BEACON POINTE RESEARCH
WHITE PAPER

HEDGE FUNDS 101
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CONFIDENTIAL – PROPRIETARY

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HIGHLIGHTS

- *Summary:* In recent years, there has been a strong surge of interest in hedge funds by both individual and institutional investors. In today's more volatile markets, it is not hard to see the allure of this asset class – as both a tool to further diversify a well-optimized portfolio and an absolute return vehicle to enhance portfolio performance.

  Hedge funds, particularly those employing market-neutral strategies, provide return streams that have low correlation to traditional asset classes.[1] In addition, while traditional investment managers base their performance versus a benchmark, hedge funds mandate an absolute return independent of overall market moves. In the following pages, we will provide a basic overview of the hedge fund industry, a summary of common investment strategies, discuss the primary advantages and disadvantages of hedge funds as a sub-asset class, and explore fund-of-funds as an investment vehicle.

- *Conclusion:* The popularity of hedge funds is a result of increases in both supply and demand. While the strong economy and raging bull-market in the 1990s expanded the pool of eligible investors, improvements to information and analytics, coupled with sweeping advancements in technology, helped fuel supply.

  While hedge funds – and other alternative investment strategies – have the potential to provide important benefits to a diversified portfolio, investors should approach these funds armed with information and caution. Beacon Pointe believes hedge funds can be an appealing addition to portfolios designed to achieve favorable risk-adjusted returns.

[1] Although widely accepted, the degree of correlation between hedge funds and traditional asset classes is still under debate. Agarwal and Naik, "Performance Evaluation of Hedge Funds with Option-Based and Buy-and-Hold Strategies," London Business School, August 2000.

Overview

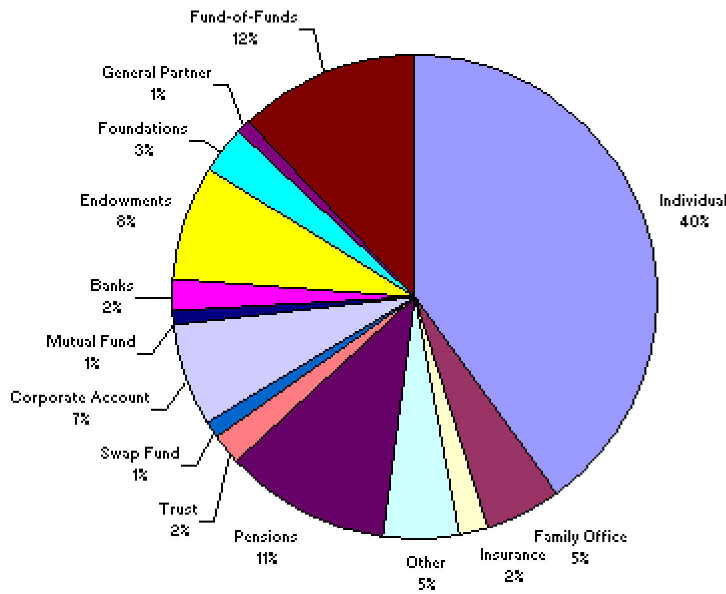
- Hedge funds refer to a broad category of investment approaches, which can be distinguished between directional and non-directional strategies.

  - Directional strategies depend on which way a security or market moves. For example, a portfolio of long positions, similar to how a traditional mutual fund generates returns.
  - Non-directional strategies do not rely on the direction of movement in the market to generate returns. Instead, returns are based primarily on the relationship between two securities/markets – buying a specific convertible debt issue while shorting its stock.

- Before the 1990s, hedge fund investors were predominantly made up of high-net-worth individuals. As more information became available regarding the nature of hedge fund strategies, as well as the risk-return-profile they offered, institutional investors began allocating a portion of their portfolio into these assets.

Figure 1

Estimated Percentage of Funds Invested by U.S. Investors in Hedge Funds, 2000



Source: Joseph G. Nicholas, Market Neutral Investing.

- In the 1990s, assets under management in the hedge fund industry swelled from approximately $20 billion to over $500 billion as the number of funds proliferated from 200 to an estimated 3,500.[2]

[2] Joseph G. Nicholas, Market Neutral Investing, 2000.

- Numerous factors have contributed to the rapid growth of both hedge funds and assets invested in hedge funds.

  - Alternative source of return – hedge funds, particularly those that utilize market-neutral (non-directional) strategies, generate returns with low correlation to traditional asset classes. The bear market of the past three years has increased the attractiveness of this strategy.
  - Expansion of global markets – continued development of new capital markets provide an expanded arena for adept investment managers to exploit pricing inefficiencies.
  - Technology – explosion in telecommunications and information technology has made information more accessible, accurate, and timely.
  - Operating platform – major Wall Street brokerage firms have made it easier to establish new funds by serving as "prime brokers" who finance transactions, lend securities, structure derivatives, settle trades, and even offer office space.
  - Wealth – the bull market of the 1990s created an enormous amount of wealth. Consequently, demand for investment vehicles drastically increased.
  - Performance – success breeds success. Even with all the other factors, the hedge fund industry would not have grown without producing some tremendous results.

- The regulatory environment is a key differentiating factor for hedge funds and contributes to the "mystery" surrounding the industry.
  - Hedge funds are considered private investment vehicles for wealthy individuals and institutional investors.
  - Formed as limited partnerships whereby the investors are considered limited partners and the money managers are general partners.
  - Hedge funds are not allowed to advertise and many funds are offshore for tax and regulatory reasons.
  - Under the U.S. Securities Act of 1933 and the Securities and Exchange Commission, hedge funds can claim the status of a "private placement," so they are exempt from most registration and disclosure requirements.
  - To qualify for the exemption, hedge funds must not have more than 35 "nonaccredited" investors (the SEC defines an "accredited investor" as someone with more than $1 million in wealth or who has earned more than $200,000 in the previous two years).
  - Under the Investment Company Act of 1940, the SEC can regulate mutual funds. However, hedge funds are able to avoid this law by having no more than 99 investors and by not making public offerings.
  - The law has been updated and hedge funds may now have up to 499 investors with more than $5 million each in assets.

- Compensation Structure
  - Broken into two categories: a 1-2% management fee and a 15-20% "incentive" fee, based on the profits.
  - The upside potential is similar to an option the manager gets for running the fund. Although managers might take greater risks because they are in a position to benefit significantly from generating large absolute returns, fund managers typically invest a large percentage of their own money into the funds, which serves to limit their aggressive investing.

Hedge Fund Strategies

- Like the term *mutual fund*, *hedge fund* does not refer to a specific investment approach. In general, *hedge fund* describes a variety of alternative strategies that seek to generate an absolute return.

- As mentioned previously, the investment strategy of hedge funds basically falls under two approaches, directional and non-directional.

- Major directional strategies include:

  - Global macro
    - Identify disparities between price and underlying value across a broad range of assets, including specific stocks, stock markets, bonds, currencies, commodities, and real estate
    - Poster child of hedge funds where managers have carte blanche over investment strategy
    - High rewards with high risk due to concentrated positions and use of leverage to magnify returns
    - Big-picture approach using top-down analysis
  - Market long/short
    - Equity markets – long (short) portfolio of stocks, options, etc.
    - Fixed income markets – long (short) portfolio of bonds, convertibles, etc.

- Major non-directional strategies include:

  - Market neutral
    - Purchase undervalued securities and sell short overvalued securities, some limited to specific industries or sectors
    - Market neutral strategies balance equal amounts of capital investment in long and short positions, in actual securities, options, or futures
    - Convertible hedging involves combining long (short) positions of convertibles or preferred stock with short (long) positions in the underlying common stock
  - Event-driven (special situation)
    - Merger arbitrage – investing in announced corporate takeovers, bankruptcies, spin-offs, divestitures, lawsuits, or other corporate restructurings
    - Distressed securities – purchase of securities of companies in reorganization, usually debt, and often involves active participation by the hedge fund manager in the reorganization process itself
  - Arbitrage
    - Convertible – seeks to generate returns from the mispricing of embedded options in convertible bonds. For example, the equity option can be isolated through a long position in the convertible and a short position in the underlying stock. An increase in the stock price causes the value of the convertible to increase, but at a disproportionately advantageous rate. Meanwhile, by employing a short position in the underlying stock, downside risk is effectively neutralized.
    - Equity (or market) – exploits differences in intrinsic value of equity and equity derivatives.

- Mortgage – attempts to capture profits from pricing differences among mortgage instruments with uncertain prepayment speeds and credit quality characteristics; usually versus a Treasury security.
- Currencies – centered on short-term fluctuations in the relative prices of various currencies.
- Commodities – focused solely on investing in commodity contracts.

➢ While traditional asset class descriptions reflect the securities within the portfolio, hedge fund classifications reflect the basic strategy of the fund. Consequently, it is more difficult to catalog hedge funds because there is far less consensus on style classifications and definitions in the hedge fund universe.

➢ Table 1, below, illustrates the range of strategies employed by various hedge fund managers as classified by Hedge Fund Research, a research and consulting firm specializing in the hedge fund industry.

Table 1

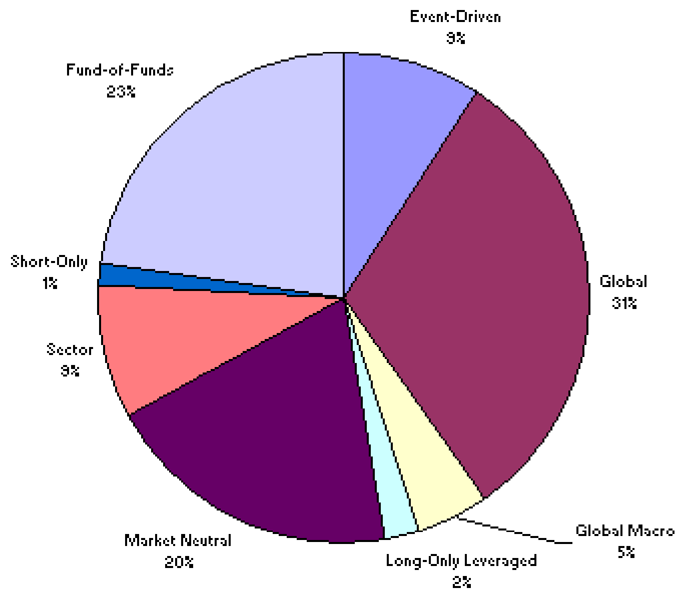
Hedge Fund Classifications:	
Emerging Markets: Asia	Convertible Arbitrage
Emerging Markets: Eastern Europe	Distressed Securities
Emerging Markets: Global	Macro
Emerging Markets: Latin America	Market Timing
Equity Hedge	Merger Arbitrage
Equity Market Neutral	Sector: Energy
Equity Non-Hedge	Sector: Financial
Event-Driven	Sector: Health Care/Biotechnology
Fixed Income: Arbitrage	Sector: Metals/Mining
Fixed Income: Convertible Bonds	Sector: Real Estate
Fixed Income: Diversified	Sector: Technology
Fixed Income: High Yield	Short Selling
Fixed Income: Mortgage-Backed	Statistical Arbitrage

Source: Hedge Fund Research, Inc. (HFRI)

- Figure 2 breaks down the percentage of hedge funds by strategy while table 2 distinguishes assets under management by strategy.

Figure 2

Percentage of Funds by Strategy, 1999



Source: Managed Account Reports (MAR)/Hedge

Table 2

Hedge Funds: Assets Under Management by Strategy, 1999	
Event-Driven	$13,118,000
Global	44,688,000
Global Macro	24,943,000
Long-Only Leveraged	646,000
Market Neutral	25,595,000
Sector	4,629,000
Short-Only	917,000
Fund-of-Funds	17,592,000
Total	$132,128,000

Source: Managed Account Reports (MAR)/Hedge

Why Invest in Hedge Funds?

- Hedge funds represent a substantial opportunity for further diversification with the potential to increase a portfolio's expected return while reducing its total risk.

- Risk-adjusted absolute returns (gross of fees) have been impressive. Table 3 and Figure 3, below, demonstrate the risk and return characteristics for specific strategies relative to traditional investments over a recent 10-year period.

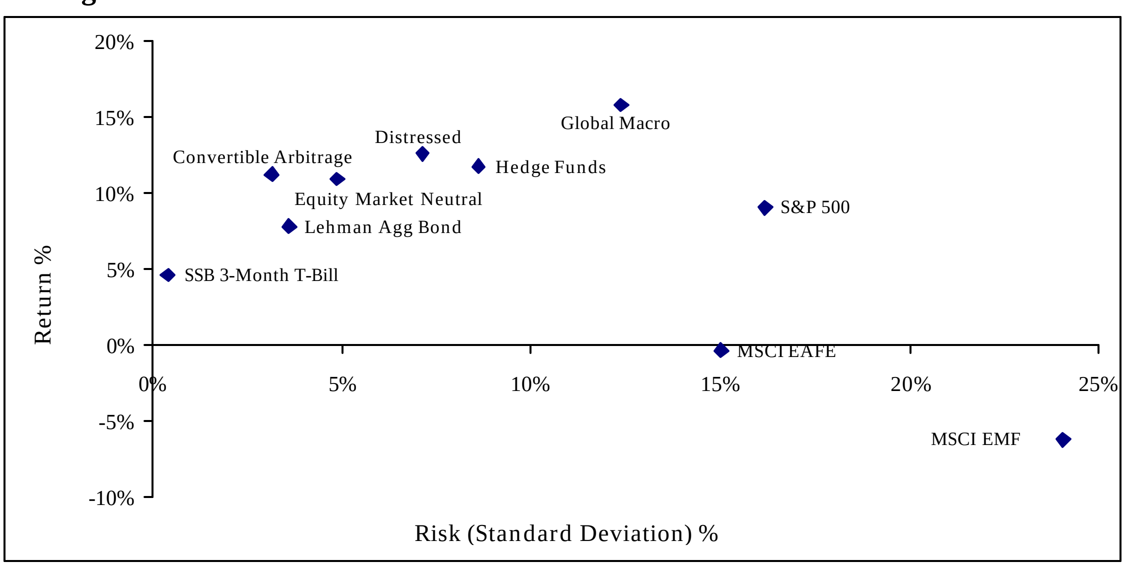
Table 3

Risk-Return Profile for Various Hedge Fund Strategies, 10 Years Ended March 2003

	Annualized Compound Return	Annualized Standard Deviation	Sharpe Ratio (5%)
CSFB/Tremont Convertible Arbitrage Index	10.94%	4.88%	1.159
CSFB/Tremont Distressed Index	12.59%	7.14%	1.022
CSFB/Tremont Equity Market Neutral Index	11.25%	3.15%	1.865
CSFB/Tremont Global Macro Index	15.79%	12.37%	0.858
CSFB/Tremont Hedge Fund Index	11.74%	8.61%	0.769
Lehman Aggregate Bond Index	7.78%	3.61%	0.746
MSCI EAFE - Net	-0.36%	15.02%	-0.274
MSCI EMF (Lazard)	-6.24%	24.06%	-0.345
S&P 500	9.03%	16.17%	0.316
SSB 3-Month Treasury Bill	4.61%	0.39%	-0.948

Source: Lazard Freres, Asset Management

Figure 3



- Hedge funds have not only been significantly uncorrelated with the U.S. equity and debt markets, but also with each other. The correlation matrix, shown in Table 4 below, illustrates the historical movements of these strategies with each other as well as that of traditional asset classes represented by established benchmarks.

Table 4

Correlation Matrix for 10 Years Ending March, 2003	Tremont Convertible Arbitrage Index	Tremont Distressed Index	Tremont Equity Market Neutral Index	Tremont Global Macro Index	Tremont Hedge Fund Index	Lehman Aggregate Bond Index	MSCI EAFE - Net	MSCI EMF	S&P 500	SSB 3-Month Treasury Bill
Tremont Convertible Arbitrage Index	1	0.520	0.294	0.271	0.383	0.067	0.042	0.182	0.110	0.154
Tremont Distressed Index	0.520	1	0.377	0.290	0.562	0.006	0.369	0.598	0.530	0.103
Tremont Equity Market Neutral Index	0.294	0.377	1	0.189	0.321	0.062	0.318	0.329	0.419	0.246
Tremont Global Macro Index	0.271	0.290	0.189	1	0.856	0.242	0.088	0.222	0.214	0.092
Tremont Hedge Fund Index	0.383	0.562	0.321	0.856	1	0.137	0.235	0.517	0.459	0.116
Lehman Aggregate Bond Index	0.067	0.006	0.062	0.242	0.137	1	-0.016	-0.173	0.002	0.108
MSCI EAFE - Net	0.042	0.369	0.318	0.088	0.235	-0.016	1	0.370	0.334	0.106
MSCI EMF (Lazard)	0.182	0.598	0.329	0.222	0.517	-0.173	0.370	1	0.676	-0.062
S&P 500	0.110	0.530	0.419	0.214	0.459	0.002	0.334	0.676	1	0.200
SSB 3-Month Treasury Bill	0.154	0.103	0.246	0.092	0.116	0.108	0.106	-0.062	0.200	1

CSFB/Tremont Hedge Fund Index consists of a master index and series of sub-indices that represent the historical returns of this asset class. The series of sub-indices is designed to track the primary categories of investment styles used by hedge fund managers. Each sub-index is calculated using the same exacting methodology as the master Index.

- By blending a diversified pool of hedge funds with traditional asset classes, portfolio diversification can generally be enhanced.

- This results in a meaningful improvement to the risk-reward profile of a portfolio.

Caution: Hedge Fund Data Biases

- Some hedge fund databases claim to be free of some or all of these biases. However, when faced with an impressive track record of a hedge manager (or a fund category), awareness of potential biases will help in the decision-making process.

- *Selection bias* – There are managers who simply choose not to be included in hedge fund databases. Two potential reasons are:
  - Managers with poor performance will not want to look inferior against better performing peers
  - Successful managers with a reliable source of capital and ideal level of assets under management simply don't want, or need, any additional business

- *Survivorship bias* – When hedge funds wind up or shut down, some hedge fund databases will completely eliminate that fund's current and historical data. This is a common criticism of historical mutual fund performance. The assumption underlying this bias is that funds that cease to exist have, as a group, poor historical performance. Thus, taking this group of poor performers out of a category average artificially boosts the category's track record.

- *Backfill bias* – Funds with some history that are not currently included in any hedge fund database may, at some point, ask to be included. Since these funds would not be new (just new to the database), these funds may be allowed to provide all of their historical data from inception, even though they were not part of the database in previous years. Managers requesting this are likely to have good performance, thereby creating another upward bias to historical hedge returns.

- *Infrequent pricing* – Since many positions held by hedge fund managers are illiquid (i.e. tough to sell quickly without driving down the price), actual market values for many securities are unavailable. Consequently, asset values are sometimes based on subjective factors.

Disadvantages of Investing in Individual Hedge Funds

- Substantial account minimums, usually between \$500,000 to \$1,000,000, limit the amount an investor can dedicate to hedge funds, thus limiting the diversification effects this asset class can provide.

- Identification of top performing managers is an extremely difficult task, considering the black box syndrome due to lack of transparency and complex trading strategies.

- Access to superior performing, well-structured hedge funds is limited, primarily due to capacity constraints and established relationships within a close-knit investment community.

- Hedge fund data is problematic and should be scrutinized with a particularly large grain of salt. Besides the biases mentioned on the previous page, reliable hedge fund databases have only been available since the early 1990s.

- Difficult to accurately model capital market assumptions – for hedge funds, in this case, and nontraditional investments, in general – in order to determine an optimal allocation.

- Liquidity concerns due to infrequent withdrawal windows – generally on a quarterly or annual basis.

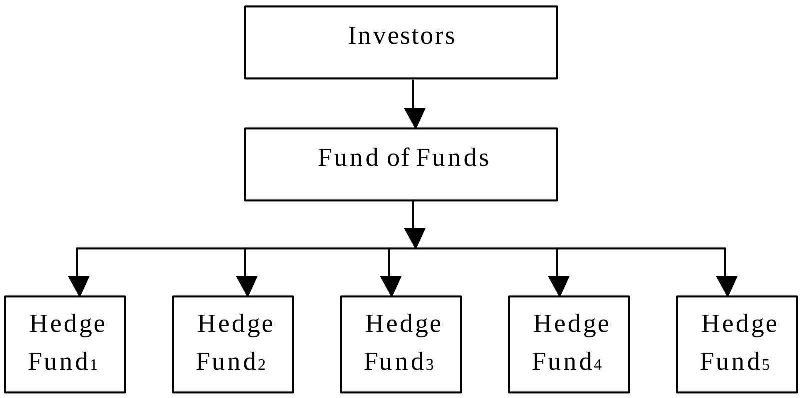
- New entrants to hedge funds and investors who desire a smaller allocation to their portfolio should consider the fund-of-(hedge)funds investment vehicle.

Fund of Funds

- A Fund of Funds ("FOF") is a commingled fund that employs multiple investment strategies and styles through a diversified portfolio of individual fund managers.

- Figure 3, below, is representative of the process.

Figure 3



- FOFs offer several distinct advantages over individual hedge funds:
  - Professional oversight of investment managers
  - Access to investment products not currently available due to large minimum investment thresholds, or "closed" status
  - Dynamic Allocation
    - Continual assessment of macro environment and individual strategies
    - Strategy exposures are modified as appropriate
    - Monitor adherence to Investment Policy guidelines
  - Diversification of Managers
    - Monitor concentration within strategies, styles, and managers
    - Managers selected within the same style may employ different approaches
    - Flexibility to invest with "Best of Breed" managers
    - Examine manager correlation to stock market and to each other
  - Ongoing Due Diligence
    - Continual evaluation of each underlying manager
    - On-site visits to individual manager offices

- There are also some disadvantages associated with FOFs:
  - Additional Layer of Fees
  - Decreased Investment Transparency
  - Inexperienced New Investment Managers
  - Potential Reversion to the Mean
  - Late Tax Reporting

Conclusion

- The popularity of hedge funds is a result of increases in both supply and demand. While the strong economy and raging bull-market in the 1990s expanded the pool of eligible investors, improvements to information and analytics coupled with sweeping advancements in technology helped fuel supply.
- Hedge funds refer to a broad category of investment approaches, which can be distinguished between directional and non-directional strategies.
- Hedge funds are categorized based upon the basic strategy employed by the fund.
- Over a recent 10-year period, the risk-adjusted absolute returns for major hedge fund categories have outperformed traditional asset classes based upon CSFB/Tremont Hedge Fund Indices.
- While hedge funds – and other alternative investment strategies – have the potential to provide important benefits to a diversified portfolio, investors should approach these funds armed with information and caution. Used properly, however, Beacon Pointe believes that hedge funds can be an appealing addition to portfolios designed to achieve favorable risk-adjusted returns.
- Fund of Funds offer professional oversight, access, diversification, and ongoing due diligence on a collection of underlying individual hedge fund managers. Beacon Pointe believes that an additional layer of due diligence combined with the full-benefits of diversification represent a superior option to individual hedge funds.
- Please feel free to contact your Beacon Pointe consultant if you have any questions.