ALTERNATIVE INVESTMENTS ATTRACT MAINSTREAM INVESTORS

Savvy Investors reduce risk and boost returns

It has been said that those who fail to learn from history are doomed to repeat its mistakes. Those who can anticipate and adapt quickly to changing market conditions are able to generate significant returns over the long-term. At the recent Canadian Hedge Fund Watch conference held in December 2004 in Niagara Falls, Jim Rogers, key note speaker and co-founder of the Quantum Fund, stated "after the recent bull market we will see equity markets trapped in a multi-year trading range coupled with a multi-year boom in commodity prices." In fact, the stock and bond markets may already be in a long-term sideways or downward trend, similar to the extended period that occurred from 1965 to 1982. During that period, markets moved in a wide trading range, grinding slowly lower and decimating many equity portfolios. History has shown that it is unlikely that a new bull market phase will start from today's lofty market valuations. Diversifying into international stocks is not likely to provide a safe haven since most major markets move in tandem. Mutual funds, which have traditionally provided diversification for investors, do not offer any protection from declining stock markets or the ability to profit from those declines. The most savvy and visionary investors, with excellent track records, have learned from history, and are already "hedging their bets". This forward type of thinking is now driving an emerging investing trend away from "buy and hold" stock and bond positions towards alternative investments such as hedge funds.

For many, the term "hedge fund" is a big mystery. Hedge funds are traditionally less regulated and have been limited to wealthy investors. Rules limiting many hedge funds from advertising or selling to a wider audience, have limited the amount of information available to the average investor. However, times are changing and investors are increasingly realizing the potential of these investments and financial institutions are reacting by making these investments available.
The term "hedge fund" does not refer to any one type of investment strategy nor does it refer to a separate asset class. "Hedge Fund" is a generic term used to describe a private investment fund where the fund manager has the ability to trade a wide range of investments based on one or more active investment strategies with the objectives of generating profits and protecting principal. Managers may trade products such as stocks and stock indices, fixed income products, futures contracts, currencies, metals and energy products. Tools such as leverage, short selling and arbitrage may also be used to help increase returns and reduce risk. Some managers may hold trades for months while others flip them after only a few hours. Among the top managers, active investment management has been shown to enhance returns while reducing the volatility of the overall portfolio.

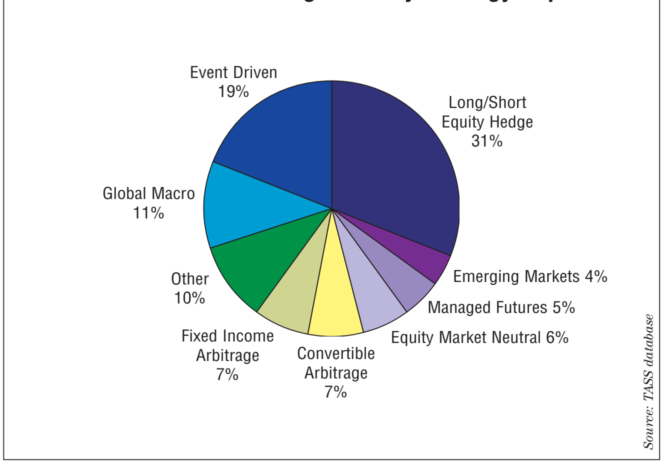
Hedge funds have come a long way since the first hedge fund was established by Alfred Jones in 1949. In fact, recent studies conducted by Tremont, indicate that the global hedge fund industry has over 8000 hedge funds with over U.S. $1.0 trillion under management. The majority of hedge funds are located in the U.S. with an →

Investors are increasingly realizing the potential of these investments and financial institutions are reacting increasing number being established in offshore jurisdictions. In Canada, Investor Economics, a Toronto based research firm, notes that there are over 220 funds and various structured note products with assets of over $14.1 billion as of December 2004. Hedge fund assets are spread over a wide range of trading strategies;

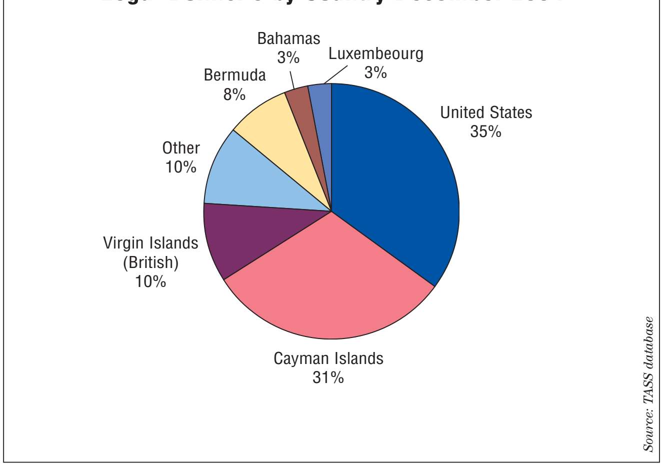
however, those based on the equity markets have received the largest allocations. The influx of money into hedge funds has come from high net worth individuals, European private banks, fund of funds, endowments, foundations, insurance companies and pension plans. The Abu Dhabi Investment Authority, the Ontario Teachers Pension Plan and the Yale Endowment are examples of investors that have benefited from the increased use of hedge funds and alternative investments.

Hedge funds are organized in a variety of ways including limited partnerships, limited liability companies and unit trusts. Hedge fund managers, unlike many traditional managers, invest a high percentage of their net worth in the funds they manage. Frank Mersh, Chief Investment Officer at Front Street Capital notes that "investing over 80% of my net investable assets in our funds ensures that my interests of

Total Assets Under Management by Strategy Sept 2004



Legal Domicile by Country December 2004



generating superior returns with low volatility are aligned with those of our clients".

The compensation structure of a hedge fund manager differs significantly from that of a traditional manager. Many hedge fund managers derive the bulk of their compensation from fees generated by positive fund performance. This structure is much more investor friendly compared to traditional managers who are compensated based on assets under management. The best hedge funds are able to command above average fees because they have historically provided superior risk-adjusted returns.

WHO CAN INVEST?

Hedge Funds are sold primarily through an offering memorandum to high net worth investors. In order to sell their products, many hedge funds either rely on the minimum investment exemption or the "accredited investor" exemption. Depending on the province or territory, the minimum investment can range between $97,000 and $150,000. The term "accredited investor" is broadly defined to cover many different entities including trust companies, pension funds and corporations with assets of at least $5 million. Individuals may be considered accredited investors if they own, alone or jointly with a spouse, financial assets exceeding $1,000,000, or if they have a 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. For investors that do not meet accredited investor requirements, there are several options available to participate.

STRUCTURED NOTES

Structured Notes have been the most popular way for investors to access alternative investment strategies. These notes are typically issued by major financial institutions, asset management firms and government agencies. In a structured note, the interest that would be received on a long-term strip bond is used to invest in an investment product such as a hedge fund or a fund of funds. How does a note work? To guarantee a $100,000 note for example, the issuer would purchase a 10-year strip coupon maturing at $100,000 for approximately $61,000 today. The difference of $39,000 - less set up fees - is then allocated to an investment product. In a worst case scenario, if the underlying investment declines to zero, investors will receive their principal back at maturity from the issuer. Steve Marshall, President of Open Sky Capital notes that "Because these investments are between seven and 10 years in duration it is important that investors carefully evaluate every aspect of the note structure to determine whether they will make money or whether they will simply receive their principal back." The performance of the underlying instrument and the fee structure are key factors determining a note's returns. Investors should evaluate total annual fees as well as the probability of the underlying investment generating returns above and beyond those fees.

Some hedge funds have been structured as closed-end funds and are listed on the Toronto Stock Exchange (TSX). An increasing number of funds are electing to list their funds on exchanges around the world to provide an alternative method for retail investors to invest in hedge funds.
Investors can also participate in hedge funds through segregated funds that

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are offered by insurance companies. Segregated funds are insurance products and are governed by insurance regulations and not by securities regulations.

HEDGE FUND MYTHS

It is commonly believed that hedge funds are completely unregulated. This is not the case. Hedge funds are less regulated compared to traditional investments but they are not unregulated. In Canada, the portfolio manager(s) of a hedge fund must be registered as an advisor or must be able to rely on a registration exemption. Registered advisers are subject to a number of regulations regarding capital requirements, record keeping and continuing education. Recent regulatory changes by the U.S. Securities and Exchange Commission (SEC) now require U.S. hedge fund managers to register as investment advisors. Those funds that trade Commodity Futures may also be subject to registration with the National Futures Association (NFA) / Commodity Futures Trading Commission (CFTC). These changes mean that hedge funds may now be subject to regular audits by one or more regulatory authorities.

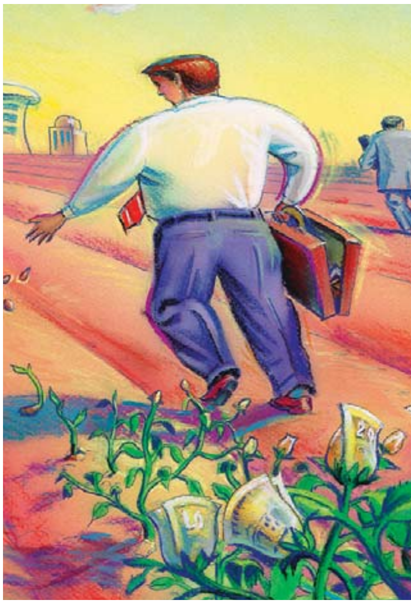
The majority of hedge funds tend to trade exchange listed products such as stocks, options and futures and as a result trading is scrutinized by each exchange. “All hedge fund trading, include those strategies that utilize leverage, are also monitored by the prime broker's internal risk management and credit departments to ensure compliance with strict internal policies on leverage and concentration of assets and conformity with Investment Dealer Association (IDA) guidelines” notes Lionel deMercado, Managing Director and Global Head of Equity Finance at TD Securities Inc. Hedge funds are also subject to applicable reporting requirements of anti money laundering and anti terrorist financing legislation.

Hedge funds are also often perceived as being risky investments because of the use of leverage and of derivatives. Tools such as leverage, commonly used in banking and real estate, can be beneficial if used wisely. In fact, some funds that do not use derivatives, such as emerging market funds, can be more volatile than hedge funds that use derivatives.

DUE DILIGENCE

Investing in a hedge fund can be a long-term commitment due to the existence of many conditions including initial minimum “lock up” periods of anywhere between three months and two years along with long notice periods or substantial early redemption penalties. Selecting a hedge fund is a multi-stage process that requires evaluating the fund's performance as well as its operational and risk management structure. This process is similar to investing directly in a business in terms of the level of due diligence required. This process can be challenging as many hedge funds and fund of funds do not disclose their holdings to investors.

To determine a fund's risk/reward characteristics, one has to first evaluate a fund's returns, its level of volatility, it's correlation to its peers and to relevant market indices. Analysis that looks at fund performance in →



calm markets as well as in volatile markets, will discern a manager's added value.

Davee Gunn , Vice-President at Abria Asset Management notes “Quantitative analysis of performance by our Investment Management team is only one of the many criteria that they use in the process of conducting due diligence on the hedge fund manager. In many cases, hedge funds are small businesses, so Operational Due Diligence (including their approach and controls relating to risk management) are an integral part of our due diligence process.” Operational due diligence involves conducting background checks of managers, evaluating credit risk, disaster recovery procedures as well as valuation procedures. It is relatively straightforward to calculate the market value of a fund that trades exchange traded products. However, hedge funds that trade over-the-counter products such as corporate bonds, mortgage backed securities, junk bonds or others are not as straight forward to value. It is important to ensure that a fund's portfolio is valued by multiple parties and with data obtained from multiple sources to ensure proper portfolio valuation.

Evaluating a hedge fund is an intensive process but it is essential to ensure that risks are minimized. A number of financial institutions now have alternative investment research departments that for a fee will conduct due diligence on behalf of their clients. Investors should consider consulting a professional to help them with this process.

HEDGE FUND SELECTION

Investors should first determine their long-term objectives, liquidity needs and their risk tolerances prior to investing. Consulting a tax professional is essential to understanding the tax implications of any distributions. Once this is completed, the process of searching for a fund begins. Hedge funds are not created equal and there are a wide variety of strategies ranging from aggressive to conservative. Strategies that are based on equities are historically more correlated to the equity markets compared to strategies such as managed futures or short selling.

Investors can invest directly in individual hedge funds or in a fund of funds. Hedge funds are available in either single or multi-strategy structures. Funds of funds are available in two varieties: (1) those that use a single trading strategy with multiple managers and (2) those that have a portfolio of managers that trade different strategies.

“There are many individual hedge funds that have good track records of consistent risk - adjusted returns that would make an ideal addition to any portfolio. However, an investor must be comfortable with both the manager’s and the strategies’ ability to continue to generate returns in the future” notes Andrew Ecclestone, President of Mountainview Asset Management. Alternatively investors could divide their hedge fund allocation over several hedge funds to provide diversification.

Fund of funds (FOF) managers utilize a number of

techniques to create a portfolio of hedge funds that are structured to maximize returns and minimize risk. The number of funds under management can be anywhere between 10 and 40. The returns on a fund of funds are a combination of the performance of the underlying funds less the applicable fees for managing the fund of fund portfolios. FOFs have the infrastructure in place to continually monitor and, if needed, to rebalance the underlying funds in their portfolios. Some FOFs offer access to funds that might otherwise be inaccessible due to high investment minimums. The success of a Fund of Funds depends on its ability to predict who will be the top performing funds in the future.

The hedge fund industry appears poised for continued growth over the next decade as institutions and individuals continue to adapt to the changing investment climate. Investors have seen the benefits of adding hedge funds to a portfolio as many of these funds have been able to generated positive returns irrespective of market conditions. There are great rewards in hedge fund investing but there are also great risks. Investors should take note of modern investment theory and not have a sizeable portion of their wealth invested in any single investment product unless they have a perfect forecast of the future.

Research by many of the world's most sophisticated investors is now being done to help improve methods of selecting hedge funds. Sorting through the thousands of hedge funds to try and find those that will continue to outperform in the future is no simple task. Often times investors jump into the hottest funds only to see their performance decline over the next six to twelve months. Finding the characteristics of hedge funds which are good predictors of future performance rather than merely chasing performance will help investors avoid many of the pitfalls of hedge fund investing.

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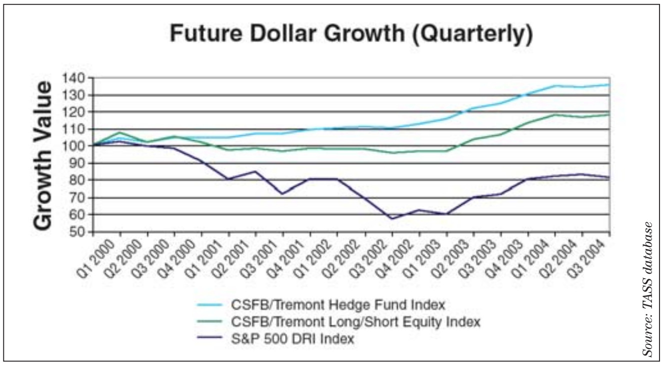
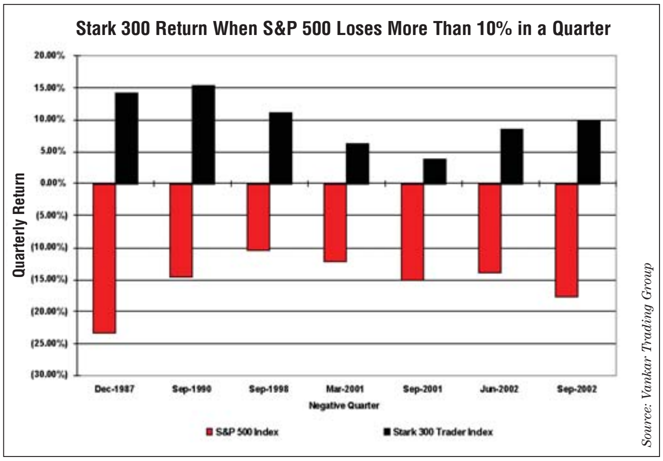
HOW CAN HEDGE FUNDS HELP A PORTFOLIO?

Hedge funds have the ability to adapt to market conditions much faster than traditional investments. Over the past four years in particular, the ability of hedge funds to profit during market declines has helped reduce the volatility of both stock and stock and bond portfolios.



Growth of Tremont Hedge Fund Index and Long/Short Equity Index versus S & P 500 DRI Index (Jan 2000-Sept 2004). An investment of $100 in a hedge fund grows to $135 versus a loss for an investor in the S & P 500.



Stark 300 CTA Index returns when S&P 500 loses more than 10% in a quarter (1987-2004): The Stark 300 CTA Index shows a consistent ability to produce above-average returns when the S&P 500 Index suffers its greatest losses. In every instance from 1987-2004, when the S&P 500 Index suffered a quarterly loss of over 10%, the Stark 300 CTA Index generated a significant positive return.. The Stark 300 is a proxy for the performance of fund managers utilizing managed futures as a primary strategy. Stark 300 CTA Index data is provided by Stark & Co, Inc.

TOOLS OF THE TRADE

HEDGE FUND COURSE/SEMINARS

Run by the Canadian Securities Institute **www.csi.ca**

CHARTERED ALTERNATIVE INVESTMENT ANALYST PROGRAM

Run by the Chartered Alternative Investment Analyst Association - the program is designed to provide individuals with a broad base of knowledge of both traditional and alternative investments **www.caia.org**

REGULATORY SITES

www.osc.gov.on.ca – Ontario Securities Commission

www.sec.gov – website for the U.S. Securities and Exchange Commission, a good source for information on Hedge Fund regulations.

www.nfa.futures.org – website for the National Futures Association is a good resource for information on futures trading and futures regulations.

HEDGE FUND RESEARCH SOURCES

www.hedgeworld.com The Hedgeworld site provides access to the TASS database for hedge fund performance figures.

www.barclaygrp.com The Barclay Group provides performance tracking services for Hedge Funds, Commodity Trading Advisors and Managed Futures programs

www.pertrac.com Strategic Financial Solutions provides advanced portfolio analysis software for conducting hedge fund analysis

SUGGESTED READING

Hedge Fund Primer for Canadian Investors – written by the Alternative Investment Management Association (AIMA) Canada can be found at www.aima-canada.org

Handbook of Alternative Investments – Mark J. Hanson provides a comprehensive guide to the various classes of alternative investments.