HEDGE FUNDS RESEARCH SERIES

HEDGE FUND THEMES IN 2010

Authored By:

Aureliano Gentilini
Global Head of Hedge Fund Research

Pennapa Tantiyakul
Hedge Fund Research Analyst

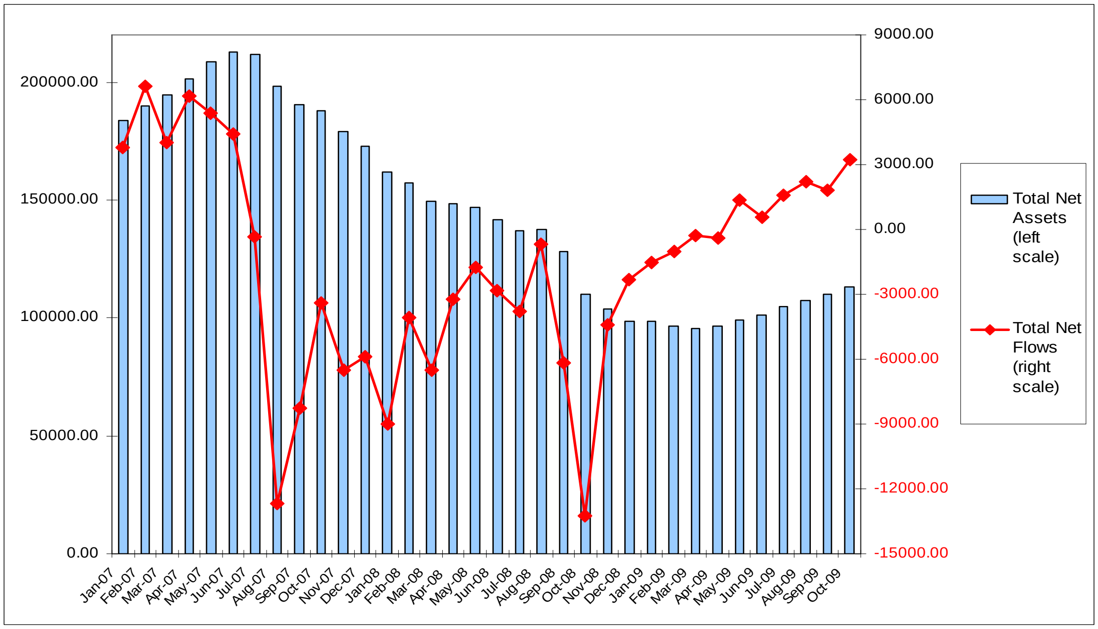
LIPPER

THOMSON REUTERS

Discussion Themes

1. **Global hedge fund (HF) assets** were estimated at US$1.55 trillion at the end of September 2009, rising to US$1.60 trillion at the end of December. Our view is that the global HF industry will be at about US$1.86 trillion at the end of December 2010 (slightly above June 2008's reading, for a growth rate of 16.24% year on year under the assumption of an average 10% annual performance in 2010 and US$100 billion net inflows).
2. The **competitive landscape** in the Absolute Return segment will get crowded throughout 2010 (mutual funds implementing hedge-like strategies, leveraged ETFs, UCITS III-compliant fund vehicles), with Absolute Return products other than HFs becoming increasingly popular among institutional investors.HF managers will aggressively launch UCITS-compliant HF-like mutual funds to penetrate retail and institutional segments.

Total Net Assets and Total Net Flows - European Absolute & Total Return Funds - January 2007- October 2009 (data in EUR millions)



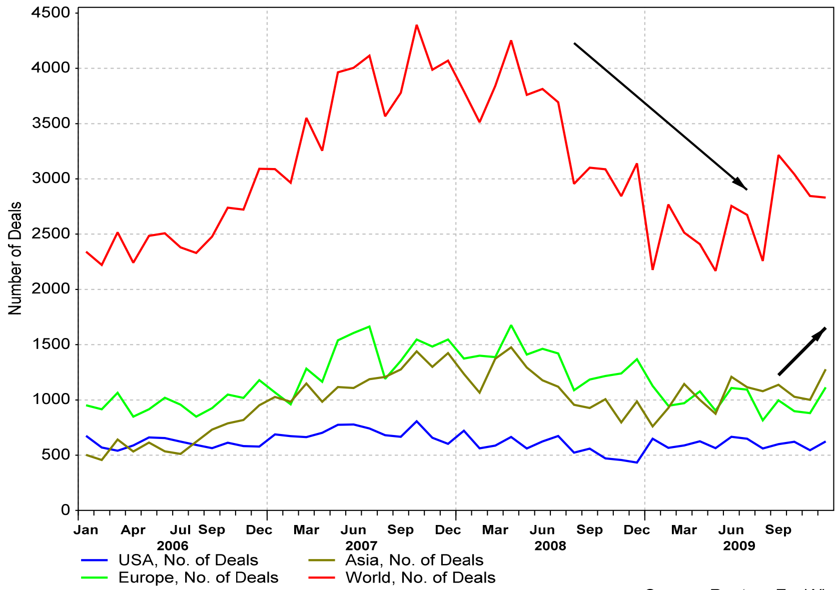
Source: Lipper-FMI, a Thomson Reuters company

3. **Managed accounts** with single managers will be a true growth story in 2010 because of institutional investor and specialized fund of hedge fund (FoHF) demand. We will observe an asset management barbell growth favoring ETF products and uncorrelated and diversified Absolute Return collective investment vehicles.
4. The **HF investor mix** is changing. Among high-growth investors can be listed corporates, public pension plans, insurance companies, banks, small- to mid-sized

endowments, Asian private banks, Australian institutional investors, Scandinavian institutions, and family offices. At the beginning of the new fiscal year in April 2010 Japanese pension plans will likely rebalance their portfolio holdings in favor of international stocks—matching domestic and foreign stock allocation, decreasing exposure to domestic equities amid expectations of the Japanese stock market faltering in 2010 and Japanese yen depreciation. Allocation to alternative investments of Japanese pension schemes will remain in the 5% region. Institutional investors will focus more on capital preservation and noncorrelation in their asset allocation decisions and to a lesser extent on absolute performance.

5. **Multi-strategy hedge funds** might be the losers in the forthcoming round of AUM growth (decorrelation drivers in portfolio allocation will weigh, as well as the FoHF segment shrinking). Investors will remain very sensitive to another steep equity market sell-off.
6. **Conditions in equity markets** will be choppy in 2010: fundamentally driven long/short portfolios will be among the winners, along with macro and niche emerging strategies. Stock-picking skills will be key to posting superior HF returns throughout 2010. Risk Arbitrage will be among the top-performing strategies, with Europe and Asia benefiting the most as the positive trend resumes in those two regions. Merger Arbitrage strategies might benefit from a pickup in M&A activity throughout 2010. At the same time Long/Short Equity managers might profit from speculative drivers' bidding on changes in performance ranking and rating agencies' credit watch of acquiring companies. Looking at historical patterns, based on the 2002 recession when M&A activity bottomed out two quarters later than the S&P 500 (which hit the minimum level in Q3 2002), we started observing early signs of a resurgence of M&A flows toward the end of 2009, after the U.S. large-cap stock market index bottomed out in Q1 2009. The healthcare sector appears to be promising in perspective, potentially leading an M&A recovery. Amid a slowdown in M&A activity over the past two years, there were a lot of deals in the pharmaceuticals industry, led by Pfizer's US$68-billion takeover of Wyeth and Merck's US$41-billion deal to acquire Schering-Plough Corp. Also, average M&A premiums in the sector signal that the market is active and set for an uplift. The average M&A premium for the initial months of the second half of 2009 in the healthcare sector was 51.8%. The last time it reached a similar level was during the healthcare boom in 2006, when 14 deals recorded an average premium of 36.1%. Dedicated Short-Bias might be a bright spot, since geopolitical disturbances will weigh throughout 2010. Asset-focused and noncorrelated portfolios should be the best/highest performing Absolute Return vehicles.

Merger/Acquisitions, Asia, Europe, North America, and World Number of Deals, January 2006-December 2009



Source: Reuters EcoWin

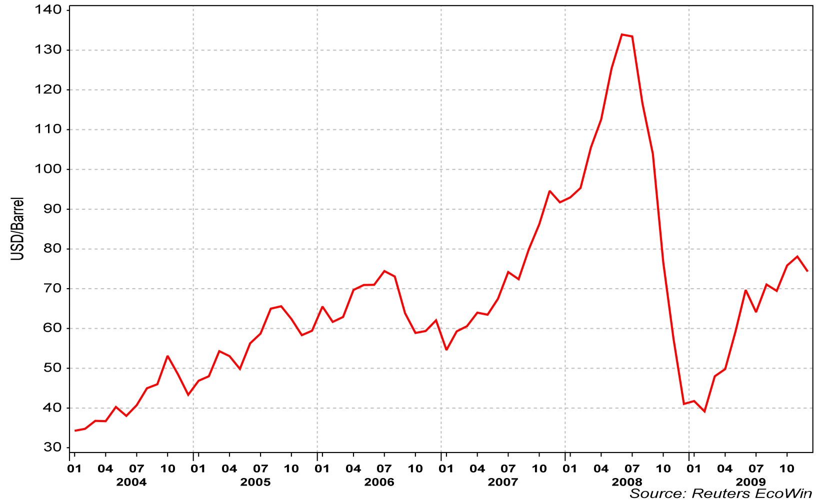
7. There will be numerous **small new fund openings** throughout the year. A trend in HF IPOs might resume in 2010. The launch of new HFs focused on emerging countries might be sensitive to any capital control measure enforced by local governments to stem any destabilizing appreciation in the home currency.

8. A **jobless recovery**, which dents consumer spending, will be the most feasible path in 2010, since the labor market on both sides of the Atlantic will fail to add ground to the rebound. Countries will emerge from global economic meltdown in 2010 but at different paces. Such an environment will offer tremendous opportunities for global macro strategies on both the long and short sides of various asset classes to generate alpha and beat market index returns.

9. **Market conditions in 2010** will be more difficult than in 2009, with a potential risk of bubbles in certain assets. Risk appetite will be volatile in 2010. Alpha drivers will be more relevant than beta factors throughout the year, with a greater dispersion of returns across HF strategies. A limited number of selected strategies might be able to return performance readings above 15% CAGR, with average annualized volatility of around 10% over calendar year 2010. Average HF CAGR will be in the 10% region, which will lag traditional equity market benchmarks as they did in 2009. Nevertheless, except for a few exceptions, HFs will deliver a better risk/return profile than most market benchmarks.

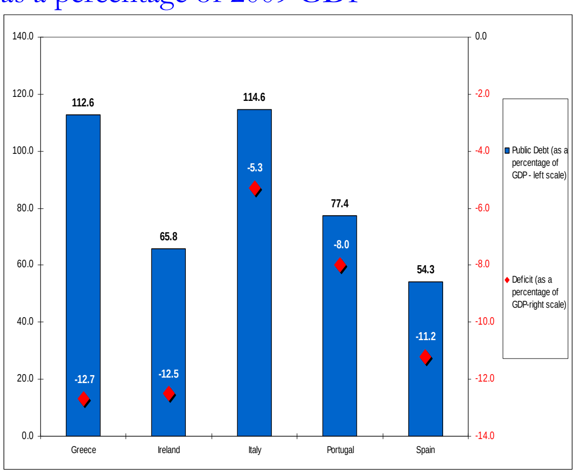
10. **Geopolitical tensions** and the **riots of internal conflicts in Iran**, along with **Saudi and Venezuela actions**, might lift the oil spot price to levels observed in July 2008. Contango in the crude oil market might be a significant threat to commodity indices' performance.

WTI Crude Oil Index, January 2004-December 2009



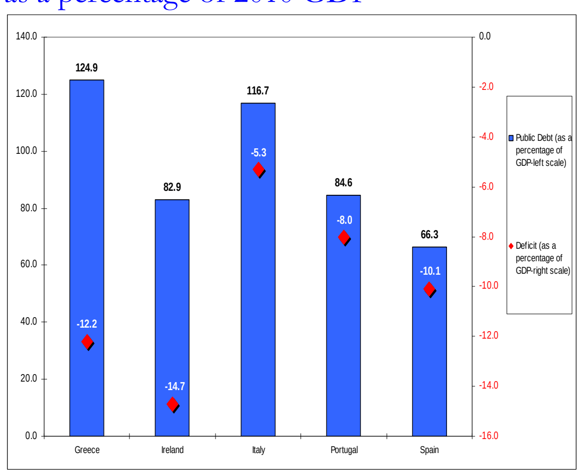
11. **BRIC versus PIIGS** (Portugal, Ireland, Italy, Greece, and Spain) countries. The fiscal position of PIIGS countries will deteriorate further, leading to fractures within the euro area. Concerns about absorption of new government bond issuances will affect the intermediate-to-long sector of the yield curve in those countries. Rating agencies will downgrade further the credit rating of PIIGS countries.

PIIGS countries-Public Debt and Deficit as a percentage of 2009 GDP



Source: EU Commission projections – Autumn 2009 Forecast

PIIGS countries-Public Debt and Deficit as a percentage of 2010 GDP



Source: EU Commission projections – Autumn 2009 Forecast

Among BRIC countries India's BSE stock index is expected to continue edging upward in 2010, although it is unlikely to repeat 2009's stellar performance. As long as a combination of fiscal measures taken to control inflationary dynamics is successful and the change to a tightening stance of the Reserve Bank of India does not hinder economic growth, the Indian stock market trend will be driven by improved corporate earnings, healthy economic growth, and sustained capital inflows. HF managers focused on emerging markets strategies will account for a relevant quota of capital inflows into India, since pension funds and endowments are eager to put money into alternative assets to recover from losses incurred during the financial crisis. India-focused investors will be the cornerstone of net sales in the Asian region in 2010, resembling the pattern observed throughout 2009. It is expected that in future periods new rules banning sales commissions in India could hinder sales of collective investment vehicles in general in the country, since bank distribution is encouraged at the expense of independent financial advisor (IFA) sales. China is expected to continue growing at about 8% to 9% in 2010, driven by rapid growth of fixed-asset investment, exports, Chinese government policies to boost domestic consumption, fiscal stimulus injection, and moderately loose monetary policy. China would not allow significant moves of the yuan until its exports have resumed a path of healthy growth, given a number of uncertainties around the effectiveness of measures to promote private consumption growth.

12. **Default rates for 2010** will likely be lower than for 2009 because of an improving outlook for economies, balance sheet deleveraging, and improved liquidity conditions in financial markets. Improved credit markets will provide attractive investment opportunities in restructuring distressed companies.
13. The **FoHFs segment** will continue shrinking in 2010—from 33% of total AUM at 2009 year-end to under 25% in 2010, since flaws in the business model (limited diversification and easier direct access to underlying managers) will weigh. This will have a significant impact on marketing policies of FoHFs, with further pressures on fees.
14. The rally in global stock markets in 2009 helped to improve the **funded status of pension funds**. At the same time defined benefit schemes experienced an increase in total deficits as liabilities exceeded investments. The further increase of the pension funding gap will progressively see in 2010 the closure of defined benefit schemes. At the same time new asset allocation models aiming at reducing exposure to volatility clustering and correlation patterns among various assets will become a standard in 2010. Counterparty risk will be a key variable in portfolio construction of institutional investors. New enhanced risk factor-driven portfolio allocation models of institutional investors will direct investment flows into alternative investments with a better risk/return profile. Allocation to HFs will focus on niche/uncorrelated strategies.
15. The **costs involved in complying with more stringent regulatory requirements** can make HFs comparatively more expensive to manage. At the same time pressures from institutional investors to reduce HF fees will continue. A clear trend toward significant changes in regulation might be observed, and changes in the mapping of geographies of HF management companies will occur throughout 2010.

16. Despite the global systemic risk/counterparty risk trade-off, significant steps toward instituting a **central clearinghouse for over-the-counter (OTC) derivatives and CDS** might be observed throughout the year.
17. Rating agencies might downgrade the **U.K.'s credit rating**, which will lose AAA status. Both U.K. debt and budget deficit will continue growing, breaking new record highs in the first half of the year. At the same time, following PIMCO's announcement of reducing its portfolio exposure to U.K. government debt ahead of the closure of the U.K.'s quantitative easing program, widespread concern that appetite for U.K. debt will not be able to match government debt supply will mount.
18. Expansion of the Chinese and Indian economies coupled with a rapidly growing population will drive **demand for more energy in 2010**. As a result the energy sector will create tremendous opportunities for investors. Significant progress in the efficiency of solar cells (and developments in alloys made from various elements from the periodic table) will encourage people to use more alternative and renewable energy but unlikely will affect global reliance on fossil fuels significantly throughout the year. At the same time renewed global focus on alternative energy and climate change will drive institutional investor demand toward those assets that impact environmental developments. Water might be the next frontier in commodity investing, and a clear trend toward commoditization of water might be observed. Water shortage will also create tremendous investment opportunities.
19. The **financial sector's profits will deteriorate in 2010** after healthy profits posted in 2009. Late last year the IMF warned that loan losses could rise in the banking sector and the broader financial sector in the wake of high unemployment levels and associated delinquencies, highlighting that U.S. financial institutions have written down only about 60% of delinquent loans, while their Eurozone and British peers recognized just 40% of losses. Banks are expected to deliver lower earnings, while struggling to build up stronger capital buffers and achieve capital ratios above the threshold that will be decided by the Basel Committee on Banking Supervision later in the year. The banking system still appears to be exposed to a potential banking crisis.
20. New social policies aiming at offsetting a trend of an ageing population and economic measures focusing on fiscal stimulus and domestic consumption that will be enforced by the Democratic Party of Japan (DPJ) are expected to display full benefits on the **Japanese economy** only in the medium to long term. In the short run the Japanese stock market might lag behind international stock market trends, mainly driven by the corporate earnings cycle and low P/E valuations. In the short run, given a number of constraints about required levels of domestic absorption of JGBs and interest expenses on the stock of outstanding debt, a weaker yen will still be the catalyst to sustain a path of healthy GDP growth in the country. In the short run Japanese yen carry-trade strategies will resume.
21. Sooner or later **inflationary pressures** will materialize globally. The European Central Bank (ECB) will be trapped between raising interest rates as the exit strategy materializes and inflationary pressures rise and a more dovish stance to avoid any

pressure on those Eurozone countries struggling to manage fiscal imbalances and interest payment on public debt.

22. **Gold spot prices** might struggle to resume the strong rally posted in 2009, despite central bank reserves and investors buying, as well as on U.S. dollar weakness. Gold returns will be negatively related with equity returns, with gold prices moving in the opposite direction to the movement of equity prices. To the extent inflationary pressures mount later in 2010 nominal gold returns will show a strong negative relationship with inflation headlines.

Contact List: Lipper Hedge Fund Research

Aureliano Gentilini (+39 02 66129303) Aureliano.Gentilini@thomsonreuters.com
Global Head of Hedge Fund Research

Pennapa Tantiyakul (+1 646 223 7079) Pennapa.Tantiyakul@thomsonreuters.com
Hedge Fund Research Analyst