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Alternative Investment Focus

Freeman & Co. LLC

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Are Hedge Fund M&A Deals a Sustainable Trend?

The recent acquisition of Highbridge Capital Management, with $7 billion AUM, by J.P. Morgan Chase was a watershed event for the hedge fund M&A industry. This deal, along with an increase in deals in 2004, has brought a heightened level of awareness to the hedge fund industry and has raised a number of industry and deal specific issues to consider when discussing hedge fund M&A opportunities. This report explores a number of issues in the hedge fund industry, including:

- Are hedge fund M&A deals a sustainable trend?
- What are the challenges facing smaller hedge funds that might cause them to merge with larger hedge funds?
- What do hedge fund of fund investors think of hedge funds selling themselves in these types of deals?
- What are the key factors and challenges affecting deals?
- How might new regulations and their costs influence M&A deals?
- How might recent returns impact smaller hedge funds and their ability to remain independent?

We thought to ask hedge fund of funds, the largest investor pool in hedge funds, about their views of hedge fund M&A deals and, in particular, their views of smaller hedge funds. Although the Highbridge / J.P. Morgan deal has led to a focus on the largest hedge funds, we believe that mergers and consolidations of smaller hedge funds may become more prevalent due to a larger number of factors affecting the smaller firms. As such, our report follows with:

- Issues affecting smaller hedge funds,
- Results of a HFOF survey on their views of smaller hedge funds and hedge fund M&A,
- Issues affecting hedge fund transactions, including recent M&A deals and regulatory issues, and lastly
- An overview of the size and shape of the hedge fund industry

We hope that you find this research useful, as we are excited about the prospects for creative M&A deals with hedge funds. As usual, please feel free to call or email us with questions, comments or arguments.

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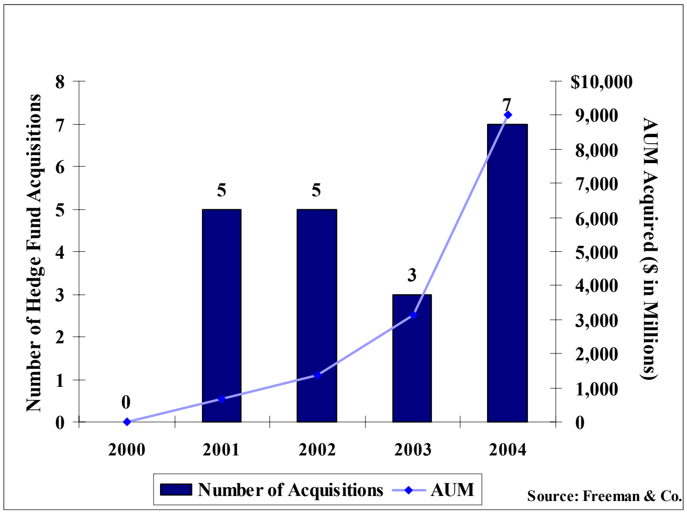
Executive Summary

Hedge fund acquisitions are on the rise again. After a slow 2003, acquisition activity in hedge fund land has surged in 2004. In 2004, 7 hedge fund acquisitions were announced with total AUM of approximately $9 billion. This is over two times the number of acquisitions in 2003 and surpasses the numbers in both 2001 and 2002. J.P. Morgan's acquisition of Highbridge Capital Management attracted a lot of attention. In addition, there are talks of other high profile acquisitions, including Lehman Brothers' acquisition of British giant GLG Partners.

What drives hedge fund acquisitions? Is the surge in acquisition activity a passing phenomenon or a sustainable trend? In attempting to answer these questions, this report analyzes the issues affecting hedge funds, investors' (hedge fund of funds') views on the hedge fund industry, major drivers behind the acquisitions and deal issues, as well as the growth and composition of the hedge fund industry.

Figure 1: Hedge Fund Acquisitions for the Last Five Years



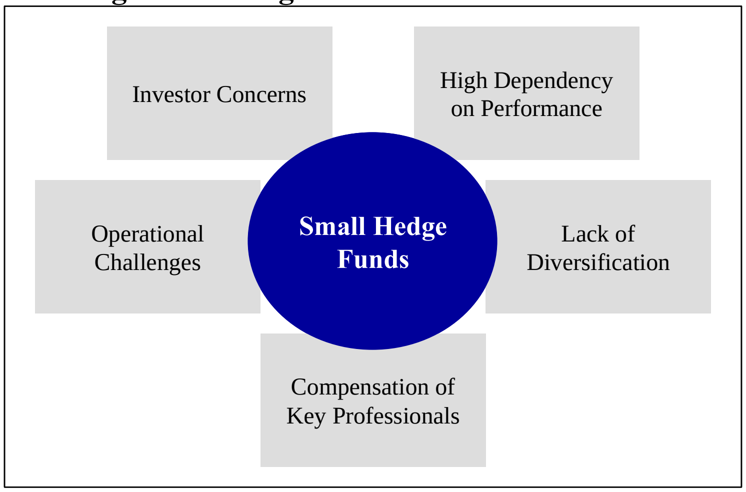
In collecting market data, we conducted a survey of hedge fund of funds to gain an investor view of these hedge fund M&A trends. In addition, we interviewed a number of legal and accounting firms serving the needs of hedge fund clients. Our special thanks to all of those who shared their thoughts and insights. Our summary observations are:

- We believe acquisitions of hedge funds will continue
- They will be driven by the need for products by buyers and the need for support, infrastructure or a liquidity event by sellers
- Managers who are able to diversify their revenues and cash flows will be more desirable acquisition candidates and will be able to realize a higher value for their businesses
- Buyers will need to put the right deal structures and incentives in place to motivate the investment team and make the acquisitions successful
- Hedge fund of funds (HFOFs) have concerns about M&A deals, but these are not insurmountable
- HFOFs have numerous concerns about funds with less than $100 or $50 million, some of which would be alleviated if small funds were part of a larger organization

Challenges Facing Small Hedge Funds

The hedge fund industry is relatively young and has an abundance of smaller firms – approximately 70% of hedge fund managers have AUM of less than $100 million. Therefore, we felt it was important to explore the challenges small hedge fund managers face. These challenges affect the managers' day-to-day business and can be a determining factor in which funds will survive. Also, we believe that these challenges will be one of the primary drivers of consolidation in the hedge fund industry. Among these challenges are:

Figure 2: Challenges Affecting Small Hedge Funds



High Dependency on Performance. Hedge funds are highly dependent on their performance fees:

- A fund that charges investors 1% of total assets, 20% of profits, and has returns of 10% a year will receive two-thirds of its revenue from performance. This high dependency puts a small firm under extreme pressure if performance is low or negative.
- The problem is magnified for funds that have high water marks or use benchmarks to calculate their incentive fees. In this case, even if the fund generates positive performance, the manager may not be getting its incentive fee until prior losses have been recouped or until the fund's return exceeds that of a benchmark.
- If the performance is negative, not only will the manager not receive its performance fee, but also the assets of the fund will decline and future capital raising will be difficult.

Small hedge funds that face even two difficult years may witness their revenues erode significantly and may not be able to cover their operating costs or retain talented professionals. This will force many to consider partnering with a larger organization that will be able to support the manager until performance returns.

Lack of Diversification. Small hedge funds typically focus on their core expertise and do not diversify across various strategies. This makes them vulnerable to the changes in market conditions affecting their strategy. For example, a merger arbitrage fund may not be able to find enough profitable opportunities to invest in if the M&A market slows down (or there may be too much money chasing the deals, which lowers spreads). If the unfavorable economic situation persists, the fund may not have a choice but to return the money to its investors. In addition, different strategies fall in and out of favor with investors for many reasons. For example, when Clinton Group was investigated for mispricing of its asset-backed securities, investors fled from other fixed income managers. In a situation like this, large funds are usually able to ride out the period of investors' capital withdrawals. For small funds, however, withdrawals may be significant enough to force them out of business.

Compensation of Key Professionals. Compensation is one of the most important drivers of key investment professionals' motivations and goals. It is important to highlight:

- A possibility of large financial gains attracts talent to hedge funds. However, if the gains are not as expected, talent moves on.
- Hedge funds are dependent on their human capital, both at the most senior management level and at the research staff level. Losing key managers or research staff can adversely impact the manager's business.
- Small hedge funds are particularly vulnerable to losing their personnel. Small managers typically do not keep significant reserves to pay bonuses if the fund does not generate sufficient revenue. Several years of weak performance can mean no bonuses for the research staff, who usually have not accumulated sufficient personal net worth to ride out the bad years.
- Reduction of fund size due to investors' withdrawals also means lower revenues and lower compensation.

Funds that are able to offer higher and more stable compensation will lure the talent away from small managers. Therefore, being part of a larger organization may be more advantageous to be able to attract and retain talent.

Operational Challenges. Small funds also face a variety of operational issues. These managers often do not have the resources to devote to full-time marketing, compliance, administration, etc. Often, in addition to searching for investment ideas and focusing on generating returns, the founding principals and key portfolio managers also have to devote a significant portion of their time to fundraising and communication with investors, regulators, and third-party service providers. While some managers don't mind multi-tasking, most want to focus on investing and delegate operational functions to dedicated personnel. Also, lack of economies of scale makes it relatively more expensive for systems, IT, external research and data providers (at least those not paid for through commissions). Being part of a larger hedge fund complex allows managers to spread the costs over a wider base, taking advantage of the economies of scale.

Investor concerns. Small hedge funds may have trouble growing their assets by attracting new investors.

- Name and brand recognition play a big role here – investors may be less willing to allocate money to smaller, less-known managers.
- In addition, investors may be concerned about the lack of infrastructure as well as key personnel risk.
- In exchange for allocating money to small hedge fund managers, some investors require special terms and protections, such as increased transparency, liquidity, and lower fees.
- Finally, many HFOF or institutional investors allocate certain minimum amounts to their investments. If their internal guidelines do not allow them to represent more than a certain percentage of a fund's total AUM, they may not be able to invest with small hedge funds at all.

Hedge Fund of Fund Survey

Since investor concerns are one of the major issues smaller managers have to contend with, we decided to conduct a survey of hedge fund of funds (HFOF) to gain their views on smaller hedge funds and hedge fund M&A. In our previous report, *Convergence in Alternatives*, we estimated the size of the HFOF industry at approximately $478 billion in AUM at the end of 2004. At its current size, HFOF assets represent over 40% of the total assets invested in hedge funds. With its size and prospects for growth, HFOF are an important investor segment in hedge funds, and their views cannot be ignored.

We approached approximately 60 HFOF managers and received responses from 20:

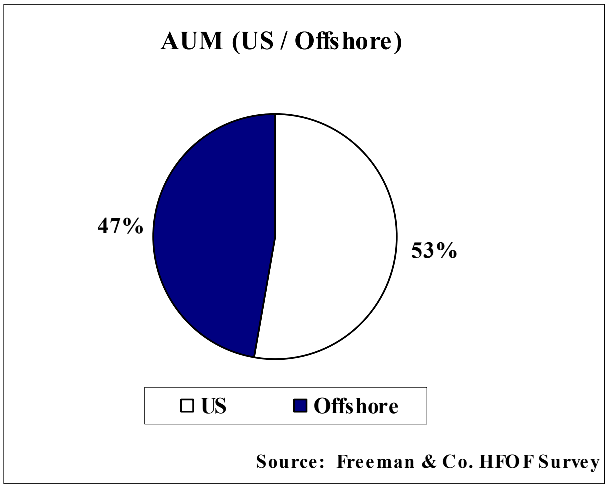
- The respondents' firm sizes varied greatly, from $37 million in AUM to $14.5 billion in AUM.
- Average firm size was approximately $1.7 billion in AUM.
- The majority of respondents (12 out of 20) managed $1 billion in AUM or less; therefore, median AUM of $475 million was lower than the average.
- The majority of the respondents (16 out of 20) managed their assets directly. 4 firms offered consulting services. Assets not directly managed represented only 5% of the total respondents' AUM.

Figure 3: HFOF Survey Respondents' Characteristics

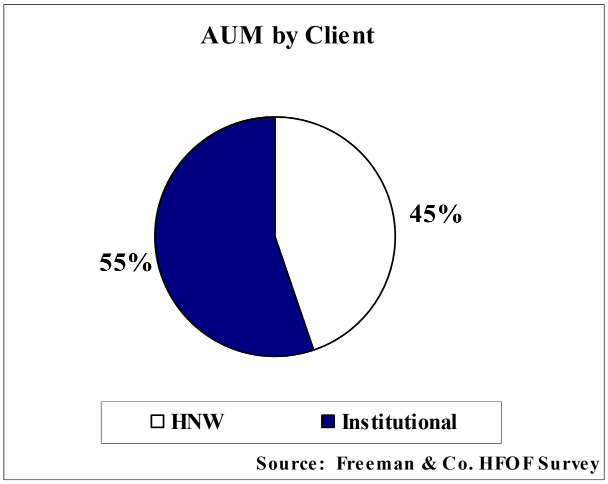
Total HFOF Approached:	**60**
Number of Respondents:	**20**
AUM Range:	**$37 million - $14.5 billion**
Average AUM:	**$1.7 billion**
Median AUM:	**$475 million**

US-Only Managers:	**2**
Offshore-Only Managers:	**3**
US & Offshore Managers:	**15**
HNW-Only Managers:	**2**
Institutional-Only Managers:	**2**
HNW & Institutional Managers:	**16**

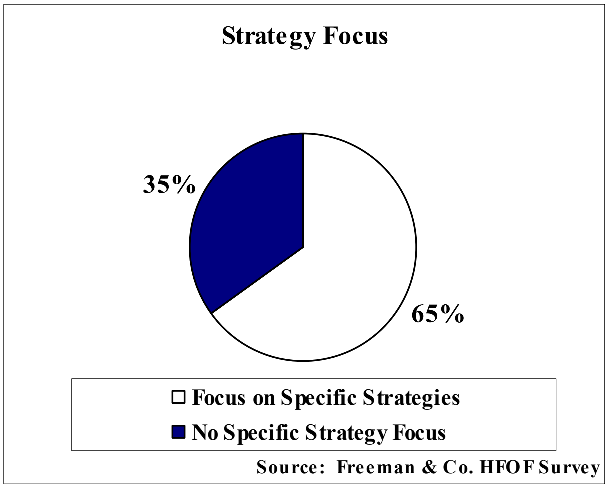
Figure 4: AUM and Strategy Breakdown



- The mix of US vs. offshore managers was varied, with 2 firms managing assets for only US investors, 3 firms managing only offshore assets, and the rest offering services to both. Overall, over half (53%) of the respondents' AUM were from US investors



- Client base of high net worth (HNW) individuals vs. institutional was mixed: 2 firms managed assets strictly for institutions, 2 firms strictly for HNW individuals, and the rest managed a mix of institutional and HNW money. Of the total assets managed by all the respondents, 55% of the AUM was institutional and 45% was HNW.



- Thirteen (13) firms (or 65% of the respondents) focused on a specific strategy, such as Equity Long/Short, Fixed Income Arbitrage, Distressed, Futures, and Global Macro, with the other 35% employing a diversified multi-strategy approach.

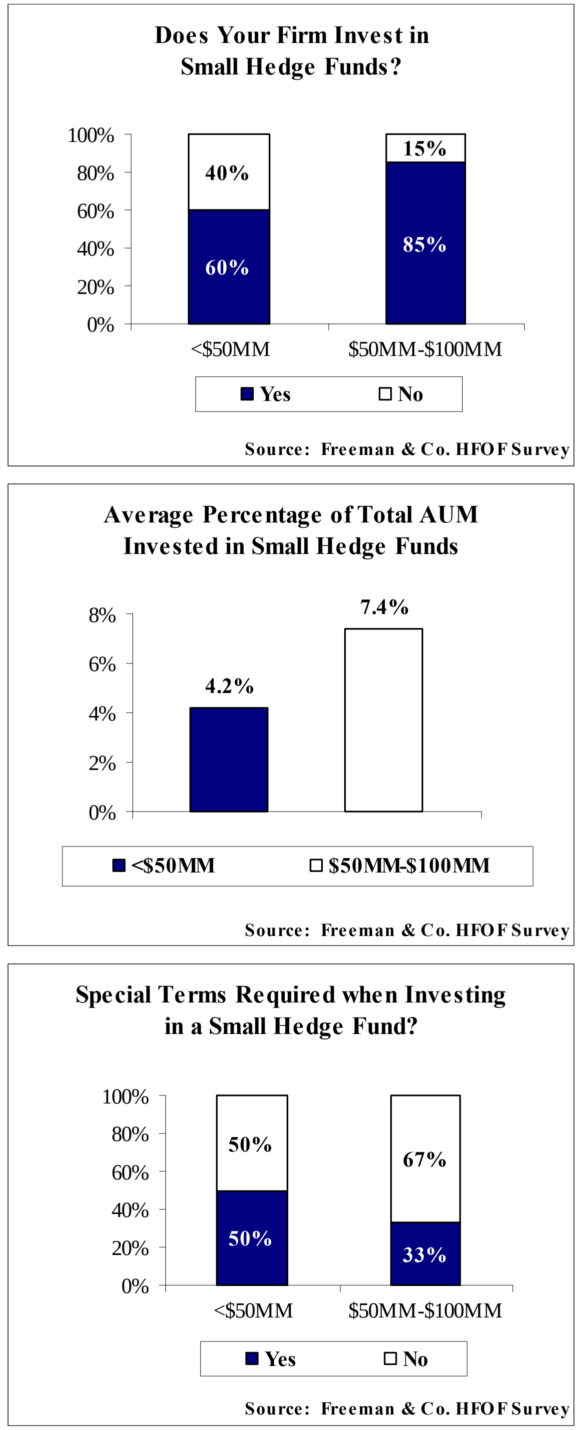
In order to determine if smaller hedge funds are at a disadvantage, and perhaps will have increased pressure to merge, we focused many of the survey questions on investments in hedge funds with less than $100 million. The reason is that we believe many small hedge funds will come under increased financial pressures due to: more modest returns, rising regulatory and compliance costs, and difficulty attracting capital due to lack of infrastructure and critical mass.

We divided small hedge funds into two groups: those having less than $50 million in AUM, and those having $50-$100 million in AUM. As we expected, HFOF managers' comfort diminishes as the size of the underlying hedge fund declines. For example, 40% of HFOFs would not invest in hedge funds with less than $50 million in assets and 15% would not invest in those with $50-$100 million. For those managers that will invest in small hedge funds, on average, approximately 4% of the HFOF total AUM is allocated to funds with less than $50 million. In contrast, HFOF seem to be more comfortable with $50-$100 million hedge funds, allocating over 7% of their assets to these funds. In addition, of those HFOF investing in small hedge funds, more firms require special terms and protections when investing in funds with less than $50 million.

Special terms and protections HFOF require when allocating money to hedge funds are important. These protections often are the price small fund managers have to pay to attract investors' capital. We asked those who require protections to list them:

- **Reduced lock-ups and better liquidity** was the most common response. This requirement can significantly impact small fund managers as it makes them more vulnerable to investors' withdrawals.
- **Transparency and access to information** was also important. Giving transparency to investors puts an extra administrative burden on managers who might not have enough resources to commit to reporting and investor communication.
- **Reduced fees** are quoted as a requirement. Charging lower fees directly affects the manager's revenues and cash flows and may cause "most favored nation" issues later.
- **Capacity** was particularly important for those investing in funds with less than $50 million in AUM. Promising future capacity means that a manager might have to turn down future investors (or give them smaller allocations).
- Other requirements included **key man** and **change of control** clauses. These protections further limit hedge fund managers' flexibility or negatively impact the managers if they are invoked.

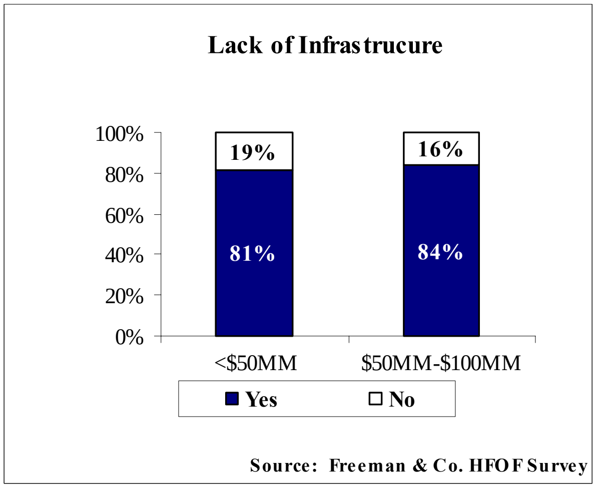
Figure 5: HFOF Investing in Small Hedge Funds



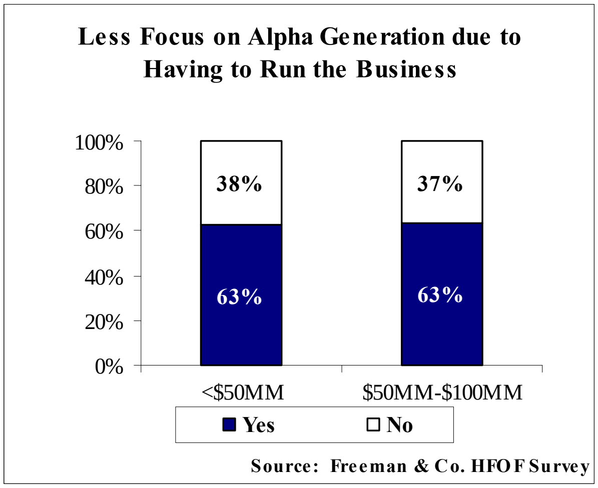
What concerns do HFOF managers have about investing with small hedge fund managers? We have identified five issues that could have been potential concerns for HFOF. The summary of the responses is below.

The responses are not surprising. Most of the concerns are focused on operational issues such as lack of infrastructure, focus on running the business vs. generating returns, and dependence on key personnel. Sophisticated investors evaluate these factors when making investment choices. Our key findings are:

Figure 6: Concerns about Investing in Small Hedge Funds

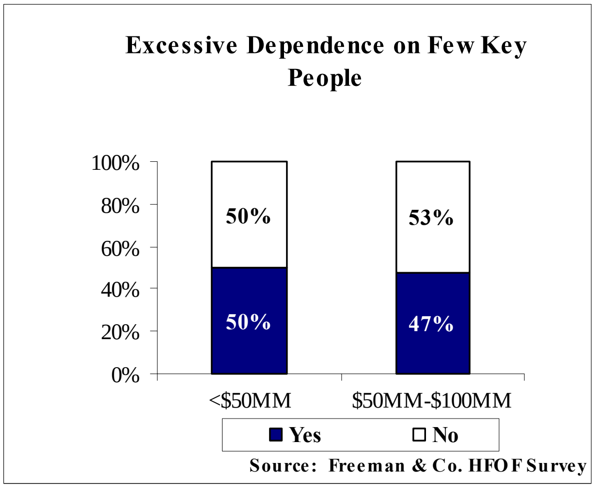


- Over 80% of HFOF worry about the lack of infrastructure. This means compliance, operations, disaster recovery, etc. – all the issues that could affect the end investor in case of a sudden unfavorable event.

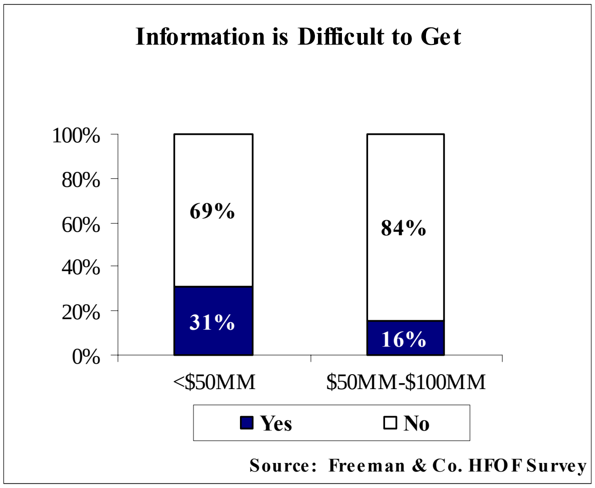


- Over 60% are concerned that small hedge fund managers have to devote a significant amount of their time running their businesses. Without dedicated marketing, operations, compliance, or administrative staff, managers must divert their focus from alpha generation.

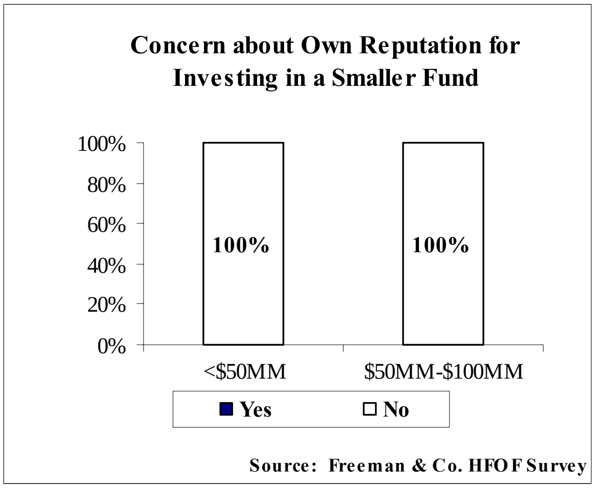
Figure 6: Concerns about Investing in Small Hedge Funds (Cont.)



- Dependence on key personnel was a concern for approximately half of respondents. The concern was lower for funds with $50-$100 million.



- Difficulty in getting information on small hedge funds was a concern for only a small group of HFOF managers. By requiring special terms and protections, HFOF are able to compensate for the initial difficulty in gathering information by demanding greater transparency.



- Finally, none of the respondents seemed to be concerned about their own reputation for investing in smaller, less-known managers. This response was unexpected, as we believed that HFOF, like other institutional investors, would have more reputational risk issues with smaller firms (but it is probably only a reputational issue if the fund, big or small, has very poor performance).

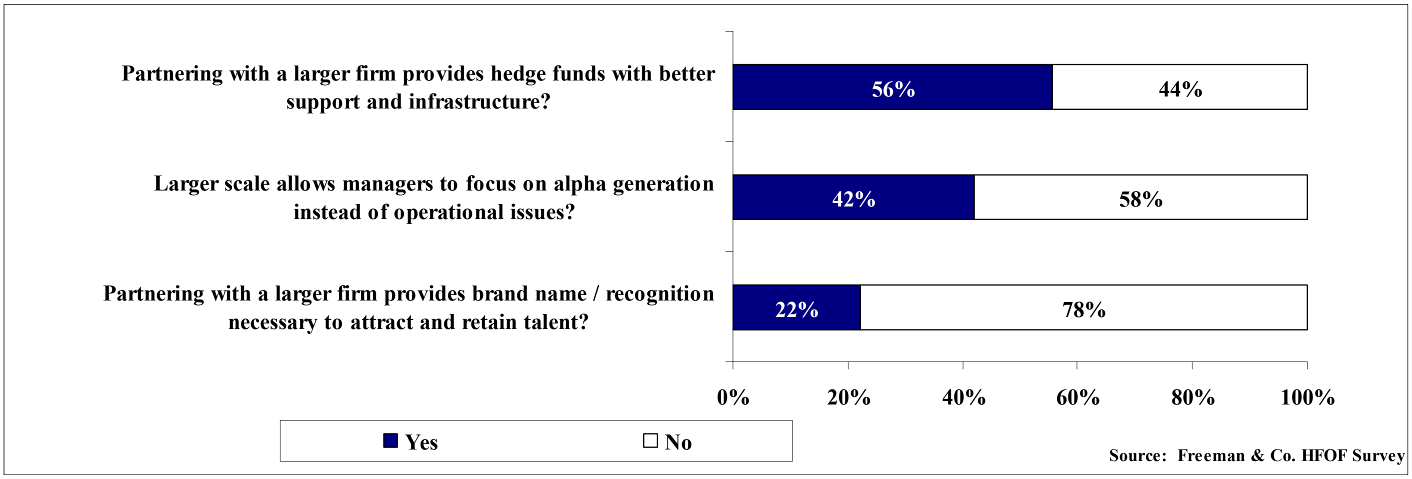
The respondents repeatedly commented on separation of portfolio management and administration functions as well as on general business risk issues. Some stated that they would not invest in a fund if they were not convinced the fund's business model would work. Other concerns included ability to deliver performance and availability of a sufficient track record.

When asked at what AUM level investors are no longer concerned about a fund being "small", the respondents stated figures as low as $30 million to as high as $250 million, with $100 million being the median. Alternatively, when asked about the minimum firm AUM size for investing, the responses varied from $5 million to $150 million, with $10 million being the minimum for most.

We asked HFOF managers about their views on Hedge Fund merger and acquisition deals and trends:

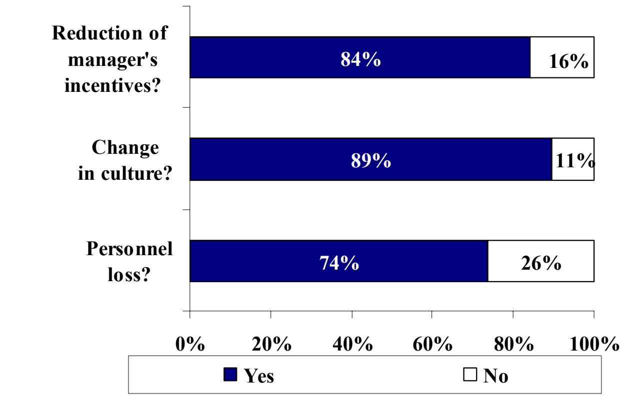
- 56% of respondents agree that partnering with a larger firm provides hedge funds with better support and infrastructure, which was their biggest concern about investing in small hedge funds.
- 42% believe larger scale allows managers to focus on alpha generation instead of operational issues. The perception of the other 58% is that larger scale may require even more of a manager's time and may present bigger business problems. Some also commented that a manager has to have the necessary capital to operate for several years in order to focus on alpha.
- 78% of respondents do not believe partnering with a large firm provides a brand name necessary to attract talent. Most believe success attracts talent. Some also mentioned compensation and share of economics as a critical factor for talent retention.

Figure 7: HFOF Views on Hedge Fund Mergers and Acquisitions



HFOF managers seemed to be concerned with hedge fund mergers and acquisitions. Their view is that hedge fund M&A may cause a reduction of manager's incentives, change in culture, and personnel loss. A reduction of compensation incentives may cause the manager to take fewer investment risks. This approach could change the firm's culture from a performance driven firm to an asset-gathering firm. With less focus on performance, talented people may leave to start their own firms once their employment and non-compete agreements expire. On the other hand, many agree that if structured correctly, with the right incentives in place, acquisitions will work.

Figure 8: HFOF Concerns About HF M&A



Source: Freeman & Co. HFOF Survey

Deal Issues

Most of the HFOF concerns about hedge fund M&A had to do with personnel and alignment of manager's incentives. However, while important, these are not the only issues that need to be solved when structuring an acquisition of a hedge fund. Like any asset management acquisition, a hedge fund acquisition involves solving several issues:

- Valuation
- Upfront vs. deferred payment
- Personnel issues
- Regulatory issues

Valuing a hedge fund is particularly difficult because of hedge funds' dependence on performance. If a larger portion of a hedge fund's revenues comes from performance fees than management fees, the fund's revenue base is highly volatile and uncertain. First of all, most hedge funds recognize performance fees at the end of the year, which creates uneven cash flows throughout the year. Second, performance fees may decline significantly or disappear if performance of the fund erodes. The problem is amplified even further if a hedge fund has a high water mark, which means that the manager may not get its performance fee until the fund recoups its prior losses.

Because of the uncertainty of performance fees, traditional valuation metrics like multiples of revenues or trailing 12 month EBITDA are not appropriate. Most buyers have not yet become comfortable with paying for performance; therefore, they are unwilling to assign a full multiple to a hedge fund's revenue or EBITDA. Those managers who are able to stabilize their revenue streams will be more likely to realize a full value for their business. Examples of successful strategies include:

- **Diversifying revenue streams.** Managers employing multiple strategies have a diversified source of revenues and can collect performance fees from different strategies at different times.
- **Timing of performance fees.** Managers who receive performance fees several times a year are able to stabilize their cash flow during the year. Some are simply able to negotiate semi-annual

or quarterly recognition of performance fees with their investors. Others receive performance fees periodically throughout the year, but have to re-calculate performance at the end of the year and return the excess fees to their investors at the end of the year, effectively receiving a loan from investors. This arrangement allows managers to solve their immediate cash flow needs.

- **Re-negotiating high water mark arrangements.** In May of 2003, Lone Pine Capital, a long/short equity manager, announced a change in its fee structure to enable it to earn half of its performance fee if the gains on its fund were below the high water mark. A few months later, other managers, like Maverick, Highside Capital Management, JANA Partners, and Farallon made similar moves. The new structure allows the managers to cover their costs and retain staff in a period of poor performance.

Once the issue of valuation has been solved and total value of the hedge fund determined, the buyer needs to decide how much to pay upfront and how much should be deferred over time. For contingent payments, target metrics need to be determined. Contingent payments are important: if structured correctly, they will serve as a powerful incentive for the team to generate returns and grow the business.

In addition, personnel issues need to be solved. This includes both people fit and appropriate incentives. Will the acquired fund be integrated or will it function as an independent subsidiary of the buyer? If integrated, will the entrepreneurial spirit of the small hedge fund, which attracted the talent in the first place, change? If it will, would the people stay? Creating incentives to keep key personnel in place and motivate them to perform is crucial. This can be achieved by both contractual and economic incentives and deterrents. For example, key personnel might be required to sign employment agreements, non-competes, and non-solicits. They might also be given part of the equity in the fund to align their interests with growing the firm. Also, succession management is important for keeping the next-generation talent.

Finally, the buyer and the seller will have to consider regulatory issues:

- What regulatory approvals are required?
- Is the buyer required to consolidate its acquisitions?
- Will the fund still be able to defer its performance fee after the acquisition?

Hedge Fund Mergers and Acquisitions

We believe the challenges facing small hedge funds as well as the need for diversification among large hedge funds will drive consolidation in the hedge fund industry. There will be two types of transactions:

- Large hedge funds acquiring small hedge fund managers or several hedge funds (or teams) merging to create a multi-strategy platform, and
- Large financial institutions acquiring hedge funds to get into the alternative asset management space

Before we explore each of these reasons in more detail, let's take a look at history. In 2004 we saw a significant increase in hedge fund acquisition activity. Seven hedge fund acquisitions, greater than twice the number announced in 2003, were announced in 2004 with total AUM of approximately $9 billion. Both 2001 and 2002 had fewer acquisitions and significantly less AUM. J.P. Morgan's acquisition of a majority stake in Highbridge Capital Management attracted the most attention.

With AUM of approximately $7 billion, Highbridge is one of the 20 largest hedge fund complexes[1] in the world. While the terms of the deal were not disclosed, The Wall Street Journal quoted a value of $1 billion, implying a valuation of 7x management fee revenue of approximately $140 million or 3.3x total revenue assuming 10% performance and 20% incentive fee. This valuation is an indication that financial institutions consider alternative investments both an attractive business and an important part of their product offering for which they are willing to pay a high price. Following J.P. Morgan's announcement, Lehman Brothers is said to be in talks of buying GLG Partners, a British hedge fund giant with over $11 billion in AUM. Lehman already owns 20% of GLG, and buying the remaining stake in the company would give Lehman another way to reach institutional clients and wealthy investors after its acquisition of Neuberger Berman last year.

Figure 9: Acquisitions of Hedge Funds through December 2004

Month	Year	Target	Acquirer	Entity Value ($ in Millions)	Total Deal AUM ($ in Millions)
12	2004	Willow Creek Capital Management LLC	Pequot Capital Management	N/A	$600
9	2004	Highbridge Capital Management	J.P. Morgan	1,000	7,000
9	2004	Harmonic Investment Management	R.J. O'Brien & Associates Inc.	N/A	220
7	2004	Credaris Portfolio Management Gmbh	HSH Nordbank AG	N/A	1,200
3	2004	Tyrell Green Ltd	Titanium Capital	N/A	N/A
2	2004	DeltaOne Capital Partners	Jovian Capital	N/A	N/A
1	2004	Real Return Holdings Co. Ltd.	Veritas Asset Management	N/A	N/A
12	2003	Bluecrest Capital Management	Man Group	712	3,100
1	2003	Parkway Capital	The Real Return Holdings	N/A	25
8	2003	Thomason Capital	Taurum Capital Partners	N/A	N/A
12	2002	LibertyView Capital Management	Neuberger Berman Inc.	N/A	1,000
9	2002	Coda Capital Management LLC	Gartmore Emerging Managers	N/A	N/A
9	2002	Cyllenius Capital Management LP	BlackRock Inc	N/A	100
3	2002	Transtrend B.V.	Robeco Group NV	N/A	273
1	2002	Hedge Funds Ltd.	Suncorp-Metway Ltd.	N/A	N/A
11	2001	FrontPoint Partners LLC	XL Capital	N/A	N/A
9	2001	Critical Advisors	vFinance, Inc	N/A	N/A
6	2001	RXR Group Inc.	State Street Global Alliance	N/A	335
2	2001	Systeia Capital Management	Credit Lyonnais AM	N/A	234
2	2001	Zola Capital Management LLC	Asset Alliance Corporation	N/A	100

Source: Freeman & Co.

We believe other large financial institutions will follow J.P. Morgan and Lehman Brothers. Higher asset-based fees and the ability to charge incentive fees make alternative investments attractive as they generate higher revenue per dollar of invested assets than traditional asset managers. The ability to reach out to HNW individuals and cross-sell existing products to hedge fund clientele is also attractive for large financial institutions. While the majority of alternative acquisitions in the past have involved hedge fund of funds, we believe as hedge funds grow and become more sophisticated, they will compete successfully with HFOF. Large multi-strategy hedge funds will be able to provide many of the benefits of

[1] Ranked by *Institutional Investor*.

diversification that HFOF offer, while eliminating a layer of fees. As a result, financial institutions' acquisitions of large hedge funds may increase.

On the other side of the spectrum is consolidation of smaller hedge funds. Large hedge funds may acquire small hedge fund managers or small hedge funds may merge to create multi-strategy platforms and achieve economies of scale. Multi-strategy platforms will allow managers to diversify their income streams and smooth out revenue and earnings volatility. This in turn will help attract and retain talent as earnings from one strategy can "subsidize" the compensation pool of another strategy if that strategy experiences difficulties. A bigger platform also allows managers to invest in appropriate infrastructure, such as compliance, marketing, and administrative personnel. A dedicated marketing function makes it easier to reach out to potential investors, improving the fund's name recognition and helping in fundraising efforts. In addition, economies of scale will spread the costs of outside service providers over a larger base.

Regulation Affecting Hedge Fund M&A

We have spoken with a number of law firms serving the needs of hedge funds to get their views on how regulation affects hedge fund mergers and acquisitions. Those we have spoken with believe that the hedge fund registration requirement will drive some merger activity in the future.

On October 26, 2004, the SEC adopted a rule that requires certain hedge fund advisers to register with the SEC. The final text of the rule was released on December 2, 2004. As registered advisers, managers will need to comply with the rules and regulations of the Advisers Act, including regulations concerning compliance procedures, record keeping, and custody of client assets. In addition, the Advisers Act prohibits charging performance fees with the exception of non-US clients and "qualified clients" (those with at least $750,000 under management with the adviser, or those the adviser reasonably believes to have a net worth of over $1.5 million), raising the eligibility standard of investors. The hedge fund advisers will be exempt from registration if they have less than $25 million in AUM and less than 15 clients, excluding executives, key employees, partners, friends and family of the investment adviser and their assets.

Although the rule does not require registration until February of 2006, we might see the effects of the rule sooner. The reason is that unlike larger firms that already have compliance infrastructure in place, smaller managers often do not have the infrastructure to bear the regulatory burden. Therefore, they might choose to partner up with a larger organization, relying on their partner to provide the infrastructure. On the other hand, some argue that the registration requirement has not been a major driver of consolidation in the traditional long-only space. Small traditional managers are able to overcome the regulatory burden by outsourcing their compliance function to the growing number of third-party service providers. The argument is that small hedge funds will follow traditional managers' practices and will choose to outsource. Whether or not managers choose to outsource, they need to be mindful of the cost of outsourcing, which may be relatively low in the short run, but higher in the long run during critical times, such as the time of an audit, when the attention of the senior personnel is needed, distracting them from their core functions.

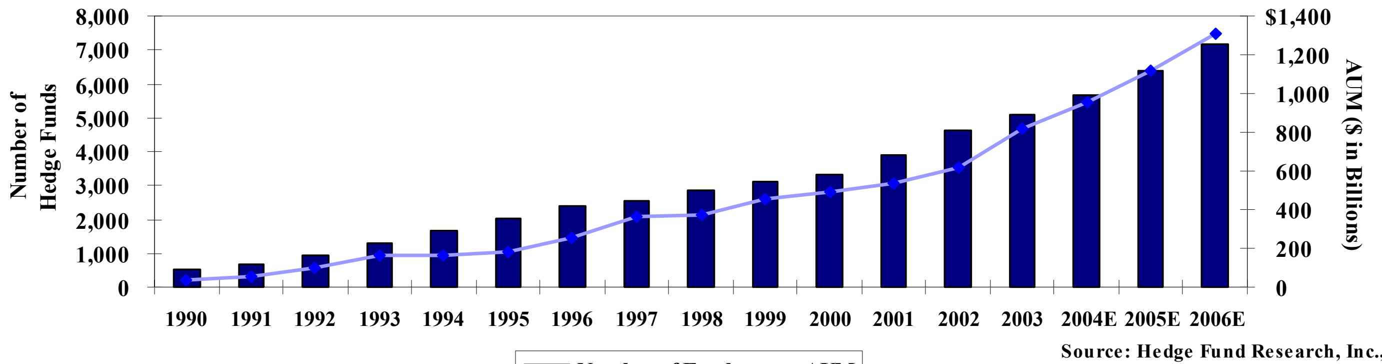
Another very important implication of hedge fund mergers is a hedge fund's ability to defer performance fees offshore. Instead of flowing the entire performance fee through the current year's partnership's P&L, offshore hedge funds are able to invest a portion of performance fees back in the fund tax-free, effectively deferring tax payments. This technique has helped hedge funds smooth their revenue streams and build up reserves to ride out times of poor performance. With the increase in the number of hedge funds being acquired, performance fee deferral raises a valid issue. Large corporations are not allowed to defer their income; therefore, if acquired by a corporation such as bank or insurance company, hedge funds lose their ability to defer. This places a limitation on who the partner for hedge funds may be and implies that the most advantageous acquirers for hedge funds are other hedge funds. However, many industry practitioners expect a regulatory change that would prohibit hedge funds from deferring, which would make the advantage of hedge funds as natural purchasers of other hedge funds disappear. The American Jobs Creation Act of 2004 enacted on October 22, 2004 has already put certain limitations on the time period in which to elect deferral.

Size of the Hedge Fund Market

This last section of our report focuses on the size, shape, growth and returns of the hedge fund industry so that we have a base from which to draw broad industry observations and assumptions that may affect future M&A trends.

The hedge fund industry is one of the fastest growing segments in financial services – low barriers to entry (availability of capital is the major one) and lack of regulation have made it relatively easy for managers to start their own funds. The possibility of returns uncorrelated with traditional equity and fixed income markets has attracted a tremendous inflow of investor capital. Since 1990, the number of hedge funds (excluding HFOF) increased tenfold from approximately 500 to over 5,000 in 2003. Hedge funds' AUM has grown 20 times from approximately $40 billion in 1990 to over $800 billion in 2003, a CAGR of 26%. If hedge funds continue growing even at a more conservative 5-year CAGR of 12.2% and 16.9% for total AUM, the number of hedge funds (excluding HFOF) will surpass 7,000 in 2006, and total AUM will reach $1.3 trillion, surpassing the $1 trillion mark in 2005. This large number of hedge funds (not to mention the numerous funds that shut down) provides a huge marketplace for M&A if hedge fund deal barriers can be overcome.

Figure 10: Growth of Hedge Funds (Excluding HFOF)



Source: Hedge Fund Research, Inc., Freeman & Co. estimates

Hedge Fund Strategies Overview

Hedge funds employ numerous strategies and can be classified in a variety of ways: by asset classes they invest in, typical holding period of manager's positions, use of leverage, directional vs. non-directional bias, etc. We categorize hedge fund strategies into the following six styles:

Figure 11: Hedge Fund Styles:

Style	Strategies Included	
Relative Value	Convertible Arbitrage Fixed Income Arbitrage Capital Structure Arbitrage	Equity Market Neutral / Statistical Arbitrage Dividend Arbitrage
Equity Hedge	Long / Short Bias Value / Growth Focus Sector Focus	
Fixed Income	MBS High Yield Convertible Bonds (non-arbitrage)	Diversified
Event Driven / Special Situations	Merger / Risk Arbitrage Distressed Securities Regulation D	
Directional Trading	Macro Market Timing Currency Trading	Commodity Trading Short Selling
Specialty / Other	Emerging Markets Multi-Strategy Opportunistic	

The vast majority of hedge funds today employ an Equity Hedge style. At the end of 2003, the number of Equity Hedge managers represented 51% of the total hedge fund market. Equity Hedge funds tend to be smaller in size than those employing other strategies, such as Directional Trading and Relative Value. The average size of an Equity Hedge fund was $99 million at the end of 2003, and assets invested in this strategy represented 31% of total hedge fund AUM. Relative Value is the next largest category, representing 17% of the total number of funds and 26% of total hedge fund AUM. An interesting fact is that only 7% of managers employ a Directional Trading strategy, but these funds tend to be large, with an average size of $442 million. The AUM in this category represents 19% of total hedge fund AUM. This is a drastic change compared to the 1990 landscape, when Directional Trading was the largest style, representing over 70% of total AUM according to HFR. Directional Trading (Global Macro in particular) lost some of its popularity after the Asian and Russian crises in the late 1990s.

Figure 12: Hedge Fund Strategy Composition as of December 31, 2003 (ex-HFOF)

Strategy	Number of Hedge Funds #	Number of Hedge Funds %	AUM Invested ($ in Billions)	AUM Invested %	Average Fund Size ($ in Millions)
Equity Hedge	2,587	51.1%	$256.8	31.4%	$99.2
Relative Value	876	17.3%	213.9	26.2%	244.2
Event Driven	712	14.1%	139.9	17.1%	196.6
Directional Trading	356	7.0%	157.0	19.2%	441.7
Fixed Income	260	5.1%	37.0	4.5%	142.5
Specialty / Other	274	5.4%	13.1	1.6%	47.8
	5,065	**100.0%**	**$817.5**	**100.0%**	**$161.4**

Source: Hedge Fund Research, Inc., Freeman & Co. Estimates

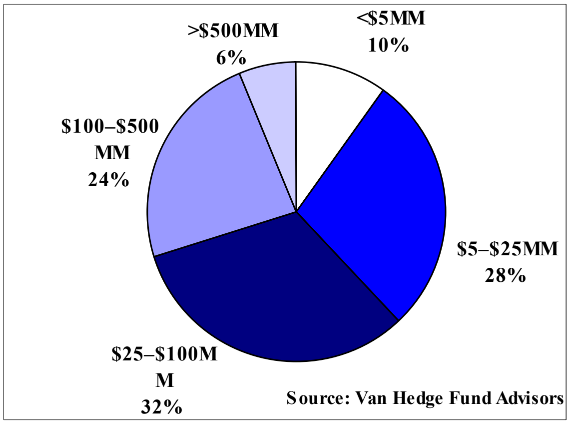
We expect the Specialty / Other category to increase in the near future as the need for strategy diversification leads to creation of multi-strategy platforms through acquisitions and consolidation.

Segmentation by Size of the Fund

The hedge fund industry has a wealth of smaller firms – 70% of hedge funds have AUM of $100 million or less, and only 6% have AUM in excess of $500 million. This segmentation is not surprising: managers typically start by trading their own capital. The next $10-$20 million come from friends and family. Once the fund has established a track record, it starts attracting outside capital from other HNW individuals, institutions, and HFOF.

Growing a fund to over $500 million is a challenge, and few funds manage to achieve that hurdle. Some managers simply don't have enough resources to commit to marketing, fundraising, or communication with the increasing number of investors on a day-to-day basis; others prefer to stay small due to capacity concerns. An abundance of smaller fund managers means opportunities for increased M&A activity since smaller managers are more likely to experience the operational issues we discussed above and are likely candidates for acquisitions and consolidation.

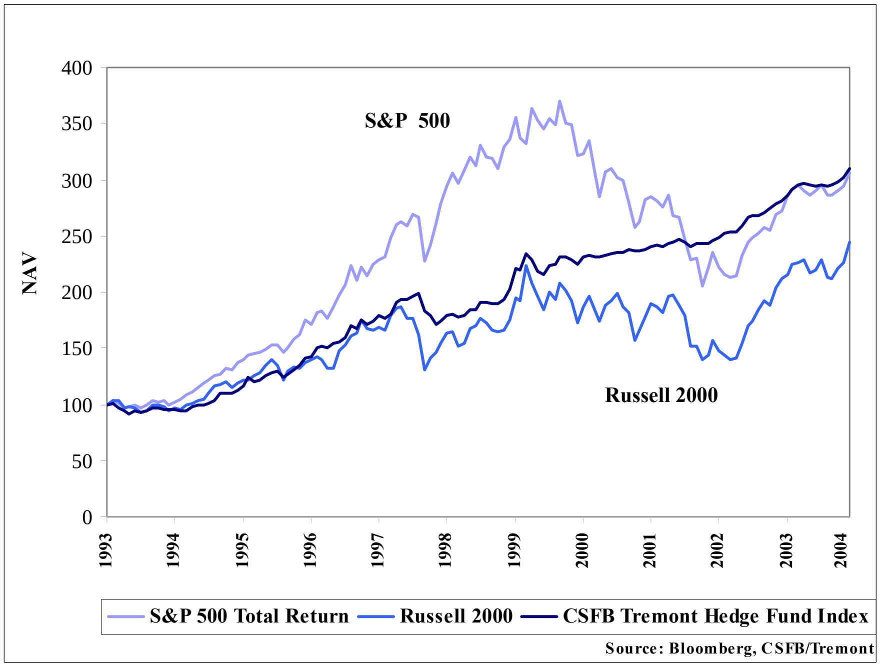
Figure 13: Hedge Funds by Asset Size as of December 31, 2003



Hedge Fund Returns

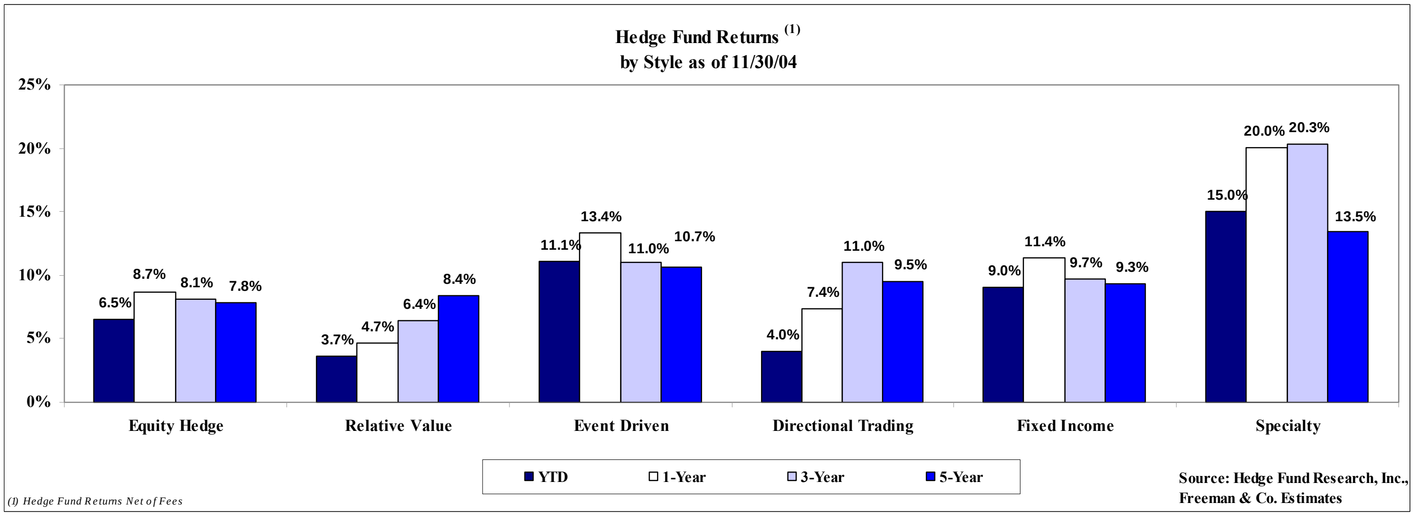
In the past decade, hedge funds have generated consistent returns with volatility lower than the broader equity markets. In addition, many hedge fund strategies outperformed passive indices. In 2004, however, most strategies experienced modest performance, which made both investors and managers aware that hedge funds are not immune to unfavorable market conditions. Poor performance has put pressure on hedge funds, particularly smaller ones, to re-examine their strategic options and consider whether they should merge with a larger hedge fund or hedge fund platform.

Figure 14: Hedge Fund Performance Through 11/30/04



Hedge fund returns vary greatly by strategy. Typically, those taking a directional bias (such as Directional Trading, Event Driven and Specialty Strategies) can generate higher returns, though the volatility is also higher. Non-directional strategies, such as Relative Value, produce a more consistent, though lower, return. Combining strategies in a multi-strategy platform allows a fund to combine a directional and fundamental approach realizing benefits of both and stabilizing returns.

Figure 15: Returns by Style as of 11/30/04



Many hedge fund investors believe that small hedge funds outperform large hedge funds. This is consistent with a view that smaller firms are more likely to take riskier positions, or are more nimble in their trading execution. However, more recent research has shown the opposite effect. According to Lyra Capital LLC, the investment manager of the Institutional Benchmarks Series, there is either positive or no correlation between risk adjusted annual returns of the fund and the size of the fund. This study supports our view that appropriate infrastructure and economies of scale allow the managers to focus on their core activity of alpha generation rather than operational distractions.

Figure 16: Correlation Between Size and Risk Adjusted Return

	2000	*2001*	*2002*
Equity Market Neutral	✓	✓	✓
Convertible Arbitrage	X	X	X
Distressed Securities	X	X	X
Merger Arbitrage	✓	✓	X
Event Driven	X	✓	✓

x – No correlation
✓ – Correlation is greater than zero

Source: Lyra Capital LLC.

We believe that the hedge fund industry with its size and predominance of smaller firms, whose operational and financial challenges are further augmented by the recent dips in performance, forms a sizable market for M&A activity in the near future.

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