Forward-thinking investors have recognized that a subset of the hedge fund industry – hedge fund seeding – offers a potential opportunity to benefit not just from attractive investment returns, but from the hedge fund industry's growth as well. For those investors who believe that the hedge fund industry will continue to grow, the environment for seeding could be extremely favorable.

EXECUTIVE SUMMARY

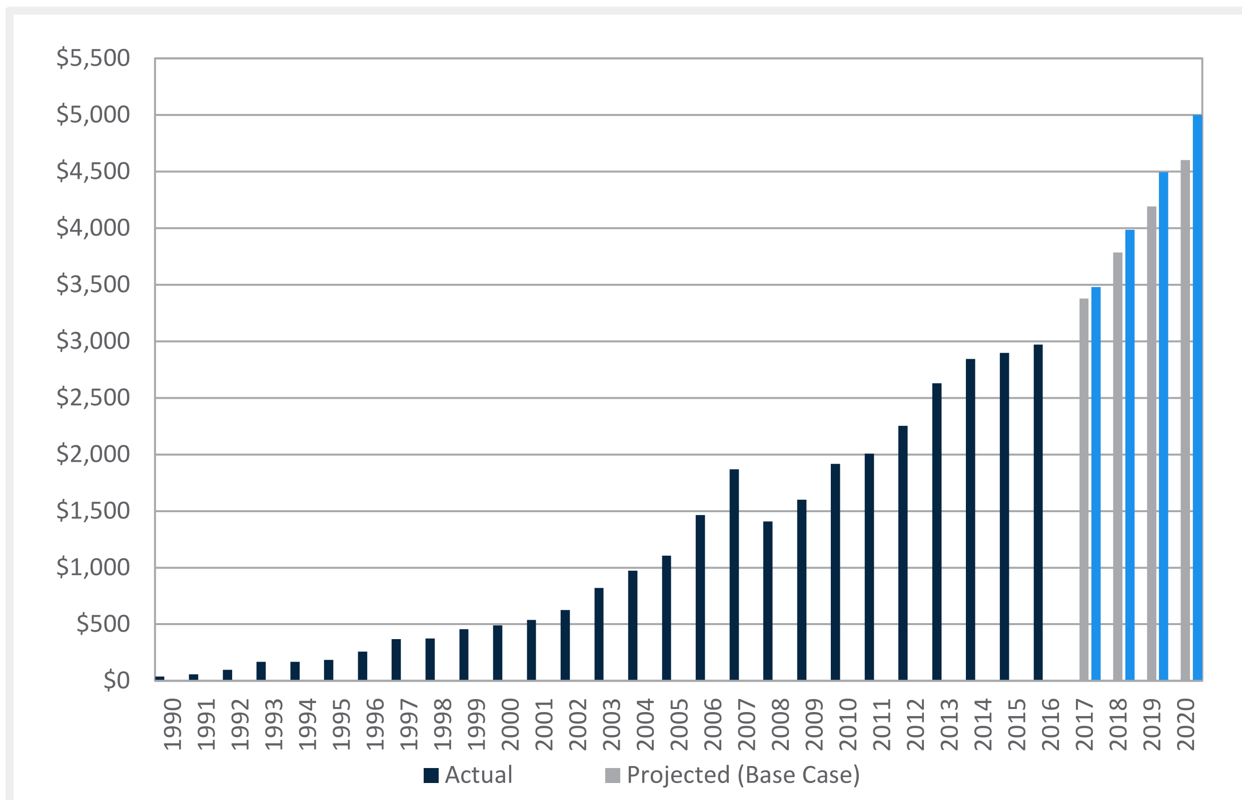
- Due to a multi-year period of sub-par performance, many hedge funds are liquidating or struggling to raise assets. This is particularly true for early stage hedge funds ("ESFs"). At the same time, there are high quality managers looking to start a hedge fund, especially those that have left funds that are closing down. Our experience shows that many of those managers have found that in order to attract a sufficient asset base to cover organizational expenses and be considered credible, they require the assistance of a seeder that can provide a critical amount of day one or early-stage capital. Consequently, we find the current market environment extremely attractive for seeders.
- A hedge fund seeding strategy may achieve a higher rate of return than an investment in a hedge fund or a fund of hedge funds due to the opportunity to participate in the seeded fund's revenue stream. We believe that the risk/return/liquidity profile of a seeding vehicle falls between funds of hedge funds and private equity funds. If an investor is willing to lengthen its investment time horizon, adding a hedge fund seeding strategy to an existing portfolio can potentially enhance returns, reduce overall portfolio risk and provide diversification benefits.
- We believe a hedge fund seeding vehicle is particularly appealing to investors who desire: 1) higher potential returns than a typical hedge fund portfolio; 2) exposure to ESFs; 3) pre-negotiated fund risk limits; 4) greater transparency than is typically provided by a traditional hedge fund; 5) opportunities for co-investment; 6) the ability to capitalize on the hedge fund industry's growth prospects; and 7) private equity-like returns with less risk and better liquidity. Investors considering a seed investment strategy should have a multi-year investment horizon and be willing to tolerate short-term volatility.
- The former team at Larch Lane Advisors (now part of Fiera Capital), is one of the first dedicated providers of hedge fund seed capital. The team has seeded 26 hedge funds through three distinct seeding vehicles and continues to be an active capital provider for the hedge fund industry.[1]
- This paper focuses on the potential benefits and process of providing seed capital to startup and ESFs through a hedge fund seeding vehicle. We present an overview of the hedge fund and seeding industry, the potential risks and the rewards of seeding, compare commonly used seeding models and explain why we believe that the current environment is attractive for seeding. A case study provides an overview of the process for identifying and structuring hedge fund seed transactions.

This paper is for informational purposes and should not be considered investment advice or solicitation to buy, or an offer to see, a security. Please refer to Endnotes and Important Disclosures at the end of this document.

INTRODUCTION

The hedge fund industry has grown substantially since 1990. Following an asset decrease in 2008 amidst the global financial crisis, growth swiftly resumed, with AUM for the hedge fund industry steadily rising to approximately $3 trillion (Figure 1).

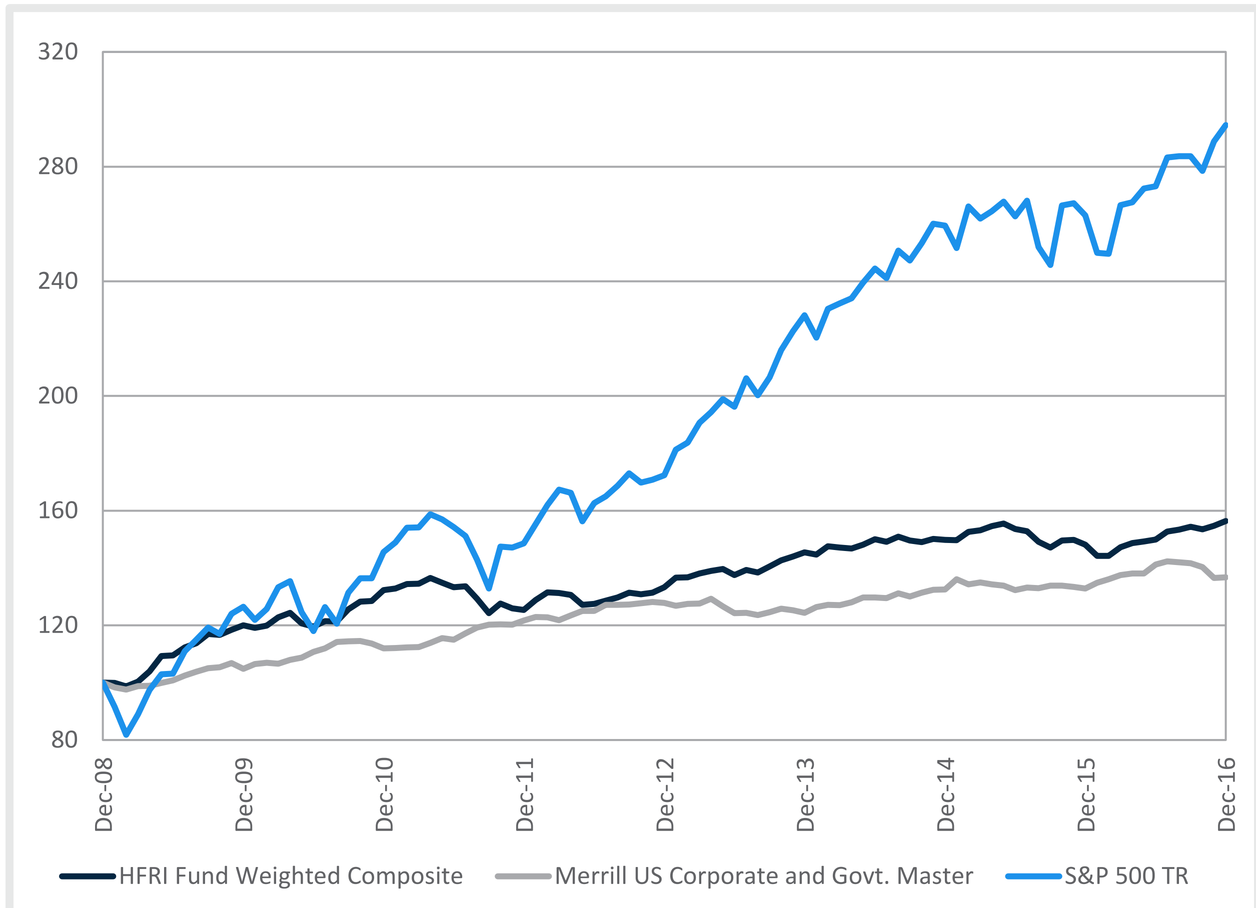
FIGURE 1: TOTAL HEDGE FUND INDUSTRY ASSETS



Sources: HFR (hedgefundresearch.com) for data 1990 through 2016. Projected Assets from PriceWaterhouseCoopers paper "Asset Management 2020" published 2015.

Hedge fund returns have trailed the S&P 500 since 2008 (Figure 2). Despite the fact that investment results have been sub-par when compared to the equity market returns, institutional investors steadily increased their hedge fund allocations in order to capitalize on the industry's attractive risk and diversification benefits[2]. Most of that AUM growth has been captured by larger, well established hedge funds. Today, many smaller ESFs are finding it extremely difficult to gain traction, and as a result are shutting down at the fastest pace since 2009.[3] This dynamic creates an opportunity for those willing to provide seed capital. In addition to seeding new funds, there are opportunities to provide "acceleration capital" to existing hedge funds facing liquidity or capital shortages. In short, like many industries, hedge fund seeding is cyclical. We consider this to be an extremely favorable stage in the seeding cycle.

FIGURE 2: COMPARATIVE PERFORMANCE



Source: Bloomberg. Please refer to Important Disclosures regarding Index Definitions.

OVERVIEW OF HEDGE FUND SEEDING

Investors can access hedge fund investment benefits through multiple strategies including direct investments, funds of hedge funds and hedge fund seeding vehicles. This paper focuses on the potential benefits and process of providing seed capital to hedge funds through a hedge fund seeding vehicle. We present the potential risks and rewards of seeding and compare commonly used seeding models. A case study provides an overview of the process for identifying and structuring hedge fund seed transactions.

Many factors influence the success of a new hedge fund, including a sound investment strategy, a talented team and robust operational infrastructure. However, even with these qualities, there is no guarantee that a fund will attract sufficient assets for survival. Most funds cannot launch with a large enough asset base to cover organizational expenses and be considered credible by many investors. There are distinct advantages for funds that can attract substantial client assets at inception:

- Increased focus on investment performance
- An early build out of personnel and operational resources, and
- Ability to take a longer term business and investment approach.

Historically, barriers to entry for new hedge funds were quite low, but after the extended period of under-performance, they are much steeper today. Investors expect greater transparency, better client service, well-known third-party service providers and high quality back office systems and personnel. Hedge funds are also subject to more regulation. Consequently, the cost of operating a hedge fund is much higher than in the past as managers have invested in improving business infrastructure to cope with an increasingly sophisticated client base and to adapt to new regulations.[4] Hedge funds must demonstrate practical controls and processes on day-one with a clear action plan for obtaining institutional infrastructure in the future.

Funds that do not attract significant assets at inception have several options. The manager can:

- Self-fund operations with the expectation the fund will attract capital once a quality track record exists
- Maintain a bare-bones operation, delaying new hires and support systems
- Seek a strategic partner ("seeder") who can provide a critical mass of capital.

If structured properly, both the fund's manager and the seeder can benefit from a seeding arrangement.

SEEDING RELATIONSHIP BENEFITS MANAGERS AND INVESTORS

By providing early-stage capital, seeders can be instrumental in the development of new and ESFs. A strategic and significant seed investment can help ESFs attract outside capital, perhaps serving as a "stamp of approval" and validating the fund's viability. We have found over our twenty-five years of investing in hedge funds that when an ESF has critical mass, others may be more willing to invest because they would no longer represent too large a share of the fund's assets. Also, many allocators have minimum asset level requirements that make it difficult for funds below a significant AUM level to attract new investors. Another benefit is that seed capital is generally committed for multiple years, giving the ESF a stable asset base to build on.

In addition to capital, seeders may offer ESFs strategic support in other areas. These may include assistance with business development, marketing, risk management and governance, as well as guidance on operations and business issues. The seeder's support lets the ESF focus primarily on investment performance at a critical juncture in the fund's existence.

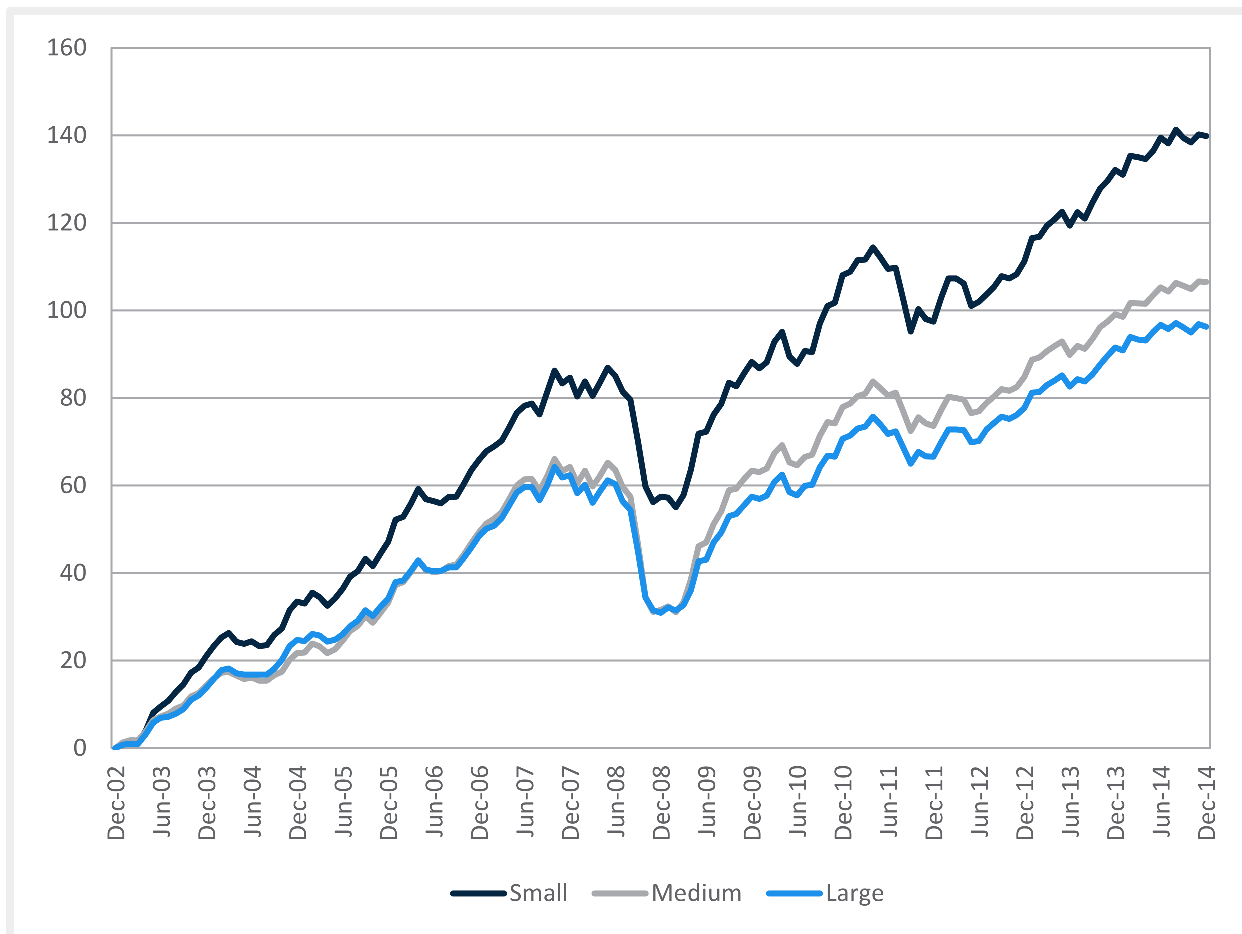
Seeders benefit as well. Providing early capital typically entitles seeders (both direct seeders and investors in seeding vehicles) to share in the ESFs revenue ("enhanced economics"). This participation can be quite rewarding and takes a number of different forms, which we discuss below (see "Enhanced Economics of Hedge Fund Seeding"). Seeders can also gain other advantages such as the extra return benefits of investing in ESFs, rights to future capacity, seeding rights for future funds, full transparency, risk controls and the potential to monetize their profit participation.

EXPOSURE TO EARLY-STAGE FUNDS

A number of research studies show that ESFs have consistently outperformed more established hedge funds, both on an absolute and a risk-adjusted basis. A 2015 study by eVestment finds that younger and smaller funds outperformed larger and older funds over the long term (Figures 3 and 4)[5]. Specifically, the eVestment study reveals that funds with less than $250 million in AUM outperformed funds with $250-$999mm AUM by 278 basis points annually over the 12-year period between 2003 and 2014, with similar volatility. The smaller funds outperformed $1+ billion funds by an even greater 363 basis points per year on average.

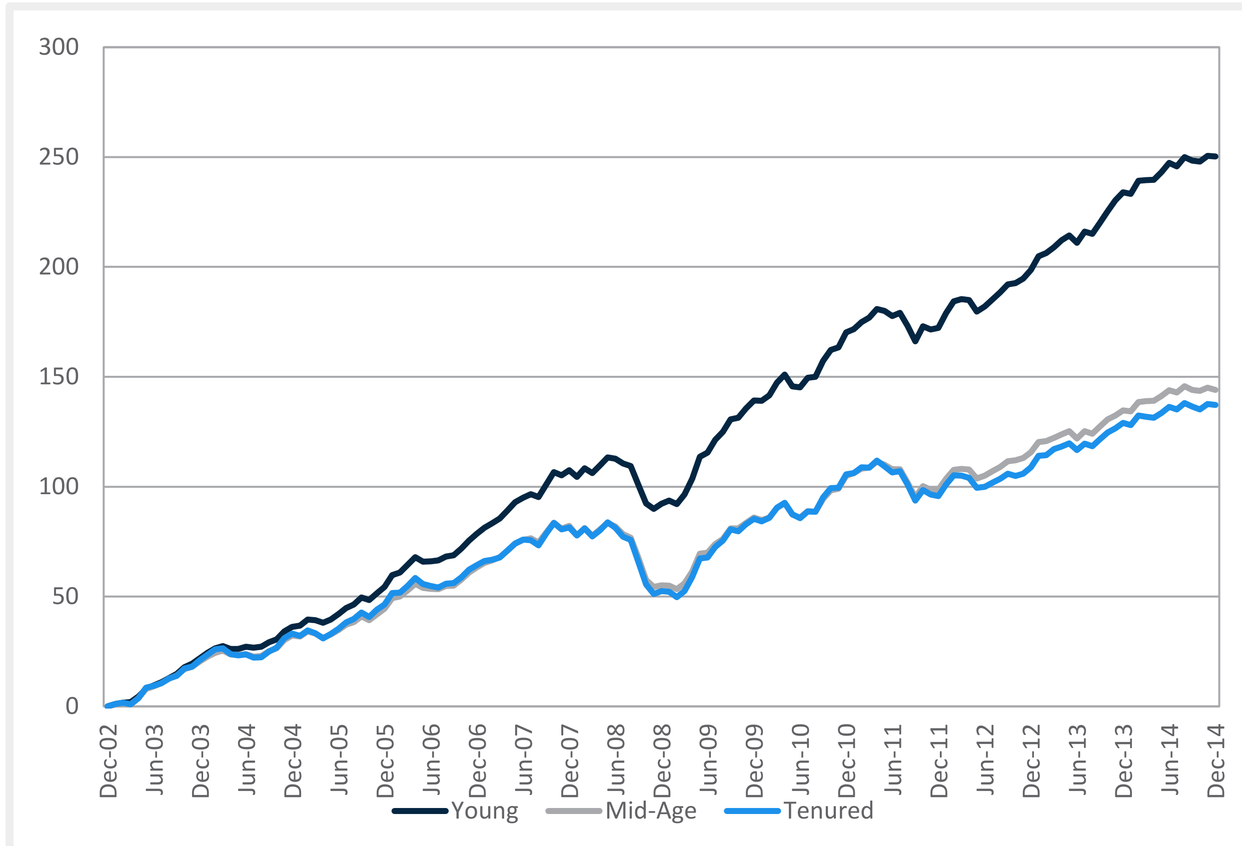
The same study finds that funds with less than a two-year track record outperformed older funds by over 9% annually, with similar volatility. On a cautionary note, research also found a somewhat higher mortality rate for new funds, primarily due to operational risks.[3] This speaks to the importance of careful manager selection discussed later in "Case Study: The Life of a Seeding Transaction."

FIGURE 3: HEDGE FUND PERFORMANCE BY MANAGER SIZE



Source: eVestment report "Impact of Size and Age on Hedge Fund Performance", 2015.

FIGURE 4: HEDGE FUND PERFORMANCE BY FUND AGE



Source: eVestment report "Impact of Size and Age on Hedge Fund Performance", 2015.

Another study, “The Performance of Emerging Hedge Fund Managers,” by Rajesh K. Aggarwal and Philippe Jorion, made a number of adjustments to raw performance data to mitigate these biases. This study also reached the conclusion that managers generate “abnormal” (excess) performance of 2.3% during their first two years relative to later years.[6]

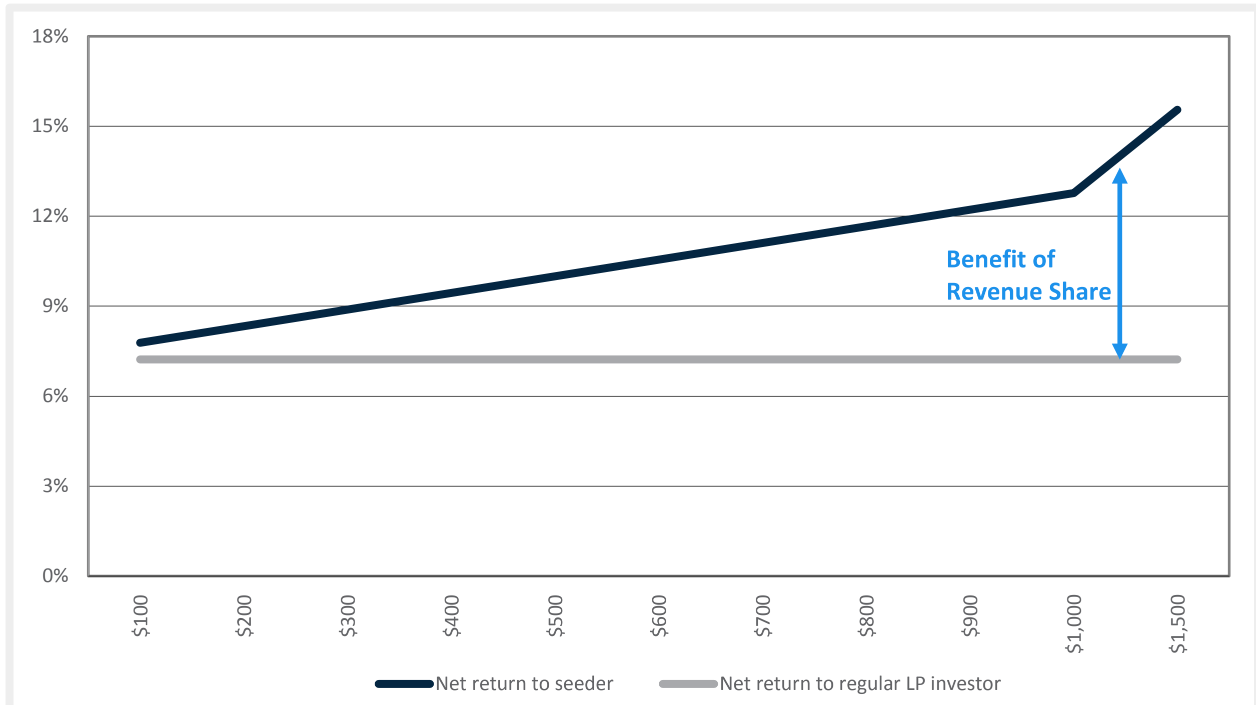
Thus, a number of independent studies have concluded that on average, ESFs outperform more established funds. Why? Our experience has shown that ESF managers may be highly motivated to outperform more established funds in order to attract assets and build a viable business. ESFs also tend to be more nimble because of smaller AUM. As a result, they may be better able to capture alpha by investing in “off-the-radar screen” securities that are simply too small for multi-billion dollar managers to invest in. Additionally, ESF managers may be able to trade into, and out of, positions more easily.

ENHANCED ECONOMICS OF HEDGE FUND SEEDING

A seeder’s return potential is greater than that of other investors in a hedge fund because the seeder receives a portion of the hedge fund’s revenue stream. Thus, the seeder’s return profile increases in tandem with the hedge fund’s asset growth.

The exact nature of the enhanced return varies substantially based on the terms of the seeding agreement. A seeder's participation can range from a simple fee discount to a majority stake in the manager's firm. Figure 5 compares the potential returns of a typical limited partner ("LP") in a hedge fund to those of a seeder who shares in the fund's gross revenues.

FIGURE 5: SEEDERS ENJOY ENHANCED RETURN OPPORTUNITIES



Source: Fiera Capital proprietary research. Net return to regular LP investor assumes a 10% gross return of the hedge fund LP interests with 1.5% management fee and 15% incentive allocation. Net return to seeder makes same assumptions, and also includes a 20% share of the seeded hedge fund's gross revenues, and 1.5% management fee and 20% incentive fee for the seed vehicle at various assumed hedge fund asset sizes up to $1.5 billion. The Illustration in Figure 5 is highly simplified and does not take into account the range of provisions possible in a seed agreement, such as limitation on the seeder's share of management fees above or below certain asset levels or reduction of a gross revenue share for management company expenses. This example also assumes the seeder keeps the original capital fully invested with the manager. However, in a typical seed deal, the seeder commits for a limited period of time (usually multiple years) after which the seeder has the right to withdraw the investment while retaining the economics. ***There is no guarantee that any of these return streams will be positive (or how big the streams will be) or, when the return streams would be generated, if at all. Inherent in any investment is the potential for loss.*** *For important information regarding the calculations in the chart above, please refer to endnote 7.*

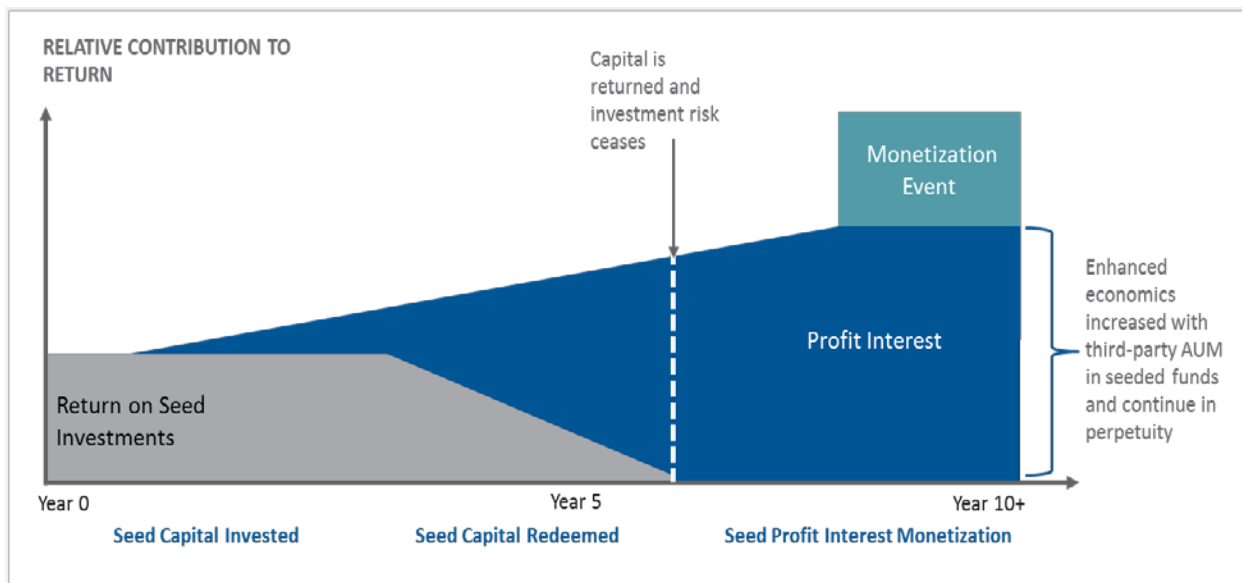
As shown in Figure 5, the net return on investment to a seeder is always higher than that of a regular LP in the same fund. Even in unusual cases where no additional third-party assets are raised, the seeder generally receives an effective fee rebate through a share of the management and incentive fees applied to the seed capital. (For a more detailed comparison of returns for a typical hedge fund investor and a hedge fund seeder, please see the Appendix.)

MANAGER PERFORMANCE DRIVES DUAL RETURN COMPONENTS

A seed investment incorporates two components of return – investment performance and enhanced economics. Obviously, investment performance depends on manager skill. Perhaps not as evident, but equally important is the connection between manager skill and enhanced economics. Enhanced economics depends on asset growth and, as with most investment vehicles, hedge fund asset growth tends to be highly correlated to performance. Managers with below- average performance will deliver neither the investment returns, nor the asset growth necessary for a successful seed investment. Therefore, seeding only managers with the ability to generate attractive risk-adjusted returns is essential.

Figure 6 shows how the return composition of a successful seed investment varies over time. Typically, in the first several years after seeding a fund, the fund's performance provides the vast majority of the investor's return. Over time, as the fund's AUM grows, more of the return comes from enhanced economics. In many cases, the seeder continues to receive enhanced economics even after redeeming the initial seed capital. These annuity-like payments may continue as long as the seeded manager continues to run a profitable firm. Also, depending on the deal terms, there may be a provision for the manager to buy out the seeder's interest or for the seeder to participate in a "monetization event" such as a sale or public offering of the fund. This event could significantly enhance the seeder's return.

FIGURE 6: COMPOSITION OF A SEEDER'S RETURN OVER TIME



Source: Fiera Capital proprietary research. For illustrative purposes only. Actual results will vary from fund-to-fund. This chart is highly simplified and meant to delineate a seeder's investment return into its key components. It depicts a hypothetical example of the amount and timing of three sources of a seeder's returns (the seed investment return in grey, the enhanced economics in blue and the seed monetization event in green). ***There is no guarantee that any of these return streams will be positive (or how big the streams will be) or, when the return streams would be generated, if at all. There can be no assurance that a seed investor will realize such any benefits or that a seeded hedge fund will be able to raise capital. Inherent in any investment is the potential for loss.***

WHERE DOES THIS STRATEGY FIT IN A PORTFOLIO?

Like hedge funds and private equity funds, a hedge fund seeding vehicle fits into a portfolio's alternative investment allocation. However, because seeding vehicles have characteristics of both hedge funds and private equity funds, determining their proper role in an investor's portfolio requires careful consideration of factors such as return potential, investment risk and liquidity. On an efficient frontier, we believe the risk/return profile of a seeding vehicle falls between funds of hedge funds and private equity funds.

DIVERSIFICATION BENEFITS

When investors analyze a hedge fund seeding strategy, it is important to consider the likely correlation of the investment to the rest of their portfolio. A group of ESFs is likely to add diversification to an existing portfolio of more established hedge funds. ESFs typically have portfolios that are substantially different than more established hedge funds. For example, as discussed above, ESFs can invest in smaller, "less crowded" securities. Consequently, adding a hedge fund seeding strategy to an existing portfolio can potentially enhance returns and reduce overall portfolio risk.

LIQUIDITY

There are several layers to a hedge fund seeding investment and each has a different liquidity profile. First, there is the liquidity of the seeding vehicle; next, the liquidity of the investment in the seeded hedge funds; and finally, the liquidity of the individual hedge funds' holdings.

Most hedge fund seeding vehicles require capital to be invested for an extended period, typically three to four years. This time frame is necessary because the seeding vehicle, in turn, commits capital to seeded managers for multiple years. If the seeding vehicle combines multiple seed investments in a single portfolio, it may take several years to identify and negotiate deals with a high quality group of managers. In such cases, investors may agree to a staggered investment schedule, committing to an investment amount from which capital is drawn as seed deals are finalized. Specific liquidity terms vary depending on the structure of the seeding vehicle.

A seeding vehicle commits capital to individual hedge funds for a certain number of years and as those commitment periods expire, money is available to be reinvested or returned to investors in the seed vehicle. If reinvested, the money may be subject to the standard liquidity terms of the seeded hedge fund.

The fact that seeded hedge funds typically hold liquid securities distinguishes seeding vehicles from private equity funds, where the underlying investments are normally illiquid. The sponsor of the seeding vehicle can further improve liquidity by negotiating the right to redeem the seeded assets early if the seeded hedge fund violates certain terms, such as risk constraints or drawdown limits. For these reasons, a seeding investment is more liquid than a private equity fund and, in some cases, may offer even more liquidity than funds of hedge funds.

The ability of the seeder to mandate and enforce portfolio risk constraints provides added accountability and may improve overall liquidity. In 2008, some hedge fund managers strayed from their stated investment strategies, investing in illiquid asset classes that exacerbated losses and created fund gates

and suspensions. This is less likely to happen when the manager of a seeding vehicle is monitoring the portfolio and has the right to redeem from that fund if any risk constraints or other contractual terms are violated.

RISK AND LIQUIDITY ADVANTAGES OF SEED FUNDS

Another way to look at risk and liquidity is to compare seeding vehicles to traditional private equity. Figure 7 shows how hedge fund seeding vehicles compare to other alternative investments in terms of liquidity, investment risk and correlation to traditional investment assets. We believe the added return from enhanced economics is more than enough to compensate hedge fund seed investors for reduced liquidity relative to direct hedge fund investing. In fact, we believe hedge fund seeding vehicles may offer higher return potential precisely because they fill a liquidity gap between private equity and hedge funds. Importantly, the revenue share to investors in seed funds continues even after their capital is withdrawn from the seeded hedge fund. This provides an effective "risk free" return stream, which is not captured in an IRR calculation. Investors who are willing to consider an opportunistic strategy that does not fit neatly into a pre-defined investment silo can reap ample rewards.

FIGURE 7: RISK AND LIQUIDITY CHARACTERISTICS OF VARIOUS ALTERNATIVE INVESTMENTS

STRATEGY	TYPICAL LOCKUP PERIOD	LIQUIDITY OF UNDERLYING ASSET	INVESTMENT RISK (VOLATILITY)	CORRELATION TO TRADITIONAL ASSETS
Venture Capital	10+ years	Less Liquid	High	High
Infrastructure	10+ years	Less Liquid	High	High
Private Equity	5+ years	Less Liquid	High	High
Hedge Fund Seeding	3-4 years	Varies	Low/Medium	Low/Medium
Passive Hedge Fund of Fund Investing	Varies	Varies	Low	Low/Medium

Source: Fiera Capital, Institutional Investor, Pensions and Investments, EnnisKnupp

COMMON SEEDING MODELS

REVENUE SHARING

Thus far this paper has focused on seeding deals in which the hedge fund manager provides a perpetual revenue share in exchange for seed capital. In a revenue sharing arrangement, the manager agrees to share a certain percentage of management and/or incentive fees in exchange for a capital commitment. The investor does not explicitly obtain an ownership stake in the business. The revenue share can be structured as an allocation from the underlying hedge fund or as a payment from the management entity. Other seeding models are available and though a detailed discussion is beyond the scope of this paper, we have provided a brief summary of two common approaches:

EQUITY OWNERSHIP

The seeder provides capital in exchange for equity ownership in the manager's business and typically takes an active partnership role. Considerations in this arrangement include the deployment of the capital (which can be seeded into the manager's hedge fund or invested directly into the management company), the level and nature of the seeder's participation in the manager's business and the potential tax consequences of being an active participant, rather than a passive investor.

PLATFORM PROVIDERS

A number of large, established hedge funds and financial institutions offer ESFs a "turnkey" solution. The sponsor provides an investment platform, marketing and operational support and seed capital. In return, the platform provider typically receives a significant share of the manager's profits. This arrangement lets managers quickly begin implementing their strategy and focusing on investment performance. It also may give them an attractive base salary or draw, but the managers are not truly running the fund as an independent business.

In all seeding models, the manager and the seeder must negotiate a wide range of terms. Each model has advantages and disadvantages and the best solution depends on the preferences of the parties involved in the deal. Each model also involves different tax considerations, although discussion of these tax consequences is beyond the scope of this paper. Figure 8 summarizes the main considerations for the three seeding structures described above.

FIGURE 8: COMPARISON OF HEDGE FUND SEEDING MODELS

SEED MODEL	PROS AND CONS FOR MANAGER	PROS AND CONS FOR SEEDER
EQUITY OWNERSHIP	**PROS:** ▪ Maintain some independence and build franchise value ▪ Input and assistance in building business	**PROS:** ▪ Ability to exert control over manager's business ▪ Participate in manager's success while allowing manager some independence
	CONS: ▪ Capital may not be invested directly in the fund ▪ More intrusive than pure revenue sharing	**CONS:** ▪ Capital covers management company expenses; more dependent on growth in third party assets ▪ Potential liability and regulatory reporting issues ▪ Potential tax consequences of active participation
REVENUE SHARING	**PROS:** ▪ Maintain full independence and build franchise value ▪ Autonomy over business/least intrusive ▪ Future funds and strategies may not be affected	**PROS:** ▪ Capital exposed to investment strategy return potential ▪ Portfolio risk controls ▪ Independence from management company
	CONS: ▪ Minimal support aside from capital ▪ Manager is typically responsible for management company expenses prior to calculation of revenue share	**CONS:** ▪ Limited or no control over manager's business decisions ▪ Limited portfolio level control
HEDGE FUND PLATFORM	**PROS:** ▪ Immediate access to significant capital ▪ Access to operational and marketing infrastructure ▪ Lower business risk	**PROS:** ▪ Direct control and oversight over all aspects of manager's investment process and business ▪ Best liquidity profile
	CONS: ▪ No independent business ▪ May not have complete investment autonomy ▪ Potential difficulty in separating from the platform provider ▪ Competition for platform providers' resources	**CONS:** ▪ Resource intensive ▪ No separation of liability

Source: Fiera Capital Analysis.

CASE STUDY: THE LIFE OF A SEEDING TRANSACTION

Initiating, executing and monitoring a hedge fund seeding transaction is a complex undertaking. Experience is vital to a smooth and ultimately successful investment. While many fund of fund firms allocate capital to established hedge funds, the universe of dedicated seed capital providers is much smaller. The Fiera Capital team from Larch Lane has been providing seed capital to hedge funds since 2001 and the firm's principals have invested in early-stage funds for more than 25 years. The team launched three seeding vehicles that are now fully invested and have seeded 26 funds. They have acquired a knowledge and experience base unique among their peers, having managed these seeding vehicles and their underlying investments through various life cycles. They will continue to use this experience to refine and improve future seeding funds.

The following case study presents a start-to-finish look at the life cycle of a seeding transaction, using key aspects of Fiera Capital's seeding process to highlight important investor considerations.

SOURCING

A hedge fund seeding transaction begins in the same manner as any other hedge fund investment. The first step is to identify prospective fund candidates. Sourcing prospects is an important component of the seed investment process and requires a strong network and specialized contact points outside the traditional hedge fund business.

Fiera Capital at Work: We rely on our industry reputation and an extensive network of industry contacts that help us identify promising new launches. We typically see a number of candidates who are identified through existing fund contacts, former colleagues, other investors, service providers and broker referrals. For example, prior seed deals have been referred to us by industry contacts, brokerage firms, and other seeded managers.

INVESTMENT PROCESS DUE DILIGENCE

No amount of enhanced economics or deal structuring makes up for mediocre investment results. First and foremost, the seeded fund has to have the ability to generate attractive risk-adjusted returns and its manager must be able to run a successful alternative asset management business.

Though similar to the investment due diligence process for traditional hedge fund investments, choosing funds to seed is more challenging because prospective funds typically have shorter track records and fewer resources. Effective selection must consider the management team's quality, investment experience and business management skills, the nature of the investment strategy and execution process, portfolio risks and the risk management process and trading capabilities. Developing a strong proof statement and conviction in the fund's ability to generate good risk-adjusted returns is critical.

Fiera Capital at Work: Our process starts with a series of extensive in-person meetings, reference checks and other qualitative due diligence techniques. We have found that references (provided by the manager

and from our own industry contacts) play an especially significant role in evaluating the team's investment acumen and ability to build a successful asset management business.

For example, in one of our prior seed deals, the principals worked at a large, well-established hedge fund. However, the principals did not have an identifiable track record due to the prior firm's decision making structure. To ascertain the investment acumen of the principals, our investment team spoke with supervisors and co-workers from prior employers, managers from companies where the principals had led investments and professionals at other investment firms who had worked with one or more of the principals. These inquiries across varied channels generated a consistent picture of talented, ethical investment professionals with complementary skills. The strength and consistency of these references gave us the conviction needed to complete the seeding transaction.

REFERENCE AND BACKGROUND CHECKING

Mark Twain is reported to have once said that history does not repeat itself, but it sure does rhyme a lot. We believe that saying applies to people as well. We engage in extensive reference checking because it tells us how an individual has behaved in the past, but more importantly, provides indispensable insight into how the individual is likely to behave in the future. We place great value on the manager's past actions, both in terms of investment acumen and integrity. References from peers, counterparts and clients quickly raise any warning flags such as exaggerated past performance or other integrity issues. We also require third party background checks on all principals of a prospective seed fund.

Fiera Capital at Work: We begin reference checks with a list from the manager, while also identifying multiple off- list references through our own extensive network. We expect on-list references to be the strongest (though some fall surprisingly short), but we often gain greater insight from off-list references. In addition to managers' colleagues and service providers, we also try to include professional investors who have had prior dealings with the prospective firm's principals. These sources are useful for past investment reviews and for projecting future fundraising potential. In our experience, investor references that point to a manager as a driver of a prior firm's success are a good indicator of a potentially successful seed investment.

OPERATIONAL DUE DILIGENCE

Some widely publicized hedge fund frauds have underlined the importance to investors of hedge funds having a strong operational infrastructure. As a seeder, a thorough operational review of the underlying seed fund is critical for two key reasons: 1) more hedge funds fail due to poor business infrastructure than poor investment decisions,[8] and 2) studies show that the higher failure rate of ESFs compared to established funds is often due to business rather than investment issues.[9]

While ESFs may be held to different operational standards than established funds, the minimum acceptable standard for any hedge fund has risen. ESFs may not yet have dedicated, full-time compliance officers and technology professionals, but they are expected to have in place codified policies, controls and systems that are adequate for their current business and consistent with any legal or regulatory

requirements to which they are subject. They are also expected to have relationships with reputable service providers.

We evaluate, and frequently advise on, the operational infrastructure of prospective seed managers. We require a seeded fund to meet our standards in the following areas:

- Governance structure and decision making processes;
- Compliance policies and procedures, particularly valuation procedures;
- Day-to-day operations;
- Third party service providers (audit, administration, prime brokerage, custodians, legal counsel); and
- Internal controls, particularly cash controls.

Fiera Capital at Work: In our experience, managers with diverse prior experience – knowledge of back office systems, trading and accounting procedures and client reporting – are better equipped to build an operational infrastructure. Therefore, we place a premium on managers with prior hedge fund experience. We also think a manager's ability to select and work with professional service providers, such as administrators, prime brokers, accountants and lawyers, is a critical indicator of the firm's future prospects. We have assisted in evaluating and selecting reputable third party service providers and may also assist a manager in securing a prime broker.

STRUCTURING A TRANSACTION

While many seeders have their own standard agreement and structure, each seed transaction is unique based on the management team, the seeder's expectations and the investment strategy to be pursued. The categories discussed here pertain to most seed transactions regardless of structure.

We have found that the deal structuring negotiations serve as a useful extension of the due diligence process. How potential seed managers negotiate terms and the relative emphasis placed on particular terms provide insight into their business acumen and motivation. The negotiation process also provides a glimpse into the ongoing interactions after the seed investment is made.

Although there are many facets to every seeding transaction, we focus on two primary features: economics and risk controls.

ECONOMICS

The economic terms of seed transactions are among the most sensitive and are generally kept confidential. We have seen revenue shares ranging from 10% to 40% or more. Where a given seed transaction falls within that range depends on many factors including the amount of capital provided, liquidity terms, seed fund capacity, strategy, team experience, negotiation skills and competition.

Fiera Capital at Work: We are convinced that the long-term success of a seed investment depends on balanced economics. The seeder must receive adequate compensation for the capital commitment and the risks taken. On the other side, the principals and their team drive the return on the seed investment, so the seed agreement must provide incentives for them to build a competitive track record and a

sustainable investment platform. An economic structure that fairly compensates the seeder and the manager for the resources each brings to the transaction better ensures a win-win outcome for all parties.

We carefully negotiate the terms of every seed agreement, seeking the terms most conducive to a successful venture. For example, we have negotiated back-weighted economics to better support the build out of management company resources. We have also adjusted buy-out formulas to take into account potential volatility in a strategy and we have permitted funds to return seed capital early to promote earlier fundraising.

RISK CONTROLS

Controls on fund activities are intended to define the 'bucket of risk' attached to the investment. Unlike investors in passive hedge funds where offering memoranda typically allow extremely broad latitude, seeders can negotiate real limitations on the risks that the seeded fund can take. These risk controls are tailored to the strategy and the manager's particular investment approach. Examples can include drawdown limits, exposure limits, position liquidity limits, allowable securities or instruments and value at risk ("VAR") limits.

Once controls are set, the seeded fund must provide reporting and transparency, while the seeder must continuously monitor to ensure that limits are adhered to. The relationship between the seeder and the seeded fund is an evolving one. Adjustments to risk constraints are possible as the seeder works collaboratively with management teams to respond to changing investment environments and opportunities.

Fiera Capital at Work: We initiate risk control discussions by requesting that managers provide a vision for the controls that will be applied to their strategy. This approach offers two key benefits. First, we gain insight into the manager's risk appetite and philosophy. Second, we can use the information to design appropriate controls that do not adversely affect the manager's investment style. In addition to investment risk controls, we also apply an overall "drawdown limit" to the seed investment. This limit allows seed capital to be withdrawn if the strategy suffers a loss that significantly impairs the option value of future enhanced economics. The stop-loss mechanism is generally calibrated to the volatility expectation for the strategy, thus allowing the manager to effectively pursue the investment strategy. Because the early withdrawal of seed capital can have a significant impact on the seeded fund and the option value of the seed, any decision to withdraw capital requires significant consideration.

ONGOING RELATIONSHIP

Once the seed investment is made, the parties enter a multi-faceted business relationship. One facet is the continual monitoring of the seeded fund and management to ensure adherence with the agreement, particularly the risk parameters. Typically, management provides enhanced transparency into portfolio holdings and accounting records to facilitate monitoring. Because asset growth is necessary for a successful seed transaction, capital raising is a critical component of the ongoing seed relationship. In the platform model, the seeder largely drives marketing and capital introductions, while seeders using other models can take a more passive role.

Fiera Capital at Work: In our transactions, managers generally have broad flexibility to direct their activities. However, in the role of protecting our seed investments, we provide solicited and unsolicited advice to our managers. Having invested in hundreds of hedge funds and seeded 26, we have a base of knowledge and experience that benefits our seed investments as well as the seeded managers. By pointing out the achievements and mistakes we have witnessed, we may help our managers attain similar success and avoid similar missteps.

ENDING THE SEEDING RELATIONSHIP

All seed transactions must plan for the end of the relationship. Such planning includes (a) defining the circumstances or events that allow parties to separate, (b) outlining the economic effects of the separation and (c) specifying any continuing duties or obligations between the parties. Below are a few situations to be anticipated and their related issues.

CAPITAL EXIT

Seed capital is committed for a defined time period to provide stability and promote the seeded fund's growth. By its nature, seed capital initially represents a significant portion of the fund's assets. If seed capital remains a significant portion of the fund's total assets at the expiration of the seed commitment, the seeder and manager must manage the liquidity event, possibly even maintaining seed capital investments beyond lock-up, to avoid weakening the fund or inhibiting its growth.

COMPLETION OF THE TRANSACTION

Seed relationships that terminate as a result of "normal" contemplated events (the exercise of a negotiated buy-out, the achievement of certain return hurdles or the term expiration) generally result in a clean separation of the parties, leaving few, if any, continuing obligations.

It is important to note that the term of the seed capital investment and the revenue participation are not necessarily tied. In many seeding models, the completion of an investment term and withdrawal of seed capital does not end the enhanced economics. This provides for a "risk free" revenue stream that may exist in perpetuity, subject to the revenue share being sold (ie. A monetization event which the investor is also entitled to share in).

EARLY TERMINATION BY MANAGER

A manager could end the seed relationship for any number of reasons, including lack of investment opportunities for the specific strategy, lack of fund growth and insufficient revenue for the management team. This is a painful option for the manager and can be accomplished only through dissolution of the seeded fund and/or the management company. Typically seeded managers are subject to non-compete restrictions.

EARLY TERMINATION BY SEEDER

The primary method for a seeder to end a relationship is to withdraw capital due to occurrences such as breach of a covenant or risk constraint. In such situations, the seeder must consider the potential impact of the capital withdrawal. We have developed risk monitoring and reporting systems to track pre-

determined risk constraints. If the manager violates any of these risk constraints, we build in a mechanism to redeem. In many cases, the early withdrawal of seed capital leads to the demise of the fund, especially if it has not yet raised significant external capital. Therefore, the seeder must weigh the seriousness of the breach against the strength of the manager's strategy and the desire to continue participating in future economics.

Fiera Capital at Work: Because we value our reputation as an effective and fair business partner, we are careful to manage the timing of our exit from any seed transaction in order to preserve the franchise value.

We explain below the steps that we believe are the foundation of a successful seed investment.

EXECUTING A SUCCESSFUL SEED INVESTMENT

STEP 1

SOURCE MANAGER CANDIDATES

Find candidates through:
- Existing manager contacts
- Former colleagues
- Investors
- Broker referrals

STEP 2

CONDUCT INVESTMENT DUE DILIGENCE

Select managers are able to generate attractive returns based on:
- Management team quality
- Investment experience
- Trading capabilities
- Business management skills
- Investment strategy and execution process
- Risk management process

STEP 3

CHECK REFERENCES

Contact manager-provided and off-list references
- Colleagues, current and former
- Service providers
- Other professional investors

STEP 4

REVIEW OPERATIONAL FRAMEWORK

- Governance and decision making
- Compliance policies/procedures
- Daily operations
- Third party service providers
- Internal controls

STEP 5

STRUCTURE TRANSACTION

Primary considerations
- Economics
- Risk controls
- Fund and management structures

STEP 6

FOSTER PRODUCTIVE RELATIONSHIPS

Capital entry
- Lump sum investment
- Capital provided at manager request

Monitoring seeded fund
- Daily position reports
- Adherence to risk limits
- Monthly portfolio update calls

Raising assets
- Confirm asset growth targets

FINAL STEP

END SEEDING RELATIONSHIP

Anticipate economic effects of separation scenarios:
- Capital exit
- Transaction completion
- Early exit by manager
- Early exit by seeder

CONCLUSION

The prospective investors for a seeding strategy may be a select group, but those who are willing to consider an investment strategy such as this – outside their traditional framework – may reap ample rewards:

- The return potential from ESFs can provide attractive investment results.
- Seeders and investors in seeding vehicles can earn higher returns than regular investors in the same hedge fund by sharing in the economics of the hedge fund manager.
- To the extent that a seeded fund attracts significant outside assets, the seeder's enhanced economic rights can significantly increase return.
- Hedge fund seeding vehicles are a practical, professionally managed option for institutions and individuals seeking to profit from the many available seeding opportunities.

We believe a hedge fund seeding vehicle is particularly appealing to investors who desire:

- Greater potential returns than a typical hedge fund portfolio;
- Exposure to ESFs;
- Diversification of a large multi-manager portfolio;
- increased transparency and better risk controls than a typical hedge fund would offer;
- Interesting co-investment opportunities;
- An ability to capitalize on the hedge fund industry's growth, not just its return potential; and
- Private equity-like returns with better liquidity.

Our analysis suggests that seeding vehicles fall between hedge funds of funds and private equity funds in terms of reward/ risk and liquidity. Investors considering a seed investment strategy should have a multi-year investment horizon and be willing to tolerate potential short-term volatility.

No seeding investments and no two seeding vehicles are identical. Every transaction is a highly structured, carefully negotiated deal. In the end, the success of individual seed investments and the performance of seeding vehicles depend on many factors, most notably, prudent manager selection, fair and informed negotiations and effective implementation. When evaluating a seeding vehicle, carefully consider the sponsor's history because prior seeding experience adds value at every stage of the process.

Based on the dynamics in the hedge fund industry that we have previously highlighted, it is clear to us that there is a shortage of capital available to new and ESFs. Meanwhile, the quality of new hedge funds we have recently seen seeking seed capital is significantly higher than we have seen in the recent past. Consequently, we find the current market environment extremely attractive for seeders. Investors who believe hedge funds will resume their growth trajectory and continue to play an important role in the investment landscape should consider a seeding vehicle as a way to capitalize on the industry's recovery.

APPENDIX

ILLUSTRATION OF SEED ECONOMICS

	SEED CAPITAL PROVIDER				
	NON-STRATEGIC INVESTOR	$200MM AUM GROWTH	$400MM AUM GROWTH	$900MM AUM GROWTH	$1,400MM AUM GROWTH
Capital Invested	$5,000,000	$100,000,000	$100,000,000	$100,000,000	$100,000,000
Current Fund AUM	$500,000,000	$300,000,000	$500,000,000	$1,000,000,000	$1,500,000,000
Seed Capital Provider's Share of Gross Revenues	N/A	20.00%	20.00%	20.00%	20.00%
Management Fee	1.50%	1.50%	1.50%	1.50%	1.50%
Incentive Fee	15.00%	15.00%	15.00%	15.00%	15.00%
Gross fund return	10.00%	10.00%	10.00%	10.00%	10.00%
(Less management fee)	8.50%	8.50%	8.50%	8.50%	8.50%
Incentive Fee	1.28%	1.28%	1.28%	1.28%	1.28%
Net fund return	7.23%	7.23%	7.23%	7.23%	7.23%
Return on capital invested ($)	$361,250	$7,225,000	$7,225,000	$7,225,000	$7,225,000
Management Fee Share	N/A	$900,000	$1,500,000	$3,000,000	$4,500,000
Incentive Fee Share	N/A	$765,000	$1,275,000	$2,550,000	$3,825,000
Total return on investment ($)	$361,250	$8,890,000	$10,000,000	$12,775,000	$15,550,000
Total return on investment (%)	7.23%	8.89%	10.00%	12.78%	15.55%

Source: Fiera Capital proprietary research. For illustrative purposes only. Net return to regular LP investor assumes a 10% gross return of the hedge fund LP interests with 1.5% management fee and 15% incentive allocation. Net return to seeder makes same assumptions, and also includes a 20% share of the seeded hedge fund's gross revenues, and 1.5% management fee and 20% incentive fee for the seed vehicle at various assumed hedge fund asset sizes up to $1.5 billion. ***There is no guarantee that any of these return streams will be positive (or how big the streams will be) or, when the return streams would be generated, if at all. There can be no assurance that a seed investor will realize such any benefits or that a seeded hedge fund will be able to raise capital. Inherent in any investment is the potential for loss.*** *For important information regarding the calculations in the table above, please refer to endnote 7.*

FIERACAPITAL

ENDNOTES

[1] On September 1, 2016, Fiera Capital Inc. assumed all of the assets of the advisory business of Larch Lane Advisors LLC (“Larch Lane”), including all of Larch Lane’s duties, obligations, liabilities and rights under Larch Lane’s advisory contracts with its Clients. Although the Investment Committee associated with Larch Lane’s portfolios and products has changed as a result of the transaction, the portfolio management team running these portfolios and products of Larch Lane on a day-to-day basis before and after the transaction is the same.

Affiliates of Larch Lane previously acted as general partner and investment manager for Hedge Fund Investment Company, L.P. and HFIC Offshore, Ltd. (together, “HFIC I”), which were liquidated as of December 31, 2013. Larch Lane previously acted as investment manager for HFIC II Offshore, Ltd. (“HFIC II Offshore”), which was liquidated as of August 29, 2013 in connection with a transfer of certain investors into Hedge Fund Investment Company II, L.P. (“HFIC II Onshore” and, together with HFIC II Offshore, “HFIC II”). Fiera Capital Inc. ("Fiera Capital") and its affiliates currently act as investment manager and general partner, respectively, for HFIC II Onshore. Fiera Capital manages Select Plus Onshore Fund, L.P. (“Select Plus Fund”) as the sub-adviser to a management company established by Fiera Capital and PineBridge Investments LLC (“PineBridge”) in a joint venture. An affiliate of Fiera Capital and PineBridge also acts as the general partner for the Select Plus Fund.

[2] According to a July 24, 2016 report produced by the Financial Times “the number of pensions investing in hedge funds increased year over year from May 2015 to 2016.

[3] According to a Credit Suisse report from December 9, 2016, “hedge fund liquidations seem to be en route to outpace launches by the widest margin since 2009.” Morgan Stanley Prime Brokerage report entitled “Start-up & Seeding Environment,” December 2016

[4] According to Preqin’s 2016 Global Hedge Fund Report

[5] According to eVestment report “Impact of Size and Age on Hedge Fund Performance” 2015 Edition published in July 2015.

[6] “The Performance of Emerging Hedge Fund Managers,” by Rajesh K. Aggarwal and Philippe Jorion. American Finance Association Meeting Paper. January 23, 2008, page 30.

[7] The following equation is used to calculate the data in Figure 5 and in the table “Illustration of Seed Economics” in the Appendix.

GR = Gross Return of Fund

MF = Fund Management Fee

IF = Fund Incentive Fee

RS = Revenue Share received by seeder

AR = Ratio of non-seed assets to seed capital invested= (Third-party capital ÷ Fund AUM)

Return to Seeder can be calculated as follows:

R= {Fund Net Return} + {Management Fee Share} + {Incentive Fee Share}

R = [(GR-MF) x (1-IF)] + [RS x MF x (1+AR)] + [RS x ((GR-MF)x IF) x (1+AR)]

[8] “Valuation Issues and Operational Risk in Hedge Funds,” by Christopher Kundro and Stuart Feffer, Journal of Financial Transformation, 2004, vol. 10, pages 41-47.

[9] “Quantification of Hedge Fund Default Risk.” Christory, Daul and Giraud, 2007. EDHEC Risk and Asset Management Research Centre. 1 Larch Lane acts as the investment manager for Hedge Fund Investment Company L.P. and Hedge Fund Investment Company Ltd. (“HFIC I”) and HFIC II, LP (“HFIC II”) and an affiliate acts as the general partner and investment manager for HFIC I. Larch Lane also acts as the investment manager for HFIC II, Ltd. (“HFIC Offshore”), which generally conducts investment activity in parallel with HFIC II. The hedge fund seed deals represent hedge fund seeding activities conducted through HFIC I, HFIC II, HFIC Offshore and with advisory clients.

IMPORTANT DISCLOSURES

GENERAL DISCLOSURES

This material is proprietary to Fiera Capital Inc. (“Fiera Capital”). This document is intended for information purposes only and may not be relied upon in evaluating the merits of investing in any Fiera Capital investment vehicle or portfolio.

The information provided reflects Fiera Capital’s views as of the date of this presentation. Such views are subject to change at any point without notice. Some of the information provided herein is from third party sources and/or compiled internally based on internal and/or external sources and are believed to be reliable at time of production but such information is not guaranteed for accuracy or completeness and was not independently verified. Fiera Capital is not responsible for any errors arising in connection with the preparation of the data provided herein. No representation, warranty, or undertaking, express or implied, is given as to the accuracy or completeness of such information by Fiera Capital or any other person; no reliance may be placed for any purpose on such information; and no liability is accepted by any person for the accuracy and completeness of any such information.

These materials are not intended as investment advice or a recommendation of any security or investment strategy for a specific recipient, investments or strategies that may be described herein are provided as general market commentary, and there may be no account or fund managed by Fiera Capital for which investments or strategies described herein are suitable due to the various types of accounts or funds that are managed by Fiera Capital. Nothing herein constitutes an offer to sell, or solicitation of an offer to purchase, any securities, nor does it constitute an endorsement with respect to any investment area or vehicle.

Any charts, graphs, and descriptions of investment and market history and performance contained herein are not a representation that such history or performance will continue in the future or that any investment scenario or performance will even be similar to such chart, graph, or description. Any investment described herein is an example only and is not a representation that the same or even similar investment scenario will arise in the future or that investments made will be as profitable as this example or will not result in a loss to any investment vehicles. All returns are purely historical, are no indication of future performance and are subject to adjustment.

FORWARD-LOOKING STATEMENTS

Discussions regarding potential future events and their impact on the markets are based solely on historic information and Fiera Capital's estimates and/or opinions, and are provided for illustrative purposes only. A number of the comments in this document are based on current expectations and are considered "forward-looking statements". Actual future results, however, may prove to be different from expectations. The opinions expressed are a reflection of Fiera Capital's best judgment at the time this document is compiled, are subject to change at any time without prior notice, cannot be guaranteed as being accurate, and any obligation to update or alter forward-looking statements as a result of new information, future events, or otherwise is disclaimed. Furthermore, these views are not intended to predict or guarantee the future performance of any individual investment strategy/style, security, asset class, markets generally, nor are they intended to predict the future performance of any Fiera Capital investment vehicle or portfolio.

INDEX DEFINITIONS

The S&P 500 TR is an unmanaged index of U.S. companies generally representative of the U.S. stock market.

The Merrill Lynch U.S. Corporate & Government Master Index (officially named the “BofA Merrill Lynch US Corporate & Government Index”) tracks the performance of dollar denominated investment grade corporate and government debt issued in the U.S, excluding collateralized debt.

The HFRI Fund Weighted Composite Index is a global, equal-weighted index of over 2,000 single-manager funds that report to HFR Database. Constituent funds report monthly net of all fees performance in US Dollar and have a minimum of $50 Million under management or a twelve (12) month track record of active performance. The HFRI Fund Weighted Composite Index does not include Funds of Hedge Funds.