

## Q3 08 Review of Hedge Fund Strategies

### Market Movements

Equity Indices	Q3 2008 Change	Fixed Income Markets	Q3 2008 Change (Basis Points)	Currencies vs USD	Q3 2008 Change	Commodities	Q3 2008 Change
S&P 500 (USD)	-8.9%	10-year US	-14.6bps	GBP	-10.6%	Gold	-5.9%
DJ Euro STOXX (EUR)	-9.3%	10-year Euro	-60.6bps	EUR	-10.6%	Oil	-28.1%
Nikkei 225 (JPY)	-16.5%	10-year Japan	-12.9bps	JPY	-0.1%	DJAIG	-27.7%

### MACROECONOMIC OVERVIEW

Financial markets experienced unprecedented levels of volatility over the third quarter with September set to go down as one of the worst months ever for global equity markets. The volatility seen in July was a sign of things to come for the quarter as negative investor sentiment resulted in big intra-month swings in the commodity and financial sectors.

Global equity markets were driven lower over the three months and are down heavily for the year to date. US equities lost almost 9% over the quarter and were down over 20% for the year to date. European markets were down just under 13% for the quarter and 24% for the year to date.

In September, equities were extremely weak across the globe. Markets were led lower by financial stocks in developed markets, with the malaise soon spreading to emerging market stocks, on the back of the threat of a global recession.

The rejection by Congress of the US bailout plan put forward by the Treasury Department on the 29<sup>th</sup> of September caused equity indices to spiral downwards, with many recording historic one day falls. The Dow Jones Industrial Index fell by 7% on the news of the rejection, its largest ever one day points fall while the S&P 500 Index recorded a daily decline of 8.8%, its largest loss since the crash of 1987.

The US equity markets suffered unusually high levels of volatility during the month of September, with the VIX Index touching 46.72% on the 29<sup>th</sup> of September.

The best performing sectors of the market over the quarter included those sectors with a high level of short interest, i.e. banks and homebuilders, whilst metals and other commodity sectors fell heavily.

Europe did not escape the widespread sell-off with equities ending the quarter at their lowest levels since January 2005. The CAC, DAX, FTSE and MSCI Europe Indices all lost over 9% in September alone.

The UK equity market took its lead from the US, with the FTSE 100 Index also recording its worst ever daily loss during the month of September. Consolidation in the troubled banking sector became a theme over the month.

In Asia, it was evident that the decoupling theory could not be supported. The events in the US resulted in large losses across most of the Asian region. Investors became extremely risk averse as uncertainty increased both on the domestic front and globally.

In China, equity markets in Hong Kong and on the mainland were down just under 20% for the quarter. In mainland China inflationary pressure eased and the focus of the authorities shifted from fighting inflation to maintaining growth, which led to a cut in interest rates. In Japan, both the Nikkei and Topix Indices fell sharply over the quarter.

Global bond markets rallied over the quarter. US Treasury 2-year yields fell by 66 basis points (bps) to 1.96%, after hitting a low of 1.64% in mid September. European and UK 2-year bond yields followed the US fall, dropping by

121bps to 4.01% in the UK and 112bps to 3.48% in Europe, due to the stress in the global financial system and the deterioration of the global economic growth outlook.

After a slight widening of spreads in July and August, corporate credit spreads widened massively on the back of the Lehman Brothers bankruptcy in mid September, but then subsequently began to tighten going into the quarter end. Over the quarter, spreads widened by approximately 127bps on high-yield corporate bonds and 28bps on investment-grade corporate bonds.

Most commodity prices fell over the quarter on the back of changing fundamentals as well as market-wide risk reduction. July was the worst recorded month for the commodity sector for a number of years.

After peaking in early July, commodity prices slumped over the quarter amid fears that the fall-out from the credit crunch may be the catalyst for a significant global slowdown. The GS Commodity Index finished the quarter down 28.61% and the DJAIG was down 27.7%. Oil prices fell from a high of \$146 per barrel in early July to \$91 per barrel on 29<sup>th</sup> September, declining 10% on the 29<sup>th</sup> alone.

It is estimated that the total open interest in commodity markets has shrunk by \$100 billion since July, while the net long open position has fallen from \$58 billion in July to about \$10 billion at the end of the third quarter.

## **CREDIT CRISIS UNFOLDING**

A year ago, few people had heard of the term credit crunch, but the phrase has now entered daily vocabulary. Defined as “a severe shortage of money or credit”, the start of the phenomenon has been pinpointed as 9 August 2007 when bad news from French bank BNP Paribas triggered a sharp rise in the cost of credit, and made the financial world realise how serious the situation was.

Even at this point, however, there was no way of knowing the extent to which the crisis would unfold. By September 2008 the credit crunch had entered uncharted territory, as excessive leverage and growing counterparty risks weighed on investor confidence in leading financial institutions. The result was the biggest transformational period in the history of global markets and Wall Street in particular.

### *EVENTS AS THEY HAPPENED*

- 7 Sep: \$200 billion bailout of Fannie Mae and Freddie Mac.
- 14 Sep: Lehman Brothers is forced into bankruptcy & Merrill Lynch agrees to be bought by Bank of America.
- 16 Sep: The US government becomes the largest shareholder of AIG following an \$85 billion loan.
- 17 Sep: Short selling is restricted in many countries.
- 22 Sep: Lloyds Bank agrees to take over HBOS. Concerns over Morgan Stanley and Goldman Sachs' viability as broker-dealers results in them becoming bank holding companies. In the space of a month five of the world's largest investment banks are “no more”.
- 26 Sep: Washington Mutual is taken over by JP Morgan. WAMU's collapse is the largest bank failure in US History.
- 27 Sep: Bradford and Bingley in the UK is nationalised.
- 28 Sep: Wachovia goes the same way as WAMU and is rescued by Wells Fargo.
- 29 Sep: The US Congress votes against the Troubled Assets Relief Program (“TARP”). Sharp falls in equity markets result, as the Dow Jones registers its biggest daily point loss in history.

Government response and regulatory intervention as the situation unravelled was unpredictable and at times surprising. Short selling was temporarily banned in US and European financial stocks and in entire markets such as Korea and Taiwan. Central banks and fiscal policy makers globally took and continue to take extraordinary measures to try and restore confidence in funding and to stimulate creditors to restore normal lending activities despite thin capital and looming economic weakness.

The quarter ended with the proposal of the \$700 billion rescue package designed to inject capital and restore confidence in the financial system. Federal Reserve Chairman Ben Bernanke warned that the crisis could plunge the US economy into a steeper downturn if no action was taken on the proposal; when the first package was defeated, investors reacted by selling stocks at any price and moving into the safety of Treasuries and other high-quality investments. On the last day of trading for the month, stocks rallied sharply, recovering much, but not all, of the ground that was lost the previous day. Congress added new provisions to the measure in an effort to make it more palatable to their constituents and finally passed an expanded bill on 3<sup>rd</sup> of October.

## **RELATIVE VALUE STRATEGIES**

Diversified relative value funds in our portfolio were down slightly over the quarter due to the withdrawal of liquidity in most markets. Volatility arbitrage funds with a long volatility bias, used as a defensive strategy within the portfolios, performed well, with underlying funds producing healthy positive returns.

Short credit funds in the portfolio posted strong gains for the quarter on the back of corporate bond spread widening. Relative value credit strategies, in which we have very little exposure, that held long positions in senior bank debt (bank loans) and short positions in higher yielding corporate bonds (more junior in the capital structure) were badly hurt by widening bond spreads, particularly in the month of September.

Convertible arbitrage strategies were struck in September, both by the deteriorating credit markets and the equity short selling ban enforced in late September. The HFRX Convertible Arbitrage Index was down 16.55% in the month of September alone. We have limited exposure to convertible arbitrage strategies.

## **EVENT DRIVEN STRATEGIES**

Event driven strategies, including distressed debt strategies, were slightly negative for the quarter, primarily due to credit spread widening over the quarter and merger arbitrage spread widening in the month of September.

## **EQUITY LONG/SHORT STRATEGIES**

Equity long/short managers were hit hard by the equity market sell-off, short selling restrictions and liquidity withdrawal from the markets. Many managers had correctly identified the problems in the financial sector and had actively established short positions in the sector earlier in the year.

After a strong first half of the year the long commodity/short financial trade reversed some of these gains in the third quarter. Although some managers had reduced their positions in this trade since the reversal began in July, it was still widely held by equity long/short managers.

Managers with a long bias in Asian and emerging markets were particularly hurt in September.

## **COMMODITY STRATEGIES**

Discretionary trading managers performed well over the quarter having adopted a defensive stance from the beginning of August. These managers identified the signs of a deteriorating global economy and were able to take advantage of falling commodity prices.

Equity long/short managers on the other hand had a much more difficult period. After outperforming the overall equity market for the first half of the year, commodity-related equities made a sharp u-turn during the third quarter and were particularly weak in comparison to the underlying commodities. For example, at the end of the third quarter the price of gold bullion was up almost 5% for the year, but the average gold stock has fallen 40% year to date. The same situation has played out in oil and natural gas markets. Despite the large falls over the last three months, they are both down only fractionally since the beginning of the year. Energy-related equities, however, are down almost 25% for the month of September.

In the short to medium term, the outlook for commodities looks negative due to the inevitable global slowdown. Going forward we believe that the discretionary traders within the portfolio will take advantage of prices, regardless of whether they go up or down. We also believe that the equity long/short managers, who have currently taken a more defensive stance, will benefit when stability returns to the markets and be able to take advantage of severely depressed equity prices in the energy and mining sectors.

## **GLOBAL MACRO STRATEGIES**

Global Macro managers experienced a very difficult quarter as the deterioration of the financial crisis impacted global economies. The focus suddenly changed from inflation to recession, causing a heavy sell-off in emerging market equities and commodities.

Although most of the managers quickly re-adjusted their exposure to take advantage of the market shift, some of the funds were surprised by the extent and speed of the trend reversal. Returns amongst managers varied significantly. Managers who were overweight cash or had anticipated a deterioration of market fundamentals

outperformed directional traders. Losses that came from equities and commodities were partially offset by gains in currency trading. Some managers had been increasing their long exposure to the US Dollar for some time as they felt that the carry trade would be unwound if the economic situation deteriorated.

Global Macro is the most liquid hedge fund strategy; given its directional nature it does not rely on leverage. Returns for the year to date, although disappointing, have been better than most other hedge fund strategies. Looking ahead the economic environment remains challenging and volatile. We intend to retain an overweight allocation to the global macro strategy as these managers run very liquid portfolios and have historically outperformed at times of market stress.

## **CONCLUSION**

Despite hedge funds lowering their net and gross exposures substantially, the sheer scale of volatility and de-leveraging meant that managers had nowhere to hide as virtually all strategies lost money over the quarter. Long positions fell more than short positions on down days and rallied less on up days. These losses forced hedge and mutual funds to sell their positions, in efforts to raise cash into the quarter-end, hence created asymmetric stress.

The landscape of financial markets changed dramatically over the course of the third quarter following the takeover of mortgage agencies and the failures of banks, insurers and broker dealers. Hedge funds face poor borrowing and trading conditions going forward, and liquidity in equity and debt markets will be reduced.

Over the coming months we expect major changes throughout the hedge fund industry. Redemption pressure may result in fewer managers, and strategies that rely on leverage to provide returns, an area we have actively avoided, will have to adapt or disappear. While it is difficult to predict when things will settle down it is our view that the hedge fund sector will be presented with opportunities to make excess returns as a result of the dislocations that now exist in most parts of the global markets.

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