

Funds of Hedge Funds Quarterly – Q308

October 2008

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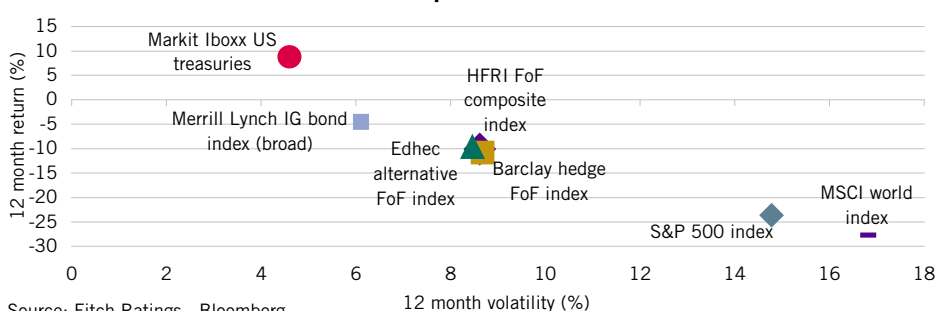
Executive Summary

- After a profitable 2007, 2008 is witnessing worst ever results for funds of hedge funds, as at October 2008.
- Rising correlation of markets, a lack of liquidity, the diminishing value of fundamental analysis, hectic behaviour of asset prices and the credit crisis have all placed growing downward pressure on hedge fund (HF) strategies.
- Hedge fund-specific risk is on the rise, as illustrated by funding difficulties, higher redemptions and investment strategy issues.
- The bankruptcy of Lehman Brothers Holdings Inc. has impacted hedge funds via its prime brokerage activities. The impact has been relatively modest for most funds of hedge funds (FoHFs), as many underlying funds had already switched to other prime brokers or reduced their exposure to Lehman as counterparty over recent months.
- The liquidity of FoHFs - and specifically the mismatch between that of assets and liabilities - coupled with investor stability, has increasingly become a main focus of fund managers and is now a determining factor in the resilience of FoHFs.
- The FoHF industry is at a turning point; assets under management may suffer severe redemptions if clients lose confidence in FoHFs capacity to act as a strong mitigator in times of crisis.
- Dispersion in FoHF returns has steadily increased since 2007, illustrating the natural differences in alpha generation capacity, risk management focus and HF selection ability among FoHF managers.

Performance Review of Funds of Hedge Funds

Market Indices (in USD terms)

12 Month Risk/Return Profile (As at September 2008)



Market and Fund of Hedge Funds Indices (as at September 2008)

	Cur.	Q3 2008 ret. (%)	Q2 2008 ret. (%)	Q1 2008 ret. (%)	YoY ret. (%)	12 mth vol. (%)	12 mth corrl. with S&P500
HFRI FoF Composite index	USD	-9.6	1.9	-4.3	-10.1	8.6	0.61
Barclay Hedge FoF index ^o	USD	-9.9	1.9	-4.4	-10.8	8.7	0.60
Edhec Alternative FoF index ^o	USD	-9.6	2.0	-3.9	-9.7	8.5	0.59
S&P 500 index	USD	-8.9	-3.2	-9.9	-23.6	14.8	
MSCI World index	USD	-15.7	-2.5	-9.5	-27.6	16.8	0.94
Markit Iboxx US Treasuries	USD	2.3	-2.1	4.5	8.8	4.6	-0.57
Merrill Lynch IG Bond index (broad)	USD	-4.6	-0.8	-0.3	-4.5	6.1	0.53

^o Based on estimates used for performance of September 2008
Source: Fitch Ratings, Bloomberg

Commentary

For this inaugural issue the performance review covers the first three quarters of the year. The next quarterly reviews will only analyse current quarters.

While in 2007, FoHFs returned good performance across the board, only suffering from credit-related strategies, the situation in 2008 is clearly very different. A combination of falling equity markets, deteriorating credit conditions, macroeconomic trend reversals (commodities, US yield curve steepening, currencies) and decreased access to liquidity have, altogether, resulted in a significant general downturn.

The first quarter of 2008 had represented a 10-year benchmark in terms of poor performance – before Q3 proved even worse. Market indices have reported sharp losses for all strategies, with the exception of the macro/commodity trading advisors (CTA) sector. Long/short equity strategies have suffered mainly from a positive equity beta factor. Convertible bond arbitrage strategies seem to have suffered from their structurally long exposure to credit (often, High Yield). Volatility arbitrageurs have not performed as well as expected, despite a technically more favourable environment of rising

volatility as the costs of implementing such strategies were consequently also getting higher and as short- and long-term volatility figures registered a heightened instability. However, the continuously rising price of commodities, the soaring value of EUR vs USD and a steepening of the US yield curve have provided ample opportunities for macro-oriented traders and CTAs, which have posted very strong performance figures for the quarter. Finally, the theory of “decoupling” emerging markets has not worked out quite as hoped, with these markets being unable to demonstrate their relative immunisation against global events. Overall, FoHFs suffered from the deterioration of liquidity and funding conditions in March 2008, which created liquidation or deleveraging scenarios for many hedge funds.

The second quarter of 2008 saw FoHFs turn in much better results; most underlying hedge fund strategies showed strong performance and portfolio allocations adopted a more market-neutral profile. While equity markets were down on the quarter, long/short equity funds benefited from their lower equity beta – which was quickly adjusted after Q1 performance – and their sector bets (long commodities and short financials). Following Bear Stearns bail-out, credit markets improved, as did liquidity conditions. Finally, macro bets continued to pay off, notably as commodities and energy prices rose to unprecedented levels.

The third quarter of 2008 saw a deterioration of performance across strategies, which more than offset the good performance of Q2 and resulted in the worst single quarter results in history. To begin with, commodities and energy in general reversed their course and commenced a sharp downturn following renewed fears of a US recession. This in turn penalised many FoHFs which had, purposely or otherwise, taken on more commodity risk via specialised or macro hedge funds. This was followed by stocks, and notably financials, experiencing extreme volatility, in a context of uncertainty regarding the health of the global financial system which created challenging conditions for most equity-related strategies. Liquidity also deteriorated significantly, returning capital markets to the situation last seen in March and penalising many arbitrage-type and event driven strategies. Finally, redemption pressure and funding issues added to the woes of single hedge funds. As a consequence, and with credit spreads rising once again, virtually all hedge fund strategies posted negative results in the quarter. On top of the overall deteriorating performance, most FoHFs have also been confronted with issues regarding specific underlying funds in liquidation or with suspended subscriptions and redemptions. Finally, it should be noted that multi-strategy FoHFs have often shown worse performance figures than global hedge fund indices.

The bankruptcy of Lehman Brothers Holdings Inc. on 15 September has also impacted hedge funds via its London-based prime brokerage activities.

The impact has been relatively modest for most FoHFs, as many underlying funds had already switched to other prime brokers or reduced their exposure to Lehman as counterparty over the course of recent months. For those hedge funds with collateral with Lehman the day it filed for bankruptcy, the recovery ratio will depend on the extent to which their assets (normally segregated) had been re-used by the bank (re-hypothecation). In any case, for those hedge funds, timing of the recovery may take several months according to PwC, the assigned administrator for Lehman's assets and liabilities. The total assets frozen are estimated to approach USD65bn, of which USD45bn are securities and USD20bn short positions. Assuming 50% recovery, the loss would represent around USD30bn, compared with around USD3tr of hedge funds' assets (assuming USD2tr client money and 50% leverage), ie 1% of the total.

As at mid-October, preliminary figures showed a continued decline in all hedge fund strategies' performance. According to the HFRX series of indices, hedge fund returns in the first half of October have already reached the level of the fall seen in September – i.e. beyond -6.0% for the broad index. Credit and equity markets are impacting long/short, event driven and distressed strategies, while broad market disruptions are taking their toll on arbitrage funds, notably convertible bond arbitrage.

FoHF Strategies Year-to-Date

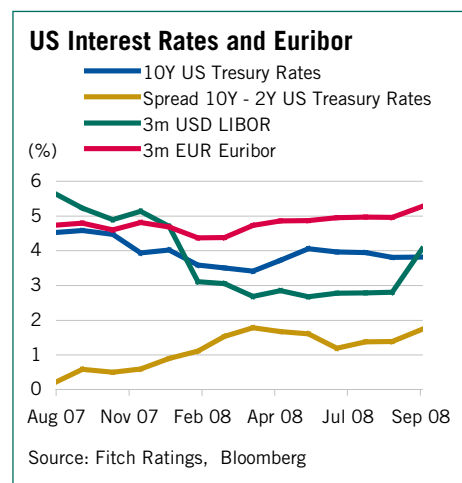
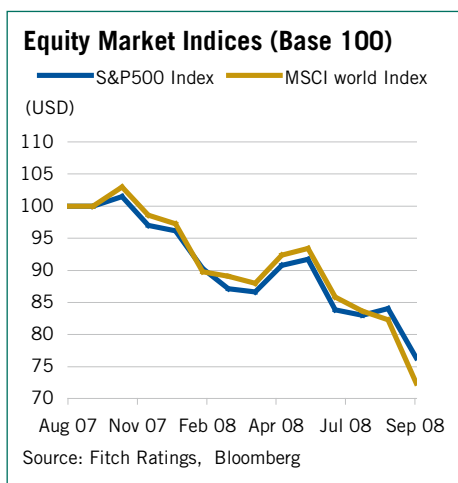
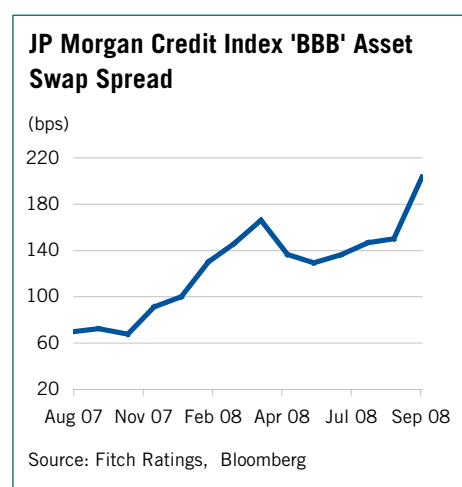
The theory behind the natural diversification of FoHFs severely challenged by the current broad collapse in asset prices. Rising correlation factors between the various markets hedge funds invest in, along with diminished access to cheap liquidity during the first three quarters of 2008, have caused serious

Underlying Strategies and Capital Market Factors

Main Hedge Fund Strategies (as at September 2008)

(%)	Cur.	Q308 ret.	Q208 ret.	Q108 ret.	YoY ret.	12 mth vol.
Equity (HFR1 Equity Hedge Total index)	USD	-12.1	2.3	-6.0	-14.9	11.3
Macro (HFR1 Macro Total index)	USD	-4.2	2.4	4.1	5.5	6.8
Relative Value (HFR1 Relative Value Total index)	USD	-5.9	2.0	-3.3	-5.2	6.5
Event Driven (HFR1 Event Driven Total index)	USD	-7.8	0.9	-3.5	-10.8	7.7
Emerging Markets (HFR1 EM Total index)	USD	-16.8	0.3	-7.2	-19.6	15.0

Source: Fitch Ratings, Bloomberg



problems for a multitude of FoHF managers. The natural diversification effect of such multi-strategy and multi-manager structures tends to fade when correlation rises. As a consequence, during this period the average FoHF manager has typically struggled to demonstrate its capacity to provide investors with: 1) a regular return; 2)

a diversification effect as compared to traditional markets; and 3) a mitigation of the impact of the credit crisis and the general fall in several sectors of alternative investments.

No big move in strategy allocation, with preference for macro and CTAs. A few general observations can be made as

regards FoHFs' asset allocation, with some variations caused by regional factors or natural biases. The strategic medium-term asset allocation of multi-strategy FoHFs has not evolved drastically over the past year. As illustrated by public market indices – such as the CS/Tremont Broad Hedge Fund Index – strategies that have shown a long bias towards equity markets (such as Long/Short Equity and, to some extent, Event Driven) still dominate allocations, often comprising about 50% of the total. However, long-credit hedge funds have now effectively disappeared from the scene, with FoHFs sometimes managing legacy positions in funds that are being liquidated. Global macro-oriented strategies, as well as CTAs, have been allocated a relatively growing share, which has proved beneficial given market conditions.

In the current context, FoHFs continue to favour macro-oriented and macro/CTA strategies, as well as the market neutral-type of relative-value traders which generally benefit from heightened volatility and dispersion. All-in-all, the asset allocation and positions of FoHFs remain generally defensive.

Risk reduction across the board: higher liquidity, lower leverage and lower market sensitivity factors. In general, a clear trend across strategies has been reduced risk exposure in the form of a higher liquidity portion, lower leverage and lower sensitivity to equity factors. In fact, most market sensitivity factors have been reduced after the severe reversal in commodities prices, making FoHFs even more defensive. This last observation, more than anything else, demonstrates the general uncertainty that prevails across the industry, as well as a dire need to improve liquidity of FoHFs as clients become nervous and thus more prone to redeem their shares. This has resulted in increased pressure on underlying hedge funds. Indeed, FoHF managers have become evermore selective, redeeming shares in uncertain or disappointing funds in

an attempt to focus on safer funds with clear and tested strategies. Another observation is the progressive and significant build-up of cash and liquid positions as a means of facing potential redemptions in coming months.

Challenges in underlying fund selection: alpha managers vs. directional players.

In this context, more resilient FoHF managers have demonstrated a superior capacity to select underlying managers with a true alpha generation engine, notably in difficult markets. Generally, directional traders have been overlooked in favour of relative value traders, or so-called “stock-pickers”, which have less or no residual exposure to the underlying markets. This is particularly true for equity hedge funds, as those FoHFs offering transparency in their asset mix demonstrate allocation to long-biased traders has decreased. The direct result of this has been a lower equity beta announced by FoHF managers, or a lower net equity exposure. Recent observations seem to show the popular short financial stocks bet is disappearing, in line with the decision made by regulators to prohibit short selling on financial stocks. This should encourage FoHFs to further scrutinise the genuine stock-picking capabilities of their managers.

Still too early for distressed strategies.

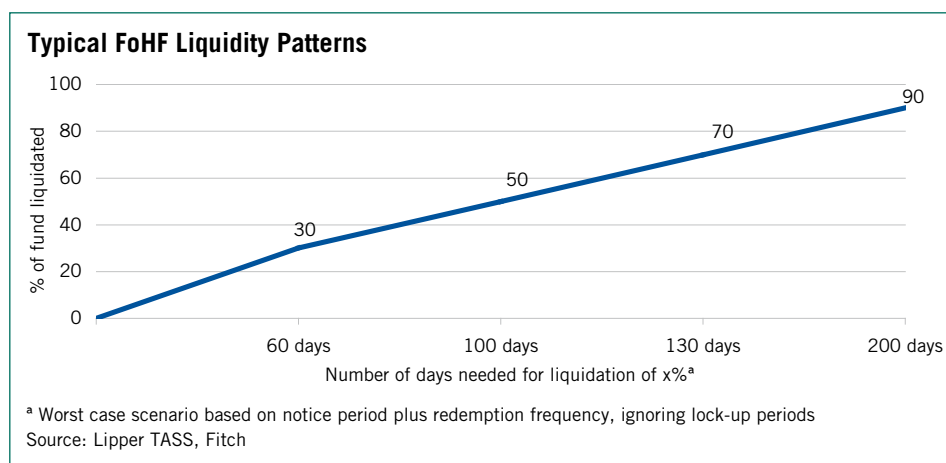
As far as credit is concerned (and more specifically, distressed assets) FoHFs have not yet demonstrated a clear

policy of reinvesting the asset class, although new specialised hedge funds are emerging. The credit crisis and its chain-reaction effect on banks' balance sheets continues to weigh on asset allocation decisions, and it may be too early to conclude that spreads will start pointing down in the near term.

Industry Issues

Liquidity Mismatch Risk in FoHF

As institutional investors have increased their allocations to FoHFs over the last three to four years, pressure for more favourable subscription and redemption terms has grown. While historically FoHFs had quarterly redemptions with 60 to 90 days' notice periods, one can now encounter funds with weekly redemptions and less than 30 days' notice period. Based on statistics from the European Central Bank (based on the Lipper TASS database), around 40% of FoHFs, as measured in terms of AUM, offer liquidity below 65 days (up to monthly redemptions and 35 days' notice, ignoring lock-up periods). To understand the underlying liquidity mismatch, one can simulate the liquidation pattern of a typical portfolio of hedge funds that comprise the assets of a FoHF, based on the same statistics and again ignoring lock-up periods. The typical liquidity profile of the HF universe is as follows:



As shown in the chart, FoHFs offering 65 days' liquidity can withstand redemption activity shocks amounting to a maximum of 30% of fund shareholder investments, through the sale of underlying fund holdings. The match can vary depending on the extent to which the FoHF invests in less liquid strategies (event driven, asset-based lending or arbitrage) or hedge funds. Conversely, the use of managed account platforms (generally offering weekly liquidity) and the existence of a cash buffer can mitigate the risk.

Liquidity mismatch risk has been growing over recent years as, in parallel with more favourable terms on the FoHF side, some underlying hedge funds have begun restricting their own liquidity by imposing lock-ups or moving to 90 or 180 days' notice periods. As an illustration – as per the European Central Bank calculation – the proportion of locked-up capital under management for both single-manager hedge funds and FoHFs was moving in tandem until 2004; since that time diverging trends can be seen, most likely reflecting different competition and sale pressure levels.

Compounding this liquidity mismatch challenge is the changing behaviour of the investor base of FoHFs, which has shown an increasing propensity to redeem FoHF investments at the first sign of real or perceived changes to the risk profile of the fund. The key drivers of this behavioural change include:

- › investors selling risky assets to improve their liquidity profile, in a context of general risk aversion;
- › FoHF performance volatility;
- › lacklustre performances (-11.8% for HFRI FoHF composite index YTD as at September 2008).

Some FoHFs may offer certain structural features (fixed capital in closed-end listed FoHFs, statutory gates, or implicit/explicit liquidity support) to better manage shareholder liquidity risk. In any case, investors should question

FoHF managers regarding the extent of their liquidity mismatch and seek to understand the manager's approach to managing portfolio liquidity risk (eg capital reallocation towards more liquid hedge funds and strategies, the use of liquid structures (managed accounts) and the maintenance of a cash buffer). Since liquidity risk is mutualised in FoHF investments, it is imperative to focus on the effects of significant redemptions on the remaining shareholders. To meet redemptions, FoHFs have several primary options. These include:

- › sale of the more liquid hedge funds, which leaves investors with greater exposure to the remaining, less liquid strategies;
- › sale of hedge funds applying redemption penalties, the cost of which is born by all investors in the FoHF;
- › borrowings (therefore introducing leverage), which leaves the remaining investors with an altered risk profile for the FoHF;
- › use of gates, which may result in increased redemption activity as investors may be prompted to exit the FoHF.

The current trends, scenarios and related options outlined above highlight a growing challenge for FoHFs, ie the need for a heightened focus on liquidity management. In the current context of disappointing performance, redemption risk will continue to grow in importance

and investors' stability will increasingly be questioned (see Fitch comment titled: "Fitch Steps up Monitoring of Fund of Hedge Fund Liquidity", released on 30 September 2008).

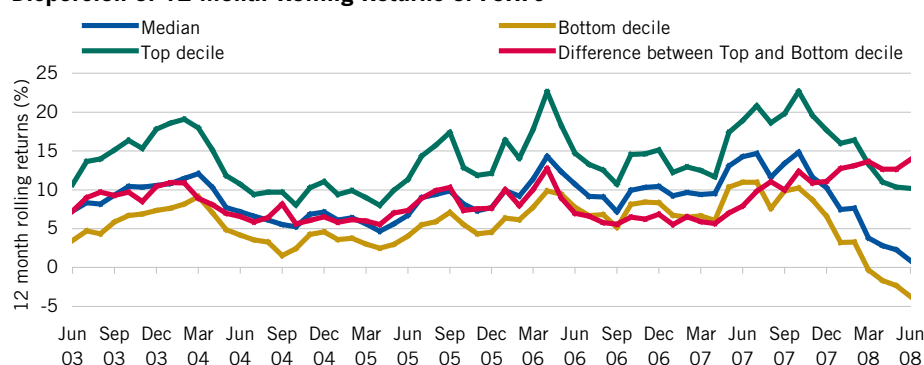
Greater Dispersion of Returns Among FoHFs Calls For Investors Scrutiny

Until the end of 2007, the investment community had been increasingly viewing FoHFs as a commodity asset, with little differentiation between the various managers and vehicles at investors' disposal. This perception must now be reviewed in light of the dispersion in returns among FoHFs which has been steadily rising since the summer of 2007. This is illustrated below using solely multi-strategy vehicles from data provider HedgeFund.net's database of FoHFs.

As shown in the graph below, an analysis of the cross-section dispersion of returns among the largest FoHF vehicles gives a good indication of this recent trend. While the best performing FoHFs managed to maintain their 12 month-rolling return above 10% as at end-June 2008, the bottom decile funds tapped into negative territory as early as March. At the end of September, data indicated that the spectrum of returns ranged from positive single digit to negative double digit figures.

Indeed, from 2002 to 2007, a period during which FoHF assets grew

Dispersion of 12 Month-Rolling Returns of FoHFs



Source: Fitch

significantly, the range of 12 month-rolling returns between best and worst FoHFs ranged between 5% and 10%. In this respect, 2008 could mark a rupture, with the difference in returns now well above 10%. Also of note, it is the first time this decade that dispersion is growing in a down market for FoHF performance in general. In fact, as historical data illustrates, dispersion has traditionally been associated with the very strong performance of top funds in bull markets. In other words, the increased dispersion today reflects a greater downside effect.

Notes: Data series taken from HedgeFund.net's online database of funds of hedge funds identified as multi-strategy vehicles. Statistics and charts drawn exclusively from the USD-based largest (based on AUM) off-shore (non-US based) vehicles with net assets under management greater than USD200.0m. No further restrictions. From January 2000 to June 2008, the minimum number of vehicles in the representative set was 32 and the maximum was 73.

Large Investors' Direct Investments in Hedge Funds: A Structural Trend?

Despite the current difficulties being experienced by FoHFs, the general

trend seems to be one of a continued search for diversifying assets, notably as a strategic portion of the asset base of institutional investors. Only recently (May 2008), Mercer reported increased interest in non-traditional assets at the expense of traditional equities. Yet the industry may see larger redemption notifications by year-end, as it appears clients are looking for safer, ie cash-equivalent, vehicles for their savings. From another perspective, the industry may be facing a change in the way large institutions, such as pension funds and insurance companies, consider their hedge fund assets. For example, the generally high fees commanded by FoHF managers, and their perceived lack of added-value, have prompted several large investors to bring in-house the job of selecting and allocating money to hedge funds. Though there are also examples of medium-sized pension funds launching searches for FoHF mandates, the disintermediation recently observed in the hedge fund market suggests a potential structural change to the historical 40%-50% of hedge fund investments that go through multi-manager investment firms. That said, it should be noted that the decision to outsource or internalise hedge fund investments is a direct function of a firm's maturity, resources and corporate strategy.

Specific Hedge Fund Risk on the Rise

A mounting number of hedge fund "blow-ups" and scandals have received substantial press coverage over the last 18 months and clearly do not place the sector in a favourable light. In 2008, numerous leading players have announced poor performance, difficulties in facing client redemptions, staff defections and even forced liquidations: Peloton; Endeavour Capital; Carlyle Capital Group; JWM Partners; Focus Capital; and Citigroup (Falcon) have all had to liquidate funds or suspend client redemptions because of extreme situations in their invested positions or wrongly directed market bets. HFR reported 350 liquidation procedures at hedge funds during H1 2008, a 15% increase compared to a year ago. Furthermore, legal amendments are increasingly being made to hedge fund prospectuses (side pockets, lock-ups, notice periods, gates) in an attempt to cope with liquidity issues and to ensure business continuity. Finally, the third quarter has witnessed several hedge funds and FoHF managers proposing cuts in their management and performance fees in exchange for a commitment from clients to maintain their investments for periods ranging from one to three years.

Disclaimer

Through its FoHF Manager Rating service, Fitch analyses and rates FoHF managers only. Fitch does not rate single hedge fund managers or single hedge fund vehicles. Please refer to Fitch's website (www.fitchratings.com) for a detailed description of the rating methodology and rating criteria.

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