ASSET ALLOCATION TRENDS & CHALLENGES

An evaluation of changing asset allocations from 2001 to 2011.

"The chaos of 2008 and early 2009 yielded to relative financial stability and modest economic recovery in 2010; however, market volatility and regulatory reform continue to pressure asset managers in 2011."[i]

— PricewaterhouseCoopers LLP

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Numerous market disruptions over the past decade, along with resulting volatility, caused institutional investors to re-evaluate their asset allocations. This re-evaluation is closely paired with increased risk management, which has become ever more important due to the global financial crisis and the ongoing European sovereign debt crisis. Data compiled from Northern Trust's Investment Risk and Analytical Services universe illuminates asset allocation trends and challenges over this volatile decade.

DATA STRUCTURE

Northern Trust's universe is segmented into distinct U.S. institutional investor segments: ERISA, not for profit (NFP), and public funds. This provides a window into the specific behavior of each segment. The structure of these segments as of September 30, 2011 was:

- **ERISA**
  - — $248 billion in plan assets
  - — 114 plans
- **NFP**
  - — $125 billion in plan assets
  - — 113 plans
- **Public Funds**
  - — $267 billion in plan assets
  - — 41 plans

Additionally, the ERISA universe contains an "ERISA over $1 billion" carve-out that isolates the behavior of the largest corporate pension plans. The structure of this universe as of September 30, 2011, was:

- **ERISA over $1 Billion**
  - — $228 Billion in plan assets
  - — 56 plans

While the "ERISA over $1 billion" universe contains only 49% of plans in Northern Trust's total ERISA universe, its plan assets comprise 92% of total ERISA plan assets. Therefore, its results dominate composite asset allocation figures and returns.

FIGURE 1: ALL FUNDS COMPOSITE ASSET ALLOCATION

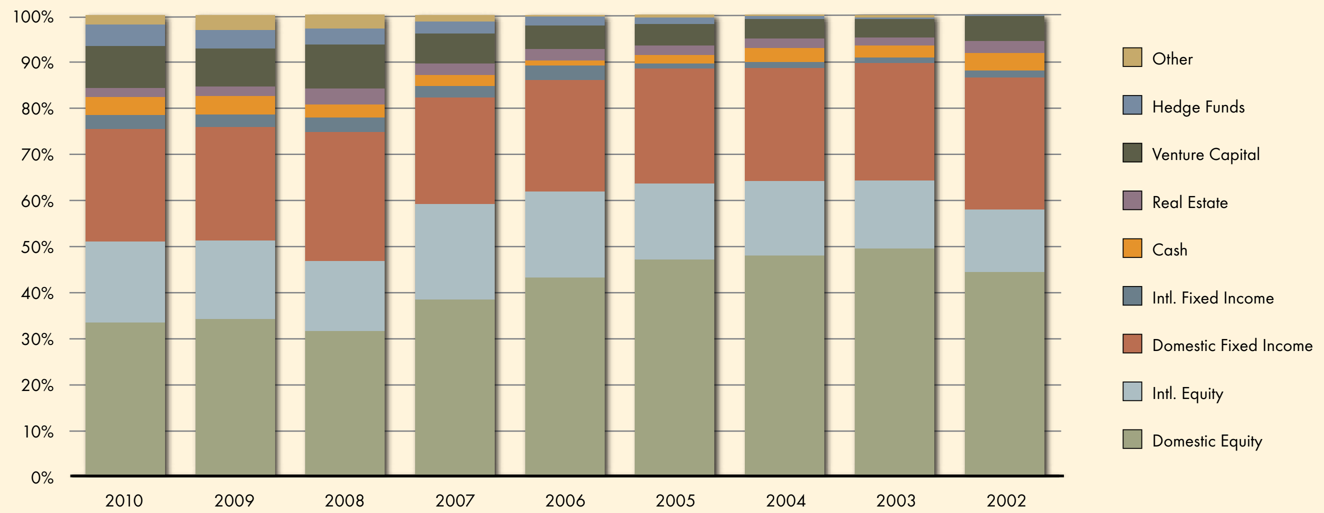
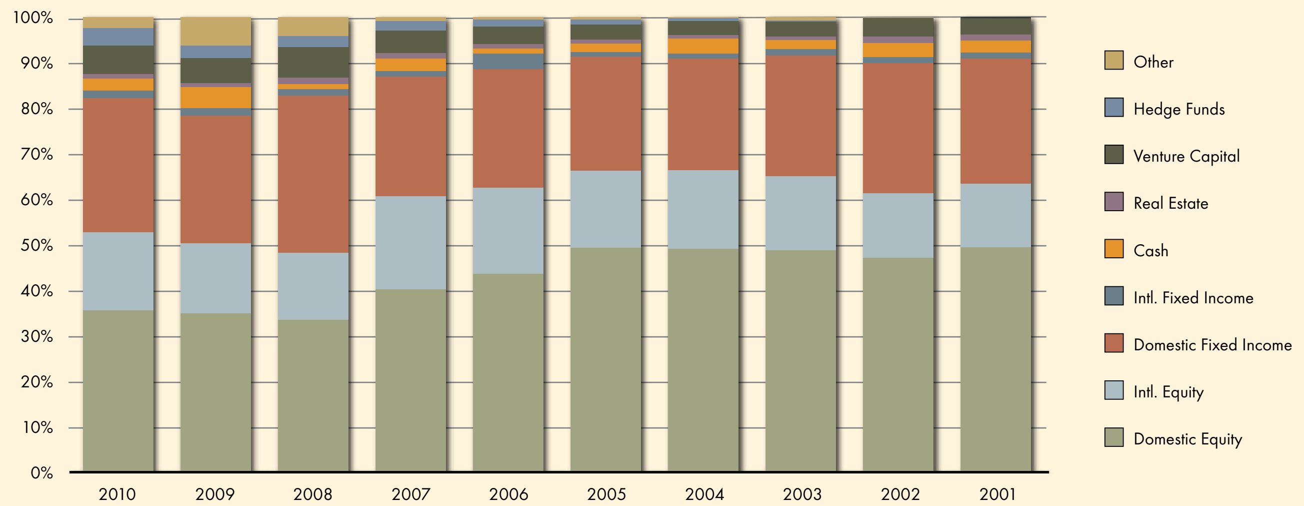


FIGURE 2: ERISA COMPOSITE ASSET ALLOCATION



SHIFTING GLOBAL EQUITY MIX

Across the universe base, the allocation to U.S. equity decreased from 50% of total assets in 2000 to only 32% of total assets as of June 30, 2011. Conversely, the allocation to non-U.S. equity portfolios has increased, indicating that investors have shifted allocations away from home country biases.

Historically, U.S. investors looked to international equities to provide portfolio diversification. However, as the recent global recession demonstrated, the correlation between U.S. and non-U.S. equities has increased.

Although institutions have been moving assets to global markets, emerging markets still represent an underweight in overall equity investment programs.[ii] The final two spaces of the investable international opportunity set are frontier markets and dedicated non-U.S. small cap mandates; neither of these spaces currently constitutes a measurable portion of Northern Trust's universe.

FIGURE 3: PUBLIC FUNDS COMPOSITE ASSET ALLOCATION

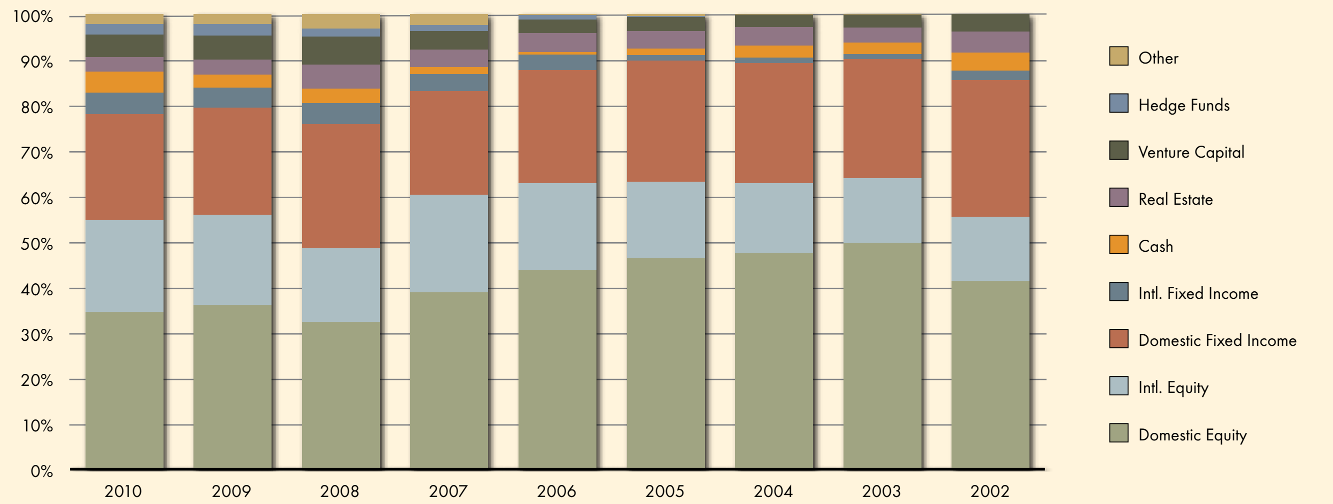
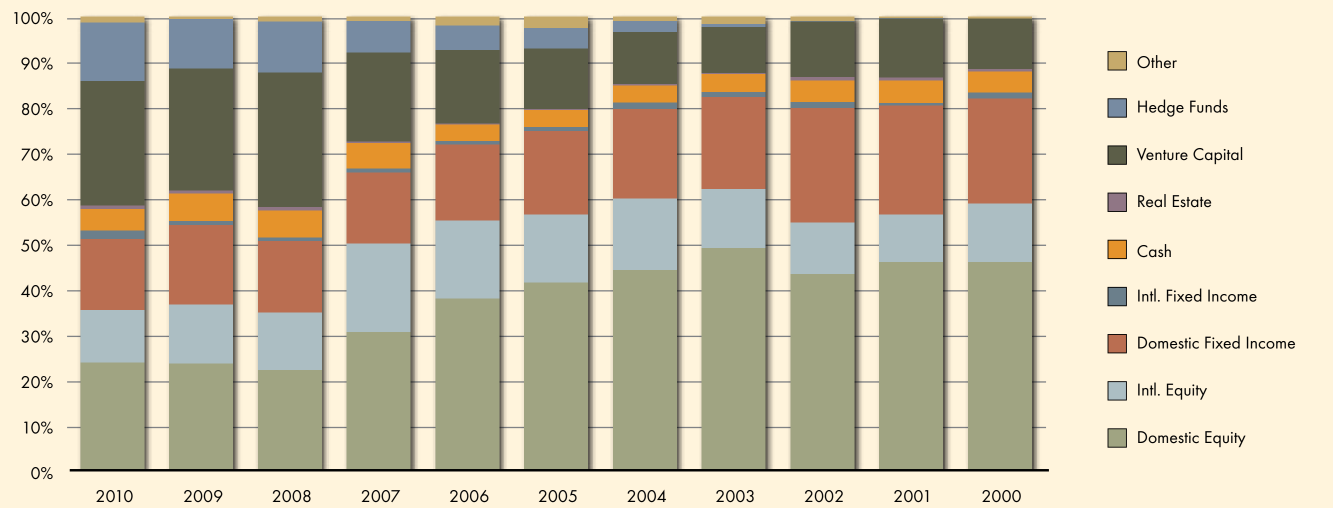


FIGURE 4: NOT FOR PROFIT COMPOSITE ASSET ALLOCATION



STEADY FIXED INCOME ALLOCATION

Institutional plans have maintained a fairly steady fixed income allocation over the last decade. Northern Trust's universe exhibited a modest increase in total institutional fixed income assets from 27% in 2000 to 30% in 2011.

Notably, the makeup seems to have evolved from a core to more of a longer-duration approach, though this is difficult to quantify due to the heavy use of commingled funds within institutional plans. On the non-U.S. side, though there have been increasing allocations to emerging markets debt, non-U.S. fixed income allocations still do not represent a material percentage of plan assets.

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GROWING ALTERNATIVES ALLOCATIONS

Alternative assets have become mainstream over the past decade. Within Northern Trust's universe, alternative assets are found more often within the largest plans.

Investing in alternative assets creates numerous challenges in monitoring and reporting on asset allocation and investment performance. These include the vehicles' lack of transparency, the retrospective nature of valuations, and the added time needed to gather the appropriate information compared to more traditional or public market asset classes. In particular, the valuations lag time in private equity makes it difficult to manage liquidity, rebalance and accurately measure performance.

Private Equity Allocations

Challenges within the private equity space include:

- **Transparency –** The structure of the vehicles can be difficult to "see through" in order to determine which assets are held.
- **Retrospective Valuations –** Valuations often are issued with a lag of one quarter or longer.
- **Mismatch between Current Cash Activity and Retrospective Valuations –** Posting cash activity on a current basis and updating valuations on a lagged basis leads to incorrect performance measurement.
- **Accounting Treatment of Expenses –** Expenses are capitalized onto the asset base and not paid from the accounts using cash. This makes it difficult to identify the total fees paid for the investment.
- **Performance Benchmarking –** There is a lack of readily available, understandable benchmarks.

Despite the challenges of this asset class, Northern Trust's universe reflects a substantial increase in allocation to private equity mandates. Specifically, institutional plan assets in this class rose from 3.5% in 2000 to 8% in mid-2011. This is despite the fact that the global private equity market remains well below pre-crisis levels, as measured by deal activity and values, though the market is showing signs of improvement. In 2010, the number of U.S. deals increased by almost 40%.[iii]

Hedge Fund Allocations

Challenges within the hedge fund space include:

- **Transparency –** Similar to private equity, the structure of these vehicles can be difficult to "see through" in order to determine which assets are held.
- **Retrospective Nature of Final Valuations –** Final valuations are often not available until late in the following month.
- **Accuracy of Estimated Valuations –** While estimated valuations are normally available earlier in the month, the potential for estimation errors could result in inaccurate valuations and performance measurement.
- **Performance Benchmarking –** The vast universe of potential benchmarks can be daunting.

Allocations to hedge funds have also increased over the past decade as investors explore the risk/return benefits of this asset class. The universe showed essentially no investment in hedge funds in 2000, yet as of June 30, 2011, 5.1% of assets are now held in hedge fund mandates. According to external sources, hedge fund assets have returned to levels last seen before the September 2008 height of the financial crisis.[iv]

Given the liquidity crunch from the credit crisis, one might expect plans to be holding an abundance of cash. However, based on our universe results, institutional funds across segments are not holding any more cash than they did at the end of 2000.

Real Estate Allocations

Challenges within the real estate space are similar to those in the private equity and hedge fund spaces, though this can vary with the type of vehicle structure employed (e.g., limited partnership or commingled fund).

Real estate as a percentage of total assets remains modest and has not fluctuated much over the past decade. A total of 3% of public fund assets are invested in real estate, while less than 1% of ERISA and NFP assets are invested in this asset class.

CASH ALLOCATIONS FLAT

Given the liquidity crunch from the credit crisis, one might expect plans to be holding an abundance of cash. However, based on our universe results, institutional funds across segments are not holding any more cash than they did at the end of 2000. The results do show, however, a contraction in the cash percentage of assets during the middle and late 2000s, suggesting the perceived increase in cash allocations today are simply a return to the practices of the beginning of the decade.

For instance, the ERISA universe reflected a 2.6% allocation to cash in 2001, a drop to 1.2% in 2008, and then a subsequent rise back to 2.6% in 2010. The NFP universe shows a similar trend, with cash representing 4.6% of assets in both 2000 and in 2010.

Possible Reasons

The relatively muted return to pre-crisis cash levels may be attributable to the basic investment structure of the fund. Cash does not earn any material return in an investment program. For this reason, clients typically do not look at cash as an "investment." Though cash can provide an easy means of creating a defensive position in a down market, most investors do not want to make tactical decisions around cash in their overall portfolios.

Another possible reason could be that elevated alternative investments and related capital call activity have demanded more funding from the cash account than a decade ago. To the degree that this is the case, the average cash balance throughout any given month would have been higher than our year-end data, once all calls had been funded.

A final possible explanation for flat cash allocations may simply be that cash is not normally part of a fund's strategic asset allocation. Because strategic asset allocation drives investment allocation decisions amongst types of mandates (e.g., equity, fixed income, etc.), any given fund's decision-making may be constrained by the strategic asset allocation in its governing documents.

FRONTIER MARKETS – IMPROVING PROSPECTS

Among the least explored pieces of the investable international opportunity set are frontier markets. An overdependence on the home country for equity investments can expose a portfolio to greater concentration risk. Investments in less-developed international markets face risks due to the lack of infrastructure and safeguards that investors are accustomed to in established markets.

Liquidity, once a major problem in frontier markets, has improved significantly. Fewer barriers to entry and more accessibility to markets have attracted investors, helping this asset class become more liquid.[v] Frontier markets posted strong returns in 2010, with the MSCI Frontier Markets Index posting an 18.3% return, beating both developed and emerging markets.[vi]

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FIGURE 2: THE FRONTIER MARKET COUNTRIES

EUROPE	AFRICA	MIDDLE EAST	ASIA	AMERICAS
Bulgaria	Botswana	Bahrain	Bangladesh	Argentina
Croatia	Ghana	Jordan	Cambodia	Colombia
Cyprus	Ivory Coast	Kuwait	Pakistan	Ecuador
Estonia	Kenya	Lebanon	Kazakhstan	Jamaica
Georgia	Mauritius	Oman	Sri Lanka	Panama
Latvia	Namibia	Qatar	Vietnam	Trinidad and Tobago
Lithuania	Nigeria	UAE		
Romania	Tunisia			
Slovak Republic	Zambia			
Slovenia				
Ukraine				

Includes those countries included in the MSCI Frontier Index, the S&P Frontier Index and the S&P Select Frontier Index and the S&P Extended Frontier 150 Index.

SHIFTING ASSET ALLOCATION BY SEGMENT

Clearly, different universe segments have different investment objectives when setting strategic asset allocations. These considerations influence the various plan structures and exisiting asset allocations across the universes.

Overall, the three segments exhibited similar asset allocation decisions for U.S. equity, but different decisions for fixed income investing. Non-U.S. equity decisions were slightly different among the plans.

ERISA

ERISA plans' asset allocation decisions are driven by the obligation to fund future liabilities to pension beneficiaries. Recent legislation (i.e., Pension Protection Act) added interim funded status targets into the plan sponsor decision making process. It is not surprising that the nature of ERISA fixed income programs has become decidedly more long in duration as plan sponsors look to better match future liabilities.

Not for Profit

NFP funds exhibited the highest level of change in asset allocations over the last decade. Their allocation to alternative assets increased from 11.1% in 2000 to 40.3% in 2011. Meanwhile, their allocation to U.S. equity decreased significantly, from 46% in 2000 to 24% in 2011.

Public Funds

Public funds have been by far the slowest to adapt to new ideas and trends in the investment landscape. Their current asset allocations are the least changed of the three segments since 2000.

SOCIALLY RESPONSIBLE INVESTING AND ENVIRONMENTAL, SOCIAL AND GOVERNANCE

The topic of Socially Responsible Investing (SRI) has been talked about but not acted upon. There appears to be growing demand for these types of mandates, but the lack of investor familiarity leads to a hesitancy to develop and manage those strategies.

Overall, risk mitigation has become a priority in all segments of the institutional marketplace. The desire to achieve strong investment returns while managing volatility is key.

We have seen a proliferation of off-the-shelf offerings in the market and are cautiously optimistic that demand will continue to grow in the United States. While other countries are well-versed in environmental, social, and governance (ESG) and green investing, experts observe that the U.S. is only in the first stage of adopting these types of mandates. [vii]

LIQUIDITY CONCERNS

As noted previously, investors across our universe have returned to the cash allocation levels previously seen in 2000 after a sustained period of lower cash balance allocations. Furthermore, investors have been reallocating capital in order to generate cash to pay benefits, grants and expenses.

For instance, investors have reduced U.S. equity exposure and used a portion of those proceeds to fund benefit payments within their pension plans. Investors also are looking to overlay and beta management strategies in an effort to control risk while increasing liquidity. Lastly, the increased presence of commingled and mutual fund vehicles supports the need for efficient withdrawal of cash without costly transition events.

INCREASED AWARENESS AND MONITORING OF RISK

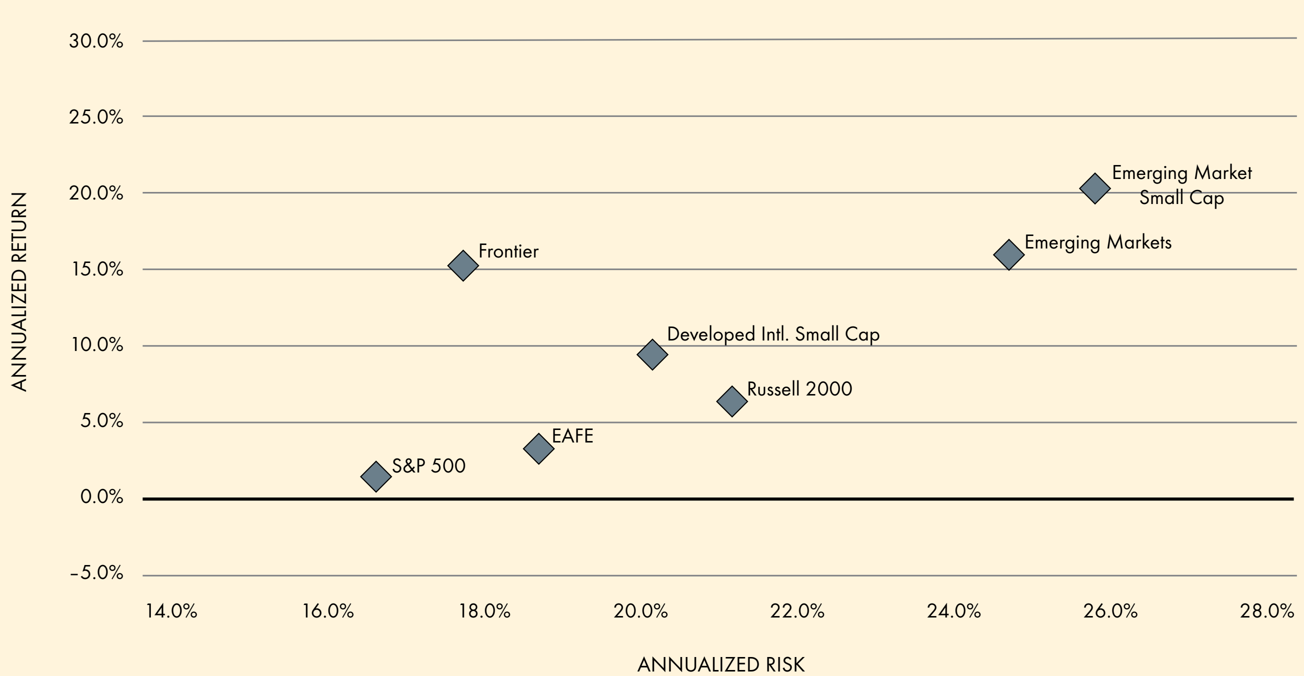
In the post-Lehman world, institutional plans are more cognizant of risks within their plan structures. Overall, risk mitigation has become a priority in all segments of the institutional marketplace. The desire to achieve strong investment returns while managing volatility is key.

One result is a move to separately managed accounts for fund of hedge funds portfolios. This allows the investor to better understand the investments or funds that are held within the larger product.

Another focal point is counterparty risk. Investors now understand the impact counterparty risk can have on their portfolios and are increasingly interested in the details of derivative holdings.

Downside risk measures as well as tail risk strategies have also entered board room discussions. Investors now seem willing to sacrifice some upside exposure for better downside protection.

FIGURE 4: NOT FOR PROFIT COMPOSITE ASSET ALLOCATION



**Sources: Developed Intl Small Cap, Standard & Poors EMI World ex U.S.; EAFE, MSCI Barra; Emerging Market Small Cap, Standard & Poors EMI Emerging Markets; Frontier, BMI Frontier; Russell 2000, Russell Investments; S&P500, Standard & Poors.* [viii]

DIFFERENCES ACROSS SEGMENTS

Over the last decade, significant changes in asset allocation have occurred in both the ERISA and NFP universes. Conversely, the public fund universe has not seen significant changes.

NFP plans are widely viewed as leading edge in embracing new investment trends, and the last ten years support this view, with NFP allocations to alternative assets more than tripling during this timeframe. While ERISA plans have not seen as significant a shift into alternative assets, the trend is still evident. Because most of the funding for these increases has been sourced from U.S. equity, the overall risk profile of ERISA and NFP plans has changed materially.

FOR MORE INFORMATION

To learn more about Northern Trust's Investment Risk and Analytical Services and the Northern Trust universe, please contact your relationship manager.

i *PricewaterhouseCoopers LLP, U.S. Asset Management: The State of the Industry, June 2011.*

ii *Northern Trust, Point of View, International Completion Strategies, Spring 2010.*

iii *PricewaterhouseCoopers LLP, U.S. Asset Management: The State of the Industry, June 2011.*

iv *The Wall Street Journal, Hedge-Fund Assets Reclaim Pre-Crisis Level, Aim Higher, March 10, 2011.*

v *Northern Trust, The Global Imperative, NTGI, Jim McDonald, December 2009.*

vi *FundFire, Managers Prep New Frontier Markets Products, Yaël Bizouati, January 10, 2011.*

vii *FundFire, Institutions Warming Up to Green Investments, November 15, 2010.*

viii *FactSet, Northern Trust Global Investments.*

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