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SUCCESSFUL HEDGE FUND IMPLEMENTATION

AUGUST 2013

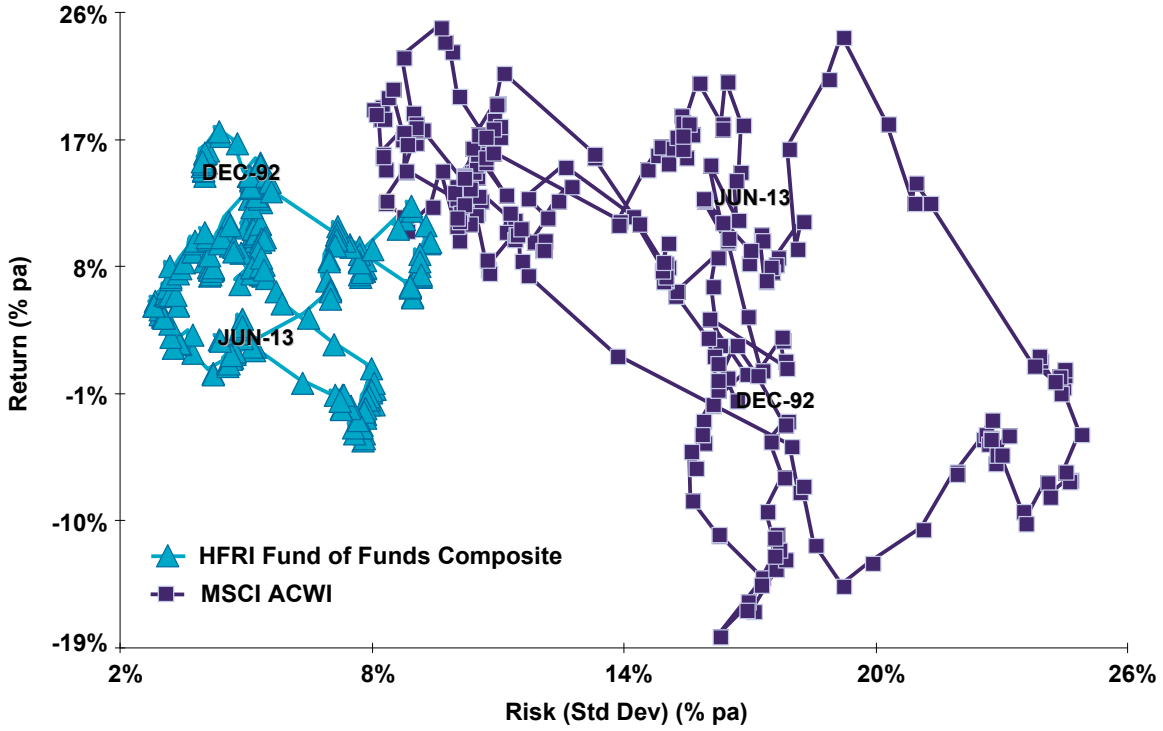
MARSH & McLENNAN COMPANIES

EXECUTIVE SUMMARY

Hedge funds have a specific and critical role in the policy portfolios of institutional investors by providing exposure to non-traditional return drivers in two ways:

- Hedge Funds provide exposure to non-traditional return drivers which diversify risks that dominate a traditional equity/bond portfolio. By introducing new return drivers, the portfolio relies less on the direction of capital markets, resulting in a lower risk portfolio. Importantly, this risk reduction capability does not necessarily come at the cost of lower expected returns, making hedge funds one of the more compelling investment opportunities available over a full market cycle.

Risk-return Profile of the HFRI Fund of Funds Composite and MSCI ACWI
Rolling 3 Years – December 1992 to June 2013 – Chart 1



Source: Mercer MPA

- Hedge funds are not an asset class but rather a collection of heterogeneous investment strategies. These strategies tend to have disparate risk/return profiles. In fact, individual hedge fund managers, implementing the same investment strategy, often target and generate contrasting risk profiles.

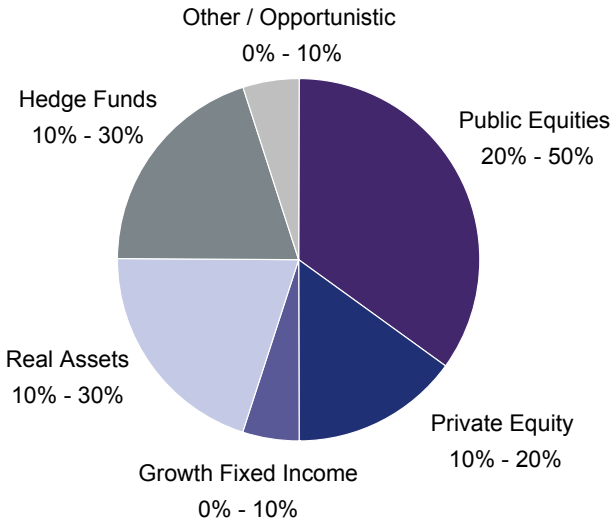
Hedge fund heterogeneity is the ultimate qualifier as it relates to any generalizations about this category of investment. In fact, many hedge funds carry meaningful exposure to traditional risk factors, which limits their diversification benefits and contradicts our risk reduction premise. Risk reduction is only achieved through a disciplined, calculated, and informed approach to hedge fund manager selection and portfolio construction. This is very different than a passive equity or bond allocation, which, by definition, provides the desired exposure.

This paper seeks to define the key elements of a successful hedge fund implementation, discusses risk premia approaches and concludes with practical applications.

DIVERSIFYING AWAY FROM TRADITIONAL RISK PREMIA

Traditional risk premia are being achieved with exposure to traditional asset classes. The equity risk premium is a common building block for many growth portfolios and there is a logical and sensible rationale for that persisting. However, by identifying and capturing uncorrelated return sources or risk premia, risk/return characteristics can be enhanced and partly decoupled from the traditional long only market dynamic. Therefore hedge funds offer a compelling role in most growth portfolios.

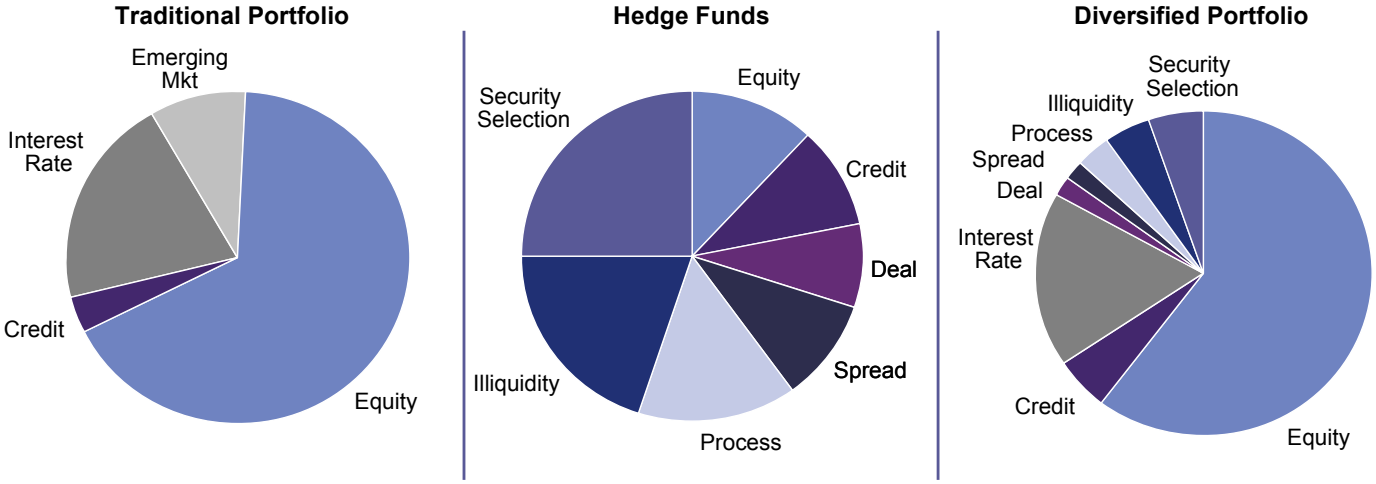
Sample Growth Portfolio – Chart 2



Source: Mercer (For illustrative purposes only)

Hedge funds can be utilized to gain exposure to a variety of non-traditional risks. Most market participants cite "alpha" as the primary reason to invest in hedge funds. Alpha is the ultimate diversifier but is also frequently described as a magical by-product of manager skill. While skill is an important component, "hedge fund alpha" is largely driven by exposure to non-traditional risk factors. By definition, alpha is the result of exposure to specific, rather than market, risks. The graph below summarizes a few of the risk premia that hedge funds are seeking to capture.

Risk Premia of Equities, Hedge Funds and Fixed Income – Chart 3



Source: Mercer (For illustrative purposes only)

Given the diversification benefits of hedge funds, and their ability to deliver long-term growth in investment portfolios, they represent a material allocation in Mercer's model portfolios. We believe they merit a place in portfolios for clients that can cope with more complex investment strategies and low liquidity. They may also be appropriate for clients who require less complexity and good liquidity.

PITFALLS OF HEDGE FUND INVESTING

Hedge funds include a number of characteristics to reduce risk and enhance diversification. However, investing in hedge funds carries a number of unique pitfalls. At some level, these challenges are the direct result of the benefits of non-traditional risks. Consequently hedge funds carry a number of "costs" that should be carefully evaluated. These generally include high fees, limited liquidity, private placement structure, active risk, opaqueness, complexity, and a "short volatility" risk characteristic. The nature of these issues goes beyond the scope of this paper.

IMPLEMENTATION CONSIDERATIONS

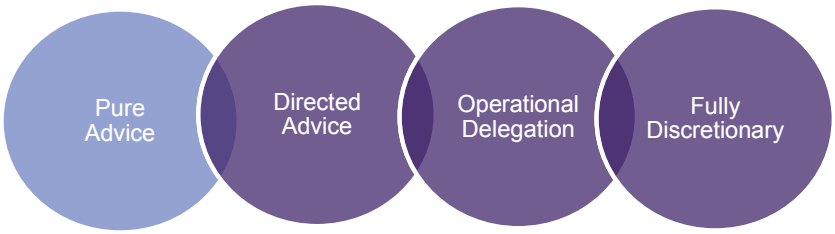
To be successful, hedge funds require active management, and with that come risks. Mercer believes that investors maximize their chances of success by investing in a multi-manager portfolio of hedge funds - the additional governance burden versus selecting one or two managers is more than outweighed by the benefits of this diversification. A multi-manager approach can help an investor blend different types of hedge funds to more reliably meet their end objectives. For most investors, a robust hedge fund allocation would also consist of a thoughtful strategy mix tilted to best reflect the investor's bias on returns versus volatility versus correlation with other growth assets. By leveraging this framework with robust manager due diligence, sensible manager selection and efficient portfolio construction investors can build an attractive portfolio of hedge funds.

Bottom up Mercer seeks out managers that have an identifiable edge, that go short as well as long, that focus on their best ideas and make prudent use of leverage. Similar biases underpin the way in constructing hedge funds portfolios. Overall, Mercer believes that investing in a tailored portfolio of direct hedge funds is the best approach for clients that have suitable governance structures in place and have large enough allocations to hedge funds for this to be viable. Delegation of operational or investment decisions or use of commingled solutions (including fund of hedge funds) can provide a suitable alternative for clients with governance constraints or insufficient scale, but even here investors should ensure that the investment objectives and mix of strategies is suited to their needs and that the additional fees charged are kept within reason.

CONCLUSION

For most investors, a diversified mix of strategies and, critically, managers will provide the most robust hedge fund allocation. The ultimate strategy mix, as well as the constituent manager risk orientations, should reflect the investor's relative focus on returns, volatility and keeping the correlation with equities low. Overall, we believe that investing in a tailored portfolio of direct hedge funds is the best approach for investors. How best to achieve this goal will vary depending on the investor's size, resources and governance capacity.

- Direct appointment of individual strategies and managers
- Delegation of some, or all, of either the operational or investment decisions.



Either way, we believe that there are material advantages to having a diversified exposure to hedge funds as part of a growth portfolio.

ABOUT THE ALTERNATIVES STRATEGIC RESEARCH TEAM

Mercer's Alternative Strategic Research Team (SRT) is comprised primarily of field consultants from Mercer's traditional Investment Consulting and Investment Management practices, as well as members of Mercer's Alternative Research Boutique. The SRT seeks to provide a client-facing perspective on research, new ideas, intellectual capital, and to serve as a resource for questions regarding this asset class and related consulting processes.

CONTRIBUTING AUTHORS

Dave McMillan is a Partner with Mercer, directing the firm's hedge fund manager research effort globally. He serves on the firm's Alternative Investment Committee, the Hedge Fund Ratings Review Committee and is member of the Alternatives US Strategic Research Team (SRT). In addition, he is the portfolio manager for several funds offered by Mercer Global Investments.

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