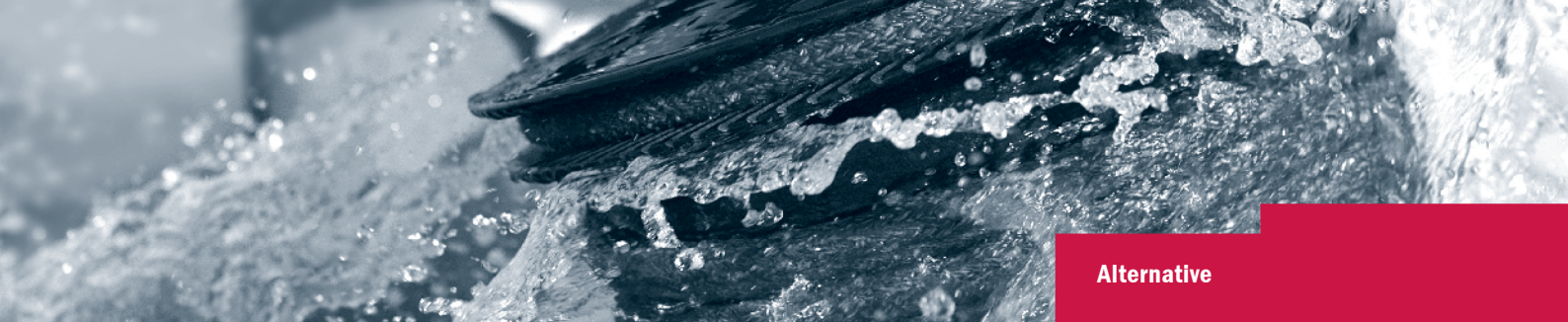


# Demystifying Hedge Funds

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Alternative

## Major Strategies

The breadth of investment strategies used by hedge fund managers makes meaningful comparison difficult. Some funds adopt investment approaches that aggressively pursue capital appreciation, while others target capital preservation with low volatility and stable returns. Three broad classifications are often used to group hedge funds:

## Hedge Fund Classifications

### Market Neutral/Arbitrage

Exploiting pricing discrepancies between closely related securities. Strategies tend to be more focused on diversification, operating independently from the direction of the market. Strategies include: Convertible Arbitrage, Equity Market Neutral and Fixed Income Arbitrage.

### Event Driven

Exploiting discrete events such as bankruptcies, mergers and takeovers that may have the potential to trigger significant changes in valuation. These strategies can be market neutral if constructed using long and short positions that avoid systematic risk in the portfolio. Strategies include: Distressed Securities and Merger Arbitrage.

### Directional/Tactical

Based on forecasting and exploiting broad market trends in equities, interest rates or commodity prices. Typically more performance focused but strategies may target high, low or neutral market correlation. There is often a trade off of higher volatility for these potentially higher returns. Strategies include: Global Macro, Managed Futures, Long/Short Equity, Dedicated Short Bias and Emerging Markets.

## Hedge Fund Growth

Hedge funds are not a new phenomenon, in fact they date back to 1949 when Alfred Winslow Jones effectively became the first hedge fund manager when he neutralised his market risk and exposure by systematically combining long investments in undervalued stocks (i.e. buying securities that are expected to rise in value), with short positions in overvalued stocks, (i.e. borrowing and then selling securities whose prices are expected to fall). However, it was during the 1990's that hedge fund numbers rapidly began to increase.

From a figure of around 600 in 1990,<sup>18</sup> there are now over 9,800 hedge funds in the marketplace, managing assets of over \$1.7 trillion. Much of this growth is attributable to the increasing importance that both institutional investors and wealthy individual investors are assigning to the absolute return and diversification benefits of this asset class.

## Why are Hedge Funds different from Mutual Funds?

### Absolute Returns:

While there is no universally accepted definition, a hedge fund's main objective is to produce positive returns irrespective of market direction; that is targeting 'absolute returns'. Mutual funds are often classified as relative return products as they are benchmarked against an index or a peer group.

### Skill Based Investing:

Whereas traditional mutual funds rely to a large degree on the direction of market performance, hedge funds are much more dependent on the skills of the fund managers.

### Minimum Investment Levels:

High minimum investment levels reflect the fact that hedge funds have historically targeted high net worth investors and institutions. However, as some regulators recognise the benefits of hedge funds, there has been a relaxation of minimum investment criteria in certain markets.

### Liquidity and Capacity:

As hedge funds generally require a stable asset base, liquidity (or the frequency of subscription and redemption), is often limited to monthly, quarterly or yearly 'lock-in' periods. Hedge funds should, therefore, be seen as a medium to long-term holding. Many hedge funds limit investment capacity and close to new investors once capacity is reached.

### Performance Fees:

The hedge fund manager typically takes a fee based on a percentage of realised positive returns subject to beating a pre-determined minimum return target, or watermark. Performance fees have helped to attract some of the best fund management talent into the asset class and act as strong incentives for producing superior returns.

## Techniques Used

Hedge fund managers have much greater investment flexibility than traditional managers and are able to employ a broad range of financial strategies and instruments including short selling, leverage and derivatives. This is in contrast to traditional asset management products that can only use a limited set of investment tools.

→ **Short Selling:** The ability to sell stocks that an investor does not own in the hope of being able to buy the stocks back at a lower level thus generating a profit. Short sellers make money when shares they have "shorted" go down and typically do well when stockmarkets fall.

→ **Derivatives:** A contract whose value is contingent upon the performance of an underlying financial asset, index, or other investment. The price movements of a derivative generally follow the price movements of the underlying assets but derivatives generally require only small amounts of capital (margin) to gain exposure to the underlying asset.

→ **Leverage:** The effect of 'gearing up' or magnifying exposure to an investment strategy, manager or asset. Leverage can be achieved by borrowing capital or by using derivatives.

# Why Invest In Hedge Funds?

## Low Correlation With Traditional Investments

The most compelling reason for adding hedge funds to a traditional portfolio is that they generally have a low correlation with the stock and bond markets that comprise the core of most portfolios. In this case, we can see the low correlation between the CSFB/Tremont Hedge Fund Index and a selection of leading indices. In contrast, the MSCI World Index has a high correlation with other regional indices, highlighting the degree to which major equity markets are now moving in concert.

## Downside Protection/UpSide Potential

The capability of hedge funds to protect investors through bear markets is derived from the use of flexible financial instruments resulting in low correlation to the broader

markets. The chart (below) highlights the positive performance of the CSFB/Tremont Hedge Fund Index during the dramatic equity losses 2000-2002. While hedge fund returns may have lagged the equity rebound in 2003, the diversification potential that hedge funds offer has been widely accepted by many investors.

## Diversification Benefits For Portfolios

The example (below) illustrates how an efficiently invested portfolio comprised of varying percentages of equities and bonds (as represented by the S&P 500 Index and the JPM Global Bond Index), is impacted by adding a percentage allocation to hedge funds. What is clear is that hedge funds offer the potential to increase returns and at the same time reduce risk.

### Correlation Matrix

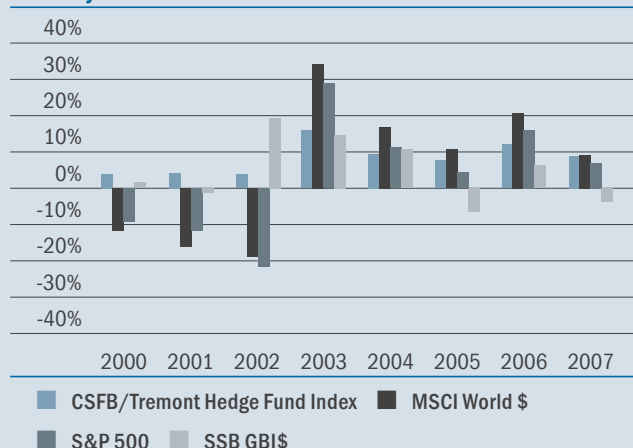
CSFB/Tremont Hedge Fund Index	
Dow	0.41
MSCI World \$	0.49
MSCI EAFE \$	0.44
S&P 500	0.49
NASDAQ	0.40

MSCI World \$ Index	
Dow	0.88
MSCI World \$	1.00
MSCI EAFE \$	0.94
S&P 500	0.94
NASDAQ	0.85

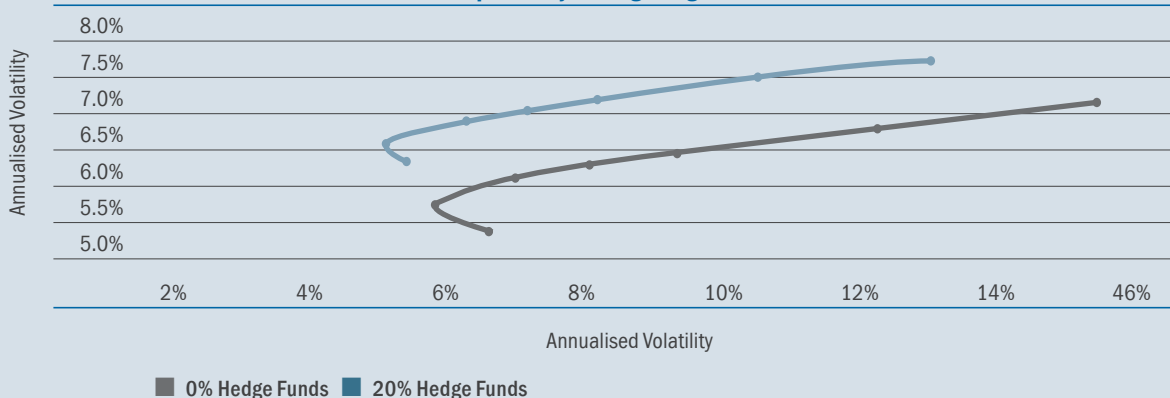
Source: hedgeindex.com. Data as at June 2007 based on correlation back to Jan 1994

### Yearly Returns



Source: Pioneer Alternative Investments. Data as at end June 2007.

### A Traditional Efficient Frontier can be Improved by Adding Hedge Funds



Source: Pioneer Alternative Investments. Data as of June 2007 based on correlation back to June 1997.

# Why Invest In Funds of Hedge Funds?

Investors looking for exposure to hedge funds have a plethora of choices. One option is to invest with a multi-manager who will combine several managers within one fund, known as a fund of hedge funds. This can be a particularly attractive route for investors as risk and volatility may be reduced when several strategies are combined, especially if each strategy is uncorrelated.

## Fund of Hedge Fund Benefits

By taking the multi-manager route, the investor benefits from professional manager selection, asset allocation and portfolio construction. Successful

multi-managers typically derive their 'edge' through the quality of their ongoing due diligence and analysis of the underlying fund managers and their strategies.

In addition, many single strategy funds are offered only to known investors or funds of hedge funds and are often closed once capacity is reached. Consequently, funds of hedge funds can sometimes be the only way of accessing the most exceptional single strategy managers. Typically the minimum investment criteria is lower for a fund of hedge funds than it is for a single strategy product.

## Summary

In today's uncertain equity and fixed income markets, institutions and high net worth individuals are paying more attention to hedge fund strategies. They offer many interesting investment opportunities and are becoming more widely accepted globally.

Although hedge funds have the appearance of being complicated investment vehicles, they often employ quite simple investment strategies but with a greater degree of flexibility than typical mutual fund investments. As a result, many of today's hedge funds have the potential to offer the following benefits:

- *Capital Preservation*: Aiming to avoid losses during bear market cycles
- *Increased Portfolio Diversification*: Achieved through low correlation to traditional markets
- *Targeting Absolute Returns*: Focus on achieving absolute not relative returns
- *Portfolio Customisation*: Ability to tailor portfolios through either single strategy funds or funds of hedge funds
- *Access to Financial Talent*: Hedge Funds are increasingly attracting the best and brightest fund managers

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