

Hedge Funds Quarterly

Q2 2010

June 2010

Contents

Summary	1
Performance and Market Review	2
Market Indices	2
Commentary	3
Hedge Fund Strategies and Capital	
Market Factors	4
Industry Issues	10
Global HF assets still rising	10
Regulation changes will have a material impact on the HF industry	12

Analysts

Paris

Olivier Fines
+33 1 44 29 92 75
olivier.fines@fitchratings.com

Aymeric Poizot, CFA, CAIA
+33 1 44 29 92 76
aymeric.poizot@fitchratings.com

Charlotte Quiniou, CFA
+33 1 44 29 92 81
charlotte.quiniou@fitchratings.com

Nicolas Bénétou
+33 1 44 29 92 73
nicolas.beneton@fitchratings.com

Keranka Dimitrova
+33 1 44 29 92 80
keranka.dimitrova@fitchratings.com

London

Manuel Arrive, CFA
+44 20 7682 7499
manuel.arrive@fitchratings.com

Alastair Sewell
+44 20 7417 6286
alastair.sewell@fitchratings.com

Frankfurt

Roger Schneider, CIIA
+49 69 7680 76242
roger.schneider@fitchratings.com

New York

Roger Merritt
+1 212 908 0636
roger.merritt@fitchratings.com

Summary

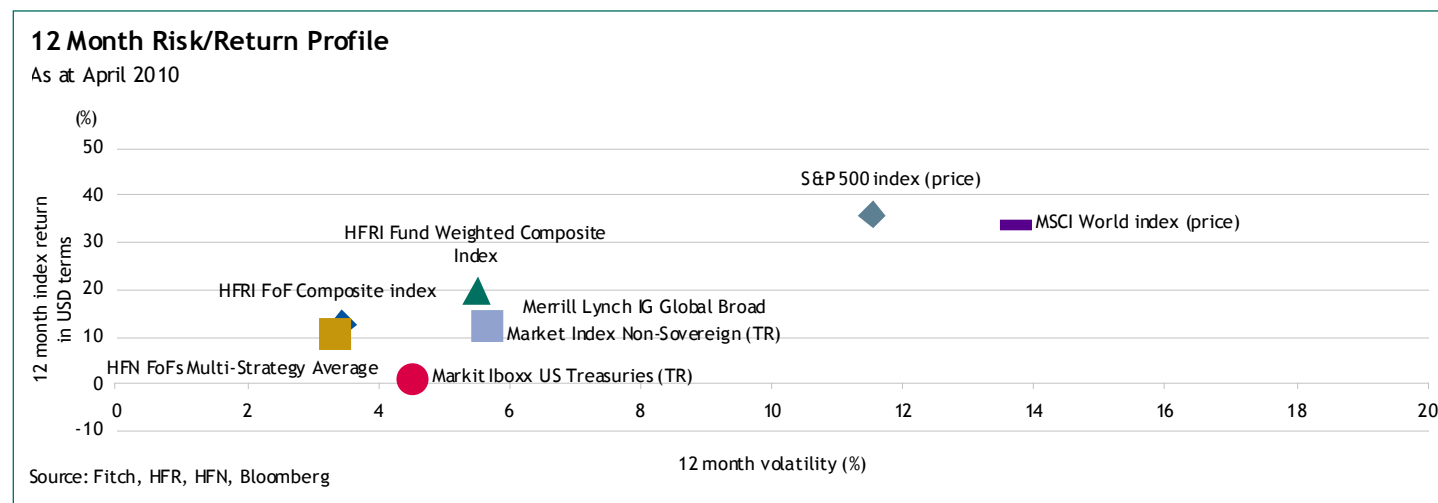
- While May erased some of the gains made over the first four months of the year, hedge funds have shown resilience, benefiting from their positioning on relative value strategies. The May crisis, which was largely sentiment-driven (impacting liquidity and confidence) and became systemic at some point, has affected many strategies, including those focused on fundamental analysis and arbitrage, with the exception of some short-term systematic trading, volatility traders or equity market neutral strategies. Investors and managers were reminded that systemic risk (ie general asset re-pricing and flight to quality) can hardly be diversified, even when portfolios exhibit limited net exposure to the direction of markets.
- Systematic CTAs and trend followers continue to be challenged in particular by range-trading markets and external macroeconomic shocks – they are currently in a phase of transition, engaging in in-depth research activity to renew their trading models. FoHFs continue to suffer from a lack of flexibility caused by legacy positions, fund restructuring and significant liquidity needs – they continue to enhance their top-down approach, portfolio construction, structuring and tailoring.
- Relative value trades, pure arbitrage and credit strategies had done well up to the end of April, when the major investment trends concentrated on: long US equities; long financial stocks; long high yield credit; long gold; long USD currency versus short EUR, GBP, JPY; and long commodities.
- In the recent months, global HF assets under management have benefited from positive asset inflows, thanks to: 1) a return to absolute return management from institutional investors looking for yield and asset diversification; 2) little clarity as regards the direction of markets. However, themes such as regulation, UCITS and consolidation will undoubtedly influence the shape of HF management and distribution, a potential sign of clearer client segmentation.

Related Research

- Reviewing and Rating Fund of Hedge Fund Managers, 22 Jun 2009
- Reviewing and Rating Credit Asset Managers, 27 Jul 2009
- Reviewing and Rating Asset Managers, 18 Jun 2009
- Know Your Manager: Investor Guide to Robust Investment Processes, 17 Nov 2009
- European Asset Management Industry: An Industry Under Pressure – Part 1: Status and Outlook, 4 May 2010

Performance and Market Review

Market Indices



Market and Hedge Fund Indices (as at April 2010)

	Cur.	April 2010 (%)	Q1-2010 Return (%)	Q4-2009 Return (%)	12 month return (%)	12 month volatility (%)	12 month return/risk ratio (%)	12 month correlation with S&P500
HFRI FoF Composite Index	USD	0.9	1.5	1.5	12.6	3.4	3.7	0.73
HFN FoFs Multi-Strategy Average	USD	0.8	1.3	1.1	11.0	3.3	3.3	0.74
HFRI Fund Weighted Composite Index	USD	1.2	2.6	2.6	19.8	5.5	3.6	0.78
S&P 500 Index (price)	USD	1.4	4.9	5.5	36.0	11.5	3.1	
MSCI World Index (price)	USD	-0.2	2.7	3.7	34.2	13.7	2.5	0.94
Markit Iboxx US Treasuries (TR)	USD	1.1	1.1	-1.4	1.7	4.5	0.4	-0.20
Merrill Lynch IG Global Broad Market Index Non-Sovereign (TR)	USD	0.4	0.7	0.2	12.9	5.6	2.3	0.40

Sources: Fitch, HFR, HFN, Bloomberg

Notes to the above table and chart: the extreme events of May will have a short-/medium-term impact on the rolling performance and risk figures for Q2. Fitch will consider these effects in more detail in the next quarterly release of this newsletter, ie Q3 2010.

The below table highlights the impact of May:

Market and Hedge Fund Indices (May 2010)

	Cur.	May 2010 (%)	YTD 2010 (%)
HFRI FoF Composite Index	USD	-2.8	-0.6
HFN FoFs Multi-Strategy Average	USD	-2.4	-0.3
HFRI Fund Weighted Composite Index	USD	-2.3	1.3
S&P 500 Index (price)	USD	-8.2	-2.3
MSCI World Index (price)	USD	-10.0	-7.6
Markit Iboxx US Treasuries (TR)	USD	1.8	4.0
Merrill Lynch IG Global Broad Market Index Non-Sovereign (TR)	USD	-1.8	-0.8

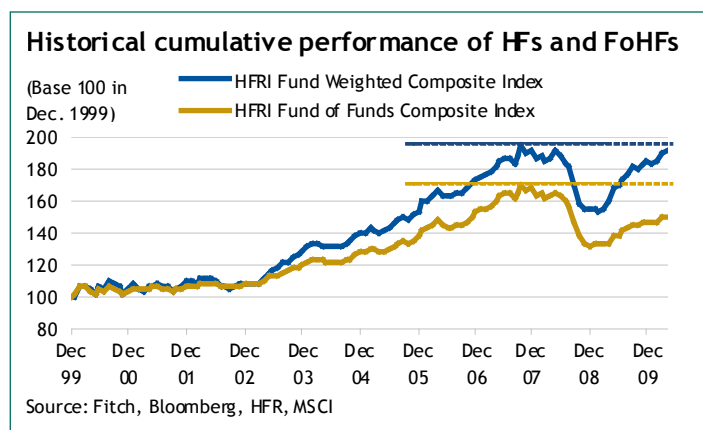
Sources: Fitch, HFR, HFN, Bloomberg

Commentary

Hedge funds (HFs) exhibited 4.6% return from December 2009 to April 2010 – Only gave up a fraction in May

While the industry has been taking more positive steps, the market volatility in May erased some of the gains made over the first four months of the year. Indeed, the performance in May was the worst month since November 2008. However, this report focuses on the major medium-term trends that can be detected and explained and will often refer to the positioning of HFs in Q1, as there is no evidence yet of a radical shift following May, either in terms of HF market exposures or even in the global macroeconomic perspectives.

The following chart illustrates that single-manager HFs are about to recoup 2008 losses and reach prior high watermarks (however, this is not the case for the average FoHF). HFs are getting closer to the level above which they could generate new revenue streams from performance-related fees.



In Q1, HFs have produced returns similar to global equities, with a fraction of the volatility (5.9% of 12-month rolling volatility for HFs compared to 13.2% for the S&P500 and 15.6% for the MSCI World). In May, while equity markets lost approximately 10% (MSCI World in USD), HFs lost 2.3% (HFRI). In other words, HFs were on average able to capitalise on the various economic themes (see below) which affected world markets throughout the quarter, while avoiding the May sell-off – thanks to low net directional exposure – and also the volatility that affected several regional equity markets.

Most noticeable and profitable investment themes in 2010 were¹:

- Long US equities vs. European equities;
- Long financial stocks and healthcare stocks;
- Long high yield credit;
- Long gold;
- Long USD currency and short EUR, GBP, JPY; and
- Long commodities.

1 See also: Société Générale – SG Hedge Fund Watch, 6 April 2010; and HFN.net, March 2010

Yet still more uncertainty than clarity in the current macroeconomic context

Putting aside the specific situation of the Eurozone and its sovereign risk crisis, many financial markets are potentially still ahead of the game and are continuing to factor in a global economic recovery. This is based largely on the inability of many governments to move to a restrictive monetary policy in the short to medium term, which translates into:

- continued low inflation environment, but no deflation;
- low interest rates;
- quantitative easing policies providing a floor to certain asset prices;
- good liquidity conditions, at least for financial institutions and large corporations;²
- corporate default rates continuing to fall and a generally improved or stabilised credit environment;³
- corporate earnings and global GDP growth figures improving.⁴

That said, significant improvements in employment levels have yet to emerge⁵, industrial capacity utilisation remains low and house prices in many markets (residential properties) have shown no signs of a strong recovery. Mounting sovereign risk coupled with the risk of deflation in Europe (especially considering that the money supply appears to be shrinking⁶ and bank lending remains feeble⁷), are also factors weighting on capital markets⁸. As illustrated in May, the hedge fund industry remains vulnerable to market regimes where risk aversion results in a generalised sell-off.

The above factors hint at an asymmetrical market with limited scope for improvement – fuelled by modest growth but fair corporate conditions – and a potentially more damaging downside, linked to sovereign, deleveraging and deflation risks⁹. Equally important are liquidity conditions – which deteriorated in May with the prospects of another systemic crisis – but improved after a European bail out was announced. Many relative value HFs can navigate non-directional markets but suffer when liquidity and rationality vanish in capital markets.

2 See Fitch Ratings – “Fitch: ECB Liquidity Extension Offers Banks Support But Structural Issues Remain”, 11 May 2010

3 See Fitch Ratings – “EMEA Corporate Portfolio: Spring 2010 Update, Delicate Stabilisation”, 28 April 2010

4 See Fitch Ratings – “Global Economic Outlook”, 1 April 2010

5 See comment by Mohammad El-Erian, CIO of PIMCO in BusinessInsider.com – “The Market is Way Too Complacent, Persistent Unemployment Will Cause Everything To Come Unglued”, 2 February 2010

6 See US Federal Reserve System, February 2010

7 See Fitch Ratings – “Fitch Expects Loan Growth to Remain Subdued for European Banks in 2010”, 10 February 2010; and The Daily telegraph – “US Bank lending falls at fastest rate in history”, 18 February 2010

8 See Fitch Ratings – “Fitch: Sovereign Outlook Weighs on Improving European Investor Sentiment”, 10 February 2010; and Global Pensions – “The EUR750bn package does not erase fears over sovereign risk”, 10 May 2010

9 See Reuters The Great Debate – “US and UK on brink of debt disaster”, John Kemp, 20 January 2010

Hedge Fund Strategies and Capital Market Factors

Main Single Hedge Fund Strategies (as at April 2010)

	Cur.	April 2010 (%)	Q1-2010 Return (%)	Q4-2009 Return (%)	12 month return (%)	12 month volatility (%)	12 month return/risk ratio (%)
Relative Value (HFRI Relative Value Total Index)	USD	1.3	3.6	4.0	23.5	3.3	7.1
Macro (HFRI Macro Total Index)	USD	0.9	0.2	0.3	6.5	5.6	1.2
Equity (HFRI Equity Hedge Total Index)	USD	1.3	3.0	2.9	23.5	7.2	3.3
Emerging Markets (HFRI Emerging Markets Total Index)	USD	1.3	3.6	4.4	35.3	10.4	3.4
Event-driven (HFRI Event-driven Total Index)	USD	1.7	4.7	4.2	28.7	4.5	6.3

Sources: Fitch, HFR, Bloomberg

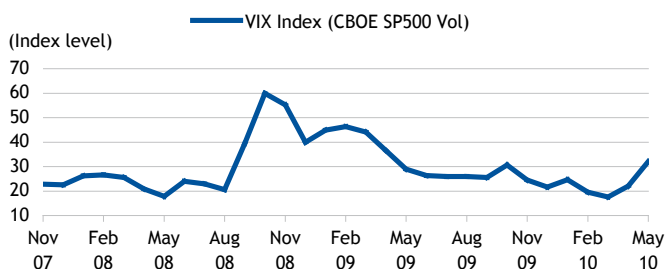
The below table highlights the impact of May:

Main Single Hedge Fund Strategies (May 2010)

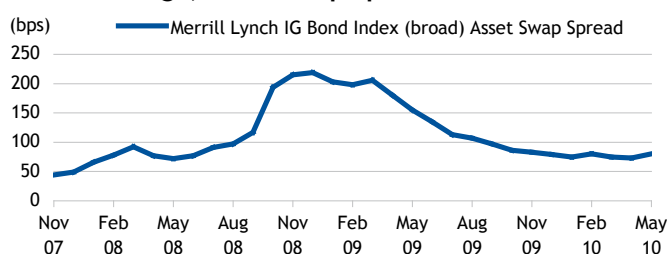
	Cur.	May 2010 (%)	YTD 2010 (%)
Relative Value (HFRI Relative Value Total Index)	USD	-1.0	3.9
Macro (HFRI Macro Total Index)	USD	-0.9	-0.3
Equity (HFRI Equity Hedge Total Index)	USD	-3.7	0.3
Emerging Markets (HFRI Emerging Markets Total Index)	USD	-6.0	-1.5
Event-driven (HFRI Event-driven Total Index)	USD	-2.2	4.0

Sources: Fitch, HFR, Bloomberg

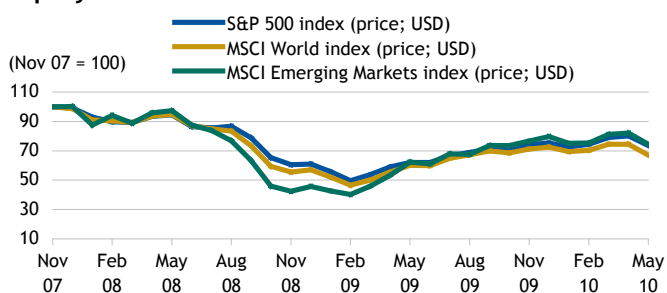
VIX Index (CBOE SP500 Imp. Vol. Index)



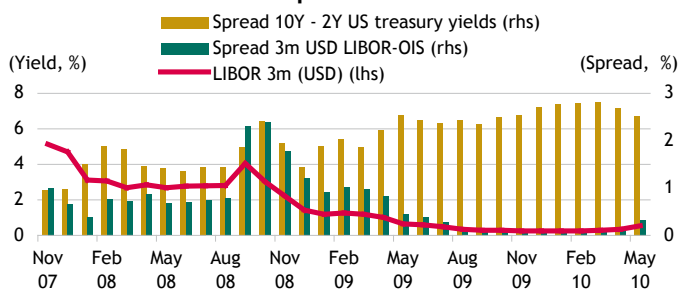
Merrill Lynch IG Global Broad Market Index Non-Sovereign, Asset Swap Spread



Equity Market Indices



US Interest Rates and Spreads



Note to the VIX and equity charts: the extreme events of May have disrupted the patterns highlighted in the above charts – essentially, we have seen a slump in equity prices and a spike in equity volatility levels. Fitch will review these in more detail in the next quarterly release of this newsletter, ie Q3 2010.

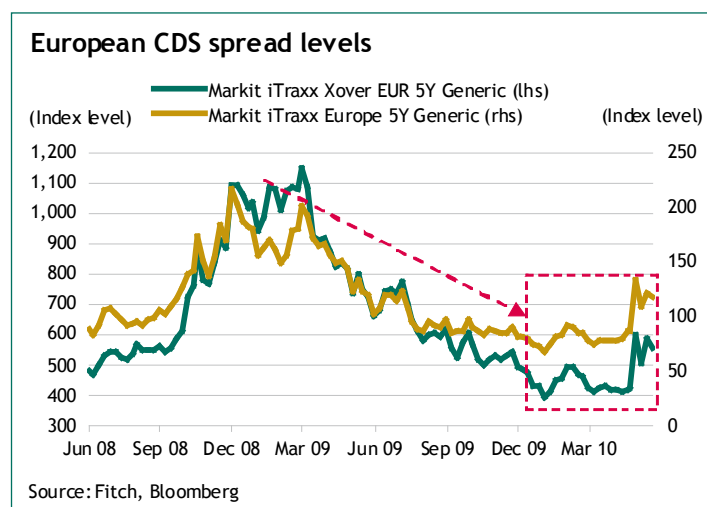
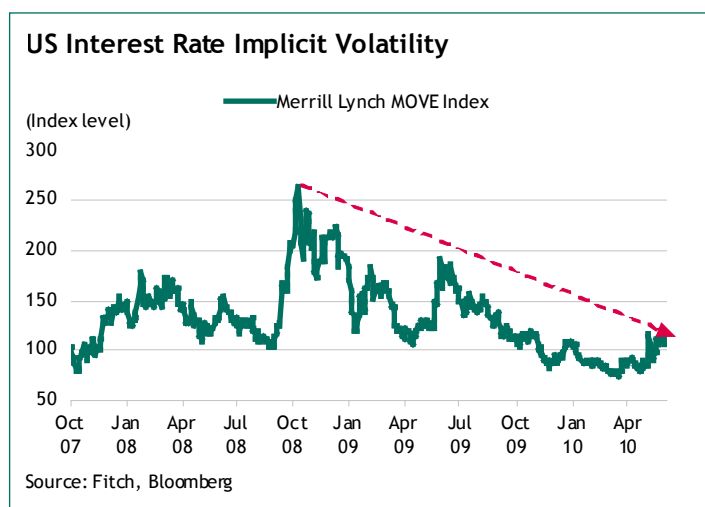
Relative Value strategies – Back to arbitrage

The credit management and fixed income arbitrage environment has changed somewhat in 2010. Basically, the large and sustained macro movements of 2009 – tightening cash and CDS credit spreads, general revaluation of asset prices, progressive steepening of yield curves, improving liquidity – have given way to arbitrage-related strategies since the beginning of the year. With less room for any additional tightening of corporate credit spreads, while the steepening of yield curves was also tailing off, HFs have been arbitraging regional yield curves, with opportunities stemming from diverging growth prospects between the US, the UK, Europe and Asia. HFs have also been reinvesting in the credit sector, which benefits from continually falling default levels and a return to more fundamental pricing.

The relative value space in general did well, up 5.20% until end-April according to HFR, and gave up about 1.0% in May. It will be interesting to see whether HFs are amending their positioning and focus on relative value strategies, after the widening seen in credit spreads during May (reversing the tightening trend that had continued into the first quarter).

Managers are seeing renewed opportunities in arbitrage trades, ie high yield versus investment grade and cash versus CDS (basis trade). The rise in sovereign risk is offering yet another source of potential profit, as some sovereign CDS spreads have spiked above those of some corporate sectors. However, with such low levels of interest rate volatility – even when considering the April and May spike – it will be interesting to see how things progress in 2010, in light of the expected monetary policy decisions by central banks later in the year.

Of particular interest is the development of convertible bond (CB) arbitrage strategies, which experienced by far their most profitable period in 2009, largely on the back of beta-driven moves. Not surprisingly, 2010 is proving more difficult, although the sector was returning positive figures at the end of April. However, it suffered from a slowdown in primary issuance in Q1 2010 to almost zero in May (albeit following a slight increase in March and April), a situation that was obviously caused by the increase in credit spreads during the month. Considering CB arbitrage funds are traditionally long the credit, short the equity and long the volatility, they are clearly finding this year more problematic.



Equity strategies doing well until April, thanks to increased arbitrage-related activity – but still suffered in May

Equity strategies were performing well until April thanks to valuations returning to fundamentals but suffered logically in May from their net long market exposure – albeit modest – and from a “moderately optimistic” positioning (sectors and stocks).

Up to the end of April 2010, equity-focused HFs have produced some interesting performance figures, at +4.3%, in an environment favouring trading-oriented managers with global equity markets demonstrating significant dispersion at regional, sector and security levels. May marked the sharp divergence in performance between directional equity hedge strategies, which posted a 3.7% decline, and market neutral strategies, which gained slightly according to HFR.

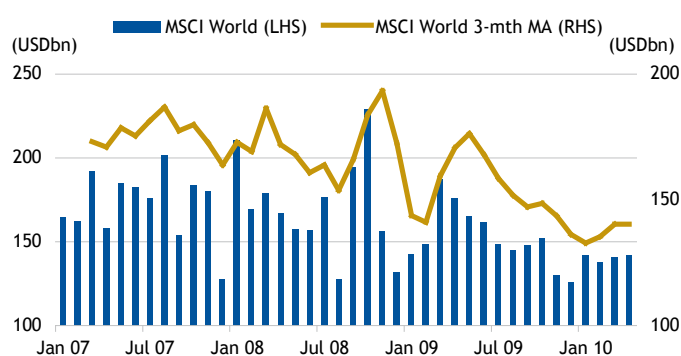
Over the first four months of the year, equity HFs had been able to take advantage of the following factors:

- As shown in the table below, HFs found many opportunities in global markets, buying the US and Asia while shorting Europe (a consequence of the current institutional and financial woes the EU is entrenched in).

- In addition, equity trading volumes have been falling since 2007, although they started to timidly pick up in Q1 2010. We shall see if heightened volumes can drive some positive beta/macro impetus into markets. Fitch has also witnessed a heightened use of short trades on the NYSE in 2010, further supporting the argument long/short strategies may be gaining strength (see charts below).

Equity Trading Volumes

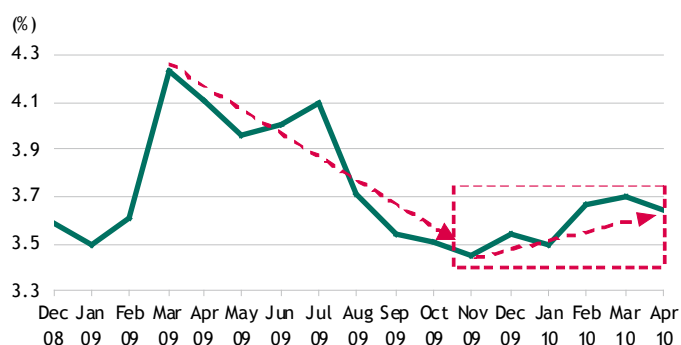
Monthly Trading Volumes



Source: Fitch, Bloomberg

NYSE Short Interest Ratio

(as % of total shares outstanding)



Source: Fitch, Bloomberg

Comparative performance between international equity markets and HFs; YTD 2010

(Monthly return in %)	Jan	Feb	Mar	Apr
MSCI North America (price; USD)	-4.0	3.1	6.0	1.5
MSCI Europe (price; USD)	-6.0	-2.2	6.2	-3.1
MSCI Pacific (price; USD)	-1.4	1.6	5.1	-0.2
Equity HFs	-1.27	0.9	3.3	1.3

Source: Fitch, MSCI

- At the same time, net exposure to equity markets has stabilised at around 20%. This showed managers’ cautious exposure to equity market beta to mitigate a possible downward-oriented market (but insufficient to fully offset the sell-off that occurred in May). By contrast, gross exposure figures have risen to above 100% of assets in many cases (a combined effect of increased confidence in the markets and fundamental values, sustained good liquidity conditions and renewed prime brokerage activity); it could be argued long/short trades and market neutral ideas were progressively coming back. It will be interesting to see whether HF managers have materially changed their positioning, thus impacting the gross exposure of portfolios.

- In terms of sector/stock strategic and tactical allocation, HFs have also demonstrated a renewed activity, notably by often positioning themselves contrarian versus traditional and institutional investors in equity markets. In April, UBS (and notably its prime brokerage unit) reported HFs had been buying equities early in 2010 and reinvesting bank stocks as well as industrial and manufacturing companies¹⁰. Some of these trades (eg. banks), consistent with a “moderately optimistic” view, have obviously been detrimental in May.

¹⁰ See UBS in Telegraph.co.uk – “Hedge Funds buying equities at fastest pace since 2007”, 11 April 2010

Global Macro strategies and CTAs in a transition phase

In the broad Macro/CTA space, having weathered the 2008 market turmoil in good condition – capitalising on rising volatility and macro trends – 2009 proved more difficult as the markets entered an uncertain, range-trading environment, with the market sensitive to exogenous shocks of macroeconomic and political nature. At the same time, it was clear such vehicles had the favour of investors, being well positioned to meet their needs in terms of liquidity, diversification benefits and the potential portability of the alpha they produced.

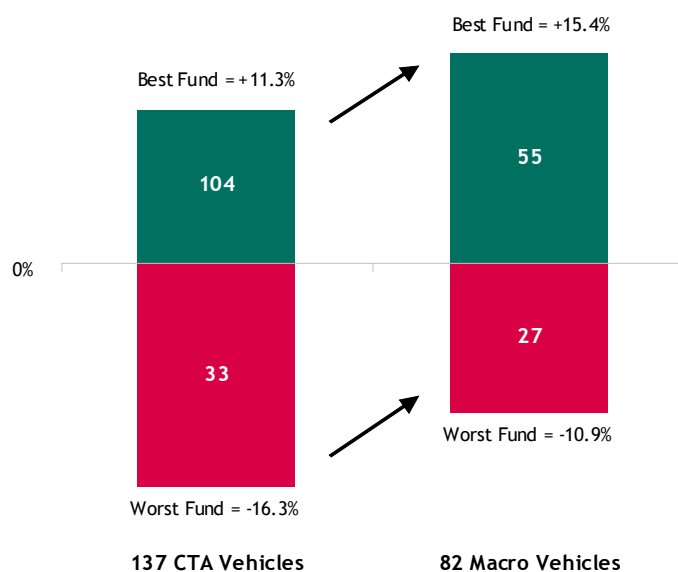
However, in 2010, macro traders are not doing so well, up about 0.6% as at end-April and giving up -0.92% in May alone. This is somewhat surprising as opportunities have existed in the areas of currencies, equity markets, inter-sector trades, and some commodities. Fitch would expect nimble macro traders to find profit opportunities in a context of an international monetary crisis, especially when regional factors prove as diverse as they are currently.

Fitch notes the following as regards this sector:

- ▶ Although with less magnitude so far in 2010, discretionary macro traders seem to be faring better than their systematic CTA cousins. Discretionary traders are better able to either react to or anticipate the market effects of non market-related impulses, such as monetary policy changes, political disruptions, shifts in regulatory framework, general uncertainty, or lack of medium/long-term trends in macroeconomic factors (eg inflation, growth differentials, interest rate differentials, purchasing power parity, or the weight of government action in the economy). When comparing CTA/Managed Futures funds and Discretionary Global Macro funds in terms of the dispersion of their April YTD 2010 performance, Fitch observes that the gross dispersion is about equal; however, it shifts significantly upwards in favour of discretionary macro traders.
- ▶ Fitch is of the opinion that systematic CTAs have suffered – and still suffer – from the much-discussed “crowded trades” phenomenon. More broadly, these algorithmic traders are constrained by their systems and models; what worked in the past economic cycle may need to be reassessed and adapted or adjusted to the current/forthcoming macroeconomic paradigm¹¹. HF managers

¹¹ See The Hedge Fund Journal – “CTAs Focus on R&D Awaiting Trend Breakout”, Bill McIntosh, April 2010

Dispersion of returns for Macro funds and CTA/Managed Futures funds on the HFN.net database (as at April 2010)



Source: HFN.net database. Figures consider funds launched on or before December 2008 with at least USD100m in assets, on a global basis.

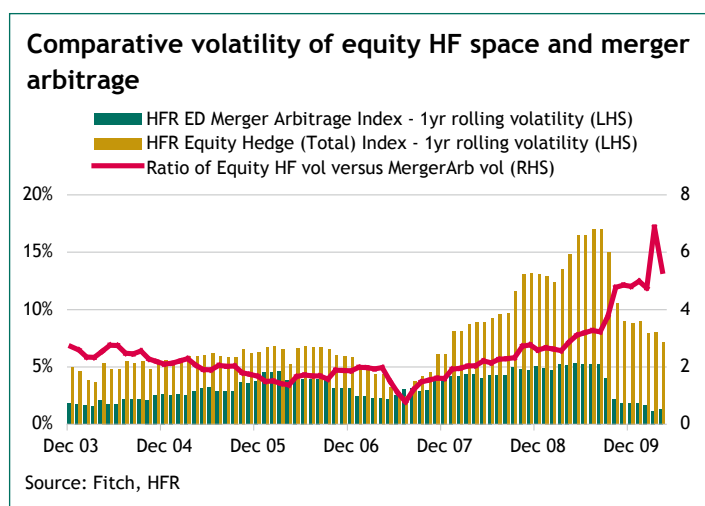
involved in systematic managed futures strategies need to re-launch a cycle of in-depth fundamental and technical research in order to devise new models and more robust systems. They must strive to become more flexible, more diversified across markets, with better access to short- and long-term liquidity, allowing them to tap into the new possibilities offered by today's more “electronic” markets. Potential changes to the environment relevant for systematic traders include:

- the rise of “dark pools” non-exchange directed trades;
- the ascent of high frequency and algorithmic trading (rapidly progressing to approximately half of all equity trades in the US);
- as a corollary to the preceding point, the speed and precision of execution is becoming crucial (notably through powerful IT systems), as well as the incorporation of algorithmic trading behaviours in model assumptions;
- the rapid development of new futures and derivatives markets, notably in commodities and energy;
- emerging markets becoming better integrated and liberalised.

Merger Arbitrage awaiting a clearer upturn of M&A activity and Distressed Debt performing well

The larger Event Driven space is doing well to date in 2010, providing a gauge for the overall market conditions and investment activity. The sector was the highest performer at end-May, with a +4% YTD return.

Although lagging HFs in general, the Merger Arbitrage segment is nonetheless proving resilient to equity market swings, returning slightly positive performance at end-May. The segment also demonstrates lower and more stable levels of volatility over time. As shown in the chart below, the volatility figures for the broad equity HF space, compared to the Merger Arbitrage index (using HFR data), have increased about threefold from the pre-crisis period, reflecting moderate risk taking by M&A arbitrageurs.



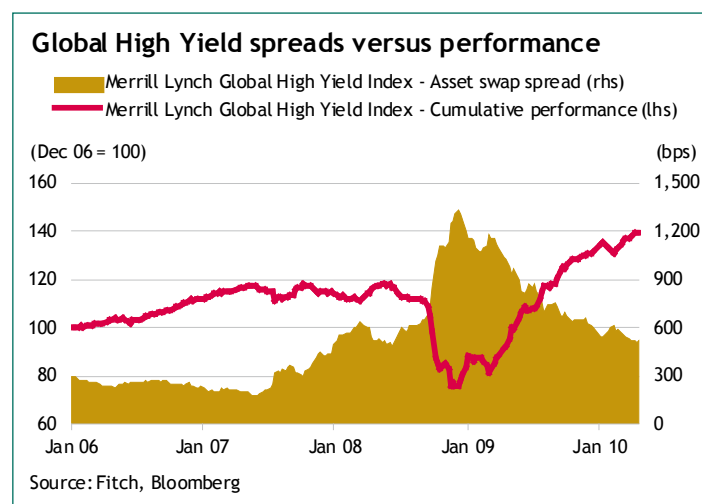
The overall performance of Merger Arbitrage HFs in 2010 will largely depend on the materialisation of the expected rise in deal activity¹². According to Bloomberg data, deal volumes have fallen steadily since mid-2007, as average premium levels on announced deals have been progressively normalising throughout 2009 at around 20% (versus 40%-60% seen in 2008). Both indicators are showing signs of strengthening in Q1 and Q2 of 2010. Furthermore, corporations are continuing to pile cash reserves, awaiting a clearer macroeconomic picture before re-entering an external (acquisition-based) growth strategy mode (this was

12 In a February 2010 study, UBS Investment Bank described the cyclicality of M&A deal activity – As 2009 constituted a clear six-seven year trough, they eventually expect rising levels of activity from 2010 onwards

notably expressed in a 2010 research piece by broker-dealer Strategas Research Partners). In a May 2010 survey, Fitch signalled improving investor sentiment in Europe, with regards to a potential rise in M&A activity in 2010, although these same investors continued to believe European corporations “will focus on hoarding cash and remain cautious on new investments”¹³.

In turn, distressed asset HFs were the best performing HF strategy, at +7.3% YTD (April), giving up 2.8% in May. The segment is benefiting from a number of positively-oriented factors, including:

- ▶ The combined effect of improved liquidity conditions, a renewed appetite for risk and bank disintermediation along with continuing corporate deleveraging. This enables corporate refinancing through record bond issuance.
- ▶ The above has also helped reduce HY and loan default rates during Q1 2010 (to their lowest rate since December 2007).
- ▶ Both HY and leveraged loan spreads benefited from a strong rally until end-April (see chart below).

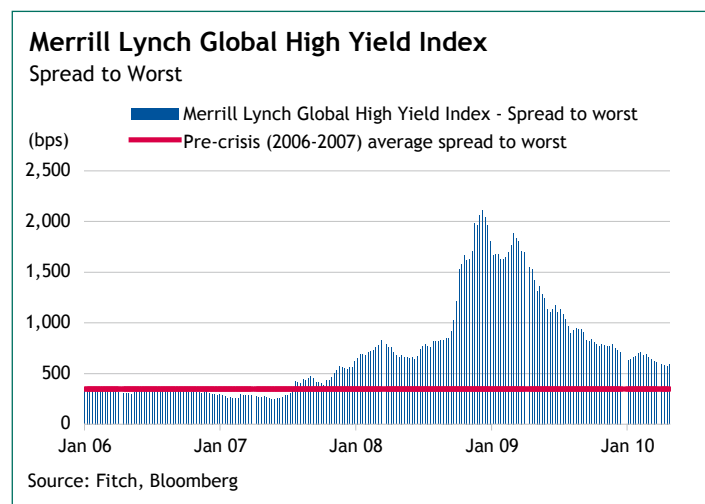


Both opportunities and threats for distressed HF managers may arise in the medium term. According to Fitch, low-rated credit structures such as LBOs continue to face pressure in terms of performance and refinancing capacity, 2013 being the next medium-term critical deadline¹⁴. Besides, the dispersion of credit quality and spreads – despite their compression since January 2009 – suggests that there are

13 See Fitch Ratings – “Fitch: European Corporates to Hoard Cash Despite Expected Increase in M&A”, 12 May 2010

14 See Fitch Ratings – “Fitch: European LBOs Still Face Medium-term Default Risk, Despite Signs of Stabilisation”, 15 February 2010

still opportunities in current market conditions (see chart below). Clearly, the disparity among situations, assets and structures, combined with a still uncertain macro-environment, call for enhanced capacity in credit research and fundamental analysis, with good coverage of the various jurisdictions.



An in-depth analysis of industry trends and a performance review of the credit management space can be found in Fitch's *Credit Management Quarterly* newsletter, published on 7 June 2010. In addition, a Fitch research article featured in Risk magazine's CreditMag (May 2010) explores the current environment and development of distressed-focused asset managers¹⁵.

FoHFs fundamentally in better position – However not yet reflected in performance

As was the case for much of 2009, FoHFs lag the performance of single-manager HF indices in absolute terms, yet generate lower levels of volatility – ie on a risk-adjusted, one-year rolling basis, they were almost on a par with single-HFs at end-April.

Reasons for this lagging include lower market exposure, legacy positions, fund restructuring and still relatively greater caution regarding liquidity. However, three elements need to be pointed out:

- › Although significant portfolio cleansing – getting rid of illiquid positions or those with suspended redemption –

¹⁵ See Risk magazine CreditMag – “Distressed Assessed”, Manuel Arrive, Fitch Ratings, May 2010

occurred in 2008 and 2009, it was Fitch's belief that in 2010 this issue would diminish in importance. Obviously, many FoHF managers are still suffering from a share of their assets either not performing or not being sellable.

- › Some managers are using secondary markets to sell HF positions, often accepting a discount to NAV that is harming performance; others are simply awaiting better times, in which case these positions are deemed illiquid. The two Hedgebay indices (the GSMI for liquid assets and the GIAI for illiquid assets) continue to trade at below par level and/or their long-term average level. However, signs of improvement in 2010 hint that trades at premium to NAV may be back in selective cases. Signs of continued nervousness remain, and this translates into seesawing prices¹⁶.
- › Although they have prepared their research engines and made room for distressed HF, FoHF managers have only cautiously invested this high performing asset class as of yet. This explains at least some part of the relative underperformance of FoHFs.

In conclusion, better times may lie ahead for FoHF managers, if or when they:

- › fix their structural impediments (liquidity mismatch, underperforming illiquid positions);
- › proceed with renewed strategic HF allocation plans and;
- › demonstrate their rationality/legitimacy to clients who wish to access alternative investments with minimal and/or controlled risk. This involves managers coupling quality bottom-up due diligence research with a new capacity to tailor portfolios from a top-down perspective. This last point means managers obviously need to further develop their capacities in beta-driven performance generation and risk overlay through the use of derivatives, exchange traded funds (ETFs) and managed accounts. The objective must be to efficiently optimise portfolios with clearer alpha-generating positions and more diversified beta factors. This contrasts sharply with the historical approach, which was almost exclusively focused on hedge fund selection.

¹⁶ See Hedgebay – Global Hedge Fund Secondary Market Index monthly report, April 2010

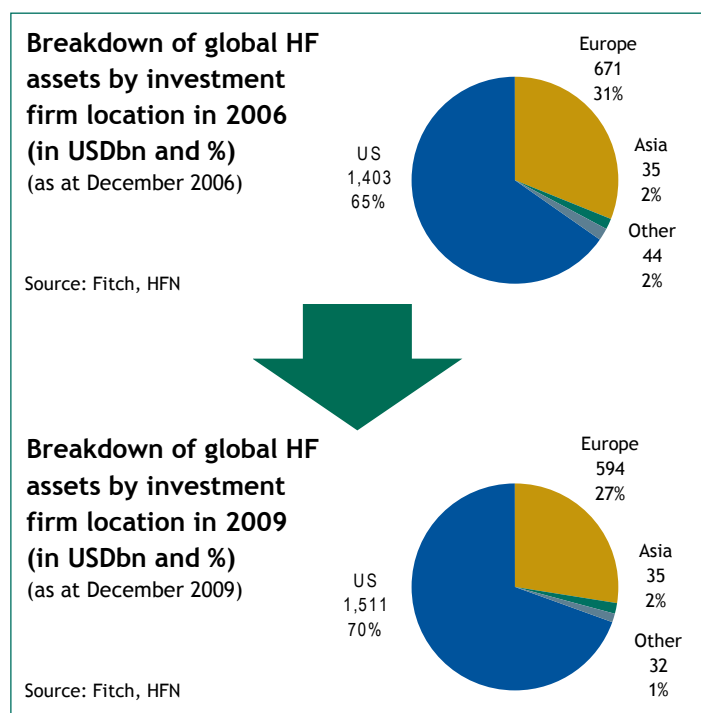
Industry Issues

Global HF assets under management benefit from client inflows; yet more client segmentation is expected

In April 2010, data provider HFN reported global HF assets under management (AUM) had risen to USD2.299trn, thanks to almost uninterrupted net positive inflows that began in April/May of 2009. Strategies that continue to attract the bulk of new money include the general equity and global macro sector, while Fitch notes a renewed interest in arbitrage strategies, focusing on fixed income and credit. The distressed assets segment could also ramp up in 2010 (see Q2 2010 Fitch's Credit Quarterly Newsletter).

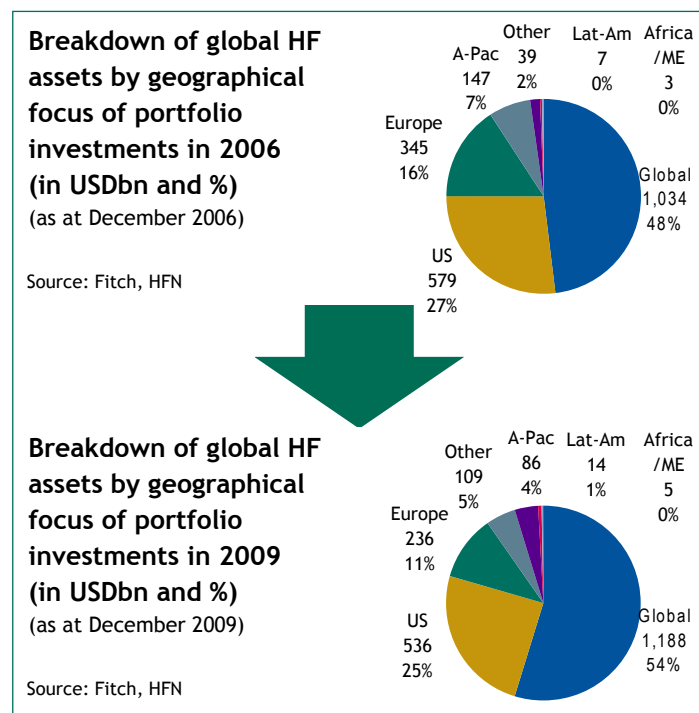
HFN has also released its Q4 2009 Asset Flow/Performance report¹⁷, providing a detailed presentation of HF asset flows over time and various observation spectrums. Fitch's study of the results spanned the last three completed calendar years, so as to measure the potential effect of the 2008-2009 financial crisis. Overall, Fitch notes that Europe's representativeness as a region may have slightly decreased in importance since 2006. Indeed, it appears Europe is today home to about 27% of HF investment firms in terms of volumes of AUM (vs 31% in 2006), while the region as the geographical focus of portfolio investments accounts for 11% of the total (vs 16% in 2006). In the meantime, as shown in the charts below, the representativeness of the US has either stabilised or increased in importance.

The diagram below illustrates the evolution of global HF assets by investment firm location, from 2006 to 2009:



¹⁷ See HFN.net – HFN Hedge Fund Industry Asset Flow/Performance Report Q4 2009

The diagram below illustrates the evolution of global HF assets by the geographical focus of portfolio investments, from 2006 to 2009:



The most important observation is that HF portfolios with a global focus have gained in importance since 2006. This suggests the industry is continuing to globalise, with diversification a key theme among both investors and HF managers.

In its search for clarified industry trends so far in 2010, Fitch has also tried to cross its own analysis with the results from various industry surveys and studies performed recently by an array of data providers, media groups, banks and international organisations¹⁸. Therefore, the main observable trends according to Fitch are:

- › **Institutional investors looking for diversification, lower volatility and absolute returns, could pour significantly more capital into alternative investments from 2010 onwards** (both in absolute and proportional terms). This includes hedge funds, real estate, infrastructure and private equity. This may be at the expense of equity investments, although sources diverge somewhat in this regard.
- › **FoHFs have been widely criticised since 2008, but it is not yet clear whether their share of global HF assets will fall further or remain stable (about 41% at end-2009 according to HFN – although down from a peak level of 50% attained in Q2 2008).** It is Fitch's opinion that, while large institutional investors will continue their in-sourcing process to some extent, small- to medium-size investors

¹⁸ These included notably: HFR Global hedge Fund Industry Report 2009; the KdK / Hedge Fund Journal UCITS FoHF Distributors Survey Q1 2010; Deutsche Bank 2010 Alternative Investment Survey; OECD – Pension Markets in Focus (October 2009); Towers Watson – 2010 Global Pension Asset Study; Mercer – Asset allocation survey and market profiles (April 2010); SEI / Greenwich Associates – The Era of the Investor (January 2010); Preqin Special Report: Sovereign Wealth Funds (May 2010)

will still require access to alternative investments through FoHF managers. However, in relation to the next point, it is possible that we will see further consolidation among FoHF managers, in favour of larger and more established players¹⁹. Furthermore, the agency believes FoHF managers will need to adapt to changing investing conditions and client demand, requiring more advanced services and integrating concepts such as: better and more flexible reporting; asset/liability management; overlay through derivatives for a better management of top-down views; the use of “alternative beta” products – such as replication, ETFs and managed accounts; better liquidity; and product structuring.

› **The joint effect of institutionalisation and consolidation within the industry seems to be gathering pace, as evidenced, for example, by the acquisitions of GLG by Man Group and Thames River by F&C.**

This statement is further substantiated by the following general observations, emerging from Deutsche Bank’s Alternative Investment Survey 2010; institutional investors clearly have a tendency to: 1) prefer managers with at least five to 10 years’ investment experience; 2) prefer managers with at least USD1.0bn in AUM; and 3) use a smaller number of investment firms, in line with the longer period of time devoted to prior due diligence. A notable effect of the crisis has been that purely institutional investors (as opposed to flows originated by retail or private banking and high net worth (HNW) individuals) now represent about 50% to 60% of global HF assets. Finally, as mentioned above, another effect has and will continue to be for pension funds to try and enhance their asset/liability management. In this regard, pension funds may shift from a relatively static, asset class-driven allocation, to one focusing on the liquidity, risk and correlation/diversification benefits of their investments²⁰ – which will undoubtedly modify the way they see, analyse and choose their providers of uncorrelated alternative investment-type of assets.

› **It seems both UCITS 3/4 and managed accounts will draw a significant share of alternative investments (although it remains to be seen whether this improves quality).**

Fitch has commented on both these issues in previous HF Quarterly newsletters (please refer to the reports published in Q1 2010 and Q1 2009). Several industry sources Fitch has analysed confer to the increasing use and offering of both structures²¹, mainly as a direct consequence of investor demand – i.e. the driving force has been the anticipation of heavier regulation and a stronger desire for transparency, as opposed to a real search for better risk/return figures. In their survey of fund distributors, KdK and the Hedge Fund Journal have established that fund distributors have had demand

for both single-manager UCITS (73% of respondents) and multi-manager/FoHF UCITS (67%)²². Towards the end of Q1, Albourne Partners estimated that around 265 UCITS HFs now manage about USD47bn. However, it is not yet clear whether traditional offshore locations, such as the Cayman Islands, the BVI or Delaware, will lose their market share of HF vehicle domiciliation. Besides tougher regulation, there is no compelling argument for a sophisticated and large institutional investor to immediately shift to a UCITS framework for its alternative investments; ie such an investor is still able to get the level and quality of service it expects and requires, using offshore structures. In Fitch’s opinion, we are rather to see a clearer segmentation of the clientele according to its needs, expectations, degree of sophistication, bargaining power and also, obviously, the level of regulation it faces.

› **The general belief that HF fees are going down needs to be put into perspective.**

Several industry surveys and studies have concluded that large institutional investors and pension funds had been able to negotiate lower fees, or that the observed average fees (whether AUM-based or performance-based) have been falling since 2009²³. Certainly, if we factor in a larger use of managed accounts and segregated mandate structures, which naturally charge lower fees, it appears somewhat logical that average fees are decreasing. Fitch believes that good performing managers will be able to retain their traditional fee structure, further fostering the notion of an industry “polarised” between best-breed managers and the rest. With the better performance figures of 2009-YTD2010, and a general trend towards reinvesting highly sophisticated investment segments – such as distressed or credit arbitrage – so far in 2010, hedge funds are proving resilient to downward pressures on fees²⁴. In cases when HF managers agree on lower fees, it may be in exchange for a longer lock-up period in the fund²⁵. A longer lock-up actually often makes sense as it rebalances the true liquidity risk of a particular strategy with the acceptance by the client of a lower level of liquidity. Finally, some industry participants have studied alternative ways to remunerate HF managers, with the objective being to continue to provide incentives for superior risk/return results, but at the same time better align the interest of the HF manager with that of the client. One such idea is to replace cash-based performance fees – often charged or provisioned on a quarterly or annual basis – with an option-based system (advocated by specialised services firm Optcapital LLC); this would foster the incentive for the HF manager to maintain an appreciable degree of performance throughout the period the investor remains invested in the fund²⁶.

19 See the Hedge Fund Journal – *Funds of Hedge Funds Consolidation: The Gun has been Fired*, Simon Kerr, April 2010; and HFR – *Fund of Funds Consolidation Accelerates*, HFR Market Microstructure Industry Report Q1 2010

20 See The Hedge Fund Law Report – *Implications for Hedge Funds of a Potential Paradigm Shift in Pension Fund Allocation Strategies*, 23 April 2010

21 See Prequin – *UCITS, The Future of Regulated Funds*, March 2010; and Prequin Research Report – *Managed Accounts on the Upswing*, February 2010

22 See the KdK / Hedge Fund Journal UCITS FoHF Distributors Survey Q1 2010

23 See consultant BFinance Global Survey – *Pension Funds have more favourable view of fees as they shift in favour of active strategies*, 5 February 2010; and The Economist – *Funds of hedge Funds, One and ten Never Again*, 24 April 2010

24 See consultant BFinance Global Hedge Fund Survey – *Alternative Manager fees structure to survive downward client pressure*, 8 February 2010

25 See Credit Suisse survey, February 2010

26 See Rick Ehrhart, JD, Optcapital LLC in HedgeTracker.com – *Closing the Pension Funding Gap, A Tweak to Hedge Fund Incentive Compensation*, 6 April 2010

Upcoming changes to global regulation likely to affect the management and the distribution of alternative investments in general and HFs in particular

Most industry participants, whether investors or HF managers, seem to accept that they must adhere to stronger regulatory rules. Fitch has identified at least four major sources of change to the regulatory framework. All seek to better control, assess and eventually limit the systemic risks posed to the global financial system. In the case of HFs, if applied and enforced as originally proposed, these new rules could make it much more difficult for several firms to remain an ongoing business and/or to find potential clients.

These new regulation frameworks include:

- › **Changes predicted at the Basel Committee on Banking Supervision – Currently Basel II.** In essence, the idea is to further bolster the capital requirements of banks and the corollary capital costs of the risk that they carry on their balance sheet. As banks have traditionally used alternative investments, such a move would impact the distribution and penetration of HF products²⁷. The financial leverage, historically provided by prime brokers, could also be affected, ultimately increasing the costs for HFs.
- › **Changes to the regulatory solvency regime of European insurance companies – Solvency II.** This would apply a similar capital requirements-approach to insurance companies as Basel II does for banks. HFs would again

²⁷ See Risk Magazine – *Basel changes stun bankers, January 2010*; and *Basel reforms include surprise requirements for counterparty risk, January 2010*

likely suffer in terms of capital allocation possibilities²⁸, as allowed model-based risk approaches may not fully or appropriately capture historical HF risks.

- › **The negotiation and eventual introduction of the European Alternative Investment Fund Managers Directive (AIFM).** This proposed regulation aims to foster an on-shore European Union hedge fund industry by way of: 1) restricting distribution of HFs to regulated vehicles (either directly by the European regulator or indirectly by way of inter-regulator agreements); and 2) imposing on managers more stringent capital adequacy and reporting rules, as well as the use of local/EU depositary banks which would in turn be required to assume more responsibility. For many market participants, the potential effects on a largely offshore industry, and one in which 60% to 70% of managers (in terms of AUM) are located in the US, would be to limit access to European investors for these managers and conversely to narrow the opportunity set for European investors.
- › **The proposed Volcker rule in the US.** This proposed rule – brought forth by former Federal Reserve Chairman M. Paul Volcker – aims to prohibit any bank with access to FDIC insurance from being able to, notably, own a hedge fund firm or a private equity firm. The impact on several hedge funds would be strongly felt.

The agency remains attentive to these changes and the manner in which they might affect the working environment of asset management firms, as these could eventually be forced to change their marketing priorities, move funds onshore or abide by stronger reporting, capital adequacy and/or custody requirements.

²⁸ See CEA, European insurance and reinsurance federation – *Why excessive capital requirements harm consumers, insurers and the economy, March 2010*

ALL FITCH CREDIT RATINGS ARE SUBJECT TO CERTAIN LIMITATIONS AND DISCLAIMERS. PLEASE READ THESE LIMITATIONS AND DISCLAIMERS BY FOLLOWING THIS LINK: [HTTP://FITCHRATINGS.COM/UNDERSTANDINGCREDITRATINGS](http://fitchratings.com/understandingcreditratings). IN ADDITION, RATING DEFINITIONS AND THE TERMS OF USE OF SUCH RATINGS ARE AVAILABLE ON THE AGENCY'S PUBLIC WEB SITE AT WWW.FITCHRATINGS.COM. PUBLISHED RATINGS, CRITERIA, AND METHODOLOGIES ARE AVAILABLE FROM THIS SITE AT ALL TIMES. FITCH'S CODE OF CONDUCT, CONFIDENTIALITY, CONFLICTS OF INTEREST, AFFILIATE FIREWALL, COMPLIANCE, AND OTHER RELEVANT POLICIES AND PROCEDURES ARE ALSO AVAILABLE FROM THE CODE OF CONDUCT SECTION OF THIS SITE.

Copyright © 2010 by Fitch, Inc., Fitch Ratings Ltd. and its subsidiaries. One State Street Plaza, NY, NY 10004. Telephone: 1-800-753-4824, (212) 908-0500. Fax: (212) 480-4435. Reproduction or retransmission in whole or in part is prohibited except by permission. All rights reserved. All of the information contained herein is based on information obtained from issuers, other obligors, underwriters, and other sources which Fitch believes to be reliable. Fitch does not audit or verify the truth or accuracy of any such information. As a result, the information in this report is provided "as is" without any representation or warranty of any kind. A Fitch rating is an opinion as to the creditworthiness of a security. The rating does not address the risk of loss due to risks other than credit risk, unless such risk is specifically mentioned. Fitch is not engaged in the offer or sale of any security. A report providing a Fitch rating is neither a prospectus nor a substitute for the information assembled, verified and presented to investors by the issuer and its agents in connection with the sale of the securities. Ratings may be changed, suspended, or withdrawn at anytime for any reason in the sole discretion of Fitch. Fitch does not provide investment advice of any sort. Ratings are not a recommendation to buy, sell, or hold any security. Ratings do not comment on the adequacy of market price, the suitability of any security for a particular investor, or the tax-exempt nature or taxability of payments made in respect to any security. Fitch receives fees from issuers, insurers, guarantors, other obligors, and underwriters for rating securities. Such fees generally vary from US\$1,000 to US\$750,000 (or the applicable currency equivalent) per issue. In certain cases, Fitch will rate all or a number of issues issued by a particular issuer, or insured or guaranteed by a particular insurer or guarantor, for a single annual fee. Such fees are expected to vary from US\$10,000 to US\$1,500,000 (or the applicable currency equivalent). The assignment, publication, or dissemination of a rating by Fitch shall not constitute a consent by Fitch to use its name as an expert in connection with any registration statement filed under the United States securities laws, the Financial Services and Markets Act of 2000 of Great Britain, or the securities laws of any particular jurisdiction. Due to the relative efficiency of electronic publishing and distribution, Fitch research may be available to electronic subscribers up to three days earlier than to print subscribers.