

Convergence and divergence:

New forces shaping the investment universe

FINANCIAL SERVICES

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Acknowledgements

This is the sixth in a series of research reports produced jointly by KPMG International and the think-tank CREATE-Research.

This latest report highlights the forces of convergence and divergence between and within long-only and alternative investments. In so doing, it aims to address the means by which the investment universe is being impacted by the increasing importance and influence of alternative investments.

Our foremost thanks go to the 348 companies from 28 jurisdictions who have participated in the research.

We would also like to offer our special thanks to those 105 CEOs, CIOs and Board Directors who participated in our face-to-face structured interviews. Their insights and foresights have helped to produce a most comprehensive picture of the global investment industry as it faces an increasingly challenging environment.

We would also like to thank members of the editorial board and other colleagues around the world who have helped us in carrying out this research: in particular, Nick Hopwood, Nina Muelders and Shiana Saverimuttu at KPMG in the UK, Joanne MacPhee at KPMG in Bermuda, and Belinda Lee and Barbara Martin at CREATE-Research.



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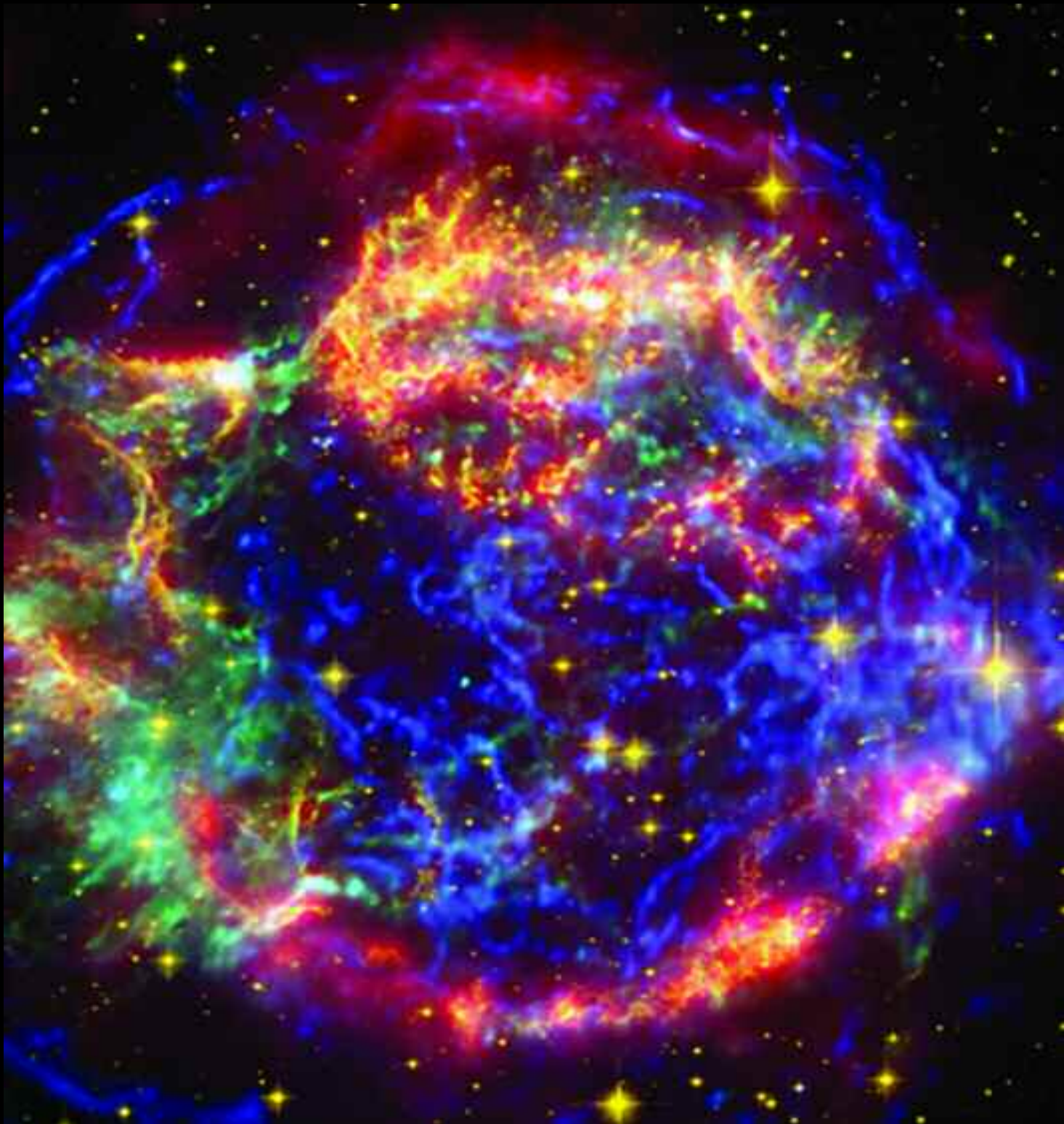
CREATE is an independent think-tank, specialising in the emerging business models in financial services. It undertakes major research assignments from prominent financial institutions and global corporates. CREATE's advisors work closely with key decision makers on both sides of the Atlantic. Their work is disseminated through high profile reports and events which attract wide attention in the media.

The anonymous interview quotes throughout this document were obtained during the face-to-face interview stage of the research project. The information reflected in the graphs and charts was obtained by KPMG International and CREATE-Research during both the face-to-face interview stage and questionnaire stage.

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1 Executive summary



Aims and background of this report

This is the sixth in the annual series of reports on global investment management produced jointly by CREATE-Research and KPMG International. The previous ones were:

- *Building Capability for the Twenty First Century (2002)*
- *Revolutionary Shifts, Evolutionary Responses (2003)*
- *Raising the Performance Bar (2004)*
- *Hedge funds: a catalyst reshaping global investment (2005)*
- *Towards enhanced business governance (2006).*

“Markets can remain irrational longer than you can remain solvent”

John Maynard Keynes,
economist (1883–1946)

In recent years the market generated a demand for new ways to make money while managing risk, sparking a new wave of convergence and divergence. This report explores the ways in which the investment universe is changing by looking at five issues:

- *What factors are driving convergence in investment management?*
- *What is its nature, scope and scale so far?*
- *What benefits have accrued to clients and their managers?*
- *Will the recent turmoil in the markets slow down its pace?*
- *What further actions will improve the benefits of convergence in future?*

The assessment of each of these issues is based on two strands: global surveys followed by structured interviews. Surveys were carried out separately for three sets of key players:

- *long-only and alternative investment managers*
- *pension funds*
- *administrators of long-only and alternative investments*

The study has benefited from the participation of 239 investment managers from across the long-only and alternative investment sectors; 61 pension funds and 48 administrators; altogether covering 28 jurisdictions (see below). Participating managers and pension funds together have around US\$28 trillion under management. The administrators have US\$38 trillion under administration. The interviews involved top executives in over 100 companies and also included prime brokers and lawyers in addition to the surveyed groups. The resulting findings, which form the basis of this report, are thus underpinned by the most comprehensive and broadly based research ever carried out on the future of investment management.

Geographical spread of participants

Australia	China	Guernsey	Japan	Taiwan
Bahamas	Curaçao	Hong Kong	Jersey	The Netherlands
Belgium	Denmark	India	Luxembourg	UK
Bermuda	Finland	Ireland	Norway	US
Canada	France	Isle of Man	Singapore	
Cayman Islands	Germany	Italy	Switzerland	

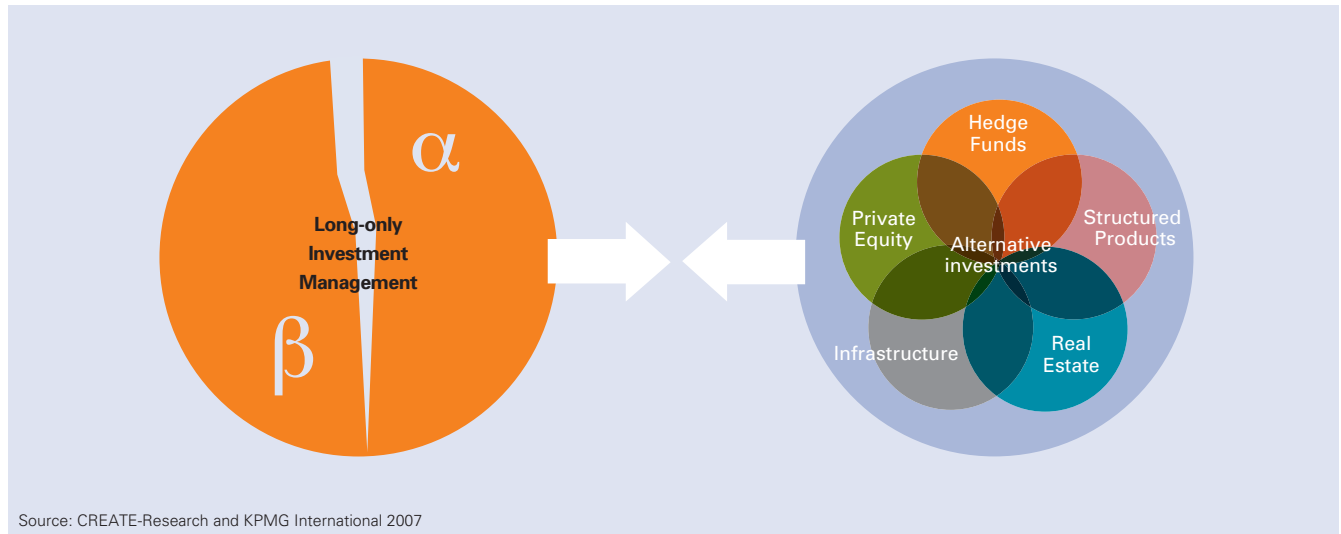
Headline messages

- Convergence is occurring as managers have diversified into new strategies that are outside their normal sphere of expertise. There are three principal trends:
 - a) Between long-only and alternative investments; long-only managers adopting alternative techniques and vice-versa
 - b) Between alternative investments – ‘product widening’. For example, private equity managers adopting hedge fund techniques and vice-versa
 - c) Within asset classes – ‘product deepening’. For example, a UK real estate fund expanding its portfolio into Europe.
- Convergence is neither universal nor unequivocal: within each sector, managers have fallen into three groups: purists, who have stuck to their core capabilities; pragmatists, who have diversified; and procrastinators, who have considered change without actions.
- Managers want to run exciting products, which is also predicted by their administrators, while investors want something they can understand that delivers good results. Real estate, infrastructure and private equity are most favoured by investors. This mismatch needs to be addressed.
- Convergence between managers, the increasing complexity of financial instruments and a changing investor base are likely to drive up the demand for risk specialists who can stress test portfolios, do independent valuation and enhance overall transparency.
- The recent credit crisis will spark flight to quality favouring a new wave of customised structured finance products with principal protection and transparency as the main features.
- As a knock-on effect, third party administrators will grow rapidly by developing new skills and capabilities for new asset classes, driven in part by the institutionalisation of alternative investments.

- The private equity industry will no longer be so private as governments and investors continue to demand more transparency, independent administration and new fee arrangements.
- Many hedge funds are absorbing the shock of the recent credit crisis through their contrarian strategies.
- Performance related fees are likely to become ever more popular as pension funds continue to force different fee structures for alpha and beta products.
- The demand for talent is outstripping supply in all corners of the market. This is likely to create retention difficulties and an increased inflationary pressure in the industry.
- The recent credit crisis is likely to slow down the pace of convergence between long-only and alternative investments as it takes its toll on managers in all sectors but it won't reverse the thrust.
- The pace of convergence in future will rest on managers' ability to deliver attractive returns, while ensuring that the nuts and bolts of operations are tight.
- Growth expectations for the next three years have fallen to average single digits for all asset classes in long-only and alternative investments.
- The investment industry will continue to consolidate with M&A activity occurring within and across all segments of the sector as organisational convergence mirrors product convergence.

These points are developed in detail in Sections 2, 3 and 4, which outline the views expressed by three sets of players in the long-only and alternative investment sectors. The 12 key themes emerging from their assessment of convergence and the future of investment management are given in the rest of this executive summary.

Theme 1: Convergence is greatest between alternatives and long-only managers



“Convergence has involved incremental diversification in opportunistic types of strategies, with no radical change in existing business models”

During this decade, explosive growth in the alternative investment industry has sparked transformational shifts in the investment universe. Skill is everything. Market-driven returns have become a commodity. In the ensuing separation of alpha and beta, investment managers across the space have diversified on a scale which has initiated a convergence in strategies, structures and cultures. Regulatory changes have encouraged the process.

“Larger hedge fund managers are becoming institutionalised”

Active long-only managers are getting closer to the alternatives sector; which is itself witnessing the convergence of hedge funds, private equity, real estate, infrastructure and structured products.

“130:30 approach is another mousetrap”

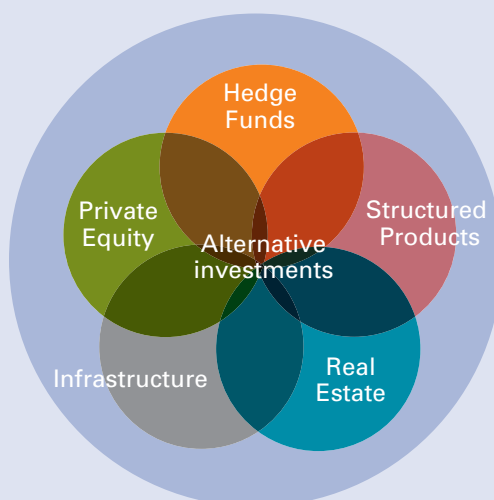
Thus far, convergence between long-only managers and hedge funds has been largely tactical in nature. Each has modestly ventured into the other’s area without major changes to their business model. A whole new class of products is emerging that sits somewhere between hedge funds and active long-only, and which has the potential for significant growth. This will produce more strategic change in the industry going forward.

“There is an illusion that there is a huge pool of alpha opportunities. In fact, it is full of piranhas”

Whether strategic or tactical, one in every three alternatives managers and two in every five long-only managers report strategy convergence over the past three years.

Long-only managers have attempted three things when entering the alternative investment world. First, using a regulatory device like UCITS III, they have offered hedge fund like products for retail investors. Second, using hybrid products like 130:30 and Global Tactical Asset Allocation (GTAA), they have widened the choice for their institutional clients. Third, via M&A, they have aimed to acquire alpha generation skills. Hitherto, many had suffered a talent drain into alternatives.

Theme 2: Convergence between alternatives is a mixture of opportunistic and strategic



Source: CREATE-Research and KPMG International 2007

“In five years time, some alternative managers will be larger than the top 5–10 investment banks”

Within the alternatives sector, convergence has occurred at the tactical and the strategic level with some managers experiencing significant changes in their business models.

“Due to a lack of investor education, innovation of new products will continue to the detriment of institutional investors”

Cheap credit, low volatility and rising equity markets had, until last summer, encouraged many hedge fund managers to make tactical forays into private equity, looking for returns. For the same reasons, many made small investments in real estate, structured products, and, to a lesser extent, infrastructure.

“Elephants can’t run like gazelles – it’s hard to do”

More strategically, some hedge funds have created permanent capital through fund listings, debt finance and ‘side pockets’ to enable them to make a more serious entrée into illiquid asset classes. Diversification into new strategies with different cycles helps smooth revenue streams for managers who have done IPOs, or who are considering doing so. Attractive fee structures and remuneration helps to attract specialist managers. Some hedge funds adopt activist approaches more akin to the buy-out market.

“In this business, you are either distinct or extinct”

A number of larger private equity groups have expanded into real estate, infrastructure or hedge funds, or a combination thereof. Real estate managers have moved into infrastructure, and a small number of real estate hedge funds have emerged. The lines are blurring, and on some deals private equity, real estate and infrastructure managers compete for assets in auctions. Structured products are pervasive, and have emerged in each sector in different forms.

A small number of mega managers are emerging, with assets approaching US\$100 billion and a full suite of alternative investment products. Some of these managers have begun to compete with investment banks, and some have raised capital in the debt and equity markets. New models are emerging. The balance of power is shifting.

Theme 3: Convergence is far from uniform, characterised by purists, pragmatists and procrastinators

Proportion of purists, pragmatists and procrastinators across the sectors



Source: CREATE-Research and KPMG International 2007

“Anyone with a five year time horizon should pay the equity risk premium. The reports of its death are exaggerated”

“Stock picking skills boil down to gut feelings”

“Much of hedge funds’ activities are equivalent to running onto a motorway to pick up pennies”

“Long-only managers have been knocked off their perch. They are history; yet pretend to be wannabes in the hedge fund world, with gimmicks like 130:30 funds”

As hedge fund managers and private equity firms went on the offensive by promising uncorrelated returns, long-only managers have gone on the defensive by offering products that mimic the returns offered by their new competitors. Those hedge fund managers and private equity firms who have done IPOs or are planning one have duly responded by venturing into the long-only space in order to secure stable revenue streams preferred by external shareholders. So far, the most extensive convergence in alternatives has been between hedge funds and private equity, some of it has even spilled over into investment banking activities.

That said, convergence is far from uniform. Within each sector, managers have fallen into one of three groups:

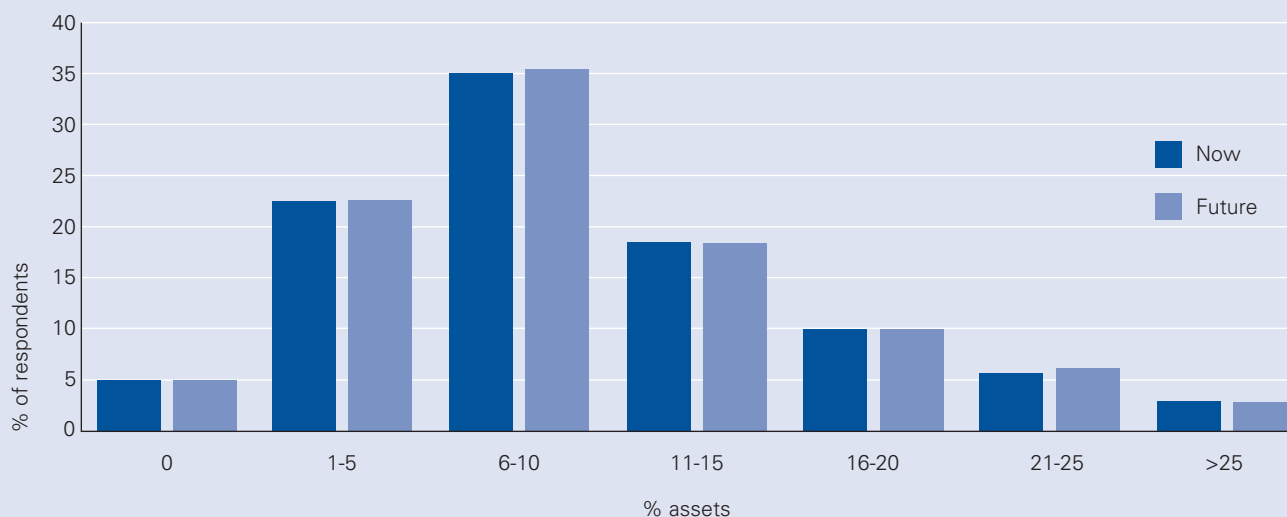
- Purists, who have stuck to their core capability. They see diversification as a dysfunctional distraction
- Pragmatists, who have diversified. They see opportunism as vital when clients’ risk appetites change
- Procrastinators, who have considered change but have yet to act on it. They use the rhetoric of convergence but not much else.

While pragmatists are redefining the contours of their sector by doing new things, the purists are standing out from the pack by doing old things better. Thus, convergence and divergence characterise today’s investment universe. Examples of pragmatists include: private equity firms moving into hedge funds and real estate; hedge funds moving into private equity; and long-only funds emulating hedge funds.

Notably, the universe is also hotting up under a new competitive wave that is institutionalising the alternative investment industry. On the demand side, pension funds have made allocations. On the supply side, their managers are creating an infrastructure of governance and systems that meet their clients’ fiduciary obligations. Either way, infrastructures as well as strategies are being emulated. Relative returns and benchmark hugging are lost in the black holes of the new cosmos.

Theme 4: Pension funds have diversified but the pace will slow over the next three years due to the knock-on effects of the recent credit crisis

What proportion of your assets is now held in areas into which you have diversified in the last 3 years; and what proportion will it be over the next 3 years?



Source: CREATE-Research and KPMG International 2007

“This is a ridiculous market. People are not thinking sensibly any more”

“The ‘Yale’ effect has created an army of lemmings; most of whom will not live to experience it”

“The July turmoil in the credit markets show that too much of a good thing can be very bad for you: it will have a big fall out”

“We may invest up to 10 percent of our reserves in hedge funds; if they succeed despite recent conditions”

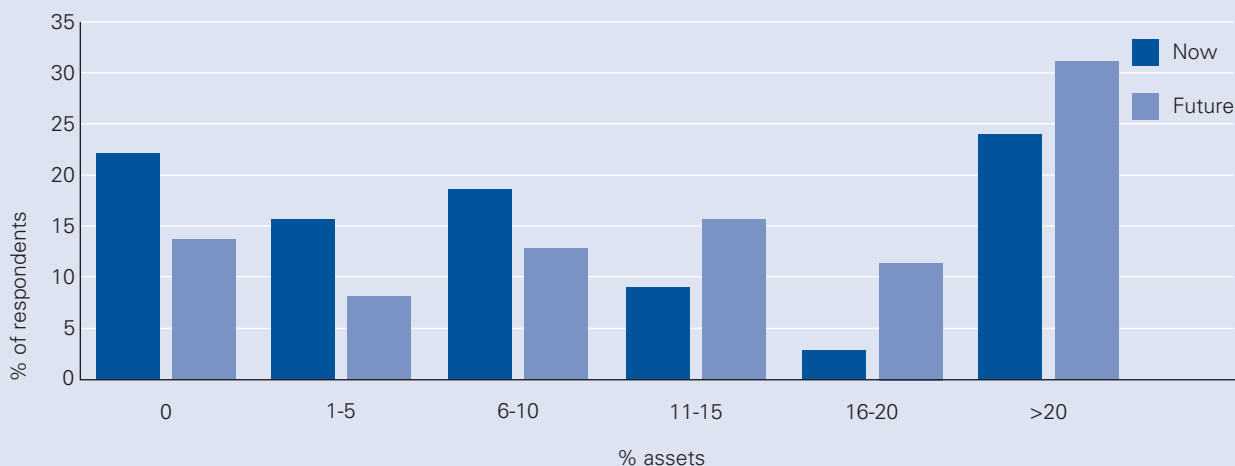
The contagion from the recent sub-prime market is likely to slow down the evolving convergence in the short term but it should be noted that there are managers in some asset classes who have performed very well during this uncertain period. When making allocations to alternatives, pension funds worldwide have followed a meticulous process, in line with their fiduciary duties. In many cases, it has taken three years to make the decision and another one to implement it. These periods will get even longer.

Nevertheless, around two in every three pension funds have diversified their asset base by up to 10 percent in the last 3 years, and a further 3 in 10 by over 10 percent. These numbers are impressive in the light of the restrictive nature of accounting and regulatory changes since 2004 – especially in Europe. Everywhere, pension funds have been attracted into alternatives on the promise of high uncorrelated absolute returns. The recent market volatility will be an acid test of whether such returns can be delivered in good times and bad.

Many pension funds expect a tiny minority of alternative investments to do exceptionally well, capitalising on the recent market volatility; with the rest turning in either poor or lack-lustre performance. Extreme caution will be their motto. Besides, like their European peers, pension funds in the US may also be forced to readjust their portfolios in the light of new rules that are now being implemented there on funding levels, earnings smoothing and mark-to-market pricing. Some of them disfavour anything perceived as overly risky. They favour some types of structured products – like constant proportion portfolio insurance – that aim to protect capital.

Theme 5: Manager diversification has been more ambitious because it has relied on all client segments, not just pension funds

What proportion of your assets is now held in areas into which you have diversified in the last 3 years; and what proportion will it be over the next 3 years?



Source: CREATE-Research and KPMG International 2007

“We follow trends but we also know when to pick the right moment”

Like pension funds, investment managers, too, have diversified their asset base. Around 40 percent of them have diversified into long-only strategies and around 30 percent into alternatives. But in cash terms, alternatives have attracted larger sums.

“Long-only managers believe in the efficient markets hypothesis; hedge fund managers have disproved it”

In the last three years, around 33 percent of the managers have diversified their funds by up to 10 percent; and a further 35 percent diversified their funds by over 10 percent. Under the optimistic scenario these numbers will rise. Within this overall assessment, two points are worthy of note.

“Managers are structuring vehicles to extract fees in more innovative ways”

First, the biggest changes have been and should continue to be within sectors, rather than between sectors. In other words, current and future diversification will be more about ‘product deepening’ rather than ‘product widening’.

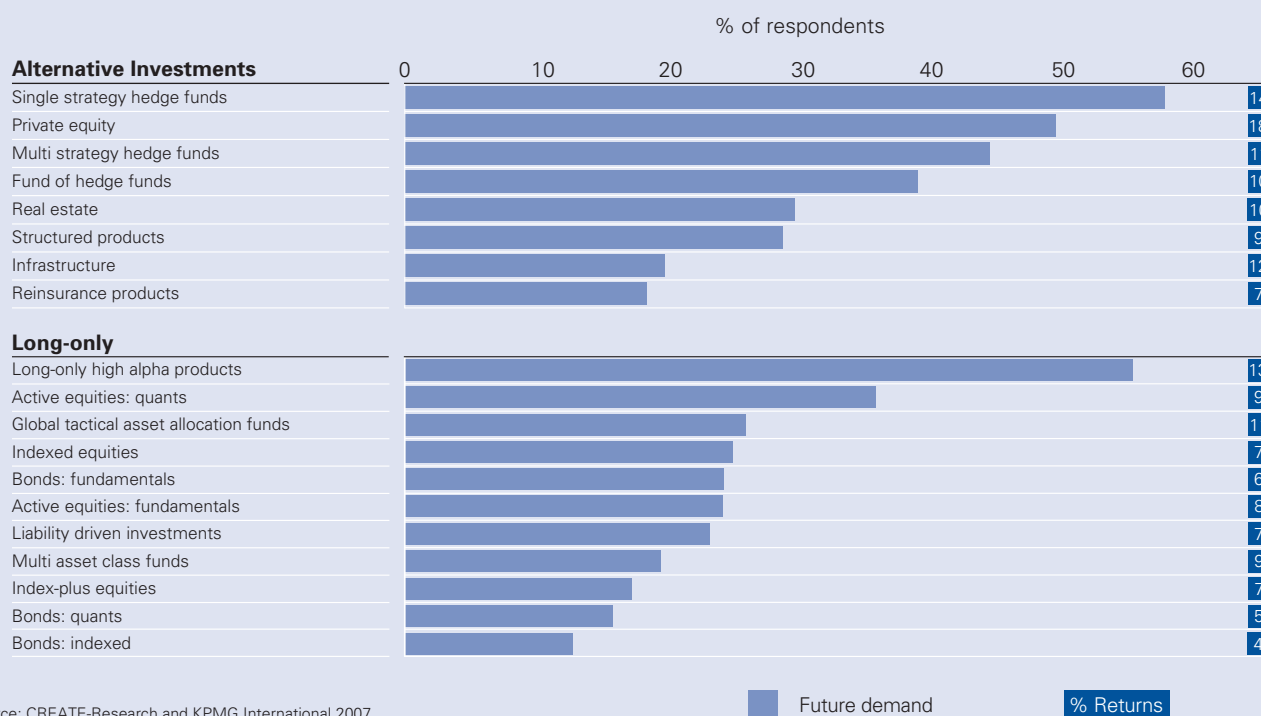
“Some hedge funds have developed ‘side pockets’ which allow a percentage of their portfolio to be invested in private equity. It gives them a greater ‘length of capital’”

The first of these involves enhancing existing capabilities by using existing products as a base for a new generation of affinity products, like 130:30 funds or high tracking error funds. The second one involves creating new capabilities to create products that bear ever less resemblance to the existing ones, like ‘side pockets’ used by hedge fund managers. So, one is about staying within familiar territory, the other about venturing outside it.

Second, product innovation has been incremental. Diversification within each sector so far has involved modest refinements which are sufficient to meet client needs. However, a series of small steps have cumulatively had a significant impact on product mix over time. Hence, even under the pessimistic scenario, the return to the status quo ante is deemed unlikely. The recent crisis is expected to slow down the thrust of convergence in the long-only sector but not in the alternatives sector.

Theme 6: Managers expect their clients to demand higher returns from alternatives compared to long-only assets

Which style and product offerings will your clients be attracted to over the next 3 years and what percentage returns do they expect from their chosen offerings (net of fees)?



Source: CREATE-Research and KPMG International 2007

“Convergence between the two universes is all the more apparent as alternative funds become less and less alternative”

“The risk-reward balance in illiquid investments is no longer attractive”

“The paradox of alternative investments is that managers with little track record are given 5–7 year mandates. There’s a lot of silly money around”

“Returns, too, are converging”

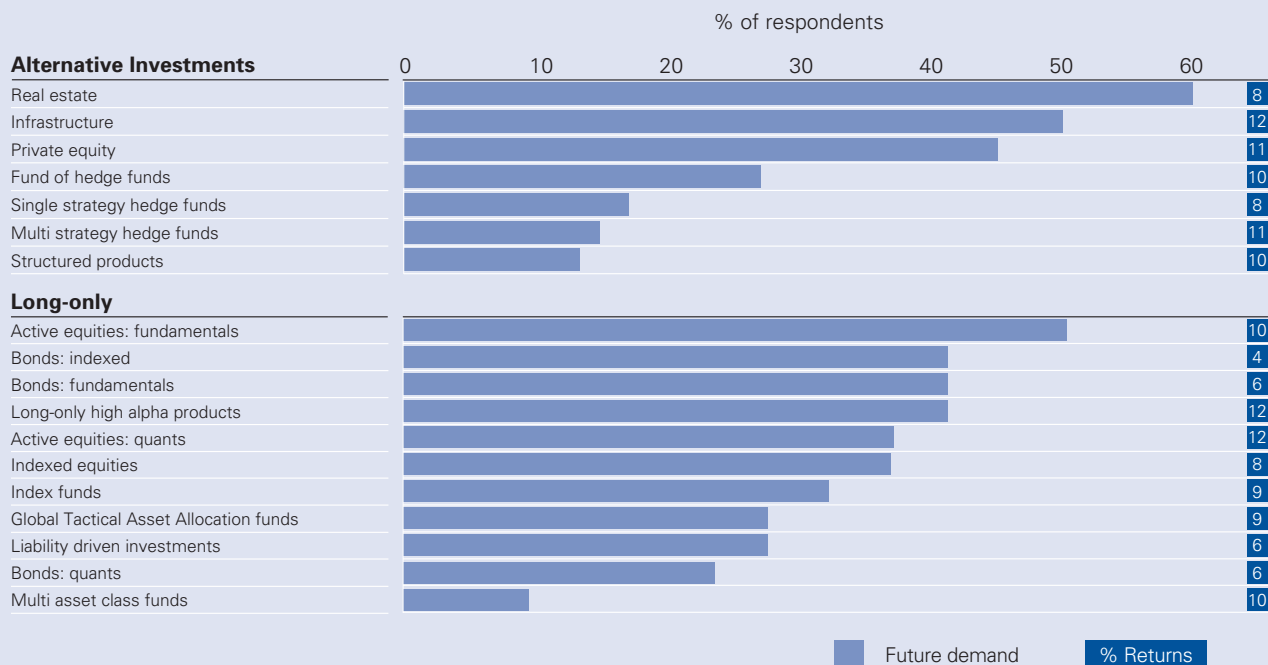
“The absolute returns party will be over when the equity markets tank. They have kept all the boats afloat”

The shift towards alternatives should continue, so long as clients are convinced that they will deliver higher returns with lower risk than the traditional long-only funds. More notably, the level of interest in hedge funds is likely to be as high as the long-only high alpha products. However, this is not an unconditional forecast. As the narrative in the case studies in Sections 2 and 3 indicate, there are serious doubts about the viability of some alternative investments, in the aftermath of the recent sub prime débâcle in the US. Hence, investment managers see convergence slowing down somewhat – especially in the long-only sector – due to three reasons.

First, clients have switched to alternatives because the traditional long-only returns had all but evaporated in the 2000–3 bear market. The switch had more to do with the failure of the old rather than the success of the new. It was the triumph of hope over experience – in search of something new and better. Now that alternatives such as hedge funds and structured products are being truly stress tested, we shall soon know how good they are at generating uncorrelated returns whose search has been a key driver of convergence. Second, within the long-only and alternatives sectors, there are managers who have eschewed any diversification in the belief that the borrowing binge of this decade will now bite back with a vengeance, potentially resulting in a worldwide recession in 2008, leading to a large scale flight to quality and simplicity in the long-only space. Third, any judgment on convergence has to be provisional: after all, markets are cyclical, strategies are adaptive, and people chase returns, not asset classes. The fact that managers in different sectors have diversified says more about their ability to adapt to changing client needs than about radical departures. The investment universe will continue to evolve.

Theme 7: Pension funds expect many long-only funds to perform as well as alternatives

Which style and products will you invest in over the next 3 years and what percentage returns do you expect from your investments (net of fees)?



Source: CREATE-Research and KPMG International 2007

“What our investor base is looking for is steady, not outrageous performance”

Pension funds do not expect shoot-the-lights-out returns: they know that institutionalisation of alternatives comes at a price. Following the practice over the past three years, pension funds will continue to diversify into alternatives as well as long-only assets, with the latter continuing to attract more assets under alpha mandates. But three points stand out.

“If a US\$50bn pension fund were to decide to get aggressive and allocate two to three percent of its asset pool to alternatives, they have to enter a very complex decision-making progress”

First, in alternatives, strategies that invest in hard assets will be in favour in the short term because trustees can understand them and their staff can monitor them. Not surprisingly, high on the list are real estate, infrastructure, private equity and fund of hedge funds. Structured products – e.g. CDOs, CLOs, SIVs – languished at the bottom long before the recent crisis. In future, their ability to grow at an exponential rate will largely depend on their appeal to institutional investors. Hence, the supply of products providing capital protection will explode, competing head-on with other alternatives on features like transparency and simplicity as well as risk-adjusted returns.

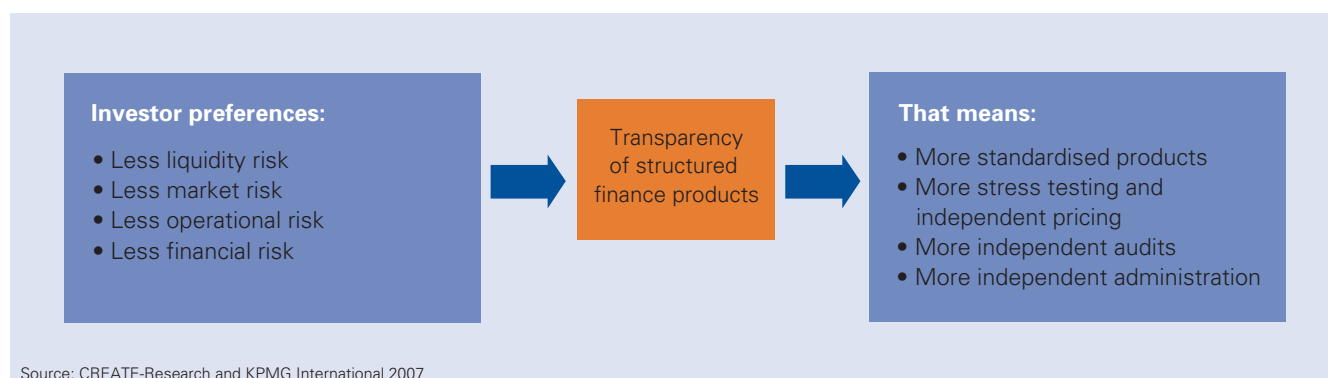
“Many pension funds do not understand alternative investments – they are not ready to invest”

Second, in the long-only space, diversification has been in ‘exotic’ bonds and equities (with emerging markets bias), global tactical asset allocation and LDI funds. This trend is likely to continue over the next three years.

“UCITS III has caused an explosion in the use of derivatives”

Third, on the whole, the returns expected from alternatives are higher than those from long-only asset classes, but only marginally. Those expected from most of the long-only funds match the expected liability profile. They also suggest that the overall low return environment of the past five years will continue.

Theme 8: Convergence of risk management processes will create the next generation of structured finance products



“Like Frankenstein, our ability to create financial monsters now outstrips our ability to control them”

“Investors will become more careful again in selecting risk exposure”

“Investors have lost too much money in strategies that follow long-term investment and short-term funding”

“Non-understandable derivatives will not be seen in the future. There will be a greater focus on more commercial structured investments”

“The big hedge funds brands are recruiting heavily to improve their corporate governance”

The competitive rivalry between the purists in the long-only and alternatives sectors has intensified in the last two years. Each side favours a market correction as a defining moment. For long-only managers, it will confirm whether many of the so-called new strategies amount to no more than financial alchemy, assisted by unusually benign conditions in the credit markets. For alternative managers, it will show whether long-only managers can deliver anything other than beta returns. The next twelve months will show which group is correct.

In the meantime, pension funds will continue to increase their allocations to alternative investments in absolute terms. However, for alternatives to retain their recent growth trajectory, they will have to do two things: deliver their proposition of absolute uncorrelated returns; and minimise the risks which their clients find hard to live with.

For pension funds, four risks stand out: liquidity risk, market risk, operational risk and financial risk. Managers need to have tools and systems to monitor and manage risk as far as possible. Pension funds’ likely losses in vehicles such as CDOs, CLOs, SIVs have made them wary of increasing their current risk budgets. Their plan sponsors won’t stand for that. Specifically, they want to see enhanced oversight of their risky investments via one or more of four avenues: more standardised products, more stress testing and independent pricing of illiquid assets, more independent audits, and more independent administration.

Of course, pension funds are not the only clients of alternative investments. In light of the recent turmoil, however, they may well set the tone for other client segments which have thus far fuelled the growth. In any event, the evolving investment universe will continue to develop a strong professional overlay – of skills and infrastructure – to exploit the opportunities opened up by the recent turmoil.

Theme 9: Alternative investments will remain core areas of growth for administrators

Over the next three years what average annual growth rate are you expecting in your own assets under administration in the following assets classes?

	Annual growth rate					% of respondents
	<1%	1-10%	11-15%	16-20%	>20%	
Hedge funds	8	26	26	24	16	
Fund of hedge funds	12	16	22	36	14	
Private equity	14	50	16	12	8	
Infrastructure	41	23	12	12	12	
Real estate	29	47	12	6	6	
Structured products	22	38	20	12	8	
Reinsurance products	4	46	32	11	7	
Mainstream long-only assets	28	34	26	8	4	

Source: CREATE-Research and KPMG International 2007

“External administration is a must. Any creditable investor will demand it”

Even though administrators expect the growth in invested assets generally to slow down notably from the recent past, most of them still expect significant growth in assets under their own administration. They expect the slow-down to come from two related sources: losses sustained by clients in the recent market turmoil and the resulting loss of general confidence. For administrators, there is little doubt that it could be a while before alternatives take off into their explosive growth trajectory again. In particular, the next generation of strategies will have to be more transparent and liquid: those that are not easily priced will have to have realistic price benchmarks which allow administrators to do robust valuations.

“European fund managers are far more willing to outsource than their US peers”

“For illiquid alternatives, TPAs must understand valuation, ‘side pockets’, clawbacks and tax”

Administrators’ expectations of industry growth does not match that of institutional investors who believe that private equity, infrastructure and real estate products will be the main growth drivers. Administrators will therefore need to ensure that their systems and platforms are capable of dealing with these types of products if they wish to capture this market share.

“You have got to open the kimono – managers need to be a lot more public with information”

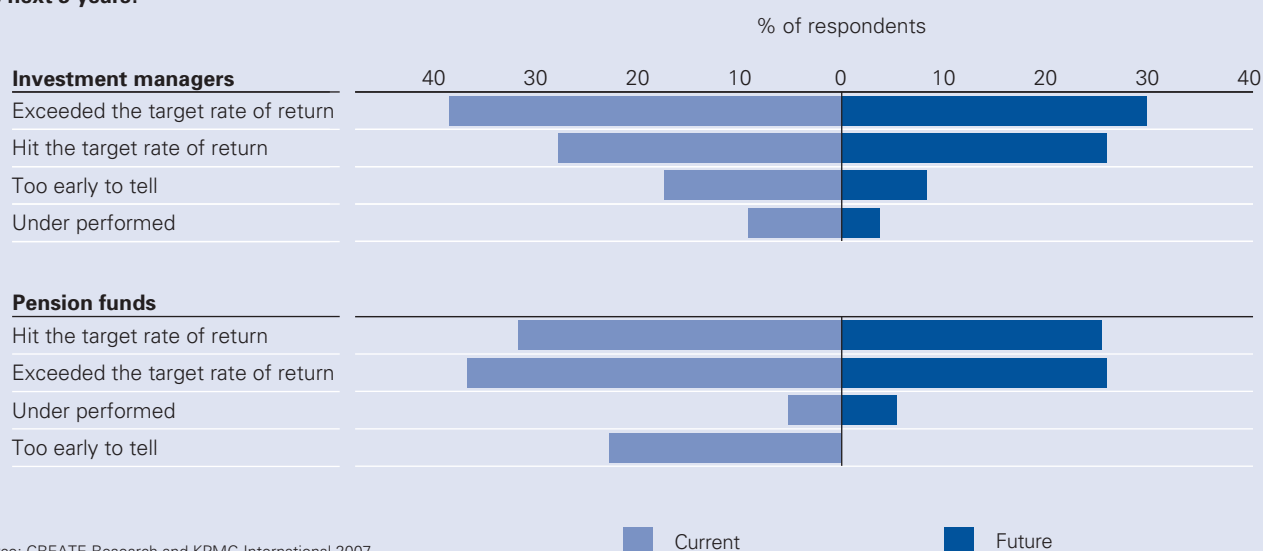
Currently, for reasons of reputation as well as legal liability, administrators have steered clear of valuation and opted for the more modest task of validating prices recommended by prime brokers or other external specialists.

“Fund administrators now go beyond basic custody and fund accounting and offer price calculations, risk analysis, performance measurement and transition management”

On the upside, however, the recent turmoil will force many hedge fund managers, private equity specialists and structured product providers to seek an external seal of approval on most of their middle office activities, including valuation and performance monitoring. For example, the recommendation made in a recent consultative paper from the British Venture Capital Association may well have major benefits for third party administrators, as private equity firms become more transparent about their corporate portfolios, fee arrangements, asset valuation models and performance monitoring. Furthermore, there is likely to be growing demand for independent administration from high net worth individuals investing in the alternatives. Hitherto, they have focused more on investment returns than business basics. The recent crisis is expected to force a shift in this balance.

Theme 10: So far, diversification has delivered mutual benefits for clients and their managers

How would you rate the success of your diversification so far and what do you expect the success rate to be over the next 3 years?



Source: CREATE-Research and KPMG International 2007

“Hedge funds were seen as the next rainbow. Now, they are being stress-tested”

From the investment managers’ perspective, there have been mutual benefits. For their clients, the process has delivered better returns and access to all-weather portfolios. For them, it has delivered improved profitability and enhanced ability to attract, retain and deploy the top talent. Investment managers reporting improved returns attribute their success to one or more of three structural factors which they have overtly focused on: a deeper talent pool; enhanced quant capability; and better ability to manage transitional issues.

“Two percent of people generate 98 percent of value. The rest continue to survive and thrive”

From pension funds’ perspective, too, there have been mutual benefits. In particular, they have been able to notch up good returns despite changing market conditions.

“If alternatives fail to deliver absolute returns, then what?”

For both groups better returns have been cited by around two in every five. From our interviews, however, both groups are a shade pessimistic about replicating the past performance in the future. They also underlined a number of caveats on the returns so far.

“There is a myth that expert managers have consistent alpha. Alpha is a feast and famine business”

First, few managers have so far done a robust performance attribution analysis which has isolated the diversification effect from the market effect, especially since there has been a growing correlation in returns between the two in the past two years.

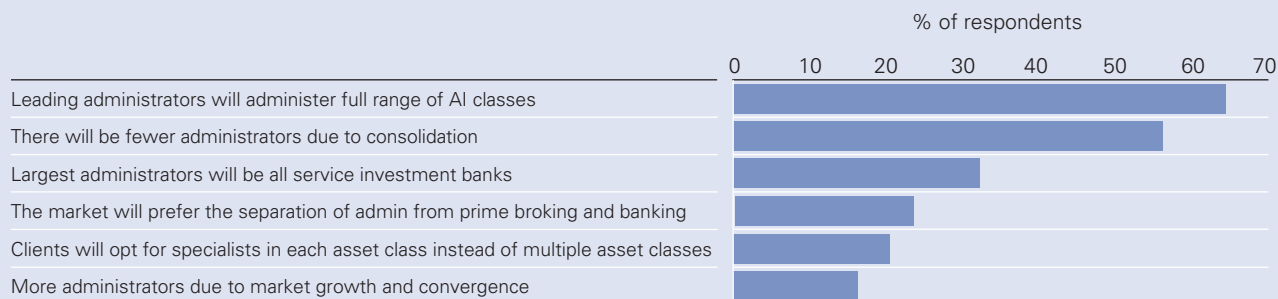
“Asian stocks are expected to have stellar performance”

Second, the reported higher returns in many cases are more in the nature of paper profits than realised gains. With the onset of market contagion in July 2007, it is hard to know the recent status, particularly with investments in hedge funds and structured products.

Third, the purists in the long-only sector report that they too have gained from the market movements and notched up attractive returns without recourse to diversification.

Theme 11: Leading administrators will offer a range of services leaving the niche players to specialise

Which of the following scenarios best describe the status of the administration industry in 3 years time?



Source: CREATE-Research and KPMG International 2007

“CDOs and CLOs have dubious valuation processes”

“Institutional clients want a good housekeeping seal of approval”

“Today, fund managers prefer to adopt a more modular approach, outsourcing only certain functions. ‘Team lift outs’ are out now”

“Administrators detect silver linings in the gathering clouds”

As the size and complexity of alternatives has increased, institutional clients have demanded independent verification in the high value added middle office activities like asset pricing, performance attribution, performance monitoring, risk and compliance. As a result, economies of scale and scope have both become important, leading to the demand for all-product platforms capable of providing a range of services in a modularised form to allow clients to cherry pick. In response, the industry has been consolidating to accommodate a large scale investment in technology and talent, upgrading legacy systems and legacy skills alike, while aiming to improve its operating leverage and profitability. In the wake of large M&As in the last two years, consolidation should continue, creating all service power houses with global reach. Most of them will increasingly run a core-satellite model: low value added services will be centralised into ever fewer remote locations; and high value added services will be provided via hubs close to clients. Outside the US and UK, those jurisdictions who are developing administrator capability in alternative investments will continue to solidify their product offerings.

Investment banks will continue to venture into administration, thereby increasing the number of touch points with clients outside the area of trading and prime broking. Such units will be typically ring-fenced into separate companies with Chinese walls in order to avoid conflict of interests. Finally, niche players are expected to survive and thrive: institutionalisation of alternatives will enhance the role of large multi-service administrators, leaving the niche players to serve the start-ups and independent boutiques. The industry will, thus, bifurcate.

Theme 12: Convergence will promote further industry consolidation with long-only managers and investment banks in the driving seat

Which of the following avenues, if any, are most likely to be used in consolidation in the global asset management industry as a result of convergence?



Source: CREATE-Research and KPMG International 2007

“Some hedge fund styles sit better in an investment bank, such as arbitrage strategies”

The combination of convergence and the nascent bear market has reportedly raised the prospects for a faster consolidation of the investment industry. It will continue through M&A, especially in the US and Europe. Its core aims will be the acquisition of skills and market position. The latter should be especially evident in Asia Pacific. Following recent trends, some of them will involve swapping capabilities rather than outright purchases.

“We are seeing the death throes of a liquidity driven boom. Cost pressures will intensify”

Four sets of players are likely to be especially active. The first one includes long-only managers buying independent hedge fund boutiques. In order to avoid internal conflict of interests as well as capitalise on the market opportunities, acquisition will remain preferable to organic growth. The second set involves investment banks. They have been very active in the absolute returns world partly via their own in-house investment managers and partly through acquisition of significant equity stakes in prominent hedge fund boutiques. They will continue down this path. The third set involves hedge fund managers buying other boutiques in order to strengthen their capabilities in the multi-strategy space which permits dynamic switching to deliver absolute returns in good times and bad. The last set involves private equity firms buying into hedge funds. The large buy-out groups are developing capability across the frontiers of alternative investments; embracing hedge funds, real estate and investment banking; and running them as distinct independent centres of excellence with their own governance structures.

“Black boxes work until they don’t. The unexpected always happens”

“The absolute returns hype may fizzle out; but the separation of alpha and beta is real. As alpha becomes scarce, the spot light will fall on exotic beta”

Convergence and M&As have fed off one another in a self reinforcing cycle, which is expected to continue with a variety of permutations that go beyond the four sets described above.

“I think greed is switching to fear”

2 Investment managers: Long-only and alternative investments



Headlines:

This section presents the results from the postal survey and face-to-face interviews involving investment managers across the entire spectrum of long-only and alternative investments. Its key points are:

“The farther backward you can look, the farther forward you are likely to see.”

Sir Winston Churchill
Prime Minister (1874–1965)

- **Diversification:** The 2000–3 equity bear market losses sparked a fresh interest in absolute returns, expressed as a top-up over a risk free benchmark. In the last five years, there has been a notable shift from long-only to alternatives. It has been driven by demand from clients in all segments in pursuit of consistent uncorrelated absolute returns. In turn, long-only managers have duly diversified in order to attract additional capital and deliver better returns.
- **Convergence:** As a result, there has been convergence in the investment strategies within and between the alternatives and the long-only sectors. Regulatory changes permitting the use of derivatives, like UCITS III, have also helped. However, the convergence so far is neither universal nor unequivocal. Indeed, some factors have worked against it: e.g. lack of requisite skills, worries about losing business focus, and the extra regulatory oversight demanded by the resulting product complexity. Be that as it may, the convergence undertaken by hedge funds and private equity firms so far has been more strategic than their peers in the long-only sector: they have made more durable changes to their business models. In contrast, the changes in the long-only sector have been more tactical.
- **Outlook:** In the alternatives sector, clients will continue to demand hedge funds, private equity, real estate, structured products and infrastructure; targeting returns of around 10 percent and over. Likewise, in the long-only sector, their interest will focus on high alpha funds, active quants, GTAA, index-plus equities and fundamental research-based strategies; targeting returns of around 9 percent and over. But this assessment is not unconditional: it comes with a major caveat.
- **Proposition:** For clients, diversification is not a default option but one based on a clear proposition on uncorrelated absolute returns. For alternatives it is not enough that long-only funds failed their clients at the end of a raging bull market in the 1990s: Clients expect alternatives to succeed in their own right by delivering their value proposition.
- **Uncertainty:** If the recent credit crunch sparked by the sub prime woes in the US persists beyond 2007, the investor appetite for certain strategies in alternative investments is likely to rapidly evaporate, at least in the short term – especially hurting some hedge funds, private equity and structured products. The crisis has severely undermined some hedge fund managers’ credibility to deliver uncorrelated returns. Interest in them was sparked off more by disillusionment with relative return funds rather than by their track record, which had not been stress-tested until the recent market meltdown. Hence there is a question mark about the pace of convergence between long-only and alternative investments from here on. That it will outlast the recent crisis is less in doubt.

Thinking aloud...

"Two factors are driving convergence: our retail clients are looking for enhanced yield in today's low return environment; and our regulators now allow leverage in our multi-strategy mutual funds. Currently, they are leveraged 1.5 times. The minimum entry ticket is an investment of US\$50,000.

In all our mutual funds we are moving towards providing maximum leverage, thereby straddling the distinct spaces occupied by hedge funds and structured products. Indeed, most of our fixed income assets are managed like hedge funds that rely on arbitrage trends.

That said, the cash sums involved so far are small – around three percent of our total FuM. We suspect it will grow, as we migrate out of traditional long-only funds. Regulators have made them costly to manage; quite apart from the bureaucratic oversight.

Our aim is to grow outside our domestic market and go to Asia-Pacific where third party distributors – especially banks and insurance companies – are keen to import our products. We can meet their stringent valuation requirements by using broker quotes, pricing agencies and Bloomberg data.

Our fixed income products are scaleable because their underlying funds are invested in deep liquid markets. Their leverage comes from

total return swaps which we buy from 15 different sources to get the best deals.

Looking to the future, we anticipate developing a multi-strategy fixed income platform that is capable of handling much higher leverage and can deliver returns of over 200 basis points over the chosen bench mark. Our target return is 10 percent (net of charges).

In the short term, however, there's worse to come in the fixed income market. It will remain ugly through the rest of this year. The recent debacle is by no means a blip.

It has severely undermined investor confidence in anything that relies on leverage. We doubt if many hedge funds will survive. Their success has relied more on cheap leverage than deep skills.

However, we deliberately carry under-invested assets (that earn only LIBOR); such that as and when opportunities arise, we snap them up. We don't charge investors for these under-invested assets: so there's no cash drag.

Taking a longer term view, we believe that regulators will increasingly tighten the screws on hedge funds and private equity, to the extent that many will go offshore. That's one worry.

The other is a more serious one: namely, what if we fail to deliver the target returns to our investors? It's one thing using the hedge fund type tools; quite another delivering the returns, especially when everyone is trying to do the same.

There is nothing inherent in these tools that guarantee success. Hence, we are taking a pragmatic view that today's environment favours their use. But if the environment changes, we will change our approach accordingly. You have to be opportunistic to survive in this business.

Administrators have an image problem: so, they fail to attract the brightest and best. Their clients continue to blame them for not delivering accuracy, timelines and consistency. They do not understand our trades.

So we have a twin challenge. In the front office, we need to deliver the returns that clients expect. In the back office, we have to get the basics right. I think it's premature to talk about convergence yet, especially with such a widespread fall-out from the credit crunch."

A European long-only manager adopting hedge fund tools

Source: CREATE-Research and KPMG International 2007 – Interview quotes

Thinking aloud...

"We went into private equity five years ago by buying a majority equity stake in a start-up. However, the deal never took off: each side felt that they had given away too much. Things came to a pass when they expected us to stump up more cash in a big funding round. We refused since they had not delivered anything in the previous four years. Neither side would even talk to each other, despite being co-located. In the end, we cut loose by selling most of the stake and withdrew our brand.

We are viewed as an 'alternatives shop' – even though we are not one. We stand out in the fixed income space where we regularly deliver out-performance of around 130 basis points. We fish in deeper liquidity pools to ensure that our strategies are scaleable. We use hedge fund type leverage to manage our assets. But we have done that for ages: nothing new there. We have also had absolute returns mandates in the equity space long before they became fashionable.

For our absolute returns products, we charge 20–30 basis points. Intermediaries think we can sell them by bucket loads to HNWI if we branded them as hedge funds and ask for a 1:10 fee structure!

Our revenue is growing at 40 percent across all products, including multi-manager and white label. The main growth area has been ethical and

environmental funds, as the market for 'theme' funds has taken off. We constantly fight shy of being something different from what we are.

The hype and lingo of absolute returns investments have reached hysterical proportions. The bubble will burst and there will be a flight towards quality. The recent hedge fund failures in the US are a timely reminder of how much froth there is in the system.

Our core mission is to stay in the long-only space and use the tools necessary to deliver consistent returns. We have secured a realistic alignment of interest by offering revenue sharing to our investment professionals. We aim to move towards providing an equity stake in the business once the revenue from our third party business exceeds 65 percent. Our reliance on the captive funds of our insurance parent has been declining steadily.

We are already seeing many hedge fund managers venturing into long-only space. They need a stick in the ground because the latest credit crunch has proved that the idea of uncorrelated returns is a myth.

Our industry is notorious at over-promising and under-delivering. Long-only managers thrived on the hype of relative returns in the 1990s. Hedge fund managers did the same

with absolute returns. These new emperors will soon be seen to have no clothes. I don't doubt that there are people who can genuinely deliver alpha consistently. But their numbers are miniscule relative to the weight of the money they are attracting. They deserve their handsome rewards. The rest are charlatans paraded as new messiahs. The thing I worry most about is the absolute returns bubble. It will tarnish the image of our industry as much as the dotcom bubble. Investment is a notoriously cyclical industry. It's a breeding ground for hype merchants.

130:30 is their latest fad: many long-only and hedge fund managers venturing into it have little track record of successful shorting. It is yet another device to fleece the clients.

For us, as long-only managers, it's not enough that these people fail. We have to sharpen our act and ensure that we succeed by design, not default. We aim to deliver risk-adjusted returns backed by a value-for-money fee structure and good service.

Long-only managers who get these basics right will still be around long after the mumbo-jumbo of convergence has hit the dust."

A European long-only manager who does not believe in convergence

Source: CREATE-Research and KPMG International 2007 – Interview quotes

Thinking aloud...

"Our strategies are designed to be adaptive to client needs at different stages of the cycle. Convergence implies major structural shifts whereas what we may be witnessing is purely cyclical.

The sub prime hurricane in the US shows all too well the folly of being definitive about anything. Investors thought that, with absolute returns, they had entered a new paradigm. But once again, they face the prospect of losing a ton of money.

The so-called 'Yale effect' – aggressive investing in hedge funds and private equity – had started a huge bandwagon back in 2003.

Our clients wanted absolute returns and we duly responded by adopting long short equity strategies, executed by the same long-only portfolio managers. Besides, we also figured that, like the Nineties, long-only equities were over valued. So the ability to go short could be very useful.

We have a deep talent pool, driven by greed and excitement in equal measures. These people relish challenge and in order to

accommodate their aspirations, we allowed our long-only managers to go short in their portfolio, without creating new structures or incentives.

However, we have realised that there is no certainty that they will succeed over a period. Yes, deep quant skills are a requisite, but competition between quant managers is already driving down their returns; it's a self defeating spiral.

You need old style gut instincts to exploit price anomalies. That's why there's no certainty that long-only managers can deliver high absolute returns. There is even less certainty that hedge fund managers can do that either without leverage. Now that the price of risk has gone up, many of them are being truly tested. By the end of 2007, the hedge fund landscape could be very different.

In many ways they are also competing with multi-line investment banks with a commanding access to capital and know how.

Our hedge funds make up around seven percent of total funds under management. Clients are mainly HNWI and endowments. Pension

funds have been slow to come on board because of their committee-driven governance structure. We have a number of products now that are sold directly or via an internal fund of hedge funds. Our performance has been mediocre so far.

To compound the problem, our back office service providers had more challenges handling partnership accounting than our hedge fund strategies per se or their use of structured products.

Service providers need to turn off the volume, focus on service quality and improve the nuts and bolts of what they do.

We have a clear compass: we are not interested in size. There's nothing more supremely useless than a mediocre fund manager with a lot of FuM. We focus on returns.

We are flexible with our approach, but always fleet of foot. If one thing doesn't work, we try another."

A US long-only manager venturing into hedge funds

Source: CREATE-Research and KPMG International 2007 - Interview quotes

Thinking aloud...

"We don't see much convergence. In our world, focus is the name of the game.

Yes, mutual funds are using leverage and hedge funds are porting alpha out of beta strategies. But these actions are peripheral to more deep-seated changes that are polarising global investment management between long-only and alternatives.

The only convergence that will outlast today's fad is between hedge funds and private equity.

Private equity will continue its headlong growth, with periodic down-drafts, like the recent one. Like hedge funds, they are based on risk-taking and new ideas that ensure that they live and die by absolute returns. Their culture and business models are so far removed from the long-only world that it's plain nonsense to suggest that these disparate universes are converging.

Long-only managers neither have the entrepreneurial edge nor the decision speeds to facilitate the convergence. Yes, many of them used to have individuals who had the right traits. But most of them have left to start a hedge fund.

Let's be clear about one thing: hedge fund and private equity managers are 'self-selected': they are highly individualistic and driven: their success rests on a strong sense of self-motivated creativity.

In the last three years, our FuM has grown by a factor of five, making us one of the top hedge fund managers

in the US. Our growth has come from a combination of factors: good performance, an energetic story for new clients, innovation around existing strategies and enhancement of our talent pool.

Our core innovations used to deploy CLOs and CDOs with tie-ins of 1–10 years. This gave us liquidity and stability to generate returns within 15–20 percent range. But with the recent credit massacre, we will craft other strategies to maintain our growth momentum. Of course, it will be hard since most of the hedge funds were clobbered last summer. But we are a highly innovative shop and our track record was superb until last July. Structured products will have to be extensively refined before they re-emerge in any form.

Overall, hedge funds will retain their distinctiveness. Pension funds have painfully realised that, for too long, they have been paying alpha fees for beta returns. Now, they want what it says on the tin.

Our pension fund clients have averaged 14 percent returns over the past five years compared to 11 percent from S&P.

We are seeing the beginning of a twenty year trend that is moving assets out of long-only funds. The recent market turmoil may slow it down but won't alter its course.

The recent and prospective accounting rules in the USA are forcing huge disciplines on pension funds, as has happened in Europe since 2004. They are ensuring that

beta will be even more commoditised. So, we have to retain our distinctiveness as an alpha shop.

Our biggest challenge is to have people who are not a one trick pony: people who are not slaves of the market style but can anticipate changes and adapt ahead of others.

We are recruiting people who can do new things constantly ahead of the curve. This degree of adaptability is near enough impossible in the checks and balances world of long-only.

Asset gathering is a dirty word here: nearly 50 percent of our staff are portfolio managers with a variety of academic disciplines ranging from trading to law to classics. Between them, they speak 20 languages. It's a formidable talent pool that operates in the informal environment of excitement and zeal, directed solely at generating alpha.

Managing and motivating these people makes a huge demand on our CEO, who also manages money, apart from getting actively involved in marketing and risk management. In hedge funds, the demands on CEOs are huge, since they have to multi-task ever more as the business grows.

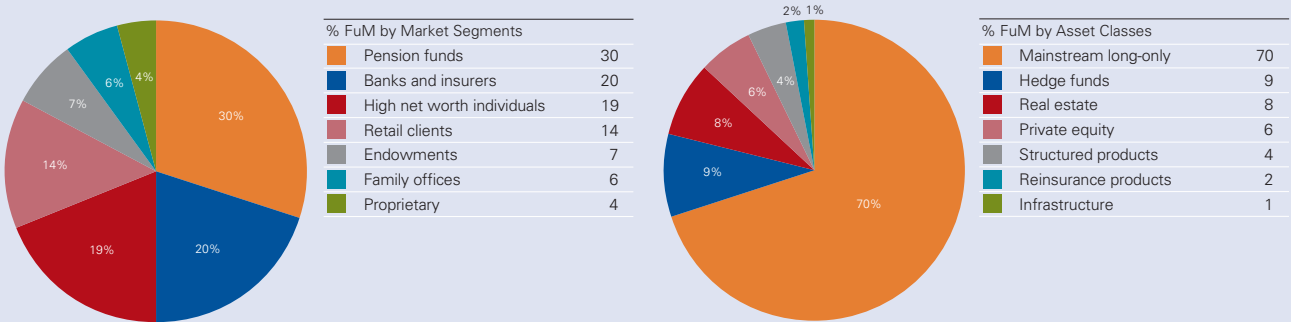
We do a lot of our own back office processing and only rely on a third party administrator to do independent valuations and accounts. We do our data management as an important aid to innovations in the front office."

A US hedge fund manager who believes in focus

Source: CREATE-Research and KPMG International 2007 - Interview quotes

The recent asset and client mix of the research sample is broad based

What is the approximate breakdown of your company's current business between the identified market segments and asset classes?



Source: CREATE-Research and KPMG International 2007

“Institutionalisation is happening more quickly than anyone anticipated”

“We will customise a lot of our products in a hedge fund form”

“Some operational aspects of convergence are found to be wanting: ‘side pockets’, no clawback, valuation, incentive fees, liquidity”

That there has been diversification by asset classes and client groups has not been in doubt. At the time of this survey, our sampled firms had a notable presence in all asset classes.

Long-only funds were the biggest component, accounting for 70 percent of combined assets. But subsequent interviews showed that this figure had come down substantially over this decade, from a high of 85 percent in 2002. The decline accompanied an explosive growth in assets channeled into hedge funds, private equity, structured products and real estate. This growth was partly organic and partly displacement, as investors switched cash from old asset classes into new. Of course, the switch did not involve a wholesale drain from long-only managers to alternative managers: some of the money was retained in long-only, as managers there retaliated by diversifying into alternative investments themselves, as we shall see later.

The relative decline of long-only funds is duly reflected in the share of assets held by pension funds. Although they remain a dominant group, alternative investments have significantly increased the importance of four other groups. The first of these are banks and insurance companies worldwide who have been drawn into hedge funds, private equity, real estate, infrastructure and structured products as a part of internal treasury operations as well as proprietary trading. The second group covers high net worth individuals whose ranks have swollen due to the rising prosperity in the world economy in general and Asia Pacific and the Middle East in particular. The third group covers retail clients whose prominence has grown as they have ventured into defined contribution pension plans due to pension reforms in Europe and Asia Pacific. The fourth group are endowments.

Growth in global investment management will be more subdued compared to the recent past

Over the next three years what average annual growth rate are you expecting in global investment management in the following asset classes?

	Annual growth rate					% of respondents
	<1%	1-10%	11-15%	16-20%	>20%	
Hedge funds	13	46	26	9	6	
Fund of hedge funds	10	40	30	16	4	
Private equity	16	40	29	9	6	
Infrastructure	12	39	26	13	10	
Real estate	20	51	22	6	1	
Structured products	24	51	12	10	3	
Reinsurance products	14	60	15	8	3	
Mainstream long-only assets	16	60	20	4	0	

Source: CREATE-Research and KPMG International 2007

“Low cost of capital combined with high risk returns has hugely shaped private equity and hedge funds”

Looking ahead, investment managers, on the whole, expect the growth in various asset classes to slow down over the next three years compared to the recent past. A significant proportion of them expect the growth rates to be in higher single digits or lower double digits; with alternatives fairing marginally better.

“The recent credit crunch is a temporary blip, but it will cause havoc all the same”

Drilling deeper into these numbers, we encountered two schools of thought.

“Liquidity is poor for hybrid products so pricing the optionality features of a structured product is very difficult”

The optimistic school believes that the sub prime contagion will be limited and temporary: the prevailing fundamentals of corporate profitability and global economic growth will reassert their supremacy. Reinforced by further central bank interventions, the worst of the recent crisis may be over by the end of 2007. Under this scenario, convergence is likely to continue.

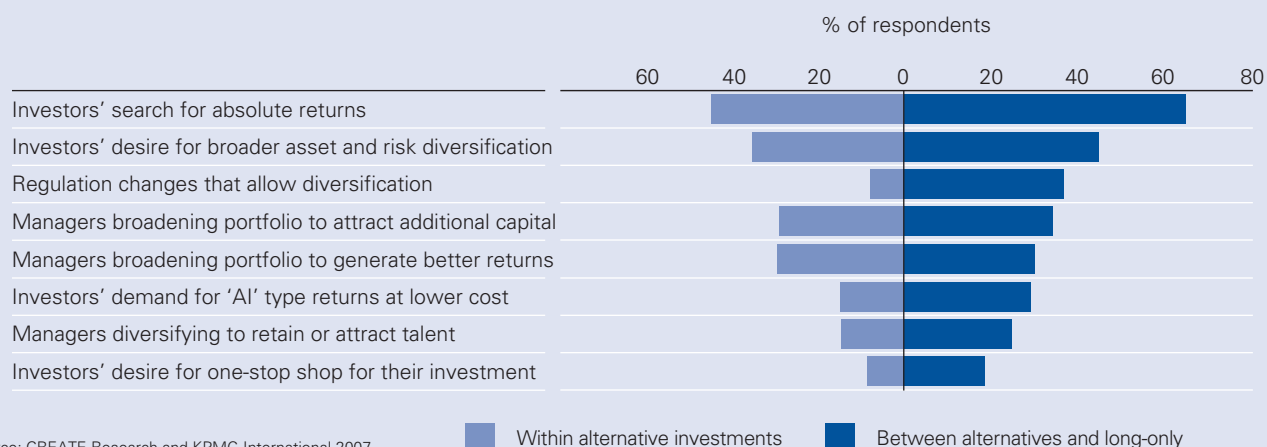
“There are too many silly boys in roles of responsibility that have never learnt from a prior crisis how to react and respond appropriately”

The pessimistic school believes that the next bear market has started, if for no other reason than the total mystery around the extent of losses, the identity of their victims, and the scale of liquidity and insolvency risks. In so far as many banks around the world may be amongst the victims, tighter credit will be the norm, ushering a global recession by late 2008. Under this scenario, convergence between long-only and alternative investments may well slow down in the short term.

The pessimists, however, concede an important point. Once whetted, the appetite for absolute returns will outlast any market downturn. Even if there is flight to quality within the long-only sector, the winners will be those who can deliver consistent risk-adjusted returns. The evolution towards absolute returns will continue. The market downturn will slow down its speed, but not reverse the thrust. The implication is clear: the purists amongst long-only managers will continue to refine the ways in which they deliver decent returns, whereas the pragmatists may either slow down or accelerate their pace of convergence.

Convergence is more demand-led than supply-led

Which factors are driving convergence within and between alternative and mainstream long-only investments?



"The extent of convergence has been more than was expected even two years ago"

Investment strategies within and between alternative and long-only sectors have been converging. As clients have turned the spotlight on absolute returns, investment managers across the industry have adopted approaches that have the potential to deliver them.

"Pension funds are driving convergence and if firms don't have alternatives, they'll go out of business"

As hedge fund managers and private equity firms have gone on the offensive by promising uncorrelated absolute returns, long-only managers have made credible defensive responses that seek to mimic the returns offered by their new competitors. As a result, competition has intensified and each side has sought to highlight the weaknesses of the other; and attract new capital. For long-only managers, however, the defensive response is not just about delivering returns. Around one in every four of them has diversified into hedge funds type strategies specifically to prevent a talent drain, which has been substantial by all accounts: many of the second generation hedge fund managers have a long-only pedigree.

"Convergence is driven by rich rewards from the alternatives; not by clients"

"The 'big guys' are more confident that they have the talent to manage long-only products in addition to hedge fund products"

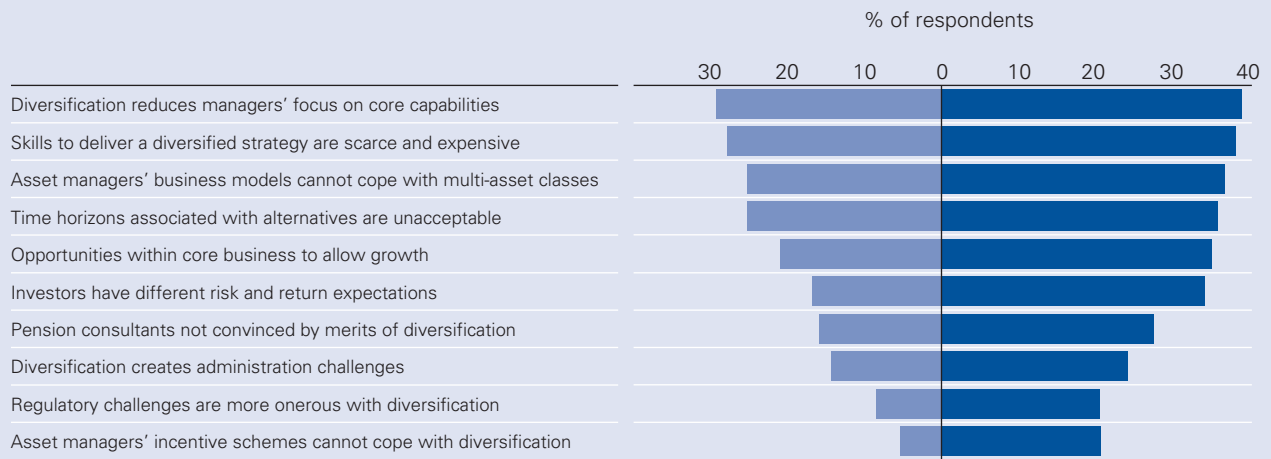
However, convergence has not been uniform. Within the alternatives and the long-only sectors, managers have fallen into three groups: purists, who have stuck to their core capabilities; pragmatists, who have diversified into absolute returns strategies; and procrastinators, who have considered change without actions. They fall into four clusters. The first one has involved a two way opportunistic convergence: long-only managers diversifying into hedge funds type strategies; and the hedge fund managers venturing into long-only funds to produce a more stable revenue stream, especially in the aftermath of their actual or prospective IPOs. The second has involved hedge fund managers and private equity firms venturing into one another's areas as part of a strategic shift. The third has involved private equity firms and hedge fund managers offering real estate funds with long lock-ins. The final one has involved real estate managers and infrastructure managers adopting overlapping approaches. So far, the second cluster has seen the most extensive convergence, some of which has also spilled over into investment banking activities.

"Three years hence, derivatives will blow up. Before then, you can make money. Timing is everything. Everything matters; nothing lasts"

"Hedge funds, private equity and real estate have different cycles – it makes sense to combine them in a business, if you can get long-term capital"

Convergence has also experienced significant head-winds

Which factors, if any, are inhibiting convergence within and between alternative and mainstream long-only investments?



Source: CREATE-Research and KPMG International 2007

■ Within alternatives

■ Between alternatives and long-only

“There are fundamental reasons why convergence between traditional and alternatives is not sustainable. First, there are enormous cultural differences. Second, the people in alternatives are brighter and more determined”

Apart from an apparent lack of uniformity, another notable feature of the evolving convergence is that the majority of the managers have so far chosen to do the opposite: namely, focus on their core strengths and not be distracted into doing things for which they have neither the necessary skills nor the culture. They also believe that many of their peers have gone into it in the mistaken belief that the grass is greener on the other side. For them, divergence via distinctiveness from the rest of the pack is the name of the game.

“There are so many long/short strategies out there with a relatively high correlation to the market”

In the long-only sector, many believe that the use of the new tools like derivatives, shorting and leverage in itself will not guarantee success. After all, many managers have not been successful at tactical asset allocation strategies in the past.

“In theory convergence is great and everyone is talking about it. But in practice the take up is not as high as hoped”

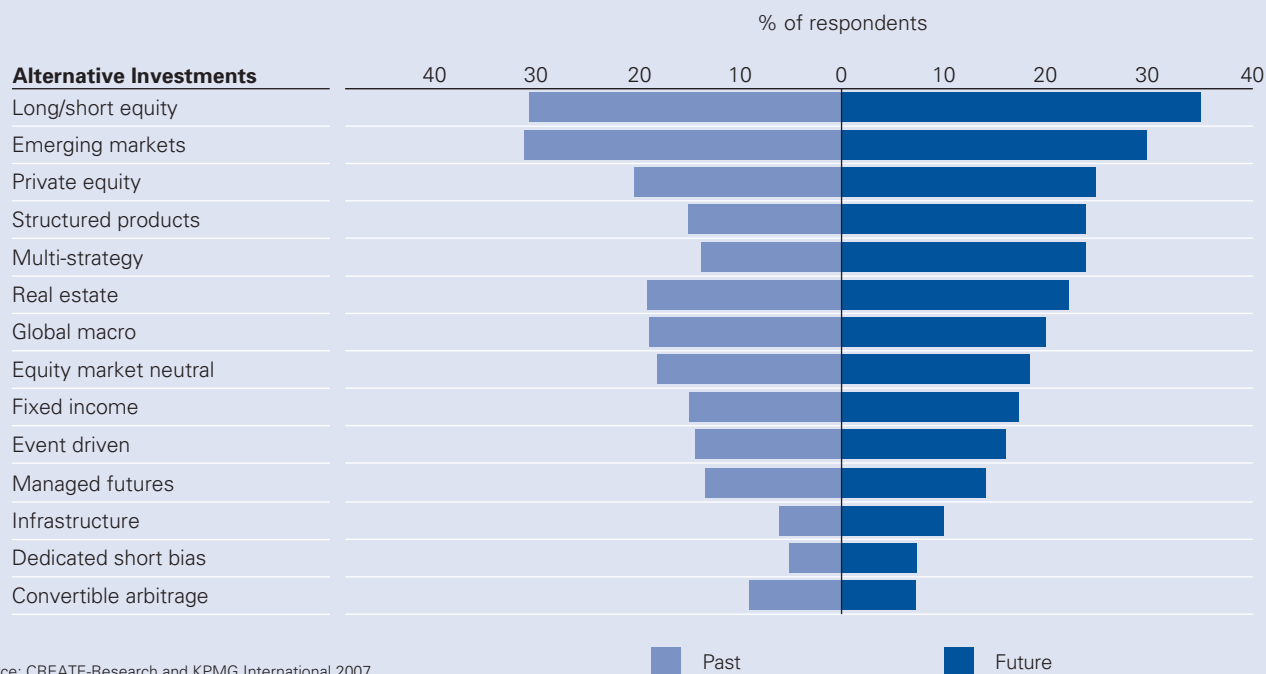
The other concern which they have is that as strategies become more complex, the regulatory and administration burdens become more onerous, posing reputational risks. There were also other transitional issues that had to be resolved: for example, the need to guard existing revenue streams, finding new distribution channels, creating realistic fee structures that do not tarnish the brand image, creating product boutiques, reshaping the culture and so on. But above all, many long-only managers believe that it is possible to deliver attractive returns by retuning their research engines and sharpening their investment processes. Their purist approach had stood them in good stead during the bear market because it kept them out of fads like dotcom stocks and benchmark hugging.

“Long-only managers lack skills for a radical diversification”

In contrast, the barriers towards diversification within alternatives are reported by notably fewer managers. That is because they believe that they have the skills and back office infrastructure – via third party administrators – to engage in radical diversification. They see their aim as identifying and exploiting mispricings in every conceivable market.

Diversification within alternatives has been somewhat opportunistic reflecting the state of the markets and credit conditions

In which investment strategies, if any, have you diversified in the last 3 years, and which ones will you be in the next 3 years?



Source: CREATE-Research and KPMG International 2007

“We plan to launch a real estate-focused fund combining the features of a private equity real estate fund with the added benefit of a hedge fund”

“The traditional industry is serving Mrs Smith from Hull – it will take a long time before she is investing in hedge funds”

“The blurring of lines between private equity and hedge funds has been a more dramatic trend. It will be hit hard as liquidity dries up”

“Hedge funds are good at extracting nuggets from noise. Long-only managers are not”

“Long-only space remains stuffed with mediocrity, having suffered a talent drain to hedge funds”

A maximum of one in three investment managers has diversified within alternative investments, with just as many aiming to do so over the next three years. The target strategies for the majority of them have been long short equity, emerging markets and private equity. Post survey interviews shed further light on these numbers.

To start with, some of the strategies in the alternatives space are more amenable to diversification than others. Within the alternatives sector, they have fallen into three clear clusters so far.

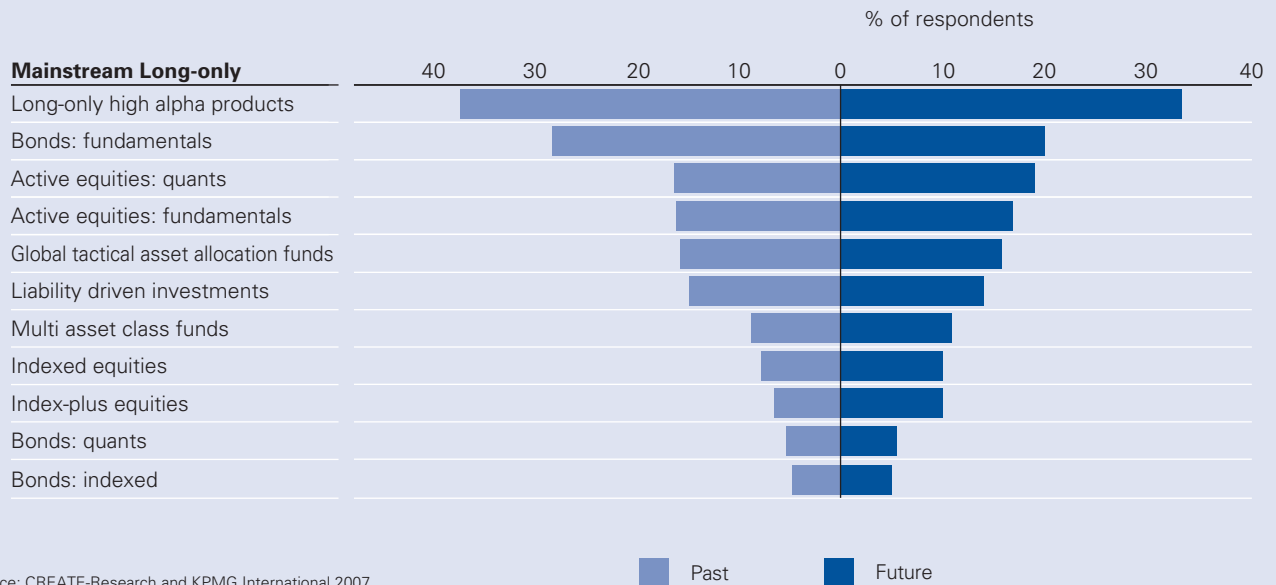
The first cluster involves long short equity, emerging markets, private equity, and structured products. Each has features that make them amenable to diversification, especially by large hedge funds and private equity firms. For example, despite the inherent issues, some hedge funds are increasingly attracting long term investments by creating ‘side pockets’ for long term illiquid strategies that emulate private equity investments. They are also venturing into investment banking type activities like lending and M&A advice.

The second cluster covers private equity and real estate. Here again, the aim has been to offer products that have long tie-in periods attracting high illiquidity premiums.

The third cluster, still at a formative stage, covers real estate and infrastructure investments which, too, command high illiquidity premiums. At the other extreme, some real estate managers firms are also issuing certificates against market benchmarks without buying the physical assets themselves; and offering high liquidity akin to the traditional indexed equities.

Diversification in long-only strategies has been opportunistic, reflecting market conditions

In which investment strategies, if any, have you diversified in the last 3 years, and which ones will they be in the next 3 years?



“Long- short is just a tool in the tool-kit. Today’s investment is not about a one club strategy. It’s about mixing and matching things sensibly”

“130:30 is the approach of the moment. Its application in the BRIC markets will keep people busy for a while”

“The quant guys analyse the hell out of everything”

“Hedge funds are not a chimera, but one of many ways of delivering absolute returns”

“Our stance on hedge funds is purely opportunistic : we have a toe-hold, in case they become mainstream”

Within the long-only sector, convergence is marked in a single cluster characterised by two sets of distinct changes.

The first one revolves around high alpha products. They are ‘freestyle go anywhere’ type mandates with high volatility and high tracking errors. Many asset managers also lump global tactical asset allocation funds in this category: these use derivatives to switch between asset classes and profit from changes in macro economic conditions – akin to macro strategies deployed by hedge fund managers.

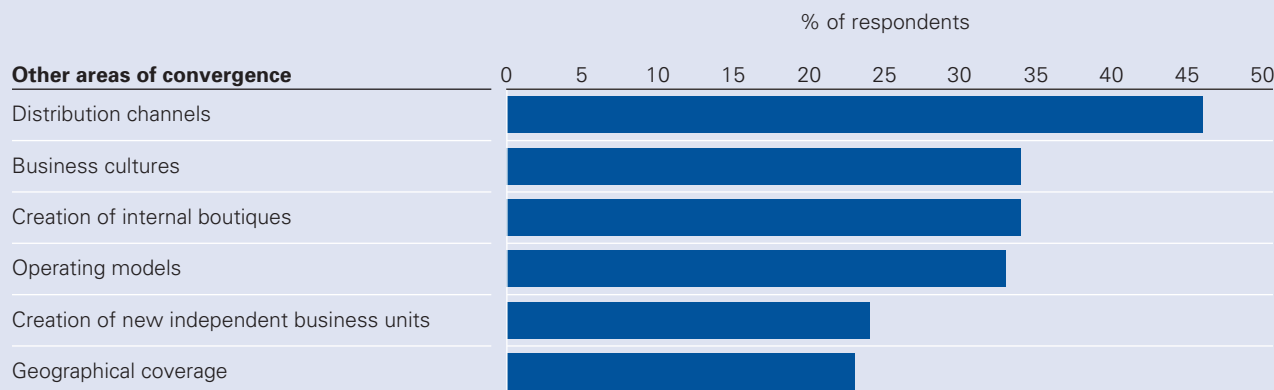
The second set involves increased use of derivatives, leverage and shorting in the traditional equities and bond portfolios. It also includes the so-called 130:30 products, although their use worldwide so far is more limited than media coverage would imply. In the last two years, they have grown from zero to around US\$100 billion. This set can also be sub-divided into two distinct groups.

The first sub group comprises long-only managers who have ramped up their quant capability so as to create a wider universe for targeting stocks for shorting and leverage. Some very prominent managers have ring-fenced such capabilities into separate companies under a different brand in order to minimise the reputational risks in the event of significant failures.

The second sub group has relied on the skills of their existing long-only managers to execute more aggressive strategies. Their key motive has been to retain their talented managers by offering them wider opportunities set to exercise their talent, with limited success.

Investment managers who see convergence as a lasting phenomenon have also made changes to their business models

What other areas, if any, will also converge as long-only and alternative investments come to overlap?



Source: CREATE-Research and KPMG International 2007

“The long-only managers will continue to have in-house hedge fund activities but these will be less important for many”

On current reckoning, investment managers are planning to reinforce the changes which have been initiated within the last two years. These relate to the structural, governance and cultural dimensions of their business models. In each case, the alternative investment managers have implemented more durable changes than their long-only peers.

“We operate boutiques with an oversight”

Taking each in turn, long-only as well as alternative investment managers are seeking to use existing sales channels by upgrading the skills of their relationship managers. Increasingly, the trend is to ensure that such individuals are ex-portfolio managers with deep product knowledge that would enable them to engineer solutions for clients. Investment banks and long-only managers have increasingly acquired ‘alternative boutiques’ in order to distribute their products through established distribution channels.

“We have a quant shop doing 130:30. It’s being ring-fenced with its own brand; the risk to our main brand is too high otherwise”

On the governance side, businesses have been increasingly organised into actual or virtual product-based boutiques where investment professionals are given the autonomy and space to generate high conviction ideas, execute them and be accountable for the results. Such boutiques have backing in the mid and back-office as well as general oversight.

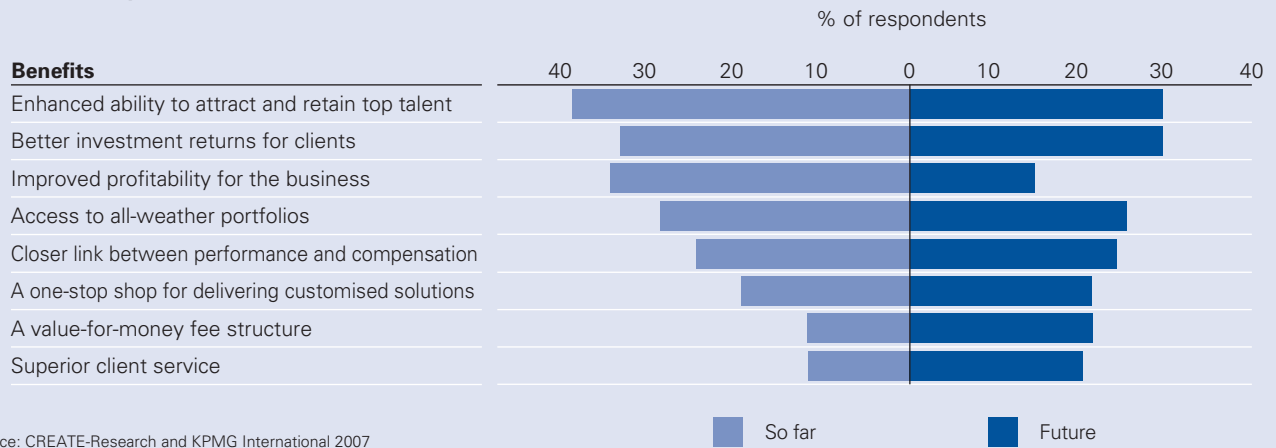
“Hedge funds and long-only are on the same platform: so the choice of who does what causes much resentment”

Where there is a perceived brand risk or scope for conflict of interests, such boutiques are overtly set up as separate independent business units with their own governance, distribution and back office.

On the cultural side, apart from creating the boutiques, there has been a clear trend towards promoting a better alignment of interests between investment professionals and end-clients by offering one or more of three incentives: equity in the business, revenue or profit sharing in specific products, and bonus linked to performance averaged over four years so as to allow for temporary hiccups. In order to discourage asset gathering, performance fee structures continue to evolve for the new generation of absolute returns products. The aim is to share the gain – or pain – with end-clients.

Diversification has produced a win-win situation for clients and their managers so far

What benefits, if any, has diversification between and within sectors produced so far and what are they likely to be over the next 3 years?



Source: CREATE-Research and KPMG International 2007

“We went into hedge funds to retain our talent”

As we saw earlier, around two in every five investment managers have diversified into other asset classes thereby promoting convergence within and between the sectors.

“There’s a disaster waiting to happen when long-only managers go into hedge funds to retain talent”

Its benefits so far are somewhat broad-based. Around one in every three investment managers report mutual benefits. For clients, the process has delivered better returns and access to all-weather portfolios; for managers, it has delivered improved profitability and enhanced ability to attract, retain and deploy top talent. This assessment needs to be qualified in the light of three recurring points made in the survey interviews about the returns.

“The liquidity boom has severely suppressed volatility and distorted risk pricing”

First, few managers have done robust attribution analysis which has isolated the diversification effect from the market effect. The latter has been very favourable since the end of the last bear market in 2003. Some managers even ventured the view that, if anything, the market correlation has increased so much that any attribution analysis would be a waste of time. Second, the higher returns in many cases had not been realised prior to the July crisis. When the dust has settled, it will be more evident as to how much of the paper profits have remained intact. Few managers now believe that alternatives have the power to deliver uncorrelated returns. Assessment of the future benefits is highly tentative: it assumes that the recent crisis will pass by the end of 2007 and there is no economic recession in 2008, as is predicted by some market analysts. Third, long-only purists claimed that they too have gained from the market movements and delivered stellar returns without recourse to diversification.

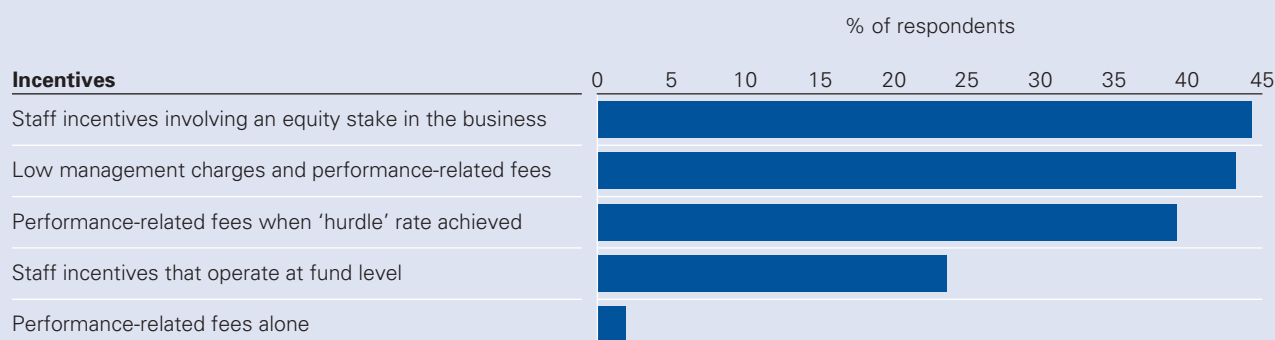
“Clients are benefiting from the headlong drive into alternatives. There’ll be a lot of accidents on route”

Having said that, diversification has produced three structural benefits: a deeper talent pool, enhanced quant capability and change management skills. Successful managers have tackled numerous transitional problems to create more robust businesses.

“Few long-only managers are becoming successful as alternatives businesses – but very few”

A better alignment of interests is critical to diversification

What incentive system is most conducive to convergence?



Source: CREATE-Research and KPMG International 2007

“With a plethora of offerings, clients have trouble telling the difference between an absolute return product and a product that just calls itself absolute return”

Critics have argued that the investment management industry is unique in one respect: the fees it charges and the remuneration structures it operates tend to favour managers more than their clients. Agents’ interests often over-ride those of principals.

Recognising this criticism, managers have been identifying the tools most conducive to a better alignment of interests and implementing them.

“Rather than reducing fees, managers are creating new ways to capture performance fees and management fees”

Granting an equity stake in the business to investment professionals has been the most favoured tool. The underlying idea is that professionals need to look beyond their immediate bonus and promote the longer term viability of their businesses by having a direct stake in it.

“The industry was expecting fee compression but we are not seeing it”

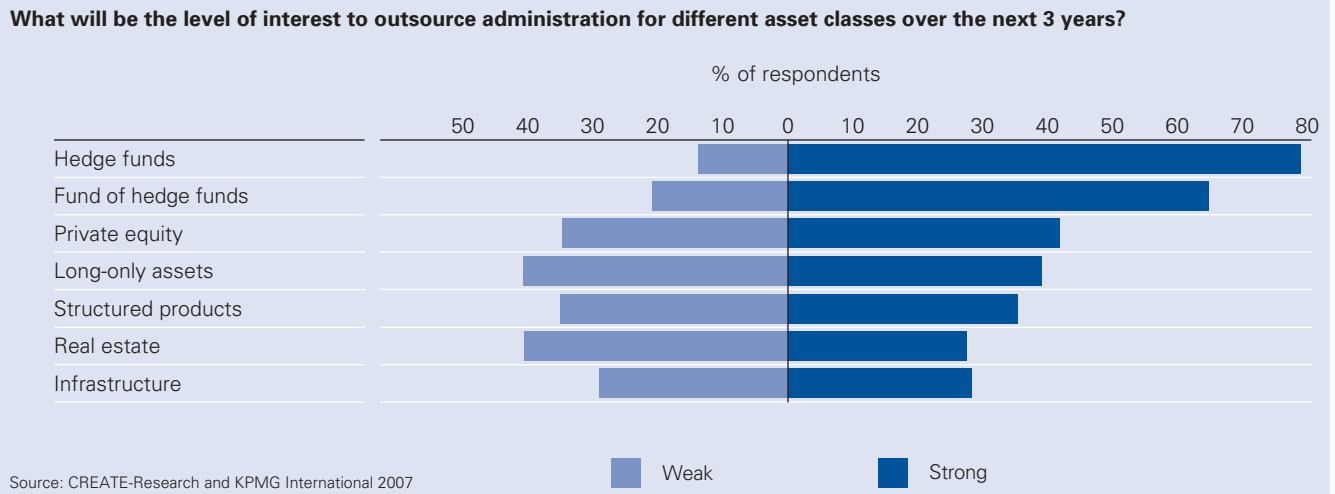
Low management charges backed by performance related fees are also finding favour. It has been argued to us that in the absolute returns world, performance is the key symbol of success, not funds under management. In order to ensure that this imperative holds, managers need to rely ever more on performance fees so that they have every incentive to close the funds which have maxed out.

“Convergence will continue but at a slow pace. But it depends upon how the recent credit crunch plays out”

Some managers are also having to accept a structure in which performance fees only kick in after the hurdle rate of return is exceeded.

Finally, some managers are experimenting with staff incentives that operate at a fund level. Under them, managers are offered units in the funds which they manage. This has not been straightforward, however. Giving too many units make staff risk-averse; or too few make them risk-takers. Finding the optimal balance has been far from easy. Besides, there have been regulatory issues in some jurisdictions.

Outsourcing of back office administration will continue to be driven by hedge funds and private equity



“The alternatives managers have fewer legacy issues than the long-only ones”

Although hedge funds have been around for over 50 years, their significant take-up has only occurred in the last ten years or so. Most of them have been driven by the new start-ups with no legacy systems.

“Without third party administration few pension funds would even go near hedge funds”

Not surprisingly, therefore, most of the interest in outsourcing back office activities will continue to come from hedge funds and, more notably, private equity which has hitherto been administered internally.

“Even after outsourcing, most long-only managers continue to have their old systems as a back up. No transition has ever been smooth”

In light of recent accounting and regulatory changes on both sides of the Atlantic (see section 3), pension funds will need to focus more on the methodology surrounding valuations of illiquid investments in their portfolios. Even more importantly, the use of complex strategies involving derivatives has raised a host of issues in their valuation as well as processing.

Foundations and endowments also want independent validation of pricing done by prime brokers and hedge fund managers. This explains the growing interest in outsourcing the administration of private equity and structured products.

As we shall see in Section 4, there are concerns about valuation and derivatives processing amongst administrators to the extent that many long-only managers are obliged to do these functions in-house currently. Their lesser enthusiasm to outsource is dictated more by reputational risks than processing economics.

It also reflects the fact that, hitherto, long-only managers have not attempted large scale changes to their business models to venture into alternatives. Their diversification is modest in scale and scope; incrementalism has been the name of the game.

3 Pension funds



Headlines:

This section presents the results emerging from the survey of pension funds and the follow-up interviews with a cross-section of the participants. Its main points are:

“Where large sums of money are concerned, it is advisable to trust nobody”

Agatha Christie,
crime novelist (1890–1976)

- **Diversification:** Since the onset of the last bear market in 2000, pension funds worldwide have started an incremental diversification of their asset base. Most of them have moved away from their traditional 60:40 equities-bonds balance and gone into alternatives. Alternatives now account for 31 percent of the allocations of pension funds surveyed. The actual diversification is not as dramatic as the one implied by this number, however, a significant part of investments in alternatives has been made with long-only managers, indicating both the blurring of boundaries and the convergence of strategies. Either way, the aim has been to earn consistent risk-adjusted absolute returns.
- **Incrementalism:** The path to diversification has been cautious for two reasons. First, the new accounting and regulatory rules in Europe and to a lesser extent Japan have enjoined pension funds to: be at least 100 percent funded within a specified period; avoid smoothing of assets and liabilities; and have all investments marked-to-market. Similar rules are now being implemented in the US. Second, most pension funds have always had severe reservations about illiquid or opaque strategies that have been implemented by hedge fund managers, private equity firms and investment banks. The recent collapse of the sub-prime market and its affects on the world financial markets, if anything, has reinforced their reservations.
- **Modest returns:** The cautious approach is also dictated by a simple imperative: around 95 percent of pension funds need returns of less than 10 percent to meet their liabilities over the foreseeable future. Of course, there are pension funds in the US and, to a lesser extent, Europe which have gone for double digit returns: some of these can afford to take higher risks in view of healthy funding levels, while others need to take higher risks to meet the target funding levels. Either way, funding levels have been a factor.
- **Blurring boundaries:** Although pension funds have diversified into alternatives, the weight of money has benefited the long-only managers who have mimicked hedge funds type strategies on the back of superior governance and operational structures. Pension funds have been chasing returns, not asset classes, thereby blurring asset boundaries.
- **Uncertain benefits:** Good returns had been recorded until the July credit crisis. Most of them were on paper rather than realised. So, the actual outcomes are uncertain at present. Doubtless the crisis has decisively turned sentiment against affected strategies. As the crisis has prolonged, the risks associated with illiquidity and leverage in some hedge funds and private equity strategies have come to the fore. Hence the pace of convergence between long-only and alternative investments from here on will be slower, at least until the health of the global economy returns.

Thinking aloud...

"Our journey towards absolute returns investing started in 2000, when the equity bear market wiped out 48 percent of our portfolio. Overnight, we switched a large slug into bonds only to find two years later that our funding levels were getting worse as interest rates continued their downward slide.

We first diversified into private equity which was easier for trustees to swallow. The same cannot be said about hedge funds, since the memories of the LTCM disaster were still vivid in peoples' minds. So, it took two years to make a decision and another year to make the first allocation. Currently, around five percent of our funds are in alternatives.

It is too early to say whether this is a right decision, especially since equity markets have recovered and our original decision to get out of equities was, in hindsight, not so clever. The trustees are learning painfully that markets are adaptive and strategies come and go in fashions. So, they are keeping a weather eye on

alternatives. If they deliver decent returns, then we shall increase our allocations. If not, we'll pull out. Much of the recent investment in alternatives is driven by greed and fear. We are taking a more pragmatic view by testing the waters. In the UK, 94 percent of pension funds have avoided hedge funds and private equity, including 10 out of top 20 funds. Mark-to-market and other accounting rules have been a major deterrent.

We have also looked at structured products: and concluded that they are a step too far for us. Not only are they expensive; their opacity conceals the place where the ultimate risks lie. Besides, our plan sponsors are very wary of us doing anything which can potentially worsen the already low funding levels. They have made three tranches of cash injections in as many years in line with the covenant. This has weakened the strength of the covenant, and made them suspicious of all that we do.

More objectively, our research shows that along with private equity,

structured credit is a rare corner of finance where managers enjoy wide discretion over valuing the assets. Many risk takers have taken their profit and gone. The originators of risk are not in the business of holding it. That job falls on investors who have to be prepared for the long haul. Besides, cutting the risk of a loan into multiple slices instead of one sounds fine. But if all holders act in the same way, we can end up swapping a bank run with a market run. That's what has happened since July. These toxic mortgages and the commercial loans in the US have contaminated the investment waters worldwide. Nobody knows the true extent of damage or its victims. Investment banks have done a huge damage to themselves and others.

Clients are very cynical of the word innovation: it stands for the latest con trick."

A UK pension fund with a pragmatic approach

Source: CREATE-Research and KPMG International 2007 – Interview quotes

Thinking aloud...

"When markets tumbled in 2000, interest in these newly discovered alternatives accelerated. They were initially perceived as uncorrelated low volatility options that complemented, not competed with, other asset classes. Since then, however, a number of factors have dictated an incremental approach that is at odds with media headlines which continue to convey the image of pension funds flocking en masse to alternatives.

Such headlines fail to take account of the fact that worldwide most pension funds outside the top 50 do not as yet have governance structures and investment expertise to achieve a radical diversification. Nor do they recognise that the worst funding crisis in living memory is re-shaping pension funds' investment approach. Now incrementalism is the name of the game.

The last bear market savagely exposed the scale of the funding crisis and damaged many reputations. In retrospect, some of the things pension funds did in the 1990s seem reckless: like being overweight in equities, relying on their risk premium to take care of long-term liabilities, declaring 'pensions holidays' when numbers

were good, awarding mandates on the basis of immediate past performance or star culture, and having total faith in their consultants.

Now, they are cautious; all the more so since the crisis has weakened the strength of the covenant between pension trustees and their plan sponsors. As a quid pro quo for extra contributions towards persisting deficits, plan sponsors are demanding that further diversification should be targeted at strategies that have been stress and time tested.

Regulators, too, are demanding a more risk-controlled approach to under-funding. The new mark-to-market accounting rules, now being implemented on both sides of the Atlantic, will inject extra volatility into the balance sheets of plan sponsors which their shareholders find unpalatable. Even in the Netherlands, one of the most sophisticated and successful pension markets in the world, the recent accounting rules – the Financial Toetsingskader – are forcing Dutch pension funds to match their liabilities to the market rate, thereby forcing a more conservative approach to asset allocation, as has happened in Northern Europe. The new rules demand 105 percent

funding. The capital and income protection strategies they favour do not necessarily leave enough assets in the classes in which they are invested, since hedging instruments are expensive.

There are other factors promoting caution as well. These are inherent in alternative strategies and the ways in which they are delivered, as exemplified by hedge funds which now account for 50 percent of the total value of assets in the alternatives universe – including structured products – now estimated at around US\$5 trillion.

We have four concerns about hedge funds: high charges, shortage of prime capacity, opaque strategies and absence of governance structures. Such concerns have not deterred ultra high net worth clients and family offices, who have largely fuelled the extraordinary growth of hedge funds in the past ten years. Accordingly, before making big allocations to alternatives, we want to see step improvements in the risk-return features of alternatives."

A Dutch pension fund dipping its toes in alternatives water

Source: CREATE-Research and KPMG International 2007 – Interview quotes

Thinking aloud...

“‘Sticking to the knitting’ is the new mantra for pension funds. That does not mean business as usual. It means product deepening rather than widening: that is, straying further afield in familiar territory rather than discovering new ones. Three points are worthy of note in this context.

First, pension funds worldwide need average annual returns of around eight percent to meet their future liabilities from existing levels of funding. A majority of them are sourcing these costs effectively from the best of breed mainstream asset managers without recourse to extra risk and high charges. The long-only sector is developing a good track record of delivering alpha. Furthermore, last year, an average hedge fund gained 12.9 percent after fees; while funds tracking S&P’s 500 stock index and charging investors a slim 0.18 percent of assets, jumped 15.1 percent.

In any event, a combination of stock market recovery and the rise in discount rates used to measure plan

liabilities has notably moderated the annual increase in pension liabilities. For example, they increased by 1.9 percent in 2006 in the US, the lowest increase since 1999.

Second, pension funds’ pursuit of high returns is no longer couched only in terms of product alpha: defined here as excess returns over a pre-defined benchmark (x percent over LIBOR). Increasingly, solutions alpha is also being sought. It involves producing targeted returns at lower risk, lower volatility and lower charges year on year.

Looking at alpha in this two-dimensional way, in turn, reflects the widespread view that beta will remain the overwhelming source of wealth creation until product alpha – as we know it – has undergone extensive innovation.

Third, the growing correlation between major asset classes is forcing pension funds to look further afield by exploiting the advantage

inherent in their status as long term investors and exploit the associated illiquidity premium via ‘exotic’ beta strategies. For example, in Denmark, the emphasis has been on infrastructure; in France on commodities; in the Netherlands on forestry.

In these and other cases, pension funds are diversifying into asset classes which they understand, using strategies which are not capacity constrained, and adopting a fee structure based on an ever closer alignment of interests between investors and their fund managers.

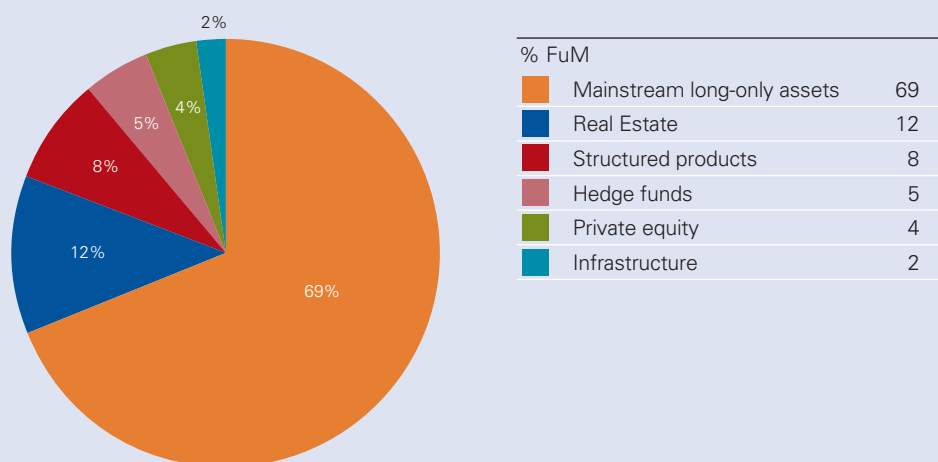
Not surprisingly, therefore, the long-only world is evolving. In the process, it is deploying the tools that are stock in trade for hedge fund managers – e.g. leverage, derivatives and shorting – within a far more competitive pricing model.”

A US pension fund seeking ‘solutions alpha’

Source: CREATE-Research and KPMG International 2007 – Interview quotes

Pension assets remain predominantly invested in long-only funds, though they have diversified significantly

What is the current breakdown of assets by asset classes?



Source: CREATE-Research and KPMG International 2007

“Convergence has been and continues to be slower and more gradual than the speculation leads us to believe”

Until the onset of the 2000–3 bear market, most pension funds worldwide had an allocation of 60:40 equities-bonds mix. Since then, they have embarked on a gradual diversification. The share of the traditional long-only assets has declined as this decade has progressed to around 69 percent. At the same time, investments in alternatives have increased steadily – especially real estate, structured products, hedge funds, private equity and infrastructure. From a relatively low base, the cash sums have been sizeable, in each case.

“As measures of value creation, old style indices are meaningless”

An interesting aspect of the new flows is that a large part of it has been invested with the long-only managers who have created in-house capacity to deliver the new strategies in their original or mimicked form. The incumbents have been quick to follow the newcomers to the extent that long-only managers have not suffered erosion in either their client base or revenue base, as was widely predicted. The old asset base co-exists with the new one.

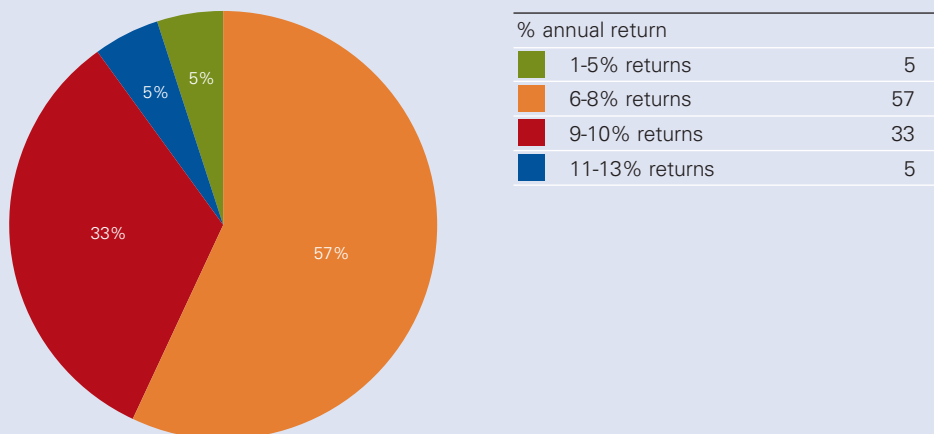
“Long-only managers have good infrastructure but little ability to attract alpha managers”

Two other factors explain why long-only managers have been able to make a successful diversification. They have better governance and operational structures, which are important to pension funds from a fiduciary perspective. Large hedge funds and private equity firms, too, have been proactive. As long-only managers have mimicked their strategies, they have increasingly emulated long-only managers’ governance structures. Convergence and institutionalisation have gone hand in hand.

“Return gets dumbed down as hedge funds institutionalise”

The large majority expect overall returns on their portfolio to be in high single digits

What total percentage of annual return are you aiming to achieve on all your assets over the next 3 years?



Source: CREATE-Research and KPMG International 2007

“Data doesn’t prove that hedge funds deliver uncorrelated returns; quite the reverse”

One overarching factor has influenced the scale and scope of diversification by pension funds: their funding needs. In this decade, pension funds have shortened the time periods between their regular asset liability modeling partly due to regulatory changes and partly due to the scale of losses suffered in the last bear market.

“We are less interested in 130:30 products than in absolute returns strategies”

As a result, they have a much better understanding of the time profile of their future liabilities and how it changes with different assumptions on interest rates, inflation and life expectancy. Most of them also now have risk budgets that aim to strike a balance between illiquidity risk, market risk and liability risk.

“If one reads through the 300 page document outlining the transaction and nature of the investment and one still does not understand clearly the commercial rationale, then one should probably not invest in it”

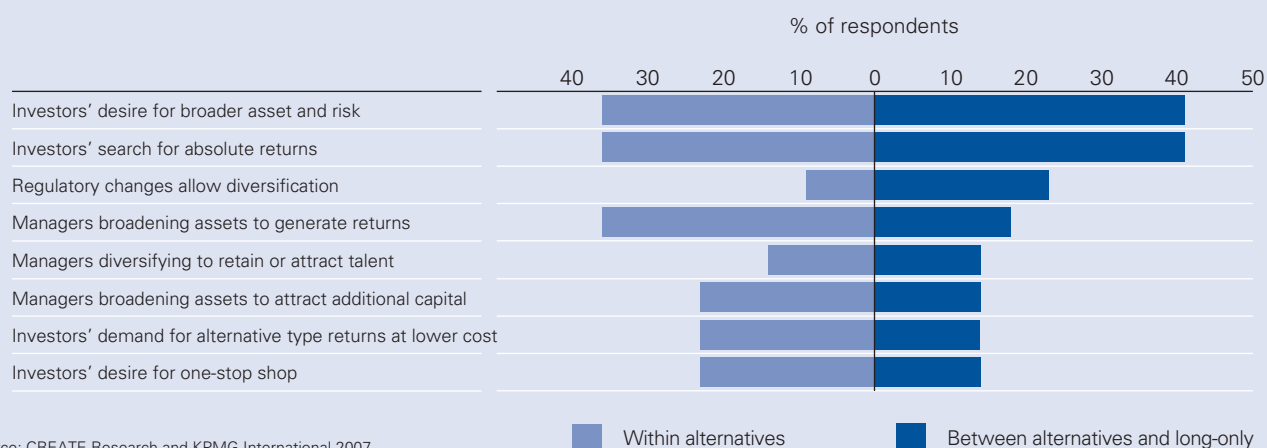
Taking a three year view, 57 percent of pension funds are aiming for returns of between 6–8 percent and a further 33 percent need between 9–10 percent to meet their liabilities. A tiny minority of 5 percent are aiming for returns between 11–13 percent.

On the whole, those aiming for higher returns, for whatever reasons, were amongst the larger pension funds in the US who had the necessary governance structures and investment expertise to undertake a more radical diversification.

It also included those who either had high funding levels or could afford to take extra risk or those with low funding levels and who were forced to take more risk.

Convergence within and between alternatives and long-only has been largely client-driven

Which factors are driving convergence within and between alternative and mainstream long-only investments?



Source: CREATE-Research and KPMG International 2007

“Private equity and hedge funds share common structures and strategies. Their scale and reach are inviting ever more regulatory concerns because both are chasing high risk assets”

Around two in every five pension funds have been diversifying in ways that have promoted convergence within and between alternatives and long-only.

Within the alternatives sector, convergence has been largely driven by clients seeking one or more of three things: risk diversification, absolute returns and one-stop shop solutions. Investment managers have duly responded by broadening their asset base.

“Institutionalisation of hedge funds is occurring on the supply as well as demand side”

For pension funds, much the same observation applies to the convergence between the sectors. However, there is one major point of contrast here.

Investments made in alternatives have led to product widening, requiring pension funds to engage in investment strategies that take them well outside their normal areas of expertise.

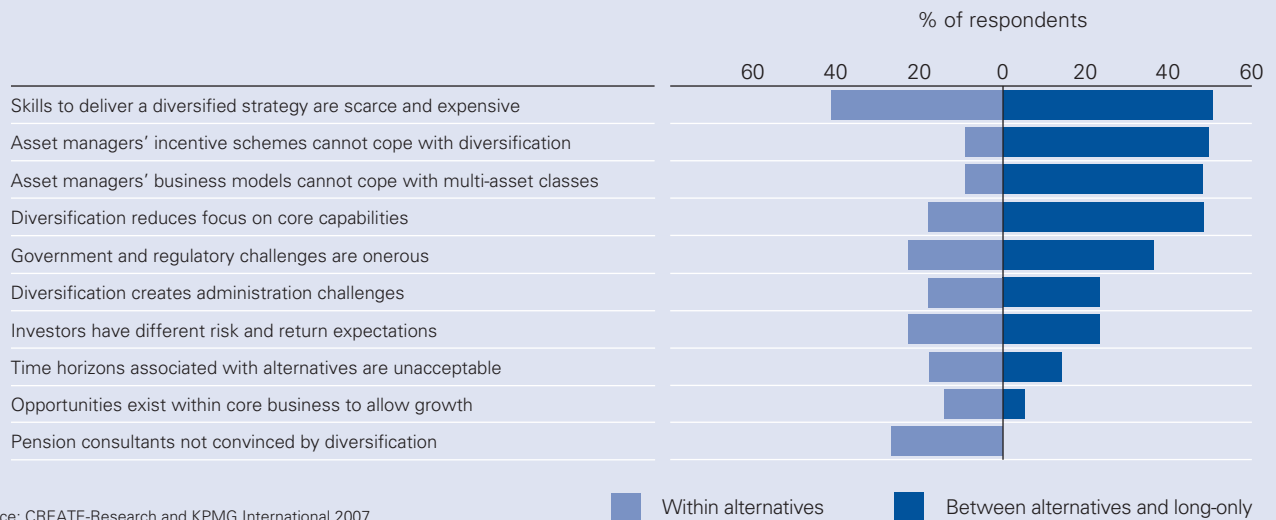
“Today, institutionalisation is the only way to create a scalable business. On the flip side, it dilutes the returns because of bureaucracy”

In contrast, in the long-only sector, convergence has promoted product deepening, creating affinity products around the existing offering without straying too far afield.

This is in line with what was reported in Section 2. As we shall soon see, pension funds also perceive numerous barriers to radical convergence, with most of them applying to long-only managers.

A multiplicity of structural factors are also working against convergence

Which factors are driving convergence within and between alternative and mainstream long-only investments?



“The world of investment management will become more diverse. Long-only managers will exist because trustees take an inordinate amount of time to make decisions about nothing”

“130:30 products seem like an excuse to ratchet up the fees”

“In the Anglo American world, the role of a pension trustee is in fact a barrier to entry for new ideas and convergence”

A number of barriers have been identified. The two common ones relate to skills and regulation.

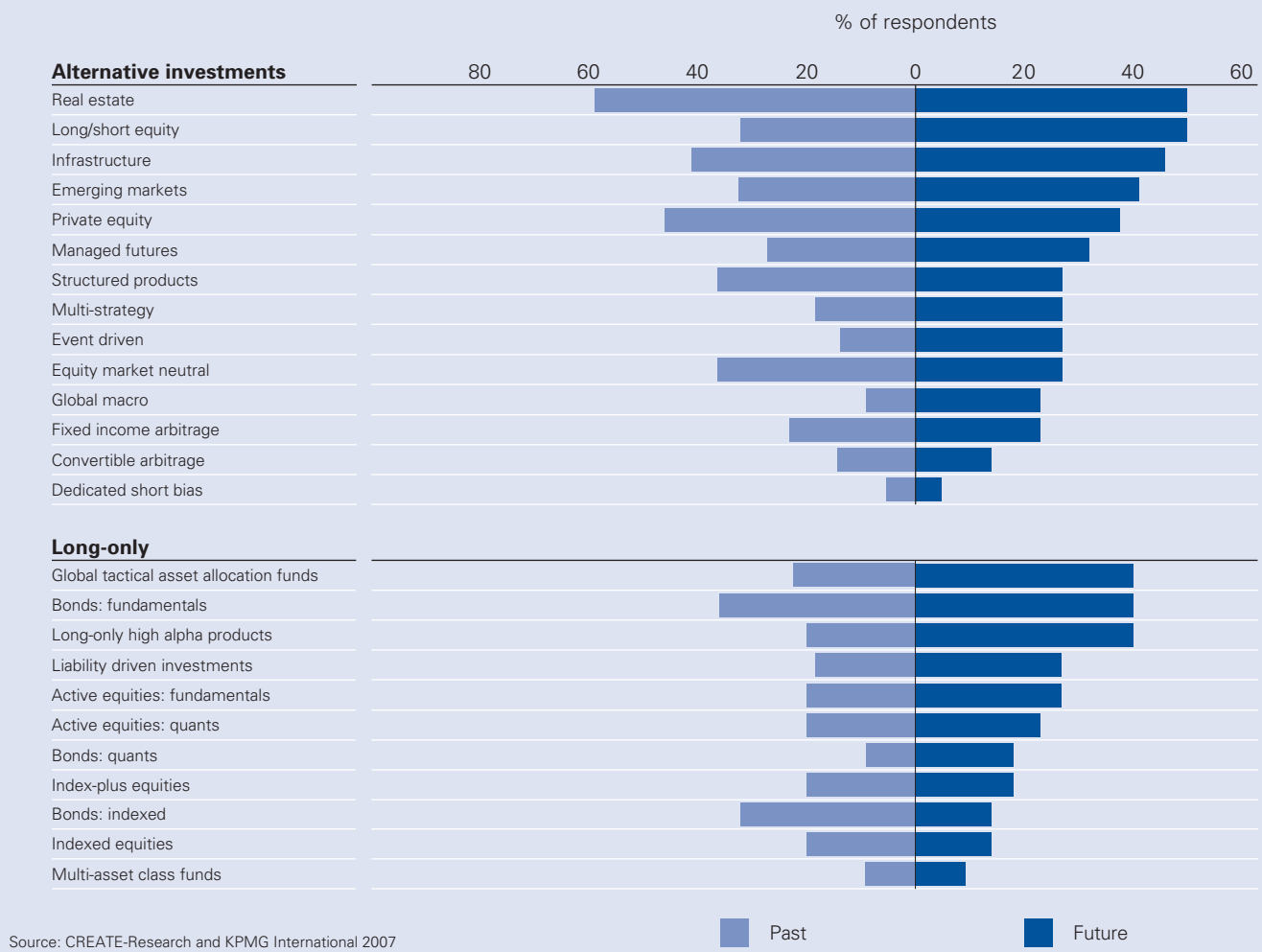
Many pension funds continue to believe that skills-based returns (alpha) are very hard to generate and replicate without further innovation that promotes more improvement in two key features of the alternatives: risk-return and volatility. For the foreseeable future, therefore, they expect beta – market-driven returns – to remain the key source of wealth creation, whilst still looking for more reliable sources of alpha.

Furthermore, new accounting rules and government regulations in Europe have been forcing a more cautious approach to investment strategies. Three new stipulations are making pension funds ever more risk averse: that Defined Benefit plans must be at least 100 percent funded by a set date; that they can no longer smooth their assets and liabilities, ensuring greater volatility in cash contributions by their sponsors; and that their assets and liabilities should be marked-to-market. These rules are now being implemented in the US. The operational risk focus of Basel II is also forcing greater scrutiny of the governance structure at the managers' end.

As a result, plan sponsors are more cautious; the strength of their covenants with trustees has decidedly weakened as the former are now faced with writing ever bigger cheques when trustees make wrong decisions.

Further diversification will continue but it will be more narrowly-based

Into which investment strategies, if any, have you diversified in the last 3 years, and which ones will they be in the next 3 years?



Source: CREATE-Research and KPMG International 2007

“Alternative funds are becoming less and less alternative”

That pension funds have been diversifying their assets is not in doubt. That it will continue in future is not in doubt. The only unknown is its pace, in part due to recent market uncertainty.

“We follow two criteria: the fund must outperform the money market by at least 100 bps; it must have short positions on the underlying markets”

In the alternatives sector, more than two in every five pension funds have gone into real estate, private equity and infrastructure. A further one in every three have also ventured into emerging markets, long-short equity, structured products and equity market neutral strategies.

“Now, hedge fund managers and private equity bosses are the new masters of the universe. But for how long?”

In contrast, the incidence of diversification within the long-only sector has been lower. Most of it is confined to strategies that use leverage, shorting and derivatives.

On the assumption that the recent contagion is contained by the end of 2007, further diversification will continue. It will focus on strategies that are easy to understand and execute. More significantly, the incidence of diversification will not be too different from the past, suggesting that the same players will continue to innovate at the edge of their portfolios. At any rate, the numbers do not imply any acceleration. But the sheer size will continue to transform the alternative investment industry.

Pension funds are very uncertain about the pattern of returns in the near future

In the next three years what average annual growth rate are you expecting in the global fund management industry in the following asset classes?

	Annual growth rate					% of respondents
	<1%	1-10%	11-15%	16-20%	>20%	
Hedge funds	15	57	20	5	3	
Fund of hedge funds	11	54	22	5	8	
Private equity	18	36	35	8	3	
Infrastructure	0	28	40	18	14	
Real estate	5	55	22	11	7	
Structured products	43	32	17	5	3	
Reinsurance products	15	42	25	13	5	
Mainstream long-only assets	8	56	29	5	2	

Source: CREATE-Research and KPMG International 2007

“We are seeing the death throes of a liquidity-driven boom”

“Average returns of the buyout business are minus one percent a year. Yet everyone is out raising multi-billion-dollar funds”

“You need to get on the consultant list, then let fund groups get to know you, which can take two to three years. A lot of time is invested during this period, then the floodgates can open”

“The allocation of a larger percentage from pension funds will continue and this will drive growth and regulatory scrutiny”

“Structured products resemble financial alchemy”

In a span of no less than seven years, pension funds have suffered a double whammy: first in the 2000–3 bear market and now the sub prime meltdown. At the time of writing this report, the extent of recent losses had not been identified. But they were likely to be significant for sure. As the narratives in the case studies at the start of this section emphasise all too clearly, pension funds now perceive any innovation as a cunning ploy on the part of their investment managers.

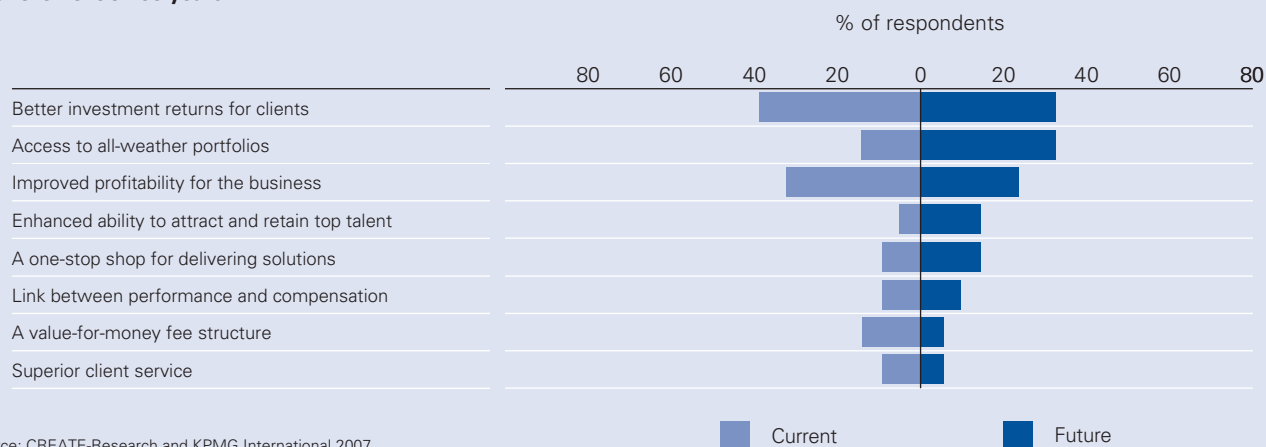
The implicit contract under which each side would promote the interests of the other is perceived as being one-sided, working against the interest of pension funds. The fact that some pension funds consider that mortgage lenders, investment banks and rating agencies were the main culprits on this occasion is neither here nor there. Everyone is tarred with the same brush when clients lose money!

Accordingly, pension funds are very cautious about making predictions about how different asset classes will fare in the near future: they've been wrong-footed too often in the past. In their view, markets will slow down in 2008, as the scale and scope of the fall-out from the recent crisis becomes more obvious. They expect flight to quality and simplicity: quality to reduce the risks and avoid capital losses; simplicity to go beyond hype and avoid over-blown expectations.

In light of the recent disillusionment, the majority of pension funds expect asset growth to remain in single digits. On a net-of-returns basis, this implies a significant slow down compared to the last three years. The brunt of the slow down is likely to be borne by structured products, hedge funds and, to a lesser extent, private equity. As we saw in Section 2, although investment managers, too, expect a slow down in the rate of growth in alternatives, they are less gloomy than pension funds. This is because they believe that high net worth individuals would take a much less pessimistic view of the alternatives due to the recent crisis.

Diversification has produced higher returns and will continue to do so in the future

What benefits, if any, has diversification produced so far for your pension fund and how do you rate their success over the next three years?



Source: CREATE-Research and KPMG International 2007

“Nearly 95 percent of the UK’s large and medium-sized pension funds have made no investments in hedge funds; with fewer than half of the 20 largest schemes having any allocation”

When it comes to benefits of diversification, it is clear that those who have diversified within or between alternatives and long-only report higher returns as the main benefit.

Fewer than one in five also report that they have had access to all-weather portfolios, allowing them to notch up better returns despite changing market conditions. Around a third of pension funds also believe that their investment managers have also done well as a result of diversification.

“We thought we were doing very well until the latest financial tsunami”

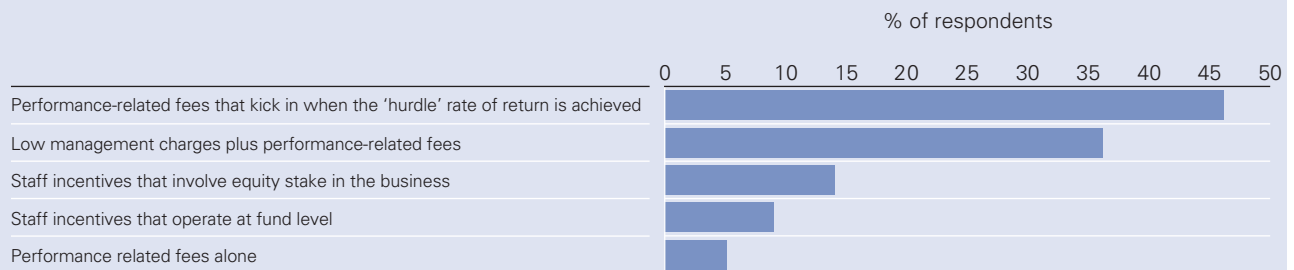
The most notable feature of the results here is that, whereas around 40 percent of pension funds reported higher returns as the main benefit of diversification in the last three years, that number is likely to fall to around 28 percent over the next three years. These expectations are overly-influenced by the recent contagion that has spread from the credit to the other markets for securities.

“There will be a flight to quality and simplicity”

Overall, the assessment shows that the benefits so far reflect the fact that some clients chase better investment returns.

Pension funds prefer variants of performance-related fees

What incentive system is most conducive to convergence?



Source: CREATE-Research and KPMG International 2007

“Currently, the dice are loaded in favour of managers”

When it comes to the incentive structure, there are three elements which pension funds perceive as being especially conducive to convergence.

“A hedge fund in Estonia is returning 96 percent every year: yes, it also does its own valuation”

The first one relates to the performance fee which kicks-in after a 'hurdle' rate of return has been achieved. They perceive this as delivering a better alignment of interests between investment managers and their clients. The underlying idea is that management charges are only justified if managers deliver a certain level of absolute returns. After all, that's what they are paid for. But if the returns delivered rise above the hurdle rate, then an incentive fee is justified.

“Mis-pricings have not gone away with new tools and models”

The second element amounts to a variant on the first in that if managers are prepared to accept a lower management fee, then performance fees can kick in as soon as returns are in the target territory. Here, the underlying idea is that there has to be a trade-off between management charges and performance fees.

The third element reflects a more general view that investment professionals who manage funds should have an equity stake in the businesses for which they work in order to secure a better alignment of interests between them, their employers and their clients.

However, one point came through clearly in the research. As clients chase absolute returns, they want an incentive structure that is predominantly focused on returns more than anything else.

4 Administrators: Long-only and alternative investments



Headlines:

This section presents the results from the survey and the follow-up interviews with administrators. Its key points are:

“The greatest thing in this world is not so much where we are, but in which direction we are moving”

Justice Oliver Wendall Holmes,
writer (1809–1894)

- **Explosive growth:** As interest in absolute returns has grown in this decade, so has the demand for their administration by an independent third party. Notably, alternatives now vastly surpass the long-only funds when it comes to the growth in the total assets under external administration. Alternatives in pure and synthetic form – alone now account for nearly 39 percent. Thus, administration is no longer a commoditized business driven by long-only managers in search of cost savings, as was the perception at the start of the decade.
- **Growth drivers:** As the size and complexity of alternatives has increased, clients’ investments have come with various strings attached. For example, apart from side letters, institutional clients have demanded independent verification of the key basics like valuation of assets, attribution analysis, performance reporting and risk and compliance. If anything, with the recent sub prime meltdown in the US, similar demands will come from high net worth clients as well.
- **Small mandates:** The shift towards alternatives has reduced the average size of mandates. On the upside, it has also ramped up the demand for a variety of value added services that now go well beyond custody and settlement. These include NAV calculations, tax planning, financial reporting, performance measurement, attribution analysis and data management. In the process, they are generating a number of functionalities that aim to accelerate product innovation in the front office and its quality assurance in the middle office. The demand for these functionalities has rocketed as their clients seek to shorten the time-to-market and reduce the ‘fat tail’ risk.
- **Global footprints:** The average size of the mandates is set to grow, as administrators expand the scale and scope of their operations outside the US. Their key targets are Europe, Asia Pacific and the Middle East. This expansion is largely client-led. As a result, the convergence reported by investment managers in Section 2 is duly echoed by their administrators. They also corroborate that the pace of convergence at the client-end is constrained by a shortage of the relevant skills and fears about the loss of focus as managers diversify.
- **Challenges:** As administrators have increasingly ventured beyond the back office services into areas traditionally associated with prime brokerage such as financing, the skills and know-how component of their activities has risen dramatically. As a result, economies of scale have been slow to emerge. Managers want a single platform which can support long-only and each variation of alternative investment products. In response, investment in the new generation of all-product platforms has accelerated, as has the recruitment of talented individuals. On both fronts, however, progress has been slow. The required technology spend is huge, due to too many legacy systems inherited from past lift-outs; and the talent pool has been vacuum-cleaned by investment managers and investment banks.

Thinking aloud...

"As administrators, we see convergence in various respects. Hedge funds and long-only managers are emulating one another's investment strategies and incentive fees. Even mutual funds are using leverage and charging performance fees on top of management charges.

Private equity and hedge funds, too, are borrowing investment ideas from one another. As if that's not enough, prime brokers are now launching their own third party administration businesses, as are some hedge fund managers. So, there are plenty of signs of convergence.

However, it has not developed to the extent where downward pressures on fees are discernible. Our margins remain high because we offer premier service especially in hedge fund and private equity administration. In both areas, we have leap-frogged our competitors

and developed middle office services centred on risk and analytics.

Despite our considerable intellectual horse-power, we do not do any valuation of illiquid assets but assist in the validation process when external experts have done the initial NAV.

The reason for not doing valuation is because of the risk of potential law suits: derivatives pricing is more an art than a science. The new generation of structured products based on them pose financial as well as reputational risks. Besides, regulators want to see a repeatable process.

On the upside, product innovation in the alternatives space has created massive growth for us. Clients are coming to us without the RFP protocol. Their institutional clients need a good housekeeping seal of approval. Because of our reputation,

we are able to cherry-pick the business, as a result.

They also view us as innovation partners who provide risk tools and data management for new strategies.

Clearly, we are viewed as an important player in their value creation process.

However, industry consolidation – both at buy-side and administration ends – means that fee compression is around the corner. Pension funds, in particular, are driving the trend towards discounted prices for a range of services. Global fund managers, too, are centralising their procurement and cherry-picking services from the cheapest locations.

As the industry becomes global, the law of one price cannot be avoided."

A global custodian bank

Source: CREATE-Research and KPMG International 2007 – Interview quotes

Thinking aloud...

"Although part of an investment bank, we are an independent administrator with strict Chinese walls between us and the internal prime brokers. We don't want to be the back office of our parent bank: that would kill us.

We focus on long-short equity and credit default swaps, using fully automated processes with no spreadsheets or paper trail at all. We use an advanced IT system that gives us total scalability in everything we do. Profitability matters more than growth.

Currently, long-short strategies are not growing so fast but as emerging markets develop, the opportunity set could be vast.

Small independent administrators will survive and prosper. They only need one client to hit a 'home run'.

Large administrators are having a hard time: they are throwing mutual fund technology at hedge funds. We have a lot of hedge funds with long-only positions, similar to long-only managers. The real convergence is

not so much in strategies, but in returns. In strategies the real convergence is between private equity and hedge funds. One of our hedge fund managers has 18 'side pockets' – all invested in private equity. Some managers have also split up assets between private equity and hedge funds.

It's hard to hire talent in the long-only sector in the US. The only managers doing well have emerging market talent.

Yet, more complex investments are around the corner. That means new regulation, for sure. Hedge funds will create options on equities when funds go up or down. To stay ahead of competitors, two things are critical. First, we need to attract and retain talent. Despite our process-driven environment, a number of middle office activities are becoming more skills-intensive and knowledge-based due to growing product complexity at the client end. Accounting and legal skills that we want are regularly vacuum-cleaned by hedge funds and private equity houses. Last year, our headcount went up by seven percent;

but the compensation bill ballooned by 28 percent.

Second, we need to develop a more robust management information system that can serve as a dashboard that gives accurate and timely readings on a number of funds, new business, attrition, revenues, profit and loss. We also need a system that provides 'heat maps' on service quality, accuracy and timeliness – especially for premier division clients. Such clients are becoming more demanding and we need to deliver a value for money fee structure that is consistent with their growth aspirations.

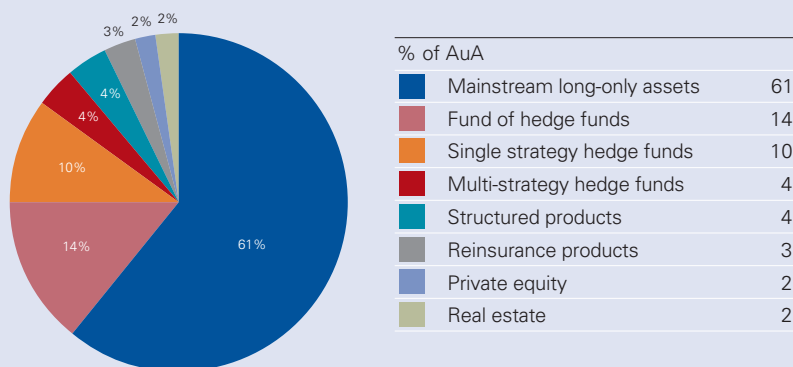
In future, clients will have multiple administrators for different services. This will make them less averse to switching between service providers. We can no longer take client loyalty for granted. We shall have to get smart at retaining clients, for sure. Being a specialist or a custodian bank will no longer be enough as the competitive landscape changes."

A specialist administrator

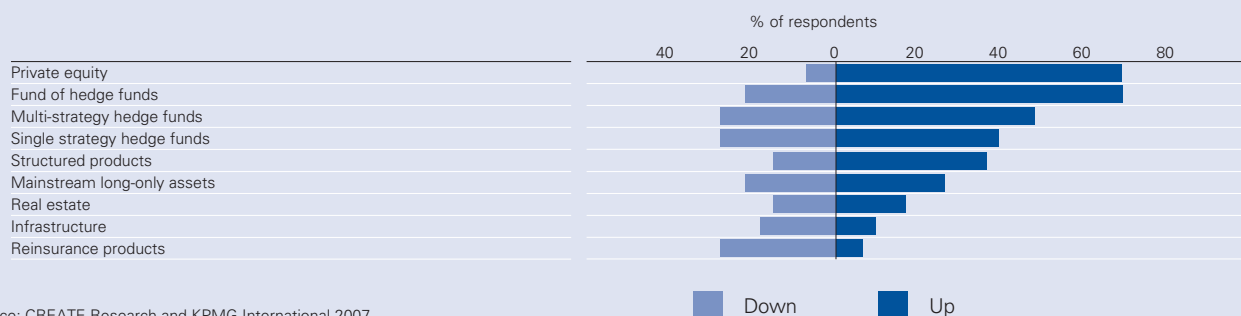
Source: CREATE-Research and KPMG International 2007 – Interview quotes

Assets under administration are much more broadly-based by asset classes, but future growth will be focused on hedge funds and private equity

What is the approximate split of your AuA between the following investment classes?



How do you expect the split across asset classes to change over the next 3 years?



Source: CREATE-Research and KPMG International 2007

“In 1995, the top three service providers had an average of US\$1,500 billion assets under administration. By 2000, this had shot up to US\$6,000 billion. Today, it is US\$11,000 billion”

“Outsourcing the back office is the fund managers’ equivalent of crossing the Rubicon”

“Today’s clients are even more demanding. They want real time systems that offer comprehensive investment accounting and portfolio information to do the analytics for global investment portfolios”

“Regulation of service providers rather than funds themselves is the best recipe for success”

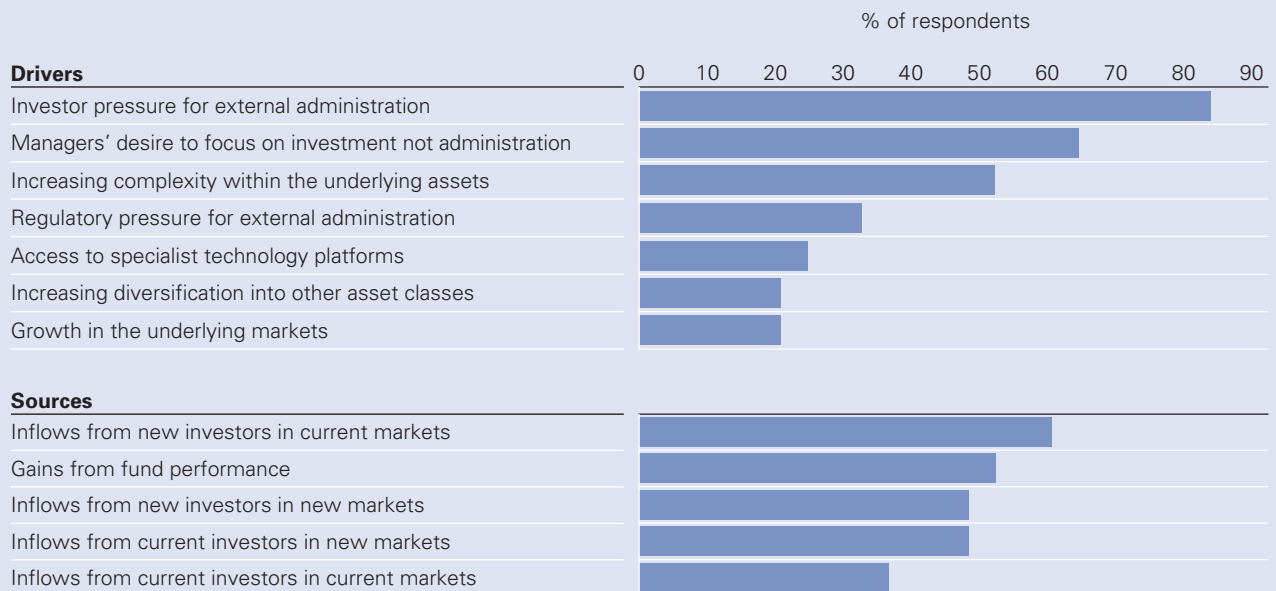
Compared to 2000, the administrators’ asset base has changed radically. Then, their main clients were long-only managers with insufficient scale to build their own in-house capability. However, as convergence between long-only and alternatives has gathered momentum, the proportion of long-only funds has declined. In fact, it has been eclipsed by hedge funds – single strategy, multi-strategy and fund of funds. Growth in reinsurance products and structured products has been just as pronounced from a negligible base.

As the end-clients have ventured into the unknown, they have increasingly required their investment managers to use independent third parties to carry out a variety of functions in order to minimise the risk of mis-reporting or fraud. Such requirements have been set by institutional investors who have had concerns about lack of governance and operational structures at the new generation of start-ups. Even long-only managers with good pedigrees have outsourced the administration for their investments into alternatives to minimise the reputational risks. For example, many of them do not as yet have the capability for processing derivatives.

Administrators anticipate that the pace of outsourcing will hot up and focus on alternatives. In particular, the share of business from private equity, fund of hedge funds, multi-strategy hedge funds, single strategy hedge funds, and structured products will accelerate. The underlying assumption is that the recent sub prime crisis will make end-investors ever more concerned about the basics of their investments: operational risks will be just as important as investment risks.

The main sources of growth will originate from new investors demanding external administration of their alternative assets

What are the principal drivers of growth within the alternative investment market?



Source: CREATE-Research and KPMG International 2007

“Both AIMA and IOSCO have issued guidelines on valuation, required primarily for the over-the-counter derivatives which are illiquid and therefore not easily priced”

“Complex and illiquid assets are typically hand-priced”

That the end-clients will drive growth in third party administration is not in doubt. That alternative managers are outsourcing their non-core activities to cope with their growing product complexity is also not in doubt.

However, it is noteworthy that growth is emanating from a variety of sources.

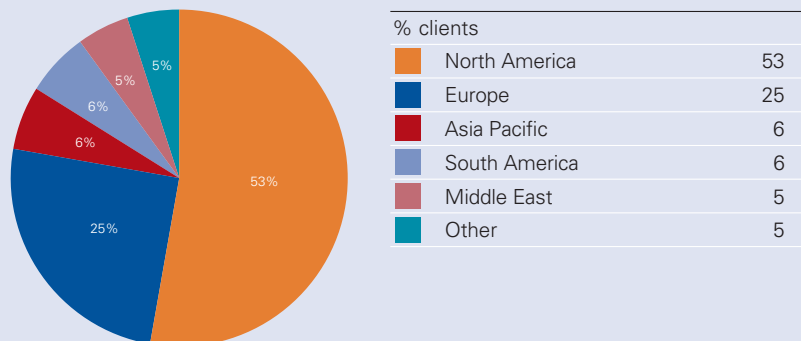
For six in every ten administrators, the majority of recent inflows come from new investors in their current geographical markets. This indicates that leading markets like the US and the UK are far from saturated: there remains ample growth potential.

For one in two administrators, there are also additional inflows from existing investors in the new markets into which administrators have already ventured. For around two in five administrators, inflows are coming from new clients and new markets.

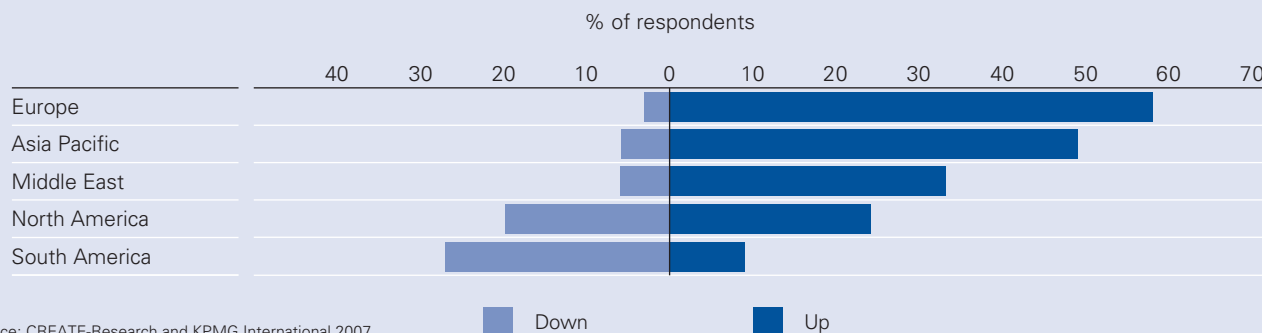
The implication is that growth in demand is more broadly-based, both in terms of clients and markets. The underlying assumption is that growth will be organic as well as displacement; organic, as the interest in absolute returns strategies grows; displacement, as the recent and new generation of clients demand independent administration at the expense of prevailing in-house servicing.

Europe and Asia Pacific will be the focal points in the next wave of growth

What proportion of your clients are located in the identified regions?



How is the split likely to change in the next 3 years?



Source: CREATE-Research and KPMG International 2007

“Europe and Japan are the new frontiers”

The US will continue to be the epicentre of alternatives but Europe and Asia Pacific will be the growth engines.

“We are seeing a lot of growth in ‘freestyle go anywhere’ type investments with aggressive tactical asset allocation”

Currently, the US accounts for around half the assets in alternatives. It has also been the fastest growing market so far. However, administrators are evenly divided about its growth prospects. One in five anticipates that it will continue its headlong growth and just as many anticipate the reverse. As for Latin America, the split may go the other way as administrators turn to other growth regions.

“Client mergers and acquisitions can just as easily end up losing mandates as gaining new business”

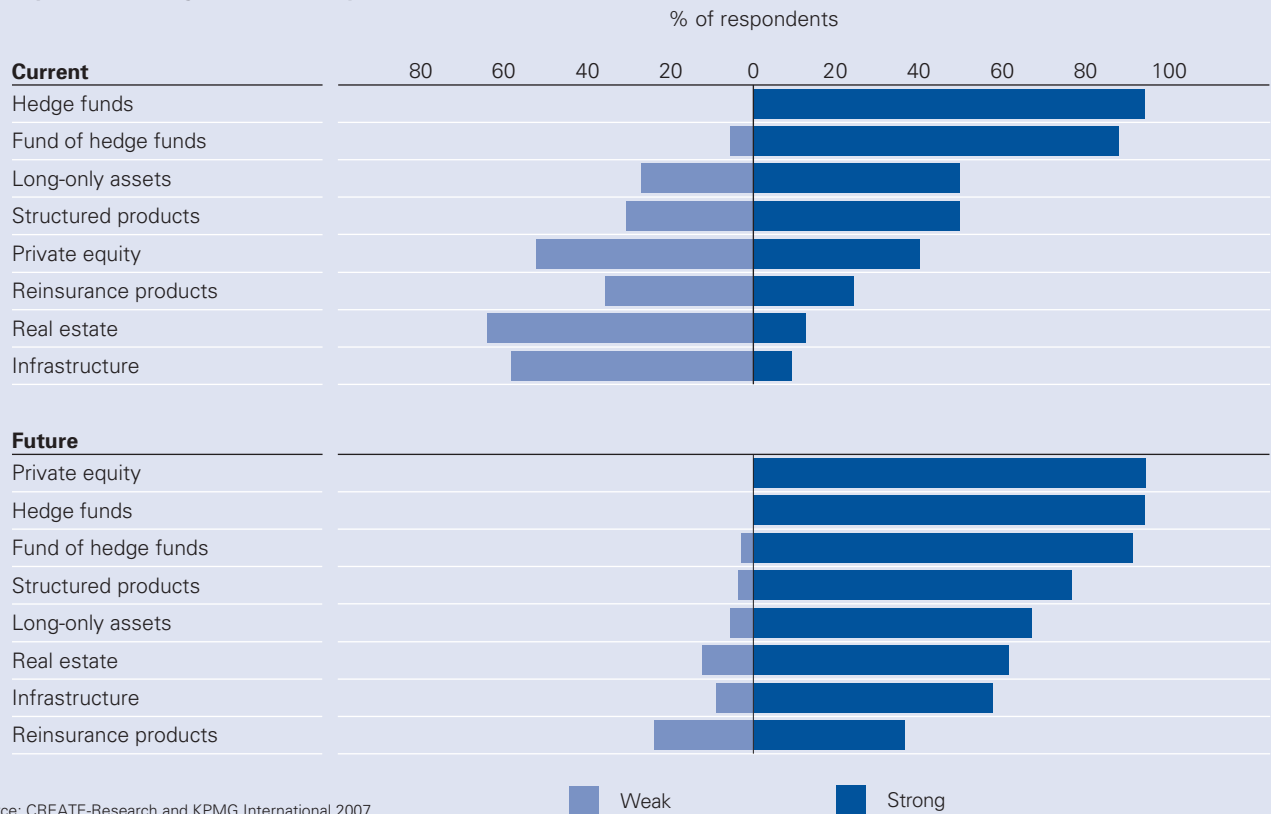
Be that as it may, Europe and Asia Pacific are likely to see major growth points. UCITS III allowing the use of derivatives and shorting is driving up the demand for mutual funds which mimic some of the basic hedge fund strategies. Furthermore, and just as important, many of the UCITS III funds are now exported to Asia Pacific under a ‘passport’ arrangement that has attracted huge inflows of funds into Europe.

“The largest mandates tend to gravitate towards the big custody bank providers”

Accordingly, administrators are creating hubs outside the Americas to provide value-added services, while squeezing further efficiencies out of the existing platforms for traditional services like custody and settlement. This form of core-satellite arrangements underpin a ‘horses for courses’ approach under which capabilities that require client proximity are decoupled into hubs, leaving the commoditised end into ever fewer locations. In particular India and Canada will emerge as centres for commoditised services; whilst Dublin, Cayman Islands, Bermuda, Luxembourg and Channel Islands will continue to grow as hubs within jurisdictions that have long-standing expertise in third party administration.

Within alternatives, the main interest for outsourcing comes from hedge funds and private equity but others will join the fray

What level of interest is there currently from other alternative investment classes to outsource administration and how do you expect it to change in the next 3 years?



Source: CREATE-Research and KPMG International 2007

“The industry is at the dawn of a dramatic metamorphosis that offers customised pick ‘n’ mix propositions”

“Data management is a major opportunity for the custodians”

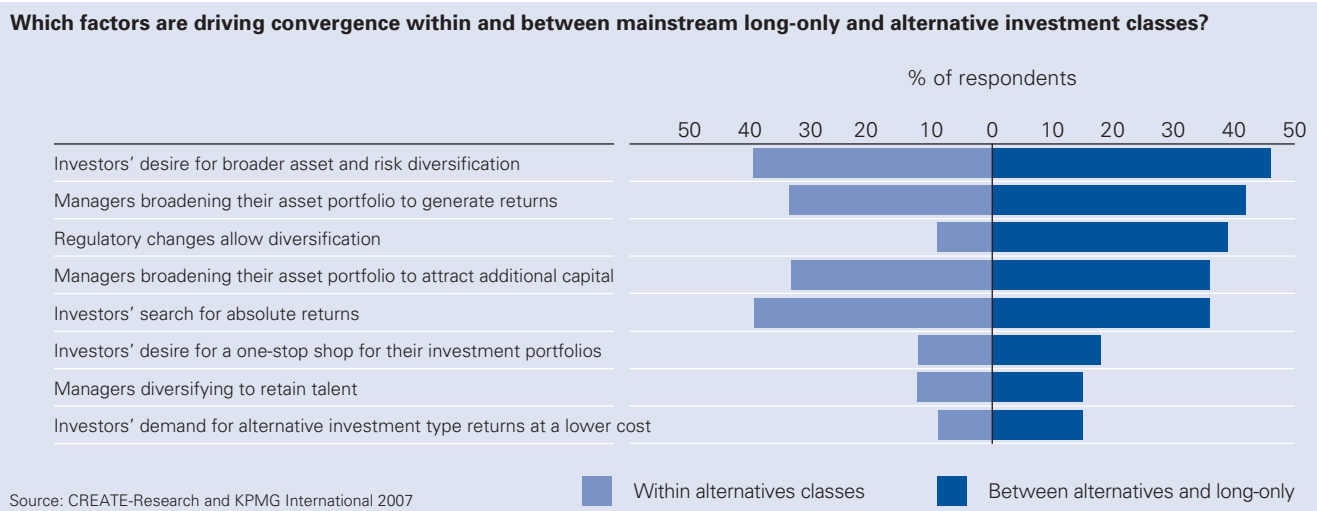
The recent level of interest in outsourcing the back office administration is strongest in hedge funds and fund of hedge funds.

To a lesser extent, there is also a varying degree of interest from long-only managers and structured product providers. In the first of these, the managers involved are medium-sized and have undertaken significant diversification in this decade.

However, so bullish are administrators that they expect the interest to increase dramatically over the next three years, especially on the part of private equity firms. Given the decision times and implementation times involved on the part of investment managers, the administration industry will change dramatically over the next five years if these expectations materialise. Not only that, even the value chain of investment management may change dramatically.

Either way, these expectations highlight the seeming paradox. On the one hand, outsourcing implies that managers will focus on what they are good at. But the accompanying convergence implies that they will venture further afield. The underlying explanation is simple. They will offload ever more non-core activities and do more things within the core activities. Outsourcing is meant to generate economies of scale by sharing activities with others. Convergence is meant to generate economies of scope by expanding the base of core activities.

Search for better returns is driving convergence amongst the clients of administrators to alternative investments



“Three factors will shake up the outsourcing industry: industry consolidation, product complexity and market competition”

“Prime brokers and hedge fund administrators have been quick to spot opportunities in custodians’ capabilities and taken business away from them”

For administrators, the convergence within and between the sectors is driven by a chain of factors led by the end-investors’ search for absolute returns via broader diversification opportunities.

Regulators, too, have obliged by allowing the use of leverage, shorting and derivatives. As a result, managers in long-only as well as alternatives sectors have broadened their asset bases, as described in Section 2.

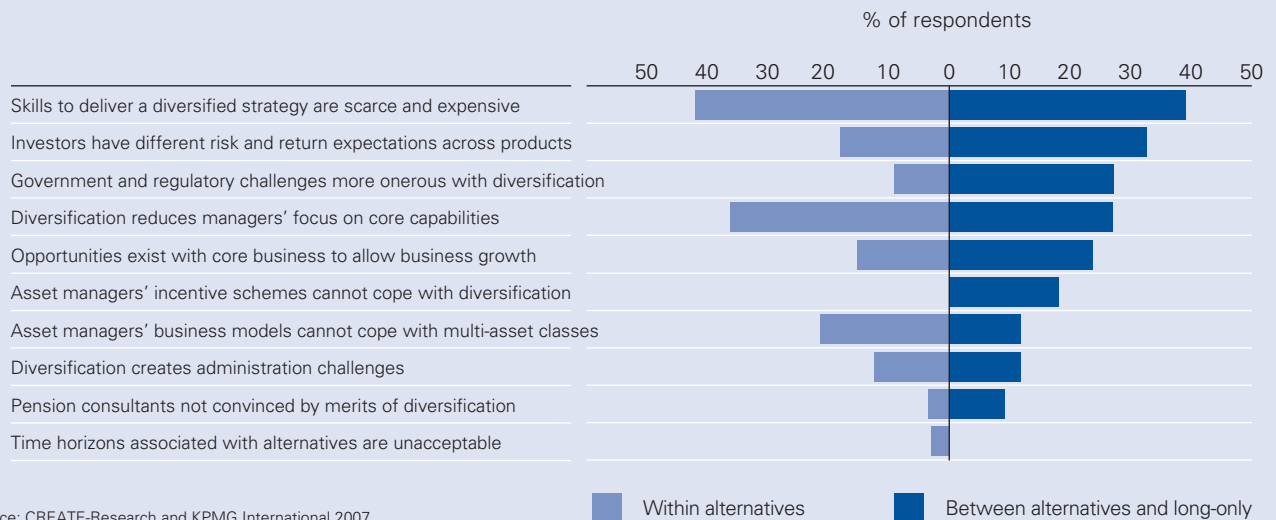
Notably, the proportion of administrators reporting convergence is broadly similar to that of managers, reported previously. But they also go one step further. Having administered many newly created funds, long-only administrators feel that absolute returns mark a new investment paradigm.

On this argument, the old world of relative returns and benchmark hugging did nobody any good. At the end of a raging bull market, investors ended up with huge losses from which they have yet to recover. By sticking to the old ways of thinking, investment managers ended up with a variety of missed opportunities for their clients and themselves alike.

As such, the recent convergence is demand-driven and therefore more likely to be durable than if it were just supply-driven.

But the state of convergence is limited by a shortage of skills

Which factors, if any, are inhibiting convergence within and between long only and alternatives classes?



“Valuation is a ‘no-go’ area for us. Credit markets are volatile and their products have not been stress-tested. Yet in the medium term, we will have to develop pricing expertise otherwise we risk degenerating into a commodity shop”

“We did consider creating a dedicated valuation capability via an independent company. But that would not mitigate the risks associated with mis-pricing”

“We have to be part of a dialogue on what operational excellence means”

Like investment managers, administrators also see two major factors currently slowing down the pace of convergence. First, they think that skills to deliver absolute returns with diversified strategies are scarce. Second, they also believe that managers run the risk of losing focus if they diversify.

A number of other factors are also cited. But the two that received special mention in the interviews were business models and incentives.

Taking them in turn, many administrators argued that even within many large investment firms with a simple product portfolio, a scalable business model has remained a mirage. Business growth has created complexity, especially when it has involved going global. Complexity, in turn, has undermined operating leverage by driving up the cost income ratio. In a bull market, that is not a problem. In a down market, it can be fatal.

Administrators believe that there is a trade off between economies of scope and economies of scale. One means doing new things; the other means doing the old things well. Few managers have managed to get the balance right. Convergence may, if anything, exacerbate it.

The second inhibitor centres on incentives, especially in the long-only space. The proliferation of strategies has also seen new incentive systems for different categories of portfolio managers. This has not only proved divisive at a professional level. It has also undermined the ‘one company’ ethos which the owners often seek to promote.

Projected growth in assets in alternatives and long-only will be broadly similar

Over the next three years what average annual growth rate are you expecting for the global investment management industry in the following asset classes?

	Annual growth rate					% of respondents
	<1%	1-10%	11-15%	16-20%	>20%	
Hedge funds	12	38	32	10	8	
Fund of hedge funds	10	32	36	16	6	
Private equity	4	38	28	18	12	
Infrastructure	12	41	25	14	8	
Real estate	14	48	26	12	0	
Structured products	20	36	26	10	8	
Reinsurance products	14	38	28	12	8	
Mainstream long-only assets	12	42	24	14	8	

Source: CREATE-Research and KPMG International 2007

“Hedge fund managers are venturing into private equity using Cayman as a familiar jurisdiction”

Within investment managers and administrators there is a widespread belief that the recent turmoil in the markets will slow down growth, but especially in alternatives compared to the recent past. Although, on the whole, administrators are far less pessimistic than investment managers.

“Investors should not rely on credit ratings alone”

That said, a significant minority of administrators expect each of the listed asset classes to record a negative growth, after the boom over the past four years. In the interviews, a number of points were emphasised.

“Every SPV should be audited”

First, the uncertainty around the scale and identity of the losses in the recent turmoil is a major factor promoting bearish sentiments. Even if final losses turn out to be far less than the worst case scenario, the crisis has been a wake-up call for investors about how quickly and seriously things can go wrong.

“The recent US sub-prime mortgage crisis is one of the stimuli to move towards understanding the risk and having greater transparency in pricing”

Second, with the recent liquidity crisis, administrators fear that many strategies using leverage will be denied liquidity on a scale that makes a material difference to the size of returns. With lower leverage, there is a possibility that even the best managers will find it hard to replicate their past performance. The mega buy-out will be much more expensive.

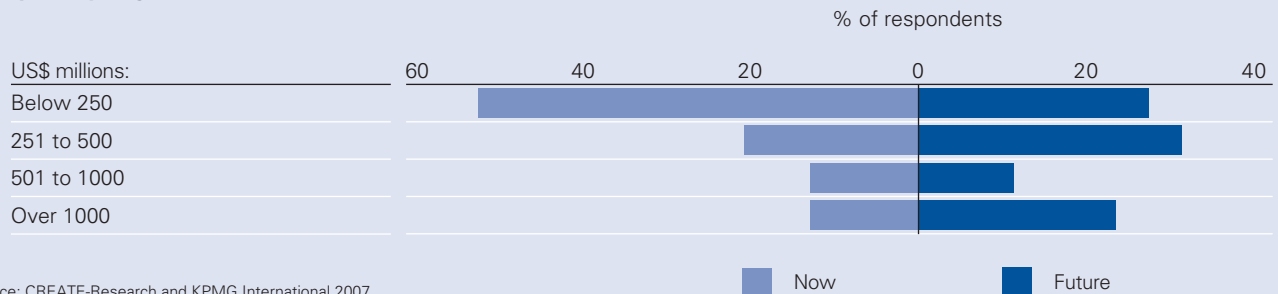
“To satisfy the demand of investors, many structured vehicles will shift towards more standardised and user-friendly documentation”

Third, on the upside, administrators expect the interest in absolute returns to continue and especially benefit them. The credit crisis has once again turned the spotlight on the criticality of basic activities such as valuation, attribution analysis, performance monitoring and risk analysis. Some administrators suggested that the latest crisis has severely undermined the integrity of prime brokers and rating agencies.

The role of independent administration is set to increase: not despite the crisis but because of it.

The prevalence of small mandates reflects the relative newness of the alternatives but it will change with growth

Currently, which fund-size does your business focus on serving? Over the next 3 years, which category do you see as your primary target fund size?



Source: CREATE-Research and KPMG International 2007

“Complex and illiquid assets are typically hand-priced, involving an evaluator calling the desk of a broker-dealer who makes the market in the asset in question”

The average fund-size which administrators focus on is low currently. More than one in every two administrators focus on funds with less than US\$250 million; a further one in five focus on mandates between US\$251–500 million. Only around one in six have mandates in excess of US\$1 billion. There are a number of reasons for this.

“The middle office is increasingly important as more funds approach the US\$1 billion mark and increase their exposure to derivatives”

The relative newness of alternatives has been a major factor. The other one is the polarised nature of the investment industry.

“Buy-side firms want flexibility in terms of service, cost and product development. They are increasingly looking to solutions that do not tie them exclusively to a single provider”

At one end, there are scale players who run multi-portfolios and have a global reach. They include long-only managers, catering for large pension clients and mass mutual funds markets, and a handful of the largest private equity firms and hedge funds.

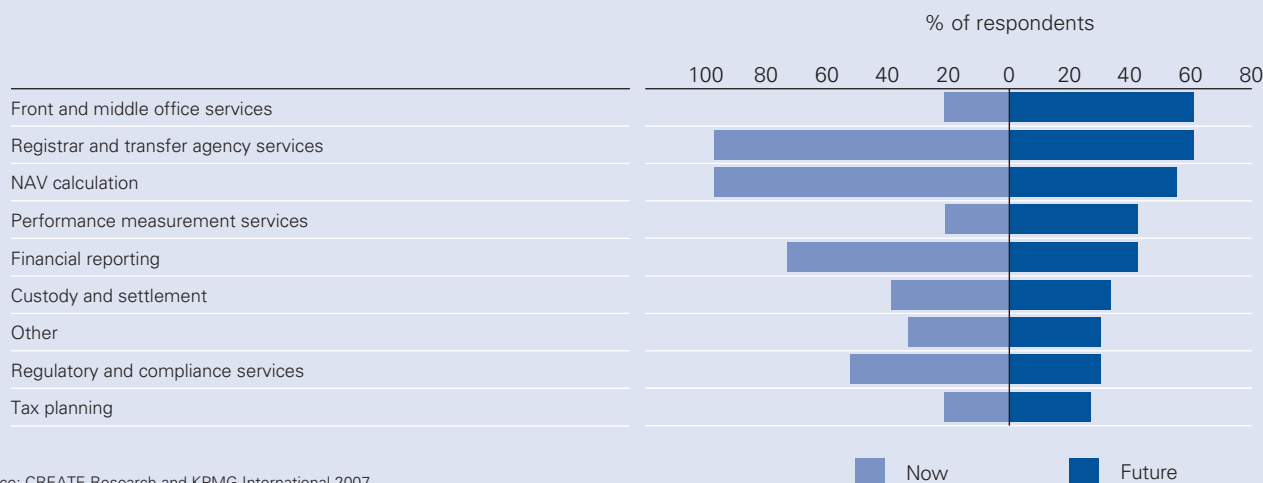
“We’re staying away from valuing products that are created on the fly. You only know their price when sold”

Outside this select band, the alternative industry retains its cottage nature, characterised by small businesses, focused on their core capabilities. Many are life-style businesses where profit matters more than growth. However, many recent entrants have grand aspirations and wish to sit alongside major players.

However, as the asset industry becomes more institutionalised, the ranks of large alternative managers is set to grow and with that will grow the size of funds to be administered.

Future growth in administration services will focus on high value added areas

Which administration services do you now provide and which do you expect to grow markedly in the next 3 years?



Source: CREATE-Research and KPMG International 2007

“Although a firm’s technology and products attract clients, it’s the calibre of a firm’s staff that retains them”

“Derivatives processing is a manual operation. Also collateral servicing agreements require a lot of sign-offs”

“Custodian banks are at different stages in developing multi-firm technology platforms to venture from back office to middle office functionalities”

Administrators expect the next wave of growth to focus on high value added services. Two sets of changes are most likely.

The first set covers the four areas which have driven growth in the past: registrar and transfer agency services; NAV calculation; financial reporting and regulatory and compliance services. Each of these areas is expected to grow over the next three years.

The second set covers areas which are relatively new but poised for a take off. They include front and middle office services, performance measurement and attribution analysis, and tax planning.

From this research, it is clear that some administrators have ambitions to compete head-to-head with prime brokers. To do this, they will need to develop a wide range of new capabilities.

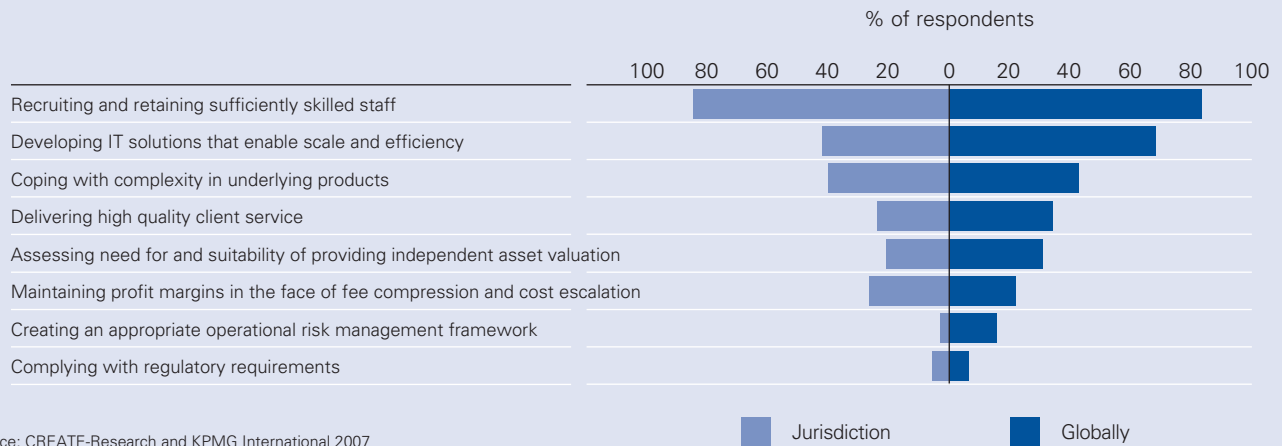
The implied diversification will have structural implications. While the expected consolidation will reduce the number of administrators, there is likely to be a clear bifurcation between all-service administrators and specialists.

The growth of alternatives will continue to favour two categories of administrators: small niche players and large investment banks seeking to diversify. Niche administrators are more likely to welcome smaller start-up managers rather than their larger peers who will look for minimum mandates of over US\$1 billion.

Thus, alongside concentration, there will be a huge variety as the investment industry grows and evolves.

Skills shortages and IT developments are the main challenges facing administrators

What are the key challenges now facing the administration sector within your own jurisdiction and globally?



“A lot of asset managers keep their old systems as a back-up”

Although the outsourcing industry is less than 15 years old, it has yet to acquire the agility of a young industry due to two reasons.

“Experience shows that custodians have been unable to produce the operating leverage and cost savings originally promised”

First, an overwhelming proportion of the first generation deals have involved lift-outs by simply managing facilities and staff of the client companies. As growth continued, the challenges for getting more and more clients on to a common platform multiplied exponentially. In part, this was because of the differences in the chronological age of the legacy systems. Limits to systems integration were narrow.

“In some cases, custodians are losing money on individual clients in a bid to ramp up their market share”

Second, administrators also had an image problem: they were perceived as commodity merchants. They have therefore found it hard to attract talent.

“Outsourcing invokes more passion than reason; issues get mired in politics and personalities and lose business focus”

However, the phenomenal growth driven by alternatives has transformed the fortunes of the industry, bringing to the fore all the problems of success which are the usual birth pangs of new industries.

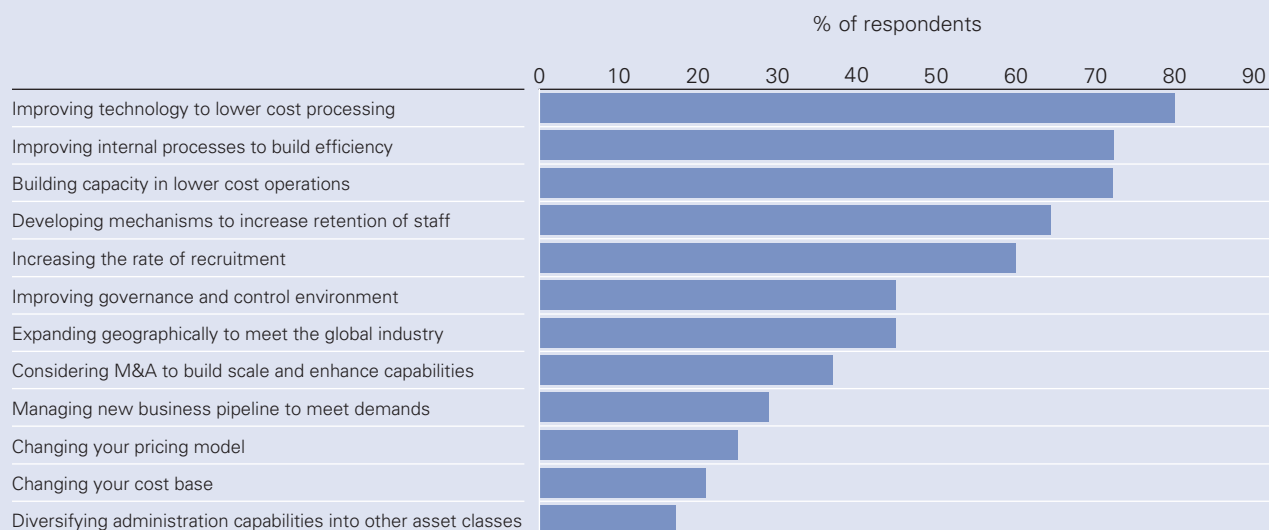
“Play-and-plug platforms are vital for credible diversification: they won’t be here for at least three years”

To start with, skill shortages have become more acute. Prevailing technology has lacked scale and connectivity with front office systems in a majority of cases. Product complexity has promoted manual operations to the detriment of costs and speed. Client service has not matched expectations.

Worldwide, some prominent outsourcing deals had to be reversed. The immediate cause was poor service and poor project management. The basic cause was the inability to build a completely new infrastructure rather than tweak at the edges of the old one. Even in labour-intensive areas like valuation of opaque instruments, administrators had to hold back partly because of the shortage of skills and partly because of reputational risk in the event of lawsuits. Administrators have had to walk a fine line between the old and the new.

The business model used by administrators is being improved by enhancing technology and process capability

How are you adapting your business model to respond to the key challenges facing the industry?



Source: CREATE-Research and KPMG International 2007

“Today’s custody accounting systems are not ideally suited to the demands of short positions or structured OTC derivative contracts. Expertise is hard to acquire. Compensation bills are rocketing as skill shortages intensify”

“In order to ensure the integrity of our processing platforms, we are ratcheting up quality improvements around measures such as Six Sigma”

“Rating agencies are looking out for signs of quality philosophy at fund managers by looking at service level agreements with administrators to assess how quality is delivered”

In order to overcome the challenges, four sets of actions are being taken, each mutually reinforcing.

The first set relates to technology. Investment is being stepped up to create all-product platforms capable of taking on business from diverse sources and generating scale economies which are the hallmark of a good administration business. The share of technology in the cost base is expected to rise from 17 percent to 24 percent across the industry. Some of the new platforms will have the capability to absorb new business without a long run-in period. They will also have to modularise to the extent that clients can cherry-pick services à la carte.

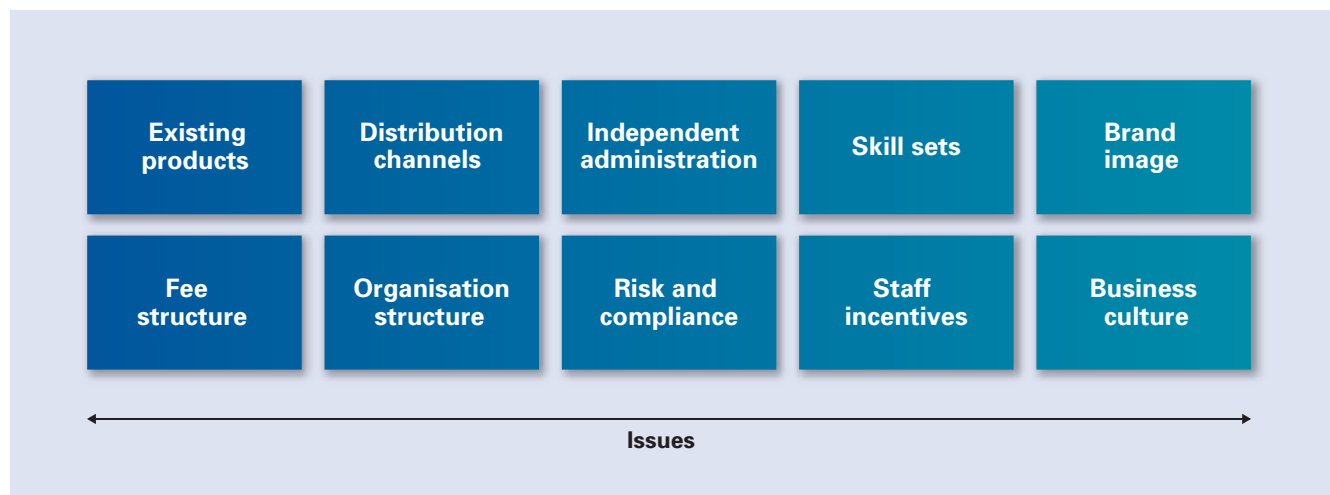
The second set refers to the restructuring of skills. Via technology, many of the clerical jobs are being phased out. Via generous compensation programmes, the talent pool is being augmented. More lawyers, accountants and IT professionals are being brought on board to spearhead the drive into added value services in the front and middle office.

The third set refers to quality. Some organisations are attempting to implement assurance tools and standards – like Six Sigma and ISO 9000. They aim to nurture the quality ethos across the value chain. The forces that are driving institutionalisation at the client-end are just as pervasive at the administration end. The aim is to improve quality while enhancing control and governance of the business.

The final set refers to M&A. The industry has witnessed major deals in the last eighteen months. One in three administrators are contemplating their strategy in this area. Most of them expect the pace of mergers to accelerate in order to consolidate the next generation of capacity around state-of-the-art platforms and talent pools which require huge outlays.

Checklist

A checklist for enhancing the benefits of convergence



“Convergence does involve some heavy lifting”

“Under the hood, there have been many challenges”

“Change management is harder than most people realise”

“It is one thing talking about a new model for a new age. Quite another delivering it”

After the recent crisis, if convergence is to enhance the benefits for end-clients and their fund managers alike, ten issues need to be addressed because of their unintended consequences. For many investment managers, they have added complexity in the business models on a scale that has raised the cost income ratio and lowered the operating leverage. They are:

- 1 Convergence has increased dysfunctional rivalries within the firms:**
how do you guard the existing revenue stream when creating a new one?
- 2 Clients report that some products look like being created on the fly:**
is the value proposition of your new products defined well enough for clients to understand what it says on the tin and what it costs?
- 3 People in distribution channels are not *au fait* with new products:**
do you have product specialists in the channels who straddle the gap between investment professionals and their end-clients?
- 4 Investment professionals have not had sufficient autonomy to generate high conviction ideas and be accountable for them:**
are the relevant structures and systems in place?
- 5 Operational issues have had lower priorities:**
what is being done to improve operational excellence in the back office to mitigate various risks that worry clients?
- 6 The biggest risk is the one we don't know:**
do your risk systems cater for the 'fat tail' risks?
- 7 Skills for absolute returns have been scarce and constantly re-priced:**
what are you doing to recruit, retain and deploy the talent?
- 8 Incentives need a clear alignment between managers and clients:**
how are you achieving this alignment?
- 9 Brand image has taken a back seat in search for alpha:**
what are you doing to ensure that the brand means 'a promise kept'?
- 10 Internal rivalries have frayed business cultures:**
what are you doing to promote a 'one company' mindset?

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