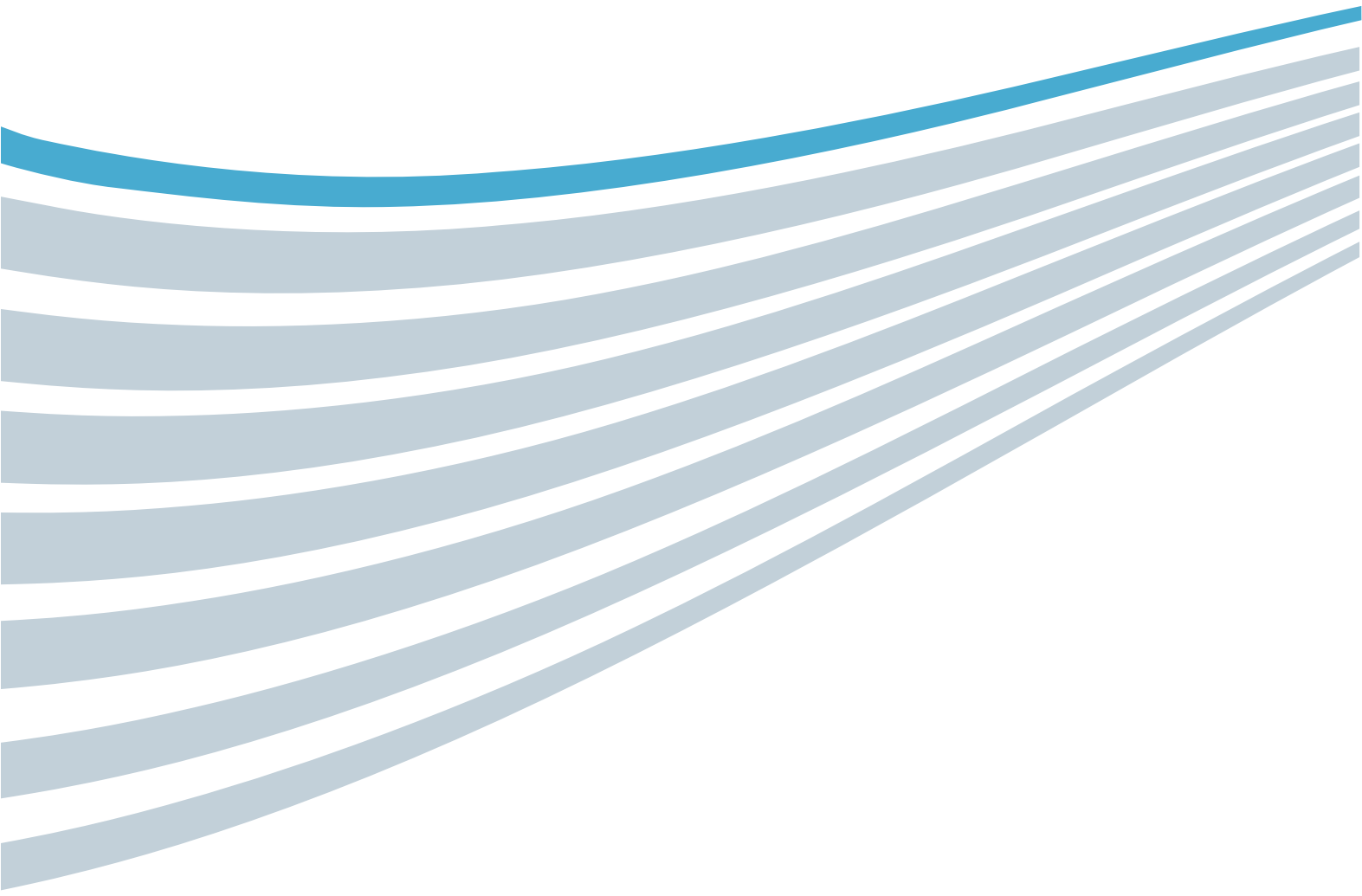




# HEDGE FUNDS 12 MONTHS AFTER SEPTEMBER 15: EMERGING FROM THE WRECKAGE

• September 2009 •





# Hedge Funds 12 Months After September 15: Emerging From The Wreckage

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## CONTENTS

### Introduction

### Part 1:

#### Major industry trends

### Part 2:

#### Performance review

### Part 3:

#### Outlook for remainder of 2009

### Conclusion

### Appendix

## Summary

- Hedge funds have had **positive net inflows** over three consecutive months since the end of May. At the same time, there are still a high number of funds that are closing and only very few new launches.
- We have **not seen** any significant changes in the liquidity terms and the fees taken by hedge funds during H1 2009. We think that new liquidity terms and lower fees will only apply to newly created funds.
- Following the Madoff scandal, hedge fund managers have put **operational risk** at the forefront of their concerns internally.
- During 2009, hedge funds have delivered the performance in line with investors' expectations. As of July 31<sup>st</sup>, the **HFR Global Hedge Fund Index is up 7.2%**.
- Strategies that performed well in 2008 (Global Macros and CTAs) are **under-performing** in 2009.
- Hedge funds have profited from the equity and credit market rally but their **leverage remains well below** its historical high.
- There has been a **significant reversal in the ranking of Fund of funds** between 2008 and 2009. Last year's winners are lagging their peers in 2009.
- Risky assets have rallied significantly since March due to both an improvement in the economic situation and massive liquidity flows. Although we cannot rule out continuation of the rally during Q3 2009, we believe asset prices overshot the growth potential of the economy.
- With the stabilization of the financial system, allocating to hedge funds again provides investors with good **diversification benefits**.



## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

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### INTRODUCTION

In 2008, the hedge fund industry posted its worst performance ever. Even if hedge funds significantly outperformed equities, they failed to deliver a positive absolute performance during a period where investors needed it most. Moreover, many hedge funds experienced significant liquidity issues that led them to restrict the liquidity of their funds by implementing gates or side pockets. Finally, the Madoff scandal further tarnished the reputation of hedge funds. By the end of December 2008, some market participants and the financial press had doubts regarding the ability of the industry to survive. Nine months later the consensus opinion is that both hedge funds and fund of funds are there to stay.

The aim of this research is to provide an update on the state of the industry. Clearly we have not returned (and we hope that we will never do) to the “brave new world of hedge funds” that was prevailing before the start of the financial crisis. However, there have been major improvements over the past nine months and we are beginning to gather sufficient information and perspective to provide a good picture of the major trends that have developed in the industry during the past few months, and are set to dominate the picture going forward.

The first part of this document is devoted to the most recent changes in the business and operating models of both hedge funds and fund of hedge funds. It also provides detailed information on the asset flows during the first half of 2009.

The second part of this document provides a detailed analysis of the performance of the industry during H1 2009. More precisely, we compare 2009 performances of both single strategies and fund of hedge funds with their 2008 performances. We also try to understand the source and quality of returns that have been generated by hedge funds during 2009.

In the third part, we provide an outlook for both the industry and the hedge fund strategies for the remainder of the year. The last part of this document draws some conclusions.

*“Just as diseases spread through contagion, so does confidence, or lack of confidence. Indeed confidence, or lack of thereof, may be as contagious as any disease”,* George A. Akerlof and Robjet J. Shiller, *Animal Spirits*

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### PART 1: MAJOR INDUSTRY TRENDS

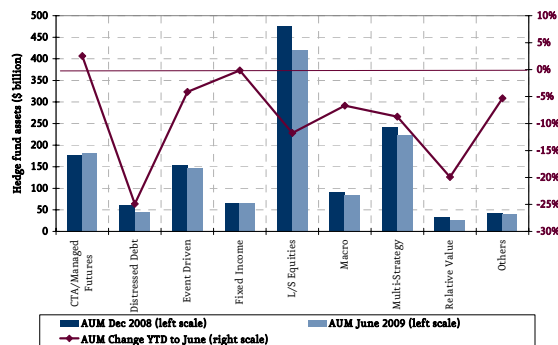
#### Asset flows in the alternative investment industry

Eureka hedge monthly reports indicate that the industry continued to lose assets during the first half of the year: the total amount of assets invested in hedge funds as of July 31st is \$1.35 trillion compared to an amount of \$1.47 trillion as of December 31st 2008. This represents a 9% decrease in the total assets invested in hedge funds.

The good news is that outflows were during the first four months of the year. Between the end of May and the end of July, there have been positive net inflows into the industry of approximately \$60 billion. This trend reversal is very encouraging as it indicates that investors are starting to re-allocate money to alternative investments despite the outstanding performance of traditional asset classes.

Not surprisingly, the flows for the different hedge fund strategies in 2009 are related to their respective 2008 performance with positive flows into CTAs and more than 25% of outflows for Distressed Debt. This is another proof of the tendency of investors to be momentum-driven.

Exhibit 1: Flows by strategy



Source: Eureka hedge

The liquidations of hedge funds have accelerated in 2009: a total of 469 hedge funds have disappeared from the HFR database between January 1st and June 30th. On the other hand, only 60 new hedge funds have been incorporated into the HFR database during H1 2009. This is 60% less than over the same period in 2008. This confirms that the current environment is extremely challenging for investment professionals who want to open new hedge funds. By netting out liquidated hedge funds from newly created hedge funds, one obtains a total attrition rate of 12% over the period. In other words, as of June 30th, there are 12% less hedge funds in the HFR database (our proxy for the industry) than on December 31st 2008.

#### The lower fees environment has not materialized

Contrary to expectations, there were no significant changes in both the level and the structure of fees taken by existing hedge funds. At the end of 2008, industry analysts expected the level of fees to decrease in order to reflect both the strong decrease in the demand for hedge funds and their disappointing performance. However, people

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

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did not consider the fact that, at the same time, the supply of hedge funds also changed significantly:

- The number of hedge funds has declined significantly (see above).
- Surviving funds are of better quality as bad performing funds generally did not survive the crisis.
- Surviving funds tend to be bigger as the attrition rate was much bigger for smaller funds than for long-established multi-billion funds.

On top of that, hedge fund managers face buyers who have themselves lost bargaining power (fund of funds for instance) and who are fragmented. Finally, there was also a timing issue as hedge fund investors had almost no new money to invest in hedge funds during the first quarter. During this period, the wave of redemptions was at its culminant point and hedge fund managers were then more than ready to negotiate more favorable terms with investors in exchange for new money. Given the strong recovery in the performance and the decrease in the outflows, there is a good chance that investors may not be able to negotiate significant fee reductions with existing hedge funds in the future. We think that investors will probably be able to negotiate lower fees with existing managers that are launching new products or with new hedge fund managers as they are still facing significant difficulties to raise money.

There has not been any significant change either in the way performance and management fees are paid out to hedge funds. Rolling and deferred performance

fees had been suggested in order to avoid excessive risk taking in an attempt to maximize performance fees - keeping in mind that paying performance fees is like attributing the manager a free call option struck at the high water mark – or make up past losses. We believe that there will be some changes in this area in the future. These changes will probably be inspired by new rules on the structure of the bonus payments that will be enforced within banking institutions.

### The positive consequences of the Madoff scandal

Even if the Madoff scandal caused irreversible reputational damages to the industry, it had one positive consequence: it forced hedge funds to become more transparent, and institutional quality to put operational issues at the forefront of their concerns. Several major industry players have taken the steps to improve the quality of both their operational setting (e.g. designation of an independent administrator) and their reporting. We hope that this trend is an irreversible one. In this context, it will be the responsibility of both investors and regulators to maintain the pressure on hedge funds in order to encourage them to pursue the changes that have been implemented since the beginning of the year.

### Be aware of the regulation trap

The financial crisis has shown that banks pose more of a threat to the financial system than hedge funds. Hence, it is highly surprising to see that the EU Commission's

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

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draft directive on Alternative Investment Fund Managers has been issued earlier than any concrete new directives on banking institutions. We have continued to re-iterate: Hedge funds were not responsible for the financial crisis and the ensuing economic recession. On one hand, we view enhanced disclosure requirements for hedge funds as desirable in the interest of managing systemic risk. Similarly, all measures aimed at improving investors' protection, such as mandatory registration by the SEC, are good for the industry. On the other hand, the part of the directive that suggests prevention of EU investors investing in funds without EU passport is extremely worrying for the industry as we risk facing loss of choice and consequently diminishing returns. We, as hedge fund investors, think that the additional layer of protection that we would receive via this directive is not enough to compensate us for the lower expected return.

This type of over-reaction to market breakdowns (adding inappropriate layers of protection and regulation as fast as possible) is reactive and dangerous. The risk is that, by trying to regulate a market entangled by complexity, regulators may compound future crises rather than extinguish them because inappropriate safeguards add even more complexity which in turn feeds more failures.

### Less than 1% of hedge funds have changed their liquidity terms

After the liquidity problems experienced by hedge funds in 2008, industry analysts expected a better alignment between the liquidity provided by hedge funds (e.g.

redemption frequency and lockups) and their underlying portfolio's liquidity. In other words, the expectation was that:

- Hedge funds that provide restrictive liquidity terms but trade liquid instruments would improve their liquidity terms.
- Hedge funds that provide non-restrictive liquidity terms but trade non-liquid instruments would worsen their liquidity terms.

In order to test whether there have been significant changes in the liquidity terms in the past 12 months, we compared the liquidity terms of the hedge funds that are in the HFR database as of May 30 2009 with their liquidity terms 12 months earlier. After exclusion of the duplicates (e.g. different fund classes), the sample of hedge funds contains 2659 funds. Out of these 2659 funds:

- 22 (0.8% of the funds) changed their redemption frequency,
- 36 (1.0%) changed their notice period,
- 22 changed their lock-up period.

The vast majority of funds that altered their liquidity terms worsened them: redemption frequency, notice periods and lock-up became generally longer. There are only few funds that improved their liquidity terms. Given the small numbers of funds that altered their liquidity terms, we did not analyze the changes by strategy as they would not be very representative.

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

### Exhibit 2: Changes in the liquidity terms of hedge funds

May 2009 versus June 2008

	Longer	Shorter
Redemption Frequency	15 (68%)	7 (32%)
Notice period	23 (64%)	13 (36%)
Lock Up	13 (59%)	9 (41%)

Source: OCM, HFR

It is somehow hard to believe that 99% of the funds that are listed in the HFR database have a liquidity that is perfectly aligned with the liquidity of their underlying portfolio. However, we can't rule out that some hedge funds have not (yet) reported eventual changes to database providers. Furthermore, we have seen several hedge funds that, for business reasons, have decided to leave the liquidity of their existing products unchanged whilst becoming much more conservative in their liquidity risk management and that plan to launch new funds with more restrictive liquidity where they intend to give investors access to highly illiquid securities' returns.

### Conclusion

After having experienced a severe contraction, hedge funds have had positive net inflows over three consecutive months since the end of May. At the same time, the number of hedge funds continues to decrease and there have been only very few successful hedge fund launches in 2009. This means that the inflows have benefited the survivors more than the newcomers. Given the reduction in the number of available

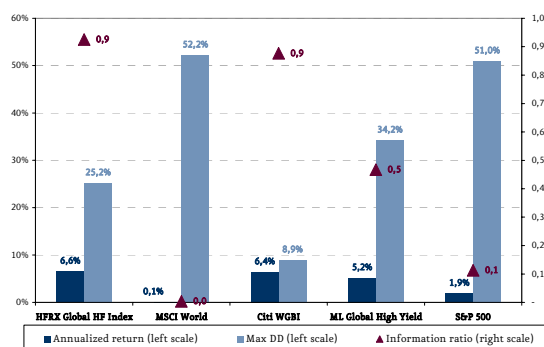
hedge funds, it is possible that existing hedge funds (the survivors) will not have to decrease the level of fees that they charge to investors. Finally, following a strong pressure from investors after the Madoff scandal, several hedge funds have undertaken significant changes in order to improve their operational framework.

## PART 2: PERFORMANCE OF THE INDUSTRY

### Beta-driven strategies are leading the race

As of July 31<sup>st</sup>, the HFR Global Hedge Fund Index is up 7.2% after a loss of 23.3% in 2008. As depicted by Exhibit 3, in the long run, hedge funds outperform all other asset classes both on an absolute and risk-adjusted (information ratio<sup>1</sup>) basis.

### Exhibit 3: Historical performance of hedge funds versus major asset classes January 1998 to July 2009



Source: OCM

The hedge fund strategies that did well during the first seven months of 2009 are

<sup>1</sup> The information ratio is computed as the annualized return divided by the annualized standard-deviation.

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

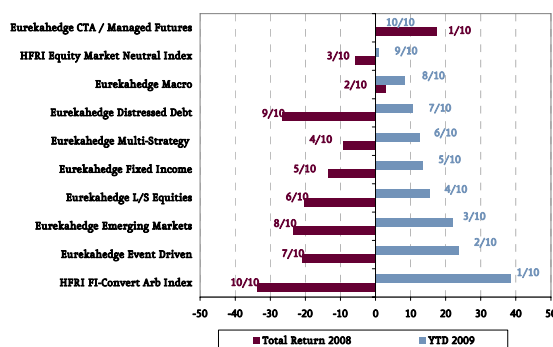
displaying at least one of the following characteristics:

- High exposure to less liquid assets.
- Positive exposure to corporate credit risk.
- Positive exposure to equities and in particular small capitalization companies.
- Negative volatility exposure or short gamma exposure.

The reverse is true for under-performing strategies. The four characteristics mentioned above are precisely those that have given rise to severe problems and poor performance for hedge fund managers in 2008. As a consequence, as shown in Exhibit 4, there is almost a perfect inverse correlation between the ranking of hedge fund strategies in 2008 and 2009. In other words, strategies that performed reasonably well in 2008 have underperformed in 2009.

### Exhibit 4: Performance of main hedge fund strategies

Year-to-date 2009 vs. 2008



Source: OCM, Eurekahedge, HFR

### Hedge funds are no longer in a period of simultaneous distress

CoVaR<sup>2</sup> is the Value-at-Risk of hedge fund strategies conditional on other strategies being under distress. An increase in the CoVaR indicates an increase in spillover risk among hedge fund strategies. The level of CoVaR also provides a good indication on how much exposure hedge funds have to systemic risk.

As depicted in Exhibit 5, CoVaR has been decreasing significantly since the end of 2008. The current level of our CoVaR measure<sup>3</sup> is now below its pre-Lehman level. This is the result of:

- The significant decrease in both funding and liquidity risk.
- The significant decrease in correlations within and across asset classes.

This improvement in the diversification benefits provided by hedge funds will lead to a decrease in the volatility of fund of hedge funds.

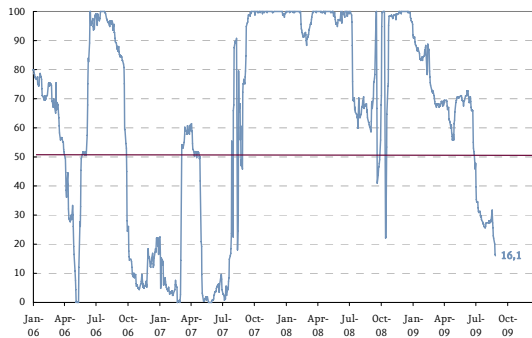
<sup>2</sup> See T. Adrian and M.K. Brunnermeier, 2008, CoVaR, Working paper available on [ssrn.com](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1269446), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1269446](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1269446).

<sup>3</sup> Instead of using the absolute value of the CoVaR measure, we use its rank in order to better capture its change through time and normalize its value between 0 and 100.

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

### Exhibit 5: CoVaR of hedge fund strategies

Rank CoVaR between January 2006 and July 2009



Source: OCM, HFR

### Leverage levels are still below historical highs

Given the stabilization of capital markets, the decrease in volatility, the renewal in risk appetite and the improvements in financing conditions, one might assume that hedge funds have increased leverage during 2009. We use the absolute value of the dynamic (Kalman filter) beta exposures of hedge fund strategies as a measure of leverage. This measure is far from being perfect but it gives a good proxy of the tendency towards leverage within the hedge fund industry.

Exhibit 6 demonstrates the leverage of hedge fund strategies as of the end of July 2009 as compared to the averaged 2008 level as well as historical highs. We clearly see that:

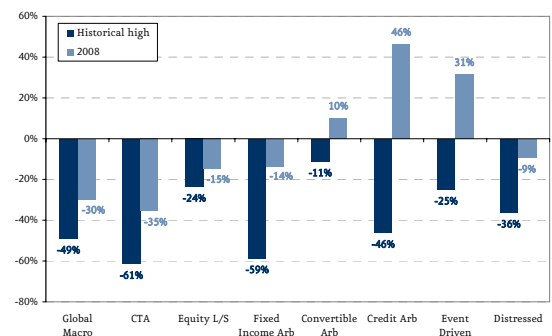
- The industry is still on a defensive stance as the level of leverage is far below historical highs.
- Most of the strategies are still running at leverage levels that are below their 2008 level. The most defensive strategies being CTA and

Global Macro whereas the most aggressive ones are relative value strategies which are, by their very nature, the biggest consumers of leverage.

These results are reassuring for three reasons. First, they show that hedge fund managers have learnt from the crisis as excess leverage was the worst performance detractor of the industry. Second, despite the significant decrease in volatility, there are still significant uncertainties regarding the long-term shape of the economic recovery and the historically low leverage numbers indicate that hedge fund managers do acknowledge it. Finally, they also demonstrate that hedge funds do not need excessive leverage numbers in order to generate good returns if the volatility is sufficiently high.

### Exhibit 6: Leverage of hedge fund strategies

Percentage change in leverage between July 2009 and 2008 as well as historical high



Source: OCM, Eurekahedge, HFR

### Hedge fund strategies exposures

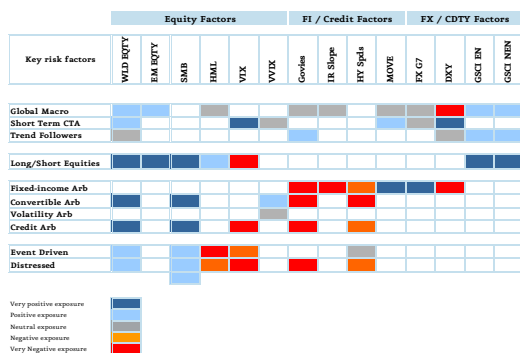
One of the main advantages of hedge funds over mutual funds is their ability to dynamically allocate their risk across or within asset classes in response to changing

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

market opportunities. We report the risk exposures of hedge fund strategies in Exhibit 7. These exposures are computed by stressing major risk factors and measuring the impact of these stress tests on the return of the strategies. It is important to note that we take the correlations between risk factors into consideration. For instance, if we stress the MSCI World Index, it will also stress both the S&P 500 and the MSCI Europe indices which are positively correlated to the MSCI World. This gives us a better picture of the strategies' exposure but can lead to some spurious results especially after a period of very high correlations across risk factors like during the second half of 2008.

### Exhibit 7: Current exposures of hedge fund strategies

Stress tests applied to major hedge fund strategy indices as of June 30 2009<sup>4</sup>



Source: OCM

We will not discuss the results for each strategy in detail, but there are four important points that emerge from Exhibit 7:

- Hedge funds have been able to profit from the equity and the credit market rally as all hedge fund strategies that traditionally invest

in these asset classes have a positive exposure to either equity (WLD EQTY) or credit markets (HY Spds); some strategies (e.g. Credit Arb.) have exposures to both.

- These same strategies are now significantly short equity market volatility (VIX). As a consequence, they are now much more vulnerable to a significant increase in market volatility.
- With the exception of a significant (but probably over-stated) short dollar exposure (DXY), Global Macro managers are running very defensive portfolios. This reflects the general skepticism of Global Macro managers regarding the sustainability of the economic recovery.
- Short-term CTA is the only strategy that provides protection against an increase in equity (VIX), interest rates (MOVE) and currency (FX G7) volatility.

### Fund of Funds: last year's winners are this year's laggards

As of the end of July 2009, the Eureka hedge fund of funds Index was up 5.6% for the year after having lost 19.5% in 2008. In order to determine which fund of funds performed the best in 2009, we have ranked all fund of funds of the HFR database that are still alive as of June 30 2009 based on their 2008 performance and then computed the 2009 year-to-date performance of each rank decile. For instance, the members of

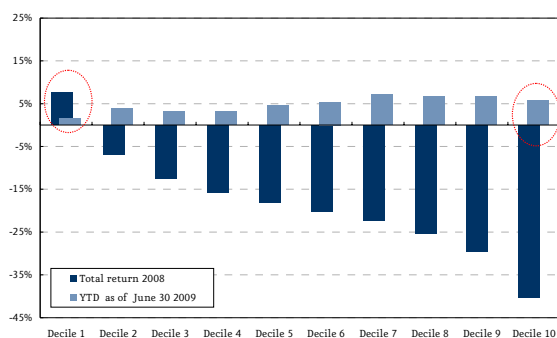
<sup>4</sup> A detailed description of the different risk factors is provided in the Appendix of this document.

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

the first (tenth) decile are the 2008 best (worst) performers.

### Exhibit 8: Fund of Funds performance in 2009

2009 year-to-date vs. 2008



Source: OCM, HFR

By looking at Exhibit 8, one can clearly see that fund of funds that performed decently in 2008 are lagging in 2009. The rank correlation between the 2008 and 2009 returns of the different deciles is close to one at -0.85.

The main explanation for this significant reversal is to be found in the reversal of the hedge fund strategies' performance that we outlined above. In 2008, the losers were punished for aggressive allocations in strategies and hedge funds that were heavily exposed to illiquid instruments and that were running leveraged directional portfolios. This year however, the 2008 winners' asset allocation was heavily tilted toward liquid and less levered strategies such as Global Macros and CTAs that are lagging significantly in 2009.

One could conclude from this that some fund of funds' managers have a static asset allocation and a very low forecasting ability for outperforming strategies. This is not entirely true. Indeed, during the first half

of 2009, fund of funds (both winners and losers) faced significant outflows which forced them to maintain their portfolios as liquid as possible. In these conditions, it was nearly impossible for last year's winners to invest significant amounts in less liquid managers. Similarly, given the number of hedge funds belonging to the 2008 losing strategies that restricted their liquidity at the end of last year, a significant number of the losers' group likely had no other choice but to stick with their 2008 positions.

### Conclusion

The performance of the hedge fund industry has clearly improved during H1 2009. This good performance is mainly due to beta-driven strategies and exposure to illiquid financial instruments. Furthermore, the performance of hedge funds in 2009 was not achieved via excessive leverage as the high volatility environment that prevailed until the end of Q2 2009 did not necessitate high level of leverage. With the stabilization of the financial system, the vulnerability of hedge funds to systemic risk has come down. As a consequence, if there is no revival of systemic risk, hedge funds should be able to provide diversification whatever the future direction of financial markets. Finally, the reversal in the performance of hedge fund strategies in 2009 caused reversal in the performance of funds of funds: last year's winners are generally lagging their peers in 2009.

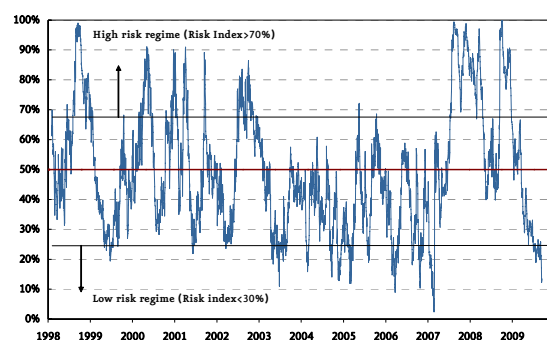
## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

### PART 3: WHAT CAN WE EXPECT FROM THE INDUSTRY IN THE CURRENT MARKET ENVIRONMENT?

#### Markets are back in a low risk regime

With the stabilization of the financial system, investors' risk appetite has increased significantly in 2009. The aggregate level of risk in the financial system has decreased to levels that are close to the pre-crisis (July 2007) ones. Given the high economic uncertainties that are still prevailing, we think that this move is highly premature. As a consequence, we would not be surprised to see an increase in the volatility of risky assets during the forthcoming months.

Exhibit 9: Olympia risk index  
January 1997 to July 2009



Source: OCM

#### The probable end of expansionary fiscal and monetary policies

Central Banks and Governmental actions has been able to restore financial stability and stabilize the economy. The period of both

monetary and fiscal stimulus is now probably over and both Central Banks and Governments will start to think about the long-run situation of both their economies and their budgets. At the same time risky assets have rallied significantly reflecting the improvements in the global economy but also as a consequence of massive inflows of liquidity. In our opinion, the recent price appreciation of risky assets goes beyond what the potential growth of the economy might justify. It can't be ruled out that it will continue for a while based on further (but transitory) economic improvements and further liquidity inflows on the part of investors that have missed the start of the rally. However, in the long run, asset prices cannot keep exceeding the growth potential of the economy without the rally morphing into a speculative bubble.

In these conditions, we view three possible scenarios ranked in order of likelihood:

- At the end of 2009 or earlier, markets start to be impacted again by fundamentals rather than by technicals (liquidity) and this will translate into a contraction in both equity and corporate bond prices in order to better reflect the fundamental economic situation.
- Risky asset prices continue to rise at this pace for the next six months and this leads Central Banks to tighten their monetary policy sooner than what the market expects.
- Risky asset prices continue to rise at this pace for longer than six months resulting in a new speculative bubble (and we all know how those always finish up).

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

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### Impact on our strategy allocation

The worst enemy of hedge funds is not a bearish equity or bond market but rather a global contraction in market liquidity. As a consequence, except if the third scenario materializes (the probability is positive but very low and it will not happen soon), an allocation in hedge funds will be able to provide diversification benefits to investors even if both equities and credit re-enter into a bear market. However, in order to perform well in this highly uncertain environment, we believe that the three objectives that we have been pursuing since the beginning of the year in our portfolios are still valid ones. Indeed, we will continue to:

- Maintain market directional exposure at a reasonable level in order to protect the portfolio against any significant equity or credit market correction.
- Keep a significant part of our portfolio in liquid strategies in order to shift our allocation if markets come under significant stress.
- Favor trading-intensive managers that have the ability to react promptly (1 to 2 months) to any major change in the market environment whilst profiting from the short-term opportunities provided by the current environment.

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

### Outlook for the strategies

Strategy	View	Key decision drivers
Global Macro	Bullish	<ul style="list-style-type: none"> <li>• Trading-intensive</li> <li>• Moderate equity exposure</li> <li>• Macro-driven market environment</li> </ul>
Long/Short Equities	Bullish	<ul style="list-style-type: none"> <li>• Dispersion will increase again once liquidity-driven flows decline.</li> <li>• Trade liquid instruments.</li> <li>• We continue to favor stock-pickers over beta players.</li> </ul>
Emerging markets	Neutral	<ul style="list-style-type: none"> <li>• The recovery will be stronger in emerging economies → above average long-term performance for emerging equities.</li> <li>• Some countries (e.g. China) will have to tighten their fiscal and monetary policy soon → short-term volatility in the equity market.</li> <li>• We favor managers that have a macro-driven top-down approach over pure stock-pickers.</li> <li>• Avoid managers with constant high directional exposure.</li> </ul>
Commodity traders	Bullish	<ul style="list-style-type: none"> <li>• Diversification benefits for the portfolios as the correlation to equities has decreased significantly.</li> <li>• Positive beta to the economy if the recovery scenario proves to be durable.</li> <li>• Trading-intensive.</li> </ul>
Trend followers	Neutral	<ul style="list-style-type: none"> <li>• Provide protection and positive convexity to the portfolios: long gamma strategies.</li> <li>• Long-term trend followers will profit if there is any durable equity market correction or as soon as Central Banks start to tighten their monetary policies.</li> <li>• Short-term trend followers behave better than long-term ones in markets with frequent trend-reversals → continue to overweight short-term traders over long-term ones.</li> </ul>
Credit	Neutral	<ul style="list-style-type: none"> <li>• Markets have recovered more than what fundamentals dictate.</li> <li>• Credit is not a macro trade (play the recovery by going straight long) any more but rather a micro trade (long/short).</li> <li>• Better risk/return tradeoff than equities even at these levels.</li> <li>• Illiquid.</li> </ul>
Volatility traders	Neutral	<ul style="list-style-type: none"> <li>• Provide protection and positive convexity to the portfolios.</li> <li>• The current low level of volatility is not justified by economic fundamentals.</li> <li>• Negative carry (time decay) in the current low volatility environment.</li> </ul>
Quantitative Long/Short	Neutral	<ul style="list-style-type: none"> <li>• Dispersion will increase again once liquidity-driven flows will decline</li> <li>• Their strong value bias can be detrimental in the current environment</li> </ul>
Convertible Arbitrage	Neutral	<ul style="list-style-type: none"> <li>• Illiquid.</li> <li>• Long credit → the strategy does not provide protection to the portfolios.</li> <li>• The convertible bonds have recovered the major part of their losses.</li> <li>• The high level of new issuances will probably continue as corporations will need to refinance → good for the strategy.</li> </ul>
Merger Arbitrage / Special Situations	Bearish	<ul style="list-style-type: none"> <li>• Illiquid.</li> <li>• Value-driven and focused on small capitalizations (they have outperformed significantly in H1 2009).</li> <li>• The M&amp;A activity will stay low as long as 1) financing facilities remain scarce and 2) corporations continue to accumulate cash reserves.</li> </ul>
Multi-Strategy	Bearish	<ul style="list-style-type: none"> <li>• Illiquid.</li> <li>• Unable to allocate capital dynamically.</li> <li>• Opaque.</li> </ul>

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

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### CONCLUSION

After the disappointing performance posted by hedge funds in 2008, hedge fund investors expected the industry to question its internal practices and improve performance. Regarding practices, we view the improvement in both the operational setting and the transparency of some hedge funds as very positive. However, as outlined in this research, we believe that there is still room for further improvements in the way hedge funds structure their performance fees, in the liquidity terms provided to investors and also to a great extent in the quality of their reporting.

As far as performance is concerned, there have been major improvements. The major driver of this improvement is the return of liquidity on global markets as liquidity is the key ingredient for steady returns for hedge funds over time. In regard to the current conservative level of leverage used by the industry, we believe that managers have drawn lessons from what happened in 2008. We clearly hope that the volatility of risky assets will not return to its July 2007 levels for a long period of time. If markets were to become that complacent, not only hedge funds but the whole economy will probably be highly levered again and it will be time to think about the burst of the next speculative bubble.

We would like to thank you very much again for the trust that you have shown us all over these years and we remain at your disposal if you were to have any additional questions.

Guido Bolliger  
Chief Investment Officer

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

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### APPENDIX

#### Exhibit 5 – Olympia Hedge Fund CoVaR Indicator

The OCM CoVaR indicator is a coincident gauge for hedge fund tail co-movements. The higher is the CoVaR, the greater is the risk that the HF strategies will hit their VaRs simultaneously. The index is computed using HFRX daily indices using a 250-rolling window. The index ranges from 0% to 100: an index of 100% (respectively 0%) indicates that the CoVaR has reached a 250-day high (respectively low).

#### Exhibit 7 – Risk factors definitions

The Table represents stylized exposures of the main hedge fund strategy indices. The indices used are the following: HFRI Macro (Total) Index, Alternative Edge Short-Term Traders, Eurekahedge CTA / Managed Futures HF Index, Eurekahedge Emerging Markets Macro HF Index, HFRX Commodity Index, HFRI Equity Hedge (Total) Index, HFRI EH: Equity Market Neutral Index, HFRI EH: Quantitative Directional, HFRI EH: Energy/Basic Materials Index, Eurekahedge Fixed Income HF Index, HFRI RV: Fixed Income-Convertible Arbitrage Index, HFRX Volatility Index, HFRX Credit Arbitrage Index, HFRI ED: Merger Arbitrage Index, HFRI ED: Distressed/Restructuring Index.

For every strategy index, a dynamic multifactor model is estimated using a wide set of macro risk factor; the set of relevant factors is set by using a full stepwise methodology. The chart above presents the results of the regression in a stylized way. A coloured box indicates that the corresponding factor is relevant to explain

the past performance of the index; a blank box indicates on the opposite that the corresponding factor is not found to be a key risk factor for the index.

The factor list is the following:

**WLD EQTY** = the World equity directional risk,

**EM EQTY** = Emerging equity directional risk,

**SMB** = Small minus Big Caps equity return differential,

**HML** = value stocks minus growth stock return differential,

**VIX** = equity volatility (VIX index),

**VVIX** = the volatility of the VIX index,

**Govies** = US Government bond total return,

**IR Slope** = interest rate slope as measured by the 10Yr / 3months interest differential,

**HY Spds** = corporate high yield spreads,

**MOVE** = short-term implied volatility of US Government bonds,

**FX G7** = implied volatility of the G7 cross rates,

**DXY** trade-weighted USD index,

**GSCI EN** = Energy GSCI index return,

**GSCI NEN** = non-energy GSCI index return.

## Hedge Funds 12 Months After September 15: Emerging From The Wreckage

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### Exhibit 9 – Olympia Risk Perception Index

The market risk index aims at gauging the current risk perception in the main financial markets.

The index is a contemporaneous, not a leading, risk indicator. The index is made of six components: 1/ equity volatility as measured by the VIX index, 2/ FX (G7) implied volatility, 3/ bond volatility as measured by the MOVE index 4/ credit risk premium as measured by the High Yield spread 5/ illiquidity risk as measured by the TED spread 6/ the equity/bond correlation that captures flight-to-quality episodes. For each component, the latest value is ranked using a 250-day window. The market risk index is computed as the arithmetic mean the rank percentiles of the six components. A market risk index of 100% (respectively 0%) indicates that every components of the index is at a one-year highest level (respectively one-year lowest), hence that risk perception is at its highest level over the last 250 days.

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