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Hedge Fund White Paper

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Kim Spinelli	ML1281HedgeFundWtPaper.r2
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INVESTOR EDUCATION SERIES

Hedge funds

Strategies to enhance returns and reduce risk

Hedge funds can play a variety of roles as part of a balanced investing plan. Those seeking to capitalize on expected market movement can enhance returns, while market-neutral strategies can help manage risk. Depending on your current objectives and portfolio allocations, investing in the right hedge funds can offer diversification, flexibility and a more efficient route to higher potential returns.

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What are hedge funds?

Hedge funds have come into prominence in the past decade, but they actually date back to 1949 when Alfred W. Jones, a sociologist and U.S. diplomat, created the first. His interest in Wall Street's workings was sparked by a new consensus: that investors cannot reliably predict the market's outcome on any given day. Jones developed a proprietary investment strategy of selling short significantly overvalued stocks, while purchasing undervalued ones.

This type of hedging may reduce a portfolio's exposure to market movements and emphasizes a manager's skill at security selection. Jones also instituted the requirement that managers invest personally in their hedge funds, and tied a handsome compensation package to positive fund performance. Taken together, these features paved the way for the growth and success of the hedge fund industry.

Today's hedge funds reflect a broad range of investment approaches, each using a unique and diverse array of investments, from basic stocks and bonds to complex derivatives. Indeed, some hedge fund managers do not hedge at all, preferring to either long or short a portfolio of securities. While these strategies can generate attractive returns, they also magnify risk. Other hedge fund managers strive to eliminate as much market risk as possible, looking instead for relative value — derived from inefficiencies between or within markets.

Strategies that span markets, regions and asset classes

Some strategies seek to capitalize on broad market movements, others focus on reducing market risk or exposure:

Long — Combining both growth and value disciplines (but not incorporating short selling and hedging), this equity strategy aims to maximize exposure to upward market movements.

Short — Anticipating market declines, some managers sell overvalued securities that they borrowed hoping to buy them back at a lower price.

Global macro — This opportunistic strategy attempts to take advantage of changing worldwide economic and political conditions, and the market movements of traditional securities, interest rates, currencies, commodities and futures by taking simultaneous long and short positions.

Market-neutral equity — The closest to the original concept of the hedge fund, this strategy seeks to balance long and short equity positions to minimize market risk exposure, and emphasize the manager's stock selection skills.

Fixed income arbitrage — This approach involves taking both long and short positions in closely related fixed income markets or securities. The strategy of *leveraging* — borrowing capital such as margin — is often used to enhance returns.

Event-driven arbitrage — Seeking to capitalize on companies involved in anticipated events such as mergers, a manager may typically take a long position in the acquired company and a short position in the acquirer. This strategy is contingent upon deal risk — not market or securities risk — and tends to perform best when interest markets are strong.

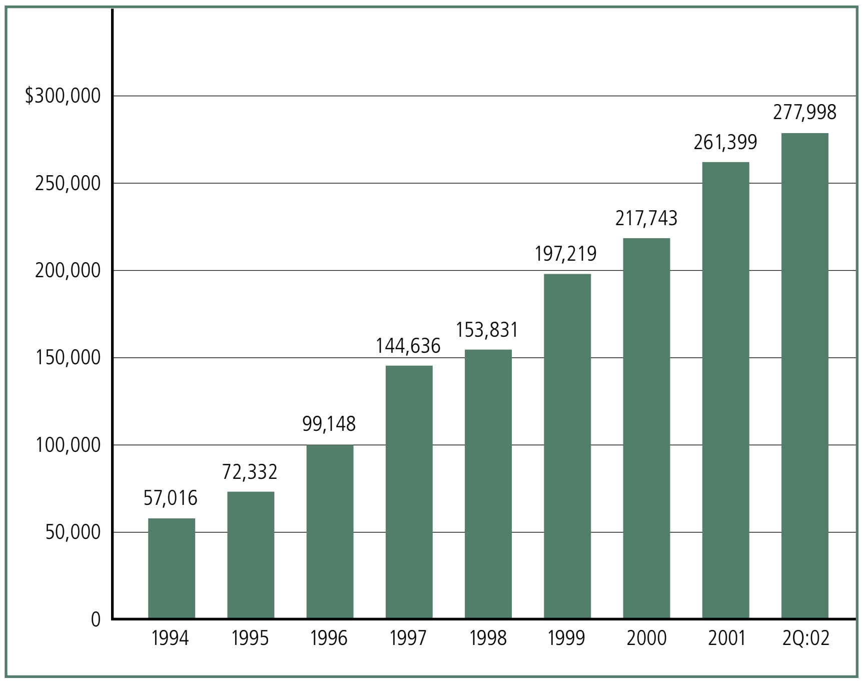
Convertible arbitrage — This approach involves taking long positions in convertible bonds or warrants, hedged with short positions, typically in the underlying stock. Since convertible bonds and warrants are derivatives, their prices reflect the price of the underlying stock, expected future volatility of returns, risk-free interest rates and the issuer-specific corporate/Treasury yield spread.

Distressed securities — Companies that are in or close to bankruptcy sometimes recover. A manager who can identify these companies can purchase the company's equity or debt at a discount in order to realize a substantial return.

Equity hedge — This strategy employs bottom-up research and seeks to balance long and short equity positions to minimize exposure to market risk. Depending on his or her views the manager can shift from a long to short, value to growth, or small to large cap bias that can be sector- or region-specific.

Emerging markets — This method focuses on investing in companies in emerging markets throughout the world. These less-mature markets often exhibit higher volatility and inflation, as well as restrictions on the use of some hedging techniques.

Growth of global hedge fund assets



Between 12.31.94 and 6.30.02, global hedge fund assets increased more than 385%, from roughly $57 billion to $277 billion, reflecting their growing importance in return enhancement and diversification strategies.

Source: TASS Research

Why invest in hedge funds?

For many years, only a handful of sophisticated investors were aware of A.W. Jones' hedged approach to investing — and its long-term success. Then, in a 1966 *Fortune* magazine interview, Jones disclosed that during the previous decade, his fund had performed twice as well as the best-performing mutual fund. This revelation sparked a boom in hedge funds, with more than 150 being created over the next four years.

Since then, interest in hedge funds has periodically waxed and waned, but in recent years, growth has been dramatic. Today, there are more than 6,000 hedge funds worldwide employing a highly diverse range of strategies, and allowing investors with a broad range of risk profiles to benefit from:

Reduced portfolio risk — Carefully selected, hedge funds are excellent diversification tools that can potentially reduce the volatility of an overall portfolio.

Enhanced portfolio returns — Hedge funds can potentially enhance short-term returns, particularly in economic environments where more traditional investments have limited potential.

New opportunities — Hedge funds offer investors a chance to participate in a range of new financial products and markets.

A valuable diversification tool

Hedge funds often function as effective diversification tools because they typically have a low correlation with traditional investments in domestic and international markets.

How hedge funds improve performance

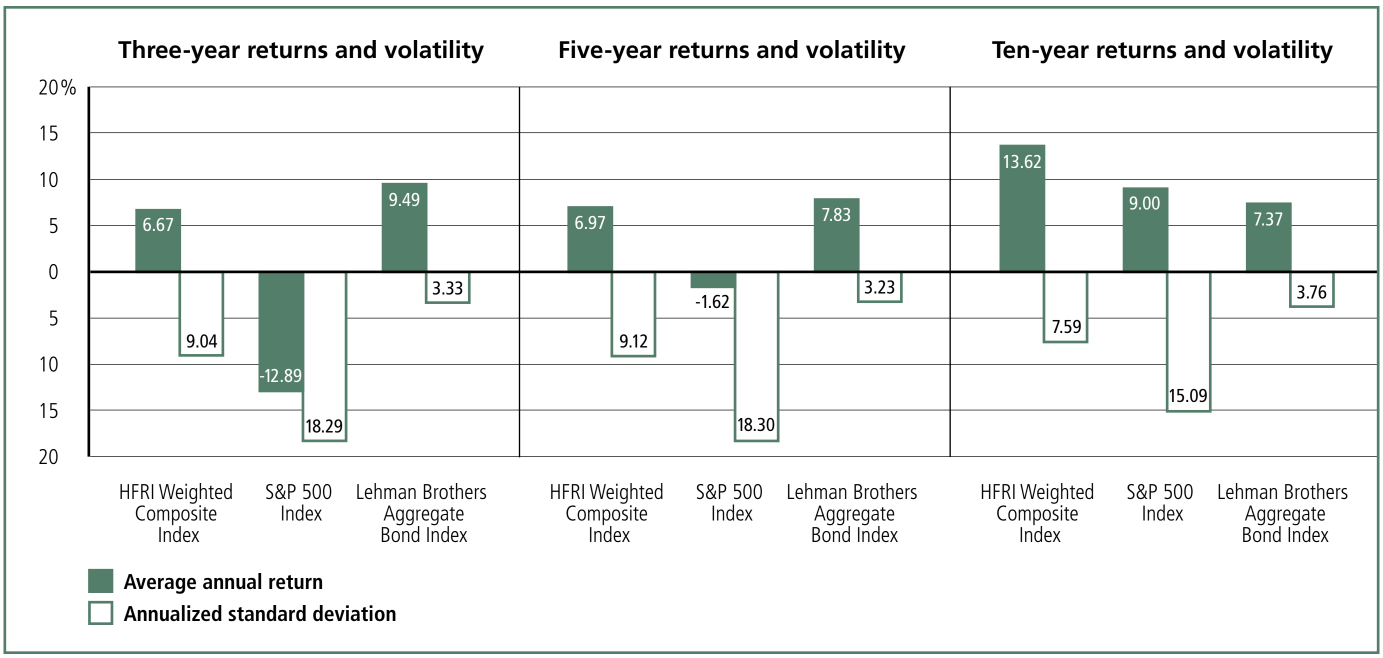
Prospective hedge fund investors should focus on the impact — risk vs. return — that hedge funds can have on a traditional portfolio's overall performance. While returns are comparatively easy to measure objectively, for many investors, risk is subjective and may be difficult to quantify.

Investment professionals think of risk in terms of downside volatility, and they quantify it using standard deviation. The higher the standard deviation, the greater the degree of fluctuation in an asset's value over time — and the greater the risk associated with that asset. This analysis can be further refined by calculating the Sharpe Ratio, a formula that illustrates how much return is gained for each unit of risk assumed when a particular investment is added to a portfolio.

These and other analytic tools have shown that during the past decade, adding hedge funds to a stock and bond portfolio would have enhanced overall portfolio returns while reducing portfolio volatility.[1]

[1] The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 33 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 1,300 funds listed on the internal HFR Database. Due to mutual agreements with the hedge fund managers listed in the HFR Database, we are not at liberty to disclose the particular funds behind any index.

How hedge funds perform compared to stocks and bonds (Annualized as of September 30, 2002)



The HFRI Weighted Composite Index is one common index of hedge fund performance, and it is compared here on a three-, five- and ten-year basis with the S&P 500 Index and the Lehman Aggregate Bond Index, representing stocks and bonds, respectively. When compared to stocks and bonds, historically, hedge funds have less risk — indicated here by standard deviation — and outperformed both asset classes in the ten-year period.

HFRI Fund Weighted Composite Index — The HFRI Monthly Indices (HFRI) are equally weighted performance indexes, utilized by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into 33 different categories by strategy, including the HFRI Fund Weighted Composite, which accounts for over 1,300 funds listed on the internal HFR Database. Due to mutual agreements with the hedge fund managers listed in the HFR Database, we are not at liberty to disclose the particular funds behind any index. The S&P 500® Index is a market-capitalization weighted index, which measures price movements of the common stock of 500 large U.S. companies within leading industries. S&P 500 is a registered trademark of The McGraw-Hill Companies, Inc. The Lehman Brothers Aggregate Bond Index is composed of the Lehman Brothers Government/Corporate Bond and Mortgage-Backed Securities Indexes. It includes Treasury, agency, corporate and mortgage-backed issues.

How to invest in hedge funds

With the time and interest to devote to careful research, some sophisticated investors evaluate and select single-strategy hedge funds on their own. Multi-strategy funds can offer a quicker way to reduce risk through strategy diversification, but they are typically run by individual fund managers. To diversify even further, many investors prefer a *fund of funds* — a portfolio of carefully selected hedge funds with different managers. Each manager adds the value of a complementary investment style. In combination, they can mitigate overall portfolio risk.

The fund-of-funds opportunity

The number of managers in a fund of funds can range from a few to two dozen or more. As with mutual funds, the strategies, objectives and risk/return profiles can vary greatly among different hedge funds of funds. The structure's primary appeal is the diversification it provides. A properly structured hedge fund of funds benefits investors through carefully controlled portfolio construction, intensive manager research, active management of the portfolio and rigorous monitoring of the hedge fund marketplace. Achieving these benefits through individual hedge fund purchases would be difficult for most investors. In fact, unless an investor has extensive financial resources (given the high minimums required for direct investment in individual hedge funds) and the experience and expertise to build a well-diversified portfolio, a fund of funds can be a very attractive solution.

The market or the manager?

Hedge fund investing is sometimes called a skill-based investment strategy, a reference to the value added by the security-selection or strategy skills of a particular manager. While some hedge fund returns are driven in part by broad market trends, a significant component of return is attributable to the manager's investment decisions — much more so than with traditional investments. As a result, many investors choose hedge funds based on their belief in the manager's ability to generate significant returns without relying solely on upward trending markets.

Accurate, ongoing evaluation of the manager requires a high level of communication about investment decisions, as well as institutional-quality performance reporting. Inconsistent investment processes, excessive leverage, use of derivatives, extreme asset concentration and lack of liquidity all pose risks that must be monitored, either by the investor directly or through a consultant with sufficient clout to gain access to this information. These issues are resolved easily through a fund of funds approach, making it all the more appealing.

Fees versus value

Some investors have the perception that hedge fund managers charge high fees, but this is subjective. A hedge fund management fee is comparable to a traditional money management fee. Emphasis on absolute return — rather than merely on exceeding a benchmark — is the reason hedge fund managers garner higher fees.

One of the most significant differences between hedge fund fees and traditional asset management fees is the performance incentive. These fees typically constitute 10%–20% of fund returns over a specified level (known as the "risk-free rate"). In addition, most managers invest a substantial portion of their net worth in their own funds, closely aligning their financial interests with those of their investors. As a result, generating the targeted level of absolute return benefits both investor and fund manager. In a typical "fund of funds," investors pay management and incentive fees to the "fund of funds'" manager and most also bear their share of the management and incentive fees charged by the underlying hedge funds.

Liquidity of hedge funds

While fairly liquid as compared with other types of alternative investments, hedge funds usually apply some restriction on investor redemptions. Before redemptions can be made, investors must notify the fund of their intent to redeem during one of its *call periods,* which are generally scheduled several times each year.

In addition, there are risks associated with investing in hedge funds that are not applicable to other typical investments. Investors should carefully review the terms of a fund with their legal, tax and financial advisors before investing.

Diverse opportunities for the right investors

Because of the range of strategies employed, hedge funds can play an important role in a suitable investor's portfolio. However, there are significant investor qualification requirements, including having at least $5 million of investable assets. Unfortunately, misperceptions about risk may inhibit some investors who could benefit significantly from the return enhancement, risk reduction and diversification advantages of hedge funds. Empirical research and analysis support the potential of hedge funds. Now, it is up to investors to take advantage of the benefits.

The Investor Education Series

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