FINANCIAL PARTNERS

VIEWPOINT

www.financial-partners.biz | Vol. 38 | October 2009

Newsflash

A new month and the thirty eighth issue of Viewpoint from FP.

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"Markets Hit Sweet Spot in September". This could easily have been the headline in many a news article following a month where equities and bonds both rallied, and in fact (almost) all asset classes performed well during the month. The two notable exceptions were Japan's equity market which was down -5.1% (in Japanese Yen terms) and commodities where agriculture (-1.0%) and oil (-10.7%) disappointed.

The Japanese equity market kept pace with global markets from the onset of the rally in March this year, but in the middle of July seemed to lose a bit of steam and for the year to date has now delivered returns of little more than 9% in USD terms. This compares to the MSCI World Index which has produced performance of around 25% for the year to date.

Investment in Japan may just prove to be the next attractive opportunity that discerning investors are looking for.

There are a number of factors that could play in Japan's favour over the next couple of years, and some of these are :

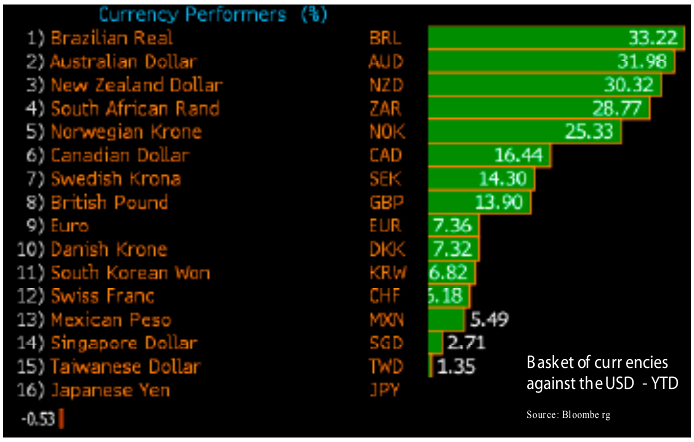
- Export growth as the global economy starts to recover. 24% of Japanese exports now go to China
- The growth friendly fiscal policy of the incumbent Japanese government in the form of the Democratic Party of Japan
- Attractive valuations of Japanese equities, especially in small caps which currently trade around 0.85 times book value

Changing the focus back to global markets in September it was the riskier assets within the bond space that performed particularly well. Local currency returns for high yield bonds in the United States (+5.9%) and Europe (+7.8%) did not disappoint and were closely followed by global convertible funds (+5.2%, in USD terms). High yield bonds have now returned nearly 50% in the US and close to 70% in eurozone over the last year, which have made it a valuable holding in multi-asset portfolios.

Spreads of investment grade corporate debt yields over government bonds seemed to have broadly normalised this month with this asset class producing somewhat more muted returns; +1.8% in the US, +1.4% in the UK and +1.5% in Europe (all in local currency). The future performance of corporate bonds is now much more aligned with government bond yields as further significant spread compression is unlikely to take place. Government bond yields are holding surprisingly steady, but this may be more a function of the central banks continuing to add government debt to their balance sheets than normal market forces. With the major part of the United States' fiscal stimulus coming in 2010 these yields could stay at or around their current levels for some time to come.

Global equity markets continued their momentum from previous months as the MSCI World Index returned 4.0% in September, and emerging markets an even more impressive 9.1%. The MSCI World (Emerging Markets) Index is now up close to 65% for the year, which is significantly ahead of developed equities. Interesting to note is that P/E ratios in emerging markets are now broadly similar to those in developed markets, and on recent momentum will probably soon trade on a premium to their more established counterparts.

The US Dollar continued its decline against most of the other major currencies as it lost ground against both the euro (-1.9%) and the Yen (-3.6%). Overall emerging market currencies still remain our preferred overweight exposure in the currency markets.



Commodities, with the exception of gold, were flat or slightly softer over the last month, and compared to other asset classes have not been able to keep pace with the increase in financial asset's prices. Oil has rebounded from its lows at the turn of the year, but is still roughly 50% below the prices seen earlier in 2008. The increase in energy prices will play a role in headline inflation picking up towards the end of the year, but core inflation (excluding energy and food) will probably continue to trend down into 2010.

We expect equity market momentum to continue for a little while longer – in the US assets in money market mutual funds still outweigh holdings in equity funds, and investors will probably grow increasingly restless as returns on cash remain low and they run the risk of not participating in the higher returns delivered by more risky assets. On setbacks we would look to add to our equity positions (as would many other investors, it seems…)

Polar Capital, October 2009
Source: RMB Asset Management / Bloomberg / Lipper Hindsight. October 2009.

Asset Class Performances

Asset Class/Region	Index	Currency	Sep 2009	YTD 2009
Equities				
United States	S&P 500 NR	USD	3.7	18.6
United Kingdom	FTSE All Share TR	GBP	4.7	23.4
Continental Europe	MSCI Europe ex UK NR	EUR	3.6	24.1
Japan	Topix TR	JPY	-5.1	7.9
Global	MSCI World NR	USD	4.0	24.9
Global Emerging Markets	MSCI World Emerging Markets TR	USD	9.1	64.4
Bonds				
US Treasuries	JP Morgan United States Government Bond Index TR	USD	0.8	-2.5
US Treasuries (inflation protected)	Barclays Capital U.S. Government Inflation Linked TR	USD	2.1	8.6
US Corporate (investment grade)	Barclays Capital U.S. Corporate Investment Grade TR	USD	1.8	17.1
Us High Yield	Barclays Capital U.S. High Yield 2% Issuer Cap TR	USD	5.9	49.8
UK Gilts	JP Morgan United Kingdom Government Bond Index TR	GBP	0.2	1.1
UK Corporate (investment grade)	Merrill Lynch Sterling Non Gilts TR	GBP	1.4	10.5
Euro Government Bonds	Citigroup EMU GBI TR	EUR	0.6	4.3
Euro Corporate (investment grade)	Barclays Capital Euro Aggregate Corporate TR	EUR	1.5	13.7
Euro High Yield	Merrill Lynch Euro High Yield 3% constrained TR	EUR	7.8	68.7
Japanese Government	JP Morgan Japan Government Bond Index TR	JPY	0.3	0.4
Global Government Bonds	JP Morgan Global GBI	USD	2.3	3.9
Global Bonds	Citigroup World Broad Investment Grade (WBIG) TR	USD	2.0	6.9
Global Convertible Bonds	UBS Global Convertible Bond	USD	4.1	35.6
Global Emerging Market bonds		USD	5.2	24.3
Property				
US Property securities	MSCI US REIT TR	USD	6.5	16.1
UK Property securities	FTSE EPRA/NAREIT United Kingdom TR	GBP	-0.5	10.6
Europe ex UK Property securities	FTSE EPRA/NAREIT Europe ex UK TR	EUR	4.5	37.4
Asia Property securities	FTSE EPRA/NAREIT Asia TR	USD	5.3	41.7
Global Property securities	FTSE EPRA/NAREIT Global TR	USD	5.3	27.3

Asset Class/Region	Index	Currency	Aug 2009	YTD 2009
Currencies				
Euro		USD	1.9	5.2
Sterling		USD	-1.9	11.2
Yen		USD	3.6	1.2
Australian Dollar		USD	4.7	26.6
Rand		USD	2.8	22.0
Commodities				
Commodities	RICI TR	USD	0.4	13.6
Agricultural Commodities	RICI Agriculture TR	USD	-1.0	-5.7
Oil	Brent Crude Index (ICE) CR	USD	-10.7	65.1
Gold	Gold index	USD	4.2	14.9
Interest rates	**Last meeting**		**Current rate**	**Last change**
United States	23 September 2009	USD	0.25%	0.00%
United Kingdom	8 October 2009	GBP	0.50%	0.00%
Eurozone	8 October 2009	EUR	1.00%	0.00%
Japan	14 October 2009	JPY	0.10%	0.00%
Australia	8 October 2009	AUD	3.25%	0.25%
South Africa	22 September 2009	ZAR	7.00%	0.00%

Source: Lipper Hindsight, October 2009

FOCUS

ADAPT or DIE

"That which does not kill us makes us stronger." Friederich Nietzsche

If the last decade could be described as the biggest financial party ever, then the fourth quarter of 2008 brought the mother of all hangovers. Hedgefundland has been force fed its necessary medicine and after a much needed reboot is now beginning to enjoy one of its best years of recent times as risk appetite and liquidity come back into the system. A number of encouraging signs mean we believe the hedge fund industry has entered a more virtuous circle, specifically the key factors; redemptions and financial markets, have stabilised. This stabilisation means the deleveraging of hedge funds is mostly over (not withstanding some overhang from those managers who continue to restrict liquidity). Redemption restrictions within the industry continued to wane as many managers sold their side pockets into the recent rally and (perhaps most significantly) a few of our managers reported net inflows. The lowest hanging fruit has already been picked, particularly in convertibles, credit relative, fixed income arbitrage and perhaps even equities. That said many dislocations remain across multiple strategies; these along with an ongoing lack of competition lead to a very positive outlook for hedge funds.

There are clouds on the horizon for hedgefundland, we are aware of the potentially damaging impact of increased regulation and government intervention in financial markets. Unfortunately the hedge fund industry is undoubtedly short of influential lobbyists (the Mayor of London Boris Johnson aside!)and have thus become an ideal political scapegoat. For example the EU has begun the process to ratify a draft directive on Alternative Investment Fund Management; the unintended consequence could be to drive hedge fund managers (and related industry jobs) to New York, Geneva and Monaco. Some of the potential downfalls of this proposed new legislation are limiting the investible universe of European investors to European managers, concentrating counterparty risk at a handful of European Banks and significantly increasing the costs of compliance which will be borne by investors. This leftward lurch is moving governments ever closer to the levers that control markets, the long-term implications of which are likely to be an unappetising mix of reduced liquidity, more price volatility and crucially a misallocation of capital.

The mood on the ground continues to be mixed. It varies from the extremes of those who see ongoing value in the equity of financials and are trading their portfolios at the upper end of historic net long averages; to those who believe the credit unwind has barely started and using the sharp increase in equity prices and tightening of credit spreads to reload long volatility option positions. However, across all our manager positions, there are common characteristics namely leverage remains low and portfolio liquidity high.

From an investor perspective, it has never been so good. Fee rebates, transparency, increased access and liquidity are all very much on the table for the buyer and hedge fund managers have to adapt their terms post 2008 or wither on the vine.

With hindsight leading up to the 2008 crunch there was plenty wrong with the industry. To those of us who have invested in the space for a long time we are always unsurprised when a combination of concentration, leverage and asset/liabilities mismatching leads to problems for any number of managers or strategies in a given stress scenario. Understanding and monitoring these factors is a crucial part of our due diligence process. However, the sheer number of hedge funds caught out in last years perfect storm of systemic crisis, massive redemptions (especially from deleveraging of structured products) and forced deleveraging by prime brokers still took us by surprise. In turn there were an additional number of negative surprises for hedge fund investors; liquidity restrictions were (and still are!) imposed, negative returns of -20% were common, high correlation with equities and worst of all some shameful practises were exposed such as in-house marking of portfolios and too few managers sharing in the losses suffered by their investors. The final straw seemed to be the unveiling of a number of hedgefundland frauds.

Now the good news for investors; the worst excesses of leverage, opaqueness, liquidity and fees which we all had to put up with for far too long are changing fast. Hedge fund managers are being forced to cut fees, improve transparency and liquidity especially if they are not the "Tiger Woods" of their strategy.

There is clear evidence the standardised fees of 2% and 20% (and worse!) are on average coming down. Whilst there are literally a handful of managers who can still justify high levels of fees through outstanding track records, the vast majority are being forced to recognise the new paradigm where investors are no longer prepared to put up with previous terms. By no means are we one of the largest investors in hedgefundland but it is interesting to note from our own experience that persuasive argument rather than size appear to be the key to enlightening managers who are often still shell-shocked and asking "how did it all go wrong!"

Old Alignment Regime	The Future
• Standardised (one size fits all) - Illiquid terms prevalent - Asset/liability	• Flexible - Liquid terms prevalent - Matched assets & liabilities where appropriate
• Side pockets & gates	• Opt-outs
• Low PM investment in the funds	• High PM investment in the fund
• High management fees	• Low management fees
• Quarterly performance fees	• Rolling performance fees, annual or longer

Looking at the table above, there are a number of changes from what we call the old alignment regime and the future. Opt-out clauses from sidepockets and gates are appearing all the time, regular investments from managers into their fund post crystallisation of performance fees (anecdotal evidence suggests most funds that failed last year had the least investment from the principles) and improved transparency are here to stay. One surprising observation we have made this year is US managers are surprisingly guilty of being the least receptive to change compared to their European and Asian counterparts but this could be related to US managers suffering less than their International brethren in terms of redemptions.

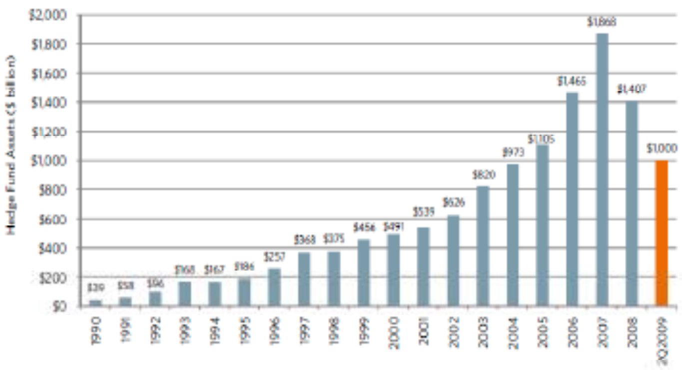
Unjustifiably long lock-ups, notice periods and egregious exit fees are also on the way out especially for the more liquid strategies such as CTA's, macro and equity long/short. We suspect these strategies will leak a large portion of their assets towards UCITs III structures over time, however the jury remains out whether UCITs III are a fad or offer something altogether more permanent. Hedgefund replicators also appear to fill a gap for some, given their recent high correlation to many hedge fund indices and correspondingly low fees. However, there is something intuitively "wrong" about these products, they are unashamedly backward looking and whilst their portfolios offer a high degree of liquid assets, they rob investors of the chance to participate in proven, but less liquid, hedge fund strategies such as credit relative and distress.

The fund of hedge fund industry is perhaps nursing the biggest hangover of all post 2008. Having been huge beneficiaries of the sharp growth of the shadow banking industry over the past decade, many were found wanting last year and in its aftermath. Too many had leverage, pitiable credit / FX hedging facilities, incomplete investment or operational due diligence and perhaps worst of all inexcusable asset / liability mismatches which left many clients high and dry when they wanted their money back. In some ways we almost welcome (Editor: Steady on!) last year's tumultuous events because up until now it has been extremely difficult to differentiate between those whom have done the job properly and those whom have not. Words such as gates and sidepockets have now unfortunately become part of many a suffering investor's vernacular. Clearly a bad situation was made worse by the staggering size of Bernard Madoff's USD50 billion Ponzi scheme. The Swiss fund of hedge fund industry has been particularly hard hit as we read their assets are down a staggering 74% from their high in the aftermath of Madoff, as many investors decided enough was enough and the outflows became a tidal wave. To make matters worse, most funds of hedge funds had previously lucrative long-term structured products as part of their product offerings and these were decimated (as were investment bank balance sheets) as losses triggered automatic selling programmes.

Those funds of hedge funds which had done a reasonable job of preserving capital in 2008 and met all client redemptions were undoubtedly impacted to a greater extent in the short-term than those which restricted liquidity, the so-called "ATM effect". Of course, those firms restricting redemptions are simply postponing the inevitable day of reckoning and we suspect they will suffer in due course. Nevertheless, as assets have fallen across the board, many business models are suddenly looking less than attractive and according to Investhedge 7% of the industry has already thrown in the towel as revenues tumble and costs rise.

The outlook for the smallest fund of hedge funds is particularly grim as the burden of regulatory costs are only likely to increase from here let alone access to credit facilities.

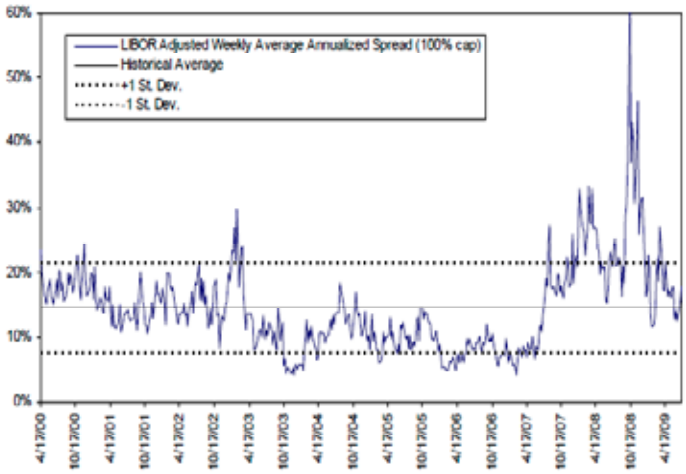
However, we, our clients and our employers see a bright future for the surviving hedge fund of funds. Fund of hedge funds remain the most viable way of accessing hedge fund managers. They offer the broadest access to managers, the resources to perform due diligence and ongoing monitoring, diversification and perhaps some alpha from strategy selection. Investing in hedge funds without the pre-requisite resources is either a guarantee of unexciting returns from institutional type hedge fund offerings or worse, opening yourself up to fraud risk outside these institutions.



Source: Hedge Fund Research, The Bank of New York Mellon and Casey Quirk Analysis 2009

Looking at the chart below, HFR estimates the industry had shrunk by nearly 50% at the end of Q2 2009. We expect assets to stabilise from here and we anticipate organic growth will remain strong enough to offset the overhang of redemptions from the legacy and restricted liquidity issues of 2008. The hedgefundland survivors and remaining investors are already undoubtedly benefitting from the massive clearout, judging by the good risk adjusted returns we have seen so far in 2009.

Dislocated assets, less competition from hedge funds and proprietary trading desks (we do not believe the latter will re-enter the room anytime soon) undoubtedly add to the attractions of hedge fund investing today. We are extremely attracted to the potentially good risk-adjusted returns from a number of strategies whose opportunity sets have not been so rich since the 1990's. Merger arbitrage is a perfect post financial apocalypse example, we can clearly observe in the chart below wide spreads, the lifeblood of the strategy, remaining at extraordinarily high levels (despite the sharp tightening we have seen already) relative to LIBOR. Furthermore the risk of deals breaking, the strategy's main risk, is temporarily on hold because the announced mergers we have seen year to date are quality deals, make strategic sense and often have high cash components attributed to them rather than being subject to financing.



Source: Barclays Capital Risk Arbitrage Research

Many hedge funds assets have rebounded hard this year, especially in the most liquid strategies, but we see further upside from here due to the scale of the dislocation and less competition. In our view, better trading opportunities abound in longer-term situations which remain disproportionately and steadfastedly cheap due to the more liquid low hanging fruit elsewhere, but this fruit will shortly be thoroughly picked over. The longer term trades all have the attraction of cheapness but have temporarily lost their natural owners from banks rebuilding balance sheets to hedge funds wariness of taking on liquidity risk in the aftermath of the perfect storm.

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