




Public School Employees'  
Retirement System



Pennsylvania 

Tom Corbett, Governor | Jeffrey B. Clay, Executive Director

# 5<sup>th</sup> Annual PAPERS Fall Workshop Hedge Fund Investing

James H. Grossman, Jr., CPA, CFA  
Managing Director of External  
Public Markets, Risk & Compliance

# What are Hedge Funds?

- Private investment vehicles
- Defines its return profile as absolute return vs. benchmark oriented
- Strategies seek to exploit inefficiencies and complexities both within asset classes and between asset classes
- Managers can be both long and/or short financial instruments
- Compensation paid to managers consists of a base fee and a performance fee
- May utilize leverage

# Hedge Funds

- Trade instruments available to all market participants
- Typically flexible and opportunistic
- Benefit from the ability to take both long and short positions

# Types of Hedge Funds

- Equity Long/Short
- Event Driven
- Relative Value
- Tactical Trading

# Equity Long/Short

- Industry Focus
- Regional Focus
- Short Bias
- Multi-Strategy

# Event Driven

- Equity Focus
- Debt Focus
- Multi-Strategy

# Relative Value

- Long/Short Credit
- Convertible Arbitrage
- Fixed Income
- Quantitative Strategies
- Multi-Strategy

# Tactical Trading

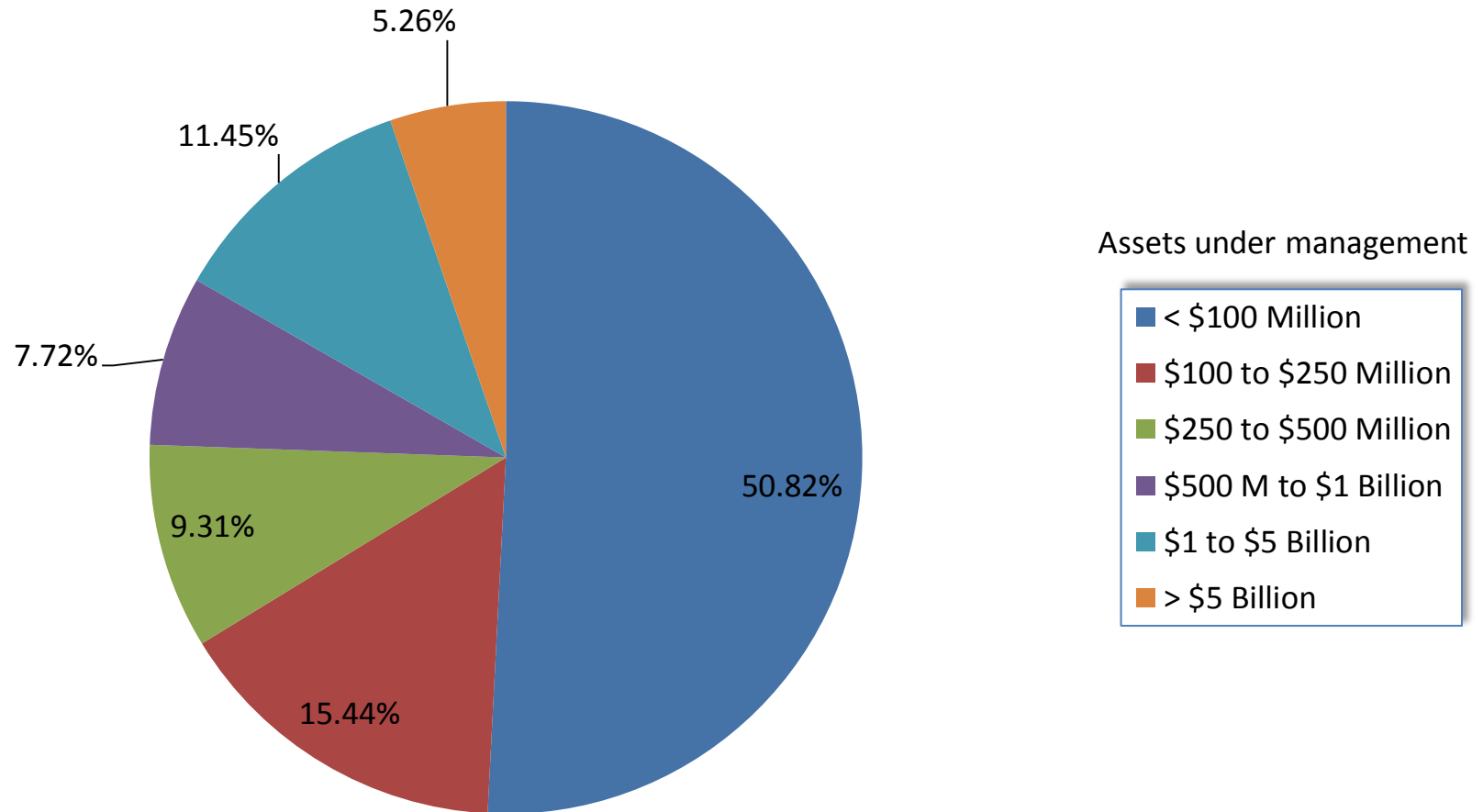
- Global Macro
- Emerging Markets Macro
- Commodities
- CTAs
- Reinsurance
- Multi-Strategy



# Hedge Fund Industry Universe

(by number of firms)

Industry estimates that there are between 4,000 and 5,000 hedge fund firms

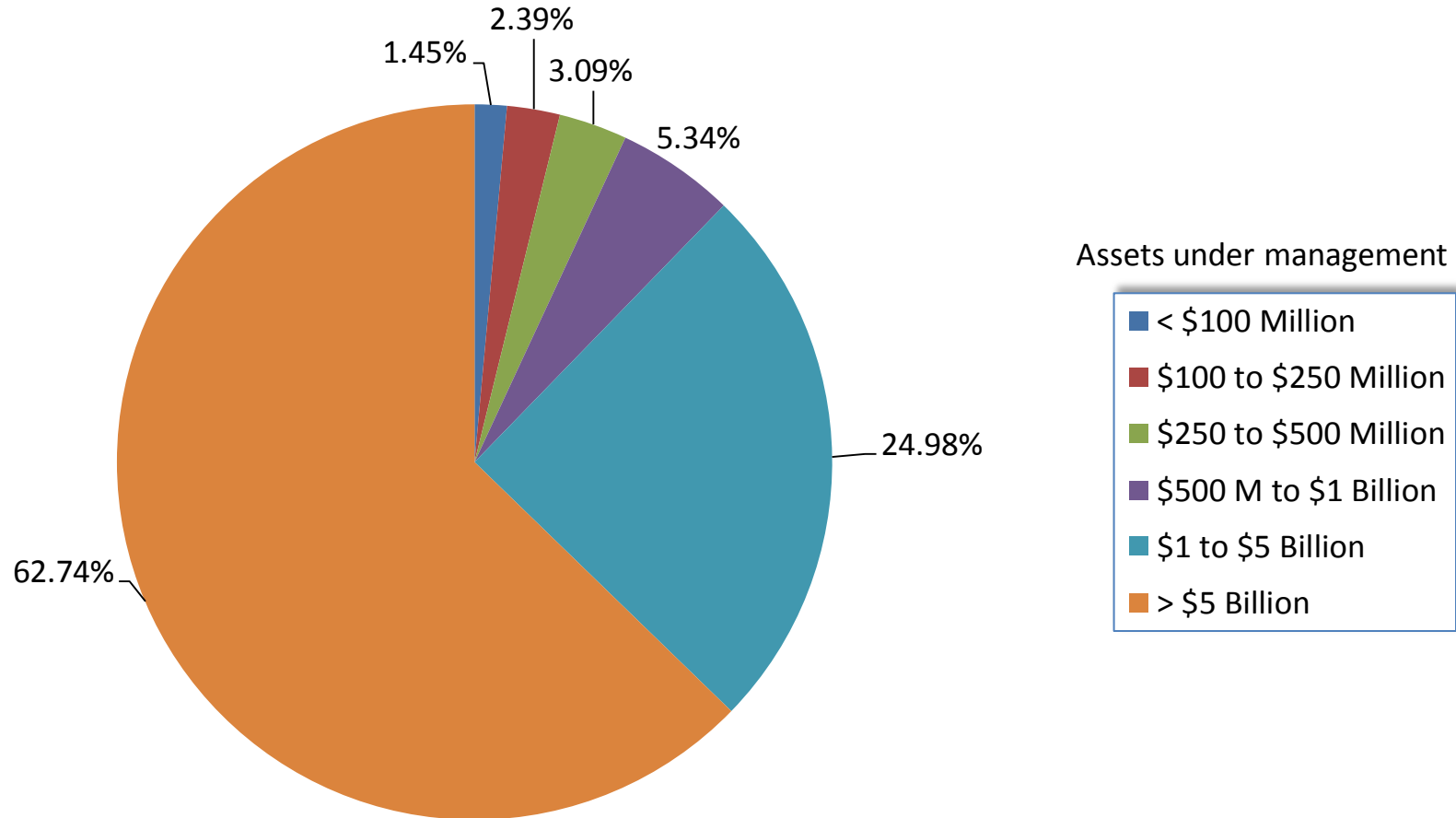


Source: HFR Global Hedge Fund Industry Report, 2011 Q3

# Hedge Fund Industry Universe

(by firm assets under management)

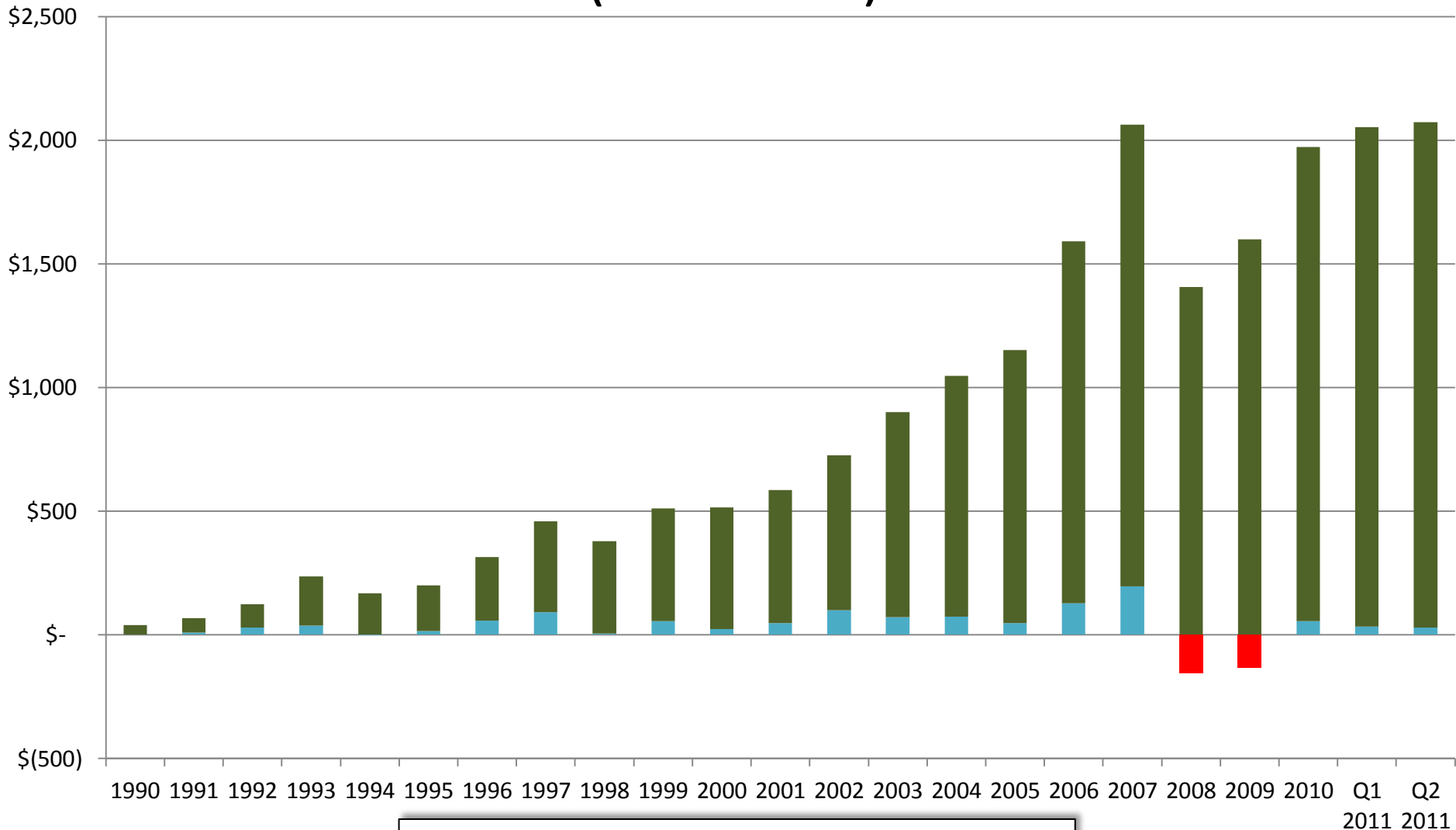
Industry estimates that hedge funds manage approximately \$2 trillion



Source: HFR Global Hedge Fund Industry Report, 2011 Q3

# Estimated Growth of HF Industry

(in billions)



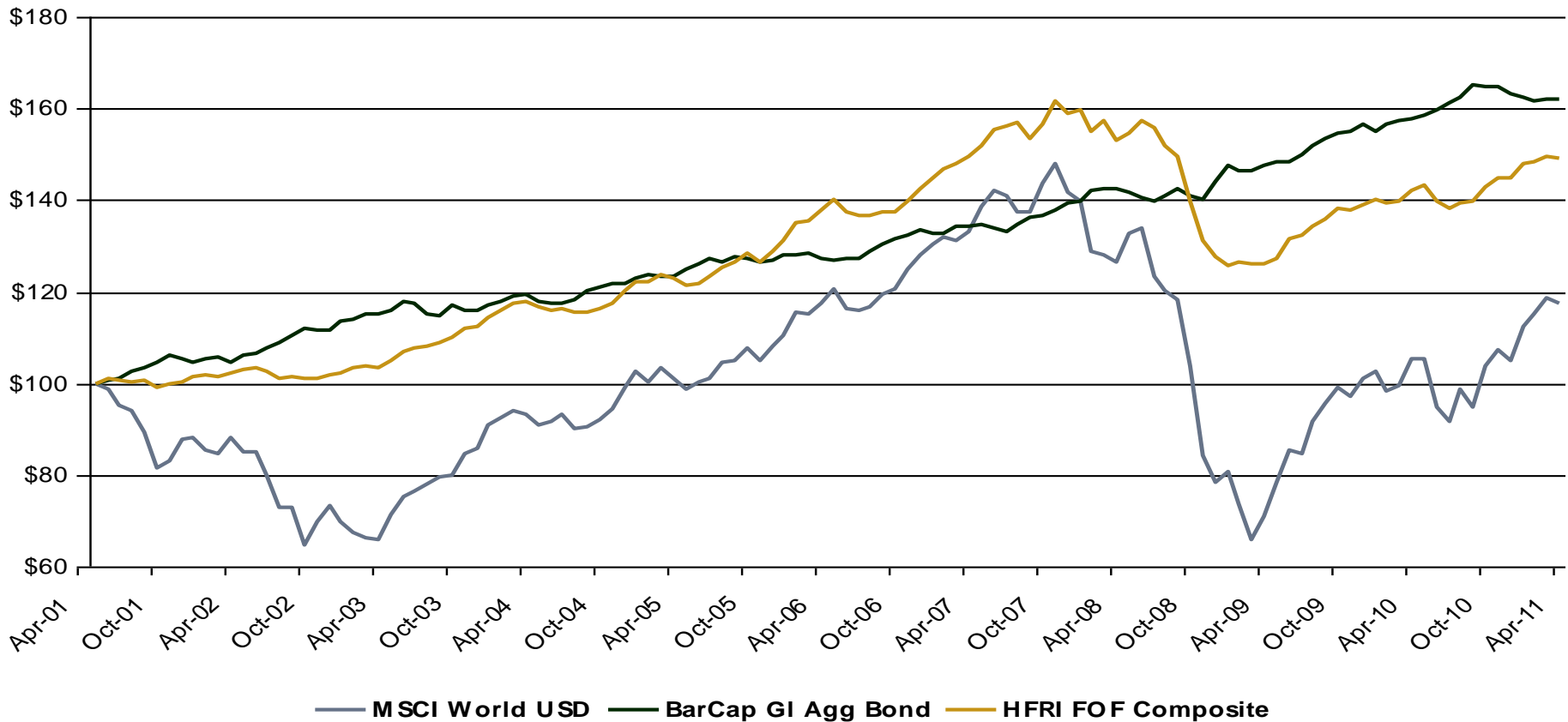
Source: HFR Global Hedge Fund Industry Report, 2011 Q3



2011 2011

# Hedge Fund Performance

Cumulative Value of \$100 Invested Over 10yr Period Ending April 2011



Source: Aksia, LLC

# Hedge Fund in a Portfolio

- Various Uses for Hedge Funds in a Portfolio
  - Absolute return
  - Equity substitute
  - Fixed income substitute
  - Portable alpha
- Important to understand nature of hedge fund
  - Directional strategy
  - Non-directional strategy

# How to Invest in Hedge Funds

- Fund of Funds
- Commingled Fund
- Fund of One
- Separate Account

# Hedge Fund Due Diligence

- Investment Review
- Operational Review
  - Critical if investing in a fund structure

# Hedge Fund Investment Review

- Investment Strategy
  - Does strategy resonate with you
- Investment Team & Structure
  - Strong personnel
  - Key man risk
- Risk Management Process
  - Strong risk controls



# Hedge Fund Operational Review

- Operations and Infrastructure
  - Independent calculation of net asset value?
- Regulatory and Compliance
- Private Placement Memorandum
- ADV Review
- Financial Statements

# Private Placement Memorandum

- Base management fee and performance fees
- Standard of care
- Hurdle rate
- High water mark
- Side pockets
- Lock-up period
- Gates
- Liquidity
- Transparency
- Key man provision

# Institutional Issues

- Headline Risk
- Leverage
- Liquidity

# Should I Invest in Hedge Funds?

- Depends
  - Do I have the expertise?
    - Investment
    - Operational
  - Do I have the backing of my Trustees?
  - Can I afford a consultant?
  - Do I have a long enough time horizon?
  - Can I handle the potential criticisms?
  - Do I have access?



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