



Theme II: Is rising demand for alternatives secular or cyclical?

Our answer: we believe it is secular, though will require investors to be patient in steep market downturns (as the alternative managers are). The Alts benefit from their long-term investing mandates (~5-10 years) and cannot only hold their positions through cycles but can also influence investment returns by managing their portfolio companies operations, business strategy, and capital structure- along with adding to their positions in downturns to improve returns after the cycle turns back up. For long-term investors, the return profiles have largely been superior to investments in publicly-traded securities, and this is being increasingly noticed in a world of more muted returns. Not only are institutional investors seeing greater merit in this investing approach, but individual investors are increasingly clamoring for products that can deliver stronger long-term returns.

Theme III: Where do we stand in the private equity cycle?

Our answer: we are roughly midway through the realization part of the cycle (cash earnings ramping up and possibly peaking in 2015-16), though strong fundraising and business line diversification may limit the "valley" that would typically come afterwards. With four of these five Alts starting out as private equity/buyout shops, they are still heavily levered to the economic cycle – i.e. portfolio returns/earnings marked down a lot in a recession - further exacerbated by fear of a fundraising drought. However, we think the traditional cycle is becoming somewhat more muted (as is the cyclicity of these firms) given a better backdrop for fundraising and capital deployment than would normally be the case at this point in the cycle. This should give the firms capacity to roughly maintain cash earnings levels after what is likely to be a heavy realization cycle over 2014-16. This said, we think distributable earnings *growth* will become more challenged after 2015 for some time, especially if global markets endure a prolonged downturn.

Theme IV: How is the complexion & role of the alternative managers changing?

Our answer: the Alts are playing a more important role in financing & capital markets, and when coupled with increasing diversification into fee-based businesses and across asset classes, the Alts should generate a steadier cash earnings profile over the long-term. As in their DNA, the Alts are innovating in ways that greatly leverage their capabilities, which is expanding both capital deployment opportunities (e.g. increasing roles in financing, investing more outside the US) and also product capabilities – across asset classes and in distribution (e.g. products structured for individual investors). This should also drive P/E expansion for the stocks over the long-term as the more predictable fee-component of their earnings increases (still more valuable) and the diversity of their revenue streams improves by asset class and product type.

Theme V: What are the near- and long-term risks for these stocks, especially after surging stock prices in 2013?

Our answer: these stocks no doubt have above-average risk profiles, and the risk list is quite long both near-term and long-term – though we see the current place in the cycle and the Alts' efforts to diversify as helping to mitigate these risks. With the stocks up a median 60% in 2013, the risks naturally become worth considering to a greater extent than over the past year. However, we see near-term downside being limited as long as the cyclical tailwinds remain favorable (e.g. strengthening economy, good capital markets activity with stable-to-higher market levels, good fundraising & organic growth).