

What is a hedge fund?

Hedge funds and fund of hedge funds involve a high degree of risk and may not be suitable for all investors. It is possible that an investor may lose some or all of its investment. Before making an investment decision, an investor and/or its advisor should carefully (i) consider the suitability of this investment with respect to its investment objectives and personal situation and (ii) consider factors such as its personal net worth, income, age, risk tolerance, and liquidity needs. Short-term investors and investors who cannot bear the loss of some or all of their investment or the risks associated with the limited liquidity of an investment in hedge funds and fund of hedge funds should not invest.

Hedge funds overview

In the investment world, there are 'traditional' investment managers and 'alternative' investment managers. Both manage investment capital but they use different approaches to generate returns.

- **Traditional investment managers**

Traditional investment managers typically buy financial instruments such as stocks or bonds and hold them in the expectation that the price of these assets will rise. This strategy is known as being 'long only' which means that the value of the portfolio can only rise when the value of the assets, for example stocks or bonds, rise.

Historically, traditional investment managers have been highly regulated because they target a broad investing public. This means that traditional investment managers must invest according to prudent guidelines as directed by the regulatory authority. Highly regulated traditional investments include mutual funds for example and these are generally available for all types of investors.

- **Alternative investment managers**

Hedge fund managers use investment pools to implement various strategies and often invest in highly speculative investments because they have a small, qualified and sophisticated investor base. For example, hedge funds can follow the long only approach that traditional asset managers use and can also be 'short' in the market by making use of a number of speculative techniques. Being short in the market means hedge funds can potentially profit from assets that fall in value. In this way, hedge fund managers can use individual long and short positions to create combined long and short strategies. In fact the first known example of a hedge fund was one set up by Alfred Jones in 1949 who founded a fund that bought stocks that he thought were undervalued and sold short stocks he thought were overvalued – a classic long and short hedge fund strategy.

Alternative investment managers include hedge fund managers, which have largely been unregulated to date. Due to the lack of regulatory protection, the typical investor group has been restricted to a small number of high net worth individuals or institutions who fulfill the criteria of 'sophisticated investor'.

Hedge fund characteristics

Hedge funds share some broad characteristics due to their entrepreneurial approach to investing as outlined below.

- **Hedge funds are designed to generate positive returns independent of general directional movement in the stock and bond markets¹**

The hallmark of hedge funds is the pursuit of absolute returns. This means the manager aims to generate positive returns, in both rising and falling market conditions, with the intention to preserve capital.¹

- **The success of hedge funds is not measured against a benchmark**

Since hedge fund managers strive for absolute returns, success or failure is not always measured by reference to a benchmark such as the S&P 500 Index. For example, if a hedge fund manager aims to achieve a positive annualized return, the manager gauges its success relative to that objective, not in terms of underperformance or out-performance relative to the S&P 500 Index.

- **Hedge funds use diverse investment strategies and techniques compared with traditional approaches to investment**

Hedge funds may trade a number of different asset classes and a wide range of financial instruments while employing a variety of investment styles, strategies and techniques in diverse markets.

- **The success of hedge funds depends on manager skill, not solely on asset class appreciation**

The performance of hedge funds is determined mainly by the skills of their managers.

Hedge fund aims and characteristics
Target absolute returns
Provide diversification to traditional investment portfolios
Skill-based rather than asset-based investing
Wide variety of speculative trading strategies
Choice of financial instruments generally unrestricted

¹As is the case with all investments, alternative investments entail risk and their value may go down as well as up. A manager may have negative returns in both rising and falling market conditions. Please see "Risk Factors" in the Prospectus.

What is a hedge fund?

Hedge fund styles

Hedge fund strategies are often grouped into different styles, although style definitions and perspectives vary among hedge fund managers. The main style groups are equity hedge, multi-strategy, event driven, relative value, variable equity, and commodity and trading. These descriptions are not intended to be complete explanations of the strategies described or a list of all possible investment strategies or methods that may be used by hedge fund managers.

- **Equity hedge**

Equity hedge managers invest in domestic and international stock markets and aim to hedge out their portfolios by going long and short stocks in roughly equal amounts. The bottom line is that market exposure – whether stock markets rise or fall – is generally not a driver of returns. This style is at risk when markets exhibit irrational characteristics – when stocks do not head towards their fundamental valuation.

- **Variable equity**

Variable equity managers invest in domestic and international stock markets, but unlike equity hedge managers, variable equity managers do not operate within tightly defined market exposure constraints. Some managers will shift gross and net exposures over time as market conditions change, while other managers may position their portfolios consistently net-long or net-short. This style is at risk from unexpected and rapid directional shifts in markets, often due to external shocks such as war; and also when markets exhibit irrational characteristics – when stocks do not head towards their fundamental valuation.

- **Event driven**

Event driven managers focus on corporate events that may cause a significant change in the future prospects and therefore the future valuation of a company. Managers attempt to profit from a variety of scenarios, including bankruptcies, mergers, reorganizations, spin-offs, restructurings and changes in senior management. This style is at risk from short-term dislocations in the equity and debt markets; external shocks such as rising interest rates; widening credit spreads between corporate bonds and treasuries; and changes in regulatory environments.

- **Relative value**

Relative value managers aim to exploit mispricings within different securities of either the same issuer or of issuers with similar characteristics. For example, the manager may perceive a discrepancy between the price of the senior and junior bonds of an issuer. Typical strategies include convertible bond arbitrage, credit arbitrage and derivatives arbitrage. This style is at risk when bonds face liquidity constraints; adverse credit spread and interest rate movements; periods of flat or decreasing volatility; and financing risks for heavily leveraged funds.

- **Commodity and trading**

Commodity and trading managers aim to generate profits from following market trends or from shifts in the relative valuations of markets such as currencies or commodities. This style is at risk from trendless markets and unexpected changes in market direction.

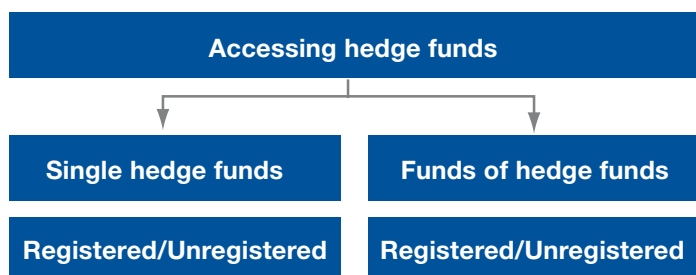
- **Multi-strategy**

Multi-strategy managers implement a number of strategies from those outlined above which allows them to allocate capital between strategies depending on the attractiveness of opportunities in the markets. This style faces the risks of any of the individual strategies outlined above.

Accessing hedge funds

Investing directly in single hedge funds makes sense for the eligible investor who has established relationships with many hedge fund managers and who has a thorough understanding of their strategies' risks and potential to perform.

For investors who wish to access single unregistered hedge funds and do not have these relationships or understanding, there are many obstacles. It is generally easier for investors to access hedge funds through a registered fund of hedge funds for reasons explained below.



Investing in a single hedge fund can impose higher risks

Hedge funds have many specific risks including strategy, company and operational risks. In the same way that investing in a single stock is risky from a performance and diversification perspective, the same applies to hedge funds. Consequently, it is important to diversify across many hedge funds.

There are a large number of single hedge funds and funds of hedge funds, many of which are unregistered and are restricted from advertising

There are estimated to be thousands of hedge fund managers, all offering a diverse range of complex products in a constantly evolving industry. There is no single database for investors to make straightforward comparisons between individual funds. To complicate matters, many single hedge funds and funds of hedge funds are unregistered and are restricted from advertising and investors or their investment advisor must have a prior business relationship with the hedge fund before they can invest. Therefore, information on them may be difficult to obtain. These may represent major hurdles before an eligible investor even has the opportunity to assess and select good single hedge funds.

Most single hedge funds have high minimum entrance levels and limited investor slots

Single hedge funds tend to be unregistered and typically have high investment minimums of at least \$250,000, while some do not accept capital from new investors. Additionally, unregistered hedge funds typically have limited slots available for investors and these slots are normally reserved for investors who can invest substantial amounts of capital. Furthermore, individuals who wish to access single unregistered hedge funds may have to meet higher minimum investor qualifications. Registered single hedge funds can have lower minimums but thorough due diligence of many managers by individual investors is difficult.

Many investors choose to invest via funds of hedge funds rather than a single hedge fund

In summary, it is extremely difficult for investors to gain access to hedge funds and build diversified hedge fund portfolios. This leads many investors to consider investing in a fund of hedge funds product to both obtain access to the asset class conveniently and to spread the risk across hedge fund managers efficiently. A more detailed overview of the characteristics of funds of hedge funds is provided in the section 'What are funds of hedge funds?'. It should be noted that investing via a fund of hedge funds adds an additional layer of fees and expenses that would not be applicable to a single hedge fund. These additional fees and expenses compensate the fund of funds manager for the value they provide in conducting initial and ongoing due diligence on the hedge fund managers and strategies and managing them as a diversified portfolio.

Registered and unregistered funds of hedge funds compared

Registered funds of hedge funds have several advantages over unregistered funds of hedge funds for eligible investors who wish to gain access to the asset class. Due to the lack of registration, unregistered funds of hedge funds avoid the costs of registering and have fewer constraints on certain investment decisions such as use of leverage and investing in certain hedge fund organizational structures. However, registered funds of hedge funds, by comparison, are permitted to advertise and undertake broader general solicitation and are not limited as to the number of investors. This often benefits the investor in terms of a lower investment minimum. Additionally, eligible investors may benefit from enhanced disclosure when investing in a registered product.

Traditional unregistered hedge funds	vs.	Registered funds of hedge funds
Limited number of investor slots	→	Unlimited number of investor slots
High investment minimums, typically at least \$250,000	→	Low investment minimums for Accredited Investors. Minimums may be as low as \$25,000
Limited regulatory oversight	→	Enhanced regulatory oversight and disclosure ¹
Restricted solicitation via private placement	→	Opportunity to advertise and broader general solicitation

¹Registration does not imply that the SEC or any other regulatory agency has approved or disapproved the securities or passed upon the accuracy or adequacy of the offering materials or the merits of an investment in the securities. Any representation to the contrary is a criminal offense. It should also be noted that the underlying managers in a registered fund of hedge funds are not necessarily registered under the IC Act of 1940. See the Risks section for important information regarding risks of a lack of regulatory oversight of hedge funds.

What are funds of hedge funds?

A fund of hedge funds invests in several hedge fund managers and encompasses manager selection, portfolio construction, risk evaluation and portfolio rebalancing. Funds of hedge funds provide investors with spreading of risk among strategies and hedge fund managers as well as professional portfolio management. By allocating to a wide range of hedge fund managers and strategies, funds of hedge funds seek to smooth out periods of above and below-average performance by individual strategies and generate a more stable return stream, although there can be no assurance of success.

Convenience

The process of manager selection, portfolio construction, risk evaluation and portfolio rebalancing is both continual and time consuming. One of the key advantages of investing with an experienced fund of hedge fund provider is that it gives investors the opportunity to access the skills and expertise of investment professionals in one package.

Access

Many attractive hedge funds are closed to new investments and only accessible through a fund of hedge funds manager with whom they have a long term relationship. In addition, many of the successful hedge fund managers do not subscribe to a commercial database. Within such an opaque industry, this gives fund of hedge funds managers access to those hedge funds which would be denied to most investors.

Risk management

An investment with a fund of hedge funds manager allows investors to benefit from various levels of risk management. In addition to each manager's own risk management, the fund of hedge fund provider will conduct its own risk evaluation for each manager and overall portfolio risk management.

Spreading of risk

Typically, a fund of hedge funds will include investments in a number of different strategies. These strategies aim to exploit different market opportunities. Combining a range of strategies creates the potential to make money in a wide range of market conditions and reduces the risk of over-exposure to any particular style of investing.

A fund of hedge funds manager may also invest in a number of different hedge fund managers. Each hedge fund manager possesses unique characteristics and is skilled in different investment areas. Combining the competitive advantages offered by each manager's investment process reduces the risk of over-reliance on too few managers.

Manager selection

Hedge funds are a people business - the success or failure of a hedge fund relies heavily on the skill and expertise of the individuals employed. Therefore, the identification of skilled and experienced hedge fund managers with a competitive advantage over managers with less skill and experience is one of the most important activities for a successful fund of hedge funds manager.

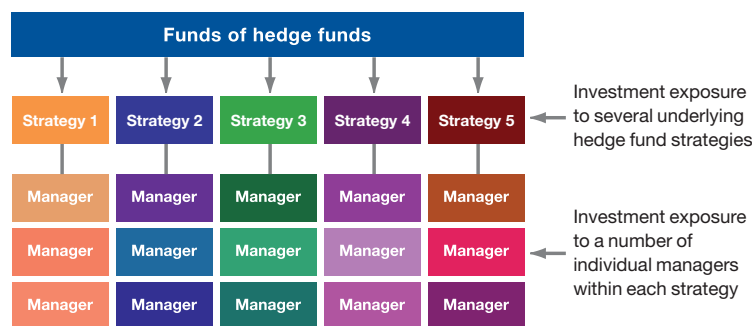
Considerable time has to be spent by the fund of hedge funds manager to identify those hedge fund managers that will best meet the goals of their fund.

Several criteria - such as individual, strategic, organizational and operational - are used to assess the quality of the hedge fund manager. A fund of hedge funds manager has the experience and the resources to identify and deal with the most promising hedge funds from the estimated 8,500 in existence.

Portfolio construction and management

Different market conditions favor different strategies and the performance of funds can vary widely depending on their approach. The construction of any successful fund of hedge funds product is therefore highly dependent upon the skill of the investment manager.

In order to spread the risk, diligent portfolio construction remains a key requirement for success. The strategies employed by a fund of hedge funds portfolio should exhibit low correlation with each other and seek to exploit different market inefficiencies as some strategies may outperform others over a given time period.



Schematic Illustration

Certain risks involved in hedge fund investing

As is the case with any type of investment, hedge funds and hedge fund investing can involve substantial risks. Below is a summary of certain risks involved in hedge fund investing, but by no means should this list be considered exhaustive.

- **Potential loss of investment**

No guarantee or representation is made that the investment programs mentioned in this presentation will be successful. Past performance is not indicative of future results. Hedge funds typically represent that their returns have a low correlation to the major market indices. Investors should be aware that hedge funds may incur losses both when major market indices are rising and falling.

- **Limited liquidity**

Investors typically have limited rights to redeem and substantially limited rights to transfer hedge fund interests. In addition, there is generally no secondary market for interests in hedge funds and none is ever expected to develop. In addition, illiquidity of a hedge fund's investments, held directly or indirectly, in the case of a fund of hedge funds, may prevent a fund's management company from satisfying investor demand for redemptions.

- **Use of leverage and other speculative investment practices**

Funds of hedge funds may use leverage to invest in hedge funds. Hedge fund managers investing directly also may employ leverage through a number of measures which could increase any loss incurred. The more leverage employed, the more likely a substantial change will occur, either up or down, in the value of the investment. Futures trading normally requires low margin deposits to permit an extremely high degree of leverage. Hedge funds involved in futures trading may experience immediate and substantial loss or gain due to relatively small movements in the price of a futures contract. In addition, hedge funds, in general may engage in speculative investment practices, which may lead to losses.

- **Lack of regulatory oversight**

Hedge funds are generally not registered under the Investment Company Act of 1940 (the '1940 Act'). Therefore, investors will not receive the protections of the 1940 Act afforded to investors in registered investment companies.

- **Valuations**

Funds of hedge funds normally look to the underlying managers for fair valuations of a fund's investment in the underlying manager's fund. While the underlying hedge fund managers must adopt policies relative to determining such fair values, funds of hedge funds managers do not have the ability to verify the accuracy of the valuations utilized by the underlying managers. Certain hedge funds may directly invest in instruments that may not be readily marketable which could complicate the determination of fair value of such instruments. It should be noted that there have been a number of high profile instances where hedge fund managers have mispriced portfolios, either as an act of fraud or negligence.

- **Tax risks**

Investors in hedge funds are typically subject to pass-through tax treatment of their investment. This may result in an investor incurring tax liabilities during a year in which they have not received a distribution of any cash from the fund. In addition, it is likely that the fund manager will not be able to prepare its tax returns in time for investors to file their returns without requesting an extension of time to file. Also be aware that additional tax disclosure forms or additional state tax returns may require filing and payments from time to time due to the activities of the underlying hedge fund managers in any given year or tax law changes that may arise in the future. There are also tax risk factors particular to tax-exempt investors as hedge fund investments may generate unrelated business taxable income. Investors should consult with their tax advisors before investing.

- **Layering of fees**

A fund of hedge fund's direct fees and expenses, including the applicable management fee and expense reimbursement to the general partner or management company, coupled with the compensation of the underlying managers, results in two levels of fees and greater expense than would be associated with direct investment. A fund of hedge fund's expenses constitute a higher percentage of net assets than expenses associated with other types of investment entities, such as mutual funds.

- **Regulatory oversight**

While the Portfolio, TEI, and Lexington are registered under the Investment Company Act of 1940, the hedge funds in which the Portfolio invests typically are not, and therefore, the Portfolio, TEI and Lexington will not receive the full protections of the Investment Company Act afforded to investors in registered investment companies.

- **Strategy risk**

Strategy risk is associated with the failure or deterioration of an entire strategy. Strategy specific losses can result from excessive concentration by multiple advisers in the same investment or broad events that adversely affect particular strategies. Many of the strategies employed by hedge funds and funds of hedge funds are speculative and involve substantial risk of loss.