Investment Evolution

Convergence Across The Hedge Fund & Private Equity Industries

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TOPICS

- Explore Similarities And Differences Between Private Equity And Hedge Funds
- Dispel Some Of The Myths And Misunderstandings About Hedge Fund Businesses, Particularly Those With Skill–Based Strategies
- Discuss The Dynamics Of Convergence Across The Private Equity And Hedge Fund Industries
- Questions & Answers
INVESTMENT EVOLUTION

- Nothing Is “Typical”

- Yet, Generalities Can Be Discussed, Recognizing That There Are Many Exceptions

- Trends Are Making Capital More Efficient (i.e. lower capital-based returns, service and skill premiums)
  - investors are seeking risk management, risk measurement, and measuring investment performance in terms of risk & return, not just historical return
  
  - continued trend toward tranching, breaking investments into more specific instruments often to parse risks (e.g. capital structure, CDS, MBS)

  - further continuing to the stage of liquidity (e.g. secondary markets, derivatives)
OVERALL INVESTMENT LANDSCAPE

INVESTMENT PORTFOLIO

STOCKS

BONDS

ALTERNATIVE INVESTMENT STRATEGIES

RISK-BASED INVESTING

SKILL-BASED INVESTING
ALTERNATIVE INVESTMENT STRATEGIES

ALTERNATIVE INVESTMENT STRATEGIES
(“Skill-Based Strategies”)

PRIVATE EQUITY
- Buyout
- Venture
- Debt

HEDGE FUNDS

OTHER
- Real Estate
- Energy
- Other

Determined By Style & By Approach

Business vs. Speculation
PROFILE OF HEDGE FUND INDUSTRY

- Hedge Funds Are “Perpetual Investment Partnerships” Across A Wide Range Of Strategies That Often Start Small, Develop A Track Record (3 Years Is A Recognized Period), And Grow Over Time If Successful

- Bifurcated Hedge Fund Industry
  - Numerous small hedge funds (90%)
  - Concentrated $ in large funds (10%)
  - Top 100 firms have >60% of the assets


- 7,000-9,000 Funds Representing 5,000-6,000 Investment Choices At 3,000-4,000 Firms; $1+ Trillion Of Assets
**HEDGE FUND INDUSTRY PROFILE**

- Over 50% Of Hedge Funds Are Equity Long/Short–Related Funds (excluding fund of hedge funds)

- Approximately 10% Of Funds Have More Than $250 Million In Capital

- The Balance Of Hedge Funds Are Relatively Small By Traditional Measures

Source: Van Hedge Fund Advisors as of December 31, 2002; grouped by Crestmont Holdings.
HEDGE FUND ATTRACTION

- Only Liquid Alternative (Skill-Based) Investment

- Return Profile Is Similar To The Historical Return Of Stocks And Bonds

- Risk Profile Of A Non-Speculative Hedge Fund Portfolio Is 20% Of The Level Of Stock Volatility And 30% Of Bond Volatility

- For A Traditional Portfolio, Hedge Funds Maintain The Return Profile And Reduce The Risk Profile; A Desirable Shift In The Efficient Frontier
PROFILE OF PRIVATE EQUITY INDUSTRY

- 3,000 Firms Globally (per Carlyle)
  1,500 Firms In U.S. (per Piper Jaffray)

- Funds Are Raised In Series (Vintages) With A Defined Life
  - Generally Don’t Recycle Capital
  - Drawdown Period 4-7 years; Life 8-15 years

- Sectors: Buyouts, Mezzanine, Venture

- Buyout/Mezz Sector: ~40% of firms; 70% of dollars
  - ~150-250 raise annually; $200 mm median

- Venture Sector: ~60%+ of firms; 30% of dollars
  - ~250-500 annually; $30 mm median

- Capital: $500+ billion deployed; $300 billion available
## Private Equity vs. Hedge Funds
### SIMILARITIES & DIFFERENCES

<table>
<thead>
<tr>
<th></th>
<th>PRIVATE EQUITY</th>
<th>HEDGE FUNDS</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Structure</strong></td>
<td>Partnership</td>
<td>Partnership</td>
</tr>
<tr>
<td><strong>Return Source</strong></td>
<td>Skill</td>
<td>Skill</td>
</tr>
<tr>
<td><strong>Return Profile</strong></td>
<td>12%-20%</td>
<td>7%-15%</td>
</tr>
<tr>
<td><strong>Fees</strong></td>
<td>? + 20%</td>
<td>1 + 20%</td>
</tr>
<tr>
<td><strong>Leverage</strong></td>
<td>High</td>
<td>Moderate</td>
</tr>
<tr>
<td><strong>Assets</strong></td>
<td>Debt &amp; Equity</td>
<td>Securities</td>
</tr>
<tr>
<td><strong>Fund Raising</strong></td>
<td>Once</td>
<td>Ongoing</td>
</tr>
<tr>
<td><strong>Liquidity</strong></td>
<td>None</td>
<td>Quarterly</td>
</tr>
<tr>
<td><strong>Horizon</strong></td>
<td>Multi-year</td>
<td>Multi-month</td>
</tr>
<tr>
<td><strong>Risk Mgmt</strong></td>
<td>Passive</td>
<td>Active</td>
</tr>
<tr>
<td></td>
<td>Diversification</td>
<td>Management</td>
</tr>
<tr>
<td><strong>Diversification</strong></td>
<td>Low</td>
<td>High</td>
</tr>
<tr>
<td><strong>Measures</strong></td>
<td>Returns: % / X</td>
<td>Returns &amp; Consistency</td>
</tr>
</tbody>
</table>
PRIVATE EQUITY / HEDGE FUND CONVERGENCE

- Synergy Driven
  - Greater information access
  - Maximizing value & return/risk relationship
  - Additional creative angles to deals

- Investor Driven: Firms Are Becoming Multi-Product

- Considerations
  - Managers have substantial investment
  - Sophisticated, smart money

- Firm vs. Fund
  - Some firms do both PE & HF investing
  - Much less often done in same fund
BARRIERS TO ENTRY

- PE Making HF Investments
  - Portfolio management skills
  - Market dynamics (constant pricing)
  - Value-added through strategic insights & operating enhancements

- HF Making PE Investments
  - Operating skills
  - Marked-to-market portfolio
  - Auditor demand for market value
  - Liquidity demands
  - Investors in & out (fair pricing)
CONVERGENCE WITH VARIETY

- Progressive Private Investment Firms
  - Multiple pools of capital
  - Individual teams of experts
  - Firm management overlay
  - Tailored investment programs

- Evolution Elsewhere
  - Strategy: absolute return mutual funds
  - Risk Mgmt: derivatives parsing risk
  - Sophistication: segmentation
EXAMPLES OF COMBINATIONS

- New Firm (expect >$1 billion)
  - Jeff Aronson, Angelo Gordon Distressed Debt
  - Mark Gallogly, Blackstone Private Equity

- Private Equity Adding Hedge Funds
  - Blackstone Group
  - Bain Capital
  - Texas Pacific Group
  - Carlyle Group (fund of hedge funds; later equity l/s)
  - D. E. Shaw & Co.

- Hedge Funds Adding Private Equity
  - Eton Park (hired Oliver Goldstein, Warburg Pincus)
  - Och-Ziff (hired David Stonehill, Blackstone & Anthony Fobel, CVC Capital)
  - HBK (structured-finance credit fund)
EXAMPLES OF CREATIVITY

- Sun Capital Securities
  - $300 mm first tranche (2004)
  - Minority equity or debt investments and purchases in middle market companies
  - $3 - $50 mm; 1-3 year profile
  - 3-Year lockup; annual liquidity; perpetual fund
  - Once invested, add next tranche; co-investing

- SPAC: “specified purpose acquisition company”
  - Blind pool raised through IPO
  - ~85%-90% held in escrow; 10%-15% for costs
  - ~18 months to buy a company
  - More than a dozen SPACs in past two years
WORKING TOGETHER: PE & HF

- Recognize Strengths And Complements

- Recognize Circumstances That Are Best For Each Profile Of Investment
  - Sometimes the most financially desirable outcome is not corporate survival

- Ways To Work Together
  - Deal Sourcing
  - Exit Strategy
  - Creative Solutions
CONCLUDING THOUGHTS

- Private Equity & Hedge Funds Have A Lot In Common, But Also Have Distinct Differences
  - Investment mission and liquidity profile drive most differences

- The Investment Landscape Continues To Change And Firms Are Adapting
  - Private equity must plan further ahead due to its long cycle

- The Convergence Is Currently Occurring Primarily Among Larger Firms
  - May begin to move into middle market later this decade

- Collaborate Rather Than Compete
  - Find ways and investments where unique skills & approach are best (don’t underestimate the competition)
Ed Easterling has more than 20 years of experience in private equity acquisitions and operations and more than 5 years of experience in the hedge fund industry. In private equity, he is currently a partner in a middle market buyout firm. In hedge funds, Mr. Easterling manages and advises fund of hedge funds, serves on the adjunct faculty in the Cox Business School at SMU and teaches the course on hedge fund investment management to MBA students, and serves on the Board of the Texas Hedge Fund Association. Mr. Easterling is the author of the recently released book *Unexpected Returns: Understanding Secular Stock Market Cycles.*

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