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PROFESSIONAL WEALTH MANAGEMENT

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INTRODUCTION

NEW ATTITUDE TO LOW VOLATILITY

Investors are now better prepared to appreciate the advantages of a portfolio that mixes in alternative strategies such as hedge funds

Three years of falling equity prices and the bounce during 2003 have dramatically strengthened the case for the inclusion of alternative investments within a traditional portfolio.

"If it's not broken, don't fix it." This might describe the approach taken by traditional portfolio managers in the booming equity markets of the 1990s. But the markets did break, suffering substantial losses in the first three years of the new millennium. This period of sustained red ink caused many investors – institutional and retail – to reconsider their strategies and even to view, with some suspicion, the highly volatile recovery of 2003 when, for example, the S&P 500 Index gained 26.38 per cent.

Among the changes in attitude brought about by these stormy markets were:

- a stronger focus on the volatility of a portfolio by comparison to its outright returns;
- a decline in enthusiasm for trumpeting benchmark outperformance when the numbers concerned are all negative;
- a greater preparedness to respond to the diversification and portfolio optimisation arguments propounded by the alternative investment industry.

WIDE RANGE

There is a wide range of hedge fund strategies, some of which have relatively high correlation to the equity markets and may exhibit high volatility. However, low correlated/ low volatility strategies such as event-driven; certain types of arbitrage and market-neutral will, when effectively combined, prove a valuable and important diversifier of a traditional long-only portfolio tending to lower overall volatility and to increase the durability of the risk-adjusted return stream.

A typical range of funds of hedge funds may be largely focused on low volatility strategies. These began to appear in 1995, when the first multi-managers started to concentrate on this subset of the alternative investment industry.

'Low volatility strategies will, when effectively combined, prove a valuable diversifier of a traditional long-only portfolio'

Michael Goldman, Pioneer Alternative Investments

Of course, 1995 was in the middle of the raging equity bull market and the comparatively modest (for the time) performance targets of 10 per cent+ on volatility of less than 5 per cent tended to be overshadowed by the extraordinary gains made by some investors in IT stocks and by some of the high profile macro-economic hedge fund managers. Microsoft, for example, gained 45.79 per cent in 1995. Today, low volatility and consistency of returns are much more attractive and multi-manager alternative portfolios are attracting serious attention. The hedging and diversification impact of the inclusion of low correlated alternative investment strategies within a long-only portfolio is illustrated in Charts 1 and 2.

Chart 1 shows the allocation of strategies (see box for definitions) within Pioneer's AllWeather Institutional portfolio. This allocation is relatively typical in a flat economic/ financial climate. Note the comparatively small allocation to merger arbitrage strategies (in a period where there were few significant takeovers or other corporate events) and, by contrast, the comparatively high allocation to distressed securities strategies as a significant number of companies were finding themselves in financial difficulties post the recession and the equity bear market.

Chart 2 shows the performance for the four years, beginning of 2000 to end-2003, of both the low volatility alternative investment portfolio and the S&P 500 index. Over the period, the S&P 500 recorded an annualised loss of –5.34 per cent with an annualised volatility of 17.87 per cent (high even by equity standards). By contrast the AllWeather institutional product recorded an annualised return of +7.93 per cent with annualised volatility of 2.42 per cent.

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Strategy allocation (as at 30 November 2003)

1 Convertible Arbitrage	5.5%
2 Distressed Securities	29.2%
3 Equity Hedge	6.7%
4 Equity Market Neutral	10.3%
5 Fixed Income Trading	23.9%
6 Global Trading	5.8%
7 Merger Arbitrage	6.5%
8 Multi Strategy	12.1%

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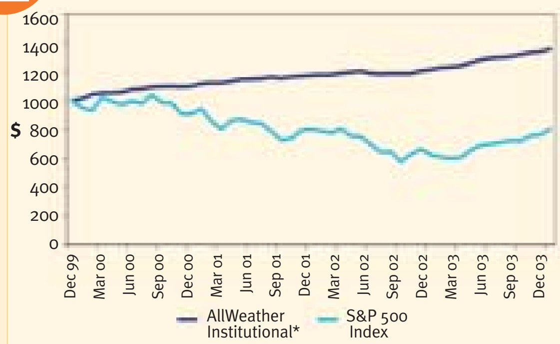
Value added monthly index



* Pioneer Alternative Investments launched a new, rebalanced AllWeather Product, primarily for institutional investors, on 20 January 2000 so the numbers provided are for the life of the fund thus far (to end-2003) matched against a surrogate long-only portfolio, in this case the S&P 500.

Low volatility hedge fund strategies

Here are definitions for six strategies:

- **Convertible Arbitrage**
  This type of arbitrage involves the simultaneous purchase of a convertible bond and the short sale of the underlying stock. Interest rate risk may or may not be hedged.
- **Distressed Securities Investment**
  The primary investment focus is on securities of companies that have declared bankruptcy and/or may be undergoing reorganisation.
- **Event Driven**
  This strategy can include merger arbitrage, distressed, liquidations and spin-offs in addition to value driven special situation equity investing.
- **Fixed Income Arbitrage**
  Employs a variety of fixed income related strategies ranging from relative value based traded (basis, yield curve etc) to directional bets on interest rate shifts.
- **Market Neutral**
  Long and short equity exposure with nearly no dollar net exposure. In theory systematic market risk is reduced by being dollar, beta, sector and market cap neutral.
- **Merger Arbitrage**
  Style typically involves the simultaneous purchase of stock in a company being acquired and the short sale of stock in its acquirer.

Source: CalPERS/Pioneer Alternative Investments

The important numbers, however, arise from a combination of the two elements: the equity index acting as a surrogate for a (dollar-based) equity portfolio and the alternative investment fund. Here the inclusion of 10 per cent or, better, 20 per cent of AllWeather Institutional makes a valuable impact on the returns and on the volatility of the overall combined portfolio. (See Chart 3.)

The absence of correlation between the alternative investment strategies and the equity markets means this is no simple case of averaging. The 20 per cent inclusion, for example, improves the performance by 51.5 per cent and reduces volatility by 18.6 per cent. While the impact is no panacea, it clearly demonstrates the advantages alternative investment can bring and the reasons that more and more investors are turning in this direction.

Michael Goldman, co-CIO fund of hedge funds, Pioneer Alternative Investments

ALLWEATHER: JAN 00 – DEC 03

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	Annualised return	Annualised volatility
S&P 500	–5.34%	17.87%
ALLWEATHER INSTITUTIONAL	+7.93%	2.42%
S&P + 10% ALLWEATHER	–3.96%	16.20%
S&P + 20% ALLWEATHER	–2.59%	14.54%

Source: Pioneer Alternative Investments

CORPORATE STATEMENT

Pioneer Alternative Investments (PAI) is one of the leading companies in the fast growing alternative investments arena, with over $3bn under management (end Dec 2003). Our mandate is to provide a one-stop solution for investors seeking exposure to the full array of hedge fund styles and strategies. The Momentum range of funds draws on over 16 years of experience in the funds of funds business and provides access to a spectrum of products ranging from low volatility strategies with limited market correlation through to more active growth and aggressive strategies.

PIONEER Alternative Investments

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