Understanding Hedge Fund Investments

MQ PORTFOLIO MANAGEMENT LIMITED
MQ Portfolio Management Limited ACN 092 552 611 ("MPML").

This educational booklet has been prepared by MPML for general information purposes only and contains purely factual information.

This booklet contains purely factual information and does not involve the expression of an opinion or recommendation. It does not constitute financial product advice and should not be relied on as such. None of the information takes into account any person’s personal objectives, financial situation or needs.

Investors should always read in full the Product Disclosure Statement (PDS) to an investment prior to making an investment decision.

No product referred to in this publication (each “Product”) is sponsored, endorsed, sold or promoted by the sponsor of any of the indices referred to herein. No sponsor has been involved in preparing this booklet. No sponsor makes any representation or warranty, express or implied, to the holders of the Product or any member of the public regarding the advisability of investing in securities generally or in any Product particularly or the ability of any index to track general stock market or other performance. The indices are determined, composed and calculated by the relevant sponsor without regard to MPML or any Product. No sponsor has any obligation to take the needs of MPML or the holders of the Product into consideration in determining, composing or calculating an index. No sponsor is responsible for and has not participated in the determination of the timing of the sale of any Product, prices at which any Product is initially to be sold, or quantities of any Product to be issued or in the determination or calculation of the equation by which any Product is to be converted into cash. No sponsor has any obligation or liability in connection with the administration, marketing or trading of the Product.

To the extent permitted by law, MPML accepts no responsibility for errors or misstatements, negligent or otherwise. The information may be based on assumptions or market conditions and may change without notice. This booklet is based on information obtained from sources believed to be reliable but MPML does not make any representation or warranty that the information is accurate, complete or up to date nor does it accept any obligation to correct or update the information or opinions in it.

No part of the information is to be construed as a solicitation to make a financial investment.

Past performance is not indicative of future performance.

MPML is not an authorised deposit-taking institution for the purposes of the Banking Act (Cth) and MPML’s obligations do not represent deposits or other liabilities of Macquarie Bank Limited ABN 46 008 583 542 ("Macquarie"). Macquarie does not guarantee or otherwise provide assurance in respect of the obligations of MPML.

This information is current as of 19 January 2007.
<table>
<thead>
<tr>
<th>Contents</th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Hedge Funds</td>
<td>4</td>
</tr>
<tr>
<td>2. The Australian Hedge Fund Industry</td>
<td>7</td>
</tr>
<tr>
<td>3. Some Hedge Fund Myths Dispelled</td>
<td>8</td>
</tr>
<tr>
<td>4. Performance of Hedge Funds</td>
<td>10</td>
</tr>
<tr>
<td>5. Types of Hedge Fund Investments</td>
<td>12</td>
</tr>
<tr>
<td>6. Hedge Fund Strategies</td>
<td>14</td>
</tr>
<tr>
<td>7. Employing Hedge Funds in a Portfolio</td>
<td>17</td>
</tr>
<tr>
<td>Strategy 1: Reducing Portfolio Risk</td>
<td>18</td>
</tr>
<tr>
<td>Strategy 2: An Alternative to Fixed Income</td>
<td>20</td>
</tr>
<tr>
<td>Strategy 3: Enhancing Australian Equity</td>
<td>22</td>
</tr>
<tr>
<td>Strategy 4: Lower Risk International Exposure</td>
<td>25</td>
</tr>
</tbody>
</table>
1. Hedge Funds

Despite the considerable attention devoted to them, there is no concise definition of a hedge fund. One of the most simple and appealing descriptions is that hedge funds employ strategies to capitalise on inefficiencies in a market. As a result they tend to be less dependent on the market’s overall direction, and successful hedge fund strategies can enjoy positive returns in both good and bad times.

Hedge fund managers typically aim to achieve specific returns with lower risk than traditional investment approaches. This reduction in risk, combined with the potential to earn positive returns in good and bad times, has seen exposure to hedge funds increasing across portfolio allocations. By providing a source of return distinct from traditional assets, it is argued that hedge funds can add diversification benefits and smooth overall portfolio returns.

Hedge funds can be thought of as a specialised form of managed fund. In Australia, the regulatory regime does not distinguish between the two and as a result domestic hedge funds are subject to the same registration, licensing and disclosure requirements.

What is a Traditional Managed Fund?

A traditional managed fund is an investment vehicle that pools the money of many individual investors. That pool of money is then invested by a professional manager in accordance with the objectives of the fund.

A traditional fund manager generally aims to make a return relative to an index or benchmark. For example the S&P/ASX 200 Accumulation Index is a broad index generally used to measure the performance of the Australian share market. It is based on the value of, and dividends paid on, 200 of the largest shares listed on the ASX.


* By market capitalisation
A traditional managed fund may achieve its aim of outperforming an index’s performance but deliver a negative return because the index has fallen in value. For example, if the S&P/ASX 200 Accumulation Index fell by 7% over the relevant period, a traditional managed fund that produced a -5% return would achieve its aim (a return 2% better than the -7% return of the index) but still deliver a negative return.

In contrast, a hedge fund manager aims to deliver returns that are less correlated to an index or traditional asset classes.

**What is a Hedge Fund?**

The term *hedge fund* is used to broadly describe managed funds that use a wider range of investment strategies and asset classes than a traditional managed fund. The origin of the term may have been used to indicate that the investment manager of the fund sought to hedge against risk by using specific investments or strategies.

For example, a *long short equity fund* may take a *long position* (by buying shares in a company that is thought to be undervalued) and seek to *hedge* that long position by taking a *short position* (by selling shares in another company that is thought to be overvalued) in the same sector. In this way the fund is hedging its exposure to the sector that both shares belong to. Hedge funds that employ hedging in the traditional sense are seeking to reduce the *volatility* of the funds returns. The term hedge fund is now used more broadly and not all hedge funds use a hedging strategy.

---

**Hedging** means investing or acquiring a financial instrument that is expected to offset the risk (to some extent) of another investment or financial instrument.

**Volatility** is a measure of the degree of fluctuation in a fund’s returns. The higher the volatility, the higher the variation you should expect in a fund’s returns.
A hedge fund manager may invest in the same types of assets that a traditional manager uses, such as the traditional asset classes of shares and fixed interest securities (such as bank bills and bonds). However, a hedge fund manager will use a range of financial instruments and trading techniques with the aim of producing returns that are relatively independent of, or have a low correlation to, general changes in market values or indices.

The low correlation to general changes in market values and indices usually sought by hedge funds has led to such funds often being referred to as absolute return funds, which refers to the ability to make profits in both rising and falling markets. The return objective of the hedge fund is to produce an absolute return not a return relative to an index or benchmark.

Hedge funds also often use leverage to increase the exposure of the fund’s portfolio to a level greater than the net assets of the portfolio by borrowing or through the use of derivatives. Leverage is also known as gearing.

**Correlation** is a measure of the extent to which the value of one variable is related to the value of another variable. A low correlation means that the movement in the value of one asset is relatively independent of the movement in the value of another asset.
2. The Australian Hedge Fund Industry

Hedge funds are not new in Australia, or to Australian investors. However the industry has experienced significant growth in the last few years, as demand from Australian investors for absolute return style investments has accelerated. Industry sources claim the Australian hedge fund industry (hedge funds with Australian based managers) manages around $60 billion across 200 funds as of 2006\(^2\). From 2004 to 2006, the industry has grown from around 3% of the total Australian managed funds to over 5\(^3\). During this same period, Australian hedge funds as a percentage of the global hedge fund industry have increased from just over 1% to nearly 3%.

Whereas once hedge funds were dominated by investments from very wealthy individuals, current hedge fund exposure can be found in many investors’ direct portfolios, or in the superannuation funds they own.

At the end of June 2006, the estimated total size of the funds invested by Australians in Australian hedge funds was $51 billion\(^4\). Approximately $39 billion of this is invested directly by retail and high net worth individuals, with the remaining $12 billion contributed by institutions such as superannuation funds. In 2003 fewer than 20% of Australian institutional investors invested in hedge funds. This rose to 1 in 3 in 2005\(^5\).

Access for retail investors into hedge funds has also been made easier as more hedge fund managers open retail funds with lower minimum investments, and as administration platforms used by retail investors offer access to wholesale hedge funds.

---

\(^2\) Recent Developments in the Australian Hedge Fund Industry’, RBA Domestic Markets Department, 2006.

\(^3\) Ibid.

\(^4\) LCA Publications. www.lcapublications.com

3. Some Hedge Fund Myths Dispelled

**Myth One: All hedge funds are extremely risky**

There is risk inherent in any investment, but the belief that hedge funds are, by definition, more risky than other investments is misplaced. Firstly, there should be a clear distinction between market risk and operational risk.

Regarding market risk, many hedge funds aim to control risk, not leave it unchecked. By protecting or hedging their portfolios against broad market risks hedge funds can present a lower risk profile than traditional funds.

Operational risk (that is, how well a hedge fund operates) should be assessed in relation to each individual fund. Investing with a reputable investment manager may mitigate this risk.

Unlike many countries, the Australian regulatory environment treats domestic hedge funds in the same way as traditional funds. Being subject to the same registration, licensing and disclosure requirements helps to remove some of the mystery that surround hedge funds. Like any investment you need to be informed before you make an investment decision and should seek professional advice where appropriate.

**Myth Two: Hedge funds will add risk to my portfolio**

The irony is that while hedge funds have been seen as risky, used wisely they can actually reduce risk in your total investment portfolio. Hedge funds often have a low correlation to traditional asset classes. For example, an equity-market neutral fund may provide a degree of protection during periods of hostile equity markets.

Of course, having too much exposure in any investment is risky. If you spread your investments wisely, hedge funds can form part of your diversification strategy, helping to strengthen your portfolio. You should be also aware of the effects of “leverage” – see Myth Four.
Myth Three: Hedge funds generate massive returns

Some hedge funds do aim to generate larger returns, but these funds also take on larger risk and can be quite volatile. There is a huge variety of hedge fund investments available, and many of them do not target extremely high returns. Rather, they aim to generate less volatile and more consistent returns than traditional funds.

Myth Four: All hedge funds use vast amounts of leverage

Leverage means increasing the exposure of the hedge fund’s portfolio to a level greater than the net assets of the portfolio by borrowing or through the use of derivatives. Leverage is also known as gearing and can be achieved by the fund borrowing money to invest, for example. Not all hedge funds use leverage, although many do. Funds that use leverage do so in an attempt to enhance their returns. Some funds use leverage to enhance returns from low-risk trades, while other funds use it to increase exposure to directional trades. Leverage is a two-edged sword and funds that use leverage can be more risky than un-leveraged funds. Historically there have been instances of funds using excessive leverage unwisely and suffering large losses as a result. The policies of a hedge fund manager in terms of risk management and leverage use are of key importance in assessing the manager for potential inclusion in a portfolio.

Conclusion

The important lesson for potential investors is to invest with a reputable manager who has the requisite experience to manage your money. Only invest in those hedge funds that suit your investment profile, thereby adding diversification and risk-reward benefits to your total investment portfolio.
4. Performance of Hedge Funds

The Global Experience

For a more complete picture of the benefit of hedge funds in a variety of market conditions, consider both the investment returns and the volatility of these returns. The chart below shows the superior performance of the HFRI Fund Weighted Composite Index (a global hedge fund index) compared to the MSCI World Index (an index of the world’s sharemarkets) since the turn of the century. As compelling as the stronger performance is, the fact that global hedge fund exposure has offered a measure of protection or lower volatility during difficult times in the global equity market (2000 – 2002) is probably more significant. Monthly volatility for the MSCI World Index was 14.3% over this period compared to 6.6% for the HFRI.
The Asia-Pacific Experience

Looking closer to home, we see that hedge funds in the Asia-Pacific region have also managed to outperform the broader equity market and provide a level of downside protection during difficult times (2000-2002). Once again the volatility of the Eurekahedge Asia Fund Index at 6.2% was significantly lower than the MSCI Asia Pacific Index at 13.7%.

Interestingly, Asian hedge funds have managed to outperform the global hedge fund industry over the same period. This reflects the success of Asian managers in capitalising on the volatility and relative inefficiencies that typify their target markets to further enhance returns, compared to global hedge funds.
5. Types of Hedge Fund Investments

There is a huge variety of hedge fund strategies and an even wider array of investments providing access to hedge funds. For Australian investors, there are four main ways to access hedge funds.

**Single Strategy Funds**

Single strategy funds invest in financial markets using one main investment strategy. The fund manager has usually developed its skills over many years and has established an ‘edge’ it believes to be sustainable through a variety of market conditions.

An example of a single strategy fund is an Australian equity long/short fund. Single strategy funds usually have high minimum investments and capacity constraints, which limit the size to which the fund can grow.

**Multi-Strategy Funds**

Multi-strategy funds are similar to single strategy funds in that they invest in financial markets. However, the multi-strategy manager uses more than one strategy to generate returns and can usually allocate the fund’s capital dynamically in response to the perceived opportunity set for each strategy.

The benefit of a multi-strategy fund is that it provides greater diversity to the investor and may therefore offer a reduced risk profile than the single strategy fund. The manager may add new strategies over time, thus helping to avoid capacity constraints.

**Funds of Hedge Funds**

For many investors, funds of hedge funds (“FOFs”) will be their first investment in hedge funds. FOFs do not invest in financial markets directly. Rather they invest in a portfolio of individual single strategy or multi-strategy funds. The benefit of a FOF investment is that the FOF manager uses its expertise to perform initial and ongoing due diligence on many hedge fund managers. This analysis allows a successful FOF manager to establish and manage a diverse and robust portfolio of hedge funds. FOF managers will usually take a dynamic approach to portfolio management, and switch between strategies and funds as opportunities arise, thereby attempting to ensure an efficient use of capital.
By pooling investor monies, FOFs are able to access funds that most individuals would not be able to access directly. For the benefits FOFs provide, investors usually face an increased level of fees compared to a single strategy fund investment.

**Structured Hedge Fund Products**

Structured hedge fund products provide access to either single strategy, multi-strategy or fund of hedge fund investments, with additional benefits. Structured hedge fund products are usually closed end offers. This means they are open to investors for a short time only, and once closed, run for a set period, which may be as little as 3 years or as much as 20 years.

Additional benefits that structured hedge fund products may offer are:

- capital protection
- currency hedging
- regular distributions
- optional leverage

Each of these benefits may appeal to different investors. Structured hedge fund products offering capital protection may provide a degree of comfort for some first-time investors in terms of capital preservation. Sophisticated investors, on the other hand, may benefit from the increased funding opportunities a 100% capital protection facility can create.
6. Hedge Fund Strategies

In Australia there is now a significant breadth of investment strategies being employed by hedge fund managers, as illustrated in the following pie chart. Some of the more popular strategies are described in greater detail in the following section. Hedge fund managers may also elect to focus on a geographic region in addition to a particular strategy.

**Equity Long Short**

This strategy combines long positions in equities that are expected to increase in value, with short (sold) positions in equities that are expected to decrease in value. Investments can be made as individual trades, sector trades or pairs trades, where one stock is bought and another sold short with the view that the former will outperform the latter. Managers usually have great flexibility in being able to hedge core positions with other shares, equity indices, options, warrants or hybrid securities. To short a stock, a fund borrows the relevant shares then sells them into the market, depositing the proceeds to generate cash returns. Short positions can act as a partial hedge against market risk or may be used to generate a discrete profit when the short sold security falls in price. Managers can shift their overall net exposure (which usually varies in a range from slightly net short to significantly net long) to match their view of the market.
**Absolute Return/Equity Market Neutral:** A type of Equity Long Short strategy where managers aim to generate excess returns, known as alpha, regardless of the direction of the equity market. This is achieved by establishing a portfolio that aims to eliminate broader market risk, known as beta. A portfolio of long and short positions is constructed to offset each other as much as possible, leaving the portfolio “neutral” across many risk dimensions. By attempting to remove these risks and their potential adverse impact on a stock’s price, the manager is aiming to capitalise purely on the expected stock-specific price movements.

**Relative Value:** These strategies employ quantitative and qualitative techniques to identify mispricing between related securities. Relative value managers aim to identify and subsequently profit from these mispricings. Examples of relative value strategies include statistical arbitrage and capital structure arbitrage.

**Statistical Arbitrage:** Funds employing statistical arbitrage strategies use quantitative techniques to identify baskets of related securities. They then purchase baskets of securities and sell short baskets of securities which together have prices that are likely to move back towards an historic average. The tendency of stocks to behave in this manner is known as mean reversion.

**Capital Structure Arbitrage:** A strategy that aims to profit from the relative mispricings of various forms of capital employed by a single company. A hedge fund using a capital structure arbitrage strategy would analyse the different securities offered by a particular company. If the fund identified a discrepancy in the pricing of the securities, it would purchase the undervalued security and sell short the overvalued security, with the expectation that the value of the two securities would converge at some time in the future.

**Event Driven:** Event driven strategies aim to profit from the market’s mispricing of a company’s securities, where the company is subject to anticipated or current corporate events. The mispricing of such securities is typically due to differences in opinion of investors and analysts of the likelihood of the relevant events occurring, and the time in which they will actually occur. Such events include mergers and acquisitions, capital restructures, dividend announcements, capital raisings, corporate buybacks, earnings announcements and any other significant market or corporate event.
Global Macro

Global macro is a highly flexible strategy usually involving active trading and managing of positions across global markets based on the manager’s understanding of economic factors that drive inter-related markets. The macro manager may trade interest rates, commodities, currencies and equities with the expectation that prices of these instruments will change as economic factors come into play. Investment styles vary greatly, depending on the expertise of the global macro manager. Decisions are made using either the manager’s judgement, called ‘discretionary trading’, or using systematic models which the manager has built based on historical pricing or fundamental information. Time frames for global macro trades can range from minutes to months.

Tactical Trading

Tactical trading, or managed futures, is a strategy employed by Commodity Trading Advisers (CTAs). CTAs can utilise directional, spread-based and option-based strategies applied to global futures markets. Futures contracts are available to access movements in commodities, currencies, equity indices and fixed income markets. Managers who use managed futures either use their own discretion to interpret fundamental or technical analysis and take positions accordingly, or use systematic models to generate trading signals. Positions tend to be held for the short to medium term.
7. Employing Hedge Funds in a Portfolio

On the next pages we discuss four strategies utilising hedge funds within a “typical” portfolio. A core theme in these strategies is to manage and often reduce risk in a particular section of the portfolio and the portfolio as a whole.

The standard approach to investing in hedge funds is as a component of a balanced portfolio. Typically hedge funds will be considered in a stand alone asset class, normally as part of Alternative Investments. Strategy 1 outlines this approach. The three remaining strategies integrate hedge funds into traditional asset classes, enhancing the risk return profile of the exposure as a result.

None of the strategies described should be taken as a personal recommendation: please seek professional advice before deciding how hedge funds might work in your portfolio.

- **Strategy 1: Reducing Portfolio Risk**
- **Strategy 2: An Alternative to Fixed Income**
- **Strategy 3: Enhancing Australian Equity**
- **Strategy 4: Lower Risk International Exposure**
Strategy 1: Reducing Portfolio Risk

This approach is perhaps the most typical application of hedge funds in an investment portfolio. It relies upon allocating a specific amount of the portfolio to hedge funds on the basis that the diversification benefits will reduce overall risk within the portfolio.

These diversification benefits rely on a few simple financial principles:

- some assets are riskier than others
- not all types of assets move in the same direction, at the same time
- some investments perform better than others when traditional markets decline.

Asset allocation theory uses these principles, and instead of chasing short term high returns, aims to create a portfolio that produces consistent returns with lower risk. Investing across a number of asset classes may mean underperforming some of those assets in bullish markets, but over longer time frames and through market cycles the highs and lows will tend to offset each other. Providing this stability of returns over time by managing overall risk is the fundamental aim of portfolio diversification.

As an effective diversification tool, well-managed hedge funds display two important properties:

- an attractive risk return profile
- low correlation to traditional asset classes
By investing in well-managed hedge funds, it may be possible to improve the risk return profile of a portfolio. To illustrate this point two theoretical portfolios can be constructed using indexes.

<table>
<thead>
<tr>
<th>Index</th>
<th>Portfolio A</th>
<th>Portfolio B</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P/ASX Accumulation Index</td>
<td>50</td>
<td>40</td>
</tr>
<tr>
<td>MSCI World Index</td>
<td>20</td>
<td>10</td>
</tr>
<tr>
<td>Eurekahedge Asian Hedge Fund Index</td>
<td>–</td>
<td>30</td>
</tr>
<tr>
<td>Lehmann Brothers Hedged Global Bond Index</td>
<td>30</td>
<td>20</td>
</tr>
<tr>
<td></td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>

This is an illustrative example only and not a recommendation. Past performance is not a reliable indicator of future performance.†

---

**Risk v Return - Portfolio Benefits of Including Asian Hedge Funds (2000 to 2006)**

---

**IN SUMMARY:**

**Benefits**
- Provide a diversified source of returns
- Reduce the overall risk of a portfolio

**Risks**
- Overall portfolio may underperform those asset classes enjoying strong performance in the short term.

---

† Actual risk profiles of the above and indices may change materially and suddenly. You should only decide how to reallocate your portfolio after discussing it with your financial adviser. This allocation does not take into account what you currently have or what you want and need for your financial future and may not be suitable for you.
Strategy 2: An Alternative to Fixed Income

Fixed Income investments are included in portfolios for a number of reasons, including the diversification benefits described in Strategy 1. Other sought after attributes of this asset class include:

- low risk exposure with an emphasis on capital preservation
- focus on income returns as opposed to growth

There are forms of hedge fund that exhibit similar characteristics to fixed income in terms of risk adjusted returns, strong income generation and a focus on capital preservation. A well diversified multi-strategy or fund of hedge fund can deliver consistent returns with low volatility (or risk). This low volatility is a function of the diversification benefits between the underlying strategies.

The performance of the various types of income indexes can be seen below with the final index being a hedge fund of fund index for comparative purposes.

<table>
<thead>
<tr>
<th></th>
<th>Return% pa</th>
<th>Volatility%</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 Year</td>
<td>3 Year</td>
</tr>
<tr>
<td>Lehmann Brothers Hedged Global Aggregate Bond Index</td>
<td>4.14</td>
<td>4.48</td>
</tr>
<tr>
<td>Salomon World Government Bond Index</td>
<td>6.42</td>
<td>4.00</td>
</tr>
<tr>
<td>Salomon World Govt Bond Index All Maturities</td>
<td>3.10</td>
<td>5.69</td>
</tr>
<tr>
<td>Lehmann Brothers Hedged Global Aggregate - Corporates</td>
<td>3.87</td>
<td>4.39</td>
</tr>
<tr>
<td>Lehmann Brothers Hedged Global Aggregate - High Yield</td>
<td>10.62</td>
<td>9.81</td>
</tr>
<tr>
<td>HFRI Fund of Funds Index</td>
<td>8.54</td>
<td>7.63</td>
</tr>
</tbody>
</table>
The table below highlights the average returns, assets under management and number of income funds that are available to Australian investors as at 30 June 2006.

<table>
<thead>
<tr>
<th>Australian Retail Income Funds</th>
<th>Return% pa</th>
<th>Combined Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>1 Year</td>
<td>3 Year</td>
</tr>
<tr>
<td>Australian Bond Funds</td>
<td>2.76</td>
<td>3.80</td>
</tr>
<tr>
<td>Global Bond Funds</td>
<td>1.12</td>
<td>4.24</td>
</tr>
<tr>
<td>Mortgage Funds</td>
<td>6.72</td>
<td>5.87</td>
</tr>
<tr>
<td>High-Yield Funds</td>
<td>5.77</td>
<td>7.92</td>
</tr>
<tr>
<td>Hybrid Income Funds</td>
<td>4.99</td>
<td>6.99</td>
</tr>
</tbody>
</table>

Source: Income Fund Characteristics and Risks, Morningstar, November 2006

Fixed income investments experience a number of risks (such as interest rate risk and credit risk) that can place returns under pressure at various times during the economic cycle. For a portfolio that is focused on generating income based return, it may not be appropriate to allocate away from fixed income to growth assets as they may not offer the same level of income returns. However, diversified hedge fund investments such as multi-strategy and hedge fund of funds may provide a similar income based return, but with less exposure to the risk factors that can drive fixed income returns. These hedge fund investments will be subject to a different set of risk factors, thereby providing diversification benefits to the overall portfolio.

IN SUMMARY:

Benefits
- Earn income based returns on a low volatility asset
- Diversify interest rate & credit risk that can drive fixed income returns

Risks
- Moves away from the traditional “asset class” style of portfolio allocation
Strategy 3: Enhancing Australian Equity

A buy write strategy uses derivatives to enhance the characteristics of an exposure to equity markets. It involves holding a portfolio of shares and then “writing” call options over those shares to generate additional income for the portfolio. The performance of a buy write strategy can be clearly seen in the comparison of the ASX 200 Index against the S&P/ASX Buy-Write Index.

The Buy-Write Index has clearly outperformed the S&P/ASX 200 Accumulation Index over this period. The key benefit of this strategy that the flow of option income acts as a buffer in flat and down months. As a result the volatility of the strategy over this period is 8.16% compared to 12.2% for the S&P/ASX 200 Index. Despite this lower risk over the period, the S&P/Buy-Write Index offered superior performance of 14.34% compared to the S&P/ASX 200 Accumulation Index’s 12.69%.

In strong bull markets however the buy write strategy is likely to underperform. This is due to the risk the option writer (holder of the strategy) being exercised and having to sell their shares at a price lower than they would have received on the market. In essence the option writer is giving this strong performance to the buyer of the option. The below breakdown of the market into a series of phases clearly illustrates this situation.

<table>
<thead>
<tr>
<th>Time Period</th>
<th>S&amp;P/ASX Buy-Write Index</th>
<th>S&amp;P/ASX200 Accumulation Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>BEAR Feb 02 to Feb 03</td>
<td>-2.32%pa</td>
<td>-14.62%pa</td>
</tr>
<tr>
<td>BULL Mar 03 to Mar 06</td>
<td>16.81%pa</td>
<td>27.43%pa</td>
</tr>
<tr>
<td>FLAT Apr 06 to Sep 06</td>
<td>6.07%</td>
<td>0.14%</td>
</tr>
</tbody>
</table>
Despite this under-performance in bull markets, the strategy has tended to outperform over the longer term, whilst lowering risk and offering all the benefits of holding a portfolio of Australian shares.

IN SUMMARY:

Benefits
- Improve the risk return profile of an Australian Equity exposure
- Receive dividends and franking credits from the portfolio of shares
- Earn additional income from written options

Risks
- Written call options are likely to be exercised in strong bull markets causing a negative impact on performance
Strategy 4: Lower Risk International Exposure

Australian investors have increasingly sought exposure to international equity markets. Despite the Australian market’s strong performance of recent times many investors are interested in growth that may exist in international equity markets and appreciate the diversification benefits of a broader equity holding.

Equity long short strategies may offer a lower risk investment in international markets than long only or index based exposures. This style of investing is one of the hedge fund strategies that is starting to join the mainstream. Many traditional long only managers have launched new funds or extended their investment mandates to allow the use of shorting. This has served to reduce the distance between long short and “traditional” long only investing. Consequently, a growing number of investors now allocate long short funds within the “traditional” asset classes alongside long only funds.

By being able to short either individual stocks or the market itself, successful long short funds can remove some of the broader risk factors from the performance of stocks in which they are investing. As an example the Eurekahedge Asia Long Short Index is compared to the MSCI Asia Pacific Index below:

The above graph shows the out performance of Asia long short funds over the period when compared to the broader market (MSCI Asia Pacific Index).
The above graph illustrates the variability of monthly returns, with the MSCI Index (in blue) showing much larger monthly up and down movements than the red Eurekahedge Asia Long Short Index. While the strategies employed by Asian long short funds may mean slightly less performance in the months the equity market performs strongly, it was the Asian long short funds better performance in the down or flat months that drove their superior long term performance.

Exposure to equity markets may benefit from holdings in both long only and long short funds. This may serve to reduce the risk of the equity exposure overall.

IN SUMMARY:

**Benefits**
- Reduce risk in volatile international equity market exposures
- Potential to remove broader market influences from the performance of the investment

**Risks**
- May underperform long only/index funds in strong bull markets
Contact your adviser or Ask Macquarie

📞 1800 025 513
(IO) www.macquarie.com/mq
(@) mq@macquarie.com