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# Going Mainstream

## Developments and Opportunities for Hedge Fund Managers in the '40 Act Space

April 2014

# Contents

# I. Study overview

The '40 Act alternatives market has recently become one of the most widely talked-about new developments for the Hedge Fund (HF) industry. Interest in these products comes at a time when the growth of assets in the HF industry has slowed, leading some observers to conclude that the HF industry has become a mature, slow-growth industry. This interest in '40 Act HFs has really only become strong in recent years although the Investment Act of 1940 itself has been around a very long time. In this content piece, we examine why the interest in these products is so strong now, what this opportunity represents for HFs, and how HFs may become involved in this space.

The main areas we address in this piece are the following:

1. **Current landscape**
   a. What are '40 Act funds? How have they performed recently?
   b. How big is the '40 Act alternatives industry? What is its composition?
   c. Why are '40 Act funds of interest to HFs, FoHFs and investors now?
2. **The players**
   a. What are the key roles to be played in the '40 Act HF market and to whom are they best suited?
   b. What options are open for different players to get involved in the '40 Act space? What are the main considerations for each of these options?
3. **Rationale for launching a '40 Act product**
   a. What is the size of the addressable asset pool for '40 Act HF managers?
   b. What are the primary motivations for HFs to enter this space? What channels are they planning to target?
   c. Is there a first mover advantage?
4. **Considerations for HF managers**
   a. What are the main considerations when approaching the '40 Act space?
   b. What are the key risks of launching these products and how can HFs best mitigate them?
   c. What are the growth prospects over the next five years and what should be some important decision factors for HF managers?

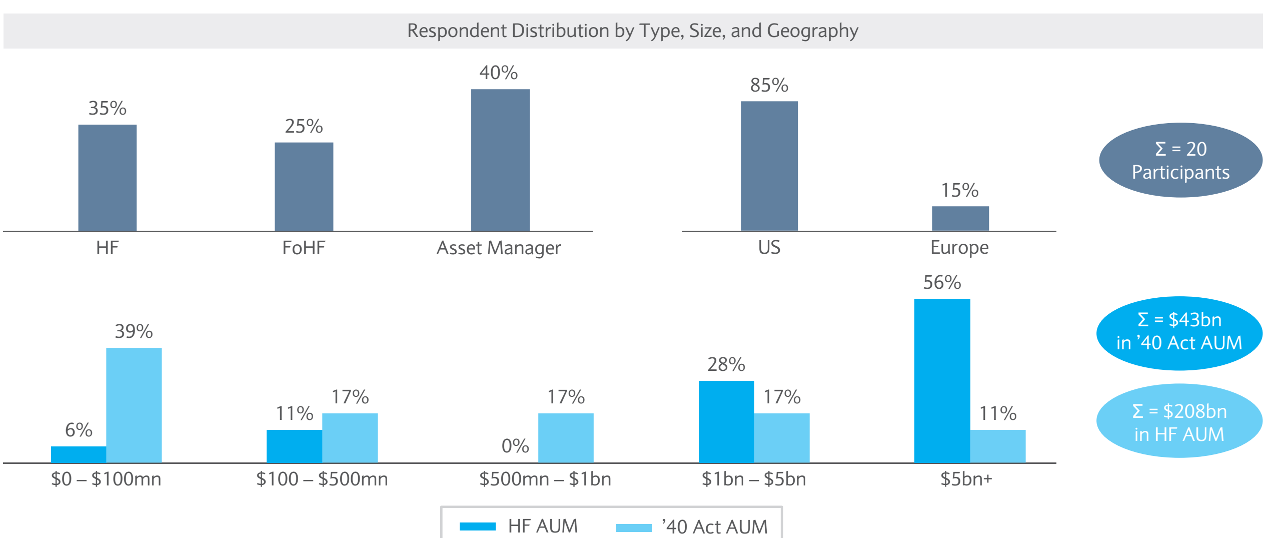
## Methodology

With these areas in mind, the Strategic Consulting team tapped four sources to gather the required information for the study:

- Interviews
  - Interviewed 20 players in the '40 Act market, including HFs, Funds of Hedge Funds (FoHFs), and asset managers.
  - Representing $43bn in '40 Act AUM (around one-third of the '40 Act alternatives industry) and $208bn in HF AUM.
  - Predominantly US-based.
- More than 10,000 data points from a number of HF and mutual fund databases: HFR, Morningstar and Strategic Insight.
- Fund prospectuses and other publicly available data on '40 Act funds.
- Reviewed existing literature on the '40 Act industry.

Figure 1 depicts the distribution of the 20 participants interviewed, by three attributes – type of business (HF, FoHF or Asset Manager), geography, and level of AUM (in both HF and '40 Act products).

FIGURE 1




Source: Strategic Consulting survey results

# II. Executive summary

The following are high level takeaways from the study:

## Current landscape

- The Investment Company Act of 1940 offers a way for Alternatives asset managers to package their strategies within the format of a mutual fund that can be marketed to US retail investors.
- These products have seen strong asset growth in recent years.
- While '40 Act alternatives are still a small part of the overall US mutual fund industry, their asset base is growing rapidly, especially compared to the growth in the more mature HF industry.
- The performance of '40 Act products managed or sub-advised by HFs has been better than the performance delivered by '40 Act products overall.

## The players

- There are three roles to be played in the '40 Act market – the investment manager, the product sponsor (responsible for setting up the fund), and the distributor; the combination of these roles played by any industry participant depends on the existing capabilities of the participant and / or their willingness to invest in developing capabilities.
- There are three main types of players in the '40 Act HF market – HFs, FoHFs, and Asset Managers.
- Depending on their scale and commitment to the '40 Act market, there are three options available to boutique HF managers to access the space: act as a sub-advisor on a platform, sub-advise their own product or be the investment advisor, sponsor and distributor of their own product.

## Rationale for launching a '40 Act product

- The size of the existing US mutual fund industry and the assets held in the US retail and retirement markets imply a significant opportunity for HFs to grow and / or diversify their businesses through '40 Act products.
- HFs could realise the higher valuation multiples asset managers and mutual funds tend to have due to their reduced earnings volatility.
- Launching a '40 Act product sooner than later may allow new entrants to realise a 'first mover' advantage.

## Considerations for HF managers

- In many cases, HFs will need to modify their strategies to comply with '40 Act regulations and / or make a significant upfront investment to deal with increased infrastructure demands.
- The most material opportunity comes from the retail market, which is a new challenge for most HF managers; as such, finding a distribution partner is usually the best course to take to overcome some of these difficulties.
- Fees in the '40 Act world are generally much lower than in the HF world and no incentive fees can be charged (except in rare circumstances), although HFs can price their '40 Act offering at a premium to non-HF offerings.
- These factors and others, such as being labelled an 'asset gatherer' by some investors, create risk for HF managers that decide to launch a '40 Act product, thus requiring HF managers to carefully weigh the pros and cons of doing so.

# III. Current landscape

To put into context the current interest in the '40 Act market, we first examine the current landscape: what these products are, how big the market is, and who the typical and potential buyers are.

## What are '40 Act alternatives?

A '40 Act fund is any fund compliant with the Investment Company Act of 1940. Some of these products are also compliant with the 1933 Act.

For HFs, the '40 Act offers a way for their strategies to be packaged in a mutual fund format and then offered to non-accredited investors. As such, a '40 Act fund can access retail distribution channels and a previously untapped pool of assets. However, the regulatory requirements for '40 Act funds are much greater than for offshore HFs.

For the purposes of this study, we will focus only on open-ended funds that calculate their net asset value daily, as these are both the most common format and the one most easily accessible to retail investors. The following are some key, high level regulations for a daily liquidity, open-ended '40 Act fund:

- Leverage
  - A minimum 300% 'asset coverage' requirement (i.e., maximum leverage of 1.33x), although this refers only to cash borrowing, not leverage attained through derivatives exposures.
- Short-selling
  - Short-selling is allowed but has to be done in a tri-party arrangement with assets segregated to cover the positions.
- Liquidity
  - The fund must honor daily redemption requests.
  - NAV must be struck daily.
  - Illiquid securities can be no more than 15% of the fund.
- Diversification
  - At least 50% of the fund's holdings must be 'diversified' – taken to mean no more than 5% of the fund can be invested in securities of any one issuer.
- Transparency
  - Portfolio holdings schedule needs to be filed with the SEC (and made publicly available) quarterly within 60 days of the end of the quarter.
  - Similarly, annual and semiannual reports need to be filed. A Prospectus and Statement of Additional Information needs to be filed with the SEC and be publicly available, including:

- Detailed information on the portfolio manager / team, with disclosure of the number of funds managed by the portfolio manager / team.
- Information on the compensation of the portfolio manager / team.

- Investment Mandate
  – Fundamental investment objectives and strategies may not be changed without shareholder approval.

## Size of the '40 Act industry

The overall '40 Act industry – that is, all US mutual funds – at $13.2tn, is more than five times larger than the entire global HF industry. As Figure 2 shows, alternatives make up just 1% of the overall '40 Act mutual fund industry, and products where the investment manager is an HF are only aproximately one-third of these. '40 Act products where the investment manager is an HF are split roughly equally three ways, between products set up by asset managers but sub-advised by HFs, products set up by FoHFs and sub-advised by HFs[1], and products set up and managed in-house by HFs.

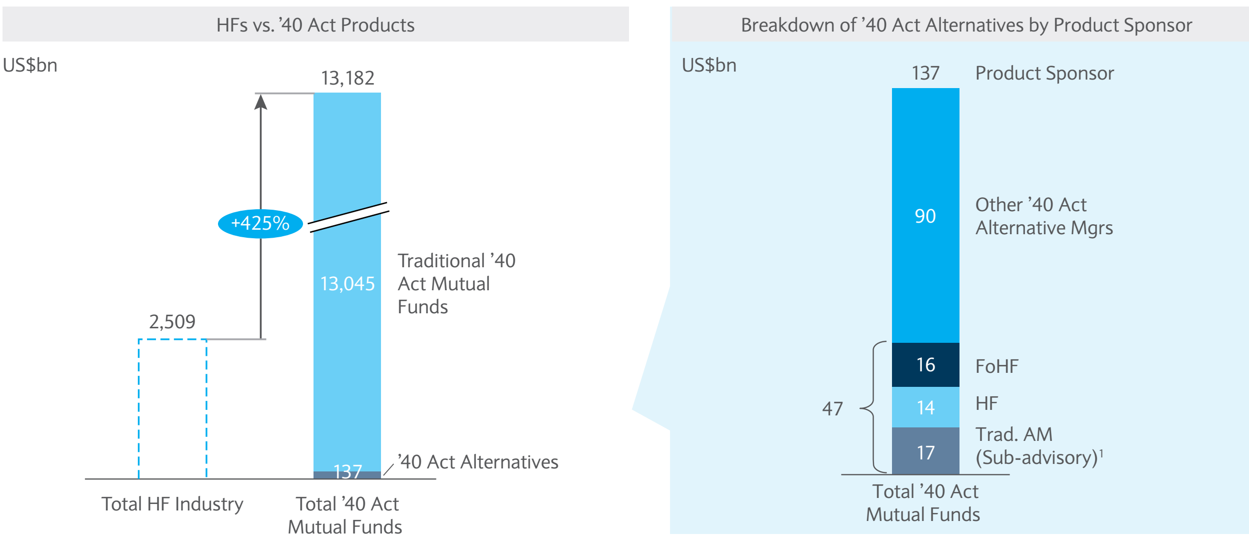
The absolute number of managers offering products where the investment manager is an HF is small: just 21 overall have >$100 million of '40 Act AUM, per our estimates.

## Growth of the '40 Act industry

Unlike the HF industry, which we consider to be a more 'mature', slower-growth industry, the '40 Act space is growing at a

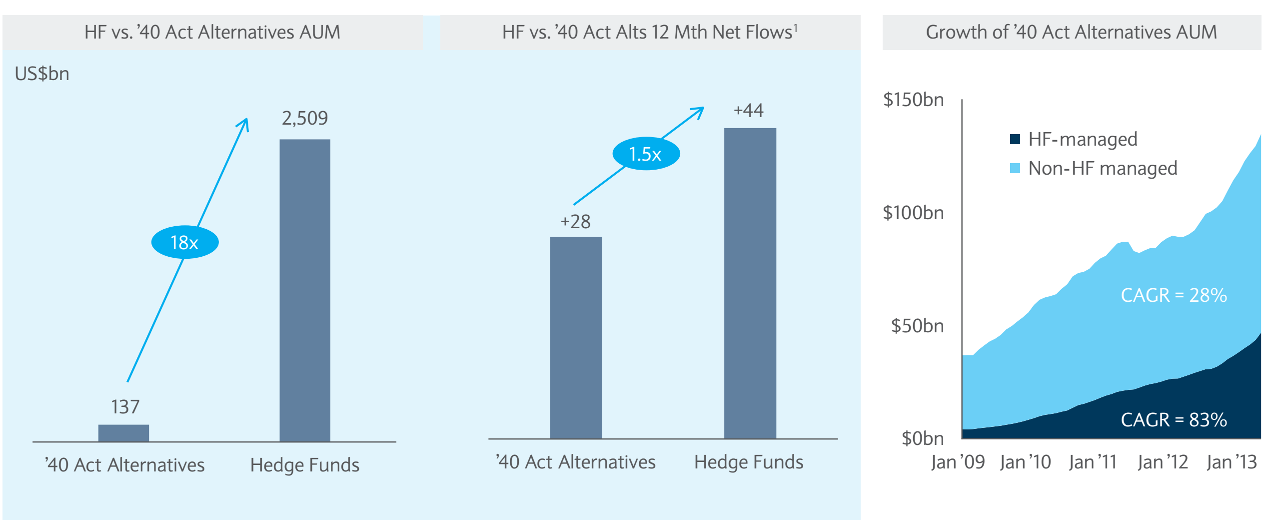
1. Sub-advisors are only responsible for investment management – they do not set up or 'own' the product

FIGURE 2




Source: Strategic Insight, Morningstar, HFR, Strategic Consulting analysis; 1. Sub-advisors are responsible for only the investment management – they do not set up or 'own' the product

FIGURE 3




Source: Strategic Insight, Morningstar, HFR, Strategic Consulting analysis; 1: July 1, 2012 – June 30, 2013 considerable pace. As Figure 3 shows, since January 2009, the '40 Act alternatives industry has grown at a CAGR of 33% (versus 14% for the HF industry), and HF-managed products have been growing at an even faster pace of an 83% CAGR. Moreover, in the last year this gap has widened further (43% for all '40 Act alternatives versus 15% for the HF industry).

Furthermore, while performance (rather than flows) has been driving most of the AUM growth in the HF industry, '40 Act funds continue to receive strong inflows. Currently, HFs have 18 times the assets in '40 Act alternatives and yet have, in the last year, only received 1.5 times the net inflows into '40 Act alternatives.

The drivers of this growth come from the supply as well as the demand side. Demand at the retail level for Alternatives has grown in part due to an increased awareness of Alternative strategies, and the role that they can play in portfolio construction, across both retail investors and their advisors. Alternatives are also increasingly perceived as a way to cushion portfolios against downside risks, especially given strong recent performance in fixed income and equities. At the same time, there has been an improvement on the supply side: relatively slow growth in the HF industry and the challenged business models of Funds of Hedge Funds (FoHFs) have encouraged both HFs and FoHFs to look at ways of tapping the retail market, and as a result there are more products managed or advised by Alternatives specialists and well-known HF managers (rather than traditional long-only asset managers). This, in turn, appears to have led to a general perception that the overall quality of '40 Act alternatives may be improving. Furthermore, investors and their advisors like the liquidity, transparency and increased regulation of '40 Act products; many of these investors also do not have access to 2 / 20 products or dislike the higher minimum investment required.

This combination of increasing investor awareness and appetite, and a perceived improvement in product offering, is likely to ensure that growth of '40 Act alternatives continues in the future. We examine other factors that have supported the growth of '40 Act HF assets later in this document.

## Strategy breakdown

What is the distribution, strategy-wise, of '40 Act HF assets? We decided to try and answer this question and compare the results to the distribution of assets across mainstream strategies in the HF industry. For the purpose of comparing strategy breakdowns, we looked only at '40 Act products where the investment manager is an HF, as most products managed by traditional asset managers are not truly comparable to HFs.

As shown in Figure 4, assets in '40 Act products managed by HFs are skewed toward equity-related strategies (Equity L / S, Market Neutral and Event Driven), accounting for 62% of assets, compared with 50% of offshore HF assets. Funds describing themselves as Equity L / S and Market Neutral account for 46% of the '40 Act assets (compared to 26% for the HF industry). However, it is worth noting that many of these products do not correspond exactly to their HF equivalents as they include:

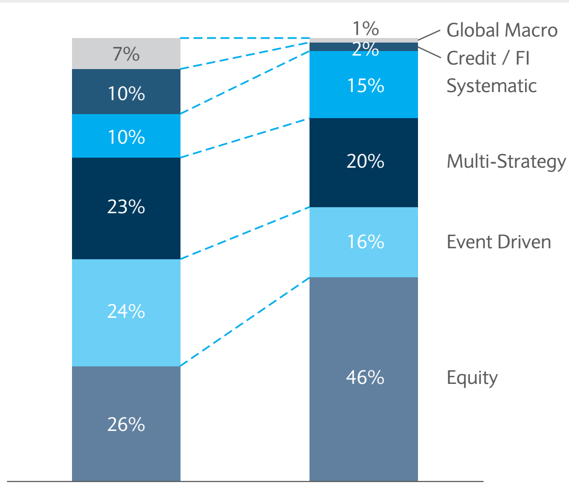
- Long-only equity strategies with an added overlay hedge of index futures or the use of options (e.g., writing covered calls).
- Funds that use broad sector exposures (through ETFs or swaps) instead of single-stock investments.

Likewise, many of the funds classified as Multi-Strategy are either asset allocation products which do not provide exposure to a broad range of HF strategies as provided by a Multi-Strategy HF manager, or multi-manager products managed by FoHFs. Systematic or quantitative strategies seem particularly suited to the '40 Act space, as evidenced by their strong representation in the asset base of the industry.

Another notable difference is that some of the largest HF strategies, in particular discretionary Global Macro and Credit / FI, appear to be underrepresented in the '40 Act HF world. The small proportion of assets in stand-alone credit-related strategies is likely as a result of the onerous liquidity requirements of the '40 Act format; however, the low level of assets in Global Macro products is surprising, given that the '40 Act regulations would not seem to impede these strategies.

**FIGURE 4**

Assets by Strategy




Source: Morningstar, Hedge Fund Research, Strategic Consulting analysis; Includes only managers with >$100mn in AUM in '40 Act and products where the ultimate investment manager is an HF

## '40 Act performance

Investor perception of the '40 Act industry is sometimes that the product offering is inferior to the offshore HF market, and this seems to be at least partially true based on an analysis of historical returns, as shown in Figure 5. The '40 Act industry (excluding short-biased funds, which are overrepresented when compared to the HF industry and skew the aggregate performance) has underperformed the HFRI Fund Weighted Index over the last six years, providing an annualised return of 0.9%, versus 2.3% for the HFRI.

However, when one looks at only the products managed or advised by HFs – that is, any product where the end investment manager is an HF) – the underperformance is less dramatic, with an annualised return of 1.6% versus 2.3%, and the average drawdown experienced by these funds in 2008 is far less than that felt by the '40 Act industry overall. As one large asset manager put it, "The retail investor is still getting a good product, although it is not the very best, most expensive, product that HFs have to offer."

It is also worth noting that the performance of '40 Act funds also compares favourably with Equity L / S HFs, which is a valid comparison given the high percentage of equity funds within the '40 Act HF universe.

## Why now?

The Investment Company Act of 1940 has been around a long time but a confluence of factors has given '40 Act Alternative products, and HF managed products in particular, critical momentum in recent years.

On the supply side, a number of factors have made this opportunity set more attractive than it has been historically.

- For hedge funds, it at least partly a response to some of the challenges in the traditional HF business, for example, the pressure on fees and difficulty generating returns and raising assets. At the same time, the unease around the greater regulatory scrutiny and transparency has been somewhat mitigated by the requirement to register with the SEC and the process HFs have had to put in place to comply with Form PF / ADV requirements. Having built the reporting infrastructure, most managers see the greater level of regulation in the '40 Act market as less of a hurdle. Lastly, there is a desire for firms to diversify their business and add differentiated and more stable return streams. This is especially true for the HFs that may become capacity constrained in their mainstream HF business in the future.
- Likewise, for FoHFs, '40 Act represents a potential new revenue stream that is additive to their current product offerings, while providing access to an untapped investor base.
- For Asset Managers, '40 Act HFs also represent a new revenue stream and an entry point into the HF business. It is a way for them to offer new products while leveraging existing distribution infrastructure for incremental revenue.

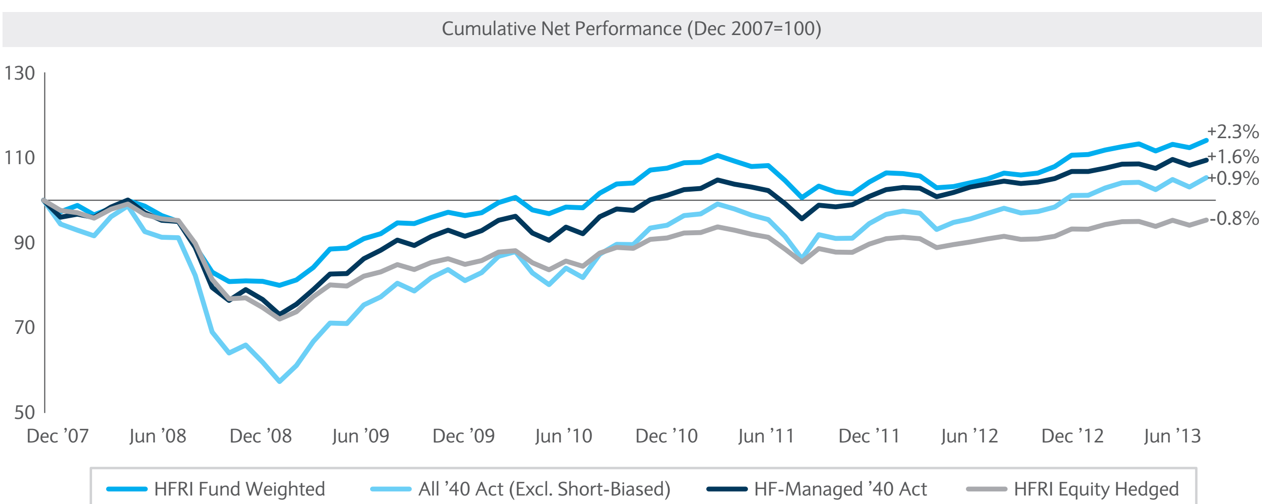
At the same time, as described earlier in this paper, there has been an increase in demand from retail investors, who would like greater diversification in their portfolios and exposure to HF-like products, and have limited or no access to 2 / 20 HF product. Most of these investors fall into the High Net Worth (HNW) category and they and their advisors are fairly sophisticated.

For HFs that have bad memories of other product extensions that failed, like 130 / 30 or 'portable alpha', it is important to note one key difference, namely that '40 Act HF products are targeted at a new investor base that has more limited access to 2 / 20 HF products, whereas those other products tended to be pitched at investors with existing access to HFs.

# IV. The players

There are essentially three roles to be played in bringing a '40 Act product to market, each of which suits different businesses depending on capabilities, and will broadly dictate a manager's approach to the '40 Act market.

**FIGURE 5**




Source: Strategic Insight, Morningstar, HFR. Note: All '40 Act performance data includes extinct funds. Short-biased '40 Act funds are excluded as they are disproportionately represented in '40 Act compared to HFs and distort average performance

## Roles in the '40 Act market

The three functions that need to be fulfiled in order to bring a '40 Act product are set out below. Any one of the three – or indeed all three – roles can be played by a single entity.

- **Investment manager.** Deals with investment management only – effectively this is the role of an advisor to the fund, and does not carry any responsibility for any of the operational aspects or the bulk of the requirements to comply with '40 Act regulations, or the distribution of the fund. Choosing to play just this role means that the additional burden of setting up and managing a '40 Act product is avoided.
- **Product sponsor.** Responsible for product setup, and ongoing compliance with '40 Act regulations, reporting, etc. This element requires significant upfront investment in infrastructure if this is not already in place – which is likely to be the case for everyone except those asset managers that have an existing mutual fund offering. Product sponsors have the choice of sponsoring product through a stand-alone trust or series trust structure:
  - A series trust allows the setup to be outsourced to a third party, an option that reduces cost and operational complexity and reduces the time-to-market, at the expense of giving up some of the flexibility to customise the product down the road (a series trust operates on behalf of a number of funds and is, by definition, less flexible).
  - A stand-alone trust requires the product sponsor to establish the fund, set up a board of trustees, policies and procedures, and contracts with third-party providers. This option comes with greater upfront cost and complexity, and typically a lengthier time-to-market. On the flip side, it also provides much greater flexibility down the road because the structure is set up to cater to just one fund. The cost disadvantage relative to the series trust also dissipates over time.
- **Distributor.** This role deals with distribution of the fund to end investors or their representatives. Fulfiling this role requires experience of distribution to retail channels and mutual fund investors, both of which are likely to be relatively new to HF distribution teams. Retail distribution tends to be more resource-intensive than distribution to institutional investors. HFs can bring this function in-house, but it is likely to take some time to build this capability and require hiring and managing sales professionals with a mutual fund background.

## Alternative models for the '40 Act HF opportunity

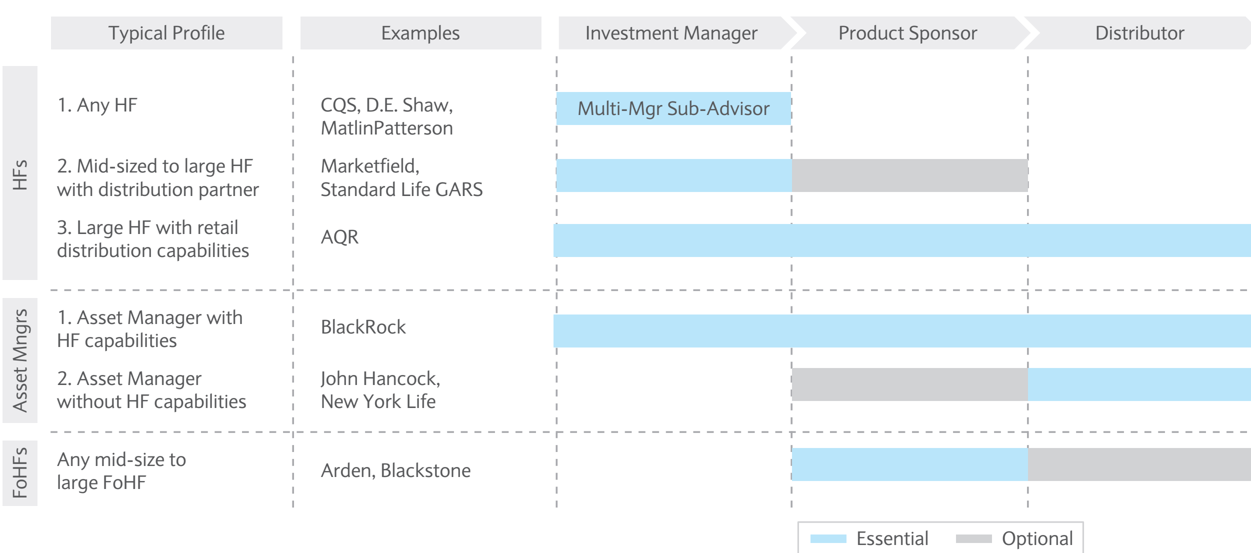
Figure 6 shows some of the alternative approaches to the '40 Act space commonly adopted by different players. The figure also demonstrates how differently positioned businesses can play to their respective strengths in determining how to participate in this market. Which role(s) will be assumed should be directed by existing levels of expertise and / or preparedness to make upfront investments. For HFs, the two difficulties may be operational (setting up a mutual fund structure and the ongoing management of the reporting / compliance requirements) and, perhaps even greater, distributing these products into the retail investor market. As a result, very few HF managers thus far have launched their own stand-alone products; many more have entered into sub-advisory relationships with asset managers or FoHFs to gain some exposure to the '40 Act space.

### HFs

Depending on their scale and commitment to the '40 Act market, there are three options available to boutique HF managers to access the space. These options are described below along with the pros and cons of each:

A. *Sub-advise a multi-manager '40 Act product.* This may be the easiest way for HFs to access the '40 Act market. For some strategies that are already managed in a '40 Act-compliant manner, this can, in practical terms, be treated in the same way as any other FoHF investment.

FIGURE 6




Source: Strategic Consulting survey results

*Pros*
The product sponsor is ultimately responsible for compliance with '40 Act regulations – this is done at the overall product level in many instances and can allow some flexibility in the extent to which each underlying investment manager (sub-advisor) has to comply with all the requirements of the '40 Act at all times. For some HF managers, this may mean that no significant modifications to their current investment process are necessary.

While the pool of assets managed by each sub-advisor is typically set up as a separate account, the returns of the individual investment managers are not disclosed. Only the aggregated return stream across all the managers is transparent to investors, thus mitigating cannibalisation risk for any individual manager.

Some investment will likely still be required for building reporting systems, and potentially hiring additional personnel who have experience in mutual fund accounting, reporting and compliance but this option comes with the lowest cost commitment for HF managers and the greatest transparency on the cost-revenue equation.

*Cons*
One downside of this approach is that allocations are likely to be proportionately smaller, and the overall brand profile gained as a result will also be limited for any individual sub-advisor (e.g., if one sub-advisor outperforms all the other managers on the platform in a given period of time, no one will know this fact). Also, the level of assets allocated to any individual manager may go up or down over time, depending on the allocation decisions made by the product sponsor.

B. *Sub-advise a single-manager '40 Act product.* The product is typically co-branded between the sponsor and the investment manager. This allows the HF to offer its own product while leveraging the infrastructure and distribution capabilities of a partner with mutual fund experience.

*Pros*
In this model, the compliance burden for the HF manager remains low (although some strategy modification may be required – and is probably advisable) while at the same time the potential for greater brand profile and AUM growth is preserved.

*Cons*
Managers will need to consider how to mitigate cannibalisation risk (performance of their '40 Act product will be transparent to current and potential investors) and how they can manage higher-fee HF product(s) alongside their '40 Act product.

The underlying strategy needs to be scalable – a distribution partner will most likely want a commitment of at least $1bn in capacity to justify their investment in taking the product to market.

C. *Sponsor and distribute own '40 Act product.* This route involves the manager playing all three roles: investment manager, product sponsor and distributor.

*Pros*
This approach allows the manager full control over the design of the product, the brand, the distribution, and the economics. With this option, the manager is fully exposed to both the risks and the rewards of offering a '40 Act product.

*Cons*
Sponsoring a '40 Act product requires significant operational build out – although this can be outsourced to a third party through opting into a series trust arrangement – and the manager has to take responsibility for compliance with all '40 Act regulations.

There is the risk of alienating and / or cannibalising existing 2 / 20 investors.

Most notable, however, is the need to develop in-house distribution capabilities for the targeted investor channels – for most HFs this would mean building some kind of retail distribution from scratch. This is not only time consuming and expensive, it also saddles the HF manager with the need to manage this sales force on an ongoing basis – a prospect that most HF managers would find daunting. Finally, a sales force focussed on distributing a single product into the relevant retail channels may be uneconomical, at least until a suitable level of scale has been realised.

### Asset Managers

The options open to asset managers depend on the level of in-house HF expertise that they have. As one remarked, "Many HFs have the investment capabilities but no distribution; most mutual fund companies have the distribution capabilities but no '40 Act HF product." The following are the two options most commonly adopted by asset managers.

A. *Manage product in-house.* '40 Act alternatives are an ideal product offering for an integrated asset management business with existing HF products: such asset managers can take their HF investment management expertise and combine it with their mutual fund infrastructure and retail distribution capabilities to bring a product to market.

B. *Tie up with HF sub-advisor.* Mutual fund companies, life insurers and other asset managers that do not have an existing HF offering can offer their retail distribution strengths and infrastructure, as well as their branding, to HFs wanting to launch '40 Act products.

The upside of this approach for them is an improved offering for their investors, which may indeed become a requirement to stay competitive if retail alternatives continue to grow in popularity.

One critical requirement in both of the above approaches is for asset managers to invest in educating their sales force, and to provide appropriate incentives so that the sales force can be effective in distributing the '40 Act HF product to investors.

### FoHFs

The most obvious choice for FoHFs is whether to both sponsor and distribute a '40 Act product, or simply to act as a sponsor and intermediary between HFs and an asset manager that offers retail distribution capability.

A. *Sponsor and distribute.* FoHFs suffer from the same problem as HFs in that they usually lack access to mutual fund distribution channels and their brands are relatively unknown to most retail investors. Like HFs, they can choose to invest in developing retail distribution capabilities, but this route is likely to be challenging to adopt. Finding a distribution partner is likely an easier way to successfully bring a '40 Act offering to market.

B. *Find a distribution partner.* Finding an experienced partner to distribute the product provides the appropriate distribution expertise needed to make these products a success, and obviates the need to try and build this capability from scratch. Additionally FoHFs will likely face the same challenges that HFs face in building a retail distribution capability (i.e., it is expensive, time consuming, requires ongoing management of the sales force, and is likely to be uneconomical to start with).

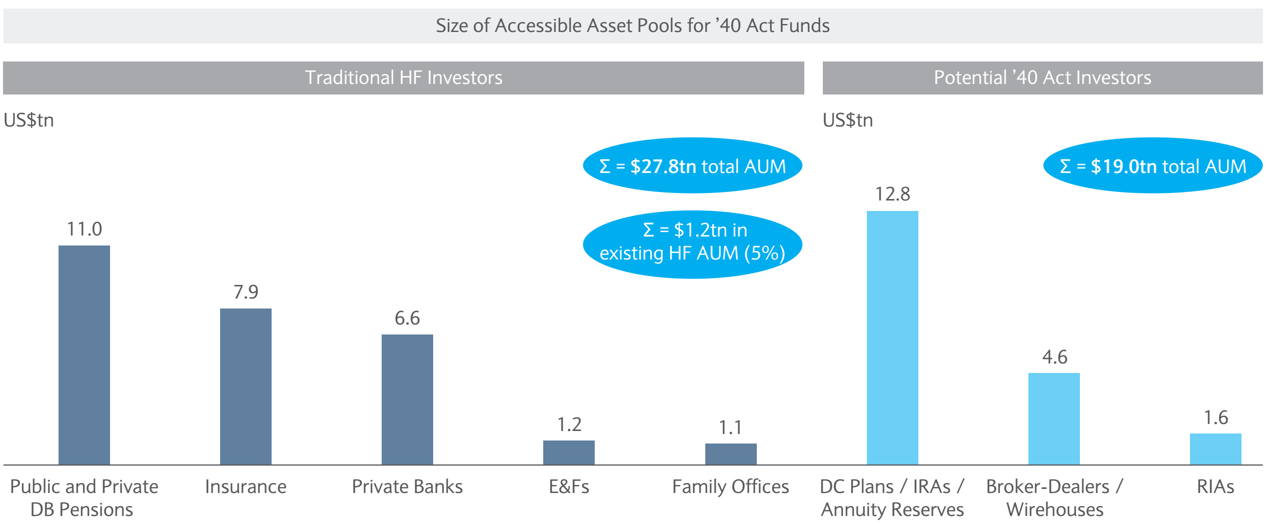
In many instances, some of the largest '40 Act FoHF-sponsored products have benefited from a partnership with large asset managers who have also seeded these products out of discretionary funds to help them attain critical mass on Day One.

# V. Rationale for launching a '40 Act product

## Size of the opportunity

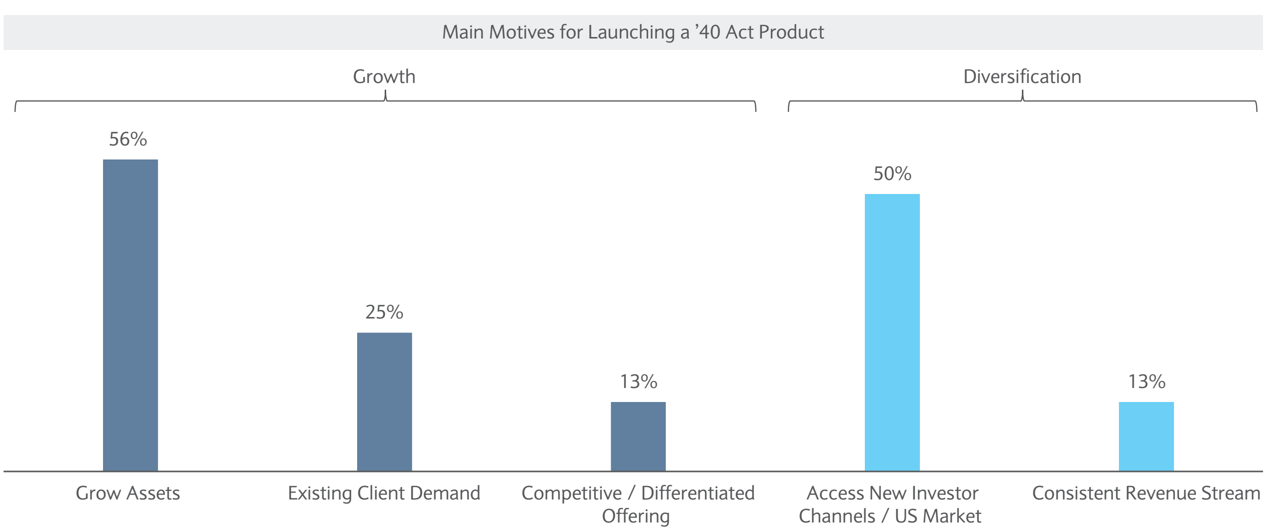
As noted earlier, one of the key reasons for HF interest in '40 Act funds is the sheer size of the previously untapped market that they can potentially provide access to. Figure 7 shows the total US investor market by channel, broken down into two categories: traditional HF investors and potential '40 Act investors. We estimate that the total US market of investable assets is $43.3tn, of which $27.8tn is already accessible to offshore HFs – the traditional HF investor base. Within this group, there is an average allocation of 5% in their portfolios to HFs, resulting in $1.2tn being currently invested in HFs. That leaves an additional

FIGURE 7




Source: Investment Company Institute, Morningstar, Strategic Insight, HFR, Strategic Consulting report 'Till Performance Do Us Part' (Jan 2013), Strategic Consulting analysis

FIGURE 8




Source: Strategic Consulting survey results

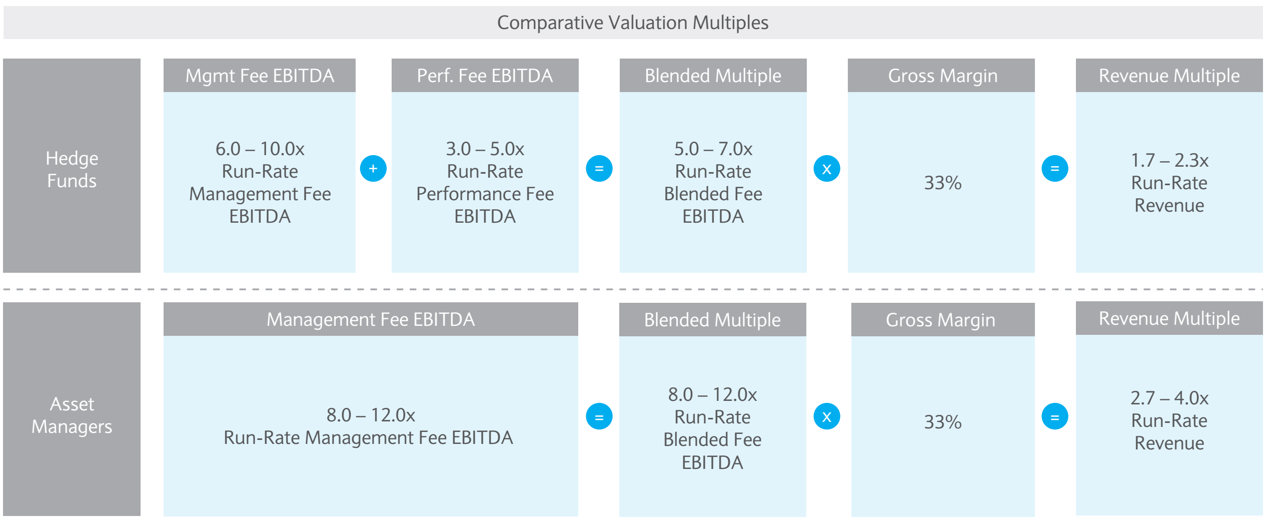
$19tn which has been previously inaccessible to HFs, across defined contribution pension schemes, individual retirement accounts (IRAs), annuity reserves, broker-dealers / wirehouses, and registered investment advisors (RIAs). This is the market that '40 Act funds launched by HFs are mainly aimed at, and we think it represents a vast new opportunity. Assuming the same 5% uptake for '40 Act funds as HFs have achieved in their traditional investor base available. We estimate there is another $1tn of potential new assets for '40 Act products to play for.

## Growth and diversification

The reasons given by managers for launching a '40 Act product are largely unsurprising: they are attracted by the potential to grow and / or diversify their businesses, as shown in Figure 8.

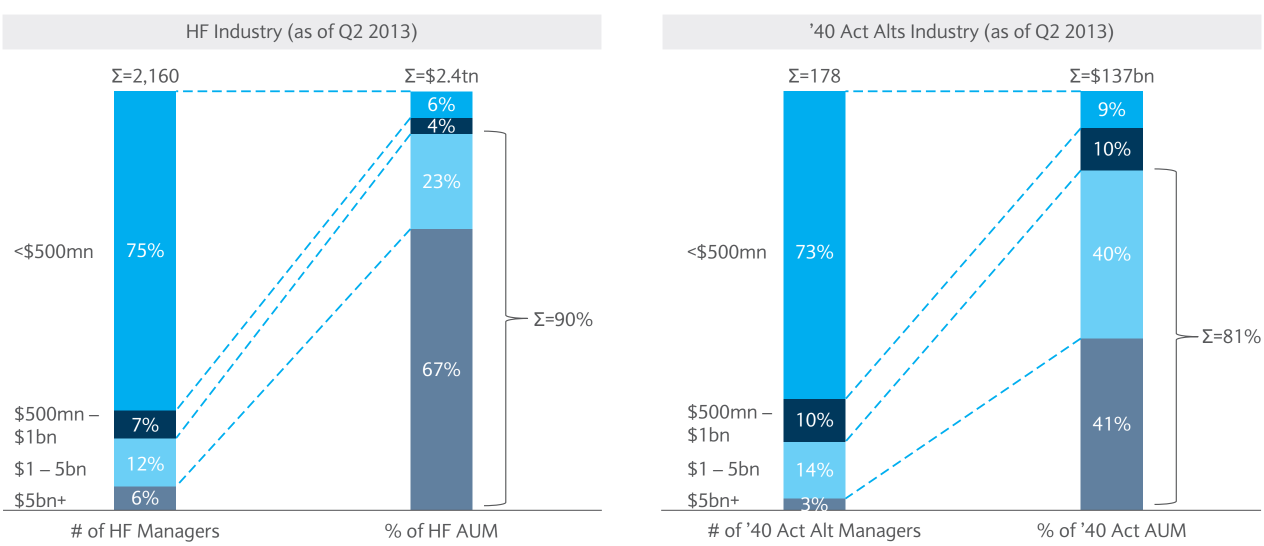
On the growth side, managers cite three principal motivators: access to retail assets, retail demand, and their ability to offer a compelling new product. They see US non-institutional investors as potentially the next source of asset growth for the HF industry, for all the reasons provided. At the same time, there is some demand for these products that appears to be emanating from institutional clients who may be looking for more transparency and liquidity, or may be looking to substitute these products for other liquid allocations in their portfolios, whether they are on the long-only side of their portfolios or potentially on the HF side. Additionally, some HF managers told us that their decision to launch a '40 Act product was partly driven by the fact that they felt they had a more compelling product to offer relative to the current range of products available (indeed, two survey participants described it as 'mediocre').

FIGURE 9




Source: Barclays estimates; company filings; FactSet. Transaction comparables for Asset Managers are based on publicly available data; for HFs comparables are based on estimates as HF transactions are private

FIGURE 10




Source: Strategic Insight, Morningstar, HFR

At the same time, diversification is also a significant factor for managers considering launching these products. Some participants were attracted by the role that mutual fund assets could play in their overall business mix: retail assets could be a diversifier in their current investor base, and may actually be stickier than other types of capital. Combined with this is the fact that the management fee-only structure is seen by analysts to offer a more consistent revenue stream versus the volatility of revenue associated with performance fees. This, in turn, can drive a firm's enterprise value higher. Lastly, for non-US managers, '40 Act products may be another way to access the US investor market, if they have not already done so through institutional channels, and thus diversify their investor base geographically.

### Enterprise value

As mentioned before, asset managers and mutual funds tend to benefit from higher earnings multiples than hedge funds due to the lower volatility of their earnings, as shown in Figure 9. HFs are generally valued at a discount to traditional asset managers, with an average EBITDA multiple of 5 – 7x for HFs versus an average of 10.2x (more precise because of publicly available data) for asset managers. This is largely due to:

- Higher volatility of earnings associated with performance fees.
- Higher investor turnover at HFs.
- Greater capacity limitations at HFs.
- Lower diversification of HFs' income streams.

As a consequence, $1 of '40 Act management fees is worth the same in terms impact on enterprise value as $1.67 of total HF fees.

### Potential first mover advantage

It is hard to assess whether there is a first mover advantage associated with being in the vanguard of the move into '40 Act products. One way to test for this is to examine the concentration of assets in the '40 Act alternatives industry and compare it to HFs. Figure 10 shows that, although much smaller and a newer industry, '40 Act alternatives exhibits similar levels of concentration to the HF industry – in the '40 Act space, 16% of the managers (all those with $1bn+) hold 81% of the assets, while in the HF industry, 17% of the managers (again $1bn+) hold 90% of the assets. The concentration of assets in both industries being very similar suggests that there could be barriers to entry in the '40 Act business (more on this later), and benefits to entering the space early (i.e., before incumbents acquire even greater scale).

## VI. Key considerations for HF Managers

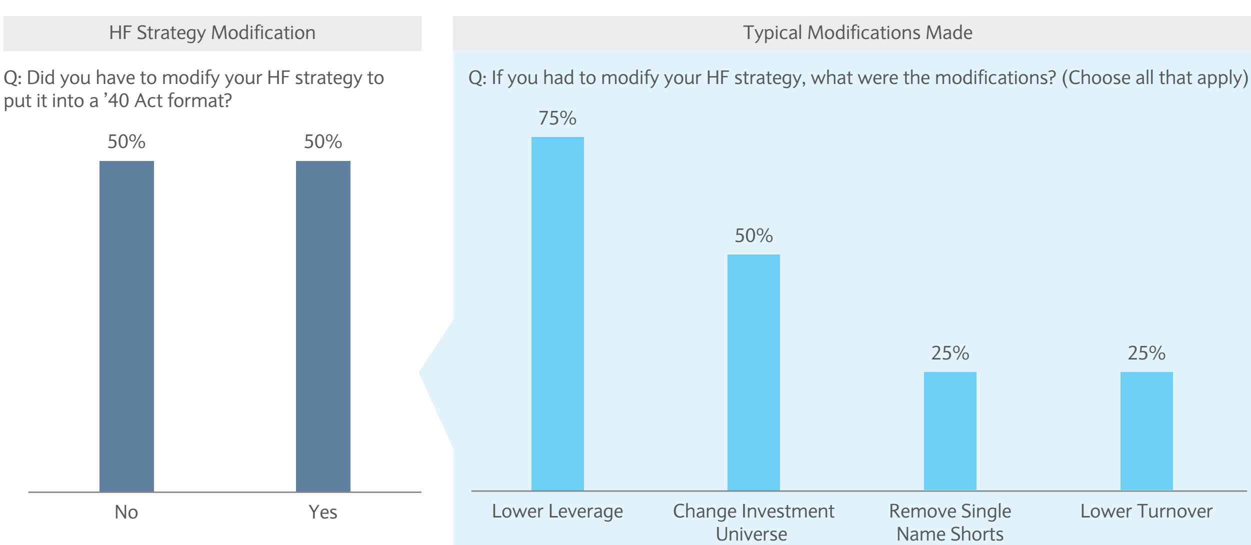
Having established the parameters of the '40 Act market and the roles that HFs typically play within it, we now examine some of the key considerations that HFs may want to take into account before deciding to launch a '40 Act product.

### Investment process modifications

The requirements of the '40 Act, along with the need to differentiate '40 Act products from existing HF products, often necessitate some modifications to an HF's investment strategy. Figure 11 shows the prevalence of strategy modifications among the respondents in our sample – nearly half of them said that they have had to make (or oversee in the case of FoHFs) strategy modifications of some sort in order to be compliant with '40 Act requirements or to differentiate their '40 Act product from existing HF products. All of those that did not have to modify their strategy were sub-advisors to FoHFs and, as such, benefited from being part of a multi-manager product. The multi-manager product provides a degree of anonymity to a sub-advisor (in that the performance of the sleeve managed by the sub-advisor is not visible from the outside), and frees up the sub-advisor from having to comply with all the requirements of the '40 Act (this is the responsibility of the product sponsor).

The most commonly adopted change was to lower leverage, largely for regulatory compliance reasons (but with the added benefit of lowering the risk taken and thus providing differentiation from an existing HF product). Other decisions

FIGURE 11




Source: Strategic Consulting survey results

included changing the investment universe – a move that was likely driven entirely by liquidity concerns.

The decision to remove single-name shorts and replace these with broader index hedges likely serves two purposes: first, it allows HFs to avoid having to publicly disclose their single-name shorts (as required by '40 Act regulations), and second, it provides the '40 Act product a point of differentiation from the same manager's HF product by effectively removing any short-side alpha from shorting individual stocks. It is evident that the modification of the strategy to fit into a '40 Act framework may have helped some HF managers mitigate cannibalisation risk.

Finally, it is worth emphasising that some strategies, either because they are illiquid or require significant leverage to perform well, simply cannot work in a '40 Act wrapper, e.g., distressed credit, highly levered equity quant strategies.

## Infrastructure considerations

Infrastructure considerations are different for '40 Act product sponsors and sub-advisors, and will depend on both managers' existing mutual fund expertise as well as their readiness to make upfront investments in the business. For managers that simply act as sub-advisors, there will be some minimal additional operational setup required, potentially some reporting systems, and / or hiring a dedicated resource for compliance.

For managers that choose to sponsor their own '40 Act vehicle, the next challenge is how to meet all the operational requirements (e.g., legal structure, reporting, governance). There are two avenues available to these managers to fulfil these infrastructure requirements: establishing a stand-alone trust or joining a series trust.

### Stand-alone trust

This is the 'do it yourself' version. It requires the manager to create the legal structure for the product offering, establish the board of directors, build / implement operating systems and hire service providers.

The chief advantage of this approach is the level of customisation that it allows – because the HF is setting up the trust structure for its own product, it has a high level of control over how it is set up. Since it is going to have to appoint its own board of directors, it will likely allow for easier implementation of any changes to the strategy at a later date. The board of directors plays a more influential role in a '40 Act fund vehicle than at an HF. In a series trust, the board of directors is responsible for all of the different funds within the 'series', which usually slows down the decision-making process because the board is less focussed on the needs of any one of the underlying funds.

On the flip side, this approach is more expensive (up to three times), time consuming, labour-intensive, and the fund sponsor typically has to bear extensive liability – which may be undesirable for many HF managers.

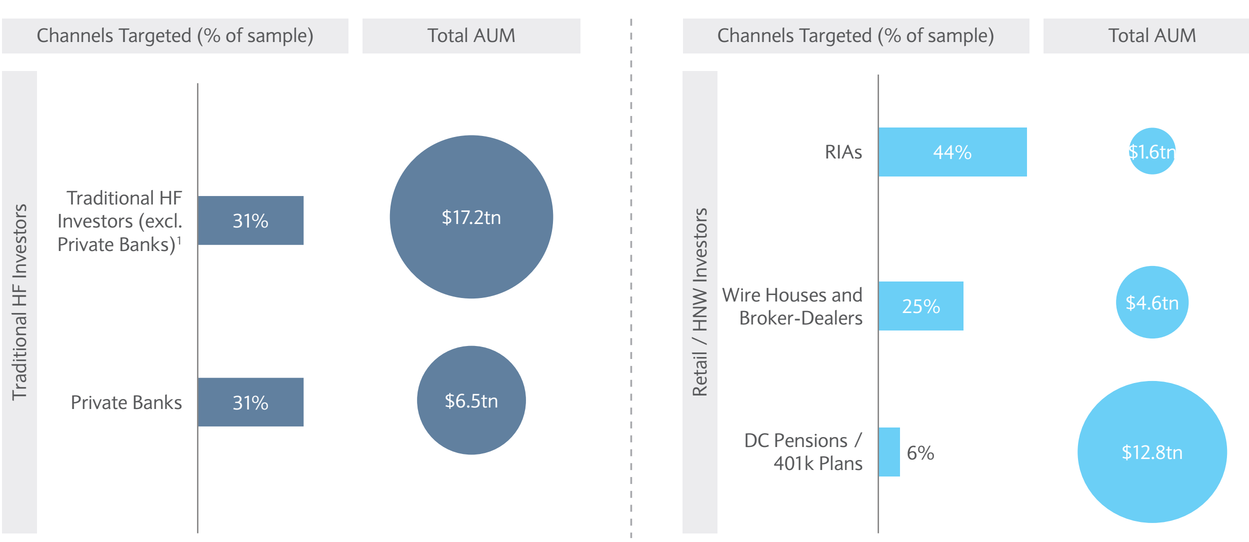
### Series trust

This is the 'turnkey' model – in a series trust, the fund sponsorship is outsourced to a third party that has already set up the required infrastructure, governance (i.e., a board of directors shared by multiple funds) and vendor relationships.

The chief advantages in this approach are the simplicity, lower costs and significantly shorter time-to-market. This approach does not require any existing mutual fund expertise, and is significantly less labour-intensive / time consuming, since the HF manager does not have to choose service providers or a board of directors. This, in turn, allows for a shorter time-to-market and lower overall costs. One further advantage is that the manager can avoid significant compliance liability, which is typically taken on by the third party. As one manager summarised it, "Leaning on our service provider was very helpful – if we had to do all of the outsourced work ourselves then the breakeven level of assets would have been much higher."

The chief disadvantage is in the fact that the externally appointed board of directors has to consider all the funds i n the series trust, which means a less customised approach, and less flexibility with regard to the needs of any one of the

FIGURE 12




Source: Strategic Consulting survey results; 1. Includes FoHFs, DB Pensions, Insurance Companies, Family Offices underlying funds. Moreover, the cost savings associated with a series trust diminish as fund assets grow, which means that the cost disadvantage disappears after a point but the inflexibility persists.

## Distribution channels

While the new investor channels that the '40 Act gives access to may offer a great opportunity to HFs looking to grow their assets, they also present a challenge as they are unfamiliar to most HF distribution teams. There may also be some uptake of these products from the traditional HF investor base. Figure 12 shows the principal channels targeted by managers launching '40 Act products, along with the pool of assets that each channel represents.

**Traditional HF investors (excluding Private Banks):** There is some demand from traditional HF investors for the liquidity and onshore structure, and HF marketing teams can leverage their existing relationships here. There is also some potential for synergies with a few investment consultants that are building out High Net Worth (HNW) aspects to their businesses. However, although the total pool of assets here is the largest by some margin, this segment represents mature and sophisticated HF investors, and managers need to keep in mind the risk that any gains in the '40 Act space with these investors may come at the expense of HF products.

**Private Banks:** Many Private Banks have existing offshore HF products on their platforms suggesting, once again, that existing relationships and familiarity can be leveraged. However, some private banks may be more biased toward offshore products if their clients tend to be qualified buyers and as such already have access to HFs.

**RIAs:** Registered Investment Advisors (RIAs) are the most popular channel, with 44% of managers in our study interested in targeting them. Although they represent a comparatively small pool of AUM (just $1.6tn), RIAs are generally felt to be more sophisticated and forward-looking in their investment approach, and often understand alternative products better. That said, they are reasonably labour-intensive to cover, given the sheer number of advisers and how geographically dispersed they are.

**Wire Houses / Broker-Dealers:** The Broker-Dealer / Wire House channel represents $4.6tn of assets, and a quarter of our respondents plan to target this pool. Getting products listed on broker-dealers' platforms, however, is a time-consuming, multi-stage process, and one that often requires a minimum AUM or length of track record threshold to be met. Once on a platform, there is further, ongoing management and oversight that is needed – to make sure than a product is placed on recommended buy-lists and staying in touch with wholesalers and the distribution teams to ensure that it has a reasonable chance of reaching the investors at the end of the distribution chain.

**DC Pensions / 401k Plans:** Although they represent the largest pool of untapped assets, Defined Contribution (DC) Pension schemes (e.g., 401k Plans, 403b Plans) appear to be the least popular channel in our sample (just 6% of our respondents are currently planning to market to them). Thus far these investors have demonstrated little interest in '40 Act alternatives, for two main reasons. Firstly, they tend to be very fee-sensitive (they are large users of passive index products and ETFs), and need more education on the merits of alternative products. Secondly, advisors to these plans tend to be very conservative investors, given that they bear extensive fiduciary liability, and as such there is less incentive for these plans to recommend alternative products.

## Distribution choices

Given the importance of raising a higher level of assets to make offering '40 Act products as attractive as the HF business, getting the distribution right is absolutely essential. Moreover, it is perhaps the most challenging element of offering '40 Act products for HF managers, given that the retail market is usually uncharted territory for HF marketing teams. To add to the difficulties, the retail market tends to be considerably more resource-intensive to cover than the institutional market due to the sheer number of buyers. Lastly, most HFs are largely unknown within the retail world and even the largest cannot leverage their brand easily.

HFs have two options open to them to tackle the distribution of their '40 Act products:

1. *Distribution in-house.* Distributing a '40 Act product through an in-house marketing team is possible, though challenging: it will likely require significant head count to be added in order to reach retail investors. The lead time to build this capability will likely be long. At least some of the new hires will need to have a mutual fund / retail marketing background.

   The advantage of creating a distribution capability in-house is that the manager can have complete control over the branding and positioning of the product, while avoiding having to pay partners for distribution services. Additionally, it may be possible to leverage some existing relationships to distribute the product: for example, as previously noted, private banks are a promising channel for '40 Act funds and many HFs already have relationships with them, and some of the investment consultants have HNW businesses which may be potential buyers of '40 Act funds.

   There are also some significant drawbacks to this approach, however. Beyond the initial expense of building a new distribution capability from scratch, having a single-product distribution team is likely to be highly uneconomical, and the ongoing management of a large retail distribution team can be both time consuming and a distraction.

   Having weighed the pros and cons, the vast majority of HFs that have launched '40 Act products have chosen not to take this approach for the reasons mentioned before.

2. *Finding a distribution p artner.* It is likely that most HFs will prefer to take this route, at least for the time being, as it allows them to bring their '40 Act product to market and gain scale quickly. Partnering with a large asset manager is a mutually beneficial arrangement that allows an HF to gain 'plug-and-play' access to an existing distribution network and the asset manager to be able to offer an arguably more sophisticated product to their existing investors. Additionally, if the manager is acting as a sub-advisor, then the distribution partner may also sponsor the product and take care of the operational setup.

   Ideally a distribution partner will have a portfolio of a large number of commingled discretionary investment products that they can place the '40 Act product into, giving it reasonable heft from Day One.

The biggest disadvantages to this approach are twofold: the first is principally economic in nature – most likely an HF will have to pay fees / expenses to their distribution partner (although these will be known up front, which is a plus), and the relationship may have to be exclusive (i.e., the '40 Act product cannot be offered through another distributor simultaneously), which can be a limitation. Secondly, taking this approach requires the HF manager to rely on their distribution partners to provide the right level of education and incentives to ensure that the product is being pushed by the sales force through the distribution channel. Especially in the case of an exclusive partnership with a distributor, there could be some frustration on the part of the manager if the distributor is not able to push uptake of the product.

## Fees and expenses

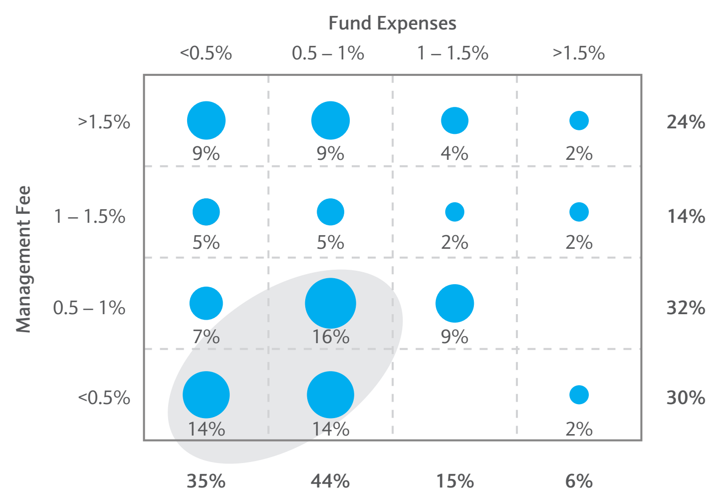
One of the most significant differences between the '40 Act and HF markets is the fees that are or can be charged. Fees charged for '40 Act products are not only much lower than those for HFs typically, but there is no performance fee on most '40 Act products[2], a considerable adjustment for HFs to make to their business model.

In Figure 13 we show the breakdown of management fees and fund expenses for the 50 largest '40 Act funds (by implication, given that these are the largest funds, their fee and expense levels must be tolerable to investors). Some 51% of the funds in the sample have fees and expenses <1% each (i.e., total fees charged <2%). As one asset manager noted, "The mutual fund world is filled with economy shoppers and the lower sticker price can be very appealing."

2. There is one notable exception to this which is for managed futures strategies which are regulated by the CFTC

FIGURE 13

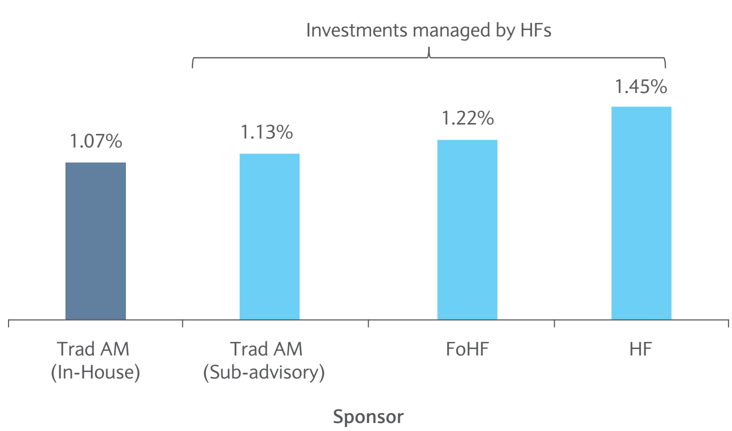
Management Fees and Fund Expenses (50 Largest '40 Act Funds)




Source: Morningstar, Strategic Insight, Fund Summary Prospectuses

FIGURE 14

Average Management Fees Paid




Source: Morningstar, Strategic Insight, Fund Summary Prospectuses

There is, however, a silver lining for HF managers who may be concerned by the low level of overall fees and expenses – as Figure 14 shows, HF-managed '40 Act products appear to be typically priced at a premium relative to those products managed in-house by asset managers within the 50 largest funds, suggesting that investors do not object to paying more for an HF-managed product. However, even at a management fee point of 1.45%, HFs would have to raise more than twice the assets to achieve the same fee income as a 1.5% / 20% fee structure (assuming 8% performance), proving that '40 Act products are certainly a 'scale play'.

'40 Act funds are *theoretically* able to pass through higher expenses than offshore HFs, as shown in Figure 15 – the average expenses eligible to be charged by a product sponsor are considerably higher than fund expenses paid by offshore HF investors. The final cost to the investor could theoretically be even higher due to sales charges or 'loads' charged by brokers and other intermediaries, depending on the investor share class. These expense pass-throughs can offset higher costs at the product sponsor, e.g., distribution; given that most platforms and RIA networks charge a fee for managers to participate, these may be offset using 12b1 fees.

In reality, however, most sponsors choose to offer a total expense cap, especially in the early years when expenses will likely be higher, to ensure that investors are not put off by high fees and expenses. Finally, most end investors prefer to access '40 Act products through an institutional share class with lower expenses. As a result, managers are unlikely in practice to benefit substantially from the higher headline ability to pass through expenses.

One further consideration is that the number of parties involved in bringing '40 Act funds to market means that fees and expenses paid by investors are often carved up between different players. Figure 16 shows the players involved in different go-to-market models and an illustrative distribution of the fee / expense pie in each model across the various players. For HF managers, sponsoring and distributing their product gives them the full extent of the economics – although they must then also bear all the infrastructure and distribution costs – whereas being a sub-advisor requires them to surrender a large portion of the gross fees but, in return, do not have to bear any additional costs.

## Risks of launching a '40 Act product

Launching a '40 Act product is not without risk and HFs need to think through how they plan to address these before they decide to enter this market. All of these issues may be mitigated to a certain extent, provided that the manager considers them up front.

### Poor product performance

Net returns (after fees and expenses) on these products may be disappointing, resulting in redemptions and reinforcement of the perception that the '40 Act product is an inherently inferior and flawed product. To mitigate this, managers must recognise that the net performance of the '40 Act product will be compared to both the equivalent HF product as well as to a relevant low cost, long-only product. They must keep their expenses low so that investors have an opportunity to achieve a reasonable return profile, given the liquidity and other characteristics.

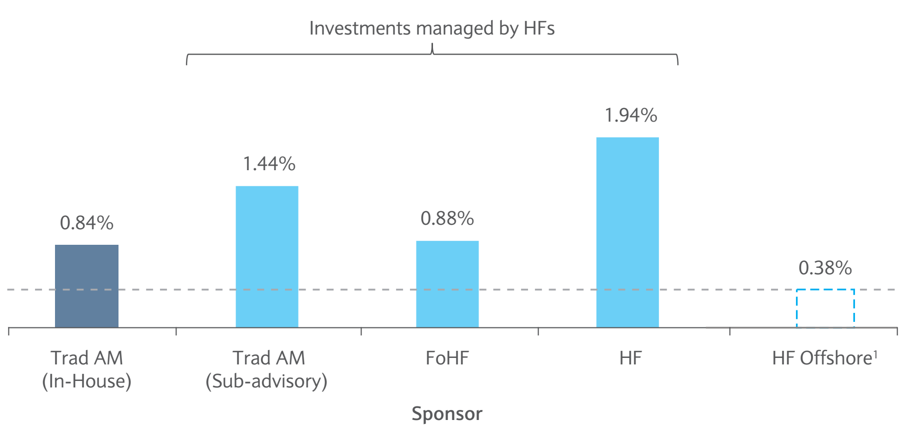
### Cannibalisation risk

Offering a '40 Act product at lower fees and better liquidity than a comparable HF product raises the possibility of 'fee arbitrage'; it also raises questions about the 'fairness' of the terms on the HF product for existing investors.

The solution to this is to find ways of differentiating the '40 Act product from existing HFs (some of which will happen by default due to the requirement to comply with the '40 Act), e.g., lowering the leverage or target volatility, replacing single-name shorts with index shorts, introducing additional beta or becoming more long-biased, or changing the investment universe may all serve to differentiate the '40 Act product from the manager's HF offering.

**FIGURE 15**

Average Headline Expenses Charged to Investors[1]




Source: Morningstar, Strategic Insight, Fund Summary Prospectuses, Strategic Consulting analysis. Fees and expenses are for Class A or equivalent shares; 1. For funds $100mn – $1bn

### Investment team compensation / distractions

The lack of a performance fee raises a question regarding how managers can compensate investment professionals for their work on a '40 Act product. While, at a firm level, launching a '40 Act product may make sense, it is also important that investment professionals are compensated appropriately for managing these assets – although not at the expense of their attention to the HF product. In cases where the '40 Act strategy is managed pari passu with the HF product, this is likely to be less of a concern.

Existing HF investors may be concerned about the risk that the investment team is being distracted by the offering of the ' 40 Act product. Again, this should not be an issue if the product is managed pari passu with the HF, but potential problems could arise when there are differences in strategy. Managers should consider adding extra resources on the investment team, if necessary, to allay the fears of existing investors.

### Conflicts of interest

There is a potential for conflicts of interest if there is a discretionary decision to be made on how to allocate trades between '40 Act and HF products, given that '40 Act funds normally charge lower management fees (and no performance fees). An argument could be made that there is less incentive for PMs to make sure to equitably allocate the most profitable trades to both the HF and the '40 Act product.

One way to address this issue is for managers to put in place clear, written rules regarding how trades are to be allocated between HF and '40 Act products, and to rigorously monitor adherence to these rules.

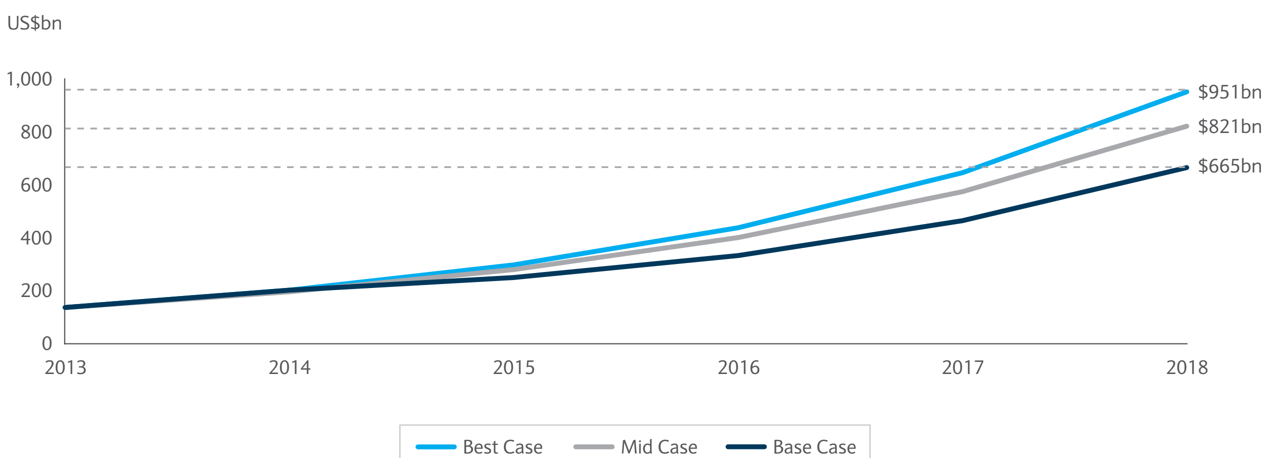
FIGURE 16

| | '40 Act Fees / Expenses | | Distribution of '40 Act Fees / Expenses across Value Chain | | | | |
|---|---|---|---|---|---|---|---|
| 1 Sub-Advised Multi-Manager Product | Fees and Expenses: Gross[1]: 175 – 225bps Paid by Investor to Distributor | = | Distribution Partner: Net[1]: 50 – 75bps For distribution (and sometimes product sponsorship) | + | Sponsor (FoHF): Net: 25 – 50bps Pays sub-advisors and keeps remainder | + | HF Manager: Net: 75 – 100bps Paid by sponsor to HF Manager |
| 2 Sub-Advised Single-Manager Product | Fees and Expenses: Gross[1]: 175 – 225bps Paid by Investor | = | Distribution Partner: Net: 50 – 150bps Net for distribution and sometimes product sponsorship | + | HF Manager: Net: 75 – 125bps Paid by distribution partner to HF Manager | | |
| 3 Sponsoring and Distributing Own Product | Fees and Expenses: Gross[1]: 175 – 225bps Paid by Investor | = | HF Manager: Net: 175 – 225 bps Margins will depend on costs associated with setting up / managing operational infrastructure and distribution; assuming higher costs than would be incurred in working with partners, it is likely to result in a considerably higher breakeven level of AUM | | | | |

Source: Strategic Consulting survey results; 1. Gross refers to total fees received; net fees refers to fees left once distribution partners / sub-advisors have been paid. Gross fees and expenses do not include brokers' and / or other intermediaries' charges

FIGURE 17

Growth Estimates for '40 Act Alternatives (Total AUM)




Source: Strategic Insight, Morningstar, Strategic Consulting proprietary market sizing model

### Risk of re-regulation

The 1940 Act has been around a long time, and regulators have not tinkered with it much over the years. Recent, broad interest in '40 Act alternative products might invite new scrutiny of practices by regulators. There is, unfortunately, no mitigation possible for this issue, although industry bodies could help regulate / self-police practices to discourage bad behaviour.

# VII. Looking ahead

## Growth expectations for '40 Act products

Our estimates, based on recent flows and the growth of assets over the last 12 months, suggest a range of ~$650 – 950bn of assets in the '40 Act Alternative industry by 2018, as shown in Figure 17. For HF managers this is a very meaningful consideration, as it is possible that these may represent the largest inflows into the HF industry in the foreseeable future.

Those managers that have launched '40 Act products have high hopes for these products – 90% of those surveyed expect at least moderate growth in this area. Many of these managers surveyed expect '40 Act products to eventually become a significant part of their overall business mix, and many are a lso considering launching new '40 Act products (or adding sub-advisory accounts) in addition to their existing lineu p.

## '40 Act: The next alternative UCITS?

A few years ago a similar case was being made for Alternative UCITS to see significant asset growth which has largely failed to materialise, despite the hype. As Figure 18 shows, growth of assets in Alternative UCITS funds has been sluggish in recent years in both absolute terms as well as relative to the '40 Act industry. Indeed, the Alternative UCITS market is currently only marginally larger in terms of total assets than the '40 Act market, despite the fact that the structure has been high-profile for a much longer time. Although the risk that the growth of assets in the '40 Act alternatives market may peter out the same way is real, we feel this is unlikely due to a combination of supply and demand issues that have constrained growth of UCITS assets that are peculiar to that market:

### Supply

There is a continued perception among some investors that the product offering in the UCITS format is inherently inferior. As one '40 Act manager put it, "UCITS has failed because most UCITS products are bad products – people took whatever was easiest to convert and put it in a UCITS format."

There has also been a lack of new launches in recent years, meaning that the selection of products available to investors is not particularly varied or compelling.

### Demand

The relatively limited number of DC pension plans in Europe means that this channel does not exist to nearly the same extent as it does in the US.

The Private Bank and Wealth Management channel in Europe has been in retrenchment mode since 2008 and not fully recovered. Many European private banks were hurt by their HF exposures in 2008 and are not hurrying back to the alternatives market.

The European market is not one single market – the economies of scale that exist for distribution to US retail investors are simply not there in Europe.

## Conclusions

In summary, managers should consider their current situation and their growth ambitions and then make a decision on whether and how to enter the '40 Act market. The following are some potential decision drivers:

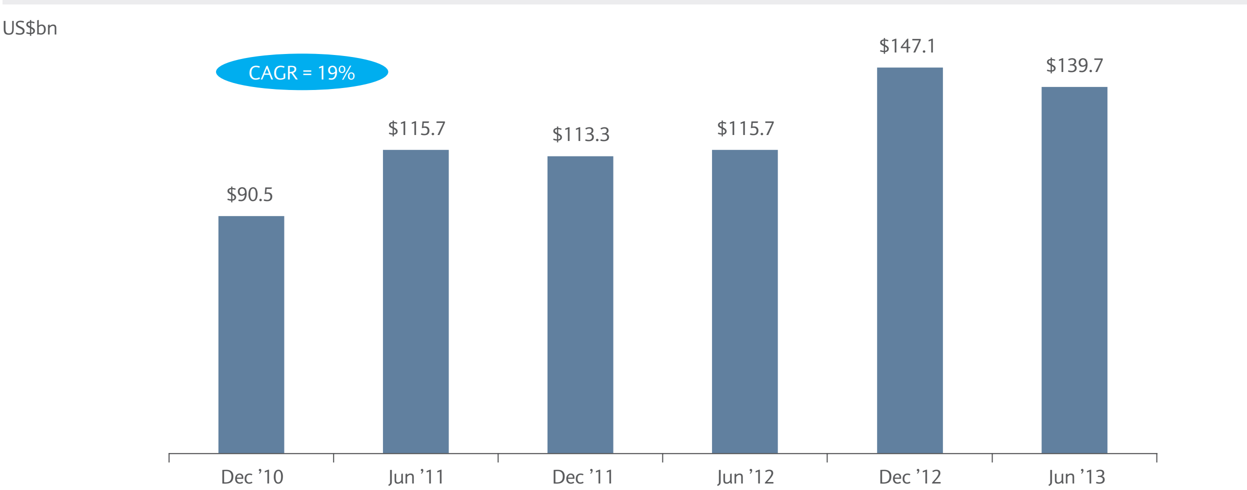
### Does a '40 Act product make sense?

*Strategy*

Is your strategy suitable for inclusion in '40 Act? Can it be run in a daily liquid format? Is it sufficiently scalable to justify the extra expense and lower fees?

FIGURE 18

Alternative UCITS AUM




Source: Absolute UCITS

*Philosophy*
Do you believe in growth through diversification of your investor base? Do you think that strong asset growth and a higher multiple can offset lower fees?

*Risk appetite*
Can you get existing investors comfortable with your plan to launch a '40 Act product? Do you have the ability to take on cannibalisation risk, conflicts of interest, and PMs' concerns about compensation?

Managers that get past the above, strategic / philosophical questions (with an affirmative answer), then need to address some more tactical questions:

**Are you ready for the task?**

*Distribution*
Do you currently have access to retail channels? If not, are you prepared to build these distribution capabilities? If not, are you willing to partner with someone who has these capabilities?

*Infrastructure*
Do you feel you already have a strong monitoring / reporting infrastructure in-house? If not, are you willing / able to build or partner with someone on the infrastructure and take on any additional operational complexity?

Depending on the answers to these questions, HF managers could potentially choose one of three alternative approaches to the '40 Act market:

**Play offence.** For HFs that answer 'yes' to all / most of the questions above, the '40 Act could be a very attractive area of growth – these managers are acknowledging the potential of the '40 Act market and their willingness to invest now to capture the opportunity.

This may be particularly true of those HFs that believe that there is a 'first mover' advantage to be had.

**Play defence.** For many managers who answer 'yes' to the first question (i.e., around Strategy), an attractive option may be to 'dip their toe' into the '40 Act market without fully committing themselves.

Becoming a sub-advisor to a multi-manager product is a good way to familiarise yourself with the '40 Act market without having to commit to the expense of building out your own product.

**Do nothing.** For managers who either have little ambition for growth in retail assets or are capacity-constrained, or have strategies that cannot be offered in a daily liquidity format, '40 Act is probably not a viable option.

Currently, this is the option that most HF managers have chosen, deliberately or by default.

# VIII. Capital Solutions

The Capital Solutions team within Prime Services offers a unique blend of industry insights and tailored client solutions for a broad range of issues.

## Capital Introductions

- Maintenance of ongoing investor dialogue to provide valuable feedback to HF managers.
- Introducing HF managers to a select number of interested investors.
- Hosting events that provide a forum for knowledge transfer and discussion / debate on industry issues that helps educate and inform both clients and investors.

## Strategic Consulting

- Development of industry-leading content, driven by primary analysis, on the HF industry and its participants (e.g., HF and FoHF managers, institutional investors, investment consultants).
- Provision of management consulting services to HFs and asset managers on business topics such as the launch of a new strategy, marketing effectiveness, product development and organisational efficiency.
- Acting as an HF competence center internally for Barclays.

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