Great outcomes. Done well.

Hedge Funds: A Look Back and a Look Ahead

By Edward H. DeFrance and Michael J. Kelly

Synopsis

Hedge funds have proven to be worthy financial instruments over the past 20 plus years, and have contributed to the growth of the modern financial industry. The addition of a well diversified group of hedge funds to a traditional portfolio has been shown to be an effective way to potentially increase returns, while also preserving capital during adverse market environments. While hedge funds have remained somewhat of a mystery to the general public, and are often vilified by the mainstream media (they were referred to as an "evil virus" in a 2005 *Newsweek* article for example), the reality is that many institutions and high-net-worth investors have invested in hedge funds for many years, and continue to do so as a means to add diversification to their portfolios.

Going into 2010, the hedge fund industry appears to be healthier than it has been in more than a decade, albeit much smaller in terms of assets than it was at its peak two

CRITICAL OBSERVATIONS:

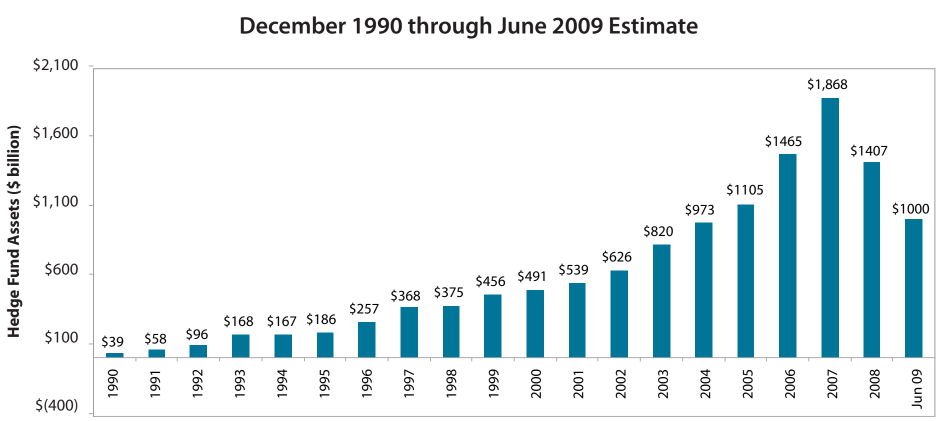
- Including a group of broadly diversified hedge funds in a traditionally allocated portfolio of stocks and bonds has been shown to potentially reduce portfolio volatility and increase return.
- The investment environment for hedge funds going forward (2010 and beyond) could be attractive. Investment strategies that can make money in rising and falling equity markets, such as those employed by many hedge funds, are better positioned for success in an uncertain/volatile economy.
- Hedge funds and the interests of their constituents are better aligned now than they were prior to 2008.
- Due to the fallout of 2008 and the Bernie Madoff scandal, investors are assigning more value to the strength and integrity of a firm's risk controls and procedures when conducting due diligence on potential hedge fund investments, as opposed to focusing only on performance.
- Investors are seeking better transparency, better liquidity, and more appropriate fee structures from funds.
- Investors are requiring the use of independent, third-party services to support funds' operations, manage custody of their assets and verify fund pricing.
- Fund of hedge funds (FoHFs) will continue to be a major channel into hedge funds, providing more investors ease of access and exposure to a broad range of investment styles and strategies, along with an additional level of risk management.

years ago. While 2008 was without doubt one of the most challenging investment environments we have seen this century, the hedge fund industry emerged from the crisis case-hardened and remains a viable compliment to traditional stock and bond investing. From an investment opportunity standpoint, the landscape is attractive as many asset classes are offering substantial risk premiums and competition has significantly diminished (with weaker, less-qualified hedge funds closing in 2008, fewer asset managers are chasing similar trades – leaving more pie for the worthy survivors to share).

For investors, the most tangible positive outcome left by the shock of 2008 has been a humbling of sorts for the industry. Many previously closed hedge funds have now opened their doors to accept new capital, are much more willing to be flexible on fees and lock-up periods, and – perhaps most significantly – are much more willing to pull back the curtain and share information about their success.

GRAPH 1:

Total Hedge Fund Assets



Source: HFR Global Hedge Fund Industry Report, second quarter 2009. Hedge Fund Research, Inc., August 2009, www.hedge-fundresearch.com

In 2009, investors are already starting to reap the benefits of this new hedge fund world order, as industry returns appear to be on pace to reach 10-year highs. Looking ahead, reduced competition and major macroeconomic trends could lead to above average returns.

A History of Success … and Misunderstanding?

"It is the nature of humans to fear what it is they do not know or understand."

~ Rod Serling, creator of *The Twilight Zone*

Clearly, hedge funds have played an important part in the expansion of capital markets in recent years. Since 1990, hedge funds have represented one of the fastest growing segments of asset management. The number of hedge funds around the world exploded from 610 in 1990 to approximately 9,000 by the end of 2008.[1] Over the same period, industry assets under management grew exponentially as well, from $39 billion to an all-time high of $1.9 trillion by the second quarter of 2008[2] (Graph 1).

For something that has grown so rapidly and become such an integral part of the global financial system through the years, there is still a general lack of understanding about the hedge fund industry. Indeed, it is often surprising to those of us who work in the industry just how much misinformation is circulated, not just among small investors, but even at the highest levels of sophisticated institutional asset management.

Hedge Funds: A Primer

What is a hedge fund?

- The term 'hedge fund' refers to pooled investment structures
- Hedge funds may utilize a broad array of financial instruments to generate performance
- There are many types of hedge funds using many different investment strategies
- Pension funds, endowments, insurance companies, private banks, and high-net worth individuals and families invest in hedge funds
- Many hedge funds attempt to achieve positive returns in both rising and falling capital market environments
- The inclusion of hedge funds in a traditional portfolio is intended to add diversification, reduce risk and potentially increase returns
- Hedge funds seek to maintain low correlations (definition on page 4) with traditional assets classes (stocks and bonds)
- Most hedge funds do not measure themselves against traditional market benchmarks (like the S&P 500 Index) but instead target "absolute" returns (positive performance regardless of the direction of the broad markets)

The confusion, and in some cases controversy, over hedge funds is likely a function of their private structure. As opposed to a mutual fund, almost all hedge funds are private offerings because they are not sold publicly on open exchanges. Because of this, the Securities and Exchange Commission strictly limits the amount of information that can be shared about them with the general public.

As such, many investors consider hedge funds highly risky, highly aggressive and somewhat speculative investments. Sensationalized hedge fund blow-ups and frauds, like Long Term Capital Management or the Madoff scandal (see page 5) naturally contribute to this misconception. While in some cases this is true, the reality is that there are a wide variety of different types of hedge funds, each utilizing different levels of risk and each seeking different types of returns. Many hedge funds actually pursue very conservative strategies that target modest but consistent returns and – above all – relatively low risk.

"Absolute" Returns

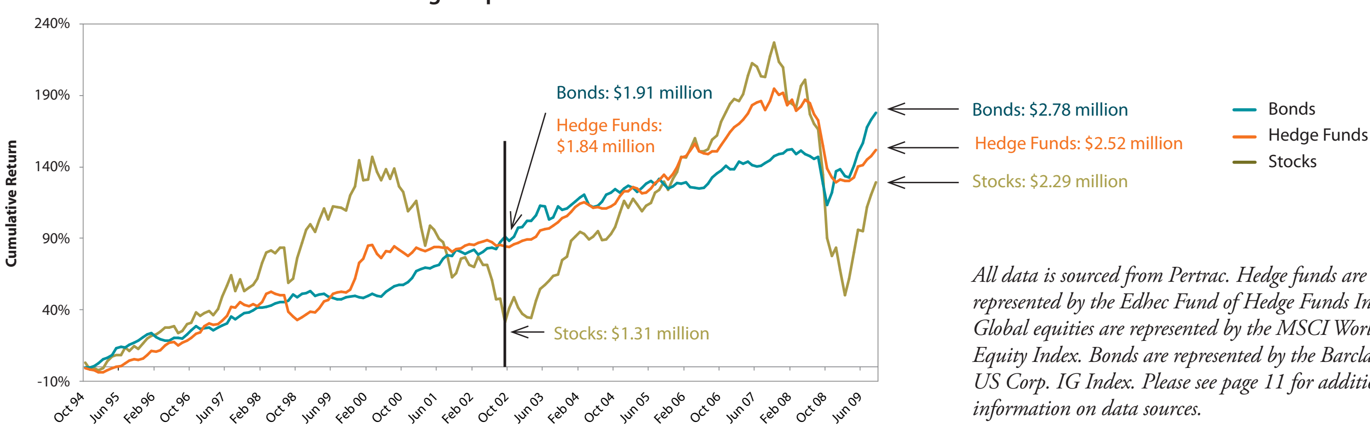
By design, most hedge funds are intended to provide consistent positive returns regardless of the direction of the broad markets, utilizing a wide variety of financial instruments to do so. This approach stands in contrast to that of traditional managers, who measure themselves in relative terms and are prepared to accept losses in value, if those losses are less than a stated benchmark (such as the S&P 500 Index).

Hedge funds have, for the most part, succeeded in achieving this goal and in preserving capital during bear markets. From 1990 to 2008, the industry experienced only two down years, weathering difficult periods like the Mexican peso crisis, the Asian financial crisis, the collapse of Long Term Capital Management, the bursting of the dot-com bubble, and the collapse of the credit markets in 2001-2002. From a performance perspective, hedge funds have been successful in achieving their objective of providing consistent returns that exhibit low correlation to the broad equity markets, while maintaining low volatility (Graph 2).

GRAPH 2:

Hedge Funds at Work – Providing Consistent Returns

Cumulative Return and Value of $1 Million Investment
October 1994 through September 2009



All data is sourced from Pertrac. Hedge funds are represented by the Edhec Fund of Hedge Funds Index. Global equities are represented by the MSCI World Equity Index. Bonds are represented by the Barclays US Corp. IG Index. Please see page 11 for additional information on data sources.

Correlation is a statistical measure of how two securities move in relation to each other. Perfect positive correlation implies that as one security moves, either up or down, the other security will move in lockstep, in the same direction. Alternatively, perfect negative correlation means that if one security moves in either direction the security that is perfectly negatively correlated will move by an equal amount in the opposite direction. If the correlation is 0, the movements of the securities are said to have no correlation; they are completely random.

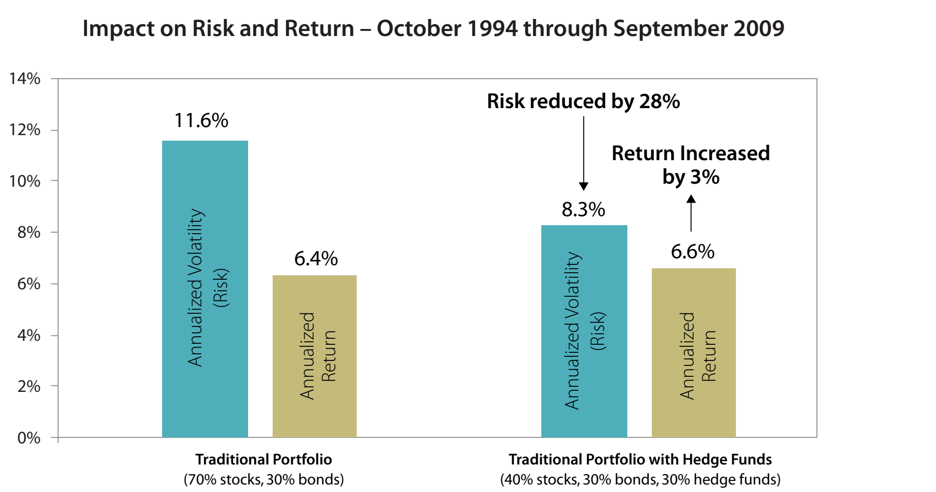
Going Mainstream

Demonstrating success during the 2000-2002 bear market, hedge funds essentially signaled their arrival to the world. What had been until then a vehicle that only the most sophisticated and ultra-high-net-worth investors were privy to – or interested in, for that matter – hedge funds began garnering attention from other parts of the investor spectrum, most notably institutions and other wealthy investors.

Institutions began seeking them out much more frequently as a source of diversification and "absolute" performance following on the stable returns hedge funds had demonstrated during the dot-com bust. Sustained low interest rates during this period, coupled with a flat equity environment, also contributed to this interest. From a performance perspective, a broadly diversified portfolio of hedge funds has fairly recently demonstrated an ability to add value to a traditional portfolio allocation, by both enhancing returns and reducing risk (see Graph 3).

GRAPH 3:

Hedge Funds at Work – Benefits to Traditional Portfolio



Volatility is measured by standard deviation. Standard deviation is a measure of the dispersion versus the mean or experienced value: the higher the standard deviation, the greater the volatility. Please see page 11 for additional information on data sources.

Growth and Consequences

As a by-product of this surge in investor appetite, industry assets under management grew substantially. From 2000 to 2008, hedge fund assets expanded 20% per year,[3] growing nearly four times in size since 2000.[4] There were some negative consequences of this exponential growth: transparency levels were not satisfactory, as investors often acquiesced to manager's preferences for secrecy; due diligence standards were often compromised (as was clearly the case for some feeder funds directing their clients to Madoff); and poor liquidity management practices emerged, high-lighted by the high number of funds who gated their investors in 2008.

Extreme growth also diluted the quality and skill of fund managers. Previously, hedge fund managers had been Wall Street's best and brightest. However by late 2006, anyone with a financial calculator suddenly believed he or she was qualified to do the job.

Hedge Fund Fraud and Blowups: Myth Versus Madoff Reality

The Bernie Madoff fiasco was very unfortunate, not only for the investors who lost money, but also for the reputation of the hedge fund industry as a whole. The reality is that organizations such as Madoff's are by far the exception and not the rule (in fact Madoff likely takes the cake in terms of exceptions).

It is important to note that Madoff's purported success, secrecy, organizational structure, and nepotism were highly unusual, and should not be considered representative of the hedge fund business. Established Fund of Hedge Funds (FoHFs) with structured approaches to due diligence require adequate transparency on trading strategies, which stands in the face of how Madoff's organization operated.

Even at a very high level, there were many red flags within the Madoff firm. As an example, Madoff's son served as chief compliance officer, the firm custodied its own assets (for what was purportedly the largest hedge fund in the world) and its books were audited by an unknown audit firm with a single office in Jersey City. Some of the less scrupulous feeder funds that invested client money in Madoff's fund acknowledge seeing "warning signs" before the end. In our view that ranks with "Don't worry it was only an iceberg." in terms of historical understatements.

FoHFs that employ a rigorous and systematic approach to due diligence – including onsite visits and background checks, as well as a clear understanding of the trading strategies being employed – would be very unlikely to ever allocate to an organization like Madoff's.

Not only did the industry experience a dilution of quality fund managers, the exponential increase in assets led to a decline in the number of true alpha-generating[5] opportunities. As a result, in order for hedge fund managers to maintain their expected return targets (often expressed as 1% or 1.5% per month), they began employing greater levels of leverage, and often engaged in less attractive and riskier trading strategies. In essence, many less-disciplined fund managers began taking on more and more beta[6] (or market) risk, as opposed to providing their investors true alpha driven gains. Thus, by 2008, the returns reported by many of the hedge funds in the industry – although better than the equity markets – fell greatly short of achieving their self-professed mandate of uncorrelated returns, independent of overall market direction.

2008: The Year of Our Discontent

2008 will forever be considered one of the worst periods in the history of global financial markets (global equities declined 42% and high-yield bonds lost 26%). For hedge funds, it was likely the worst year the industry had ever seen, with the Edhec Fund of Hedge Funds Index dropping 21%. The silver lining lies in the contention that the hedge fund industry is learning from the events of 2008, and emerging stronger than before. We view last year as a much needed and valuable correction – separating the wheat from the chaff, leaving the worthy hedge funds that survived better positioned for future success. We discuss this in detail further on, but before doing so we thought it would be valuable to first look back and understand what it was that led up to last year's crisis in the global markets.

Creating the Leverage Monster

"Crazy, am I? We'll see whether I'm crazy or not!"

~ *Frankenstein,* 1931

Debt use across the financial system increased dramatically over the last 10+ years, spurred by bull markets, soft lending standards, a presumption of continued prosperity and the belief that real estate prices would never decline. Consumers, businesses, investors and investment banks financed more, while Wall Street developed elaborate structured products to meet their credit demands. Corporations' substituted debt for equity in their companies' capital structures, levered up results and reduced any margin for error. Consumers carried unpaid credit card debt, rolled over credit card balances, and in some cases maintained multiple lines of credit. Homeowners financed home purchases using a variety of exotic and complex mortgage structures (interest only, adjustable rate loans, 100% financing, etc.). And, perhaps most pertinent to 2008's crisis – and by extension hedge funds – it was the norm for investment banks' balance sheets to be levered as much as 20 to 30 times larger than their capital base. In fact, a 2004 rule change by the SEC exempted the five largest banks from regulation that had capped their debt-to-capital ratio at 12-to-1.[7]

Ultimately, as we all experienced first hand in 2008, this long-term trend toward credit creation collapsed upon itself, eventually evolving into the most substantial global financial crisis in modern history.

The Impact on Hedge Funds

For hedge funds, the unprecedented market decline – and, more specifically, the distress in the investment bank community – proved troublesome. As the banks swiftly moved to reduce risk (by selling whatever they could), hedge funds were also impacted. Investment banks and hedge funds held many common positions, so liquidation of bank holdings put significant downward pressure on hedge fund portfolios as well.

In addition, at the height of last year's crisis, the government instituted a temporary ban on selling stocks "short" in an effort to stem the tide of panic (unlike most investments that bet on the markets going up, hedge funds often sell equities short, which is a trading strategy aimed at profiting when the prices of securities they believe are fundamentally overvalued eventually decline). While the intent was good, the end result of the short sale ban may have only served to make matters worse. The ban significantly hindered the ability of many hedge funds to reduce risk and/or profit during the severe market decline. Instead, they were again forced to sell their long positions into plunging equity markets just to reduce risk, which further exacerbated the market collapse.

Still, despite the severity of the crisis, hedge funds in general outperformed most long-only indices in 2008 – though not as successfully as during previous downturns.[8]

2009: A New Chapter for Hedge Funds – Better, Stronger, Faster

When considering the state of the hedge fund industry today and the opportunities going forward, we are reminded of the 1970s television show "The Six Million Dollar Man." After being severely injured, the show's protagonist (Steve Austin) undergoes a grueling medical procedure. He is "rebuilt," using the latest in "bionic" technology to create the world's first bionic man – better, stronger, faster.

Similarly, hedge funds have emerged from their own crash of sorts, and we derive they are better and stronger than they were before. While not employing "bionic" technology (and, unfortunately, costing constituents a good deal more than six million dollars), we believe the hedge fund industry is now better positioned for the future than at any time in its history.

A peripheral effect of an event such as the dislocation of 2008 is that all parts of a hedge fund are tested, not just the viability of its investment strategy. Also tested are the strength of a fund's operational infrastructure, investment judgment, execution, commitment to portfolio diversification, risk mitigation, IT infrastructure, investor relations, and operational and counterparty risk assessments. Those that emerged from the gauntlet of 2008 likely possess more wisdom and have demonstrated their ability to survive in one of the worst of environments in recent history.

What is a Fund of Hedge Funds?

- A FoHF is a pooled investment vehicle that invests in multiple hedge funds pursuing different investment strategies.
- A FoHF provides ease of access and exposure to a broad range of investment styles and strategies.
- A FoHF seeks to mitigate the idiosyncratic risk of investing in a single hedge fund through diversification.
- A FoHF provides professional management of hedge fund investments.
- A FoHF seeks to deliver more consistent returns than portfolios of stocks, mutual funds, unit trusts or individual hedge funds.
- A FoHF may provide access to otherwise "closed" hedge fund managers.

Opportunities in 2010 and Beyond: The Potential for Above-Average Returns, Lower Risk, Better Access and Lower Fees

Surviving funds are now reaping the benefits of the fertile investment landscape that remains. The financial markets are once again operating normally so asset prices more accurately reflect their true fundamental value, as opposed to being driven down by forced selling. Leverage has been drastically reduced, liquidity has returned and, most notably, competition has substantially diminished. Historically, this type of environment has resulted in periods of above average returns for hedge funds.[9]

The dramatic decline in competition is potentially the most significant change we see going forward. In addition to the hedge funds that were forced to close due to the failure of their individual business models, many investment bank trading desks no longer exist, and others have been required to reduce trading activity to reflect their new bank holding company charters. The hedge fund industry's largest competitor has historically been investment banks, meaning there will be fewer asset managers chasing similar trades now that the ranks have thinned.

Equally important, we believe the risk associated with hedge fund investing has also declined. Weaker less qualified managers who may have used excessive beta (over exposure to the market direction) to generate returns have been purged from the industry. FoHFs whose due diligence procedures fell short – and, in some egregious cases, was non-existent – have also been exposed. In addition, there will be less reliance on financing counterparties with weak balance sheets.

Finally, for investors seeking hedge fund exposure, it is clearly a buyer's market. The terms of investments – the management and incentive fees charged by funds – are more favorable to investors than they have been in years. In addition, we are seeing a number of funds reducing or eliminating lock-ups, a pre-defined period where an investor's capital is prevented from being withdrawn – typically one year; moving to more frequent withdrawal periods; and becoming much more transparent.[10]

Looking Ahead: A Renewed Focus on True Due Diligence

The events of 2008 have changed investor preferences in terms of the focus of the due diligence they seek from FoHF managers, as well as the depth and rigor of the process itself. According to a survey by Deutsche Bank, conducted in 2009, "Risk Management" moved to being the second most important factor when selecting a manager. "Transparency" also moved up in priority. Historically, investors had indicated the "3Ps," Performance, Philosophy and Pedigree, to be the most important characteristics when selecting a manager.

Clearly, institutional and high-net-worth investors today are more focused on examining every aspect of a hedge fund program, not just the quality/performance of its track record, but also the integrity of its risk control/compliance procedures. For example, sophisticated investors are seeking a rigorous and systematic approach to due diligence from FoHFs – one that focuses on the operational integrity of a program, conducts ongoing risk monitoring and manages the liquidity needs of its clients. In addition, investors are also spending more energy assessing the creditworthiness/financial stability of prime brokers, and are requiring an independent third-party administrator to provide independent valuations.

Transparency has also become an important issue. In our view, complete transparency with clients will become a trademark of quality FoHF investment programs. That is to say, any and all portfolio information that a firm possesses should be shared with all of its clients. This would extend well beyond that of simply providing a list of underlying manager names. Clients should know and understand a fund's investment rationale, its reasons for allocating to a particular organization versus another, and its view and outlook for the future. Frankly, with regard to transparency, we have always taken the view that the more a client is willing to learn and understand regarding procedures and decision-making patterns, the better and stronger a partnership he or she will have with the investment manager.

Looking Ahead: Hedge Fund Asset Flows

Following more than 15 months of redemptions, flows are returning to hedge funds. After four consecutive quarters of net withdrawals, hedge funds recorded a net asset inflow in the third quarter of 2009, with investors adding $1.1 billion in new capital during the period. Forecasts are that industry assets could approach $2.6 trillion by year-end 2013. Investors and advisors have broadly indicated they still believe in the premise behind hedge fund investing. In fact, many withdrew capital in 2008 because of liquidity demands that they could not meet with their equity holdings, which experienced losses much more severe than those of their hedge fund positions.

Funds of hedge funds are expected to continue to be the major channel into hedge funds. For many investors, FoHFs represent the only viable or prudent way to access hedge fund strategies. Institutional quality FoHFs can provide at least four key services most investors find difficult to replicate, even with a consultant or advisor:[11]

- Manager-sourcing
- Thorough manager due diligence
- On-going risk monitoring
- Appropriate diversification

Looking Ahead: Economic Uncertainty

We believe the aforementioned flows into hedge funds may be a byproduct of the less attractive environment we predict for other asset classes. As we talk with investors, we continue to hear concerns about the equity markets, as well as the potential for higher inflation and/or rising interest rates.

The current rally in the global markets has two historical precedents in terms of size and velocity. The S&P 500 Index rallied by over 50% in 1938 and in 1974-75.[12] After both spikes, it spent the next couple of years treading water. Those sharp rallies also came during short-lived economic revivals in the midst of a difficult structural backdrop. In fact, sharp rallies in the first year of recovery have historically been followed by horizontal movement in stocks for at least 12 months.

Unlike traditional long only investments, hedge funds have typically demonstrated they are capable of earning profits independent of a steady run up in the markets.

Looking Ahead: Higher Taxes?

If we are to enter a period of rising tax rates, after-tax hedge fund returns may actually become more attractive on a relative basis to other traditional investments. For the high-net-worth investor, hedge fund returns are generally considered tax-inefficient because much of their return is typically taxed at ordinary income rates as opposed to the lower capital gain and qualified dividend rates, which are currently 15%. As legislated, capital gain and dividend rates will automatically rise at the end of 2010. In a previous whitepaper,[13] we showed that the impact of these rising tax rates on a relative basis would favor hedge funds as an asset class in asset allocation modeling. This is due to an expected higher percentage change in capital gain and dividend rates than the percentage change in ordinary income rates. The result of this is a much more negative tax impact on asset classes that have historically benefitted from the lower capital gain and dividend rates, leaving the after-tax returns from hedge funds in a relatively better position.

Looking Ahead: Increasing Regulation

In July, the Obama administration outlined a broad proposal for changes to the U.S. financial regulatory system. For the most part, the proposed changes were directed at the industry as a whole and not central to hedge fund managers, though there were two key implications for the hedge fund industry. The first would require all hedge funds with at least $30 million under management to register as investment advisors with the SEC. The second would authorize the SEC to share fund manager information with the Federal Reserve on a confidential basis. The Federal Reserve would then be tasked with determining if any of those funds or fund families requires greater regulation in terms of risk.

Regardless of the outcome, we think these proposals are investor friendly and represent good housekeeping for the industry at large. Based on our experience, we estimate roughly 70-80% of the funds worthy of investment are already registered with the SEC anyway. As SEC-registered investment advisers, each fund manager will be required to have a CCO and compliance manual, which we consider to be sound practices.

Summary

Adding a group of broadly diversified hedge funds to a traditional portfolio allocation can be an effective way to potentially enhance returns while preserving capital during adverse market environments. For qualified investors that do not possess the time, expertise or resources to conduct the necessary due diligence and ongoing risk monitoring, FoHFs represent an appropriate vehicle for gaining exposure to hedge funds. FoHFs provide investors ease of access and exposure to a broad range of investment styles and strategies, help mitigate the idiosyncratic risk of investing in a single hedge fund through diversification and offer professional hedge fund management expertise.

In our view, the environment for hedge fund investing is more compelling than it has been in many years. Less-directional trading strategies (i.e., less reliant on directional market moves) are better positioned for success in an uncertain/volatile economy, and the crisis of 2008 has resulted in a significantly more sustainable industry in which there are fewer excesses and a better alignment of interests between all of the various participants.

Institutional and high-net-worth investors are still committed to the value hedge funds add to a diversified portfolio, but they are assigning much more weight to the strength and integrity of a firm's risk controls and procedures when determining where to put their money. They also are conducting thorough due diligence when assessing a firm's qualifications. Outsized returns are much less important than are consistent returns that exhibit low correlations to other asset classes. Going forward, investors will likely enjoy better transparency, improved liquidity and better alignment of interests from the funds they select.

In a sense, the crisis of 2008 marked the start of a new and compelling chapter for the hedge fund industry whose story, on balance, has been one of steady success. Based on the industry's history as well as the robust performance it has delivered so far in 2009, hedge fund investors appear poised for a potentially rewarding future.

ABOUT THE AUTHORS:

Edward H. DeFrance, CPA, CFA, CAIA, is Vice President of Baird's Private Wealth Management group in Milwaukee. He works with his two partners, Christopher Didier and David Klenke, to provide wealth management solutions to high-net-worth families. The team currently advises on over $3 billion of assets across approximately 50 clients. Prior to Baird, Ed was a senior manager in Deloitte & Touche's Investment Consulting Services group and was a manager in Arthur Andersen's Investment Advisory Services division. Ed received a B.A. in Economics from the University of Illinois and a B.S. in Accounting from Illinois State University. He is a Certified Public Accountant, and holds the Chartered Financial Analyst (CFA) and the Chartered Alternative Investment Analyst (CAIA) designations. You can contact Ed at 414-298-7396 or edefrance@rwbaird.com.

Michael J. Kelly, CAIA, is responsible for all client communications for Aetna Capital Management, LLC, a Registered Investment Adviser headquartered in West Hartford, CT. Michael graduated with a Bachelor of Arts degree from Syracuse University, and is a CAIA charter holder. Michael has worked as a writer in the financial services industry for more than nine years, focusing specifically on hedge funds since December 2005. Aetna Capital Management specializes in the construction and management of multi-manager hedge fund portfolios. The firm is a wholly-owned indirect subsidiary of Aetna Inc., a Fortune 100 insurance holding company, and manages/advises on more than $600 million in affiliated and external hedge fund investments. You can contact Michael at 860-380-1224 or kellym3@aetna.com.

Important Information:

Hedge funds engage in leveraging and offer specialized investment practices including the use of derived securities and short positions. These positions may increase the risk of investment loss. Hedge funds often charge higher fees than other forms of investment and can be highly illiquid. Hedge funds are not subject the same regulations as mutual funds. Hedge funds are not required to provide periodic pricing or valuation information and may involve complex tax strategies. Hedge fund investing is not suitable for all investors and it is important to carefully evaluate the risks and benefits of individual strategies before investing.

This material is provided for informational and educational purposes and is not provided in an attempt to influence particular or pending investment decisions with any particular public jurisdiction or government entity. The information and any disclosures provided in this document do not constitute a solicitation or offer to purchase or sell any security or other financial product or instrument. Past performance is based on historical data and is not necessarily indicative of future results.

The Edhec Fund of Hedge Funds Index uses returns on competing hedge fund indices to calculate the returns on the EDHEC Fund of Hedge Funds Index. They are dollar denominated and net of fees. The Edhec Index Advisory Board determines the inclusion or exclusion of an index in the calculation of the Edhec Alternative Indexes. The criteria upon which the committee bases its decisions are as follows: >The available history, >The clarity of its construction method >Its representativity in terms of being a reference index for managers and/or investors, as well as whether it takes existing funds into account >The completeness of the provider's indexes >The stability of the composition >The regularity with which the data/index is published. This committee is composed of nine specialist professionals and recognized researchers in the domain of alternative investment. The information and any disclosures in this document may be considered confidential and any distribution, modification, copying, forwarding or disclosure by any person is strictly prohibited. Hedge fund indices are limited by a number of factors including survivorship bias where results for funds are excluded and results from poor performing funds are not reported.

[1] Hedge Fund Research, Inc.

[2] Ibid

[3] *The new power brokers: How oil, Asia, hedge funds, and P/E are shaping global capital markets*, McKinsey Global Institute, July 2009.

[4] Ibid

[5] *Alpha is a risk-adjusted measure of the so-called "excess return" on an investment. It is a common measure of assessing an active manager's performance as it is the return in excess of a benchmark index or "risk-free" investment.*

[6] Beta is a quantitative measure of the volatility of a given portfolio, relative to the overall market, usually the S&P 500. Specifically, it measures the performance the stock, fund or portfolio has experienced in the last 5 years as the S&P moved 1% up or down. A beta above 1 is more volatile than the overall market, while a beta below 1 is less volatile.

[7] Roger G. Ibbotson and Peng Chen. "The A,B,Cs of hedge funds: Alphas, betas, and costs," Yale ICF working paper, September 2006.

[8] "The hedge fund of tomorrow: Building an enduring firm," Casey Quirk and BNYM, April 2009.

[9] Bryan Goh, Hedge Fund Law Blog: June 2009 "*Overview of the Hedge Fund Industry in June*"

[10] 2009 *Alternative Investment Survey*. Deutsche Bank, March 2009.

[11] *The new power brokers: How oil, Asia, hedge funds, and P/E are shaping global capital markets*, McKinsey Global Institute, July 2009.

[12] *Investing in a Horizontal World*. Morgan Stanley Investment Focus, October 2009.

[13] David A. Klenke and Mark Blumenthal, "Asset Allocation in a Rising Tax-rate Environment", 2008

MC-27006 First use: 12/09