Quarterly Report December 2008

"If you can keep your head while all around you are losing theirs, you'll be a man, my son!"

- If, Rudyard Kipling

Volatility is Here to Stay

The elevated levels of volatility, which hurt so many of the Convergent/Short Volatility strategies in 2008, are expected to continue in 2009 due to the persistent price uncertainty across all asset classes (see Volatility Clustering 2009 below).

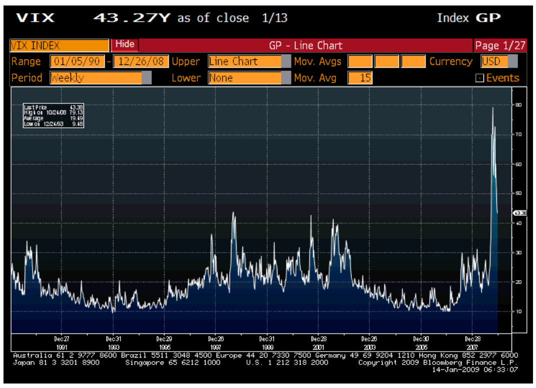
According to the CSFB/Tremont Benchmark Performance Summary below, Managed Futures were the only profitable strategy in 2008 aside from Dedicated Short Bias. Managed Futures are expected to continue this profitable form into 2009 due to their robust risk mangement processes, wide diversification, and the ability to profit from both bullish & bearish trends. CTA's are thus expected to "continue to perform well and to gather assets" ("2008 The Breakout Year for Managed Futures", Opalesque Survey 2008/12).

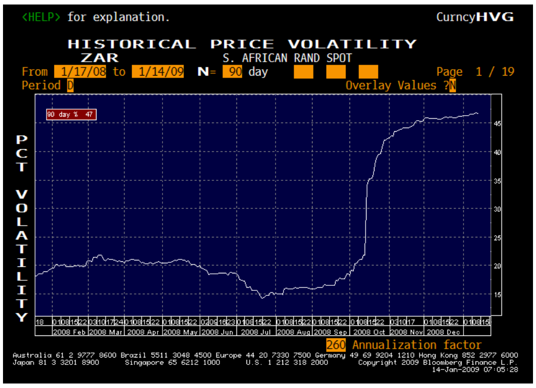
Benchmark Performance Summary

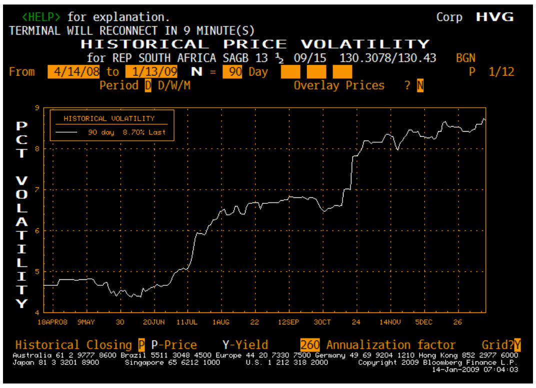
		Index Value		Return		
	Currency	Dec 08	Nov 08	Dec 08	Nov 08	YTD
Credit Suisse/Tremont Hedge Fund Index	**USD**	**351.08**	**351.20**	**-0.03%**	**-4.15%**	**-19.07%**
Convertible Arbitrage	USD	221.62	223.82	-0.98%	-1.88%	-31.59%
Dedicated Short Bias	USD	88.94	90.46	-1.68%	3.04%	14.87%
Emerging Markets	USD	264.49	263.92	0.22%	-1.87%	-30.41%
Equity Market Neutral	USD	225.47	224.54	0.41%	-40.45%	-40.32%
Event Driven	USD	395.52	400.56	-1.26%	-3.21%	-17.74%
Distressed	USD	452.18	463.96	-2.54%	-5.00%	-20.48%
Multi-Strategy	USD	371.03	372.86	-0.49%	-2.17%	-16.25%
Risk Arbitrage	USD	277.63	273.26	1.60%	-0.02%	-3.27%
Fixed Income Arbitrage	USD	166.79	168.13	-0.80%	-5.60%	-28.82%
Global Macro	USD	582.69	576.30	1.11%	1.54%	-4.62%
Long/Short Equity	USD	401.98	397.78	1.06%	-1.41%	-19.76%
Managed Futures	USD	284.19	277.61	2.37%	3.22%	18.33%
Multi-Strategy	USD	275.79	280.04	-1.52%	-4.63%	-23.63%

Volatility Spike 2008

The VIX spiked from already elevated levels of 40% to the "got-to-be-seen-to-be-believed" level of 90% on 2008/10/24. It has since halved, but remains at an historically elevated level of approximately 40% (right). Similar extremes occurred across all asset classes (see charts below, CRY (CRB), ZAR, R157 and ALSI40).

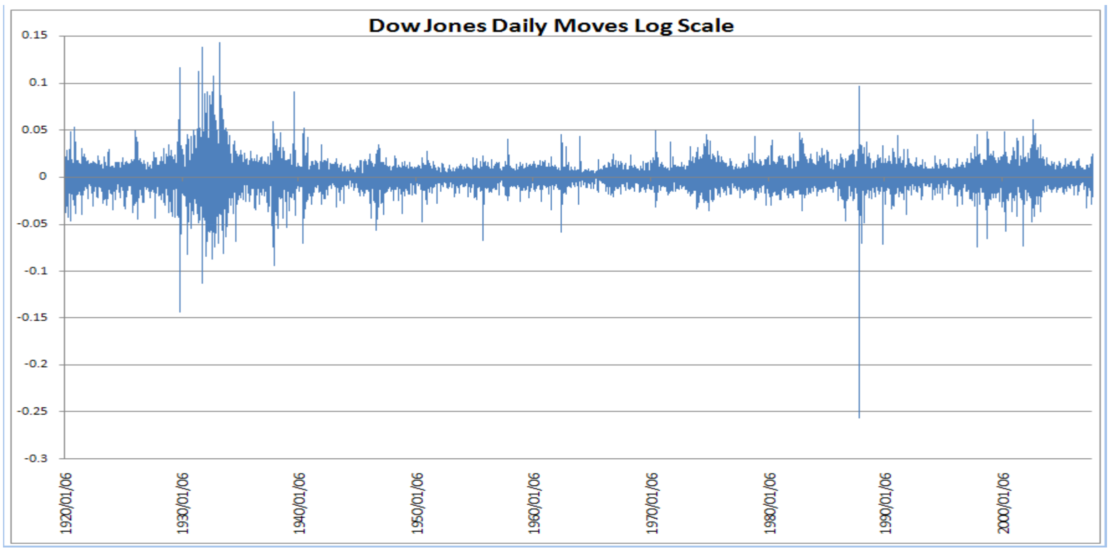






Volatility Clustering 2009

Time series of financial asset returns often exhibit *volatility clustering* - high volatility persists as large changes in price cluster together. The chart below shows daily changes in the Dow Jones Index over time, represented on a log scale. It clearly demonstrates persistence of high price changes, i.e. volatility clustering, from 1929 to 1935 (The Great Depression). Due to the current economic climate exhibiting similar characteristics to those experienced from 1929 – 1935, we believe that market returns are currently in a period of volatility clustering that will persist for the foreseeable future – certainly longer than most optimists hope.



Long Volatility Strategies Under-Invested in South Africa

Long Volatility strategies have been criticised by the South African Fund of Hedge Fund community as being too volatile, in spite of South Africa being a high volatility environment that is ideally suited to their payoff profile. Short Volatility and Long Beta strategies have typically had a lower standard deviation than their Long Volatility counterparts during the 2003 – 2007 bull market and became the standard investments of choice as the 2003-2007 bull market wore on.

However, the advent of extreme volatility across all asset classes globally in 2008 has firmly placed Long Volatility strategies in the spotlight due to their profitability over the period. In South Africa, three of the top four performing funds for 2008, including the Trendline Diversified Fund with a return of over 30%, were Long Volatility strategies. In spite of having an investment capacity of between 7.5 – 10% of the total assets under management by the 56 funds represented by the Symmetry Hedge Fund Survey, these top four funds represent less than 1% of the total assets under management.

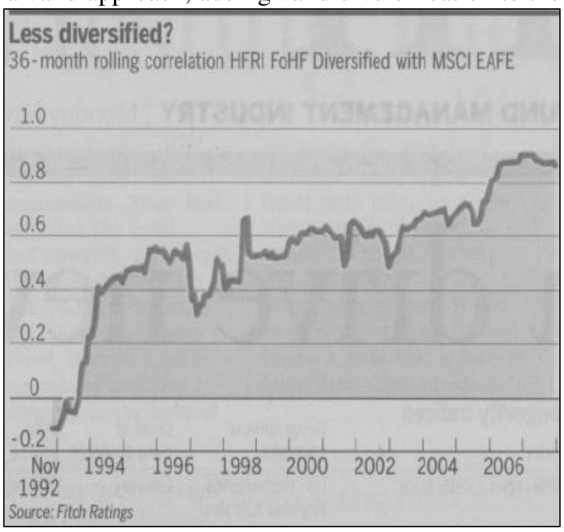
Sub-Optimal Portfolio Construction

Post 2008, the role of fund of hedge funds will be subject to intense re-evaluation. Aside from due diligence functions, fund of funds must identify the various risk premiums in the global capital markets, execute systematic risk budgeting, i.e. find the proper asset allocation across various risk factors, and actively manage those risks … if they mistake beta for alpha then they will pay too much for it … *if they restrict themselves to a too limited set of return sources, they will end up with a sub-optimal portfolio* and forego the possibility of constructing the most "absolute return like" portfolio possible (my italics)(Lars Jaeger, Partners Group Research Flash 2008/ 08).

Red or Black … or Red and Black?

In the Trendline March 2008 Quarterly Report we noted that FoHF correlation with equities was increasing, "indicating a bias towards equity-related strategies which are either unhedged, or long of illiquid positions" i.e. short volatility and/or long beta. While we have never looked to promote trend following (long volatility) as the only way of investing, both domestic & international results in 2008 have reminded the investment community that it is a valid approach, adding valid diversification to the plethora of equity-based strategies available in the market until recently. We have therefore focused on placing in context the benefits of systematic trend following strategies. These include:

- wide diversification across all asset classes,
- no bias to being long or short,
- robust portfolio construction & risk management methodologies,
- only trading in the most liquid & transparent markets,
- no funding requirements from prime brokers, and
- being very liquid to investors.



Conclusion

Volatility clustering suggests that the current elevated levels of volatility will persist for a significant period. A failure by FoHFs to invest in Long Volatility strategies in this environment will lead to sub-optimal portfolio construction. This will result in the "all weather" FoHFs continuing to display short volatility & long beta characteristics – something which will be detrimental to capital preservation in an industry already beset by both performance & due diligence issues in the post 2008 & post Madoff era.