
GUIDE TO INVESTING IN HEDGE FUNDS AT SOPHIA CAPITAL SECURITIES



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Before you buy an investment, it is important to review your financial situation, investment objectives, risk tolerance, time horizon, diversification needs and need for liquidity with your Financial Advisor. This guide will help you better understand the features and costs associated with hedge fund and fund of hedge funds investments, as well as how Sophia Capital Securities is compensated when you invest in these products.

WHAT IS A HEDGE FUND?

There is no exact definition of the term “hedge fund” in federal or state securities laws. Hedge funds are basically private investment pools for wealthy, financially sophisticated investors. Traditionally, they have been organized as partnerships, with the general partner (or managing member) managing the fund’s portfolio, making investment decisions, and, typically, investing personally in the fund.

Hedge fund managers generally seek to target a specific range of performance and attempt to produce targeted returns irrespective of the underlying trends of the stock market. In an attempt to achieve this performance, hedge fund managers typically use sophisticated investment strategies and techniques that are described in detail below.

Because they are generally open only to limited numbers of wealthy, financially sophisticated investors and do not advertise or publicly offer their securities, private hedge funds are usually not required to register with the SEC. As a result, unregistered private hedge funds do not provide many of the investor protections that apply to registered investment products.

Investors should keep in mind that alternative investments such as hedge funds are speculative, involve a high degree of risk, may have substantial charges, and are suitable only for the investment of the high-risk capital portion of an investor’s portfolio.

WHAT IS A FUND OF HEDGE FUNDS?

Funds of hedge funds, also known as Funds of Funds, are pooled investments in several unregistered hedge funds. Unlike the underlying private hedge funds, the fund of funds itself can register with the United States Securities and Exchange Commission (SEC) under the Investment Company Act of 1940. In addition, the fund of funds’ securities also can be registered for sale to the public under the Securities Act of 1933. Registered funds of funds can have lower minimum investments than private hedge funds (some as low as \$25,000). A registered fund of hedge funds can be offered to an unlimited number of investors. However, there is no investor right of redemption — shares cannot be redeemed directly with the fund unless the fund offers to redeem them. Nor are the shares usually listed on a securities exchange. With very limited exceptions, there is no secondary market available, so you won’t be able to sell your investment readily.

Although funds of hedge funds have been made available to more investors due to the lower minimum investments, it is important to note that these investment vehicles are not suitable for all clients.

An investment in a fund of hedge funds does have some potential advantages over a direct investment in a private hedge fund. For example, a fund of funds may diversify between a number of different investment styles, strategies and hedge fund managers, in an effort to control risk.

WHAT IS AN OFFSHORE HEDGE FUND?

Hedge funds not organized under U.S. law and domiciled outside the U.S. are designated as “offshore hedge funds”. These funds are not registered with the SEC and, like other offshore products, offshore hedge funds cannot generally be sold to U.S. residents or offered to any persons while they are in the United States.

Additionally, not all funds are authorized for sale in all countries. Offshore Funds may be structured as an individual fund or a fund of funds and generally involve the same risks, trading strategies, and characteristics as their domestic counterparts.

Offshore hedge funds are not subject to U.S. income taxes on distributions received from the fund or to U.S. estate taxes on fund shares. Generally, offshore hedge funds are exempt from withholding taxes as well because the funds are located outside the United States. Because of the nature of the U.S. tax and securities laws, non-U.S. investors may not want to invest in hedge funds that are based in the United States if offshore hedge funds are available to them.

In certain, limited circumstances, offshore funds may be purchased by qualified U.S. Tax-Exempt Entities or Persons. Tax-Exempt Entities or Persons are urged to consult their tax advisors concerning their ability to invest in an offshore fund as well as regarding any potential tax consequences.

FEATURES AND BENEFITS

“ABSOLUTE” RETURNS

Most hedge funds and funds of hedge funds seek to achieve positive or “absolute” returns in any market (rather than strive to merely beat a market index). It is important to note that in seeking “absolute” returns, hedge funds and funds of hedge funds may use sophisticated and high risk investment strategies such as arbitrage, or investing in volatile international markets or single issuer securities.

LOW CORRELATION TO TRADITIONAL ASSET CLASSES

Hedge funds and funds of hedge funds also attempt to use these sophisticated high-risk investment strategies to provide returns independent of (i.e., or not correlated to) traditional asset classes.

POTENTIALLY LOWER VOLATILITY

Many hedge funds actually strive to “hedge” risk. Since hedge funds generally have low correlations to traditional investments, such as stocks and bonds, they may reduce the overall volatility of a portfolio that includes traditional investments.

RISKS

UNREGISTERED INVESTMENTS

Most hedge fund managers and funds of hedge funds are unregistered with the SEC. A fund not registered with the SEC is therefore subject to less regulatory oversight. Funds of hedge funds generally invest in

several private hedge funds that are not subject to the SEC’s registration and disclosure requirements. Consequently, unregistered investments have less regulatory oversight, and may offer less investor protection. This makes it difficult for both you and the fund of funds manager to assess the performance of the underlying hedge funds or independently verify information that is reported. All of this can make it easier for an unscrupulous hedge fund manager to engage in fraud.

RISKY INVESTMENT STRATEGIES

Hedge funds very often use speculative investment and trading strategies which may involve a high degree of risk. Some hedge funds or funds of hedge funds have low volatility compared to the stock markets or in some cases the bond markets. This may lead some investors to mistake hedge funds for “risk free” or “safe” investments. Investing in hedge funds or funds of hedge funds involves inherent risk and performance can be highly volatile.

To achieve positive investment performance, hedge fund managers use sophisticated investment strategies and techniques such as short selling, arbitrage, hedging, and leverage. Furthermore managers may invest heavily in concentrated positions of a single issuer or market, distressed and bankrupt companies, derivatives such as options and futures contracts, volatile international markets, and privately issued securities. Many hedge funds are managed appropriately and balance a high risk of capital loss with a high potential for capital growth. Please review the section on hedge fund strategies at the end of this document for additional illustrations of the main hedge fund investment styles. Due to the strategies (and inherent risks) hedge funds may employ, you may lose your entire investment. If you can’t afford to lose your entire investment, hedge funds and funds of hedge funds are not suitable for you.

LACK OF LIQUIDITY

Hedge funds, whether registered or unregistered, are illiquid investments and are subject to restrictions on transferability and resale. Almost all hedge funds and funds of hedge funds restrict liquidity to monthly, quarterly, semi-annual or annual intervals. Funds of funds also typically require a ‘redemption notice,’ often as much as 6-8 weeks in advance of the desired redemption date. There are no specific rules on hedge fund pricing. Registered hedge fund units may not be

redeemable at the investor's option as no secondary market exists for the sale of the hedge fund units and none is expected to develop. In other words, you may not be able to get the money you invested in the hedge fund back when you want to liquidate the investment.

MANAGER RISK

The hedge fund manager has total trading authority over the fund. The use of a single advisor applying generally similar trading programs could mean lack of diversification, and consequently, higher risk. Furthermore, most single hedge funds are founded by an individual or partners. It is solely the manager's skill that is responsible for returns for these funds. If the founder or key person departs, the hedge fund returns may be impacted.

You or your Financial Advisor have no control or power in the management of the fund, although you will receive periodic reports from the fund manager. The fund may not always provide all the information as requested by you because certain information may be considered proprietary or otherwise confidential. This lack of information may make it more difficult for you to evaluate the risk of the fund.

TAXES

Generally hedge fund investors are subject to income taxes on the interest, dividends and / or capital gains distributed to them from the fund. However, in retirement accounts such as IRAs, taxes are deferred until distributions are taken from the account.

Hedge funds may produce Unrelated Business Taxable Income (UBTI), which may subject a tax-exempt investor, such as a retirement plan, IRA, foundation or endowment, to taxation. In instances where tax-sensitive funds are available for tax-exempt investors, you are encouraged to consider the potential advantages of utilizing such a fund for a hedge fund allocation. Please consult your tax advisor to consider the potential impact of UBTI.

Hedge funds and funds of hedge funds are highly tax inefficient vehicles and you should analyze the tax consequences before making an investment. There are a number of adverse tax consequences that should be taken into account when considering an investment in hedge funds or funds of hedge funds.

Most hedge funds and funds of hedge funds are organized as Limited Partnerships or Limited Liability Companies. Because of their structures a 'pass-through taxation' strategy is achieved. All domestic hedge funds and funds of hedge funds send Form K-1 tax statements to the investors that are typically issued later than 1099s. As a result of complex tax-reporting requirements, and since Sophia Capital Securities is not a tax and/or legal advisor, investors should consult with their tax advisor or attorney prior to investing in hedge funds.

COSTS OF INVESTING IN HEDGE FUNDS

Expenses in hedge funds are significantly higher than many other traditional investment vehicles. There are no limits on the fees a hedge fund can charge its investors. There are several types of fees and charges in hedge funds and funds of hedge funds. You need to understand these expenses before investing. Costs will reduce the value of your total investment and your return.

All expenses are disclosed in the hedge fund offering documents and you should be aware of these expenses. The expenses include, but are not limited to:

PERFORMANCE FEE

Most hedge funds charge a performance-based fee. This fee is usually a fixed percentage of the performance results. For example:

If the hedge fund manager returned 10% (net of management fee) in the first year, and the performance fee is 20% of new profits, the performance fee would be 2% (20% of the 10% return above the high watermark, which is the previous point of performance measurement), resulting in a net return of 8%. A performance fee could motivate a hedge fund manager to take greater risks in the hope of generating a larger return.

PLACEMENT FEE

The placement fee is a front-end sales charge paid to the placement agent, which in turn may pay a portion of those fees to affiliated or unaffiliated registered broker-dealers or other entities involved in the offer and sale of the hedge fund interests. Sophia Capital Securities is compensated by a placement fee.

MANAGEMENT FEE

Investors are charged an annual management fee on the value of their investment. This fee is the cost of having a hedge fund manager making the investment decisions for you. Typically, the hedge fund manager receives a fee of 1 or 2 percent of net assets.

TRANSACTION AND ADMINISTRATIVE EXPENSES

As a limited partner, investors are charged a pro-rata share of all transaction and administrative expenses incurred by the fund. In addition to the fees outlined in the offering documents, Sophia Capital Securities may charge a nominal transaction fee.

COSTS OF INVESTING IN FUNDS OF HEDGE FUNDS

In addition to the expenses incurred by the underlying hedge funds, investors in Funds of Hedge Funds also pay an additional layer of placement fee, advisory fee, performance fee and a pro-rata share of the fund's expenses. These two layers of fees can be expensive and you should analyze the added cost against the benefit of diversification obtained by investing in funds of hedge funds.

INVESTOR CHARACTERISTICS

SUITABILITY REQUIREMENTS

Hedge funds are not suitable for all investors. Prospective investors are required to meet minimum financial eligibility guidelines to invest in hedge funds or funds of hedge funds. You should evaluate your individual financial condition and your ability to tolerate risk before you invest in hedge funds.

SEC guidelines require that U.S. individual investors have at least \$1.5 million total net worth in order to invest in a registered hedge fund. U.S. entities should have at least \$5 million in investable assets.

Federal Securities law defines an Accredited U.S. Individual Investor as an individual with at least \$1 million in individual or joint net worth or individual annual income of at least \$200,000 or combined annual income of at least \$300,000 for the past two calendar years with the reasonable expectation that

the income will continue in the current calendar year. An Accredited U.S. Institutional Investor should have at least \$5 million in investable assets.

Federal Securities law defines a Qualified Investor as an individual with at least \$5 million in investable assets and other entities (corporations, foundations, etc.) with at least \$25 million in investable assets.

In the case of offshore hedge funds and other unregistered funds, the financial eligibility requirements may be lower than those listed above but investors still must be capable of tolerating the risk involved with the investment including the potential loss of their entire investment.

DIVERSIFICATION

Sophia Capital Securities believes that investors should diversify their investments. It is recommended that investors observe an asset allocation strategy and not overweight their overall portfolio in any one class of securities, in particular hedge funds. Although asset allocation can be an effective investment strategy it cannot eliminate the risk of fluctuating prices and uncertain returns.

HOW IS SOPHIA CAPITAL SECURITIES, L.P. PAID ON HEDGE FUNDS AND FUNDS OF HEDGE FUNDS?

For helping you invest in the most appropriate funds, Sophia Capital Securities is compensated in ways that vary depending on the selected investment. Funds pay Sophia Capital Securities from the fees paid by you. For most purchases, Sophia Capital Securities' compensation is also based on the sales concession that is set by the funds and described in the offering documents.

The compensation formula that determines the amount of payment to Sophia Capital Securities is generally the same for all funds. However, some funds may carry higher sales charges than others, and that may create an incentive for Sophia Capital Securities to recommend such funds. Typically, registered funds have higher upfront sales charges and lower investment minimums than unregistered funds, due to the costs associated with filing the registration statement.

SOPHIA CAPITAL SECURITIES' RELATIONSHIPS WITH HEDGE FUND SPONSORS

At Sophia Capital Securities, we receive payments from some of the companies whose hedge funds we offer. These payments may be used to pay for training, educational conferences, meetings for our clients or prospective clients, as well as for conducting due diligence on the funds. The payments also provide marketing support, which is usually calculated as a percentage of fund sales or assets.

These arrangements do not affect your sales charge. Hedge fund policies can be found in a fund's Offering Document, which is available on request from the hedge fund company. Hedge fund sponsors, Absolute Capital Management and Globalvest Management Company, paid Sophia Capital Securities in 2005 for marketing and/or other service fees. For an updated list, see www.Sophia-Capital.com. If you have any questions about these practices, please contact Sophia Capital Securities.

OTHER HEDGE FUND RELATIONSHIPS

Sophia Capital Securities provides a range of financial services to various hedge fund companies through its subsidiaries and affiliates. These other relationships provide financial and other benefits to Sophia Capital Securities. As part of these relationships:

Sophia Capital provides investment management and other services to the Sophia Hedge Strategies family of hedge funds. The Sophia Hedge Strategies funds (as well as other unaffiliated hedge funds) are distributed through Sophia Capital Securities.

HEDGE FUND STRATEGIES EXPLAINED

There are many different ways to classify the investment strategies of hedge fund managers. Moreover, some managers combine several strategies in what is often referred to as "multi-strategy funds". The list below illustrates the four major categories and sub-categories of investment strategies.

I. RELATIVE VALUE

1. Convertible Arbitrage

In general, the strategy entails purchasing a convertible bond while simultaneously hedging a portion of the equity risk by selling short the underlying common stock. Certain managers may also seek to hedge interest rate exposure by selling Treasuries. The strategy generally benefits from three different sources: interest earned on the cash resulting from the short sales of equities, coupon offered by the bond component of the convertible and the so-called "gamma effect". The last component results from the change in volatility of the underlying equity and involves frequent trading. This strategy is often leveraged in order to enhance returns.

2. Fixed Income Arbitrage

This strategy seeks profits by exploiting the pricing inefficiencies between related fixed-income securities while often neutralizing exposure to interest rate risk. This strategy is often leveraged in order to enhance returns.

3. Statistical Arbitrage

Managers using this strategy attempt to benefit from pricing inefficiencies that are identified using mathematical models. Statistical arbitrage strategies are based on the premise that prices will return to their historical norms. These strategies are often leveraged in order to enhance returns.

II. EVENT-DRIVEN

1. Merger Arbitrage

Also known as risk arbitrage, this strategy invests in merger situations. The classic merger arbitrage strategy consists of being long on the stock of the target company while simultaneously selling short the stock of the acquiring company.

2. Distressed Securities

This investment strategy generally consists of buying securities of companies in bankruptcy proceedings and/or in the process of restructuring the debt portion of their balance sheets. The complexity of such

operations often creates mispricing opportunities, hence high potential returns.

3. *Special Situations*

Also known as corporate life cycle, this strategy focuses on opportunities created by significant transactional events, such as division spin-offs, mergers, acquisitions, bankruptcies, reorganizations, share buybacks, and management changes.

III. LONG/SHORT EQUITY

1. *Growth/Value/Industry/Geographical/Capitalization*

This style accounts for the majority of the strategies used by hedge fund managers today. This directional strategy combines both long and short positions in stocks. The net market exposure is adjusted opportunistically. The manager can diversify holdings across different industries, countries, market capitalizations, etc...

2. *Market Neutral*

This strategy is designed to exploit inefficiencies in the equity market by trying to remove the element of systematic risk while extracting the stock-specific returns. These portfolios minimize market risk by being simultaneously long and short on stocks having different characteristics.

3. *Short Sellers*

The short selling approach seeks to profit from declines in the value of stocks. The strategy consists of borrowing a stock and selling it on the market with the intention of buying it back later at a lower price. By selling the stock short, the seller receives interest on the cash proceeds resulting from the sale. If the stock advances, the short seller takes a loss when buying it back to return to the lender.

IV. OPPORTUNISTIC

1. *Macro*

Macro managers make in-depth analyses of macro-economic trends and formulate their investment strategy based on these, taking out positions on the fixed income, currency and equity markets through either direct investments or futures and other derivative products.

2. *CTA*

CTA is the acronym for Commodity Trading Advisor and is also known as Managed Futures. This strategy essentially invests in futures contracts on financial, commodity, and currency markets around the world. Trading decisions are often based on proprietary quantitative models and technical analysis. These portfolios have embedded leverage through the derivative contracts employed.

To learn more about hedge funds and/or funds of hedge funds, ask your Financial Advisor or visit the following websites:

- Sophia Capital Securities — www.Sophia-Capital.com
- National Association of Securities Dealers — www.nasd.com
- Securities and Exchange Commission — www.sec.gov
- Securities Industry Association — www.sia.com

Hedge funds are speculative investments and are not suitable for all investors, nor do they represent a complete investment program. The funds are usually open to qualified investors who are comfortable with the substantial risks associated with investing in hedge funds. For a more complete description of the risks associated with any hedge fund investment, please read the Private Placement Memorandum or consult your Financial Advisor. This document is not an invitation to subscribe for shares in any fund and is intended for information purposes only.

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Hedge Funds: Risk Warning: The funds are unregistered private investment funds, or pools, which employ different investment, hedging, leverage and arbitrage methodologies, with exposure to many different securities and futures markets, are not subject to the same regulatory requirements as mutual funds or unit trusts, including mutual fund / unit trust requirements to provide certain periodic and standardized pricing and valuation information to their investors.

Readers should note the following:

- † The funds represent speculative investments and involve a high degree of risk;
- † An investor could lose all or a substantial portion of his/her investment;
- † Any investment in the funds should be discretionary capital set aside strictly for speculative purposes;
- † An investment in a fund is not suitable for all investors;
- † The funds may be leveraged and a fund's performance can be volatile;
- † Fund managers have total trading authority over their funds;
- † Some funds may use a single advisor or employ a single strategy, which could mean a lack of diversification and higher risk;
- † Some funds may execute a substantial portion of trades on foreign exchanges, which could mean higher risk;
- † An investment in the funds may be illiquid and there are significant restrictions on transferring interests in a fund;
- † There is no secondary market for an investor's investment in a fund and none is expected to develop;
- † A fund's fees and expenses -which may be substantial regardless of any positive return- will offset the fund's trading profits;
- † Hedge fund fees are higher than fees for mutual funds;
- † Some funds may involve complex tax structures and delays in distributing important tax information;

This summary is not a complete list of the risks and other important disclosures involved in investing in the funds and is subject to the more complete disclosures contained in the funds' respective offering documents, which should be reviewed carefully.

All performance information is net of applicable fees unless otherwise specifically noted. This material is provided for informational purposes only as of the date hereof and is subject to change without notice. Sophia is compensated for finding investors for the funds. This material may not be suitable for all investors and is not intended to be an offer, or the solicitation of any offer, to buy or sell any securities. No offer or solicitation may be made prior to the delivery of appropriate offering documents to qualified investors. The information contained herein, including investment returns, valuations, fund targets and strategies, has been supplied by the funds or their agents to Sophia and, although believed to be reliable, has not been independently verified and cannot be guaranteed. Sophia makes no representations or warranties as to the accuracy or completeness of such information. Sophia does not perform "due diligence" on clients' behalf, and is

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Sophia Capital Securities is a registered broker-dealer, member NASD, SIPC.

