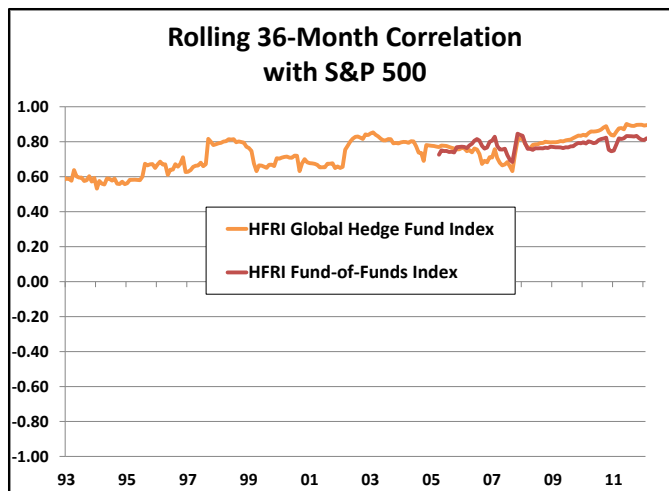


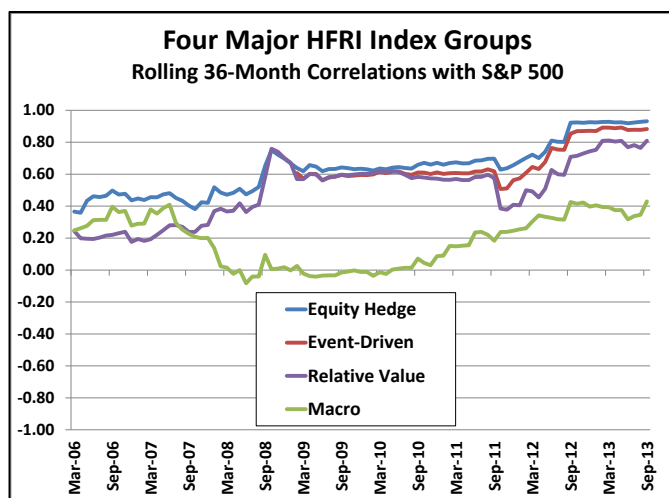
WHICH HEDGE FUND STRATEGIES BEST DIVERSIFY S&P 500 RISK?

Another article (“Diversification by Asset Class”) focused on the fact that attractive diversification of the S&P 500 is difficult to find. Bonds have low expected returns, and the historically diversifying international and real estate assets classes have seen their correlations climb dramatically. Even hedge funds have seen an increase in their (always high) correlations with the S&P 500. The graph at right shows two HFR indexes as a proxy for hedge funds: 1) HFR Global Hedge Fund Index (orange line), which is designed to represent the all hedge funds globally, and 2) HFR Fund of Funds Index (red line), which is designed to represent funds of hedge funds.



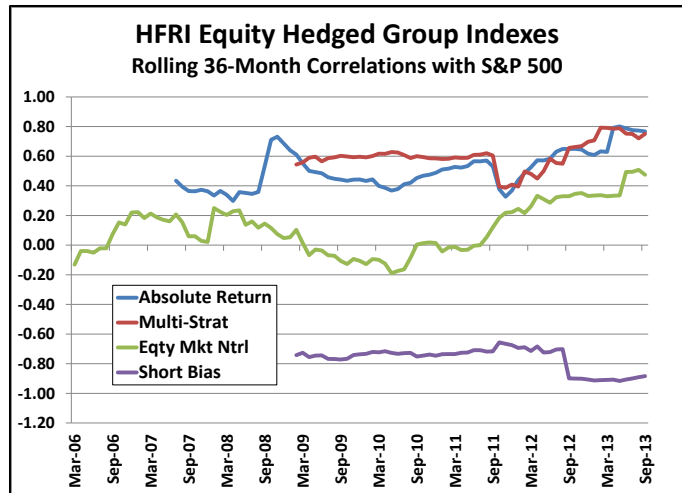
Of course, lumping all hedge funds together into one index is not really appropriate. “Hedge funds” are not an asset class. **Hedge funds employ many diverse strategies** in many different asset classes. A hedge fund is merely a form of pooled asset management that allows for the use of shorting and leverage and for the collection of incentive fees by the manager. Beyond those few characteristics, hedge funds share little in common.

HFR divides its various hedge fund indexes into the four major groups shown at right. Of these, only the Macro group has a low correlation with the S&P 500.

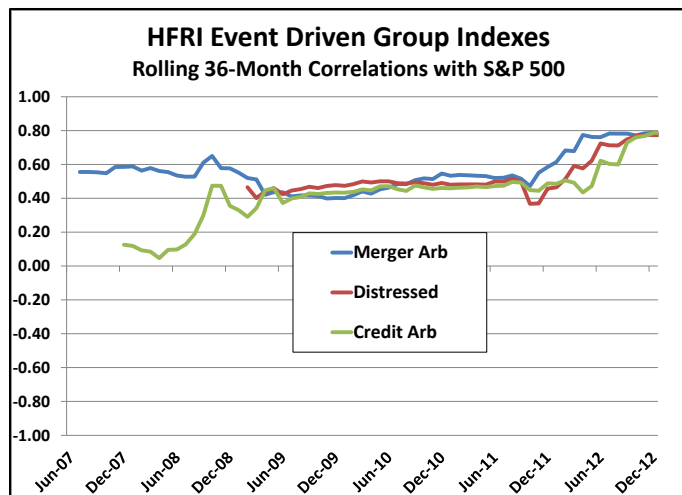


In the four graphs below we dig a little deeper into the specific hedge fund strategy indexes supplied by HFR in our search for diversifying investments. I highlight a few of those that demonstrate the best diversification of the S&P 500 within each group. I should point out that these HFR indexes present the averages of the hedge funds in each category, and that hedge funds are notorious for having a very wide return dispersion, even among funds with similar strategies—typically several times larger than would be the case for long-only strategies.

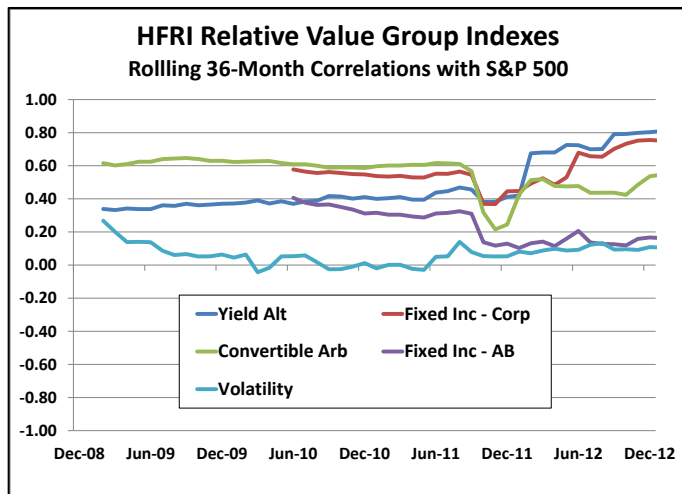
In a few of the HFRI **Equity Hedged** component indexes (shown at right) we find some attractive diversifying return patterns, with low correlations with the S&P 500. The **Absolute Return** and **Multi-Strategy** indexes both reflect that fact that the typical “long/short” hedge fund tends to be net long. Although the **Equity Market Neutral** index is decidedly better, even these funds have had a positive market beta in recent years. On the other hand, the **Short Bias** funds display the expected negative correlation with the S&P 500. The problem with the short bias strategy is that the market has a pernicious tendency to go up!



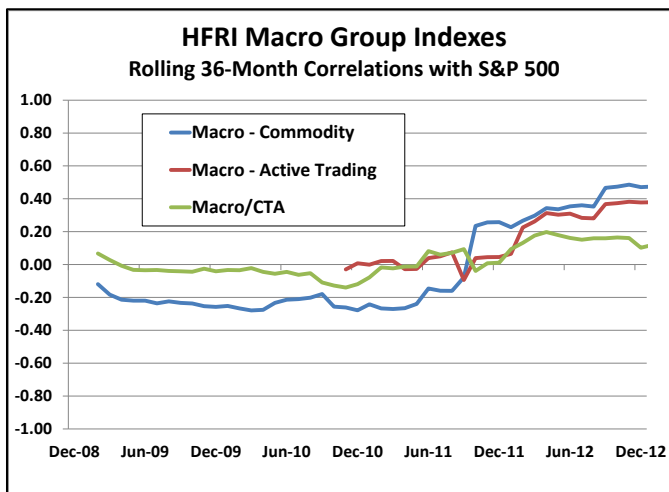
The HFRI **Event Driven** Indexes follow the pattern of generally increasing correlation with the S&P 500 over time. **Merger Arbitrage** funds buy either announced or expected takeover candidates, and often hedge with shorts either on the market or on announced or expected buyers. **Distressed** (specializing in bankruptcies and restructurings) and **Credit Arbitrage** (specializing in long and short positions in various classes of debt and/or equity for a given company) also exhibit correlations with the S&P 500 that are close to 0.80.



The **Relative Value** group includes a wide spectrum of strategies. **Yield Alternative** funds often own high-yielding equities. **Corporate Fixed Income** funds invest mostly in equity-sensitive high-yield bonds. **Convertible Arbitrage** funds short the stock and own the convertible long, but only partially hedge. **Asset-backed Fixed Income** funds (often specializing in mortgage debt) show a low correlation to the S&P 500, as do **Volatility** funds. Negatively correlated VIX Index instruments are important to the strategies of volatility fund managers.



We saw above that the HFRI **Macro** Index group exhibited a decidedly lower correlation with the S&P 500 than the other three major groups, and this characteristic is also evident in the component indexes. **Macro** hedge funds and **Commodity Trading Advisors (CTAs)** generally take positions in various futures and other derivatives. Perhaps because **Commodity** prices tend to be tied to economic growth expectations, there has been a recent increase in correlation with the S&P 500 as economic concerns have increased, though the correlation remains low enough to provide excellent diversification.



Most investors are surprised to learn that in the last few years, quite a few hedge fund-like strategies have been made available through **ETFs** (exchange traded funds). These are **low-cost index funds** that use objective criteria to construct portfolios that reflect a particular strategy. In the table below I highlight a few ETFs that are roughly comparable to the corresponding HFR Index on the same line. There are two points I'd like to make with this data. First, in most cases there is at least one (and sometimes more than one) alternative ETF for a given hedge fund strategy. Second, in most cases the ETF has an S&P 500 correlation that is comparable to the HFR Index, and in some cases, noticeably lower.

| HFR Index | | | | ETF | | | |
|-----------------------|--------------------------------|-------------------------|--|--------|------------------------------|-------------------------|-------------------------|
| Bloomberg Ticker | Description | 36M Correl 9/30/2013 | | Ticker | Fund Name | Strategy | 36M Correl 9/30/2013 |
| Equity Hedged | | | | | | | |
| HFRIFI Index | HFRI RV: Multi-Strategy Index | 73% | | QAI | IQ HEDGE MULTI-STRAT TRACKER | Multi-Strat HF Replictn | 71% |
| HFRXEMN Index | HFRX EH: Equity Market Neutral | 42% | | RALS | PROSHARES RAFI LONG/SHORT | Market Neutral Value | 40% |
| HFRISHSE Index | HFRI EH: Short Bias Index | -87% | | VIXY | PROSHARES VIX SHORT-TERM | Long VIX | -83% |
| Event Driven | | | | | | | |
| 4 HFRXMA Index | HFRX ED: Merger Arbitrage Inde | 74% | | CSMA | CS MERGER ARBITRAGE INDEX | Merger Arb | 48% |
| | HFRIDSI Index | 82% | | CSD | GUGGENHEIM SPIN-OFF ETF | Spin-Offs | 84% |
| Relative Value | | | | | | | |
| HFRXYA Index | HFRX RV: Yield Alternative Ind | 84% | | MLPI | ETRACS ALERIAN INFRASTRUCTUR | MLPs | 64% |
| 7 HFRIFIHY Index | HFRI RV: Fixed Income-Corporat | 81% | | PHB | POWERSHARES FNDMTL H/Y CORP | High Yield Bonds | 69% |
| 3 HFRXCA Index | HFRX RV: FI-Convertible Arbitr | 56% | | CWB | SPDR BARCLAYS CAPTL CONV SEC | Convertible Bonds | 91% |
| HFRIFIMB Index | HFRI RV: Fixed Income-Asset Ba | 27% | | MBB | ISHARES BARCLAYS MBS BOND FD | MBS | -11% |
| HFRXVOL Index | HFRX RV: Volatility Index | 37% | | XVIX | ETRACS DAILY L/S VIX ETN | Long/Short VIX | 8% |
| Macro | | | | | | | |
| HFRXTRAD Index | HFRX Macro: Active Trading Ind | 35% | | MCRO | IQ HEDGE MACRO TRACKER ETF | Macro HF Replication | 64% |
| HFRXCUR Index | HFRX Macro: Currency Index | 44% | | ICI | IPATH OPTIMIZED CURRENCY ETN | Devel Currency Carry | 44% |
| 6 HFRXCOM Index | HFRX Macro: Commodity-Index | 46% | | DJP | IPATH DOW JONES-UBS COMMMDTY | Broad Commodity | 65% |
| Other | | | | | | | |
| | | | | UNG | US NATURAL GAS FUND LP | Natural Gas Futures | 9% |
| | | | | IAU | ISHARES GOLD TRUST | Physical Gold | 27% |
| | | | | BAB | POWERSHARES BUILD AMERICA PO | Municipl Bnds - Taxable | -35% |
| | | | | SCHP | SCHWAB U.S. TIPS ETF | TIPS | 1% |
| | | | | BWX | SPDR BARCLAYS CAPITAL INTL D | Devel Gov't Bonds | 47% |

Alternative investments have historically been attractive because of their low correlation with stocks and bonds. However, since 2008, many types of alternative investments have experienced a dramatic increase in their correlations with the S&P 500, and now many are above 0.80, which means that their diversification impact is modest. Significant diversification is getting harder to find. Investment strategies that include shorting often offer the greatest diversification benefit. These are available through primarily through hedge funds, or increasingly, through ETFs.

Kevin Means, CFA
Principal
Select Alternative Investments LLC

October 24, 2013

SELECT ALTERNATIVE INVESTMENTS LLC

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