



Quarterly review

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Q4 2008 – the case for hedge funds re-visited

- Hedge funds and most other assets struggled during the quarter as the world economy fell off a cliff
- Q4 2008 was characterised by a complete loss of market confidence and spiking volatility
- Managed futures were a rare exception, finishing the year with double-digit gains
- After the shock, hedge funds offer in most cases the better means than long-only investments to profit from market normalisations
- While the absolute return concept has been damaged, claims that the asset class is dead are premature

Performance review Q4 2008

Q4 marked the start of the economic crisis

The final three months of 2008 will be remembered as one of the most difficult quarters for investors in history. Equity indices fell in excess of -20% (YTD -40.11%)¹ across the globe and credit markets also dropped substantially as high yield spreads shot up to 1,706 bps over comparable US Treasuries.² Volatility reached extremely high levels. The VIX index rose above 80 on two trading days (27 Oct and 20 Nov), its highest level since inception in 1993. Nearly all advanced economies suffered a deep contraction as new orders for durable goods came to a standstill. The auto sector was hit particularly hard and the already struggling industry had to be supported by government intervention. One example was the rescue package doled out to the big three US automakers in December to prevent their immediate bankruptcy. In essence, the fourth quarter marked the start of the economic crisis that followed on from the financial crisis which began in mid-2007.

Emerging markets and commodities sold off strongly

Emerging markets also felt the pinch as most developing economies are export and/or commodity driven. The MSCI Emerging Market Index lost -27.60% (YTD -53.33%).³ The fear over slowing global growth and the limited availability of letters of credit weighed heavily on commodities and the global shipping industry. As a result, commodities continued the downtrend which started in July 2008, with WTI crude oil falling to USD 33.87 on 19 December 2008, a level not seen since early February 2004.⁴ The Baltic Dry Index, a good indicator for world trade activity, also dropped to multi-year lows. Central banks around the world cut interest rates heavily to counteract the deepening slump. The global risk awareness and flight to safety could best be observed in global government bond prices, which continued their uptrend (5.88%, YTD 8.90%)⁵.

All hedge fund styles (ex CTAs) struggled

Hedge funds endured their worst quarter on record as all styles except managed futures and (systematic) global macro recorded double-digit losses. Even the most diversified funds suffered. The HFRX Global Hedge Fund Index dropped -13.17% (YTD -25.45%)⁶. Arbitrage strategies, which normally exhibit little correlation to the general market, were hurt by de-leveraging, which led to forced selling, and the general shortage of liquidity. Convertible bond arbitrageurs had a particularly hard time.⁷ Event driven was hit by the rapidly deteriorating credit markets and equity hedge was not able to escape the general sell-off in the stock markets. The Madoff episode in December was an additional blow to the hedge fund industry.

¹ MSCI World in LC

² High Yield spread-to-worst as measured by the CS High Yield Index

³ MSCI Emerging Market Index (in USD terms)

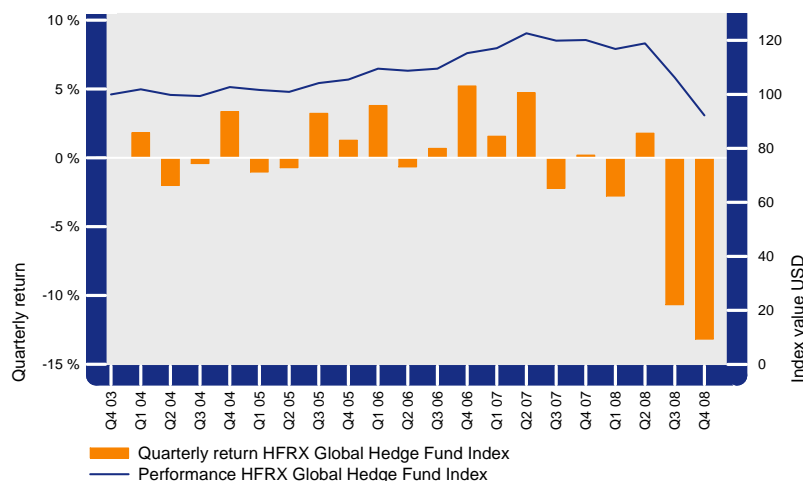
⁴ Bloomberg

⁵ Citigroup Global Government Bond Index, all maturities in LC

⁶ Hedge Fund Research, Inc.

⁷ HFRX Convertible Arbitrage Index QTD -44.90% versus ML G300 (global long-only convertibles) -9.07%

Figure 1: HFRX Global Hedge Fund Index



Source: Bloomberg. Period analysed: January 2004 to December 2008.

Illiquid holdings can be managed in different ways

A substantial number of managers are currently holding a high percentage of their funds in cash in order to meet redemption requests. However, there are also managers with illiquid holdings that cannot be converted to cash, at least not in the short term. This is particularly an issue in the relative value and event driven styles. As a result, some managers are delaying the redemption payments by either gating or suspending redemptions or creating side pockets. In most cases, managers were acting in good faith and in the best interest of their investors in the face of radically changed financial market conditions. Under these conditions, managers could not find reasonable bids as other hedge funds and investment banks were unable or unwilling to add new risk at a time when they were under pressure to de-lever their balance sheets. Furthermore, by delaying redemption payments, managers are not forced to fire sale assets. This prevents remaining investors from being at a disadvantage to redeeming investors. The differences between different payment deferral possibilities are outlined in figure 2:

Figure 2: Overview of different hedge fund payment deferral possibilities

Redemption delay type	Needs investor consent	Payment methodology	Payment delay
Gate	No, but predetermined and set out in the fund documentation.	<p>Generally, in the event redemption requests received are more than a predefined percentage or threshold of the total NAV of the shares then in issue, the Fund is entitled to reduce the requests pro rata amongst all applicable shareholders. Many funds provide that, in the event that a gate is triggered, gated shareholders are paid out pro rata up to the threshold among and are given priority at the next redemption date.</p>	<p>Redemption requests above the gate threshold are deferred to the next redemption date. Sometimes such redemption payments are subject to further deferral if the aggregate deferred amounts and new redemption requests exceed the predefined percentage as of the next redemption date. In case of indefinite gating, a “gating cleanup” can be applied, which requires that investors receive redemption payments within a predefined time period after the gate has been imposed.</p>
Suspension	No, but the authorisation to do so is predetermined and set out in the fund documentation.	<p>Most funds may suspend redemptions and the determination of NAV in the following circumstances:</p> <ul style="list-style-type: none"> a) during closure of a market in which the investments are traded, other than standard holidays; b) existence of an emergency as a result of which disposal of investments would not be practicable; and c) during any period when realisation/acquisition of investments cannot be effected at normal rates of exchange. <p>Sometimes funds have a broad general right to suspend where the fund directors believe such suspension to be in the best interests of investors.</p>	<p>Suspension time is not predetermined and may be indefinite.</p>

Figure 2 (continued):

Redemption delay type	Needs investor consent	Payment methodology	Payment delay
Side pocket	No, provided that the authorisation to side pocket investments is included in the fund documentation.	The manager or the fund directors (depending on the fund documentation) may designate certain illiquid investments as side pockets, which designation is usually reflected as a separate share class with no redemption rights.	Once realised, assets which have been designated as side pockets are usually converted back to the original share class designation.

Source: Man Investments Research. Please note that this table is only indicative and should not be seen as a complete legal documentation regarding gating/suspension/side pockets, as individual terms and conditions may vary.

Equity hedge managers could not escape technical issues and de-leveraging

Equity hedge managers could not escape the broad sell-off in the markets despite running reduced net and gross exposures. The HFRX Equity Hedged Index lost -13.71% (YTD -25.45%).⁸ While equity hedge managers did better than unhedged equity managers, their downside protection did not work well enough. There were several issues. First, fundamental bottom-up analysis could not predict the extent of the unfolding macro, technical and de-leveraging issues. Second, indiscriminate selling disrupted the historical factor relationships between aspects such as value versus growth or large caps versus small caps. In some cases, managers were unable to adjust their betas quickly enough. Third, long/short managers were unable (or unwilling) to modify their exposure through options due to the spike in volatility.⁹

Short selling bans did not prevent (financial) stocks from falling further

Finally, short selling strategies were impacted by a shift in regulation and/or government intervention. Several countries around the world introduced short-selling restrictions in autumn 2008, mainly on financial stocks, to protect them from falling further. This ban affected new short positions, not existing ones. Unfortunately, financial stocks kept falling despite the short-selling ban. This proved that short-sellers were not the cause for falling financial stocks. Furthermore, bid/ask spreads increased during this time. As a result, short-selling bans did not achieve their expected results. Hence, most short-selling bans have been lifted by the end of December/January, with the exception of Australia and Japan.

⁸ Hedge Fund Research, Inc.

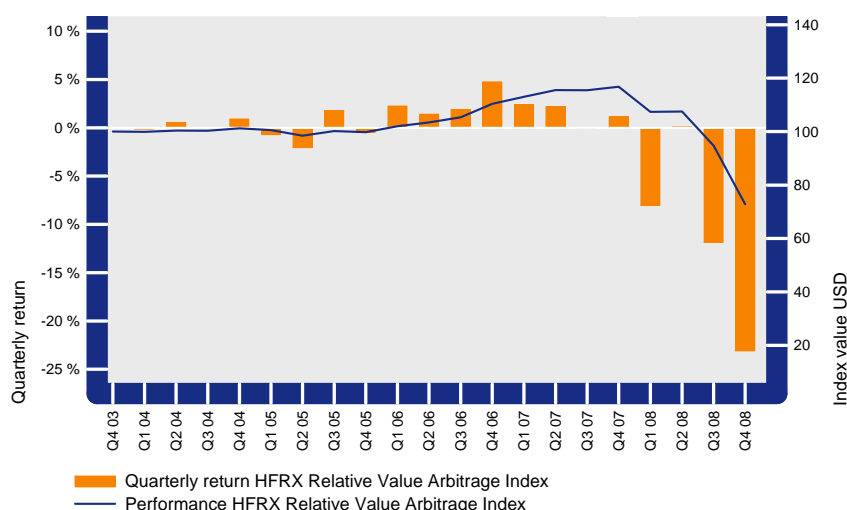
⁹ When implied volatility is high, the time decay (theta) of options is very costly and thus may not be economical

Relative value suffered as liquidity vanished...

...e.g. in convertible bond arbitrage

Relative value was the worst affected hedge fund style, not just in Q4 08 (-23.09%), but also throughout 2008 (YTD -37.60%).¹⁰ Extreme market volatility and illiquid markets paired with accelerated de-leveraging led to huge losses, as prime brokers changed the rules of the game overnight.¹¹ The poorest performing strategy in this style was convertible bond arbitrage. The HFRX Convertible Arbitrage Index lost -35% in October alone (QTD -44.90%, YTD -58.37%)¹² as convertibles were caught in a negative spiral and cheapened dramatically as several prime brokers ceased their convertible activities and flooded the market with paper. In November and December the market calmed somewhat as new buyers entered the market and several companies started to buy back their outstanding convertibles. Even considering the recent strength in the convertible market, overall valuations remain attractive compared to most other asset classes and many names continue to trade at distressed levels globally.

Figure 3: HFRX Relative Value Arbitrage Index



Source: Bloomberg. Period analysed: January 2004 to December 2008.

Fixed income arbitrage also suffered...

...while equity market neutral was slightly positive

Fixed income arbitrageurs suffered as credit basis (i.e. difference in credit spreads between cash bonds and comparable CDS) continued to widen to extremes. This was mainly due to the lower liquidity in cash bonds versus CDS. In normal market conditions, these spreads quickly converge as being long the cash bond and the CDS carries no market risk (but obviously liquidity risks). A 180 degree U-turn by the US government in regard to the TARP also created confusion in fixed income markets. In mid-November, the Treasury announced that TARP money would not be used to purchase troubled assets (as the market anticipated) but only to re-capitalise the banks. This led to a further sell-off of these assets, including MBS, ABS, and other corporate debt instruments. Equity market neutral managers were the rare bright spot within

¹⁰ HFRX Relative Value Arbitrage Index, Hedge Fund Research, Inc.

¹¹ E.g. short selling bans, margin requirements, etc.

¹² Hedge Fund Research, Inc.

relative value. A variety of models worked well throughout the quarter, including value and price reversal models, while growth and momentum models were less profitable.

Event driven was negatively impacted by a number of factors

Event driven managers had a disappointing fourth quarter with the HFRX Event Driven Index dropping -10.77% (YTD -22.11%).¹³ The VW/Porsche deal in October was the main story, with hedge funds taking losses from spread trades and outright shorts, and special situations proved difficult in general. While the Inbev/Anheuser Busch transaction provided some upside for managers, BHP Billiton's decision to scrap its offer for Rio Tinto resulted in losses as Rio dropped sharply. The financial crisis weighed heavily on the completion of deals and 1,362 M&A deals worth USD 923 billion were cancelled globally.¹⁴ Distressed managers also struggled during the quarter, as high yield spreads increased to 1,706 bps over UST¹⁵ and leveraged loans also suffered. Default rates increased in 2008, with loan default rates ending the year at 5.10%¹⁶ and high yield bond default rates at 2.25%¹⁷ Overall, distressed was heavily affected by the weakness in the credit markets, the general flight to quality and the de-leveraging and risk reduction by financial institutions. Due to the illiquid nature of the distressed market, a number of managers had to announce deferral of payment for redeeming investors.¹⁸

Global macro did OK but emerging market exposure dragged on performance

Global macro managers posted a gain of 2.94% (YTD 5.61%)¹⁹. However, investors have to keep in mind that the HFRX Macro Index also contains a number of systematic macro strategies that we would classify as managed futures. In general, macro managers were lightly positioned with little equity exposure. While they benefited from interest rates and currency moves, they were less fortunate in emerging markets. EM currencies, equities and fixed income all suffered due to the flight to quality and a steep rise in country risk premia. In FX the Turkish Lira, the Mexican Peso and the Brazilian Real all lost in excess of -20% against the USD.²⁰ This put pressure on many global macro funds that tend to be long these currencies. Another challenge was the reduction in liquidity in some market segments that left managers with illiquid positions such as Argentinean inflation-linked bonds, Ukrainian bank bonds, Malaysian corporate bonds or various types of asset-backed securities. Within the commodity sector, managers benefited from long-dated puts in unleaded gas, gas oil and crude, as well as short positions in energy, base metals (specifically aluminium) and agriculture. While all long-only commodity indices kept falling²¹, hedge funds active in this sector were able to protect investor capital, thereby generating significant alpha.

CTAs had one of their best quarters ever...

CTAs benefited from the general market uncertainty, as markets were governed by fat tail behaviour, i.e. large price moves which do not occur very often. Interestingly enough, market participants react to new significant information in a similar manner, i.e. there is a clear link between today's prices and recent events. CTAs had one of their

¹³ Hedge Fund Research, Inc.

¹⁴ Dealogic, figure refers to full year 2008

¹⁵ Spread to worst CS High Yield Index

¹⁶ JPMorgan Issuer-weighted institutional loan default rate

¹⁷ JPMorgan Dollar-weighted high yield bond default rate

¹⁸ Various forms of deferral possibilities are explained in figure 2

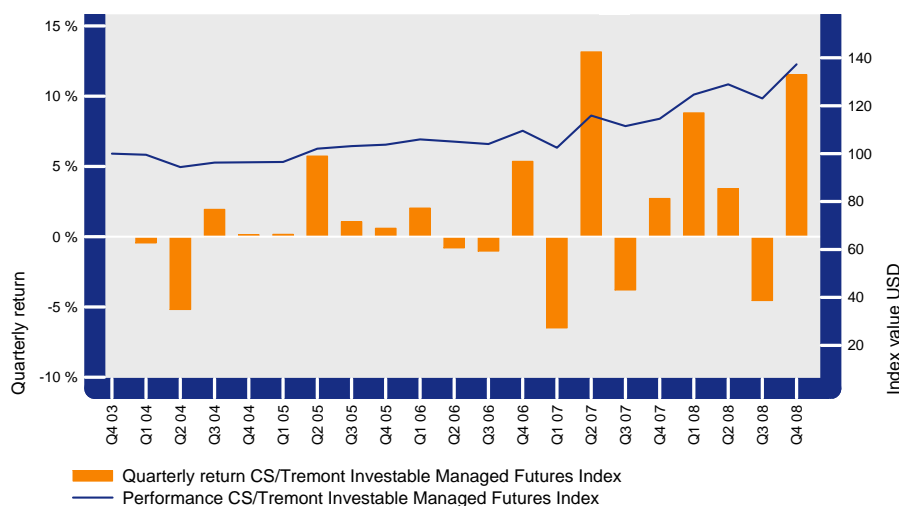
¹⁹ HFRX Macro Index

²⁰ Bloomberg

²¹ S&P GSCI: Q4 -47%, Reuters Jeffries CRB: Q4 -34%

best quarters ever (up 11.54% YTD 19.82%).²² For the whole year, managed futures had their best showing since 2003.

Figure 4: CS Tremont Investable Managed Futures Index

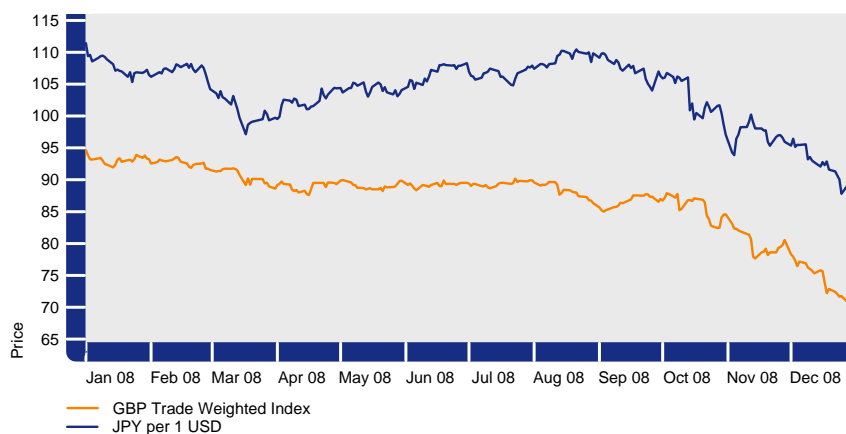


Source: CS/Tremont. Period analysed: January 2004 to December 2008.

...profiting from large moves in currencies, fixed income and energy

The main performance drivers for CTAs were large directional moves in currencies, fixed income and energy. In FX markets, the higher yielding currencies came under pressure while the Yen and Swiss franc trended higher. The British pound was the main victim, as the BoE rapidly cut rates (and indicated more cuts to come) and the UK economy quickly deteriorated. Sterling lost -30% (YTD -40%) against the Yen. In fixed income, CTAs benefited from the rally in government bonds towards year end while in energy short positions were very profitable.

Figure 5: GBP fell against all major currencies, JPY appreciated against USD



Source: Bloomberg. Period analysed: January 2008 to 9 January 2009.

²² CS Tremont Investable Managed Futures Index

Special topic: the case for hedge funds re-visited

Hedge funds have come a long way since the early days...

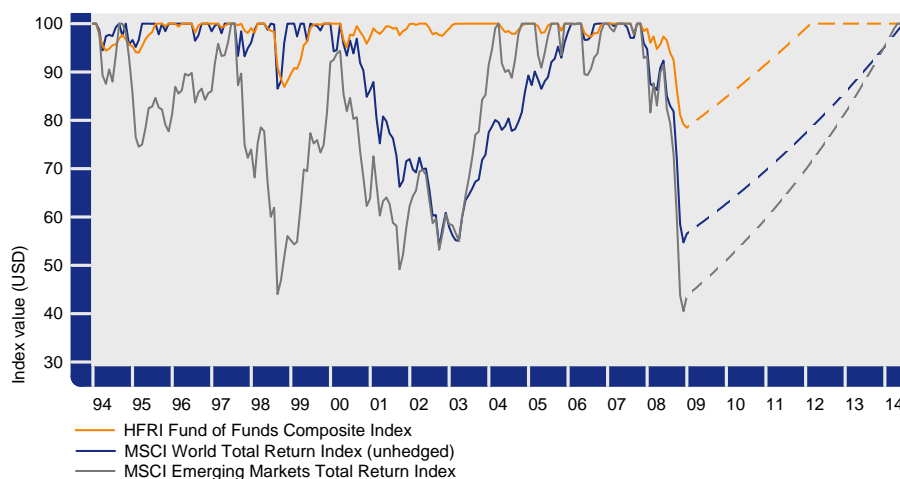
The asset class has come a long way since Alfred W. Jones created what is believed to be the first hedge fund in 1949. Until the early 1990s hedge funds were largely a side show. The first multi-billion dollar outfits appeared in the mid-1990s, including the industry's first major accident: LTCM in 1998. At the end of that year, confidence in the hedge fund model was broken and many predicted the end of the industry. However, despite this set back, the hedge fund model proved to be flexible and adapted to a new environment of lower leverage and more public scrutiny. After a few difficult years, the hedge fund industry regained widespread acceptance after it successfully navigated the turmoil of the tech bubble. While equity markets dropped by some -50% (from March 2000 to February 2003), hedge funds were able to not only preserve capital, but also achieve a small gain (2.35%²³). From 2002 onwards, the industry began to enter the mainstream and attracted large inflows of institutional money and larger public interest and press coverage.

...but where do we go from here?

In the mid 2000s, the industry generally delivered what was promised with yearly gains in the high single or low double digits until the end of 2007. Of course we know what happened in 2008. Nevertheless, investors should not forget that hedge funds recover faster than equities. For once, because they have less ground to recoup after a drawdown that is less deep than equity market drawdowns, and second, because hedge funds do not solely rely on bull markets. This can be clearly seen in the underwater chart below. While data until December 2008 is real performance, data starting in 2009 are projections, using average annual return expectations, based on average annual returns achieved for the time period since inception of the index until the last high water mark (October 2007 for all three indices). According to the projected chart below, hedge funds will reach high water mark in roughly 2011, world stocks and emerging market stocks in 2014.

²³ HFRI Fund of Fund Composite Index.

Figure 6: Under water chart comparing hedge funds with global and emerging market stocks



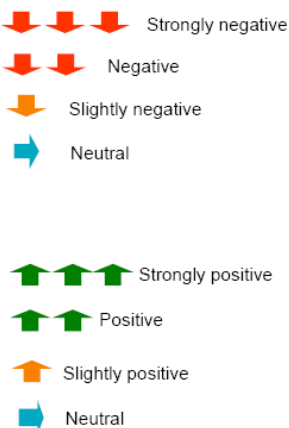
Source: Bloomberg and RMF Investment Management, a wholly owned subsidiary of Man Group plc. Period analysed: January 1994 to December 2008 (real data), data after December 2008 are projections, based on the following expected annual returns (index inception date in brackets): HFRF Fund of Funds Composite Index (January 1994): 8.04%; MSCI World Total Return Index (unhedged) (January 1970): 10.99%; MSCI Emerging Markets Total Return Index (January 1988): 16.90%. The underwater chart is calculated by measuring the index value as a percentage of its previous all-time-high. It allows us to visualise losses, the length of negative compounding as well as the time spent under water.

In this section, we will not review the events of 2008 further, as this was done in our review/outlook paper (www.maninvestments.com/press/research) and previously in this report. Instead, we want to focus on the case for hedge funds in 2009 and beyond, mainly in comparison to long only investments such as stocks and bonds.

Conflicting forces are at work

Currently, there are a number of conflicting forces at work in favour and against the hedge fund industry. The main headwind is the still on-going de-leveraging process of the financial system, including hedge funds, which makes allocation of new risk capital highly difficult. On the positive side, most asset classes are now trading at a substantial discount and offer many opportunities while decreased competition should allow for higher risk-adjusted returns once markets stabilise. The next figure illustrates a number of head- and tailwinds for hedge funds. The colours indicate the severity and timelines of the positive and negative factors we currently see in the hedge fund industry.

Figure 7: Current headwinds and tailwinds for the hedge fund industry

Outlook	2009				2010 onward	
	Headwinds	Q1	Q2	Q3		
Continued de-leveraging	3 red down	2 red down	1 red down	1 blue right	1 blue right	
Some positions still crowded	2 red down	1 orange up	1 orange up	1 orange up	1 blue right	
Money flow	3 red down	2 red down	2 red down	2 red down	1 blue right	
Institutions need cash	2 red down	2 red down	1 orange up	1 orange up	1 orange up	
Perceived fraud risk after Madoff	3 red down	3 red down	2 red down	2 red down	2 red down	
Impaired confidence	3 red down	3 red down	2 red down	2 red down	1 orange up	
Available risk capital	3 red down	2 red down	2 red down	1 orange up	1 blue right	
Tailwinds	Q1	Q2	Q3	Q4		
TED spread retreating	3 green up	2 green up	1 orange up	1 blue right	1 blue right	
Investment grade credit recovering	2 green up	1 orange up	1 blue right	1 blue right	1 blue right	
Lower mortgage rates/energy prices help consumers	2 green up	2 green up	2 green up	1 blue right	1 blue right	
Hedge funds are suited to benefit from normalisation	1 blue right	1 blue right	1 orange up	2 green up	3 green up	
Policy responses will work over time	1 blue right	1 orange up	2 green up	2 green up	2 green up	
Less crowded playing field	1 blue right	1 blue right	1 blue right	1 orange up	3 green up	

Source: Man Investments Research.

Industry headwinds

De-leveraging is nearing an end but outflows will persist over the next few months

The most pressing issue for hedge funds over the last few months has clearly been de-leveraging. We will not further touch on this here, as we already covered this earlier in this report and in our review 2008 paper. We estimate that the de-leveraging process is not completely over yet but has reached its final stages. In addition, a number of hedge funds are in liquidation mode and outflows are likely to continue as there is an overhang of redemptions for the foreseeable future. This will slow a recovery in many hedge fund styles and strategies, particularly in the event driven and relative value styles. Some positions (e.g. Japanese inflation-linked government bonds) are still crowded which could lead to further forced selling should the market stay weak or deteriorate further. Furthermore, there are few exit strategies for non-traded instruments. During the good times, many multi-strategy managers added private equity type, non-publicly traded instruments to access the liquidity premium. While this made sense at the time, it is now a headwind because the premium turned to a discount and investors now prefer only liquid instruments.

Institutions need to repair their balance sheets

There is also a strong need for cash among institutional investors and FoHF. This cash is primarily needed to meet capital adequacy ratios, retain solvency and reduce risk in the balance sheet. While hedge funds are certainly not the ideal asset class to raise money quickly, they offer at least some form of liquidity that other 'alternatives' (e.g. timber, real estate or private equity) do not. This has led to high redemptions, even from strong performers and healthy funds have been used as 'ATMs' for the hedge fund industry.

Risk capital remains scarce...

...and confidence has been bruised

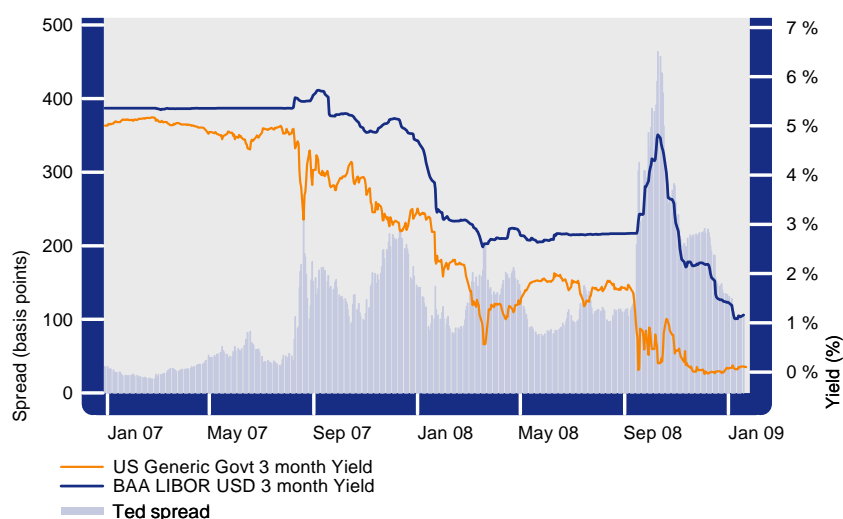
Industry tailwinds

The interbank markets show signs of improvement

This will obviously hinder surviving hedge funds looking to add new risk capital. In many ways, today's world is the polar opposite of 2003-2007. During that time there was a global liquidity glut and investors could not get enough of risky assets and yield pick up. Today, a lot of asset classes offer substantially more attractive yields and return potential but the sentiment has reversed. In some segments of the market, e.g. convertible bonds, we have seen some crossover buying interest from long only investors. However, crossover buying will remain muted in many areas in which hedge funds are active in (e.g. leveraged loans). The viability of the absolute return concept is being questioned and belief in the idea that it is possible to achieve superior risk-adjusted returns with little market risk has suffered a great deal. This will make it more difficult for the hedge fund industry to attract and retain assets in future. The Madoff episode is likely to exacerbate this.

In our review/outlook report two months ago we argued that we need a functioning interbank market before the financial market can begin to stabilise. For most of 2008, particularly in the fourth quarter, the interbank market did not work properly due to confidence and solvency issues. The TED spread, i.e. the premium that banks pay to borrow money compared to the government, rose rapidly in the aftermath of the Lehman failure. Since then, the TED spread has narrowed but is still slightly above 100 bps. This indicates significant progress as lower policy rates are now also reflected in lower LIBOR rates. This is likely to lure some companies back to the credit markets to take advantage of these lower rates.

Figure 8: The interbank markets show signs of improving

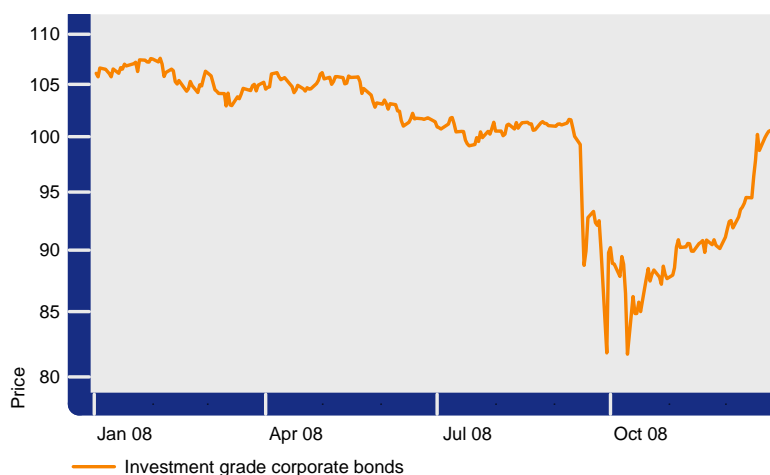


Source: Bloomberg. Period analysed: January 2007 to 20 January 2009.

The improved interbank market has also led to an easing in the corporate credit markets. Investment grade corporate bonds, under severe pressure during Q4, have already largely recovered their losses. While credit spreads remain elevated, and lower

quality credits remain depressed, the higher quality corporates are benefitting from the lower policy rates and crossover buying.

Figure 9: Investment grade credit has recovered



Source: Bloomberg LQD US Equity (I-shares investment grade corporate bond fund ETF). Period analysed: January 2008 to December 2008.

A less crowded playing field

It is important to keep in mind that crises always bring opportunities. The playing field will be less crowded in the future and many surviving hedge funds will benefit from a smaller competitive universe, significantly smaller balance sheets at investment banks and, consequently, proprietary trading desks. The de-leveraging of balance sheets globally has in part led to a complete re-rating of risk by investors. Thus, the opportunity set has become dramatically larger and the number of willing risk takers reduced. This opportunity is however partially offset by a likely reduction in volumes and therefore a continued state of less liquid markets in the near term.

Lower energy prices and mortgage rates will help consumers

Among the few bright spots for the economy going forward is the decline in mortgage rates that will allow sound borrowers to refinance and lower their monthly payments which will help them to either improve their balance sheets or increase consumer spending. Lower rates also make houses more affordable and could, at some point, put a floor under still falling home prices. But relative to everything that is going on in the economy and in financial markets, the amount of stimulation it will provide is unlikely to be enough. The drop in energy prices also helps stressed consumers as lower gasoline prices will translate into hundreds of billions of dollars of savings. Despite these tailwinds, we believe that consumer spending will remain quite weak for 2009, mostly due to the worsening job market and the negative wealth effect.

Asset class overview

At several points over the last few months we have argued that we do not necessarily need a new bull market in order for hedge funds to recover. Over the next few pages we try to give investors some insight into our proposition. We will focus on the equity, fixed income, credit, foreign exchange and commodity markets. The goal is to contrast the value proposition for hedge funds with long only alternatives. For example, investors may be curious as to why they should use long/short equity instead of long only equity, distressed versus long high yield etc. It is important to note that hedge funds are not always the better means. In some cases, long only makes more sense.

Equity

Opposing forces are at work

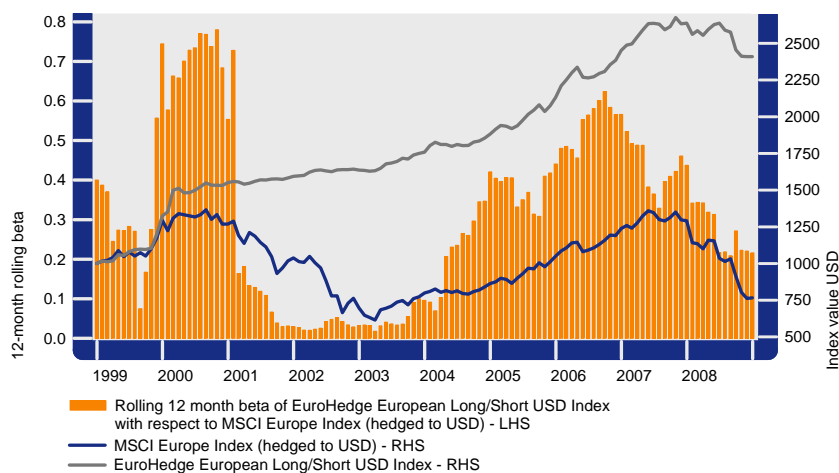
Equity markets globally fell off a cliff in 2008 and most equity indices have erased most if not all of the gains made in the 2003-2007 bull market to trade at multi-year lows. By some measures, equities are trading at very cheap valuation levels. Hence it might look attractive for long-only investors to get into the markets now. However, 2009 did not start well and global stock markets continue to edge lower. While we do not know where the market will be in 12 months, we can expect the environment for equities to remain difficult as long as the economy is worsening. However, a snap back is likely when the macro picture improves. Hence, the most likely scenario is a tug-of-war between these two forces.

Net and gross exposure is much lower

Equity hedge managers did not do so well during 2008 as we discussed previously. However, we are convinced that equity hedge managers can make money in 2009 as both the long and the short side offer opportunities. Unlike long-only investors, hedge funds are able to not only pick stocks but also swiftly change their net/gross exposure. Currently, we estimate the net long exposure (beta) at about 15-30% and the gross exposure at between 50 and 80%.²⁴ This is significantly lower than one or two years ago. As a result, managers will be less exposed to the overall market and their performance will depend significantly more on their stock picking skills and sector exposures. It is also important to keep in mind that equity hedge managers only apply a minimal amount of leverage and thus are normally not forced sellers.

²⁴ Man Investments Research.

Figure 10: Exposure of European long/short equity managers



Source: Bloomberg, EuroHedge and RMF Investment Management, a whole owned subsidiary of Man Group plc. Dynamic beta are estimated with Kalman Filter and Kalman Smoother techniques. Period analysed: January 1999 to December 2008.

As mentioned earlier, several countries imposed short-selling bans in autumn 2008, but most of these restrictions were lifted in the meantime, as they did not prevent (financial) stocks from falling further. With few exceptions such as Australia and Japan, equity long/short managers are once again able to fully express their views on stocks and have their entire tool box available.

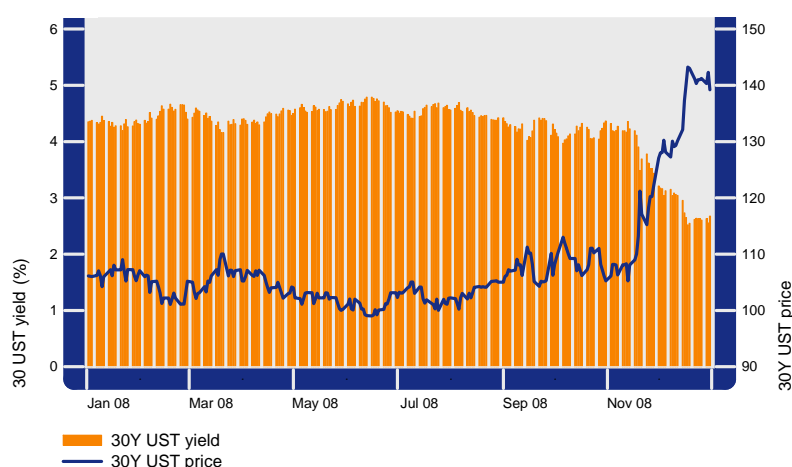
Dispersion is the name of the game

Equity hedge managers should be able to pick the winners and short sell the losers of the current recession. While recession proof companies will trade up, over-leveraged and fundamentally weak companies will trade lower. Many companies will not make it and their stocks will edge towards zero. This offers good opportunities on the short side, e.g. in retail, leisure and gaming, consumer goods industries. On the long side, managers currently favour defensive sectors such as healthcare or consumer staples. Furthermore, as a result of the various stimulus packages around the world, stocks of companies active in the infrastructure sector such as renewable energy, transportation, constructions, materials, telecom and internet look interesting but managers have to be very selective. We expect volatility to remain elevated which should increase single stock dispersion. As a result, successful stock and sector-picking remains the name of the game for equity hedge managers.

Fixed income (sovereign)

Perhaps nowhere has the risk aversion been more visible than in the global government bond markets. In the US, 30-year treasuries have risen almost 30% on a price basis in the past few months and near-term yields have approached zero. This implies a Japanese-type environment with persistent deflation and very little economic growth, even in the longer term. The main trigger for this super-rally has been the Fed's official adaption of ZIRP and quantitative easing.²⁵

Figure 11: Risk-free return OR return-free risk?



Source: Bloomberg. Period analysed: January 2008 to 21 January 2009. The term return-free risk is from Jim Grant, a veteran newsletter publisher.

The risk/return reward for fixed income investors is poor

The huge price appreciation in government securities has led to a very poor risk/return situation for fixed income investors. While (G7, AAA) government bonds are said to be 'risk free', this only refers to default risk. However, other risks such as interest rate risk, duration risk and inflation risk are currently inherent in these bonds, especially for long-duration securities that are highly exposed to rising interest rates. Moreover, bond issuance is set to rise sharply over the next few years as authorities embark on large scale fiscal initiatives (stimulus packages and tax cuts) in support of the economy. There may likely not be as much demand as today, which will lead to lower prices and higher yields. Hence, the word play 'return-free risk' refers to accepting these risks with a very low return potential, even in the best of outcomes.

In the near term bond yields are constrained

Hedge funds (global macro) have been following these developments with interest but have so far not accumulated huge short positions in Treasuries. In the near term, bond yields are constrained because of the Fed ZIRP and quantitative easing. Also, the current deflationary tendencies will not warrant much higher yields. However, at some point during 2009 (or perhaps 2010 and beyond) global macro managers (and also

²⁵ ZIRP = Zero Interest Rate Policy. Quantitative easing refers to the central bank 'printing of new money', in order to increase the supply of money. 'Quantitative' refers to the money supply; 'easing' essentially means increasing. Quantitative easing was used notably by the Bank of Japan to fight deflation in the early 2000s. More recently during the global financial crisis of 2008, policies announced by the US Federal Reserve under Ben Bernanke to counter the effects of the crisis have been likened to quantitative easing coupled with the issuance of new debt on the US federal balance sheet. The amount of assets held by the Fed more than doubled to USD 2.14 trillion as of 7 January 2009 from USD 909 billion in August. Bernanke prefers the term **credit easing**, instead of quantitative easing.

CTAs) will greatly benefit from higher (long term) yields and a steepening yield curve. In sovereign fixed income, the long only case is certainly not warranted.

Fixed income (corporates and EM)

Hedge fund performance should improve with better credit markets

Balance sheet pressures have been the single biggest driver of the poor performance by credit markets, which has also affected hedge funds greatly. We expect a pick up in hedge fund performance once credit markets improve. A first silver lining has appeared over the last two months with some buying interest in investment grade corporates (as we described previously). The vast array of government policies (TARP, TALF, quant easing etc.) has also injected some life into credit. Moreover, the technical (forced) selling pressure has eased somewhat and there has been some inflows into high yield mutual funds. However, we believe a broad recovery in credit is highly dependent on the length and severity of the recession as well as the pressures associated with de-leveraging, poor sentiment, risk aversion and low liquidity.

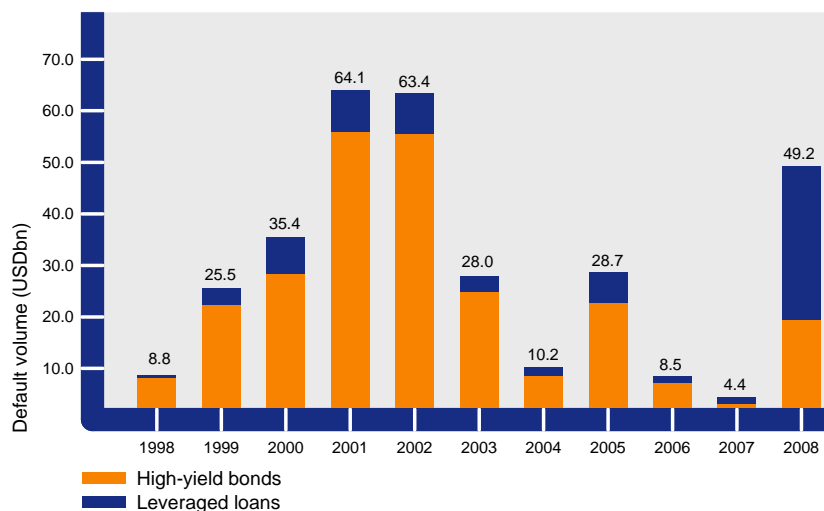
Distressed securities fared poorly in 2008 but now offer value

Hedge funds focusing on distressed securities have had a very poor showing recently. For the most part, they entered too early and sometimes with too much leverage and were not able to reduce risk due to the illiquid nature of the distressed market. As a result, they were forced to mark down their holdings (both public and private). Needless to say, the majority of managers underestimated the severity of the downturn and the flight to quality. However, the prices of distressed securities are now so low that even in a grim economic environment a lot of value will materialise over the next few years.

Defaults have picked up and will continue to rise quickly

Given the current levels of credit spreads, we expect a more idiosyncratic environment in credit selection. While investment grade credit can easily be played in a long only format, the sub-investment grade is trickier. A large number of companies are expected to default over the next two years and there will be a huge supply of distressed paper. The default volume has already risen to almost USD 50bn in 2008. Unlike in previous years, more loans than bonds defaulted. These were mostly second-lien loans.

Figure 12: Default volume increased in 2008



Source: JPMorgan. Period analysed: 1998 to 2008.

Most distressed managers currently focus on the top of the capital structure

It is important to note that debt securities at the top of the capital structure often gain in value when (and after) a company files for bankruptcy as the business stops bleeding cash when under creditor protection. Hence, insolvency is not necessarily bad for distressed hedge funds. Currently, most distressed managers focus on the top of the capital structure as they expect the higher quality credit segment to improve ahead of the lower quality segment. We see recovery rates for both leveraged loans and high yield bonds materially lower than in 2007/2008. Overall, the sub-investment grade corporate debt markets looks more promising for hedge funds than long only investors as special credit selection skills and proper hedging strategies are paramount.

Convertible bonds offer value both outright and delta-hedged

Another asset class that looks attractive are convertible bonds. Here, the investment proposition is attractive for both outright and hedged investors. As we mentioned in the review section, the convertible bond sector has been severely impacted by hedge fund de-leveraging and the exit of prime brokers. This has led to a severe cheapening of the asset class. While a slight cheapening could have been expected due to lower stock prices, higher credit spreads and a widening liquidity premium, the magnitude of the sell-off was heavily influenced by technical factors (i.e. forced selling). Over the last few weeks we have seen the emergence of new convertible buyers. These buyers were largely cross-over buyers who normally do not own convertible securities. Hence, some of the most severe cheapness of the asset class has disappeared. However, the asset class remains attractive for both long only and delta-hedged buyers.

EM differentiation is a big theme

There are also opportunities for global macro managers in emerging markets. While pretty much all emerging markets went up (equity, FX and EM bonds) in the boom years from 2003-2007, there is likely to be far greater differentiation in the coming years. Regions like Central and Eastern Europe look vulnerable, as do economies that saw housing booms such as Dubai, or which have large trade deficits (e.g. Turkey). By contrast those economies with large savings or with plenty of room for policy manoeuvre look in relatively good shape. Most Asian countries, for example, are

structurally in much better shape than ten years ago. We expect Asia to get worse over 2009, but not worse than during the Asian crisis. Brazil offers an interesting opportunity (receiver of fixed rates, long bonds) as the central bank has just started to lower rates²⁶ and may be behind the curve as inflation is falling rapidly. More cuts are expected.

Foreign exchange (FX)

FX has been very beneficial to CTAs

FX is not usually an asset class for long only investors. Traditional investors usually only have indirect FX exposure through assets denominated in currencies other than their own. Hedge funds, on the other hand, frequently take currency bets. Besides dedicated currency funds, which are rare, FX is usually played by global macro traders and managed futures. CTAs did exceptionally well in 2008 as there were a large number of trends, most notably the strengthening of the Yen and the weakness in commodity currencies and the British pound. While global macro funds place bets in anticipation of an outcome (e.g. lower interest rates, lower commodity prices, relative over- und undervaluation to PPP²⁷), managed futures build up positions when the trend is already established. Also, macro managers tend to be more discretionary while CTAs are mostly systematic.

FX is the largest and most liquid market

We think that FX will continue to be an attractive source of alpha for hedge funds that cannot be easily accessed with long only strategies as there is no inherent beta. For starters, FX is the largest and most liquid market in the world. It offers a large number of derivative contracts (futures, forwards, options etc) at little cost to express more nuanced views, i.e. with respect to volatility. FX volatility, as in other asset classes, has also risen sharply, benefiting long biased volatility strategies. As an example, in December 2008 EUR/USD traded between 1.2550 and 1.4719, a 17% range.²⁸

Valuation, momentum and carry are the typical FX strategies

For 2009 most managers expect continued high volatility as market uncertainty remains high. This is most positive for the JPY and also to some degree the CHF, the Scandies (SEK, NOK) and USD. The question is how this will clash with the ZIRP²⁹ in the US. The other complicating factor is that other central banks are also heading rapidly towards ultra-loose monetary policy. In Japan, the odds of intervention have risen sharply due to the pace at which the yen strengthened over the last few months. The most negative outlook is for the high(er) yielding (commodity) currencies that are still behind the curve (i.e. AUD, NZD, ZAR, RUB) and other EM currencies with high outflows and current account deficits. However, there is not one unified opinion and some managers have somewhat opposing positions. FX managers usually use valuation, momentum and carry strategies with the latest now being out of favour. The next figure gives an overview of some of the factors that FX specialists use:

²⁶ Copom (Brazil's monetary authority) cut rates from 13.75% to 12.75% on 21 January 2009

²⁷ Purchasing Power Parity. PPP models assume a long term equilibrium (i.e. fair value) for each currency and will short the overvalued and go long the undervalued currency. The simplest PPP model is the Big Mac Index by the Economist.

²⁸ Bloomberg

²⁹ Zero Interest Rate Policy (ZIRP)

Figure 13: Overview of factors used in a FX model

- | | |
|---|---|
| <ul style="list-style-type: none"> • Volatility recognition
GARCH process to predict and capture short-term volatility. • Current account model
tracks current account balances; tends to favour current account surpluses over deficits due to money flow. • Central bank action
assesses and predicts central bank action as monetary policy greatly affects FX movements. • Relative valuation
PPP based, in its simplest form the Big Mac Index. Goes long undervalued and short overvalued currencies. Tends to favour high real interest rates. | <ul style="list-style-type: none"> • Optionality (long gamma)
Many FX funds aim to be 'long gamma', i.e. benefit from rising volatility. • Pair trading (mean reversion)
Works similar to L/S equity. Often, the currencies are in the same region and somewhat correlated. Aims to benefit from mean reversion. • Momentum
This is the way managed futures (systematic trend followers) trade. • Positive carry
Most 'beta'-like FX strategy. Goes long high yielding currencies and short low yielding ones and thus captures the difference. Currently not favoured. |
|---|---|

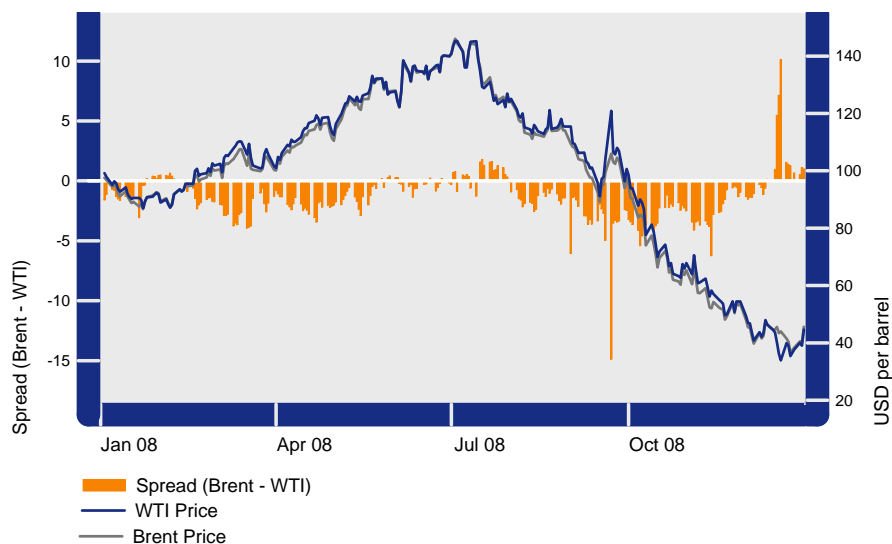
Source: Man Investments Research. (Please note this list is not exhaustive). GARCH – Generalised Autoregressive Conditional Heteroskedasticity.

Commodities

The energy markets offer interesting arbitrage opportunities

We believe that commodities, which endured a roller-coaster ride in 2008, will continue to struggle as a long only asset class until the economy improves and deflationary forces abate. Perhaps the stiffest headwind for a long commodity portfolio is the steep contango that has developed in most futures forward curves. In a contango curve, the nearby futures are priced lower than the longer dated ones. Hence, they can only be rolled at a loss and being long a commodity can produce losses even if the spot price goes up slightly. This situation is most notable in crude oil as WTI spot prices in the US have been depressed as of late due to a severe drop in demand. As inventories rise, the spot price has declined further, magnifying the contango and has also led to storage build up on oil tankers. In this environment, hedge funds can make money by taking advantage of the contango (i.e. short the nearby futures and roll down the curve). Other interesting trades are in the distillate markets (gasoline, crack spreads, heating oil), or in the WTI/Brent spread. Many energy hedge funds have been able to preserve capital during 2008 and are in a good position to continue to do so.

Figure 14: Spread between WTI and Brent oil prices widened



Source: Bloomberg. Period analysed: January 2008 to 21 January 2009.

Base metals should remain under pressure until the economy brightens

Industrial metals have also fallen dramatically over the last few months and in some cases mines have had to be closed and expansion projects halted as prices have fallen below the cost of production. It is likely that most base metals will remain under pressure in the near term as the emerging market economies, which have become large consumers of base metals, are now just entering the downturn. It should take until at least the second half of 2009 for the decreased supply to filter through and give prices a boost. China's stimulus package will be a key part of any demand-led recovery in metals markets. Commodity hedge funds that focus on the metals markets have also done quite well during 2008 as many had short positions on. Now, they can also take advantage of contango situations. An alternative trade could be a short position in copper while being long gold. Gold has shown a stable outperformance over other precious metals over the last few months. While demand for jewellery is under pressure due to the drop in consumers spending on discretionary items, central bank sales of gold have dropped sharply and investor buying also picked up.

In softs, cocoa looks interesting

Soft commodities have also been affected by the credit crunch. Currently there is a shortage of credit available to farmers, particularly in emerging economies. While this is potentially very bullish for grain prices in the longer term (due to lower supply), the financial de-leveraging has also affected soft commodities over the last few months. Hedge funds active in the agricultural markets have been lightly positioned due to a lack of convincing opportunities. One commodity with excellent fundamentals in 2009 is cocoa. Export from Ivory Coast, the largest producer and exporter of cocoa, has been constrained by administrative bottlenecks as well as a slow start to harvesting. The market will likely be buoyed by slow arrivals. This should skew the risk for price movements to the upside. Overall, we believe that commodity markets present value in the long term but face continued difficulties in 2009, particularly in H1. We therefore would prefer a hedged exposure. Similarly to 2008, hedge funds in the commodity space are set to outperform the broader commodity indices.

Conclusion

There are currently a number of conflicting forces at work in favour and against the hedge fund industry. We believe that hedge funds will continue to face difficulties in the near term as the de-leveraging process is not completely over and continued outflows will weigh on the industry. Also, confidence in the asset class has been tarnished. However, there are a number of positive developments such as decreased competition and large dislocations in most asset classes. We expect that the surviving hedge funds will benefit substantially once markets stabilise.

In our asset class overview (pages 13-21) we contrast the value proposition for hedge funds with long only investments. We conclude that in most cases hedge funds offer the better means to profit from market normalisation than long-only investments. We think, for example, that equity hedge strategies offers better value than long-only equities because they have more flexibility in adjusting their exposure levels and should benefit from sector and single stock dispersion. The value proposition for hedge funds is particularly evident in sovereign fixed income markets where yields have approached zero. As a result, government bonds across nearly all maturities offer little value to buy and hold investors. We also argue that investment grade corporate bonds offer value for both long only investors and hedge funds while non-investment grade debt is best played through hedge funds that have expertise in distressed investing. We expect the recession to last for some time and that defaults, and by association the volume of distressed paper, will increase significantly over the next two years. Almost all commodities are currently in a steep contango, so negative roll yields will hinder long-only investors. We believe that hedge funds are better positioned to take advantage of the term structures and arbitrage opportunities. Currencies are not a traditional asset class as there is no inherent beta and hence no real opportunities for long only investors. Hedge funds, on the other hand, frequently take currency positions and are poised to benefit from various trends and relationships.

Looking at a drawdown analysis (underwater perspective) we conclude that hedge funds will recover faster than stocks as they have less ground to recoup. The chart illustrates that large drawdowns (i.e. -50%) require significantly more time to heal than smaller ones (i.e. -25%). However investors have to keep in mind that it will still take time for hedge funds to fully recover their losses. Hence, while sentiment regarding the viability of the absolute return concept has been damaged and the hedge fund industry will go through a difficult time, claims that the asset class is dead are premature.

Important information

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