

H1 2010 Hedge Fund Industry Review

July 2010

Industry Review

H1 2010 Highlights and Key Points¹

- Hedge funds, as measured by the Dow Jones Credit Suisse Hedge Fund Index² (the "Index"), are up 0.6% year-to-date as of June 30, posting positive performance for four out of six months in the first half of 2010.
- To date in 2010, the hedge fund industry has outperformed global equity markets³ by over 10% as managers continue to employ a diverse range of alpha-generating investment strategies.
- Performance among the ten index sectors was mixed with six out of ten sectors posting positive returns in the first half of the year; top performers included Fixed Income Arbitrage (+5.5%), Global Macro (+4.2%) and Event Driven (+1.8%).
- Individual fund returns have been more dispersed this year with 51% of all funds posting positive performance compared to 80% for the same period in 2009.
- While the repayment of "impaired" assets has slowed, an estimated 67.8% of all impaired assets have been repaid to investors representing \$118 billion. We estimate an additional \$56 billion in impaired assets currently remains illiquid⁴.
- The hedge fund industry experienced outflows of approximately \$1.4 billion in the first half of 2010. Some strategies, however, saw positive flows in the first six months and those with traditionally lower beta to broad markets experienced some of the largest inflows of the year.
- Including performance gains, we estimate current industry assets under management (AUM) remain at \$1.5 trillion as of June 30, 2010.

¹ All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to the accuracy, completeness or reliability of such information.

² Formerly known as the Credit Suisse/Tremont Hedge Fund Index.

³ As represented by the Dow Jones Global Index.

⁴ Data as of June 30, 2010. Please see page 8 for a complete description of "impaired" assets.

Key Market Events through the first half of 2010

Global Markets:

- A “Flash Crash” on May 6th temporarily wiped out nearly \$1 trillion in market value, with some major indices dropping roughly 7% in 15 minutes, following which they largely recovered.
- The Dow Jones Global Index rose to a 21-month high of over 242 in mid-April. Shortly thereafter, concerns over Greece’s debt crisis and a slowdown in the economic recovery ignited global market sell-offs, with the Dow Jones Global Index sinking to a 9-month low of 203 in mid-June.

Sovereign Debt:

- European Sovereign debt became a paramount concern in 2010, as a variety of rating agencies downgraded the government bonds of Euro members Spain, Portugal and Greece.
- Eurozone members and the IMF agreed to a bailout package of more than 110 billion Euros, preventing the default of Greek debt. The Euro fell to its lowest level since early 2006.

Regulation:

- In the U.S., the Volcker Rule requires Banks to limit investments in Hedge Funds and Private Equity firms to 3% of tier-one capital.
- Eurozone negotiations were formally tabled until September, as the standardization of regulation across 27 countries proved difficult to implement.

H1 2010 Industry Performance

After a favorable 2009, when hedge fund managers capitalized on positive conditions and generated returns of 18.6%, the overall industry has shown more muted performance in 2010, posting returns of 0.6% in the first half of the year. Despite lower absolute returns, hedge funds as a whole have outperformed global equity markets, as represented by the Dow Jones Global Index, which is down 9.7% year-to-date. The Index has posted positive performance for four out of the first six months in 2010 with 51% of funds ending the first half in positive territory.

In response to increased market turbulence, specifically in the second quarter, many managers seem to have taken defensive measures by reducing their overall portfolio risk and sensitivity to broad market movements. As a result, it appears that hedge fund returns have not been subject to the same volatility experienced by global equity markets in 2010. As shown in Figure 1 below, the monthly standard deviation of the Index (1.7%) remains significantly lower than that of the Dow Jones Global Index (5.5%).

While broad market sell-offs and high levels of correlation across asset classes made it difficult for the industry to avoid losses altogether, hedge funds’ cautious stance and investment strategies enabled the industry to maintain positive performance through the first half, outperforming equities, commodities and bonds⁵ on a risk adjusted basis (Figure 1).

Figure 1: H1 2010 Hedge Fund Performance Statistics by Sector

Jan 10 - Jun 10	Sector Weights (as of 5/31/10)	Cumulative Return	Monthly Standard Deviation	Number of Positive Funds	Number of Negative Funds	Best Performing Fund	Worst Performing Fund	2009
Broad Index	100.0%	0.6%	1.7%	237	228	30.8%	-59.0%	18.6%
Convertible Arbitrage	1.8%	2.6%	1.6%	20	4	19.1%	-2.0%	47.3%
Dedicated Short	0.2%	-2.8%	5.1%	3	4	2.4%	-4.4%	-25.0%
Emerging Markets	7.5%	-0.8%	2.7%	35	40	24.5%	-19.0%	30.0%
Equity Market Neutral	2.1%	-4.6%	1.5%	9	12	13.0%	-20.9%	4.1%
Event Driven	26.7%	1.8%	2.2%	55	15	20.1%	-59.0%	20.4%
Fixed Income Arbitrage	3.6%	5.5%	1.1%	17	8	30.8%	-13.2%	27.4%
Global Macro	18.7%	4.2%	0.8%	19	14	14.9%	-18.0%	11.6%
Equity Long Short	21.9%	-3.2%	2.6%	42	105	23.1%	-20.8%	19.5%
Managed Futures	3.8%	0.3%	3.3%	17	15	16.5%	-18.7%	-6.6%
Multi-Strategy	13.7%	0.5%	1.3%	20	11	17.5%	-13.5%	24.6%
S&P 500		-6.7%	5.4%					26.5%
Dow Jones Global Index		-9.7%	5.5%					32.0%
Barclays Global Aggregate Bond		-0.3%	1.0%					6.9%
DJ UBS Commodity Index		-9.6%	4.6%					18.9%

Source: Dow Jones Credit Suisse Hedge Fund Index, Bloomberg. 2010. All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to the accuracy, completeness or reliability of such information.

As illustrated in Figure 1, six out of ten sectors posted positive returns in the first half of 2010 with just over half of all funds generating positive performance (compared to 80% in the first half of 2009 and 68% in the first quarter of 2010). Among the top performing sectors for the first half of the year were Fixed Income Arbitrage (+5.5%), Global Macro (+4.2%), and Event Driven (+1.8%). These strategies have outperformed in 2010 due in part to their low overall beta to traditional markets and ability to generate returns by way of relative value and tactical trades. Conversely, Long/Short Equity and Emerging Markets were among the worst

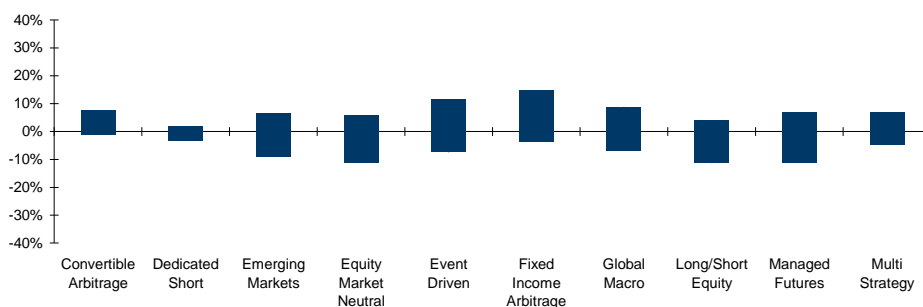
⁵ Hedge Fund returns represented by the Dow Jones Credit Suisse Hedge Fund Index. Equity returns represented by the Dow Jones Global Index and the S&P 500 Index. Bond returns represented by the Barclays Global Aggregate Bond Index.

performing sectors. These strategies, which typically generate returns through directional positions, have been negatively impacted primarily by the recent market declines and increased volatility.

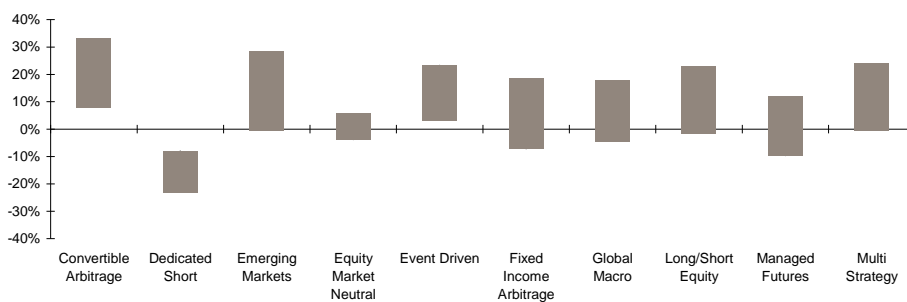
Figure 2 below illustrates return dispersions across different Index sectors in H1 2010 compared to H2 2009. Overall, H1 2010 sector returns appear to be more compressed than those in the second half of 2009 and while the bulk of H2 2009 sector returns lie in positive territory, 2010 returns appear to be more equally distributed across both sides of the 0-axis.

Figure 2:

H1 2010 Sector Return Dispersion



H2 2009 Sector Return Dispersion



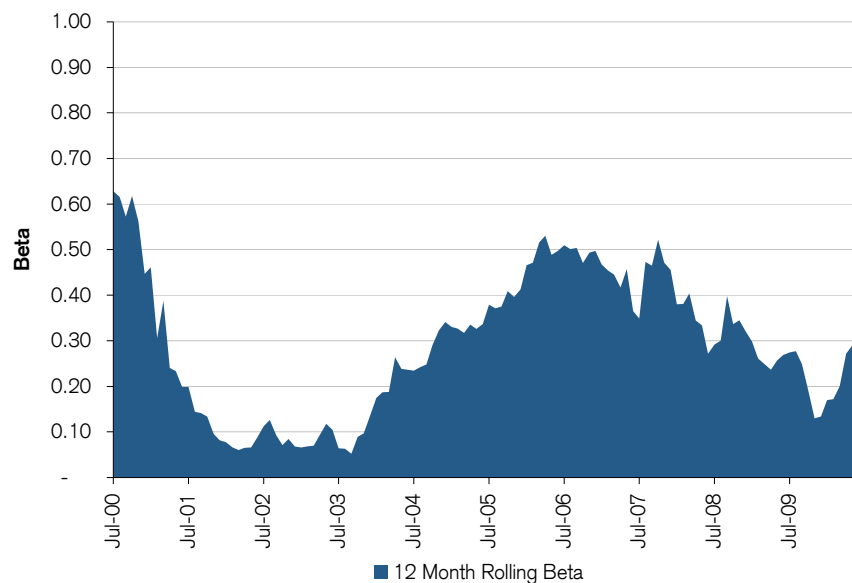
Note: The blue boxes above represent the bulk of returns that lie one standard deviation from the mean assuming a normal distribution.

Source: Dow Jones Credit Suisse Hedge Fund Index. 2010. All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to the accuracy, completeness or reliability of such information.

Current Market Environment

In our Q1 2010 industry review we noted the 12-month rolling beta of the Broad Index to the Dow Jones Global Index was at its lowest level in over five years. Due to the broad market sell-offs that have occurred since March, hedge fund beta to equity markets has increased over the last three months rising from 0.2 at the end of March to 0.3 as of June 30, 2010 (Figure 3). Despite this rise, beta remains relatively low compared to historical highs signaling that returns are currently less driven by systematic risks as managers continue to employ a number of diverse investment strategies aimed at reducing their sensitivity to overall market volatility.

Figure 3: Rolling 12-Month Beta of Dow Jones Credit Suisse Hedge Fund Index to Dow Jones Global Index (as of June 30, 2010)

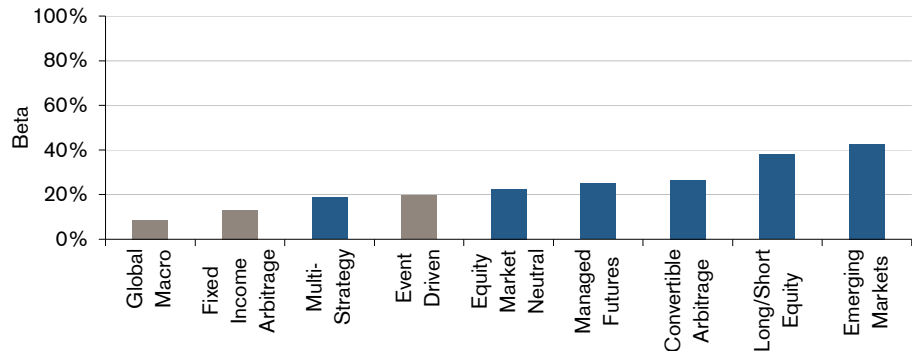


Source: Dow Jones Credit Suisse Hedge Fund Index, Bloomberg. 2010. All internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information.

Sector Focus

With recent instability in equity markets, investor interest, especially in the second quarter, seems to have shifted from directional strategies such as Long/Short Equity, which were among the top performers in 2009, to relative value and tactical strategies such as Fixed Income Arbitrage and Global Macro. These two sectors have benefited from their relatively liquid portfolios and the ability to quickly shift positions so as to avoid or capitalize on some of the fluctuations experienced year-to-date. The Event Driven strategy has also attracted considerable interest in 2010 as managers have capitalized on idiosyncratic opportunities in the distressed credit space. As illustrated in Figure 5 below, these three sectors have shown some of the lowest betas to global equity markets, and in general their returns through the first half of 2010 have been primarily alpha driven and largely unaffected by broad market movements.

Figure 5: 2010 Average 12-Month Rolling Beta of DJCS Hedge Fund Index Sectors to the Dow Jones Global Index (as of June 30, 2010)



Source: Dow Jones Credit Suisse Hedge Fund Index, Bloomberg, 2010. All internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information.

Fixed Income Arbitrage

Fixed Income Arbitrage has generated the best performance in the first half of the year, returning 5.5% and posting positive returns for five out of six months. Fixed Income Arbitrage managers benefited from their ability to trade actively amid volatile markets, quickly changing direction when necessary. Funds reported that their year-to-date 2010 returns were largely attributed to their ability to capitalize on increased market volatility through advanced relative value trades. The strategy has also benefited from its ability to generate returns despite overall market direction. For example, managers have used macro-hedges to protect against the flight-to-quality behavior seen across global markets in 2010. Many believe that expectations for this sector continue to be favorable for the remainder of 2010 as arbitrage opportunities in the credit space could provide opportunities to generate alpha. In addition, with the proprietary trading desks of many large investment banks slowly closing as a result of increased regulatory pressures, profit-generating opportunities in the space are likely to increase.

Global Macro

The Global Macro sector was also among the top performers, up 4.2% year-to-date, as managers remained nimble and adjusted their exposures throughout the year to avoid losses sustained by general markets. Due to its flexibility to invest across different asset classes, Global Macro has historically proven to be an effective strategy during acute periods of volatility. In fact, macro managers maintained relatively low equity exposures in the first six months of the year, which limited much of the downside for the strategy. The strategy's competitive advantage came from its ability to trade in the foreign exchange arena and on the front end of the yield curve.

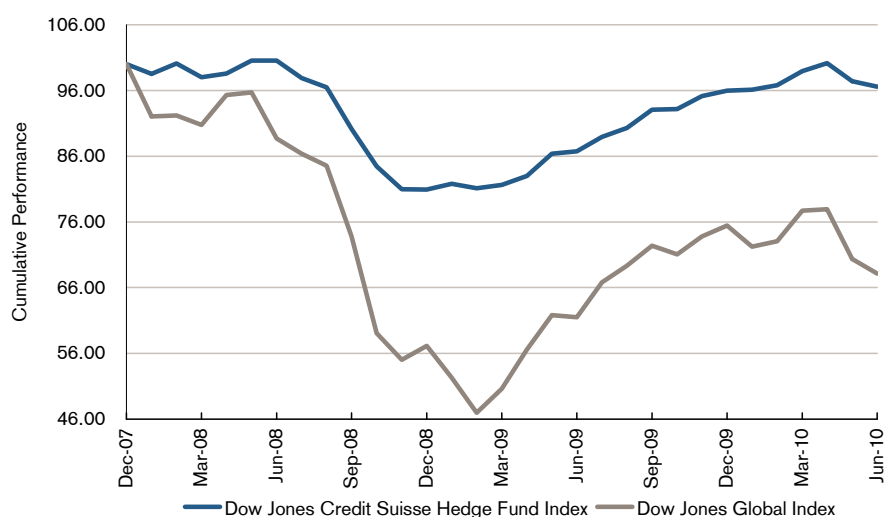
Event Driven

Finally, Event Driven managers, which finished up 1.8% as of June, were similarly able to navigate a difficult trading environment, generating returns through distressed credit opportunities. Although the strategy was the top performer in the first quarter, losses caused by equity market sell-offs in the second quarter negatively affected its overall year-to-date performance. Nevertheless, some of the more recent fluctuations in this sector's returns are largely attributable to mark-to-market losses and may only affect short term performance. Many managers believe that the intrinsic value of distressed positions will be realized over the medium-term spectrum of 12-24 months. Moreover, while some think that opportunities will be less prevalent in the distressed space as a result of low relative default rates, restructuring situations still represent an opportunity due to high volumes of debt (such as the relative size of the present high-yield market). Presently, other sub-strategies such as merger arbitrage have not been as active, since merger and acquisition deals have been subdued as a result of market volatility.

Hedge Fund Recovery Analysis

At the end of 2009, hedge funds had recouped 76.7% of the losses they incurred during the 19.5% drawdown that occurred between June 30 and December 31, 2008. As illustrated in Figure 6, with the gains earned in the first half of 2010, funds have now earned back 80% of all 2008 losses and the Index would need to generate an additional 3.9% in performance in order to be on par with or surpass previous peak performance levels. In comparison to the hedge fund industry, global equity markets (as represented by the Dow Jones Global Index) fell deeper into drawdown in the first half of 2010. The current equity market drawdown remains at 31.9% (as of June 30, 2010).

Figure 6: Drawdown Analysis, Dow Jones Credit Suisse Hedge Fund Index and Dow Jones Global Index (Data as of June 30, 2010)



Source: Dow Jones Credit Suisse Hedge Fund Index, Bloomberg. 2010. All internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information.

Overall, the performance of hedge funds through the first six months of this year suggests that hedge funds could continue to serve as a portfolio diversifier during volatile market environments.

Classifying Impaired Funds

Suspended Redemptions:

Certain hedge funds may temporarily suspend or defer redemptions as a defensive measure to avoid disruptive liquidation of positions.

Sidepocket:

Sidepocketing occurs when hedge funds segregate illiquid assets from liquid assets.

Gate Provisions:

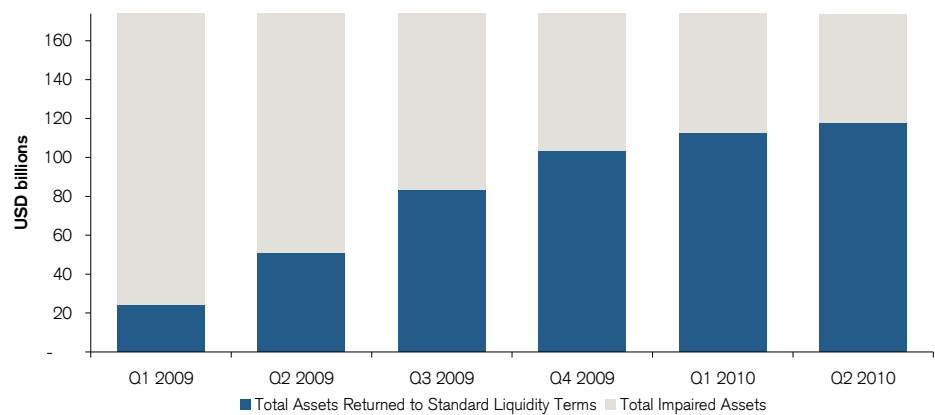
A fund may impose a gate provision to restrict the amount of withdrawals from the fund during a redemption period.

Liquidity Continues to Improve

The liquidity profile of the overall hedge fund industry generally improved in the first half of 2010 as managers continued to find opportunities to liquidate illiquid positions. We estimate that \$174 billion of assets within the industry were “impaired⁶” as of December 2008. Of this \$174 billion, we now calculate that approximately \$118 billion has been repaid to investors as of June 30, 2010, while \$56 billion remains illiquid.⁷

Despite this overall improvement in liquidity, the rate at which impaired assets have been repaid to investors in 2010 has plateaued (Figure 7). Many funds have indicated that they plan to retain these holdings until market conditions improve for certain sectors which are more illiquid.

Figure 7: Liquidation of Impaired Assets (as of June 30, 2010)⁶



Source: Dow Jones Credit Suisse Hedge Fund Index. 2010. All internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information.

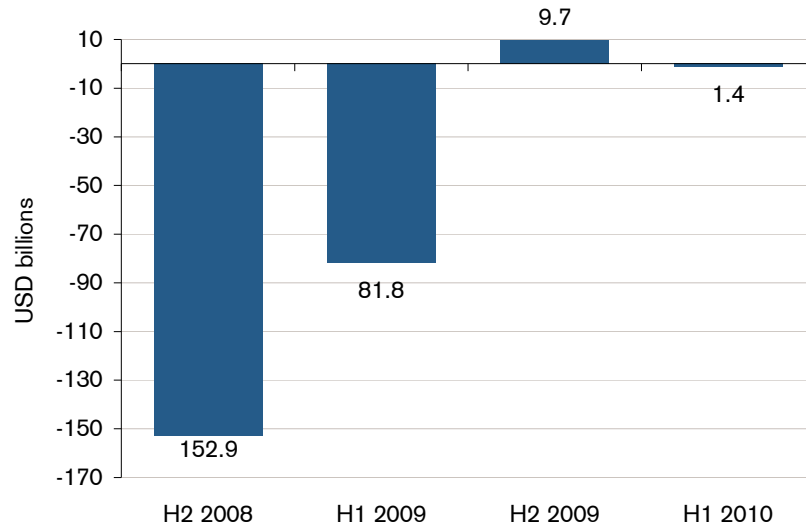
⁶ See “Classifying Impaired Funds” for a description of impaired funds.

⁷ Data based on a sample set of funds reflective of the Dow Jones Credit Suisse Hedge Fund Index as of June 30, 2010.

Asset Flows

Overall assets under management for the hedge fund industry are reported to have remained relatively flat, falling by an estimated \$1.4 billion in the first half of 2010. This compares to a \$9.7 billion increase in the second half of 2009. In general, smaller funds that are in their first stages of raising capital are finding it more difficult to attract assets as investors remain cautious, gravitating towards larger funds with longer track records. Our estimate for the total industry AUM remains stable at \$1.5 trillion as of June 30, 2010.

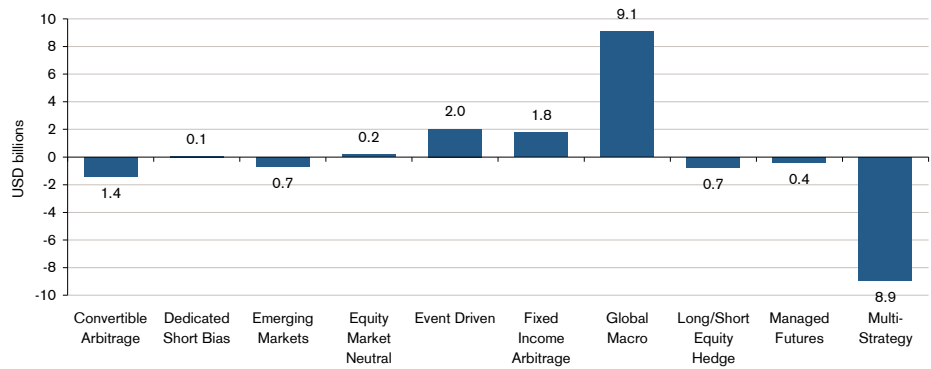
Figure 8: First Half 2010 Estimated Asset Flows (as of June 30, 2010)



Source: Dow Jones Credit Suisse Hedge Fund Index, 2010. All internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information.

On a sector level, it appears that the top-performing sectors of 2010 have also attracted the highest asset flows. As illustrated in Figure 9 below, the Global Macro, Event Driven, and Fixed Income Arbitrage strategies have seen the highest inflows in 2010 and are among the only four strategies that have experienced positive asset flows. Investors reportedly view these sectors as portfolio diversifiers due to their low correlations to equity markets. Conversely, directional sectors such as Long/Short Equity and Emerging Markets have seen negative asset flows for 2010 as investors appear to be shying away from strategies whose returns might be significantly affected by overall market turbulence.

Figure 9: H1 2010 Estimated Asset Flows by Sector (as of June 30, 2010)



Source: Dow Jones Credit Suisse Hedge Fund Index. 2010. All internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information.

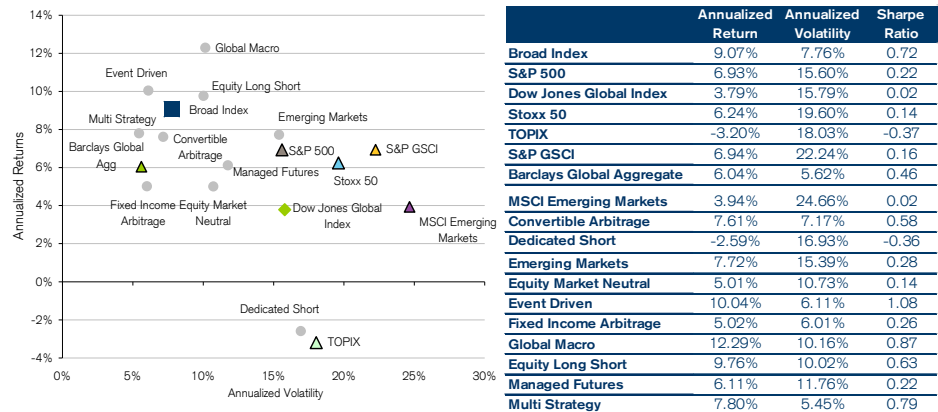
Finally, hedge fund managers continue to open their doors to new investments through the launch of retail vehicles such as UCITS III funds, exchange traded products and mutual funds. These vehicles are also capturing the interest of many institutional investors due to their increased levels of transparency and regulation and many believe that they could become a crucial asset base for the industry going forward.

The Continuing Case for Hedge Funds

2010 has proven to be a challenging environment for hedge funds as both volatility and correlations between asset classes have increased. Nevertheless, hedge fund managers have outperformed traditional asset classes by employing a wide array of investment strategies and limiting portfolio risk levels.

Historically, the hedge fund industry has been able to limit downside losses in certain periods of market uncertainty. Our risk/return analysis of hedge fund performance since the inception of the Dow Jones Credit Suisse Hedge Fund Index in January 1994 suggests that funds have generally outperformed other broad market indices on a risk-adjusted basis. (Figure 10). Over this period, the Index has posted annualized performance of 9.1% with annualized volatility of 7.8% compared to the 3.8% annualized performance and 15.8% annualized volatility of the Dow Jones Global Index. In fact, hedge funds have posted the highest returns of all asset classes presented with only global bonds exhibiting lower volatility.

Figure 10: Risk/Return Analysis



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Conclusion

Through the first half of 2010, hedge funds have continued to provide anticipated performance and diversification profiles. Given that many investors seek these characteristics during periods of high market volatility, we expect to see continued interest in hedge funds as a portfolio diversification vehicle.

Sectors with lower beta to equity markets such as Event Driven, Global Macro and Fixed Income Arbitrage, may likely continue to attract a portion of these assets. In the short term, we expect inflows from institutional investors to increase as allocators seek investments that limit their portfolio volatility and provide additional diversity. We also anticipate additional assets to be sourced through new mutual fund or UCITS III retail channels that many managers are exploring.

Many in the industry are anticipating recent regulatory initiatives which may impact the hedge fund space. In the US, the Volcker rule will limit the size of banks' proprietary positions. Many believe this could be beneficial for the hedge fund industry as it would allow funds to operate more independently of banks. In addition, we expect to see more opportunities for funds as well as an abundance of new intellectual capital, as top talent flows from some proprietary trading desks to the hedge fund industry.

Steps to implement regulatory reform in the Eurozone have proven difficult, as disagreements have emerged over the enforcement of uniform standards across the 27 EU governments. While negotiations have been tabled until September, several tenets of the Alternative Investment Managers Directive were taken into consideration, including legislation which would impose strict new reporting and custody rules on hedge funds and private equity funds, as well as possible leverage and borrowing limits. To the extent that regulation is focused on increased transparency and standardized reporting practices, we believe this will benefit the asset class, as it would serve to bolster investor confidence in the industry.

Overall, the first half of 2010 has served to distinguish hedge fund performance from other asset classes. As demonstrated by the Index's generally stable performance, hedge funds have managed to outperform many broad equity and bond markets while maintaining lower levels of volatility. Over the coming months we believe there could be opportunities for hedge fund managers to continue to exploit market inefficiencies and generate alpha by using diverse investment strategies across different asset classes, specifically in the relative value and tactical trading space.

Endnotes

The Dow Jones Credit Suisse Hedge Fund Index (the "Index") is compiled by Credit Suisse Hedge Index LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The Index uses the Credit Suisse database, which tracks over 5,000 funds, and consists only of funds with a minimum of US\$50 million under management, a 12-month track record, and audited financial statements. It is calculated and rebalanced on a monthly basis, and shown net of all performance fees and expenses.

Dow Jones Global Index: The Dow Jones Global Index is a broad yet investable measure of the global stock market. It targets 95% coverage of markets open to foreign investment. The index currently tracks 51 countries, including 25 developed markets and 26 emerging markets.

MSCI Emerging Markets: The Emerging Markets Index is a float-adjusted market capitalization index that is designed to measure equity market performance in global emerging markets.

Barclays Global Aggregate Bond: A market-value-weighted index government securities, mortgage-backed securities, asset-backed securities and corporate securities, each with a maturity of over one year, designed to simulate the universe of bonds in the market.

S&P 500: The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Investors cannot invest directly in an index.

TOPIX: Including all First Section listed shares, TOPIX provides a comprehensive measure of stock price changes. The Tokyo Stock Exchange domestic market is divided into two sections. The First Section is the market place for stocks of larger companies, and the Second Section is for those of smaller and newly listed companies. Close to 1,500 companies are listed on the First Section. TOPIX is a weighted index, the market price of each component stock is multiplied by the number of shares listed. The index is the exclusive property of the Tokyo Stock Exchange.

Stoxx 50: A market capitalization-weighted stock index of 50 large, blue-chip European companies operating within eurozone nations. The universe for selection is found within the 18 EURO STOXX Supersector indexes, from which members are ranked by size and placed on a selection list.

S&P GSCI: The S&P GSCI provides investors with a reliable and publicly available benchmark for investment performance in the commodity markets, and is designed to be a "tradable" index. The index is calculated primarily on a world production-weighted basis and is comprised of the principal physical commodities that are the subject of active, liquid futures markets.

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