The Fundamentals of HEDGE FUND INVESTING

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Introduction

The linking of global financial markets in the past twenty-five years is triggering a seismic shift in the allocation of the world's capital. Unfettered by geographic borders and tired asset-allocation models, vast capital flows are finding their way to managers whose performance hinges on their wits, not on the happenstance of underlying financial markets.

To take maximum advantage of this convergence of capital and investment opportunity, the world's finest investment managers are establishing vehicles as flexible as the investment strategies themselves. Hedge funds — four decades since their introduction — are poised to become the investment vehicle of the 21st century.

The hundreds of billions of (U.S.) dollars already invested in hedge funds are pursuing a myriad of strategies in virtually all established and emerging markets on earth. While explaining a few of the more popular strategies, the following pages present some of the fundamentals with which anyone considering allocating capital to hedge funds should be familiar.

No information in this brochure constitutes or should be interpreted as a solicitation for any investment. Such offers may be made only by means of a fund's private placement memorandum. A prospective client should independently investigate an investment manager before engaging services of that manager, and should consult with independent qualified sources of investment advice and other legal and tax professionals before using the services of an investment manager. Due to, among other things, the volatile nature of the markets in which investment managers are involved, the investments written about in this brochure may be suitable only for certain qualified investors. Past performance should not be considered indicative of future results.

Hedge funds are pools of capital that *generally* have the following characteristics:

- The use of various hedging techniques, such as short-selling, options-strategies, arbitrage and diversification by sector or geography.
- A manager who has developed an expertise in a specific non-traditional investment strategy.
- A manager with a significant portion of his personal net worth in the fund alongside investors.
- Incentive, or performance-based, compensation for the manager.
- The availability of leverage, which may be used to a significant degree or may not be used at all, as outlined in each fund's offering document.
- Investment returns that have no or relatively modest correlation to traditional assets classes, such as stocks and bonds.

Reason: **Absolute returns vs. relative returns**

Traditional stock or bond portfolios are intended to outperform certain popular indices. For example, if the stock market, as measured by the S&P 500, falls 15% during the year, a traditional equity manager whose accounts fall by only 10% would be regarded as a success due to the "relative" outperformance. Yet, market data show two things - first, that most traditional managers fail to keep pace with unmanaged indices over the long haul, and second, that the greatest determinant of an investor's return from traditional-style investing is the performance of the asset-class itself, not the individual manager.

Conversely, hedge funds mostly pursue "absolute" levels of returns, regardless of how various asset-classes or indices perform. *An investment in a hedge fund is chiefly an investment in a manager*. By using managers who have demonstrated the ability to generate absolute returns, hedge fund investors seek the more consistent and stable year-over-year returns that are more difficult to achieve with traditional investing.

Reason: **Superior investment management talent**

The opportunity to manage one's own investment fund and thus to keep a greater portion of the earnings has sparked a massive migration of investment talent from large investment banking and traditional money management firms. As a result, many of today's most skilled managers go on their own after serving multi-year apprenticeships in niche areas of large management companies. Only by investing in their hedge funds can investors gain access to their talent.

Reason: **Powerful, balanced incentives for management**

Two common features of hedge funds provide strong but counterbalancing incentives for management. First, managers receive the bulk of their fees based on their performance. If investment returns lag, their compensation suffers.

The second feature assures that managers do not assume inappropriate risks in order to earn their performance fees. Hedge fund managers commonly have most of their personal net worth in their funds alongside their investors.

Consequently, a manager's incentive to perform is kept at optimal levels.

Reason: **Opportunistic investment management structure**

Even most traditional-style managers frequently spot opportunities to enhance their returns by various non-traditional techniques, such as selling-short or using leverage. Yet the tight guidelines within which they must operate prevent such actions. For example, mutual fund managers must contend with restrictions on their ability to sell short and to realize short-term capital gains.

Hedge fund managers, on the other hand, operate without such straight-jackets and can capitalize on most any opportunity they discover.

History of Hedge Fund Investing

The term "hedge fund" was coined in the 1950s to describe the pioneering investment strategy of Alfred W. Jones. In an attempt to generate a higher compound return with appreciably lower volatility than traditional long-only accounts, Jones used leverage to add short positions to his portfolio.

Short positions are established by investors who, in hopes of profiting from a price decline, first sell a stock with the expectation of buying it back later at a lower price.

Jones and his many imitators enjoyed celebrated success pursuing this strategy throughout the 1950s and most of the 1960s. However, by the time the great post-World War II bull market in U.S. stocks ended in 1968, most hedge fund managers had stopped using leverage to finance short positions. Instead, they used leverage to fund additional long positions, causing "net" market exposure (longs minus shorts) to exceed 100%. Most of these "unhedged" hedge funds sustained enormous losses and were driven out of business by the time the market bottomed in 1970, some 35% lower than where it had ended 1968.
A few hedge fund managers, among them Michael Steinhardt, remained true to the hedging implicit in the strategy's name and produced superior returns throughout the bear market that persisted until 1982. This period gave birth to a multitude of new strategies, including arbitrage and diversification into the international markets. Most notably, George Soros enjoyed great success as a "macro" manager who capitalized on opportunities across the globe.

The Crash of 1987 accelerated interest in hedge funds by institutions and high net-worth individuals. Several high profile managers made money during the crash and finished the year with returns far greater than those posted by the popular stock market averages.

The ensuing years have brought explosive growth to the hedge fund industry, with the most talented money managers leaving traditional firms to launch their own funds. The collapse of Long Term Capital Management in 1998 momentarily dimmed the popularity of hedge funds and prompted a demand for greater porfolio transparency and liquidity by institutional and high net worth investors. Since then, the strong performance of hedge funds, relative to traditional managers caught in the first bear market in U.S. stocks in 10 years, further stoked the flows of capital and managerial talent to hedge fund investing.

While the pioneering style of Alfred Jones remains popular, it is now only a subset of current hedge fund offerings. Among the more popular strategies employed by hedge fund managers are:

Long/short stock trading. This category includes Jones-model funds, which use leverage to add short positions to long stock portfolios. Among other long/short funds are those that persistently maintain more than 100% net market exposure and funds that have a net short bias. Targeted levels of annual returns are 20% and higher, though managers who maintain non-leveraged, equal long and short exposure usually attempt to compound their money at a 12%-16% rate. The trading philosophies pursued by long/short traders are too numerous to list comprehensively, though they include:

> **Fundamentally-driven portfolios specializing in certain industry sectors,** such as technology, oil services, financial services, utilities or REITs. These funds frequently are managed by former brokerage firm analysts who have specialized in certain industries or by former workers in those industries.
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> **Technically-based trading.** Some managers utilize technical analysis as the basis of their long and short positions. Technical analysts believe that a close examination of past prices and volume can indicate the future direction of prices. They may keep their portfolios close to neutral in terms of long/short exposure or may be heavily directional, speculating on the trend of the general market.

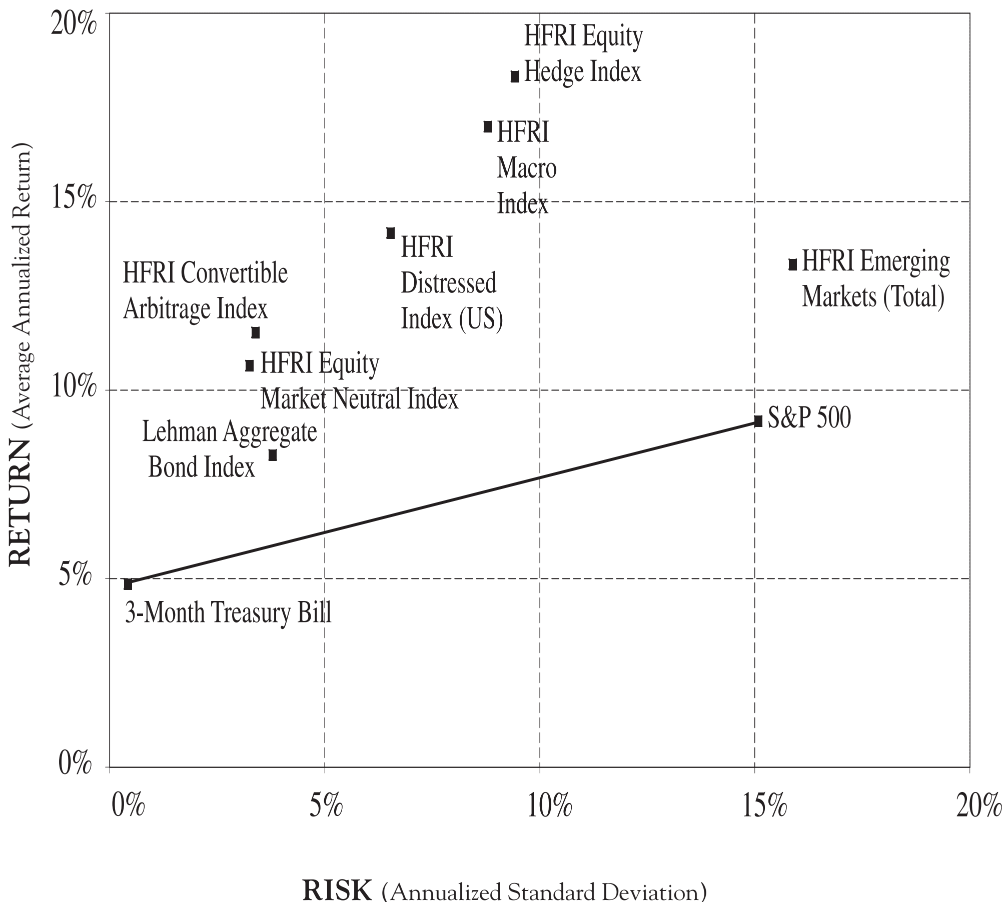
Statistical arbitrage. This strategy is commonly based on proprietary computer models that instruct which stocks should be bought and which should be held short, usually with equal dollar amounts on the long and short sides. These funds involve very active trading and generate returns that are not correlated to stock indices. This strategy targets returns of 10%-18% without leverage, higher with the use of leverage.

Earnings-surprise model trading. Some managers believe that stocks react in a predictable fashion in the weeks following the public release of earnings. They buy and sell based on their expectation of how stocks will perform in the days and weeks following quarterly earnings reports that are above or below the consensus estimate.

Event-driven strategies. These strategies often are pursued by managers who have worked in corporate restructuring and proprietary trading departments of investment banking firms. Targeted levels of returns differ widely. Among the most popular corporate event-driven strategies are:

Risk arbitrage, which involves buying the stock of a company that is in the process of being acquired while selling short shares of the company that is making the acquisition. Some managers substitute call options for long stock positions in order to reduce the amount of money at risk.

RISK/RETURN COMPARISON OF HEDGE FUND STRATEGIES



The hedge fund indices on the above chart appear courtesy of HFR Investments, Inc., 108 S. LaSalle, Suite 774, Chicago, Illinois, 60604, USA, (Telephone: 312-658-0965). The HFRI indices are composed of blended net performance figures from hedge funds tracked by HFRI Investments, Inc. from January 1990 - September 2002 and are not meant to indicate how any particular strategy or fund will perform in the future.

Bankruptcies. Some managers bring a deep understanding of the bankruptcy process to their investment strategy. They purchase equity or debt of companies in or near bankruptcy with the expectation that the value of the securities will rise after the companies emerge from bankruptcy.

Spin-offs. Historically, when corporations distribute to shareholders stock in companies that previously had been units of the corporation, the spun-off shares tend to dramatically outperform the general market. Many hedge fund managers specialize in companies that are spin-offs from larger corporations.

Distressed securities trading. This style of trading generally refers to purchasing debt securities of companies experiencing some level of financial distress, though not necessarily bankruptcy. As an offshoot of a manager's familiarity with a company's debt, stocks also may be traded.

Targeted annual returns can range from 15% to 30%, depending on the manager's trading style. Many hedge fund managers who specialize in this area believe that they take advantage of pricing inefficiencies caused by the "herd-like" buying and selling of corporate debt by high-yield mutual funds.

While corporate bonds are the predominant instrument, in recent years a vibrant secondary market in senior bank debt has emerged. Some distressed debt managers acquire the collateralized bank debt of companies undergoing some financial strain, finance their purchases with less costly bank loans and leverage their holdings as much as 10 or 12 to one.

Convertible arbitrage. This type of arbitrage involves buying convertible stocks or bonds and hedging away much of the equity risk by shorting the issuing company's common stock. The expected profit generally comes from two sources: the coupon on the convertible and the rebate paid to those who short stocks. Convertible arbitrageurs also can gain or lose from sudden changes in the two securities' prices.

This highly popular strategy seeks to deliver annual returns of 10%-15% with only slight correlation to the movement of bond prices. Higher targeted returns are sought by managers using leverage.

Macro investing. Popularized by managers such as George Soros, macro funds seek virtually any investment opportunity in any country. These managers may trade equities, debt, futures, options, currencies, real estate and anything else for which there is a market.

Rather than focusing on individual securities, macro managers generally research and invest based upon the future behavior of national economies. They both purchase securities long and sell them short.

Macro funds are one of the few categories in the hedge fund universe that can operate effectively with very large amounts of money under management.

Emerging markets trading. This style involves any combination of debt and equity issued by corporations or governments in countries with newly developing economies. Russia and the other former Soviet republics, Brazil, Turkey and Mexico are representative emerging-market nations.

Managers invest in emerging market debt because the cost of capital is usually higher than in developed (G-7) nations. While some managers attempt to hedge their currency exposure, others conclude that the cost of hedging is too great and assume the risk of currency fluctuations.

Equity investing is especially popular in those countries that have privatized national assets and distributed shares to the public. Targeted annual returns are high, with many funds in recent years generating returns greater than 70%.

It should be noted that the difficulties in hedging many of the risks in emerging markets trading cause the volatility of this sector to be among the highest in the hedge fund arena.

Market neutral investing. This style can include subsets of each of the other strategies. The common element is the attempt to produce monthly returns that have no correlation to market indices.

Market-neutral investing includes dollar-neutral long/short stock trading, convertible arbitrage, statistical arbitrage and fixed-income arbitrage. For example, a manager of a dollar-neutral long/short fund with $100 million of securities might have $50 million invested long and $50 million invested short.

While traditional market-neutral styles seek to achieve very non-volatile annual returns of 10%-15%, presently many managers claim that their market-neutral strategies can achieve returns of 20% and higher. The "market-neutral" label means different things to different managers and should be scrutinized closely by prospective investors.

Fixed-income arbitrage. Tremendous amounts of money have been flowing into fixed-income arbitrage strategies since the early 1990s. The types of fixed-income securities used in this category range widely, as do the volatility and risk profiles of various fixed-income arbitrage strategies.

Many managers simply use lower-cost short-term financing to acquire longer-term higher-yielding debt. Most, however, use one form of debt to finance more complex financial derivatives, such as collateralized mortgage obligations (CMOs). The normal objective is to capture a difference in yield between two similar securities, and then use leverage to magnify the return on capital.

Because of the extensive use of financial leverage in these strategies, it is essential that the investor or the advisor have a broad and deep understanding of the fund's underlying instruments.

Opportunistic. This classification applies to funds that use their expertise in multiple strategies to allocate capital among the strategies at times they consider most opportune. Managers who possess such a broad range of trading skills can deliver returns that avoid the occasional down-cycles that afflict most other strategies. A common form of opportunistic investing within the event-driven realm occurs when a manager shifts his focus from merger arbitrage, to bankruptcies to restructurings in an attempt to be in synch with the economic cycle.

Funds of Funds. Funds of funds are multi-manager pools that diversify away some of the manager-specific risk and possibly some of the strategy-specific risk. These funds typically are created to deliver a certain range of annual returns within a defined level of volatility.

In return for paying a second layer of fees to the fund's manager, investors in funds of funds should benefit from access to managers with high minimum investments, diversification and ongoing, proactive due diligence.

The general partner of a fund of funds needs to be scrutinized by prospective investors just as other hedge fund managers are scrutinized. Of particular importance is the general partner's ability to find talented managers, combine them effectively into a fund with a defined objective, and monitor ongoing performance.

Statistical Performance Measures

The statistical measures that are used to evaluate risk and return on traditional investments are also applicable to hedge funds. Among the most commonly used measures are:

Compound annual rate of return: The rate at which money invested in a fund has grown when compounded once a year.

Annualized standard deviation: A measurement of volatility of returns that is most useful when compared to the compound annual return. Specifically, the annualized standard deviation is the equal distance above and below the average annual return that defines the span in which roughly two-thirds of all annual returns have fallen.

Standard deviation provides a measurement of one facet of an investment's risk. In short, the lower the standard deviation, the lower the volatility; conversely, the higher the standard deviation, the higher the volatility.

Sharpe Ratio: A comparison of returns and volatility. It is calculated as: (Compound annual return - T-bill rate) / Annualized standard deviation.

When comparing similar funds, higher Sharpe ratios generally are desirable.

Correlation: A measurement of the degree to which investments or indices move in tandem, as expressed by the "correlation coefficient." For example, a perfect positive correlation between a fund and an index would have a coefficient of +1; a perfect negative correlation would have a coefficient of -1.

WARNING: With many of today's hedge fund managers paying scant attention to hedging, the term "hedge fund" may give a false sense of security to some inexperienced investors.

It is essential that a hedge fund investor or advisor perform a thorough examination of a fund and its financial operations. This process is referred to as "due diligence." Investors must be certain that funds undergo annual financial audits performed by reputable accounting/auditing firms and should request a copy of the most recent report.

Additionally, the financial stability of the fund's clearing firm and bank need to be verified. It also is important to note that the fund's documents have been drafted by a respected law firm.

A background check of the hedge fund manager is essential. It can begin with conversations with the manager's previous co-workers, and may include discussions with others in the industry as well as formal background searches.

Capital invested by non-U.S. investors typically are in funds with experienced administrators headquartered in Bermuda, the Bahamas or in Ireland. The same due diligence performed on the money manager should be applied to the fund's administrator.

Hedge funds are not registered securities and are not reviewed by government agencies. Therefore it is incumbent on the investor or the advisor to perform sufficient review to verify the financial soundness of all intermediaries and the honesty and integrity of the fund's manager.

While due diligence is most vital prior to making the initial investment, *it is a process that should continue for the life of the investment.*

Fee Structure of Funds

There is no single industry standard on fees for hedge fund investors. Many U.S. funds charge an annual 1% to 1.5%-of-assets management fee and a performance fee of 20% of annual profits. Funds with less-ambitious return targets frequently have lower fee structures, such as a 1% or 1.5%-of-assets management fee and no performance fee. Performance fees are very much market-driven — the most successful funds with the highest average annual returns can charge as much as 50% of profits, though few managers can command such a fee.

Performance fees generally apply only to "new profits." New profits are those that bring the investor's capital to its highest value to date, often referred to as a "high watermark." Performance fees on funds with high watermarks are not earned until drawdowns from peak performance have been recouped.

Sometimes performance fees apply only to those returns above a certain level, called the "preferred return." For example, a fund may have a performance fee of 15% of profits that applies only to profits above 8%. This fund would be said to have an 8% preferred return.

Prospective investors should read a fund's offering document carefully to understand the applicable fee structure.

Liquidity: Terms of accepting new capital and of redeeming existing investors' interests

In hedge fund parlance, the issue of timing and frequency in which investors may invest or redeem their interests is called "liquidity." Most funds accept investments monthly, some do so quarterly, while others accept new money only once a year. The terms of withdrawal also vary, with quarterly being the most common for U.S.-based funds and monthly the most common for non-U.S funds.

Some funds may require that the original investment not be redeemed for a set period of time, such as one year. This is referred to as a "lock-up agreement." The presence of a lengthy lock-up agreement (i.e., more than one year) sometimes can indicate that the fund manager is making investments that cannot readily be liquidated.

In instances where a fund's terms of liquidity are a concern for the prospective investor, a manager may agree to create a separately managed account. Whether a manager agrees to this is usually determined by the size of the investment.

Communications from the manager

Most non-U.S. funds inform their investors of their monthly performance, with some doing so weekly or even daily. These weekly and daily reports often are printed in various financial journals. U.S-based funds are more likely to make monthly or quarterly reports to investors. All fund investors receive annual financial audits.

Investment minimums

Hedge funds have minimum investments that are set by the manager, who may retain the right to waive the minimum at his discretion. Smaller funds typically will begin with $250,000. Mid-size funds will usually have $1 million minimums, while the largest funds have minimums of $5 million-$10 million.

Frequently, investors can gain access to managers who have prohibitively high minimums by investing in a fund of funds that already has capital with the manager.

Tax considerations

The tax ramifications of investing in hedge funds differ according to each country's tax code. Prospective investors should take into account how a fund's mix of short- and long-term gains affects its net after-tax return. Before making a hedge fund investment, prospective investors should consult with a tax counselor.

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