

## **ADAPT OR DIE TRYING**

### **Darwinism and Intelligent Design in the Hedge Fund Industry**

November 21, 2005

Hedge assets are \$1.2 trillion, expected to double by 2010. The conventional wisdom is that the Alternatives industry will simply expand to accommodate new demand, but we think not. The influx of pension money will be a "climate change" for hedge firms - investors and Fund of Fund intermediaries - forcing them to adapt, or die trying.

Pension plan sponsors are not so much afraid to invest as afraid to commit - it's a "summer of love" with Alternatives. How much more flirt, fondle and flee before pensions grow up? We think the next five years will be a period of rapid maturation. By 2010 we expect the Hedge industry to find its long term shape and economics.

Institutions wanting hedge exposure have yielded to "take it or leave it" trader-managers. Will a natural order arise with pensions dominant? Is CalPERS' at the top of the food chain or the bottom? We foresee a bifurcated industry wherein - as with most other financial services - family needs and institutional needs are handled by different means at different fees.

In a low return low volatility world can the lucrative, ludicrous business of Fund of Hedge Funds thrive by serving rich families and a few gamine (or trepid) institutions? Yes, if needs must, but very hard years are ahead for the largest and the smallest. Those grown fat on institutional experimentation must shrink back to their natural market, while those who have not grown into their "big boy pants" may not be viable. There is room in the middle for specialized offerings and proprietary distribution, but few will be independent.

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## **CONTENTS**

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A Harsh Environment is the Context for Evolution .....	1
What do Pensions Deserve? .....	7
How Big is Big? .....	9
Who's There? .....	14
Who's Next? .....	17
And M&A? How, When and Why Not. ....	19
Highlights / Recap .....	20

## **EXHIBITS**

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Exhibit 1: AUM: "Old Market" vs. "New Market" & by Firm Type.....	3
Exhibit 2: Revenues: "Old Market" vs. "New Market" & by Firm Type.....	4
Exhibit 3: Management and Performance Fees: Pension vs. HNW, F&E .....	4
Exhibit 4: The Next Five Years for FoHFs .....	4
Exhibit 5: Use of FoHFs by Endowments and Foundations (12/2004) .....	5
Exhibit 6: The Next Five Years for "Trader" Hedge Firms .....	6
Exhibit 7: Pension Allocations to Hedge Exposure to 2010 .....	7
Exhibit 8: Hedge AUM to 2010 .....	9
Exhibit 9: TASS Database - Strategy Market Share and Growth Rates .....	10
Exhibit 10: Hedge Management Fees to 2010 .....	11
Exhibit 11: Hedge Performance Fees to 2010 .....	12
Exhibit 12: Total Hedge Revenues to 2010 .....	13
Exhibit 13: Fees, Active Risk, and Probability of Alpha .....	14
Exhibit 14: Relaxing Constraints Enhances Portfolio Efficiency .....	15

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Many colleagues, clients, mentors and fellow "quants" have provided patient advice. Jeremy Grantham, Lang Wheeler and Jeff Skelton deserve special mention. They and others did their best to help us "get it". Friends from The Q-Group reviewed an early draft, and offered helpful and pointed comments. In deference to the standards of that fine group, please note that we do not call our work "research"; it is opinion.

Most of the analysis presented here will be wrong to some degree, and I alone am responsible for the inevitable failures of foresight, analysis, emphasis or writing style.

Donald H. Putnam  
November 21, 2005

**A Harsh Environment is the Context for Evolution**

"Survival of the Fittest" echoes of High School, but think on it: Darwin's mechanism needs an environment of escalating challenge; it has no grip when everything is rosy. In an environment of peace and plenty, survival is everyone's bounty. Such were the 90's; halcyon days of robust markets ripe with volatility.

The current decade is proving to be abundantly Darwinian. A capital markets ice age, in which entropy is the rule of the day: in this barren landscape survival should not be taken for granted. The wreckage at the end of the halcyon era, we now realize, may have marked a most important turning point. Perhaps we were overly concerned with the apparent rotation out of growth into value and not enough concerned with the permanent effects of increases in market efficiency and liquidity.

This paper considers some consequences for hedge fund managers if recent trends - lower returns, low volatility, escalating pension liabilities - continue for a time. We consider pension funds a powerfully disruptive influence on the hedge fund business. Pensions face an unforgiving combination of underfunding and anemic returns. Adding insult to injury, more vigilant accountants are humorlessly measuring pension liabilities using grim assumptions, including upward revisions to employee longevity.

For thirty years pension assets have been managed with beta exposure, bought dear. In doing so, the pension community has been perpetually reacting to the past instead of anticipating the future. This is true in both market and business terms. In market terms, overdiversification has been a plague on every house. In business terms, pensions have been slow to reconsider roles and fees - they have remained essentially unchanged since first established in the aftermath of ERISA in 1974.

We believe the next five years will be an unusual time - a period of "fast forward" evolution through aggressive adaptation. While some of the evolution will be voluntary - pensions are rethinking how to more effectively manage assets (and leverage) - much of it will be bloody. It will be a time of false starts, good ideas badly executed, and banditry - as are all transitional eras.

The transition will be most evident in the untamed territory that is hedge funds and the wagon-trains that traverse the wilderness: Funds of Hedge Funds.

Hedge Funds emerged when traders could make money using huge pools of poorly supervised capital (at banks, natch) to play on the predictable behavior of other market participants; notably those bound by rote and the desperate or uninformed.

With a Hobbsian world-view, these new Gladiators soon sought independence. They discovered they could replace bank equity with old family money, and that the banks and brokers would lend against it many-fold. The independent hedge fund was born.

Thus success led to riches, riches bred hubris, hubris bred discord, and discord begat fragmentation. The ultra-wealthy - as when they financed the Colonies, the silk trade, the quest for nutmeg, gold or poppies - held their noses and accepted any demand as long as the trader could bring the coin. "Opacity" was a familiar concept - after all, the *methods* of prior quests were also unscrutinized (and deniable in polite company).

By the early nineties, courtiers to the ultra-wealthy created a permanent role for themselves as purveyors of diversification and access. Their creation, the Fund of

Hedge Funds, soon became a key organizing force in an unregulated, fragmented and secretive market.

Such a Rube Goldberg thing: double fees, double-dip draw-downs, rear-view decisions, and perverse incentives. Surely if designed (intelligently) for anything, FoHFs must be designed to be superseded: a speed bump in the evolutionary roadway. But where plenty is the norm, any oddity can thrive.

The rise of this oddity had two important consequences: First was the acceleration in the number of Hedge Funds. By 2000, there were 3,000 hedge funds where fifteen years before there were perhaps 300. Second was a focus on allocation among "styles". In the nineties this worked for clients, despite the fact that the styles were not enduring classifications, because diversification was important in a volatile world.

Still, FoHFs grew in power and scope for ten years straight – conveying on their young "research" analysts the impression that they add value. Recent quantitative research makes a persuasive case that sources of return in that period were mis-measured and that risk levels were higher than understood at the time. Other work suggests that the cycle of optimal asset reallocation is shortening. We believe these are among many manifestations of increased competition among sophisticated investors.

Consider the Great Death of Convert Arb: perhaps half the practitioners are sidelined or retooled irretrievably. The other half has simply moved a few feet around the trading floor – working in a distressed, credit or other team. However unlikely it might seem, if spreads were to widen, the models, modelers and traders could re-form in a flash. Partly for that reason, spreads may never widen in/among the primary markets (*on the other hand ... and so it goes - reflections in a barbershop mirror*).

This is not to comment on prices, only volatility. What we call "trading" is converging with "investing". Investing imposes a judgment of reality (value) on price, and relies on truth to emerge over time. Trading imposes a judgment about a sequence of prices (market) on position, relies on agent relationships to persist and structural financial relationships to hold fast. In this paradigm, prices are an expression of both longer-wave perceived value and shorter-wave trading effects. If the dynamics discussed above are indeed taking hold the relative importance of trading fades persistently.

The solutions of yesteryear, preserved in silicon and experience, create a state of dynamic tension enforced through real-time monitoring of "old" data pairs. Because technology does not falter or forget in the same way humans do, market cycles may be expected to better and better embody the volatility of non-capital-market phenomena. Not only is there no turning back, but the relative importance of asset allocation, reallocation cycles and implementation techniques must be reconsidered.

For the few non-traditional managers who can sharpen their competitive edge there are huge spoils. A harsh competition for allocations from pensions is in the offing. Darwin would be proud: survival is the impetus to evolution; necessity the mother of invention. We may hardly recognize the result in 2010.

Some aspects of the future are of the *Past Is Prelude* variety: segregation of beta and alpha and the marginalization of conventional long-only styles. There is little new in this – it is mainly a matter of giving new labels to old ways, encouraging new tactics

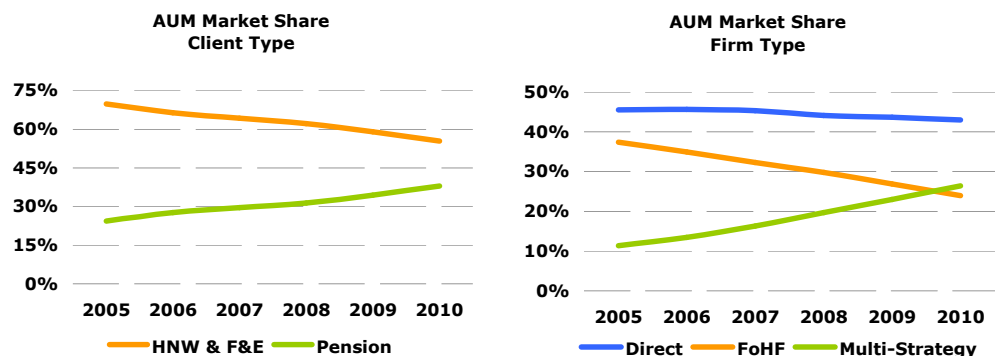
and lower, better structured fees. Such herd movements in the vast pension veldt are for another time; here we focus on how pensions will force changes on a young hedge industry.

Our hypothesis is that in five years the Alternatives world will not merely be bigger because of pension, it will be *different*: it will split in two:

- The “old” market is the super-rich and small foundations, endowments and pensions. This big market is saturating.
- Institutions – pensions, principally and the larger foundations and endowments – are the “New” market, a very rapidly growing market which will change the hedge world as it gains in power and size.

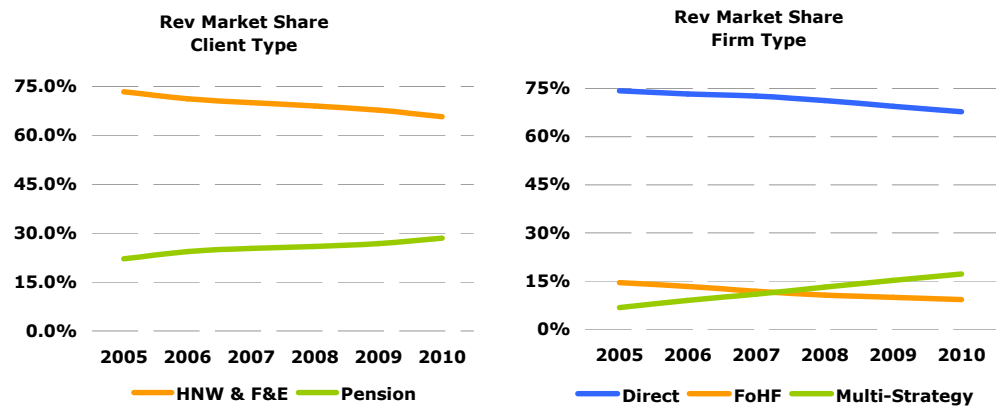
The Old Market will grow only 10% CAGR through 2010, to \$1.4 trillion. However, it will change quite a bit despite the placid pace of growth:

Exhibit 1: **AUM: “Old Market” vs. “New Market” & by Firm Type**



The bulk of the AUM growth will be toward multi-strategy offerings which intermediate the FoHFs, who will not be able to reduce price fast enough to compete. The effect of this in overall revenues is modest, but five years of no growth means compressing margins for old market FoHFs.

Over the same period, in the pension market, overall growth is much faster. The composition of AUM deployments is more heavily skewed and the evolution of revenue composition is much faster:

**Exhibit 2: Revenues: "Old Market" vs. "New Market" & by Firm Type****Exhibit 3: Management and Performance Fees: Pension vs. HNWF&E**  
(\$ billions)

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>CAGR</u>
<u>Management Fees</u>							
Pension	\$5.4	\$6.8	\$7.5	\$8.0	\$8.5	\$9.1	11.0%
HNW, F&E	18.1	21.2	23.0	24.5	26.2	27.3	8.6%
<u>Performance Fees</u>							
Pension	\$4.0	\$5.1	\$6.0	\$6.8	\$7.9	\$9.5	19.0%
HNW, F&E	13.0	13.6	14.3	14.9	15.3	15.6	3.8%

In addition to the "old" and "new" markets, growing Global Retail and Other Institutional segments figure in our detailed forecasts but are not represented above.

We expect the two groups that dominate the hedge industry - Fund of Hedge Funds and "Trader" Hedge Firms - to be challenged during the next five years. Both the mission and the methods of both types of competitors are under attack, as further described below.

**Exhibit 4: The Next Five Years for FoHFs**

- 1) FoHF AUM growth will slow: market share of pension assets invested in hedge funds will drop though AUM will rise, to a mere \$600 billion in 2010,
- 2) FoHF clients will be 2/3rds HNW / small F&E, and 1/3rd institutional,
- 3) FoHF fees will normalize to 0.75%+ 5% over cash rate of return,
- 4) FoHFs will consolidate sharply: 10 at-scale multi-channel firms, 40 also-rans, 40 niche/specialty providers, and countless "products" provided as loss-leaders by brokers and banks,
- 5) FoHF technology will simplify, with a focus on risk *instead of* transparency,
- 6) FoHFs will solve the double whammy drawdown problem by increased use of managed accounts with fee sharing arrangements.

FoHFs in the “old” business (more on their other choices later) will differentiate based on product management and marketing - product niche, fees and affiliation – rather than return. Note the pattern of hedge exposure in endowments and foundations, where investors committed 14% (vs. 1.5% by pensions) of assets at the end of 2004.

*Exhibit 5: Use of FoHFs by Endowments and Foundations (12/2004)*

	FoHF	Dedicated Strategy
North American Institutions	35%	65%
Endowments and Foundations > \$1bn	4%	96%
Endowments and Foundations < \$1bn	30%	70%

Source: Russell Survey on Alternative Investing 2005-2006, Greenwich Associates, Grail Partners

This data suggests that the FoHF is part training wheels, part TV dinner. For large funds it is a format to be abandoned as soon as the learning curve levels off, while for smaller funds it is a well-rounded meal, easier and cheaper (risk-wise) than cooking. We expect continuing allocation away from FoHF by foundations and endowments, all of which will be taken up by pensions “just starting to learn”.

The same thing happened when private equity was first the rage for pensions, but by 2004 the situation had stabilized: Funds of Private Equity Funds (FoPEFs) flows were 10% of new pension allocations to private equity and represented about the same proportion of all pension Private Equity. Concentration? The largest quartile of firms control 80% of the FoPEF assets, with a product that has friendlier features than FoHF (no performance fees, for one thing). Our conclusion: Once everyone discards the training wheels, some institutional consumers (say 10%?) will still buy TV dinners, but they will pay less and less.

Within the world of hedge portfolio managers we also see bifurcation:

- **“Trader” Hedge Firms:** One or a few related strategies staffed with intuitive practitioners. These firms are made up of semi-autonomous teams who may use technology to cobble together a multi-strategy offering. The culture is team-return-driven not client-return driven. Execution is proprietary.
- **Multi-Strategy Quants:** firms with an active quantitative culture, may be proprietary in execution, partly open architecture, or hybrid / synthetic.

For the Trader Hedge Firms we foresee five years of success, during which the main enemy is hubris – manifest in the desire to become what one is not.

**Exhibit 6: The Next Five Years for "Trader" Hedge Firms**

- 1) AUM will grow moderately as the competition shifts from getting a slice of a growing pie to a more predatory dog-eat-dog fight,
- 2) Most AUM will be from clients who insist on being serviced directly, and firms will have to gear up service and sales, but the press for *transparency* will be repulsed by simply rationing capacity,
- 3) Hedge fund fees will average 2%+20% over cash returns, with longer lockups – the ante for clients will go up, not down, through 2010,
- 4) Half the firms from 2004 will be gone by 2010, some through voluntary merger – there will be fewer, bigger players in this lucrative market, and
- 5) Technology will deepen, as will research, with a focus on real time market and trading support systems *instead of* transparency.

As dramatic as some of our hedge predictions are, we foresee more profound changes in the institutional world. Because the force of pensions will be so great, we will begin with a closer look at the motives of this ungentle giant, new to the playground.



## What do Pensions Deserve?

Why is this so important to pension plans? The answer is part science and part history.

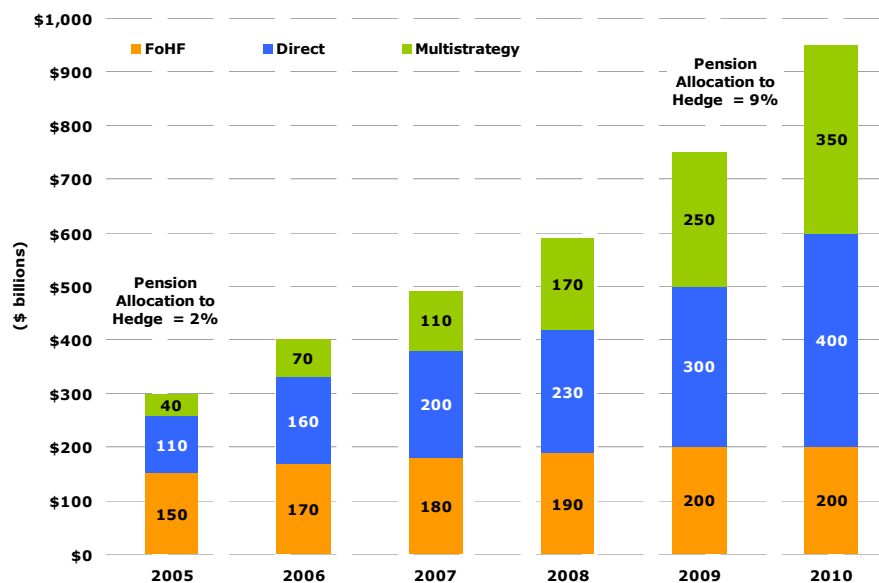
The science part is an unwelcome correlation between conventional asset allocation and crappy results. This unwelcome test of the advice of pension consultants against the real world is bringing disdain upon the consultants and their corporate stewards. Both groups labor under adverse selection and inadequate incentives.

Then there is the cost: pension plans have paid a huge price to buy beta -paid in fees, risk and market impact. We now know beta is cheap and abundant while Alpha is rarer than we thought. Clearly, a new way of thinking about and acting on asset allocation is needed if pensions are to serve long-living employees. These are relatively new realities – it has taken a long time for the capital markets to deliver the efficiency and liquidity that was first imagined by scholars over twenty years ago.

The history includes the interesting demographics of those who guide foundation and endowment funds: successful contrarian and outcome-oriented investors picked from the best based on whispered references. Many move on to shepherd the funds of the super-rich, enjoying a much greater economic interest in success. By contrast, the alpha-seeking truffle-pigs who guide pension funds are doomed by their constraints to find only beta instead.

The history part also includes five years of scandal, publicity and litigation. Some corporate masters new to the board room are trying to rethink asset allocation top to bottom. Will this result in a wholesale remake of allocations? Not yet. However, we do expect moves to the edges - passive and hedge –within the next five years.

*Exhibit 7: Pension Allocations to Hedge Exposure to 2010*



Source: Grail Partners Estimates

Prodded by pension underfunding, pensions will reward the accelerating capabilities of quantitative hedge firms. To pay for this, they will utilize sophisticated hybrid solutions for execution of beta exposure and take full advantage of the willingness of banks to

provide leverage for hedge exposure. Thus, when pension committees act on their new imperative to “get it fixed” they will be aided by much more science than ever before. That being said, they are no more trusting than ever before and they absolutely will not give up their belief in transparency.

Leave aside the relevance of the information, what pensions want is simple: real-time risk management metrics and daily audit trail of positions and flows. In the mid-1970’s it took five years for Master Trust banks to deliver this for US equity portfolios. It was required because new upstart firms – non-bank independents started by young, smart and bloody-minded portfolio managers – were running money without having custody. (The hedge fund managers of yesteryear? The parallels are eerie.)

This time around, we expect full real-time transparency for all portfolio types by the end of 2007. After that, brace an escalation of tensions between pension clients and hedge managers. This is what happened in the late 70’s: first, portfolio management (call it *talent*) segregated from custody (call it *work*) and the profits went to the talent. Then a price/technology/service war erupted among providers of work. That war ended twenty years later with a marketplace dominated by five banks, after which all portfolio managers had to provide full transparency. It was a matter of only a few years before AIMR-compliant portfolio measurement and attribution – built on the same infrastructure – was the de facto law of the land.

This time around, for hedge, the dealers – never inclined to conflate work with value – have compressed the cycle into a ten-year shakeout of prime brokers. A prime broker is a custodian on steroids, with lending and trading powers – in other words, just what banks thought they were in 1980, before twenty years of self-doubt and mergers.

So if pensions cannot give up transparency and the most successful managers will not provide it, they will part ways. After all, there are very few hedge managers who have more than a minority of their capacity earmarked for pension.

Pensions prefer to operate on a pension cycle and use pension metrics. They favor fees based on three year rolling alpha generation while hedge managers prefer high-water-mark gain-sharing. Pensions favor static, standard fee schedules across providers, while hedge firms use fees to auction capacity. These differences, too, will provoke the migration of hedge firms toward or away from the new paradigm.

Another reason some hedge managers will eschew pension mandates will be the scope of the assignment. For pensions, the perfect solution has three parts: unconstrained search for alpha, ultra-cheap exposure to beta, and drawdown avoidance. The alpha/beta divorce does not mean that alpha gets to go bingeing while beta stays home. Pensions will gravitate to managers who will “throw in” beta exposure for free. Drawdown moderation techniques, fully in the public domain since the Grossman/Zhou article in ‘93, are most efficiently applied to the overall portfolio. This, too, is within the capabilities of the “new age alternative quant manager”.

We predict the ascendancy of hedge fund firms operating on a “new” business model; new yet oddly familiar fee structures, more than a whiff of quantitative techniques, buttoned-down sales and service, and the entrepreneurial drive needed to compete.

**How Big is Big?**

The "old" game continues to attract pension money despite weak hedge returns. Old paradigm managers have feasted on the flows: hedge assets grew at a 22% CAGR over the three years through 2004, with a majority coming from institutions. Perhaps half of those mandates were shoehorned into a "retail" format, while the savvier half was awarded to institutional-grade firms like AQR, BGI, GMO, Numeric and Symphony.

We expect hedge assets to reach \$2.5 trillion by 2010, a 15% CAGR of which 8% will come from returns and 7% from net new flows. High net worth individuals account for a large majority of the industry's asset base but their contribution to growth will slow materially. Worse yet for FoHFs, large family fortunes will shift to direct ownership of multistrategy products while small institutions fill in with the diversified FoHFs.

*Exhibit 8: Hedge AUM to 2010*  
 (\$ billions)

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>CAGR</u>
Pension FoHF	\$150	\$170	\$180	\$190	\$200	\$200	5.9%
Pension Direct	110	160	200	230	300	400	29.5%
Pension Multistrategy	40	70	110	170	250	350	54.3%
Total Pension	\$300	\$400	\$490	\$590	\$750	\$950	25.9%
Market Share	24%	28%	30%	31%	34%	38%	
HNW, F&E FoHF	\$310	\$335	\$355	\$370	\$385	\$400	5.2%
HNW, F&E Direct	450	500	550	600	650	675	8.4%
HNW, F&E Multistrategy	100	125	160	200	250	310	25.4%
Total HNW, F&E	\$860	\$960	\$1,065	\$1,170	\$1,285	\$1,385	10.0%
Market Share	70%	66%	64%	62%	59%	55%	
Other Institutional	\$50	\$60	\$70	\$80	\$90	\$100	14.9%
Global Retail	\$20	\$25	\$30	\$40	\$50	\$65	26.6%
<b>Total</b>	<b>\$1,230</b>	<b>\$1,445</b>	<b>\$1,655</b>	<b>\$1,880</b>	<b>\$2,175</b>	<b>\$2,500</b>	<b>15.2%</b>
<i>growth YoY</i>		17.5%	14.5%	13.6%	15.7%	14.9%	

Source: Russell, Greenwich Associates, Morgan Stanley, Merrill Lynch, Grail Partners' estimates

Research from Greenwich Associates shows that FoHFs with more than \$1 billion have a virtual lock on exploratory mandates from institutional investors. If we are right about the new paradigm managers, this is very bad news for the largest FoHFs, who will lose their early-adopter pension clients rapidly in the face of a more compelling proposition for direct and multistrategy offerings. The biggest FoHFs have built up a sizable cost base building databases, inventing pseudo-science tools and overpaying inexperienced staff. Darwin's curse is that today's predator is tomorrow's prey.

How big is the opportunity? Our forecast is premised on "old" flows moderating in the face of lower returns and saturated HNW sales. When pensions mandates hit stride in 2007 and rise aggressively thereafter, the spotlight will have shifted to multi-strategy.

As a directional matter, we believe our forecast is more likely to be overly optimistic than to be overly pessimistic. The forces we identify all point toward bifurcation of the market with concomitant loss of revenue, disintermediation of FoHFs and the evolution of a new paradigm competitor. Faint of heart, we hesitate to call a sharp downward

turn. Thirty years of history militates for the familiar over the rational, the old over the new. That said, we find a few heartening signs.

The mix of invested assets has begun to shift. Equity long/short has been the loser as beta-surfers have been unmasked, and the hunt for alpha has teased investors away from mainstream strategies toward unconstrained multi-strategy.

*Exhibit 9: TASS Database - Strategy Market Share and Growth Rates*  
(\$ billions)

<b>TASS Database Investment Objective</b>	<b>Assets Jun-05</b>	<b>Market Share Jun-05</b>	<b>Market Share Jun-02</b>	<b>Annzd. Growth 3 yrs*</b>	<b>Annzd. Perf. 3 yrs**</b>
Long Short	224.6	30.6%	42.6%	23.8%	9.3%
Event Driven	147.3	20.0%	19.4%	39.8%	11.1%
Multi Strategy	97.5	13.3%	0.8%	253.4%	9.9%
Global Macro	71.4	9.7%	9.3%	40.3%	13.1%
Fixed Income Arbitrage	58.3	7.9%	5.7%	54.5%	6.7%
Equity Market Neutral	37.6	5.1%	6.8%	25.8%	7.2%
Emerging Markets	36.3	5.0%	3.4%	56.7%	15.3%
Managed Futures	31.4	4.3%	3.2%	52.8%	13.6%
Convertible Arbitrage	28.4	3.9%	8.6%	5.9%	6.0%
Dedicated Short Bias	1.2	0.3%	0.3%	42.6%	-10.3%
<b>Total</b>	<b>\$734.0</b>	<b>100.0%</b>	<b>100.0%</b>	<b>38.3%</b>	<b>9.9%</b>

Source: TASS database, Grail Partners' analysis

\* Includes net flows, new and closed funds, and market growth

\*\* CSFB Tremont

The fragmented industry of today is in contrast to the relative concentration of the early 1990s, when a few global macro funds controlled much of a smaller pool - \$30 billion. The spores cast off from the center took root and grew well: global macro today is \$100 billion AUM, only 9.7% of hedge AUM.

Multi-strategy can be *Revenge of the Nerds Part II*, in which the Nerds bet on the game instead of playing it, dress up snappy and quote poetry to win the cheerleaders, and then buy the team and run it with new discipline. Has this happened before? There are numerous firms powered by an "Intel Inside" that is sold as "part but only part" of the investment culture.

Implosions of single strategy managers have driven clients to established multi strategy firms, and pierced the pretensions of FoHF manager research. Clients who are interested in the unconstrained search for alpha resonate with the idea that speed and ease matters in asset allocation and alpha-chasing. As the Bard wrote "*if 'twere done, 'tis best 'twere done quickly!*". As important, the nimble multi-strategy format also ameliorates or eliminates the double-dip draw-down.

Today, a substantial proportion of multistrategy AUM is charged at a flat management fee of 100 to 125bps. We expect management fees to drop to 75bps across the board, but we also expect institutional clients to accept a performance fee of 20% of returns in excess of a hurdle rate (cash, adjusted for leverage) on a three-year rolling basis. For FoHFs we add 0.75% to the underlying management fee of 2% - training wheels can be costly - to estimate total management fees for the hedge business.

Despite trending toward lower fee rates over the next five years, the business opportunity is substantial: in 2010, management fees will be \$40 billion, up nicely from \$25 billion this year.

*Exhibit 10: Hedge Management Fees to 2010*  
 (\$ billions)

	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>CAGR</u>
Pension FoHF	\$3.8	\$4.7	\$4.7	\$4.7	\$4.6	\$4.3	2.3%
of which FOHF Mgmt Fees	1.6	1.7	1.6	1.6	1.6	1.5	-1.4%
of which Underlying Direct Mgmt Fees	2.2	3.1	3.2	3.1	3.0	2.8	4.7%
Pension Direct	1.3	1.6	1.9	2.0	2.3	2.6	15.2%
Pension Multistrategy	0.3	0.6	0.9	1.3	1.7	2.3	48.0%
Total Pension	\$5.4	\$6.8	\$7.5	\$8.0	\$8.5	\$9.1	11.0%
HNW, F&E FoHF	\$8.7	\$10.0	\$10.4	\$10.5	\$10.9	\$11.3	5.3%
of which FOHF Mgmt Fees	3.7	3.9	3.8	3.6	3.8	3.9	1.3%
of which Underlying Direct Mgmt Fees	5.0	6.2	6.6	6.9	7.1	7.4	8.0%
HNW, F&E Direct	8.1	9.5	10.5	11.5	12.5	13.3	10.2%
HNW, F&E Multistrategy	1.2	1.7	2.1	2.5	2.8	2.8	18.0%
Total HNW, F&E	\$18.1	\$21.2	\$23.0	\$24.5	\$26.2	\$27.3	8.6%
Other Institutional	\$0.6	\$0.6	\$0.6	\$0.7	\$0.7	\$0.7	4.8%
Global Retail	\$0.6	\$0.8	\$1.0	\$1.2	\$1.6	\$2.0	25.5%
<b>Total Hedge</b>	<b>\$24.7</b>	<b>\$29.4</b>	<b>\$32.0</b>	<b>\$34.4</b>	<b>\$37.0</b>	<b>\$39.2</b>	<b>9.7%</b>
<i>growth YoY</i>		19.3%	8.8%	7.5%	7.4%	5.9%	

Source: Grail Partners' estimates

Our forecast of performance fees assumes alpha generation of 5% for direct hedge investments, including the effects of leverage (net after management fees above an expected return for cash of 3.5%).

**Exhibit 11: Hedge Performance Fees to 2010**  
(\$ billions)

<b>Variables</b>	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	
Direct funds charging from 0% vs. above cash	70.0%	60.0%	50.0%	40.0%	30.0%	20.0%	
Expected Cash Return	3.5%	3.5%	3.5%	3.5%	3.5%	3.5%	
FoHF Alpha Net (after mgmt. fee)	2.0%	2.0%	2.0%	2.0%	2.0%	2.0%	
Blended Hedge Alpha for performance fee	7.5%	7.1%	6.8%	6.4%	6.1%	5.7%	
FoHF Performance Fee	10.0%	10.0%	9.0%	7.8%	6.3%	5.0%	
Direct Performance Fee	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	
Multi Strategy Performance Fee	20.0%	20.0%	20.0%	20.0%	20.0%	20.0%	
Other Inst	20%	20%	20%	20%	20%	20%	
Global Retail	0%	0%	0%	0%	0%	0%	
	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>CAGR</b>
Pension FoHF	\$2.2	\$2.6	\$2.7	\$2.7	\$2.6	\$2.5	2.7%
of which FOHF Perf Fees	0.3	0.3	0.3	0.3	0.2	0.2	-4.9%
of which Underlying Direct Perf Fees	1.9	2.3	2.4	2.4	2.4	2.3	3.5%
Pension Direct	1.5	1.9	2.4	2.8	3.2	4.0	21.0%
Pension Multistrategy	0.3	0.6	0.9	1.4	2.1	3.0	63.9%
Total Pension	\$4.0	\$5.1	\$6.0	\$6.8	\$7.9	\$9.5	19.0%
HNW, F&E FoHF	\$5.0	\$5.2	\$5.3	\$5.2	\$5.0	\$4.9	-0.5%
of which FOHF Perf Fees	0.6	0.6	0.6	0.6	0.5	0.4	-7.8%
of which Underlying Direct Perf Fees	4.4	4.6	4.7	4.6	4.6	4.5	0.4%
HNW, F&E Direct	6.9	6.7	7.1	7.4	7.6	7.6	1.7%
HNW, F&E Multistrategy	1.0	1.6	1.9	2.3	2.7	3.2	25.1%
Total HNW, F&E	\$13.0	\$13.6	\$14.3	\$14.9	\$15.3	\$15.6	3.8%
Other Institutional	\$0.7	\$0.8	\$0.9	\$1.0	\$1.0	\$1.1	10.1%
Global Retail	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	\$0.0	n/a
<b>Total</b>	<b>\$17.6</b>	<b>\$19.4</b>	<b>\$21.2</b>	<b>\$22.6</b>	<b>\$24.3</b>	<b>\$26.2</b>	<b>8.3%</b>
growth YoY		10.3%	9.1%	6.9%	7.2%	7.8%	

Source: Grail Partners' estimates

The practice of charging for results above zero instead of above a cash return hurdle will decline as investors demand fairer terms. We expect FoHFs to provide on average a 2% return over cash (again net of their management fee) with the performance fee rate declining from 10% to 5% over the next five years.

**Exhibit 12: Total Hedge Revenues to 2010**  
(\$ billions)

	<b>2005</b>	<b>2006</b>	<b>2007</b>	<b>2008</b>	<b>2009</b>	<b>2010</b>	<b>CAGR</b>
Pension FoHF	\$6.0	\$7.3	\$7.4	\$7.3	\$7.2	\$6.7	2.4%
of which FOHF Fees	1.9	2.0	1.9	1.9	1.8	1.7	-1.9%
of which Underlying Direct Fees	4.1	5.3	5.5	5.5	5.4	5.0	4.1%
Pension Direct	2.8	3.5	4.3	4.8	5.5	6.6	18.5%
Pension Multi Strat	0.6	1.1	1.8	2.7	3.8	5.3	55.9%
Total Pension	\$9.4	\$11.9	\$13.5	\$14.8	\$16.4	\$18.6	14.7%
HNW, F&E FoHF	\$13.7	\$15.3	\$15.6	\$15.7	\$15.9	\$16.2	3.4%
of which FOHF Fees	4.3	4.5	4.4	4.2	4.2	4.3	0.2%
of which Underlying Direct Fees	9.4	10.8	11.2	11.5	11.7	11.8	4.7%
HNW, F&E Direct	15.1	16.2	17.6	18.9	20.1	20.8	6.7%
HNW, F&E Multistrategy	2.3	3.3	4.1	4.8	5.5	6.0	21.4%
Total HNW, F&E	\$31.0	\$34.8	\$37.3	\$39.4	\$41.5	\$42.9	6.7%
Other Institutional	\$1.2	\$1.4	\$1.5	\$1.7	\$1.8	\$1.8	7.8%
Global Retail	\$0.6	\$0.8	\$1.0	\$1.2	\$1.6	\$2.0	25.5%
<b>Total</b>	<b>\$42.3</b>	<b>\$48.9</b>	<b>\$53.2</b>	<b>\$57.1</b>	<b>\$61.3</b>	<b>\$65.3</b>	<b>9.1%</b>
<i>growth YoY</i>		15.5%	8.9%	7.3%	7.3%	6.7%	

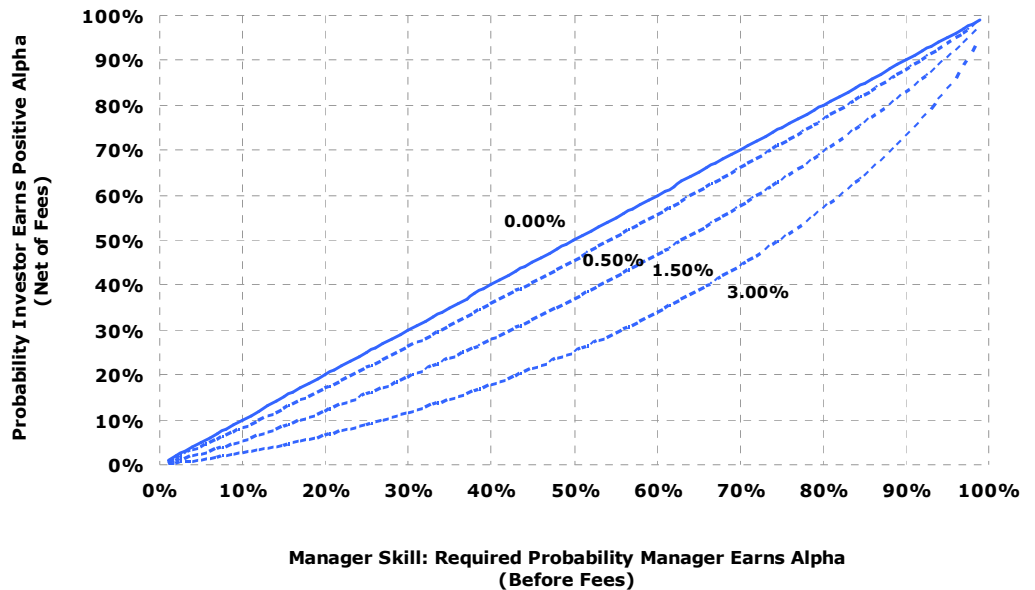
Source: Grail Partners estimates

By any measure, hedge is a big part of the money management world, and will become a bigger part as the next five years play out.

### Who's There?

The ephemeral nature of arbitrages, new or exotic financial instruments, and opacity: these do not fit nicely within the standards of institutional decision making. Great inroads have been made nonetheless.

Exhibit 13: **Fees, Active Risk, and Probability of Alpha**



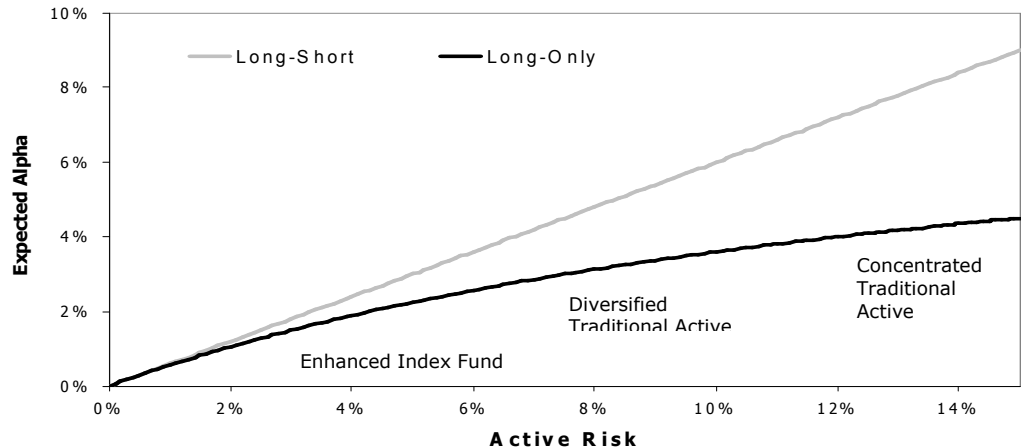
Source: Adapted from EnnisKnupp and Associates

Today approximately 200 hedge firms have assets in excess of \$1 billion, of which roughly a third are large, familiar institutional managers with deep existing pension relationships. BGI, Bridgewater Associates, Goldman Sachs, GMO, SSGA, Aronson, AXA Rosenberg, Jacobs Levy, and First Quadrant have all successfully recast themselves as part of the new era.

Financial markets and instruments have evolved in the past decade to the point where investors can deconstruct asset positions and associated risks. Managers can in turn tailor portfolio return and risk expectations with unprecedented precision, flexibility, and economy. The hedge fund industry depends upon these new capabilities, so it is important that they are rapidly gaining acceptance. One reason is that the scientific foundation is well-laid.

Quantitative institutional managers were "first responders" to pension client demand for absolute return. By repurposing their stock-selection technology to construct long/short equity portfolios, they built bespoke portfolios to fit to specific active risk targets. As a fillip, derivatives were used to port the alpha.



**Exhibit 14: Relaxing Constraints Enhances Portfolio Efficiency**

Source: Barclays Global Investors

Much has been written about the institutionalization of the hedge world, much of it misguided. Three themes continually recur: slick sales, style adherence and systems for transparency and risk aggregation. We beg to differ:

- Slick sales and service: an “institutional” gloss over traders’ predatory growl. Baloney – with unlimited millions to pay for it, there is plenty of institutional slickness in Hedge Funds already. True, most traders suffer from low affect disorder – it is at the core of their capability – but it is very specific decisions about the business plan and the culture that will attract or repel institutions. Be wary of the “I know a guy” syndrome; as if the solution is in the next hire (“... and when the man dances, certainly boys, the piper pays him!”).
- Style adherence is an institutional oversimplification that simply will not die. “Style” in hedge is misused when it contradicts the purpose of Alternatives: to budget risk and vary methodology. By categorizing methodologies in terms of a fixed definition of a class of arbitrage, convenience for clients is made a higher priority than returns.
- Transparency and risk aggregation are institutional goals that run counter to the business goals of many hedge fund managers today. *A Zebra may look like a horse but it simply cannot be domesticated.* Traders fear sharing positions, and they fear they will face a Lilliputian court if they behave other than as expected. Traders will allocate capacity to those who accept opacity.

So what does matter in the institutional market for hedge exposure?

1. Business Continuity and Structure
2. Investment Thesis and Valuation Structure

### 3. Cultural Coherence

### 4. Client Communications

What of new entrants? We think the market could be more “wide-open” than is generally believed. Capacity concerns hamper some who are already well-positioned, and there are simply too few credible players today.

Were it not for their conservative incrementalism, we would nominate the “global network banks” – Bank of New York, UBS, State Street, a few others – as contenders. They have the technology, service and sales talent to make clients comfortable. And one of their own has shown the way: Barclays Global is the poster-child for stealthy use of quantitative insights and incentives to create a new business (\$15bn in hedge is a lot of market share from a standing start).

BGI is *Revenge of the Nerds Part III*, in which the Nerds take over a dull business with contracting earnings (a tedious first reel), lock themselves in the garage challenging themselves relentlessly (a long second reel) and invent two types of Flubber to find power and wealth (apologies to Fred MacMurry fans). We foresee \$100 billion in hedge mandates to BGI, plus the kick from inventing ETF’s (the Silly Putty of index funds: *simply press it on and Wow, it copies anything!*).

Will the other banks follow? Nope; they will copy products and pluck stragglers from the ranks but never “get it”: it is vision, culture *and* incentives that make BGI possible.

**Who's Next?**

Who else might grab the gold ring? One group likely to succeed is the dealers – they can swiftly assemble trader teams into a “platform” of technology and leadership. Goldman is already there, and Citi has its own Tanya-of-Ark to show the rest of us how it's done, complete with sermons. We expect Morgan Stanley and JPMorgan to carve-out really significant market share once the trail is blazed (give JPMorgan credit for being first to twig to the idea that multi-strat might be the wave of the future).

Performance, per se, is not a prerequisite, credibility is. If Morgan Stanley decides to enter this market aggressively will it face performance concerns? Of course not – it will face questions of staffing, capability, technology and pricing but like other large institutional managers (even those past their sell-by date) they will get a free pass on performance. This is not to say it is easy, merely that the current players are vulnerable to new entrants with just the right combination of advantages.

Obsession with track record is one of the many ways of false-flagging other concerns: mainly related to the personality of the new vendors. Institutions rightly fear that what was once a healthy “alignment of interest” has become lethal at large doses.

*A pension frog needed – really needed – to cross the raging river. He picked as his guide a scorpion with local knowledge of the current, and proposed to carry him safely across in return for navigation help. “But please Mr. Scorpion, I’ve heard some terrible stories – how can I be sure you will not sting me?” “Why Mr. Frog, it isn’t in my interest” said the scorpion, and the pension frog was reassured. We all know the ending: “it’s my nature!” said the Scorpion.*

Still, pensions are getting beyond the basics (*gimme a Liquid Market, splash of Risk Control slathered with Low Correlation, barkeep!*). Large conventional managers will fire up their product development wonks to gain the competitive advantages of a new age multi-strat firm:

- More rapid, economical and stealthy reallocation among strategy “bets”
- More ways to execute exposure: proprietary teams, synthetic exposure, overlay, outside teams, and more
- One layer of fees, and lower performance fees in absolute terms because there is no double-dip drawdown

The result should be lower volatility and higher alpha – partly driven by cost aspects (we subscribe to the “risk budget” metaphor) and partly driven by the fact that the kind of firm we are describing makes the best possible use of scale: to amplify the impact of insight.

But the size of the opportunity may be a powerful motivator. Where should we look to find the “next generation” competitors?

- 1) Quants doing new age asset allocation dynamically among proprietary products designed to fit their quantitative world view: few beyond BGI and GMO have a full range of proprietary execution capability, but it could be built out by integrated quantitative / thematic firms.

- 2) Firms with a “trading room” culture use quantitative and fundamental insights to allocate exposure within a risk budget. Some of these firms are dealer prop desks today, or multi-method family offices, or multi-strategy firms. We expect this group to be the most active in tightening the role of quantitative overlay to create success. We expect some firms to go toward the new market at new pricing, while other raise price and ration capacity serving the old market.
- 3) A few new contenders will evolve from firms with other business plans:
  - a. Independent trading-based firms that decide to serve institutions with quant allocation wrapping a mix of quant and trader investing,
  - b. Global firms with a lot invested in the game already: Axa, SocGen and others who lend to, invest in or manage hedge portfolios, and
  - c. A few FoHFs who decide to morph from tick into dog by asking risk management and research to get out and “do” rather than “watch”. There are good candidates, but the will is rare and the vision rarer.

To get in the game has been relatively easy – in times of plenty ... In challenging times, with competitors focusing more explicitly on the potential spoils, winning will require very specific business strategies, many of which have yet to be conceived much less battle-tested.

### And M&A? How, When and Why Not.

Absolute return strategies are more accessible to pensions; the total hedge market is growing at a hell of a clip while the "old" business settles into its long-term form. Sounds like a situation tailor-made for the rough and tumble of M&A. We think not.

Yes, there will be a few transactions of note in the next few years, but they will focus on a limited number of industrial combinations:

- One or two large institutions will buy their multistrategy platforms, but more will build them. After all hedge teams and second generation quantitative tools are like Lincoln Logs (or, for you younger readers, Lego sets): they can rapidly be assembled into any shape, large or small. All it takes is talent (traders and quants), glue (money), leadership (hubris) and institutional determination (political license). Sound like Citi? Sure, but don't count out the French banks. Bottom line: only one or two big "platform" buyers.
- Small-sized FoHFs – those with less than \$1 billion – will be thick on the ground and may sometimes merge but they will not usually sell for more than scrap value. What few do sell will be bought as "starter yogurt" for sales organizations wanting to sell sexy product to in-house clients. Most such transactions will fail, so this volume too will die out after a few years.
- Specialized quantitative hedge firms will sell, and sell well, to larger organizations aspiring to credibility. Unlike specialized non-quant firms, which will sell rarely or not at all, quant pricing has shown to be, and will remain, strong.
- Roll-up strategies - the catnip of middle management - will produce a mewling sound in boardrooms all over, but will rarely if ever meet success in the marketplace. Their downfall will be attributed to the math, but it will be more a function of failure by buyers to listen to sellers - getting fiercely independent personalities to collaborate is no easy trick (see *Scorpion*, above).

We expect more IPO and reverse merger activity. As odd as it may seem, the public markets are a more congenial home for many of these firms than conglomerate or holding company purchase. Man, RAB, BKF– these companies illustrate that markets will listen and decide optimistically what the right share value is. More important, with the Calamos offering we have a format for reconciling the needs of the team with the needs of the market. Look for lots of IPO activity in two-tier structure on the horizon.

Pricing will be robust, both on and off-exchange. To-date, a diverse investor base (Public) has shown greater appreciation for volatile revenue streams. Whether expressed as a perpetual growth formula or a multiple of their normalized profitability, performance fees which are not the preserve of the Team earning them are worth a second glance. And a nifty tax arbitrage ensures that they will be available for sale.

After the next few years, though, the M&A boomlet will play itself out and M&A activity will be a tool of the failed. What small transactions take place will take place at modest pricing, amounting to little more than employment arrangements for the key talent. Talent in the non-quant hedge world has achieved virtual free-agent status. By 2010, second tier firms will be peopled with second tier talent, and second tier talent cannot command a premium in a transaction.

**Highlights / Recap**

- Evolution is Brutal 1 – only a handful of independent Fund of Hedge Funds (FoHFs) will survive the next five years.
  - Those that do will be less profitable and serve specific product or distribution niches, usually as part of a large conglomerate (“take a left just past the sign that says ‘Trust Operations’”)
  - A few of the largest FoHFs will try to morph into multi-strategy firms with innovative fees and a patina of technology and pseudo-quant processes. Very few will be able to turn the sow’s ear of “Fund Manager Research” into the silk purse of “Hedge Portfolio Management”.
- Evolution is Brutal 2 – Single strategy “trader” firms will also suffer, winnowed by ritual suicide (Yellow Pages under Convert Arb?) and more demanding clients.
  - Some will add teams and evolve into multi-strategy firms, but with qualified investment talent in “free agency” status it will be hard to hold the teams together. Said the scorpion “It’s my nature”.
  - Some will join banks and brokerage firms, to sip a thin gruel of shared success.
  - Some will thrive by abjuring any notion of being a business -- or “building franchise value” – and learning to be comfortable as a sole proprietorship.
- We are in the first stages of a powerful move toward more efficient allocation of risk, exposure and leverage to meet future pension liabilities.
  - Institutional motives for hedge are a hodgepodge: part alpha porting, part reconsidered risk budgeting, part anti-drawdown, part hula-hoop. Still, the appeal of low correlation, low drawdown, high Sharpe Ratio endures.
  - Paying up for alpha only makes sense if pensions buy beta in bulk. Although reserved for another paper, the implications for active firms are being felt.
  - As early adopters get acclimated, their “reports from the front” will accelerate rationality in fees, selectivity in vendors, and demand for new product.
  - “Intuitive” trading hedge firms will be overtaken by “scientific” investing firms. This is a big deal because the business models are very different, although the terms are in quotes because neither is either.
  - Performance will be crucial to relationship longevity of course, but secondary to anti-drawdown in selling to institutions.

- Pension allocations to hedge will grow by 3x through 2010, while allocations from a saturated HNW/foundation/endowment client base will level off.
  - In 2005, the hedge industry will generate over \$40 billion in fees, roughly equal the fees earned by U.S. stock and bond mutual funds.
  - Growth of new money flows will moderate in the near term, as the institutional experimental phase subsides.
  - Multistrategy and large direct funds will be preferred to FoHFs and will deliver higher returns, better control, and better risk management.
  - Product terms will bifurcate into a “retail model” for HNW clients and an “institutional model” for large pools of long term capital. Hedge firms will pick one or the other – it will be hard to serve two masters from one platform.
- Transformational M&A will be rare, but there will be IPO’s and reverse mergers.
  - The “I wanna own the team” fad will pass, as it becomes more obvious that GP interests encourage adverse selection and loyalty to failing.
  - Quantitative firms will remain the most attractive to buyers. Buyers will be reassured by methodology but rewarded by scalability.
  - Those that have clients or technology for sale will find the pricing disappointing – an industry reinventing itself does not pay much for prototypes.