

Performance Update

Fund of Hedge Funds Indices	July	June	YTD	2004	2003	2002
EDHEC Fund of Funds Index	1.60%	1.31%	2.69%	7.07%	11.46%	1.25%
HFRI FoHF Composite Index	1.69%	1.34%	2.68%	6.86%	11.61%	1.02%
CISDM FoHF Diversified Median	-	1.28%	0.83%	7.52%	10.04%	0.65%
CISDM FoHF Niche Median	-	1.17%	1.28%	8.33%	10.62%	1.99%
InvestHedge Composite ¹⁾	-	1.35%	1.20%	6.12%	9.28%	1.99%
Altvest Sub-Index: Fund of Funds	1.65%	1.46%	3.01%	7.39%	11.12%	1.23%
Eurekahedge Fund of Funds Index	1.59%	1.31%	2.62%	6.58%	11.49%	2.09%
Barclay/Global HedgeSource FoF Index	1.60%	1.27%	0.83%	6.61%	10.36%	1.79%

1) Updated by the end of the month.

Investable Hedge Funds Indices	July	June	YTD	2004	2003	2002
CSFB/Tremont Investable HF Index	0.88%	0.93%	1.10%	5.31%	11.04%	5.67%
MSCI Hedge Fund Composite Index	1.06%	1.15%	1.23%	3.10%	14.7%	5.30%
S&P Hedge Fund Index	0.98%	1.03%	0.97%	3.95%	11.12%	4.14%
HFRX Global Hedge Fund Index	1.67%	0.91%	-0.11%	2.69%	13.39%	-
FTSE Hedge Index	0.91%	0.32%	0.33%	3.12%	12.36%	2.05%

Numbers prior to the date of inception of the Investable Indices are pro forma. Fees may not be included.

Fund of Funds of Hedge Funds	July	June	YTD	2004	2003	2002
PrimFund Diversified	1.33%	1.27%	3.47%	8.39%	13.68%	-

Inception of the fund was July 1st 2004. The simulated data prior reflects the net performance of a weighted composite of the targeted fund managers.

Industry News

Hedge Funds See \$10.9 Billion in New Flows in Q2

HFR

The hedge fund industry continued its growth in the second quarter of 2005, with \$10.9 billion in new fund flows coming in, according to data released by Hedge Fund Research (HFR). Total industry assets now stand at a record \$1.025 trillion.

The \$10.9 billion in new flows for the 2Q was down significantly from the \$27.3 billion in new flows for the first quarter of the year, but up from the \$7.5 billion in new money raised by the industry in 2Q 2004. Convertible Arbitrage continued to be the biggest loser, dropping \$4.15 billion in assets for the quarter, bringing total losses in the strategy to \$5.1 billion in assets year to date, or a 15% loss of assets since the beginning of the year. Macro and Equity Hedge funds saw some of the greatest inflow, both attracting \$3.2 billion in new money for the quarter. Fund of Funds saw both flows and performance decline compared to 1Q 2005. Flows dropped to \$3.5 billion in 2Q from \$9.4 billion, while 2Q returns fell to 0.29% from 0.80%. Total assets in the Fund of Funds category currently stands at \$375 billion, representing approximately 37% of total hedge fund assets.

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Q2 inflows into hedge funds fall

Tremont

The second quarter of 2005 saw the hedge fund industry recording its smallest net quarterly inflow of investor assets since the fourth quarter of 2001, according to research compiled by Tremont Capital Management. All told, US\$11.6 billion in assets were invested in hedge funds in the quarter, compared to a net allocation of US\$24.6 billion for the first quarter of the year.

Strategies attracting the most net assets were multi-strategy (US\$6.3 billion), event-driven (US\$3.9 billion) and fixed-income arbitrage (US\$1.8 billion). Convertible arbitrage took the biggest lumps, with a net loss of US\$2.9 billion, suffering net losses for the fourth consecutive quarter, while managed futures registered a net loss of slightly less than US\$1 billion.

Hedge fund assets slide 2% in Q2, managed futures assets increase

Barclay Group

Hedge fund assets decreased by two percent during the second quarter of 2005, from \$1,080.8 billion to \$1,059.2 billion. Managed futures grew by \$100 million to \$121 billion, an increase of 0.08 percent. In spite of the second quarter decline, hedge fund assets have grown by \$17 billion, or 1.63 percent, since year-end 2004. Fund of funds assets maintained their strength during Q2, climbing 11.64 percent, from \$510.5 billion to \$564 billion.

Hedge fund demand and capacity will continue to grow

Van

A recent report from Van examines the demand for hedge funds, worldwide, as well as the capacity of the industry to fill this demand. According to Van, there was an unhappy confluence of several factors which were detrimental to the industry in the year 2004: unfavourable markets, unusually low volatility and spreads and unprecedented demand. Van believes that it will take the hedge fund industry at least another year to adjust to new demand levels.

This adjustment involves, in part, the exploitation of new strategies and markets. Demand will continue to grow as institutions and family offices look for a "safer haven" than unhedged investments. Van believes the hedge fund industry will grow, as a minimum, to: \$2 trillion by 2009, \$4 trillion by 2013, \$6 trillion by 2015. Although these projections might seem aggressive, one should consider the following: 1) the explosive growth of the mutual fund industry. After it attained \$1 trillion in assets in 1990, it grew more than fourfold in the next 7 years; 2) the logic of investing in hedged investments vs. traditional long-only investments; i.e., the ability to obtain much better risk-adjusted returns with hedge funds; 3) the steady growth of the hedge fund sector over the last 16 years; 4) the scepticism, in the 1990s, when Van forecasted that hedge fund assets would be \$1 trillion by 2005. Van concludes that the industry will see huge growth in coming years. And overall, capacity will not be a problem.

Fund of hedge funds clients of Riskdata have seen their assets grow

Over the last year, assets at Riskdata's fund of hedge funds client base (a representative cross-section of FoHF from continental Europe, the UK and North America) have increased from a base of 100 in June 2004 to 156 on an AUM-weighted basis in July this year, and to 162 on an equal-weighted basis.

The bulk of the growth in their AuM (85%) comes from inflows of institutional investor money, with the rest made up of high net worth inflows and performance gain over the period.

Brownstone will merge into Fairfield Greenwich Group

Brownstone Advisors, LLC will merge its business into the Fairfield Greenwich Group ("FGG") as of August 1, 2005. The resources and global credibility of FGG will profoundly enhance the ability to identify, manage and offer quality alternative investment strategies according to a press release.

FGG, founded in 1983, has over \$9 billion in assets and approximately 75 employees worldwide. The firm manages and offers a diverse group of products, including internal and external single-manager strategies, multi-strategy funds, funds of funds, real estate funds and structured products. FGG is headquartered in New York and has offices in Greenwich, Miami, London, Madrid, Lugano, Rotterdam, Rio, Singapore and Bermuda.

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Massachusetts pension fund adds money to funds of hedge funds

The Massachusetts fund invests roughly \$1.6 billion with five funds of funds -- Ivy Asset Management, Arden Asset Management, K2 Advisors, as well as Pacific Alternative Asset Management and Rock Creek Group. Because the market has improved, the fund in August added another \$145 million in new money, allocating money to all but Pacific Alternative Asset Management.

Illinois State Board of Investment allocates to fund of funds

The Illinois State Board of Investment has selected Rock Creek Group and Suoritus Partners for fund of fund mandates. But contracts must first be finalized before the sizes of the allocations are disclosed, a source close to the negotiations said. As of June 30, 2005, the total amount of assets managed by the ISBI amounted to \$10.9 billion. The asset allocation to alternative assets, including private equity, amounted to \$438 million or 4% of the portfolio.

Advisor/People News

Former Deutsche executive to head Citigroup hedge fund operations

Citigroup Alternative Investments appointed Raymond Nolte chief executive of its funds of hedge funds unit. He also will be responsible for the group's single-manager business and will sit on the management and investment committees.

Previously Mr. Nolte was a managing director and vice chairman of the Deutsche Bank absolute return strategies fund of funds and single-manager hedge fund operations.

Lombard Odier managing director joins GAM

GAM, a fund of funds and hedge fund business that is part of UBS AG, appointed Joe Gieger as managing director for the Americas.

Mr. Gieger is leaving Lombard Odier Darier Hentsch, Inc. in New York, where he was managing director and president. That firm is an arm of the Swiss private bank. As of Sept. 6, he will work on expanding GAM's institutional and fund distribution operations in the United States and develop new products.

Product News

KGR Capital to launch new "dynamic" Asian fund of funds

KGR Capital announced the launch on September 1st of the KGR Capital Asian Dynamic Absolute Return Fund. This will be a multi-manager, multi-strategy fund of Asian hedge funds, and will initially have a portfolio of 27 hedge funds, including 11 strategies. Just over 40% of the fund's exposure will be to Japanese strategies, whilst the rest will be allocated to other parts of Asia, including the rapidly growing economies of Greater China, Korea and India. The manager is targeting returns of 15-20% over the cycle, and is expecting volatility to be about 7-10%.

Russell targets retail investors for the first time

Russell Investment Group has launched its Russell Private Investment Series, a range of funds of funds targeted at Australian retail investors.

The new product is a world's first for Russell, which previously sought only institutional investors. The development suggests a high level of sophistication in the Australian retail market, particularly in burgeoning DIY [Do It Yourself] - self-managed private pension funds typically established by high income executives. Russell's funds of funds, described as multiasset, multistyle, multimanager funds, will allocate to 32 underlying funds including two hedge funds, the Multi Strategy Frank Russell Alternative Investment Funds Plc and the Russell Alternative Strategies Fund.

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Academic/Research

Hedge Funds: Performance, Risk and Capital Formation

Fung, Hsieh, Naik, Ramadorai

There has been an explosion of interest in and investment into hedge funds over the past decade. In this paper, they use a comprehensive dataset of funds of hedge funds to investigate the performance, risks, and process of capital formation of these vehicles. They find, contrary to popular belief, that fund of hedge funds returns are a (time-varying) mix of systematic risk exposures (beta bets) and absolute returns (alpha), with the preponderance of returns coming from the beta bets. Second, they find evidence that the magnitude of fund of hedge funds alpha is sensitive to market conditions, and that alpha appears to have declined since the beginning of their sample period. Third, the behaviour of capital flows into funds of hedge funds suggests that sophisticated investors are moving into these vehicles in search of alpha. They argue that this apparent mismatch between the supply of and demand for alpha has interesting implications for the organization of the hedge fund industry.

Building a Better Fund of Hedge Funds: A Fractal and Alpha-Stable Distribution Approach

Olszewski

Markowitz's (1952) portfolio theory has permeated financial institutions over the past 50 years. Assuming that returns are normally distributed, Markowitz suggests that portfolio optimization should be performed in a mean-variance framework. With the emergence of hedge funds and their non-normally distributed returns, mean-variance portfolio optimization is no longer adequate. Here, hedge fund returns are modelled with the alpha-stable distribution and a mean-CVaR portfolio optimization is performed. Results indicate that by using the alpha-stable distribution, a more efficient fund of hedge funds portfolio can be created than would be by assuming a normal distribution. To further increase efficiency, the Hurst exponent is considered as a filtering tool and it is found that combining hedge fund strategies within a range of Hurst exponents leads to the creation of more efficient portfolios as characterized by higher risk-adjusted ratios. These findings open the door for the further study of econophysics tools in the analysis of hedge fund returns.

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