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535 Madison Ave., 19th Floor
New York, NY 10022
212.207.1000 (phone)
212.207.1019 (fax)

The Berkshire Capital Newsletter is distributed electronically.

To subscribe or unsubscribe, contact: bcs.feedback@berkcap.com

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DEMAND IS STRONG FOR HIGH-QUALITY, FOCUSED INSTITUTIONAL PLAYERS

AS WITH THE ASSET MANAGEMENT INDUSTRY IN GENERAL, THE INSTITUTIONAL SECTOR HAS FOR SEVERAL YEARS BEEN DEALING WITH A CHANGING LANDSCAPE, PARTICULARLY RELATING TO THE DEFINED BENEFIT MARKET AND EVOLVING PLAN SPONSOR INVESTMENT STRATEGIES. CORPORATE AMERICA, FOR ONE, HAS BEEN RE-EVALUATING THE FINANCIAL WISDOM AND NECESSITY OF PROVIDING DEFINED BENEFIT PLANS, AND SEVERAL BLUE CHIPS HAVE ALREADY TAKEN STEPS TO FREEZE EXISTING PLANS, WITH CITIGROUP, IBM, MOTOROLA AND VERIZON JUST A FEW OF THE NOTABLE EXAMPLES.

Research firm Greenwich Associates estimates that the percentage of corporate defined benefit pension plans closed to new employees rose three points to 22% between 2004 and 2005, but the largest plans - those with $5 billion-plus in assets under management (AUM)–are closing at a faster rate.

Local and state governments, saddled with major commitments to their employees, have begun to take notice. Even in labor-friendly California, Gov. Arnold Schwarzenegger boldly proposed to freeze the state employee pension plan, a position from which he was quickly forced to retreat.

In another significant and widely noted trend, plan sponsors and other institutional investors are consistently increasing their allocations to hedge funds. Net inflows to traditional long-only managers slowed in 2005 and were negative in 2006, while inflows to hedge funds continued to grow (see table below). Consultant Casey, Quirk & Associates and **Bank of New York** estimate that institutions will account for half the projected $1.2 trillion in hedge fund inflows in the four years through 2010.

INSTITUTIONAL NET FLOWS VS. HEDGE FUND NET FLOWS (U.S. $BN)

	2006	2005	2004	2003	2002
Institutional Net Flows	(14.24)	13.43	135.03	173.48	203.32
Hedge Fund Net Flows	126.47	46.91	73.59	70.64	99.44

**Sources: Casey, Quirk & Associates and Hedge Fund Research*

The shifting marketplace and resulting challenges aside, the sector remains highly attractive. In the U.S., the traditional long-only institutional market

accounts for nearly $7 trillion in AUM, according to Casey, Quirk, with international equity and fixed income investments enjoying particular favor in 2005 and 2006. A recent study by Casey, Quirk and eVestmentAlliance also bodes well for the future of traditional institutional investors, indicating that interest in equity strategies remains strong and will continue to generate the most search activity among managers. It's no surprise, then, that retail king **Fidelity Investments** is making an aggressive play for institutional business through a separate company it set up in 2005, **Pyramis Global Advisors** (AUM: $149 billion). In January, the fast-growing firm announced plans to introduce a range of new quantitative and long-short products for its clients.

Federated Investors, like Mellon based in Pittsburgh, went shopping last year in another flourishing arena, as it acquired noted "quant" shop MDT Advisers of Cambridge, MA. (AUM: $7 billion)

In a reflection of the sector's appeal, institutional firms are being actively courted by dealmakers, with an annual average of 40 transactions in the five years through 2006. For most of the key deals last year, the driving force was product need, with a focus on high quality processes and strong performance. Buyers showed a great deal of selectivity in targeting firms, a trend reflected in solid pricing (which says more about the quality of the targets than any change in the discipline of buyers). Another trend of note: in pursuit of expertise and expanded capabilities, buyers are increasingly willing to scour the globe for targets. For sellers, a significant motivation involves gaining the benefits of multi-channel distribution. A sweetener for many sellers involves the retention of a large measure of independence, retention of brand identity, and in some cases a continued equity stake.

A number of key deals that took place in 2006 illustrate the trends in the sector. On the surface, **Mellon Financial**'s acquisition of **Walter Scott & Partners** (AUM: $29 billion) of Edinburgh appeared as just another cross border effort designed to buy a presence in an overseas market. But Mellon's primary motivation was to gain access to the international know-how of Walter Scott, which already had a strong institutional base in the U.S and had experienced impressive growth in the last few years on the back of the strong investment results. In linking with Mellon, Walter Scott sought the advantages of distribution and administration so it could focus on its core investment expertise.

In accordance with Mellon's "multi-boutique" model, Walter Scott retained its identity and management team and operates as an independent subsidiary. Started up in 1983 by Walter Scott, a Cambridge University Ph.D. in nuclear physics, the firm invests in growth companies and follows a "buy and hold" strategy. In the year through April 2006, pretax profit was $64 million, about double the level two years earlier, while AUM has doubled since 2003.

Federated Investors, like Mellon based in Pittsburgh, went shopping last year in another flourishing arena, as it acquired noted "quant" shop **MDT Advisers** of Cambridge, Mass. (AUM: $7 billion). Founded in 1988, the firm uses its "Optimum Q" process, which seeks "to exploit multiple market inefficiencies to outperform the appropriate benchmark with moderate relative risk." MDT offers a mix of separately managed accounts and mutual funds with a focus on U.S. equities.

The transaction fits Federated's strategy of expanding beyond its traditional business of managing money

market accounts (comprising three-quarters of its $240 billion in AUM). For its part, MDT benefits from the new parent's distribution network. The structure of the deal provides for an upfront payment of $110 million and a series of payments over three years totaling up to $130 million, based on performance.

New York Life has been notable among insurers for the growth of its asset management business, with AUM more than doubling since 2000 to $235 billion. In 2006, the firm extended its institutional capabilities via acquisition for the second time in three years, with the purchase of Institutional Capital Corp. (AUM: $14 billion)

The demand for talented investment managers in structured financial products was at play in **Pioneer Investment**'s purchase of **Vanderbilt Capital Advisors**. Established in 1988 and pursuing a strategy that mixes quantitative techniques and traditional analysis, New York-based Vanderbilt (AUM: $13 billion) is one of the largest U.S. managers of collateralized debt obligations. This includes a short-duration product that Pioneer found a particularly attractive addition to its own menu of offerings. For Pioneer, majority-owned by **Unicredito** of Italy, the transaction meets the twin goals of expanding its institutional business and its lineup of alternative products; institutional assets make up 16% of Pioneer's $285 billion in AUM.

New York Life has been notable among insurers for the growth of its asset management business, with AUM more than doubling since 2000 to $235 billion. In 2006, the firm extended its institutional capabilities via acquisition for the second time in three years, with the purchase of **Institutional Capital Corp.** (AUM: $14 billion). The established Chicago firm provides New York Life with a highly disciplined approach to investing in large cap and international stocks with a solid long-term record. In 2004, New York Life acquired $3 billion of client assets in high-yield investments from **Pareto Partners** of London. The deal was done through the insurer's **MacKay Shields** affiliate, which manages high-yield assets.

In its 2006 acquisition of **Metropolitan West Capital Management** (AUM: $4.5 billion), **Evergreen Investments** gained a large cap value investor that "fosters capital preservation and consistency of returns." For Evergreen, the asset management arm of **Wachovia**, the deal fits with its broad strategy of targeting firms with up to $5 billion in AUM, and, within the institutional sector, a large cap bias. Of the $105 billion Evergreen manages for institutions, three-quarters is in fixed income products (Evergreen has a total of $270 billion in AUM).

The deal is also indicative of the flexible structures buyers and sellers are cementing, with Evergreen leaving 30% of equity in the hands of Metropolitan employees. Early this year, Evergreen returned to the fixed income world with the goal of adding international expertise, as it acquired London-based **European Credit Management** (AUM: $26 billion).

Separately, the institutional sector is also eliciting interest from private equity firms, in instances where either the restructuring or recapitalization of a target is involved. This includes the sort of management buyouts that took place at **Gartmore Investment Management** and **Munder Capital Management**. In the former, established private equity firm **Hellman & Friedman** joined management at the international operations of Gartmore (AUM: $45 billion) to buy out parent **Nationwide Mutual**

Insurance for a price believed to be around $900 million. It marked the third investment H&F has made in an asset manager in the last several years. H&F also holds interests in **Modrian Investment Partners** (AUM: $30 billion), a London-based international equity and fixed income specialist that serves U.S. institutions; and **Artisan Partners** (AUM: $50 billion), a multi-product firm headquartered in Milwaukee. Newly minted private equity company **Crestview Partners** and management at Munder (AUM: $25 billion) joined to acquire **Comerica**'s 90% interest in that firm, for $302 million.

Although inflows to hedge funds have surpassed those to traditional long-only strategies in the last year or so, several factors ensure that M&A activity involving institutional firms will remain robust in the years ahead:

· With $7 trillion in assets, the long-only institutional business continues to be an important source of revenue.

· Increasing intermediation of the high net worth sector (wrap, family office, etc.) is boosting demand for institutional-quality investment processes and performance.

· The Pension Protection Act of 2006 will increase the use of 401(k) plans by providing for automatic enrollment into the plans. The act also amends the ERISA fiduciary rules. This combination provides for increasing demand for institutional quality and institutionally priced investment options within the 401(k) channel.

· And many traditional managers are adapting to shifting demand by adding innovative products such as 130/30 funds in order to better serve their clients.