# Hedge Fund of Funds in the Mutual Space

*A pioneer in the area, Alpha Hedged Strategies (ALPHX) defies easy comparisons. The fund employs real hedge fund managers with various strategies to create a risk-return profile suitable for mass affluent mutual fund investors. Through tight control over sub- managers and compliance with mutual fund requirements, Alpha eliminates many of the hurdles between these two worlds. Financial intermediaries are crucial to educating investors on this complex product.*

**Q: *How would you describe your investment philosophy?***

**A:** We are very conservative and our philosophy is, first and foremost, capital preservation, and then, good returns consistently achieved year in and year out. We focus on risk-adjusted returns, not relative returns. We try to be non-correlated to both equity markets and interest rates. Our goal is absolute positive returns regardless of what the market's doing; it's not designed to outperform the S&P 500.

We employ various hedge fund managers that have successfully executed their strategies in the hedge fund arena. We pioneered putting together multiple hedged strategies in an open-end no-load mutual fund, so that it could be more acceptable and accessible to the broader marketplace.

A focus on risk adjusted returns is rare in the mutual fund arena; it has almost exclusively been the domain of hedge funds until recently. But, you have to be an accredited investor to participate in a hedge fund, meaning that you may need half a million dollars just to get in. Now it is more broadly accessible, both directly and through financial intermediaries, such as advisors and brokers.

The Fund is targeting financial intermediaries primarily because it's a complex product. It's not as simple as most retail mutual funds, which tend to have very narrow objectives. Generally, the Morningstar style boxes of large-cap value or small-cap growth are much easier for the retail investor to comprehend.

Overall, in Alpha we look for high single-digit returns, let's say 8% to 10%, but with very diminished risk metrics. We target a market beta of about 0.10 versus the S&P being 1.00, so we're quite market neutral and have much lower volatility than the general equity markets.

**Q: *Could you explain your concept of risk-adjusted return? Which risks are you adjusting?***

**A:** It's adjusting the return expectation relative to the risk taken. We tend to focus on beta and standard deviation. Beta has a component of correlation to the market as well as volatility. Basically, if you get a 10% return by being long the S&P index, you have a beta of 1.00. Conservative hedge fund of funds have returned 8% plus per year over the last

## AIP Alpha Hedged Strategies

### Fund Facts

| | |
|---|---|
| Symbol | ALPHX |
| Website | www.aipfunds.com |
| Address | Alternative Investment Partners LLC<br>701 Westchester Ave., Ste. 312-W<br>White Plains, NY 10604 |
| Tel. No. | 877-569-2382 |
| Inception | 9/23/2002 |

### Portfolio

| | |
|---|---|
| Total Net Assets * | $ 195.8 |
| Avg Mkt Cap ($ Weighted) * | N/A |
| Average Price/Earnings Ratio | N/A |
| Average Price/Book Ratio | N/A |
| Turnover Ratio | 112 % |

### Investment Information

| | |
|---|---|
| New Investment | Open |
| Min Initial Investment | $ 10,000 |
| Min Subsequent Investment | $ 250 |
| Min Initial IRA Investment | $ 10,000 |

### Risk (Against S&P 500 - 3 Years)

| | |
|---|---|
| Alpha | 7.09 |
| Beta | 0.12 |
| R-Squared | 0.10 |
| Ann Std Deviation | 4.49 |
| Sharpe Ratio | 1.52 |

### Returns vs. HFRI Conservative FOF Index

| | ALPHX | Index |
|---|---|---|
| 3 Mo. (Cum.) | 6.60 % | 3.58 % |
| 1 Year (Cum.) | 9.77 % | 7.89 % |
| 3 Year (Ann.) | 8.90 % | 7.14 % |

### Returns vs. S&P 500

| | ALPHX | Index |
|---|---|---|
| 3 Mo. (Cum.) | 6.60 % | 4.21 % |
| 1 Year (Cum.) | 9.77 % | 11.73 % |
| 3 Year (Ann.) | 8.90 % | 17.22 % |

### Fees and Expenses

| | |
|---|---|
| Max Sales Charge - Front | 0.00 % |
| Max Sales Charge - Deferred | 0.00 % |
| Max Redemption Fee ** | 2.00 % |
| Total Expense Ratio | 3.99 % |

### Portfolio Manager

| | |
|---|---|
| Lee Schultheis | 9/23/2002 |

** millions ** within 3 months after purchase*

*Data through: 3/31/06*

*Source: Company Documents; Lipper*

Q&A

TICKER's Choice

© 2006 123jump.com, Inc. Ticker.com is a publication of 123jump.com. **All rights reserved**. The entire contents of the publication are copyrighted. Reproduction in part or in whole is not permitted without written permission of the publisher. Unauthorized reprints are punishable by fines of up to $50,000. Requests for reprints or permission to copy editorial matter for other purposes, please contact the corporate office at 305-673-6339.

15 years. If you're getting 2% more by being long the market, the question is, at what additional risk?

I think that for many people who have accumulated a great degree of wealth already, the goal is to protect principal first. It's great if they can get a return well above the money market rate, but they really don't want to take significant risks to do that. That's where we think that absolute return strategies make a lot of sense for the mass affluent investor. That's the void in the mutual fund marketplace that needed to be filled.

Many people intuitively know that they are more risk averse than they used to be, but they may be still thinking in terms of just stocks, bonds, and cash. Today, fixed-income is not the safe haven it used to be, so if investors can get high single-digit returns, but without the greater risk of negative return periods associated with equities, that might be exactly the area for investors to look into.

**Q:** ***What's the strategy for achieving this goal?***

**A:** Our strategy is to select hedge fund managers with various styles that individually are market neutral. We look for managers with a demonstrated track record of producing consistent risk-adjusted returns. We have a bias towards fundamental managers as opposed to quant models. Just like in the world of long equity funds, where most managers are a bit more fundamental in their approach; they do research and decide which of the different stocks should outperform their peer group.

But, we're looking for managers with a dual "hedged" portfolio, or long-short strategies. That means that they select not only the stocks that should outperform their peer group, but also the ones that should underperform. By being equally long and short, it doesn't matter so much if the market's going up or down, but whether the long stock positions outperform the short stock positions.

**Q:** ***How do you research the hedge fund managers?***

**A:** We do our research much as a typical hedge fund of funds would. There are fairly industry standard due diligence questionnaires that are looking at investment philosophy, depth of research within the shop, track record, compliance, and risk controls for these various disciplines. It's not unusual to find managers with two different track records: one in the early years of operations and one when they later employ certain risk controls that allow them to retain 90% of the net return, and get rid of 50% of the volatility. You can always get back to the prior return level by using modest leverage, which we also employ in our Fund.

We also look at the different underlying strategies to make sure that the securities are fairly liquid and can be readily priced by independent means, because of the uniqueness of our product. Despite using hedged strategies, we are an open-end mutual fund that has to produce a daily net asset value for our shareholders. We don't want to rely on the sub-manager to price their portion of our portfolio because that's been one of the hedge fund world's problems in the past.

Once we fund a manager, we have 100% transparency to what they're doing. We usually start with a smaller amount than we plan to invest, and at this point we can give a higher level of scrutiny than a typical hedge fund of funds manager has with their underlying funds.

Because the managers execute their style within our Fund, we see all the trades, all the positions, and how they are valued independently. That's an ongoing due diligence process, which makes sure that the managers are executing the strategies as advertised. We also make sure that they are up to speed on any nuances of dealing with a mutual fund. Then, once we are comfortable, we can fully fund their account.

**Q:** ***Could you highlight your portfolio construction process?***

**A:** We use a model that helps to optimize the portfolio by using all the statistics on each manager and by looking at historical patterns of correlation to the market. Currently, we have 11 strategies and by the end of the year, we'll have about 15 to 20. Ideally, we would like to be in the 30 to 40 range, where a lot of conservative hedge fund of funds are, because that diversification provides an optimal non-correlation effect to dampen down the beta and the standard deviation, while keeping returns pretty stable. It winds up increasing the predictability of returns.

After determining an initial mix, we may decide that there's too much on the standard deviation side, so we need to dial down some of the managers to get in the right range. We might sometimes find that the risk stats are tame, but the return might be under our target. Then we can increase the aggressiveness of the mix, or add modest leverage.

**Q:** ***What are the key risk control measures?***

**A:** I think that transparency is a key risk control. It keeps the managers honest and executing the right strategy, so that we get what we expect in terms of risk-adjusted performance. On an ongoing basis, we analyze four key metrics –return, correlation coefficient to the S&P, annualized standard deviation, and beta. We make sure that those metrics stay within the range that we're comfortable with. That range is targeted by manager, but our real job is to synthesize an overall composite fund that, in the end, provides good risk-adjusted returns to shareholders.

© 2006 123jump.com, Inc. Ticker.com is a publication of 123jump.com. **All rights reserved**. The entire contents of the publication are copyrighted.
Reproduction in part or in whole is not permitted without written permission of the publisher. Unauthorized reprints are punishable by fines of up to $50,000.
Requests for reprints or permission to copy editorial matter for other purposes, please contact the corporate office at 305-673-6339.

There are two other key controls embedded in a mutual fund structure that you typically don't find in a hedge fund – independent valuation and independent custody. Independent valuation is a counterbalance and check to ensure the fund is properly valued and that managers are candid about performance. Regarding custody, when all the securities are resident in the name of our fund at an independent mutual fund custodian bank, you avoid hedge fund fraud cases, where a manager may abscond with assets of the fund. In our case, our sub-advisors can only execute trades that settle against the separate account they're managing; they cannot pull out cash or securities.

So the three key protections, transparency, valuation, and custody, take out a lot of the risk that potentially resides in the hedge fund vehicle. The incidences of problems in the hedge fund world are few, even though they are widely publicized, but nevertheless, these measures make it easier for retail investors to benefit from the attractiveness of hedged strategies.

**Q:** ***What type of strategies do you generally like?***

**A:** Currently, we have the basic arbitrage styles; convertible bond arbitrage, fixed-income arbitrage, merger arbitrage. We also have a number of long-short equity strategies, not just domestic, but also international and global long-short managers. We have a long-short REIT manager, and a deep discount value long-short manager that deals with micro to small-cap names, where there are more market inefficiencies. We have three approved managers for distressed securities, a very attractive risk-adjusted return market segment.

Typically, hedged strategies find such inefficiencies in smaller pockets of opportunity, which is why we have a bias towards managers with assets of $50 to $200 million in a given strategy. If somebody's managing $2 billion in a strategy, it's very difficult to find opportunities where they can deploy all that capital, so their returns may diminish over time, or they have to reach for more directional exposure to get the return.

Our Alpha Fund, which is a market neutral product, tends to be used primarily as a fixed-income substitute. Our more aggressive Beta Hedged Strategies Fund (BETAX) will be used as a substitute for being long the equity market.

"Currently, fixed-income is not the safe haven it used to be, so if investors can get high single-digit returns, but without the greater risk of negative return periods associated with equities, that might be exactly the area for investors to look into."

**about Lee Schultheis**

Before co-founding Alternative Investment Partners, LLC and AIP Funds, from 1999 to 2002 **Mr. Schultheis** was Chief Operating Officer of Kinetics Asset Management, advisor to Kinetics Mutual Funds. From 1995 to 1999, he served as President and Managing Director of Vista Fund Distributors with Chase Manhattan Bank's Vista Family of Mutual Funds. He has more than 20 years of investment industry experience.

Mr. Schultheis is often interviewed and quoted on mutual fund and hedge fund industry issues for on-line and print media. He is a frequent speaker at investment industry conferences, and has appeared on broadcasts such as *Power Lunch* on CNBC, Bloomberg TV, and CNN*fn's Your Money* and *The Money Gang*. Mr. Schultheis holds a Bachelor of Science degree from Cornell University.

**Q:** ***How often do you change the weightings of the various strategies?***

**A:** It's a very actively managed portfolio and I'm not doing this alone. An affiliate, our portfolio research consultant, has been very active in the hedge fund of funds business for many years, so we collaboratively adjust the weightings. As we evolve and add managers, we make sure that we've got room to add new strategies. We don't want to be moving the percentages and the strategies up and down too frequently, so we try to plan it out in stages.

We've been fairly active at times. In certain strategies you see conditions changing to being favorable or not-so-favorable. In 2004, and the beginning of 2005, we let convertible bond arbitrage diminish from 20% to 12%, because it was clear that there was a real imbalance in the supply and demand for convertible situations. Then, in May 2005 our manager was seeing a real opportunity going forward in the spreads. He felt that a lot of the dislocation was over, so we decided to increase our allocation back up, and the result was quite positive.

**Q:** ***Is there an investment minimum for the fund? I guess it would be lower than the minimum for a hedge fund.***

**A:** Oh yes, much lower. The investment minimum is $10,000 if you invest directly with the Fund, but most of our clients are advisors that use Schwab, Fidelity, or TD Waterhouse, who are able to set lower minimums. I think that with Schwab and Fidelity it is $2,500, while with TD Waterhouse it might be as low as $1,000.

So, investors get access to the type of strategy that historically required half a million to get into. In addition, it provides features, such as not being locked up for a year, which provides the type of comfort investors have with mutual funds, as long as the strategies are the right ones. Once we launch our second fund, we're going to look at adding some load share classes for the brokerage channel by the end of June. ▮

**Ticker.com**

© 2006 123jump.com, Inc. Ticker.com is a publication of 123jump.com. **All rights reserved**. The entire contents of the publication are copyrighted.
Reproduction in part or in whole is not permitted without written permission of the publisher. Unauthorized reprints are punishable by fines of up to $50,000.
Requests for reprints or permission to copy editorial matter for other purposes, please contact the corporate office at 305-673-6339.