



HERITAGE TOTAL RETURN

5th of February 2009

December 2008

Performance analysis

Heritage Total Return fund USD class finished December 2008 at -0.15% and was down -10.56% on the year. December saw some kind of respite in the market place with reduced volatility and lower volumes, especially around the holiday break. The hedge fund industry continued to post negative returns: the Barclays FoF index was down 0.94% (-21.76% YTD), the HFRI FoF index lost 0.9% (down -20.68% YTD) and finally the CSFB/Tremont HF index dropped -0.03% in December (-19.07% YTD). HTR is still significantly outperforming its peers and the hedge fund industry: +1012bps over the HFRI FoF in 2008.

HTR's directional strategies (Global Macro, CTAs and Equity L/S) contributed a total +45bps. Best performers were Equity managers (+27bps) followed by Macro managers (+13bps) and finally CTAs (+5bps). Two out of nine investments in Equity L/S posted negative contributions (-8bps total) while the other seven managers generated +32bps of contribution: Equity strategies with a trading bias were the best performers; exposures to Japan, shipping and Asia were also rewarding with a combined 18bps gain.

Fixed income assets continued their bull run in December and enabled systematic advisors to post positive returns (+5bps contribution). Within discretionary macro investments, Commodity specialists were the best contributors (+9bps) thanks to a decent rebound both in energy futures and stocks in the last two weeks of the year. Diversified Global Macro managers also had a positive contribution to the fund (+4bps) but displayed more dispersion of returns (+3.90% to -6.21%): managers with an emerging market & Commodity focus suffered more than managers diversified across all asset classes within the developed regions.

Non-directional strategies (ABL & Structured Credit, Convert/Vol Arb, Credit, Event, Fixed Income Arb and Multi-Strategy) posted a negative gross contribution of -43bps. Credit strategies (ABL, Credit & Distressed) suffered heavy losses as their combined contribution reached -50bps mainly on the back of further mark down due to illiquidity in certain markets (structured credit and emerging market bonds in particular). On the other hand, relative value strategies such as FI Arb and Convert/Vol Arb investments did deliver some positive performance: their total contribution reached +8bps; gains were made on volatility (+9bps) while only -1bp was lost in FI Arbitrage.

Portfolio analysis

HTR entered December with a 51.1% allocation to Directional strategies (11.76% to Global Macro, 8.67% to Commodities, 25.79% to Equities and 4.88% to systematic strategies) and 46.7% to Absolute return strategies (4.46% to ABL, 4.77% to Convert/Vol Arb, 7.56% to Credit, 3.63% to Event, 11.76% to Fixed Income Arbitrage and 14.49% to Multi-Strategy). These allocations were kept unchanged from November and the fund still holds 36 investments. No new investments were made during the month and further risk reduction is currently in progress (mainly reducing equity exposure) in order to position the portfolio adequately to benefit from compelling opportunities sometime in 2009.

Performance review

Just to remind you of how tough 2008 was, here is a quick recap of the yearly performances of the various markets as well as of selected Hedge Fund indices:

Stocks & bonds

MSCI World Local	-42%
Citi WBI (1-10yr) Local	+11%
MSCI Financials	-57%
CSFB HY Index	-31%
MSCI Energy	-41%
S&P500	-41%
Eurotop300	-46%
NIKKEI300	-42%
MSCI Emerging Markets Loc	-48%
Russia	-73%

Currencies

Dollar Index	+5%
GBP	-27%
AUD	-21%
Yen	+24%

Hedge Fund Indices

HRFI FoF index	-20.68%
CSFB/Tremont HF index	-19.07%
Barclays FoF index	-21.68%
EDHEC Funds of Funds	-18.76%

These figures are self-explanatory and the reasons of why and how this crisis took place have been widely covered in many of HTR's past monthly bulletins and in the global press. What we would like to concentrate on in this section are the drivers of our performance throughout the year, slicing and dicing contributions and allocations per style, strategies and managers. You will find below a table summarising HTR's strategy allocations and contributions quarter by quarter. Readers should be aware that figures displayed below do not perfectly match as they include final figures as well as estimates.

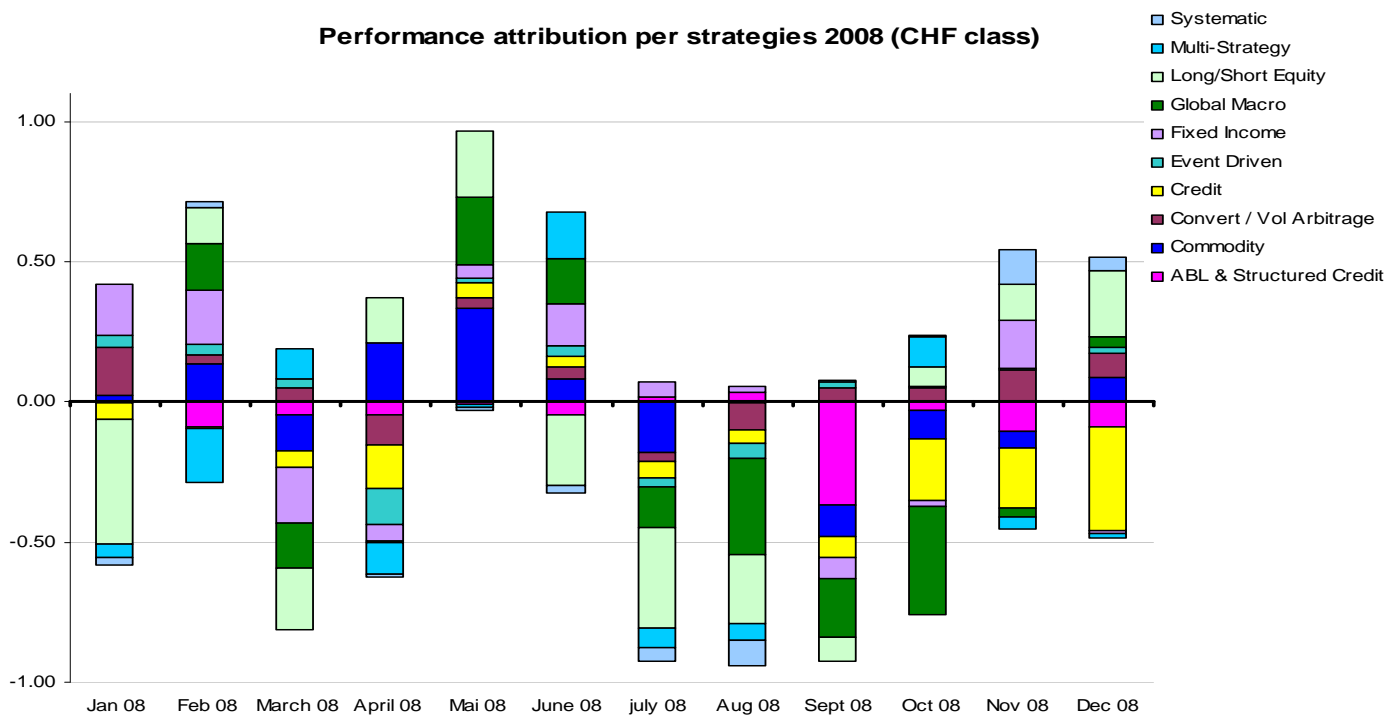
Directional Strategies (Macro, Commodities, Systematic and Equity L/S)

First of all, it is worth noting that the directional tilt given to the portfolio (+56.28% on average in 2008) was initiated back in the second half of 2007 when the tightness of credit spreads and the level of leverage applied by non-directional strategies in order to extract low levels of return raised our concerns. This combined with the identification of a more friendly environment towards Global Macro and commodity specialist managers from our Top Down/Strategy Allocation Model led us to become underweight in both Non-directional strategies and Equity L/S (ELS) and to put more emphasis towards Macro and Commodity advisors.

The first comment to make regarding HTR's Directional strategies globally is that the yearly outperformance of the style over their corresponding Tremont HF indices came from Equities (+1300bps). Macro (GM + Commodities) and CTAs were very disappointing as they did not manage to add alpha for reasons described further in this report (-1431bps for Macro and -2062bps for CTAs).

CTAs massive underperformance can be explained by the fact that exposure to the strategy in Q1 & Q2 was meaningless (< 3%) and only achieved through an allocation to a pure Asian single stocks trend follower who suffered from plummeting prices in the region (-11bps contribution for 2008). HTR allocation to CTAs was increased in Q3 by the addition of a medium-term trend follower (2% allocation) which contributed 5bps to the fund's performance. The low level of contribution is attributable to timing issues: indeed, this investment was created in July at a time when Commodity markets entered what ended up being one of the largest and most violent corrections in history. It is important to note that medium term trend followers made lots of money being long this sector in the first half of the year and were still exposed to it when the correction took place. Good profits were generated by short positions in stock indices, long bonds, short-term interest rates (STIR) and long dollar positions. HTR has now three positions in the strategy having just deployed capital in a short-term trend follower system in the New Year. Total allocation is currently 8% and should not move much from this in the near future.

	Jan 08	Feb 08	March 08	April 08	Mai 08	June 08	July 08	Aug 08	Sept 08	Oct 08	Nov 08	Dec 08
ABL & Structured Credit	(0.01%)	(0.21%)	(0.09%)	(0.06%)	(0.02%)	(0.06%)	0.04%	0.03%	(2.20%)	(0.14%)	(0.15%)	(0.10%)
Commodity	0.06%	0.33%	(0.26%)	0.26%	0.58%	0.10%	(0.41%)	(0.00%)	(0.69%)	(0.42%)	(0.08%)	0.09%
Convert / Vol Arbitrage	0.39%	0.08%	0.10%	(0.13%)	0.06%	0.05%	(0.07%)	(0.09%)	0.29%	0.22%	0.16%	0.09%
Credit	(0.13%)	(0.02%)	(0.13%)	(0.19%)	0.09%	0.05%	(0.14%)	(0.05%)	(0.44%)	(0.96%)	(0.30%)	(0.40%)
Event Driven	0.10%	0.09%	0.06%	(0.16%)	0.02%	0.04%	(0.07%)	(0.05%)	0.14%	0.01%	0.01%	0.02%
Fixed Income	0.42%	0.46%	(0.40%)	(0.07%)	0.08%	0.18%	0.13%	0.02%	(0.45%)	(0.09%)	0.24%	(0.01%)
Global Macro	(0.01%)	0.40%	(0.32%)	(0.01%)	0.42%	0.19%	(0.32%)	(0.33%)	(1.27%)	(1.65%)	(0.04%)	0.04%
Long/Short Equity	(1.03%)	0.30%	(0.45%)	0.20%	0.41%	(0.29%)	(0.81%)	(0.24%)	(0.50%)	0.31%	0.19%	0.25%
Multi-Strategy	(0.10%)	(0.45%)	0.22%	(0.14%)	(0.02%)	0.19%	(0.16%)	(0.06%)	0.03%	0.45%	(0.06%)	(0.01%)
Systematic	(0.06%)	0.04%	0.00%	(0.01%)	(0.02%)	(0.03%)	(0.11%)	(0.09%)	0.00%	0.03%	0.17%	0.05%



Global Macro underperformance (-1431bps) was also disappointing as HTR investments displayed a huge disparity in returns: performances were either very good or very poor but no in-betweens. The majority of the underperformance came from Global Macro but Commodity specialists did not provide much comfort. Worst performers were managers with an emerging market (EM) tilt who were penalised during Q3 by indiscriminate forced selling in both EM stocks and bonds on the back of margin calls enacted by investment banks. Total negative contribution from this group amounted to roughly -173bps. A couple of more traditional/plain vanilla macro managers were taken by surprise by the violence of the corrections and/or were too early to redeploy capital at work at the end of Q3. On the other hand, advisors whose focus is Commodity futures had a good year where most of their performance was achieved in the first six months characterised by ultra bullish trends especially in the energy sector (oil reached USD147 in mid-July). Their combined positive contribution amounted to +69 bps for the full year for an 11.5% average allocation. Q1 & Q2 saw positive contributions for Macro & Commodity strategies while Q3 & Q4 were highly detrimental. The main reason for this was the unwinding of the long Commodity, short Financials trades that many macro funds were exploiting at the time. This unwinding proved to be highly detrimental to advisors specialised in commodity-related stocks in Q3 & Q4. As mentioned before, the forced sell-off of EM assets added fuel to the fire in Q4 and contributed to exacerbate losses amongst the majority of our managers.

Allocations to the strategy averaged 25% in 2008; capital was allocated to 12 managers over the course of the year (only 7 remain invested as of Jan 1st 2009) while single manager position sizes ranged from 2% to 4%.

Five managers were redeemed, two of which evolved in the Commodity space and two in the Global Macro sector mainly due to poor performance and/or negative alpha generation. We have identified a handful of sound managers in the peer group and are in the process of finalising our Due Diligence.

Finally, Equity L/S provided the highest alpha generation (+1300bps) and with an average weight in the portfolio of 27.7% was the main responsible for HTR outperformance over HF indices. Within HTR universe of ELS managers, all funds but one outperformed their corresponding benchmarks. Managers performances ranged from -40% to +31% while market benchmarks posted losses in the -50% to -40% region depending on the sector or region. Disappointment came from "beta leverager" but the mix of style within the Equity L/S strategy was changed very early in the year. Managers with a trading approach or being able to generate gains in either long or short positions were favoured. We focussed on managers not using extreme level of leverage as it became evident that deleveraging was the talk of the market.

As a result, HTR universe of Equity L/S managers now resembles the following: the first group of managers can be described as nimble/flexible/adaptative being able to switch their strategy from sector/region selection (able to identify underlying trends) to a more bottom up/stock specific selection process which enables the managers to concentrate on company fundamentals and avoid being trapped in momentum plays. The common feature of these advisors is the low level of Gross and Net exposure put at work and the philosophy of capital preservation. Those managers outperformance over their respective market benchmarks

(ballpark figure) ranged from +40% to 70%. It is also worth noting that their Gross and Net exposures have substantially been reviewed in 2008 (reduced for the former and in negative territory a good part of the year for the latter). Out of these four managers, three have posted positive returns for 2008 (between 1% and 31%) while the fourth ended the year slightly negative (-3%). There's no bias towards any region or sector, these managers geographical exposures varying from global to US centric or EM across all sectors.



By taking a close look at our L/S Equity managers our Q1 performance was in line with the Tremont L/S equity index at -4.1%, below par in Q2 (-1.17% vs. +3.78% for the index), and outstanding in Q3 & Q4 as these two quarters were marked by violent equity sell-offs around the globe (combined 16.5% outperformance vs. the Tremont index).

The second group of managers can be characterised by features such as value, higher Gross & Net exposures, slower motion (slower Net exposure adjustment), in one case long bias. This group of managers underperformed the first group obviously but still managed to beat their corresponding market and HF benchmarks (for all but one manager). Funds with a value bias suffered most of the year (Q1, Q2 & Q3) just to recover substantial ground in Q4 as indiscriminate selling took place irrespective of the regions, countries or sectors. In the end, they still managed to recoup their underperformance and despite finishing negative for the year outperformed both market and HF indices. As far as sector/region specialists were concerned, pain was felt all year long for our Asian manager (-68bps contribution with every quarter in negative territory). This manager has now been redeemed. HTR shipping/energy investment did a great job in 2008 (+6% performance) despite having had a patchy Q3 (-6.4% performance). The strategy generated returns by being short shipping but gave back a little bit by being whipsawed in the Energy sector which explains Q3 negative returns. Finally, our Japan equity advisor detracted 24bps to performance but managed to outperform the Nikkei (+3300bps) and HF indices.

Eleven L/S Equity funds were used in 2008 and only seven remain invested as of Jan. 1st 2009: we have redeemed of our Asian manager as explained above (a new candidate has been identified and should be soon invested) and have also decided to redeem our Utility specialist mainly due to asset base deterioration and to a lesser extent to performance considerations (-34bps yearly contribution).

Non-directional (Absolute) Strategies (Credit/Distressed, Multi-Strategy, Fixed Income, Convert/Vol Arbitrage)

In the same way we started the above section pointing out HTR directional tilt in 2008, we should also stress the fact that HTR outperformance in 2008 was also the result of underweighting Non-directional strategies on the back of our Top Down/Macro and Strategy Allocation Model (SAM) outcomes. With hindsight, this strategic decision was also another way to create some alpha. Just by looking at some of the Tremont HF indices, we can easily see that just by avoiding being invested in them was already a winning move (Convertibles for example).

As we identified that tight spreads and high levels of leverage due to low levels of volatility were needed by some hedge fund managers to achieve expected returns in some of our directional strategies, it also became clear that the same features were common in the non-directional world. As a result, we completely avoided dedicated both Convertible Arbitrage and Credit RV strategies (capital structure arbitrage, basis arbitrage) to concentrate on Volatility Arbitrage managers. Due to the small number of (good) managers available we decided to select an Asian-based advisor in order to benefit from greater dislocation provided by the region's stock markets. Focusing on equity option rather than convertibles to extract alpha was critical, as options remain quite liquid vs. convertibles (pure HF play/Lehman impact). The result was striking with this one manager contributing +100bps to HTR performance in 2008. Whatever index provider you look at, Convertible Arbitrage lost between 21% and 37% for the period. From a world where premiums or spreads were not aligned with the level of risk taken (a world best described by the "yield-picking mania"), a world where above average economic growth numbers were achieved thanks to indiscriminate borrowings both by individuals, corporate (mainly financial companies) and governments, we entered a phase of total collapse of our financial structures in a matter of months. The premises of the cracks were there however but investors were in total denial.



One of the first cracks in the system happened in March 2008 when Fixed Income arbitrageurs experienced a bloodbath. The main driving force was a liquidity squeeze in the financial sector (ultimately related to the sub-prime crisis and its contagion effects) that appeared to be heading toward the worst-case scenario (a complete withdrawal of balance sheet funding or an increase in funding cost to punitive levels). The

liquidity squeeze eventually abated when the Federal Reserve made an unprecedented move in rescuing Bear Stearns from its near collapse and in the process taking on some of its credit risk exposure – but not before the worsening situations caused widespread deleveraging by hedge funds. This resulted in many flagship names going under as their monthly performance ended up in double digit negative territory. Within this context, HTR Fixed Income investment did feel the pain in March (-6.63% monthly performance) but only detracted 26bps for the quarter. All quarters thereafter saw positive contributions from this manager (total yearly contribution of 27bps and a YTD performance of 9.6%). The corresponding Tremont HF index finished the year down 29%. Again, great alpha was generated but for different reasons this time. Our Top Down/SAM findings did not lead us to avoid the strategy (we had a neutral weight) but it was rather our manager selection stringent process that led us to avoid certain managers perceived to be inadequate for HTR profile and to select this one in particular. It must be reminded that all potential candidates for investment are always put in comparison with a peer group (relative terms) after analysing intrinsic characteristics (absolute terms). Most of the fixed income potential candidates faced hard times during October-November, explaining thus a part of 2008 collapse in this area. HTR's two other investments in the Fixed Income sector display macro features in their respective strategies. One is more specialised in government securities and currencies in developed countries (directional bets and yield curve plays including short-term interest rates), whereas the other, has an EM focus both in government and corporate securities. The former had an exceptional year (+19% performance with a +66 bps contribution) while the latter suffered in the last two quarters from forced selling in the EM bond space (-53bps contribution). The FI Arb strategy did post a positive contribution for the year (+40bps) for an average allocation of almost 10%. No redemption and no new investments were made during the year.

The Multi-Strategy bucket represented another area of satisfaction in 2008. The +2189 bps outperformance generated by this strategy was achieved through various means. First, we have gradually increased our allocation over the quarters (6.5% in Q1, 4.5% in Q2, 10.3% in Q3 and 14% in Q4). Second, we have concentrated our investments with sound managers displaying solid risk-adjusted profiles and very low correlations between themselves. Thirdly, and this is linked to the second point, they were very few overlap between the managers. The span of exposures ranged from a fund specialised in global fixed income and credit, another focused on Asian special situations/volatility arbitrage, through a developed markets credit volatility arbitrage specialist to a strategy combining high frequency mean reversion systems with single stock volatility arbitrage globally and statistical arbitrage. Their geographical scope was broad and, at times, different.

The majority of the returns were generated on the back of increased volatility across all sectors within the fixed income spectrum. For the first time, it was (is) possible to set up positions that had the potential to yield double digit or greater returns on an unlevered basis while hedging credit risk (reference to the "Yield picking mania"). It quickly became obvious that high volatility was here to stay, but many areas of the option markets had not yet re-aligned to reflect this reality.

Consequently, our investment with a focus on credit volatility was well positioned to benefit from those dislocations in Q4 and especially in October when the fund posted an 8% monthly performance. Contribution for the year amounted to +36bps. HTR Asian special situations strategy did extremely well in the first half of the year (+10bps contribution in H1 2008), a time when commodity-related stocks outperformed substantially, but its fortune reversed in the second half and ended up giving back -31bps to finish the year with a negative contribution of -19bps.

Without a legacy position from 2007 which was redeemed at the end of Q1 with an associated cost to HTR of -41bps, the group of strategies described above generated a combined contribution of 31bps (combined performance of +3.1% for the year) which bodes extremely well when compared to the corresponding Tremont Multi-Strategy index (-23.63%).

Credit/Distressed strategies were represented by three investments: a multi-strategy fund within the credit space with a distressed bias, an EM distressed specialist and an Asian credit multi-strategy advisor with a distressed tilt. All three posted negative returns for the year and generated a negative contribution of -262bps for the whole year. This negative contribution is a good indication of the credit market sell-off as those managers' portfolios exhibited low or no leverage! While our Asian manager suffered all year long from market illiquidity and on-going stock market corrections, the other two strategies were only severely impacted in Q3 & Q4 at the climax of the crisis. The global slowdown only partially explains the wave of selling that hit the emerging markets in October. Probably more significant was the effect of global deleveraging that gained significant momentum and investment banks forcing funds facing huge redemptions to

liquidate their portfolios, but also cutting some credit exposure out of their prime brokerage business. At the same time, the Argentine government decided to nationalise the pension system which sent the wrong message to the investment community. Argentine bonds which were already trading at distressed levels (low 20s) got marked down further as the belief of an imminent default gained momentum. This contributed to further losses as Argentine bonds accounted for roughly 20% of our EM Distressed specialist portfolio. As a result, this investment contributed -139bps in the last two quarters only (-141bps for the whole year). On the other hand, HTR multi-strategy Credit advisor managed to contain the pain to -61bps contribution in 2008: losses were attributable to the same illiquidity problem at year end but also to detrimental macro overlay positions which effectively did not provide the expected protection in this adverse environment.

Credit/Distressed strategies were tagged underweight from our SAM all year which led us to have only 8% of HTR capital on average allocated to it.

As far as the ABL & Structured credit negative contribution is concerned (-296bps), around two third of the total loss (-195 bps) came from an investment subject to a fraud (Lancelot) for which we decided to fully write off its value. The legal case is pending and will probably take time to be resolved. The remaining negative contribution (-101bps) was split between three other strategies of which two suffered from their investments illiquidity once they had to sell due to oversized redemption requests placed by investors.

HTR allocation to this strategy was limited to 7%.

Conclusion

2008 was an extremely difficult year to endure as even the most pessimistic forecast did not foresee the speed and breadth of the damage done to both financial markets and economic growth. Opportunities to be wrong and to do the wrong things were multiple and although we did make some mistakes we managed to survive this episode of a multi-year crisis. It is in challenging times that someone can judge of the solidity and viability of an investment process. At Heritage, our solid top down analysis did prevent us from engaging in certain crowded and risky strategies (below average risk/reward profile such as Convertible Arbitrage) and to underweight others not expected to generate compelling returns (Non-directional strategies in general and Credit/Distressed in particular), while our stringent manager selection process enabled us to limit the damage in terms of frauds and/or blow-ups (HTR had only one investment that turned out to be a fraud and which cost the fund 195 bps in total). Finally, we must stress that HTR extensively used all year a strategy not listed above: cash. This along with CTAs and Dedicated Short Equity managers was the best strategy to be in. Cash levels fluctuated between 3% and 12% during the year.

HTR's mandate to be structured as a Multi-strategy and well diversified fund of fund (conservative approach) and to offer equity like returns with a bond-like risk profile over a full cycle was challenged this year to say the least. Performance in 2008 in the region of -8.7% on a gross basis is the proof. However, there are encouraging signs which we would like to point out to you.

First, as we mentioned above, sticking to the process enabled us to weather the storm and deliver alpha over HTR corresponding hedge fund indices and peers.

Second, HTR managed to limit the drawdown to 75% of 2007 performance (-9% peak to trough) whereas indices and peers have in some cases given back 200% of last year returns and have their business seriously put at risk.

Third, volatility of returns in 2008 since inception still lies at 5.7% for the dollar class and 4.4% for the CHF class, despite volatility spiking to 6.1% in 2008 for the dollar share class (5.9% CHF class).

Finally, HTR's best 12-months rolling compounded return over the life of the fund is still higher than its worst 12-months rolling compounded return: 17.3% vs. -10.6%. Again, this important feature has sensibly been deteriorating lately for all industry indices and most competitors.

We believe that the aim of the game is to remain in the game and that by limiting HTR drawdown we should be able to get out of it faster than others and start getting positive results for our investors again.

OUTLOOK 2009



Industry / regulations

The industry is facing tough challenges for the years to come. Let's try to draw a list of key points for our industry.

Industry

We have to deal with a crisis of confidence: investors whatever their nature (HNWI or institutional) have had their fingers burnt by the HF industry (leveraged beta performances and scandals/frauds). It is hard to see how investors will behave going forward. This poses the question of the viability and sustainability of the HF business. Short-term challenges will be faced by certain strategies such as equities (EM equities in particular), Commodities and Convertibles which at this stage of the cycle offer better opportunities (in terms of performance and costs) from a long-only angle rather than from a HF perspectives. ETFs do also offer a good alternative in terms of market exposure (either on the long side to express a view/them or on the short side as a hedge), cost efficiency, liquidity and transparency. Over the long term and once the "cleansing" is over, the HF industry will survive and will have to refocus on alpha generation as it originally did. The beauty of this industry is that a

specialist can be found in each asset class and strategy you can think of. This is where talent will make the difference and where the industry's skill set is at best. After all, even in a disastrous year, HF indices did manage to beat underlying markets by a margin (HFRI Equity Hedge -26% vs. MSCI World Local -42%). The result of the above point is a drastic reduction in assets managed (around 50% drop) which leaves the industry around the trillion dollar mark.

What lies ahead in terms of ideal size from a hedge fund manager? Some reckons that only large HFs will survive as smaller funds depend too much on performance fee in order to meet expenses. Others reckon small boutiques will see strong growth mainly on the grounds of nimbleness, specific expertise, shrinking of the investment pools. Those small boutiques will face the hard job of raising assets whereas larger firms will find it hard to deploy lots of capital in a shrunken market place. There are

however more issues at work to determine the future landscape of the HF industry such as fund's liquidity windows, high water mark, side pockets, legacy positions, etc...It will take time for certain managers to liquidate their portfolios and not one of them can be 100% sure to still be alive and running afterwards. Some managers might also decide to throw in the towel as it becomes harder to get back to the high watermark. What is certain is that transparency and risk management will become paramount issues (for those who did not consider that top priority already) and a fund's liquidity will have to be aligned with the underlying strategy. We could possibly live in a world where half the industry provided very liquid terms due to the liquid nature of their underlings and half provided Private-Equity like liquidity features due to the illiquidity and long term nature of their securities. Or we could live in a world where the time horizon of each investor dictates the nature of investments he wants to make. Or we could well be living in both...

Regulations

The current financial crisis (including recent frauds and scandals) has pushed policymakers and regulatory agencies to homogenise regulations globally. However it is highly probable that different political and regulatory models around the globe will persist over time due to political interference divergence. Some states will remain relatively free of political interference and as a result regulatory environments driven by pragmatism and effectiveness will see an increase

in business. Regulatory arbitrage will always exist between managers serving investors with little need to deal with regulated entities and manager serving investors who need regulated counterparties and who are likely to maintain higher compliance expenses. Changes in market regulations, such as banning short selling, bring more problems than solutions and are not effective (stocks subject to the ban underperformed the market during its

enforcement!). Scandals, similar to those like Madoff, will certainly bring the US authorities to implement new regulations which will bring the US HF industry more in line with their European counterparts who are already required to use external clearing agents in order to ensure third-party scrutiny. What might ensue are more regulations for large HFs pari passu with investment banks, while leaving the boutiques largely unregulated

Strategy Allocation

The Financial crisis is now well entrenched into the real economy globally and macro figures that have been released over the past couple of months keep deteriorating in all regions. Even China is slowing down drastically: GDP figures for Q4 2008 published last week (6.8% slowest pace in 7 years) came on the soft side of expectations and growth is also expected to slow further in the coming quarters.

The questions now are the following: how long will this recession last, will it transform itself into a deflation/depression comparable to what Japan and the US experienced in the 90's and 30's, or will governments and central banks succeed in avoiding the deflation/depression scenarios by reflation economies globally?

Today, although consensus is hard to determine as different asset classes are pricing different outcomes (Equities are currently pricing a prolonged recession, bonds deflation while Credit is pricing depression with unprecedented yield spreads and corporate default rates), it seems that most street economists expect global economies to keep deteriorating for the remainder of 2009 (negative growth in the US, Europe and Japan with China still believed to grow around 5%) before aggressive monetary policies and huge fiscal stimulus impact kick in 2010.

As to what probability to apply to each scenario for the coming 12 months, here is a table with our own assessment:

Consensus	40%
Reflation	30%
Deflation	20%
Depression	10%

The rationale behind these probabilities is based on the fact that aggressive monetary policies coupled with fiscal stimulus directed to both individuals and corporations will help avoid a great depression. However, while these efforts will not be enough to revive growth in the near future, there is a danger that the current

deleveraging process ends up in a deflationary spiral similar to what Japan went through in the 90's.

As you can see we give those three scenarios a lower weight (40%) as we believe that current measures will have a different outcome.

We expect the steps taken by most governments to eventually revive inflation without necessary boosting growth going forward. The world is on the verge of witnessing billions and trillions of dollars of liquidity injection in the near future. Inflation is the result of too much liquidity, surging asset prices, supply bottlenecks and inefficiencies. High level of inflation in Argentina, for example, is not because business is good but rather because there is too much money creation, public employment, flight capital, tax evasion and corruption.



Inflation is a monetary phenomenon and wealth transfer mechanism as well as a mean to reduce the value of debt payments. If the heads of central banks say that they will do whatever it takes to avoid dropping consumer prices and promise to flood markets with money, you should expect them to do so and be scared for the purchasing power of your savings and investments. If someone promises to depreciate the purchasing power of money and has the power to do so, may be we should believe him. At the

moment, inflation is not an issue as investors are concentrating on the depth and length of the recession but at some point (timing is always tricky), there will be a time when we will have to protect our capital from inflation.

This is why we think that in the short/medium run the governments/central banks could manage to prevent a meltdown (consensus view) but will ultimately revive inflation to make that future debt payments on the massive borrowings under way are much smaller (reflation).

Within this context, returns across many HF strategies will be higher, possibly much higher than they were in 2006-2008. We will at some point in the next 6 to 12 months enter a golden age similar to the 1990's where HF indices could potentially compound at roughly 20% for a couple of years without having to deploy any leverage at all.

While we are still slightly underweight Credit and Distressed, there are a number of dislocated markets out there, especially within the Credit space.

The majority of the returns will be generated by directional Credit strategies:

Long emerging market corporate bonds hard currency denominated but also local currency denominated (forced selling triggered dislocations) However, some returns could be driven by relative value strategies: basis trading (spread between cash bonds and CDS) and L/S Corporate bonds strategies

Opportunities in Distressed situations will abound but it might be a little too early to start deploying capital for now. Current default rates are presently around the historical norm but are predicted to rise sharply during the course of 2009.

We still expect this environment to create more discrepancies to be exploited by Global Macro strategies both discretionary and systematic (both overweight). Discretionary managers have historically displayed great skills at reading future macro trends in challenging times. As far as systematic advisors are concerned, the current environment should benefit trend following systematic strategies; however, medium to long-term trend followers (which have performed extremely well over the past 12 months) could be subject to wild swings as they get caught in sharp corrections. We tend to favour short-term strategies as we expect

markets to display see-saw behaviours in the near future.

We favour an underweight allocation to ELS with an emphasis on liquid strategies (Large Caps, low Gross/low Net, Value, defensive sectors, stock pickers and Trading strategies), and underweight Europe and the US while more constructive in Japan and selected emerging markets. Finally, we are also underweight in Event driven strategies.

A slight overweight in RV strategies (Fixed Income, Convert/Vol Arb and EMN) is favoured with capital deployment seen in the coming months. Convertible exposure will be achieved through long-only

investments to avoid hedge funds' gatings or redemption suspensions. Performance drivers will be credit spread tightening, potential equity prices recovery (not a prerequisite), companies' buy-back, and institutional investor's inflows to name a few. Finally, strategies trying to benefit from higher level of volatility particularly in equity markets (but also in currencies and soon to come in fixed income) should also be favoured. Strategies employing market neutral exposures in the equity space with low levels of leverage should also benefit from a return to normalcy, hence our slight overweight in the Equity arbitrage bucket.

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