Alternative Asset Management Research Collection
January 1, 2004

Alternative Investment Research
Freeman & Co.

Alternative Investment Research Collection

A number of clients recently asked for copies of research we have written over the years on the subject of alternative assets, in particular the hedge fund of funds business. We thought it might be useful to our friends in the industry to combine this research into one book (and due to Microsoft, this is a relatively easy task).

What you'll find inside this compilation is a wide range of subjects on alternatives, including:

- Partnerships, acquisitions and strategic alliances
- Demand estimates for hedge fund of funds products
- Market share estimates for hedge fund of funds firms
- New product developments and product launches
- Institutional allocations to hedge fund related products
- Industry revenue estimates for new capital allocations
- The introduction of hedge fund indexes
- Performance of various hedge fund indexes over time
- Rating criteria for collateralized fund obligation (CFO) managers
- New entrants in the hedge fund of funds industry
- Guaranteed funds, structured products, registered funds and index-linked notes
- The role of service providers and acquisitions in that market
- Growth estimates for the industry
- SEC inquiries into the industry and potential ramifications

We hope you find this collection useful, and as always, don't hesitate to contact us with questions or comments.

Indices at January 2, 2004:

DJIA	10,409.90
NASDAQ	2,006.68
S&P 500	1,108.48
FTSE 100	4,510.20
10 Year US Treasury Bond Yield	4.37%
Euro to dollar	$1.26

Contents

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Changing Tides—First Quarter 2001

Activity

In our March 2000 report we identified the move towards a specialized product and service focus. This represents the strategic focus by many firms on differentiation and niche strategies to target new opportunities. One of the most prominent specialized products of the past year has been hedge fund of funds, as shown at right.

Alternative Asset Class Partnerships

Traditional Firm	Non-Traditional Firm	Partnership and Comments
Bank of New York*	Ivy Asset	Acquired fund of funds manager with $2.7 billion under management
Mellon Bank	Optima	Exclusive agreement to offer Optima fund of fund products
Mass Mutual	Hennessee Group	Exclusive arrangement for due diligence and manager selection
ED&F Man plc	Glenwood	Acquired US fund of funds business with $1.4 billion for $110 million.
Capital Z	High Star Capital	Joint-owned between Capital Z and 4 ex-Merrill Lynch executives
Mackenzie Financial	Tremont Investment	New fund of funds business with Tremont as advisor to the fund.
Morgan Stanley	Greystone Weyerhaeuser team	Asset allocation for ultra high net worth individuals Six person team as new venture to expand alternative investments
Dresdner Kleinwort Wasserstein	Man-Group	Distributing exchange-listed multi-manager fund
New Direction Finance	CSFB	Distributing an absolute return product with a capital guarantee to retail investors
HSBC	New product launch	Launching an internally managed fund of fund product as a closed end fund
Henderson	New product launch	Launching Henderson Absolute Return Portfolios
Deutsche Bank	New product launch	Launching Xavex HedgeFirst multi-manager fund listed in London
Matrix Money Mgmt	Tremont Partners	Launching Matrix Conservative Approach Strategy with Tremont as the hedge fund selection advisor

Source: Freeman & Co., *Financial News* , Bloomberg

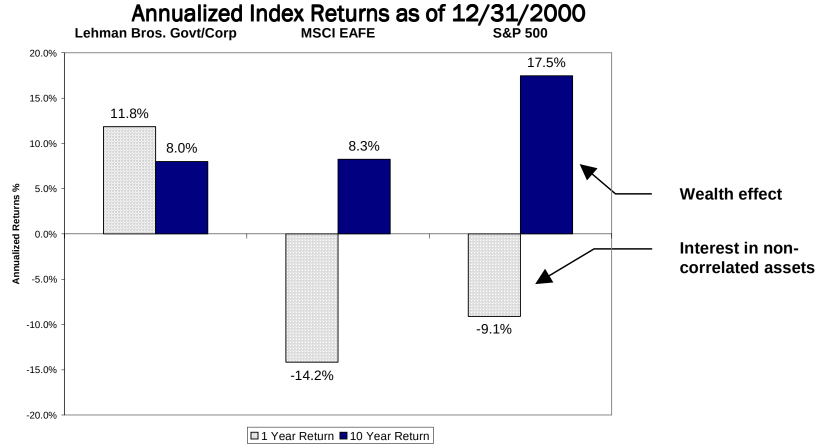
*Freeman & Co. acted as M&A advisor

A few catalysts this year have heightened interest in these products, but we believe the foundations for growth have been building for some time. Three key factors have been driving the increased demand in hedge fund of funds: first, the wealth effect created by the long bull market; second, rising interest in diversification and non-correlated asset classes; and lastly, the development of reporting information infrastructures supporting the industry. One catalyst was CalPERS announcement of a $1 billion commitment to hedge funds, although interest in hedge funds had been building among many other institutions.

Most of the new ventures were targeted at reaching the high net worth client base, with a few of them targeting institutions as well. Two acquisitions occurred in the industry, with Bank of New York and ED&F Man acquiring Ivy and Glenwood, respectively. These deals highlight the fact that these firms are viewed and valued more like traditional asset management firms, with smooth recurring revenue bases.

In contrast, hedge funds should remain difficult to acquire due to individual risk and revenue volatility. Hedge fund roll-up strategies, such as Asset Alliance, try to position themselves between these two camps, but we think the strategy fails for two reasons. First, although the different styles should balance the total performance fees throughout a year, there is still a great deal of revenue risk. Second, we believe agents (e.g. Ivy and Glenwood) will be more salable and will command higher multiples than principals (e.g. Asset Alliance) in the business.

Annualized Index Returns as of 12/31/2000



To further highlight our comments on the underlying trends driving demand in hedge fund of funds, we have created a highly scientific chart. As you can see, our conclusions are on the right. Over the past ten years individuals and institutions have been enriched by the wealth effect, and this past year their interest in non-correlated asset classes increased.

One instrumental factor that has supported the growth is the increase in information and data available. New ventures such as Altvest (performance data) and PlusFunds (on-line risk and trading data), as well as expansion of other service providers (CSFB/Tremont indexes) have helped to educate, inform and support the increased interest in this asset class

Size of the Market – Demand

The demand for hedge funds has been growing and our estimates are that it should be a 20-25% growth segment for the next five years. Current US demand for hedge funds is approximately $350 billion, with the majority from high net worth individuals. We estimate that increased transparency, more available data and information and education will lead to institutional allocation increases at a 25% annual rate. The high net worth individual demand is estimated to grow at a 20% annual rate. In total, we estimate the demand for hedge fund products could increase almost $1 trillion in five years.

US Demand for Hedge Fund Products ($ billions)

Client Type	Total AUM 2000	AUM 2005E	Allocation 2000	Allocation 2005E	Hedge Fund AUM 2000	Hedge Fund AUM 2005E
HNW Individuals	$12,500	$18,367	2.30%	4.00%	$287.50	$734.70
Endowments	267	392	5.00%	10.00%	13.4	39.2
Foundations	259	381	5.00%	10.00%	13	38.1
Corporate	2,286	3,359	0.50%	1.20%	11.4	40.3
Public Funds	3,028	4,449	0.50%	1.00%	15.1	44.5
Life Insurance	3,190	4,687	0.10%	0.30%	3.2	14.1
Other Insurance	893	1,312	0.10%	0.30%	0.9	3.9
Taft-Hartley (Union)	354	520	0.00%	0.10%	-	0.5
Total	$22,777	$33,467			$344.50	$915.30

Source: OECD, Nelsons, AM Best, Freeman & Co. estimates

Changing Tides—First Quarter 2001

Looking at the demand for hedge fund of fund product within the broader asset class of hedge funds, we believe current US demand is $75-85 billion. This represents approximately 23% of the hedge fund market. We estimate that the demand for hedge fund of fund product could grow to approximately $250-275 billion over five years, representing a 28% market share of the hedge fund industry.

This translates into asset growth of 27% CAGR for the industry. We think this growth will be concentrated in the larger firms (30% CAGR) and mid-sized firms (25% CAGR); small firms should grow at 16% CAGR. Another benefit is the asset class's low correlation to equities and bonds, so it provides a stable, uncorrelated revenue source. In fact, hedge fund of funds may be counter-cyclical for firms, with demand rising when returns in traditional asset classes fall.

Supply of Fund of Funds

Although there are many new entrants from traditional managers or consulting firms, we estimate there are less than 50 sizable competitors with established performance track records. Of these firms, perhaps one-half are small boutiques with limited infrastructure and the remaining 25 firms are well established and have the infrastructure to support the addition of sizable asset inflows.

We expect a blurring of product lines as firms compete for assets, with offerings falling into three types: funds, separate accounts and consulting. The key factors affecting providers will be pricing (% of assets or flat fee for services) and costs (low marginal costs in a fund or high cost customized design). Over time, we expect low to no fee pressure on funds, low to moderate pressure on separate account services and moderate pressure on consulting services. The main support for these fees will be fund of funds' access to managers, specialized information and a transfer of risk and liability to fund providers.

Types of Products and Firms

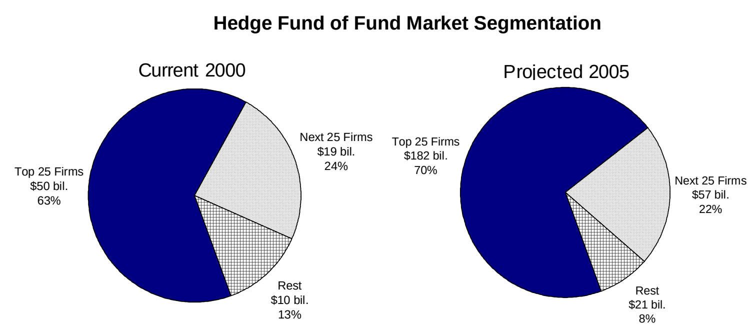
We developed the chart below to simplify the type of products that firms were creating. It is an amalgamation of a chart from one firm and comments from another. We think it gets to the point of what hedge fund of funds are trying to do: provide a short-term bond substitute, a stay rich product or a get rich product. We know this over simplifies the industry and the product innovations being developed, but it is the simplest way to describe the products that firms are offering, particularly those to individual investors.

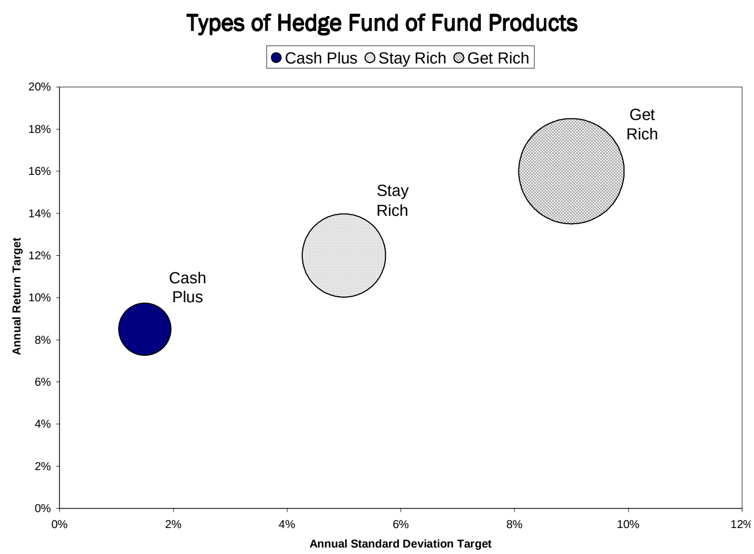
There are a variety of products and innovations occurring in the fund of fund arena: collateralized products, principal guaranteed funds, and hybrid investment/ownership stakes. New product offerings will continue to increase as the information and support infrastructure continues to develop in the industry, and larger firms will be best positioned to capitalize on these opportunities.

US Demand for Hedge Fund of Fund Products ($ billions)

Client Type	Hedge Fund	Hedge Fund	% in FoF 2000	% in FoF 2005E	FoF AUM 2000	FoF AUM 2005E
HNW Individuals	$287.50	$734.7	15.0%	18.0%	$43.1	$132.2
Endowments	13.4	39.2	60.0%	70.0%	8.0	27.5
Foundations	13.0	38.1	60.0%	70.0%	7.8	26.6
Corporate	11.4	40.3	60.0%	70.0%	6.9	28.2
Public Funds	15.1	44.5	70.0%	80.0%	10.6	35.6
Life Insurance	3.2	14.1	50.0%	50.0%	1.6	7.0
Other Insurance	0.9	3.9	50.0%	50.0%	0.4	2.0
Taft-Hartley (Union)	-	0.5	100.0%	100.0%	-	0.5
Total	$344.5	$915.3			$78.4	$259.7
Market Share of Hedge Funds					23%	28%

Source: OECD, Nelsons, AM Best, Freeman & Co. estimates





Growth Opportunities—October 2001

Alternative Investments—Growth Opportunities

In Freeman & Co.'s March 2001 report, Changing Tides, we highlighted the increasing demand for hedge fund products and the increased activity in the alternative investment space. We predicted that the hedge fund market would be a 20%-25% growth sector for the next 5 years. Since then we have tracked the number of new entrants launching hedge funds, with much of the activity concentrated in institutional entrants. In the third quarter alone, we tracked 42 firms or managers announcing the launch of new hedge funds; since many start-ups, like a Segovia Capital, do not make grand announcements, we estimate that the total number of new hedge fund start-ups may approach 90-100 for 3Q 2001.

3rd Quarter Activity

Transaction Type	Hedge Fund	Fund of Funds
New Entrants (Managers)	6	4
New Entrants (Companies)	27	9
Acquisitions/JV	9	5
Total	**42**	**18**

Source: Freeman & Co.

In addition to the benefits enjoyed by portfolio managers, independent firms and large institutions from this growth, we believe that numerous other types of companies will be beneficiaries of this growth. Our bets are on the following types of companies:

- prime brokers
- service providers (accountants, administrators)
- technology providers (risk management, trading software)

These firms should be able to capitalize on the infrastructure development to support the alternative industry. Currently many of these services are provided by a highly-fragmented pool of mostly smaller firms. As these firms expand their capital development, many will be forced to look for ways to finance their business growth. Their high top-line growth rates will make these firms attractive targets for acquirers, such as Advent, ADP or CITCO, that can provide capital and national or global reach.

The major change we see is the entrance of institutional financial services firms to the market for hedge funds, generally to add a high-profile, high-profit product set. Firms such as Mellon, American Express, Deutsche Bank, BlackRock, Dexia and KBC come to mind. We think this has two major implications, one positive and one negative. On the positive side, institutions should add risk management tools, transparency and institutional processes. On the negative side, institutions will need to be extremely careful in how they provide incentives to and retain control over hedge fund mangers. Providing capital and a track record to managers may provide them with the perfect launching pad to leave the institution. Obviously this turnover is detrimental, so firms will need to manage this by enhancing variable compensation schemes, creating manager teams to provide consistency or by using contractual obligations.

To illustrate the institutional growth in demand, we illustrate recent commitments to hedge funds, $5.5 billion, and fund of funds, $4.4 billion (below and on the next page). These hedge fund allocations alone could provide normalized revenue of $220 million, or 4% of $5.5 billion AUM; the fund of fund allocations would add another $44-65 million of revenue (1-1.5% of AUM), plus the money that would then flow back into hedge funds adding another $176 million in revenue. These allocations that we have identified represent approximately $450 million in revenue, and are a small slice of the market and future allocations to come.

Recent Allocations to Hedge Funds

Date	Firm	Total Assets	% Allocation	Value of Allocation ($MM)	Notes
8/1/00	Mount Holyoke College	430	7%	29	Boosts hedge fund exposure to 10% of assets
11/13/00	California Employees' Retirement System	171,000	1%	1,710	More than twice the previous amount was approved for allocation
11/13/00	Teacher Retirement System of Texas	71,700	0%	200	The allocation is the pension fund's first alternative investment
11/20/00	Varma-Sampo Mutual Pension Fund	13,600	2%	272	Will boost its total alternative investments exposure to 5%
3/27/01	AstraZeneca Plc	2,857	4%	100	Plans to invest in hedge funds as part of its specialty portfolios
3/27/01	San Diego County Retirement Assoc.	3,700	1%	50	Invested in hedge fund products
5/19/01	University of Connecticut Foundation	260	2%	5	Planning to makes its first direct investment in hedge funds
6/1/01	New Hampshire Retirement System	4,500	1%	50	Trustees will interview hedge fund managers
6/21/01	International Paper	7,000	5%	350	May allocate $350 mil. to specialists for 'portable-alpha strategies'
7/19/01	Retail Employees Superannuation Trust	1,500	2%	35	The REST has allocated $35 million to a US hedge fund
8/21/01	Assumption College	40	5%	2	Trustees have approved hedge funds
10/2/01	Oklahoma Police Pension and Retirement	1,200	3%	40	Added a multi-strategy hedge fund to its $405 million bond portfolio
10/5/01	North Carolina State Retirement System	52,000	5%	2,600	The state Senate passed the bill allowing investments in hedge funds
10/5/01	Pennsylvania State Employees' Retirement	26,000	0%	35	The allocation is part of the fund's alternative investments asset class
		355,787	**2%**	**5,478**	

Capital Allocations—October 2001

In our March 2001 report (Changing Tides) we estimated the US hedge fund of fund industry at $78 billion with a potential for $260 billion in 2005 (27% CAGR). Within the institutional area we estimated $35 billion in fund of funds demand, and predicted a 29% growth rate. The fund of fund allocations above add $4.4 billion in AUM, $43-65 million in annual revenue and provide 12.5% growth to the business. If we assume that we have captured 50% of the allocations, then institutions are adding about $8.7 billion in AUM and $86-130 million in revenue growth. Individuals' asset allocations to these products may be at similar levels, fuelling further industry growth.

Recent Allocations to Fund of Funds

Date	Firm	Total Assets	% Allocation	Value of Allocation ($MM)	Notes
12/1/00	Loyola University of Chicago	700	10%	70	Loyola said it was interviewing hedge fund-of-funds specialists
5/17/01	Drake University	125	15%	19	The allocation would be the fund's first
5/21/01	ABP	135,200	2%	2,704	Said it will put 2% of its assets into funds of funds
7/11/01	GM Investment Mgmt	99,153	0%	100	Glenwood appointed as hedge fund manager
7/19/01	Ontario Municipal Employees Retirement	22,293	5%	1,115	Fund goes looking for hedge fund managers
7/31/01	Golden LEAF Foundation	160	12%	19	Fund agreed to invest in fund of funds
8/9/01	Smith College	1,000	8%	75	Smith College makes first hedge fund investments
10/5/01	Pennsylvania State Employees' Retirement	26,000	1%	260	The allocation is part of the fund's domestic equities asset class
		284,631	**2%**	**4,362**	

Revenue Growth—October 2001

We decided to lay out the revenue opportunity for firms in detail by using our data on allocations to make total AUM assumptions for both institutions and individuals, and to follow these through to revenue assumptions.

Based on our research and assumptions the total incremental revenue opportunity this year is approximately $1.6 billion for hedge funds, $227 million for fund of funds and a combined total of $1.8 billion. We estimate that $568 million would be recurring base fees, and $1.2 billion would be performance fees.

In our March 2001 report, we sized the hedge fund market at $344 billion and the fund of fund market at $78 billion — so our estimates at the right indicate growth rates of 11.5% for hedge funds and 22% for fund of funds. The hedge fund growth rate is almost certainly too low—representing a much greater revenue opportunity that becomes difficult to estimate. The implied fund of fund growth rate is probably low by 3-8% points, adding incremental revenue to the pool of perhaps $50 million.

Investment Type	Announced Amount	Est. Share	Est. Amount	Base Fees	Perf. Fees	Total Fees
Hedge Funds - Direct						
Institutions	$5,478	50%	$10,956	$110	$329	$438
Individuals			10,956	110	329	438
Total Hedge Fund Direct			**$21,912**	**$219**	**$657**	**$876**
Hedge Funds - through FOF						
Institutions	$4,362	50%	$8,724	$87	$262	$349
Individuals			8,724	87	262	349
Total Hedge Fund - FOF			**$17,448**	**$174**	**$523**	**$698**
Total Hedge Fund			**$39,360**	**$394**	**$1,181**	**$1,574**
Fund of Funds						
Institutions	$4,362	50%	$8,724	$87	$26	$113
Individuals			8,724	87	26	113
Total			**$17,448**	**$174**	**$52**	**$227**

Hedge Fund Assumptions		**Fund of Fund Assumptions**	
Base Fee	1.0%	Base Fee	1.0%
Performance Fee	20.0%	Performance Fee	2.5%
Returns	15.0%	Returns	12.0%

Some may disagree with our key assumptions which were that we only captured 50% of the institutional allocations, and that for now, individual allocations would equal those of institutions. We have provided the tables to the right so you can adjust the figures if you see fit.

New Entrants & Competition—October 2001

Over the past year the rush by firms to enter the fund of fund business has been overwhelming. Our research indicates that 18 firms have either entered the business or launched new products (top table), and 11 firms have partnered or acquired fund of fund firms (bottom table). This has outpaced our previous thoughts on how firms would view the attractiveness of the business. The method of entrance has varied from acquisitions, joint ventures and alliances to new start-ups, team lift outs and key hires. In addition to the many entrants, other firms continue to examine the opportunities. The typical issues that arise when evaluating this business are concerns about sustainability of growth, fees and margins. For now, these do not seem to be affected as demand is outpacing supply.

New Entrants

Date	Firm	New Firm / Fund	Notes
7/23/01	Aon Consulting		Will offer multi-manager product alongside its traditional investment advice
6/5/01	CIBC Oppenheimer Advisors	Alyeska Fund LLC	Will offer a closed end fund that invests in hedge funds
3/15/01	Collins Stewart	Hirzel House Absolute Returns Funds	Adding two products manage downside risk and volatility
11/27/00	Commerzbank Securities	Comas 2, Comas 3	Comas 2 offers an absolute return strategy
7/3/01	Credit Suisse Private Banking		Launched two fund of funds for its Asian clients
6/4/01	Frank Russell Co.	Alternative Investments Funds	Launched its first multi-manager hedge fund for clients outside US
7/24/01	Global Asset Management	GAM Trading III	Promises uncorrelated returns to the equity markets
6/27/01	Harris Associates LP	Pleiades Offshore Fund Ltd.	Fund similar to nine-year old onshore sibling
2/27/01	HSBC	HSBC European Absolute	Closed-ended fund with leading funds invested in UK and Europe markets
7/18/01	HypoVereinsbank	Value Vision, Value Vision Protect	Raised $267 million in its first two hedge FOF aimed at retail clients
5/4/01	ING Furman Selz Asset Mgmt.	Topaz Fund	Launched the second sub fund in its umbrella fund on May 1
6/26/01	Investec	Investec Absolute Return Fund	Launched hedge FOF for South African high-net-worth individuals
7/20/01	John A Levin & Co	AltVantage Group	Launched AltVantage Group for fund of funds
6/18/01	Lazard LLC	Lazard Alternatives LLC	New unit will offer Lazard Diversified Strategies Fund LLC
5/25/01	Pioneer Alternative Mgmt.	Pioneer Alternative Strategy Fund	Launching notes issued by Societe Generale with 100% capital guarantee
6/11/01	Raymond James Financial		Alternative investment group will launch a fund of funds within a year
7/12/01	RMB Investments Services	Alternative Strategies Fund of Funds	Launched and simultaneously closed fund of funds
8/22/01	Turner Investment Partners	Ascendant Capital Partners LLC	Gary Shugrue will develop and manage Ascendant's structured funds.

Source: Freeman & Co.

However, all of this activity is not without its consequences. The competition is increasing, and as we outlined in March 2001 we do not believe that firms will share equally in this growth. Our past estimates were that large– and mid-sized firms would grow at 30% and 25% per year and small firms at 16%. We think we were wrong. Larger firms could grow at 40-50% rates for the next two years, with slower growth thereafter. Small firms may grow at only 10-15%. As an example, Ivy Asset Management has grown from $2.7 billion to $4.3 billion in the one year since its acquisition, a 60% growth rate. Other mid– and large-sized firms have had similar growth rates over the past year, too. As a result, we think that 10-15 large firms will control perhaps 60-70% of the industry, and these firms will have the resources to develop new product innovations, advanced risk management systems and other tools to keep their lead.

However, we do not believe in the demise of the small firm. Although they may experience slower growth rates, firms with less than $1 billion will be profitable and able to develop innovative products with strong performances. Like the traditional asset world, there is room for numerous boutiques. In the short run, we also believe that smaller firms will be able to leverage other resources, such as prime brokers and research desks, for intellectual capital and technology.

Partnerships & Acquisitions

Year	Target	Acquirer/Partner	Total Deal AUM $MM	Comments
2001	Alternative Investment Managers	Indocam	1,500	Acquisition - Fund of Funds
2001	Arden Asset Management	Phoenix Investment Partners	1,800	Joint Venture - Fund of Funds
2001	Fauchier Partners	BNP Paribas	300	Joint Venture - Fund of Funds
2001	P/E Investments LLC	Asset Alliance Corporation	130	Acquisition - Hedge Fund
2001	Symphony Asset Management	John Nuveen Co.	4,000	Acquisition - Hedge Fund
2001	Systeia Capital Management	Credit Lyonnais Asset Mgmt	234	Acquisition - Hedge Fund
2001	Tiney Group	Dexia Group		Acquisition - Hedge Fund
2001	Tremont Advisers Inc	Oppenheimer Funds Inc		Acquisition - Fund of Funds
2001	Zola Capital Management	Asset Alliance Corporation	100	Acquisition - Hedge Fund
2000	Asset Alliance	Lehman Brothers International		Alliance - Hedge Fund
2000	Glenwood Capital	ED&F Man Group	1,400	Acquisition - Fund of Funds
2000	Hennessee Group LLC	MassMutual Financial Group		Alliance - Fund of Funds
2000	High Star Capital Management	Capital Z Partners LLC	250	Joint Venture - Fund of Funds
2000	Ivy Asset Management	Bank of New York*	2,700	Acquisition - Fund of Funds
2000	Optima	Mellon Bank		Alliance - Fund of Funds
2000	Tremont Advisers Inc	Mackenzie Financial Corp		Alliance - Fund of Funds
1998	Grosvenor Capital Management	Value Asset Management	3,800	Acquisition - Fund of Funds

**Freeman & Co. acted as adviser*

Performance—October 2001

There has been a great deal of industry focus regarding both the value provided by fund of funds as well as the potential industry-wide capacity constraints. Generally, fund of funds have offered three main advantages to investors: (1) uncorrelated investment returns; (2) downside protection; and (3) product structuring skills. The detractors of these products have noted (a) the double layer of fees, (b) tax inefficiency and (c) lack of measurable comparisons amongst fund of fund products.

Performance as of September 30, 2001

Index	Sept.	YTD
S&P 500	-8.17%	-21.16%
NASDAQ	-16.98%	-39.33%
LBGC*	+0.92%	+8.44%
60% S&P 500 / 40% LBGC	-4.53%	-9.32%
1/3 S&P 500, 1/3 NASDAQ, 1/3 LBGC	-8.08%	-17.35%

Firm	Fund	Sept.**	YTD**
Berens Capital	BCP L.P.#	-0.50%	+1.49%
Commerzbank	Global Alternatives	-0.07%	+6.69%
Ivy Asset Mgmt.	Defenders Fund	-0.19%	+7.80%
K2 Advisors	K2 L.P.	+0.60%	+6.84%
Lighthouse Partners	Diversified Fund	-0.60%	+5.34%
Marquee Investments	Marquee Fund	-6.20%	-3.66%
Parker Global	Sentinel Fund	-2.22%	+3.78%
Average		**-1.31%**	**+4.04%**
High		**+0.60%**	**+7.80%**
Low		**-6.20%**	**-3.66%**

*Lehman Brothers Government/Corporate index

** Net of fees # Long/short equity

We thought to examine if and how fund of fund products delivered on their promises of uncorrelated returns and downside protection. Our discussions with firms and the product performance list below generally indicates that they have delivered on expectations. We compared our sample of fund of fund performance to the capital market indexes. Across the board, this fund of fund sample beat any of the market indexes that had exposure to the equity markets.

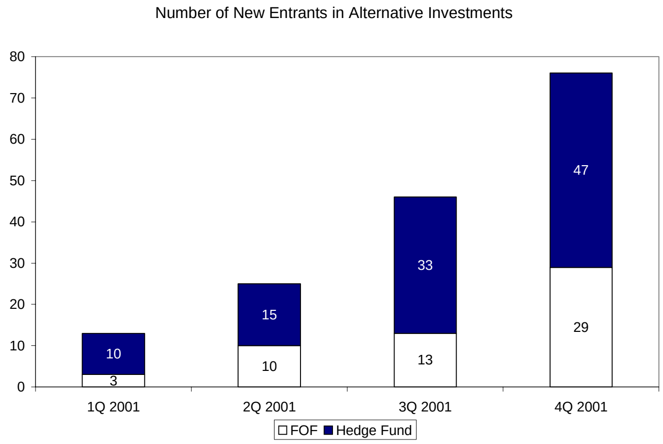
Looking at average performance, these fund of funds have outperformed:

- S&P 500 by +25.20% YTD, and +6.86% in September
- NASDAQ by +43.37% YTD, and +15.67% in September
- 60% S&P 500 / 40% LBGC index by +13.36% YTD, and +3.22% in September
- an equal blend of S&P 500, NASDAQ and LBGC by +21.39% YTD, and by +6.77% in September

The key question remains as to whether returns will be sustainable with the increased flow of assets. We can speculate, but believe the keys will be supply and demand of the underlying securities, natural constraints (e.g. short side), and allocation decisions by fund of fund managers to move money to styles with capacity.

Growth Opportunities—2001, Year in Review—January 2002

The number of new entrants into the alternative investment space in the 4th quarter of 2001 surged 65% over the preceding quarter. Since Freeman & Co. began tracking the number of announced new entrants at the beginning of 2001, we have seen a steady rise across all four quarters growing at a rate of 80% quarter over quarter.



Source: Freeman & Co.

The majority of the new entrants are established managers and investment banks rolling out additional products to increase capacity and expand their product offerings. The number of fund of fund new product launches, for example, was 29 during 4Q01. This represents a mix of new entrants and follow-on products from existing managers.

As competition increases with the launch of products and firms, many new and existing firms will face challenges. For new entrants, every investor will not accept "pro-forma" results, and will value managers with experience during periods such as the Asian currency crises, Russian default, LTCM failure and NASDAQ crash. Since many institutional investors don't accept 'pro-forma' figures from new traditional asset managers, we think the presentation of pro-forma numbers will lose acceptance as education increases among investors and consultants who are used to AIMR compliant performance presentation standards. For small firms, size and scale will become more important — institutional investors will scrutinize internal systems and processes, large competitors will gain ratings from Fitch, S&P, etc. and hedge funds will offer accommodations to larger capital providers. Many smaller firms may face distribution challenges among the 'noise' from so many new competitors.

Many established firms have realized the importance of distribution in the face of this competition. Not all of these firms will succeed in getting to their AUM goals of $500 million or $1 billion. At a certain point, institutions and their consultants will set higher minimum AUM levels to be included in searches. Those firms that fail to reach their growth goals will need to decide what type of firm they would like to be (boutique, style specialist, HNW focused, etc.)

Allocations—2001, Year in Review—January 2002

We have listed a number of announcements for alternative allocations for 4Q01, which have fallen as institutions fail to announce every allocation they make. The institutional allocations seem to be averaging in the 1-5% range we first identified in our March 2001 report. This increase in allocation levels, we predicted, would add $570 billion in AUM over five years to hedge funds; we thought fund of funds would gather $182 billion of these assets. Based on our discussions with fund of fund managers, most had strong asset increases last year and we think the industry growth is on track with our expectations, although most of the AUM inflows for fund of funds is concentrated in a small number of firms.

The additional allocations to alternatives range from large institutions like Shell Pensions and Washington State, who are expanding their efforts, to smaller groups making their first investments, such as the Nature Conservancy and Nestle USA. As clients and institutional consultants gain experience with the asset class, the rate of new allocations should increase.

4th Quarter Alternative Investments

Date	Firm	Total Assets ($MM)	% Allocation	Value of Allocation ($MM)	Notes
10/16/01	Nature Conservancy	850	5%	43	Nature Conservancy trustees approved a 5% allocation to alternative investments
10/23/01	ABP	150,000	0.5%	720	The Netherlands civil servants pension fund has appointed its own hedge fund of funds manager
10/25/01	Shell Pensioenfonds Beheer	12,600	-	-	Shell pension fund will be allocating assets to hedge funds and private equity
11/28/01	Washington State Investment Board	40,000	17%	6,800	The Washington-based fund plans to boost its commitment to alternatives to 17 percent from 15 percent
10/30/01	George Washington University	700	-	-	GW is looking to expand its alternatives portfolio
11/27/01	Nestle USA	750	3%	25	Nestle USA to invest in hedge fund of funds
	Average:	**34,150**	**6%**	**1,897**	

Source: Freeman & Co.

Product Development—2001, Year in Review—January 2002

As the knowledge of hedge fund of funds has increased among investors, consultants, attorneys, rating agencies and investment banks, the evolutionary change of new product developments has progressed with three products of note: reinsurance businesses (e.g. MaxRe), CDO products and ratings, and closed-end funds.

Max Re, founded in 1999 and publicly listed in 2001, is a Bermuda-based reinsurer whose business model is designed to allocate up to 50% of its portfolio to alternative investments. This evolutionary change provides two investment features to Max Re equity owners. First, the alternatives portfolio may provide higher long-term returns compared to other fixed income or equity investments. Second, it provides non-correlated returns, which can provide substantial benefits in recent market results.

MaxRe Assets & Investing Profile

Investment Style		Assets $MM	% of Assets	% of Alternatives	1 Year Return
Cash & Fixed Maturities	$	982.4	61.0%		8.55%
Global Macro		125.7	7.8%	20.0%	8.36%
Long/Short Equity		83.8	5.2%	13.3%	-5.39%
Convertible Arbitrage		75.3	4.7%	12.0%	17.88%
Merger Arbitrage		45.6	2.8%	7.3%	8.11%
Diversified Arbitrage		99.2	6.2%	15.8%	10.01%
Distressed Securities		85.9	5.3%	13.7%	0.86%
Opportunistic		47.6	3.0%	7.6%	11.55%
Insurance U/W		64.7	4.0%	10.3%	
Total Alternatives	**$**	**627.8**	**39.0%**	**100.0%**	**6.69%**
Total	**$**	**1,610.2**	**100.0%**		**7.78%**

Source: SEC filings

The other benefit for investors is taxes. First, since Max Re is Bermuda-based, it pays no corporate tax and its investment earnings and book value compound on an equivalent "pre-tax" basis. Second, investors buy equity in an operating company, so they pay taxes only upon the sale of their stock. The effect is to create a "tax free" compounding effect on book value for investors in a pool of fixed income and alternative investments. If the stock trades at a premium to book and the under writing results are favorable, then investors gain, too.

One factor that has been brought up is whether Max Re could allocate a greater percentage of its assets to alternatives. This potential "pure play" model could have some advantages: a higher percentage, or total, allocation to alternatives could raise the asset returns for the reinsurer if alternative investing results are sustainable; investors in alternatives would have more control over their total asset allocation if the allocation was 100% to alternatives; lastly, it would provide deferred capital gains treatment for a tax-inefficient asset class.

CDO Asset Manager Criteria

- company and management experience,
- financial condition,
- staffing,
- procedures and controls,
- asset acquisition,
- portfolio management,
- CDO administration,
- technology, and
- portfolio performance

Source: Fitch Ratings

The second product innovation is structured products, with a particular focus on CDO vehicles using hedge fund of funds as the asset manager. To date, there has not been a publicly rated "CFO", or collateralized fund obligation, although we understand that a private deal has been closed. We believe the increase in education about the asset class, development of industry information (e.g. hedge fund style indexes) and acceptance of the asset class will lead to a public rating in 2002.

Recently (1/25/02) Fitch announced their rating system for CDO asset managers, for which it will publish scores for nine criteria (listed at left). Firms will be given a rating from CAM 1-4. Although Fitch's rating system covers all types of asset managers of CDO's (loans, bonds, etc.), it lays out the first rating system for hedge fund of fund managers. This outside scrutiny helps increase transparency and education of the industry, and provides benchmarks for investors to consider in making decisions.

Another effect this development will have on hedge fund of fund managers is a further differentiation between large and small firms. Only the largest managers will be able to launch and finance these CFO deals, and size and scale will matter in attaining a favorable rating. We also believe that CFOs will help support the growth of institutional investing in hedge funds, as the debt tranches are likely to be attractive to traditional fixed income investors such as insurance companies. Increasing their exposure to and knowledge of hedge fund investing could do a lot to support the growth of the industry.

The third product development, closed end hedge funds of funds, could become a retail product with proposed minimums as low as $25,000. Charles Schwab's US Trust has launched a product and CIBC World Markets has registered a product. Unlike hedge funds, these products will be registered with the SEC, but will be able to offer attributes of hedge funds such as leverage and wider investment parameters than mutual funds. Of particular interest to the mass affluent, these products would offer non-correlated market returns and access to products unavailable to them previously. The advantage of the closed-end structure is the alignment of the liquidity of the investment structure (infrequent) with the liquidity in the underlying hedge funds (infrequent). As the funds will not be listed on an exchange and redemption provisions will be limited, there are obstacles to these products gaining wide spread acceptance.

These products indicate how the hedge fund market is maturing as Wall Street and others create ways to use, invest and package these investment vehicles. Also, all of these products add to the public domain of knowledge on hedge funds and increase the level of transparency for the industry, which we believe are vital to the long term growth and health of the industry.

Distribution—2001, Year in Review

Despite the increased demand for alternative products, many smaller firms have not seen the growth they were expecting. For hedge fund of funds, we believe $1 billion AUM has become the standard for critical mass to compete in the institutional marketplace. Firms under this size will face difficulty winning large mandates or sub-advisory roles from distributors. Many of these smaller boutiques have strong performance records, but lack the infrastructure or distribution support that institutional investors and intermediaries desire.

In announced allocations in 2001, larger funds seem to be winning the majority of mandates. Among the names below, Barclay's, Blackstone, Carlyle Group and Thomas H. Lee stand out as prime examples of large firms beating out boutiques for mandates. We expect firms above $1 billion AUM to develop multiple products and distribution channels. They will become innovators and gain early mover advantages in structured products, closed end retail funds, etc.

Recent Mandates Awarded

Date	Firm	Asset Manager	Product	Value of Allocation ($MM)
10/5/2001	Pennsylvania State Employees' Retirement System	A.G. Capital	Hedge Fund	15
10/23/2001	ABP	ABP Investments	FOF	720
7/31/2001	Golden LEAF Foundation	Archstone Partners LP	FOF	6
7/31/2001	Golden LEAF Foundation	Arden Asset Management Inc	FOF	13
11/28/2001	Washington State Investment Board	Barclays Global Investors	Hedge Fund	800
10/2/2001	Oklahoma Police Pension and Retirement System	BBT GenPar	Hedge Fund	40
10/5/2001	Pennsylvania State Employees' Retirement System	Blackstone Alternative Asset Management	FOF	200
7/11/2001	General Motors Investment Management Co	Glenwood Capital Management	Hedge Fund	100
8/9/2001	Smith College	Lighthouse Partners, Alternative Investment Group, Pine Grove Associates	Hedge Fund	75
9/4/2001	General Retirement System of the City of Detroit	Mount Lucas Management	Futures	5
7/26/2001	Memphis Light, Gas and Water	Mount Lucas Management	Futures	10
3/27/2001	San Diego County Retirement Association	Mount Lucas Management	Hedge Fund	50
8/1/2000	Mount Holyoke College	Oz Overseas Fund Ltd	Hedge Fund	10
11/1/2000	Mount Holyoke College	Standard Pacific Capital Offshore Fund LP	Hedge Fund	10
11/13/2000	Teacher Retirement System of Texas	Thomas H Lee Co, Carlyle Group Inc	Hedge Fund	200
10/5/2001	Pennsylvania State Employees' Retirement System	Twin Capital	FOF	60
10/9/2001	Cigna Corp	Wellington Management	Hedge Fund	

Source:Freeman & Co.

Smaller boutiques may lack the financial and human capital resources to tackle retail, high net worth, institutional and foreign markets. Most will not be innovators in the products described earlier. Successful boutiques will develop a strategy focused on either product, distribution or geographic niches. Developing momentum in one of these areas should build the foundation for future growth for those firms that focus their efforts.

Hedge Fund of Fund Performance—2001, Year in Review

We wanted to review the performance of hedge fund of funds (HFOF) to determine if they are delivering on their promises of uncorrelated returns and downside protection. The returns below suggest that many hedge fund of funds continue to perform the way their managers had promoted. The three year annualized performance of this subset is +15.83% compared to –1.00% for the S&P 500 and +1.76 for a 60/40 balanced portfolio; adjusting for any selection bias in those fund of funds that choose to report performance figures, we estimate the average diversified FOF returned 11-14% over three years, still providing significant out-performance to long only alternatives.

Fund of Fund vs. Market Returns

Company	Fund Name	Net Returns 1999	Net Returns 2000	Net Returns 2001	Annualized Return 3 Yr	Targeted Return	Targeted Volatility
Ivy Asset Mgmt	The Seedling Fund, LP	28.05%	14.97%	12.40%	18.28%	15%+	8%+
Ivy Asset Mgmt	The Defenders Fund, LP	6.30%	18.31%	9.44%	11.24%	12-15%	5-8%
K2	K2 Investment Partners	34.96%	17.63%	6.67%	19.19%		
Lighthouse Partners	Lighthouse Diversified LP	24.25%	13.35%	7.40%	14.79%	12-15%	5-8%
MaxRe		-	4.22%	6.69%	NA		
Treflie Capital Mgmt	Treflie Absolute LP	25.48%	16.56%	7.01%	16.10%	12-15%	3-5%
Yankee Advisers	Yankee Clipper Fund	32.10%	17.80%	-1.36%	15.35%	15%+	5-8%
Average		**25.19%**	**14.69%**	**6.89%**	**15.83%**		
High		**34.96%**	**18.31%**	**12.40%**	**19.19%**		
Low		**6.30%**	**4.22%**	**-1.36%**	**11.24%**		

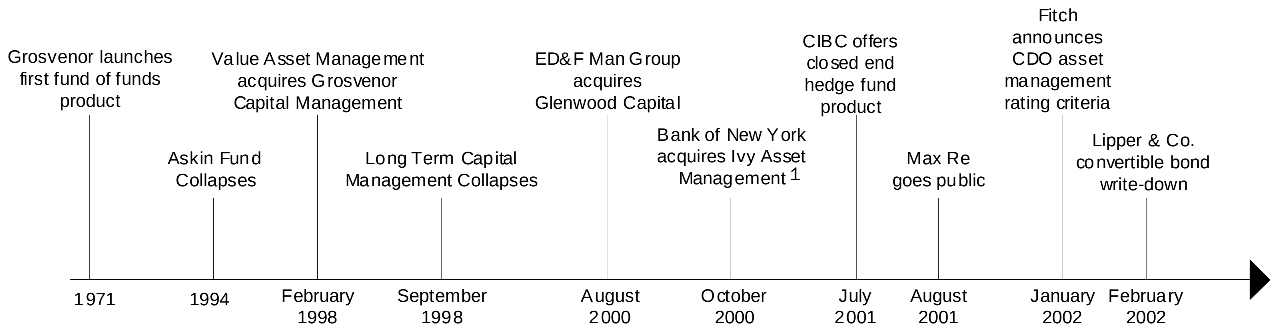
Market Returns	Returns 1999	Returns 2000	Returns 2001	Annualized Returns 3 Years	Annualized Returns 10 Years	Std. Dev. 10 Years
S&P 500	21.04%	-9.10%	-11.88%	-1.00%	12.93%	15.80%
NASDAQ	85.59%	-39.29%	-21.10%	-3.80%	12.77%	31.68%
LBGC*	-2.15%	11.84%	8.50%	5.90%	7.27%	4.48%
60% S&P 500 / 40% LBGC	11.76%	-0.72%	-3.73%	1.76%	10.67%	9.80%
1/3 S&P 500, 1/3 NASDAQ, 1/3 LBGC*	34.83%	-12.18%	-8.16%	0.37%	10.99%	14.73%

Source: SEC filings, company reports, Freeman & Co. analysis

*Lehman Brothers Gov't/Credit index

We also think it is beneficial to compare the HFOF's targeted returns and volatility to those of long-only indices. The market decline has brought 10 year returns in-line with historical figures: equities 12-13%, bonds 7-8% and balanced 9-11%. HFOFs are outperforming these benchmarks with significantly lower volatility. In addition we have seen HFOFs with sharpe ratios of 1.5 to 2.5 compared to –0.5 to 0.5 for the S&P 500 over

Historical Developments—2002 Preview



We decided to take a historical perspective of the alternative investment industry to examine the effects that recent developments may have on the future of the industry. Traditionally known for their high stakes risks for sophisticated investors, such as ultra high net worth investors and foundations/endowments, hedge funds are rapidly expanding to include more retail oriented investors. The products are still out of reach for most of the population, but the minimum investments required to invest in hedge fund style product is falling due to the offering of closed end funds by certain institutions with minimum investments of $50,000.

Several major events have helped to fuel the current alternative investment boom. The bull market of the last decade created a never before seen rise in the number of millionaires and high net worth individuals across the world. Investors looking to preserve their wealth have poured money into alternative investments that are not correlated to the fledgling markets. Several developments in the alternative industry also helped to fuel the recent growth. Hedge funds had always been perceived as "risky" investments as they often require lock-up periods and $1 million minimum investments. Events such as collapses of Askin (1994), Long Term Capital (1998), and Lipper & Co. (2002) have reminded investors with a certain consistency every four years of individual manager risks.

These high profile events brought attention indirectly to hedge fund of funds, which have become popular as they provide investors an opportunity to pool their money and spread their investment across several funds (usually ranging from 8-15 managers). In return for paying a base fee, and occasionally a performance fee, investors can gain a level of diversification, due diligence, product structuring and on-going monitoring that they might not be able to achieve on their own. The hedge fund of funds also provide an advisory layer to institutional investors not comfortable investing directly into hedge funds and the fiduciary risks to which they may be exposed.

The hedge fund of fund business seemed to go mainstream in the fall of 2000 when ED&F Man Group (August) and Bank of New York[1] (October) completed acquisitions of Glenwood Capital and Ivy Asset Management, respectively. Since then, these firms have experienced rapid growth and numerous competitors began educating themselves about this product and developing market entry strategies. Most firms have chosen to pursue partnerships or internal development compared to acquisitions, although there have been a number of firms reportedly for sale. We believe two things need to occur for more M&A transactions to occur: first, more potential buyers need to understand the hedge fund of fund business, its key drivers and risks, and second, the growth rates of firms need to slow (we have seen annual AUM growth rates of 75-100%), so that fair value can be successfully negotiated.

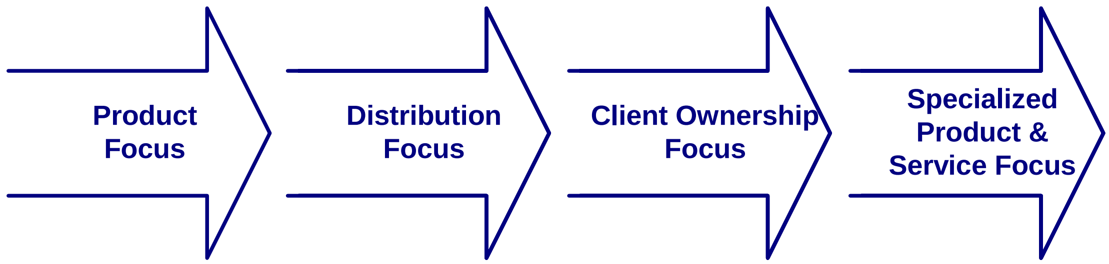
The number of new entrants to the industry has been very high (see page 9), drawing some comparisons to internet mania. The main difference is that hedge funds and fund of funds have revenue models that actually work. However, we believe that this intense competition will lead to market segmentation among participants as smaller firms may be forced to pursue niche strategies. We also caution firms from expecting to achieve the AUM growth of some larger competitors. Firms of all sizes need to find an edge, a strategic advantage or a differentiating factor to compete in this market segment. As an example of this, most of our conversations with participants or potential entrants has revolved around distribution issues.

Where does the future lead us then? We think there will be a continuation of strategic partnering, matching product providers with distribution channels. Many of these may follow our predictions for the European asset management marketplace, where alliances are precursors to acquisitions. Also, the development of a large structured product (CFO) market for hedge fund of funds may force many firms to partner or be acquired in order to have a capital source for the equity tranches, as has happened with many fixed income CDO managers.

[1] Freeman & Co. acted as financial advisor to Bank of New York in its acquisition of Ivy Asset Management

Lifecycle—2002 Preview

We decided to examine the hedge fund of funds industry using a lifecycle model we first presented in our March 2000 report. At that time we presented this model as representative of the 1990's, and said that the "fourth [stage] is beginning to emerge." The hedge fund of fund business fell into this category, but now we examine the lifecycle of this business:



Product Focus

Product Focus was and is the core strength of hedge fund of fund firms; they offer an unusual product that fits investor's needs. Initial resources were generally put into developing a strong product, through research, manager contacts, proprietary models and risk management tools. Although firms all have a different methodology for product creation and management, product focus remains the key edge for firms as they present to investors.

Distribution Focus

With an increase in competition and the success of the Bank of New York—Ivy Asset Management and ED&F Man—Glenwood Capital Management transactions in raising capital, many firms have begun to focus on distribution. Rarely does the plan of "build a better mousetrap and the world will beat a path to your door" work (sometimes it does). As such, fund of funds need to make a transition to focus part of the business on distribution strategy. Not all firms will manage this well, but we believe that those who do will be well positioned for success.

We have seen a number of distribution strategies in this area. Institutional: some have followed the traditional long-only world approach and targeted the pension fund consultants. A number of issues arise here including long lead times, the educational process required and the potential that the consultant is forming its own fund of funds. Third-party marketing: we believe these have mixed success, but it can be a viable way for small funds to add marketing as a variable cost function. A big concern of ours is if the manager does not achieve a client ownership focus; that is, know the customer and not be disintermediated by the marketing relationship. Partnerships: can be very successful with the right partner, but a number of factors have to work including commitment, economics, teamwork and branding.

Client Ownership Focus

This stage has not developed yet in the fund of funds business, but may be on the horizon. It is the ability to have a relationship with your end client as a way of extending the longevity of client relationships, preventing disintermediation, cross-selling and improving profitability.

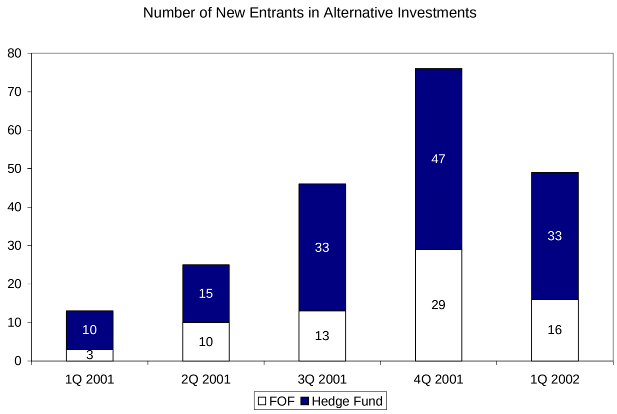
When do we think this will be a priority? It should be now, but many firms may not focus on it until they experience its negative impact, although the foundation is being laid now. As an example, mutual funds who relied on Charles Schwab's OneSource platform saw large asset outflows after the 1997 Asian currency crisis and realized then that they did not know their customers. With the proliferation of partnerships, some fund of funds may realize after the next negative event that they do not own or know their clients.

Specialized Product & Service Focus

The fund of funds industry has already reached this stage in its development, although we believe this will be a 3-5 year cycle. The first part of core product differentiation has been developing for about 18 months. We have seen this include product expansion along the risk/return spectrum (cash plus, low volatility, higher target returns), along hedge fund investment types (long/short only, diversified, arbitrage only, "new" managers) and along geographic lines (US, Asian or European Managers).

The next set of product trends are in their infancy and could lead to sizeable growth in the business and for service and support companies in the industry. These products include (1) closed-end funds, (2) structured products (CFOs), (3) reinsurance/insurance vehicles and (4) private equity hedge fund incubator business.

New Entrants—2002 Preview



The number of new entrants into the alternatives investment space decreased by 36% since the 4th quarter of 2001 to 49. The decline was fueled by a 37% decrease in the number of established companies that launched new hedge fund products since last quarter. The number of individual managers (versus large companies) who started hedge funds this quarter increased by 50% over the last quarter.

Fund of funds products represented 48% of the new entrants for the first quarter, which is proportionate to the trend we have seen since Freeman & Co. began tracking new entrants in the first quarter of 2001. During this time fund of funds have accounted for 51% of the new entrants.

Although we expect the popularity of alternative investments to continue, it appears the rush to launch new products may have hit its peak in the previous quarter. Many of the large financial institutions and asset managers have already established their presence and will likely concentrate on growing the asset levels in their current funds, versus launching additional funds. However, many may try to differentiate their product suite by targeting new products such as closed end funds and structured products, but this should be concentrated among those with critical mass already.

This new level of competition leads to questions about which firms will do well in product performance and capital raising over the short and long term. The key factors for success for many firms will be brand name, distribution, product development, access to managers, intellectual creativity and critical mass. Currently, we favor the independent firms, particularly in the short term, based on their ability to focus on product management and capital raising. These firms will become differentiated as they hit $500 million, $1 billion and $2 billion AUM. Larger financial services firms entering the business will have a slow go at first as they add people and try to leverage internal distribution channels. Over the long run, the best large firms will bring advantages, like capital, structuring capabilities and distribution to eclipse smaller firms if these points can be well managed.

Allocations—2002 Preview

1st Quarter 2002 Alternative Investments Allocation Announcements

Date	Firm	Total Assets ($MM)	% Allocation	Value of Allocation ($MM)
1/8/02	Canada Pension Plan Investment Board	7,500	1%	100
2/7/02	Pentegra Group	1,700	15%	250
3/20/02	Smith College	300	4%	13
2/11/02	Swiss Life Hedge Fund Partners	40	-	-
	Average:	**2,385**	**3%**	**121**
	Total:	**9,540**	**4%**	**363**

Firms Considering Allocations to Alternative Investments

Date	Firm	Total Assets ($MM)	% Allocation	Value of Allocation ($MM)
3/21/02	Abilene Chstian University	140	3.6	5
3/8/02	Creighton University	210	10.0	21
3/11/02	Illinois Teachers' Retirement System	22,600	7.0	1,582
3/15/02	Montana Board of Investments	9,000	1.5	135
3/22/02	Northwestern Memorial Hospital	1,300	39.0	507
2/12/02	Ohio State University	1,000	3.9	39
2/6/02	Public Policy Institute of California	190	10.5	20
3/27/02	Shelby County Retirement System	745	-	-
1/29/02	State of Michigan	47,500	3.0	1,425
2/6/02	Smithsonian Institute	-	-	670
3/8/02	Texas Tech University System	250	20.0	50
1/3/02	United States Holocaust Memorial Museum	100	5.0	5
2/15/02	University of Illinois Foundation	800	5.0	40
1/24/02	University of Memphis	170	10.0	17
3/6/02	University of Wisconsin	300	10.0	30
2/22/02	Virginia Retirement System	44,000	-	-
	Average:	**8,554**	**9.9**	**325**
	Total:	**128,305**	**-**	**4,546**

Source: Freeman & Co.

Another $363 million of alternative investment allocations were announced during the 1st quarter of 2002, with an average allocation of roughly 3.8%. This allocation percentage is in line with our past research of 2-6% from 2001.

We continue to see a strong institutional pipeline demand for alternative investments. During this quarter, funds totaling $128 billion are considering allocations to alternative investments, with an estimated allocation totaling $4.5 billion AUM. At an estimated average return of 15%, this adds roughly 400 basis points of revenue, or $180 million, to the hedge fund industry. We believe a large percentage of these allocations will flow into fund of funds, primarily the larger firms.

Up until now, we have not seen large allocations from insurance companies, but this may change in the near future. The CFO (collateralized fund obligation) product sponsored by Investcorp Management has targeted three tranches of debt including AAA ($250MM), A ($65MM) and BBB ($50MM) that would allow insurance companies and other investors to indirectly allocate assets to the hedge fund class. These CFOs would also help to educate investors about the hedge fund asset classes, and perhaps lead to future direct allocations.

Entry Strategies—2002 Preview

1st Quarter 2002 Alternative Investment Transactions

Month	Year	Partner 1 / Target	Partner 2 / Acquirer	Details	Ownership %
1	2002	Focus Group Ltd	Brownstone Advisors	JV - Fund of Funds	
1	2002	Goodwood Inc	KBSH Capital Management	JV - Hedge Funds	
1	2002	Hedge Funds Ltd.	Suncorp-Metway Ltd.	Acquisition - Hedge Funds	50
1	2002	Saks MedScience Fund	Ladenburg Thalman & Co	Alliance - Hedge Funds	
1	2002	Solaris Capital Advisors	J. Goldman & Company	JV - Hedge Funds	
3	2002	LJH Global Investments, LLC	Attica Portfolio Management	JV - Fund of Funds	
3	2002	LJH Global Investments, LLC	Phoenix Investment Partners	Alliance - Fund of Funds	
3	2002	Transtrend B.V.	Robeco Group NV	Acquisition - Hedge Funds	49

Source:Freeman & Co.

In the first quarter of 2002 there were eight strategic partnerships involving alternative investment managers. Since Freeman & Co. began tracking these relationships in the beginning of 2000, this is the most activity we have seen in any quarter. Although joint ventures and alliances rarely seem to be a big success in the long-only world, they continue to be a popular choice for entry into the alternative investment industry. In fact, four of the five asset management joint ventures Freeman & Co. tracked in the 1st quarter of 2002 involved alternative investment products. We believe alliances and joint ventures have a higher chance for success in the alternative area than in the long-only world. Our reasoning is that the higher fees in hedge funds allow firms to reach critical mass in revenue with a much lower asset base than in the traditional world. For example, a fixed income arbitrage firm with a 1% base and 20% performance fee would earn 400 basis points of revenue at a 15% return. In contrast, a traditional fixed income manager may earn 40 basis points. We believe these economics will allow alternative partnerships to reach revenue critical mass earlier and to provide a high level of incentives for the key people and firms involved.

Another trend that has surfaced is one of non-exclusive partnerships. An example is Florida-based LJH Global Investments which was involved in two strategic partnerships during the first quarter: a joint venture to produce fund of funds with Attica Portfolio Management and a fund of funds alliance with Phoenix Investment Partners. These two partnerships were LJH's second and third in the last 6 months after announcing a plan to co-manage a fund of funds with Caprock Capital Advisors in October. Phoenix has also announced multiple alternative investment partnerships recently; aside from the LJH arrangement, Phoenix announced in June of 2001 that they had teamed with Arden Asset management to develop and distribute fund of funds to Phoenix's client base.

Several established firms launched new alternative products in the first quarter, including Allianz, OppenheimerFunds and GAM. OppenheimerFunds and their recent acquisition (Tremont) launched the first of their highly-publicized closed end funds at the end of February. The success of closed end funds will rely on retail investors' understanding of, and desire for hedge fund product and the performance of the funds, which are generally burdened with above average fees, including management and underwriting fees.

Fund of Funds Activity

Date	Firm	New Firm / Fund	Notes
2/13/02	Allianz Hedge Fund Partners		Allianz Hedge Fund Partners launched three fund of funds
2/8/02	Archery Capital	Helios	Archery Capital recently kicked off its first domestic fund of funds
3/5/02	Barclays Global Investors		Barclays Global Investors launches a "high octane" version of popular market neutral fund
1/15/02	Baron Advisors	Landmark Value Strategies	Baron Advisors plans new offshore fund of funds
2/15/02	Global Asset Mgmt	GAM Global Multi-Alpha	GAM is launching its first Swiss fund of funds at the end of the month
2/7/02	GNI Fund Mgmt Ltd	GNI Global Strategies III Fund Ltd	GNI launched a capital guaranteed fund with a seven year maturity
3/12/02	Investec Asset Mgmt	Investec Global Opportunity Income Fund of Funds	Investec rolls out offshore fund of funds for South African investors
2/1/02	Meyerhoff Investment Holdings		FOF based on the $100 million-plus hedge fund portfolio of the Meyerhoff family
1/31/02	Montrusco Bolton Investments	Montrusco Bolton Focus Global Fund Ltd	Launching a FOF open to Canadian investors
3/15/02	Taurum Capital Partners LLC		Taurum opens fund of funds using in-house sector funds
2/6/02	Waters Associates Inc	Sonata Multi-Strategy Fund LP	Will launch a second fund to mimic Sonata, but leverages 2 or 3 times
2/5/02	Yankee Advisers LLC	Yankee Eagle Fund LP	Yankee Advisers has launched its second fund of funds

Hedge Fund Activity

Date	Firm	New Firm / Fund	Notes
2/11/02	AXA Rosenberg Investment Mgmt		Axa-Rosenberg to offer pan-European market-neutral strategy
3/7/02	DA Capital	DA Long/Short Equity	Former INVESCO executives launch a hedge fund
2/14/02	Decision Capital Mgmt LLC	Decision Strategy Fund LP	DCM launched its first hedge fund with a top-down analytical approach
2/12/02	Enhanced Alpha Mgmt LP	Enhanced Alpha Fund LP	Enhanced Alpha Management launched a new hedge fund
3/1/02	Goodnow, Gray & Co.	Old Kings Capital LP	Offering a long/short equity fund aimed at institutional investors
3/20/02	IKOS	IKOS LP	IKOS has slated to launch a multi-class feeder fund to allow for US investment
1/16/02	J&W Seligman & Co.	Seligman Technology Spectrum LP	J&W Seligman opens first hedge fund to external investors
2/6/02	KBC Alternative Investment Mgmt Ltd	KBC Convertible Opportunities Fund	KBC is broadening its convertible arbitrage strategy with a second fund
2/19/02	Klesch & Co.	Klesch European Distressed Fund	Launching its first hedge fund with a focus on a growing European distressed market
3/11/02	Landmark Partners	Landmark Equity Partners XI LP	The fund will purchase venture capital, buyout and mezzanine stakes globally
1/2/02	Lee Munder Capital Group	MedScience Partners LP	Launched its third hedge fund with assets garnered from friends and family
2/27/02	Mikros Ecnomics	Mikros Economics LLC	Managed futures veteran Mikros readies SEC-registered hedge fund
1/23/02	Millrace Asset Group		Millrace focuses on small-cap equity in first hedge fund
2/25/02	OppenheimerFunds	Oppenheimer Tremont Opportunity Fund LLC Oppenheimer Tremont Market Neutral Fund LLC	Launching two closed end funds with a $50,000 minimum investment
3/7/02	Orn Capital	European Value Event Fund	Orn Capital rolls out European fund
2/27/02	Quest Investment Mgmt LLC	Quest Global Convertible Fund Ltd	Global convertible fund seeks active returns
1/10/02	Scottwood Capital Mgmt		Scottwood launches an onshore and offshore hedge fund
2/14/02	Summers Fund Mgmt	Proximo Fund	Summers Fund Management is gearing up to kick off its first hedge fund
1/15/02	Viewpoint Investment Partners	High Point Offshore Ltd	Viewpoint launched its first offshore fund
1/16/02	Whitebox Advisors	Whitebox Hedge High Yield Fund	Whitebox Advisors added a new fund
2/20/02	Whiteford Advisors LLC	Symmetry International Ltd	Whiteford launched its fourth hedge fund that will focus on the consumer sector

Source: Freeman & Co., Hedgeworld.com, InvestorForce.com, Financial Times

Index Performance—2002 Preview

The recent collapse of the Lipper & Co. convertible arbitrage fund highlights the risks of hedge fund investing. While the write-down the fund took in February was probably the result of an operational risk failure—mispricing of securities without appropriate checks and balances—it also had a great impact on hedge fund performance indexes.

The CSFB/Tremont index has kept its official performance as inclusive of Lipper's performance. This has three effects on the development of indexes and related businesses. First, it shows the underlying problems of creating these indexes and the potential for errors that are cumulative in nature. Second, a loss that can be hidden, whether in Lipper & Co. or Allied Irish Banks, can have ripples that affect the ability to create investable cash indexes. A potential liability arises for the investor who withdrew its assets in January and the new investor that added assets in February. Has the NAV been fraudulently calculated in January and February, and are investors due compensation for any losses in an investable cash index? What type of result will this have for businesses like CSFB/Tremont and Zurich Capital markets that have created investable cash indexes. Third, these index results will negatively impact Wall Street's ability to create derivative structures (options, swaps, futures) off hedge fund indexes. Risks in the creation and calculation of these index returns undermines confidence in building new businesses that rely upon them. The good news is that the issue has surfaced now, and the Street can create solutions before building these derivative businesses.

CSFB/Tremont Convertible Arbitrage Index Returns

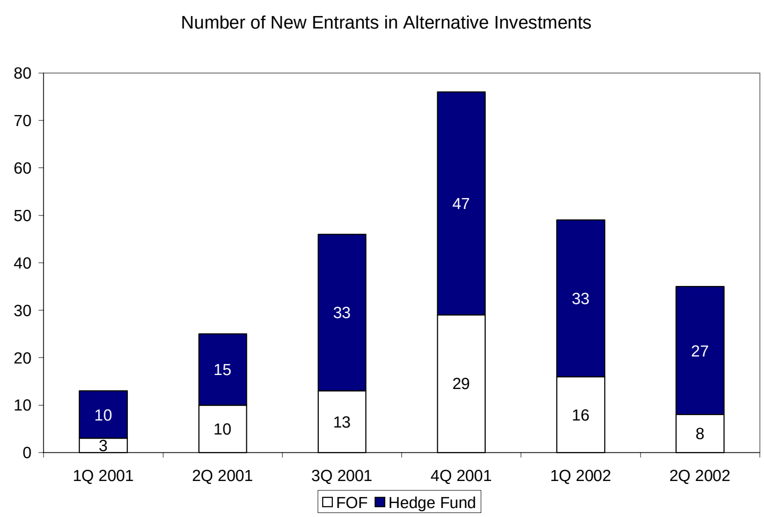
	Feb-02	Mar-02
with Lipper	-3.2%	-0.02%
without Lipper	0.0%	0.4%
Difference	**3.2%**	**0.42%**

Source: CSFB/Tremont

New Entrants—July 2002

New entrants into the alternative investment marketplace declined for the second consecutive quarter after reaching a peak in the fourth quarter of 2001. We have seen a drop in individual hedge funds of about 20% and hedge fund of funds of 50%. Although this may seem dramatic, it represents the product and business launches that we are able to track. It does not represent all activity in the industry (which we are examining how to capture). We think of it as a proxy for industry activity and also a measure of euphoria. In the latter case, we think it is a good thing if euphoria for hedge funds cools a bit to allow the managers to absorb the capital and put it to profitable use.

Fund of fund new product launches were nearly in line with the number of transactions involving fund of funds with 8 of the former and 5 of the latter occurring in the second quarter of 2002. It appears that more firms are abandoning plans of launching their own funds in favor of partnering to gain instant traction. With the rapid growth in the industry, new entrants may have significant difficulty in building a top 10 or top 20 firm without partnering with an existing player.



Source: Freeman & Co.

Within the fund of fund world, $1 billion is now regarded as the critical size level. We believe that most firms below this level will have difficulty competing in the institutional investor marketplace, where due diligence by consultants will focus on infrastructure, risk management systems, reporting capability, management depth and financial stability. This leads to the next two questions: when and where does the critical size level move to?, and what happens to firms below this level? First, we believe that the next critical size point will be $2 billion AUM, but we don't believe that investors will begin to reference this level until the end of 2003. Asset inflows are still healthy, but pension funds move slowly through the process of a new asst class allocation — studying, proposing, approving, searching and selecting. Also, the low returns by fund of funds in the first half of the year naturally slows the compound effect of growth. Second, those firms below critical size should continue to prosper, but with different business models, marketing strategies and future expectations. Many of these boutique firms will succeed with regional and smaller clients, and may be unable or unwilling to support a national or international distribution team. We believe that many of these smaller firms will continue to be innovators in product creation and structuring, as the market will continue to increase its differentiation of products. Most of these firms need to set their sites on reasonable AUM goals and work to achieve the $500 million or $1 billion level. Everyone now realizes that the interest in hedge fund of fund products does not automatically grow every $200 million firm to the $2 billion level without a solid team, effective execution and aggressive marketing.

New Entrants—July 2002

2nd Quarter 2002 Alternative Investment Transactions

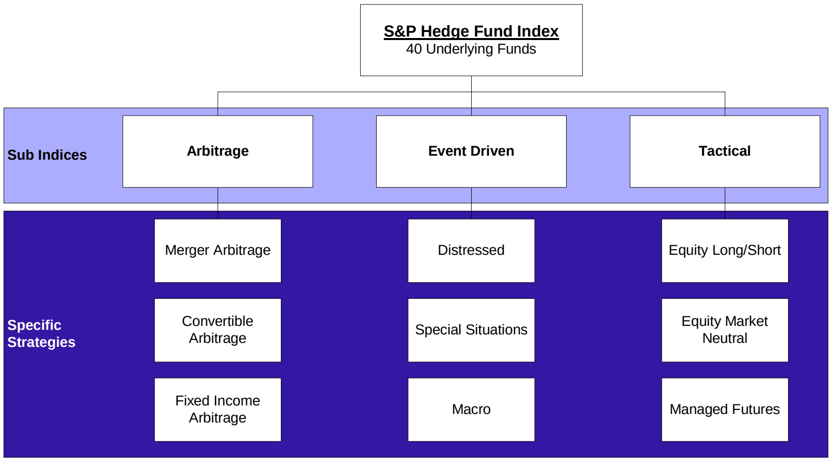
Month	Year	Partner 1 / Target	Partner 2 / Acquirer	Details
6	2002	Attica Asset Management	Threadneedle Asset Management	Acquisition - Fund of Funds
6	2002	Riverview International Group Inc	Gartmore Group	Acquisition - Fund of Funds
6	2002	HBV Capital Management	Mellon Financial Corp	Acquisition - Hedge Funds
6	2002	DB Absolute Return Strategies	PNC Advisors	Distribution - Fund of Funds
6	2002	Global Asset Management	PNC Advisors	Distribution - Fund of Funds
5	2002	3C Fund Management Ltd	Mandatum (Sampo Group)	Acquisition - Hedge Fund
5	2002	RMF Investment Group	Man Group Plc	Acquisition - Hedge Fund
4	2002	LJH Global Investments, LLC	LaSalle Bank (ABN Amro)	Alliance - Fund of Funds

During the quarter we tracked two fund of funds acquisitions, both of which involved smaller firms. These included Threadneedle's acquisition of London-based Attica Asset Management ($300 million AUM) and Gartmore's acquisition of US-based Riverview International ($360 million AUM). After the quarter ended, Robeco announced on July 15th its purchase of US-based Sage Capital ($300 million AUM). These deal sizes are significantly below the earlier deals involving Ivy Asset Management ($2.4 billion), Glenwood ($1.4 billion) and Grosvenor ($3.8 billion). We believe that as large firms, which lack this product capability, continue to explore the competitive landscape and educate themselves about fund of funds, we will see larger acquisitions that fill both the product manufacturing and critical size criteria.

Hedge Fund Indices—July 2002

This quarter Standard & Poor's announced the creation of its hedge fund index. The structure of the index (shown below) uses three broad categories—arbitrage, event driven and tactical—which each consist of three specific investment strategies. Within this framework, the index will be built using 40 different hedge funds, which will all be equally weighted to avoid "popularity" biases.

S&P plans to work with other partners to create unique features for this index. Among the partners, Albourne Partners will act as a consultant, monitoring the hedge funds to ensure they adhere to their investment parameters. One feature is that to be included in the index, a hedge fund must agree to offer daily transparency, which will be used by Derivatives Portfolio Management, a S&P partner, to verify prices. In addition, this feature will allow daily pricing of the index.



Source: Standard & Poor's

S&P has granted PlusFunds an exclusive license to develop certain products based on the index. S&P's approach appears to eliminate the issue of index creation and pricing we raised in our 1st Quarter report, where we highlighted that CSFB/Tremont issued two convertible index returns, with a total difference of 362 bps, due to the Lipper & Co. collapse. PlusFunds' plan to offer investable indices raises two questions: if they are cash-based, how much capacity can these funds absorb?; if they are derivative based, how does the swap counterparty hedge its position?

Guaranteed Funds—July 2002

The European marketplace continues to create and sell a myriad of capital guaranteed funds, including single strategy and multi-strategy hedge fund products. We have listed a number of European firms that offer capital guarantee products, and all of them have been created through partnership. These products create a business relationship between product manufacturers and distributor/underwriter that has existed infrequently in the US.

In the US, many large firms that would like to distribute hedge fund of funds may find the economics of distributing a third-party product uneconomical after the fee is split between the manufacturer, salesperson and distribution platform. In Europe, large universal banks appear eager to help distribute third-party guaranteed products due to the higher fees they receive for that guarantee. In the list below, the guarantee fee for European products range from 175-250 bps, which provides enough economics in the value chain for the guarantor to assist in the distribution of the product. We believe that in certain US client segments, there would be significant demand for a guaranteed product to eliminate career-risk in choosing an Askin or Lipper fund in the future.

Date	Type of Product	Firm	Fees Annual/Guarantee/Performance	Other Features	Assets
Jul-02	Fund of Fund	HSBC Republic	1.70% / 1.75% / 10.0%	Leverage; step-up in guaranteed amount	NA
Jul-02	Fund of Fund	Coronation Intenational Principle Protected Notes		Dresdner Bank offers guarantee	$170 million
Jun-02	Fund of Fund	Coutts Private Banking Orbita Diversified Strategy Deposit		Zero coupon and yield; three year term	$170 million
May-02	Hedge Fund	New Star Asset Management Asian Hedge Fund		Guarantee offered by HSBC	$125 million
Feb-02	Fund of Fund	AXA - Credit Lyonnais	1.50% / 2.50% / 10% over 7%	Partnership between AXA and Credit Lyonnais	$500 million
Jan-02	Hedge Fund	New Star Capital Guaranteed Fund		Guarantee offered by HSBC	$180 million
Jul-01	Fund of Fund	Bank of Ireland Private Banking		Asset Alliance is sub-advisor	
May-01	Fund of Fund	Unicredito/Pioneer Alternative Investments		MTNs backed by Societe Generale	

Source: Financial News, Hedgeworld

Collateralized Fund Obligations—July 2002

The first publicly rated hedge fund of fund collateralized fund obligations (CFOs) were launched during the 2nd quarter. The first was a $250MM deal managed by Investcorp and underwritten by CSFB, and the second was a $550MM deal managed by Man Glenwood and underwritten by J.P. Morgan Securities. These product launches continue the rapid development of products and services that capitalize on the growth in the hedge fund arena, which have included CFOs, start-up and incubation funds, hedge fund indexes, reinsurance businesses, risk management systems and administrative services.

We believe the successful pricing and placement of these CFOs leads to important, long-run developments for the industry. First, it launches a new product class for the industry, which should help sustain the long-term growth in the hedge fund and fund of fund industry. For example, the CDO business is estimated at $90-100 billion annually by Lehman Brothers. Although we do not expect the CFO business to reach anything close to this level, the CFO structure does open the hedge fund market to investors that must own investment grade securities.

Diversified Strategies CFO - Investcorp

Tranche	$MM	%	Rating	Spread over 6 Months $LIBOR
A	$125.0	50%	AAA	+60 Basis Points
B	$32.5	13%	A	+160 Basis Points
C1	$10.0	4%	BBB	+280 Basis Points
C2	€ 16.2	6%	BBB	+270 Basis Points
D	$67.5	27%	Unrated	-
Total	**$250.0**	**100%**		

Man Glenwood Alternative Strategies I

Tranche	$MM	%	Rating	Spread over 6 Months $LIBOR
A	$242.0	44.0%	AAA	+70 Basis Points
B	$33.0	6.0%	AA	+95 Basis Points
C	$41.3	7.5%	A	+185 Basis Points
D	$57.7	10.5%	BBB	+300 Basis Points
Equity	$176.0	32.0%	Unrated	-
Total	**$550.0**	**100%**		

Source: S&P, Moodys and company press releases

Second, the product opportunity will not be equal for all competitors. Small fund of fund managers (under $1 billion), we believe, lack the resources to capture this business opportunity. The underwriters will focus their efforts on the larger firms that have the personnel, risk management systems, brand names, infrastructure and capital resources to support this product. Also, the rating agencies will play a large role in segmenting this market opportunity and effectively eliminating small managers that would not pass the ratings criteria. Fitch Ratings, for example, has published ratings criteria for CDO management companies that leans heavily on infrastructure issues (Jan. 25, 2002).

Third, the CFO product should have a great influence on institutional investors and their views of and appetite for hedge funds in general. Although the investors in the debt pieces of the CFOs are buying investment grade paper, the underlying exposure is to multi-manager hedge fund product. As such, these investors, which may be insurance companies or banks, need to educate themselves about the underlying hedge fund styles (long/short, arbitrage, event-drive, etc.) and their risks (market movements, interest rates, credit spreads, etc.). Combining this investor exposure with the rating agencies work, should increase institutional investors understanding of and interest in hedge funds.

Collateralized Fund Obligations—July 2002

Man Glenwood Alternative Strategies I Investment Restrictions	
Manager Diversification	
Minimum # of managers:	35
Maximum % to any manager:	8%
Maximum % to Top 10 managers:	50%
Liquidity	
5 months or less	>= 40% of assets
6 months or less	>= 60% of assets
15 months or less	>= 93% of assets
Strategies (Maximum %)	
Commodities & Futures:	20%
Distressed Securities:	30%
Equities Long/Short:	60%
Industry Sectors:	60%
Interest Rate Strategies:	20%
International regional:	50%
Mergers and Reorganizations:	40%
Relative Value:	20%

Fourth, CFO structures increase transparency of hedge fund of fund managers and the underlying hedge fund investments. This increased transparency and monitoring will be beneficial to the industry by setting standards, giving investors more access to information and by setting limits on risk and positions (see box). In fact, some of the investment restrictions are significantly more conservative that one would see in a typical fund of fund. For example, a typical fund of fund would normally have 12-18 managers, while the Man Glenwood CFO requires 35 managers. The additional manager diversification requirements (no more than 8% in one manager and no more than 50% in ten managers) would likely be exceeded by many successful and popular fund of funds. We question whether these diversification requirements create a more diluted talent pool of managers in the fund that inadvertently leads to a more passive, index style approach.

Lastly, the creation of CFOs continues the product development innovation in the hedge fund industry, which has numerous secondary benefits. It continues the growth of the industry, not just in assets, but also in service and support firms, which helps create a solid infrastructure to support the continued health and growth of the industry.

Service Providers—July 2002

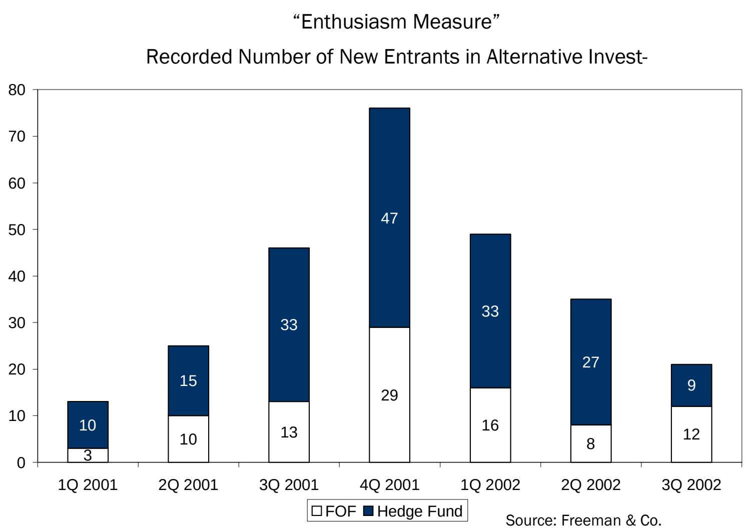
The growth in the hedge fund market continues to provide opportunities in service and support companies, such as primer brokers, administrators, systems providers, etc. In the first half of 2002, two large public companies, BISYS ($2.7 billion market cap.) and State Street ($13.4 billion market cap) entered the hedge fund administration business through acquisitions. We think these trends will continue and expect these and other firms to extend their acquisitions to include a wide range of support companies such as analytics providers, trading systems, order routing systems, etc. When we began tracking and calling on hedge fund of fund providers five years ago, we were not projecting that firms like Bank of New York, BISYS and State Street would make hedge funds a major focus area. We believe that five years from now, hedge funds will no longer be viewed as an “alternative” asset class.

Hedge Fund Administrator Acquisitions

Date	Acquirer	Target	# Clients	Assets $B	Price $MM
3/7/2002	BISYS Group	Hemisphere Group	400	$50.0	$130.0
7/5/2002	State Street	Int'l Fund Services		$3.0	

New Entrants—October 2002

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).

Transactions—October 2002

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 on-going 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.

Registered Hedge Funds—October 2002

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	

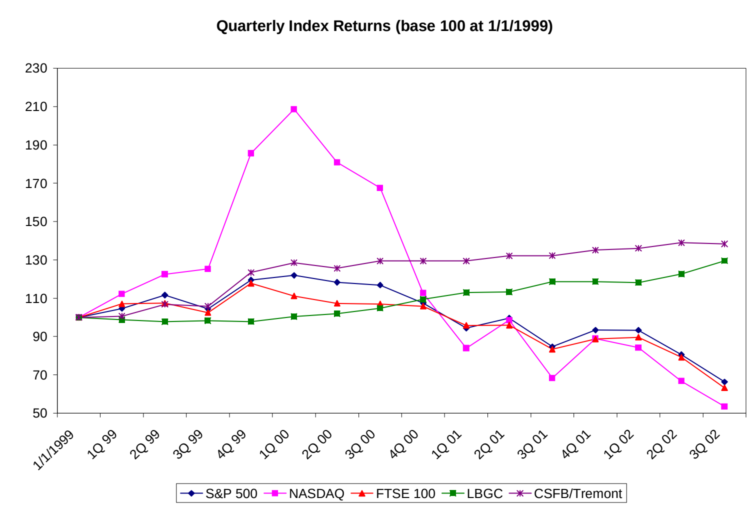
** These firms launched multiple funds*

Source: SEC filings, press releases

Indices—October 2002

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?



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.

Activity—2002 Year End Summary

4th Quarter 2002 Alternative Investment Strategic Partnerships

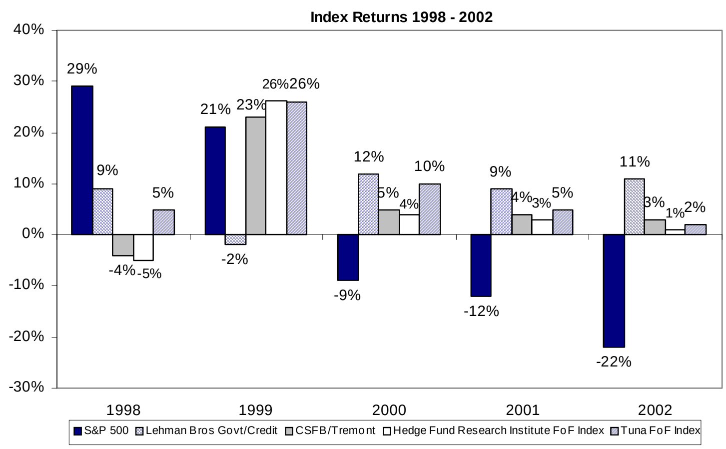
Month	Target	Acquirer	Total Deal AUM ($MM)	Description
12	LibertyView Capital Management	Neuberger Berman Inc.	1,000	Acquisition - Fund of Funds
12	Parallel Ventures	Man Investment Products		Acquisition - Private Equity
12	Westport Private Equity	Man Investment Products	1,700	Acquisition - Fund of Funds
12	Arrow Hedge Partners	KBSH Capital Management Inc.		JV - Fund of Funds
10	PlusFunds Inc.	XL Capital Ltd.		Alliance - Fund of Funds

There were only three acquisitions of alternative investment managers in the fourth quarter, two of which were announced by the Man Group Plc. One interesting note is that four of the five strategic partnerships announced during the quarter involved public companies. Neuberger Berman, one of the largest US public money managers, acquired LibertyView Capital Management, a US-based alternative investment manager. This adds Neuberger Berman to a growing list of public money managers who have made acquisitions to diversify their product offering into the alternative investment arena. Other recent acquirers of alternative investment products have included Affiliated Managers Group, John Nuveen and BlackRock Inc.

As more public companies continue to expand their alternative investment product offerings there is an increased level of acceptance of alternatives and a likely increase in regulation of alternatives. Our belief is that hedge funds and fund of funds will come under a higher level of regulatory scrutiny in large part due to their increased popularity in the current market environment. All of the public companies that are venturing into the asset class are already regulated by multiple agencies (SEC, NASD, FSA, etc.) and will raise the standard for what is expected in the industry (a good thing generally). However the increase in reporting and regulatory standards will come with a real economic cost for all of the current participants and will have a disproportionate effect on small hedge funds. Many of the small hedge funds and fund of funds may have difficulties if legal and compliance bills increase by $250,000 per annum or additional personnel in compliance are needed. All of this leads in the direction of the institutionalization of the business and market share gains by the largest firms in the industry at the cost of smaller firms.

Index Returns —2002 Year End Summary

As a whole the alternative investment industry did not generate large absolute returns in 2002, but it seems to have delivered on its promises of protecting value in bear markets. Among hedge fund of funds, the highest returns we have seen are in the 6-7% range; many are in the 1-3% range; and the long-short focused products seem to be down 2-4%. The other two points for the industry are that investors now realize hedge fund of funds don't return 12-15% every year, and that returns alternatives deliver in the next bull market will be important.



Prospectively the alternative asset class looks appealing to investors when alternatives are low fixed income yields (how much price appreciation is left), real estate and equities. With three straight years of losses in the S&P 500, many investors (private and institutional) are probably managing rebalances and trying to determine where not to lose money.

With this background, we believe that there will be continued new flows into alternative products (hedge funds, fund of funds) over the next five years, but that most of these net new flows will be concentrated among the largest firms in the world. One strong reason supporting this, we believe, is the continued institutionalization of the hedge fund industry. For example, we have listed three separate hedge fund indices in the chart, all of which have sub-indices by styles (Note: there are numerous other hedge fund indices that we have not included). Another example is the recent publication by Institutional Investor of a Top 50 list of the largest hedge fund of funds in the world. All of these combine to educate investors, their intermediaries and consultants about the product class and to direct them to one of the larger firms in the industry. The larger firms generally have an advantage in marketing, distribution, structured product capabilities, reputation risk and the all important "sleep well at night" factor for trustees and institutions.

Alternative Investment Institutionalization—2002 Year End Summary

Select Hedge Fund Indices

1. Standard & Poor's
2. Morgan Stanley Capital International
3. CSFB/Tremont
4. Zurich Hedge Fund Indices
5. Hedge Fund Research Institute
6. Tuna Index
7. Van Hedge Fund Advisors

One of the important characteristics of the hedge fund industry that we have stressed in the past is the need for infrastructure and information to make it a large institutional market. One of the items that helps the industry grow is information availability and clarity for how the information was produced. As listed at right, there has been an increase in the firms providing hedge fund indices, with a general trend from the smaller independent firms to the entrance of large global investment banks (e.g. Morgan Stanley). While we reserve judgment on the "accuracy" or applicability of hedge fund indices, we do believe that they support and encourage the growth of the industry by making information easily available to investors.

The other support area that has popped up are "Value Line Reports" on hedge funds. Recently we have come across firms such as Allenbridge Hedge Fund Research and HedgeWorld that are offering background and due diligence reports. Fees for these services range from $900 to $15,000. Since we have not reviewed any of these reports, we will skip any comments on content and quality — the point we do want to highlight is that access to information, in a traditionally secretive industry, would support institutional growth in assets.

The last area we want to comment on is the increased hedge fund developments by market leading investors such as CalPERS, GM Pension and ABP. These firms should do a great deal to expand the market acceptance of hedge funds by institutions. All of these organizations are viewed as sophisticated first-movers, and their actions should directly lead to future allocations by other investors, albeit slowly.

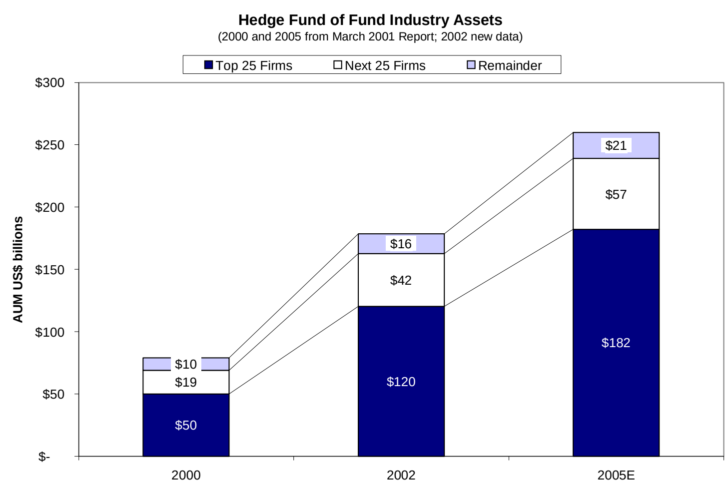
One element these developments all share is they raise the profile of the hedge fund industry and its activities. As such, we believe these will generally lead to two results: (1) an increase in regulatory interest and (2) some increase in fraudulent events due to increased interest in hedge funds.

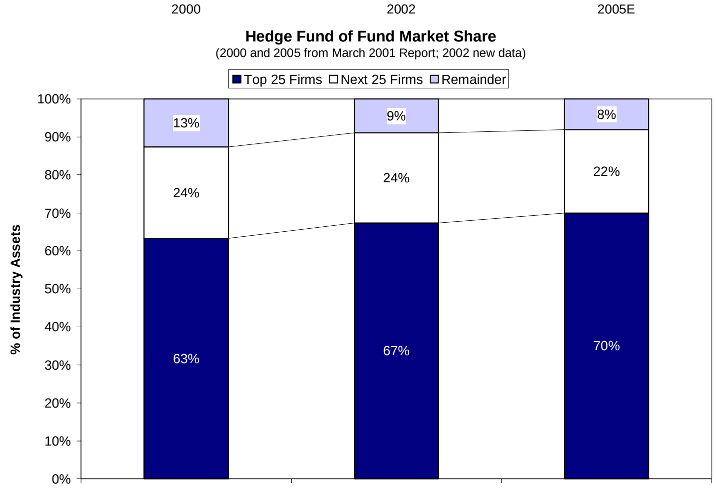
Fund of Fund Challenges—May 2003

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.

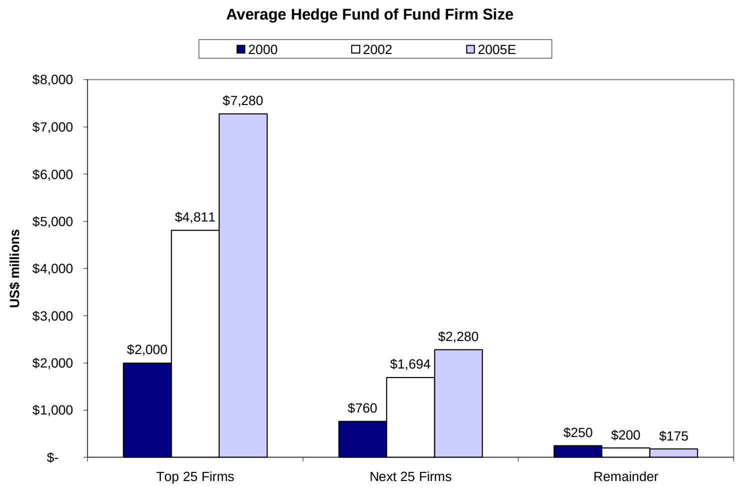
When we look at estimated market share using our projections, plus *II's* Top 50 list, we see that the top 25 firms continue to collect the vast majority of the assets. In fact, the top 25 firms have on average 2.7x the level of assets of the next 25 firms. We expect this figure to continue to rise as 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.





Fund of Fund Challenges—May 2003

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.



Hedge Fund Indices & Index Linked Products— May 2003

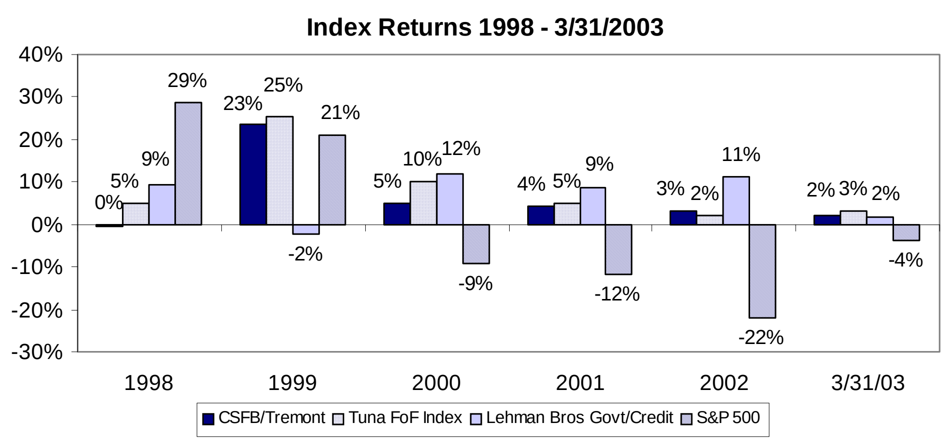
Hedge fund indices had positive results in the first quarter of 2003 with returns ranging from 1 to 3%. Hedge funds continue to outperform the equity indices as the S&P 500 lost 4% in 1Q03, and hedge fund returns were generally on par with fixed income returns as evidenced by the Lehman Brothers Govt./Credit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



Hedge Fund Indices & Index Linked Products—May 2003

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.

Current Developments— October 2003

In the third quarter of 2003, the SEC published a staff report entitled "Implications of Growth of Hedge Funds" which studied hedge funds, including their investment advisers, other service providers, and their investors in order to shed light on the hedge fund industry and explore ways of potentially increasing regulation. The report recommended the following proposals to the Securities Exchange Commission as main directives for regulating the hedge fund industry:

1. *Require hedge fund advisers to register as investment advisers under the Advisers Act, taking into account whether the benefits outweigh the burdens of registration*
2. *Address certain valuation, suitability and fee disclosure issues relating to registered fund of hedge funds*
3. *Permit general solicitation in fund offerings limited to qualified purchasers*
4. *Monitor closely capital introduction services provided by broker-dealers*
5. *Encourage the hedge fund industry to embrace and further develop its best practices*
6. *Improve investor education regarding hedge funds*

Although it is uncertain which of the recommendations will eventually be enacted, we believe the push to greater levels of disclosure and regulations will increase the costs of doing business for hedge funds, hedge fund of funds and their distributors and service providers. The next key point is who will eventually bear these increased costs along the value chain: investors, hedge funds, fund of funds or service providers. We are fairly certain that investors will bear some of the costs through either higher direct fees or additional charge-backs against the funds in which they invest. However, the hedge funds and fund of funds may shoulder a disproportionately high portion of these costs and their ability to pass these costs on to investors will depend on the laws of supply and demand (generally directly proportional to the net returns a fund has been generating).

Current Developments — October 2003

Additional SEC Recommendations being Considered

- Require all registered companies that invest in hedge funds to have procedures to ensure hedge funds are valued in a manner consistent with 1940 Act requirements
- Disclose in prospectuses estimated fee and expense tables to address concerns that registered fund of hedge fund investors do not understand the impact of multiple layers of fees
- Permit hedge funds which limit their investors to a higher investment standard, to engage in general solicitation

While the largest fund complexes will have little trouble supporting an additional $250,000 to $1 million in regulatory and compliance costs, the biggest burden will fall on the thousands of small hedge funds and fund of funds that will have the greatest difficulty in carrying these costs. This leads to the next question of whether firms will seek critical mass to help cover the higher cost of doing business: regulatory, compliance, marketing, distribution, etc. Although it is hard to place a value on a hedge fund and sell it in a traditional M&A transaction, there are emerging models that combine firms or provide a platform for hedge funds. Most of these provide all the back-office services in return for the base management fees; on top of that, they may provide marketing and distribution, for which they will split the incentive fees.

Hedge fund of funds are easier to value due to the lower percentage of variable fees, and they present themselves as better M&A candidates. The key question is: What will they need to do to be both competitive and profitable? We believe that the long-only world provides a template for the future hedge fund of fund landscape; in the long-only world there are a number of very large complexes (e.g. Fidelity) and a long tail of much smaller firms, many of which are quite successful and profitable. However, at the small end, many of the firms should be larger and more profitable than they usually are; we think the hedge fund of fund world will follow a similar pattern. Currently, many firms are trying to reach critical mass and become top 20 firms — the only problem is that only 20 firms can fit in the top 20 list. We continue to believe that those firms that do not reach critical mass and show momentum in asset growth will have difficulty raising capital and investing in the infrastructure that institutional investors will require from their hedge fund of fund managers in the near future.

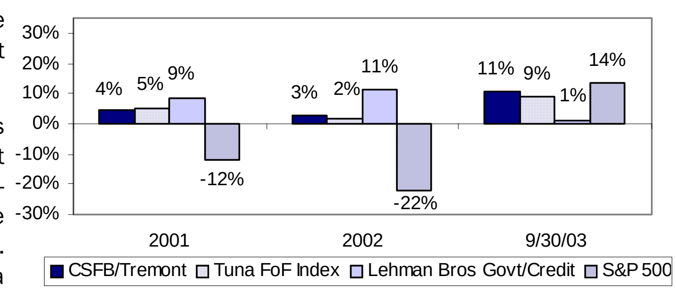
The recent mutual fund trading/timing scandal will certainly increase the focus on hedge funds and their practices. Although a very small proportion of hedge funds ever pursued mutual fund timing strategies, the current events provide the opening for regulators to begin exploring other parts of hedge fund activity (sales practices, suitability tests) and to push for an increased level of regulatory oversight of the industry. One potential avenue for this is by approaching hedge funds indirectly by increasing the reporting and regulatory burden on the prime brokerage firms (virtually all of which are owned by firms that have settled other matters with Elliot Spitzer recently). It is clear that the capital introduction services provided by prime brokers is a targeted area — sales practices and investor suitability issues have been investigated in most financial products over time (mutual funds, variable annuities, etc.). Whether or not Mr. Spitzer's group decides to take this road remains to be seen, but the fact that a potential route like this exists should warn firms to review their current business practices to make sure that they uncover any problems, if any, and take corrective actions before the regulators do it for them.

Investable Indexes—October 2003

In the previous issue of *Asset Management Focus* we highlighted the growing number of hedge fund indices and the related index products. Since that time there have been a number of additional partnerships and product launches.

In August, CSFB/Tremont launched the first investment product that tracks their long-standing index. MSCI and Lyxor launched a product in July that uses separate accounts to track the MSCI Hedge Fund Index. More recently, Lyra Capital LLC announced that Dow Jones will begin publishing the hedge fund index returns that are a basis for Lyra's investable products. Lyra Capital had previously grown their business to $1.3 billion in AUM as a part of Zurich Capital Markets prior to their MBO in October of this year.

Index Returns 2001- 9/30/2003



Hedge Fund Index-related Partnerships

Mo	Year	Partner 1	Partner 2	Summary Details
11	2003	PlusFunds Inc.	XL Capital Ltd.	Creating structured products for the insurance industry based on the S&P Hedge Fund Index
10	2003	**Lyra Capital**[2]	Dow Jones Indexes	Dow Jones will publish the Hedge Fund Indices formerly owned by Zurich Capital Markets
8	2003	CSFB	Tremont	Launched investable fund that tracks the CSFB/Tremont Index
7	2003	Lyxor Asset Mgmt	MSCI	MSCI launched investable index using separate accounts owned by Lyxor
4	2003	MondoHedge	MPS Alternatives	Partnered to launch hedge fund index for the Italian Market
5	2002	PlusFunds Inc.	S&P	PlusFunds will act as investment manager for product tracking the S&P Hedge Fund Index

Source: Freeman & Co

[2] Lyra Capital was formed through the management buyout of the Zurich Benchmark Series from Zurich Capital Markets, Inc. Freeman & Co. Securities LLC acted as financial advisor to Zurich Capital Markets, Inc.

Hedge Fund Administrator Acquisitions — October 2003

In order to capitalize on the growing hedge fund market and in several cases to increase their relationships with hedge fund managers, several large financial institutions have acquired hedge fund administrators over the past several quarters. Most recently, Citigroup acquired Forum Financial Group for approximately $47 million. The acquisition allows Citigroup, with $5.5 trillion of fund assets under custody, to offer accounting and administrative services to its mutual fund and hedge fund clients for the first time. Around the same time as the Citigroup announcement, HSBC announced that it was acquiring Bank of Bermuda for approximately $1.3 billion, primarily for its fund administration and private client businesses. Bank of Bermuda is one of the world's largest fund administrators with $113 billion in assets which account for approximately 45% of the company's overall revenue. Other notable transactions were BISYS' acquisition of the Hemisphere Group and PNC's acquired the remaining minority interest it did not own in PFPC.

With the rapid growth that the hedge fund industry has experienced over the past several years, large financial institutions have been looking for ways to further develop their relationships with hedge fund managers by becoming one-stop shops. Additionally, the economics of administrators, whose fees are linked to assets under administration, allows large institutions to catch a ride on the growth of the industry while potentially solidifying cross-selling relationships for their prime brokerage and trading desks. It also provides firms with recurring, asset-based fees in businesses that should have good operating leverage and require low amounts of capital allocation, in contrast to the prime brokerage businesses.

As the hedge fund business continues to gain traction with institutional investors, we expect further expansion of service provider efforts and increased consolidation in the sector.

Recent Acquisitions of Hedge Fund Administrators

Year	Target	Country	Acquirer	Country	Price ($MM)	Total AUM ($MM)
2002	Hemisphere Group	Bermuda	BISYS Group	US	130	50,000
2003	PFPC Inc.	US	PNC Financial	US	54	
2003	Bank of Bermuda	Bermuda	HSBC	UK	1,300	113,000
2003	Forum Financial Group	US	Citigroup	US	47	

Source: Freeman & Co

Notable Alternative Investment Transactions — October 2003

The alternative investment industry continues to be one of the most active segments of the broader industry in terms of strategic business alignments. During the third quarter we recorded 10 alternative investment business relationships or partnerships that were created, of which 6 were acquisitions and the remaining 4 were alliances or joint ventures. Generally, these all involved investment products although we continue to see an expansion of partnerships involving platforms for IT, infrastructure and information services to the industry. Although it is now easier to get information on alternative products and performance than it was just 2 years ago, the alternative industry's infrastructure lags behind those of other financial products such as mutual funds or variable annuities in terms of reporting, shareholder services and information availability. We continue to see opportunities for select firms to capitalize on these transactions.

Notable Alternative Investment Transactions of 2003

Month	Year	Partner 1 / Target	Country 1	Partner 2 / Acquirer	Country 2	Transaction Type
10	2003	**Zurich Benchmark Series**[3]	US	Lyra Capital LLC	US	MBO
9	2003	LJH Financial Marketing Strategies	US	Capco	US	Alliance
9	2003	Stone Harbor Advisors	Japan	RMF Investment Management's Hedge Fund Ventures	Switzerland	JV
9	2003	The Crossroads Group	US	Lehman Brothers	US	Acquisition
9	2003	Attica Asset Management	UK	Threadneedle Asset Management	UK	Acquisition
8	2003	Thomason Capital	US	Taurum Capital Partners	US	Acquisition
7	2003	Hedgefund.net	US	Wall Street Access	US	JV
7	2003	JD Farrods Securities Ltd.	UK	Integrated Asset Management	Canada	Acquisition
7	2003	Appleton International	UK	Integrated Asset Management	Canada	Acquisition
6	2003	**Zurich Capital Markets**[3,4]	US	BNP Paribas	France	Acquisition

Source: Freeman & Co

[3] Freeman & Co. Securities LLC acted as financial advisor to Zurich Capital Markets, Inc.

[4] Transaction included the majority of ZCM's structured product assets.

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