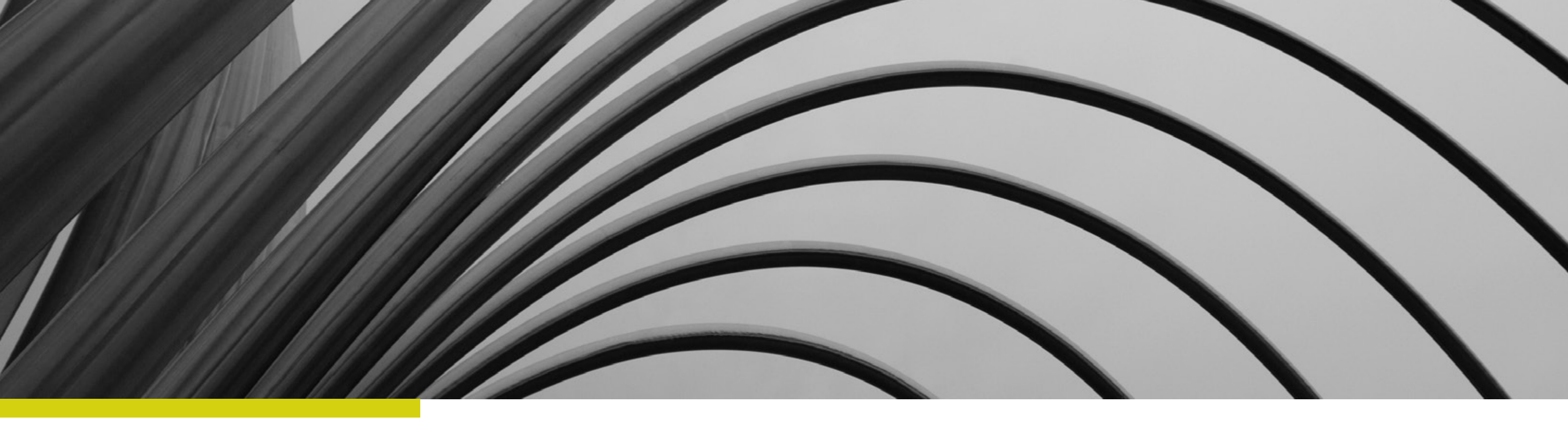
INVESTOR SERVICES

Alternative Strategies in the '40 Act World: Opportunities and Obstacles for Multi-Manager Registered Mutual Funds

Alternative strategies have become a steadily growing part of the asset management mix in recent years. Despite a pronounced setback during the financial crisis, alternative assets under management doubled from 2005 through 2011, reaching US$6.5 trillion. With a compound annual growth rate of 14 percent during that period, alternative assets grew at a pace that was seven times greater than traditional asset classes.[1] This steady growth of institutional investments in hedge funds, private equities, commodities and other alternatives is widely expected to continue for at least the next several years.

For both hedge funds and traditional asset managers, multi-manager '40 Act funds are a relatively new frontier, presenting a series of complex and unfamiliar challenges.

J.P.Morgan



Alternatives also are becoming a growing part of the mix for smaller institutions and the mainstream retail market. The number of alternative mutual funds and ETFs increased from 495 in 2008 to 806 in 2011.[2] As pressures to seek new alpha-creating solutions continue in the uncertain global economic climate, alternative strategies are attractive, especially given the emerging liquid alternatives paradigm. By 2015, alternative investments are likely to account for one quarter of retail revenues and the majority of the growth in assets under management.[3]

With so much at stake, both hedge fund and traditional asset managers have launched registered funds that incorporate alternatives strategies, both in competition and collaboration. New products based on these strategies have emerged in two ways:

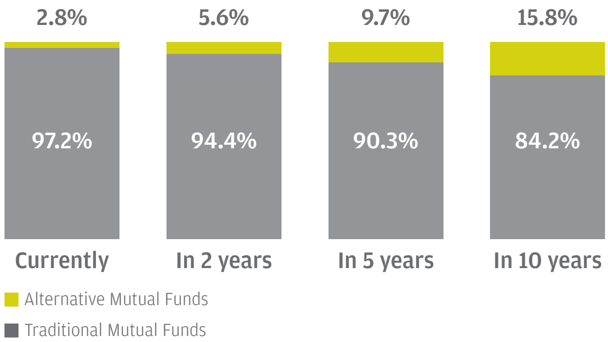
1. Hedge fund managers have launched highly complex, multi-manager, multi-strategy mutual funds and sought distribution opportunities for them.
2. Traditional funds have hired hedge fund managers as sub-advisors for similar fund structures.

For both hedge funds and traditional asset managers, multi-manager '40 Act[4] funds are a relatively new frontier, presenting a series of complex and unfamiliar challenges.

While the opportunity is clear, there are meaningful barriers that must be overcome, including distribution, risk management, sales, marketing and even cultural issues. Those who prove most adept at meeting these challenges will be well positioned to capture opportunities in the mainstream retail arena.

Alternative Mutual Funds Expected to Steadily Gain Market Share

Expected allocation of traditional and alternative mutual funds in 2, 5, and 10 years, 2012



Source: Strategic Insight/SIMFUND, Cerulli Associates[5]

Absolute returns prove relatively appealing

Confronted with volatile financial markets and the specter of inadequate retirement savings, retail investors have been slow to re-engage in the traditional markets. More than $2.7 trillion in cash is sitting on the sidelines. With bond yields historically low and memories of large stock market losses still rattling investor nerves, a shift in investment frameworks from relative to absolute return can be very compelling. Many alternative strategies present this opportunity.

Most retail investors and many smaller institutions cannot meet the high minimums of the best performing hedge funds, and many have concerns about long-term lock-ups. The average retail investor is also not in a position to compare the relative merits of hedge fund strategies and make wise decisions about incorporating them into a diversified portfolio.

The convergence of traditional and alternative asset classes in a registered mutual fund provides an easier point of access for many of these investors. Through multi-manager, multi-asset class funds, investment management companies can offer their clients a broader range of strategies, and hedge fund managers can access a vast new market.

CREATING, DISTRIBUTING AND ADMINISTRATING A MULTI-MANAGER REGISTERED MUTUAL FUND THAT INCORPORATES ALTERNATIVE STRATEGIES PRESENTS A HOST OF UNFAMILIAR CHALLENGES TO BOTH HEDGE FUNDS AND TRADITIONAL ASSET MANAGERS.

Overcoming the unfamiliar: challenges for traditional asset and hedge fund managers

While traditional asset managers are obviously very comfortable operating in a registered environment, their sales forces generally don't have the technical product expertise to sell more sophisticated alternative strategies. Both retail investment advisors and institutional investors also rank traditional asset managers lower than hedge funds in their risk management capabilities. To compete successfully in the market, traditional managers recognize they need to focus on advisor segments with an ability to sell alternatives, train and/or hire alternatives-fluent sales people and manage a range of compensation and cultural issues. As a whole, traditional asset managers are not particularly optimistic about their ability to overcome these challenges. In a McKinsey survey, only 36 percent of traditional asset managers considered themselves well- or best-positioned to win with alternatives.[6]

In contrast, most hedge fund managers face a steep learning curve when entering the registered world.

Few have the institutionalized capabilities to govern, manage risk and adhere to the regulatory framework. Distribution and marketing capabilities must be added or enhanced, and some funds also face challenges at the investment strategy level. To compete effectively on platforms with thousands of investment funds, hedge fund strategies must not only accommodate the demands created by daily liquidity requirements, they must be clearly differentiated in the market. They also need a sales force that can make a compelling case for that product to retail investment advisors, family office and broker-dealers, as well as a broader spectrum of institutional clients.

The Lessons of Experience

Palmer Square Capital Management, a Kansas City-based manager of multi-strategy limited partnerships and structured corporate credit portfolios, made its first foray into the registered mutual fund marketplace in May 2011. Their absolute return, multi-strategy mutual fund was launched in response to client demand for a more transparent and liquid alternative investment vehicle. Palmer Square President Chris Long reports that his firm had initial concerns about the daunting tasks of building out their distribution capabilities to compete in the registered fund environment. "Launching the first fund turned out to be far more expensive and challenging than we thought, mostly due to the complexities of supporting a multi-tiered distribution strategy."

Once all those "pipes" were in place, Long notes, there were considerable efficiencies when it came time to launch their second fund, an Alternative Income Mutual Fund. Despite the complexities, Long believes it was essential to build out their own distribution capabilities to gain efficiencies and "control their own path." His advice to alternative asset managers entering the registered mutual fund market includes:

1. **Make sure you have a differentiated strategy.** Me-too products will have a difficult time standing out in a very competitive market. Understand that some strategies will work given daily liquidity requirements, and not all managers adapt well to the environment.
2. **Hire and train an educated distribution sales force** that can support institution, RIA and broker-dealer channels. If you can't get on the platforms, you don't have the opportunity to sell product.
3. **Invest in quality marketing materials.** There are many misperceptions about alternatives strategies in the retail market. Assume that you will have to do a lot of educating.

Key issues in multi-manager, multi-asset-class funds

Regardless of whether a multi-manager, multi-asset fund is being launched by an alternatives fund manager, a traditional asset manager or some combination of the two, several key issues must be addressed. These include:

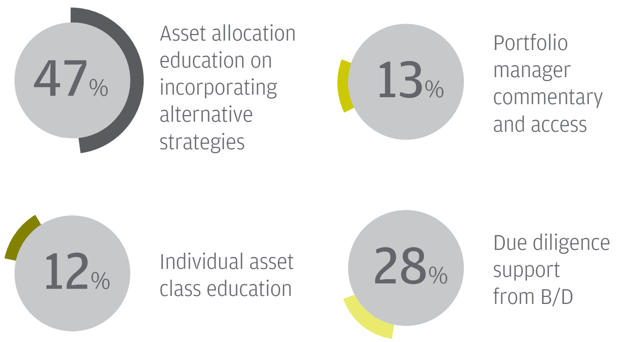
Regulatory and disclosure—Despite the recent SEC reporting requirements, most hedge fund managers have limited expertise with the full range of regulations affecting registered mutual funds and compliance with all aspects of The Investment Company Act of 1940. Some of the main areas on which managers are focused include: adherence to the '40 Act compliance rules with attention to leverage and diversification, regulatory disclosures and fair valuation in a daily NAV environment. The learning curve is steep and arduous in many of these areas, and the penalties for not getting it right can be substantial. The SEC has made it clear that use of alternative investments in '40 Act funds will be a top enforcement priority for 2013, and fund sponsors must be able to demonstrate that they have the proper controls in place.

Of course, traditional asset managers are well versed in the requirements of the '40 Act. In a multi-manager structure, however, fund sponsors must understand the strategies employed by each manager and implement oversight guidelines to ensure fund compliance. Managers also face increased disclosure requirements through financial statements and other frequent filings requiring the release of their holdings information. While not insurmountable, the implications of these requirements must be understood.

Distribution—Exceptionally successful hedge funds can be built through very narrow distribution channels, sometimes stretching no wider than the contacts of the fund manager. Success in the registered mutual fund world is all about broad distribution by gaining access to as many platforms as possible. Having a strong hedge fund track record with a solid institutional investor base does not correlate with attracting assets through a retail mutual fund. Developing a well-defined distribution strategy is an important factor in a manager's ability to attract meaningful assets. Considerable resources are required to adequately support distribution and marketing efforts in the retail, family office, broker-dealer and institutional spaces.

Sales and marketing—Hedge funds are widely misunderstood in the retail market, and investors may be concerned about the potential for relatively high volatility. Sales and marketing processes may need to be adjusted, and extensive training may be needed, to effectively explain the benefits of alternatives strategies and to advise both institutional and retail investors

Most Helpful Method for Increased Adoption of Alternatives



Source: Cerulli Associates, in partnership with the Investment Management Consultant Association and Advisor Perspectives

on their place in a well-diversified portfolio. This applies to traditional asset managers as well as hedge fund managers. Selling alternatives strategies presents entirely different challenges than selling long-only strategies, and investors have noticed a lack of product expertise.

In a recent survey, 69 percent of retail investor managers stated that traditional asset managers needed to improve their ability to communicate the strategy details of their products.[7] This ranked second to only pricing as their greatest concern.

Cultural and compensation issues—Hedge funds and traditional managers have strikingly different governance structures, compensation paradigms and even general attitudes toward the investment business. Reconciling these cultural differences can present a major hurdle on the way to an effective partnership with hedge funds and may complicate efforts to bring alternatives talent in-house.

30 PERCENT OF ASSET MANAGERS SURVEYED CITED COMPENSATION ISSUES AS THE GREATEST BARRIER TO INTEGRATING ALTERNATIVES INTO THEIR ORGANIZATIONS. AN ADDITIONAL 29 PERCENT CITED CULTURAL AND TALENT MANAGEMENT ISSUES.[8]

Prime custody in the multi-manager, multi-asset class fund

Without the need to meet '40 Act regulations, many hedge funds have never needed a custody relationship, relying instead on their prime broker for trade processing, settlement and a host of other services. Conversely, as long-only investors, many traditional asset managers have never needed a prime brokerage relationship. Where long and short strategies come together in a single fund, however, a bifurcated model emerges. The institutional fund manager's new need for short side services, and the hedge fund manager's use of long side services, have created challenges spanning investment processes, trade execution, reporting, accounting, and regulatory and tax compliance. The situation puts both traditional and hedge fund managers through a variety of unfamiliar operational tests.

PRIME CUSTODY PROVIDES AN INTEGRATED SOLUTION. IN TERMS OF EFFICIENT, AUTOMATED PROCESSING OF INFORMATION FROM TRADE INPUT TO REPORTING, AN INTEGRATED LONG/SHORT ASSET MANAGEMENT SERVICING PLATFORM HAS ADVANTAGES.

The pressure from investors for segregated custody of unencumbered assets, coupled with the need to move assets efficiently between the custodian and the prime broker, makes the case compelling for sponsors of multi-manager, multi-asset class funds.

Converging lines

Like most game-changing opportunities, the migration of alternatives strategies into the registered mutual fund marketplace presents significant challenges. Traditional asset managers will need to build on their traditional strengths while developing the risk management and sales capabilities to support a more complex product set. Hedge fund managers will need to build distribution capabilities to bring their products to a consumer-driven market, and create strategies that will stand out once they are there.

ALTERNATIVES AND TRADITIONAL ASSET MANAGERS WILL HAVE TO CLOSE A CULTURAL DIVIDE TO FORGE EFFECTIVE ALLIANCES AND/OR DRAW QUALIFIED PROFESSIONALS TO THEIR CAUSE.

It is a challenge to capture significant new asset flow as both institutional and retail investors migrate toward alternative investments. Those who have a well-defined distribution strategy and are willing to invest in the required risk management infrastructure, however, may be best positioned to capture the better part of future growth in the investment management industry. **thought**

Needing Alternatives

Percentage of asset managers who say they need alternatives to optimize the risk-adjusted performance of their portfolios:

In 2011: 73%

In 2012: 89%

Source: Cerulli Associates

1. McKinsey & Company, "The Mainstreaming of Alternative Investments: Fueling the next wave of growth in asset management," June 26, 2012, www.mckinsey.com/insights.
2. Cerulli Associates, *Cerulli Quantitative Update: ETFs and Retail Alternative Products and Strategies 2012*, www.cerulli.com. **3.** McKinsey & Company. **4.** The Investment Company Act of 1940.
5. Cerulli Associates, page 16, exhibit 1.05; alternative allocation is based on an average of respondents' expected percentages **6.** McKinsey & Company. **7.** Ibid. **8.** Ibid.

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