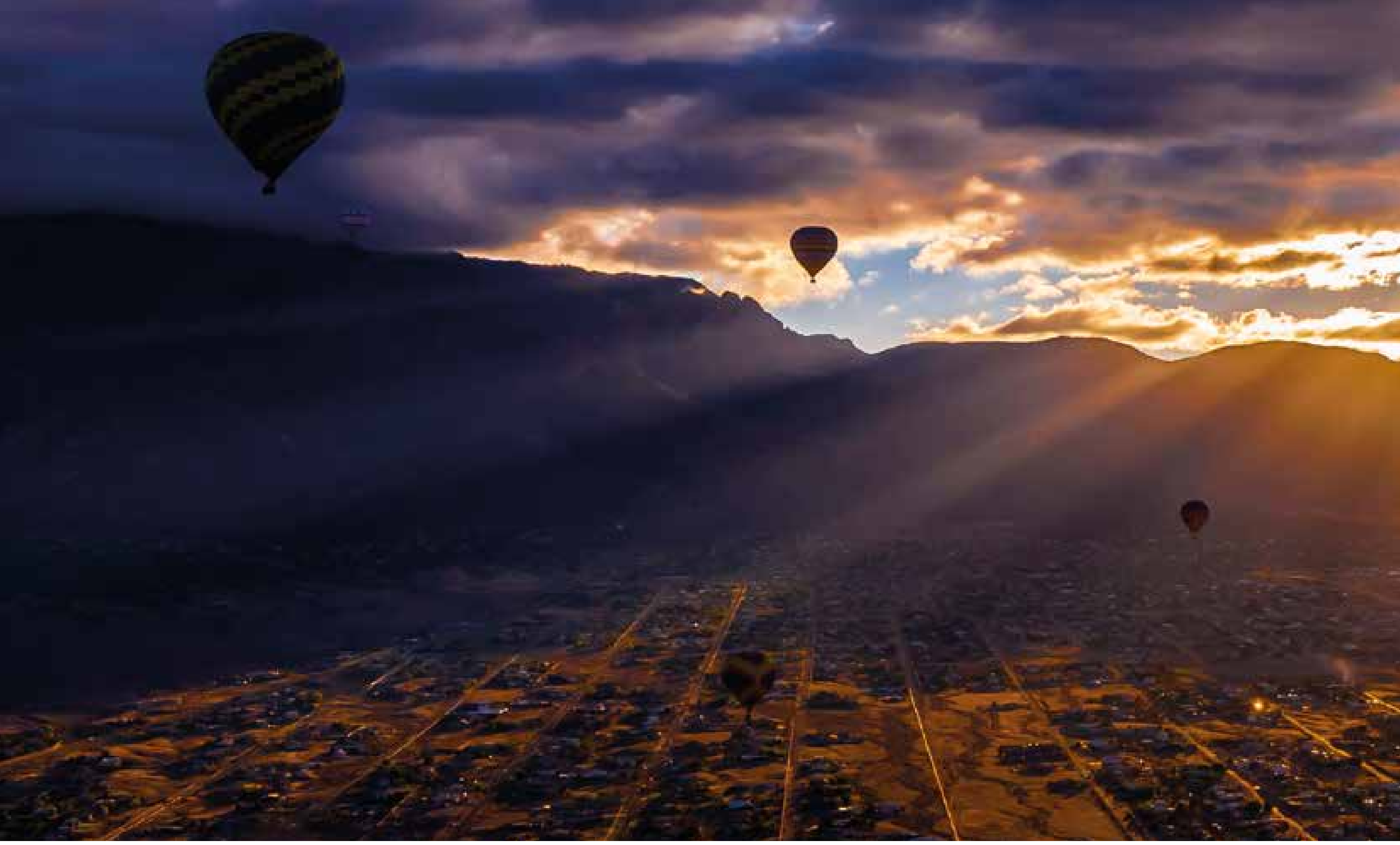

2015 Alternative Investment Outlook

Complex grounds, new frontiers

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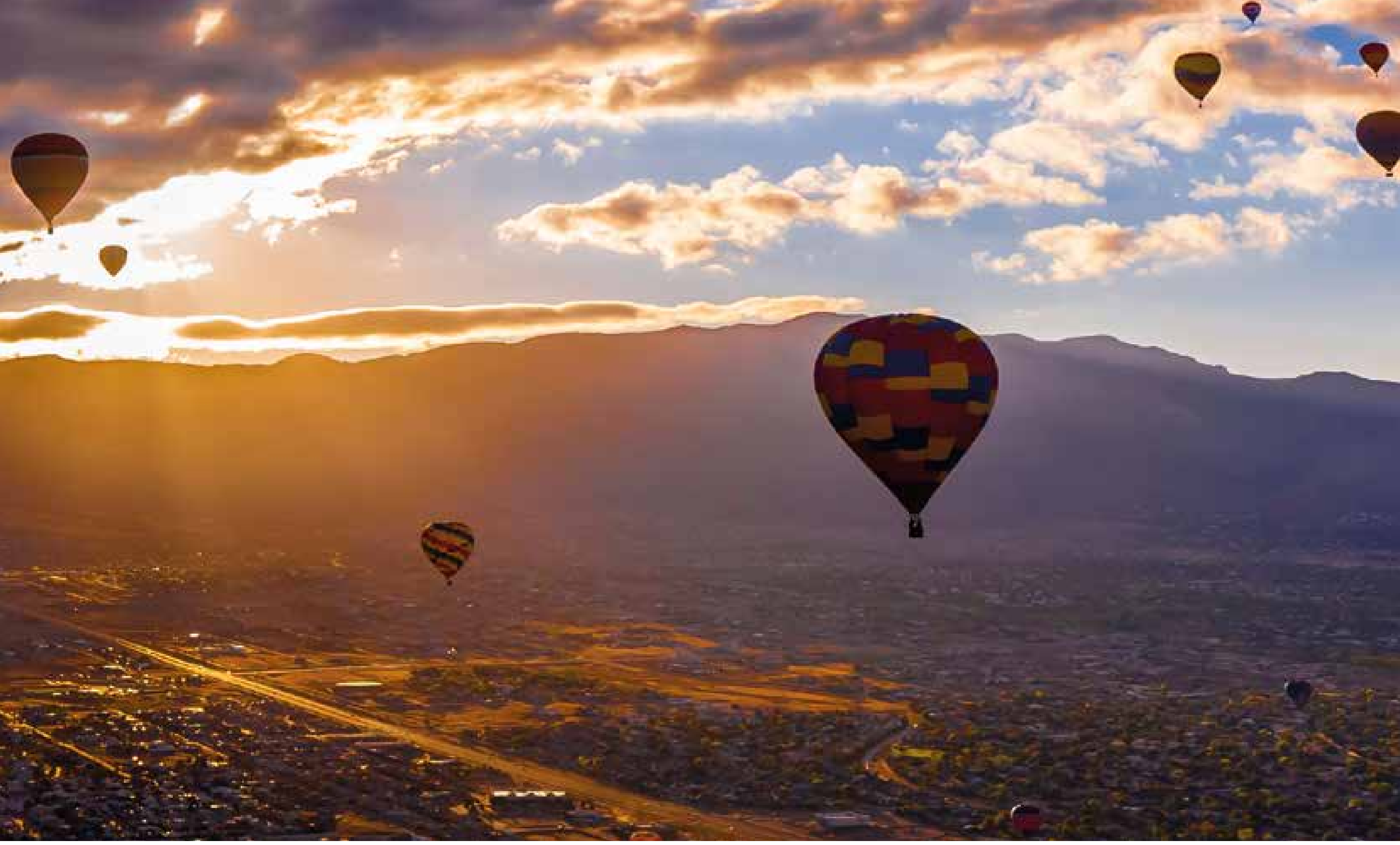
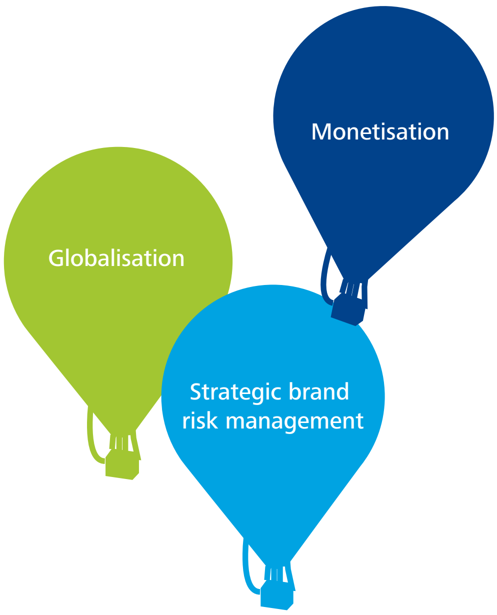
In many ways, the alternatives industry is still among the most nimble and adaptive sectors of the financial industry, producing tremendous innovation across many aspects of the business.



The alternative investment industry looks ahead to 2015 as the broader market compiles an impressive performance streak. The performance of alternatives looks relatively weaker, causing some to question the long-term fundamentals of the industry. Others are pointing out that the very appeal of alternatives is that they are intended to be inversely correlated to the broader market and that it would be more of a concern if alternative investments were performing in lockstep with the broader indices.

From Deloitte's perspective, with a view of the industry across organisations of many sizes and shapes, there are both challenges and opportunities. The prevailing sense is that the alternative industry is strong overall, but rapidly evolving amidst existing and emerging complexities. In many ways, the alternatives industry is still among the most nimble and adaptive sectors of the financial industry, producing tremendous innovation across many aspects of the business.

Figure 1: Three focus areas for 2015



The 2015 Alternative Investment Outlook focuses on three key issues:

1

Globalisation

Increasingly, companies of all sizes are being affected by international markets, events and opportunities. Communications and travel technology continue to shrink the world, many foreign economies are expanding more rapidly than the U.S. economy is growing, and as a result, wealth is being created around the world. Conversely, Europe is facing many challenges and will see the U.S. dollar continue to appreciate against the Euro. This is generating tremendous opportunity for alternative managers in the form of both new investment opportunities and new investors. However, it is also dramatically increasing the complexity of running an alternative investment manager.

2

Monetisation

Growing numbers of hedge funds and private equity managers are raising capital — or "monetising" their businesses — by selling stakes in their firms to institutional investors. This trend is creating opportunities for both buyers and sellers, but it is also raising dynamic technical and regulatory issues.

Many industry observers believe that brand resilience and the management of reputational risk are becoming as important in attracting assets as investment performance

3

Strategic brand risk management

Many industry observers believe that brand resilience and the management of reputational risk are becoming as important in attracting assets as investment performance. As managers become more risk-aware, more money will be spent to identify and mitigate risks. The concept of a brand narrative around any event impacting the firm, solid corporate communications providing information and transparency to investors and regulators, and the building of goodwill through these actions has become paramount. In the financial services industry, trust is essential, especially for alternative managers acting as fiduciaries. The loss of trust can be fatal, and trust is reflected in an organisation's brand.

The following pages explore these topics in more depth and highlight expectations for the coming year. While all topics are examined independently, it is prudent to remember that they are interrelated and interdependent as part of an increasingly complex industry.

The global perspective

Focus on excellence and growth will come

Alternative investment managers are looking at the global investment landscape for two key reasons:

- First, managers are aware that significant wealth is being created around the world as emerging economies expand and developed economies recover, and they are very interested in managing that wealth. Extending into new geographies with new products gives managers access to these new investors.
- Second, with the cost of breaking even climbing, managers are entering new geographies for investment opportunities. By looking at investment opportunities on a global scale, many managers are able to participate in far more diverse and differentiated investment strategies. The global market offers a variety of ways in which alternative managers can participate. Some managers are setting up extensive local operations in the geographies they wish to serve while others are collaborating with local firms. Certain firms are choosing to handle the operations and technology internally while others are primarily outsourcing. There is no "right" answer; it all depends on the manager, the opportunity and the geography.

According to Deloitte's 2014 Global Economic Outlook, the trend of weakness in developed countries and strength in emerging markets appears to be reversing. However, emerging markets are still growing at a faster rate than developed nations and their long-term prospects appear strong. There also appears to be a shift in capital flowing back to the United States now that U.S. monetary policy is changing.[1] The net result is that there continues to be a significant pool of international wealth that is interested in alternative investments. As discussed in the 2014 Alternative Investment Outlook, much of this money is coming from institutions, including sovereign wealth funds, pensions and endowments.

From an investing standpoint, having a global reach allows alternative managers the flexibility to take advantage of a wide range of opportunities. The marketplace has seen a dramatic shift in next wave of buyers and what they are looking for in products and services. Products continue to vary widely by institution and geography, but areas of continued interest include credit funds, especially those that focus on distressed assets and energy.

This growth of investors and investments from a variety of geographies is adding significant complexity to the operations of alternative managers. Each new jurisdiction entered brings new legal, regulatory, tax, valuation and processing issues into play. This complexity is hitting the back office, increasing cost, and adversely affecting return on investment. Firms that do not fully understand and plan for the financial impact of global expansion might not receive the benefit they expect from an investment. In short, if alternative managers only evaluate opportunities by the same standards they use for their U.S. investments, they are unlikely to understand the full cost of owning investments outside of the United States.

For example, an alternative manager may see distressed real estate as an opportunity and decide to invest in single-family homes in a foreign market. By the manager's domestic standards, the deal may look very attractive.

However, unless the manager has done similar deals in the same market, the manager could very easily underestimate the costs of day-to-day operations. These costs can include property management under local regulations such as eviction standards and the reconciliation of books and records across currencies. Managers should also take into consideration local laws, regulations and customs, which can vary widely by jurisdiction. In an example like this, it is possible that a manager's assets and revenues could remain relatively stable while the net return could be lower than anticipated due to the structural complexity and associated costs of the deal. You take on unnecessary risk when you engage in activities you do not fully understand or have not appropriately evaluated. In 2015, the firms that prioritise due diligence and bring in tax, legal and regulatory advice up front are most likely to be satisfied with their global portfolios. Alternative managers that spend a little more time up front to ensure that they have a true understanding of what they are asking the back office to do, and the risks they are taking on, are likely to do better in the long term.

1 *Dr. Ira Khalish, Global Economic Outlook, Q3 2014, Deloitte University Press.*

Focus for 2015

The largest asset managers are best able to participate in the global market. They have the scale and infrastructure to go almost anywhere and the resources to see that they do it well. Yet they are still able to be nimble, launch niche products, and respond quickly to opportunity. In many ways, they have the best of both worlds, and it is increasingly challenging to compete against them. Smaller firms will look to compete by leveraging partnerships and relying on outside expertise in areas such as distribution and operations. In addition, spending on up-front due diligence is expected to rise as managers seek to fully understand the implications of deals that they are undertaking. As one industry executive recently put it, *"You need to kick the bricks, ride the elevators, and understand the tenants"* in each deal.

The bottom line

In order for firms to compete, they must continue to think globally. There is simply far too much wealth and far too many investment opportunities outside the United States to ignore. The complexity of alternative operations will continue to increase as firms expand globally across various jurisdictions and investments. Complex operations will continue to be a cost of doing business internationally, and the largest firms, which have the resources to address this complexity, have an advantage. Spending the time and effort to understand the full tax, regulatory, and operational implications of each deal may seem expensive, but it can mitigate surprises on the back end and should prove to be a good long-term investment.

Figure 2: Going global adds complexity

Opportunities for U.S. alternatives managers in other countries introduce challenges that can affect return on investment

Source: Deloitte Center for Financial Services analysis

Monetisation strategies move forward

Monetisation transactions are expected to continue in 2015, although they raise important business and technical issues for both buyers and sellers

In 2014, a significant uptick occurred among hedge funds and private equity managers raising capital by selling a piece of their businesses. At the same time, that interest was matched by institutional investors seeking to make such acquisitions. Such “monetization” has created an active marketplace, where new entrants launching funds specifically to purchase minority interest stakes in alternative investment managers are joining a number of firms already in the space. These transactions are expected to continue at a healthy pace throughout 2015, although they raise important business and technical issues for both buyers and sellers, including agreement on the nature and extent of the relationship between the parties involved.

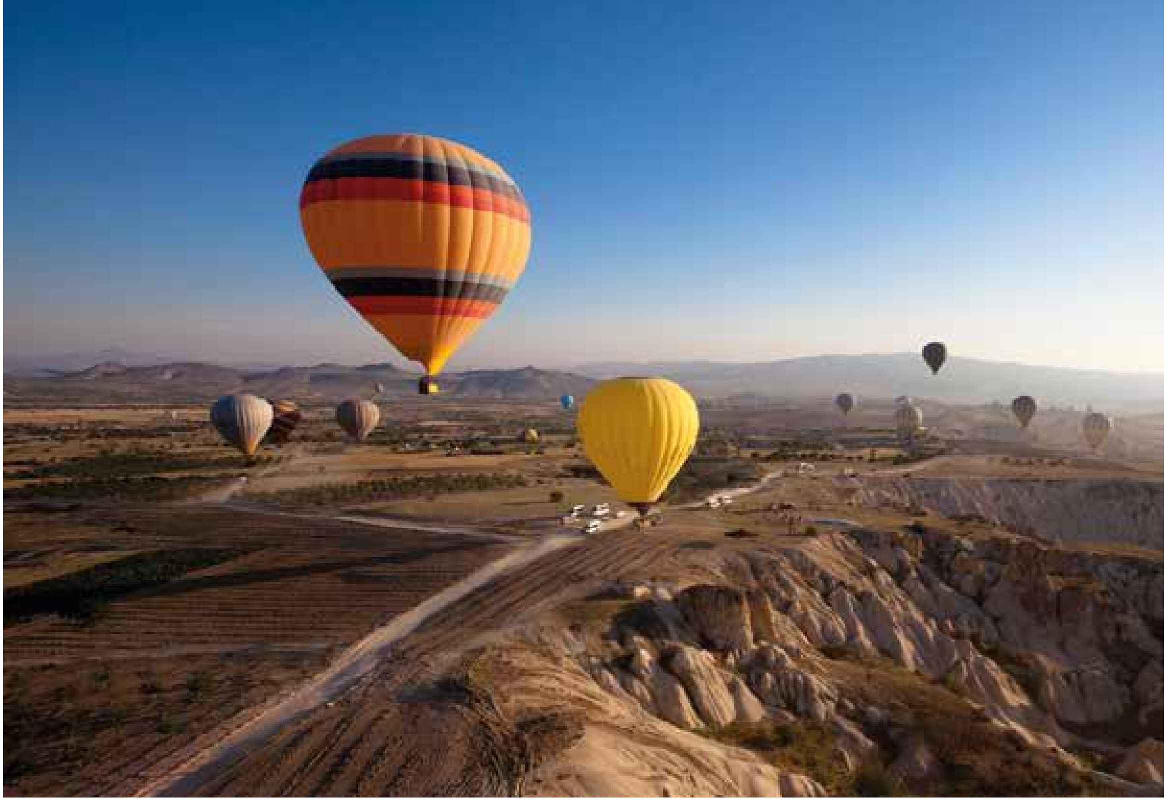
There are a number of reasons why monetisation transactions are so popular. Key drivers include personal issues for finance principals, such as succession planning and/or retirement planning, which require an “institutionalisation” of the business. The demographics of finance principals, many of whom are baby boomers, suggest that this trend is likely to continue for many years to come.

Another key driver is the desire of some alternative managers to raise a base of capital to expand their businesses. Having fresh capital to invest in the business allows managers greater flexibility in expansion planning. They can launch new products, diversify their investor base, expand their investment focus beyond its current footprint, improve their distribution capabilities, or do all of these at the same time.

Finally, as we saw in the late 2000s, some monetisation transactions may serve as a precursor to an initial public offering (IPO), allowing managers to establish a price point for a future offering. Given where the financial markets are today, it appears to be a good time for sellers to consider monetising a piece of the business, while buyers appear to believe current valuations justify the purchase price based on future opportunities for growth. It’s no wonder that some industry participants refer to these monetisation deals as providing “acceleration capital” to managers, allowing them to take their businesses to the next level.

What do buyers seek in these transactions? Typically, they look for a manager who has a strong track record in his or her area of expertise, and usually, but not always, is committed to running the business for the foreseeable future. Buyers also look for a manager who has been able to build a business that is supported by a solid operational and compliance infrastructure and that has a stable investor base. In 2015, the growing complexity of operations and compliance brought in by increased regulation, cyber threats and product expansion, as well as the need for operational efficiency brought on by continued fee pressure, may indicate that buyers will place even more emphasis on the infrastructure side of the business. Managers seeking new and flexible sources of capital are finding it with investors who are looking for a stable organisation, strong leadership and a desire to create a franchise beyond the original founders of a fund.

From the manager’s perspective, it is important to identify a strategic partner with the resources to help implement expansion plans and build the business by launching new products, entering new geographies, and/or targeting new types of investors. Most managers want a strategic partner to make their business stronger. This long-term approach, where a manager looks for a partner able to help drive the future of the business, is expected to generate continued interest in 2015.



Like any other important business relationship, due consideration is appropriate on both sides before entering into a transaction. Of course, formal due diligence is important from both the finance and tax perspective, but the buyer and seller also need to be able to look each other in the eye and say, *"Yes, I can work with this person or with this organisation."* To protect both sides, there should be an agreement outlining the level of participation that the strategic investor will have in the ongoing business. Some people will be comfortable with a passive approach while others, particularly on the buyer side, may be more interested in having an active role in managing and developing the underlying business. As one industry executive recently commented, *"Don't break the fabric of the culture -- be there as an advisor and a sounding board."*

It is impossible to say which approach is the better model for operating. It depends on the perspective of the buyer and seller. Again, it's critical to have a mutual understanding prior to entering into the strategic relationship.

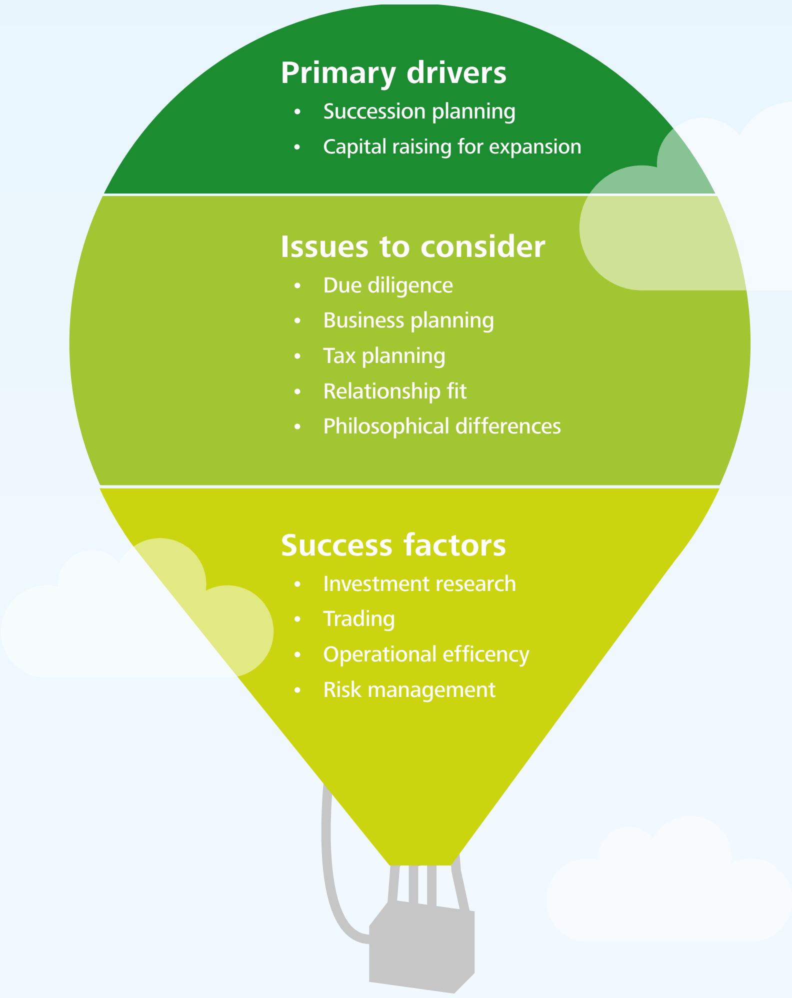
There are a number of obstacles to success in closing a deal. Valuation is one key area of negotiation. Just as calculating the fair value of a security held in a portfolio is an imprecise science, deciding the fair price for a manager can be a challenge. In addition, in times of transition such as the alternatives industry is experiencing currently, valuation becomes even more important — especially given the trend toward a more regulated environment and ongoing fee pressure. There are typically other negotiating points as well, including the allocation of purchase price, the right to claw back purchase price, earn-out provisions, and "key person" provisions.

From the buyer's perspective, "key person" risk is of paramount consideration. Succession planning and due diligence are key. As discussed earlier, the existing management is often a critical aspect of the deal, and the buyer needs to be comfortable that the manager or the management team running the business will continue to be engaged. This often includes investor relations as well as the investment/trading side of the business. Speaking of investor relations, there must be mutual agreement on when and how communication to existing investors should be made, as well as when and how communication should be made to the public.

Taxes typically rise to the top of key considerations in a strategic transaction; it is important that both the buyer and seller understand the tax implications of the transaction they are contemplating. The buyer will want to ensure that the purchase price will be recovered through amortisation deductions. From the seller's perspective, the objective typically is to maximise the long-term capital gain arising from the transaction. These two outcomes are not mutually exclusive, but care must be taken to optimise the result for both sides. Taxes paid by alternative asset managers is an issue that is being reviewed by the Treasury Department and is widely discussed in the media; as a result, possible implications, including government and media scrutiny, should be taken into consideration when evaluating a deal.[2] Finally, both sides must seriously consider exit strategies before entering into a transaction. Key issues include put options, call options, so-called "tag along" and "drag along" rights, and other exit-strategy issues that may differ depending on whether the exit strategy is an IPO, an effective redemption, or a sale to a third party. In addition, timing when these rights or obligations may be exercised is important to decide up front, as is a mechanism for establishing a valuation for the exit.

2 *Zachary R. Mider, "Treasury Is Weighing Action on Hedge-Fund Tax 'Loophole,'" Bloomberg, September 11, 2014.*

Figure 3: Riding the monetisation train



Focus for 2015

We expect that 2015 will bring more monetisation deals to the fore, provided the capital markets continue on an upward trajectory. The pace of deals may pick up a bit, but strategic buyers need to make sure to balance new transactions with the onboarding of managers on deals just closed. This onboarding, which would include sharing leading practices in investment research, trading, operational efficiency and risk management, is critical to the success of a deal. The deal sizes are also not likely to change, as most firms appear to be interested in similar types of targets. However, we may see more cross-border transactions as the globalization of the hedge fund business continues. Cross-border deals are by their nature more complex, and this may increase the time needed for onboarding even more.

The bottom line

As deal momentum continues in 2015 due to succession planning needs and the desire of managers to raise a stable base of capital for expansion, expect monetisation to continue. Done well, these transactions represent an opportunity for both sides of the deal and allow managers to "accelerate" the business. Monetisation deals reflect the continued maturation of the alternatives industry, and perhaps represent a harbinger of greater consolidation. However, it is essential that proper due diligence and business and tax planning be done up front, and that both sides see eye-to-eye and have realistic and reasonable expectations. It is also essential that managers carefully evaluate the investor relations and public relations aspects of the deal, and consider the potential impact of both on their brand and reputation.

Embracing strategic risk management to protect and grow a business

An argument can be made that brand and reputation are at least as important as investment performance to the vitality of an investment organisation

Investment managers are very well acquainted with the concept of risk management. Alternative managers, in particular, understand that investment risk, if well-managed, can lead to enhanced portfolio returns. As such, alternative managers frequently embrace risk to generate superior investment performance. This management of investment risk has always been a key part of the value proposition of alternative managers: it is core to what they do, and, in many ways, it is the lifeblood of the alternative investment industry.

However, the management of other types of risks that the industry faces, including operational, technology and regulatory risk, has not always been viewed the same way as investment risk. This is not to say that these other risk types are not considered important by alternative managers. In fact, many alternative managers are allocating significant resources to managing these risks. For example, over the last few years, many alternative managers have incurred the cost of becoming registered advisers and dealt with the global regulatory focus on conflicts of interest. However, the spending to mitigate these other risks has usually been considered a necessary cost of doing business and a defensive strategy, rather than a proactive way to generate additional value for the organisation and its clients.

This traditional view of risk management is beginning to change as some alternative managers are realising that a "risk event," whether stemming from a valuation error, a conflict of interest or a data breach, can have a significant negative impact on their brand and their reputation.

They also understand that the trust of their customers, employees and business partners is essential to their future livelihood. In fact, an argument can be made that brand and reputation are at least as important as investment performance to the vitality of an investment organisation. Just as poor investment performance will usually lead to fewer assets under management, a negative headline can do the same. For example, cyberattacks in other industries have affected revenues of companies, harmed brands and cost senior executives their jobs.

This growing realisation of the importance of brand is causing some alternative managers to move away from the defensive view of risk management toward a more proactive and strategic approach. These firms understand that if managed correctly risk management is a competitive differentiator and can be transformed into an asset that drives brand equity and provides a measurable, positive return in the form of increased asset retention and new asset flows.

"In world-class companies, risk is positioned in strategy, not in compliance."— Chief risk officer, Deloitte

In 2015, it is expected that the alternative investment industry will increase adoption of some of the leading risk-management approaches that other industries are already using. While each organisation will have a different approach to risk management, there are three common building blocks that many firms are likely to adopt:

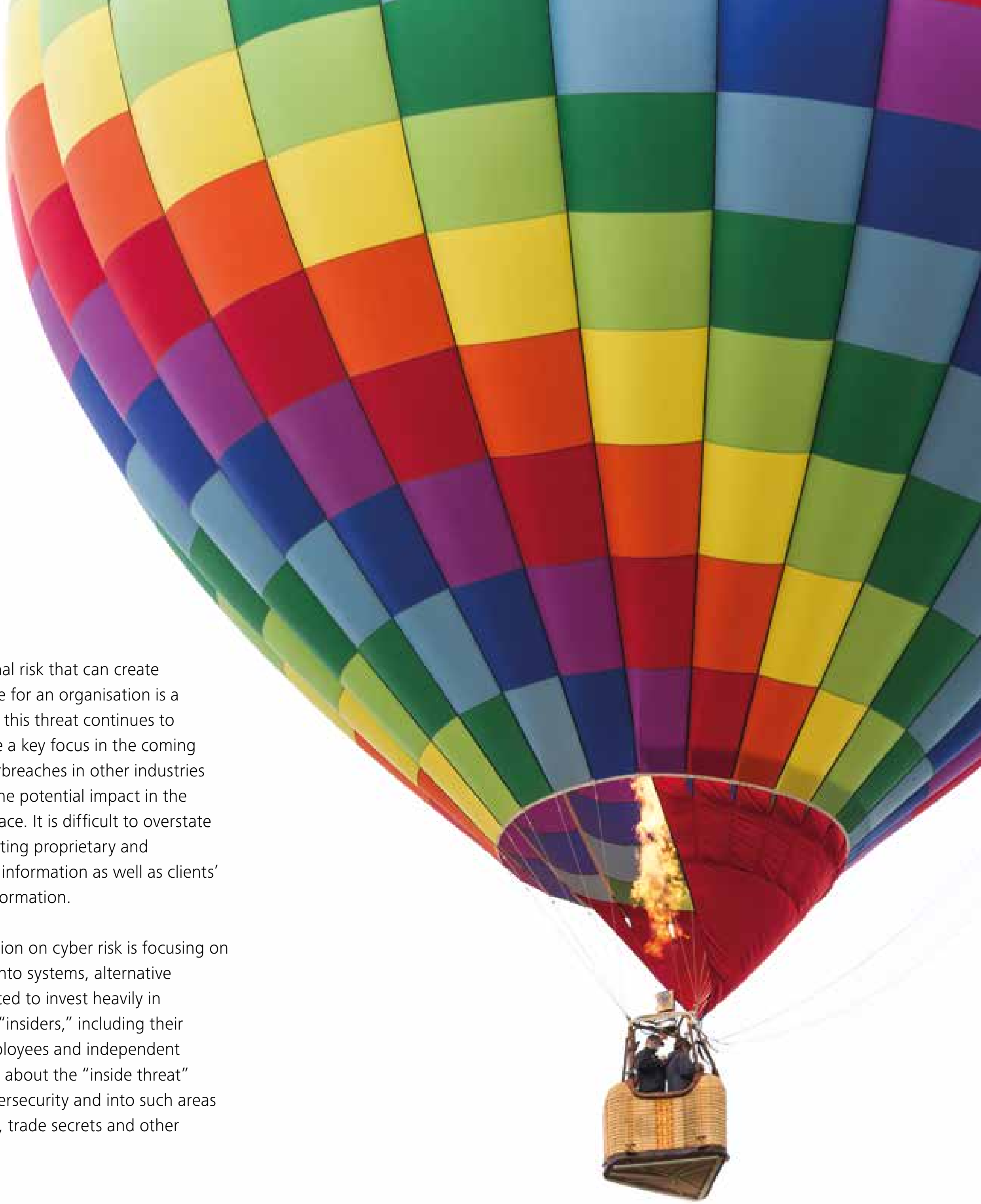
Governance. Proper governance entails getting the entire organisation, typically led by a chief risk officer with guidance and input from the CEO and board, to work together to make risk a strategic enabler. The board, executive management and business units each have individual responsibilities and are all accountable for collaborating across the organisation's silos to continuously identify, prioritise, and manage risks. A standard cadence is established in which business unit risk leaders meet to discuss emerging risk trends and mitigation strategies, escalating key themes and concerns to the board and executive management as needed. Proper governance creates a more manageable and meaningful risk process within an organisation, setting the appropriate "tone at the top" and driving accountability and transparency. Risk management must become part of the very ethos of the firm in order to be truly effective.

Standardised risk reporting. Enhanced risk reporting creates better visibility into emerging risks and helps drive risk-based decisions during the governance process. To ensure effective risk reporting, the process must be fully aligned with the company's strategic goals and objectives. The process must also filter out any irrelevant, excessive, disjointed or obsolete data. In the coming year, alternative managers are expected to make more use of risk-reporting dashboards on computers and mobile devices to capture emerging risks affecting the organisation's strategy. By giving an updated view of vulnerabilities and their potential impact, dashboards are critical to effectively prioritising and mitigating risks. Dashboards must be updated periodically — daily or weekly, depending on the risk — with an aggregated version prepared monthly or quarterly. A dashboard should also provide the board and executive management with the ability, at a glance, to evaluate the most relevant risks that could affect reputation, share price, corporate strategy, and, most importantly, assets under management.

Risk sensing. The ability to identify emerging risks and risk trends quickly and thus allow for a more nimble and effective response to risk is a critical skill in today's complex financial environment. Known as risk sensing, this skill involves a combination of human analysis and sophisticated technology that continuously analyses massive amounts of structured and unstructured data in near real time. This can provide highly relevant information specific to strategic decision making that tries to help executives peek around the corner to see what is ahead.

Firms can build risk sensing into their operations by embedding it in the formal governance process and standardising the reporting resulting from it. Key decision-makers must be able to digest easily the information derived from risk sensing. Among other benefits, an operationalised risk-sensing capability provides an organisation with the ability to continuously adapt its risk management focus based on data from both traditional and social media, and to adjust its response accordingly.

Because risk sensing can help executives understand how customers, competitors, suppliers and regulators view the risks facing an organisation, it is expected that these capabilities will gain traction in the alternatives industry. It is even possible that once alternative managers become adept at using risk-sensing tools, they may be able to incorporate them into their investment management process. In other words, they may be able to gather data on companies that they own or are targeting, in order to understand the risk these companies face.



Focus for 2015

One emerging reputational risk that can create irreparable brand damage for an organisation is a cyberbreach. The level of this threat continues to rise and is expected to be a key focus in the coming year. The impact of cyberbreaches in other industries is a leading indicator of the potential impact in the alternative investment space. It is difficult to overstate the importance of protecting proprietary and confidential organisation information as well as clients' personally identifiable information.

While much of the attention on cyber risk is focusing on outside entities hacking into systems, alternative managers are also expected to invest heavily in protecting systems from "insiders," including their employees, vendors' employees and independent contractors. This concern about the "inside threat" extends well beyond cybersecurity and into such areas as regulatory compliance, trade secrets and other confidential information.

The bottom line

Organisations that view risk management as a strategic enabler are expected to have a long-term advantage in the alternative investment industry.

While an up-front investment is required, in return an organisation will be better prepared to withstand market disruptions, cyberattacks, regulatory scrutiny, and many other risks. Anticipating the risks of tomorrow and pivoting quickly in response is critical to every firm. In addition, managers who make risk management a part of the core value proposition of their firms will have a compelling story to share with current and prospective clients. In an increasingly competitive industry, it is very possible that this could lead to higher client retention and the attraction of new assets. For organisations that value long-term wealth creation, for both owners and their clients, strategic risk management can be essential to achieving that goal.

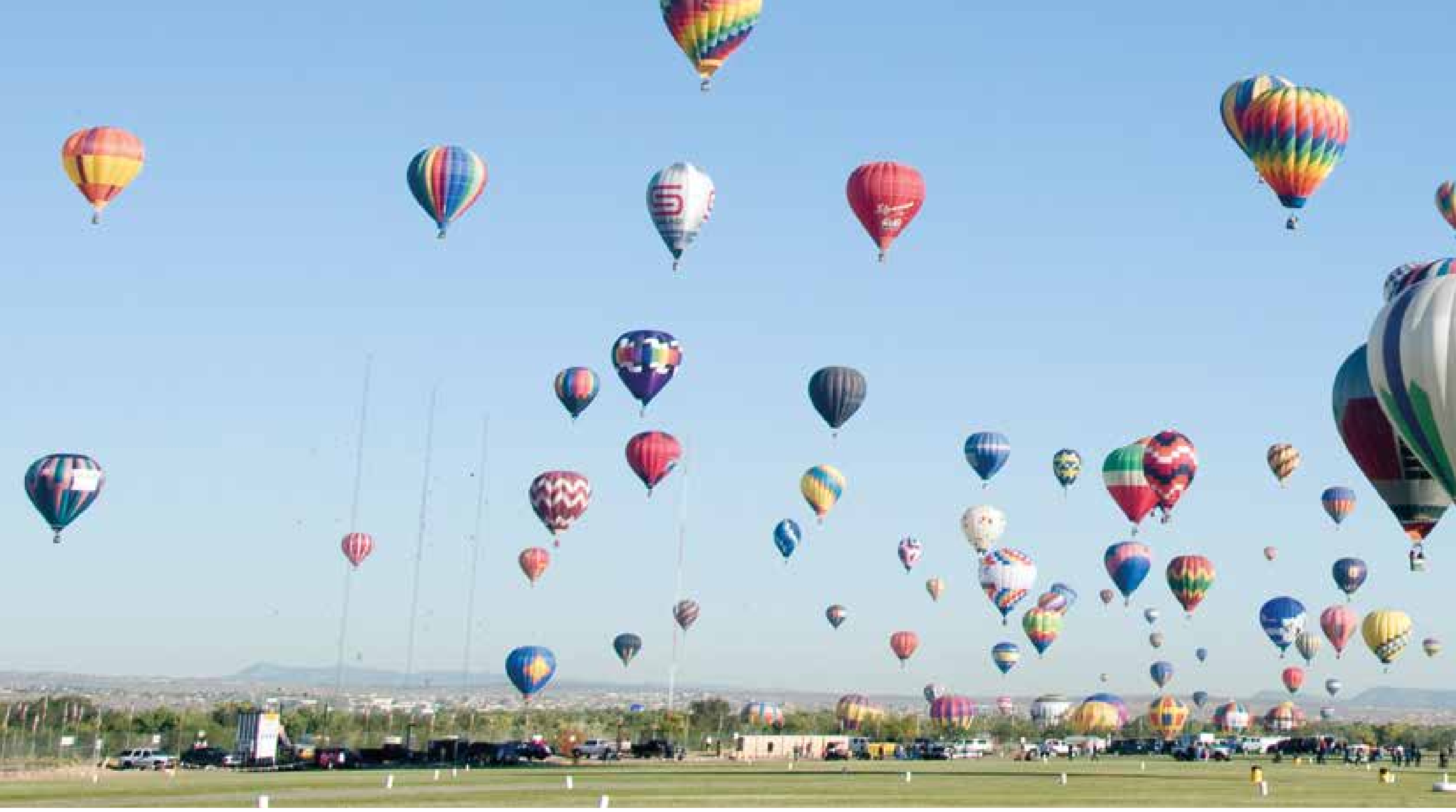
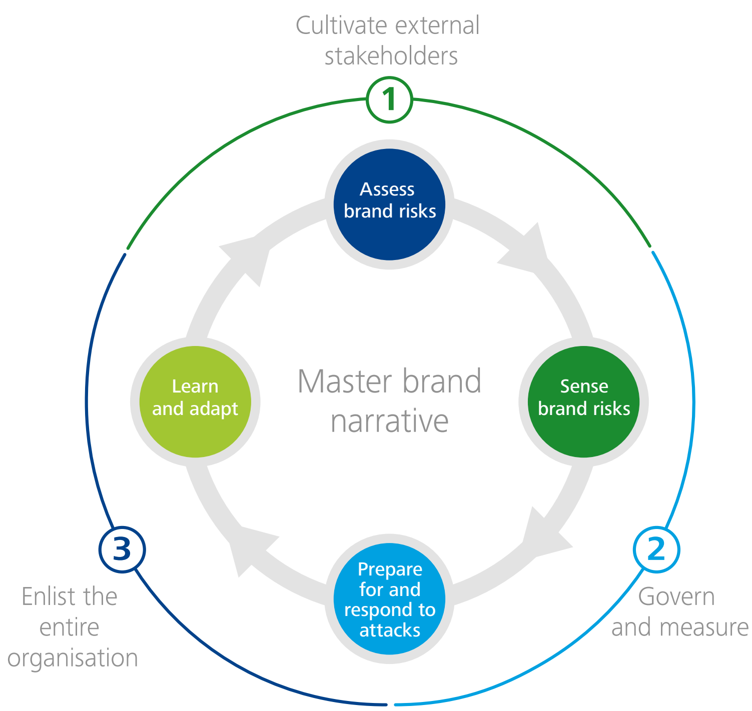


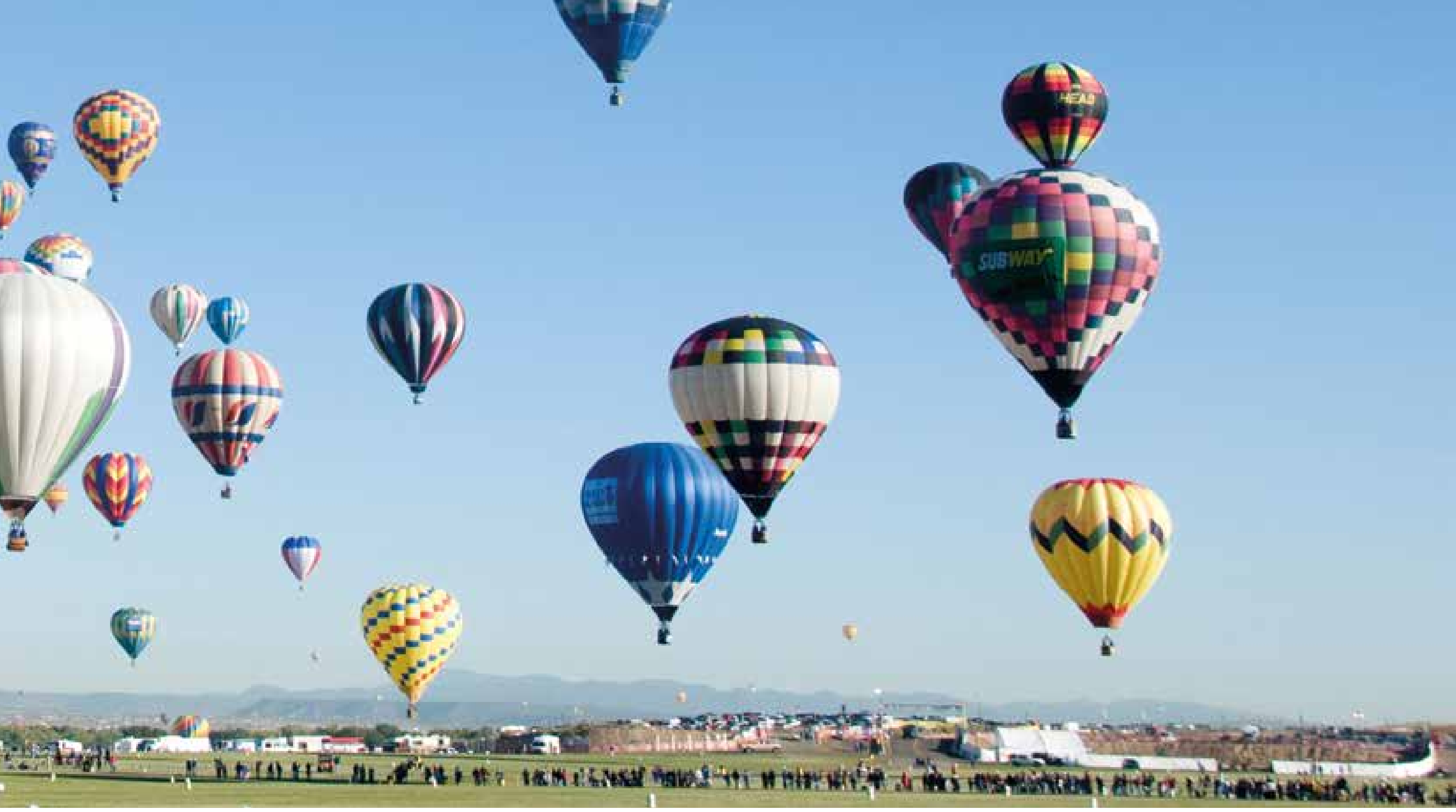
Figure 4: Building a brand and reputation risk management program



Strategic impact

- Identify opportunities to positively impact brand perception
- Strive to reduce or eliminate "traditional" crisis situations/ brand attacks
- Further differentiate the organisation's brand from its competitors
- Create "what if" scenario planning to positively alter our strategic focus
- Link internal strategies with brand strategies to create differentiation

Source: Deloitte Center for Financial Services analysis



To the **point**:

- The alternative investment industry is in a state of transition. Many factors, including increased regulation and globalisation, are combining to make the industry more costly, more competitive and more complex than ever before
- Alternative managers must continue to think globally if they want to be relevant in today's worldwide economy
- Monetisation is expected to continue as owners look to retire and transition ownership of their firms or to raise stable capital for expansion
- In today's era of instant communication and social media, the risk to brand from one key operational, regulatory or technological mishap can be devastating.
- The alternative investment firms that take the time to be thoughtful about what the future holds, map that vision of the future with their key value proposition and have a willingness to invest in a plan of action are likely to lead

In today's era of instant communication and social media, the risk to brand from one key operational, regulatory or technological mishap can be devastating