

BARRA ROGERSCASEY

AN INTRODUCTION TO HEDGE FUNDS

The First in the BRC Hedge Fund Series

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Summary

This paper is the first in BARRA RogersCasey's white paper series about one of the fastest growing areas of investment management: hedge funds. This paper seeks to explore the growth of hedge funds, discusses the various types of hedge fund strategies, describes attractive characteristics of hedge fund strategies and identifies the issues that have prevented hedge funds from becoming a significant part of institutional investors' portfolios to date.

We believe that hedge fund strategies are worthy of consideration within investor portfolios as many of these strategies offer the opportunity to generate returns independent of the movements of the broad capital markets. In other words, they offer significant diversification benefits to investors. In addition, many of these strategies have demonstrated the ability to generate attractive risk adjusted returns over time. However, as with any type of investment strategy, there are specific risks associated with hedge fund strategies that must be clearly understood by any potential investor.

Additional papers in this series will cover how hedge funds might be used in a portfolio and issues surrounding the implementation of hedge fund strategies.

Introduction

Over the last ten years, the hedge fund market has grown dramatically. Although hedge funds have existed since Alfred Winslow Jones created the first one in 1949, the market began experiencing its most rapid growth in recent years. Estimates suggest there are now over 6000 active hedge funds globally which represent more than \$500 billion in assets under management.¹ In fact, global capital committed to hedge funds has risen at an annualized rate of 18.9% from 1988 to 1998.² There are several factors driving the growth and interest in this area. The recent bull market has been a tremendous source of asset growth, but recent falling equity returns (and prospects for lower future returns) are causing investors to seek new sources of return as well as opportunities for diversification. In addition to the allure of higher absolute returns, hedge funds, with generally low correlations to traditional investments, are being considered as complements to traditional investment strategies in order to improve total portfolio performance. This paper will be the first in a series of papers with future topics to include the role of hedge funds in a portfolio, considerations in designing a hedge fund program, and the ongoing monitoring of a hedge fund program.

¹ *Van Hedge Advisors.*

² *The Benefits of Hedge Funds: Asset Allocation for the Institutional Investor*, September 2000 by Thomas Schneeweis, Ph.D., Professor of Finance and George Martin, Director of Research, Center for International Securities and Derivatives, Isenberg School of Management, University of Massachusetts.

What is a Hedge Fund?

A hedge fund is an investment structure for managing a private, loosely regulated investment pool that can invest in both cash (physical securities) and derivative markets on a leveraged basis.³ Legally, it may take the form of a limited partnership, corporation, trust or mutual fund depending on where the fund is domiciled and the type of investors it seeks to attract. The domicile or legal location of the hedge fund determines the structure. Most U.S.-based hedge funds are structured as limited partnerships while hedge funds outside the U.S., or “offshore” funds, are typically structured as limited liability companies.

As with more traditional styles of management, investor funds are allocated either in a separate account or, more typically, in a commingled fund. The hedge fund structure gives investors access to hedge fund managers with specialized investment skills.³

Unlike traditional asset managers, many hedge fund managers try to create value primarily through positions uncorrelated with systematic exposure to capital markets. Instead, they seek to generate portfolio performance regardless of the direction of the capital markets.

Return opportunities come from two sources: an expanded universe of securities from which to trade; and a wider array of trading strategies implemented without the constraints of regulation common to most traditional products. For example, hedge fund strategies may access financial and commodity markets and may take long, short, spread, option and levered positions in any of these markets. Therefore, hedge funds provide unique risk and return characteristics that are not accessible by traditional asset management strategies. The hedge fund structure encompasses a diverse set of strategies that attempt to create value by exploiting specific arbitrage opportunities. Investment objectives vary widely among hedge fund managers. Some hedge fund strategies, such as market neutral, attempt to avoid systematic exposure to the capital markets and are true diversifiers. Other hedge fund strategies, such as equity long/short, are more sensitive to the same market factors as traditional stock strategies.²

² *The Benefits of Hedge Funds: Asset Allocation for the Institutional Investor*, September 2000 by Thomas Schneeweis, Ph.D., Professor of Finance and George Martin, Director of Research, Center for International Securities and Derivatives, Isenberg School of Management, University of Massachusetts.

³ *Investing in Hedge Funds Strategies for the New Marketplace*, Joseph G. Nicholas, Chairman, Hedge Fund Research, L.L.C., 1999 Bloomberg Press.

Specific investment strategies are discussed in more detail later in this paper. Today, the institutional investment universe consists of traditional investments and a growing list of alternative investments. Figure 1 illustrates where hedge funds fall within the universe of investment opportunities with respect to their composition versus more traditional investments:

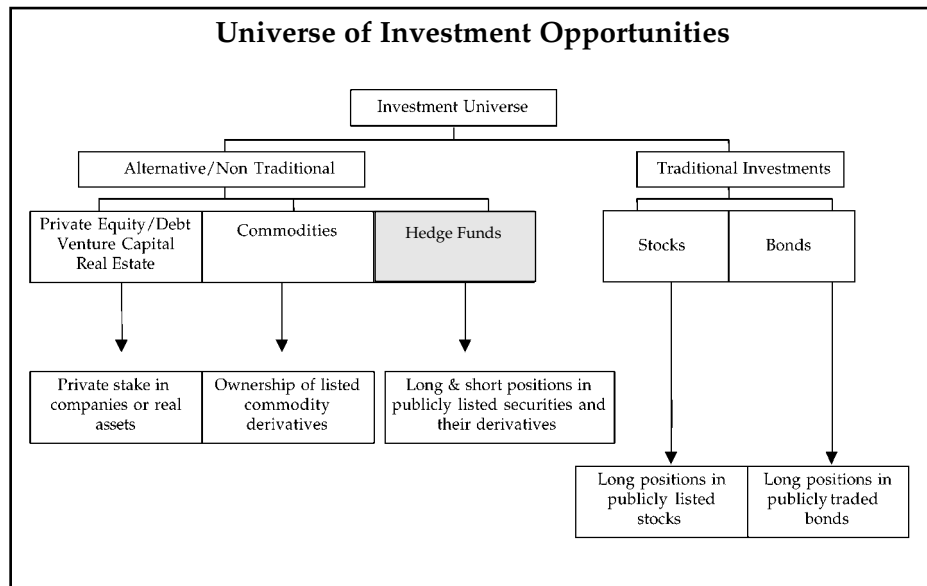
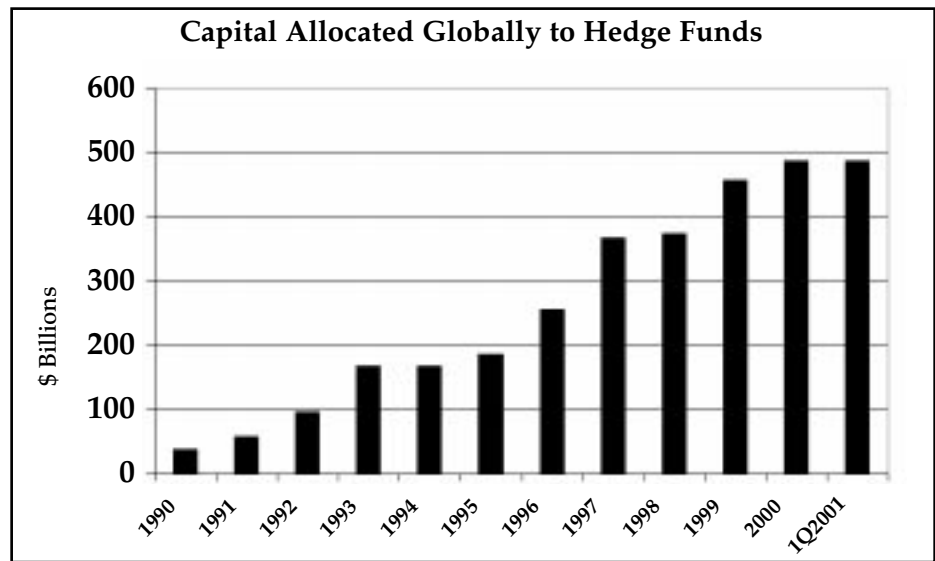


Figure 1

Hedge Fund Industry

As evidenced below in Chart 1, the flow of global capital to hedge funds has risen dramatically over the last decade. However, capital allocated to hedge funds from all sources still pales in comparison to the roughly \$3.8 trillion allocated to more traditional strategies by institutional investors alone.⁴



Source: Hedge Fund Research

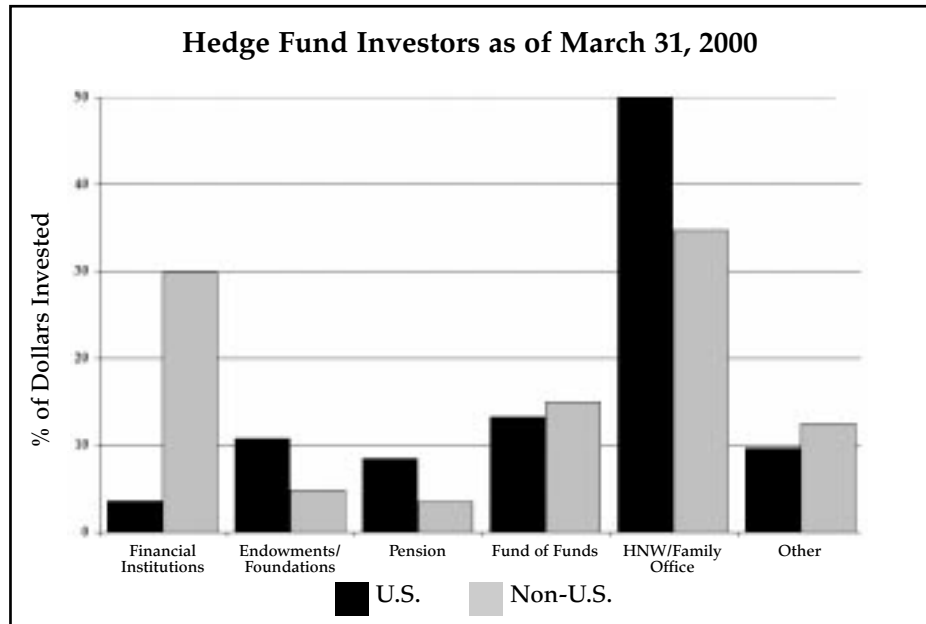
Chart 1

It is estimated that the assets managed by hedge funds will increase from approximately \$500 billion today to \$1.7 trillion in 2005 and that at least half of this \$1.7 trillion will come from institutional investors.⁵

⁴ *P&I 1000*, Pensions & Investments, January 22, 2001.

⁵ *Hedge Funds: An Industry Overview*, Esra Zask, *The Journal of Alternative Investments*, Winter 2000.

Who are the Investors?



Source: Hedge Fund Research

Chart 2

In the past, hedge fund investors have primarily been high net worth individuals. Today, institutional assets account for only 19% of the total source of hedge fund assets.⁶

While institutional capital invested in hedge funds is still relatively low, institutional investors are showing greater interest in these strategies. In September 1999, CalPERS (\$174 billion in assets) raised the ceiling on alternative investments to \$11.0 billion, 6% of total plan assets. Subsequently, CalPERS reportedly has decided to allocate as much as \$5 billion specifically to hedge funds.

Alternative investments have primarily been focused on private equity and real estate with institutional investors hesitant to invest in hedge funds. There are a number of possible explanations for this resistance:

1. **Lack of Transparency:** Hedge funds, inherently private investment vehicles, have not met traditional institutional levels of transparency and accountability. In recent years, institutional investors and funds of hedge funds have exerted enormous pressure on hedge funds to provide greater transparency.

⁶ Hedge Fund Research, Inc. (HFR).

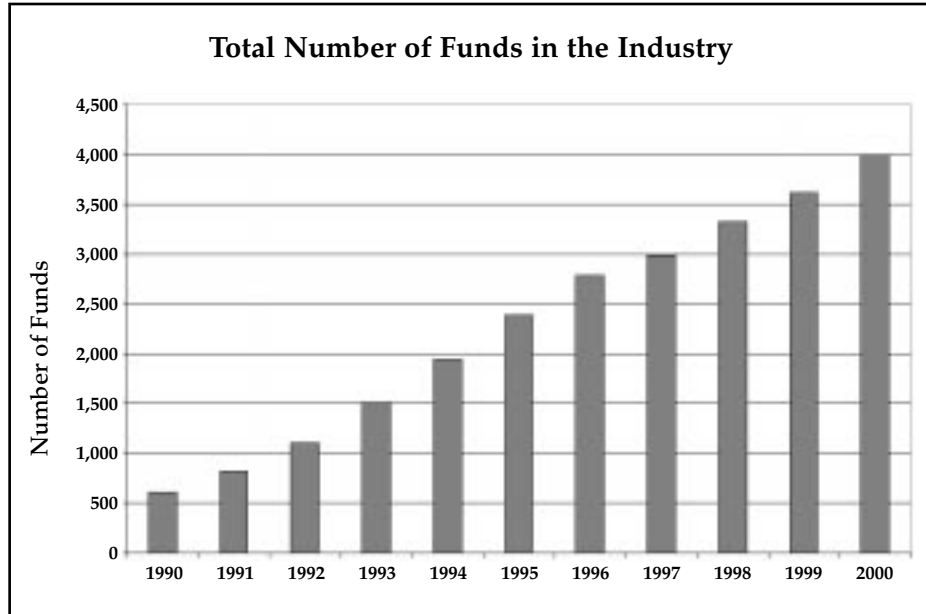
The reason is simple: fiduciaries find it difficult to justify investing in a fund with unknown risks and exposures. Hedge fund managers must further develop investment processes and infrastructure in order to meet these institutional requirements. As knowledge increases, institutional investors may be more willing to accept “risk transparency”; i.e. sufficient information to measure risks, rather than total transparency of holdings. For their part, hedge funds may be more willing to accommodate higher levels of transparency in order to attract institutional assets.⁷

2. **Insufficient Diversification:** Another consideration has been skepticism regarding the ability to achieve “true” diversification through uncorrelated hedge funds. Cliff Asness points out in “Do Hedge Funds Hedge?” that many hedge funds underestimate their relationship to traditional markets. By examining hedge funds’ implicit exposure to the market as a function of multiple time periods, Asness’ paper finds a more significant relationship than one would initially conclude.⁸
3. **Headline Risk:** Another meaningful issue is career risk. Although a portfolio of hedge funds may in aggregate benefit an investor, a rogue fund can sometimes conspicuously impair overall performance and generate very adverse publicity. Well-known examples of hedge fund implosions include the Manhattan Fund and Long Term Capital Management.
4. **Fees:** The higher fees charged by hedge fund managers have been an additional deterrent to institutional investors. Similar to private equity partnerships, hedge funds tend to charge 1% of assets plus 20% of profits. This fee structure is referred to as a “1 and 20” arrangement.
5. **Liquidity:** Finally, hedge funds are relatively illiquid investments with “lockup” and “liquidity” provisions. Most hedge funds specify a lockup period ranging from 6 months to 5 years. An investment cannot be redeemed during this initial period. After this initial lockup period, the fund becomes subject to standard liquidity provisions. For example, a fund may offer quarterly liquidity with 45 days notice or in some cases funds may only offer year-end liquidity.

⁷ *Come Together*, Charles Ruffel, Global Custodian, Spring 2001.

⁸ *Do Hedge Funds Hedge?*, Cliff Asness, Robert Krail, John Liew, Unpublished Draft, March 2001.

Notwithstanding these issues, the demand for hedge fund product has soared. As a result, an astounding number of hedge funds have been created to meet this demand. The chart below illustrates the growth in the number of hedge funds globally:



Source: Hedge Fund Research

Chart 3

Beyond investor demand, there are other factors driving the growth of hedge fund firms:

1. With few SEC regulatory requirements and low start-up costs, the barriers to entry are trivial.
2. Investment professionals are attracted by the compensation structure common to hedge funds. As noted earlier, a typical fee arrangement for hedge funds is 1% of the capital committed plus 20% of the gross profits. Assuming a 5% net trading profit for hedge funds, the total fee would equal 200 basis points (1% + 20% of 5%) per annum. This would amount to more than five times the fees for most traditional active equity products.
3. Investment professionals are attracted by the freedom to manage assets without constraints imposed by client benchmarks and guidelines. This freedom combined with the financial rewards is attracting professionals from Wall Street and traditional money management firms.

Types of Hedge Fund Strategies

Table 1 illustrates the breakdown of hedge fund assets by investment strategy:

Allocation of Hedge Fund Assets By Strategy	
Strategy	% of Assets as of March 31, 2001
Convertible Arbitrage	4%
Distressed Securities	3%
Emerging Markets	3%
Equity Hedge (Long/Short)	31%
Equity Market Neutral	5%
Equity Non-Hedge	11%
Event Driven	9%
Fixed Income Arbitrage	8%
Macro Funds	15%
Merger Arbitrage	2%
Relative Value Arbitrage	3%
Sector Funds	5%
Statistical Arbitrage	1%

Source: Hedge Fund Research

Table 1

Up to this point, we have used the term hedge fund to broadly characterize a wide range of investment strategies. As Table 1 suggests, there is quite an array of categories within the hedge fund universe. While they are all primarily focused on preserving capital and producing consistent positive returns, there are significant differences in how the various strategies try to achieve this. It is critical to understand the basis of the underlying strategies and their differences in order to develop a coherent plan to exploit the opportunity hedge funds offer investors to diversify their portfolio and enhance returns. For example, long-biased equity and fixed income strategies are impacted by the same market risk factors as traditional stock and bond managers. Therefore, these strategies might be considered alternative forms of active management within broader equity and fixed income portfolios. Other strategies, such as equity market neutral and fixed income arbitrage, are designed to remove exposure to underlying stock and bond markets and might be considered diversifiers to a traditional portfolio. Other hedge fund strategies attempt to exploit changes in market risk or market direction, and, therefore, may do well during periods of market volatility. In short, analyzing the appropriateness of a hedge fund should incorporate an understanding of the sources of return for that strategy and recognizing the risk exposures underlying each investment. Risk management of a hedge fund portfolio will be discussed in more detail in future installments of our hedge fund paper series.

For discussion and comparative purposes, we have divided hedge funds into three broad categories: Convergence, Divergence and Security Selection. The following is a discussion of selected hedge fund strategies.

Convergence Strategies

The general theme among these strategies is a bet that two securities or market prices will get closer (or converge) over time. Holdings focus on asset specific return while minimizing exposure to systematic factors or market movements.

Convertible Arbitrage

Seeks to profit from mispricing of the embedded option in a convertible bond. Frequently, this strategy is characterized by a long, convertible position and corresponding short position in the underlying stock. Convertible arbitrage may use low or high levels of leverage depending upon the specific securities held by the manager.

Equity (or Index) Arbitrage

Exploits mispricing of equity and equity derivative securities. For index arbitrage, the manager evaluates the pricing differences between the futures market and the cash or physical markets. Usually, this strategy is implemented through long positions in the stocks that underlie the index and short positions in the equity derivative security. Equity arbitrage strategies may use moderate to high amounts of leverage.

Mortgage Arbitrage

Seeks to profit from the pricing difference between a mortgage instrument with uncertain prepayment and credit quality characteristics and a non-prepayable Treasury security. Moderate to high amounts of leverage are used in these strategies.

Fixed Income Arbitrage

Attempts to capture mispricing within and across global fixed income markets and associated derivatives. Value may be added by exploiting tax loopholes, yield curve anomalies, volatility differences and arbitraging bond futures versus the underlying bonds (basis trading). Typically, a large amount of leverage is used to enhance returns.

Merger Arbitrage

Seeks to exploit the change in price of a firm's securities as a result of a takeover or merger. Typically, the manager will take long positions in the securities of the target firm and short positions in the securities of the acquiring firm.

Security Selection Strategies

These strategies attempt to exploit the misvaluation of specific securities. The investment processes used to establish these positions vary greatly.

Equity Long / Short

The manager will take long and short positions in equity securities. The resulting portfolio may be either long-biased or short-biased and, thus, the portfolio returns will not be completely independent of market movements. Value is added primarily through superior security selection. There is typically low leverage used in these strategies. In terms of assets and number of funds, equity long/short represents the largest hedge fund category.

Distressed Securities

Invests in the illiquid debt or equity of firms in or near bankruptcy to profit from potential recovery. Portfolios are generally unlevered.

Market Neutral

Uses balanced long and short positions in equity markets to insulate the portfolio from overall market risk. A truly market neutral portfolio will have beta neutrality (the long portfolio beta equal to the short portfolio beta) and dollar neutrality with more risk-controlled funds incorporating additional risk controls on other factors (e.g., sectors, style).

Divergence Strategies

These strategies are generally defined by bets on prices of markets or securities moving apart. Global macro strategies, including those implemented by well-known hedge fund managers George Soros and Julian Robertson, and managed futures are examples.

Global Macro

These strategies seek to profit from changes in global financial markets and take positions to exploit changes in interest rates, exchange rates, liquidity and other macroeconomic factors. Strategies typically use moderate amounts of leverage.

Managed Futures/Commodity Trading Advisors

There are two broad types of Commodity Trading Advisors (CTAs): 1) Systematic, who invest in trend-following strategies using technical analysis tools. These portfolios tend to have negative beta exposure resulting in positive performance in equity market downturns and 2) Discretionary, who follow a judgmental approach to making trading decisions. These strategies are more directional than the systematic CTAs. Both types of CTAs tend to use moderate amounts of leverage.

Fund of Funds

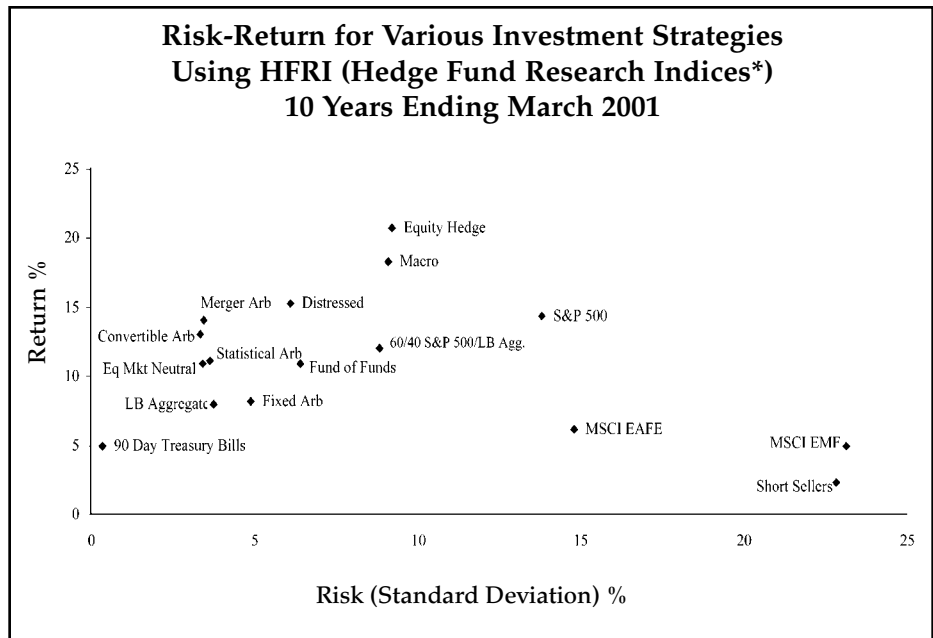
Fund of funds provide a diversified exposure to multiple hedge fund strategies or to managers within a given strategy. A fund of funds may overweight or underweight certain strategies or managers based on a macroeconomic outlook or quantitative optimization techniques. A typical fund of funds would provide exposure to 8 to 10 different investment strategies and 30 to 50 managers. Fund of funds managers usually charge a management fee and a performance-based fee in addition to the underlying manager fees. This usually results in the “fee netting” issue. An investor in a hedge fund of funds may end up paying incentive fees even though the overall portfolio has posted no return. For example, consider a fund of two hedge funds. Assume that both hedge funds charge an incentive fee and the investor has equally allocated to the two funds. If one fund is up 10% while other is down 10%, the investor must pay the incentive fee associated with the fund that is up 10%, even though their total investment has not earned a profit.

Multi-Strategy

Multi-Strategy funds are similar to funds of funds except that all assets are managed within the same organization. Liquidity or lockup issues that are present in individual hedge fund partnerships may be avoided when the multi-strategy manager changes the weights on individual hedge fund strategies.

Hedge Fund Performance

How will hedge funds perform versus traditional investments? What can history tell us? While we cannot predict future performance, we gain valuable insight from historical data about past hedge fund performance relative to traditional investments. First, have hedge funds provided high risk-adjusted absolute returns after fees are paid? Second, how risky have hedge funds been in the past? In order to investigate these two points we have analyzed Hedge Fund Research (HFR) data on approximately 1400 levered and unlevered hedge funds. Resulting risk and return characteristics for specific strategies and traditional investments over a 10-year period are illustrated in Tables 2 and 3.



* The HFRI is an equally weighted performance summary of about 1400 hedge funds, comprising over \$260 billion in assets under management, categorized by strategy.

Table 2

INVESTMENT CHARACTERISTICS

10 YEARS ENDING MARCH 2001

	RETURN	RISK*	SHARPE RATIO
HFRI Merger Arbitrage	14.0%	3.5%	2.46
HFRI Convertible Arbitrage	13.0	3.3	2.28
HFRI Equity Market Neutral	10.9	3.4	1.66
HFRI Statistical Arbitrage	11.1	3.7	1.59
HFRI Equity Hedge	20.7	9.2	1.58
HFRI Distressed Securities	15.3	6.1	1.57
HFRI Macro	18.3	9.1	1.38
HFRI Fund of Funds	10.9	6.4	0.89
HFRI Fixed Income Arbitrage	8.2	4.9	0.64
HFRI Short Selling	2.3	22.8	0.00
S&P 500	14.4	13.7	0.70
MSCI EAFE	6.2	14.7	0.15
MSCI Emerging Markets Free	4.9	23.1	0.12
LB Aggregate	8.0	3.7	0.80
90 Day Treasury Bills	5.0	0.3	0.00

*As measured by standard deviation

CORRELATION MATRIX — 10 YEARS ENDING MARCH 2001

	Fixed Arb	Conv. Arb	Stat Arb	Merger Arb	Distressed	Macro	Eq. Market Neutral	Eq. Hedge	Short Selling	Fund of Funds	S&P 500	MSCI EAFE	MSCI EMF	LB Agg	90 Day T-Bill
HFRI Fixed Income Arbitrage Index	1.000														
HFRI Convertible Arbitrage Index	0.167	1.000													
HFRI Statistical Arbitrage Index	0.015	0.172	1.000												
HFRI Merger Arbitrage Index	-0.018	0.430	0.251	1.000											
HFRI Distressed Securities Index	0.406	0.626	0.250	0.519	1.000										
HFRI Macro Index	0.129	0.406	0.211	0.200	0.431	1.000									
HFRI Equity Market Neutral Index	0.048	0.224	0.634	0.268	0.188	0.266	1.000								
HFRI Equity Hedge Index	0.041	0.469	0.207	0.421	0.578	0.564	0.349	1.000							
HFRI Short Selling Index	-0.015	-0.368	-0.165	-0.329	-0.502	-0.399	-0.192	-0.859	1.000						
HFRI Fund of Funds Index	0.272	0.546	0.212	0.432	0.652	0.762	0.292	0.792	-0.604	1.000					
S&P 500	-0.099	0.312	0.479	0.365	0.361	0.389	0.200	0.641	-0.648	0.509	1.000				
MSCI EAFE	0.014	0.244	0.236	0.270	0.385	0.399	0.179	0.560	-0.519	0.490	0.615	1.000			
MSCI Emerging Markets Free	0.179	0.404	0.099	0.468	0.573	0.501	-0.013	0.620	-0.577	0.687	0.613	0.542	1.000		
LB Aggregate Index	-0.250	0.210	0.388	0.033	0.024	0.364	0.244	0.124	-0.079	0.134	0.307	0.144	-0.025	1.000	
90 Day Treasury Bills	-0.242	0.152	0.106	0.101	-0.146	-0.041	0.162	0.015	0.053	-0.072	0.074	-0.080	-0.153	0.344	1.000

Table 3

As the historical data indicate, hedge funds have not all been high risk, high return strategies. In fact, the strategies span a relatively wide risk spectrum. Understanding their unique characteristics is important when evaluating allocations within traditional portfolios.

Caveats

To better interpret our findings, some caveats should be stated. Few databases are perfect and hedge fund databases are no exception. Biases, in addition to the survivorship bias imposed by our analysis, may exist. For example, self-reported manager data often is not verified by outside auditors. Some managers may opt out of the database for performance reasons or to preserve an exclusive reputation. When poor performers do not report, the historical average return of those managers that do report rises overall. This results in over-estimation of historical returns. Also, fund leverage is not considered when making return comparisons.

We found that monthly return distributions in each strategy display non-normality. This effect is most pronounced for the relative value style because it encompasses both fixed income and equity strategies. The Goldman Sachs report “Hedge Funds Revisited”⁹ suggests that standard deviation continues to be a meaningful measure for hedge funds, despite the fact that many of the return distributions tend to be skewed. Some funds of funds use other measures such as downside deviation, skewness and kurtosis to gauge the non-normality of strategy return distributions. However, these measures are not commonly used for traditional asset classes, so it is difficult to get an intuitive feel for the statistics. Kahn and Stefek¹⁰ studied the use of downside deviation as a risk measure and found that, unlike standard deviation, downside deviation cannot be forecasted. A recent paper from Harry Kat and Gaurav Amin of the University of Reading attempts to circumvent the non-normality of hedge fund returns.¹¹ The authors do so using a continuous time version of Dybvig’s¹² payoff distribution pricing model. In essence, the approach uses the futures market to try to achieve the same returns as a hedge fund, at a lower cost. The paper’s main conclusion is that hedge funds do seem to add value to a broader portfolio.

Finally, a large part of the performance analysis represents a bull market period. Hedge funds with a long bias do benefit in a rising equity market. In this environment, the performance characteristics of those funds will be upwardly biased. We recognize that a full market cycle would better represent strategy returns. Unfortunately, the hedge fund universe becomes very small for longer periods of analysis.

⁹ Goldman Sachs & Co. and Financial Risk Management Ltd., Pension & Endowment Forum: *Hedge Funds Revisited*, January 2000.

¹⁰ BARRA: *Heat, Light and Downside Risk*, Ronald Kahn, Pebble Beach Seminar, July 15-18, 1997.

¹¹ *Hedge Fund Performance 1990-2000, Do the ‘Money Machines’ Really Add Value?*, Gaurav S. Amin and Harry M. Kat, University of Reading. www.ismacentre.rdg.ac.uk

¹² *Distributional Analysis of Portfolio Choice*, Journal of Business, Vol.61, pp. 369-393. 1988.

Conclusions

Hedge funds provide new avenues for improving portfolio performance in today's low equity return environment. While traditional investments derive the majority of investment return from the capital markets, many hedge fund strategies are less affected by the direction of underlying capital markets. Given their generally low correlations to traditional investments and the intent to "hedge" market risk, hedge fund strategies are worth evaluating along side traditional investments.

In considering an allocation to hedge fund strategies, we believe that it is imperative to understand the interaction or relationship between specific hedge fund strategies and the balance of the investment portfolio. The impact of hedge funds depends on the choice of specific strategies and the composition of the overall investment portfolio. Particular consideration should also be given to the selection of hedge fund managers as the process of, and criteria for, manager selection may be different than for traditional asset managers. Finally, monitoring of a hedge fund program is important to ensure fulfillment of the initial objectives and to assess any change in the manager's style or risk level. In future papers, we will discuss each of these issues in greater detail.

As investors become more comfortable with the potential risks and rewards associated with hedge funds, we expect hedge fund allocations to increase over time. In particular, the potential impact of institutional investors allocating to hedge funds is significant due to the large capital allocations they control. Institutional investors have the potential to transform the hedge fund industry with demands for higher levels of transparency, risk information and accountability in the investment process.

Appendix: Glossary of Hedge Fund Strategies

Cash/Futures Arbitrage

A strategy characterized by long (short) the stocks in an index together with a short (long) in the index futures contract. The position is held to maturity, usually 3 to 6 months.

Collateralized Loans

The strategy is to invest in securitized bank loans to earn a positive carry over the funding rate. Fees are earned for arranging loans and deal syndication as well.

Convertible Arbitrage

The strategy is to take positions in convertible bonds while hedging out certain market risks to profit from an appreciation in the value of a specific feature of the convertible. For example, the equity option can be isolated by taking a long position in the convertible and a short position in the underlying stock. The size of the short position in the stock is determined by the delta or price sensitivity of the convertible to changes in the underlying stock. In cases where the convertible bond has a high premium to conversion i.e., it is a more bond-like instrument, the deltas will be lower and the market risk will be driven largely by interest rates which can be hedged by shorting interest rate futures, bonds or swaps.

Discretionary Trading

Strategies characterized by speculation on the direction of currency, equity, commodity and bond markets. The fund manager may employ computer models but the portfolio decision is largely subjective.

Distressed Securities

The strategy involves investing in the illiquid debt or equity of firms in or near bankruptcy to profit from potential recovery. Portfolios are generally unlevered. Equity risk may be hedged by shorting the stock or using index derivatives.

Emerging Equity Long / Short

The strategy attempts to exploit informational inefficiencies in emerging markets. Portfolios will generally take long positions in the securities of firms operating in emerging markets. Shorts may not be available in many emerging markets so the manager may have to short ADR's or related securities.

Equity Arbitrage

Strategies that exploit mispricings of equity and equity derivative securities.

Equity Long / Short (Equity Hedge)

Strategies that take long and short positions in equity markets. Managers are either long-biased or short-biased. Value is added primarily through superior security selection.

Equity Options Arbitrage

The strategy exploits mispricing of equity derivatives. Combinations of longs and shorts are used to create synthetic payoffs.

Event Driven

These strategies are designed to exploit a specific capital markets transaction. The strategy is successful if a specific event occurs within an expected time frame.

Fixed Income Arbitrage

These strategies attempt to capture mispricing within and across global fixed income markets and associated derivatives. Leverage is used to enhance returns. Value may be added by exploiting tax loopholes, yield curve anomalies, volatility differences and arbitraging bond futures versus the underlying bonds (basis trading).

Fixed Income Long / Short

These strategies attempt to hedge out interest rate risk on government and corporate debt investments by using shorts, futures and swaps, and by moving between principal gain and yield investments.

Global Macro (Global Opportunistic)

These are strategies that employ a top-down macroeconomic approach to opportunistic investing globally. Managers will attempt to exploit changes in interest rates, exchange rates and liquidity for different instruments.

Long / Short

This is a broad category of strategies characterized by long positions in securities expected to appreciate in value together with short positions in securities expected to depreciate in value.

Market Timers

Fund managers that vary their long/short exposure in response to market factors within a short period of time.

MBS Arbitrage

Strategies designed to exploit pricing inefficiencies in the U.S. mortgage-backed securities market. Managers that pursue these strategies typically use moderate to high amounts of leverage.

Merger Arbitrage (Risk Arbitrage)

These strategies seek to exploit the change in price of a firm's securities as a result of a takeover or merger. In many cases, the manager will go long the securities of the firm being acquired while shorting the securities of the acquiring firm.

Regional Funds

Strategies designed to tactically exploit opportunities in specific geographical regions.

Regulation D Arbitrage (Private Placement Arbitrage)

Strategies that attempt to profit from appreciation in the value of short-term investments in firms that need to raise capital quickly. These short-term investments are governed by U.S. Regulation D which applies to the private offerendum of the securities.

Relative Value (Market Neutral, Statistical Arbitrage)

These are strategies that attempt to isolate return specific to assets while hedging out systematic factors driving return for the assets.

Sector Funds

Sector funds invest in specific industries or segments of the economy. They tend to be equity long /short managers that develop a view of the industry and use fundamental analysis to identify opportunities within that industry.

Short Sellers

Funds that attempt to add value by taking short positions in assets that are expected to depreciate in value.

Special Situations

These are event driven strategies where the event is a spin-off or a corporate reorganization that will affect the price of the firm's securities.

Systematic Trading

These strategies take a directional view in markets based on computer models. The strategies reflect an emphasis on market trends and behavioral psychology.

Tactical Trading

Strategies that reflect a focus on systematic factors (i.e. interest rates, inflation, etc.) driving returns.