<table>
<thead>
<tr>
<th>Contacts</th>
</tr>
</thead>
</table>
| Conor Clancy  
Manager– Audit  
Deloitte & Touche Ireland  
E: coclancy@deloitte.ie  
T: +353 417 22 33 |
| Hervé Hens  
Manager– Capital Markets  
Deloitte Tax & Consulting Luxembourg  
E: hehens@deloitte.lu  
T: +352 417 57 63 |
## Agenda

1. **Alternative Investments & Hedge Funds**
   - Definition of Hedge Funds
   - Definition of Alternative Investments

2. **Type of Hedge Funds**
   - Fund of Funds
   - Managed Accounts
   - Single Manager Funds

3. **Hedge Funds Strategies**
   - Market Trend Strategies
   - Event Driven Strategies
   - Arbitrage Strategies
   - Multi Strategy

4. **European AIFs**
Alternative Investments

Definition

• Alternative investment universe: traditional asset classes used in non-traditional strategies

• Alternative investment universe: non-traditional asset classes

Alternative investment markets encompass:

– hedge funds
– venture capital
– private equity
– real estate
Alternative Investments

Definition

• Sophisticated investments that carry different risks to traditional investments such as shares and property.

• Alternative investments carry
  – *Additional diversification, premium yields for taking on different risks (liquidity risk, information risk)*
  – *Improved risk/return characteristics*
  – *Alternative Asset managers possess flexibility to make investment decisions « skill based » strategies*
  – *Focus on absolute returns instead of relative returns: performing well in any market situation*
Hedge Funds

No standard definition
- Ability to short the market, to leverage the portfolio to multiply gains, and to hold high concentrations of positions
- No industry-wide classifications of hedge fund strategies, each major industry group has its own classification system

Attractions
- Expectation of strong returns (historical data)
- Low correlations to traditional asset classes and ability to provide diversification
- Absolute returns / Traditional managers that have relative return orientation

Misconceptions
- All hedge funds are risky investments: many funds have low degree of risk inherent in their strategies.
- Hedge Funds are illiquid: not necessarily the case
Structural organization of Hedge Funds

Differences between Hedge Funds and traditional Funds

• The role of Prime Broker
  – Why a Prime Broker?
    ➢ Clearance
    ➢ Custody
    ➢ Research
    ➢ Financing
    ➢ Stock Lending

• Other differences:
  ➢ Fee structures
  ➢ Lock in period
  ➢ Redemption windows
  ➢ Side pockets
Key Market Participants of Hedge Funds

- **Investors**
  - Subscribe / Redeem
  - AML / Communications

- **Transfer Agent**
  - Manages Subs & Reds
  - Maintains Shareholder Register

- **Investment Manager**
  - Manages Fund
  - Earns fees
  - Executes trades

- **Hedge Fund**
  - Calculates NAV
  - Reporting / Financial Statements

- **Administrator**
  - Regular Reporting

- **Prime Broker**
  - Regular Reporting
  - Holds Cash & Investments

- **Board of Directors**
  - Governance and oversight

**Link'n Learn – Introduction to Hedge Funds**
Hedge Funds
Key Participants and Roles

Investment Manager

- Responsible for establishing the fund
- Often located in hedge fund centres such as London and New York
- Vary in size from boutique firms to global players
- Markets the fund to investors (often works with distributors to market fund across multiple jurisdictions)
- Manages portfolio of investments and makes investment decisions (portfolio management may be undertaken by a separate investment advisor)

Board of Directors

- Ultimate responsibility for the governance of the fund and for safeguarding the interests of investors
- Also responsible for approving the fund documents, the financial statements and the appointment of the service providers
Alternative Investments
Key Participants and Roles

Administrator

• Calculation of Net Asset Value (NAV)
  • Maintaining and updating the portfolio of investments
  • Pricing of assets/calculation of Net Asset Value
  • Calculating fees and expenses
• Preparing interim and annual accounts

Transfer Agent

• Completes Know Your Client (KYC) and Anti-Money Laundering (AML) procedures
• Processes subscriptions and redemptions including the collection and payment of cash
• Maintains shareholder register
• Manages shareholder communications
• Processes dividends/distributions
Types of Hedge Funds
<table>
<thead>
<tr>
<th>Type of Hedge Fund</th>
<th>Definition</th>
<th>Minimum Subscription</th>
<th>Advantages</th>
<th>Drawbacks</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund of Funds</td>
<td>Access a variety of underlying funds managers and strategies</td>
<td>Less than required for participation in the individual funds</td>
<td>✔ Lower level of risk ✔ Diversification ✔ Uncorrelated ✔ Expert knowledge ✔ Short-term ✔ Due Diligence</td>
<td>✔ An additional layer of fees ✔ Returns tend to be more modest ✔ Limited liquidity ✔ Lack of control/customisation</td>
</tr>
<tr>
<td>Managed Accounts</td>
<td>Investment account that is owned by an individual investor and looked after by a hired professional manager.</td>
<td>Between 2m$ and 20m$</td>
<td>✔ Full disclosure ✔ Daily liquidity ✔ Risk management ✔ Transparency ✔ Selection of prime broker, custodian, and auditor</td>
<td>✔ Tax ✔ Regulatory reasons ✔ Investment restrictions</td>
</tr>
<tr>
<td>Single Manager Funds</td>
<td>One single fund manager who invests directly in securities.</td>
<td>High minimum subscription</td>
<td>✔ Strategy specialists ✔ Market neutral ✔ Arbitrage ✔ Relative value ✔ Event driven ✔ Market trend</td>
<td>✔ Diversification ✔ Transparency</td>
</tr>
</tbody>
</table>
Hedge Funds Strategies

Market Trend (Directional / Tactical) Strategies

- Global Macro
- Managed Futures/CTAs
- Emerging Markets
- Equity Long/short
- Short Bias
Market Trend
Global Macro

• Aims to profit from changes in global economies, typically brought about by shifts in government policy which impact interest rates, in turn affecting currency, stock, and bond markets.

• Participates in all major markets.

• Uses leverage and derivatives.

• May have long and short positions that are not designed to hedge each other.

• Objective: profit by making concentrated directional bets in these markets.

• **Main Characteristics:**
  – Among the highest returns of all hedge fund strategies.
  – Among the most volatile strategies.
  – High correlations to stocks and bonds in comparison to other hedge fund strategies.
Market Trend
Managed Futures/CTAs

• Managed futures are investments that allow the investor to access the world's futures markets through the services of professional money managers known as commodity trading advisors (CTAs)

• CTAs are highly specialized and trade only in their area of expertise while others focus on the advantage of trading a broad, diverse range of opportunities

• Managed Futures invests in futures and currencies on a global basis.

• The majority of CTAs are trend following.

• Even though hedge funds use derivatives, especially in global macro strategies, managed futures typically concentrate their overall returns, uniquely, on their ability to take directional bets either way on a leveraged basis through liquid derivatives (futures, forwards and options)
Market Trend
Managed Futures/CTAs

Benefits of Managed Futures:
- Reduce portfolio volatility risk
- Low correlation with traditional assets
- Capacity to profit from bear markets as well as from bull markets
- Suitability for global diversification of portfolios
- Efficient use of low-cost derivatives markets
- Participate in a wide variety of financial products and markets not available in traditional investment products (e.g. commodities)
Market Trend
Emerging Markets

• Invests in equity or debt of emerging (less mature) markets which tend to have higher inflation and volatile growth

• Can specialize in equity or fixed-income positions or have balanced positions.

• Very sensitive to economic and political factors

• Investments in emerging market => Fairly volatile

• Short selling is not permitted in many emerging markets
Market Trend
Equity Long / Short

• Equity Long/Short involves share based investing on both the long and short side of the market across a range of sectors, categories and regions

• Represents the largest amount of hedge funds assets

• Tends to be more correlated to benchmark indices because of a bias towards net long market exposure

• Effort is made to buy and sell the right stocks (or stock sectors)

• Focus on market direction

• Difficult to get consistent performance results

• Important to review the performance of the funds individually
Market Trend

Short Bias

• Short sale of over-valued securities, by either selling borrowed stock or using derivatives to create synthetic shorts

• Because losses on short-only positions are theoretically unlimited (because the stock can rise indefinitely), these strategies are particularly risky

• Some of these dedicated short funds are among the first to foresee corporate collapses

• The managers of these funds can be particularly skilled at scrutinizing company fundamentals and financial statements in search of red flags
Event Driven Strategies

- Distressed Securities
- Merger / Risk Arbitrage
Event Driven Strategies
Distressed Securities

• Buys equity, debt, or trade claims at deep discounts of companies in or facing bankruptcy or reorganization (Chapter 11 of the United States Bankruptcy Code).

• Profits from the market’s lack of understanding of the true value of the deeply discounted securities and because the majority of institutional investors cannot own below investment grade securities. (This selling pressure creates the deep discount.)

• Strategy relies on being able to buy securities with enough profit potential to offset the obvious risk of loss

• Exposure to the risk of default, usually not hedged

• Results generally not dependent on the direction of the markets
Event Driven Strategies
Distressed Securities
Event Driven Strategies
Merger / Risk Arbitrage

- Risk arbitrage, or merger arbitrage, managers take a long position in the stock of a company being acquired in a merger, leveraged buy-out, or takeover and a simultaneous short position in the stock of the acquiring company.

- Success relies almost entirely on whether the announced deal is completed or not. If the takeover fails, this strategy may result in large losses.

- Risk is often reduced by avoiding hostile takeovers and by investing only in deals that are announced. The “spreads” between the prices of the stocks of companies involved in these transactions are at all time lows.

- The potential profit spreads between the initial offers and the final deal prices are greatest in the case of hostile transactions.
Event Driven Strategies
Merger / Risk Arbitrage
Arbitrage Strategies

- Market Neutral
- Convertible Arbitrage
- Fixed Income Arbitrage
- Equity Arbitrage
- Mortgage Arbitrage
Arbitrage Strategies

Market Neutral

- Market Neutral/Arbitrage takes offsetting positions in closely related financial instruments with the aim of exploiting disparities in pricing relationships

- Managers of market-neutral long/short equity hedge funds make scores of investments by picking stocks they believe are sufficiently balanced to keep the portfolio buffered from a severe market swing

- Managers make sure the baskets of long and short investments are beta neutral; eliminating systematic risk

- Managers tries to create similar sector exposure, market capitalization, and currency risk in the long and short portfolios
Arbitrage Strategies

Market Neutral

• Rule of one alpha
  – Only one source of risk adjusted return;
  – One alpha refers to security selection;
  – L/S positions integrated to neutralize beta risk;
  – Differs from equity long short for which there are two alphas.

• Dollar Neutral
  – Equal amounts of long and short positions so the manager has zero net exposure to the market.
Arbitrage Strategies
Market Neutral

• Market risk is reduced, but effective stock analysis and stock pricing is essential to obtain meaningful results

• To keep the long/short portfolios balanced, the managers has to enter into large number of buying and selling transactions
  – Importance to execute trade efficiently
  – Importance to keep brokerage costs low
  – Invest in liquid assets

• Leverage may be used to enhance results

• Usually low or no correlation to the market

• Low volatility
Arbitrage Strategies
Market Neutral
Arbitrage Strategies
Convertible Arbitrage

• To be long the convertible securities and short the underlying equities of the same issuer: “working the spread” between the two types of securities

• Returns result from the difference between cash flows collected through coupon payments and short interest rebates, and cash paid out to cover dividend payments on the short equity positions

• Returns can also result from the convergence of valuations between the two securities

• Risk originates from the widening of the valuation spreads due to rising interest rates or changes in investor preference
Arbitrage Strategies
Convertible Arbitrage

- **Junk, Out-of-the-money**
- **At the money**
- **In the money**

- **Typical Issue Price**
- **Convertible Price**
- **Parity**
- **Premium**
- **Bond Floor**

- Stock Price
- Convertible Price
Arbitrage Strategies
Fixed Income Arbitrage

• To be long and short positions in bonds and other interest rate sensitive securities

• When combined, these positions approximate one another in terms of rate and maturity, but are suffering from pricing inefficiencies

• Risk varies with the types of trades and level of leverage employed. In the US, this strategy is often implemented through mortgage-backed bonds and other mortgage derivative securities

• This has proven to be a very profitable but unpredictable strategy. Mortgage securities carry imbedded options that are very difficult to value and even more difficult to hedge
Arbitrage Strategies
Fixed Income Arbitrage
Arbitrage Strategies

Equity Arbitrage

- Buying or selling a “basket” of stocks or other securities and taking a counter position in index futures contracts or options to capture differentials due to inefficiencies in the market.

- Unfortunately, computerized trading and the massive liquidity of modern securities markets have conspired to increase the efficiency of index pricing and therefore reduce the potential for profits from this strategy.

- Moderate returns with moderate risks.

- Slightly higher volatility of returns than these other arbitrage strategies but with sufficient returns to justify the increased risk.

- Fairly high correlations to stock indices and other equity hedge fund strategies (45-50 percent).
Arbitrage Strategies
Mortgage Arbitrage

• Mortgage bonds are complicated instruments that resemble a bond paired with a short position in an embedded option

• These securities are reengineered into collateralized mortgage obligations (CMOs) and real estate mortgage investment conduits (REMICs) that are designed to divide the prepayment risk => creation of securities with very low prepayment risk and securities with amplified prepayment risk

• Mortgage hedge funds are important owners of these risky issues (sometimes called « toxic waste »)

• Strategy: identify undervalued and overvalued issues

• The most difficult instruments to hedge are attractively priced
Hedge Funds Strategies
Multi Strategies

• Investment approach is diversified by employing various strategies simultaneously to realize short- and long-term gains

• Other strategies may include systems trading such as trend following and various diversified technical strategies

• This style of investing allows the manager to overweight or underweight different strategies to best capitalize on current investment opportunities
European AIFs
European AIFs

• There are a number of different types of European AIFs which a hedge fund manager could set up.

• Examples:
  1. Qualified Investment Alternative Investment Fund (QIAIF)
  2. Retail Investment Alternative Investment Fund (RIAIF)
  3. Common Contractual Fund (CCF)
  4. Trust
  5. Specialized Investment Fund (SIF)

• Benefits of European AIFs
  − Marketability – regulated product, jurisdiction and service providers
  − EU passport and can be market in the European Union (under AIFMD)
  − Tax efficient vehicle
  − Speed to market – QIAIF & RIAIF can be authorised within 24 hours
Where in the world were the assets managed in 2013?

- US hedge funds managed in the US: $1,785bn
- European funds managed in Europe: $437bn
- Asia-Pacific funds managed in Asia-Pacific: $125bn
- Asia-Pacific funds managed in Europe: $12bn
- European funds managed by US firms: $26bn
- Latin America: $66bn
- Canada: $26bn
- Africa: $9bn

Source: HedgeFund Intelligence
Any questions?

Thank you for your time today.
Deloitte refers to one or more of Deloitte Touche Tohmatsu Limited, a private company limited by guarantee, and its network of member firms, each of which is a legally separate and independent entity. Please see www.deloitte.com/ie/about for a detailed description of the legal structure of Deloitte Touche Tohmatsu Limited and its member firms.

With nearly 2,000 people in Ireland, Deloitte provide audit, tax, consulting, and corporate finance to public and private clients spanning multiple industries. With a globally connected network of member firms in more than 150 countries, Deloitte brings world-class capabilities and high-quality service to clients, delivering the insights they need to address their most complex business challenges. With over 210,000 professionals globally, Deloitte is committed to becoming the standard of excellence.

This publication contains general information only, and none of Deloitte Touche Tohmatsu Limited, Deloitte Global Services Limited, Deloitte Global Services Holdings Limited, the Deloitte Touche Tohmatsu Verein, any of their member firms, or any of the foregoing’s affiliates (collectively the “Deloitte Network”) are, by means of this publication, rendering accounting, business, financial, investment, legal, tax, or other professional advice or services. This publication is not a substitute for such professional advice or services, nor should it be used as a basis for any decision or action that may affect your finances or your business. Before making any decision or taking any action that may affect your finances or your business, you should consult a qualified professional adviser. No entity in the Deloitte Network shall be responsible for any loss whatsoever sustained by any person who relies on this publication.

© 2015 Deloitte. All rights reserved