The Road from Long-Only: To 130/30 and Long-Short

May, 2008

The Old World

Hedge Fund Investment Options

	Direct Investment	Fund of funds	Index tracking
Portfolio	A single manager's trading strategies	A diversified portfolio of funds actively managed with the goal of selecting the best managers for the portfolio	A diversified portfolio of funds passively manged to mimic an index's return
Fees	Management fee plus performance fee	Additional management fee and performance fee	Management fee - performance fee
Liquidity	Low	Low	Medium
Valuation frequency	Low	Low	Medium
Trading	Active	Active	Passive
Transparency	Low	Low	High

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Long – Short Equity Investment Options

Today as the Long-Short market continues to evolve, investors have a broader selection when examining appropriate investment vehicles. While the actual structures may vary among individual managers, here are some typical characteristics that investors are likely to find in the marketplace today

	Separately Managed Account with Sub-Advisor	Direct investment in Commingled Fund	Fund of funds	Index tracking	Active index
Portfolio	A single manager's trading strategies	A single manager's trading strategies	A diversified portfolio of funds actively managed with the goal of selecting the best managers for the portfolio	A diversified portfolio of funds passively manged to mimic an index's return	An investible index that is designed to emulate a particular strategy or theme
Fees	Management fee only, or management fee plus performance fee	Management fee only, or management fee plus performance fee	Additional management fee and performance fee	Management fee - performance fee	Management fee - performance fee
Liquidity	Medium -High	Medium	Low	Medium	Medium
Valuation frequency	High	Medium	Low	Medium	Medium
Trading	Active	Active	Active	Passive	Active
Transparency	High	Medium - Low	Low	High	High

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Benefits of Utilizing a Separate Account

- **Control over investment style and structure**
  - Can ease in to product with modest exposure, i.e. 105/5
  - Client can impose restrictions on investments to comply with investment policy
- **Control over operating process**
  - Power to decide whether to custody assets with your custodian or broker/dealer versus manager's
  - Negotiate borrowing/financing fees that will be the same regardless of the investment manager
- **Transparency and Liquidity**
  - Client knows exactly what costs are related to operating the portfolio (admin fees)
  - As only investor, investment exposure is clear
  - No lock up period
- **Consolidated reporting**
  - Aggregation across multiple managers
- **Control over income**
  - Dividends and capital gains, receipt of revenue from lending long assets

Benefits of Utilizing a Commingled Fund Structure

- **Ease of Implementation**
  - Leverage existing structure
  - Accounts at custodian and broker dealer, as well as operating procedures, will be in place
- **Streamlined Documentation Process**
  - Controlled by Manager
- **Pass-through Fees and Collateral Requirements**
  - Negotiated by manager
- **Outsourced operational relationships**
  - Manager deals directly with prime brokers, administrators, etc

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Operational Structure

Long Short and 130/30 strategies

Similarities Between Custodians and Prime Brokers	Differences Between Custodians and Prime Brokers
A Custodian and a Prime Broker can provide: – Custody of Assets – Clearing – Reporting: position, portfolio management, transaction - aggregation – Securities Lending – FX transactions – Cash Management – Securities Lending*	**A Custodian:** – Operates as a securities lender only, but typically not directly to Long-Short funds – Fee structure: typically based upon a combination of transaction and custody fees, securities lending, cash management, and any out of pocket expenses – Additional Services: Global custodian and fiduciary in local markets **A Prime Broker** – As a Broker Dealer, acts as margin lender and short facilitator to Long-Short funds – Fee Structure: Based on financing fees on debt and short balances – Additional Services: Prime Consulting Risk Management

* Not all Prime Brokers provide Agency Lending

Prime Broker Client Asset Protection

- **Creditworthiness of Counterparty**

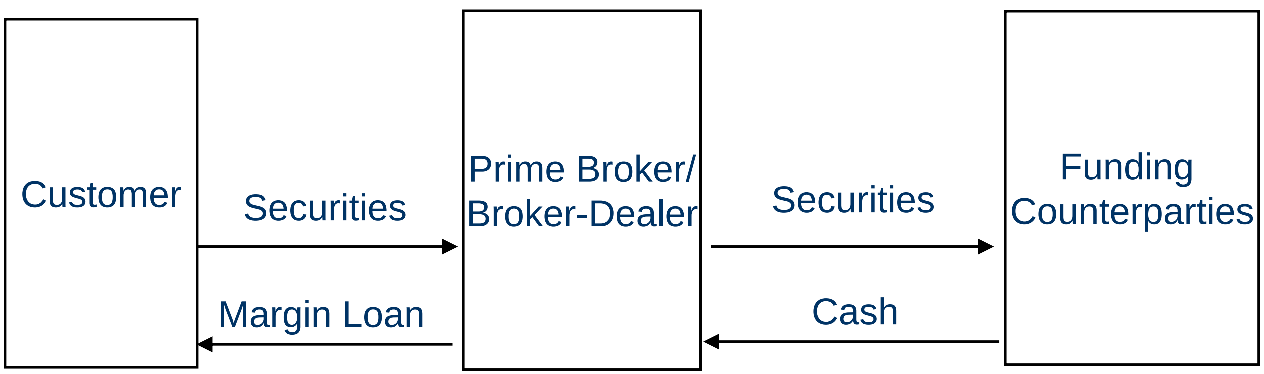
- **Various SEC, NYSE and NASD rules and regulations govern broker-dealers protection of customer assets**
  - 15c3-3 (segregation of assets)
  - 15c3-1 (minimum net capital)
  - SIPC coverage

- **Excess SIPC coverage through CAPCO**

Prime Broker "Rehypothecation" of Assets

A Broker-Dealer may use customer assets as collateral to support indebtedness of its customers

Example: a 130/30 customer with $30 debt – requires Prime Broker to raise cash



Not a factor in determining a client's net equity claim

Multiple Prime Brokers

- **As Long-Short funds grow, they commonly diversify suppliers**
  - Diversification of Counterparty Risk
  - Additional Source of Securities to Borrow
  - Pricing Transparency
  - Product Expertise

- **Manageable through advances in third party technology**

- **Typically divided per fund; more difficult to split a single fund between providers**

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Structural Considerations

Other issues that arise for long only Investors entering the Long-Short segment

UBTI

Unrelated Business Taxable Income

- A tax exempt organization may be liable for tax on its unrelated business income
- The purchase of a security on margin by a tax exempt organization entity would cause the entity to incur “acquisition indebtedness”
- UBTI Sensitive funds cannot pay interest expense or acquire debt – requires structural or prime brokerage solution

ERISA

ERISA

- Benefit plan investments are greater than 25% of each class of fund equity
- Qualified Professional Asset Manager (“QPAM”) exemption provides relief from certain prohibited transaction restriction
  - To qualify for QPAM exemptions, the manager must be a registered investment adviser, and
  - Client assets under management must be in excess of $85 million.
  - QPAM does not provide relief for fiduciary self-dealing transactions, CS will perform due diligence on plans’ investors

Mutual Funds

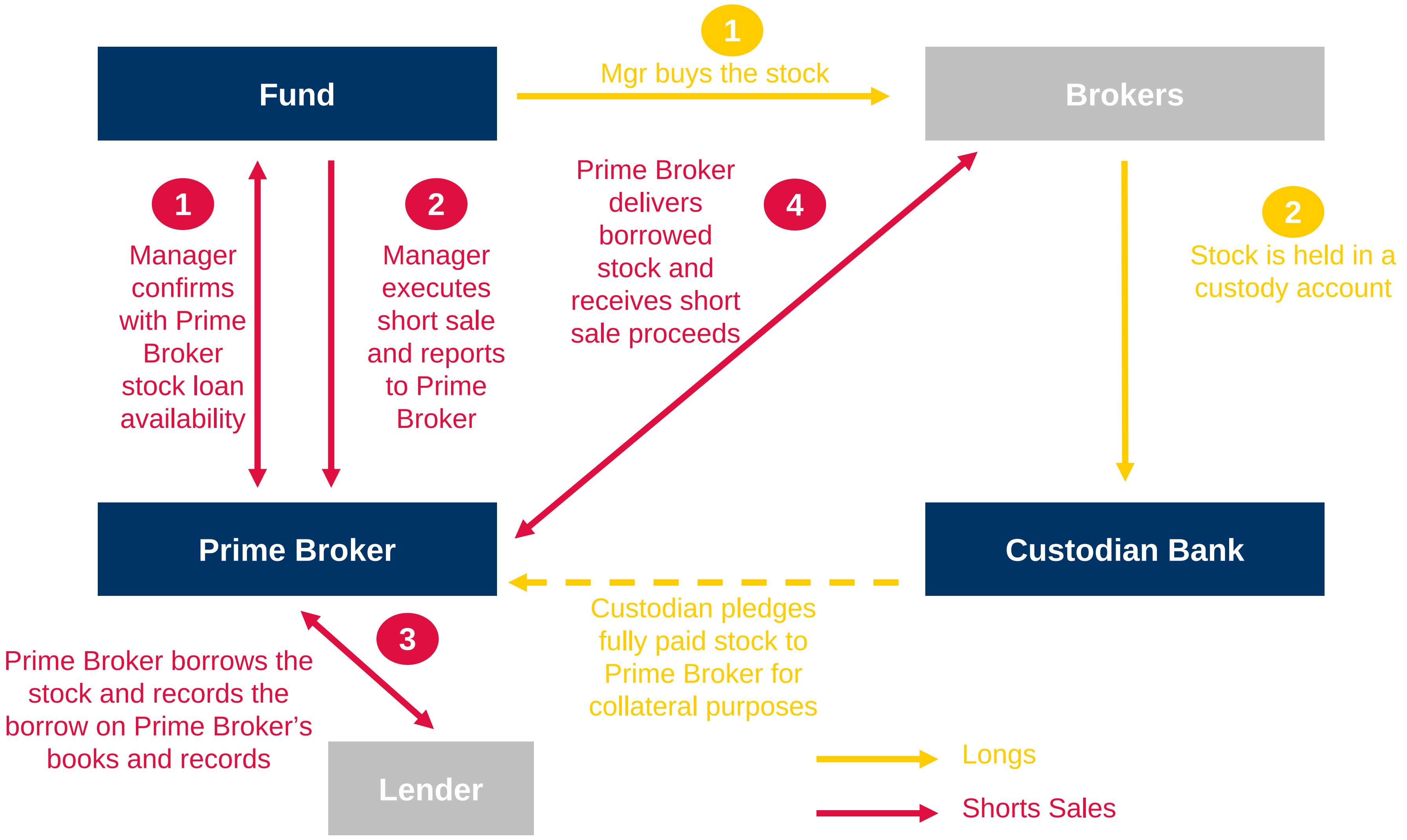
Registered US Mutual Funds

- 1940-act registered funds are required to hold their longs at a US bank
- Long and short assets tied together through “tri-party” arrangements – introduces cost and operational considerations

European Funds Registered Under UCITS III

- Leverage and Short through derivative (swaps)

"Tri-Party" Arrangements



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Equity Swaps

Meeting Alternative Needs of Long Short funds Funds

	Prime Brokerage	Equity Swaps
LEVERAGE	Yes	Yes
FLEXIBILITY		
Access to additional markets	No	Yes
Potential to enhance yields	Limited	Yes
Tax-efficient structures	No	Yes
Portfolio/Basket Applications	Limited	Yes
CONTROL		
Voting rights	Yes	No
Dividends	Actual	Manufactured
REDUCED TRANSACTIONS COSTS	Limited	Yes
ANONYMITY in the Market	No	Yes

130/30

Common Myths

- **Short Sale proceeds are used to “pay for” an additional $30 of long securities**
  - Short proceeds are not required to purchase additional longs
- **With increased demand for shorts, securities lending could become prohibitively expensive.**
  - The estimated pool of assets available for borrow is $13 to $15 trillion. At any given time, less than 5% of those assets are out on loan.
  - New supply by custodians
  - Use of options market?
- **The increase in short selling could drive the markets down.**
  - Shorting helps keep the market efficient and improves information.
  - Shorting creates latent demand.
  - Shorting helps identify issuer fraud (Enron, World Com).
- **The increase in shorting will be supported exclusively by institutional lenders.**
  - Leverage on the long side creates supply as a result of rehypothecation by Prime Brokers.
- **Securities Lending (of long positions) cannot be done after converting a long-only portfolio to long-short.**
  - Agency lending platforms allow for optimal collateral management.
  - Lending revenue can offset costs to the fund.

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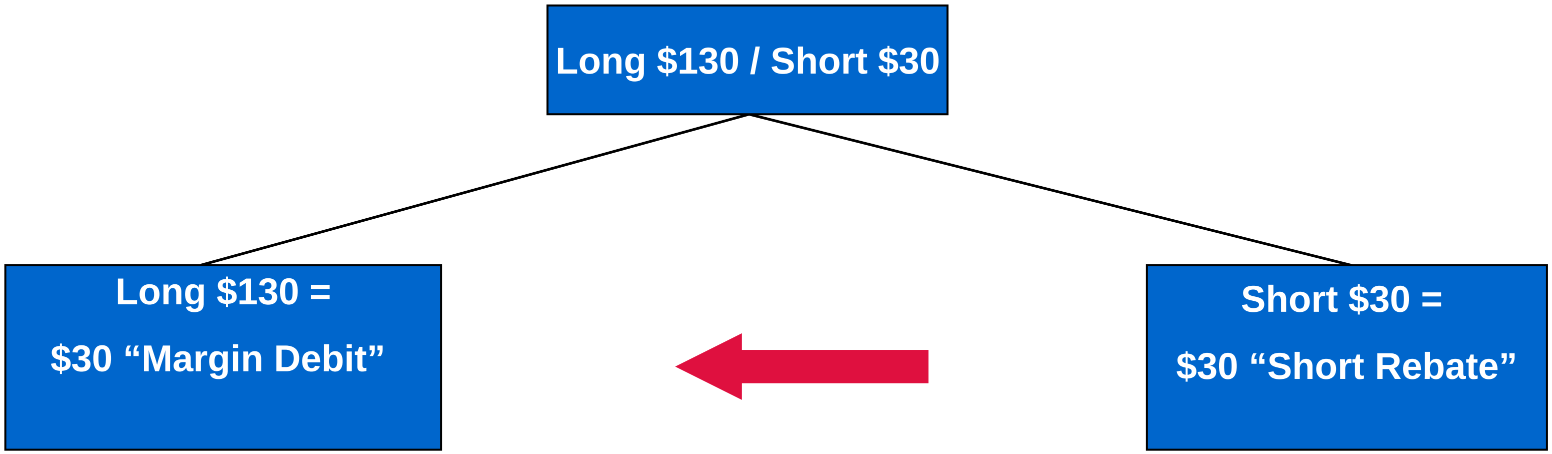
130/30 - Prime Brokerage Financing Example



Typical PB Fees For 130/30 Funds:

= Charge FF + 25 bps * $30 million Margin Debit

+ Pay FF – 25 bps * $30 million Short Rebate

Net Typical PB Fees For 130/30 Funds:

= $30 million * 50bps = $150k

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Securities Lending – Unlocking the Value

Opportunity: **Combine prime brokerage and securities lending platforms to unlock the securities lending revenue potential in the 130/30 strategy, and increase revenue to the fund(s).**

Advantage: **Clients that choose to lend the long assets of their 130/30 strategy can reduce the prime brokerage cost/generate additional earnings.**

How it Works: **Securities lending team identifies securities trading "special", and works with custodian to assign the non-special securities to the collateral pledge account. This leaves lendable assets in the trading account, available for loan.**

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Securities Lending Example

Long $130

“Lendable” Assets

Long $40

+

Prime Brokerage Collateral

Custodial Account	PB Account
Long $90	Short ($30)

Program Average for Mutual Funds = 15% Utilization @ 25 bps

15% of $130 @ 25 bps = $48,750

Revenue Share of 80/20 = $39,000

Average PB Fees For 130/30 Funds = 50

= $30MM * 50bps = $150k

Over 25% Savings vs. Prime Broker fees

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