***Growth***—Clearly, alternatives are poised for rapid growth, expected to reach record levels by 2007
- ***Hedge funds will dominate***—Hedge funds will likely continue to garner the greatest share of increased commitments among alternatives
- ***Smaller markets will invest heavily***—Smaller capital markets have significantly increased their investment in alternatives compared to more mature markets, a trend that is expected to continue

Adding Insights

Russell's senior investment managers briefly expand on the key findings in the report. As you read their views and assimilate the survey results, you may find elements that strike a chord with your particular investment strategies. Indeed, we hope the report will prove valuable to you and your organization. We encourage your comments on the survey and welcome your suggestions for further refinement of this research.

Most importantly, Russell gratefully acknowledges the organizations who responded to this year's survey. Your participation and thorough responses are much appreciated.

Sincerely,

Tom F. Hanly

Tom F. Hanly
Chief Investment Officer
Russell Investment Group

Overview

Investing large pools of institutional tax-exempt financial assets is an evolving pursuit, particularly in light of current financial markets and generally increased levels of governance. The last two decades have seen robust growth in the use of alternative investments which continues today. North America led the way, with real estate and private equity becoming significant components of portfolios from the early 1980s. By the end of the 1990s, private equity had become a mainstream asset class in North America and today is increasingly important in other regions while real estate has also solidified its place in the asset mix of investors in other regions. Hedge funds, once considered a fringe investment primarily utilized by endowments and foundations in North America, continue to move into mainstream acceptance among other institution types across the globe.

In reviewing the results of the survey, the following three key themes emerged, which are further expanded upon by Russell senior investment managers.

- Commitments to alternatives have increased, and are forecast to reach record levels by 2007
- Hedge funds have been the main beneficiaries of the increased commitments
- Smaller markets have increased their allocations to alternatives significantly compared to more mature markets

The results of the survey show that private equity continues to play an important role in institutional portfolios across the globe. Allocations to private equity are forecast to reach record levels in all markets in 2007, with markets that have traditionally had lower allocations to private equity (continental Europe and Japan) showing the largest expected increases. In addition, the percentage of respondents investing in private equity has also increased across most geographies. These trends reflect the increasing appetite of institutional investors to seek out the higher returns that private equity has historically provided and a greater acceptance of the liquidity and risk profiles of the asset class.

David Braman
Senior Partner
Pantheon Ventures—Russell Investment Group

Our survey reflects a greater reliance on hedge funds to boost returns and increase portfolio diversification. Clearly institutional investors, still mindful of the precipitous three-year market downturn that began in 2000, remain wary of stocks. Anticipated higher interest rates are making them leery of bonds, too. Added to their concerns are forecasts that the return premium for stocks over bonds in the next decade might be as low as three percent. They still believe in active money management and the ability of hedge fund managers to extract alpha from inefficient markets around the world. The detailed survey results on the following pages will prove useful in further assessing investors' hedge fund practices and expectations.

Victor Leverett
Director—Hedge Funds
Russell Investment Group

The realm of alternative investing typically begins with real estate for many institutional investors. As noted in the report, real estate continues to play an integral role in many institutional portfolios. Investors have historically been attracted to real estate for its competitive rate of return, ability to diversify a portfolio, inflation-hedging attributes and income generating capability. Although some regional differences exist, global allocations to real estate remain strong and are generally expected to increase by 2007. This is not an unexpected result given the longer period of experience and familiarity many investors have with this category. The survey results again point to an implied confidence in real estate as an alternative investment.

Karl Smith
Director—Real Estate
Russell Investment Group

Executive Summary

Private Equity

- The percentage of respondents investing in private equity increased in Europe, Australia, and Japan compared to 2003, continuing the trend since 2001, but decreased somewhat in the U.S.
- Strategic allocations to private equity are also up in Europe and Japan, and down modestly in North America and Australia. Allocations are forecasted to increase by 2007 in all regions.
- Commitments to private equity in excess of strategic allocations (overcommitments) continued to grow in Europe, but have declined in North America and Australia, reversing their previous trend.
- Funds of funds are identified as the preferred route for respondents from markets that have traditionally had lower investments in private equity, such as continental Europe and Japan. In the more mature markets of North America and the U.K., investment in single-fund partnerships has increased.
- The composition of investors' portfolios by investment strategy remained fairly consistent in North America, while the percentage of respondents' capital committed to buyouts increased in Europe and the percentage committed to special situations increased in Australia.
- Mezzanine financing and special situations in all regions are forecast to grow in popularity as investment strategies over the next three years.
- Average return expectations across the globe are all in double digits, with Australian respondents showing the largest increase in return expectations over 2003.

Hedge Funds

- Use of hedge funds, both in terms of the percentage of respondents utilizing and strategic allocations, continued to increase across all regions. Strategic allocations are forecast to increase by 2007 in all regions.
- Those respondents who do not invest in hedge funds continue to be concerned primarily with transparency and perceived risk; many also cite a shortage of internal resources and a concern that too much money is chasing too few hedge fund opportunities.
- The percentage of respondents utilizing funds of funds continues to grow.
- Relative value, event driven and long/short are among the most popular hedge fund strategies in most regions—multi-strategy is popular in Australia.
- Australian respondents are far less disposed to funds of funds than their counterparts in other regions.
- Median hedge return forecasts are lowest in Japan (5%) and highest in Australia (10.3%).

Real Estate

- The percent of respondents utilizing real estate remained virtually unchanged compared to 2003 for North America and Europe, but increased in Australia. Real estate questions, included in Japan for the first time in 2005, revealed 22% of respondents investing, much lower than any other region.
- Strategic allocations to real estate range from 3.4% of total assets in Japan to 10.4% in Australia. This represents a slight decline in North America and Australia, but gains in Europe compared to 2003 levels. All regions, with the exception of Australia, forecast increased allocations by 2007.
- Respondents in all regions except Japan commit most of their capital to direct investments in land and buildings. Almost two-thirds of European capital is committed to direct investments while approximately half of North American and Australian capital follow that path. This trend tends to be influenced by size of the respondent, with larger institutions who are well represented in this survey tending to use direct investments.
- Respondents are heavily committed to their own regions, committing an average of about 90% or more locally, and are expected to maintain that policy.
- Median respondent return forecasts fell in a fairly tight range of 5% to 8.4% across all regions.

Other Alternatives

- Currently, the most frequently utilized "other" alternative is currency overlay followed by tactical asset allocation overlay (using derivatives to create asset exposure separate from the underlying assets in the portfolio) and absolute return strategies (long only and cash).
- Portable alpha, absolute return strategies and commodities strategies are cited most often as being considered for future use though not currently utilized.

Executive Summary

Summary of Regional Findings

North America

- Fifty-seven percent of North American respondents utilizing private equity is down somewhat compared to 2003's 70%. About 55% continue to invest in real estate, virtually unchanged since 2003. Twenty-seven percent now report utilizing hedge funds, up from 23% in 2003 and 17% in 2001.
- North American respondents' strategic allocations to private equity and real estate are relatively stable compared to 2003 and are expected to remain that way. Allocations to hedge funds, on the other hand, although less than private equity and real estate, are on the rise and are expected to continue that trend through 2007.
- Canadian investors' average strategic allocations to private equity and hedge trailed U.S. investors; however, their strategic allocation to real estate was slightly higher.
- Overcommitment to private equity declined among North American respondents in dollar terms and as a percentage of strategic allocations.
- The percentage of private equity capital committed to leveraged buyouts increased from 51% to 57% at the expense of special situations which fell from 14% to 10% and expansion capital which dropped from 9% to 6%.
- Relative value, event driven, and long/short strategies account for about 70% of committed hedge assets.
- Direct ownership of real estate continues to be the preferred method of choice, accounting for over half of North American respondents' real estate commitments. As noted earlier, this finding is influenced by the large size of survey respondents. Core and non-core commingled funds account for 15% and 20% respectively, while publicly listed real estate securities account for 8%.

Europe

- The percentage of European respondents investing in private equity and hedge has been increasing since 2001, while real estate use has remained level since 2003—the first year real estate was included in the survey. Hedge fund use is up dramatically in 2005, particularly among continental European investors, whose use nearly doubled from 24% of respondents in 2003 to 48% in 2005.
- Real estate represents the largest share of the allocations to alternatives in Europe, accounting for 60% of total alternative assets.
- Average strategic allocations to private equity, hedge, and real estate increased in the region compared to 2003 and are expected to continue this trend through 2007.
- Overcommitment to private equity increased in Europe.
- Leveraged buyouts increased to two-thirds of European commitments. The percentage of capital committed to mezzanine financing, special situations and "other" funds decreased.
- Investment through private equity funds of funds decreased in the U.K. and increased on the continent. Continental European portfolios decreased their capital commitment to single-fund partnerships—U.K. portfolios increased their commitment.
- Although a broad range of hedge strategies are used in the region, relative value strategies account for just over 35% of hedge assets, nearly double those committed to event driven and long/short.

Europe (continued)

- European real estate investors continue to have nearly two-thirds of their capital committed to direct investments in land and buildings—down from 87% in 2003.

Australia

- Real estate continues as the most popular alternative investment in Australia, used by 86% of the respondents. Not far behind is private equity, which continues to grow in usage and is now used by nearly three out of four Australian respondents. Although hedge funds come in a distant third, their use has experienced dramatic growth since 2001, now used by a third of Australian respondents.
- Average strategic allocations to hedge funds increased from 4.3% in 2003 to 6.2% in 2005, while allocations to private equity and real estate dropped slightly. Allocations to private equity and hedge funds are expected to increase by 2007—real estate allocations are expected to decrease slightly.
- Private equity commitments to special situations nearly doubled since 2003, accounting for 35% of private equity assets. Leveraged buyouts and expansion capital each accounted for about a quarter of the assets, while venture capital, which accounted for 27% of the assets in 2003, now accounts for 14%.
- Long/short and multi-strategy funds each account for nearly 50% of committed hedge fund assets.
- Direct real estate ownership continues to account for half of real estate commitments.

Japan

- The percent of Japanese respondents utilizing private equity and hedge funds continues to increase. While Japan's private equity market continues to be somewhat nascent, commitment levels have mushroomed from 2003's ¥42.6 billion to ¥99.8 billion currently.
- Average strategic allocations to private equity and hedge also increased, and are expected to continue increasing by 2007. Real estate allocations, new to the survey for Japan this year, are also expected to increase by 2007.
- Overall commitments to hedge funds among Japanese respondents rose by a factor of four from ¥237 billion to ¥994 billion.
- The majority of respondents utilize relative value and long/short hedge strategies and plan to continue with those strategies.
- Reversing 2003 preferences, a larger percentage of Japanese respondents are showing partiality toward hedge funds of funds (84%) vs. other structures.
- Public real estate securities account for 38% of Japanese respondents' real estate assets, followed closely by core funds (31%).

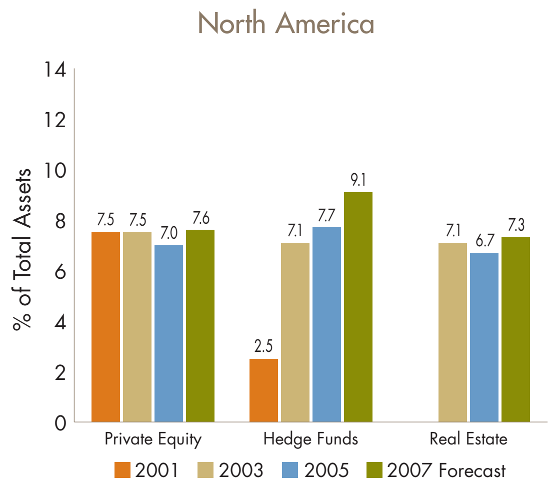
Although this survey represents a sizeable, representative sample of large global institutions, it is important to keep in mind differences between sub-groups (based on region, organization type, organization size, or other criteria) can result in wide variations from year to year due to small sample size dynamics.

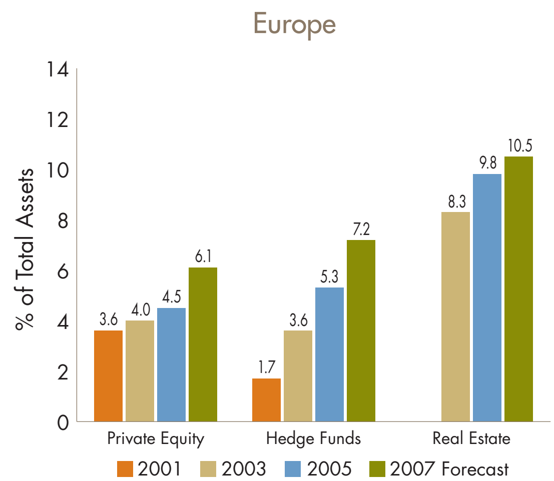
Information from 2003 and earlier was drawn from previous surveys conducted jointly with Goldman Sachs International. Copies of the report can be requested by including name, title, organization, and country of domicile by email request to altsurvey@russell.com.

Executive Summary

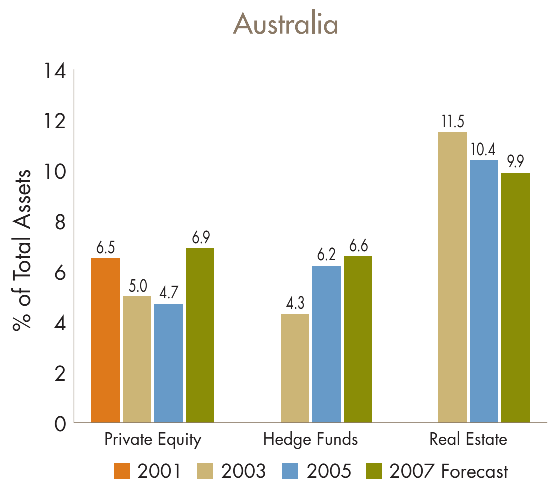
Strategic Allocations

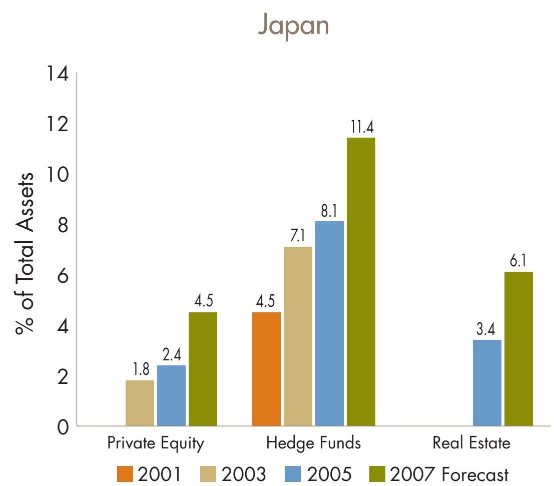
Exhibit 1: Current and Forecast Mean Strategic Allocations to Alternative Investments





Note: 2001 North American hedge fund allocation is represented by the median.





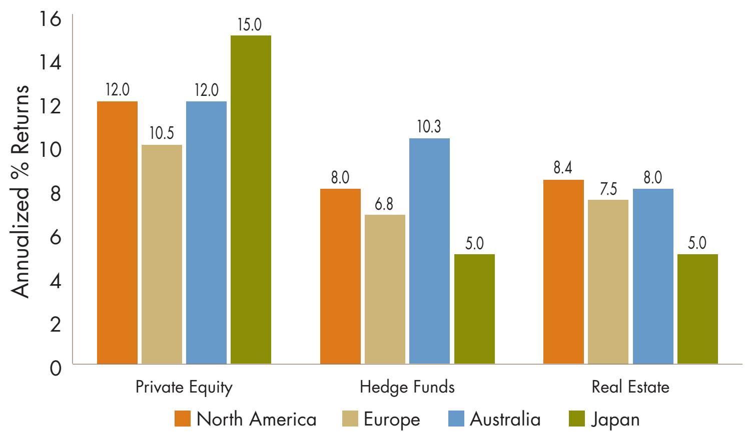
2003 (2005 in Japan) is the first year that information on strategic allocation to real estate was collected. Hedge fund allocations in Australia and private equity allocations from Japan in 2003 were drawn from a small number of respondents.

Average strategic allocations to alternatives have increased, and are expected to continue increasing to record levels by 2007. Much of this growth is being driven by increased allocations to hedge funds across all regions. Private equity allocations, which increased in Europe and Japan in 2005 but fell slightly in North America and Australia, are expected to increase by 2007 in all regions, particularly Australia and Japan. Real estate allocations were down slightly in North America and Australia, but slightly higher in Europe. All regions but Australia are projecting increased allocations to real estate by 2007.

Executive Summary

Expected Returns

Exhibit 2: Median Annualized Forecast Returns—2005-2007



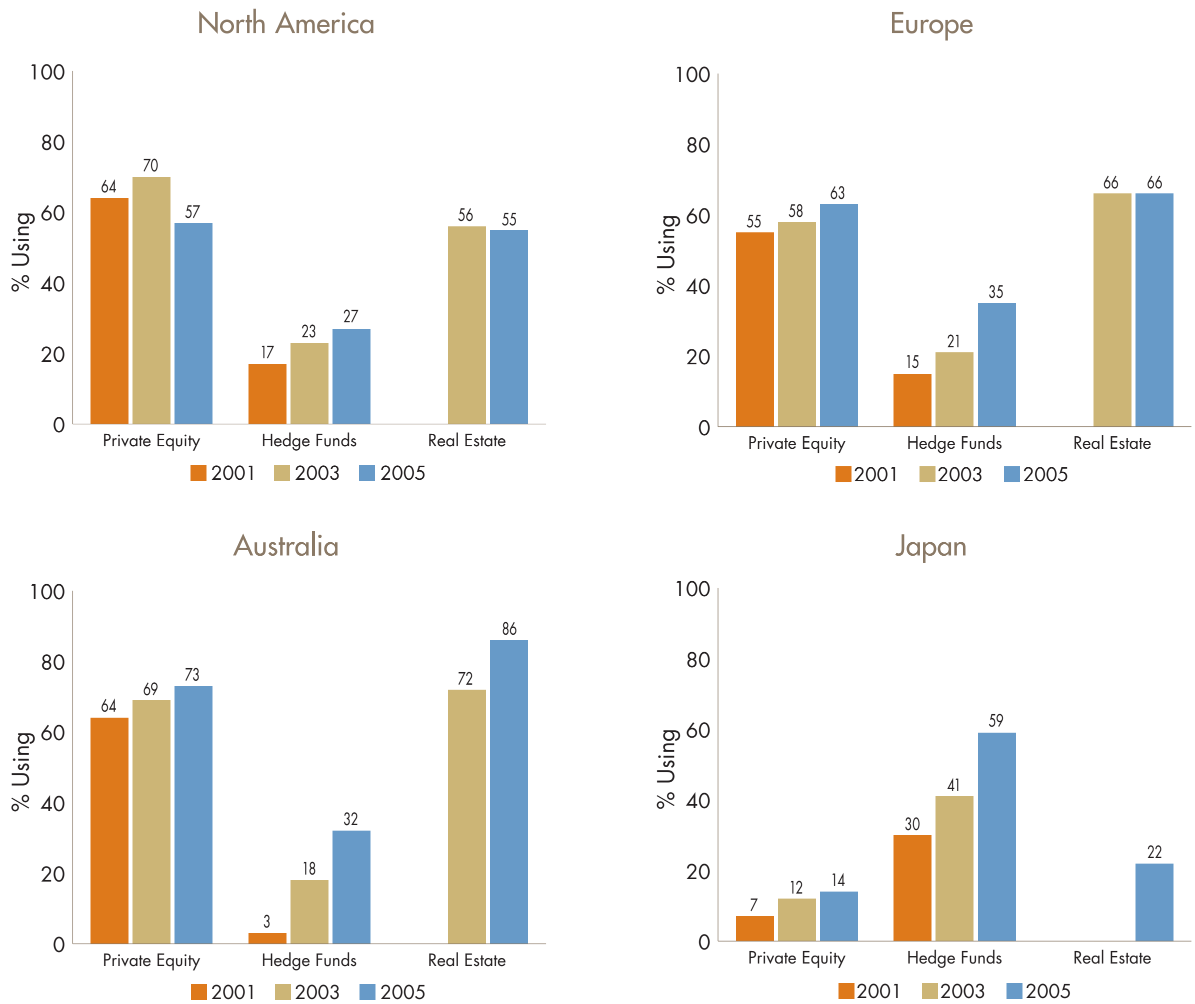
Note: Small sample size for Japan private equity and Australia hedge funds.

Private equity return expectations through 2007 continue to be greater than 10% across all regions, with a particularly robust expectation of 15% in Japan, albeit from a small sample. With the exception of a 10.3% expected return for hedge funds in Australia, all regions are forecasting hedge fund and real estate returns in the 5% to mid-8% range.

Executive Summary

Regional Participation

Exhibit 3: Percent of Respondents Utilizing Alternatives

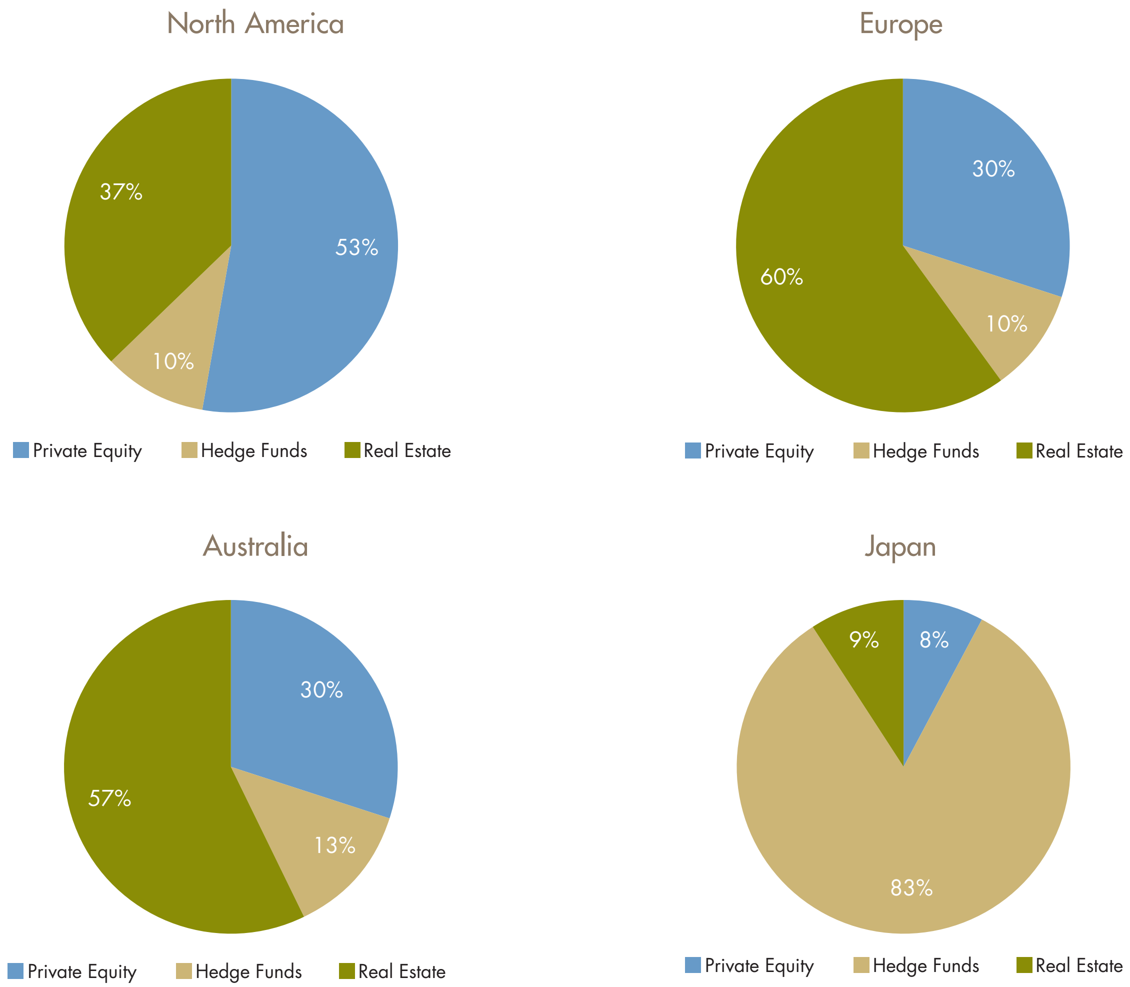


North American, European and Australian respondents exhibit the same general use of alternatives, with more Australians (86%) utilizing real estate than their North American and European counterparts at 55% and 66% respectively. The percent of respondents utilizing hedge funds continues to increase dramatically across all regions, particularly outside North America. Use of private equity has continued to increase at moderate rates in all regions except North America, where it has fallen below the 2001 level.

Executive Summary

Regional Commitments

Exhibit 4: Percent Breakout of Alternative Investments



Compared to 2003, hedge funds exhibit a growing share of the overall respondent allocations to alternatives across most regions, particularly in Australia, where they now account for 13%, up from 1% in 2003. In North America and Europe, hedge funds now account for 10% of the overall allocation to alternatives, roughly double the 6% and 5% levels found in 2003, respectively. The private equity share has remained relatively stable in Europe and Australia since 2003, while the real estate portion fell in both these regions.

In North America, overall allocation to private equity among alternatives fell to 53%, down from 67% in 2003, while real estate is up to 37% from 27%. Since real estate allocations were not included in the 2003 survey for Japan, it is not possible to directly compare their 2005 results; however, hedge funds continue to account for the majority of Japanese alternatives. As seen in previous exhibits, there is evidence of increased private equity use in Japan, which may accelerate in the future due to favorable structural and regulatory changes.

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