



Review 2007 and outlook 2008

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- Most hedge funds are on track to meet their performance targets in what has been an eventful year
- 2007 is set to be the best year since 2003 for the industry in terms of performance for fully diversified funds of hedge funds
- Event driven, emerging market and CTA funds performed best while commodity, quantitative and arbitrage strategies lagged
- The outlook for 2008 is positive though we expect increased volatility as the US economy is skating on thin ice
- Manager skill will increasingly be at the forefront as growth slows, volatility increases and markets diverge

Review 2007

Subprime problems gradually spilled over to other markets...

...leading to action from central banks

The first few months of the year were fairly uneventful for most asset classes. Equity markets continued their uptrend with only a brief hiccup in late February and early March. The first signs of a weakening US housing market emerged when several subprime lenders went out of business or had to declare bankruptcy in March and April. At first, financial markets deemed the problems were isolated in the subprime segment. Most equity indices continued to rise until July as the news outside the housing sector remained positive. The picture changed sharply over the summer months as problems in the subprime sector began to spill over into the wider credit markets in July, triggering a global repricing of credit risk. As a result, the liquidity of structured credit instruments such as Collateralised Debt Obligations (CDOs) and asset-backed securities (ABS) dried up completely. Banks were no longer willing or able to lend to each other and overnight lending rates soared. Central banks around the world had to step in and inject liquidity to ensure market stability. Nearly all risky asset classes corrected and volatility surged to levels not seen since 2003.

The crisis came to a head in August, with a sharp correction



Source: The Economist (illustration by Andy Potts).

Emerging markets took off as growth outside the US was deemed to remain strong

Equity markets staged a strong recovery rally after it became clear that the Fed would lower interest rates (which it did twice in September and October). Emerging markets made particularly strong gains, soaring past previous highs. Hong Kong's Hang Seng Index, for example, gained more than 50% in the two and a half months following its mid August low. Developed markets also recovered nicely from the summer blues as moderate valuations, decent US job numbers and continued economic strength outside the US pointed towards a continuation of the ageing bull market. However, in November markets gave back some of their gains as financial stocks slumped due to fears of higher than expected write-offs in connection to mortgage related securities.

Hedge funds are set for their strongest year since 2003

Hedge funds started the year well and were largely able to navigate the spring sell-off in February and March. In the period leading up to the Summer events, most hedge funds had already built a performance cushion and many managers expressed rather cautious views on the markets. However, the speed and the sequence of events during the summer overburdened them as many were stopped out and incurred losses. Managers entering the period with lower exposure were able to stay invested and recovered their losses quickly. Others had to de-lever and re-adjust their exposures. The period following the sell-off turned out to be the best two months for hedge funds in years with September and October both in the region of 2-3% for highly diversified funds of hedge funds. Assuming an average December, the hedge fund industry is set for the strongest year since 2003 with most funds exceeding their performance targets. The following table illustrates some of the themes in which hedge fund managers have been active in 2007.

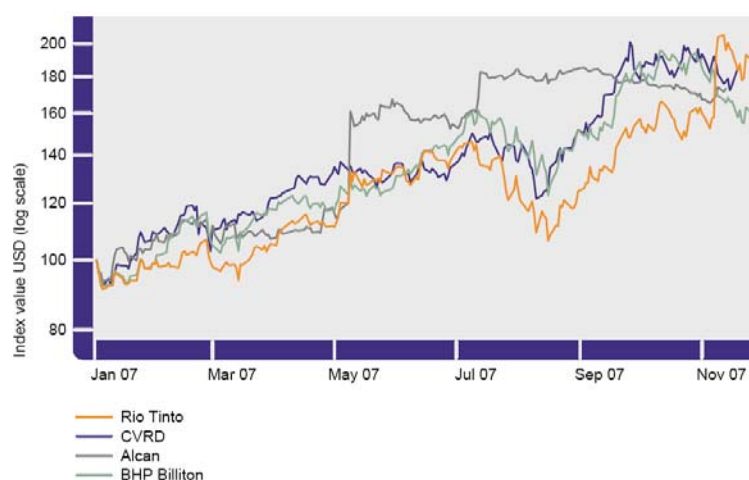
Style	Themes and trading ideas in 2007	Did it work?
Equity hedge	Long emerging Asian stocks	Yes
	Long Japan	No
	Growth stocks outperform value/tech stocks as 'safe haven'	To some degree
	Large caps outperform small caps	Yes, especially in the US
Event driven	Long exchanges, mining, energy, steel and iron ore, utilities, rail roads	Yes
	Short subprime securities/ lenders	Home run!
	During H2, short financials	Yes
Relative value	Long volatility in all asset classes	Yes
	Credit arbitrage	Not really, as trades were hard to implement due to distortions in CDS markets
	Yield curve steepening during H2	Yes, yield curves steepened significantly
	Convertible arbitrage	Average returns were achieved
Global macro	Long soft commodities	Mostly yes
	Unwinding of carry trades (e.g. long CHF, JPY, short AUD, NZD)	Very positive during August and November but not over the whole year
	During H2 short USD versus EUR and/ or Asian currencies	Yes
	Long emerging markets equity, local fixed income and EM currencies	Yes, very positive
Managed futures	Long equities	Not a major performance driver
	Long commodities (particularly oil, gold, wheat)	Yes
	Short USD	Yes
	Short fixed income	No, big loser in May/ June
	Long fixed income	Big winner in November

What were the best performing strategies?

Special situations had another great year...

Special situations had another great year. While LBO activity slowed after the summer credit crunch, strategic deals are still running strong. During October, global M&A volume surpassed the USD 3.55 trillion achieved in the whole of 2006. The battle for ABN AMRO, the intensifying consolidation in the mining sector, ongoing activity in financial exchanges, utilities and railroads were major performance drivers. Private equity firms dominated the first half of the year while strategic deals took over in H2. Some managers anticipated the problems in the subprime markets and set up short positions in mortgage related securities and exposed financial services companies. This worked perfectly throughout the year as many of these securities became worthless. The mining sector also offered large profit opportunities. Major deals included Rio Tinto's bid for Alcan, the Canadian aluminium maker. Rio itself became a target in November when BHP Billiton, the largest mining group, launched a bid for the company. Nearly all mining stocks are up solidly YTD.

Mining stocks YTD performance



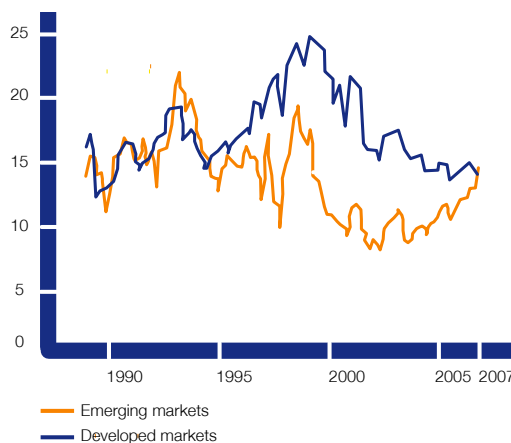
Source: Bloomberg. Please note that Alcan stopped trading after being acquired by Rio Tinto. CVRD: Companhia Vale do Rio Doce.

...with mining stocks being a strong performance driver

Emerging markets no longer offer a discount

Emerging market managers also recorded strong gains. The MSCI Emerging Market Index gained over 25% YTD (as of 28 November). Emerging Asia and Latin America performed equally well as economic growth and earnings were adjusted upward. The valuation discount of emerging markets compared to developed markets has now disappeared. Stocks with strong earnings and price momentum have continued to outperform. While some markets in Asia, e.g. Hong Kong or India, are no longer cheap, most emerging markets are not fundamentally overvalued with an average forward P/E ratio of about 15. Managers also posted gains in fixed income securities and currencies. Brazil and Turkey offered profit opportunities as local currencies appreciated and real interest rates remain relatively high.

12-month forward P/E: The gap has closed



Source: Thomson Datastream.

CTAs exploited several trends

Managed futures are set to record the best year since 2003 as several strong trends emerged during the year. Nearly all the performance was derived in Q2 and Q4. During the April to June period, CTAs made money with long equities, long high yield currencies and short fixed income. September until mid November offered highly profitable short USD, long oil, long gold and to some extent long soft commodity positions. Towards year end short bond positions became very profitable.

What strategies lagged?

Commodity hedge funds had a tough time this year...

...particularly in natural gas and base metals

Commodity hedge funds had a hard time this year. Unlike last year, when most managers handsomely outperformed indices, this year it was difficult to beat the long only benchmarks. The S&P Goldman Sachs Commodity TR Index, for example, is up over 30% YTD (as of 28 November). One reason for the strong index performance is clearly the return to backwardation in crude oil, where roll yields are now positive again compared to last year when they were strongly negative. Natural gas was a tough market as many managers had a bearish stance going into the winter as high inventories and moderate temperatures pointed to lower prices. However, natural gas held firm thanks to rising oil prices. Soft commodity managers were finally rewarded when the soft complex gained momentum during the summer months. Rising wheat prices made the headlines as many food producers raised their prices for bread and pasta. The term 'agflation' was used to describe food (agricultural) inflation. Base metal funds were generally weak as the sector gave back some of its outstanding performance in 2005 and 2006. In contrast, precious metals traders were up strongly. Relative value managers had a hard time as few profit opportunities arose in calendar, crack or location spreads. Occasionally, managers were simply wrongly positioned.

Global traders lagged as key themes did not play out

Global traders also had difficult year. Several ideas such as the Japanese reflation (rising inflation, rising equity market, rising interest rates) did not materialise. Also, fixed income markets proved tricky as rate expectations shifted several times during the year, but there were no real surprises. The unwinding carry trades, which have been a big topic throughout the year, offered only temporary gains during March, August and November. Over the course of the year, most high yielding currencies, such as the AUD, GBP and NZD appreciated. After the summer sell-off global traders generally reduced their exposures to preserve capital for investors. Hence, many of them missed out on subsequent rallies in equities. The sagging USD offered opportunities. The greenback declined steadily against other major currencies and short USD positions were profitable most of the year, particularly in H2. As can be seen on the next chart, the dollar reached its lowest value ever against a combination of other major currencies.

Trade-weighted dollar index 1973-2007



Source: Bloomberg (USTW\$ Index).

The quant meltdown grabbed headlines

Quantitative equity strategies (also referred to as equity market neutral or quant funds) dominated the headlines during July and August when many well-known funds suffered steep losses in just a few weeks. While there are many explanations for the 'quant meltdown', it seems that an unfortunate combination of events led to very unusual market behaviour which their statistical models could not handle. Some called it model misbehaviour. In particular, low beta value stocks (which they tend to be long) were sold to cover credit losses while higher beta stocks (shorts), which normally sell off more than the market, rallied. Tech stocks, for example, were seen as a safe haven from the credit turmoil. When performance deteriorated, quant funds exited positions in unison which further exacerbated the situation. In the ensuing mass liquidation, highly leveraged funds recorded large losses. The strong rebound following the Fed action on 17 August meant that managers who kept exposures or redeployed capital quickly recovered. However, other funds were not so fortunate and are still under water towards the end of the year.

Performance indicators				
Hedge funds (as at 31.10.2007)	YTD		Equities (as at 28.11.2007)	YTD
HFRI Fund of Funds Composite Index	11.23%		MSCI World Index (LC)	2.15%
HFRI Relative Value Arbitrage Index	8.96%		S&P 500	3.45%
HFRI Event Driven Index	10.29%		DJSTOXX 600	flat
HFRI Macro Index	11.71%		Nikkei 225	-11.04%
Stark 300 Trader Index	6.30%		MSCI Emerging Markets	25.71%
Fixed income	YTD		Commodities (as at 28.11.2007)	YTD
Citigroup World Government Bond Index (LC, as at 28.11.2007)	3.48%		S&P Goldman Sachs Commodity Index (Total Return)	30.98%
JPM Emerging Market Bond Index (global diversified, as at 31.10.2007)	5.80%		Crude oil (WTI)	52.47%
CS High Yield Index (as at 22.11.2007)	1.86%		Gold	25.75%

Source: Bloomberg, Hedge Fund Research, Inc. Latest data available at time of production. Please note that hedge fund performance represents industry performance and not Man Investments products.

Outlook 2008

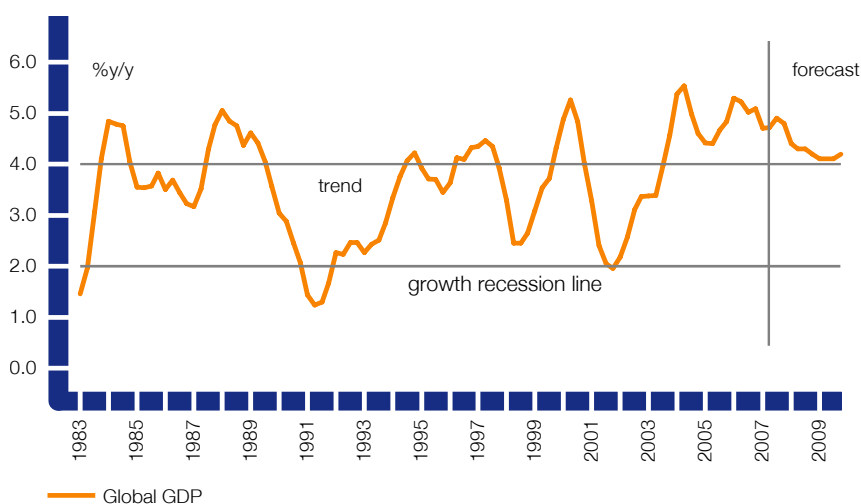
The US economy is skating on thin ice...

The world economy is expected to decelerate moderately in 2008 but the strong momentum of major emerging markets such as China and India will prevent a massive slowdown. The US economy is skating on thin ice as consumer spending is likely to be curtailed by falling house prices, rising energy costs and stricter lending policies. The Fed is in a Catch 22 situation as it has to help consumers by lowering interest rates while simultaneously fighting rising inflation. It remains to be seen how the central bank will navigate this predicament. We do not expect a full recession in the US and think that emerging markets, which are less credit driven, will be able to offset a slowdown in the US. This outcome is referred to as 'goldilocks light', which we covered in detail in our paper 'Where to from here' (October 2007).

...but global growth will remain strong...

According to the latest forecast from the IMF (IMF economic outlook 2008), global growth will slow from 5.2% in 2007 to 4.8% in 2008. Many economists lowered their growth forecasts in November, but most still expect moderate to strong growth outside the US. UBS, for example, has the lowest figure (4.3%) for global GDP growth during 2008. Hence, even the most conservative forecast is far above trend growth.

Global growth expected to decelerate towards trend – no recession in sight

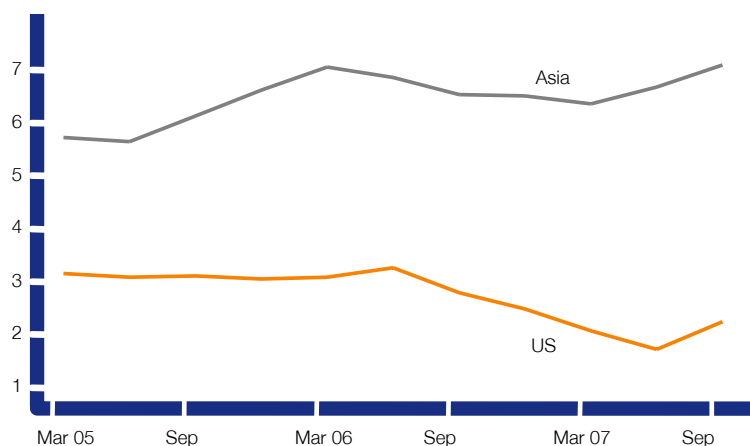


Source: UBS and Man Investments Research.

...thanks to emerging markets

Emerging markets are now a significant part of the world economy, accounting for about 30% of global GDP at market exchange rates. This year, they have contributed half of global GDP growth. Next year, it is highly likely that they will contribute more to global GDP growth than the G7, for the first time. Demand for products and services is likely to remain strong in these countries as consumers there are less reliant on credit, local currencies are relatively undervalued and most have lower budget deficits than developed countries. The next chart shows that the much talked about economic decoupling of Asia and the US has already occurred.

GDP growth – Emerging Asia versus US (in % YoY, 2qma, simple moving averages)



Source: DBS Bank Ltd. *US – China: who walks on foreign crutches?* 16.11.2007. Emerging Asia includes China, India, Hong Kong, Taiwan, South Korea, Singapore, Malaysia, Thailand, Indonesia, and the Philippines.

Sector dispersion
expected to increase

The current macroeconomic uncertainty suggests that equity markets will remain volatile for some time. With an average P/E ratio of about 15 times 2008E earnings, equities in developed markets are currently attractively priced if earnings hold up. Despite the fact that the valuation gap between small/mid caps and large caps has narrowed, we expect large caps will continue to outperform with increased sector dispersion. In this environment, sector and stock picking skills will be paramount for long/short hedge funds as they can no longer rely on a rising overall market.

Volatility will stay at a
medium to high level

Relative value managers will face several challenges. Volatility arbitrageurs will benefit from a general long exposure to various levels of volatility and frequently shifting sentiment. Fixed income managers will look for opportunities in the yield curve that will arise from uncertainty around central bank action. Steepeners (a trade that benefits when the yield curve steepens) will be well placed should central banks lower interest rates more than expected. Possibly, long term rates would not respond or might even rise due to stubborn inflation, which would result in a massive steepening.

Within relative value multi-
strategy managers have
best outlook

Convertible bond arbitrageurs are likely to remain profitable, especially when realised volatility frequently exceeds implied, which allows more profits from gamma trading. New issuances could also help managers. A higher volatility regime is generally a good environment for new offerings. Within relative value, multi-strategy managers have the best outlook, as they have plenty of cash at hand and can quickly shift their investments to the most promising opportunities. For example, they recently moved their investments from CB arbitrage to FI arbitrage.

Volatility has increased in 2007 and will stay at a medium to high level



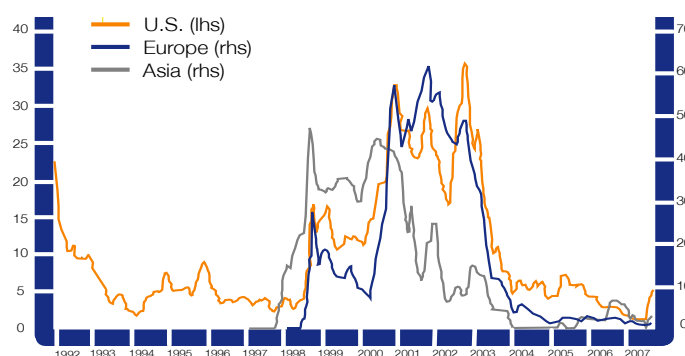
Source: Bloomberg.

We continue to see opportunities in event driven

There are opportunities for both distressed and special situations in the event driven style. Managers focusing on distressed paper should have a larger playing field next year as the fallout from the credit and subprime crises will have to be dealt with. Some managers are now focusing on undervalued structured credit securities that were sold off during H2 2007. Many institutional money managers had to sell such securities when they were downgraded, often irrespective of their true value. Such forced selling often offers opportunities for specialised managers that have the capacity and expertise to analyse and value such positions correctly.

Classic distressed investing, shortly before or after a default, will remain limited as most companies in trouble are approached and restructured long before they actually default. Hence, the default rate as reported by the rating agencies will remain relatively low. There are also some companies that are 'walking wounded', often due to covenant light structures that were granted during the height of the credit boom in H2 2006 and H1 2007. Such conditions allow troubled companies to avoid default, which explains the low default / distressed ratios.

Distressed ratio still low



Source: Merrill Lynch. Chart shows proportion of bonds trading at spreads over 1,000 bps. Period: April 1991 to October 2007.

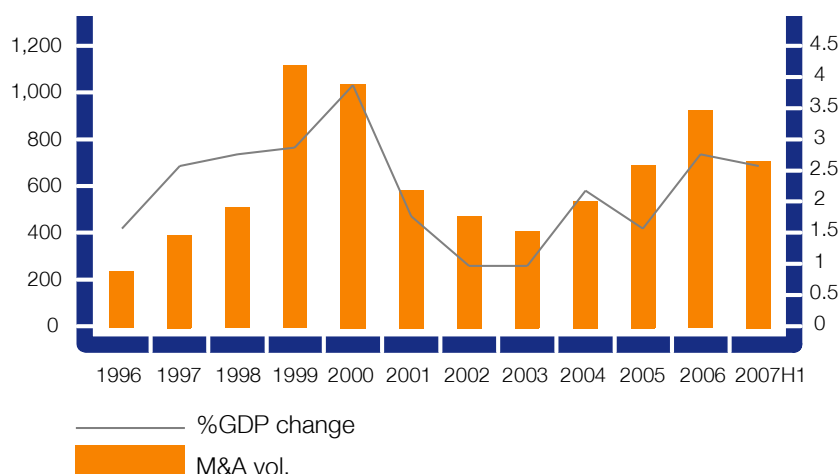
Despite the recent slowdown in M&A volume we expect continued strength

After two boom years, announced M&A volume started to slow in H2 2007 as private equity firms, which dominated the scene in H1 now face tougher financing conditions. Nevertheless, 2007 has still been a record year. At the end of October, global M&A volume overtook last year's record of USD 3.55 trillion. For 2008 we expect a lower, but still decent volume as strategic deals fill the gap. Many companies have large amounts of cash on their balance sheets and will be looking for external growth. Sectors such as mining, energy and insurance are expected to see further consolidation.

Sovereign Wealth Funds (SWFs) are also expected to increase their hunting ground as they are looking to diversify their huge foreign exchange reserves and fixed income holdings. According to the IMF, SWFs already manage USD 2.5 trillion worldwide and this figure will increase rapidly. One recent example is Abu Dhabi Investment Authority's USD 7.5 billion cash infusion to Citigroup. Special situations managers will carefully monitor the future development of SWFs activities.

The chart below shows the fairly close relationship between M&A activity and GDP growth. Although the chart shows figures for Europe, the situation is fairly similar on a global basis.

M&A activity versus GDP growth in Europe



Source: SDC, Thomson Financial/Economist, Intelligence Unit.

Fed is caught between a rock and a hard place

The environment for global traders will remain challenging. The outlook for FX and fixed income is unclear and will depend on further data flow. The Fed is caught between a rock and a hard place as no matter what it does there is a high risk it will be wrong and there will not be a shortage of criticism. We expect inconsistent data flow will lead to continued high FX and FI volatility. The USD is set to rebound at some point in 2008 as the current overly negative sentiment may wane. A possible catalyst for a dollar rally could be when market participants realise that the ECB may also be forced to cut rates.

Carry trades are off...

Carry trades will probably be unattractive for most of next year as elevated FX volatility will lead to a strengthening of the funding currencies, such as the JPY.

Yen carry trades are losing attractiveness



Source: Bloomberg, Capital Economics. This carry trade attractiveness index divides the spread between US and Japanese 3 month interbank rates by the implied 3 month volatility of the JPY against the USD derived from options markets.

...but several other opportunities continue to exist around the world

Opportunities around the world for global macro managers



Source: Man Investments Research, Analysis and Strategy Group.

US dollar reversal: The USD is undervalued according to purchasing power parity indices and sentiment is extremely negative. There could, however, be a sharp reversal when market participants realise the ECB and BOE also have to cut interest rates. Any narrowing of the US budget deficit and/or trade deficit could trigger a change in sentiment. As a result, some global macro managers are tentatively positioning themselves for a recovery.

Mis-priced credit: The massive downgrades of structured investment vehicles such as collateralised debt obligations, mortgage-backed securities and asset-backed securities have resulted in a huge wave of selling. Some managers are now looking for value as many of these securities may have been thrown out with the bathwater. For managers with the necessary skill set, this offers an excellent playground.

Emerging market local debt: Local emerging market bonds (sovereign bonds denominated in LC, not USD) continue to offer opportunities as many countries can now issue bonds in their home currency and build a local yield curve. Attractive markets include Brazil, Turkey and Mexico.

Domestic demand in emerging markets: Over the last decade, emerging markets have evolved into large consumer markets. They no longer just rely on export and cheap labour. While consumers are less debt-driven than in rich countries, they now have access to consumer finance and, increasingly, mortgages. This has fuelled domestic spending, making these economies more diverse and adaptable

Japanese reflation trade: Long Nikkei, long Yen, short JGB: A popular trade over the last three years which never really worked because Japan never exited from deflation. As a result the trade is not as popular, but it remains on the backburner.

Carry trade: The classic FX carry trade has been profitable for most of the last few years as FX volatility remained low and the Yen weak. This year, however, it has only worked partially and for 2008 it is expected to abate. Some managers are positioned to benefit from a reversal by being long JPY and CHF and short AUD, NZD or GBP.

Long Asian currency basket: Although Asian currencies have appreciated substantially over the last few years, they remain undervalued according to various measures. On a purchasing power basis (e.g. Big Mac Index), Asian currencies such as MYR, TWD, IDR, HKD, TWD, CNY or JPY continue to look inexpensive.¹

Food inflation: Continued growth of the global population coupled with rising income and higher living standards in emerging countries increases the demand for high protein food and grains. Many countries will have to rely on imports. At the same time, some crops such as sugar and corn are used to produce biofuel. This has caused a sharp rise in many soft commodities and pushed up consumer prices (especially in countries with a high share of food in the CPI).

New silk road: We expect the Chinese economic expansion to strongly influence the development of countries in central Asia. This region has not seen much development yet, but it lies between two prosperous areas (Middle East, Far East). Countries around the Black and the Caspian Sea, sometime also termed CIS (Commonwealth of Independent States) or FSU (Former Soviet Union) are not yet on the investment map but could emerge soon as frontier markets.

¹ MYR – Malaysian Ringgit, TWD – Taiwan Dollar, IDR – Indonesian Rupiah, HKD, Hongkong Dollar, TWD – Taiwan Dollar, CNY – Chinese Yuan Renminbi, JPY – Japanese Yen.

Carbon trading: Until recently, arbitrage opportunities between different energy markets such as oil, petrol or natural gas were based on assumptions regarding fundamental and/or political developments. With the introduction of the carbon trading scheme, these individual energy markets became more closely connected to each other, offering multiple trading and arbitrage opportunities.

Gulf region investing: The Middle East region offers a variety of compelling investment opportunities such as abundant domestic liquidity, strong corporate earnings, high consumer confidence fuelled by high and rising income levels as well as cheap equity valuations following the correction in 2006. Furthermore, the Middle East has historically shown low correlation to other regions and traditional asset classes outside that region.

Commodities continue to be attractive

The outlook for the energy complex is mixed. While the IEA (International Energy Agency) has substantially cut its 2008 demand growth forecast to 1.9 million barrels per day, non-OPEC supply forecasts are converging toward 1.0m million barrels per day for 2008 after a rise of 0.6 million barrels per day in 2007. Some analysts have been projecting a non-OPEC peak. The current market reality of very high oil prices reflects short-term tightness in global supply and demand, which could be reduced by technical selling at the beginning of 2008.

Looking into 2008 the environment for precious metals will remain favourable in general. Gold equities are very attractively valued compared to bullion. Within the industrial metal sector, supply disruptions and labour disputes are still a problem. However, weak demand from US housing should offset this somewhat. We expect prices to remain range bound for most of next year.

Trends often emerge quickly and unexpectedly

With regards to managed futures, we do not expect a large number of strong trends. But this should be taken with a pinch of salt, as trends can sometimes emerge quickly and unexpectedly, thereby creating interesting opportunities for systematic CTAs. In FX and FI there could be trends in either direction as rates and the USD may overshoot.

Hedge funds ideal in an all weather environment

The only real certainty for 2008 is that there will be a great deal of uncertainty. While we are reasonably confident that the global economy will continue to grow strongly, though at a slower pace than in the past couple of years, there may still be some shocks related to the credit market and it is unclear just how much trouble the US is in or what impact this will have on other markets. In this environment we expect heightened volatility, with clear sector and market differentiation which should put the advantage firmly in the hands of skill-based hedge fund managers who have the ability to spot the opportunities and the tools to take advantage of them. 2007 has demonstrated that hedge funds are able to benefit from market stress, dislocations and heightened volatility.

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