

2009 Review

What happened to the Hedge Fund Industry in 2009?

As the financial crisis deepened towards the end of 2008, the outlook for hedge funds in 2009 was very poor. Indeed, most industry pundits were negative about the future of the industry and mainstream forecasts were calling for an attrition rate of at least 50% in the opening new year. The truth is that none of this has actually happened and 2009 turned out to be one of the best years in a decade in terms of investment performance. Although there has been a drop in assets under management and a larger than usual closure level, the industry held up much better than anticipated. In fact, interest for the asset class rebounded in the second half of the year and the industry started to recover and has seen positive net inflows as well as a number of successful new launches.

As a whole, 2009 will go down as a very good year for global stock markets, with the benchmark MSCI World Index returning +23.3%, the S&P 500 climbed at +23.5% and even the Nikkei posted +19.0% (in local currency). The combination of various positive factors, such as the surprising recovery of the global economy, the coordinated sharp reductions of interest rates by global central banks and the quantitative easing dominated the investment landscape in 2009. However, this hides the fact that markets remained very volatile and that the first quarter of the year witnessed a peak in terms of investor pessimism and negative sentiment. Despite being caught in this storm, hedge fund managers held up much better than traditional asset classes and ended up posting positive returns for almost every month of 2009.

Indeed, hedge fund managers in most strategies had positioned themselves much more cautiously at the beginning of 2009 and benefitted from a more stable and friendlier environment compared to the extreme conditions of 2008. Furthermore, as almost all markets had experienced major dislocations, we have seen a real proliferation of trading opportunities and much more attractive spreads. As a result, hedge fund managers were able to generate significant profit whilst at the same time keeping leverage at very low or inexistent levels.

The measures taken at the end of 2008 (reduction of leverage, market risk, etc.) quickly had a visible impact. Volatility fell sharply, as did the correlation with stock markets. Many hedge funds have also made efforts on the transparency of their investments and their liquidity, both of which have clearly improved in aggregate. This enabled the industry to go some way in its efforts to regain the confidence of investors.

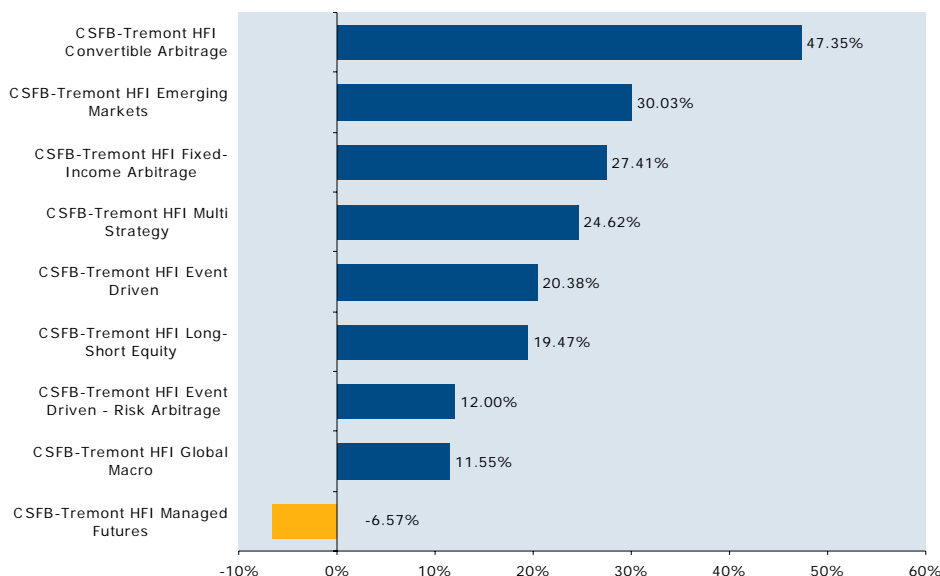
2009 was one of the best years for the industry since 1999, the HFRI Fund of Hedge Fund Index was up over +11.55%, with almost all strategies being positive, the notable exception being CTAs/Managed Futures. On the other hand Convertible Bond Arbitrage proved to be a winner this year posting a return of +47.35%, experiencing a significant reversal as this was the worst-performing strategy in 2008.

In the third quarter we have seen a reversal of trends: the industry was no longer experiencing net outflows. Investors allocated USD 14 bn in the last quarter, the largest quarterly inflow since the end of 2007. The AUM of the industry has now stabilised at around USD 1600 bn. There are increasing net inflows and interest in the hedge fund asset class. We feel the trend is definitely changing and are increasingly witnessing the launch of new funds, 2010 also promises to be a positive year for the hedge fund world.

There is no doubt however, that the entire hedge fund model has been tested in 2009 and that we will see significant changes in terms of regulations, operational due diligence and risk management. These changes will have profound impacts on the industry and will force out the players that do not have the resources to build the infrastructure needed in a new environment. The renewed investor focus on demonstrated and durable investment talent will challenge weaker players as markets screen out hedge fund managers which have not shown ethical behaviour or displayed little concern for the interests of their investors.

The changes in the operating environment will be profound, but ultimately very positive for investors who remain committed to the asset class. Managed accounts, the move towards a more regulated environment and even the encroachment of hedge funds in the UCITS III world will offer investors a much more transparent and in the end more institutional environment. We believe that these changes are good for investors and the industry is emerging stronger and sounder. We remain excited about its prospects.

Hedge Fund Strategies - 2009 Performance Figures



Source: CSFB Tremont

Note: CSFB Tremont are non-investable indices

3A Portfolios - 2009 Performances Figures

Figures as at end December 2009 <i>*with estimates for December 2009</i>	Year 2009	3-year annualised return	5-year annualised return	10-year annualised return
MSCI World Index (USD)	23.32%	-8.38%	0.14%	-2.60%
HFRI FoF Composite (USD)	11.55%	-1.11%	2.79%	3.99%
3A Multi Arbitrage Fund (USD)	11.51%	0.32%	2.68%	N/A
3A Multi Strategy Fund (USD)	12.51%	-0.64%	3.48%	4.86%
ALTIN NAV (USD)*	13.35%	-2.28%	4.07%	4.86%

As stated previously, 2009 has been one of the best years in hedge fund history. The most impacted strategies in 2008 have been the winners in 2009. Convertible Bond Arbitrage for example has demonstrated a fantastic recovery. The arrival of outright investors hunting for bargain opportunities associated with the renewal of new issues have been the engines of this strong performance.

The most interesting point in 2009 is the robustness of the performance as all strategies ended in positive territory with the exception of CTAs/Managed Futures. This stability is one of the reasons explaining why 3A Multi Strategy Fund was able to generate 12 consecutive positive months despite high volatility in equity markets.

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2010 Outlook

3A's expectations for the Hedge Fund Industry in 2010

After 2009, a better than anticipated year for financial markets, the predominant focus for 2010 will most probably be the end of expansionary policies from central banks, the potential re-pricing of sovereign debt by market participants and to a lesser extent the renewed inflation risk. Zero rates policy and quantitative easing have pushed term rates to historical lows and have thus provided a massive floor for economies on a global scale. With no doubt, markets will be more erratic by this change in policy or stimulus withdrawal, as economies will not have the safety net that was laid out last year. This increased level of risk in financial markets may be outweighed by better than expected economic growth.

Our view is that alternative investments are positioned in a good place for 2010. We will keep diversifying our portfolios and position the funds for a more challenging market environment. We anticipate higher volatility and increased dispersion amongst companies, and therefore favour stock and bond pickers.

Our strategy for 2010 will remain the same as during the last two quarters of 2009, i.e. favour hedge funds investing in liquid markets (futures and large caps) and offering liquid redemption terms. With the lack of competition hunting for opportunities, hedge funds can generate attractive returns without having to take liquidity or market risks. Finally, we strive to be able to react quickly to the main macro-economic challenges we have identified several months ago:

- The strategies for moving out of the crisis: will the authorities succeed in managing the "posttraumatic" phase as successfully?
- Governments' indebtedness implying significant pressure on long-term interest rates

In this context and considering the risks mentioned above, we have implemented in our portfolios two positions betting on a steepening and an increase in long-term interest rates in the US, UK and Japan. We do believe that the likelihood of this trade to be profitable is low but the payoff is very asymmetric, providing a tremendous positive return if it turns out to be right. We perceive them as hedges against an adverse macro-economic scenario in 2010.

3A's 6-month forecasts and outlook for the different Hedge Fund strategies

Macro & CTA ↗

We maintain a positive view on Macro players and favour short-term managers. Their wide spectrum of investment opportunities make them very attractive to take advantage of the wide economic imbalances.

Concerning CTAs/Managed Futures, a higher volatility environment seems to provide a better ground for this strategy. Volatility is very much linked with uncertainty and currently a certain level of uncertainty prevails and will continue to prevail. We feel that next year is more likely to be an average to good year for CTAs/Managed Futures considering those factors with the end of the quantitative easing programs adopted by central banks.

Equity Long/Short ↗

We are increasingly positive on discretionary Equity Long/Short managers and favour managers that are proven stock pickers, who will take advantage of inter and intra sector stock dispersion. We believe the market direction will be less critical than the fundamental rationale that will separate good from poor companies. We continue to remain focused on highly liquid managers.

Event-Driven ↗

Increased M&A activity is expected. Companies may find it easier to increase earnings through M&A synergies rather than by increasing their Top line number. Cash levels in balance sheets have significantly increased during 2009. Companies have the required cash reserves to consider acquisitions.

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Credit →

2010 will most likely be a more challenging year for Credit Strategies as last year was definitely a banner year as credit markets scored their best ever year on record. We are likely to experience more dispersion; however, this presents good opportunities for funds which can extract value from careful security analysis and selection. As our equity managers, we will favour Long/Short credit managers maintaining a liquid portfolio.

Arbitrage →

Valuations are still attractive but outright investors are taking profits. The valuation gaps have been mostly closed and expected returns should be back to historical ranges. The main advantage of Relative Value strategies is the current lack of competition faced by hedge funds.

Natural Resources & Commodities →

As in 2009 we favour managers with a low net exposure and trading styles. We place an emphasis on managers that are quick to turn their portfolios and adapt to a new environment. We especially prefer those managers with strong fundamental skills and good macro calls as we believe macro factors will be a major driver of commodity prices in 2010.

Best regards,

José Galeano
Chief Investment Officer
3A SA & 3A Asia Ltd

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