

HNWIs' Asset Allocations Become Slightly More Aggressive

- Global HNWI allocations held reasonably consistent in 2005, with regional variations
- Europe replaced Asia-Pacific as the region with the most balanced HNWI portfolios
- Investments in private equity jumped in 2005
- Hedge fund popularity waned, leading to a net outflow in Q4 '05 — the first in more than 10 years
- HNWIs pulled funds from North America to pursue higher returns in Asia-Pacific

HNWIs Adopt a Measured Perspective on Risk

On the surface, HNWI asset allocations do not appear to have differed significantly from those observed in 2004. However, closer examination and focus interviews with HNWIs and relationship managers reveal a shift in HNWIs' attitudes towards investing.

While asset allocations have remained fairly consistent over the past two years, history and interviews show that HNWIs are very sensitive to the economic environment, and reallocate their portfolios depending on current and impending economic conditions. As Figure 9 illustrates, in 2002, HNWIs adopted defensive allocations of their assets to weather an economic recession and very poor market performance. A market recovery one year later prompted these wealthy individuals to reallocate assets to equities and alternative investments, which offered high returns. In 2004, HNWIs took a conservative and diversified approach to their portfolios, increasing their allocations to fixed-income and cash/deposits to combat market volatility following exceptionally high returns in 2003. In 2005, HNWIs adopted more aggressive strategies than in 2004: They increased their allocations to equities and alternative investments and, anticipating interest rate hikes, shifted funds away from fixed-income.

Although the Dow Jones World Stock Index gained only 9.4% in 2005, compared with 14.4% in 2004, three years of solid global performance has renewed HNWIs' optimism and motivated them to increase their overall investments in equities by two percentage points¹⁶. This trend was strongest in Europe, North America and Asia-Pacific, respectively¹⁷.

HNWI allocations to real estate remained constant in 2005, at 16%¹⁸. Despite rising interest rates and fears of a downturn in the

sector, real estate continued to provide strong returns throughout the year. Double-digit returns on securitized real estate holdings helped reinforce HNWIs' decisions to stay the course in this asset class. The Dow Jones Wilshire (DJW) Global Real Estate Securities Index returned 14.3% in 2005, and the DJW U.S. REIT Index returned 13.8%. Although these gains were markedly lower than in 2004, when the indexes rose 39.9% and 33.2%, respectively, strong 2005 performance amply rewarded HNWIs' decisions to sustain their allocation to real estate¹⁹.

Based on interviews with HNWIs and relationship managers from multiple institutions, we anticipate that HNWIs once again will begin to reduce their real estate allocations: The sharp deceleration of returns in 2005 coupled with the expectation of higher interest rates suggest returns will continue to diminish.

Private Equity Gains as Hedge Funds Falter

During the technology boom, private equity was a popular alternative investment, but its popularity sank during the subsequent market downturn. Private equity re-emerged as a popular alternative investment in 2004 and continued to attract HNWI attention and funds in 2005. In fact, private equity was the primary driver for HNWIs' increased allocation to alternative investments in 2005²⁰.

Globally, private equity fund inflows increased to US\$174 billion in 2005, up from US\$42 billion in 2004, a 314% rise²¹. This growth is best explained by the superior returns that these funds delivered in 2005. Indeed, the U.S. Private Equity Performance Index returned 22.6% in 2005, compared to 16.4% in 2004²². These returns are particularly impressive when compared with the weaker performance of hedge funds in 2005 (Figure 10).

¹⁶ "Year-End Review: Markets & Finance 2005," *The Wall Street Journal*, January 3, 2006

¹⁷ Capgemini/Merrill Lynch Relationship Manager Survey, March 2006

¹⁸ "Performance Summary," Dow Jones Wilshire Real Estate Indexes, as of January 31, 2006, available at www.djindexes.com

¹⁹ Capgemini/Merrill Lynch Relationship Manager Survey, March 2006

²⁰ Emily Thornton, "Going Private," *BusinessWeek*, February 27, 2006 (data from Thomson Financial)

²¹ Thomson Financial/National Venture Capital Association

Average hedge fund returns have declined significantly in recent years, decelerating from 19.7% in 2003 to 7.1% in 2005²³. Correspondingly, hedge funds recorded their first single-quarter net outflow of funds in over 10 years during the fourth quarter of 2005²⁴.

Lower returns, higher management fees and tighter government regulation contributed to cooling investor interest in hedge fund investments. In 2005, hedge fund management fees rose to an average of 1.44%, up from 1.27% five years earlier²⁵. Many funds also lost favor by trying to tie up investments for longer periods of time (at least two years) to avoid having to register with the Securities and Exchange Commission in the United States²⁶. As the hedge fund environment changed, so too has the profile of the hedge fund investor: Individuals have been eclipsed by an influx of institutional investors. Some estimates suggest that today as much as 60% of hedge fund assets are institutional — which may alter hedge fund strategy, as these institutions are more risk-averse and demand greater transparency²⁷.

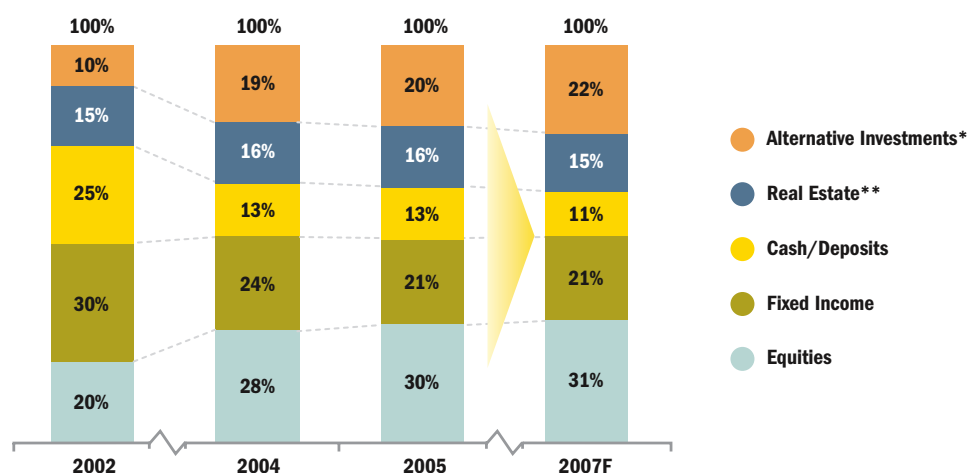
As a result, HNWI's hedge fund allocations plateaued in 2005 and private equity, a higher-yielding alternative in recent years, gained in popularity²⁸.

Regional Differences Continue to Grow

In 2005, HNWI's in North America continued to hold the most unbalanced portfolios — with the largest allocation, 43%, going to equities — compared to their peers in other regions²⁹. This emphasis on equity investments paralleled a decline in fixed-income investments brought on by the U.S. Federal Reserve's and Bank of Canada's steady stream of interest rate hikes. Of note, North America's allocation to alternative investments is the lowest among the regions, underscoring the importance of equities.

In 2005, North American HNWI's increased their allocation to real estate by one percentage point, to 12%³⁰. However, looking ahead, our primary research indicates that North American HNWI's will reduce their real estate investments in 2006, as interest rates continue to climb and speculative demand slows. Confirming this forecast, two-thirds of surveyed Canadian HNWI's said they believe the real estate market will trend downward within the next year³¹.

Figure 9 | HNWI Assets by Investment Class, 2002 – 2007F



Note: 2004 numbers have been restated due to a change in methodology: To improve accuracy, regional data has been weighted to reflect the net financial wealth of that region; results were then aggregated to create a more representative global figure.

* Includes: Structured products, hedge funds, managed funds, foreign currency, commodities (including precious metals), private equity and investments of passion (fine art & collectables)

** Includes: Direct real-estate investments and REITs

Source: Capgemini/Merrill Lynch Relationship Manager Surveys, March 2003, April 2005, March 2006

²³ Greenwich-Van U.S. Hedge Fund Index

²⁴ "Net Outflows for Hedge Fund Assets in Q-4 Global Macro and Emerging Market Strategies Hold Ground," Tremont Capital Management, February 8, 2006; Chris Clair, "Mixed Fund Flow Bag for '05," *HedgeWorld News*, January 26, 2006

²⁵ "Alternative Assets: Net New Hedge Fund Money Inflows Slow," *Private Banker International*, February 2, 2006 (data from Hedge Fund Research, Inc.)

²⁶ Becky Yerak, "At Declaration Day, Hedge Funds Circumvent Rules," *The Chicago Tribune*, February 1, 2006

²⁷ "Growing Pains - Hedge Funds," *The Economist*, March 4, 2006

^{28,29} Capgemini/Merrill Lynch Relationship Manager Survey, March 2006

³⁰ Capgemini/Merrill Lynch Relationship Manager Surveys, March 2005, March 2006

³¹ 2006 T. Stenner Group TrueWealth Report

Ultra-HNWIs Take the Lead

Over the years, we have found that Ultra-HNWIs — individuals with more than \$30 million in net financial assets — often make investing decisions ahead of market trends. Ultra-HNWIs, who account for 1% of the global HNWI population and about a third of its financial wealth, tend to be more sophisticated and better informed than other HNWI investors when it comes to managing their assets. In many ways, Ultra-HNWIs are thought leaders — whose behaviors and attitudes about wealth management hold important lessons for HNWIs and financial institutions alike.

This year, to more clearly delineate Ultra-HNWIs' investment practices and behaviors, we isolated the survey responses of relationship managers with the highest share of Ultra-HNW clients and conducted focus interviews with Ultra-HNWIs and subject matter specialists. The output was compared to our overall survey findings[†].

Results demonstrate that Ultra-HNWIs' portfolios not only are more diversified, they also are more aggressively invested than those of individuals in lower wealth bands. Overall, Ultra-HNWIs allocate a greater percentage of their assets to alternative investments than the average HNWI, 24% compared to 20%, respectively. The use of alternative investments demonstrates Ultra-HNWIs' "tax intelligence," as many of these investments allow them to minimize and defer taxes. While Ultra-HNWIs allocate a smaller portion of their portfolios to equities than HNWIs, they exhibit a taste for more complex investment products such as hedge funds, private equity/venture capital, structured products and investments in their own businesses — a range of investment vehicles that often relies on equity-type products. Furthermore, Ultra-HNWIs hold a significantly lower share of their assets in fixed income and cash, while allocating more of their wealth to real estate, than the average HNWI.

Ultra-HNWIs are also far more aware of how wealth is managed internationally, according to the professionals who help manage their portfolios: They have more exposure to international markets and have more geographically diversified portfolios than their HNWI counterparts. Ultra-HNWI feedback validates that this group currently allocates a lower percentage of its assets to North America in favor of regions with a higher number of emerging markets, such as Asia-Pacific and Latin America. In fact, Ultra-HNWIs stated that they are likely to adjust these geographic allocations more dramatically than the market currently anticipates — further proof of Ultra-HNWIs' risk-neutral and open-minded investment attitudes. This trend among Ultra-HNWIs supports our findings that HNWIs as a whole are moving funds out of mature economies, such as the United States, and into attractive growth economies in other parts of the world.

As they develop a global footprint, a large percentage of Ultra-HNWIs are creating both physical and financial presences in international locations. While more than 25% of HNWIs have homes and relationship managers abroad, Ultra-HNWIs have an even greater international presence: At least half have residences and financial accounts abroad, and 45% have relationship managers in international locations.

Ultra-HNWIs also have a different — and perhaps more sophisticated — approach to wealth transfer, particularly regarding philanthropic giving. Overall, they plan to give almost twice as much of their wealth to philanthropic causes than HNWIs^{††}. In addition, Ultra-HNWIs take a very active role in managing their philanthropic investments and have monitoring mechanisms in place to ensure that anticipated results are being achieved. In effect, they manage their philanthropic investments in much the same way as their traditional investments — an approach that merges philanthropic giving with the acumen displayed in their business and financial affairs.

Overall, Ultra-HNWIs' more sophisticated and aggressive wealth management behaviors help explain how they have achieved and maintained their elite status on the world stage. It also sheds further light on their role as investment trendsetters.

Given their proven power to move markets, we anticipate that Ultra-HNWIs' already significant allocation to alternative investments and their growing exposure to Asia-Pacific will prompt HNWIs to embrace more sophisticated investment vehicles and to allocate a greater percentage of their assets to emerging economies.

[†] Please note: This new base of respondents from the Capgemini/Merrill Lynch Relationship Manager Survey includes RMs with a regular HNWI clientele and a higher-than-average book of Ultra-HNWI clients. Ultra-HNWI figures are directionally accurate, but do not represent a discrete selection of Ultra-HNWIs.

^{††} Philanthropic causes include charitable and educational institutions and other not-for-profit organizations.

In 2005, European HNWIs replaced those in Asia-Pacific as having the most evenly distributed portfolios among all asset classes. Consistent with global trends, the Europeans significantly reduced their allocations to fixed income in 2005 and, seeking to capitalize on continued strong domestic stock market performance, pushed their equity allocations to 27%, from 25% in 2004³².

European allocations to alternative investments also increased, climbing from 18% of holdings in 2004 to 22% in 2005; this helped European HNWIs add balance to their portfolios³³. Strong interest in private equity fueled these gains. (Research suggests that private equity fund-raising in Europe more than doubled in 2005³⁴.) Direct real estate allocations also increased, from 21% in 2004 to 24% in 2005, as European HNWIs took advantage of low interest rates to finance purchases ahead of potential interest rate hikes³⁵.

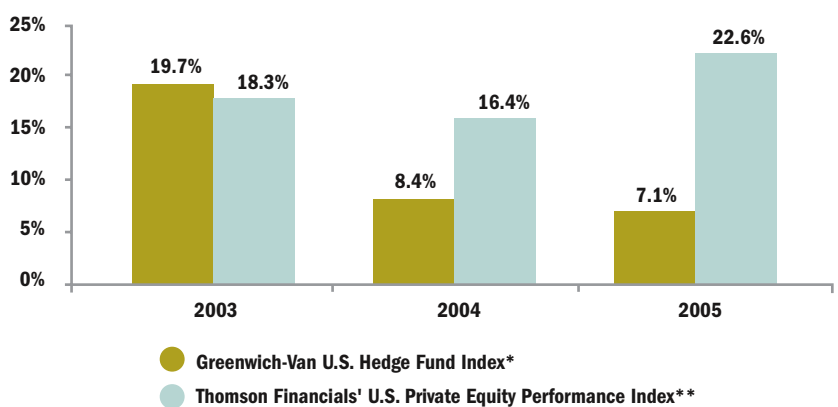
In the Asia-Pacific region, HNWIs fine-tuned portfolio allocations in favor of equities and cash/deposits. In response to particularly strong regional stock market performance — in 2005, the Japanese Nikkei 225 gained 40.2%, South Korea's Kospi moved ahead by 54.0% and India's Bombay index advanced 42.3%³⁶ — Asian HNWIs boosted their allocation to equities by two percentage points, to 24%. These moves were made at the expense of real estate and alternative investments³⁷.

Latin American HNWIs maintained the most consistent and also the most conservative allocation approach of any group in 2005, investing nearly one-third of their assets in fixed-income. However, Latin Americans did diversify slightly, decreasing fixed-income allocations from 33% in 2004 to 31% in 2005, and increasing their holdings in real estate and alternative investments³⁸.

International Markets Draw Increased HNWI Investments

In 2005, HNWIs around the world continued to diversify their holdings internationally, a trend that has been building steadily in recent years (Figure 11). Among the most notable developments: HNWIs increased investments in Asian markets — the MSCI AC Asia-Pacific Index returned 21.0% in 2005, up from 14.1% in 2004 — and decreased their exposure to North America.

Figure 10 | Private Equity vs. Hedge Fund Performance, 2003 – 2005



* The Greenwich-Van U.S. Hedge Fund Index is produced from the company's database of hedge funds, one of the world's largest collections of hedge fund data.
 ** Thomson Financials' U.S. Private Equity Performance Index is based on the latest quarterly statistics from Thomson Venture Economics' Private Equity Performance Database, and analyzes the cash flows and returns of over 1,814 U.S. venture capital and private equity partnerships with a combined capitalization of US\$657 billion.

³² Capgemini/Merrill Lynch Relationship Manager Surveys, March 2005, March 2006
³³ The European Private Equity & Venture Capital Association, March 16, 2006
³⁴ Capgemini/Merrill Lynch Relationship Manager Surveys, March 2005, March 2006
³⁵ "Year-end Review: Markets & Finance 2005," The Wall Street Journal, January 3, 2006
³⁶⁻³⁸ Capgemini/Merrill Lynch Relationship Manager Surveys, March 2005, March 2006

While North America remains the most popular region for investment, foreign investors' interest in this part of the world has decreased in recent years. In 2004, HNWI's showed a decided lack of confidence in the U.S. dollar, decreasing their North American investments; despite the dollar's appreciation in 2005, HNWI's from other regions trimmed allocations to North America due to low returns.

In 2005, Asia-Pacific surpassed Europe as the second most popular destination for HNWI investments, accounting for 23% of their total assets³⁹. A number of emerging economies with large growth prospects, combined with strong performance in the region's more mature markets, is likely to keep international interest focused on this part of the world for some time.

Europe retained 22% of HNWI's total assets in 2005. Strong performance by Europe's mature capital markets coupled with strong advances in its emerging markets — the MSCI Emerging Markets Eastern Europe Index returned 46.1% in 2005 — persuaded local HNWI's to increase their allocation to domestic markets to 48%, up from 40% in 2004⁴⁰.

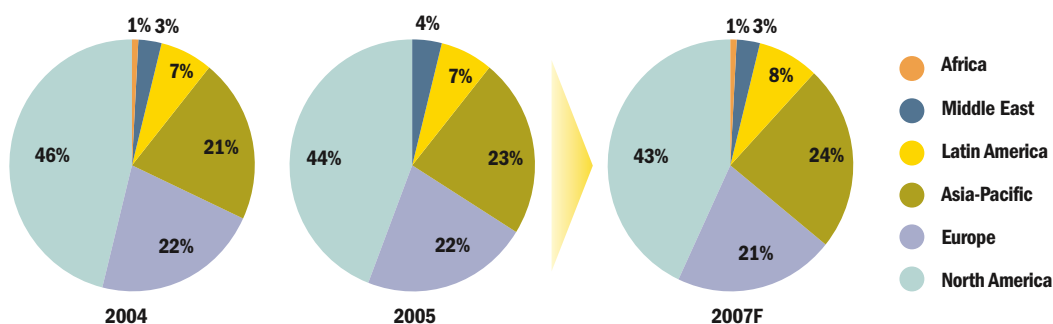
In general, HNWI's continue to view Latin America as unstable, and allocated only 7% of their total assets to markets in the region in 2005. In fact, Latin America is the only region in our analysis in which HNWI's prefer to send their investments elsewhere rather than place them in domestic markets: Wealthy Latin Americans allocate only 28% of their assets to domestic holdings and send 42% of their assets to North America⁴¹.

Looking Ahead

Our research suggests that HNWI's investments in North America and Europe will continue to decline over the next few years as HNWI's reallocate funds to Asia-Pacific and other emerging markets (Figure 11). In terms of asset mix, HNWI's are likely to continue to embrace a slightly more aggressive portfolio. Decreasing their cash/deposits and real estate positions, HNWI's will move funds to equities and alternative investments (Figure 9).

HNWI's heightened interest in international investments, along with their growing exposure to equities and alternative investments, are clear signs that the world's wealthiest individuals are not only becoming more sophisticated investors, they also are more determined than ever to achieve returns comparable to those experienced in 2003 and 2004.

Figure 11 | HNWI Assets by Region, 2004 – 2007F



Note: 2004 numbers have been restated due to a change in methodology. To increase the accuracy of our findings, we are now weighting regional data based on the net financial wealth of that region and aggregating the results to create a more representative global figure.

Source: Capgemini/Merrill Lynch Relationship Manager Surveys, April 2005, March 2006

³⁹⁻⁴¹ Capgemini/Merrill Lynch Relationship Manager Surveys, March 2005, March 2006

Where Does the Wealth Come From?

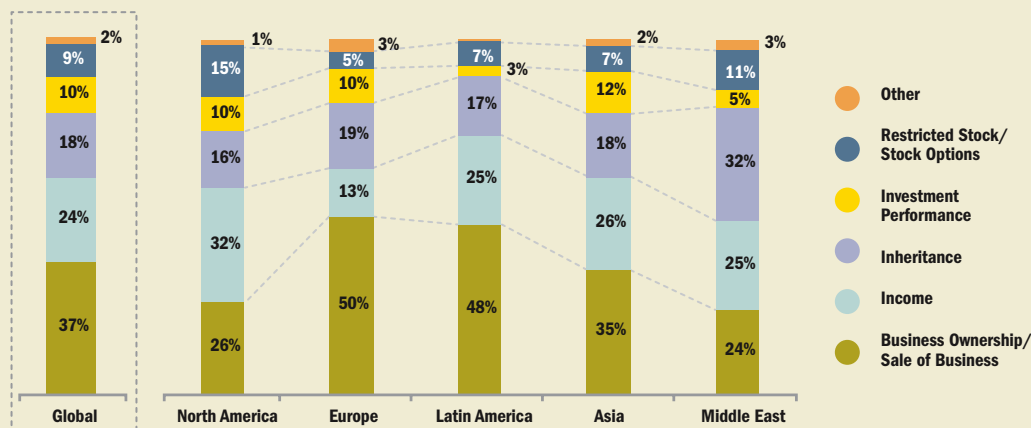


Figure 12 | Sources of HNWI Wealth, 2005[†]

How do millionaires become wealthy? To answer this question, we asked relationship managers around the globe to estimate the sources of wealth creation among their HNWI clients. We then validated the findings with a selected group of clients. Our survey shows that business ownership or the sale of a business is the primary source of wealth (37%) for the majority of the world's HNWIs (Figure 12).

Income ranks second, the source for 24% of HNWI wealth, and inheritance ranks third, with 18%. In earlier WWRs inherited wealth accounted for more of HNWIs' financial assets than it does today^{††}. As recently as 2001, 21% of North American and 37% of European HNWIs' wealth was inherited. Clearly, earned wealth has grown faster than wealth passed down from an earlier generation. If this trend continues, we can expect to see an ever-growing number of wealth earners joining the ranks of the world's HNWIs.

With only 10% of their wealth coming from investment performance, our research confirms that HNWIs, overall, are very good at creating new wealth; they are not simply relying on global economic prosperity to expand their financial holdings through reinvested interest payments, dividends and capital appreciation.

There are strong regional differences in sources of wealth. The largest share of North Americans' wealth is from income (32%) versus business ownership (26%). This is also a region of wealth earners: Inheritance represents the smallest share (16%) of wealth origination, compared to other regions. In Europe, business ownership, or the sale of a business, was the No. 1 source of wealth, at 50%, while income ranked lower (at 13%) in that region.

Middle Eastern HNWIs derived the largest share (32%) of their wealth through inheritance. Although Asia-Pacific HNWIs became wealthy primarily through personal business and income, we noticed that a higher percentage (12%) of wealth came from investment performance, compared to other regions.

Do the ways in which HNWIs generate wealth have an impact on how they invest and vice versa? Comparing the regional findings on sources of wealth to HNWIs' regional asset allocations provides some initial insights^{†††}. The easiest conclusion to draw is North American HNWIs' strong reliance on equities, reflected in their significant allocation (43%) to this asset class, compared to other regions; also by the high percentage (25%) of wealth originating jointly from investment performance and restricted stock/stock options.

European HNWIs seem to show a high risk tolerance, as they allocate the lowest share of their portfolios to safe asset classes. However, they are clearly well informed and engaged in their wealth management strategies: They have exceptionally well-diversified portfolios — a set of character traits attributable to business owners.

Finally, we were not surprised to see that Asia-Pacific HNWIs, relative to other regions, gain more of their wealth from business ownership, income and investment performance since a lot of new money is being created in the region's fast-growing markets. HNWIs' portfolios in this part of the world are visibly geared towards wealth accumulation, with strong allocations to alternative investments, real estate and equities.

[†]Source: Capgemini/Merrill Lynch Relationship Manager Survey, March 2006

^{††}2002 WWR, Figure 6, "Source of Wealth" and 2003 WWR, Figure 6, "HNW Investor Trends, 1960-2002"

^{†††}Asset allocation findings from the Capgemini/Merrill Lynch Relationship Manager Survey, March 2006