



MARKETING INTELLIGENCE Report

Making Sense of Hedge Funds

Introduction

While the investment characteristics among various hedge funds vary widely, hedge funds are broadly defined as private investments that allow the manager to maintain long and short positions with a wide degree of flexibility in the choice of investment. Assets managed by the U.S. hedge fund industry grew from approximately \$300 billion in 2000 to nearly \$1.5 trillion by 2007. Despite a decline in assets under management as a result of the recent financial crisis, and subsequent investor redemption, the asset class remains appealing for investors seeking to minimize equity market risk, preserve capital, and achieve returns under a variety of market conditions. Because these funds typically employ strategies that involve a high degree of asset turnover, including options, hedge funds generally are less tax-efficient than other “long-only” investment funds. For this reason, owning hedge funds within insurance products offers a unique ability to access alternative investments while not having to recognize taxable gains in the funds as income.

M Financial Group has offered a proprietary private placement universal life (PPVUL) product—MAGNASTAR®—since 2001, which at present offers 23 alternative investment funds. MAGNASTAR®’s assets under management reached \$1 billion for the first time at the end of 2009, a total that includes \$347 million in non-registered investment funds. MAGNASTAR® has achieved great success over the past decade and significant opportunities remain for affluent clients.

The following is part one of a two-part primer on hedge funds published by investment consulting firm Arnerich Massena & Associates. The primer provides details on the structure and types of hedge funds.

What Makes a Hedge Fund a Hedge Fund?

Hedge funds have a mythical reputation but are one of the least understood investments in the industry. Mention the words “hedge fund” and even seasoned investors have a tendency to tune out. In this primer, our objective is to make comprehensible the principles, structure, and advantages of hedge fund investing. In this two-part series we will:

- Clarify the difference between traditional investing and hedge fund investing
- Describe some of the strategies used in hedge fund investing
- Discuss funds of hedge funds
- Identify key considerations for alternative investors

Like mutual funds, hedge funds are pooled investment vehicles. They generally provide investors with a diversified group of securities in a single fund. However, hedge funds differ from mutual funds in their structure, strategies, and objectives.

Hedge Fund Structure

Hedge funds are not required to register under the SEC (Securities and Exchange Commission) and as such are not bound by the same requirements as mutual funds. (The current trend, however, is that while not required, more and more hedge funds are

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choosing to register under the SEC.) While they are still subject to fiduciary responsibility and a prohibition against fraud, they have much greater flexibility in terms of available investments, reporting, minimums, fees, and liquidity.

U.S. hedge funds are usually structured as private partnerships, often with the fund manager or general partner having a significant personal stake in the fund. To maintain their unregistered status, hedge funds may not advertise to the general public and must accredit their investors, holding them to a net worth or income standard. Hedge funds usually require a significant minimum investment and are limited by regulation to a certain number of investors, typically 100 or 500.

Fees - Hedge funds have a different fee structure from traditional investment vehicles. Traditional mutual funds charge a percentage of assets under management and pay managers according to the same structure. Many hedge funds use an incentive pay structure in which managers are compensated based on the performance of the fund. For this reason, a typical fee structure for investors would include an annual fee based on assets under management and a share of the investment gains. However, most MAGNASTAR® hedge funds do not charge performance fees. High water marks help ensure that managers are not paid incentive fees for poor performance. Hedge fund fees are almost always higher than mutual fund fees. However, because the upside potential income for managers is virtually unlimited, hedge funds tend to attract skilled, talented, and knowledgeable managers. The structure also ensures that the management team is highly motivated to produce results.

Liquidity - Mutual fund investments are highly liquid; investors can more or less redeem their shares at any time. Hedge funds, on the other hand, may place restrictions or even impose lock-up periods when investors are unable to liquidate shares. This is a critical difference between traditional and alternative investments, requiring alternative investors to evaluate liquidity provisions in addition to other considerations. Investing in securities involves risk, including the possible loss of principal. When redeemed shares may be worth more or less than their original value.

Mutual Funds and Hedge Funds: What's the Difference?		
	Traditional Mutual Funds	Hedge Funds
Regulation	Highly regulated with many restrictions and reporting requirements	Historically set up as a limited partnership with relatively little regulation in terms of investment restrictions, reporting, and fees (the 2008 crisis is prompting increasing regulation in the hedge fund space)
Investment universe	Limited by regulations	Unlimited
Investment objective	Performance is measured relative to a benchmark index	Performance success is based on an absolute return objective
Risk/Return	Work to generate added value compared to an index	With hedge strategies, can generate positive return in both up and down markets - using leverage can result in unlimited downside risk
Liquidity	Daily liquidity	Varying liquidity provisions; may have lock-up periods
Fees	Limited by regulation, based on percent of assets under management	Unlimited by regulation, typically includes a fixed fee and performance-related incentive fees

Hedge Fund Investment Objective

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Passive mutual funds track an index. Active mutual funds strive to outperform an index. Both types of funds are measured by relative performance — their success is based on returns relative to an index. Hedge funds, on the other hand, seek absolute returns. In other words, they are trying to earn as much positive return as possible. The potential advantage for hedge fund investors is double: first, an absolute return strategy acts as a hedge against the downside risk of long investments (investments made with the expectation that the value of the assets will rise over time). Also, hedge funds can provide significant diversification; having such a different objective means utilizing very different strategies, with the result being that hedge funds tend to have low correlation with most stock mutual funds. Diversification does not ensure a profit or protect against loss in a declining market.

Hedge Fund Strategies

Alfred Jones, often called the father of hedge funds, created the original hedge fund, which used short selling to reduce the risk of long-term stock investing. He was hedging his long-term bets, so to speak — hence the eventual term of hedge fund. Nowadays, hedge funds may use short selling to minimize risk and generate return, but the category of hedge funds encompasses a much larger set of potential tactics.

In general, hedge fund managers work to capture inefficiencies in the market. Whereas mutual funds engage in long-only investing, making straightforward buy and sell decisions, hedge funds may use short selling, options, leverage, derivatives, or other aggressive tactics to increase return potential while minimizing risk. Because hedge funds may seek opportunities virtually anywhere, the success of a hedge fund depends largely on the talent and skill of its manager.

Hedge fund strategies are often divided into three categories based on trading style: arbitrage, event-driven, and directional/tactical.

Arbitrage (also called relative value) - A pure arbitrage strategy involves the simultaneous purchase and sale of an asset priced differently in different markets. The transaction takes advantage of the price inefficiency and makes an immediate profit. This strategy theoretically involves no risk, since transactions are simultaneous. However, true price inefficiencies are rare and quickly eliminated, so managers use a relative value strategy. This strategy also takes advantage of price inefficiencies in the market, but by finding assets in the market that are mispriced relative to their normal or historical value. Purchases and sales are planned so that profits will be made when prices return to normal. This strategy is not without risk, as prices or interest rates may shift suddenly and unexpectedly. Typically, fund managers will work to eliminate as much risk as possible through hedging. Arbitrage strategies often make use of leverage, using borrowed capital to increase the potential for return.

As the names suggest, convertible arbitrage and fixed income arbitrage refer to strategies in which managers seek mispricing in convertible assets and fixed income assets respectively. An equity market-neutral strategy works to minimize exposure to the market through simultaneous long and short positions. This strategy works to capitalize on inefficiencies in the equity market, using statistical analysis to identify opportunities. Equity market-neutral strategies seek to produce consistent returns in any market environment.

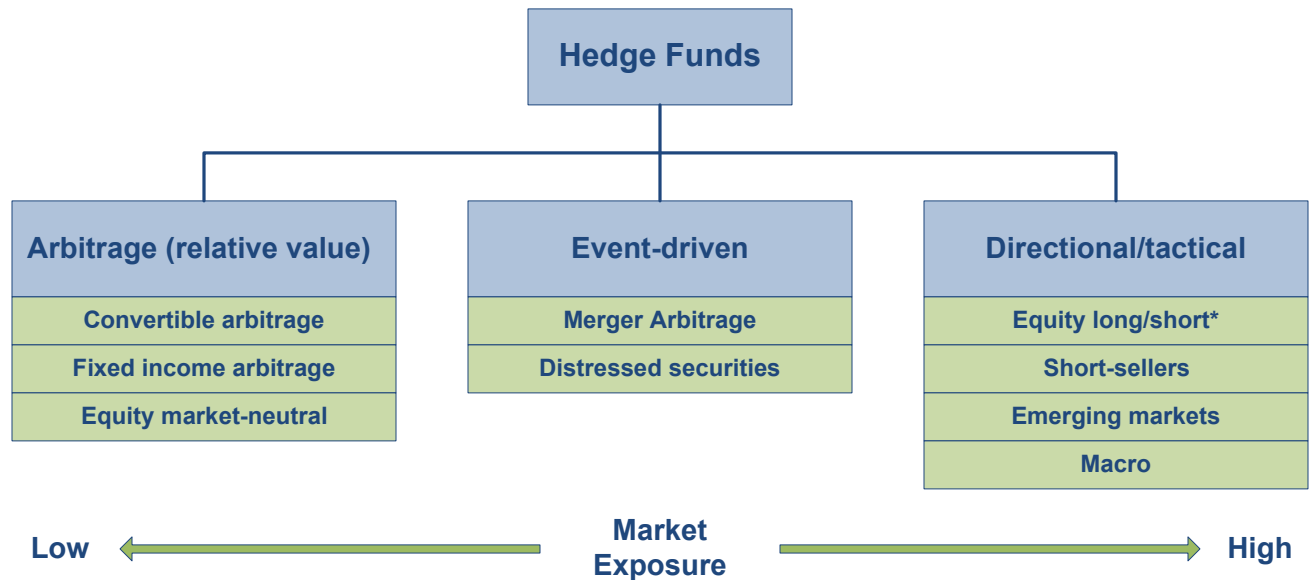
What is short selling?

Short selling occurs when an investor sells borrowed securities with the intention of purchasing them at a later date. The seller makes money if the price of the security declines.

What is the risk of short selling?

If the price of the security increases, the lender of the securities can recall the shares, forcing the short-seller to cover the difference in cost. If the shares are not recalled, rising share prices result in the security becoming a larger proportionate share of the portfolio and potentially requiring more intensive monitoring and attention. The greatest risk in short selling is that there is unlimited downside risk, there being no limit to the potential increase of an asset's value.

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Sources: Ineichen, Alexander "In Search of Alpha: Investing in Hedge Funds" UBS Warburg Global Equity Research, October 2000. Ineichen, Alexander and Silberstein, Kurt "AIMA's Roadmap to Hedge Funds" November 2008.

*While this chart indicates that equity long/short typically has higher market exposure, this category can span the entire spectrum of market exposure depending on whether a manager is net short, net long, or relatively market-neutral.

A Note About Leverage

Leverage: The use of financial instruments or borrowed capital which amplifies an investor's financial exposure in an effort to increase potential return.

As an example, imagine a hedge fund manager discovers a particular security which is trading simultaneously on both the London and U.S. exchange. Although the security is technically priced the same, there is a very slight currency differential. By purchasing shares of the one at a lower cost while simultaneously selling shares of the higher-priced security, the manager can make a profit. Because markets are efficient, however, the currency differential results in a profit of only \$.002 per dollar. By investing \$1,000,000, the profit would be only \$2,000. However, by using borrowed capital to purchase \$10,000,000 of shares, the profit is amplified to \$20,000. The borrowed capital can then be returned.

Leverage can be an important tool for both increasing return potential (particularly in arbitrage strategies that take advantage of minute inefficiencies in the market) and for risk management. However, leverage also increases an investor's financial exposure and potential loss.

Event-Driven - Event-driven strategies are focused on opportunities created by singular events, such as mergers (as in merger arbitrage). Managers may also seek out firms that are temporarily in "distress," experiencing liquidations, restructuring, bankruptcies, and other situations. Hedge fund managers will take advantage of price discrepancies between the ultimate valuation of the company following the event and the fluctuations caused by ongoing news of the event.

Directional/tactical - The largest category of hedge funds is the directional/tactical category, also called an opportunistic strategy. Directional means that the profit from an investment depends on the manager accurately predicting the future price movement of a security or market. Directional/tactical hedge funds largely rely on the manager's skill in security selection or economic analysis, and can be classified into the following groups:

- **Long/short equity** - A long/short equity strategy can make use of leverage to take short positions that profit from price declines and to hedge long positions, reducing risk and generating additional return. Long/short equity fund managers can profit from both rising and declining stock prices. Long, or traditional, positions take

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advantage of rising stock prices while short sells hedge the long positions, reaping the benefits from declining stock prices and reducing the market risk of long investments. Typically, long/short portfolios are more concentrated than traditional funds. Short-sellers concentrate specifically on profiting from declines in stock prices.

- **Emerging markets** - Emerging markets hedge funds, as the name suggests, seek opportunities in emerging markets. In addition to investing in long positions, they also look for undervalued securities and price inefficiencies. Emerging markets hedge funds may also take advantage of currency differentials. Because emerging markets don't necessarily offer the same opportunities for unusual strategies like short selling, emerging markets hedge funds have fewer tools for controlling risk than other types of hedge funds.
- **Macro** - Global macro hedge funds, also called simply macro hedge funds, focus on macroeconomic movements and invest based on major economic events and shifts, such as currency movements or interest rate adjustments. Because there are often many moving parts in a macro strategy, this type of hedge fund can be unpredictable and difficult to categorize.

Any classification of hedge fund strategies is bound to be somewhat lacking, since they do not fit neatly into categories in the same way as traditional investments. Hedge funds may take a multi-strategy approach and use several different strategies. Managers may also shift and adopt new strategies depending upon the market and the opportunities they come across. There is no standard system of classification in the industry; the one thing experts seem to agree on is that the main defining characteristic of hedge funds is their heterogeneity.

Indexes, such as the HFRI Index and HFRI Funds of Funds Index, are intended as benchmarks for hedge funds. Because hedge funds span a variety of strategies, these indexes are imperfect. However, they provide a valuable frame of reference for evaluating the risk and return of different hedge fund strategies and managers. It is not possible to invest directly in an index.

In Part two, we will look at the return, correlation, and volatility characteristics of hedge funds, as well as the benefits of hedge funds-of-funds for investors.

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