White Paper:

Outlook for 2015 – Major Industry Issues and Implications

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I. Introduction

As we enter 2015, key issues facing the hedge fund community are the pace of institutional allocations, the growth of new manager talent, consolidation in the industry, mergers and acquisition, the evolving role of funds of funds, the development of asset management firms and the growing role of liquid alternatives.

These topics and their implications will be discussed in the white paper. Infovest21 discussed these issues with many hedge fund participants and observers to provide its outlook for 2015.

Institutions reassess hedge funds

One of the major events in 2014 was California Public Employees' Retirement Association's decision in September to terminate its hedge fund investment program. That decision sparked other pension funds to reassess the role hedge funds play in terms of risk exposure and return profiles. Whereas hedge funds had historically been the default format to gain those sorts of risk exposures, they are increasingly being seen now as one way an investor can get those risk exposures. Liquid alternatives, replication or separate accounts are other ways being considered. [1]

Another implication going forward is that investors are increasingly acting as a collective group. Some pensions are discussing investment pooling, piggybacking with larger public plans or investment bundling through collaborative RFPs.

Despite CalPERS' termination of its hedge fund program and lackluster hedge fund performance in 2014, asset flows to hedge funds were strong as other institutional investors continue to seek alternative exposure to traditional equity and fixed income. The momentum is expected to continue in 2015.

Asset raising environment

In the last couple of years, a broader investor base has become more interested and involved with hedge funds. Liquid alts opened hedge funds to the accredited investor – the smaller end of the higher net worth investor.

An important point is that different investors have different performance goals. For example, tax-exempt institutions are looking for non correlation so a diversified lower volatility strategy works. Taxable high net worth investors need higher returns to compensate for hedge funds' tax efficiency.

As the investor base for hedge funds broadens out, hedge funds are being viewed as less alternative and more mainstream.

Start-Ups

Managers that started in 2013 and 2014 generally have generated very good performance, providing momentum for start-ups in 2015. A number of spin-offs in 2014 raised more than $1 billion for their launches.

Family offices and private equity firms are becoming more active in seeding.

Seeding in Asia continues to gain momentum. Experienced Asian portfolio managers who have set up and run regional hedge fund offices in Asia are increasingly seizing on investor interest. Many Western-trained Asians are building businesses that provide access to local markets. Many of these markets, especially on the private equity and real estate side, are difficult for non residents to access. [2]

Mergers & Acquisitions

Two forces are driving M&A. First, older founders and/or key principals at firms that are smaller are reaching a stage where an exit might be the sensible course of action. These firms generally do not have a succession plan and could be good candidates for acquiring firms looking to growth their platforms. [3] Second, as institutional money continues to pour into hedge funds, larger hedge funds are looking to expand products by acquiring smaller platforms. [4]

Managers monetize some of the equity while maintaining control. They can also benefit from technology, compliance and possible access to investors and broad distribution.

For those managers that don't transact with an outside buyer, an internal recapitalization program, pricing trend and valuation measure have been established.

Other large asset managers are making strategic acquisitions in order to grow assets and capture capabilities.

Private equity firms e.g. Neuberger Berman's Dyal, KKR, Goldman Sachs, Affiliated Managers Group, Foundation Partners, and Carlyle have actively been diversifying their businesses by taking minority stakes in hedge funds.

Some hedge fund observers expect to see increased partnerships between hedge fund managers and long-only funds. Pensions may increasingly hire hedge fund managers for long-only mandates because of their differentiated fundamental research and investment process. [5]

With long-only managers pressured by commoditization from passive investing and ETFs, alpha generation is so key so that the traditional asset manager will look to partner with hedge fund managers that may have a stronger active sell-side discipline. [6]

Funds of Funds

Some positive signs are appearing in the funds of funds space e.g. inflows are starting after three consecutive years of outflows.

The best positioned funds of funds are those that offer differentiated product as well as those that can deliver on changing distribution requirements. The shift is for individuals who can have a conversation at the portfolio level instead of just the portfolio level.

Funds of funds are evolving in three different directions – converging with consultants, specializing and providing customized services, or becoming a full-fledged asset management firm.

These hedge funds and funds of funds that are evolving into asset managers, offer different products and diversify their revenue stream. Some are adding private equity and longer lock-up strategies such as distressed recovery funds and commercial loan obligations. Some are adding long-only strategies and/or liquid alternatives. Co-investments are also increasing in frequency.

Growth of liquid alts

Short term growth is expected to come from larger multi-family offices and wealth advisors. Long term growth, however, is expected to come from retirement plan market. Target funds and defined contribution plans have yet to embrace liquid alts. Fees have to go lower and track records need to get longer.

Multi-manager funds may have better initial traction given their diversification. They will serve as a "gateway" for retail investors similar to funds of funds for pensions in the late 1990s/early 2000s. Pensions used fund of funds as a way to create a hedge fund allocation and educate themselves. Many retail investors may follow a similar path. [7]

II. Institutions Reassess Hedge Funds

California Public Employees' Retirement System, UK's Local Pensions Fund Authority and Dutch Pensioenfonds Metaal en Techniek were among the large pension funds that dropped their respective hedge fund programs in 2014. Other pensions such as UK's Railway Pension Scheme are reassessing their situation. The main complaints have been lack of transparency; high fees; lackluster performance; and complexity of selecting, monitoring and managing hedge funds.

As the largest US public pension fund and a pension pioneer in hedge funds, the CalPERS announcement was particularly noteworthy. CalPERS said it paid $135 million in fees for its hedge fund managers in 2013 which accounted for $4 billion of their assets i.e. 1.3% of the $298 billion total portfolio. The hedge fund portfolio returned 7.1% in FY2014, contributing 0.4% to the pension's total return.

CalPERS' decision on absolute return hedge funds brought the issue to the forefront - what is the value the institution is getting out of its alternative investments platforms? Does it make sense from a return standpoint? risk-mitigation standpoint? Are the fees in alignment for what institutions are paying for these exposures? [8]

Some institutions e.g. New Zealand Super Fund and London Pension Fund Authority are building internal teams to replace external hedge fund managers. Others have been moving into "smart beta" products where the fees are less.

Risk exposure versus legal structure

Some say a number of hedge fund programs haven't lived up to their billing. "That isn't an indictment on hedge funds. Investors are re-thinking where hedge funds fit in terms of risk exposure and return profile in different market situations." [9]

"Hedge funds have been the default format to gain those sorts of risk exposures. That is changing to hedge funds being <u>one</u> of the formats in which an investor can get these risk exposures which is most appropriate for that investor." [10] CalPERS' decision is accelerating the trend towards saying there are multiple ways of getting these risk exposures, whether through hedge funds, liquid alternatives, replication or separate accounts. [11]

Some point out that hedge funds were never an asset allocation but a legal structure. "There is now maturation in the market place where investors are thinking about the legal structure and whether it is the appropriate structure for the risk exposures they want and the investment products they want. We're going to wind up with asset allocations that are based on risk exposures rather than asset allocations based on legal structures." [12]

Fee pressure/ Pooling arrangements

Fee pressure is hitting managers and liquid alts (see page 28 for additional details on liquid alts fees).

Innovative thinking is occurring on the fee front. For example, in its fee resolution passed in February, Orange County Employees' Retirement System advocated P-shares where public pension funds receive lower fees if their aggregate investments exceed certain thresholds. There is graduated pricing based on aggregate public fund investments where fee tiers are based on individual account size. For example, P-1A, P-2A and P-3A share classes for investments of $25, $50 and $100 million if total public pension investments are greater than $250 million. P-1B, P-2B and P-3B share classes would exist with lower fees for $25, $50 and $100 million if total public plan investments are greater than $500 million. OCERS also supports hard hurdles where the investor pays for alpha, not beta. [13]

Investors are increasingly acting as a collective group. Some public pensions are discussing investment pooling in states where there is significant decentralization and assets (e.g. California, Pennsylvania, Florida, Michigan, Illinois and Texas) or across state lines with a national buyers' cooperative. A cooperative alternatives platform structure would permit portfolio customization with individual funds on the platform.

Other approaches could include piggybacking with larger public plans as host or investment bundling through collaborative RFPs. In collaborating through bundled bidding, there would be a joint RFP and joint selection committee to improve bargaining power but individual boards would remain independent.[14]

Another example is The Alignment of Interests Association, a group of investors, which put forth best practices in early December. Proposals included:

- Hurdles - Managers should produce alpha above benchmarks before charging incentive fees. There should be minimum return levels before charging performance fees.

- Claw backs – Incentive money can be returned to clients if they have losses or lag their benchmark. Performance fees should be no more than once a year rather than monthly or quarterly.

- Management fees – Management fees should cover reasonable operating expenses and not be used to generate profits.

- Operating expenses – Operating expenses should be disclosed to investors.

- Employee-only funds that aren't available to investors should be disclosed to investors.

- Notification of legal/regulatory inquiries – Funds should notify clients of non-routine legal or regulatory issues.

Strong asset flows to continue

eVestment's 2015 Hedge Fund Industry Outlook, based on its quantitative data and analysis, predicts that hedge funds are positioned for another year of solid growth as institutional investors seek to gain alternative exposures to traditional equity and fixed income. Institutional investors will maintain their investment and continue to allocate more to hedge funds in 2015.

Barring a major financial market event, eVestment expects asset flows into hedge funds of at least $90 billion to $110 billion in 2015. If a major market event were to occur, then only the most defensive asset classes would gain new assets in the very short term.

Despite lackluster hedge fund performance in 2014, eVestment finds that through November 2014, investors allocated over $112 billion to hedge funds - 80% more than the full 12 months of 2013. This is the largest inflow into the industry on an absolute basis since 2007 but also surpasses 2010 on a rate-of-growth basis. eVestment concludes that the long term asset flow trend is driven by institutional portfolio allocation decisions while performance determines the near-term distribution of those assets.

Year	Inflows ($B)
2012	25
2013	62
2014	112

A number of industry experts are forecasting increased volatility in both the equities and fixed income markets in 2015 due to reduced central bank involvement.

Historically, higher volatility has benefitted many alternative strategies. From that perspective, 2015 could be a better year than 2014 for most funds in the alternative space in terms of performance relative to traditional benchmarks. [15]

With fundamentals back at work, renewed interest exist in long/short equity strategies. Some interest is being seen in macro strategies which have been relatively underperforming over the past several years. [16]

According to one third party marketer, there is large interest in sector specific strategies e.g. technology, health care.[17] Investor interest has been strong in private equity, real estate and other high yielding or yield driven strategies.

Others highlight a cooling off of credit-based strategies unless they have a trading orientation and proven track record of delivering alpha and going short.[18]

Others point out that a large number of investors are chasing the Europe trade. Some people are concerned there is too much of a herd mentality.

Based on a quantitative analysis, for 2015, eVestment predicts distressed, a subset of credit, is positioned to see more than the $9 billion it saw in inflows in 2014.

Multi-strategy hedge funds are headed for another good year in 2015 with flows that may surpass the $48 billion seen in 2014 YTD while macro and managed futures fund flows will likely lag other segments.

eVestment forecasts continued flows into equity focused strategies though at a lower rate than in 2014. Credit strategies will likely see growth similar to that of 2014 which is below the accelerated growth of 2012-13.

III. Asset Raising

Broader investor base

While the hedge fund investment environment seemed brighter in the past year compared to prior years, it was challenging from a sales perspective. Following the post financial crisis, the hedge fund industry started to come back to life in 2010-2011. Asset flow was clearly directed toward the larger, more well known brand names. Not all types of investors were on board at that time.

In the last couple of years, more investors became interested in hedge funds through liquid alts (UCITS and '40 Act mutual funds). Liquid alts opened hedge funds to the accredited investor – the smaller end of the higher net worth investors. (see additional discussion on page 28)

The perception of alternatives has dissipated due to increased transparency and regulation as well as the advent and growth of liquid '40 Act strategies/UCITS. Liquid alts cleared a path allowing smaller investors, their handlers and intermediaries, the ability to access these strategies with less operational difficulties (i.e. K1 tax reporting), regulatory, high fees and liquidity requirements. Alternatives are becoming more traditional.[19]

"Hedge funds are widely used in today's asset allocation modeling programs, transforming themselves from a once opaque and overtly complex set of strategies used by sophisticated institutional and ultra high net worth investors to a traditional asset class or approach used by many today." [20]

Different performance goals for different investor types

Different investors have different performance goals. For example, tax-exempt institutions look at hedge funds differently than taxable high net worth investors.[21]

Tax-exempt institutions seek investments that can deliver non correlated Libor plus 3-5%. Taxable high net worth investors are different. Due to the tax inefficiency of hedge fund investing, the return profile for high net worth investors are higher.[22] For lower volatility-oriented hedge funds, the bar is higher. They'll either lean toward fundamentally driven higher beta equity strategies (long bias, event driven or activist), high volatile non correlated CTA strategies or potentially low turnover, deep value strategies that can best maximize the return potential for taxable investors. Non correlated Libor+3-5% works for tax exempt investors, not for taxable high net worth investors. [23]

Divergence of performance was very wide in 2014

In 2013, most strategies did well. In 2014, some did very good while others were mediocre and some not so good. "We haven't seen that in the industry for years. The markets were harder in 2014. Certain strategies didn't do well in 2014." [24]

Trend following commodity trading advisors were one of the top performers in 2014 following a dismal 2013. Some activists did extremely well such as Pershing Square, Trian Partners while others such as Paulson & Co and Owl Creek suffered losses.
Such a situation provides an opportunity for the astute investor to find and exploit opportunities.

IV. Start-Ups

New manager talent is doing well

Managers that started in [2013 and] 2014 have performed very well. Investors have been very happy with 2014 start-ups which is going to give momentum to start-ups in 2015. [25]

For example, HFR data shows emerging managers gained 4.7% in the first nine months of 2014 compared with the broader index's 2.85% increase.

eVestment's data shows funds launched in 2013 gained 4.56% from January through November 2014 compared with the broader eVestment index of 2.85%. [26]

In Q3 2014, for the first time since 2009, inflows to both small and mid-sized firms exceeded the inflows to the largest firms. HFR reported that those with less than $1 billion in assets had inflows of $5.1 billion while mid-sized firms (those with between $1 billion and $5 billion) had $6.6 billion in inflows. The largest firms, those with more than $5 billion, had inflows of $4.2 billion. [27]

Top managers are still commanding most of the capital. The top 500 managers overseeing $1 billion or more account for over 90% of all the investments in hedge funds. "That leaves over 10,000 managers competing for crumbs. Managers must look for alternative pools of capital in order to compete and remain viable. The odds are heavily stacked against them."[28]

In the first nine months of 2014, 814 funds launched which is about the same pace as in 2013. [29] Start-ups have been across the board, particularly long/short equity and special event. Not too many quantitative start-ups are seen as it is perceived as too complicated. [30]

A large number of the spin-offs have been quite successful. The largest managers dating back 5 to 15 years ago are now being populated by the second and third generation. The good ones are being recognized and raising significant pools of capital early. These managers are also being selective in the amount of capital they want to take in so they don't suffer the same fate of some large managers prior to the crisis. Most star managers today are better suited to managing their investment portfolios than portfolio platforms.[31]

Fine Point Capital, Two Creeks Capital, Three Bays Capital and Dansana Capital are among the start-ups that raised over $1 billion in 2014. Herb Wagner, who had been co-portfolio manager at Baupost, raised $2 billion for Fine Point. Ryan Pedlow, who had managing director at Ziff Brothers Investments, formed Two Creeks Capital Management and raised $1.5 billion. Matthew Sidman, who had been at Highfields Capital Management for 14 years, launched Three Bays, an event driven fund, on January 1, 2014 with more than $500 million. Within months, Sidman had raised over $1.2 billion. Anand Desai, former senior portfolio manager at Eton Park Capital, formed Darsana Capital Partners and raised $1.2 billion for a June launch.

A Sampling of the Largest Start-Up Launches 2014

Fund	Principal	Estimated Amount Raised ($M)	Launch	Prior Firm/Position
Fine Point Capital	Herb Wagner	2000	May 2014	Co-portfolio manager at Baupost Capital
Two Creeks Capital	Ryan Pedlow	1500	Aug 2014	Managing director/financials sector head at Ziff Brothers
Three Bays Capital	Matthew Sidman	1200	Jan 2014	Portfolio manager at Highfields Capital
Darsana Capital Partners	Arnard Desai	1200	June 2014	Senior portfolio manager at Eton Park
Aravt Global	Wui Yen Liow	870	Feb 2014	Managing director/sector head at Ziff Brothers

Growing role for family offices and private equity firms in seeding

Some family offices are seeding managers for the first time. Their allocation size tends to be smaller and they take a different revenue share. Some are seeding only one entity. With traditional seeders, there has been a fairly narrow set of terms. Now, with family office participation, the terms are more skewed.

Some family office names that have recently seeded new hedge funds include Joseph Tsai, vice chairman of the Alibaba Group Holding, who pledged close to $100 million through his family office, Blue Pool Capital, to Hong Kong-based Andrew Bazarian. Bazarian's Pinyon Capital was one of the largest Asian start-ups in 2014. Bazarian had previously been a portfolio manager at SAC Capital Advisors.

The Tanger family seeded Shuster Tanger's Red Alder fund with $30 million. Tanger had previously been an analyst at Third Point.

Audrey McClendon, the former founder of Chesapeake Energy and current head of American Energy Partners, and a group of investors invested in Jason Strasser and William Cooper's Caption Partners.

Private equity firms are also relatively new and active players in the seeding space. A growing focus is on Asia.

TPG Capital is starting to seed Asian hedge funds in partnership with HS Group after it bought a stake in HS Group. Meanwhile, KKR is taking a minority interest in Feng Hsiung's Hong Kong-based Acion Partners. Blackstone Group seeded Jason Brown's Arkkan Capital Management, its second Asian hedge fund.

A few innovative seeders are capping seeded managers' assets under management so that performance is more important than asset gathering. "I'd rather have a 20% performance fee on 15% gross returns than 20% of a management fee on $9 billion where the manager is not performing. You don't need $3 billion or $9 billion in assets under management if you're performing," says one seeder.

Asian managers
Interest in Asian managers is expected to remain high.

Over the past year and a half, the supply of managers in Asia has been motivated by the Dodd-Frank Act and Volcker rule, which has forced the closure of most investment banking proprietary trading desks and financing of hedge funds. This has motivation many very high quality managers to open their own asset management businesses.[32]

Experienced portfolio managers and analysts who have set up and have run regional hedge fund offices in Asia want to seize on growing investor interest.

One seeder observes that a number of Western-trained Asians look at their home market as offering opportunity. "These people believe they can build a business by providing access to local markets. We believe they can attract Western capital to their home markets. They are very entrepreneurial. Many of these markets – especially on the private equity and real estate side – are difficult for non residents to access." [33]

"In Asia, managers have made great strides recently to improve the kind of infrastructure we require for investment. We find that very encouraging," observes another seeder. [34]

"What has changed very dramatically is that A- and B+ grade Asian managers – who formerly launched with $2-$10 million of Day One money and pursued a "build it and they will come" approach to marketing whereby they established a good track record in 6-12 months and assets then poured in – are no longer capable of building assets with this strategy. For managers to use platforms and seeders was formerly seen as a sign of weakness, now they are seen as vital to the success of those B+/A- managers. B grade managers and below will struggle to survive in this environment." [35]

V. Merger & Acquisition Activity

Two driving forces are at work with regard to mergers and acquisitions:

1) Older founders and/or key principals at firms that are smaller in scale are reaching a stage where an exit might be the sensible course of action. These firms generally do not have a succession plan and could be good candidates for acquiring firms looking to grow their platforms. [36]

2) Significant amounts of pension and other institutional money are still being allocated to alternative strategies. For larger hedge fund platforms that are looking to take advantage of this increased demand, they are looking to expand products by acquiring smaller platforms (as opposed to hiring more portfolio managers or doing lift-outs). Acquisition criteria would include potential targets that are high-performers with lengthy track records or potentially firms that manage specific strategies that could help the acquirer meet investor demand. [37]

Performance for some might not be a factor. "We definitely worked with some firms that had great performance in 2014. It did not necessarily make them a good acquisition candidate though because of other reasons like size, ability to replicate performance again in future years, etc," says one investment banker. [38]

Most alternative asset managers, particularly long/short equity managers, underperformed the broad market. It put potential sellers in a weaker position. If managers wanted to sell, it wasn't the year to sell when performance was sub-par. [39]

Monetization of equity interests

Traditional exit strategies for hedge funds have been selling interests to partners, or selling interests or entire companies to another financial institution. Now, private equity funds are [actively] raising capital to buy interests in investment management businesses. [40] Due to the capital those firms have raised, the monetization of equity interests is greater today than a year ago. These funds are a new and viable additional source for an exit strategy.[41]

Dyal, Blackstone, KKR and others have been diversifying their businesses by taking minority stakes in hedge funds. These private equity investors want long term income. As a hedge fund's assets grow, the fees grow. Minority stakeholders get a percentage of both management and incentive fees. About 75-85% of the fund's earnings go to shareholders.[42]

On the sell side, a number of big banks are selling their hedge fund stakes due to tighter bank regulations in Europe and the US.

The managers monetize some of the equity in the firm while maintaining control. They can benefit from technology, compliance and possible access to investors and broader distribution.

With a market value for its equity, the hedge fund can better retain portfolio managers. The financial flexibility allows it to cash out retiring partners or attract new talent.[43]

For those managers that decide not to transact with an external buyer, but would rather create an internal recapitalization program, a pricing trend and comparable valuation measure has now been established. “The internal recapitalization mechanism can facilitate, and work in conjunction with owners who care to implement a succession plan and other incentive programs, yet still build franchise value and liquidity for the hedge fund management company. While valuations are always dependent on specific firm characteristics, these transactions build a pricing trend.”[44]

The quality of the business viewed in terms of depth and experience of the team, diversification of product offering, repeatability of the investment process and alpha generation, and investor concentration are all important factors. Those firms that can demonstrate depth and consistency of revenue/earnings generation will always trade at the upper end of the valuation range.

Below is a summary of the active private equity firms acquiring minority stakes.

Dyal

Dyal Capital Partners' announced strategy for its first and second funds were to buy minority interests in 12-15 institutional hedge fund management companies that have assets ranging from $1 billion to $6 billion.

Dyal Capital Partners I closed in 2012 with $1.3 billion in assets. For Dyal Capital Partners II, Neuberger Berman’s goal is raising $1.5 billion.

Institutions tend to like this approach toward hedge funds. A number have invested or committed to invest in the Dyal funds including University of Michigan, Alaska Permanent Fund and the New Jersey Division of Investment.

Dyal is now working on its third fund where it is targeting 10-15 private equity firms each with assets between $2.5 billion and $5 billion. [45]

Dyal Capital Partners’ Equity Stakes (in chronological order)

Target	**Date Stake Acquired**	**Strategy**	**AUM at time of announcement ($B)**
Orchard Square Partners **	Dec 2014	Long/short credit	0.475
Providence Equity Partners	July 2014	Private equity	40.0
Blue Harbour Group	May 2014	Activist with collaborative approach	3.0
Waterfall Asset Mgt*	July 2013	Specialist credit	2.3
Capstone Investment	June 2013	Volatility	2.4

Advisors			
Scopia Fund Mgt	Jan 2013	Long/short equity	3.4
MKP	Dec 2012	Debt specialist	6.4
Pinnacle Asset Mgt	Dec 2012	Commodities fund of funds	2.3
Halcyon Asset Mgt	Dec 2012	Multi-strategy	13.0
MAST Capital Mgt	July 2012	Credit	1.5
Capital Fund Mgt	Dec 2011	Quantitative	5.1

*acquired a passive minority interest from MD Sass-Macquarie Financial Strategies. MD Sass-Macquarie Financial Services seeded Waterfall in 2007.
**acquired Ramius' interest

KKR
Henry Kravis said KKR is planning to take more equity stakes in hedge funds. He said acquiring investment firms that expand KKR's capabilities is a better use of its assets than repurchasing shares.[46] KKR uses its balance sheet to buy minority stakes rather than raise client money. [47]

KKR has been actively searching in Asia with its fast growing economies and diverse markets. In addition to taking an equity stake in Acion Partners, KKR is providing support and helping build Feng Hsuing's team. Hsuing plans to launch Acion Partners in the first quarter of 2015. He had been the Asian regional chief at York Capital, set up York's Hong Kong office, and co-managed the York Asian Opportunities Fund.

KKR has also shut down acquisitions. In May 2014, KKR liquidated KKR Equities Strategies after three years. The equity fund was run by Bob Howard and a team of traders from Goldman Sachs. The fund had about $510 million of which about $150 million was initially from KKR. KKR said the closure was due to lack of scale.

Citigroup analysts said the hedge fund generated revenue of about $4 million via management fees but high compensation of employees ate most of it up. "Senior management may want better risk-adjusted returns with capital deployed elsewhere."[48]

KKR's Equity Stakes (in chronological order)

Target	**Stake (%)**	**Announced Date**	**Strategy**	**AUM at time of announcement ($B)**
Prisma Capital Partners	**	2012	Fund of funds	7.8
Nephila	24.9*	Jan 2013	Catastrophe insurance	8.0
BlackGold Capital Mgt	24.9	July 2014	Credit investments in	1.4

			energy related companies and assets	
Acion Partners	N/A	Sept 2014	Asian event driven	Start-up

*a portion of the stake was owned by Man Group. Man bought a 25% stake in Nephila in 2008. After the transaction, Man retains an 18.75% stake. **Aegon which helped set up Prisma in 2004 sold its stake in the firm but remains a significant investor in Prisma's funds.

Goldman Sachs

Petershill Fund I was established in 2007 with $1 billion in assets. It focused on managers with four-to-five year track records and strong cash flow. Funds had revenue between $100 million and $1 billion, and assets ranged between $2 billion and $15 billion. Winton Capital and Capula Investment Management have been the big winners while Goldman Sachs lost money with Shumway Capital Partners and Level Global as both closed down in 2011.

Petershill Fund I intends to wind down before 2021. The most likely exit strategy is an IPO, or selling the portfolio to a publicly listed private equity manager or to private investors such as the hedge funds' original investors. [49]

Sampling of Petershill I Acquisitions

Fund	**Year Stake Acquired**	**% Stake**	**Strategy**
Winton Capital	2007	10	Managed futures
Capula Investment Mgt	2008	@20	Fixed income
Trafalgar Asset Managers	2008	@20	Takeovers, company restructurings
Longacre Fund*	2008	@20	Distressed debt
Claren Road Asset Management	2008	@20	Long/short credit
Shumway Capital Partners*	2010	8	Long/short equity
Level Global*	2010	@20	Long/short equity
Mount Lucas Management Corp	2010	@20	Global macro
Altana Wealth	2012	@20	Emerging markets, multi-strategy

*closed

Petershill Fund II's stated goal is taking 10-20% stakes in established hedge funds managers. It took a 10% stake in Caxton Associates, Knighthead Capital Management and Pelham Capital in 2014. It plans to raise more than $1 billion to make additional investments.

Sampling of Petershill II Acquisitions

Fund	Year Stake Acquired	% Stake	Strategy
Caxton Associates	2014	10	Global macro
Knighthead Capital Mgt	2014	10	Credit
Pelham Capital	2014	10	Equity long/short

Affiliated Managers Group

As of September 30, 2014, AMG's affiliates had an aggregate of $617 billion in assets under management in more than 400 investment products across a broad range of styles, asset classes and distribution channels. Companies in the alternatives space account for 36% of Affiliated Manager Group's products. It has minority stakes in AQR, BlueMountain Capital Management, ValueAct, Pantheon, EIG Global Energy Partners and First Quadrant.

AMG increased its stake in BlueMountain Capital Management in 2012. In December 2014, AMG increased its minority investment in AQR Capital Management.

AMG's Equity Stakes

Target	Strategy	AUM at time of announcement ($B)
AQR	multi-strategy	12 (2004) 115 (2014)
BlueMountain	Global credit	7 (2012)
ValueAct	Activist	6
Pantheon	Private equity fund of funds	22
EIG Global Energy Partners	Energy and energy related infrastructure	16
First Quadrant	Quantitative	11

Blackstone Group

Blackstone bought a minority stake in Senator Investment Group in February 2014. It has said it is raising $3 billion for similar acquisitions.

Blackstone Equity Stakes

Target	Stake (%)	Announced Date	Strategy	AUM at time of announcement ($B)
Senator Investment Group	Minority	Feb 2014	Event driven	6.7

Foundation Partners

Reports indicate that Deutsche Bank is in advanced talks to sell its 17.5% minority stake in Arrowgrass Capital Partners to Foundation Capital Partners. The price is reportedly between $100 million and $200 million for a 20% stake. [50] The multi-strategy fund spun out of Deutsche Bank during the financial crisis. This would include Deutsche Bank's share plus additional equity.

London-based Arrowgrass manages about $5 billion in assets. The deal, if completed, would value Arrowgrass at more than $500 million. It would also be the first minority stake for Foundation.

Carlyle

Carlyle has not actively made any minority stake purchases in the past two years.

Sampling of Carlyle's Minority Stakes

Target	Stake (%)	Announced Date	Strategy	AUM at time of announcement ($B)
Claren Road Asset Mgt	55	Dec 2010	Long/short credit	4.5
Emerging Sovereign Group	55	July 2011	Global emerging market equities and macro	1.6
Vermillion Asset Mgt	55	Oct 2012	Commodities focused hedge fund	2.2
AlphInvest Partners	60/40	2011/2013	Private equity fund of funds	44/44

Hedge fund managers and long-only funds

Access to multiple channels of distributions has been, and will continue to be a driving factor in M&A activity in this sector of asset management. [51]

Some hedge fund observers expect to see increased partnerships between hedge fund managers and long-only funds. "Active investing and deep fundamental research, focused not only investing on the longs but on the shorts, will drive combinations between long-only asset managers and hedge fund managers. With long-only managers pressured by commoditization from passive investing and ETFs, alpha generation is so key that the traditional asset manager will look to partnerships with hedge fund managers that may have a stronger active sell-side discipline," says an investment banker.[52]

These observers believe there will be a growing demand by pension funds to hire hedge fund managers for long-only mandates because of their differentiated fundamental research and investment process. As hedge fund managers begin to enjoy a stronger recurring revenue stream from the traditional institutional mandate (albeit at a different fee structure), hedge funds will view partnership opportunities with long-only managers as attractive for the cross-sell opportunities.[53]

Funds Closing

Through September, 661 hedge funds closed in 2014 compared with 608 funds in the same time period in 2013. Hedge Fund Research reports more than 200 funds closed in September 2014 alone. At that pace, more funds may close for the full year 2014 since 2009 when 1,023 funds liquidated.

Many of those closed in 2014 were macro funds (e.g. Woodbine Capital Advisors, Anderson Global Macro, Kingsguard Advisors) or commodity funds (e.g. Brevan Howard Commodity Fund, Hall Commodities) as oil prices plummeted.

Some expect to see more long/short equity funds close as they haven't kept up with the equity markets.

Some take the view that there are still too many mediocre hedge fund managers and a thinning out is not a bad thing. [54]

Some hedge fund veterans expect some established funds in different strategies will close. "We might see managers with successful hedge funds close. Their attitude may be they don't want to do this anymore. That's not a bad thing and not unusual. Strategies go out of favor." [55]

Funds of Funds

As large asset managers think about the need for alternatives, they can grow organically or by acquisition. Large asset managers may make strategic acquisitions in order to try to capture capabilities. [56]

Certain larger funds of funds continue to have a good investor base and will continue to be on the acquisition side. Other funds of funds are taking the diversification path i.e. setting up emerging manager platforms, doing single strategy products, and even co-investing with other single strategy funds on one-off investment ideas. [58] (see page 24 for additional details)

One example of those making acquisitions is the Man Group. Man's assets stood at $72.3 billion at the end of September, within close distance of its June 2008 peak of $79.5 billion.

Man Group entered into agreements to acquire funds of funds Pine Grove and Merrill Lynch Alternative Investments in 2014. Pine Grove had about $1 billion in assets while the Merrill Lynch unit had about $1.2 billion at the time of the respective announcements.

Man Group's transaction to buy Silvermine Capital is expected to close in Q1 2015. Man is paying up to $70 million - an initial $23.5 million in cash with two follow-up payments of up to $16.5 million after year one and up to $30 million after year five, depending on performance. The leveraged loan manager has $3.8 billion in assets under management across nine active collateralized loan obligation structures. Silvermine will be integrated within Man GLG and will operate under the Man GLG Silvermine name. Silvermine's team will remain in place under the firm's co-founders.

Man also acquired Numeric Holdings, a quant manager, for $219 million in cash with up to $275 million after five years.

Man Group's 2014 Acquisitions

Target	Strategy	Target's assets ($B)	Price
Silvermine Capital	Leveraged loans	3.8	Up to $70M - an initial $23.5 million in cash with two follow-up payments of up to $16.5 million after year one and up to $30 million after year five, depending on performance
Merrill Lynch Alternative Investments	Fund of funds	1.2	Upfront payment of $2.9M, 35% of net management fees over five year period. Capped at $30M
Pine Grove	Fund of funds	1.0	NA
Numeric Holdings	Quant	14.7	$219M in cash with up to $275M after 5 years

There will likely be more consolidation of funds of funds with assets below $300 million.

For smaller funds of funds, costs and fee structure can have a significant impact on the ability to operate as a going concern. Given the increasing costs of running asset management businesses combined with post-credit crisis fee compression, fund of funds managers have had to operate more efficiently with lower staff and less infrastructure. For some, this can be sustainable if manager allocation is yielding high performance fees, but for many others, especially those below $300 million in total assets under management, this can be very challenging. [58]

Smaller funds of funds are likely to fade out unless they are unique or have a specialized focus. One investment banker expects more consolidation of funds of funds, but not at premium valuations. "Their business models need assessment. It's a matter of survival of the fittest." [59]

Role of Performance

Performance is not always a clear cut factor. There are situations when the fund has experienced a bad year in terms of performance, say a distressed credit fund, but is not overexposed and holds a significant amount of assets in cash. There can be a positive outlook to that fund if the manager has the ability to use this dry power when events turnaround and can funds can be re-invested in better opportunities. [60]

However, if the funds are totally overexposed and the manager has doubled or tripled down, it could be the kiss of death. [61]

EBITDA guidelines

Although most deals are case-specific versus metric-specific, there are some guidelines to keep in mind with regards to entering a potential transaction. Applying a multiple of 9X-11X to cash flow (annualized and adjusted) is still a common starting point, however the range of multiples can diverge significantly depending on the situation. Applying multiples to future revenue and assets under management also comes into play depending on the deal structure. [62]

Management buy-outs

With regulatory changes like the Dodd-Frank Act, there has been an increase in management buy-out activity with the asset management divisions of US banks over the past few years. However, some institutions have found ways to reorganize certain alternative investment divisions without having to make a disposition and are benefitting from the positive cash flows from being in these business lines. [63]

Given the continued deleveraging of European banks, there may be more MBO opportunities in that part of the world. [64]

Reports indicate that Highbridge's management has been in discussions with JPMorgan for several six months as it tries to free itself from the parent company.[65] Highbridge currently manages about $26 billion in assets.

Part of the motivation is that it would be free of Dodd-Frank restrictions and it would not have to compensate employees with JPMorgan stock. Both are considered major competitive disadvantages compared with other hedge funds.[66]

Glenn Dubin and Henry Swieca formed Highbridge in 1992. In 2004, JPMorgan bought a 55% stake for a reported $1.3 billion. In 2009, the bank bought the remaining 45%.

Another MBO example is State Street Global Advisors and SSARIS Advisors ending their affiliate relationship. State Street is selling the hedge fund unit back to its senior management. The management buy-out is expected to be completed in early 2015. State Street held a 60% stake in SSARIS since 2001.

VI. Continued Evolution of Funds of Funds

The old model of fund of funds, one which serves as the intermediary between hedge funds and investors, is quickly disappearing.

Since the financial crisis, large US public pensions have increasingly left funds of funds and invested directly with hedge funds. Funds of funds have suffered deteriorating margins while costs have increased. Funds of funds face competition from cheaper hedge fund beta and replication strategies as well as from consultants.

Performance continues to be lackluster. Year-to-date through the end of November, funds of funds were up 3.7% for the year.[67] Equities, as measured by the S&P 500, gained 14.0% over the same time frame. In 2013, funds of funds and hedge funds generated roughly similar results with gains of 10.3% and 10.9% respectively.

Funds of funds assets peaked at $1.37 billion in 2007 and then dropped to a low of $880 million in 2012. In 2013 and 2014, assets have moved upward and are currently estimated at $952 billion. Funds of funds currently represent about 24% of the total hedge fund industry.

Assets Under Management

Year	Hedge Funds ($B)	Funds of Fund ($B)	Total Assets ($B)	Funds of Funds as % of Total AUM
2003	845	446	1291	34.5
2004	1293	680	1973	34.5
2005	1531	779	2310	33.7
2006	2153	1078	3231	33.4
2007	2861	1377	4238	32.5
2008	1932	951	2883	32.9
2009	2171	886	3057	28.9
2010	2472	948	3420	27.7
2011	2456	890	3346	26.6
2012	2600	880	3480	25.3
2013	2852	910	3762	24.2
2014*	3020	952	3972	24.0

*through November
Source: eVestment

Funds of Funds Asset Flow

Year	$B
2004	216.7
2005	62.4
2006	215.2
2007	198.4
2008	-164.2

2009	183.4
2010	2.97
2011	-28.7
2012	-57.9
2013	-48.9
2014*	20.40

*through November
Source: eVestment

Performance

Year	Funds of Funds (%)	Hedge Funds (%)
2003	13.5	23.5
2004	8.5	11.9
2005	8.4	10.6
2006	11.6	14.0
2007	11.2	12.3
2008	-19.6	-15.2
2009	8.4	20.0
2010	5.6	12.1
2011	-3.7	-2.2
2012	4.0	6.3
2013	10.3	10.9
2014*	3.7	2.9

*through November
Source: eVestment

Funds of funds have been reassessing their situation, trying to figure out how to add value, stay relevant and be competitive. Those that have survived have been innovative.

Some positive signs are appearing in the funds of funds space. Funds of funds assets are starting to see inflows. After three consecutive years of outflows, inflows for the first eleven months of 2014 were $20.4 billion.[68]Net outflows in 2011, 2012 and 2013 were $28.7 billion, $57.9 billion and $48.9 billion respectively.

Some feel funds of funds have stabilized and are strong. "They are valuable, very important and not going away. It's no longer about access. They provide important due diligence. They may even grow slightly." [69]

Funds Close/ Transition

Others still see funds of funds as challenged. "Funds of funds for the past five years have been asked to do more with less. They don't have the luxury they had in the middle of the last decade. With fees in decline and margins compressing, intermediaries have fewer people to manage tasks and are asked to do more. They can't field every call from managers as they don't have enough time or manpower. This has made it a more challenging sales process for hedge funds managers seeking capital."[70]

There are still a large number of funds of funds. Some of the economics may not make sense and some may decide to close. [71]

A number of funds of funds transitioned into other structures in 2014. For example, Hermes BPK's fund of funds business is transitioning into a multi-asset initiative. The BPK name will not be used for the new Multi-Asset Inflation Fund.

The UK insurance firm Aviva closed down its US fund of funds unit. The unit had about $2 billion in assets under management which allocated to outside hedge fund managers.

Evolution

The best positioned funds of funds are those that offer differentiated investment products as well as those that can deliver on changing distribution requirements. The shift is for individuals who can have a conversation at the portfolio level instead of just the product level.

As a result, funds of funds are evolving. Three major trends have emerged: 1) convergence with consultants, 2) specialization on certain niches and/or strategies, and 3) evolution towards a full-fledged alternative investment model with direct investment and co-investment capabilities. Firms may decide to grow in one particular direction or chose a combination of different options depending on their areas of expertise. [72]

- <u>Convergence with consultants: Solution provider – a more holistic approach</u>

Large funds of funds are increasingly viewing themselves as solution providers i.e. helping their clients understand how they fit in the overall portfolio. They have a more holistic relationship today with clients than they did five to ten years ago. Now, they discuss hedge funds in the context of the investor's total portfolio. [73]

- <u>Specialization and Customization</u>

Some funds of funds provide more customized services. For example, some include funds of funds concentrating on private credit funds, private equity funds, emerging managers, frontier market managers as well as expertise in managed accounts and product engineering i.e. a hybrid approach to asset allocation. More and more pensions are taking the fund of one route which allows protection of assets, improved governance, the ability to customize investments and operational support. [74]

- <u>Evolution of the full-fledged alternative investment model</u>

Some hedge funds and funds of funds are evolving into asset managers where they offer different products and diversify their revenue stream. Many are offering a variety of products including commingled funds (ranging from multi-strategy to specific strategy), customized solutions for larger clients, advisory services, separate accounts, liquid alternative funds, alternative beta solutions, direct investment and co-investment capabilities. [75]

Some are adding private equity and longer lock-up strategies such as distressed recovery funds and commercial loan obligations. Some are adding long-only strategies and/or liquid alternatives.

One example is Grosvenor Capital Management which manages $47 billion in assets. In January 2014, it bought Credit Suisse AG's Customized Fund Investment Group – a private equity and real estate investment group - which just about doubled its then-asset size. New York-based CFIG had about $18 billion in assets. Credit Suisse was forced to sell some of its riskier holdings due to the Volcker rule. The move diversified Grosvenor's product base, making it more competitive with other asset management firms.

In October 2014, California Public Employees' Retirement System selected GCM Grosvenor to manage it $200 million private equity emerging manager fund of funds mandate.

Crestline Investors is another fund of funds that has moved into credit and distressed recovery funds with longer lock-ups while also maintaining its hedge funds of funds commingled and separate account strategies. It has about $8 billion in assets under management.

As of March 31, opportunistic and private credit strategies represented about 36% of Crestline's total assets. Hedge fund of funds assets accounted for 35.5% of assets while hedged beta strategies represented 28.9%. [76]

Crestline raised $1.7 billion of commitments for two funds of funds - the fifth and sixth funds in the opportunistic funds series. Crestline Opportunity Fund II, the fifth fund, invests in alternative investment managers' private credit strategies including direct lending, distressed credit, performing and non performing loans. Niche managers may include those such as royalty streams, structured finance, investments in hedge fund secondary interests. The Crestline Recovery Fund III, the sixth fund, had $738 million in commitments for its focused investment in hedge fund secondary interests. This firm's opportunistic funds account for $2.7 billion of the firm's assets.

Crestline has partnered with Kirschner Group to form the Crestline-Kirschner Private Equity Group which focuses on acquiring, managing and investing in underperforming private equity assets, portfolios and funds.

Crestline Investors also partnered with Denali Capital, a syndicated commercial loan asset management firm in October 2013, to further expand its collateralized loan obligation platform under the broader Crestline suite of products. The business operates as Crestline Denali Capital. The alliance adds the CLO manager to Crestline's product offerings and uses Denali's expertise in sourcing and managing syndicated senior loans and related assets for the purpose of structuring and managing CLOS and other funds.

On the manager side, Fortress Investment Group and Och-Ziff are examples of hedge fund managers continuing to evolve into asset management firms. Of Fortress' $66 billion in assets, traditional fixed income accounts for $31 billion, private equity $9.8 billion, hedge funds $7.5 billion, credit private equity $7.1 billion, credit hedge funds $6.1 billion and permanent capital vehicle $4.4 billion.

Och-Ziff Capital Management has $47 billion in assets under management. Multi-strategy hedge funds account for $33.9 billion, credit funds $5.2 billion, CLOs $4.7 billion, real estate funds $1.9 billion. [77]

Co-investing
A growing number of large hedge fund managers are offering co-investment products to investors. Many relate to activist and credit investments.

"They bring investors into their "inner circle" which makes them feel part of the club and special." Co-investing also can be used to help a manager start a track record in an area of investment new to the manager. Co-investing may allow the manager to expand his concentration limits outside a fund's mandate or restrictions. [78]

Hedge fund managers can use co-investments to attract a new audience and obtain capacity for those co-investments.

Managers need a circle of co-investors as speed and nimbleness are important. The manager wants the deal done quickly. Sometimes the investor has only a few hours to decide whether to invest or not.

Co-investing also allows the investor to be nimble. The fees are often low and sometimes there are no fees. One family office noted that investors may look for managers who will put them on a list of co-investors. "It is possible that we will enter into a fund relationship with a manager on the expectation that they will have co-investment opportunities going forward. Without that co-investment opportunity, we may not have done the fund deal."

Many pension plans have a strong desire to have the right to participate in co-investment opportunities. They will often negotiate this right prior to a fund's closing so that when opportunities present themselves, the managers will give the plans adequate time to make investment decisions.

VII. Growth of Liquid Alts

Growing number of top managers

Up until two years ago, the liquid alt models were similar. Managers were small and very few recognizable brand names. By creating a mutual fund, these managers wouldn't have to compete against the larger hedge funds and they could charge lower fees to attract capital. The game-changer arrived two years ago when Fidelity selected Arden as their first fund of funds sub-adviser for a '40 Act mutual fund. Some of the biggest names entered the '40 Act space. This opened up a whole new pool of investors. [79]

As larger funds of funds get into the liquid alt business, a growing number of top managers have become sub-advisors in '40 Act funds. This trend will continue to gain momentum in 2015. As seen in the Appendix, Chilton, River Canyon Capital, Graham Capital, Lazard Asset Management, Sirios Capital, TT International and York are among those that are sub-advising to more than one fund.

Managers need to differentiate product

Some managers will launch their own single strategy fund(s), manage separately managed accounts for sub-advisers, and potentially pursue white labeling opportunities. Managers who launch their own funds sooner will have a significant first mover advantage. The endgame or "holy grail" for these managers is the 401(k) market. [80]

Managers may need to differentiate between their '40 Act products and private fund products. Multi-capability managers have the ability to create a differentiated product. Credit managers that can move up and down the liquidity spectrum are also well positioned. These managers may offer a distressed illiquid strategy in their private funds, and offer a more liquid, slightly lower yielding strategy in a '40 Act structure. Equity long/short focused managers may focus on sub-advising in a multi-manager structure or launching a long-only fund. Smaller equity long/short managers facing broader industry headwinds may focus solely on the '40 Act space." [81]

The importance of distribution

"We are now at Liquid Alts 2.0 – big-name managers are involved as sub-advisors. That is the big difference yet the industry is still in its formative stage. The reality is that shelf space is limited and distribution is critical…A lot of these large institutionally-oriented funds of funds who are relative newcomers to the high net worth channels will require partnering with large distributors who have natural access to high net worth investors. Funds going it alone require a large distribution army which can be expensive whether you partner with large distribution engine or get purchased by someone who has a large taxable distribution."[82]

Fee pressure

'40 Act fund fees continue to be pressured lower. Single manager fund fees are typically 125-200 basis points all-in (versus the 1.5 to 2/20 fees for investing in LPs). Other traditional mutual funds are in the 1.0% range or below. [83]S&P trackers are the lowest in basis points. SDPR S&P500 ETF, which tracks the S&P500, charges 0.09%.

Multi-manager mutual fund fees are as low as 160-230 basis points all-in. Three or four years ago, fees were 3-4% all-in. [84]

"The sub-advisor – the hedge fund manager - will probably settle between 75 and 100 basis points. The hedge fund of fund manager will be between 45 and 65 basis points. Of course, there are other fees on top of the management fees."[85]

Over time, fees are expected to drift down. "I think you will see downward pressure as more products emerge, and advisors have more investment choices. Advisors may use a fee cut off as a "screen" similar to what they do for other mutual fund asset classes." [86]

In a low interest rate environment, fees matter. "High fees and no track record make it easy to say "no" and move on. If I'm an RIA and I see a short track record and fees at 240 basis points, I have to explain the rationale to my client to add this to his/her portfolio. It's a hard sell. Do I want to get into a potentially difficult debate with my client for a 5% allocation?" [87]

Retirement plan market

The significant avenue for growth in the short term will come from larger multi-family offices and wealth advisors that have invested in hedge fund limited partnerships. They understand hedge funds and the strategies. They'll be attracted to the liquidity and simplicity of 1099s. But they'll want to see a track record in this format. They also need to be assured that managers aren't putting watered-down offerings in these products. [88]

However, it is the retirement plan market that is driving hedge fund managers into the liquid alt space. That is a huge untapped market for many hedge fund managers. They want to participate in the qualified plan space and the best way to do that is through open-end mutual funds. [89]

According to Investment Company Institute, a large portion of mutual fund assets are in qualified retirement plans from IRAs, IRA Rollovers, 401(K)s and 403(b)s. This is going to grow because: 1) as people get older, they are going to save more for retirement and those that start with required minimum distributions will simply transfer the required minimum distribution to another fund, and 2) there are more active participants in 401(k) plans than ever. [90]

"I continue to see 401(k) participants allocate to mutual funds. Mutual funds are the clear choice of 401(k) plan trustees as they provide daily liquidity, transparency, and online access. The next generation of investors likes to go online and see how they're doing toward retirement. That trend will continue." [91]

<u>Defined contribution plans</u>

Target funds and defined contribution plans have yet to embrace '40 Act funds. Insurance companies are very conservative and feel most comfortable with long-only products.

Alternatives have been a big part of the defined benefit plans for many years but the DB pool of assets is shrinking. Many are closing their DBs or limiting DBs to new participants and are moving their employees to DC plans with some sort of employer match. [92]

According to BNY Mellon, DB plans have about a 15% average allocation to alternatives while DC plans have a 1% allocation on average. The large gap can be attributed to three factors. First, there has been a lack of alternative investment options historically in DC plans. Since these plans need '40 Act compliant products that are available to retail investors, they simply could not invest in many alternative strategies. Prior to the last five years, few products met these requirements. [93]

Second, DC plan sponsors are less familiar with the use of alternatives than their DB plan sponsor counterparts. Also, DC plan participants themselves generally do not have asset management backgrounds, and would be hard pressed to allocate to stand-alone alternatives.

Third, DC plan sponsors are very fee sensitive, more so than DB plan sponsors. Adding any types of funds with higher fees, which is often the case for liquid alternatives compared to traditional, long-only mutual funds, will take time to gain broader momentum among plan sponsors. [94]

A watershed event occurred in November 2013 when Hartford HealthCare added Neuberger Berman Absolute Return Multi-Manager Fund as an investment option for employees in its DC plan. Hartford HealthCare became one of the first major not-for-profit institutions to introduce hedge funds in a mutual fund format to employees as part of a comprehensive plan to serve their retirement need." [95]

PIMCO's DC practice surveyed 49 consulting firms that had aggregate DC assets of over $2.8 trillion. 98% of the consultants support or strongly support the use of alternatives in custom target date funds. [96]

PIMCO data shows that in the aggregate, DB plans (which incorporate hedge funds, long/short, liquid and illiquid assets) outperformed DC plans annually over the past 20 years. The advantages of DB plans are diversification and noncorrelation. The DB plans tend to be more diversified, using many investment vehicles and many managers. They protect against volatility and are less dependent on stocks. [97]

In many cases, the same investment committees are in charge of both the DB and DC plan. The two types of plans need to be harmonized. DC enrollees need to have access to the same vehicles as DB plans. [98]

As interest rates rise, passive fixed income holdings will lose value, possibly adding risk to those investments that retail investors have used to preserve principal. [99]

One barrier to DC fiduciary acceptance of liquid alts is fiduciary liability from the use of alternatives. High fees and poor performance are fiduciary risk factors. Actively managed liquid alts are more expensive than passive index funds. [100]

With self directed DC plans, performance outcome liability is borne by the individual enrollee. The approach is more self directed. [101]

Some DC plans say that none of these products have been tested since most started post-crisis. “We might have to go through a crisis and shakeout first. What happens if we go through even a mini-financial crisis affecting liquidity or if interest rates go up or the market falls more than 10%? What happens to some of these funds? Until this happens, the DC markets may not allocate to ’40 Act funds. DC plans are waiting to see if it is a fad or whether it has staying power.” [102]

One large fund of funds executive observes: “We are still very early in the process. Fees have to get lower and track records need to get longer so that target date or stand-alone options are comfortable adding liquid alts as an option. We are still years away from acceptance. Fee compression needs to occur. Lower fees and longer track records will make it easier for DC professionals to be objective when considering it for their portfolio.”

Going forward, plan sponsors will become more comfortable with these funds as they develop 3+ year track records and qualify for Morningstar ratings. [103]

Smaller institutions

Going forward, smaller institutions may become significant consumers of liquid alts and larger institutions may use them selectively. Smaller institutions are likely using commingled funds in their broader portfolio, and are not large enough to qualify for separate accounts. They don’t always have access to the highest quality managers. Because of the size of smaller institutions, reduced fees (relative to 2/20) could be appealing. [104]

While larger institutions may not want to invest in commingled funds for large mandates, they may consider these funds for smaller satellite mandates. As managers develop longer term track records and further develop expertise in running registered funds, larger institutions may use these funds alongside or in place of their private commingled investments. [105]

Target Date and Target Risk Funds

According to Strategic Insight, eight actively managed target date fund series currently use underlying open-end liquid alternatives funds. These products have similar investment objectives to traditional alternatives. [106]

Their primary role will be for increased diversification and reduction of volatility. Long-only portfolios are often fully exposed to the broader markets and therefore are more fully exposed to market volatility. This was certainly the case in years like 2008 and 2002 when markets were down significantly. [107]

Their secondary role will be as a potential different source of alpha. Most liquid alternatives products seek to generate uncorrelated alpha. Investment consultants have well documented the ability of traditional alternatives to improve both a portfolio's return potential and reduce risk. Many of these same consultants are advocates of adding alternatives to DC plans.[108]

According to a Casey Quirk study, 80% of net asset flows between 2010 and 2020 will go into target date and target risk funds. Target date and target risk funds in 2010 made up 15% of DC assets. They are projected to make up 50% of DC assets by 2020.

"I think you will see managers with stand-alone options push to place their products into target date funds and target risk funds. Those managers should be well positioned to crack the market." [109]

In order to be considered for a target date fund, managers need to have their own stand-alone '40 Act fund. Target date fund allocators are sophisticated and take an institutional approach to selecting their managers. Thus, the process is lengthy, and the short track record of many funds in this space is prohibitive.[110]

One industry veteran suggests'40 Act fund of funds may become more prevalent as stand-alone offerings as opposed to part of target date funds in 401(k)s. It is very difficult to get hedge funds into 401(k)s. The '40 Act fund of funds' sub-advisor diversification should round out some of the volatility and potential downside risk. (Goldman Sachs was one of the few cutting-edge firms to have offered hedge funds in their 401(k) for over a decade. This, however, is an exception and not likely to be replicated.) Consequently, single strategy '40 Act alternative funds will probably become more prevalent in 401(k)s after '40 Act funds of funds have gained traction.[111]

This conclusion was echoed by another liquid alt expert. "I think multi-manager products will serve as a "gateway" for retail investors similar to fund of hedge funds for pensions in the late 1990s/early 2000s. Pensions used funds of funds as a way to create a hedge fund allocation, and educate themselves. The "all-in one" allocation was a common entry point. I think many retail investors may follow a similar path." [112]

Projected Growth

Morningstar's Direct US Open-End Asset Flow Update for November 2014 shows that alternative mutual funds had net flows of $22.5 billion for the first 11 months of 2014, bringing total assets in the category to $205 billion.

Estimated Net Flows - Nov 214

Category	**Nov Net Flow ($M)**	**YTD**	**Assets ($B)**
US Equity	16,125	39,924	5,977
Sector equity	6,408	50,958	718
International equity	12,657	140,894	2,302
Allocation	2,082	46,961	1,275

Taxable bonds	14,698	99,344	2,959
Municipal bonds	3,474	27,250	574
Alternatives	**254**	**22,490**	**205**
Commodities	(743)	(2,234)	91
All Long Term	54,954	425,586	14,102

Source: Morningstar

On a category basis, multi-alternatives had the largest inflow during the first 11 months of 2014 at $8.5 billion while long/short equity had $6.4 billion in inflows. Long/short equity remains the largest category with $56 billion in assets with multi-alternatives and market neutral following at $39 billion and $34 billion respectively.

Estimated Net Flows in Nov 214

Category	**Nov Net Flow ($M)**	**YTD**	**Assets ($B)**
Long/short equity	(887)	6,352	56
Multi-alternatives	869	8,461	39
Market neutral	(138)	3,459	34
Managed futures	165	2,161	15
Multi-currency	(59)	(210)	12
Bear market	(188)	(1,004)	5
Volatility	290	1,608	4

Source: Morningstar

Various surveys project strong show liquid alt growth. Projections by Citi and Goldman Sachs have liquid alternatives assets under management growing at ~20% annually for next five years. However, flows into the space are very concentrated. According to an MMI Institute report, 20 funds accounted for 93% of all liquid alternatives net asset flows in the top three wire houses in 2013. Many funds linger at asset levels below $100 million. There is clear momentum for increasing allocations among advisors, and many model portfolios at home offices now have allocations to these products. While liquid alternatives allocations will grow, education will play a large role in how fast it will grow. [113]

VIII. Appendix

Sampling of Frequently Allocated To Sub-Advisors (sorted alphabetically)

Sub-Advisor	Sampling of Funds Sub-Advised to
Achievement Asset Mgt (formerly PEAK6)	Arden Alternative Strategies Fund I and II
Apex	Permal Alternative Select Fund
AQR	Principal Global Multi-Strategy Fund
Babson Capital	Arden Alternative Strategies Fund
Brevan Howard	Permal Alternative Select VIT Portfolio
Canyon Capital Partners	Permal Alternative Select Fund
Caspian	Blackstone Alternative Multi-Manager Fund
Cerberus	Blackstone Alternative Multi-Manager Fund
Chilton Investments	Arden Alternative Strategies Fund, DWS Strategic Equity Long/Short Fund, Wells Fargo Advantage Alternatives Strategies Fund, Deutsche Strategic Equity Long/Short Fund, Alliance Bernstein Multi-Manager Alternative Strategies Fund
CQS	Arden Alternative Strategies Fund I and II, Alliance Bernstein Multi-Manager Alternative Strategies Fund
Cramer Rosenthal McGlynn	Neuberger Berman Absolute Return Multi-Manager Portfolio
DE Shaw	Arden Alternative Strategies Fund II
Eclectica Asset Mgt	Arden Alternative Strategies Fund
Ellington Management Group	Arden Alternative Strategies Fund II
Estlander & Partners	Arden Alternative Strategies Fund
Finisterre Capital	Principal Global Multi-Strategy Fund
First Pacific	Alliance Bernstein Multi-Manager Alternative Strategies Fund
GAMCO	Neuberger Berman Absolute Return Multi-Manager Portfolio
Goldman Sachs Asset Mgt	Arden Alternative Strategies Fund II
Graham Capital	Goldman Sachs, LoCorr Tactical Trend Fund, Principal Global Multi-Strategy Fund
Halcyon Liquid Strategies	Alliance Bernstein Multi-Manager Alternative Strategies Fund
JANA Partners	Arden Alternative Strategies Fund
JP Morgan Investment Mgt	Arden Alternative Strategies Fund II
Kynikos Associates	Alliance Bernstein Multi-Manager Alternative Strategies Fund
Lazard Asset Management	Neuberger Berman Absolute Return Multi-Manager Portfolio, DWS Strategic Equity Long/Short Fund, Littman Gregory
Levin Capital	Neuberger Berman Absolute Return Multi-Manager Portfolio
Lyrical Asset Management	Alliance Bernstein Multi-Manager Alternative Strategies Fund
Marisco Capital Mgt	Littman Gregory
Matlin Patterson Global Advisors	Arden Alternative Strategies Fund I and II
MPAM Credit Trading Partners	Alliance Bernstein Multi-Manager Alternative Strategies Fund
Numeric Investors	Arden Alternative Strategies Fund

Omega Advisors	DWS Strategic Equity Long/Short Fund; Deutsche Strategic Equity Long/Short Fund
Owl Creek	Dreyfus Select Managers Long/Short Equity Fund
Passport Capital	Wells Fargo Advantage Alternative Strategies Fund, Alliance Bernstein Multi-Manager Alternative Strategies Fund
Perella Weinberg	Dreyfus Select Managers Long/Short Equity Fund
Pine River Capital	Wells Fargo Advantage Alternatives Strategies Fund
River Canyon Capital Partners	Permal, Wells Fargo Advantage Alternative Strategies Fund, Alliance Bernstein Multi-Manager Alternative Strategies Fund
Santa Fe	Arden Alternative Strategies Fund
Sirios Capital	Dreyfus Select Managers Long/Short Equity Fund, Wells Fargo Advantage Alternatives Strategy
Standard Pacific Capital	Dreyfus Select Managers Long/Short Equity Fund
Third Avenue Management	Littman Gregory
TT International	Permal Alternative Select VIT Portfolio, Principal Global Multi-Strategy Fund
Visium Asset Management	Neuberger Berman Absolute Return Multi-Manager Portfolio
Whitebox Advisors	Arden Alternative Strategies Fund II
York	Principal Global Multi-Strategy Fund, Arden Alternative Strategies Fund I and II

X. Footnotes

1 Jon Lukomnik, managing partner, Sinclair Capital

2 Hugh Lamle, president, MD Sass

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10 Jon Lukomnik, managing partner, Sinclair Capital

11 Jon Lukomnik, managing partner, Sinclair Capital

12 Jon Lukomnik, managing partner, Sinclair Capital

13 Girard Miller, chief investment officer, Orange County Employees Retirement System

14 Girard Miller, chief investment officer, Orange County Employees Retirement System

15 Karl D'Cunha, senior managing director, Madison Street Capital

16 Doug Cramer, managing principal, Alternative Access Capital

17 Doug Cramer, managing principal, Alternative Access Capital

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Afternoon Seminar	**Major Decision Points in Launching a '40 Act Fund**	February 11	Stamford, CT

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  - Quad Group
  - Rogers Asia

  12 pages including tables and graphs; $150 per issue; $1000 for annual subscription

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  - Fund of Funds >$1 billion
  - Hedge Funds <$1 billion
  - Hedge Funds >$1 billion

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- Co-investing
- New product offerings
- Niche focus: emerging managers
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Appendix:

- $1B+ funds of funds list
- Sampling of multi-manager liquid alt funds

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