Issue 7
1st Quarter 2003

May 30, 2003

Asset Management Focus
Freeman & Co.

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Indices at May 30, 2003:

DJIA	8,850
NASDAQ	1,596
S&P 500	964
FTSE 100	4,049
10 Year US Treasury Bond Yield	3.89%
Euro to dollar	$1.18

A Nadir or Not? Lowest Deal Levels in Over 6 Years

The war, soft economy and undistinguished markets have led to a fall in asset management deals to the lowest levels since the start of the bull market run in the 1990s. The combined effects of falling assets, weak corporate P&Ls and general uncertainty have taken their toll. Strategic expansions to capture growth opportunities seem few and far between.

Instead, companies are repositioning themselves through either divestitures (notice the recent Schwab-State Street and Zurich-American Express announcements) or are pursuing selective opportunities in products, distribution channels or geography. The good news is that perhaps the worst is behind us, although we do not expect things to return to "normal" until 2004.

Performance as of March 31, 2003

Index	Total Return 1Q 2003	Total Return Trailing 12 Months	Total Return Annualized 3 Yr	Total Return Annualized 5 Yr
S&P 500	-3.2%	-24.8%	-16.1%	-3.8%
NASDAQ	0.4%	-27.3%	-33.6%	-6.1%
FTSE 100	-8.3%	-31.5%	-17.9%	-9.4%
LBGC*	1.7%	13.4%	10.1%	7.6%
HFRI FoF**	0.9%	-2.2%	0.4%	6.9%
CSFB/Tremont***	2.2%	4.6%	3.5%	5.9%

*Lehman Brothers Govt./Credit Index ** Hedge Fund Research Institute Fund of Funds Index ***CSFB/Tremont Hedge Fund Index

Summary

Our key findings are:

- Globally only $19.8 billion of assets under management were acquired during the first quarter; the lowest amount for any quarter in over 6 years, and a fraction of the $252 billion quarterly average of the past three years (2000-2002)
- There were a total of 25 asset management acquisitions announced globally in the first quarter representing a decrease of 11% compared to the first quarter of 2002 and an increase of 39% compared to the fourth quarter of 2002
- Strategic partnerships (e.g. joint ventures, alliances and distribution arrangements) were out of favor during the quarter with only one joint venture announced
- There were only six US acquisitions announced during the quarter, the largest of which was Gartmore Global Investments' acquisition of Groupama Asset Management, a $1.2 billion separate accounts manager
- In structured fixed income products, global CDO issuance was $7 billion in the first quarter of 2003, a decline of 36% compared to the first quarter of 2002
- According to research by Sector Analysis, mutual fund of funds are expected to grow across Europe during 2003 by approximately 20% in most countries
- Hedge fund indices were generally positive for the first quarter of 2003 with returns ranging from 1—3%, with trailing 12 month returns of 3-7%
- Max Re's Diversified Strategies experienced strong returns during the quarter of 2.9%. Overall its alternative investments portfolio returned 3.1%

Eric Weber	+1 (212) 830-6162	eweber@freeman-co.com
Akram Ben	+1 (212) 830-6192	akram@sectoranalysis.co.uk
Eric Schwarzbach	+1 (212) 830-6169	eschwarzbach@freeman-co.com
Kerry Saladino	+1 (212) 830-6174	ksaladino@freeman-co.com

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Freeman & Co. 1301 Avenue of the Americas 30th Floor New York, NY 10019 • Tel: +1 (212) 830-6161 • Fax: +1 (212) 265-4998 • www.freeman-co.com

Sector Analysis, Ltd., 77 East Road, 1st Fl London N1 6AH UK • Tel: +44 207-490-0222 • Fax: +44 207-336-0100 • www.sectoranalysis.co.uk

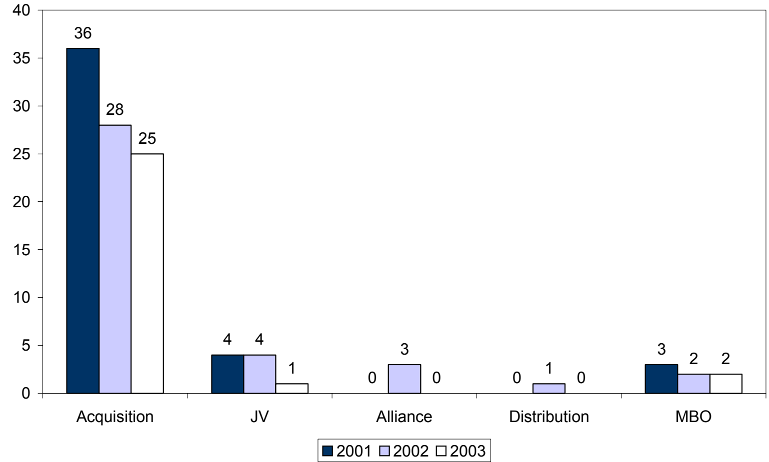
Global Asset Management Transactions

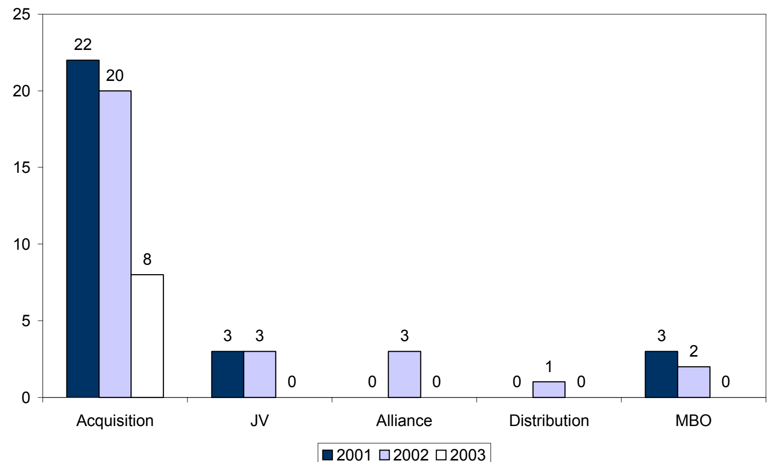
The number of acquisitions in the first quarter of 2003 was down 11% from 28 to 25, compared with the first quarter of 2002, while the number increased 38% over the 18 deals in the fourth quarter of 2002. The total of 18 acquisitions announced in 4Q02 had been the lowest in over 5 years.

Strategic partnerships (e.g. joint ventures, alliances and distribution arrangements) were few during the first quarter with only one joint venture occurring. Two MBOs occurred during the quarter, both of which were related to companies disposing of their private equity portfolios by selling them to the portfolio managers. There were no strategic alliances or distribution arrangements announced during the quarter.

At the current pace we would expect to see approximately 100 asset management acquisitions for the year, or less. This contrasts significantly from the period between 1998 to 3Q2002, when we recorded 30-40 acquisitions per quarter. This drop of 20-40% in the number of deals is even more dramatic when one examines total AUM acquired, which is down by 80+% from the peak level in 2000, when over $1.7 trillion of assets were acquired.

With the end of the war and a small stock market rally, activity might pick up later this year, but only slightly we predict. The large deals that are occurring are all driven by strategic shifts and corporate divestitures — note the sale of Threadneedle by Zurich Financial Services to American Express and the sale of State Street's personal trust business to US Trust as examples of this.



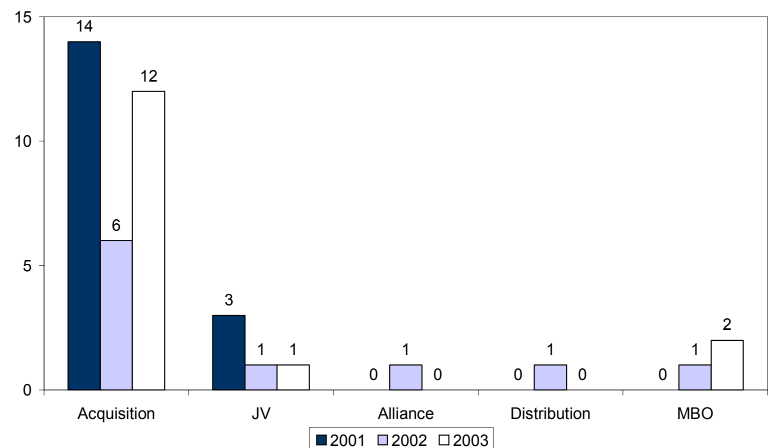


US vs. European Activity

Acquisitions involving European companies (12) outnumbered those involving US companies (8) by 33% in the first quarter. Asset management deal activity was slow in the US during the first quarter, declining 40% compared to the first quarter of 2002 (14 deals). On the other hand, acquisitions involving European companies increased 100% over the first quarter of 2002 from 6 deals to 12 deals.

This shift is startling, as the US has consistently had far more asset management deals than Europe. The boom in the US asset management business post-ERISA and the structure of the US retirement system has provided a large pool of small– to mid-sized managers. The US has also had a steady stream of strategic, financial and consolidation buyers. Europe, on the other hand, does not have a large pool of independent asset managers, and the marketplace has historically been fragmented along country lines.

We expect that activity in the US will rebound next year to levels slightly below historical norms, while we would expect activity in Europe to increase steadily as firms continue to position themselves for pan-European competition.



Source: Freeman & Co.

US Companies acquired in the First Quarter

There were only six US asset management-related companies acquired in the first quarter of 2003, and only 8 acquisitions in total for the first quarter involving a US company as buyer or seller. The 6 acquisitions are down from 7 US companies acquired in the 4th quarter of 2002, when there were only 18 companies acquired globally.

The largest deal of the first quarter by assets under management was Gartmore Global Investments purchase of Groupama Asset Management, a separate accounts manager with $1.2 billion in AUM. The remaining acquisitions during the quarter were quite small in comparison, with the next largest US deal being the acquisition of Pension Benefits Inc with $155 million in pension assets by Patriot Bank Corp. Along with the purchase of the Groupama Asset Management, the Gartmore Group also acquired the $23 million Montgomery Absolute Return fund, a $23 million AUM fund of hedge funds that had not been included in Wells Fargo's acquisition of Montgomery from Commerzbank.

Mellon Financial Corp acquired DirectAdvice, an online financial planning service, to add to its servicing platform. Mellon has traditionally been very acquisitive in the asset management space and has recently focused its business on bulking up its servicing platform.

The collapse in deal activity has two sides to it. On the buyer side, many firms continue to struggle with product performance, disappointed customers and poor profitability. Senior management is spending their time on other issues, not on how to expand product lines or distribution channels. On the seller side, many firms either have unrealistic price expectations in this marketplace or have seen their assets decline enough (i.e. growth managers) that they are unwilling to attempt a sale. Unfortunately, we think the days of paying double digit EBITDA multiples for average firms is done; the strong bull market of the late 90s could make most of those deals profitable, but that is no longer the case. With slow, stagnant or declining growth for the industry and a less sanguine view by buyers, high priced deals will be infrequent.

1st Quarter 2003 US Companies Acquired

Month	Year	Partner 1 / Target	Partner 2 / Acquirer	Ownership %	Total Deal AUM ($MM)
1	2003	DirectAdvice (SM)	Mellon Financial Corp	-	
1	2003	Montgomery Absolute Return Fund	Gartmore Group	100	23
1	2003	Stone Capital Management Inc	First Community Bancshares Inc	100	94
1	2003	Pension Benefits Inc	Patriot Bank Corp	100	155
2	2003	Rutherford Asset Planning	Clarfeld Financial Advisors	100	
3	2003	Groupama Asset Managerment	Gartmore Global Investments	100	1,200

Source: Freeman & Co.

Assets Acquired in the First Quarter

Assets acquired in the first quarter declined dramatically to the lowest level since the fourth quarter of 1996. AUM acquired was down 59% to $19.8 billion compared to the first quarter of 2002 and down 72% compared to the previous quarter.

One of the most distinguishing trends when looking at AUM acquired in the first quarter is that both South America and Asia sold more than twice the assets as the US[1]. The reason for such a large amount of assets being acquired in these regions is primarily the result of three deals: 1) In Australia (Asia) CPH Investment Corp acquired Challenger International with $6.8 billion in AUM, 2) In Mexico (South America) GNP Pensiones SA acquired the remaining 40% stake from AIG in the $4.6 billion pension fund Grupo Nacional Provincial Pensiones SA and 3) HSBC acquired Banc of Americas $620 million Brazilian funds unit.

The war and the floundering stock market earlier this year certainly contributed to this low level of activity. With the war over (but certainly not the reconstruction) we have seen an improvement in outlook for the markets, and the potential for more activity later this year. Our best educated guess is that overall activity in the industry will be below the levels of 2002 (a bad year coming off previous highs in 2000 and 2001) and 1998 (a normal year back then). Already as we write this, two larger deals have been announced: Schwab buying a business from State Street and American Express buying a Threadneedle from Zurich Financial Services. News should get better in 2004 after the market works off its hangover from 2000.

Asset Acquired by Seller Region ($MM)

Region [1]	1998	1999	2000	2001	2002	2003
Africa	34,910		28,900		11,700	
Asia	68,982	82,244	28,802	26,842	6,797	7,645
Canada	11,600	8,304	43,181	48,152	33,830	
Europe	126,422	160,057	667,646	115,454	322,890	5,275
South America	8,285	19,062	2,122	2,047	3,683	5,290
US	229,605	415,067	945,624	647,321	97,967	1,622
Total	**$479,804**	**$684,734**	**$1,716,275**	**$839,816**	**$476,866**	**$19,833**

Source: Freeman & Co.

[1] Please note that for regional classification Freeman & Co. includes Australia in Asia and Mexico in South America

The Mutual Fund Industry

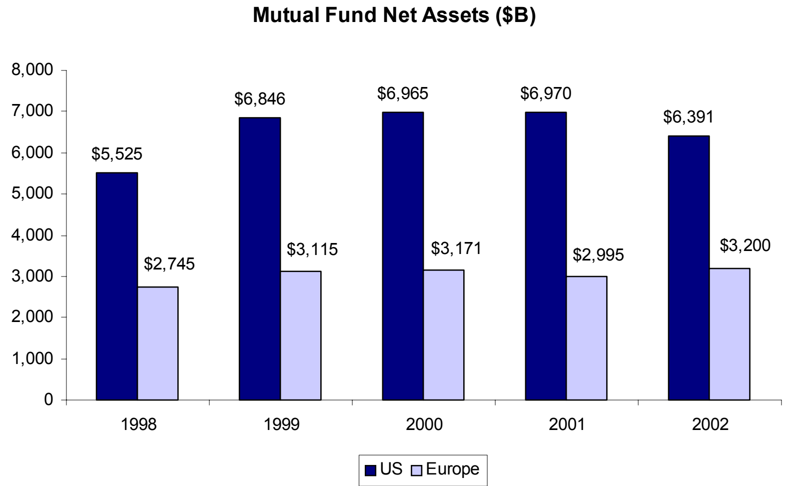
In 2002 the US mutual fund industry suffered its first overall decline in assets in recent history with the industry's asset level falling from $7.0 trillion in 2001 to $6.4 trillion, representing a decline of 8%. The European mutual fund industry fared better for the year experiencing an increase of assets of 7% after losing 6% of its total assets in 2001.

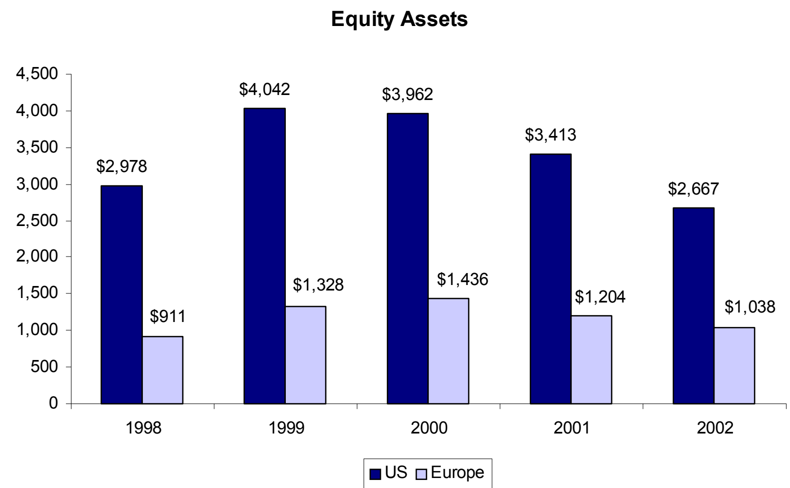
Equity assets have been battered in both the US and Europe. The US mutual fund industry has lost 34% of its equity assets since its peak of $4.0 trillion in 1999 and finished 2002 with total equity assets of $2.7 trillion. The European mutual industry's equity assets reached a peak of $1.4 trillion in 2000, but has since declined 28% to a total of $1.0 trillion.

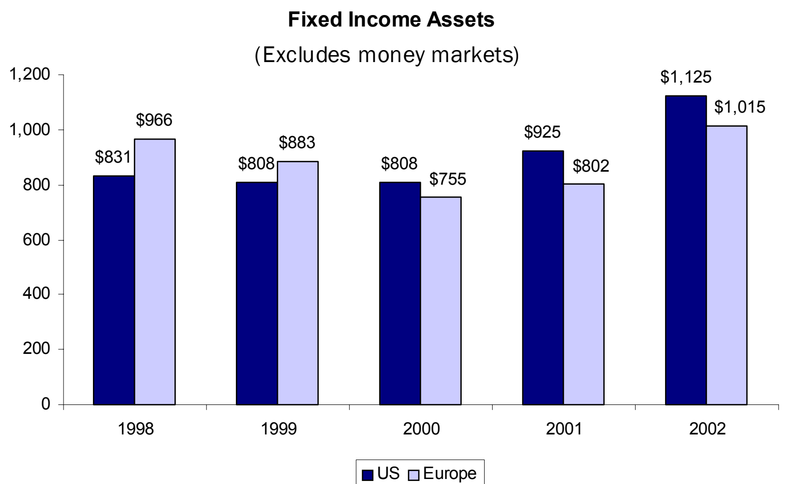
On the other hand, fixed income assets have experienced a surge over the past three years. After remaining at a fairly stagnant level for the latter part of the past decade, fixed income assets have increased significantly during a period of declining equity markets. Both the US and Europe have seen two straight years of strong growth in fixed income assets. In the US, fixed income assets grew 14% in 2001 and another 22% in 2002 to reach its highest level ever of $1.1 trillion. European fixed income assets grew modestly at 6% in 2001 and leapt 27% in 2002 to a peak of $1.0 trillion.

In Europe, fixed income assets represent a much larger percentage of the total industry's assets accounting for 32% compared to the US where fixed income assets represent 18% of the total industry. In the US, equity assets are more than double its fixed income assets, whereas equity and fixed income assets are almost on par in Europe at $1.04 trillion and $1.02 trillion, respectively. In comparison, the US and European mutual fund industry's fixed income assets are nearly equal in size despite the overall US mutual fund industry being twice as large.

To illustrate these trends, it is useful to look at two different types of asset managers: Blackrock in fixed income and Janus in growth equities. From early 1999 to early 2001, Blackrock grew its assets from $140 billion to $200 billion. Since then Blackrock added another $75 billion, bringing it to $275 billion or roughly double its size of 4+ years ago. On the other hand, Janus had a similar level of assets in early 1999 ($160 billion), but grew that to $300+ billion in early 2001. Since then assets have fallen over 55% to $135 billion at the end of March 2003. While this comparison may be a bit dramatic, it is indicative of our 3Q02 report's title—*Diverging Results Lead to Diverging Fortunes.*

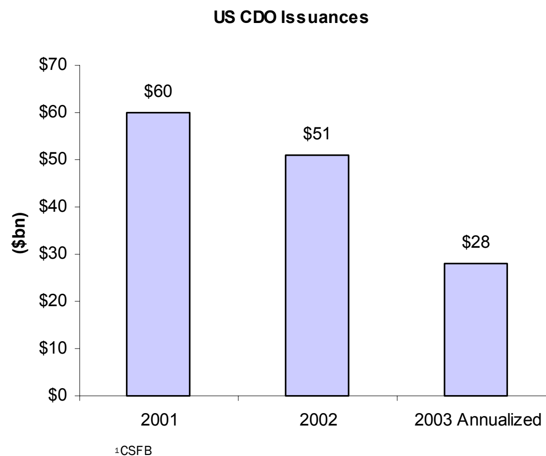






Source: ICI, FEFSI

Structured Products Fixed Income



We have written a great deal about alternative asset management products over the past two years, although most of this focus has been on the hedge fund and hedge fund of fund business. The "alternative" asset management business continues to expand, driven, generally, by two trends: first, the creativity of Wall Street's sellside and buyside, and second, the expansion of institutional investor's appetite for these asset classes.

One trend we have seen is the development of multi-product alternative asset management firms — combining asset classes such as private equity, hedge funds, real estate, and structured products. Firms have embarked upon a product expansion strategy for internal and external reasons. Internally, these firms can diversify their revenue bases and draw on different investment perspectives (credit, equity, industries, etc.). Externally, they are focused on delivering multiple products to their customers and relationship bases. The best example of this has been The Blackstone Group, which has private equity, mezzanine, CLO, hedge fund of fund, real estate and private equity products. One critical reason, we believe, that its hedge fund of fund platform has been one of the fastest growing is the firm's ability to cross-sell the product to its existing relationships — a strong advantage as the industry gets more competitive.

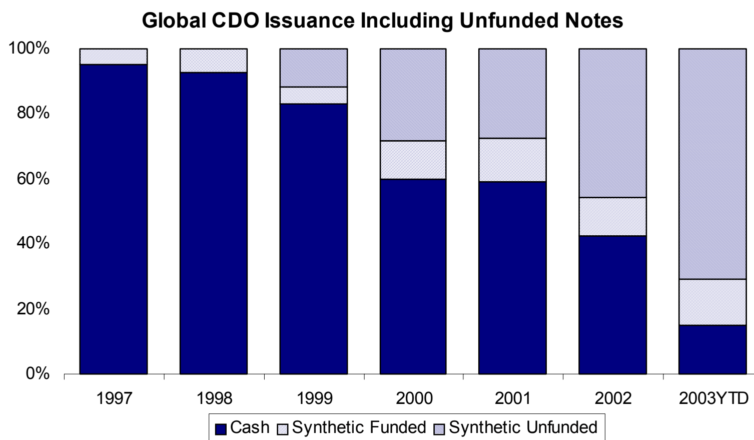
US Deals Downgraded

	Vintage Year							
Year	1996	1997	1998	1999	2000	2001	2002	Total
2002	13	27	48	54	37	17	2	198
2001	3	20	31	19	6	2	0	81

Source: CSFB. * By deal count, including previously downgraded deals as of 12/13/2002

One product that many traditional asset managers and private equity firms have launched is structured fixed income vehicles. Originally these were collateralized pools of high grade debt, high yield debt or loans. Unfortunately, many of these CDO deals bought the huge corporate debt originations that fueled the telecom boom of the late 1990s. Note the large number of CDO downgrades for deals originated in 1998 and 1999. Today, these CDO products are shifting to hold synthetic underlying credit positions through credit default swaps and other fixed income derivative securities. Size estimates of the credit derivates market range from $2.0 to $2.6 trillion according to Fitch, ISDA and *Risk*.

Although the CDO market has experienced intense growth over the last few years, the deterioration of many of the deals from 1998-2000 has slowed origination. US CDO issuance was approximately $7 billion in the first quarter of 2003, down 36% or $11.7 billion from the first quarter of 2002. This puts 2003 annualized origination at only $28 billion, a steep drop from volumes in previous years. Certainly, the dramatic losses taken by some equity tranche investors in past deals has made raising the assets for each part of the capital structure difficult in this environment.



Source: Creditflux, MCM Corporate Watch, IFR Markets, Bloomberg, Merrill Lynch. As of 3/31/2003

Global issuance was down compared to the same time last year. Year to date, globally funded CDO issuances totaled roughly $11 billion compared with $16 billion in the same period last year, a drop of 31%. However, according to S&P; 884 credit classes from 337 CDO transactions were rated by the agency last year, a 59% increase in the number of classes.

We believe the structured fixed income product market place has some similar characteristics to the hedge fund business that will help support long term growth in the asset class. This includes increased access to information (both on managers, deals and underlying collateral), increased transparency, education of investors and the development of a secondary market. Much as hedge fund of funds have developed to invest in hedge funds, CDOs of CDOs have developed to create customized investment products. Although the product class is suffering a bit at this time due to the large volume of credit defaults in the cash debt market, we believe the underlying trends will promote growth once the credit cycle improves.

In the industry, we expect more firms to develop multi-product alternative asset management platforms to leverage marketing and distribution channels and to diversify revenue streams. Currently Blackstone is the best example of this, although other firms, both large and small are pursuing this model: of larger firms, Credit Suisse has restructured part of its asset management operations to consolidate its alternative asset classes; numerous smaller firms that we talk to continue to expand product lines to promote cross selling of products. We would expect this to continue.

Europe—Fund of Funds and Open Architecture

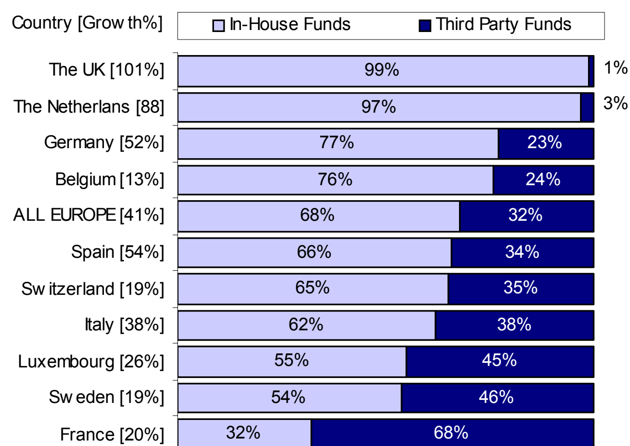
Both research and casual observation of the industry in Europe indicates that fund of funds (mostly long-only, but some involving hedge funds) are becoming a popular product, with many industry participants bullish about the prospects for these vehicles. However, we have found that beyond the casual observation, there are a number of diverging characteristics that are affecting this business model. As a result, we believe that different participants in the value creation chain for these products will have significantly different growth and profit opportunities.

Research through Sector Analysis shows that the industry projects fund of fund products to grow by 41% over the next year, with growth predicted in each of the ten countries surveyed by Sector. At the low extreme, organizations in Belgium were looking for 13% growth in funds of funds, while the product was expected to grow by 19-20% in France, Switzerland and Sweden and at even higher rates in the other countries. The most optimistic distributors were in the UK, where funds of funds were anticipated to grow by just over 100%.

Overall this projects a fantastic future that we should begin celebrating! However, this rosy picture fails to explore the conflicting and challenging relationship between distributors and product providers and the economic relationship between them as they fight for the minds and wallets of the investor.

First, distributors and product manufactures are both business partners and competitors fighting for the same investment funds. As such, the fund of fund product area has become a unique area for these two parties. On one hand, it would appear that strong product brand names with strong performance (i.e. Fidelity) were forcing distributors to accept “open architecture”. However, we believe there are two types of open architecture: distributor-biased and product provider-biased. The best example of a product provider-biased business model would be Schwab’s OneSource mutual fund platform. On this, the investor can select each investment product to build his or her own portfolio. In this case, brand name and individual product performance can have a significant influence over the selection of each investment vehicle. A distributor-biased example would be firms like SEI Investments and Frank Russell, where they construct the product for the end investor and do not always offer full transparency on the underlying investments or the selection criteria.

Although, both product-biased and distributor-biased open architecture offer capital raising opportunities for product mangers, the resources necessary to target each type are quite different. For example, the product-biased platform is likely to require a broader, retail oriented marketing campaign to convince the end customer of products’ positive attributes. Also, because the end investor is likely to make investment decisions, the service component will be more of a wholesale, supporting relationship with the distributor. On a distributor-biased platform, the marketing is likely to be at an institutional quality level. Since the distributor is building a fund of fund product and selling its expertise in doing so, the service component will also be of an institutional nature.



Source: Sector Analysis Ltd.

Second, although rising tides (and assets) generally lift all boats, the economics of these relationships are not always factored in. For example, it is generally believed that the push to open architecture is positive for product manufacturers. Although we generally agree with this, we believe that many economic costs are overlooked when assessing the potential gains. To begin, there will be increased marketing costs to target these distributors and, in some cases, their end customers. Next, there will be additional service costs to support these customers, who will be quite demanding on the required service levels. The other squeeze that eventually happens is that after the product manufacture has built up its fixed costs to support this channel, the distributor will squeeze the manufacture for a greater share of the economics. Since the product provider does not control the customer relationship, there is little it can do. This has happened in the US with both mutual fund platforms and “wrap” account platforms and it will eventually happen in Europe.

Third, fund of fund products are being used by distributors to distribute proprietary, in-house fund products, as shown by the chart above, with in-house products averaging 68% of assets in fund of funds across Europe . A financial firm certainly gains greater economics by acting as both product provider and distributor. The main (economic) point is that although growth in fund of funds will provide positive, economic opportunities for product manufactures, the majority of the economic gains will be captured by the firms that control the customer relationships (i.e. banks, insurers, IFAs). Pressure may come on distributors if investors begin to ask for more transparency in the underlying investment programs, selection processes and risk monitoring procedures.

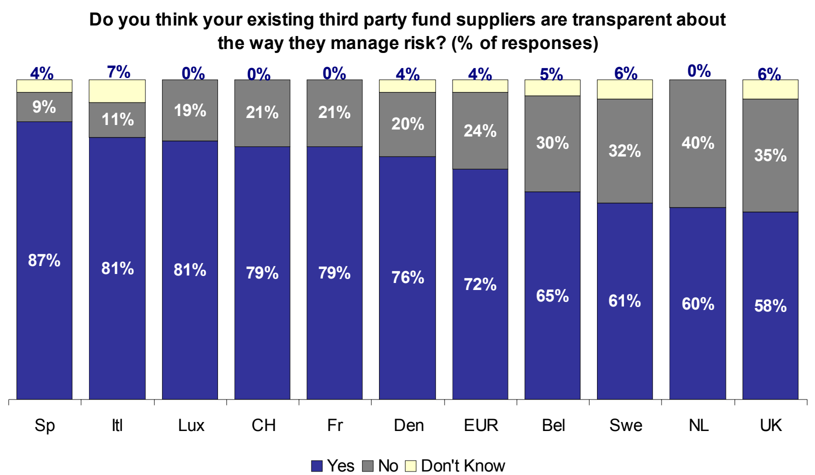
Europe— Fund of Funds and Transparency

Sector Analysis recently carried out a survey to measure the extent to which fund providers in Europe are perceived by fund distributors as transparent in the way the product manufacturers manage risk. Across Europe, 72% of distributors believed their third-party fund suppliers are transparent about risk management (see chart below). However, 24% of distributors across Europe believed that product providers were not transparent about risk management processes. This data is important in light of the growing use of fund of fund products and the move towards open architecture — we believe that product manufacturers will be asked to disclose more information if they are to be selected for a platform or product.

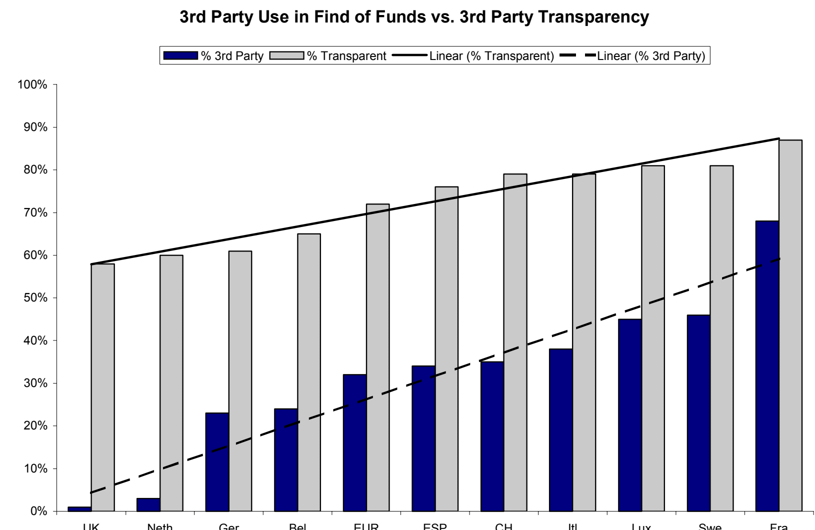
When we examine the data, we find interesting examples in the UK and Netherlands. These two countries have the highest reported non-transparency level of investment providers (UK of 35% and Netherlands of 40%), and each have the lowest use of third party funds in fund of fund products (UK at 1% and Netherlands at 3% use). Our view is that these two characteristics are related, although the exact correlation is difficult to establish precisely. Clearly, a correlation between lack of risk management transparency and low use of those products makes intuitive sense.

Beyond the intuitive sense, the survey respondents agreed that transparency in risk management is "of the highest priority and that "a lot can be done to improve the current situation further".

- UK portfolio manager: "The language used is often confusing and opaque".
- Dutch insurance company: "there is a lack of transparent information about fund composition".
- German bank: "Fund providers try to keep the figures secret, in order to have greater freedom regarding investments."



Drawing from these comments, the survey results and trends in the US, we can make some projections about future industry developments. The growth in fund of funds, as demonstrated on the previous page, makes the sales process for product providers more competitive. In particular, as fund of fund providers gain critical mass, product providers will focus their sales efforts on the larger players. As these larger players get "courted" by more parties, they will become more selective of the product provider and more demanding of supporting service. The supporting service required certainly will expand to include risk management reporting, holdings transparency and more detail on security selection processes. Product manufacturers that do not meet distributors' needs in these areas cannot expect to gain the largest market share.



The next, long-term market impact would be for fund of funds and other distributors to provide greater transparency to the end-customer. However, this development is likely to be hindered by two factors: lack of demand and lack of purchasing power concentration by the investor. In the first case, many European retail investors are not looking for the same level of transparency and risk reporting that institutional fund of fund providers are from product manufacturers. While this has developed in the US, it has been helped by the broad-based education of investors through 401 (k) plans and individual financial planners. In fact, it is probably the financial planners who have had the greater impact on request for transparency. In the second case, since retail investors act independently and make small investments, they do not have the purchasing power or influence to drive distributors to increase the level of transparency for their internally managed products (either single funds or fund of funds).

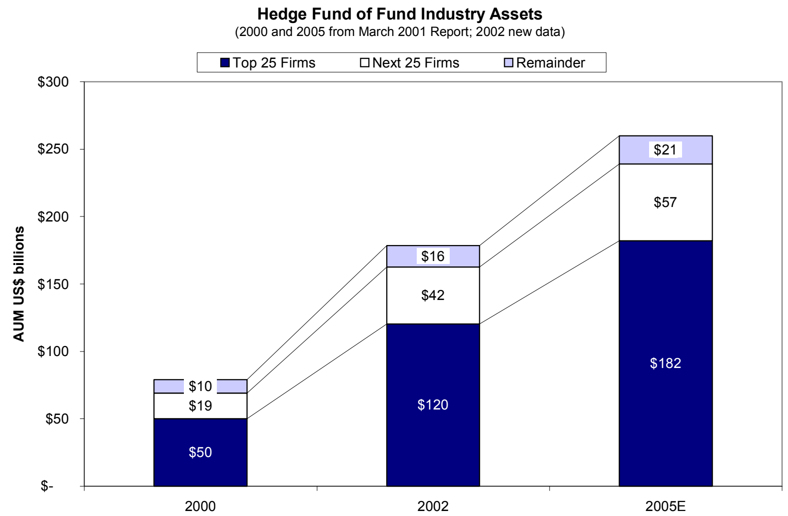
Alternative Investments—Fund of Fund Challenges

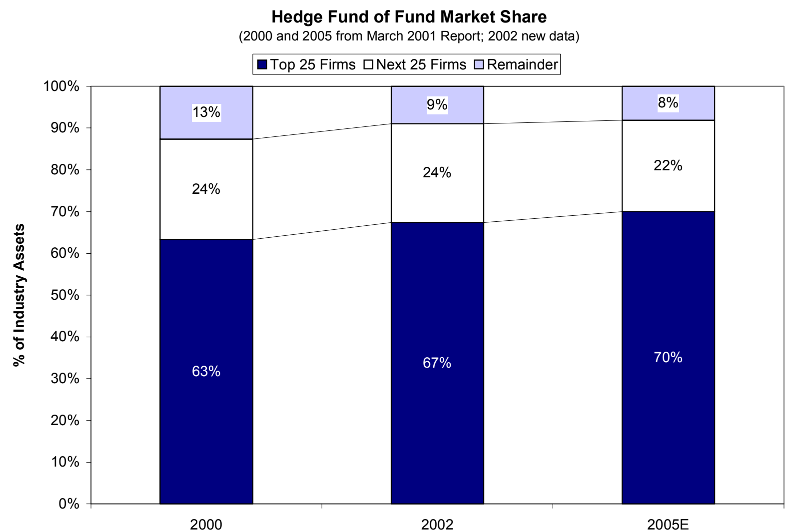
We wanted to explore how the competitive landscape for hedge fund of funds is changing, so we have compared our original projections in our March 2001 report, *Changing Tides,* to data on the industry compiled in *Institutional Investor.* We had originally looked at market size and share in 2000 and made some projections for 2005. We have filled in the data for 2002 with figures from *II's* Top 50 Fund of Fund list, and added some of our own research on the rest of the industry. We have looked at three main characteristics of the industry: total assets, market share and average firm size.

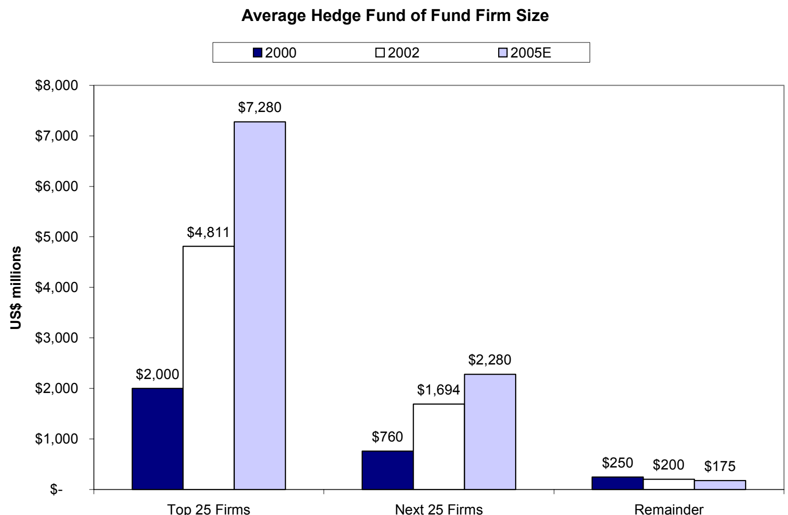
Total assets in hedge fund of funds have grown from an estimated $79 billion in 2000, to approximately $179 billion in 2002, with our original estimates of AUM in 2005 at $260 billion. It seems quite reasonable that assets in 2005 will exceed $260 billion, as this would only be a 13% CAGR from today's levels. Industry growth rates of 15-20% seem more realistic, given asset performance of 6-8 % net of fees and incremental allocations of 7-14%. These growth rates would place the industry at $272-309 billion in 2005.

When we look at estimated market share using our projections, plus *II's* Top 50 list, we see that the top 25 firms continue to collect the vast majority of the assets. In fact, the top 25 firms have on average 2.7x the level of assets of the next 25 firms. We expect this figure to continue to rise as the largest firms have competitive advantages in terms of building risk systems, developing structured products, developing new distribution channels and expanding globally. The market share of the smallest firms will remain relatively stable, but most of the increase in assets will be spread across a large number of existing and new firms.

Lastly, we have examined average firm size, as it is a reflection of firms' abilities to develop new products, hire talented people and increase market share through new distribution efforts. The research indicates that the top 25 firms average $4.8 billion today and should average over $7.2 billion each in a few years. The next 25 firms have grown from an estimated $760 million to $1.7 billion today, with a targeted AUM size of almost $2.3 billion in three years. Finally, we examined the smallest and most difficult segment of the market (those firms outside the top 50 firms). The problem with the smallest firm segment is that the large number of new entrants is dragging down the average firm size in this segment. While the hedge fund of fund industry was cottage-like for a long time, it was quite common to find a firm that had been managing $200-400 for 5+ years. Now, there are more firms than we can count with $10-50 million in assets. While many of these firms survived on performance fees in the boom years, we question how many will survive the next three years.







Alternative Investments— Hedge Fund Indices & Index Linked Products

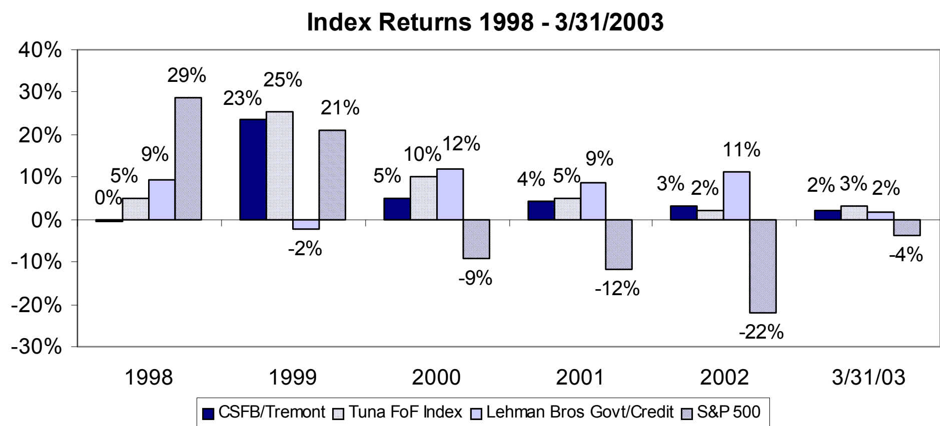
Hedge fund indices had positive results in the first quarter of 2003 with returns ranging from 1 to 3%. Hedge funds continue to outperform the equity indices as the S&P 500 lost 4% in 1Q03, and hedge fund returns were generally on par with fixed income returns as evidenced by the Lehman Brothers Govt./Credit Index's return of 2%.

In March 2001, we wrote of the hedge fund industry, "one instrumental factor that has supported the growth is the increase in information and data available". We didn't realize at the time that the rate of growth in the number of hedge fund indexes would be greater than the growth rate in hedge fund assets. Nonetheless, we continue to believe that the increase in data availability on hedge funds is a great positive for the industry as a whole. For example, increased information helps educate investors, trustees and investment consultants, which should lead to greater awareness of and investment in hedge fund vehicles.

However, greater information dissemination often leads to disintermediation of a middle man, as mutual fund platforms such as Schwab's OneSource have accomplished with direct mutual fund sales. Luckily for all the hedge fund of funds out there, picking and monitoring hedge funds is a lot more complicated than picking or monitoring mutual funds. In addition, many investors, particularly institutions, will want to pass fiduciary responsibility to another party.

The number of indices has increased to include, among others:

- CSFB / Tremont
- MSCI
- Standard & Poor's
- Van Hedge Advisors
- Zurich Benchmarks
- Tuna Indices
- Evaluation Associates



Many of the new hedge fund indexes are being created for two reasons: marketing (brand name, market presence, etc.) and to create index-linked products.

S&P, for example, has teamed with Plusfunds Group to offer investment products linked to its hedge fund index (highlighted in our 2Q02 edition). These products include separately managed accounts that are based on the 9 sub-strategies that compose the S&P 500 hedge fund index. Many of the indices mentioned above offer investment products designed to track the returns of the respective indices. In most of these instances the process of creating and maintaining the index is separated from the investing and creation of the product either through partnerships (e.g. Standard & Poor's—Plusfunds) or through an independent academic relationship (Zurich Benchmarks Index managed by an independent industry committee).

One of the business units at investment banks driving the use of hedge fund indices is equity derivatives. Many of the equity derivative desks of the European banks have a strong business of creating index-linked notes on current equity indices (e.g. FTSE, CAC, etc.) and capital guaranteed products. Most of these firms are pushing to develop similar businesses based on hedge funds and hedge fund of funds. As a result the indices are needed to create and sell the products, and the underlying hedge funds are need to provide a hedge against the note being issued. In time, there will be enough interest in trading hedge fund indices (long and short) that a liquid futures market could develop, thereby reducing or eliminating the need for the underlying hedging positions in the funds.

The other main product linked to hedge fund of funds is capital guaranteed notes. Again, these are being driven by the equity derivative desks of the European investment banks. However, the terms of these notes have changed dramatically over the past three years as interest rates have fallen. The capital guarantee writer manages its risk by comparing the indexed net asset value (NAV) of the insured product (i.e. 100) to the price it could purchase a US Treasury zero coupon note of the same maturity. This is the gap risk between the market value and the price to immunize the future liability. The problem is that as interest rates fall the buffer between the bond floor and the NAV shrinks — the result is that the maturity of the notes has to be longer. For example, Man Group has recently raised over $700 million in guaranteed notes with a 12 year maturity in 2015. Although capital guaranteed products are popular in Europe, we question how long investors will have strong demand for notes with 12+ year maturities, since these products are difficult to terminate prior to maturity.

Alternative Investments—Max Re

Max Re Financial Data as of March 31, 2003

Asset Type	Market Value ($000)	Total %	Alternative %	Returns 1Q03	Returns Last 36 months	Asset Change Q4-Q1 $000	Asset Change Q4-Q1 %
Cash and Fixed Maturities	$1,424,974	65.9%	NA	1.2%	8.9%		
Global Macro	87,046	4.0%	11.8%	2.0%	9.0%	(6,194)	-2.9%
Long / Short Equity	72,481	3.4%	9.9%	2.4%	0.1%	13,259	0.8%
Convertible Arbitrage	53,495	2.5%	7.3%	5.1%	14.1%	17,205	1.9%
Diversified Arbitrage	149,472	6.9%	20.3%	2.7%	12.2%	26,299	1.5%
Distressed Securities	65,427	3.0%	8.9%	5.2%	3.0%	(14,018)	-3.8%
Opportunistic	27,849	1.3%	3.8%	0.0%	5.1%	(5,768)	-1.6%
Emerging Markets	43,906	2.0%	6.0%	3.5%	1.3%	18,935	2.4%
Fixed Income Arbitrage	73,310	2.4%	10.0%	2.5%	4.5%	26,146	3.0%
Event-Driven Arbitrage	49,959	2.3%	6.8%	3.1%	8.1%	1,673	-0.7%
Commodity Trading Advisers	34,561	1.6%	4.7%	2.9%	0.2%	1,121	-0.5%
Max Re Diversified Strategies	**$657,506**	**30.4%**	**89.4%**	**2.9%**	**5.3%**	**$78,658**	**0.0%**
Insurance Underwriting	78,226	3.6%	10.6%	5.3%	5.8%		
Alternative Investments	**$735,732**	**34.1%**	**100.0%**	**3.1%**	**5.7%**		
Total Investments	**$2,160,706**	**100.0%**	**NA**	**1.8%**	**7.8%**		

Max Re reported better than average returns for its alternative investments portfolio in the first quarter of 2003. The Max Re Diversified Strategies hedge fund of funds portfolio (managed by Moore Capital) returned 2.9% for the first three months of the year and the insurance underwriting investments returned 5.3%. In total, the alternative investment strategies returned 3.1% compared to 1.8% for the overall investment portfolio of the firm. Returns were highest amongst distressed securities and convertible arbitrage at 5.2% and 5.1%, respectively, with each style accounting for 9-10% of the alternative investments portfolio. In fact, every hedge fund style was positive with the exception of the opportunistic strategy which was flat.

At March 31, 2003 Max Re had 34.1% of its investment portfolio invested in alternative investments compared to 32.2% of its portfolio at December 31, 2002. Strong returns are responsible for a significant portion of the increased ratio of alternative investments. Within its Diversified Strategies fund of funds, the company made few significant reallocations. The largest adjustments made to the portfolio were a decrease in distressed securities of –3.8% of assets and a reduction in long/short equity of –2.9% of assets. Fixed income arbitrage assets under management increased the most, up 3%, mostly attributable to its returns of 2.5%.

Moore Capital—Strategic Positioning

At a total of $657.5 million in assets under management, the Max Re Diversified Strategies fund would be one of the larger hedge fund of funds in the US, and it is certainly one of the largest single accounts. As hedge funds, bankers and investment banks continue to look at ways of creating an M&A market for hedge funds, Moore Capital has created a very nice business line of critical mass that could be capitalized in the future. Although the reliance on a single account for a large portion of assets always affects valuation levels, Moore has created a business line that is certainly more sellable than a single strategy hedge fund. This business approach shows how lines are beginning to blur in the alternative world.

We believe that hybrid business models will continue to develop between the traditional positions of hedge funds and hedge fund of funds, and that firms like Moore Capital will continue to lead these developments. Previously it was simple — hedge funds managed money and fund of funds allocated money. Today, the gap is being filled by both firms. For example, many hedge fund of funds are incubating hedge funds — assisting with the start-up, risk management systems and taking economic stakes in the firms. Many of the largest hedge funds are managing multiple styles internally, and are themselves becoming allocators of capital. Firms such as Front Point Partners are also targeting this gap between the two business models.

In the long-only world, there were a number of businesses that provided liquidity events for asset management owners, such as UAM, Nvest and AMG. The liquidity event business model for hedge funds has not yet been perfected, but judging from some failed imitators of AMG, it will be important to be one of the first to get public liquidity to make the financial models work.

US Public Money Managers—Valuations

				3/31/03	Last 12 Months							
	Avg, AUM $Bil.	Enterprise Value (EV) [1]	Market Cap $MM	Share Price	Revenue	EBITDA[2]	Core Net Income[3]	EV/ EBITDA[2]	EV/ EBIT[3]	Price/ Core Income[3]	Price/ TTM Income	% of AUM
Diversified												
Blackrock (BLK)	260.5	1,803	1,803	$43.54	573.6	219.6	134.9	8.2x	8.2x	13.4x	13.2x	0.7%
Eaton Vance (EV)	56.3	2,158	1,957	$26.73	512.2	194.2	114.8	11.1x	12.5x	17.0x	17.2x	3.5%
Federated Investors (FII)	189.2	3,281	3,203	$25.45	699.4	342.8	210.1	9.6x	10.1x	15.2x	16.0x	1.7%
Franklin Resources (BEN)	257.1	7,742	7,166	$32.91	2,492.9	590.7	413.7	13.1x	13.5x	17.3x	17.3x	2.8%
Gabelli (GBL)	21.2	854	846	$27.55	198.0	89.1	51.4	9.6x	9.6x	16.5x	17.9x	4.0%
Neuberger Berman (NEU)	56.2	2,072	1,927	$28.23	608.9	232.3	107.7	8.9x	9.6x	17.9x	17.9x	3.4%
SEI Investments (SEIC)	76.5	3,104	3,070	$26.20	612.2	210.7	130.5	14.7x	14.7x	23.5x	21.7x	4.0%
Janus Capital (JNS)	145.3	7,018	6,168	$11.39	1,052.0	296.9	(46.6)	23.6x	31.3x	NA	236.3x	4.2%
T Rowe Price (TROW)	140.2	3,544	3,487	$27.12	895.6	318.1	183.1	11.1x	12.0x	19.0x	19.4x	2.5%
Waddell & Reed (WDR)	27.4	2,458	2,248	$17.57	424.5	116.2	64.1	21.2x	22.4x	35.1x	32.7x	8.2%
Total	*1,229.9*	*$34,033*	*$31,875*		*$8,069*	*$2,611*	*Average*	*13.1x*	*14.4x*	*19.4x*	*41.0x*	*3.5%*
							Median	*11.1x*	*12.3x*	*17.3x*	*17.9x*	*3.5%*
Insurance												
Nuveen Investments (JNC)	76.6	2,925	2,701	$22.35	405.4	219.7	134.3	13.3x	13.6x	20.1x	21.0x	3.5%
Total	*76.6*	*$2,925*	*$2,701*		*$405*	*$220*		*13.3x*	*13.6x*	*20.1x*	*21.0x*	*3.5%*
Consolidators												
Affiliated Managers (AMG)	70.5	1,073	626	$41.57	473.4	209.2	131.9	5.1x	5.7x	4.7x	11.5x	0.9%
Total	*70.5*	*$1,073*	*$626*		*$473*	*$209*		*5.1x*	*5.7x*	*4.7x*	*11.5x*	*0.9%*
Bank/Trust Companies												
Boston Private Fincl. (BPFH)	6.4	639	638	$14.96	118.4	33.5	19.7	19.1x	19.2x	32.5x	33.5x	9.9%
Wilmington Trust (WL)	29.7	1,988	1,826	$27.80	516.6	203.6	130.9	9.8x	9.8x	13.9x	14.0x	6.2%
Total	*36.1*	*$2,627*	*$2,464*		*$635*	*$237*	*Average*	*14.4x*	*14.5x*	*23.2x*	*23.8x*	*8.0%*
							Median	*14.4x*	*14.5x*	*23.2x*	*23.8x*	*8.0%*
Limited Partnerships												
Alliance Capital L.P. (AC)	398.3	7,408	6,968	$28.80	2,624.5	612.2	546.0	12.1x	12.5x	12.8x	12.6x	1.7%
Total	*398.3*	*$7,408*	*$6,968*		*$2,625*	*$612*		*12.1x*	*12.5x*	*12.8x*	*12.6x*	*1.7%*
Overall												
Total	*1,811.3*	*$48,066*	*$44,634*		*$12,208*	*$3,889*	*Average*	*12.7x*	*13.7x*	*18.5x*	*33.5x*	*3.8%*
							Median	*11.1x*	*12.5x*	*17.2x*	*17.9x*	*3.5%*

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

US Public Money Managers— AUM Analysis

Average AUM Analysis $Billion									
Quarter Ending	**3/31/2001**	**6/30/2001**	**9/30/2001**	**12/31/2001**	**3/31/2002**	**6/30/2002**	**9/30/2002**	**12/31/2002**	**3/31/2003**
Diversified									
Blackrock (BLK)	$ 201.6	$ 212.7	$ 225.6	$ 238.6	$ 238.1	$ 249.8	$ 245.9	$ 272.8	$ 273.6
Eaton Vance (EV) *	49.0	50.4	56.6	59.3	59.2	54.8	55.6	55.8	-
Federated Investors (FII)	146.4	160.8	163.6	179.7	177.6	185.0	180.9	195.4	195.7
Franklin Resources (BEN)	224.9	267.9	246.4	266.3	274.5	270.4	247.8	257.7	252.4
Gabelli (GBL)	23.7	25.6	22.3	24.8	25.9	23.2	20.2	21.2	20.1
Neuberger Berman (NEU)	54.8	58.2	52.1	59.0	61.9	58.7	53.6	56.1	56.3
SEI Investments (SEIC)	78.1	79.9	74.0	77.5	79.0	76.8	72.2	78.0	79.0
Janus Capital Group (JNS)	294.4	223.9	171.8	193.0	188.8	161.5	148.4	138.4	132.7
T Rowe Price (TROW)	148.7	158.6	140.4	156.3	159.8	148.8	131.6	140.6	139.9
Waddell & Reed (WDR)	35.3	34.0	29.8	31.8	32.0	29.1	27.1	26.9	26.6
Total	**1,256.9**	**1,272.1**	**1,182.7**	**1,286.3**	**1,296.8**	**1,258.1**	**1,183.2**	**1,242.8**	**1,176.2**
Insurance									
Nuveen Investments (JNC)	61.4	63.0	66.5	68.5	69.5	68.5	76.9	79.7	81.4
Total	**61.4**	**63.0**	**66.5**	**68.5**	**69.5**	**68.5**	**76.9**	**79.7**	**81.4**
Consolidators									
Affiliated Managers (AMG)	69.7	73.7	65.2	81.0	81.4	74.1	68.5	70.8	68.4
Total	**69.7**	**73.7**	**65.2**	**81.0**	**81.4**	**74.1**	**68.5**	**70.8**	**68.4**
Bank/Trust Companies									
Boston Private Fincl. (BPFH)	5.6	6.2	5.3	6.5	6.8	6.5	6.0	6.4	6.8
Wilmington Trust (WL)	38.7	38.5	34.7	36.9	37.0	31.7	29.1	28.9	28.9
Total	**44.3**	**44.7**	**40.1**	**43.4**	**43.8**	**38.2**	**35.1**	**35.4**	**35.7**
Limited Partnerships									
Alliance Capital L.P. (AC)	454.0	454.9	421.4	455.0	448.0	451.6	368.7	386.6	386.3
Total	**454.0**	**454.9**	**421.4**	**455.0**	**448.0**	**451.6**	**368.7**	**386.6**	**386.3**
Total	**$1,886.4**	**$1,908.4**	**$1,775.8**	**$1,934.2**	**$1,939.5**	**$1,890.4**	**$1,732.4**	**$1,815.3**	**$1,747.9**

* EV periods end January, April, July, October

Freeman & Co. LLC
1301 Avenue of the Americas, 30th Fl.
New York, NY 10019
www.freeman-co.com

Sector Analysis, Ltd.
77 East Road, 1st Floor
London N1 6AH
United Kingdom
www.sectoranalysis.co.uk

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