

2011

INVESTMENTS

BROADER OPTIONS, FEWER CONSTRAINTS: A FRESH LOOK AT HEDGE FUNDS

In today's challenging times, the Atlantic Trust Asset Allocation Committee believes that hedge funds should be an integral part of a well diversified portfolio. Just as it took many years for the case for international investing to be generally accepted, the time has come to acknowledge the diversification and risk reduction benefits of hedge funds. Despite the mystery and misconceptions that generally surround hedge funds, at their core they remain a fairly simple structure with a flexible mandate.

Multi-Manager Investment Program Hedge Fund Research

Alan Fields
Managing Director

Jigar Patel, CFA
Senior Vice President

Ohm Srinivasan, CFA
Senior Vice President

Hedge funds have a long track record dating back to the 1950s.¹ Some of the world's most influential and well known investors had their beginnings and operated their business in a hedge fund format – A.W. Jones, George Soros, Michael Steinhardt, Julian Robertson, Barton Biggs, Warren Buffett and Jim Simons, to name a few. Because hedge fund structures provide a compensation incentive tied to investor profits, cream-of-the-crop talent will continue to populate this industry. Stringent regulation of major financial institutions in the Dodd-Frank Act, passed in 2010, will further intensify the drive of investment talent towards this most entrepreneurial format.

By definition, hedge funds are an investment vehicle through which managers have broader options and fewer constraints than typically faced by traditional equity and fixed income managers. The core philosophy of a hedge fund manager rests on capital preservation and achieving favorable risk-adjusted returns. The compensation structure, in which the manager and investor share in the profits, better aligns the interests of the parties than a traditional manager or mutual fund that charges a management fee irrespective of results.

Past, Present and The Future of Hedge Funds

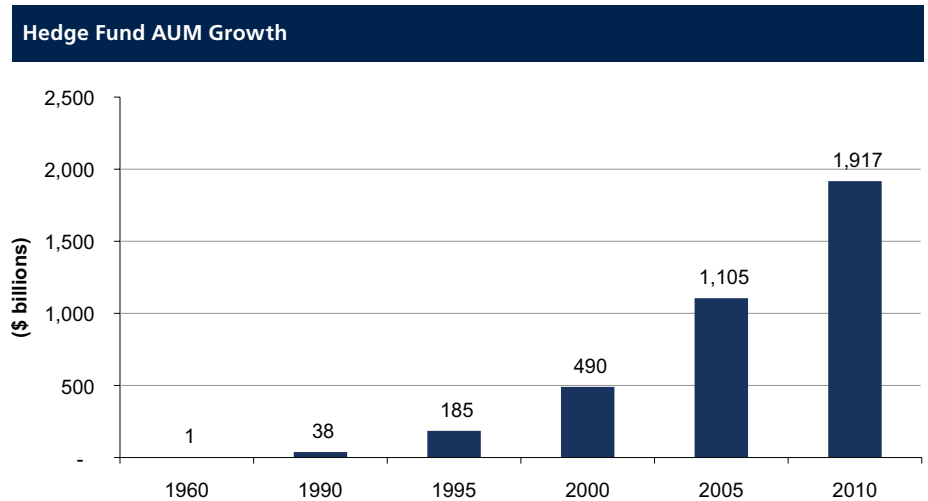
The hedge fund structure was established in 1952 with the formation of the A.W. Jones partnership.² This unique operating structure enabled Jones to "hedge" its long positions against "short" positions in order to offset market risk of the overall portfolio. Leverage was used to broaden the opportunity set. A W. Jones invented the concept of performance or incentive fees charged over and above a fund's "high water mark" which is still a standard practice in the hedge fund industry today.³

ATLANTIC TRUST

PRIVATE WEALTH MANAGEMENT

Study the past if you would define the future - Confucius

The first growth wave of the hedge fund industry occurred in the 1960s, led by sophisticated high net worth individuals.² The second wave occurred in the late 1980s after large institutions started to allocate to hedge funds.⁴ The institutional flows were further intensified after hedge funds outperformed major indices during the “tech bubble” in the early 2000s. Since the 1990s, assets continued to grow at 8 to 10% annually and peaked at \$1.86 trillion in 2007, before the credit crisis of 2008. By the end of 2010, assets surpassed the previous peak, reaching an all time high of \$1.91 trillion (see chart).



Source: HFR [2010], Fortune [1969]

Whereas a handful of hedge funds (like Paulson) posted spectacular gains during the 2008 credit induced market collapse, the majority of hedge funds registered disappointing losses. Nonetheless the majority of hedge funds were able to achieve results that were relatively favorable to long only managers by utilizing their basic tools of risk management i.e. hedging long positions and maintaining a diversified approach across a broader range of investment options.

We believe the hedge fund industry is poised to begin the third “super wave” of asset growth. Total industry assets are estimated to grow to \$2.6 trillion by 2013. The underfunded U.S. pension funds that continue to have high investment assumption rates have recognized that in a world of low interest rates the hedge fund asset class offers the opportunity for higher returns than traditional fixed income with less market volatility than long-only equity. Industry estimates suggest that U.S. pension funds alone are expected to allocate \$252 billion to hedge funds by 2013. Despite this trend it is estimated that hedge funds will still only constitute 5.5% of a pension fund’s total assets by 2013. In short, the hedge fund industry has high potential for asset growth in the future.⁵

Since the inception of this industry, a flexible philosophy has enabled hedge fund managers to adapt to various market cycles by broadening strategies from the traditional equity long/short. By combining fundamental and technical analysis, hedge fund managers have been able to protect capital and produce more favorable risk-adjusted returns.

What Is a Hedge Fund?

Hedge funds are largely unregulated private pools of capital and are generally not subject to the same disclosure and regulatory requirements as registered investment advisers or mutual funds.⁶ “A hedge fund constitutes an investment program whereby the managers or partners seek absolute returns by exploiting investment opportunities while protecting principal from potential financial loss.”⁷ This definition highlights two important aspects of hedge funds: producing attractive risk-adjusted returns by utilizing a flexible mandate and avoiding large losses through the utilization of various hedged strategies. The flexible mandate provides the managers with tools to adjust the portfolio’s risk profile as conditions change.

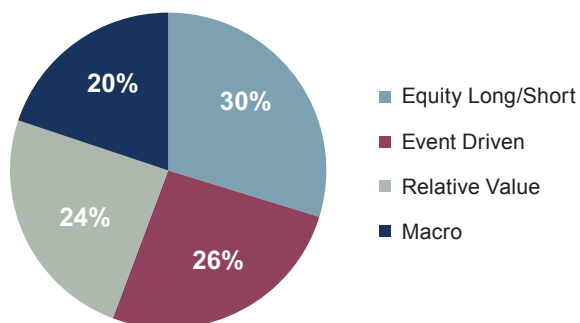
A hedge fund is not a separate asset class like stocks, bonds and currencies. Rather it is a format or structure that provides a platform for a variety of flexible investment mandates.

Hedge Fund Strategies Defined

Hedge funds are able to deploy a variety of strategies to generate profits. The total number of strategies can be difficult to define as every strategy is generally customized by the manager to maximize his or her investment team’s aggregate skill set. According to Hedge Fund Research (HFR), an industry leader in hedge fund research, hedge funds employ one of five broad strategies – equity long/short, event driven, relative value, global macro and fund of funds.⁸

Equity long/short strategy involves capturing investment opportunities on both long and short positions by conducting fundamental equity research. The style of investment can entail growth, value, or a more opportunistic approach. The investment thesis generally revolves around the fund manager having a much differentiated view of a company than others do. Over time, as the market discovers the mispricing, the manager profits as the price of the company stock approaches the manager’s pre-defined price target of the company. The manager can be a generalist, sector or regional specialist. Within the hedge fund universe, equity long/short is the most prolific strategy, representing approximately 30% of the industry’s assets under management.⁸

Hedge Fund Industry AUM



Source: HFR

If all risks were hedged, so would be the returns – Alexander Inechein

"In a volatile world, opportunities and risks will appear and disappear in short order. Flexibility has to be the watch word" – Peter Bernstein

Event driven strategy involves profiting from companies involved in corporate transactions such as mergers and acquisitions, restructurings, buybacks, financial distress, debt exchanges and various other capital structure adjustments. The managers tend to allocate across the capital structure of a company and can invest in debt or equity of the company. The investment thesis depends on analyzing the impact of the "corporate event" and how its outcome will change the price of the underlying security in the manager's favor. A bankruptcy judge's decision on how a company should restructure is a good example of event driven investing in the distressed arena. As such, Merger Arbitrage, Distressed and Activist investing are common examples of an event driven strategy. This strategy in aggregate represents about 25% of the market today by assets.⁸

Relative value strategy involves identifying valuation discrepancies between multiple securities using fundamental or non-fundamental/quantitative measures of analysis. The security type can involve equity, fixed income, currency, commodity and derivatives. The strategy can be discretionary or fully systematic. Within equities the discrepancy can be based on fundamental metrics between two similar companies or statistical differences in pricing between the two. The strategy can also invest in corporate activity as well, but unlike event driven strategy, the relative value manager will trade purely on the basis of pricing discrepancies between securities, whereas the event driven manager will rely on the "event" or the outcome of the single security. Statistical arbitrage or 'pairs trading' is a classic relative value strategy. Fixed income arbitrage, convertible arbitrage and volatility arbitrage are few other common examples of this strategy. Relative value today represents close to 25% of the total hedge fund AUM.⁸

Global macro/CTA strategy involves analyzing the impact of changes in economic variables globally on a variety of asset classes. Global macro managers generally trade a broad range of strategies ranging from currencies and commodities to debt and equity. In order to profit, a manager must be skillful in correctly assessing the economic and other macro shifts globally and have a significant portion of returns come from "market timing" and strong risk management. Within equities, the managers call the direction of markets using top down analysis as compared to a bottom up analysis conducted by equity long/short managers. A global macro manager may take directional bets on any asset class or region. Global Macro strategy today represents approximately 20% of the industry's assets under management.⁸

Fund of fund strategy involves creating a diversified portfolio of hedge funds by allocating to one or more of the strategies mentioned above. The investor's return is dependent on the fund of fund manager's ability to select the appropriate strategy weights and manager selection skills.⁸

The Case for Hedge Funds

1) Alignment of interests

Hedge fund managers typically earn a fixed management fee and a performance or "incentive fee." If the manager profits in the first year but incurs losses in a subsequent year, the manager has to recoup the losses first before earning any incentive from the profits generated. This is referred to as a "high water mark" provision. In many cases, hedge fund managers are the largest investor and have a significant portion of their net worth invested in the fund. The high water mark and co-investment concepts are keys to aligning the interest of managers with their investors. Both the compensation structure and having "skin in the game" are key factors in driving the performance-oriented focus of the hedge fund industry.

“The essence of investment management is the management of risks, not the management of returns” – Benjamin Graham

2) Flexible investment mandate

Hedge fund managers use a variety of strategies and can invest in any geography or asset class to generate “alpha” (relative outperformance versus a benchmark). The managers are able to “short” and use derivatives to hedge their portfolios. Since hedge funds are not tied to any benchmarks, the managers have full discretion to make any tactical bets by changing asset classes, regions, sectors and position size, on a dynamic basis. This flexible structure allows the manager to construct a portfolio which is expected to have lower correlation to markets.

3) Asymmetric returns

By having a direct exposure to the markets, an investor can generate a return that is “symmetric” to the market. To that extent, most mutual funds and any passive investment strategy like index funds or exchange traded funds (ETFs) have returns that are “symmetric” to the market. Most mutual funds and passive strategies capture both the upside and the downside market returns in a “symmetrical” fashion. Hedge funds are designed to have an “asymmetric” portfolio as they generally capture a significant portion of the upside but generally not a significant portion on the downside.⁹

4) Active vs. passive investment

Hedge funds are a prime example of an active investing strategy. Active investing is a process of strategically updating portfolio exposures by optimizing positions within a business cycle. The key facet of active investment is the ability to structure a portfolio that adapts to changing market conditions. As markets change, investment opportunities change. Only a dynamic investment strategy can fully adapt and profit from it. Historically, hedge funds have successfully created “alpha” over various business cycles using an active investment strategy. A passive investment, by definition, cannot make strategic or tactical shifts in a portfolio.

5) Diversification benefits

Hedge funds have historically added value to a balanced portfolio by providing lower correlation “to the direction of the markets” versus traditional market indices. In summary, the addition of hedge funds to a traditional portfolio generally reduces risk and increases the potential to outperform a traditional balanced portfolio (see chart below).

The benefit of hedge funds as an integral part of a well diversified portfolio...

The Challenging Decade – 12/31/2000 to 12/31/2010				
	Annualized Return	Annualized Volatility	Market Correlation	Maximum Drawdown
Equity Index	1.5%	16.3%	100.0%	-50.9%
Aggregate Bond Index	6.0%	3.8%	-8.1%	-3.8%
Hedge Fund Index	7.1%	6.5%	80.6%	-21.4%
Asset Allocation Benchmarks				
60% Equities/40% Bonds	3.6%	9.8%	98.8%	-32.5%
40% Equities/40% Bonds/20% Hedge	4.4%	8.0%	97.4%	-27.8%

Source: Bloomberg, December 2010. S&P 500 is used as a proxy for the Equity Index, Barclays U.S. Aggregate Bond Index is used as proxy for the Aggregate Bond Index and Hedge Fund Research Index (HFRI) is used as a proxy for the Hedge Fund Index.

“Only when the tide goes out that you see who has been swimming with their trunks off” – Warren Buffett

6) Talent

The incentive compensation structure of hedge funds helps attract some of the best talent in the financial industry. The regulatory changes of 2010 significantly increased the talent pool in the hedge fund industry as proprietary traders who once were only available to generate profits for the investment banks are now setting up their own funds.¹⁰ The hedge fund business is about “investing in talent” and the availability of talent is at an all time high. We believe the current climate will clearly benefit hedge fund investors.

Considerations and Challenges in Hedge Fund Investing

An investor must consider fees, liquidity and transparency characteristics before investing in hedge funds. In addition, hedge fund strategy and manager selection can pose additional challenges for investing in this asset class.

1) Fees

Hedge funds typically charge a management fee ranging from 1 to 2% and an incentive fee ranging from 10 to 20%. As a comparison, an ETF fee can range from 6 to 85bps and fees for a mutual fund can range from 75 to 120bps.¹¹ We believe higher fees are justified for hedge fund managers that have a proven skill set in producing higher risk-adjusted returns (net of fees) when compared to traditional benchmarks.

2) Liquidity

Hedge funds pose two types of liquidity constraints for investors. Their investment terms are generally more stringent than their traditional counterparts, with most funds typically having monthly subscriptions and quarterly redemptions with 45 days’ notice.¹² The investment terms generally reflect the liquidity of the underlying positions and are set to reduce asset/liability mismatch between redeemable portfolio value and investor redemptions. The portfolio liquidity of hedge funds varies by strategy and underlying assets deployed by the managers.

Generally speaking, managers deploying equity strategies have fairly liquid portfolios and the ability to cover their positions to fund client redemption requests. Managers using credit instruments to employ their strategies are generally less liquid (distressed credit for example). The liquidity profile of the hedge fund portfolios can be reasonably estimated by conducting a comprehensive investment, risk and operational due diligence of the hedge fund strategy and gaining an understanding of the typical portfolio construction and investment profile of the particular manager.

3) Transparency

Hedge fund managers are not regulated and are not mandated to display all their portfolio positions to the public. In the U.S., managers with investment discretion of at least \$100 million report their holdings to the SEC and public every quarter.¹³ Since the credit crises of 2007-08, most managers have increased their portfolio transparency to investors and many managers will give full transparency upon request by an investor.

	ETF	Long Only	Hedge Funds	Private Equity
Fees	Lowest	Low	Medium	Medium
Liquidity	Highest	Highest	Varies ¹⁴	Low
Transparency	Highest	Highest	Varies	Low
Alpha Expectation ¹⁵	None	Low	High	High
Volatility	High	High	Medium/Low	Low

4) Strategy & manager selection

Hedge fund strategies have different risk/return characteristics. The dispersion of manager returns can also vary over time. As a result, manager selection is critical during hedge fund portfolio construction. Hedge funds are a simple business from an investment standpoint but some funds tend to be more complex in terms of their operational setup. An assessment of the soundness of a fund's operational infrastructure is a key aspect of determining the hedge fund as an ongoing business entity. A seasoned team of investment and operational due diligence specialists should be able to screen appropriate hedge fund investments tailored to client needs.¹⁶

Conclusion

In today's challenging times a hedge fund allocation should be considered as an integral part of a well diversified portfolio. A flexible investment philosophy which provides the opportunity for favorable risk-adjusted returns and an incentive structure which aligns clients and manager interests are compelling reasons to consider the inclusion of this investment vehicle in a well diversified portfolio. Atlantic Trust has a long history of successful investing in hedge funds. Atlantic Trust remains committed to hedge fund research and management and will continue to allocate our resources to top talent within the industry.

As always, the most important asset allocation discussion is between you and your relationship manager. Every client portfolio is managed to address customized objectives. Therefore, some of the recommendations referenced above may not be appropriate for your specific situation, so please speak with your relationship manager about balancing the risks of hedge funds with the stated benefits.

Please contact the Multi-Manager Hedge Fund Team if you have any additional questions:

Alan Fields

Managing Director
 afields@atlantictrust.com

Jigar Patel, CFA

Senior Vice President
 jpatel@atlantictrust.com

Ohm Srinivasan, CFA

Senior Vice President
 osrinivasan@atlantictrust.com

"I wish Karl would accumulate some capital, instead of just writing about it"
 – Mother of Karl Marx

¹ Fortune Magazine [1969]

² Fortune Magazine [1969], Roger Lowenstein's Buffett: The Making of an American Capitalist, The SuperInvestors of Graham and Doddsville [1984]

³ A "high water mark" is a standard provision among hedge funds which aligns investor interest with the manager. If the manager profits in the first year but incurs losses in a subsequent year, the manager has to recoup the losses first before earning any incentive from the profits generated.

⁴ Yale Endowment letter [2000]

⁵ BNY Mellon and Casey Quirk Analysis [2009]

⁶ SEC website - <http://www.sec.gov/rules/final/ia-2333.htm>

⁷ Ineichen[2003a], p.34

⁸ Hedge Fund Research [HFR, 2010]

⁹ Asymmetric Returns – The future of active management[2007]

¹⁰ Bloomberg [2010] <http://www.bloomberg.com/news/2011-01-10/goldman-sachs-proprietary-traders-roskis-benatoff-planning-own-hedge-fund.html>

¹¹ Bloomberg[2010]

¹² Hedgefund.net

¹³ <http://www.sec.gov/answers/form13f.htm>

¹⁴ Liquidity and Transparency varies by hedge fund strategies. For example Equity Long/Short is generally liquid and transparent in terms of their portfolio holdings. Event Driven Distressed is generally less liquid and less transparent.

¹⁵ "Alpha" is the excess return on an investment over a benchmark [Hedgefund-index.com - http://www.hedgefund-index.com/d_alpha]

¹⁶ Please contact Atlantic Trust hedge fund team for additional information on investment and operational due diligence capabilities

Atlantic Trust Private Wealth Management includes Atlantic Trust Company, a division of Invesco National Trust Company (a limited-purpose national trust company), and Stein Roe Investment Counsel, Inc. (a registered investment adviser), both of which are wholly-owned subsidiaries of Atlantic Trust Group, Inc. This document is intended for educational purposes only and the material presented should not be construed as an offer or recommendation to buy or sell any security. Concepts expressed are current as of the date of this newsletter only and may change without notice. Such concepts are the opinions of our investment professionals, many of whom are Chartered Financial Analysts® (CFA®). The CFA designation is a globally recognized standard for measuring the competence and integrity of investment professionals. Certified Financial Planner Board of Standards Inc. owns the certification marks CFP® and CERTIFIED FINANCIAL PLANNER™ in the U.S.

There is no guarantee that these views will come to pass. Past performance does not guarantee future comparable results. To ensure compliance with requirements imposed by the IRS, we inform you that any U.S. federal tax advice contained in this communication (including any attachments) is not intended or written to be used, and cannot be used, for the purpose of (i) avoiding penalties under the Internal Revenue Code or (ii) promoting, marketing or recommending to another party any transaction or matter addressed herein. Atlantic Trust does not provide legal advice, and the information contained herein should only be used in consultation with your legal, accounting and tax advisers. To the extent that information contained herein is derived from third-party sources, although we believe the sources to be reliable, we cannot guarantee their accuracy.

Investment Products Offered are Not FDIC-Insured, May Lose Value and are Not Bank Guaranteed. For Public Use 03/11.

Atlanta 404 881 3400	Chicago 312 368 7700	New York 212 259 3800
Austin 512 651 7800	Denver 720 221 5000	San Francisco 415 433 5844
Baltimore 410 539 4660	Houston 713 214 7640	Washington, D.C. 202 783 4144
Boston 617 357 9600	Newport Beach 949 660 0080	www.atlantictrust.com

ATLANTIC TRUST
PRIVATE WEALTH MANAGEMENT