

## Q2 09 Review of Hedge Fund Strategies

### Market Movements

Equity Indices	Q2 2009 Change	Fixed Income Markets	Q2 2009 Change (Basis Points)	Currencies vs USD	Q2 2009 Change	Commodities	Q2 2009 Change
<b>S&amp;P 500 (USD)</b>	15.2%	<b>10-year US</b>	+87.0bps	<b>GBP</b>	14.9%	<b>Gold</b>	+0.8%
<b>DJ Euro STOXX (EUR)</b>	15.6%	<b>10-year Euro</b>	+39.1bps	<b>EUR</b>	5.9%	<b>Oil</b>	+40.4%
<b>Nikkei 225 (JPY)</b>	22.8%	<b>10-year Japan</b>	+0.6bps	<b>JPY</b>	-2.6%	<b>DJAIG</b>	+15.1%

The second quarter saw a continuation of the sharp rally that began in early March. All the major indices moved into positive territory for 2009 albeit temporarily. From their March lows, equity markets have risen approximately 35%.

Whilst economic data still showed signs of weakness, the fact that the rate of economic contraction slowed and some indicators began to turn positive, gave investors confidence that the economy may have started to turn around.

A number of factors drove the rally, including oversold conditions in the first quarter, government initiatives to contain the crisis and an improvement in economic indicators. However, the single most important factor contributing to the strong stock market performance in the second quarter was the improvement in investor psychology. Since the turn of the year the fear of a great depression has weighed on the public consciousness. And although there is no doubt we are in the middle of a severe recession the possibility of a great depression seems to have faded.

The rally was led by assets that had performed the worst over the prior seven months and the shift of funds from lower-risk assets to higher-risk assets was evident. Small companies outperformed large companies; emerging markets dramatically outpaced developed markets.

Credit markets are functioning almost normally again as creditworthy companies are now able to borrow at reasonable rates. In addition, the banking sector, while not fully recovered, has improved significantly. In March, some worried that the entire banking sector was insolvent and facing nationalisation; by the end of June, many US banks were repaying their TARP loans, once again on firm financial footing.

Bond investors demonstrated a renewed appetite for risk, as high-yield outperformed other types of debt. Treasury yields rose over the quarter, partially due to the significant issuance of new debt by the federal government, but also because other investments became relatively more attractive as investors become more risk tolerant. The yield on the 10-year Treasury bond rose from 2.60% to 3.52%.

### RELATIVE VALUE/ EVENT DRIVEN STRATEGIES

The relative value allocation within our portfolios performed well in the second quarter, while our event-driven allocation detracted slightly from returns over the period. Exposure to convertible bond strategies again performed well for both the volatility arbitrage funds and the multi-strategy funds in our portfolio, as managers maintained exposure to convertible bonds and took advantage of the continuation of the recovery that began in December 2008.

Long exposure to corporate credit within relative value multi-strategy funds also contributed to returns as high yield performed extremely well. For the quarter the IBOX Investment Grade Credit Index was up 9.07% and High Yield Credit Index was up 18.66%.

Long volatility exposures lost money over the quarter as implied volatility levels dropped substantially over the quarter. The VIX index declined from 44.14 at the end of March, to pre-Lehman bankruptcy levels of 26.35 at the end of June.

Within the event-driven strategy, the portfolio's largest investment was down slightly over the quarter, losing money on their slightly net short credit positioning on financials, industrials and sovereigns, as well as their moderately net short equity positioning. The small allocation to a distressed debt fund made a small positive contribution to the return over the quarter.

## **EQUITY LONG/SHORT STRATEGIES**

Stocks rose sharply around the globe in the second quarter, particularly in emerging markets. The FTSE All World stock index rose by more than 20% to post the best quarterly performance since records began. Quarterly gains in developing countries such as India, China and Brazil (up 43%, 25% and 26% respectively) outpaced those in the US and Europe.

European and US equity long/short managers performed well over the quarter. However, returns lagged behind the outsized returns of the indices. The main reason was that it was the "junk" that led the rally. The leaders were high risk, had very poor balance sheets and had traded very cheaply. Therefore even though managers had positioned themselves for an equity market rally they didn't fully benefit as good quality companies were left behind.

Regionally, strong attribution came from China and Japan as the market recovery broadened throughout the quarter. Higher net exposures for long/short pan-Asian managers resulted in strong gains despite a mid-month correction in June. A number of managers began to reduce their long exposure or add protection towards the end of the month in order to lock in gains. Managers running low net exposures also benefited from relative value positions which have been consistent performers through recent months, irrespective of market direction.

## **GLOBAL MACRO STRATEGIES**

Macro managers benefited from long exposure to equities & commodities, a fundamentally bearish view of the USD and steepener trades in the fixed income space. Managers started to reposition their portfolios to be long risk mid way through April leading to a very profitable May.

June however, was a difficult month for discretionary trading managers. Having benefited from the recent market rally they entered the month with a small net long exposure to both equities and commodities. As a result they had a good first week but suffered when the market turned. In addition, the use of steepener trades to hedge equity risk didn't work out as yield curves flattened towards the end of the month.

Overall, we are still very bullish about the opportunity for global macro managers and the exposure to this strategy in our multi-strategy portfolios is at its historical high.

## **COMMODITY STRATEGIES**

Despite weak consumer data causing large falls in commodity markets towards the end of June, most commodities finished the second quarter with double-digit percentage gains in their first positive quarter since last summer. Commodity indices ended the second quarter with total returns averaging nearly 15%. Crude oil rallied more than 40% over 3 months, the biggest quarterly gain since Saddam Hussein's invasion of Kuwait in the third quarter of 1990.

Discretionary managers came into the quarter with a long exposure, having become more optimistic on the macro environment and therefore more bullish on commodities. This helped portfolios make strong returns over the first two months of the quarter however, the turn in market sentiment during June led to managers giving back some of their gains.

## CONCLUSION

Quarter two saw a remarkable turnaround in investor psychology. We now go into the second half of the year with a level of optimism that was unthinkable at the start of the year. There is evidence that the worst might be over for the global economy and signs of increased stabilisation in money market conditions and indicators such as the Vix. The fact that the Chinese economy grew 7.9% over the quarter offers a further confidence boost for the global economy.

The greatest challenge for us going forward is to balance growing optimism about the near term economy with the many longer-term concerns about the sustainability of a recovery. It is with this view that we continue to look for new managers and focus on risk-adjusted returns for our investors

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