

## Funds-of-Funds Issues and Administration

### Background

Funds-of-funds (FOFs) comprise an important and growing component of the hedge fund industry. On the one hand, they provide valuable diversification for investors; on the other, they have become a significant source of capital for “normal” hedge funds. This discussion is a brief description of APM processes and procedures that relate to the nuances of FOFs.

APM has been administering FOFs for more than 20 years. Although APM now is solely an administrator, we have a broad and historical perspective on the business, having started and managed hedge funds in the early 1980’s, plus having formed one of the first dozen or so domestic FOFs in 1985.

### General

A FOF can, in some regards, be thought of as simpler than a “normal” hedge fund, and in some ways is more complex. What makes a FOF simpler? Primarily, there is no portfolio accounting at the administrator’s level. If broker reporting is problematic due to frequent trade errors or high turnover, there are almost inevitable problems getting final portfolio valuations on a timely basis and getting them to reconcile for audit purposes. However, a FOF eliminates that problem – unless the FOF also uses managed accounts as well as hedge fund investments.

What makes a FOF more complex? The additional complexity comes from managing the information flow from perhaps dozens of different underlying managers, each of whom may have a different quality and timing for reporting. This is a monthly challenge, which can become acute during tax and audit season.

### Information Flow

APM arranges for the underlying managers of the FOF to report directly to us, not via the FOF manager. This requirement assures that our performance and capital calculations are independent, which, in turn, enhances the credibility of the FOF reports.

Once APM is engaged, the APM FOF administration team will email a letter to the fund’s underlying managers introducing APM as an administrator. The letter includes a suggested monthly input report template that the managers can use to report monthly performance in sufficient detail for our purposes. In practice, few underlying managers utilize the APM format; however, it is still a useful way to communicate the desired level of detail in the information we’re requesting.

Typically, APM will send a reminder email near the end of each month to each underlying manager. We track the timing of receipt of manager reports and revisions in case that information would be of interest to the FOF manager.

The collection of current month performance often involves updates of previous months’ numbers, so it is normal for reported results to be “non-final” for a number of months.

### Underlying Manager Data

We record monthly performance information in the APM FOF Tracking Template. This Template will track returns by manager and strategy grouping and provides additional reports as described below. Manager results are aggregated in the APM FOF Tracking Template and are then posted into GLASS<sup>SM</sup>, APM’s partnership accounting system. GLASS<sup>SM</sup> then allocates income among participants and creates fund and investor reports.

### Use of Estimates

APM does not endorse the use of estimates in reporting FOF returns; however, if one out of a sufficiently large group of underlying managers is late in its reporting, there may be reason for the fund manager to consider using an estimate in order to provide a timely, approximate report to investors, rather than a tardy yet precise one. If the late-reporting manager has 5% of the FOF assets and the estimate is off by 2%, the effect on Fund net asset would be 0.10%. Depending on the FOF, the possibility of reporting a number that was off by 0.10% may or may not be deemed material for reporting purposes. If an underlying manager has 10% of assets and results that are volatile, the potential reporting discrepancy may be unacceptable.

A FOF manager electing to use estimates should consider creating a written "use of estimates policy" to memorialize the background facts, reasoning and policy.

Note that it is APM's general practice to adjust previous months' returns and capital account balances if updated results are received from underlying managers of a FOF. Moreover, underlying manager numbers are expected to be subject to their own audit adjustments. Accordingly, estimates will be replaced by actual numbers when received. Normally, new valuation statements are not issued; however, the adjustment will usually be made in the proper accounting period and reflected in future capital account reports. If investors are sensitive to changes in reported numbers, a FOF manager may adopt a policy of applying non-material adjustments in the future periods when received. Such a policy should be in written form and vetted by both legal counsel and the FOF auditors.

### Underlying Manager Tracking Reports

The samples of reports included in this discussion are:

- **Manager Summary:** A "bottom line" report for tracking current month and year-to-date performance for underlying managers. It can also group managers by strategy and report similar numbers for strategy groups.

- **Manager Reports & Timing:** A "Timing" report is useful in tracking timeliness and accuracy of estimates. Some managers report one or more estimates and then a final; some report final only. The Timing report is also useful as a status report from APM to the FOF Manager indicating what we're waiting on in order to determine the FOF results.
- **K-1/PFIC Status:** Used to track status of annual reports from underlying managers.
- **Manager Dollar Returns, Percent Returns:** These reports break out dollar and percent returns by month.
- **Manager Assets:** Reports assets by underlying manager by month.
- **Underlying Fund Exposures Report:** This report can be used to "look through" to underlying portfolios in order to get a picture of overall fund exposures, long and short. Note that many sub-managers do not routinely provide enough underlying information to make this report useful.

### Other Reporting

In addition to the sub-manager reports above, APM also sends the reports at the FOF level which include:

- A flash report showing summary fund net performance, plus monthly ending capital balances by investor.
- A fund "Perf Rep" showing longer term performance results, plus statistics.
- Unaudited monthly financial statements.

### Timing Issues on Annual Reports

Because tax reports for FOFs are dependent on receipt of reports from underlying managers, it is likely that FOF K-1s will be sent too late for their participants to file a timely tax return.

Many FOF offering documents attempt to preempt complaints about K-1 timing by disclosing upfront that it is likely that investors will have to extend their personal tax returns.

Note that filing the FOF tax return using estimates could expose investors to possible fines. As we understand it, if the underlying fund has "reportable transactions" that the FOF tax return does not reflect, it could result in a violation of reporting requirements which may result in fines for investors of \$100,000 per occurrence. Because of that, most tax preparers (usually the auditor in funds that APM administers) will not file a fund-of-funds tax return without having received all underlying K-1s. However, in cases where a majority of underlying K-1s have been received, it is usually possible to request an estimate of taxable income for investors to use.

### Annual Audit

The APM audit preparation process for a fund is fully explained in another Hedge Fund Elements publication called "APM Tax-Audit Package."

SEC-registered investment advisers who manage FOFs are generally required to deliver their audits within 180 days of year-end. However, the SEC requires non-FOFs to deliver the audit within 120 days. The main reason the SEC gives more time for FOF audits is that FOFs are dependent on the timing of those other funds.

What if the 180 day delivery requirement is not met? Managers in that situation should consult with counsel and, if possible, ensure that current underlying managers are responding in ways that would permit the reasonable belief that reporting for the current year will be within the time limit.

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## Manager Summary Report

FOF Manager Summary Report	Month #				4	Percent Returns		Dollar Returns	
	Mgr #	Group	End Assets			Percent	Month	YTD	Month
AAA	1	1	6,682,098	reported	8.6%	2.81%	7.89%	182,912	488,707
BBB	2	2	6,012,120		7.7%	-1.20%	3.16%	(73,022)	184,379
CCC	3	1	11,577,224		14.9%	4.05%	19.62%	450,627	1,898,891
DDD	4	1	5,568,697	reported	7.1%	2.25%	14.71%	122,380	714,227
EEE	5	1	5,871,940		7.5%	2.20%	11.90%	126,402	624,413
FFF	6	1	4,878,762		6.3%	2.40%	12.47%	114,346	540,808
GGG	7	1	5,742,768		7.4%	1.13%	10.07%	64,168	525,312
HHH	8	4	10,224,393		13.1%	2.50%	10.22%	249,375	948,036
III	9	1	2,924,190	reported	3.8%	0.89%	2.93%	25,924	83,107
JJJ	10	1	0		Liq as of 3/1/06				(15,022)
KKK	11	5	4,581,280		5.9%	2.90%	11.79%	129,113	351,285
LLL	12	1	3,840,414	reported	4.9%	-5.10%	0.48%	(206,273)	18,352
MMM	13	1	5,059,369		6.5%	0.67%	13.57%	33,672	309,369
NNN	14	1	4,936,875		6.3%	4.83%	7.44%	227,465	186,875
<b>Managers in Total</b>			77,900,129		100%	1.89%	10.32%	1,447,090	6,858,738

# = not yet updated from previous month  
note that aggregate returns are gross

Group Data									
Equity Long/Short Hedged		1	57,082,337		73.3%	2.04%	11.11%	1,141,623	5,375,038
Special Situations/Event Driven		2	6,012,120		7.7%	-1.20%	3.16%	(73,022)	184,379
Event Driven Equity Long/Short		3	10,224,393		13.1%	2.50%	10.22%	249,375	948,036
Distressed Securities		4	4,581,280		5.9%	2.90%	11.79%	129,113	351,285
			<b>77,900,129</b>					<b>1,447,090</b>	<b>6,858,738</b>

## Manager Reports & Timing

	Year: 2006		Month #		4	
FOF	Initial Report		"Final" Report			
Manager Reports & Timing	Date	Percent	Date	Percent	Change	Percent
AAA	-	2.81%	-	-		-
BBB	05/02	-1.20%	-	-		-
CCC	05/05	4.05%	-	-		-
DDD	05/02	2.20%	05/02	2.25%	0.05%	-
EEE	05/05	2.20%	-	-		-
FFF	05/05	2.40%	-	-		-
GGG	05/01	1.13%	-	-		-
HHH	05/05	2.50%	-	-		-
III	-	0.89%	-	-		-
JJJ	-	-	-	-		-
KKK	05/05	2.90%	-	-		-
LLL	05/01	-5.09%	05/03	-5.10%	-0.01%	-
MMM	05/02	0.67%	-	-		-
NNN	05/03	4.83%	-	-		-

## Summary

Total Managers:	13	reporting initial & final	reporting Final Only	initial Initial Only	no report
Percent of sample		15%	0%	69%	15%
Average days until a "final" report		3		n/a	
Average change for those managers who changed	0.027%				
Incidents of Previous month "final" reports changed this month		0		0	
Average change for those managers who changed	0.000%				

## K-1/PFIC Status Reports

FOF	2005 K-1/PFIC Status	r Sent	Expected	K-1/PFIC Status	Received	Stmts
AAA		02/01/2006	03/15/2006	Received	03/14/2006	Received
BBB		03/28/2006	03/29/2006	Received	04/12/2006	
CCC		03/15/2006	03/24/2006	Received	03/27/2006	
DDD		03/15/2006	-	Received	03/21/2006	N/A
EEE		03/31/2006	?	Received	04/11/2006	N/A
FFF		03/15/2006	03/15/2006	Received	03/21/2006	
GGG		03/15/2006	03/24/2006	Received	03/21/2006	
HHH		03/15/2006	03/24/2006	Received	03/23/2006	
III		03/15/2006	03/17/2006	Received	03/21/2006	Received
JJJ		03/15/2006	03/17/2006	Waiting for Response	-	
KKK		02/01/2006	03/20/2006	Received	03/24/2006	
LLL		03/15/2006	-	*DRAFT ONLY*	03/21/2006	
MMM		03/15/2006	03/15/2006	Received	03/10/2006	Received
NNN		03/28/2006	03/31/2006	Received	03/30/2006	

## Manager Dollar Returns Report

FOF Manager Dollar Returns	1 Jan	2 Feb	3 Mar	4 Apr	5 May	6 Jun	7 Jul	8 Aug	9 Sep	10 Oct	11 Nov	12 Dec
AAA	235,349	(19,286)	89,732	182,912								
BBB	98,620	2,265	156,516	(73,022)								
CCC	802,144	(205,044)	851,164	450,627								
DDD	372,178	(16,112)	235,781	122,380								
EEE	280,218	0	217,793	126,402								
FFF	240,756	(4,579)	190,284	114,346								
GGG	159,654	(49,908)	351,398	64,168								
HHH	426,712	9,703	262,245	249,375								
III	25,570	11,467	20,147	25,924								
JJJ	50,437	(65,459)										
KKK	171,899	(78,797)	129,070	129,113								
LLL	155,693	55,889	13,042	(206,273)								
MMM	65,300	48,845	161,552	33,672								
NNN	52,419	(101,143)	8,134	227,465								
<b>Month</b>	3,136,950	(412,160)	2,686,858	1,447,090								
<b>Year-to-date</b>	3,136,950	2,724,790	5,411,648	6,858,738	6,858,738	6,858,738	6,858,738	6,858,738	6,858,738	6,858,738	6,858,738	6,858,738
<b>Group Data</b>												
<b>Equity Long/Short Hedged</b>	1	2,439,718	(345,331)	2,139,028	1,141,623							
<b>Special Situations/Event Driven</b>	2	98,620	2,265	156,516	(73,022)							
<b>Event Driven Equity Long/Short</b>	3	426,712	9,703	262,245	249,375							
<b>Distressed Securities</b>	4	171,899	(78,797)	129,070	129,113							

## Manager Percent Returns Report

FOF Manager Dollar Returns	1 Jan	2 Feb	3 Mar	4 Apr	5 May	6 Jun	7 Jul	8 Aug	9 Sep	10 Oct	11 Nov	12 Dec
AAA	3.80%	-0.30%	1.40%	2.81%								
BBB	1.69%	0.04%	2.64%	-1.20%								
CCC	8.29%	-1.96%	8.28%	4.05%								
DDD	7.67%	-0.31%	4.53%	2.25%								
EEE	5.34%	0.00%	3.94%	2.20%								
FFF	5.55%	-0.10%	4.16%	2.40%								
GGG	3.06%	-0.93%	6.60%	1.13%								
HHH	4.60%	0.10%	2.70%	2.50%								
III	0.90%	0.40%	0.70%	0.89%								
JJJ	1.82%	-2.33%										
KKK	6.93%	-2.50%	4.20%	2.90%								
LLL	4.07%	1.41%	0.32%	-5.10%								
MMM	6.53%	1.37%	4.47%	0.67%								
NNN	5.24%	-2.85%	0.24%	4.83%								
<b>Sum</b>	4.86%	-0.56%	3.84%	1.89%								
<b>Group Data</b>												
<b>Equity Long/Short Hedged</b>	5.20%	-0.63%	4.17%	2.04%								
<b>Special Situations/Event Driven</b>	1.69%	0.04%	2.64%	-1.20%								
<b>Event Driven Equity Long/Short</b>	4.60%	0.10%	2.70%	2.50%								
<b>Distressed Securities</b>	6.93%	-2.50%	4.20%	2.90%								

### Underlying Fund Exposures Report

FOF Underlying Fund Exposures	Month #	4	Dollars			Percent			
	Mgr #	Percent	Assets	Long	Short	% Long	% Short	% Net	% Gross
AAA	1	8.3%	6,682,098	6,882,561	3,541,512	103%	53%	50%	156%
BBB	2	7.4%	6,012,120						
CCC	3	14.3%	11,577,224						
DDD	4	6.9%	6,468,697						
EEE	5	7.3%	5,871,940						
FFF	6	6.0%	4,878,762						
GGG	7	7.1%	5,742,768						
HHH	8	12.7%	10,224,393						
III	9	3.6%	2,924,190	2,084,947	701,806	71%	24%	47%	95%
JJJ	10	0.0%	0						
KKK	11	5.7%	5,581,280						
LLL	12	4.8%	3,840,414	3,264,352	844,891	85%	22%	63%	107%
MMM	13	6.3%	6,059,369	8,664,898	2,908,497	143%	48%	95%	191%
NNN	14	6.1%	4,936,875	1,658,790	854,079	34%	17%	16%	51%
<b>Managers in Total</b>		96%	80,800,129	22,555,548	8,850,785	28%	11%	17%	39%
<b>Group Data</b>									
<b>Equity Long/Short Hedged</b>	1		58,982,337	22,555,548	8,850,785	38%	15%	23%	53%
<b>Special Situations/Event Driven</b>	2		6,012,120						
<b>Event Driven Equity Long/Short</b>	3		10,224,393						
<b>Distressed Securities</b>	4		5,581,280						
			80,800,129	22,555,548	8,850,785	28%	11%		