InvestmentMetrics

Historical Funding Flows into Cross-Border Mandates through Market Cycles

by InterSec Research

While we are currently experiencing unprecedented market movements, historic periods of notable non-U.S. equity underperformance have been followed by sharp increases in fundings. Herein please find our latest client memo which details the historical relationship between performance and funding patterns for the U.S. tax exempt cross border market place.

Managers of U.S. tax exempt international equity funds experienced $43.9 billion in net outflows during 2007, marking the first net outflow from these mandates since 2003. Subsequently, initial fundings during the first half of 2008 receded from the lofty peaks posted during the second half of 2007 and unprecedented stock price declines have kept many prospective investors sitting on the sidelines. October proved particularly painful for international markets as the MSCI EAFE Index posted its worst monthly return on record and the median manager in the InterSec Research EAFE Plus Universe registered a 21.0% decline.[1] As institutional investors assess the impact of 2008 declines, international flows and funding behavior will be influenced largely by the confidence investors place in financial markets and their eagerness to strategically rebalance to under-performing asset classes. For example, preliminary net flows from State Street's Independent Consultants Cooperative ("ICC")[2] in September and October indicate that in aggregate, defined contribution plans, endowments, foundations, and high net worth individuals withdrew funds from EAFE and emerging markets mandates as international markets cratered, while defined benefit and corporate plans seized the opportunity to add assets to these mandates at bargain prices.

In this memo, we take a closer look at the relationship between performance and historical funding patterns, with a specific focus on historical funding behavior in our International and Emerging Markets Universes. We also review the increasing interest in international fixed income mandates and the negative impact passive currency hedging has had on international investors year-to-date. We believe this analysis sheds light on the factors influencing current funding decisions and potentially offers insight into future funding expectations and plan behavior.

The Historical International Funding Environment

To put some of the recent funding challenges into context, Exhibit I illustrates the total International Universe flows since 1994. Terminations (in yellow) and outflows (in dark blue) hit all-time highs during 2007, spurring the first net outflow for international mandates since 2003. While a considerable dollar amount, $43.9 billion represents just 4.2% of the total $1 trillion U.S. tax exempt international assets tracked by InterSec Research.

This sharp rise in international outflows and terminations is to some extent, an expected result of regular rebalancing as plans reallocate the previous five years of excess returns generated by international mandates. Increasing interest in shifting assets from an EAFE focus to more globally oriented mandates also may be a contributing factor in the rise in 2007 outflows. Simultaneously, initial fundings (shown in purple in Exhibit I and in greater detail in Appendix Exhibit I) have receded from the heights reached in 2004 and 2005 and contracted to levels more comparable with previous periods, as opposed to continuing the funding momentum of the second half of 2007. Increases in acquisitions, lift outs, and manager turnover within the industry also corresponds with rising terminations. Plan sponsors' fascination with less liquid and less market-correlated alternatives also has reduced the size of traditional asset allocations and diminished replacement fundings of international mandates. (Allocation shifts over the past eight years can be seen in the average allocations of the top 1,000 DB and DC plans illustrated in Appendix Exhibit II of this memo.)

While we acknowledge that the net outflows experienced during 2007 and the market environment of 2008 are

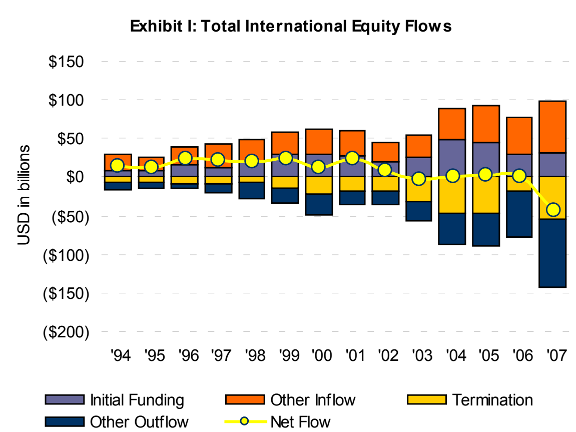


Exhibit I.

1 Please note that performance is preliminary.

2 As of December 31, 2007, State Street's Independent Consultants Cooperative consisted of 1,472 institutional funds with assets totaling $2,154.8 billion.

historically unprecedented, we believe that the underlying funding trends during the most recent period do share some similarities with previous international funding cycles. In the next section we examine these similarities, contrasting the relative performance of U.S. and non-U.S. indices in conjunction with year-over-year fundings in InterSec's International and Emerging Markets Universes.

Past Performance and Initial Fund Flows in International

Exhibit II shows the total flows in international mandates and the 3-year relative performance of the MSCI EAFE Index vs. the S&P 500 Index. The 5-year period beginning in 1996 illustrates an increase in flows to non-U.S. mandates as international markets under-performed the broad U.S. index. The impetus for this increase in international fundings is two-fold. First, performance for U.S. mandates rose steadily during this 5-year period, coinciding with the ascent of the tech bubble and a strengthening U.S. dollar. Gains for U.S. allocations were conceivably redeployed into under-performing asset classes in non-U.S. markets. This coincided with plan sponsors' increasing appetite for non-U.S. exposure and provided a well-timed entry point into non-U.S. equities. Conversely, the opposite held true for the 5-year period beginning in 2003. Net flows into international mandates contracted from 2003 to 2006 and fell into dramatically negative territory during 2007. This period was characterized by strong international returns and outflows from these mandates were largely due to out-sized gains being "taken off the table" and reallocated to under-performing asset classes, bringing allocations on both sides of the equation back toward target weights. Strong international returns over this timeframe also translated into little need for plans to commit "new money" to these mandates and flows consisted primarily of "replacement" business. However, the sharp declines in non-U.S. equities in 2008 and recent allocation range increases for international mandates in select plan structures may provide an opportunity for institutional investors to revisit these allocations.

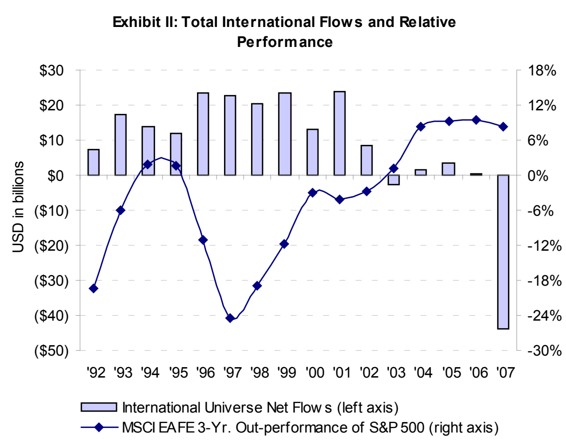


Exhibit II.

On a broad level, net flows for international mandates have been at all-time lows over the past five years, yet reviewing detailed style characteristics allows us to delineate the trends between differing products. For example, diversified core mandates have experienced the greatest outflows during the past five years, while concentrated value mandates generally have continued to see positive net inflows over the same period (albeit at a slower pace during 2006 and 2007). The opposite holds true for fundamental managers, who have experienced significant outflows from 2003 through 2007, but have recently seen increasing interest through 2008. Quantitative managers on the other hand, saw interest peak from 2002 to 2005 as plans allocated to quant managers in favor of spending their active risk budget in higher risk segments of the portfolio. Demand for quantitative mandates subsequently began to taper off in 2006 and 2007 coinciding with a generally weak performance period. The relative under-performance of these products was highlighted extensively in the financial press during mid-2007 and fundings for quantitative portfolios have continued to weaken in 2008.

Past Performance and Initial Fund Flows in Emerging Markets

Historical funding trends for InterSec's Emerging Markets Universe demonstrated a similar corollary between net flows and relative performance as the broader International Universe. In Exhibit III, yearly net flows into emerging markets mandates are plotted along with the 3-year relative performance of the MSCI Emerging Markets Index vs. the MSCI EAFE Index. While net flows for emerging markets products have demonstrated slightly higher year-over-year volatility relative to the International Universe, the broader trend of

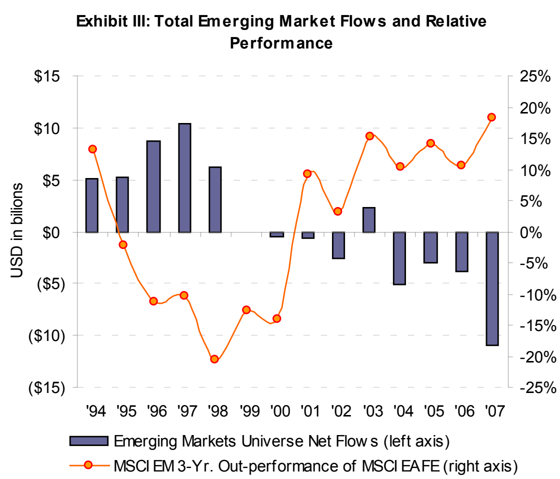


Exhibit III.

increased inflows during periods of under-performance and outflows during periods of out-performance remains principally intact. The 5-year period from 1995 to 2000 illustrates this trend as fundings increased, coinciding with a decline in 3-year relative performance. Conversely, periods of heightened out-performance such as 2007, correspond with a spike in outflows and defundings. This sharp decline likely represents active plan rebalancing and the redistribution of emerging markets' excess returns to under-funded areas of the plan structure. Amid the most recent downturn, select plans have begun funding emerging markets mandates as preliminary flows for State Street's ICC universe show positive inflows for defined benefit plans and endowments and foundations, while high net worth individuals and defined contribution plans registered outflows in September and October.

Demand Increases for International Fixed Income

Global and emerging markets fixed income mandates have bucked the broader trend of net outflows experienced by their equity counterparts, as non-U.S. fixed income products have seen increasing interest from 2003 onward, as illustrated in Exhibit IV. According to State Street Investment Analytics' U.K.-based research group, WM Company, increases in local currency emerging markets and global debt fundings have coincided with rising interest in LDI, as plans continue to pursue financial instruments that are longer duration and better matched with their future liability streams. Relative to U.S. securities with comparable credit ratings and maturities, local currency emerging markets bonds typically have traded at wider spreads to their respective benchmarks. In addition to higher levels of current income, the global fixed income universe also boasts a broader opportunity set, increased diversification benefits, and a greater potential for future price appreciation. While the median manager in InterSec's Global Fixed Income and Emerging Debt Universes have trailed their indices by 110 and 140 basis points respectively year-to-date (as of September 30, 2008), longer-term performance results have proven the merit of non-U.S. fixed income allocations. Emerging debt managers in particular have proven their long-term skill as the median manager in InterSec's Emerging Debt Universe has outperformed the Emerging Markets Bond Index by wide margins over the most recent 3-, 5-, 7-, and 10-year periods (as of September 30, 2008). Various risk profiles and credit tranches in non-U.S. fixed income markets also present disparate investment strategies the opportunity to select from a wide range of duration, diversification, and total return characteristics for their product suite. Additionally, while the last few years have seen a proliferation in Lehman Aggregate products, we anticipate increases in demand for Citigroup World Government Bond products as the global flight to quality, driven by the recent U.S. credit crisis, has enhanced the attractiveness of global treasuries and foreign fixed income securities.

Currency's Mean Reversion

A number of plans have elected to manage their currency exposure in international investments through a passive hedge. While that hedge proved beneficial as currencies strengthened, in 2008 currencies reversed course and passive overlays unintentionally compounded the

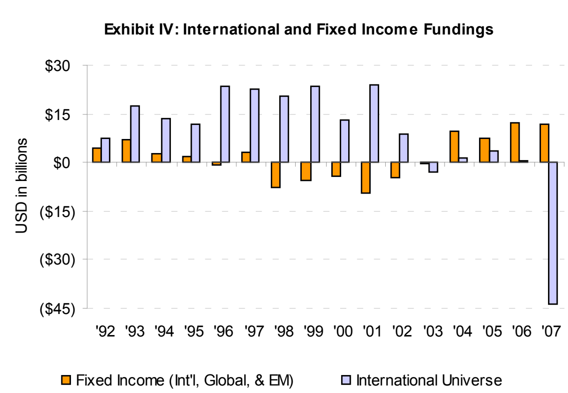


Exhibit IV.

negative returns for international equity allocations. Asset managers and currency specialists have noted that passive currency hedges may have been adopted too readily, and perhaps too uncritically by plans based in strengthening currency markets. Plans in markets where hedging strategies have recently added value as well as a number of U.S.-based hedge fund managers have also been quick to adopt passive overlays. Unfortunately, these passive hedges generally have been a drag on performance year-to-date, as the mean reverting nature of currencies has caught passively hedged investors off guard. The increasing use of leveraged currency funds has also presented challenges as managers struggle with the technical difficulties of raising sufficient liquidity to offset hedged losses these funds have incurred.

Exhibits VI, VII, and VIII highlight the trend of a recently weakening U.S. dollar and illustrate its resurgence beginning in 2008. Each exhibit shows the monthly exchange rate of the pound, euro, or yen relative to the U.S. dollar (in blue) and the long-term average exchange rate over the entire period (in red). As noted in each exhibit, the dollar hit 20-year lows relative to both the euro and pound in 2007, while only one period (during the mid-1990s) proved weaker for the dollar/yen exchange. Average exchange rates over these 20-year periods illustrate the severity of the dollar's decline and raise questions as to its future direction. While the percentage of international assets to be hedged and their allocation within a plan structure remains an issue of contention among plan sponsors, recent currency events may prompt plans to reevaluate their hedging strategy going forward.

Exhibit VI: EUR

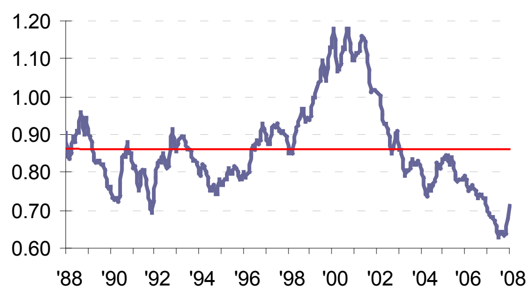


Exhibit VII: GBP

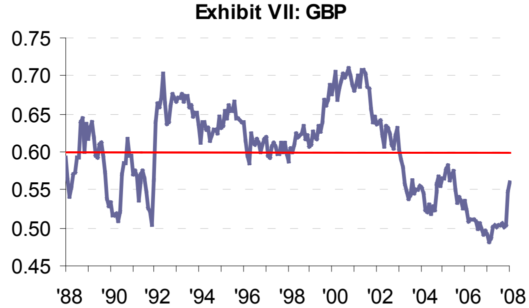
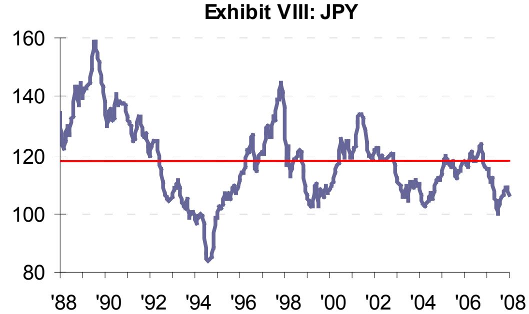


Exhibit VIII: JPY



Conclusion

While unprecedented market movements for much of 2008 make it difficult to determine how international equities, fundings, or currency markets may behave in the final weeks of 2008 and into 2009, we remain optimistic that the historic cycles presented in this memo point to some factors that suggest fundings to non-U.S. equities may increase. New infrastructure in emerging markets and the current global downturn may also provide the necessary catalysts to promote new product development and the type of products that offer risk and return characteristics better suited to help immunize plans' long-term liabilities. Similarly, the growing interest in global equity products as a source of added alpha and increases in fundings suggest that these mandates with broader opportunity sets will continue to be an area of interest among plan sponsors and their consultants.

Similar to 2008, prior periods of notable non-U.S. equity underperformance have been followed by sharp increases in new fundings. Institutional investors have demonstrated an interest in funding international mandates at low prices and pundits, analysts, and strategists alike seemingly agree that international equities are currently attractively priced; far below what normal business fundamentals would dictate. While we anticipate plans to continue to exercise caution in new fundings through the remainder of 2008, the potential for an uptick in initial fundings in international mandates amid periods of underperformance is certainly not without precedent.

Appendix

Exhibit I: International Initial Fundings 1997- 2008

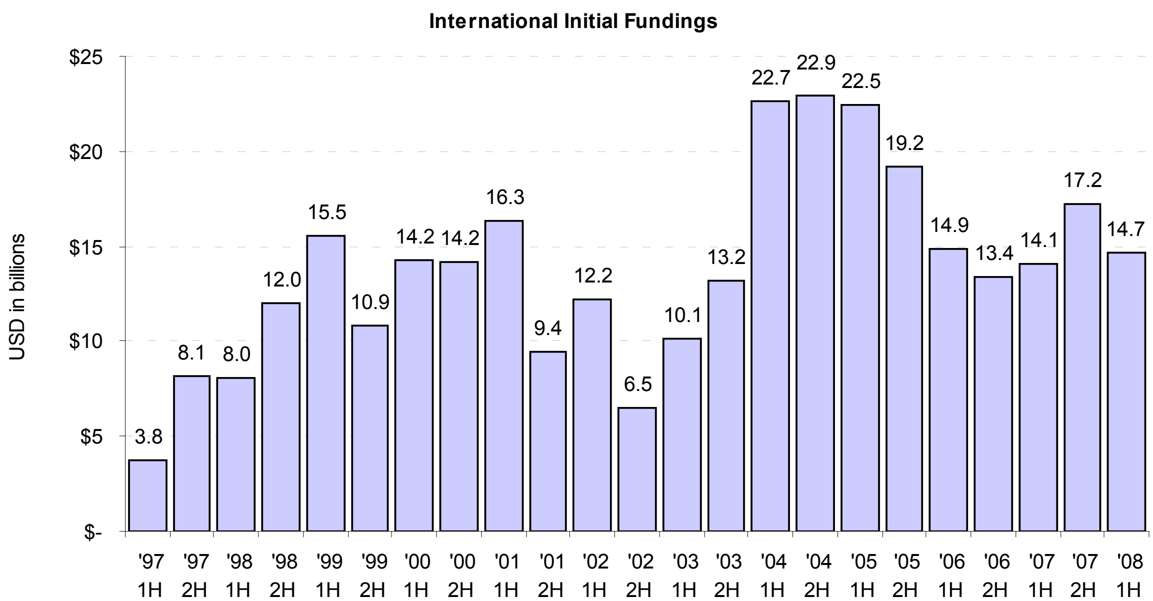
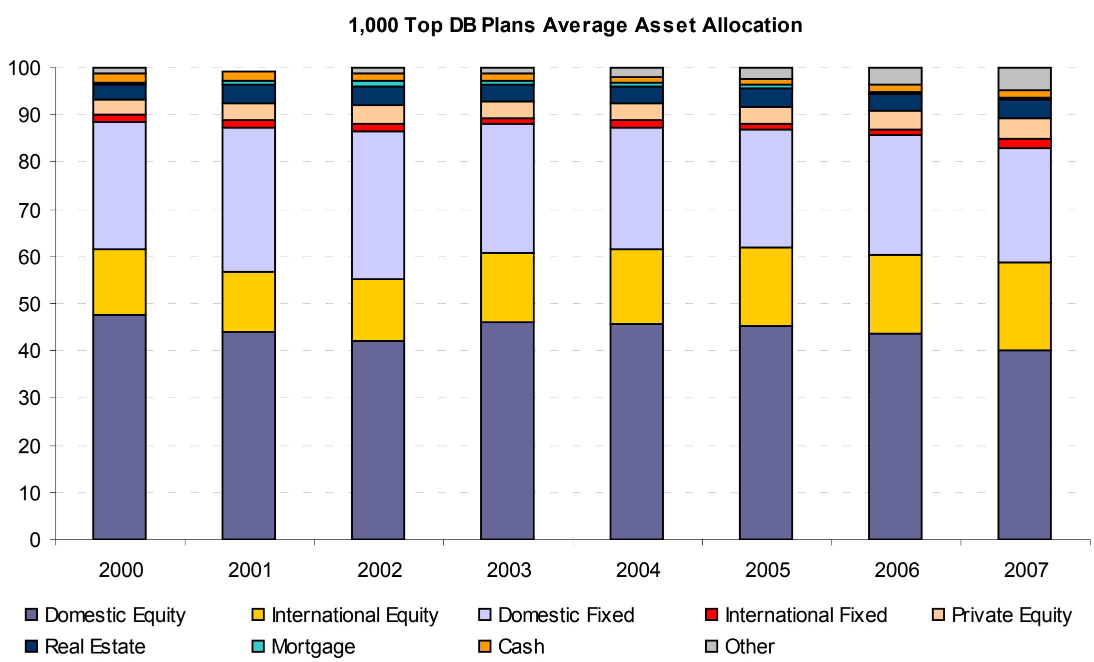
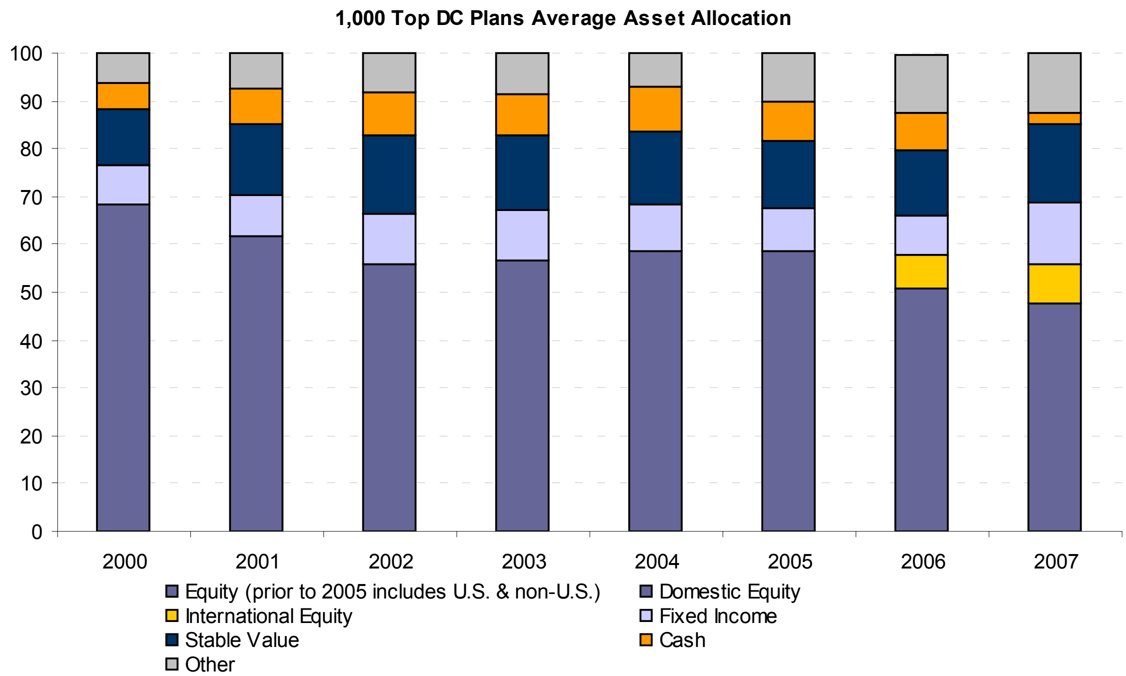


Exhibit II: 1,000 Top DB & DC Plans Average Asset Allocation 2000 - 2007



Source: P&I Magazine



Source: P&I Magazine

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