White Paper

Written by

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Hedge Funds within a Wealth Management Strategy

As pointed out in a previous post ("Feeling Hedgey?") there has been a lot of publicity about the notion of using hedge funds within an investment management strategy and whether or not such vehicles are appropriate, There are many points that are raised as issues to be concerned about. This should not come as a surprise since any potential investment has risks. The challenge is to understand them and be able to balance the risks with the benefits to a person's portfolio and wealth management strategy. Let's start with identifying the areas of risk.

- **Lack of transparency** or the lack of the ability to see and personally assess the underlying activities of the fund manager(s) is often cited as a risk. The fund managers will likely respond that that they are attempting to exploit inefficiencies in the market and do not want their strategy known to others.

- **Loss of capital** is true in most investments, however, the strategies often used that might include leverage (borrowing), sophisticated trading strategies, taking positions in thinly traded securities and many other risks expose the owners of alternative investments to a higher level of risk.

- **Limited or no liquidity** common to investments of this type are common, leaving the investor with limited options if they desire to liquidate their investment. There is no established market for interest in these investments on the secondary markets.

- **Dependence on the skills** of the manager and/or management team may leave an investor exposed if there is a departure of key team members or distraction caused by personal or family matters away from the portfolio.

- **Event risk** due to abrupt markets shifts can work against particular funds' ability within their niche expertise.

- **Use of highly leveraged and/or speculative investments** such as futures contracts, options and short trades, exposes the portfolio to higher gains and losses.

- **Incentive fee arrangements** can act as an encouragement to managers to speculate and take higher risks to enhance their compensation.

- **Valuation of some securities**. Particularly if securities are not traded on a public market, they are valued on the funds mangers expertise sometimes leading to wide disparities in the actual value.

If we were to stop here one could easily conclude that investing in a hedge fund should not be considered and stop reading this piece now. It should also be mentioned the hedge funds are not available to all and frankly they shouldn't be. The current rules by the SEC call for investors to need a minimum of a $1,000,000 net worth to be able to invest in a hedge fund. The SEC has proposed raising the level to an even higher number in an attempt to assure unsophisticated investors are not likely to participate.

So is the news all negative? We say no for the following reasons:

- **Hedge Fund/Alternative Investments** provide additional diversification to a portfolio. If an investor believes that diversifying across different types of investments or assets classes makes sense for safety reasons they will likely be interested in having more tools at their disposal to reduce the volatility of their portfolio. The use of hedge funds, private equity, commodities, and other alternatives provide additional options to enhance returns and reduce risk.

- **Low correlation to market risk** is how using these types of vehicles can reduce the volatility of an investment portfolio with a wealth management strategy. Hedge fund managers often focus more on absolute return strategies than "market returns". This means their portfolios will likely behave in a different manner than one that is more exposed to beta or market only risk. This is particularly important in portfolios that are intended for financial independence purposes and regular withdrawals to sustain lifestyle are planned.

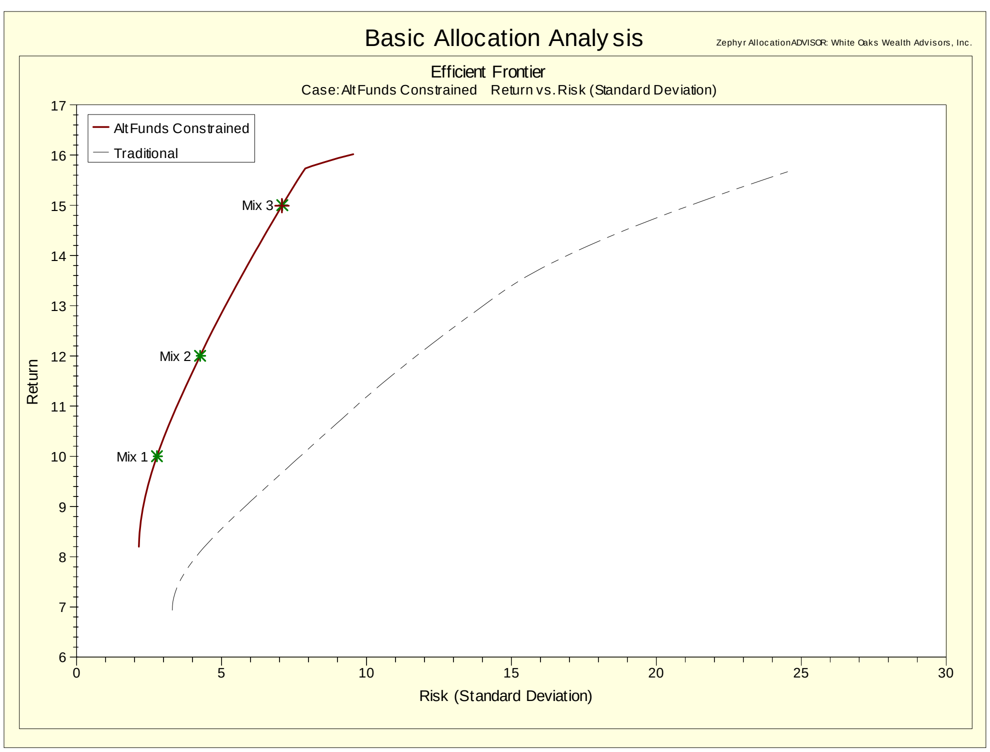
- **Absolute return strategy** as alluded to above, can mean underperforming in up markets but also producing positive returns in down markets as well.

- **Accessing top management** is the converse to the compensation problem mentioned in risks above. Sometimes the best and brightest recognize that they are better served by setting up their own fund than being employed by another firm. Tiger Woods, for example, makes more money playing golf than most anybody playing professionally. Why? Because he is good at what he does and can market it well besides. Increased flexibility in management and an entrepreneurial instinct lead many managers to these types of investment structures.

There are several examples of very smart people where their strategies "blew up". Long Term Capital Management (run by Nobel Laureates), SOWA Capital and others where some of the risks above became very apparent. That is why significant due diligence and limited exposure to one manager or particular strategy is important. Large endowment funds have been increasing their use of these vehicles for the reasons above. Harvard and Yale have 15% and 25%, respectively, of their portfolios allocated towards alternative investments.

Hedge funds and the alternative investment space in general provide important tools to consider in protecting and enhancing a portfolio within a wealth management strategy. Careful screening of funds, investigation of the funds results (including audit reports), manager interviews to ascertain strategies and relevant risks, thorough review and understanding of the offering documents, understanding the leverage used within the portfolio, and background checks can be useful tools in determining whether or not a particular fund or manager can play an important part in an investor's portfolio.

The illustration below shows the potential impact of adding a portfolio of hedge funds to a wealth management strategy. Using historical HFRI index returns, correlations and standard deviations of a mix of hedge fund index strategies that include convertible arbitrage, energy, Fixed Income Arbitrage, Event Driven, Equity Hedged and Distressed Securities is compared to comparable returns, correlations and standard deviations of a traditional mix of assets that include stocks and bonds. The further one goes to the right on the chart the higher the volatility of fluctuation of the portfolio. The higher you go on the chart, the higher the expected return based on historical averages. The sloping lines represent efficient portfolios. The dashed line represents the traditional asset classes and the steeply sloped line to the right represents the potential efficient portfolios for the hedge fund portfolios.



When using a chart such as this, it is clear that the risk return characteristics are potentially very attractive for investing in a portfolio of this type. It is important to note that past history is no assurance of a future result and the portfolio has constraints to put no more than 25% into any one strategy.

Hedge funds and Alternative investment strategies are not for everyone, but to not examine the risks and rewards of whether or not these tools will bring value to your wealth management strategy would be like Tiger Woods deciding to not take all his clubs to the next tournament. He may decide not to take all on a particular round for many well thought out reasons but to not have all the tools at his disposal would seem to be unprepared. As pointed out above there are many risks with these types of investments. There is no substitute for a complete due diligence on any hedge fund strategy within a wealth management strategy.

This makes for some interesting statistical information but how does this factor into a real scenario? Let's assume that an investor has a portfolio of $5,000,000 and needs to withdraw $200,000 per year adjusted for inflation at 3%. The first graph that follows represents the Hedge Fund portfolio. Using Monte Carlo modeling that runs 10,000 simulations the portfolio value before taxes in the 50th percentile would be over $15,000,000. In the 90th percentile (leaving a 10% probability of a lower number) the value is over $11,000,000. The second graph is targeting the same risk or volatility of the portfolio but using traditional stock and bond asset classes. Here in the 50th percentile the portfolio value is a little over $9,000,000 compared to over $15,000,000 for the hedge fund portfolio or 65% difference. In the 90th Percentile the numbers are also dramatic with nearly an 80% difference. Of course, past results do not guarantee future or will be indicative of future performance, but clearly to not consider these assets classes leaves important tools on the table.

I don't know any financial advisor who would recommend 100% of a portfolio to alternative investments and we would not consider it prudent either. But to consider 20-30 per cent in a long term wealth management strategy may in fact be very appropriate and useful in meeting long-term financial objectives.

If you would like to learn more about the financial services provided by White Oaks Wealth Advisors, Inc., call us at 800-596-3579, or visit [www.whiteoakswealth.com.](http://www.whiteoakswealth.com)

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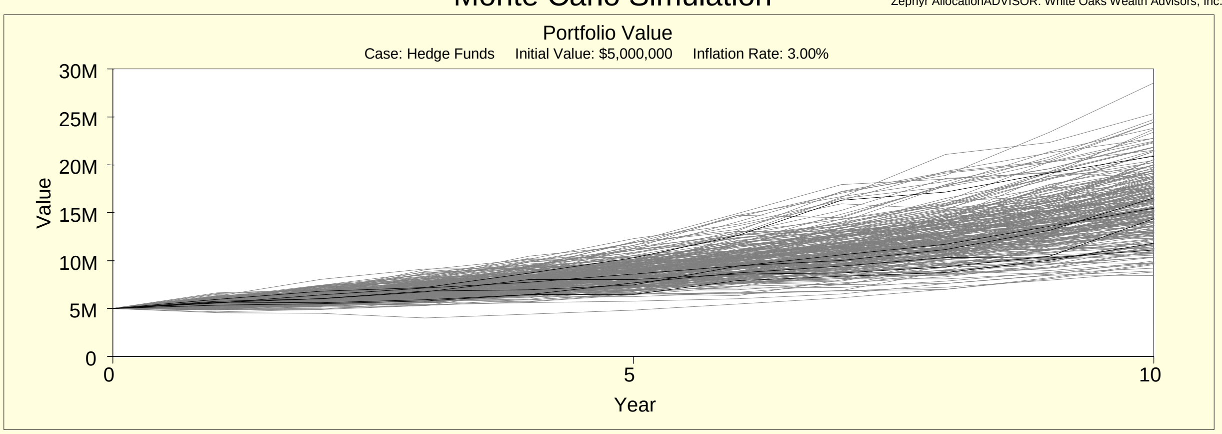
Monte Carlo Simulation

Zephyr AllocationADVISOR: White Oaks Wealth Advisors, Inc.



Portfolio Value

Case: Hedge Funds Initial Value: $5,000,000 Wealth Goal: $1,000,000 Inflation Rate: 3.00%

Simulation Trials

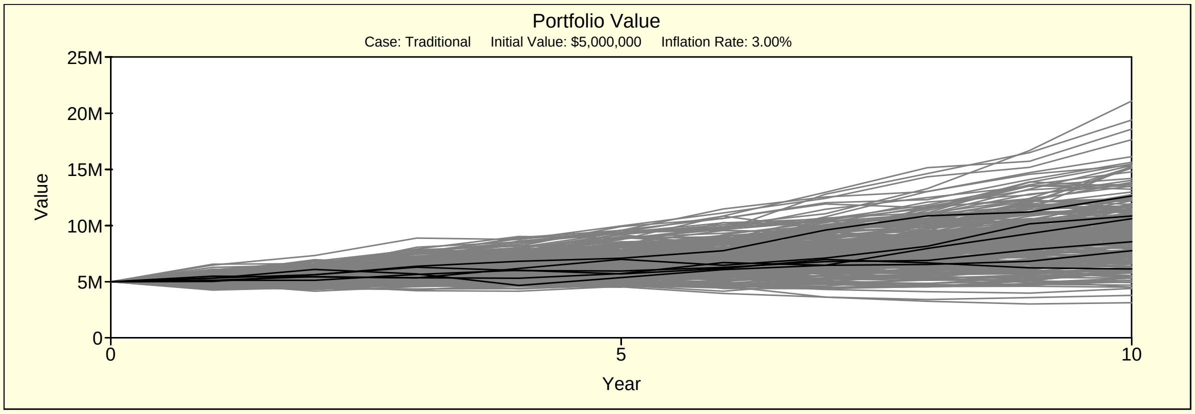
	Year 5	Year 10
Portfolio Value		
10th Percentile:	$10,290,275	$20,200,736
25th Percentile:	$9,424,876	$17,720,742
50th Percentile:	$8,497,279	$15,218,417
75th Percentile:	$7,681,045	$13,108,790
90th Percentile:	$7,012,562	$11,462,758

Flows

	Year 5	Year 10
$200k Per Year		
Average Flow:	($231,855)	($268,783)

Monte Carlo Simulation

Zephyr AllocationADVISOR: White Oaks Wealth Advisors, Inc.



Portfolio Value

Case: Traditional   Initial Value: $5,000,000   Wealth Goal: $1,000,000   Inflation Rate: 3.00%

Simulation Trials

	Year 5	Year 10
Portfolio Value		
10th Percentile:	$8,463,761	$13,085,750
25th Percentile:	$7,536,916	$11,045,266
50th Percentile:	$6,688,782	$9,190,796
75th Percentile:	$5,922,718	$7,603,012
90th Percentile:	$5,282,805	$6,380,215
Flows		
$200k per year		
Average Flow:	($231,855)	($268,783)