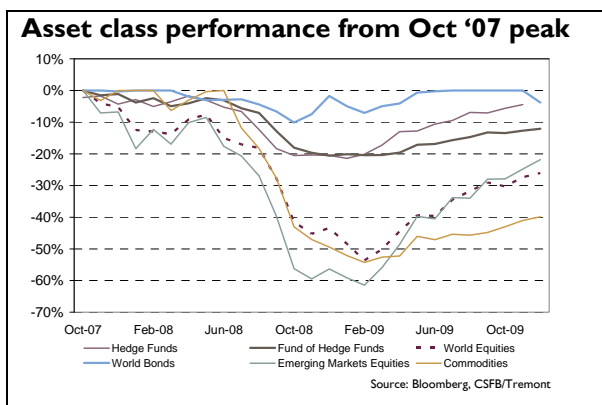


Hedge funds: restoring credibility

Despite its recent status as the scapegoat for all that went wrong during the credit crisis, the hedge fund industry as a whole substantially outperformed other risk assets over the period of the downturn and the subsequent recovery. This year hedge funds seem set to further restore their credibility and to add value within a diversified investment portfolio. In what we believe will be an environment of more modest returns for investments generally, against a backdrop of continued volatility, history suggests hedge funds could continue to post favourable gains. Further intervention by monetary and fiscal authorities in many parts of the world is also likely to create attractive opportunities for some hedge fund strategies in particular.

Relatively unscathed by the crisis



The hedge fund industry has come through the carnage of the credit crisis with superior returns to other risk assets, such as equities and commodities, over the two years since the turmoil began. The chart above, tracking the performance of various asset classes from the peak for risk assets in late 2007, shows that the unfolding financial crisis left investors in equities, particularly in emerging

markets, and commodities with substantially larger losses that still need to be recovered. Indeed, two years on from the October 2007 peak, 28% of all hedge funds tracked by Credit Suisse/Tremont had recouped all of their losses.

Dispelling the myths

With the crisis having passed, perceptions that hedge funds were overly reliant on leverage and doomed to extinction in a world of tighter credit are being seriously challenged. Ironically, it was the highly-regulated banking sector, not the hedge fund industry, which suffered spectacular collapses and took the global economy to the brink of depression.

Funds of hedge funds have indeed suffered an exodus, with assets under management almost halving from their peak in the first half of 2008 to their trough at the end of that year. However, since the third quarter of 2009, hedge funds have seen net inflows again. Hedge funds in general are not as dependant on leverage as generally perceived, with only some managers and specific strategies employing leverage to magnify returns. Although the new environment of tighter and costlier credit will certainly change the game for some managers, the main factors for success remain the ability to anticipate market developments and pick the right securities.

Hedge funds are well positioned

The moment of truth may have arrived for hedge funds. Their strong 2009 performance was not so surprising in an environment of rapidly receding risk aversion, massive government-sponsored liquidity and a normalisation of extremely distressed market conditions. The going is likely to get tougher for financial markets compared to last year, as we have argued in our *2010 Investment Outlook: Sailing Into the Wind*. Our central scenario foresees relatively modest positive returns for

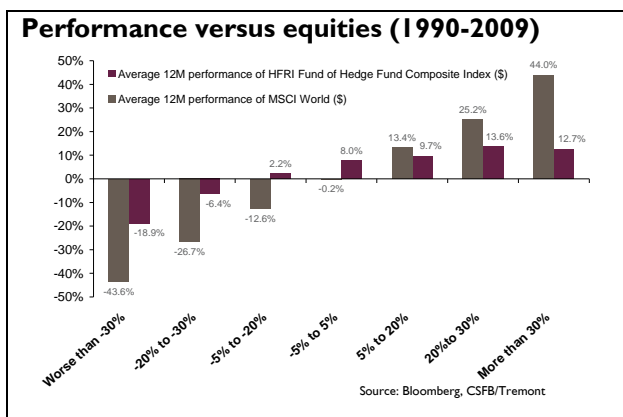
Carl Astorri
+ 44 20 7753 1612
firstname.lastname@coutts.com

Jean-Maurice Ladure
+ 44 20 7753 1469

Henry Lancaster
+ 44 20 7957 2426

Georgios Tsapouris
+44 20 7753 1888

equities and credit markets compared to 2009, while we expect volatility to remain high.



In past early recovery phases of the economic cycle equities have posted modest average real returns (adjusted for inflation) of 5% per annum, having already anticipated recovery and rallied strongly during the late recession stage. In periods of modest equity returns, hedge funds have historically produced favourable relative returns (see chart above). This suggests that funds of hedge funds would represent an attractive option against the backdrop of our central scenario. Even if stock markets surprise to the upside, the 'missed opportunity' may be limited in size.

In this more challenging environment asset allocation, anticipating developing trends and picking the right securities to be long or short of will be important. A simple buy-and-hold strategy, which worked very well for the brave investors who bought stocks as equities hit bottom in March 2009, may not be enough to generate attractive returns in the year ahead.

Spotting the best hedge fund opportunities

Taking into consideration our house view, strategy diversification and tilting portfolio weights towards the most promising strategies will be key in 2010, rather than just picking the best managers.

Credit managers specialising in structured instruments and distressed assets probably have some of the best opportunities in front of them. The credit rally of the past year was most pronounced in high-yield and investment-grade bonds and in leveraged loans. However, there is

still a good amount of 'normalization' yet to come for structured credit and distressed securities.

Event-driven managers, including merger arbitrageurs, are likely to find rich pickings for an extended period of time, with plenty of corporate restructurings and strategically motivated merger transactions to come. In the absence of robust economic and earnings growth, companies are likely to seek growth through acquisition. The departure of a number of market participants has also helped increase spreads in merger transactions considerably.

Long/Short Equity managers could be looking at an ideal environment, if it proves to be one of modest equity returns in general as we envisage. They should be able to capture a good part of the (more modest) upside, while also being able to make money on short positions. **Commodities** managers could also prosper in an environment of growing commodity demand in the medium term.

New regulations bring some uncertainty

To be sure, the hedge fund industry does face many uncertainties, not least of which is pending legislation in the US and Europe that is likely to lead to stricter regulation. Hedge funds have accepted the need to provide transparency and liquidity to investors within a stronger regulatory framework. However, these new pieces of legislation are subject to intense negotiations, and it is unlikely that there will be enough clarity to assess the consequences before mid-year.

Summary

Returns for many risk assets are likely to become more modest, while volatility is expected to continue and the regulatory environment is becoming more restrictive. In this environment, funds of hedge funds have the advantage of being able to capture opportunities unavailable to traditional long-only funds and to apply industry and investment knowledge to help investors navigate more challenging times. We remain confident that, having emerged from the credit crisis in better shape than most other risk assets, hedge funds will continue to prove their worth within a well diversified portfolio.

Carl Astorri
+ 44 20 7753 1612
firstname.lastname@coutts.com

Jean-Maurice Ladure
+ 44 20 7753 1469

Henry Lancaster
+ 44 20 7957 2426

Georgios Tsapouris
+44 20 7753 1888

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