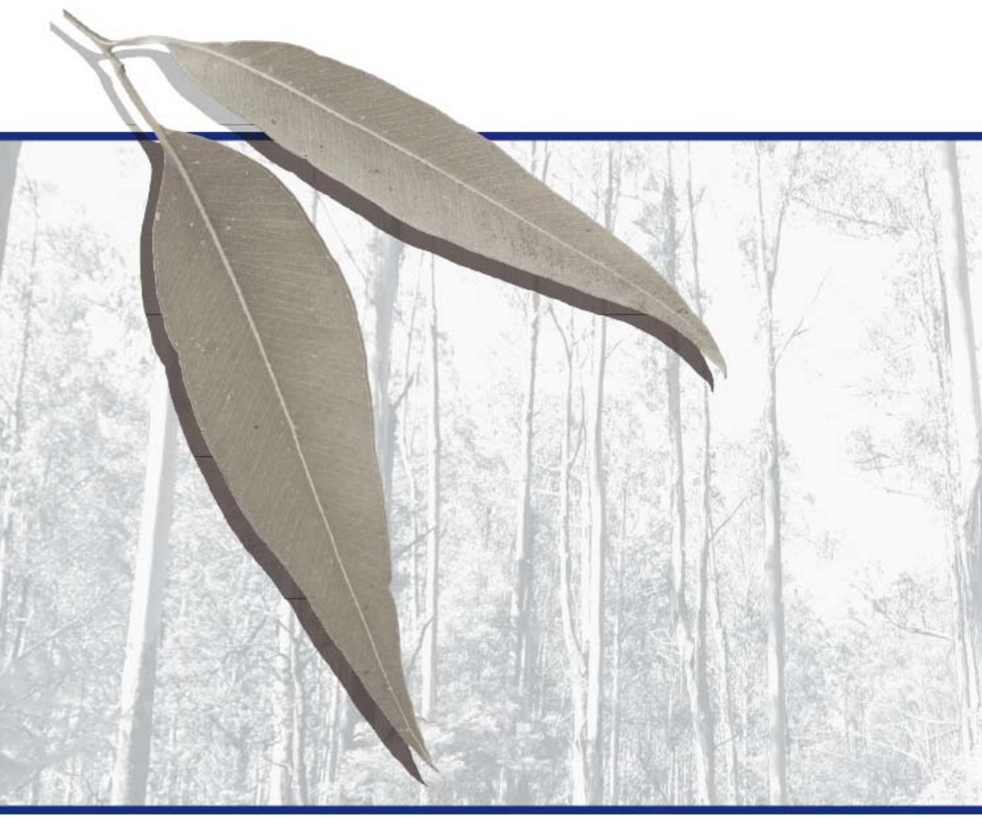

Investment Strategy Letter

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Man Investments

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Bear market rally or new bull?

Whenever equity and credit markets rally as stunningly as they have since the March lows, long-only investors have to ask themselves ‘how long will the move continue?’. The market is no longer oversold and the drivers of the rally appear to be more technical than fundamental. All risky assets are benefiting from the abundant liquidity in portfolio managers’ accounts, which is demanding to be put to work, in order to mitigate the career risk of evidently having missed the rally. This move may well be supported through the end of the year and possibly beyond.

I believe economic conditions have improved a great deal since March. The risk of another major failure in the financial sector has become remote, due to decisive action by the authorities. In many ways, banks are less risky now than they were before the crisis: the stress tests have increased transparency; leverage has been reduced; and substantial capital has been raised. Also, the recovery of the market itself is creating a number of positive feedback loops. The ability of corporates to improve their balance sheets has strengthened, while consumer sentiment has increased through the wealth effect, partly compensating for still lacklustre real estate prices.

On the flip side, I am concerned that the overall economy-wide unwinding of leverage that must take place has not really started yet. Excess leverage was one of the deep roots of the crisis and it has simply shifted from households to the government. For the time being, central banks are having significant difficulties formulating an exit strategy from their policy of quantitative easing.

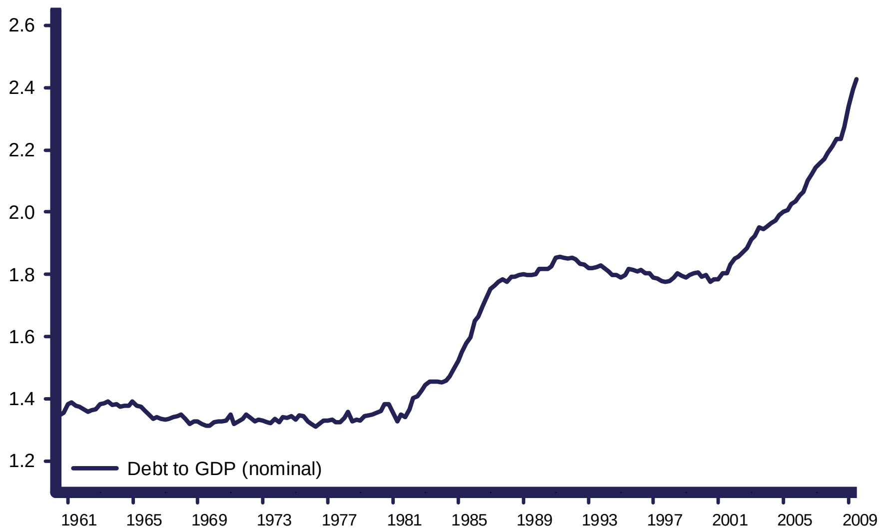

Figure 1. Debt vs. GDP (Nominal). Source: Bloomberg. DOUTTOTL index/GDP CUR$ index. April 1960 to August 2009

In order to deal with the excess debt in the system, the savings rate in the US has to stay high and consumption subdued for a number of years. The markets have started building in high recovery hopes. A senior representative of a consulting firm that I spoke to recently called the rally a Mulligan. For non-golfers: a Mulligan is an undeserved second chance, in this case, getting rid of unwanted risks at a decent price.

Correlation across asset classes

The financial crisis and the response to it were of unprecedented magnitude. One of the effects of the deleveraging and the government response – two powerful and opposing forces – is large, correlated moves across asset classes.

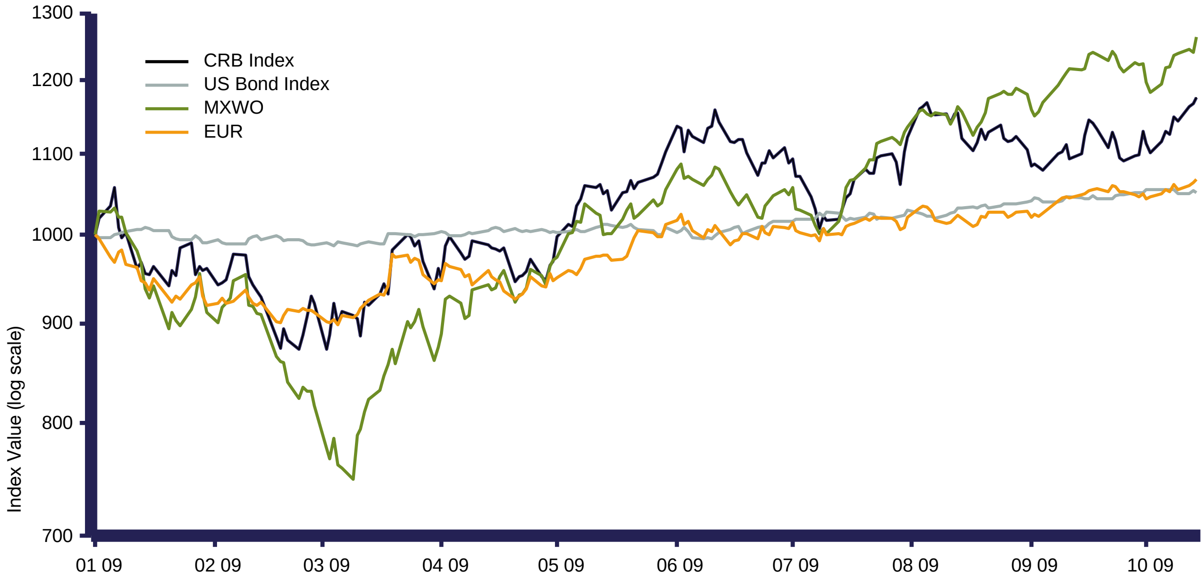

Figure 2. Cross asset-class correlation: USD/EUR X-Rate, JP Morgan US Aggregate Bond Index Total Return Unhedged USD, MSCI World, CRB. Source: Bloomberg from January 2009 to October 2009

As these forces alternate, liquidity flows in and out of markets and we end up in an environment in which every trade in the world is essentially one trade i.e. 'risk on', 'risk off'. This explains why recently rising equities have correlated so highly with rising interest rates, rising commodities and rising currencies vs. the USD. This 'correlation of everything' is an increased risk for certain strategies, as diversification benefits across asset classes are low, and managers are forced to reduce positions as correlation rises. Overall, the assets traded need to be liquid, managers need to be nimble and their strategies actively managed. Typically, this environment favors macro managers, managed futures and some equity hedge managers, namely those with low and variable net exposure.

Positioning of our portfolios

I am more skeptical of an economic recovery than consensus and remain cautious on aggregate net exposure to risky assets – equities and credit. Where we do take net exposure to either of these, we favor credit over equity from a valuation perspective.

We favor managers who are agile, liquid, and agnostic – it is not the time to be complacent or stubborn in your directional views.

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Our positioning of styles and strategies is as follows:

- Equities: we maintain a bias toward equity hedge managers with relatively low net exposure or managers who actively adjust net exposure. This combination gives us the ability to capture both the "risk on; risk off" phenomenon as well as the longer term trend toward dispersion.

- Credit: we have relatively high net long exposure (within the limits of underlying liquidity). In addition, we have significant exposure to long/short credit managers who can profit from dispersion within credit.

- Relative Value: relatively high exposure to strategies benefiting from potentially rising volatility.

- Macro & CTA: in order to maintain high exposure to large directional moves in non-risk assets (currencies, commodities, and interest rates), we will continue to have a large allocation to global macro and managed futures.

- Liquidity: we will remain extremely sensitive to the underlying liquidity of our managers' assets both in absolute terms and relative to the terms of the managers' fund vehicles at all times. This matches the strong liquidity preference of our clients.

Macro and managed futures strategies will be able to exploit as well as protect from large correlated moves. Equity hedge strategies should be able to capture dispersion within equities with a combination of nimble traders and low-net stock pickers. They should benefit from dispersion while also exploiting big directional moves.

Also, we have activated our Tail-Protect-Volatility program and allocated to it for a number of portfolios. It is a managed account in which allocations are translated into long volatility exposure in the form of forward-starting variance swaps. This program will protect portfolios against a potential spike in volatility at a well-controlled cost.

If you're interested in general science and are looking for a book this autumn, 'Ubiquity' by Mark Buchanan is a great read. It has been out for a few years and deals with the question as to why catastrophes in all areas including the financial system happen. Complex systems, under certain circumstances, have been discovered to behave in mathematically similar ways. The key point of the book seems to be that many systems are organized on the critical edge between instability and stability. The smallest force can have massive effects and sudden disruptions can strike seemingly out of nowhere. The approximate frequency of such upheavals can be predicted, but not when they will happen or their potential size. This is a truly captivating book full of concepts which, although theoretical, are plausible and offer alternative explanations for the vagaries of the financial system in which we operate.

In closing, I would like to take the opportunity to thank you as our investor for the continued trust and commitment you have given us.
We remain focused on delivering performance.

Sincerely,

Herbert Item

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