Alternative Investment Spotlight:
Hedge Funds

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- The purpose of this report is to provide clients an introduction to hedge funds.
- We provide an overview of hedge fund strategies and their structure, and outline the benefits and drawbacks to investing in hedge funds.
- The goal of this report is to communicate the diversification and risk reduction benefits available to high net worth clients by employing hedge funds in portfolio construction.
- In making our case for hedge funds, we introduce our approach of maintaining two hedge fund lists — 1 for equity-oriented investors and another for more conservative clients.
- Our fund selections will be reviewed and updated on a quarterly basis.

For some time, institutions have used alternative investments such as hedge funds to diversify their portfolios, help reduce risk and generate returns. While universities such as Harvard and Yale were early adopters of alternative investments, increased interest from corporate pension plans and other institutions, as well as heightened media attention, have prompted individual investors to ask themselves whether hedge funds are the answer to immunize their portfolios from the volatility of equity investing, while seeking to bolster the paltry returns currently offered by fixed income markets.

While there is no doubt that many institutions are moving aggressively to add alternative investments to their existing portfolios, a lack of understanding among individuals has largely kept higher net worth investors from capitalizing on what we believe to be an attractive opportunity to help reduce portfolio risk and increase diversification by adding a non-correlated asset to a traditional portfolio of stocks and bonds.

The focus of this report will be to both explain alternative investment funds (specifically, hedge funds) and present our case for their inclusion in individual high net worth client portfolios.

What are Hedge Funds?

The term *hedge fund* dates back to 1949 when a sociologist by the name of Alfred Winslow Jones, while working on a project for *Fortune Magazine*, devised a system of investing that involved buying securities while selling short other companies to neutralize overall exposure to the market. Mr. Jones's goal was to purchase undervalued equities, while *hedging* his market exposure by selling shares in less attractive companies with similar attributes. His success was touted by *Fortune Magazine*, his former employer, in a 1966 article which highlighted his unique investment style and other factors that are still prominent in hedge funds today. These included his performance based compensation, the investment of nearly his entire net worth in his own fund and most importantly, his stunning outperformance of his long-only peers and the index.

Comment: Long-only pertains to investors, who do not short stocks, and only hold long positons — mutual funds are long-only investments.

Today, the term hedge fund has become a homogenous term that has been used to label investment pools that utilize strategies that are not eligible to be used in the strictly regulated mutual fund industry. These strategies include the use of leverage, derivatives and short selling. While many people view the use of these investment *tools* as being speculative in nature, the funds we highlight will focus on funds that use alternative strategies to help reduce risk in a portfolio — not add to it.

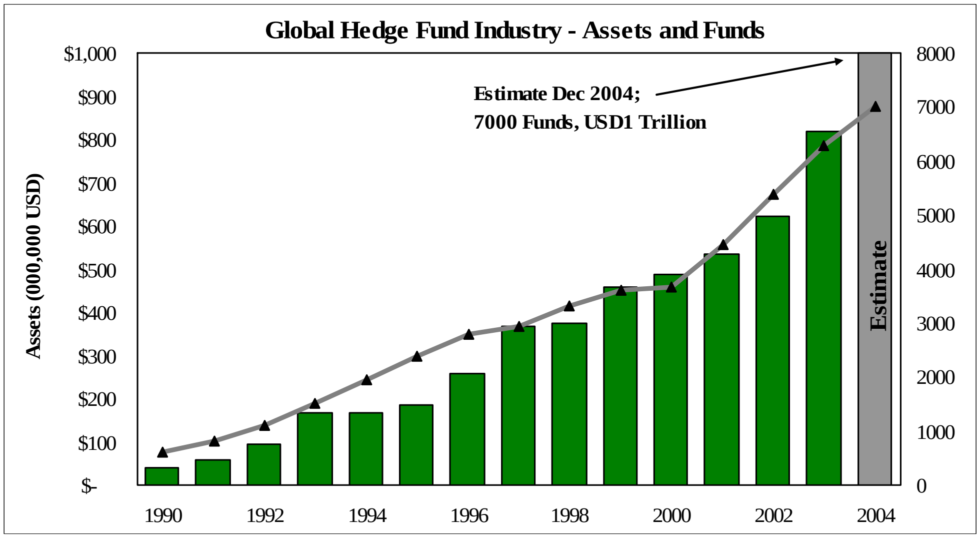
Comment: Leverage is calculated by taking the net assets invested in the fund and dividing it by the fund's capital base.

Comment: Derivatives of equity and bond markets include options and futures. By buying an option or a future, one is receiving levered exposure to the returns or losses of an underlying security.

Comment: Short selling involves borrowing an asset in the hope that its price will decline. In hedge funds, however, short selling can be used as a tool to mitigate risk on another position that is held in the portfolio.

Hedge funds have been largely unregulated and have been known to provide little in the way of transparency to investors. While a push by the Securities and Exchange Commission in the United States is forcing every hedge fund to register itself with the agency and follow more stringent reporting rules, the lack of transparency in the area continues, as many hedge fund managers believe that disclosing their holdings and current trades will rob them of their competitive advantage.

With nearly a trillion dollars in assets and an estimated 7000 funds globally, alternative investment funds are on the cusp of becoming mainstream in Canada. Hedge fund providers have answered the demand and interest in hedge funds with, literally, thousands of new products globally. While many talented investment managers have started up hedge funds in the past, there have also been a number of companies in the hedge fund space that are looking to capitalize on the current market trend.



Source: Hedge Fund Research Inc. & Research Marketing Group

For investors looking to invest in hedge funds, we believe a disciplined and stringent due diligence process of both the manager and the potential benefits of a strategy should precede any thoughts of investment.

The Anatomy of a Hedge Fund

While it is true that hedge funds differ significantly from mutual funds, investors' familiarity with mutual funds allows us an opportunity for comparison.

Factor	Hedge Funds	Mutual Funds
Return Targets	Absolute	Relative
Strategies	Flexible (leverage, shorting)	Constrained by a Benchmark
Diversification Benefits	Low Correlation to Market	High Correlation to Benchmark
Liquidity	Less Liquid	Daily Liquidity
Regulation	Less Transparent	Strictly Regulated
Fees	Performance Based	Asset Based

Source: Research Marketing Group

Absolute Returns

The central reason that investors are contemplating investing in hedge funds is the potential for absolute, positive returns through all market environments. Equity mutual funds tend to be highly levered to the returns of the stock market. Certain hedge fund's strategies aim to generate absolute returns with low correlation through the use of alternative strategies such as shorting, the use of derivatives for hedging purposes, and leverage.

Comment: Page: 2
A statistic that measures the strength of the relationship between two series of data. Strong positive correlation (close to +1) indicates assets whose prices move in the same direction. Conversely, negative correlation indicates assets whose price move in opposite directions. Low correlation (close to 0) is optimal for diversification purposes.

In the mutual fund arena, portfolio managers' performance is typically measured against a benchmark index, such as the S&P/TSX Composite or the S&P 500. For this reason, mutual fund managers tend to make investments in companies and sectors *relative* to their tracking benchmark. A manager can be deemed successful, having lost money, if they lose less than their tracking benchmark. Losing only 10% when the index a fund manager is tracking has lost 20% is an example of value being added on a relative basis. Typically, value is attempted to be added as the fund manager will have a view of over, or underweighting certain companies or sectors relative to their weighting in the index. Hedge fund managers tend to pay far less attention to the benchmark weighting of companies as they are focused, and compensated on *absolute* returns, not their performance compared to an index.

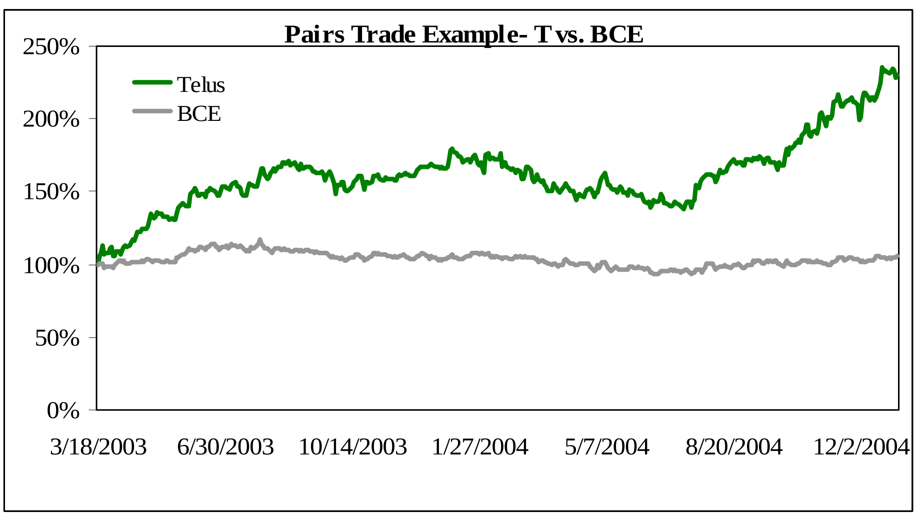
Flexibility

The flexibility afforded alternative investment fund managers, shorting specifically, allows managers to diversify the source of their returns away from that of the stock market by neutralizing the systematic risk in a portfolio by offsetting market exposure with appropriate short positions. Hedge managers can employ a diverse number of strategies including capitalizing on corporate events and arbitrage opportunities as a means of generating return. Equity long/short strategies, despite having varying levels of market exposure, use the ability to short securities as a means to immunize a portfolio from market risk. A prototypical "pairs trade" for a long/short equity manager could be to purchase the strongest company in a sector while shorting a company in the same sector with weaker fundamentals.

Comment: Idiosyncratic risk is the unique risk of a specific security. Systematic risk is the risk inherent in the entire market.

Comment: A pairs trade involves the purchase of one security and the simultaneous sale (shorting) of another. These companies are generally in the same industry and have similar attributes. These trades are typically viewed as a market neutral.

To carry our example one step further, we could hypothesize that a long/short fund manager operating in the Canadian market had a view in March 2003 that Telus would outperform BCE. Due to the fact that the two companies operate in the same environment with similar core businesses, one could argue that their individual businesses would be affected by economic and overall market forces in a similar fashion. The fund manager's investment return, by being long one telecom company and short the other in the same proportions, would be based on the performance of the firms with respect to one another, and would be insulated, for the most part, from exogenous market factors.



Source: Bloomberg

In the example above, we can see how with near perfect timing, instituting the hypothetical trade, a hedge manager would generate a positive return of nearly 125% while exposing the portfolio to minimal sector or market exposure.

Low Correlation = Diversification

Hedge fund managers are able to achieve low correlation to equity or bond benchmarks through the portfolio construction process. Market neutral or arbitrage strategies, by design, exhibit very low correlation to traditional asset classes. In arbitrage strategies, the returns generated by the investment manager is dependent on individual security selection and the interplay between the portfolios holdings, and is not simply a function of market returns. The driver of investment returns in hedge funds is the manager's ability to invest in winning trades. As such, good hedge fund managers should make money in almost any market environment.

Comment: A trade, or portfolio, is considered market neutral when the projected beta, or exposure to the market, is at or near 0.

Comment: An arbitrage is the opportunity to exploit a market inefficiency for profit on a risk-free basis. The term is also used as a generic term for trades that have, to some extent, been hedged.

Less Transparency and Liquidity

While we believe there are many reasons to invest in alternative investment funds, many investors ignore some of the drawbacks associated with the space. Alternative investment funds tend to be less liquid and less transparent than mutual funds. Hedge funds offer less liquidity as managers view the facilitation of frequent cash flows to be a detriment to fund returns. Also, due to the complex nature of structuring certain hedge portfolios, managers do not want to be forced to return capital to investors at inopportune times. For this reason, many fund managers limit purchases and redemptions to weekly, monthly or even quarterly frequencies.

The issue of transparency is a difficult one for hedge fund managers as their instinct is to resist their investors' demand for full portfolio transparency. For some investors, having access to a fund's underlying investments is a requirement, as they see a need to understand a strategy within their portfolio, and monitor a manager closely. As managers seek capital, and investors seek investment opportunities, the issue of transparency continues to be a factor that requires special attention. Hedge fund providers, for the most part, understand investors' need to have some kind of look-through into their investment portfolios and, in Canada, provide reasonable disclosure to individual investors.

The hedge fund industry is very competitive, as successful managers are very well compensated for being successful. For this reason, fund managers are incredibly dubious of, and resistant to anything that could negatively affect fund returns. Factors such as high levels of liquidity and transparency are viewed as detractors to fund returns, and thus manager compensation.

Fund managers wish to minimize non-investment factors that can detract from returns. The key reason for this is that hedge managers are much more highly compensated for a dollar of return versus a dollar of assets. Mutual funds typically charge a flat fee on assets, while hedge have a two-pronged fee structure. The first is a nominal fee charged on assets to cover the fixed costs of the manager. The second is a performance fee charged by fund managers based on their profitability, generally on earnings above a predetermined hurdle rate. We believe that manager reliance on performance fees aligns their interests with those of their investors, while a highwater mark discourages managers from taking outsized risks.

Comment: A hurdle rate is the rate of return that a manager must achieve before collecting performance fees. Often the hurdle rate is pegged at 0 or at the short-term bond rate.

Comment: A highwater mark is a mechanism used to ensure that managers only charge performance fees on net new gains. Should a fund lose money, the manager would not collect performance fees on gains back to the highwater mark.

Classification

Despite the size of the global hedge fund industry and the increased interest from pension funds and individual investors, there continues to be a lack of a standard categorization of hedge strategies and sub-strategies. While a number of firms have emerged to construct both broad-based and strategy specific indices, no global standard currently exists for the classification of hedge funds.

Benchmarks are widely used for performance comparison in traditional investing. In the world of hedge funds, performance comparisons between a fund and its index is less useful for a number of different reasons.

The construction of indices segmented by hedge fund investment style is also not terribly useful for performance comparison, as hedge strategies vary widely within their broad style categories. Such a wide disparity in fund strategies makes comparison between a fund and its index less useful. This can be exemplified by examining the make-up of a broad managed futures index. Within a managed futures index, both discretionary Commodity Trading Advisors (CTA) as well as systematic trend-following managers are included. While both of these investment strategies use futures in order to generate their investment return, their performance and risk profiles will vary greatly in different market environments. Within every hedge strategy there will be wide variance in how strategies are executed.

The statistical biases of hedge fund index data are well documented. While some studies have come out to refute the effects of both survivorship and selection bias on hedge indices, it is our belief that there are inherent biases in the return streams of hedge indices, which, likely, positively skew return data. Due to these inherent biases, comparison is more difficult as the history of an individual fund is not affected by survivorship or selection biases.

Comment: Survivorship bias is believed to positively skew index data, as funds that have closed down are no longer included in the index. Survivorship bias implies that the funds that closed down, had negatively affected performance over their life, a point refuted in a recent European study.

Comment: It is believed that poor performing hedge funds will not report their returns to index providers. With less poor performing funds reporting, this would create a positive effect on the indices. Selection bias has also been refuted by the fact that managers who perform strongly, but are not looking to raise capital, also do not report to the index provides.

While we are forced to use aggregate index data for illustrative and explanatory purposes, we feel that evaluating hedge fund managers against their stated risk and return objectives and a small group of similarly minded peers is more valuable than comparing a hedge manager's performance to that of an index.

Strategies

While there is no standard for hedge fund classification, to better understand both the level of market risk and return drivers, we have segmented the industry into three main categories, and given examples of strategies that fall within each.

Relative Value	Event Driven	Opportunistic
Convertible Arvitrage	Distressed	Emerging Markets
Credit Arbitrage	Merger Arbitrage	Equity Long/Short
Corporate Structure Arb	Risk Arbitrage	Global Macro
Equity Income Arbitrage		Short Selling
Statistical Arbitrage		

Low — **Sensitivty to Market Direction** — **High**

Source: AIMA Hedge Fund Primer, Research Marketing Group

Relative Value

Relative value strategies exhibit the lowest level of market exposure. While there are many different types of relative value strategies, managers in this space tend to generate modest returns by investing in arbitrage scenarios.

Common to all of the relative value strategies is a view by the manager that one asset or portfolio of assets, is expensive relative to another. Returns are generated when the prices of the expensive asset drops and/or the inexpensive asset climbs. Equity market neutral managers maintain a portfolio of long positions the market exposure of which is offset by a portfolio of short positions. In certain strategies, opportunities need not even be between two separate companies, as managers can take a view that a portion of a company, whether it is debt or equity, is expensive in relation to another portion of the capital structure.

Relative value managers are looking to exploit mispricings between two securities or two groups of securities, in situations where the market should have only a minimal effect on the investments.

Market Neutral Equity Example

Source: Research Marketing Group

In the chart above, we see how $100 invested with a market neutral equity manager is put to work. By purchasing a basket of companies with a positive beta, and borrowing (shorting) a number of companies with a similar negative beta, the fund manager seeks to generate investment returns (alpha) through security selection. In rising markets, a fund manager would expect his

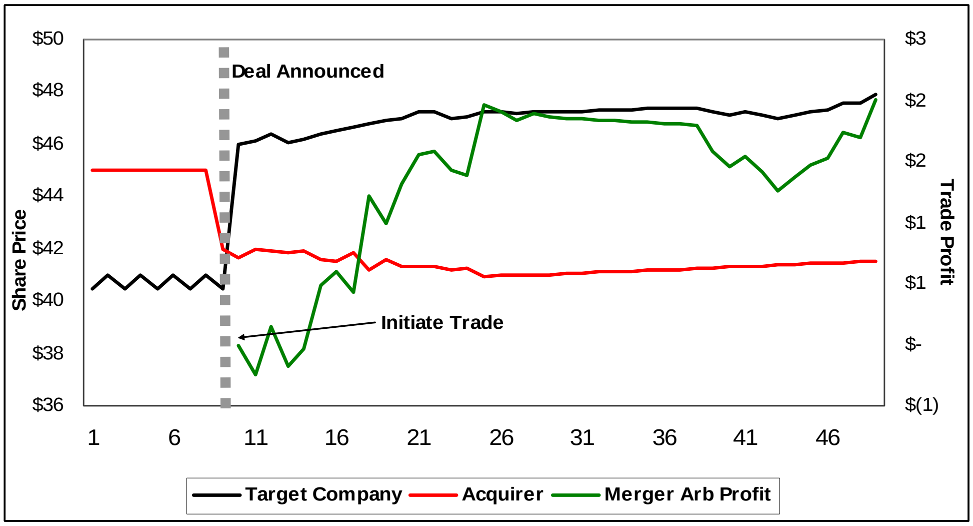
Comment: Beta is a statistical measure that gauges a security, or a portfolio's, sensitivity to a benchmark. A Beta of 1, suggests a fund's return will move in line with the market.

Comment: Alpha is a measure of a fund's outperformance to its benchmark or stated objectives. A positive alpha indicates that the manager is adding value through portfolio management.

longs to appreciate more than his shorts, and conversely in a down market, his shorts to depreciate more than his longs — in each case creating a positive return.

Event Driven

Event Driven strategies include merger arbitrage, as well as investing in distressed securities. The different event driven strategies can have varying levels of market exposures, however, for the most part, overall market exposure tends to be low, as strategies in this space rely on external corporate events to generate returns.



Source: Research Marketing Group

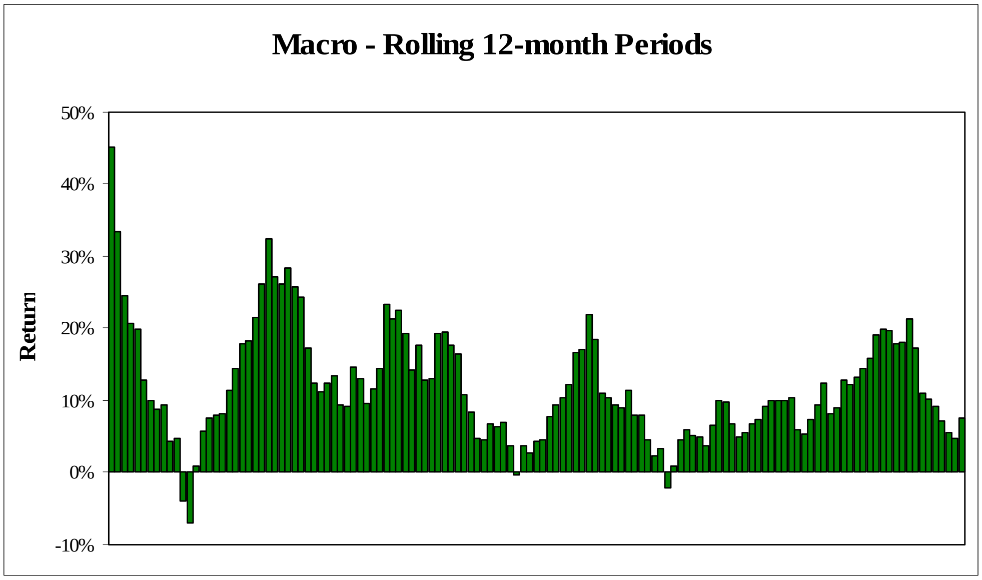
In a typical merger scenario, a firm will generally purchase another company at a premium to its current market price. The market price of the firm being acquired will generally trade a discount to the agreed upon acquisition price prior to the deal closing. The size of the discount is commensurate with the risk of the deal not closing and the time before the expected closing. To benefit from this corporate event, after the announcement of an acquisition or merger, the hedge fund manager would purchase shares in the target firm, while at the same time shorting stock in the acquirer. Due to the fact that the target firm will generally trade at a discount to the acquisition price, and the acquiring firm — under the expectation that an acquiring firm will either be diluted or have to take on more debt — will trade lower, a positive trading profit is created. The profitability of the trade, by being short the acquirer and long the target, is dependent on the widening price spread between the two companies.

Opportunistic

The opportunistic category encompasses a number of strategies that include managed futures, long/short equity, emerging markets and global macro funds. Funds that fall into the opportunistic fund category tend to exhibit a much higher degree of market exposure.

Opportunistic managers are known for making bets on the direction of individual securities or markets in general. While generally known as the most volatile strategy, several global macro managers have become very well-known in the investment business, and even in the broader community, for making sizeable bets that generate astounding returns. George Soros became a household name back in 1992 when it was estimated that he made over US$1 billion by shorting the pound sterling — in the end, forcing the Bank of England to devalue the currency.

While there have been a few notable successes in this area, there are certainly many managers who made bets that did not work out, or moved against them. For this reason, we view opportunistic managers as higher risk, due to their levels of market exposure. The chart below shows the rolling twelve month returns generated by Global Macro managers, starting in 1994. We can see that there is a high degree of variability in the returns.



Source: Bloomberg

Offering Memorandum Products and Accredited Investor Rules

The most common way for individual investors to access hedge funds in Canada is by purchasing funds sold by Offering Memorandum. Funds sold via this route are subject to high minimum investments. While seemingly contradictory, for wealthy investors who qualify under Accredited Investor Rules, funds can be purchased in much smaller increments, as low as $5,000 in some cases. Accredited Investor Rules apply in every Canadian jurisdiction, with the exception of New Brunswick and the Yukon and are applicable to investors who qualify under the following guidelines:

- An individual or couple who have net investable assets of over $1million.
- An individual who has an annual gross income over the past two years of at least $200,000 per annum, or combined income with his or her spouse of over $300,000.
- A company, trust or estate that has net assets of at least $5million.
- In certain jurisdictions, qualification as a Sophisticated Investor.

Residents of Alberta, British Columbia and Nova Scotia who are not accredited investors, can become accredited by signing a Risk Acknowledgement Form. This form essentially states that the investor consents to invest in a security where he or she could lose all the money invested.

While an Offering Memorandum (OM) is a legal document, unlike Prospectuses however, there are no prescribed formats to which it must adhere. For this reason, even after gaining comfort with the fund manager's investment style and skill, special attention must be paid to factors such as fees, structure and tax treatment as set out in the OM before undertaking an investment.

Prospectused Funds

While very few prospectused hedge funds exist in Canada, we believe that this will become a very interesting area to watch in the coming months and years as the lines between mutual funds and hedge funds begin to blur. Due to the fact that prospectused funds do not require investors to be "accredited" and are available with low minimums, there is an appeal for mutual fund companies wanting to add shorting as a competitive advantage to their long-only portfolios and alternative investment firms wanting to tap the mass market. The prospectused fund area will likely be a battle ground for mutual funds with a hedge-like feel and hedge funds in a mutual fund wrapper.

The ability to offer hedge strategies in a prospectused fund has its limitations; however, the Ontario Securities Commission has begun granting exemptions to regulations that limit the use of shorting stocks and the use of derivatives. Currently, established funds and new funds alike, can apply for an exemption that will allow a fund the ability to make short sales up to 10% of the net asset value of the fund.

Managed Futures funds have, for some time, been able to go both long and short within a mutual fund trust (or prospectused) structure, as the economic participation in a future is similar whether the investor is long or short. For this reason, there have been a limited number of managed futures products offered with low minimums and no requirement of accredited or sophisticated investor rules.

Comment: A future is a derivative instrument that gives a symmetrical pay-off on underlying investment. These differ from options as options have asymmetric payoffs.

We expect this area to grow significantly in the near term, and believe that the line between mutual funds and hedge funds will become less distinct as the number of prospectused hedge funds, and mutual funds with the ability to short, grows.

Structured Notes

Due to the high minimums required to invest in hedge funds, the limitations applied to prospectused funds, and also the relative unfamiliarity of the investing public with alternative investment products, there has been a movement to offer hedge funds in a principal-guaranteed structure, which, among other things, provides low minimums and tax effectiveness.

While principal-protected structured notes appear to be a panacea for investors, there are significant costs associated with the principal protection and individuals should weigh the benefits carefully against the costs.

It is also worthwhile noting that special attention should be paid to the managers and strategies underlying the note and evaluate them on their merits and not just purchase a note based on a guarantee. We believe it is imperative to correctly position these funds in a portfolio and for expectations to be reasonable given the underlying investment and its structure. The risk to investors in a principal-guaranteed investment is not one of losing capital, but one of opportunity cost. In this case, the opportunity cost is the foregone return that would have been earned on another investment.

Closed-End Funds

A number of hedge funds have been offered as closed-end, exchange traded funds. Closed-end funds allow investors good access to underlying hedge fund managers, with no minimum investments and no need for investor accreditation. Closed-end funds are only constrained by the terms in their offering documents, so complex strategies using hedging techniques, leverage and derivatives can be used.

Closed-end funds can suffer from a lack of liquidity and share prices can deviate significantly from the fund's net asset value.

Dealing with the Misconceptions of Hedge Funds

Many investors, and advisors for that matter, are unwilling to discuss hedge funds due to a number of myths that surround this widely misunderstood subset of investing. We wish to address some of these issues here briefly, as we continue to make our case for hedge funds' inclusion in the portfolios of high net worth investors.

1. Hedge Fund strategies are too complex, too exotic and inexplicable

Some hedge funds strategies employ approaches that are more complex than typical long-only investing and utilize financial instruments that can be characterized as exotic. While there is additional complexity in a number of hedge fund strategies, many investors believe that investing with a hedge fund manager must include a leap of faith, that certain hedge strategies just cannot be understood. We believe that investing in hedge funds does not have to be a leap of faith. For those interested in doing the due diligence and monitoring the funds — which is an arduous and time consuming task — investing in hedge funds can be fully understood and rewarding.

2. Don't hedge funds "blow up?"

The hedge fund industry has been marred by a small number of high profile blow-ups. The most noteworthy was the forced bail-out of Connecticut-based Long-Term Capital Management (LTCM) in 1998. Despite having Nobel Prize winners and highly experienced people on their staff, LTCM suffered serious losses in the aftermath of the Russian debt crisis. These losses were magnified by the fact that each of its "convergence" trades became highly correlated during the flight to quality that ensued Russia's debt default. The extent of LTCM's exposure necessitated a bail-out from its largest counterparties, which was essentially all the major Wall Street firms.

Comment: While on the surface all of LTCM's trades appeared non-correlated, it became evident that their investments, based on the convergence of prices between the same assets of different liquidities and maturities were all correlated when the market was seeking safety.

LTCM has become an incredible lesson to investors and all financial market participants. Due to its background and early success, LTCM was afforded liberties that made it impossible for outsiders to gauge its risk levels.

Many lessons on portfolio risk management were learned, or at least reinforced, with the crisis at LTCM. While history can repeat itself and crises hit financial markets relatively often, hedge fund managers have become increasingly aware that during times of market crisis, themes and trades that do not appear to be correlated can all work against them at the same time.

Risk management, and more precisely tail management, has become a major focus among hedge fund managers, especially those constructing fund of hedge fund portfolios or employing a multi-strategy approach. Increasingly, stress testing and modelling worst case scenarios are used alongside more traditional risk measures.

Comment: This refers to dealing with extreme events that are only supposed to occur in extreme circumstances. Tail management alludes to the "tails" of a normal distribution curve.

With a large number of new funds being launched in the last few years, simply to capitalize on hedge funds' popularity, we fear that the potential for investors to encounter serious losses in hedge funds is higher due to some low quality providers in the space. We do believe, however, that there are many good hedge fund managers, who are acutely aware of their risk exposure, and can deliver their stated objectives to their investors while minimizing the potential of a significant drawdown.

Comment: Drawdown is a term used in the hedge fund industry in describing losses of capital within a fund.

3. Aren't leverage, derivatives and futures too risky?

In the case of LTCM, the use of derivatives and leverage did prove risky as both were used in excess. While we will never know the full extent of the leverage that LTCM employed, it is believed that its full leverage facility exceeded 250 to 1. While the use of leverage varies from strategy to strategy, in our research, we carefully evaluate how managers use leverage and only highlight hedge fund managers who use no more than nominal degrees of leverage.

Comment: $4.8 billion in capital $1,250 billion in available credit facilities.

Also, the use of futures and derivatives need not be for speculative purposes alone. Futures and derivatives are often used as "hedges" to reduce risk in a portfolio. While some portfolios use futures as speculative tools, they tend to be volatile — these are managers with which we are comfortable.

While the use of leverage and derivatives contributed to the failure of LTCM and likely many other hedge funds, it is not these tools that are to blame, simply their application.

4. Aren't the fees on hedge funds ridiculous?

The fees on hedge funds differ from those of mutual funds, due to the fact that there are two distinct components. The first component is generally a flat percentage fee, levied on assets, which allows the fund manager to cover the fixed costs of its operation. A second component — typically unique to alternative strategy funds — is a performance-based fee that the manager charges on fund returns. For single strategy funds, this fee is typically 20% of net new investment gains, and sometimes may be subject to a hurdle rate. Fund of funds charge a more modest performance fee, generally 10% of gains, but is applied to the net performance of the underlying portfolio.

Perfromance-based compensation may mean that one has a fund with a high management expense ratio (MER) after a period of strong performance, it also ensures that the hedge fund manager's interests are aligned with those of the investor. Both the investment manager and the investor benefit from strong performance, while highwater marks keep the manager from taking undue risks.

While fees are a part of the analysis when seeking a hedge fund, we are more focused on results-based analysis, as all the hedge fund return numbers that we analyze are reported net of fees. This allows for the comparison of a fund's returns to that of a competitor and against its stated objectives, after all fees and expenses are taken into account.

5. Hedge funds are becoming the hot new investment, should I rush to invest?

It is true that hedge funds have garnered a lot of attention in recent years, this attention has attracted many low-quality product providers to the space. While we are believers in the merits of high quality hedge funds, we are intensely concerned that investors may have a bad investment experience with hedge fund providers who are simply looking to capitalize on the emergence of hedge funds as a market trend.

We believe that investors should focus on fund managers that have demonstrated track records of consistent performance and have real experience in the area in which they invest. For arbitrageurs, this can include time spent on a proprietary trading desk within an investment bank, and for long/short investors, experience shorting stocks in their respective markets.

Our Case for Hedge Funds

Thus far, we have attempted to provide investors with an outline of how hedge funds differ from traditional investments and also deal with some of the misconceptions and misunderstanding that mire the alternative investment space.

While there are hedge funds that can complement the portfolio of many investors, in making our case for alternative investment funds, we will focus on the diversification and risk reduction benefits of certain hedge fund strategies, and leave the discussion of high-octane, aggressive funds or more esoteric strategies for another time and another research report.

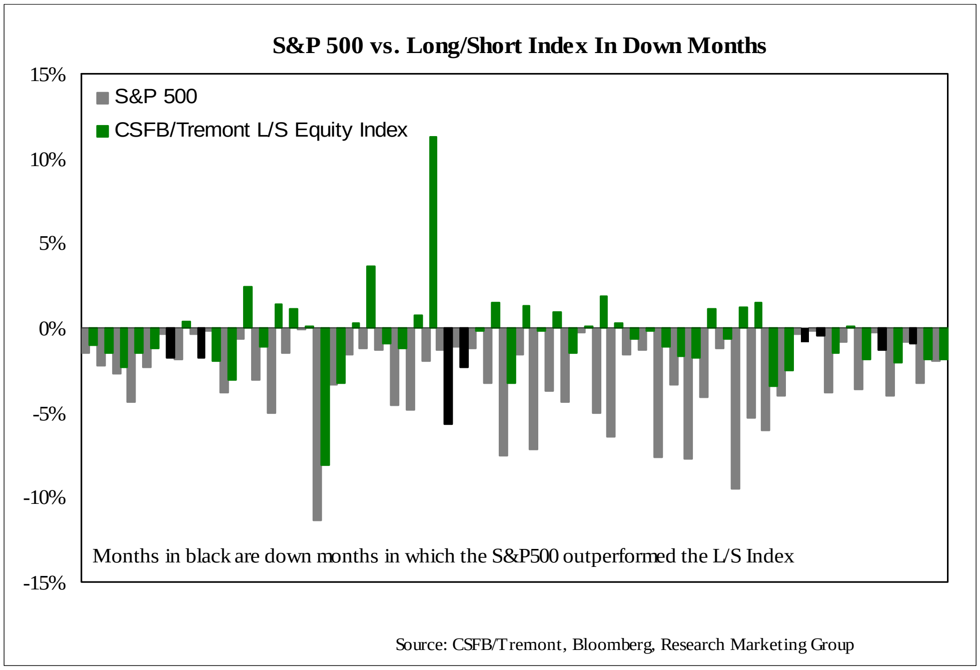
Evaluating the potential risk in a hedge fund is not an easy task. Using traditional metrics, such as standard deviation, does not fully capture the potential for outsized positive or negative returns in certain hedge fund strategies during times of market crisis. As it was seen in late 1998 with LTCM, seemingly conservative strategies can be susceptible to exogenous market forces in times of crisis. While the potential for portfolio drawdowns in such situations are not captured by a fund’s risk measures during normal markets, insight into a fund’s risk management process and extensive due diligence of a manager gives us a broader sense of quantifying potential loss in times of crisis.

In the context of the two traditional asset classes we hypothesize that typically, investors will choose to allocate to a hedge strategy in order to complement a portfolio of stocks and bonds. We further propose that the hedge alternative to long-only equities is simply to add a long/short strategy to an equity-oriented portfolio. Conversely, for conservative portfolios, we believe that hedge fund of funds are suitable as a complement in a conservative portfolio.

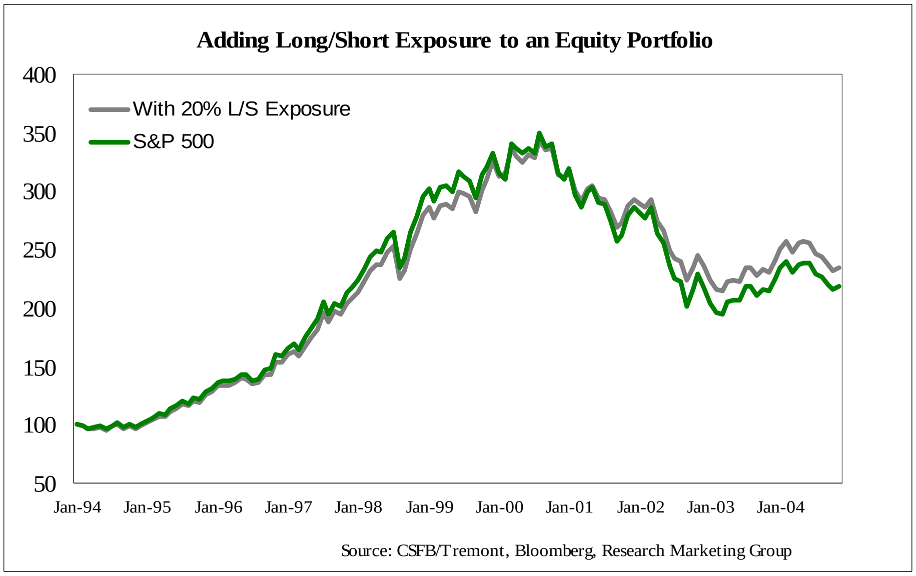
Hedge Funds of Equity Investors

In recent years, equity investors have been plagued with severe market extremes of irrational exuberance and drastic lows. Skilled investment managers who have the ability to short stocks have been able to flatten out some of these extremes and mitigate the risk inherent in being “long the equity market.

One of the tenets of active management is capital preservation in poor markets. Since the start of 1994, the S&P 500 has lost money in 56 months. The CSFB/Tremont Long/Short Hedge has outperformed the S&P in 47 of those 56 months. The average negative monthly return for the S&P 500 was 3.1%, versus an average drawdown of slightly only 0.66% for the long/short hedge index during these negative months. This would indicate that, on average, hedge managers are able to protect capital in down markets through their ability to short.



This downside protection is a key reason why the long/short index is a third less volatile than the equity index, with slightly better returns over time. We show the benefit on an equity portfolio for an investor to have a 20% exposure to equity long/short. We see from the comparative graph below, how a portfolio of 80% S&P 500 and 20% CSFB/Tremont Long/Short Index has outperformed the S&P 500 with less volatility over time.



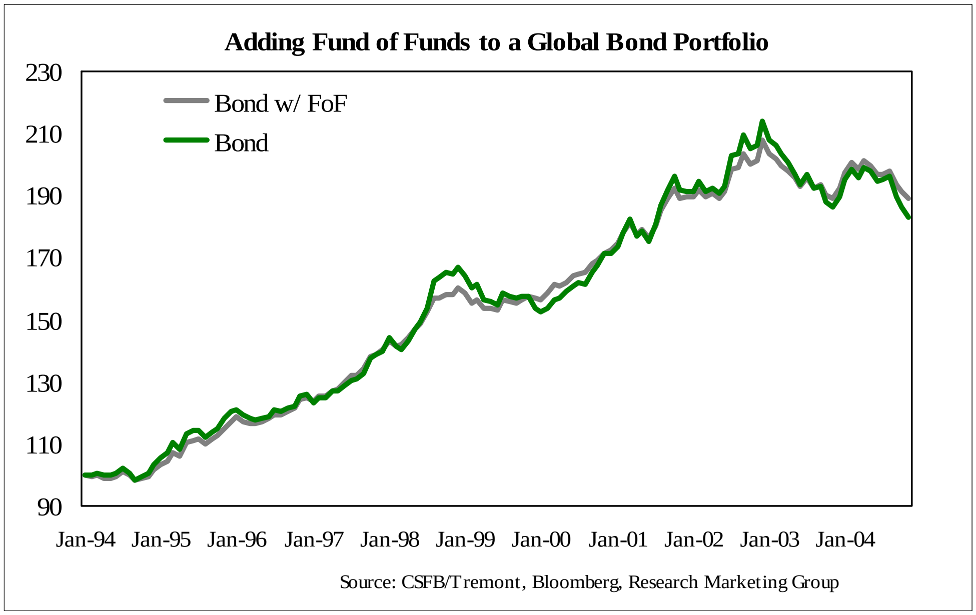
While the shape of the two return series are very similar, we see that by virtue of losing less money in periods of decline, the long/short allocation allowed the portfolio to outperform the index. We also believe that the adaptive nature of long/short managers and flexibility that they are afforded allows them to react more quickly when markets begin trending in either direction. As the downward trend persisted in 2000, hedge managers began adapting their market exposures and adding to their short portfolio in an effort to protect capital.

We believe that the potential for capital preservation in poor markets and the reduction of volatility over the long-term are the key drivers behind an equity-oriented investor allocating capital to a long/short hedge manager.

Hedge Funds for Conservative Investors

While we are not suggesting that investors make a wholesale switch out of their well-diversified government bond portfolios to invest in hedge funds, we suggest that hedge fund of funds (FoFs) are a potential way to diversify a conservative portfolio from typical corporate or high yield bond holdings.

Over the past 20 years, a long-term decline in interest rates has provided bond portfolios with a "wind at their back. With yields at low levels in historical terms, one must consider the fact that the capital gains story in bonds is largely over, and that rising rates could actually hamper bond portfolios.



As an alternative, we suggest diversifying one's conservative portfolio away from being purely exposed to interest rates. Hedge FoFs provide exposure to a number of different hedge fund strategies, while their returns have little reliance on the direction of equity or bond markets.

The FoFs' underlying managers can employ complex trading strategies, utilizing exotic strategies in order to generate returns.

Due to the wide variance in the quality of hedge fund managers, the fees paid to a high quality FoF manager for the due diligence, risk management and portfolio construction performed are well deserved, in our opinion. Also, purchasing more esoteric strategies within a portfolio, mitigates both manager and strategy risk.

Hedge FoFs also exhibit very low volatility, while their returns are generated on a tax-deferred basis for Canadian investors. That is to say, that investment returns are taxed as capital gains in the hands of the investor upon disposition of the fund — a net benefit to taxable investors over receiving interest payments from government or corporate issuers.

Hedge FoFs also provide some degree of positive correlation to interest rates. Due to the structure of many arbitrage portfolios, managers own treasury bills, as their trades are dollar neutral. The fund collects interest on the cash in their account, which increases, commensurate with short-term rates.

Comment: Dollar neutral trades are structured so that every dollar of long exposure is offset by a dollar of short exposure. This means that the investor's capital sits in near-cash in a trading account as margin for the trade.

We believe the comparison for FoFs versus corporate or high yield bonds will become more compelling as investors realize that historical returns from the bond market are not likely to be repeated in this environment. Also, the poor showing of FoFs seems to have improved of late as the market's implied volatility returns to more normal levels.

Conclusion

In this research report, we have attempted to provide our view of both the risks and opportunities provided by hedge funds. Different hedge fund strategies can have very distinct risk and return profiles. We hope to have conveyed the fact that alternative investment strategies, despite being lumped into one category, represent a group of heterogeneous funds. It is of paramount importance to the investor that a suitable product is selected from a risk and return perspective, and that the client's expectations are reflective of the stated objectives of the fund.

With hedge funds garnering much more interest from many investors, we wish to underscore the fact that all funds are not created equal. In fact, the disparity between good and bad in the hedge fund world is more significant than can be found in long-only investment funds. This signals a higher importance for investors to conduct thorough due diligence before investing with a hedge fund manager.

TD Waterhouse maintains two lists of hedge fund choices. We propose that clients view hedge funds as a complement to traditional equity and bond investments. For this reason we publish *Hedge Funds for Equity-Oriented Investors* and *Hedge Funds for Conservative Investors* two distinct lists that, we believe, will serve investors well in finding a suitable hedge fund for their portfolio.

Please contact your TD Waterhouse Private Investment Advice Advisor to determine whether hedge funds are suitable for your portfolio, or if you would like copies of our most recent hedge fund reports.

Investment Fund Research, February 2005

Disclaimers:

Commission, trailing commission, management fees and expenses all may be associated with hedge fund investing. Please read any offering documentation before investing. Hedge funds are not guaranteed, their values may change frequently, and past performance may not be repeated.

RSP tax savings are available on any RSP eligible investment and tax is payable on all amounts withdrawn from RSPs. Investments must be held for 8 years to keep tax credits. Tax credits vary per province, therefore, ensure you have reviewed your prospectus before investing. Important information about the Fund is contained in its prospectus. Please obtain a copy from your Investment Advisor and read it carefully before investing. Commission, trailing commissions, management fees and expenses all may be associated with this investment. This fund is not guaranteed and its value changes frequently and past performance may not be repeated.

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