

15 January 2010

Key Information at a Glance

L/S Equity	↗
Macro - CTA	→
Arbitrage	↗
Credit	→
Event Driven	→
Nat. Res., Commo.	→

6-month forecasts

Index Performance (HFRI FoF)

	MTD	QTD	YTD
<i>Composite</i> Multi Strategy	0.45%	1.19%	11.16%
<i>Conservative</i> Low Volatility	0.31%	0.92%	9.46%
<i>Diversified</i> Multi Strategy	0.05%	0.85%	10.68%
<i>Market</i> <i>Defensive</i> Short	-2.28%	-1.42%	2.18%
<i>Strategic</i> Long Short	0.99%	1.73%	13.25%

Estimated figures as at 31 December 2009

After a better than expected year for financial markets in 2009, the predominant focus for 2010 will most probably be on the ending of expansionary policies by Central Banks, the potential re-pricing of Sovereign debt by market participants and to a lesser extent the renewed risk of inflation. The market consensus is to expect a change in Central Bank policies around mid-2010. Zero policy rates and Quantitative Easing have pushed long term rates to historic lows and have thus provided a massive floor for economies on a global scale. No doubt, market behaviour will be more erratic as a result of this change in policy or stimulus withdrawal, as economies will not have the safety net that was provided last year. This increased level of risk in financial markets may be outweighed by better than expected economical growth.

The opportunity set going forward to make significant profits from the stimulus withdrawal is extensive. However, timing again will be crucial in order to realise this alpha, without getting caught on the wrong side of trades during the liquidity vacuums that may temporarily occur. The key factors for managers to watch are to maintain liquidity and be disciplined in managing the downside of their thematic views. A more satellite approach we have also adopted is to be long longer term rates in the US, UK and Japan.

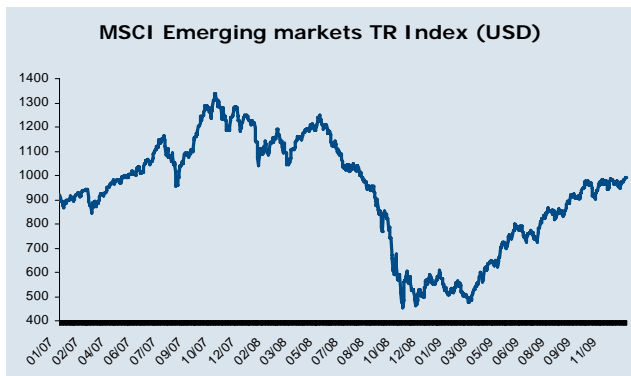
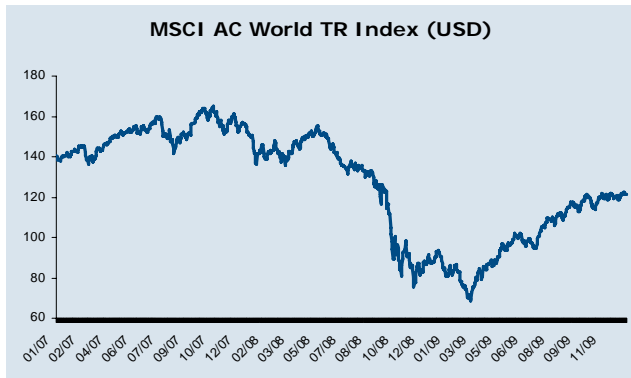
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Outlook by Strategy

Long/Short Equity

Equity markets closed the chapter of quite a bustling year on a traditional year-end rally note. However, the range of performance was quite wide with a very weak rally in the US posting a modest gain of +1.78% for the S&P 500 compared to a better European performance of +4.28% and +6% posted respectively by the FTSE 100 and the DJ Euro Stoxx 50, and an impressive return of +12.85% for the Nikkei 225 in Japan. The Equity Long/Short managers in general did well and posted modest returns as per their cautious positioning.



We can see encouraging signs of Equity Long/Short managers keeping a cool head when confronted with this impressive rally since March of last year. Directional bet is not played importantly but as we have repeated promising fundamental discrimination is made and attracting alpha potential has been build out for the bulk of the managers in this strategy. Macroeconomic factors remain key for the evolution of financial markets but what will be interesting will be the expectations of either a strong recovery or a drastic reversal in the economics figures, creating an environment where directionality becomes contingent and stock differentiation necessary.

In other words, there is a high probability that investors will try to make money on extracting alpha rather than trying to catch liquidity-driven trends. This would be a particularly positive environment for the Equity Long/Short strategy. Manager selection should also prove to be critical in a gradual but clear change of environment. We remain focused on highly liquid managers and keep gradually increasing exposure to fundamental stock pickers.

Event Driven

The Event Driven space is seeing activity. The end of year saw things tail off a little as banks took risk off their balance sheets with regards to credit creation and breathed a sign of relief, with 2008 still at the back of their minds. Big deals are happening and should continue to go through. However, as central banks invariably start withdrawing their stimulus programmes, deal flow may become a little less active in the short-term. In the longer term, as the support that governments have provided to the economy in recent months disappears, industry leaders who are in a stronger position may start bargain hunting and snap up some serious bargains when weaker competitors fail to renew their loans and pay creditors.

Again, we tend to favour the more technical managers who play rights issues or stock class arbitrage, arbitrage ADRs and GDRs and similar strategies. Playing the legal intricacies of legal aspects of deals in such arbitrage strategies will not result in triple digit returns in one year, but will provide smoother returns in troubled markets. We expect such opportunities to increase in Asia this year and expect to see corporate activity in Asia pick up in 2010. We are therefore increasing our allocation to this region where spreads yield are higher, and opportunities more abundant.

Credit

Last year was definitely a banner year, as Credit Markets scored their best year ever on record. As mentioned, the outsized returns from credit in 2009 were mainly due to spread tightening occurring in names that were sold down to distressed levels. Although these trades have for the most part been capitalized on, they were the low hanging fruit and by no means the only opportunity available in the space. The ample liquidity backdrop has been a major contributor to the strong returns in the Credit space, but we are mindful that this liquidity cannot be sustained forever and that real fundamental improvements will have to take place in order for Credit markets to maintain this upward trend.

Given that funds in 2009 have already captured most of the opportunities from the spread tightening in distressed names, the majority of returns going forward will come from the funds' abilities to analyse companies and differentiate between those that are able to pay from those that cannot. 2010 will definitely be a more difficult year for Credit Strategies on a year-on-year basis as we will likely experience more dispersion; however, this presents good opportunities for those funds which can extract value from careful security analysis and selection.

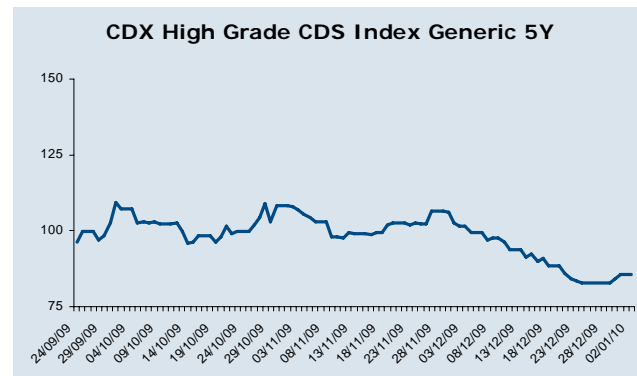
Going forward, we expect the latter to perform better, especially if equity dispersion increases (good companies vs. bad companies). The short correlation trade could therefore be a positive source of returns in 2010. Managers having a systematic long bias in volatility should also do better in 2010 if markets become choppy.

Macro & CTA

The month started quite well as a continuation of November but on 4 December the non-farm payroll numbers came out much better than expected, triggering some sharp reversals. The USD strengthened sharply, moving from 1.51 against the EUR to as low as 1.4218 in 13 trading days, while simultaneously, Gold, that had just hit a new high at USD 1227, dropped to as low as USD 1075 during the same 13 trading days. The picture was not any more attractive on the bond side as Treasuries sold off with the 10 year yields rallying from 3.18% at the beginning of the month to close at 3.90% on 31 December 2009. The only bright spot was the equity market that remained strong during the month and helped CTA and Macro systematic funds to sweeten the pain of the other three asset classes.

Short-term CTAs suffered the most in December, as there was little follow-through of the intraday trends, i.e. the market opened lower, went down and reversed to close flattish, or vice-versa on the upside. The medium-term CTAs suffered from the reversals mentioned previously. Macro systematic funds weathered the month slightly better but remained for the most in negative territory.

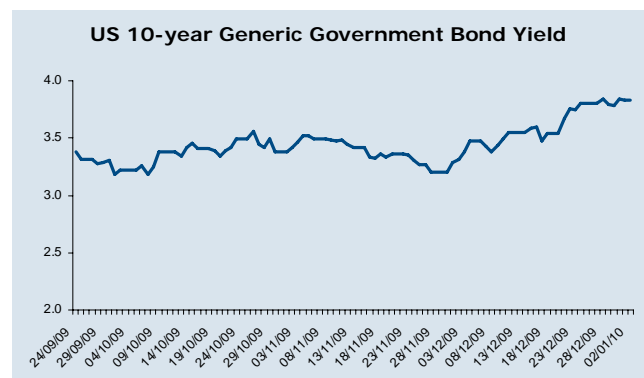
2009 looks in many instances as most likely the worst year over the last 15 years for this strategy. Unfortunately, at this stage, research into timing momentum strategies has remained unsatisfactory but the best strategy is still to maintain an allocation to this strategy in your portfolio; 2008 is not too far away and should be kept in mind to assess the quality of this strategy.



Arbitrage Strategies

Relative Value strategies ended the year with returns above the historical average. The market disruption in 2008 offered numerous opportunities for arbitrageurs who were able to extract good value from pricing inefficiencies using little leverage. The best performing strategy has been Convertible Bond Arbitrage which benefited from many positive factors, such as valuation recovery, a healthy new issues market and tightening credit spreads. December was similar to the rest of the year with a strong performance. We believe this valuation gap is now closed and foresee returns to the historical range of the strategy. As a result of the equity market rally, convertible bonds are trading at lower premiums and the strategy becomes more sensitive to volatility rather than to credit.

Equity Arbitrageurs had a decent month in December even though the market environment was not ideal for this strategy during the course of last year; managers have been hurt by some violent sector rotations. Going forward, we expect this strategy to offer better risk-adjusted returns as we anticipate less momentum in 2010 and a more selective market together with higher volatility. Volatility arbitrage posted disparate performances this month and over the year. Some managers with a long volatility bias suffered from lower volatility in the major asset classes. More Relative Value managers posted low to mid teens returns in 2010.



Natural Resources, Commodities

Commodity prices continued to rally in December as illustrated by the S&P GS Commodity Spot Index which was up +2.4% (the S&P GS Commodity Total Return Index was up +0.9% for the period). For all of 2009, the S&P GS Commodity Spot Index and S&P GS Commodity Total Return Index was up +50.3% and +13.5% respectively. The strong gain in 2009 was attributable to the strong global economic recovery and strong demand from China, which grew at approximately +9%. China imported record amounts of raw materials which helped offset sluggish demand in developed countries. Currently, China is the biggest consumer of commodities such as Copper and Iron Ore. Last month, Base Metals experienced the largest gain with Nickel, Zinc and Aluminium gaining +13%, +10.3%, +8.3% respectively on speculation of increasing demand as the global economy recovers. Another highlight for the month was the strong gain in sugar (+22%) which rose to the highest price in two decades on speculation that supply would fall behind demand for yet another year.

Agriculture was mixed in December with Wheat down -4.6%; Soybeans down -2%; Corn up +2.9% and Cocoa up +2.3%. Wheat and Soybean were hit on speculation of rising global stockpiles and healthy production. The selling pressure early in the month was abated mid-month on speculation of increasing investment flows in early next 2010, as investors buy into soft commodities as a proxy to hedge against a falling USD.

Commodity managers delivered mixed performance in December. The sharp reversal in the USD caused a swift turn in several commodities prices. As mentioned previously, Gold rose to a record of USD 1,227 an ounce, fell by -8% in four consecutive trading days from the peak and ended the month below USD 1,100 an ounce. The reversal of the USD did cause some commodity managers some difficulty. Our outlook towards commodity managers remains very positive. Investing into commodity funds offers very attractive risk/return trade-offs which cannot be capitalized on when investing into an index. We especially prefer those managers with strong fundamental skills and good macro calls as we believe macro factors will be a major determinant of commodity prices in 2010.

Chart sources: Bloomberg