CAIS IQ

Hedge Funds

Foundations of Alternative Investments

Co-authored by Mercer

MERCER DISCLAIMER

FOR INSTITUTIONAL INVESTORS USE ONLY.

THIS INFORMATION IS FOR SOPHISTICATED INVESTORS ONLY WHO ARE ACCREDITED INVESTORS AND QUALIFIED PURCHASERS.

This contains confidential and proprietary information of Mercer and is intended for the exclusive use of the parties to whom it was provided by Mercer. Its content may not be modified, sold or otherwise provided, in whole or in part, to any other person or entity, without Mercer's prior written permission.

This material is provided for educational purposes only and is not intended to be relied upon as investment advice, and is not a recommendation, offer or solicitation to buy or sell any securities or to adopt any investment strategy. The findings, ratings and/or opinions expressed are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed. Private capital funds are speculative and involve a high degree of risk. Private capital fund managers have total authority over the private capital funds. Funds of private capital funds are not liquid and require investors to commit to funding capital calls over a period of several years; any default on a capital call may result in substantial penalties and/or legal action.

An investor could lose all or a substantial amount of the investment. There may be restrictions on transferring interests in private capital funds. Reliance upon information in this material is at the sole risk and discretion of the reader. The material was prepared without regard to specific objectives, financial situation or needs of any investor.

CAIS DISCLAIMER

The information contained herein is for discussion purposes only and does not constitute an offer to sell, or the solicitation of an offer to purchase, any security or investment product. Any such offer or solicitation may only be made to qualified investors pursuant to the delivery of formal offering documents. Except where noted otherwise, the information contained herein generally reflects the views of Mercer and/or CAIS, and does not necessarily reflect the views of the broader financial industry. CAIS makes no representations or warranties with respect to the information contained herein, and such information should not be relied upon as the basis for an investment decision or for any other purpose whatsoever. Please note, CAIS and/or its affiliates are paid a fee for the sale of certain products, funds and strategies facilitated through its platform. Furthermore, CAIS and/or its affiliates may be paid a higher fee for certain products, funds and strategies that have the investment objective addressed in this presentation, in relation to other funds and strategies.

None of Capital Integration Systems, LLC, CAIS Capital LLC or any of their respective employees, members, principals, agents or affiliates (or any affiliate of any of the foregoing persons) is a fiduciary or advisor with respect to any financial services or products. CAIS does not provide any investment planning, legal, regulatory, tax, compliance or other advice and neither the Information, nor any prior or subsequent communications from or with CAIS or its representatives, should be construed as any such advice. Investment advisors and all investors should ensure that they have independently obtained sufficient information to ascertain the legal, financial, tax and regulatory consequences of any investments they consider.

The Information contained herein is subject to change, may be revised without notice and does not purport to be a complete description of any security, investment product or service. Past performance is not a guarantee or indication of future performance.

Hedge Funds, an Introduction

Building a diverse portfolio helps to navigate the rise and falls of capital markets. A hedge fund is considered an alternative asset class that invests in a variety of actively managed strategies. These strategies often involve sophisticated techniques to control risk exposure and generate investment returns. Investors may increasingly consider the active risk management that hedge funds can provide.

Hedge funds typically seek to diversify equity, credit and interest rate risks that come from traditional asset allocation policies. **Hedge funds could provide exposure to non-traditional return drivers and play an important role in achieving a well-diversified portfolio.** By introducing new return drivers, the total portfolio relies less on the direction of capital markets.

While many investors remain attracted to the potential diversification, return enhancement, and low exposure to markets that hedge funds seek to provide, it is important for investors to understand how such aims are accomplished.

What is a Hedge Fund?

One helpful way to define hedge funds is to first define what they are not: a mutual fund. While hedge funds share some characteristics with mutual funds, namely being professionally managed portfolios of pooled investment types, there are key differences. A hedge fund is a private investment and is subject to less regulation than mutual funds and many other comparable mainstream investment options. **Hedge funds generally use skill-based strategies and can be managed more or less aggressively than a mutual fund with goals such as higher returns, lower market risk exposure, or better risk-adjusted returns.** Hedge funds also have the ability to borrow. Applying leverage enables a strategy to amplify position exposure with the view of trying to exploit opportunities; however, this flexibility needs to be managed carefully to avoid undue market risk.

The first hedge fund was created in 1949 by Alfred Winslow Jones, who combined long and short positions in an effort to offset some of the risks in an "either-or approach." In a traditional ("long-only") approach, investors purchase undervalued securities that they believe will outperform. Jones saw the value in short positions as well, which is just the inverse of long positions – they allow you to benefit from the decline in a security's market price. Jones combined both long and short positions, in consideration of both a rising and declining market. This is known as hedging, which generally means investing in two securities that are expected to move in opposite directions, one of which is the investment and the other, the investment insurance.[1]

His innovative approach is known today as the classic long/short equities strategy. Its success led to the sizable growth of hedge funds. Today, hedge funds cover a wide breadth of strategies. The broadest categories of hedge funds include equity hedge, event-driven, relative value, and macro trading. Each of these styles has varying investment approaches, risk profiles, and return dynamics. Niche products that once were exclusive to institutional buyers, have grown into a more accessible industry available to a multitude of investors. **Interest in hedge funds has remained consistent due to their unique risk-return characteristics, and creativity and skill in portfolio implementation, along with investors' market expectations.**

[1] Gregoriou, G. & Duffy, N., Hedge Funds: A Summary of the Literature, Pensions: An International Journal, 2006.

FIGURE 1

Hedge Fund Industry Growth

Source: Hedge Fund Research (HFR).

The goal for many hedge funds is to earn positive risk-adjusted performance in all market conditions. To try to meet this goal, hedge funds investment guidelines are generally **unconstrained and flexible in nature, often permitting dynamic trading strategies that are intended to enhance returns by exploiting market inefficiencies.** Finding market inefficiencies requires creativity and skill on the part of the hedge fund manager.

Hedge funds can be classified as either directional or non-directional. Hedge funds that are non-directional are generally less sensitive to broad market risks, whereas directional hedge fund strategies may be more correlated to broad markets.

Generally, hedge funds are evaluated using an absolute return standard, such as a risk-free return level plus a spread, and therefore, independent of how the market or benchmarks are performing. Mutual funds, on the other hand, are typically evaluated using a relative return standard. This means that the investments are expected to either move in tandem with a particular market or outperform it. However, certain funds or investors may compare their unique hedge fund strategy to certain market benchmarks.

Understanding the Characteristics of Hedge Funds

The following are some general characteristics of hedge funds:

- They are often formed as a private investment pool and thus, can use leverage and more complex trading – **hedge funds have the ability to invest long and short positions.**
- They measure their performance in **absolute terms**, or independent of markets and uncorrelated to any benchmark.
- They usually charge both a **management and incentive fee.**
- They generally require **high minimum investments** and are only available to accredited investors or qualified purchasers.
- They are generally **less liquid** than mutual funds and may impose **lock-up periods.**
- Hedge fund managers usually **invest their own capital** along with their clients.

FIGURE 2

Hedge Funds

Long/Short

Hedge funds have the ability to invest long and short, taking long positions in securities that are expected to appreciate and short positions in securities that are expected to decline in value.

Short selling enables a strategy to profit from a position that is expected to decline in value.

Manager Skill

Hedge funds are more reliant on investment manager skill (successful active management) than the direction of markets in general.

Returns are less reliant on market direction and therefore should be more consistent over time.

Absolute Return

Hedge funds focus on absolute rather than performance relative to a specific benchmark.

Leverage

Hedge funds have the ability to borrow. Applying leverage enables a strategy to amplify position sizing to exploit opportunities in a more sizable manner. However, this flexibility needs to be managed carefully.

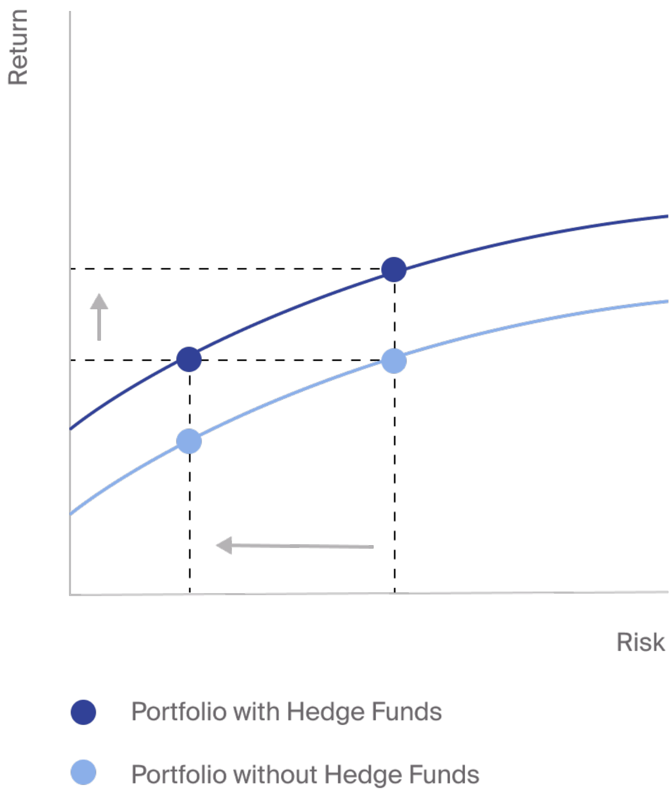
Investment Flexibility

Hedge funds have few restrictions on asset classes and investment techniques they can employ. However, most hedge funds do tend to specialize.

Source: Mercer. For illustrative and educational purposes only.

FIGURE 3

Efficient Frontier



Source: Mercer. For illustrative and educational purposes only.

Hedge funds, by exploiting and magnifying opportunities in an innovative way, currently trail closely behind private equity as being the most popular alternative investment, especially due to their risk and reward proposition[2]. As illustrated in Figure 3, hedge funds can be used to increase the expected level of return at a given level of risk or to maintain expected returns while reducing expected risk.

Core Foundations of Hedge Funds

The Structure

Because hedge funds are privately organized and typically less regulated than public investment vehicles, they enjoy greater flexibility to engage in unique strategies. By being private, most of a hedge fund's marketing and fundraising efforts are limited to wealthy individuals and institutions, such as family offices, foundations, endowments, and pension funds. Still, there are growing efforts to increase the accessibility of hedge funds to retail clients.

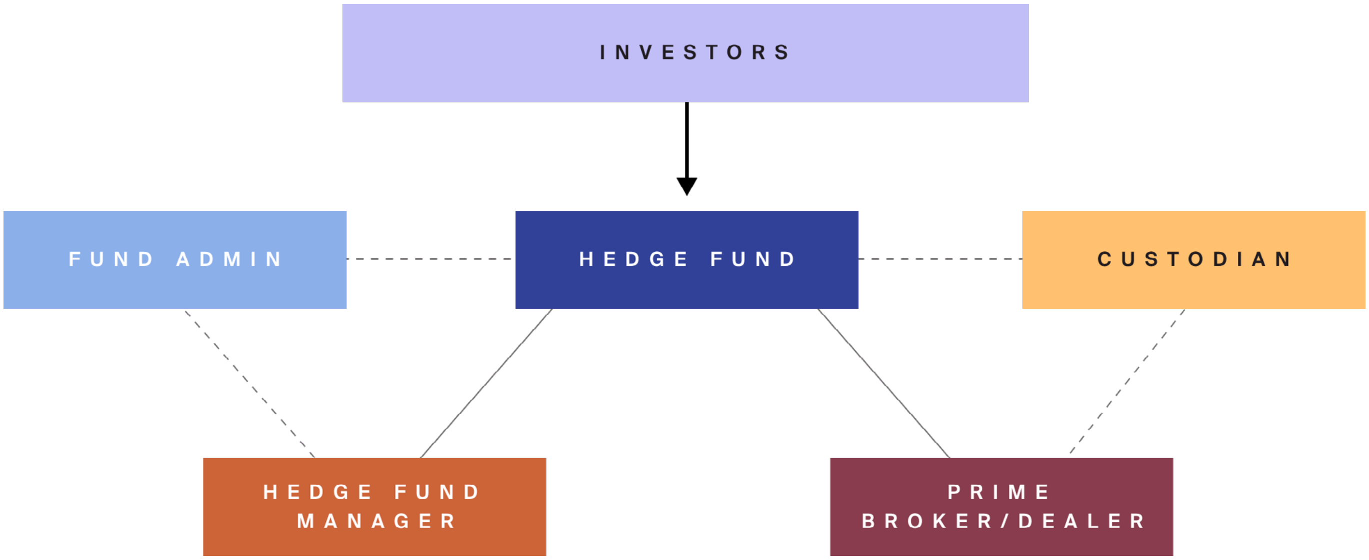
Hedge funds can be organized as **domestic funds** or **offshore funds.** In a domestic fund, income and gains are typically reported on the investors' individual tax returns. As shown in Figure 4, **hedge funds are often structured as a limited partnership, with a limited liability company (LLC) affiliated with the hedge fund manager being the general partner, and limited partners of the fund as the investors.** The general partner is typically responsible for the day-to-day duties of running the partnership's investment. The **general partner** usually has total liability for the fund, while **limited partners** are only accountable for the amount they invest.

At the center of any hedge fund's operations is its dependency on one or more prime brokers. Hedge funds rely on prime brokers for their core operating and financing services. In other words, the prime broker both facilitates and coordinates trading. The selection of a prime broker is a big decision for a hedge fund manager, as prime brokers offer a variety of different pricing, securities, and trading options.

[2] Preqin, The Future of Alternatives 2025, 2020.

FIGURE 4

Hedge Fund Structure



Source: Alternative Investment Management Association (AIMA) and ASSIRT.

Offshore funds are typically not subject to U.S. taxation or other regulations and are organized as limited partnerships. The Cayman Islands and the British Virgin Islands are the two most commonly used jurisdictions for offshore funds. A single fund, parallel, or master-feeder structure can be used for establishing offshore funds. A master fund is generally the investment fund for several feeder funds to pool their capital, both from tax-exempt and U.S.-taxable investors, to potentially take advantage of economies of scale.

The typical hedge fund fee structure, often referred to as **"2 and 20"**, varies greatly across the industry. For 2 and 20, the 2% represents a management fee applied each year to the total assets under management and the 20% is an incentive fee (or performance fee) charged on the profits earned over a hurdle rate. **The hurdle rate and high-water mark are two types of benchmarks that some hedge funds set as requirements for collecting incentive fees from investors.** The **hurdle rate** is the minimum rate of return (generally payable to the limited partners) that the hedge fund manager must generate before it can charge an incentive fee. A **high-water mark** is the highest value that a hedge fund has reached. A manager must get the fund above the high-water mark before receiving the incentive fee.

The Styles & Categories of Hedge Funds

A hedge fund can be broadly broken down into three categories:

- **A single-strategy hedge fund** invests using one investment strategy that the manager has expertise in.

- **Multi-strategy hedge fund** invests in many different strategies across the hedge fund universe, while still operating under a single fund.

- **Fund of hedge fund (FoHF)** invests in a collection of different hedge funds, typically looking to diversify risk from any single manager. These funds include an additional layer of fees.

These categories can be broken into four styles:

- **Equity Hedge:** The manager purchases positions that are expected to appreciate in value and sells positions that are anticipated to decrease in value, and books positive returns later by repurchasing them at a lower price. *Long/short equity* is the most common equity hedge strategy used by hedge fund managers. It combines both long and short positions in stocks with the objective of gaining outperformance on both, while minimizing exposure to the market.

- **Relative Value:** The manager seeks to enhance returns by exploiting pricing inefficiencies between related financial instruments such as stocks or bonds. *Convertible arbitrage* is an example of a relative value strategy that aims to take long positions in convertible securities and short positions in the underlying common stock, to capitalize on pricing inefficiencies between the convertible and the stock.

- **Event-Driven:** The manager seeks to enhance returns by capitalizing on mispriced securities associated with corporate transactions such as mergers, acquisitions, reorganizations, bankruptcies, or other unique corporate actions. *Distressed debt* is an example of an event-driven strategy, one where the manager identifies securities of financially troubled companies that appear to be trading at a price below estimated intrinsic value.

- **Macro Trading:** The manager applies a very opportunistic approach that aims to profit from market swings caused by political or economic events. Macro trading strategies seek to maximize earnings in periods of greater market volatility and lower liquidity. CTA (*Commodity Trading Advisor*), also known as managed futures, is a common macro trading strategy. It generally invests in futures contracts on global financial, commodity, and currency markets.

The Life Cycle

Hedge funds experience various stages of development like any other business. Opportunities and risks evolve as a hedge fund progresses through its life cycle. Understanding the life cycle is important when choosing a hedge fund and when setting expectations for return, volatility, and correlation. **The life cycle of a hedge fund can be broadly classified into four stages: Emerging, Growth, Maturity, and Decline,** as shown in Figure 5. The length of each stage is not fixed and does not always follow in sequence. The growth and early maturity stages of a hedge fund generally represent a "sweet spot" for investing and typically involve operational stability at the firm.

Potential Value Creation in Hedge Funds

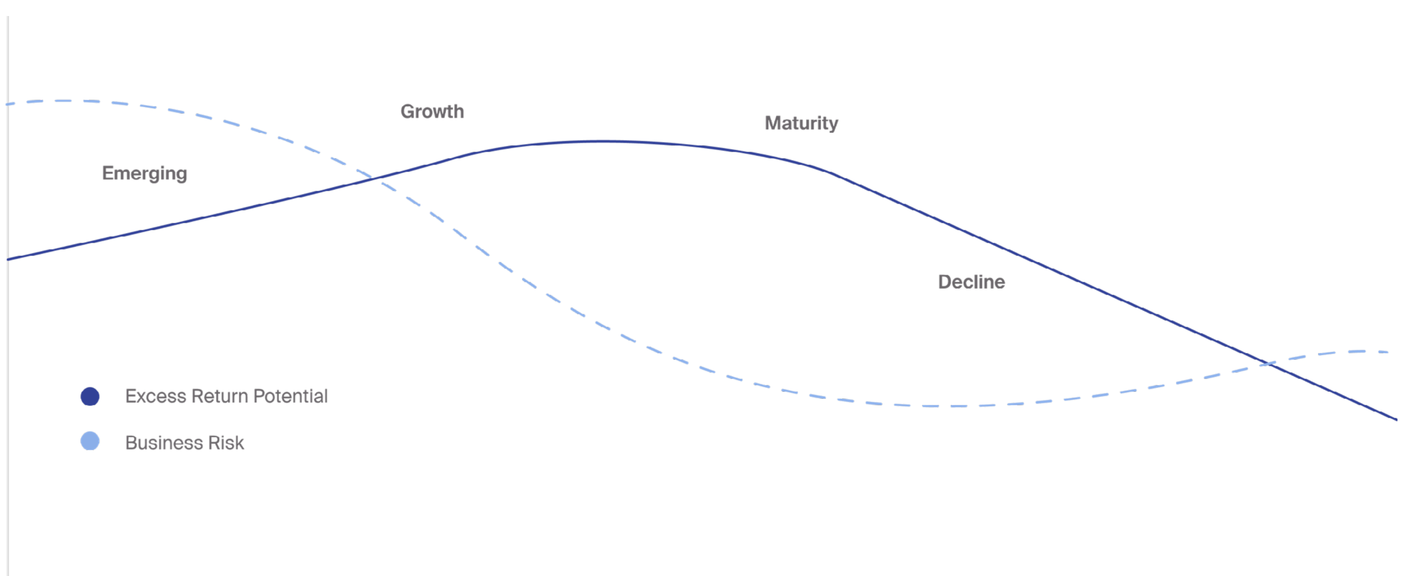
Successful hedge fund managers generally sit between the **"optimistic entrepreneur"** and the **"pessimistic risk manager."** They seek balance between exploiting opportunities and controlling risk. Unique characteristics that can help managers add value include:

- **Active Management and Expertise:** Hedge funds are actively managed by managers who have a strong personal interest and incentive to generate positive returns. Managers usually invest personal money in the funds they manage, sharing in the investor's risks and rewards. The incentive fee, if performance is positive, is intended to further align interests between the manager and investors. To be a seasoned hedge fund manager requires substantial skill and specialized expertise.

- **Flexibility of Investment Vehicles:** Hedge funds are extremely flexible by nature, which means they have access to a wide array of investment strategies and instruments. They are not limited by certain regulations and public disclosure requirements and thus can engage in short-selling, leverage, derivatives, and other strategies. It is this flexibility that provides investors with alternative ways to both potentially diversify risk and sources of return.

FIGURE 5

Life Cycle of a Hedge Fund



- **Low Correlation to Traditional Asset Classes:** Many hedge fund strategies seek to generate returns independent from the performance of stock and bond markets. The potential ability to deliver attractive risk-adjusted returns that are less correlated with other asset classes is a key attribute of the asset class. Over some periods, hedge funds have provided returns competitive with global equities while exhibiting less volatility.[3]

Noteworthy Risks of Hedge Funds

- **Illiquidity:** Hedge fund investments are relatively illiquid. Most hedge funds have lock-up periods of about one to two years, periods when the investor is unable to withdraw or sell back investments. Also, during a challenging period for a fund, some funds can impose a gate, which limits the amount of withdrawals from a fund during a redemption period. The investor does have redemption rights that allow them to give advance notices for withdrawals. The **key man clause** also gives investors the option to redeem their funds if a key manager suddenly leaves the firm.

- **Use of Leverage:** The use of leverage allows a hedge fund manager to access a greater value of assets than that contributed by investors, multiplying the power of every dollar contributed to the fund. There are several ways to achieve leverage in a fund, such as options, swaps, and futures. These all have an explicit cost along with the associated increase in risk relative to non-leveraged portfolios. For these reasons, investors should be cautious of highly leveraged strategies.

- **Lack of Transparency:** Hedge fund disclosures are often not mandated, reviewed, or approved by regulatory bodies. As a result, investors may be unaware of the hedge fund's underlying investments or strategies. Additional analysis and evaluation are necessary to compensate for the lack of transparency.

- **Strategy-Specific Risk:** Most strategy processes and investments are different and therefore have differing amounts of expected risk and return. Understanding the processes and investments, and the associated risks, is important and helpful when aligning investor return goals and preferred risk levels with the appropriate strategy.

Allocating to Hedge Funds

Diversification

When considering how to best combine hedge fund investments, additional steps that diversify manager skills, strategies, and styles can reduce the potential impact of any one manager. The three areas an investor can diversify include:

- **Manager:** Manager selection is key, as the performance of hedge funds is often tied to the manager's skill at identifying opportunities. Investors may want to consider allocating to multiple managers given the active management risk associated with hedge funds.

- **Strategy:** Hedge funds have access to a broad and diverse tool kit. Strategies can perform very differently due to variations in approach, trading, leverage, short-selling, derivatives, etc.

[3] Mercer, The Case for Unconstrained Hedge Funds, 2021.

- **Risk:** Flexibility in strategy results in a broad range of potential risk types. Evaluating sources of risk is crucial. While a portfolio including multiple hedge funds with different risk and return profiles may control risk exposure, the potential operational, credit, and market risks should be understood prior to investing.

Establishing an Allocation Strategy

Strategies for allocating to hedge funds include:

- **Fund of hedge funds (FoHFs):** A fund of hedge funds is an investment vehicle that invests pooled money into a collection of hedge funds. The fees in this approach are generally higher. Alternatively, investors can get strategy diversification through a single manager multi-strategy fund, but should be aware of the concentrated manager risk.

- **Direct Investment:** Investors with sufficient assets may elect a direct investment approach that allows customizing the mix of hedge fund strategies. This approach provides control over allocation timing, concentration, strategy weighting, and manager selection.

- **Core/Satellite:** The core/satellite approach is a hybrid of the previous two allocations strategies. This approach allows investors the ability to both diversify and gain access to niche hedge fund strategies or managers. ■

Hedge Fund Terms

- **Absolute Return:** The return that an asset achieves over a period of time. The goal is to have a positive return, irrespective of market direction over a full market cycle.
- **Derivatives:** Financial instruments whose value depend on the value of their underlying securities or assets. Examples of derivatives are options, warrants, futures, forwards, and swaps.
- **Future:** A contract that provides for the sale of financial instruments or physical commodities for future delivery on a commodity exchange.
- **Gate:** Restriction limiting the amount of withdrawals from the hedge fund during the redemption period.
- **General Partner ("GP"):** The manager of the hedge fund that is given authority to make the fund's investments.
- **High-Water Mark:** The performance level a hedge fund manager would need to exceed in order to earn further incentive fees. The high-water mark is generally in excess of the fund's highest prior performance level. This is to ensure the investor does not pay for covering the same ground twice.
- **Hurdle Rate:** The return where the manager begins to earn incentive fees.
- **Incentive Fee:** Manager compensation based on the performance of the investment.
- **Leverage:** The use of borrowed money or securities to increase the potential return of a fund.
- **Liquidity:** The degree to which a financial instrument can be sold or converted to cash.
- **Limited Partner ("LP"):** A business partner whose liability is generally limited to the amount of capital they commit or invest.
- **Lock-up Period:** Window of time during which investors of a hedge fund are not allowed to redeem or sell shares.
- **Management Fee:** Manager compensation based on assets size.
- **Prime Broker:** A broker that offers more services than a classic broker. Prime broking services might include back office operations, trade reconciliation, financing, record keeping, or custodian activities.
- **R-Squared:** A measure of how closely a portfolio's performance varies with the performance of a benchmark.
- **Sharpe Ratio:** A measure of risk-adjusted return, calculated by dividing a fund's return over the risk-free rate by the standard deviation of returns.

Mercer does not provide tax or legal advice. You should contact your tax advisor, accountant and/or attorney before making any decisions with tax or legal implications.

This does not constitute an offer to purchase or sell any securities.

The findings, ratings and/or opinions expressed herein are the intellectual property of Mercer and are subject to change without notice. They are not intended to convey any guarantees as to the future performance of the investment products, asset classes or capital markets discussed.

For Mercer's conflict of interest disclosures, contact your Mercer representative or see http://www.mercer.com/conflictsofinterest.

This does not contain investment advice relating to your particular circumstances. No investment decision should be made based on this information without first obtaining appropriate professional advice and considering your circumstances. Mercer provides recommendations based on the particular client's circumstances, investment objectives and needs. As such, investment results will vary and actual results may differ materially.

Information contained herein may have been obtained from a range of third party sources. While the information is believed to be reliable, Mercer has not sought to verify it independently. As such, Mercer makes no representations or warranties as to the accuracy of the information presented and takes no responsibility or liability (including for indirect, consequential, or incidental damages) for any error, omission or inaccuracy in the data supplied by any third party.

Funds of private capital funds are speculative and involve a high degree of risk. Private capital fund managers have total authority over the private capital funds. The use of a single advisor applying similar strategies could mean lack of diversification and, consequentially, higher risk. Funds of private capital funds are not liquid and require investors to commit to funding capital calls over a period of several years; any default on a capital call may result in substantial penalties and/or legal action. An investor could lose all or a substantial amount of his or her investment. There are restrictions on transferring interests in private capital funds. Funds of private capital funds' fees and expenses may offset private capital funds' profits. Funds of private capital funds are not required to provide periodic pricing or valuation information to investors. Funds of private capital funds may involve complex tax structures and delays in distributing important tax information. Funds of private capital funds are not subject to the same regulatory requirements as mutual funds. Fund offering may only be made through a Private Placement Memorandum (PPM).

Investment management and advisory services for U.S. clients are provided by Mercer Investments LLC (Mercer Investments). Mercer Investments LLC is registered to do business as "Mercer Investment Advisers LLC" in the following states: Arizona, California, Florida, Illinois, Kentucky, New Jersey, North Carolina, Oklahoma, Pennsylvania, Texas, and West Virginia; as "Mercer Investments LLC (Delaware)" in Georgia; as "Mercer Investments LLC of Delaware" in Louisiana; and "Mercer Investments LLC, a limited liability company of Delaware" in Oregon. Mercer Investments LLC is a federally registered investment adviser under the Investment Advisers Act of 1940, as amended. Registration as an investment adviser does not imply a certain level of skill or training. The oral and written communications of an adviser provide you with information about which you determine to hire or retain an adviser. Mercer Investments' Form ADV Part 2A & 2B can be obtained by written request directed to: Compliance Department, Mercer Investments, 99 High Street, Boston, MA 02110.

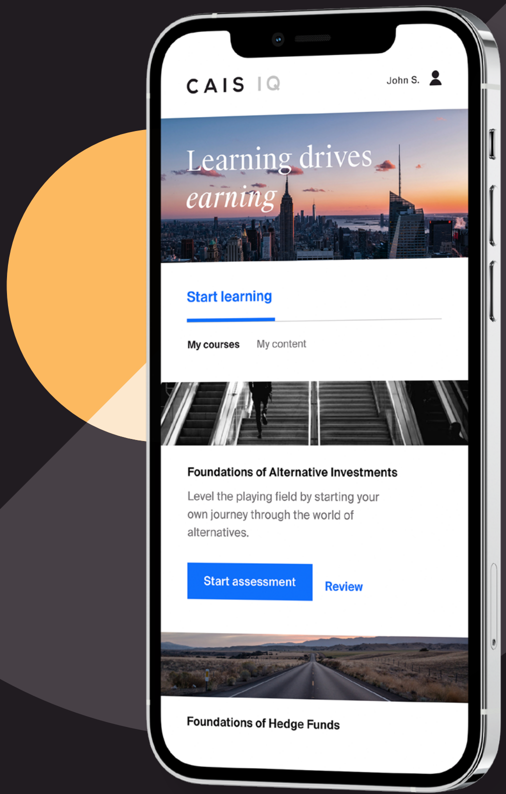
CAIS IQ

Knowledge is power.

CAIS IQ is the future of financial education, today.

By bringing industry leaders directly to advisors via our state of the art intelligence and insights platform, a live and interactive community creates deep and lasting knowledge, helping financial advisors seeking to enhance client outcomes and master alternative investments.

To learn more, login to **caisiq.com** or
contact a product specialist at **info@caisgroup.com**



Follow us on social to get fresh market insights and perspectives from a diverse set of industry leaders

CAIS | 527 Madison Ave. 2nd Floor | New York, NY, 10002 | (212) 300-9350