Foreword

As investors strive to achieve adequate long-term returns in the current volatile investment climate, a range of investment products now exists to address the challenge. These include innovative portable alpha, absolute return and derivative-based strategies, along with non-traditional and alternative assets, such as private equity, hedge funds and real estate.

In separate surveys, JPMorgan Asset Management polled institutional investors in Continental Europe and the U.S. to find out more about attitudes to these products and strategies. How well are they understood? To what extent are they being implemented? What do investors hope to achieve by employing them?

The trends identified by our research provide valuable insights into the understanding and usage of this new generation of investment strategies in the U.S. and Europe. While there were similarities, we also noticed some key differences between markets, not all of which are fully explained by their regulatory frameworks.

In this report we briefly explore these transatlantic similarities and differences in the context of identifying future investment trends. We hope our report will provide a valuable multi-national perspective and serve as part of our continuing dialogue with institutional investors on both sides of the Atlantic in their quest for enhanced returns.

We would like to extend our warmest thanks to all those institutions in Europe and the U.S. who took part in this research.

Eve Guernsey, CEO of the Americas
Jens Schmitt, Head of Institutional Business, Continental Europe

About our respondents

The U.S. New Sources of Return Survey canvassed 125 respondents representing 120 of the largest 350 U.S. pension plans — ranked by defined benefit plan assets. Respondents included 64 corporate, 46 public and 10 other plans which, taken together, accounted for over USD 1,200 billion (EUR 991 billion) in assets. The survey was conducted in February 2005.¹

The European New Sources of Return Survey canvassed 193 institutions across six European markets² — Germany, the Nordics, the Netherlands, Switzerland, Italy and France — with interviews conducted in May and June 2004. Respondents accounted for EUR 1,074 billion of institutional assets (USD 1,300 billion). Although the survey included responses from a number of different types of institutions, it was primarily focused on pension funds.

Throughout this analysis we present a comparison in broad strokes — contrasting the “average” European institutional investor surveyed with their “average” U.S. counterpart. There are of course, clear differences in culture and attitude — not to mention regulatory constraints — across Europe’s individual markets, and to a somewhat lesser degree between corporate and public sectors in the U.S. We acknowledge these differences and refer the reader to our individual European and U.S. New Sources of Return Survey reports, where these intra-regional results are explored in greater detail.
Starting point — a comparative profile

Before delving into what respondents had to say about how they are using or intend to use new sources of return, it is instructive to compare and contrast how U.S. and European institutions described themselves at the time they were surveyed — in terms of:

- Portfolio allocations
- Return expectations
- Measures of success

We believe these dimensions can provide an important backdrop to our findings regarding the current and intended use of new sources of return.

Portfolio allocation:

**Current asset mix**

As Exhibit 1 illustrates, there are pronounced differences in the average portfolio allocations of participants in our European and U.S. surveys.

*Equity/fixed income:* On average, U.S. institutions hold considerably more of their portfolios in equities (63% equity/27% fixed income) while Europe favors a more conservative mix (31% equity/50% fixed income). Underlying these averages, the variation across Europe is notable. Germany, for example, has over 65% in bonds and Switzerland only 35% — but still above the U.S. average.

*Domestic/international:* Another key difference is the greater U.S. concentration in domestic assets, with 75% of equity and nearly 100% of fixed income exposure allocated to U.S. markets. The equivalent figures for European portfolio domestic allocations are 50% of equity and 75% of fixed income.

*Real estate:* On average, European investors have a higher allocation to real estate (11% against 4% in the U.S.). Here too, there are significant cross-country differences, with Italy and Switzerland allocating over 20% and Germany only about 5% to the asset class.

* Alternatives: Hedge funds and private equity each account for 3% or less of European as well as U.S. portfolios, but as we will see, these shares are expected to grow.

**Comments**

What accounts for these differences in asset allocation? While a detailed comparison by country is beyond the scope of this report, we believe the following general statements can be made.

*Portfolio restrictions:* Clearly, the direct limits on equity that are in place in many countries in Europe have led to a more conservative, fixed income-intensive portfolio structure, although constraints are being gradually lifted.

*Reporting and funding regulations:* These restrictions can also impact investment behavior. As an example, current accounting regulations in the U.S. allow for smoothing techniques which help to dampen the impact of portfolio volatility on earnings and are one factor contributing to the level of risk tolerance and equity exposure in the U.S.

Exhibit 1: Asset allocations for U.S. and European institutional portfolios

* For Continental Europe, “domestic” is defined as countries within the Eurozone. Allocations as of December 2003

** U.S. allocations as of December 2004
Size, depth and breadth of domestic equity markets: Another possible explanation for the large U.S. allocation to equity is that the “equity culture” is more deeply entrenched in the U.S., as manifested in the size, depth and breadth of the U.S. equity market in comparison to Europe. Even where the equity culture is particularly strong (such as in parts of the Nordic region) equity allocations are not as high as in the U.S.

In the smaller, narrower European equity markets on the other hand, there is a greater need for international diversification. Arguably, American pension schemes can achieve a satisfactory degree of diversification by market cap, style and number of holdings by investing solely in their own deep and liquid domestic market without the same need for international diversification.

Higher real estate exposure among European investors can be seen as consistent with the lower risk profile of their portfolios, as discussed above. Real estate offers potential return enhancement above fixed income, as well as diversification benefits.

The difference in allocation to private equity (3% in the U.S., 1% in Europe), while minor, perhaps again reflects a generally more conservative investment approach, less entrenched equity culture and less experience with private equity in Europe relative to the U.S. — where private equity as an asset class originated.

Asset allocation management
As with asset mix, current approaches to managing portfolio allocation were also quite different between U.S. and European respondents.

<table>
<thead>
<tr>
<th>Exhibit 2: Current approaches to managing asset allocation</th>
<th>% of respondents</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Europe</td>
</tr>
<tr>
<td>Passive (rebalancing):</td>
<td></td>
</tr>
<tr>
<td>• Range-based</td>
<td>23%</td>
</tr>
<tr>
<td>• Periodic/calendar-based</td>
<td>17</td>
</tr>
<tr>
<td>Active (tactical allocation)</td>
<td></td>
</tr>
<tr>
<td>• Physically moving assets</td>
<td>56</td>
</tr>
<tr>
<td>• Using an overlay</td>
<td>25</td>
</tr>
<tr>
<td>Other</td>
<td>8</td>
</tr>
</tbody>
</table>

Note: European totals are greater than 100% as some respondents specified multiple approaches while U.S. respondents indicated which single strategy best described their approach.

In the U.S., over 75% of respondents said their approach to portfolio rebalancing was best described as passive — and primarily range-based. In contrast, only 40% of European respondents used a passive approach (alone or in combination with an active strategy), while over 80% employed active allocation management — with the majority using cash vs. derivatives for implementation.

In short, European investors appear more willing to actively shift away from their strategic allocations to take advantage of perceived short-term changes in the relative attractiveness of different asset classes. U.S. investors are more inclined to routinely rebalance, correcting the portfolio’s drift away from its strategic allocation.

Allocation to active versus passive equity management
For purposes of our survey, equity management styles were defined as follows:

- Passive — managed to track a benchmark
- Constrained active — actively managed with stock and sector weightings referenced to (i.e., kept within agreed limits of) an equity benchmark
- Unconstrained active — actively managed, but stock and sector weightings are not referenced to a benchmark (i.e., have no benchmark limits)

At the time of our surveys, the mix of these equity management styles was very similar for European and U.S. portfolios — roughly 30% passive, 60% constrained and 10% unconstrained. As we will see, however, this may prove to be an area of divergence going forward.

<table>
<thead>
<tr>
<th>Exhibit 3: Active versus passive equity management</th>
</tr>
</thead>
<tbody>
<tr>
<td>Average allocations</td>
</tr>
<tr>
<td>Europe</td>
</tr>
<tr>
<td></td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

Return expectations:
The surveys revealed a clear disparity between Continental Europe and the U.S. in terms of return expectations. American institutions, on average, anticipate considerably higher returns than their European counterparts (8.6% vs. 6.0%) over a three-to-five year investment horizon.
The discrepancy in expected returns relates primarily to the difference in asset allocations. Most notably, the average U.S. allocation to equities is more than double that of Europe.

Measuring success:
To complete our current snapshot, we look at differences in how success is measured by U.S. and European respondents.

Almost all (99%) U.S. pension plans surveyed measure their performance against market benchmarks. Performance relative to peers is also an important consideration.

A large percentage (82%) of European respondents also judge themselves against market performance — but this is not as pervasive an approach as it is among U.S. respondents. Peer group comparison was far less important for Europe vs. the U.S.

Almost all (99%) U.S. pension plans surveyed measure their performance against market benchmarks. Performance relative to peers is also an important consideration.

In many Continental European countries, there are a variety of players in the pension market, operating under different regulations and guidelines, making direct comparisons more difficult. In addition, public plans represent a greater proportion of pension assets and are less likely to be judged against an often limited number of peers within their domestic markets.

Exhibit 6 below summarizes our current snapshot of survey respondents.

New sources of return
Given this current snapshot of our European and U.S. survey participants, how are these institutional investors planning to meet their needs for higher returns? We look at their response and attitudes towards three potential sources of enhanced portfolio performance:

- Utilizing a broader range of assets and strategies
- Shifting to more active investment management
- Employing innovative strategies and tools
Utilizing a broader range of assets and strategies:
Survey participants were asked which of the non-traditional asset classes and strategies in Exhibit 7 they would be interested in using to deliver higher returns in the future.

Exhibit 7: Interest in using a broader range of assets and strategies to deliver higher returns

<table>
<thead>
<tr>
<th>% of respondents*</th>
<th>Europe (193)</th>
<th>United States (81)*</th>
</tr>
</thead>
<tbody>
<tr>
<td>Tactical asset allocation (TAA)</td>
<td>81%</td>
<td>46%</td>
</tr>
<tr>
<td>Emerging market equity</td>
<td>72</td>
<td>72</td>
</tr>
<tr>
<td>Long-only absolute return</td>
<td>67</td>
<td>49</td>
</tr>
<tr>
<td>Hedge funds</td>
<td>65</td>
<td>52</td>
</tr>
<tr>
<td>High yield bonds</td>
<td>63</td>
<td>58</td>
</tr>
<tr>
<td>Private equity</td>
<td>57</td>
<td>75</td>
</tr>
<tr>
<td>Currency as a source of alpha</td>
<td>52</td>
<td>46</td>
</tr>
</tbody>
</table>

* Based on 81 of 125 U.S. respondents indicating that “delivering higher returns” was a reason they would consider new asset classes and/or strategies.

On average, European and U.S. respondents alike show a willingness to use this range of non-traditional asset classes and strategies to enhance returns.

With the exception of private equity, European respondents were as — if not more — willing than their U.S. counterparts to use these strategies, with over 50% expressing interest across the board.

Among U.S. respondents, enthusiasm was greatest for private equity, an interest echoed, though to a lesser extent, by their European counterparts (75% vs. 57%).

Highest on the list for European respondents was Tactical Asset Allocation (TAA), which Europeans were almost twice as willing to use as U.S. respondents (81% vs. 46%).

Comments

The greater enthusiasm for private equity in the U.S. is not surprising, given its origins and longer history of use. However, we see the fact that 57% of European respondents were interested in using or expanding their use of private equity as an indication of a growing acceptance of the asset class among these investors.

The much more pronounced interest in Tactical Asset Allocation strategies in Europe may be due to a greater currency focus among European investors. Also, as our comparative snapshot shows, European respondents have more internationally diversified portfolios and, in their approach to rebalancing, are more willing to actively shift away from strategic allocations to take advantage of potential short-term relative value opportunities. TAA then, can be seen as a familiar investment vehicle for extracting more value from this diversified investment positioning, potentially offering more uncorrelated sources of performance in a globally diversified portfolio.

In contrast, Tactical Asset Allocation in the U.S. has historically been dominated by a single equity-bond decision. This resulted in poor performance for TAA in the late 1990s. However, more recent emphasis on incorporating decisions across a broader global opportunity set could improve interest in these strategies in the U.S.

Trends in active versus passive equity management:

As noted in our comparative snapshot, the current mix of equity management styles is approximately 30% passive, 60% active-constrained and 10% active-unconstrained for both European and U.S. respondents (Exhibit 3). When asked if and how these proportions were likely to change going forward, the majority of respondents seemed content with current allocations. However, as the results in Exhibit 8 show, taking a closer look, some interesting indications of potential future trends emerge.

For European respondents, the results are as follows:

**Passive:** Slightly higher percent plan to **increase** vs. decrease (18% vs. 13%).

**Constrained active:** Higher percent plan to **decrease** vs. increase (21% vs. 8%).

**Unconstrained active:** Higher percent plan to **increase** vs. decrease (27% vs. 5%).

This suggests that for European portfolios, the primary shift in equity management is likely to be from constrained to unconstrained active management, with a slight increase in passive management, reflecting a “barbell” approach (passive management combined with unconstrained active management).
Absolute return strategies are typically managed with the objective of producing positive returns under all market conditions, with returns usually measured as a fixed percent or a spread over cash or inflation. These strategies (e.g., market neutral strategies and many hedge funds) typically have low correlation to market returns.

Alpha transport is a tool which allows the investor to keep a particular skillful manager’s (e.g., a hedge fund or small cap equity manager’s) excess returns without having to keep any underlying market exposures or alter the strategic allocation. These strategies are usually structured using liquid derivative instruments (e.g., index futures, swaps).

Continental European investors are, on the whole, more likely to use absolute return strategies, with more than 75% saying they use or are considering using them. This compares to just 56% of U.S. investors. Europeans are, however, less interested in alpha transport, with only 37% using or considering these tools vs. 52% among their U.S. counterparts.

**Comments**

As noted in our comments on TAA, international investments comprise a greater proportion of European (vs. U.S.) equity portfolios. European respondents also appear to have a greater inclination to deviate from benchmarks in their investment decisions. This may explain the growing preference among European investors for an unconstrained and/or “barbell” approach to equity management — allowing managers to better capture the alpha generation potential of a more internationally diversified portfolio.

**Absolute return and alpha transport strategies:**

A comparison of European and U.S. respondents using or considering absolute return and portable alpha strategies shows a divergence between these two groups.

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### Exhibit 9: Use of absolute return and alpha transport strategies

<table>
<thead>
<tr>
<th>% of respondents</th>
<th>Absolute return</th>
<th>Alpha transport</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Europe</td>
<td>U.S.</td>
</tr>
<tr>
<td>Using/have used</td>
<td>49%</td>
<td>30%</td>
</tr>
<tr>
<td>Considering</td>
<td>27</td>
<td>26</td>
</tr>
<tr>
<td>Not considering</td>
<td>24</td>
<td>42</td>
</tr>
<tr>
<td>Not familiar with/</td>
<td>2</td>
<td>33</td>
</tr>
</tbody>
</table>

A similar analysis for U.S. investors suggests a move away from passive management (25% planning a decrease versus only 7% planning an increase), with these assets being allocated towards active management — both constrained and unconstrained. It is worth noting that in our U.S. study, the most pronounced shift indicated was among public pension plans, where respondents planned to decrease passive, while increasing primarily constrained active management allocations.

**Comments**

As noted in our comments on TAA, international investments comprise a greater proportion of European (vs. U.S.) equity portfolios. European respondents also appear to have a greater inclination to deviate from benchmarks in their investment decisions. This may explain the growing preference among European investors for an unconstrained and/or “barbell” approach to equity management — allowing managers to better capture the alpha generation potential of a more internationally diversified portfolio.

**Absolute return and alpha transport strategies:**

A comparison of European and U.S. respondents using or considering absolute return and portable alpha strategies shows a divergence between these two groups.
a tool for overlaying alpha generated in less efficient markets on, for example, their large cap equity allocation. In addition, results from our U.S. survey showed that the vast majority of those employing a portable alpha strategy were using the S&P 500. The availability of liquid derivative markets in the U.S. (e.g., for S&P 500 futures) lends itself more easily to portable alpha techniques (particularly for equity), with implementation being more of a hurdle in Europe.

**Derivatives and leverage:**
Attitudes towards derivatives are similar in both markets, with the majority of investors using derivatives as additional tools of investment management which have the potential to enhance portfolio performance.

Leverage is a far less popular tool than are derivatives in both the U.S. and Europe, with a majority of investors in both markets not willing to use leverage to boost returns.

**Exhibit 10: Use of derivatives**

<table>
<thead>
<tr>
<th>% of respondents</th>
<th>Europe</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Using derivatives</td>
<td>70%</td>
<td>64%</td>
</tr>
<tr>
<td>Considering use of derivatives</td>
<td>11</td>
<td>16</td>
</tr>
<tr>
<td>Not considering use of derivatives</td>
<td>19</td>
<td>19</td>
</tr>
<tr>
<td>Don’t know</td>
<td>–</td>
<td>1</td>
</tr>
</tbody>
</table>

**Exhibit 11: Use of leverage**

<table>
<thead>
<tr>
<th>% of respondents</th>
<th>Europe</th>
<th>United States</th>
</tr>
</thead>
<tbody>
<tr>
<td>Willing to use leverage</td>
<td>27%</td>
<td>29%</td>
</tr>
<tr>
<td>Not willing</td>
<td>73</td>
<td>66</td>
</tr>
<tr>
<td>Don’t know</td>
<td>–</td>
<td>5</td>
</tr>
</tbody>
</table>

**Conclusion**
Our surveys have provided us with many insights into uses of new sources of return on both sides of the Atlantic. Although the European pension industry is less mature and has in the past suffered from restrictions limiting the use of more innovative approaches, it is clear that both European and American pension schemes are now highly sophisticated and open to the use of new sources of return.

Higher alpha products and other new investment strategies are, therefore, of considerable interest to both sets of investors, with pension schemes aiming for more innovative ways to boost long term returns and optimize the risk/return profile of their portfolios. As a result, our surveys suggest that allocations to new sources of return are set to grow further in the years to come.

The specific products and strategies chosen may vary across markets and sectors, given regulatory differences, the degree of home bias, current portfolio allocations, past experiences, attitudes toward risk and a host of market and plan-specific needs and objectives.

We are committed to listening to our clients around the world, positioning ourselves to address their current and future needs and to helping plan sponsors navigate the evolving global investment landscape.

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Notes

1. The U.S. survey was conducted for JPMorgan Asset Management by Schulman, Ronca & Bucuvalas, Inc. (SRBI), a third-party research firm. Opinions, estimates, forecasts and statements in the U.S. survey report are based on research derived from the survey.

2. Results for some individual European markets are based on small sample size, i.e.: Germany (55), Nordics (43), Netherlands (34), Switzerland (32), Italy (14) and France (15). To calculate Continental European figures, the survey data from each of the six individual markets has been weighted according to the country’s total pension assets as given in the William Mercer Pension Fund Managers Guide 2003.

3. Though not revealed in the survey itself, there is also a difference in the way real estate exposure is generally gained, with U.S. investors preferring to invest in REITs and real estate funds (i.e., indirect approaches) while European investors make more direct property investments which are generally managed in-house.

Survey reports

For copies of the original survey reports for the U.S. and/or Europe, please visit our website at: jpmorgan.com/assetmanagement/am/institutional