

Heritage Alternative Investments

The current crisis and the future opportunities

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Dear Investors,

It is needless to say that we are in a very serious crisis as it has been well documented in the headlines. Therefore, we decided to be pragmatic and provide clear answers to the points we consider to be most important to our investors in such an environment :

- 1. How will the current crisis most likely unfold ?**
- 2. What is the impact of the current crisis on our industry and on each hedge fund strategy ?**
- 3. The opportunities going forward.**
- 4. What are the actions that we have taken to manage the current situation and how will we position the portfolios in the future ?**

1. How will the current crisis most likely unfold ?

We consider the current crisis to be an asset crisis that can be compared to:

- the Savings and Loans crisis in the US,
- the real estate bubble of the early 90's in Switzerland,
- and, to some extent, to the Great Depression of 1929.

The current situation is not a financial crisis and should not be compared to the 1998 crisis (LTCM and Russia meltdown) or the accounting scandals (WorldCom/Enron) in 2002.

As a matter of fact, an asset crisis is different from a financial crisis in the sense that:

- **It takes much longer to unfold as the assets**, ie the house prices and not just the toxic subprime products, take much longer to clear.
- It is characterized by **government intervention** which will have both negative and positive effects. Usually, political bodies cannot pass legislation as these though measures are difficult to explain to the public. It is only when people understand that they have no choice that the government will be able to pass the legislation needed to tackle the crisis.
- An asset crisis usually is **characterized by a U-shape rather than the V-shape** of a financial crisis which impacts the way we position our portfolios.

Finding a value for assets is the core problem of the current crisis as banks need to mark those troubled assets on their balance sheets. But market prices are completely driven by the current fire sale of assets driving them much lower than their intrinsic value re-introducing a concept almost forgotten a few years ago: the liquidity premium.

Thus, if banks use the current market prices, they might not have sufficient equity to support their balance sheets and they will either need to raise capital or reduce their balance sheets. This uncertainty has frozen the market place and today banks are reluctant to lend to each other as well as to the rest of the economy, exacerbating the problem. This situation could be avoided if banks could use prices closer to the intrinsic value rather than current market prices which represent fire sale valuations.

The Paulson plan

The central point in the plan is to provide some form of relief to the financial institutions in order to restore confidence among market participants by **reducing the liquidity premium** and thus enabling banks to sell their troubled assets at prices closer to their intrinsic value rather than at "fire sale" value.

The House of Representatives shocked financial markets by voting against the Paulson Plan on Monday September 29th. On Wednesday October 1st, the Senate adopted the Plan with sweeteners and on Friday October 3rd the House of Representatives adopted it as well.

In the short run there will be a lot of volatility around the acceptance of the plan as the market realizes that the medicine will not produce any miracle. It is very likely that Governments as well as Central Banks will have to come with another set of measures such as cutting interest rates as well as coordinating the Paulson plan on an international level with European Governments and Central Banks. Ultimately they will have to **revise the accounting standards** in order to enable banks to mark those troubled assets at or closer to their intrinsic value.

It is only then that there will be some stability and it will be **the turning point in the credit cycle**. We will enter a new phase where the market starts to heal itself, which will provide **huge opportunities** for our hedge fund managers. As stated before we do not expect a V-shape recovery as it happened in 2002 but a much slower process.

In such an environment we think that:

- **growth will slow down** causing equities and commodities to trend lower,
- interest rates will remain low with the FED and other central banks likely to cut them, resulting in a **steepening of yield curves**,
- **credit spread will remain high** for some time before tightening again,
- it is unclear what will be the impact on currencies: on one hand the growing deficit, the need to save troubled financial assets mostly denominated in USD should push towards a bearish view on the dollar, on the other hand the USD has corrected so much against other currencies and only lately it has become clear to the market that it was not a US only problem (intervention of various European governments to save banks, UK housing bubble...). We expect to see **volatility in the currency space** that macro managers should be able to benefit from.

2. What is the impact of the current crisis on our industry and on each hedge fund strategy?

The nature of the crisis explains the disappointing returns that the hedge fund industry has posted since the second half of the year and more specifically during the month of September.

Relative Value strategies have been mostly impacted by their exposure to Lehman, a fire sale of assets, the widening of credit spreads and a difficult access to funding.

Equity Long Short have been impacted by their market directionality as well as the erratic government intervention (bailing out Fannie and Freddy, not bailing out Lehman, and subsequently bailing out AIG, thus sending opposite signals to the market).

Credit and Distressed strategies have been impacted by the widening of credit spreads and a general fire sale of assets.

Macro strategies have been impacted by the erratic government intervention.

Within the industry only a few managers have been able to produce positive returns in September: they are to be found in the credit space with a short bias, dedicated short sellers, volatility traders, CTAs as well as some macro traders.

3. The opportunities going forward

We do believe that there will be a **once in a lifetime opportunity to invest in the credit space**: from the distressed managers that will be able to buy assets at very cheap prices to relative value credit managers that will benefit from high spreads as well as mean reversion.

In the near term we expect **opportunities** to arise for our hedge funds managers as we think that:

- Spreads in general are exceptionally wide and will remain wide for a while and ultimately revert to their mean. Therefore, we are quite positive on the opportunities in Relative Value strategies where higher return will be achievable without too much leverage.
- We are very optimistic in the near term on Directional Credit managers as they will be able to buy very cheap assets.
- Post crisis environment should be quite profitable for Macro traders and CTAs especially as the government will act more and more in line with what the market expects.

4. What are the actions that we have taken to manage the current situation and how will we position the portfolios in the future?

In such an environment **we have been reducing risk** in various ways by:

- reducing our allocations to market directional strategies such as Equity Long Short and by redeeming managers with the highest beta,
- cutting allocations to managers/strategies that need leverage and Relative Value strategies in particular,
- exiting from Asset Based Lending managers as we expect that sooner or later they will have to mark their books at lower prices,
- raising our cash at unprecedented level,
- monitoring our managers who have, themselves, been reducing risk on their books mainly by raising their own cash level.

We have been **analyzing credit hedge fund managers** looking for the ones that are best positioned to survive the current crisis and to benefit from the upcoming recovery. We are constantly monitoring the situation in this arena in order to redeploy our cash in these new opportunities in due course.

Concluding thoughts

In 2008, hedge funds have not been able to demonstrate their de-correlation properties. In such a systemic crisis and over such a short term span, it should not be expected for any asset class to produce negative correlation.

We would like to emphasize that any allocation to hedge funds should not be judged over a short period of time but over an **entire cycle (at least 3 to 5 years)**.

We believe that we are about to enter a **new phase of the credit cycle** and are quite **enthusiastic about future prospects and opportunities** for the hedge fund industry in general and in particular for credit hedge fund managers.

Thank you for your continuing support.

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