

HEDGE FUND GUIDE

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Investment strategies for volatile markets...

"Your guide to the hedge fund market place"





Introduction

More and more investors are looking to alternative assets to protect their private or institutional wealth. Commonly, this is motivated by a desire to preserve capital growth whilst de-coupling a proportion of one's investment portfolio from the vagaries of equity market returns. 'Non-directional' or 'non-correlated' hedge funds have expanded dramatically in recent years to fill this niche and have earned their place in the wealth management framework by providing regular, positive returns, irrespective of market conditions.

This guide has been prepared in order to familiarise investors and their advisors with some of the most popular strategies and commonly used terminology associated with this asset class.

What is clear is that the time-honoured priorities of thorough research and informed manager selection are as critical to the decision making process in the 'alternative' arena as they have always been in mainstream equity investment. That is why we have chosen to work in partnership with MAXAM Capital Management LLC, whose team of investment professionals has gained extensive experience over the last 20 years as hedge fund consultants.

The Funds managed by MAXAM include 'fund of hedge funds' designed to enable private clients to invest in a high quality portfolio of alternative investment funds that is continually researched and professionally managed. In recognition of the fact that the industry has grown exponentially both in terms of assets invested and number of managers, MAXAM focuses on identifying superior managers with a clear investment edge and a proven ability to perform. MAXAM subjects the individual funds within the portfolio to regular and detailed analysis, with a particular emphasis on performance monitoring and, accounting integrity. Diversity exists in terms of both asset allocation and manager-style, with the balance between different strategies if necessary to reflect current and anticipated market conditions. At all times MAXAM is dedicated to maximising returns, whilst observing the parameters of the fund which have been put in place to promote consistency and a lack of correlation with major equity markets.

ALPHA INVESTMENT MANAGEMENT

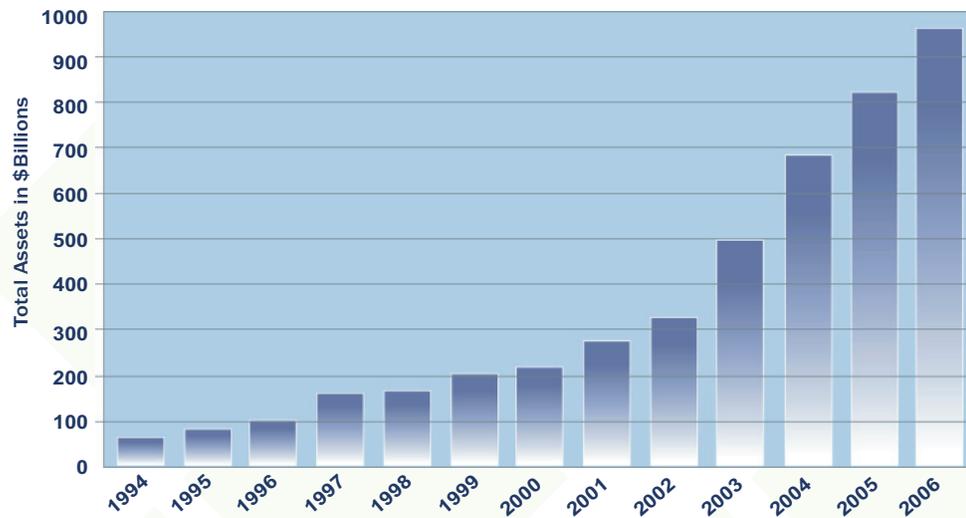




The Hedge Fund Industry

The hedge fund industry, including funds of funds, is now estimated to be worth in excess over 1 Trillion USD and to be growing at about 20% per year. The successful historical performance of many of these funds, together with a series of shocks within the major equity markets and low interest rates, has encouraged a flood of private and institutional investors to reallocate part of their portfolios towards this sector.

Asset Growth Of hedge funds single manager funds, source TASS



Historically, by far and away the largest classification of investors has been high-net-worth families, followed by Swiss private banks and U.S. endowments/foundations. However, institutional interest is growing year on year and is expected to continue to provide significant capital flows.

Because of their historically low correlation to equities and bonds, hedge funds are often viewed as a separate asset class, providing diversification from traditional, market-correlated investments.

What is a 'Hedge Fund'?

'Hedge Fund' is a wide-ranging term that is used to describe a variety of 'alternative' investment approaches to the more traditional 'long-only' style. What nearly all of them share in common is that they are dedicated to achieving an absolute-return investment objective (normally expressed as a defined targeted range of return – for example, 9%-15%) that is not index- or benchmark-based.

The most important difference between hedge funds and traditional collective funds is that, in order to achieve these objectives, they are normally allowed to create both long and short positions in securities or related contracts that fall within the investment parameters of that fund. It is this strategic flexibility that enables them to control or mitigate Beta in a way that is not possible for 'long-only' managers. Moreover, they also normally have the freedom to employ the widest possible range of financial instruments in order to create and implement their investment strategy.

It is important to understand the differences between the various hedge fund strategies because they vary enormously in terms of investment returns, volatility and risk. One important myth to dispel is that all hedge funds are volatile or 'high risk'. – i.e. that they all utilise significant leverage and unmatched derivatives to make large directional bets. Whilst this is true of some of the most famous (or infamous) funds, it is estimated that such funds represent less than 10% of the market. Many hedge funds do not use leverage or use it only as a short-term measure to manage liquidity and most managers use derivatives to manage their portfolio more efficiently and reduce risk rather than to magnify it.

As with any developing industry, the hedge fund world is riddled with jargon, but nonetheless, most strategies can be broadly grouped into the following three main headings:

Relative Value Strategies

Relative Value funds aim to exploit pricing or spread inefficiencies between related securities, whilst correspondingly 'hedging' out market or interest rate risk in order that the fund is only exposed to the relative movement between the instruments concerned. Strategies that fall within this category would include convertible arbitrage, fixed income arbitrage, and the various strategies that capture pricing inequalities between derivative contracts and the underlying asset upon which they are based.



Event-Driven Strategies

Event Driven funds aim to exploit market prices that incorrectly reflect the manager's view of the probability of a particular event occurring such as a merger, take-over, or even, in some cases, the probability of insolvency. Merger Arbitrage (announced or unannounced) is a common example, and Distressed Securities (investing in, what the manager believes to be, excessively discounted securities or companies in financial distress) would be another. As with Relative Value strategies, the Manager will normally aim to remove directional risk.

Opportunistic Strategies

Opportunistic strategies can be global or can be country, sector or asset class specific. However, they all rely upon the manager correctly identifying the prospects for stock, bond, currency or volatility in markets and positioning the portfolio to benefit. The most common of these strategies is 'Global Macro', and such funds may often employ leverage. These types of fund are potentially more volatile, although this has often been reflected in higher returns than the lower risk Relative Value or Event Driven strategies.

Hedge Fund Strategies

Hedge Fund strategies vary significantly in terms of both the potential magnitude of returns and the risk inherent in achieving them. At the lower risk end, we have the Relative Value strategies which aim to reduce or remove systematic market risk, whilst benefiting from a perceived pricing inefficiency in the market in which they operate. At the highest end of the spectrum, we find strategies designed to increase, or leverage, the return received when the manager correctly calls the direction of a particular market or sector, giving a much higher risk/reward profile.

There are many different types of hedge funds, seeking to exploit all manner of international, country, sector or sub-sector opportunities. However, they broadly tend to employ a variant or combination of one of the following strategies – which we have attempted to place in approximate ascending risk order. However, it is critical to recognise that, depending upon the precise details of the mandate, a particular fund may have a higher or lower risk/reward profile than the text book definition. That is why fund specific research is so important.

Index Arbitrage

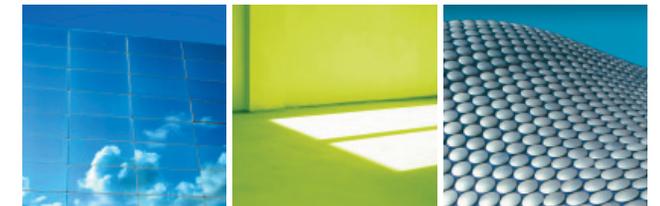
This strategy involves identifying and then taking advantage of anomalies between the price of the underlying stocks that form an index and the futures contract relating to that index. Assuming that the manager is skilled at replicating the futures contract and is not forced to close out positions early, the strategy is considered very low risk in terms of market exposure as an equal and opposite effect should remove beta. In fact, the main risk of this strategy is that it may under-deliver to investor expectations (particularly in bull markets) precisely because it reflects an almost risk-free return. The strategy has spawned a whole range of variants, all aimed at exploiting the spread between either a derivative and its underlying asset, or two derivatives on the same or similar underlying asset.

Convertible Bond Arbitrage

This strategy involves exploiting the spread between convertible instruments such as convertible bonds or warrants and the underlying security upon which they are based. For example, if the manager identifies that the convertible is undervalued, he may take a long position in the convertible whilst mitigating market risk by short selling the underlying equity.

Fixed Income Arbitrage

This strategy aims to exploit the spread between fixed interest securities, often whilst attempting to mitigate interest rate risk. Because returns can be slender and margins tight, these funds frequently employ significant leverage.





Long/Short Equity

Perhaps the best known of the Alternative Strategies, Long/Short Equity involves buying securities identified as undervalued and selling those identified as overvalued. Depending upon the balance and correlation between the long and short positions, the fund may be market insensitive (have eliminated beta) or market directional (attempting to further enhance performance by taking an, albeit diluted, view on the direction of the market as a whole). In any event, the strategy fundamentally relies upon successful sector analysis and stock picking.

Long Biased

A subset of Long/Short equity, long-biased funds are (as their name suggests) tilted towards positive market moves. Many sector specialist funds, such as technology, healthcare or financial funds fall into this category.

Short Biased

These funds are bearish in so far as they are tilted towards negative market moves.

Merger Arbitrage

This strategy seeks to capture the disparity between the current market price of a security and its value upon successful completion of a take-over or merger. Market risk is sometimes mitigated by taking a short-position in the acquiror to offset the long-position in the acquiree.

The risk profile of this strategy varies depending upon:

- Whether it is being run on an announced or unannounced basis - 'announced' funds can, as the name suggests, only invest in situations that have been formally announced. Un-announced funds can also invest in earlier in the event cycle, albeit with less certainty.
- Whether it focuses on agreed corporate activity, hostile corporate activity or a combination of the two. – clearly the risk of the action not going ahead is greater in hostile situations.

Distressed Securities

A Distressed Securities strategy relies upon the manager correctly identifying mis-valued or versold securities issued by companies facing financial difficulty or some other similar uncertainty. They are normally structured in such a way as to be relatively market insensitive. The risk in this strategy is that the manager has mis-judged the situation and, rather than the security re-valuing over time, the issuer of the security fails to recover or even becomes fully bankrupt.

Emerging Markets

More of a fund classification than a strategy per se, these funds may invest in equities, debt securities or both. The important point to remember is that short selling is often either not practicable or even not allowed in many emerging markets. Consequently, these funds are often not hedged, only partially hedged or imperfectly hedged (i.e. the instrument used for hedging is not accurately negatively correlated to the reference position).

Global Macro

This strategy depends upon the manager correctly predicting the relative performance of different world economies and the impact that that will have on currencies, equity markets and bond markets. Although they may occasionally employ hedging strategies, these funds normally use both leverage and derivatives to maximise exposure to that judgement having been correct. This makes the strategy one of the most potentially rewarding, but also one of the most volatile and with a significant degree of 'manager risk'.





Blending Hedge Funds and Traditional Investment Strategies

Formulating a Wealth Management Strategy

When formulating a wealth management strategy it is important to consider all of the invested assets of the client, irrespective of the 'wrapper' or portfolio type in which they are held. The investment advisory can then map out the investors aggregate exposure to different asset classes, currencies, markets and related sectors and other recognised security classifications (for example large, medium and smaller companies). In turn, this will provide a profile of risk and potential reward that can then be compared with the client's objectives, priorities and tolerance for risk.

Traditional Investments

Irrespective of the strategy being employed – from 'index tracking' which aims to perfectly emulate beta, to a totally 'bottom up' stock-picking approach which relies on the managers ability to pick superior stocks and capture 'alpha' – the results of long-only investment strategies (where the manager's only option is either to own or not to own a security which falls within his investible universe) are irrevocably impacted by the direction of the market concerned.

The long term attractions of having one's wealth associated with equity markets is well documented, as is the significant short and medium term volatility that is inherent to capturing these benefits.

Smoothing the Path...

In order to stabilise an investor's mainstream, beta-oriented, investments, an advisor is faced with two fundamental choices:

1. to select assets with an inherently lower risk/reward profile (such as Government Bonds or highly rated cash deposit facilities); or
2. to find assets which maintain the growth potential and risk/reward profile of traditional market investment, but that deliver those returns in a pattern that is un-correlated with mainstream markets.

Absolute Returns

Absolute return hedge fund investing, which uses existing market instruments in a totally different and highly sophisticated way (designed to produce absolute returns irrespective of market conditions) can make option 2 a feasible reality).

Implementation...

Hedge Funds, or indeed any alternative investment class (such as property) should be blended with the client's mainstream investments in a proportion commensurate with their investment objectives. However, it is important to appreciate that alternative assets can only smooth equity returns if the allocation to them is of sufficient magnitude to act as a counter-weight to the equity portfolio.

Why Employ a Fund of Funds Structure?

Well managed 'Fund of hedge funds' vehicles enable investors to enjoy the benefits of style and manager diversification with a relatively small investment. This is important both from a risk management perspective and because the individual funds that enjoy the best track record frequently have levels of minimum investment that are prohibitively high for single investors (\$ 1 000 000 is not uncommon).





Glossary of Terminology

Alpha

That part of the return on a security that is unique to that security and does not derive from returns on both the market as a whole or the sector/sub-sector in which that security falls.

Seeking to exploit pricing inefficiencies between related securities – for example, identifying that a futures contract is undervalued, versus the underlying securities on which it is based, after allowing for cost of carry.

Beta

That part of the return on a security (or portfolio of securities) that reflects its participation in the returns received on the market as a whole. If a security (or portfolio) has a beta of less than one, it will appreciate less than the market as a whole during rising markets, and depreciate less than the market as a whole during falling markets (all other things being equal). If it has a beta greater than 1 the reverse would be true. Index trackers aim to provide a beta of exactly 1.

Capacity

This is the limit set by the manager of the portfolio beyond which he cannot accept additional funds under management. The most common reason is that he believes that this is the point where the portfolio will no longer be able to fully participate in attractive deals, thereby aking additional inflows dilutive to performance.

Greatest Losing Streak

The longest time during which the portfolio decreased in value

High Water Mark

Many funds have enshrined within their prospectus, a High Water Mark policy. This is designed to prevent the manager from disproportionately benefiting from an upswing in performance following a period of under-performance. It works upon the principle that each time the Net Asset Value (NAV) hits a new high, it represents a new High Water Mark.

Subsequently, the performance fee only becomes payable on returns calculated with reference to the High Water Mark. This effectively removes the opportunity for fund managers to be rewarded for merely returning the NAV to its earlier high after a period of under-performance. The High Water Mark may or may not be re-based annually.

Hurdle Rate

Enshrined within the prospectus for some hedge funds, the hurdle rate is a pre-determined level of performance which must be achieved before a performance fee becomes payable. It is often set with reference to a cash or short dated treasury note rate, as these are regarded as proxies for the 'risk free rate' referred to in the Capital Asset Pricing Model (CAPM theory). The presence of the hurdle rate ensures that the manager is only receiving additional reward when the portfolio is providing excess return over and above the base line rate.

Market Insensitive

Portfolios whose long and short positions have very closely matched exposure characteristics such that market risk is, to a large extent, neutralised.

Maximum Draw-down

This is a statistic often used in hedge fund draw-down analysis, and refers to the greatest % loss made by the portfolio in any consecutive period since inception.

Maximum Leverage

The maximum level, normally represented as a % of the portfolio, to which the hedge fund may borrow.

Sharpe Ratio

This is a measure of the excess return that has been achieved over & above the risk-free rate of return), per unit of risk taken. The formula to calculate it essentially takes the annual rate of return achieved, minus the risk-free rate (often US Treasury Bills), divided by the annualised standard deviation.



Selling Short

The sale of shares or other financial instruments that the fund does not actually own, in anticipation of buying them back for a lower price, at a future date, thus closing out the position at a profit.

Standard Deviation

The average extent to which actual returns have varied around the average return. A large standard deviation denotes much greater volatility of results than a lower standard deviation.

Stop Loss

A policy imposed by the manager upon himself whereby he must close out a loss making position when the losses hit a pre-determined level. This is considered good discipline and is designed to limit the downside that can be suffered if the manager's original judgement regarding a particular opportunity proves not to be borne out by events.

Style Shift

Style shift is widely regarded to be one of the key risks facing investors in hedge funds. It refers to the phenomena whereby, overtime, a manager 'drifts' away from the application of the style and risk profile promised to investors in order to try and bolster disappointing or below trend results. Typically, this means they have started taking bigger risks, either than they used to or than they promised.

Transparency

This occurs when the manager allows investors to view the make up of his portfolio on a regular (though perhaps lagged) basis. If the recipient is skilled at interpreting the information provided, it can enable them to monitor whether the manager is staying within the expected parameters and to allow them to satisfy themselves that the manager is applying the strategy he promised to use.

Perception	Reality
"Hedge Funds are speculative investment vehicles"	Most Hedge Funds are absolute return oriented, provide consistent returns, have a relatively low volatility and don't take large bets on the market.
"Hedge Funds target outsized returns"	Most Hedge Funds target modest returns of 8-15%
"Hedge Funds are a new craze"	The first Hedge Fund was created in 1949; the industry grew slowly until the mid-1980's when new investment technologies made hedging easier. Since then, the number of Hedge Funds has increased steadily.
"The performance of Hedge Funds is suffering because of the massive sudden inflow of new assets"	The inflow of assets has been steady and there are no signs that Hedge Funds cannot deal with new money.
"Recent Hedge Fund performances show that their performance targets are just big talk: they are hardly positive this year!"	Performance targets are long-term – an analysis of past Hedge Fund performances shows that there are periods with above and with below average performance. Recent performance shows that in extreme market volatility, Hedge Funds provide strong protection.
"Hedge Funds are responsible for recent sharp market falls"	It is no doubt true that some Hedge Funds short the market – these funds form a small minority in the Hedge Fund business and in fact they are not really Hedge Funds but leveraged funds – and we stay well away from them!
"Most Hedge Funds do not hedge"	The degree of hedging varies – but most strategies are hedged and these form the largest proportion of funds in the Alternative Growth and Optimum Strategy fund of hedge fund ranges. High risk funds can be totally unhedged.
"Charges are too high"	Charges are mainly related to performance; the management fees reflect the very specific expertise required to produce absolute return strategies; all returns are quoted net of fees".