Issue 12
1st Half 2005

August 17, 2005

New York • Paris

Asset Management Focus

Freeman & Co. LLC

Changing Tides II*

Deal volume, as measured by AUM, is at its highest since 2001. But this measure alone is deceptive in two respects. First, there were two large transactions that drove this AUM volume. These blockbuster deals included Legg Mason's purchase of Citigroup's asset management business ($437 Billion) and Credit Agricole's purchase of Banca Intesa's Nextra unit ($122 Billion), which accounted for 74% of total deal AUM. Second, the underlying reasons for these transactions represent a fundamental strategic shift from growth-driven to business realignment deals. We explore the factors causing this and the strategic responses firms should consider throughout this report.

Inside this Issue:

Performance as of June 30, 2005

Index	Total Return 1H05	Total Return 1 Year	Total Return Annualized 3 Yr	Total Return Annualized 5 Yr
S&P 500	-0.8%	6.3%	8.3%	-2.4%
NASDAQ	-5.5%	0.5%	12.0%	-12.3%
FTSE 100	4.5%	6.2%	3.2%	-4.1%
LBGC*	2.8%	7.3%	6.4%	7.7%
HFRI FoF**	1.9%	8.1%	9.4%	6.2%
CSFB/Tremont***	1.3%	8.0%	9.3%	7.3%

**Lehman Brothers Govt./Credit Index ** Hedge Fund Research Institute Fund Weighted Composite ***CSFB/Tremont Hedge Fund Index*

Summary:

- The first-half of 2005 saw 83 acquisitions, a slight increase over 78 in 1H04, but powered by two large deals, global assets acquired surged to $755 Billion in 1H05 to a five-year high
- Excluding two jumbo transactions, AUM acquired was still 44% over 1H04 AUM volume. Median AUM returned to 2000 levels
- European M&A activity is robust, with the number of deals surpassing those in the US for the first time since 2001. But many deals reflect realignment and retrenchment, instead of expansion, as the market matures. Asian deals were also up
- Regulatory pressure, marketing issues and operational concerns are making it hard to leverage sales of internal products, forcing firms to choose between manufacturing and distribution
- Alternative deals, particularly hedge funds and HFOF, continued their hot streak despite performance challenges
- Convergence among alternative investments continues, with different asset class firms joining forces and larger firms creating single asset class platforms with multiple products
- Legg Mason's acquisition of Permal reflects the belief that alternatives are needed by large firms to complete their product platform
- Investment banks continue to divest in-house private equity firms to avoid perceived conflicts of interest with one of their largest client segments

Indices at 6/30/05:

DJIA	10,275
Nasdaq	2,057
S&P 500	1,191
FTSE 100	5,113
10 Year US Treasury Bond Yield	3.94%
Dollar to Euro	$1.21

Eric Weber, CFA	+1 (212) 830-6162	eweber@freeman-co.com
Brad Southern	+1 (212) 830-6189	bsouthern@freeman-co.com
Akram Ben	+33 (1) 4088-1053	aben@freeman-co.com
Olga Freidzon	+1 (212) 830-6175	ofreidzon@freeman-co.com
Frank Reynolds	+1 (212) 830-6180	freynolds@freeman-co.com

* Changing Tides I was published in March 2001

Divorce: Manufacturing vs. Distribution

Citigroup's sale of its asset management business to Legg Mason, in return for Legg's brokerage business, was a watershed event, but the industry pressures that led to its execution have been building for some time. Large financial conglomerates have been facing a number of issues for years related to the "financial supermarket" business models, including sale practices of internally managed products through captive sales channels. The challenging issues for these firms include:

- Violations of NASD sales and promotion practices
- Regulatory investigations into "purchases" of shelf space
- Poor sales of internally managed products
- Brokers' reluctance to sell in-house brands
- Difficulty generating top-quartile returns
- Loss of talent to hedge funds

As a result the industry has seen a number of completed and contemplated transactions to address these concerns, including:

- Citigroup's swap of its asset management business ($437 Billion AUM) to Legg Mason in return for its retail brokerage network
- Credit Agricole's acquisition of Banca Intesa's asset management business ($122 Billion AUM)
- AmSouth's divestiture of its $5.5 Billion mutual fund business to Pioneer Investments
- Rumors of Merrill Lynch divesting asset management
- Rumors of Morgan Stanley divesting asset management

While these transactions may be large and "new" we believe that the catalysts have been developing for about three years and will continue to pressure a number of firms, forcing them to address core strengths of manufacturing and distribution. For some firms, a divorce of their product manufacturing and their distribution business units may be the best value option. Although asset management is generally considered an "attractive" business, firms should choose to focus on their core strength instead of "forcing" a business that has difficulties. In the case of Citigroup and Banca Intesa, that choice was to divest the product manufacturing component and focus on distribution.

We believe the primary issue facing financial supermarkets revolves around their attempts to leverage sales of in-house products through captive sales channels. Within this theme, we believe their focus should be on three areas:

1. Regulatory Problems
2. Internal Sales Skepticism
3. Standalone Business Considerations

Regulatory Issues – Loss of Home Field Advantage

Financial conglomerates have, at times, pushed to the edge (and beyond) on permitted sales practices. These include sales promotions of in-house products that weren't disclosed to customers and "purchasing" prominent shelf space with financial distributors. All of this has led to a number of regulatory investigations, sanctions and fines:

- Purchasing shelf space
- Internal sales promotions
- Lack of disclosure to clients of compensation arrangements with other firms
- Fines and regulatory tightening

The result of this increased regulatory scrutiny is the elimination of any "home field advantage" that the financial conglomerate may have had. Although the undisclosed "purchase" of premium shelf space in supermarkets by food manufacturers may be a permissible and unregulated practice, in the financial services world the NASD and other regulators have numerous rules and regulations to protect the investor from unlawful sales practices.

So the question remains: do financial conglomerates make sense if any home field advantage for product distribution is prohibited? And, what does one do if one's business model or strategy was dependent on an important home field advantage? We believe that each business has its own idiosyncratic strengths and weaknesses that can be evaluated and profitably exploited. As a result, firms should be focused on an honest self-assessment and realignment to focus on core strengths. The divestiture of a $5.5 Billion mutual fund business by AmSouth is one such move. While these decisions may be difficult, it is better to realize value now than to exit in a depressed market with negative asset flows and poor returns. With private equity firms holding piles of cash and strategic buyers with better fits, opportunistic exits are possible and should be considered, allowing the seller to invest the proceeds back into its core businesses.

Internal Sales Skepticism

The second major issue affecting financial conglomerates is sales of internally managed products through captive distribution channels in the growing world of open architecture. Internal sales of in-house products face the following challenges:

- Brokers' reluctance to sell in-house brands
- Customers' wariness of in-house brands
- Influence of independent ratings firms (Morningstar, S&P, Lipper, etc.)
- Manufacturing firms' strong branding and marketing campaigns (Fidelity, Vanguard, etc.)

In light of the tight regulatory environment, these added factors change the potential leverage from owning manufacturing and distribution significantly.

Exploring the potential for "skepticism" we look at a potential sale: Mr. Broker from Glen Rock Securities calls up our grandmother to pitch her the Quadruple I Fund, which is the Internet IPO Investment & Income Fund. Its manager is Glen Rock Asset Management. Well, our grandmother has done quite well with her stock picks of pharmaceutical and health care product companies focused on geriatric care (she has a proprietary research group at her assisted living home). And she's been around the block a few times (although more slowly now), so she picks up on the fact that her broker is selling an in-house product. The issue is does she believe that the broker has her best interests in mind; and is the broker willing to take the risk of offending his client and harming his relationship (and long-term compensation) to sell an in-house brand.

The strategic question for a firm is whether the brokers' loyalties and best interests lie with their employers or their customers, and how this will affect their employer? As more clients become aware of open architecture and best in breed formats, it is reasonable to expect that brokers will be more aware of serving their clients needs first and the goals of their sales mangers second. This seemingly small detail becomes a turning point on the front lines as conglomerates battle to sell more in-house product and may be the root cause of distribution/manufacturing divorces.

Another issue leading to what we call sales skepticism is the ubiquitous independent advice and advertising in the industry. A number of firms provide rankings products, including Morningstar, Lipper and S&P, and investment mangers of all shapes and sizes advertise the rankings. These services, the Internet and the financial press carry a great deal of information, which is available to the average investor. As such, it becomes very easy for our grandmother to ask if the Quadruple I Fund has a five-star rating, and if it doesn't, to ask why Mr. Broker is trying to sell it to her.

Lastly, the advertising and branding of financial products, including low-cost investment alternatives, such as Vanguard's index funds or Barclay's ETF's have increased investors' awareness of their available investment opportunities.

Standalone Business Considerations

One key issue that comes up in our conversations is how independent an asset management business should be from its parent and how this affects its long-term prospects. While a financial conglomerate's CEO may want all businesses under one brand, we believe that is not always the best case. We think this issue has two main components, which we believe are interrelated: branding and compensation. When looking at branding, we also point out three firms that have succeeded with different brand names from their parent organizations:

- Marsh & McLennan – Putnam Investments
- PNC – BlackRock
- St. Paul Travelers – John Nuveen (never integrated)

Each of these is (or was) majority owned by a financial institution that did not leverage the parent's brand name. While the separate branding may be a historical "accident" in some cases, we believe it has a distinct advantage in many cases. A different brand can provide organizational focus and clarity as well as differentiation for different product or customer segments. We note that firms such as LVMH in luxury goods and Procter & Gamble in consumer goods use multiple brand names with unique consumer impressions to build their firms. The disadvantage is the cost of two separate marketing and branding campaigns, but we would argue that this is often overweighed by the operating independence (or appearance thereof) of the subsidiary, which is often viewed positively by pension consultants and investors.

In fact, the asset manager with the most globally recognized name has even recognized when change is in order -- Fidelity recently chose to spin-off its institutional business into Pyramis Global Advisers as a separately managed firm. The purpose is to create a separate firm with a single focus on institutions and to align all the processes within this firm (product creation, portfolio management, trading, marketing, branding, compensation) to achieving the goal of building a world-class firm. We believe that financial conglomerate CEOs should consider whether one brand is appropriate for all the product and customer segments that they serve.

On the compensation side, we believe it is important for the key professionals to believe that their form of compensation is "relevant". By relevant we mean that: it is tied to their actions, that it measures results and that they believe their actions can directly influence the results against which they are measured. For example, if an asset management division is 5% of group profits and the key managers are paid in the parent's stock, they may believe that any success they have in their division will have little impact on their stock. As a result, a disconnect may develop where managers long for a system where they get rewarded for their own efforts. With a separate operating subsidiary, this can be accomplished more easily by awarding phantom equity or options linked to that particular business unit. The result, we would argue, is a better alignment of interests of the managers with the results that they can actually control, and that this "relevance" is a key component to long-term retention. While many executives may disagree with us, in the long run the failure to address issues like this can cause the managers to leave to form their own firms where they have 100% control over their results and compensation.

Summary

We believe that financial conglomerates need to determine if a divorce between manufacturing and distribution is warranted and which is their core strength that they can leverage best over the long run. In doing so they need to consider the regulatory impact of losing home field advantage for internal products, sales skepticism by brokers and clients as well as the prevalence of open architecture, and the issue of creating a standalone asset management business unit with the accompanying branding and compensation focus.

Deal Activity

This year has already seen significant deal volume (96 total deals), as well as a large amount of assets acquired (a whopping $755 Billion). While the first quarter began with only 36 acquisitions, the second quarter leaped ahead with 47 acquisitions, making 1H05 the most prolific first half for acquisitions in the past five years. While this reflects the general trend in M&A across industries worldwide, a range of factors are responsible for this: cash built-up on balance sheets, regulatory changes, and the strength of foreign currencies, to name a few. Tied to these reasons, international acquisitions played an increasingly important role in the growth in acquisitions. Asian and European firms were involved in 67% of all the acquisitions in the first half.

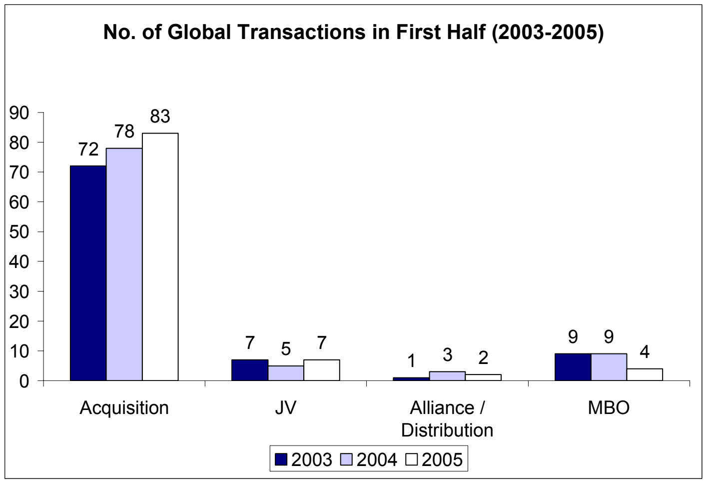
The two largest and most significant deals of the year were:

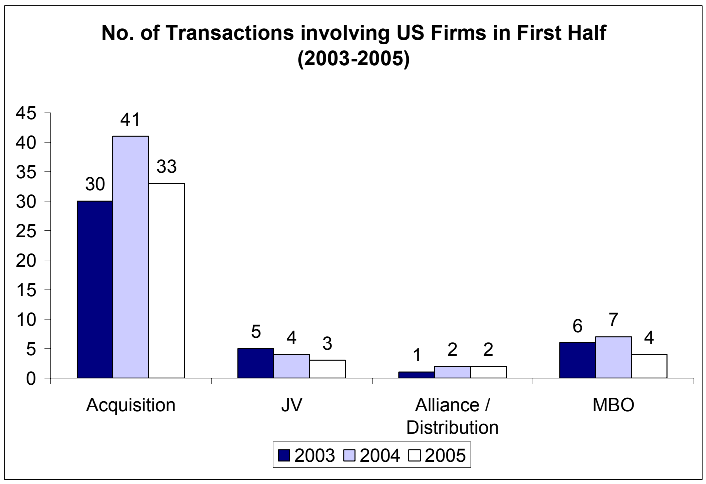
- Citigroup's swap of its asset management business ($437 Billion AUM) to Legg Mason in return for its retail brokerage network
- Credit Agricole's acquisition of Banca Intesa's asset management business ($122 Billion AUM)

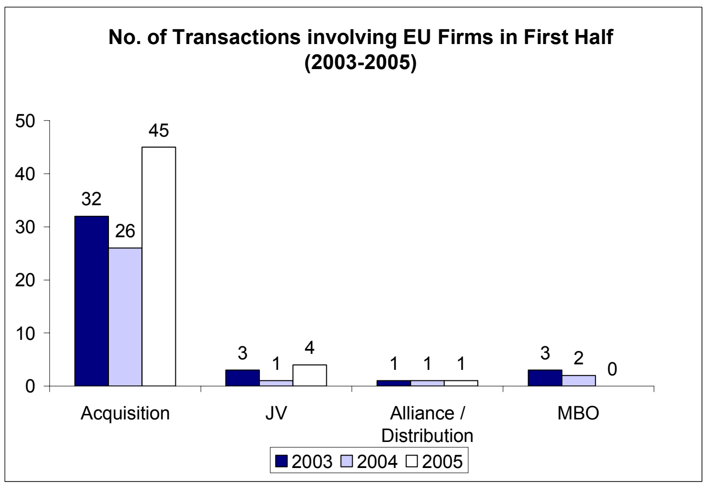
1H05 saw 83 acquisitions, a five-year high and a 6% increase from 78 acquisitions the previous year. Deal activity rebounded from a slight dip in the second half of 2004, where there were only 70 acquisitions, and continued the stronger trend from 1H04 and 2H03 where there were 78 and 97 acquisitions, respectively. If 2005 continues on the same pace, it will come close to matching 2003's 169 acquisitions, a five-year high at the time.

European firms, bolstered by the strength of the Euro and keen to execute on their strategic realignments (see European Tends section), were very active in the first half of 2005. Deals involving EU firms rocketed 73% moving from a three-year low of 26 to a five-year high of 45. European firms continued to sell and purchase mostly alternative asset managers and HNW/private banking businesses.

Strategic partnerships (JVs, alliances, and distribution arrangements) have remained fairly consistent since 2003. In contrast, MBO activity fell sharply from the first half of 2004, continuing the lighter trend of 2H04 where only 2 transactions were announced. The rise of MBOs in the first half of 2003 and 2004 occurred as a result of failed company sales that were followed-up by management purchases. It is possible that 2005 would have had a similar number of acquisitions and MBOs as 1H04 and 1H03, had some of 1H05's buyers decided not to push forward with an acquisition. As it stands, 1H03, 1H04 and 1H05 all had a very close number of total transactions with: 89, 95 and 96 respectively.



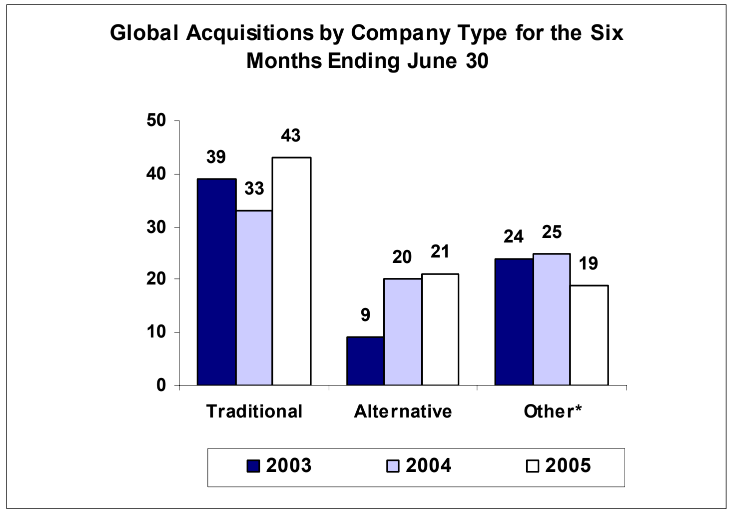




Source: Freeman & Co.

Acquisitions by Company Type

Acquisitions of alternative and traditional managers were both up in the first half of 2005. While 1H05's 21 alternative acquisitions were only slightly higher than 1H04's 20, the number is still very high on a five-year basis: 2001-2003 each saw only 9 alternative acquisitions. Further, Legg Mason's purchase of Permal Group, a hedge fund of funds manager with AUM of $19.1 Billion, is the largest alternative deal in the past five years. Hedge funds made up a significant proportion of these alternative deals. Of the 21 alternative acquisitions announced in the first half, 12 involved hedge funds or hedge fund-related product providers. Notable alternative acquisitions included: Lehman's purchase of a 20% stake in Ospraie Management, a $2.0 Billion commodities hedge fund, XL Capital's acquisition of a minority stake in Artemis Advisors, LLC, a long/short equity hedge fund, (their 8th minority acquisition since inception) and Credit Suisse Asset Management's purchase of Artemis' fund of funds business.



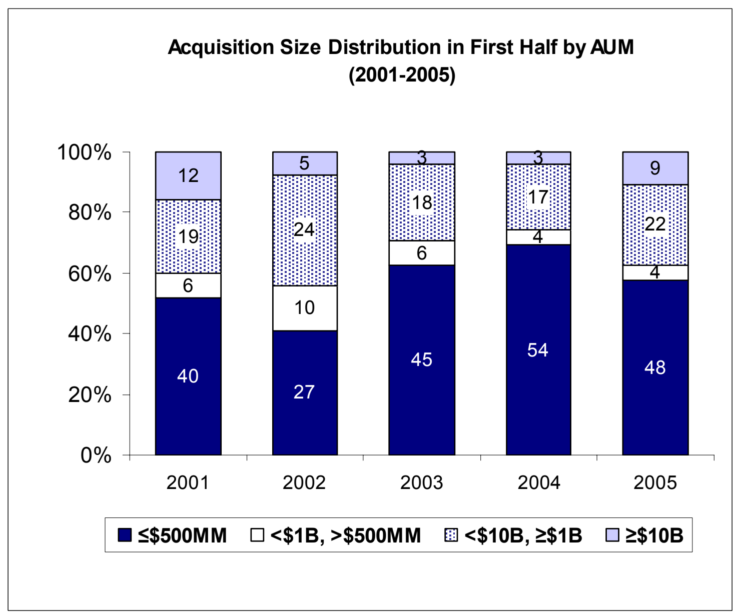
Source: Freeman & Co.

**Other includes: Administrators, Consolidators, Consultant/Data Providers, Financial Planners, Private Banks and Trust Companies*

Deal Size

The most important factor this year is the significant growth in acquisitions of firms with more than $10 Billion AUM, with 9 of these occurring (see list below). Deals with AUM of $1 Billion or greater accounted for a larger percentage of the total number of deals, 37%, compared to 1H03 and 1H04's values of 29% and 26%, despite a significant increase in the total number of acquisitions in 1H05.

1H05 has seen a number of large acquisitions. The total number of acquisitions of firms with $1 Billion or greater in AUM is even with 2001's level and is a five-year high at 31. This does not, however, explain the significant differential in median AUM acquired between the two years. 1H05 has 25% fewer acquisitions over $10 Billion, but median AUM of $2.05 Billion, which is 32% higher than 1H01's median. 1H01 had a number of deals at the extremes while 1H05 had a more even distribution of large and medium-sized deals.



Source: Freeman & Co.

First Half 2005's Deals over $10 Billion AUM:

1. Legg Mason's purchase of Citigroup's Asset Management business ($437.0 Billion)
2. Credit Agricole's purchase of Banca Intesa's Nextra unit ($122.0 Billion)
3. AMG's purchase of First Asset Management ($23.0 Billion)
4. Hana Bank's purchase of Daehan Investment & Securities Co. ($21.3 Billion)
5. Legg Mason's purchase of Permal Group ($19.1 Billion)
6. Merrill Lynch's purchase of Royal Philips Electronics NV's Asset Management Arm ($17.7 Billion)
7. Phoenix Companies' purchase of the remainder of Seneca Capital Management ($13.8 Billion)
8. Fortis's purchase of Dryden Wealth Management ($11.0 Billion)
9. BNP Paribas's purchase of FundQuest ($10.0 Billion)

Assets Acquired by Seller Region

Assets Acquired by Seller Region for the First Six Months by Year ($MM)

Region	2001	2002	2003	2004	2005
Africa		11,700	638		
Asia	16,101	2,486	11,313	18,702	29,002
Canada	27,200	26,429		2,006	23,000
Europe	64,395	169,673	110,818	33,702	193,750
South America		3,421	7,890		
US	319,620	60,826	44,542	81,917	509,727
Total	**$427,316**	**$274,534**	**$175,201**	**$136,326**	**$755,479**

Acquisitions	77	66	72	78	83
Average Size	5,550	4,160	2,433	1,748	9,102
Median Size*	1,550	1,350	1,000	1,468	2,050

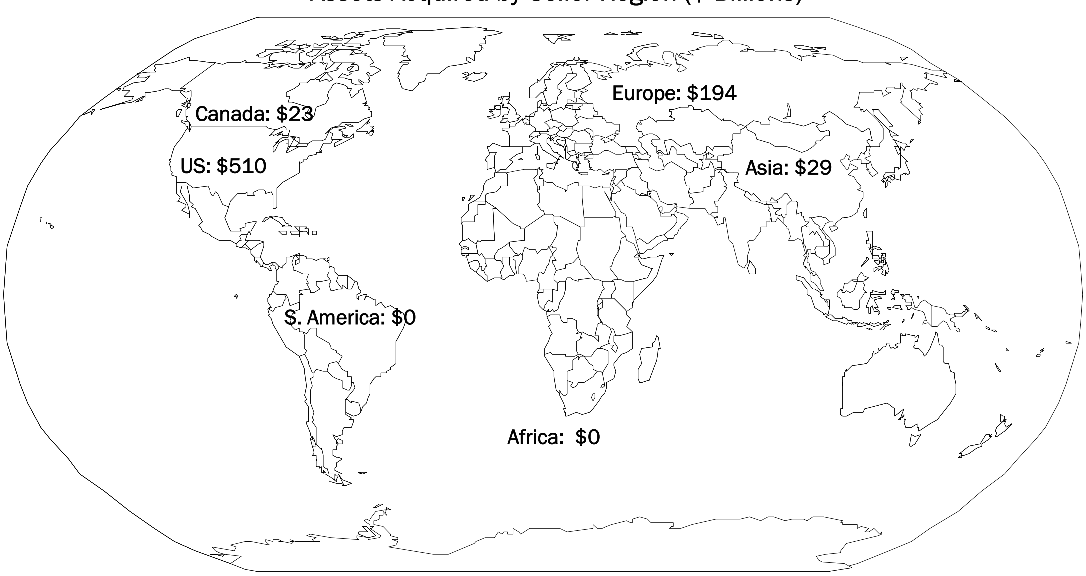
**Median deal size calculated using only deals with reported AUM*

Source: Freeman & Co.

1H05's total AUM clearly stands out against prior years. While 74% of 1H05's AUM came from two deals, even excluding those deals there was still $196 Billion acquired, a 44% increase from 1H04. Similarly, in addition to the colossal average deal size, the significant increase in median deal size, over 30% greater than any of the past five years, reflects a first half with an unusually high number of large deals aside from the Credit Agricole / Nextra and Legg Mason / Citigroup deals.

Asian acquisitions were largely bolstered by regulatory changes. Singapore, South Korea and China all saw landmark regulatory changes that allowed foreign and domestic companies to purchase stakes in firms as never before. Hana Bank's acquisition of Daehan Investment & Securities Co. marks the complete privatization of South Korea's big-three asset managers, Straits Lion's purchase of OCBC Asset Management Ltd. created the largest non-government linked domestic asset management company in Singapore, both Schroders PLC and CSFB created the first fund-management companies with Chinese commercial lenders. China continues to be the focus of several global investment banks as UBS and Deutsche Bank also either purchased stakes or created new fund companies with Chinese firms.

Assets Acquired by Seller Region ($ Billions)



Source: Freeman & Co.

Assets Acquired by Buyer Region

Assets Acquired by Buyer Region for the First Six Months by Year ($MM)

Region	2001	2002	2003	2004	2005
Africa		11,700	638		
Asia	221	4,730	10,313	102	24,816
Canada	46,240	31,109	9,000	2,006	7,900
Europe	212,736	181,989	33,688	23,508	187,701
South America	1,400	885	4,670		
US	166,720	44,122	116,892	110,711	534,762
Total	**$427,316**	**$274,534**	**$175,201**	**$136,326**	**$755,479**

No. of Acquisitions	77	66	72	78	83
Average Size	5,550	4,160	2,433	1,748	9,102
Median Size*	1,550	1,350	1,000	1,468	2,050

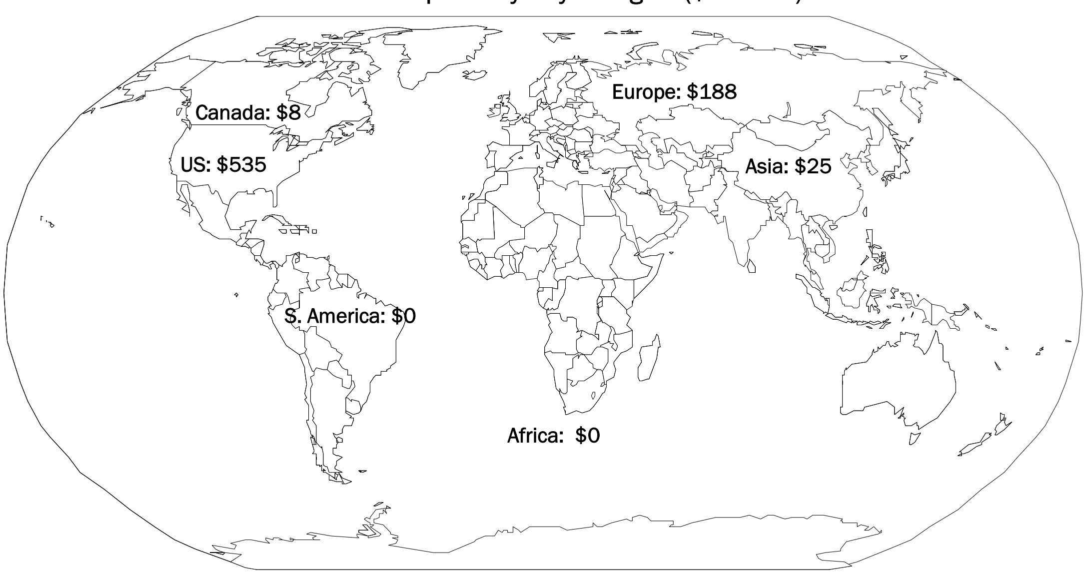
**Median deal size calculated using only deals with reported AUM*

Source: Freeman & Co.

AUM acquired for all regions increased significantly in 1H05. Except for Africa, which had no deals with reported AUM in 1H05, every region surpassed total AUM acquired for all of 2004.

- The U.S. accounted for 71% of total global AUM acquired, which is down slightly from 81% for 1H04. This is due largely to the Credit Agricole / Nextra deal, which bolstered European AUM. In 1H05, the U.S. was a net buyer by approximately $25 Billion or 3% of AUM acquired
- AUM acquired by European firms jumped from $24 Billion to $188 Billion from 1H04 to 1H05. This is a nearly 700% increase over 1H04 and a 300% increase over the FY04. Europe was a slight net seller in 1H05 by just over $6 Billion in AUM
- Assets acquired by Asian firms also increased significantly from 1H04 to 1H05. Acquisitions by Asian firms increased dramatically from a paltry $102 Million acquired in 1H04 to a solid $25 Billion in 1H05. Asia was still a net seller in 1H05, however, by about $4 Billion in AUM
- AUM acquired by Canadian firms nearly quadrupled from 1H04 levels of $2 Billion to 1H05 levels of almost $8 Billion. Canada was still a net seller due to AMG's purchase of First Asset Management, a consolidator with interests in several Canadian managers

Assets Acquired by Buyer Region ($ Billions)



Source: Freeman & Co.

European Trends

Structural Trends Forcing Change

The European asset management sector is in the midst of profound change, with significant implications for the competitive environment. These changes include:

- Slowing market growth due to sluggishness in global financial markets
- Increasingly sophisticated, demanding clients who insist on best-of-breed products and the ability to generate alpha in all market conditions
- Distribution evolving toward highly professional intermediaries (including financial advisors and investment banks)
- Increased competition from US fund families and a rising number of boutiques
- Higher operating costs due to heightened regulatory oversight and increasing compensation levels

The result is much like a maturing market in any industry—growth becomes difficult to achieve, profitability is threatened and market share must be defended from predatory competitors. Responding to these changes drove much of Europe's 1H05 M&A activity.

Strategic Responses

These conditions require asset managers to respond strategically, with the right course of action dependent on a firm's competitive position, resources, and ability to invest in change. Strategies being pursued by European companies generally reflect four major themes:

1. Retrenchment and withdrawal
2. Refocusing activities and shedding weak business lines
3. Targeting desirable market segments
4. Expanding internationally

Retrenchment and Withdrawal

For some firms, retreat may be the better part of valor. We saw financial services conglomerates begin to exit the asset management business last year, when both US insurer Safeco and UK online broker EGG sold their mutual fund businesses opportunistically. The acquirers were Pioneer and Fidelity, respectively, both of whom benefited from the opportunity to acquire assets. The trend has accelerated in 1H05. Among those selling their asset management operations in this period: US regional bank AmSouth; French brokerage house Aurel-Leven; foreign exchange and commodity broker Refco; insurer Mutuelles du Mans; and electronics firm Royal Philips. Divesting sub-scale in-house asset management businesses enabled them to redeploy capital to their core activities.

Asset Management Divestitures in 1H05

Month	Seller	Seller Industry	Buyer	AUM ($MM's)
4	Royal Philips	Electronics	Merrill Lynch	$ 17,700
3	Refco	Brokerage	Bridgepoint plus Mgmt.	9,400
6	AmSouth	Banking	Pioneer AM	5,500
3	SwissPartners	Private banking	LLB Group	3,600
3	Mutuelles du Mans	Insurance	Oddo & Cie	2,700
2	Aurel-Leven	Brokerage	KBL	1,293

Source: Freeman & Co.

An exception worth noting is the sale by Banca Intesa of its Nextra Investment Management arm to Credit Agricole Asset Management. Nextra manages approximately $122 Billion, mostly in Euro Bonds for the Italian market. The dual competitive pressures of a saturated domestic market and a low margin product lineup, compounded by an image tarnished by client losses from the Parmalat debacle, pushed management sell control of the business to Credit Agricole, which is the largest shareholder of Banca Intesa and a strategic partner in other business lines. This transaction puts the business into the capable hands of Credit Agricole, and gives Nextra access to a higher-performing range of products, a fresh image, and critical mass throughout Europe.

Refocusing

For many firms this is a time to refocus their activities along product or geographic lines and to shed weak businesses. In the past, buoyed by strong markets and high growth, firms with strong positions in their core markets had been tempted to expand into adjacent areas. As the industry matures, some have been forced to reconsider, particularly where the expansion is not closely related to the firm's core competency and where growth and scale are difficult to achieve.

For example, ING has made a number of divestitures as it has refocused its strategy on building its core asset management and financial protection businesses. In 1H05, ING sold its French wealth management business, which had AUM of only $3 Billion. ING had initially been attracted by the overall size of the French wealth management market, but failed to understand how tightly the market was controlled by domestic competitors (primarily large French banks, with their control of distribution) and by international wealth management specialists (such as the Swiss private banks, who bring scale, technology and strong brands). This divestiture followed the 2004 sale by ING of Barings Asset Management to MassMutual. Unable to compete in the sophisticated UK institutional market, this sub-scale ($32 Billion) business was never able to achieve the market position or profitability that ING had hoped for when they acquired it in 1995. ING's investment business is now concentrated on three areas: ING's domestic market, the US pension and retirements services market, and global real estate.

Likewise, ABN AMRO and Deutsche Bank have made strategic reassessments and have decided to focus on expanding their private client groups in key European countries while pulling back from the Trust business and global institutional market, respectively.

Refocusing Deals

Company	Acquisitions	Divestitures
ING:	Baring Capital Partners (Real Estate)	Barings AM (Institutional Asset Mgmt.) ING Ferri (Wealth Mgmt.) ING Capital Mgmt Ltd (Leveraged Loans) ING Private Bank (Wealth Mgmt.)
ABN AMRO:	Banque Corluy (Private Bank)	ABN AMRO Trust (Trust Mgmt.) Nachenius, Tjeenk & Co. (Private Bank)
Deutsche Bank:	Anglo & Overseas Trust (Trust Mgmt) Wilhelm Von Finck AG (Private Bank)	Scudder Private Inv Counsel (Wealth Mgmt.) Deutsche AM UK (Institutional Asset Mgmt.)

Source: Freeman & Co.

Zeroing In on Desirable Market Segments

A number of European financial institutions have determined that they can reignite growth by targeting attractive customer groups and markets more narrowly, and applying the resources necessary to meet the needs of those desirable segments. Many have found the High Net Worth market to be particularly attractive, with its favorable demographics and increasing demand for new products. These clients have a large appetite for advice, asset protection, and absolute return products. Demand should grow rapidly as baby boomers enter their prime saving years to the benefit of well-positioned players.

Success in the HNW market requires an integrated, client-centric offering (including a broad array of equity funds, bond funds, alternative investments and other structured products, as well as financial planning and other services) across asset management and private banking, under one centralized platform and management structure. Larger firms have the advantage of being able to offer the latest relationship management or portfolio analysis applications and can afford global advertising to build recognizable brands.

Potential entrants to this sector should also be thinking about ways to best integrate their systems to enable them to respond as quickly as possible to feedback from the market. Other ingredients of success in the HNW marketplace include:

- Employing quantitative tools to better evaluate the utility of proposed strategies for clients
- Selectively introducing new products while managing down overall complexity
- Continuing to invest in the face-to-face advisory process while supporting advisors with better tools to ensure consistency and
- Understanding the contribution that the brand makes to economics

To implement this strategy, a number of European firms have been actively acquiring private client assets, financial advisory and planning firms, alternative managers and specialist boutiques. BNP and UBS have been the most aggressive buyers, each with six acquisitions in the past 18 months that have added both distribution and additional product offerings.

UBS Acquisitions since 1/1/04

Date	Target	Sector
Feb-04	Laing & Cruikshank IM Ltd.	Wealth Manager
Feb-04	Scott Goodman Harris	Financial Planner
Nov-04	American Express' Luxembourg Private Banking operations	Wealth Manager/Private Bank
Dec-04	Dresdner Bank's Latin American HNW Business	Wealth Manager
Jan-05	Siemens AG's real estate funds	Real estate manager

Source: Freeman & Co.

Likewise, BNP Paribas followed up on its four acquisitions in 2004 (two private banks, an alternative manager and a risk management consultant) with its purchase of FundQuest and Dutch private bank Nachenius, Tjeenk & Co. in 1H05 to further penetrate the affluent investor market. FundQuest is one of the leading managed account providers in the U.S., with $10 Billion in assets under management and administration and a superior technology platform. The company provides a wide range of wealth management solutions including: asset allocation, analysis and advice on selection of institutional investment boutiques, portfolio management, and superior reporting analytics.

Societe Generale increased the scale and coverage of its Lyxor Asset Management hedge fund managed account platform by acquiring the U.S. structured product business of Bank of America. In addition to meeting needs of institutional clients, the acquisition gives Societe Generale enhanced alternative products for distribution to its HNW client base. This client base has been enhanced recently by purchasing two private banks in 2001 and one in 2003 based in Slovenia, Belgium and Switzerland.

In similar moves Aegon purchased in May 2005 growth equity specialist Westcap, following its 2004 purchase of IFA Aurora Financial Group (6th purchase of UK-based financial advisors), and Fortis purchased in June 2005 UK-based Dryden Wealth Management which manages $11 Billion of private client assets concentrated in the UK and Monaco.

Expanding Internationally

Some industry participants face saturated home markets where taking market share from rivals is difficult and costly, and therefore have chosen to expand internationally into growing, less competitive markets such as in Eastern Europe and Asia. China has been of particular interest. China has recently allowed commercial lenders to establish fund management operations, and has increased the level of equity participation available to foreign companies to 49%.

As a result, 1H05 saw four major European players establish alliances (either joint ventures or minority investments) in Chinese firms in order to access this huge market.

Chinese Alliances in 1H05

Investor	Entity	Transaction
UBS:	China Dragon Fund Management Co. ($400mm asset manager)	Purchase of 49% equity stake
Credit Suisse:	Industrial and Commercial Bank of China China Renaissance Capital Investment Inc.	Distribution JV Distribution JV
Schroders Plc:	Bank of Communications Co.	Distribution JV
Deutsche Bank:	Harvest Fund Management ($3.8bb asset manager, third largest in China)	Purchase of 20% equity stake

Source: Freeman & Co.

These alliances follow similar moves last year by European firms looking to take advantage of high growth and competitive opportunity in India, Japan and Korea. These deals are not easy to do. Because of cultural differences and government intervention, the process of negotiating, developing and implementing these alliances is expensive, time consuming and risky. However, these early entrants should be well positioned to fend off later arrivals and take advantage of the high growth of this developing market.

Conclusion

At first glance, the increased number of deals (and significantly higher transacted AUM) in 1H05 may appear to signal a robust, growing market. The reality is a bit different. Slowing growth and increasing competition threaten profitability. The result has been a shakeout of marginal players and unsuccessful strategies. A number of firms have abandoned the asset management business, while others are shedding weak divisions and refocusing on their core capabilities. Stronger players are taking advantage by adding assets and expanding their product sets, and focusing on desirable market segments such as HNW individuals. They are also looking outside their borders to attractive new markets such as China.

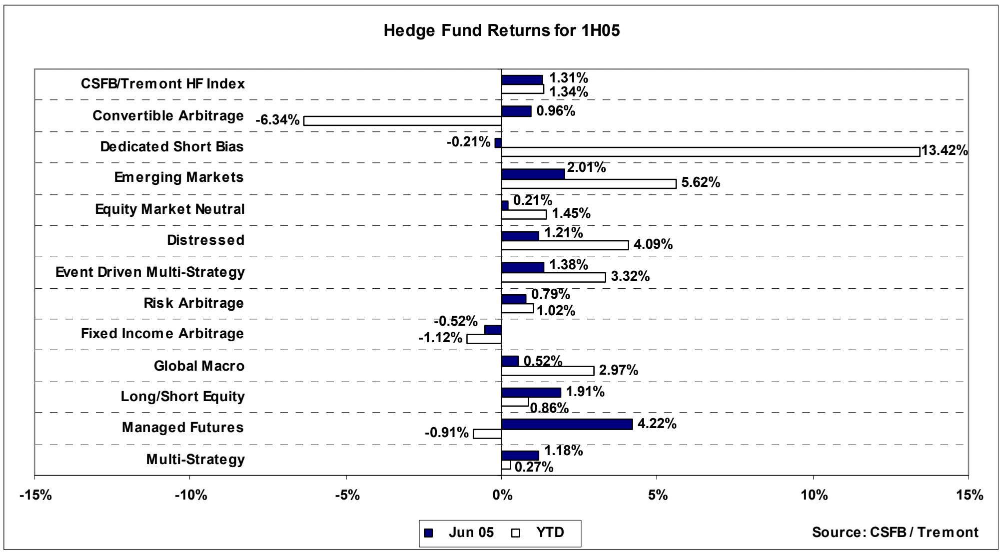
Success in European M&A today is more a matter of “picking your spots” than robust expansion. There was no transformational European deal in 1H05 comparable to Legg Mason / Citigroup, and we expect the trend of specialized and targeted acquisitions to continue.

Alternatives

Returns and Asset Flows

Alternative investments have continued to grow into the first half of 2005. According to HFR, investors added approximately $38 Billion in new money to hedge funds in 1H05, bringing the total hedge fund industry assets to over $1 Trillion. The number of funds has also grown as, according to Tremont Capital Management, approximately 1/3 of the new inflows in 1Q05 went to new funds. On the private equity side, 96 US-based venture funds raised over $11 Billion in the first half of the year, and 76 Buyout and Mezzanine funds raised over $35 Billion over the same period, with the second quarter having the highest average commitment size since 2000.

With the amount of assets being poured into the alternative investments industry, generating the same types of returns that have attracted investors in the first place is becoming more challenging. Profitable hedge fund strategies are more difficult to identify and sustain, and private equity deals are harder to source as more money is chasing the same investment opportunities. We have already seen this effect on hedge fund performance. Though June was a relatively good month for hedge funds, with the CSFB Tremont Hedge Fund index returning 1.31% for the month, overall returns for the first half of the year were only 1.34%. Hardest hit was the convertible arbitrage strategy, returning a loss of 6.34% for 1H05.



Difficult market conditions and poor returns have forced several funds to shut down. Marin Capital Partners was one of the funds that closed due to lack of investment opportunities. Having managed $2 Billion in AUM, Marin had been one of the largest convertible arbitrage shops. Other funds, such as GLG Partners, an $11 Billion convertible arbitrage manager, and Bailey Coates Asset Management, a long-short equity manager, were forced to return significant amounts of capital to investors. Vega Asset Management, which manages over $7 Billion in AUM in multiple strategies, has experienced large investor redemptions in 2005 due to poor performance.

Alternative Convergence is Continuing

What can alternative managers do to continue generating returns and to stay in business? Many managers have found an answer in expanding their expertise beyond their traditional focus areas. For example, for venture capitalists, this may mean focusing on larger, later stage companies; for buyout shops, this may mean expanding their industry or geographic focus; and for hedge funds, getting into areas traditionally covered by private equity firms. While hedge funds accumulating large stakes in companies is not a new phenomenon, in the latest trend, hedge funds are attempting to play a much more active role in the corporate governance of the companies they invest in. For example:

- New York-based hedge fund Atticus Capital, along with London-based TCI Fund and others have played a major role in the resignation of Werner Seifert, the CEO of Deutsche Boerse, in an effort to pressure the German exchange to drop its bid for the London Stock Exchange
- OfficeMax has come under pressure from several hedge funds over performance issues and executive compensation and agreed to appoint an independent member to the board
- Following a proxy contest, three nominees of hedge fund Steel Partners, a vocal critic of BKF's compensation and corporate governance practices, were elected to the board of BKF Cappital Group, a long-only manager

Such active corporate governance behavior has traditionally been reserved for private equity shops, and seeing hedge funds acting in a private equity-like role indicates that the boundaries among alternative asset classes are becoming more vague, supporting our view that alternative asset classes are converging.

Alternative Acquisition Activity

While the trend of convergence in alternatives is not new, a new trend has been emerging in the first half of 2005: consolidation among alternative investments firms. The majority of the 21 acquisitions of alternative firms in 1H05 involved other alternative managers or large institutions already playing a significant role in the alternative space as buyers. Examples of such acquisitions include:

- UBS AG's acquisition of a 51% stake in the real estate funds unit of Germany's Siemens AG with approximately $2.7 Billion in AUM. UBS made this acquisition to continue their expansion in Europe. UBS' existing German real estate business will be part of the merged business
- Apax Partners Worldwide's acquisition of Saunders Karp & Megrue, a middle-market focused US-based private equity firm with approximately $1.5 Billion in AUM. Apax is Europe's largest buyout and venture capital firm with over $18 Billion in AUM, and the acquisition will help it strengthen its position in the US
- Highland Capital Management's acquisition of ING Capital Management, Ltd. (ICML), a London-based CLO manager with approximately $835 Billion in AUM. Highland manages over $14 Billion in AUM in various alternative products focusing on senior secured loans, high yield bonds, mezzanine debt, structured products, and special situation investing. The acquisition of ICML gives Highland access to Europe's leveraged finance market

Notable exceptions to the alternative consolidation trend included:

- Legg Mason's acquisition of an 80% stake in Permal, a HFOF with approximately $19.1 Billion in AUM. This was a transformational event as it provided an entry into the alternative space for Legg Mason
- Lehman Brothers' acquisition of a 20% stake in Ospraie Management, a $2 Billion commodities hedge fund. While the acquisition involved only a minority stake, Lehman will gain access to new investment opportunities started by Ospraie as Ospraie's fund is currently closed to new investors. In return, Lehman will provide Ospraie with marketing support

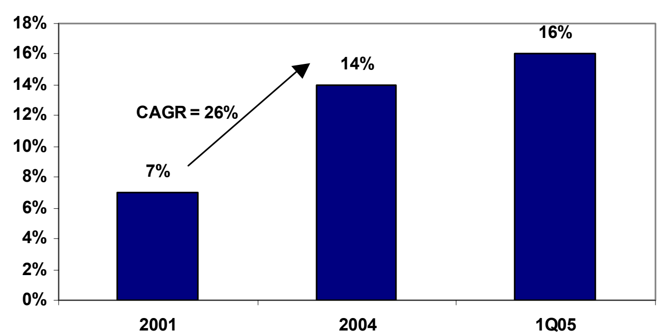
Private Equity Divestitures

Another trend to notice is recent activity around private equity subsidiaries of large financial institutions. For a while, investment banks have faced complaints from their financial sponsor (private equity) clients about competition these clients face from investment bank-affiliated private equity subsidiaries when bidding for companies. Increasing concerns about conflict of interest inherent in private equity funds run by financial institutions have spurred a number of spinouts of private equity subsidiaries.

- JP Morgan announced a spinoff of JP Morgan Partners, its private equity subsidiary, in March. JP Morgan will retain a commitment to private equity through the smaller investment business of Bank One's One Equity Partners
- CSFB announced a restructuring of its private equity arm, DLJ Merchant Banking Partners, where the group head and several bankers will leave to start their own firm, Avista Capital Partners. Originally, CSFB announced a spinout of the entire division, but later agreed to keep DLJ MB while limiting its role to more passive co-investments in big deals
- Morgan Stanley announced a spinout of Morgan Stanley Venture Partners in June. The new firm will be named Crossmark Capital. This announcement comes after Morgan Stanley spun out its Capital Partners unit, which became Metalmark Capital, last August
- These spinouts come after similar moves by Deutsche Bank, UBS AG, and others that have sold or spun of in-house private equity divisions

As private equity clients become a more important revenue source for investment banks, generating over 15% in total investment banking fees (up from 7% in 2001), we see several implications for investment banks. The conflict of interest issue should be taken seriously by banks that still have private equity subsidiaries. Even if these institutions elect to keep in-house private equity units, we expect them to take certain measures to separate their private equity activities to reduce the appearance of conflict of interest.

Global I-banking Fees from Private Equity/Financial Sponsor Clients as % of Total Fees



Source: Freeman & Co., Thomson Financial, Bloomberg

As the hedge fund industry grows, and it increasingly plays a more active role in private equity deals, we expect many investment banks to re-evaluate their business coverage models. Traditionally, hedge funds are covered through Capital Markets Sales and Trading departments, while private equity clients are covered by Investment Banking units. We expect many banks to expand their Investment Banking coverage to hedge funds in an effort to capture the revenues from private deals in which these hedge funds participate.

This Page Intentionally Left Blank

Recent Publications by Freeman & Co.

Asset Management Newsletters

Asset Management	A Slow Year, Focused on Repositioning	January 2005
Asset Management	Alternatives Go Mainstream, Move up the Charts	August 2004
Asset Management	Will Strong Returns Lead to Increases in Industry Activity?	March 2004
Asset Management	Alternative Investment Research: A Compilation	January 2004
Asset Management	Struck by Scandal, but Buoyed by Bounce in Returns	October 2003
Asset Management	A Nadir or Not? Lowest Deal Levels in Over 6 Years	May 2003
Asset Management	2002 Year End Summary	January 2003
Asset Management	Diverging Results Lead to Diverging Fortunes	October 2002
Asset Management	Challenges to Growth in a Sliding Equity Market	July 2002

Asset Management Reports

Asset Management	Are Hedge Fund M&A Deals a Sustainable Trend?	January 2005
Asset Management	Convergence in Alternatives	November 2004
Asset Management	Who are the Leading Suppliers of Segregated Mandates in Europe?	November 2002
Asset Management	Reaching the End Customer in Europe	October 2002
Asset Management	To Whom do Brand and Reputation Matter in Europe?	July 2002
Asset Management	Distributors Don't Care about Domicile in Europe	May 2002
Asset Management	Big Four US Players Dominate the Spanish Market	April 2002
Asset Management	What are Private Banks in Europe?	April 2002

Freeman & Co. LLC

645 Fifth Avenue, 9th Floor
New York, NY 10022
USA
+1-212-830-6161

171 bis avenue Charles de Gaulle
Batiment C
Neuilly sur Seine, Paris 92200
France
+33-1-4088-1053

www.freeman-co.com