

STRENGTH FROM KNOWING™
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The Future of Hedge Fund Investing

Presentation to National Council on Teacher Retirement
October 13, 2009

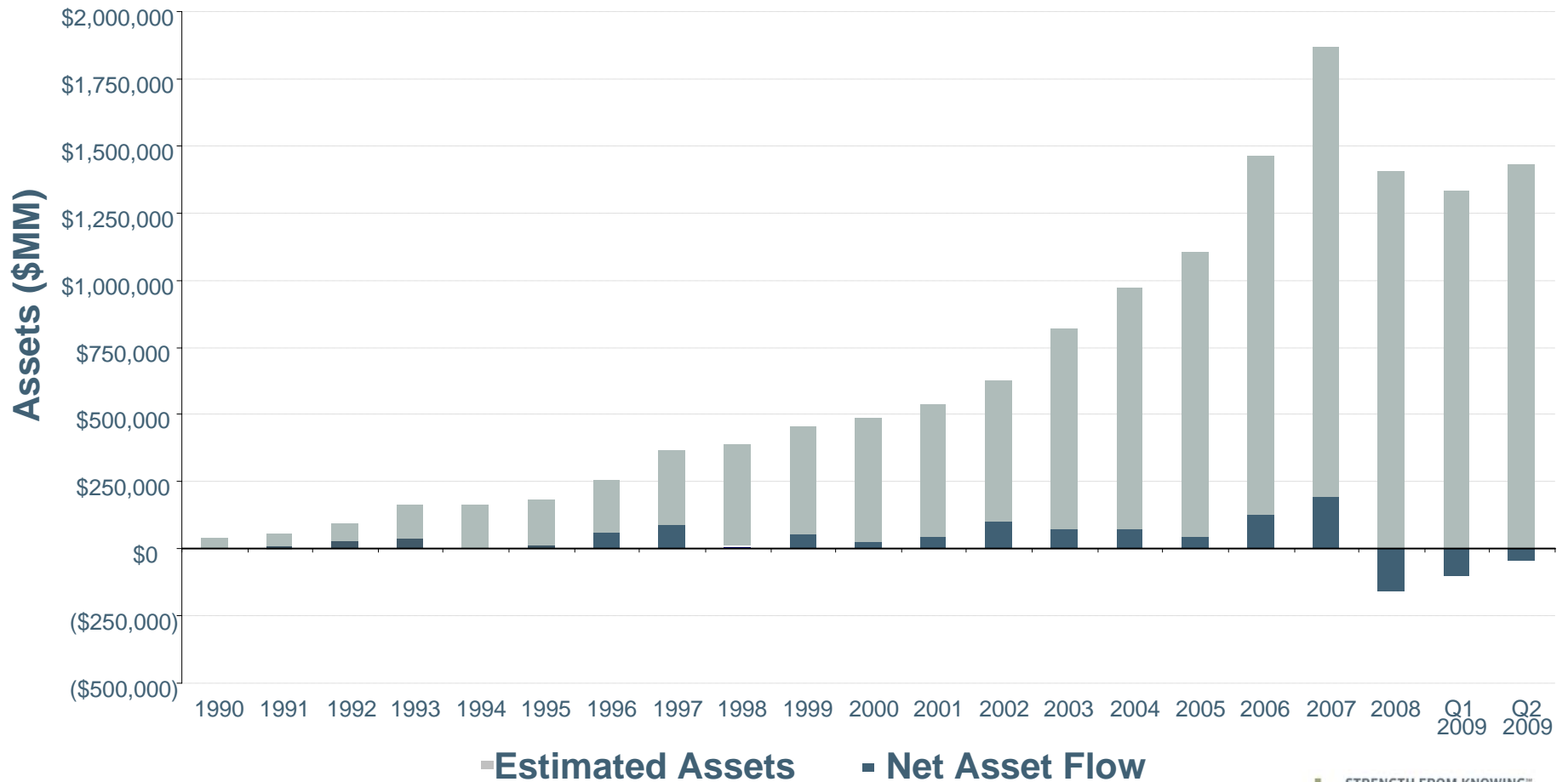
Keith Black, CFA, CAIA, Associate



Hedge Fund Growth

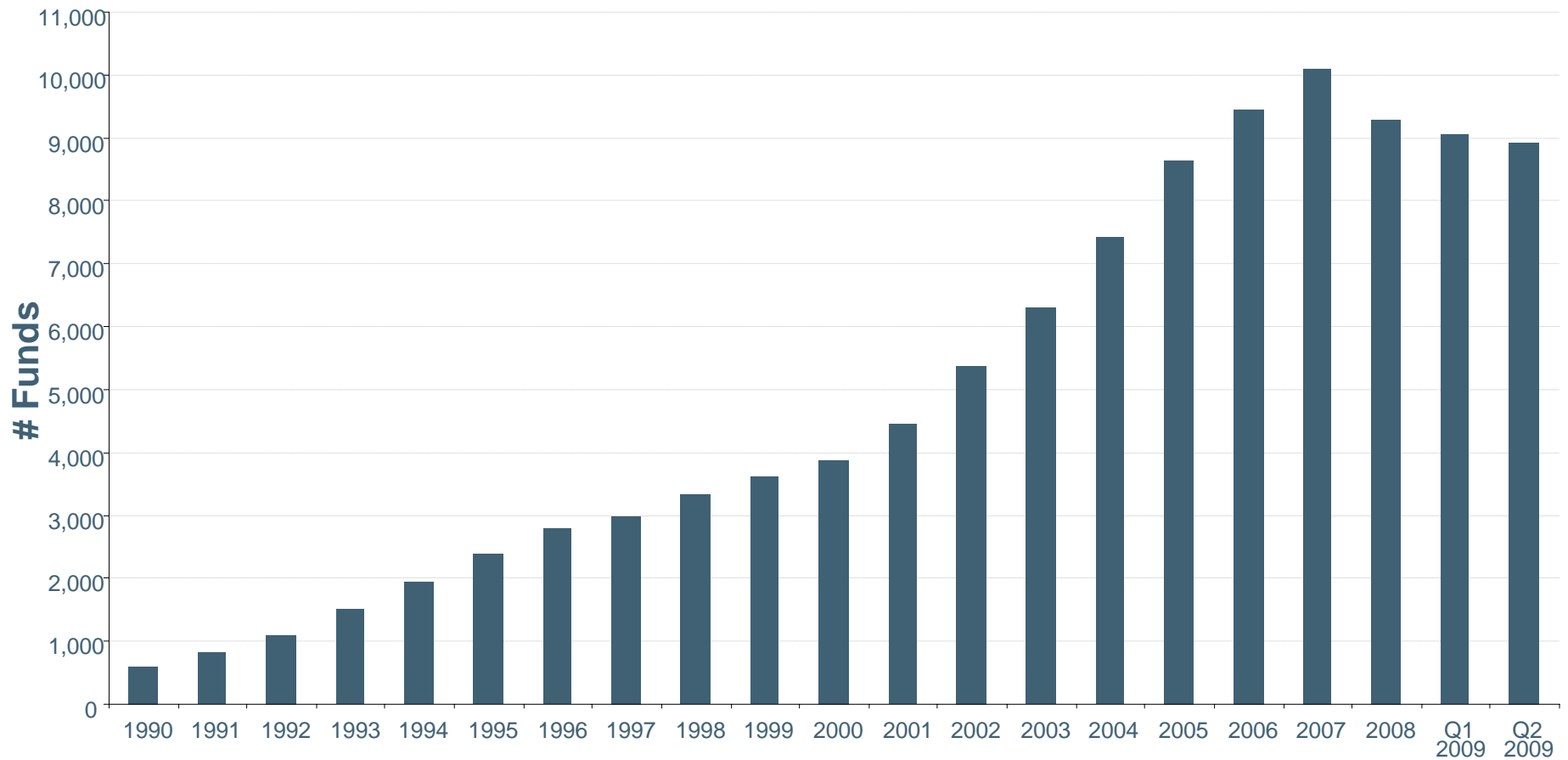
- The hedge fund industry enjoyed significant growth over the past two decades
 - In 1990 there were approximately 600 hedge funds, now there are over 8,800 hedge funds
 - In 1990, hedge fund assets totaled approximately \$40 billion, with current AUM estimated as \$1.3 trillion
 - Assets and funds declined rapidly in 2008 from both redemptions and negative performance
 - The last five quarters saw net outflows of nearly \$260 billion, contributing to the demise of over 1,200 funds

Estimated Growth of Assets / Net Asset Flow Hedge Fund Industry 1990 – Q2 2009



Source: HFR

Hedge Fund Growth (cont'd)



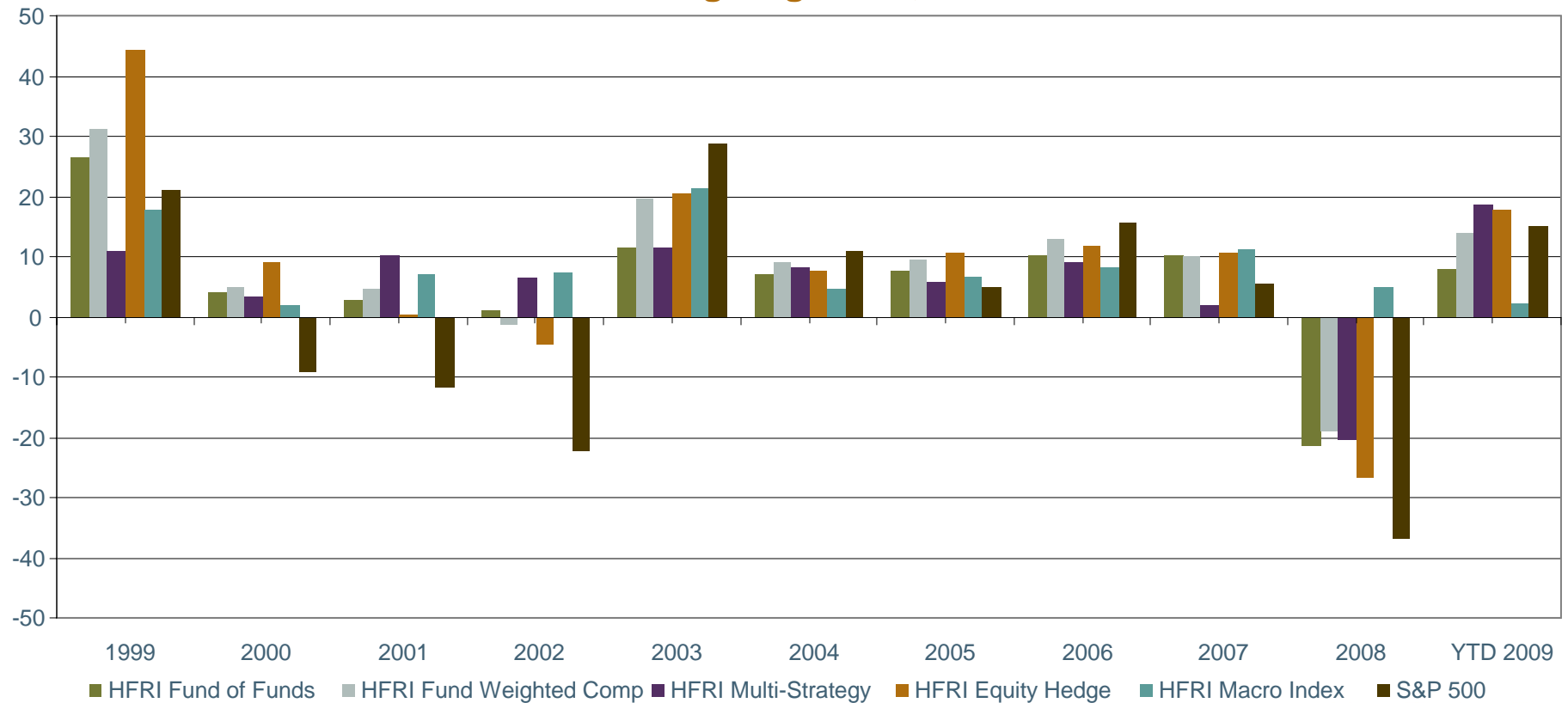
Source: HFR

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Hedge Fund Performance

Hedge Fund Performance 1999-2009 Ending August 31, 2009



Source: HFR

Declining Hedge Fund AUM

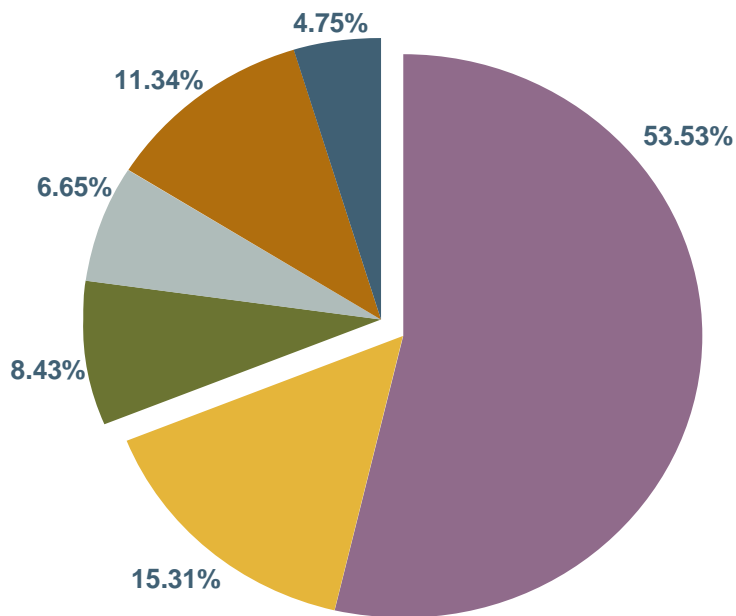
- Investors pulled approximately \$260 billion from hedge funds over the last six quarters
- When combined with market losses, this brought hedge fund AUM down 28% from year end 2007
 - Another \$300 billion in hedge fund assets were subject to some sort of restriction on withdrawals by the end of 2008
- A survey of 1,000 investors (that in aggregate held \$1.1 trillion in hedge fund AUM) forecasted hedge fund market declines would be steeper still in 2009
 - Assets were forecasted to fall to approximately \$1.33 trillion by year-end, or approximately 33% from their mid-2008 high water mark. Will redemptions increase further after reaching this asset level?

*Deutsche Bank survey

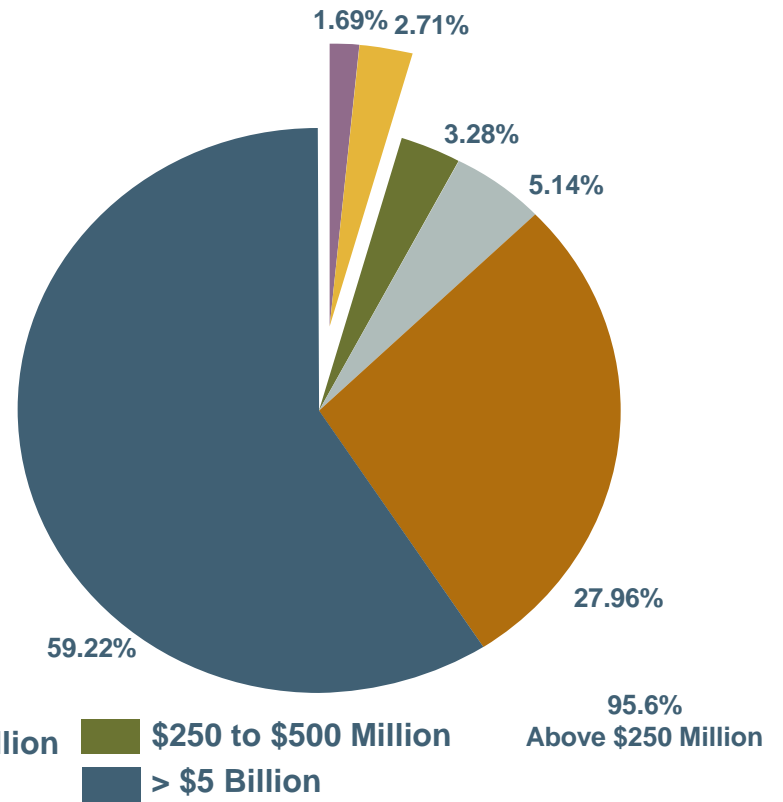
Distribution of Industry Assets by Fund AUM Tier Q2 2009

31.17%
Above \$250 Million

By # Funds



By Fund AUM Size



< \$100 Million
 \$100 to \$250 Million
 \$250 to \$500 Million
 \$500M to \$1 Billion
 \$1 to \$5 Billion
 > \$5 Billion
 95.6%
Above \$250 Million

Source: HFR



Industry Consolidation

- The hedge fund industry is Darwinian, even during good times
 - Industry consolidation was well underway before the events of the last 18 months unfolded; the big were getting bigger and the small were going out of business
- 2008 was the first time hedge fund liquidations exceeded hedge fund launches
 - After Q109, there were 1,000 fewer single manager hedge funds and 200 fewer funds of funds
 - In calendar 2008, 1,400 hedge funds liquidated while only 600 were launched

Industry Consolidation (cont'd)

- It has been estimated that the top 15% of managers (in terms of assets under management) control 85% of hedge fund assets
 - Institutional investors require quality managers
 - 1,200 funds with over \$500m AUM control \$1.1 trillion of industry assets
 - 6,600 funds with under \$200m each control only \$110 billion
- Attrition rates are expected to spike in 2009
 - “The consolidation is happening right now. By summer it will be done and dusted....I would say that if half (of all hedge fund managers) had to close, I wouldn't be surprised.”*

*Ken Kinsey-Quick, Head of multi-manager products at Thames River Capital

The Future of Hedge Fund Investing

- Viability concerns for certain hedge fund strategies
- Shift in power from fund managers to investors and funds of funds
- Shift to an institutional focus (which was already underway) will accelerate
- Changing economics for hedge fund managers
- Investors will be forced to re-think where hedge funds fit within their investment program

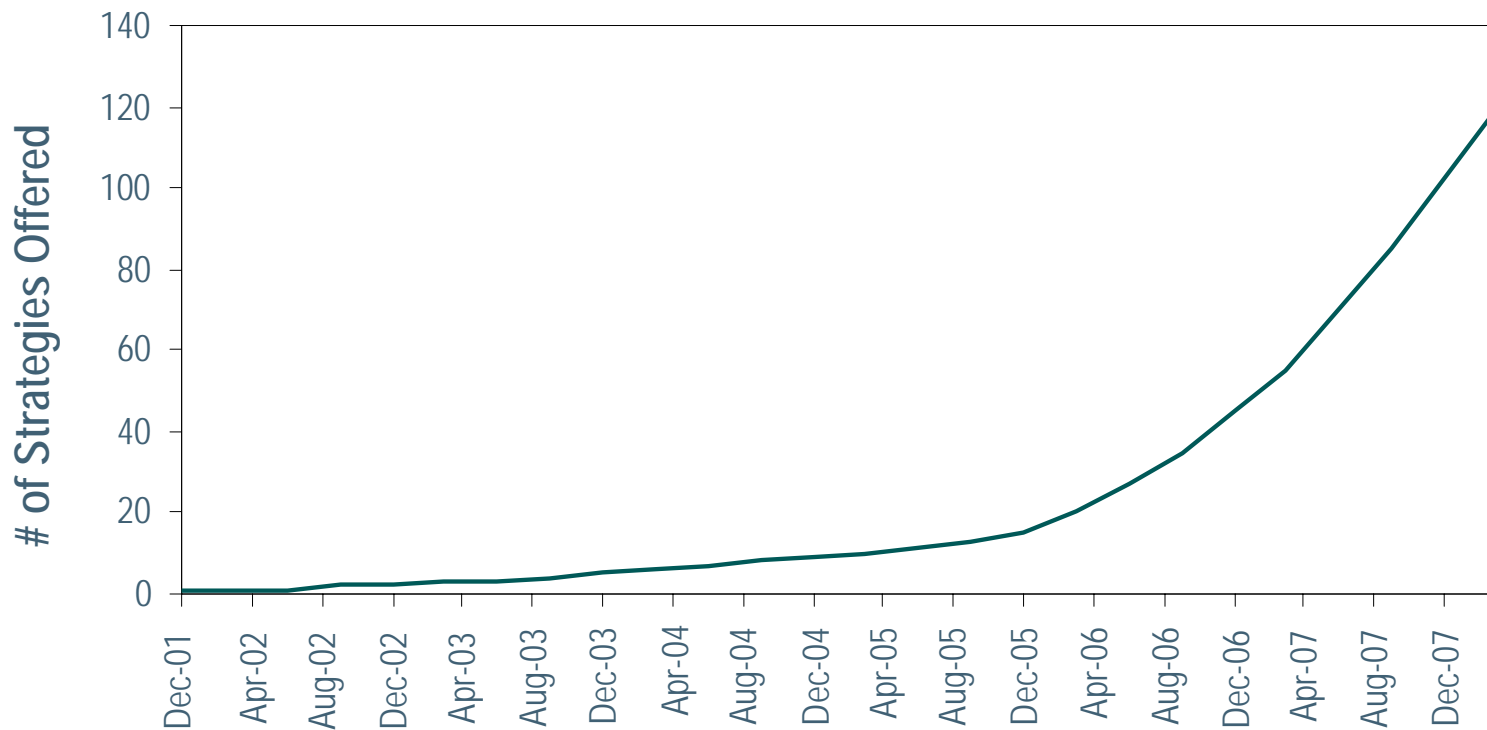
Strategies with Viability Concerns – 130/30

- In early 2008, a Merrill Lynch study* found that 16% of investors utilized 130/30 strategies
 - 1/3 of those surveyed expected to initiate or increase allocations to 130/30 strategies in the next 36 months
- 130/30 offerings proliferated as managers reacted to institutional demand

*160 institutional investors surveyed with aggregate assets of approximately \$1.5 trillion

Strategies with Viability Concerns – 130/30 (cont'd)

Growth of 130-30 Strategies



Strategies with Viability Concerns – 130/30 (cont'd)

- **But the events of 2008 have put the brakes on 130/30s**
 - Limited and more costly prime brokerage availability
 - Increased counterparty risk
 - Regulatory issues related to short selling
 - Widespread risk-aversion
 - Long-side now more attractive
- **We do not believe 130/30 is dead....but it is wounded**
 - Interest is likely to be drastically diminished over the next few years

Strategies with Viability Concerns – Portable Alpha

- Portable alpha is only viable if the alpha is beta free
 - Even then there are risks as portable alpha is, in essence, a leveraged portfolio
- 2008 proved that pure alpha engines are few and far between
- Many portable alpha programs were devastated, as “alpha” losses of 15%-25% were layered on top of substantial beta losses
 - Liquidity issues exacerbated problems
- We expect investor interest in portable alpha to be low for the next several years

Strategies with Viability Concerns – Hedge Fund Replication

- Hedge fund replication strategies were beginning to gain favor in recent years
- These strategies attempted to replicate hedge fund returns by capturing the traditional market exposure present in hedge funds
 - Hedge Fund Index Return = F(SPX return, HY return, Emerging Markets, Small-Large, etc)
- As expected, these strategies fared poorly in 2008
- We never believed that these strategies had a place in investors' portfolios

Strategies with Viability Concerns – Highly Levered Strategies

- Strategies that utilize large amounts of leverage to coax big returns out of small arbitrage opportunities, such as fixed income arbitrage, face two problems
 - Leverage is more expensive and/or less available
 - Investors tolerance for risk / leverage has decreased
- With more volatile markets and higher credit spreads, return and volatility targets might be achieved without leverage

Changing Dynamics Between Hedge Fund Managers and Investors

- The hedge fund industry has historically been a seller's market
 - Demand outstripped capacity
- The events of 2008 have spurred a change in this dynamic, at least at the margin
 - Fee concessions, increased transparency, more investor-friendly fund structures
 - More funds are open to new investors, separate accounts are now more prevalent
- More hedge funds are allowing secondary trading of LP interests
- Managers now prefer “sticky” assets, such as those from pensions, endowments and foundations

Changing Dynamics Between Hedge Fund Managers and Investors

- Some high profile public funds (Utah, CalPERS) and endowments (NACUBO) are attempting to organize institutional investors to tip the scales further
- **Increased transparency**
 - Position level transparency
 - Explicitly track leverage and tier 3 liquidity exposures
- **Increased liquidity**
 - Separate accounts eliminate the impact of gates, lock-up periods, and suspended redemptions
- **More rational fee structures**
 - Management fees should decline as investor assets and hedge fund assets rise
 - Increased use of hurdle rates
 - Performance fees may be deferred or subject to clawback provisions

Increasing Institutional Focus

- Hedge funds used to cater almost exclusively to wealthy individuals
- Over the past decade, hedge fund managers have gradually shifted their focus to institutions
- This trend is likely to accelerate for three reasons:
 - Many of the “super rich” are now, at best, “rich”
 - Madoff and subsequent scandals will raise the back office/infrastructure bar substantially
 - Institutions now control the majority of hedge fund assets

Increasing Institutional Focus (cont'd)

- Going forward we expect the funds with the largest asset growth will be those that offer:
 - Increased transparency
 - Robust back office
 - Investor friendly structures and reporting
- Registration may also play a key role

Changing Economics

- Hedge fund management is a high margin business
 - Falling incentive fees hurt industry economics in 2008
 - It is estimated that the hedge fund industry lost 10,000 jobs in 2008*
 - Another 20,000 positions are forecasted to be cut in 2009*
- In order to make Alpha Magazine's top 25 hedge fund earners list in 2007, a manager needed to turn a \$360 million profit
 - To make the list in 2008, a manager "only" needed to earn \$75 million
- The specter of tax law changes also looms
 - The Obama administration has proposed that carried interest be taxed as ordinary income instead of capital gains starting in 2010

*Options Group

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Changing Economics (cont'd)

- Some managers have begun lowering fees fees in an attempt to lure/retain clients
 - Perry Partners
 - Renaissance Technologies
 - Citadel
- The entrance of traditional asset managers into long-short equity funds is hastening fee reductions
- Successful implementations of hedge fund replication would also pressure fees

What Role Do Hedge Funds Play in the Portfolio?

- Hedge funds are a true bastion of active management of a broad variety of investments
- Hedge funds generally held up much better than equities during 2008
- The problem was many investors considered their hedge fund / absolute return allocation as part of their “low risk” bucket
 - Fund of funds positioned themselves as a bond substitute
 - Historical volatility (pre 2008) in line with bond volatility
- Many plans will need to re-asses the risk of their hedge fund allocation and reposition their portfolio accordingly
 - Some hedge funds may legitimately be allocated to the equity or fixed income asset class



Current Market Conditions

- The 2008 market environment drastically changed the hedge fund landscape
 - Fewer hedge funds with less assets under management
 - Reduced availability of leverage
 - Forced liquidations by hedge funds and the exit of banker's proprietary trading desks
- Could this provide enhanced opportunity for hedge fund managers, as there is a shortage of capital and liquidity?

Will Hedge Funds of the Future be Less Risky?

- Several trends suggest that this could be the case
- Reduced use of leverage
- Consolidation of assets with institutional quality managers
- Enhanced use and tolerance of tough due diligence questions by investors
- Increased use of separate accounts and third party transparency systems