MAXIMISING RETURN WITHOUT LOSING CAPITAL

The fund of hedge fund strategy aims to produce absolute returns while inherently keeping a close grip on risk

Alternative investments are a great source of returns in many different market scenarios. The growing complexity of the hedge fund universe and the higher barriers to entry make it increasingly difficult for investors to invest directly. Funds of funds have a genuine role to play by providing strategic allocation, investment diversification, and access to the best hedge funds with lower entry ticket. Funds of hedge funds combine the search for alpha, or absolute returns, with a tactical allocation, leading to better risk control.

PORTFOLIO CARE

Funds of hedge funds provide absolute returns with low volatility through careful portfolio construction and asset allocation.

Funds of funds offer two sources of alpha: “the top-down” approach to determine the various strategies as well as the “bottom up” approach by selecting the best managers for a particular strategy. See Chart 1.

While hedge fund selection is crucial, constructing a quality alternative investment portfolio requires skill and discipline.

A significant part of CA-AIPG’s investment team is dedicated to asset allocation as hedge fund strategies cover a broad range of strategies, styles and instruments. Our aim is to optimise the allocation between the different alternative strategies to achieve two objectives: maximise returns and minimise risk.

Our investment process is based on three criteria:

- An exhaustive optimisation using all correlation matrices for all strategies involved to establish the global investment guide lines for each fund of hedge funds. Hence broad guidelines will, for example, be 10-20 per cent on primary hedge fund strategies and 0-10 per cent on secondary hedge fund strategies.
- An in-depth macro-economic analysis and strategy-specific forecasts to achieve an optimal portfolio that responds to return and risk objectives. It is a continuing process that not only includes permanent analysis of the macroeconomic conditions and the investment strategies to which allocations have been made, but also relies on a strategic asset allocation that is reviewed on a yearly basis (around 10 per cent within the broad investment guide lines).
- A dynamic tactical allocation in accordance with market trends and macro-economic evolution. On a monthly basis, tactical allocation and the degree of diversification determine the degree of risk, with each alternative strategy having its own volatility, cross-correlation to other strategies and distribution pattern (around 5 per cent within the strategic allocation parameters).

ADDED SECURITY

Since alternative strategies are uncorrelated, the risk of a portfolio can be lowered from the addition of different alternative strategies. Consequently, the allocation of the different strategies will fine-tune a fund’s risk profile,

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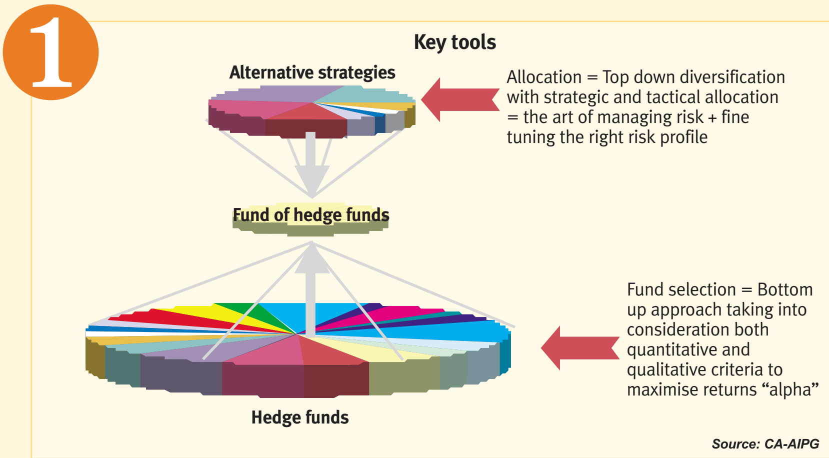
Carl Dunning-Gribble, CA-AIPG



are in the best position to understand the various managers and strategies, de-selecting funds that for example, lose their key people, who suffer unexplained negative performances.

A successful global group might have offices in London and Chicago or New York, focused exclusively on selecting hedge funds.

The investment team benefits from their proximity, both physically and culturally to the traditional centre of the hedge fund industry in the US as well as to increasingly important European and Asian hedge fund markets. The investment team would maintain close contact with over 750 manager contacts each year to select the best funds in their class. The average CA-AIPG analyst, for instance, has five years' experience with the company.

With an audited track record since 1992 and 53 employees, CA-AIPG provides more than 300 institutional investors worldwide with access to the best hedge funds in the world; many of each are closed or selectively open to new investments.

A critical size and long-existing relationships with hedge fund managers enables key players to overcome entry barriers and offer higher liquidity and lower minimum investments to investors.

Qualitative analysis of managers and quantitative filters enable the investment committee to target the best performers in each peer group, maximising performance returns. See Chart 2.

protecting the capital invested. Through their research and risk control, funds of funds add security to the sometimes-obscure hedge fund universe providing absolute returns while controlling volatility.

At year-end, the investment team assesses the added value derived from asset allocation compared to industry indices.

DIRECT ACCESS

Contrary to single hedge funds with a significant barrier to entry, funds of funds give access to the large spectrum of hedge funds. Enabling investors to benefit from the most talented hedge fund managers within each strategy is the role of the funds of hedge funds.

Finding talented hedge fund managers requires skill, and convincing them to accept your investment is equally challenging because of capacity constraints.

Many good hedge funds tend to have long lock-up periods and high minimum investments, as they often need certain stability of assets to invest in sometimes less liquid markets or in strategies that require time to unfold. Also, many hedge funds are closed to new investors.

Funds of hedge funds operate much closer to the hedge funds industry and carry out ongoing due diligence and analysis of the hedge funds marketplace. In doing so, they

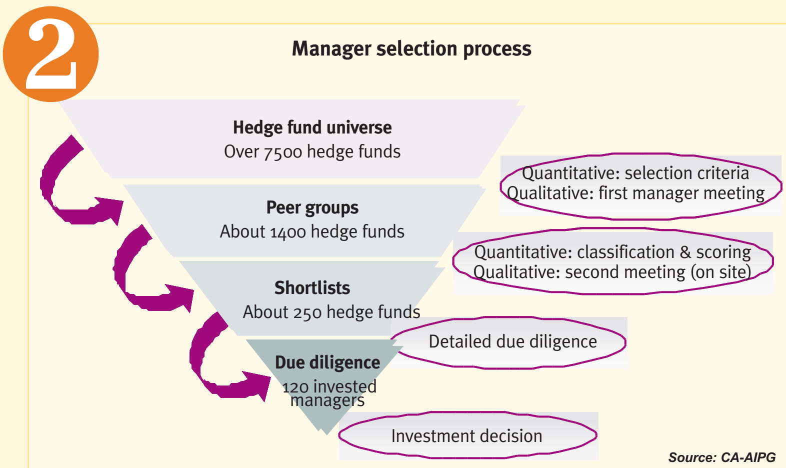
RANGE ON OFFER

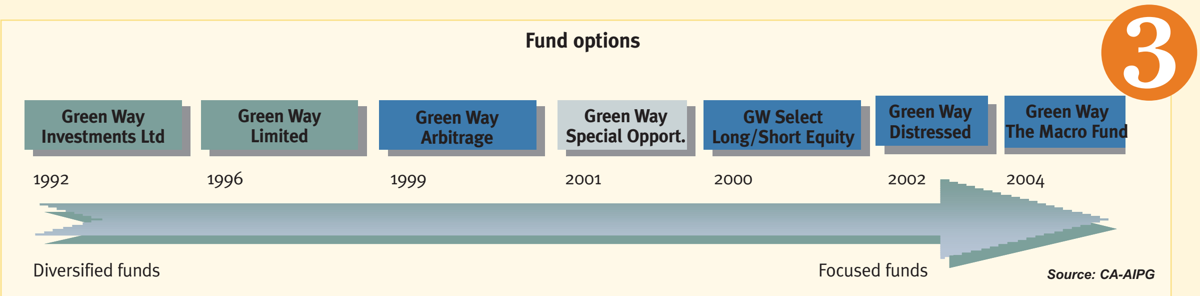
Successful product providers need to offer a comprehensive range of funds of hedge funds to meet the demands of investors with very different risk profiles but who all have in common a need for investments with low correlation to stocks and bonds and good risk-adjusted returns.

The core product range may be based on two fund of hedge funds lines:

- Diversified funds invested across the entire range of alternative strategies and styles
- Specialised funds invested in a single strategy or a small group of strategies, such as arbitrage, long/short equity, distressed securities and high yield bonds, macro global and systematic futures trading.

CA-AIPG manages 17 open-ended





mutual funds as well as "white label" funds and segregated mandates. See Charts 3 and 4.

To meet specific client risk/return profiles or to accommodate certain legal/domicile requirements, specialist fund groups need the expertise necessary to customise dedicated funds of hedge funds and create structured products with various guarantees and liquidity features.

4 GREEN WAY PERFORMANCE RESULTS

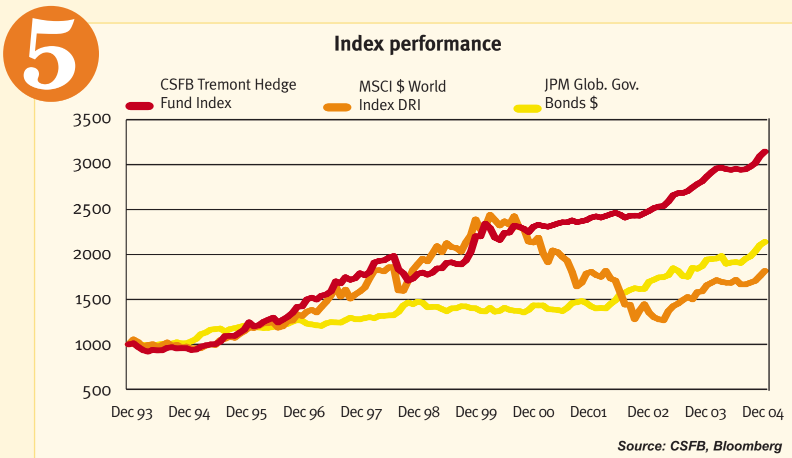
Fund's name	Investment objective	Ann. return since inception	Annualised volatility
Green Way Limited	Euribor/Libor/YenLibor+ min. 500 bps	6.9%	4.7%
Green Way Arbitrage	EUR/USD/YEN/CHF-Libor + min.300 bps	8.5%	2.1%
Green Way Special Opportunities	10-20% per year	9.2%	3.1%
Green Way Select – The Global Long/Short Equity	8-15% per year	5.5%	4.2%
Green Way Distressed and High Yield	10-20% per year	15%	2.5%
Green Way Select – The Macro Fund	10-20% per year	6.8%	NS

COMPARING

Chart 5 compares the performance of the CSFB Tremont Hedge Fund Index with that of the MSCI World Index and the JP Morgan Government Bond Index. Over a 10-year period, alternative investments through funds of hedge funds have given superior returns than both equity and bonds. The chart clearly indicates that investing through a well-balanced fund of hedge funds gives regular and consistent returns with a low level of risk.

With a low level of risk (volatility), alternative investment strategies give investors an unparalleled risk-reward ratio.

Carl Dunning-Gribble, head of marketing and sales, CA-AIPG in Paris



Strategic aims

Alternative investment strategies aim to give:

- **Alpha**
  Returns equal to the long term equity returns
- **Volatility**
  Volatility equivalent to the bond portfolios
- **Capital protection**
  Careful portfolio construction + uncorrelated strategy