SOCIALLY RESPONSIBLE INVESTING WITH HEDGE FUNDS

Strategic Investment Group®

Fiduciary Insights

SOME INSTITUTIONAL INVESTORS SEEK TO ALIGN THEIR INVESTMENT DECISIONS WITH THEIR SOCIAL MISSION AND CORE VALUES BY PURSUING WHAT HAS BEEN LABELED "SOCIALLY RESPONSIBLE INVESTING" (SRI). Implementing SRI with hedge funds without compromising SRI goals has been abandoned as impossible by many investors. We believe that such compromise is no longer necessary. We have developed an SRI hedge fund solution that allows investors to maintain their SRI bearings through the complexity of hedge fund investing.

Approaches to Mission-Based Investing

Some institutions seek to integrate their core values into the composition and stewardship of their investment portfolios. This approach to portfolio management — often called "mission-based" investing or "socially responsible investing" (SRI) — encompasses a range of techniques that can include stock screens; shareholder advocacy campaigns; careful evaluation and voting of proxy ballots; incorporation of environmental, social and corporate governance (ESG) criteria into securities analysis; and financing for community-based investments. These institutions and their stakeholders value the way that SRI aligns investment activities with their broader mission and core values.

Mission-based investing gained widespread acceptance among institutions during the 1980s with the divestment from companies perceived to support South Africa's regime of racial segregation known as "apartheid." By 2010, according to the Social Investment Forum's latest bi-annual Trends Report, roughly $3.1 trillion in assets under professional management in the United States (12.3% of the $25.2 trillion total) was managed using some form of SRI technique. Institutional portfolios accounted for $2.3 trillion, or about 75%, of total SRI assets under management.

SRI screens are designed to eliminate the bond and equity securities of U.S. and non-U.S. corporations engaged in businesses that are deemed to be incompatible with the core values of the investor. The screening process typically examines corporate financial statements to quantify the extent to which earnings derive from undesirable activities. If a certain threshold is breached, the company's securities are excluded by the screen from inclusion in the investment portfolio. Broadly used screens may include companies that derive revenue from alcohol or tobacco products, pornography, gambling services, weapons, weapon systems, and abortifacients and abortion-related services.

Mission-based investors have found it relatively easy to design screens that exclude companies whose activities are incompatible with their core values from traditional equity and fixed income investments. The task has proven to be less tractable, however, in the case of hedge fund investments, and has resulted in uneasy compromises. Some institutions would like to incorporate hedge funds into their portfolios, but believe that they must abandon their SRI objectives to do so. Others have chosen instead to forego the important benefits of hedge fund investments entirely. As our SRI hedge fund solution demonstrates, neither uneasy compromise is necessary.

The Role of Hedge Funds in Institutional Portfolios

Our long experience with alternative investments, suggests that the inclusion of a well-chosen, diversified hedge fund allocation in a broader institutional portfolio can enhance absolute and risk-adjusted return. While hedge funds are sometimes associated with risky investment schemes, the reality is that most pursue sober and careful investment programs with a strong emphasis on risk control. In fact, a prudently diversified institutional hedge fund portfolio should fall between equities and fixed income in terms of expected risk and return. And because hedge funds generally derive return from mispriced securities within an asset class rather than the overall performance of the asset class, they are usually only weakly correlated with most asset class returns. Therefore, when included in a diversified portfolio with traditional equity and bond investments, a hedge fund allocation that incorporates diversified styles and managers can enhance risk-adjusted return without introducing additional long-term risk.

While hedge funds clearly offer potential for enhanced portfolio diversification, increased return and reduced volatility, implementing

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mission-based screens in a hedge fund portfolio has often posed insurmountable challenges. Many hedge fund managers have been reluctant to incorporate SRI screens into their process, feeling that such restrictions would overly constrain their ability to add value and inject unwanted complications in the portfolio construction process. Other hedge fund managers, prizing the confidentiality of their proprietary trading techniques, have been reluctant to reveal holdings and trades, making it difficult for mission-based investors to monitor compliance with SRI restrictions.

Institutions without the staff, systems, and expertise needed to perform due diligence on hedge fund strategies, operations, and risk management seek hedge fund exposure through investment in hedge funds of funds. Yet funds of funds add an additional layer of opacity and often hide the identity of underlying managers, making it impossible to monitor underlying strategies and security holdings. If screens are offered, a "one size fits all" strategy is all that is available, thus preventing an institution from customizing screens to reflect its particular mission and core values. These obstacles have unduly constrained the hedge fund options available to mission-based investors.

The hedge fund industry is evolving, and the trend is toward increased transparency. With increased transparency comes the ability to implement and monitor SRI screens in hedge fund investments. Transparency alone is not enough, however. Strong analytical capabilities are needed to construct a hedge fund portfolio that is appropriately diversified across strategies and managers, has low exposure to broad market movements (or beta), and comprises a range of relatively uncorrelated streams of value added (or alpha). Understanding the underlying exposures in a diversified hedge fund portfolio is essential to assessing the likely contribution of hedge fund investments to the risk-adjusted returns of the total portfolio. An insight into underlying exposures is also a key element of monitoring compliance with SRI objectives.

Strategic has combined its long experience in designing and supervising diversified hedge fund investments with the new trend in the industry toward transparency to construct an SRI hedge fund solution. We believe that mission-based institutional investors can now access an appropriately diversified hedge fund portfolio that closely reflects their core institutional values and SRI objectives.

Strategic's SRI Hedge Fund Solution

Our goal is to construct an SRI hedge fund portfolio that is well-diversified across managers and strategies, has relatively low exposure to broad market risk (beta), and offers the potential to deliver a variety of uncorrelated streams of alpha. In short, we set out to create a solution that respects mission-based values and enhances risk-adjusted return for the overall portfolio. The hedge fund managers included in Strategic's hedge fund solution are subject to the same rigorous investment and operational due diligence and risk analytics that we apply to all of our hedge fund investments.

Our hedge fund solution can incorporate the following broad range of strategies and offers scope to weight these to create an optimal mix of expected alpha streams.

Market-Neutral Strategies

Market-neutral strategies avoid net long or short market exposure and seek moderate positive returns independent of broad market moves.

- *Equity Market-Neutral* strategies exploit pricing anomalies through offsetting long and short equity positions.
- *Event-Driven* strategies exploit pricing anomalies related to acquisition, exchange offers, cash tender offers or corporate reorganizations.
- *Convertible Arbitrage* strategies generally consist of the purchase/short sale of a company's undervalued/overvalued convertible security and corresponding short sale/purchase of the underlying security. Most seek to profit from the investment's yield return and relative volatility.

- *Equity Statistical Arbitrage* strategies exploit price disparities among assets that have historically maintained a statistically significant, stable relationship.

- *Fixed Income Arbitrage* involves simultaneous purchase/sale of similar fixed income securities to capture short-term pricing anomalies.

Directional Strategies

Directional strategies tend to be more opportunistic and aggressive than market-neutral strategies and seek higher returns in part through exposure to broad market moves.

- *Equity Long/Short* strategies invest long and short in equities and equity derivatives, usually with a net long bias (i.e., the overall portfolio will generally have some market exposure).

- *ABS/Credit/Distressed* strategies include investments in securities of companies experiencing a liquidity crisis, default, bankruptcy or other financial distress, and may include long credit, short selling and capital structure arbitrage.

- *Global Macro* strategies speculate on the direction of currencies, commodities, equities and/or bonds.

Strategic's SRI hedge fund solution combines these strategies with the objective of providing an optimal risk-adjusted return and strong diversification benefits to the total portfolio (see Exhibit 1 on Page 4). Our SRI hedge fund solution is built on three segments.

- **No SRI Impact.** The first segment is built using hedge fund strategies that do not include corporate securities (e.g., strategies focusing on government bonds, mortgage-backed securities, or currencies). These strategies are inherently free from any possible SRI conflict and would typically represent 15-20% of the total SRI hedge fund portfolio.

- **SRI Screened.** The second segment is based on a range of hedge fund managers willing and able to integrate restricted lists of securities into the investment process. In these cases, the managers might have purchased screened companies had they not been restricted, but are generally able to avoid them by using substitutes and other methods. This segment is likely to represent 20-30% of the portfolio.

- **SRI Reporting.** The third segment comprises managers and strategies that are not typically offered as separate accounts and thus cannot implement SRI screens tailored to a particular investor. However, our analysis of the past security holdings of managers and strategies included in this segment shows that, with very few and temporary exceptions, restricted securities, when included at all, have represented less than 1% of the total. Moreover, the managers included in this segment have indicated their expectation that holdings of restricted securities in the future will remain fleeting and at minimal levels. These managers have further agreed to report their security holdings regularly, so that any exceptions can be monitored and the materiality of such exceptions assessed. This final segment would typically represent 50-60% of the portfolio.

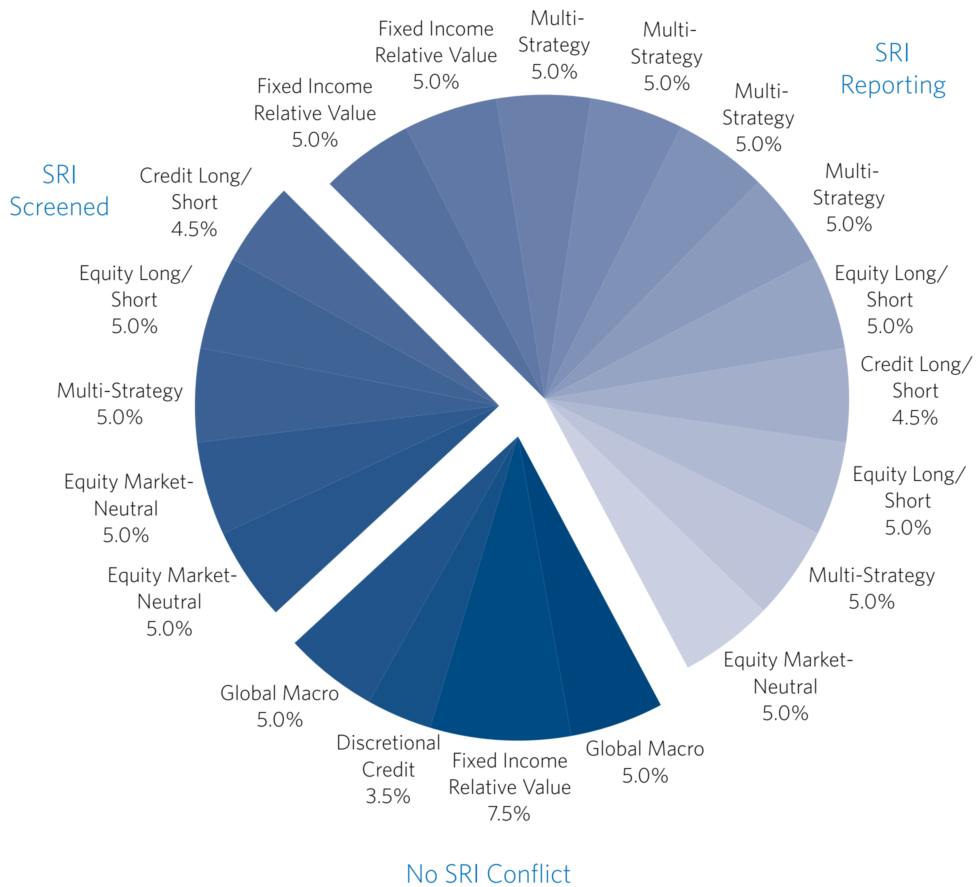
The three segments described on Page 4 are the basis on which Strategic's SRI hedge fund solution is built. It is a solution that achieves a portfolio that has the expected risk, return, and correlation of a well diversified set of hedge fund investments and is nearly perfectly aligned with SRI objectives. A regularly updated list of securities restricted because of SRI considerations will be provided by a third party directly to each hedge fund manager to ensure that up-to-date criteria are being applied. In the case of all three segments, the actual holdings of each relevant hedge fund manager will be regularly monitored to assess compliance and determine the continued suitability of retaining the manager.

Most importantly, our SRI hedge fund solution has all of the key elements of an optimal hedge fund portfolio. It is well diversified across managers and strategies. It combines strategies that have a low expected correlation with broad market movements (beta), yielding an important potential diversification benefit to the total portfolio. And the strategies included in the hedge fund portfolio are combined with the intent of bundling a broad range of streams of added

EXHIBIT 1:

Combining Hedge Funds for SRI

Portfolio construction is shown for illustrative purposes only, does not represent an actual portfolio and is subject to change at the sole discretion of Strategic. An actual portfolio may have very different allocations and related risk exposures.



value (alpha) that are not expected to be closely correlated with each other. Moreover, our SRI hedge fund solution offers a high degree of visibility into the underlying risk exposures of each hedge fund strategy, which enables us to continually refine the mix of strategies and managers included in the portfolio. This transparency is also critical for monitoring the implementation of SRI objectives. The analytical capabilities and risk monitoring tools that Strategic has put in place in its management of hedge fund portfolios afford us the opportunity to design an SRI hedge fund solution that minimizes the need to compromise. These tools make it possible to have both an optimal hedge fund portfolio and one that promotes SRI objectives.

Conclusion

Institutions that adopt a mission-based approach to investing must artfully balance the use of security screens with the need to achieve prudent portfolio diversification and competitive investment returns. With long experience in the area of hedge fund manager research and selection, Strategic can build diversified, mission-sensitive portfolios that minimize market exposure and offer the potential to produce uncorrelated alpha streams.

Our analytical tools allow us to:

- Untangle the underlying exposures of different strategies.
- Show how these underlying exposures can be combined into an optimal mix.
- Assess how mission-based screens will impact different strategies.
- Perform the operational due diligence needed to assess managers' internal controls, compliance procedures, operational safeguards, valuation methods, and risk controls.
- Determine how a hedge fund allocation can fit into an institution's broader portfolio mix.

Mission-based investing has a long and admirable track record of success with traditional long-only portfolios. Here, a diverse range of investors — including colleges and universities, healthcare systems, public employee retirement plans and faith-based institutions — have achieved their investment goals without providing capital to companies that they perceive to violate core institutional values. We know that many institutions remain skeptical that they can achieve the same degree of success with hedge funds, where complexity, opacity, and disinterested managers have posed difficult challenges in the past. Yet these obstacles have faded. Many hedge fund managers are now embracing a heightened transparency and a stronger commitment to client service as they seek to build and broaden their relationships with institutional clients. Institutions can now build nearly perfectly mission-compliant hedge fund exposures that offer important risk and return benefits, enhancing their ability to meet targeted investment goals.

Strategic can build diversified, mission-sensitive portfolios that minimize market exposure and offer potential to produce uncorrelated alpha streams.

Strategic Investment Group

Strategic, a pioneer in dedicated Outsourced CIO (OCIO) solutions since 1987, offers a comprehensive service platform for managing customized portfolios for institutional and private investors. Our proprietary process combines active portfolio management, rigorous risk management, and open architecture manager selection.

Strategic functions as our clients' investment partner and co-fiduciary, effectively becoming an extension of their resources. Clients are then free to focus on their core businesses, while we focus on providing the highly specialized portfolio management expertise that clients need to meet their investment goals. Depending on a client's needs and preferences, Strategic can orchestrate the management of an entire portfolio comprising multiple asset classes, focus on specific asset classes, such as alternatives (e.g., hedge funds, real estate, and/or private equity) or international investments, or manage strategies with high potential for adding value (e.g., portable alpha through investor-friendly turnkey structures). Customized liability-driven investing (LDI) solutions, whether through an integrated total portfolio approach or a targeted long-duration strategy, are also available, as are solutions that address mission-related investment objectives.

We strive to build enduring partnerships with our clients by strengthening their investment programs through a dynamic, value-enhancing investment process, sound governance framework, and world class client service. Our mission is to empower investors through experience, innovation, and excellence.

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