

Canadian Hedge Fund Performance Index

Scotia Capital Canadian Hedge Fund Performance Index Overview

The aim of the Scotia Capital Canadian Hedge Fund Performance Index (the 'Index') is to represent a comprehensive overview of the Canadian Hedge Fund universe, defined as those managers who are domiciled within Canada. The Index will be launched with specific criteria to determine index eligibility. The initial launch will be the overall flagship index which will include all qualifying Canadian hedge funds across all strategies and styles. Shortly thereafter, Scotia Capital will look to publish several sub-indices based on the qualifying funds' styles and strategy to provide further granularity on the Canadian hedge fund market.

For managers who are not eligible for the initial Index launch owing to Assets Under Management and Track Record constraints, there are plans to launch an Emerging Managers Index to accommodate this important area of the Canadian Hedge Fund universe.

Initial Index Eligibility

- ✚ **Canadian Funds:** Potential Index constituents shall be restricted to both open and closed hedge funds managed by Canadian-domiciled hedge fund managers.
- ✚ **Hedge Funds:** Funds must have no restrictions on ability to sell short or utilize leverage other than what is stipulated in their relevant offering documentation. Funds may not be regulated under NI 81-102 or US 1940's Act.
- ✚ **Assets Under Management:** All prospective constituent hedge funds must have a minimum of C\$15 million in capital. If a fund begins the period above C\$15 million in assets but then falls below during the quarter, it will be included in index returns until the following quarterly rebalancing when it will then exit the index.
- ✚ **Track Record:** All funds must have at least 12 months of reported monthly returns.
- ✚ **Monthly Performance and Capital Reporting:** All funds will report performance and total capital for the previous month-end by the end of the following calendar month. Initial Index performance numbers may use estimated returns provided by fund managers until the end of the calendar month. Funds that do not provide final returns by the end of the following calendar month-end will not be included in the monthly return. These funds will also be dropped from future index calculations until they are eligible for a quarterly rebalance and final returns have been provided on time for three consecutive months.

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Failure to comply after reinstatement is grounds for removal from the index on a permanent basis at the discretion of the Index Committee. Scotia Capital will also monitor the variance of the estimate to final performance. If the variance is greater than 200 bps for 2 out of any rolling 12 month period, future estimates will not be included in preliminary index returns.

- ✚ **Annual Audit:** All fund returns must be audited annually. Significant deviations between audited performance returns and those provided to Scotia Capital are grounds for exclusion from the index, at the discretion of the Index Committee.
- ✚ **Exclusions:** Fund of Funds are not eligible.

Sub Indices

Sub indices, when published, will be classified by investment style as detailed in Appendix 1. Within each investment style, funds will be further categorized into one of 19 strategy category groupings.

While not all hedge fund strategies will have sufficient data to warrant the publication of a distinct sub index, it is anticipated that the three style as well as certain strategy sub indices will be published as the number of contributing constituents allows.

The fund's reported strategy classification will be utilized for the purposes of the Scotia Capital Canadian Hedge Fund Performance Index. Scotia Capital may periodically conduct statistical analyses to verify proper fund style classifications and may reclassify funds as deemed appropriate by the Index Committee.

Rebalancing

Following an initial ramp up period, changes to the composition of the Index will be on a quarterly basis, depending on the nature of the change.

Weighting

The Index will be calculated and reported on both an Asset Weighted and an Equal Weighted basis.

Due Diligence

Scotia Capital will review fund offering documents, performance/track records of prospective constituents solely for the purpose of ensuring compliance with Index constituency requirements.

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Note: Performance and capital information which is used by Scotia Capital to construct the indices is provided by the constituent funds on a voluntary basis. Scotia Capital has not reviewed, audited or in any other way performed any due diligence on the accuracy of the underlying data provided to construct the Index. Neither Scotia Capital, the Bank of Nova Scotia, nor any of its affiliates or subsidiaries expresses any opinions on the qualifying constituents by virtue of their inclusion in the Scotia Capital Canadian Hedge Fund Performance Index.

Transparency

It is anticipated that only the Manager Name and Fund Name will be included in and distributed via the Scotia Capital Canadian Hedge Fund Index material available for publication in various public media.

Index History

While the Index will be launched in the first quarter 2006, Index history will initially be available for a minimum of 12 months, although index constituents are to provide their full performance history since inception. As a result, while Scotia Capital may report Index history for periods in excess of 12 months, there is no guarantee that all constituents have track records that go back through the entirety of the relevant historical period.

Index Committee

Scotia Capital has formed an Index Committee that will meet at minimum quarterly, whose responsibilities include:

- ✚ Review of new constituents, removal of constituents
- ✚ Index rebalancing

Scotia Capital will also form an Index Advisory Committee comprised of representatives from the Canadian hedge fund industry. The purpose of the Index Advisory Committee will be to periodically review the index and its construction methodology and to provide recommendations for future sub index launches.

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Collection of Index Data

Managers who agree to participate in the Index (the “Managers”) will be required to provide both performance and qualitative data on a fund-by-fund basis, as set forth below. The primary purpose of this information is to enable Scotia Capital to create and manage the Scotia Capital Canadian Hedge Fund Performance Index. It is anticipated that only the Manager Name and Fund Name will be included in and distributed via the Scotia Capital Canadian Hedge Fund Index material available for publication in various public media.

The following data is to be provided by prospective constituents of the Indices. These generally consist of:

- ✚ Manager/Fund Profile information, which will largely remain static unless advised of changes by the Managers;
- ✚ Month-End Performance and Capital Information, which will be updated by Managers monthly.

Data Requirements

Manager Profile:

- ✚ Manager name, address, city, country, main phone number
- ✚ Year of formation and domicile
- ✚ Key Contact Information for data enquiries (name phone, fax, e-mail)

Fund Profile:

- ✚ Fund name
- ✚ Fund inception date
- ✚ Senior portfolio manager name
- ✚ Auditor company name
- ✚ Administrator / Custodian name
- ✚ Strategy classification

Performance & capital:

- ✚ Performance updated monthly (before tax and net of management and incentive fees):
 - ❖ estimates (M+10 days)
 - ❖ final figures (M+28 days)
- ✚ as @ date
- ✚ Status (estimate or final)
- ✚ Fund status (open or closed)
- ✚ Fund capital
- ✚ Total manager AUM (total hedge fund capital managed by firm including managed accounts and other funds)

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The literature on hedge funds categorize the different investment approaches to hedge fund investing into a variety of styles and strategies. To date there has been no standard classification system of hedge fund strategies in the industry as it has been historically dominated by wealthy individual investors and family offices who have been less concerned with classification and more concerned with the absolute returns that these funds have yielded. As the sector becomes increasingly “institutionalized” and investors are using the most current risk management and optimization tools to manage their holdings in these funds within professionally managed portfolios, there has developed a general consensus among professional allocators and industry service providers that hedge funds may be classified into three broad styles: Arbitrage, Event-Driven, and Directional/Tactical.

Each style grouping has several sub strategies, each of which has unique characteristics in terms of markets traded or instruments utilized. It should be noted that even within each strategy there can be managers who focus on different elements and will therefore have some degree of non-correlation with their strategy peers. For example, within the convertible bond arbitrage strategy, some managers may focus on deep in-the money convertibles (essentially a synthetic put strategy), others derive their returns from trading the optionality/volatility of the underlying bond, while others focus on busted converts (high yield). While there is some commonality in these types of managers, their specific trading approaches will often result in differing risk-return profiles, however for the purposes of a broad classification methodology, we will ignore these sub-strategy groupings.

While the nineteen strategies Scotia Capital has selected are not an exhaustive list of investment styles and asset classes used by hedge funds, they represent a large portion of hedge fund activities, as well as most of the liquid, transparently priced activities.

Following are the strategy definitions which may be used in the construction of the Scotia Capital Canadian Hedge Fund Performance Index:

1. Relative Value Strategies

1.1. Convertible Arbitrage

Convertible Arbitrage typically involves taking long positions in convertible securities (convertible bonds, warrants, convertible preferred shares) and hedging those positions by selling short the underlying common stock. Convertible Arbitrage funds attempt to exploit the mispricing in convertible securities, and as such may also look to hedge duration and credit risks.

A convertible security's valuation is dependent on the price of the underlying stock, expected future volatility of returns, risk free interest rates, call provisions, supply and demand for

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specific issues and, in the case of convertible bonds, the issue-specific corporate/Treasury yield spread. Thus, there is ample room for relative mis-valuations. A convertible manager takes an exposure to the volatility and/or the credit risk of the bond, usually hedging out the other factors. As noted above, the stock exposure is typically hedged out with a short position in the underlying company shares. The strategy is thus typically market neutral.

While convertible arbitrage strategies can be categorized under a discrete group, there are at least three broad sub-strategies or styles that convertible managers can pursue which relate to where they propose to derive their returns. A manager can choose to emphasize trades that generate income ("cash and carry") or those that depend on volatility ("gamma trading") for trading opportunities. A third area is capital structure convertible arbitrage ("credit trading"). This latter style involves a focus on deep out-of-the-money convertibles which trade more like straight debt, with extra sensitivity to the credit component of the bond. The credit sensitive strategy requires a great deal of fundamental credit analysis which is similar to that required for other relative value strategies and equity market neutral styles. Because most convertible managers participate in different portions of the curve at different times, it is difficult to classify managers solely in one of these groups.

1.2. Equity Market Neutral

Equity market neutral managers strive to generate consistent returns in both up and down markets by selecting positions with a total net exposure of zero. Managers will hold a large number of long equity positions and an equal, or close to equal, dollar amount of offsetting short positions for a total net exposure close to zero. A zero net exposure is referred to as "dollar neutrality" and is a common characteristic of equity market neutral managers. By taking long and short positions in relatively equal amounts, the equity market neutral manager seeks to neutralize the effect that systematic changes will have on values of the stock market as a whole.

Some, but not all, equity market neutral managers will extend the concept of neutrality to risk factors or characteristics such as beta, industry, sector, investment style and market capitalization. In all equity market neutral portfolios stocks expected to outperform the market are held long, and stocks expected to under perform the market are sold short. Returns are derived from the long/short spread, or the amount by which long positions outperform short positions.

1.3. Statistical Equity Arbitrage

Statistical Arbitrage utilizes quantitative analysis of technical factors to exploit pricing inefficiencies between related equity securities, neutralizing exposure to market risk by combining long and short positions. The strategy is based on quantitative models for selecting specific stocks with equal dollar amounts comprising the long and short sides of the portfolio.

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Portfolios are typically structured to be market, industry, sector, and dollar neutral. Statistical Arbitrage usually engages in very short-term trading and usually focuses on residual mean reversion.

1.4. Fixed Income Arbitrage

Fixed Income Arbitrage funds exploit the pricing anomalies among related securities within and across global fixed income markets and their derivatives. The manager takes offsetting long and short positions in government bonds and investment-grade corporate bonds, government agency securities, swap contracts, and futures and options on fixed income instruments that are mathematically, fundamentally, or historically interrelated. Relationships are typically distorted over time due to market events, investor preferences, exogenous shocks to supply and demand, or structural features of the market – in all cases the Manager aims to identify and profit from mispricings caused by distortions. The manager generally constructs the portfolio on a market neutral basis and often constrains it to be duration neutral within a given country (often developed countries).

1.5. Mortgage and Asset Backed Securities Arbitrage

Mortgage and Asset Backed Securities (MBS/ABS) Arbitrage funds look for arbitrage opportunities by take positions in mortgage-backed securities such as residential pass-through securities and derivatives, commercial mortgage securities and, to a lesser extent, other asset-backed paper. The manager attempts to neutralize the impact of interest rate changes and prepayment behavior of borrowers by combining long and short positions in mortgage securities with different characteristics and other hedging positions such as shorts in U.S. Treasuries and interest rate options and swaps.

Many funds focus solely on AAA-rated bonds. Instruments include: government agency, government-sponsored enterprise, private-label fixed- or adjustable-rate mortgage pass-through securities, fixed- or adjustable-rate collateralized mortgage obligations (CMOs) and stripped mortgage-backed securities (SMBSs). Funds may look to capitalize on security-specific mispricings. Hedging of prepayment risk and interest rate risk is common.

1.6. Credit Arbitrage

Credit Arbitrage funds attempt to exploit structural inefficiencies in global credit markets, by looking for relative value opportunities in bonds, loans, credit default swaps, structured credit products (CLN's, FTD Baskets), and a range of other derivative instruments usually within a single reference entity. These structural inefficiencies can exist as different financial market participants face disparate laws, regulations, investment parameter constraints and objectives. These characteristics of the marketplace interact with natural fixed income risk premia such as term, liquidity, volatility and credit to create inefficiencies, which may be arbitrated by these

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funds. Credit Arbitrage funds have emerged more recently, as CDS and structured credit markets have now developed sufficient depth to allow for arbitrage opportunities.

1.7. Relative Value - Other

Encompasses managers who trade in a range of niche sub-strategies that generally seek to profit from a perceived mispricing in a specific asset or security. With each portfolio position, the manager attempts to isolate and capitalize on a feature of an asset or combination of assets that is mispriced relative to a theoretical fair value or equilibrium relationship.

Examples of such niche strategies include, inter alia, index rebalancing arbitrage (exploiting market and timing inefficiencies occurring as equity indices are rebalanced), structured discount convertibles arbitrage (more commonly known as Regulation D securities trading) and factoring/structured notes trading (where managers offer secured, short term financing to borrowers in support of receivable, trade, inventory and new-in-box goods liquidation financing).

2. Event-Driven Strategies

2.1. Merger Arbitrage

The Merger Arbitrage strategy (also known as Risk Arbitrage) involves taking positions in companies that are either currently or likely to be engaged in corporate mergers and acquisitions. When a tender or exchange offer or a proposal for a merger is publicly announced, the offer price or the value of the securities of the acquiring company to be received is typically greater than the current market price of the securities of the target company. Normally, the stock of an acquisition target appreciates while the acquiring company's stock decreases in value. If a manager determines that it is probable that the transaction will be consummated, it may purchase shares of the target company and in most instances, sell short the stock of the acquiring company. Factors that effect returns include the extent of the spread that can be earned through this transaction, the likelihood of a deal coming to fruition (it may break for regulatory, financial, or company-specific reasons) and the likely date of completion of the deal.

Managers may employ the use of equity options as a low-risk alternative to the outright purchase or sale of common stock. Many managers will hedge against market risk by purchasing S&P put options or put option spreads. Low to moderate levels of leverage are typically used.

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2.2. Distressed/High Yield Arbitrage

Distressed security funds generally invest in securities of financially troubled companies (companies involved in bankruptcies, exchange offers, workouts, financial reorganizations, and other special credit event-related situations). These managers may identify distressed securities in general or focus on one particular segment of the market (e.g., senior secured debt). Investments may be accumulated with a view to an exit via the secondary market, or with the expectation that the company will be recapitalized, restructured, or liquidated, where the fund manager may either seek to be actively or passively involved in the process. Managers may be either long or short the securities of the distressed firm depending on their assessment of market valuations, although most funds typically have a somewhat long bias. Leverage employed is typically low (on average 1-2x balance sheet leverage). Profits in this sector result from the market's lack of understanding of the true value of the deeply discounted securities. Results are generally not dependent on the direction of the markets, and have a low to moderate expected volatility.

High-yield funds price more easily and have more long/short activity than distressed; thus they have reasonable pricing transparency and better liquidity. These funds take positions either within the capital structure of a firm or long and short positions in the debt of different companies, seeking to both add value and hedge out some market/systematic risk.

2.3. Special Situations

Special Situations or "corporate life cycle investing" encompasses funds that seek profit opportunities from a broad range of corporate events. Managers are either generalists, who engage in trading keyed to corporate events such as a merger, distressed finances or share prices, and changes to an index, or specialists who concentrate on a specific niche they can exploit. Value-oriented funds invest in undervalued obligations including bank debt, high-yield bonds, trade claims, and equity securities created by discrete and often extraordinary events. Niche strategies include Capital Structure Arbitrage or other relative-value trades, such as trading between ADRs and local shares or voting versus non-voting shares, as well as strategies involving trading a holding company versus positions in its listed subsidiaries. Trading involves attempting to predict the outcome of a particular transaction as well as the optimal time at which to commit capital to it.

2.4. Closed End Fund Arbitrage

Closed End Fund Arbitrage involves the purchase and hedging of closed-end funds which typically trade at a significant discount from the net asset value of their underlying asset portfolio. Closed end fund managers will typically get involved in some form of shareholder activism to accelerate the unwinding of the fund to realize this discount.

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3. Opportunistic Strategies

3.1. Equity Hedge (Long/Short Equity)

Equity Hedge, also known as long/short equity, combines core long holdings of equities with short sales of stock or stock index options. Equity hedge portfolios may be anywhere from net long to net short depending on market conditions. Equity hedge managers generally increase net long exposure in bull markets and decrease net long exposure or even are net short in a bear market. Generally, the short exposure is intended to generate an ongoing positive return in addition to acting as a hedge against a general stock market decline. Stock index put options are also often used as a hedge against market risk. Profits are made when long positions appreciate and stocks sold short depreciate. Conversely, losses are incurred when long positions depreciate and/or the value of stocks sold short appreciates.

Equity hedge managers' source of return is similar to that of traditional stock pickers on the upside, but they use short selling and hedging to attempt to outperform the market on the downside. Leverage utilized tends to be low.

3.2. Dedicated Short Bias

Dedicated Short Bias funds seek to identify securities that are overpriced in relation to their fair value. By shorting such securities, short sellers seek to profit from declines in their market value. These funds tend to be negatively correlated with equity markets and thus perform well when equity markets fall and, to a disproportionately smaller degree, when equity markets perform well. From a hedge fund portfolio perspective, Dedicated Short Bias funds often tend to be utilized as "portfolio insurance" against falling equity markets.

3.3. Managed Futures (CTAs)

Managed Futures funds, or Commodity Trading Advisors, take long and short positions in liquid financial futures such as currencies, interest rates, stock market indices, and commodities. Managed Futures programs typically base their investment decisions on strict quantitative methods, notably, trend-following models. Some managers tend to use a mixture of systematic trend following models overlaid with discretionary/judgmental trading type approaches to temper quantitatively derived model trading outputs with market experience to capitalize on prevailing/expected market dynamics.

3.4. Global Macro

Global Macro (or Macro) funds take long and short positions in currencies, bonds, equities, and commodities. The manager tries to exploit perceived divergences between and within these various asset classes. The investment decisions are based on a manager's top-down or macro views of the world, economy, government policy, interest rates, inflation, market

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dynamics, and sentiment. The manager may also base investment decisions on relative valuations of financial instruments within or between asset classes.

Macro strategies attempt to identify extreme price valuations in stock markets, interest rates, foreign exchange rates and physical commodities, and make leveraged bets on the anticipated price movements in these markets. To identify extreme price valuations, Trading Managers generally employ a top-down global approach that concentrates on forecasting how global macroeconomic and political events affect the valuations of financial instruments. These approaches may be systematic trend following models, or discretionary. The strategy has a broad investment mandate, with the ability to hold positions in practically any market with any instrument. Profits are made by correctly anticipating price movements in global markets and having the flexibility to use any suitable investment approach to take advantage of extreme price valuations. Trading Managers may use a focused approach or diversify across approaches. Often, they will pursue a number of base strategies to augment their selective large directional bets.

3.5. Emerging Markets

Emerging Markets managers invest in equity or fixed income products of emerging markets, and tend to have a long bias. Managers look to exploit inefficiencies surrounding undervalued and under-researched securities. Opportunities often surface due to informational inefficiencies, poor accounting, lack of proper legal systems, unsophisticated local investors, and companies with less experienced management.

These funds have historically tended to be more volatile in nature due to the inherent volatility of emerging markets, as well as the presence of limited short selling and futures markets.

4. Multi-Strategy

Multi-Strategy

Multi-Strategy managers will pursue a variety of different hedge fund strategies often using specialized in-house portfolio teams. Managers reallocate capital amongst these strategies as market opportunities present. Many of the largest and most well established hedge funds often adopt a multi-strategy approach as managers look to smooth return streams and leverage off of their organizational and risk management infrastructures.