FPPTA
Evolution of Hedge Funds

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Why Hedge Funds?

- Wealthy families, endowments and foundations wanted protection.
- Stocks are too highly correlated to preserve capital.
- Few active long only managers add value.
- Achieve equity returns with bond-like volatility.

Typical DB Pension Plan - Situation

- Pension plan portfolios have 60% - 75% equity allocations.
- Remaining 35% in bonds earns less than the actuarial earnings assumption.
- The higher allocation to equities is necessary to achieve the actuarial bogey.
- Both domestic and international equity asset classes are highly correlated.
- High correlation means greater risk.
- Long-only equity classes tend to move downward together.
- Conclusion – find better ways to manage risk.

Assumptions

- Diversification is achieved by combining low correlating asset classes.
- Alpha returns are not related to market returns (Beta).
- Alpha returns come from manager skill.
- Beta returns are determined by the broad equity market.

Hedge Fund Categories

- Convertible Arbitrage: purchase convertible bonds and short the stock (hedge).
- Merger Arbitrage: purchase stock of company being acquired and short the acquirer.
- Event-Driven: long/short equity or debt opportunities – spin-offs, M&A, bankruptcy, reorganizations.
- Distressed Securities: selling short a distressed company stock.
- Equity Market Neutral: within each industry - long strong names and short weak names 50/50.
- Equity Long/Short: short some stocks, along with a core holding of long equities.

Hedge Fund Categories

Annualized net % return
of indexes 6/30/06
Source: CISDM (Barron's)

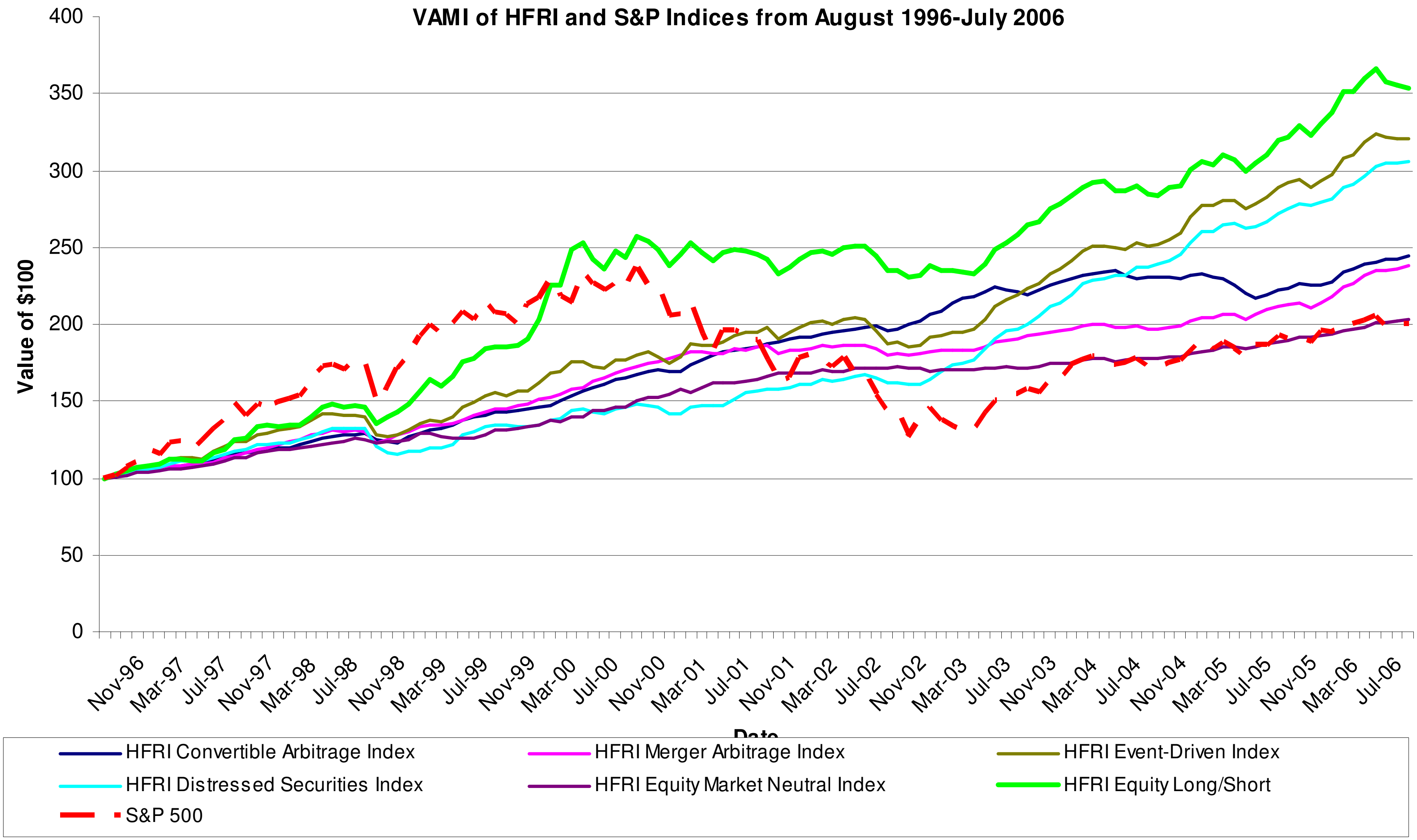
	1-Yr.	rank	3-Yr.	rank
Convertible Arbitrage	9.76	5	12.99	9
Merger Arbitrage	8.17	9	24.68	5
Event-Driven	9.58	6	36.31	2
Distressed Securities	12.04	4	47.69	1
Equity Market Neutral	8.12	9	23.53	7
Equity Long/Short	9.29	7	35.08	3
Other				
S&P 500	8.63	8	11.21	10
R2000	14.57	3	18.70	8
EAFE	26.61	1	23.96	6
Lehman Aggregate	-0.81	11	2.05	11
Wilshire REIT	22.2	2	27.8	4

Volatility - Ten Years

Annualized Standard Deviations for August 1996-July 2006

HFRI Convertible Arbitrage Index	3.48%
HFRI Merger Arbitrage Index	3.87%
HFRI Event-Driven Index	6.63%
HFRI Distressed Securities Index	5.59%
HFRI Equity Market Neutral Index	3.13%
HFRI Equity Long/Short Index	9.34%
S&P 500	15.59%

10 Year - Performance



Facts

- Single-manager Hedge Funds - $1.7 trillion (HFR, Chicago).
- $77.2 billion added during 2Q06.
- Hedge Funds are an alternative to long strategies.
- Hedge Funds have a low correlation to the broad market.
- Long strategies are highly correlated to the broad market.

Short Selling - Defined

- Short selling means selling a security that you do not own.

- Short strategies sell borrowed securities that are expected to decline in value in the hope of buying the securities later at a lower price and receiving back money based on the difference in price.
  - Sell borrowed stock @ $50.
  - Stock falls to $40.
  - Purchase stock @ $40 and deliver back to lender.
  - Profit = $50 - $40 – dividends, say $9.75

BCA

Long / Short Market-Neutral Hedge Funds

- Short 50% of portfolio with stocks expected to decline.
- If 50% of the portfolio is long and 50% is short, the total portfolio is not expected to lose money if the broad market declines.
- Preserve capital during down market periods.
- Lower volatility is similar to bonds (very low).
- Results trail in performance during rising market periods.

Hedge Funds Using Leverage

- Leverage occurs when the hedge fund borrows money or securities.
- Leverage increases risk and returns by magnifying events.
- Tax strategies are required to avoid unrelated business income tax (UBIT).

Fee Structure – Performance Based

- 1% of assets plus 20% of return above index (S&P 500)
  - Fund earns 18% versus 12% (S&P 500) during a 12-month period
  - Net return is 18% - 1% - 1.2% = 15.8%
  - Total Fees paid to manager = 2.2%
  - Difference: 15.8% - 12.0% = +3.8%

Transparency and SEC Registration

- Hedge Funds may delay reporting positions or trades to maximize effectiveness.
- Lack of transparency may cause compliance problems with your IPS.
- SEC registration has been resisted by the industry.
- Short Sales are not reported to the SEC.

Operational Risk – Moody's Criteria

- Back office administration.
- Regulatory compliance.
- Risk reporting and control.
- Legal and financial structure.
- Human resources.

Glossary

Convertible Arbitrage involves purchasing a portfolio of convertible securities, generally convertible bonds, and hedging a portion of the equity risk by selling short the underlying common stock. Certain managers may also seek to hedge interest rate exposure under some circumstances. As the default risk of the company is hedged by shorting the underlying common stock, the risk is considerably better than the rating of the un-hedged bond indicates.

Merger Arbitrage sometimes called Risk Arbitrage, involves investment in event-driven situations such as leveraged buy-outs, mergers and hostile takeovers. Normally, the stock of an acquisition target appreciates while the acquiring company's stock decreases in value. These strategies generate returns by purchasing stock of the company being acquired, and in some instances, selling short the stock of the acquiring company. Managers may employ the use of equity options as a low-risk alternative to the outright purchase or sale of common stock.

Event-Driven is also known as "corporate life cycle" investing. This involves investing in opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations and share buybacks. Instruments include long and short common and preferred stocks, as well as debt securities and options.

Distressed Securities strategies invest in, and may sell short, the securities of companies where the security's price has been, or is expected to be, affected by a distressed situation. This may involve reorganizations, bankruptcies, distressed sales and other corporate restructurings. Depending on the manager's style, investments may be made in bank debt, corporate debt, trade claims, common stock, preferred stock and warrants.

Equity Market Neutral investing seeks to profit by exploiting pricing inefficiencies between related equity securities, neutralizing exposure to market risk by combining long and short positions. Typically, the strategy is based on quantitative models for selecting specific stocks with equal dollar amounts comprising the long and short sides of the portfolio. One example of this strategy is to build portfolios made up of long positions in the strongest companies in several industries and taking corresponding short positions in those showing signs of weakness.

Equity Long/Short investing consists of a core holding of long equities hedged at all times with short sales of stocks and/or stock index options. Where short sales are used, hedged assets may be comprised of an equal dollar value of long and short stock positions. Other variations use short sales unrelated to long holdings and/or puts on the S&P 500 index and put spreads. Conservative funds mitigate market risk by maintaining market exposure from zero to 100 percent.