STRATFORD ADVISORY GROUP

Should Institutional Investors Continue Investing in Hedge Fund of Funds?

Synopsis:

Many institutional investors implemented hedge fund allocations during the past several years. Surveys indicate that more institutional investors plan to add hedge funds to their investment programs and many that already have hedge fund allocations plan to increase them. Given the growth of hedge funds and recent hedge fund "blow ups", it seems timely to re-examine whether hedge funds have delivered the value they promised.

The typical goals that institutional investors have for a hedge fund investment program are:

1. Superior returns, particularly relative to fixed income;
2. Stable return pattern, reducing volatility of overall fund returns;
3. Downside protection; and
4. Low correlation of returns with traditional asset classes, leading to improved diversification.

In this paper, we examine whether hedge fund of funds have achieved their objectives.

Superior Returns

A comparison of the returns of hedge fund of funds to other asset classes shows that during the past three years, the average fund of funds provided more than twice the return of fixed income securities. Hedge fund of fund returns, however, were significantly lower than stock returns over this same period.

Exhibit One: Hedge Fund of Fund Returns vs. Stock, Bonds, & Tbills + 5% Cumulative Annualized Returns

Time Periods Ending Dec. 31, 2006	S&P 500	LB Aggregate	Tbills +5%	HFRI[1] FOF
1 year	15.8%	4.3%	10.0%	10.4%
3 years	10.4%	3.7%	8.1%	8.3%
5 years	6.2%	5.1%	7.4%	7.4%
7 years	1.1%	6.5%	8.2%	6.3%
10 years	8.4%	6.2%	8.8%	7.9%

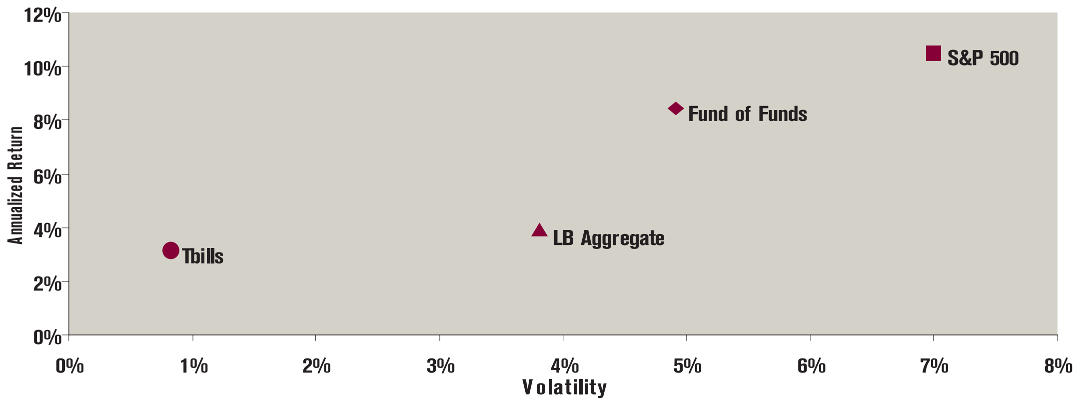
Over the shorter time periods, the average hedge fund of funds provided a return that was in line with the Treasury Bills + 5% return objective often given for hedge funds. Over the longer time periods, which included the bear market years of 2000 to 2002, neither hedge funds nor stocks were able to keep pace with a Treasury bills plus 5% benchmark. An investor would have had to choose an above average fund of funds in order to achieve this objective.

[1] Hedge Fund Research Investable Fund of Funds Composite Index.

Superior Returns
CONT'D

Although hedge fund of funds provided returns that were lower than stocks during the three years ended December 31, 2006, they incurred one-third less volatility. Hedge fund of funds provided a significant return advantage relative to bonds, with only slightly more volatility.

Exhibit Two: Risk/Return Comparison (Three Years Ended December 31, 2006)



Portfolio Impact

At the portfolio level, returns improve with only a marginal increase in risk when hedge fund of funds substitute for bonds. When hedge fund of funds substitute for stocks, the expected average return is the same, but risk declines.

Exhibit Three: Portfolio Comparison

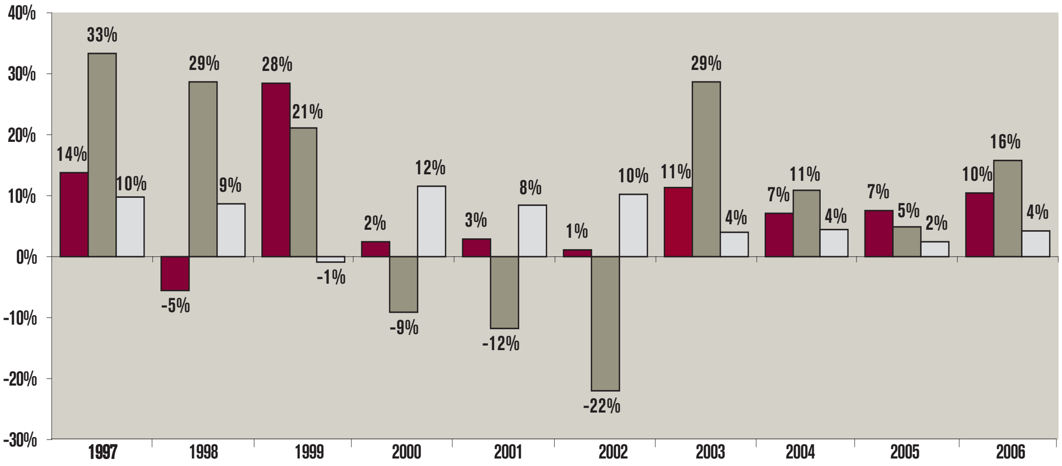
Asset Allocation	60% Stocks 40% Bonds 0% Hedge Funds	60% Stocks 30% Bonds 10% Hedge Funds	50% Stocks 30% Bonds 20% Hedge Funds
Return	8.7%	9.2%	8.7%
Risk	5.3%	5.5%	4.9%
Return/Risk	1.6x	1.7x	1.8x

For investors seeking superior returns relative to fixed income, the average hedge fund of funds achieved its objective. The ability of the average hedge fund of funds to achieve superior long-term returns relative to equities has been difficult in the recent strong stock market environment. We believe that hedge fund of fund returns will usually lag stock market returns during periods when stocks perform well because of the hedged nature of the strategies employed.

Stable Return Pattern

On a year-by-year basis, hedge fund of funds provide a more stable return pattern than stocks. The return pattern of hedge funds, however, is more variable than that of fixed income.

Exhibit Four:
Return Pattern

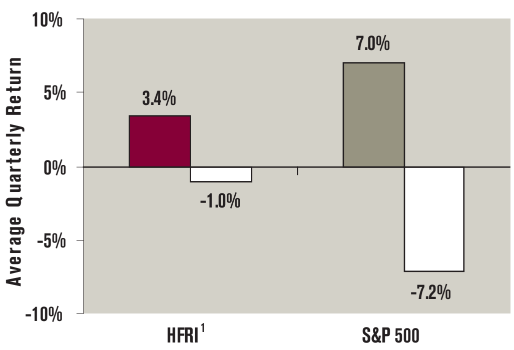


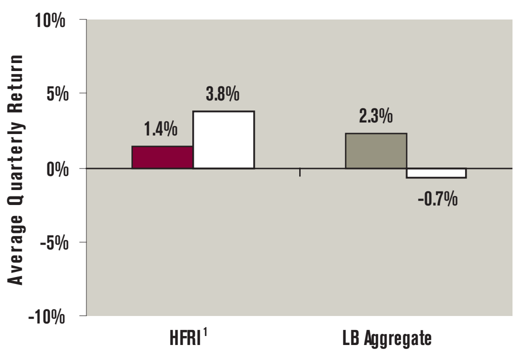
From an absolute return perspective, hedge fund of funds beat bonds in six of past ten years. The average hedge fund of funds beat stocks in five of the past ten years.

Downside Protection

With the exception of 1994 and 1998, hedge fund of funds have provided investors with good downside protection. In general, hedge funds have provided monthly returns of 0.0% to 2.0% during quarters when the stock market declines. While not stellar, these positive returns have helped mute the effect of negative stock market returns on the overall Fund return. Both 1994 and 1998 were affected by sharp rises in U.S. interest rates and a breakdown in market confidence related to emerging markets events and the demise of Long Term Capital Management, which caused many hedges to break down simultaneously.

Exhibit Five:
Up/Down Market Performance
(Five Years Ended
December 31, 2006)



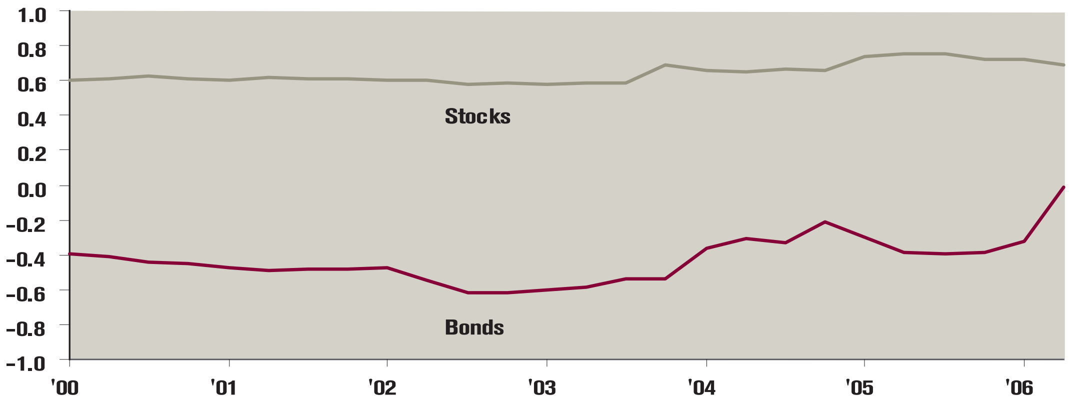


[1] Hedge Fund Research Investable Fund of Funds Composite Index.

Low Correlation of Returns

Hedge fund of fund returns have exhibited a negative correlation with bond returns. The correlation of returns with stocks is also low, on average 0.64, but has been drifting up to about 0.70[1]. The correlation of hedge fund of fund returns to both stock and bond returns has been remarkably stable over time.

Exhibit Six:
Correlation of Hedge Fund of Funds to Stocks and Bonds
(Rolling Three-Year Periods)



Costs and Risks of Hedge Funds

There are unique costs and risks to investing in hedge funds. Among these are the high fees that hedge funds charge. The management fee, incentive fee, and charge through of expenses can easily result in fees of 4% or more. There is also event risk with hedge funds. Unlike traditional stock and bond portfolios, which rely on long-only investment strategies, most hedge funds rely on trading strategies. Some strategies are complex, so that monitoring the investments is challenging. The use of leverage can magnify market movements. Daily market events and portfolio shifts by the manager can significantly and quickly shift the risk profile of hedge fund portfolios. This can result in huge gains as well as huge losses. Hedge fund of funds can reduce event risk, but at the cost of additional fees. This added cost needs to be evaluated against the potential benefits of investing in the strategy.

Summary

Overall, we believe that hedge fund of funds have achieved their stated objectives:

1. Superior returns, particularly relative to fixed income;
2. Stable return pattern;
3. Downside protection; and
4. Low correlation of returns with traditional asset classes.

Looking forward, we believe that over the next several years, hedge fund of funds will continue to provide superior returns relative to fixed income. As fund of funds become more diversified and take on more assets, it will become increasingly difficult for them to beat stock market returns. In fact, most hedge fund of fund managers project returns of approximately 8% net of fees, much lower than the long-term average return from the stock market of 10.4%. We believe that the diversified nature of fund of funds will continue to provide a stable return pattern with good downside protection, which will result in favorable diversification for most investment programs.

[1] Correlations range from 1.0 to -1.0, indicating perfect positive or negative correlation. A correlation of 0.0 indicates no correlation of returns.