

Hedge Fund and Absolute Return Strategies

Hedge fund strategies vary widely in terms of investment approach, instruments used and sensitivity to the broader markets. Nevertheless, we can categorize hedge fund strategies into two broad groups:

- 1 Discretionary strategies, which are market-directional, and*
- 2 Relative value strategies, which tend to be event- or arbitrage-driven, and are intended to be market-neutral.*

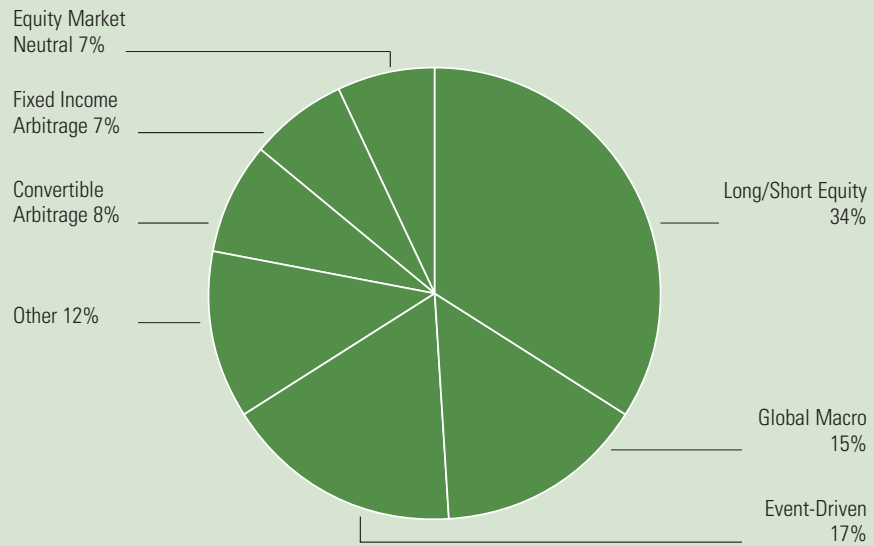


HEDGE FUND INDUSTRY — RECENT DEVELOPMENTS

The hedge fund industry continues to experience strong asset growth, reflecting greater acceptance of hedge funds and hedge fund strategies among a broadening group of investor types. In many respects, endowments and foundations have been early and active participants in allocating capital to hedge fund strategies. Assets under management in the hedge fund industry are estimated to total more than \$800 billion (see chart on following page), with an estimated \$70 billion of growth in 2003. Funds-of-funds are estimated to comprise about 40 percent of the hedge fund industry, indicating that a meaningful percentage of investors choose to use a fund-of-funds to achieve their hedge fund exposure. The number of hedge funds also continues to grow, with an estimated 7,000-plus managers in existence as of December 31, 2003.

Hedge Fund Strategy Breakdown

\$817 Billion Total Industry January 1990–December 2003



Source: TASS

The chart, **Hedge Fund Strategy Breakdown**, above also shows how the hedge fund industry breaks down by strategy. What is apparent is that there is a wide range of strategies making up the hedge fund industry. Note that the two discretionary strategies, long/short equity and global macro, account for about half of the total capital in the industry. This reflects both historical considerations (hedge fund capital in the early 1990s had been heavily weighted towards macro and long/short equity) and the fact that discretionary strategies are not as capacity-constrained as relative value strategies. Relative value strategies are capacity-constrained because they are arbitrage-based, with these managers trying to identify and capture relative pricing inefficiencies between related securities.

INVESTMENT STYLE RISK/RETURN

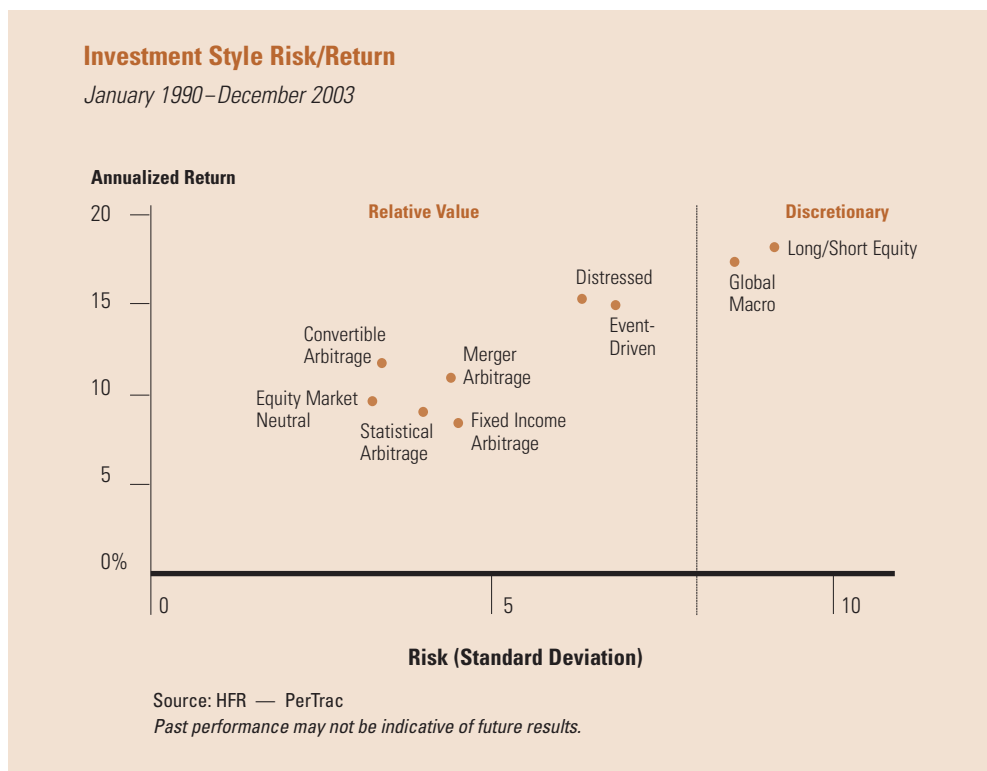
The chart on the opposite page, **Investment Style Risk/Return**, illustrates how hedge fund strategies have behaved historically on a risk/reward basis (as measured by annualized return and volatility of returns). The chart highlights the key factors that differentiate discretionary from relative value strategies — that is, their substantially different levels of volatility and return. Discretionary strategies are so called because managers in these strategies have the ability to be net long or short the markets at their discretion. Hence, the risk-adjusted returns of discretionary strategies often are broadly influenced by the direction of markets. Those markets include currency markets, fixed income markets, equity markets and commodity markets.


Relative value strategies, on the other hand, do not rely on market direction to generate alpha. These strategies deliberately attempt to substitute spread risk and event risk for market-directional risk. As this chart clearly shows, discretionary strategies tend to be more volatile and offer the potential of higher returns than relative value strategies.

DISCRETIONARY STRATEGIES

Long/short equity

Long/short equity entails funds that take long and short positions in listed equities. Managers are searching for equities whose intrinsic values are not currently reflected in market prices. As a result, they seek to find stocks which are “undervalued” by the market and shorts whose prices are “overvalued” by the market. Undervalued stocks populate the manager’s long portfolio while overvalued stocks comprise the manager’s short portfolio. A variety of valuation measures such as price/earnings or price/book are used in distinguishing opportunities from a valuation standpoint. Managers seek to generate excess return above the market from both long and short positions, leading to the “double alpha” label. As long/short equity managers tend to have net long or short market exposures — meaning that their long stock positions on a dollar basis are greater than or less than their short stock positions on a dollar basis — this strategy has a directional characteristic, which is why we include it in the discretionary category. As returns are driven by both stock selection and the overall degree of market exposure, it is important to assess how each affects risks and returns.





While long/short equity managers are stock pickers, differences in style or approach can be significant, leading to very different risks and returns. For instance, some managers may employ a capitalization oriented approach and favor large cap stocks, while others may have a specific geographic focus, such as the U.S. or Europe. Managers may also have an emphasis on value stocks, growth stocks or certain sectors. Managers may also have very different approaches as to how they manage risk by stock, sector and on a portfolio basis. These style differences can lead to very different performance and risk characteristics.

“MANAGERS SEEK TO GENERATE EXCESS RETURN ABOVE THE MARKET FROM BOTH LONG AND SHORT POSITIONS, LEADING TO THE ‘DOUBLE ALPHA’ LABEL.”

Global macro

As the strategy name implies, global macro entails a global, top-down approach to investing. Typically, managers invest across a range of markets, including fixed income, equity, currency and commodity markets. Managers analyze a variety of fundamental economic factors such as GDP, inflation, trade, and monetary and fiscal policies. Complementing this work, managers assess the relative valuations of various financial markets, including equities, fixed income, currency and, to some extent, commodity markets. Finally, managers analyze investment flows, as the bridge between fundamental economic analysis and financial market conditions and valuations.

Investment views are often expressed through broadly-based generic market instruments, such as index products, since managers are attempting to capture broad market opportunities, as opposed to micro opportunities (i.e., the performance of a given stock). Typically, managers are investing in a variety of themes or investment ideas. Global macro is directional by nature, as managers are trying to opportunistically participate in directional moves in broader markets. Therefore, understanding how market and portfolio risks are managed is essential.

RELATIVE VALUE STRATEGIES

Distressed securities

In general, managers in distressed securities invest in credit impaired corporate obligations (bonds, bank debt or in some cases trade claims). Hedge fund managers often have a passive investment approach in a distressed situation, enabling them to trade positions in an unrestricted manner, in contrast to an active or controlling approach, which could restrict their ability to trade positions. Managers seek undervalued investment opportunities and attempt to identify a catalyst or event to serve as an opportunity to

realize profit. Therefore, valuation alone is not sufficient, which is why the strategy is categorized as a type of event-driven investment approach. Events can take a variety of forms, including a recapitalization, debt restructuring, spin-off or liquidation of assets. Because of the less liquid nature of the distressed instruments, it is important to assess the overall liquidity of these funds. Funds that grant relatively frequent investor liquidity tend to be invested in more senior portions of the capital structure and generally seek a cash or restructured debt outcome from a restructuring, as opposed to receiving the equity of a reorganized company. While distressed debt opportunities always exist, they are far more prevalent during periods of economic weakness such as the 2001–2003 period. Given the cyclical nature of the opportunity set for distressed debt managers, they may also engage in other types of event-driven strategies such as merger arbitrage. Both strategies entail deep fundamental analysis of companies combined with legal analysis of the events. Merger arbitrage opportunities also tend to be countercyclical to distressed debt opportunities providing managers with more balanced investment opportunities over time.

Merger arbitrage


Merger arbitrage is also an event-driven strategy. Merger arbitrage entails investing in announced mergers of publicly traded companies. As such, the announcement of the merger is the initial catalyst or event and the completion of the merger is the concluding event. Managers attempt to capture the difference between the price of a target company and the proposed acquisition price. In executing the strategy, managers purchase the stock of the company being acquired and short the stock of the acquiring company.

The risk of a merger not being completed — combined with the expected time to complete the transaction — creates a difference in prices, or spread, between the price of the acquiring company and the price of the target company. The factors affecting a deal's outcome are primarily functions of shareholder approval and regulatory approval. As both shareholders and regulators must approve transactions, understanding issues associated with such approvals is critically important to merger arbitrageurs. Regulatory approvals have become increasingly complex given the global nature in which many companies operate, necessitating regulatory approvals in multiple markets. As a result, having managers who can properly analyze such transactions is important. Managers focus on assessing these key factors from fundamental, financial and legal perspectives to determine whether to participate in a transaction, given its spread.

Convertible bond arbitrage

Convertible bond arbitrage is another relative value strategy. A convertible bond is essentially a corporate bond with an option attached. The option embedded in a convertible bond gives the holder the ability to convert the bond into the underlying issuer equity. Owing to this option, pricing inefficiencies occur regularly. In executing the strategy, managers buy underpriced convertible bonds and sell short the corresponding equity.





Although there are three components of risk in a convertible bond — interest rate risk, credit risk and volatility risk — arbitrageurs generally hedge their interest rate risks and attempt to generate returns by correctly assessing a bond’s credit and volatility exposures. Managers attempt to identify credits that will improve via a fundamental analysis of the underlying company. Long positions are often initiated in convertible bonds where the credit spread (i.e., the yield on the convertible bond relative to the yield on a comparable U.S. Treasury note) is too wide.

Quantitative option valuation models are used to assess the volatility of a convertible bond relative to the volatility of its underlying stock. Convertible bond managers will purchase convertible bonds when the implied volatility on the convertible bond’s imbedded option is too cheap. Long positions in convertible bonds are often hedged with “delta,” or volatility-weighted short positions, in the underlying stock. As volatility increases, the option in the convertible bond becomes more valuable causing the convertible bond to appreciate in value.

While sources of profit are primarily due to credit and volatility, managers also make money from the bond’s coupon payments and interest income on the short sale of stock.

Equity market neutral

Equity market neutral is a relative value strategy involving long and short positions in equities. These managers seek to capture alpha by finding pricing inefficiencies or anomalies between related securities through fundamental or statistical analysis. Fundamentalists focus on factors such as cash flow, operating margins, earnings growth and return on equity. Statistical arbitrageurs focus purely on pricing information and use quantitative analysis to identify inefficiencies. Undervalued equities populate the long portfolio while overvalued equities comprise the short portfolio. Similar to long/short equity, this strategy has a double alpha label because the managers are trying to capture returns from both their long and short positions.

The key aspect that differentiates equity market neutral managers from long/short equity managers is the construction of the portfolio. Equity market neutral managers balance their long and short positions to limit market exposure or systematic risk. For example, many of these funds are dollar neutral, meaning that for every dollar long, they’re a dollar short. They also tend to be beta neutral, so they don’t have exposure to the direction of the S&P 500. Risk factors such as sector exposure, value bias, capitalization, momentum and volatility could be neutralized as well. As a manager neutralizes the portfolio to additional factors, the portfolio has a higher degree of idiosyncratic or stock-specific risk. Hence, it becomes harder to generate returns because the opportunity set is reduced. Equity market neutral managers need dispersion among stock prices to generate returns. As stocks within sectors become less correlated, price differentials, or spreads between stocks, also increase, providing a

larger opportunity set from which to extract alpha. Because the nature of their investing is more arbitrage related, equity market neutral managers generally utilize shorter time horizons than long/short equity managers. Equity neutral managers ultimately want a discriminating or rational market with normalized levels of volatility because they are buying and selling stocks that they believe have deviated from their theoretically fair value in the hope that these pricing inefficiencies will correct. Markets with momentum and price persistence are difficult for these managers because equity valuations trend away from historical, or normal, levels.

***“EQUITY MARKET NEUTRAL MANAGERS BALANCE
THEIR LONG AND SHORT POSITIONS TO LIMIT
MARKET EXPOSURE OR SYSTEMATIC RISK.”***

Fixed income arbitrage

Fixed income arbitrage entails a variety of strategies involving fixed income securities, including G-7 government debt, agency debt, U.S. debt, corporate debt, municipal debt, mortgage-backed securities, asset-backed securities, sovereign emerging market debt and related derivatives. Managers profit by finding pricing anomalies between these securities and trading them away. The strategy is generally dependent on pricing inefficiencies which occur because credit, volatility or liquidity premiums are too high. For example, “on the run” securities typically trade rich to “off the run” because they have better liquidity. Some of the more common trades in this strategy are yield curve arbitrage, basis trading and mortgage arbitrage.

Yield curve arbitrage entails buying and selling treasury bonds at different maturities to take advantage of yield spreads among different issues. For example, if there were an excess number of buyers for five-year notes they would probably trade rich relative to other bonds along the yield curve. A manager can take advantage of this pricing anomaly by providing liquidity to buyers of five-year notes, selling short the five-year note and going long other notes along the curve. Basis trading is an arbitrage of the spread between Treasury securities and futures contracts on these securities. Prices of Treasury securities and their futures contracts generally converge on the contract’s last delivery day. When there are differences in prices between physical securities and their futures contracts, managers can take advantage of the spread by going long the cheaper instrument and shorting the more expensive instrument.

Mortgage arbitrage typically entails going long or short mortgage-backed securities and taking offsetting positions in Treasuries, interest rate swaps or other mortgages of similar maturity. Mortgage-backed securities typically trade at higher yields than Treasury notes. Managers profit by capturing the spread between these securities. Fixed



income arbitrage strategies often hedge interest rate risk but are exposed to risks such as volatility, credit and liquidity. These strategies also tend to use varying degrees of leverage because of the low volatility of the underlying trading instruments.

CONCLUSION

While hedge fund strategies can be broadly grouped into discretionary and relative value categories, there are key differences in strategies within these categories. As a result, it is important to thoroughly understand each strategy to determine how hedge fund strategy exposures can perform and affect a broader investment portfolio. In addition, as each hedge fund manager takes a unique approach to applying a given hedge fund strategy, it is essential to appreciate more subtle differences in strategy applications, as these less obvious differences in approach can lead to very different risk and return characteristics.

Institutional investors should also pay careful attention to portfolio construction from a strategy and manager standpoint. Because each hedge fund strategy has unique characteristics — combined with the fact that manager applications of strategies vary — constructing portfolios of hedge funds has the potential to add substantial value.

Given the substantial resource requirements of selecting and monitoring hedge fund managers, as well as the challenge of constructing and managing portfolios of hedge fund investments, what is the optimal way to gain exposure to these strategies? The answer to this question varies by institution and is a function of resources, objectives and philosophies. Regardless, the task requires a significant ongoing effort with staff who are appropriately skilled in this highly specialized and often opaque investment arena. For many institutional investors, funds-of-funds present a compelling choice.

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