CIBC Private Wealth Management

STRATEGIES

UNDERSTANDING HEDGE FUNDS AND THEIR POTENTIAL ROLE IN YOUR PORTFOLIO

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Masters Series

This is one of a series of articles prepared for CIBC Private Wealth Management™. The series is written by professionals in such fields as taxation, trusts, and estates.

Hedge funds debuted more than half a century ago, but their popularity has grown substantially in the past few years as investors have sought alternatives to equity markets. As the name suggests, hedge funds attempt to invest in a way that offsets adverse market movements. Rather than providing a return that follows the market, the goal is to generate returns no matter what the rest of the market is doing.

Needless to say, this approach is attractive and as more hedge funds are being created, more people are becoming aware of them. In addition to high net worth investors and family endowment funds, an increasing number of charitable foundations and pension plans are investing in them. And the more recent "fund of hedge funds" approach is bringing hedge funds within the reach of the average retail investor.

Today, hedge funds make up one of the largest segments of the investment management industry. The global hedge fund industry is now estimated at US$1 trillion, having grown at a rate of about 25% per annum from 1990 to 2004.[1]

What's in a hedge fund?

Hedge funds can make use of a diverse group of investment strategies. They differ by style, risk level, and market exposure. Regardless, all have in common the flexibility to leverage, or invest with borrowed funds, in order to magnify profits, and the ability to short sell in order to generate profits from a falling share price. In a short sale, an investor or fund manager sells stocks he doesn't yet own to be delivered at a future date, with the intention of buying them back later, at a lower price.

A hedge fund manager can choose to isolate a particular stock, currency, commodity, or other financial instrument from general market movements. For example, the manager might wish to isolate a particular sector from market effects, or a particular market from global effects.

A hedge fund manager can use a wide range of investment strategies and tools, such as derivatives and leverage, to gain exposure to specific opportunities and/or to minimize a particular risk related to an opportunity. The variability of the fund should be less than that of a comparable market index.

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Distinction from mutual funds

Although hedge funds are a form of pooled fund, they differ considerably from mutual funds. The objective of most actively managed mutual funds is to outperform a specific index or benchmark — for example, to exceed returns on the S&P/TSX Composite Index. Hedge funds, on the other hand, focus on providing absolute returns, irrespective of a benchmark or the rest of the market.

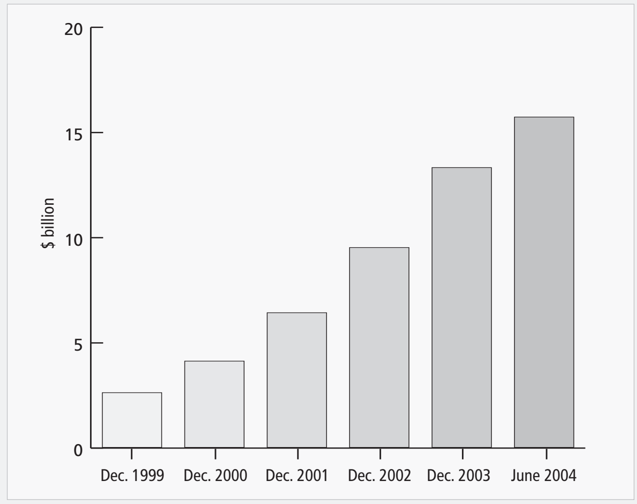
They also differ in how they are marketed and offered to the public. Although some retail versions, designed for the general public, are beginning to appear in the marketplace, hedge funds have traditionally been available only to sophisticated, knowledgeable investors — the so-called exempt market. Most are sold by private placement or limited partnership and typically cannot, or do not, advertise. They are generally not offered by prospectus and are not subject to the same disclosure provisions as mutual funds.

The assumption is that prospective hedge fund investors are sophisticated and knowledgeable enough to investigate the potential risks on their own. Accordingly, the typical cautions and warnings associated with mutual funds are not required.

Hedge funds are usually structured as limited partnerships, with a limited number of investors. The minimum investment is typically $25,000 to $150,000 and sometimes as much as $500,000 to $1,000,000. Some retail-

Hedge funds in Canada are growing

Since 1999, investment in hedge funds has grown considerably. Canadian-sponsored hedge fund assets under management have grown from about $2.6 billion in December 1999 to almost $15.7 billion in June 2004.



Source: Investor Economics, Winter 2005

THE HEDGE FUND SPECTRUM

Hedge funds are actually a diverse group
universe on a spectrum running from pu

Long/short market neutral. Market neutral funds typically hold both long and short positions in securities, usually in the same sectors of the market. For example, a fund manager might pair up a long position in an undervalued gold mining stock with a short position in an overvalued gold mining stock.

Absolute return. Absolute return funds are expected to yield positive returns most of the time. Losses are expected to be rare and to be associated with unexpected occurrences or unusual events. Often, the objectives are described as earning the 91-day T-bill or 5-year government bond rate plus 2 or 3 percentage points, regardless of market conditions.

Convertible arbitrage. These funds pursue a combination strategy of buying undervalued convertible bonds and selling short the shares of the underlying company to reduce the market or systemic effect.

Event driven. These funds exploit pricing inefficiencies caused by anticipated specific events such as mergers, spin-offs, and reorganizations. The managers attempt to predict the outcome of the event as well as the optimal time to commit capital.

oriented versions are also available, usually offering a fund of hedge funds with a lower entry level.

The manager's compensation is normally based on a combination of fund size and on surpassing a minimum performance "hurdle." Unlike mutual funds, which with a few exceptions can be redeemed daily, hedge funds are generally subject to lock-in periods that restrict when an investor can get in and out.

The rewards in place for talented hedge fund managers are lucrative, and designed to attract the best. The manager often has a large stake in the fund, so that his or her prospects are aligned with those of investors.

Benefits of investing in hedge funds

Given the apparent complexities, why would anyone want to invest in hedge funds? In fact, there are some compelling reasons.

Higher potential return. There is the potential for solid returns over the long run since the expert manager is permitted to concentrate on the securities or sectors of his or her knowledge base. Although the performance of markets can affect hedge funds, it is often not the determining factor. Many hedge funds are structured with the expectation of producing positive annual returns on a consistent basis.

Reduced portfolio risk. Most hedge funds will have low or zero correlation with the rest of the market (i.e. market neutral) and thus may reduce the overall risk within a diversified portfolio. Because the hedge fund's long positions are paired with offsetting short positions (this may be achieved through either stocks or derivative securities), the fund should be less variable than a market index.

Liquidity. Unlike real estate and private equity (two other popular alternative investment choices), many hedge funds are relatively liquid. Because they invest mainly in public markets, they are easier to sell. On the other hand, many hedge funds have a minimum lock-in period of several years and may not be liquid.

Potential risks

Don't be fooled by the name: Hedge funds do not hedge away all of their risk. Though the expected returns may be high, there may also be significant risk of loss.

Selection and monitoring risk. Investing successfully in hedge funds requires time and expertise. Many funds have relatively short records and may have operated only in a

o of investment strategies. They differ by style, risk level, and market exposure. You can visualize the hedge fund
urely market neutral to partially market neutral (usually with a bullish bias) to fully directional or speculative.

Merger arbitrage. The strategy of these funds is based on merger activity. The fund manager buys the target company and sells short the takeover company. A fund manager will weigh the arbitrage profit against the probability of the deal closing.

Fixed-income arbitrage. These funds attempt to exploit price inefficiencies among fixed-income securities and fixed-income derivatives. For example, a fund manager might buy a government bond and sell short a high-yield bond on the expectation that the quality spread is about to widen.

Multi-strategy. These are funds that invest among a number of different strategies through a number of different hedge fund managers. These include managed futures funds and funds of hedge funds. Typically, these funds invest in 20 to 40 different strategies or funds that have low correlation with each other.

Global macro. These funds hold long and short positions in any capital or derivative markets located in the world, taking advantage of investment opportunities as they arise.

Emerging markets. The managers of these funds invest in securities from emerging markets and may also sell short securities from developed countries. This investment approach may change over time to benefit from opportunities.

specific economic environment. The fund manager's degree of transparency, shifting strategies, and short time frames make the selection process much more daunting. Some funds still operate under a "cowboy" mentality, in which the fund's strategy may shift suddenly.

Survivorship risk. Sustainability is an issue for these funds. Each year a number of hedge funds disappear, forced to close up shop because investors have drawn out their capital.

Integration risk. There is a challenge in integrating components of a hedge fund into a conventional portfolio. A degree of care is needed to ensure that the hedge fund's holdings don't work against or replicate the portfolio's conventional holdings.

Exposure risk. Probably the biggest challenge is measuring the risk exposure. If the hedge fund employs substantial leverage or holds illiquid positions or over-the-counter derivatives, it may be difficult to price specific positions and to estimate the downside risk exposure. The lack of long-term, transparent history and the fact that distributions may be irregular make it challenging to measure and forecast risks and benefits. Hedge funds may have radically different return distributions than common shares.

The bottom line: What to look for

If you are considering investing in a hedge fund, there are five key features to look for.

1. A transparent statement of objectives. What is the fund manager trying to accomplish? What are the specific strategies to be employed? Are deviations from the strategy allowed? What are the profit targets and benchmarks? Unless you're seeking a retail-oriented version (in which case this information may be available from the company marketing the fund), it's best to speak directly with the fund manager.

2. A solid track record. A review of the fund's past performance is essential. If the fund manager is not prepared to supply a documented, audited record of past performance, drop the fund from your list.

3. Correlation. What is the fund's correlation with conventional asset classes? The fund manager should be able to provide a correlation matrix setting out the relationship between the fund's rate of return and that of the stock and bond markets.

4. Manager incentives. Is there a high-water mark beyond which the manager shares in the profits? Is it cumulative and reasonable?

5. Liquid assets. Does the fund hold strictly liquid, measurable assets? Strict, objective marking-to-market is a key feature of a proper hedge fund. It can be difficult to assess a fund if the value of what it holds is subject to interpretation.

Hedge fund roots

The genesis of hedge funds can be traced back to 1949, to Alfred Winslow Jones and his specialized interest in investing. Jones was looking for a way to isolate the market exposure of individual securities.

His strategy was to buy undervalued securities and to sell short overvalued securities in specified proportions. He also borrowed to leverage his positions. Jones's unique approach captures the essence of hedge funds: to isolate the analytic talent of the hedge fund manager from the fluctuations of the market.

Jones launched a hedge fund in 1949. He structured the fund as a partnership and gave himself a 20% participation fee on profits of the partnership. Ultimately, Jones's success led to public awareness of the hedge fund concept. The structure he used in 1949 is still the primary structure used today.

Hedge funds can be an effective part of a diversified portfolio. This article is a brief summary of the main features of hedge funds and is not intended to represent a thorough examination. The views expressed in this article are the personal views of the author and should not be taken as the views of CIBC Private Wealth Management or Canadian Imperial Bank of Commerce. This document is provided for general informational purposes only and does not constitute investment advice. Individual circumstances and current events are critical to sound investment planning; anyone wishing to act on this article should consult with his or her advisors. The information contained in this document has been obtained from sources believed to be reliable and is believed to be accurate at the time of publishing, but we do not represent that it is accurate or complete and it should not be relied upon as such. All opinions and estimates expressed in this document are as of October 2005 unless otherwise indicated, and are subject to change.

[1] Source: UBS Investment Research, AIS Report, March 2005