PICTET 1805

Pictet Alternative Advisors SA

An introduction to hedge funds

April 2018

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Executive Summary

Hedge funds gained a reputation for preserving investors' capital and generating relative outperformance in market crises. Carefully selected hedge funds provide an alternative investment exposure with diversification and enhanced return potential over the long-term.

At Pictet Alternative Advisors SA, in addition to an extensive know-how of other alternative assets such as private equity and real estate, we have been selecting hedge funds for private and institutional clients since the 1990s.

Selecting the best hedge fund managers means that we invest in only a small portion of all the funds we screen worldwide. Finding hedge fund managers who are able to achieve genuine, provable and repeatable performance requires extensive research and skill, as well as careful qualitative and quantitative monitoring.

Correctly assessing sources of risk is perhaps even more important than analysing sources of performance. Operational, credit and market risks are just a few aspects that need to be grasped before any investment in a hedge fund. Investors need to fully understand the manager's investment strategy and assess whether it is likely to be successful in a given macroeconomic environment.

Our team of hedge fund investment professionals helps clients to understand these demanding aspects and offer a set of hedge fund investment solutions. Clients may choose from Pictet's various commingled funds of hedge funds, diversified across several prominent managers, or opt for a tailor-made mandate.

In each case, our investment philosophy is based on the same key investment principles and rules, derived from best industry practices and our long experience. We search for the best talents and allocate capital according to our macroeconomic views. Our portfolio construction integrates the three main elements of our investment process: strategy allocation, manager selection and risk management.

Part I
Hedge funds in perspective

The first hedge fund was launched in 1949

The beginnings of hedge funds

It is generally said that the first known hedge fund was an investment partnership established more than 60 years ago by Alfred Winslow Jones.

He sought to separate the two risks inherent in investing in stocks: 1) Market risk defined as the general change in stock prices due to market influences and 2) Specific risks related to factors particular to each individual stock.

Jones' partnership held a short position in a basket of stocks as insurance against a downturn in the market, "hedging" to some extent the systematic risk. Jones' fund was unique in that it combined unconventional characteristics such as market neutral exposure and incentive fees.

According to Warren Buffett, however, the first person to manage a hedge fund was none other than Benjamin Graham, who used long, as well as short positions and charged an incentive fee as early as the mid-1920s. Benjamin Graham is considered by many to be the father of financial analysis and value investing.

Definition of hedge funds

There are various definitions in use, but broadly speaking, a hedge fund is any type of investment company or private partnership that uses the following instruments and techniques:

- Long or short positions across asset classes.
- Derivatives, such as options (call or put), futures, swaps, etc.
- Financial leverage.

In addition, hedge funds often share the following characteristics:

- They are often formed as an unregulated investment pool and are generally domiciled offshore.
- They measure their performance in absolute terms (i.e., independent of market direction and uncorrelated to any benchmark).
- They usually charge a performance fee.
- They require high minimum investments.
- Their subscription and redemption policies are fairly restrictive and may even impose lock-up periods or gates.
- Hedge fund managers usually invest their own capital along with their clients.

The industry has grown more than 20-fold in the past decade

No standard classification of hedge fund strategies

The hedge fund industry today

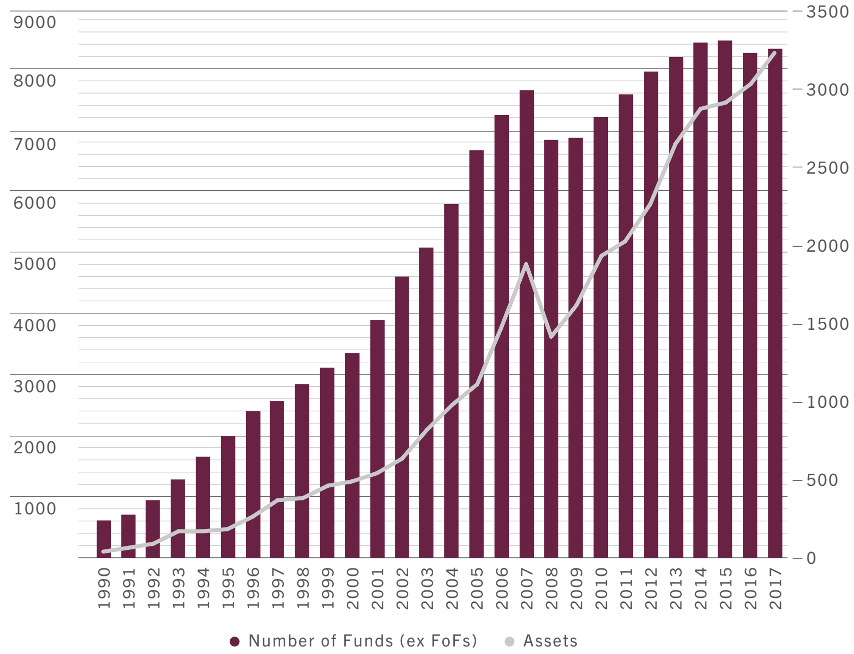
The hedge fund industry is generally estimated to have grown from about USD 40 billion in assets under management in 1990 to over 3.0 trillion in December 2017.

However, it is believed that the amount of assets actually managed far exceeds the figures officially reported. Nevertheless, although assets continue to grow significantly, the size of the hedge fund industry remains small compared to the mutual fund industry and global financial markets.

In terms of the number of funds, the industry has experienced similar growth, rising from around 500 hedge funds in 1990 to approximately 8,335 at the end of December 2017.

So far, the number of new funds has continued to grow despite approximately 10% of hedge funds closing each year because of their inability to raise sufficient assets or deliver satisfactory performance.

HEDGE FUND INDUSTRY GROWTH

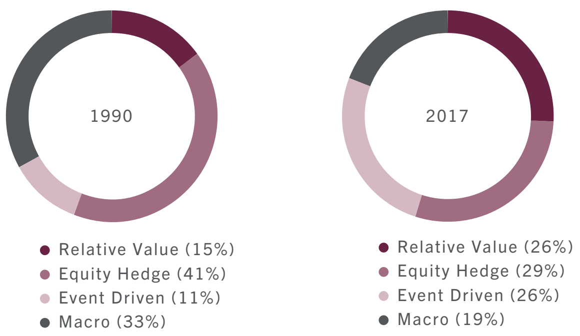


Source: HFR Global Hedge fund industry report - Q4 2017

Hedge fund strategies

There are many ways of classifying the investment strategies of hedge fund managers. Moreover, some managers combine several strategies in what are often referred to as “multi-strategy funds”. The table illustrates the three broad strategic approaches of hedge funds and the underlying investment strategies.

AUM BREAKDOWN BY HEDGE FUND STRATEGIES



Source: HFR Global hedge fund report - Q4 2017

HEDGE FUND STRATEGIES

Arbitrage	Equity Hedge	Tactical Trading
Relative Value – Volatility Arbitrage – Statistical Arbitrage	**Long Short Equity** – Market Neutral – Short Sellers	**Global Macro**
Fixed Income – Credit Arbitrage – Capital Structure Arbitrage – Convertible Arbitrage	**Distressed**	**Commodity Trading Advisors (CTA)**
	Event Driven – Merger Arbitrage – Special Situations	**Emerging Markets**

Source: Pictet Alternative Advisors SA

Arbitrage

Relative value

Relative value is an investment strategy that aims to exploit pricing inefficiencies between related financial instruments such as stocks or bonds. Relative value managers will value the fundamentals of related instruments and go long and/or short expecting prices to converge towards a norm. As managers profit from the convergence of relatively small differentials, this strategy can be leveraged in order to enhance returns.

Volatility arbitrage

Volatility arbitrage trades the implied volatility versus the historical volatility on the same asset across different strike prices or maturities expecting an increase in the fluctuations of the underlying security’s price.

Statistical arbitrage

Managers using this strategy seek to profit from pricing inefficiencies identified using mathematical models. Statistical arbitrage strategies are based on the premise that prices will return to their historical norms.

Fixed-income arbitrage

This strategy seeks to exploit mispricings developed between related classes of fixed income securities such as yield curve and credit spread trading, often neutralising exposure to interest rate risk.

Credit arbitrage

Credit arbitrage seeks to take advantage of pricing inefficiencies between the credit sensitive securities of different issuers.

Instruments commonly traded include CDOs (collateralised debt obligations) and CDSs (credit default swaps).

Capital structure arbitrage
Capital structure arbitrage aims to profit from the pricing inefficiencies across the issuing firm's capital structure with the expectation that the pricing disparity between the two securities will converge.

Convertible arbitrage
This strategy captures inefficiencies in the pricing of convertible securities relative to its underlying stocks.

Typically, a manager goes long the convertible bond and shorts its common stock, effectively hedging the equity risk. Credit default swaps then allow the credit exposure to be hedged.

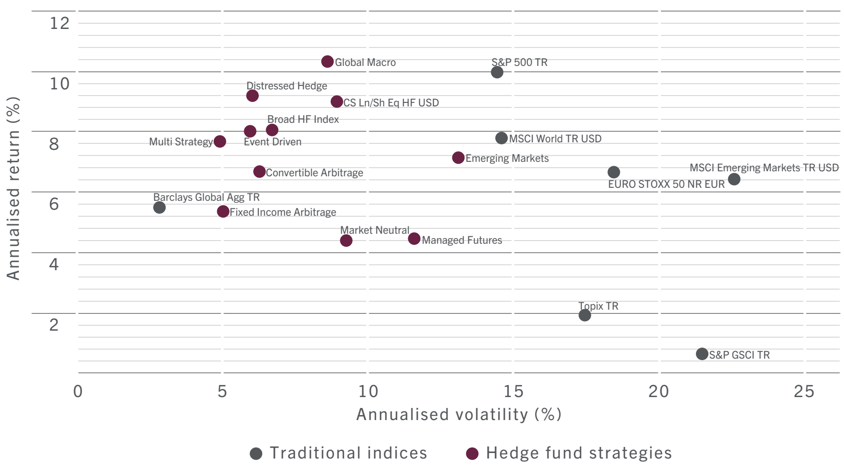
Equity Hedge

Long/short equity
This style accounts for the majority of the strategies used by hedge fund managers today. This directional strategy combines both long and short positions in stocks with a simple objective to minimize exposure to the market. A manager would typically short an overvalued stock and go long an undervalued stock. A manager can either be a generalist or focused on specific regions, sectors, industries or market capitalizations. They can also specialize in types of stocks such as value and growth.

Market neutral
Market neutral managers seek to exploit investment opportunities unique to some specific group of stocks while maintaining a neutral exposure to broad groups of stocks defined for example by sector, industry, market capitalization, country or region. These portfolios minimise market risk by being simultaneously long and short, and produce one single source of returns (the rule of one alpha).

Short sellers
Short selling seeks to profit from declines in the value of stocks. The strategy consists in borrowing a stock and selling it on the market with the intention of buying it back later at a lower price. By selling the stock short,

ANNUALISED RISK/RETURN BY STYLE (APRIL 1994 - FEBRUARY 2018)



Source: Lipper, Credit Suisse Hedge Fund Indices in USD, data as at 28.02.2018 the seller receives interest on the cash proceeds resulting from the sale. If the stock advances, the short seller takes a loss when buying it back to pay back the lender.

Distressed

This investment strategy generally consists of buying securities of companies in bankruptcy proceedings and/or in the process of restructuring the debt portion of their balance sheets. The complexity of such operations often creates mispricing opportunities and hence a potential to profit when prices converge.

Event driven

Event driven strategies seek to exploit relative mispricings between securities whose issuers are involved in mergers, divestures, restructurings or other corporate events. The strategies can be leveraged to enhance returns.

Merger arbitrage

Also known as risk arbitrage, this strategy invests in merger situations. The classic merger arbitrage strategy consists in buying the stock of the target company while simultaneously selling short the stock of the acquiring company.

Special situations

Also known as corporate life cycle, this strategy focuses on opportunities created by significant transactional events, such as division spin-offs, mergers, acquisitions, bankruptcies, reorganisations, share buybacks and management changes.

Tactical trading

Global macro

Global macro managers make in-depth analyses of macroeconomic trends in order to arrive at their investment strategy, taking positions on the fixed-income, currency and equity markets through either direct investments or futures and other derivative products.

CTA

CTA stands for Commodity Trading Advisor and is also known as a Managed Futures strategy. This strategy essentially invests in futures contracts on financial, commodity and currency markets around the world. Trading decisions are often based on proprietary quantitative models and technical analysis.

Emerging markets

Emerging markets' trading strategies include global macro and CTA managers who rapidly adjust the risk profile of a portfolio to short term market conditions, regardless of long-term convictions, with a bias on emerging markets. Such tactical moves can be made either judgementally or with a systematic approach, and may be based on a wide range of data, from economic fundamentals to pure technical indicators.

Part II
Investing in hedge funds

Over the long-term, hedge funds tend to generate better risk-adjusted returns than traditional asset classes

The case for hedge funds

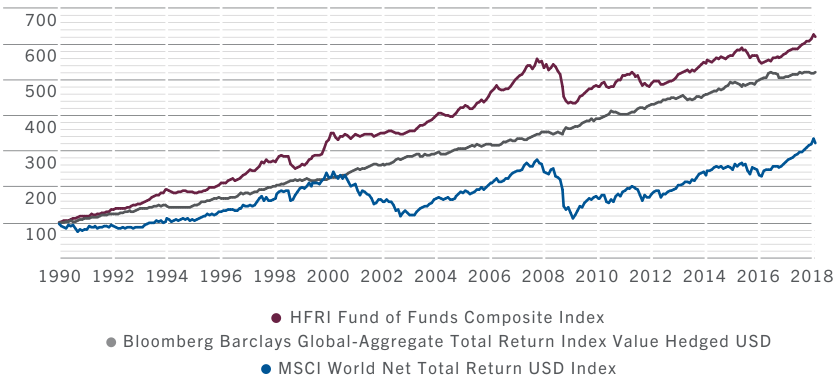
One of the biggest misconceptions about hedge funds is that they must take excessive risks in order to gain higher returns. The best hedge funds are specialists at minimising risk and make it an integral part of their investment plan. Conscientious risk management serves to limit losses and promotes more consistent, generally higher risk-adjusted returns.

Hedge funds can serve an important and valuable role in a well-diversified portfolio, especially since hedge funds tend to reduce market risk by providing downside protection in bear markets and upside participation in bull markets. The more an investor understands hedge funds and how they work, the more he can set aside myths and misconceptions and capitalise on the advantages that hedge funds offer.

Investors' concerns

Misconceptions about hedge funds often arise from their complex nature and the lack of transparency that still prevails in this industry. Investors often regard hedge funds as "black boxes" that are risky by nature but offer high potential returns. For these reasons, first-time investors tend to opt primarily for long/short equity strategies whose investment style is similar to that of traditional investment funds.

PERFORMANCE OF FOHFS VS MAIN INDICES (1990=100)



Source: Bloomberg and MPI, data as at 30.03.2018

Myth and reality

We list some of the most recurrent myths and explain why, in our view, these are indeed myths.

Hedge funds are often misunderstood

Myth	Reality
Hedge funds are very risky and highly volatile	The primary objective of hedge funds is to preserve capital by minimising volatility, which has historically been much higher on stock markets than with hedge funds
Hedge funds lack transparency in their portfolios and organisation	Nowadays, most hedge funds provide investors with monthly reports containing appropriate financial details. Pressure from institutional investors has helped to increase transparency
Hedge funds use significant leverage	Less than 30% of hedge fund managers employ a leverage effect greater than 2x (source: Van Hedge Fund Advisers International)
Hedge funds are always unregulated investment vehicles	Although true for many offshore hedge funds, numerous investment managers are regulated by local authorities such as the SEC in the US and the FSA in the UK. Hedge funds regulation is a widely discussed matter among financial authorities in today's world
Hedge funds offer no economic added value	Hedge funds offer a valid alternative to traditional asset classes by allowing investors to optimise the return of their portfolios and the cost of capital
Hedge fund blow ups result in systemic risks (example: the failure of LTCM)	The failure of LTCM was related to a combination of human failure, inappropriate risk management techniques and greed (leverage up to 28x). It was also the failure of large investment banks which sometimes provided unlimited leverage, incorrectly assessing the risks embedded in LTCM's strategy
Hedge funds are a main cause of market downturns and volatility	There is no evidence that hedge funds are linked to stock market crises. Hedge funds only represent a very small amount of total investments worldwide
Hedge funds are only for wealthy private investors	This idea belongs to the past. Today, even retail clients can invest in hedge funds via fund of hedge funds.

Source: Adapted from the journal of Global Financial Markets, Vol 2, No 4, Winter 2001 pp. 34-46

Hedge funds improve portfolio diversification

The added value of hedge funds

As presented in Part I, the hedge fund industry is characterised by a breadth of different trading strategies and manager styles. Individually, they offer a diverse source of risk-adjusted returns depending on the trading environment and economic expectations. Together, hedge funds target the long-term preservation of capital regardless of broad market moves. In a portfolio context, an allocation to hedge funds can contribute significantly to portfolio diversification. Their low correlation to equity bear markets, their participation in market upsides and low volatility profile assists in reducing a portfolio's overall risk exposure while contributing to the portfolio's return.

The following section highlights the main differences between traditional investments and hedge funds.

	Traditional investments	Hedge funds
Financial instruments	Managers have limited access to sophisticated instruments and hedging techniques such as short selling or derivatives trading owing to the restrictive regulatory environment	Managers have a wide range of financial instruments and investment techniques to choose from, allowing them to reduce risks and take advantage of pricing inefficiencies
Performance drivers	Performance is largely dictated by the direction of traditional markets	Performance is driven by investment style and the manager's ability to employ it within any market environment
Performance objectives	Managers have a relative return objective and aim to outperform a benchmark, hence providing little protection in times of market downturns	Hedge fund managers aim to achieve risk-adjusted absolute returns regardless of the market environment, rather than simply tracking or attempting to outperform a classic benchmark
Exposure	In most cases the portfolio is fully invested	The manager is free to choose the investments and weightings with full discretion
Pricing	Fee income depends on the amount of assets in the portfolio, and managers are rewarded for increasing assets under management	Fees are based both on the assets under management and the fund's absolute performance. Most of the hedge fund manager's remuneration is tied to performance. Generally, fees are higher than in the rest of the industry. Most hedge fund managers stop raising new money if they perceive further growth as being detrimental to the fund's strategy
Liquidity	Investments are usually very liquid	Most hedge funds allow for monthly subscription and quarterly redemption. Some funds impose lock-up periods as well as gates. The liquidity offered to hedge fund investors often reflects the liquidity of the underlying investments in a given strategy
Alignment of interests	Regulations may prohibit managers from investing in the same securities or funds as their clients	Managers invest part or all of their own assets in their funds and hence bear the same risks as their clients
Incorporation	Investment vehicles are often domiciled in regulated jurisdictions	Hedge funds are incorporated in offshore jurisdictions which sometimes lack specific regulations

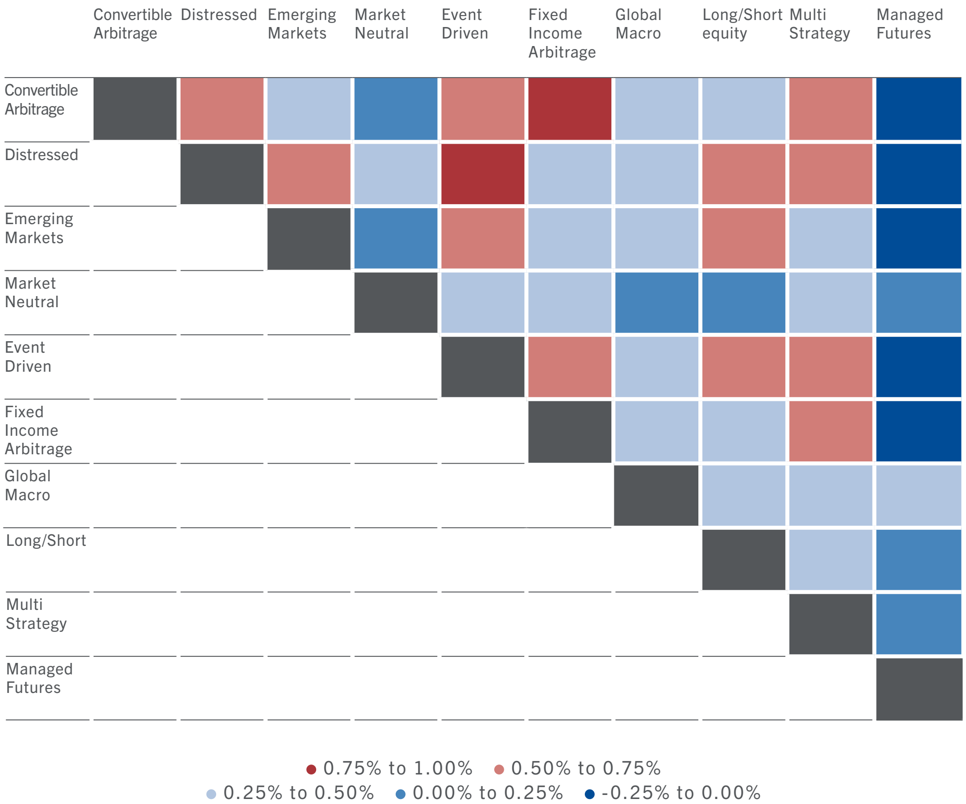
Fund of hedge funds model

A widely recognised benefit of a fund of hedge funds (FoHF) is the diversification effect which comes from minimising the idiosyncratic risks inherent to investing directly in a handful of single managers.

Simulations show that a higher number of funds reduces volatility and drawdowns leading to an improved preservation of capital. FoHFs provide an access to a wider universe of hedge funds that may otherwise be closed to new investors, or that are "under the radar" and not available to the broader investor community. Finally, a FoHF allows an allocation to a range of hedge fund strategies (a multi-strategy portfolio) in one single vehicle or to several managers competent in a given strategy (a thematic portfolio) serving a specific purpose in an investors' asset mix.

Structurally, investors benefit from partnering with an asset manager that has been selecting hedge funds and constructing portfolios for a variety of different clients over different economic cycles. This highly resource intensive process, developed over time, allows asset managers to optimise the terms (liquidity, operational workflows, transparency, reporting). Finally, FoHFs allow investors to bypass the substantial minimum investment generally required by individual funds.

CORRELATION BETWEEN DIFFERENT HEDGE FUND STRATEGIES (APRIL 1994 - FEBRUARY 2018)



Source: Lipper, Credit Suisse Hedge Fund Indices in USD, data as at 28.02.2018

Part III
Pictet: a strategic partner for hedge funds

Pictet Group

Founded in 1805 in Geneva, Pictet is a leading asset manager in Europe for both private and institutional investors.

As at July 2017, assets under management and in custody totalled around USD 498 billion (CHF 478 billion; EUR 405 billion).

Pictet Group employs more than 4,000 people worldwide, including 900 investment professionals, analysts, economists and strategists.

Pictet Alternative Advisors SA

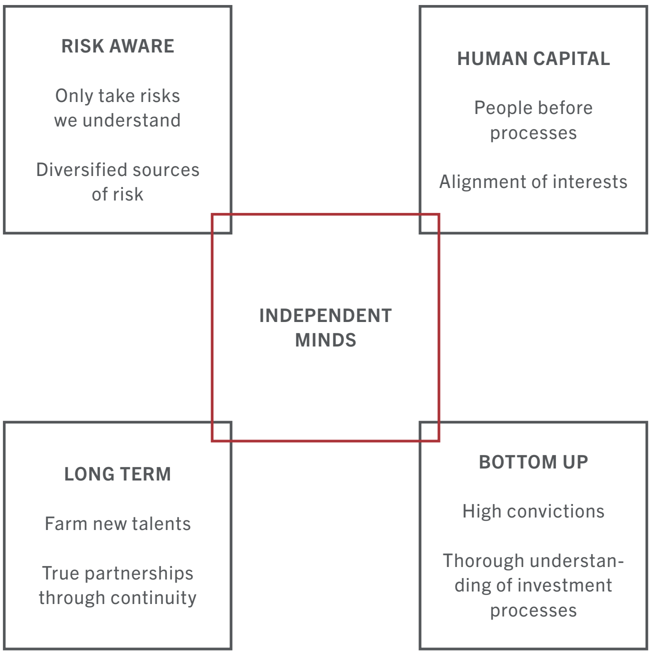
Pictet's Alternative Advisors department (PAA) is a division of the Pictet Group responsible for investments in hedge funds, private equity funds and real estate funds. Applying a rigorous investment process, PAA today manages approximately USD eleven billion in its funds of hedge funds and tailor- made mandates. The entire division is located in Geneva and employs around 59 people.

Investment philosophy

PAA's mission is to provide investors with hedge fund solutions offering both capital preservation and absolute performance. Over the years, PAA has developed key investment principles and rules based on best industry practice and solid experience, which today lie at the heart of our investment philosophy.

PAA follows four simple principles in its investment philosophy. A risk aware approach, driven from the bottom-up, focusing on human capital, with a long-term time horizon.

OUR INVESTMENT PHILOSOPHY HELPS US MAKE NO COMPROMISE AND STAY FOCUSED



Source: Pictet Alternative Advisors SA

We draw on a network of professionals built up over the years

Portfolio construction

Our portfolio construction integrates the three main elements of our investment process. The process creates the discipline necessary to base our decisions on facts, rather than on sentiment which is critical in a people business.

In its **manager selection**, PAA targets hedge fund managers who exhibit exceptional skills in their field of expertise. Thorough due diligence enables us to identify managers with whom long-term relationships can be nurtured in an independent and risk conscious manner.

Strategy allocation at PAA depends on a strategic and a tactical allocation. Our strategic allocation acts as our long-term neutral exposure in a multi-strategy portfolio of hedge funds. In contrast, our tactical allocation reviews and monitors the major factors and risk drivers of hedge fund returns and draws upon Pictet's research committees to assess top tier information across all asset classes and geographic regions. Together, they enable the team to establish a medium term allocation to hedge fund strategies.

Risk management in hedge funds is not limited to analysis of volatility, but also focuses on higher moments of the return distribution as well as measurement of time-varying betas. PAA employs sophisticated risk management tools throughout the entire investment process from selecting and monitoring managers to controlling risk levels in each portfolio. Portfolio risk is controlled by means of two different multi- factor approaches, namely principal component analysis (statistical factors) and dynamic style analysis (pre-defined factors).

MANAGER SELECTION – 4 STEP PROCESS

Hedge fund universe	Sourcing	Manager selection	Approved funds
c. 8'400 funds	c.1,300 funds	c.230 funds	c. 132 funds
• Exclusion criteria – insufficient size, liquidity or track record – specific strategies	• Pictet partners • Hedge funds • Industry consultants • Prime brokers • Competitors	• Due diligence – Qualitative – Quantitative – Operational	Continuous monitoring

Source: Pictet Alternative Advisors SA

Glossary and useful terms

Administrator
The financial institution, generally a bank, responsible for all the administrative duties required to manage a fund.

Alpha
Investment performance that is not explained by market returns. Alpha measures skill and may be derived from security-picking ability, suitable rotation of management styles or sectors or market timing (see also "Beta").

Arbitrage
The simultaneous purchase and sale of a security on different markets in order to profit from a temporary discrepancy in prices.

Benchmark
A gauge of performance of a predetermined set of securities or funds used for comparison purposes. Such sets can be based on indices or specially-customised to suit an investment strategy.

Beta
Investment performance that can be explained by market returns (see also "Alpha").

Black box
A proprietary computerized trading system whose formulas and calculations are not disclosed or readily accessible. Users enter information and the system utilizes pre-programmed logic to return output to the user, which may include trading signals and other data.

Collateralised debt obligation (CDO)
Sophisticated financial tools that repackage individual loans into a product that can be sold on the secondary market.

Convertible bond
A bond that gives the holder the option of converting into shares of the company at certain times at predetermined prices during the life of the bond.

Correlation
The degree to which two variables fluctuate in sync with one another. Correlation is always expressed between –1 and +1, with –1 being completely inversely correlated, 0 meaning no correlation and +1 being completely correlated.

Credit default swap (CDS)
An instrument that enables the risk of default to be transferred from the holder of the fixed income security to the seller of the swap.

Custodian
The financial institution that is responsible for the management and safekeeping of a fund's securities.

Derivatives
Financial instruments or contracts whose value depends on the value of their underlying securities, assets, or variables. Examples of derivatives are options, warrants, futures, forwards, and swaps.

Drawdown
The fall in the value of a unit or share in a fund from peak to trough in a given interval of time.

Exposure
The amount of assets that a fund has invested on a market in relation to the fund's total assets.

Financial leverage
Investments made in excess of capital available, expressed as a percentage of net asset value.

Future
A contract that provides for the sale of financial instruments or physical commodities for future delivery on a commodity exchange.

Gamma trading
A trading technique in which the manager bets that the implicit volatility of an option is different from the expected volatility of the underlying asset.

Gate
Restriction limiting the amount of withdrawals from the hedge fund during the redemption period.

Incentive fee
Manager compensation based on the performance of the investment.

Liquidity
The degree to which a financial instrument can be sold or converted to cash. A liquid market describes a market characterised by sufficient trading volumes to allow for buying and selling with minimum price disturbance.

Lock-up period
Window of time during which investors of a hedge fund are not allowed to redeem or sell shares.

Long
A trading or investment strategy whereby the investor owns a security and benefits when its price rises.

LTCM
Long-Term Capital Management. A well-known hedge fund whose collapse in 1998 shook world financial markets.

Management fee
Manager compensation based on assets size.

Prime broker
A broker that offers more services than a classic broker. Such prime broking services might include backoffice operations, trade reconciliation, financing, recordkeeping or custodian activities.

Sharpe ratio
A measure of risk-adjusted return calculated by subtracting the risk-free rate from the annualised return and then dividing by the standard deviation of returns.

Short selling
A trading strategy whereby an investor sells a security that he does not own. The holder of a short position benefits when the price falls. Unlike a long position, a short seller is in theory exposed to unlimited loss.

Sortino ratio
A measure of risk-adjusted return calculated by subtracting the risk-free rate from the annualised return and then dividing by the downside deviation of returns.

Stop-loss
A trading instruction in which, once a pre-determined percentage loss on any one position has occurred, it triggers either a review of the position or its immediate closing.

Top-down
An analysis method in which the manager first analyses macroeconomic trends and then picks securities that might be affected by them (see bottom-up).

Volatility
A measure of the variability of return of a financial instrument or market. For a fund, volatility is a measure of risk, generally expressed by the standard deviation of the fund's monthly returns, at an annual rate.

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