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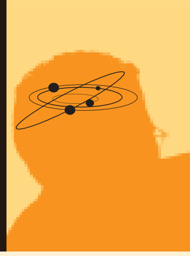

EQUITY HEDGE FUNDS

INVESTING WITHOUT COMPROMISE

Funds of equity hedge funds combine efficient active management with levels of accountability professional investors have come to expect

Of all asset classes, equities offer the greatest potential reward for active investment management, and the depth and diversity of equity markets provide limitless opportunities for differentiated performance.

Equity hedge funds seek to translate these opportunities into positive absolute returns. Their success owes much to flexible mandates and the vitality of their organisations.

However, these same characteristics mean they generally fall short of the standards of accountability and transparency professional investors have come to expect. Investing in a fund of equity hedge funds can bridge this gap.

The business of equity investment has changed radically over the past 20 years. Institutionalisation created a virtuous drive for specialism and accountability, with rigid mandates, benchmarks and tracking errors shifting the focus from absolute to relative returns.

Without disputing the validity of this form of investing for the long term, it is clear that many investors do not share the extensive time horizon, solvency or tolerance of absolute losses that modern portfolio theory demands.

Among investment institutions, relative return psychology has become ingrained to the extent that behaviours are self-defeating. Assets under management are the measure of success, contrarian behaviour is reported to risk committees and divergent performance is cause for litigation. Active management has been increasingly marginalised. Equity hedge funds moved into this void, enjoying the flexibility to take full advantage of the inefficiencies it has created.

Equity hedge fund managers are incentivised to design strategies that play to their strengths in order to maximise the efficiency of their performance. Typically, hedge funds earn a management fee and a share of performance in excess of a high watermark.

Performance fees are potentially far greater than management fees, so managers are disinclined to allow assets to reach a level where they begin to impede performance.

Limiting assets also enables them to continue to exploit opportunities in less efficiently priced stocks, without compromising liquidity.

The hedge fund model continues to attract the very best fund managers and analysts. The adoption of a high watermark, allied to managers' often significant personal investment, encourages capital preservation in difficult markets, with a view to compounding capital when opportunities return.

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Hedge fund tools

SHORT SELLING:
- The ability to sell stocks short to profit from falling prices potentially doubles the opportunity to earn stock specific returns and limit market exposure.

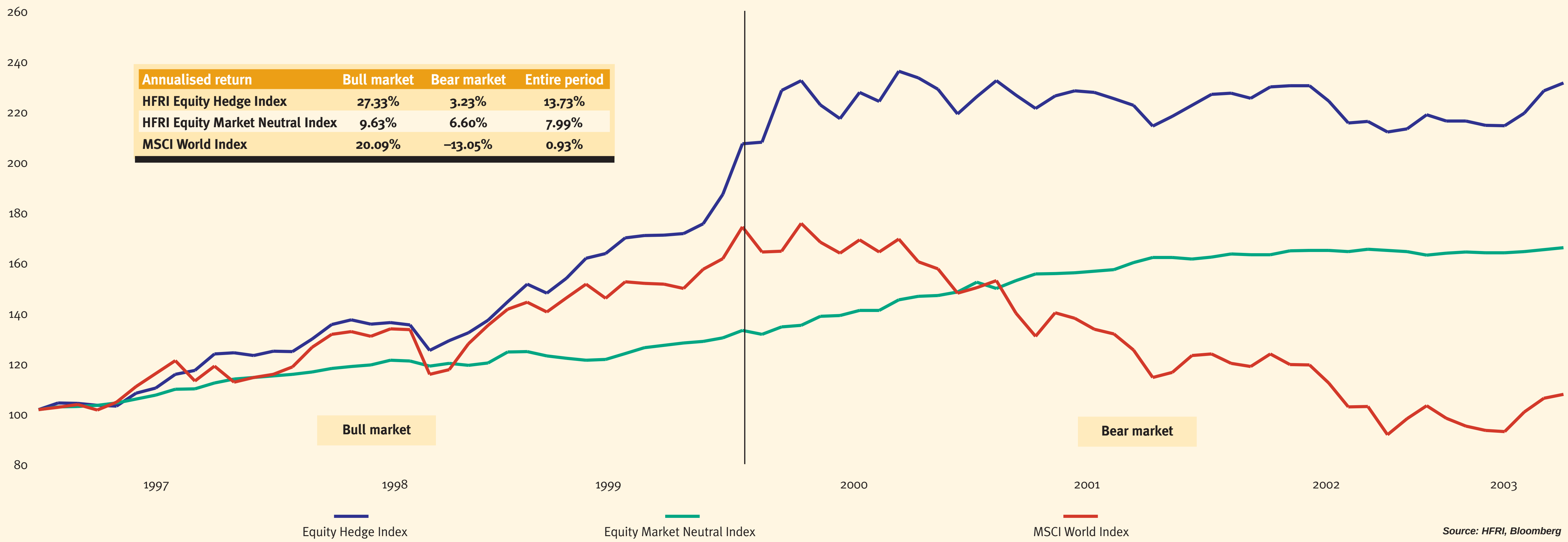
TIME HORIZON:
- Streamlined decision making, with portfolio manager, analyst and trader working closely together to evaluate information in real time, broadens the opportunity set to include short, medium and long term trades.

FOCUS:
- Managers have freedom to focus on niches they know best and where they can claim an information or analytical advantage.

PORTFOLIO STRUCTURE:
- Market neutral managers invest proportionately equal amounts long and short, aiming to isolate stock selection as the driver of their returns. Other managers may operate either long or short biases, to take advantage of broad based opportunities in equity markets, but the vast majority still aim for their stock specific exposure to dominate their market exposure.

LEVERAGE:
- Leverage is sometimes used to scale risk/return profiles. Neither short sales or derivative instruments tie up capital and can therefore be viewed as a form of leverage, but in equity hedge strategies they are typically used to provide efficient hedging. Generally managers employ leverage based on conviction and will similarly use cash actively when uncertainty is high or liquidity poor.

1 Performance of equity hedge fund indices versus global equities



Annualised return	Bull market	Bear market	Entire period
HFRI Equity Hedge Index	27.33%	3.23%	13.73%
HFRI Equity Market Neutral Index	9.63%	6.60%	7.99%
MSCI World Index	20.09%	–13.05%	0.93%

Source: HFRI, Bloomberg

Issues addressed by fund of funds

INVESTOR PROTECTION:
- Background checks on individuals, cross referencing with fund counter-parties, verifying pricing of securities, analysis of the fund's audited financial statements.

BUSINESS RISK:
- Analysis of economic viability (overheads and revenues), compensation structure, stability of infrastructure/investor base.

TRANSPARENCY:
- Customised performance analysis, verifying adherence to risk controls, monitoring exposures.

This theory has been borne out in practice during the turbulent recent history of equity markets. Chart 1 illustrates how long/short funds managed to lock in bull market gains as the bear market ensued, while market neutral funds made steady progress.

Notwithstanding aligned interests and compelling performance, equity hedge funds fall short of most professional investors' expectations in certain respects. Fund of funds explicitly address these issues.

Fund of funds act as gatekeepers to hedge funds and consequently benefit from greater access to managers and portfolio transparency.

The proliferation of equity hedge funds over the last five years makes the task of finding strategies focused on uncrowded opportunities with stable risk/return profiles more demanding.

Being solely dedicated to investing in hedge funds, funds of funds are able to devote the resources necessary to identify superior strategies and products, and crucially to hold managers to account.

Building a portfolio of equity hedge funds can further enhance risk/return efficiency through diversification by style, focus and turnover. This is likely to include market neutral and long and short biased managers, though the overall exposure and risk profile of funds of funds varies widely.

The degree to which funds of hedge funds provide comfort to investors ultimately depends on the nature of their working relationships; specifically the level of transparency and quality of communication.

It may be impossible for a direct investor in equity hedge funds to achieve the same level of diversification, due to the high minimum investment requirements typically in the range of $1m (€880,000) to $5m.

Funds of funds offer both lower investment thresholds and superior liquidity to their pool of investors. A further and often under-estimated benefit of investing through a fund of funds is consolidated fund administration and reporting. Professional investors reporting to clients have little time to reconcile and digest periodic information from numerous hedge fund managers.

Funds of funds can offer institutional best practices without stifling the flexibility or vibrancy that make equity hedge funds optimal active investors.

Funds of equity hedge funds are increasingly being added to portfolios to provide either active exposure or a source of absolute returns. Whichever their role, they offer a compelling form of equity investing.

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