

What Is A Hedge Fund?

A hedge fund is a fund that can take both long and short positions, use arbitrage, buy and sell undervalued securities, trade options or bonds, and invest in almost any opportunity in any market where it foresees impressive gains at reduced risk.

Hedge fund strategies vary enormously -- many hedges against downturns in the markets -- especially important today with volatility and anticipation of corrections in overheated stock markets.

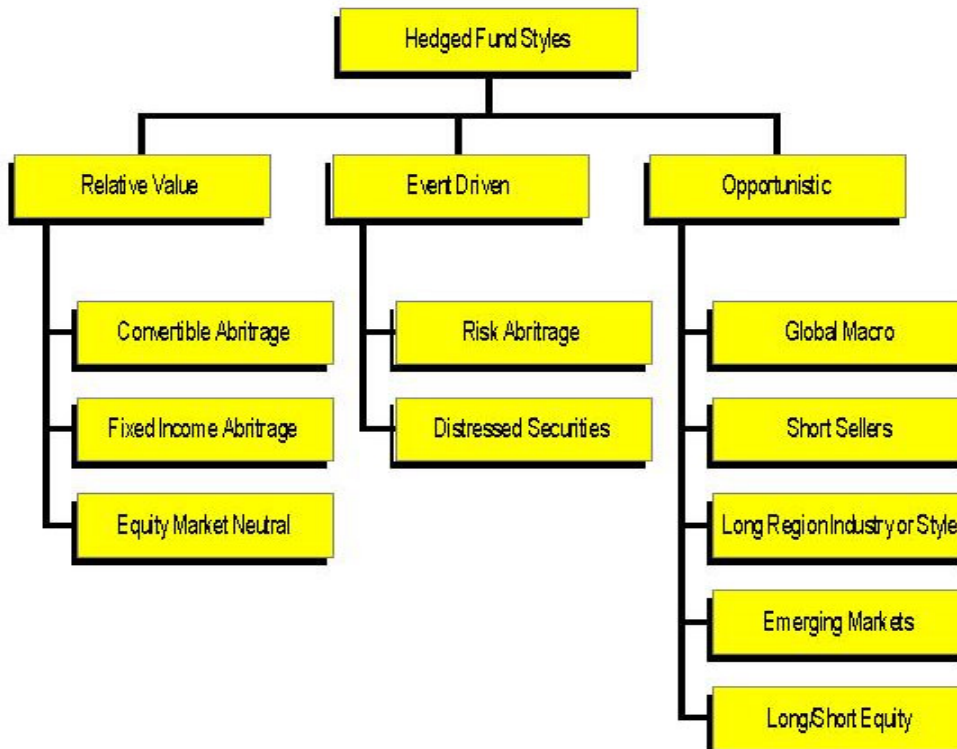
The primary aim of most hedge funds is to reduce volatility and risk while attempting to preserve capital and deliver positive returns under all market conditions.

Understanding Hedge Funds

Not all hedge funds are the same - there are different hedged fund strategies, investment returns, volatility, and risk vary enormously. Some strategies that are not correlated to equity markets are able to deliver consistent returns with extremely low risk of loss, while others may be as or more volatile than mutual funds.

A successful fund of funds recognizes these differences and blends various strategies and asset classes together to create more stable long-term investment returns than any of the individual funds

To understand more about hedge funds, it is crucial that one understand the different hedge fund strategies/styles that are usually employed. See Chart Below



Why An Investor Should Consider Investing In A Hedge Fund

- Many hedge funds are flexible in their investment options (can use short selling, leverage, derivatives such as puts, calls, options, futures, etc.).
- Hedge funds vary enormously in terms of investment returns, volatility and risk.
- Many, but not all, hedge fund strategies tend to hedge against downturns in the markets being traded.
- Experienced, disciplined & diligent investment professionals generally manage most hedge funds.
- Pension funds, endowments, insurance companies, private banks and high net worth individuals and families invest in hedge funds to minimize overall portfolio volatility and enhance returns.
- Most hedge fund managers are highly specialized and trade only within their area of expertise and competitive advantage.
- Hedge fund managers' remuneration is heavily weighted towards performance incentives, thus attracting the best brains in the investment business.
- Many hedge funds have as an objective consistency of returns and capital preservation rather than magnitude of returns.
- Hedge fund managers usually have their own money invested in their fund.
- Hedge funds utilize a variety of financial instruments to reduce risk, enhance returns and minimize the correlation with equity and bond markets. Many hedge funds have the ability to deliver non-market correlated returns.

See Data Below: From Jan 1994 to end Oct 2002

Performance	Global Macro	Long/Short	Fixed Income Arbitrage	Convertible Arbitrage	CSFB/Tremont Hedged Fund Index	MSCI World \$	S&P 500
1 Year	14.67%	-0.60%	4.89%	1.44%	2.61%	-14.50%	16.42%
2 Years	44.74%	-6.92%	14.53%	15.01%	6.43%	-36.08%	38.03%
3 Years	69.34%	16.90%	22.63%	47.74%	25.78%	-35.19%	-35.01%
5 Years	64.67%	65.29%	25.45%	60.63%	41.56%	-6.04%	-3.16%
5 ys Avg	10.49%	10.57%	4.64%	9.94%	7.20%	-1.24%	0.64%
Since Inception	221.13%	165.01%	77.49%	131.85%	143.23%	54.76%	89.89%
Incept Avg Ann1*	14.12%	11.66%	6.71%	9.99%	10.59%	5.07%	7.53%

Correlations

Correlations	Global Macro	S&P 500	MSCI World
Dow	0.21	0.9	0.89
MSCI World	0.19	0.94	1
MSCI EAFE	0.12	0.77	0.93
S&P 500	0.26	1	0.94
NASDAQ	0.19	0.8	0.78

Hedge Fund VS. Traditional Asset Management

Investment Structure - The investment structure of hedge funds gives great control and flexibility to the general partner of the hedge fund. Traditional equity management on the other hand gives the individual investor greater control and access to the portfolio information, regulatory protection and liquidity.

Capacity Constrains - Hedge Funds being largely unregulated gives the fund much flexibility to tap on opportunities but they have constraints as to the extent of their marketing efforts, communication to clients etc. Many hedge funds do close once a certain asset size has been achieved for returns to remain attractive to investors.

Transparency of Portfolio - Hedge funds offer very little transparency compared to traditional assets. Many hedge fund managers are reluctant to do so partially to keep their 'trade secrets' within themselves for the fear of competition. However, many hedge funds now do provide monthly performance statements with ratios like sharp ratios, beta & alpha etc.

Risk - Hedge funds are viewed as higher risk than traditional asset management due to leveraging & shorting. However, shorting can be viewed as a risk management tool during periods of market declines between 2000-2002

Are Hedged Funds Only Good During Bear Markets?

Hedged Funds are not necessarily only good only during bear markets, as statistics have shown that they can perform well during both good and bad times.

However, certain hedge fund strategies like short-bias can under perform during economic boom periods.

	Hedge Funds	Mutual Funds
Top 10	62.20%	51.50%
Top 10%	46.30%	27.20%
Top 25%	36.30%	20.30%
Bottom 25%	6.40%	5.60%
Bottom 10%	0.70%	4.00%
Bottom 20	-4.40%	-16.10%

Performance of Hedge Funds & Mutual Funds

Source: Van Money Manager Research. Based on a 5 year net compound returns Q195 to Q499

Understanding Hedge Fund Styles

1) Relative Value - Relative value portfolios are sometimes referred to as market-neutral strategies, primarily focused on liking specific positions in a 'hedged' fashion. Long & short positions are combined to seek returns independent of market movements and limit systematic risks. This strategy is more of an art rather than science.

a) Convertible Arbitrage - This strategy is identified by hedge investing in the convertible securities of a company. A typical investment is to be long the convertible bond and short the common stock of the same company. Positions are designed to generate profits from the fixed income security as well as the short sale of stock, while protecting principal from market moves.

b) Fixed income arbitrage - This strategy aims to profit from price anomalies between related interest rate securities. Most managers trade globally with a goal of generating steady returns with low volatility. This category includes interest rate swap arbitrage, US and non-US government bond arbitrage, forward yield curve arbitrage, and mortgage-backed securities arbitrage. The mortgage-backed market is primarily US-based, over-the-counter and particularly complex.

c) Equity Market Neutral - This investment strategy is designed to exploit equity market inefficiencies and usually involves being simultaneously long and short matched equity portfolios of the same size within a country. Market neutral portfolios are designed to be either beta or currency neutral, or both. Well-designed portfolios typically control for industry, sector, market capitalization, and other exposures. Leverage is often applied to enhance returns.

2) Event Driven - This strategy is defined as 'special situations' investing designed to capture price movement generated by a significant pending corporate event such as a merger, corporate restructuring, liquidation, bankruptcy or reorganization. There are three popular sub-categories in event-driven strategies: risk (merger) arbitrage, distressed/high yield securities, and Regulation D. The strategies tend to be long bias.

a) Risk (Merger) Arbitrage - Specialists invest simultaneously long and short in the companies involved in a merger or acquisition. Risk arbitrageurs are typically long the stock of the company being acquired and short the stock of the acquirer. By shorting the stock of the acquirer, the manager hedges out market risk, and isolates his exposure to the outcome of the announced deal. In cash deals, the manager needs only long the acquired company. The principal risk is deal risk, should the deal fail to close. Risk arbitrageurs also often invest in equity restructurings such as spin-offs or 'stub trades'.

b) Distressed/High Yield Securities - Fund managers in this non-traditional strategy invest in the debt, equity or trade claims of companies in financial distress or already in default. The securities of companies in distressed or defaulted situations typically trade at substantial discounts to par value due to difficulties in analyzing a proper value for such securities, lack of street coverage, or simply an inability on behalf of traditional investors to accurately value such claims or direct their legal interests during restructuring proceedings. Various strategies have been developed by which investors may take hedged or outright short positions in such claims, although this asset class is in general a long-only strategy.

c) Regulation D, or Reg. D - This sub-set refers to investments in micro and small capitalization public companies that are raising money in private capital markets. Investments usually take the form of a convertible security with an exercise price that floats or is subject to a look-back provision that insulates the investor from a decline in the price of the underlying stock

3) Opportunistic - As the name suggests, such hedge funds are opportunistic in nature

a) *Global Macro* - Such managers carry long and short positions in any of the world' s major capital or derivative markets. These positions reflect their views on overall market direction as influenced by major economic trends and or events. The portfolios of these funds can include stocks, bonds, currencies, and commodities in the form of cash or derivatives instruments. Most funds invest globally in both developed and emerging markets.

b) *Long/Short Equity* - This directional strategy involves equity-oriented investing on both the long and short sides of the market. The objective is not to be market neutral. Managers have the ability to shift from value to growth, from small to medium to large capitalization stocks, and from a net long position to a net short position. Managers may use futures and options to hedge. The focus may be regional, such as long/short US or European equity, or sector specific, such as long and short technology or healthcare stocks. Long/short equity funds tend to build and hold portfolios that are substantially more concentrated than those of traditional stock funds.

c) *Managed Futures* - This strategy invests in listed financial and commodity futures markets and currency markets around the world. The managers are usually referred to as Commodity Trading Advisors, or CTAs. Trading disciplines are generally systematic or discretionary. Systematic traders tend to use price and market specific information (often technical) to make trading decisions, while discretionary managers use a judgmental approach.

d) *Emerging Markets* - This strategy involves equity or fixed income investing in emerging markets around the world. Because many emerging markets do not allow short selling, nor offer viable futures or other derivative products with which to hedge, emerging market investing often employs a long-only strategy.

e) *Dedicated Short Bias* - Dedicated short sellers were once a robust category of hedge funds before the long bull market rendered the strategy difficult to implement. A new category, short biased, has emerged. The strategy is to maintain net short as opposed to pure short exposure. Short biased managers take short positions in mostly equities and derivatives. The short bias of a manager' s portfolio must be constantly greater than zero to be classified in this category.

Are Hedge Funds For You?

We feel that hedged funds have a place in everyone's portfolio. One may want to allocate between 5-25% of their LONG-TERM investments into hedge funds. A hedge fund being an asset class, which is negatively or lowly correlated to traditional assets can lower portfolio volatility and increase returns

Note that leveraging can cause a fund to lose all of its assets. A hedge fund manager who-leverages excessively can make wrong calls on both short and long bets e.g. Long Term Capital Management.

Diversify into Funds of Funds Hedged Funds. They are constructed to invest in numerous other hedge funds with low correlation to each other. Such funds are suppose to reduce risk by not investing 'you're your eggs into one basket' , and proves as a safer and affordable way for retail customers

Hedge Funds are fast become a retail product and may one day become a traditional asset class. We believe that hedge funds investing will still be attractive for the next 5 years. As hedge funds become more available in the retail market, it will mean that too much money will be chasing after too few opportunities, making hedge funds a possible ' boring' traditional asset class.

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