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Hedge funds are worth considering for portfolio



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With the economy slowing and equity expectations tempered after three consecutive years of robust returns, investors are in somewhat of a quandary.

This is especially so in the small and mid-cap markets as valuations also look relatively high. Although long-term bond interest rates have risen and spreads between treasuries and corporates are narrow, the fixed income markets don't offer high expectations either. In addition, real estate markets are slowing and expensive.

However, we believe that an allocation to quality absolute return and long-short hedge funds may be a solution to incrementally increasing return while lowering the overall risk of the portfolio.

With traditional strategies, the market drives a large majority of the return an investor experiences. Simplistically, if one invests in an actively managed large-cap equity manager--and after one year, the fund is up 10 percent while the S&P 500 is up 9 percent--we can conclude that approximately 90 percent of the return was driven by the investor's decision to invest in large-cap stocks.

That is part of the basic argument that passive investing proponents make in promoting index fund investing. If an index is driving the return, why pay active-management fees when so little of the performance is attributed to a manager?

A long/short equity fund is one way to extract added performance (alpha) without taking a lot of market risk.

Recently, a major driver for long-short hedge funds has been low short-term interest rates, which have resulted in disappointing returns. Typically, long-short hedge funds will be invested long (they own shares of stock) with a majority of the portfolio (50 percent-90 percent), but offset some of this market exposure by investing "short" with 20 percent to 40 percent of the fund.

Shorting a stock is the act of borrowing shares, selling them with the expectation of re-purchasing the stock at a lower price. Proceeds from the short sale are invested in money market funds, which add to the total return of the fund.

Now that short rates have risen to the highest level in three years, hedge funds have better interest-rate support, adding to return expectations.

With a higher fee structure in hedge funds compared to long-only management, there's been great growth in new hedge funds coming to the marketplace. And because hedge funds are less regulated than other investments, hedge fund manager due diligence is crucial. Here are some key considerations:

- **Track Records** -- They always should be considered. But also, understanding why performance is strong or poor is important.

Of the hedge funds that have performed well in the last few years, many were a result of credit-driven strategies. However, as the yield curve has flattened (short rates rising faster than long rates) and credit spreads (premium paid for a corporate bond vs. a treasury bond) have narrowed, the arbitrage and leverage opportunities have diminished.

Investors not only must understand how the fund achieved its return, but also must be able to assess the strategy's potential.

- **Onsite Visits** -- Get beyond track records and fancy marketing. Some of the best hedge fund products have little marketing, and many mediocre products have great marketing. Understand a firm's capabilities, systems, personnel, back-up procedures, etc.

- **References** -- Confirm with both the legal counsel and auditor that they provide services to each hedge fund. Review the audit, do background checks on key personnel and check regulatory history.

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Because hedge funds are in a much less-regulated environment than traditional investments, it allows for more flexible strategies -- but that comes with additional risks.

Systematic (manager specific) risks are much higher, and outright fraud can occur, although uncommon.

We recommend diversification between hedge fund managers and strategies.

Studies show that risks can be significantly reduced without negatively impairing returns through prudent diversification. This can be accomplished through investing in a multistrategy hedge fund, a group of single-strategy hedge funds or through a fund-of-hedge-funds vehicle.

Hedge Funds can have a positive impact on portfolios but careful implementation and due diligence are musts. We expect the environment for hedge funds to be much better.