

Memo

To: MDE Clients & Friends
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Chief Executive Officer
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Recommended New Investment in Hedged Funds of Funds

Introduction

Given the dismal performance by the equity markets over the past two plus years, “hedge funds” have grabbed the market spotlight. However, this term is so broad as to include everything, yet mean nothing. In general, the term “hedge fund” only refers to the structure of the investment vehicle—usually an unregulated limited partnership—wherein the general partner has unlimited discretion to employ any management technique it sees fit. The investment styles employed by hedge fund managers run the gamut from simple short sales of stocks to leveraged risk arbitrage and include any money management technique the creative mind can imagine.

Hedge funds were widely abandoned in the late summer of 1998 with the collapse of the highly touted Long Term Capital Management fund which almost brought down the U.S. financial system before the Fed engineered a bail out. By the end of 1999, hedge funds had reached their low point of popularity, with many household names such as George Soros, Julian Robertson, and Jeff Vinik closing their funds. Investors had become unwilling to pay high fees to invest in non-liquid and non-transparent vehicles with hard to understand strategies only to earn tax-inefficient returns that were some 60% to 80% of the then high-flying S&P 500.

However, times have changed. With equity markets on their way to their third consecutive year of double-digit losses, and with fixed-income yields at or near a 40-year low, investors have become *desperate* for any investment with the promise of stable and consistent positive returns. Therefore, hedge funds have become Wall Street’s *investment product de jour* with new funds springing up almost daily.

Strategic Recommendation

Having followed hedge funds throughout the 1990s, we at MDE approached this *new hot investment* with a great deal of caution and cynicism. However, the financial realities surrounding the continuing volatility of the equity markets make it impossible to ignore this resurgent investment vehicle. Over the past 24-plus months we have reviewed over 100

hedge funds encompassing all disciplines and have interviewed over two dozen hedge fund managers. Having given this area considerable study and evaluation, we have decided to recommend a strategic allocation of at least 10% of a client's total portfolio to this investment vehicle.

We remain bullish on the long-term prospects for the American capitalist system, the greatest economic engine the world has ever seen. And we remain committed to the stock market as the best wealth-creation vehicle available to long-term investors. However, we make this recommendation in an attempt to mitigate the continuing volatility of the equity markets without attempting to navigate tactical moves between stocks, bonds, and cash—an exercise which has always proven all too dangerous even for the most adept and nimble investors. We also make this investment with the knowledge that the recommended hedge funds will likely only capture some 60% to 80% of the gains in a resurgent equity market. In addition, we also acknowledge the inherent tax inefficiency of these vehicles. However, given the magnitude of recognized capital losses we have booked through proactive tax management in this down market, much of the recognized gains in these funds can be offset by recognized losses to date.

We further recommend that clients should only access this investment vehicle through multiple manager and multiple strategy “funds of funds” to further reduce the risk in this non-transparent investment. After considerable due diligence, we have approved several “funds of funds” for those clients who would like these investments in their portfolios. With respect to some of our approved funds, we have been able to negotiate a preferential fee structure for our clients, as well as minimum investments as low as \$250,000.

Since these funds are “unregistered” investment vehicles subject to minimal SEC oversight, to protect investors the securities laws strictly prescribe those individuals who are allowed to participate on the basis of either net worth or investable assets. We must be sensitive to these legal restrictions when making our investment recommendations. However, in order to capture a larger investor base, some funds are creating new “registered” vehicles that will be available to a broader population. We expect to see several high-quality vehicles of this type in 2003. Once available, we will identify those that we would feel comfortable recommending to those clients for whom the “unregistered” funds may not be appropriate.

Investment Implementation

The source of funds from which to implement this investment is a highly individualized decision. However, in making this decision we have some general guidelines. Some people have chosen to accumulate cash in this difficult market environment rather than taking market risk by investing in either equities or fixed income. With the advantage of 20-20 hindsight, this has proven to be a good tactical choice. However, it does not represent a good long-term investment strategy. And as we all know, timing an exact entry point into the markets is all but impossible. Therefore, to the extent a client has accumulated liquid cash that is not earmarked for any special purpose, we would recommend that hedge fund investments be made from this accumulated cash. The hedge funds would be expected to provide a long-term return much higher than cash,

e.g. somewhere between bonds and equities, but with relatively low downside risk. Therefore, non-earmarked cash would be the most logical source of new investment funds.

To the extent a client is already fully invested in, for example a portfolio with 60% in equities and 40% in bonds, we would recommend that the hedge fund investment be made from cash raised on a pro-rata basis from both the stock and bond portions of the portfolio. The rationale for this position is based on the premise that the risk/reward profile of these funds is expected to be between that of stocks and bonds. Therefore, to raise assets from one investment over another would be a form of tactical market timing, rather than the creation of a strategic allocation to a lower risk/return vehicle. Only to the extent that an individual feels the need to further reduce equity exposure should the entire allocation to hedge funds come from the equity portion of the portfolio. However, we must recognize that doing so would be tantamount to a form of market capitulation after a large loss since the hedge fund would be expected to underperform equities during a bull market.

Conclusion

As was the case when we implemented our value tilt strategy over the summer, each client's portfolio must be reviewed personally and a customized strategy devised for each individual's unique situation. This is a detailed and time-consuming task. All portfolios will be reviewed over the next few weeks and where this strategy is appropriate, we will contact each client directly with our personal recommendations, including information on the firm or firms we recommend for your personal account.

In the interim, if you would like any additional information on this strategy, the asset class in general, or our recommended firms, please contact your Personal Financial Advisor. As always, we thank you for your confidence and loyalty over the years as we work together to weather this turbulent period.