Issue 5
3rd Quarter 2002

October 31, 2002

Asset Management Focus
Freeman & Co.

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Indices at October 31, 2002:

DJIA	8.397
NASDAQ	1,330
S&P 500	885
FTSE 100	4,040
10 Year US Treasury Bond Yield	3.91%
Euro to dollar	$.99

Diverging Results Lead to Diverging Fortunes

The markets (equity, fixed income and alternatives) are driving in different directions and the result is that firms are experiencing diverging fortunes. The equity markets continue to deteriorate, while the fixed income market remains strong (plus it got a boost from the 50 bps rate cut), and alternative hedge funds are preserving capital and making money (see table below and chart on page 8).

We see growing hedge fund of fund firms and prospering fixed income firms as appealing to strategic partners. In equities, many large firms (e.g. buyers) are dealing with internal turmoil. There remain attractive mid-sized equity firms (based on their clients and distribution channels), however, they are generally unwilling to have strategic discussions at this point in time (e.g. valuation).

Performance as of September 30, 2002

Index	Total Return 2002 YTD	Total Return Trailing 12 Months	Total Return Annualized 3 Yr	Total Return Annualized 5 Yr
S&P 500	-28.2%	-20.5%	-12.9%	-1.6%
NASDAQ	-39.9%	-21.8%	-24.7%	-7.0%
FTSE 100	-28.7%	-24.1%	-14.9%	-6.6%
LBGC*	9.1%	9.2%	9.7%	7.9%
CSFB/Tremont**	0.9%	3.1%	8.8%	6.9%

*Lehman Brothers Govt./Credit Index　　**CSFB/Tremont Hedge Fund Index

Summary

Our key findings are:

- 31 asset management firms were acquired globally in the third quarter compared to 37 in the second quarter, a 16% decline, and down 6% as compared to the third quarter of 2001
- Assets under management ("AUM") acquired fell 30% this quarter to $147 billion from $210 billion in the second quarter, and 59% as compared to the third quarter of 2001
- The acquisition of Deutsche Bank's $120 billion AUM US index business by Northern Trust accounted for 82% of the assets acquired during the quarter
- There was a total of 6 acquisitions that involved greater than $1 billion AUM in the third quarter, down from totals of 12 and 13 in the first and second quarters, respectively
- The US mutual fund industry has lost an estimated $1.3 trillion AUM in equity funds while adding $236 billion AUM in bond funds over the last two years
- We estimate that revenue in the US mutual fund industry has fallen $11.9 billion over the past two years, with bond fund revenue adding $1.8 billion and equity funds losing $13.3 billion
- In Europe we expect the third party fund market to grow to $2.4 billion by 2006, amounting to a 19% compound annual growth rate
- Six firms filed SEC registrations for hedge funds/fund of funds this year
- Six alternative investment strategic partnerships were formed during the third quarter
- MaxRe's Diversified Strategies fund was flat (-0.16%) during the quarter compared to the S&P 500 (-17.3%). We see hedge fund of funds preserving capital in these markets (from +5% to -2% YTD).

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Global Asset Management Transactions

The number of asset management firms acquired globally declined in the third quarter to 31 from 37 in the previous quarter and 33 in the third quarter of 2001.

If the number of acquisitions in the fourth quarter is in line with the third quarter we would expect the total number for 2002 to be in the range of 125. This would represent a 14% decline from the 145 acquisitions in 2001 and would result in two consecutive years of declining acquisition activity, having fallen 3% between 2000 and 2001.

For the year to date period, announced acquisitions have fallen 19% from 118 to 96 in 2001. There has been a larger drop for deals involving either US or European firms. The number of acquisitions involving US firms as buyer or seller fell 31% during the first 9 months compared to last year. In Europe this figure was 33% falling from 54 to 36 acquisitions.

Globally, alliances and distribution agreements increased for the first 9 months of 2002 as compared to the same time period in 2001. Year to date the number of distribution deals announced globally (4) has already surpassed last year's total (2) being driven almost entirely by deals involving alternative investment products.

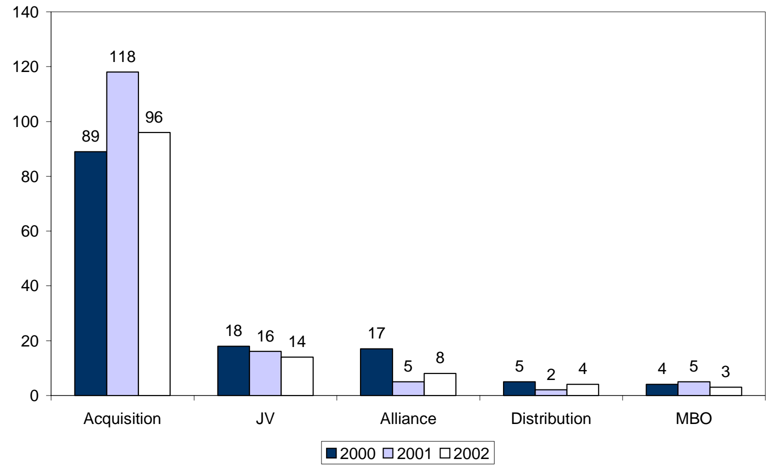
Some potential buyers may use distribution arrangements in lieu of acquisitions to "test the waters." If the companies are able to grow a business together the buyer may be inclined to buy the firm in the future to capture the value of the business.

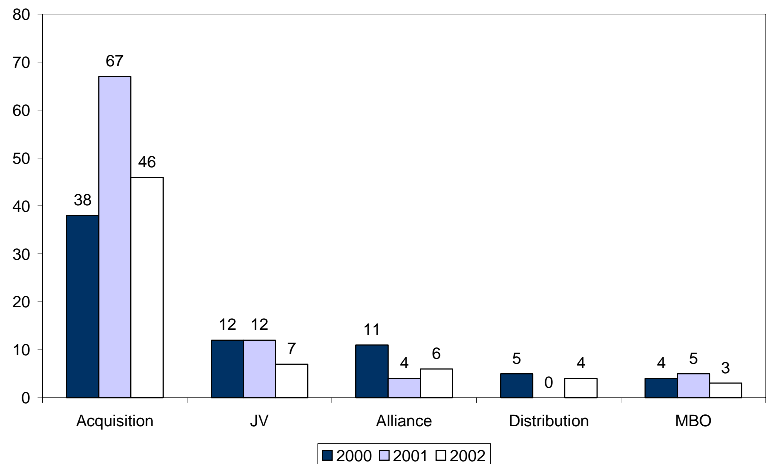
Regional Consolidation

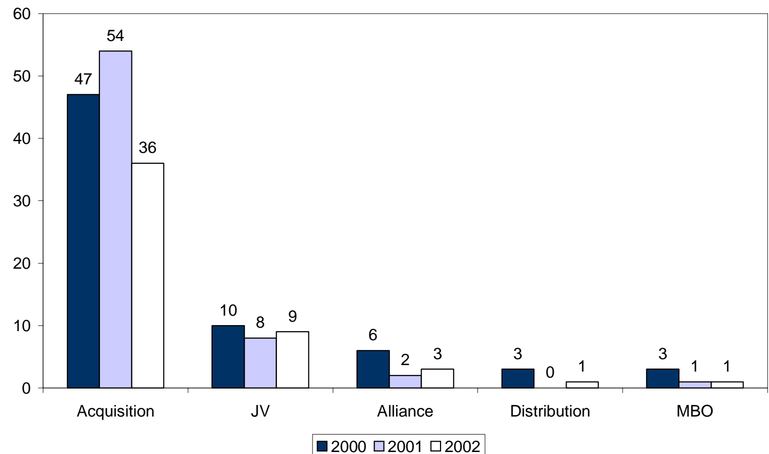
In the previous issue we highlighted a trend of domestic-focused consolidation in the asset management industry, which is continuing to take place. In the third quarter there were 9 US companies acquired and 9 European companies acquired, most of which was regional activity:

- 7 of 9 US companies acquired were purchased by US buyers
- 7 of 9 European companies acquired were by European companies
- 2 deals were Europe—US (one of which was a US buyer—Northern Trust—acquiring the US operations of a European company—Deutsche Bank's US Index business)
- 4 of 5 acquisitions of Canadian companies were by domestic buyers

The US, UK, Netherlands and France were the only countries to make acquisitions outside of their own country. Overall 68% of acquisitions were intra-country and 74% were intra-region. With the continued downturn in equities, we expect domestic consolidation, not foreign expansion to be the trend.







Source: Freeman & Co.

US Companies acquired in the Third Quarter

As expected, acquisitions in the US this quarter were led by managers whose products are more appealing in bear markets. Aside from value managers, we do not expect acquisitions of long-only equity managers in the current market. The value of long-only firms has been driven down by the markets and managers will wait for a rebound before considering a sale. In the meantime, fixed income, equity value and hedge fund of fund managers have seen their value rise with the current demand for their products. We have seen a higher percentage of these firms being acquired, as reflected in the chart below, and we expect these asset classes to be popular future acquisition targets. In fixed income, lower rates have boosted returns among many segments, but weakness in certain types of corporate credits have bee a sore spot. Firms that have avoided these should be well positioned for growth or an attractive partnership opportunity. With hedge fund of funds, there remains a knowledge gap between the boutiques that manage these products and the large firms who are logical acquirers of this product capability. When equity markets stabilize, we expect more transactions in this area.

3rd Quarter 2002 US Companies Acquired

Month	Year	Target	Description	Acquirer	Ownership %	Total Deal AUM ($MM)
7	2002	Addison Capital Management, LLC	ETF Investment Products	Walnut Asset Management	100	800
7	2002	Sage Capital Management	Hedge Fund of Funds	Robeco Group NV	100	301
8	2002	Dynamic Ideas	Quantitative Mutual Fund Investors	American Express Co.	100	-
8	2002	State Street's Corporate Trust Business	Corporate Trust	US Bancorp	100	-
9	2002	Ashland Management Inc's Separate Accounts Business	Separate Account Manager	Mellon Financial Corp	100	590
9	2002	Boston Partners Asset Management LP	Equity Value Manager	Robeco Group NV	60	9,000
9	2002	Coda Capital Management LLC	Convertible Bond Manager	Gartmore Emerging Managers LLC	100	-
9	2002	Cyllenius Capital Management LP	Long/Short Equity Hedge Fund	BlackRock Inc	100	100
9	2002	J.L. Kaplan Associates LLC	Small/Mid-Cap Equity Manager	Evergreen Investments (Wachovia)	100	3,000

Source: Freeman & Co.

AUM Acquired Globally

The level of AUM acquired continues to drop significantly, compared to the number of transactions, leading to a further decline in the average deal size. Assets acquired in in the third quarter fell 30% over the second quarter to $147 billion. Over 80% of the assets acquired in the third quarter were the result of a single deal: Northern Trust's acquisition of Deutsche Bank's $120 billion US index tracking business. If the Northern Trust—Deutsche Bank transaction is excluded assets acquired in the third quarter declined 87% over the second quarter.

We estimate that AUM acquired may reach its lowest levels since 1998 as deal sizes continue to fall. At the current pace of $95 billion AUM acquired quarterly in 2002 (excluding the Northern Trust/Deutsche Bank deal), full year volume may be $380 billion. This would represent a 51% annualized decline in AUM acquired since the peak in 2000. In contrast, the number of deals has declined only 9% annualized during the same time period.

When we include the Northern Trust acquisition, we estimate total AUM acquired in 2002 at $500 billion, which would be similar to 1998's levels and down significantly from levels in 1999-2001. These drops have been driven by the lack of large deals (which we highlight in the bottom left chart). The drop is a reflection of expectations of smaller future growth, buyers dealing with internal issues (e.g. layoffs, cost-cutting), and sellers knowing that lower AUM leads to lower nominal prices.

An unprecedented number (5) of $100 billion+ AUM deals occurred in 2000, while now we expect only one deal per year of that size. Deals in the $50-$100 billion size fell off after 2000, but deals in the $10-50 billion AUM size remained strong into 2001 before falling significantly this year. The healthiest segment appears to be $5-10 billion, with a range of 9-12 deals per year since 1998. We expect the number of smaller deal acquisitions ($1-5 billion) to be steady compared to 2001, but down from highs in 1999 and 2000.

Asset Acquired by Region ($MM)

Region	1998	1999	2000	2001	2002 YTD	2002 YTD adjusted*
Africa	34,910		28,900		11,700	11,700
Asia	68,982	82,244	28,802	26,842	6,797	6,797
Canada	11,600	8,304	43,181	48,152	28,746	28,746
Europe	126,422	160,057	667,646	115,454	289,353	169,353
South America	8,285	19,062	2,122	2,047	3,683	3,683
US	229,605	415,067	945,624	647,321	64,917	64,917
Total	**479,804**	**684,734**	**1,716,275**	**839,816**	**405,195**	**285,195**

** excludes Northern Trust's acquisition of Deutsche Bank's US Index business*

Number of Acquisitions Globally by AUM Size

AUM Deal Size	1998	1999	2000	2001	YTD 2002	Est. 2002
> $100 billion	0	1	5	1	1	1
$50-100 billion	2	1	6	2	2	2
$10-$50 billion	10	9	12	12	3	5
$5-$10 billion	9	9	12	11	7	10
$1-$5 billion	18	35	38	26	18	24
Total	**39**	**55**	**73**	**52**	**31**	**42**

Source: Freeman & Co.

US Asset Management Industry

The change in appetite for acquisitions is clearly driven by underlying asset returns, return expectations for the future and investors' faith in asset classes being good long term investments. As shown to the right, AUM acquired has dropped dramatically for the past two years in the US, Europe and Rest of World. These figures are in contrast to the number of deals, which have declined about 15-20% per year, and continue to remain healthy in the under $10 billion AUM category.

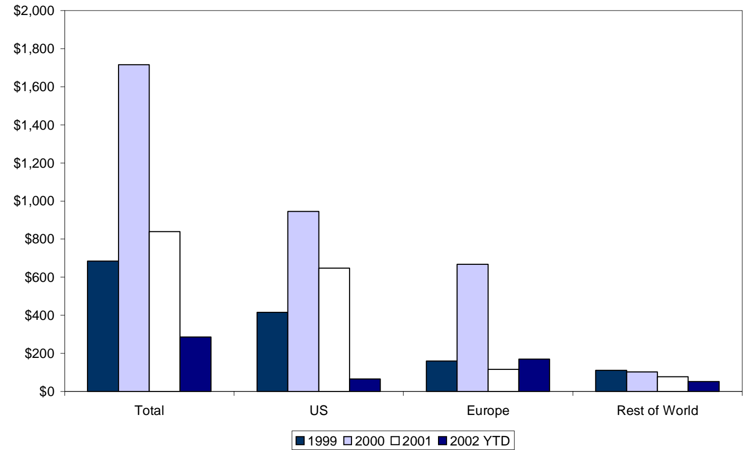
The table below shows the year-over-year change in AUM acquired compared to the S&P 500 returns. Since there is a natural lag effect of about one year, we would expect that acquisitions in 2003 would be down again. We believe the decrease will be spread unevenly with equity manager deals continuing to drop and fixed income and alternative manager deals remaining strong.

Change (Year / Year %)	1998	1999	2000	2001	Est. 2002
AUM Acquired	n.a.	43%	151%	-51%	-40%
S&P 500	29%	21%	-9%	-12%	-25%

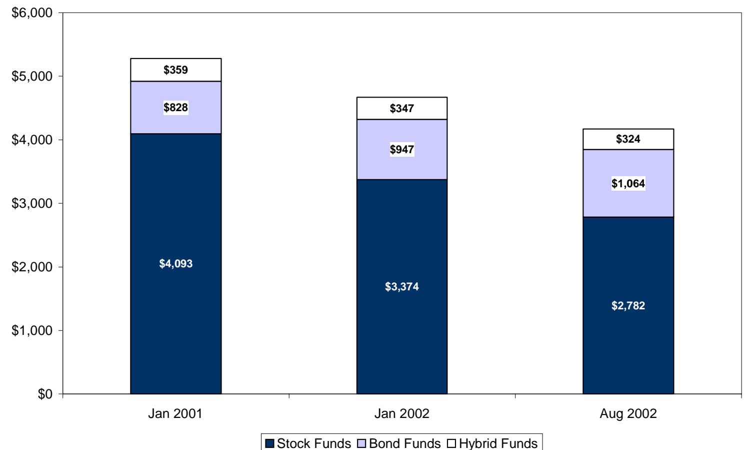
An example of the market leading to diverging results is the AUM by asset class in the US mutual fund market. Over the past twenty months, the US mutual fund industry AUM has fallen by $1.1 trillion, or 21%. However, this has been concentrated in equity funds, which have fallen by $1.3 trillion AUM, or 32%. Fixed income funds have grown by $236 billion, or 29%, during the same time period.

The result is that the market leaders in equity funds (Fidelity, Vanguard, American Funds, Putnam and AIM) have suffered along with the market. Many of these firms are also leaders in bond funds (Vanguard, Fidelity and Putnam) that have performed well and added assets, however, the impact from falling equities overwhelms the positive impact of bond funds. On a positive note, Franklin Templeton, Blackrock and PIMCO have largely avoided the turmoil that has affected many of their equity-based competitors and have continued to grow their businesses.

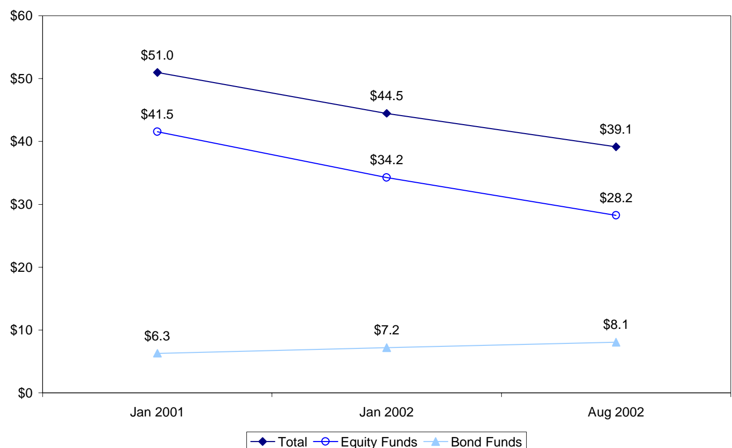
The end result of the market swings has been a dramatic reduction in revenue to the industry. We have isolated one part of the industry, mutual funds, and estimated the revenue impact on a run-rate basis over the past twenty months. On a run-rate basis, we estimate that mutual fund industry revenue has fallen $11.9 billion, or 23%. This is roughly equivalent to the 12 month revenue of the publicly traded money managers ($12.8 billion, see page 11). Our estimated revenue loss in equity funds is $13.3 billion, a 32% fall, and greater than the total revenue of the public firms on page 11. Meanwhile, bond fund revenue has increased an estimated $1.8 billion, or 29%, during this time period, a dramatic difference that nonetheless falls short of offsetting the lost equity revenue (Note: it offsets 13.5%). Again, these figures highlight the theme of this research note—diverging results lead to diverging fortunes.



Source: Freeman & Co.



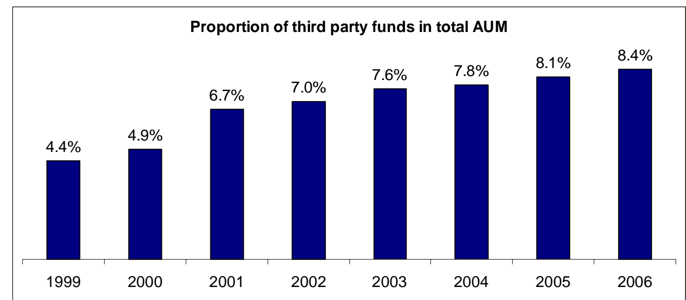
Source: Investment Company Institute



Source: ICI, Morningstar, Freeman & Co. Estimates

European Third Party Funds—Open Architecture and Profitability

By 2006, Sector Analysis predicts the European third party fund market will grow to $2,400bn. In the space of two years the idea of open architecture has been widely accepted among established European asset distributors and product manufacturers. As shown in the chart to the right, the open architecture trend measured by the percentage of third party funds within total AUM has steadily increased since 1999.



Source: Sector Analysis estimates

We also look at the profitability of the third party fund business and its growth drivers from the perspective of the asset management industry (i.e. management fees). The distribution channels/asset gatherers examined are universal banks, insurance companies and standalone portfolio managers. Due to the greater maturity of the UK market we've decided to exclude it and to provide an analysis covering only the continental European market represented by its major countries[1]. The distribution channels examined represent 86% of total European AUM and 84% of the third party fund market in Europe. We have made the following assumptions:

- only discretionary assets generate management fees
- distribution fees are non-existent for the institutional market
- retail fees are equal to 1.5 times HNW fees and 3 times institutional fees. We have considered that specialized products' fees are less sensitive to client segments. HNW and institutional fees represent 90% and 80% of retail fees, respectively. We tried to reflect the rule of increased costs of distributing and managing smaller lot-sizes.
- Individuals served by stand-alone portfolio managers in continental Europe have been considered as HNWI since a large portion of these firms act as wealth managers.

We estimate that the total revenue pool in 2002 equates to $3.7bn. It represents an average gross revenue spread on third party fund managed assets of 43bp. Less than half (46%) of the industry's revenue is paid to distributors of retail assets. The remaining $2bn represents the revenue retained by the product management groups, which equates to 23bp on total third party fund assets. Once estimated operating costs are absorbed, our assumptions for product manufacturers' pre-tax net income is $492 million.

We estimate products managers using universal banks for distribution generate two times more gross revenue ($1.88bn) than ones using stand alone portfolio managers and insurers for distribution. They also show the highest gross revenue spread on total third party fund assets managed (50bp). When we compare segments at the net revenue spread level, the two other segments show a slightly better ratio (25bps for portfolio managers and 23bps for insurance companies). Indeed a large portion of the gross revenue generated by asset managers using universal banks evaporates due to distribution fees paid to capture the large amount of retail assets (net revenue of 22 bps).

Even though insurance companies hold slightly less non-discretionary assets and a larger institutional pool of assets (no distribution fees) than portfolio managers, we estimate that they generate a smaller net revenue ratio than standalone portfolio managers (23bp vs 25bp). This is due to the latter managing/distributing larger proportions of high-fee third party products (equity: 58% vs 50% and alternatives: 9% vs 2%) requiring a higher level of expertise. Other types of assets (real estate, structured products, sector funds, etc.) are also predominant amongst portfolio managers (13% vs 0%). We have assumed that these types of assets generate an intermediate level of management fees.

Third Party Fund Market Parameters in Europe (2002)

	Europe ex UK	Universal banks	Portfolio managers	Insurance companies
AUM sourced from individuals	47%	69%	50%	22%
AUM sourced from organisations	53%	31%	50%	78%
	100%	**100%**	**100%**	**100%**
Third party funds to discretionary clients	61%	65%	62%	55%
Third party funds to non discretionary clients	33%	35%	36%	28%
Third party funds for own internal purposes	6%	1%	3%	17%
	100%	**100%**	**100%**	**100%**
Third party equity funds	51%	47%	58%	50%
Third party bond funds	30%	33%	15%	41%
Money market or cash	6%	7%	6%	4%
Hedge funds	3%	1%	8%	2%
Private equity funds	1%	2%	1%	0%
Other types of assets	8%	9%	13%	2%
	100%	**100%**	**100%**	**100%**
Third party passive funds	15%	16%	9%	18%

Gross Fees	Retail	HNW	Organizations
3P Equity funds (active management)	1.30%	0.90%	0.40%
3P FI funds (active management)	0.80%	0.50%	0.30%
3P Money Market funds	0.50%	0.30%	0.20%
3P Alternative funds	2.00%	1.80%	1.60%
Other types of 3P assets	0.80%	0.70%	0.60%
3P Passive funds	0.20%	0.10%	0.10%

Third Party Fund Profitability in $Billions (2002)

Gross revenue $Billions	Europe ex UK	Universal banks	Portfolio managers	Insurance companies
active equity	1.96	1.00	0.51	0.45
active bonds	0.75	0.44	0.08	0.23
Money Market	0.11	0.07	0.02	0.02
Alternative	0.42	0.15	0.21	0.06
Passive	0.09	0.05	0.01	0.03
Other assets (specialized products)	0.34	0.18	0.14	0.03
Total	**$3.67**	**$1.88**	**$0.97**	**$0.82**
Distribution fees[2]	**$1.70**	**$1.06**	**$0.40**	**$0.24**
Net Revenue	**$1.97**	**$0.82**	**$0.57**	**$0.58**
Pre Tax Income[3]	**$0.49**	**$0.20**	**$0.14**	**$0.14**
Gross revenue/AUM	0.43%	0.50%	0.42%	0.33%
Distribution fees/AUM	0.20%	0.28%	0.17%	0.10%
Net revenue/AUM	0.23%	0.22%	0.25%	0.23%

[2] We have considered distribution fees = 2/3 of gross revenue generated on retail assets
[3] We have considered pre tax margins to be 25% of net revenue

Source: Sector Analysis, Freeman & Co. Estimates

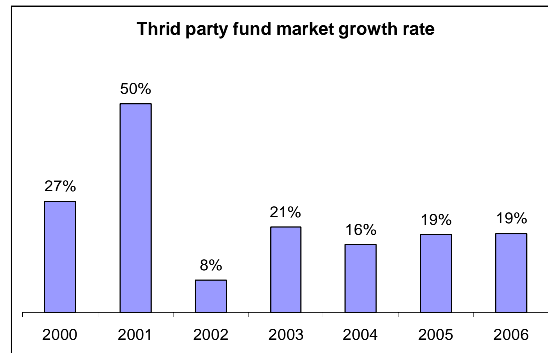
Note: Gross revenue is significantly influenced by the origin of the assets (individual/organizations) and asset allocation between asset classes and styles.

[1] France, Germany, Italy, Switzerland, Spain, Luxembourg, Belgium, Netherlands and Sweden

European Third Party Funds —Future Industry's Profitability and Growth

We have focused on five growth drivers for the third-party asset management segment. We simulated different scenarios based on the following assumptions:

- Third party fund asset growth of 19% per annum.
- Increased proportion of discretionary assets resulting from a shift towards advice-driven business models.
- Increased equity asset allocation. The European continent is under-invested in equities compared to the UK and the USA.
- Increased alternative asset allocation due to risk-diversification properties.
- Increased passive management style allocation. The European continent is under-invested in passive management compared to the UK and US.



Source: Sector Analysis estimates

The third party fund market is expected to grow at a reasonable pace from 2003 at 19% CAGR through 2006. The compound annual growth rate over 2001-2006 is comparable to the growth rate the overall European mutual fund industry has experienced in the 90s (15%). Two critical factors affecting this growth rate are: (1) the appreciation of the underlying assets and (2) the shift from proprietary to third party products. For the first of these (asset appreciation), we estimate that asset growth will be less than during the 1990s (perhaps 6-8% on a weighted asset basis). The real driver of asset growth will be the shift away from proprietary products to third party products, which we expect to add 11-13% growth per year. This trend is similar to the broad-based changes that were seen in the US during the 1990s as assets shifted from bank and brokerage proprietary products to specialized asset management firms (e.g. Fidelity, Putnam Investments, Alliance Capital, etc.)

The chart at right shows estimated third-party industry profits and its sensitivity to four factors: (1) proportion of discretionary assets, (2) equity allocation shifts, (3) alternative asset allocations and (4) passive allocations. We estimate that product manufacturers are currently generating $492 million in pre-tax income from third-party products, and we estimate that this will grow to $994 million in 2006, a 19% CAGR.

Industry Pre-Tax Income Sensitivity US$ billions

	Total 2002	Total 2006	+10% disc.	+20% disc.	+10% equity	+20% equity	5% Altern.	+10% passive	+20% passive
Universal Banks	205	443	23	47	8	13	25	-2	-7
Portfolio managers	143	287	16	32	-5	-10	0	-2	-3
Insurance companies	144	265	11	21	3	6	34	-4	-8
Total	492	994	50	100	6	9	59	-8	-18

A major driver of growth is the portion of discretionary assets within third-party mandates. The reasons why discretionary assets should grow are: (1) the ongoing shifts in product usage from bank deposits to packaged savings products, such as life insurance, annuities, pensions and mutual funds, and (2) the progressive withdrawal of direct pension benefits by governments. We think that an additional increase of discretionary assets by 10% is a likely target over the next 4 years, which should increase third party product revenue from $3.7 to $4.3 billion and pre-tax net income to product manufacturers by $50 million, for example.

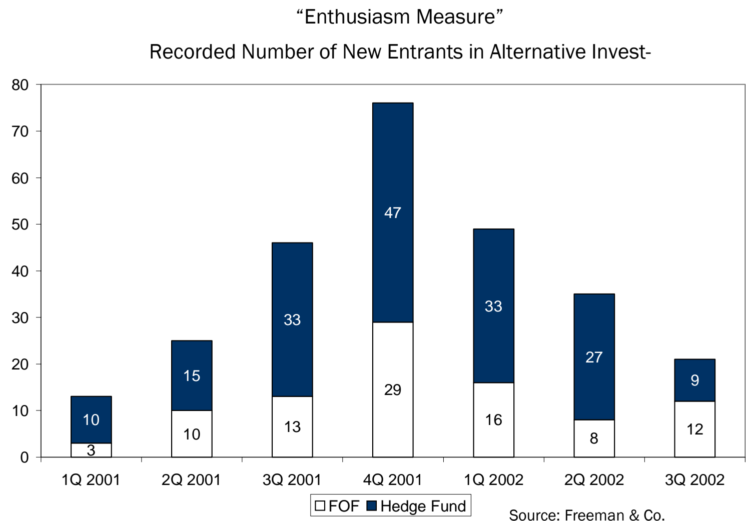
An increase in passive management style will have a negative impact on overall industry margin due to the very low fees charged on this type of style management. In both scenarios an increase (10% and 20%) in passive management will outweigh the positive impact of an equivalent increase in equity allocation. Asset managers using European portfolio managers for distribution will be the least affected by an increase in passive management since the variation is calculated from a smaller base. The result of a 10% increase in passive allocations would be a decrease of pre-tax income to product manufacturers of about $8 million.

Should universal banks and insurance companies increase their third party alternative asset allocation to 5% within the next 4 years, the pre-tax profitability of the third party fund industry could improve by an estimated $59m. Alternative investments are becoming increasingly accepted and understood, which should drive and support these increased allocation assumptions. The low volatility of returns of some alternative hedge fund of funds, for example, and their low correlation to the underlying direction of equity markets should attract significant inflows of institutional and retail money. The increased introduction of capital guaranteed products (see our July 31, 2002 research note) should help to increase money flows into these products.

We continue to believe that open architecture trends in Europe offer profitable opportunities for asset managers who are willing to invest in developing external distribution channels. Although these benefits would accrue over time as the industry gradually shifts, it offers a compelling opportunity. Firms that shift to a product manufacturing focus should require less capital investment, could earn higher ROEs and would be more flexible in adopting to change than the large distribution focused firms (e.g. universal banks). This involves a process of separating an industry into product manufacturing and product distribution components, with each assuming different economic models. The distributors generally require higher capital investments to support systems, marketing, custody and other services. These types of platforms lead to higher fixed costs, higher break-even revenue levels, less business flexibility, lower operating margins and lower ROEs. The product manufacturers generally have less fixed costs, greater business flexibility, higher operating margins and higher ROEs. It is similar to what Coca-Cola did by separating its bottling operations (capital intensive) from its syrup manufacturing business (less capital intensive). The asset management can be described similarly since Fidelity is trying to leverage off the imbedded infrastructure of Deutsche Bank, UBS, Credit Lyonnais and others, while also trying to displace the house brands. The good news is that large distributors have the power to raise their fees, as we have seen in the US wrap-account and mutual fund businesses.

[4] For the chart we have assumed that 5% allocation to alternative products is the minimum required to benefit from their diversification properties. Alternative asset allocation amongst portfolio managers has not been changed (currently above 5%)

Alternative Investments—New Entrants



Our tracking of new entrants to the alternative investment industry is often misunderstood, although we continue to find use in the data. First, it does not capture every new entrant as we do not have perfect information. That would require tracking new account openings at prime brokerage firms and cross-referencing those to eliminate multiple accounts from the same new firm (Note: if someone in the prime brokerage business want us to conduct market share research, etc. on this topic give us a call) Second, the data is based on the information that we are able to collect from financial news sources.

As such we think of the data as a form of "enthusiasm" measure, imperfect yet telling nonetheless. The chart at right may be telling us a few things about the state of the alternative investment industry: (1) it is giving us the middle finger (about what we do not know), (2) it is showing a near-perfect normal distribution, (3) it is indicative that alternative assets have been a popular business to enter, but that eagerness to enter by late comers has fallen due to lower returns in 2002. Obviously, we think item #3 is the most relevant. It is important to note that there were 91 entrants into the hedge fund of fund business over 21 months. The good news is that more entrants lead to more marketing, more education of investors and more investment in infrastructure. The bad news is that most of these entrants (and many existing firms) will struggle to gain distribution for their products. Among all firms, the smaller firms will be impacted the most — developing distribution channels requires a substantial investment in resources, while deciding to rent distribution through other firms has a real cost (generally expressed in basis points). As the wirehouses have recently squeezed fees paid to product providers on wrap accounts, it reminds us of the economic difficulties of relying on intermediaries for distribution (see our March 2000 report on Charles Schwab's squeezing of fees on its OneSource mutual fund platform).

Alternative Investments—Transactions

In the past we have written about the risks of acquiring hedge funds as compared to hedge fund of funds. It was our opinion that it was not an attractive investment for buyers to pay a premium for individual hedge funds due to the key person risk and the volatility of performance fees. Alternatively, the market seems to have placed a multiple of zero on performance fees for hedge funds for M&A valuation purposes. Perhaps the word "acquisition" is being used inappropriately here — it is more likely that hedge fund "acquisitions" are really economic partnerships where the parent helps with infrastructure, marketing and other functions and the parties agree to an ongoing split of the performance based fees.

One of the problems of acquiring hedge fund firms, compared to hedge fund of fund firms, it the risk of severe losses in hedge fund firms. Beacon Hill Asset Management, a $1.5 billion hedge fund is the latest example. It is liquidating all of its portfolios and is being investigated by the SEC after reporting a loss of over 50% in September. Its parent is Asset Alliance, a holding company that has stakes in numerous hedge fund firms. A number of issues arise for Asset Alliance and firms like it, including a write-down of its investment, potential (certain?) litigation expense, reputation expense, and questions about the quality of oversight, infrastructure and pricing mechanics.

This raises the question, which we have raised before, of would you rather own a fund of funds or a pool of individual hedge funds? We continue to favor the fund of fund business due to its stability of revenues, diversified products, minimal chance of a massive loss and lower risk of client litigation. The events of Beacon Hill and Lipper & Co. further enforce this notion for now.

Month	Partner 1 / Target	Country 1	Partner 2 / Acquirer	Country 2	Description
7	Scottish Mutual	Scotland	Bucephale Group	UK	JV - Fund of Funds
7	Shinsei Bank Ltd	Japan	Ramius Capital Group, LLC	US	Distribution - Hedge Funds
7	Sage Capital Management	US	Robeco Group NV	Netherlands	Acquisition - Fund of Funds
9	iPerformance Fund Group	Canada	Man Investment Products	UK	Alliance - Hedge Funds / FoF
9	Coda Capital Management LLC	US	Gartmore Emerging Managers LLC	US	Acquisition - Hedge Fund
9	Cyllenius Capital Management LP	US	BlackRock Inc	US	Acquisition - Hedge Fund

Source: Freeman & Co.

Alternative Investments—Registered Hedge Funds

A new trend in the industry is alternative products (hedge funds and fund of funds) that are registered with the SEC. Generally, these products have higher management fess than institutional products (often by 75-100 basis points), placement fees of up to 3.5% and minimum investment levels of $25-50,000 (although the investors need to be accredited). One interesting future development is how the SEC will balance these new products and their disclosures with its recent research of and inquiries into the hedge fund industry.

The concept is to deliver the same benefits of hedge fund of funds to the semi-affluent through a variety of product structures and sub-advisors. A number of well-known firms are entering this area including Banc of America Capital, Deutsche Bank, Citigroup and Man Glenwood. Although we support the notion that firms need to grow to retain and compensate their professionals, we are not yet supportive of these retail type products (at least until someone convinces us otherwise). First, the fees are high, particularly when the placement fees are included. Second, we are not certain the average semi-affluent person will actually understand what they are buying (although many may not have understood Internet stocks, either). Third, placement fees, in our opinion, suggest that products are sold and not bought, which may not be a good thing. Lastly, there has been a tremendous amount of litigation by clients in retail brokerage, and the last thing the industry needs is a little old lady testifying before congress about her losses in a hedge fund of fund. Just because you disclose that a pneumatic drill is dangerous, doesn't mean that you should let a teenager play with it, is our view.

Registered Hedge Funds / Hedge Fund of Funds

Type	Sponsor	Sub-Advisor	Management Fee	Maximum Placement Fee	Minimum Investment ($ Actual)	Other Restrictions
Hedge Fund	Banc of America Capital Management	Alkeon Capital Management LLC			$100,000	$1.5 million net worth
Fund of Funds	Deutsche Bank	NA		3.50%	$50,000	Accredited Investors
Fund of Funds	Man Glenwood	NA	1.75%	3.00%	$25,000	$1.0 million net worth
Fund of Funds	Evergreen Investment Management*	Ivy Asset Management	2.00%		$50,000	
Fund of Funds	Aetos Capital Management*	NA				
Fund of Funds	Citigroup Alternative Investments	AMCAR Partners	2.00%		$1,000	

** These firms launched multiple funds*

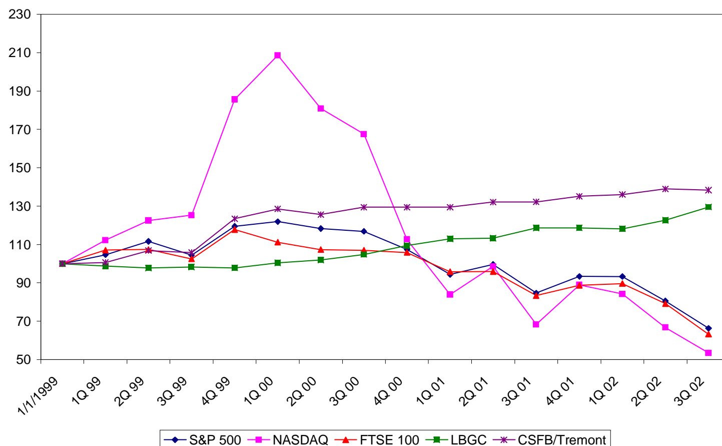
Source: SEC filings, press releases

Alternative Investments— Indices

We analyzed various market sectors to highlight our theme this quarter, *Diverging Results Lead to Diverging Fortunes*. The chart below highlights five market segments including the S&P 500, FTSE 100, NASDAQ, Lehman Brothers Government/Credit and the CSFB/Tremont indices since January 1, 1999. This is the one graph that best tells the fortunes of various firms — growth equity managers having a really tough time, equity mangers suffering and fixed income and alternative managers having stable positive returns.

The resulting turmoil internally at most equity managers has led to the dramatic drop in M&A volume, as we highlighted earlier. However, we would be interested in learning how many institutional investors would get the following question correct: since January 1999 which index has generated the greatest total return, Lehman Brothers Government/Credit or the CSFB/Tremont index? We would speculate that many investors with limited knowledge of hedge funds would have picked the fixed income index due to the prevailing knowledge of falling rates. The key question for the industry, including hedge funds, administrators, fund of funds, lawyers and prime brokers is: what would be investors' allocations to hedge funds if they knew that hedge funds had dramatically outperformed equities and moderately beat fixed income over this time period?

Quarterly Index Returns (base 100 at 1/1/1999)



Source: Morningstar, CSFB Tremont

One issue in the industry is the use of indices for hedge funds. While some are critical of any attempt to use them, we believe that indices help to increase understanding for investors and help to support long-term growth of the industry. However, we agree that trying to put a diverse pool of 6,000 hedge funds into styles is problematic. However, if we study the historical trends of classifying mutual funds, we realize that originally they were classified as equity, fixed income or money market. Today we have better, but not perfect systems. Although current hedge fund index attempts may not be perfect, we are more interested in seeing how they progress from these first attempts.

Alternative Investments— Max Re

The struggling markets have led Max Re Capital Ltd. (Tk: MXRE) to announce that it is de-emphasizing its alternative investment portfolio in favor of more traditional investment . This announcement is in sharp contrast to the original purpose of the firm. Max Re's business plan dictated that the firm would seek to generate superior investment returns by investing up to 50% of its premiums in diversified alternative investment strategies. As a result, it was hoped, the firm could outpace its peers by using a more aggressive mix of fixed income and alternative styles. Unfortunately it appears that timing and markets have caused the firm to deemphasize this unique asset allocation mix.

The company's statement indicates the reason for the change: "The operating loss stems principally from the continued low return from the company's alternative investment portfolio. While the company's alternative investment portfolio produced a small positive return in the third quarter, it continues to fall short of the level needed to generate net income." MaxRe's hedge fund of fund performance appears to be inline with asset returns we are seeing in the industry. Certainly its diversified strategies fund is outperforming equities, which would have lead to disastrous results for the firm's asset management results. Although, the company indicates that the shift away from alternatives is necessary, we think that there is a great deal of timing issues involved. As a start-up reinsurance company, MaxRe was building and diversifying its insurance risks, while having to generate enough current income to offset overhead costs. Simultaneously, alternative asset returns flattened out from their historical norms. There is a good chance that the company will increase allocations to its hedge fund of funds as it matures and as performance returns. In any event, we remain bullish on using alternative asset classes to generate superior returns that are well diversified, even if it does not suit MaxRe's needs now.

Max Re Financial Data as of September 30, 2002

Asset Type	Market Value ($000)	Total %	Alternative %	Returns 3Q02	YTD	TTM	Asset Change Q2-Q3 $000	%
Cash & Fixed Maturities	1,323,618	68.5%	NA	4.82%	7.69%	8.23%		
Global Macro	96,455	5.0%	15.9%	1.10%	3.06%	10.67%	(10,375)	-0.7%
Long/Short Equity	57,112	3.0%	9.4%	0.06%	-3.03%	-1.31%	(16,157)	-2.1%
Convertible Arbitrage	33,790	1.7%	5.6%	-0.22%	1.96%	4.12%	(32,287)	-5.2%
Merger Arbitrage	-	0.0%	0.0%	0.00%	-0.43%	0.00%	(106)	0.0%
Diversified Arbitrage	110,122	5.7%	18.1%	0.02%	3.93%	7.12%	9,811	3.0%
Distressed Securities	90,134	4.7%	14.8%	-2.88%	-3.92%	-1.75%	(54)	1.1%
Opportunistic	43,898	2.3%	7.2%	0.92%	-2.28%	-1.32%	(11,278)	-1.4%
Emerging Markets	14,897	0.8%	2.5%	0.25%	-0.63%	-63.00%	63	0.2%
Fixed Income Arbitrage	31,429	1.6%	5.2%	3.77%	8.73%	4.28%	6,129	1.4%
Event-Driven Arbitrage	10,920	0.6%	1.8%	-2.00%	-2.74%	-2.45%	(29,727)	-5.1%
Commodity Trading Advisers	17,565	0.9%	2.9%	4.41%	4.41%	4.41%	17,565	0.0%
Max Re Diversified Strategies	**536,322**	**27.8%**	**88.3%**	**-0.16%**	**0.13%**	**2.75%**	**(36,414)**	**0.0%**
Insurance Underwriting	71,011	3.7%	11.7%	3.68%	9.73%	7.73%		
Alternative Investments	**607,333**	**31.5%**	**100.0%**	**0.25%**	**1.11%**	**3.63%**		
Total Investments	**1,930,951**	**100.0%**	**NA**	**3.26%**	**5.37%**	**6.75%**		

Source: Max Re third quarter earnings release

During the quarter, we see a wide range of investment results in MaxRe's alternative portfolio: the high return was 4.11% for commodity trading advisers and the low return was –2.88% for distressed securities. In fixed income its performance was +3.77%, which is in sharp contrast to the results of Beacon Hill, a fixed income hedge fund that was forced to shut down due to large losses in September. Two important points can be drawn from this example: first, diversification is important, and avoid mortgages every four to eight years (e.g. Askin Fund circa 1994). All of the remaining strategies were up or down approximately 100 basis points during the quarter.

During the quarter, MaxRe also made substantial shifts in assets. Over six months it has reduced its convertible arbitrage portfolio from $77.4 million to $33.8 million (5.6% of alternatives); event driven has been reduced by a further $29.7 million to $10.9 million (1.8% of alternatives); two other strategies lost significant allocations — global macro $10.4 million and long/short equity $16.2 million. Only three strategies received new monies: diversified arbitrage ($9.8 million), event driven arbitrage ($6.1 million) and CTAs ($17.6 million). Overall, $36.4 million was removed from the alternative strategy portfolio (about 6.3% of assets).

Although hedge fund of funds may not be the right product for MaxRe at this time, the market data indicates that they have provided down side protection in very difficult markets and some have provided positive returns as well. As we enter 2003, investors have a choice in how they view hedge fund of fund products — they protected on the downside or they failed to provide returns of 8-12% per annum. We think the result, which could drive huge flows of capital over the next five years, will be that hedge fund of funds provide very good downside protection in falling markets and three year average returns of 8-12% per annum. If the market takes our expected view, the largest hedge funds and fund of funds will be the primary beneficiaries (we have talked often about distribution challenges for small firms).

Public Companies—AUM Analysis

Average AUM Analysis $billion									
Quarter Ending	**9/30/2000**	**12/31/2000**	**3/31/2001**	**6/30/2001**	**9/30/2001**	**12/31/2001**	**3/31/2002**	**6/30/2002**	**9/30/2002**
Diversified									
Blackrock (BLK)	$ 190.8	$ 203.8	$ 201.6	$ 212.7	$ 225.6	$ 238.6	$ 238.1	$ 249.8	$ 245.9
Eaton Vance (EV) *	49.2	49.3	49.0	50.4	56.6	59.3	59.2	54.8	-
Federated Investors (FII)	130.4	134.3	146.4	160.8	163.6	179.7	177.6	185.0	180.3
Franklin Resources (BEN)	229.9	226.5	224.9	267.9	246.4	266.3	274.5	270.4	247.8
Gabelli (GBL)	23.8	23.6	23.7	25.6	22.3	24.8	25.9	23.2	20.2
Neuberger Berman (NEU)	55.5	55.5	54.8	58.2	52.1	59.0	61.9	58.7	53.6
SEI Investments (SEIC)	76.7	76.3	78.1	79.9	74.0	77.5	79.0	76.8	72.2
Stilwell (SV)	324.2	284.7	294.4	223.9	171.8	193.0	188.8	161.5	148.4
T Rowe Price (TROW)	179.3	166.7	148.7	158.6	140.4	156.3	159.8	148.8	131.6
Waddell & Reed (WDR)	39.9	37.8	35.3	34.0	29.8	31.8	32.0	29.1	27.1
Total	1,299.7	1,258.4	1,256.9	1,272.1	1,182.7	1,286.3	1,296.8	1,258.1	1,127.0
Insurance									
John Nuveen (JNC)	60.4	61.3	61.4	63.0	66.5	68.5	69.5	68.5	76.9
Total	60.4	61.3	61.4	63.0	66.5	68.5	69.5	68.5	76.9
Consolidators									
Affiliated Managers (AMG)	85.1	77.5	69.7	73.7	65.2	81.0	81.4	74.1	68.5
Total	85.1	77.5	69.7	73.7	65.2	81.0	81.4	74.1	68.5
Bank/Trust Companies									
Boston Private Fincl. (BPFH)	5.8	5.7	5.6	6.2	5.3	6.5	6.8	6.5	6.0
Wilmington Trust (WL)	42.8	41.5	38.7	38.5	34.7	36.9	37.0	31.7	29.1
Total	48.6	47.2	44.3	44.7	40.1	43.4	43.8	38.2	35.1
Limited Partnerships									
Alliance Capital L.P. (AC)	392.8	421.1	454.0	454.9	421.4	455.0	448.0	451.6	368.7
Total	392.8	421.1	454.0	454.9	421.4	455.0	448.0	451.6	368.7
Total	**$1,886.6**	**$1,865.4**	**$1,886.4**	**$1,908.4**	**$1,775.8**	**$1,934.2**	**$1,939.5**	**$1,890.4**	**$1,676.2**

* EV periods end January, April, July, October

US Public Money Managers

Revenue Analysis $ millions

Quarter Ending	9/30/2000	12/31/2000	3/31/2001	6/30/2001	9/30/2001	12/31/2001	3/31/2002	6/30/2002	9/30/2002
Diversified									
Blackrock (BLK)	$127.7	$128.5	$133.7	$135.3	$134.8	$129.4	$146.1	$156.7	$137.1
Eaton Vance (EV) *	114.5	120.1	115.5	124.7	126.1	130.7	132.8	130.7	-
Federated Investors (FII)	173.1	170.5	171.4	180.9	181.2	182.3	182.1	182.4	173.2
Franklin Resources (BEN)	593.1	564.1	577.4	609.5	603.9	618.2	626.0	666.1	608.3
Gabelli (GBL)	59.2	59.9	58.3	57.0	56.1	52.9	58.0	57.4	47.3
Neuberger Berman (NEU)	151.7	157.5	154.8	157.0	149.9	151.6	160.2	160.3	153.5
SEI Investments (SEIC)	155.6	158.0	161.3	168.5	163.4	164.8	159.2	158.9	153.3
Stilwell (SV)	609.5	530.5	448.5	411.5	361.6	334.1	328.3	310.4	257.8
T Rowe Price (TROW)	303.7	291.6	280.5	262.1	243.6	241.3	242.1	236.1	220.3
Waddell & Reed (WDR)	129.9	129.7	119.4	127.9	114.9	114.9	114.8	114.0	102.7
Total	2,417.9	2,310.3	2,220.9	2,234.3	2,135.5	2,120.2	2,149.7	2,173.0	1,853.7
Insurance									
John Nuveen (JNC)	89.0	91.8	85.7	86.2	97.5	101.6	92.6	90.3	102.4
Total	89.0	91.8	85.7	86.2	97.5	101.6	92.6	90.3	102.4
Consolidators									
Affiliated Managers (AMG)	118.2	114.8	100.5	100.7	96.6	110.5	119.3	129.6	115.3
Total	118.2	114.8	100.5	100.7	96.6	110.5	119.3	129.6	115.3
Bank/Trust Companies									
Boston Private Fincl. (BPFH)	14.2	17.8	19.7	20.8	21.4	28.1	28.3	29.0	29.1
Wilmington Trust (WL)	111.6	116.6	113.6	115.2	116.4	121.7	124.6	128.8	131.2
Total	125.8	134.4	133.3	136.0	137.8	149.8	152.8	157.9	160.3
Limited Partnerships									
Alliance Capital L.P. (AC)	615.6	793.2	742.4	760.2	724.8	765.4	720.5	724.1	649.7
Total	615.6	793.2	742.4	760.2	724.8	765.4	720.5	724.1	649.7
Total	**$3,366.5**	**$3,444.5**	**$3,282.8**	**$3,317.4**	**$3,192.3**	**$3,247.6**	**$3,235.0**	**$3,274.9**	**$2,881.3**

* EV periods end January, April, July, October

US Public Money Managers— Current Valuations

	Avg, AUM $Bil.	Enterprise Value (EV)[1]	Market Cap $MM	10/31/02 Share Price	EBITDA[2]	Core Net Income[3]	EV/ EBITDA[2]	EV/ EBIT[3]	Price/ Core Income[3]	Price/ TTM Income	% of AUM
Diversified											
Blackrock (BLK)	243.1	2,330	2,330	$35.72	206.2	127.5	11.3x	11.5x	18.3x	18.2x	1.0%
Eaton Vance (EV)	57.5	2,177	1,919	$28.71	197.3	132.5	11.0x	11.0x	14.5x	14.9x	3.3%
Federated Investors (FII)	180.6	3,377	3,163	$26.80	351.5	210.5	9.6x	10.1x	15.0x	16.2x	1.8%
Franklin Resources (BEN)	264.7	9,234	8,646	$32.99	602.6	427.6	15.3x	15.8x	20.2x	20.0x	3.3%
Gabelli (GBL)	23.5	991	946	$29.81	105.0	67.4	9.4x	9.4x	14.0x	16.8x	4.0%
Neuberger Berman (NEU)	58.3	2,242	2,081	$29.36	245.2	126.2	9.1x	9.7x	16.5x	16.5x	3.6%
SEI Investments (SEIC)	76.4	3,072	3,033	$26.69	205.0	126.5	15.0x	15.0x	24.0x	21.9x	4.0%
Stilwell (SV)	172.9	3,163	2,626	$11.71	402.3	20.5	7.9x	10.2x	128.1x	23.2x	1.5%
T Rowe Price (TROW)	149.1	3,695	3,623	$28.23	326.0	193.1	11.3x	11.6x	18.8x	18.8x	2.4%
Waddell & Reed (WDR)	30.0	1,639	1,439	$17.50	163.8	91.2	10.0x	10.5x	15.8x	15.1x	4.8%
Total	***1,256.2***	***$31,920***	***$29,806***		***$2,805***	***Average***	***11.0x***	***11.5x***	***28.5x***	***18.1x***	***3.0%***
						Median	***10.5x***	***10.8x***	***17.4x***	***17.5x***	***3.3%***
Insurance											
John Nuveen (JNC)	70.9	2,228	2,018	$27.26	209.2	124.8	10.7x	11.0x	16.2x	16.5x	2.8%
Total	***70.9***	***$2,228***	***$2,018***		***$209***		***10.7x***	***11.0x***	***16.2x***	***16.5x***	***2.8%***
Consolidators											
Affiliated Managers (AMG)	76.2	1,675	1,196	$52.25	116.0	55.2	14.4x	18.2x	21.7x	21.6x	1.6%
Total	***76.2***	***$1,675***	***$1,196***		***$116***		***14.4x***	***18.2x***	***21.7x***	***21.6x***	***1.6%***
Bank/Trust Companies											
Boston Private Fincl. (BPFH)	6.4	437	437	$18.75	37.1	27.0	11.8x	11.9x	16.2x	32.0x	6.8%
Wilmington Trust (WL)	33.7	1,698	1,536	$30.87	209.1	133.0	8.1x	8.2x	11.6x	11.6x	4.6%
Total	***40.1***	***$2,136***	***$1,973***		***$246***	***Average***	***10.0x***	***10.1x***	***13.9x***	***21.8x***	***5.7%***
						Median	***10.0x***	***10.1x***	***13.9x***	***21.8x***	***5.7%***
Limited Partnerships											
Alliance Capital L.P. (AC)	430.8	8,266	7,652	$30.20	732.4	615.1	11.3x	12.3x	12.4x	12.4x	1.8%
Total	***430.8***	***$8,266***	***$7,652***		***$732***		***11.3x***	***12.3x***	***12.4x***	***12.4x***	***1.8%***
Overall											
Total	***1,874.2***	***$46,224***	***$42,645***		***$4,109***	***Average***	***11.1x***	***11.8x***	***24.2x***	***18.4x***	***3.1%***
						Median	***11.0x***	***11.0x***	***16.2x***	***16.8x***	***3.3%***

Notes
1 Enterprise Value (EV) includes equity plus long term debt
2 Before tangible depreciation and amortization
3 Excludes extraordinary items and minority interest expense/income

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