International Asset Management Limited

Independent specialists in tailor-made portfolios of hedge funds since 1989

Summary of the Improved Relevance of Hedge Funds

January 2013

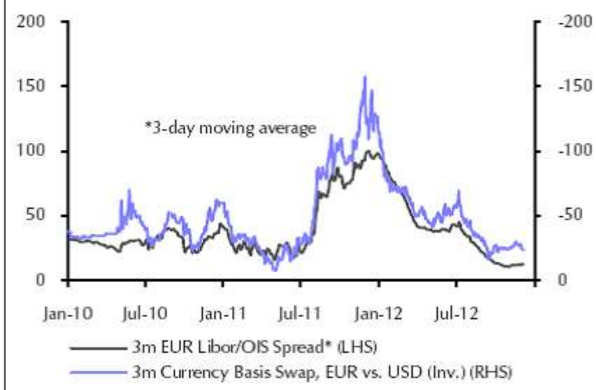
Summary

Where have we come from?	▪ Rare combination of the simultaneous financial and economic crisis of 2008 ▪ Relief rally in 2009 ▪ 2010-2012 H1 continued market uncertainty on account of heightened systemic risks.
Resulting market behaviour	▪ Repeated risk on/risk off market conditions ▪ Cross-asset-class correlations reached all-time highs ▪ Increased demand for yield ▪ In this environment, hedge funds have protected well against risks on the downside but this has come at a cost to the capture of upside returns.
Where are we now?	▪ Greater credibility in central bank activity having reduced risks of systemic failures ▪ Markets becoming less macro-orientated ▪ Global growth remains reasonable and has not collapsed.
Current opportunities	▪ Limited upside potential in government and corporate bonds ▪ No automatic case for a bull market in equities ▪ Complex credit securities still provide opportunities for capital appreciation ▪ Value to be added in security selection.

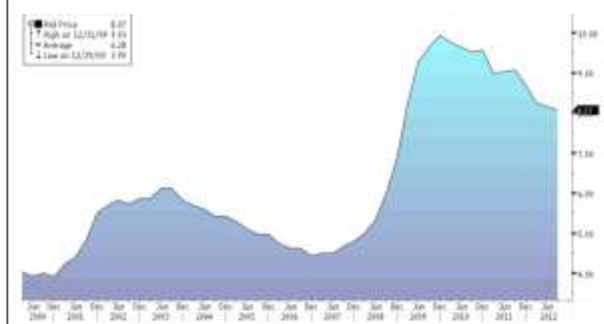
Economic and market background

- Systemic risk substantially reduced but not eliminated
- Significant structural reforms taking place in Europe
- US is leading the recovery in developed markets while some concerns over European and Japanese developments remain
- Economic growth in Emerging Markets remains significant
- Cross-asset class correlations reducing.

Measure of bank funding stress

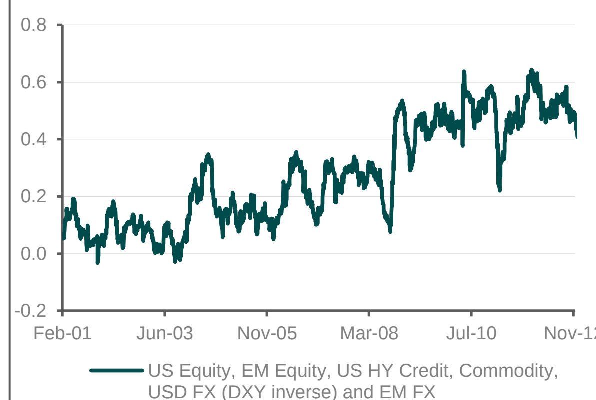


US unemployment rate (%)



US NAHB Housing Index

Average correlation (13 week rolling) between risky assets on a daily basis

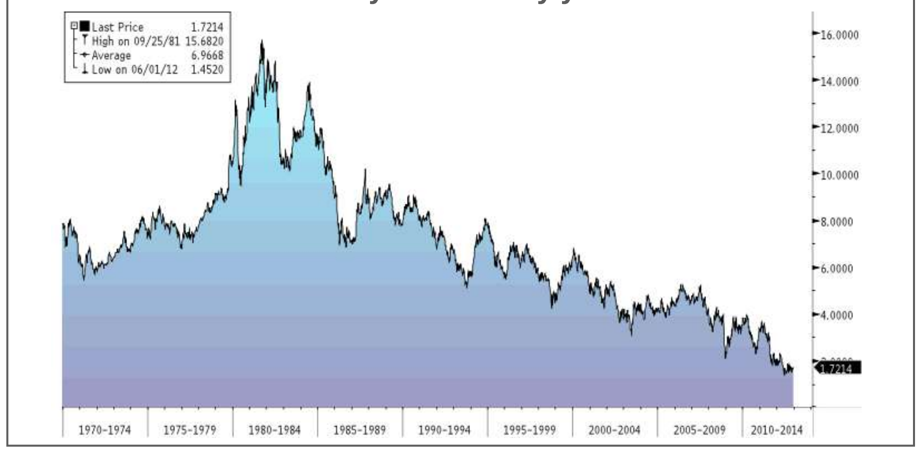


Source: Capital Economics, Bloomberg, IAM.

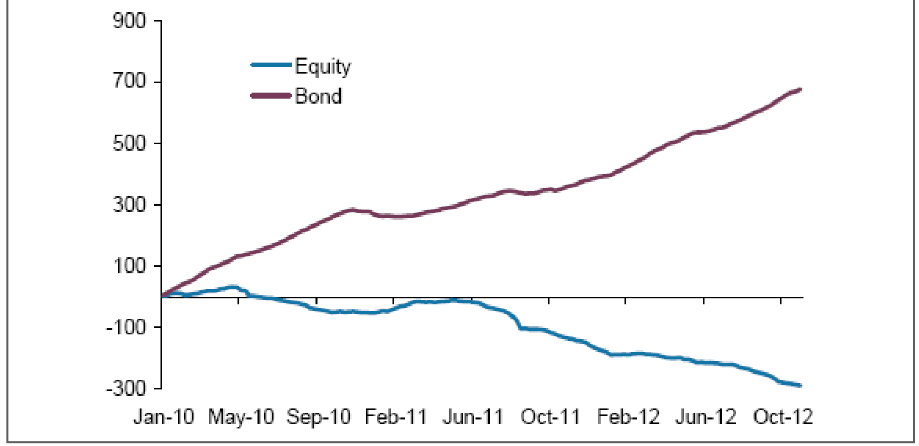
Government bond markets

- 30-year bull market coming to an end
- Deliberate, sizeable market intervention designed to encourage growth
  - Impact on yields has been dramatic
  - Investors continue to be ‘pushed’ into risky assets
- Flows into bond funds have reached highs
- Central banks in developed countries continue to give clear signals that interest rates will remain low for another couple of years
- Thereafter, potential for significant price weakness when rates rise or inflation reappears.

US 10 year treasury yields



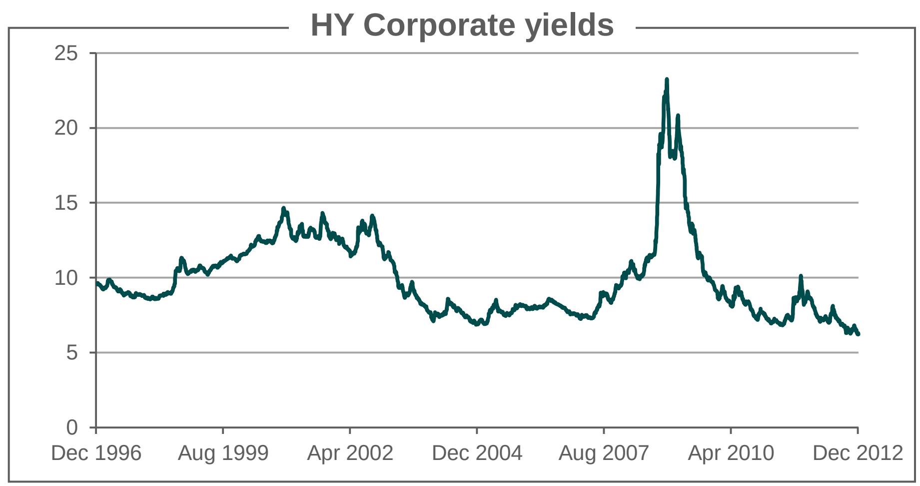
Cumulative US Fixed Income and Equity Fund Flows ($bn)

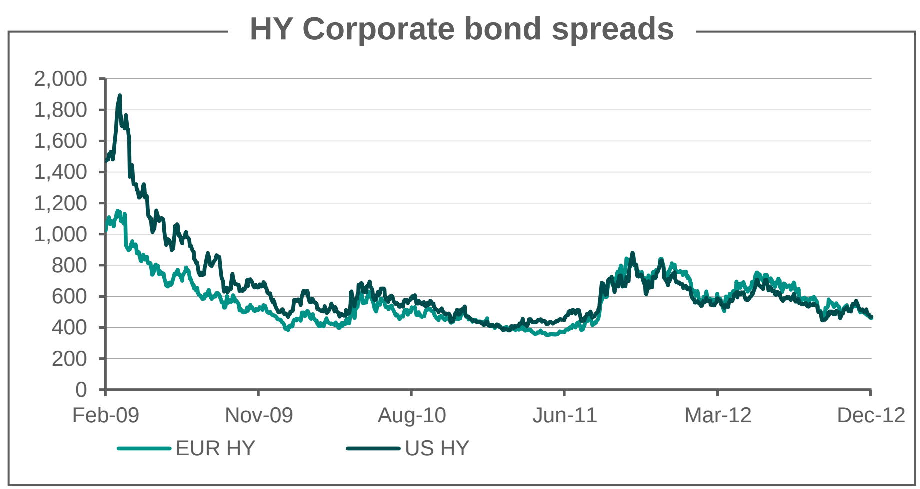


Source: IAM, Morgan Stanley Research.

Credit markets

- Impact of central bank activity on credit markets has been substantial with enormous demand for yield
- New corporate debt supply Q1–Q3 2012 was ~US$3 trillion
- HY corporate yields near historic lows and spreads have considerably tightened
- Attractive entry points on the short side and the cost of running negative carry much reduced
- Interestingly, flows into HY funds were negative in October and November 2012
- Specialist market opportunity areas: TARP, RMBS, CMBS, bank hybrid debt, CLOs.



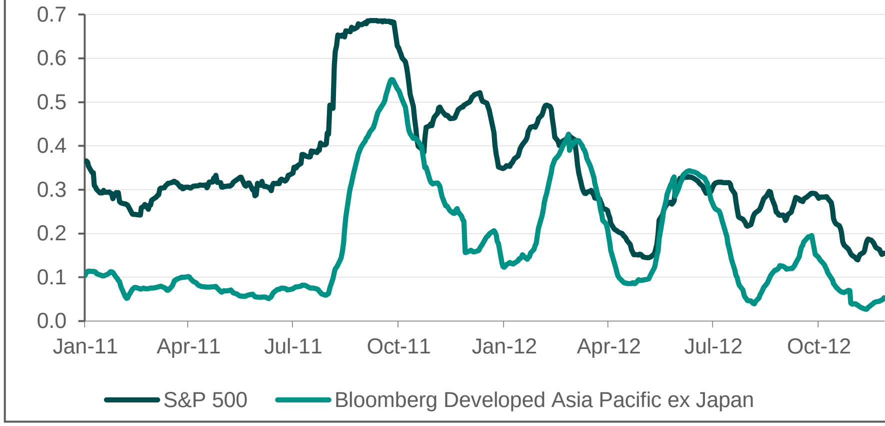


Source: IAM.

Equity markets

- Volatility levels have been relatively low
- Correlations within equity markets are now at the bottom end of the recent ranges
- Divergence in sector performance is at levels indicative of more fundamentally driven markets
- Earnings momentum reduced, requiring stock selection to extract returns
- Morgan Stanley observes that hedge fund stock picking is improving: 2012 is the first time in the past four years that longs outperformed the index and shorts were up less than it.

Correlation (13 week rolling) within the US and Asian equity markets on a daily basis



Stock picking value increasing

	2009	2010	2011	2012 YTD
Long Attribution	51.9	22.9	-7.1	19.7
Short Attribution	40.1	17.4	-11.8	9.8
Longs minus Shorts	**11.8**	**5.5**	**4.7**	**9.9**
MSCI AC World	35.3	13.2	-6.9	13.4
Longs minus MSCI World	**16.7**	**9.7**	**-0.3**	**6.3**
Shorts minus MSCI World	**4.9**	**4.2**	**-4.9**	**-3.6**

Source: IAM, Morgan Stanley Research.

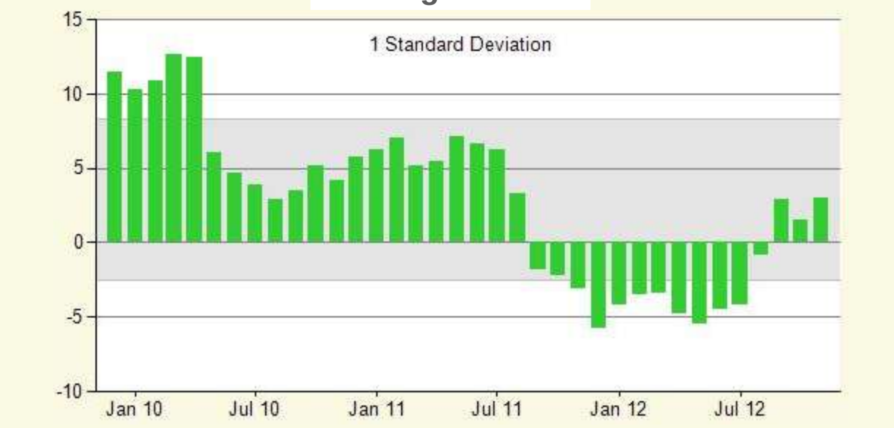
Hedge funds

- Strong risk management attributes
- Revival of demand for hedge funds led by institutions
- Rolling returns improving.

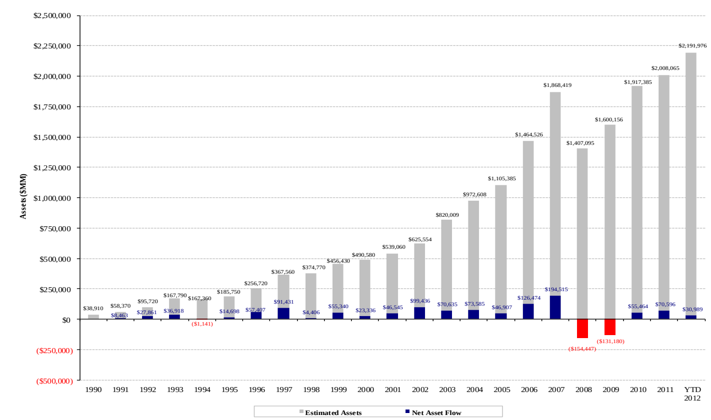
Strong risk management in negative equity months

	MSCI World Index (%)	HFRI FOF Index (%)
2010[1]	-24.09	-2.93
2011[2]	-26.28	-9.05
2012[3]	-10.36	-1.89
Indicative Total	**-60.73**	**-13.87**

Rolling Returns



Flows into hedge funds



Notes: [1] 2010 months = Jan, Apr, May, Jun, Aug and Nov. [2] 2011 months = Mar, May, Jun, Jul, Aug, Sep, Nov and Dec. [3] 2012 months = Apr and May. Hedge funds represented by HFRI Fund of Funds Composite Index.
Source: HFR, IAM as at end Nov 2012.

Conclusion

Overall, we see hedge funds' relevance increasing on account of:

- Less of the return given up in protecting against systematic risks
- Active risk management – optionality in terms of market direction and general market agility
- Specialist know-how in less liquid, complex security areas
- Security selection skill-set likely to be better rewarded.

On account of the above, we consider it probable that hedge funds' returns will be more attractive on both an absolute and relative basis.

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