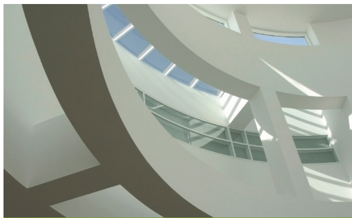
Larch Lane Advisors LLC

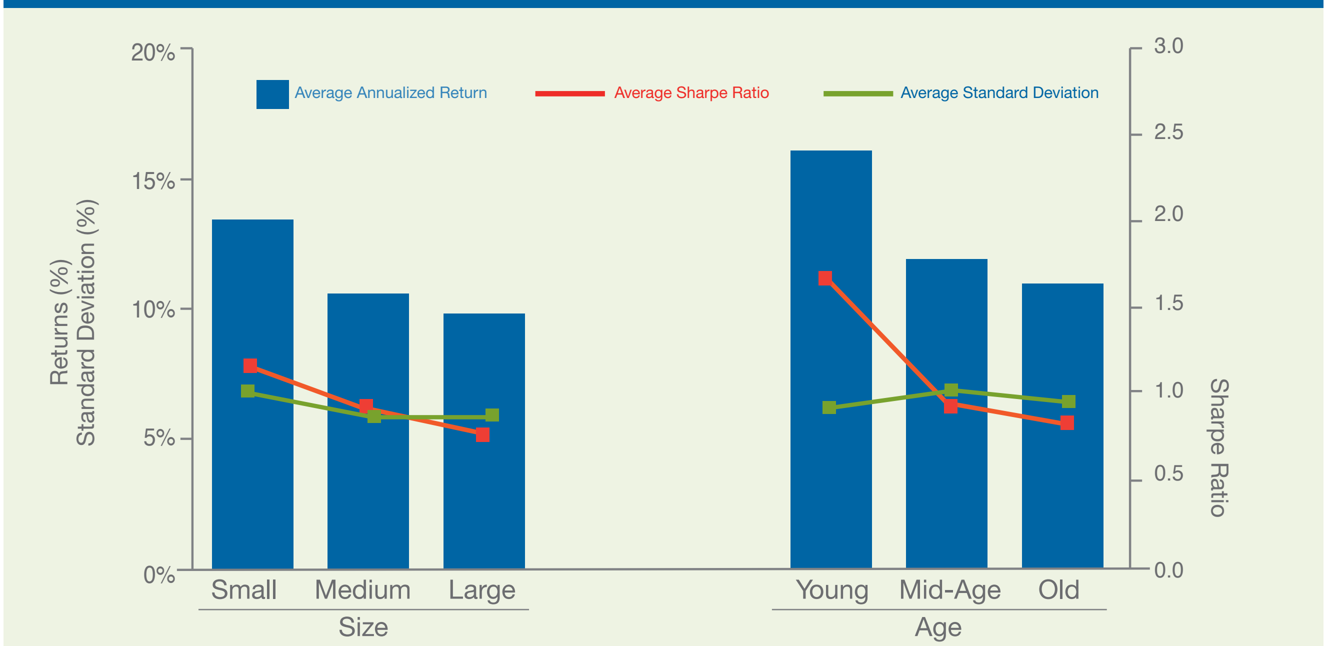


Effective Due Diligence Overcomes Challenges of Early Stage Hedge Funds

Introduction

Commercial and academic studies have shown that, on average, early stage hedge funds (ESFs) and smaller hedge funds outperform their more established and larger peers.[1] The charts below illustrate how smaller and younger funds have historically outperformed larger and older funds with roughly the same risk (as defined by standard deviation).

Funds Performance by Size and Age



Source: An Examination of Fund Age and Size and Its Impact on Hedge Fund Performance by Meredith Jones. PerTrac Financial Solutions. Data from January 1996-December 2008.

Possible explanations for this outperformance include:

- ESFs tend to be more nimble, enabling managers to trade more aggressively without affecting security prices.
- ESFs have a larger opportunity set of investable securities, including smaller capitalization names that larger funds typically ignore.
- ESFs tend to have more streamlined decision-making processes.
- ESFs must generally outperform established funds in order to attract capital.
- Managers of established funds are motivated to protect their substantial capital bases. As a result, performance tends to "cluster around the mean."

With the added performance potential of ESFs comes a unique set of challenges that require specialized expertise across a host of disciplines – investment, business, operations, administration and legal. This paper highlights the challenges implicit in evaluating ESFs and discusses how Larch Lane addresses these challenges.

Past performance is not indicative of future results. Please refer to Important Disclosures at the end of this Paper.

Hedge Fund Due Diligence

Due diligence processes for evaluating hedge fund investments have evolved rapidly over the past three years. Best practices for due diligence now include a holistic appraisal of investment, operational and business risks. Certain aspects of this process become more complicated when evaluating ESFs due to the inherent challenges of ESF investing.

To assess the many issues that affect the future success of any hedge fund, Larch Lane uses a proprietary scoring system that ranks managers based on a large number of qualitative and quantitative factors. Key factors we consider include:

- The quality of the investment process and the discipline in adhering to the process
- The strength of the risk management process
- The liquidity of the instruments traded
- The amount of capital invested directly in the fund by key employees
- The level of transparency and access given to investors
- The expected composition of the fund's investor base
- The firm culture and ability to retain key employees

We find that the qualitative factors in our scoring system are especially relevant when evaluating ESFs. Over time, we have used this and other observations to customize our due diligence process for effective ESF selection. Below, we look at notable challenges of ESF investing and how Larch Lane's due diligence process helps to overcome these hurdles.

Challenge: Limited Track Record

By definition, ESFs do not have lengthy track records, making it particularly difficult to evaluate the capabilities and talent of the investment team.

> Larch Lane Approach: To address this challenge, we believe it is important to focus on ESFs where the principals have significant experience managing portfolios at other hedge funds or financial institutions. Access to specific portfolio performance is beneficial and, whenever possible, we verify prior performance with investors in the hedge fund(s) where principals previously worked. It is also essential to look beyond the stated performance to ascertain managers' actual involvement in the investment decision-making. For example, did the principals have full authority to execute trades or were they subject to another person's influence or approval?
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> Bottom Line: Focus on ESFs managed by experienced professionals that have demonstrated prior track records as portfolio managers at a well respected hedge fund(s).

Challenge: Sourcing

There are no widely accepted ESF hedge fund databases and ESFs often lack the financial resources for expansive marketing efforts. Consequently, most ESFs fly under the radar and identifying them is especially difficult.

> Larch Lane Approach: We find that service providers such as prime brokers, administrators and audit firms are good referral sources. However, by providing seed money and early stage capital to hedge funds, we have also created our own valuable sourcing capability. In the ESF world, word-of-mouth is powerful.

Many ESFs seeking seed capital can become investment candidates for a fund-of-funds focused on ESFs. As seeders, we tend to get early views of hedge fund start-ups, giving us a first mover advantage as well as access to founder's share class investments. A founder's share class offers investors advantageous terms (typically lower fees for a limited period of time) as a reward for investing early in a hedge fund's life.

Bottom Line: Sourcing ESFs is more difficult than sourcing established funds, but a firm that develops a reputation as an early stage allocator is better positioned to find high quality managers in the start-up phase.

Challenge: Operational Due Diligence

Operational risk includes the risk of financial loss, liquidity impairment, disruption of information flow or damage to an investor's reputation that could result from inadequate or temporarily inoperable procedures or controls within a hedge fund or any of its critical service providers. These risks can be greater for ESFs, which typically have fewer resources as well as procedures that may be less well-documented and have not yet been tested in a real world situation.

Larch Lane Approach: Accurately assessing operational risk is core to Larch Lane's ESF investment process. We believe such assessment must be performed by experienced staff using a combination of quantitative screens, qualitative assessment and ongoing monitoring. We evaluate a hedge fund's organization, its service providers, its processes and its culture to assess its ability to control various operational, liquidity and counterparty risks. Our goal is to determine whether the ESF's control environment is working effectively and will deter financial and reputational loss.

No matter how compelling an investment thesis or opportunity appears to be, it is critical to avoid investments where the managing firm fails to meet or maintain minimum standards for its operational infrastructure. We believe the minimum standards to mitigate operational failure include:

- Dedicated operational staff
- Written procedures and valuation policy
- A written Business Continuity/Disaster Recovery Plan
- Compliance manual with employee trading policy
- 1st or 2nd tier service providers in the following categories: prime broker, fund administrator, auditor and legal counsel
- Audited and timely financial statements with clean (unqualified) opinions
- Segregated signing and authority to move assets (two people)
- Segregated cash away from prime broker
- Limits on counterparty credit exposure
- Restricted employee trading and strong portfolio surveillance methods

Bottom Line: Regardless of investment quality or strategy, ESFs must adhere to best practices in all operational areas or be excluded from consideration.

Challenge: Risk Management

Properly assessing risk management controls for ESFs is a critical due diligence function. Unlike established funds which tend to be overly risk averse in order to protect their capital base, ESFs have greater incentive to deliver high returns. Without proper risk management in place, ESFs could be exposed to unintended downside risk.

Larch Lane Approach: Though specific risk management criteria depend on the strategy employed by a fund, we believe that, at a minimum, an ESF employing any hedge fund strategy should have the following:

- Documented risk policies and procedures with limits appropriate for the particular strategy
- Demonstrated adherence to risk policies and procedures
- Documented net/gross exposure and position sizing guidelines
- Appropriate systems in place given the portfolio size and the securities traded. Systems must accurately measure exposures and track liquidity of positions

More complex strategies (such as relative value fixed income) should be judged by a higher standard, specifically having:

- A qualified, independent individual dedicated to risk management
- Robust systems to monitor exposures, liquidity and risk sensitivities of individual positions and the aggregate portfolio, with capability to track limits and flag breaches
- Risk manager who can take risk-mitigating actions and who reports to the investment committee, if one exists

Sometimes, the most cost effective means of ensuring appropriate risk management is to outsource all or portions of the risk management function to a qualified third-party. In such a scenario, we subject the third-party to the same standards outlined above. We also evaluate how the ESF uses the third-party's information, because it is crucial that all risk-related data are fully incorporated into the fund's decision-making process.

Bottom Line: ESFs must demonstrate that they have the people, processes and systems in place to effectively measure and manage the risks inherent in their portfolios or show that they have outsourced risk management to a reputable third party.

Challenge: Business Risk

ESFs typically struggle to generate positive cash flow early in their life cycles. As a percentage of fund assets, ESF fund expenses (including administration, audit and legal costs) are typically higher compared to larger funds. Investors often negotiate with ESFs to cap fees until assets under management ("AUM") are large enough to bring the expense ratio to a level similar to more established hedge funds.

With greater financial constraints, the risk of failure increases. Therefore, investors should pay particular attention to a fund's financial position and its break-even point. It is important to understand how a firm plans to grow as AUM increases and what the consequences are if assets do not grow according to plan. Ongoing communication and face-to-face meetings to review the fund's progress should occur quarterly, at a minimum.

Larch Lane Approach: We focus on ESFs that do not require substantial infrastructure (i.e. long/short equity, convertible arbitrage). We generally consider ESF strategies that require more resources (quantitative, CTA and macro strategies) only when they are established as a lift-out of a team from another fund and only when there is adequate funding. We expect such funds to quickly build appropriate infrastructure and resources as AUM increases. Because ESFs involve more business risk than their established counterparts, it is essential to identify ESFs that invest in liquid securities and allow investors to redeem in a reasonable time frame.

Bottom Line: ESFs should have enough working capital to keep the firm running for two to three years even if assets do not grow. Fee caps should be pre-negotiated. Focus should be on ESFs with liquid strategies that require less extensive resources.

Conclusion

At Larch Lane Advisors, we firmly believe that an ESF allocation is an integral part of any hedge fund of funds portfolio. In general, ESFs provide better risk-adjusted returns, access to high quality investment professionals, fund transparency and often better fee terms. However, by their very nature, ESFs have a unique set of challenges that must be overcome in the due diligence process. We have outlined the major challenges in this paper and how our due diligence team addresses them.

- To overcome the challenge of limited track records, we focus on ESFs managed by experienced professionals with demonstrated prior track records as portfolio managers at a well respected hedge fund(s).
- To enhance sourcing, which is more difficult for ESFs than established funds, we capitalize on our reputation as an early stage allocator and seeder to help us find high quality managers in the start-up phase.
- We conduct intense operational due diligence to ensure that ESFs under consideration adhere to best practices with regard to operational issues.
- We expect ESFs to demonstrate effective processes and procedures to measure and manage the risks inherent in their portfolio, whether through internal or third-party resources.
- We require ESFs to have enough working capital to keep the firm running for two to three years even if assets do not grow. We pre-negotiate fee caps and we generally focus on ESFs with liquid strategies that require fewer resources.

We believe Larch Lane's thorough investment process and experienced team enable us to effectively identify, analyze, invest in and monitor ESFs, thus managing the inherent risks and giving our clients access to the attractive performance advantage these funds can provide.

Important Disclosures:

This document contains statements which constitute forward-looking statements. These statements may include statements regarding the intent, belief or current expectations of Larch Lane with respect to, among other things: (i) portfolio allocations; (ii) the ability to identify investment opportunities; (iii) the performance of the portfolio managers or their affiliates; and (iv) the state of the economy, the financial markets and the financial industry. Prospective investors are cautioned that any such forward-looking statements are not guarantees of future performance and involve risks and uncertainties, and that actual results may differ materially from those in the forward-looking statements as a result of various factors.

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Endnotes

[1] See e.g. "Emerging Manager Out-Performance: Alpha Opportunities from the Industry's Newest Hedge Fund Managers." HFR Asset Management, 2005. "An Examination of Fund Age and Size and Its Impact on Hedge Fund Performance" by Meredith Jones. PerTrac Financial Solutions. Data from January 1996-December 2008. "The Performance of Emerging Hedge Fund Managers" by Rajesh K. Aggarwal and Philippe Jorion. American Finance Association Meeting Paper. January 23, 2008, page 30.