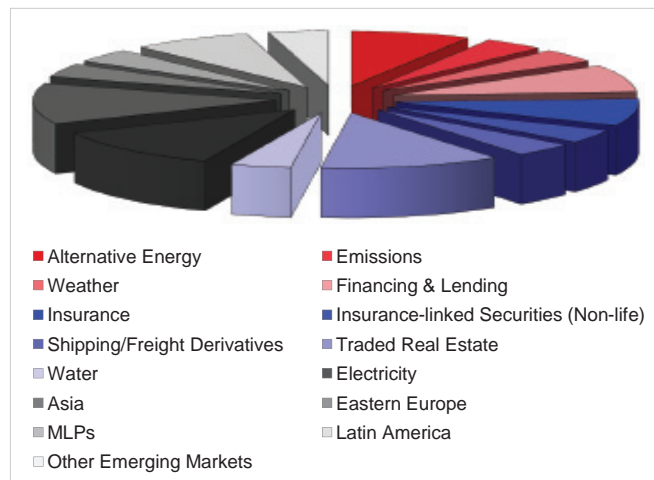


## INNOVATION



47°N Innovation Fund Exposure  
Source: 47°N Capital Management

## 47°N INNOVATION FUND

### Focus:

- Offers diversification and global access to selected hedge fund managers that pursue strategies in "alternative" investment areas
- Areas of innovation: up-coming strategies, instruments, sectors; unveil opportunities in emerging markets
- Targeted return of 15-20% (net of 1.25%/10% p.a. fees) with a target volatility of around 6-8%

### Strengths:

- Research & development (aimed at uncovering "innovative" managers, markets, strategies, sectors)
- Identification of tail-risks and its implication on portfolio construction and management
- Designed to secure "first-mover advantage" that captures early market opportunities (inefficiency-premium)

### Weaknesses:

- Illiquidity constraints posed by underlying markets

### Opportunities and threats:

- "Reserve" capacity in evolving markets
- Time-lag to diminishing inefficiencies

## Risk Management

Low Low / Moderate Moderate Moderate to High High

- Risk at portfolio level:
  - Underlying markets: Liquidity constraints
  - Regulatory changes in new areas (e.g. emissions)
- Ability to source innovative managers: ☐☐☐☐☐☐
- Due diligence expertise: ☐☐☐☐☐☐
- Portfolio construction: Allocation matrix: allocation verified by risk exposure & liquidity characteristics
- Avg. monthly correlations amongst managers <0.3
  - Market and portfolio risks: Dispersed by diversification
  - Time required to liquidate the portfolio: Generally no liquidity mismatch, i.e. liquidity in line with the underlying liquidity (<150 days)

- Key person risk: ☐☐☐☐☐☐
- Manager specific risks
  - Investment: ☐☐☐☐☐☐
  - Leverage used: ☐☐☐☐☐☐
  - Valuation: ☐☐☐☐☐☐
  - Operational risk: ☐☐☐☐☐☐
  - Legal (structure, contracts, compliance) risk: ☐☐☐☐☐☐
  - Manager's reputation related risk: ☐☐☐☐☐☐

## Performance Parameters

Low Low / Moderate Moderate Moderate to High High

- No. of position: Approx. 20
- Diversification:
  - Geographic: Global; Broad based
  - Innovation area exposure: Diffused
  - Strategies, instruments: Diffused
- Liquidity: At portfolio level – 1 year lock up
- Probable correlations with:
  - MSCI World Index: 0.4
  - Global JPM Govt Bond: 0.1
  - GSCI: 0.2

## Outlook

- Barrier to entry: Experience, R&D expertise
- Outlook for a fund such as 47°N Innovation Fund: Upside Potential
- Threat posed by competition: Leader-laggard benefit
- Due to limited correlation expected to perform well in downturns
- Performance could be challenged during a convergence, when normally non-correlating sectors, start to correlate
- Post launch, fund ability to deliver targeted returns over the next 12 months: Realistic

## Investment

- Soft open – plans to go live Q4 2007
- Capacity: USD 500mn
- Fund is targeted at: Institutional investors, pension funds, HNWI
- Recommended holding period to optimise returns: min.24 months
- Fund's base currency: USD, other currencies could be catered for
- Transparency provided to investors: Good
- Manager is registered with: SEC registered

## ALTERNATIVE ALTERNATIVES

### ALLOCATING TO ALTERNATIVE ALTERNATIVES

#### What is the role of alternative alternatives within a portfolio?

Alternative alternatives provide an unrelated and uncorrelated return stream to an institutional portfolio of equities and fixed income. Moreover, alternative alternatives have a low correlation to hedge fund and fund of funds returns. Capital markets have attracted a lot of investment capital over the past five years. Strategies revolving around traditional hedge fund strategies, whether capturing market beta or traditional alpha, have unattractive risk/return profiles looking forward.

A portfolio of investments in sectors where capital markets have not penetrated yet, can and does, still deliver attractive risk-adjusted returns. Additionally, alt alt strategies deliver "portable alpha."

A portfolio of alt alt investments can be bolted onto any traditional institutional investor's portfolio to enhance returns or add diversification benefits. Our internal research indicates that an allocation of between 5-10% to alt alt investment strategies benefits most institutional investors' portfolios. Also, these investments look just fine on their own. They create absolute return streams of between 10-15% net of fees.

#### Does your research indicate a conclusive % that needs or should be allocated to alternative alternatives to improve the overall risk/reward profile?

We have done a lot of research on what is the "right" % allocation of alternative alternatives in a portfolio, and have uncovered that all institutional investors can benefit from an allocation to the alt alt investment strategies. The actual benefit depends on their current portfolio. For example, for an institution currently holding stocks, bonds, commodities, and hedge funds, the benefits of allocating 5-10% to alternative alternatives are tremendous.

We have found alternative alternatives to have low correlations and betas to the traditional beta and alpha products. In summary, the less aggressive an institutional portfolio is, the more benefit the portfolio can achieve through an allocation to alt alts.

#### How does one sieve the choices and identify the "relevant" alternative alternatives that would achieve the above?

We believe the "relevant" alt alt sectors and strategies are investments where one does not need to take large amounts of business or operational risks. Examples of investments with the "right" balance of operational risk and pure investment risk are strategies that revolve around cash flow producing assets. The cash flow from the assets produces a "base" rate of return. To the extent an investor can identify ways of enhancing the cash flows from the assets they own through operations, the return potential from these assets increases significantly. Most of our investments revolve around asset acquisition, asset "exploitation" to enhance cash flow, and an exit strategy to "unleash" the return potential at an appropriate time. We generally invest with a three to four year time frame and this lock-up constraint creates an additional "sieve" for what we can invest in.

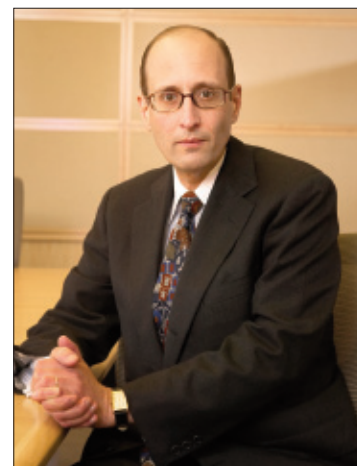
#### How does one effectively implement these allocations?

The most effective way of implementing these allocations is to create a portfolio adhering to strict investment guidelines. Wood Creek employs a formal investment process to identify investment sectors of interest and then focuses on strategies within those sectors which match up our constraints (on operational risk, market risk, liquidity, etc.) Finally we seek a manager to deploy capital with. If we cannot find an existing manager available to manage capital in our preferred strategy within a sector, Wood Creek may create one *de novo*.

#### How do you overcome constraints imposed by: liquidity; headline risk; size and track record, capacity?

We believe the best way to extract returns from an alt alts portfolio is through a 3-4 year lockup. Giving up liquidity is an easier trade-off as long as there is a commensurate return for the illiquidity. As alt alt investments are relatively new, there is lack of a meaningful track record.

There is a dearth of true alt alt investments currently available in fund format. As the market evolves, this situation will change. In the mean time, we often create from scratch, new investment vehicles that offer institutional investors the opportunity to deploy their capital. We negotiate capacity for our investments such that our portfolio offers investors capacity in capacity-constrained sectors.



**Brett D. Hellerman is the CEO of Wood Creek, which focuses exclusively on the alternative alternative (alt alt) investment space**

## ALTERNATIVE ALTERNATIVES

### ALLOCATING TO ALTERNATIVE ALTERNATIVES

#### Performance measurement (relative and absolute)

Performance measurement for alt alt investment strategies is a challenge. As there are relatively few other investments with a similar mandate, it's difficult to assess relative performance unless one is completely focused on evaluating these investments. Also, most of these funds have short and statistically meaningless, track records. We have created customised benchmarks to understand the performance drivers for the different alt alt investment strategies we invest in. We also employ peer group analysis and other measurement tools to assess individual investments and model the portfolio.

#### These strategies impose distinctive risk management challenges. Elaborate.

Alt alt is a new and distinctive asset management space and, as you say, risk management creates some unique and distinctive challenges. We think of risk management in alt alt as a continuum between extremes. For instance, we seek to limit our operational risk (what I call "business plan risk"); as we want to take our risk more in the underlying asset or sector inefficiency than in a given manager's business plan to exploit it.

Yet if we take too little operational risk, we end up with a pure play asset cash flow that many financial investors will want to bid for, making the returns likely unattractive. On the other hand, if we take on too much operational risk, we may jeopardise receiving a good current return and may end up in an illiquid private equity investment with no coupon.

We have chosen to work along the risk continuum for other risks such as liquidity, market risk and efficiency of sector.

Eventually, these decisions about where to position our fund along the risk continuum are qualitative decisions driven by fundamental research and insight that are confirmed by quantitative methods. The investment process requires a lot of time and is far from a typical fund of funds' "allocation" process to traditional hedge fund strategies.

#### Is it possible to "customise" a skilled specialist in the alternative alternatives space? How?

If by customise, you mean focus on a particular area of the alt alt space, sure. For instance, there are firms that focus on sectors like asset-based lending and infrastructure among others. Such exposures, present a very effective way to corral assets in a "pure play" kind of approach.

In terms of specific underlying managers in our portfolio, it is certainly possible to customise investments. We may see a manager that we like but the fund he manages takes too much risk outside our mandate. We would seek out a separate account with the manager, to take risk in just the area which we prefer. We can establish separate accounts with the manager or seed a new fund for him/her. Our goal is to get the exact slice of risk for our investors and investments.

There is tremendous opportunity to exploit the inefficiencies borne by alternative alternative strategies and very little global "installed capital" dedicated to investing in them.

#### Performance differential that can be expected in a portfolio with and without alternative alternatives

An alt alt portfolio can potentially deliver over 12% net return to investors while keeping the annual portfolio volatility below 3%. Adding 10% of a portfolio of alternative alternatives to a conservative (30% equity and 70% bond) portfolio enhances portfolio returns by over 6% and lowers the overall portfolio risk by 2%. Adding 10% of a portfolio of alternative alternatives to a more aggressive (30% equity, 20% bonds, and 50% alternative investments) portfolio enhances portfolio returns only marginally but still lowers the overall portfolio risk.

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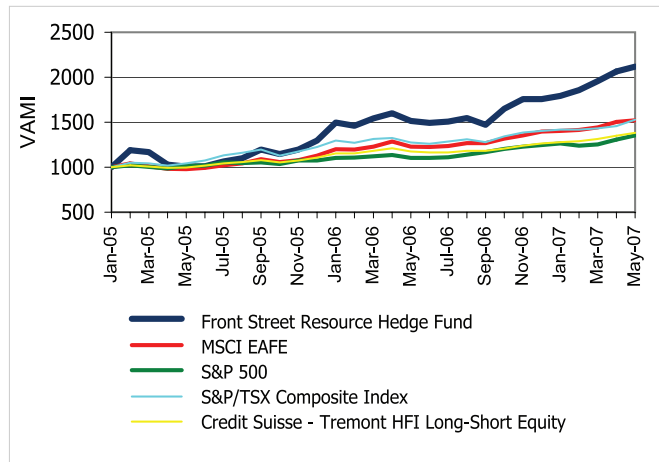
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## NATURAL RESOURCES



## STREET RESOURCE HEDGE FUND

### Focus:

- Fund selects and strategically trades both long and short positions in equity, debt and derivative securities of business entities operating in a range of natural resource sector industries including mineral resource mining and exploration, forestry, oil and gas exploration, production; power generation and water resource projects

### Strengths:

- Natural resources sector industry related experience, expertise and investment history

### Weaknesses:

- Fund's underlying not immune to unforeseen, sudden, sharp, pull backs - (volatility also presents opportunities)

### Opportunities:

- Demand-supply mismatch for nearly all minerals and metals; global drive toward natural resource exploration, production, optimisation & conservation
- Scope for innovation within the natural resource sector industries

### Threats:

- Globally depressed natural resource consumption conditions could stagger future investments
- Legal and regulatory issues

## Risk Management

Low Low / Moderate Moderate Moderate to High High

- Major risk: security concentration risk - ie natural resource sector which could be concentrated in specific regions or countries

- Ability to identify investment opportunities:

Low / Moderate

- Ability to "market time" entry and exists of investments:

Low / Moderate

- Ability to manage volatility:

Low / Moderate

- Illiquidity of underlying:

Low / Moderate

- Valuation risk:

Low / Moderate

- Leverage at fund level: none

- Currency risk:

Low / Moderate

- Hedges if used to speculate:

Low / Moderate

- Counterparty risk:

Low / Moderate

- Conflict of interest: vis-a-vis fund's other investment vehicles:

Low / Moderate

- Key person risk:

Low / Moderate

## Performance Parameters

Low Low / Moderate Moderate Moderate to High High

- Avg. no. of positions: 50-60

- Diversification:

- Geographic : Canadian bias

- Sector: mineral resource mining and exploration, forestry, oil and gas exploration, production; power generation and water resource

- Strategy: long, short

- Securities: equity, debt and derivatives

- Ability to sustain performance in:

- rising markets:

Low / Moderate

- falling markets:

Low / Moderate

- sideway trending markets:

Low / Moderate

- VaR(99%): -12.08%:

- Max drawdown: -15.3%

## Outlook

- Barriers to entry: Expertise, extensive network of contacts with management teams of companies that are active in the natural resource space
- Outlook on natural resources sector industries: Upside potential
- Outlook for a fund such as Front Street Resource Hedge: Upside to range bound
- Threat posed by competition: Expertise and space related investment and

management history give them an edge

- Ability for the fund to deliver targeted annual returns over the next:

- 1 year : Realistic

- 3-5 years: High

- Fund tends to outperform: in a commodity bull environment

## Investment

- Current AuM: USD 188mn (as of 31.05.07)

- Strategy AuM approx. USD 850mn

- Fund is targeted at: Institution investor, pension funds, HNWI (Non- resident of Canada)

- Geographic restrictions: Apply

- In order to optimise returns, recommended holding period: min.12 months

- Fund's base currency USD

- Fund's complexity for an investor: Simple

- Transparency provided to investors: High

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## COLLATERALISED DEBT OBLIGATIONS THE ART OF VALUATION

**Do you believe CDOs (collateralised debt obligations) on Wall Street are probably marked 30% higher than where they should be?**

In our opinion, the above statement is incorrect and undifferentiated. There are only three reasons why independent valuations are "significantly off" those offered by the market:

- a) The rare occasion where valuations vary significantly from the market due to severe, short term market disruptions. This may be the case in very particular segments, but is not the case for the market as a whole.
- b) In the rare case a valuation is not done independently. This is a compliance issue that is not of concern in wellrun companies.
- c) If the underlying volume of the market transaction is insignificant and as such bears no relevance to the fair market value of a security

### Valuation Fundamentals

One should not forget that certain financial institutions can value securities based on criteria other than mark- to-market, in particular if they intend to hold them to maturity. These valuations, of course can be very different to where a security should trade.

In order to understand why it is possible to value securities even if they do not trade - certain fundamental principles should be reconsidered: Any reasonable buyer and seller of structured credit instruments such as collateralised debt obligations, mortgage backed securities and other types of securitisations (in short, "asset backed securities") will likely base their sale and/or purchase price on the following principles:

- The value of asset backed securities fundamentally depends on the value of the underlying instruments and their expected development over time
- Typically, an investor will base their decision to buy or sell on the present value of the future cash flows generated by such investments
- In order to assess this present value, a number of factors play a vital role:

Default expectations of the underlying collateral, recovery assumptions of such defaulting collateral, spread development of the underlying collateral, prepayment and reinvestment assumptions of underlying collateral, discount rates (based on forward rates and spreads applicable for the security to be valued)

Typically, the valuation department of any investment bank will test the parameters used for their soundness and will cross-check with actually observed data from trades in the market. Often, the sensitivity of valuations to various parameters is tested, too.

If there is a considerable difference between a valuation and that traded by the market; one can assume that market participants have changed their assumptions for one or several parameters relevant to the valuation.

On the other hand, those that have actually made valuations may not have adjusted the parameters for a number of reasons:

- a) they believe the change in the parameters has no bearing on that particular transaction
- b) they believe the volume of the market transaction to be irrelevant, or
- c) they lag behind in observing a significantly changed parameter.

### Observations from a practical viewpoint

Valuations are not an exact science. Differences between valuations and the market will always occur.

Some securities exhibit a high degree of sensitivity to even the slightest change in a parameter. An informed investor can take this into account. Our experience suggests that our weighted average sales price of CDO securities has been around one per cent above valuations received. Sometimes differences of several points can occur. This is a normal phenomenon - and is just as likely as intra-day volatility in a stock's price.

What we have seen in the US sub-prime mortgage market is a commonly observed phenomenon: The market has, following a review of the underlying securities, decided that the default assumptions and recovery assumptions have changed significantly.

### The role of rating agencies

The rating agencies express their opinions based on their own assumptions, and these assumptions are based on a very long term (over a full credit cycle) view. A change in their assumptions, therefore, by design takes longer than any market participant's would do.

However, ratings have no bearing on market prices of securities: For instance,



**Daniel Riediker**

one can observe that the same time AAA rated security could trade anywhere between 6 and 65 basis points in spread. The difference can, most likely, be traced back to the difference in collateral. But other factors such as the collateral manager, vintage year of the security play an important role. As such, ratings are no guidance for market value of securities.

### Fall out of the current sub-prime mortgage market crisis?

First and foremost, the problems stem from loose underwriting standards in a very particular segment in mortgages. The sub-prime segment bears little relevance for the US economy and even less relevance for the European or global markets. There may be some technically driven spill-over effect - but more importantly the market has a chance to learn from its mistakes and can take home an important lesson:

In any structured credit instrument, the performance of the underlying collateral is crucial to its outcome. If the fundamentals of these instruments change, they will have an impact on the structured credit instrument as well. Basing investment decisions only on ratings, structures and management of such structures without an understanding of the underlying collateral is not the right approach to investing in these instruments.

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