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INVESTMENT BEHAVIOR OF GERMAN INVESTORS

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MODIFIED ENVIRONMENT ON THE CAPITAL MARKETS

Over the last three years, hedge funds have also become a topic of interest to investors in Germany. A multitude of institutional and private investors have invested in alternative investments; the majority of the funds have been allocated into hedge funds. What was the motivation behind this decision?

Concerning annual statements of income, personal insurance companies are in tough competition with e.g. life insurance companies. Due to declining equity markets and regressive interest rates, there has been pressure on the historical average excess return of 6-7% p.a. In order to reduce the return risks of the investments, diversification was a priority topic. Low volatility in combination with low correlation to classical investments in equities or bonds, as well as the option of absolute returns, perfectly fit with the obligations of pension funds and life insurance companies. Banks have also invested in hedge funds for reasons of diversification of existing investments and low needs for risk capital, often due to low Value at Risk.

Some companies, e.g. production firms, have been hesitant concerning hedge funds, certainly because liquidity is a priority here, and investments are often only part of cash management. Nevertheless, a number of companies have already incorporated funds of hedge funds into their strategic, long-term liquidity reserves, as well as in existing pension funds.

Private investors were used to high annual returns from the equity market within the 1990s. As these returns could no longer be generated over the last 2 to 3 years, investors were looking for alternative investment possibilities with a strong goal of tax-optimization. This was the start of the good times for funds of hedge funds; a multitude of alternative investment certificates was offered.

Generally speaking, a new modesty is appearing on the markets. Hedge fund returns have also lowered significantly over the last few months. Currently, the majority of funds of hedge fund products available in Germany has a return range of +/-3%. This is mostly due to a high allocation of equity related strategies of many products which showed a significant underperformance last year, as well as a significant fall of money market interest rates and high market volatility. The result was that many investors' return expectations were not met, but compared to other asset classes, no capital was lost, which means that capital preservation was maintained.

WHAT IS THE CURRENT REACTION OF INVESTORS TO THE MODIFIED ENVIRONMENT ON THE CAPITAL MARKETS AND THEIR FIRST EXPERIENCES WITH HEDGE FUND INVESTMENTS?

A number of investors are disappointed with the low returns of hedge funds and turn away from this investment possibility. At the same time, many investors face a dilemma. Equities are emotionally heavily burdened with high

losses, international interest rates are extremely low, which puts additional pressure on e.g. current returns on personal insurance companies or further reduces the after-tax yield of private investors. Furthermore, the rates of fixed-interest securities are at historical peaks.

This contributes to the danger of rebounds in case the escape into bonds ceases, e.g. due to stabilization of the political or world economic environment. Maybe we are currently experiencing a similar hyperbole on the interest rate side as we experienced on the equity side a few years ago – a highly liquidity-driven rate development. The pressure on returns is high, which pushes the duration risk. Coupons as a float have a tendency to be low which endangers the total return approach.

Given the dramatic developments of the capital markets and the resulting portfolio developments of many institutional investors, these investors are in the process of reconsidering their asset allocation. Many companies have produced asset liability studies, and had losses in their assessments of value or even hidden debits. This fact minimizes the options open to future capital investments. At the same time, the performance and competitive pressure on the insurance and financial services industries is aggravating. The players in this segment are also seeking asymmetric risk/return profiles.

A number of companies have therefore incorporated the topic of alternative investments and hedge funds into their strategic asset allocation, but only at a one-digit percentage. Following the first »test-investments«, exposure is being enlarged. Especially insurance companies and pension funds face regulatory restrictions, e.g. illegibility for investment in premium stock, »Öffnungsklausel«, etc. Especially for this group of investors, HVB Alternatives has introduced participating certificates as an innovative alternative.

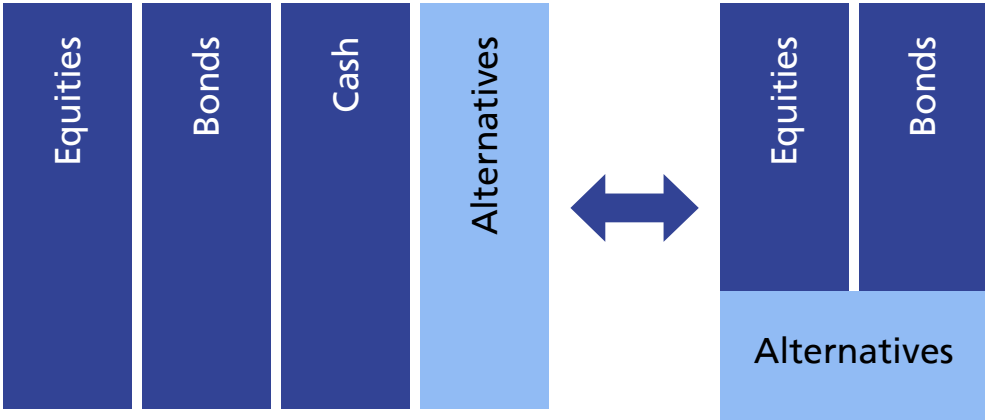
Due to the sometimes dramatic developments on the equity markets over the past few months, banks and insurance companies face two challenges: a) to generate the highest possible running returns, and b) to rebuild their reduced or exhausted reserves. In the past, running returns were mainly generated through reinvestments, reserves via equities.

Bonds are still used to generate running interest rates. However, also given the higher risks with interest rates, investors are looking for alternative, uncorrelated hedge fund portfolios. If the structure allows ongoing payouts, hedge fund products can serve as an interesting alternative to fixed-income securities.

Today, many institutional investors are also building up hedge fund exposures as an alternative to equity investments. Equity exposure has already been significantly reduced over the last years and/or is still being reduced. Investors hope to further improve the risk/return structure of their portfolio through

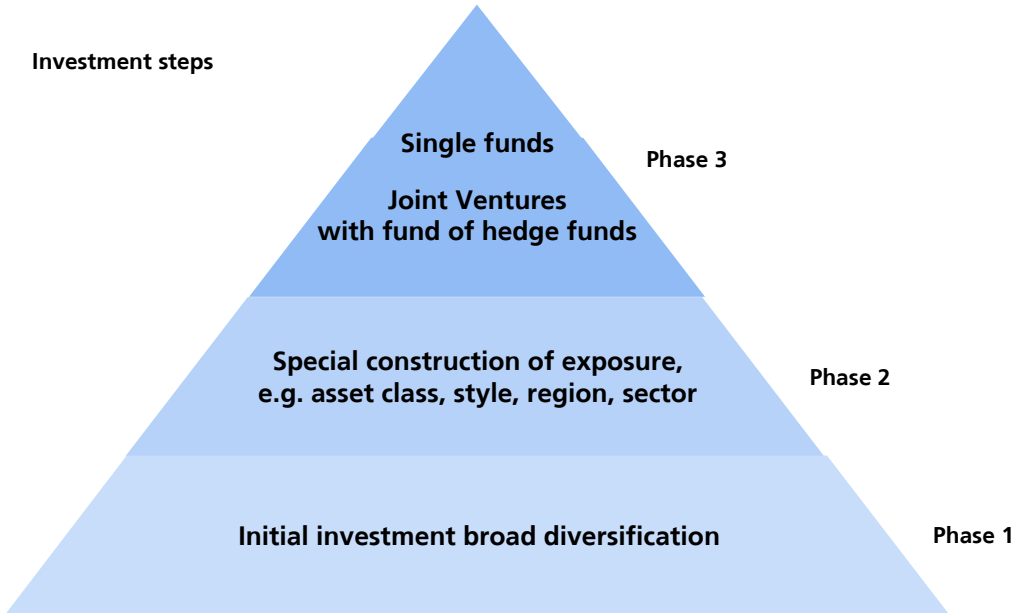
hedge fund investments. By the use of steady, uncorrelated developments reserves should possibly be rebuilt without any surprises on the balance sheet.

INCORPORATION OF HEDGE FUNDS INTO ASSET ALLOCATION



Basically, it depends on the view of the investor: does he see alternative investments/hedge funds as a separate asset class or as an overlay strategy for existing asset classes? If hedge funds are seen as a separate asset class, a pyramid development will be the target. If hedge funds are seen as an overlay strategy, target portfolios will be used from the beginning. In order to round off a portfolio of European equities, a European fund of hedge funds using equity-related strategies (e.g. Long/Short-Equity, Equity Market Neutral, etc.) can make sense.

HEDGE FUNDS AS A SEPARATE ASSET CLASS – PYRAMID DEVELOPMENT



On the first investment level, institutional investors mainly seek well-diversified, risk-reduced portfolios as test investment for new investors, or as a basis for hedge fund investments.

Many investors have already reached the second level of investment. Here, we mainly face the need for targeted exposures in addition to strategies or geographical regions. At this point, many investors are assessing their existing internal resources. Personnel is often being shifted to execute the manager selection and monitoring processes. This often comes along with the openly discussed Core Satellite approach. The majority is invested into passive, benchmark-oriented assets. The need for resources is lower, as the monitoring process mainly targets asset allocation. Personal resources are then needed in the satellites, such as hedge funds, Private Equity, Emerging Markets, etc.

Some investors are already on level three of hedge fund investments. This means consideration of investing in single funds, incubator hedge funds, setting up an internal fund of fund teams or investing in an existing fund of hedge funds.

REQUIREMENTS TO FUND OF HEDGE FUNDS

On the one hand, different risk/return profiles on a broad basis need to be considered. HVB Alternatives implements this through the Targeted Multistyle approach within the Non Directional, Balanced and Opportunity portfolios.

On the other hand, some investors are looking for specific exposures, e.g. a diversified, European Long/Short Equity portfolio as a mixture of a European equity portfolio or a widely diversified Asian hedge fund portfolio for the risk-adjusted construction of exposure to the Asian capital markets.

These requirements determine a high flexibility on the portfolio side, without abstaining from a structured and stable investment process. HVB Alternatives achieves these guidelines via a Luxembourg Master/Feeder structure, whereby the single hedge funds are embodied in Core Groups (optimized sub-portfolios). The allocation according to the desired exposure and risk/return profiles is executed at the Core level.

Some investors ask for leverage on this level. The use of leveraging outside funds on the fund of fund level has the advantage of easier control and higher flexibility in the choice of the credit supplier. It can be an advantage, if the investor himself delivers the leverage, e.g. in the form of a bond. These bonds can then be part of the interest portfolio governing the leverage costs. Considerations with regard to different risk ratios of hedge fund portfolios include hedge fund CFO structures, where institutional investors can invest according to their risk comfort level (across different rating classes).

Popular structuring possibilities for institutional investors are e.g. bearer bonds for banks (low impact on capital resources), with or without payout, and

capital-protected products or participating certificates, with and without payout, for insurance companies. Generally speaking, institutional investors will have higher demands in the future: what specific edge does the manager have?

How transparent and stringent is the investment process and the risk management? What type of market entry is open to the fund of hedge fund provider? How flexible is he concerning portfolio/structuring?

WHAT IS THE SPECIFIC STORY OF A PROVIDER?

We at HVB Alternatives are convinced that the hedge fund markets are subject to dramatic changes. In the past, manager selection was regarded as the main source of performance. Due to higher transparency and better risk management on the single fund level, correct fund selection has become a must. There are index trackers available at reasonable prices. But experience shows that hedge fund styles are also subject to cycles. These cycles can be used as an additional source of revenue within asset allocation. As an example, Event Driven strategies had a bad year in 2002, but CTAs or Short Only strategies had a good year.

HVB Alternatives generates a big portion of its returns via strategic asset allocation. The basis for this is the high quality of the analyst team and a cooperative agreement with GlobeOp on the quantitative side. GlobeOp offers a high level of transparency and analysis which we need for our risk management and our allocation decisions.

HEDGE FUND INVESTMENTS IN THE FIELD OF PRIVATE BANKING AND FAMILY OFFICES

Risk/return considerations instead of pure return considerations are getting more and more attention from private investors. Due to high losses resulting from equity investments, a large percentage of liquid assets is invested in money market related investments. In the medium term, these investors will once again be looking for higher returns and therefore will also take higher risks. Many investors have become highly risk-conscious and therefore avoid classical equity investments.

How can we explain such behavior? Looking at private investors, their main interest is to preserve capital. From this position they are looking to generate returns. This approach is quite different from that of investors who want to build up capital and therefore must also take higher risks. Hedge funds also have the primary goal of securing the invested capital, but with a focus on risk-adjusted investment decisions.

For this reason, particularly family offices in the US and Europe are investing in hedge funds. In the US, allocations of 30 to 50% are common. Family offices in Germany have also started to become interested in hedge funds.

In classical Private banking, there is currently a great interest in bonds or structured equity investments, e.g. with capital preservation. The German market has already seen the first wave of products, which are highly diversified index products with low target volatility. We expect a future demand for complementary products, especially for investors with a relative risk comfort level. These could be, for example, fund of hedge funds with a specific edge and higher return/volatility expectations. The general question is no longer whether to invest in hedge funds. It is much more about how to use hedge funds in order to stay flexible for changing environments or with changing requirements.

The market expects sophisticated products. We at HVB Alternatives implement this need with our Companion Product Family, which consists of the Companion Certificate as an alternative to interest rate investments, the Advanced Companion Certificate as a risk-adjusted alternative to equities, and the Dynamic Companion Certificate. In particular, the Dynamic Companion Certificate supports the targeted risk-adjusted construction of capital market exposure via hedge funds.

Through the use of the three different products, the investor can manage his portfolio in a flexible manner. The Companion Certificate represents a diversifying element in a conservative, highly bond-heavy portfolio. The Advanced Companion Certificate is a reasonable supplement in a mixed equity/bond portfolio, and the Dynamic Companion Certificate is a highly interesting mixture for a purely equity-oriented investor. Additionally, the investor can easily adapt to his respective risk requirements. In times of high volatility and when there is a strong need for security, a substantial allocation in the conservative Companion makes sense. With growing optimism, allocations to the Advanced or Dynamic Companion can be increased. This flexibility is only granted in case of continuous purchase possibilities.

SUMMARY

Especially due to the current tax environment, the need for new optimized investment possibilities is growing. Within the planned European liberalization concerning structuring and distribution of hedge fund products, many new applications are possible. The distribution of funds related to fund of hedge fund products might be possible in Germany by 2004, which could result in potential applications in existing fund of funds or unit-linked life insurances policies.

We expect future demand for hedge funds from both institutional and private investors to depend on the regulatory environment and investor behavior. This means that providers of fund of hedge fund products like HVB Alternatives will need to be extremely knowledgeable in the areas of allocation and structuring. In addition, high flexibility is required in order to incorporate client needs into their product range.