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PERSPECTIVES
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OCTOBER 2014

Hedge Fund Outlook

Table of contents

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Executive summary – market environment

Hedge Fund Return Drivers	Over the past year, hedge fund returns were broadly driven by their beta component - the market risk premium priced into assets. Manager skill played less of a role due to global central bank policies, which have suppressed interest rates and the market's focus on fundamentals as a determinant of asset prices. These events have limited opportunities for managers to generate alpha.
Current Environment	Today, we observe low risk premiums across most asset classes (i.e., assets are fully valued), which limits return expectations. Historically large allocations to hedge funds may contribute to tighter trades, limiting alpha potential.
Evolving Environment	However, the environment for hedge fund strategies should see improvement if (1) we observe a normalization of monetary policy and interest rates, and/or (2) the market recognizes differences in company fundamentals across countries and industries (i.e., valuations, stage of the business cycle).
Opportunity Set	Until monetary policy and interest rates recover to normalized levels, allowing asset values to reflect fundamentals, hedge fund strategies will seek to add value by focusing on (1) idiosyncratic and catalyst-driven opportunities, and (2) opportunities provided by diverging growth and interest rate cycles across markets.

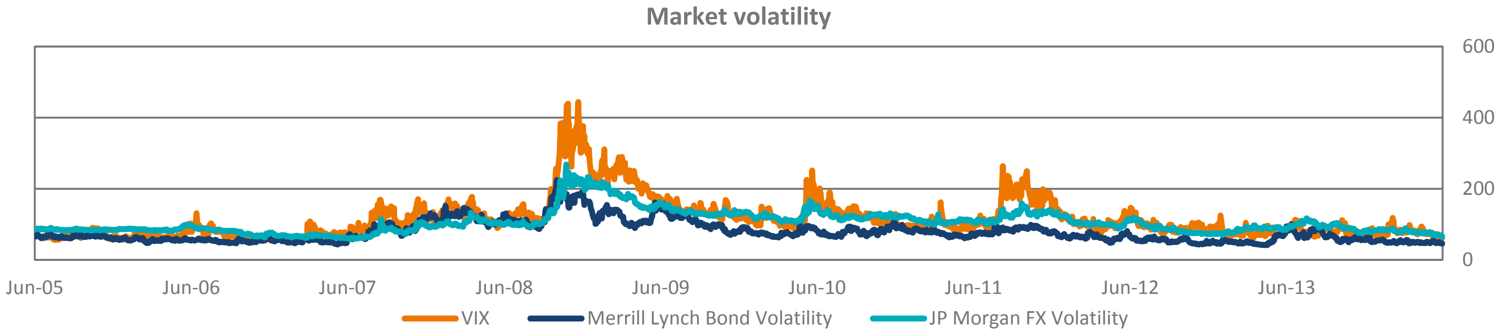
Executive summary – strategies

Hedged Equity	Today's environment for hedged equity strategies is characterized by low risk premiums, limiting expected returns. However, as equity returns become driven less by multiple expansion and more by differences in earnings growth, we would expect to see an increasing portion of returns driven more by a manager's ability to identify idiosyncratic opportunities (alpha) and less from the market risk premium to equities (beta).
Macro Strategies	The trading environment for global macro managers will improve as unconventional monetary policies wind down, allowing markets to recognize divergence in macroeconomic conditions across developed and emerging markets (uncovering unsustainable differences in relative values of assets).
Arbitrage Strategies	The decoupling of policy cycles and growth expectations across countries should lead to a divergence in growth rates, interest rates, currency values, and inflation across countries, which should provide an array of relative value opportunities. In the meantime, relative value strategies will rely on idiosyncratic opportunities and event driven trading to generate returns.

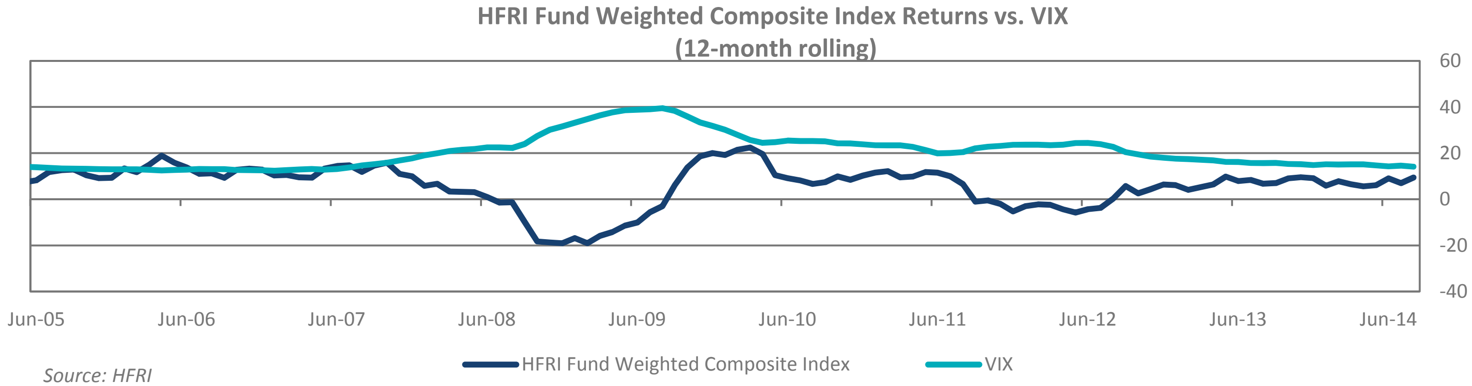
Market environment - volatility

— Market volatility in equities (VIX), bonds (Merrill Lynch Option Volatility Estimates index: MOVE), and currency (JP Morgan FX Volatility index) have all been falling as markets perceive stability supported by central bank policies. Cross sectional volatility, a measure of dispersion in equity returns, has also been declining for developed and Emerging Market equities.

— Decreasing volatility and price dispersion have been significant headwinds to performance, according to what we have been told by the hedge fund community. However, this does not seem consistent with our experience; hedge funds have historically been able to perform in similar regimes of below-average dispersion and below-average volatility.



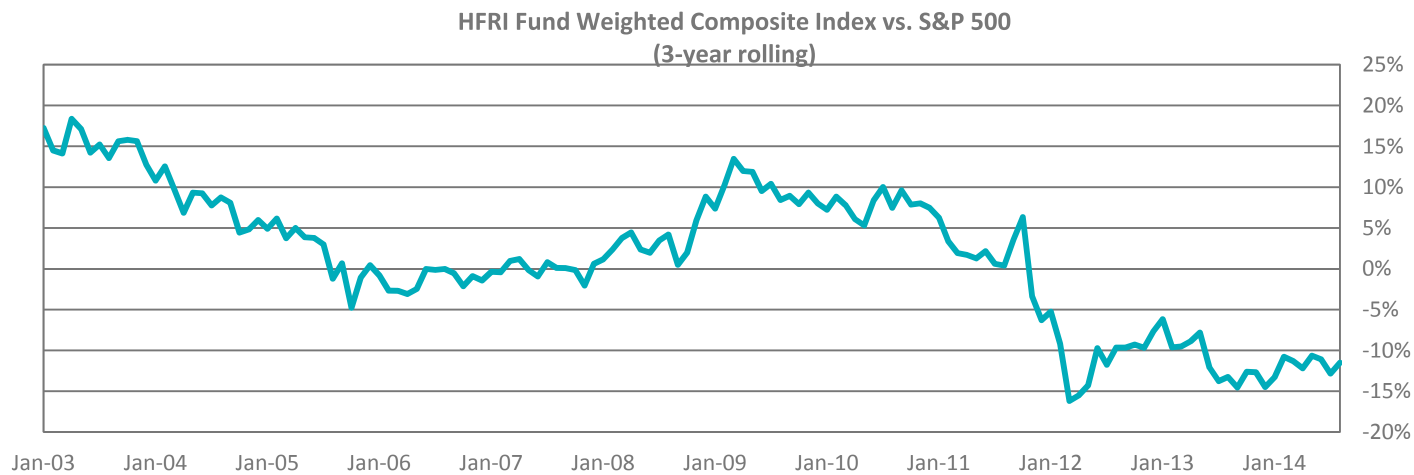
Source: CBOE, Merrill Lynch, JP Morgan, Bloomberg

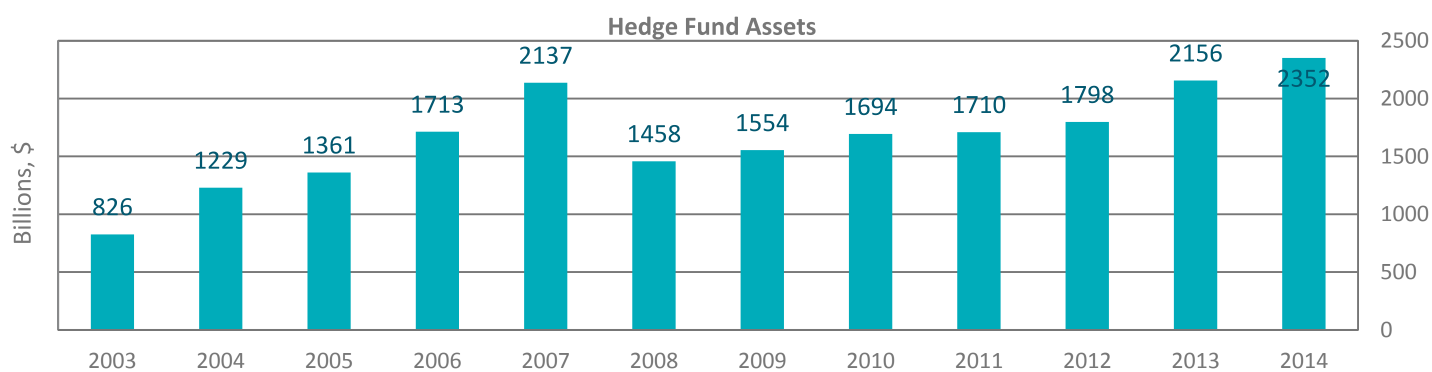


Source: HFRI

Market environment – asset growth and excess return

— As hedge funds assets have grown over the last 10 years, the ability of managers to generate returns has diminished.





Source: Barclays Hedge

Source: HFRI

Market environment – expectations

	Base Case: Low Growth	Growth Slows	Growth Accelerates
Economy	▪ Slow but sustainable growth across global economies ▪ Inflation low and stable ▪ Monetary policies diverge across the US, Europe, Japan and Emerging Markets	▪ Growth slows in response to US Fed tightening, Europe and Japan fail to stimulate their economies ▪ Global inflation continues to fall ▪ Capital flows out of Emerging Markets	▪ US growth reaches trend. Europe, Japan and Emerging Markets growth accelerates ▪ Inflation rises ▪ Monetary policy tightens across the globe
Markets	▪ Nominal and real interest rates remain low and stable ▪ Asset values increasingly driven by fundamentals across global markets ▪ Volatility remains low	▪ Equity markets fall ▪ Real interest rates rise ▪ Volatility spikes ▪ Asset correlations rise and price dispersion falls in short-run; both widen as fundamentals replace risk-on, risk-off sentiment	▪ Equity markets rise ▪ Real and nominal interest rates rise ▪ Volatility increase ▪ Asset correlations fall and price dispersion increases
Hedge Fund Opportunity Set	▪ Environment favorable for global strategies with the ability to act on dispersion across asset values, which is increasingly driven by differences in economic fundamentals across nations ▪ Low risk premiums (i.e., assets fully valued) not favorable for directional beta driven strategies	▪ Market sell-off is favorable for long-short and short-biased strategies ▪ Rising asset correlations is reflective of risk-on, risk-off environment; returns are beta-driven, a poor environment for alpha generation ▪ Upon economic and market stabilization, rising risk premiums on asset sell-off favorable for beta driven strategies	▪ Asset values driven by fundamentals ▪ Low risk premiums (assets fully valued) hurts beta driven strategies ▪ Favorable for event driven strategies and alpha generation

Summary – hedge fund styles

Long-short equity

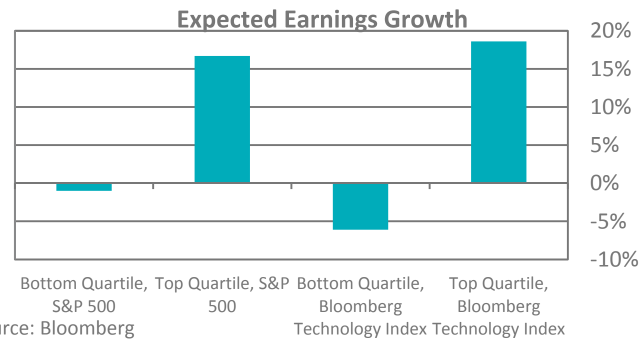
MARKET ENVIRONMENT

- Equity market returns have been driven in part by expansionary monetary policy and improving growth around the globe.
- This environment has contributed to strong equity market returns that are driven less by earnings growth and more by multiple expansion, and has resulted in a beta driven market which favors longer-biased strategies. This has been a headwind to alpha generation.

MARKET OUTLOOK

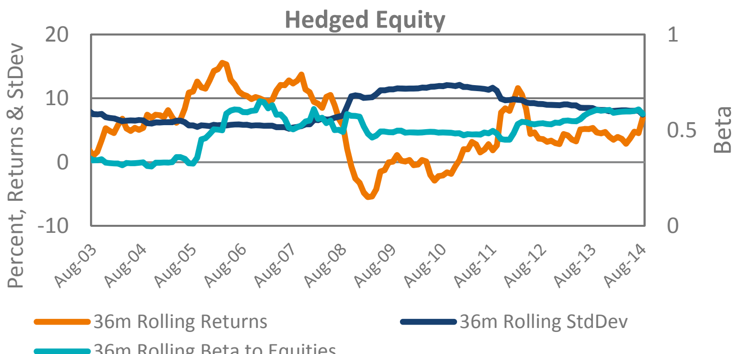
- Looking forward, the positive impact of economic growth on earnings growth and equity returns may bump up against high equity valuations, limiting beta driven returns.
- The environment for long-short equity returns should improve, however, as interest rates and market volatility rise.
- A rise in volatility and interest rates should lead to increased dispersion in profitability across companies, raising the importance of distinguishing between good and bad companies in making long-short decisions. This will increase the opportunities for these strategies to generate alpha.

As monetary policy normalizes and fundamentals matter more, differences in expected earnings suggest widening price dispersion; a tailwind for long-short equity strategies.



Source: Bloomberg

The correlation of hedged equity strategies to equity markets remains high, limiting the contribution of these strategies to portfolio diversification.



Source: HPRI

Equity: market neutral

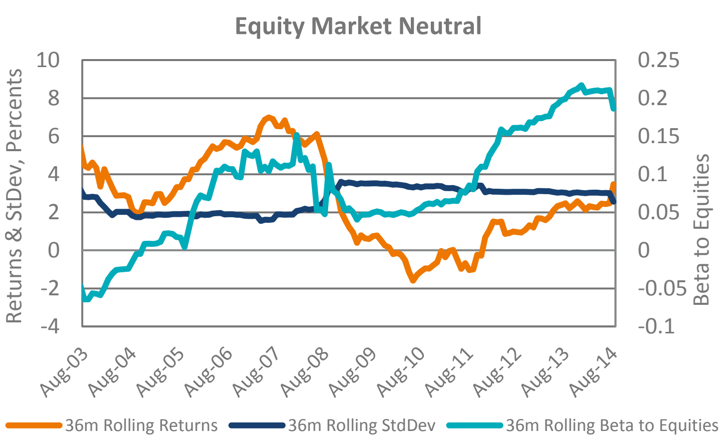
MARKET ENVIRONMENT

- Market neutral strategies generate returns by taking advantage of short and medium-term relative value opportunities driven by differences in fundamentals (valuation, earnings quality, and performance trends across companies).
- In an economic environment where returns are driven more by macroeconomic policy and multiple expansion than fundamentals and earnings growth, and where interest rates are low, limiting the short-rebate managers earn, returns are likely to be low and have been (3.1% annualized over the last four years).

MARKET OUTLOOK

- Historically, as growth and interest rates normalize, markets pay greater attention to fundamentals and valuation, improving the ability of market neutral strategies to generate returns.
- With growth and interest rates expected to diverge across the globe, market neutral strategies should see an improving environment for beta-driven returns over the next 18 months.

The diversification benefits of market neutral strategies have lessened as markets were driven higher by Fed liquidity driving investors out on the risk curve, and thus focused less on fundamentals and valuation



Source: HFRI

A year ago, markets paid little distinction between the best and worst performing stocks. More recently, as economic growth diverges across the globe, growth, leverage and risk factors are being rewarded.

Global Factor Returns (6/30/2014)		
		1 year
Value	P/B	0.41
	P/E trailing	0.54
	Yield	0.19
Growth	Hist EPS Growth	0.22
	Proj EPS Growth	0.21
	Hist Sales Growth	0.04
Sentiment	Price Momentum	0.27
	3m Analyst Up/Down	0.57
Quality	Operating Margin	0.08
	ROI	0.06
	Leverage	0.24
Risk	Beta	0.15
	Volatility	0.33
	Size	0.01

Global factor returns reflect the return differential, computed monthly, of a universe of developed market stocks greater than $200mm in market capitalization. Source: S&P, I/B/E/S, Lazard

Equity: short-bias

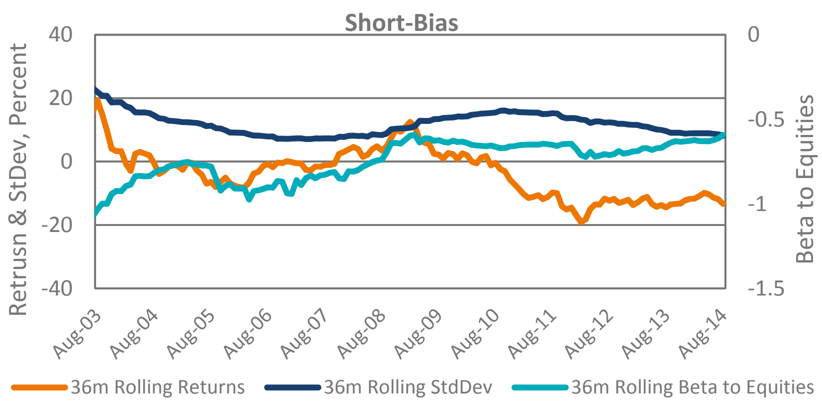
MARKET ENVIRONMENT

- Short-bias equity strategies have delivered negative returns. This is due not only to the strength of equity market returns, but to (1) the market's lack of attention to fundamentals which made it difficult to distinguish between the best and worst performing stocks; and (2) to the headwind of low interest rates, which have reduced the short rebate managers earn on their short positions.
- Earlier in 2014, short interest rose on the belief of many short sellers that equities were overvalued. As equities continued to rally, short sellers were caught in a short-covering rally (a basket of the top 50 shorted stocks has outperformed the broader market year-to-date). As a result, many managers decreased their short positions on the belief that stock prices were disconnected from traditional valuation measures.

MARKET OUTLOOK

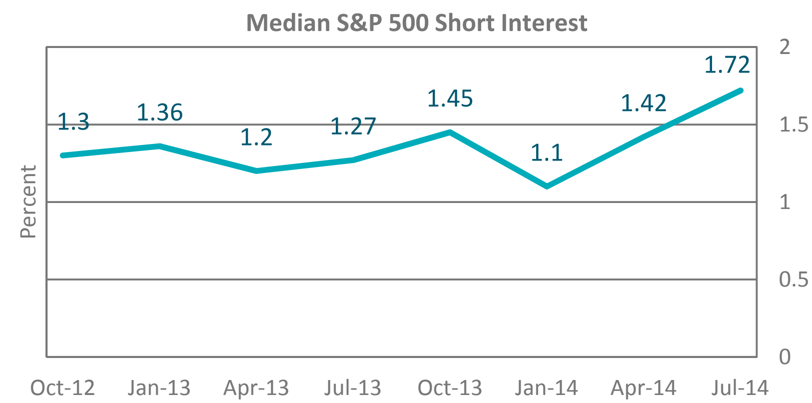
- The headwinds to short-bias strategies - beta-driven equity markets and low interest rates - should diminish over time as monetary policy normalizes, leading markets to focus on fundamentals and valuations in assessing companies.
- Rising interest rates have historically been a positive determinant of returns, by leading to greater earnings dispersion across equities. Managers may benefit from rising rates by shorting levered companies that are negatively affected by higher interest rates.

As volatility returns to the markets and interest rates begin to rise, the environment for short-bias strategies may improve.



Source: HFRI

Rising short interest in 2014 was rewarded with a short covering rally as equities continued to rally. The most shorted stocks outperformed the broader index in July.



Source: Bloomberg, Allianz Global

Macro: emerging markets

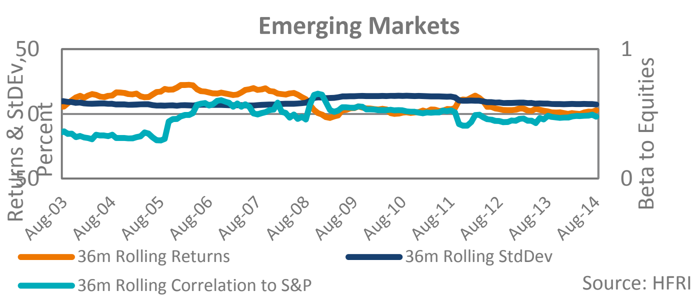
MARKET ENVIRONMENT

- Emerging Market equity and bond prices fell in mid-2013 and early 2014, driven in part by asset flows out of Emerging Markets in response to the announcement of Fed tapering, and then again over market concerns regarding the foreign capital needs of nations with large current account deficits.
- Bonds have recovered much of their earlier losses, supported by new asset flows into Emerging Markets. New asset flows have been driven by (1) compressing US yields which have led many investors to seek out carry trades in higher yielding Emerging Markets; and (2) changing expectations about economic and earnings growth, which have stabilized, and nations' abilities to fund their current account imbalances.

MARKET OUTLOOK

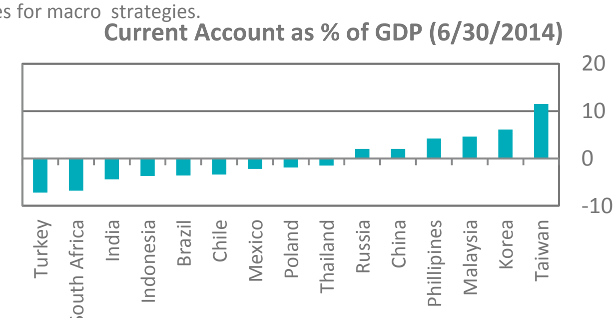
- Differences regarding nations' stage of their business cycle, the sources of their growth (domestic consumption, exports, commodities), the degree of their dependence on foreign capital flows, and their stage of economic and market reform, is leading to a wide dispersion in the behavior of macroeconomic variables across Emerging Markets.
- Attractive asset prices, changing economic leadership, and active central banks, are creating a broad opportunity set for a variety of investment strategies. This is creating a range of opportunities for long-short equity, relative value, and macro strategies, but hedge fund managers appear to remain cautious, however, as Emerging Markets remain susceptible to higher US rates, which presents a potential headwind.
- Successful strategies should be those which recognize that nations most dependent on global liquidity are generally also the most sensitive to changes in Fed and global central bank policy; and can position their portfolios to protect against unexpected changes in emerging and developed market policy (e.g., earlier tightening of US interest rates which could lead to capital outflows, falling asset prices, and depreciating currencies).

The correlation of Emerging Markets hedge fund strategies to the US equity market has stayed remarkably constant since before the financial crisis.



Source: HFRI

Differences in current account deficits can lead to different exchange rate movements, creating opportunities for macro strategies.



Source: Bloomberg, Allianz Global

Macro: global macro

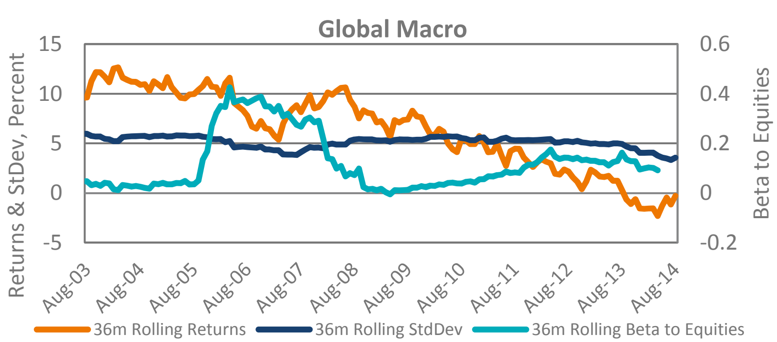
MARKET ENVIRONMENT

- Macro strategies as a group have not delivered as expected. Not only has market volatility been exceptionally low as markets discount the continued central bank and government intervention in markets, but asset classes most influenced by central bank or government intervention have not performed as would be expected, given economic fundamentals (ex: bonds).
- Thematic macro managers suffered as market prices failed to reflect new information (such as the on-going bid for Treasuries). Strategies which trade currencies or commodities (where policy is less impactful) have performed more in line with expectations.

MARKET OUTLOOK

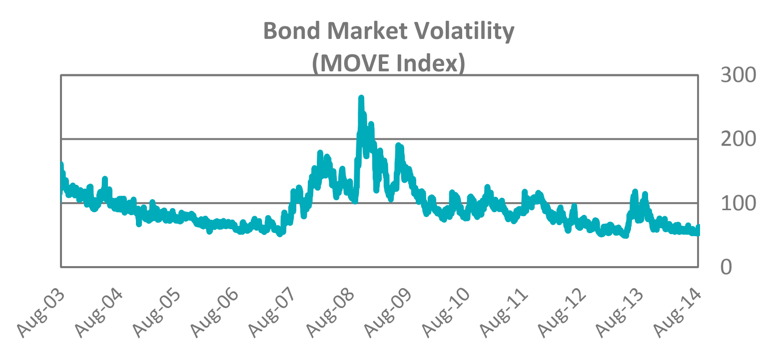
- Unconventional monetary policy has contributed to a disconnect between asset prices and underlying economic fundamentals. This effect is likely to take some time to unwind, suggesting a continuing but diminishing headwind to macro strategies.
- The trading environment for global macro managers should improve as volatility recovers to historical levels, the US yield curve normalizes, and divergences in monetary policy across the developed and Emerging Markets reveal unsustainable differences in relative values.
- Rising volatility should create a wide range of relative value trades for managers with an understanding of the differences between central bank and government policy across countries. The ECB's willingness to undertake policy measures to support growth and inflation if successful may provide opportunities to benefit from a continuation of the rally in European risk assets. Attempts by the Japanese to reflate their economy supports strategies which capitalize on a falling yen.

While macro strategies have struggled, their low correlation to equity markets suggests they may play a diversifying role in a rising volatility environment.



Source: HFRI

A variety of market structure factors, investor behavior, and central bank policy has reduced volatility and led to fewer market opportunities.



Source: Merrill, Bloomberg

Macro: managed futures

MARKET ENVIRONMENT

- Managed futures strategies, which depend to a great extent on identifying price trends, have delivered negative performance. This is due in part to trend reversals. In a continuation of 2013's market environment, strategies based on longer-term models have delivered the worst performance while shorter-term strategies have performed better.
- Returns have been hurt by:
  - Managed futures strategies positioning portfolios to take advantage of rising rates ,while rates continue to fall.
  - The zero interest rate environment, which has limited interest earned on cash when not trading.

MARKET OUTLOOK

- Over time, trend following strategies should benefit from the declining role that monetary policy may play in influencing asset prices, while economic fundamentals will increase in importance.
- In the near term, however, managed futures strategies should continue to face a number of headwinds to performance. Medium and long-term trend followers tend to have high beta to global equities, which trade at high valuations and are subject to market corrections, leaving the defensive characteristics of managed futures in question. The tendency of trend followers to be short Treasuries suggests they will be hurt in any flight to quality brought on by a return of market volatility.

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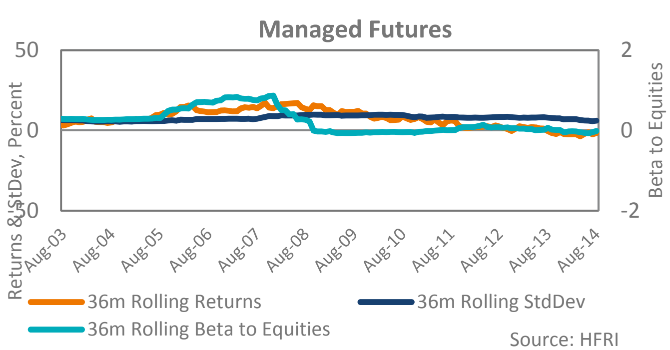

Source: HFRI

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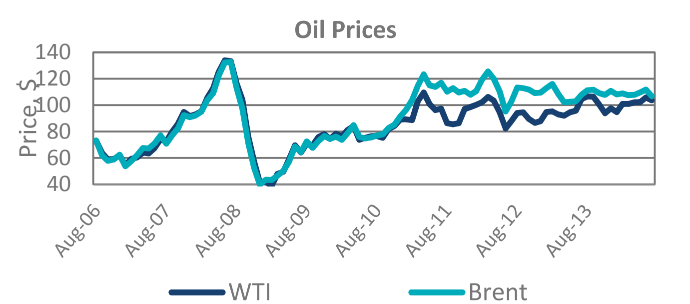


Source: St. Louis Fed

Arbitrage: merger arbitrage

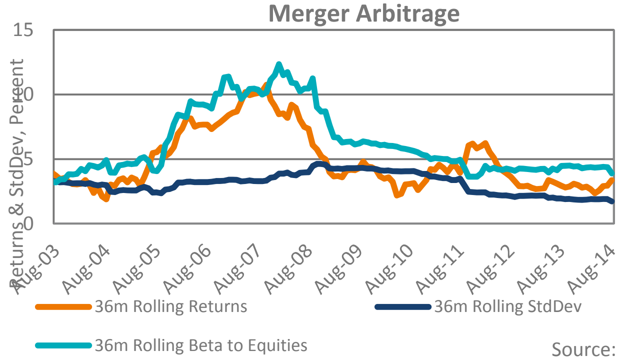
MARKET ENVIRONMENT

- The long anticipated rally in merger and acquisition (M&A) activity is underway. Global M&A activity reached $1.8 trillion in the first half of 2014, a 43% increase from the same period in 2013. Drivers of M&A activity include low organic growth, record amounts of cash on balance sheets, and continued low interest rates over a span of several years.
- So why the recent increase in M&A activity? Among the explanations: (1) rising CEO confidence in the accretive value of acquisitions, (2) the appeal of tax inversion strategies as a means to improve profitability, (3) low interest rates which are expected to rise, and (4) the increasing attractiveness of M&A as a method for enhancing shareholder value.

MARKET OUTLOOK

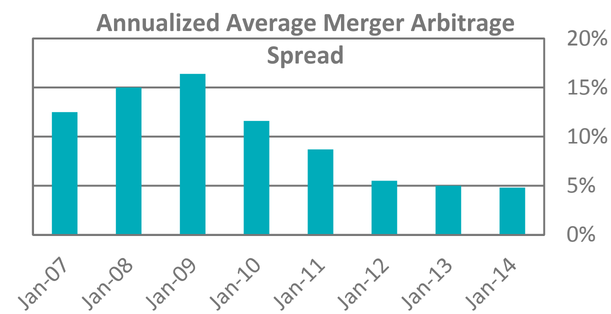
- M&A volume has picked up, but arbitrage spreads remain well below their historical average; a headwind to returns.
- Among the explanations for the decline in spreads are (1) strong asset flows to event driven funds which focus on merger arbitrage; (2) a decline in high bid premium deals such as hostile take overs; and (3) a decrease in transaction costs allowing more deals to remain profitable, which attracts asset flows that can drive bid spreads down.
- At current spreads, plain vanilla deals can generate returns of 3-4%. Strategies seeking higher returns are focusing on more complex deals with the potential for 5-10% returns. More complex deals include hostile deals and deals exposed to anti-trust risk.

Returns to merger arbitrage have been hurt by weak activity and strong asset flows that have negatively affected spreads.



Source: HFRI

While M&A activity has recovered, merger arbitrage spreads have decreased; a headwind to returns.



Source: JP Morgan

Arbitrage: convertible arbitrage

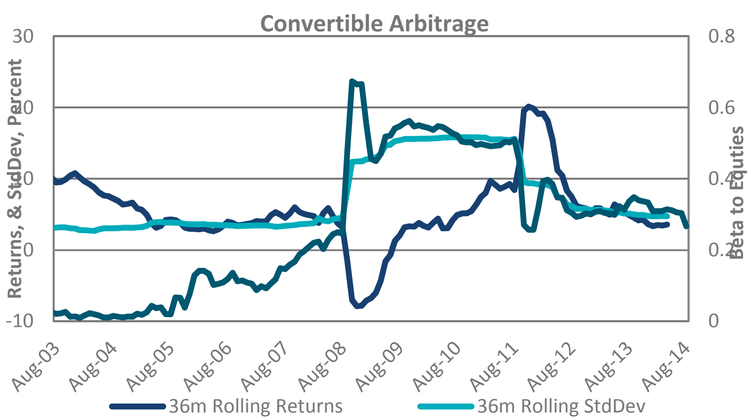
MARKET ENVIRONMENT

- As equity prices continue to move higher, convertible arbitrage strategy returns have dropped, as has the correlation of these strategies to the equity market.
- Strong equity market performance and tight credit spreads have contributed to strong growth in convertible bond issuance, which should lead to cheaper prices. However, current valuation levels appear likely to act as a headwind to performance.

MARKET OUTLOOK

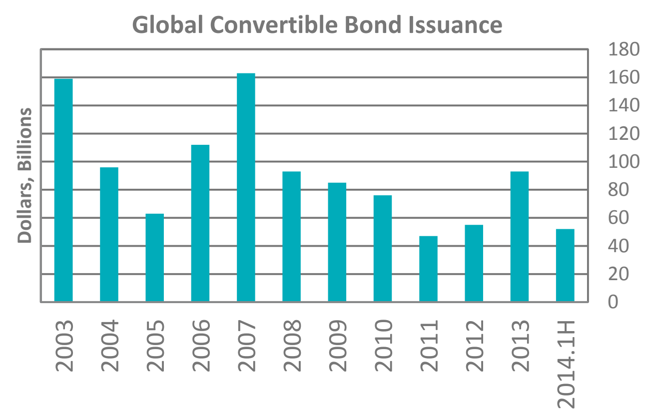
- Strong global issuance and the expectation of increasing volatility should create wider dispersion and opportunities for convertible arbitrage strategies; however, until that time, managers are finding limited opportunities at current valuations.
- The growth of long convertible bond funds and a decrease in dedicated hedge funds has contributed to greater dispersion in prices, creating alpha opportunities. New issues coming from troubled sectors (alternative energy, finance, biotech) or companies facing idiosyncratic issues and a possibility of being either deep in the money or distressed bonds, have created opportunities for strategies that are willing to play in that space.

Convertible arbitrage beta varies significantly over time, a function of strength in equity market issuance and credit spreads.



Source: HFRI

Though valuations are near fair value, rising convertible bond issuance should lead to greater price dispersion; a tailwind to performance.



Source: BofA Merrill Lynch

Arbitrage: fixed income arbitrage

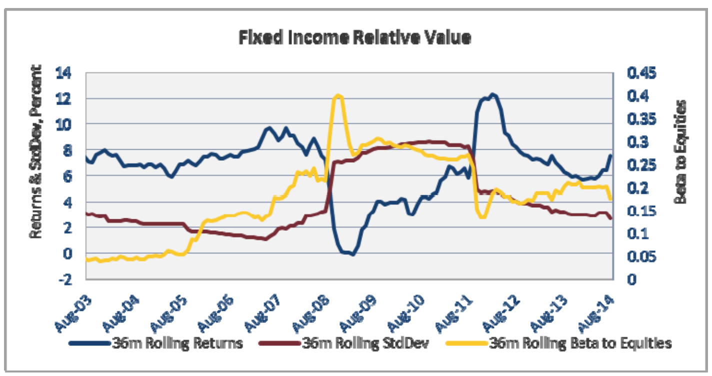
MARKET ENVIRONMENT

- Fixed income relative value strategies trade across the spectrum of fixed income, including: sovereign bonds, agencies, structured credit, and corporate credit (by some definitions). These strategies depend on volatility to create price discrepancies, and rely on mean reversion as the basis for asset prices to converge to fair value.
- Fixed income relative value strategies have faced headwinds to performance. Recently, Fed transparency regarding its policy intentions has resulted in low volatility; particularly for short-term interest rates.
- The Fed's provision of liquidity has also resulted in tight credit spreads across assets. This has proved a headwind to relative value strategies that hope to capture a divergence in fair value spreads between various sovereigns, agencies, and credits.
- Declining liquidity, however, has created mismatched valuations; a tailwind to relative value opportunities.

MARKET OUTLOOK

- The decoupling of policy cycles across developed markets, and diverging growth expectations, should over time lead to increasing market volatility and provide an array of relative value and flow-driven opportunities.
- In the meantime, relative value strategies will rely on idiosyncratic opportunities and event driven trading to generate returns.

Returns have remained relatively high, while volatility has decreased since the financial crisis.



Source: HFRI

Differences in the direction of monetary policy across nations should lead to valuation differentials and greater dispersion, tailwinds to relative value trading opportunities.

Rates (6/30/2014)	US	Japan	Germany	EM
	Current Value	Current Value	Current Value	Current Value
Nominal Yield	2.5	0.6	1.2	5.6
Real Yield	0.4	-2.8	0.2	1.7
Curve	2.1	0.5	1.2	0.9

Source: Verus

Market overview

The role of hedge fund

	Strategy	Beta (Source)	Return-Enhancing	Risk Reduction (capital preserving)	Diversification (exposure to new risk factors)	Liquidity*
Equity Strategies	Long-Short Equity	Long-short stock portfolio seeking to take advantage of a range of relative value and timing opportunities in global markets.	Moderate	Moderate	Low/None	Level 1
	Market Neutral	Global developed stock portfolio which balances long & short positions, while seeking to capture short and medium term relative value opportunities. These strategies are based on differences in fundamentals (valuation, earnings quality, etc.).	Low/None	High	Low/None	Level 1
	Short-Bias	Short-biased, global developed stock portfolio seeking to capture inefficiencies due in part to a general long-bias orientation, balanced by a long portfolio that hedges characteristics of the short portfolio.	Moderate	High	High	Level 1
	Emerging Markets	Long-short stock portfolio which seeks to take advantage of a range of relative value and timing opportunities in Emerging Markets.	High	Low/None	Low/None	Level 1
Macro Strategies	Global Macro	Long-short and tactical allocation strategies in developed and Emerging Market equities, bonds, and currencies. This strategy is based on attractive fundamentals, performance trends, and carry.	Moderate	High	High	Level 1
	Managed Futures	Short, medium, and long-term trend-following strategies in equities, interest rates, currencies, and commodities.	Moderate	High	High	Level 1
Arbitrage Strategies	Event Driven	Seeks to capture spread between the current value of merger targets and the value once a deal is completed. This strategy also focuses on spin-offs and other capital structure transactions.	Moderate	Moderate	Moderate	Level 2, 3
	Convertible Arbitrage	Seeks to capture a discount between the current price of convertible bonds and their fundamental value as a bond plus an equity call option.	Moderate	Moderate	Moderate	Level 2
	Fixed Income Arbitrage	Long-short relative value and tactical credit market portfolio, comprised of global fixed income securities and currencies. This strategy is based on valuation, trends, and carry.	Moderate	High	High	Level 2

	Low/None	Moderate	High
Magnitude			

Liquidity	Level 1	Level 2	Level 3
*See Appendix for complete definitions	Quoted prices. Active Markets	Fair value based on over-the-counter prices.	Infrequently traded assets, model-based prices.

Market environment – risk factors

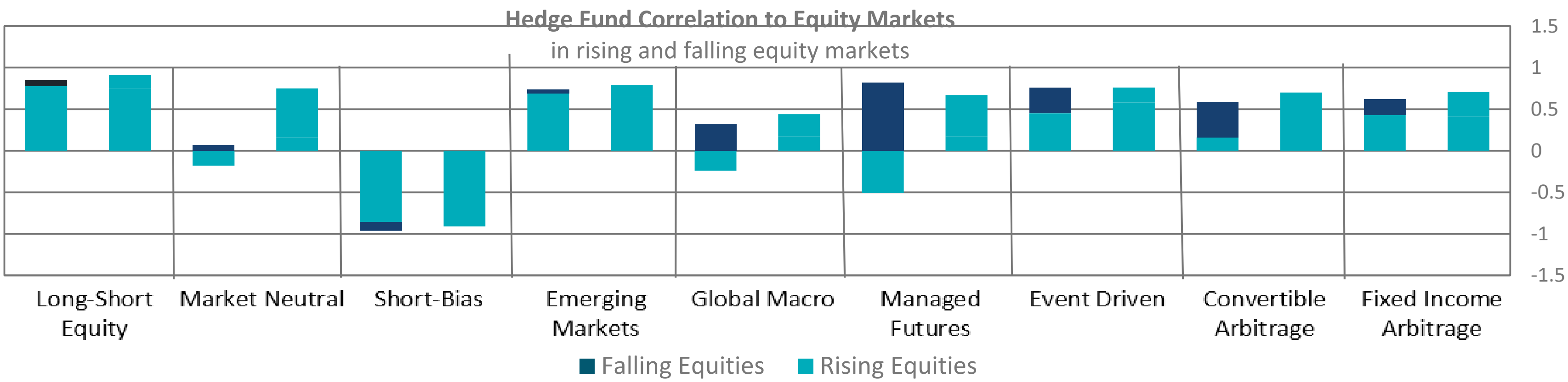
	Environment	Long-Short Equity	Market Neutral	Short-Bias	Emerging Markets	Global Macro	Managed Futures	Event Driven	Convertible Arbitrage	Fixed Income Arbitrage
Equities	▪ Low Volatility; historically consistent with rising equity prices ▪ Stock correlations falling; positive for security selection ▪ Margins at historical highs; subject to compression ▪ US: markets fully valued to expensive ▪ Emerging Markets: sentiment improving, markets recovering	High	High	High	High	Moderate	Moderate	Moderate	High	Low/None
Rates	▪ US monetary policy tightening; rate increases expected in 2015 but bound by low inflation and modest growth ▪ ECB, BOJ, Bank of China undertaking expansionary monetary policy ▪ European sovereign rates low relative to US Treasuries ▪ Emerging Markets central bank policy is country-specific, depending on whether country is importer/exporter of capital	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	Moderate	High
Credit	▪ High yield & bank loan issuance exceeding 2013 levels ▪ Absolute yields low and spreads narrow ▪ Default rates low; covenant-light issuance rising	Moderate	Moderate	Moderate	Moderate	Low/None	Moderate	Moderate	Moderate	Moderate
Inflation	▪ US: still below 2% target, but labor market tightness suggests rising inflation, ▪ Europe, Japan: below target inflation ▪ Emerging Markets: differing inflation rates	High	High	High	High	High	High	High	Moderate	Moderate
Currency	▪ Tightening in US monetary policy relative to rest-of-world suggests increasing dollar strength ▪ Divergence across Emerging Markets with regard to stage of economic/monetary cycle implies differences in rate of currency change	Moderate	Moderate	Moderate	Moderate	High	High	Moderate	Low/None	Low/None

Magnitude	Low/None	Moderate	High

Hedge fund characteristics

Over the long-term, hedge funds have differing abilities to provide risk-adjusted returns, limit volatility and protect capital relative to one another and equities. Over the past 3 years, many hedge fund strategies have been driven largely by their beta component, correlating highly with the equity markets.

	Annualized return (Periods ending 8/31/2014)				Volatility (StDev)	Correlation to equities		Correlation to bonds		Sharpe ratio	Maximum drawdown
	One Year	Three years	Five Years	Ten Years	10 yr	10-yr	3-yr	10-yr	3-yr	10-yr	10-yr
Long-short equity	11.7	6.9	6.5	5.7	8.7	0.86	0.92	-0.04	-0.24	0.43	-30.6
Market neutral	4.9	3.5	2.5	2.8	2.8	0.51	0.86	-0.27	-0.20	0.43	-9.2
Short-bias	-12.3	-13.4	-13.4	-6.2	11.0	-0.89	-0.88	0.04	0.25	-0.63	-61.5
Emerging markets	8.1	2.8	4.9	6.9	9.6	0.75	0.81	0.06	-0.10	0.54	-32.6
Global macro	4.5	-0.3	1.6	4.6	4.8	0.24	0.32	0.03	0.29	0.53	-8.0
Managed futures	5.2	-1.6	1.1	7.0	8.1	0.07	-0.11	0.03	0.39	0.60	-11.8
Event driven	4.0	3.4	3.7	5.2	3.2	0.67	0.75	0.05	-0.17	1.02	-8.1
Convertible arbitrage	6.3	6.1	7.3	4.9	9.2	0.65	0.82	0.17	-0.18	0.36	-35.3
Fixed income arbitrage	9.4	7.5	8.3	6.7	5.0	0.70	0.78	0.10	-0.01	0.96	-18.0
HFR fund weighted	9.4	5.4	5.9	6.0	6.4	0.78	0.70	0.00	-0.01	0.45	-21.4
S&P 500	5.7	2.9	4.5	4.7	14.7	1.00	1.00	0.03	0.24	0.51	-50.9
Barclays US agg	25.3	20.6	16.9	8.4	3.2	-0.25	0.03	1.00	1.00	0.94	-3.8



Summary

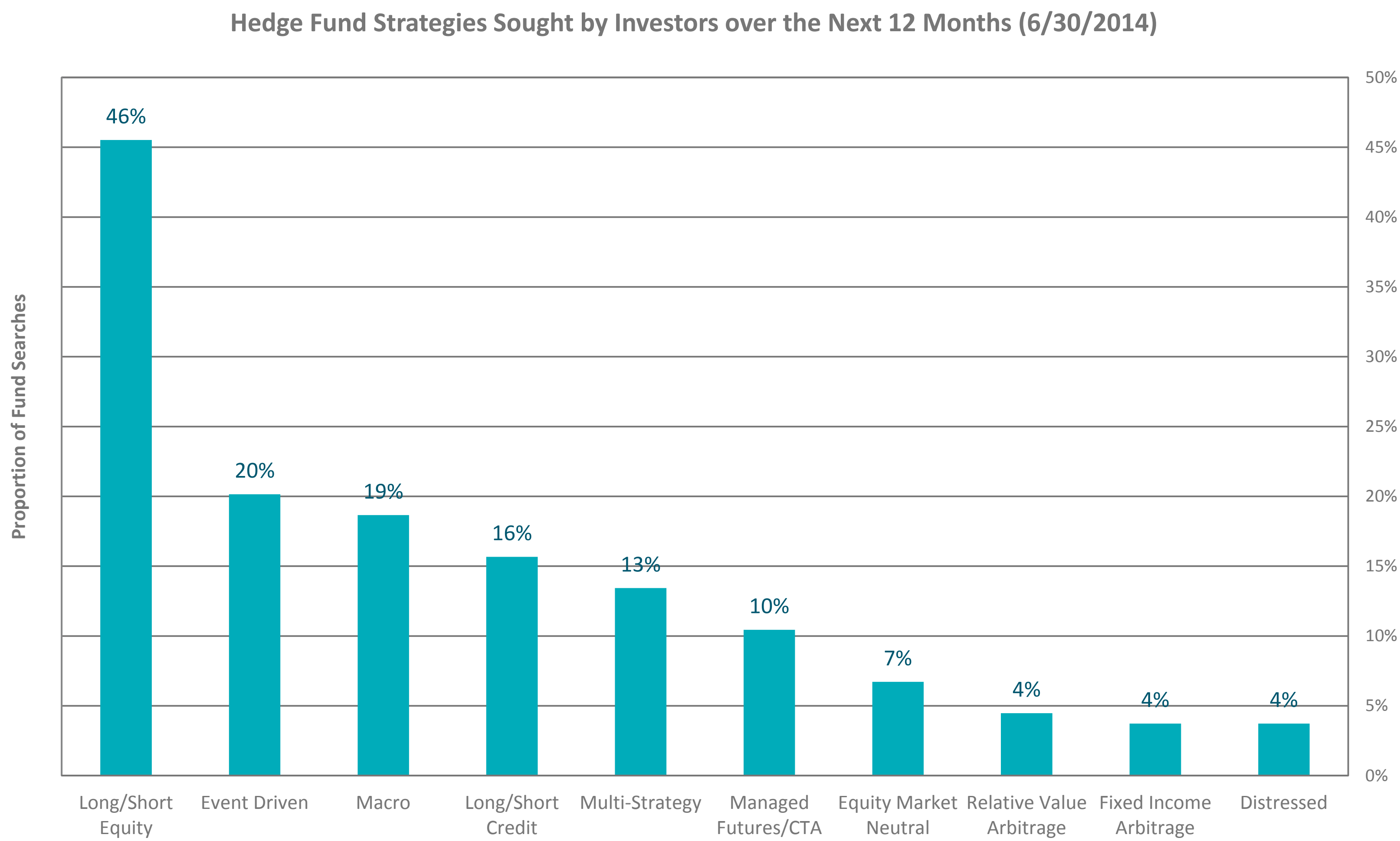
Strategy	Current Environment	Intermediate Outlook
Long-Short Equity	▪ Equity market returns have been driven in part by expansionary monetary policy and improving global growth ▪ This environment has contributed to strong equity market returns that are driven less by earnings growth and more by multiple expansion, resulting in a beta driven market which favors longer-biased strategies	Favorable
Market Neutral	▪ The wind down of quantitative easing should lead to increased attention to fundamentals, supporting increasing price dispersion within and across markets (sectors, countries), and rewarding factor bets	Favorable
Short-Bias	▪ Markets fairly valued to over valued ▪ Normalization of interest rates will increase short-rebate ▪ Volatility is at below-average levels and should rise as monetary policy and growth cycles decouple across nations ▪ Increasing price dispersion within and across markets (sectors, countries) should lead to greater earnings dispersion across equities; a tailwind to returns	Neutral
Emerging Markets	▪ Differences in stage of growth across countries favorable to relative value and macro strategies ▪ Emerging Markets remain susceptible to higher US interest rates ▪ Possible dislocations caused by capital flows creates value opportunities	Favorable

Summary

Strategy	Current Environment	Intermediate
Global Macro	▪ "Unconventional" monetary policy has been responsible in part for asset prices not reflecting economic fundamentals. This will take some time to unwind, suggesting a continuing, but diminishing headwind to macro strategies. ▪ Divergent policy responses to differing macro challenges (wind down of QE, Japanese & ECB reflation theme) creates opportunities for discretionary strategies	Favorable
Managed Futures	▪ Returns continue to struggle in environment that lacks fundamentally driven trends ▪ In near term, managed futures strategies continue to face a number of headwinds including high beta to global equities which trade at high valuations and are subject to market corrections, leaving the defensive characteristics of managed futures in question.	Neutral
Merger Arbitrage	▪ M&A volume has picked up, but arbitrage spreads remain well below their historical average; a headwind to returns.	Neutral
Convertible Arbitrage	▪ Strong equity markets and tight credit spreads have contributed to strong issuance which should lead to cheaper prices, but average valuations are near fair value; a headwind to performance.	Neutral
Fixed Income Arbitrage	▪ The Fed's provision of liquidity has also resulted in low volatility for short-term interest rates and tight credit spreads across assets; a headwind to relative value strategies hoping to capture divergence in fair value spreads between various sovereigns, agencies, and credits. ▪ The decoupling of policy cycles across developed markets should lead to increasing market volatility and provide an array of relative value and flow-driven opportunities.	Neutral

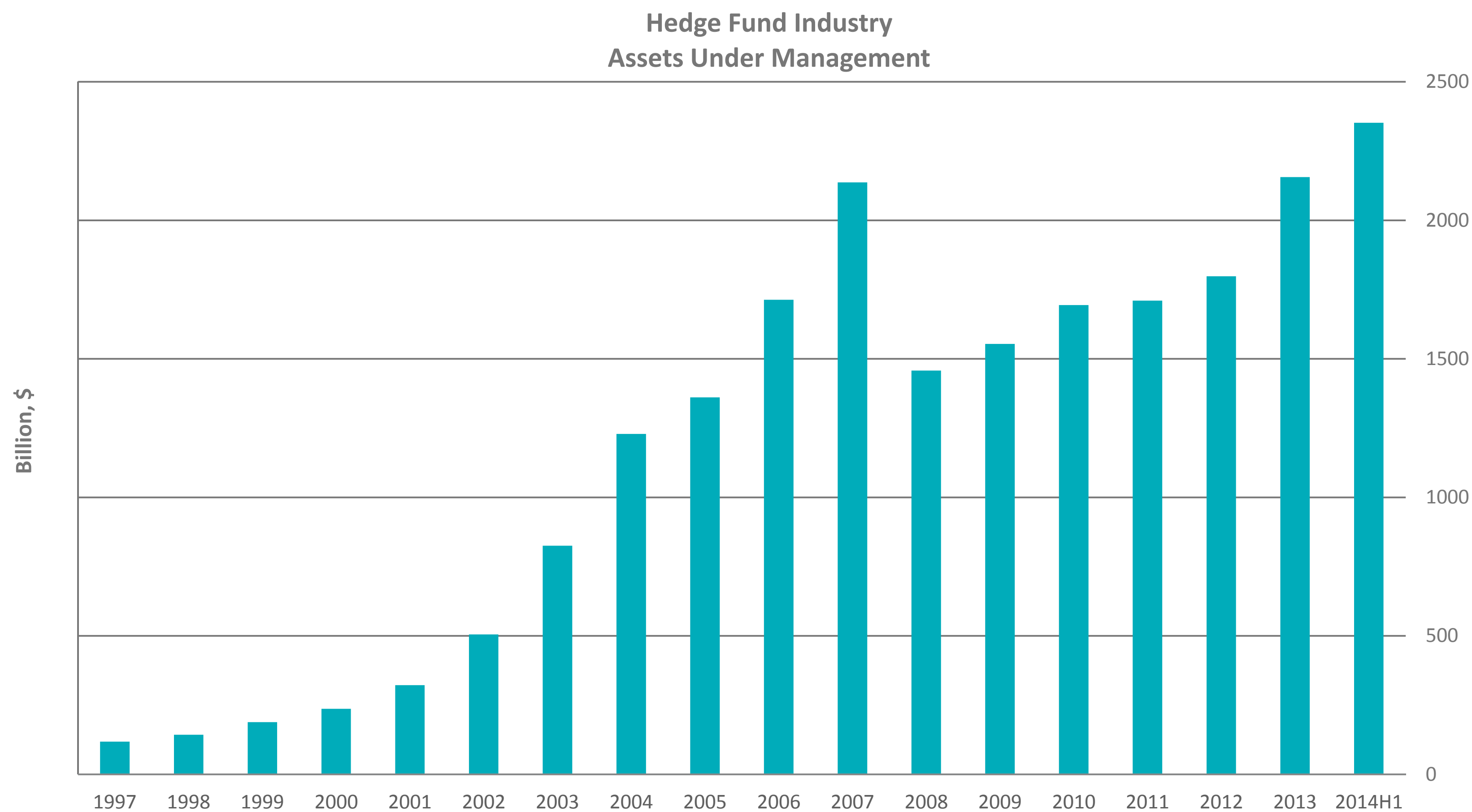
Appendix

Hedge fund searches



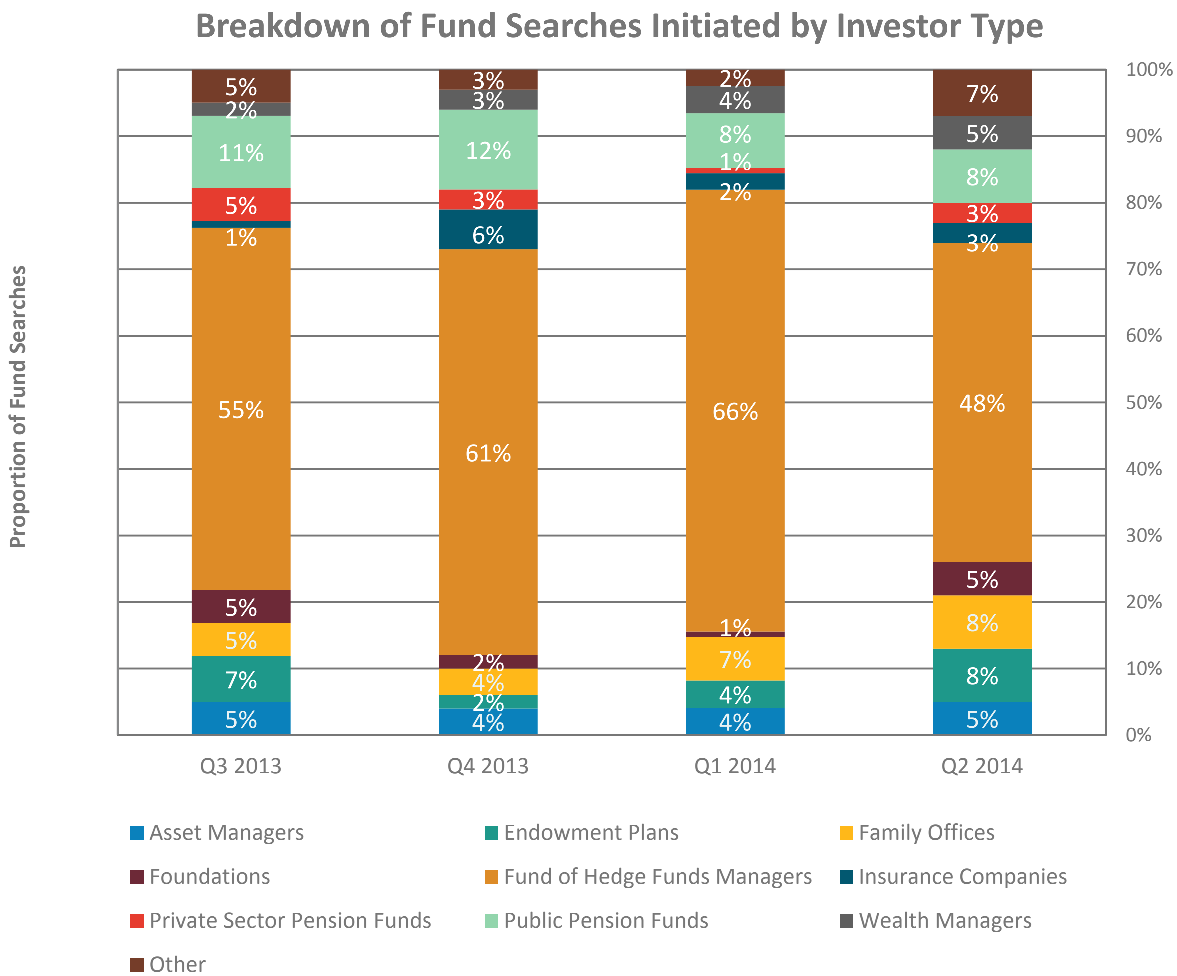
Source: Preqin

Hedge fund assets under management



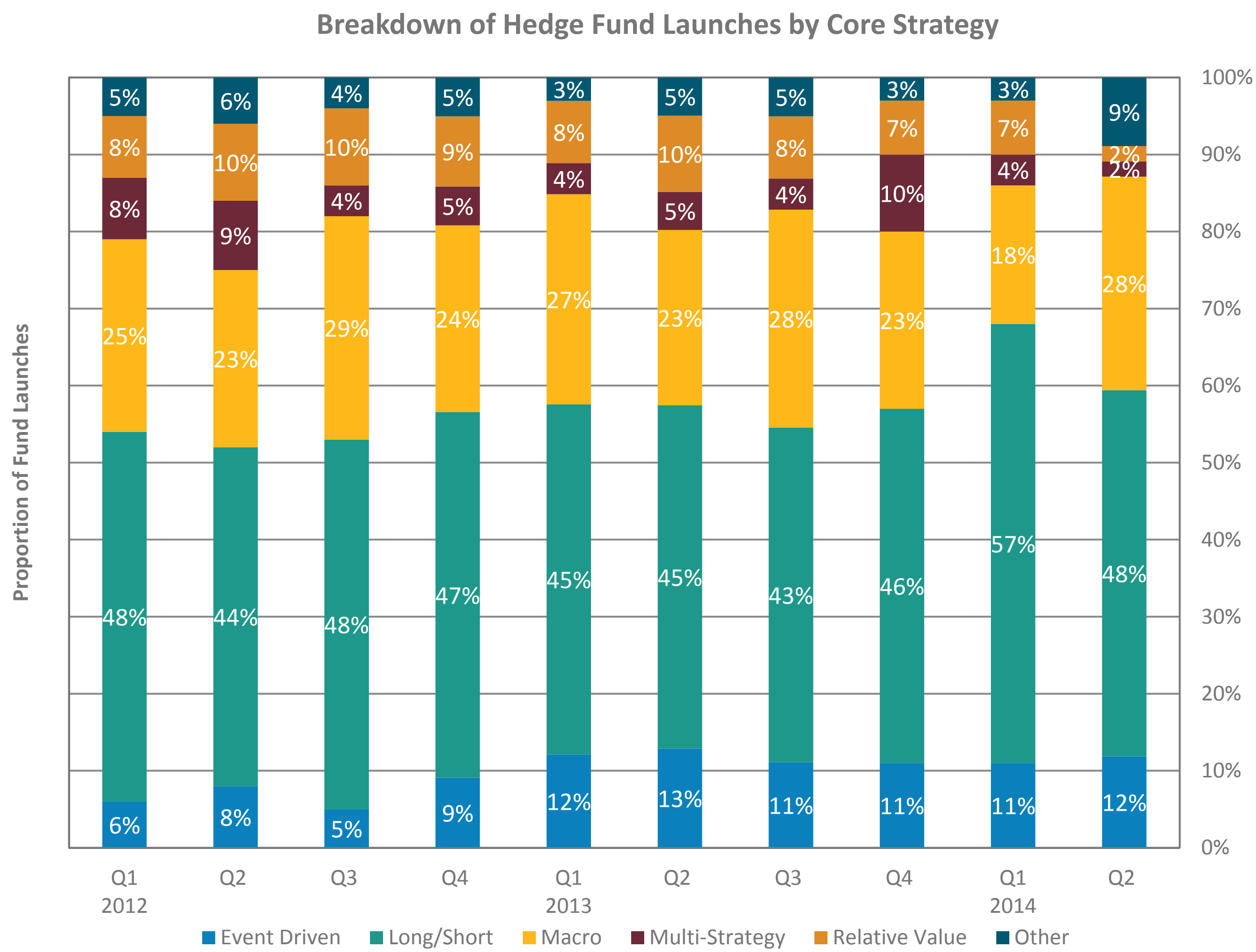
Source: Barclays Hedge

Hedge fund searches



Source: Preqin

Hedge fund launches



Source: Preqin

Hedge fund strategy liquidity

	Strategy	Asset	Security examples
More liquid	Global macro Managed futures Long-short equity Market neutral	**Level 1:** Active markets Daily pricing Daily liquidity	Stocks Currencies Commodities REITs BDCs
	Event driven: merger arbitrage Multi-strategy Relative value Nontraditional bond Long-short debt	**Level 2:** No regular market pricing Fair value based on OTC prices	Corporate bonds Municipal bonds Interest rate swaps CMBS
Less liquid	Event driven: activist Event driven: distressed Private equity buyout Venture capital Private real estate	**Level 3:** Infrequently traded Non exchange traded Most unobservable	Private companies Non-traded REITs Distressed securities

Source: Hatteras

Hedge fund classification and definitions*

EQUITY STRATEGIES

— Long-Short Equity strategies maintain both long and short positions in primarily equity and equity derivative securities. A wide variety of investment processes can be employed to arrive at an investment decision, including both quantitative and fundamental techniques; strategies can be broadly diversified or narrowly focused on specific sectors and can range broadly in terms of levels of net exposure, leverage employed, holding period, concentrations of market capitalizations and valuation ranges of typical portfolios. Equity Hedge managers would typically maintain at least 50% exposure to, and may in some cases be entirely invested in, equities - both long and short.

— Short-Bias strategies employ analytical techniques in which the investment thesis is predicated on assessment of the valuation characteristics on the underlying companies with the goal of identifying overvalued companies. Short-biased strategies may vary the investment level or the level of short exposure over market cycles, but the primary distinguishing characteristic is that the manager maintains consistent short exposure and expects to outperform traditional equity managers in declining equity markets. Investment theses may be fundamental or technical and nature and manager has a particular focus, above that of a market generalist, on identification of overvalued companies and would expect to maintain a net short equity position over various market cycles.

— Market Neutral strategies employ quantitative techniques to analyze price data and ascertain information about future price movement and relationships between securities for purchase and sale. These can include both Factor-based and Statistical Arbitrage/Trading strategies. Factor-based investment strategies include strategies in which the investment thesis is predicated on the systematic analysis of common relationships between securities. In many but not all cases, portfolios are constructed to be neutral to one or multiple variables, such as broader equity markets in dollar or beta terms, and leverage is frequently employed to enhance the return profile of the positions identified. Statistical Arbitrage/Trading strategies consist of strategies in which the investment thesis is predicated on exploiting pricing anomalies which may occur as a function of expected mean reversion inherent in security prices; high frequency techniques may be employed and trading strategies may also be employed on the basis on technical analysis or opportunistically to exploit new information the investment manager believes has not been fully, completely or accurately discounted into current security prices.

— Emerging Markets strategies primarily invest in securities of companies of developing or 'emerging' countries. Emerging Markets regions include Africa, Asia ex-Japan, Latin America, the Middle East and Russia/Eastern Europe. Emerging Markets Global funds will shift their weightings among these regions according to market conditions and manager perspectives.

MACRO STRATEGIES

— Global Macro strategies trade a broad range of strategies in which the investment process is predicated on movements in underlying

Hedge fund classification and definitions*

MACRO STRATEGIES

— economic variables and the impact these have on equity, fixed income, hard currency and commodity markets. Managers employ a variety of techniques, both discretionary and systematic analysis, combinations of top down and bottom up theses, quantitative and fundamental approaches and long and short term holding periods. Although some strategies employ Relative value (RV) techniques, Macro strategies are distinct from RV strategies in that the primary investment thesis is predicated on predicted or future movements in the underlying instruments, rather than realization of a valuation discrepancy between securities. For Macro strategies the overriding investment thesis is predicated on the impact movements in underlying macroeconomic variables may have on security prices.

— Managed Futures, also known as Systematic Diversified strategies have investment processes typically as function of mathematical, algorithmic and technical models, with little or no influence of individuals over the portfolio positioning. Strategies which employ an investment process designed to identify opportunities in markets exhibiting trending or momentum characteristics across individual instruments or asset classes. Strategies typically employ quantitative process which focus on statistically robust or technical patterns in the return series of the asset, and typically focus on highly liquid instruments and maintain shorter holding periods than either discretionary or mean reverting strategies. Although some strategies seek to employ counter trend models, strategies benefit most from an environment characterized by persistent, discernible trending behavior. Systematic Diversified strategies typically would expect to have no greater than 35% of portfolio in either dedicated currency or commodity exposures over a given market cycle.

EVENT DRIVEN STRATEGIES

— Merger Arbitrage strategies focus on opportunities in equity and equity related instruments of companies which are currently engaged in a corporate transaction. Merger Arbitrage involves primarily announced transactions, typically with limited or no exposure to situations which pre-, post-date or situations in which no formal announcement is expected to occur. Opportunities are frequently presented in cross border, collared and international transactions which incorporate multiple geographic regulatory institutions, with typically involve minimal exposure to corporate credits.

— Convertible Arbitrage strategies are predicated on the realization of a spread between related instruments in which one or multiple components of the spread is a convertible fixed income instrument. Strategies employ an investment process designed to isolate attractive opportunities between the price of a convertible security and the price of a non-convertible security, typically of the same issuer. Convertible arbitrage positions maintain characteristic sensitivities to credit quality of the issuer, implied and realized volatility of the underlying instruments, levels of interest rates and the valuation of the issuer's equity, among other more general market and idiosyncratic sensitivities

— Fixed Income Arbitrage strategies are predicated on the realization of

Hedge fund classification and definitions*

EVENT DRIVEN STRATEGIES

— Fixed Income Arbitrage strategies are predicated on the realization of a spread between related instruments in which one or multiple components of the spread is a fixed income instrument backed physical collateral or other financial obligations (loans, credit cards) other than those of a specific corporation. Strategies employ an investment process designed to isolate attractive opportunities between a variety of fixed income instruments specifically securitized by collateral commitments which frequently include loans, pools and portfolios of loans, receivables, real estate, machinery or other tangible financial commitments. The investment thesis may be predicated on an attractive spread given the nature and quality of the collateral, the liquidity characteristics of the underlying instruments and on issuance and trends in collateralized fixed income instruments. In many cases, investment managers hedge, limit or offset interest rate exposure in the interest of isolating the risk of the position to strictly the yield disparity of the instrument relative to the lower risk instruments.

Hedge fund strategy definitions are adopted from Hedge Fund Research (HFR).