

UK Treasury Review Advises Institutions to Consider Hedge Funds

The Myners review found that UK pension fund trustees had not focussed on the benefits of hedge funds

“There has been limited understanding of the different styles of hedge funds and the risk diversification and return enhancement potential they can provide”

Hedge Funds Allow Institutions to Reduce Portfolio Risk

- Flexibility to make money in all market environments
- Preserve capital in falling markets
- Not constrained by benchmarks, tracking errors and regulations that can prevent maximising returns
- Environment attracts highly talented and experienced fund managers
- Institutions increasingly focusing on hedge funds to enhance returns and reduce risk

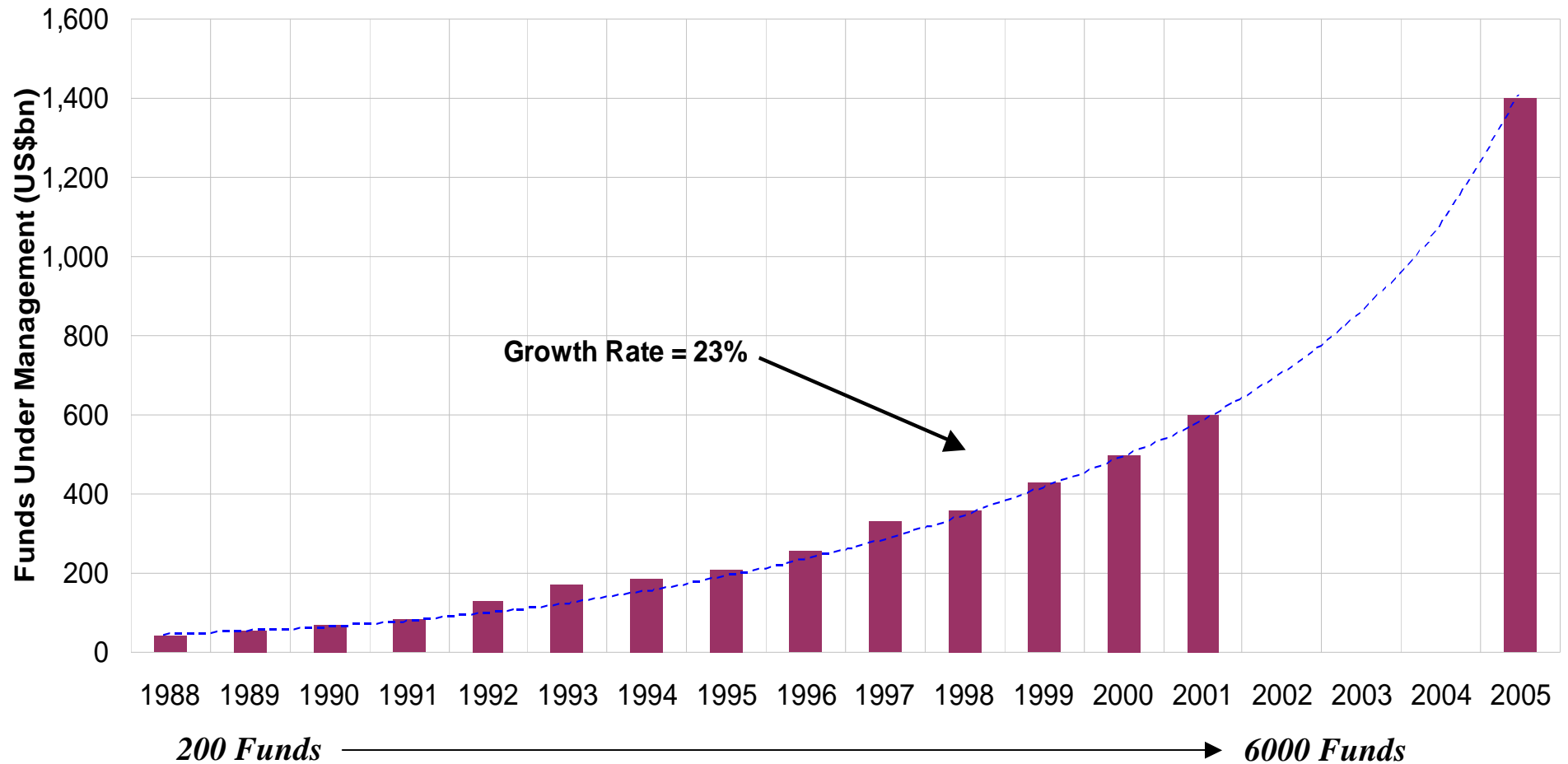
Key Characteristics of Hedge Funds

- Focus on absolute return
- Generate alpha through distinct strategies and skilled managers
- Capture most upside but protect downside - “the power of compounding”
- Low correlation with other asset classes
- Alignment of investors’ and managers’ interests

Development of The Hedge Fund Industry

- Started over 50 years ago with a few managers picking long/short equities
- In 1980's there were less than 200 funds
- Early 1990's small number of high profile global macro funds predominated
- LTCM mismanagement and ensuing crisis highlighted liquidity risk and affected investor perception
- Today's hedge fund offerings have developed significantly - style diversification and increased attention to risk control
- Maturing institutional asset class - growing globally

Growth of The Hedge Fund Industry



Source: HFR

Broad Range of Hedge Fund Strategies

Long/Short Equity

Investment Style

- Directional strategies involving equity orientated investing on both the long and short sides of the market

Sub-Strategies

- Value/Growth Specialists
- Sector Specialist
- Geographical Specialist
- Opportunistic
- Short Selling

Features

- Largest strategy
- Generally low leverage

Event Driven

Investment Style

- Invests in strategies that can benefit from the occurrence of special situations

Sub-Strategies

- Merger Arbitrage
- Distressed Securities
- Corporate Restructuring

Features

- Low market exposure
- Probabilistic models

Relative Value

Investment Style

- Strategies aiming to profit by capitalising on the mispricing of related securities or financial instruments

Sub-Strategies

- Convertible Arbitrage
- Fixed income Arbitrage
- Statistical Arbitrage
- Market Neutral

Features

- Very low market exposure
- Arbitrage anomalies

Trading

Investment Style

- Diverse mix of strategies/instruments that are generally momentum based over short holding periods

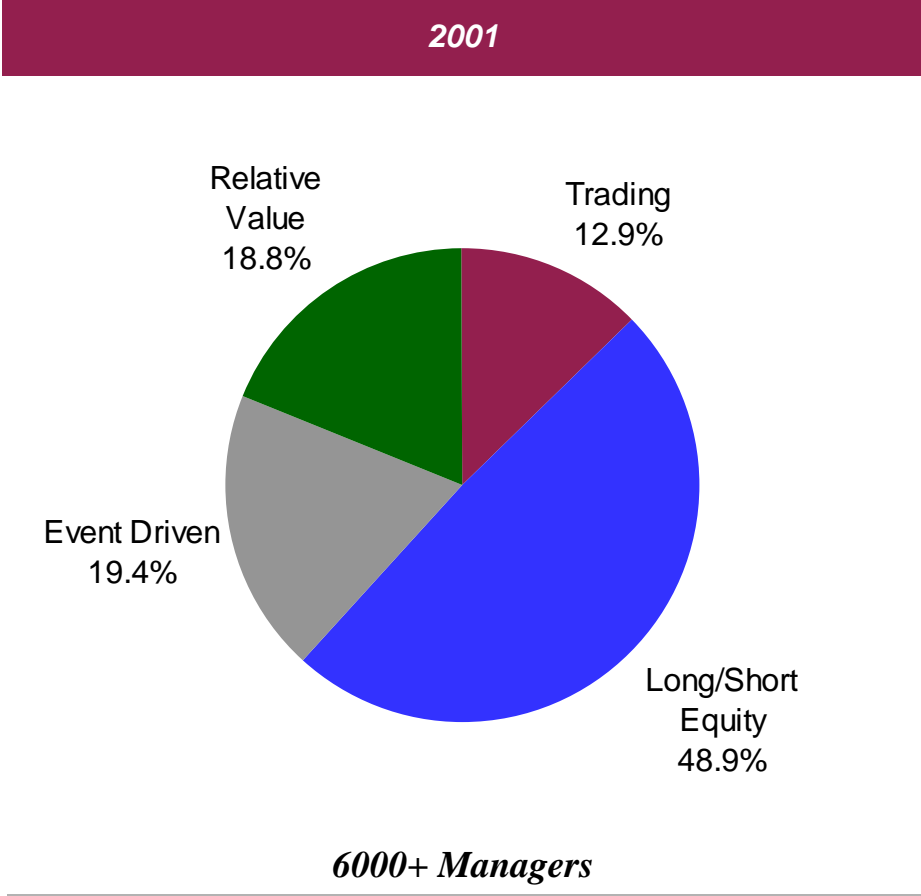
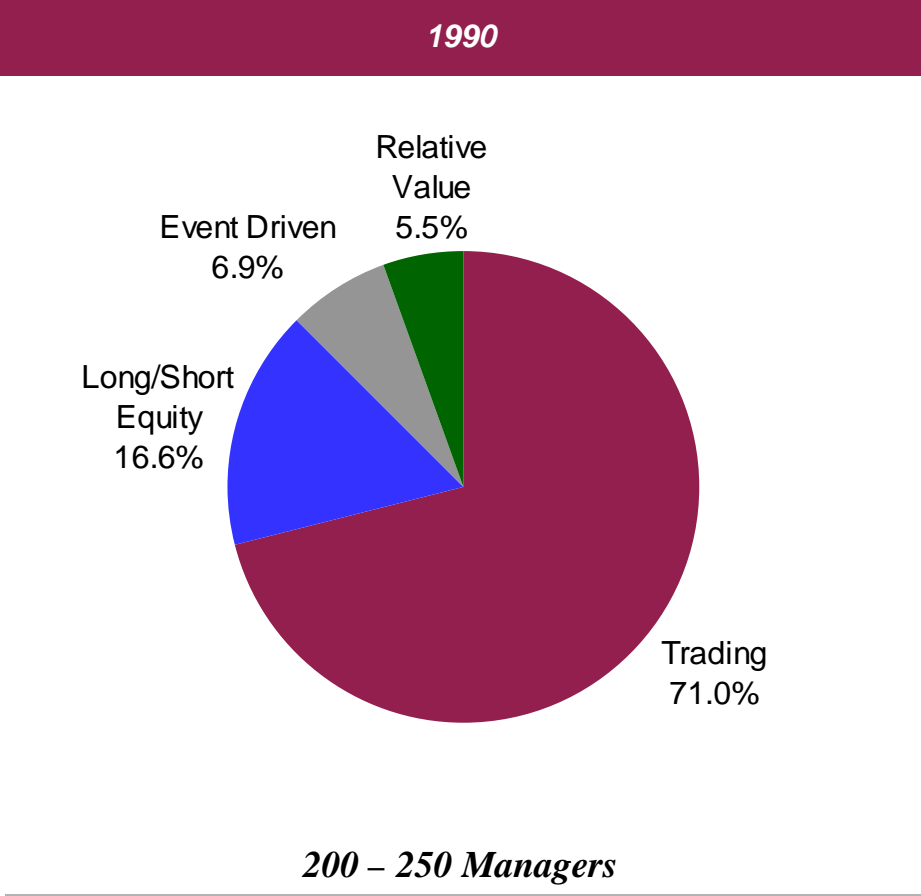
Sub-Strategies

- Systematic
- Global Macro
- CTA's

Features

- No correlation with MSCI
- More volatile

The Hedge Fund Industry Has Changed: 1990 vs 2001



Source: HFR

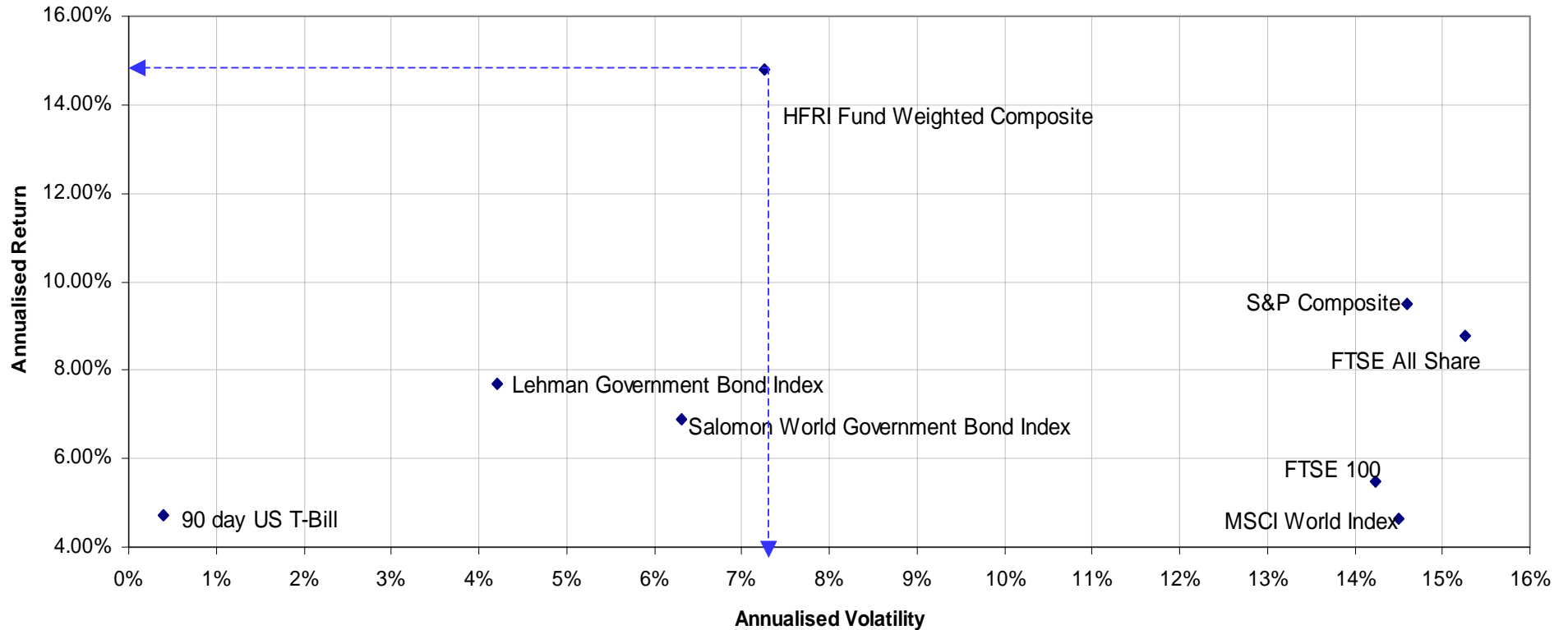
Hedge Fund Risk and Return Characteristics

<i>Jan 1990 – July 2002</i>		Correlation				
Strategy	Sub-strategy*	Annualised Return	Volatility	S&P500	MSCI	LBI
Long/Short Equity	Long/Short Equity	18.72%	9.44%	0.66	0.62	0.14
	SectorSpecialist	19.71%	14.55%	0.57	0.55	0.07
	Short Selling	4.02%	23.01%	-0.69	-0.67	-0.10
Event Driven	Merger Arbitrage	11.39%	4.54%	0.46	0.41	0.10
	Distressed Securities	14.50%	6.38%	0.39	0.35	0.10
Relative Value	Convertible Arbitrage	11.51%	3.41%	0.35	0.33	0.10
	Fixed Income Arbitrage	8.75%	4.68%	-0.06	0.00	-0.07
	Statistical Arbitrage	10.36%	4.00%	0.53	0.43	0.34
Trading	Global Macro	17.24%	8.84%	0.42	0.42	0.36

Source: HFRI as of May 2002

Equity-Like Returns with Bond-Like Volatility

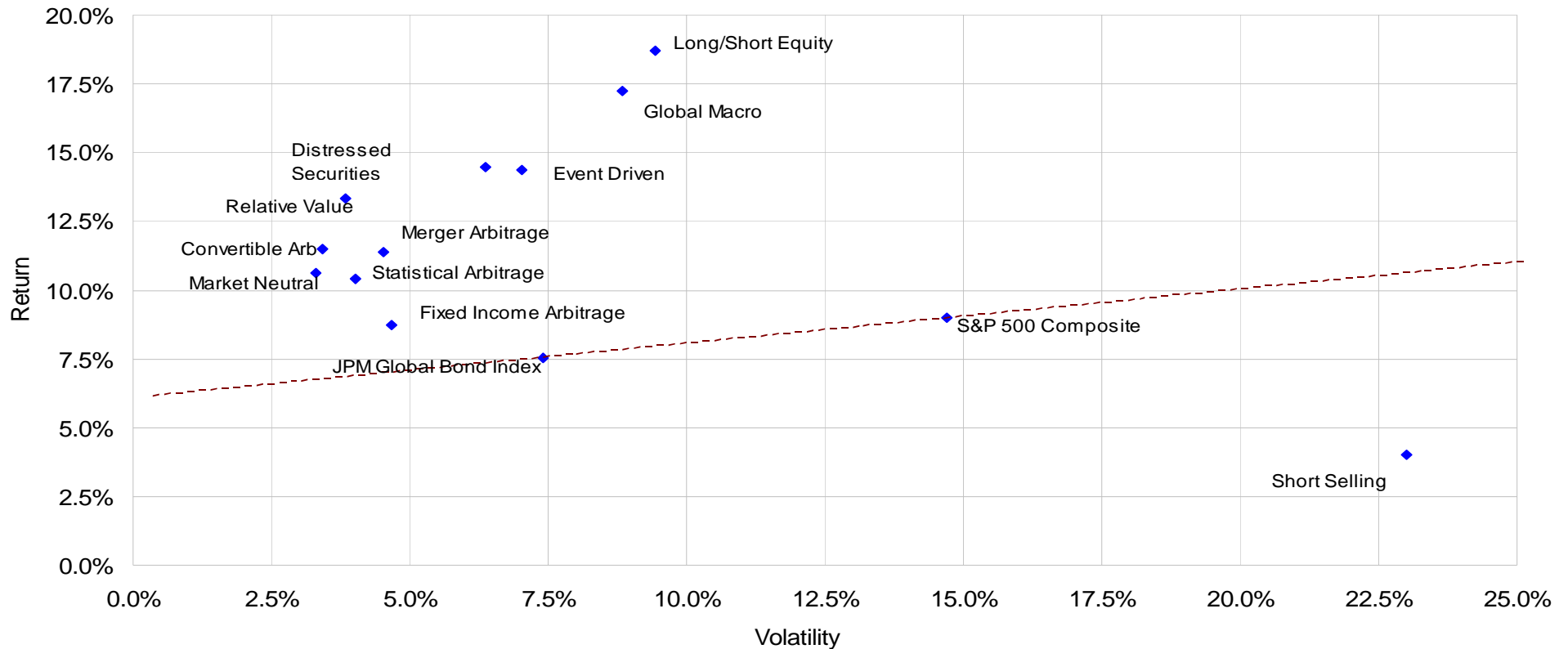
Risk/Return Analysis January 1990 to July 2002



Source: HFR

Out-performance by Hedge Fund Strategies

Adding Alpha In All Market Conditions
January 1990 to July 2002



Source: HFR

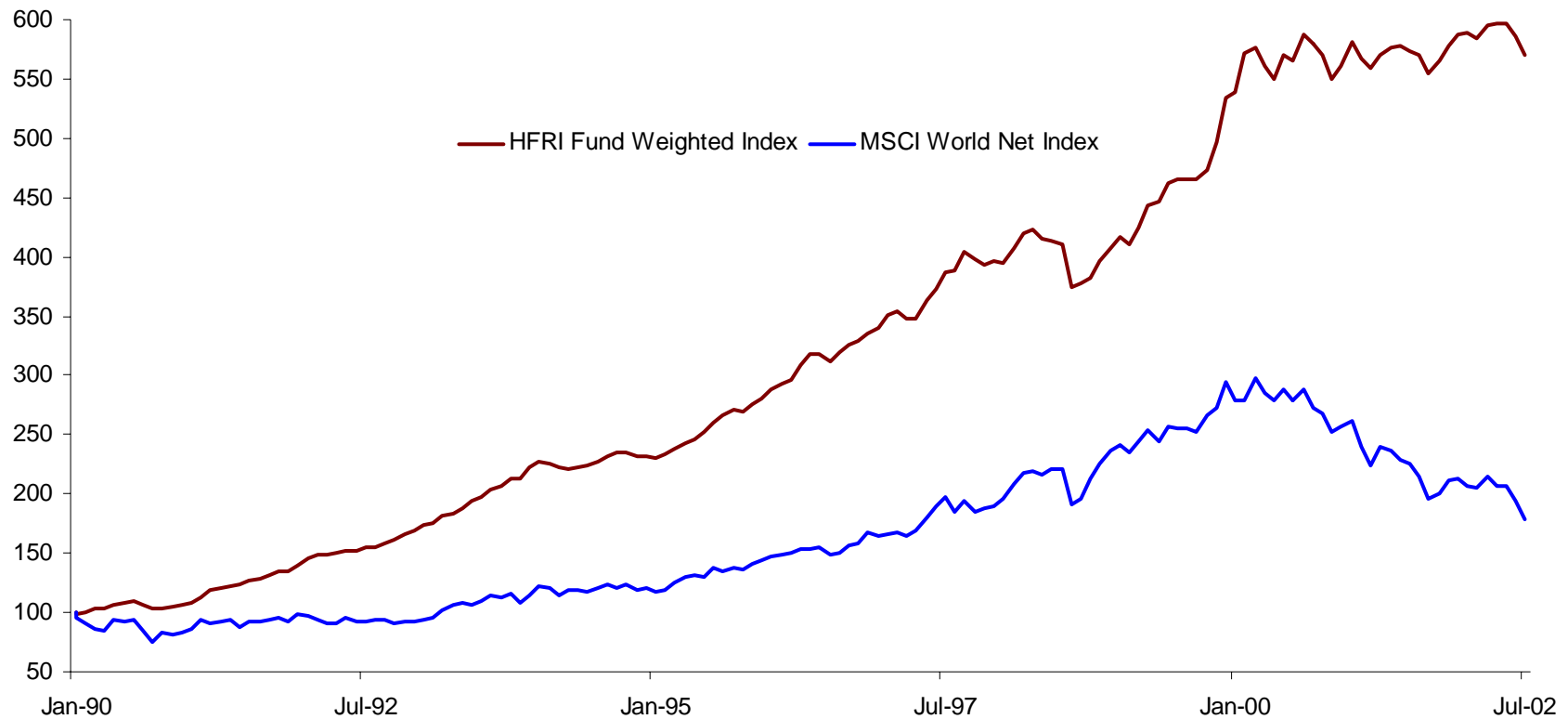
Why Should Institutions Invest in Hedge Funds?

To improve overall portfolio efficiency through:

- Enhanced returns
- Reduced risk
- Diversification - Low correlation with existing asset classes

Performance Comparison with MSCI World Index (net)

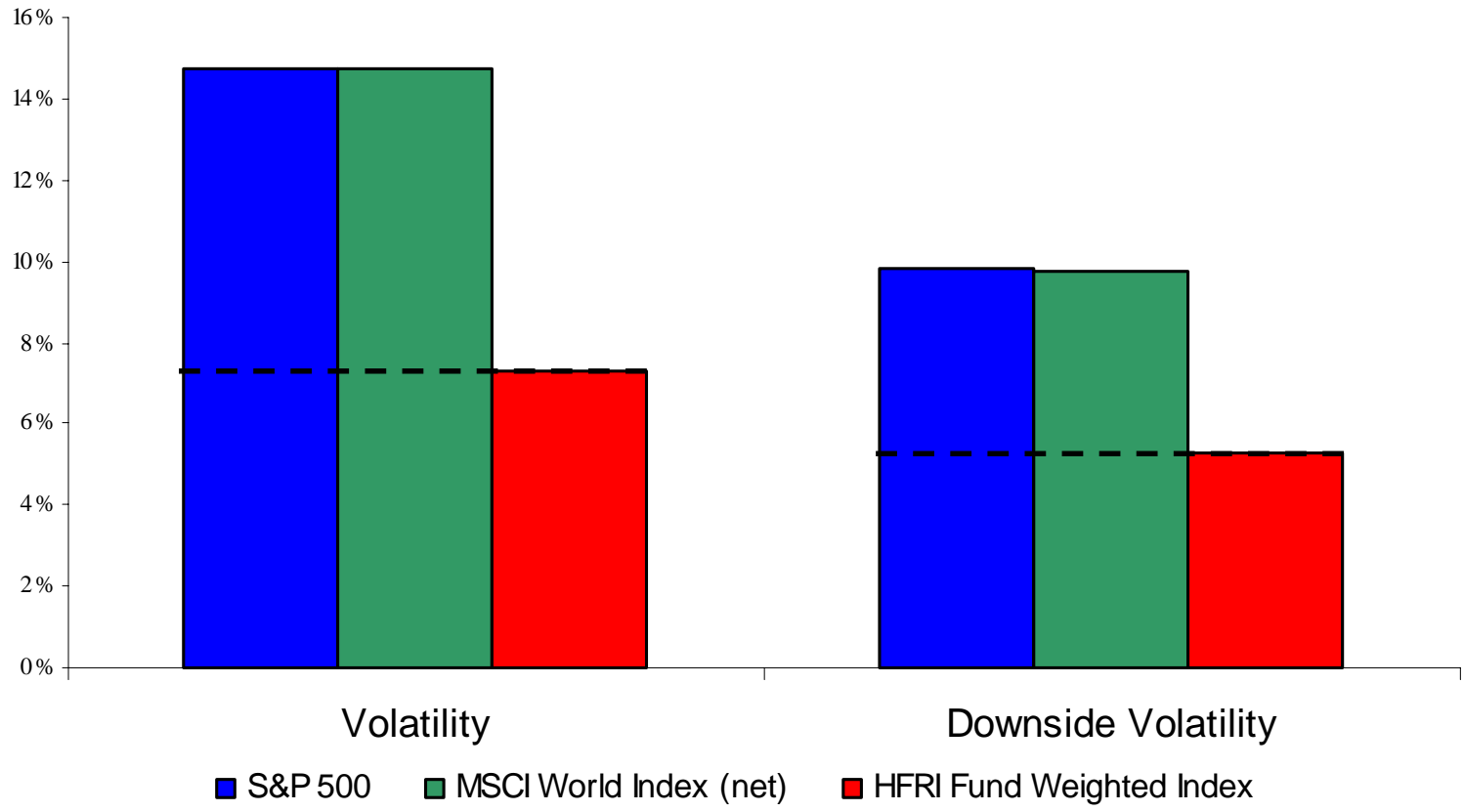
Cumulative hedge fund returns vs MSCI World Index (net)
January 1990 to July 2002



Source: IAM

Lower Volatility of Returns Over Time

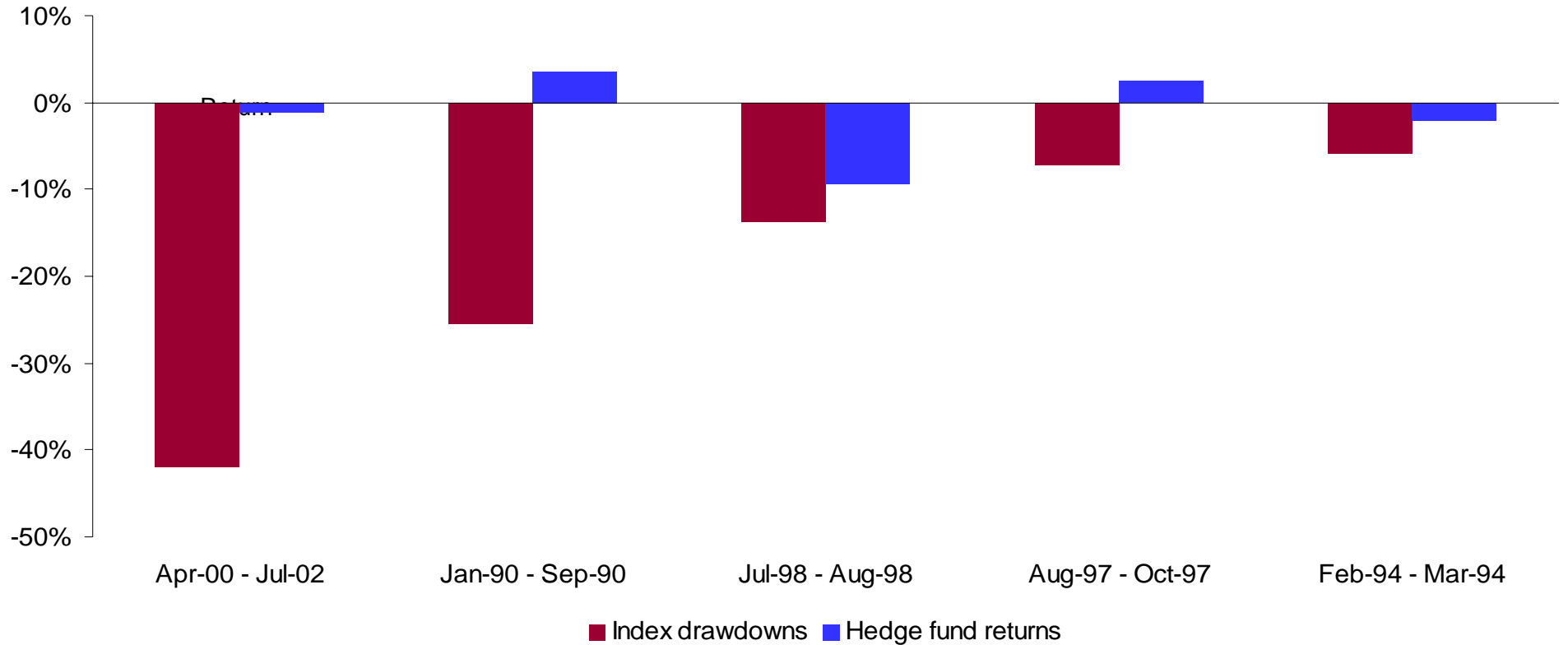
January 1990 to July 2002



Source: IAM

Hedge Funds Can Preserve Capital in Falling Markets

Hedge Fund Returns During Index Stress Periods
January 1990 to July 2002



Source: IAM

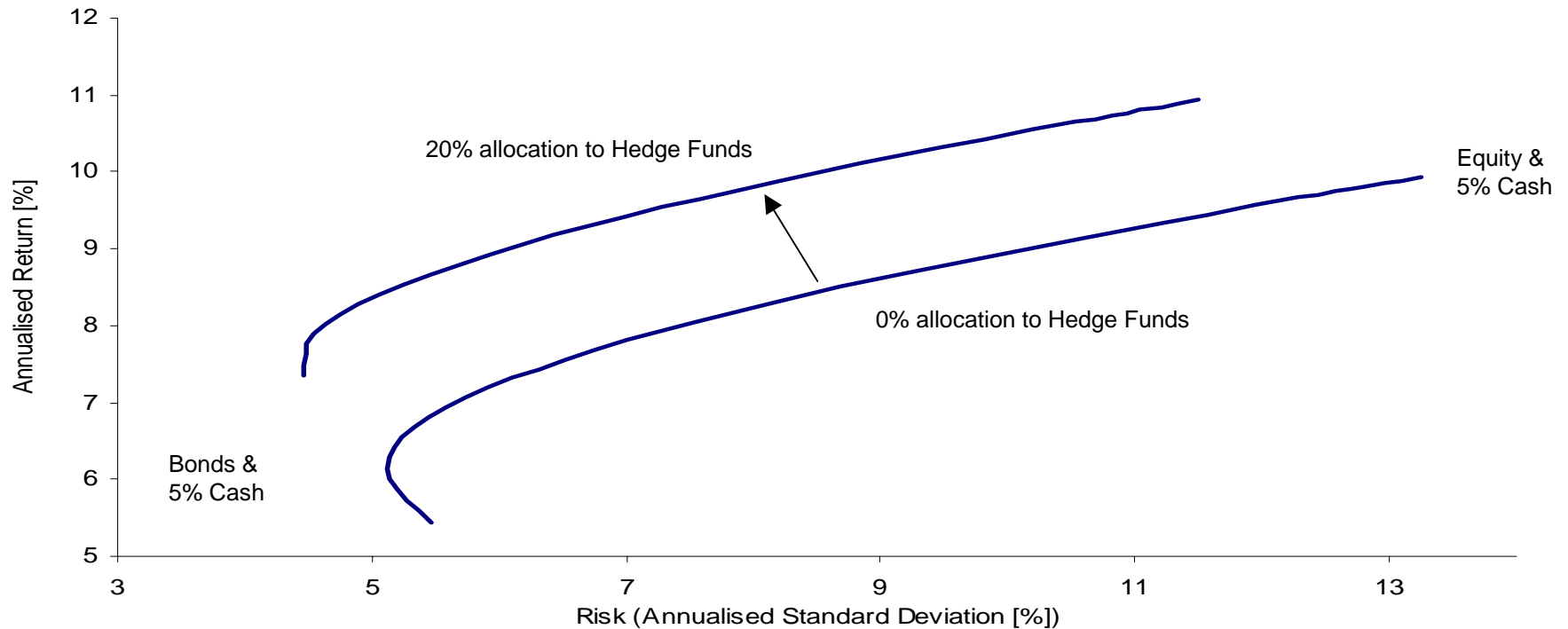
Index: MSCI World Index
Hedge Funds: HFRI Fund Weighted Composite Index

Hedge Funds Complement Traditional Investment Portfolios

Efficient Frontier

Benefits of Incorporating Hedge Funds in a Classical Portfolio of Stocks, Bonds and Cash

10 years to July 2002



Hedge Funds: HFRI Fund Weighted Composite Index
Bonds: JP Morgan Global Bond Index
Equity: S&P 500 Composite
Cash: 3 month Interbank Eurodollar Deposit Rate

Source: IAM

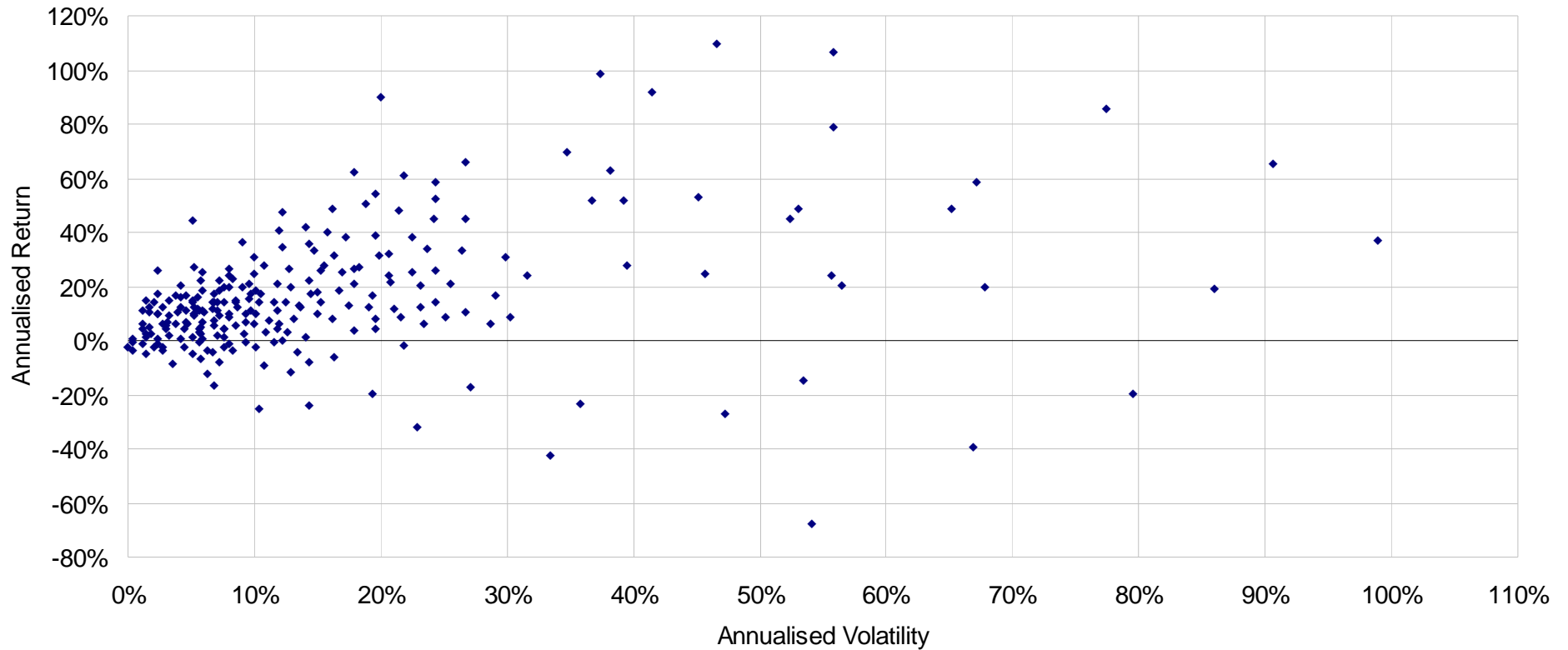
What Is The Role of The Multi-Manager?

To construct a diversified optimal portfolio of hedge funds by:

- Utilising expertise in selecting high quality managers over their various strategy cycles
- Ongoing monitoring of managers - ensure consistent application of strategy/risk control principles for which initially selected
- Adjusting positions to maintain optimal allocation throughout the life of the portfolio

Wide Dispersion of Single Fund Returns

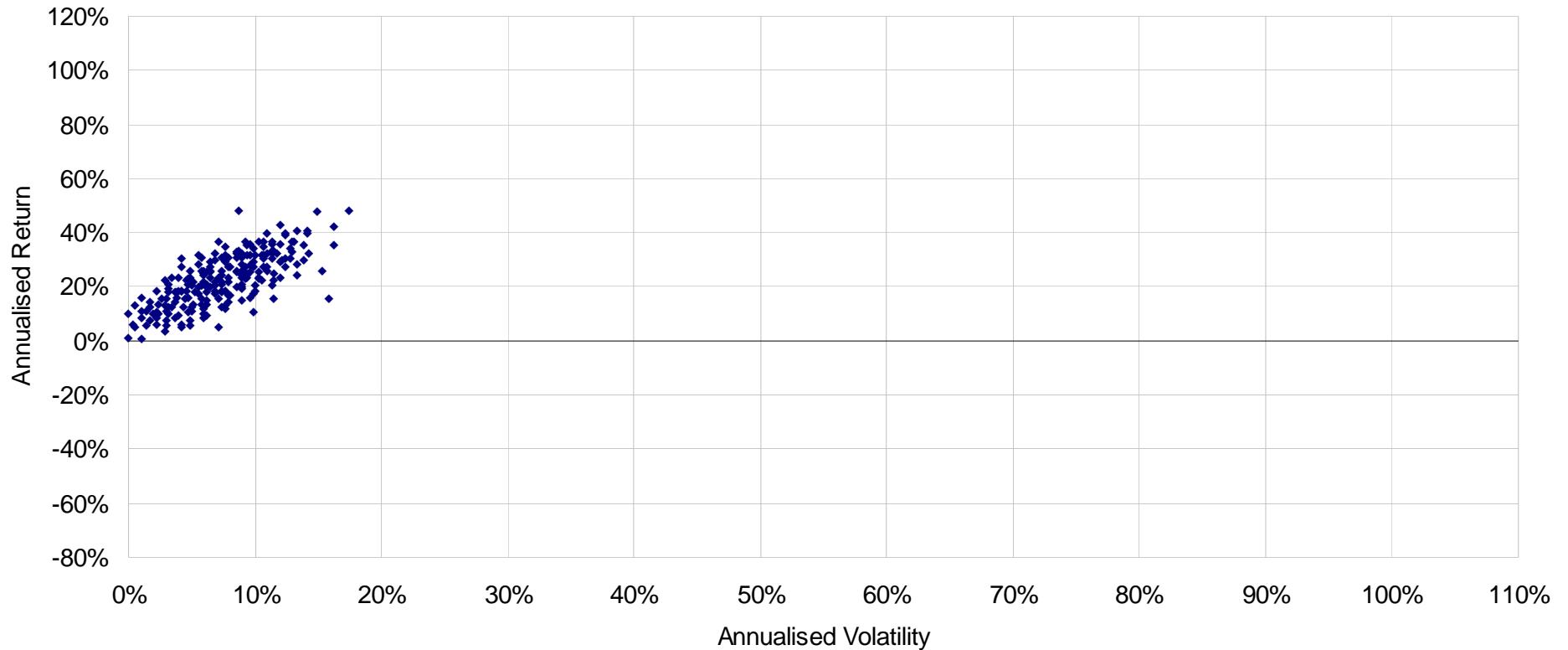
5 years to July 2002



Data set: 250 funds chosen at random from the International Asset Management proprietary database

Multi-Manager Approach Reduces The Dispersion of Returns

5 years to July 2002



Data set: 250 portfolios consisting of 25 funds chosen at random from the International Asset Management proprietary database

Strengths and Weaknesses of Hedge Funds

Strengths

Sustainable good performance

High risk adjusted returns

Motivated bright managers

Greater flexibility of investment instruments

Pro-active approach to investing

Possible Weaknesses

Lack of transparency

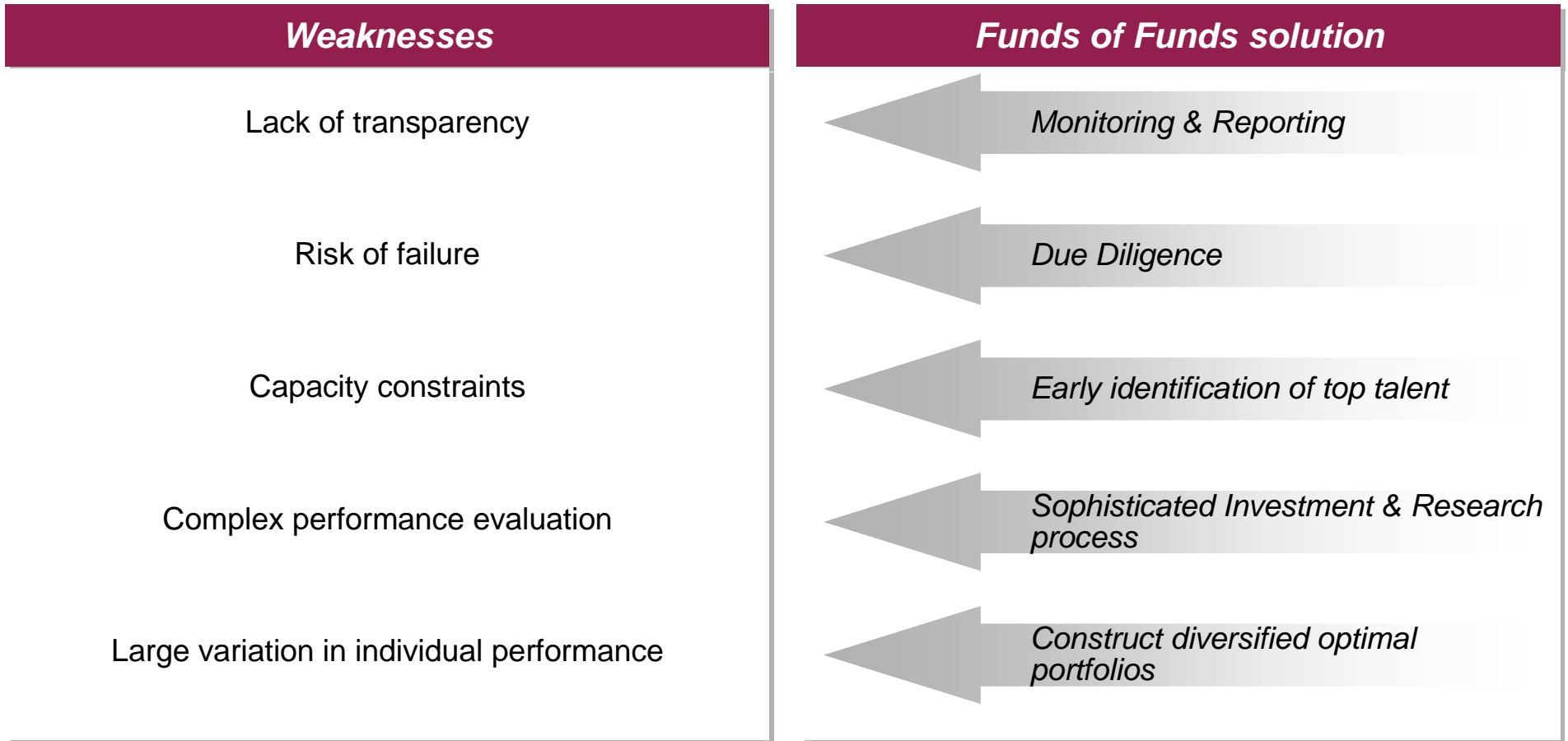
Risk of failure

Capacity constraints

Complex performance evaluation

Large variations in individual performance

Fund of Funds as a solution



Selecting The Best Hedge Funds Is Not Easy...

Problems of Choosing Single Funds

Time consuming

High cost of data & manager visits

Complex

Requires detailed knowledge

Ongoing monitoring

Risk of poor performance

Advantages of Funds of Funds

Dedicated full-time team

Economies of scale

In-depth experience and knowledge

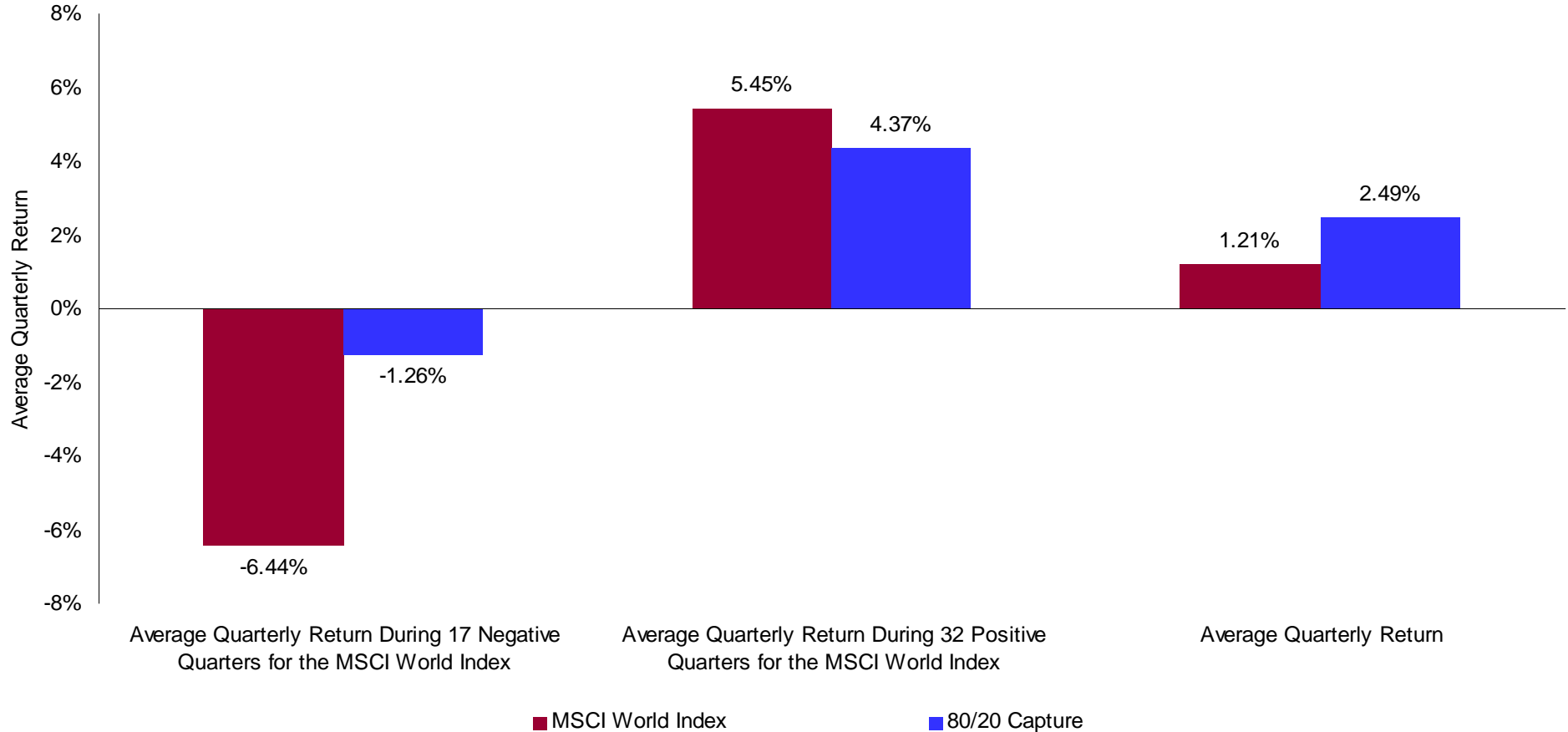
Specialist skills give attractive risk adjusted returns

Due diligence processes

Diversification reduces risk

Benefits of The Power of Compounding - 80/20 Capture

January 1990 to July 2002



Summary

- Hedge funds contribute to the overall risk/return profile of a traditional investment portfolio
- Choosing top rated hedge fund managers is critical
- Multi-manager approach offers benefits
- Need to select experienced multi-manager