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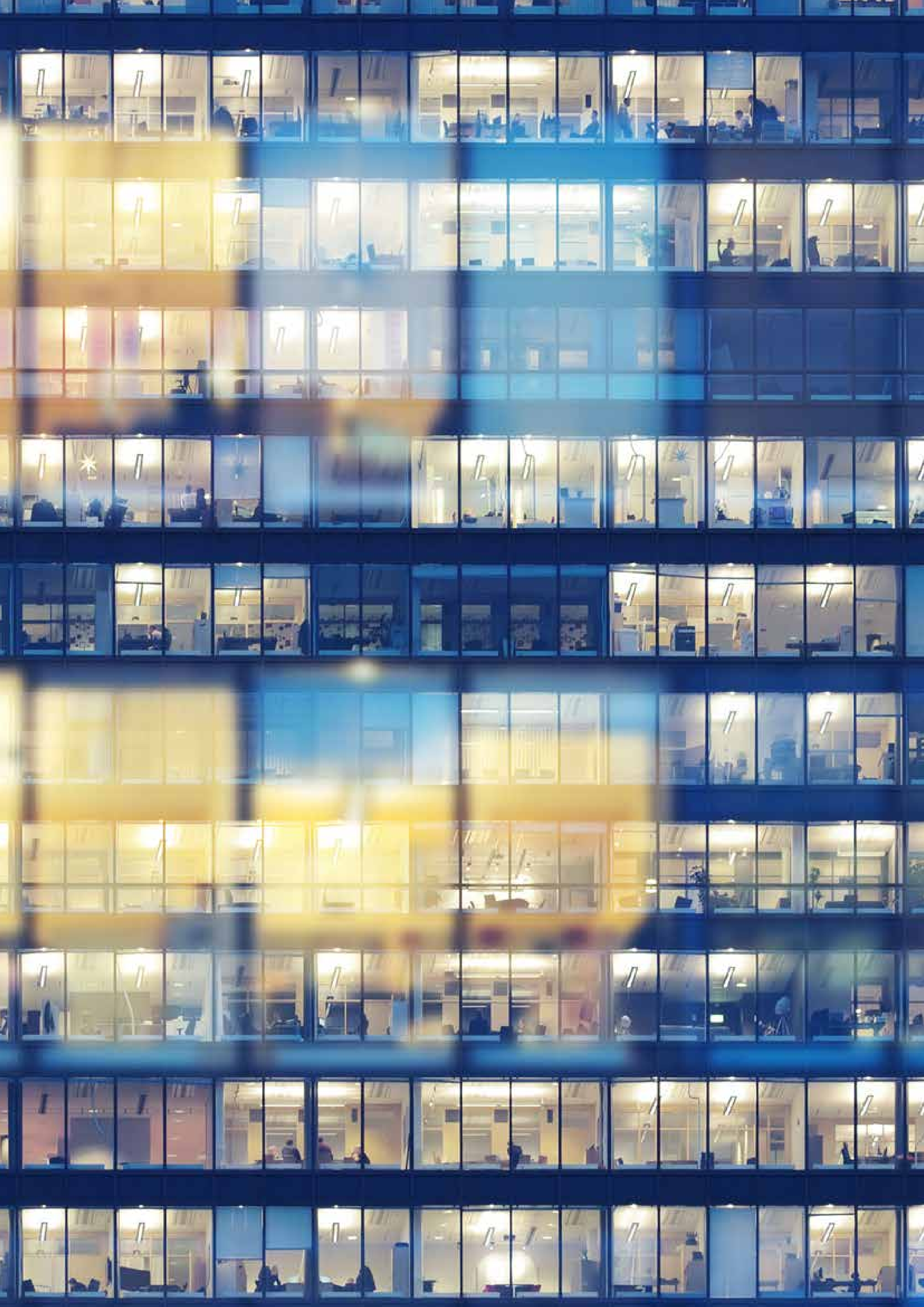
# Hedge fund strategies – an introduction



# Hedge funds–key characteristics

Hedge funds are investment vehicles that pool capital from multiple investors in order to invest across a diverse set of assets in both traditional and alternative markets. They employ strategies that are not typically available through traditional long-only mutual funds.

Unlike traditional asset classes, hedge funds are not constrained by benchmarks, allowing them to be opportunistic in their investment approach. This flexibility gives hedge funds a differentiated return profile versus traditional investments. Moreover, hedge funds can invest both long and short across asset classes, which is a differentiating factor versus other asset classes. This feature enables many hedge funds to perform well irrespective of market directionality.

## Key advantages

- **Additional sources of performance:** Hedge funds invest in distinct and often less efficient asset classes and across a broad set of strategies. This allows hedge funds to tap into a variety of differentiated alpha pools and to potentially generate strong returns over a market cycle.

- **Flexibility:** Hedge funds have greater flexibility in their investment choices compared to traditional investments. They can invest in a wide range of assets, including stocks, bonds, commodities, currencies and derivatives. In addition, hedge funds can express their views by going both long and short in securities, distinguishing them from other asset classes. This versatility gives hedge funds the ability to generate alpha and absolute returns in different market conditions.

- **Risk management and diversification:** Many hedge funds strive to deliver positive returns, irrespective of market conditions. They achieve this by employing hedging techniques to mitigate potential losses and manage risk effectively. In addition, many hedge funds tend to exhibit low to no market beta, and they are therefore less correlated to the broader equity and credit markets. These qualities make hedge funds a valuable source of portfolio diversification. Moreover, hedge funds have historically outperformed the MSCI World in major market downturns (see chart 1).

- **Liquidity:** Hedge funds offer attractive liquidity terms relative to other alternative asset classes such as private equity and real estate. Liquidity can vary by hedge fund strategy and range from monthly to multi-year lockups. This liquidity provides investors with the option to move away from underperforming hedge funds or to reposition their portfolio as the environment or opportunity set changes.

- **Investment innovation:** Hedge funds frequently lead the way in exploring new markets, asset classes or cutting-edge data sources. This can help them to generate alpha by capitalizing on less efficient areas of the market or harnessing alternative data to gain attractive investment insights.

## Key risks

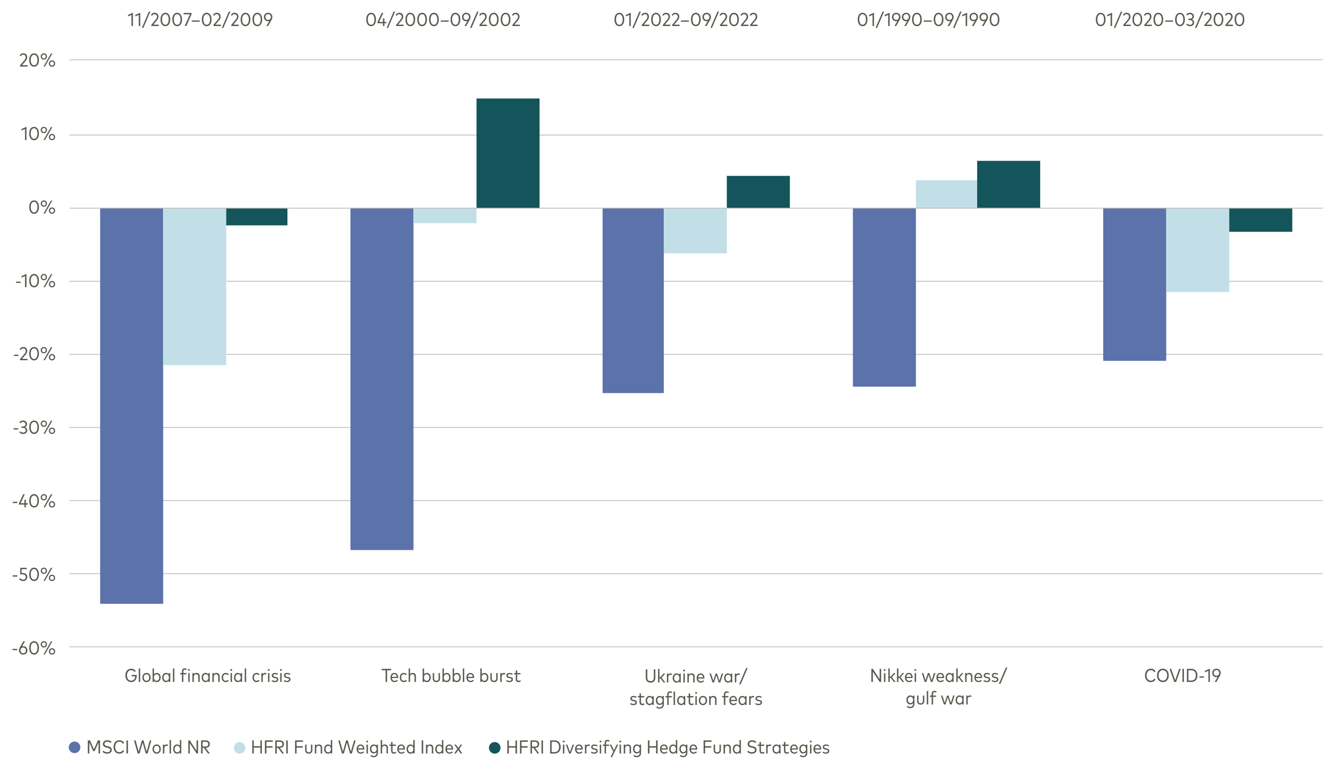
- **Complex strategies:** Hedge funds pursue complex strategies and require a higher level of expertise to evaluate and invest in those strategies. Considering the opportunistic nature of hedge funds, diligent monitoring of these investments is crucial to ensure performance is aligned with expectations and does not entail unwarranted risk-taking.

- **Transparency:** The level of transparency provided often varies by hedge fund and the type of strategy employed. Given that hedge funds invest in public markets, they often refrain from fully disclosing their portfolios to investors, except when investors maintain separately managed accounts. This makes it more difficult to conduct proper due diligence and to effectively monitor some hedge fund strategies.

- **Fees:** Hedge funds charge both a management fee and a performance fee. While the performance fee serves as an incentive for managers to generate strong returns, these fees can potentially reduce the returns for the end investor.

- **Regulation:** Hedge funds operate with less stringent regulations compared to traditional investments, creating both advantages and disadvantages. On the one hand, this gives hedge funds the flexibility to be more opportunistic and agile than traditional asset classes. On the other hand, as hedge funds are subject to less regulatory oversight, this also means that investors do not benefit from the same level of protection.

**Chart 1: Performance of hedge fund strategies during the five largest equity market drawdowns since 1990**




Data from 1 January 1990 to 31 December 2023 in USD.
HFRI Diversifying strategies include the average of HFRI CTA, Equity Market Neutral, HFRI Relative Value, and HFRI Merger Arbitrage.
Indices are shown for illustrative purposes only and are unavailable for direct investment. Refer to the glossary for additional index-related disclosures.
Source: LGT Capital Partners, Refinitiv
Returns may increase or decrease as a result of currency fluctuations. Past performance is not indicative of future results.

# Hedge funds–investment strategies

Hedge funds employ a variety of strategies that can differ by asset class, style, region, sector, and market-exposure. Hedge funds can also pursue discretionary or systematic approaches. Discretionary strategies involve investment professionals making the final investment decision, while systematic strategies rely on computer-based models to generate investment ideas and portfolios. Furthermore, each strategy typically consists of several sub-strategies. A diversified hedge fund portfolio will usually have exposure to the following strategies:

- Discretionary
  - Equity long/short
  - Relative value
  - Event-driven
  - Global macro
- Systematic
  - Managed futures/commodity trading advisors ("CTAs")
  - Quantitative equity

**Equity long/short:** Equity long/short is an investment style where hedge fund managers take both long and short positions and exploit inefficiencies by gaining an informational edge through rigorous fundamental analysis. It is predominantly executed in the form of bottom-up stock selection strategies by specialist hedge fund managers. Equity long/short strategies can be further divided into three sub-strategies:

- Allrounder: These are fundamental strategies that take risk across a broad opportunity set. They may still focus on certain market segments (sectors, market capitalization), but the hedge fund managers are very flexible and opportunistic in their allocations.

- Regional or sector specialist: These strategies focus on a relatively narrow set of sectors or countries with the clear goal of identifying winners and losers. This may be especially important for sectors or countries that undergo structural changes driven by secular trends that will benefit a sub-set of companies to the detriment of others.

- Trading oriented: Strategies that, in addition to stock selection, use an assessment of the market environment for directional positions in sectors, countries and the markets as a whole.

**Relative value:** The objective of relative value strategies is to generate returns that have minimal market exposure (beta) by simultaneously going long and short in a related security. These types of strategies benefit from mispricing in the market, liquidity mismatches, regulatory changes and irrational behavior. The most common sub-strategies include:

- Convertible arbitrage: This strategy unlocks inefficiencies between the convertible bond and the reference stock. Its implementation typically involves buying or going long in the convertible bond of a company and hedging it or going short in the stock of the same company.

- Fixed income arbitrage: This strategy exploits price discrepancies in interest rate securities and takes advantage of small price differences while limiting interest rate risk. Classic fixed income arbitrage is a market-neutral strategy. However, a small macro tilt can now be observed within these hedge fund strategies, given the efficiency of markets.

- Multi-strategy: These strategies combine multiple relative value approaches and can opportunistically allocate capital to the relative value strategy that is producing the most attractive risk/reward at any given time.

**Event-driven:** Event-driven is an investment style that groups together strategies that take specific positions focused on single transactions or one-off events. These events can include mergers and acquisitions ("M&A"), distressed/restructuring opportunities, credit events and other corporate activities. The goal of the strategy is to generate returns by leveraging opportunities resulting from events created by companies in need of refinancing or restructuring or by acquisitions/spin-offs or distressed situations, among others. Event-driven can be further broken down into the following areas:

- Merger arbitrage: This strategy exploits the uncertainty premium involved in M&A transactions. Hedge fund managers focus on transactions that are typically more complex in nature and involve a degree of uncertainty as to whether they will close. Typically, this involves taking a long position in the company being acquired and a short position in the acquirer for stock deals, or only a long position in the target stock for cash deals.

- Credit long/short: Hedge fund managers focus on the debt side of balance sheets with an emphasis on identifying relative mispricing within the capital structure. Equity positions can also be taken but they are typically used as a hedge. A key part of the strategy is to analyze the detailed legal covenants for the debt securities and identify differences in the treatment of certain debt holders that may be misunderstood by the market.

- Distressed credit: The goal of the strategy is to unlock value in failing companies by buying distressed securities. Hedge fund managers typically buy securities (often bonds) of companies that have already declared bankruptcy, or where the market expects the underlying company to go bankrupt, and they then hold the securities until convergence to fair value.

**Global macro:** This approach leverages macro-economic data points to inform investment decisions and portfolio construction. This strategy involves analyzing and capitalizing on major shifts in global economies, geopolitics and financial markets. Hedge fund managers specializing in this strategy examine a variety of factors, such as interest rates, economic growth, inflation, currency movements, political events and societal trends. This strategy is not constrained by specific asset classes or regions; instead, it seeks to profit from macroeconomic trends, whether they are driven by changes in government policies, technological advancements or global events.

**Managed futures/CTAs:** This is a systematic strategy that seeks to generate returns by trading global futures and forward markets, often by identifying price trends in various markets. The typical sub-strategies include:

- Trend-following CTAs – core markets: These types of funds invest in futures contracts and have been around for several decades. These CTAs follow any form of price chart to identify positive and negative price trends that they capture using various investment speeds to follow medium- to long-term trends in markets. Classic trend-following CTAs, which trade in core market instruments, have historically shown some of the best downside risk mitigation during equity market crises and dislocated markets.

- Trend-following CTAs – exotic markets: These types of hedge funds employ very similar investment techniques as classic trend-following CTAs but focus on a much wider set of markets when following trends. They could include interest-rates swaps in emerging markets, European carbon allowances and power markets credit instruments or onshore Chinese commodity markets traded via swaps, among others.

- Short-term trading CTAs: These strategies trade on the basis of various investment techniques primarily using price, volatility and co-movements as input factors for their signal-generation process. These managers also invest across all markets but trade in a fast and agile way, with an average trade length per position of just a few days and some models even trading on an intraday basis.

- Quantitative/systematic macro: These types of strategies use computer-based models and tend to use any sort of macro-economic data points as input in their systematic decision-making process. Such data could include interest rate differentials, CPI numbers, GDP data, housing market information, job market data or money flows, among others. Some of these hedge fund managers trade market-neutral portfolios with limited directionality, while others have clear directional exposure in the way they invest and capture opportunities.

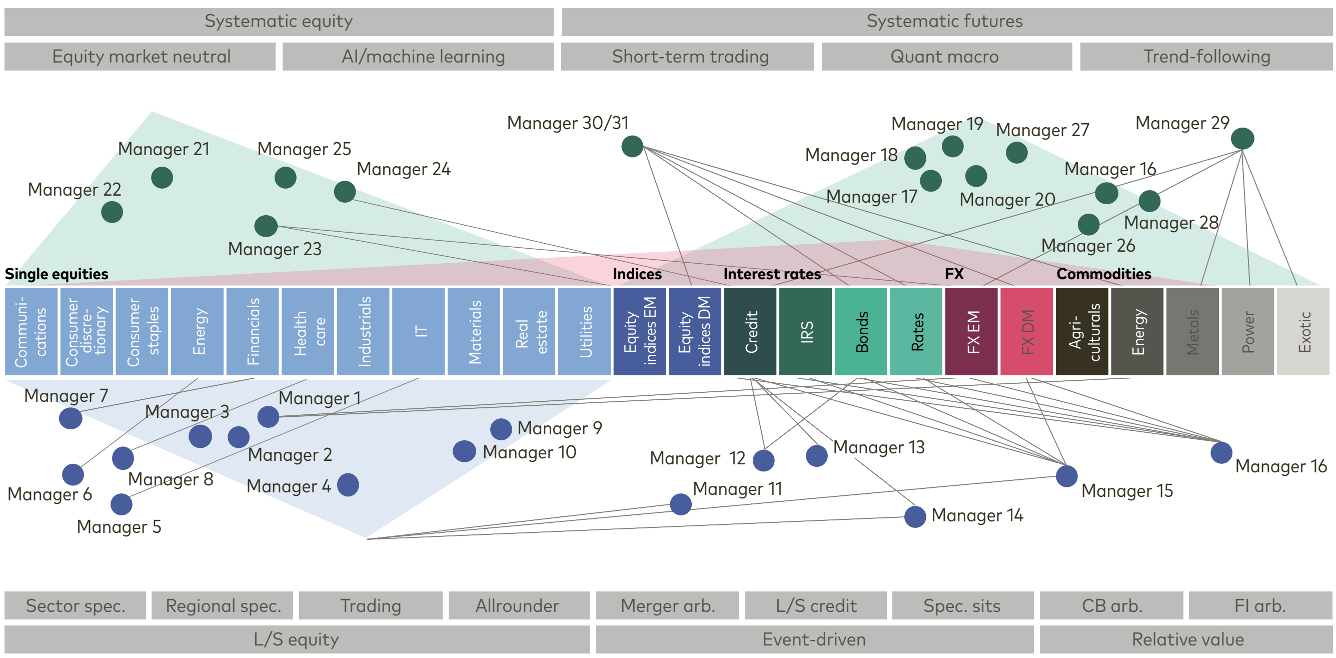
**Quantitative equity:** With this investment style, hedge fund managers use computer-based trading to exploit market inefficiencies in global stock markets through algorithms that forecast equity returns. These hedge fund managers generally run with market-neutral portfolios and rely on advanced technology and research teams to build and maintain their competitive edge. Quantitative equity can be divided into two sub-strategies:

- Equity market neutral: Quantitative strategies that use hypothesis-driven factors such as valuation, momentum, growth, quality and more proprietary factors to forecast stock returns. Typically, these approaches trade medium frequency signals and allow for fundamental explanations of returns.

- AI/machine learning: Innovative approaches in quantitative investing, using the growing availability of data and technological advances in computer technologies. Typically, these strategies are higher frequency and can include non-linear and other complex signal expressions, which can make return attribution more challenging. However, risk adjusted returns can be higher as they minimize exposure to common risk factors.

The chart below (chart 2) illustrates all the potential sources of performance that can be achieved when investing in different strategies across both discretionary and systematic hedge funds.

**Chart 2: Sources of performance by hedge fund strategy**




Source: LGT Capital Partners

# How to gain exposure to hedge funds

An investor can gain exposure to hedge funds in one of the following ways (see chart 3 below):

- Direct hedge fund investment
- Fund of funds investment
- Fund of one
- Separately managed account

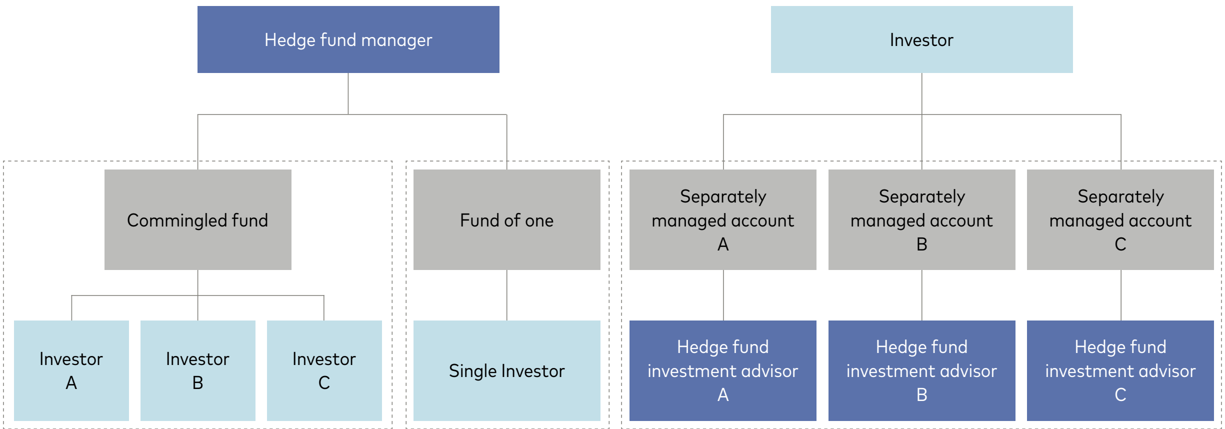
1. **Direct hedge fund investment:** In order to invest directly into a hedge fund, investors must generally be accredited investors, meaning that they must have a minimum level of income or assets. Hedge funds typically also have high minimum investment requirements. Consequently, direct investments typically work best for professional clients. Direct hedge fund investments are made into a commingled fund, i.e. a vehicle created by the hedge fund manager that multiple investors can allocate to.

2. **Fund-of-funds investment:** Funds-of-funds pool capital and use it to invest in a portfolio of hedge funds. This is a more common way for smaller institutions and high-net-worth individuals (qualified investors) to gain exposure to a broad set of hedge funds. By pooling capital, the fund-of-funds can typically negotiate favorable terms for its investors. Fund-of-funds investors also typically invest in a commingled fund.

3. **Fund of one:** In this structure, hedge fund managers create a separate fund for a specific investor. This structure allows the end investor to customize the account. As in direct fund investments, however, investors do not own the assets in the account. This may mean that investors do not gain the level of transparency they desire. In addition, the minimum investment for such structures is often high.

4. **Separately managed account:** Due to the many benefits they offer, separately managed accounts ("SMAs") are an increasingly popular way to access hedge fund investments. With the SMA structure, the end investor ultimately owns the account. This set-up, similarly to the fund-of-one structure, allows for a high degree of customization. One notable advantage of SMAs is their ability to provide full transparency, which is a key differentiating feature versus the other options. This transparency allows for better oversight of the hedge fund investment, thus empowering investors to construct higher conviction portfolios. However, SMAs typically have higher minimum investment requirements. In addition, this structure requires the investor to have a robust infrastructure and technology in place in order to obtain the full benefits of the SMA.

**Chart 3: Investment structures**




Source: LGT Capital Partners

# Due diligence considerations

Hedge funds employ complex strategies and are subject to less regulation than traditional investments. Investors, therefore, need to conduct extensive due diligence before investing. The due diligence process encompasses many different aspects, often including the following considerations:

**Organization:** The structure of the organization needs to be carefully examined to ensure that it has sufficient staff and an adequate infrastructure to run the strategy. The experience of the team running the strategy also needs to be verified. In addition, the alignment of the team's interests with those of the investors should also be confirmed. Moreover, the asset base and the concentration of the investor base should be evaluated.

**Strategy:** A clear understanding of the strategy and of the hedge fund manager's distinctive edge is critical. Equally important is the presence of a consistent, repeatable investment process that all team members adhere to. Furthermore, the hedge fund manager should be able to provide ample investment examples demonstrating its investment approach.

**Portfolio construction and risk management:** This is one of most important parts of the due diligence process and should focus on aspects such as position sizing, diversification, use of leverage, historical exposures, transparency, the risk management framework and the approach to risk management.

**Quantitative analysis:** An extensive quantitative review should be conducted to assess historical returns, volatility, exposures, correlations, and many other statistics.

**Reference checks:** Reference checks should be conducted to assess both the strategy and the character of key professionals within the hedge fund. Seasoned hedge fund investors will typically leverage their deep industry network to arrange independent reference calls.

**Operational and legal review:** This part of the due diligence process verifies that this is a legitimate organization and that protocols and checks are in place to deter any form of fraudulent activity. Within the operational due diligence review, the investment and trading process should be examined, along with back-office operations, corporate governance, compliance, technology, counterparties and services providers. On the legal front, the offering and legal documents associated with the hedge fund investment should be reviewed carefully.

**Background check:** Third-party providers are often used to conduct a background check on any key personnel involved with managing the hedge fund.

**Investment terms:** Investment terms should be reviewed to ensure they are properly aligned with the strategy.


File
Compare
Templates
Analyze
Alerts
Option
GRP Inc. GLOBAL
Main Chart
GRP Inc. GLOBAL
Market Cap
Price-to-earnings
Dividend Yield
Beta
EPS
$480.00
182034.00
91.00
629.00
791.00
Balance Sheet
File
Compare
Templates
Analyze
Alerts
Option
Income Statement
Debt to Assets

# Hedge funds in a portfolio context

Hedge funds play an important role in a broader portfolio from a performance and a diversification perspective. Hedge funds can access a variety of asset classes and instruments not available to traditional investors, such as currencies, commodities, derivatives, and other non-traditional instruments. This flexibility, combined with their relatively higher liquidity compared to other alternative asset classes, enables investors to flexibly adapt to changing market conditions. Moreover, this enhanced degree of diversification can help to potentially generate higher overall returns versus a traditional 60/40 portfolio (see chart 4). In an ever-changing financial landscape, hedge funds serve as a tool for investors seeking to effectively navigate different market environments, while still aiming to generate risk-adjusted performance.

Investors can use hedge funds in various ways, depending on their objectives. They generally use them to access additional sources of returns, as well as to diversify their more traditional portfolios and mitigate risk.

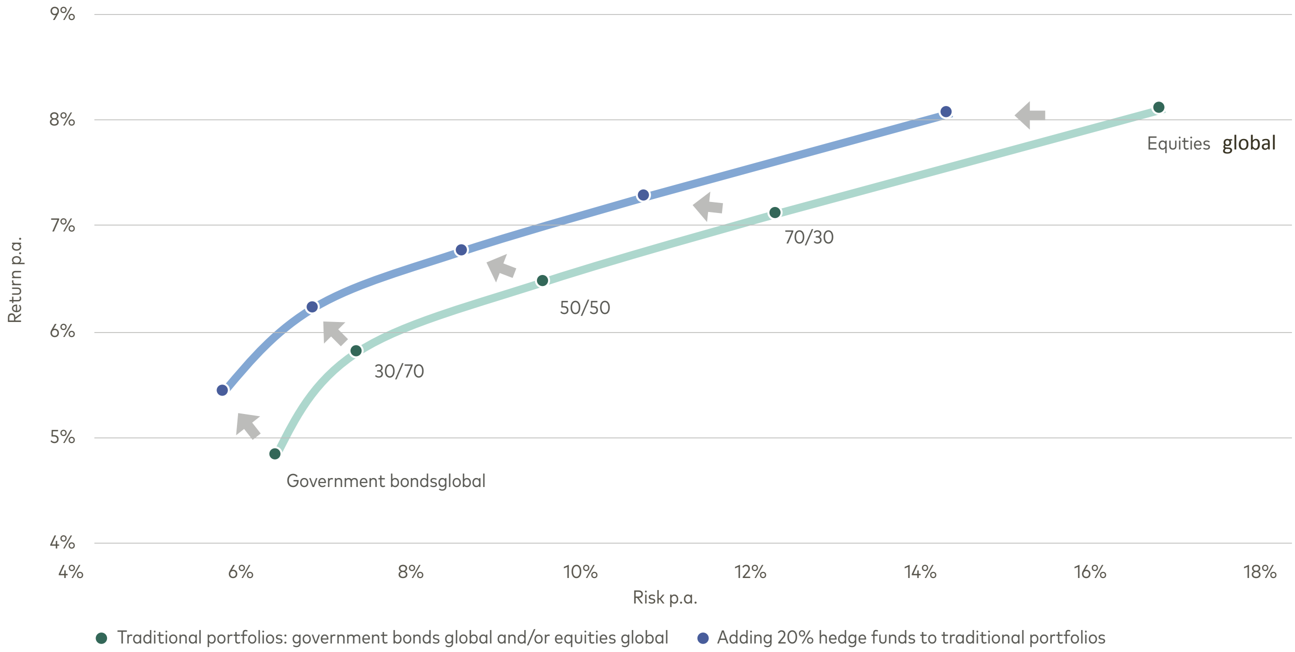
When constructing a hedge fund portfolio, investors should consider the following aspects:

1. **Purpose of hedge fund allocation:** Investors should first decide on the objective of the hedge fund portfolio within their broader overall asset allocation. Investors often use hedge funds in order to diversify and mitigate risk. Although less common, hedge funds can also serve as asset class substitutes in broader portfolios.

2. **Risk and return objectives:** Market directionality, the volatility profile, and return objective are all important considerations when constructing a hedge fund portfolio. Investors seeking to mitigate risk and diversify their portfolios often prefer hedge fund portfolios that exhibit low market beta to both equity and credit markets, as they believe that beta can be more efficiently obtained from other traditional and alternative asset classes.

3. **Selection of strategies:** After defining the hedge fund portfolio's objectives and risk-return targets, the next phase involves selecting specific strategies for the portfolio. As previously described, hedge funds employ a wide range of strategies, often with further sub-categories. Predicting the performance of a specific hedge fund strategy is very challenging. Constructing a portfolio that is well diversified in terms of strategy and style is therefore crucial. Consequently, investors often choose to combine both discretionary and systematic hedge funds to improve diversification.

**Chart 4: Improving the risk/return characteristics of a traditional portfolios – illustrative example**




Source: LGT Capital Partners
Hedge fund returns are shown for illustrative purposes only and are not representative of any actual results. Accordingly, no assumptions or comparisons should be made based upon these returns.

# Conclusion

Hedge fund allocations have continued to grow over the last few decades as investors have gained a deeper appreciation of their advantages. Hedge funds stand out by offering diversification and exposure to differentiated markets and by employing distinct strategies to express their views.

Hedge funds, especially those with low market beta, have historically demonstrated their ability to mitigate risk during market dislocations. This characteristic has prompted a growing number of investors to consider hedge funds within their asset allocation.

While hedge funds offer attractive benefits, it is essential to remember that they are not without risks. They may, for example, have higher fees than traditional investments, and their performance may vary widely, depending on the strategies selected, the skill of the hedge fund managers, and market conditions. Rigorous due diligence must therefore be conducted before making an investment.

# Glossary

**Alpha**
A measure of a hedge fund's risk-adjusted performance compared to its benchmark. Positive alpha indicates the fund outperformed, while negative alpha suggests underperformance.

**Assets under management ("AuM")**
The total market value of assets that a hedge fund manages on behalf of its investors, often expressed for a fund or for an entire manager firm.

**Beta**
A measure of a hedge fund's sensitivity to overall market movements. A beta greater than 1 indicates the fund is more volatile than the market, while a beta of less than 1 indicates lower volatility.

**Diversification**
Spreading investments across various assets to reduce overall risk and enhance potential returns.

**Equalization shares**
Equalization shares are shares in hedge funds that are issued to ensure that the appropriate performance fees are allocated to investors who invest at different times in order to profit from the high-water mark at the expense of other investors. Equalization shares may be applied or not.

**Exposure**
The level of investment in a particular asset or sector within the hedge fund's portfolio.

**Fund of funds**
Hedge funds that invest in other hedge funds rather than directly in securities or assets.

**HFRI Fund Weighted Index**
The HFRI Fund Weighted Composite Index is a global, equal-weighted index of single-manager funds that report to HFR Database. Constituent funds report their monthly performance net of all fees in US dollars and must have a minimum of either USD 50 million under management or USD 10 million under management and a 12-month track record of active performance. The HFRI Fund Weighted Composite Index does not include funds of hedge funds.

**Hedging**
The use of financial instruments to offset potential losses in the hedge fund's portfolio.

**High-water mark**
A high-water mark means that a manager may only share in a fund's profits if they have made up previous losses. The high-water mark represents the highest earned income of a fund, or the highest NAV. If returns in terms of the NAV are lower than the high-water mark, the performance fees are either reduced or not paid at all. If the profits/NAV in a subsequent exceed the high-water mark, only the portion above the mark is relevant. High-water marks prevent a hedge fund manager from creating a "performance gamble", where they generate significant losses in one year only to benefit from the returns in the following year. The manager does not profit from the performance fee until the portfolio's historical high point has been surpassed.

**Hurdle rate**
The hurdle rate is the minimum return that a fund must generate in order for the performance fee to apply. This hurdle may, for example, be tied to the European money market interest rate for 3 months. "3-month EURIBOR plus 300 base points" is a good example of a hurdle rate: a performance fee must be paid only if the fund achieves an annual profit corresponding to the EURIBOR interest rate plus 3%, i.e. around 6%–7%. If the fund achieves, a 10% return, for example, the fund manager would receive 20% the outperformance of around 3%, which is 0.6%. Consequently, of the 10% profit, the investors would receive 9.4%, and the fund manager 0.6%.

**JPM Global Government Bond Index**
The J. P. Morgan Hedged USD Global Bond Index tracks total returns of local treasury bonds in the thirteen most liquid developed market countries hedged in US dollars. The index's Bloomberg ticker symbol is JHDCGBIG. More information is available at: www.jpmoprgan.com

**Leverage**
Borrowing funds to amplify potential returns; this also increases the risk of losses.

**Management fee**
A fixed fee component of hedge funds is the management fee, which covers the fixed costs of a fund. This fee is generally expressed as an annual percentage, but it is calculated and paid periodically (e.g. on a monthly, quarterly or annual basis). It includes all administrative costs and the salaries of the employees. The management fee is calculated based on assets under management. As a general rule, the management fee corresponds to 1%–2% of the fund's assets.

**MSCI World NR**
The MSCI World Net Total Return Index is a free-float weighted equity index that represents large- and mid-cap equities across 20+ Developed Markets ("DM") countries. The index covers approximately 85% of the free float-adjusted market capitalization in each country. It is calculated daily and includes the reinvestment of dividends after the deduction of withholding taxes.

**Net asset value ("NAV")**
The value of the hedge fund's assets minus liabilities. The NAV, which is calculated regularly, may be expressed for an entire fund or as NAV per share.

**Open-ended fund**
A hedge fund that continuously issues and redeems shares based on their NAV.

**Performance fee**
Based on the 2%/20% rule (see above), a performance fee of 20% of the fund's profits is charged in addition to the management fee. In practice, fees of 10%–20% are often observed, sometimes in combination with a hurdle rate.

**Quantitative analysis**
The use of mathematical and statistical models to analyze and make investment decisions.

**Redemption**
The process of an investor withdrawing their investment from a hedge fund.

**Sharpe ratio**
A measure of risk-adjusted return, indicating the excess return per unit of risk.

**Track record**
The historical performance of a hedge fund, which is often considered when evaluating its potential.

**Typical fee structures (fund of funds)**
Fund of hedge funds may, for example, require a share of profits of 7.5% and a fee of 1.5% of assets under management per year.

Since funds of hedge funds pool the money of a number of clients, there is a degree of bargaining power, even with the fees. This allows for clients to negotiate preferential rates at the single-fund level, which significantly lowers the total cost burden.

**Typical fee structures (single funds)**
Hedge fund fees comprise various fixed and variable components. Single funds often employ a 2%/20% structure, with a management fee of 2% of assets under management (fixed component) and 20% of the profit (variable component).

It should also be noted that although the 2%/20% approach is widely used, in practice a management fee of 1% is also common.

**Underlying assets**
The actual securities, commodities or other assets that a hedge fund invests in.

**Valuation**
The process of determining the value of the hedge fund's assets for reporting and performance assessment purposes.

**Waterfall structure**
The order in which profits and fees are distributed among the hedge fund's general partners and investors.

**Yield**
The income generated by the hedge fund's investments, expressed as a percentage of the investment amount.

**Head office**

**Pfäffikon (Switzerland)**
Schuetzenstrasse 6, P.O. Box
CH-8808 Pfaeffikon
+41 58 261 8000

**USA**

**New York**
30th Floor
1133 Avenue of the Americas
New York, NY 10036
+1 212 336 0650

**San Francisco**
Suite 1330, Floor 13
580 California Street
San Francisco, CA 94104
+1 628 201 0050

**EMEA**

**Dubai**
Office 7, Level 3, Gate Village 10
Dubai International Financial Centre
P.O. Box 125115
Dubai, United Arab Emirates
+971 4 401 9900

**Dublin**
Third Floor
30 Herbert Street
Dublin 2
+353 1 264 8600

**London**
1 St James's Market
London SW1Y4AH
+44 207 484 2500

**Luxembourg**
21-25, Allée Scheffer
2520 Luxembourg
+352 27 86 66 86

**Frankfurt am Main**
Neue Mainzer Strasse 6-10
60311 Frankfurt am Main
+49 69509 55 55 55

**Paris**
43 Avenue de Friedland
75008 Paris
+33 1 81 80 5600

**The Hague**
WTC The Hague, Prinses Beatrixlaan 582
2595 BM The Hague
+31 70 701 8270

**Vaduz (Liechtenstein)**
Herrengasse 12
FL-9490 Vaduz
+423 235 2525

**APAC**

**Beijing**
Floor 61/Unit 01, China World Tower 3B
1 Jianguomenwai Ave
Chaoyang District
Beijing, P.R. China 100004
+86 10 5082 5354

**Hong Kong**
4203 Two Exchange Square
8 Connaught Place Central
G.P.O. Box 13398
Hong Kong
+852 2522 2900

**Sydney**
Suite 40.04, Level 40
264 George Street
Sydney NSW 2000
+61 2 7908 7777

**Tokyo**
9th Floor, Okura Prestige Tower
2-10-4, Toranomon, Minato-ku
Tokyo 105-0001
+81 3 4510 6900

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It should be noted that historical returns and financial market scenarios are not a guarantee of future performance.

Additional risks of alternative investments include: (i) substantial or total loss on the investment due to extensive use of short sales, derivatives and debt capital, (ii) incentives to make investments that are riskier or more speculative due to performance based compensation, (iii) potential lack of diversification and resulting higher risk due to concentration, (iv) high fees and expenses that may offset profits, (v) no requirement to provide periodic pricing or valuation information to investors, (vi) complex tax structures and delays in distributing important tax information, and (vii) fewer regulatory requirements than registered funds.

LGT Capital Partners Ltd.
Schuetzenstrasse 6
CH-8808 Pfaeffikon

+41 58 261 8000
lgt.cp@lgtcp.com