

canadian**hedgewatch**



Hedge Funds 101 Presentation

March 3, 2009

Disclaimer

Canadian Hedge Watch (“CHW”) is an information, research and education firm reporting on hedge funds and alternative investments.

- CHW does not provide advice or recommend investments to investors.
- Our presentation should not be misconstrued as a recommendation from CHW to invest specifically in certain funds.
- All graphs and numbers presented today are taken from Canadian Hedge Fund Quarterly Industry Report, December 2008.
- Performance data provided by hedge funds is not verified by CHW.

How is a hedge fund different from a traditional fund?

Hedge funds are pooled instruments that employ a wider variety of strategies compared to traditional investments. There are a vast number of differences.

Traditional Investing

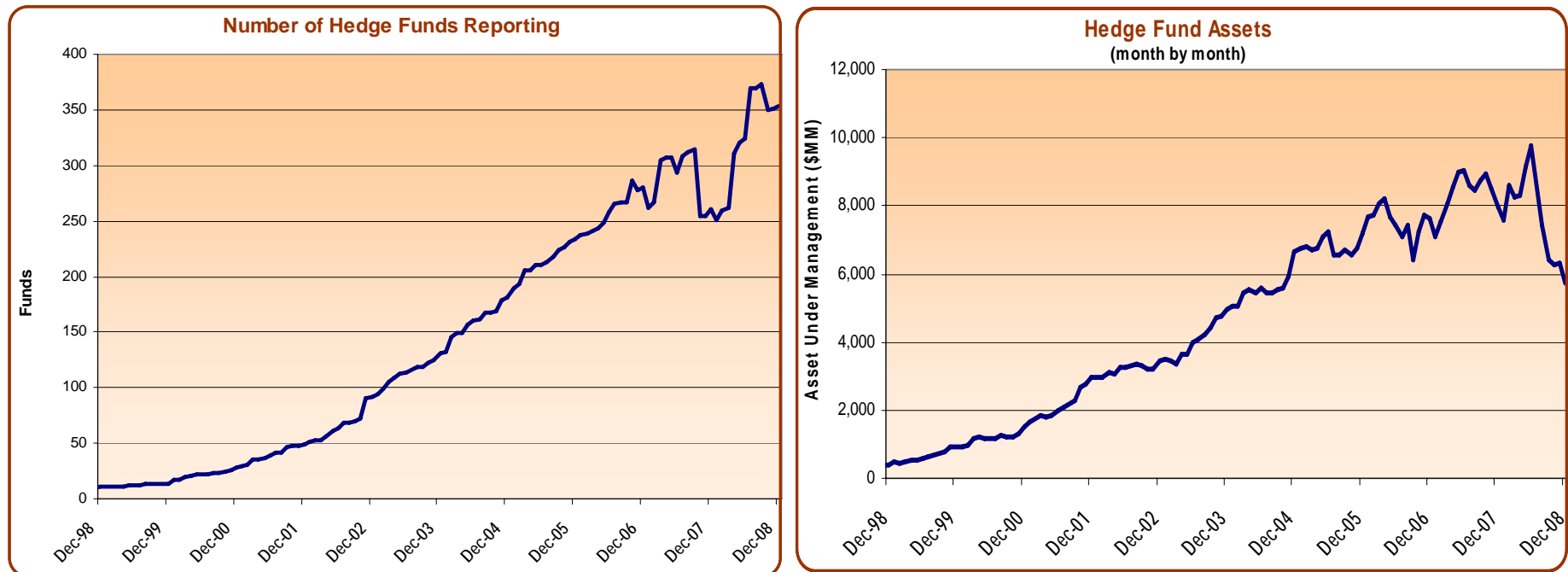
1. Markets are efficient and only temporary mispricings occur
2. Greater constraints: long only, liquid investments, concentration limits
3. Set return objectives based on other benchmarks / indices
4. Investment decisions made through committees
5. Fixed rate management fees
6. Provide full, true and plain disclosure of fund details through Prospectus
7. Homogenous – high degree of correlation among mutual fund performance
8. Open to the public for investing
9. Manager usually does not have own money invested in fund

Hedge Funds

1. Markets are not efficient – hedge funds take advantage of price anomalies through market knowledge
2. More techniques available: short selling, arbitrage, leverage, derivatives
3. Different benchmarks depending on strategy
4. Investment decisions made more quickly among a smaller group of people
5. Incentive fees based on performance
6. Less disclosure required through Offering Memorandum
7. Heterogeneous – less correlation among funds due to a wider variety of strategies
8. Generally limited to accredited investors
9. Manager usually has own money invested in fund

Canadian Hedge Fund Market

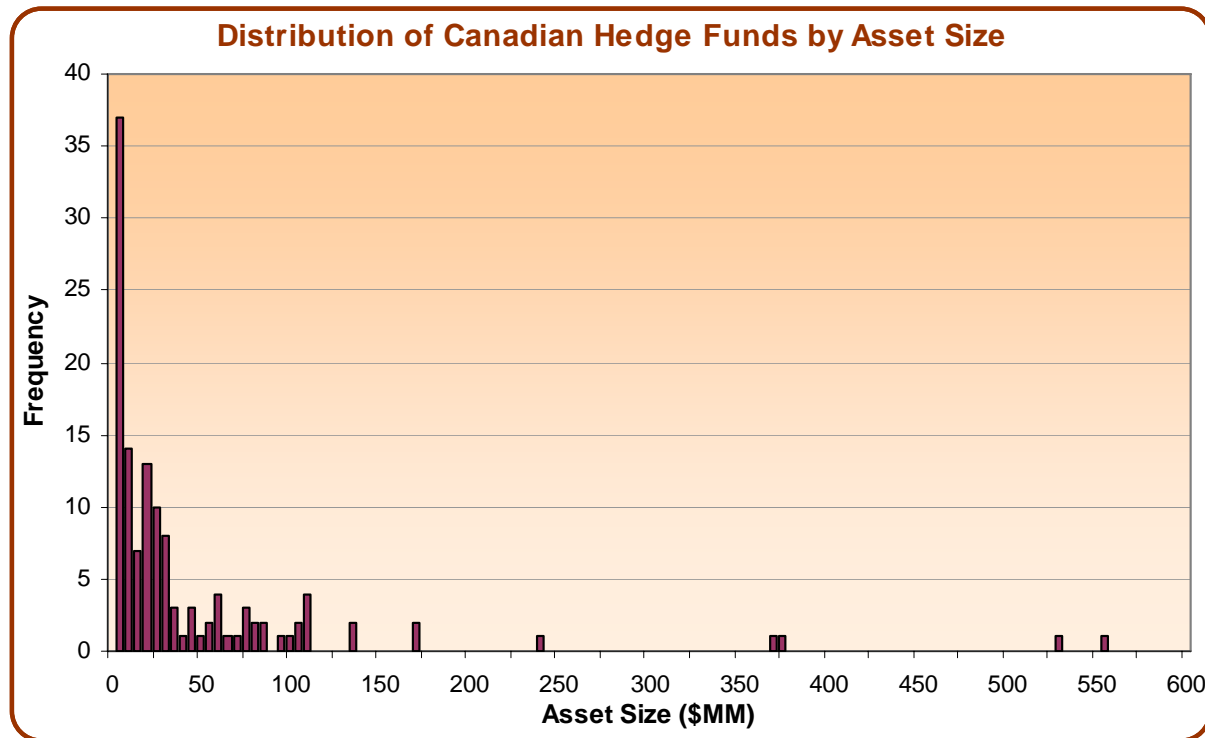
As of December 2008, there were about 60 hedge fund managers reporting 353 hedge funds with about \$5.7 billion in assets reported, which is a drop of about 28% from \$7.9 billion in 2007.



- Of the 353 hedge funds reporting, only 129 report the size of their assets
- The decline in assets is attributable to a combination of negative performance and redemptions

Composition of the Hedge Fund Market

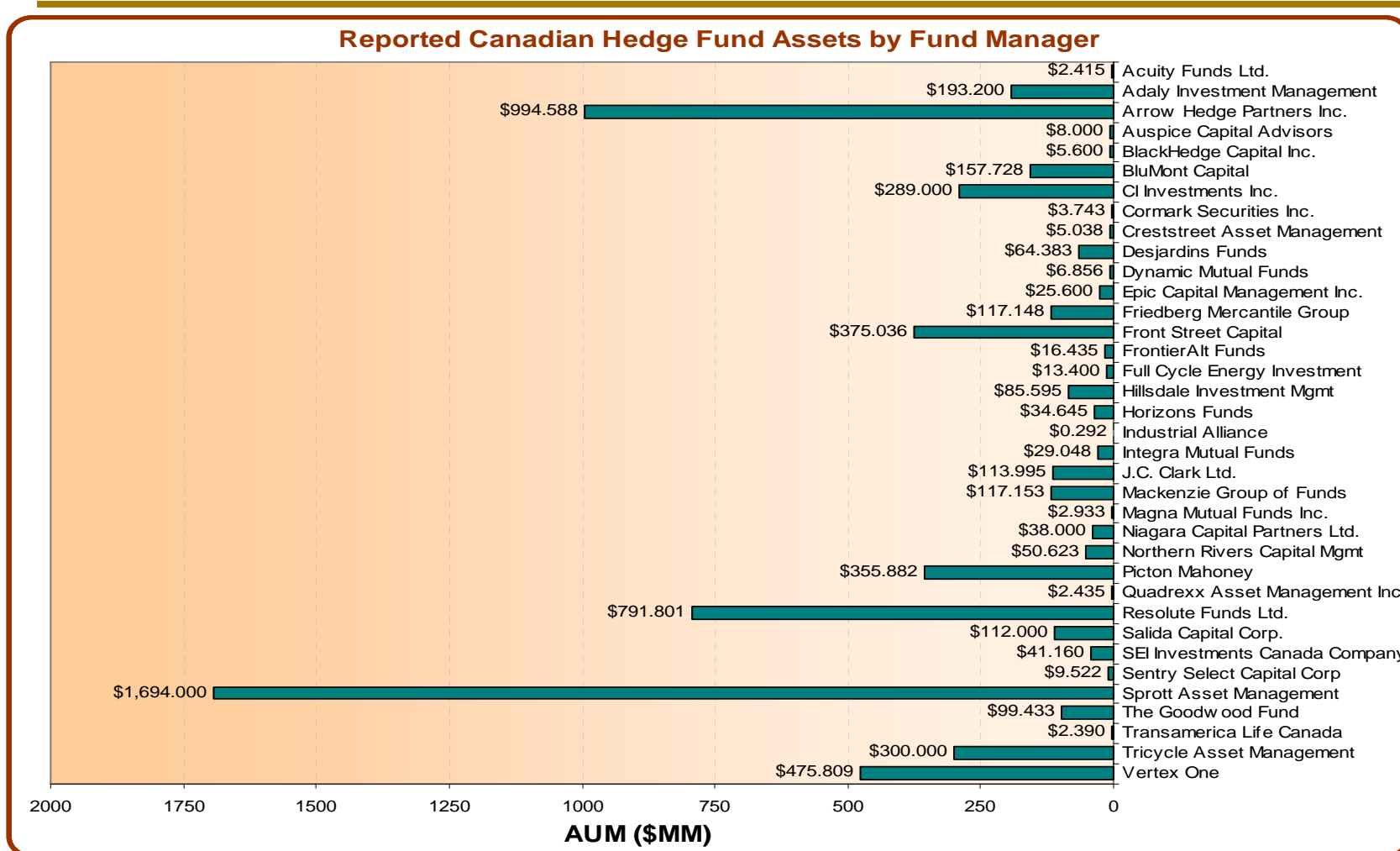
Approximately 88% of the hedge funds reporting are under \$50 million in assets under management in 2008, up from 78% in 2007. The Canadian hedge fund industry continues to be dominated by small funds raising capital through the retail channel.



- Less than 2% of hedge funds have \$200 million in assets or more in 2008 (down from 3% in 2007)
- Less than 6% of hedge funds have \$100 million in assets or more in 2008 (down from 11% in 2007)

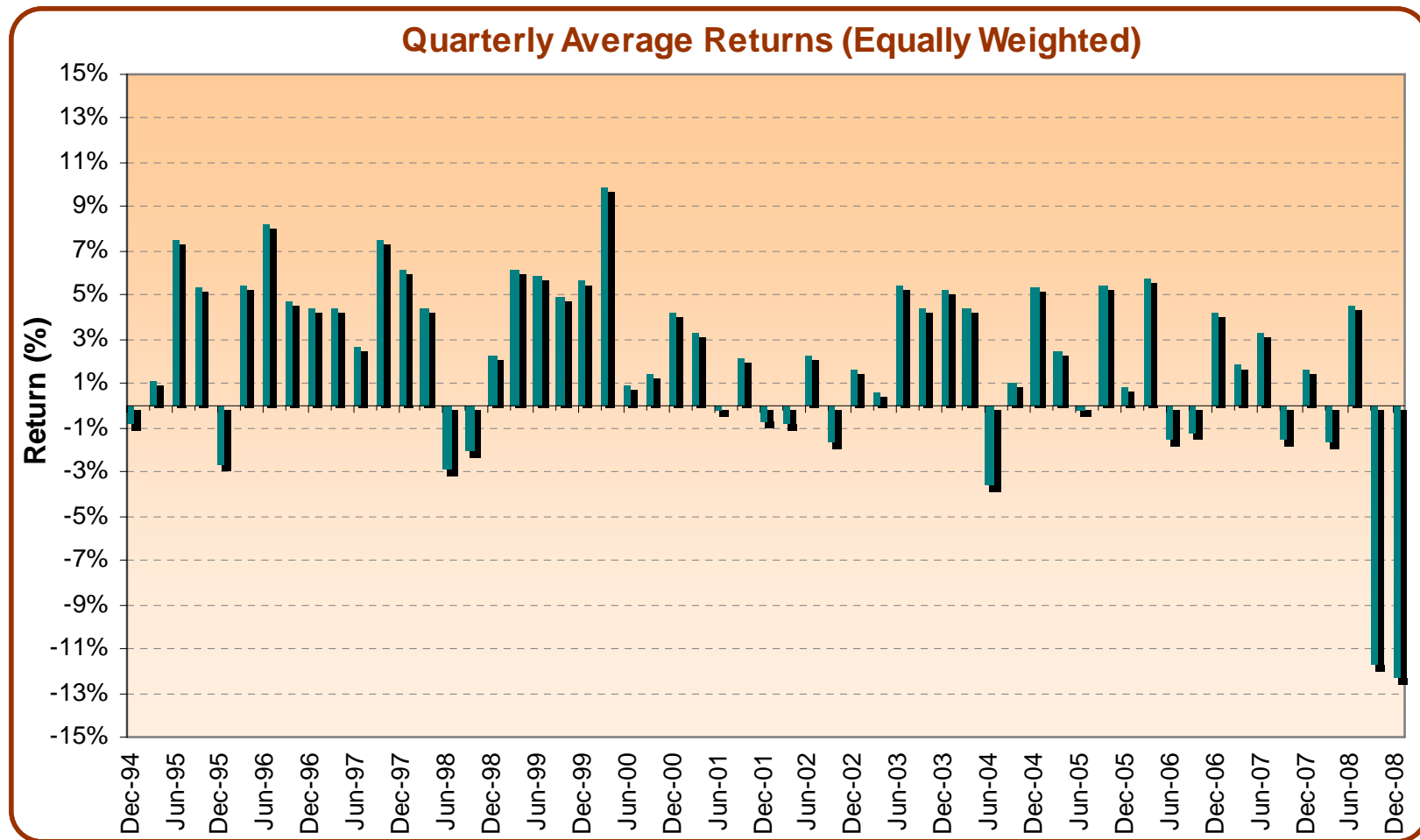
Key Players

Sprott Asset Management continues to be the largest manager of Canadian hedge funds, with \$1.7 billion in reported assets. Including mutual funds and other assets, Sprott is estimated to have well over \$4 billion in assets under management.



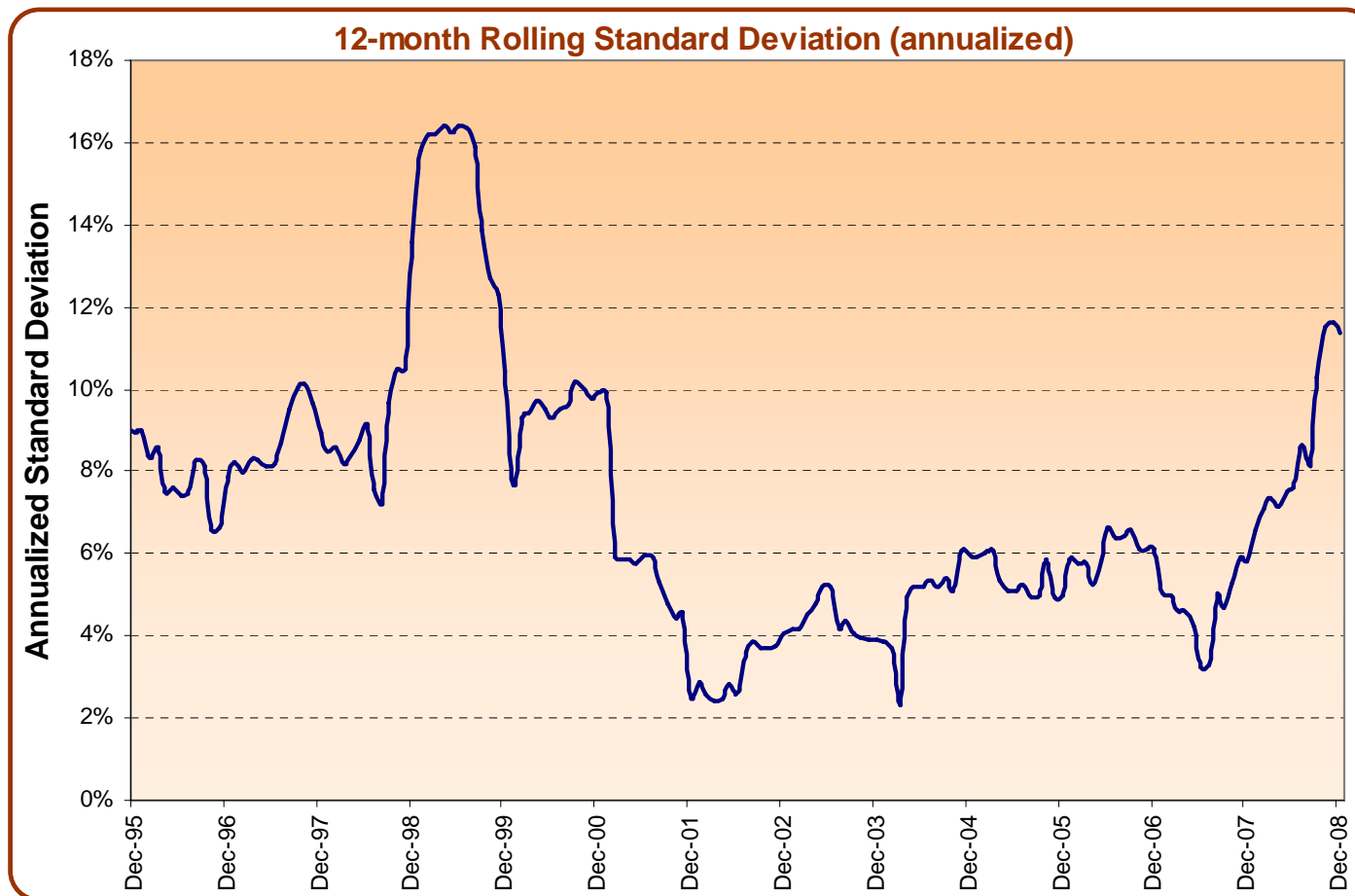
Hedge Fund Performance

Q3 and Q4 2008 are clearly the worst quarters since 1994 at -11.74% and -12.33%, respectively. However, hedge fund returns have been mostly positive prior to this period.



Hedge Fund Volatility

Standard deviation is used as a measure of variance in hedge fund performance. Volatility has steadily increased since mid 2007, but has not reached the levels seen in '98 and '99 during the Asian crisis.



Sharpe Ratio

Sharpe Ratio is a common ratio used to evaluate hedge funds. The ratio takes performance and volatility into consideration. The higher the ratio the better as investors prefer greater returns and lower volatility.

$$\text{Sharpe Ratio} = \frac{\text{Return} - \text{Risk Free Rate of Return}}{\text{Standard Deviation}}$$

Ex: ABC Hedge Fund and XYZ Hedge Fund both return 10% in 2008. However, ABC has a 5% standard deviation and XYZ has a standard deviation of 25%. Government T-Bills pay 1%.

$$\text{ABC's Sharpe Ratio} = \frac{10\% - 1\%}{5\%}$$

$$\text{XYZ's Sharpe Ratio} = \frac{10\% - 1\%}{25\%}$$

$$\text{ABC's Sharpe Ratio} = 1.8$$

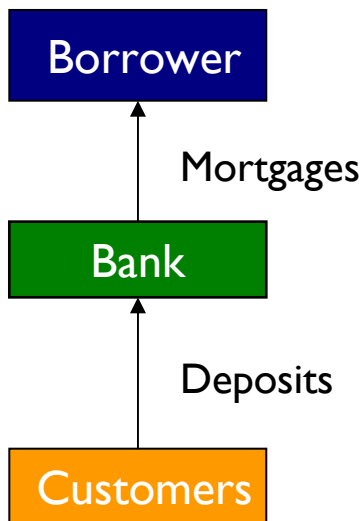
$$\text{XYZ's Sharpe Ratio} = 0.36$$

Based on a rolling average of all hedge funds that report their information since 1994, the Sharpe Ratio is 0.60 vs. 0.09 for the TSX.

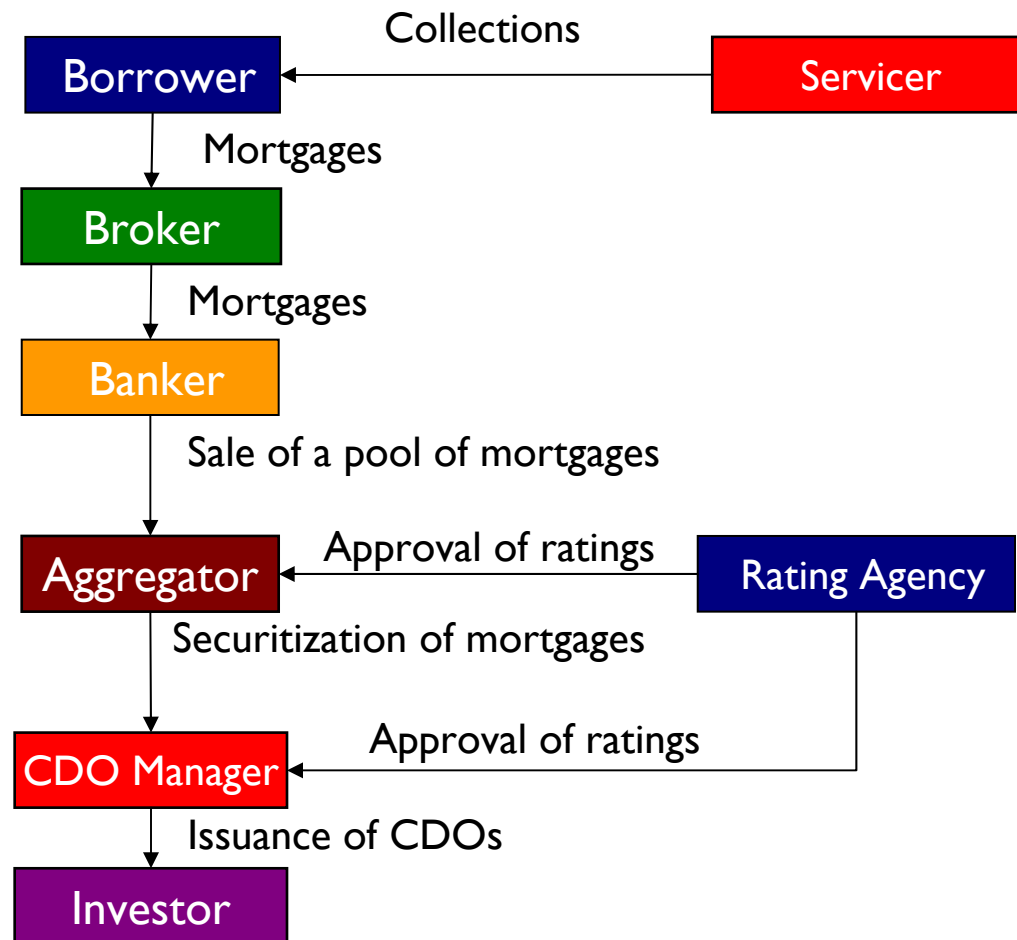
US Subprime Debacle

There are two key causes of the debacle – 1) Too many degrees of separation between the originator of the mortgage and the risk taker and 2) Greed.

Traditional Model



Today's Reality



How does short selling work?

Short selling is the act of selling a stock that one does not own in anticipation of being able to buy it later at a lower price. In other words, the investor perceives the stock as overvalued and anticipates the price will go down.

Investor short sells 100 shares of ABC stock at \$10, in anticipation it will go down. The proceeds from the sale are \$1,000 upfront.

ABC drops to \$6

- Investor sells 100 shares of ABC stock immediately and receives proceeds of \$1,000.
- Investor assumes correctly and the stock is down.
- Investor decides to buy back shares and realize profit.
- Investor purchases 100 shares at \$6, for a total purchase of \$600.
- Investor earns a profit of \$400.

ABC increases to \$14

- Investor sells 100 shares of ABC stock immediately and receives proceeds of \$1,000.
- Investor assumes incorrectly and the stock rises.
- Investor decides to cover position to minimize losses.
- Investor purchases 100 shares at \$14, for a total purchase of \$1,400.
- Investor loses \$400.

Why do hedge funds use margin?

Some hedge funds use leverage in order to magnify returns. Unfortunately this magnifies losses as well. We expect hedge funds to do less leveraging in 2009, as the cost of borrowing has risen significantly and liquidity is scarce.

Investor short purchases 100 shares of ABC stock at \$10, and decides to borrow to purchase an additional 100 shares.

ABC drops to \$6

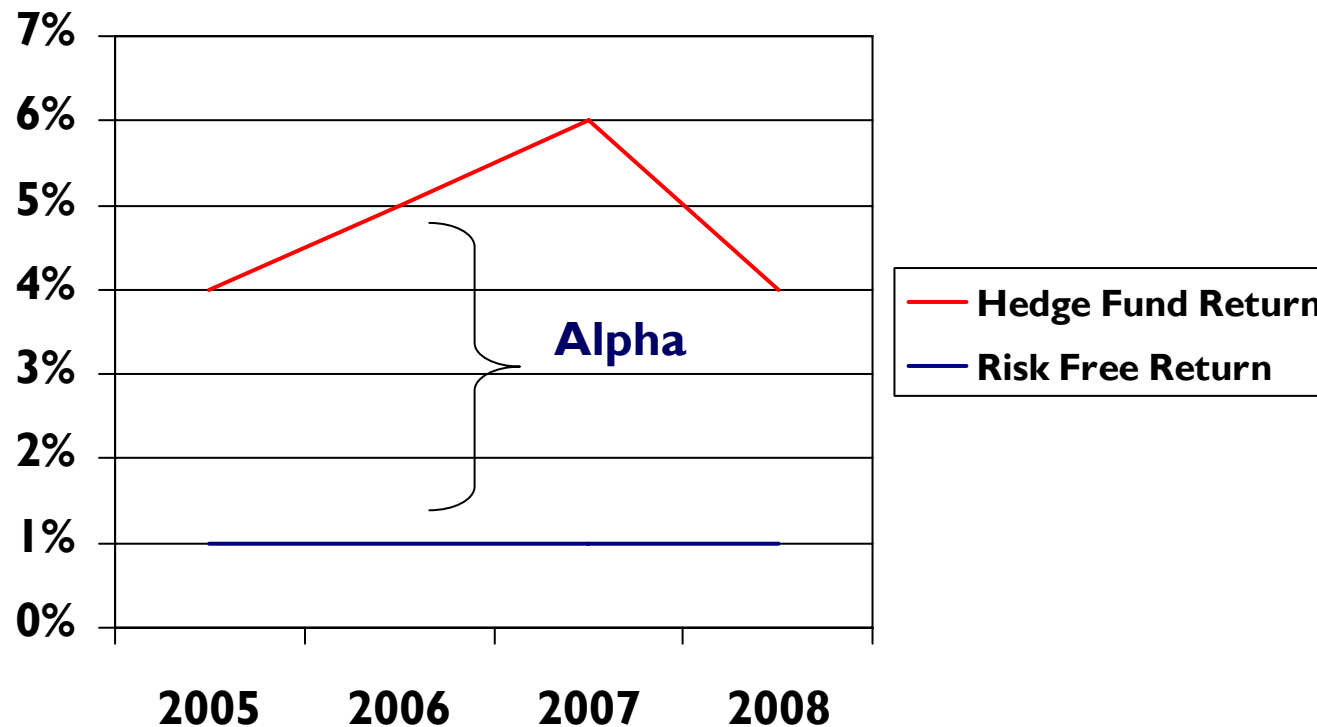
- Investor invests \$1,000, borrows an additional \$1,000 and owns 200 shares of ABC stock
- Investor decides to sell stock and cover position to minimize loss
- Investor sells 200 shares at \$6 for total proceeds of \$1,200
- Investor returns \$1,000 to bank and recovers \$200
- Investor loses 80% on investment

ABC increases to \$14

- Investor invests \$1,000, borrows an additional \$1,000 and owns 200 shares of ABC stock
- Investor decides to sell stock and realize a gain
- Investor sells 200 shares at \$14 for total proceeds of \$2,800
- Investor returns \$1,000 to bank and realizes a gain of \$800
- Investor returns 80% on investment

What is this concept of Alpha?

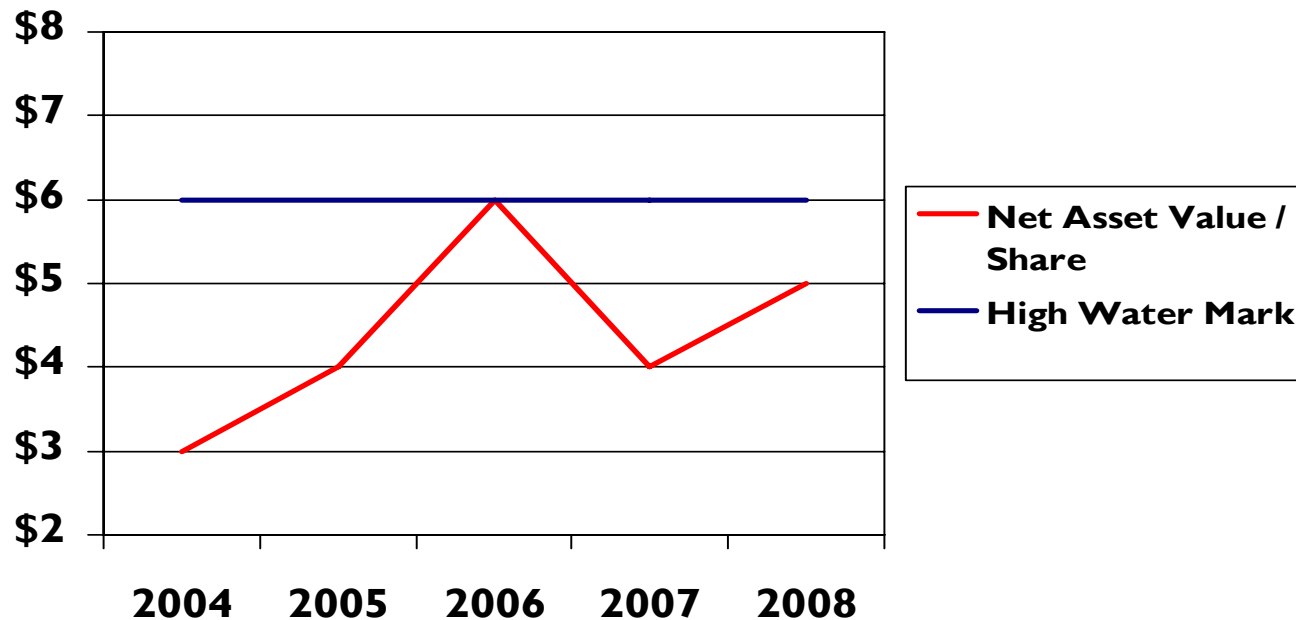
Alpha measures the value that an investment manager produces by comparing the manager's performance to that of a risk-free investment, whereas Beta is the measure of volatility of fund in comparison to the rest of the market.



- Beta of less than 1 means low volatility, Beta = 1 means matching the market, and Beta greater than 1 means more volatile than the market
- Collectively, Beta, along with Alpha account for 70-80% of hedge fund returns

What is this concept of the High Water Mark?

The typical fee structure for a hedge fund is the 2/20 structure, which encompasses a 2% fixed rate on the net asset value plus 20% performance fee. The performance fee is applicable when the fund surpasses the High Water Mark.



- A HWM is the highest peak in value that an investment fund/account has reached
- Manager earned performance fees in 2005 and 2006 with positive performance in the fund
- Manager does not earn performance fees in 2007 or 2008
- Manager will not earn any more performance fees until the NAV / share recovers beyond \$6

Long Short Equity

Hedge funds use a variety of strategies, which need to be fully understood by investors. The majority of hedge funds in Canada use a long short equity strategy.

- Manager determines undervalued and overvalued stocks and takes long and short positions respectively
- Generally bottom-up approach
- Success depends on manager's ability to determine fair value of each stock
- Long Bias: fund has more long exposure than short exposure as a percentage of the portfolio
- Short Bias: fund has more short exposure than long exposure as a percentage of the portfolio
- Market Neutral: 50:50 balance of long and short positions
 - Leverage often used to enhance returns
 - Beta neutral: small or no market risk
 - Pairs trading

Global Macro

A global macro strategy involves the opportunistic allocation of capital to a wide variety of strategies and asset classes in various geographies and sectors.

- Top-down approach: Managers take view on various sectors and makes a decision on the most opportunistic industries
- Most funds invest globally in developed and emerging countries
- Global macro managers have greater exposure to interest rate, exchange rate and liquidity risk
- Performed relatively well in 2008

Managed Futures

Managed Futures managers make trades in the spot or futures markets globally and are referred to as Commodity Trading Advisors (CTAs).

- Low correlation to traditional equities
- Most fund managers trade derivative contracts linked to commodities and currencies
- Some trades take long and short positions on the same commodity
- Tend to outperform other asset classes in an environment with high volatility
- Best performing asset class in 2008

Arbitrage

The term arbitrage is the practice of sourcing temporary mispricing opportunities, making a trade and profiting when markets realign to fair value.

- Convertible arbitrage: generally seeking mispricing in convertible bonds
 - Typical trade: purchase a convertible bond and short the stock of the same company
- Merger arbitrage: generally seeking mispricing opportunities in the event of a merger, restructuring or some other corporate transaction
 - Typical trade: after a preliminary takeover announcement, buy company being acquired and sell short acquirer
- Fixed-income arbitrage: generally seeking mispricing in securities with interest like bonds
 - Typical trade: Short a low yield bond like treasuries and go long on a high yield bond like BBB corporates

Why were most hedge funds down in 2008?

Despite what we see in the media, there are actually a number of hedge funds that exhibited superior positive returns in 2008. However most have negative performance much like the rest of the market and correlation seems to be higher than expected.

What are some factors causing hedge funds to be down?

Deleveraging

- In a market of panic, Prime Brokers are calling on their margin, thus forcing deleveraging
- Hedge funds are being forced to liquidate assets to meet margin calls, often selling their most liquid and best performing assets to free up cash

Redemptions

- The negative press on hedge funds has exacerbated redemptions as investors flee to cash
- Some hedge funds have been unable to meet redemption requests, because underlying investments are not liquid enough
- Fund of funds have been making redemptions as well

Net Long Bias

- As most hedge funds have had a net long bias, it is no surprise most have fallen with the rest of the market
- Short bias and market neutral funds have performed exceptionally better

Themes for 2009

While things may look bleak for the industry, it is important to understand that hedge funds are being put through the toughest test we have seen in our lifetime. Those that weather the storm should come out stronger, as the weak will be weeded out.

- Liquidations of hedge funds that have been overexposed
- More robust due diligence
- More focus on operational risks, along with credit risk
- Increased transparency
- More regulation
- Pressure on hedge funds to lower fees
- Trust needs to be rebuilt in the industry
- A better understanding that not all hedge funds are the same – more education

Contacts

For general inquiries:

Daryl Ching

416-848-0277 Ext. 2238

ching@canadianhedgewatch.com

For membership inquiries:

Sean Datta

416-848-0277 Ext. 2234

datta@canadianhedgewatch.com