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Re: Hedge Funds as Part of a Diversified Investment Portfolio

Dear Client:

For many years, institutional investors have invested in hedge funds as a way to lower portfolio risk and enhance investment returns. More recently, the combination of exceptional volatility and disappointing longer-term equity market performance has fostered an increased interest in hedge fund strategies by individual investors. This interest has resulted in the emergence of products that make investing in hedge funds – or securities employing hedge fund strategies – an option that may be appropriate for investors to consider. In this letter, we provide a brief introduction to hedge fund investments and their potential role in a diversified portfolio.

What are hedge funds?

At the most basic level, hedge funds are simply limited partnerships or limited liability companies that hire advisors to manage securities held by the funds. Hedge fund investments are sold through private placements to limited numbers of accredited investors or qualified purchasers.[1] A hedge fund of funds (FoF), as the name implies, is a hedge fund that invests in other hedge funds.

An important distinction offered by hedge funds is that they typically invest in securities outside the traditional equity, bond, or cash asset classes and implement different strategies than traditional long-only equity, bond, or cash vehicles. This means that, as a group, hedge funds offer returns that may not be correlated with stock and bond returns, which can be helpful in improving the expected risk and return characteristics of a diversified portfolio.

Hedge funds span a broad range of strategies, and even those employing familiar strategies can offer non-correlated returns due to their varying portfolio construction. For example, equity-focused hedge funds may go short as well as long, use derivatives, and leverage their portfolios. The following list outlines some popular hedge fund strategies:

- **Long-Short Equity** is the classic hedge fund strategy, seeking to exploit perceived mispricings by buying undervalued, and selling overvalued, stocks;
- **Market-Neutral Equity** involves the construction of portfolios with offsetting long and short positions of equal dollar amounts using fundamental and/or quantitative selection techniques;

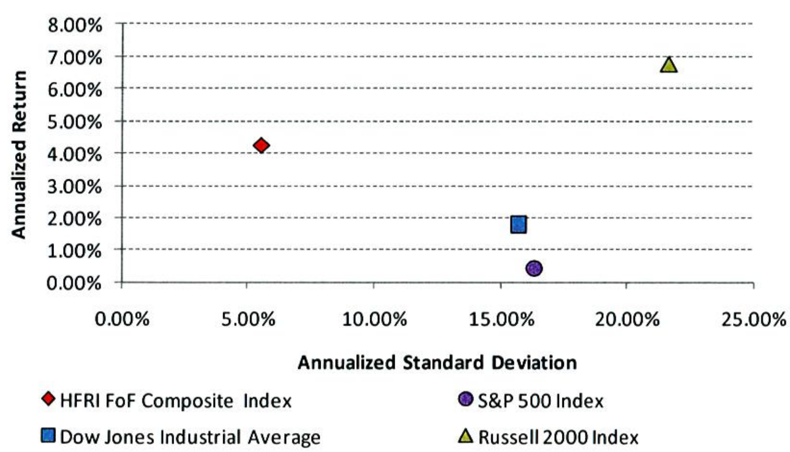
[1] An "accredited investor" generally includes a person whose net worth exceeds $1,000,000 (excluding the value of any primary residence) or who has had income in excess of $200,000 in each of the two most recent years or joint income in excess of $300,000 in each of those years and has a reasonable expectation of reaching the same in the current year. A "qualified purchaser" generally includes a person who owns at least $5,000,000 in investments. The actual definitions of these terms are complex, and investors should confer with their professional advisors to determine whether they qualify as accredited investors or qualified purchasers.

- **Macro Strategies** holds longer-term directional positions across markets based on expected shifts in macro-economic policies, economic trends, political events, and/or supply and demand shocks;
- **Merger Arbitrage** invests in companies that are being acquired or are involved in a merger, often shorting the acquiring company as a hedge;
- **Distressed Securities** invests in the securities of firms that have filed for bankruptcy protection or are trying to avoid bankruptcy by negotiating an out-of-court restructuring with their creditors;
- **Convertible Arbitrage** seeks to exploit perceived mispricings in convertible debt securities and may involve shorting the issuing company's common stock;
- **Long-Short Credit** seeks to buy undervalued, and sell overvalued, corporate bonds across the credit spectrum from high-yield to investment-grade;
- **Managed Futures** pursues a wide range of strategies that are implemented through various futures instruments, such as commodities, currencies, equity indexes, and interest rates.

Hedge funds typically charge a management fee based on the value of the fund investments and a performance fee charged on returns above the high water mark, which is the highest cumulative return attained. Hedge funds usually offer less liquidity than traditional equity and fixed-income investments. Also, investors typically can only sell their holdings periodically, often monthly or quarterly, and may face a lockup, a period of time after their initial investment during which they cannot sell their holdings. For these reasons, hedge fund investments should be evaluated carefully in light of the investor's personal liquidity needs.

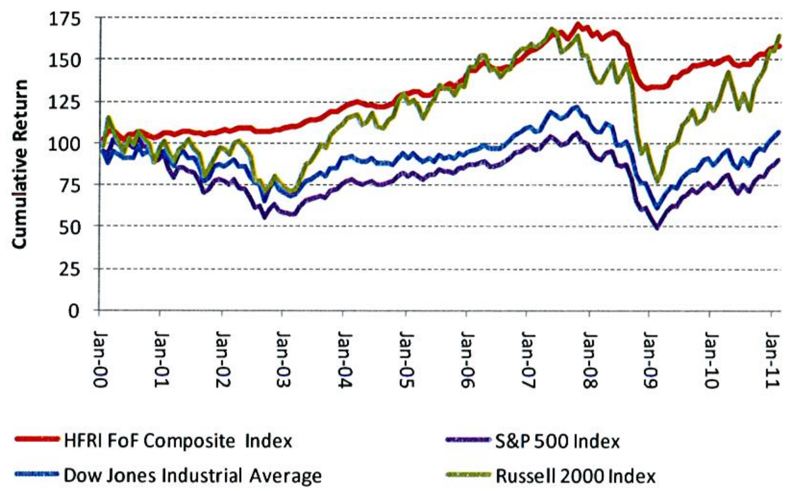
Why invest in hedge funds?

Despite the misperception of hedge funds as risky investments, the key attraction of hedge funds is their potential to improve the expected risk and return characteristics of a diversified portfolio. Many hedge fund strategies have low to moderate correlation with stocks and bonds. Since January of 2000, the HFRI Fund of Funds Composite Index produced higher returns with less risk than both the S&P 500 and DJIA and produced 63% of the return of the Russell 2000 Index with only 26% of the volatility (measured by standard deviation as seen in the chart below).



Sources: HFRI, Bloomberg
Note: Data analyzed from January 2000 through February 2011

One reason for this difference in performance is that hedge funds can serve to protect capital. Since January of 2000, relative to the larger equity markets, hedge funds generally have experienced shallower and shorter declines. This was particularly evident during the 2001-2002 and 2008 equity market downturns.



Sources: HFRI, Bloomberg
Note: Data analyzed from January 2000 through February 2011

How can one invest in hedge funds?

As with any investment, allocations to hedge funds should be made in light of overall portfolio holdings and the investor's objectives, preferences, and constraints. As previously discussed, many hedge fund investments provide limited liquidity.

For individuals who do not qualify as accredited investors or who have liquidity constraints, a variety of mutual funds and exchange-traded funds (ETFs) are available as an alternative to hedge funds. These funds seek to replicate the risk-adjusted return characteristics of hedge funds. Mutual funds that seek to imitate hedge funds generally do so by employing long-short equity strategies. They typically are actively managed funds that have the advantages of more transparency, competitive fees, and better liquidity than private partnerships.

Some ETFs allocate to other ETFs, while others invest in liquid securities. ETFs offer advantages similar to those offered by actively managed mutual funds and may offer even lower fees. Similar to any other passive investment strategy, a disadvantage is that they do not capture the particular ability of a manager to produce excess returns.

Individuals that qualify as accredited investors or qualified purchasers can invest directly into certain FoFs and individual hedge funds. While investing in individual hedge funds allows for specific fund selection, many funds have high minimum investment requirements, reducing the investor's ability to diversify across a variety of different strategies, and all funds require extensive due diligence. FoFs can mitigate some of these issues. As pooled investments, they provide diversification, generally lower minimum investment commitments, and professional due diligence and portfolio management. The major disadvantage is the additional layer of fees.

What diligence is required when investing in hedge funds?

Due diligence for hedge funds requires both qualitative and quantitative analysis. Typically, each hedge fund has a private placement memorandum (PPM) that describes in detail its investment strategy, objectives, risks, and conflicts, and the PPM is presented to and discussed with investors in advance of any investment. In general, however, fund due diligence includes reviewing the following features:

- **Investment philosophy, process, and management** – understanding how the fund invests, the abilities of management, and the competitive environment;
- **Risk management** – reviewing investment guidelines and risk management controls, including who is responsible for monitoring and implementing risk management procedures;
- **Business risk** – evaluating risks such as the potential for limited liquidity in the event of significant withdrawals;
- **Operational risk and controls** – examining operational areas, including portfolio monitoring, trading procedures, cash control, portfolio pricing, NAV calculation, compliance manuals, third-party service providers, and investor relations;
- **Performance measurement and attribution** – understanding the important risks for the particular strategy.

As this list indicates, increased due diligence is necessary when investing in hedge funds. Nevertheless, given the potential for reduced volatility and enhanced returns, hedge funds and alternative investment strategies utilizing mutual funds and ETFs are investments that many individuals should consider. The Colony Group has reviewed and analyzed a variety of investment vehicles and managers in this asset class and can incorporate these opportunities into our asset allocation strategies.

As always, please contact your financial counselor if you would like to discuss how hedge funds and alternative investment strategies can be incorporated into your portfolio. We appreciate the opportunity to be of service to you.

Very truly yours,

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This letter is not to be construed as investment or legal advice and is not an offer for sale of any security. Individuals should seek advice from their financial counselors before undertaking actions in response to the matters discussed herein. This letter is intended for clients and should not be further disseminated. Sources: HFRI, Bloomberg.