

A NOTE FROM OUR PRESIDENT

The volatility of today's markets has many investors a bit anxious about their investment portfolios. In anticipation of such volatile markets, we have been adding a broad range of asset classes to clients' portfolios, including international bonds and hedge funds, to help reduce overall portfolio risk. In this issue of the *Fiduciary Perspective*, our feature article focuses on hedge funds. The types of hedge funds we recommend, with their low correlation to equity and debt investments, are likely to reduce overall portfolio risk as well as enhance returns.

We hope you enjoy the spring issue of the *Fiduciary Perspective*. If you have any questions or feedback regarding this issue, please contact your investment officer or email us at perspective@fiduciary-trust.com.

Doug Smith-Petersen
President and CEO

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HEDGE FUNDS: AN OVERVIEW OF THIS ALTERNATIVE ASSET CLASS

What Are Hedge Funds?

Alfred Winslow Jones is widely credited with forming the first modern hedge fund in 1949. While working as a journalist at *Fortune* magazine, he authored an article titled "Fashions in Forecasting," reporting on a new class of stock market timers. In researching and writing the article, he came to the conclusion that he had a better system for managing money. The investment approach of Jones's novel fund was "hedging" his long stock positions by selling short other stocks (expecting them to decline in value) to limit market risk. The crucial question was not the direction of the market, but whether Jones had picked the right stocks to buy and sell.

As their name implies, hedge funds often seek to offset potential market losses by hedging their investments using a variety of methods. However, the term hedge fund now used in modern vernacular is applied to a wide range of investment strategies ranging from any low volatility, absolute-return oriented fund to highly concentrated, high volatility, high-return funds. Hedge funds are no longer a homogeneous asset class as first established by Jones, since many may now involve very little hedging.

While today there is no legal definition of hedge fund under U.S. securities laws, they are recognized by pension funds, banks, insurance companies and other sophisticated investors as a way to reduce portfolio volatility and potentially enhance

returns. Hedge funds are generally regarded as private investment vehicles and are typically organized as limited partnerships. The fund managers usually serve as the general partners and generally invest a portion of their own wealth in the partnership to align their economic interest with that of the limited partners (outside investors). While the investment strategies employed by hedge funds can vary greatly from fund to fund, there are traits that many hold in common. These include:

- ability to buy and sell virtually any type of security;
- ability to "short" securities;
- use of leverage (borrowing to increase the potential investment return); and
- use of derivative securities.

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FIRE BURN, AND CAULDRON BUBBLE - *Macbeth*, Act IV, Scene i

The sound you hear of bubbles bursting is not that from a fine champagne. Rather, it is the ugly sound of the debt markets contracting as balance sheets are de-leveraged. Only Shakespeare's Weird Sisters could capture the "toil and trouble" of these excesses being unwound. The breadth and depth of the problems continue to surprise investors.

The first quarter of 2008 ended with all of the pain and fear normally associated with a stock market bottom: the failure of a large financial institution, such as Bear Stearns; emergency actions by the Federal Reserve and Treasury taken in concert to rescue the institution; and Treasury arm-twisting to bring the government housing agencies Fannie Mae and Freddie Mac to the equity markets so they can bolster their balance sheets and ultimately take on troubled mortgages from the debt markets. All in all, the government, whether it was the Federal Reserve, the Treasury Department or the agencies, has been and will be very active in reducing the financial system's indebtedness.

But have we actually reached the bottom of this stock market correction?

The U.S. stock market has indeed been punished. As of mid-March, the S&P 500 was down almost 12% from the beginning of the year. Technicians are excited that the March lows match the lows of January, thereby describing a "double bottom." This can be seen on the accompanying graph of the S&P 500 for the first three months of 2008. Insider activity shows strong buying as the market bottomed out, suggesting that insiders see value in their companies' stock at these prices. Investor attitudes had become so bearish that all of the bulls were in hiding. Market historians see the active and creative role by the Fed and Treasury as lenders of last resort who have finally taken out their toolboxes to fix the financial system. These events all tend to happen at market bottoms.

Indeed, this may be a market bottom. But we believe that the overall correction is not done. Bear market rallies, such as we see at the end of this quarter, can be powerful and breathtaking. Ultimately they fizzle out as we are reminded of the poor underlying prospects of economic growth. We are due for a rally, but we believe it will be short-lived.

S&P 500 Index first-quarter performance; daily closes



The credit market problems continue to expand outward, like the ripples on a still pond when disturbed by a tossed pebble. We see further signs of dislocation in the mortgage markets as well as in other asset-backed securities markets. Housing prices continue to fall as inventories of unsold homes grow. High-yield bonds continue to deteriorate as their corporate issuers feel the pain of an economic slowdown. We expect further deterioration in corporate balance sheets as profit margins compress and asset values are written down. All of these trends will, we believe, mean further difficulties for corporations and individuals both here and abroad.

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NEWS AND NOTES

FIRE BURN, AND CAULDRON BUBBLE

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The dollar has become the handmaiden of our economic distress—falling along with our stock market. It is important to note that, as our Federal Reserve and Treasury officials have flexed their might to correct our financial system, the dollar bears have retreated and the dollar has strengthened. This dollar rally may only be a temporary reprieve and may be as ephemeral as the equity rally until the underlying credit market malaise can finally be resolved.

MARKET HISTORIANS SEE THE ACTIVE AND CREATIVE ROLE BY THE FED AND TREASURY AS LENDERS OF LAST RESORT WHO HAVE FINALLY TAKEN OUT THEIR TOOLBOXES TO FIX THE FINANCIAL SYSTEM. THESE EVENTS ALL TEND TO HAPPEN AT MARKET BOTTOMS.

This is still no time for heroics. The crosscurrents are too confused and misleading to safely navigate these waters by buying into this rally. The market's volatility is so great just now that it is difficult to discern a meaningful trend due to all of the background market "noise." Too many previous excesses have yet to be wrung from the economy and the financial system. Indeed, a recession's role in the economic cycle is to help rid the economy of just these excesses as the economic growth slows and contracts. At that point, the high levels of debt can no longer be carried. Companies and individuals assess which commitments are most important and discard those initiatives which no longer can be justified. Once these excesses are removed, inevitably through painful market sell-offs, it will be time to recommit capital and invest in the stock market again. Until then, we continue to see short-term municipals, cash and defensive alternative assets as our safe harbor.

○ | **Increased security for our PrivateView™ users**

As part of our commitment to provide our online clients the best protection possible for their confidential data, we will add an additional layer of security during the second quarter. Fiduciary clients who currently use PrivateView™, our proprietary online account access tool, will be prompted the first time they log in from their computer to provide answers to questions that only they would know. Going forward, this step will not be necessary unless log-in is attempted from a different computer. Additional information will be provided prior to the launch of this new security initiative.

○ | **As seen in the Wall Street Transcript**

Chris White, Vice President and Chief Investment Officer at Fiduciary Trust, was recently interviewed by the *Wall Street Transcript*. Mr. White's interview was included in the Money Manager Interview section of the publication's March 10th edition. The interview presents an interesting history of our firm and highlights some key differentiators that make us unique from other wealth management providers. Mr. White provides an in-depth look at our investment process, including asset allocation, risk reduction and stock selection, and outlines how we construct customized portfolios for clients utilizing a broad array of asset classes and top-tier external managers. The article has been sent to our clients and can also be found on our web site at www.fiduciary-trust.com.

○ | **Renovation project on schedule**

As reported in our last issue of the *Fiduciary Perspective*, renovations to the 16th and 17th floors of our building began on February 25. New design elements to the 16th floor include our new reception area with two new adjacent conference rooms, which will offer clients and visitors comfortable seating and meeting space with attractive views of Boston Harbor.

Most investment officers are now located in temporary offices on the 5th floor of the building. We expect that the newly renovated space will be ready for occupancy in early June. Next steps will be the renovation of the 15th floor, where our operations and technology groups are located.

We thank all of our clients for their patience during our renovations.

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Two common misnomers that surround hedge funds are: (1) they are all high risk and (2) they all implement overly complex “black box” investment strategies. It is important both to remember that hedge funds come in many different flavors and to understand each strategy’s risk and return parameters.

Recently hedge funds have begun to be offered as mutual funds, making them available to a larger group of investors. Increased competition between fund managers to attract investment dollars has led to a gradual decrease in fees for hedge fund mutual funds and for some of the fund-of-fund hedge funds as well. Like all mutual funds, hedge fund mutual funds are regulated by the U.S. Securities and Exchange Commission with all of the transparency and reporting that are required. Currently, mutual funds are the primary hedge fund structure that we use.

WHY INVEST IN HEDGE FUNDS?

Historically, hedge funds have successfully met several criteria for inclusion in a diversified portfolio:

- high risk-adjusted return when compared to public equity and bond markets;
- low correlation with other traditional investments; and
- access to a broader set of financial instruments and managers.

A wide range of investment strategies is utilized by hedge funds. The hedge fund universe can be divided into two broad categories based on the strategies employed. The first is referred to as non-directional (often called absolute return). This category of strategies benefits from being non-correlated to the general direction of market movements. In contrast the second category, directional hedge funds, accept at least some degree of exposure or correlation to market movements.

HOW DOES FIDUCIARY APPROACH HEDGE FUND INVESTING?

Our ultimate goal is to allocate client portfolios to hedge fund strategies that will provide a compelling trade-off between risk (volatility) and return while exhibiting low correlation to traditional stocks and bonds. We begin by constructing a diversified hedge fund portfolio for our clients. To this end, a large percentage of our hedge fund exposure is accomplished via a diversified absolute return fund-of-funds. This “core” strategy is complemented by additional (“bolt-on”) strategies that are more focused in nature and strive to provide greater expected returns. Our goal is to gain complementary exposure to hedge funds, thereby diversifying within this alternative asset class.

We look beyond the headlines that have given hedge funds a bad name and realize these funds, like any other investment strategy, are as good as the individuals operating them. Therefore, evaluating and researching the character and history of the fund manager is of paramount importance. The vast majority of hedge fund failures revolve around two common themes: operational or business risk and the degree of leverage employed. Our due diligence process addresses these concerns.

In summary, the hedge fund strategies we employ in client portfolios typically have:

- high degrees of transparency;
- limited or no leverage;
- significant operational infrastructures;
- sound, articulated business plans;
- limited use of esoteric or illiquid securities; and
- managers with significant personal investment in their funds.

Our goal at Fiduciary is to build portfolios that demonstrate improved levels of return for lower levels of risk. Our research has shown that a properly structured portfolio that holds both absolute return and directional hedge funds is much more compelling than a traditional stock and bond portfolio. The end result is a portfolio that has provided superior risk-adjusted returns during virtually all market environments.