In the wake of the bear market, hedge funds have garnered significant attention from both investors and the media. During a period when the broad equity market indices have declined on a trailing three-year basis, people have discovered that many hedge funds have not only delivered significantly higher relative returns, but have actually delivered positive returns during the same three-year period.

The purpose of this report is to familiarize investors with hedge funds as an asset class, describe that main strategies employed by hedge funds and to provide several recommendations from the growing universe of hedge funds that are available to Canadian investors.

A Brief History

Hedge Funds or Alternative Investment Funds (AIFs), while lacking a formal or legal definition, can be satisfactorily described as investment funds that are not constrained by the rules that apply to mutual funds or pooled funds and thus are able to employ flexible investment strategies. In particular, hedge funds have the ability to use leverage and take short positions.

A.W. Jones created the first hedge fund in 1949. Recognizing that the two primary risks inherent in equity investing were stock selection risk and market risk, Jones launched an equity fund in the form of a private partnership that used both long and short positions to minimize market risk while using leverage to augment performance.

Table 1 illustrates the logic behind Jones’ strategy. An investor who has $1,000 to invest borrows an additional $200 and purchases $1,200 worth of stock. Yet the investor also shorts $700 worth of stock. Thus the investor’s gross investment is $1,900 (represented by adding the $1,200 in long positions to the $700 in short positions), which represents 190% of the original capital. The investor’s net market exposure is only 50% ($1,200 less $700), which is also referred to as being 50% net long. Being 50% net long means that only 50% of the portfolio’s initial capital is exposed to a broad market decline. This holds true since the $700 in short positions should offset the losses from $700 of long positions. The short positions act as a “shock absorber” during weak markets. Jones maintained that this strategy maximized a manager’s ability to add value via stock selection, regardless of the direction of the broad market. His strategy made perfect sense: establish a portfolio...
of long investments, which he considered to be undervalued, neutralized by short investments which he considered to be overvalued.

In addition to creating the first hedge fund, Jones’ strategy contained two important features: he charged a 20% performance fee and almost all of his personal liquid capital was invested in his fund. Investing his personal assets in his own fund not only reflected his conviction that his strategy would outperform traditional strategies, but it also ensured that his interests were aligned with his investors’ interests.

Jones essentially ran his fund in secrecy until a Forbes article released in 1966 reported that, even after performance fees, Jones’ performance had trounced the most popular mutual funds of that day.

During the 1980s and early 1990s individuals such as Julian Robertson and George Soros became exceedingly popular topics in the financial press when it became evident that their strategies not only outperformed during bull markets, yet outperformed during bear markets as well.

**Hedge Funds Today**

It is estimated that there are more than 5,000 hedge funds currently in existence. Although there have been several high profile losses by hedge funds, such as Long-Term Capital Management in 1998, the industry continues to attract some of the most talented investment managers. Differentiating the structure of hedge funds versus mutual funds, investment pools and managed accounts helps to explain the continued growth of hedge funds and the migration of talented investment managers from traditional fund management to hedge fund management.

**Hedge Funds Versus Traditional Investment Funds**

*Absolute return objective*

Many traditional investment funds benchmark themselves to a broad index such as the TSX/S&P, the S&P 500 or the MSCI World index. If the Fund beats the performance of the underlying index, the Fund managers will argue that they have added value. Yet as many investors have discovered to their chagrin, there is little comfort in beating a benchmark by 4% if the benchmark has lost 20%. In such as case, the old adage reads: “one can’t pay the bills with relative performance”.

Most market neutral hedge funds have a mandate of delivering absolute returns. As such, their aim is to achieve positive performance net of fees every month. Their primary goal is to protect capital and avoid negative compounding. Their relative performance to an index is irrelevant to their investment strategy.

*Flexible investment strategies*

Traditional investment managers are generally bound by a detailed investment policy. For example they may be constrained to:

**Table 1 – The Jones Model**

<table>
<thead>
<tr>
<th>Description</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Original Investment</td>
<td>$1,000</td>
</tr>
<tr>
<td>plus: Leverage</td>
<td>$200</td>
</tr>
<tr>
<td>Long Exposure</td>
<td>$1,200</td>
</tr>
<tr>
<td>Short Investment</td>
<td>$700</td>
</tr>
<tr>
<td>Short Exposure</td>
<td>$700</td>
</tr>
<tr>
<td>Investment Opportunity</td>
<td>$1,900</td>
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<tr>
<td><strong>Market Exposure</strong></td>
<td></td>
</tr>
<tr>
<td>Long Positions</td>
<td>$1,200</td>
</tr>
<tr>
<td>less: Short Positions</td>
<td>$700</td>
</tr>
<tr>
<td>Net Market Exposure</td>
<td>$500</td>
</tr>
<tr>
<td>Percent Market Exposure</td>
<td>50%</td>
</tr>
</tbody>
</table>

Calculations: BMO NB Mutual Fund Research
• What percentage of the portfolio must be invested at any given time
• What sectors they may invest in (industry or country)
• A specific market capitalization for underlying securities
• How many securities may be in their portfolios
• The “style” of stocks they may purchase (i.e. value, growth or momentum).

Most hedge funds have the ability to make hedged investments in any area where they believe they can deliver an absolute return. They can participate in any sector or market that they choose.

*Unconstrained by benchmark*

Many investment funds, and especially pension funds and managed programs, place a high premium on a manager’s tracking error. Tracking error describes the extent to which a manager deviates from a benchmark’s performance or sector weightings. To illustrate this point, certain fund managers tend to attribute their performance in terms of over-weighting or under-weighting a specific sector or stock. Hedge fund managers maintain little regard for benchmark weightings, as their focus tends to dwell on delivering absolute returns.

*Lower correlation to market*

Constructing a portfolio of high quality, low-correlated assets is the foundation of successful investing. Quite simply, investors should seeks distinct asset classes that “zig” when the others “zag”, which lowers volatility and the probability of losses. Yet finding asset classes that are negatively correlated throughout bull and bear markets is difficult. Hedge funds are one of the few asset classes that still maintain a low correlation with the broad market indices, including bonds and stocks. In fact, many hedge funds lack any significant correlation with the broad market. Thus, the inclusion of hedge funds in a diversified investment portfolio tends to lower volatility and increase the potential for gains.

*Can take both long & short positions*

Mutual funds, investment pools and managed asset programs are prohibited from shorting stocks. Hedge fund managers make a compelling argument as to why this represents a hindrance to delivering consistent and absolute returns.

Theoretically, long-only strategies limit fund managers to delivering half their potential alpha (alpha being a term for outperformance). If a long-only manager believes that a particular stock, sector or region is overvalued and destined to decline, they can only achieve relative outperformance by either underweighting their exposure or eliminating their exposure altogether. Hedge fund managers have the potential to double their outperformance by shorting the sector, or the stock, thereby profiting from a price decline.

*May use leverage*

Unlike traditional funds, hedge funds can employ leverage. Leverage is defined as the ratio of investment capital to total assets. Quite simply, leverage is borrowing to invest. Intuitively, leverage augments gains or losses.

Some hedge fund strategies, such as fixed income arbitrage, use leverage to enhance returns since their strategy exploits very small pricing inconsistencies. While leverage ratios such as 15:1 are common for fixed income strategies, the market-neutral nature of such strategies tends to keep the volatility low. But highly levered funds can present a threat to investors, as poorly executed strategies can have a disastrous effect on
performance. For instance, during the peak of Long-Term Capital’s turmoil, their leverage ratio, when considering off-balance sheet activities, approached 100:1.

Most hedge funds available to Canadians don’t carry leverage ratios higher than 2:1. In fact, several hedge funds have a policy of not employing leverage at all.

Less liquid & transparent

Hedge fund managers are highly competitive. They vehemently strive to beat their competitors on both an absolute and risk-adjusted basis. Understandably, they have little desire to share the secrets, strengths or weakness of their proprietary trading models and systems. Furthermore, revealing their current positions or trades could severely limit their ability to achieve their performance goals.

Mutual funds are required to document their entire portfolio semi-annually, although many investment funds or managed asset programs reveal their positions monthly. Hedge funds are not bound by these regulations.

While investment funds and pooled funds offer daily liquidity, most hedge fund offer liquidity on a monthly basis with, in most cases, 90 days written notice. The primary reason for this is that, unlike traditional management, hedge fund managers often execute trades that are very time sensitive or may involve relatively illiquid securities. Thus facilitating daily redemptions could significantly drag on performance.

Manager compensation tied to performance

Most traditional investments managers are compensated on a combination of assets under management and their relative performance versus their peer group or an index. Furthermore, the total fees charged to investors in traditional investment funds are a function of total assets under management - regardless of performance.

Hedge fund managers are compensated on their ability to exceed a specified hurdle rate, which is often anything above 0%. The standard performance fee is 20% of all gains. Thus, unless the fund generates positive returns, the manager does not get paid. Although hedge funds charge an annual fee of 1-2%, this fee primarily covers the day-to-day operations of the fund. Performance fees, which are of course derived from delivering positive returns, are the primary source of motivation.

In addition to performance fees, hedge funds also employ “high water marks”. This is a policy that ensures that performance fees are only charge on sequential gains. For example, if a $100,000 hedge fund investment earns a 10% net-of-fee return in one year followed by a 4% loss the next year, performance fees will not be charged until the value of the investment exceeds $110,000 (the high water mark achieved after the first year).

As most hedge fund managers have a substantial amount of their personal capital invested in their own fund, their financial interests are truly aligned with their investors.

Larger minimum investments and maximum fund size

Considering that hedge fund managers earn their living by delivering positive returns, they will often cap their fund at a level that, if exceeded, they believe will hinder performance. For hedge fund managers, bigger is not necessarily better and the ceiling on manageable assets varies by strategy.

While one can purchase a mutual fund for as little as $500, access to elite hedge fund managers has historically been restricted to institutions and wealthy investors. As most hedge funds are purchased via Offering Memorandum versus a prospectus, Canadian sophisticated investor rules apply to minimum purchase size.
Main Hedge Fund Strategies

While there are more than twenty distinct strategies employed by hedge fund managers, eleven main strategies represent the vast majority of hedge funds available.

With each of the strategies we have generated normal distribution graphs of the monthly performance results for the past nine years ending December 2002. While a normal distribution, or lognormal distribution for that matter, is not a perfect representation of the risk/return characteristics of historical returns, it more than adequately highlights the risk/return nature of a particular strategy versus a benchmark.

For each strategy we have provided the normal distribution curve for an appropriate benchmark, which is always the green dotted line. We also provide the normal distribution for the hedge strategy, which is the solid blue line. Lastly, we have illustrated a more accurate representation of the hedge fund strategy through a histogram, which are the solid red bars.

In theory, 100 percent of all returns lie within the normal distribution. Therefore, the longer and higher the left side (tail) of the graph, the larger the loss. By referring to Chart 1, one can see that the monthly returns of the Scotia McLeod Universe Bond index are concentrated between –1% and +3%. Conversely, the returns of the TSE 300 index are far more dispersed, stretching from –15% to +15%.

As most hedge fund strategies attempt to achieve absolute rates of return on an annual basis, one should seek strategies with return distributions that are concentrated on the positive side of the monthly return axis (x in this case with the y-axis representing the frequency of the returns).

Hedge fund databases are often criticized for suffering from a high degree of survivorship bias. Survivorship bias implies that when a fund ceases to exist or stops reporting returns to data providers (presumably due to poor performance), the index is falsely skewed to the upside. Yet several US-based hedge fund consultants have concluded that many hedge fund databases are actually skewed to the downside as many exclusive and top performing hedge funds have no interest in drawing attention to themselves by reporting to the data providers. Thus, we maintain the conclusions derived from the following graphs are well substantiated.
Convertible Arbitrage

This strategy looks for mispricings between a convertible security and the underlying stock. Convertible securities have a theoretical value that is based on a number of factors, including the value of the underlying stock. When the price of a convertible security deviates from its theoretical value, an arbitrage opportunity exists.\(^1\)

Hedge funds focusing on convertible arbitrage would typically buy an undervalued convertible bonds and sell the underlying stock short in anticipation of either the stock moving down in value to match the convertible, or the convertible moving up in value to match the price of the stock. Typically, during a period of weakness, the value of the stock will drop faster than the value of the convertible bond, providing an opportunity to take profits.

As one can see from Chart 2, convertible arbitrage strategies tend to deliver consistent performance that rivals bond indices. The one outlying negative period occurred in the fall of 1998 when the Russian debt crisis resulted in a flight to quality, hurting the monthly returns of fixed income funds and related fixed-income strategies for 3 months. While convertible bond arbitrage is an important component of most fund-of-hedge funds, there are few pure strategies available to retail investors in Canada.

Merger Arbitrage

Merger Arbitrage, sometimes called Risk Arbitrage, involves investment in event-driven situations such as leveraged buy-outs, mergers and hostile takeovers. Normally, the stock of an acquisition target appreciates while the acquiring company's stock decreases in value. These strategies generate returns by purchasing stock of the company being acquired, and in some instances, selling short the stock of the acquiring company.\(^2\)

While it may seem intuitive to, upon a merger announcement, assume a long position in the company being purchased and a short position in the acquiring company, there are many factors that can affect the trade.

Merger arbitrage managers must have a detailed knowledge of every M&A deal. As such, they need to posses a high degree of knowledge pertaining to tax law, corporate law and accounting. The largest risk facing merger arbitrage managers is the break-up of a proposed deal. In this event, they can quickly lose money on both their longs and shorts as both the acquiring company and the target company stocks return to their previous trading levels.

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1 Hedging Fund Research, Inc.
2 Hedge Fund Research, Inc.
Chart 3 illustrates that merger arbitrage funds could be successfully included in more conservative portfolios. While merger arbitrage tends not to have monthly returns in excess of 2.5%, they achieve consistence outperformance by grinding out 0.5% to 2% every month while avoiding negative compounding. Although merge arbitrage tends to reflect the volatility of bonds while delivering consistent equity-like returns, they do not provide income distributions.

One historic example of merger arbitrage would be taking a long position in Canadian Pacific, shorting the pieces that it was spinning off and continually trading the spread.

**Equity Market Neutral**

Equity Market Neutral strategies seek to profit by exploiting pricing inefficiencies between related equity securities, neutralizing exposure to market risk by combining long and short positions. One example of this strategy is to build portfolios made up of long positions in the strongest companies in several industries and taking corresponding short positions in those showing signs of weakness.3

Equity market neutral can be described as a long/short portfolio that has a Beta of 0 or that its long positions are completely offset by its short positions. Market neutral strategies are designed to take the market effect out of a portfolio, resulting in the performance being a complete function of the manager’s ability to buy/short securities. Market neutral managers tend to maintain proprietary quantitative trading systems that identify distinct buy and sell signals.

Some market neutral funds employ a strategy called pair trading, which is taking a long position and short position in the same sector. An

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3 Hedge Fund Research, Inc
example in the Canadian steel sector may be going long IPSCO and shorting Stelco.

Chart 4 highlights the conservative results of market neutral hedge funds. Contrasted against the MSCI World index, market neutral funds have been very consistent, stable performers throughout bull and bear markets and consequently have historically delivered the highest risk-adjusted returns.

While we believe that the inclusion of market neutral hedge funds will add considerable value to almost any investment portfolio, investors should also recognize that such funds might not keep up with growth funds during a raging bull market. In a world of “get rich” and “stay rich” investment strategies, market neutral is the epitome of “stay rich”.

**Fixed Income Arbitrage**

Fixed Income Arbitrage is a market neutral hedging strategy that seeks to profit by exploiting pricing inefficiencies between related fixed income securities while neutralizing exposure to interest rate risk. Fixed Income Arbitrage is a broad description of a variety of strategies involving investment in fixed income instruments, and weighted in an attempt to eliminate or reduce exposure to changes in the yield curve. Managers attempt to exploit relative mispricings between related sets of fixed income securities.  

While most investment dealers have a wide variety of proprietary fixed income arbitrage desks - such as interest rate swaps – there has been little interest in making such strategies available to retail investors. Many of the proprietary fixed income traders we have spoken to maintain that they require a large financial and systems infrastructure, such as those offered by a large brokerage firm or a bank, to successfully execute their strategies. This, coupled with the fact that fixed income arbitrage requires large amounts of leverage in order to achieve acceptable rates of return, will most likely limited the availability of fixed income arbitrage to fund-of-hedge fund offerings.

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4 Hedge Fund Research, Inc.
Equity Long/Short

An Equity Long/Short strategy, as represented by the Jones model, consists of a portfolio of long equities hedged with short sales of stocks or related derivatives, such as index options.

Equity long/short strategies will vary in degree as to what percentage of the portfolio is “net long”. Defensive funds can maintain a 0% net market exposure while more aggressive funds can augment market exposure past 100% or, in several cases, maintain a “net short” exposure if they believe that markets are poised to fall. Assuming a long/short fund is “net long”, long/short managers simply establish a portfolio where they believe that the gains on their long positions exceed the losses on their short positions.

Equity long/short is the most popular equity strategy available to Canadian investors. Many successful long-only managers have made the relatively easy transition to hedge fund management via long/short equity funds as the structure allows them to enhance their long-only skill set with the ability to short securities – in essence, the ability to double their alpha.

As one will see from Chart 6, long/short tends not to be an absolute return strategy. During weak markets, portfolios that are net long tend to experience various months of negative performance yet with significantly less negative results and less volatility than long-only managers. In our opinion, long/short funds best complement existing equity portfolios and should not represent a complete sector allocation.

Global Macro

Macro involves investing by making leveraged bets on anticipated price movements of stock markets, interest rates, foreign exchange and physical commodities. Macro managers employ a “top-down” global approach, and may invest in any markets using any instruments to participate in expected market movements.5

When the popular press makes an inference to hedge funds, they are often referring to global macro funds. Global macro is the quintessential “get rich” hedge fund strategy. George Soros’

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5 Hedge Fund Research, Inc.
Quantum funds and Long-Term Capital Management are prime examples of global macro strategies.

As Chart 7 illustrates, global macro managers can win big or lose big. They tend to make large, concentrated investments that ride a current trend—such as the devaluation of a currency.

While there are a few global macro managers available to Canadian retail investors, we would strongly recommend that investors gain exposure via fund-of-hedge funds.

**Hedge Fund-of-Funds**

Fund-of-Funds invest with multiple managers through funds or managed accounts. The strategy designs a diversified portfolio of managers with the objective of significantly lowering the risk (volatility) of investing with an individual manager. The fund-of-fund manager has discretion in choosing which strategies to invest in for the portfolio.⁶

We believe that fund-of-hedge funds represent the best risk/return option for investors. Not only do such funds facilitate a diversified hedge fund investment across multiple strategies, but they also offer the service of constant monitoring and rebalancing as various strategies go in and out of favour.

Fund-of-hedge funds also grant access to world-class hedge fund managers that are unavailable to the average investor. Such managers often require minimum investments in excess of $10 million, which precludes even the high net worth segment of the retail market. Although the fund-of-hedge fund manager will layer on an additional fee for their services, our research has concluded that the added value of such structures more than justifies the fee.

While the return distributions displayed in Chart 8 may seem rather volatile, the hedge fund-of-fund universe represented by the index includes hedge funds that portfolios of long/short strategies. The three fund-of-hedge funds that we recommend are market neutral in that they are structured to deliver positive returns every year, if not every month.

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⁶ Hedge Fund Research, Inc.
Event Driven

Event-Driven is also known as "corporate life cycle" investing. This involves investing in opportunities created by significant transactional events, such as spin-offs, mergers and acquisitions, bankruptcy reorganizations, recapitalizations and share buybacks.  

Event driven hedge funds will shift in allocations between Risk Arbitrage and Distressed Securities or may even take a broader scope. The broader investment scope of event funds leads to higher volatility yet increases the potential for higher annual returns.

Distressed Securities

Distressed Securities strategies invest in, and may sell short, the securities of companies where the security's price has been, or is expected to be, affected by a distressed situation. This may involve reorganizations, bankruptcies, distressed sales and other corporate restructurings.

As with merger arbitrage and event driven strategies, distressed securities investing requires an acute understanding of the details surrounding a company’s share price decline. Therefore, seasoned investment bankers and bankruptcy lawyers are often the senior investment managers on such funds.

In essence, distressed strategies are extreme value funds or “contrarian” funds. By possessing a better understanding of a companies woes, distressed arbitrage profits from purchasing securities at fire sale prices as investors, or pension fund managers that are prohibited from owning securities below a certain quality, flee for the exits and drive down share prices.

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7 Hedge Fund Research, Inc.
8 Hedge Fund Research, Inc.
Dedicated Short Bias

Dedicated short sellers were all but extinct after the bull market of the 1990s. Yet after the technology bubble burst, this category, in which the fund must always maintain a net short position greater than 0, is gaining in popularity.

The distribution of returns illustrated in Chart 11 reveals the predictable returns of dedicated short sellers – very strong returns in bears markets and pitiful returns during bull markets.

Currently, there are no single dedicated short sellers available in Canada. Although they may represent very small positions in some fund-of-hedge funds, this strategy is often avoided to the potential of extreme drawdowns.

Managed Futures (CTAs)

Managed Futures funds are involved in the trading of listed financial and commodity futures markets and currency markets.

Often referred to as Commodity Trading Advisors (CTAs), managed futures are diversified investments as they have the ability to trade in over 50 different markets worldwide.

CTAs attempt to take advantage of price trends. For instance, they could buy long futures positions in anticipation of a rising market or sell futures positions if they anticipate a falling market. Managed Futures tend to outperform during period of crisis. Considering the geopolitical event of the past two years, it should come as no surprise that managed futures funds have performed well. Yet, as highlighted by Chart 12, managed futures can also experience prolonged periods of weakness couple by undesirable levels of volatility.

While we would not recommend that an investor make a pure play investment in a managed futures strategy, there are several managed futures principal-protected notes available that offer downside protection, which should increase the appeal of the sector. Yet would recommend that the allocations to managed futures funds be left to a fund-of-fund manager.
For whom are hedge funds appropriate?
While the minimum investments applied to hedge funds may make it impractical for many clients to purchase them, we believe that hedge funds can have a positive impact on almost any portfolio. As investors, and regulators for that matter, become more comfortable with the concepts and strategies employed by alternative investment funds, we believe that it is likely that minimums will fall. In the meantime there are a number of hedge strategies coming to market in the form of guaranteed notes, which have lower minimums. We will continue to cover these new products and make recommendations on an issue-by-issue basis. For larger investors we believe that market neutral hedge fund of funds can form the cornerstone of a portfolio. These funds’ low volatility and attractive return profile generates positive returns irrespective of market gyrations. They are neither economically or cyclically sensitive like stocks or interest rate or credit sensitive like bonds. The recurring theme in structuring a fund of fund portfolio is to avoid low-probability, high impact events, such as a market crash or a situation that dramatically affects a particular sector. Single strategy funds can also be very attractive to many clients as the added ability to short a security or use leverage can generate better returns and provide lower volatility than long-only funds. Single strategy funds, however, can vary widely in terms of risk and return objectives. The four single strategy funds that we are recommending have an extremely low probability of significant drawdowns, and we believe, over time, will reward investors.

What is an accredited investor?
In a number of provinces, accredited investors are exempt from alternative investment fund minimum purchase rules. While accredited investor rules vary slightly from province to province, they generally follow a similar formula. We will highlight the rules used in Ontario, which was based on similar rules from the United States. To qualify as an accredited investor one must have:

One million dollars in investable assets, net of any liabilities, excluding the investors primary residence. These assets can be held singularly or can include the assets of a spouse.

or

Income exceeding $200,000 in each of the previous two years or, that has exceeded $300,000 when combined with their spouse’s earnings.

or

be a Corporation, limited partnership or endowments with investable assets of over $5,000,000.

Being an accredited investor allows individuals to invest in alternative investment funds without any asset minimums. It is important to note however that many hedge funds still require a minimum investment of $25,000. Here are the accredited investor minimums for each province. Please note that not every province has enacted accredited investor rules, in such cases the minimum remains $150,000.

What are your recommendations?
The following list of seven funds highlight our recommended alternative investment funds for BMO Nesbitt Burns clients. With new products being launched daily and the hedge fund world innovating to deliver products to as many investors as possible, we will continually evaluate and update our list of recommendations.

It is quite clear that we believe alternative investment funds offer a tremendous opportunity for our clients,
however, as with anything, there are varying degrees of quality. While we believe there are many myths in the marketplace surrounding the risk associated with hedge funds, we are concerned about the viability of a very limited number of funds in Canada.

Our recommendations represent, what we believe to be the very best hedge funds available to Canadian investors. Due to the fact that this is a new asset class to many people we have conducted extensive due diligence to ensure these funds can and will deliver on their stated objectives.
Market Neutral Fund-of-Funds

Abria Diversified Arbitrage Trust

About Abria Financial Group:
Abria Financial Group was founded by Henry Kneis in 2000. Mr. Kneis founded the firm after leaving the position of CEO at Maple Partners. Over the course of his career Mr. Kneis has overseen the management of many alternative investment fund of fund products. Since taking over his first portfolio in 1987, Mr. Kneis has never experienced a down quarter.

Fund Overview:
The Abria Diversified Arbitrage Trust is a market neutral fund of funds that diversifies itself over several investment strategies and also by using multiple managers within each strategy. By investing in up to thirty different market neutral hedge managers the fund attempts to achieve rates of return that surpass the return of US T-Bills by 5-7%. The fund's management errs on the side of caution and diversifies risk over a number of arbitrage strategies including the use of convertibles, mortgage-backed securities, fixed income, equities and techniques using statistical, volatility and merger arbitrage.

The fund chooses not lever the portfolio at all, opting instead to allow the managers of the underlying fund to utilize their own amounts of leverage. As with any fund of fund portfolio, the importance of the manager is two-fold. The fund manager must first broadly allocate fund assets to a number of market neutral strategies. These strategies can include, merger arbitrage, fixed income arbitrage, statistical or volatility arbitrage or numerous others. Once the manager has made his broad allocations to each strategy, he must then allocate funds to individual managers within each arbitrage strategy. The fund managers extensive hedge fund and proprietary trading experience affords him excellent access to many discerning hedge fund managers, allowing the fund to invest with talented individuals with whom they could not invest individually.

The fund manager’s focus is on risk management. That being said, portfolios previously managed by Mr. Kneis have managed positive returns in times of extreme crisis. Through the stock market crash of 1987 to the Asian crisis in 1998, the fund manager’s portfolios demonstrated extreme resilience by posting positive returns over both time periods. To be considered for inclusion in the fund of funds, a portfolio must meet a strict quantitative screen, which evaluates funds on risk adjusted returns and correlation to other major asset classes.

Once a fund has passed Mr. Kneis’ quantitative assessments they are then subject to an extensive due diligence process and if selected are subject to periodic monitoring and constant scrutiny from the fund of fund manager. Mr. Kneis favours funds where the investment professional has commingled a significant amount of their own personal assets with those of fund investors.

The fund charges a fee of 1.95% for the management of the fund, which is in addition to the fees levied by the underlying managers within the fund of fund structure. The manager also receives a performance fee equal to 10% of the return of the fund and is subject to a high water mark.

Recommendation:
Henry Kneis started Abria after leaving Maple Partners where he spent many years running the Maple Key product. The fund offering from Abria encompasses much of the investment discipline that Henry instilled at Maple and benefits from his years of networking and due diligence with hedge fund managers. The product is migrating towards thirty underlying funds, a number Mr. Kneis believes is optimal.

While strategy allocations will change depending on Abria’s market outlook, the real feat for the fund is to avoid market catastrophes. Mr. Kneis’ track record, borrowed from Maple, and his current track record since 2000 with Abria is envious.

We believe that market neutral fund of funds can form the basis of any portfolio and that this is an excellent choice as a client’s fund of fund allocation.

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>1 Mth</th>
<th>3 Mth</th>
<th>6 Mth</th>
<th>YTD</th>
<th>1 Yr</th>
<th>2 Yr</th>
<th>3 Yr</th>
<th>4 Yr</th>
<th>5 Yr</th>
</tr>
</thead>
<tbody>
<tr>
<td>Abria Diversified Arbitrage Tr</td>
<td>0.3%</td>
<td>3.5%</td>
<td>4.7%</td>
<td>2.0%</td>
<td>7.7%</td>
<td>8.3%</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Maple Key

About Maple Financial:
Maple Financial is a privately held financial organization that was created due to the spin-off of First Marathon Inc.’s Financial Products Group in 1997. Many of the products and services provided including banking and trust services have been available since the group was founded as part of First Marathon in 1986. The firm has offices in Toronto, Jersey City, London, Frankfurt, Milan and Amsterdam and over $17 billion in assets.

Fund Overview:
The process employed by Maple Partners is, as with any market neutral fund of fund, very risk averse. While the fund aims to return 5-7% over treasuries, its main focus is on avoiding any disasters. Since, the strategy’s inception at Maple Partners, there has never been a single losing quarter.
The Private Client Services Committee begin by setting economic and market outlooks and evaluating fundamentals from the perspective of what strategies stand to benefit going forward. Once an overall, macroeconomic outlook has been decided, Maple utilize a number of proprietary and public databases to source managers. Managers that emerge from this process pass a fairly rigorous analytic filter which, among other things, tests the market neutrality of the fund candidate. Once market neutrality has been established the PCS Committee analyze the returns, alpha and volatility measure of the portfolio candidate and test their correlation to the broader market indices. Once the quantitative assessment has been concluded extensive due diligence is undertaken which includes on site visits and audits of the manager’s trading execution and hedging analysis.
Once potential candidates are qualified and identified, the PCS Committee then relies on its macro perspective to devise a portfolio that delivers on its return objectives while maintaining the volatility of a medium term government bond. Maple Key is available to investors with a minimum US$150,000 and charges a 1.5% management and a 10% performance fee of net new returns.

Recommendation:
Maple Financial may not be known to many Canadian investors however they have a tremendous track record offering financial services to high net worth Canadians and corporations. The Maple Key product is the jewel of their asset management business. Maple Key benefits from Maple’s expertise in proprietary trading as well as the tax advantaged structure afforded by a number of Maple Financial’s subsidiaries. Maple Key is managed by the Private Client Services Committee and has a track record dating back to 1986. The fund prides itself on being ‘long the event’. The fund aims to weather severe market downturns and invest in funds that can actually benefit from a negative market event.
We believe that market neutral fund of funds can form the basis of any portfolio and that this is an excellent choice as a client’s fund of fund allocation.
Univest II

About Norshield Financial Group:
Norshield Financial Group was founded in 1984 by John Xanthoudakis. The firm is taking a three-pronged approach to the alternative investment field, and through its overseas affiliates hopes to have $3 billion in assets by 2004. The firm aims to specialize in product creation, alternative investment consulting and hedge fund manager research.

Fund Overview:
The Univest II Fund is a market neutral fund of funds aiming to provide clients with positive returns through all market environments. The fund has created solid absolute returns with bond-like volatility over the current equity bear market. The fund’s investment philosophy is centered on the premise of weathering stock market and world political crises. Since the fund’s inception in April 1991 the fund has lost money in only 6 months with the average loss being only 0.42%. The fund manager’s investment process focuses on risk management through the use of a complex proprietary model that evaluates a number of criteria including monetary factors, technical indicators, sentiment and fundamentals. This model creates a clear output to help in the construction of the fund of fund portfolio by making recommendations for each underlying strategy such as capitalization bias and investment style and also the percentage exposure that is prudent for the strategy.

The fund chooses underlying managers that use little or no leverage, opting instead to apply leverage at the overall fund level. The fund managers believe that handling leverage at the fund level allows more risk control and also minimizes the potential for an underlying manager to have significant drawdowns.

The fund charges a 1.75% management fee and also takes a 10% performance fee of net new returns. These fees are in addition to those levied by underlying hedge managers. Few hedge fund of funds portfolios price weekly, however, to surmount this obstacle and to create more transparency the fund managers have engaged third-parties service providers to liaise with the prime brokers of their underlying managers to determine any change in values and then determine a Net Asset Value for the fund.

Recommendation:
The Univest II fund is a market neutral hedge fund of funds that offers investors the opportunity to participate in strong absolute returns regardless of the movement in equity markets. The fund benefits from Norshield Financial Group’s extensive process and allocation models and also the company’s dedication to fund manager research.

We believe that market neutral fund of funds can form the basis of any portfolio and that this is an excellent choice as a client’s fund of fund allocation.

<table>
<thead>
<tr>
<th>Fund Name</th>
<th>1 Mth</th>
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<th>YTD</th>
<th>1 Yr</th>
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<td>0.2%</td>
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Single Strategy Funds

Arrow Ascendant Arbitrage Trust/ Ascendant LP

About Arrow:
Arrow Hedge Inc. is a company that was founded by Jim McGovern, in December of 1999. Mr. McGovern is the former co-founder and CEO BPI Financial, a company that was purchased by CI Fund Management in August 1999. The goal of Arrow Hedge is to make alternative investment funds more accessible to retail and institutional investors in Canada by offering high quality managers who focus on risk management. Currently, the company and its sub-advisors manage in excess of $125 million in both single strategy and fund of fund products.

About Ascendant:
Ascendant Capital was founded by David Jarvis and Rick Kung in 1999. Mr. Jarvis is the former Senior Vice President and Director of Midland Walwyn’s derivatives group. After the merger with Merrill Lynch, he left the firm to become Vice President of the derivatives group at First Marathon Securities. Mr. Kung held a variety of positions at Merrill Lynch including serving as Vice President of the Capital Markets Risk Management Group. Ascendant Capital currently manages approximately $50 million in market neutral arbitrage strategies.

Merger arbitrage funds by definition are market neutral due to the fact that the investment process involves being long one company and short another in order to benefit from an arbitrage scenario. The fund’s risk arbitrage strategies have produced steady returns that are uncorrelated to major equity markets with volatility levels that are more in line with bond markets.

Fund Overview:
Investors in the fund benefit from the managers combined 30 years of investment experience whose strict adherence to their risk management programs, they hope, will lead to a targeted annual return of 10% net of all fees.

A typical risk arbitrage trade occurs after the announcement of one firm’s intention to acquire another. Once a deal is announced the fund managers will analyze the potential for deal failure. If there is little chance for failure the fund manager will short the shares of the acquiring company and buy the shares of the target company. The reckoning is that with an increased debt load related to an acquisition the purchasing firm’s shares will decrease, while the firm that is being acquired generally trades slightly below the announced share price until the deal is completed. Since the fund continues to be both dollar and market neutral the investors profit from the spread differential between the acquirer and the target.

The fund makes money on a trade in several scenarios. Should the price of the acquirer fall faster than the shares of the target, there is a positive spread. If the price of the target rises faster than the shares of the acquirer there is also a positive spread. In the case where a deal turns against the managers at Ascendant, they will terminate their positions before the arbitrage scenario reaches their maximum allowable drawdown of 2%.

While the fund does utilize leverage from time to time, it is generally only a financing facility if there is overlap from month to month on any particular deal. The success of the fund generally hinges on the robustness of the merger and acquisition market and the availability of deal flow. While the strategy seems quite simple, there is an immense amount of finesse that occurs in picking both entry and exit points and also the amount of capital to commit to a certain investment. There is also an intense importance on low fees and good pricing from the fund’s executing broker. The fees applied to the fund are a 2.25% MER plus a 20% performance fee.

Recommendation:
Despite a mergers and acquisitions environment that is arguably the worst in a generation, the fund has continued to eke out solid gains. Fund managers David Jarvis and Rick Kung have extensive risk arbitrage experience and are extremely well-known globally among arbitrageurs and brokerage houses.

While the number of deals is definitely below the norm and much lower than during the technology boom, Mr. Jarvis and Mr. Kung continue to find a number of opportunities through which they hope to add value to investors. Merger arbitrage is one of the most compelling single strategy hedge mandates due to its ability to generate significant returns with volatility that is more in line with a bond index. It’s market neutrality is also attractive in down markets as gains can be made using the strategy irrespective of market direction.

The risk associated with the Ascendant fund can be systematic, meaning a decrease in the frequency and quality of mergers and acquisitions or issue specific.
Mr. Kung and Mr. Jarvis have proven that the fund can generate returns in poor M&A environments and we believe that their deal analysis is extensive and thorough. In 2002, however, there was one instance where a portfolio holding sold out at the stop-loss due to Cardinal Health’s suspected fraud at Syncor – a company with which it had planned to merge. While there was no material fraud found at Syncor, the company sold off sharply due to the resignation and widespread accounts of fraud at Tenet Healthcare, invoking to stop-loss. While the fund management was proven correct a week later when the Cardinal Health deal closed at a renegotiated price the negative impact had already been locked in to portfolio returns. While this was an extremely unfortunate event we are comforted by the fact that no amount of due diligence could have foreseen such an event and that, ultimately, it was the market that overreacted. We continue to recommend this fund to investors who seek an equity product that can deliver stellar returns in a strong equity environment while protecting capital and indeed generating positive returns in bear markets.

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<tr>
<th>Fund Name</th>
<th>1 Mth</th>
<th>3 Mth</th>
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<td>2.0%</td>
<td>2.0%</td>
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**Arrow Goodwood Fund/ Goodwood Fund –Class B**

**About Arrow Hedge:**
Arrow Hedge Inc. is a company that was founded by Jim McGovern, in December of 1999. Mr. McGovern is the former co-founder and CEO of BPI Financial, a company that was purchased by CI Fund Management in August 1999. The goal of Arrow Hedge is to make alternative investment funds more accessible to retail and institutional investors in Canada by offering high quality managers who focus on risk management. Currently, the company and its sub-advisors manage in excess of $125 million in both single strategy and fund of fund products.

**About Goodwood:**
Goodwood Inc. is an asset management firm started by Peter Puccetti in October 1996. The company currently manages about $160 million in assets in long only and long/short mandates. The firm currently has six investment professionals applying Goodwood’s value investment style which tends to focus on smaller capitalization companies.

**Fund Overview:**
Goodwood employ a ‘bottom-up’ value approach that compares company fundamentals with its current valuation to determine whether a company should be purchased. Long positions in the fund will be undertaken in companies that, according to the fund management’s assessment, are trading at significant discounts to their intrinsic value. The intrinsic value is set by estimating the amount that a rational businessperson would pay for the company. The fund focuses its investment in large cap companies that have a history of solid earnings and strong operating efficiency that are trading at discounts to their intrinsic value. The second group of companies are small and medium sized businesses in high growth sectors whose value is generally ignored by investors. The fund also participates in corporate events such as mergers and acquisitions and will also purchase distressed securities if the values become compelling or an arbitrage opportunity exists.

Short positions in the fund are generally made in companies whose fundamentals are deteriorating and a turnaround is unlikely. Companies that tend to fall into this category have high levels of debt and are operating in a weakening business environment, while still having to make capital expenditures. At any given time the fund will hold between 20-25 holdings.

The fund charges a fee of 1.9% and a performance fee of 20% of net new returns.

**Recommendation:**
Goodwood’s investment management team are fundamental bottom-up value managers. In any market, value managers have distinct opinions on which companies are attractively valued and which companies are extremely overvalued. The hedge structure allows Goodwood the opportunity to short the companies that they feel are extremely overvalued or have declining fundamentals. This fund is a long/short equity fund that despite less than stellar performance in the short-term has created a tremendous amount of wealth for their investors over longer time periods. Peter Puccetti and Cam McDonald have had a tremendous amount of success uncovering hidden gems in the Canadian market that offer significant growth potential and low valuations. Their recent drawdowns can be partially explained by their preponderance to the long side. While the fund has the ability to short, both managers concede that it would take extraordinary circumstances to push the fund to a net short position. Goodwood’s concentrated portfolios intensify the discussion of single issue risk, however many of their long positions are trading at valuations that the managers consider compelling. Last summer was a particularly difficult time for the fund, with significant drawdowns in both July and August. A tactical error to take profits on their shorts at the beginning of July prior to a dismal month and the fact that several of their portfolio companies that are thinly traded came under selling pressure in August detracted from fund performance.

We believe that Goodwood should be viewed as a value fund that can short stocks. For investors who entered the fund over a year ago it has been a difficult time, however we believe that the fund management is able to deliver strong absolute performance going forward. We believe that adding a long/short equity fund to a portfolio makes a tremendous amount of sense as skilled investment managers with a sound approach can double their potential alpha when given the ability to short stocks.

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<td>-4.3%</td>
<td>-3.9%</td>
<td>-6.9%</td>
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<td>-20.0%</td>
<td>-1.7%</td>
<td>10.4%</td>
<td>20.8%</td>
<td>18.7%</td>
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<td>GoodWood Fund Class B</td>
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<td>-19.9%</td>
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<tr>
<td>Arrow Goodwood</td>
<td>-4.3%</td>
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<td>-7.2%</td>
<td>-2.1%</td>
<td>-20.5%</td>
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Horizons Mondiale Hedge Fund

About First Horizons:
First Horizons Capital Corporation was founded in 1987 and offers a number of sub-advised alternative investment funds. The company’s offerings are prospectused funds allowing purchases with a $5000 minimum. FHCC provide back office and sales support in the Canadian market for their sub-advisors.

About Mondiale Asset Management:
Mondiale Asset Management Ltd. is a Vancouver based firm that utilize a quantitative, trend-following approach to hedge fund management. Mondiale, currently comprised of three professionals and one support staff and currently manages CDN$140 million.

Fund Overview:
The Horizons Mondiale Hedge Fund employs a quantitative approach that admittedly is somewhat of a ‘black box’. The fund uses a proprietary quantitative strategy that involves trading foreign exchange, fixed income, equities and derivatives on world markets. The trading system was devised by the firm’s principals and is completely computer driven to eliminate human judgment and the potential for error in the investment process. The quantitative model follows short, medium and long-term trends in the market and also diversifies by strategy, asset class and by market. Short term strategies can be traded intra-day, while long term strategies can take a matter of weeks or months to come to fruition. Strategy diversification involves trading different strategies based on the same underlying asset or market. Due to the fact that shorter and longer-term trends can be divergent, it is possible to have different strategies enacted on the same market or security at the same time. Diversification by asset class reduces risk due to the fact that strategies based on the US equity market will generally have little correlation to strategies based on European currency markets. The final diversification is market level, which entails investing in the same type of asset across different markets. Each individual decision is backtested to determine its effectiveness over a number of different market cycles and final decisions are made in the context of the entire portfolio, not on a trade by trade basis. The risk measures also go further, by having predetermined stop-losses, exit and entry points on each trade. The overall goal of this portfolio is to preserve capital during market downturns and participate in robust equity markets. The fund managers charge a management fee of 2.5% and also receive a performance fee of 20% of new returns that surpass the Canadian T-bill rate. Due to its status as a prospectused investment, the fund is available with a minimum investment of $5000, but can only short up to 35% of its asset value.

Recommendation:
While we have never been tremendous fans of long-only portfolios that have utilized a quantitative trading approach, Mondiale Asset Management have been innovators in the quantitative investing field. Since the fund’s inception they have refined their model as the portfolio’s size has grown and their ability to gain exposure to a number of markets and asset classes has improved. The model is dynamic in the sense that the asset management team is always re-evaluating the models output and trying to find improvements to their trading strategies. The fund has generated excellent downside protection over the past three years due to their insistence on downside protection and the fact that the a downward trend was a common theme in equity markets. The fund’s lackluster performance in 1999 can be partially blamed on the fund’s lack of exposure to large cap equities, which drove performance. The fund was limited to small and mid cap markets over that time period because the capital necessary to participate in the S&P 500 was too great. Given the fund’s current size, fund management believe that the return in 1999 would have been in the 5-6% range. The risk for the fund’s trading strategy occurs if there is little trend persistence in the market. Should markets decline slowly with large intra-day swings, there would be very few trends that would emerge from the model and would lead to drawdowns. The markets that were seen in December of 2002 are an example of an environment that would be negative for fund performance.

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<thead>
<tr>
<th>Fund Name</th>
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<tr>
<td>Horizons Mondiale Hedge</td>
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<td>1.8%</td>
<td>7.8%</td>
<td>6.6%</td>
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</tr>
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</table>
SciVest Market Neutral Equity

About SciVest:
SciVest Capital Management began as the manager of the Quantum Aggressive Market Neutral Equity Fund in May, 2001. The fund, then offered by Maxxum Financial Services, was sold to fund manager John Schmitz in the fall of 2001 as Mackenzie Financial divested the fund from its lineup following its merger with Maxxum. Dr. Schmitz is the principal fund manager and President of SciVest Capital Management. He has an extensive academic background and has been the fund’s manager since inception.

Fund Overview:
The SciVest investment process begins with a size and liquidity screen that pare down the entire US and Canadian stock universe to about 3000 companies. This process ensures that small and illiquid companies are not included in the final portfolio and also makes the output from the quantitative model more manageable. Each of these companies is then ranked by SciVest’s proprietary quantitative model, which ranks companies based on an extensive number of factors which encompass valuation, financial stability and growth, price and earnings momentum indicators and technical analysis. There are also specialty models that take into account factors such as insider trading. This process ranks the companies from most attractive to least attractive. The portfolio management team then utilize a portfolio construction tool to select approximately 350 companies that will form the portfolio. The portfolio allocation model runs correlation numbers on each company and provides an optimal mix of both longs and shorts based on risk numbers and expected returns. Due to the fact that this process is quantitatively driven, there is no opportunity for style drift or portfolio management impropriety.

This fund is market neutral, meaning that it will always have a Beta equal to 0. This means that the market risk taken on by the portfolio’s long positions is offset by the portfolios short positions. This means that the fund should move independently of stock market movements. The model stresses buying quality companies and shorting poor quality companies, this creates a rather high turnover portfolio, which intensifies the importance of low transaction costs – an input for which the model also factors.

The fund charges a management fee of 2.5% and charges a 20% performance fee on net new gains over and above the Canadian T-Bill rate.

Recommendation:
John Schmitz’s model is currently focusing on quality companies while his shorts are generally firms with excessive amounts of debt. During certain times of euphoria poor quality companies rally and investors seek to participate by selling high quality assets. During short times of irrational exuberance the fund will underperform, as has been evidenced by single months of underperformance when the markets have rallied. In each case, the markets have given back these speculative gains and the SciVest portfolio has rise higher as levelheaded investors prevail.

The fund’s resilience over the recent bear market is a testament to Dr. Schmitz’s quantitative model. The market neutrality of this fund is also attractive as it eliminates the importance of stock market movements and intensely focuses on choosing the correct factors that will be rewarded by investors. It follows that given a broad decline in stock markets that if the fund’s shorts decline faster than the fund’s longs profits are still made for fund investors. We believe that adding a long/short equity fund to a portfolio makes a tremendous amount of sense as skilled investment managers with a sound approach can double their potential alpha when given the ability to short stocks.

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<tr>
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<tr>
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<td>US T-Bill Rate</td>
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<tr>
<td>Hurdle Rate</td>
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<td>T-Bill Rate</td>
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<td>3 months</td>
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<td>Arrow Goodwood Fund</td>
<td>Equity Long/Short</td>
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<td>Inception Date</td>
<td>29-Jun-01</td>
<td>01-Oct-96</td>
<td>01-May-01</td>
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<td>Mgmt Fee</td>
<td>2.25%</td>
<td>1.90%</td>
<td>2.50%</td>
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<td>Perf Fee</td>
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<td>Canadian T-Bill Rate</td>
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