



INVESTMENT MANAGEMENT

Beyond the credit crisis:

the impact and lessons learnt for investment managers

July 2008

FINANCIAL SERVICES

Acknowledgements

This report, produced by KPMG International in cooperation with the Economist Intelligence Unit, examines in detail for the first time how the fund flows, returns and reputations of investment managers have been impacted by the credit crisis and the economic conditions of the past 12 months.

It aspires to go further than this though. It investigates how, in the light of the challenges presented by the credit crisis, fund management firms are managing the increasing complexity of the instruments they use and the strategies they adopt.

Our foremost thanks go to the 333 respondents from 57 countries who answered our online survey and the 16 executives who gave us their time for interviews.

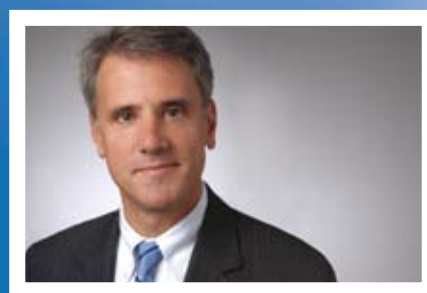
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Respondents by geography

31%

based in North America

29%

based in Western Europe

23%

based in Asia Pacific

17%

rest of the world

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About the research

Beyond the credit crisis: the impact and lessons learnt for investment managers was written in cooperation with the Economist Intelligence Unit and is based on their survey of 333 senior executives from across the global fund and investment management community, in March and April 2008. Respondents were based in fund or investment management firms, institutional investors, private equity funds, hedge funds and real estate funds.

References within the report to “mainstream fund management firms” or “fund managers” are based on a filtered sample of respondents that excludes either alternative investment funds (private equity funds and hedge funds) or fund managers’ key clients (institutional investors).

A range of organization sizes were represented: 58 percent had assets under management of at least US\$1billion; and nearly one in four (23 percent) had assets of at least US\$50billion. Geographically, about one-third (31 percent) were based in North America, 29 percent

in Western Europe, 23 percent in Asia Pacific, with the balance from the rest of the world. The respondents themselves were very senior: 41 percent of participants were C-level executives, 35 percent were in SVP/VP or director positions, or were heads of business units or departments, with the balance from other management positions.

Supplementary to the survey results, in-depth interviews were also conducted by the Economist Intelligence Unit with 16 senior asset managers, hedge funds and industry experts.

Participating countries

| | | | | | | | |
|-----------|----------------|-----------|------------|-------------|--------------|--------------|----------------|
| Argentina | Chile | Germany | Israel | Mexico | Russia | Sweden | United Kingdom |
| Australia | China | Ghana | Italy | Netherlands | Saudi Arabia | Switzerland | United States |
| Austria | Colombia | Greece | Japan | New Zealand | Serbia | Thailand | of America |
| Bahrain | Czech Republic | Hong Kong | Kenya | Nigeria | Singapore | Trinidad and | Vietnam |
| Belgium | Denmark | Iceland | Luxembourg | Pakistan | South Africa | Tobago | |
| Brazil | Egypt | India | Macedonia | Peru | South Korea | Turkey | |
| Bulgaria | Finland | Indonesia | Malaysia | Poland | Spain | United Arab | |
| Canada | France | Ireland | Mauritius | Portugal | Sri Lanka | Emirates | |

Respondents by business type



Please note that with the graphs illustrated, not all answers add up to 100 percent because of rounding or because respondents were able to provide multiple answers to some questions.

Executive summary

Since the summer of 2007, banks have suffered significant losses as a result of one of the biggest crises ever to hit the financial services sector, the so-called credit crisis. So far, banks have been the focus of attention as bearing the brunt of the credit crisis impact. But what of the fund management sector? This report asks how fund managers have been affected by the credit crisis – and what strategies they are adopting in response.

Some of the key findings within the report include:

■ Investors do not have the same enthusiasm for complex instruments as fund managers.

Increasing complexity defines the fund management industry today. This survey of fund management and investment professionals reveals that 57 percent of mainstream fund management firms use derivatives in their portfolios. The figure is even higher within large mainstream fund management firms: nearly one-third of those with assets of at least US\$10billion use derivatives to a major extent. Even more fund managers (61 percent) now manage hedge fund strategies, which in many instances are complex. The survey also found that half of mainstream fund management firms manage private equity strategies, nearly half manage asset-backed securities and more than one-third manage collateralized debt obligations (CDOs). Fund managers still believe that with the exception of CDOs, all the above strategies and asset classes will rise over the next two years. On the other hand, 70 percent of the investors who answered the survey say that the credit crisis has reduced their appetite for complex products.

■ Trust in fund managers has fallen as a result of the credit crisis.

Fund management firms have suffered a degree of fallout from the credit crisis, although nothing nearly as severe as the banking sector. Well over half of mainstream fund managers say investment returns have fallen and about the same proportion report falling subscriptions. But the damage potentially goes further than short-term losses in funds: six out of ten respondents believe trust in fund managers has been eroded due to the effects of the credit crisis.

60%

of respondents believe trust in fund managers has been eroded due to the effects of the credit crisis

Executive summary, continued

There is a widespread feeling that fund management firms need to re-evaluate what kind of business they are conducting and the risks they are running.

- **Lack of skills and experience is a key concern.** There is evidence, in the light of the credit crisis, that some aspects of fund management require urgent attention. The skillsets of staff, for instance, have to some degree failed to keep up with growing sophistication. One in five fund managers that have invested in complex financial instruments, such as derivatives, CDOs or structured products, admit to having no in-house specialists with relevant experience. Investors are at greater risk still, with about one in three of the institutions investing in such instruments saying they have no in-house expertise of these. Rating agencies are seen as providing little support: one third of the respondents agree that rating agencies provide an accurate assessment of whether an instrument will default and just 1 percent of respondents think rating agencies are very accurate in predicting defaults.
- **Risk management, valuation methods and governance structures are all being shaken up.** There is a widespread feeling that fund management firms need to re-evaluate what kind of business they are conducting and the risks they are running. Four out of ten firms surveyed for this report say they have already formalized risk frameworks in the past two years as a result of managing more complex strategies, with a similar number planning to do so over the coming two years. Valuation methods have come under intense scrutiny during the credit crisis and a third of firms have reviewed this activity, while a further third will do so in the next two years. An even higher proportion, 38 percent of respondents, have reviewed governance arrangements – particularly relevant in the cases of funds that used risky instruments to enhance returns on supposedly low volatility funds – and a further quarter will do so in the next two years.
- **Making fund management successful in the future requires a renewed focus on the client proposition.** The credit crisis will sharpen the minds of fund managers: in a time of increasing uncertainty and investor conservatism, they need to demonstrate their added-value proposition. The concern is that investors will reject further innovation, particularly if it involves complex strategies and instruments. As mentioned previously, 70 percent of investors say the credit crisis has reduced their appetite for complex products. The fund management industry will need to prove the doubters wrong by developing products and services that perform well over the cycle and in changing economic environments. All-weather strategies, lifestyle funds, insightful asset allocation advice and sound risk management and governance practices are all likely to be at a premium in the coming months and years.

20%

of managers that have invested in complex financial instruments admit to having no in-house specialists with relevant experience

65%

of firms surveyed say they have already formalized risk frameworks in the past two years or are planning to do so in the next two years

70%

of investors say the credit crisis has reduced their appetite for complex products by a major or moderate extent

KPMG comment

While the fund management sector has not been as badly affected as the banking sector by the credit crisis, the landscape has changed and many investment management firms should re-position themselves in the new environment. It is clear that derivatives will continue to become more and more important in the investment management environment. Successful firms need to embrace the use of derivatives in their products in order to enhance performance with acceptable risk parameters. Derivatives have become the tools of the trade, they cannot be uninvented. However, the use of derivatives and investment in complex products requires an upgrade in the sophistication of how investment management firms are run. In particular, the following areas should be addressed:

People

There needs to be a migration of experienced people from the investment banks to investment management firms, especially in derivative operations and risk management. The requirements of a derivative operation are so fundamentally different from running a long-only business that it is very difficult to develop sufficient skills in-house.

Incentive plan design needs to evolve to take more account of long and short-term performance as well as risk and investor satisfaction: at the level of the firm as well as the individual. For most organisations this will require a significant shift in organizational behavior and strengthening of performance management process and systems.

Risk management

While many investment management firms have developed sophisticated risk management programs, there is a shortfall across the industry in investment risk management capabilities, especially where firms are using complex instruments and strategies in their funds. Analysis of complex products, scenario and stress testing, price validation and liquidity risk management are all key areas to focus on in funds as well as fund of fund treasury structures. Another important lesson learned from the experience of the credit crisis is the importance of treasury and credit risk management (and how to best manage surplus cash in fund structures) as well as liquidity risk management (and how to best manage extreme redemption scenarios). The area of treasury and investment risk management is where we expect to see significant investment and increased focus within investment management firms in future.

Customer propositions

As the credit crisis has unfolded, investor confidence has taken a hit and their appetite for investment risk has been diminished. It is not that long ago that investors were badly burned by the bursting of the tech bubble. The fund management industry has been criticized for being too product-led and not sufficiently customer-focused. In order to rebuild investor confidence and attract long-term savings, successful firms should focus on a much clearer explanation of how products will perform and on much greater levels of investor assurance about governance and risk management. On their side investors need to understand the risks and features of what they have invested in or permitted their investment managers to invest in. While retail investors enjoy a much greater degree of regulatory protection, 'caveat emptor' or 'buyer beware' very much applies to institutional investors. Reliance on rating agencies is not enough. Proper analysis and risk assessment is required. On the other hand, firms will also need to pay more attention to customer demands, i.e. if clients want simple products that is where the client proposition needs to be focused.

Complex instruments and strategies: investment managers take the plunge



Despite what some of the political and media circles say, fund managers do not set out to confuse investors. While complexity exists, it is typically the by-product attempts to enhance the offering, through improved risk controls, protection of capital or enhancement of returns.

This report considers complex instruments to be those that are illiquid in nature and hard to value using conventional valuation measures. Complex strategies are taken to be those that, again, may be illiquid or hard to value. But they may also be innovative and not widely understood across the investment spectrum and by investors of either institutional or retail variety. By definition, complex instruments and strategies are understood by a small number of people and this, in turn, increases the risks associated with their use.

Such instruments are worthy of special attention, given that increasing complexity defines the fund management industry today. This survey of fund management and investment professionals reveals that a substantial majority (61 percent) of the mainstream fund management firms that responded to this survey – encompassing fund and investment managers, retail fund managers and real estate funds – now manage hedge fund strategies which in many instances are complex. This rises to 71 percent of fund managers with over US\$10billion in total assets.

Many have invested significantly in building up a hedge fund capacity, in the belief that investors will increasingly demand funds that deliver returns in all weathers. The rise in hedge fund assets from US\$1,000billion in 2005 to US\$2,650billion at the end of 2007, according to HedgeFund Intelligence, a data provider, bears out this belief. The head of alternatives distribution at

a large London-based investment firm, says: “We think investors are tiring of funds that are highly correlated to markets.” The firm runs US\$1billion in five single strategy hedge funds and two fund of funds, and has just launched a new hedge fund, managed in Hong Kong. The new fund invests in very different sub-sectors from a traditional long-only strategy. They include directional strategies, tactical trading, long-short, market neutral and event-driven tactics. It is typical of larger, institutional-focused fund firms that have responded to investors’ demands and attracted significant assets in non-core investment areas.

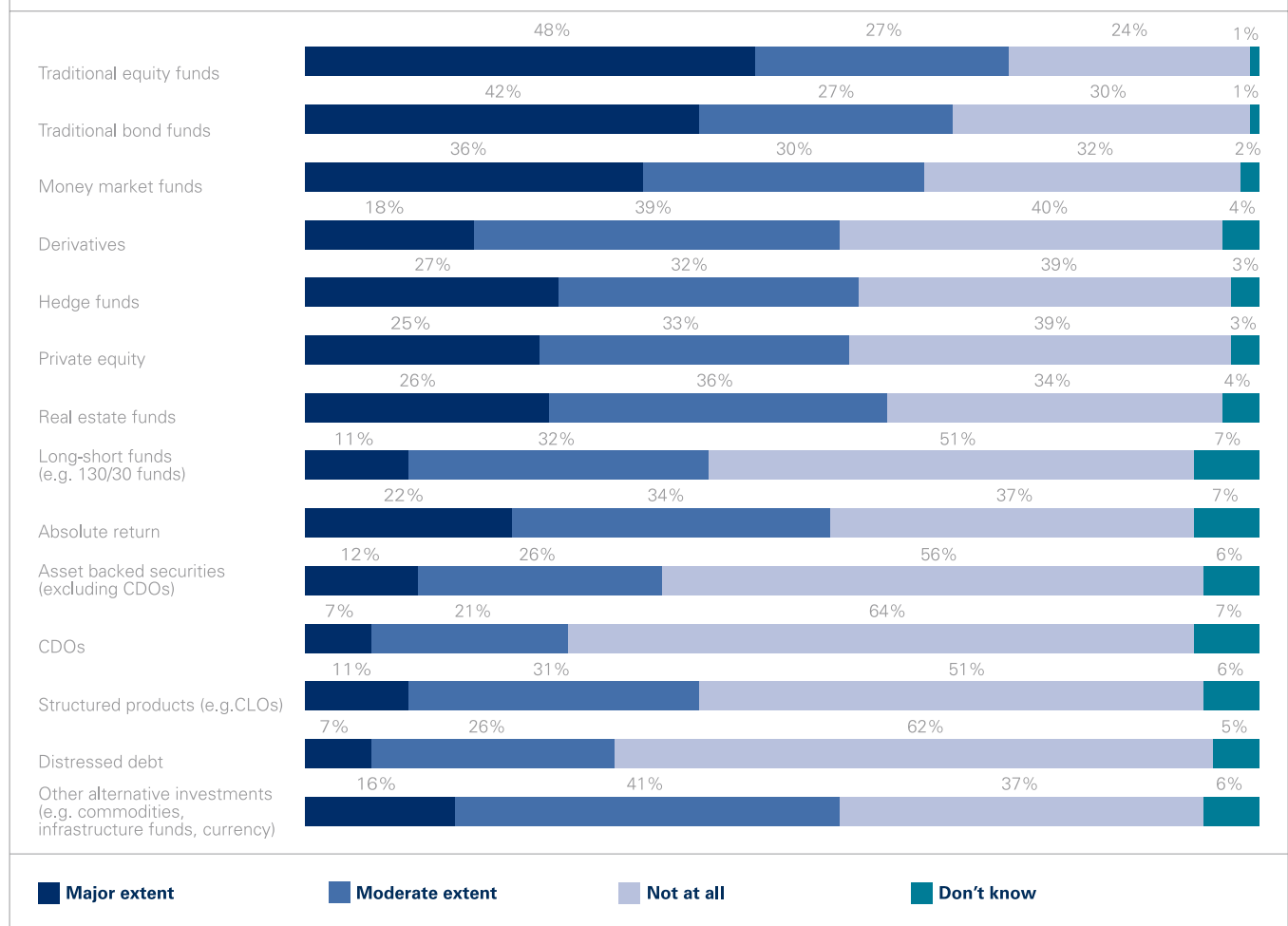
Derivatives are also a significant growth area, with 57 percent of firms surveyed for this report saying they use derivatives in their portfolios (see Chart 1). The figure is slightly higher (61 percent) within mainstream fund management firms and much higher within larger ones (74 percent): nearly one-third (29 percent) of those with over US\$10billion in total assets say they use derivatives to a major extent. Derivatives are used in a variety of fund strategies including fixed income, money market and some equity strategies, such as the 130/30-type vehicles that balance a gross long position of 130 percent of assets with a 30 percent short position. Just over half (51 percent) of mainstream fund managers run long-short funds of the 130/30 type.

The head of wealth management at an Asia-based bank says: “130/30 funds are another way for talented fund managers to demonstrate their skills. If the risks are well communicated to investors and well understood they can be a great product.” But he cautions that specialized skills are needed. “The ability to buy the right stocks is a valuable skill, but shorting certainly requires additional capabilities.”

51%
of mainstream fund managers run long-short funds of the 130/30 type

Complex instruments and strategies: investment managers take the plunge, continued

Chart 1 Answers from all respondents to the question: To what extent does your firm invest in, or offer to clients, the following products today?



Source: Economist Intelligence Unit survey, March - April 2008

47%

of respondents in Asia Pacific expect that the use of derivatives will increase in the next two years. This was the highest percentage among respondents

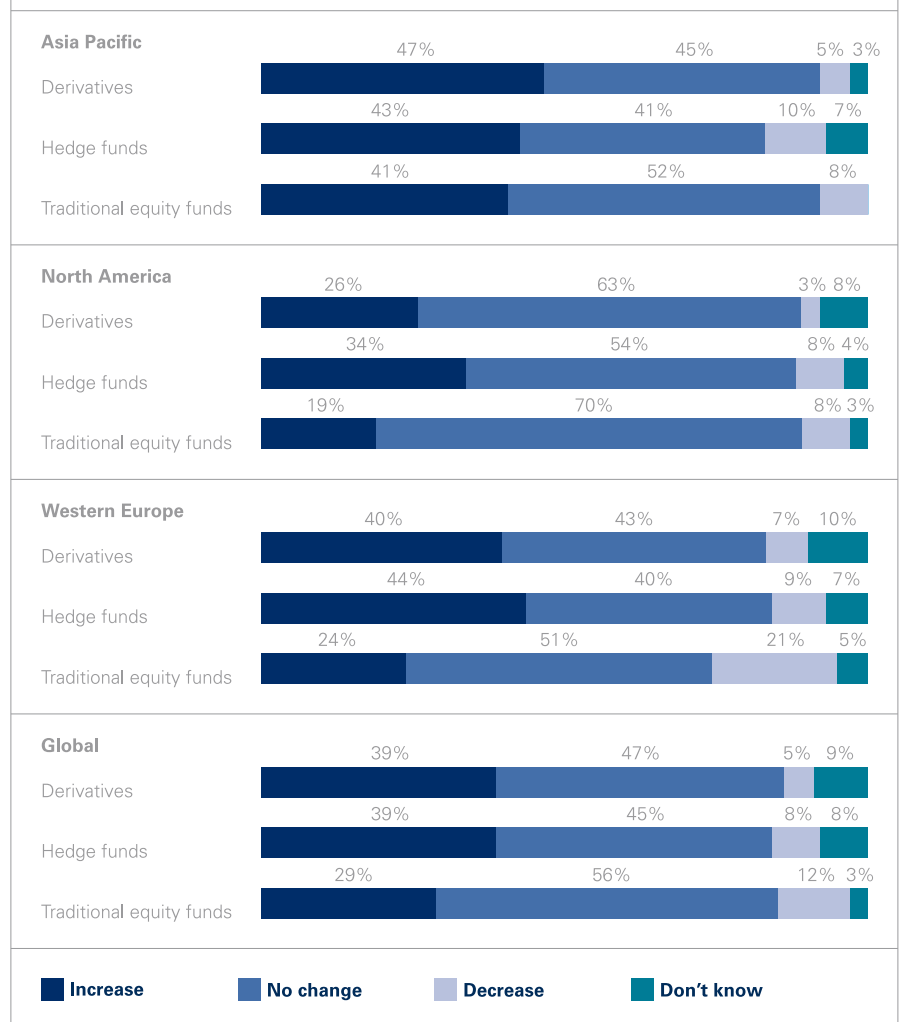
Derivatives have a number of functions. Some of these are practical, such as to offset cash drag – the negative impact on performance caused by holding cash to meet demand for redemptions. Assets held in exchange-traded derivatives that match the characteristics of the portfolio can be quickly cashed if there is a sudden demand for redemptions.

Derivatives are widely used in fixed income portfolios to seek extra yield or as protection against certain economic and portfolio-specific events. A wealth management head says: “They can, for instance, neutralize the risks of an imminent central bank decision that could affect the value of government bonds in a portfolio.” Derivatives are also the building blocks of ‘overlay’ strategies which allow dynamic asset allocation without having to incur the costs of buying and selling underlying assets.

But hedge funds and derivatives are just part of the picture. The survey also found that 50 percent of mainstream fund firms manage private equity assets, 42 percent use asset backed securities and 37 percent manage collateralized debt obligations (CDOs). With the exception of CDOs, exposure to all these strategies and asset classes are expected to rise over the next two years. For example, far more (26 percent) of North American investment firms plan to increase their exposure to derivatives, compared with those who will decrease their exposure (3 percent). The same story plays out for hedge funds: 34 percent of North American firms will increase investment here, while just 8 percent will back away.

In Western Europe, the market for traditional equity funds should inch up: 24 percent of firms say they will increase investment here, nearly as many as the number of firms that will reduce investment (21 percent). By comparison, demand for more complex

Chart 2 Answers from all respondents to the question: How do you expect your firm’s use of the following products to change over the next two years?



Source: Economist Intelligence Unit survey, March - April 2008

Complex instruments and strategies: investment managers take the plunge, continued

strategies is rising much faster. Indeed, 40 percent of firms will increase the use of derivatives, while just 7 percent will cut back. The same is true for investment in hedge funds: 44 percent plan to increase use of those, far more than those who will reduce exposure (9 percent). In the Asia Pacific region, where fund penetration overall is lower, traditional equity funds have still to fulfill their potential. Far more firms (41 percent) will increase exposure to these than those who will pull back (8 percent). But this will be accompanied by an increase in the number of investment firms using derivatives (47 percent increasing exposure, with 5 percent decreasing). Similarly, 43 percent will increase investment in hedge fund assets,

compared with 10 percent who will reduce theirs (see Chart 2).

However, according to survey respondents, the use of CDOs will fall considerably: just 9 percent will increase investment in that asset class, whereas 17 percent plan to reduce exposure. But experienced market observers argue that CDOs are resilient vehicles. The deputy chairman of the asset management division of a Swiss investment bank says CDOs have run into problems before and made a subsequent resurgence. "This situation is not new – it is the assets backing them that have changed," he says. "In 1998 it was emerging market debt and in 2001 it was Enron bonds. You can't blame the vehicles themselves for this."

KPMG comment

One of the main factors behind the growth of complex financial instruments in recent years has been the search for yield by investors. In order to generate the required yield for investors in a market where funding was readily available, product developers turned to increasingly complex structured financial instruments. An example of such a product is the 'CDO squared' (a structured credit vehicle that invests in other structured debt notes). There is no doubt that over the last decade there has been the demand for such instruments. It is still unclear as to whether growth in this market will return and if so whether the design of the instruments will have to change.

What is clear, however, is that funds are increasingly using derivatives as part of their investment strategies. What has been highlighted by the credit crisis and its effect on structured credit products is how important it is to fully understand the pricing and risk of such investments. Funds that should be successful are those that have differentiated investment strategies (i.e. there may be demand for an allocation to a specialist structured credit fund, but investors should not expect money market funds to invest in such products). In addition, those funds that can provide transparency of the underlying valuation risk will meet the increased investor demand to understand the risk in their portfolio.

KPMG comment

Investors have had a bad time in the structured finance market and very few new structured finance-related transactions are currently being carried out. We do not expect the markets to return for a while and whenever that happens, the transaction volume will be lower and the structures should be less complex and easier to understand.

Improved transparency is required for the market to pick up, but exactly what changes need to be made remains to be seen. It is interesting that existing transactions had disclosure documents that were hundreds of pages long with lots of information about the transaction and its risks. Yet the transparency from these documents did not prevent the credit crisis from happening. The road ahead needs to be a move to simplify and standardize what information is needed to make better investment decisions. Market participants need to work together on this.

The subprime sector of the market probably has the most questionable future of any of the other asset classes. It has suffered a material public image hit related to this crisis and, as a result, many people feel this sector will not return until 2010 at the earliest. Some parallels are being drawn to the manufactured housing securitization market that collapsed back in 2000/02 and has subsequently never recovered. However, subprime credits will always exist, giving the sector a fighting chance to return to some semblance of its former self. It will be interesting to see developments emanating from the rating agencies that help design securitization structures, as one benefit from this crisis has been an overwhelming amount of data points related to default behavior and the facts and circumstances surrounding this behavior. It is likely that rating agencies will enhance models to incorporate these behavioral tendencies as well as build in forward-looking aspects to their models like home price appreciation origination patterns in the industry, and possibly monitor primary market trading activity.

Credit crisis exposes risks of complex strategies



“People will undoubtedly save more and invest in less risky products.”

A Managing Director at a large US-based money management firm

While complex strategies are appealing to fund managers and their clients in low-yield, low volatility environments, the inherent risks sometimes only become apparent in turbulent markets. The credit crisis which began in early summer 2007 and continues – albeit in an evolved form – today has proved the undoing of a number of complex strategies and instruments.

Structured credit vehicles containing CDOs and credit default swaps (CDSs) have been some of the highest-profile casualties. CDSs had seemed fairly simple instruments – they were insurance against a company defaulting on its debt obligations. But the side-effects were unanticipated by many investors. For instance, years ago, an investor buying US\$100million of a company’s bonds would have sought to avoid that company going bankrupt, since that would devalue the bonds. But if the investor bought CDSs as insurance, there would be an incentive for the investor to support bankruptcy rather than restructuring if the company had financial difficulties, since a default would trigger the derivative and pay all the money back. Similarly, investors selling credit protection through CDS may be exposed to unanticipated credit risk if they enter into a CDS assuming that the underlying company is less likely to default than it really is.

According to Morgan Stanley research, from January to April 2008 alone there were 4,485 downgrades of CDOs, leading to a fall in their value in the secondary markets. Just over 4,000 of these downgrades were on CDOs of asset-backed securities. Tranches

with AAA ratings – the kind that pension funds were most exposed to – accounted for 1,000 of these downgrades, more than any other ratings class. Structured investment vehicles (SIVs) have also suffered from the credit crisis. In January, for example, Victoria Finance, a US\$6.8billion SIV run by Ceres Capital Partners, had its credit rating cut by Standard & Poor’s to D, its lowest level.

Some hedge funds, particularly those with high exposures to asset-backed securities and derivatives, have also experienced losses. Of these, Peloton Partners, the London-based firm, gained the most notoriety. The company’s flagship ABS hedge fund enjoyed an impressive year in 2007, returning 87 percent to investors, and assets under management grew to US\$3.5billion. But within a matter of a few weeks in January it collapsed. A Financial Times commentator and financial markets author says: “Their fatal bet appears to have been a big position in synthetic asset-backed securities that had to be forcibly liquidated when some banks tightened their credit terms.” He believes certain themes are at the core of many hedge fund collapses: high degrees of leverage; concentration in a relatively narrow asset class; and liquidity problems brought on by an unforeseen deterioration in market conditions. In other words, he views hedge funds exhibiting those characteristics as fundamentally flawed from a risk perspective. Yet some hedge funds have profited handsomely from the credit crisis. New York based Paulson & Co bet heavily against subprime assets and its three funds returned between 130 percent and 650 percent in 2007.

4,485

The number of downgrades of CDOs from January to April 2008 alone according to Morgan Stanley

Credit crisis exposes risks of complex strategies, continued

Other complex strategies that have lost out in the credit crisis include the “enhanced” money market funds that invested in hedge funds and CDOs to increase returns. Some fixed income funds adopted the same strategy and suffered similar consequences. Private equity activity, too, has been heavily impacted and large leveraged buyout deals are now a rarity (although mid-market deals have remained buoyant). Ultimately, the crisis spilled over into equity markets as doubts surfaced over the ability of banks to finance economic growth, with Western markets falling 10 percent and more in the first quarter this year.

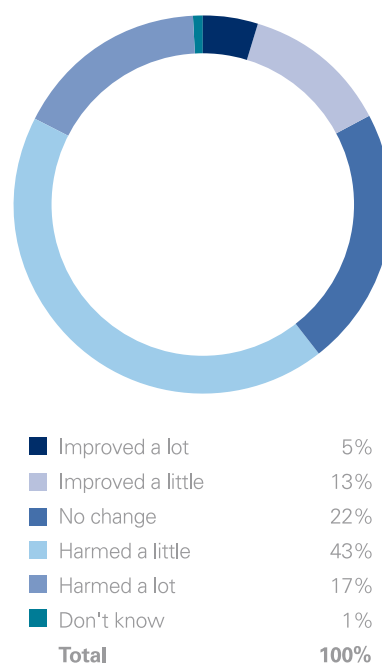
Fund management firms have also felt the impact of the credit crisis. Well over half (60 percent) of mainstream fund managers say investment returns have fallen (see Chart 3) and about the same proportion report falling subscriptions.

By comparison, only 45 percent of hedge funds and 44 percent of private equity funds say returns are down. Although a much smaller set of respondents, the trend among real estate fund respondents appeared far worse: two-thirds say returns have been impacted – far more than in any other asset class.

But the damage potentially goes further than short-term losses in funds. Six out of ten survey respondents believe trust in fund managers has been eroded due to the effects of the credit crisis (see Chart 4). A managing director at a large US-based money management firm, says: “People will undoubtedly save more and invest in less risky products.”

Intriguingly, investors themselves are less inclined to rush to judgment. In all, 47 percent of institutional investors say their trust in fund managers has been eroded. While this figure is high, it does mean many investors do not blame fund managers for losses or that the managers have succeeded in safeguarding their clients’ assets or managing these relationships. There is, seemingly, opportunity for fund firms with talented managers and strong processes to prove their mettle in the aftermath of this crisis. But many of them will need to adapt in the coming months and years if they are to succeed.

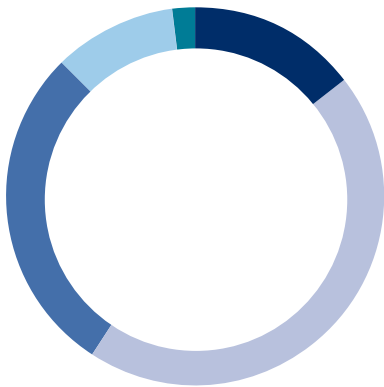
Chart 3 Answers from mainstream fund managers to the question: What effect has the credit crisis had on return on assets?



Source: Economist Intelligence Unit survey, March - April 2008 based on responses from fund/investment management firms, real estate funds and retail fund managers

Chart 4 Answers from all respondents to the question: To what extent do you agree or disagree with the following statement?

Trust in fund managers has been eroded as a result of the current crisis



| | |
|----------------------------|-------------|
| Strongly agree | 15% |
| Agree | 45% |
| Neither agree nor disagree | 29% |
| Disagree | 10% |
| Strongly disagree | 0% |
| Don't know | 2% |
| Total | 100% |

Source: Economist Intelligence Unit survey, March - April 2008

KPMG comment

With the benefit of hindsight we can now see that, even though they may have followed what was thought to be good market practice at the time, a number of funds did not have an adequate valuation governance structure for managing the valuation risk inherent in illiquid, structured products. For funds where illiquid assets were not core, there was often little fundamental analysis performed of the products that they acquired, instead reliance was placed on the analysis performed by the rating agencies and sales materials. Consequently, when the crisis struck, these funds found it hard to quantify the level of risk they were exposed to, as a key risk metric used was the proportion of the portfolio invested in AAA-rated assets. It is now recognised that funds may need to perform a more thorough analysis of all new structured products, including assessing the most appropriate valuation technique, or source of valuation information and outlining contingencies for what happens in the event that the primary source of pricing information becomes unavailable. The work that has been done by the Hedge Fund Working Group (in the UK) and the Presidents Working Group (in the US) has set out some broad principles for hedge funds with respect to valuation governance, which should be considered by all fund managers that invest in illiquid assets.

Investment managers reveal holes in their risk processes



20%

of fund manager respondents admit to having no in-house specialist with relevant experience of the complex financial instruments they have invested in

The fallout from the credit crisis has so far only proved disastrous for a handful of hedge fund managers. And, as just noted, there is an indication that many investors have not lost faith in fund managers. At the same time, there is a widespread feeling that firms need to re-evaluate exactly what kind of business they are conducting or wish to conduct and ensure it is in alignment with client interests. They also should reassess what risks they are knowingly or unknowingly running.

There is evidence that some aspects of their businesses may require urgent attention. The skillsets of staff, for instance, have to some degree failed to keep up with growing sophistication in fund management. One in five fund managers who, according to the survey, have invested in complex financial instruments, such as derivatives, CDOs or structured products, admit to having no in-house specialists with relevant experience of them. A similar proportion (23 percent) of hedge fund managers admitted the same (see Chart 5).

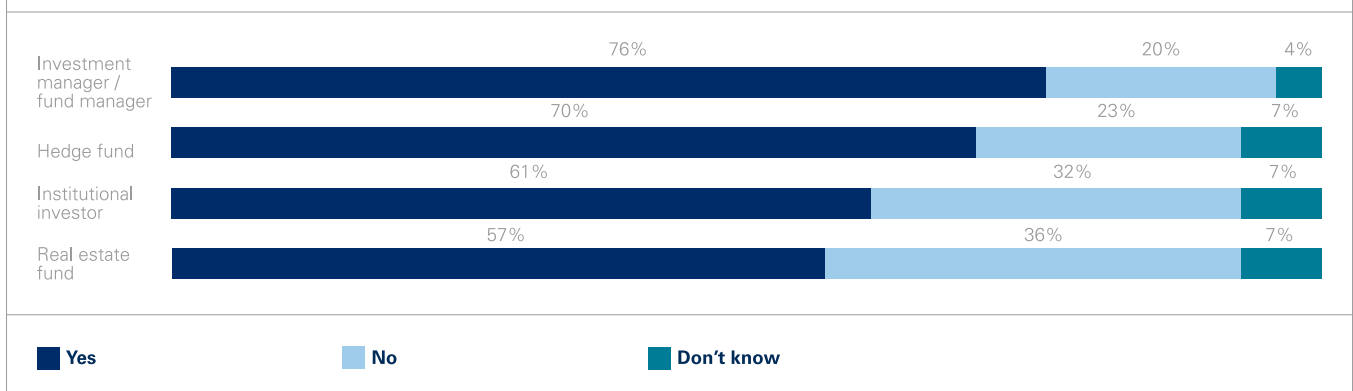
Investors are at greater risk still, with about one in three (32 percent) of the institutional investors that invest in instruments such as derivatives, CDOs or structured products saying they have no in-house expertise for these. If the fund management industry is to retain the trust of investors, it would seem imperative for it to both develop the necessary skills and then offer these skills to investors.

Alan Greenspan, former chairman of the US Federal Reserve, believes investors were helpless to resist risky instruments. He has been widely quoted as saying they became addicted to asset-

backed securities that offered additional yield over treasury bonds as if they were 'cocaine'. Investors are not alone in displaying such an addiction. A high proportion (40 percent) of fund managers say they have bought a product for which they did not have the framework to assess the risk. While the vast majority of mainstream fund managers and hedge funds have bought or developed risk systems, the finding provides evidence that these systems have either become outdated or were not entirely suited to the purpose in the first instance. Less than half (42 percent) of fund management firms say they can quantify completely their exposure to complex instruments and just one-quarter (24 percent) say they can completely quantify the risk associated with the exposure (see Chart 6).

The head of sales at a European risk technology provider says: "Firms are developing products using instruments such as bank debt, loans, derivatives, which they have not managed before. They are looking to open up new avenues in terms of markets and clients. But this creates a dilemma because cross-asset class cashflows are not easy to track."

Chart 5 Answers from all respondents in various categories to the question: If your firm/fund uses any complex financial instruments, does it have in-house specialists with relevant experience of these?



Source: Economist Intelligence Unit survey, March - April 2008

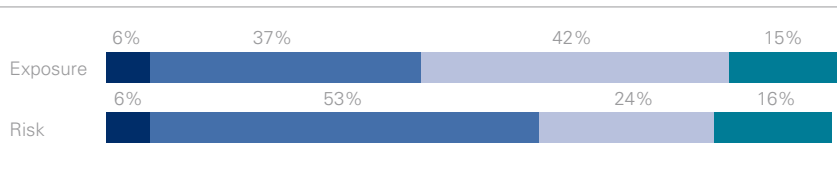
Investment managers reveal holes in their risk processes, continued

One of the issues is whether fund managers are identifying and tackling the right types of risk. Less than half (41 percent) of fund managers think their principal measure of risk reflects the majority of the risk an investment firm is taking and just 6 percent think this measure completely reflects the actual risk of loss. This rises to 10 percent among hedge funds, which tend to have greater experience of managing complex strategies. The managers often cut their teeth on trading floors and have an understanding of both trading strategies and the instruments used (the aggregated answers from all respondents are shown in Chart 7).

One of the world's biggest fund of hedge funds, with US\$38 billion under management, has a two-tiered approach to managing risk in its portfolios. It has identified that its main risks are the prevailing macroeconomic environment and the selection of underlying managers. So it has developed top-down and bottom-up processes operating in tandem. Top-down asset allocation decisions are taken by an experienced four-person investment committee which has about 70 years' experience between them. The firm's chief executive says: "Top-down views are big creators of alpha in our portfolios."

The bottom-up process starts with a rigorous quantitative process but is ultimately guided by the firm's ability to get a close-up view of the managers, having built up relationships with them over two decades of being in the hedge fund business. The chief executive says: "The best managers come from firms we have known for a long time. They are frequently spin-outs from existing firms, sometimes second or third generations of a firm."

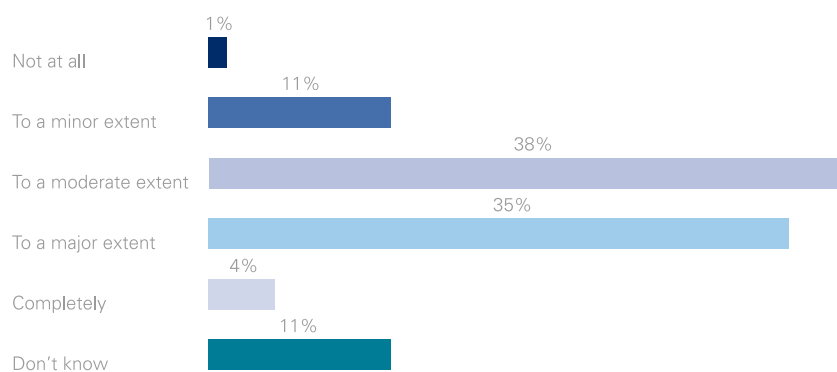
Chart 6 Answers from mainstream fund managers to the question: To what extent does your firm quantify the exposure and risk in complex financial instruments?



■ We can't quantify this at all ■ We can quantify this completely
 ■ We can quantify this in part ■ Don't know

Source: Economist Intelligence Unit survey, March - April 2008 based on responses from fund/investment management firms, real estate funds and retail fund managers

Chart 7 Answers from all respondents to the question: To what extent do you think your firm's principal measure of risk reflects the actual risk of loss to portfolio?



Source: Economist Intelligence Unit survey, March - April 2008

“Top-down views are big creators of alpha in our portfolios.”

Chief Executive, one the world's biggest fund of hedge funds

KPMG comment

Improved risk management has come into greater focus as a result of the market turmoil. Many of the currently employed risk management measures such as value at risk (VaR) or stress testing are backward looking in nature and lack the ability to take in current data or views about the future. For example, in ABS CDOs, one of the key shortcomings made in analyzing the risks in these products was that the underlying mortgage securities were more diversified than they turned out to be. We can now see that the mortgage securities were highly correlated and how sensitive they were to the decline in home prices. That information was not reflected in stress testing.

Another area highlighted by the credit crisis is the degree to which companies are subject to model risk. Many companies may be reliant on models to assess their credit risk or value their holdings. Yet these models may not have been validated by an independent party or have the proper risks and controls regarding their use. Federal Reserve Chairman Ben Bernanke recently said in a speech, “No model regardless of the sophistication, can capture all the risk that an institution might face. Those institutions faring better during the recent market turmoil generally placed relatively more emphasis on validation, independent review, and other controls for models and similar quantitative techniques. They also continually refined their models and applied a healthy dose of scepticism to model output.”

Rating agencies and investment banks criticized over transparency of products



86%

of respondents think conflicts of interest is a concern in respect of rating agencies

88%

of respondents think that lack of understanding of the instruments they rate is a concern in respect of rating agencies

While the infrastructure within some fund management firms may have proved with hindsight, insufficient to manage the risks they were taking, the external inputs have often been less than perfect too. Survey respondents think that both rating agencies and banks may have contributed to the lack of understanding of products. And yet fund managers and their clients alike have come to rely on the major rating agencies.

Where a vehicle was awarded a rating of AAA, the market, rightly or wrongly, took this to be a firm statement of quality. But in the last 12 months, a series of AAA-rated CDOs have been found to contain securities that were worth significantly less in a distressed market. A managing director of a large US-based investment firm says: "People relied blindly on credit ratings and mutual funds blindly bought products."

The investment community has been stung and this is reflected in the survey responses, where 35 percent of respondents agree that rating agencies provide an accurate assessment of whether an instrument will default (see Chart 8). Asked why this should be the case, some 86 percent cite conflicts of interest, while 88 percent say rating agencies fail to understand the instruments they rate. Other comments include an inability to respond rapidly enough to market and corporate events (see Chart 9).

The Chief Executive of an Indian risk management consultancy says: "The efforts by the rating agencies to improve their processes will not do anything to address the fundamental conflict of interest that exists in their business model; as long as companies pay for ratings that investors use, there will – from time to time – be crises like Enron, subprime and so on".

The rating agencies are said to be only a part of the reason why so many

asset managers and their clients bought products that have been found to be less than reliable. The originators of many of the products, the investment banks or manufacturers, also come in for criticism. About one-third (34 percent) of fund managers say they have been sold a product where the risk was under-stated by the originator (see Chart 10). This rises to 50 percent among institutional investors.

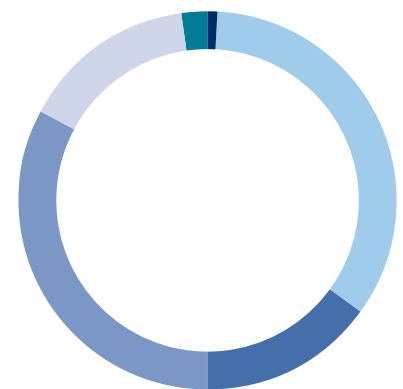
Respondents to the survey demand wholesale changes to the way the investment banks do business with them. The vast majority of respondents say they want investment banks to improve the risk transparency of products and about six in ten (59 percent) would like investment banks to change their remuneration structures to avoid over-zealous sales tactics (aggregated answers from all respondents are shown in Chart 11).

The head of financial systems at a European central bank says the current bonus system creates an incentive to take risks without being fully accountable for them. "At the upper end, the size of the bonus is not limited," he says. "Higher net profits generated by the employee translate into higher bonuses. At the lower end, however, the bonus is limited to zero. In other words, any losses are borne entirely by the bank and the shareholders and not by the employee."

He suggests three ways to improve the bonus system. Firstly, bonus schemes should be longer term. Instead of being primarily based on last year's performance, the bonus should take the performance of several years into account. Secondly, the level of the average bonus in investment banking should be reduced in order to take into account that potential losses are not borne by the employee. Thirdly, guaranteed bonuses should be abolished.

Chart 8 Answers from all respondents to the question: To what extent do you agree with the following statement?

Rating agencies provide an accurate assessment of whether an instrument will default

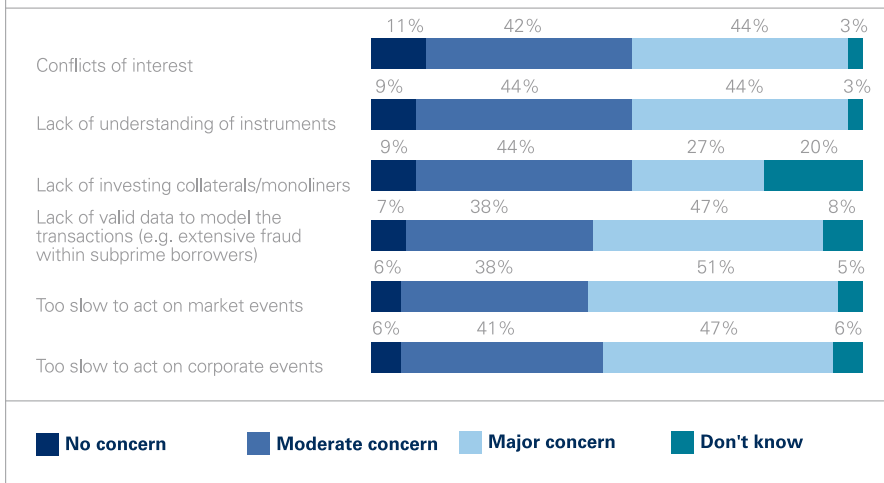


| | |
|----------------------------|-------------|
| Entirely agree | 1% |
| Somewhat agree | 34% |
| Neither agree nor disagree | 15% |
| Somewhat disagree | 33% |
| Entirely disagree | 15% |
| Don't know | 2% |
| Total | 100% |

Source: Economist Intelligence Unit survey, March - April 2008

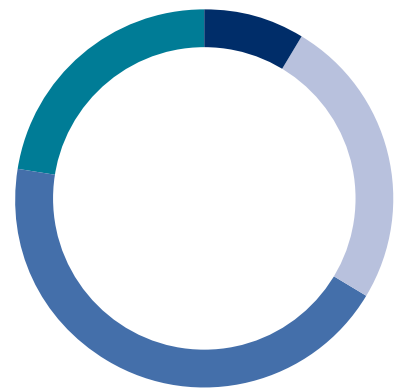
Rating agencies and investment banks criticized over transparency of products, continued

Chart 9 Answers from all respondents to the question: In your view, how much of a concern are the following issues in respect to ratings agencies?



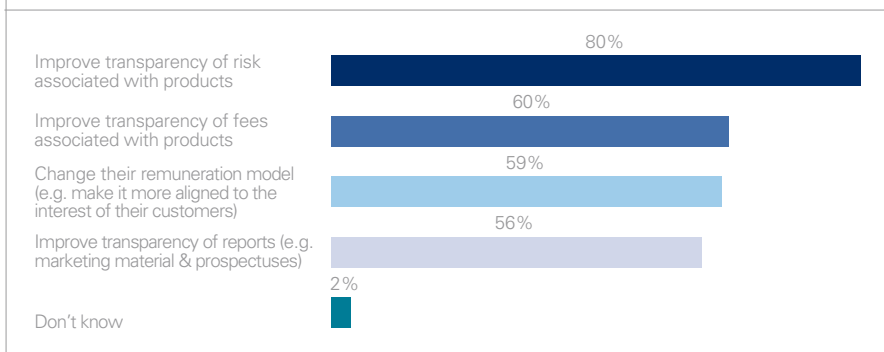
Source: Economist Intelligence Unit survey, March - April 2008

Chart 10 Answers from mainstream fund managers to the question: Do you believe your company has been sold a financial product/instrument in the past 12 months in which the seller either knowingly or unknowingly misstated its level of risk?



Source: Economist Intelligence Unit survey, March - April 2008 based on responses from fund investment management firms, real estate funds and retail fund managers

Chart 11 Answers from all respondents to the question: Which of the following would you like investment banks to do differently over the next two years? Select all that apply.



Source: Economist Intelligence Unit survey, March - April 2008

“ People relied blindly on credit ratings and mutual funds blindly bought products.”

Managing Director, US-based investment firm

KPMG comment

It is expected that the current slowdown may drive a wave of innovation in incentive plan design. We are already seeing some financial institutions shifting the balance of their incentive plans to greater reliance on long-term performance. The issue of symmetry of interests between investors and executives is crucial if management and shareholder interests are to be aligned. Rolling out of deferred annual bonus plans further down organizations could however be challenging, because of risks to participants, which is more of an issue at this level.

When reviewing the make up of compensation packages and addressing the mix of salary, bonus and long-term incentives it will be important to strengthen the links between client satisfaction and reward, and risk performance indicators and reward. The idea is to reward against a balanced set of performance indicators not just short-term revenue and profit targets. We believe that reward should include benchmark performance of the sector as a whole and should recognise the value of low volatility. For most organisations this may require a significant shift in organisational behavior and strengthening of performance management process and systems.

Time for a rethink on risk



38%

of respondents say that their firms have formalized operational risk frameworks in the past two years as a result of managing complex products or strategies

27%

of respondents are planning to formalize their firms operational risk framework in the next two years complex products or strategies

As noted earlier, fund management has emerged, thus far, relatively unscathed from the credit crisis. But there is evidence of complacency in the sector and this should serve as a warning sign. Some firms simply cannot assess the type and size of the risks they are taking, and court disaster. And uncritically accepting another person or company's advice on products is inadvisable – especially if that person or company stands to gain by playing down the true risks.

One of the keys to managing complex strategies and instruments would seem to lie in the skills of an investment firm's staff allied to formal processes and technology. However 41 percent of respondents think that even when their company's internal processes were not able to adequately assess the risk of a particular instrument, the company still invested in that instrument (see Chart 12). As the chief executive of a pan-European institutional investment firm says: "You have got to build a risk management culture."

This process has, in many cases, already started. A sizable number (38 percent) of respondents to this survey say that their firms have formalized operational risk frameworks in the past two years as a result of managing more complex strategies, with another 27 percent planning to do so over the coming two years. In practice, this entails an increased focus on areas such as key performance indicators, risk mitigation programs and risk communication programs.

In Western Europe, more fund management firms (42 percent) have already made changes in this respect than the proportion of North American firms (36 percent). In the next two years, a further fifth of respondents in North America and Europe are expected to improve their risk frameworks, and a full third of Asian respondents will do so, which suggests a concerted attempt by Asian firms to match their Western competitors.

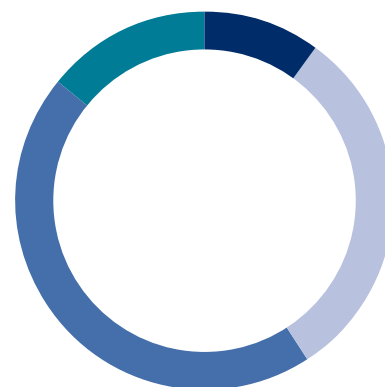
Valuation methods have come under intense scrutiny during the credit crisis and a third of firms (34 percent) say they have reviewed this activity, while a further third (33 percent) will do so in the next two years (see Chart 13). An even higher proportion, 38 percent, say they have reviewed governance arrangements – particularly relevant in the cases of funds that used risky instruments to enhance returns on supposedly low volatile funds – and 25 percent say they will do so in the next two years.

In addition, spending on risk and compliance looks set to rise significantly in the next two years, particularly in Asia Pacific where 93 percent of respondents plan to increase spending, compared with 87 percent in Western Europe and 88 percent in North America. Human capital forms a significant portion of expenditure on risk and compliance. Industry experts suggest that fund management firms have increased the size of their risk and compliance staff by 50 percent over the past three years. This is a result of pressure on firms to improve their management of complex instruments, according to the principal at an industry forum. "In the past, derivatives just sat in a block at the bottom of the portfolio. Now pension funds want to know why they are being used," she says.

At the same time, implementing risk controls is not necessarily evidence of the ability to manage risk. The chief risk officer of an Australian bank, which manages over US\$100 billion of infrastructure assets, says: "You can give investors all the numbers in your stress-tests. But as an investor, you will still ask: 'What type of person did the stress-test, under what conditions, and with what supervision?' The variables are endless." In other words, a certain amount of thought and consideration, as well as hard cash, is required to create a risk-aware organization.

Chart 12 Answers from all respondents to the question:

Do you believe your company has invested in a financial product/instrument in the past 12 months for which your internal processes were not able to adequately assess the risk?



| | |
|---------------------|-------------|
| ■ Yes, I'm certain | 10% |
| ■ Yes, I suspect so | 31% |
| ■ No | 45% |
| ■ Don't know | 14% |
| Total | 100% |

Source: Economist Intelligence Unit survey, March - April 2008

Time for a rethink on risk, continued

Banks and fund managers may not be afforded the time and space to rethink their processes. Politicians and regulators across the world have watched in shock over the past year as some of their biggest institutions have run into trouble. They may not want to wait for each individual institution to reach sensible conclusions about what best practice risk management entails before acting. The vast majority (82 percent) of survey respondents believe there will be more regulation for complex instruments in two years' time (see Chart 14). The deputy chairman of a Swiss-owned investment house says: "Sarbanes-Oxley was the upshot of the problems we saw in 2001. I think there will be a major increase in regulation this time too, probably focused on the investment banks."

Will new rules necessarily help to protect investors, though? Regulation may help focus minds, but it can also be a blunt instrument. The chairman of a UK-based financial advisory firm argues that the Basel regime for capital adequacy, for instance, does "nothing to constrain credit booms. Its effect, if any, on the crisis will be to deepen it further".

A period of reflection and self-regulation is likely to benefit the banking and fund management industries and their customers far more than a slew of regulation delivered by policymakers with a partial understanding of the issues. Banks and fund managers may have limited time to do so, though: only rapid remedial action by both groups working together on their shared problems is likely to help solve their problems without outside intervention.

Chart 14 Answers from all respondents to the question: To what extent do you agree or disagree with the following statement?

There will be greater regulation for complex instruments in two years time

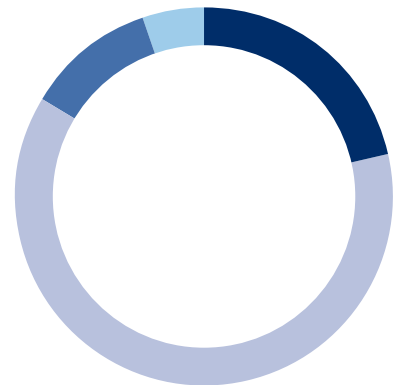
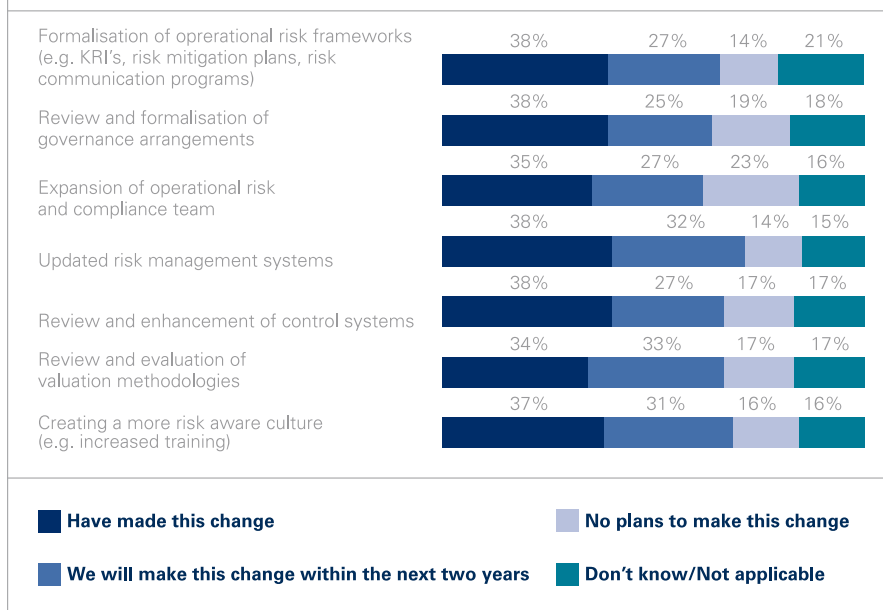


Chart 13 Answers from all respondents to the question: What changes has your firm made to its operational risk framework over the past two years as a result of adopting complex/alternative products and strategies? And what changes do you expect your firm to make in the next two years?



| | |
|----------------------------|-------------|
| Strongly agree | 21% |
| Neither agree nor disagree | 11% |
| Agree | 61% |
| Disagree | 5% |
| Don't know | 0% |
| Total | 100% |

Source: Economist Intelligence Unit survey, March - April 2008

“As an investor, you will still ask: ‘What type of person did the stress-test, under what conditions, and with what supervision?’ The variables are endless.”

Chief Officer at an Australian bank

KPMG comment

With the required implementation of fair value accounting (FAS 157) coupled with the seize up of the credit markets, participants have been challenged to determine the fair value of complex securities. We have seen many KPMG member firm clients enhance their valuation techniques and processes to arrive at a value. In the absence of a trading market, no one valuation technique has all of the information. Managers are best served by using a variety of valuation techniques, differing viewpoints and information from both within and outside the organization to triangulate to a value.

That said, enhancements to valuations still need to evolve, as many market participants are not content with what they consider to be an overly burdensome rule based FAS 157. Many feel that market valuation reference points like ABX are forcing them to make accounting entries that are not consistent with the true economics of the securities they are valuing. Dislocated markets are not always producing consistent data points and market participants are having a difficult time discerning between true market prices and ‘distressed’ prices.

The depth and breadth of risk management activities within the investment management industry vary considerably, and typically fall behind those which we observe in banking.

Best practice risk management for the fund industry is reliant upon empowering the independent risk function to provide a challenge on the suitability of investments, ensuring that the fund stays within investment mandates, and that these investment mandates are sufficiently granular and focused to ensure that the fund’s investment strategy is in line with the fund’s risk appetite as defined by the investment prospectus. In order for this to work, funds need to retain and recruit qualified risk professionals and conduct more rigorous risk assessments of new investment opportunities.

The risk management around liquidity matching between investor redemption terms and underlying assets needs significantly greater focus.

The way forward: where can investment managers add value?



55%

of respondents believe the fund management industry will manage more assets in two years than it does today

This report has sought to examine some of the challenges fund management firms currently face and some of the strategies they have adopted, or plan to adopt. It remains to take a glimpse into the future and focus on how they can translate the lessons of today's turmoil into better returns and higher assets.

Certainly, an increase in assets and returns is not guaranteed if fund managers fail to add value. Only slightly more than half (55 percent) of respondents believe the fund management industry will manage more assets in two years than it does today (see Chart 15). That rises to 60 percent among mainstream fund managers themselves.

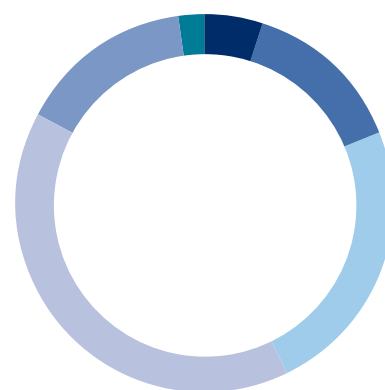
One of the key courses of action is to seek to avoid the herd mentality – which can inevitably increase risk – and instead develop a unique selling point, whether that is on the investment or risk side of the business. As the Asia-based wealth management head says: “Everyone is looking for something new. In the end everything becomes commoditized, so it is important to look for the new, the thing that differentiates you in the market.”

The worry is that investors may reject further innovation, particularly if it involves complex strategies and instruments. A significant 70 percent of investors say the credit crisis has reduced their appetite for complex products by a major or moderate extent (see Charts 16 and 17). The fund management industry will need to balance these competing demands: the need for innovation and differentiation on the one hand and the demand for greater simplicity from their clients on the other hand. To prove the doubters wrong, they will need to develop products and services that perform well over the cycle and in changing economic environments.

Other types of funds also have the potential to perform through cycles. Infrastructure funds have, to date, demonstrated such characteristics. They have certainly convinced some investors of their all-weather credentials: in May, despite the continuing credit problems,

Chart 15 Answers from all respondents to the question: To what extent do you agree or disagree with the following statement:

The fund management industry will manage fewer assets in two years than it does today



| | |
|---------------------------|-------------|
| Strongly agree | 5% |
| Agree | 14% |
| Neither agree or disagree | 24% |
| Disagree | 40% |
| Strongly disagree | 15% |
| Don't know | 2% |
| Total | 100% |

Source: Economist Intelligence Unit survey, March - April 2008

The way forward: where can investment managers add value? continued

Morgan Stanley raised US\$4 billion for a new infrastructure fund, substantially exceeding its target of US\$2.5 billion. And Global Infrastructure Partners, a private equity firm backed by Credit Suisse and General Electric, announced it had raised US\$5.6 billion.

In the retail and pension sectors, there are signs that investors could be attracted by products that manage assets dynamically over long periods. These products aim to reduce complexity for individuals who do not have the time and expertise to choose and manage their own investments. A wealth management head says: "A lot of modern products are around a fixed time-period now. We are coming full circle back to the days when asset management was an offshoot of the life insurance business. Products that have

a life-duration aspect – combined with some sort of capital guarantee – could be the way forward."

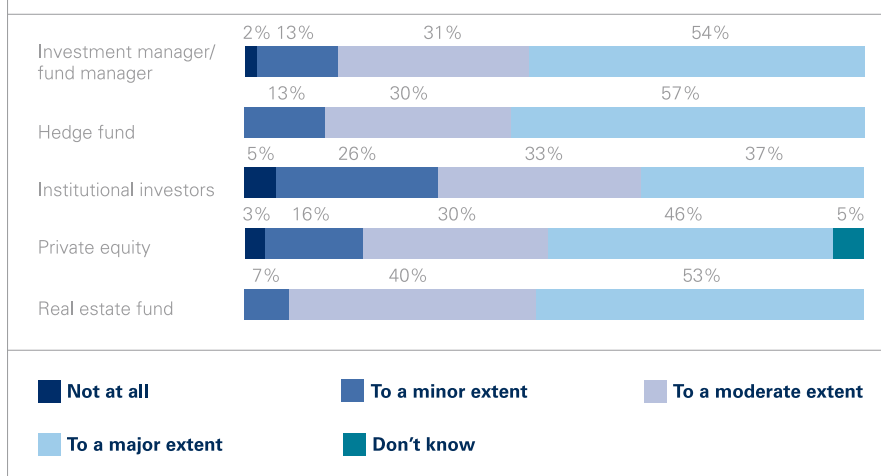
There could even be demand for a successor to the endowment, which is a long-term product that was designed to smooth out volatility and provide stable risk-adjusted returns. It has declined in popularity since its heyday in the 1980s due to underperformance linked to high charges and falling interest rates. The global head of product development at one of the world's largest commercial and investment banks, says: "It was a great product but was killed by its faults. If we could create a long-term product like the endowment, which did not have the inherent problems, it could be real winner."

Some fund managers, including Fidelity, have all-in-one lifestyle funds,

50%

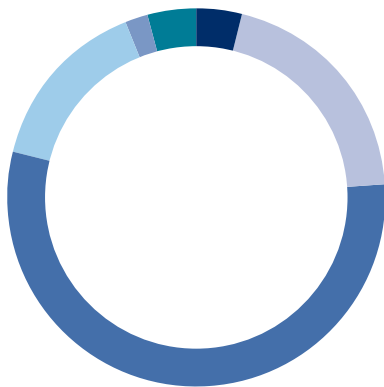
of fund managers surveyed believe they have sufficient in-house skills to run strategies outside their core activities

Chart 16 Answers from all respondents in various categories to the question: In your view, to what extent has the credit crisis reduced investors' appetite for complex instruments and strategies?



Source: Economist Intelligence Unit survey, March - April 2008

Chart 17 Answers from all respondents to the question: **In your view, how long will it take for the market's appetite for complex instruments to return?**



| | |
|-------------------------------|-------------|
| ■ Up to 6 months | 4% |
| ■ Between 6 months and 1 year | 20% |
| ■ Between 1 and 3 years | 55% |
| ■ Between 3 and 5 years | 15% |
| ■ Over 5 years | 2% |
| ■ Don't know | 4% |
| Total | 100% |

Source: Economist Intelligence Unit survey, March - April 2008

which hold a mix of shares and bonds. The weighting between the asset classes changes depending on the investor's age and risk profile. Asset allocation is likely to be a key differentiator for fund managers across the spectrum, not just those managing lifestyle funds. Given the divergence in performance between asset classes and the consequent importance of top-down asset allocation, demand for asset allocation advice is likely to increase. The need for diversification and the importance of manager selection could boost the demand for multi-manager products both in long-only and in hedge funds.

Unique selling points, however, can take many forms. The best 'edge' might, in the final analysis, accrue to those fund managers that offer a narrower range of products and services and demonstrate they have the risk and governance infrastructure to manage them prudently. They may resolutely avoid the temptation to dazzle clients with constant innovation. After all, as investors will attest, the worst thing fund managers can do is to attempt to manage assets without the requisite capabilities. The subsequent disappointment among investors could be devastating to the business. And the risks of this are real: only half of the fund managers surveyed believed they had sufficient in-house skills to run strategies outside their core activities.

The message is clear: fund management firms should stick to core competencies and innovate only where the infrastructure exists. Adhering to these principles means they will need to continue to hire and attract the human capital that can streamline risk and governance processes. This may entail paying more for people with marketable risk and governance skills and scaling back expenditure on a small number of 'star' managers.

As the global head of product development at one of the world's largest commercial and investment banks says: "People talk a lot about the 'war for talent', but I'm not sure war for talent is the best description of what investment firms are looking for. I think it is a war for knowledge and competence more than anything. With these attributes on your payroll, you'll do better than most."

The way forward: where can investment managers add value? continued

KPMG comment

The future of product design and management requires more focus on customer needs and service throughout the product life cycle. The importance of treating customers fairly from the product competitive advantage and regulatory perspectives results in the need for:

- senior management to ensure that the product strategy is well documented and not static – it should be subject to ongoing review and reflect feedback from distributors and consumers;
- a robust product development process which should identify the target market and will often be based on market intelligence and market demand. This is particularly important where fund managers do not actually deal directly with end consumers due to intermediated distribution methods. Firms should keep close links with their distributors to ensure their products reach the target market and;
- stress testing to validate the suitability of product characteristics including investment performance as well as liquidity management.

Challenges ahead: the keys to success

KPMG comment

| Key ideas from findings | Conclusion | Possible actions |
|---|---|--|
| <ul style="list-style-type: none"> Fund managers report falling returns and falling subscriptions – especially amongst mainstream fund managers | Although not as hard hit as the investment banking sector, the fund management sector has also been affected by the credit crisis | <ul style="list-style-type: none"> Business model review Strategy review |
| <ul style="list-style-type: none"> Investment managers are worried that the market has lost trust in them | The damage is not only short-term but also long-term and will require focus on building back trust | <ul style="list-style-type: none"> Enhancing client communications to restore trust Customer centric product development |
| <ul style="list-style-type: none"> Fund managers have started to address challenges by getting the right skill set and the right risk measures | Industry recognizes that products became too complex for them to understand due to the lack of internal know-how (from sales to valuation and risk management) | <ul style="list-style-type: none"> Recruit from investment banks to gain know-how |
| <ul style="list-style-type: none"> Rating agencies have been challenged to keep ratings up with the changes in the market | Fund managers trusted rating agencies and ended up with more risk than they thought they were taking | <ul style="list-style-type: none"> Review risk and valuation models More focus on own analysis |
| <ul style="list-style-type: none"> Many fund management firms are already implementing changes around their risk and compliance framework, their valuation methods and their governance arrangements | Firms are significantly enhancing investment risk processes and governance | <ul style="list-style-type: none"> Regulation may emerge to drive change. In some cases self-regulation will be the starting point Upgrade of people, processes, governance and incentive plans re-engineered |
| <ul style="list-style-type: none"> Many fund management firms think their returns and assets could fall in the next two years and they see demand for complex instruments falling | Concern about falling demand for complex instruments and falling returns and growth means firms are likely to concentrate on reviewing the client proposition in the short-term | <ul style="list-style-type: none"> Fund managers will need to re-design their client propositions focusing on what clients want and can understand while at the same time developing unique selling points in order to stand out from competition |

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