STANDARD & POOR'S

Funds-of-Hedge-Funds Q3 2009

Highlights

- Strong inflows during the third quarter, with positive net inflows in each individual month.
- Funds-of-hedge-funds returned over 4% in the third quarter and are up over 8% over the year to date.
- Gross and net exposures remain below historical levels, but net market exposures increased in the third quarter.
- FOHFs maintained team resources through the past year despite a sharp decline in fee income. Some of them have added resources, generally to reinforce operational due diligence.

Fund inflows

The hedge fund industry has seen a meaningful recovery in total funds under management following strong performance and net inflows during the third quarter of 2009. According to HFN's statistics the hedge fund industry's total assets reached $1.95tn by the end of September 2009 after inflows of $42.3bn in the third quarter and positive absolute returns in each of the individual months. Since net flows turned positive after April, we have now seen five consecutive months of net inflows. The HFN Funds of Funds Aggregate index recorded a 4.2% increase over the quarter and is up 8.5% over 2009 to end September.

Leading strategies have been emerging markets, most relative value arbitrage strategies and long/short equity strategies with meaningful net market exposure. Strategies that performed best last year (eg, managed futures and short biased equity) have generally been the worst during the current year. Short-biased equity has been the only strategy that has lost money. Equity market neutral and low beta long-short equity hedge have been disappointing, particularly within Europe.

Low exposure

Gross exposures remain well below historical levels because many FOHFs have had to continue dealing with liquidity issues beyond the recovery in equity and credit markets. Underlying net market exposures within FOHFs also remain below historical levels, but have increased during the third quarter. In general, net exposures have moved up only gradually because hedge fund managers held in FOHF portfolios have not been convinced on the sustainability of the rally in markets and have preferred to concentrate on alpha-generating opportunities. This has been particularly the case in Europe, where returns have generally been disappointing despite competitive returns in the underlying equity markets.

Some FOHF managers have also deliberately resisted increases in aggregate net exposure. GAM's David Smith maintains an agnostic view on markets and has focused GAM Diversity's portfolio on "managers able to generate alpha regardless of market conditions". Charles Hovenden, CIO of Absolute Fund Managers, tends to avoid equity hedge fund managers who run their portfolios with net exposures over 30%. Hovenden has deliberately reduced exposure to Crispin Odey this year because the manager took net market exposure up to a higher level than he was comfortable with. On the other hand he has continued to hold a small exposure to short-biased managers despite disappointment with their slowness to cut losses on cyclical shorts. Thames River's multi-manager alternatives team believes that markets could continue to rise ahead of recovery in economic fundamentals while monetary stimulus remains in place. However, it sees some vulnerability at this stage to a technical correction and has therefore applied some direct macro hedges to its FOHF portfolios using market derivatives.

Performance

During the current year FOHFs that focus on emerging markets have generally led the recovery: among S&P-rated FOHFs, GAM Multi-Emerging Markets has returned 20.5%, Permal Asian Holdings has returned 26.1% and Permal Emerging Markets Holdings has returned 24.8%. Underlying managers have mixed views on the sustainability of emerging markets equities' outperformance of developed markets. Kier Boley at GAM reports that managers held in the GAM Multi-Emerging Markets portfolio "have shifted to a more tactical approach in their portfolios due to the uncertainty surrounding the sustainability of momentum in global emerging markets going into the year end."

One positive surprise has been Permal Japan Holdings, which has returned 16.0% over 2009 to end September. Japan has been a laggard in the equity markets recovery (the Nikkei 225 is only up 14.4% to end September); outside of emerging markets, however, Permal's Japan Holdings Fund has been one of the best performing single region funds. Permal's team was relatively quick to go fully invested on this fund and its selection of long-only managers (about 26% of the portfolio) has collectively achieved more than double the market average return. Going forward Permal sees some of the best opportunities for alpha generation in Japan where its managers are able to find many stocks on extremely low valuations.

Permal Fixed Income has been another positive surprise, returning 22.0% over the year to end September. All sub-strategies have posted double digit returns,with the strongest being credit-related strategies within developed markets, which has returned 39.0%. Many of the managers within this allocation are long-biased and have benefited from tightening credit spreads. Going forward, Permal sees a multi-year opportunity for managers who can generate alpha through name selection, short sales, investing in complex securities, distressed debt and event-driven situations.

As mentioned, Europe has been disappointing and even Permal's Europe Holdings Fund has been slow this year (up 4.8% to end September). However, Paris-based HDF's Eurovest Fund stands out positively with an 11.9% return to end-September. The group reports that its managers continue to see a lot of stock-specific opportunities, but have also been increasing net and gross exposures as the market rally has progressed.

The Absolute Fund

The Absolute Fund returned 2.1% during the third quarter and is up 6.0% over 2009 to end-September. While these returns are slightly below average, Absolute is managed very cautiously and was one of the best performing multi-strategy FOHFs last year. As a result the NAV is now only 5% off its all time high. Just over half of Absolute's portfolio is invested with long/short equity hedge fund managers. Charles Hovenden reports that most of those held remain distrustful of the economic recovery and therefore have low net market exposure. This has hurt the fund's returns during the quarter. Within the equity-based strategies the portfolio contains two short-biased managers. Over the year to end September one of them is down 32.7% and the other is down 19.6%. However, they represent less than 3% of the overall portfolio so the impact on total return is small.

While equity hedge strategies have been profitable in aggregate for Absolute, better returns have come from the portfolio's fixed income strategies. The portfolio's two convertible bond arbitrage funds have been spectacular performers. They represent less than 8% of the portfolio, but have accounted for almost half of total return. However, while one of the holdings has almost doubled and the other is up over 50%, they lost a lot of money last year and a third convertible arbitrage holding collapsed in February of this year, losing 99% of its value. Hovenden redeemed from the fund and expects to get back the proceeds in December.

Fundana

Fundana is one of the few groups to come through the past 12 months without any liquidity issues. During the current year it has built on this success with strong performances from its two S&P AA rated funds-of-hedge-funds. Prima Capital Fund, which is mainly invested in US equity hedge funds, is up 9.6% over the year to end September, and Trocadero Capital Holdings, Fundana's global fund, is up 14.9%.

Fundana reports that its managers are still cautious in their positioning and overall directionality but are finding many stock-specific opportunities. Aggregate long-short exposure for Prima Capital was 75% long and 50% short at end September 2009, which is below average historically, but up from earlier in the year.

GAM

GAM Diversity returned 3.4% in the third quarter and is up 4.4% over 2009 to end-September. David Smith is maintaining an agnostic view on markets and has focused the portfolio on managers who are able to generate alpha regardless of market direction.

GAM Trading II returned 3.5% in the three months to end-September with all sub-strategies making positive contributions; it is up 6.1% over the year to date. Managers held in the portfolio have been running below average risk levels during this year, although they had reverted to normal positioning by the end of September.

GAM Multi-Emerging Markets returned 9.7% in the third quarter, and is up 20.5% over the year to end September. The fund continues to have a large position in Thames River Nevsky, representing over 20% of the portfolio. Kier Boley added four new managers to the portfolio with exposure to emerging markets credit, liquid global emerging markets, Eastern Europe and Asia Pacific equities. Most of the managers held in the portfolio have shifted to a more tactical approach in their portfolios due to the uncertainty surrounding the sustainability of momentum in global emerging markets going into the year end.

HDF

HDF Eurovest has performed exceptionally well this year (it is up 11.9% to end-September) considering the generally disappointing returns of long/short European equity hedge funds. Managers held continue to see lots of stock-specific opportunities, but have also been gradually increasing net and gross exposures as the market rally has progressed. The group's HDF Multi-Alternatives has also performed well this year (returning 8.5% to end September) compared with other low volatility multi-strategy funds. However, many of the long/short credit managers held in the fund's portfolio are wary of the much reduced spread levels and are keeping a market-neutral position.

HDF Trading has returned 6.8% over 2009 to end September, which is a decent performance given that CTAs have moved from being among the best performers in 2008 to one of the worst in the current year. While the portfolio includes CTAs it also holds macro managers and other hedge funds that are managed in a short-term, technically driven style. HDF's macro managers believe that global economic growth is likely to beat consensus over the next few months with an inventory led steep recovery. In the short term they see little inflation risk because of the presence of deflationary pressure on wages. However, they also believe that the prospects of non-inflationary recovering growth are offset by the consequences of the future withdrawal of fiscal and monetary stimuli.

Notz Stucki

There have been some changes in the management of Haussmann Holdings and DGC Pendulum. Haussmann (a joint venture between Notz Stucki, Mirabaud and Banca del Ceresio) is now managed by a committee of three managers: Constantin Melas-Kyriazi (Notz Stucki), Umberto Boccato (Mirabaud) and Federico Foglia (Banca del Ceresio). Haussmann is up 14.2% over the year to end September 2009, reflecting its opportunistic, semi-directional style.

DGC Pendulum is now managed by a committee of three Notz Stucki managers: Constantin Melas-Kyriazi, Hilmi Ünver and Sebastien Poiret. The fund is up 9.6% over the year to-date.

Lynx Election Holdings is up 9.8% over the year to end-September, outperforming most other funds of European equity hedge funds due to its relatively high net long exposure. There has been no change in Lynx's management.

Permal

Permal has reduced the notice period on its funds from 95 days to 65, and intends to review dealing terms again at the end of the year with the intention of returning to 20 days notice subject to market conditions continuing to normalize.

Permal Investment Holdings had some exposure to Raj Rajaratnam. Some of this was through a managed account and some was through the Galleon Offshore Fund. During 2009, the separate account was up 19% to end-September 2009 and Galleon was up 32%. In contrast with other hedge funds where a significant operational issue has been exposed, Mr Rajaratnam decided to wind down his US funds and return money to investors rather than clinging on to them. As a result there has not been any significant loss. For Permal Investment Holdings the cost of winding down positions in the middle of October was about 10bps. Galleon was held within the US emerging growth allocation. This was the strongest allocation for the fund (it returned 31% to end September), helped by the rally in Nasdaq stocks. It even outperformed PIH's emerging markets allocation, which is up 29% over 2009 to end-September. The fund's total return over the year to date is 12.6% and the only sub-strategy that has lost money so far this year has been European equity hedge.

Among Permal's other rated funds there have been some positive surprises and a couple of funds where returns have been a bit lower than might have been expected given the manager's investment approach and improved market conditions. Starting with the latter, Permal European Holdings has returned 4.8% over the year to end-September 2009 and Permal Long/Short Equity Holdings has returned 6.5%. Given that European equities have performed well this year and that Permal aims to participate meaningfully in equity market rallies, it is surprising that the fund has not returned more. It is partly attributable to European equity hedge fund managers being slower to increase net exposures than managers elsewhere in the world, but it is also noticeable that Permal has maintained a relatively high cash balance in European Holdings and a higher macro allocation than in its other single country/region funds. The weak performance of European equity hedge fund holdings is the main reason why Permal Long/Short Equity is up only 6.5% over 2009 to date.

Two positive surprises among the group's range of rated funds have been Permal Fixed Income Holdings (up 22.0% over 2009 to end-September) and Permal Japan Holdings (+16.0%). Permal Emerging Markets and Permal Asian Holdings have also performed well relative to peers (+24.8% and +26.1% over 2009 to end-September), in keeping with generally strong performance in emerging markets and Permal's partially directional approach to managing these funds. The big surprise on Japan Holdings is that the fund has produced a very strong return despite the comparatively weak performance of Japan equities. Somewhat unusually, the fund has outperformed a rising market. Over the year to end-September its 16.0% return compares with the Nikkei 225 index's 14.4% return. Outperformance has come from significant outperformance by the fund's long-only managers, and the manager was relatively quick to invest the cash that was held in the portfolio at the beginning of the year. Long/short equity hedge managers have performed respectably (+13%) and Permal has taken the allocation to over 50% (the highest it has been over the past 10 years) to capture perceived strong alpha generating opportunities in Japan because of low valuations, attractively priced small-caps and investment in green technology to meet the Government's aggressive greenhouse gas emission reduction target.

Within Permal Fixed Income Holdings all sub-strategies have posted double digit returns over the year to date. The strongest has been credit-related strategies within developed markets, which has returned 39.0%. Many of the managers within this allocation are long-biased and have benefited from tightening credit spreads. Going forward, Permal sees a multi-year opportunity for managers who can generate alpha through name selection, short sales, investing in complex securities, distressed debt and event-driven situations.

Theta

Theta Multistar Medium Volatility fund had a good third quarter, returning 4.1%. Year to date it is up 4.6%. It started the year in decent form and then lost money when markets turned in March and April.

Theta tightened its risk guidelines after its experience of last year, but reports that most of the portfolio adjustments required have been implemented and that the portfolio is generally positioned for a continued volatile environment.

Turnstone Europe Fund

Turnstone Europe Fund held up better than almost all other funds of equity hedge funds during 2008's extremely difficult market conditions, and limited its full year loss to 6.8% (EUR). Its managers maintained defensive positioning into 2009, which hurt performance relative to peers during the first six months. However, underlying net exposure has increased to 46% by the end of September 2009 and gross was 140%. As a result it has had a good third quarter, returning 5.2%, with each individual month up more than 1%.

Thames River

Thames River Warrior has recovered well during the current year, returning 13.6% over the year to end-September. Warrior II and Sentinel have also shown decent performance during the current year, up 9.6% and 7.5%, respectively. Thames River's multi-manager team believes that markets could continue rising regardless of economic fundamentals while rates remain low, as liquidity continues to drive asset prices. The majority of the underlying managers are also positive. However, the team has started to use some of the positive returns achieved so far this year to buy macro hedges in the belief that markets have risen too fast and are vulnerable to a technical correction.

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