Alternative Asset Managers: Don't Get Carried Away

FINANCIAL SERVICES SECTOR REPORT

For more information:

If you have any questions, please contact a local Edward Jones financial advisor, or write to: Edward Jones,12555 Manchester Road, St. Louis, MO 63131.

Alternative asset managers invest in nontraditional asset classes, including private equity, real estate, infrastructure, private debt, natural resources, currencies and various hedge-fund strategies. Interest in alternative asset classes has grown significantly in recent years, as returns are often uncorrelated with the stock market.

When most of the U.S. alternative asset managers went public, they were structured as limited partnerships. Following changes in U.S. tax laws, these companies have either completed or announced conversions to traditional C-corporations, which has ignited investor interest, particularly among foreign and institutional investors.

We believe that there is a high level of risk with owning these stocks, and we do not believe that they are appropriate for many individual investors. Income has been variable, and these companies are likely to experience sharp reductions in earnings during periods of financial market weakness.

Key Investment Considerations

- **Investing in a Management Company, not a Fund.** Purchasing the shares of an alternative asset manager does not give an investor direct exposure to the returns associated with its underlying investment funds. Rather, investors are gaining exposure to the earnings and long-term growth of the investment manager.
- **Earnings Are Highly Market-Sensitive.** Earnings are highly sensitive to the health of the overall economy, and particularly to the strength of financial markets. In addition, robust mergers and acquisitions (M&A) activity and strong investor demand for initial public offerings provide the liquidity that alternative asset managers require in order to convert noncash investment gains into cash distributions. Recently, market conditions have been favorable for alternative asset managers, but that will not always be the case. In a weaker market environment, we'd expect to observe pressure on both earnings and stock prices.
- **Dividends Paid Inconsistently.** Alternative asset managers have regularly paid dividends, but the size of those dividends has been inconsistent. Furthermore, most of the alternative asset managers have reduced or suspended their quarterly dividends at some point during their respective histories as public companies.
- **Political Risk.** At any time, tax laws could change and adversely impact these companies. For example, taxation of carried interest would be extremely detrimental.

Analyst: James Shanahan, CFA

Please see important disclosures and analyst certification on page 4 of the report.

Traditional asset managers create investment products, including mutual funds, unit trusts and exchange-traded funds and market them to institutional and retail investors around the globe. Investments are passive and substantially in highly liquid, publicly traded equity and fixed-income securities (stocks, bonds and cash).
Investors in traditional asset managers participate in the long-term growth in fee income, which is driven by the manager's ability to attract and grow investment assets. Long-term investment performance is tracked very closely, given that it is a significant driver of net investment flows over time.

Alternative asset managers invest primarily in nontraditional asset classes such as hedge funds, private equity, real estate, infrastructure, private debt, natural resources and currencies. While still small relative to the traditional asset-management industry, alternative assets are growing rapidly.

Purchasing an interest in a publicly traded alternative asset manager represents an opportunity for investors to participate in the rapid growth in alternative assets. It is important for investors to understand that purchasing the shares of a publicly traded alternative asset manager does not give an investor direct exposure to the returns associated with its underlying investments.

For example, when an investor purchases the publicly traded shares of a specific alternative asset manager, the investor is not purchasing a direct interest in one of the manager's funds. Rather, the investor is purchasing an interest in the earnings of the management company responsible for investment funds focused on various private equity, hedge fund and credit strategies. Over time, if the manager is able to continue to achieve positive investment performance and further grow managed assets, the company should also deliver growth in earnings, and investors can participate in this growth.

Not Just Private Equity. "Private equity" simply refers to equity securities that do not trade on a stock exchange. While many alternative asset managers are involved in private equity, many are involved in other activities, such as public and private debt securities, real estate, hedge funds, infrastructure and natural-resources portfolios.

Unique Aspects of Alternative Asset-Management Business Models

Earnings Are Highly Market-Sensitive.
Alternative asset managers generate revenues from management, transaction and monitoring fees. After deducting general and administrative, compensation and other expenses, we arrive at an earnings measure that is highly likely to be recurring in nature. For some alternative asset managers, these recurring earnings actually represent only a small percentage of reported earnings. That is because reported earnings also reflect the impact of valuation changes for assets held within the manager's funds. Typically, this shows up in earnings in two different places. Firstly, if the manager has co-invested alongside fund investors in a particular investment, and that investment has been written up, the manager will record investment income. Secondly, the manager reports "carried interest" income, which is usually around 20% of the gain that fund investors have earned on their invested capital. At some point, if the asset has been valued correctly and markets are liquid, the manager will report an actual cash gain that approximates the cumulative total of all recorded carried interest income. Until that time, these revenues are noncash.

It should be clear that earnings are highly sensitive to the health of the overall economy, but particularly to the strength of global financial markets. In addition, robust mergers and acquisitions activity and strong investor demand for initial public offerings provide the liquidity required to turn noncash gains into distributable cash earnings. Recently, market conditions have been overwhelmingly favorable for alternative asset managers. That won't always be the case, however. In a weaker market environment, we'd expect to observe pressure on both earnings and stock prices.

It's Not Just the Assets That Make These Managers "Alternative"

Long Investment Cycles. Once an alternative asset manager has identified an attractive investment opportunity, the company may spend 12-24 months meeting with investors, including institutions such as pension funds, endowments or sovereign wealth funds, and/or wealthy individual investors. After fund investors have made commitments, the manager could take several more years identifying specific investment opportunities and actually investing

the capital. Years later, if the investments have performed as expected, the manager will liquidate the portfolio and return the capital to fund investors. It is not uncommon for the entire investment process to take more than 10 years from beginning to end.

Use of Financial Leverage (Debt). Unlike traditional asset managers, alternative asset managers often use financial leverage to boost investment returns. For example, a private equity fund may purchase a company for its portfolio, but only utilize a small percentage of equity to make that acquisition. Use of financial leverage is considered to be aggressive because it can magnify losses if the investment does not perform as expected.

For example, consider a traditional asset manager making a $40 million investment in a publicly traded stock, using capital contributed by investors to a managed mutual fund. If the value of the investment increases by 25%, mutual fund investors gain $10 million, or 25%. If the value of the $40 million investment declines by 25%, mutual fund investors lose $10 million, or 25%.

Separately, an alternative asset manager may invest a total of $40 million in a buyout of a small company, using $10 million raised in its buyout fund plus another $30 million that the manager has borrowed. If the value of the acquired company increases by 25% to $50 million, buyout fund investors double their $10 million investment because the debt is still only $30 million. However, if the value of the acquired company declines by 25% to $30 million, investor equity is wiped out entirely.

While the use of debt to make acquisitions can have some downside ramifications, there are some positives. Given mostly investment-grade credit ratings, alternative asset managers can access financing at favorable rates and terms. In addition, debt-service requirements encourage private equity managers to focus on maximizing cash flow and reducing leverage. For alternative investments, reduction of debt is one of the key drivers of long-term returns.

Operational Expertise. Alternative asset managers typically employ professionals with deep industry experience, including retired former senior executives of outside public companies. These executives often lead industry-focused investment teams and are involved in all phases of the investment process. At the earliest stages, they help to identify attractive acquisition candidates. Later, they can assume seats on the board of directors of acquired companies, assume managerial responsibilities, or make significant business model changes. Driving operational improvement within acquired portfolio companies is one of several unique ways that alternative asset managers can add value.

Additional Investment Considerations

Dividend Yields Could Be Misleading. Firstly, we believe that some yield-seeking investors have been attracted to the alternative asset managers from time to time by high dividend yields. Many of the largest publicly traded North American alternative asset managers have consistently paid quarterly dividends. However, many of them have also reported one or more sharp reductions in the quarterly dividend payment over the same time period.

Secondly, reported dividend yields for some alternative asset managers are based on the total dividends paid over the most recent four quarters. For others, the dividend yield is based only on the most recent quarterly dividend, but it is annualized. Investors should understand that the method utilized to estimate the dividend can be misleading by itself. More importantly, we believe that it is reasonable to conclude that recent dividends for the alternative asset managers may be near cyclical highs.

Valuations Could Be Impacted by Reductions to Carried Interests. Earlier in this report, we discussed how earnings are impacted by valuation changes for investments held within their funds. While these mark-to-market valuation changes are noncash, they represent the manager's outlook for their carried interest in distributable cash gains within the fund portfolios that they manage. If financial markets were to weaken, we would likely observe negative valuation marks, and investor expectations for realized cash gains and cash dividends would also be reduced. Everything else held constant, we would expect this to negatively impact the stocks.

Analyst Certification

I certify that the views expressed in this research report accurately reflect my personal views about the subject securities and issuers; and no part of my compensation was, is, or will be directly or indirectly related to the specific recommendations or views contained in the research report.
James Shanahan, CFA

Required Research Disclosures

Analysts receive compensation that is derived from revenues of the firm as a whole which include, but are not limited to, investment banking revenue.

Other Disclosures

This report does not take into account your particular investment profile and is not intended as an express recommendation to purchase, hold or sell particular securities, financial instruments or strategies. You should contact your Edward Jones Financial Advisor before acting upon any Edward Jones Research Rating referenced.
All investment decisions need to take into consideration individuals' unique circumstances such as risk tolerance, taxes, asset allocation and diversification.

It is the policy of Edward Jones that analysts or their associates are not permitted to have an ownership position in the companies they follow directly or through derivatives.

This opinion is based on information believed reliable but not guaranteed. The foregoing is for INFORMATION ONLY. Additional information is available on request. Past performance is no guarantee of future results.

In general, Edward Jones analysts do not view the material operations of the issuer.

Diversification does not guarantee a profit or protect against loss in declining markets.

Special risks are inherent to international investing including those related to currency fluctuations, foreign political and economic events.

Dividends can be increased, decreased or eliminated at any time without notice.

An index is not managed and is unavailable for direct investment.

Edward Jones - Member SIPC