
The Current and Future State of the Hedge Fund Industry

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The Hedge Fund Industry

**Past Trends,
Present Challenges,
Future Outlook**

Hedge Fund Industry – Past Cycles of Renaissance & Wreckage



CYCLE 1:	1949 - A. W. Jones launched	1960's - First "Golden Era" (Buffet Partners launched)	1969-70 - End of the "Go-Go" Years 1973-74 - Bear Market	1970's - Dark Ages
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CYCLE 2:	1980's - Second "Golden Era" (Tiger; Tudor; Odyssey Partners launched)	1980's - Bull Market	1987 - Black Monday 1989 - UAL deal collapses 1989 - RTC created	1990 - Market Correction
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CYCLE 3:	1991-92 - Recovery	1992-93 - Age of the "Masters of the Universe" (The Carry Trade; ERM Convergence; Soros vs. Bank of England)	1994 - Rate Hikes, Mexico Currency Crisis (LTCM launched)	1994 - The Year of "Mere Mortals"
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Hedge Fund Industry – Past Cycles of Renaissance & Wreckage



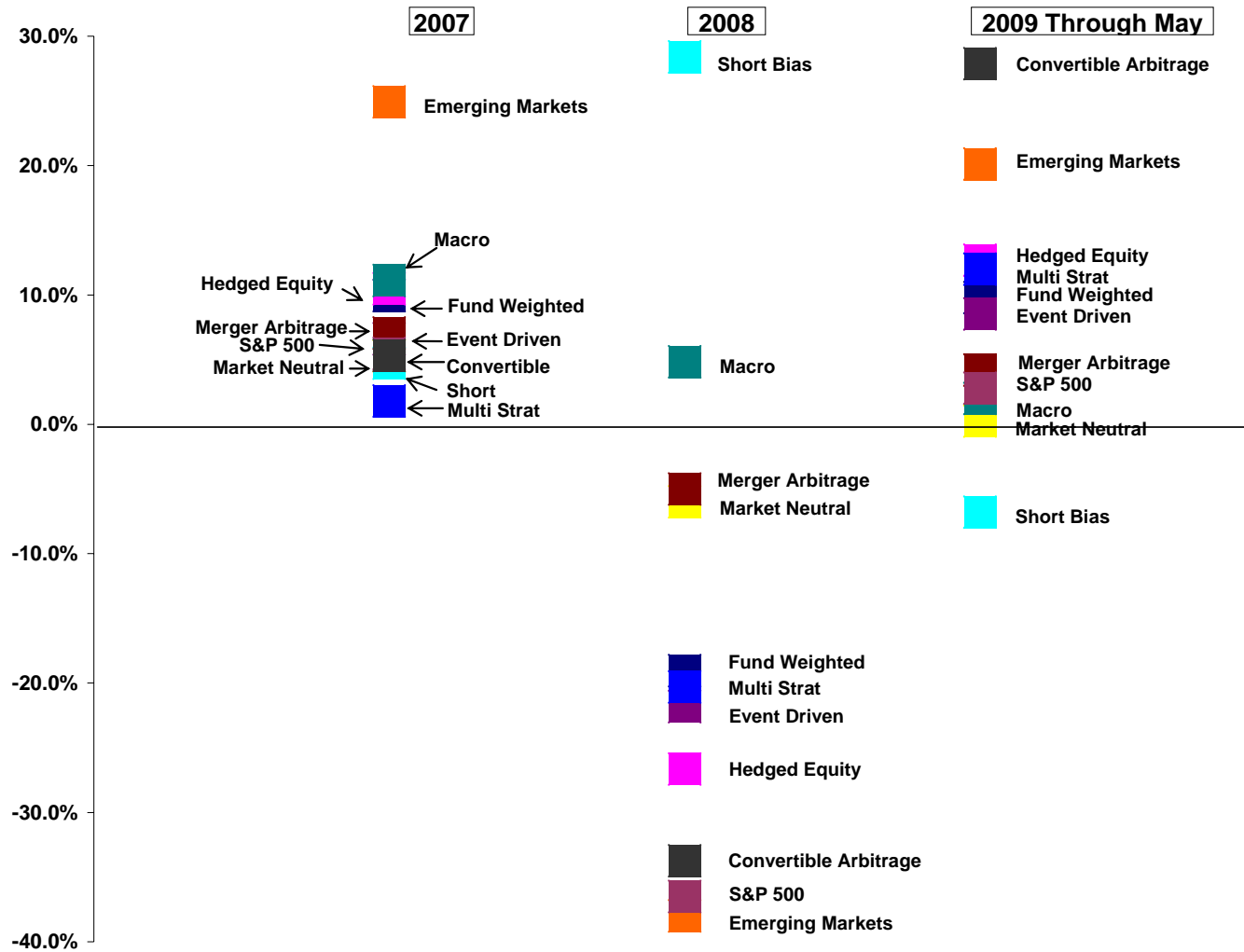
CYCLE 4:	1995-97 - Bull Market	1997- Apex of the "Third Golden Era"	1998 - Russian Default (LTCM collapses)	1998 - The Year of the Margin Calls
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CYCLE 5:	1999 - Bull Market continues	1999 - Bull Market continues	2000 - Dot.com Bubble Bursts	2001-02 - Bear Market
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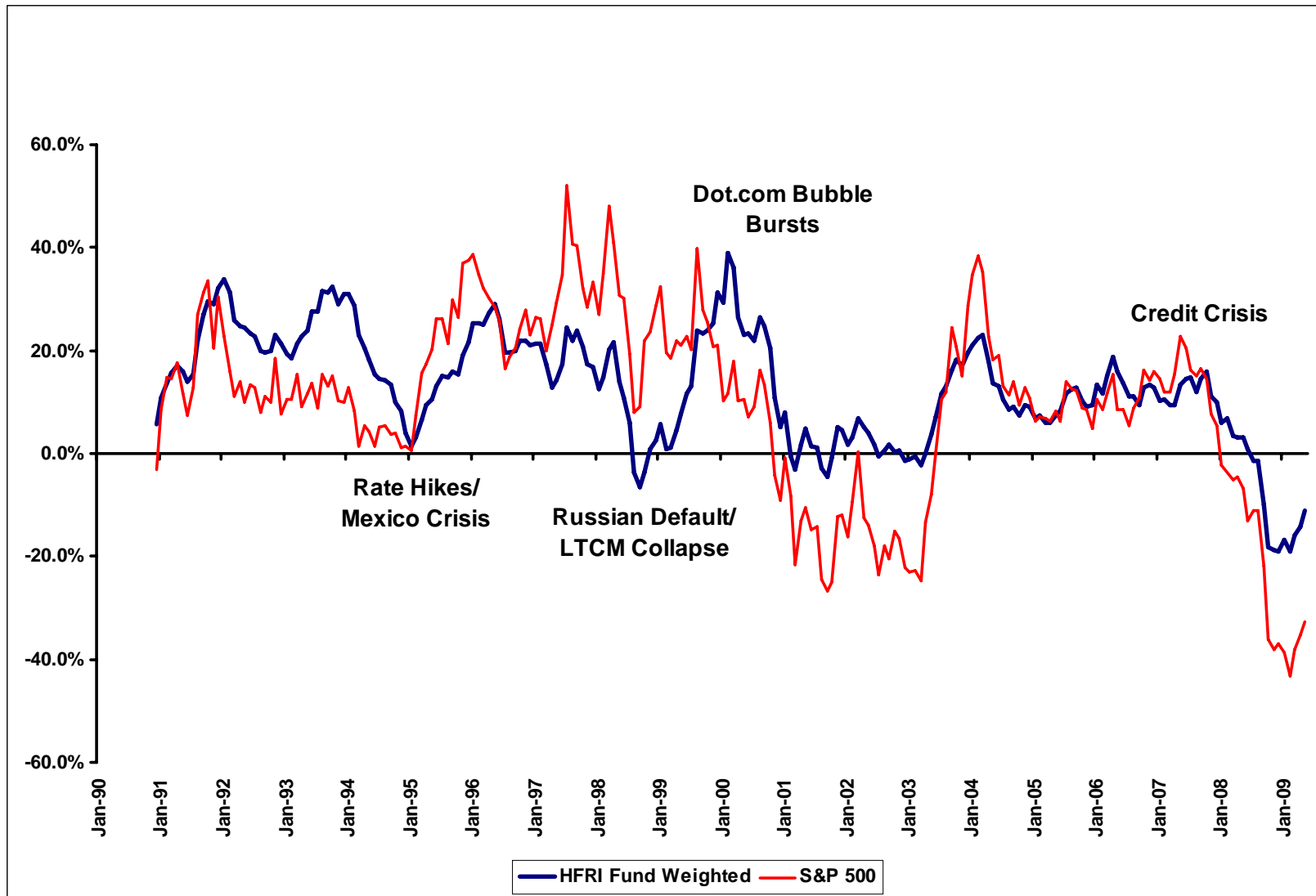
CYCLE 6:	2003 - The "Era of Institutionalization" begins	2004-07- Volatility Vanishes (Hedge Fund AUM doubles from \$1T in '04 to \$2T in '06)	2008 - Credit Crisis The Year of the "Gate" (Hedge Fund AUM peaks at \$3T)	2009 - Retrenchment (Hedge Fund AUM falls to \$1.7T)
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CYCLE 7:	2009-10?	?????	?????	?????
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Hedge Fund Returns – Recent Reversals & Rebounds



HFRI Fund Weighted & S&P 12 Month Rolling Returns (1/1/90-5/31/09)



Hedge Funds – Investment Themes & Challenges – 4Q '08

- Deflation Nation, the “D” Word, and Beyond
- Global Contagion is Ragin’
- Cash is King
- Delever or Die
- Ride the Short Side
- P/Es? Puhleeeez!
- Gold is Precious; Oil Tanks



Hedge Funds – Investment Themes & Challenges – 2Q '09

- Reflection Nation, the “I” Word, and beyond
- “Green Shoots” Go Global
- Cash is Trash
- Junk is Jumpin’
- Get Shorty
- P/Es? Yes, please!
- Oil Floats up a Slippery Slope



Hedge Funds – Investment Themes & Challenges – 2010? And Beyond?

- **Opportunities for Trend Followers**
 - Credit Cycle
 - Commodity Cycle
 - Economic Cycle
 - Liquidity Cycle
- **Opportunities for Contrarians**
 - Credit Cycle
 - Commodity Cycle
 - Economic Cycle
 - Liquidity Cycle



Illustration Credit: H. L. Schwadron

Hedge Funds – Investment Themes & Challenges – 2010? And Beyond?

- **Opportunities for Bottom Up Stock Pickers**
 - Value trends
 - Growth trends
 - US vs. Non US
- **Opportunities for Arbitrage**
 - M&A
 - Convertibles
 - Fixed Income
- **Opportunities for Niche Strategies**
 - Distress
 - Finance



Illustration Credit: H. L. Schwadron

Hedge Funds – Investment Themes & Challenges – 2010? And Beyond?

- All of the above
- None of the above
- Risks and potential dislocations
- Don't forget that cycle of leverage/exposure/concentration
 - Availability of financing
 - Supply of capital
 - Impact of regulation and market constraints



Illustration Credit: H. L. Schwadron

The Systemic Role of Hedge Funds & the Rationale for Regulation

<i>Who caused the latest Crisis?</i>	<i>Who will get us out of this Crisis?</i>	<i>Who will cause the next Crisis?</i>
• Hedge Funds	?????	?????
• Banks	?????	?????
• Investment Banks	?????	?????
• Broker/Dealers	?????	?????
• Subprime Lenders	?????	?????
• Finance Companies	?????	?????
• Fannie Mae; Freddy Mac	?????	?????
• Sovereign Wealth Funds	?????	?????
• Rating Agencies	?????	?????
• Borrowers	?????	?????
• Mutual Funds	?????	?????
• All of the above	?????	?????
• None of the above	?????	?????
• Central Banks	?????	?????
• Politicians	?????	?????
• Capitalism	?????	?????

The Investment Role of Hedge Funds & Investor Preferences

- **Investor objectives**
 - Stability of returns vs. “Alpha”
 - Tolerance for volatility
 - Diversification vs. “Beta”
- **Liquidity**
 - Redemption terms – real vs. restricted
 - Underlying portfolio constraints – expected vs. unexpected
- **Disclosure**
 - Exposures and risk characteristics
 - Position details – meaningful vs. intrusive

The Investment Role of Hedge Funds & Investor Preferences

- **Costs and alignment of interests**
 - Management fees
 - Incentive fees
 - Expenses
 - Terms
- **Due Diligence**
 - Registration; reporting; monitoring
 - Conflicts of interest
 - Custody and safeguards
 - Fraud

From Aristocracy to Democracy

The Democratization of Alternative Strategies

Independence Day: Hedging For The People

A short history of alternative strategies in mutual funds.

The Catalyst

- **1997 repeal of “Short-Short” Rule**
 - First mutual fund practitioners initiate more hedging
- **1998 creation of first dedicated “Hedged Mutual Funds”**
 - Universe of “Hedged Mutual Funds” begins to grow

Seeds of Public Policy

- **SEC Hedge Fund Rutable – 2003**
- **A commissioner leads comments, now an Obama advisor**

The Future is Now

- **Markets, sponsors and investors drive innovation**
- **Rapid growth in AUM and variety of alternative mutual funds and structures**

Definition Of Hedged Mutual Funds

- Building blocks of liquid alternatives.

Definition: “Hedged Mutual Funds”

- Open-end investment companies registered under the Investment Company Act of 1940 which implement their underlying portfolios using the strategies or investments below on an ongoing, regular or periodic basis:

Strategies

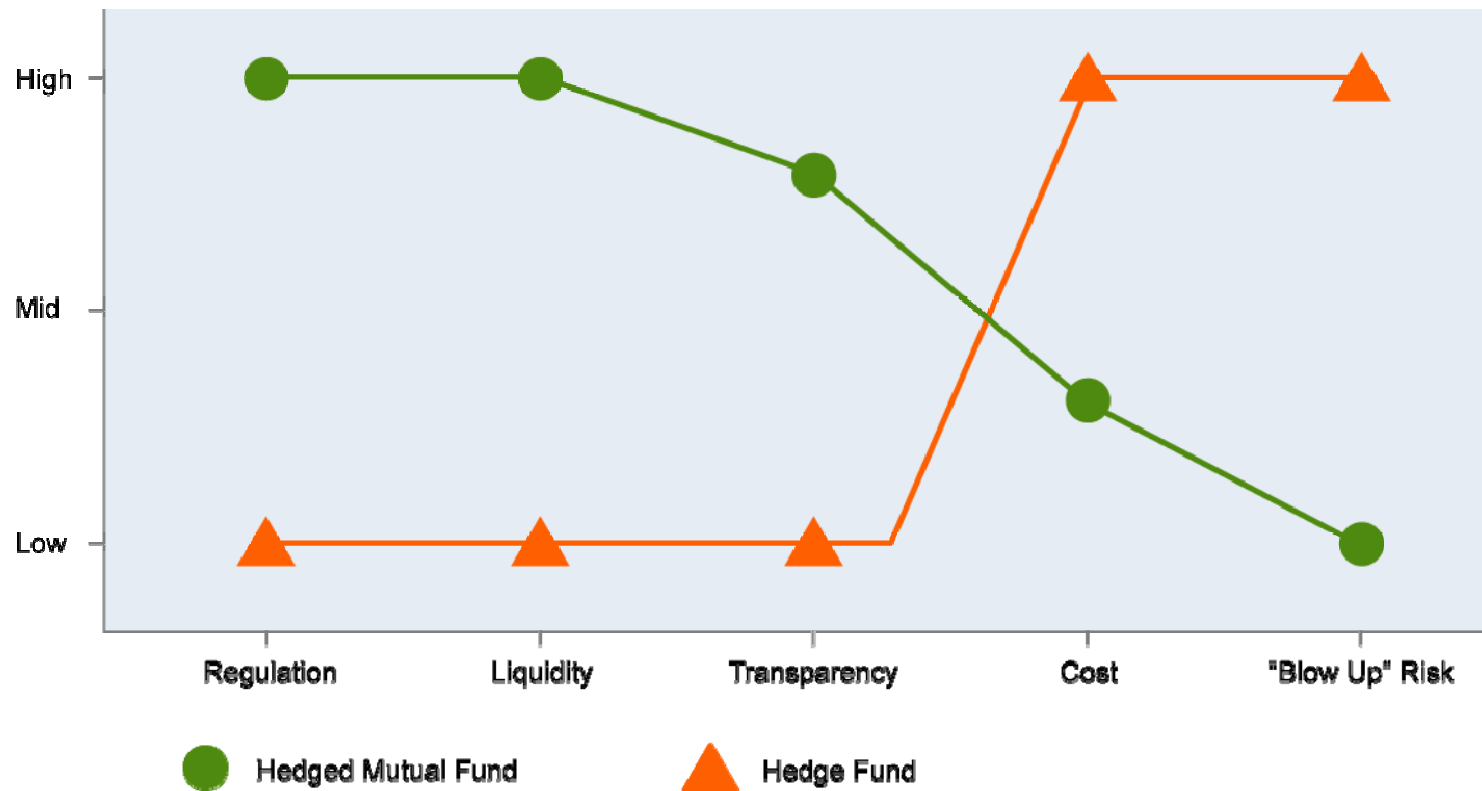
- ***Long and short*** position in various securities;
- ***Hedging***, including options, futures, derivatives, or similar instruments; (however, this excludes foreign or global equity or bond funds, long-only by policy, that hedge foreign currencies back into the U.S. dollar);
- ***Alternative investment strategies***, which include commodities or commodities-linked investments; leverage; derivatives; illiquid, private placement, or distressed securities; and investment instruments or techniques not generally correlated to major market indices; (however, this excludes equity or bond funds that are long-only by policy and do not utilize alternative investment strategies or are long-only via derivatives); or

Additional Tools

- In addition to open-end mutual funds:
- Registered Closed-end Funds, Exchange Traded Funds or Exchange Traded Notes which may use long and short positions, hedging, or alternative investment strategies.

Hedged Mutual Funds Vs. Hedge Funds: Kinder, Gentler

- Hedged mutual funds provide access to alternative strategies with lower costs, more oversight, and better liquidity and transparency than hedge funds.



Regulatory Safeguards: “Hedged Mutual Funds”

Independent Custody

- Independent bank custodian required
- “Segregated Account” requirement (short sales)
- Tri-party agreement

Limitations on Leverage

- “Senior Securities” rule (as interpreted)
- 3:1 Asset coverage, or full collateral

Liquidity & Daily Pricing

- Requirement for daily, “fair” pricing (FASB 157, etc.)
- 15% maximum illiquid securities
- Limited use of illiquid securities in face of daily liquidity
- Implicit limitations on derivatives

Lower Costs

- Restrictions on incentive fees
- “Qualified Client” Rule
- Fulcrum fees as option

Alternative Strategies In Mutual Funds

- The variety of hedged mutual funds continues to expand.

Principal Categories of Hedged Mutual Funds

Hedged Equity

Long/Short Bonds

Futures, Commodities & FX

Multi-Strategy Funds

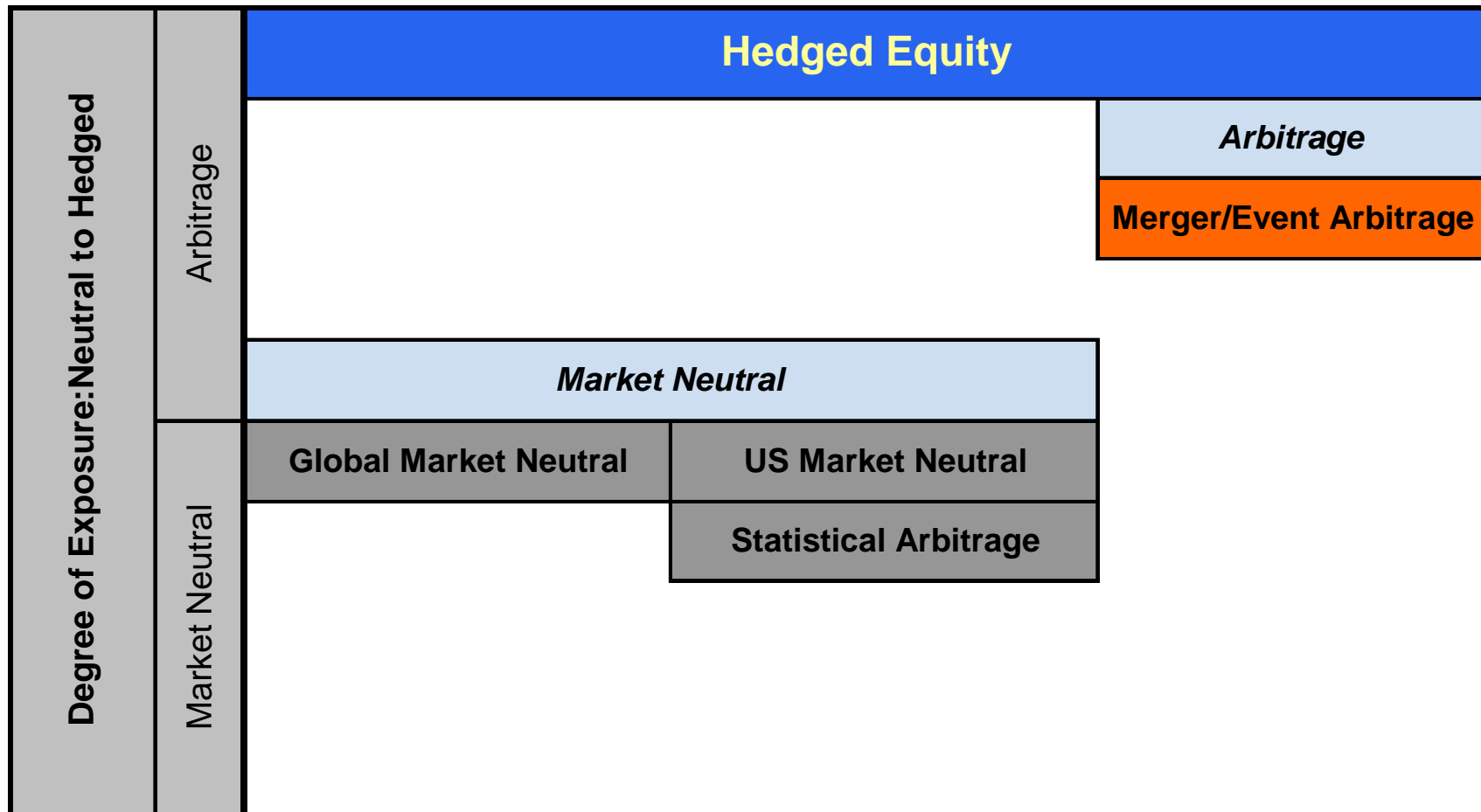
Hedged Mutual Funds: Equity-oriented

- Equity-oriented alternative strategy mutual funds encompass a variety of longs, shorts, leverage and options

Degree of Exposure:Hedged to Long	Leveraged Long	Hedged Equity		
		<i>Leveraged Index</i>		
		Leveraged Global Index	Leveraged Market Index	
			Leveraged Sector Index	
	(Lower) Long Exposure (Higher)		<i>Long/Short US Equity</i>	
			Long Bias	
		<i>Long/Short Global Equity</i>	Net 100	
		Global Equity with Overlays	Equity with Overlays	<i>Option Strategies</i>
		Hedged Global Equity	Hedged Equity	Option Hedging
			Sector Hedged	
		Highly Hedged Global Equity	Highly Hedged Equity	Option Income

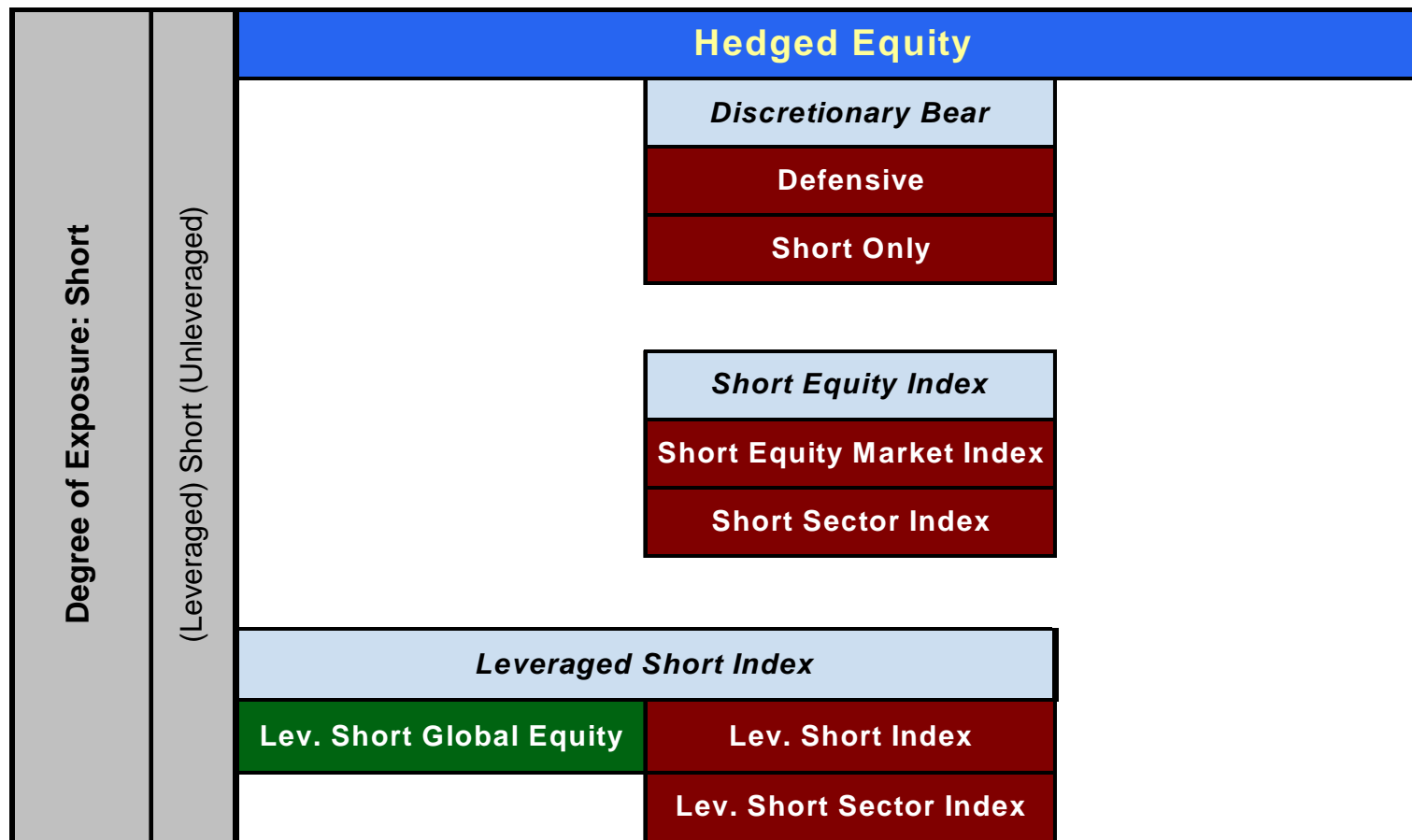
Hedged Mutual Funds: Merger Arb/Market Neutral

- Equity oriented absolute return strategies include merger arbitrage and market neutral



Hedged Mutual Funds: Short Equity

- Short equity mutual funds range from “bear” and discretionary short funds
- to a variety of leveraged and un-leveraged short index funds.



Hedged Mutual Funds: Long/Short Bonds

- The variety of long/short fixed income strategies available through mutual funds has recently increased.

Long/Short Bonds			Leveraged	Degree of Exposure
	Leveraged Index			
	Leveraged Bond Index			
<i>Long/Short Bonds</i>			Long/Short	
Convertible Arbitrage	Long/Short US Bonds	Long/Short Global Bonds		
	Absolute Return			
<i>Short Bonds Index</i>			Short	
	Short Rates	Short Credit		

Hedged Mutual Funds: Futures, Commodities And Fx

- Long/short currency, managed futures and global macro are recent entries
- in the universe of hedged mutual funds.

Futures, Commodities & FX			Active	Active - Passive - Short
<i>Active</i>				
Overlay	Macro	Managed Futures & FX		
			Passive	
<i>Commodities</i>				
Commodity Index	FX & Financials	Metals		
			Short	
<i>Short Futures Index</i>				
Short Commodities	Short Financials	Short Metals		

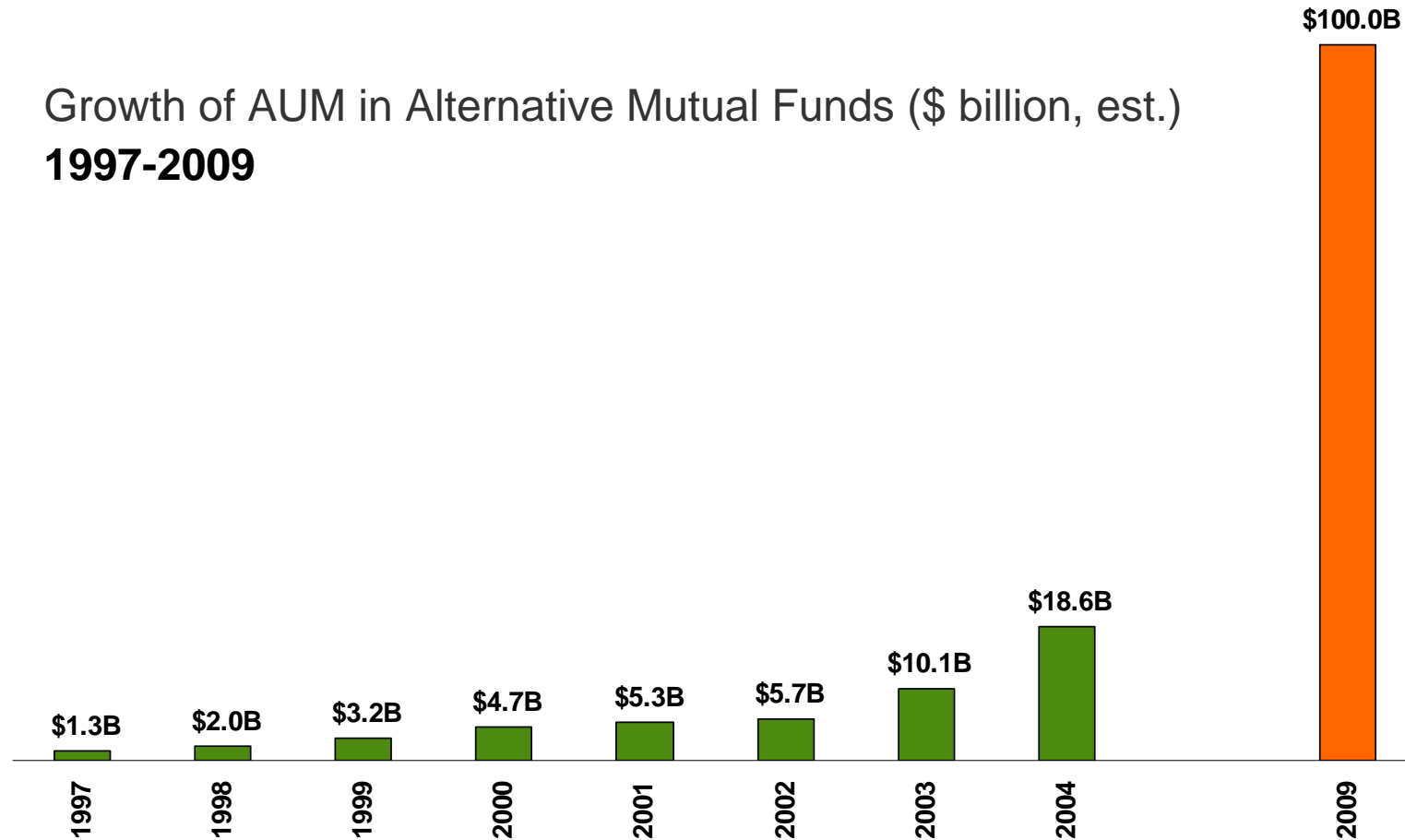
Hedged Mutual Funds: Multi-strategy

- Multi-strategy funds can offer a turnkey approach to asset allocation and alternative strategies.

Multi-Strategy Funds			Alternative & Traditional	Mix: Alternative/Traditional
<i>Multi-Asset Hedged</i>				
Balanced Hedged	US Multi-Asset Hedged	Global Multi-Asset Hedged		
			Alternative Only	
<i>Multi-Alternative Strategy</i>				
Multi-Fund	Multi-Manager	Alt. Index Sampling		

Growth Of Hedged Mutual Funds

- Growth of AUM in Alternative Mutual Funds (\$ billion, est.)
- **1997-2009**



Attracting A Growing Variety Of Investors, Managers

Who is driving the current and future marketplace for hedged mutual funds?

Investors: Individuals, HNW, Family Offices

- Once exclusive, now broadly available
- No longer just for institutions and HNW
- “Alternatives for all”... who seek to move beyond limitations of traditional investments

Investment Professionals

- **Manufacturers:** broaden offering to investors, diversify revenues
- **Advisors:** enhance investor choices and portfolio management flexibility
- **Managers of alternatives:** a liquid tranche for practitioners

Fiduciaries, Foundations, Endowments

- Seeking greater liquidity than private funds
- Preference for regulated instruments

Retirement Plans

- **DC:** diversify the participant menu
- **DB:** more investment options for increasing number of plan fiduciaries
- **Non-qualified:** alternatives with daily pricing

Opportunity For Investors And Professionals

- Increasing choices, flexibility and applications.

Greater Choice

- Innovation with investor protection
- Widen investment menu with alternatives

Additional sources of potential returns

- Broader array of strategies and instruments
- Absolute vs. relative returns
- Complement to traditional assets

More tools for risk management

- Hedging as a risk management tool...
- To potentially reduce volatility
- For potential downside protection

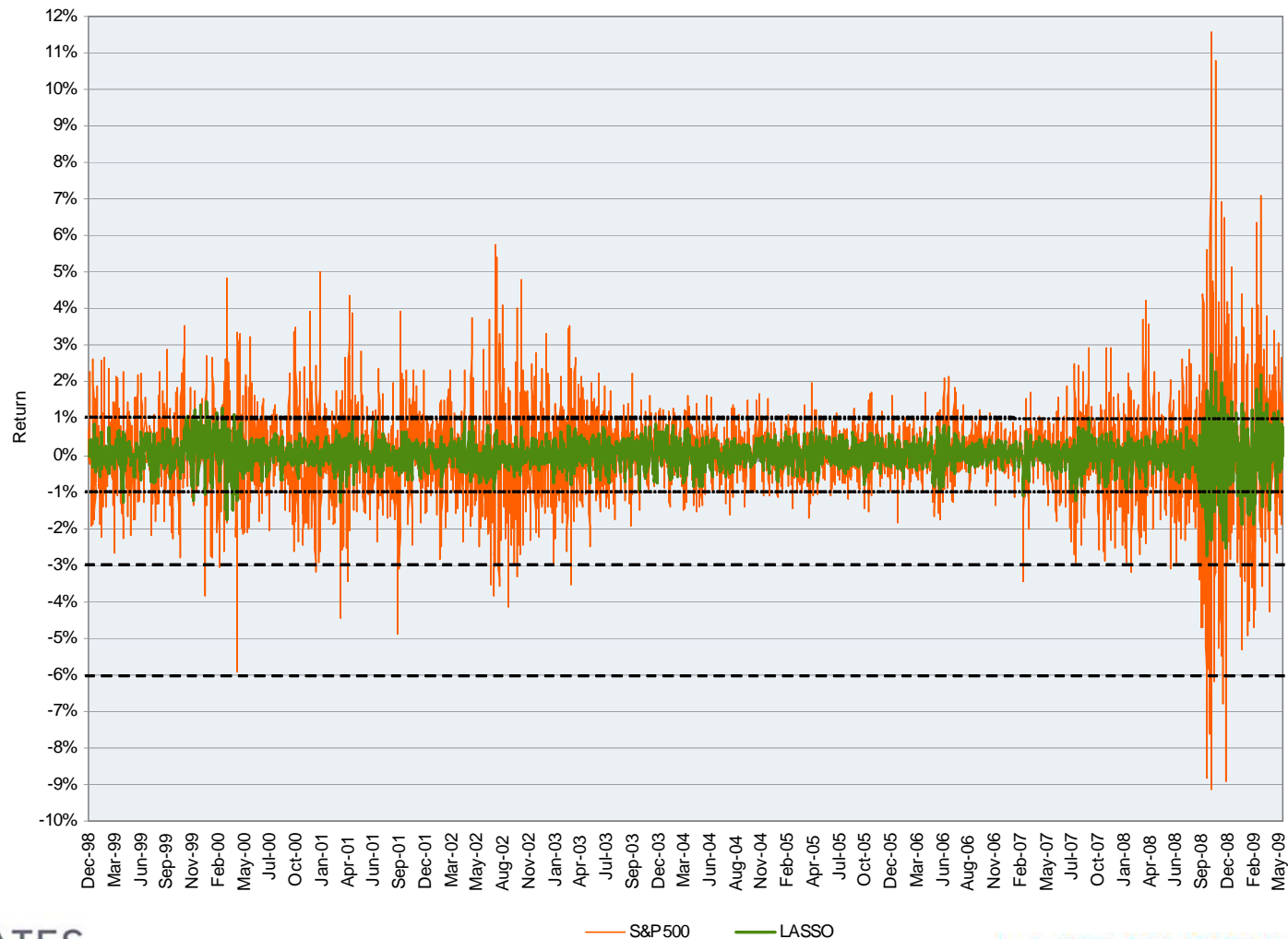
Enhance diversification

- Potential lower correlation to traditional assets
- Greater variety of performance and risk characteristics
- Potentially enhance risk-return profile of diversified portfolio
- New portfolio solutions for the “post crisis” era

Case Study In Risk Management: Daily Volatility

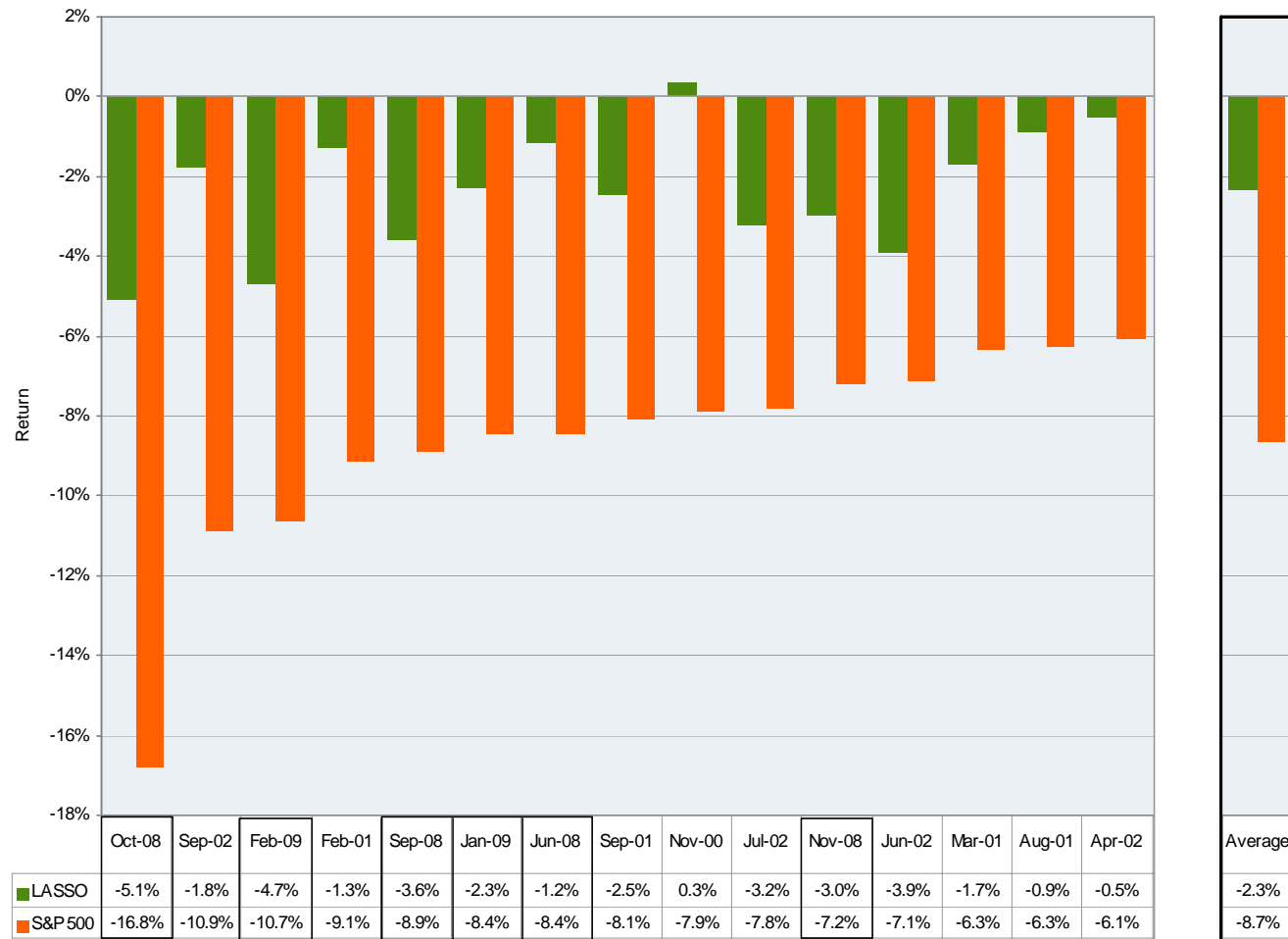
- Daily Returns: LASSO Composite (net) vs. S&P 500
Inception of hedged mutual fund portfolio from 12/31/98 through 5/31/09

See Explanatory Notes and Disclosures



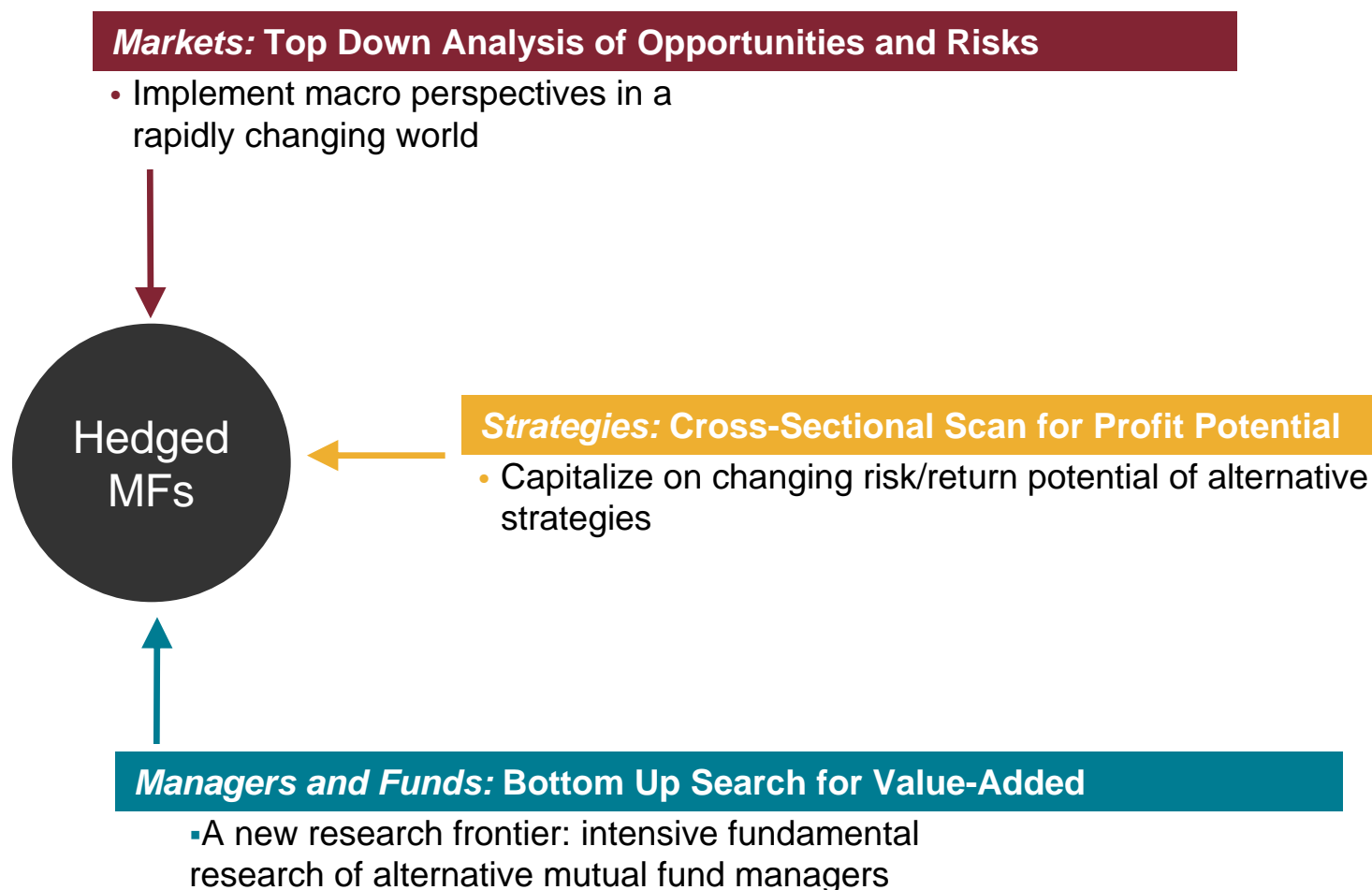
Case Study In Risk Management: Monthly Drawdowns

- Performance of LASSO composite during the 15 worst months for the S&P 500
Inception of LASSO from December 31, 1998 through May 31, 2009
- See Explanatory Notes and Disclosures



Hedged Mutual Funds: Flexible Management Of Opportunity

- Find and implement opportunities across multiple dimensions in real time.



Hedged Mutual Funds: Historic Outperformance

- “...the first comprehensive examination of a new category of mutual funds.”¹

Long-Term Academic Study of Hedged Mutual Funds

- **Naik, Agarwal and Boyson, 2007. “Hedge Funds for Retail Investors? An Examination of Hedged Mutual Funds.” Hedge Fund Centre, London Business School, Working Paper.**

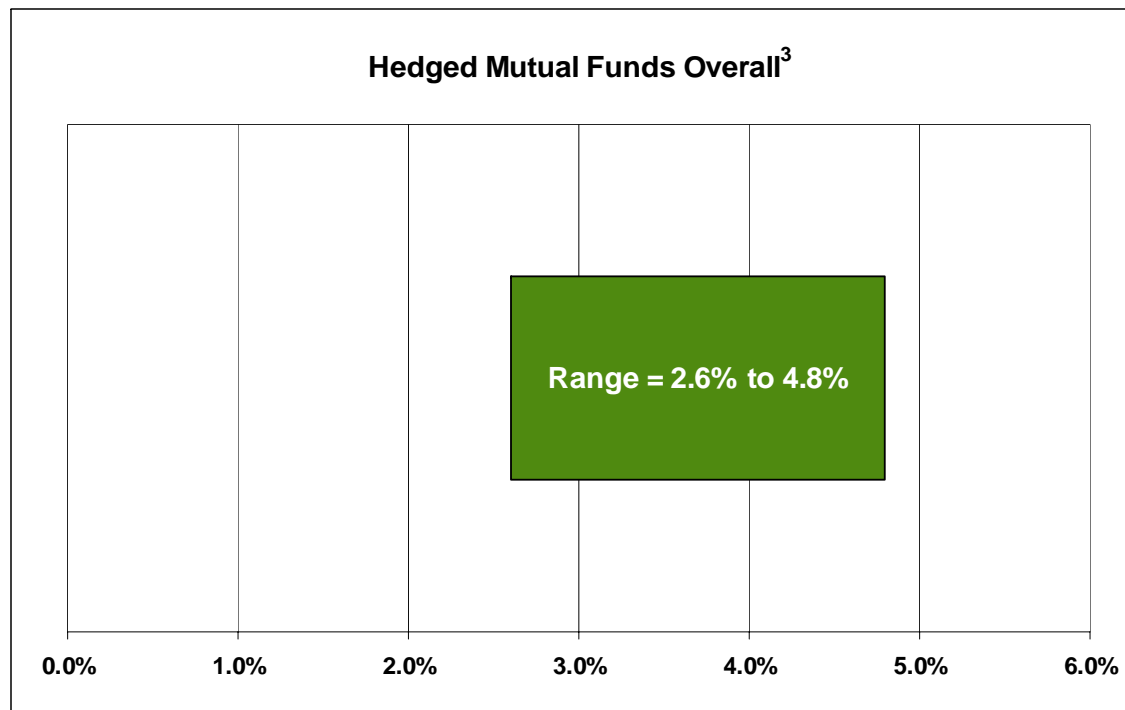
“...hedged mutual funds will play an increasingly important role in the field of investment management as they provide access to hedge-fund-like strategies with the fee structure, liquidity, and regulatory requirements of mutual funds.”²

Hedged Mutual Funds: Outperformance Via Flexibility

- Access to new tools can help manager performance.

“Strategy Hypothesis” and Findings

- HMFs have greater flexibility in trading and investment strategies.²
- “Thus, HMFs are able to capture alpha on both the long and short side...”²
- As a result, HMFs outperform traditional mutual funds “by as much as 4.8% per year” “despite higher fees and turnover.”²

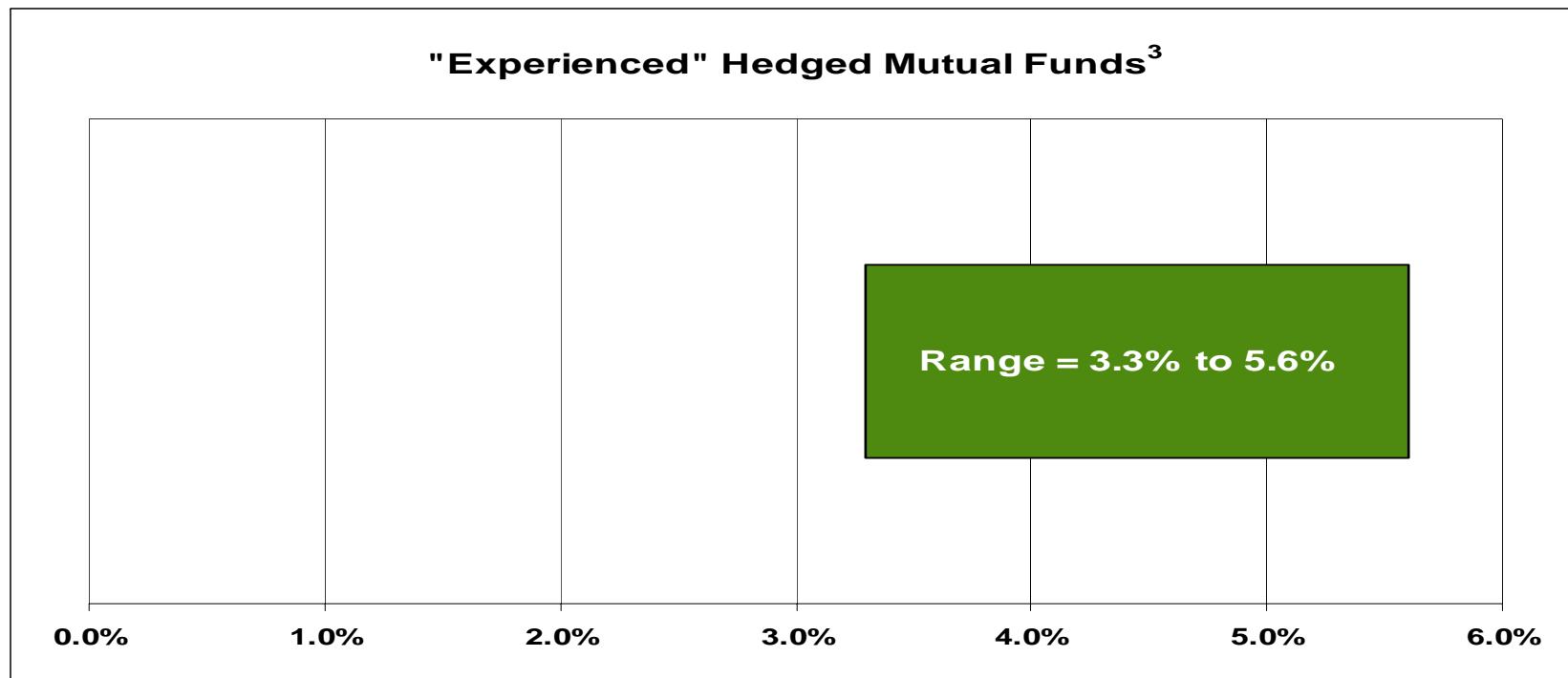


Hedged Mutual Funds: Historic Outperformance

Experience makes a difference.

“Skill Hypothesis” and Findings

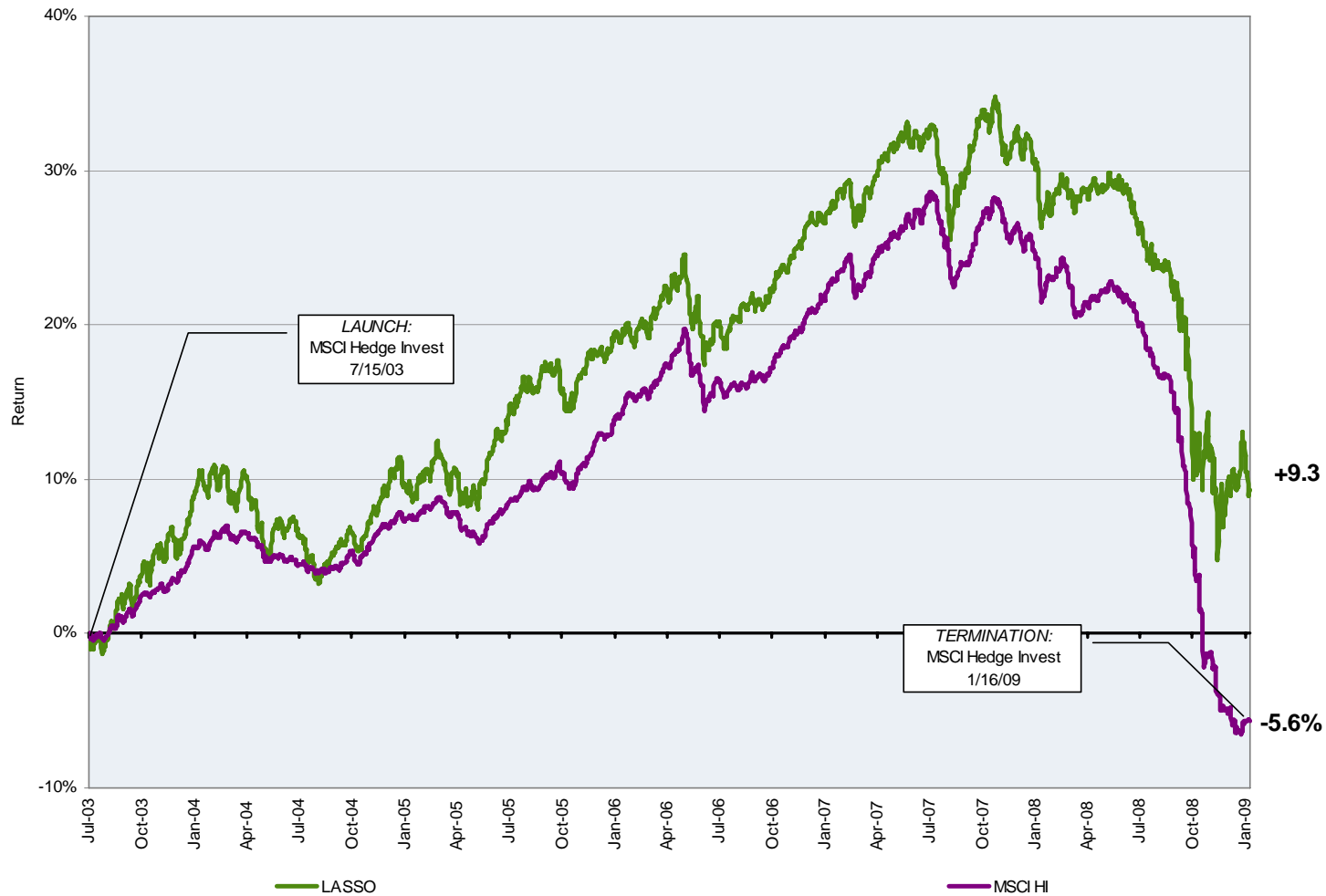
- Half of HMF managers in study have prior or concurrent experience managing a hedge fund.²
- “HMF managers with hedge fund experience outperform those without.”²
- Experienced HMF managers outperform other HMF managers by “as much as 4.1% per year net-of-fees”² and “are persistent winners”.¹



Lasso Cumulative Daily Returns

- LASSO Composite (net) vs. MSCI Hedge Invest Index
- From July 15, 2003 through January 16, 2009

See Explanatory Notes and Disclosures



Hedged Mutual Funds Vs. Daily Valued Hedge Fund Indices

- Darwin revisited: outlasting the benchmarks.

Daily Valued Hedge Fund Indices: Discontinued

- **S&P Hedge Fund Index**

- Launched 09/30/2002
- Terminated due to custodial breakdown, 06/30/2006

- **Dow Jones Hedge Fund Balanced Index**

- Launched 12/31/2004
- Suspended due to leverage and pricing issues (distressed and converts), 10/31/2008

- **MSCI Hedge Invest Index**

- Launched 07/15/2003
- Terminated due to lack of product related revenue, 01/16/2009

- **FTSE Hedge Fund Index**

- Launched 07/01/2004
- Terminated due to decline in number of underlying funds, 03/31/2009

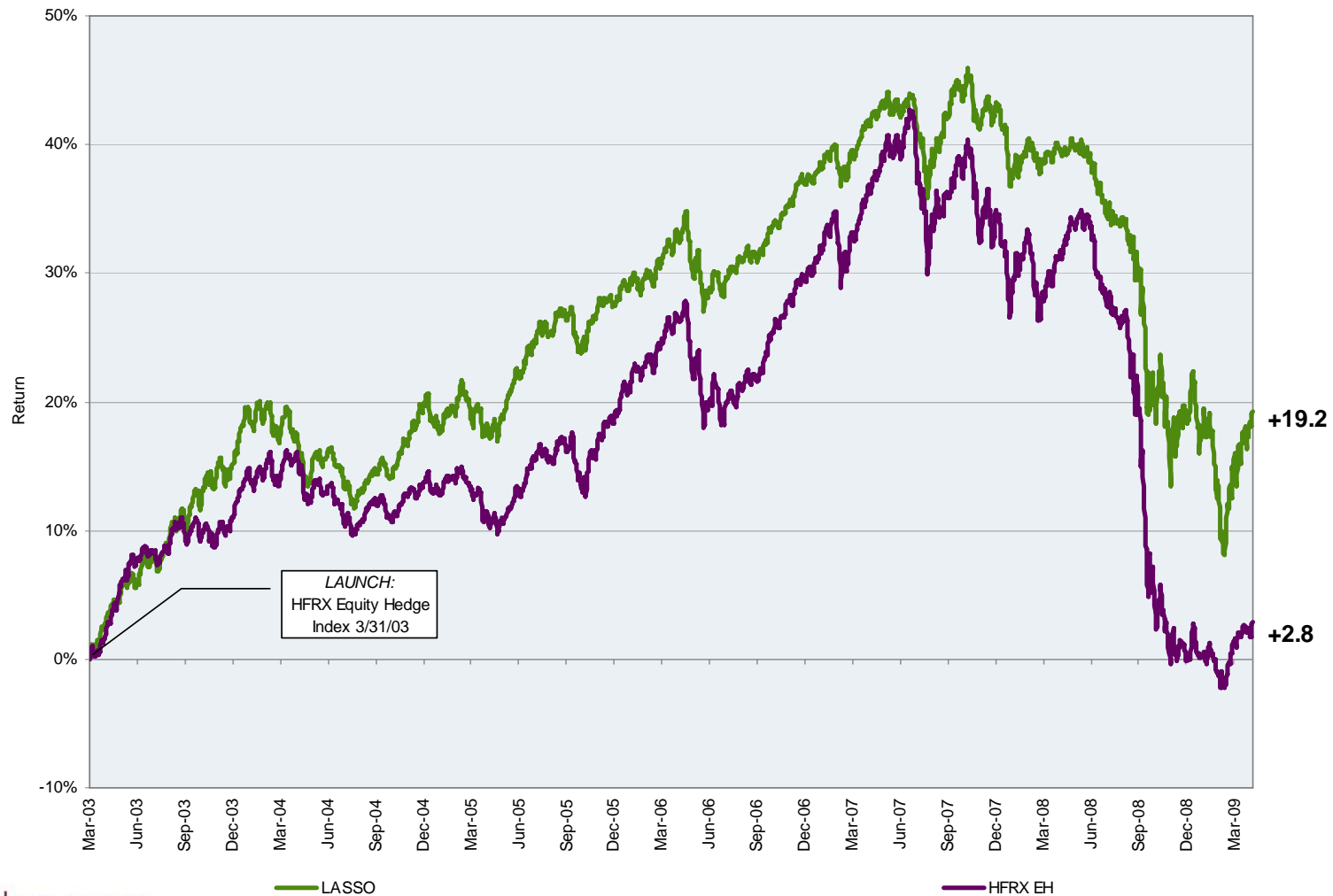
Daily Valued Hedge Fund Indices: Continuing

- **HFRX Equity Hedge Index**

- Launched 03/31/2003

Lasso Cumulative Daily Returns

- LASSO Composite (net) vs. HFRX Equity Hedge Index
Inception of HFRX Equity Hedge from March 31, 2003 through April 30, 2009
See Explanatory Notes and Disclosures



A New View Of Liquidity

- Match portfolio securities with delivery structure.

		Portfolio Securities	
		Liquid	Illiquid
Delivery Structure	Liquid	Mutual Fund	Limited Use In Mutual Fund
	Illiquid	Hedge Funds: Risk of "Gate"	Hedge Funds

Explanatory Notes And Disclosures

- LASSO® Long and Short Strategic Opportunities®
Explanatory Notes and Disclosures—Composite Performance of Actual Accounts
- **The preceding performance is a composite of all discretionary, fee-paying accounts managed by Lake Partners, Inc. utilizing the LASSO Long and Short Strategic Opportunities strategy. Performance is weighted by account size and time-weighted for each performance period, and reflects the reinvestment of dividends and other earnings. Performance is net of all fees and expenses, including: mutual fund management fees and expenses, portfolio management fees of Lake Partners, Inc., and brokerage, administrative and custodial costs.**
- All securities investing involves the risk of loss. Past performance is no guarantee of future results. There can be no assurance that the LASSO Long and Short Strategic Opportunities program can meet its stated objectives.
- **Actual results of individual accounts and products utilizing the LASSO strategy will vary due to client cash flows, timing of implementation, different custodians, the availability of underlying mutual funds, regulation and other factors. Small accounts may perform below the composite due to the greater impact of transaction costs.**
- **Performance has been verified for the period from January 1, 1999 (inception) through December 31, 2005 by Eisner LLP. Lake Partners, Inc. prepared and presented performance for this verification in compliance with the Global Investment Performance Standards (GIPS®). A copy of the verification report is available upon request.**
- LASSO differs substantially from the market indices, which are included for comparison purposes only.
- **The S&P 500 is an unmanaged, capitalization-weighted index of the common stocks of 500 widely held U.S. companies. It does not include fees or expenses. Direct investment in an index is not possible. (S&P 500 is a registered trademark of The McGraw-Hill Companies, Inc.) LASSO differs substantially from the S&P 500, which is used for comparison purposes as a widely recognized measure of U.S. stock market performance. While the returns of LASSO are somewhat correlated to the index, LASSO through its underlying funds may invest in different stocks and in different proportions than in the index.**
- **The MSCI Hedge Invest Index was designed to be both investable and to reflect the overall structure and composition of the hedge fund universe. The index included funds with weekly liquidity from a wide range of strategies available on a platform administered by an affiliate of Société Generale designed to be licensed for tradable investment products. As of December 2008, the index consisted of 119 funds. (The index is a service mark of MSCI Barra.) The index ceased publication in January 2009. • LASSO differs substantially from the MSCI Hedge Invest index, which is used for comparison purposes as a daily-valued measure of hedge fund performance. LASSO is comprised of “hedged mutual funds,” a limited universe of mutual funds that use short-selling, hedging and other hedge-fund-like strategies. The index used a sampling from the broad hedge fund universe, which contains more funds and strategies than**

Explanatory Notes And Disclosures

- available through hedged mutual funds. The index is net of fees and expenses of the underlying managers. The index reflects incentive fees charged by underlying managers, a type of fee generally not charged by the mutual funds in LASSO due to regulatory restrictions. The index does not reflect a “fund-of-funds” management fee, which is reflected in LASSO performance. Direct investment in an index is not possible. Commingled pools based on the index were available to investors, subject to additional fees and expenses.
- HFRX Equity Hedge Index (“HFRXEH”) is part of the HFRX series of hedge fund indices, published by Hedge Fund Research, Inc., which are designed to reflect the *daily* performance of a variety of hedge fund strategies. The indices include funds that meet the screening criteria of Hedge Fund Research, Inc., including a 24-month track record, \$50 million under management, and are open to new investments. The HFRXEH is designed to be both investable and to reflect the overall structure and composition of the equity long/short hedge fund universe. • LASSO differs substantially from the HFRXEH, which is used for comparison purposes as a daily-valued measure of hedge fund performance. LASSO is comprised of “hedged mutual funds,” a limited universe of mutual funds that use short-selling, hedging and other hedge-fund-like strategies. In contrast, the HFRXEH uses a sampling from the broad equity long/short hedge fund universe, which contains more funds and strategies than available through hedged mutual funds. In addition, hedge funds in the index may also use a greater degree of leverage and illiquid securities than permitted for mutual funds. Nevertheless, the performance of LASSO and the HFRXEH exhibit a significant level of correlation, reflecting the emphasis of long-short equity strategies in the universe of hedged mutual funds. • The index is net of fees and expenses of the underlying managers, including incentive fees, a type of fee generally not charged by the mutual funds in LASSO due to regulatory restrictions. The index does not reflect a “fund-of-funds” management fee, which is reflected in LASSO performance. Direct investment in the index is not possible. Commingled vehicles based on the index are available to investors, subject to additional fees and expenses.
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Regulatory Developments

How Might Regulatory Reform Affect You?

- Proposals to require hedge fund advisers to register under the Advisers Act
- Proposals to require hedge funds themselves to register under the Investment Company Act of 1940
 - Hedge Fund Transparency Act

What do the Regulators Want?

- Ability to impose recordkeeping and reporting requirements on fund advisers and on hedge funds themselves, so that the regulators can assess whether a particular fund poses systemic risks.

Risk of a Hedge Fund's Classification as a "Tier 1 FHC"

- Entities that pose a threat to financial stability due to their size, leverage and interconnectedness may be deemed "Tier 1 FHCs." As such, they would be regulated by the Federal Reserve Bank and subjected to Bank Holding Company regulation.
- Classification as a Tier I FHC would likely be disastrous for any hedge fund.

Proposed Regulation of Short Selling

- Proposal to reinstate the uptick rule
 - The abolition of the uptick rule two years ago has been followed by severe market volatility, but opinions differ as to whether there was a causal relationship
 - SEC has proposed two variations on the old uptick rule and three variations on a circuit breaker rule.

Proposed Regulation of the Derivatives Markets

- Hedge funds may be subject to new prudential supervision and regulation because their use of derivatives may create large exposures to counterparties.
- Proposal by the White House to bring OTC derivatives under a comprehensive regulatory regime for the first time to contain systemic risks.
- Require clearing of all standardized OTC derivatives through regulated central counterparties.
- Subject all OTC derivatives dealers to prudential supervision and regulation.

Proposed Amendments to the Custody Rule

- Registered advisers would be required to undergo an annual surprise examination by an independent public accountant.
- If an affiliate of the adviser serves as custodian of the assets of the adviser's clients, an independent accountant would be required to render an opinion about the custodian's controls.
- Or the SEC may simply require advisers to custody assets with independent custodians.

New OCIE Initiatives

- OCIE examiners will receive enhanced training in order better to detect fraud and understand complex financial products.
- OCIE will request more information from advisers before arriving on site so that the examiners can better assess the risk profile of the adviser.

OCIE Red Flags

- Use of affiliate for custody
- No independent audit
- Audit by obscure firm
- Dire financial condition of the adviser or its principals
- Aggressive self-promotion
- Unusual activity in intercompany accounts
- Overlap between registered and unregistered entities creates possibility of concealing fraudulent activity in the unregistered entity

Enforcement Activity

- 22 enforcement actions against hedge funds in 2008
- Dramatic increase over prior years

Enforcement Priorities

- Rumor mongering
- Insider trading
- Portfolio pumping
- Allocation
- Valuation

New Opportunities – TALF Funds

- Funds designed to invest in portfolios of securities that are eligible for and utilize term financing under the Term Asset-Backed Securities Loan Facility.

International Developments

- EU's proposed Alternative Investment Fund Managers Directive would subject hedge fund managers operating or domiciled in the EU to new regulations and reporting requirements
- Dubai's regulatory regime for hedge funds, based on British common law, comports with international standards and has significant tax advantages
- China has abstained from introducing new regulations on hedge funds

Precautions in Dealing with Counterparties

- The collapse of Lehman Brothers and other institutions has highlighted the need for hedge funds to take precautions against counterparty risk
- Fund managers can manage their exposure by addressing risks associated with:
 - Providers of derivatives;
 - Prime brokerage relationships; and
 - Insolvency of counterparties

Tax Developments

Change in Tax Treatment of Carried Interest

- **Carried interest**
 - GP receives right to incentive allocation because of services to be provided to fund
 - Character of fund's income and gain flows through to GP and its members even though related to services
 - Administration budget proposal would treat all allocations with respect to “services partnership interest” – which would include the GP's interest in a fund – as ordinary compensation income
 - Prior versions of legislation had only applied to investment management partnerships – primarily, funds

FBAR

- Change in TD F 90-22.1 Instructions for 2008 filings due June 30, 2009
 - Expanded definitions of “Financial Account,” “Signature Authority,” “United States Person”
 - Voluntary Disclosure Program for Past Years May 6 FAQs
 - Program expanded on June 24 to allow 2008 FBARs to be filed by September 23, 2009 -- with conditions
 - Administration budget proposals would beef up offshore account reporting rules and penalties

Other Administration Proposals

- Stop use of swaps to avoid dividend withholding
- Require ordinary income treatment for dealers of equity options and commodities
- Change business entity classification rules for certain foreign entities
- Eliminate capital gain tax on investments in certain small business stock

Adjustments to Recent Developments

- Loss of Offshore Fee Deferral
- Possible use of FMV Equity Options to provide deferral

Massachusetts Withholding

- Exemption for “investment partnerships”
- Form PTE-EX

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