

Investing in Hedge Funds

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Fund Evaluation GroupSM
investment advisors

Hedge Funds

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This paper will be divided into the following five sections and a conclusion.

- 1: Overview**
- 2: Characteristics**
- 3: History and Structure**
- 4: Why Invest in Hedge Funds**
- 5: FEG Approach to Hedge Fund Investing**

Hedge Funds

Overview

A hedge fund is the popular name for an investment structure, usually in the form of a private investment vehicle such as a limited partnership, which has a flexible investment mandate. Due to the nature of the private vehicle structure and limited regulatory restrictions, the hedge fund structure provides investment managers an unconstrained investment vehicle. Hedge funds are not an asset class, nor does the term hedge fund define any single investment strategy. Hedge funds may invest in all markets globally and can have exposure to equities, fixed income, commodities, credit, and currencies, as well as derivatives associated with these asset classes.

There are few constraints placed on hedge funds other than those they place on themselves. Hedge funds are generally not open-ended registered investment vehicles like mutual funds and therefore do not have to follow the regulatory requirements placed on these structures. In order to provide for ease of valuation and perceived investor protection, mutual funds and other open-ended traditional long-only structures limit tools such as leverage and short selling and require underlying holdings to have readily available market values. These restrictions do not apply to the hedge fund model. The lack of constraints is a benefit of the structure but it also creates a need for greater caution and diligence when investing. Other benefits of the hedge fund structure include alignment of interests, diversification of systematic risks, and access to top asset management talent. The potential negatives of the structure are the lack of regulatory oversight, high fees, leverage, illiquidity, and lack of transparency.

The hedge fund industry has grown dramatically in the past ten years as institutional and high net worth investors have been attracted by the risk adjusted returns, downside protection, and diversification benefits. In many asset allocation studies, hedge funds have been considered a separate asset class and their use has been limited by placing an arbitrary ceiling on the allocation based on a comfort level with the structure. This constraint is being lifted as investors become more comfortable with the hedge fund structure and the benefits available to their portfolio.

Characteristics

Total hedge fund industry assets reached \$1.5 trillion as of December 31, 2006. There are approximately 9,400 hedge funds and 1,600 hedge fund of funds¹. Net asset flows into hedge funds are increasing dramatically, largely due to institutional allocations. In the latest National Association of College and University Business Officers (NACUBO) Endowment Study, hedge funds have an allocation of 18.0% of college and university portfolios on a dollar-weighted basis. This is the second largest category behind equity at 47.6% and ahead of fixed income at 15.0%. On an equal-weighted basis, hedge funds receive a 9.6% allocation, illustrating that larger institutions tend to have higher allocations than their smaller peers. While this data is limited to college and universities, the

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acceptance of the hedge fund structure is growing across all investor types. Competitive pressures have forced all investors to consider and make informed decisions on the use of hedge funds in their portfolios.

Structures

Hedge funds are most often structured as commingled investment funds in a limited partnership for taxable onshore investors or an offshore corporation for tax-exempt U.S. institutions and foreign investors. Hedge funds generally are limited to no more than 99 or 499 investors in a fund based on which exclusion from registration the hedge fund meets. Section 3c1 funds are limited to 99 investors. These investors must meet the “accredited investor” status, which is a net worth requirement of \$1 million for individuals and \$5 million for institutions. Section 3c7 funds accept up to 499 investors, but the investors must meet a higher “qualified” standard. The qualified standard requires \$5 million in investments for individuals and \$25 million for institutions. Some fund of funds have also been designed as closed-end registered investment companies (RICs). These RICs are subject to regular filings with the U.S. Securities and Exchange Commission (SEC), and in turn, have fewer restrictions on the number of investors and investor net worth qualifications relative to the private structures.

Taxes

U.S. based tax-exempt investors generally access hedge funds through investments in offshore corporations which provide an unrelated business taxable income (UBTI) blocker. UBTI is the result of leverage utilized by hedge funds triggering the debt-financed property rule, which states that income from debt-financed property owned by a tax-exempt organization is taxable. By locating the hedge fund offshore and structuring it as a corporation, the income is cleansed of the negative tax implications associated with UBTI. The acceptance of the offshore structure is widespread and well tested.

Fees and Liquidity

Fee and liquidity terms of hedge funds vary widely based on the strategy employed and manager preferences. Typical terms may include a lock-up of up to three years. A lock-up is a period of time when an investor cannot withdraw the investment. Investors can usually liquidate their investment after the lock-up on a quarterly or annual basis. Gates on outflows, which limits the capital that investors in aggregate may liquidate in any single period, are also fairly standard and range from 5% to 20%. Management fees range from 1-3% with a typical performance fee of 20%. These fees and liquidity terms are draconian relative to traditional long-only management. There are, however, investment benefits that can be achieved when investment managers have a stable asset base and are not in danger of facing liquidation pressure. Industry standard is to report all returns net of fees.

Regulatory Oversight

While the majority of institutional hedge funds are not registered vehicles, the majority of investment managers are registered with the SEC as registered investment advisors (RIA) and are subject to oversight by the SEC. Regardless of whether a vehicle or management company is registered with the SEC, anti-fraud provisions and securities laws apply to anyone managing capital for outside investors and the SEC has the authority to pursue legal and monetary recourse. Many hedge fund managers are also registered with the Commodity Futures Trading Commission (CFTC) and the National Futures Association (NFA). Hedge funds are lightly regulated on a day-to-day basis, however, between the regulatory oversight, third party due diligence efforts, and industry participant monitoring, the hedge

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fund industry is institutional by all accounts.

Fund of Funds

Investors can choose to access hedge funds by selecting funds from specific hedge fund firms, or through a fund of funds structure. Fund of funds have been extremely popular for all types of investors as a way to diversify manager risk, gain access to closed managers, benefit from expert manager selection and due diligence, and receive consolidated reporting. These potential benefits of the fund of funds structure must be weighed against the additional layer of fees ranging from a 0.75% to 2% management fee and performance fees of up to 10% at the fund of funds level.

History and Structure

The first hedge fund was developed by Alfred Winslow Jones in 1949. This fund and other early hedge funds were designed to manage risk and provide outsized returns through shorting stocks and applying leverage to an equity portfolio. The incentive fee structure and resulting alignment of interests was a novel idea at the time and was attractive to both investors and asset managers. After early success, hedge funds did a poor job managing risks through the early 1970s and the model essentially disappeared from public consciousness until reemerging in the 1990s.

Hedge funds were re-born at this time, in part out of a desire to break free of the significant constraints placed on traditional asset management. Benchmarking, categorizing, and boxing of asset managers had become the norm. To fit within investors' portfolio construction methodology, asset managers were expected to adhere to a specific mandate and closely approximate benchmarks to allow for better portfolio modeling and asset allocation optimization. The risk management function was removed from the asset managers' toolbox and was performed solely at the portfolio level through asset allocation. The hedge fund model is, in part, an attempt by asset managers to take back the risk management function in order to provide better risk-adjusted returns within their asset class or strategy. This shift away from performance relative to a benchmark and towards absolute performance is a key attribute of the hedge fund structure.

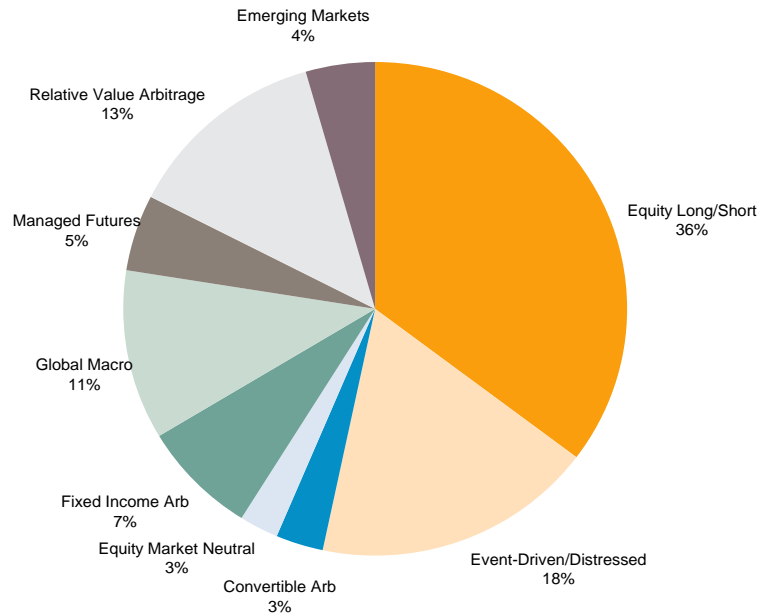
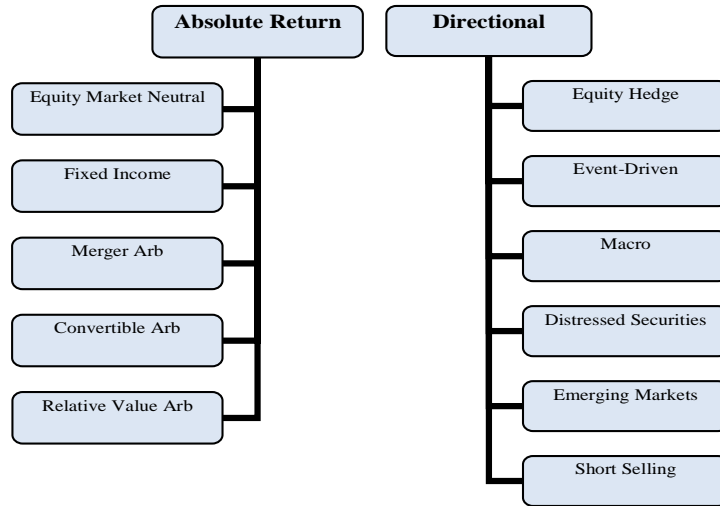
Categorization

Providing a general description of a structure with no investment restrictions is difficult, however, a framework for the hedge fund industry can be provided. FEG divides the universe of hedge fund strategies into two general themes to simplify the discussion. No two funds are alike; however they do tend to operate under one of the following two mandates.

- **Absolute Return** – Absolute return strategies attempt to provide consistent returns unrelated to broad market moves. These strategies tend to neutralize traditional market risk, or systematic risk, and assume individual security or idiosyncratic risk.

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- Directional** – These strategies tend to opportunistically invest while remaining exposed to a degree of market risk, as well as idiosyncratic risk. These funds may be “net long” or “net short” the equity, credit, commodities, or currencies markets on a global basis.



Source: HFR Industry Reports, © HFR, Inc [April 4 2007],
www.hedgefundresearch.com

The chart above details the general strategies as defined by Hedge Fund Research (HFR) and the percentage of the hedge fund assets attributed to each strategy. As the industry has grown, the directional strategies have increased their percentage of the total hedge fund assets. Many arbitrage strategies have limited capacity and are unable to expand at the rate of directional strategies.

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Performance

Following is a performance chart that details the annual performance of the HFR indices.

	Annualized Return			Standard Deviation			Sharpe Ratio 10 Year	Correlations (10-yr)		
	1 Year	5 Year	10 Year	1 Year	5 Year	10 Year		S&P 500	MSCI EAFE	Lehman Agg
Composites										
HFR Index Fund Weighted Composite Index	9.6%	9.9%	10.6%	3.7%	4.7%	7.3%	0.76	0.72	0.75	(0.06)
HFR Index Fund of Funds Composite Index	8.4%	7.9%	7.7%	4.0%	3.6%	5.9%	0.47	0.52	0.62	(0.02)
Directional										
HFR Index Equity Hedge Index	7.9%	9.2%	13.3%	4.4%	6.0%	9.3%	0.87	0.70	0.71	(0.05)
HFR Index Event-Driven Index	12.0%	11.8%	12.2%	3.3%	5.6%	6.6%	1.04	0.67	0.70	(0.10)
HFR Index Macro Index	5.5%	9.4%	9.3%	4.3%	5.0%	6.3%	0.67	0.34	0.48	0.19
HFR Index Distressed Securities Index	14.5%	15.7%	11.8%	2.4%	4.2%	5.6%	1.17	0.45	0.52	(0.08)
HFR Index Emerging Markets (Total)	18.7%	20.0%	11.2%	8.3%	8.6%	14.8%	0.47	0.60	0.70	(0.13)
HFR Index Short Selling Index	-5.4%	-1.3%	-0.1%	5.7%	10.4%	21.0%	(0.13)	(0.71)	(0.67)	0.11
Absolute Return										
HFR Index Equity Market Neutral Index	6.5%	4.5%	7.1%	1.4%	1.8%	3.1%	0.65	0.14	0.18	0.17
HFR Index Fixed Income: Diversified Index	6.9%	8.0%	7.8%	1.6%	2.9%	3.7%	0.73	0.05	0.14	0.47
HFR Index Merger Arbitrage Index	12.6%	6.9%	9.1%	2.8%	3.3%	3.9%	0.99	0.49	0.50	(0.05)
HFR Index Convertible Arbitrage Index	10.2%	6.1%	9.2%	1.3%	3.4%	3.5%	1.15	0.23	0.22	0.05
HFR Index Relative Value Arbitrage Index	10.8%	8.0%	9.5%	1.6%	2.0%	3.2%	1.36	0.47	0.41	0.05
Benchmarks										
S&P 500 TR	11.8%	6.3%	8.2%	6.2%	12.3%	15.2%	0.28	1	0.81	(0.11)
MSCI EAFE - Net	20.2%	15.8%	8.3%	8.0%	13.1%	15.0%	0.28	0.81	1	(0.15)
Lehman Aggregate Bond Index	6.6%	5.4%	6.5%	2.6%	3.7%	3.5%	0.41	(0.11)	(0.15)	1
90 Day LIBOR	5.4%	2.8%	4.2%	0.1%	0.5%	0.6%	(1.43)	N/A	N/A	N/A

Source: HFR Industry Reports, © HFR, Inc [April 4 2007], www.hedgefundresearch.com

Data through 12/31/2006

Hedge fund indices are notoriously unreliable. There are a number of biases included in hedge fund indices, including survivorship bias, backfill bias, and a short track record which inflate the index returns. Furthermore, increased competition and assets flowing into capacity constrained strategies make it unlikely that the returns of the 1990s are sustainable. Investors must be cautioned that past performance is not indicative of future performance.

As is apparent from the above chart, hedge funds have historically provided an attractive risk-adjusted return relative to both equity and fixed income, while also providing diversification benefits. Over the long-term, hedge funds in aggregate are not expected to outperform the equity market on an absolute basis, but are expected to outperform on a risk-adjusted basis. Directional strategies have tended to provide equity-like performance with lower risk, as measured by standard deviation, than the equity indices and absolute return strategies have provided higher returns than fixed income with similar risk to the fixed income indices.

Risks

Due to their structure, flexibility, and lack of transparency, the following risks should be considered when investing in hedge funds. These risks are not necessarily captured through a simple quantitative measure such as standard deviation.

- **Leverage** – Hedge funds generally apply some form of leverage to investments. The amount of leverage that is reasonable varies widely between strategies.

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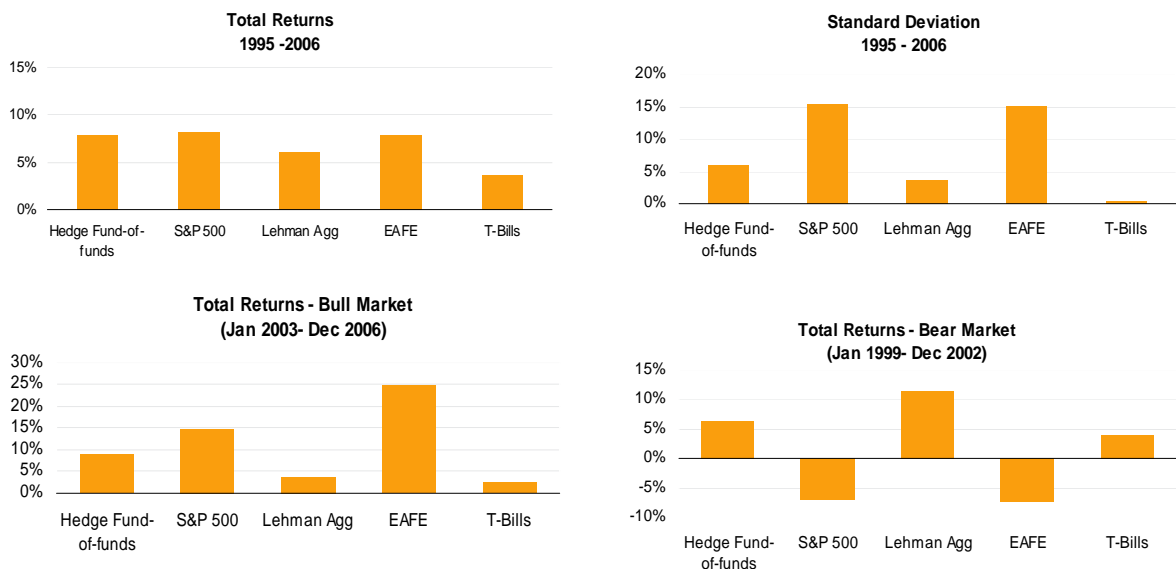
- **Operational** – Operations for many hedge fund managers can be more complicated than traditional managers due to the use of derivatives, leverage, and complex trading techniques.
- **Fraud** – Hedge funds are no more susceptible to fraud than other private investment vehicles. The popularity of the industry however, will attract unqualified and unsavory individuals.
- **Liquidity** – Investors have reduced liquidity due to lock-up provisions and limited withdrawal rights. Underlying positions can also be illiquid and subject to valuation risk.
- **‘Blow ups’** – The most frequent cause of a ‘blow up’ is fraud or operational issues. Leveraged market risk can also cause significant losses that could be termed a “blow up”. The vast majority of hedge fund closures, however, are caused by failure to reach scale or underperformance rather than a “blow up” scenario.

The additional risks associated with the hedge fund structure must be managed through a rigorous initial and disciplined ongoing due diligence process.

Why Invest in Hedge Funds?

The flexibility of the hedge fund model allows managers to target a wide range of risk and return. While certain hedge funds could be used to target higher total returns, FEG recommends hedge funds as risk reducers rather than return enhancers. The purpose of adding hedge funds should be to increase the consistency of returns, reduce downside volatility, and increase the return attributed to alpha (excess return) rather than beta (market return). Comparing the relative performance of hedge funds to equities and fixed income during specific periods of the market cycle provides insight into their portfolio benefit.

Relative Performance



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The top two charts detail the performance and risk of hedge fund of funds compared to equity and fixed income indices for the 1995 to 2006 period. The lower two charts detail the performance of hedge fund of funds compared to the traditional market indices during the 2003-2006 bull market and the 2000-2002 bear market. Overall, hedge fund of funds provided returns near those of equity markets, as represented by the S&P 500 and MSCI EAFE indices, with risk slightly above that of the Lehman Brothers Aggregate Bond Index. The hedge fund of funds index is a combination of both directional and absolute return strategies. On a stand alone basis, directional strategies have fluctuated more significantly with their underlying market risks, while absolute return strategies have provided stable returns regardless of underlying market conditions.

FEG Approach to Hedge Fund Investing

FEG's investment philosophy embraces the use of flexible investment structures and strategies and integrates them into a total portfolio approach. Utilization of illiquid strategies in order to benefit from the illiquidity premium is recommended. Specific liquidity needs must be assessed in order to gauge each client's tolerance and maximum allowable level of illiquid holdings. Although hedge funds are the more liquid of the alternative investment strategies, they generally offer only annual or quarterly redemptions, with an initial lockup of one year or more, and should provide a corresponding illiquidity premium to investors.

Asset Allocation

Many investors create a separate category for hedge funds when making asset allocation decisions. This practice allows investors to monitor the different investment structures and liquidity parameters of their portfolio. This practice, however, does not provide insight into the exposure by market risk factors of the portfolio. FEG recommends including hedge funds not as a separate category, but as opportunistic strategies within the broad asset categories of global equity, global fixed income, real assets, and diversifying strategies.

The directional strategies can easily be included in the asset classes in which they invest. A long/short equity hedge fund manager is essentially an equity manager with a risk management strategy and a greater focus on idiosyncratic risk, rather than market risk. A distressed debt hedge fund manager seeks to isolate the credit portion of fixed income risk premiums. These types of hedge funds should be included in the broad asset classes of global equity and global fixed income because market risk, albeit hedged, is often the largest determinate of return.

Absolute return strategies, while often investing in the same asset classes as traditional investment managers, do so in a market neutral framework that attempts to arbitrage pricing discrepancies or other anomalies that are unrelated to general market moves. Absolute return strategies are designed to reduce exposure to the market risks that define the broad asset classes and therefore should be included in a separate absolute return or diversifying strategy category for asset allocation purposes. This allocation can be used by investors as a way to manage the total market risk of their portfolio.

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Decision Process

Hedge fund investments may not be suitable for all investors. The decision to invest in a hedge fund is predicated first on acceptance and ability to increase the illiquidity of the portfolio. Secondly, a determination of hedged directional exposure vs. absolute return must be made based on the investor's asset allocation, risk tolerance, and future expectations. The decision to invest in hedge funds should always be viewed within the context of the total portfolio. Directional funds should be considered a way in which to reduce the risk and exposure to equities or credit while maintaining return potential. Absolute return hedge funds should be selected to provide a non-directional, diversifying return stream. Thirdly, investors must determine whether they will access hedge funds directly or through funds of funds.

Fund of Funds

Hedge fund investments can be accessed through direct funds or fund of funds, or combination of the two. A fund of funds structure offers diversification by strategy and by manager by investing in several (usually 10-50) funds. Fund of funds can add value through manager selection and due diligence, access to closed managers, strategy selection, and consolidated reporting. The fund of funds structure carries an additional layer of fees. The management fees on fund of funds range from 0.75% to 2.0% and may also include a performance fee. A simple comparison of the HFR Fund Weighted Composite to the HFR Fund of Funds Composite indicates a return differential of 2.8% points over the last ten years, which is above the cost of the additional layer of fees. Fund of funds have also realized a standard deviation of 5.9% vs. 7.3% for direct funds over this ten year period. The risk and return differential has narrowed considerably over more recent periods. Fund of funds have come under some fee pressure in recent years due to the institutionalization of the industry and emergence of multi-strategy hedge funds that provide diversification by strategy with a single layer of fees. Fund of funds, however, will continue to be the method of choice for investors who do not have the comfort, asset size, or experience to invest directly.



Direct

Adding direct hedge funds saves an extra layer of fees but requires an investor and their advisor to spend significant additional time and resources on manager selection and oversight. Utilizing direct hedge funds will usually result in more concentrated positions in fewer managers relative to a fund of funds mandate, thus increasing the manager specific risks to the portfolio while increasing the likelihood of underperforming or outperforming the industry in aggregate.

Multi-strategy

As the hedge fund industry continues to institutionalize, hedge fund firms are building multi-strategy platforms and internal allocation vehicles that provide diversification of strategies with a single layer

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of fees. The emergence of the diversified hedge fund has reduced the need to include a large number of hedge funds to achieve strategy diversification. These multi-strategy funds do not reduce the single manager risks that are elevated in the hedge fund industry, but with proper selection and monitoring one can comfortably invest in a smaller number of hedge funds than was possible even a few years ago.

While the hedge fund portfolio should be designed within a total portfolio context, special attention must be paid to the manager and strategy specific risks that are often less understood and magnified relative to traditional investment vehicles. FEG works with clients to construct portfolios that are diversified both by manager and strategy. An investor's assets, experience, and comfort with alternative investments determine how hedge funds are accessed.

Conclusion

- Hedge funds are a compelling investment due to the flexibility of the structure, a focus on managing risk, and the opportunity to provide skill-based returns.
- The hedge fund structure increases certain non investment risks including; leverage, operations, liquidity, and fraud.
- Many hedge fund strategies are exposed to the same underlying return drivers as the traditional long-only management industry and should be viewed within a total portfolio context.
- Allocating capital to hedge funds should reduce the risk of an investor's portfolio through diversification and downside protection.
- The growth of the industry, additional risks of the structure, and complex strategies results in an industry that is difficult to navigate without professional assistance. Hedge fund investments may not be suitable for all investors. Successful investing in this high growth industry requires increased attention to the additional non-investment risk factors.
- Manager selection and monitoring are crucial in building a successful hedge fund investment program. FEG assists investors in navigating the hedge fund industry through professional and thorough due diligence, manager selection, risk monitoring, and portfolio construction.

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Hedge Fund Glossary

3(c)1: An investment vehicle structured under Section 3(c)1 of the Investment Company Act of 1940 that permits the exclusion of investment companies from standard registration requirements with the SEC if they have no more than 99 U.S. investors and those investors are either Accredited Investors or Qualified Purchasers.

3(c)7: An investment vehicle structured under Section 3(c)7 of the Investment Company Act of 1940 that permits the exclusion of investment companies from standard registration requirements with the SEC if all U.S. investors are considered to be "Qualified Purchasers". There is no numerical limit to the number of investors if all investors are "qualified". However, as a practical matter, the number is limited to 499 in order to avoid the registration and reporting requirements of the Securities Exchange Act of 1934.

Accredited Investor: A term defined by the SEC to determine investor eligibility for unregistered investment vehicles based on the wealth of the individual or institution. To meet this requirement, a businesses must have discretion over \$5 million; an individual who has an individual net worth, or joint net worth with his or her spouse, in excess of \$1,000,000; or, the individual had income (exclusive of any income attributable to his or her spouse) of more than \$200,000 in each of the past two years, or joint income with his or her spouse of more than \$300,000 in each of those years; and reasonably expects to reach the same income level in the current year. Accredited Investors may invest in a 3(c)1 investment vehicle but must also meet the higher Qualified Purchaser standard to invest in 3(c)7 funds.

Administrator: An outsourced provider to investment funds that offers a range of back office functions including calculating net asset values and the management of money inflows and outflows.

Capacity constraints: The subjective limit on how much money a given strategy can support without creating market distortions; or that a hedge fund organization can handle given its current staffing.

Capital structure arbitrage: An investment strategy that involves going both long and short different securities from the same issuer to take advantage of temporary pricing disparities between the issues, such as convertible/common stock.

Commodity Trading Advisor (CTA): An investment manager licensed to trade in futures, both for physical commodities, and financial futures, such as index or bond futures.

Convertible arbitrage: An investment strategy that involves going long convertible bonds and short the related stock. The complex pricing relationship of convertibles allows for arbitrage managers to exploit the pricing inefficiencies.

Custodian: A third party that physically holds the assets of an investment fund, including cash in the

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fund as well as the actual securities. The custodian also collects dividends, exercises rights and options and may make margin payments. An administrator might also serve as a custodian.

Derivatives: Financial instruments whose value is dependent on the price of underlying traditional instruments, such as stocks, commodities, or bonds. Derivatives include options, futures, and swaps that are traded over-the-counter or are privately negotiated.

Distressed securities: Investments in the debt or equity of companies undergoing financial stress such as bankruptcy, reorganizations, distressed sales. •

Emerging Markets: A strategy that invests in securities of companies or in sovereign debt of developing or “emerging” countries. Investments are primarily long.

Equity Hedge: A strategy that combines a core long equity portfolio with short sales of stock or stock index options. At any one time, they may be net long or net short. These managers are most like traditional stock-pickers, but often run more concentrated portfolios and use leverage and short sales to enhance or protect returns.

Equity Market Neutral: A strategy involving investments in offsetting long and short positions in equity securities structured to neutralize the impact of any market movements and thus capture pure security selection skill. Often this strategy is “equitized” by pairing it with exposure to an equity index to produce enhanced index returns.

Event-Driven: An investment strategy that involves investments in companies undergoing significant changes in their corporate life-cycle, including bankruptcy, restructuring, mergers, acquisitions, spin-off of a division or subsidiary. This is a broader category encompassing the strategies of merger arbitrage, distressed, and special situations. Managers will allocate their portfolio to the most attractive sector.

Fixed Income Arbitrage: A strategy involving investments in offsetting long and short positions in related fixed income securities and their derivatives whose values are mathematically or historically interrelated but may be temporarily dislocated. Typically, significant leverage is used to increase returns.

Fund-of-Funds: Funds that invest in other investment funds. These funds have the same investment qualifications and requirements as direct fund investments. Benefits include a single manager relationship providing manager and strategy diversification, portfolio construction and monitoring, oversight and due diligence. The primary detraction of this structure is the layer of fees and expenses paid to the fund-of-funds manager.

General partner: An individual, subchapter S corporation, or a Limited Liability Corporation (LLC), which is formed to manage an investment pool. General partners are often rewarded for good performance with an incentive allocation of capital appreciation. On the downside, general partners have unlimited liability.

Macro: A strategy involving investing in a broad array of securities and markets based on a top-down global macroeconomic assessment of the world markets. These managers are making investments based

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on predicated macro movements of such things as interest rates, foreign exchange rates, physical commodities, etc.

High-water mark: A measure under which a manager collects no performance fees. This measure corresponds to the highest previous asset level. Hedge fund managers may charge a percentage fee based on profits. If a fund has a high-water mark provision, it cannot charge that fee until the fund makes up any losses and surpasses the highest previous asset level.

Hurdle rate: A threshold that must be surpassed prior to an incentive fee being charged by a hedge fund manager. It is often the current interest rate on Treasury bills, or LIBOR, or an absolute number based on a minimum performance expectation such as 5%. For equity-oriented strategies the hurdle rate may be pegged to a long only equity index. A hurdle rate may be in addition to a high-water mark. Many hedge funds do not have a hurdle rate and instead charge an incentive fee on all profits.

Incentive Fee: The fee on new profits earned by the fund for the period. Based on the terms of the fund, it may not apply until performance has surpassed a hurdle rate or high-water mark. This incentive fee generally ranges between 10% and 30%.

Kurtosis: A statistical measure of the peakedness of a distribution. The higher the peakedness, the greater the possibility of an extreme return (either positive or negative), and the less likely the distribution will conform to the properties of a normal distribution.

Leverage: The amount of assets owned or controlled by the fund divided by the amount invested. Most hedge funds incorporate a modest level of leverage into their strategies.

Limited partner: The underlying investors of a fund that have none of day-to-day responsibilities of operating the fund. Limited partner losses are limited to the amount invested. A typical limited partnership is comprised of a 1% general partnership interest and a 99% limited partnership interest.

Lock-up: The time period that an initial investment cannot be redeemed from the fund. Reasons may include the illiquidity of the underlying investments or the time required to harvest an initial investment.

Macro: A strategy involving investing in a broad array of securities and markets based on a top-down global macroeconomic assessment of the world markets. These managers are making investments based on predicated macro movements of such things as interest rates, foreign exchange rates, physical commodities, etc.

Managed futures: A strategy that invests in commodity and financial futures as well as currency markets, often using quantitative techniques, called systematic trend following.

Master-Feeder Fund: A commonly used structure allowing a hedge fund to pool assets from onshore and offshore investors. Typically a master-trading vehicle is domiciled offshore and has two "investors," an offshore investment fund and a US (usually Delaware) Limited Partnership. These two funds feed assets to the master fund where the manager actively invests it.

Max drawdown: A historical performance measure of the percentage decline from a peak to a low.

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This measure is sometimes further defined by the length of time that it takes for this decline to occur.

Merger arbitrage: (or Risk Arbitrage) – An investment strategy involving investments in companies being acquired or involved in a merger. Generally, the manager is long the target company and short the acquiring company to lock-in the spread between the two. Leverage may be used to enhance potential returns.

Multi strategy: An investment strategy that allocates investment capital to a variety of underlying strategies managed by the same investment firm. Multi-strategy funds provide strategy diversification but retain manager specific risk.

Net market exposure: A measure of the percentage of investment capital exposed to directional market risk. For example, a long/short equity fund that is 100% long and 25% short will have a “net” exposure of 75%. A more accurate measure of market exposure adjusts for relative betas.

Non-directional: An investment strategy with return objectives, irrespective of market movements. Such strategies are broadly categorized as absolute return.

Offshore Funds: A private investment fund domiciled outside the U.S. and open to non-U.S. and non-taxable U.S.-based investors. Most tax-exempt entities invest via offshore vehicles to avoid unrelated business taxable income (UBTI). Common domiciles include the Cayman Islands, Bermuda or the Virgin Islands.

Onshore Funds: U.S.-based private investment partnerships. These funds are typically used by taxable domestic investors or by tax-exempt investors if the fund does not anticipate generating unrelated business taxable income (UBTI).

Pari-Passu: This is a Latin term that means “of equal step” or “without partiality.” It is often used in hedge fund terminology when a master-feeder structure is utilized. This indicates that all of the feeder funds are managed and dealt with in an equal manner.

Pairs trading: A non-directional relative value investment strategy that seeks to identify two companies with similar characteristics whose equity securities are currently trading at a price relationship that is out of the historical trading range. This strategy entails buying the undervalued security while short-selling the overvalued security.

Prime broker: A primary service provider for hedge funds. Typically, it is a large Wall Street firm that serves as a hedge fund’s primary relationship for trading, custodial services, clearing, research and the supply of stocks to sell short. Prime brokers often offer turn-key hedge fund launches to new managers by providing everything from office space and financing to marketing through an established network.

Qualified Purchaser: A term defined by the SEC to determine investor eligibility for unregistered investment vehicles based on the wealth of the individual or institution. This standard is the higher of two levels of qualification. An investor meets this requirement if he or she is an individual who owns \$5 million or more in investments including investments held jointly with a spouse; is a family-held business that owns \$5 million or more in investments; is a business that has discretion over \$25

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million or more in investments; or, is a trust sponsored by qualified purchasers. Qualified purchasers can invest in 3(c)1 or 3(c)7 investment vehicles.

Registered Investment Company (RIC): A fund structure that is registered with the SEC and can accommodate an unlimited number of investors. This structure is open to both Accredited Investors and Qualified Purchasers and may offer a low minimum investment. Other benefits include oversight by an independent board of directors and public filings of documents with the SEC. Detractions include significant administrative costs and the potential to limit access to hedge funds that do not want fund information, including fees, made public.

Relative Value Arbitrage: A strategy involving investments in various strategies that take advantage of the mispricing of related securities. Typically, these situations exist due to financial stress, a complex structure or some temporary dislocation in the markets.

Short rebate: The interest earned on the proceeds of the short sale. Short sales proceeds are normally deposited in a money market account held with the prime broker as collateral. Depending on negotiations, much of the interest the account generates is rebated to the manager.

Short Selling: Investment structures that benefit from a decline in stock price. The investor must borrow the securities he intends to sell short and is responsible for all dividend payments.

Skewness: A statistical measure of the degree of asymmetry of a distribution around its mean. A positive measure indicates a distribution with an asymmetric tail extending toward more positive values. A negative measure indicates a distribution with an asymmetric tail extending toward more negative values.

Special situations investing: An investment strategy that looks at companies that face a major change, such as a merger, spin-off or restructuring.

Transparency: The ability of investors to see the investment process, portfolio holdings and results of an investment fund.

Value-at-risk (VAR): A probability analysis of the maximum loss on a position at a given level of statistical confidence, over periods ranging from a day to a week to a month. With hedge funds, it's not the 95% confidence level that counts, but something like the 99% confidence level, i.e., one chance in a hundred.

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