

Hedge Fund Demand and Capacity 2005 - 2015



Is Worldwide Hedge Fund Demand Outstripping Capacity?

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1. Summary

This report examines the demand for hedge funds, worldwide, as well as the capacity of the industry to fill this demand. In summary:

- From 1988 through the present, the hedge fund industry has experienced brisk annual growth. This growth has been composed of two elements: appreciation of assets and new money entering the industry.
- Whenever hedge funds stumbled, there was speculation about their demise. The industry continued to grow.
- *In 2004, in addition to unfavorable markets and low volatility, a new factor entered the equation: unprecedented investment inflows as investors, both institutional and retail, decided they couldn't afford to be without hedge funds.* Hedge funds reached their “tipping point”¹ with the resulting demand taking on a life of its own.
- *The lack of transparency; liquidity; higher fees; leverage and regulation: all are factors that could repress demand. However, none is expected to have a noticeable effect.*
- *The hedge fund industry continues to operate with low leverage. As of year-end 2004:*
 - *VAN research showed that approximately 20% of hedge funds used no leverage whatsoever while another 50% used leverage (borrowed money) of less than one time their equity (including short positions as leverage).* It is important to note that this definition of leverage includes short positions in addition to borrowings. These statistics belie the widely-held belief that hedge funds, generally, use large amounts of leverage.
 - *New SEC regulations of December 2004, requiring many managers to register with the SEC, are not expected to slow the growth of the U.S. hedge fund industry or to have a noticeable impact on the growth of the non-U.S. (offshore) hedge fund industry.*
 - *Approximately 40% of offshore funds currently are clones of U.S. funds; in many cases, these managers already are registered with the SEC.*
 - *Another 40% of offshore funds already accept U.S. investors. Most of these funds are expected to register quietly* rather than lose their U.S. investors (should these funds meet the guidelines for registration).
 - *The remaining 20% of offshore funds do not accept U.S. investors and are not expected to register;* however, they will continue to accept U.S. investors in non-U.S. companies or non-U.S. trusts.
- *Large capital inflows, combined with low volatility and perverse markets, have stressed numerous strategies.* Exhibit 1 on page 7 summarizes VAN's outlook for various current strategies (described in

¹“The Tipping Point” refers to the point at which a social trend achieves critical mass and takes on a life of its own. See Appendix 1, p. 42.

more detail in section 4.1). It may take the industry at least another year to fully digest recent massive capital inflows. Subsequently, growth will accelerate.

- Strategies with the most capacity at this time tend to be those drawing on the broad markets. They include Macro, Futures, Aggressive Growth, Opportunistic and Special Situations.
- In the meantime, innovative hedge fund managers have entered strategies that are new to hedge funds. They also have entered new markets, both in developed and developing economies. As developing economies continue to grow, they provide great additional capacity to hedge funds.
- New Strategies are described in Section 4.2. They include:
 - Energy;
 - Private Equity;
 - Real Estate;
 - Middle Market Lending;
 - Asset-Backed Financing;

and the growing use of:

- ETFs;
- Credit Derivatives.
- New markets for hedge fund investing include:
 - Developed economies such as Canada, several major European countries and Japan;
 - Developing economies, led by China, whose GDP is expected to surpass that of the U.S. by 2035; also India, pulling into third place by the same year.
- We estimate that approximately 40% of hedge fund industry assets currently are invested through FOFs.
- The majority of assets invested in hedge funds products will be in public vehicles in the not-too-distant future.
- Hedge funds, after approximately two years of adjustment to new inflows, will again cope successfully with rapidly growing demand. We expect hedge fund assets under management to rise to at least:
 - \$2 trillion by 2009;
 - \$4 trillion by 2013;
 - \$6 trillion by 2015.

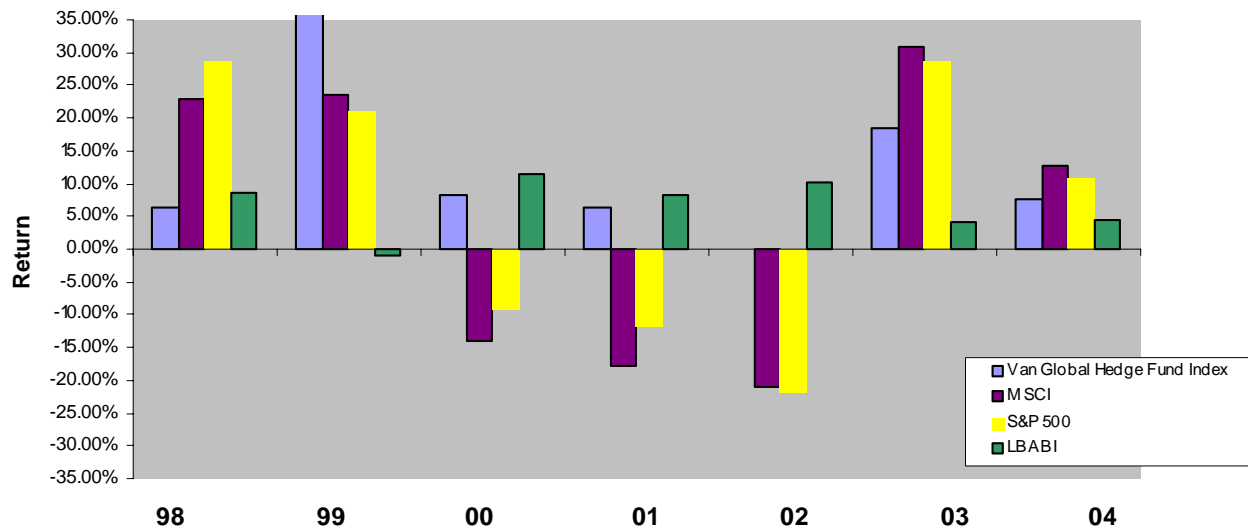
Exhibit 1: Outlook for Capacity of Current Strategies

| Strategy | Current Situation | Outlook |
|---|---|---|
| Acceptable | | |
| Aggressive Growth | Good | Acceptable |
| Emerging Markets | Good | Acceptable |
| Futures | Good | Good |
| Macro | Good | Good |
| Market Neutral Securities Hedging | Good | Good (with Europe included) |
| Multi-Strategy | Good | Good |
| Opportunistic | Good | Acceptable |
| Special Situations | Good | Good |
| Value | Good | Good |
| Moderately Stressed | | |
| Fixed Income Arbitrage | Narrowly defined strategies- Stressed Broadly defined strategies- Acceptable | Some relief in non-US markets |
| Income | Narrowly defined, close to Stressing, depends on strategy | Acceptable with new instruments and strategies in US and non-US markets |
| Merger/Risk Arbitrage | Stressed but will recover somewhat with economy | Acceptable to Good |
| Distressed Securities | Good, starting to be under some pressure in US | Good opportunities in Europe |
| Stressed | | |
| Market Timing | Virtually dead in US for legal reasons. Alive offshore | Acceptable outside US |
| Short Selling (as a stand-alone strategy) | Acceptable to Stressed, depending on manager | Difficult due to nature of strategy - as always |
| Statistical Arbitrage | Stressed | May be Acceptable with non-US markets |
| Convertible Arbitrage | Stressed, improving | Some relief in non-US markets |
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2. 2004 – An Inflection Point

Hedge funds first attracted widespread attention in the early 1990's. They comprised a fledgling industry that became closely watched, especially when hedge funds underperformed the broad markets. This occurred in 1984 and, more notably, in 1998 and 2004.

Exhibit 2: Performance of Hedge Funds and Market Indices, 1998 – 2004



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In 2004, the hedge fund industry experienced a watershed event. Institutional investors and others noted that, in the bear market of April 2000 through September 2002, hedge funds had preserved investors' capital, returning 2.1% while the S&P 500 lost 43.8%. This recognition was heightened by the string of significant losses in many traditional portfolios.

The resulting demand for hedge funds reached an all-time high in 2004 as investors sought a "safer" haven for their money. This wave of investments, in addition to unfavorable market conditions, made it difficult for many hedge funds to find enough attractive investments. A few strategies, such as those based on arbitrage, struggled noticeably. The Van Global Hedge Fund Index returned 7.7% for 2004 while the S&P 500 returned 10.9%. A recent VAN study shows that more hedge funds turned away new investors in 2004 than in 2003 or 2002. About 50% of these were first quartile funds².

The hedge fund industry is at an inflection point. Will there be adequate capacity to meet demand or not? Others addressing this question have examined current strategies and current markets. We welcome their findings, examine similar areas and generally agree with them. In addition, we consider *additional* capacity that is becoming available in *new strategies* that some hedge fund managers are entering. Finally, we look at the capacity offered by *new markets* that we believe will be exploited increasingly by hedge funds in the future.

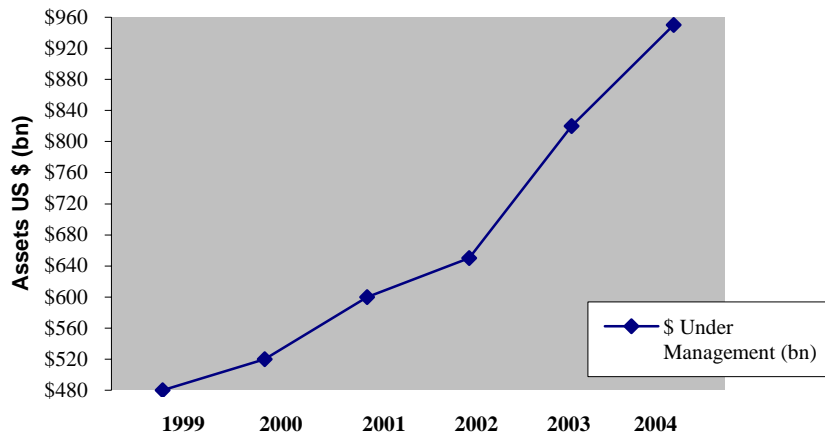
² Based on a risk-adjusted return ranking.

3. Hedge Fund Demand, Current and Future

Hedge fund demand, for the purposes of this paper, refers to investors' monies seeking hedge fund investments.

Hedge fund demand has been strong, over the years, increasing steadily in absolute dollars.

Exhibit 3: Hedge Fund Dollars under Management 1999–2004



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The assets in hedge funds doubled from 1999 through 2004, to approximately \$950 billion. This is considerable growth for any established industry, coming on the heels of continuing average annual growth of 24% per year from 1988 through 1998.

Institutional Demand: Institutions worldwide have been rapidly increasing their allocations to hedge funds. This higher level of institutional demand is a new factor, in the sense that most of the institutional sector previously had only made exploratory investments. The trend is noteworthy given the huge amounts of capital potentially available to hedge funds from foundations and endowments, pension plans and large family offices.

About 60% of U.S. foundations and endowments have invested in hedge funds while 20% of U.S. pensions have done so. Interestingly, while pensions have, by far, the biggest dollars to allocate, their allocations represent only about 1% of their \$5 trillion assets.

Institutional investment in hedge funds has been accelerated by the 2000 – 2002 bear market, which caused shrinkage of institutional assets and a perceived need for “safer” investments (hedge funds).

The capital debts of global pension funds were as high as \$1.5 trillion at the beginning of 2004. Recently, more than 1/3 of European pension funds outside the U.K. were under-funded with insufficient assets to meet their obligations, even after recovery of the stock markets.

Many institutional managers now believe they do not have a choice – they must move to alternative investments and particularly hedge funds. With their increasing commitments to hedge funds, they have moved them into the mainstream. For example, in November 2004, the staff of the California Public Employees Retirement System (CALPERS) indicated their desire to double their allocation to hedge funds, from about \$1 billion dollars to \$2 billion dollars. Given CALPERS' high visibility, this decision has sent a signal to other pension funds worldwide.

Internationally, the World Bank has invested \$1.5 billion dollars (of its \$12 billion dollar pension fund) in hedge funds.

Current investments in hedge funds by institutions account for approximately 1% of the assets of U.S. institutions or about \$70 billion dollars. If one assumes an ultimate 15% allocation, these groups, in the U.S. alone, would more than double 2004 hedge fund assets. If one similarly adds an incremental 10% allocation by non-U.S. pension plans, the added monies flowing to hedge funds would be approximately another \$850 billion dollars.

The assets of non-U.S. pensions, endowments, foundations, and high net worth investors total approximately \$39 trillion dollars. The potential is large.

According to a survey by Prince & Associates, 45% of family offices invested in funds of funds (“FOFs”) in 2004. Over the next 3 years, 84% expect to do so. The 653 family offices surveyed had approximately \$1.2 trillion in investable assets.

In addition to large capital inflows into hedge funds, available capacity is further diminished by bank proprietary desk trading in many of the same markets. Industry studies have shown that proprietary desk trading volume in many strategies is at least equal to or greater than hedge fund trading volume. This has added to the erosion of profitable inefficiencies.

Retail Demand: Finally, there is the retailization of hedge funds that presages the future of hedge funds as public vehicles.

In the US, for example, the trend to register hedge funds is growing. At the beginning of 2001, there were no registered funds. Today, approximately 60 brokerage firms have products registered with the SEC. In a parallel development, Charles Schwab Corp. and some competitors are attempting to replicate hedge fund advantages with mutual funds that do some shorting.

There are other signs of the proliferation of hedge funds and their increasing use as investment vehicles by smaller investors. Although recommending hedge funds and diversified hedge fund products used to be the province of specialized consultants (and wealth-management departments of banks), these practices have recently been adopted by brokerage houses who cater to the general public.

As part of the hedge fund migration to public vehicles, larger hedge fund companies will go public, further permitting smaller investors to participate in hedge fund activity. Currently, there is widespread speculation in the industry about sizable hedge fund companies going public. This speculation is of the type that usually precedes actuality.

In Europe, for some years, institutions have been registering hedge funds (or hedge fund companies) on stock exchanges. The volume sold to retail investors is increasing rapidly. One of the volume leaders,

MAN Group PLC, had assets of \$4.7 billion dollars in March 2000. Today, MAN has assets of over \$40 billion dollars.

The rapid propagation of hedge funds and their increasing use by smaller investors will force the inevitable – in coming years, the majority of hedge fund products will be public vehicles.

Continuing and Transient Demand: The increasing demand, described above, for mutual fund/hedge fund and retail investors may be viewed as falling into two categories: first, *continuing* demand driven by the favorable reward/risk characteristics of hedge funds; second, *transient* demand caused by the temporary lack of an acceptable opportunity set in the markets.

An example of transient demand is the replacing of normal bond allocations with a structured hedge fund basket (to cope with low interest rates). Further expanding the demand bulge is the exploitation of the “chameleon effect” of hedge funds, which have the ability to look and act like something else.

Some examples follow.

Principal protected notes are very popular outside the U.S.

- They look and act like bonds.
- They are attractive due to current low interest rates.

Leveraged hedge fund baskets have some advantages.

- They can look and act like options or warrants.
- They can be tax efficient, converting ordinary income to taxable gains.
- They also are attractive due to the superior reward/risk characteristics of hedge funds.

Insurance companies increasingly are interested in hedge funds. Some are looking at replacing bond allocations with structured hedge fund baskets – to obtain interest rates and have the upside of hedge funds.

Other factors potentially affecting the demand for hedge funds are leverage, transparency, liquidity, fees and regulation. As discussed below, we believe the first three to be neutral influences at present while the others are minor factors.

Funds of Funds: The discussion above, on hedge fund demand, encompasses the growth of FOFs. However, the rapidly increasing impact of FOFs on the industry, due to their dramatic growth in both numbers and in assets, mandates brief discussion.

In 1990, we estimate that there were fewer than 50 FOFs worldwide. Today there are approximately 3,000. Growth of assets has been equally dramatic. From a few dollars in 2000, their assets (investments in individual funds) now approximate \$400 billion, or about 40% of industry assets.

Their increasing domination of the industry stems from numerous reasons, including their well-known advantages such as diversification, built-in due diligence, access to closed funds and professional optimization.

A more recent and compelling reason for their accelerating assets is the realization by institutions that they could have fared better in the recent bear market had they been more heavily invested in hedge funds. They are well aware that while FOFs, on average, produce lower returns than individual hedge funds, the diversification of some FOFs reduces risk.

It seems possible that, in the future, the number of FOFs will be greater than the number of individual hedge funds. As hedge funds become public vehicles, as they surely will, over time, this seems likely, as has been the case for mutual funds and stocks.

Leverage: Some observers have noted that hedge funds increased their leverage in 2004. Prime brokers believe that this is not an issue. VAN research, described below, highlights that, overall, hedge funds use leverage conservatively.

Van research has found that, as of year-end 2004, 20% of hedge funds used no leverage whatsoever while another 50% used leverage of less than one time their equity, including short positions. These statistics belie the widely-held belief that most hedge funds use large amounts of leverage.

A spokesman for Deutsche Bank recently stated that, over the last couple of years, funds did not borrow fully against their capacities. A broker for Morgan Stanley agreed, saying that while leverage had increased, it was still at fairly modest levels. He added that there was slightly more leverage because of growing confidence in the markets and the increased use of long-short strategies. A J.P. Morgan spokesperson similarly stated that while there had been some gearing up, it generally was restricted to fixed-income macroeconomic funds.

Exhibit 4: Global Hedge Funds – Use of Leverage

| Global Hedge Funds – Use of Leverage ^{3 4} | | | |
|---|--------------------|-----------------|-------------------|
| As of December 2004 | | | |
| Hedge Fund Strategy | Don't Use Leverage | Use Leverage | |
| | | Low (<2.0:1) | High (>=2.0:1) |
| Aggressive Growth | 20% | 60% | 20% |
| Emerging Markets | 20% | 50% | 30% |
| Equity Market Neutral | 15% | 50% | 35% |
| Event Driven | 15% | 60% | 25% |
| Income | 35% | 30% | 35% |
| Macro | 10% | 30% | 60% |
| Market Neutral | | | |
| Arbitrage | 10% | 25% | 65% |
| Market Timing | 55% | 35% | 10% |
| Multi-Strategy | 10% | 50% | 40% |
| Opportunistic | 10% | 60% | 30% |
| Short Selling | 30% | 40% | 30% |
| Value | 20% | 60% | 20% |
| Total Sample | 20% | 50% | 30% |

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³ Short positions are counted as leverage

⁴ Derivatives are not included as all derivatives have inherent leverage.

A relatively small number of funds, especially arbitrage strategies, need leverage in order to produce acceptable profits.

Transparency: From the late 1990s until about a year ago, institutional investors strongly desired trading transparency. In this context, the term referred to the ability of investors to determine positions and trades from moment to moment. Recently, there has been widespread realization that:

- Some of the more successful (“better”) managers do not feel the need to provide such transparency.
- Having minute-to-minute information is not particularly helpful if an investor does not have the time or the knowledge to make judgments on the trading tactics.
- Being armed with this detail can create liability for the investor. If something goes wrong and the investor has not taken action, he’s in a worse position than if he had totally delegated the day-to-day trading to the hedge fund manager and did not have this information. Trading transparency has become a matter of little importance in most situations.

Liquidity: The desire for liquidity has been a factor for most investors and certainly for funds of funds and institutions. As is the case for transparency, many better-performing funds are not willing to provide liquidity concessions; they already are experiencing high demand for their services and don’t need to provide concessions. In other cases, they have received legal advice against providing more favorable terms to certain investors.

At this time, some funds are reducing liquidity.

Many institutions, with a long history of investing in private equity (which has much longer lockups) will be more accepting of long lockups. However, FOFs need liquidity and will tend not to invest without good liquidity.

Another factor that affects liquidity is the recently-issued 160-page SEC narrative on new registration requirements for hedge fund managers. Funds with two-year or longer lockups are not required to register. A few funds are increasing their lockups to two years or more in order to avoid registration. This will somewhat reduce investments and dampen demand. However, we believe the number of U.S. and offshore funds lengthening lockups, in order to avoid registration, will be relatively small.

Fees: A few managers with long records, strong performance and high demand for their services are raising fees. For them, the traditional 1% of assets and 20% of profits is *passé*.

A variety of new fee structures has been introduced. One of the more common structures is 3% for the management fee and 30% for the performance fee. For example, Bruce Covner of Caxton, with \$10 billion dollars under management, recently increased his fees to 3% and 30%.

Regulation: The new SEC regulation mentioned above will require managers of *U.S. funds* to register if they have more than 14 U.S. investors, over \$30 million in assets and lock-ups of less than two years. We estimate that approximately 50% of U.S. hedge fund managers have already registered.

Unregistered U.S. managers who will have to comply by February 1, 2006 will incur significantly higher costs for compliance. However, in absolute dollars, that incremental cost is insignificant compared to the rewards of running even a moderately successful hedge fund.

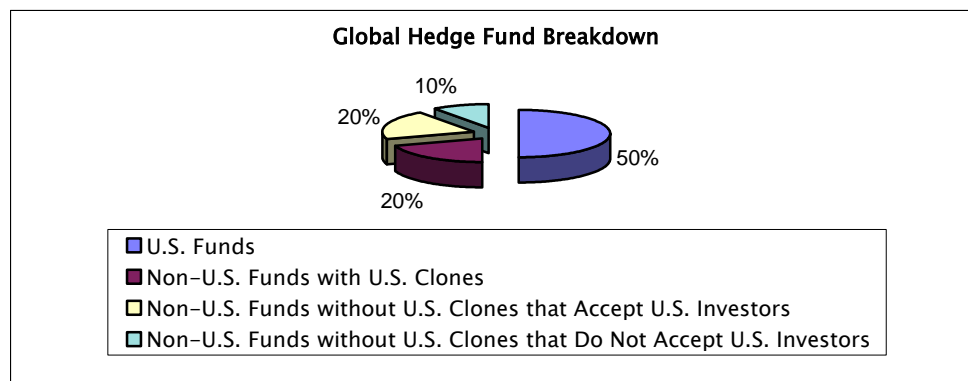
The U.S. hedge fund industry postures and complains about new regulation for obvious and understandable reasons. Nevertheless, in relative terms, registration will be a mere inconvenience while, hopefully, it will add some safety for investors.

For the reason above, prospective hedge fund managers will not be deterred from starting funds.

The new SEC regulations also require managers of *offshore funds* to register if they have more than 14 U.S. investors and if their lockups are less than 2 years. The number of investors is calculated by including not only the direct investors in the offshore fund, but also the underlying investors of any FOFs that invest in it.

An important question here is how many such managers will ban U.S. investors so as not to have to register.

Exhibit 5: Hedge Fund Universe: U.S. and Non-U.S. Funds



Van research indicates that approximately 20% of all funds are offshore clones of U.S. hedge funds. Usually, they have been set up by U.S. managers who already are registered with the SEC. The remaining offshore funds are managed by non-U.S. managers. They are not registered with the SEC, for the most part. But the majority of these, which represent 20% of all hedge funds, permit investments by U.S. investors. We expect these firms to register rather than lose current and future U.S. investors, particularly if such investors now, or in the future, comprise a noticeable part of their asset base. The situation is mitigated further. SEC compliance requirements are lighter for sponsors of offshore funds if they do not also sponsor U.S. hedge funds or separately-managed U.S. accounts. If U.S. investors represent a noticeable part of their asset base, we expect these funds to register rather than lose investors.

Those offshore funds without U.S. clones, which usually do not accept U.S. investors, comprise about 10% of all hedge funds. This group will elect not to register with the SEC. Regardless, a few U.S. investors will be able to invest in them indirectly, through non-U.S. companies or non-U.S. trusts.

Some offshore fund managers will start new funds in which they will place their U.S. investors, to keep their non-U.S. investors out of the U.S. regulatory spotlight.

We do not believe that these new SEC regulations will have a significant effect on worldwide hedge fund capacity or demand. The picture will become clearer after February 1, 2006, the effective date of the new regulations.

Summary: The rapid pace of hedge fund promulgation will continue, accelerated by institutional demand and retailization of hedge funds. With the latter, hedge funds have begun their transition to becoming public vehicles. Various characteristics of hedge funds, such as the lack of transparency, will not reduce demand, nor will new registration regulation.

Money flows to hedge funds will continue to increase.

4. Hedge Fund Capacity, 2005–2015

In examining capacity, we look at the following:

- First, capacity available in existing strategies, in current markets.
- Second, new capacity arising from the use of new strategies. Many hedge fund managers are embracing totally new strategies or sectors as these become available through the evolution and refinement of financial markets. Other managers are moving into areas that were previously the exclusive province of other disciplines, such as lending and real estate. These areas have the potential to add significant capacity.
- Third, hedge funds are entering new markets, creating still more capacity. Capital markets are expanding in Asian countries particularly. This also will provide significantly greater hedge fund capacity. (Demand also will arise in these countries, using some of the new capacity, but this will occur after an inevitable lag.)

4.1 Today's Strategies In Today's Markets

Hedge Fund strategies can be described as follows⁴:

Market Neutral Group

- Event-Driven
 - Distressed Securities
 - Special Situations
- Market Neutral Arbitrage
 - Convertible Arbitrage
 - Fixed Income Arbitrage
 - Merger/Risk Arbitrage
 - Statistical Arbitrage

Long/Short Equity Group

- Aggressive Growth
- Market Neutral Securities Hedging
- Opportunistic
- Value

⁴ In order to reflect changing strategy structures in the hedge fund industry, VAN occasionally may change its configuration of strategies in its presentation of strategy performance. The configuration herein will not necessarily reflect that used in the company's index reporting. Please address any questions to vhfai@vanhedge.com.

Directional Trading Group

- Macro/Futures
- Market Timing

Specialty Strategies Group

- Emerging Markets
- Income
- Multi-Strategy
- Short Selling

Exhibit 6: Hedge Fund Strategies: Asset Size and Performance

| | 2004 | | 2000-2004 | | | 1988-2004 | | |
|---------------------------------------|--------------------------------|---------------------------------------|-----------|------------------|-----------------|-----------|-----------------|-------------------------|
| | Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR ⁵ | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Market Neutral Group | | | | | | | | |
| Event Driven | | | | | | | | |
| –Distressed Securities | 69 b | 7.3% | 18.4% | 12.7% | 1.6 | 18.8% | 1.4 | 0.3 |
| – Special Situations | 90 b | 9.5% | 10.4% | 8.5% | 0.9 | 17.5% | 1.7 | 0.7 |
| Market Neutral Arbitrage ⁶ | 188 b | 19.8% | 3.6% | 8.2% | 2 | 13.0% | 2 | 0.4 |
| Long/Short Equity Group | | | | | | | | |
| Aggressive Growth | 49 b | 5.2% | 6.0% | 1.4% | 0 | 17.5% | 0.9 | 0.8 |
| Market Neutral Securities Hedging | 18 b | 1.8% | 6.0% | 9.7% | 1.7 | 15.3% | 2.5 | 0.4 |
| Opportunistic | 39 b | 4.1% | 7.7% | 9.3% | 0.7 | 19.7% | 1.5 | 0.7 |
| Value | 141 b | 14.8% | 11.5% | 10.2% | 0.7 | 16.9% | 1.2 | 0.8 |
| Directional Trading Group | | | | | | | | |
| Macro | 99 b | 10.4% | 2.1% | 5.8% | 0.5 | 16.4% | 1.2 | 0.4 |
| Futures | 81 b | 8.5% | 6.9% | 11.7% | 0.8 | 17.9% | 0.9 | -0.2 |
| Market Timing | 1 b | 0.1% | 3.1% | 4.8% | 0.3 | 16.2% | 1.4 | 0.7 |
| Specialty Strategies Group | | | | | | | | |
| Emerging Markets | 67 b | 7.1% | 13.6% | 10.5% | 0.6 | 16.8% | 0.7 | 0.5 |
| Income | 14 b | 1.5% | 8.8% | 9.4% | 2.2 | 10.1% | 1.7 | 0.3 |
| Multi-Strategy | 91 b | 9.6% | 5.9% | 5.7% | 0.4 | 14.9% | 1.3 | 0.7 |
| Short Selling | 3 b | 0.3% | -9.7% | 3.2% | 0.2 | 1.3% | 0.1 | -0.8 |
| Van Global Hedge Fund Index | | | 7.7% | 8.0% | 0.8 | 16.0% | 1.5 | 0.7 |
| Comparative Benchmarks | | | | | | | | |
| S&P 500 | | | 10.9% | -2.3% | -0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | -3.8% | -0.2 | 6.4 % | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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⁵ Compound Annual Return

⁶ Includes Convertible Arbitrage, Fixed Income Arbitrage, Merger/Risk Arbitrage, Statistical Arbitrage

Distressed Securities

Definition: The manager invests long or short in the debt and/or equity of companies likely to declare bankruptcy in the near future, currently in the bankruptcy reorganization process or emerging from bankruptcy. Because of their distressed situations, the manager can buy such securities of companies at deeply discounted prices. The manager stands to make money on such a position should the company successfully reorganize and return to profitability. Also, the manager could realize a profit if the company is liquidated, provided that the manager had bought senior debt in the company for less than its liquidation value. "Orphan equity" issued by newly reorganized companies emerging from bankruptcy may be included in the manager's portfolio. The manager may take short positions in companies whose situations he deems will worsen, rather than improve, in the short term. Another strategy used by managers is to buy the distressed debt and simultaneously short the company's common stock. Managers can profit regardless of changes in the firm's financial position. If it improves, both the stock and bonds of the firm will likely increase in value and the investor generates gains from the interest income on the short rebate and the distressed debt. If the financial condition worsens, the stock value generally declines more than the value of the bonds because the bonds have higher priority in the bankruptcy process.

Exhibit 7: Distressed Securities Strategy: Asset Size and Performance

| | 2004 | | 2000-2004 | | | 1988-2004 | | Correlation with S&P |
|-----------------------|-----------------------------|------------------------------|-----------|-------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | |
| Distressed Securities | 69 b | 7.3 % | 18.4% | 12.7% | 1.6 | 18.8% | 1.4 | 0.3 |
| S&P 500 | | | 10.9% | -2.3% | -0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | -3.8% | -0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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In addition to comprising a significant part of the hedge fund industry, distressed securities hedge funds also make up an important part of their segments of the bond industry.

Distressed securities hedge funds have exhibited many desirable characteristics. They have strongly outperformed broad market indices both in returns and risk. Their low correlation to the S&P also is attractive.

Their strong returns in 2004 were their third-best in 8 years. This tended to obscure the fact that their environment had changed – at least temporarily – during 2004. After an increase in the size of the distressed debt market to \$900 billion (face value), in early 2003, it decreased to \$675 billion (face value) in the second half of 2004.

As 2004 progressed, some funds (particularly large ones) found it increasingly difficult to deploy capital. (Some of these currently maintain cash balances of up to one-third or more of their assets.) Some increased their allocations to less liquid distressed securities, including bank debt.

Despite these issues, the contrarian view is that the leveraged loan market has grown steadily since 1993, notwithstanding some fluctuations in issuances. In 1993, this market was under \$200 billion while

currently, it is estimated to be in excess of \$1.3 trillion. According to Moody's, default rates for B1, B2 and B3 credits range from 21% to 38% by the fourth year following issuance and from 27% to 45% by year five.

Further, in 2005, the Bond Market Association forecasts that high-yield issuances will increase to \$123 billion or 15% higher than 2004. This is in the face of slightly lower expected corporate issuances, overall.

Non-U.S. markets offer great potential. European markets in particular are increasingly being exploited, as are Asian markets, although to a lesser extent so far.

Special Situations

Definition: Investing, both long and short, in stocks and/or bonds which are expected to change in price over a short period of time due to an unusual event.

Special situations managers invest in the following areas, among others: a broad range of merger arbitrage transactions (as described elsewhere); convertible debt; company spin-offs; distressed securities (debt); company liquidations; capital structure arbitrage; companies in restructurings; companies with out-of-favor equities.

Exhibit 8: Special Situations Strategy: Asset Size and Performance

| | 2004 | | 2000-2004 | | | 1988-2004 | | |
|--------------------|-----------------------------|------------------------------|-----------|-------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Special Situations | 90 b | 9.5% | 10.4% | 8.5% | 0.9 | 17.5% | 1.7 | 0.7 |
| S&P 500 | | | 10.9% | -2.3% | -0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | -3.8% | -0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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This strategy has outperformed broad market indices in the period 1988 - 2004.

Because the strategy is virtually not definition-constrained, the markets continue to offer it much capacity.

Market Neutral Arbitrage Group

Exhibit 9: Market Neutral Arbitrage Strategies: Asset Size and Performance

| | 2004 | | | 2000–2004 | | 1988–2004 | | |
|--------------------------------|-----------------------------|------------------------------|--------|-----------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Market Neutral Arbitrage Group | 188 b | 19.8% | 3.6% | 8.2% | 2 | 13.0% | 2 | 0.4 |
| S&P 500 | | | 10.9% | -2.3% | -0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | -3.8% | -0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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Definition: The manager seeks to exploit specific inefficiencies in the market by trading a carefully hedged portfolio of offsetting long and short positions. By pairing long positions with related short positions, market risk is greatly reduced, resulting in a portfolio that bears a low correlation and beta to the market. The paired long and short securities are related in different ways depending upon the arbitrage strategy but, in each case, the manager attempts to take advantage of pricing discrepancies and/or projected price volatility involving the paired long and short securities.

The four strategies within the Market Neutral Arbitrage group include convertible arbitrage, fixed income arbitrage, merger/risk arbitrage and statistical arbitrage. Each is discussed below.

Convertible Arbitrage

Definition: The manager buys a convertible security and shorts the common stock of the company in similar proportion and attempts to profit from a perceived mispricing of the conversion option in the convertible security. This strategy is highly dependent upon volatility, an important factor in option pricing. Managers may also profit from changes to interest rates and credit spreads depending on the nature of the hedges in the portfolio.

Convertible arbitrage hedge funds have had a dominant influence on the markets in which they invest.

Because of increasing investor interest in good market-neutral performance, more hedge funds have adopted this strategy.

In 2004, the highly attractive historical performance of convertible arbitrage funds ceased. As a result, investor inflows diminished. Some managers and some investors gave up. Other convertible arbitrage managers began to make directional bets to capture alpha.

The weakening of performance occurred for several interrelated reasons:

- Overall, demand was too strong for the available supply of opportunities.

- Issuances of convertible debt diminished as many companies took advantage of low rates to refinance in 2003. In 2004, convertible debt issuances were \$48 billion but, in the same year, \$65 billion was removed from the market.
- In 2004, corporate profits grew for the second year in a row, diminishing the perceived need for companies to use bonds to raise capital.
- Arbitrage spreads tightened as more managers entered the area.

In addition, implied volatility fell and therefore so did valuations – both in 2003, 2004 and 2005. Actual volatility was very low.

At mid-year 2005, redemptions continue for convertible arbitrage hedge funds. However, it seems that a bottom is being reached and that there will be some good opportunities in the near future. Unfortunately, when profits return, it seems possible that the tide of institutional money that flooded convertible arbitrage funds in 2003 and 2004 will once again swamp them.

At the very least, it is likely that the easier pickings for convertible arbitrage managers may be gone. While there will continue to be opportunities they will be more difficult to identify and exploit. However, debt and equity markets outside the U.S. will create more capacity for the strategy in the future.

Fixed Income Arbitrage

Definition: The manager takes offsetting positions in fixed income securities and their derivatives in order to exploit mispricings between interest rate securities; these include, for example, interest rate swaps, government and corporate debt, mortgage-backed and asset-backed securities, etc.

Demand for fixed income arbitrage varies strongly, depending on the manager and strategy. Managers have had to cope with significant capital inflows. In this low-volatility environment, that has put pressure on the strategy, and particularly on narrowly-defined fixed income arbitrage. This, in turn, has put pressure on earnings, causing demand to lessen.

Fixed Income Arbitrage strategies vary widely and include, among others, first, exploiting anomalies between one issuer's debt securities; second, exploiting anomalies between debt securities of different issuers; third, exploiting dislocations between emerging market securities and U.S. debt securities. Other approaches include using macro overlays, thus drawing on greater worldwide capacity.

The most narrowly-defined strategies include, for example, basis trading. The broadest strategies use macro components to a significant extent. Capacity is correlated with where a particular strategy falls on this spectrum of narrowly- to broadly-defined. The more narrowly-defined the strategy, the smaller the capacity. The more broadly-defined the strategy, and the greater the macro component, the greater the capacity.

Narrowly-defined strategies are stressed; broadly defined: acceptable. Fixed Income Arbitrage strategies tend to invest in U.S. markets. Non-U.S. markets offer them additional capacity. Some managers already use emerging markets and/or non-U.S. debt instruments for this strategy.

Merger/Risk Arbitrage

Definition: The manager takes positions in companies expected to be involved in a merger or acquisition. A frequent trade is "long the acquiree, short the acquirer."

The volume of global merger and acquisition arbitrage increased each year from 1997 through the recent peak in 2000, (as measured by closed deals). From 2000 through 2002, the dollar value and number of deals declined to 1997 levels. Worldwide M&A activity stayed at this same level through 2004. These trends largely followed the direction of the stock market and the economy.

In the U.S., however, 2004 merger activity increased almost 50% over 2003 due to corporate cash reserves, a strong economy, and a rising market. In 2005, similar factors exist and many expect an equally good year for mergers and acquisitions. The first quarter of 2005 saw significant renewed activity in the U.S: Procter & Gamble/Gillette, SBC/AT&T, Met Life/part of Citigroup.

Traditionally, hedge funds have bought stock of the acquiree and shorted the stock of the acquirer. Now, some European hedge funds are acting as principals in acquisitions with U.S. funds beginning to follow suit. The use of derivatives by hedge funds in these transactions has given them two advantages: leverage and also the ability to avoid rules that require large shareholders to make disclosures, as is the case in Britain.

Merger arbitrage hedge fund success tends to follow the broad markets, as mentioned above. While this hedge fund strategy has been under pressure, it is expected to improve with the markets.

Statistical Arbitrage

Definition: The manager uses mathematical methods to examine the current value of a security relative to its historical mean. If the difference is determined to be statistically significant (generally measured by the number of standard deviations from the mean) an "arbitrage" opportunity exists. Trades tend to be short-term and the overall portfolio is usually neutral in terms of various risk characteristics (e.g., beta, sector and dollar exposures). Pairs trading, where a manager invests long and short in companies in related industries (e.g., Ford and GM), is a common form of statistical arbitrage. One limitation of Statistical Arbitrage is that it is heavily dependent upon the historical mean of security prices, which is often not an accurate indicator of future prices.

This has always been a niche strategy.

In the U.S., where it is a well-established strategy, it has become stressed by high money flows, low volatility and an insufficient supply of opportunities.

Non-U.S. markets should offer capacity.

Aggressive Growth

Definition: The manager invests in companies experiencing or expected to experience strong growth in earnings per share. The manager may consider a company's business fundamentals when investing and/or may invest in stocks on the basis of technical factors, such as stock price momentum.

Managers employing this strategy generally utilize short selling to some degree although a substantial long bias is common.

Exhibit 10: Aggressive Growth Strategy: Asset Size and Performance

| | 2004 | | 2000–2004 | | | 1988–2004 | | |
|-------------------|-----------------------------|------------------------------|-----------|-------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Aggressive Growth | 49 b | 5.2% | 6.0% | 1.4% | 0 | 17.5% | 0.9 | 0.8 |
| S&P 500 | | | 10.9% | –2.3% | –0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | –3.8% | –0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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This strategy is highly correlated with the broad markets (0.8 with the S&P), which did not perform well over the last five years. Aggressive Growth's popularity was high during the boom years of the '90s. Capital inflows again are increasing at a brisk pace due to institutional investors' interest in long/short strategies.

The capacity of Aggressive Growth is large. The World Federation of Exchanges reports that market capitalization of the major exchanges is approximately \$30 trillion while the total market capitalization of exchanges worldwide is about \$37 trillion. Given the economic outlook described elsewhere, it seems likely that this strategy will have no practical constraints in the foreseeable future.

Market Neutral Securities Hedging

Definition: The manager invests similar amounts of capital in securities both long and short, maintaining a portfolio with low net market exposure ($\pm 20\%$). Long positions are taken in securities expected to rise in value while short positions are taken in securities expected to fall in value. Often, quantitative multi-factor models are used to identify investment opportunities based on factors such as the underlying company's fundamental value, its projected rate of growth, or the security's pattern of price movement (e.g., momentum). Due to the portfolio's low net market exposure of the portfolio, performance is generally insulated from equity market volatility.

Exhibit 11: Market Neutral Securities Hedging Strategy: Asset Size and Performance

| | 2004 | | 2000–2004 | | | 1988–2004 | | |
|-----------------------------------|-----------------------------|------------------------------|-----------|-------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Market Neutral Securities Hedging | 18 b | 1.8% | 6.0% | 9.7% | 1.7 | 15.3% | 2.5 | 0.4 |
| S&P 500 | | | 10.9% | –2.3% | –0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | –3.8% | –0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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Demand is brisk. New managers with credible performance have had large capital inflows in recent years, including 2004.

This strategy is basically long/short. In addition to serendipitously investing in “attractive” long positions and shorting “unattractive” stocks, the manager needs to have the discipline to remain market-neutral; i.e., equally asset-weighting (and possibly beta-adjusted) long and short positions.

The whole equity universe potentially is available to market neutral securities hedging managers. However, the just-mentioned additional discipline (of remaining market neutral) makes stock picking more difficult than for a basic long-short strategy.

An additional constraint is the ability of Market Neutral Securities Hedging managers to identify acceptable short positions. Still another is their ability to successfully implement the short positions in the faces of various obstacles; e.g., the uptick rule and analyst coverage. There have been some capacity strains in the U.S. However, European equity markets are less developed and offer capacity expansion – as private companies go public and as they increase the floats of their stocks for market liquidity.

The outlook for the Market Neutral Securities Hedging strategy is good.

Opportunistic

Definition: The manager's investment approach changes over time to better take advantage of current market conditions and investment opportunities, rather than consistently selecting securities according to one strategy's guidelines. Characteristics of the portfolio, such as asset classes, market capitalization, etc., are likely to vary significantly from time to time. The manager may also employ a combination of different approaches at a given time.

Exhibit 12: Opportunistic Strategy: Asset Size and Performance

| | 2004 | | | 2000–2004 | | 1988–2004 | | |
|---------------|-----------------------------|------------------------------|--------|-----------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Opportunistic | 39 b | 4.1% | 7.7% | 9.3% | 0.7 | 19.7% | 1.5 | 0.7 |
| S&P 500 | | | 10.9% | –2.3% | –0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | –3.8% | –0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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Demand increased in 2003 and 2004 after weaker returns in 2001 and 2002 reflected the equity markets.

This long-short strategy draws on the large equity markets; therefore, capacity constraints are not expected in the foreseeable future.

Value

Definition: The manager focuses on the price of a security relative to the intrinsic worth of the underlying business. The manager takes long positions in stocks that he believes are undervalued and

short positions in stocks believed to be overvalued. Possible reasons that a stock may sell at a perceived discount could be that the company is out of favor with investors or that its future prospects are not correctly judged by Wall Street analysts. If the manager is correct and the market comes to better understand the true value of these companies, he expects that the prices of undervalued stocks in his portfolio will rise while the prices of overvalued stocks will fall. The manager often selects stocks for which he can identify a potential upcoming event that will result in the stock price changing to more accurately reflect the company's intrinsic worth.

Exhibit 13: Value Strategy: Asset Size and Performance

| | 2004 | | 2000–2004 | | | 1988–2004 | | |
|---------|-----------------------------|------------------------------|-----------|-------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Value | 141 b | 14.8% | 11.5% | 10.2% | 0.7 | 16.9% | 1.2 | 0.8 |
| S&P 500 | | | 10.9% | –2.3% | –0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | –3.8% | –0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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The value strategy enjoys well-deserved popularity. In the seventeen years ended December 31, 2004, its return was 4.5 percentage points above that of the S&P 500. In the recent difficult five-year period ended December 31, 2004, its annualized positive return differential with the S&P 500 was 12.5 percentage points.

Value is one of the two largest strategies, measured in assets.

Given their strong performance, value managers have experienced growing demand. However, the breadth and depth of U.S. equity markets offer great capacity. When one factors in non-US markets, this strategy has no practical capacity constraints in the foreseeable future.

Macro/Futures

Macro and futures managers tend to trade the same asset classes. Therefore, we discuss them together in this paper.

Macro: The manager constructs his portfolio based on a top-down view of global economic trends, considering factors such as interest rates, economic policies, inflation, etc. Rather than considering how individual corporate securities may fare, the manager seeks to profit from changes in the value of entire investment sectors. For example, the manager may hold long positions in the U.S. dollar and Japanese equity indices while shorting the euro and U.S. treasury bills. Views are generally implemented using derivatives in equity, interest rate, currency and commodity markets.

Futures: The manager utilizes futures contracts to implement directional positions in global equity, interest rate, currency and commodity markets. Managers use either systematic models or their own discretion to identify investment opportunities in various markets. **Discretionary:** Discretionary strategies utilize futures contracts to implement trades based on the manager's judgment on the direction of futures prices. **Systematic:** Strategies employ quantitative models to identify investment opportunities using historical prices of and relationships between futures contracts. One popular systematic strategy is

based on trend-following analysis, which assumes the direction of futures contracts will continue over the short, intermediate, or long term.

Exhibit 14: Macro & Futures Strategies: Asset Size and Performance

| | 2004 | | | 2000–2004 | | 1988–2004 | | |
|---------|-----------------------------|------------------------------|--------|-----------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Macro | 99 b | 10.4% | 2.1% | 5.8% | 0.5 | 16.4% | 1.2 | 0.4 |
| Futures | 81 b | 8.5% | 6.9% | 11.7% | 0.8 | 17.9% | 0.9 | -0.2 |
| S&P 500 | | | 10.9% | -2.3% | -0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | -3.8% | -0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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Most macro managers use futures heavily (as well as other derivatives) to implement their trades. Many futures managers (who invest in financial futures) look like macro managers. Macro strategies have become more conservative over time. The freewheeling macro strategies of the 1990s, with huge bets, often produced strong returns, but with high volatility. After several difficult market years, investors voted with their feet for less volatile approaches. In response, macro managers have tended to become more conservative – with more diversification and hedging. Many macro managers now are invested primarily in fixed income, forwards and financial futures, as opposed to individual equities.

In the early 1990s, the majority of investors would not consider investing in futures as they were thought to be too risky. Since then, futures have entered the mainstream and many investors use them for portfolio diversification. Hedge fund managers invest in futures because they offer advantages, including built-in leverage and decreased trading costs. The demand for macro funds and futures is increasing. Two of the investment pools most widely used by macro managers are the foreign exchange markets and the fixed income markets.

The foreign exchange market is, by far, the largest and the most liquid in the world, transacting over \$1.5 trillion on a daily basis. (The CME's Eurodollar contract is the world's largest futures contract.)

In fixed income, the EuroBund futures contract is the world's most heavily traded fixed income futures contract with an average daily volume of approximately \$10 billion.

New markets and capacity are constantly being created. One of the latest is OTC Energy Futures. At year-end 2004, the New York Mercantile Exchange and the Intercontinental Exchange cleared approximately 30 million OTC energy contracts. This represented more clearing than the entire New York Board of Trade and as much as the International Petroleum Exchange. Hedge funds are significant participants in the energy sector.

Demand should continue to increase for Macro and Future strategies. While the hedge fund industry adjusts to an unprecedented level of demand, macro and futures strategies currently are not capacity-constrained.

Market Timing

The oldest definition: the manager attempts to predict the short-term movements of various markets (or market segments) and, based on those predictions, moves capital from one asset class to another in order to capture market gains and avoid market losses.

A more recent definition: the manager trend-follows mutual funds that have favorable price momentum.

Exhibit 15: Market Timing Strategy: Asset Size and Performance

| | 2004 | | 2000–2004 | | | 1988–2004 | | |
|---------------|-----------------------------|------------------------------|-----------|-------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Market Timing | 1 b | 0.1% | 3.1% | 4.8% | 0.3 | 16.2% | 1.4 | 0.7 |
| S&P 500 | | | 10.9% | –2.3% | –0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | –3.8% | –0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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The most recent definition: the manager invests in a mutual fund in one time zone with the expectation that its price will rise because the price of its counterpart, in an earlier time zone, already has risen. (An event occurring in time zone A almost certainly will affect the price of a counterpart mutual fund in “later” time zone B, when that market subsequently opens.)

Market timing by hedge funds has always been a specialized area with a relatively small number of funds. Managers have employed several strategies using mutual funds as the investments. As stated in the definitions, in recent years, they used trend-following with mutual funds that were identified by programs. More recently, time zone arbitrage either replaced trend-following or was added to it, depending on the manager.

This strategy was quite successful for some years until September 2003, when the New York State Attorney General investigated Canary Partners, a U.S. market-timing hedge fund. He alleged that they had been allowed to trade after hours. The ensuing brouhaha chilled the market timing strategy for both investors and managers. The Canary Partners in charge ultimately settled with a \$40 million penalty in September 2003.

Today, for all practical purposes, hedge fund market timing tends to be practiced only by a small number of non-U.S. funds. It may regain popularity in the U.S. after the legal furor has totally subsided. Its non-U.S. outlook is acceptable.

Emerging Markets

Definition: The manager invests in securities issued by businesses and/or governments of countries with less-developed economies (as measured by per capita Gross National Product) that have the potential for significant future growth. Examples include Brazil, China, India, and Russia. Most emerging market countries are located in Latin America, Eastern Europe, Asia, or the Middle East. This strategy is

defined purely by geography; the manager may invest in any asset class (e.g., equities, bonds, currencies) and may construct his portfolio on any basis (e.g. value, growth, arbitrage).

Exhibit 16: Emerging Markets Strategy: Asset Size and Performance

| | 2004 | | | 2000–2004 | | 1988–2004 | | |
|------------------|-----------------------------|------------------------------|--------|-----------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Emerging Markets | 67 b | 7.1% | 13.6% | 10.5% | 0.6 | 16.8% | 0.7 | 0.5 |
| S&P 500 | | | 10.9% | –2.3% | –0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | –3.8% | –0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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Emerging markets hedge funds have provided attractive returns over the years, albeit with volatility. Profitable inefficiencies have included limited institutional interest (due to size and volatility of the markets), illiquidity, the inability to short stocks in those countries, lower accounting standards, opacity of company information, and insider trading.

The demand for emerging market strategies has been brisk in recent years. The capacity pool is large compared to the demand; the capitalization of emerging market equities, alone, is approximately \$2 trillion.

Income

Definition: The manager invests primarily in yield-producing securities, such as bonds, with a focus on current income.

Exhibit 17: Income Strategy: Asset Size and Performance

| | 2004 | | | 2000–2004 | | 1988–2004 | | |
|---------|-----------------------------|------------------------------|--------|-----------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Income | 14 b | 1.5% | 8.8% | 9.4% | 2.2 | 10.1% | 1.7 | 0.3 |
| S&P 500 | | | 10.9% | –2.3% | –0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | –3.8% | –0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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Income hedge funds have always represented a relatively small niche in the hedge fund industry. More recently, however, as a result of fast-growing investor demand for hedge funds, income funds have received much interest. Funds with narrowly-defined strategies have had to turn away investments.

The underlying markets are quite large. U.S. bond issuances in municipal, corporate, mortgage-related, asset-backed, and CDO securities were \$3.46 trillion in 2004. They are expected to be about \$3 trillion in 2005. Hedge fund managers will continue to find ways to exploit these markets.

Multi-Strategy

Definition: The manager typically utilizes two or more specific, predetermined investment strategies; e.g., Value, Aggressive Growth, and Special Situations. Although the relative weighting of the chosen strategies may vary over time, each strategy plays a significant role in portfolio construction. Managers may choose to employ several strategies in order to better diversify their portfolios; to more fully use their range of portfolio management skills; and to permit them to focus on the currently most profitable strategy.

Exhibit 18: Multi-Strategy: Asset Size and Performance

| | 2004 | | | 2000-2004 | | 1988-2004 | | |
|----------------|-----------------------------|------------------------------|--------|-----------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Multi-Strategy | 91 b | 9.6% | 5.9% | 5.7% | 0.4 | 14.9% | 1.3 | 0.7 |
| S&P 500 | | | 10.9% | -2.3% | -0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | -3.8% | -0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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This strategy, by definition, encompasses an eclectic grouping of other strategies, each of which is discussed elsewhere in this paper.

Short Selling

Definition: The manager maintains a consistent net short exposure in his portfolio, meaning that significantly more capital supports short positions than is invested in long positions (if any is invested in long positions at all). Unlike investing in long positions, which he expects to increase in value, short positions are taken in securities the manager anticipates will decrease in value. In order to short sell, the manager borrows securities from a prime broker and immediately sells them on the market. The manager later repurchases these securities and returns them to the broker. If the stock price falls, the manager profits by keeping the difference between the price at which he sold the stock and the price at which it was repurchased. In this way, the manager is able to profit from a fall in a security's value. Conversely, if the stock price rises, the manager is forced to make up the difference between the price at which he sold the stock and the price at which it was repurchased. Short selling managers typically target overvalued stocks; these are characterized by prices the manager believes to be too high, given the fundamentals of the underlying companies.

Exhibit 19: Short-Selling Strategy: Asset Size and Performance

| | 2004 | | | 2000–2004 | | 1988–2004 | | |
|---------------|-----------------------------|------------------------------|--------|-----------|--------------|-----------|--------------|----------------------|
| | HF Assets (USD) in Strategy | Strategy as % of HF Universe | Return | CAR | Sharpe Ratio | CAR | Sharpe Ratio | Correlation with S&P |
| Short Selling | 3 b | 0.3% | -9.7% | 3.2% | 0.2 | 1.3% | 0.1 | -0.8 |
| S&P 500 | | | 10.9% | -2.3% | -0.2 | 12.4% | 0.7 | 1 |
| MSCI | | | 12.8% | -3.8% | -0.2 | 6.4% | 0.3 | 0.9 |
| LBABI | | | 4.3% | 7.7% | 1.3 | 8.1% | 1.3 | 0 |

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Dedicated short selling, as a hedge fund strategy is challenging. Demand has been weaker than for other strategies and the number of short-selling hedge funds has decreased significantly. Short Selling is the second smallest strategy after market timing. In 2004, hedge fund managers in many strategies experienced difficulty in finding good short positions. Many began using ETFs.

Short interest peaked on the following dates on U.S. exchanges:

Exhibit 20: Short Interest: Peak Points for US Exchanges⁷

| Exchange | Date | Millions of Shares |
|----------|------------|--------------------|
| NYSE | May 2005 | 8,569 |
| AMEX | March 2004 | 955 |
| NASDAQ | June 2005 | 5,835 |

Source: Bloomberg, L.P.

One of the reasons for the scarcity of good short positions has been the increasing number of equity-based hedge funds which use short selling. Given the large size of equity markets, capacity for the strategy does exist but there is now much more competition for profitable short positions.

⁷ Data as of June, 2005

4.2 New Strategies or Areas for Capacity Expansion

Hedge fund managers have recently been creating capacity by entering new investment sectors, at unprecedented rates. The obverse also is true: in these same new sectors, traditional, specialized companies are starting hedge funds.

Every few weeks, we see funds implementing a new strategy. One of the most recent, for example, is reinsurance.

A number of new strategy sectors are described below.

Energy

The number of hedge funds specializing in the energy sector is growing rapidly. We estimate that there are well over 300 energy-specific funds today, some posting stellar returns. In addition, over the last two years, long-established hedge funds have begun allocating increasing assets to energy investments. They include, among others, Perry Capital, Cerberus, and Citadel.

Energy investments range from trading in established commodities, such as oil futures, to new energy derivatives such as spread options and storage swaps, to direct investments in power-generating plants and pipelines.

This interest of hedge funds in energy is a result of several factors:

- Energy markets are both inefficiently priced and deep;
- Volatility has been rising;
- Arbitrage opportunities abound;
- Hard assets, such as power plants, are cheap;
- Prices have been rising.

Oil prices have been rising for these reasons, among others:

- Concern about supply limits of oil producers in Saudi Arabia, Russia and Venezuela;
- Terrorism threats and unrest in the Middle East;
- Rising demand caused, in part, by China (which has become the world's second largest energy consumer), as well as by India and other fast-growing economies.

In the 1990s, energy trading grew rapidly until the problems of Enron and Dynegy. Their demise caused a retrenchment in the sector. It also made available some talented traders who have since been recruited by hedge fund companies like Citadel and D.E. Shaw. In addition, some of the Enron/Dynegy alumni started their own hedge fund companies; e.g., John Arnold, of Enron, founded Centaurus Capital.

The energy industry continues to offer great capacity to hedge funds. In addition to hard assets and the equity and debt of energy-related companies, energy commodities are valued at about \$2 trillion. Index trading represents over \$20 billion.

Private Equity

Hedge funds have increased their participation in these traditional private equity areas: corporate restructurings/purchase of corporate assets, mezzanine investing and distressed debt. In addition, as is the case for the energy sector, hedge funds are being started by traditional, specialized private equity managers.

When Centerpoint Energy put Genco (a subsidiary) up for sale, three hedge funds – Cerberus, Seneca and Caxton – went up against four private equity firms including KKR and Blackstone.

Hedge funds also have been participating increasingly in the mezzanine area.

In distressed company space, hedge fund activity is growing. In 2004, hedge funds (and their affiliates) entered into transactions involving approximately \$30 billion in 23 companies. D.E. Shaw acquired toy store FAO Schwartz out of bankruptcy. Steel Partners made a hostile bid for rocket-motor-maker Gen Corp. Highfields Capital Management made an offer for Circuit City. ESL Investments made a bid for Sears. Appaloosa (and others) led a hostile offer in January 2005 for nursing home operator Beverly Enterprises.

As examples of private equity firms starting hedge funds, buyout firm Texas Pacific Group started TPG-Axon with former Goldman Sachs trader Dinakar Singh. Carl Icahn has raised over \$2 billion for a new private equity hedge fund.

Real Estate

In the early 1990s, it was hard to find a real-estate-dedicated hedge fund. Today, as is the case for other alternative investment areas, hedge funds are increasing their activity in real estate. Some invest exclusively in real estate while others invest in it opportunistically. When hedge funds began investing more frequently in real estate securities about three years ago, they needed the liquidity offered by REIT securities. Now, some are investing in hard assets.

An example of a company already in the hedge fund space starting a dedicated real estate fund is Angelo Gordon's starting AG Long Short Realty Fund (2003).

Examples of hedge funds investing opportunistically in real estate include Baupost Partners, Farallon Capital Management and Perry Capital.

Donald Trump's well-publicized recent financing of a Chicago skyscraper involved hedge funds Blackacre Institutional Capital Management (a Cerberus subsidiary), Grove Capital (a Soros affiliate) and Fortress Investment Group.

Companies already in this alternative investment sector are starting hedge funds.

Ironically, one of the reasons real estate companies are starting hedge funds is that these companies consider urban commercial real estate to be overpriced – so they are moving in the opposite direction of real-estate-investing hedge funds; i.e., away from hard assets into their own new hedge funds which trade REITs.

Real estate investors recently starting hedge funds include Apollo Real Estate Advisors, Claros Real Estate Security Hedge Fund; also, Prudential Real Estate Investors and Madison Capital Management (jointly).

Real estate companies with existing real-estate-dedicated hedge funds include Helix Realty, Gem Investors and Wesley Capital.

REIT investments offer hedge funds liquidity along with a real-estate play. The capitalization of REIT securities is growing. In March 2005, it was \$290 billion. REIT transaction volume represents about 25% of total U.S. real estate volume.

While hard-asset transacting offer low liquidity, private investments in hard assets represent a large pool. It amounts to about one-half of U.S. real estate transaction volume.

Middle Market Lending

We define middle market lending as deals up to \$500 million. Hedge funds recently have entered this arena. Their competitiveness is causing significant concern to traditional private equity firms as well as to some lending industry giants like CIT.

An example of hedge fund entrants into this arena is Cerberus. Existing hedge funds active in this area (for junior debt) include Patriarch Partners, Highbridge Capital Management, Silver Point Capital and Fortress Investment Corporation.

Asset-Backed Financing

A few hedge funds have been in this arena for several years. Others have been entering it.

Funds active in this area: Centrex Fund does sub-prime auto financing; IIG Trade Opportunities Fund does trade financing; e.g. financing goods for a producer until the shipment arrives at destination. Regiment Capital, Silver Point Capital and Cerberus are examples of other funds that are active in asset-backed financing.

The volume of asset-backed loans outstanding doubled to \$805 billion during the first half of 2004.

Exchange-Traded Funds

Since their inception in 1993, the popularity of ETFs has continued to grow. They have made available to hedge funds a new, user-friendly investing mechanism and thus enlarged the playing field for hedge funds. They have been particularly helpful in providing hedge funds opportunities to sell short, at a time when short positions are much sought after.

The ETF story is well known. According to a recently published CSFB study, hedge funds accounted for 70% of the trading volume in ETFs.

Credit Derivatives

This sector has grown fast. In the early 1990s, there was virtually no market for credit derivatives. By 2006, the credit derivatives sector is expected to exceed \$7 trillion (in the U.S.). Like ETFs, credit derivatives offer a user-friendly way to invest in various slices of the credit market and thus increase the options available to hedge funds.

Hedge funds accounted for 30% of U.S. trading in credit derivatives in 2004, according to Greenwich Associates.

4.3 New Markets for Capacity Expansion

What is the potential, by country, for hedge fund capacity expansion? While there are many factors, one indicator is a country's potential for market capitalization growth. Exhibit 21 below shows this relative metric in the far right column.

Exhibit 21: World Domestic Market Capitalization

| World Domestic Market Capitalization and Population Ranked by Capitalization | | | |
|---|-----------------------------------|---------------|---|
| Country | Market Capitalization (USD MM) | Population | Capitalization per Capita (USD 000s) |
| North America | | | |
| United States | 16,323,509 | 293,027,571 | 56 |
| Canada | 1,177,518 | 32,507,874 | 36 |
| Asia | | | |
| Japan | 5,844,722 | 127,333,002 | 46 |
| China | 1,309,183 | 1,298,847,624 | 1 |
| India | 363,276 | 1,065,070,607 | 0.5 |
| Taiwan | 441,436 | 22,749,838 | 19 |
| Korea, South | 389,473 | 48,598,175 | 8 |
| Singapore | 217,618 | 4,353,893 | 50 |
| Europe | | | |
| United Kingdom | 2,865,243 | 60,270,708 | 48 |
| Germany | 1,194,517 | 82,424,609 | 15 |
| Switzerland | 826,041 | 7,450,867 | 111 |
| Spain | 940,673 | 40,280,780 | 23 |
| Italy | 789,563 | 58,057,477 | 14 |
| Sweden | 376,781 | 8,986,400 | 42 |
| Finland | 183,765 | 5,214,512 | 35 |
| Denmark | 155,233 | 5,413,392 | 29 |
| Central America | | | |
| Mexico | 171,940 | 104,959,594 | 2 |
| South America | | | |
| Brazil | 330,347 | 184,101,109 | 2 |
| Australia & New Zealand | | | |
| Australia | 776,403 | 19,913,144 | 39 |
| Africa | | | |
| South Africa | 442,527 | 42,718,530 | 10 |

Sources: World Federation of Exchanges; US Census Bureau, International Database; World Factbook 2004. Capitalization Data is for 2004 year end; population data are 2004 estimates. Countries with market capitalization below 100 bb not included.

Developed Economies

Various developed economies, which have not had hedge fund investment of any significance, represent growth opportunities for the hedge fund universe. In addition to providing capacity for U.S. and European hedge funds, these markets are fostering the growth of hedge funds within the countries themselves, particularly in some European countries and, to a much smaller extent, in Canada.

In Asia, developed economies, such as Japan, have been invested in by funds based in Japan, U.S. and Europe.

Developing Economies

A few years ago, the only Asian hedge fund investors were large domestic life insurance companies and wealthy families. Now, Asian hedge funds and hedge fund investors are springing up virtually everywhere, either within Asian countries or as investors in Asia from outside Asian countries. In 2005, this region's hedge fund population consists of over 500 funds; Asian-based hedge funds represent 60% of this number. Investment in Asia by funds outside the area is also growing strongly. Hong Kong, Korea, Taiwan and Singapore also are experiencing hedge fund investing activity both from within and from outside.

Investors in Asia are motivated by volatile local equity markets, overvalued bonds, and low dollar interest rates. However, there are brakes on hedge fund growth: the inability to sell short equities in some markets; a lack of futures and options markets and index derivatives; lack of liquidity; laws prohibiting local investors from investing in hedge funds in South Korea, Thailand and Malaysia.

In Europe and Asia (ex-China and India), Russia is generally considered to be the front-running country in terms of future capacity for hedge funds. In Latin America, it is Brazil. In Africa, it is South Africa.

Overall, the most significant emerging economies, for future hedge fund capacity, are usually referred to as "the BRICs". They are Brazil, Russia, India and China.

Exhibit 22: Projected GDP Levels for the BRICs Group

| | Brazil | Russia | India | China | USA |
|------|--------|--------|--------|--------|--------|
| 2000 | 762 | 391 | 469 | 1,078 | 9,825 |
| 2010 | 668 | 847 | 929 | 2,998 | 13,271 |
| 2020 | 1,333 | 1,741 | 2,104 | 7,070 | 16,415 |
| 2030 | 2,189 | 2,980 | 4,935 | 14,312 | 20,833 |
| 2040 | 3,740 | 4,467 | 12,367 | 26,439 | 27,229 |
| 2050 | 6,074 | 5,870 | 27,803 | 44,453 | 35,165 |

Goldman, Sachs economists have projected that, within twenty years, the BRIC GDP will be half that of the G6. In about forty years, the BRIC GDP is expected to surpass that of the G6.

As the above exhibit shows, the BRIC GDPs (and therefore their hedge fund capacity other things being approximately equal) are expected to increase very significantly. However, the population bases of Brazil and Russia are relatively small compared to those of China and India. Further, Brazil has a high debt rate and macro instability. Russia's population is shrinking.

The economic leaders, by 2050, are expected to be China, the U.S., India, Japan, Brazil and Russia, in that order, according to the Goldman Sachs study.

Hedge fund investments in India and China have existed (in small quantities) for some time. That activity is growing and we expect that it will expand at an increasing rate.

China's GDP is expected to surpass that of Germany within five years; that of Japan within ten; and that of the U.S. less than forty years. At that point, China will have the world's largest economy. Its growth already is fueling world markets – most notably in its need for commodities as it builds its infrastructure.

Bill Gates is one of China's many outspoken proponents. He believes it is the place to invest. At the January 2005 World Economic Forum in Davos, Switzerland, Gates praised China's economic system as "a brand-new form of capitalism." He is a large investor in the country as are Warren Buffet, Merrill Lynch and others.

India, the Second Most Populous Country

The hedge fund industry will grow rapidly in India. India's GDP is expected to exceed that of Italy in ten years: of France in fifteen; of Germany in twenty and of Japan in thirty years.

India's growth will increase its already-large capacity for hedge funds. As mentioned above, in less than thirty years, it is projected to have the third largest GDP in the world.

To appreciate India's future impact on the hedge fund industry, it is useful to understand its recent economic and political developments.

India's Rapid Economic Development: This era began when India gained its independence from England in 1947. Since then, its government has been increasingly progressive. For forty-five of its fifty years of independence, the Congress party ruled. Until 1984, its economic strategy was grounded in socialism and Soviet-style central planning. As a result of its restricting imports (to protect its own manufacturers), by 1980, its share of international trade had dropped to one-fifth of the volume at Independence.

The Congress Party's Rajiv Gandhi then began liberalizing the economy. Unfortunately, by this time, the voters were fed up with inequalities of power and wealth, with scandals and allegations of corruption. Gandhi lost the 1989 election and was assassinated in 1991.

The incoming BJP-led government (Bharatiya Janata Party) maintained power for its full five-year term from 1999 to 2004. It continued Rajiv Gandhi's reforms and achieved an average economic growth of 6% during BJP tenure, with 10.4% in the first quarter of 2004. It also increased foreign investment and achieved the highest level of reserves.

The BJP's economic reforms successfully transformed India's socialistic, closed economy to a more market-based economy. These factors were important in the turnaround: lower trade barriers; lessened restrictions on foreign investment, and disinvestments by the government from many of its publicly-owned, inefficient companies.

Current Prime Minister Manmohan Singh led many of these recent reforms. He is an Oxford-based economist who was previously Finance Minister.

Included among these dramatic successes, imports and exports as a share of GDP increased from 17.2% in 1991 to 30.5% in 2003. Foreign direct investment (FDI) also has increased significantly. Between 1981 and 1990, net FDI in India increased minimally by \$130 million per year. Following reform, between 1991

and 1995, annual FDI increased to \$800 million per year. Since 1996, FDI has grown, on average, approximately \$2.9 billion per year.

The Asian Development Bank describes the medium-term outlook for India's economy as "buoyant", expecting growth of 7.4% per year. Equally important, a number of experts have described India as having the fastest growing economy over the next several decades.

The fact that India's economy increasingly is based on technology is a large plus. China, its next-door neighbor, will be one of the world's largest users of that technology.

However, India does have its problems, not the least of which is taking care of its poor who tend to be voters.

India has twenty-three stock exchanges with 90% of the trading volume being handled by the Bombay Stock Exchange and the National Stock Exchange. Both have expanded greatly since market reforms were instituted.

While U.S. market capitalization approximates \$49k per capita, India's is \$0.5k per capita. Even taking into account demographic differences and India's challenges, the Indian economy (and hedge fund capacity) has great potential for growth.

Even today, India has the twelfth largest economy in the world and the third largest in Asia, after Japan and China. In thirty years, as mentioned earlier, it is projected to have the third largest GDP in the world, after China and the U.S., respectively.

Hedge funds based in India will flourish, as will those funds investing in India from other countries.

China, Tomorrow's World Economic Leader

Like India, China will offer enormous capacity for hedge funds. It is the world's most populous country with the fourth-largest GDP. Currently, automobile production, tourism, education and information technology are growing fast. Market reforms continue to be instituted, driven by the rebellion of China's leaders against collectivism. These reforms also are driven by the terms of China's agreement with the World Trade Organization. One of the WTO-required reforms is of China's exchanges.

The state-owned enterprises (SEOs) are proving hard to reform. As of the late 1990s, they contributed less than 30% of gross industrial output but employed almost 60% of urban workers. A national audit five years ago showed that 81 SEOs had falsified their books. Discoveries like these are causing increasing public outrage.

China's banks have large portfolios of non-performing loans. China has committed to opening up the banking system completely by December 2006. Experts on China, Professors Sachs and Woo, believe that issuance of currency can successfully be used, if necessary, to meet withdrawals.

China is transforming itself from a communist centrally-planned economy to a bureaucratic market economy. Economic wealth is spreading and members of the People's Congress are increasingly educated and independent. They can vote according to their own judgments on more and more issues.

China skeptics continue to be proven wrong about their negative attitudes concerning China's move to a free market. Hong Kong has been permitted to continue under its separate system. The Chinese people have increasing information flow from the outside via television and Internet, which is not as easily manipulated as the traditional media.

The most important government officials are highly capable and have shown great motivation in continuing to push reforms.

The Chinese people are hard-working and entrepreneurial. Like expatriates from India, they have prospered everywhere but in their native land. That will change.

China is expected to experience growth rates of 6.5% to 7.5% until 2020. In less than forty years, it is expected to have the largest GDP in the world.

China should have a fully viable economic marketplace very soon, providing a huge – and excellent – environment for hedge funds.

5.0 Conclusion

Hedge fund demand and capacity will continue to grow. Overall, capacity will not be a problem.

In the year 2004, there was an unhappy confluence of several factors which were detrimental to the industry: unfavorable markets, unusually low volatility and spreads and unprecedented demand.

We believe that it will take the hedge fund industry at least another year to adjust to new demand levels. This adjustment involves, in part, the exploitation of new strategies and markets; this already is occurring.

Demand will continue to grow as institutions and family offices look for a “safer haven” than unhedged investments.

The rapid growth of hedge funds and their widespread and increasing use as investments will force the inevitable. In the not-to-distant future, the majority of hedge fund products will be public vehicles.

We believe the hedge fund industry will grow, as a minimum, to:

\$2 trillion by 2009

\$4 trillion by 2013

\$6 trillion by 2015

Some will believe that these projections are aggressive. Please consider the following:

- the explosive growth of the mutual fund industry. After it attained \$1 trillion in assets in 1990, it grew more than fourfold in the next 7 years. Further, the growth to \$1 trillion in assets took mutual funds 66 years; it took hedge funds 10 years less to attain the same level.⁸
- the logic of investing in hedged investments vs. traditional long-only investments; i.e., the ability to obtain much better risk-adjusted returns with hedge funds;
- the steady growth of the hedge fund sector over the last 16 years;
- the skepticism, in the 1990s, when we forecasted that hedge fund assets would be \$1 trillion by 2005. Greg Newton, publisher of MarHedge, reported in his August 2004 edition that, when we made the forecast, many considered it to be quite unrealistic.

The industry will see huge growth in coming years.

⁸ Mutual funds, 1924 - 1990
Hedge funds, 1949 - 2004

About the Author

George Van is Chairman and primary founder of VAN. In the early 1990s, he and his associates performed the first robust research on the reward–risk characteristics of hedge funds, using the world’s largest hedge fund database. He has spoken many times at hedge fund conferences, authored numerous articles and papers on hedge funds and been interviewed frequently on the subject by the U.S. and international print media as well as U.S. and international television networks.

Mr. Van has had a distinguished business career, both founding and managing large companies and serving as a director of international organizations. He received a B.A. and a D.H.A. from McGill University and the University of Toronto, respectively, as well as various academic honors. He has held teaching appointments at the University of Alberta. Mr. Van is multi–lingual.

About Van Hedge Fund Advisors, LLC

Van Hedge Fund Advisors International, LLC and its affiliates (“VAN”) were founded in 1992. VAN is a Securities and Exchange Commission (“SEC”) Registered Investment Advisor.

VAN is a provider of hedge fund indices and their derivative products, including the Van Institutional Investable Index and structured products.

VAN advises U.S. and European institutional investors, families, and individuals worldwide on construction of hedge fund portfolios. VAN has offices in Greenwich, Connecticut and Nashville, Tennessee. VAN also has representation in Europe, South America, and Australia and Asia through various partnership arrangements.

The Company does not publish directories of individual hedge fund information and releases information on individual hedge funds to accredited investors only after obtaining the manager’s permission.

VAN has these distinguishing characteristics:

- It performed the world’s first large–scale research on hedge funds with methodological assistance from faculty of the Owen Graduate School of Management at Vanderbilt University, in the early 1990s.
- It maintains one of the largest hedge fund databases in the world.
- It produces monthly the Van Hedge Fund Indices of U.S. and offshore hedge fund performance; these indices are used extensively by the financial community and the media.
- VAN information, over the years, has been quoted very extensively in the international media.

VAN’s hedge fund information is well recognized as to its quality. The Milken Institute used it extensively in their policy brief on hedge funds. The International Monetary Fund also sought VAN’s help for their Occasional Paper on hedge funds. VAN testified before the U.S. House Banking and Finance Committee on Long Term Capital Management. Cerulli Associates, a prestigious Boston consulting firm, used VAN as their provider of aggregate hedge fund data in a white paper on the industry. Commonfund also has used VAN information for some of its benchmarking.

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Appendix 1

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Malcolm Gladwell explores the causes of “tipping points” in various social phenomena; i.e., the point in time at which these phenomena had spread enough so that they took on a life of their own. The author examines fashion trends, direct mail, smoking, children’s television and the early days of the American Revolution.

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Pearson, Ryan – Vice President
Song, Zhiyi – Vice President
Tansil, Olga – Project Manager
Van, John – Managing Director
Velakacharla, Aditi – Vice President
Whelan, Thomas – President and CEO

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Note: Names of managers or hedge funds are mentioned only if they are already in the public arena due to recent media coverage.

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Explanatory Notes

- All information is from sources believed to be reliable. Data are not necessarily audited or independently verified.
- As with any investment, hedge fund investors are subject to a risk of loss.
- Past results are not indicative of future performance.
- Compound annual returns are calculated using geometrically-linked quarterly average returns by strategy and in aggregate.
- S&P 500 returns reflect the reinvestment of dividends; Dow Jones Europe Stoxx 50 returns do not reflect the reinvestment of dividends.
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