AIMA Canada Hedge Fund Primer

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Purpose of the AIMA Canada Hedge Fund Primer

The AIMA Canada Hedge Fund Primer is designed to assist the financial community and investors in their understanding of hedge funds. The document covers the hedge fund market in Canada, hedge fund strategies, and the risk/return characteristics of hedge funds. It is also designed to assist financial advisors and investors with respect to hedge fund asset allocation decisions within a diversified portfolio. The document is available from the AIMA Canada website, www.aima-canada.org.

A number of Canadian institutional and individual investors have held hedge fund investments for many years. As education increases, more investors will begin to recognize the benefits of including hedge funds in a diversified portfolio.

Alternative Investment Management Association (AIMA)

The Alternative Investment Management Association ("AIMA") was established in 1990 in the UK as a non-profit organization for the alternative investment industry. It specifically includes hedge funds, managed futures and managed currency funds.

AIMA's objectives are to:

- Increase investor education, transparency and promote due diligence and related best practices, and
- Work closely with regulators and interested parties in order to better promote the responsible use of alternative investments.

Established in 2003, the Canadian National Group of AIMA is currently the largest industry organization servicing the alternative investment industry in Canada. We have 74 corporate members including hedge fund managers, institutional investors, pension fund managers and consultants, administrators, auditors, lawyers, prime brokers and other service providers. We maintain an active presence by both hosting and attending industry events. We promote research and education as well as sound business practices and proper due diligence. We maintain contact with industry regulators and provide updates on industry issues related to legal taxation compliance due diligence.

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Section 1: The Hedge Fund Industry

1.1 History of the Hedge Fund Industry

Over the past 50 years, the hedge fund industry has grown from a handful of fund managers in the US into a global business at the forefront of investment innovation.

THE PERIOD 1949-1984

Alfred Jones, who established the first known hedge fund in the US in 1949, is considered by many as the father of hedge funds. Jones wanted to create a fund that offered protection in a falling market, while achieving superior returns over the long run. Jones' model was based on the premise that performance should depend more on stock selection than market direction. To achieve this goal, Jones used two speculative tools - short selling and leverage - and merged them into a conservative strategy for investing in both rising and falling markets. Jones set up his fund as a general partnership with performance-based fee compensation, and invested his own capital in the fund. The fund was converted to a limited partnership in 1952.

Jones believed that in rising markets, one could buy stocks that would rise more than the market, and sell short stocks that would rise less than the market. In falling markets, one could buy stocks that would fall less than the market, and sell short stocks that would fall more than the market. By balancing these strategies, Jones believed that his fund could yield a net profit in both rising and falling markets. In fact, during the 1950s and 1960s, Jones' hedge fund consistently outperformed the best equity mutual funds.

Jones' success led many new hedge fund managers to enter the marketplace, and by 1968 there were approximately 200 hedge funds in the US, including those managed by George Soros and Michael Steinhardt. However, during the 1960s' bull market, many hedge fund managers decided not to follow Jones' model, as they ceased selling short but continued to lever their long positions. Consequently, many of these new hedge funds did not survive during the bear market of the 1970s, and by 1984 there were only 68 hedge funds.[i]

Meanwhile, Jones' hedge fund continued its success during the 1970s, and over time he hired other stock pickers to autonomously manage portions of his fund. In 1984, Jones created a "fund-of-funds" by amending his partnership agreement to reflect a formal fund-of-funds structure.

THE PERIOD 1985-1999

The growth in the hedge fund industry accelerated in the 1980s and 1990s. During this time, an increase in new financial instruments, and changes in technology, facilitated the development of sophisticated investment strategies. Traditionally these investment strategies were operated within the proprietary trading desks of large investment banks. However during this time period, performance-based incentive fees and low barriers to entry for new funds, led highly skilled entrepreneurial investment professionals to leave the investment banks to start up their own hedge funds. Some of these managers had initial financial backing from their former employers, and many invested their own investment capital in their funds.

During the 1980s, most US hedge fund managers did not register with the Securities and Exchange Commission (SEC). Hence, they were prohibited from advertising and relied on word-of-mouth referrals to grow their assets. During this period, European investors also recognized the advantages of hedge funds, and this fueled the growth of many tax-efficient offshore hedge funds. The 1980s and 1990s saw a significant period of growth for hedge funds, with exceptional performance from a number of star managers. For example, Julian Robertson's Jaguar Fund, Steinhardt's Steinhardt Partners and Soros' Quantum Fund earned compound returns in excess of 30% per annum. Not only did these managers outperform in bull markets, but also in bear markets.[ii]

By the end of the 1990s, hedge funds were attracting money from multiple parties, including family offices, high-net-worth individuals, private banks (mostly European), US endowments and foundations, insurance companies, pension plan sponsors and hedge fund-of-funds (FoFs).

THE PERIOD 2000-2008

The flow of new investments into hedge funds slowed during the late 1990s as investors allocated capital to stock markets which were experiencing an extraordinary bull market. The industry experienced remarkable growth during the 2000-2002 bear market. This period coincided with the bursting of the dot-com bubble and hedge funds fared far better than their long equity counterparts. Individual and institutional investors began allocating to hedge funds during this period in an effort to diversify their portfolios, recover from sharp losses in the search for absolute returns independent of market direction. Hedge funds continued to post attractive absolute returns and superior risk-adjusted returns throughout the middle part of this decade. In terms of total returns between 2003 and 2007, on average, hedge funds underperformed US equity markets and especially international and emerging equity markets.

Unfortunately, global markets crashed precipitously in the second half of 2008 with stock market losses not seen since the Great Depression. A credit crisis paralyzed financial markets, which resulted in liquidity evaporating, extreme risk-aversion, credit spreads blowing out to unprecedented levels, forced selling of financial assets, and multiple financial entity failures, which led to unprecedented regulatory and government intervention and bailouts. This created an unpredictable and detrimental trading environment. Most hedge fund strategies suffered losses in 2008 and many structurally failed as leverage was declined and counterparty relationships were challenged. Strategies which posted positive returns in 2008 were certain global macro and managed futures funds as well as dedicated short-selling funds. Despite historically poor performance, the overall hedge fund industry experienced far less pronounced losses when compared to their traditional long only peers.

Following the systemic events of 2008, the functioning of the capital markets improved within 2009 and into 2010. Assets began to flow into hedge fund strategies and performance in various hedge fund strategies rebounded from the lows experienced in 2008.

The current decade has witnessed a proliferation of hedge fund choices. While mostly US-located (but offshore-domiciled) global macro and long/short equity funds dominated the industry in previous decades, the creation of thousands of relative value, event driven, arbitrage, directional, and managed futures funds over the past several years across Europe, Asia, and the US, gave investors a plethora of strategies and funds from which to choose from.

With the increase in number of hedge funds, the complexity of strategies and underlying financial instruments it became increasingly complicated for investors to perform proper initial and ongoing due diligence on a basket of hedge funds. This led to the creation of fund of hedge funds. These fund of hedge funds performed all levels of due diligence for investors, provided access to sought-after managers, and were often available for lower minimum investment levels than the underlying hedge funds. Fund of funds receive a management fee and often a performance fee, often resulting in a layering of fees for investors.

Fund of funds were not the only instruments which allowed individual investors access to multi-manager, multi-strategy hedge fund portfolios; the last several years has seen the creation of principal-protected note structures and, more recently, investable hedge fund index products. Institutional investors also benefited from other forms of financial engineering such as customized hedge fund solutions based on portfolio needs, portable alpha pooled funds, hedge fund replication strategies, and 130/30 funds.

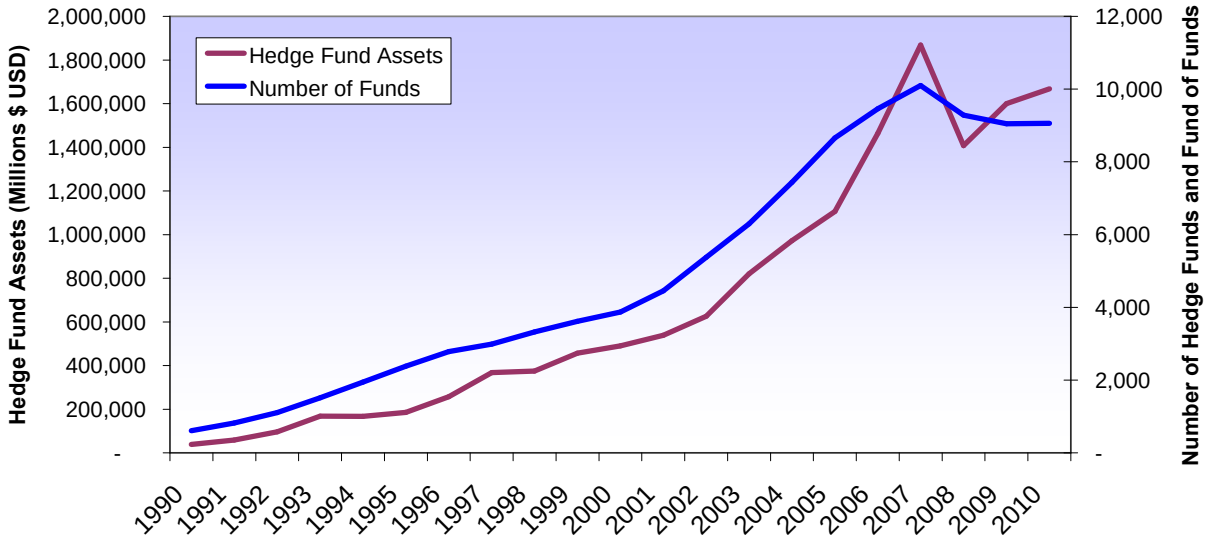
As hedge funds began hitting the mainstream, investors demanded and received increasing levels of transparency and the industry also became more regulated as the SEC issued a rule requiring many hedge funds to register under the Investment Advisers Act. While this rule was overturned in court, the trend is still towards increased regulation for hedge funds around the world.

1.2 Size of the Global Hedge Fund Industry

Figure 1.2.1 provides the growth in both the number of hedge funds as well as hedge fund assets from 1990 to the end of June 2009 [iii]. The qualitative history of the industry described in Section 1.1 is represented in the figure below. The acceleration in the growth of the industry is visible in the post tech-bubble period of 2001 through to 2005. In addition the contraction of 2008 is visible. The decline in hedge fund assets observed for 2008 and into 2009 is due to both investor redemptions and well as investment losses. In their Q2/2009 report, HFR indicated that through the first and second quarters of 2009, the pace of redemptions was slowing and hedge fund performance was improving. These factors led to an increase in hedge fund assets from Q1/2009 to Q1/2010. As of Q1/2010 hedge fund assets are estimated to be 1.67 Trillion USD.

FIGURE 1.2.1: GROWTH OF THE GLOBAL HEDGE FUND MARKET

(Source: Hedge Fund Research, Inc.)



1.3 Typical Hedge Fund Investors

Initially, high-net-worth individuals were the primary investors in hedge funds, as they sought to generate reasonable returns while protecting their capital. During the decade of the 2000's the landscape changed with institutional investors increasing their allocations to hedge funds, as they searched for alternative investments with low correlations to traditional portfolios of cash, bonds, and stocks. For example, from December 2005 to December 2008 the proportion of hedge fund assets attributed to Pension Funds increased from 15% of global hedge fund assets to 25% of global hedge fund assets[iv]. Hedge fund investing through portable alpha structures whereby hedge fund alpha is combined with market beta also grew in adoption.

1.4 Canadian Hedge Fund Landscape

MARKET SIZE AND DESCRIPTION

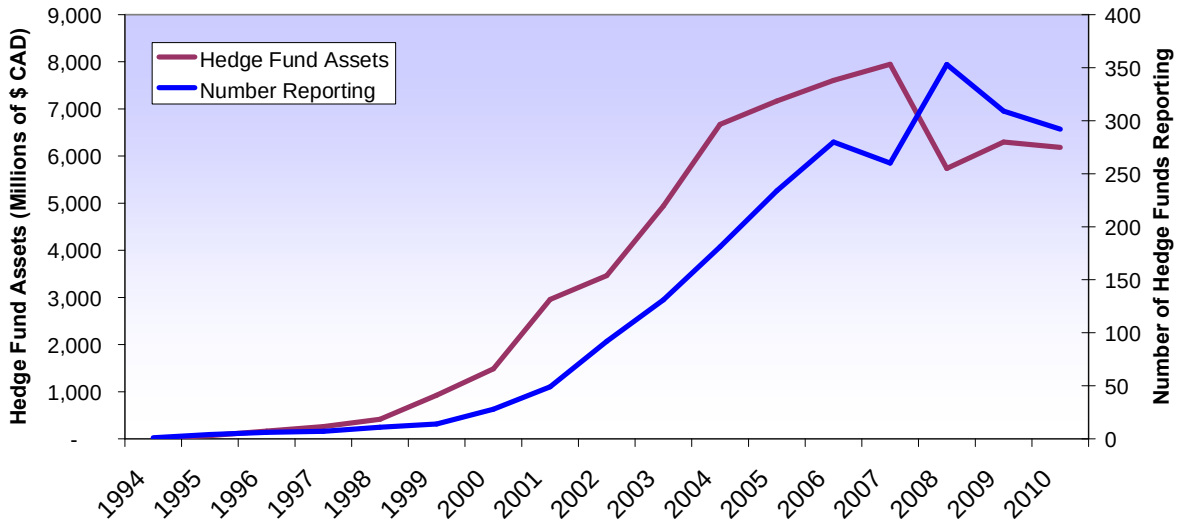
A complete picture of the Canadian hedge fund market is difficult to define and measure. Components of the market include: assets managed by domestic managers for domestic investors, assets managed by domestic managers on behalf of international clients, and assets of domestic investors managed by

international investors. Some of the Canadian investor's assets may reside in Canada, or within off-shore legal structures. The Canadian client base can generally be divided into institutional and individual investors. Individuals can access hedge funds directly or through their investment advisor. Hedge fund investors and managers can operate privately and industry reporting is mostly voluntary. These factors make it difficult to accurately measure the size of the market.

The growth of the Canadian hedge fund industry has mirrored that of the global industry. In the early 2000's, the increase in interest hedge fund investments was driven primarily by the bear market within equity markets, and by investors' desire to diversify and lower their risk exposures. While the trend was in line with other parts of the world, unlike the more mature US and European markets, general awareness of alternative investments and hedge funds in particular was low in Canada, by both and institutional and individual investors.

FIGURE 1.4.1: GROWTH WITHIN ONE COMPONENT OF THE CANADIAN HEDGE FUND INDUSTRY

(Source: Canadian Hedge Watch)



Canadian Hedge Watch publishes a quarterly report describing the size, composition, and performance of Canadian Hedge Funds. Figure 1.4.1 highlights that there has been significant hedge fund growth in Canada from 1994 to date, both in assets and in the number of domestic funds available to Canadian investors[v]. The results are provided as at December 31st for each calendar year and at June 30th for 2009. The drop in Hedge Fund Assets observed in 2008 is due to investor redemptions and fund closures; as well as investment losses experienced in 2008. On average in 2008 Canadian hedge fund indices lost between 7% and 38% depending upon the specific index used[vi]. It should be noted that there was a wide dispersion of individual fund returns with many hedge funds posting positive results. For example, most managed futures funds had positive returns for 2008.

The hedge fund assets provided in the figure above only include those funds which voluntarily provide AUM numbers. For example, there are hedge fund managers which report their performance but do not report their AUM. Therefore there are large components within the Canadian hedge fund landscape which are not contained in the Figure above. For example, investments in hedge funds by Canadian institutional investors are estimated to be greater than CAD 15 Billion[vii]. Some of those assets may overlap with the value contained in the Figure above, however the large majority will not.

Initially, Canadian individual investors favoured guaranteed FoF-linked notes backed by highly rated international banks. These note structures provide a principal-repayment feature and a low minimum investment. Overtime, these notes have become less popular and direct hedge fund investment has increased.

This decrease in popularity is likely due to two reasons. The first is the higher fee loads related to these products due to the FoF structure as well as the embedded cost of the principal guarantee. The second reason is related to the increased familiarity with hedge fund strategies and the underlying managers. Institutional investors also initially favoured FoFs as a first-time hedge fund investment. Some of the larger institutions have migrated toward direct investment with single-strategy and multi-strategy hedge funds. This migration is due to the increased familiarity with hedge funds, an increase in the capabilities of internal alternative investment teams, and the fee savings achieved for a sufficiently large hedge fund investment through avoidance of the FoF structure.

Another interesting feature of the Canadian industry is the number of Canadian hedge fund managers that have a presence offshore. Despite their smaller size, many Canadian managers already have offshore structures in the Bahamas, Ireland, and the Cayman Islands, among others. These managers recognize that an offshore structure is beneficial in attracting capital from internationally-based institutional investors outside of Canada. A growing number of Canadian managers have distribution and research activities outside of Canada, with offices located in countries such as the US, UK and Switzerland.

PRODUCT STRUCTURES AND OFFERINGS

Canadian investors can access hedge funds through a number of different forms including managed accounts, pooled funds and derivatives. The appropriate product structure depends on numerous factors including tax considerations and the prospective investors to whom the product can be marketed.

Hedge funds can be marketed in one or both of the following markets: The exempt market, which refers to high-net-worth and institutional investors; and the retail market, which refers to the general investing public.

The retail market is subject to numerous regulations intended to provide investor protection, which restrict the type of products that can be offered. However, since the exempt market is not subject to the same type of regulation, numerous product structures can be used to service this market.

- Product Offerings for High-net-worth and Institutional Investors (Exempt Market): Hedge fund offerings restricted to the exempt market are often structured as managed accounts or pooled funds. A managed account allows a hedge fund manager to invest on behalf of investors according to the terms of an investment management agreement between the parties. One of the drawbacks of a managed account is that it requires a large investment (e.g., $50 million), in order to implement the particular trading strategies agreed upon by the parties. For example, a managed account may be used by multi-strategy, multi-manager FoFs. An alternative is to invest with other investors on a pooled basis in a fund established by the hedge fund manager. Such pooled funds are usually structured as limited partnerships or trusts. Another alternative in the exempt market is to use derivatives to obtain exposure to an underlying hedge fund.

- Product Offerings for the General Investing Public (Retail Market): Regulatory restrictions apply to hedge funds offered to the retail market. These restrictions include the need for a prospectus, and prohibitions or restrictions on certain investment strategies. If a hedge fund permits redemption of its securities at the net asset value, it may be a mutual fund under securities law. Mutual funds sold to retail investors are subject to rules that prohibit the use of leverage or short selling by the fund manager. However, commodity pools are an exception, since they are considered a special type of mutual fund that can use leverage and engage in short selling using derivatives. Unlike conventional mutual funds, commodity pools must be sold pursuant to a long-form prospectus, and there are additional requirements for mutual fund salespersons that sell them.

- In order to avoid the mutual fund investment restrictions, a hedge fund may be structured as a closed-end fund (i.e., redemptions by the fund, if any, are not more frequent than once a year). Closed-end funds can be offered to retail investors by prospectus but are not subject to the investment restrictions applicable to mutual funds. In order to provide liquidity to investors, closed-

end funds are often listed on the Toronto Stock Exchange (TSX). This listing also allows retail investors to gain access to the fund through the secondary market.

- Structured notes are also a popular structure that is not subject to the restrictions of securities law. These products provide investors with exposure to the returns of one or more hedge funds, and a return of principal on maturity that is guaranteed by a Schedule I or II bank in Canada. Retail investors can also gain exposure to hedge funds through segregated funds offered by insurance companies, since segregated funds are not subject to the mutual fund investment restrictions.

HEDGE FUND REGULATIONS

The key issues relating to hedge fund regulations in Canada are summarized below.

- Registration: Anyone engaged in trading securities or advising with respect to investing in securities in Canada, is subject to the registration requirements of securities law, which are within the jurisdiction of the provinces and territories and may vary across the country. For a hedge fund, this means that the portfolio manager(s) must be registered as an adviser, or be able to rely on a registration exemption. Registered advisers are subject to numerous regulations related to matters such as proficiency, record keeping and capital requirements. Portfolio managers not resident in a jurisdiction may have limited registration exemptions available to them. However, in some cases, it may be necessary for the fund to have an adviser registered in the local jurisdiction or to apply for relief from registration. If a fund based in Ontario, or sold to investors resident in Ontario, will use futures or options on futures, the advisor must either register under commodity futures legislation or apply for relief from registration as there are no registration exemptions available without an application. Trading in securities can include marketing activities and not just buying or selling securities. As a result, it may be necessary for the fund manager to obtain registration even if it is not in direct contact with potential investors. In some provinces, registration for trading may be necessary to rely on exemptions from the requirement to provide investors with a prospectus. The registration requirements in Canada are being revised. New rules, which will change the current rules, and introduce a registration category for investment fund managers, are expected to be finalized in late 2009.

- Disclosure: Hedge funds in Canada are sold primarily in the exempt market (i.e., without a prospectus). There are three commonly used prospectus exemptions: the minimum investment exemption, the "accredited investor" exemption and the offering memorandum exemption.

    1. A Minimum Investment Exemption: The minimum investment exemption allows hedge funds to sell their securities without a prospectus to investors who make a prescribed minimum investment. The prescribed minimum investment is the same in all jurisdictions ($150,000).

    2. "Accredited Investor" Exemption: A prospectus exemption for accredited investors is available in all Canadian jurisdictions. An "accredited investor" is defined broadly to cover many different entities including pension funds, trust companies and corporations with net assets of at least $5,000,000. Individuals may be accredited investors if they own (alone or together with a spouse) net assets of $5,000,000, financial assets with a realizable value exceeding $1,000,000, or if they have net income before taxes exceeding $200,000 (or $300,000 if combined with that of a spouse) in each of the two most recent years and have a reasonable expectation of exceeding the same net income level in the current year.

    3. Offering Memorandum Exemption: A number of jurisdictions provide an exemption from the prospectus requirement if the issuer delivers an offering memorandum to investors in the prescribed form and within the prescribed time. The investor must sign a risk acknowledgement statement in prescribed form at the time of investment.

        An offering memorandum may also be the primary disclosure document provided to investors in conjunction with either the minimum investment exemption or the "accredited investor"

exemption. Investors who purchase under the offering memorandum exemption will have a statutory right of action for recession or damages against the issue if there is a misrepresentation in the offering memorandum. In a number of the jurisdictions any document purposing to describe the business and affairs of an issuer may be considered an offering memorandum under applicable securities legislation and purchasers given a statutory right of action for rescission or damages for misrepresentations in the offering memorandum against the issuer (and in some jurisdictions other parties).

- Reporting: Once a hedge fund completes the sale of securities pursuant to a prospectus exemption in Canada, a report of the trade in prescribed form must be completed and filed with the appropriate securities regulators. A report of the exempt distribution sets out the name and address of the issuer (or seller), the name, address and telephone number of the manager of the fund, the name, residential address and telephone number of the purchasers, a description of the securities, the date of the trade(s) and the particulars of the trade(s), such as the number of securities sold and the purchase price. The deadline for filing reports of trades in funds pursuant to the accredited investor, minimum investment or reinvestment of distribution exemptions is 30 days after the financial year end of the fund. Reports of trades pursuant to the offering memorandum exemption must be filed within 10 days of the trade. Most of the provinces and territories require a fee for filing a report of trades. The fee ranges from a flat fee of $25 to a fee of 0.03% of the gross value of the securities distributed pursuant to the exemption in the jurisdiction.

- Financial Statements: Although hedge funds that are not sold pursuant to a prospectus are not "reporting issuers" under securities law, they may still have financial statement reporting obligations. Some jurisdictions require that funds established under local law must file interim and annual financial statements, even if they do not distribute securities pursuant to a prospectus. Funds which are not reporting issuers can be exempt from the filing requirements if they file a notice with the securities regulators, deliver financial statements to investors in accordance with applicable requirements and include a note in their financial statements that they are relying on the exemption. Statements which are filed must be filed in electronic format on the System for Electronic Document Analysis and Retrieval (SEDAR). Once filed on SEDAR, the financial statements will be available to the public on the Internet.

- Privacy: Hedge funds are subject to applicable provincial or federal privacy legislation with respect to information about their investors. Privacy legislation addresses the collection, use, disclosure and disposal of personal information.

- Money Laundering and Terrorist Financing: Hedge fund managers must comply with applicable record keeping, client identification and reporting requirements of anti-money laundering and anti-terrorist financing legislation, and must implement a compliance regime, including appointment of a compliance officer, a written compliance program, risk assessment, an on-going training program, and effectiveness reviews. Suspicious or large cash transactions must be reported to the Financial Transactions and Reports Analysis Centre of Canada (FINTRAC). Registered advisers or dealers are also required to make monthly reports to securities regulators, stating whether they have had any dealings with persons on official lists of terrorists or persons or countries subject to economic sanctions As well, legislation also prohibit investments by Canadians or hedge funds operating in Canada in countries subject to economic sanctions.

SERVICE PROVIDERS

Canada has a mature and established financial services industry. There are many domestic prime brokers offering custodial, brokerage, stock-lending and on-line portfolio services. Back-office fund administrators, legal and accounting firms, including most of the large global franchises, are all active in the Canadian hedge fund industry. Many of these firms are members of AIMA Canada, and are listed in Appendix I. Many Canadian accounting and legal firms have representation internationally to support managers that have both domestic and offshore fund structures. This "one-stop-shop" approach works well for master-feeder

structures used by many Canadian hedge fund managers. The centres for these support firms are mainly in Toronto, Montreal and Vancouver.

Canada also has a number of well-established stock exchanges, with the TSX being the largest and most established. In addition, Canada has an active futures and derivatives exchange in the Montreal Exchange (ME). Many Canadian hedge fund managers actively trade on both the TSX and the ME, and are also active in the US markets. Since Canada is ranked as one of the world's foremost adopters of technology per capita, a connection to most global markets is possible from nearly every major centre in the country.

As discussed, hedge fund managers targeting retail investors (i.e., non-accredited investors) have offered hedge funds and FoFs through structured products and listed closed-end funds on the TSX. The majority of hedge fund products for individuals are sold though the major brokerage houses owned by the five major Canadian banks, along with several large insurance companies and non-bank-owned mutual fund dealers. A common electronic distribution platform (FundSERV) connects most Canadian fund distributors to Canadian hedge fund managers.

Section 2: Hedge Fund Characteristics

A hedge fund is generally defined as a private investment program where the manager seeks positive returns by exploiting investment opportunities, while protecting principal from financial loss.[viii] Hedge funds are very heterogeneous, as numerous strategies and techniques can be used to achieve the similar investment objectives. For this reason, hedge funds are synonymous with the term "alternative investment strategies." As well, hedge funds are associated with active investment management[ix]. As with active management in general, hedge fund performance is directly related to the manager's abilities with respect to: strategy execution, security selection, and/or market timing.

Just as the term "mutual fund" does not describe a particular investment strategy, the term "hedge fund" does not describe a particular investment strategy. Some hedge funds are very conservative while others are more aggressive. Although they are called hedge funds, some funds may not hedge their underlying positions.

2.1 Comparing Hedge Fund Managers to Traditional Investment Managers

Although hedge fund managers represent a form of active investment management, they differ from traditional active managers in a number of ways. Traditional active managers often define risk as the deviation from a stated benchmark (tracking error or active risk). Most of the variability of a traditional manager's returns originates from the variability of the underlying benchmark. Hedge fund managers generally seek to deliver a positive return that is independent of the general direction of the financial markets, where the manager's goal is an absolute return. Traditional active managers generally seek to deliver returns that are above a related benchmark. This return of a traditional manager may be negative if the benchmark return is negative. While both rely on skill to improve returns, the manager's investment decisions generally has the largest impact the variability of hedge fund returns, while most of the variability of the underlying benchmark has the largest impact on the traditional manager's returns. Table 2.1 summarizes the key differences between traditional investing and hedge fund investing.

TABLE 2.1: COMPARING TRADITIONAL INVESTING TO HEDGE FUND INVESTING

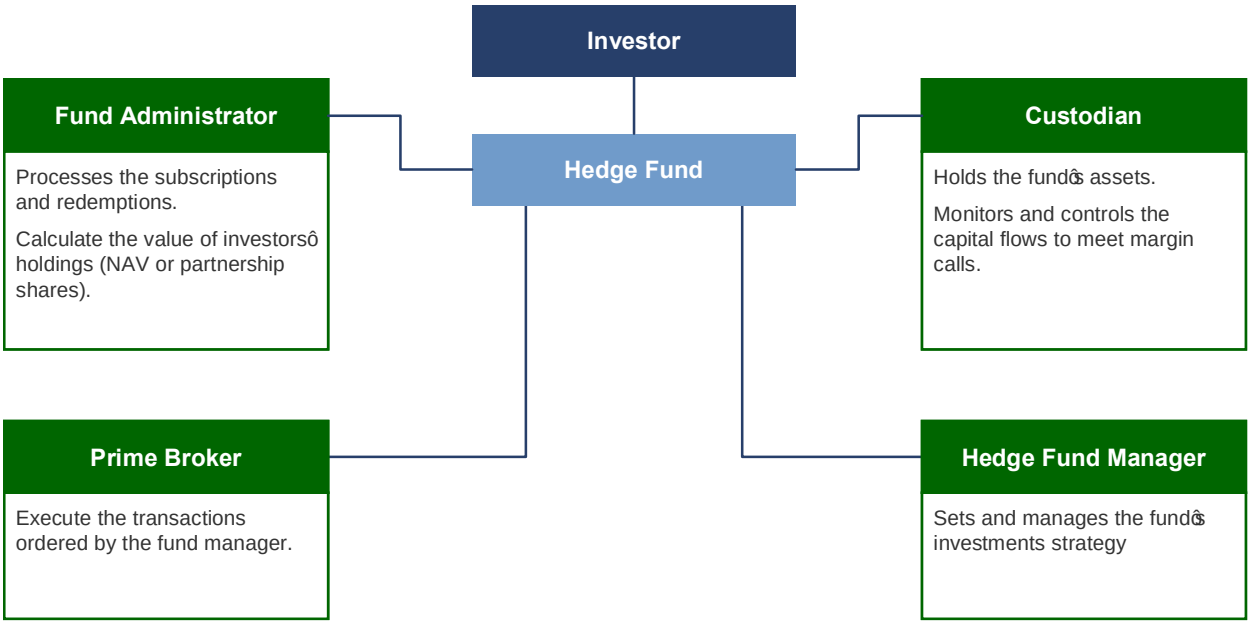
Characteristic	Traditional Investing	Hedge Fund Investing
1. Return Objective	Relative Returns	Absolute Returns
2. Benchmark	Constrained by benchmark index	Unconstrained by benchmark index
3. Investment Strategies	Limited investment strategies Take long-only positions Do not use leverage	Flexible investment strategy Take long and short positions May use leverage
4. Market Correlation	High correlation to traditional asset classes	Generally, low correlation to traditional asset classes
5. Performance	Dependent on market direction	Often independent of market direction
6. Fees	Tied to assets under management, not to performance	Tied primarily to performance

Characteristic	Traditional Investing	Hedge Fund Investing
7. Manager's Investment	Manager may or may not co-invest alongside investors	Manager generally co-invests alongside investors
8. Liquidity	Good liquidity	Liquidity restrictions and initial lock-up periods
9. Investment Size	Small minimum investment size (e.g. $1,000 minimum)	Usually large minimum investment size (e.g. $25,000; depends on prospectus exemption)
10. Structure and Documentation	Set up as a trust or investment company Often sold by prospectus	Set up as a private investment, limited partnership or a trust Usually sold by offering memorandum
11. Regulation	Highly regulated; restricted use of short selling and leverage High disclosure and transparency Can market fund publicly	Less regulated; no restrictions on strategies Less mandated disclosure, and limited or no position level and risk exposure transparency Marketing restrictions apply Prospectus exemption

2.2 Structure of Hedge Funds

The structure of a typical hedge fund is shown in Figure 2.2. This diagram shows the various hedge fund service providers, together with their roles and relationships.

FIGURE 2.2: TYPICAL STRUCTURE OF A HEDGE FUND OFFERING



2.3 General Characteristics of Hedge Funds

The following key characteristics distinguish hedge funds from traditional investment funds:

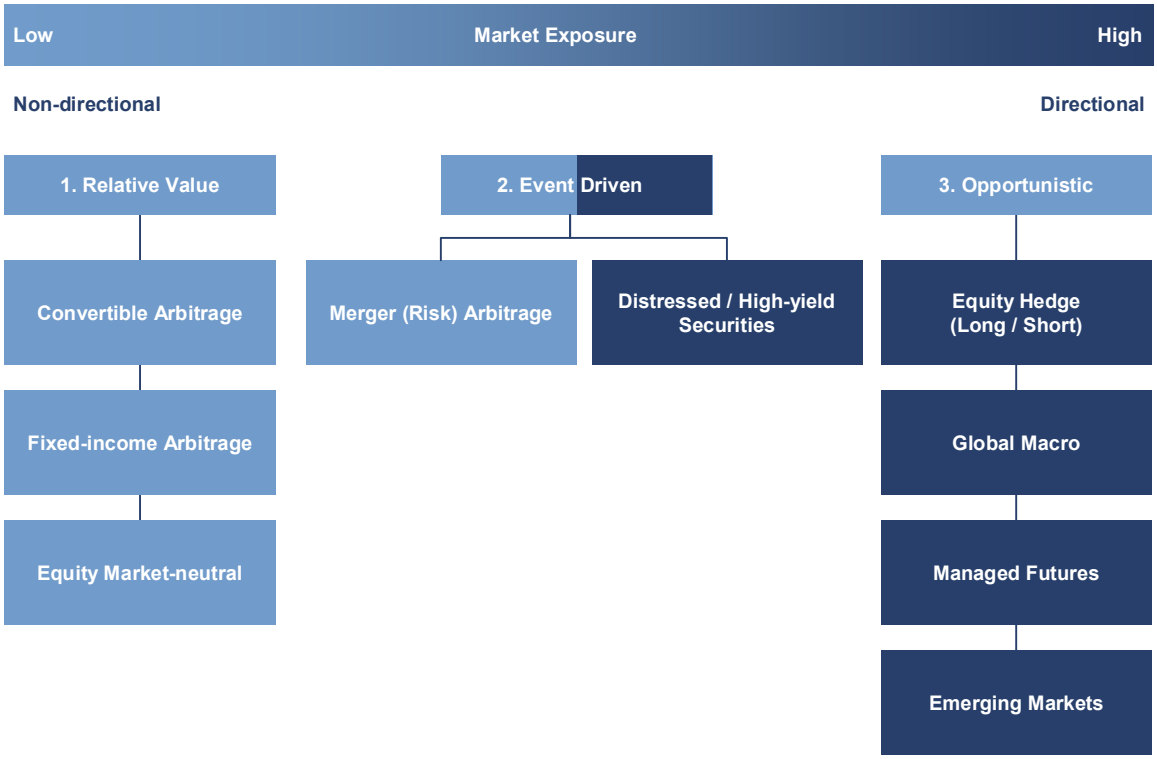
- Absolute Return Objective: Hedge fund managers typically strive for positive returns in all market conditions, since their primary goal is to preserve investors' capital.
- Flexible Investment Strategies: Hedge fund managers can use a wide range of investment strategies and tools, such as derivatives and leverage, to gain exposure to specific opportunities, and/or to minimize a particular risk related to an opportunity.
- Investment Structure: Hedge funds can be organized in a variety of ways including limited partnerships, limited liability companies, unit trusts, or listed entities. Many hedge funds are domiciled offshore in jurisdictions such as the Cayman Islands, Ireland, Bermuda, etc.
- Performance Fees: Performance fees are a key characteristic of hedge funds. Funds typically have a high-water mark to ensure that the manager only earns performance fees on profits generated by positive returns above a certain level.
- Alignment of Managers' and Investors' Interests: Typically, a significant proportion of a hedge fund managers' personal wealth is invested in their own funds, which aligns their interests with those
of their investors.
- Limited Liquidity and Lock-up Periods: Hedge funds typically sell or redeem units monthly, but certain funds/strategies may require lock-up periods where investors cannot redeem their investment. Lock-up periods for hedge funds typically range from 3 months to 1 year, but may be longer. Also, some quarterly redemption policies may require a long notice period (e.g., 60 days). Alternatively, there may be early redemption penalties or gating provisions.
- Low Correlations with Traditional Asset Classes: Many hedge fund strategies seek to have low correlations with traditional asset classes, such as stocks and bonds. Many hedge fund strategies also have low correlations with each other. Therefore, hedge funds can provide valuable diversification benefits.
- Leverage: Varying amounts and types of leverage are used in most hedge fund strategies. Many relative value strategies (non-directional) tend to use higher leverage than directional strategies.
- Capacity Constraints: While hedge funds can stay open to new investment for many years, some hedge funds may close to new investors, because they wish to limit their size to preserve investment returns. FoFs managers will often reserve capacity with selected managers to allow their investors to continue participating in the underlying funds.
- Transparency: Many single-strategy managers do not disclose their holdings to investors. Position level transparency (i.e., disclosure of the fund's underlying holdings) and/or risk transparency (i.e., disclosure of the fund's overall risk parameters) is currently a key issue in the hedge fund industry. The industry continues to move towards greater transparency.
- Investment Minimums: Since hedge funds are sold primarily in the exempt market (i.e., without a prospectus), there are high minimum investments, which are typically between $97,000 and $150,000, depending on the province or territory in which they are sold. Note that hedge fund companies can set their own minimum investment levels for "accredited investors," which is typically $25,000.
- Income Distributions and Taxes: The income distributions from hedge funds differ depending on the hedge fund structure (i.e., whether it is a limited partnership or a trust). Investors should understand the tax implications of any distributions, and consult a tax professional prior to investing in hedge funds.

Section 3: Typical Hedge Fund Strategies

There are a multitude of strategies used by hedge fund managers, and hedge funds can be classified in a variety of ways: based on process or strategy, asset class, geographical location, industry sectors, or return drivers. To date there is no standard classification system of hedge fund strategies in the industry.

There are numerous hedge fund indices developed by financial services companies[x], each with different characteristics and classification methodologies. The most consistent classification is based on the hedge fund's investment strategy and asset classes. Generally, these strategies can be further divided into directional and non-directional strategies. Figure 3.1 provides an overview of a typical hedge fund strategy classification, and we use this classification system as a framework for reviewing the various strategies.

FIGURE 3.1: CLASSIFYING HEDGE FUND STRATEGIES



3.1 Relative Value Strategies (Non-directional)

When using relative value or arbitrage strategies, a manager generally seeks to profit from a perceived mispricing in a specific asset or security. With each portfolio position, the manager attempts to isolate and capitalize on a feature of an asset (or combination of assets) that is mispriced relative to a theoretical fair value or equilibrium relationship.

The most common relative value strategies include convertible arbitrage, fixed-income arbitrage and equity market-neutral. The degree of leverage used in arbitrage strategies varies depending on the strategy and the portfolio objectives, but is usually between two and ten times the underlying equity value.

3.1.1 CONVERTIBLE ARBITRAGE STRATEGY

A convertible arbitrage strategy aims to profit from mispricing opportunities within convertible bonds and other hybrid debt/equity securities[xi]. Convertible securities are a combination of various instruments, and the

parcel as a whole may have a different price than the sum of the component parts. If the price is different, there is an opportunity to buy (sell) the parcel and to sell (buy) the component parts to lock in a profit. Therefore, the generation of "alpha" is independent of the general market direction.

A typical investment is to buy the convertible bond and sell short the common stock of the same company, to take advantage of the stock's price volatility. Positions are designed to generate returns from both the bond and the short sale of stock, while protecting principal from market moves. The fund generally receives the yield on the convertible bond and the interest on the short sale's cash proceeds. The fund uses the short stock position to protect against declines in the bond's principal value. When executing a strategy of long convertible bonds and short equity, the manager must consider the credit risk associated with the trade. Credit defaults swaps can be used to remove the credit risk from convertible bonds and interest rate swaps can be used to remove the interest rate risk from the convertible bonds.

CONVERTIBLE BOND EXAMPLE:

Assume a fund manager believes a convertible bond is undervalued relative to its component parts.

Manager's Actions and Profit Opportunity: The manager buys the convertible bond (goes long the bond) and shorts the stock of the same issuer to eliminate the stock-price risk embedded in the convertible bond. Depending on the specific situation, the manager may hedge the interest rate and credit spread risk of the convertible bond. The manager typically expects to generate a profit on the trade based on the stock price's volatility.

3.1.2 FIXED-INCOME ARBITRAGE STRATEGY

Fixed-income arbitrage managers aim to profit from price anomalies between related interest-rate securities. Most managers trade globally, with a goal of generating steady returns with low volatility. A fixed-income arbitrage strategies may include interest-rate swap arbitrage, US and non-US government bond arbitrage, forward yield curve arbitrage, and mortgage-backed securities arbitrage. The mortgage-backed securities market is complex, and primarily trades over-the-counter in the US.

The leverage used in fixed-income arbitrage strategies depends on the type of portfolio positions, which include basis trading, inter-market spreads, yield curve trading, relative-value options strategies, and financing strategies. Generally, basis trades are less risky than yield curve trades.

FIXED-INCOME ARBITRAGE EXAMPLE:

A basis trade is an example of a fixed-income arbitrage strategy. This trade involves the purchase or sale of an interest-rate futures contract and a concurrent offsetting sale or purchase of a fixed-income security that is deliverable under the futures contract.

Manager's Actions and Profit Opportunity: Assume a hedge fund manager simultaneously buys a government bond and sells a bond futures contract on this bond. The manager may profit from the:

1. Uncertainty regarding the bond to be delivered under the bond futures contract.
2. Shifts in the supply and demand for the underlying bonds.

3.1.3 EQUITY MARKET-NEUTRAL STRATEGY

An equity market-neutral strategy is designed to exploit equity market inefficiencies, and usually involves long and short matched equity portfolios of the same size[xii]. The manager typically aims to position the portfolio to be dollar neutral or beta neutral, or both. The portfolio often has a small net market exposure. Well-designed equity market-neutral portfolios typically control sector, style, market capitalization, and other factor exposures. Leverage is often used to enhance returns.

EQUITY MARKET-NEUTRAL EXAMPLE:

An example of a typical equity market-neutral trade is a pairs trade in two listed companies of similar size and geography in the same industry. This strategy involves buying one company's stock and selling short the stock of another company in the same sector.

Manager's Actions and Profit Opportunity: The manager:

Buys $100,000 of shares in Company A in sector X.

Sells short $100,000 of shares in Company B in sector X.

The manager expects Company A's stock to rise in price relative to Company B's stock or Company B's stock to fall relative A, or some relative valuation anomaly to narrow.. The manager does not typically take market or sector risk, but instead tries to profit from differences in company-specific performance.

3.2 Event-driven Strategies (Non-directional and Directional)

An event-driven strategy is designed to capture price movements generated by a significant pending corporate event, such as a merger, corporate restructuring, liquidation, bankruptcy, or reorganization. Two sub-categories in event-driven strategies are merger or risk arbitrage (non-directional) and distressed/high-yield securities (directional).

3.2.1 MERGER (RISK) ARBITRAGE STRATEGY

Merger arbitrage managers exploit merger activity to capture the spread between the current market values of securities and their values in the event of a merger, restructuring, or other corporate transaction[xiii]. Managers generally consider a transaction once an announcement is publicly made. Most merger arbitrage managers exploit both cash-only deals and stock deals.

Before entering into a merger arbitrage strategy, the manager analyzes the probability of the deal closing, the bid price, and the timeframe to the closing date. The probability of the takeover's success directly influences the size of positions the manager will take, since the trade's profitability depends on the merger's success. The post-announcement and pre-closing spread on a particular deal will depend upon a variety of risk factors such as financing risk (ability of the acquiring company to secure financing for the deal) and regulatory risk (deals may require regulatory approval depending on the industry in which they operate).

MERGER ARBITRAGE EXAMPLE:

In mergers where the target company's shareholders are offered stock in the acquiring company, the spread is the difference between the current values of the target company's stock and the acquiring company's stock. The spread is captured where the arbitrageur buys the stock of the target company (Company B) and sells the stock of the acquiring company (Company A).

Manager's Actions and Profit Opportunity: Table 3.1 provides an overview of the hedge fund manager's actions and the profit opportunity (Actions 1-6). A key risk of this strategy is deal risk, since the merger may not be completed as planned.

TABLE 3.1: MERGER ARBITRAGE EXAMPLE

Action	Company A (Acquirer)	Company B (Target)
1. Takeover Announcement:	Company A is the acquirer	Company B is the target
2. Offer:	Company A makes an offer to acquire Company B	The offer is at a 20% premium of Company B's current market price
3. Market Reaction	Company A's stock price typically declines or remains flat	Company B's stock price appreciates by 10%
4. Manager's Expectation:	Company A's stock price will decline or remain flat	Company B's stock price will rise
5. Manager's Response:	Manager sells short Company A's stock	Manager buys Company B's stock
6. Position Will Profit it:	Takeover completed successfully and stock prices converge, so that Company A's stock price declines and/or Company B's stock price rises. Or Another suitor, Company E (the new acquirer) makes a bid for Company B (the target) for a higher price than offered by Company A. The manager then switches the short position from Company A to Company E.	

3.2.2 DISTRESSED/HIGH-YIELD SECURITIES STATEGY

Fund managers involved in distressed or high-yield securities are active in bond and equity markets, where the strategies focus on actual or anticipated events, such as a bankruptcy announcement or corporate reorganization as a result of debt default. Distressed or high-yield securities are generally below investment grade, and require extensive due diligence to take advantage of the low prices at which they trade. Investors in distressed securities seek capital appreciation of the debt rather than an income stream.

Performance depends on how well the managers analyze event-specific situations, rather than on the direction of the stock or bond markets. Managers investing in distressed or high-yield securities vary in terms of the level of capital structure in which they invest (debt or equity, and the security's ranking), the stage of the restructuring process, and the degree to which they become involved in negotiating the terms and managing the restructuring (i.e., the manager determines whether the investment is passive or active). In certain cases, managers may attain a seat on the company's board, take an activist role if appropriate, or even pursue litigation against the company or its directors and officers.

DISTRESSED SECURITIES EXAMPLE:

The following is an example of a typical distressed securities scenario (cross reference the numbered steps below to Figure 3.2):

1. A financial institution (Finance Co.) makes a loan of $10 million to a borrower (Tel Co.). Tel Co. uses the funds to restructure the company and/or to repay some of its debt.
2. Tel Co. then finds itself in financial difficulty, resulting in bankruptcy or near-bankruptcy.
3. Tel Co. defaults on its debt, resulting in a decrease in the loan's value.

Manager's Actions and Profit Opportunity:

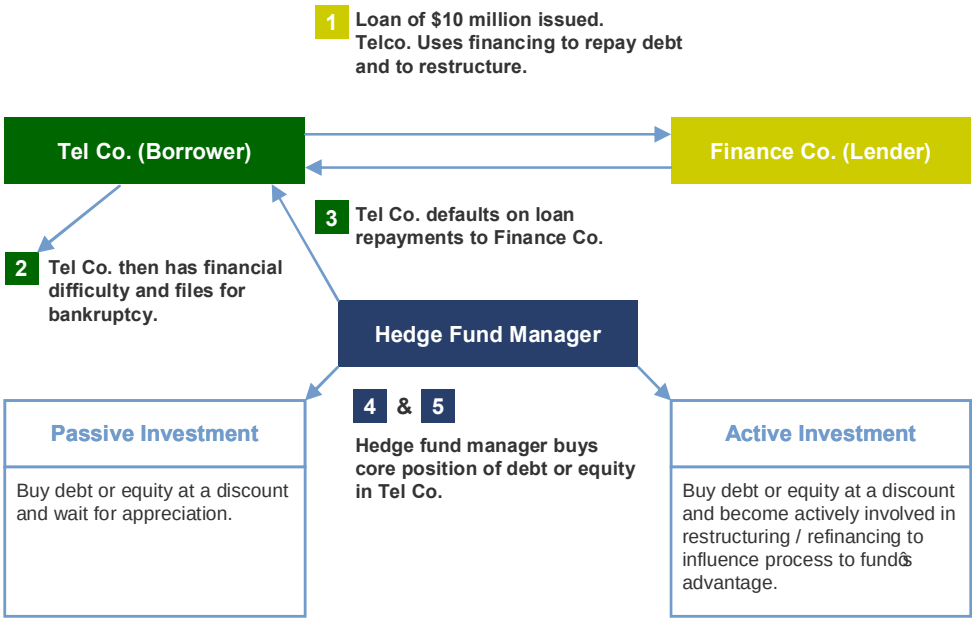
4. A hedge fund manager specializing in distressed securities analyzes the situation for possible investment, either in the company's debt or equity.
5. The hedge fund considers the following types of questions:

   Does the business have long-term value? Is the company having problems, such as over-leveraging, which can be rectified?

   Are the company's operating metrics declining? What class of debt will have the highest priority in the restructuring?

If the cost-benefit analysis of the distressed company appears favourable, the hedge fund then makes either a passive or an active investment. The manager's goal is to buy the distressed securities at a deep discount and sell them at a significantly higher price, which is usually after an extended period of restructuring. A key risk of this strategy is that the company goes bankrupt and does not recover after a restructuring.

FIGURE 3.2: DISTRESSED SECURITIES EXAMPLE



3.3 Opportunistic Strategies (Directional)

Opportunistic strategies generally include any hedge fund where the manager's investment approach changes over time to take advantage of current market conditions and investment opportunities. Opportunistic strategies may have higher risk than relative value and event-driven strategies, as they have higher directional market exposure.

An opportunistic hedge fund's investment theme may change as opportunities arise in order to profit from events such as an initial public offering (IPO), sudden price changes caused by an earnings disappointment, hostile bids, and other event-driven opportunities. Some opportunistic funds use several investing strategies at a given time, and are not restricted to any particular investment approach or asset class. Opportunistic strategies include equity hedge, global macro, managed futures and emerging markets.

3.3.1 EQUITY HEDGE (LONG/SHORT EQUITY) STRATEGY

In an equity hedge (long/short equity) strategy, the manager's investment decisions depend on the degree to which individual stocks are undervalued or overvalued relative to current market prices[xiv]. This strategy is heavily reliant on a manager's skill in discerning a stock's fair value. Managers typically perform both quantitative and qualitative analyses.

Equity hedge fund managers take positions along the entire risk-return spectrum, and try to distinguish their performance from the equity asset class as a whole. Equity hedge strategies combine long and short stock positions, which reduce directional market risk. Returns are generated from the price movements of individual stocks. Therefore, as stated in Section 2, equity hedge fund returns typically deviate from underlying equity market returns.

An equity hedge strategy involves holding both long and short equity positions with either a net long or net short exposure. The objective is not to be market neutral. Also, this category excludes long-only portfolios. To be considered an equity hedge fund, the manager's strategy must include short positions, while maintaining an absolute return objective.

Managers have the ability to shift from value to growth and from small-, medium- to large-capitalization stocks. In addition, managers may use futures and options. For certain managers, the focus may be regional such as US or European stocks, or sector specific such as technology or healthcare stocks. Other managers take a generalist approach and invest across various geographies, sectors and company capitalizations.

Managers with a "long bias" or "short bias" may have similar strategies, but remain either net long or net short with a larger proportion of their equity portfolios. Other managers have a "variable bias", where they switch between net long and net short equity exposures.

Some equity hedge managers use a pair trading strategy, and have a short position for each corresponding long position in a particular sector. Other managers take outright positions on both the long and short side, and only hedge dollar exposure and market exposure, without perfectly matching sector exposure. (Note: In an equity market-neutral strategy the goal is to have no exposure to market factors, so the portfolio is typically dollar neutral, beta neutral, sector neutral, capitalization neutral and currency neutral).

LONG BIAS EXAMPLE:

Managers with a long bias take both long and short equity positions, depending on their market outlook. Portfolios may shift between small-, medium- and large-capitalization stocks, and across sectors within a particular market.

Manager's Actions and Profit Opportunity: Table 3.2 provides an example of a manager's typical positions in a long-bias equity hedge fund portfolio that trades within and across sectors. The portfolio has a long exposure of 60%, with 42% held in short positions, which results in a gross exposure of 102% (60% long + 42% short = 102%), and a net long exposure of 18% (60% long - 42% short = 18% net long). Ideally, the manager expects to profit from both the long and short positions in the portfolio. However, this strategy is exposed to equity market risk as the portfolio has a net long exposure. Further, the strategy has stock selection risk.

TABLE 3.2: EXAMPLE OF A LONG-BIAS EQUITY HEDGE FUND PORTFOLIO

Industry Sector	Expected Price Change	Position	Stock	Position size as % of Portfolio (1)
Banking	Up	Long	Bank 1	15%
	Down	Short	Bank 2	13%
	Up	Long	Bank 3	16%
Technology	Up	Long	Tech. Co. 1	14%
	Down	Short	Tech. Co. 2	16%
Consumer Discretionary	Up	Long	Department Store 1	15%
	Down	Short	Department Store 2	13%
			Total Long Positions in Portfolio	*60%*
			Total Short Positions in Portfolio	*42%*
			Net Portfolio Exposure	**18% Long**

(1) Note: The percentages used are for illustrative purposes only, where 100% of the portfolio is invested in stocks. In reality, a long-bias equity hedge fund portfolio is more diversified, and is not concentrated with such large weightings in each stock.

3.3.2 GLOBAL MACRO STRATEGY

A global macro strategy involves opportunistically allocating capital among a wide variety of strategies and asset classes. Strategies or themes may be directional or non-directional. Global macro is the most flexible hedge fund strategy, with managers often taking a top-down thematic approach to market opportunities.

With a top-down approach, managers invest on an opportunistic basis, moving between countries, markets and instruments based on expected changes in interest rates, exchange rates and liquidity. A variety of trading strategies are used depending on the opportunities identified. Most funds invest globally in both developed and emerging markets.

GLOBAL MACRO EXAMPLE:

A manager will attempt to exploit global trends and market movements by entering into leveraged directional positions. Assume a global macro manager expects interest-rate spreads between Canada and the US to widen due to interest rate increases in Canada.

Manager's Actions and Profit Opportunity: The fund manager takes a position to buy the Canadian dollar (and sell the US dollar) with the expectation that the Canadian dollar will rise against the US dollar following an increase in Canadian interest rates. The risk of this strategy is that the Canadian dollar may depreciate against the US dollar.

3.3.3 MANAGED FUTURES STRATEGY

A managed futures strategy will take long or short directional positions on a short to medium term basis in currencies, commodities, equities and fixed-income securities[xv]. These managers trade on the spot or futures markets globally and are referred to as Commodity Trading Advisors (CTAs). Trading disciplines are generally systematic or discretionary.

Systematic managers use price and market-specific information (often technical) to follow trends, while discretionary managers use a less quantitative approach, relying on both fundamental and technical analysis. Typical trades for a managed futures strategy include: (1) Trend following using technical analysis with a stop-loss; (2) Long-term directional trading based on market fundamentals; and (3) Short-term spot trading based on flow information. Instruments typically used include currency futures, forwards, and exchange-traded and OTC options and warrants.

3.3.4 EMERGING MARKETS STRATEGY

Broadly defined, an emerging market economy is one with a low to moderate per capita income as compared to the world's developed economies. Emerging markets constitute approximately 80% of the global population and 20% of the world's GDP. These markets are associated with the potential for greater economic growth as compared to developed markets and therefore greater investment potential.

The emerging markets strategy used by hedge funds involves equity or bond investing in emerging markets globally. Emerging market investing often involves a long-only strategy, because many emerging markets do not allow short selling, nor offer viable derivative products with which to hedge. Further, an investment in an emerging market results in exposure to the movements in the country's currency, since the currencies of many emerging markets generally cannot be hedged using derivatives. For these reasons, the strategy tends to contain a large beta component and will exhibit a larger volatility as compared to other hedge fund strategies.

3.4 Composition of Assets by Strategies

3.4.1 GLOBAL MARKETPLACE

The growth of hedge fund strategies and its composition within the industry changes over time. For example, Figures 3.3 to 3.5 provide a snapshot of the strategy composition within the global hedge fund industry in 1994, 2003, and 2008. Figure 3.3 shows that in 1990, global macro dominated the marketplace with 53% of assets. Long/Short equity strategies represented 21%, event driven strategies represented 10%, and emerging market strategies represented 6% of the marketplace. All of the remaining hedge fund strategies each represented less than 11% of the total assets.

FIGURE 3.3: BREAKDOWN OF GLOBAL HEDGE FUND ASSETS BY STRATEGY AS AT DECEMBER 1994
(Source: EcoWin, CS Tremont Hedge Fund Indices)

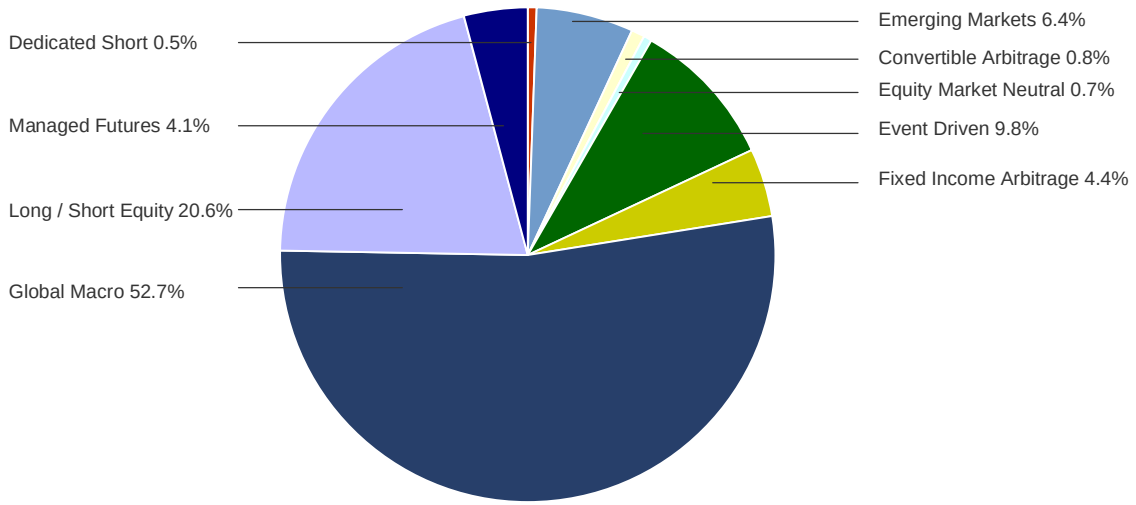


Figure 3.4 shows the strategy composition of the hedge fund industry in December 2003. Global macro funds had a significant decline in market share from 52.7% in 1990 to 11.7% by the end of 2003. This decline reflects outflows from global macro funds following the strategy's poor performance (particularly in 1994 and 1998), and the closure of a small number of dominant global macro managers in the industry. Equity hedge strategies increased in market share from 20.6% in 1994 to 27.4% by the end of 2003. Event-driven strategies increased from 10.0% to 20.5%. Multi-strategy funds increased in market share from essentially zero (0.1%) to 11.5%, while emerging markets funds decreased from 6.4% to 2.4% for the period. Other significant changes for the period include an increase in equity market neutral strategies from 0.7% to 5.5%; and convertible arbitrage strategies from 0.8% to 7.1%.

FIGURE 3.4: BREAKDOWN OF GLOBAL HEDGE FUND ASSETS BY STRATEGY AS AT DECEMBER 2003
(Source: EcoWin, CS Tremont Hedge Fund Indices)

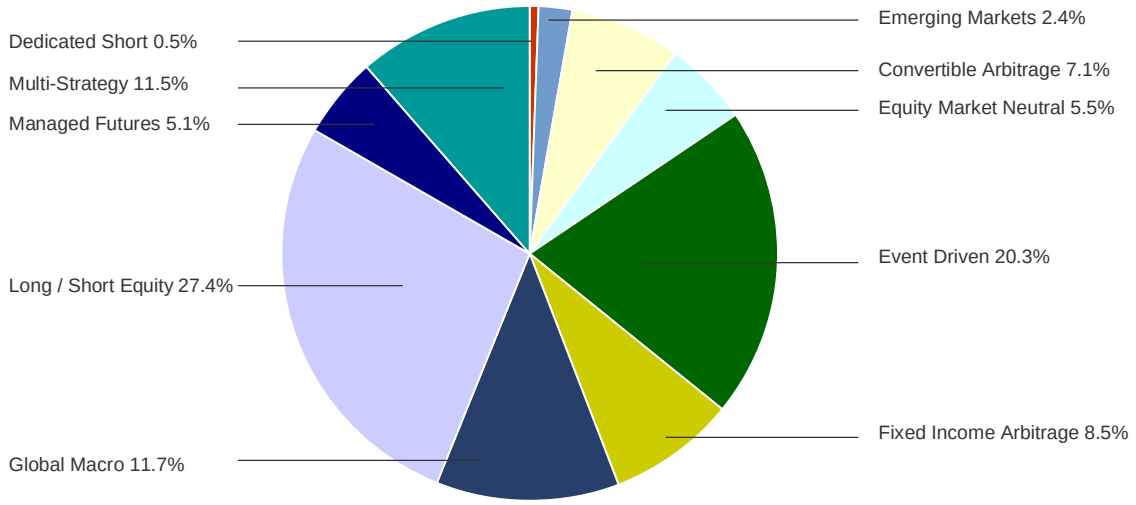


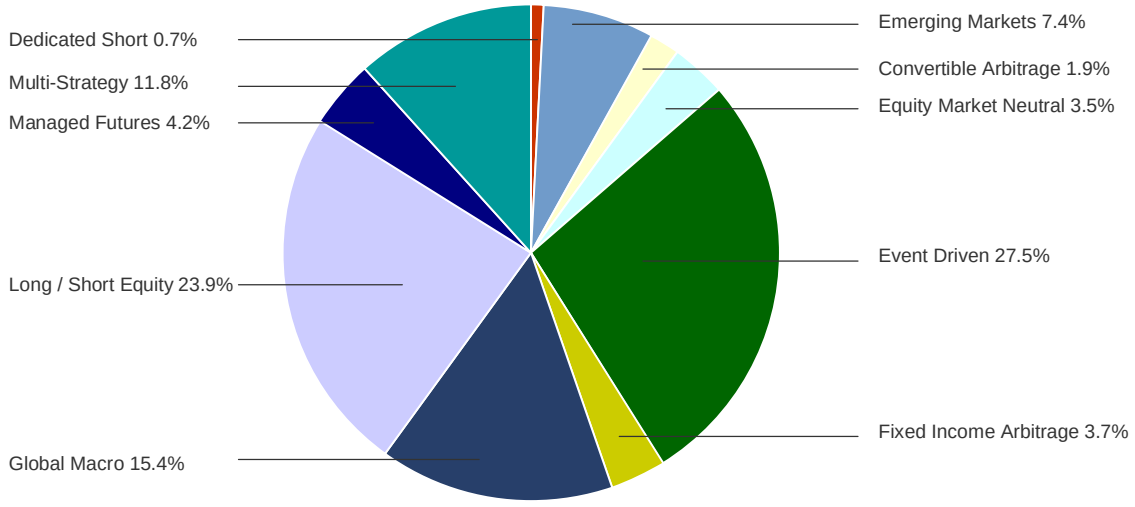
Figure 3.5 shows the strategy composition of the hedge fund industry in December 2008.

The changes from 2003 through to 2008 were less dramatic than those observed from 1994 to 2003 although there were several trends that emerged. Event driven strategies continued to expand market share from 20.5 to 27.4. Long/Short Equity was relatively stable through the period. Two strategies rebounded from the

previous time period with global macro strategies increasing market share from 11.7 to 15.4, and emerging markets growing from 2.4 to 7.4. Two strategies suffered large shifts in market share with convertible arbitrage shrinking dramatically from 7.1 to 1.9 and fixed income arbitrage shrinking from 8.5 to 3.7.

FIGURE 3.5: BREAKDOWN OF GLOBAL HEDGE FUND ASSETS BY STRATEGY AS AT DECEMBER 2008

(Source: EcoWin, CS Tremont Hedge Fund Indices)



Section 4:Hedge Fund Risk/Return Drivers

Hedge fund investors must consider a fund's degree of exposure to broad market movements, and its effect on the fund's risk and return. Hedge funds are generally constructed with specific targets and strategies, where investors expect a certain risk/return profile.

4.1 Historical Risks and Returns of Hedge Fund Strategies

The risk/return characteristics of hedge fund strategies differ substantially from each other, and from traditional bond and equity markets. A typical mantra often voiced within the hedge fund industry is to seek to provide returns similar to the level of equities held over long time horizons while maintaining risk levels similar to those of fixed income investments held over long time horizons. These characteristics vary depending on the specific hedge fund strategy. For example, emerging market and dedicated short managers exhibit high volatility, while equity market neutral and event driven managers exhibit lower levels of volatility. In general, as a fund's exposure to market direction increases, its volatility will also increase.

While past return and volatility measures offer insight into a hedge fund's historical behaviour, strategies can exhibit a variety of unique statistical characteristics. For example, negative skewness is sometimes associated with certain hedge fund strategies such as fixed income arbitrage and merger arbitrage. Negative skewness refers to the tendency to provide months of small positive returns followed by a large negative return.

Fund of Funds generally exhibit moderate risk/return characteristics when compared to hedge fund strategies and broader capital market indices. The FoFs risk/return profile highlights the diversification benefits that can be achieved using a range of hedge fund strategies.

4.2 Risk Factors of Hedge Fund Strategies

Since hedge funds have an absolute return objective, it is useful to measure their correlations and volatilities (both the upside and downside deviations) relative to each fund's specific objective, rather than their performance relative to an index or peer group. However, most hedge fund strategies have had substantially smaller negative returns than the traditional equity markets. The incidence of positive returns is generally expected to be higher with absolute return strategies.

CATEGORIZING HEDGE FUND RISKS

Figure 4.3 categorizes a broad range of financial risks, which highlights the complexity of analyzing hedge fund performance and completing the due diligence on a hedge fund company. Recognize that one cannot simply analyze a hedge fund's volatility of returns (i.e., standard deviation) and use this number as a measure of a hedge fund's risk. In effect, hedge fund risks are multi-dimensional, since hedge fund strategies are typically exposed to both credit risks and market risks, as well as to operational risks.

The risks associated with each hedge fund strategy depend on the type of strategy, and the degree to which it is exposed to market factors. These market factors include credit risks and market risks as shown in Figure 4.3. The most common risks associated with each hedge fund strategy are summarized in Table 4.1.

FIGURE 4.3: CATEGORIZATION OF FINANCIAL RISKS

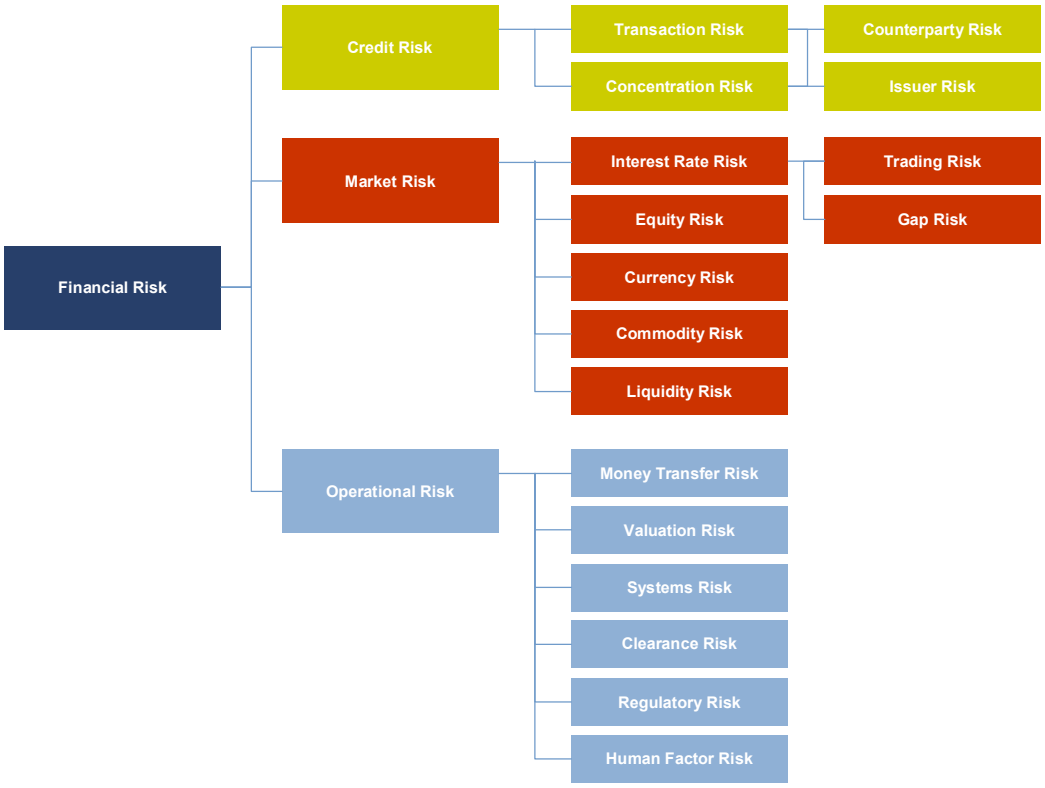


TABLE 4.1: TYPICAL RISK EXPOSURES OF HEDGE FUND STRATEGIES[x]

Hedge Fund Category	Typical Risk Exposure by Strategy
1. Relative Value	1. **Convertible Arbitrage:** Interest rate risk, credit risk, equity volatility risk.
	2. **Fixed-income Arbitrage:** Interest rate risk, credit risk, model risk.
	3. **Equity Market-neutral:** Individual equity risk, model risk.
2. Event Driven	1. **Merger Arbitrage:** Deal risk/corporate event risk, equity volatility risk.
	2. **Distressed/High-yield Securities:** Corporate event risk, credit risk, equity volatility risk, interest rate risk, liquidity risk.
3. Opportunistic	1. **Equity Hedge:** Equity market risk, equity volatility risk.
	2. **Global Macro:** Equity market risk, interest rate risk, currency risk, credit risk.
	3. **Managed Futures:** Commodity market risk, interest rate risk, currency risk, model risk.
	4. **Emerging Markets:** Equity market risk, interest rate risk, political risk, credit risk, currency risk, liquidity risk.

ANALYSIS OF HEDGE FUND MARKET RISK

As the hedge fund industry has matured, the sophistication of hedge fund analysis techniques has also improved. Market risk is can be analyzed using a holdings-based approach and a factor-based approach. The holdings-based approach involves aggregation and analysis of the positions held by the fund at a point in time. This approach will provide the most complete representation of the market risks and exposures of a hedge fund. A holdings-based approach allows for a traditional market risk analysis of the fund using quantitative techniques such as sensitivity analysis, stress testing, and value-at-risk analysis[xvi]. While comprehensive, holdings-based analysis is difficult to perform and generally requires a systems-based implementation for efficiency.

Factor analysis requires only the return history of a hedge fund (usually provided on a monthly frequency). The return history of a hedge fund can be decomposed into alpha and beta contributions using statistical techniques, typically linear regression. The types and magnitude of the beta and alpha components of the hedge fund returns can be isolated[xvii]. One of the drawbacks of this approach is the dynamic nature of hedge funds. For example, a global macro fund may change their exposure to US Treasury Bonds from long to short over the course of a few months as economic conditions change. A factor analysis using monthly data may be unable to accurately isolate the change in risk exposure. In addition, factor analysis requires some degree of statistical sophistication. Selecting the specific factors, the appropriate number of factors, and the time frame for analysis are all necessary parameters for a successful factor analysis.

Tools for holdings-based and factor-based analysis of hedge funds have become commercially available over the past several years[xviii]

OPERATIONAL RISK OF HEDGE FUNDS

It is also important to consider the operational risks of hedge funds. Some of the risks of investing in hedge funds are non-quantifiable risks, such as transparency issues, key person risk, and fraud. These risks are more pronounced in hedge funds since the majority of hedge fund firms are entrepreneurial boutique finance companies.

Hedge funds operate within and are a part of the global financial system. Therefore, in addition to the broad range of financial risks outlined in Figure 4.3 hedge funds are also exposed to systemic risk. The year 2008 possessed a large amount of systemic risk. The unique interaction of market risks and operational risks occurred in 2008 as a result of increased systemic risk. The collapse of the US housing market caused large losses and failures within the US banking and Investment banking sectors. These problems as well as a global recession resulted in falling equity and commodity markets and increasing credit spreads. The combination of mark-to-market losses, illiquid investments, hedge fund redemptions, prime brokerage and investment banking de-risking caused a wide variety of problems. Some hedge funds were enable to meet redemption requests since they were holding illiquid securities and therefore suspended redemptions. Investors who had originally thought they were investing in relatively liquid strategies such as convertible arbitrage were suddenly faced with gates and lock-ups in addition to investment losses.

In a "normal" market environment operational risks can be minimized through diversification across a large number of managers and across a variety of strategies. This is the investment model typically followed by hedge fund-of-funds and generally works in the presence of infrequent idiosyncratic operational events. However as discussed above with respect to the events of 2008, this approach generally did not work as anticipated due to the unique interaction of market risk, operational risk, and widespread systemic risk.

The use of these market risk tools may also help to reduce operational risk. Since an investor is able to see the market exposures or positions within the underlying manager's portfolio. Some larger institutions require a sufficient level of position data disclosure before or to maintain investment in the fund.

Section 5: Investing in Hedge Funds

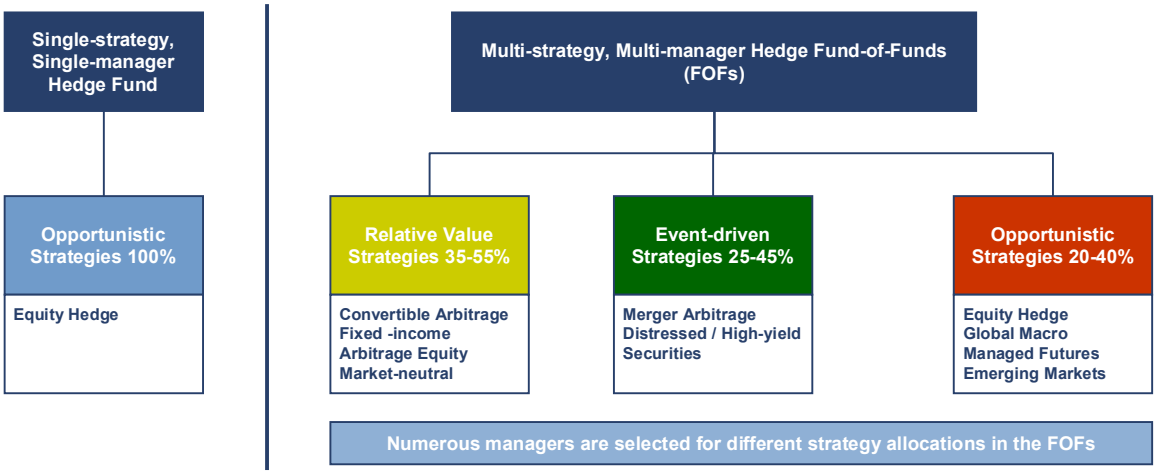
5.1 Types of Hedge Funds

It is important for investors to understand the different types of hedge funds available and their specific operational risks. The investor's goal should be to minimize individual hedge fund manager risk through diversification. There are currently four main types of hedge funds:

- Single-strategy, Single-manager Fund (referred to as a single-strategy fund): A single-strategy hedge fund that is managed by a single manager typically focuses on one or two related hedge fund strategies to generate returns. This type of fund has relatively high strategy and manager risk, since there is little or no diversification of hedge fund strategies or managers.
- Single-strategy, Multi-manager Fund-of-Funds (FoFs): Some FoFs focus on a single hedge fund strategy, such as equity hedge, but employ multiple managers in this single strategy to generate returns. Therefore, the manager risk is diversified and significantly reduced, as multiple managers with different styles and correlations contribute to the FoFs returns. However, there is still strategy risk, since the FoFs is invested in a single strategy.
- Multi-strategy, Single-manager Fund (referred to as a multi-strategy fund): A multi-strategy hedge fund is characterized by the ability of a single manager in one hedge fund company to dynamically re-allocate capital among multiple hedge fund strategies in response to market opportunities. The multi-strategy manager therefore has a number of in-house managers who invest in different hedge fund strategies, and the multi-strategy manager determines how best to allocate the capital. This type of fund has relatively high manager risk, since there are no allocations to outside managers as in a typical FoFs.
- Multi-strategy, Multi-manager Fund-of-Funds (FoFs): Many FoFs combine multiple hedge fund strategies and multiple managers within strategies to diversify across both strategies and managers. There are diversification benefits when investing in a variety of hedge fund strategies and hedge fund managers, since both the strategies and the managers may possess low to moderate correlations with each other.

Figure 5.1 provides an example of a single-strategy, single-manager equity hedge fund; and multi-strategy, multi-manager FoFs.

FIGURE 5.1: EXAMPLE OF SINGLE-STRATEGY FUND, AND FUND-OF-FUNDS



HEDGE FUND-OF-FUNDS (FoFs)

FoF managers invest in multiple hedge funds, numbering anywhere from 10 to over 50. The investment returns of a FoF are a combination of the underlying funds' performance minus applicable fees. The FoF manages the strategy allocation, selection of underlying fund managers. As well, they perform the tasks of due diligence and operational risk management in order to minimize the chances of experiencing a large loss within any single fund as well as fraud. A FoF represents a layer of active investment management on top of the hedge fund investments (which in turn represents a form of active investment management).

Investors may gain diversified exposure to hedge funds initially through FoFs, and then add single-strategy hedge funds to their portfolios over time. Sophisticated hedge fund investors can build their own FoFs using a combination of single-strategy funds. While this "do-it-yourself" approach has additional costs for internal research, risk management and external consultants, it may result in lower fees than a FoFs vehicle.

5.2 Reasons to Invest in Hedge Funds

As noted in Section 1, the type of investors attracted to hedge funds range from individual investors to institutional investors, such as pension plans and endowments. During a market cycle, there are periods where equity and bond markets offer both attractive and unattractive investment opportunities.

The difficulty with investing in any market is identifying when these opportunities will occur, and positioning a portfolio to take advantage of favourable market conditions. An equity bear market may follow an equity bull market, with lower returns from market-based strategies, due to a price/earnings contraction. However, it is difficult to predict the duration and extent of a bull or bear market.

Therefore, investors should consider including hedge funds in a diversified portfolio due to the possibility of enhanced risk-adjusted returns (as highlighted in Section 4), and the low correlations that many hedge funds have with traditional asset classes. A lower correlation between asset classes in a portfolio helps to reduce the portfolio's overall risk level.

A key question is whether hedge funds should be treated as a separate asset class, like equities or bonds. To be considered a separate asset class, the securities within an asset class should be highly correlated with each other, and these securities should exhibit the same distinct risk/return characteristics. However, this is not the case for hedge funds. Hedge funds are not a homogeneous asset class, since there is a diverse range of hedge fund strategies, and these strategies tend to have low correlations with each other.

Note that one could consider a multi-strategy, multi-manager hedge FoFs as a separate asset class, like equities or bonds.

5.3 Asset Allocation and Hedge Funds

Investors' portfolios exhibit certain risk and return characteristics based on their investment objectives, time horizon and overall "comfort" with short-term volatility. When assessing a hedge fund investment, investors should consider the following key issues:

1. What is the appropriate amount to allocate to hedge funds?
2. Which assets should be redeemed to accommodate a hedge fund allocation? Should allocations be reduced on a pro-rata basis across all asset classes, or should the bond or stock allocations be reduced?
3. How should the hedge fund investment be accessed? 'Portable-alpha' or 'alpha-beta separation' can be utilized to structure hedge fund investments on top of an existing portfolio allocation.

APPROPRIATE AMOUNT TO ALLOCATE TO HEDGE FUNDS

In order to determine an appropriate percentage to allocate to hedge funds in a diversified portfolio, it is important to consider the following types of questions:

- **Reasons for Adding Hedge Funds to the Portfolio:** What is the investor's primary reason for adding hedge funds to a portfolio? Are hedge funds being used to provide added diversification to reduce the portfolio's overall risk, to enhance returns, or to achieve a combination of both? Suitable hedge fund strategies and types of hedge funds can then be selected based on the investor's primary hedge fund objective.
- **Hedge Funds' Characteristics:** What are the key characteristics of the specific hedge funds that may be included in the portfolio, and how do they provide added diversification benefits to the portfolio? These characteristics include the hedge fund's volatility, return and correlation characteristics in both calm markets and in periods of stress. It is also important to assess the operational risks of the specific hedge funds.
- **Initial Allocation with Increased Allocation over Time:** It is essential to make a meaningful allocation to hedge funds if investors' portfolios are to benefit from their diversification characteristics. Many investors begin with a 5-10% allocation to hedge funds, which are typically invested in FoFs. Over time, investors may consider allocating at least 20% to hedge funds if they expect this allocation to have a meaningful impact on their portfolios' overall risk and return.

PORTABLE ALPHA

Portable alpha investment management strategies are designed to: separate the skill-based returns ("alpha") generated by an investment strategy from market risk ("beta"); and subsequently add this alpha to a targeted benchmark or index return to create an improved overall risk adjusted return performance[xix]. Derivatives allow the investor to deconstruct returns into their alpha, beta, and risk-free rate components and then reassemble them in a different manner. The key benefit to this process is the ability to transport the alpha component from the original strategy to another strategy. When this is successfully done across multiple indices, the investor is able to improve the total return of their portfolio and results in a return that exceeds the benchmark they are being measured against. Portable alpha can help investors generate outperformance in asset classes where it may be otherwise difficult to add value through active management.

While any actively managed investment strategy can form the basis for alpha transport, one of the more commonly used alpha engines is a diversified portfolio of hedge funds. This portfolio can be a single hedge fund, a fund of funds created in-house, or an offering from a third party fund of funds manager. There are several compelling reasons for using fund of funds. A fund of funds employs many hedge fund strategies across multiple individual hedge fund investments to generate returns with low correlation to each other and to the market.

Typical benchmark returns are liquid indices such as the S&P 500, Nasdaq 100, Lehman Aggregate Bond index. Access to these benchmark returns or indices is achieved through the use of futures, options and swaps. The success of the strategy is primarily dependent on the successful identification of sources of alpha and transporting these skill-based returns on top of the index returns acquired synthetically at low cost. Due to the complexity of the structuring requirements of portable alpha, typically institutional investors have implemented portable alpha approaches to investing.

Note that each hedge fund and FoFs will have different risk, return and correlation characteristics over time, depending on the strategies and managers used. Investors should ensure that they fully understand the sources of returns and all of the risk exposures of the different hedge fund strategies before investing.

When investing in a single-strategy hedge fund, it is appropriate to allocate funds from the asset class that exhibits similar risk/return characteristics to that fund. For example, it may be appropriate to shift a portion of an investor's equity allocation to a hedge fund strategy which exhibits a reasonably large equity market correlation.

5.4 Factors to Consider Before Investing in Hedge Funds

In conclusion, the following factors should be considered when assessing whether to invest in hedge funds, and how much of the investor's portfolio to allocate to hedge funds.

- Investment Objective - Return Enhancement, Risk Reduction, or Both: It is essential to consider the portfolio's overall investment objective, including the risk/return objective and the investor's risk tolerance. Is the investor's goal to enhance returns, to reduce risk, or to achieve both of these objectives relative to the current portfolio?
- How to Allocate Hedge Funds in a Portfolio: Investors must assess which asset class to source capital from for a hedge fund investment. This decision will depend primarily on the hedge fund's risk/return objective, and its correlation with other asset classes.
- How to Structure the Hedge Fund Investment: Investors can choose to overlay hedge funds on top of an existing portfolio allocation to a traditional asset class. This approach is will require the use of some form of derivative transaction in order to access both the hedge fund investment as well as the original asset class. This approach will also impact the type of hedge fund selected. Typically fund of hedge funds are used within portable alpha implementations.
- Single-strategy Fund, Fund-of-Funds (FoFs), or Both: Investors must assess whether they have the time and expertise to research single-strategy funds and to build and monitor their own FoFs, or whether they should invest in an existing FoFs. In general, FoFs are more suitable for first-time hedge fund investors, since they can often improve a portfolio's return profile at a slightly lower risk. As investors develop expertise over time, they could consider investing in single-strategy funds, recognizing the higher manager risk. Any allocation to a single-strategy fund should assess whether the hedge fund has bond- or equity-like characteristics.
- Risk, Return, Correlation Characteristics of Hedge Fund Strategies: Investors must ensure that they fully understand the sources of return for the different hedge fund strategies, their unique risk exposures, and the correlations of the different strategies with each other and with traditional asset classes.
- Unique Risks of Hedge Funds: The risks associated with hedge funds depend primarily on: The specific hedge fund's strategy. The hedge fund manager's skill in implementing and managing the strategy. The hedge fund manager's operational risk in running the business (i.e., how well is the hedge fund company managed?). It is essential to recognize that the due diligence required to select and monitor hedge fund managers is an ongoing process.
- Lock-up Period and Liquidity Needs: Investors must assess their investment time frame and consider any lock-up period the hedge fund manager may impose.
- Investors' Tax Situations: Investors' income and tax situations should always be considered. Investors should understand the tax implications of any distributions, and consult a tax professional prior to investing in hedge funds.
- Expert Advice: Finally, investors must recognize the importance of professional guidance in determining the appropriate hedge fund allocation in a diversified portfolio, and in selecting and monitoring hedge fund managers.

Conclusion

In this document a review of the hedge fund industry with a Canadian perspective has been provided. Clearly there is a lot to cover in one document. Appendix II provides a wealth of information for the interested reader. The question "What is a hedge fund?" can lead to an open ended debate regarding investment strategies, markets, fee structures, legal structures, and regulation. The question has been discussed in a macroscopic fashion by Richard Bookstaber[xx]. His discussion raises the point that hedge funds encompass virtually all investment styles, all asset markets, and all legal vehicles. A discussion of hedge funds is essentially a very broad discussion of investment management. Within this view, traditional long-only investments represent a constrained approach to investment management. While traditionally the long-only investment community is viewed as the mainstream approach and hedge funds represented as "alternatives", in reality it is the other way around. The potential for building efficient portfolios increases when utilizing a broad range of investment strategies across the global capital markets. With this increased potential also comes an increase in complexity when compared to the construction of a 60/40 equity/bond portfolio. When constraints are relaxed, the complexity of the investment landscape increases, and the need for understanding the characteristics of the investment strategy and underlying managers also increases.

Section 6: Glossary

Accredited Investor	Refers to institutional investors or individuals with high net worth or high net income, as specified by securities regulators, and therefore not requiring the protection of a prospectus and registration requirements under securities law.
Active Risk (Tracking Error)	Refers to the variation between a fund's returns and a benchmark's returns. A large tracking error indicates a large variation from the benchmark, and implies a high level of manager risk.
Alpha	A numerical value indicating a fund's risk-adjusted excess return relative to a benchmark. Alpha is usually associated with a manager's "skill-based" return and measures the value-added by a fund manager.
Arbitrage	To take advantage of disparate pricing between two similar instruments in the same or different markets.
Asset Swap	An interest rate or cross currency swap used to convert the cash flows from an underlying security (a bond or floating-rate note), from a fixed coupon to a floating coupon, a floating coupon to a fixed coupon, or from one currency to another. An interest rate swap can be used to change the cash flow characteristics of an institution's assets to provide a better match with its liabilities.
Benchmark	A reference security or index against which an investment portfolio's performance can be evaluated and compared.
Beta	Measures the sensitivity of a security/fund's returns relative to the market's returns. Beta represents the extent to which the fund's returns have varied relative to movements in the benchmark's returns. The market has a beta of 1.0. A fund with a beta greater than 1.0 is more volatile than the market, while a fund with a beta less than 1.0 is less volatile than the market. Note on Beta and Alpha: In colloquial terms, beta refers to the market-based returns of the asset class (i.e., returns generated from a benchmark index), while alpha refers to skill-based returns generated by hedge fund managers (i.e., returns generated from security selection, market timing, and exploiting market inefficiencies).
Beta Neutral CTA	Describes a fund with no sensitivity to broad market movements. Therefore, the fund's beta is close to zero.
CTA	Commodity Trading Advisor (CTA). CTAs generally trade commodity futures, options and foreign exchange, and many are leveraged.
Closed-end Fund	An investment fund whose securities do not provide a right of redemption on demand based on a net asset value. The fund's securities may be listed on an exchange and, as a result, may trade at a discount (or premium) to the fund's net asset value. Canadian securities regulators treat funds that redeem at net asset value no more frequently than once a year as closed-end funds.
Correlation	A measure of how investments/asset classes tend to move in relation to one another. Investments/asset classes that rise or fall in the same direction are positively correlated, and those that move in opposite

	directions are negatively correlated. Correlations range from -1 to + 1.
Credit Risk	The financial risk that debt will not be repaid, resulting in a loss. For example, debt holders face the risk of not receiving interest and/or principal from the issuer when payments are due. Usually, the higher the issuer's credit rating, the lower the default risk, and vice-versa. Credit risk is closely linked with the financial condition of the company or government issuing the security. Companies with strong sales and profits have a lower credit risk. The federal government has almost no default risk, due to its powers of taxation, while provincial governments have lower default risk than corporations.
Credit Spread	The spread between government securities and non-government securities, which are similar in all respects except for their credit rating. An example of a credit spread is the difference between yields on government bonds and those on single A-rated corporate bonds with the same term to maturity.
Derivatives	Financial instruments whose value is derived from the value of an underlying security, asset or variable. Examples include options, warrants, futures, forwards and swaps.
Diversification	Minimizing portfolio risk by investing capital in several securities and investment strategies with low correlation to each other. A measure of how interest rate changes affect a bond's price. Duration also measures how long, on a present value basis, the bondholder has to wait to receive coupon payments and the final repayment. It is the bond's weighted-average term to maturity.
Duration	A measure of how interest rate changes affect a bond's price. Duration also measures how long, on a present value basis, the bondholder has to wait to receive coupon payments and the final repayment. It is the bond's weighted-average term to maturity.
Efficient Frontier	A two-dimensional risk-return chart showing all optimal combinations of a portfolio's expected return and expected risk, given a specified set of asset classes/investment strategies. The risk is measured by the standard deviation of a particular portfolio.
Forward Contract	An agreement between two parties to buy or sell an underlying asset at a specified future date for a specified price. The contract is not traded on an exchange, but between specific parties.
Fund-of-Funds (FoFs)	A fund that invests in a series of other underlying hedge funds. A fund-of-fund portfolio typically diversifies across a variety of hedge fund strategies and hedge fund managers.
Future Contact	A standardized, exchange-traded contract for the future delivery or receipt of a specified amount of an asset at a specified price.
Hedging	Transactions entered into that protect against adverse price movements, and limit exposure to a specific risk. These are usually opposite transactions within the same asset class or market.
High-water Mark	The assurance that a hedge fund only earns fees on profits once past losses are recovered. If an investment is made and subsequently falls in value, the fund will only earn performance fees if the investment grows above its initial value.
Hurdle Rate	The minimum investment return a fund must exceed before a performance fee is earned.

Leverage	The practice of borrowing money to add to an investment position when one believes that the return from the position will exceed the cost of borrowed funds. Hedge fund managers use leverage in order to increase returns. Leverage can have the effect of magnifying returns as well as losses.
Long Position	Holding (buying) a positive amount of an asset.
Market Risk	Refers to risk factors that affect financial market returns as a whole. This risk is present in all financial markets, including the money, bond, stock, and currency markets. Market risk is common to all portfolios with securities from these particular markets. For example, market risk is present in nearly all equities in the stock market, since the prices of equities generally move together. Market risk is due to macroeconomic factors, such as major changes in interest rates. (Note: Market risk is often referred to as beta.)
Managed Account	A trading account held with a broker and owned directly by the investor (e.g., an individual investor or a FoFs). Hedge fund managers complete their transactions on behalf of the investor by executing trades in the investor's managed account.
Master-feeder Structure	In this structure, one or more investment vehicles (the feeder funds) with identical investment objectives, pool their assets in a common portfolio held by a separate investment vehicle (the master fund). This structure allows both domestic and offshore investors to invest in the same offshore corporation, limited liability company, or partnership (the master fund). Domestic investors generally invest directly in a limited partnership (the domestic feeder), which invests its assets in the master fund. Offshore investors generally invest in an offshore corporation (the offshore feeder), which also invests in the master fund.
Market-neutral Strategy	Taking long and short positions in related assets (such as spread trades) in order to offset directional market risk.
Offering Memorandum	A document provided to a potential hedge fund investor that describes the hedge fund's business and operations. This document is usually developed for potential purchasers of hedge funds offered under a prospectus exemption. The offering memorandum should disclose all of the fund's material facts and help the potential investor assess whether to purchase the hedge fund offered.
Option	A financial instrument that gives the holder the right, but not the obligation to buy (call option) or sell (put option) the underlying asset up to and including (American option), or on (European option) a defined expiration date for a specified price.
OTC	Over-the-counter (OTC) trading. Trading of financial instruments between two parties outside of exchanges.
Portable Alpha	An investment approach where market exposure (beta) is gained through a futures or swap agreement and hedge funds typically accessed through a fund of fund (the source of the alpha) is transported on top of the beta.

Pair Trading	Non-directional, relative-value investment strategy that seeks to identify two companies with similar characteristics whose shares are currently trading at a price relationship outside of their historical trading range. This strategy involves buying the undervalued stock and selling the overvalued stock, usually in the same sector.
Prime Broker	Refers to a broker offering professional services specifically aimed at hedge funds and other large institutional clients. The prime broker clears the trades, custodies the securities, provides margin financing, lends stock to cover short sales, and provides cash and position reports. When a hedge fund designates a prime broker, it instructs all executing brokers to settle its trades for cash with a single firm. After the fund executes a trade, it reports the details to its prime broker.
Rescission	A remedy that cancels an existing contract and restores the parties to their situation prior to entering into the contract. If money has been paid by one party to another, that money is returned as part of the rescission process.
Risk	Any measure that provides an estimate of potential losses at some point in the future.
Sharpe Ratio	Demonstrates the reward to risk generated by an asset. It is the difference between the portfolio's return and the risk-free rate, divided by the portfolio's standard deviation.
Short Position	Holding a negative amount of an asset, whereby assets are sold without owning them (i.e., selling short an asset).
Standard Deviation	A statistical measure of the variability of investment returns. It is the most commonly used measure of the volatility of returns or investment risk.
Swap	An agreement between two parties to exchange cash flows over time according to a pre-determined formula.
Systemic Risk	The risk of a collapse of the financial system.
Total Risk	The potential loss of invested capital. The goal of absolute return managers is to manage total risk, which is to avoid absolute financial losses, preserve principal and to actively manage volatility.
Volatility	The degree of price fluctuation for a given asset, rate, or index. The variability of investment returns is one form of investment risk. It is typically used synonymously with standard deviation.
Warrant	An option in the form of a security. Banks or companies issue warrants that are either traded on exchanges or OTC.

APPENDIX I: Additional Reading and Resources

ADDITIONAL READING

AIMA – CANADA'S STRATEGY PAPER SERIES (Available at www.aima-canada.org)

- Equity Market-Neutral Strategy
- Long/Short Equity Strategy
- The Role of the Prime Broker
- Convertible Arbitrage Strategy
- An Overview of Short Selling
- An Overview of Leverage
- Merger (Risk) Arbitrage Strategy
- Portable Alpha/Alpha Transport Strategies
- Managed Futures Strategy

BASIC MATERIAL

- "Alpha: Canada's Other Natural Resource, October 2007 (available at www.aima-canada.org)
- "AIMA's Roadmap to Hedge Funds," November 2008 (available at www.aima.org).
- "All About Hedge Funds: The Easy Way to Get Started," by Robert A. Jaeger.
- "Hedge Fund of Funds Investing: An Investor's Guide," by Joseph G. Nicholas.
- "Alternative Assets", 2nd Edition, Mark Anson.

ADVANCED MATERIAL

- "Absolute Returns: The Risks and Opportunities of Hedge Fund Investing," by Alexander M. Ineichen.
- "Managing Risk in Alternative Investment Strategies: Successful Investing in Hedge Funds and Managed Futures," by Lars Jaeger.
- "Hedge Funds: Myths and Limits," by Francois-Serge Lhabitant.
- "Hedge Funds: Quantitative Insights," by Francois-Serge Lhabitant.
- "Hedge Fund Risk Transparency: Unravelling the Complex and Controversial Debate," by Leslie Rahl.

WEBSITES/CURRENT EVENTS

- Albourne Village: http://village.albourne.com/
- AllAboutAlpha: http://www.allaboutalpha.com/
- Canadian Hedge Watch: http://www.canadianhedgewatch.com/
- FinAlternatives: http://www.finalternatives.com/
- Financial Times Alphaville: http://ftalphaville.ft.com/
- HedgeWorld: http://www.hedgeworld.com/
- Hedge Fund Research, Inc.: http://www.hedgefundresearch.com/
- InvestHedge: http://www.hedgefundintelligence.com/ih/index.htm

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END NOTES

[i] "The Case for Hedge Funds", Tremont Advisors and Tass Research.

[ii] For a comparison of hedge fund and equity returns over different market environments see: "Chart 2: Hedge fund performance in ten worst quarters for equities" (page 30) of "AIMA's Roadmap to Hedge Funds," November 2008 (available at www.aima.org); and also "Figure 2: Indexing to capture attractive returns over the long term (Jan 1994 – Dec 2006)" (page 5) of "Hedge Fund Indexing: Gaining efficient hedge fund exposure through passive investing" September 2007, Credit Suisse/Tremont, (available at www.hedgeindex.com).

[iii] See Slide 13 and Slide 19 from the "Q1/2010 HFR Global Hedge Fund Industry Report", Hedge Fund Research, www.hedgefundresearch.com.

[iv] See Exhibit 8 "Global Hedge Fund Assets by Investor Type", from "The Hedge Fund of Tomorrow: Building an Enduring Firm" Casey Quirk and The Bank of New York Mellon, Thought Leadership Series, April 2009.

[v] See Table 1.1 (page 6) and Table 1.4 (page 9) from "Q1/10 Canadian Hedge Fund Quarterly Industry Report", Canadian Hedge Watch www.canadianhedgewatch.com.

[vi] See page 42, Table of Historical Monthly Returns for the CHW Composite, CHW Equity, CHW Notes, and CHW FoHF Indices, from "Q2/09 Canadian Hedge Fund Quarterly Industry Report", Canadian Hedge Watch.

[vii] This value is estimated from a survey of the annual reports of several large Canadian institutional investors. For example, the Ontario Teachers' Pension Plan had CAD 7.8 Billion invested in Hedge Funds as of December 2008 and another CAD 7.1 Billion invested in Absolute Return Strategies. The Caisse de Dépôt and Placement du Québec had CAD 5.1 Billion invested in Hedge Funds as of December 2008. The Canada Pension Plan Investment Board reports the fair value of their Absolute Return Strategies to be CAD 1.8 Billion as of March 31, 2009.

[viii] A discussion surrounding the definition of a hedge fund is contained within: "What exactly is a hedge fund?" pages 10-22 of "AIMA's Roadmap to Hedge Funds," November 2008 (available at www.aima.org).

[ix] A comprehensive review of active investment management can be found in "Active Portfolio Management", Richard C. Grinold and Ronald N. Kahn, Second Edition, 2000.

[x] Sample hedge fund indices along with recent performance data are produced by Hedge Fund Research: www.hedgefundresearch.com (HFRX daily indices, and HFRI monthly indices); Credit Suisse/Tremont www.hedgeindex.com; Dow Jones www.djhedgefundindexes.com; and Scotia Capital http://www.scmonline.com/analytics/cgi-bin/hedgefund/entry_screen.cgi.

[xi] See AIMA – Canada Strategy Paper: "Convertible Arbitrage Strategy" Available at www.aima-canada.org

[xii] See AIMA – Canada Strategy Paper: "Equity Market-Neutral Strategy" Available at www.aima-canada.org

[xiii] See AIMA – Canada Strategy Paper: "Merger (Risk) Arbitrage Strategy" Available at www.aima-canada.org

[xiv] See AIMA – Canada Strategy Paper: "Long/Short Equity Strategy" Available at www.aima-canada.org

[xv] See AIMA – Canada Strategy Paper: "Managed Futures Strategy" Available at www.aima-canada.org

[xvi] An explanation of traditional market risk analysis techniques can be found in: John Hull, Risk Management and Financial Institutions, 2nd Edition, 2009.

[xvii] See Chapters 7 and 8 of Francois-Serge L'Habitant, "Hedge Funds: Quantitative Insights", 2004. This approach can be considered as a multi-factor version of the original CAPM application to the analysis of mutual fund performance by William F. Sharpe (see W. F. Sharpe, "Mutual fund performance", Journal of Business, 1966).

[xviii] Market risk measurement tools for hedge fund investor's are available from: Algorithmics (www.algorithmics.com), Investor Analytics (www.investoranalytics.com), MeasuRisk (www.measurisk.com), RiskData (www.riskdata.com), RiskMetrics (www.riskmetrics.com).

[xix] See AIMA – Canada Strategy Paper: "Portable Alpha" Available at www.aima-canada.org

[xx] See Chapter 11 "Hedge Fund Existential" in Richard Bookstaber, "A Demon of Our Own Design", 2007.