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535 Madison Ave., 19th Floor
New York, NY10022
212.207.1000 (phone)
212.207.1019 (fax)

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To subscribe or unsubscribe, contact:
bcs.feedback@berkcap.com

In the "Lost Decade," Institutions Embrace Hedge Funds

For most of the 1990s, while the U.S. stock market was in the midst of one of the greatest bull runs in history, West Virginia's state pension plan managers watched from the sidelines, their inaction the legacy of 19th-century rules that prohibited public funds from investing in equities. Having played catch-up when the ban was lifted in 1997, the state is moving far more rapidly to embrace alternatives: last year, the legislature gave the West Virginia Investment Management Board approval to invest up to 20% of its $8.9 billion portfolio in such assets, including hedge funds.

West Virginia is hardly alone. Throughout the U.S., and indeed the world, pension funds, endowments, insurance companies, banks and other institutions are expanding their holdings of alternative investments. In part, this reflects a sea change in investment philosophy. Amid what the Wall Street Journal recently called the "lost decade" for stocks, alternatives are increasingly viewed as a prudent component in a diversified portfolio, not a heart-thumping roll of the dice.

Among the largest institutional players, public employee pension plans, that conversion is also driven by a pressing financial reality: the need to fund the commitments made to retiring baby boomers. Since those commitments are theoretically guaranteed, any future shortfall would have to be made up by taxpayers, an unattractive course of action for any elected official — especially in an era when the private sector is cutting traditional pensions.

The latest survey of U.S. state pension plans from consultant Wilshire Associates places the actuarial value of assets relative to liabilities at 87% for 2007, compared with 103% in 2000 — the year the bull market ended. Three-quarters of state pension plans are under-funded, with a number dangerously short on assets, including West Virginia's. In recognition of these challenges, state equity allocations in total have jumped eight points in the last five years to 69%.

New Jersey is among a number of states that failed to make sufficient contributions to their pension plans during the heady 1990s and now face the arduous task of filling the gap. Accordingly, the state has been ratcheting up its alternatives portfolio, to 10.5% of total investments as of February 2008, nearly double the level just eight months earlier. However, the state has approved up to an 18% allocation in alternatives for its $78 billion plan, including 7% in hedge funds. Between 2000 and 2006, the $112 billion Teacher Retirement System of Texas (TRST) went from fully funded to $13.5 billion in the hole, leading Texas Gov. Rick Perry to shake things up. This included bringing in the ex-CEO of asset manager **Bridgewater Associates**, Britt Harris, as chief investment officer.

Last year, alternatives accounted for 7% of TRST's assets, more than double the level in 2005, with hedge funds enjoying similar growth to 2.5% of assets. But Harris has far more radical plans for the fund, proposing to shift up to $38 billion into alternative investments in the years ahead. Referencing the five years it took the fund to recover from stock market losses suffered in 2001-02, former TRST Chairman Jarvis Hollingsworth said last year that the transition toward alternatives "will guard against the downturns of the markets" and provide the "opportunity for more robust returns." In California, the $8.4 billion San Diego County Employees Retirement Association has kept 15% of its assets in hedge funds, even though it was burned by its investment in **Amaranth Advisors**, a hedge fund that collapsed in 2006.

But even among public sector plans that are in good shape, such as New York State's, alternatives are becoming a more significant part of the mix. In its last annual summary through March 2007, New York's $155 billion plan had 3% of its assets in hedge funds, three times the level of the previous year, and another 6.5% in private equity. The $245 billion California Public Employees Retirement System

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(Calpers) last year approved a new allocation range that could double its hedge fund commitment to more than $10 billion.

Although public pension plans are now the largest and fastest-growing class of investors in hedge funds, accounting for 24% of AUM, according to Private Equity Intelligence, endowments and private pensions are also key players, at 17% and 14%, respectively. To appreciate the extent to which such investments have become commonplace among institutions, consider that even prep schools are getting into the act, with the elite Phillips Academy committing one-third of its $800 million endowment to hedge funds.

The increasing demand from deep-pocketed institutions for hedge funds is evident in the rapid growth of AUM, which in the four years through 2007 doubled to $1.9 trillion worldwide, according to Hedge Fund Research (HFR). Fund inflows continue to set records, with HFR placing the 2007 number at $194 billion and Hennessee Group figuring $278 billion. Although the subprime meltdown and resultant implosion of several hedge funds have revived concerns about performance and risk management, most observers expect, and surveys suggest, that demand for hedge funds will remain strong.

In a major survey of North American financial consulting firms just released by Casey Quirk & Associates and eVestment Alliance, nearly 80% said they expect this year to “focus on alternatives,” with hedge funds and fund of hedge funds the most sought-after products. Among pension consultants, 90% said they expect to see increased demand for alternatives (consultants say “distressed strategies” will be in particular demand). Private Equity Intelligence projects public pension plans worldwide will increase their average hedge fund allocation to 8% to 9% over the next two years.

A 2007 **JPMorgan Asset Management** survey of European institutional investors representing $3 trillion in assets shows that since 2004, the percentage of these institutions holding hedge funds and the average portfolio allocation have both doubled to 42% and 5.1%, respectively. Among hedge fund investors, 63% expect to increase their holdings; however, among investors with no hedge fund exposure only 12% plan to make such an investment.

In the years ahead, observers believe hedge funds will receive an additional boost from an increasingly high-profile institutional player, sovereign wealth funds, whose assets now total around $3 trillion — a number **Morgan Stanley** projects will reach $12 trillion by 2015. In a harbinger of that anticipated demand, **China Investment Corp.** last year took a direct 10% stake in **Blackstone Group**, which manages hedge fund investments in addition to its primary private equity business.

As institutions displace wealthy individual investors as the industry’s driving force, the money has been gravitating toward the largest and best-known funds, which are associated with greater levels of safety and transparency. Absolute Return figures that assets among the 262 largest hedge funds (managing $1 billion or more) increased 34% last year, or $407 billion, the greatest one-year gain since the magazine began tracking such data in 2003. Morgan Stanley estimates that the top 100 hedge funds accounted for 67% of AUM in 2006, an 18-point gain since 2003. By Private Equity Intelligence’s reckoning, institutions account for 75% of assets among hedge funds managing $25 billion or more, and a similar percentage among firms in business at least 14 years.

Their eyes clearly focused on both money flows and margins — a 2007 McKinsey & Company study of “traditional” U.S. asset managers showed that alternatives in general accounted for 15% of institutional assets but 36% of revenues — investment banks, diversified financial services companies and pure asset managers have become more aggressive in either enhancing an existing hedge fund portfolio, or adding that capability.

In 2006 and 2007, there were a total of 58 deals in the hedge fund sector, compared with just 25 in the previous three years, and the value of deals in 2007 was a record $8.4 billion, more than double the total for the previous four years. In the first quarter of 2008, dealmakers continued to invest aggressively in hedge funds, even as the credit crisis and economic slowdown exacted a heavy toll on the larger M&A universe. (In the first quarter, the value of deals worldwide dropped 24% to $730 billion, with U.S. activity off 51%, according to Thomson Reuters.)

Perhaps the busiest player has been Morgan Stanley, under the leadership of John Mack, who returned to the firm as chairman and CEO in 2005 pledging to fire up its under-performing asset management business. In line with that commitment, Morgan Stanley has cut seven hedge fund deals involving diverse managers since 2006. The largest was for **FrontPoint Partners**, a Greenwich, Conn.-based firm that pursues an absolute return strategy. Morgan Stanley took 100% ownership of FrontPoint — where AUM has jumped more than 50% to $9.3 billion since the transaction closed in 2007 — but five of the deals involved minority stakes. (The other majority acquisition involved a small Boston-based firm, Oxhead Capital Management.)

That minority-investor strategy, evident in many industry transactions, delivers a range of benefits. For buyers, it immediately adds new or additional in-demand products to an existing asset management portfolio, along with a potentially dynamic long-term investment. At the same time, a minority stake limits a buyer’s risk while allowing a successful target to maintain its management and culture. For sellers, the benefits often include easier and more attractive access to capital, along with expanded distribution and the cachet that comes from affiliating with a brand-name firm. In addition, these deals provide sellers the opportunity to capitalize part of the business without ceding control.

Referring to Morgan Stanley’s strategy, Stuart Bohart, head of the alternative investments unit, told BusinessWeek in November 2006 that the company’s goal “is to participate in the growth of firms that are on the cusp of going from being a hedge fund to an investment management firm.” He added: “We want people to hold Morgan Stanley out as the investment management firm that can offer access to the world’s best portfolio managers. Some of those will work here, and some of them will be outside.”

Like many buyers, Morgan Stanley has also been seeking targets worldwide, with three of its investments involving non-U.S. firms. For the hedge fund industry as a whole, cross border deals accounted for a combined 42% of M&A activity in 2006 and 2007. In Europe, Morgan Stanley acquired 19% of **Lansdowne Partners**, a London-based

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multi-strategy firm whose AUM had more than doubled to $12.5 billion prior to the deal in 2006 and has since reached $19 billion.

In its most recent investment, announced in April of this year, Morgan Stanley took a minority stake in another London firm, 7-month-old **Hawker Capital (Cayman) Ltd.**, which focuses on commodities. (Interestingly, the firm has a research office in China, a voracious consumer of commodities.) In Asia last year, Morgan Stanley bought a "significant" minority interest in another start-up, **Abax Global Capital**, which pursues special situations in China, Hong Kong and Taiwan. As a result of all this activity, Morgan Stanley's alternative AUM jumped 44% in the year through the first quarter of 2008, to $111 billion, accounting for 19% of total assets, and half of the 74 new investment products the firm offered last year were classified as alternatives.

Morgan Stanley has been joined on the acquisition trail by several of its investment banking neighbors in New York. **Lehman Brothers** has acquired minority stakes in five hedge fund managers, including the 20% it took last year in **D.E. Shaw**, one of the largest hedge fund managers in the world. **Merrill Lynch** and **Goldman Sachs** have also made acquisitions of hedge funds, with Goldman cutting deals this year for minority shares in New York credit specialist **Claren Road Asset Management** (AUM: $2.7 billion) and London relative value and macro manager **Capula Investment Management** (AUM: $3 billion). Goldman concluded those deals through its **Petershill** private equity fund, which was capitalized with $500 million last year to make investments in hedge funds. In 2007, Petershill also acquired a 10% stake in **Winton Capital Management**, a fast-growing London managed-futures investor with $10 billion in AUM at the time of the deal.

Along with banks such as **BNP Paribas**, **Citigroup** and **Fortis**, and asset managers like **Affiliated Managers Group, BlackRock, EFG International** and **Threadneedle Asset Management**, insurers are also testing the waters. These include **American International Group**, **Aviva** and **Swiss Re**, which last year bought a 15% stake in one of Europe's largest hedge funds, **Brevan Howard**.