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Alternative Investments: Fact, Fiction and Fantasy

Presented to the
Chicago Estate Planning Council
October 17, 2007

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Fact, Fiction and Fantasy

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Fantasy

“Alternative investments provide
high returns with low risk”



I. Why include Alternative Investments?

- A. Modern Portfolio Theory**
- B. Risk and Return of Asset Classes**

II. Overview of Alternative Investments

- A. Hedge Funds**
- B. Commodities**
- C. Private Real Estate**
- D. Private Equity**

III. Integrating Alternative Investments into Financial and Estate Plans



I. Why Include Alternative Investments?



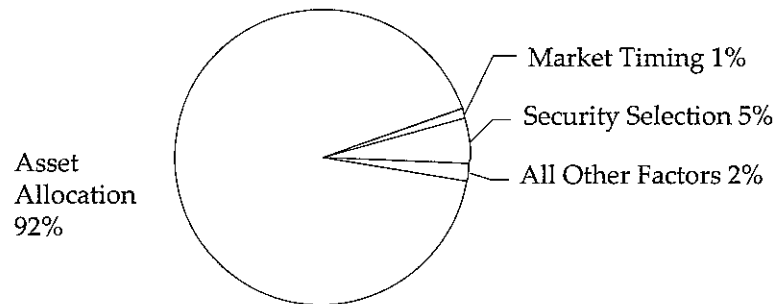
Fiction

“Alternative investments have no place in a portfolio overseen by a fiduciary”



Importance of Asset Allocation

Determinants of Investment Return Variability



Data Source: "Determinants of Portfolio Performance", Brinson, Hood & Beebower, *Financial Analysts Journal*, July-August 1986. Updated 1991.



Principles of Modern Portfolio Theory

- Diversification is achieved by combining asset classes whose returns do not move in tandem
- Portfolio diversification provides investors with a “free lunch”
 - Reduce risk without sacrificing expected return
 - Increase expected return without increasing risk
- Codified in Restatement 3rd of Trusts as part of the prudent investor rule

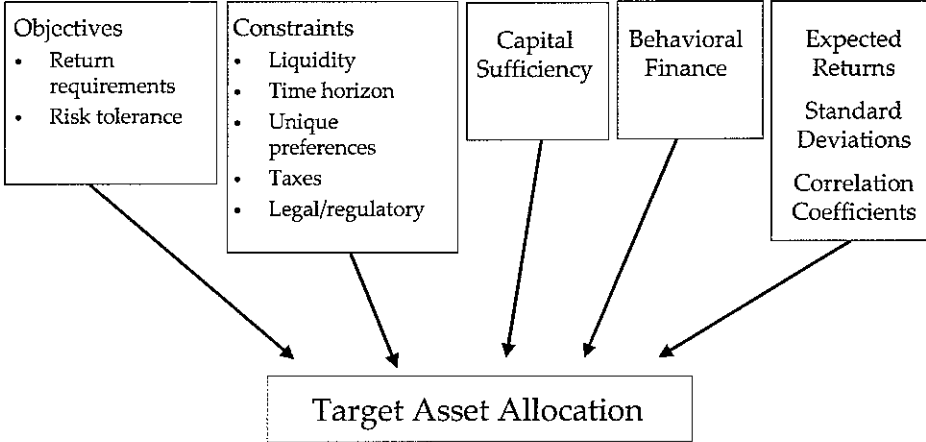


Applying Modern Portfolio Theory

- Define asset classes
- Determine capital markets expectations
 - Expected returns
 - Expected standard deviations (risk)
 - Expected correlation coefficients
- Choose asset class constraints
- Create an efficient frontier - “optimize”
- Select a target asset allocation



Asset Allocation: Art and Science



Traditional Asset Classes

- | | |
|--|--|
| <ul style="list-style-type: none">• Large Cap Equity<ul style="list-style-type: none">- Growth- Value• Small Cap Equity<ul style="list-style-type: none">- Growth- Value• International Equity<ul style="list-style-type: none">- Developed Markets- Emerging Markets- Small cap | <ul style="list-style-type: none">• Equity REITs<ul style="list-style-type: none">- US- Non-US• Fixed Income<ul style="list-style-type: none">- Municipal- Taxable- High Yield |
|--|--|

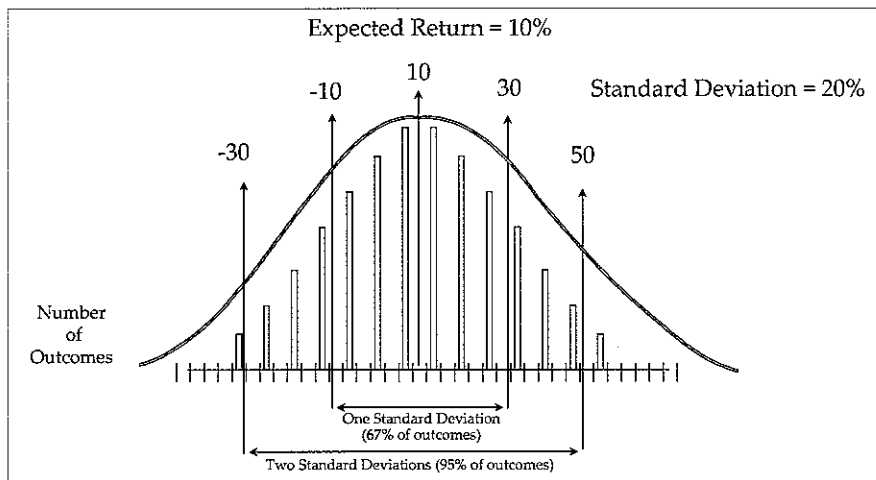


Alternative Asset Classes

- Private equity
 - Venture capital
 - Buyouts
 - Mezzanine financing
 - Distressed debt
- Private real estate
 - Apartments
 - Industrial
 - Office
 - Retail
- Commodities
 - Energy
 - Metals
 - Agricultural
- Hedge funds
 - Equity-based
 - Arbitrage
 - Opportunistic



Modern Portfolio Theory's Definition of Risk





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Traditional Asset Classes – Return and Volatility

Asset Class	Expected Return	Expected Standard Deviation
Large Cap Equity	11.7 %	20.3 %
Small Cap Equity	14.3	28.7
International Equity	12.5	26.5
Intermediate Term Fixed Income	4.7	7.4
High Yield Fixed Income	7.3	12.6
Real Estate (Equity REITs)	12.6	18.4
Cash	2.9	2.9

Data Source: Ibbotson Associates

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Alternative Asset Classes – Return and Volatility

Asset Class	Expected Return	Expected Standard Deviation
Private Equity	21.5%	31.1%
Private Real Estate	9.4	10.0
Fund of Hedge Funds	10.2	6.9
Commodities	12.8	21.5

Data Sources: Brian Singer's 2002 AIMR paper, "Determining Appropriate Allocation to Alternative Investments", Hedge Fund Research, Inc. and National Council of Real Estate Investment Fiduciaries (NCREIF)

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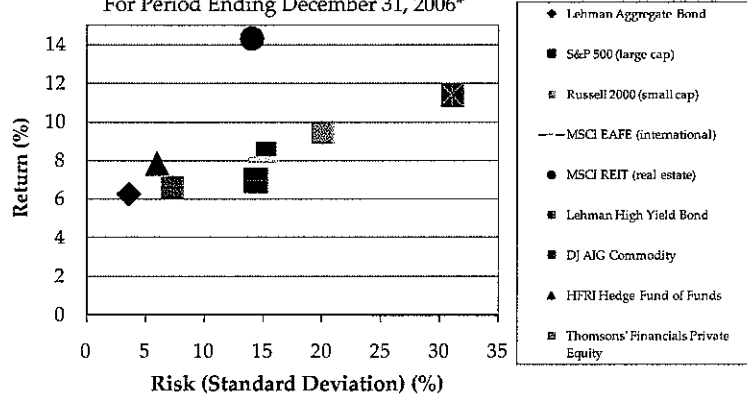
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Historical Performance

10-Year Annualized Return and Standard Deviation
For Period Ending December 31, 2006*



*Data ending 12/31/2006, with the exception of private equity. Private equity returns are for the 10-year period ending 9/30/2006 and the standard deviation is an estimated value given the limitations of measuring standard deviation using appraisal data.

Sources: Altair Advisers, HFRF, Morningstar, Thomson Financial

Past performance is not indicative of future results.



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Correlation Coefficients

	Large Cap	Small Cap	Intl Equity	Int Term FI	High-Yield FI	RE (Equity REITs)	Commodities	Hedge Funds	Private Equity
Large Cap	1.00	.71	.59	.34	.47	.48	-.30	.29	.70
Small Cap		1.00	.44	.18	.50	.74	.08	.26	.76
Intl Equity			1.00	.04	.39	.27	-.10	.21	.48
Int Term FI				1.00	.48	.28	-.28	.10	.19
High-Yield FI					1.00	.25	-.31	.16	.37
RE (Equity REITs)						1.00	-.28	.12	.27
Commodities							1.00	.22	.08
Hedge Funds								1.00	.19
Private Equity									1.00



Diversification Benefit of Alternative Asset Classes

	Correlation Coefficient*	
	Lehman Aggregate Bond	S&P 500
MSCI REIT (real estate)	0.28	0.48
Lehman High Yield Bonds	0.48	0.47
DJ AIG Commodity	-0.28	-0.30
HFRI Hedge Fund of Funds	0.10	0.29
Thomson Financial Private Equity	0.19	0.70

- A correlation of less than 1.0 implies that diversification benefits can be achieved

*Correlation is the tendency for the returns of two assets to move together relative to their average. The measurement of this statistic (the correlation coefficient) can range from -1 (perfect negative correlation, one goes up the other down) to 1 (perfect positive correlation, both moving in the same direction). A correlation of 0 means no relationship can be found.
Source: Altair Advisers, Ibbotson Associates



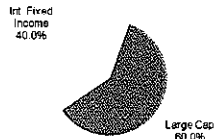
Fiction

“Alternative investments add risk to a portfolio”

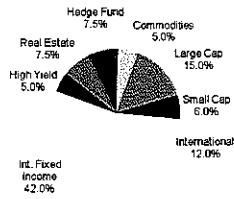


The Benefits of Diversification

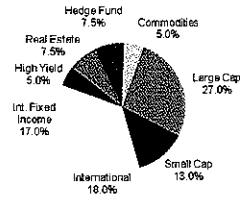
Portfolio A



Portfolio B



Portfolio C



	Portfolio A	Portfolio B	Portfolio C
	60% Equity 40% Fixed Income	33% Equity 47% Fixed Income 20% Alternatives	58% Equity 22% Fixed Income 20% Alternatives
Expected Return	8.9%	8.9%	10.8%
Standard Deviation	13.5%	9.3%	13.5%

Data Source: Ibbotson Associates



II. Overview of Alternative Investments



Fiction

“Only extremely wealthy investors
can gain access to alternative
investments”



Fiction

“All alternative investments are
illiquid”



Fiction

“Investors frequently incur losses that equal or exceed their investment in alternatives”



Understanding the Structure of Alternative Investments

- Investor Qualifications
- Investor Liquidity / Lock-up
- Leverage
- Pricing
- Custody
- Taxes
- Performance Tracking
- Implementation



Understanding the Structure of Alternative Investments

	Alternative Investments: Limited Partnerships (LPs), Limited Liability Companies (LLCs) or Statutory Trusts	Open-End Mutual Funds and Separate Accounts
1	Investor Qualifications: Accredited Investors: (Regulation D Securities Act of 1933) Qualified Purchasers: (Securities Act of 1933)	\$1 million net-worth for individuals or jointly (including personal residence) or individual income in excess of \$200,000 per year in each of the two most recent years (or \$300,000 for married couple). Entities are subject to \$5 million in total assets. \$5 million net-investments for individuals or jointly (excludes residential property and segregated funds, such as money in spouse's name or trust and irrevocable trusts). Institutions are subject to a \$25 million in total assets.
		Only requirement is meeting investment minimums.
2	Liquidity / Lock-ups: Lock-ups range from monthly to multiple years <i>Typical Examples:</i> <i>Commodity Futures:</i> <i>Hedge Funds:</i> <i>Private Real Estate:</i> <i>Private Equity:</i>	Daily liquidity / No lock-ups Monthly lock-up One-year lock-up with quarterly withdrawals 10-year partnership life with expected interim distributions 12-15 year partnership life with expected interim distributions



Understanding the Structure of Alternative Investments (cont.)

	Alternative Investments: Limited Partnerships (LPs), Limited Liability Companies (LLCs) or Statutory Trusts	Open-End Mutual Funds and Separate Accounts
3	Leverage: Leveraged strategies are common <i>Typical Examples:</i> <i>Commodity Futures:</i> <i>Hedge Funds:</i> <i>Private Real Estate:</i> <i>Private Equity:</i>	Uncommon No (assuming collateralized positions) Yes Yes Yes
4	Pricing:	Fair market value (marked-to-market daily)
5	Custody:	Assets held in a brokerage or custodial account. Although managers may have trading authority on the accounts, they cannot move cash out of accounts, which provides investors with an extra level of protection.



Understanding the Structure of Alternative Investments (cont.)

	Alternative Investments: Limited Partnerships (LPs), Limited Liability Companies (LLCs) or Statutory Trusts	Open-End Mutual Funds and Separate Accounts
6 Taxes:	LPs, LLCs: Pooled investments, but capital accounting ensures that there is no risk of buying into other investors' gains.	Mutual Funds: Pooled investments, but unit accounting creates risk of buying into other investors' gains. Separate Accounts: Investors own the underlying securities and thus don't buy into any embedded gains.
	Reporting:	K-1 – may be delayed and cause investor to file an income tax extension.
	State Taxes:	Potentially subject to taxes in state where entity is deemed to be doing business.
	Unrelated Business Taxable Income (UBTI):	Interests acquired by borrowing or leveraging investments have the potential to generate UBTI, which can create problems for ERISA plans and IRAs (however, some funds have created offshore structures to avoid UBTI).
7 Performance Tracking:		Normally quarterly data – in some categories (like Private Equity) performance cannot be tracked in early years.
8 Implementation:	Methods vary	Capital is 100% invested
	Typical examples:	
	Commodity Futures:	100% invested
	Hedge Funds:	100% invested
	Private Real Estate:	Make a commitment, but capital is then called only as opportunities arise
	Private Equity:	Make a commitment, but capital is then called only as opportunities arise



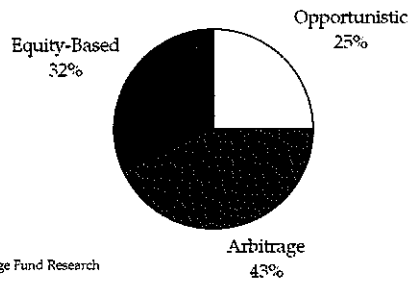
Understanding Hedge Funds

- Hedge Fund definition:
 - Hedge funds are private investment partnerships that attempt to generate absolute positive returns irrespective of the overall market direction by allowing maximum flexibility in their management
- Equity Market Neutral definition:
 - Although hedge funds have an unlimited investment universe, the classic market neutral definition involves maintaining an equal allocation to long and short positions, such that the manager is "neutral" to the direction of the overall equity market
- Hedge Fund of Funds definition:
 - A hedge fund of funds is a private investment partnership that assembles a mix of underlying hedge funds, controls asset allocation decisions among strategies, monitors performance and replaces underlying hedge funds as necessary



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Hedge Fund Strategies (% of total hedge fund assets)



Source: Altair Advisers, Hedge Fund Research

- **Arbitrage strategies:**
 - Attempt to profit from a misalignment in pricing between two securities
- **Equity-based strategies:**
 - Attempt to generate returns by taking advantage of pricing differences between related stocks or by using knowledge of specific sectors in the equity markets
- **Opportunistic strategies:**
 - Typically take directional bets in specific markets or securities

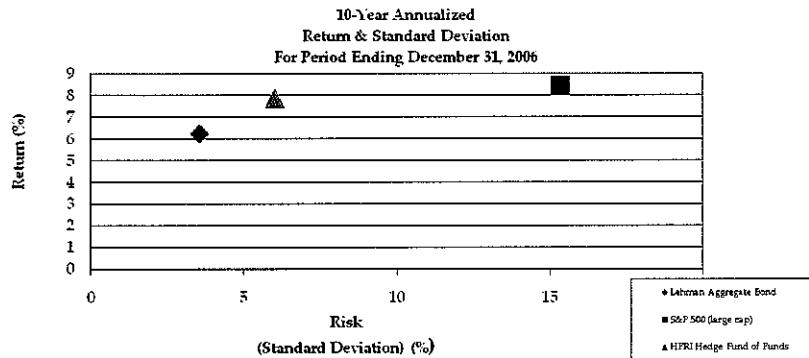
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Historical Performance for Diversified Hedge Fund of Funds



Source: Altair Advisers

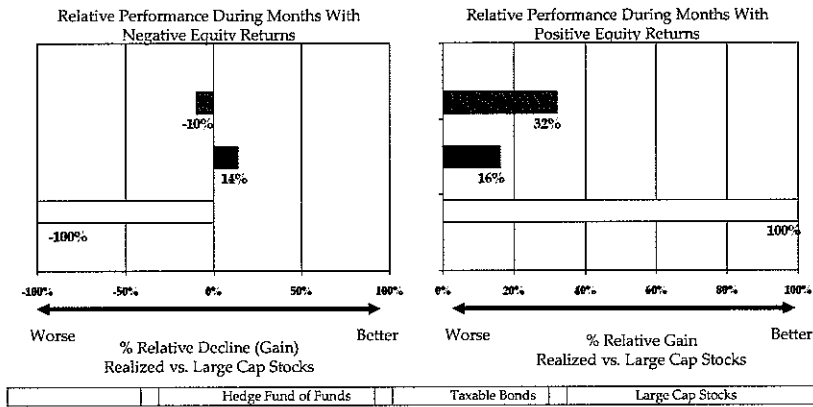
- A multi-strategy hedge fund of funds may be expected to exhibit a risk profile similar to bonds with return expectations between that of stocks and bonds

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Diversification Benefits of Hedge Fund of Funds



- Hedge fund of funds have historically behaved somewhat independently of traditional stocks and bonds, adding diversification to a portfolio



How to Invest in Hedge Funds

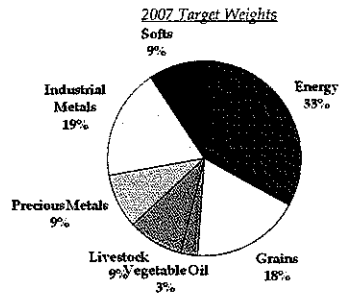
- Most investors should invest through fund of funds, which provide the following benefits:
 - Diversification across strategies
 - Access to top quartile managers
 - Active control of allocation
 - Due diligence (investment & operational)
 - Simplified tax reporting (generates one K-1)



What are Commodities?

- Commodities represent “real” or hard assets and are the raw materials in the production process

The Dow Jones-AIG Commodity Index



Source: Dow Jones

Representative components:

Energy: Crude Oil & Natural Gas

Grains: Soybeans & Corn

Livestock: Cattle & Hogs

Precious Metals: Gold & Silver

Industrial Metals: Aluminum & Copper

Softs: Cotton & Coffee

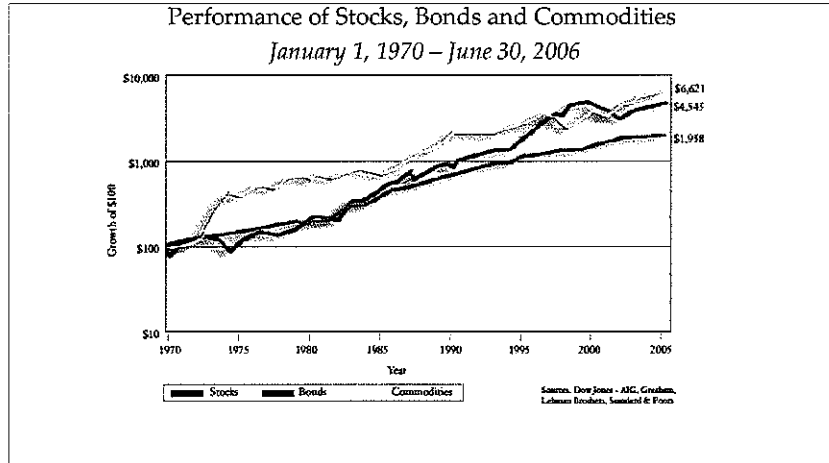


Why Include Commodities?

- Commodities have historically provided:
 - Compelling longer-term returns
 - A hedge during inflationary periods
 - Low correlations to financial assets
- Until recently, investing in commodities was difficult with few available investment alternatives.



Compelling Longer-Term Returns of Commodities



Commodities can be a Hedge During Inflation Periods

High Inflation
January 1, 1970 – December 31, 1981

	Annualized Return (%)	Risk (Standard Deviation) (%)	Cumulative Return Adjusted for Inflation (%)
Inflation	7.91		
Stocks	6.89	17.24	-10.77
Bonds	6.54	7.78	-14.53
Commodities	15.92	18.55	136.09

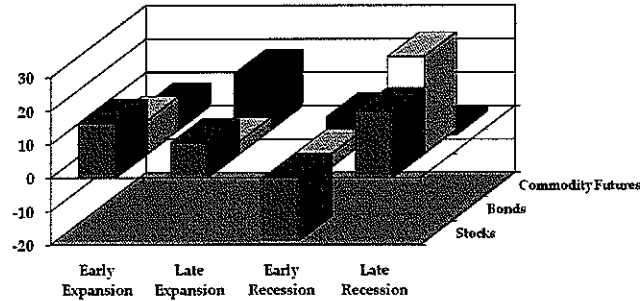
Source: Dow Jones - AIG, Gresham, Lehman Brothers, Standard & Poor's, U.S. Bureau of Labor Statistics



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Diversification During the Business Cycle

Commodity Futures, Stocks and Bonds
Average Returns by Business Cycle Stage
1959 to 2004



- Returns for commodity futures have historically been positive early in recessions as near-term demand for commodities remained strong while equities provided negative returns due to the expectation of weaker economic data ahead.

Source: Yale Working Paper No. 04-20

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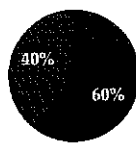


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Low Correlation to Financial Assets

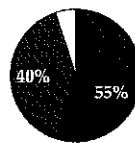
Adding Commodities Benefits a Portfolio: Return and Risk
January 1, 1970 – June 30, 2006

Portfolio 1



40% Stocks

Portfolio 2



40% Stocks, 55% Bonds, 5% Commodities

		Annualized Return (%)	Risk (Standard Deviation) (%)
Portfolio 1	60% Stocks/40% Bonds	10.32	10.99
Portfolio 2	55% Stocks/40% Bonds/5% Commodities	10.50	10.18

Sources: Altair Advisers, Dow Jones - AIC, Gresham, Lehman Brothers, Standard & Poors

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Accessing the Commodity Markets

- ✖ Own physical commodities (i.e. not futures contracts)
 - Impractical given storage, delivery and spoilage
 - The prices of many commodities are expected to go down over time through technological innovation
- ✖ Own stocks of commodity producers (e.g. natural resource stocks)
 - These companies behave more like stocks than commodities. Investors may not get pure commodity exposure here due to hedging and company specific risk.
- ✖ Own stocks of emerging markets companies
 - Many emerging market companies are commodity exporters, but there are unique risks and variables aside from commodity prices that impact their performance



Accessing the Commodity Markets (Continued)

- ✖ Active futures trading strategies
 - Most follow an absolute-return strategy (can buy long and sell short)
 - Some use proprietary trading strategies
 - Neither strategy gives consistent long-only exposure to commodities
- ✓ Index-tracking and enhanced strategies
 - Provides consistent long-only exposure to commodity futures
 - Mimics a diversified index while potentially adding value in implementation and management of the collateral



Understanding Commodity Futures

- Investors earn returns from the following sources:
 - *Unexpected* increase in the price of the commodity
 - Earnings on the collateral (futures contracts only require a 5% deposit; the rest of the money can be invested until the expiration of the contract)
 - Capturing a premium for providing "price insurance" to a seller looking to hedge their exposure
- To maintain exposure to commodity futures, an investor must continuously renew expiring futures contracts



Risks of Commodity Investing

- *Volatility* – Commodity futures have similar longer-term volatility to the S&P 500 and can experience sharp declines in value (since 1970 the worst year for the DJ AIG Commodity Total Return Index was -27.03% in 1998 versus the S&P 500's worst loss of -26.47% in 1974).
- *Deflation Risk* – Deflationary periods may potentially put downward pressure on commodity prices.
- *Global Recession Risk* – Any decrease in aggregate demand may have a negative impact on commodities.
- *Counterparty or Credit Risk* – The use of swaps to mimic commodity futures relies on the creditworthiness of the counterparty, whereas the use of structured notes involves creditworthiness of the structured note issuer.
- *Tax Inefficiency* – Swaps and structured notes may be taxed as ordinary income, whereas futures contracts are deemed to be 60% long-term and 40% short-term capital gain.



Why Invest in Real Estate?

- Diversification (i.e. low correlation to traditional equity and fixed income markets)
- Volatility Reduction
- Income Generation and Appreciation Potential
- Partial Inflation Hedge



Public versus Private Real Estate

- **Public Real Estate** – Equity Real Estate Investment Trusts (REITs) are traded as public companies and represent approximately 140 companies traded on the New York Stock Exchange collectively owning approximately 10% – 15% of the commercial real estate in the U.S. estimated at \$400 – \$600 billion
- **Private Real Estate** – Private ownership of commercial real estate in the U.S. is estimated to exceed \$4 trillion.



Public versus Private Real Estate Cont'd

Attributes:

- Real Estate Exposure –
 - Equity REITs are public companies that invest in real estate, whereas private real estate is a direct real estate investment.
 - Like direct real estate, the pricing of Equity REITs is heavily influenced by the underlying real estate holdings, but is also impacted by influences within the public equity markets, resulting in REIT prices that often trade at a premium or discount to the underlying property values.
- Opportunity Set –
 - Equity REITs represent approximately 10%-15% of the commercially owned real estate universe with a bias towards investing in core properties in big metropolitan areas.
 - Private real estate encompasses the remaining 85%-90% of the universe with opportunities across the real estate spectrum.



Public versus Private Real Estate Cont'd

- Inefficiencies –
 - Equity REIT market typically focus on larger properties and often must compete with other large institutional buyers in competitive bidding.
 - Private real estate managers often avoid competitive bidding and focus on smaller deals or unique opportunities uncovered through their expertise or local networks to capitalize on pricing inefficiencies.
- Liquidity/Time Horizon –
 - REITs trade as public equities offering liquidity to investors. This liquidity can subject REITs to trading activity of short-term investors and speculators.
 - Private real estate investments are often structured as partnerships that may have a 10 year life with limited liquidity. However, shareholders in these vehicles often have a long-term commitment to real estate.

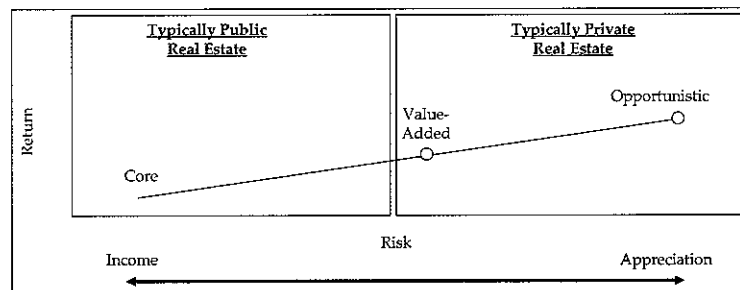


Public versus Private Real Estate Cont'd

- Volatility –
 - As publicly traded equities, Equity REITs are impacted by the operations of the management company. Thus, issues with management, quarterly earnings, or investor sentiment towards REITs can impact volatility. Often, Equity REITs are shown to correlate most closely with small cap value stocks.
 - Private real estate tends to exhibit less volatility than equity REITs. Given that values are determined by periodic appraisals, valuations are not as transparent and periodic appraisals can create "valuation smoothing," which may understate actual volatility of the investment.
- Tax Reporting –
 - Equity REITs generate annual 1099's
 - Private real estate partnerships generate IRS schedule K-1s.



Real Estate Investing Strategies



- Core – Focus on income from stable leases with exposure to diversified offices, apartments, retail, etc.
- Value-Added – Focus on appreciation and income with exposure to properties with moderate redevelopment or re-leasing opportunities
- Opportunistic – Focus on appreciation through redevelopment, distressed properties and special opportunities (often through employing higher leverage)



How to Invest in Private Real Estate

- Most investors should invest through fund of funds, which provide the following benefits:
 - Diversification across strategies (and countries)
 - Access to top quartile managers
 - Due diligence (investment & operational)
 - Simplified tax reporting (generates one K-1)
 - Coordination of capital calls to underlying managers

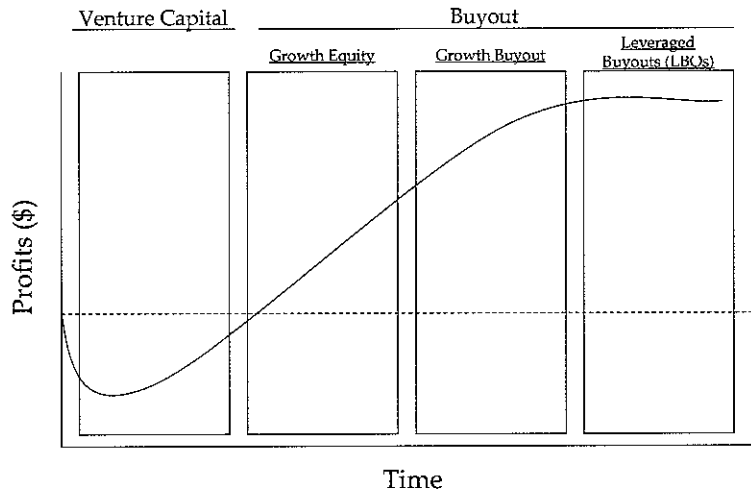


What is Private Equity?

- Private Equity involves investing in privately-owned (i.e. non-public) companies ranging from start-ups to well-established businesses generally divided between venture and buyout strategies
 - Venture capital involves investing directly in firms that range from start-ups to fast growing small companies
 - Buyouts or Leveraged Buyouts (LBOs) utilize leverage to buy a controlling interest in an established business, recapitalize business, or take a public company private



Lifecycle of a company



Historical Performance of Private Equity Funds

Thomson Financials' US Private Equity Performance Index (PEPI)
Investment Horizon Performance through 6/30/2006

Fund Type	1 Year	3 Year	5 Year	10 Year	20 Year
All Venture	16.20	9.00	-3.50	20.80	16.50
All Buyouts	27.30	16.30	6.60	8.90	13.40
All Private Equity	22.50	13.40	3.60	11.40	14.20
S & P 500	6.60	9.20	0.70	6.60	9.79

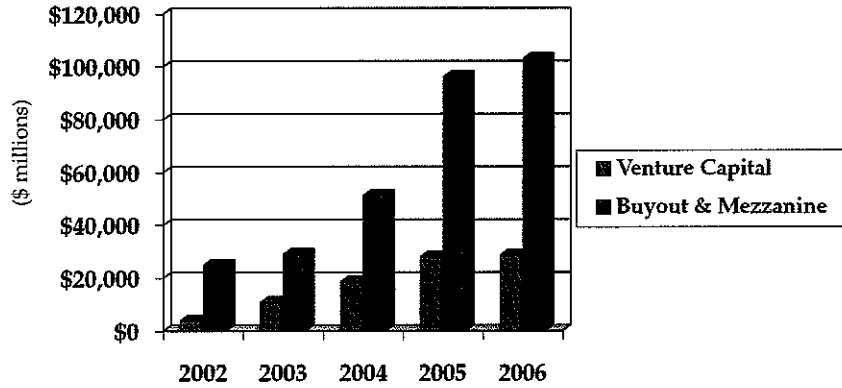
Source: Thomson Financial/National Venture Capital Association



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Volume of Private Equity Deals

Fundraising by Venture and LBO/Mezzanine Funds



Source: Thomson Venture Economics & National Venture Capital Association

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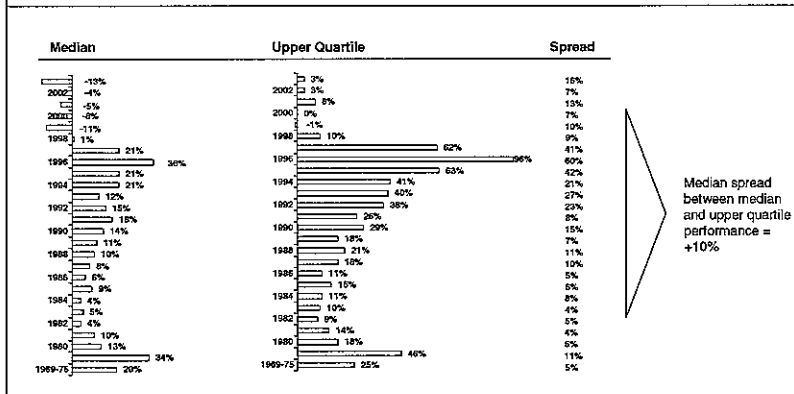
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The Importance of Top Quartile Managers in Private Equity Investing

Venture Capital Top Quartile vs. Median Performance *



* Venture capital returns are as of 12/31/2005. Vintage returns for 2003-2006 are not meaningful.

Source: Venture Economics, HRJ Capital

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Implementation of Private Equity Investments

- Since deals are funded by calling capital over time, dollars committed do not equal dollars invested
- Based on the cash flows of dollars called vs. distributions received, many investors may only have a maximum of approximately 50% of their committed dollars invested at any point in time
- To reach a target allocation, investors must make a multi-year commitment to funding private equity versus making a one-time investment



Projected Cash Flow of a One-Time Private Equity Investment

<i>Year</i>	<u>1</u>	<u>2</u>	<u>3</u>	<u>4</u>	<u>5</u>	<u>6</u>	<u>7</u>	<u>8</u>	<u>9</u>	<u>10</u>	<u>11</u>
Called	102	170	170	170	127	59.5	51	0	0	0	0
Distributed	0	0	<29>	<72.5>	<145>	<261>	<362.5>	<217.5>	<145>	<145>	<72.5>
Net Exposure	102	272	413	510.5	492.5	291	n/a	n/a	n/a	n/a	n/a

**Peak
exposure
of 50%**

Assumes investment in a typical buyout fund

Commitment = \$1m

Assumes 15.6% internal rate of return (IRR) and multiple of investment capital returned of 1.7x



How to Invest in Private Equity

- Most investors should invest through fund of funds, which provide the following benefits:
 - Diversification across strategies
 - Access to top quartile managers
 - Due diligence (investment & operational)
 - Simplified tax reporting (generates one K-1)
 - Coordination of capital calls to underlying managers



III. Integrating Alternative Investments into Financial and Estate Plans



Fiction

“IRAs/tax deferred accounts are always the best place to hold alternative investments”



Understanding Asset Location

- Determining the most appropriate account or entity to hold various investments
- For example:
 - Use IRA dollars to invest in taxable bonds or hedge fund of funds which tend to be very tax inefficient
 - Use GST trust or other long time horizon assets to invest in private equity or other investments with low liquidity and long life cycles



General Factors Influencing Asset Location

- Liquidity
- Tax rates
- Time horizon
- Tax efficiency of investments
- Income vs. appreciation
- Expected return



Alternative Investments and Asset Location - Tax Deferred Accounts

- Long time horizon on deferred accounts
- Little need for liquidity inside deferred accounts
- Tax filing complexities can be avoided
- Tax inefficiency of investments has no impact on returns



Alternative Investments and Asset Location - Tax Deferred Accounts

- *Best candidates*
 - *Hedge fund of funds, some commodities funds*
- *Poor Candidates*
 - *Private equity, private real estate, some commodities funds*
 - Distributions from tax deferred accounts are taxed at ordinary rates, thus investments which generate capital gains (e.g. private equity) should be located in taxable accounts to take advantage of favorable tax treatment
 - Private real estate investments generate depreciation expenses and potential deduction of these is lost if inside tax deferred account
 - Tax exempt/deferred accounts should avoid UBTI by investing in funds that do not leverage assets or by using those that are off-shore entities.



Advantages of owning Alternatives in Family Partnerships/LLCs and Trusts

- Pooling assets to reach investment minimums provides a business purpose for an FLP/LLC
- Allows for gifting FLP/LLC interests which own underlying investments in alternatives
- Entities typically have long investment time horizon which makes them suited to the lower liquidity, longer horizon nature of many alternative investments
- Early valuation of private equity investment may provide for greater discounts when transferring units of the FLP/LLC

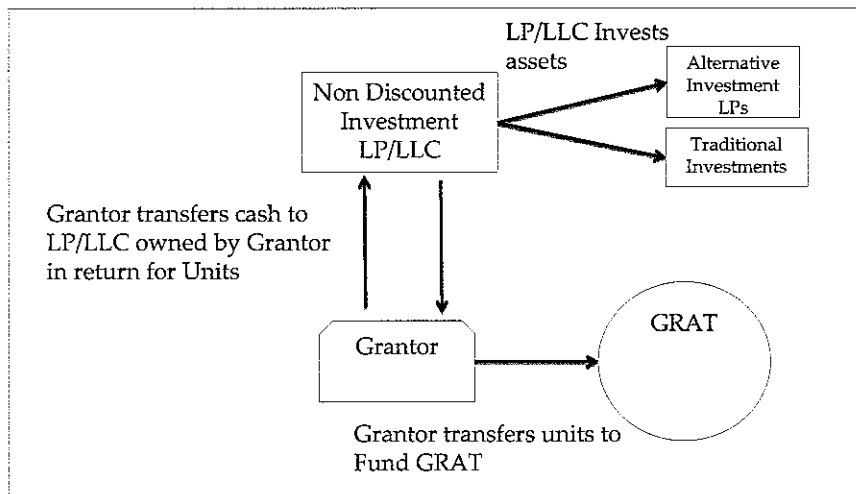


Pitfalls of owning Alternatives in Family LPs/LLCs and Trusts

- Many alternative investments have Qualified Purchaser or Accredited Investor requirements that must be met by the partners, trustees and settlors or entity must qualify for the gift exception where the entity takes on the QP status from the transferor
- LP/LLC must have cash to meet capital calls or each funding will be an additional gift/transfer
- Trusts may need cash for payment of taxes as many alternatives generate tax consequences without corresponding tax distributions (phantom income)
- Lack of market pricing requires valuation when transferring interests

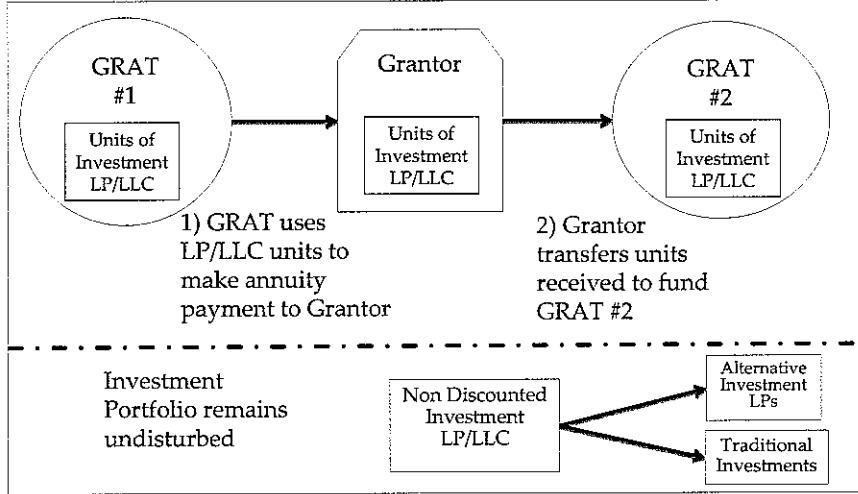


Alternatives and GRATs

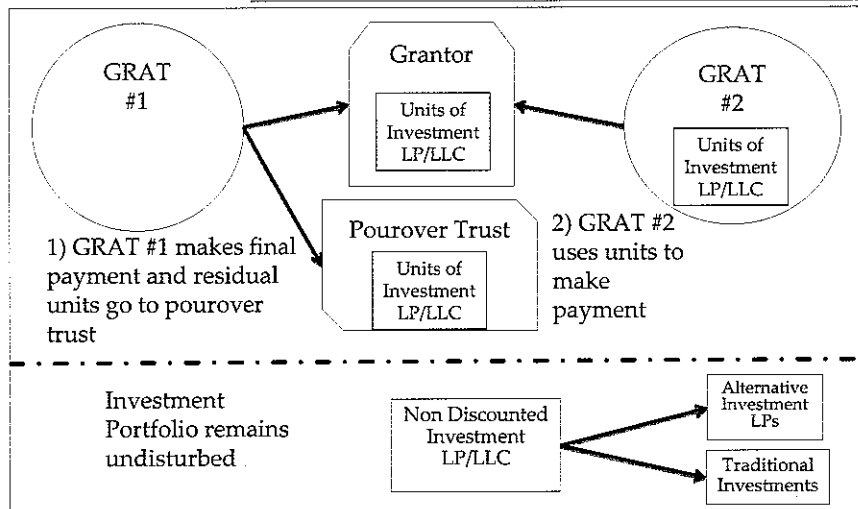




Alternatives and GRATs



Alternatives and GRATs





Alternatives and GRATs

Three main issues should be considered when using alternatives inside of GRATs

- *Qualification of GRAT as an investor* - QP/AI rules must be considered
- *Liquidity* – GRATs need to fund pre-determined annuity payments
 - Many alternative investments are illiquid assets and/or have limited redemption windows. Keeping cash on hand to make payments can defeat the purpose of establishing the GRAT. Using assets instead of cash to make these payments, might be one way around this issue. However, this can be logistically difficult, since many alternatives are private LPs where the GP determines transferability from one owner to another.
 - These hurdles can be avoided through forming a non-discounted LP/LLC for investment of GRAT assets. The GRAT then uses units of this entity as its currency for payment. The LP/LLC can be fully invested regardless of the need for annuity payments to be made.
 - The benefits of an LP/LLC for investment of GRAT assets are even greater when doing a rolling GRAT program. This allows for ease in moving units from GRAT to grantor to new GRAT, to pourover / residual trusts.



Alternatives and GRATs (continued)

- *Market Value of Assets in GRAT* – Annuity payments need to be determined based on the market value of assets in the GRAT.
 - There can be significant issues if there are not daily valuations on the investment portfolio of the GRAT. To do a rolling GRAT plan, having easily attainable market values allows for payments on sequential GRATs to be easily calculated.
 - Some alternatives, such as private equity and private real estate, are valued at cost until fund is mature. Others, such as hedge fund of funds, only provide valuations monthly. Some commodities funds and funds that are organized as publicly traded mutual funds offer daily valuations.
 - Even if establishing a GRAT on a date where the underlying alternative investments provide valuations, doing rolling GRATs with one day in between the return to the Grantor and funding of a new GRAT can cause issues in getting valuations for establishment of each subsequent GRAT.



Unique Gifting Opportunities for Private Equity Fund Principals

Principals in private equity funds have three types of ownership:

- 1) *Capital*: amount invested in fund
- 2) *Cash/Fee income*: fee for managing fund earned regardless of success of underlying investments
- 3) *Carried interest*: incentive fee portion of the fund

Gifting Opportunities:

- Carried interest may provide best opportunity to shift value. Low current value compared to potential. CI can be compared to an out-of-the-money option which is worthless unless "hurdle rate" is met.
- Cash/fee income is not optimal for gifting. It is equivalent to principal's wages. It also has an ascertainable current value based on cash flows.
- Capital has more value than CI as investors repaid before CI is in the money. Requires gifting of cash for meeting capital calls.



Gifting interests in Private Equity for Fund Principals – Potential Pitfalls

- Beware of 1998 Rev. Ruling regarding gifts of unvested stock options which may apply to gifts of carried interest.
 - Ruling states that value of gift is determined upon date of vesting – not upon date of transfer.
 - Critical that LP document allows for vesting upon transfer of carried interest for gift to be complete when value is still uncertain.



Gifting interests in Private Equity -- for Fund Principals – Potential Pitfalls

- Be aware of Sec. 2701 regarding gifts of stock in closely held businesses
 - Section deems a gift of one class of stock a pro rata gift of all classes of stock.
 - Carried interest may be equated to “common” and capital interest to “preferred”. Gift of carried interest (less certain value) can create a deemed gift of capital interest (more certain value).
- Solutions
 - Can accept the treatment and pay some gift tax.
 - Create a private derivative contract to transfer growth opportunity of carried interest.



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