



Hedge Funds: A More Compelling Investment

September 2009

The unprecedented turmoil and structural changes that the hedge fund industry underwent in 2008 have resulted in a compelling case for investing in hedge funds in the current environment. First and foremost, the dislocations that have occurred in financial markets present dramatic opportunities for investing and trading that hedge funds have historically been able to exploit. Second, the reduction in size of the hedge fund industry that resulted from the financial crisis, means that fewer managers and less assets are left to profit from these opportunities. Third, the dispersion of returns among managers and hedge fund strategies has increased resulting in greater diversification benefit for investors in hedge funds. Last, in order to regain assets lost in the deleveraging and flight to quality that occurred last year, many hedge fund managers are offering investors incentives and other concessions to attract assets. We believe these factors present one of the most attractive environments for investing in hedge funds in many years. In the following research report, we analyze each of these factors and explain how they have created this opportunity for hedge fund investors.

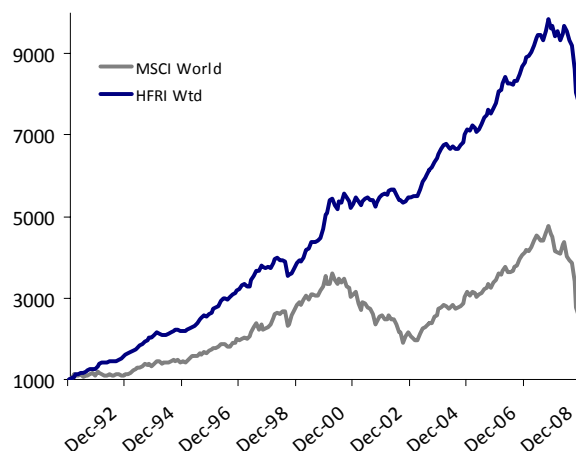
The case for investing in hedge funds remains sound

Hedge funds have historically had higher returns and lower volatility than most other asset classes. This is true despite the perception that hedge funds only earn outsized returns by taking higher risks. Exhibit 1 reveals that since 1992, the performance of the hedge fund industry has exceeded that of global equities as measured by the MSCI World. Even in the aftermath of the technology bubble in 2000, hedge fund performance remained positive despite the prolonged correction that global equities experienced.

Exhibit 2 paints a similar picture. The annualized returns of both single manager hedge funds (HFRI Weighted Index) and funds of hedge funds (HFRI FoF Index) exceed that of the other major asset classes, dating back to 1991. The volatility (as measured by the annualized standard deviation) is lower for hedge funds than for other asset classes excluding global bonds and of course treasuries. Likewise, risk adjusted returns (as measured by the Sharpe ratio)

are higher for hedge funds than for other asset classes except bonds. The results remain similar even when accounting for reported biases in hedge fund indices of up to 3% for single managers and up to 1% for FoFs.

Exhibit 1
Hedge Funds vs Global Equity



Source: MSCI Barra ,Hedge Fund Research

The financial market dislocations of the last two years have reduced the assets of both investors and money managers. This turmoil, however, has also presented expanded opportunities for investing and trading.

Exhibit 2
Risk/Return of Major Asset Classes
(Jan. '91- Dec. '08)

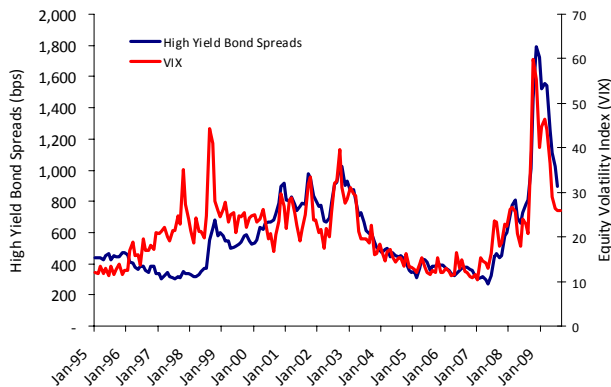
	Ann. Return	Ann. Std. Dev.	Sharpe Ratio	Max Drawdown
Hedge Funds (HFRI Wtd)	12.1%	7.1%	1.31	-21%
Funds of Hedge Funds (HFRI FoF)	7.5%	6.2%	0.77	-22%
Global Bonds (Barclays Agg. BI)	6.7%	3.9%	1.01	-5%
Managed Futures (Barclay CTA)	6.1%	8.4%	0.40	-10%
Global Equities (MSCI World)	5.6%	14.3%	0.20	-47%
Commodities (GSCI)	2.8%	21.0%	0.00	-62%
US 3 Mo T-Bills (ML3m Tbill)	4.1%	0.5%	N/A	N/A

Source: Pertrac

In global equity markets, volatility reached unprecedented levels in 2008 as equity prices plummeted across the globe. Volatility remains high despite the rebound in global equity markets in 2009. Likewise in credit markets, spreads on debt across all parts of the capital structure have widened dramatically from very tight levels prior to start of the financial crisis.

Exhibit 3 shows the spread on US high-yield corporate debt along with the VIX equity volatility index. These are two indicative measures of both the financial turmoil that took place and the opportunities that currently exist.

Exhibit 3
Trading Opportunities for Hedge Funds



Source: Morgan Stanley Prime Brokerage, Bloomberg

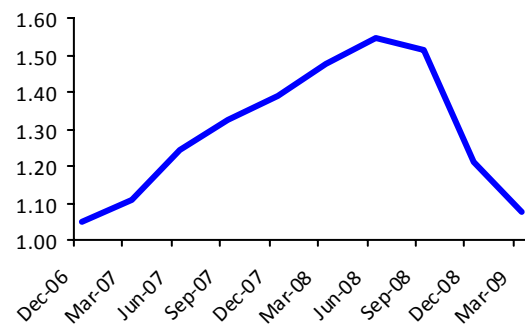
In equity markets, high volatility is potentially profitable for hedge fund managers with the trading systems to take advantage of the volatility. Lower equity valuations that accompany the decline in equity prices can be profitable to managers who are skilled in security selection. Furthermore, as the credit markets return to more normal functioning, credit spreads such as the high yield spread shown above will tighten again offering opportunities for skilled credit and multi-strategy managers. Other hedge fund strategies, such as global macro and commodity trading, should also benefit in that environment.

Next, we analyze the five structural changes that we expect will make the hedge fund industry more attractive to investors.

Reduction in assets in the industry

As the events of 2008 unfolded, many hedge fund managers posted negative performance, while risk aversion among investors increased. These factors caused a large number of investors to exit their hedge fund investments. As a result, the assets managed by the hedge fund industry declined dramatically. Data from Thomson Reuters shows that hedge fund industry assets peaked in Q2 2008 at \$1.55 trillion and ended Q1 2009 at \$1.08 trillion. This represents a decline of approximately 30% in industry assets (Exhibit 4).

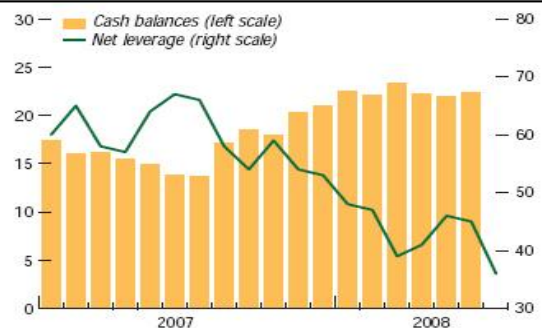
Exhibit 4
Growth & Decline of Industry Assets



Source: Lipper Tass Asset Flows Report: Q1 2009

The reduction in assets was accompanied by a significant reduction in leverage provided by prime brokers to hedge funds (Exhibit 5) further exacerbating selling pressure and negative performance.

Exhibit 5
Reduction in Leverage



Source: Morgan Stanley: Leverage defined as assets divided by equity capital cash balances as a percent of total assets.

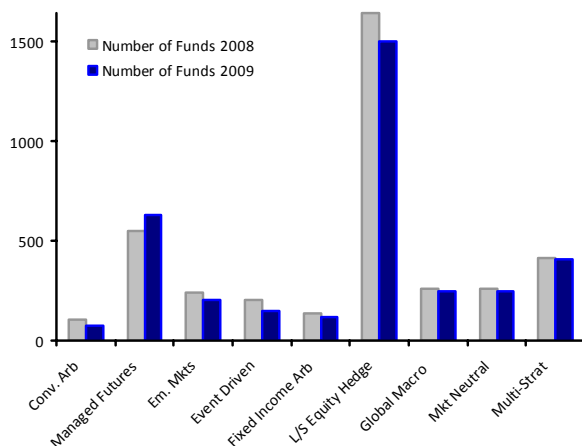
Reduction in the number of hedge funds and funds of hedge funds

More than 275 funds of hedge funds were liquidated in 2008 (according to Hedge Fund Research), setting a record. The total number of hedge funds declined on a net basis by 8% according to data by HFR. The total number of liquidations in 2008 was 1,471 representing an increase of over 70% from the previous full year record of 848 liquidations set in 2005. According to the Lipper Tass Asset Flows Report Q1 2009, the number of hedge funds followed by them decreased from 5,106 in Q1 2008 to 4,685 in Q1 2009 (Exhibit 6).

This steep reduction in the number of managers is complemented by a significant reduction in the number of proprietary trading desks at global investment banks who were trading similar strategies. This decreased level of competition should create wider spreads and greater opportunities for hedge fund managers to exploit.

Exhibit 6

Number of Hedge Fund Managers: Q1 2008 vs. Q1 2009



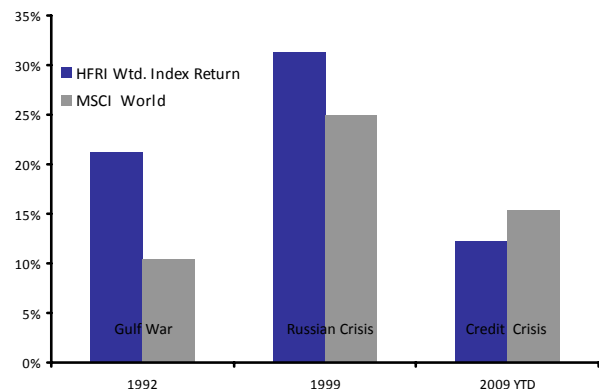
Source: Lipper Tass Asset Flows Report: Q1 2009

Hedge Funds have historically outperformed post crisis

Hedge funds have historically outperformed following periods of crisis due to their ability to identify and opportunistically take advantage of dislocations in the market through long and short positions (Exhibit 7). For the first seven months in 2009, HFR's Fund Weighted Index had positive performance of more than 12%.

Exhibit 7

HFR vs. MSCI World (post crisis)

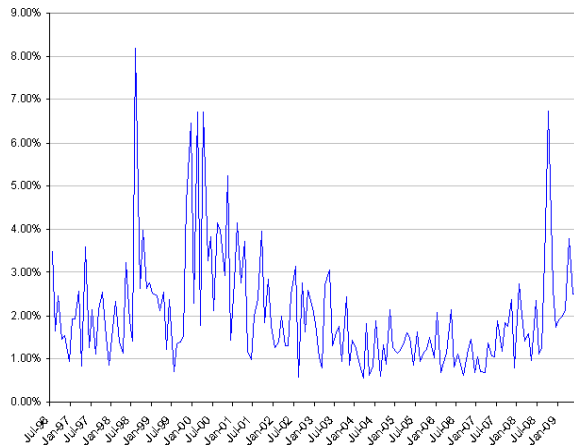


Correlation among strategies has declined and dispersion of returns among managers has increased

The dispersion of returns among hedge fund strategies has declined substantially from 2000 to mid-2007 and then started to pick up again through 2008 and into 2009. At the same time, the dispersion of manager returns across strategies has increased (Exhibit 8). This increased dispersion of returns leads to lower correlation among managers and strategies, also known as intra-correlation. Having lower intra-correlation among managers and hedge fund strategies leads to higher levels of diversification for investors as well as higher risk-adjusted returns.

Exhibit 8

Dispersion of Hedge Fund Strategy Returns



Source: hedged.biz

Hedge Fund managers are more willing to provide investors with incentives

Given the magnitude of client redemptions in 2008, hedge fund managers are offering investors greater concessions in order to attract back assets. These concessions may include:

- Additional capacity with managers which may have been soft or hard closed.
- More favorable liquidity terms through improved liquidity share classes or other fund structures (such as UCITS, as well as a more accurate match between assets and liabilities.
- Higher levels of transparency and reporting
- Reduced or more competitive fees
- Tighter terms in the offering memorandum

Favored strategies for the remainder of 2009 include:

The current environment is one in which emergence from the financial crisis is slowly taking place, but where reversion to near-crisis conditions remains possible. In this environment, hedge fund

strategies that are able to take advantage of directional moves and adapt to the adjustments and possible pullbacks that may take place in financial markets are best suited to outperform. In our opinion, strategies that invest in liquid asset classes are the ones most likely to meet these criteria, particularly if periods of extreme liquidity constraints return.

1. Traditional (non-CTA) Global Macro managers have the ability to participate in a variety of markets and invest using a top-down approach. These managers typically invest in highly liquid securities and can also take advantage of broad directional changes and trends in markets.

2. Arbitrage and Event-Driven managers, particularly in the credit space are also well positioned to outperform. Considerable volatility and directional moves remain in the credit markets due to both technical and fundamental factors. Arbitrage managers can take advantage of pricing discrepancies that can be found between similar assets. Further, in these uncertain times event-driven and activist managers should be able to realize value in distressed credit, where defaults have not yet peaked. Managers who understand the post-default process can realize exceptional value.

3. Equity Hedge (L/S equity managers) are likely to be able to distinguish between equity issues that have declined to become undervalued following the financial crisis and others that have rebounded too aggressively in the recent rally and may now have become over-valued. Managers with the ability to generate alpha through security selection should outperform as the global economy rebounds and equity markets discount the recovery.



London

Capintro Partners, Ltd.
8 Queen St, Mayfair
London W1J 5 PD
United Kingdom
+44 207 659 2900

www.capintropartners.com

Dubai

Capintro Partners, Ltd.
Grosvenor House Commercial Tower, Office 410
P.O. Box 115110
Dubai, United Arab Emirates
+9714 329 8511

marketing@capintropartners.com

Disclaimer

This material is for your general information only and is not an offer or solicitation to buy or sell any security including any interest in a hedge fund. This material is based upon information Capintro Partners ("Capintro") believes is reliable.

However, Capintro does not represent that it is accurate, complete, and/or up-to-date and accepts no liability if it is not. Analysis, historical information or value(s) or other information are as of the date and, if applicable, time indicated. Capintro does not accept any responsibility to update any opinion, analyses or other information contained in the material.

Neither Capintro, nor its officers, directors, agents or employees makes any warranty, express or implied, as to the suitability of any hedge fund as an investment or of any kind whatsoever, or assumes any responsibility for, and none of these parties shall be liable for, any losses, damages, costs or expenses, of any kind or description, arising out of your participation in this survey or your investment in any hedge fund. You understand that you are solely responsible for reviewing any fund, its offering and any statements made by a fund or its manager and for performing such due diligence as you may deem appropriate, including consulting your own legal and tax advisors, and that any information provided by Capintro shall not form the primary basis of your investment decision.

The distribution of this Report by Capintro should not be construed as an endorsement or recommendation by Capintro of any strategy referred to or any other information contained in the Report. Under no circumstances shall Capintro and its affiliates and subsidiaries be liable for any direct, indirect, incidental, special or consequential damages that result from the publication or use of the Report.

No part of this material may be (i) copied, photocopied, or duplicated in any form, by any means or (ii) redistributed without Capintro prior written consent.

Nothing in the foregoing shall be construed as excluding or restricting any duty or liability to you on the part of Capintro arising under the Principles or Regulations of the UK Financial Services Authority ("FSA"). Capintro is authorized and regulated by the FSA.