



SUPPLEMENTAL RISK DISCLOSURE INFORMATION

Alternative Investments
Integrity. Knowledge. Experience.

When considering alternative investments, such as hedge funds and managed futures, you should consider various risks including the fact that some hedge fund and managed futures products use leverage and other speculative investment practices that may increase the risk of investment loss, can be illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees, and in many cases the underlying investments are not transparent and are known only to the investment manager.

With respect to alternative investments, such as hedge funds and managed futures, in general, you should be aware that:

- Returns from some alternative investments, including hedge funds and managed futures, can be volatile
- You may lose all or portion of your investment
- With respect to single manager products the manager has total trading authority. The use of a single manager could mean a lack of diversification and higher risk
- Many alternative investments that include hedge funds and managed futures are subject to substantial expenses that must be offset by trading profits and other income. A portion of those fees is paid to Altegris
- Trading may take place on foreign exchanges that may not offer the same regulatory protection as US exchanges

With respect to an investment in a hedge fund or managed futures fund, you should be aware that:

- There is often a lack of transparency as to the fund's underlying investments
- With respect to hedge fund of funds, the fund's manager has complete discretion to invest in various sub-funds without disclosure thereof to you or to us. Because of this lack of transparency, there is no way for you to monitor the specific investments made by the hedge fund or to know whether the sub-fund investments are consistent with the hedge fund's historic investment philosophy or risk levels
- A hedge fund of funds invests in other funds and fees are charged at both the fund and sub-fund level. Thus the overall fees you will pay will be higher than you would pay by investing directly in the sub-funds. In addition, each sub-fund charges an incentive fee on new profits regardless of whether the overall operations of the fund are profitable
- There is no secondary market for fund interests. Transfers of interests are subject to limitations. The fund's manager may deny a request to transfer if it determines that the transfer may result in adverse legal or tax consequences for the fund

A hedge fund's Offering Memorandum or a money manager's Disclosure Document describes the various risks and conflicts of interest relating to an investment and to its operations. You should read those documents carefully to determine whether an investment is suitable for you in light of, among other things, your financial situation, need for liquidity, tax situation, and other investments.

Keep in mind that the past performance of any investment is not necessarily indicative of future results. You should only commit risk capital to any Investment Product. Alternative investment products, including hedge funds and managed futures, are not for everyone and entail risks that are different from more traditional investments. You should obtain investment and tax advice from your advisers before deciding to invest.

FROM THE DESK OF JON SUNDT

Are There Too Many at the Table?

Quarterly Commentary
3rd Quarter 2004

Quality is never an accident; it is always the result of high intention, sincere effort, intelligent direction and skillful execution; it represents the wise choice of many alternatives.

– William A. Foster

If you have received this letter, you are a high net worth investor and are possibly looking for new investment ideas. In the current market environment, some people are turning to hedge funds as a way to diversify their portfolios. Recent publications by the SEC estimate that assets invested with US hedge funds alone are approaching \$1 trillion.¹ US pensions are getting in the act as well. According to the SEC, pensions' investments in hedge funds have increased to more than \$72 billion so far in 2004, a nearly five-fold increase in assets since 1997.²

This recent large increase in assets has not only drawn attention from investors, it also has the SEC concerned—concerned enough to propose a new rule requiring that hedge fund advisors register with them (most likely by the end of this year) and face increased regulatory scrutiny. While there are many details to be worked out, I think in theory increased regulation will be good for the industry as a whole.

But beyond the regulatory changes that are undoubtedly on the way, there are several other concerns that are routinely discussed in the world of alternative investments as a result of the growing asset base. At the most basic level, many of these concerns boil down to these questions: Can hedge funds continue to perform with all these assets pouring in? Is there a hedge fund bubble, and will it burst?

JON SUNDT, PRESIDENT



Jon Sundt is President of Altegris, and has been working in the alternative investments arena for more than 17 years. Jon lives in La Jolla, California, with his wife and daughter.

As most of you know, I run a boutique firm of 30+ employees that searches for unique alternative investments for high net worth investors and institutions. No investment can guarantee that it will make profits or avoid losses in any particular market environment. Having said this, our focus is on finding talented managers that, in our opinion, have a replicable edge of some kind and exhibit the potential to do well in different market cycles. For a number of reasons, many of the alternative investment choices that we identify are hedge funds. As a result when I hear recent talk of too much money flowing into hedge funds, you might expect that I have an opinion.

I have been in the alternative investment arena since the late 1980's and have witnessed first-hand the various stages of growth of the industry. As a result, this latest round of questioning of hedge fund performance does not surprise me. In fact, I ask myself many similar questions every day: How will the industry sustain its growth? What are the implications for my clients? How can my team continue to find top talent? Will the strategies that worked three years ago work today? I suspect these are questions that any industry professional in practically any discipline needs to consider—not just those working with hedge funds.

But while these questions are relevant to many disciplines, they are particularly difficult to answer with a neatly packaged reply or generalization for the world of hedge funds. Why is this true? After all, aren't hedge funds just another asset class? In my opinion, they are not.

One of the key characteristics of hedge funds is their broad investment mandate. These funds are privately offered, unregistered, managed pools of money designed for sophisticated investors. This means they generally have more flexibility in how and what to trade than, say, your typical mutual fund. There are also risks unique to hedge funds that are important to understand, including a lack of transparency, higher fees and lower liquidity relative to many other traditional investments. Some additional risks associated with hedge funds can be found at the end of this newsletter.

¹ William Donadson, "Testimony Concerning Investor Protection and the Regulation of Hedge Funds Advisers," US Securities and Exchange Commission, July 15, 2004.

² "10th Annual Hedge Fund Manager Survey," The Hennessee Hedge Fund Advisory Group, August 2, 2004.

Beyond these general characteristics, the lines get a little fuzzy. As I said earlier, there are many different types of funds that fall under the “hedge fund” umbrella. It is estimated that there are over 7,000 hedge funds in existence today³—a fact that ensures our staff are kept very busy. What makes their job particularly challenging is the lack of a centralized source of hedge fund data and the plethora of different trading styles and strategies that hedge

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funds employ. Clearly, there are some hedge fund styles and strategies that are used by many funds (like Long/Short Market Neutral or Convertible Bond Arbitrage) and encompass a large mass of investor assets. But there are also many hedge funds that do very different things from the norm, and new strategies are emerging all the time.

I have interviewed managers that trade Global Long/Short, Currencies, Sector Specific Micro Caps, Long Biased Deep Value, Second-Rate Car Loans, Collateralized Debt Obligations, Tax Liens, Real Estate Long/Short, grain traders, metals traders, crude oil traders, and the list goes on. The differences between any two of these styles can be as fundamental as night and day. Some use leverage, some don't. Some trade highly liquid listed securities, some trade complex derivatives.

Again, think about the sheer number of hedge funds out there. Now compound this with the fact that each fund can employ styles or mixes of styles (only a few of which I mentioned above) that are so varied that even creating indexes for hedge funds becomes a challenge. In an attempt to categorize hedge funds, some firms have created multiple indices, each one with significantly different characteristics and performance, but each falling under the heading of “hedge funds.” All of this is simply to make the point that hedge funds are not a generic asset class, and praise or criticism should not be painted uniformly across every fund or style. I think that it is all but impossible to characterize hedge funds with any meaningful global observation that rings true for all strategies. In fact, in my view most observations about hedge funds

only make sense in the context of a specific fund.

Let's take this opportunity to look at a couple of generalizations that have been floated recently: concerns about the use of leverage (borrowing against an underlying portfolio and investing the funds to gain more exposure), and the worry that the hedge fund opportunities are drying up as new entrants jump in. Granted, with all the money pouring into hedge funds, many of the hedge fund styles that worked in the past are having a more difficult time today finding the same opportunities that existed before their space became crowded. Some of these strategies will fail. This is to be expected. And certainly there are many hedge funds that I believe use too much leverage. But as I have said, I believe blanket statements applied to all hedge funds make little sense. To me, generalizations such as these are pure mental laziness.

For example, concerning leverage, a recent study by a well-known industry group stated that 85% of all hedge funds have never used more than Reg T (2:1) leverage.⁴ Regarding the shrinking opportunities for hedge funds to exploit, J. P. Morgan has recently published a study and has found that indeed overcrowding and capacity is an issue, and many opportunities are shrinking as a result. This is a problem. But the study also goes on to note that some opportunities remain to be exploited. The authors of the study note that “...market opportunities have been eroded in the areas where we have seen the most hedge funds (or hedge fund like) activity: equities, and interest rate markets. Opportunities remain alive in areas where there are few hedge funds (credit) or where they remain small against world capital flows (foreign exchange).”⁵ Obviously J. P. Morgan doesn't believe that the opportunities are all gone, as they have just recently bought a majority stake in Highbridge Capital Management, a massive hedge fund with approximately \$7 billion in assets under management. Public reports put the purchase price at over \$1 billion dollars.⁶

So if you'll accept the fact that hedge funds aren't a generic asset class, we can then dig deeper and look at the effect of the money flooding in to particular funds.

Some of you may have heard me use the following analogy before. If so, forgive me for repeating it, but I

³ “10th Annual Hedge Fund Manager Survey,” The Hennessee Hedge Fund Advisory Group, August 2, 2004.

⁴ Ibid.

⁵ “Have hedge funds eroded market opportunities?” J. P. Morgan Securities Ltd., October 1, 2004.

⁶ Henny Sender and Robin Sidel, “J. P. Morgan to Move Into Hedge Fund,” *Wall Street Journal*, September 27, 2004.

think it helps to make the point. For me, the hedge fund industry can be compared to the restaurant industry. There are thousands upon thousands of restaurants in operation today. Some of these are large chains, some are small independents. For those looking for a quick meal at a reasonable price and with a standard, consistent “no-guesswork” menu, the large chain may perfectly fit the bill. But try getting creative with the menu at one of these restaurants and you may be quickly frustrated. In terms of the flexibility of the menu – the ability to better adapt to the market – it is the smaller, independent restaurants that are generally better equipped.

Of course, just because a restaurant is small and flexible doesn't mean it is good. Small restaurants may not have the standards in place that a large chain does. You have to “trust” the chef, and this means if you want to avoid learning by trial-and-error, you have to do your homework.

Some of these same ideas can be applied to hedge funds. If a manager who trades micro-caps becomes too big, what are the implications? At what point will the manager have too much money under management to effectively buy micro-caps? Will he or she “style drift” and buy more

operator do? The operator's only recourse is to find a different restaurant that can handle all the people. If this were to happen to every restaurant in town, it may resemble what is happening to the hedge fund industry today. It's a simplified analogy, but in my opinion it's useful in painting a picture of the industry.

The fact is, some hedge funds will feel the strain of all this new money, and others won't. Much of it depends on their size and the strategy or niche they are involved in. For example, many arbitrage styles seem to be affected by the rush of assets. As they deploy their strategies to a finite amount of “inefficiencies” they may, over time, be smoothing out the inefficiency that exists. Convertible Bond Arbitrage, for example has seen a decline as a whole in their rates of return. Many feel, as I do, that this is a result of too much money in the space. This strategy is dependent on finding a pricing inefficiency between the convertible bond and the underlying stock. A hedge fund will typically buy the convert and short the stock. With a finite number of convertible bonds issued, it is easy to understand how the space may be getting squeezed. Another very popular style, Market Neutral Long/Short

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common stocks? What will that do to the fund's rates of return? Will the fund reach capacity and close to new assets in order to stay nimble, or will the manager choose to expand and face the challenge of more customers?

One of the real challenges for large brokerage firms right now, in my opinion, is that they have a lot of customers that want hedge funds and not enough good talent to allocate to. Let's return for a moment to the restaurant analogy. Imagine the finest local restaurant in your town – small, with very good service, exceptional food and a talented and well-known chef. Now imagine 10 tourist buses pulling up every night and unloading 300 hungry tourists to dine. What does the owner do? Expand or limit seating? If the owner expands, does the quality of the experience stay the same? Suppose instead the owner decides to limit seating - now what does the tour bus

Equity hedge funds also have more players in the game. Some Market Neutral styles that depend on arbitraging pricing differences between two similar stocks have a lot of competition today.

On the other hand, hedge funds trading very liquid markets and taking longer term, more directional bets may fare better. For example, a currency trader would have a hard time “moving” the dollar, so constraining capacity may be less of a concern. And the spread between the dollar and another currency can't really be called an inefficiency that will get smoothed out. These are large global trends that involve massive amounts of money. Although there can be no guarantee that any particular strategy will produce profits or avoid losses, in this case I believe the issue of constraining capacity is less likely to be a hindrance.

Why are these challenges important to you as an investor? In my view, with hedge funds it all comes down to selection. When you choose a hedge fund, you are not choosing an asset class, or a broadly defined investment. You are selecting an individual manager or firm, who has (hopefully) an identifiable expertise. Some questions to ask:

- Who are you selecting to manage a portion of your assets? What is his or her pedigree?
- What style of hedge fund is it?
- Is it too crowded in this space, or do opportunities exist?
- What kind of leverage is being used?
- Is the hedge fund too big for the style?
- Is there an identifiable and sustainable skill or edge?
- Can it do well in this environment? What about future environments?

As a sophisticated investor, it is important to understand these challenges facing the hedge fund industry. As a consumer, you need to know that EVERY hedge fund is different: different manager, different resume, different prospectus, different trading style, different capacity, different leverage, different opportunities and different risks. Proper due diligence through rigorous qualitative and quantitative investigation is critical. Investing in hedge funds requires a sober understanding of the risks and potential rewards. Generalities won't get you there. You've got to read the menu carefully.

Until next time,



Jon C. Sundt
President

Altegris Investments, Inc. is headquartered in La Jolla, California, and specializes in finding unique alternative investments, including hedge funds and managed futures products, to help high net worth and institutional investors diversify their portfolios. Altegris' clients currently represent a trading level of approximately U.S. \$1 billion in hedge fund and managed futures investments. You can access other Altegris Quarterly Commentaries on the web at www.managedinvestments.com or call us at 800.828.5225 or 858.459.7040.

Alternative investment products, including hedge funds and managed futures, involve a high degree of risk, often engage in leveraging and other speculative investment practices that may increase the risk of investment loss, can be highly illiquid, are not required to provide periodic pricing or valuation information to investors, may involve complex tax structures and delays in distributing important tax information, are not subject to the same regulatory requirements as mutual funds, often charge high fees which may offset any trading profits, and in many cases the underlying investments are not transparent and are known only to the investment manager. Alternative investment performance can be volatile. An investor could lose all or a substantial amount of his or her investment. Often, alternative investment fund and account managers have total trading authority over their funds or accounts; the use of a single advisor applying generally similar trading programs could mean lack of diversification and, consequently, higher risk. There is often no secondary market for an investor's interest in alternative investments, and none is expected to develop. There may be restrictions on transferring interests in any alternative investment. Alternative investment products often execute a substantial portion of their trades on non-U.S. exchanges. Investing in foreign markets may entail risks that differ from those associated with investments in U.S. markets. Additionally, alternative investments often entail commodity trading, which involves substantial risk of loss. PAST RESULTS ARE NOT NECESSARILY INDICATIVE OF FUTURE RESULTS.

Altegris, a member of NASD and the NFA, offers various alternative investments, including hedge funds, futures funds and managed commodity and futures accounts, that may operate in commodities markets and foreign markets, among others. Altegris and/or its officers/partners may have a financial interest in such alternative investments.

