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The Hedge Fund of Tomorrow: Building an Enduring Firm

- **The hedge fund industry is facing a transformational crisis.** The industry must address key shortcomings in its business and operating models in order to position itself as the future of active asset management.
- **We forecast that hedge fund assets will reach almost \$2.6 trillion by the end of 2013, after reaching their low point in 2009.**
- **Institutions are committed to hedge fund investing and accounted for less than 17% of net redemptions during 2008 and 2009.** North American institutions will be the greatest source of institutional net flows into hedge funds between now and 2013.
- **Global high-net-worth investors' commitment to hedge funds will depend on capital market conditions and hedge fund returns during the next several years.** High-net-worth and retail investors accounted for more than 80% of redemptions for 2008 and 2009.
- **Funds of hedge funds will maintain their role as the primary hedge fund distribution channel, capturing almost 60% of net flows between 2010 and 2013.** Funds of hedge funds will likely oversee close to 50% of total hedge fund assets in 2013, compared with 36% in 2005 and 17% in 2000.
- **Investors will carve their previously amorphous hedge fund allocation into three distinct categories: Market Directional Liquid, "Classic" Hedge Liquid and Illiquid.** There is growing recognition that hedge funds may not be an asset class, but instead represent an investment framework applicable across all traditional asset classes and investment programs.
- **We predict that, regardless of capital market returns, "Classic" Hedge strategies will experience the most stable demand.**
- **Successful hedge funds will rebuild their operating models.** Managers will have to invest in robust systems, processes and controls and rely on independent third parties for key administrative and operational activities.
- **The Enduring Firm will be built upon a foundation of strong alignments.** Hedge funds have to restructure fee models, liquidity terms and compensation, and align client requirements with business needs across four functional areas: management, operations, distribution and investments.
- **Fee models will evolve to ensure better, more stable revenues for managers.** Performance fees will vary by strategy, firm and liquidity terms, and will incorporate rolling periods and deferrals.
- **There are four viable business models the hedge fund of tomorrow can pursue.** The Multi-Capability Platform (a better designed and more durable model) will see the greatest growth in share.

Introduction

This is the third collaboration between The Bank of New York Mellon and Casey Quirk, marking the latest installment in a series started in 2004 with *Institutional Demand for Hedge Funds: New Opportunities and New Standards*, and expanded in 2006 with *Institutional Demand for Hedge Funds II: The Global Perspective*. In our first two papers, we outlined how institutional investors would become a key source of capital for hedge funds, leading to profound changes in the industry.

In 2006, we estimated that by the end of 2008 institutions would have invested more than \$680 billion in hedge fund investments, accounting for about 37% of the industry's assets under management (AUM), or nearly double the 2005 figure of \$361 billion. In fact, we underestimated growth. By year-end 2007 (prior to the 2008 crisis) institutional assets in hedge funds were about \$750 billion, or 40% of total industry assets. Since then, as we shall describe in Chapter 1, the global financial crisis has accelerated the institutionalization of the industry's capital base.

We concluded our last paper on a note of caution:

“The single factor that would materially change our growth expectations would be a scenario where hedge fund and fund of hedge fund managers meaningfully and broadly underperformed the net return expectations of institutional investors.

What could cause this underperformance? The sudden and dramatic inflow of assets into hedge funds (which we are in the middle of seeing) could lead hedge fund managers to drift from their absolute return roots and take ever-greater beta exposure.”

- *Institutional Demand for Hedge Funds II: The Global Perspective*, page 21

Today the hedge fund industry faces a transformational crisis, precipitated by external market events and worsened by two key factors: the industry's mixed record at meeting investors' risk and liquidity expectations, and weaknesses in the hedge fund business model. Negative portrayal of the hedge fund industry as a party responsible for the financial crisis has not helped. Given the state of the industry, we set a more ambitious scope than in our previous reports, seeking to answer three big questions:

1. How will investors globally—institutional and individual—think about and employ hedge fund strategies after 2008?
2. What are the implications regarding the wholesale changes to hedge funds' operating environments?
3. How can misalignments in the hedge fund business model be corrected?

Organizing Our Thoughts

This report aims to outline the future of the hedge fund industry, providing a prescription to address key business model challenges through the following four chapters.

Chapter 1, **State of the Industry**, establishes the context for our study, tracing the industry's recent evolution and surveying the current investor landscape in the aftermath of the havoc of 2008: Where are current assets by geography and investor type? Which investor segments drove redemptions? How committed are remaining investors?

Chapter 2, **The Evolving Operating Dynamic**, describes the impact of changes to hedge funds' operating environment: how the legacy operating models' key building blocks—internal operations, prime brokers and administrators—have been altered fundamentally, and the implications for hedge fund operations going forward.

Chapter 3, **Future Demand Landscape**, projects future industry flows and assets between now and 2013 and examines how investors' application of hedge fund strategies will change. We forecast future demand trends across the primary global institutional and high-net-worth segments, seeking to identify the major sources of future flows, the evolving role of funds of hedge funds, and the effects future capital market conditions may have on our projections.

Chapter 4, **Blueprint for the Enduring Firm**, identifies flaws in the current hedge fund business model, including liquidity terms, fees and compensation and suggests potential alternative models to cure the legacy model's inherent instability. We outline the "Enduring Firm Checklist," cataloguing the specific attributes of successful managers going forward, and the "Enduring Funds of Hedge Funds Checklist," which focuses on the fund of hedge fund business. We conclude with four business models, their competitive positions, and their projected future market share.

Research Approach

As in our prior reports, there were two elements in our research process:

1. Interviews. From December 2008 through March 2009 we conducted 144 hour-long interviews with 158 individuals around the world. Interviewees represented a broad cross section of senior industry professionals, including institutional investors, investment consultants, family offices, wealth advisors, private banks, auditors, accountants, lawyers, prime brokerage professionals, fund of hedge fund managers and hedge fund managers.

We employed four different questionnaires by interviewee-type; sample questions included:

- How satisfied are you with your hedge fund investments?
- Is your original premise for investing still valid?
- What role do hedge fund strategies play in your portfolio? How is this evolving?
- What are your most important manager selection criteria? How have they changed since 2007?
- Will funds of hedge funds play a bigger or smaller role going forward?
- What are the emerging operating best practices?
- What will be the primary sources of leverage going forward?
- How do you expect fees and liquidity terms to evolve?
- How will you respond to managers that suspended redemptions or introduced gates?
- What are the primary challenges the hedge fund industry must address?

Exhibit 1: Interviewee Matrix

	North America	Europe / Middle East	Asia / Australia	Total
Investors and Advisors	33	13	17	63
Hedge Funds	18	16	5	39
Funds of Hedge Funds	19	2	9	30
Influencers and Service Providers	9	14	3	26
Total	79	45	34	158

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

2. Global demand model. In addition to the interview process, we built a demand model that quantifies total investor assets, hedge fund assets and flows, and fund of hedge fund assets and flows across 36 different market segments from 2007 until 2013. Our model starts with year-end 2007 assets as a pre-crisis baseline and builds projections on a bottom-up basis. The model is based on two trends: industry contraction in 2008 and 2009, followed by industry expansion through 2013. After the second quarter of 2009 the model divides our projections into three scenarios: a Base Case, which forms the basis of many figures in this report, as well as a Bear Case and a Bull Case, characterized by different assumptions for overall capital market returns and hedge fund returns in each of the market segments, as well as different assumptions regarding the change in each segment's allocation to hedge funds.

For certain segments, in particular those comprised of high-net-worth individuals, our research indicated future flows would vary substantially depending on future returns, prompting us to develop the three scenarios described.

“Institutional” segments include all institutions globally with at least \$100 million under management. Our definition of “institution” includes pension and retirement schemes, endowments, foundations and charities, sovereign wealth funds and central banks, proprietary balance sheet bank assets and proprietary insurance assets. In all cases we counted only externally managed assets, both for total investor assets and hedge fund assets. Our model therefore excludes all internal hedge fund teams among institutional investors. We excluded US, UK and Japanese defined contribution plans from our model.

“High-net-worth” segments include family offices, independent wealth advisors, private banks, trust banks and wirehouses, further segmented by geography; as well as non-US retail investors with access to hedge fund strategies.

Chapter 1: State of the Industry

Summary

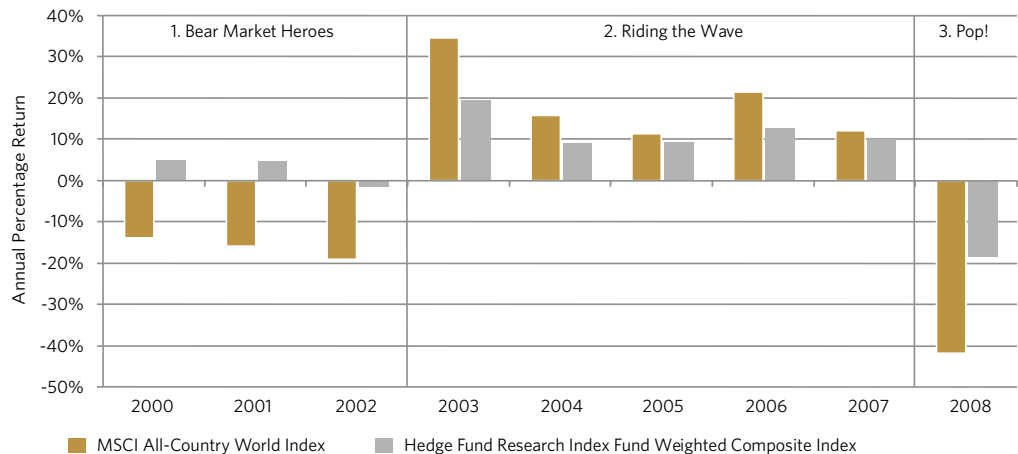
During the past decade, hedge funds represented one of the fastest growing segments in asset management, with industry assets under management expanding at more than 20% per year between 2000 and mid-2008. These years of rapid expansion were marked by a shift in both hedge funds' investor base and in several core investment attributes, while some of the industry's more controversial traits, including its obsession with secrecy and an antagonistic attitude towards any regulation, calcified into business as usual.

Since peaking in 2008, hedge funds have experienced a severe contraction, with total assets under management predicted to fall by half by mid-2009. High-net-worth investors, primarily from European and Asian platforms, have led the redemption charge. Certain institutional segments, however, also saw meaningful outflows — in excess of 20% in the case of Japanese institutions. The result is not only a smaller industry, but a capital base that is more institutional and more North American. Remaining investors across the board are broadly committed to hedge funds, but need to be convinced that the industry will correct the business model imbalances and the flaws exposed by the recent crisis.

Hedge Funds' Evolution Since 2000

There have been three distinct phases to the hedge fund industry's rise and recent fall: their coronation as bear-market heroes during 2000-2002, their expansion through the asset-growth wave of 2003-2007, and their contraction from crisis and redemptions during 2008-2009.

Exhibit 2: Annual Hedge Fund Returns
December 2000 through December 2008



Source: Hedge Fund Research Index, eVestment Alliance and The Bank of New York Mellon and Casey Quirk Analysis 2009

During the “Bear Market Heroes” phase, hedge funds comprised a relatively small and peripheral industry, characterized by small funds; a selective and savvy investor base of ultra-high-net-worth groups and a few large, innovative institutions; and investment strategies that promised to be both liquid and uncorrelated to the equity markets. In this first phase, the stable returns hedge funds provided investors with during the equity bear market of 2000 to 2002 (without the illiquidity costs other alternatives imposed) awarded the industry powerful credibility and acted as a beacon to a wide swath of new investors, both individual and institutional.

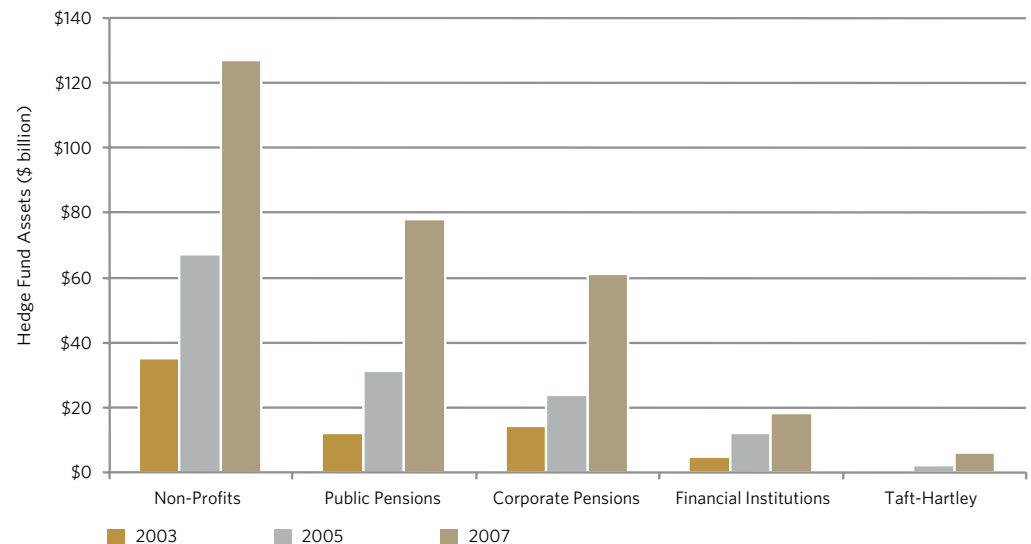
During the industry’s second phase of evolution, between 2003 and 2007, four major trends further shaped the growth of hedge funds:

1. Mainstream Investors Enter:

Institutions in ever-growing numbers began using hedge funds as a source of diversification and more stable, “absolute” returns. Sustained low interest rates and flattening equity returns, coupled with institutions’ required rates of return, helped stoke this interest. Our 2004 report indicated that US institutions had \$66 billion invested in hedge funds in 2003, or roughly 8% of total hedge fund assets under management. By year-end 2007, that figure had mushroomed to \$290 billion, approaching 16% of total hedge fund assets. Globally, institutional investment in hedge funds rose from \$361 billion as of year-end 2005 to \$748 billion just two years later.

High-net-worth individuals also flocked, as wealth advisors and bank platforms subscribed to the same investment premise institutions found so attractive. In particular, a combination of stable returns with high levels of liquidity made hedge funds ideal engines to power the structured notes favored by many European and Asian investors.

Exhibit 3: US Institutions’ Investments in Hedge Funds
2003 vs 2005 vs 2007



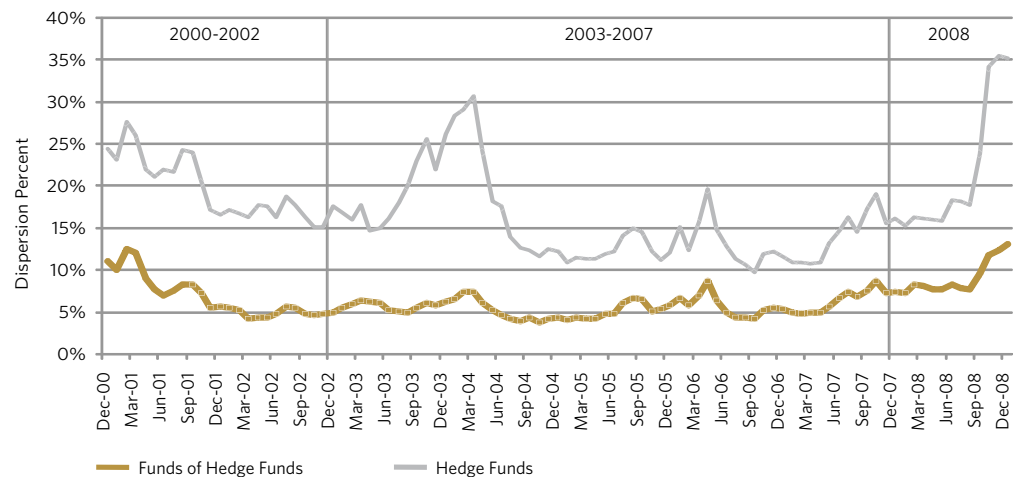
Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

2. Growing Beta, Leverage and Illiquidity:

Asset growth and shifts in the capital markets environment changed the mix of hedge fund strategies, with growth occurring in equity-oriented strategies (primarily long-biased long-short equity), multi-strategy and event-driven, at the expense of the “classic” hedge fund strategies that dominated prior years. Higher correlation of returns to equity markets, less dispersion among hedge fund managers, growing use of leverage and creeping portfolio illiquidity accompanied these changes. In addition, funds of hedge funds’ liquidity terms failed to evolve with the liquidity of underlying hedge fund investments. In short, key features that attracted new investors to hedge funds during the bear market began to fade.

Exhibit 4: Hedge Funds Returns' Dispersion, 25th vs 75th Percentile Dispersion on Rolling One Year Returns

December 2000 through December 2008



Source: Barclay Hedge, The Bank of New York Mellon and Casey Quirk Analysis 2009

3. Calcification of Fees, Terms and Compensation Practices:

The changes in hedge funds’ investor base and investment strategies did not trigger an evolution in fee structures, liquidity terms, and internal compensation schemes. The legacy structure of a fixed management fee and annual performance fee stayed largely in place, although fund of hedge fund fees were compressed among certain institutional segments. Liquidity terms usually did not vary by investor type or time horizon, or by the changing liquidity profile of hedge fund portfolios. Meanwhile, hedge funds heavily biased their internal compensation toward short-term cash payouts, and provided limited visibility to employees into how specific figures were derived. The overarching concern regarding compensation seemed to focus on outbidding rival hedge funds for investment talent.

4. Stubborn Attitude Towards Transparency and Regulation:

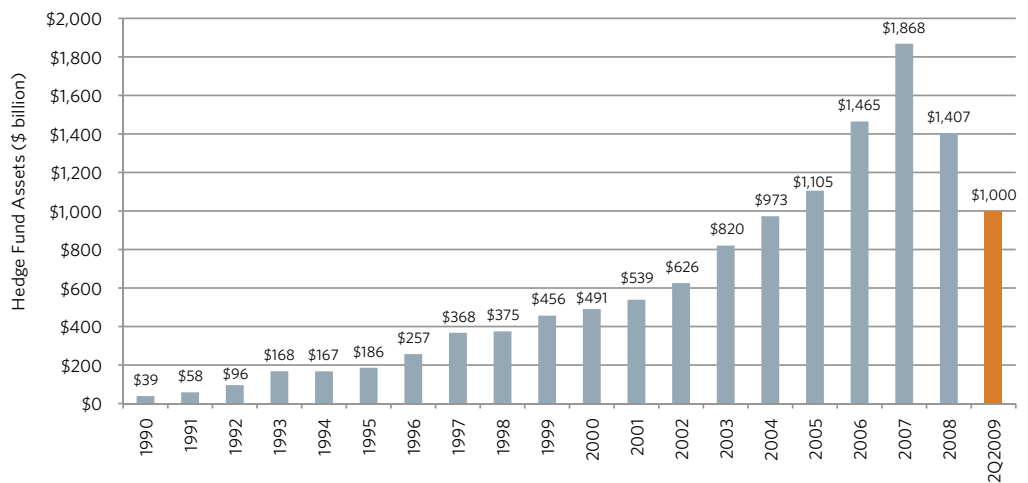
Throughout its growth phase, the hedge fund industry generally ignored new investors’ need for relevant information on their hedge fund investments. For some hedge funds, legitimate manager concerns about sharing proprietary market-moving information morphed into a perceived constructive investor communication, including disclosure of portfolio risks and the drivers and rationale behind specific investment decisions. Investors, seeking to stay in managers’ good graces, did not take a hard line on transparency and frequently acquiesced to managers’ preferences.

In addition, the industry repeatedly took an antagonistic approach towards regulators, particularly in the US. Instead of recognizing that regulation could benefit the industry through reassuring investors and weeding out fraud, and that by adopting a friendly tone the industry could actually shape regulation, hedge funds' attitude was one of reluctant cooperation at best and litigious confrontation at worst.

In many ways, this "partial" evolution left the industry poorly positioned for the crisis of late 2008, which represents a third phase of evolution.

Starting in the third quarter of 2008, the hedge fund industry suffered from net redemptions for the first time since the collapse of Long-Term Capital Management. This was the result of deteriorating investment returns, a need for liquidity, and overall investor de-risking in the face of a systemic financial crisis. Combined with absolute underperformance, these factors created an abrupt drop in industry assets. Consequently, we estimate total industry assets will recede to a nadir of about \$1 trillion by mid-2009.

Exhibit 5: Total Hedge Fund Assets
December 1990 through 2nd Quarter 2009 Estimate



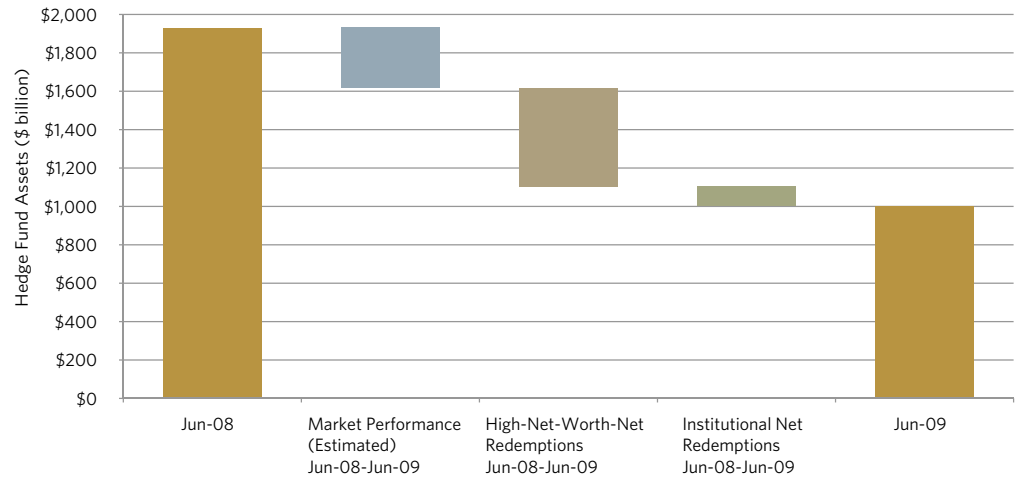
Source: Hedge Fund Research, The Bank of New York Mellon and Casey Quirk Analysis 2009

Net outflows have come primarily from high-net-worth investors around the globe. Based on redemption patterns up until our publication date and our estimates of frozen assets, we project that for the year through June 2009 net redemptions across all high-net-worth segments globally will exceed \$500 billion. However, there are substantial differences among regions and different high-net-worth segments. European high-net-worth investors, particularly those using bank platforms, are, generally speaking, the largest source of outflows. Asian high-net-worth investors also account for a very high redemption rate, in excess of 30%, although the absolute outflow in dollars is smaller than those recorded in the larger European and North American high-net-worth markets. The widespread use of structured notes with automatic redemption triggers in the Asian and European markets drove these outflows.

Outflows from US high-net-worth segments, though meaningful on an absolute basis, were much lower as a percentage of the total US high-net-worth investment in hedge funds. In fact, US family offices are likely to post a net redemption rate in the single digits, as their liquidity needs have not been as pronounced as those in other segments and (unlike Europe) they did not rely as heavily on leveraged or capital protected structures for their hedge fund investments.

Exhibit 6: Projected Hedge Fund Redemptions

June 2008 through June 2009



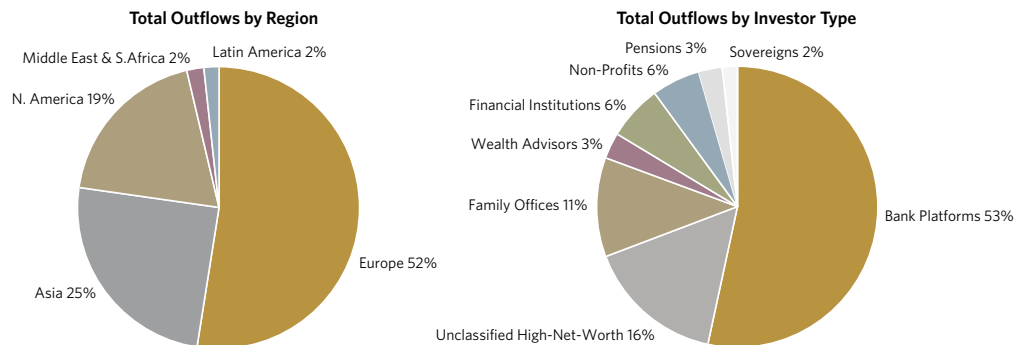
Source: Hedge Fund Research, The Bank of New York Mellon and Casey Quirk Analysis 2009

Institutional investors accounted for a small fraction of total outflows, but the aggregate figures mask divergent dynamics across institutional segments. Some segments, notably US pensions, will record positive flows into hedge funds for both 2008 and 2009. US non-profits, on the other hand, will have a net redemption rate of more than 15%, driven primarily by their unexpected liquidity needs.

Broadly speaking, Japanese institutions, including private pensions, banks and insurance companies, are also reporting relatively high redemption rates (in excess of 20%), driven in many cases by stop-loss redemption policies. For Japanese banks, in particular, gradual implementation of Basel II accounting standards already had exerted pressure on banks' proprietary hedge fund investments and the crisis accelerated this trend.

Exhibit 7: Two Year Net Outflows by Region and Investor Type

December 2007 through December 2009

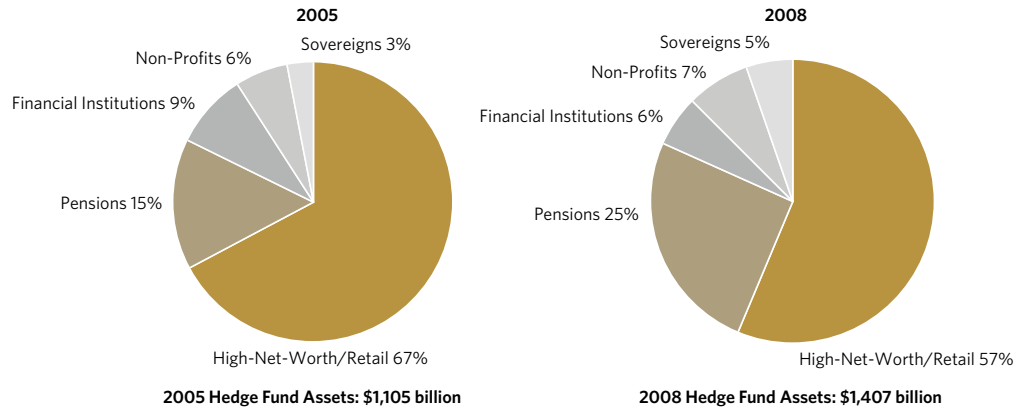


Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Therefore, while year-end 2008 figures capture a moment where the capital base is still in flux, its rapid institutionalization is already evident. The high-net-worth share of assets remains higher than institutional, but it has dropped considerably from 67% in 2005 to 57% as of year-end 2008. The growing institutional share has been driven by rapid investment from pensions.

Exhibit 8: Global Hedge Fund Assets by Investor Type

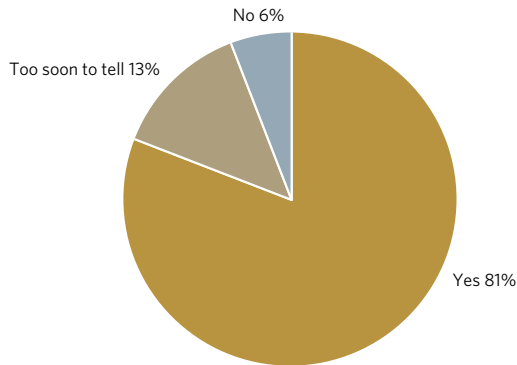
December 2005 vs. December 2008



Source: Hedge Fund Research, The Bank of New York Mellon and Casey Quirk Analysis 2009

Current Investors' Perspective

Exhibit 9: Is Your Original Premise for Investing in Hedge Funds Still Valid?*



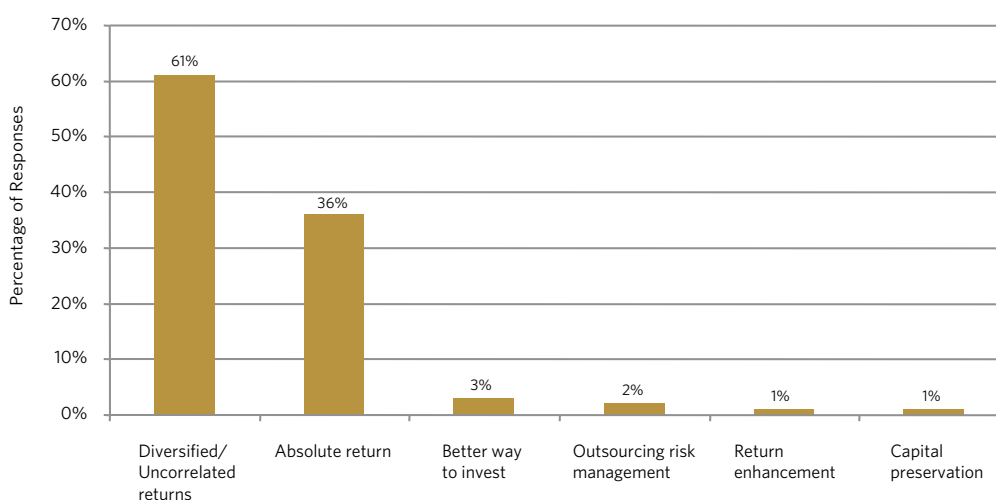
* Includes investor, advisor, and influencer responses

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

The committed core of current investors, those that believe the rationale for investing in hedge funds remains true, are the cornerstone to a recovery and growth in total hedge fund assets. Our interviews indicated that while hedge fund investors broadly expected better absolute returns for 2008, they still feel that their original rationale for investing in hedge funds is largely intact. Many groups in redemption mode, particularly non-profits, indicated that immediate liquidity needs fueled withdrawals, and said they expect to reallocate back into hedge fund strategies in the future.

Exhibit 10: What is Your Investment Rationale for Hedge Funds?*

Multiple Responses Allowed



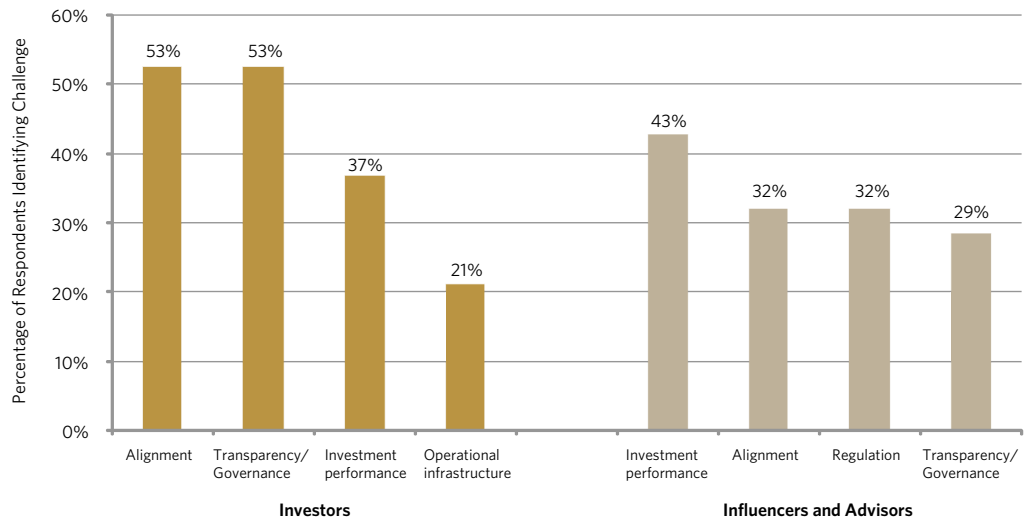
* Includes investor, advisor, influencer, and funds of hedge fund responses

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

What is investors' rationale? As in our past reports, the greatest proportion of investors said that they view hedge funds as a necessary source of diversification, primarily away from equity market volatility, that provides superior returns to traditional fixed income investments. A key element of investors' rationale is the concept of alpha-beta separation: assessing investments by the composition of their risk profile, for example, how much is derived from market exposures ("beta") versus idiosyncratic risks unique to the manager ("alpha"). Hedge fund strategies are widely viewed as having generally more alpha than traditional investments and less (or hedged) beta exposures. A central reason for this is that hedge fund strategies benefit from imposing fewer constraints on managers, allowing skilled investment teams far wider latitude in how they invest relative to traditional benchmark-driven strategies. Nonetheless, a clear lesson for investors from 2008 hedge fund performance is that most hedge fund strategies have a beta component and are not pure alpha.

While committed to the investment premise of hedge funds, remaining investors nevertheless feel strongly that the industry must change. They highlighted three key areas in which they seek reform: alignment, liquidity and transparency.

Exhibit 11: What Are the Top Challenges Hedge Fund Managers Face Going Forward
Multiple Responses Allowed



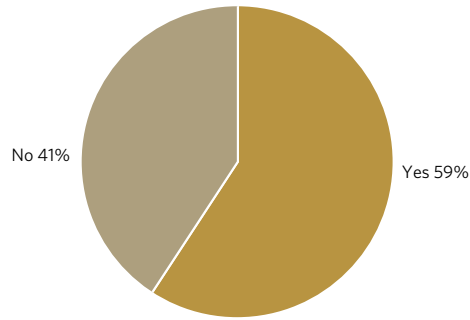
Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Alignment: Investors told us that they considered alignment a major challenge for the industry, on par with investment performance. Investors are seeking a restructuring of fees and terms that better aligns their long and short-term objectives with those of managers.

Liquidity: Most of our interviewees had a portion of their investment gated or locked within suspended redemptions. Respondents noted that while some managers had behaved in a straightforward fashion regarding such lock-ups—legal under the terms of their agreements with clients—in many cases clients perceived the use of gates as abrupt and high-handed. Some report that their hedge fund managers continue to charge fees on gated assets, or that the portfolio is actually liquid and managers are using the gate provision as a business-continuity tool rather than an investor-protection measure. Some investors said they intend to “black-list” managers perceived to apply gates in this way.

Transparency: As we will see in Chapter 2, investors have redefined transparency, and will no longer accept incomplete visibility into managers’ portfolio risks and operations. Coupled with renewed regulatory scrutiny, the industry will have no choice but to open up. The industry could help itself by embracing transparency and helping shape how it would work with investors and regulators.

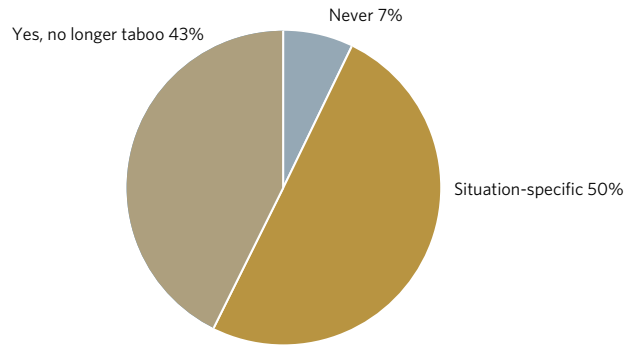
Exhibit 12: Were You (or Your Clients) Caught in Gates, Frozen Redemptions, or Put in a Liquidation Trust?*



* Includes investor, advisor, influencer, and funds of hedge fund responses

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Exhibit 13: Will You Ever Re-Invest with Managers that have Gated You or Suspended Redemptions?*



* Includes investor, advisor, influencer, and funds of hedge fund responses

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Conclusion

After a period of remarkable growth and change, hedge funds have experienced a severe contraction. The hedge fund industry's best asset today is its committed remaining investors and their continued adherence to hedge funds as a better and complementary form of investing than long-only, benchmark-oriented strategies. Industry renewal will come from building on this asset. This will require re-affirming hedge funds' core investment proposition, and evolving into a more mature industry regarding its non-investment functions.

Chapter 2: The Evolving Operating Dynamic

Summary

The events of 2008 upended hedge funds' legacy operating models. For most of its history, the hedge fund industry benefited from having the prime brokers subsidize hedge funds' operational infrastructure. The severe turmoil affecting prime brokers' parent organizations has put a sudden end to this lifeline, forcing hedge funds to bear the full cost of operations. At the same time, the crisis with prime brokers has had three important consequences: curtailed leverage, a revived specter of counterparty risk, and the rationalization of prime brokers' hedge fund clients.

From the managers' perspective, the combination of multiple factors, including poor investment returns, unexpected illiquidity, rapid market de-leveraging, major counterparty failures and unprecedented fraud has caused investors (and soon, regulators) to redefine standards for transparency and business risk, forcing hedge funds to restructure their operations.

What does this mean for managers? We see at least two implications:

1. A greater reliance on non-conflicted third parties for a growing range of operational and administrative functions.
2. Stronger in-house operations and controls to shadow and verify these third parties, as well as providing deeper and timelier reporting to investors and regulators, demonstrating robust and segregated compliance and controls.

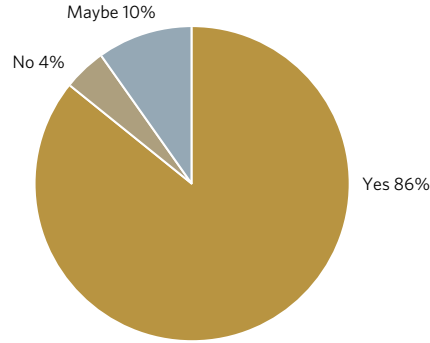
The Old Model Stumbles

Hedge funds' legacy operating models were traditionally built around three overlapping templates: manager operations focused around the operations of the prime broker (characterized by a symbiotic relationship with a key prime broker), manager operations focused on a substantial internal middle and back-office infrastructure, or a combination of both.

Prime brokers' economics were driven by their position as the nearly sole providers of leverage to hedge funds, as well as their ability to lend hedge funds securities to short. In order to attract and retain these two businesses, prime brokers took on key administrative roles for hedge funds, such as aggregating and clearing trades, as well as many back and middle office functions, including custody of assets and cash. Over time, prime brokers' menu of additional subsidized services extended into a cornucopia of unrelated value-added options, ranging from HR consulting to capital introduction and even real estate services.

The events of 2008 changed the old dynamic. Complications arising from the sudden demise of two prime brokers jolted many managers and investors, making them aware of the immense business risk created by their concentrated use of one or two outside firms. This also raised questions about who ultimately held investors' cash and securities. Many large managers did employ multiple prime brokers before the 2008 crisis, however, for most managers this was less about diversifying counterparties and more about securing access to a wider array of capabilities and securities to short.

Exhibit 14: Is Using Multiple Prime Brokers a Key Operational Requirement?*



* Includes investor, advisor, influencer, funds of hedge fund, and hedge fund manager responses

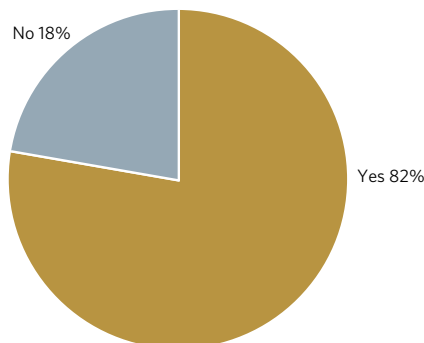
Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

In addition, broader challenges to the financial system are applying new pressures to prime brokers, forcing them to re-examine how they work with their hedge fund clients. Investment banks, suffering from financial and political stress on their balance sheets, are more limited in the leverage they can extend to hedge funds. Many institutions are withholding their securities from lending programs, shrinking prime brokers' inventories for short-selling. Regulation limiting short-selling further constrains this business. Consequently, as prime brokers watch their two most profitable services for hedge funds contract dramatically, many are forced to rationalize their businesses to disengage from less profitable clients, and either charge for or eliminate many "value-added" services. Finally, these actions have broken the trust that used to exist between prime brokers and managers. The implication for hedge fund managers is that the convenience of having prime brokers effectively serving as a back office is gone.

A New Definition of "Transparency"

Another result of the turbulence in the prime brokerage industry has been investors' renewed attention to the custody of hedge fund assets and cash. Many investors and managers were caught unaware by some of the nuances around the custody agreements they signed and the ultimate domicile of assets and cash in their funds, leading many to wonder how a prime broker's unexpected bankruptcy could affect them. The crisis at key prime brokers kept investors and managers from accessing their cash and securities at the speed required given market conditions. In addition, other counterparty considerations came to the fore: for example, what would happen if a portfolio's hedges depended on swaps written by an institution under sudden duress or one which ceased to exist?

Exhibit 15: Is External Administration a Key Operational Requirement?*



* Includes investor and funds of hedge fund responses

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Fraud concerns magnify this new awareness and scrutiny. Managers are expected to have the ability to track and verify the movement of assets, and investors desire the reassurance of having independent third parties check multiple steps of the process, including those involving custody and the valuation of assets. This has been most pronounced among North American investors, where self-administration among hedge fund managers has been more common.

Finally, as we outlined in Chapter 1, investors experienced three surprises in 2008: inferior returns, illiquidity and the Madoff fraud, all of which prompted demands for greater portfolio and investment risk transparency, including real-time snapshots of portfolio risk and liquidity attribution analysis and independent accounting.

Exhibit 16: The Seven Dimensions of Risk

1. Investment/portfolio risk
 2. Liquidity risk (ability to access capital)
 3. Counterparty risk
 4. Operations risk (independence, competence & compliance)
 5. Financing risk
 6. Co-investor risk (capital stability)
 7. Key man & talent risk (business stability)
-

On the whole, this has created new definitions of transparency and risk reporting: institutional investors, their gatekeepers, and high-net-worth intermediaries want a complete and timely risk and valuation picture of their investments. This includes investment risk (historically the focus of requests for transparency), but also visibility into other dimensions of risk, including concerns as basic as the confirmation that assets do in fact exist, and their location. Investors recognize that their fund investment represents an investment in the manager's business as well.

Historically, hedge fund investors failed to fully recognize the priority of operational due diligence and independence, so actual enforcement of operational best practices frequently took a backseat to other considerations. Consequently, managers were able to continue less transparent or less independent customs such as self-administration. The events of the past year appear to have changed this attitude. Our interviews indicate that willingness to ignore best practices and acquiesce in manager preferences is now at a low point.

Implications for the Future Operating Model

Given this new operating dynamic, with investors demanding outside verification and the legacy third party—the prime brokers—retrenching, what will characterize the future operating model for hedge funds?

Third parties' expanding role: Hedge funds will increasingly turn to independent and non-conflicted third parties for custodial, accounting, administrative and operational functions that were previously under the purview of the prime brokers and in-house operations. These include critical middle and back-office activities such as reconciliation, independent pricing and valuation, portfolio accounting, administrative activities, investor servicing, custody of non-collateral assets, collateral management, and cash management. Third parties will also expand their role as counterparty risk mitigants. The growth in tri-party repurchase agreements is one example of this. Finally, some managers will choose to rely on third parties to fully outsource their portfolio risk and technology platforms.

Delegation, not abdication: Managers will have to bolster and realign their internal operating capabilities. Hedge fund firms will need to protect clients and themselves by implementing systems and people that track assets, shadow third parties' reconciliation and pricing, and support their investment and compliance teams' data needs.

Historically, many managers have opted for self-administration because the same data and systems that powered the middle and back offices (for instance, to generate statements) also powered the investment team's portfolio management tools (for instance, to model trades or confirm margin levels). At the same time, managers felt third parties lacked the appropriate capabilities or experience. Managers' front-office data requirements have increased as their business and operations have become more complex. In addition, data needs for reporting requirements (both to investors and regulators) have increased both in frequency and level of detail.

Therefore, maintaining the ability in-house to generate this information real-time is a portfolio management requirement, not simply a question of overseeing third parties. Maintaining in-house operations for these dual purposes requires very clear segregation of roles and strong compliance and controls.

Exhibit 17: Old vs. New Operating Paradigm

Legacy Operating Paradigm	New Operating Paradigm
Concentration: Managers rely primarily on 1-2 Prime Brokers	Concentration: Managers diversify business across multiple Prime Brokers
Custody: With Prime Broker	Custody: 3rd Party
Cash: With Prime Broker, passive	Cash: 3rd Party, actively managed
Pricing: In-house	Pricing: 3rd Party
Administrators: Clerical functions	Administrators: Operational functions
Cost: Subsidized via Prime Broker-lending	Cost: Higher, borne by managers
Investor scrutiny: Ad-hoc	Investor scrutiny: Real

This new operating environment will place greater emphasis and responsibilities on hedge fund administrators. Previously, fund administrators played a largely clerical role, handling subscriptions and redemptions, fund accounting, basic reporting and corporate secretarial actions such as convening fund boards. Under the new operating model, administrators' functions will greatly expand. In fact, most of the third-party functions listed above are (or will be) provided by the administrator. However, this evolution is not a fait accompli: administrators will need to better integrate their existing hedge fund servicing activities with traditional custody and cash management platforms. Managers will increasingly turn to institutional hedge fund administration providers who are able to integrate the full complement of services.

Conclusion

Hedge funds' legacy operating model no longer functions effectively due to changes in the financial landscape as well as investor demands. Allowing third parties to play a bigger role in their business will be a sign of the hedge fund industry's maturation, and a welcome move away from its historic proprietary and secretive tendencies. Combined with expanded responsibilities for internal operations, hedge funds' future operating models will likely be costlier going forward.

Chapter 3: Future Demand Landscape

Summary

We forecast that the years following 2009 will reignite substantial growth in the industry. Future growth through 2013 will be strongest in North America, both among institutions and high-net-worth clients. The slowest growing segments in our forecast center on high-net-worth investors from Europe and Asia, where we estimate that even by 2013 proportional hedge fund allocations will still be lower than they were in 2007 (although the absolute dollar values will be higher). High-net-worth segments overall are more sensitive to capital market condition and, to a large extent, future returns will dictate the pace at which these investors return to hedge funds. A central premise of our forecast is that the hedge fund industry will prove it can address its alignment and transparency challenges and regain investors' trust.

Funds of hedge funds will continue to be the major channel into hedge funds. We forecast that they will capture a majority of future flows from both institutions and high-net-worth individuals. However, this growth will accrue to funds of hedge funds that adapt to evolving investor needs around packaging, liquidity and investment offerings.

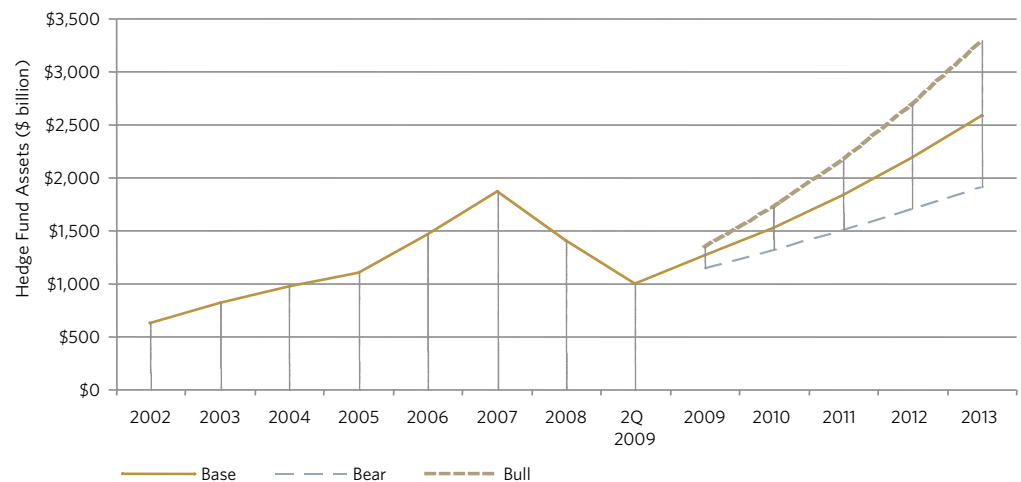
As investors' understanding of hedge fund strategies has grown, the practice of grouping a disparate set of hedge fund investments and confining them to a single "alternatives" allocation is gradually being replaced. Instead, hedge fund strategies are starting to be employed across investors' portfolios based on the strategy's risk exposures and liquidity profile.

Future Demand Landscape: Projections through 2013

Given recent market uncertainty and the severe contraction in hedge fund assets, we developed three scenarios against which to model future demand. For the high-net-worth segments in particular, future market conditions and hedge fund returns are the primary drivers of future flows into hedge funds. Unless otherwise stated, the figures we refer to will be from our Base Case scenario.

We forecast hedge fund strategy assets will grow to almost \$2.6 trillion by year-end 2013. Fueling this growth will be cumulative net inflows of more than \$800 billion between 2010 and 2013.

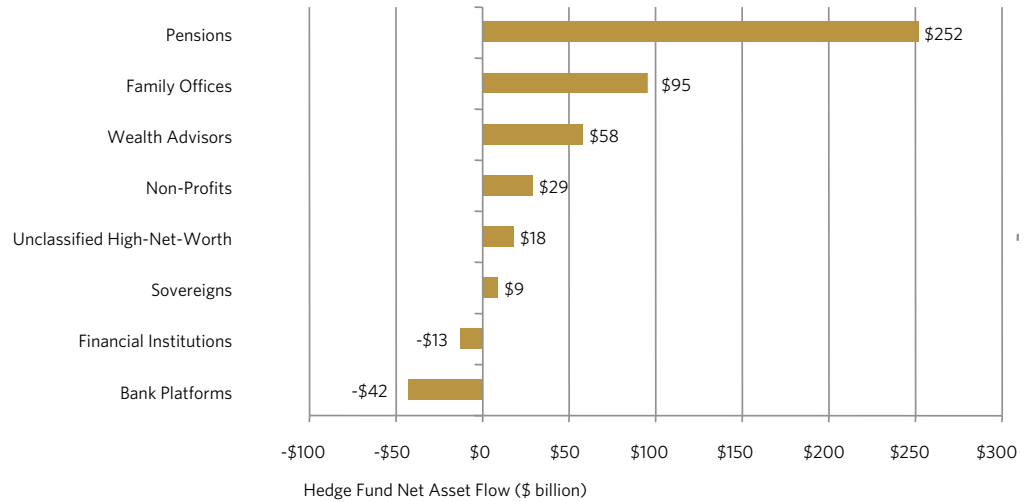
Exhibit 18: Projected Hedge Fund Assets by Scenario
December 2002 through December 2013



Source: Hedge Fund Research, The Bank of New York Mellon and Casey Quirk Analysis 2009

While pensions will be the greatest source of net flows, we expect net flows post-2010 to be strongest from high-net-worth segments.

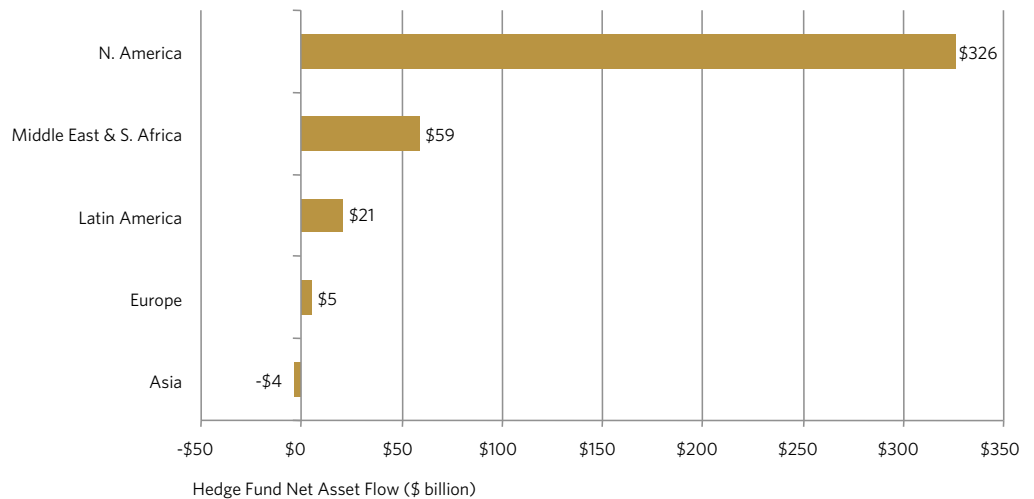
Exhibit 19: Cumulative Net Hedge Fund Flows by Investor Type
December 2008 through December 2013



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Our research indicates that nearly half of future flows will come from **North America**. Public and corporate pensions will continue to gradually build their hedge fund portfolios, holding more than 5.5% of assets in hedge fund strategies by 2013. Non-profits will return to hedge fund strategies once their liquidity issues are behind them after 2010. Our Base Case forecast for North American high-net-worth segments calls for net positive flows starting in 2010. Family offices, whose hedge fund allocations have only fallen modestly from 2007, are expected to be the fastest movers among US high-net-worth investors.

Exhibit 20: Cumulative Net Hedge Fund Flows by Region
December 2008 through December 2013



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

We forecast **Europe** will be the second-biggest source of positive flows after 2010, despite being the primary source of recent outflows. Initially flows will be institutional. UK pensions, like their US counterparts, will continue to slowly build their hedge fund portfolios. In Northern Europe, the move to incorporate hedged strategies across the portfolio (not just in a “hedge fund” allocation) will accelerate, but growing internal trading teams at a few large institutions will mitigate the full extent of future flows available to external managers. Other European institutional markets will proceed very slowly, or in the case of most European sovereign wealth funds, not at all.

Future flows from European high-net-worth investors are highly sensitive to future returns, and represent the greatest source of volatility among our Bear, Base and Bull projections. In our Base Case, we estimate this segment will eventually represent a source of substantial flows, as European high-net-worth and select retail investors cautiously return to hedge funds. We expect, that as in the US, European family offices will be the first movers. Our Base projection calls for European high-net-worth segments to drive flows of about \$140 billion back into hedge funds between 2010 and 2013, more than European institutions during the same period. However, this still represents far less than the total redemptions for 2008 and 2009 from the European high-net-worth segments.

The **Middle East** estimates also vary substantially across our scenarios. Barring a sustained depression in energy markets, the Middle East will be a source of positive net flows, both from institutions and high-net-worth investors. We estimate that the region’s sovereign wealth funds, cautious but steady allocators over the past five years, will pause in 2009 and into 2010, but we expect their investment to pick up soon after. Unlike Northern European institutions, we do not expect Middle East sovereign wealth funds to allocate meaningfully to in-house teams.

Overall hedge fund investments from Middle East family offices and private banks have been low (just over 2% of total portfolios), but trending upward. In the case of large family offices, they will take their cue from the regional sovereign wealth funds and accordingly increase their use of hedge fund strategies. For private banks in the region, the relatively attractive and stable returns of hedge funds compared to most other regional investments—equity, property, and commodities—provide an added impetus for investments in hedge fund strategies to inch upwards.

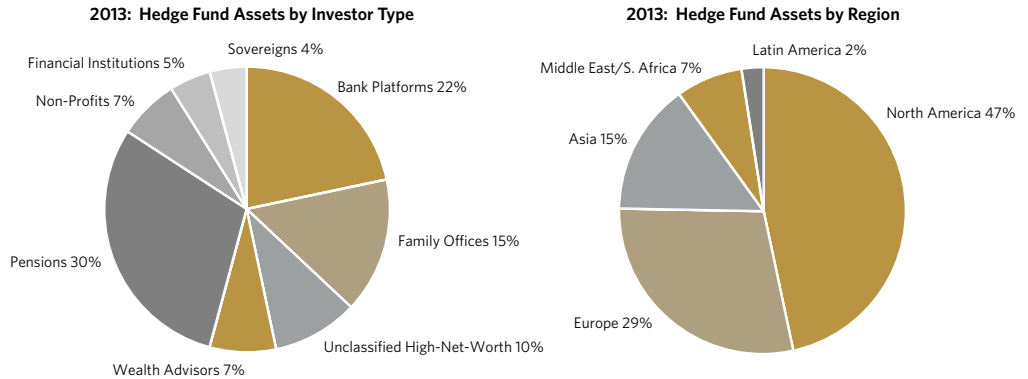
We estimate that **Asia**, while still a source of positive flows, will see its share of global hedge fund assets shrink. The region’s primary sources of capital, both institutional and high-net-worth, are subject to unique dynamics that will keep them from investing meaningfully in hedge funds over the next few years. High-net-worth investors in Asia and Australia were particularly hard-hit by the downturn in their overall portfolios, not just hedge funds, and so balance sheet rebuilding, combined with serious concerns over hedge funds’ illiquidity and fraud, will keep flows from recovering as quickly as US and even European high-net-worth segments.

Japanese institutions, historically Asia’s primary source of institutional hedge fund assets, were a source of sizeable and early redemptions in 2008 and currently suffer from acute risk intolerance, likely to last into 2010. This is especially the case with pensions, which were late entrants and experienced poor results from both the quant market-neutral meltdown in 2007 and the 2008 turmoil. Banks, which accounted for about half of Japanese institutional hedge fund assets prior to 2007, are subject to Basel II standards and will no longer add to their hedge fund portfolios, in fact they are more likely to be a source of trickling outflows.

We predict that an Asian bright spot for positive flows are some of the sovereign wealth funds, pensions and other institutions in mainland China, Singapore, and Taiwan, which are either just starting to allocate assets to hedge funds, or have plans to make their first investments this year. We expect this segment will be the primary source of positive flows from Asia, although at least one prominent sovereign wealth fund from the region is pursuing an in-house team approach. Korea is another potentially bright spot, where both institutions and high-net-worth intermediaries will cautiously increase investments in hedge fund strategies, albeit from a very low base.

For **Latin America**, primarily a source of high-net-worth assets mostly invested offshore, we forecast hedge fund investments will likely continue to increase, slowly but steadily, driven by a desire for stable, predictable returns. The largest onshore market, Brazil, has seen a severe correction in local equity markets, and we believe this will prompt both local institutions and high-net-worth investors to reconsider their strategy allocation among hedge funds, historically dominated by long-biased, Brazil-biased strategies. As with the rest of Latin America, however, a desire for “hedged” returns means hedge fund allocations will continue to trend upward.

Exhibit 21: Hedge Fund Assets in 2013

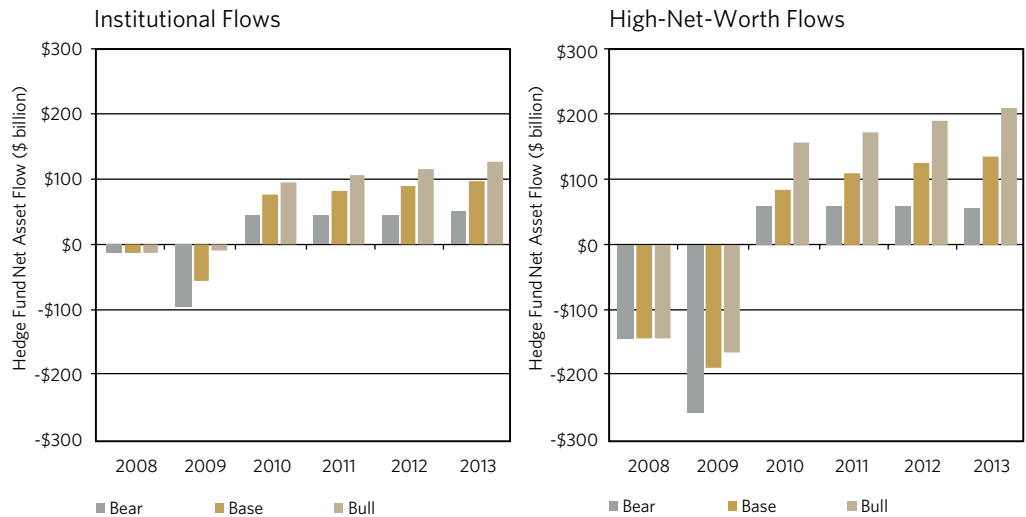


Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Bull versus Bear: Key Drivers and Contrasts

Future returns, both for the broad capital markets as well as for hedge funds, are the biggest variable in our projections. In addition, investor behavior, particularly among most high-net-worth segments, is closely tied to returns. Therefore, we modeled three different scenarios, with clear variations in return assumptions (overall market returns and hedge fund returns) and in investor behavior, as expressed through growth (or contraction) of each segments’ total investments in hedge fund strategies.

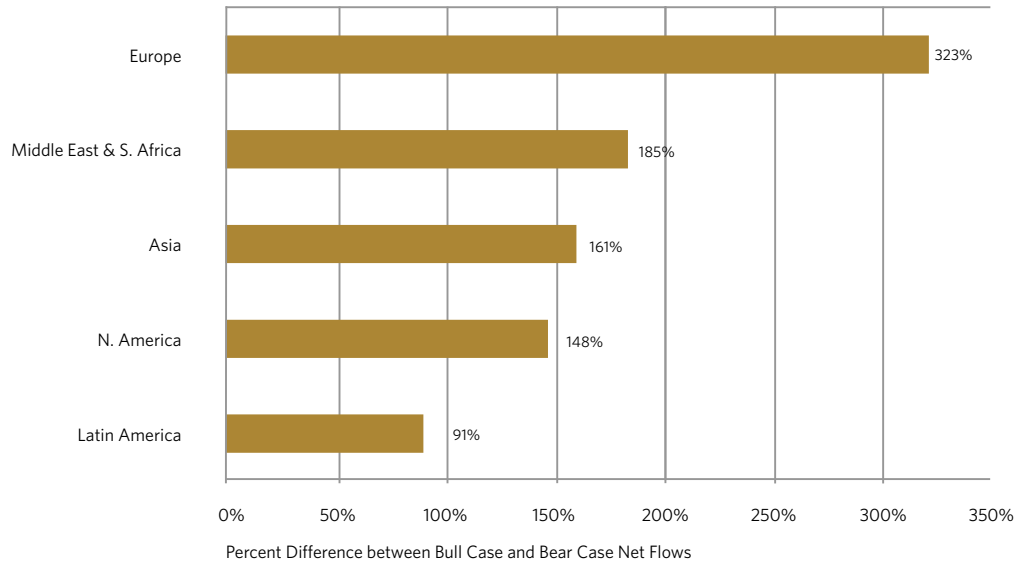
Exhibit 22: Annual Hedge Fund Flows by Scenario
December 2008 through December 2013



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

The spread in future hedge fund assets by investor type across the Bull and Bear scenarios is much more pronounced for high-net-worth investors. For both hedge fund and fund of hedge fund managers, institutional investors today represent the more stable source of business going forward. Therefore, we expect high-net-worth clients to continue to represent the small majority of hedge fund assets.

Exhibit 23: Percent Difference Between Bull Case and Bear Case Net Flows by Region
2010 through 2013



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

There is also substantial variation in the spread across the Bull and Bear Cases for each global region. Future growth prospects, perhaps not surprisingly, are linked to the proportion of potential high-net-worth versus institutional assets for each region. However, this driver is modulated by regional factors. In the Middle East the overall position for both institutions and high-net-worth investors is sensitive to the price of oil. In Europe, this spread is directly linked to the wide range of outcomes for European high-net-worth segments tied to capital market returns.

Funds of Hedge Funds Remain a Primary Channel

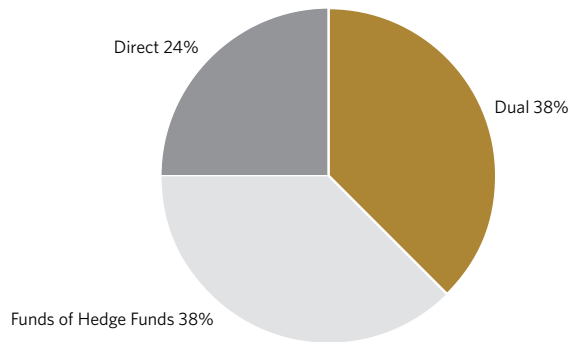
Our forecast calls for funds of hedge funds to capture a majority of net flows between now and 2013. Given the turbulence the fund of hedge fund industry is currently facing, this may sound ambitious or even fanciful. However, for most investors, funds of hedge funds represent the only viable way of accessing hedge fund strategies. Institutional quality fund of hedge funds can provide at least four key services most investors find difficult to replicate on their own, or even with a consultant or advisor:

- Manager-sourcing
- Thorough manager due diligence
- On-going monitoring
- Appropriate diversification

Importantly, the ability by funds of hedge funds to take a consultative approach to clients (institutions and high-net-worth platforms) will continue to be a key factor in their ability to compete as a channel with consultants and advisors.

Funds of hedge funds will continue to play an essential role for the vast majority of high-net-worth investors, whose portfolios are not large enough to safely invest directly in single strategies, as well as many institutional investors globally, who lack the infrastructure and potentially the size to prudently invest directly. In fact, even among the institutional investors we surveyed, a sample that is biased towards very large, fully staffed institutions, a large majority rely on funds of hedge funds for at least some of their investments (the “dual approach”).

Exhibit 24: How Do You Invest in Hedge Fund Strategies?*



*Includes investor responses

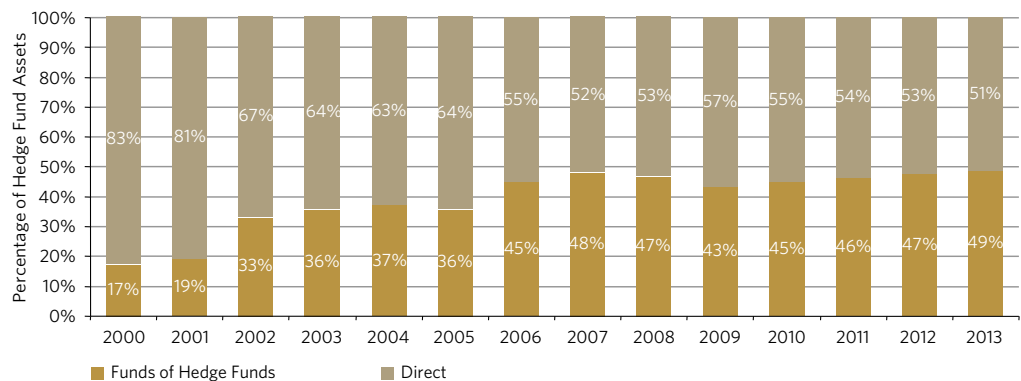
Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Institutions we surveyed provided a similar rationale for continuing to invest in fund of hedge funds, adding that:

- Internal resources are challenged. There is limited in-house capacity for thorough due diligence. A problem compounded by turnover in staff with hedge fund knowledge.
- Career “insurance”: The potential marginal return from bypassing funds of hedge funds’ fees is not worth the potential risk of a blow up or fraud, provided that the investor can trust that the fund of hedge fund manager performed proper due diligence.

Exhibit 25: Global Hedge Fund Assets by Channel

December 2000 through December 2013

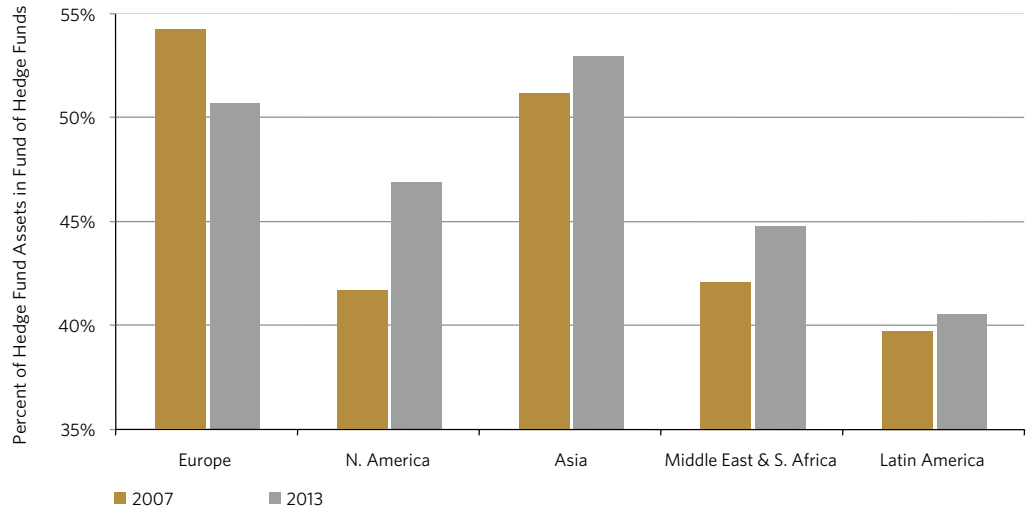


Source: Hedge Fund Research, The Bank of New York Mellon and Casey Quirk Analysis 2009

Fund of hedge fund share of assets dipped in 2008 and will continue to in 2009, as more than 70% of high-net-worth redemptions have been from funds of hedge funds, not direct investments. However, we predict that after 2009, funds of hedge funds will capture a majority of flows, bringing their share of total hedge fund assets back up to approximately 49% by 2013.

We expect funds of hedge funds will gain share in virtually every region and market segment, except for Europe. European institutional assets outside of the UK are highly concentrated with groups that are primarily direct investors. European high-net-worth investors, historically major fund of hedge fund buyers, will only come back slowly, and family offices, the quickest European high-net-worth segment to reembrace hedge funds, will have a higher proportion of direct investments.

Exhibit 26: Fund of Hedge Fund Share by Region
December 2007 vs December 2013



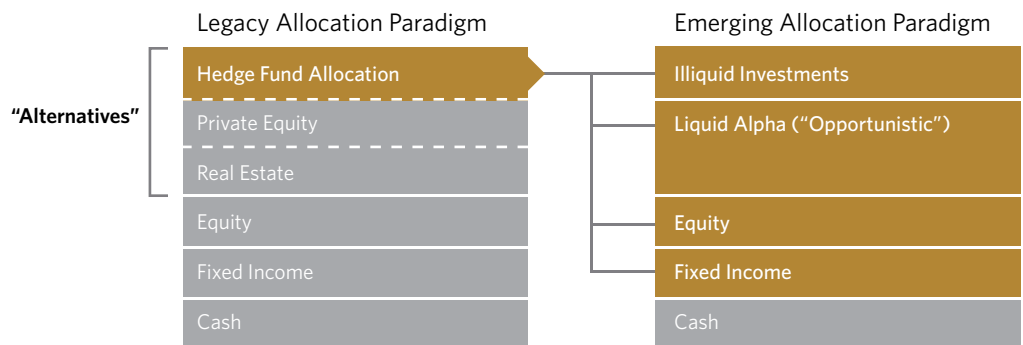
Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

As we will discuss in Chapter 4, our fund of hedge fund projections assume the fund of hedge fund industry is successfully addressing the primary business and product offering challenges it faces.

Breaking Up the Hedge Fund Allocation

A growing number of investors recognize that hedge funds are not a distinct asset class, but rather a type of investment strategy. Portfolios that are less constrained than traditional long-only mandates, aimed at delivering more consistent returns. A related development is the clearer differentiation of hedge fund strategies by investors. Just as they are not a single asset class, hedge fund strategies cover a wide swathe of investments with radically different risk and liquidity profiles.

Exhibit 27: Emerging Asset Allocation Framework*



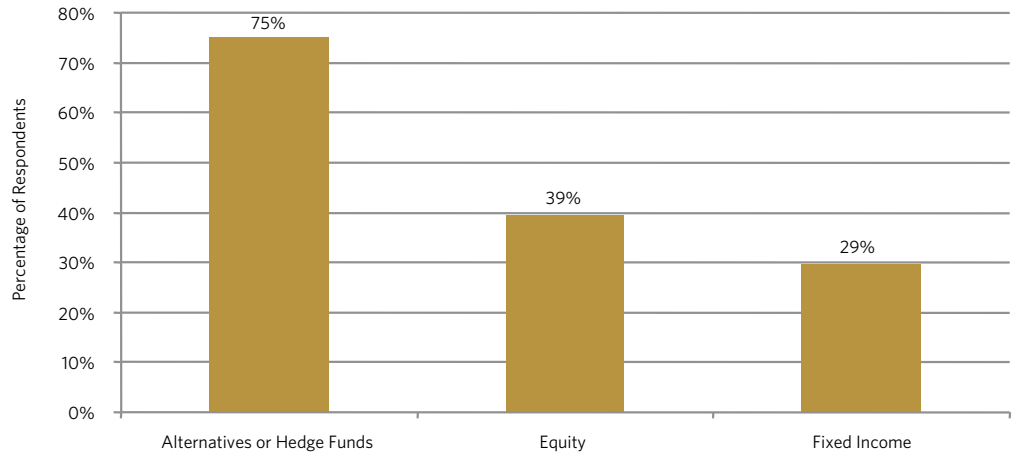
*Not to scale

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

One implication of this recognition is a move by some investors to start incorporating hedge fund strategies in other parts of their portfolios, such as equity or fixed income allocations, depending on the specific hedge fund strategy, and not as simply a distinct “alternative” or “hedge fund” allocation. Among institutions we surveyed, the vast majority still invest in hedge funds as part of a unique “hedge fund” allocation, or within their “alternatives” exposure. However, a minority employed hedge funds alongside traditional investments as part of their equity or fixed income allocations. In fact, some of these groups no longer have a distinct hedge fund allocation at all.

Exhibit 28: Where in Your Portfolio do you Employ Hedge Fund-Type Strategies?*

Multiple responses allowed



* Includes investors with hedge fund investments

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

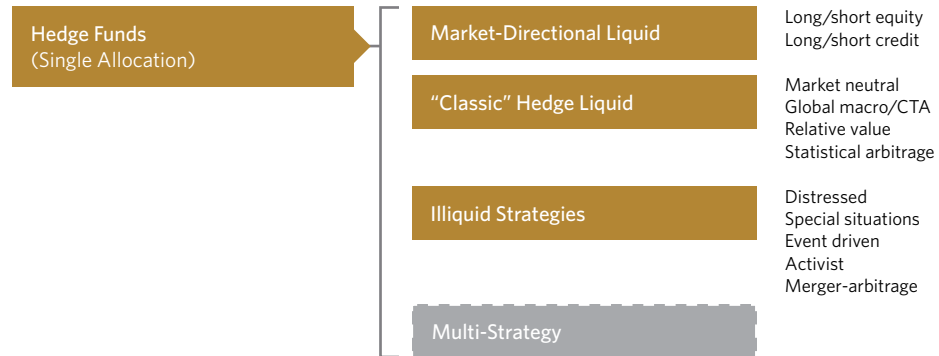
This evolution in hedge funds’ application represents a major paradigm shift for most investors, and implies a redefinition of what active asset management involves. For now, this is a relatively limited phenomenon. It appears to have taken root more firmly in the segments with the longest hedge fund experience and overall decision-making independence: North American non-profits and ultra-high-net-worth investors, select experienced in North America and Northern Europe, and large financial institutions, banks and insurance companies with proprietary hedge fund investments. However, we believe this trend will accelerate, as most institutional consultants and high-net-worth advisors surveyed were adherents to, and promoters of, this evolution.

Importantly, this trend is distinct from the recent portable alpha trend. In fact, the move to employing hedge fund strategies as part of traditional allocations reflects some of the shortcomings many portable alpha schemes possess: that the hedge fund portfolios powering such arrangements were not always truly market-neutral, and held risk exposures that overlapped with the underlying index swap. In most of these cases, a straightforward hedge fund portfolio without the underlying index swap would have provided sufficient beta exposure.

Hedge Funds Re-Categorized

Investors' differentiation of hedge fund strategies has led to a re-categorization of hedge funds by liquidity and risk exposures. Hedge fund strategies fall into roughly three camps, and their role within investors' portfolios varies accordingly.

Exhibit 29: Hedge Funds Re-Categorized



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

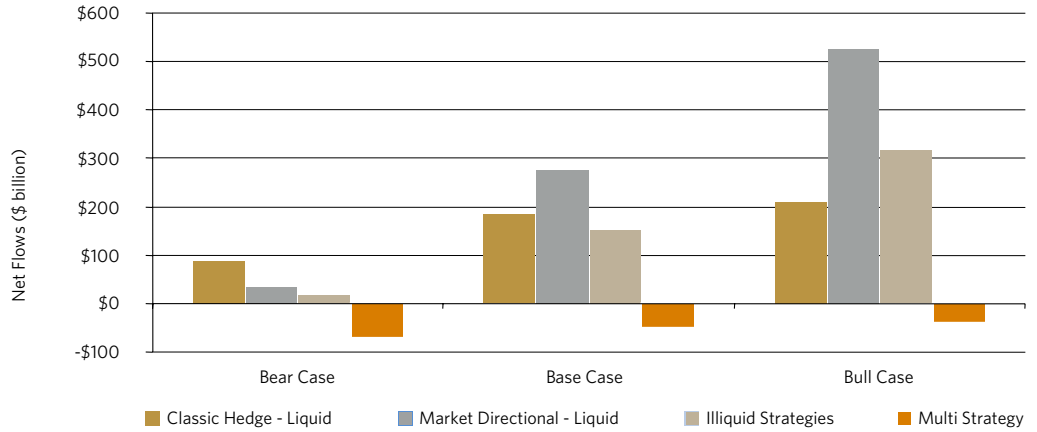
- 1. Market-Directional Liquid:** This group of strategies is characterized by a consistent bias to equity or credit market exposures and no reliance on any illiquidity premium for returns. This includes the vast majority of long-short equity strategies, including dedicated shorts (although it excludes equity market neutral). There are far fewer credit strategies that fit this profile, although some, including many long-biased high-yield bond and loans strategies, would generally qualify. These strategies have market beta and increasingly will be used as a source of lower risk, hedged exposure to such beta, supporting expectations of risk-adjusted returns superior to a standard long-only, benchmark-oriented strategy over the market cycle.
- 2. "Classic" Hedge Liquid:** This category includes many legacy hedge fund strategies such as global macro and CTA, as well as market neutral, liquid relative value and arbitrage strategies. Their defining characteristics include the lack of consistent exposure to equity or credit market risk and no reliance on any illiquidity premium for returns. Some of these strategies, such as market-neutral, pure relative value and arbitrage have marginal market exposures by design, while others have varying market exposures, resulting in returns that have little correlation to any single market over time. These strategies will be used as a source of overall portfolio diversification and "pure" alpha, whether in conjunction with specific beta exposures or as a standalone, liquid diversifier.
- 3. Illiquid Strategies:** This broad category includes most hybrid or private equity-like strategies, or any strategy where the lack of liquidity, even on a varying basis, is an important driver of returns. Specifically, this means virtually all forms of distressed investing, most event-driven and special-situation strategies, as well as activist and merger-arbitrage. These strategies will generally require a longer time horizon, anywhere from two to six years, and will increasingly be categorized by investors as a part of their overall mix of illiquid investments together with their real estate, timber and infrastructure investments, all of which usually involve commitments exceeding ten years, or private equity and venture capital, with investment horizons between five and ten years.

“Classic” Hedge Business Most Stable

Just as investors increasingly differentiate hedge funds into the three categories described earlier: Market Directional Liquid, “Classic” Hedge Liquid and Illiquid, investor preference across the three will vary across the different scenarios.

Exhibit 30: Cumulative Net Flows for Hedge Fund Strategies by Scenario

December 2009 through December 2013



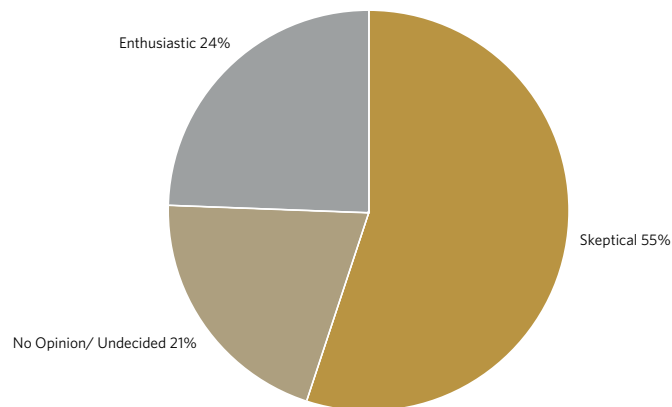
Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

In our Bull Case, we forecast investors will gravitate toward strategies with higher market exposures (Market Directional Liquid) and Illiquid strategies, as investors’ own premiums for illiquidity will be lower in an environment of rising asset values. Conversely, in our Bear Case, “Classic” Hedge Fund strategies with low market exposure and high liquidity are the most favored. Our Base Case favors a balance of the three, with an edge for strategies that have a hedged market exposure over “Classic”, as many “Classic” strategies are capacity constrained.

A key implication is that while their share varies by scenario, the absolute opportunity for “Classic” Hedge Fund strategies is the most stable going forward, as their relevance to investors is less dependent on external capital market returns.

Hedge Fund Replication

Exhibit 31: What Do You Think of Hedge Fund Replication?*



* Includes investor, advisor, influencer, funds of hedge fund, and hedge fund manager responses

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Hedge fund beta or replication has become a more prominent topic since our last report in 2006. Replication generally takes two forms. The majority involve mathematical model-based replication of existing hedge fund indices, and a minority use sampling-based “mechanical” replication, where the manager attempts to recreate a specific hedge fund strategy. Institutions and high-net-worth investors are very interested in the premise behind replication: access to a cheaper form of hedge fund returns. However, our survey indicates that replication still has to prove itself for most investors and advisors.

Putting Things in Perspective

As discussed in Chapter 1, institutional investors, consultants and high-net-worth advisors almost unanimously feel that the premise for investing in hedge fund strategies is still valid. In addition, as hedge fund strategies start to be incorporated across the portfolio, they will comprise a larger proportion of investors’ total investment assets, implying that the use of hedge fund strategies could increase substantially.

On an aggregate global basis, we feel our projections regarding the proportion of total investor assets in hedge funds are conservative. Overall, we are estimating a moderate shift from year-end 2007 figures by 2013: hedge funds controlled approximately 3% of total investor assets in 2007, compared to almost 3.5% by 2013 in our Base Case. Across specific markets, we expect that some big segments are unlikely to fully recover, even by 2013. We expect that the European high-net-worth segment’s hedge fund assets, as a percentage of total segment assets, will be about 25% lower in 2013 as compared to 2007.

Our estimates assume that the industry successfully tackles the key investor challenges we outlined in Chapter 1: liquidity, alignment and transparency. In the next chapter, we outline specific prescriptions for hedge funds and funds of hedge funds seeking to address these three challenges.

Conclusion

The hedge fund industry as a whole will recover from the current crisis, and we forecast total industry assets will approach \$2.6 trillion by year-end 2013. There are two key drivers of this recovery: the fact that investors and advisors broadly still believe in the premise behind hedge fund investing, and the way in which investors are rethinking hedge fund strategies’ role within their broader portfolios. This has led to a recategorization of hedge fund strategies into three types: Market Directional Liquid, “Classic” Hedge Liquid, and Illiquid. Almost half of future flows will come from North America, both from high-net-worth and institutional investors. As an investor segment globally, pensions will be the greatest source of flows between now and 2013. Funds of hedge funds will remain the primary channel for hedge fund investing and will capture a majority of flows through 2013. However, these projections depend on the hedge fund industry addressing its key challenges of liquidity, alignment and transparency.

Chapter 4: Blueprint for the Enduring Firm

Summary

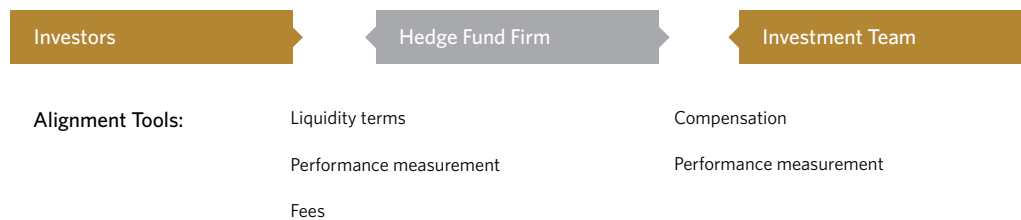
Flaws in the standard hedge fund business model have triggered investor demands for better alignment. These flaws must be addressed in a comprehensive fashion; selective tinkering will not solve the alignment conundrum. Our prescription involves redesigning liquidity terms, fee structures, and investment team compensation in the context of investors' long-term objectives, starting by harmonizing all three along a consistent time period not necessarily a calendar year. This means terms, fees and compensation will vary across managers and strategies, and therefore the industry will move away from a standard and static structure. It also means some old dogmas, such as the high-water mark feature, have outlived their usefulness and should be let go. The result will be the Enduring Firm, a hedge fund business that has a real chance of surviving multiple downturns and becoming a multi-generational firm.

Beyond alignments, our blueprint for the Enduring Firm marks a clear break with hedge funds' cottage industry roots and is characterized by excellence and balance across four functional areas: business management, investments, distribution and operations; each with their own set of best practices. These common attributes are applicable to a wide range of business sizes and types, and we outline four models which the Enduring Firm can pursue: Single-Strategy Boutique, Multi-Capability Platform, Merchant Bank, and Converged Traditional-Alternative Manager. Our conclusion is that the Multi-Capability Platform model will see the greatest growth going forward. We also explore a fifth emerging model, the Alternatives Holding Company, which may facilitate growth and a form of ownership transition for Single-Strategy Boutiques.

Finally, funds of hedge funds are facing their own set of unique business challenges. As outlined in Chapter 3, investors still favor funds of hedge funds as a means for investing in hedge fund strategies. However, we believe this demand relies upon funds of hedge funds adapting their product and service capabilities to meet new investor demands.

Hedge Funds' State of Misalignment

Exhibit 32: Three Stakeholders



Source: *The Bank of New York Mellon and Casey Quirk Analysis 2009*

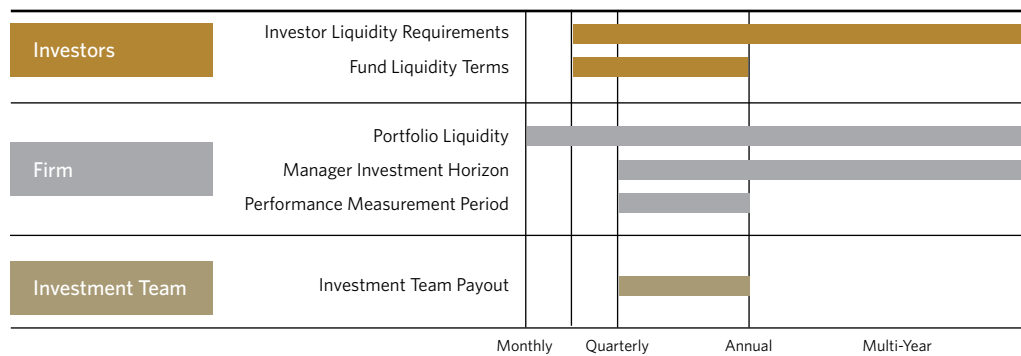
The recent crisis has revealed the extreme degree of instability inherent to the hedge fund business model, largely a function of poor alignments between three parties: investors, hedge fund firms, and firms' investment teams.

The legacy alignment structure has four big flaws:

1. **Business timing mismatch:** A serious imbalance affecting all the alignment tools listed in the previous chart (liquidity terms, fees, performance measurement, performance payout, compensation structures) is the timing mismatch that has grown among them. For the majority of hedge fund strategies, there is little or no consistency within strategies for most of these tools. In times of stress, the result is, at best, investor surprise and frustration, and perhaps anger; at worst, a breakdown in a manager's ability to remain a going concern, as survival comes to depend on locking assets against investors' wishes.

Exhibit 33: Business Timing Mismatch

Typical Duration of Key Manager and Investor Metrics

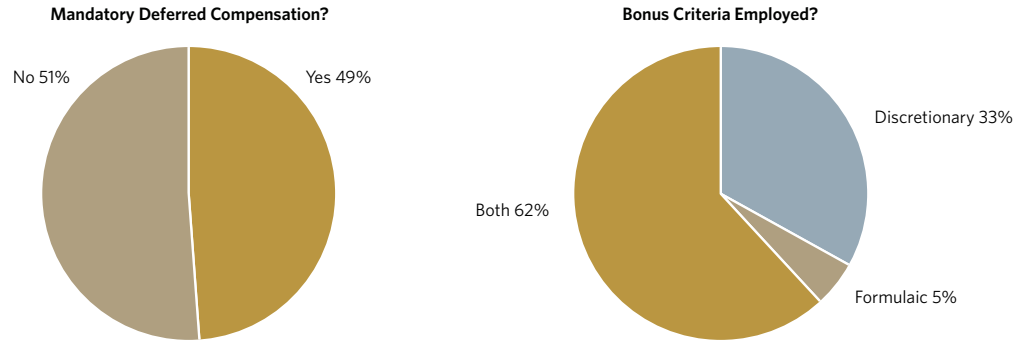


Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

2. **Destructive incentives:** Much has been written about the asymmetry in hedge fund managers' potential payout, and the high-water mark was one way to reduce this asymmetry. Unfortunately, rather than protecting the investors, the high-water mark has become a toxic incentive, setting the three stakeholders against one another and leading to a vicious cycle of destructive behaviors: excessive risk-taking in an attempt to make up losses, fund (or firm) closure, and investor redemption due to fears of the first two. Any investment with a performance-fee component can never have completely symmetrical payouts, but we believe there are better ways to mitigate the payout asymmetry than with a high-water mark.
3. **Rigid terms:** A common standard for fee structures and liquidity terms made sense when the industry was smaller and concentrated in a few related trading strategies. As investment strategies and the investor base evolved, fee structures and terms should have evolved as well. There is at least one lingering rigidity that makes no sense regardless of strategy or investor base: the calendar-year orientation for most managers' performance fees and liquidity. Even for liquid, short-term strategies, tying all of a manager's investor base to a common calendar for redemption notices increases business instability. Likewise, cashing out the investment team every year, even for a short-term investment strategy, leads to volatile expenses and likely lowers team retention during a downturn, potentially putting the business at risk.

4. **Hedge fund compensation practices:** For most hedge fund investment teams, measurement of personal performance and personal payout is not aligned to investors' or firms' long-term objectives, other than having personal assets invested in the fund. This may have been adequate when hedge fund firms were mostly single-fund and so the interests of the firm were closely tied to a fund and the investor base was primarily high-net-worth (so investors' requirements and objectives may have matched those of the team). Neither is the case anymore. Additionally, the industry broadly does not provide investment teams with clear and transparent compensation drivers that give the team visibility and, therefore, reassurance as to how their compensation is derived.

Exhibit 34: Hedge Fund Compensation Practices



Source: *Recruiting & Retaining Investment Professionals: What Works, What Doesn't*, Merrill Lynch & Co., August 2008; based on 2008 survey of 92 hedge fund managers

The legacy alignment structure results in an unstable business and continued investor frustration. The current crisis provides an opportunity to fix these imbalances and establish the foundation for future growth.

The New Alignment Regime

Exhibit 35: Emerging Alignment Regime

Legacy Alignment Regime	New Alignment Regime
Standardized ("one size fits all")	Flexible: strategy specific terms
Timing mismatch	Matched timing
Initial lock-ups	Rolling notice periods
Fixed liquidity windows	Rolling notice periods
Single liquidity share-class	Segregated liquidity classes
Side pockets & gates	Side pockets & gates superseded
Annual performance fees	Rolling performance fees
High-water marks	No high-water marks
Hedge fund compensation: opaque, cash-based, annual	Hedge fund compensation: transparent, multi-year

Source: *The Bank of New York Mellon and Casey Quirk Analysis 2009*

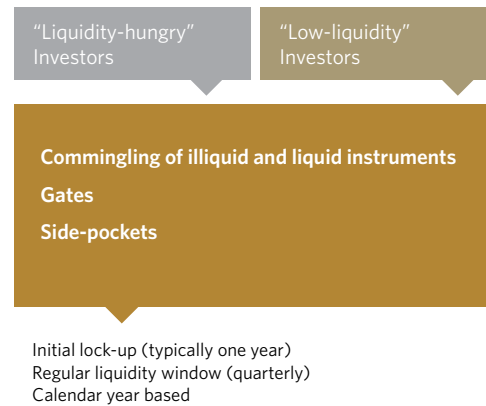
Our objective in prescribing this new alignment model is to establish a framework that addresses the primary sources of hedge fund business instability, while maintaining the industry's core DNA: rewarding success and earning fees from returns, not simply assets under management. As with any framework, this one should be flexible enough, allowing firms to adapt it to their specific business parameters.

We believe the alignment concepts apply to virtually all hedge fund and fund of hedge fund firms. However, if we were to apply this framework to each of the three categories of strategies we discussed in Chapter 3, then the strongest application is with liquid strategies (Market Directional Liquid and “Classic” Hedge Liquid), which together make up the vast majority of total hedge fund assets. For truly illiquid strategies, these concepts all apply but implementation would likely be more along the lines of the private equity and real estate alignment models.

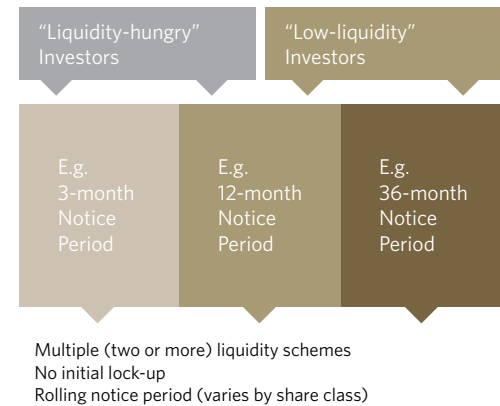
Aligning Liquidity Terms with Investor Type and Strategy

Exhibit 36: Old vs. New Liquidity Structure

Legacy Liquidity Regime:



New Liquidity Regime:



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Our starting principle is that liquidity terms should reflect underlying portfolio liquidity, investor liquidity requirements and investment horizon. For many hedge fund strategies, this is a seemingly impossible set of constraints, especially if they have a mixed client base with a wide spread in liquidity preferences.

Our solution is for managers to consider segregating their portfolios by both investment and investor type, and to vary liquidity terms for different client objectives. This could be implemented by introducing separate funds across the same strategy, each with distinct liquidity terms. This provides the manager with the flexibility to consider less liquid investments (if appropriate) and minimizes co-investor risk in the fund. Investors would have to accept that performance across liquidity classes could be meaningfully different.

Our second change to liquidity terms is to replace the whole superstructure of lock-ups, rolling liquidity subject to notice periods, and gates (all usually tied to the calendar year) with a simple idea: a rolling notice period. This would remove the instability that comes from having the fund’s capital base come up for renewal at a regular interval. Investors would not have to make the active decision to pass up on a redemption period; they can redeem any day and would get paid out after the notice period has passed. Combined with our first prescription, this removes the need for gates: investors can self-select the fund or share class with the appropriate liquidity (for example, 45-day, 90-day, 1-year, 3-year). The relevant portfolio is segregated to ensure liquidity actually exists, and the rolling notice period means that sudden surges in redemption requests are less likely.

Admittedly, these reforms would create operational complexities, but they would align manager and investor objectives. Even if the investment strategy is short-term and liquid, this segregated approach makes sense: multiple liquidity share classes increase the manager’s business stability and may be a critical feature to attracting institutional assets. Institutions we surveyed preferred to see less liquid fund terms due to perceived co-investor risk from mixing institutional assets with flightier high-net-worth or fund of hedge fund assets.

Separate Accounts?

Many investors and advisors increasingly view separate accounts, a fixture of traditional institutional asset management, as a potential “silver bullet” for the liquidity and transparency challenges with hedge funds. As with many silver bullets, we believe this one is only part of the solution, not the whole solution, and at any rate remains consistent with our new liquidity framework.

For very large investors, capable of investing \$50 million or more in a single hedge fund, separate accounts might represent viable alternatives to investing in commingled funds. The underlying alignment issues (investment liquidity versus terms) and structure would be no different than a segregated share class as described above. However, there are real impediments to separate accounts becoming the standard across the board, especially for more esoteric or less liquid strategies (where it may be impossible to run a separate account *pari passu* to the commingled fund), and the benefits they accrue may be less relevant under our proposed liquidity and transparency regimes. Furthermore, separate accounts can bring a whole set of operational challenges and increased costs to both managers and investors, as well as unwanted fiduciary concerns or potential liabilities in excess of principal invested for certain investment strategies and structures. Investors should proceed with caution. Separate accounts will become far more common in the hedge fund world, but our forecast is that most investors will continue to use commingled funds.

Exhibit 37: Evolving Fee Framework

	Legacy	Enduring Firm
Management Fee:	Flat	Scale fee schedule
Performance Fee:		
Measurement Period	Calendar year	Rolling (consistent w. liquidity terms)
Payment Period	Calendar year	Rolling (consistent w. liquidity terms)
High-Water Mark:	Annual or perpetual	None

Rethinking Fees

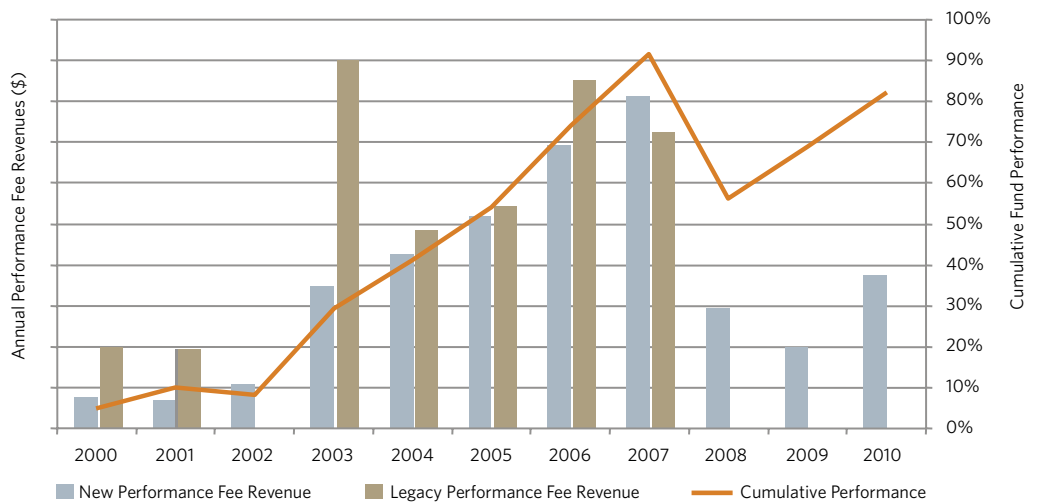
As with liquidity, our key assumptions around fees include our belief that fees should be tied to investor liquidity and investment horizon and should not be forced into a calendar year schedule automatically. While specific fee levels will vary by strategy and firm, and illiquid strategies in particular are likely to follow private equity-like structures where performance fees are paid concurrently with investor liquidity, the Enduring Firm fee structure has some common features:

Scaled management fee: A flat management fee that does not scale down with mandate size is a holdover from the “cottage industry” days, and has persisted until now due to the high demand for hedge fund strategies up to 2008. While management fees are a good source of business stability, investors have a strong preference and tolerance for performance fees, and the introduction of scaled management fees are one way managers can reward large investors without entirely surrendering management fee revenues.

Rolling and deferred performance fees: Performance fees will be more closely tied to investors’ realized returns and longer-term objectives. This means a performance fee measurement period that is not always a calendar year, or even necessarily twelve months, but is tied to liquidity terms and by implication, investment horizon. This also means the performance fee payout will likely transition away from a strict quarterly or annual basis, and towards a rolling basis incorporating a deferral.

Exhibit 38: Annual Performance Fee Revenues: Legacy vs. New Alignment Regimes

January 2000 through December 2010



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

As an example, the previous exhibit compares the revenues generated by the legacy performance fee structure with the performance fees generated by a revised, rolling structure. In both cases, assets, investment returns, and the performance fee level of 20% is maintained. The difference lies in how performance fees are calculated and paid. The proposed scheme has a monthly rolling performance fee timing and calculation of which varies according to investor liquidity. Our hypothetical example has four liquidity classes ranging from quarterly to five years. Total cumulative performance fees paid over the ten-year period is roughly equal across both schemes. The proposed fee structure has a smoother distribution of performance fee revenues, reducing variable-revenue volatility by a third.

Although less straightforward than the legacy practice, this rolling fee approach provides a better alignment for investors, emphasizing consistent returns for the investor and stable revenues for the manager.

Higher hurdles for higher performance fees: Most hedge fund managers have so far avoided a performance fee hurdle, arguing that the tactical decision to earn returns simply equivalent to cash was a choice that investors should reward in certain market conditions. This line of argument may have become harder to defend since 2008, when few managers made such a decision. In any case, managers may find that investors will likely accept a higher performance fee in exchange for a hurdle, even a cash hurdle. In our framework, the hurdle is not necessary for every strategy, but it is an optional tool to better align managers with investors. In particular, for market-directional strategies with a great deal of embedded beta, a hurdle makes sense.

High-water mark: As outlined earlier, the high-water mark feature is a source of bad incentives and destructive behavior. While the premise of the high-water mark, to keep investors from effectively paying for the same returns multiple times and act as a “risk break” on managers, is fair, it does not always work as intended. In the context of the new Enduring Firm alignment regime, the high-water mark provision should disappear.

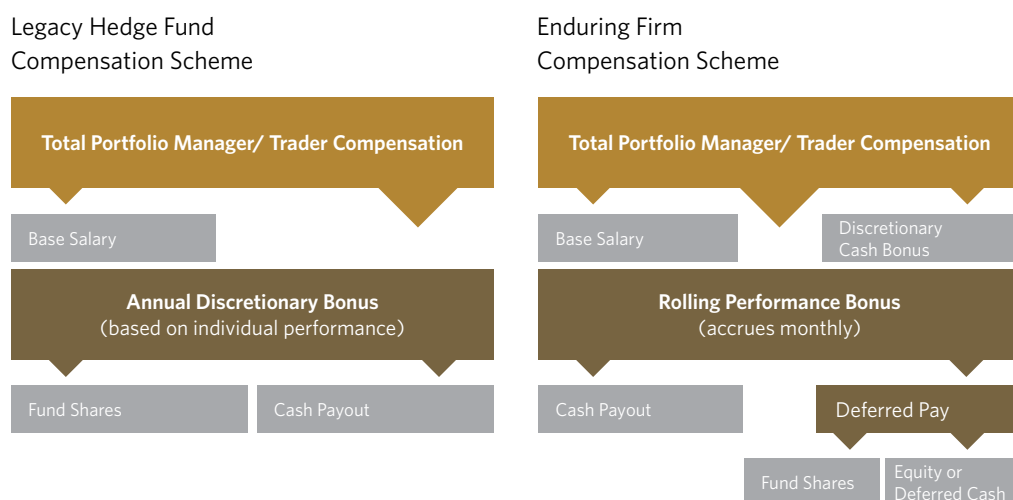
Removing the high-water mark could create new benefits for investors. Restructuring performance fees as described above greatly reduces the “pay for performance twice” effect. Rolling performance fees should more closely align fees paid with returns booked, reducing overall fees until underperformance runs off, potentially years into the future (similar to a high-water mark). And the rolling performance fees reward consistent performance over the investment horizon, not simply a quick win before year-end, maintaining the high-water mark’s original objective of protecting investors with a risk break.

Other structures: We considered the idea of a claw-back or hold-back for performance fees as, in fact, a few hedge fund managers have implemented. In practice this is a cumbersome feature to implement, has unfavorable tax implications for managers, and frankly appears to be less effective than the framework we prescribe.

Our primary motivation was to address business model stability. For the example used in the previous exhibit, cumulative performance fees earned over the ten-year period are roughly equal using the legacy or Enduring Firm fee structure; however, the new fee structure would have led to a more stable business, which is ultimately in the best interest of investors and managers.

Hedge Fund Compensation & Business Practices

Exhibit 39: Old vs. New Hedge Funds Compensation Structure



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

The Enduring Firm employs a compensation framework for its investment teams that has strong alignment with investors’ long-term return objectives (and actual experience), as well as the firm’s long-term viability and growth. In addition, team members should feel the framework is clear, transparent and predictable, and not ad hoc.

While the specifics will vary by firm and strategy, the key components and attributes of compensation should follow a common template:

- Performance fee-driven income should form the bulk of ongoing compensation; however, a majority of these payments should be deferred, into the firm’s products, as well as equity-like long-term incentives.
- Over the long-run, the team’s upside should come from their stake in the business, including dividends and not just their fund investments.
- Although it should not dominate pay, a discretionary component gives the framework flexibility and can be used to motivate behaviors beyond investment performance, such as cooperation with the distribution team.

- Competitiveness must be maintained: investment teams' compensation levels must remain competitive relative to comparable firms and strategies.
- Firms should implement compensation reforms in stages over multiple years, careful to balance the competitive advantage of cash components with the longer-term incentives that ownership and equity-like interests would create.
- Finally, the process to award pay within teams should be clear and transparent.

Retained Earnings. In tandem with rethinking compensation practices, hedge fund managers should also re-examine the standard industry practice of fully paying out all company profits on an annual basis. Introducing retained earnings provides managers with a capital cushion to maintain resource levels and investment talent during a downturn. Implementing retained earnings in a tax-efficient manner will likely require substantial changes to managers' corporate structures.

Implications

The new alignment regime promotes greater business stability by smoothing performance fee revenues and team payouts, eliminating destructive incentives like the high-water mark, empowering investors through better liquidity terms, aligning the business with investors' long-term return objectives, promoting investment team retention, and supporting a long-term perspective. Few hedge fund businesses have been able to fully transform itself away from being a single-generation firm and into a multi-generational firm. The Enduring Firm alignment framework sets the stage for this transformation.

The Enduring Firm Checklist

Exhibit 40: Balance and Excellence Across Four Business Functions



Addressing the alignment conundrum is the industry's critical challenge. Strong alignments are the foundation for the Enduring Firm and, therefore, represent a starting point. Once the alignments are in place, excellence and balance across four key functions must be developed.

A balanced organization is one where the four key business functions are able to work effectively together with appropriate resources, empowerment and latitude given to each function. Historically, hedge funds have generally been poorly balanced organizations, with the investments function dominating the business, distribution being relegated to an atrophied utility and no dedicated, separate senior business management setting the overall strategic vision and direction. By relying on senior investment professionals to drive these businesses "on the side," most hedge funds had a short-term, reactive approach to distribution and no long-term business strategy. The industry's tremendous growth through 2007 masked this imbalance, as strong investment performance, combined with some presence among buyers, was enough to drive flows.

In the current environment, and even more so going forward, we believe balanced organizations will have a strong competitive advantage over their out-of-balance peers by being more focused, nimble and effective across all four functions. In this section we provide basic checklists, by function, of best practices for the balanced Enduring Firm.

Exhibit 41: Enduring Firm Checklist: Business Management

✓ Real business leadership: Professional(s) that are experienced, accountable, empowered, and dedicated to business leadership; senior management should be a separate personnel function (i.e., the head trader as CEO is not sustainable).
✓ Strategic vision and objectives: Vision and long-term objectives are clearly defined and well understood throughout the firm.
✓ Business strategy: Strategy for business success is clear, consistent with objectives and with firm's strengths.
✓ Client-centric culture: Senior leadership embraces key clients as partners, and extends this approach throughout the firm.
✓ Product development process: Systematic process to review and test new product ideas incorporating input from investments, distribution and operations.
✓ Aligned compensation framework: Compensation across the firm is aligned for (i) role specific behaviors and (ii) longer-term firm success, and is driven by consistent, systematic inputs (not solely discretionary).

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Exhibit 42: Enduring Firm Checklist: Distribution

✓ Empowered distribution team: Distribution function (sales, marketing, relationship management, and client service) viewed as equal partner to investments, staffed and managed accordingly.
✓ Client-centric culture: Distribution team embraces key clients, is open and forthcoming.
✓ Systematic relationship development and management: Clear rationale behind target channels/clients, firm and product story, process to initiate and track relationships; explicit objectives.
✓ Client tiering and service levels: Tiering rationale is clear and consistent with distribution and firm objectives; consistent service levels apply to each tier.
✓ Managing capacity: Monitoring and communication in place to ensure investment capacity not overwhelmed by distribution team success.
✓ Strategic marketing: Sustained campaign to deepen existing relationships and create new ones through education, thought leadership, and other forms of creative engagement with targets and clients.

Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

Exhibit 43: Enduring Firm Checklist: Operations

✓ Operational resources: Dedicated, experienced operations team with clear role specialization, and strategy-appropriate staffing levels.
✓ Independence and empowerment: Operations team is empowered and key pricing and reconciliation roles do not report to investment team.
✓ Counterparty diversification, quality and monitoring: Prime brokerage relationships, custodial relationships, cash management, swap counterparties and other sources of financing need to be of highest institutional quality, diversified across multiple organizations, and continuously monitored.
✓ Third-party administration: Employment of a third party for administration, including the provision of fund accounting, reconciliation and pricing.
✓ Delegation but not abdication: In-house ability to shadow and verify third party administrator.
✓ Effective tracking and reporting: Systems and processes to track in real-time data and money, bridging operations', clients', regulators' and investment team's data requirements.
✓ Strong controls and compliance: Processes and systems are widely understood and adhered to; independent compliance capability enforces controls.

Source: *The Bank of New York Mellon and Casey Quirk Analysis 2009*

Exhibit 44: Enduring Firm Checklist: Investments

✓ Source of alpha and investment "edge": Capacity to deliver alpha is effective, consistent, and well understood throughout the firm.
✓ Disciplined investment process: Investment decisions follow a logical and transparent process, with clear integration of risk management techniques.
✓ Investment leadership and team: Investment team is appropriately staffed, and investment leadership is experienced, credible and effective at managing people (not just a portfolio).
✓ Aligned investment team compensation: Investment team compensation fully aligns team with investor and portfolio time horizon, and with firm's long-term viability and success.

Source: *The Bank of New York Mellon and Casey Quirk Analysis 2009*

The Enduring Firm: Four Business Models

Exhibit 45: Four Business Models for the Enduring Firm

1. Single-Strategy Boutique

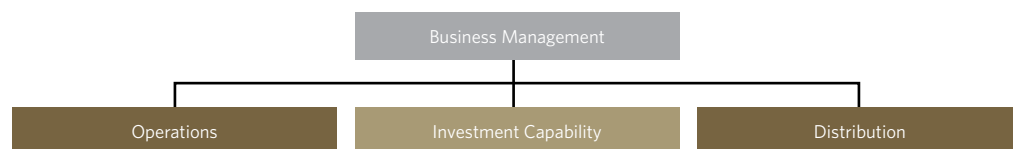
2. Multi-Capability Platform

3. Merchant Bank Manager

4. Converged Traditional-Alternatives Manager

The Enduring Firm framework can be applied across the hedge fund manager universe. There are no size, product offering, or business scope constraints. However, we can identify four different types of hedge fund businesses which will prosper within the Enduring Firm framework. Each model has individual strengths and weaknesses, as well as unique critical success factors. While the Single-Strategy Boutique will continue to command a large share of assets, we forecast that the Multi-Capability Platform model will experience the highest growth going forward.

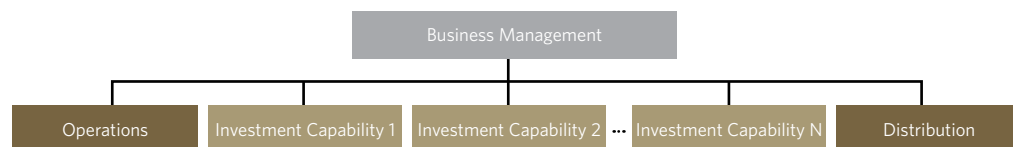
Exhibit 46: Single-Strategy Boutique



1. Single-Strategy Boutique: In many ways the standard hedge fund, the Single-Strategy Boutique is built around a core investment capability. The critical success factors for the Single-Strategy Boutique are strong investment returns and concentrated focus, in particular around distribution strategy and resources. This model benefits from simplicity: being easier to manage and providing a straightforward story for potential investors.

However, the model's growth potential is limited as it likely suffers from investment capacity constraints, and it will increasingly struggle to attract attention from the major institutional and high-net-worth intermediaries. Organizational balance is hard to achieve and maintain in these investment-dominated businesses. As a business, constrained growth will cap any potential economies of scale, and this model will also be susceptible to revenue volatility (even with the Enduring Firm fee and liquidity structures in place).

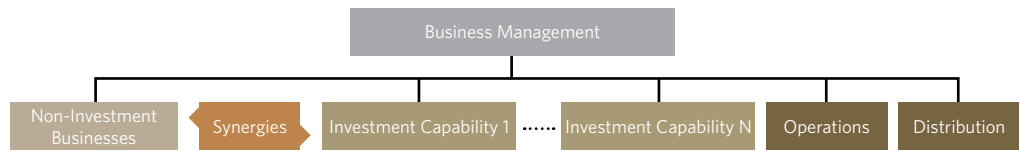
Exhibit 47: Multi-Capability Platform



2. Multi-Capability Platform: The Multi-Capability Platform represents the hedge fund version of the typical multi-product traditional firm. It also differs from legacy Multi-Strategy firms by unbundling strategies and teams into more distinct product offerings. This model is based on a series of distinct investment capabilities which leverage a common business infrastructure, brand and distribution. Its critical success factors are highly effective business management and strong alignments across investment capabilities. The Multi-Capability Platform model has high growth potential and benefits from being scalable, maintaining a diversified revenue-stream, attracting more attention from institutional and high-net-worth intermediaries, and realizing better support and attention from operating and trading counterparties.

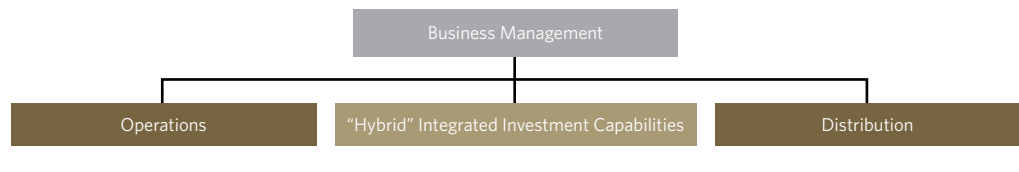
The primary challenges are creeping business-management complexity, difficult distribution decisions (either too focused or too dispersed), and the risk of a “star” team or personality rising to disrupt organizational stability.

Exhibit 48: Merchant Bank Manager



3. Merchant Bank: This model represents the “heirs to Wall Street” firms with capabilities across a range of disciplines beyond asset management, such as M&A advisory, origination, or market making, coupled with core capabilities in alternative asset management. Its primary success factor, therefore, is the strong collaboration, synergies and alignment across the firm’s breadth of services. This is a less common model, but benefits from the perception of a unique investment “edge” and highly diversified revenue streams. On the other hand, this model is the most complex to manage and has high potential for conflicts of interest.

Exhibit 49: Converged Traditional-Alternatives Manager

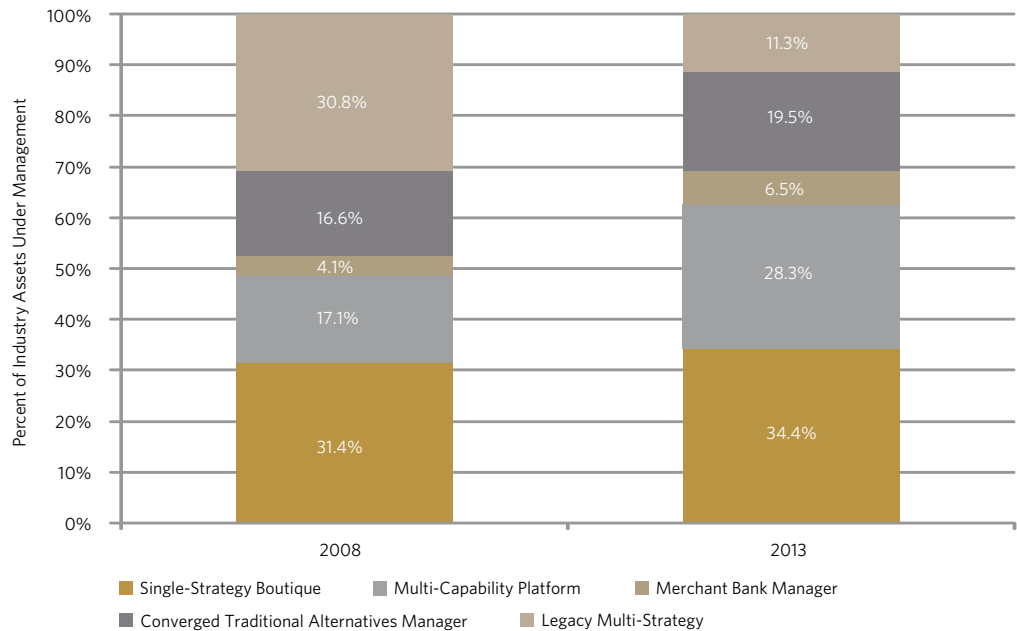


4. Converged Traditional-Alternatives Manager: This is a franchise that transcends the traditional-alternatives divide, with strong, integrated investment capabilities powering both traditional and hedge fund strategies, under a common business infrastructure, brand and distribution. Its critical success factors are effective integration of the alternatives and traditional businesses, with strong and deep alignments. The model has the greatest scale potential and likely benefits from a legacy market presence, brand, infrastructure, and diversified revenue streams.

However, the converged model is very difficult to execute: effective investment integration is a major challenge, including eliminating likely conflicts, as is the development of a single distribution infrastructure.

Exhibit 50: Four Business Models: Share of Assets Under Management

December 2008 vs. December 2013



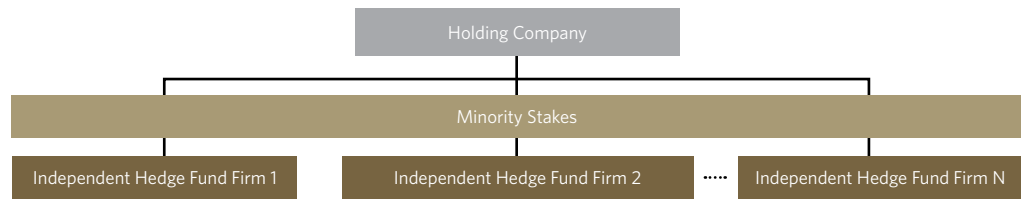
Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

As of 2008, no single business model dominated total hedge fund assets, but the largest share was held by Single-Strategy, followed closely by legacy Multi-Strategy. Our forecast is that by 2013 legacy Multi-Strategy will lose substantial share to Multi-Capability Platform firms. Multi-Capability Platforms are more scalable than Multi-Strategy firms, have a stronger investment proposition to buyers and are more conducive to organizational balance and alignments. In fact, our model shows a large portion of 2008’s legacy Multi-Strategy managers converting back into Single-Strategy Boutiques or making the leap to become Multi-Capability Platforms.

A Distinct Fifth Model: The Alternatives Holding Company

A final business model that is not an Enduring Firm per se, but will likely play a growing role in the hedge fund industry, is that of the Alternatives Holding Company. In general this can take two forms: either a seeding-oriented model where an important long-term objective is eventual affiliate maturation and independence or a model built around investing in managers at scale and creating a diversified mix of affiliates, without the elements of seeding that resemble venture capital investing. Historically, financial holding companies concentrated on hedge funds almost exclusively focused on seeding, but this has changed in recent years.

Exhibit 51: Alternatives Holding Company



In this model, the holding company parent will have limited operational interaction with affiliates, without any major attempt to integrate business or distribution functions. Specific to hedge funds, the holding company should be open (and perhaps prefer) minority stakes. For many managers, but especially Single-Strategy Boutiques, selling a stake to an Alternatives Financial Holding Company can be an effective step towards ensuring long-term internal alignments are strong, while facilitating an inter-generational transfer of ownership and management.

Funds of Hedge Funds Evolve

The fund of hedge fund industry is facing its own set of challenges, all of them closely related to the problems hedge fund managers need to address. As with our overall projections, our fund of hedge fund projections are predicated on the assumption that there will be a class of funds of hedge funds that are themselves able to evolve into Enduring Firms, a list which will likely include both legacy leaders as well as newer groups.

The fund of hedge fund specific challenges fall into two groups:

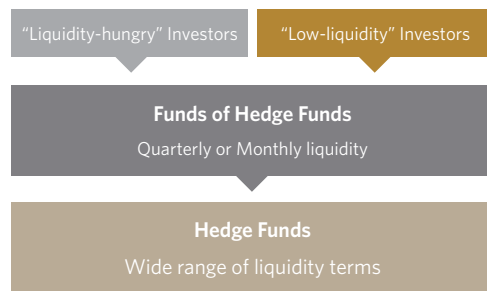
Liquidity: As with hedge funds themselves, liquidity bedevils the fund of hedge fund industry. There is a short-term tactical element to this problem: the majority of 2008 redemptions occurred at the fund of hedge fund level, putting severe strain on these businesses, triggering gates and suspended redemptions. The underlying problem remains the same as that which plagues hedge funds: the commingling of a wide swathe of underlying strategies holding wildly divergent liquidity profiles together with a mixed investor base with different liquidity requirements.

Application & value-add: As investors and advisors move away from looking at hedge funds as a single amorphous allocation, and start to use hedge fund strategies within their allocations to equity, fixed income or illiquid assets, fund of hedge fund offerings will need to reflect this new reality. Furthermore, the growth of specialist consultants whose services overlap with some fund of hedge fund functions introduces new questions among investors about precisely how they should use funds of hedge funds.

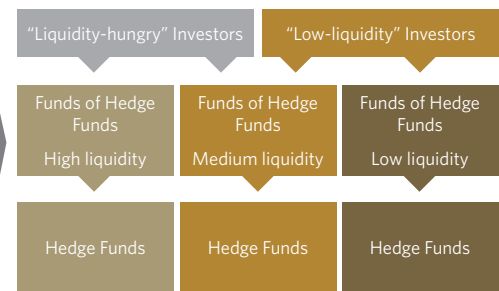
The solution to the underlying liquidity challenge is to fully align liquidity terms with investment liquidity and investor requirements, similar to the Enduring Firm hedge fund. This means segregating investors by liquidity requirements into distinct funds or share classes and maintaining that alignment down through the underlying hedge fund managers. By definition, this means that illiquid strategies will have no role in liquid fund of hedge fund portfolios.

Exhibit 52: Funds of Hedge Funds Liquidity Framework

Legacy Liquidity Regime:



New Liquidity Regime:



Source: The Bank of New York Mellon and Casey Quirk Analysis 2009

The bigger evolutionary leap is around funds of hedge funds' application and value-add to investors. This will require two major changes in perspective. The first centers on a strong validation of funds of hedge funds' value proposition, which will vary substantially by firm and could include one or more of the following: manager sourcing, access and research, due diligence and monitoring, strategy allocation, portfolio construction and management. Secondly, funds of hedge funds must clearly articulate how to best package this value proposition.

What is certain is that the classic funds of hedge funds offering a broadly diversified commingled portfolio with a diverse array of managers representing the hedge fund strategy universe will lose share to another, more focused packaging set that builds on investors' changing perceptions regarding hedge funds.

As with hedge funds, there are some common best practices that characterize the next generational funds of hedge funds.

Exhibit 53: Enduring Firm Checklist: Funds of Hedge Funds

✓ Core Value Proposition: Key sources of value to investors are effective, competitive and well-understood.
✓ Product and Service Offerings: Offerings are relevant to investors and represent the best packaging of funds of hedge fund's core value proposition.
✓ Business Leadership: Dedicated senior leadership with clear vision and business strategy that is consistent with funds of hedge fund's strengths.
✓ Aligned Compensation Framework: Compensation across funds of hedge funds is aligned for (i) role-specific behaviors and (ii) longer-term funds of hedge funds success, and is driven by consistent, systematic inputs (not solely discretionary).
✓ Investment Excellence: Investment team is key driver of value-add, is fully resourced and follows a disciplined and logical process; investment results validate effectiveness.
✓ Investment Process Integrity: Both operational due-diligence and risk management are fully resourced, independent from investment team and have veto-power over investment team.
✓ Strategic Distribution: Sales, marketing, relationship management and client service are fully-staffed and coordinated; pursue a clear distribution strategy that is consistent with funds of hedge fund's core value proposition.
✓ Holistic Sales and Client Service approach: Regardless of target markets and offerings, funds of hedge funds need to have the capability to guide investors and intermediaries on their offerings and overall portfolio role.
✓ Operational Infrastructure: Dedicated and experienced operations team with appropriate resources and systems.
✓ Dynamic Organization: Culture of continuous improvement with ability to evolve with clients and managers.

Source: *The Bank of New York Mellon and Casey Quirk Analysis 2009*

Conclusion

The hedge fund industry's recovery and future prosperity depend on correcting the poor long-term alignment that exists between investors, firms and investment teams. Future alignment structures will match investor liquidity needs, portfolio liquidity, investment horizon, performance measurement and payout periods. Liquidity terms will vary by firm and strategy but will be a direct function of the investor base and the strategy's liquidity characteristics. In many cases, a rolling notice period will supersede the cumbersome legacy liquidity terms of lock-ups and gates. The high-water mark feature will fade and firms will measure performance fees on a continual rolling basis. Multi-Capability Platforms will thrive, while Single-Strategy boutiques will maintain market share.

Funds of hedge funds will consolidate their role as chief hedge fund investors, but to do so, most will need to overhaul liquidity practices, change product and service offerings and re-affirm their core value proposition to investors.

Parting Thoughts: The New Active Management

We remain optimistic on hedge funds' future, perhaps because of, and not in spite of, the crisis and turmoil. The industry's current trials will, no doubt, result in a dramatic reconfiguration of the hedge fund and fund of hedge fund landscape, a wrenching process which will hurt competent managers and damage otherwise good businesses.

However, this process also represents a unique opportunity for this industry to finally mature, shedding many practices, standards and anachronisms that ultimately hold back hedge funds and their managers. This includes an operating model that no longer works, poor transparency practices, an anti-regulation mindset, outdated terms, and poorly aligned fees and compensation schemes. In sum, a business model designed to maximize short-term volatility.

Ultimately, hedge funds have the opportunity to be at the forefront of asset management, and vie for control of a far greater asset pool than the \$2.6 trillion we estimate. This is the really big prize for hedge funds: if they can get the alignment and business balance right and become fully-fledged asset management companies, this industry will redefine the products and services that characterize "active asset management."

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Aksia LLC	Jim Vos	Chief Executive Officer and Head of Research
Aldea Capital Management	Pierre-Paul Benoit	Chief Executive Officer
Allianz Insurance Plc	Geoffrey Hall	Chief Investment Officer
Alpha Equity Management	Kevin Means	Chief Investment Officer
The Alternative Investment Management Association (AIMA)	Tom Kehoe	Research Manager
Alternative Investment Products Co. Ltd	Ted Uemae	President
Angelo, Gordon & Co.	John Angelo	Chief Executive Officer
The Archstone Partnerships	David R. Parker	Chief Operating Officer
Arden Asset Managemet LLC	Averell Mortimer	President and Chief Executive Officer
Atrato Advisors LLC	Brian Reich	President
Aviva Investors	Steve Stotts, CFA	Vice President, Senior Portfolio Manager
BlackRock, Inc.	Barbara Novick	Vice Chairman
Blue Sky Group	Ramon Tol	Fund Manager Equities
BNY Mellon Asset Management	Cyrus Taraporevala	Head of North American Distribution
BNY Mellon Asset Management	Robert Jaeger, PhD	Senior Market Strategist
Boomerang Capital	Donough McDonough	Managing Member
Brightrust PE Japan Co., Ltd	Joji Takeuchi	Chief Executive Officer
The Britannia Steamship Insurance Association Limited	Seren Halil	Director
Cadogan Management, LLC	John Trammell	President
Cadogan Management, LLC	Drianne D. Benner	Global Marketing Director
Cadogan Management, LLC	Melissa Santaniello	Vice President, Sr. Marketing Analyst
Canyon Partners	Michael Charlton	Managing Director
CN Investment Division, CN Rail	Mathieu St. Jean	Manager Absolute Return
Coldstream Capital	Elbridge Stuart	Director of Research and Director of Alternative Investments
Corbin Capital Partners, LP	Tracy McHale-Stuart	Partner and Chief Executive Officer
CP Eaton Partners	Thomas S. Kreitler	Managing Director

Credit Suisse (Europe) Limited	Ian Lynch	Director
Credit Suisse (Europe) Limited	Martin Donnelly	Vice President
Credit Suisse Alternatives	Stephen Foster	Director
Deloitte & Touche	Brian Forrester	Partner
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Ernst & Young, LLP	Zeynep Meric	Senior Manager, Financial Services (Hedge Funds)
Explora Active Management AS	Ola Wessel-Aas	Portfolio Manager
Fauchier Partners	Christopher Fawcett	Chief Executive Officer
Federal Street Partners LLC	Edgar W. Barksdale, Jr.	Principal and Chief Executive Officer
FrontPoint Partners LLC	Daniel Waters	Co-Chief Executive Officer
Fund Evaluation Group	J. Alan Lenahan	Managing Principal and Director of Hedged Strategies
Galena Asset Management Ltd	Gerard Lynch	Chief Financial Officer
GAM London Ltd	Matthijs Vis	Client Director Intermediaries and Institutions Benelux
Gartmore Investment Management PLC	Angus Woolhouse	Head of Global Institutional
GCI Capital	Takahiko Suenaga	President
GFIA pte lth	Peter Douglas, CAIA	Principal
Gottex Asset Management Ltd	William Landes, PhD	Senior Managing Director
GE Asset Management	David Weiderecht	Vice President, Alternative Investments
Great Lakes	Greg Guelfand	Chief Financial Officer
HBK Investments, LP	Baker Gentry	Managing Director and Chief Financial Officer
Highfields Capital Management	Jonathon S. Jacobson	Co-Founder and Senior Managing Director
Highvista Strategies	Brian Chu	Chief Operating Officer
Hong Kong Hospital Authority	Herman Wong	Executive Director
HSBC Alternative Investment Group	George Covo	US Head of Due Diligence
HSBC Alternative Investment Group	Christopher Smith	Director
Integra Capital Management	Tristram Lett	Managing Director Alpha Beta Strategies

Ivy Asset Management	Sean Simon	President
Ivy Asset Management	Patrick Thomson	Managing Director
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J.P. Morgan Alternative Asset Management	Douglas Smith	Vice President
JANA Investment Advisers Pty Ltd. Australia	Ken Marshman	Chair and Managing Director
K2 Advisors LLC	John Ferguson	Chief Operating Officer
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Kinetic Partners LLP	Raymond O'Neill	Founding Partner
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Korea Investment Trust Management Co. Ltd	Bong Jin Yang	Head of Alternative Investment Division
KPMG LLP	Brian Clavin	Partner
KPMG LLP	Mikael A. Johnson	Partner
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Lasair Capital	Carrie McCabe	Chief Executive Officer and Founder
London & Capital	Pau Morilla-Giner	Senior Fund Manager
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Maples & Calder	Barry McGrath	Partner
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Massachusetts Pension Reserves Investment Management	Mike Travaglini	Executive Director
Matheson Ormsby Prentice	Michael Jackson	Partner
McKinsey & Company	Salim Ramji	Partner
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Mercer Ltd.	Simon Fox	Senior Associate
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MLC	Chris Condon	Chief Investment Officer
NAB Invest	Garry Mulcahy	Chief Executive Officer
NAB Invest	Troy Swan	General Manager of Boutiques and Joint Ventures

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National Grid	Barbara Lupo	Director of Investment Management
National Social Security Fund	Larry Zhang	Senior Advisor, Overseas Investment Department
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Rockefeller & Co.	James Crystal	Managing Director
RogersCasey	Kevin Lynch	Director of Research
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Stamford Associates (U.K.) Ltd.	Nathan Gelber	Chief Investment Officer
Standard Life Investments	Mark Connolly	Director, Distribution and Client Service
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Strategic Investment Group	Brett Felsman	Principal
Symphony Asset Management	Jeffrey L. Skelton	President and Chief Executive Officer

Tabb Group	Larry Tabb	Founder and Chief Executive Officer
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* Some interviewees requested to remain anonymous and are not listed here.

The Bank of New York Mellon

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