A RESEARCH AGENDA FOR ALTERNATIVE INVESTMENTS: A LIMITED PARTNER’S PERSPECTIVE

September 2009

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EXECUTIVE SUMMARY

This document outlines a long-run research agenda for The Emory Center for Alternative Investments based on vital issues facing limited partners. Five key areas of research are discussed: (i) asset allocation, (ii) value creation, (iii) incentive alignment, (iv) transparency, and (v) oversight, regulation & taxation. The objective of this document is to build a network of institutional investors and alternative asset managers and to secure their support to execute on this research agenda to inform our collective understanding of what alternatives do and do not do.

The Center’s aim is to provide balanced contributions borne of thoughtful research to a dialogue currently characterized largely by polarizing statements informed by limited information. The Center brings a unique perspective to this dialogue by providing independence, access to the best academic minds worldwide, and a deep analysis of industry relevant questions.
THE EMORY CENTER FOR ALTERNATIVE INVESTMENTS

The Center’s mission is to be a leading international source of research, education and thought leadership on alternative investments that aims to be at the forefront of this evolving industry. As an organization staffed by scholars and experts, the Center will develop the data and set a research agenda comprising topical issues relevant to the institutional investment community. A parallel objective of the Center is to teach and disseminate this knowledge.

Located in Atlanta, Georgia, Emory University's Goizueta Business School is one of the world’s premier business schools, offering top-ranked degree programs, including an Undergraduate BBA, Executive MBA, Evening MBA and Full-Time MBA, as well as a doctoral program. Additionally, the School offers a portfolio of non-degree courses through Emory Executive Education. Our faculty is equally renowned, having been recently ranked in the top 10 most influential in Marketing, Finance and Accounting by the Chronicle of Higher Education.

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INTRODUCTION

For decades, institutional investors leveraged the diversification and return benefits that alternative investments provided for their investment portfolio. Following in the footsteps of pioneering university endowments, today nearly every institutional investor has a large fraction of their assets allocated to alternatives. Consequently, the market for alternative investments has grown exponentially, with larger and larger portfolio allocations dedicated to this market by institutions. Callan Associates estimates that between 1997 and 2007 mean allocations to alternatives increased from 3% to 14%. Entrance to the top managers who invest in alternatives is restricted and competition for access is severe. Indeed, it is commonly believed that the top funds provide an unparalleled opportunity to invest with the best and the brightest minds; those who can turn companies on the brink of bankruptcy into successful companies again; those who can turn nascent ideas into IPOs; those who can turn mathematics into profitable trading strategies and those who can turn bare land into profitable developments.

Recently, many of those same institutional investors are revisiting the rationale behind their allocation to alternatives. Did their returns justify the risks taken? How will the credit crunch affect the investments made by vehicles that have a lock-up period of many years, such as private equity and venture capital? Is past investment performance a reasonable expectation going forward? Not only are institutional investors questioning the role of alternatives—many of them have been forced to reassess their business more broadly and are asking themselves fundamental questions, including: Should risk/reward trade-offs be re-evaluated? Has our risk appetite changed? Did we truly understand the risk of the instruments we invested in? How should we allocate our assets? What role should the current market environment play in that decision? How do we balance today’s versus tomorrow’s capital needs by our constituencies? How do we set up incentives such that our Chief Investment Officers act in the best interest of our constituents’ short and long-term capital needs? What value do investment consultants add? These broader issues impact how institutional investors think about their asset allocation in general and their allocation to alternatives in particular. Indeed, these questions suggest that the role of alternative investments in future institutional investment portfolios is far from certain. Clearly, if these questions are being asked at university endowments, pension funds, charitable foundations and family offices across the world then the answers to these questions are important.

To answer these questions, one first needs to understand the role that alternatives play in the financial markets, and how, when it works, alternatives add value to companies and
generate returns for investors. Second, one needs to understand the dynamics created in the market for alternatives by the incentive and asset allocation challenges faced by institutional investors.

Much of the current skepticism surrounding alternatives can be attributed to a lack of information about the industry. Asset allocation targets are not publicly known. Fees charged to investors are opaque. Terms of agreements between institutional investors and the firms that manage their money are private. Industry returns are typically reported in aggregate and also skewed by reporting biases. Little is known about how fundraising concerns influence investing behaviors and vice versa. Consequently, even the most reasonable skeptic lacks the information necessary to differentiate between those who do and do not warrant their scrutiny.

In short, when it comes to alternatives, much more is believed than is known. Despite this observation, calls for transparency grow louder, legislative proposals regarding the treatment of industry profits circulate and while some prominent institutional investors seek to liquidate their portfolios, many alternative asset managers bemoan the lack of exit options and limited availability of credit. Absent concrete information on the industry, though, such dialogue will continue to be driven more by intuition and opinion than by logic and fact.

The current state of affairs can be attributed, at least in part, to the fact that the investment model for alternatives has evolved at a much more rapid rate than academic research on alternative investing has accumulated. More importantly, progress has been limited more by a lack of information than by a lack of interest or sophistication. If the popular press seems more opinionated than academics, then this is probably due more to academics' higher standards of empirical evidence (relative to journalists).

Clearly, the current state of affairs can (and should) be improved. To that end, this document outlines a long-run research agenda for Emory University's Center for Alternative Investments. The Center's aim is to provide balanced contributions borne of thoughtful research to a dialogue currently characterized largely by polarizing statements informed by limited information. The objective of this document is to secure the support of institutional investors and alternative asset managers to execute on this research agenda and inform our collective understanding of what alternatives do and do not do.
Generally, the Center aims to address research questions that speak to the following broad questions:

- What role should alternative investments play in an institution’s portfolio of investments, taking into account not only the risk and return profiles of the different asset classes, but also the incentive conflicts that are present at different stages of the investment process?
- Under what conditions do alternatives most likely create value? Does value creation amount to more than just leverage?
- Does the market for capital adequately reward alternative investment managers that do create value and punish those who do not?
- Of the various terms included in investment agreements, which are most (least) effective at aligning the incentives of institutional investors and asset managers?
- What would be the likely effects of regulatory and tax policy changes?

Support of this research agenda is an urgent matter for institutional investors, for alternative asset managers themselves and for managers of portfolio companies. Institutional investors rely on the widely-documented superior expected investment returns of alternatives relative to other asset classes and large amounts of capital flow in and out of the alternatives industry. These returns fund the operating expenses of institutions tasked with educating the next generation, funding the retirements of current and future generations, supporting the missions of charitable foundations and preserving the wealth of families. It is imperative that such investments be informed by the best academic research possible.

The next few sections present a research agenda for The Emory Center for Alternative Investments. Five key areas of research are discussed: (i) asset allocation, (ii) value creation, (iii) incentive alignment, (iv) transparency, and (v) oversight, regulation & taxation.
ASSET ALLOCATION

Traditionally, most institutional investors view asset allocation as an interplay between expected returns, risks, and correlations of different asset classes taking place in a reasonably efficient and transparent market. This theory has been well established since the 1960s, but has some crucial implementation short-falls in today’s market. Indeed, the recent market turbulence has forced many investors to reassess their understanding of this interplay. Not only have realized returns been many standard deviations below their historical averages (causing massive decreases in institutional portfolio values) and volatilities been at historical highs, but also, more importantly, asset class correlations have been much higher than the historical record would have suggested. Creighton Capital Management indicates that correlations between a broad range of assets in 2008 compared with the ten years ending in 2006 increased by a staggering 33%. Consequently, the much touted diversification effects of different asset classes, and especially of alternative investments, have not played out as most institutional investors had expected and hoped. Beyond these increased correlations, what used to be perceived as alpha in the bull market, has now often been revealed as levered beta masquerading as alpha. In short, alternatives have failed investors at a time for which they were designed.

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<th>Increase in Correlation Between Assets Classes 2008 vs. 1996-2006</th>
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<td><strong>Large Value</strong></td>
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Source: Creighton Capital Management
In addition to the funding shortfalls caused by the subpar realized returns and increased correlations among asset classes, a recent survey by Greenwich Associates of 1,000 large US institutional investors indicates that future expected returns will be lower as well. These three effects have created a new market reality and have forced institutional investors to reconsider the basic assumptions underlying their asset allocation policy formulation. If alternatives are to survive, they will need to adjust to this new market reality. Firstly, from the perspective of alternative asset managers and the asset allocation decision made by institutions, increased correlations imply that alternatives may not be in an asset class by themselves. Consequently, these alternative asset managers’ products now may compete directly with assets outside of what was traditionally thought of as the alternative asset space. Secondly, institutional investors will likely be much more discerning about the type and performance of the alternative investment vehicle they invest in. Closer scrutiny of the alternatives industry will make it harder for subpar performers to survive and may cause changes in the industry structure. Much like the market dynamics in the 1960s forced changes upon the then fragmented investment banking industry, one possible future scenario is a restructuring of the alternative investment industry which will result in a few truly global players with a focus on large deals in a variety of industries and niche players with a focus on deals with a much narrower scope.

Even if the institutional investors are steadfast in their portfolio allocation decisions, it is not clear if, and to what extent, market timing should play a role in those decisions. For example, simple supply and demand theory suggests that when capital is scarce (relative to the past), returns will be high (relative to the past). Given today’s scarcity of public capital for many companies, this theory indicates that a temporary increased allocation to private capital sources would yield superior returns. However, many portfolio allocation decisions made by institutions today are moving away from alternative assets since they are faced with (i) target allocations in conjunction with the denominator effect causing a rebalancing away from alternatives into public equities, (ii) pre-committed capital to alternatives that has not been called yet. Some studies suggest that future capital calls as of end of 2008 are close to one trillion dollars for private equity alone. Indeed, a number of institutional investors are already struggling to produce enough cash to finance upcoming capital calls, forcing them to sell their portfolio stakes in secondary markets. Even though the dollar amount available for secondary purchases (around $59 billion) is small relative to the total AUM by alternative investment vehicles, the growth in the last year exceeded 50%. The impact of portfolio rebalancing and capital calls has been even more dramatic for liquid alternative investment vehicles, such as hedge funds. Oliver Wyman suggests that 3,000 to 4,000 hedge funds and fund of funds will have closed by the end of 2009.
Finally, many institutional investors, such as universities, have a certain degree of discretion on how much capital to withdraw from their endowment for current spending purposes. It is unclear how to balance optimally the tradeoff between a large future endowment and constituents’ current spending needs – for example, should one optimally decide upon an endowment spending policy by minimizing endowment size volatility or by minimizing volatility of the endowment’s constituents’ annual budget? Clearly, these spending policies have a large impact on how institutions need to think about their asset allocation.

All these changes will inevitably impact the alternatives industry in a dramatic way. A report by the World Economic Forum suggests a couple of key trends. First, given the liquid nature of hedge funds relative to other types of alternative investment vehicles, hedge funds will likely take major steps to retain their relevance for institutional investors by revising their overall business model, including a reduction in fees and a migration to a more private equity-like funding structure. Second, given the lower allocations to alternatives by current investors, limited partners with relative long-term liabilities (such as sovereign wealth funds and family firms) will prove the least constrained, potentially allowing them to enter into transactions that more liability-driven investment vehicles (such as pension funds) simply cannot accept. This potential shift in power will allow these unconstrained investors to dictate the most advantageous terms to alternative asset managers.

Given that capital allocation decisions are at the core of the institutional investment business, a solid understanding of the forces that drive these decisions is critical. Scholarly examination of data on formulated asset allocation plans and spending policies, actual asset allocation and spending decisions, and the resulting performance of endowments would inform our collective understanding of the investment process and the role that alternatives play in that process.
VALUE CREATION

A critical step in the decision to allocate money to an alternative investment vehicle is to understand how these vehicles create value. As indicated in the previous section, when alternative asset managers solicit money from investors, their value proposition is that they provide portfolio diversification and a better risk-return trade-off than most other asset classes. Fundamental to this proposition is whether alternative investments generate true value for companies; that is, do alternative investments generate alpha? Even though the returns to alternatives before the current market turbulence were far better than the returns in most other asset classes, a clear understanding of what generated those returns is lacking.

Leveraged loan and high-yield issuance
1993-2008Q1 (USD billion)

Value-add in alternatives comes from a variety of channels which can be broadly categorized as (i) pricing ability (including identifying mispriced assets and correctly pricing assets in illiquid markets), (ii) execution ability (including corporate governance and operational improvements) and (iii) financing ability (including securing value-increasing financing for investments). Although returns can be generated in a variety of ways, many, from the popular press to big institutional investors, believe that the largest return generator is simply leverage. The recent spectacular failure of some large highly levered investments certainly seems to suggest that leverage was used excessively in many
alternative investment transactions over the last few years. In today’s tight credit markets, it seems unlikely that banks and other lenders will be as generous as in the past when providing capital to alternative asset managers. Indeed, the pre-crisis wave of large leveraged buyout transactions is likely to be replaced by a focus on smaller deals that will prioritize operational improvement, distressed and turnaround situations over the use of financial leverage. Therefore, going forward, it is critical to understand the performance drivers of these funds. If, as is commonly believed, that leverage is the primary determinant of past success, and that other value drivers only play a marginal role, a shake-out of the industry over the next couple of years is unavoidable. However, if the contrary is true, then a substantial shake-out is unlikely.

These are critical issues. Indeed, the realization of many institutional investors, that alternatives’ value drivers are different from what they expected them to be, will force many alternative asset managers to make fundamental changes to their business model. For example, a report by the World Economic Forum indicates that the characteristics of the new private equity world are starting to emerge: (i) larger equity contributions (increasing on average five to ten percentage points from 2007 to 2008), (ii) smaller deal size (average financial sponsor buyouts’ deal size decreased by 61 percentage from 2007 to 2008), (iii) fewer deals (number of deals completed decreased by 36 percentage from 2007 to 2008), (iv) high cost of debt (average loan over LIBOR spread increased by 50 percentage from 2007 to 2008), and (v) increased minority stakes (minority investments increased 26 percentage points from 2007 to 2008).

Given that most alternative investment transactions render unobservable to academic researchers, we have severely limited insights into what investors actually do when they buy a firm. Simple questions relating to job creation, management compensation, debt pay-down schedule, and many others, remain elusive. Although many alternative asset managers will most likely hesitate to share such information – especially if doing so would highlight a primary emphasis on leverage – it is imperative for institutional investors to get a better understanding of alternative investments’ value drivers and under what conditions it may reasonably be expected to occur. It follows that the success of institutions’ investments in alternatives over the next few years will hinge on directly addressing these issues.
INCENTIVE ALIGNMENT

Conflicts of interest occur at various points in the investment process. Two major points in this process at which the misalignment of incentives may occur is in the relationship between (i) the constituents supported by the endowment’s proceeds and those managing the endowment and its proceeds and (ii) the alternative investment managers and the institutional investors.

There are many conflicts in the relationship between those managing the endowment and its proceeds and the constituents supported by the endowment’s proceeds. First, the performance evaluation of chief investment officers (CIO) is often based on the returns achieved by said CIO relative to the returns achieved by CIO’s at similar endowments. If these performance evaluation criteria are not carefully calibrated, job security concerns and compensation structures of chief investment officers (CIO) may induce them to herd with other CIOs and mimic their investment decisions. This is not in the best interest of endowment’s constituents – if CIOs have investment skill, the endowment’s constituents want them to deviate from the herd; if they do not have investment skill, the endowment’s constituents want them to leave. Clearly, CIOs with the least investment talent are the ones most incentivized to mimic other CIOs.

Second, those evaluating the CIOs (typically an investment board) may also have a skewed incentive set. This board is ultimately responsible to the constituents in ensuring the realization of the stated goals of the endowment; however, they may act only in their own best interest by avoiding risky decisions to retain their reputational capital. One example is the role of consultants in the investment decision making process. Consultants are often hired by boards to advise them on the CIOs proposed investments. At first glance it seems reasonable for a board with limited time to hire an outside party to help them evaluate a CIO’s proposed investments to mitigate, at least to a certain extent, the CIOs incentive problems. However, commonly, the remuneration of the consultant is not linked with the performance of their recommendations, and thus it is unreasonable to expect that consultants make decisions aligned with the long run objectives of the endowment. Indeed, an investment consultant’s only objective is to retain their position as an investment advisor and to mitigate downside risk. Consequently, a cynical view of the role of consultants in the investment process is that they only serve as liability insurance for the board.
Third, those managing and benefiting from the activities supported by the endowment’s proceeds often have a short tenure relative to the life of the endowment. This creates clear conflicts of interest between current and future generations of endowment beneficiaries. For example, in a university endowment setting, students want to increase spending while they are enrolled. Although a focus on these short-term expenditures benefits current students, it may not be in the long run interest of future generations of students.

It is unclear to what extent these incentives are misaligned. Data on compensation structures and employment contracts would allow one to examine if investment officers, trustees, those managing the endowment proceeds, and the endowment beneficiaries all work in unison to reach the endowment’s stated goals.

In the second relationship between alternative asset managers and institutional investors, it is commonly believed that incentives are aligned better than in most other delegated investment opportunities. This is achieved through two main channels. First, institutional investors typically require alternative asset managers to invest along with the institutions into the fund. Given the large wealth of some of these principals, these effects may not be as large as institutions desire them to be. Second, perhaps more importantly, by designing governance and fee structures that align the interests of those who provide capital and those who invest capital, institutions hope to mitigate problems seen in other asset classes. An example is the carrot and stick approach used to implement such structures. Severe penalties, functioning as a stick, detract alternative asset managers from acting against the interests of their investors. Specifically, prohibitive covenants in these agreements guard against rent-seeking behavior and excessive risk-taking behavior. In a similar manner substantial rewards, functioning as a carrot, push managers towards achieving results desired by their investors. Specifically, performance-based compensation (carried interest) provides strong incentives to generate profits. Finally, beyond these incentive mechanisms between investment manager and investor is the discipline of the market for capital. It is widely believed that an alternative asset manager’s desire to build a credible and strong market reputation serves to align the incentives of investors and those that manage their money. The rationale is that if alternative asset managers do not achieve satisfactory returns for the risks they are taking, then their firm will not be able to secure future capital.

Underlying this incentive alignment is an implicit assumption that well-functioning capital markets will have a disciplinary effect and allocate capital only to those alternative asset managers that create value for their investors. However, alternatives have the ability to distort the functioning of these capital markets in a variety of ways. First, by charging hidden fees (e.g. money invested in a project is spent on consulting services provided by an
affiliate of the alternative asset manager), the alternative asset manager can increase their compensation and distort the incentive alignment between them and their investors. Second, by providing only selectively-favorable information on investments that have not exited yet, or by not exiting investments that are effectively defunct, an alternative asset manager can advertise an incomplete or potentially inflated track record that will allow them to raise new capital. Third, the alternative investments market is highly segmented. Certain segments of these capital markets are not competitive and as a result they may not deliver the discipline that investors seek. Finally, the fees which are unrelated to the performance of the fund (management fees, typically levied as a percentage of the total fund size or invested capital) can be a substantial source of income for the asset manager—especially in today's environment in which multi-billion dollar funds are commonplace. Even though those management fees have started to come under pressure in the current market environment in which power has shifted away from the asset manager to the institutional investor, they still play a large role. Metrick and Yasuda (2009) suggest that between 1993 and 2006 on average two-thirds of expected revenues in the venture capital and private equity industry are not sensitive to performance. The mere fact that the alternative investment industry measures success by the amount of money under management rather than their return performance, suggests that the non-performance related fees are substantial indeed.

It is unclear empirically how well the incentives of alternative asset managers and investors are aligned in practice. The argument is well grounded in economic theory but has yet to be substantiated by empirical evidence. Outstanding questions include: By how much does managing a poorly-performing fund reduce the likelihood that an alternative asset manager raises a subsequent fund? By how much does managing a poorly-performing fund reduce the likelihood that a high profile investor (e.g., Yale, CalPERS, Princeton) in the last fund declines to invest in the subsequent fund? How much of the fund principal’s compensation is generated by non-performance related fees. Does the introduction of hurdle rates distort investment choices? Does the investment behavior of successful alternative investment managers change their risk-taking behavior so as to preserve the management fees associated with a long-lived franchise?

The recent market volatility has re-focused the attention of the institutional investors on their relationship with the investment manager. As a result, detailed investment principles have been proposed by various institutions, including the Institutional Limited Partners Association and the Oregon Investment Council. These investment principles proposals have generated much interest and describe in detail minimum standards for contract clauses to obtain a better alignment of interests.
These principles are a first step to ensure better alignment. Data-driven research is the logical next step. By collecting data on fund returns and the total fees charged, one could for example examine how performance and fees charged to investors separately and jointly condition the likelihood of successfully raising funds, increasing capital under management and retaining high profile investors. Perhaps more importantly, an examination of the strength of market-based incentives to guard against rent-seeking behavior of alternative asset managers would be informative for institutional investors, who might wish to change the terms of partnership agreements based on the findings of such research.

TRANSPARENCY

One reason more is believed than known about the alternative investment industry is that the industry is rather opaque to the public and even to the popular business press. It follows that public perception of the industry is in no small part informed by the lavish spending of a few alternative asset managers, the controversial takeovers of several large companies, the direct investments of a handful of foreign governments and other highly visible aspects of the industry. Both industry participants and observers agree that greater transparency would likely result in a more informed understanding of how the alternative investment industry operates. At issue is the question of how the industry should be made more transparent.

Many industry observers are concerned with alternative investments for reasons unrelated to returns. Primarily, these concerns relate to the effects of investments on corporate employment, the involvement of alternative investment firms in public infrastructure projects and the investments of foreign nations in funds that invest in companies connected to national security, energy and public infrastructure. Labor unions like the Service Employees International Union (SEIU) have committed substantial resources to public awareness campaigns designed to bring these issues to the public’s attention. Calls for transparency typically involve independent third-party monitoring of the industry, full disclosure of all investors in alternative investment private partnerships, governmental registration of sovereign wealth funds, governmental review of alternative asset investments and increased reporting requirements for alternative investment vehicles.

The efforts to increase transparency come at a cost. Seeking to clarify its role in financial markets without incurring the costs of increased oversight by regulators, the alternative asset managers have responded to growing transparency concerns. For example, in 2007 the British Private Equity and Venture Capital Association hired an independent consultant
to issue a set of voluntary guidelines for disclosure and transparency in private equity investing (aka the Walker Guidelines). Similarly, the Private Equity Council, a US industry trade association formed in 2007, issued a set of responsible investment guidelines two years later. 

Weighing the perceived benefits of enhanced transparency against their likely costs is a difficult exercise. Little is known about how increased oversight and reporting requirements would alter the investment behaviors of alternative asset managers or influence their investment returns. Moreover, many of the concerns about investments in public infrastructure or the involvement of sovereign wealth funds are borne of anecdotal evidence from a few high-profile cases and not from rigorous analysis of systematically-collected data. What is likely true, though, is that transparency is likely greater for some institutional investors than others; some institutional investors are better-informed – by general partners or by investment office staff – of the operations of the funds in their portfolios. In addition, transparency is likely greater for particular types of funds or for funds located in certain countries. Scholarly examination of data on the investments of alternative asset managers would inform our collective understanding of how investment behaviors and outcomes vary with different degrees of transparency and whether these transparency proposals achieve their stated objectives.

**OVERSIGHT, REGULATION & TAXATION**

In recent years, the alternative investments industry has been a hot topic in public policy circles. Discussion tends to focus on changes in the industry’s registration and reporting obligations to the securities regulator and the tax treatment of carried interest. Such debates are generally characterized by normative statements about the need for greater oversight (if not outright regulation) and fairness of the tax proposals or the potentially dire consequences of such changes. Such debates should be informed by academic research that provides objective insights into the likely effects of any such changes. To be clear, at present very little is known about how variation in tax or oversight and regulatory regimes influences the investment behaviors or returns of alternative investment managers.

To illustrate the value of academic research on such topics, we intend to focus in our research on some aspects of the debate about regulation and the taxation of carried interest. On the regulatory front, the current crisis has put a spotlight on hedge funds.
Oliver Wyman has suggested that the trading strategies employed by hedge funds (particularly short-selling) have exacerbated the market instability by increasing the systemic risk in the economy. Others have suggested that hedge funds have done the opposite by taking risks of the balance sheet of deposit taking institutions. Both points of view have merit and research can inform the industry and policy makers about how systemic risks are influenced by hedge funds.

On the taxation front, carried interest is taxed at the capital gains rate (15% in the United States) and not the ordinary income rate (35% - at the current highest bracket – in the United States). Most policy proposals call for taxing carried interest at either the ordinary income rate or at some rate between the capital gains rate and the ordinary income rate. Preservation of the current capital gains treatment is, of course, favored by the alternative investments industry. Consideration of the different arguments reveals several promising research inquiries that would likely inform the debate.

Alternative asset managers argue that carried interest is a financial incentive for investors to invest capital, labor and skills in what is an inherently risky investment. Carried interest is designed to align the interests of alternative asset managers and their institutional investors by ensuring that both parties benefit from a job well done and both incur losses should profits fail to materialize. Raising the tax rate on carried interest, industry leaders argue, would dilute this incentive and result in capital flight to other countries, diminished risk-taking, lower investment returns and/or higher fees for institutional investors and a reduction in financing for entrepreneurs and small businesses. Finally, industry pundits have argued that by taxing alternative asset managers, other enterprises, also organized as a limited partnership, would be unintentionally hurt by increased taxation.

Although these tax proposals have materialized in an environment characterized by heightened post-crisis social sensitivities and legislative and regulatory activism, it is important for the public debate to examine the validity of the arguments. To what degree do these arguments have merit, and to what degree do they make an effort to maintain the comfortable status quo? Incremental revenue projections associated with an increase in the tax rate applied to carried interest must take into account any changes in investment behaviors and outcomes that such changes would produce. And such projections do not even touch upon the fairness issues that are certain to cloud the interpretation of such estimates. While we cannot observe the same alternative asset managers operating under different tax regimes, we can observe them operating under different tax regimes by leveraging variation in tax rates across state and national levels. And such variance is likely to be related to the terms of partnership agreements, the nature of the deals firms pursue and the returns realized on investment.
Of course, such relationships can only be observed with fine-grained data drawn systematically from partnership agreements, deal documents and financial statements. With such data, we aim to address questions such as: Do firms subject to higher tax rates invest in riskier deals than firms subject to lower tax rates? Do firms subject to higher tax rates charge greater fees to institutional investors than firms subject to lower tax rates? Do firms subject to higher tax rates produce lower, average or higher volatility than firms subject to lower tax rates? Do tax increases simply get passed through to the institutional investors and their clients?

Clearly, similar arguments can be made for regulations other than taxation. For example, do regulations change the investment behavior of investment firms? Do costs outweigh the benefits of regulation? Answers to these questions will bring greater clarity to important public policy issues regarding the alternative investments industry.

**CONCLUSION**

This document outlined a research agenda for the Emory Center for Alternative Investments. Important questions regarding asset allocation, value creation, incentive alignment, transparency and regulation remain unanswered. To answer such important questions, the Center seeks to build a network of institutional investors, alternative asset managers and firms that receive capital from these managers and to secure their support to execute on this research agenda. Returns on alternative investments support institutions of higher education, current and future retirees, charitable foundations and generations of families. It is imperative that such investments be informed by the best academic research possible.