SHINNECOCK PARTNERS

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Water, Water, Everywhere and Not a Drop to Drink: Investment Sourcing in Alternatives

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Horace Walpole's neologism "serendipity," meaning "a discovery joined by chance" was coined in the 18th century by Walpole as he chronicled his recollections of a Persian fairy tale. In the story, three princes use (pre-Arthur Conan Doyle) Sherlockian "deduction" to determine the appearance of a camel and the load it bore by evaluating one sign each: the grass it had chewed, the tracks it left, and traces of the rider. Together they come up with a picture of a one eyed, lame camel missing a tooth. Accused of stealing the animal after giving this precise description of its appearance, the trio is forced to explain how they deduced the appearance of the camel they had never seen, and then are off on their next adventure. Often, finding investments in alternatives requires the same attentiveness, diligence and simply being out in the field where the signs are there to see.

Discovering superior money managers is often described as difficult and frustrating. There are more than a few war stories about the initial challenges investors face when there is cash to spend: how do you source investments in a space as opaque as alternatives? Great investments rarely come to those without open eyes and an open mind, but even an attentive investor may not be in the right place at the right time to find camel tracks and deduce, "camel."

Regulatory restrictions on marketing private investments create a significant initial hurdle for the searcher. Most alternative investments are organized as limited partnerships (LPs) or limited liability companies (LLCs) that take the form of private offerings under Rule 506(b) of SEC Regulation D[1]. This classification strictly limits the audience to which the investment can be presented; anything resembling a public solicitation is prohibited. These off[1]erings also usually rely on "3(c)1" or "3(c)7" exemptions from the Investment Company Act of 1940. The SEC allows investment managers to claim exemption via one of these sections of the Act, to avoid registering their fund offerings as "investment companies," (and thus avoid certain SEC requirements). A manager relying on the 3(c)1 exemption must restrict their fund to 100 investors, generally all of which must be "Accredited Investors" (typically, a $1 million+ net worth, excluding primary residence, or an entity with $5 million+ of assets). A manager relying on the 3(c)7 exemption must restrict their fund to 2,000

[1]Most funds elect to offer their wares under Rule 506(b) while a few choose 506(c). The reporting requirements of Rule 506(c) for verifying investor qualifications are burdensome as well as poorly defined, which explains why few select this option.

[2]Schneeweis, Thomas and Kazemi, Hossein B. and Szado, Edward, Hedge Fund Database 'Deconstruction': Are Hedge Fund Databases Half Full or Half Empty? (January 23, 2013), Pages 7 – 8

investors, all of which must be "Qualified Purchasers" (typically, an individual with a $5 million+ investment portfolio, or an entity with a $25 million+ investment portfolio).

Investment databases are touted as one solution to the lack of publically available information on hedge funds. Each database has its own mission, methodology, and clientele, both in terms of investors who buy the database and funds looking to list their products.

Databases are typically affected by biases that deteriorate the quality of the information. A 2013 study on hedge fund databases found that four distinct factors may deter investors from using databases as the foundation of any research[2].

1. Firm and fund characteristics and return measurement are not uniform between databases.
2. Leverage utilization is not defined.
3. Current qualitative information may not accurately mirror historical quantitative data.
4. Biases in constructing the database, including removing young managers or managers with low assets under management.

The databases on the attached list present thousands of alternative investment products. The Hedge Fund Research (HFR) database alone is said to represent nearly 7,000 products from 2,200 firms. The haystack is large when you're looking for just a dozen or so needles.

Take the example of alternative (non-bank) lending strategies. Within each investment database, often containing thousands of managers, there is unlikely to be a category labelled "alternative lending." So, scratching your head, you're left to laboriously search for what you are interested in, while ignoring the other 95%.

Often missing from databases are pre-launch investments and closed-end investments. These may not appear on external databases until launch, at which point many are either fully subscribed or currently closed to investors. If a manager does not choose to report to databases in their early history, it may have already experienced its best performance years before coming onto your radar. A City University Center for Asset Management study showed small funds outperformed large funds from 1995 to 2014 with a 1.68% higher compound annual return. Discovering, performing diligence, and investing in small funds or new funds with track records too short for some databases has been empirically shown to add alpha versus investments in larger and older funds.

It is ideal to supplement external databases with myriad other sources to develop a proprietary internal database. Each source has its own advantages, and challenges.

1. Investment conferences

   Investment conferences such as Skybridge Alternatives (SALT), Opal Group, Context Summits, ivyFON, and countless others connect investors with investment products, introduce new asset classes, assess trends and generally facilitate networking and education. They are powerful services, but not without a few caveats: (1) conferences are generally focused on specific topics, groups, or products you may not be interested in; (2) they take considerable energy and time; (3) they can be expensive to attend, whether because of the opportunity cost without surety of success, the expense of travel, or large fees to attend (sometimes waived for investors).

By attending these conferences and the many networking events that come part and parcel with them, there is the opportunity to learn about products and also build out networks of intelligent individuals. These individuals, whether looking for investments or selling them, are more productive to meet face to face at a conference (and maybe with a drink in hand) than over the phone or by email.

2. Investor networks

   Whether it is geese flying south in a V formation, bicyclists on a tour or investors searching, working together reduces the frictional costs by dividing it among the whole. The benefit of sharing ideas with non-competitive peers manifests in increased information and reduced costs (e.g., obtaining ideas generated from a conference you did not attend or sharing the costs of research). A valuable source of manager referrals for Shinnecock has always been our own investors, who share interesting managers they learn about or are already part of their portfolio.

3. Broker networks

   Broker networks also increase idea generation capabilities at no cost to the investor (though in this case the fund manager pays a price). Brokers, or more generally the sell-side marketing teams of prime brokerages, custodial platforms, third-party marketing firms and in-house marketing teams, offer the sales pitch for their sponsored products.

4. Marketer relationships

   Cultivating relationships with third-party marketing firms is mutually beneficial. Investors define their criteria, including asset classes, strategies, risk tolerance, etc. and receive a focused stream of manager prospects. Marketers, of course, are more than happy to provide this ongoing service.

5. Reverse inquiries

   Attending conferences, speaking with investors and marketers, and building a web presence increases visibility within the alternative investment space, which leads to many otherwise difficult-to-find money managers knocking on your door. Your name on a conference list or mentioned by a peer during cocktails can lead to an email or phone introduction with a manager previously unknown to you.

6. Articles and studies

   News articles and studies are an option available even to the most isolated investor. *The Wall Street Journal*, *Barron's*, research papers, etc. frequently discuss alternative investments by name and put you on the trail. Most managers never make it to news media, but attention in daily reading can supplement your efforts.

7. Web searches

   The Internet is a useful but unwieldy tool in seeking information on alternative investments. As mentioned earlier, websites are hampered by regulatory restrictions, and broad searches usually bring up only the most public and largest funds. While it remains in the toolkit, it is most appropriate for research purposes rather than discovering new investments.

Omitted from the list above is an industry combining facets of both databases and broker networks. Investment platforms, often run by brokers, marketing firms, or banks, invest directly in existing fund vehicles as a feeder entity, in parallel vehicles set up as a managed accounts, or in a swap account. The swap account structure inserts a bank between the investor and the fund. Typically, a bank accepts the investor's money directly and provides a contract to deliver the performance of the underlying fund. This approach insulates the investor from malfeasance on the part of the manager in exchange for the investor accepting the risk of the counterparty's failure, i.e., the bank. The tax implications become complicated, yet in some cases advantageous for longer term investors by creating long-term gains or losses from managers who, with a direct investment, generate short term gains or losses.

The platforms act as third-party marketers for the hedge funds they represent, actively sourcing new investors to grow both platform assets and the assets under management of the underlying investment programs. Platform investing is popular with smaller investors as it typically allows for the following:

1. Lower investment minimums. As mentioned above, the 3(c)1 and 3(c)7 exemptions prohibit investment managers from admitting more than 100 or 2,000 investors into a fund, respectively. In order to achieve assets under management of hundreds of millions, minimum account balances of $500,000 - $1 million are common (and often higher). Investment platforms typically offer lower minimums to investors, often between $50,000 and $100,000 except in swap structures, which can be north of $1 million.

2. Lower investor qualification requirements. Based on the way a hedge fund is organized, and the exemptions it claims, SEC guidelines dictate minimum investor qualifications, such as Accredited Investor or Qualified Purchaser. Funds claiming the 3(c)7 exemption, for example, require a Qualified Purchaser standard – generally a $5 million investment portfolio for individuals and a $25 million investment portfolio for entities. In this scenario, a platform may allow non-Qualified Purchasers to invest by pooling assets from all of their investors to meet the $25 million threshold.

3. Available leverage. Take as an example an equity hedge fund. To lever a direct hedge fund investment, an investor would need to take out a bank loan and directly invest the additional, borrowed capital into the fund. Platform operators can instead use margin trading in a managed account to trade the same strategy as the underlying hedge fund on a leveraged basis at a much lower cost than an individual can achieve with a bank loan.

4. Increased transparency and/or liquidity. Hedge funds commonly impose liquidity restrictions, including long redemption notice periods and lock ups that exceed the liquidity of their underlying portfolio in an attempt to retain capital and prevent quick exits by new investors. Platforms offering the same strategy through a parallel managed account may have more favorable liquidity provisions. It is also common in such platform investments to

receive greatly enhanced portfolio transparency via the platform's online user interface. Liquidity and transparency concerns are particularly important for investors with shorter investment timeframes or worries about overlapping positions between similar investments.

5. Outsourced due diligence. Platforms may provide due diligence reports on the strategies offered. This is useful for individuals who do not have the time, experience or money to perform their own due diligence.

Platform investments obviously offer a number of benefits, but come with additional operational and financial risk. Investors should treat a platform operator as they would any direct hedge fund investment, checking cash controls, service providers and other counterparty risks, viability of the company's business model and, if used for due diligence as well as access to investments, an evaluation of operator skill in performing due diligence on the platform strategies.

Whatever method an investor uses, the burden of both sourcing and categorizing these investments lies with the investor and/or an investment advisor. This challenge, like our camel clue hunters, however, is what makes our jobs as investors interesting. Theodore Roosevelt said, "Nothing in the world is worth having or worth doing unless it means effort, pain, difficulty."

Database	Website
Altegris	www.altegris.com
BarclayHedge	www.barclayhedge.com
Bloomberg	www.bloomberg.com
CogentHedge	www.cogenthedge.com
EurekaHedge	www.eurekahedge.com
eVestment	www.evestment.com
Fundbase Fund Services	www.fundbase.com
Fund Peak	www.fundpeak.com
Greenwich Alternative Investments	www.greenwichai.com
HedgeCo	www.hedgeco.net
HedgeConnection	www.hedgeconnection.com
Hedgefund Intelligence	www.hedgefundintelligence.com
HFR	www.hedgefundresearch.com
InvestHedge	www.investhedge.com
Lipper	www.lipperweb.com
MorningStar	hedgefunds.datamanager.morningstar.com
Preqin	www.prequin.com
Reuters Hedgeworld	www.hedgeworld.com
Stark Research	www.starkresearch.com

Platform	Website
Alternative Capital Advisors	www.acaem.com
Amundi Alternative Investments	www.amundi.com
Attain Porftolio Advisors	www.attainfunds.com
BNY Mellon Hedgemark	www.bnymellon.com
Deutsche Bank Select	www.db.com
FRM/ Man Group	www.frmhedge.com
Gemini	www.thegeminicompanies.com
HFR Platform	www.hfram.com
Hydra	www.ketterastrategies.com
InfraHedge	www.infrahedge.com
Innocap	www.innocap.com
Linear	linearmanagedaccounts.com.au
Lyxor	www.mylyxormap.com
Morgan Stanley Multi-Asset Platform	www.morganstanley.com
Permal Group	www.permal.com
R.J. Oasis	www.rjoasis.com
Sciens Group Alternative Strategies	www.sciensam.com
UBS Liquid Alpha	liquidalpha.ibb.ubs.com
Worth Venture Partners	www.wvpem.com

The lists above do not include all platforms and databases, but represent the largest and most used known to Shinnecock as of April 2017