Unified Hedge Fund Classification[1]

All Security Investments:

Traditional Investments

Traditional investing is characterized by the purchase, holding, or sale - but not short sale - of publicly issued securities (primarily stocks, bonds, and cash). The dominant variable in the performance of traditional investment management is the performance of the relevant market. Except in rare cases, investment skills of the portfolio manager are relegated to the pursuit of incremental performance, relative to the appropriate market benchmark. Bank trusts, insurance companies, mutual funds, pension funds, and investment advisory accounts primarily utilize traditional investment portfolios.

The primary attribute for classifying traditional investments is the asset class. The *expected return* for a traditional investment, assuming no alpha, is the return of the appropriate market index.

Non-Traditional (or Alternative) Investments

Non-traditional investments have historically been privately placed securities, but are sometimes offered publicly, today. Some major categories are: Venture Capital and Private Equity Funds, Real Estate Securities, Oil and Gas Partnerships, Commodities Trading Pools, True Hedge Funds and Nominal Hedge Funds. **The primary attributes for classifying non-traditional investments vary significantly.**

True vs. Nominal Hedge Funds

There is no *definitive* trait shared by true and nominal hedge funds. They often share structural and other characteristics customarily perceived (and frequently represented in the financial media) to be definitive for all hedge funds, but these characteristics are simply descriptive, not definitive.

True Hedge Funds

True hedge funds are diversified, managed investment pools *designed* to extract returns from given markets, with less risk than is inherently required of traditional investors participating in those same markets.

They achieve this by systematically employing some form of arbitrage strategy or strategies at all times, for a significant portion of assets (at least 50% of invested assets - not capital), thus creating a value-added hedge (not an insurance hedge) that considerably insulates investment skills from the gravity of markets. In doing so, they fundamentally alter the relationship between risk and return for assets invested "within the hedge".

The primary attribute for classifying true hedge funds is strategy. The *expected return* for assets within the hedge in a true hedge fund, assuming no alpha, is zero.

Like nominal hedge funds, true hedge funds are usually offered by private placement; they usually have performance-based compensation for their fund managers; and their fund managers often have a significant personal stake in the fund… but none of these widespread characteristics are defining characteristics for true hedge funds.

There are only three major categories of true hedge funds: Jones model funds, relative value funds, and macro hedge funds.

Jones Model Funds

Jones model funds are true equity hedge funds. They are equity funds that maintain no less than 50% of invested assets within a value-added hedge structure at all times.

This original hedge fund model seeks to profit from the arbitrage between a basket of long equities and an equal value basket of short equities, maintained within the hedge at all times, but not necessarily with all assets. Any assets not within the hedge comprise "net market exposure," which is expressed as a percent of capital.

NET MARKET EXPOSURE (%) = (Longs-Shorts)/Capital

Aggressive Jones model funds

(Alfred Jones's original hedge fund would have been classified as aggressive, and in this peer group.)

Aggressive Jones model funds may occasionally or regularly amplify market risk by exceeding net market exposure of 100%, thus using leverage outside of the hedged structure, or by going significantly "net short" with negative net market exposure. Nonetheless, they maintain no less than 50% of invested assets within a value-added hedge structure at all times. Though uncommon today, aggressive Jones model funds should be recognized for their very different risk/return characteristics from conservative Jones model funds.

Conservative Jones model funds

Conservative Jones model funds mitigate market risk at all times, by maintaining net market exposure from -20% to 100% of capital, inclusive, thus keeping leverage within the hedge at all times. This subclass allows tremendous manager flexibility, and includes numerous subclasses characterized by the use of different equity markets, sectors, regions, styles and exposure ranges.

Long/short equity funds are "fully hedged" conservative Jones model funds that hold equal dollar long and short positions with a goal of market neutrality. Some long/short funds are balanced by beta, sector and/or other variables.

GENERAL EQUITY SUBCLASSES: Whereas some of these categories are primary classes for traditional investment classification, they are secondary or lower classes under this system. These are useful subclasses for Jones model funds, as well as for nominal equity hedge funds. The subclasses listed here are neither comprehensive nor mutually exclusive, and order is a matter of preference.

Investment Style Subclasses
Growth, Value, Mixed, Trading-oriented, etc.

Market Capitalization Subclasses
Large Cap, Mid Cap, Small Cap, and Micro Cap

Geographic Subclasses
Global, International, Regional or Emerging Markets subclasses

Industry Sector Subclasses

Relative Value Funds (Market Neutral)

Relative value funds seek to fully hedge (completely neutralize) the influence of markets, through the *arbitrage* between baskets of related securities maintained within the hedge at all times. The number of subclasses utilizing such arbitrage strategies is virtually unlimited.

[1] Unified Hedge Fund Classification, *Lookout Mountain Hedge Fund Review*, 3rd Quarter 1996, © Lookout Mountain Capital, Inc. Subsequent updates to this classification system are posted at www.Jonesmodel.info. (uhfc.lmc.rev. 2002.11)

Capital Structure Arbitrage Funds

Convertible Arbitrage Funds

Convertible arbitrage funds go long convertible securities and short the underlying common stock.

Other Capital Structure Arbitrage Funds

Fixed-Income Arbitrage Funds

Fixed-income arbitrage funds exploit price differentials between related fixed-income securities and/or derivatives.

Mortgage Arbitrage Funds

Mortgage arb funds are primarily long mortgage-backed securities while hedging interest rate, volatility, and prepayment risk.

Other Fixed Income Arbitrage (non-mortgage) Funds

Merger Arbitrage Funds (Risk arb)

Merger arb funds specialize in the simultaneous purchase of stock in a company being acquired and the short sale of the acquiring company, thus making a directional bet that the deal will go through. They sometimes reverse this strategy.

Multiple Arbitrage Funds

A substantial number of funds utilize multiple relative value strategies, which may include a combination of the above and/or a variety of index or other derivative arbitrage strategies.

Macro Hedge Funds

Macro hedge funds seek to capitalize on changes in the relative values of securities, interest rates, and/or currencies affected by regional or global economic change. They tend to be aggressive asset allocators; their use of leverage and derivatives tends to be substantial; and their methods and degree of hedging may be highly concentrated or vary significantly.

Due to the directional nature of some forms of macro arbitrage, macro funds that do not utilize a significant level of other value-added hedge strategies should arguably be classified as broad mandate nominal hedge funds.

Nominal Hedge Funds

Nominal hedge funds are usually privately placed investments with performance-based fees for managers who often hold a significant personal stake in the fund. Yet, while they fit the customary description for hedge funds, **nominal hedge funds fail to employ a significant level of value-added hedging at all times.**

The primary attribute for classifying nominal hedge funds is structure, not strategy. The *expected return* for a nominal hedge fund, assuming no alpha, is the performance of the appropriate market benchmark. While nominal hedge funds often present attractive, low-correlation investment opportunities, **low correlation with traditional market benchmarks should not be confused with the lower risk characteristics of true hedge funds.**

Long-bias Equity Funds

Long-bias equity funds are structured as traditional hedge funds, and may use index options or some short selling, but they do not maintain a Jones model hedged structure.

Unleveraged Equity Funds

Leveraged Equity Funds

Short Funds

Short funds seek to profit from the short sale of securities, primarily the stock of overvalued, fundamentally flawed, or fraudulent companies.

Short-only Funds

Short-only funds focus exclusively on the short sale of securities.

Short-biased Funds

Short-biased funds seek to profit primarily from the short sale of securities, but may buy securities as a hedge.

Special Situations Funds

Distressed Securities Funds

Distressed securities funds buy, and may occasionally short, the securities of companies under bankruptcy and/or reorganization.

Opportunistic Fixed Income Funds

Opportunistic fixed income funds purchase debt securities, undervalued due to mitigating circumstances.

Activist Investing Funds

Activist investing funds seek to directly impact the value of securities held by influencing other securities holders, or by becoming activist shareholders.

Emerging Markets Funds

Emerging markets funds encompass a broad and growing classification with debt, equity, and mixed subclasses for investing, primarily long, in the securities of developing countries.

Broad Mandate Funds

Broad mandate funds are macro or mixed strategy funds that don't employ significant value added hedging at all times.

OTHER: Nominal hedge funds with unclassified strategies.

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