

‘The growing relevance of hedge fund investment to portfolio diversification’

What investment sector has provided 15.6% net compound annual return for the past 17yrs and 7 months for approximately half the standard deviation annually of the S&P 500? (During this same time period the S&P produced 12.1% compound annual return).

What investment sector has low correlation with equities and bond markets but has global liquidity?

For the years 2000 – 2004 what investment sector has produced a return net of fees of 10.3% more than the S&P 500? While during the same period outperforming the Lehman Brothers Aggregate Bond Index?

Trick questions or an impossible riddle? Well not either – these are in fact the results of the VAN Global Hedge Fund Index – an aggregate of the global hedge fund industry. VAN today has the World’s largest database of hedge funds - with 6,700 hedge fund managers and compiles global performance indices on the industry each month.

Today a growing number of investors are aware that traditional ‘long only’ investment management styles do not produce consistent returns or reduce portfolio risk as we would like to believe or that institutional investors demand.

Globally, traditional (long-only) fund management operations are in a scramble to develop solutions for investors that include reliable risk adjusted returns within diversified portfolios – a major reason for the inclusion of alternative investments into portfolios. In fact many major funds management groups have developed or are developing hedge fund and private equity units to exploit this realization.

Traditional long only strategies with equity and bond markets are fine in bull markets but when the run is over investment managers must be smarter and more flexible to capture excess market returns.

As Robert Schulman, CEO Tremont Capital Management was recently quoted as saying in CFA Magazine - 'Recognize that at the end of the day when the environment became terrible, long only portfolios lost three to four times what hedge funds lost'

In fact our data shows that the VAN Global Index has over the past 17 yr 7 mth has never had a losing calendar year. This shows us that unconstrained talent does in fact consistently produce 'alpha' – in other words good 'hedge fund' managers perform. The term 'hedge fund' is used to describe the disparate group of ever evolving investment strategies unconstrained by restrictive institutional mandates. Traditional investment management is often also benchmarked to underperforming measures of mediocrity – hedge funds typically are pursuing above market returns or absolute returns measured against their peers.

It is armed with this realization (hedge funds as a sector out- perform long only exposures, by all major measures of risk adjusted returns) that institutional investors are adding broadly diversified allocations of hedge funds to portfolios.

However hedge fund investing like equity investing requires great research and a focused attention to the true skill and style of managers. Just like picking companies you do not necessarily want to own them all. Such tracking and research of hedge funds requires years of training and expertise.

Like equity research the work doesn't stop once you have found managers and investment strategies. The process needs to be ongoing as the risk of 'style drift' - where managers have been found to alter their stated investment style can kill an initially well constructed highly diversified exposure to hedge funds. This monitoring takes labour, skill, patience and an acute understanding of what the manager is doing in the first place.

The once broadly held perceptions of 'money laundering' or 'dodgy investment operatives' catering to high net worth individuals under secret circumstances in offshore jurisdictions soon dissipates once an understanding of the facts is made available. That is, that manager skill and the exploitation of investment anomalies via sophisticated investment strategies can occur consistently – where the manager has talent.

With ongoing demand for such performance comes the demand for understanding and the search for these facts. It has also led to what has been described as a new 'Gold Rush'. We are now seeing people thinking 'how do we get some of this action?' Surely anyone can do this? Let's launch a fund of funds and make a killing! Or 'let's 'seed' some traders and make fees we once only dreamed of!'

Most of these scenarios are going to end in tears. The reality is that managing a hedge fund is the tough end of the funds management business. The fees people are excited about, those that hedge fund manager's charge, need to be earned. Good managers, make no mistake – do not grow on trees. Sophisticated investment strategy discovery and execution is not for the novice fund manager. The discovery and exploitation of new financial anomalies is not the domain of traditional 'long-only' portfolio managers. These skills are only found at the elite end of the skill spectrum and this is what the market will learn, the hard way.

In turn these growing demands by the investing masses, on the hedge fund sector, will lead to better data collation, research and analysis. Which in turn leads to the demand for better disclosure of what these ‘guys’ are up to. Such education and understanding of what is really going on in the diverse and deep global capital markets is where the industry finds itself today.

We will see during this period of evolution of the hedge fund industry a period of increasing regulation. Interestingly this added disclosure and regulation will further legitimize the industry. As William Berg, President of Sigma Investment Management was recently quoted as saying in CFA Magazine ‘Ten years from now, the distinction between hedge funds and other stuff won’t exist’

With this newly acquired institutional conformity and credibility in turn grows institutional demand for hedge funds. Also as the veil of secrecy and confusion is removed so access by the smaller investor via superannuation, pension or wrap account structures will also increase.

So who has used this area of investment to any scale and what is the future of institutional allocations to hedge funds and alternative investments? In 2003 the Investment Management Consultants Association published in the July/August issue of ‘The Monitor’ some interesting data. Included was a review of major university endowments, corporate and public pension funds investing in alternatives. (In this report exposure to real estate is included as an alternative investment.)

The top 15 USA University endowments had allocations to hedge funds of 14%- private equity 17% and real estate 6%. An average aggregate total of a staggering 37%! The 12 Corporate pension funds listed showed an average allocation to alternative investments of 13% - at the time representing some A\$185 billion FUM. And finally for 17 Public Pension Funds an average aggregate allocation to alternatives of 12 % - this group representing at the time some A\$742 billion in FUM.

George Van, the founder of the VAN Group has recently published a paper (August 2005) on the growth prospects of the demand and sustainability of the hedge fund industry 2005-2015. This paper validates the growing allocations to hedge funds from USD\$ 1 Trillion today to approximately USD\$ 4 Trillion by 2013.

At ‘VanMac’ we recommend investors be allocating up to 25% to hedge funds, private equity and real estate in equal weightings as a starting point for all portfolios for the following three reasons.

The first is access to superior absolute performance. The second reason is the fact that alternative investments have lower correlations with traditional equity and bond markets. Third, alternative investments typically provide access to top investment talent and proprietary strategies. I say typically as the real key to alternative investing is to know what

you are buying and to have the courage to seek out specialist consultants and research that will enable you to make objective educated investment decisions.

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