# Overcoming the Shortfalls of the "Traditional" Approach to Investing in Hedge Funds

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JANA

# Agenda

1. Hedge Funds – Why Invest in this Sector?

2. Issues with Current Structures

3. Understanding Hedge Fund Returns

4. More Intelligent Structures – Managed Accounts

# The Investment Environment

- Reductions in inflation and economic volatility led to the “Long Boom”. The decline in the cost of capital led to one-time increases in real value of assets.

- Households responded by decreasing savings and spending more, which created a positive feedback loop in terms of economic growth.

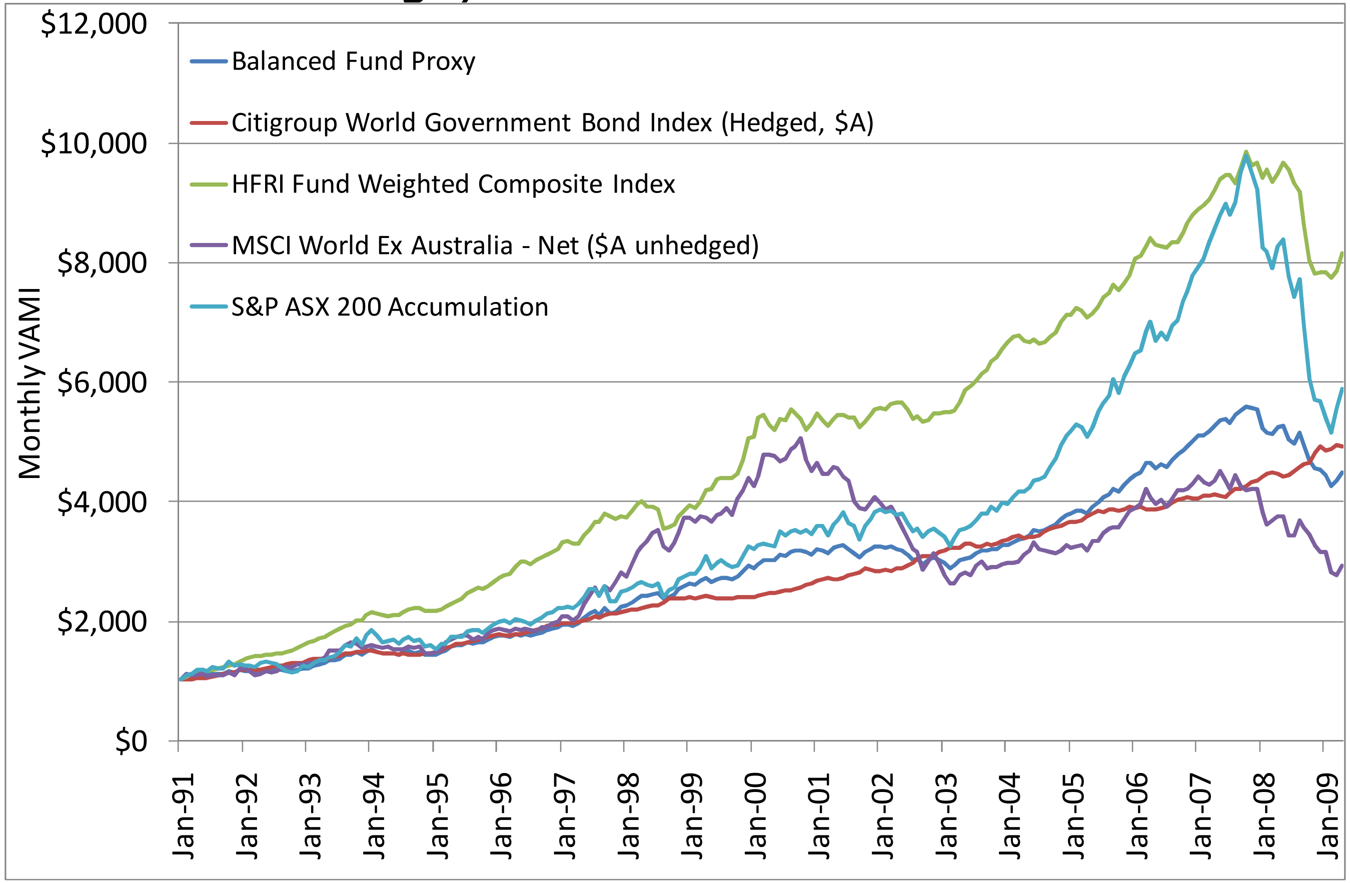
- Stock market crashes in 2000 led to a further decrease in interest rates and was replaced by a housing bubble. The result was a negative savings rate even as personal wealth stood at all time highs!

**NOW**

We are in the period which may be known as the “Long Goodbye”.

# What are Hedge Funds?

*A collection of heterogenous investment techniques (short selling, derivatives and leverage) used within traditional asset classes.*




** Balanced Fund Proxy = 10% UBSA Bank Bills, 10% Mercer Unlisted Property pre tax, 25% MSCI World ex Australia Unhedged, 35% S&P ASX 200 Accumulation, 20% Citigroup WGBI. Rebalanced Monthly.*

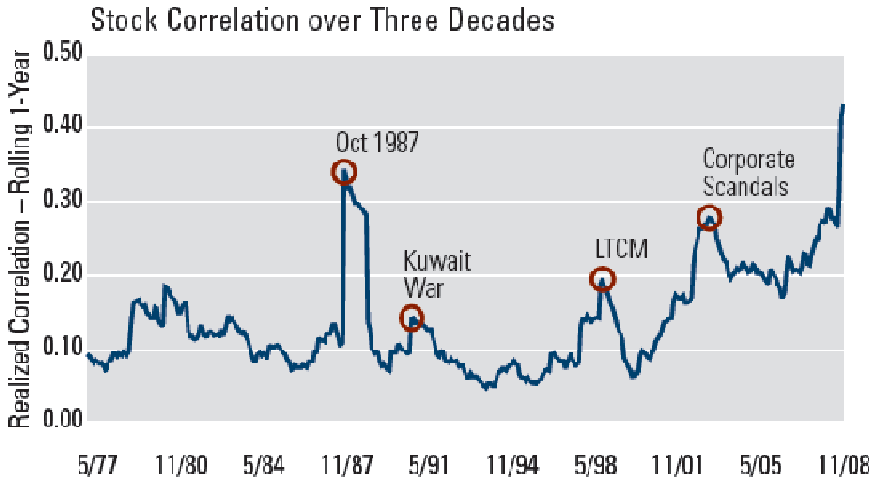
## Expectations versus Reality

| Expectation | Reality |
|---|---|
| Always deliver cash + 5% returns. | Hedge funds target absolute returns. No investment can deliver a riskless cash plus 5% return. |
| Low correlations to traditional markets. | Hedge funds have exhibited low correlations to traditional markets (but not negative). |
| Volatility is a good measure of risk. | Volatility is not a good measure of risk in hedge funds nor any investment which holds investments that are not marked to a clearing value (e.g. direct property, infrastructure, private equity etc). |
| Hedge funds should be funded from bonds and are as defensive as bonds. | Hedge funds have never been as defensive as bonds but offer greater upside (US 10 Year Treasuries 3.5% p.a.). |

# Why is the Current Environment for Hedge Funds Compelling?

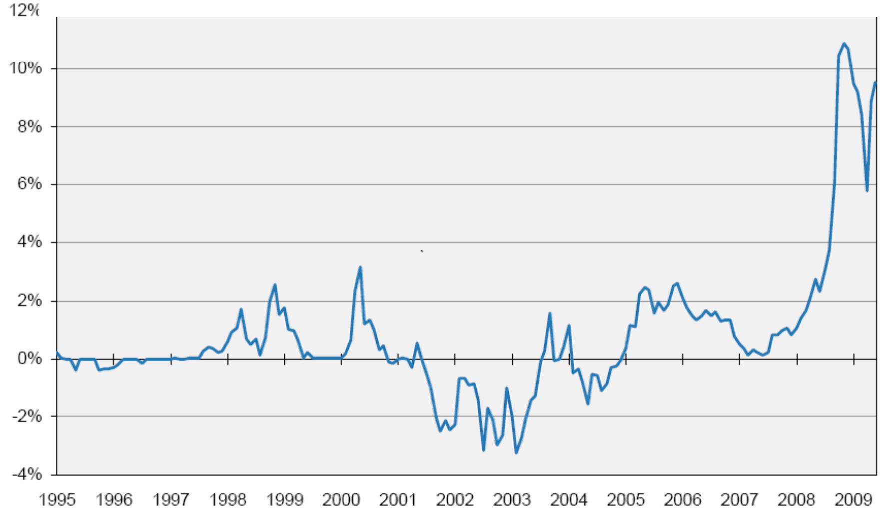
- Mispricings and inefficiencies are so great that less leverage (if any) is needed to generate returns
- Lower competition from investment banks and far fewer hedge funds.

**Stock Correlations at Historical Highs**




Universe is largest 1,900 US Stocks.
Source: Wellington Management

**Median Discount of Convertibles to their Theoretical Values**




* This represents the median cheapness of the universe of convertible bonds that have a moneyness of above 0.65
Source: AQR Proprietary Models. Data updated through 06/30/2009. Theoretical values are hypothetical in nature.
Please see important disclosures on the last page.

## What are the hurdles to investing in hedge funds?

Some hedge funds charge performance fees, simply for positive returns → How do I ensure I am paying appropriate fees?

Hedge funds are a "black box", leading to false expectations or outright fraud, eg. Madoff → How do I get transparency so that I know what I'm investing in?

Some funds suspended redemptions and lost their currency hedges → How can I ensure that a fund will maintain control of its assets and ensure liquidity in its portfolio?

Overcoming the first shortfall:

ENSURING FEES ARE APPROPRIATE

# De-constructing hedge fund returns

## Hedge Fund Return Drivers

### ~30% Traditional Market Exposures

- Growth, Credit cycles, and Public Debt drives
- Corporate Earnings
- Interest Rates

### ~30% Manager Skill

- Security Selection
- Market timing
- Control Value Add (e.g. Private Equity)

### ~20% Liquidity Risk

- Compensation for giving up the ability to:
- Rebalance
- Re-invest
- Cash flow management

### ~20% Underwriting Risk

- Event risk (what if company X does not buy company Y?)
- Writing options
- Insurance

**Balanced Funds Return Drivers**

70-80%

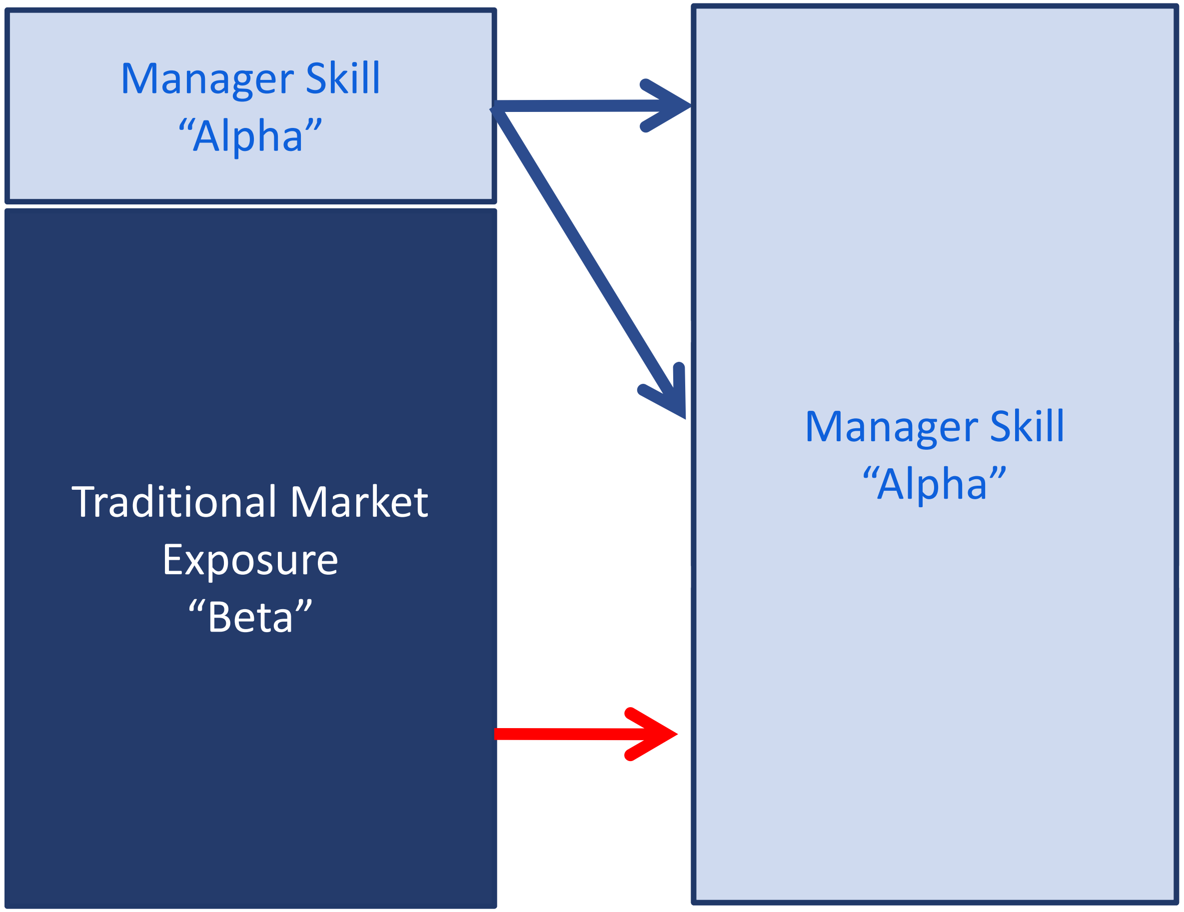
~10-20%

~10%

*Source: Citigroup*

# Alpha and beta in Hedge Funds

**Traditional Investment Fund** | **Hedge Fund**

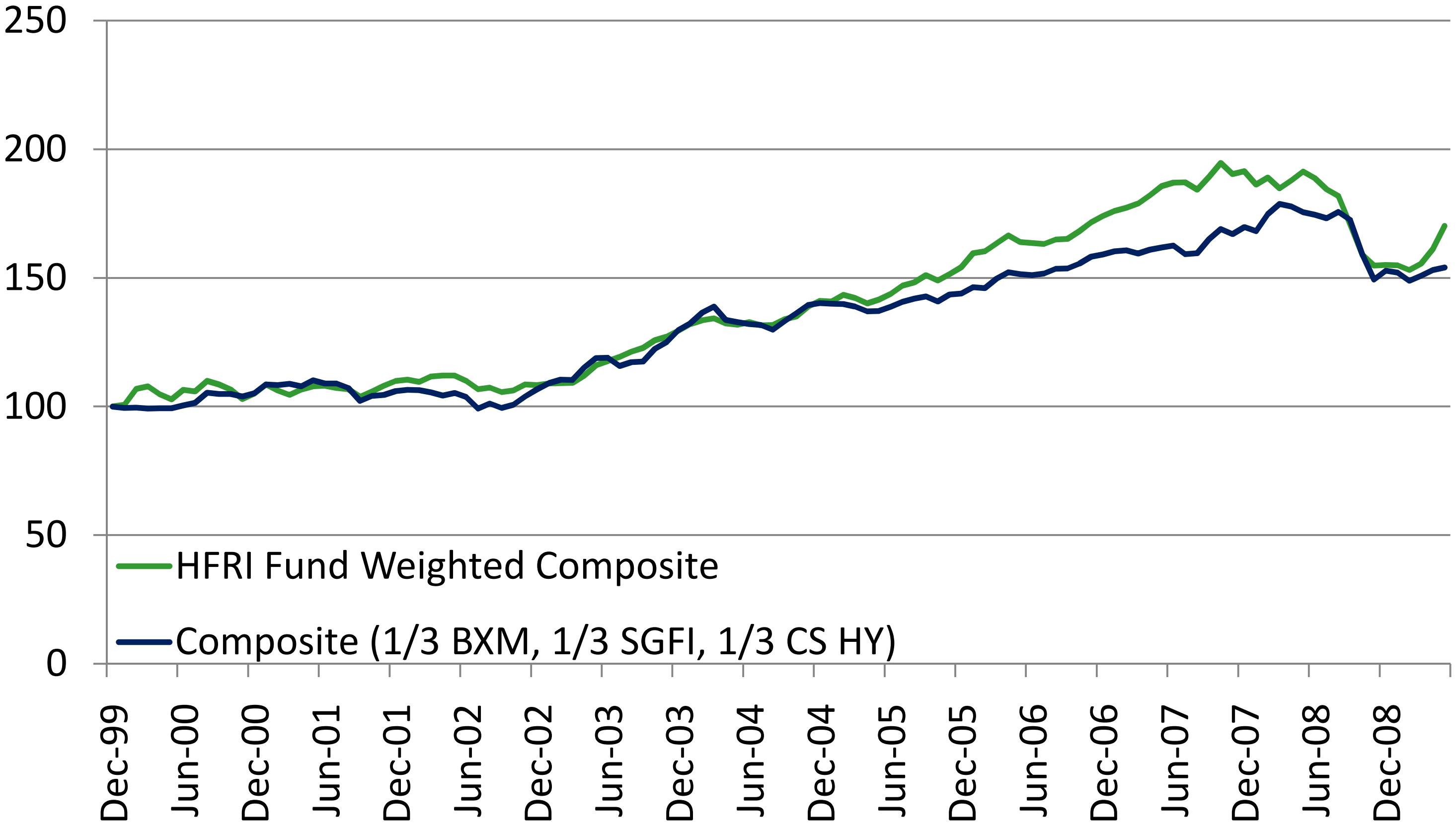



- Security Selection
- Market Timing
- Execution

- Event Risk Premium
- Volatility Risk Premium
- Liquidity Risk Premium
- Small Cap Risk Premium
- Value Stocks Risk Premium
- Carry Risk Premium

- Equity Risk Premium
- Bond Risk Premium
- Emerging Markets Risk Premium

# Alternative Risk Premiums




**Hedge Funds**

Return: 5.8% p.a.

Volatility: 7.1% p.a.

**Composite Risk Premiums**

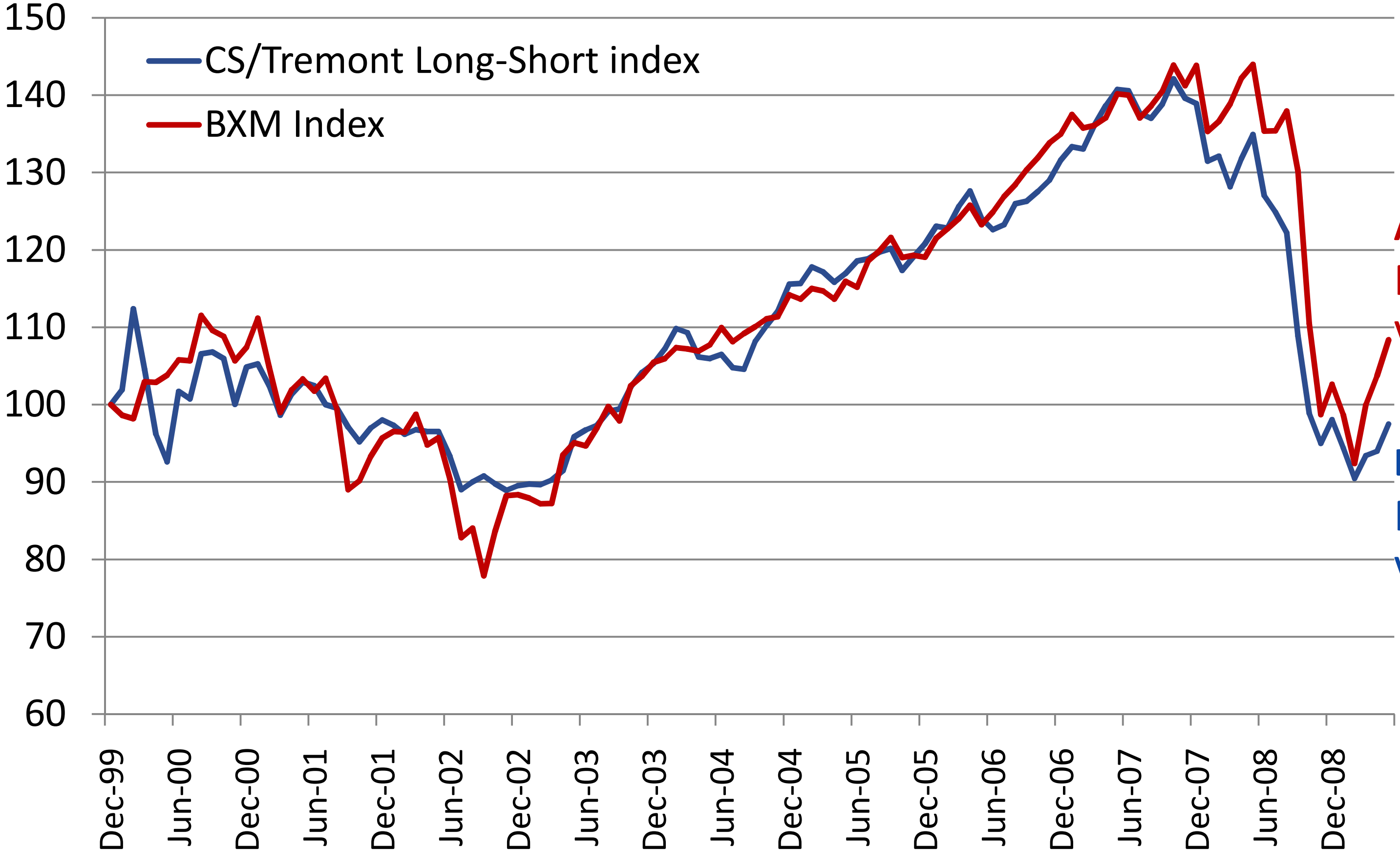
Return: 4.7% p.a.

Volatility: 6.8% p.a.

*Source: Bloomberg/Pertrac*

A combination of risk premiums – trend following index (SGFI index), buy-write index over S&P 500 (BXM index) and high yield credit index (CSFB HY index), equally weighted – explains a large portion of hedge fund returns

# Alternative Beta
## Example 1 – Long/short equities




**Alternative Beta (BXM)**
Return: 0.8% p.a.
Volatility: 12.3% p.a.

**Long/Short Funds**
Return: -0.3% p.a.
Volatility: 10.7% p.a.

*Source: Bloomberg/Pertrac*

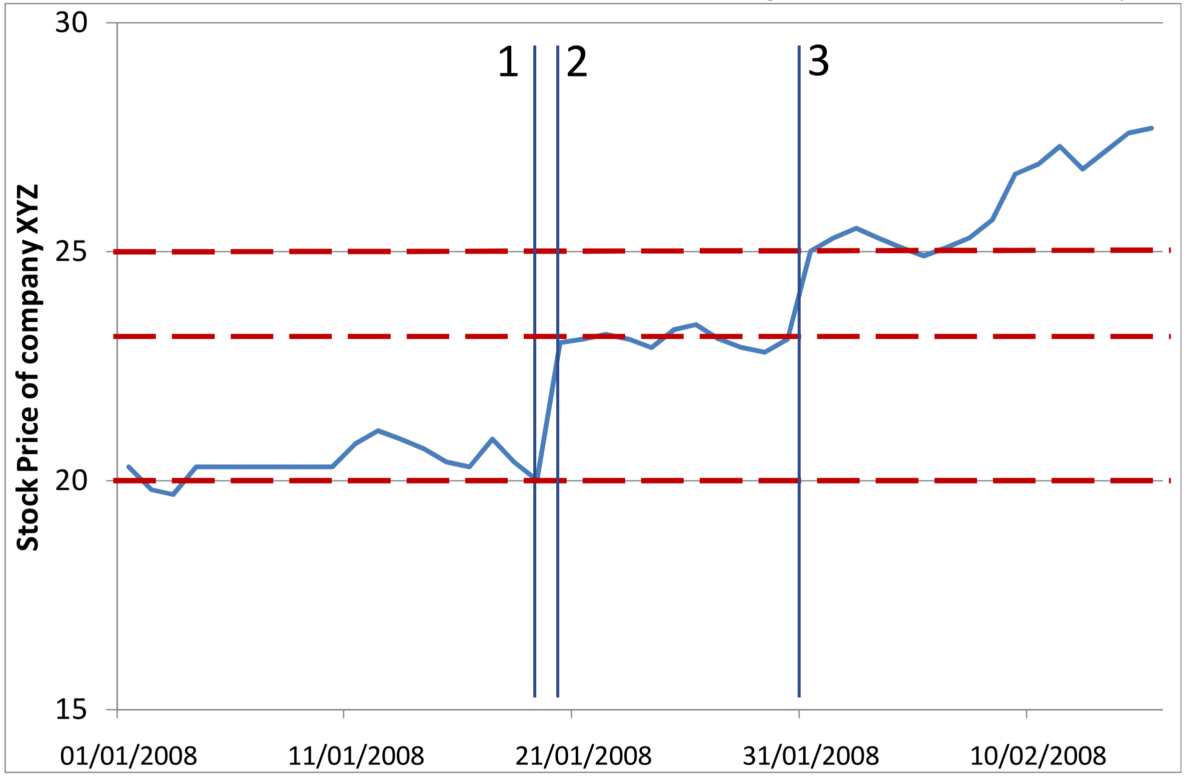
BXM index: investor buys a portfolio of the S&P 500 stocks, and also sells (or writes) covered call options on the S&P 500 Index → Caps upside, but gives certainty of income

# Alternative Beta
# Example 2 - Merger Arbitrage

**1**. Company ABC makes an offer to buy company XYZ at a price of $25 per share for close 31/01

**2**. XYZ share price moves immediately from $20 to $23 – but not the full price of $25 due to the chance of the deal failing

**3**. On 31/01, deal goes through successfully and XYZ share price moves to the deal price of $25




The probability of a successful deal is built into the stock price of the target company – an insurance premium against deal failure

# Alternative Beta
# Example 2 - Merger Arbitrage

The best way of playing the insurance game is to ***diversify***

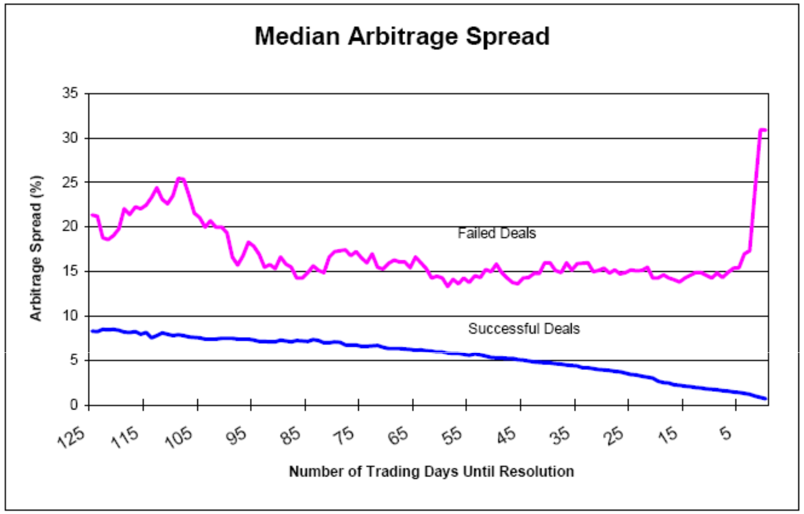



**Figure 1:** This figure plots the median arbitrage spread versus time until deal resolution. The arbitrage spread is defined to be the offer price minus the target price divided by the target price. For failed deals, the deal resolution date is defined as the date of the merger termination announcement. For successful deals, the resolution date is the consummation date.

*Source: Mitchell and Pulvino, Characteristics of Risk and Return in Risk Arbitrage, 2001*

Mitchell and Pulvino (2001) – studied 4750 merger transactions from 1963 to 1998, looked at returns if invested in all deals, including transaction costs:

- Return 10.6% p.a. Volatility 7.7% p.a.
- Returns very similar to those of Merger Arbitrage Hedge Fund indices

## Impact on Portfolio Construction

Manager Skill
"Alpha"

Specialist managers in many different strategies. True manager skill is hard to find and when available is subject to higher costs and performance fees.

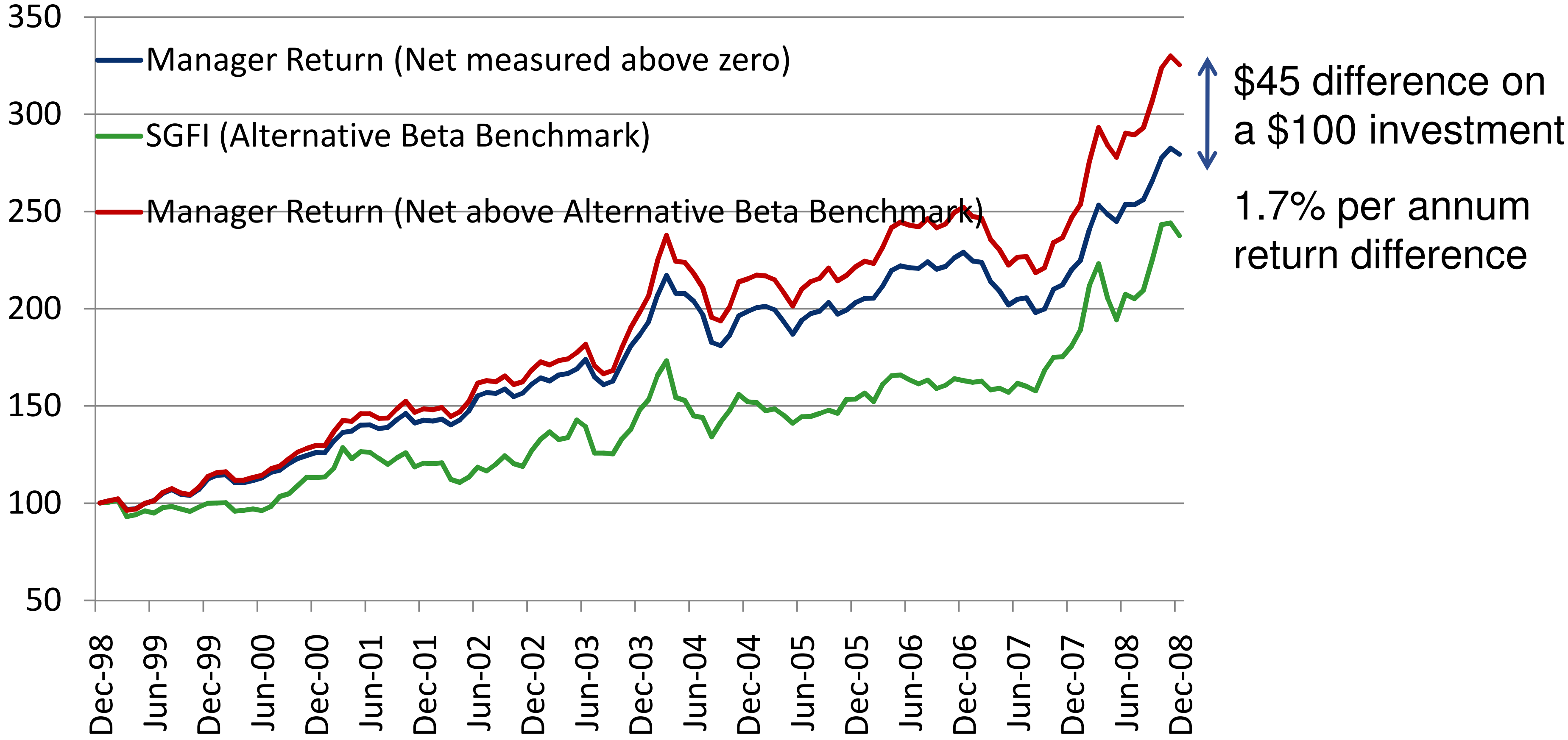
Common Hedge Fund Exposures
"Alternative Beta"

Portfolio replicates hedge-fund like strategies based on set of trading rules. Research required to set up trading rules and requires short selling and use of derivatives

Traditional Market Exposure
"Beta"

Easy to implement, passive long term exposures, cheap to buy as readily available and no manager skill

## Other Advantages – Negotiating Fees and Measuring Skill




In performance fees, measure alpha against an appropriate benchmark – not against zero

Overcoming the remaining shortfalls:

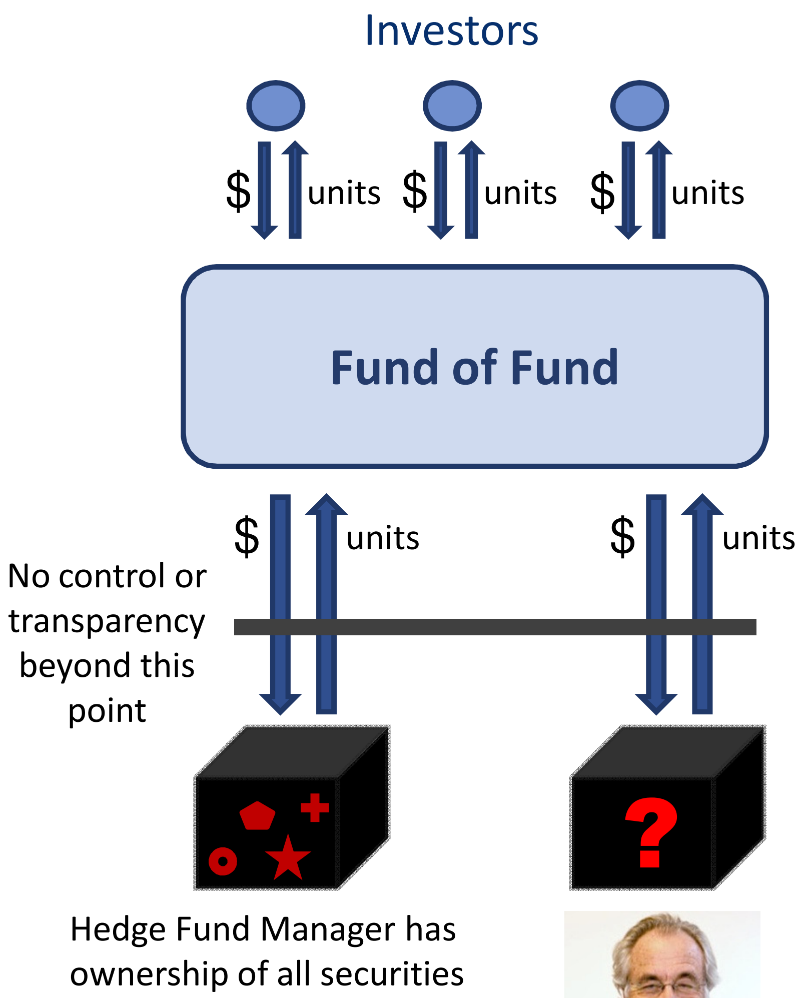
TRANSPARENCY, CONTROL AND LIQUIDITY

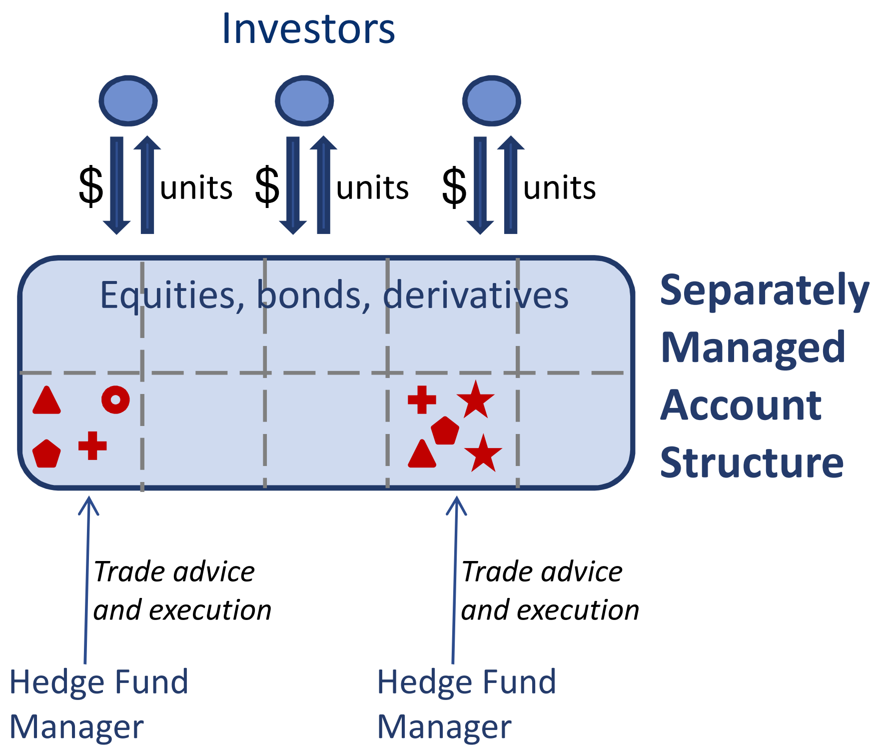
## Hedge Fund Risks

- Corporate Governance Risk
- Operational Risk
- Strategy Risk
- Style drift
- Correlation Risk
- Process Risk
- Liquidity Risk
- Leverage

These risks can all be managed more effectively through position level transparency - provided real-time through a Managed Account Structure.

# Resolving Structural Issues of Hedge Funds




- Account keeps custody of assets
- Full transparency into underlying positions
- Risk management can be performed on the composite portfolio

## Principles to follow to Resolve Structural Issues

- Maintain control of assets
- Demand position level transparency from independent source
- Ensure liquidity being offered is the liquidity of underlying instruments
- Pay fees that are reasonable, appropriate and commensurate with the manager’s skill

## Summary

- Hedge Funds' historic risk/return profile and low correlation with traditional asset classes provide a compelling case for inclusion of these strategies in investors' portfolios.

- However, structural flaws and well-publicised blow-ups with existing hedge fund offerings are a significant hurdle for investors.

- By gaining a greater understanding of the drivers of hedge fund returns, more intelligent structures can be built that focus on:
  - fairer fee structures;
  - greater transparency and control of portfolio assets; and
  - appropriate liquidity and better management of risk.

# What is the JANA Triplepoint Fund?

The JANA Triplepoint Fund is a multi manager portfolio* that seeks to invest in a diversified portfolio of alpha (manager skill) and beta (market) return streams. The combined portfolio is designed to deliver high risk adjusted returns, with competitive fees and greater transparency to investors.

## Investment Objective

To achieve a cash plus 5%p.a. return with 6% volatility over rolling 4 year periods.

## Investment Philosophy

JANA believes hedge fund strategy returns are cyclical and there are occasions when markets diverge from fair value. By recognising these occasions, and positioning portfolios and manager configurations accordingly, it is possible to reduce risk and outperform over the long term.

## Funds under Management

Initial seed investment of AUD 152M made on 5th December 2007

Ongoing applications now see FUM at $343M

** A multi-manager hedge fund operates similarly to a fund of hedge funds, but does not typically use the underlying investment managers' hedge fund vehicles. Instead a multi-manager hedge fund will typically hold all the individual securities in pools and appoint an investment manager to manage each pool. This allows the multi-manager fund to have visibility of the fund's assets and to more effectively monitor the individual investments and the investment managers. This is an important advantage over fund of hedge funds, where such transparency is the exception rather than the rule.* ***The JANA Triplepoint Fund is a multi-manager hedge fund.***

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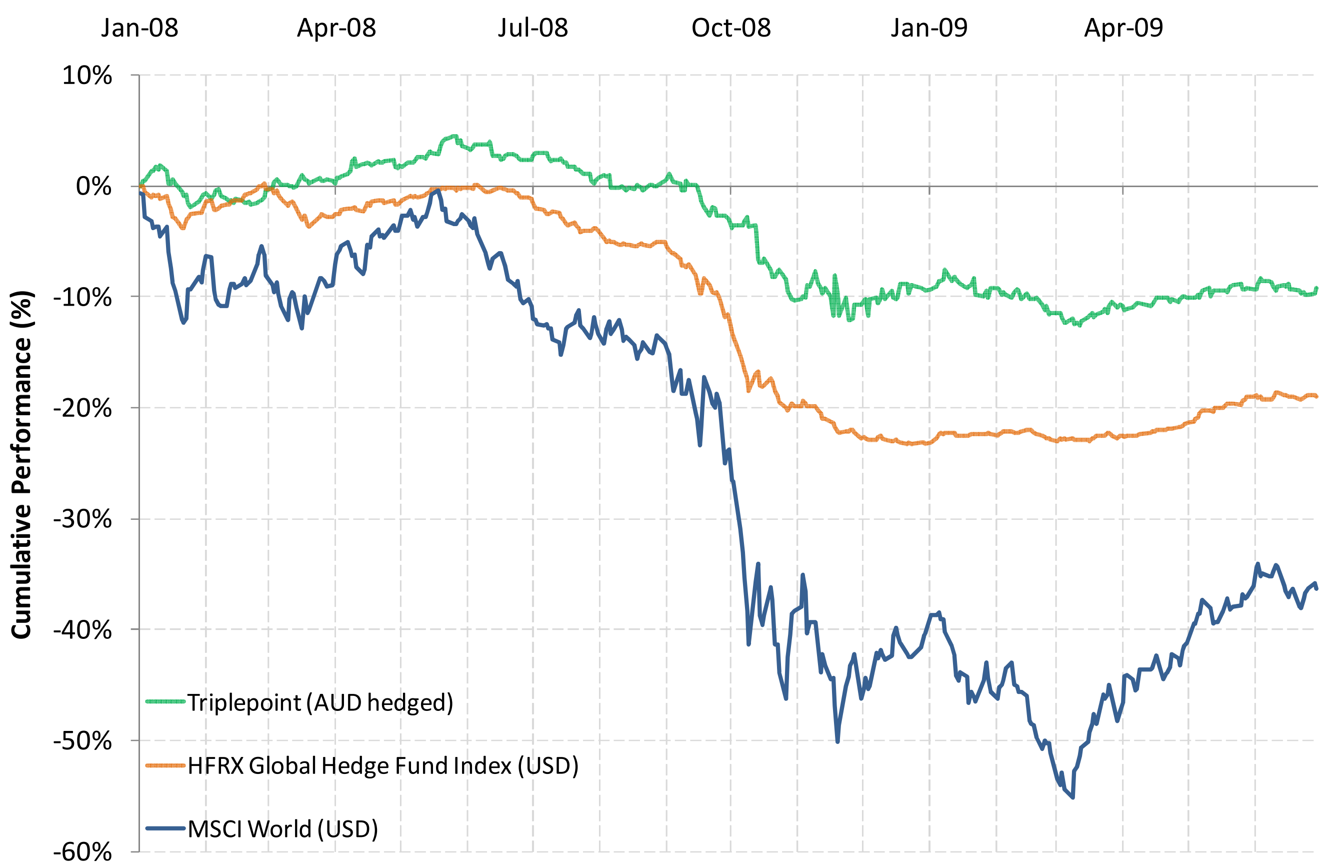
# By using return drivers as building blocks for Portfolio Construction it is possible to save ~50% of the fees and ~75% of the trading costs

## JANA Triplepoint Fund

| **40%** (20 - 60%) | **20%** (0 - 40%) | **40%** (20 - 60%) |
|---|---|---|
| **Efficient Beta** *(Traditional Market Exposures)* | **Alternative Beta** *(Common Hedge Fund Exposures)* | **Alpha** *(Manager Skill)* |
| **Traditional market exposures, such as stocks, bonds (duration), credit, real estate etc.** | **Hedge fund "like" strategies which can be replicated without incurring a hedge fund fee.** | **A variety of market neutral strategies** |

| | |
|---|---|
| **Little manager skill.** | **More Manager Skill** |
| **Cheap / infrequent trading** | **More expensive / more frequent trading** |

# Triplepoint Performance




Triplepoint Highlights:

- Maintained FX hedge
- Maintained daily liquidity and pricing
- No fraud
- No exposure to Bear Stearns or Lehman Brothers
- No suspension of redemptions

*Source: JANA, Factset, HFR*

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