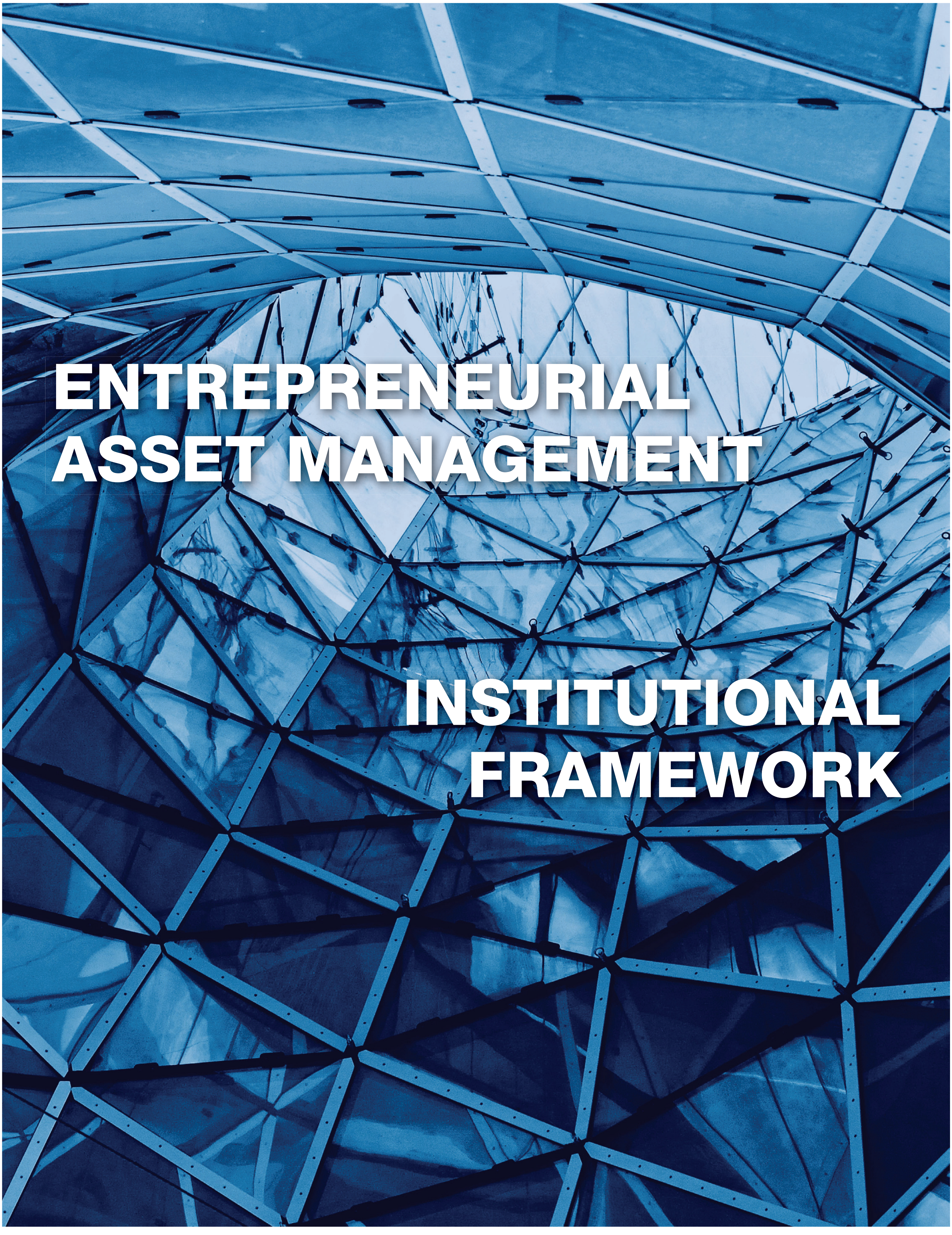

ENTREPRENEURIAL ASSET MANAGEMENT

INSTITUTIONAL FRAMEWORK

AN INTRODUCTION TO HEDGE FUNDS

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AN INTRODUCTION TO HEDGE FUNDS

HISTORY AND DEFINITION

The first hedge fund was developed in the US in 1949 by doctor of sociology, Alfred Winslow Jones. His pioneering insight came from his appreciation of the complementary nature of leverage (investing borrowed money) and short selling (borrowing stock to trade). Both of these concepts were used widely in isolation, often for speculative purposes. However, Jones discovered that they could be effectively combined to produce a conservative investment portfolio. This strategy is known today as 'equity long/short'.

Jones stepped down from fund management in the early 1980s. His track record demonstrated that he lost money in only three years out of 34, while the S&P 500 index recorded nine years of negative returns during the same period. Significantly, Jones' fund substantially outperformed the market during the boom years of the early 1960s and also provided resilience during the sharp downturn of 1973-74.

Jones' dramatic outperformance of mutual funds in the early-to-mid 1960s sparked a wave of interest and by 1968, there were 200 hedge funds in operation in the US. However, it was not until the early 1990s that the industry began to grow in earnest. The real boom period for hedge funds followed the bursting of the technology bubble and the ensuing bear market. Investors were impressed by the ability of hedge fund managers to preserve capital in such stark conditions and the number of hedge funds subsequently doubled between 2002 and 2007.

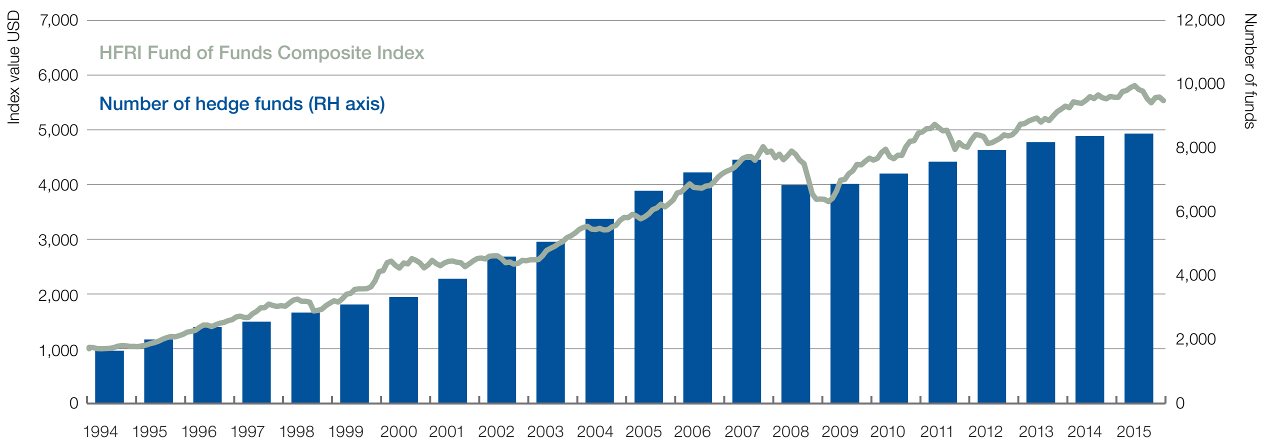
In recent years, the growth and contraction of the industry has been driven by hedge fund performance. Although 2008 was a poor year for hedge funds in terms of meeting absolute return objectives, the exceptionally difficult trading conditions acted as a form of quality control with many low-calibre hedge funds folding.

The term 'hedge fund' was initially used to describe a private investment fund which followed Alfred Jones' original strategy of using leverage to enhance returns and short selling to limit risk. However, such a narrow definition is no longer appropriate due to the evolutionary nature of the industry. Trading techniques are constantly being redefined and enhanced and the number of sub-strategies is steadily expanding.

DISTINCT CHARACTERISTICS OF HEDGE FUNDS

- Key performance driver is manager skill rather than market returns
- Target consistent returns in the long term rather than outperformance of a benchmark index
- Managers are unrestricted in their choice of investment strategies
- The ability to invest in any asset class or instrument

GROWTH OF THE HEDGE FUND INDUSTRY[1]



1. Source: Bloomberg and 'HFR Global Hedge Fund Industry Report', Q4, 2015. Hedge Fund Research, Inc. There is no guarantee of trading performance and past performance is not necessarily a guide to future results. Please note that the HFRI Index data over the last four months may be subject to change. Date range: 1 January 1994 to 31 December 2015.

HEDGE FUND STYLES

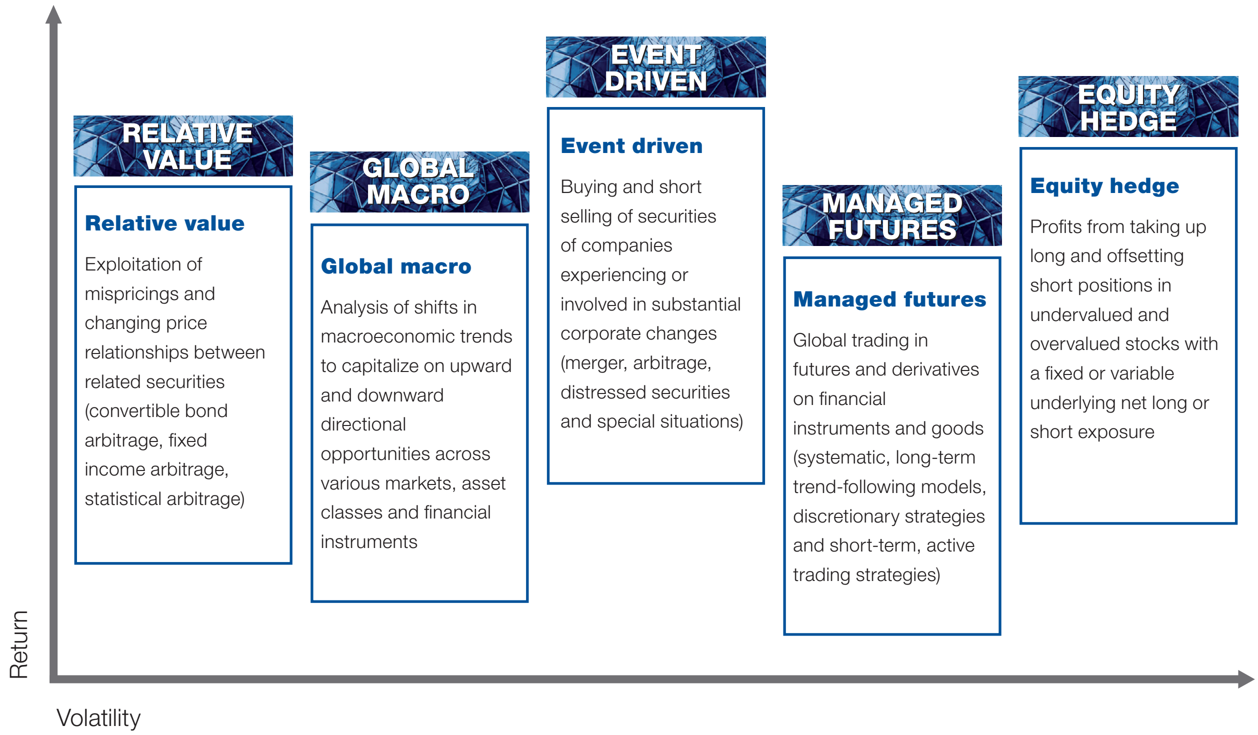
The equity hedged style incorporates equity long/short which, as discussed, is the founding strategy of the hedge fund industry. Equity hedged also constitutes the largest segment of the industry, accounting for approximately 30% of total assets. Similar to equity hedged, both the relative value and event driven styles are concerned with the appraisal of underlying asset values. However, global macro and managed futures disciplines are based on the observation of market trends and are therefore more tactical than fundamental in their orientation.

Arbitrage can be an important component of both the event driven and equity long/short investment philosophies, but it is the foundation of relative value strategies, as the name implies. Arbitrage is a term used to describe the exploitation of anomalies stemming from the mispricing of related assets and the potential convergence of prices. Relative value managers are able to exploit such opportunities by taking a short position in the overvalued asset and a long position in the undervalued asset. Profits are generated if the prices of the two assets converge, regardless of the overall direction of the market.

Event driven managers identify specific events with the capacity to trigger significant changes in the price of securities and seek to exploit the resulting investment opportunity. Consequently, these strategies are focused on corporate actions, such as bankruptcies, mergers or takeovers.

Global macro and managed futures disciplines are based on the development of views on economic and market themes. They use highly liquid financial instruments such as futures contracts to implement a strategy to reflect these observations. The major difference between the two styles is that global macro is a more discretionary discipline which tends to produce portfolios that are quite concentrated. Conversely, managed futures is almost completely systematic and typically takes a much larger number of small positions.

Hedge fund managers employ a diverse and constantly evolving range of trading strategies to generate returns. These can be grouped into five broad investment styles as illustrated below.[2]



2. Schematic illustration adapted from Bloomberg data covering period 1 January 1994 to 31 Dec 2015.

THE MYTHS AND FACTS ABOUT HEDGE FUNDS

Traditional asset managers typically allocate capital to equities, bonds and cash on a 'long-only' basis. Although they employ skill-based security selection, they manage their portfolios against a passive benchmark (usually a familiar and established index which is representative of the markets and assets they invest in). Consequently, their scope is limited to outperforming a benchmark index by an amount sufficient to justify their management fees. If they diverge too far from the index the relative risk carried will be considered unacceptably high. This makes it virtually impossible for traditional managers to produce positive returns when markets are declining.

In a financial context, the term 'hedge' can be defined as 'guarding against risk of loss'. As such, any inference that hedge funds (in general) are riskier than traditional investment strategies is misguided, especially considering that the long-only approach fails to make any provision against the fundamental risk of market downturns.

The underlying philosophy of the hedge fund industry is that, the skill of the manager ('alpha'), rather than the performance of a market or asset class ('beta'), should principally determine the success of the strategy. This key difference is also reflected in the remuneration of managers and the freedom that they are given to invest in a much broader range of financial instruments and assets.

Traditional investment funds typically levy a flat fee for active management regardless of the level of performance delivered. Conversely, hedge fund manager remuneration comes in part from performance fees which can only be charged when positive investment returns are generated. This fee structure enhances the alignment between the interests of fund managers and their investors. Additionally, many hedge fund managers invest their own capital in their funds, meaning that their interests are further aligned with those of their investors.

Hedge fund misconceptions	Reality
They are unregulated	Established providers are regulated at the manager level
They are very risky	Can potentially provide enhanced diversification/downside limitation
They are highly leveraged	Leverage is typically low; many banks use significantly more leverage
They charge excessive fees	Performance fees only levied when 'earned'
They have long 'lock-up' periods	Range of liquidity profiles available according to strategy
They lack transparency	Disclosure is improving but data interpretation is complex

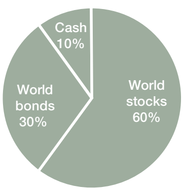
Consequently, hedge funds can provide investors with a number of advantages relative to traditional funds.

Traditional investments	Hedge funds
Restricted opportunity set	Can exploit wide range of price distortions
Mainly dependent on beta	Focused on alpha generation
Relative return objectives	Target consistent performance
Flat fee structure	Alignment of manager/investor interests
Limited diversification sources	Large number of strategies
Inefficient dispersion of risk	Enhanced risk/reward trade-off

Hedge funds are normally used in a portfolio context rather than being considered as stand-alone investments. As the performance of hedge funds is not closely correlated with traditional asset classes – especially in declining markets when correlations tend to be low – they can offer a valuable source of diversification for most investment portfolios.

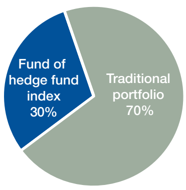
The illustration below demonstrates how a 30% allocation[3] to a fund of hedge funds can enhance the risk and return dynamics of a traditional investment portfolio comprising equities, bonds and cash.[4]

TRADITIONAL PORTFOLIO



Total return	288.4%
Annualised return	6.4%
Annualised volatility	8.3%
Worst drawdown	-31.5%
Sharpe ratio[5]	0.39

ENHANCED PORTFOLIO



Total return	334.6%	Improvement of	46.2%
Annualised return	6.9%	Improvement of	0.5%
Annualised volatility	7.6%	Lowered by	-0.7%
Worst drawdown	-28.6%	Improvement of	2.9%
Sharpe ratio[5]	0.50	Improvement of	0.11

3. 30% as an allocation amount is for illustrative purposes only. Investors should discuss with their investment advisor the appropriate allocation to various asset classes generally, and if suitable to the hedge funds as part of a diversified investment portfolio. **4.** Source: Bloomberg and MSCI. Date range: 1 January 1994 to 31 December 2015. There is no guarantee of trading performance and past or projected performance is not a reliable indicator of future performance. Please note that the HFRI Index data over the last four months may be subject to change. Hedge fund index: Hedge funds: HFRI Fund Weighted Composite Index. World stocks: MSCI World Net Total Return Index hedged to USD. World bonds: Citigroup World Government Bond Index hedged to USD (total return). Cash: 3 month USD LIBOR rate. **5.** Sharpe ratio is a measure of risk-adjusted performance that indicates the level of excess return per unit of risk. It is calculated using using the risk-free rate in the appropriate currency over the period analysed. Because the Sharpe ratio is an absolute measure of risk-adjusted return, negative Sharpe ratios are shown as n/a as they can be misleading.

MULTI-STRATEGY AND FUNDS OF HEDGE FUNDS

The significance of there being five major hedge fund styles is that each has different drivers of performance and therefore different return dynamics. This leads to comparatively low correlation coefficients between different styles and traditional assets (as illustrated below) and means that portfolios composed of various hedge fund strategies can constitute an attractive investment proposition. For example, although global macro and managed futures have similar investment styles, as discussed previously, the table demonstrates that the correlation between their returns is only 0.54. This effectively means that only half of their performance can be attributed to their similarities.

A low correlation coefficient between two elements of an investment portfolio is highly desirable as it implies that one component is an excellent diversifier for the other. Blending the two components together in one portfolio can provide an enhanced risk-adjusted return than either could provide as stand-alone investments. Notably, the correlation between managed futures and world stocks is slightly negative which signifies that an allocation to managed futures could help counteract the negative performance of world stocks in a bear market, rather than merely cushion the impact. This was the case in 2008 when managed futures delivered positive returns while capital markets collapsed.

CORRELATION MATRIX[6]

	World stocks	World bonds	Equity hedge	Event driven	Global macro	Managed futures	Relative value
Relative value	0.63	-0.12	0.73	0.82	0.32	-0.09	1.00
Managed futures	-0.11	0.35	-0.02	-0.04	0.55	1.00	
Global macro	0.37	0.25	0.54	0.50	1.00		
Event driven	0.76	-0.18	0.88	1.00			
Equity hedge	0.79	-0.16	1.00				
World bonds	-0.17	1.00					
World stocks	1.00						

1.0 = perfect correlation
0 = no correlation
-1.0 = perfect inverse correlation

Two vehicles are used in the hedge fund industry to provide investors with a diversified portfolio of different hedge fund strategies; multi-strategy hedge funds and funds of hedge funds. Both allocate capital to a number of different hedge fund strategies, either by utilising the capabilities of in-house investment teams or by selecting third party managers. In either case, the objective is to create a diversified portfolio that delivers more consistent investment returns than stand-alone hedge funds. Both approaches have their advantages, with a multi-strategy portfolio potentially reducing fee layers as well as increasing information transparency, while fund of hedge funds have the ability to access the skills of talented investment professionals across the entire industry, providing even better scope for diversification. Whether or not either is suitable is dependent on multiple factors such as desired risk/return profile, liquidity, level of transparency and size of the investment.

6. Source: Bloomberg, MSCI and Barclays BTOP 50 Index. There is no guarantee of trading performance and past or projected performance is not a reliable indicator of future performance. Please note that the HFRI Index data over the last four months may be subject to change. Please note that the Barclay BTOP 50 Index data over the last twelve months may be subject to change. World stocks: MSCI World Net Total Return Index hedged to USD. World bonds: Citigroup World Government Bond Index hedged to USD (total return). Equity hedge: HFRI Equity Hedge (Total) Index. Event driven: HFRI Event Driven (Total) Index. Global macro: HFRI Macro (Total) Index. Managed futures: Barclays BTOP 50 Index. Relative value: HFRI Relative Value (Total) Index. Date range: 1 January 1994 to 31 December 2015.

GLOSSARY OF TERMS

Alpha	The component of investment return that can be attributed to the skill of the fund manager(s).
Beta	The component of investment return provided by (positive or negative) market movements (alpha +/- beta = total return).
Correlation	A measure of the interdependence or strength of the relationship between two investments. A correlation of 1 means that the two investments are perfectly synchronised, while a correlation of -1 implies that they move in symmetrically opposite directions.
Derivative	A financial instrument that offers synthetic access to the properties of an underlying asset, typically a commodity, bond, equity or currency. Examples of derivatives include futures and options. Derivatives can be used to manage the risk associated with the underlying security, to protect against fluctuations in value, or to profit from periods of inactivity or decline.
Drawdown	A term used to describe the extent of a decline in asset value from peak to trough in any given cycle. The worst or maximum drawdown constitutes the greatest peak to trough fall since inception of the fund. In this context, the worst drawdown for any comparison index relates to the period being analysed rather than the full history of the index.
Leverage	A term used to describe the degree to which an investor utilises borrowed money or speculative derivative positions to enhance investment returns.
Liquidity	A relative term describing the speed at which an asset or assets can be converted into cash (liquidated) and vice versa.
Lock-up period	Indicates how liquid a hedge fund is through the specification of a notice period which investors must provide prior to making a withdrawal. This is typically 30 days although certain hedge fund styles such as event driven and relative value may be less liquid to enable the manager to avoid having to sell assets cheaply to fund redemptions.
Risk-adjusted performance	Describes the investment return achieved for each unit of risk absorbed, typically measured using the Sharpe ratio.
Sharpe ratio	The original measure of risk-adjusted performance. It is calculated by dividing the sum of the return on an investment less a risk-free (cash) rate by the annualised volatility of the investment. If one investment is similar to another in composition but has a higher Sharpe ratio, it can be considered to offer greater efficiency.
Short selling	A trading technique whereby an investment manager arranges to borrow stock from a stock lender with a view to selling it and buying it back at a lower price in the future.
Transparency	A term that relates to the level of disclosure that a hedge fund manager is willing to provide. Hedge funds have traditionally been seen as opaque but levels of transparency have improved in the aftermath of 2008. Fund of hedge fund managers are usually able to negotiate enhanced transparency terms in return for a guarantee of confidentiality, which enables them to provide superior risk management.
Volatility	A measure of the relative rate at which the price of an investment moves up and down. Volatility is found by calculating the annualised standard deviation of daily change in price. If the price changes rapidly over short time periods, it has high volatility and is therefore riskier than investments with lower volatility. (Please note that volatility is an absolute measure of the total range of prices and does not convey any information about price direction).

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