

In what has been the worst-ever year on record for funds-of-hedge-funds, the question being asked is whether the basic fund-of-hedge-funds model is flawed. We feel the basic investment idea behind the FOHF model (manager/strategy diversification and investing in funds that pursue absolute returns as opposed to those that are long-only and benchmark constrained) is sound. If anything, the year 2008 demonstrated very clearly the risk associated with long-only index-driven investing. Although most hedge funds failed to deliver positive absolute returns in 2008, drawdowns were lower than for mainstream funds and indices (the average global multi-strategy FOHF lost about 18%, while the S&P Global 1200 fell 40.1% in 2008). Moreover, despite the worst-ever conditions for hedge funds, very few FOHFs have closed down as a result, while the same has not been true of single-manager hedge funds.

While we feel the basic idea behind the FOHF model is robust, recent market conditions have exposed a weakness in the liquidity structure, in particular the mismatch between the dealing/redemption notice period offered by the FOHF and the liquidity of its own portfolio. Most funds-of-hedge-funds have monthly dealing and had redemption notice terms of about a month. Their portfolios include many hedge funds that deal monthly and require about a month's notice for withdrawals.

However, funds with longer notice periods and lock-ups are also included, which created a mismatch between the notice period for withdrawing from a FOHF and the time in which the portfolio could be liquidated. In the past, this did not matter because inflows exceeded outflows, and in the

Highlights

- In 2008 the average global multi-strategy fund-of-hedge-funds (FOHFs) lost 18%, which is the worst calendar-year performance on record. Nevertheless, this was considerably better than long-only investing in equities, and compares with a -40.1% return on the S&P Global 1200 index.
- About 20% was withdrawn from rated FOHFs during the fourth quarter of 2008, and redemptions have continued into the first quarter of 2009.
- The past six months have exposed weaknesses in fund-of-hedge-funds' liquidity structure.
- About 18% of rated FOHFs have either suspended or gated investor redemptions, 10% have side-pocketed illiquid investments and 41% have changed their dealing/redemption notice terms.
- Investor withdrawals from FOHFs typically require three months' notice now, compared with about 30 days 12 months ago.
- FOHF managers are cautious in the short term, but some see unprecedented opportunities for hedge funds once liquidity has been restored.

event of net withdrawals most FOHFs had a credit facility that was available to meet the mismatch (typically 25% to 50% of NAV). However, credit facilities provided by banks have looked increasingly unreliable in 2008 as bank lending capacity has reduced.

This was tested during the fourth quarter as investor withdrawals from funds-of-hedge-funds escalated. We estimate that the average rate of withdrawals from S&P-rated funds-of-hedge-funds during the fourth quarter was about 20% of NAV. The situation has quickly become self-feeding as FOHFs have been gated on their withdrawals and have recognised that bank credit may not be reliable. They have therefore put in more redemption notices than needed to meet their own investor withdrawals on the basis that if not needed, the requests can be withdrawn at the last minute.

However, the resulting avalanche of withdrawal requests faced by hedge

funds has caused more of them to suspend dealing or gate withdrawals than could have been expected from the underlying investors alone cashing in. In this update, we have therefore focused on changes in liquidity, most of which took place during the fourth quarter of 2008.

Our survey of funds-of-hedge-funds revealed that about 18% of them had been forced to suspend or gate investor withdrawals and about 10% of them had been forced to side-pocket illiquid hedge-fund holdings. About 41% of rated FOHFs have changed their dealing/redemption notice terms during the past six months. Most now have a notice period for investor withdrawals of about three months.

We feel there is some justification for lengthening the notice period in the current environment and are more comfortable with this than the imposition of gates or use of side-pockets. However, after the dust has

settled we would like to see notice redemption periods come back down again. We would also like to see much greater resistance by FOHFs to lock-ups and long redemption notice periods by hedge funds, particularly outside of naturally illiquid strategies like asset-based lending and investing in distressed securities.

Recent experience underlines the importance of keeping portfolio liquidity in line with the FOHF notice period, without placing too much reliance on credit to bridge a mismatch. We also believe some of the funds managed for absolute-return consistency making full use of Ucits III-sophisticated provisions merit consideration for a FOHF's portfolio since they offer daily dealing and good transparency. Addressing the liquidity structure is the main priority, but we would also like to see more transparency and a more questioning approach to the fee structures of the underlying hedge funds.

Our review focused primarily on FOHF liquidity. However, during the course of it we found some managers who were optimistic about the second half of the year. Charles Hovenden, CIO of Absolute Fund Management, has for many years been one of the more cautious FOHF managers. However, he thinks "once-in-a-career" pricing anomalies created within securities markets in the wake of the credit crisis should see the Absolute Fund deliver its strongest ever 12-month period. He agrees with the majority that for these opportunities to be realised we need to see a break in the vicious cycle of forced selling, so that investment fundamentals begin to drive asset prices again. In contrast, David Smith at GAM is wary that poor macroeconomic and corporate data releases could give rise to renewed volatility within financial markets. He felt this could provide further opportunities to trading-oriented managers.

HDF also remains cautious on equity markets and therefore wants minimal directional exposure. Long/short equity hedge fund managers held within its funds have below 10% net long exposure in aggregate.

The Turnstone European Fund invests only in long/short equity hedge funds. Its underlying net long position is similarly very low currently, at 2%. The fund's manager, Amanda McCracken, believes equities are in a structural bear market, so she is wary that the post-October 2008 rally may prove to be a false dawn. She reports that managers held in the fund's portfolio have used the rally to increase their short books in overly indebted companies within the industrial, retail and commercial real estate sectors, in the belief that they are most vulnerable to deteriorating macro and corporate newsflow.

On a contrarian note, some of them have closed out short positions in banks and built small long positions. This was on the basis that this may be one of the few sectors in which there is pricing power during the current recession, following the sharp reduction in product availability, particularly in areas like buy-to-let mortgages.

Fundana also shows a cautious outlook, with the underlying aggregate net long position on its Prima Capital Fund at 3% in January 2009.

Just before we began our update on the funds-of-hedge-funds sector, the news that Bernard Madoff had been arrested on charges of fraud by the SEC was announced. It is disappointing to report that seven S&P-rated FOHFs had exposures to funds directly or indirectly advised by Madoff Securities and we immediately placed them Under Review. They are RMF Four Seasons; DGC Pendulum (managed by Notz Stucki); Bonhote Multi-Arbitrage; Dinvest Total Return Fund (managed by UBP); Dinvest Concentrated Opportunities Fund (also UBP); Constantia Low Volatility (advised by Notz Stucki and managed similarly to DGC Pendulum); and Constantia Composite (also advised by Notz Stucki).

Our Under Review process has involved further discussion with the relevant team's risk officers to understand why the exposure to Madoff

was originally taken and how it evaded the team's ongoing surveillance.

The Absolute Fund

Absolute Fund Management has not changed the liquidity terms of its S&P-rated Absolute Fund, and all redemptions have been met without suspending or gating withdrawals. However, side-pockets have been implemented for about 3% of the portfolio's investments.

The fund was down 9.2% on the dollar share class (-8.9% on the sterling class) in 2008. This is one of the only global multi-strategy FOHFs that have limited losses to a single digit in 2008. The loss is still a disappointment to the fund's manager Charles Hovenden, although he is optimistic about being able to make up for it over the next two years. He believes the "once-in-a-career" pricing anomalies created within securities markets in the wake of the credit crisis should see the Absolute Fund deliver its strongest ever 12-month period, surpassing the 15% its strategy made in 1999.

Hovenden expects some of the best returns to come from long/short equity hedge funds and has been increasing the allocation to this strategy, which now represents about 60% of the portfolio.

Antarctica

The Antarctica Market Neutral Fund experienced withdrawals amounting to about 10% of NAV during the fourth quarter, leaving the fund at \$880m at the end of December 2008. Antarctica has not changed its dealing terms (still monthly with 80 days' notice) and it has not had to suspend or gate any of its investor redemption requests. However, it has side-pocketed a small number of fund holdings that have suspended redemptions or are in liquidation.

Bonhote

Bonhote Multi-Arbitrage had a 7.4% holding in Kingate (as at 30 September 2008). This was held from launch of the fund in 1997 and has grown to its current size through outperformance, without ever being added to. The managers planned to reduce the holding to 5% of the

portfolio and put a partial redemption in during August. However, Bernard Madoff was charged before the redemption took effect. The fund is currently Under Review.

Bonhote Multi-Performance, which is managed in a partially directional style, did not have any exposure to Madoff and remains S&P A rated.

We spoke with Bonhote and PrismInvest (the fund adviser) at the beginning of February 2009 about fund liquidity. Neither of the two S&P-rated funds have experienced significant outflows (less than 10% each so far), dealing and redemption notice terms remain unchanged, all investor withdrawal requests have so far been met without the need to suspend or gate redemptions, and no investments in the two funds have been side-pocketed.

Commerzbank

Commerzbank suspended dealings temporarily for Comas Asia Growth in December 2008 and also took the same action on Comas Global Alternatives, Comas Strategy Fund and Comas ELinAS in January 2009. The Commerzbank alternatives team reports that the suspensions are due to withdrawal requests from its own hedge fund investments being suspended and gated. For each of these funds, the percentage of the portfolio invested in funds that have either suspended or gated redemptions is: Comas Asia Growth 17%; Comas Global Alternatives 14%; Comas Strategy Fund 50%; and Comas ELinAS 20%.

Commerzbank's other rated funds (Comas Global Opportunities, Comas Global Alternatives Enhanced and Commerzbank Global Alternatives R) remained open to investor redemptions during the fourth quarter. Commerzbank has not changed the redemption notice period on any of its rated funds-of-hedge-funds and it has not side-pocketed any of the funds' investments to date.

Across the Commerbank alternatives team's range of funds-of-hedge-funds its equity long/short hedge fund investments have done relatively well. ELinAS lost 5.8% in 2008 (about the best we have seen from a

fund that is primarily invested in long/short equity hedge funds) and Comas Asia Growth's 16.8% decline does not look good in absolute terms, but compares very well with long-only and other FOHFs focused on the region.

However, its relative value arbitrage hedge fund investments have not performed well, and the Comas Strategy Fund, which has a bias towards relative value arbitrage funds, lost 25.7% in 2008. The Comas Global Opportunities Fund was the team's best performer in absolute terms, down only 2.9%. It is primarily invested in CTAs and global macro hedge funds, which have proved defensive in the past 12 months.

Deka-HedgeSelect Fund

Deka has made no change in the fund's dealing terms and has neither suspended nor gated any investor withdrawal request. Moreover, it has not side-pocketed any investments. Overall, the fund remains highly liquid and transparent due to its approach of investing only through managed accounts. At the end of September, when we conducted our annual review of the portfolio, 100% of the holdings could be converted into cash within one month, 38% could be liquidated within a week and 30% could be realised within one business day. According to RMF, who advises the portfolio, the liquidity position had not changed materially from this by the end of December 2008.

Fortune

Fortune has not changed the dealing or redemption notice terms of its S&P-rated Fortune Horizon Fund. All redemptions from the fund have been met, without the need to suspend or gate requests or to side-pocket any investments despite its high exposure to activist managers 12 months ago. These were almost entirely removed (two small positions remain - Pardus and Wyser Pratt Eurovalue) from the portfolio in March 2008.

Fundana

During the fourth quarter of 2008, Prima Capital Fund and Trocadero Capital Holdings met investor

redemptions amounting to 27% and 24% of NAV. Fundana met these without changing the dealing or redemption notice terms and without having to suspend or gate investor withdrawals and without having to put any of the funds' investments into side-pockets.

During 2008 Trocadero Capital Holdings returned -20.8% and Prima Capital Fund declined by 17.8%. The latter is almost entirely invested in equity long/short hedge funds. Reflecting Fundana's caution on the outlook, the underlying aggregate net long position within Prima Capital's portfolio was 3% at the beginning of January 2009.

GAM

GAM has increased the redemption notice period on Diversity, Global Multi-Alpha, Multi-Star Diversity and GAM Trading II to 95 days, and has extended the notice period on GAM Multi-Emerging Markets to 45 days. It has also introduced standard provisions across its multi-manager range to give the directors the ability to limit, if required, the total redemptions that may be dealt in a fund on any one dealing day.

During 2008 GAM's rated funds-of-hedge-funds have proved more defensive than comparable peers. GAM Diversity lost 15.8%, GAM Multi-Star Diversity lost 13.0%, GAM Multi-Emerging Markets lost 24.6%. GAM Trading II was one of the rare funds-of-hedge-funds to have made money during the full calendar year, returning 5.8%. In contrast with most funds-of-hedge-funds, it had a good fourth quarter (+3.3%) with all of its sub-strategies except systematic macro contributing positively.

Looking forward, David Smith is wary that poor macroeconomic and corporate data releases could give rise to renewed volatility within financial markets. However, he felt this could provide further opportunities to trading-oriented managers. Within emerging markets, Kier Boley sees opportunities in local currency emerging markets and expects to add some bond focused managers who may be able to take advantage of them.

HDF

HDF has not changed the dealing and redemption notice terms on any of its funds, except for Eurovest where it has replaced its old quarterly +90 days' notice with the current monthly with 45 days' notice subject to a 10% gate. This represents an improvement in liquidity because any withdrawals gated under the new terms have to be paid to investors once the former quarterly +90 days' notice has elapsed. During the fourth quarter the group's S&P-rated funds incurred redemptions of HDF Eurovest 20%; HDF Multi Alternatives 16%; HDF Global Long-Short 12%; and HDF Global Equity 11%. All of these redemption requests and those pending for the first quarter of 2009 have been met in full without the need to suspend or gate withdrawals.

HDF has not side-pocketed any investments, despite each of its rated funds having some (small) exposure to funds whose liquidity terms have deteriorated. However, it has agreed with its auditor, PWC, to reduce valuations of these funds by 5-25%.

HDF's investment team remains cautious on equity markets. It has therefore reduced exposure to managers with directional exposure. It has reallocated to those who understand the macroeconomic situation well, to tactical traders who understand flow dynamics and to those managers who have both low gross and net exposures.

Long/short equity hedge fund managers held within HDF's funds have below 10% net long exposure in aggregate. Within the HDF Global Equity Fund the long-only allocation is close to its minimum 60%, and the portfolio had 13% cash at the end of December.

HDF has increased the number of people on its risk management committee from four to five after creating a new role of head of research and risk management, which has been filled by ex-deputy CIO Eric Dubonnet. HDF has recently hired Thierry de Rycke, who was head of FOHF management at Barep-Sgam, as new deputy CIO.

Notz Stucki

Notz Stucki has lengthened the notice period on DGC Pendulum and Lynx Selection Holdings to 95 days for redemption on the last business day of the month where that notice period has completed. Pendulum has activated a gate on redemptions in excess of 15% in a month. However, Notz Stucki has neither changed the redemption notice period nor activated a gate on Haussmann Holdings.

DGC Pendulum had a 6.0% holding in Plaza Investments, a managed account set up by Notz Stucki to access Madoff strategies. After Bernard Madoff was arrested we placed the fund Under Review.

Permal

Permal changed the notice period on its funds from 20 days to 95 in October 2008. The change in notice period was made indefinitely but subject to monthly review, taking account of net inflows/outflows, progress on restoring credit lines and general market conditions. In January 2009 the extended notice period remained in place.

RMF Four Seasons

The fund returned -16.2% in 2008. This was after writing down to zero a holding in Rye Select Broad Market XL Portfolio (that represented 1.29% of Four Seasons' portfolio at end-September 2008), a fund that was indirectly sub-advised by Madoff Securities. The fund is currently Under Review.

RMF has made no change in the fund's dealing terms and has not suspended or gated any investor withdrawal request. Moreover, it has not side-pocketed any investments. Overall, the fund remains relatively liquid and transparent due to its significant use of managed accounts to invest with preferred hedge fund managers. At the end of September, when we conducted our annual review of the portfolio, 99% of the holdings could be converted into cash within one year, 88% could be liquidated within three months and 38% could be realised within one month. According to RMF, the liquidity position had not changed

materially from this by the end of December 2008.

SAIL Flagship Fund

SAIL Advisors have not changed dealing or redemption notice terms on the S&P-rated SAIL Flagship Fund. Redemptions during the fourth quarter were met without the need to gate investor withdrawals. Moreover, SAIL has not side-pocketed any of the fund's investments. It returned -23.1% in 2008. Multi-strategy arbitrage, followed by equity long/short and fixed income arbitrage were the main detractors.

Thames River

Thames River has realigned the liquidity terms offered for the original 35-day notice share classes of its funds of hedge funds, in line with those of the share classes introduced in January 2008 that offer monthly redemptions with 100 days notice. During the fourth quarter of 2008 Thames River Sentinel experienced redemptions amounting to about 10% of NAV as of end-October 2008, Warrior received around 26% redemptions and Warrior II's redemptions were about 31%. Thames River suspended redemptions temporarily for the dealing dates 3 November, 1 December and 2 January. The funds re-opened for dealing on 2 February 2009. Thames River has not side-pocketed any investments. However, during the period in which dealing was suspended, redeeming investors were given shares in special purpose vehicles, which had been set up to return cash as redeemed portfolio investments paid out.

Theta

Theta Multistar Low Volatility Fund and Theta Medium Volatility Fund lost 19.2% and 24.7% respectively in 2008. Theta reports that marking-to-margin has been responsible for a significant portion of the losses in its funds last year, and explains that "counterparties mark securities at such levels that the holder needs to fully fund the security and therefore cannot hold any leverage against it. Often these marks hold little relationship with the fundamental value of the security but provide counterparties with a means to

aggressively reduce their exposures." The process has accelerated since October, and was responsible for a large part of Theta Low Volatility's 3.4% loss in December.

Turnstone European Fund

The fund continues to deal monthly with a 30-day redemption notice period, and Turnstone has neither suspended dealings nor gated any redemption requests. The fund had about 15% redemptions in September 2008 and nothing material since then. So far in 2009, inflows have exceeded outflows. The fund has proved very defensive in the current environment, declining just 6.8% over the full calendar year 2008. This is the best result we have seen among funds of long/short equity hedge funds. In the European segment it compares with Permal European Holdings (-17.6%) and Notz Stucki Lynx Selection Holdings (-33.4%). However, the Permal and Notz Stucki funds are managed in a slightly more directional style, and are therefore more vulnerable to poor market conditions.

Amanda McCracken believes equities are in a structural bear market, and is therefore wary that the post-October 2008 rally may prove to be a false dawn. She reports that managers held in the fund's portfolio have used the rally to increase their short books in overly indebted companies within the industrial,

retail and commercial real estate sectors, in the belief that they are most vulnerable to deteriorating macro and corporate newsflow. On a contrarian note, some of them have closed out short positions in banks and built small long positions on the basis that there has been a significant reduction in mortgage lending capacity and new business is being written on much higher spread margins than for many years.

UBP

UBP's Dinvest Total Return Fund and its Dinvest Concentrated Opportunities Fund experienced respective redemptions of around 16% and 14% of NAV during the fourth quarter. These were met without UBP suspending or gating withdrawals, and there has been no change in the funds' dealing terms. However, side-pockets have been implemented for each of the funds. The hedge funds placed in the side-pockets are being valued by the administrator used for UBP's funds-of-hedge-funds.

Dinvest Concentrated Opportunities Fund has been placed Under Review pending further consideration of its risk control in light of a 2.3% position (at 1 December 2008) in its internal feeder fund into Bernard Madoff strategies. Dinvest Total Return Fund has also been placed Under Review due to its 2.0% holding (at 1 December 2008) in Kingate.

UFG Alteram

UFG Alteram changed dealing on its S&P A rated Alteram Low Volatility Fund (previously called Alteram Tresorerie Plus) from daily to weekly during the fourth quarter of 2008. It also introduced a 5% gate on any outflows exceeding 5% in a week.

The change in name and dealing frequency is part of a move by UFG to market the product as a low volatility fund-of-hedge-funds, where previously it was marketed as a cash enhancement product. We have always viewed it as a fund-of-hedge-funds, and are therefore comfortable with this change. UFG has also increased the average allocation to hedge funds from 40% to 50% to underline the change. Currently hedge funds represent 54% of the overall portfolio.

During the fourth quarter Alteram Low Volatility experienced significant outflows, which have pushed the fund size down from €18m at end-September to €29m by end-December. The fund's gate was activated six weeks in a row between the beginning of November and mid-December. No side-pockets have been put in place.

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