

Alternative Investments and the Semi-Affluent Investor

Chapter 5: Advisory Businesses and Alternative Investments

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V. Advisory Businesses and Alternative Investments

While investing client assets in alternative investment products may be helpful in constructing an optimal portfolio, advisors must also consider a host of aggregation, operational, legal and tax issues when using these asset classes. This section examines many of these factors and the choices that are available.

There is a host of aggregation, operational, legal and tax issues that advisors must consider before allocating to alternative investments

A. Aggregation Issues and Funds of Funds

One way of including alternative investments in client portfolios is to make direct investments in private equity and real estate transactions. Although a few firms have been successful in doing so, such transactions generally go beyond the current core competencies of most advisory organizations.

Another means of investing in alternative asset classes is through pooled vehicles. Most pooled alternative investment vehicles are limited partnerships. Under Section 3(c)(1) of the Investment Company Act of 1940, partnerships and other non-registered pooled vehicles are limited to 100 investors. A recent change to Section 3(c)(7) allows for non-registered pooled vehicles with an unlimited number of investors; they are subject to certain reporting requirements and participants must meet certain suitability criteria.

Table 5.1

Investor Qualifications				
Type of Investor	Net Worth	or	Annual Income	Vehicle Used
Accredited	\$1,000,000.00		\$200,000 / \$300,000 jointly	3(c)(1)*
Qualified Client	\$1,500,000.00		---	3(c)(1)
Qualified Purchaser	\$5,000,000 in investments		---	3(c)(7)

*If a client is only accredited and not qualified, then it cannot participate in a vehicle with a performance fee.

Source: Deloitte & Touche, LLP

A majority of alternative investment partnerships are 3(c)(7) vehicles

A majority of alternative investment partnerships are 3(c)(7) vehicles. The objective of typical hedge fund and private equity managers is to capture as much money to manage as possible. By using a 3(c)(7) vehicle, they can accept money from an unlimited number of investors. However, if the vehicle accepts more than 499 investors, it will no longer be considered a private vehicle and will have to comply with regulations for public securities.

Most Advisory Clients May Not Invest in 3(c)(7) Partnerships

Most advisory clients, however, have net worths less than \$2 million and investable assets of about \$1 million. Consequently, they are ineligible to participate in 3(c)(7) partnerships.

More problematic, nearly all 3(c)(1) alternative investment pooled vehicles are not practical for most advisory clients because they usually have very high minimum investment requirements. With so few eligible spots per vehicle, the best alternative asset managers set absolute dollar minimums that often exceed any prudent allocation level for a semi-affluent individual.

There are three types of funds of funds vehicles

1. Funds of Funds

Funds of funds are a third way to invest in alternative asset classes. Funds of funds are pooled vehicles that invest in several individual hedge, private equity or real estate funds. Funds of funds allow investors with smaller amounts of money to get better diversification of their alternative asset class investments – and thus a more consistent return pattern – and to access select hedge and private equity funds that have high investment minimums.⁹³

There are three types of funds of funds vehicles. An advisory firm could form its own investment partnership. Such a vehicle could accept up to 100 typical advisory clients and an investment in another 3(c)(1) could count as only one slot for aggregation purposes.

Advisory firms can also invest in funds of funds partnerships sponsored by outside organizations. These third party funds of funds are usually managed by very sophisticated specialty organizations whose full time business is evaluating alternative investment managers and overseeing investments in alternative asset class partnerships.

The third choice is to invest in funds of funds vehicles that are registered under the Investment Company Act of 1940. With the repeal of short-short rules that greatly limited the ability of registered vehicles to sell short securities, many investment management firms have recently launched or are developing pooled alternative investment vehicles. They are able to accept an unlimited number of investors and thus have very low minimum investment thresholds.

2. Tradeoffs of Alternatives

Alternative # 1 – Sponsoring Own Proprietary Funds of Funds

Many investment management firms have recently launched or are developing pooled alternative investment vehicles

Some advisory firms are attracted to the idea of sponsoring their own fund of funds because it can be a clear differentiating factor for their organizations. Most advisory firm investments are limited to mutual funds, privately managed accounts, and (in a few cases) individually selected stocks. Adding an alternative investment fund of funds would allow the firm to clearly distinguish itself from its competition.

As a sponsor of a proprietary fund of funds, the advisor would also have much more control over its clients' investments. An outside fund of funds manager has very broad discretion as to how to allocate assets and which managers to select. Some advisors we interviewed were uncomfortable with the idea of sub-contracting a portion of a client's portfolio allocation and manager selection responsibilities to a third party. By creating its own pooled vehicle, all of these decisions remain with the advisor.

Many advisory firms, however, will quickly find that the research and operations burdens of sponsoring their own fund of funds can be overwhelming. In order to invest in a minimum of 15 top tier absolute return funds, a fund of funds sponsor may have to conduct due diligence on several hundred firms. One advisor interviewed more than 400 potential managers during an 18-month period to invest the assets of a \$7 million fund of funds. The vehicle sponsor must not only identify and evaluate these organizations in an industry that offers little public information, they must also convince the 15 managers that they select to accept their funds' money.

Risk Management Without Transparency

For absolute return funds of funds vehicles, the operational workload is particularly burdensome. In addition to overseeing a limited partnership with all of the required investment and tax reporting, the sponsor must track and monitor each of its investments. This can be very challenging because the best absolute return managers usually will not share their portfolio holdings with investors. In the words of one hedge fund manager, "If a manager does not view his strategy as proprietary, then it probably isn't."

Successful absolute return funds of funds sponsors manage the risk in their portfolios through a series of complicated models based on sector and strategy exposure. Their managers will provide them with only general information on their portfolio holdings. The sponsors have created systems that allow them to manage risk across several investments on a macro basis and shift their allocations as market conditions warrant. Few advisory firms have the resources to develop similar models and systems.

As we will discuss further in this section, an advisor that decides to sponsor its own fund of funds may also incur additional legal liability given the inherent risky nature of these investments. One advisory firm that we interviewed found that several insurance companies are unwilling to bear this potential liability. As a result, the advisor could find only one carrier that would provide directors' and officers' liability insurance to firms that sponsor their own alternative investment funds of funds.

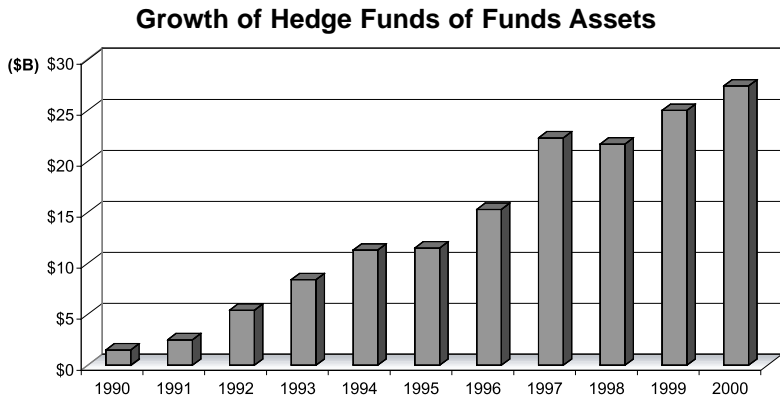
Advisors that sponsor their own funds of funds may incur legal liability due to the risk involved in these types of investments

Finally, the cost of creating and operating a proprietary alternative investment pooled vehicle is very high. It is unclear whether clients will pay increased advisory fees to organizations that sponsor their own funds of funds. Without adequate compensation for their time, effort and potential liability, advisory firms would have a hard time justifying the risk/return tradeoff from sponsoring a proprietary fund of funds vehicle.

Alternative # 2 – Investing in Third Party Funds of Funds

Investing in funds of funds partnerships sponsored by outside organizations has several benefits. Many of these organizations have existed for more than a decade and have extensive knowledge of the industry's participants and its pitfalls. Several have extensive research staffs and have made large investments in technology and risk management systems that help them more effectively oversee their investments.

Figure 5.1



Source: Grosvenor Capital Management L.P., Undiscovered Managers estimates

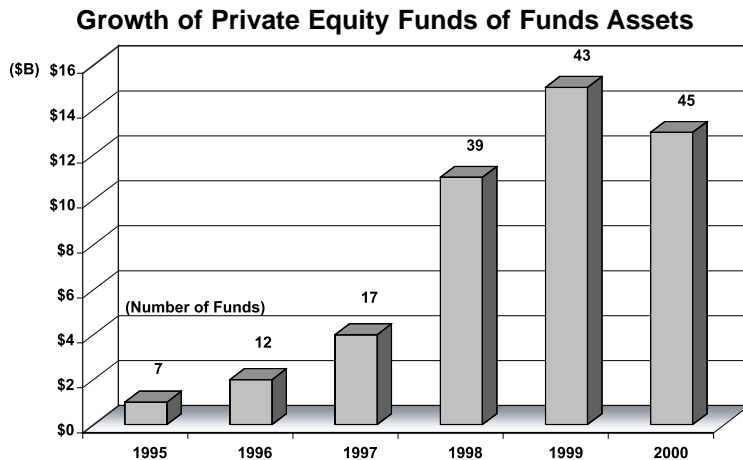
The best hedge fund and private equity managers are reluctant to accept money from new investors

Funds of funds sponsors will often have pre-existing relationships with many of the best hedge fund and private equity managers. Such managers are reluctant to accept additional money from investors that they have not known for a long time. Consequently, a key part of a sponsor's value added is its ability to access these managers' products.

Outside third party partnerships, however, also have several negatives. Many have relatively high minimum investment requirements (\$500,000 to \$1 million) that are greater than a prudent allocation for most advisory clients. Worse yet, several sponsors have their own investment advisory businesses and, similar to using the products of a bank trust department, using their vehicle may heighten the risk of losing a client to a potential competitor.

The cost to clients from investing in outside funds of funds can also be substantial. Typical fee structures include a 1% management fee, 10% of the partnership's profitability and partnership operating costs (that can often exceed 1% of assets). These fees are in addition to those charged by the individual hedge funds themselves.

Figure 5.2



Source: Asset Alternatives, Inc.

Potential For Conflicts of Interest

Another vexing problem of using third party funds of funds vehicles is that, similar to the hedge fund industry, it is an unregulated business that has attracted some unsavory participants and practices. Several fund of funds companies have set up their own brokerages and will not invest in a manager unless it transacts through their entity. Such transactions with affiliates are unacceptable to most advisors.

The third party funds of funds industry has attracted some unsavory participants and practices

Still other funds of funds sponsors demand a portion of the hedge fund manager's compensation be rebated back to them as a precondition of investing in the hedge fund. These sponsors try to justify their activities by arguing such rebates allow them to charge lower fees on their vehicles. And although they claim the size of the rebate has no effect on their decisions, such practices strip away all pretense of independence in the selection of managers.

As we outlined earlier, some sponsors of industry benchmarks are also funds of funds managers. The indices are supposed to be independent of the sponsor's investment activities and are designed to serve as benchmarks for investors to measure their performance. However, several firms will not consider including a manager in a benchmark unless it is willing to accept money from the index sponsor's fund of funds. Consequently, the performance of the sponsor's fund of funds becomes the benchmark, undermining the credibility of the index.

We were surprised during our research by just how many fund of funds firms subscribe to practices that would be considered unacceptable by most advisory firms. Advisory firms, therefore, must conduct comprehensive due diligence to ensure that the interests of the funds of funds manager and its investors are in alignment.

Alternative #3 – Registered Third Party Funds of Funds Vehicles

A more recently developed option for advisors is to consider using a third party fund of funds vehicle that is registered under the Investment Company Act of 1940. Such vehicles are legally mutual funds and can accept an unlimited number of investors and, thus, offer very low investment minimums. They also could be managed by organizations that specialize in funds of funds vehicles and, thus, would provide many of the same benefits – research, due diligence, systems, etc. – that third party fund of funds partnerships provide. An added benefit is that, since they function as mutual funds, they will likely be compatible from a systems standpoint for an advisor to track and include in client reports.

Unlike partnerships, however, registered funds of funds are highly regulated and are subject to independent trustee and SEC oversight. They are subject to a series of disclosure rules and their managers are generally prohibited from self-dealing.

Similar to third party funds of funds partnerships, such vehicles would be expensive relative to traditional mutual funds. In addition to fees that compensate the fund of funds manager, they would have substantial administrative charges that reflect the high operating costs of such pooled vehicles.

Table 5.2

Strengths and Weaknesses of Alternative Investment Vehicles		
Vehicle Type	Strengths	Weaknesses
Direct Investment	Complete discretion on investments	Difficult to diversify
	No intermediary fee	Difficult to meet minimums
		Higher evaluation/monitoring costs
		Increased liability
		Difficult to access best managers
Advisory firm sponsored fund-of-funds	Complete discretion on investments	Diversification still difficult
	No intermediary fee	Still difficult to access best managers
		High due diligence requirements
		High ongoing administrative costs
Third party fund-of-funds	Greater diversification	Intermediary fee
	Greater access to best managers	Less control over manager selection
	Greater transparency	Less control over investment direction
	Smaller due diligence requirements	Incomplete transparency
	Less liability	
	Less ongoing administrative costs	
Third party 1940 Act vehicle	Not limited to 100 investors	More expensive
	Not limited to qualified purchasers	Vehicle slightly hurts performance
	Board of Directors	Decreased flexibility
	Some SEC oversight	
	Familiarity with vehicle	

Few funds of funds managers have more than 15 years of experience in the industry

Evaluating Third Party Funds of Funds Managers

Over the last five years, funds of funds firms have proliferated in large numbers. Zurich Capital Markets estimates that today there are more than 1,200 absolute return funds of funds as well as dozens of private equity pooled vehicles.⁹⁴

As part of due diligence on a fund of funds manager, it is important to conduct careful background checks on the individual members of investment and risk management teams. However, given the relative immaturity of this industry, few investment professionals will have more than 15 years of experience in the field.

Relationships with Alternative Investment Managers

An equally important part of a fund of funds manager's value added is its ability to access top alternative asset class managers. They generally

have too few slots in their partnerships relative to the number of investors that want to participate. A top tier hedge fund of funds manager must not only be able to select and evaluate good alternative asset class managers, it must also be able to invest with them.

Technology

Tracking and monitoring alternative asset class investments requires a huge investment in technology. The most successful fund of funds firms typically have spent in excess of \$1 million to develop the necessary proprietary systems to evaluate and manage risk and adjust allocations accordingly.

Such systems are particularly important to absolute return funds of funds managers because they receive only broad information about the actual holdings of their partnership investments. A fund of funds manager must convert that information into something that is useable to manage the overall risk and structure of the portfolio.

B. Suitability and Advisory Firm Liability

Another important factor of alternative investment assets that advisors must consider is that they are generally unregulated products. The normal safeguards that are common to most traditional investments are, in large part, absent with these asset classes. Likewise, few hedge fund or private equity managers register with Securities Exchange Commission as registered investment advisors.

Instead, most alternative investment managers operate in a gray, unregulated area in which only sophisticated investors such as institutions and high net worth individuals have been allowed to participate. Prior to investing, individuals are required to make specific representations as to their assets, capabilities and understanding of the risks involved in owning such products.

Consequently, when things go bad in the area of alternative investments, they go really bad. There have been several instances of investors suffering substantial losses due to fraudulent activity by alternative investment managers. Some more notable recent examples include:

- ◆ **Ashbury Capital Partners** – the SEC filed an October 2000 complaint against this organization that stated "...the defendants sent investors falsified monthly statements significantly overstating the holdings and performance of investor accounts, and have distributed monthly updates that misrepresent the performance and status of the fund." The SEC contends that Ashbury raised millions of dollars from at least 20 investors, much of which the company's CEO used for his own personal use.⁹⁵
- ◆ **Cambridge Partners** – the managing partner of the Cambridge Partners and Cambridge Partners II funds admitted in March of 2000 that he created false audits, tax documents and monthly statements, defrauding 180 worldwide investors of \$40 million during an eight-

Alternative investments are mostly unregulated and operate in gray areas

One hedge fund manager claimed assets in its funds totaled \$50 million when they actually totaled \$3 million

year period. At one point, he claimed that the assets in these two funds totaled \$50 million, when, in fact, they totaled \$3 million.⁹⁶

- ◆ **Laser Advisers, Inc.** – in perhaps the most famous fraud case to date, the SEC filed an enforcement action charging this firm and its Chairman of overstating the value of the assets held in three funds by a total of \$71 million. The firm concealed its investment losses by:
 - Intentionally incorrectly valuing options owned by the portfolio
 - Altering documents, including instructing broker-dealers to return to the firm blank pricing sheets, on which the firm subsequently entered inflated prices.⁹⁷

- ◆ **The Manhattan Investment Fund, Ltd.** – the managing partner was sued by Austrian federal regulators for hiding losses of more than \$300 million while reporting annual returns of as much as 27%. The fund had approximately 280 shareholders.⁹⁸

These examples highlight the risks of including investments in unregulated products in client portfolios. A key part of each advisory firm's analysis involves what level of legal liability it will be willing to bear.

The higher risk in alternative investments require a closer consideration of a client's suitability

As a result of their analyses, many firms may elect to sub-contract much of the due diligence process to specialized alternative investment consulting and funds of funds firms. Others may decide to rely solely on registered vehicles and benefit from both independent trustee and SEC oversight. Still others may decide to forego these asset classes entirely.

The higher risk nature of alternative investments, as well as the potential for fraud, requires that advisory firms closely consider client suitability and firm liability issues before utilizing these asset classes. Suitability refers to the appropriateness of including an investment in client portfolios. This is the most obvious, yet clearly most important aspect in avoiding potential liability. Client needs vary greatly depending on wealth, age, occupation and tax status. The resulting suitability of a particular investment will likewise vary.

The following is by no means a complete list of issues, but it includes four points that advisory firms should consider before including alternative assets in client portfolios. **However, prior to investing client assets in alternative investment products, advisory firms should seek the advice of counsel regarding all legal issues including personal liability and client suitability.**

1. Minimum Investments

Hedge funds organized as private partnerships require minimum investments that range from \$500,000 to more than \$5 million, but are usually between \$500,000 and \$1 million. Private equity funds organized as private partnerships have minimums that are higher, ranging from \$1 million to more than \$25 million. Minimum investments for vehicles registered under the Investment Company Act of 1940 are significantly lower, but the question still must be asked, "what can a client reasonably afford?"

Clients with \$1 million of investable assets may not be able to invest directly in a hedge fund or private equity partnership because they don't have sufficient net worth. They also may not have sufficient assets to properly diversify a position in alternative investments through direct investments.

2. Lockup Period

A lockup period is the length of time that investors must remain invested before their investment can be redeemed. The lockup period for hedge funds organized as private partnerships ranges from six months to five years, but is normally one year. Lockups for private equity funds organized as private partnerships are for the life of the partnership, which is normally seven to ten years.

Lockups are designed to help prevent early redemptions. This proves beneficial in reducing the cash balance and helps managers focus on longer-term investments and avoid closing any positions on short notice. Registered vehicles may also have an initial lockup period and may only open at specified intervals with advance notification of redemptions required. There is no guarantee, however, that investors can redeem the entire amount desired.

Depending on a client's specific situation, vehicles with long lockup periods may not be appropriate. Client investment horizon must be considered carefully.

3. Liquidity

Private equity funds are highly illiquid instruments. There are substantial penalties for early withdrawal from the fund – some funds typically keep 50% of the investor's paid-in capital – and the nature of the positions that the fund takes makes these investments appropriate for the long-term investor only.

Most hedge funds, by comparison, have quarterly liquidity, meaning investors can redeem their investment at the end of each calendar quarter after the initial lockup period (registered vehicles will typically have quarterly liquidity if structured as interval funds, although there will be no guarantees for full redemptions).

Table 5.3

Alternative Investment Characteristics			
	Hedge Funds	Private Equity Funds	Fund of Funds
Minimum Investments	\$500,000 - \$5 million	\$1 million - \$25 million	low minimum
Lock-up periods	6 months - 5 years	7-10 years	No lock-ups/30-90 day notification required
Liquidity	Quarterly liquidity	Highly illiquid	Quarterly liquidity
Risk profile tolerance	Mid to high risk	High risk	Mid to high risk

However, hedge funds cannot generate cash for investor redemptions on short notice and nearly all reserve the right to suspend redemptions in the event of unfavorable market conditions. The redemption notice required by the fund generally ranges from 30 to 90 days.

Another factor that must be explored is whether the fund will make payments in cash or securities, which could be typical of funds invested in private or illiquid securities such as those of bankrupt companies. Similar to vehicles with long lockup periods, illiquid funds may not be appropriate for every advisory firm client.

4. Risk Profile/Tolerance

Private equity funds, in particular, can be high-risk investments. But so can investments in single hedge funds or single real estate properties, just like an investment in a single stock is a high-risk venture. Clients unable to bear significant losses in their portfolio may not be suitable for investments in private equity or an undiversified position in hedge funds or real estate.

C. Additional Ways to Limit Advisor Liability

A prudent process for determining client suitability can greatly enhance advisors' use of alternative investments and insulate them from potential lawsuits. There are five ways advisors may further reduce their potential liability.

1. Demonstrate due diligence/understanding

An advisor must clearly understand a product and its structure

Simply determining appropriate suitability may not be sufficient. Advisors must be able to demonstrate that they've fulfilled their fiduciary duties to clients to avoid possibly being characterized as having been negligent. With respect to alternative investments, that means thoroughly understanding the offering and subscription memoranda, as well as the underlying documents, and educating the client about the investment and specific strategies.

Evaluating and monitoring investments is an essential component of any advisor's business. Alternative investments tend to be more complicated than traditional advisor investments and take more time and resources to evaluate and monitor adequately.

How much leverage is being used? What kinds of strategies is a certain hedge fund or funds invested in? When do these strategies do well and poorly? Do they correlate with traditional market benchmarks in times of crisis or not? The better educated the advisor, the better it can educate clients and reduce the risk of being classified as negligent.

Also important in product knowledge is an understanding of product structures. As shown in Table 5.2, there are four main types of product structures, each with its own strengths and weaknesses, as indicated by the chart above.

2. Review Directors' and Officers' Liability, Errors and Omission Insurance Policies

As part of an analysis of whether to invest in alternative vehicles, every advisory firm should review its Directors' and Officers' Liability and Errors and Omission insurance policies. Many existing policies have specific exclusions for the use of alternative investment products, particularly those vehicles sponsored by the advisory firm itself.

3. Client Form Agreement – The Basis for Potential Liability

The basis of any client relationship is the advisor-client contract. Typically, there is a condition written in the contract giving clients some legal rights if some form of negligence is witnessed, whether it be "gross" or "simple." The attorneys that we spoke with recommended that a gross negligence standard be used.

4. Review Form ADV

Part II of the Form ADV provides advisors with an opportunity to describe the types of investments they make in great detail – from the types of vehicles they invest in to the use of short selling and derivatives to the fees charged for various vehicles.

An advisor's first line of defense against potential liability is to ensure their Form ADV indicates the use of alternative investments. Having clients acknowledge, in writing, that they have received and reviewed Part II of the Form ADV demonstrates an advisor has properly informed its clients about the investments it makes.

5. Have Clients Sign Disclosure Statements

To further show that a sufficient attempt has been made to educate clients about alternative investments, advisors should consider having their clients sign disclosure statements indicating that they understand their assets are being invested in alternative vehicles and they understand the risks associated with them. Many large brokerage firms already participate in this practice for clients that invest in alternative assets and other specialized products, such as derivatives.

This process is relatively painless once the original set of client signatures has been obtained. The forms are simple to prepare and need very little updating. Perhaps more importantly, these forms force clients to recognize the unusual or unique nature of alternative investments.

Fee Structures, Access and Manager Incentives

A lack of regulation and the potential resulting liability are only a few aspects of alternative investment products that can be problematic from the perspective of many advisory firms. Product fee structures, ability to access competent managers and ensuring correct manager incentives further complicate the process of selecting alternative asset class investments.

One challenge for advisors is to ensure that a manager's incentives are aligned with investors

Fees Are Not Inclusive

One of the more immediately noticeable differences between traditional and alternative investments is fees. Alternative investment product fee structures are much higher than traditional asset classes. All institutional mutual fund expenses – such as management fees, administrative and operating costs – are usually included in a single expense cap. By comparison, most alternative products have 1% to 2% management fees, incentive compensation up to 25% of the partnership profits (investors must meet the “qualified client” investor requirements to participate in vehicles that charge an incentive fee) and partnership operating costs that can exceed 1% of assets in the aggregate. Table 5.4 lists some of the more typical partnership operating costs paid by investors.

Table 5.4

Typical Partnership Operating Costs
Non-investment related interest expense
Cost of vehicle set up and creation
Legal and accounting fees
Annual audit fees
Custody and escrow fees and expenses
Cost of errors and omissions/directors and officers insurance policy
Cost of equipment and services used in communicating with custodian or other agents
Fees and travel expenses of managers
Other "extraordinary" expenses
Front-end sales charges to selling and placement agents
Miscellaneous expenses approved by the Board of Directors of the Fund
Brokerage commissions
Governmental fees and taxes
Compliance costs
Tax return preparation
Assorted administrative fees
Shareholder servicing fees
Advertising expenses

Like any other unregulated business, there are also many examples of partnerships that allow non-standard and even egregious expenses to be passed onto investors. Some of the more dubious examples included private equity managers charging their partnerships separate additional fees for 1) arranging the financing for companies they invest in; 2) providing consulting services to the companies they invest in; and 3) finding the companies to invest in.

Inherent Conflict Between Size and Incentives

Overall size of the alternative investment manager – that is, managers trying to manage far too much money than is feasible – can create a manager/investor conflict of interest.

Consider the following mathematics. Assume a private equity manager can achieve 40% annual returns investing a fund with \$50 million. As shown in Table 5.5, with a 2% management fee and a 20% incentive fee, the manager can earn (over a seven-year average weighted life of the fund) about \$124 million in total fees.

Assume another private equity manager has \$1 billion under management. The management fees alone will total almost \$167 million over the life of the fund. If the manager does a poor job of investing the fund and generates only a 5% annual return, the manager would still receive an additional \$81 million for a total of \$248 million. Any rational money manager – and when it comes to their fees, alternative investment managers are very rational – would almost always opt for taking much larger amounts of money regardless of its ability to invest it.

Table 5.5

Incentive to Perform Decreases as Fund Size Increases				
\$50 million fund				
40% Annualized Returns				
Year	Assets	Management Fee (2% of Assets)	Incentive Fee (20% of Appreciation)	
Fund commenced	\$50,000,000	-	-	
1	\$70,000,000	\$1,200,000	\$4,000,000	
2	\$98,000,000	\$1,680,000	\$5,600,000	
3	\$137,200,000	\$2,352,000	\$7,840,000	
4	\$192,080,000	\$3,292,800	\$10,976,000	
5	\$268,912,000	\$4,609,920	\$15,366,400	
6	\$376,476,800	\$6,453,888	\$21,512,960	
7	\$527,067,520	\$9,035,443	\$30,118,144	
Total Fees		\$28,624,051	\$95,413,504	\$124,037,555
\$1 billion fund				
5% Annualized Returns				
Year	Assets	Management Fee (2% of Assets)	Incentive Fee (20% of Appreciation)	
Fund commenced	\$1,000,000,000	-	-	
1	\$1,050,000,000	\$20,500,000	\$10,000,000	
2	\$1,102,500,000	\$21,525,000	\$10,500,000	
3	\$1,157,625,000	\$22,601,250	\$11,025,000	
4	\$1,215,506,250	\$23,731,313	\$11,576,250	
5	\$1,276,281,563	\$24,917,878	\$12,155,063	
6	\$1,340,095,641	\$26,163,772	\$12,762,816	
7	\$1,407,100,423	\$27,471,961	\$13,400,956	
Total Fees		\$166,911,173	\$81,420,085	\$248,331,258

D. Aligning Manager and Investor Incentives

Despite these examples, with correctly structured incentives, alternative investment managers can and have produced, in many cases, exceptional results for their investors. Several of the most sophisticated institutional investors are even willing to pay above market fees for top tier managers. The challenge for an advisor is to understand what exactly are market-standard practices for different types of alternative investments (individual partnerships can vary dramatically) and ensure that a manager's incentives are correctly aligned with its investors.

Advisory firms need to review and understand the terms and structure of partnerships and the likely resulting manager behavior. We have assembled a common, but not comprehensive, list of structural tools used by institutional investors to ensure an alignment of manager and investor incentives:

- ◆ **Hurdle rates** – Managers only receive a percentage of the partnership's profits after investors have achieved a minimum return on their capital. These hurdles can range from 8% to 20% and ensure that the manager must deliver some minimum level of performance before earning greater than traditional asset management fees.
- ◆ **Claw-Back Provisions** – Claw-back provisions preserve the limited partners' right to recover their capital and management fees before the general partners receive carried interest by requiring the general partners to give back their earlier distributions.⁹⁹ These provisions are designed for instances when a private equity partnership has made a partial distribution of cash and/or securities from which incentive fees are paid to managers and at a later point, the fund suffers losses on other partnership investments.
- ◆ **High-water marks** – For hedge funds, incentive fees are paid to managers only after any previous losses in the fund are recovered. The objective of this incentive is to keep the manager focused on the partnership's long-term rate of return, rather than simply trying to boost near-term performance. For example, if in one year a fund has \$100 million, and suffers \$10 million in losses, the manager is ineligible to receive incentive fees the next year until the fund has recouped the \$10 million.
- ◆ **Limited capacity** – As part of the partnership agreement, the manager agrees to limit its asset size to some level appropriate to the fund's strategy.
- ◆ **Management fee payment timing** – One approach is to pay solely on invested assets of a partnership. The goal of this kind of structure is to aggressively encourage managers to seek out investment opportunities. Such structures must be balanced with other controls to ensure that the managers do not have an incentive to simply invest money as quickly as possible, regardless of the merits of available transactions. These controls include no-fault divorce procedures that allow limited partners to withdraw from the partnership – at no cost or penalty – should certain benchmarks or standards not be met.

- ◆ **Manager investment** – It is critical that alternative investment managers make a substantial investment into the partnerships that they manage in order to align their interests with their investors. This investment should be a material amount of money from both an absolute basis and as a percentage of the manager's total net worth.
- ◆ **Capital Takedown Schedules** – For private equity and real estate partnerships, investors make capital commitments and "phase-in" their investments over time, as transactions are completed. This delayed investment process is designed to maximize the limited partners' returns and provide capital only when the managers are prepared to deploy it. Limited partners are usually required to invest a certain amount initially, then have between 25% and 33% invested by the time the fund closes.¹⁰⁰ Should a limited partner fail to meet a capital call, it usually is penalized by forfeiture of 50% of the partner's capital account.
- ◆ **Key-Man Provision** – Limited partners may either exercise their right to have the general partners terminate the partnership, or they may exercise their right to cease any further capital commitments should certain named individuals within the general partnership or a specified percentage of the original general partners leave the fund.¹⁰¹
- ◆ **Conflicts of Interest** – A key issue with every alternative investment product is to ensure that the general partner's personal investment activities do not conflict with the partnership. Managers will often be restricted in their outside investment activities and require partnership approval for certain transactions.

Termination of General Partners – Many agreements include provisions that allow the limited partners to terminate and replace the general partner in the event that it violates conflict of interest rules or should certain kinds regulatory or legal action be taken against it.¹⁰²

- ◆ **Wind-Down Provisions** – Agreements usually include provisions that define the maximum life span of the partnership and the process for the liquidation and distribution of assets at its last stage.

Assessing Proven Managers Can Be Difficult

Investors in alternative investment classes face a multi-faceted challenge. They want to find proven managers with strong performance records that will allow them to invest in their partnerships. They also want to ensure that the terms of their investment create the right incentives so the manager will continue to deliver the best results. This has become increasingly problematic as demand for alternative investments has increased.

As shown in Figure 5.3, the assets flowing into alternative investments during the past 10 years have been staggering. Only one buyout fund raised more than \$500 million in 1990. Fifty-three raised at least that much in 2000. More than \$65 billion was raised in seed and early stage venture capital funds in 2000, compared with less than \$5 billion in

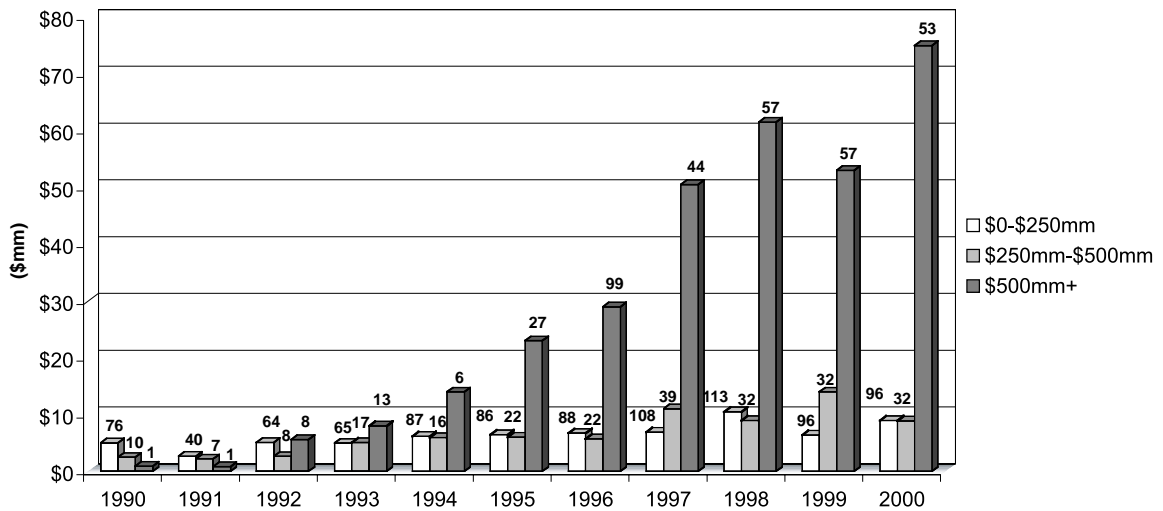
1995.¹⁰³ Several top performing hedge funds have likewise grown from only a few hundred million dollars to several billion dollars in only a few years. And the demand shows little sign of relenting in the near future.

This tremendous demand for alternative assets has made access to top managers with excellent long-term track records even more difficult. They are in such great demand that they can effectively dictate the terms of their partnerships.

New alternative investment managers, on the other hand, often have a very difficult time raising their first limited partnerships and, thus, are much more flexible in the terms and conditions they are willing to accept. But new managers are generally unproven and lack a long-term investment track record.

Figure 5.3

There were 52 More Large Buyout Funds Raised in 2000 than 1990



Source: CSFB

Track Records May Be Misleading

An equally challenging problem of investing in alternative asset classes is that many of the proven managers develop their long-term track records while managing only small amounts of money. Their results may not be a good indicator of a manager’s potential future performance because it is much harder to deliver strong returns with larger amounts of money.

The problem is that proven managers with strong performance records have no need for the investors’ money. The top alternative investment managers are besieged by potential investors and usually have fewer available slots than people wanting to invest, particularly during periods of high demand like the industry is experiencing today.

Many managers develop long-term track records while managing small amounts of money

Equally problematic is that most proven managers developed their long-term track records while managing small amounts of money – usually far smaller than they currently manage. And they have a clear incentive to take as much money as possible.

The Difficulty with Small New Managers

For example, most new private equity managers raise only small amounts (\$20 million to \$40 million) of money for their first fund. From the perspective of the manager, the fund has one primary goal – create a measurable investment track record that can be used to raise more money.

After the fund is invested and begins to yield its first results, the manager will begin wide-scale marketing efforts to raise a second private equity fund. Touting the track record of the small initial fund, the fund-raising goal can be as large as \$500 million to \$1 billion.

And while it is an enormous challenge to manage a second fund with 20 to 30 times more money than the first, many private equity managers do not stop fund-raising with their second fund. They often will begin raising third and even fourth funds, prior to fully investing the assets of the second vehicle. And their primary marketing tool is the performance record of the small first fund.

Size Changes Transaction Environment

According to two leveraged buyout managers that we interviewed, private equity managers with small funds operate in a very different environment from those with large pools of money to invest. Smaller managers usually invest in transactions that involve less than \$100 million of total consideration. Such deals can often be negotiated transactions. While the buyer must pay a full price for a company, that price is not determined through a frenzied auction.

Large private equity managers have to operate in different environments. Most of their transactions exceed \$100 million of total consideration and, consequently, are almost always auctions. They can often find themselves in competition with other private equity managers that have raised far too much money and are desperate to invest even if they have to overpay for a company.

Harder to Add Value to Large Transactions

The larger the acquisition, the harder it is for a private equity manager to add value

Large transactions are also problematic because an essential part of successful private equity investing is finding ways to add value that go beyond financing and capital structure.

The larger the acquisition, however, the harder it is for a private equity manager to add value that materially impacts the overall value of the enterprise. It is one thing to merge two \$50 million companies in the same business and create sufficient scale to better amortize fixed costs. It's another to try to do that with two \$2 billion companies.

All of these factors mean that investors who rely on previous track records of private equity managers are often buying something completely different than they expect. The same manager that generated spectacular performance with a relatively small amount of money must now operate in a completely different and more difficult environment.

From the perspective of the manager, however, lower performance across a large amount of money is not a horrible outcome in terms of total fees received. And if the manager has enough demand for its services, it can often slip into its partnerships some of the more egregious fee structures – getting paid additional fees for arranging financing and for consulting to acquisitions – which we outlined earlier.

Hedge Funds Also Often Grow Too Quickly

Hedge fund managers also go through a similar fundraising lifecycle. New managers often have a very hard time raising money and some choose to operate initially using an incubator structure, investing only the manager's own money in a new partnership.

After two to three years of performance (including the incubator period), the manager will usually commence an aggressive marketing campaign. In similar fashion to private equity funds, hedge funds that had only \$25 million to \$50 million under management can suddenly become \$1 billion funds. And within a year or two, they can grow to \$3 billion or \$4 billion, again using the track record from when the fund was small.

Unlike private equity investing, hedge fund managers that we interviewed believe that, while size of assets under management could have a detrimental effect on returns, its impact varies by strategy and does not occur in a homogeneous fashion.

Some absolute return strategy managers – such as fixed income arbitrage, risk arbitrage and global macro – operate in very liquid markets. Thus, depending upon the market cycle, it can be as easy for a good manager to invest \$1 billion as it is \$100 million.

Other strategies – such as distressed securities and emerging markets – lack these levels of liquidity and size can quickly become a detriment to generating good investment performance. In still other strategies, such as long/short equity and market neutral, size can hurt performance but it does not do so in a linear fashion.

A very successful hedge fund manager that we interviewed argued that while limiting assets under management to \$200 million will allow a manager to be more nimble, it is as easy to manage \$3 billion as it is \$1 billion. In these market sectors, small size is only an advantage if a manager is committed to remaining very small.

However, once a manager crosses a certain size threshold (thresholds vary depending upon liquidity of investment style), it can be in the interests of investors for their managers to oversee larger amounts of assets. A key benefit to scale is that it affords the manager the ability to build a substantial infrastructure to support its activities. A manager is able to

Size has a non-homogeneous effect on hedge fund returns

hire professionals to oversee the operations, marketing and accounting functions and focus solely on investing money. In addition, with scale the firm can afford to recruit top investment analysts that can provide proprietary research and boost investment performance.

Accessing Managers That Will Deliver Good Future Performance Can Be Vexing

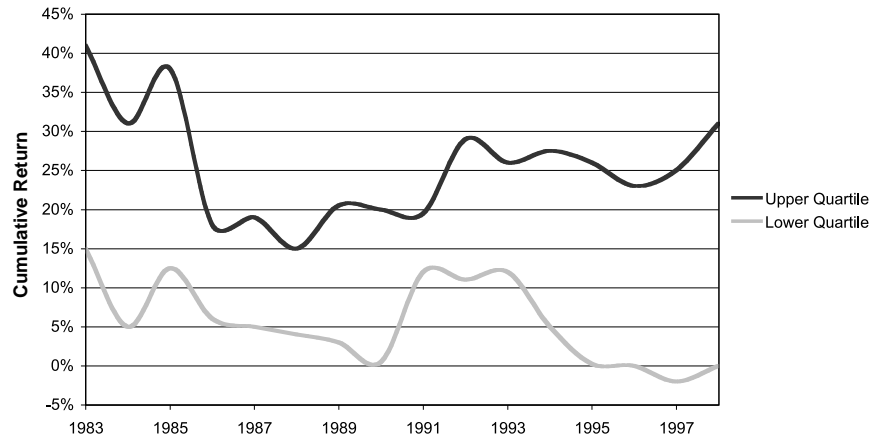
As a manager becomes more successful, investors have less leverage to negotiate terms

Investors in alternative investment classes find themselves facing multiple conundrums. In order to get good performance they need to invest with good managers. But they have a hard time accessing experienced managers because everybody wants to invest money with them. And if they are able to access good managers, they may not get what they paid for because the manager has too much money to effectively invest and now has an incentive to provide only mediocre returns.

It is critical that investor and manager interests remain aligned to ensure continued good investment performance by the manager. However, the more successful a manager has been in the past, the less leverage an investor has to negotiate incentives.

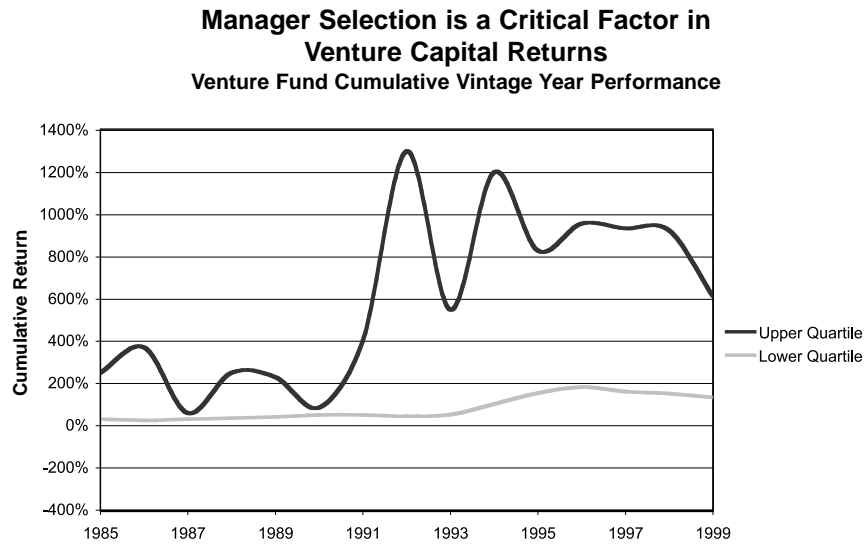
Figure 5.4

Managers Selection Has a Major Effect on Buyout Fund Returns
Buyout Fund Cumulative Vintage Year Performance



Source: CSFB

Figure 5.5



Source: CSFB

E. Tax Issues

Tax considerations are some of the most complex issues that advisors must consider when investing in alternative asset classes. The following is a non-inclusive list and analysis of some of these tax issues. **However, prior to investing client assets in alternative investment strategies, advisory firms should seek the advice of qualified tax counsel regarding all tax issues.**

Major Factors in Selecting the Correct Vehicle

The primary tax consideration is selecting a vehicle that fits a client's tax status

The primary consideration in the tax analysis of alternative investment products is selecting the correct investment structure given a client's particular tax circumstances. Advisory clients generally fall into two categories:

- ♦ **Taxable** – assets of individuals are subject to tax on investment income and loss. Ordinary income can be taxed at up to 39.6% and long-term capital gains at 20%.
- ♦ **Tax-exempt** – assets of individuals and institutions are not subject to tax, but could be subject to tax on unrelated business taxable income (UBTI) exceeding \$1,000, at regular corporate (up to 35%) or individual tax rates depending on type of organization. UBTI is income that is directly attributable to leverage used in purchasing securities. For example, if a manager purchases 10,000 shares of Intel at \$50 per share, and uses \$250,000 of borrowed money, then the gain on 5000 shares of Intel could (would) be UBTI. This triggers a tax-event for tax-exempt investors under a partnership structure.

Investors have generally invested in alternative investment asset classes through partnership or offshore investment funds. Taxable assets should normally be invested in a partnership or a registered vehicle, while non-taxable assets should be invested in a manner that does not attract U.S. tax, such as the tax on UBTI.

Most often, to avoid UBTI, non-taxable assets are invested in offshore companies or commingled vehicles structured as registered investment companies. Not all strategies can be offered as offshore investment funds, however, but exceptions are available to certain strategies, such as venture capital, which eliminate the pass-through of UBTI to investors.

Partnership Investment Funds

Partnerships are often offered on terms somewhat similar to traditional mutual funds. However, unlike a traditional mutual fund, a partnership is a pass-through entity. For taxable investors, the taxable income and losses are treated as received directly by the partners. One advantage of partnerships is the ability of investors to utilize the losses that are directly passed through to them. These losses can be used to offset income from other investments. Also, for certain kinds of alternative asset classes, such as real estate and leasing transactions, a key part of the investor's overall return consideration can be the passed-through tax benefits.

Partnerships that employ leverage can create tax problems for tax-exempt money

Partnerships that employ substantial leverage (real estate partnerships are typically leveraged 30% to 70%) historically have benefited from the ability to pass through losses. These losses are primarily derived from servicing debt, and can be used to offset gains in the portfolio. If leverage is not prevalent, however, the tax advantages of the partnership structure are not nearly so obvious. In fact, the disadvantages may outweigh the marginal benefit received from passing through small losses. For tax-exempt investors, partnerships can trigger the UBTI problem as discussed above. In addition, partnerships make the filing of tax returns much more complicated. Instead of investors filing Form 1099s, as is required with mutual funds, investors in partnerships must file Form K-1s. Form K-1s typically are not produced in time to meet the April 15 deadline, forcing investors to file extensions. Also, if investors participate in a partnership that invests assets outside of their state of residence, they must file state tax returns for that state.

Mutual Funds

A traditional mutual fund, on the other hand, is considered a pay-through rather than pass-through vehicle for tax purposes. Thus, although it can avoid tax at the entity level like a partnership, it pays through all of its net income and net capital gains to its shareholders in the form of dividends. Losses are included in the calculation of income and therefore, are not passed through to shareholders. Mutual funds are almost always registered investment companies, and therefore are suitable (from a tax perspective) for non-taxable investors.

To be clear, the terms mutual fund and partnership, as used here, refer to the tax classification of each entity and not necessarily its registration

under the Investment Company Act of 1940. Thus, for example, a vehicle that is registered as an investment company under the Investment Company Act of 1940 may be treated as either a partnership or as a regulated investment company for U.S. tax purposes.

Offshore Investment Funds

Individuals may also invest in alternative investment funds through offshore corporations. Normally, investment managers will offer offshore investment funds side-by-side with their partnership offerings. Offshore investment funds are generally organized specifically for nontaxable assets because they are deemed corporations for tax purposes and therefore do not pass through UBTI to investors.

QEF elections are made by taxable investors in offshore corporations

Offshore corporations may also provide investors with the opportunity to make a Qualified Electing Fund (QEF) election. Generally, such an election is only made by people investing taxable assets in the offshore corporation.

A QEF will be treated as a pay-through entity with respect to the electing shareholder. Thus, the fund's ordinary income and net capital gains are treated as paid through to shareholders, regardless of cash distributions. Absent the QEF election, all gains and losses in an offshore investment fund are generally deferred until the shares are liquidated.

Investors of taxable assets would likely make a QEF election to avoid the deferred tax charge on offshore investment company distributions and permit tax-favored characterization of net capital gains that are treated as paid through. Investors of nontaxable assets that might be subject to the tax on UBTI, however, would generally not make a QEF election because of the remote risk that UBTI might be treated as passing through to the investor.

Conclusions on the Assets Allocated to Alternative Investment Funds

For advisors and their clients, there are a number of different vehicles available for accessing alternative investments. For U.S. taxable investors, either a mutual fund (registered investment company), partnership or QEF offshore fund is suitable. Mutual funds and QEF offshore funds are pay through vehicles, where losses are deducted at the entity level and used in the calculation of net income and net capital gains, which are distributed to shareholders. With partnerships, income, capital gains and losses are "passed through" directly to the limited partners.

For non-taxable investors, entities domiciled in the U.S. that are considered registered investment companies for tax purposes and offshore funds are the most suitable vehicles. Both entities avoid the possibility of UBTI when leverage is used in the underlying strategies.

Additional Factors

There are dozens of other tax factors that advisors should also consider when selecting alternative investments for their clients. Rather than go

into each in great detail, we have provided in the Appendix seven matrices that outline many of these issues and compare tax treatment under different circumstances depending upon the tax classification of the investor and the type of vehicle.

VI. Conclusion

Recent market conditions are leading many advisory firms to consider the inclusion of alternative investments in clients' portfolios. A potential period of prolonged mediocre equity market returns and increasing correlations between traditional asset classes may force advisors to find ways to increase absolute returns and better diversify portfolios.

They are turning to alternative investment products because of the success institutional investors have had with these strategies. In the aggregate, alternative investments have boosted their investors' returns and lowered overall portfolio risk. But the aggregate does not necessarily reflect the results achieved by many participants in these products.

In addition, typical advisory clients have fewer assets than institutional investors and face a series of issues that impact the suitability and practicality of investing in alternative asset classes. Aggregation, legal, tax and operational issues are but a handful of important factors that affect how advisory firms should invest in the products and also whether they are appropriate for all clients.

**Uninformed investing
in alternative asset
classes is analagous to
doing surgery on
oneself**

Successful institutional investors have used these products to accomplish specific objectives in portfolios. And they have used them in a fashion that reflects an understanding of the potential benefits and risks of each product and the effect of their use in the aggregate.

These institutions gained their level of insight into alternative investments only after extensive study and due diligence. They recognize that alternative asset classes are complex investments that require special expertise that is often only found outside of their organizations. As advisory firms consider these products they would do well to learn from their institutional predecessors' experience.

Uninformed or unknowledgeable investing in alternative asset classes is like doing surgery on oneself. It is very easy to cause irreparable damage.

Successful advisors will use alternative investments to their advantage. They will take the time to perform proper due diligence and educate themselves and their clients so that they can develop an adequate understanding about these asset classes and how they can enhance their clients' portfolios.