



YANNI
PARTNERS

DELIVERING
THE PROMISE

IN THIS
ISSUE

A look at the benefits and drawbacks of hedge fund investment strategies.

MEASURING UP

Volume 14 | Number 4 | Fall 2002

Hedge Fund Investments

Hedge funds are opportunistic funds that seek consistent positive returns regardless of the market environment. Hedge funds neutralize “market risks” (changes in value from movements in the capital markets); however, they subject investors to active management and other types of risks

The main reason to invest in hedge funds is to curtail a portfolio’s downside exposure without a reduction in upside potential. A diversified portfolio of hedge funds is likely to produce a long-term return commensurate with a balanced portfolio of traditional investments – equities and fixed income. The potential benefit from adding hedge funds to traditional investments is the possibility of a more favorable risk/return trade-off.

Hedge funds fall within the broad category of “alternative investments.” Private equity constitutes the other major form of alternative investments. Hedge funds offer potential diversification and risk control benefits; however, they are not likely to improve a portfolio’s expected return. Private equity offers the potential for higher returns, but it is not likely to improve a portfolio’s diversification.¹

Description of Hedge Fund Investments

Hedge funds are unregulated pools that invest in all forms of marketable instruments. The managers of hedge funds have enormous flexibility compared to traditional managers. Investors evaluate traditional

managers by market benchmarks, such as the S&P 500. In contrast, hedge funds are not constrained by market benchmarks. Hedge funds seek consistent positive returns, regardless of the market environment. This flexibility allows hedge funds to engage in various forms of arbitrage, long and short positions, derivatives, currencies, and leverage. Because hedge funds face few regulatory restrictions, their managers may be better positioned to take advantage of short-term market inefficiencies than traditional managers. Estimates suggest that there are more than 6,000 funds comprising over \$500 billion.

Hedge funds have their own unique characteristics and limitations, however, and investors need to be aware of all aspects prior to investing.² Examples of hedge fund concerns include strategic risks such as manager risk, volatility, leverage, and event risk. Structural risks associated with hedge funds include limited liquidity, an unregulated industry, and limited transparency. Hedge fund strategies fall within the following broad groupings:

- **Equity Long-Short:** Managers combine long and short positions. Managers buy issues they

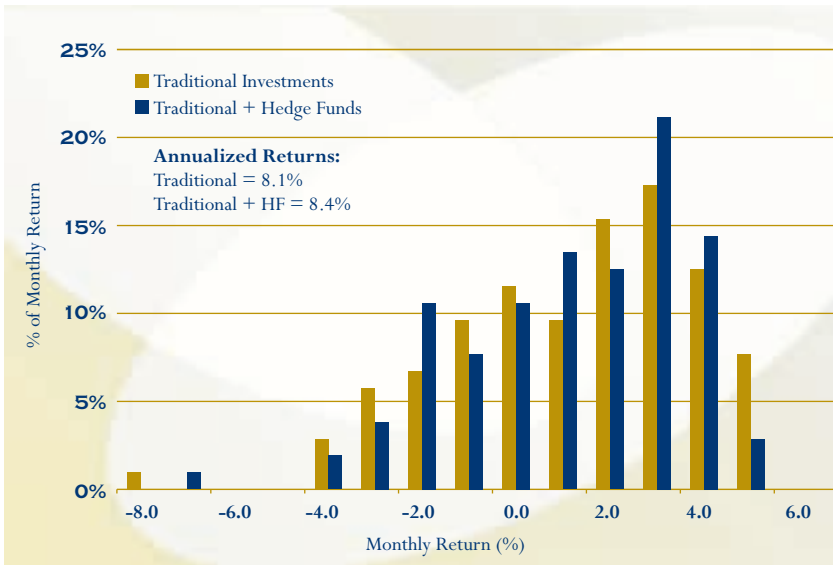
Note:

¹ *Measuring Up* – Private Equity Investments. Volume 14, Number 3, Summer 2002, Yanni Partners.

² There exist several published indices of hedge fund universes. These indices are subject to certain limitations such as “survivor bias.”

FIGURE ONE

Distribution of Monthly Returns: Dec. 1993 - Aug. 2002



Allocations:

Traditional: 60% Equity and 40% Fixed Income
 Traditional + HF: 50% Equity, 40% Fixed Income, and 10% Hedge Funds

Indices:

Equity: 70% S&P 500, 10% Russell 2000, 20% MSCI EAFE
 Fixed Income: Lehman Bros Aggregate
 Hedge Funds: CSFB Tremont Hedge Fund Index

consider attractive and sell securities short that they deem over-priced. A short seller’s objective is to repurchase the securities at lower prices for profits. A fund’s net market exposure typically ranges between zero and 50%.

- **Arbitrage and Event Driven:** Arbitrage transactions involve the purchase and sale of similar securities in an attempt to capture perceived mispricings. An example is convertible bond arbitrage whereby the manager arbitrages a convertible with the same issuer’s equity and debt securities. Event-driven managers seek to profit from investing in companies facing transactional events such as mergers and acquisitions, restructurings, liquidations, reorganizations, recapitalizations, bankruptcies, and spin-offs. The key to profitability depends upon the correct assessment of current and future events within an anticipated timeframe.
- **Global Macro:** Managers predict “directional” moves in major markets – currencies, commodities, equities, or fixed income. Such managers often implement decisions using derivatives to move quickly with minimal transactions’ costs.

A key characteristic of hedge funds is their approach to risk and return objectives. Hedge fund managers

tend to target a positive return in all market environments rather than attempting to outperform a benchmark index. The primary source of returns is from security selection rather than from asset class exposure. Typically, hedge funds tend to have relatively fewer but very well-researched positions and tend to be highly specialized, focusing on particular niches of inefficiencies. Hedge fund managers also tend to focus on downside risk and preservation of capital.

Another notable characteristic of hedge funds is their people and skill-based investment focus. The investment industry has experienced structural changes in recent years as many talented individuals from traditional firms have migrated to hedge funds. The hedge fund structure attracts top-tier talent since it offers greater financial rewards and fewer constraints than traditional funds. Hedge fund managers harbor strong views about the optimal way to manage capital. Such managers can practice their “craft” without “bureaucracies” imposed by a hierarchical organization. These managers typically invest substantial amounts of their own capital in their funds, thereby aligning managers’ interests with clients’ interests.

Investment Rationale

The primary investment rationale is to improve a total fund’s risk/return characteristics, particularly in weak markets. Investors should recognize, however, that hedge funds are not likely to produce higher expected returns than traditional investments over the long term.

Figures One, Two, and Three show how the addition of hedge funds to a traditional balanced portfolio improved a portfolio’s risk/return characteristics. These Figures show how the allocation of 10% in hedge funds curtailed losses without diminishing returns since December 1993. The 10% hedge fund allocation was funded from a reduction in the allocation to a diversified portfolio of traditional equities (70% large, 10% small, and 20% international).

Figure One plots the distribution of monthly returns from December 1993 to August 2002. The inclusion of hedge funds moderated the effect of negative outliers.

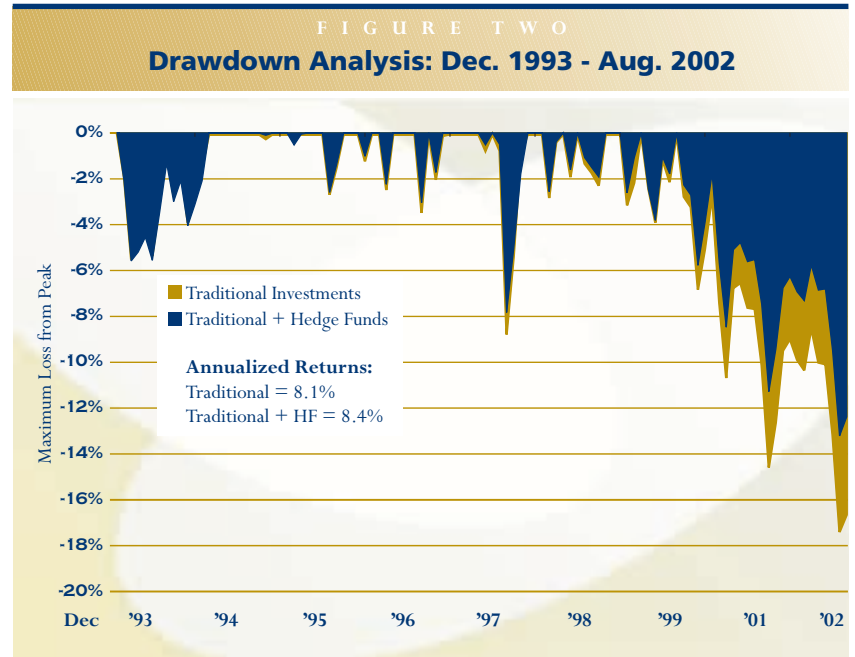
Figure Two shows “drawdowns.” This measure plots the cumulative loss from the all-time peak. The addition of hedge funds reduced the maximum loss of traditional investments.

Figure Three compares quarterly returns of a traditional portfolio and one that includes hedge funds from December 1993. The paired returns are ranked in ascending order of the returns of the traditional portfolio. The addition of hedge funds moderated the extreme negative and positive returns relative to the traditional portfolio.

Will hedge funds continue to provide diversification benefits to investors? The answer depends upon the availability of market inefficiencies given the inflows of capital and the ability of hedge fund managers to continue to exploit these opportunities.

Drawbacks

Among the challenges facing hedge funds are the lack of standardization, regulation, and transparency. Moreover, liquidity is limited. Hedge funds impose lock-up periods (typically one year) that prevent investors from redeeming their investment. Unlike traditional managers, hedge funds may allow



redemptions on a quarterly or yearly basis subject to advance notice. Limited capacity is another drawback. Performance often deteriorates after a fund grows beyond a certain level.

Investment Vehicles

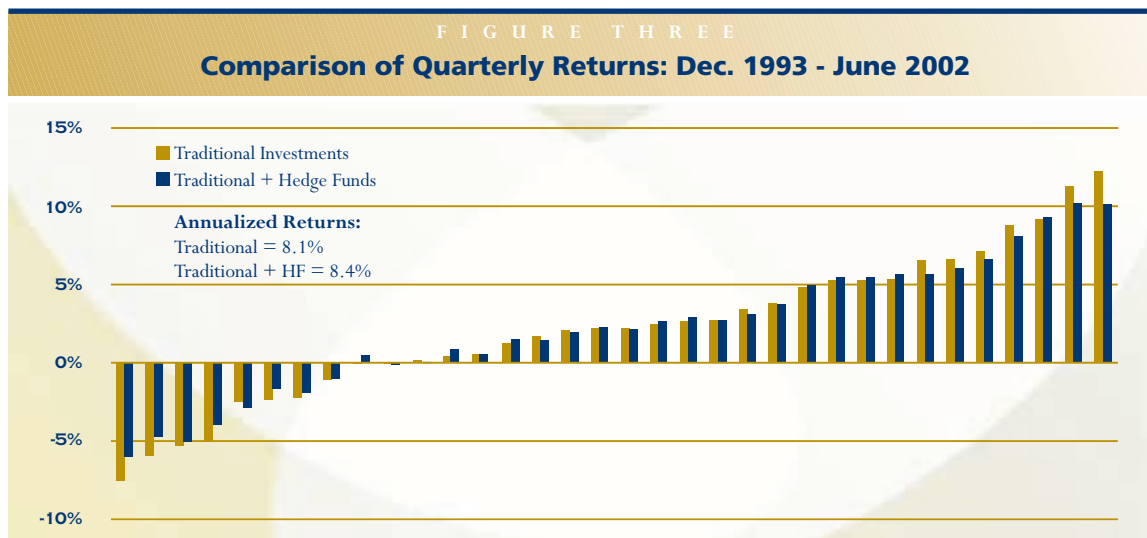
Hedge Funds are typically structured as either Limited Partnerships (LP) or Limited Liability Corporations (LLC). They can be off-shore (domiciled outside of the United States) or on-shore (domiciled within the United States) investment vehicles. In the U.S., hedge funds are generally exempt from regulation under the Investment

Allocations:

Traditional: 60% Equity and 40% Fixed Income
Traditional + HF: 50% Equity, 40% Fixed Income, and 10% Hedge Funds

Indices:

Equity: 70% S&P 500, 10% Russell 2000, 20% MSCI EAFE
Fixed Income: Lehman Bros Aggregate
Hedge Funds: CSFB Tremont Hedge Fund Index



MEASURING UP

Yanni Partners

310 Grant Street, Suite 3000
Pittsburgh, PA 15219-2302

Company Act of 1940. As such, they typically comply with one of the exclusions of the Act, which effectively restricts participation to “accredited investors” or “qualified purchasers.”

The investment manager of the hedge fund often assumes the role of the General Partner. The General Partner performs all portfolio management functions including organizing the partnership. The investor in a hedge fund is a Limited Partner. Limited Partners provide capital and serve as passive investors.

The General Partner receives compensation for organizing/managing the fund and for assuming unlimited financial liabilities. General Partners typically charge two levels of fees: an annual management fee and an incentive fee. The annual management fees are typically 1% - 2% of the net assets and pay for the fixed costs of operating the fund. The incentive fee typically ranges from 10% to 20% of a fund's net profits subject to recovery of all previous losses.

An investor can access hedge funds in two ways: (a) direct investments in individual funds, and (b) a “fund of funds.” A well-managed fund of funds provides broad diversification, access to highly qualified managers, and rigorous accounting. A fund of funds charges an additional management fee. A fund of funds is generally the most efficient method for organizations with less than \$2 billion in total investments. The reason is that organizations with smaller funds normally would not employ the full time personnel

who have the time and experience to evaluate and track individual funds, nor are their assets large enough to obtain adequate diversification if using individual funds.

Who Should Invest in Hedge Funds

Hedge fund investing is suitable only for investors who fully understand the risks, complexities, and liquidity limitations associated with hedge funds. Endowments, foundations, and high-net worth individuals have been early investors in hedge funds. More recently, pension funds, financial institutions, and healthcare providers have started to invest. An organization's commitment to hedge funds should generally range between 5% to 15% of the total fund. An investment below 5% will not have a material effect on the fund. An upper limit of 15% will help to insulate the total portfolio from hedge funds' unique risks.

Summary

Hedge funds offer diversification and risk control benefits. An investor must build a diversified portfolio with skillful managers to achieve this objective. An investor's ultimate decision regarding hedge fund investing depends on the investor's unique preferences and circumstances. And, unless an organization has the necessary full time staff to evaluate individual funds, and substantial enough assets to utilize multiple individual funds of differing styles, we would suggest a “fund of funds” would be more appropriate.

Calendar of Events

MAR 27

**Yanni Partners
Client
Symposium**

**Wyndam Airport
Hotel
Pittsburgh, PA**

*Attendance by
invitation only.*

Yanni Partners provides a full range of consulting services vital to the management of various portfolios. Our ultimate goal is to offer a basis for improved investment monitoring and performance.

Yanni Partners is registered as an investment advisor and as an NASD registered broker/dealer. Yanni Partners is also a member of the Securities Investors Protections Corporation (SIPC).

© 2002 Yanni Partners, Inc. All rights reserved. Any copying, redistribution or retransmission of any of the contents of this newsletter without the written consent of Yanni Partners, Inc. is expressly prohibited.

