

Emerging Manager Out-Performance:

Alpha Opportunities from
the Industry's Newest Hedge Fund Managers



Leading the Way in Transparent Hedge Fund Investing

HFR
Asset Management

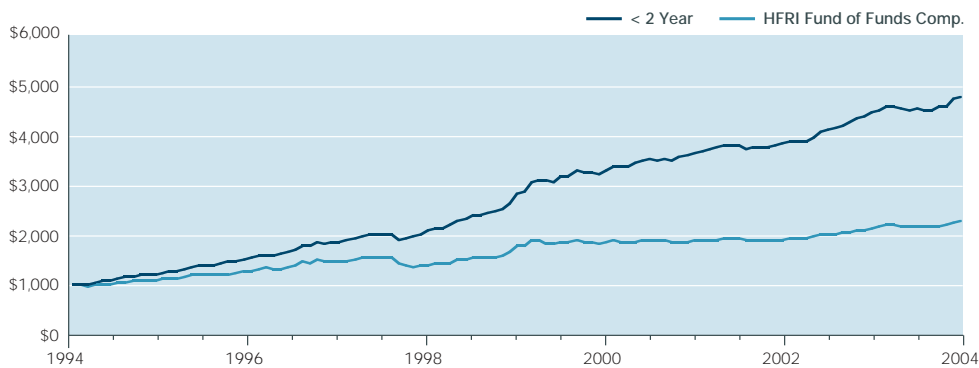
Emerging Manager Out-Performance:
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Executive Summary

Emerging managers, defined as managers with less than a two year track record, represent nearly 10% of the hedge fund universe based on assets under management. Emerging managers exhibit compelling absolute return profiles and have typically outperformed the overall hedge fund market.

There have been numerous articles published over the past few years documenting the out-performance of newer funds, particularly in their first two years, but HFR has advanced this analysis to identify the greater performance potential from new managers versus established managers launching new funds.

EMERGING MANAGERS HISTORICALLY OUTPERFORM THE OVERALL HEDGE FUND MARKET:



Source: Hedge Fund Research, Inc. (Jan. 1995 – Dec. 2004)

		< 2 Year	HFRI FoF
10 Year	Ann. Ret.	16.91	6.38
	Std. Dev.	5.25	5.21
5 Year	Ann. Ret.	11.13	5.17
	Std. Dev.	4.52	4.44
3 Year	Ann. Ret.	9.37	6.35
	Std. Dev.	3.20	2.96

The results of HFR's analysis conclude that:

- ▶ Funds in their early years tend to outperform funds in their later years, with the most significant out-performance occurring in the first 12 months of operation. Volatility remains constant, resulting in higher risk adjusted returns.
- ▶ Our analysis of new funds by new managers versus new funds by existing managers found that while both outperform in early years, new managers significantly outperform the established managers in the first year.
- ▶ While our analysis demonstrates that emerging managers can provide significant potential as a group, there are challenges to selecting the right managers and monitoring operational risks.
- ▶ As a group, the 564 managers tracked by Hedge Fund Research, Inc. provide broad representation across the major hedge fund strategies. This diversity provides the potential to mitigate some of the risks inherent with emerging managers through diversification.

Emerging managers can offer significant potential through alpha-pursuing* strategies driven by:

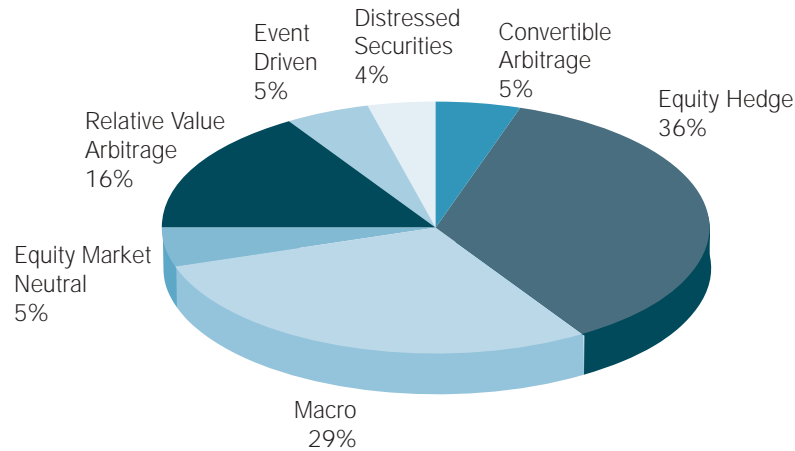
- ▶ Greater incentive of young managers to outperform their peers to attract assets
- ▶ The nimble nature of smaller funds to focus on their best investment ideas
- ▶ The application of specific expertise to niche exposures

* Alpha is defined as the excess rate of return on a portfolio over what would be predicted by an equilibrium model such as the Capital Asset Pricing Model (CAPM). Alpha in the context of hedge funds is considered out-performance attributable to a manager's skill and is often used as a measure of the value added by the fund's manager.

Characteristics of the Emerging Managers Market

Emerging managers, defined as managers with less than a two year track record, represent nearly 10% of the hedge fund universe and average \$74 million under management.

THE 564 MANAGERS PROVIDE BROAD REPRESENTATION ACROSS THE MAJOR HEDGE FUND STRATEGIES.



Source: Hedge Fund Research, Inc. (Dec. 2004)

Performance Drivers for Emerging Managers

In the life cycle of the hedge fund, the first year of operation is often the optimal time for performance for the following reasons:

► Focused and Dedicated Talent

Emerging managers are driven to produce superior returns in order to establish a successful track record to attract and retain assets. In fact, investors are more likely to withdraw from young funds with positive returns but fail to rank in the top quartile, than from older funds which produce negative returns.*

► New Opportunities & Flexibility

Emerging managers are generally smaller and well suited to adapt to changing market conditions and exploit new opportunities. That young funds exhibit superior return and "profit making is more [prevalent] for younger funds than older funds" was observed in "Entry and Exit: The Lifecycle of a Hedge Fund," by Gimbel, Gupta & Prices (2002), stating that new ideas are more likely to generate superior returns than are "copy cat" ideas, and attributes the superior returns of younger managers to an increased likelihood of new ideas among this group.

*"Offshore Hedge Funds: Survival & Performance 1989 – 1995," Brown, Stephen J.; Goetzmann, William N; Ibbotson, Roger G. (1998)

HFR: Analysis of Emerging Managers

HFR's analysis confirms that new hedge funds tend to outperform established funds in their initial years, particularly when run by new managers.

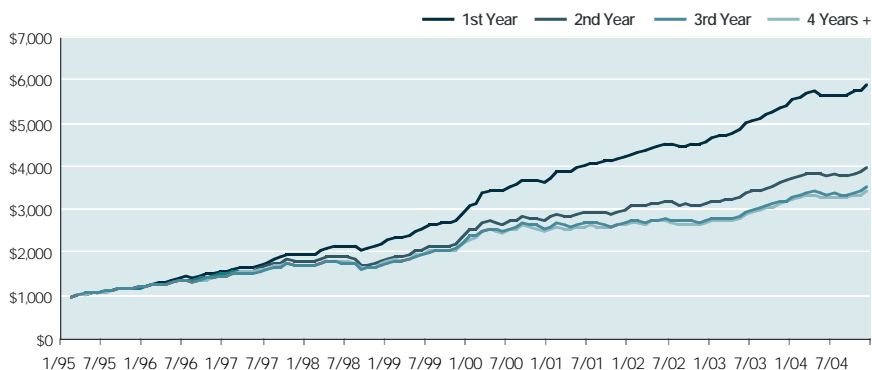
STUDY PARAMETERS

Using the Hedge Fund Research, Inc. database, we considered the relationship between the age of a fund and performance. We started by creating the following indices: Funds aged 1-12 months ("1st Yr"), Funds aged 13-24 months ("2nd Yr"), Funds aged 25-36 months ("3rd Yr"), and Funds in excess of 36 months ("4 Yr+"). The Funds were weighted equally within the index.

For all periods, funds performed better in the first two years, and significantly better in the first year with similar volatility, as shown below.

		1st Year	2nd Year	3rd Year	4 Years+
3 Year Period (1/02-12/04)	Ann. Ret.	11.96	9.63	8.67	9.60
	Std. Dev.	3.15	3.53	4.36	4.10
5 Year Period (1/00-12/04)	Ann. Ret.	14.14	9.80	8.19	8.59
	Std. Dev.	4.72	4.88	5.89	5.52
10 Year Period (1/95-12/04)	Ann. Ret.	18.95	14.17	12.38	12.78
	Std. Dev.	5.78	6.55	6.67	6.71

PERFORMANCE BY AGE OF FUND



Source: Hedge Fund Research, Inc. (Jan. 1995 – Dec. 2004)

Digging Deeper: Understanding the Rookie Effect

The second part of HFR's analysis compared the performance of new funds launched by new managers with new funds started by established managers. We divide each of the indices studied into two sub-indices, one consisting of funds launched by new managers, and one of established managers.

For each time period, funds launched by new managers outperformed funds launched by established managers during the first year of operation. During the second year, new managers outperformed established over the ten-year period, but underperformed for the three and five-year periods. During the third year, new managers outperformed for all time periods.

		1st Year		2nd Year		3rd Year	
		Est.	New	Est.	New	Est.	New
3 Year Period (1/02-12/04)	Ann. Ret.	9.71	11.04	8.53	7.01	6.03	9.79
	Std. Dev.	3.54	3.67	3.22	4.55	4.26	5.33
5 Year Period (1/00-12/04)	Ann. Ret.	12.64	14.16	8.44	7.03	5.85	8.59
	Std. Dev.	3.54	3.67	3.22	4.55	4.26	5.33
10 Year Period (1/95-12/04)	Ann. Ret.	17.37	20.70	12.72	14.45	11.18	13.02
	Std. Dev.	5.89	6.76	6.31	7.90	6.66	7.58

Source: Hedge Fund Research, Inc.

With Increased Opportunities Come Increased Risks

While our analysis demonstrates the significant upside potential of hedge funds in their early years, this is also a time when hedge funds are most vulnerable:

- ▶ They must establish a distinguishing track record in order to attract assets
- ▶ They frequently have limited infrastructure and often operate below break-even levels

As a result, funds in their first years of operation have higher mortality rates.

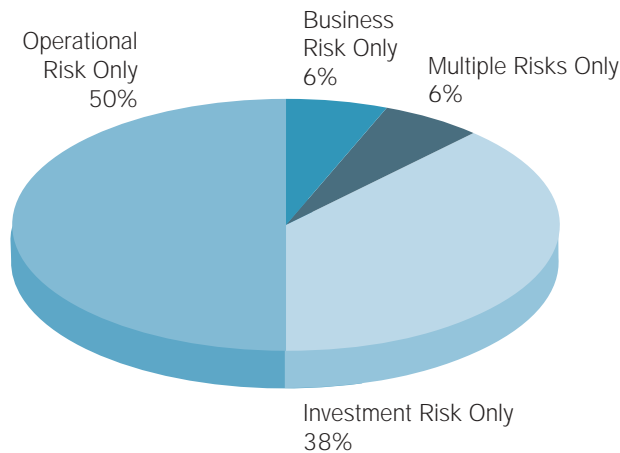
Mortality Rates of Hedge Funds

First Year	10.21%
Second Year	14.14%
Third Year	14.50%
Fourth Year	12.91%
Fifth Year	9.33%
Sixth Year	8.46%
Seventh Year	6.39%

Source: Hedge Fund Research, Inc. (Dec. 2004)

Operational Risks Are a Key Source of Failures

Given the growing pains of a hedge fund starting up, it is no surprise that operational risks are a key source of failures. A March 2003 study* by The Capital Markets Company of the hedge fund industry found that the majority of hedge fund failures were a result of operational and business risks, as broken down below:



Key Operational Issues:

- ▶ Misrepresentation of Investments: False or misleading reporting of investment valuations
- ▶ Misappropriation of Funds: Removal of money from fund either as outright theft or to hide trading losses
- ▶ Unauthorized Trading & Style Breaches: Investments made outside of stated fund strategy without investor approval
- ▶ Inadequate Resources: Technology, processes or personnel unable to handle operating volumes

* Source: The Capital Markets Company, "Understanding and Mitigating Operational Risk in Hedge Fund Investments," March 2003. (Failed funds defined as funds forced to cease operations for reasons outside of management's control.)

Conclusion:

Emerging Managers Outperform their Established Counterparts

Hedge funds in their early years tend to outperform funds in their later years, with the most significant out-performance occurring in the first year of operation. Volatility remains constant, resulting in higher risk adjusted returns in the first and second years.

While considering new funds launched by new fund managers compared to new funds launched by established fund managers, both show early stage out-performance. However, new manager funds have typically outperformed the established manager funds over similar time periods.

Emerging managers can offer significant potential to a core hedge fund portfolio, offering alpha-pursuing strategies driven by:

- ▶ Greater incentive of young managers to outperform in order to attract assets
- ▶ The nimble nature of smaller funds to focus on their best investment ideas
- ▶ The application of specific expertise to niche markets

However, this is also a time when hedge funds are most vulnerable to operational risks that can be a key source of failures.

Access to a representative basket of funds launched by new managers represents a material return opportunity relative to general hedge fund industry performance.

ADDITIONAL RESOURCES

The following references are offered for informational purposes only. We cannot verify or endorse the information contained therein.

"Flows, Performance and Managerial Incentives in Hedge Funds," Agarwal, Vikas; Daniel, Naveen D.; Narayan Y. (2004)

"Offshore Hedge Funds: Survival & Performance 1989 – 1995," Brown, Stephen J.; Goetzmann, William N; Ibbotson, Roger G. (1998)

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"On Taking the 'Alternative' Route: Risks, Rewards and Performance persistence of Hedge Funds," Agarawal, Vikas; Naik, Narayan Y. (1999)

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"Entry and Exit: The Lifecycle of a Hedge Fund," Gimbel, Thomas; Gupta, Francis; Pines, Dan (2002)

"Do Hedge Funds Exhibit Performance Persistence? A New Approach," Boyson, Nicole (2003)

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The Emerging Managers ("Portfolio") returns contained herein include pro forma net returns based on the actual net returns of HFR single manager trusts, and if unavailable, of the flagship funds as self-reported by managers to the HFR Database. HFR has not verified this self-reported information.

Returns include the reinvestment of dividends and other earnings to the extent any exist. Actual returns may differ due to factors such as the timing of an investment, fees, expenses, performance calculation methods, portfolio size and composition, type of investment vehicle managed, and economic and market factors.

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