3Q2011 IAC Meeting Materials

IAC Meeting – November 22, 2011

Hedge Fund Discussion Presentation

Hedge Fund Discussion

Investment Advisory Council

November 22, 2011

Background

The SBI has not invested in hedge funds to date. However, several developments indicate that now is the time to re-evaluate the position of the SBI regarding hedge funds.

- Discussion of lowering the 8.5% discount rate
- Recent volatile market performance creating more interest in downside protection
- Improved transparency more attractive to institutional investors
- Acceptance of strategy by peers

Learning about hedge fund investing cannot be accomplished by reading books or taking a class. Rather, it is beneficial to discuss this topic with consultants, peers with programs, fund managers and fund of fund managers. These discussions were focused on the following questions.

1. What are hedge funds?
2. What is the role of hedge funds in the total portfolio?
3. What are the risks associated with hedge funds?
4. What are the costs associated with hedge funds?
5. How are programs implemented and maintained?

What are hedge funds?

"A group of skill-based strategies without a benchmark orientation that have the objective of making money in all market environments"
Callan Associates

"A structure to take advantage of an opportunity" *Scott Sousa, Blackstone*

The first hedge fund was established in 1949 to invest in equities, use leverage and sell stocks short to reduce market exposure. There are now more than 9,000 hedge funds of varying strategies and risk levels, and more than $2 trillion invested in these strategies.

The term "hedge fund" is broadly used to describe investment strategies or structures with the following characteristics:

Investment

- Funds have extensive flexibility, including the use of derivatives, both long and short positions, leverage, traditional marketable securities like bonds and equities, as well as non-traditional securities like currencies and commodities

Structure

- Typically private investments, set up as limited partnerships or corporations
- Managers typically invest and are expected to invest their own money in their fund

Administration

- Fund may open and close periodically based on current inflows and investment opportunities
- Liquidity is typically quarterly or annually with appropriate notice

There are two primary types of strategies:

1. Non-directional

   - Attempt to neutralize exposure to market shifts or interest rate moves (lower beta)
   - Source of value added is security selection
   - Examples include equity market neutral and merger arbitrage

2. Directional

   - Capitalize on market exposure
   - Top-down orientation that may include market timing
   - Examples include long/short and global macro

More detailed descriptions of the strategies are included in Appendix A.

What is the role of hedge funds in the total portfolio?

- Diversification –Lower Volatility
- Limit Downside Risk
- Take Advantage of Interesting Opportunities
- Increase Returns
- Absolute Returns

What are the risks associated with hedge funds?

- Political/Headline Risk
- Value-added Risk
- Liquidity Risk
  - Possibility of loss of liquidity in moving markets
  - Margin call risk resulting from a highly leveraged portfolio
  - Access to invested funds

- Change in Strategy Risks

  Strategy is chosen according to how well it fits in total portfolio. If a manager changes strategy without telling investors, volatility may increase

- Size Risk

  The larger the fund, the more difficult it is to move in and out of positions, and fast executions are possible only at large transactions costs. Growth in assets may preclude the fund manager from taking advantage of opportunities

- Lack of Transparency

  This complicates the selection of appropriate funds and performing ongoing risk/return analysis, and complicates risk monitoring, risk aggregation, strategy drift monitoring

- Manager Risk

  Risk of fraud/misrepresentation of performance, false audits, misappropriation of funds, manager going out of business, back office capabilities

- Leverage Risk

  Including increased volatility and counter party risk

What are the costs associated with a hedge fund program?

1. High Fees Relative to Long Only Managers

   Hedge funds typically have base plus incentive fee structures:

   - A base fee of 1-2% based on assets under management plus
   - An incentive fee or "carry" of 20% of the profits earned

   In order to protect investors, many managers institute a "high water mark," which is the level of assets under management below which a fund cannot charge a performance fee.

   Fees can run as high as 2% for a management fee and 20% for an incentive fee.

2. Additional Resources Needed to Administer Program

   - Extensive due diligence and ongoing manager monitoring
   - Monitoring/management (people and systems)
   - Complex investment structures accounting and reporting
   - Experience with non-traditional, sophisticated investment vehicles and trading strategies
   - Legal resources
   - Specialized consulting resources

How are programs implemented and maintained?

Four methods in which a fund can invest in hedge funds:

1. **Direct Investment** – Investor invests directly in one or multiple hedge funds
   - Pros: Greater Control
   - Cons: Research intensive, administratively burdensome, manager cross correlation, single manager risk

2. **Separately Managed Account** – Manager builds a customized portfolio of numerous hedge funds for the particular investor
   - Pros: Ability to customize, negotiate fees, immediate liquidity, position level transparency, fraud deterrent
   - Cons: Costly, limited availability

3. **Hedge Fund of Funds** – Manager builds a diversified pool of hedge funds (usually 30-60) with specified guidelines, open to numerous investors
   - Pros – The F of F manager is responsible for research, selection, monitoring, administration
   - Cons – Higher Fees, lack of control/customization

4. **Hedge Fund Replication (passive)** – Strategies with portfolios of futures and ETFs intended to mirror the performance of a hedge fund index.

    - Pros-Low cost, and liquid
    - Cons-No opportunity for added value

Appendix A

Non-Directional Strategies

Lower Beta Strategies

Non-Directional Strategies

Event Driven

Equity Market Neutral

-Equal dollar exposure of long and short positions resulting in a total net portfolio exposure of zero

- Value-added results regardless of the direction of the market

-Returns are generated to the extent that the prices of the long positions increase and the prices of the short positions decrease

Fixed Income Arbitrage

-Investing in one or more fixed income securities and hedging against underlying market risk by simultaneously investing in another fixed income security

-In general, these strategies employ higher levels of leverage.

Convertible Arbitrage

-Holding a convertible security long and its underlying stock short

-A relative value strategy in which returns should be made as the underlying stock and convertible bond move up or down in price

Merger Arbitrage

-Involves purchase and sale of securities of two companies involved in a merger (or other extraordinary corporate event) with the intent of going long or short the closure of the transaction

-Profit/loss is derived by realizing the price differential between the price of the securities and the value ultimately realized from the transaction

Distressed Securities

-Focused upon the purchase of debt instruments that are mispriced on an absolute or relative basis. May include companies involved in workouts, liquidations, reorganizations, bankruptcies, etc.

-Profits result from the market's lack of understanding of the true value of the deeply discounted securities as well as mispricings

-Strategy may also be categorized as directional

Appendix A

Directional Strategies

Higher Beta Strategies →

Directional Strategies

Long/Short Equity

-Equity alternatives in which managers invest long and short in stocks

-As with traditional equities, managers often specialize by geography, industry, style, and capitalization

- Profits are made when long positions appreciate and short positions depreciate

Global Macro

-Managers seek opportunities in global markets by examining macro-economic data

-Strategy is highly opportunistic as managers look for extreme price valuations sought in stock markets, fixed income markets, interest rates, currencies and commodities

-Profits made by having the flexibility to take advantage of price movements in global markets

Emerging Markets

-Strategy consists of primarily long investments in both equity and debt in countries with developing financial markets

-Similar to traditional emerging markets

-Securities are generally more volatile due to the liquidity constraints

-Profits are made by exploiting the markets for undervalued assets and purchasing them before the market corrects itself

Leveraged Long

-A long-only strategy investing in undervalued securities. Fund can be highly leveraged, and short selling, is used sparingly, if at all.

-Funds are highly sensitive to market movements due to the leveraged positions