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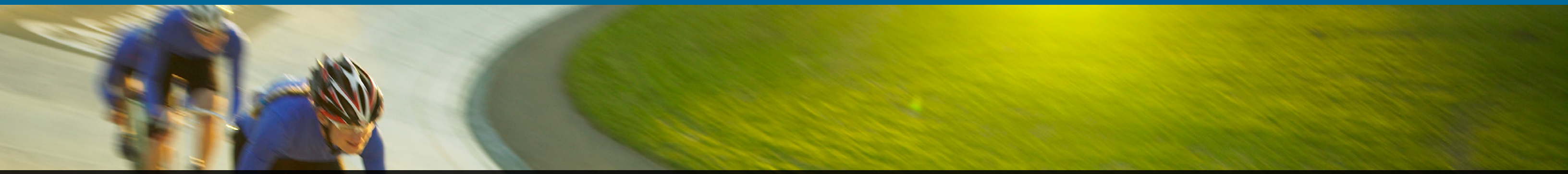
POINT OF VIEW Investment Expertise from Northern Trust



The Value of Dynamic Allocation in Hedge Fund Investing

Active allocation, risk management and manager selection can make a powerful combination.

"The manager research process should not just assess whether a manager has a strong track record, but determine whether they have the ability to remain successful given the market outlook."

– John Frede, CFA, Director of Research at 50 South Capital

The hedge fund industry has grown from $39 billion in managed assets in 1990 to about $3 trillion today, a growth rate reflective of the demand for the asset class.[1] However, when investing in this increasingly popular asset class, understanding and managing complicated risk exposures is key.

Point of View recently consulted with Adam Magyar, CFA, FRM, Quantitative Strategist at 50 South Capital Advisors, LLC; John Frede, CFA, Director of Research at 50 South Capital; and Jessica Chu, CAIA, Investor Relations at 50 South Capital, for their insights on this expanding industry.

***Point of View:* When it comes to hedge funds, manager selection is key. What are some of the necessary considerations?**

Adam Magyar: Some investors might think they can simply invest with hedge fund managers who have, historically, delivered strong performance. But this approach may not produce optimal results. A risk management review is a key element when researching hedge fund managers. We have developed a robust risk management process to analyze the exposure level detail we receive. This is essential to understand where the risk exposure is, as well as how it may be shifting over time.

Key Points

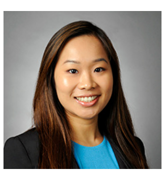
- **Mistakes investors make** with hedge fund manager selection.
- **Active management** requires discerning discipline.
- How to avoid **risk management danger zones.**

Different than traditional long-only investments, hedge fund managers generally do not follow a benchmark. As a result, their investment mandates are often flexible and can change with market opportunities. Different market environments can favor different strategies and managers, so our process is designed to take these considerations into account.

John Frede: The manager research process should not just assess whether a manager has a strong track record, but determine whether they have the ability to remain successful. At 50 South Capital, we are very focused on identifying manager talent

"While often an afterthought, the risk piece of hedge fund performance should be a key component of ongoing monitoring."

– Jessica Chu, CAIA, Investor Relations at 50 South Capital



early, often leading us to invest with smaller and more nimble hedge fund managers. We believe they are often able to take advantage of opportunity sets and avoid crowded trades, one of the biggest challenges of hedge fund investing today. In the end, we don't follow the crowd; we want to invest in truly unique and differentiated sources of returns.

Jessica Chu: We believe investors should seek active portfolio decisions and risk management for long-term performance. There's a lot more to it than assembling a group of well-known names. Without active management, you might not realize your exposures are overweighted or canceling each other out. This is a key consideration during challenging markets. You do not want to have all the same trades across the entire portfolio. You want your hedge fund portfolio to have lower correlation or at least pull on different levers so you have more opportunities to generate return.

There were funds that were well-positioned in the event that the housing bubble burst back in 2007. They were positioned in a way that would create windfall gains if they got the market call correct, but protect capital if they got the call wrong. Some of these funds returned in excess of 300 percent from late 2006 through the middle of 2009. However, in the three years following 2009, these same funds could be known to be down nearly 50 percent. A manager who invests in hedge funds needs to know when the appropriate time would have been to invest in those funds and the appropriate time to sell those funds. Well-timed, these investments could have led to outstanding results while poorly timed could have led to losses.

***Point of View:* When selecting hedge fund managers who employ an active management style, how should the discerning investor proceed?**

Jessica Chu: Part of the due diligence process of selecting an asset manager or consultant should be asking the question, "How much value do you add through portfolio construction and tactical decision-making?" There should be value beyond just selecting hedge funds.

Adam Magyar: Portfolio construction is a key component of our process, and it should be for any asset manager. For instance, what worked in 2012 through 2014 was longer-biased type strategies, equity-oriented strategies, but toward the end of 2014, we had the view that volatility in the markets would pick up. Over a few quarters, we slowly shifted to more market neutral managers who we believed could deliver strong alpha from both their long and short books. Additionally, we moved more into credit strategies and away from equity strategies.

We believe these changes were meaningful — and asset managers or consultants should be able to demonstrate their ability to do the same. Just buying managers isn't the solution; effective hedge fund programs also require appropriate allocations.

You need to think about the strategies in which you want to invest. But it is also important to keep in mind: Your choice of strategy is dynamic and ever changing. An event-driven approach is a good example of how you can't simply allocate to what has worked in the past. It was a fantastic strategy from 2010 through 2013, but over the past two and a half years, the story has changed quite a bit.

***Point of View:* You mentioned risk management is also critical for long-term hedge fund performance. What's the best way for investors to approach risk management?**

Adam Magyar: Your due diligence process may lead you to some strong hedge fund managers on a standalone basis, but what if they all decide they want to be in the technology sector? Now all of a sudden you have several managers who are all in the same space. That's a big risk coming from one sector.

We take a monthly look at hedge fund managers to evaluate the total risk. We look at how much risk is being taken, how it compares today relative to last month, and the last quarter and last year — and figure out what we are comfortable with. Then that's where the portfolio allocation work comes in — we tilt into or away from areas based on the opportunity.

Jessica Chu: The risk management process can be challenging for investors to replicate on their own, due to the amount of data and systems needed to analyze and interpret the information. While often an afterthought, the risk piece might be more effectively managed by a team of experts — and it should be a key component of ongoing monitoring.

John Frede: Our investment team pays a lot of attention to what the risk reporting reveals to make sure we're not overweighting certain risk factors. We look at these risk exposures to ensure they are consistent with our top-down strategic outlook.

For more expert insights on this popular asset class, read our 2016 Hedge Fund Outlook and visit 50SouthCapital.com.

[1]Prequin 2016 Global Hedge Fund Report

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