

Insights

Hedge Fund Industry Observations Series

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Important Determinants of Manager Success in 2009

Our “Hedge Fund Industry Observation Series” highlights the latest insights and perspectives from J.P. Morgan Alternative Asset Management (JPMAAM)

In 2008, hedge funds experienced the deepest drawdown in the history of the asset class. Revelations of fraud and numerous headlines have only amplified investor concerns.

Lessons have been learned and many of the managers that weathered the storm in 2008 may be competitively positioned to succeed in 2009. Key determinants of manager success in the near-to-medium term include: scale, customization, transparency, fees and liquidity.

Scale: Bigger, but not too big

Catalyzed by the events of 2008, the environment for hedge funds continues to become more complex, in terms of regulations, client demands, infrastructure, risk management, and transparency, to name a few. Scaling the business appropriately is critical. Firms will need the resources in terms of both personnel (both quantity and quality), and assets (i.e. revenues) to meet these increased demands. For those few traders looking to launch a fund in 2009, they will be very heavily pressured to partner with organizations that can provide back office, compliance, and other services. Smaller funds will experience barriers to entry, while massive and complex funds will also face challenges. Several large funds broadened into a wide variety of strategies, employed hundreds of people, and often took leveraged market bets. This complexity can create excessive business risk if not properly managed.

Customization: Give investors unique solutions

Customized separate accounts will likely be in greater demand by institutional investors with

sophisticated staff members *and the ability to invest in size*. Investors will also seek out more niche or single strategy fund of funds, as they formulate their own views on particular strategies, and build out their allocations factoring both the attractiveness of certain investment strategies and their liquidity needs. Finally, institutional investors who are interested in building out their hedge fund allocations directly are more likely to seek advisory services from hedge fund of funds managers to leverage the manager's research, risk management, and operational due diligence expertise.

Operational due diligence, risk management, and investment due diligence: Intertwine processes

In the *Importance of Liquidity Management in 2009* section of this publication, we point out how important it is for each diligence and risk team to share findings and incorporate them into decisions. Examples include:

- Operational due diligence professionals must understand who provides leverage and what the terms are. For instance, can the provider pull the leverage, or is the provider's business at risk (e.g. Lehman)

- Investment professionals must understand the portfolio, and assess whether it can be liquidated to satisfy a capital call from a leverage provider
- Risk management professionals should assess the likelihood that triggers in the leverage agreement would be breached, based on market movements (i.e. stress testing, etc.)

All of these findings need to be discussed as a team to make informed decisions.

Transparency: Provide more

Demand for regulations and transparency will increase². Hedge fund of funds managers will be required to obtain more information, and all hedge fund managers will be required by regulators and investors to report more. Furthermore, as transparency increases, investors will be held accountable for analyzing and acting on the information.

Fees: Better align interests with investors

As the balance of power in the hedge fund industry tilts toward investors, we expect managers to be more open to revising their fee structures if warranted³. Firstly, we expect management fees to compress. Management fees will be lowered to more appropriately reflect the necessities of paying ongoing expenses of the business. In our view, management fees should be less about increasing the wealth of the principals, and more about paying for the operating expenses of the business in terms of salaries, overhead, etc., and ideally with enough left over to generate a modest net profit for the management company.

Performance fees should pay managers handsomely when they perform well. That said, many investors will hesitate to pay performance fees on returns that are heavily influenced by beta, which is notably the case among strategies that require managers to invest in attractive opportunities with a long bias. Going forward, we believe that investors will need to better understand the degree to which performance reflects beta, and should demand that performance fees be charged accordingly.

Although we believe that fees will and should compress, we also support the notion of managers being compensated if they perform. Hedge funds will continue to attract the best and brightest investing talent, and that talent should be paid if justified by performance.

Liquidity: Manage it well

Management of a fund to account for redemptions and stress tests of redemptions is going to be extremely important, after many managers suspended redemptions in 2008. The best hedge fund of funds managers are very well equipped to think through what fund terms make the most sense (e.g. gates, notice periods, investor rights, in kind distributions, side letters, etc.), especially when considered in relation to the hedge fund strategy and the underlying investment holdings of a fund⁴. Further, the strongest hedge fund of funds are equipped to analyze the value proposition and to capitalize on others' challenges in the secondary market, buying hedge fund shares at a discount to NAV from other investors seeking liquidity⁵. Overall, resources dedicated to understanding and negotiating the most prudent liquidity framework will differentiate hedge fund of funds providers in 2009.

² Please see the *Transparency and Regulations* section for additional considerations related to transparency and regulatory trends.

³ Please see the *Impact of Fees* section for additional considerations related to hedge fund fee structures.

⁴ Please see the *Importance of Liquidity Management* section for additional considerations related to liquidity management.

⁵ Please see the *Opportunities in the Secondary Markets* section for additional considerations related to activity in the secondary market.

Managing Against Systematic Risk: Hedge Fund Leverage and Liquidations

The troubles of 2008 for hedge fund managers were centered on the months of September and October. The industry witnessed severe losses in these two months, with managers losing -6.9% in September and -9.4% in October, as measured by the HFRX Hedge Fund Index. It was during these months that managers were forced to reduce leverage at a dramatic pace.

Further, following the short selling regulations that were imposed in September, managers with short exposure to equities were subjected to large basis risk losses as they rushed to cover their short positions. Were it not for these regulations, we believe that short sellers would have provided much more of a hedge against the systematic market risk (equity beta) that hurt many hedge funds, and in turn hedge fund of funds portfolios.

With 2008 behind us, it is worthwhile to consider how things look today compared to how they looked just before the turmoil. Below we discuss where leverage levels are today, and discuss our thoughts on guarding against severe systematic (left tail) risk.

Leverage

Leverage has and will continue to come down. The drivers of the reduction are both demand and supply, which in this case each will intersect at investment value.

The **demand for leverage** by hedge funds has declined and will remain much lower than it has been during prior years, we estimate by 30%-50% cumulatively across the industry. Strategies that have historically used high leverage witnessed dramatic declines in 2008 as “basis risk” took hold, and a number of managers who traded areas such as fixed income arbitrage, statistical arbitrage, or even fundamental equity long/short managers using excessive leverage have gone out of business (or will within the next six months). In addition to hedge funds managers who have reduced leverage or closed, another large segment of highly leveraged investors has almost ceased to exist: proprietary trading desks. In the past, these desks had been leveraged by as much as 20x, depending on the trading strategy. Many were shut down by large banks starved for capital or by those struggling to improve their balance sheets, and the remaining trading desks now

employing far less leverage. As a result of the capital withdrawals and leverage reductions by managers and the closing of proprietary trading desks, some estimate the “alpha seeking money” to have declined by as much as 85% (see **Exhibit 1**). We believe the resulting market environment should translate into attractive returns for investors.

Exhibit 1: Decline of “alpha seeking money”
(dollar amounts in trillions)

	Hedge funds		Proprietary desks		Total
	Equity	Leverage	Equity	Leverage	
Early 2008	\$2.0	3.0x	\$4.0	20x	\$86
Early 2009	\$1.2	1.5x	\$1.0	10x	\$12

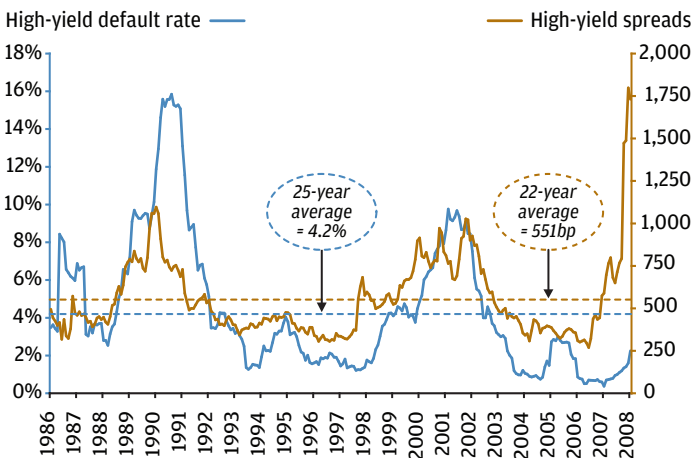
Source: GFIA of Singapore.

The **supply of leverage** has also decreased. First, several historical providers have ceased to exist, with Lehman Brothers and Bear Stearns as two prominent examples. Second, of the remaining willing providers, the credit crisis has resulted in them scaling back on their own balance sheet risk, and in some cases constrained by capital shortfalls. The result is that leverage is more expensive, comes with terms that are less appealing, and otherwise far less available.

Where value and leverage intersect: One can say that there is an equilibrium that has played out in the market for leverage. The demand by hedge funds and proprietary trading desks is much less, and so is the supply. Importantly, in the hedge fund industry demand and supply of leverage intersect with each other at investment value, and this should be more than just a discussion point to truly determine the attractiveness of certain asset classes and managers going forward.

The value of various classes of securities is currently very attractive compared to historical levels. Consider credit as one example. Spreads for high yield bonds are trading at levels that far exceed levels observed over the past two decades (see Exhibit 2).

Exhibit 2: Default rate versus high-yield spreads



The catch is that much of this is a result of the leverage that came out of the system, which was either driven by a forced reduction as suppliers recouped their capital, and/or a concurrent willing reduction in leverage by investors (hedge fund managers included). Whatever the motivating forces driving the reduction, it resulted in a mass liquidation of assets, which in-turn resulted in the attractive valuations we see today. However, to truly say that valuations are attractive, one must also think about the leverage supply and whether it will increase again any time soon. After all, a security may appear cheap compared to when there was excess leverage and capital driving its value to lofty levels, but if that capital is not likely to be reintroduced into the market, then using that prior reference is a flawed approach in determining cheapness. Such a course of action would be similar to an equity manager who feels the resulting pain of investing in a “value trap” stock, where earnings multiples appear low until the actual earnings collapse.

Assessing the “real value” level

We believe value must be based on fundamental principles more today than in previous periods in assessing whether a security is properly valued. Investors should not only examine where a security is trading today compared to where it was trading in an environment of excessive leverage, but also where it should be trading assuming those excessive leverage levels do not return.

If a security is trading below this “real money” level, then it really is cheap and dislocated from fundamental value. As part of our due diligence process, we will be actively discussing what really constitutes cheapness, and how the managers we allocate to interpret the same.

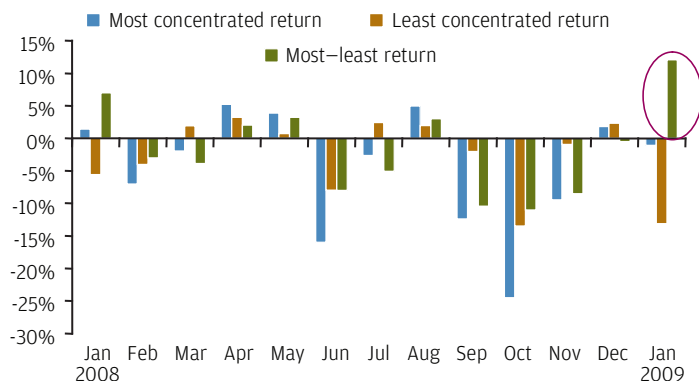
Signs that leverage—and to a lesser extent liquidations—have abated: is “alpha” resurfacing?

The delevering and liquidation challenges that faced managers in 2008 are abating. This is important, since it means that managers who have weathered the period and in many cases raised cash are not forced to sit on the sidelines, and instead can actively go after alpha. While referencing only one month is certainly not scientific, the alpha generated by equity long short managers in January is hopefully a preliminary sign of additional alpha yet to come. Consider two examples of how hedge fund managers generated alpha.

First, in January the S&P 500 index declined by (-8.43%), but equity long/short managers were actually positive. The HFRX Equity Hedge index was off by only (0.15%), and long/short equity managers in our complex, as represented by the JPMorgan MSF Composite, appreciated by an estimated +2.19%.

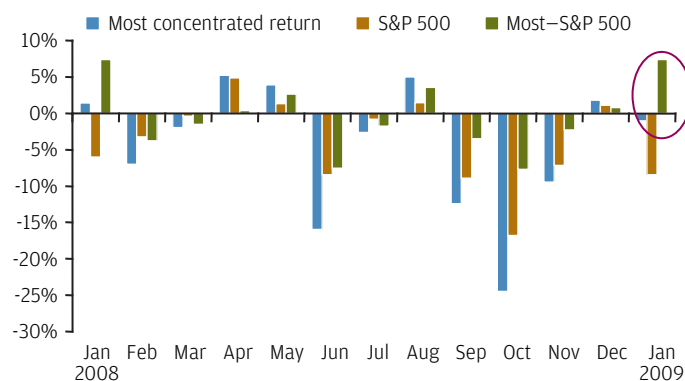
Second, and likely very much related to the first point, the most concentrated equity holdings by hedge fund managers significantly outperformed the least concentrated holdings in January, a reversal from what occurred in 2008. Goldman Sachs tracks these holdings, described as their “High hedge fund ownership concentration basket”, and their “low hedge fund concentration basket”. The high concentration basket is composed of the 20 stocks with the highest concentration of their market capitalization owned by hedge funds, and the low concentration basket is composed of the 20 stocks with lowest concentration of their market capitalization owned by hedge funds. In 2008, as hedge funds were forced to delever and to meet redemptions, stocks in the high concentration basket declined by (-47%), while stocks in the low concentration basket were off by much less, only (-21%). In January the situation completely reversed, with the high concentration basket down by only (-1.08%), and the low concentration basket off by (-12%). The high concentration basket outperformed the S&P 500 by approximately +7%, and outperformed the low concentration basket by approximately +12% (Exhibits 3a and 3b). This suggests (but does not prove) that hedge fund

Exhibit 3a: Most concentrated versus least concentrated stock baskets



Source: Bloomberg, Goldman Sachs Hedge Fund Trend Monitor.

Exhibit 3b: Most concentrated versus S&P 500



Source: Bloomberg, Goldman Sachs Hedge Fund Trend Monitor.

managers were able to redeploy capital in search of alpha, as opposed to scaling back. While the performance is positive, we are also mindful of the risk that overcrowded names present to hedge fund investors, and investors in hedge funds need to understand their exposure.

Hedging Fund of Funds against systematic risk, including beta and “left tail” periods

As short sellers continue to face additional regulatory scrutiny and uncertainty, and as more managers increase their long bias in search of deep value, the beta risk to our portfolios is likely to increase. We believe that short sellers will remain viable, and we are confident that they will continue to deliver alpha and mitigate systematic risk (equity beta). One of the unique challenges faced by short sellers, and in-turn by us as a hedge fund of funds using short sellers for exposure management, is that when their investments are successful (i.e. the stock they are short declines), their overall short exposure as a percentage of the equity in their fund decreases. The same works in reverse for their losers, as stocks they are short appreciate, their equity decreases while short market exposure increases, in other words they become highly leveraged (see Exhibit 4 for an example).

Following the severe equity declines in 2008, many short sellers now are underinvested, and are also apprehensive to put on additional short exposure considering how much equity markets have fallen. As result, this dilemma has left hedge fund of funds managers somewhat vulnerable to being under-hedged. One alternative is to increase the number of short sellers; however the supply of talented short sellers is minimal. To offset this lack of short sellers, an option for hedge fund of funds managers is to increase exposure to dedicated volatility traders, who tend to profit when the markets suddenly decline.

Exhibit 4: Manager sells short 100 shares of XYZ @ \$100

Total equity	\$50,000	
Sell 100@\$100	\$10,000	
Reg T requirement 50%	\$5,000	client-deposit equity
	\$15,000	credit balance

Assuming the manager has \$50,000 of total equity: Gross short exposure is 20%

Scenario A		Scenario B	
If the stock declines to \$60 per share:		If the stock rises to \$140 per share:	
\$15,000	credit balance	\$15,000	credit balance
-\$6,000	current market value	\$14,000	current market value
\$9,000	equity in short account	\$1,000	equity in short account
\$4,000	profit	(\$4,000)	loss
New total equity:	\$54,000	New total equity:	\$46,000
New gross short exposure:	11%	New gross short exposure:	30%
	(\$6,000/\$54,000)		(\$14,000/\$46,000)
	Not 12% due to the increase in equity!		Not 28% due to the increase in equity!

The above is shown for illustrative purposes only and is not meant to represent actual results.

Summary

The leverage landscape has changed from 2008 and investors need to feel confident now more than ever about the ability of their managers to recognize true fundamental value, but also the ability to minimize tail risk. Fortunately, with leverage severely reduced, the systematic risk is much lower, but we still foresee active “tail risk management” as a significant issue throughout the hedge fund industry.

2008 Will Impact Transparency and Regulations in the Hedge Fund Industry

In the aftermath of 2008, it is not surprising that the drumbeat for more transparency from hedge funds is getting louder.

Pending Regulations

U.S. Government insiders and regulators have called for the regulation of hedge funds and the international committee of current and former senior regulators, the “Group of 30,” has begun to flesh out proposed hedge fund regulation requirements¹. Below are several of the obligations under consideration by the Group of 30:

1. An end to fund manager exceptions from federal registration;
2. Ongoing information reporting requirements;
3. Substantive regulation (such as leverage limits);
4. Stricter investor suitability standards;
5. An investment advisor “self-regulatory organization”; and
6. Self reporting requirements.

While it is unlikely that specific reforms will be adopted in the near term, we are confident that transparency will increase. Following the dramatic market stresses and volatility of 2008, the revelation of alleged fraud committed by Bernard Madoff and the increasing pressure on and from regulators, managers will be required to be more open and transparent.

As the balance of power shifts to investors, those with the requisite scale, resources and expertise will be far more competitively positioned, since they will be able to demand more information from managers, and perhaps more importantly, to digest, analyze and act upon it. Further, hedge fund of funds and Advisors with scale will also be better equipped to provide their investors with detailed exposure data on a “look through,” consolidated basis. In addition, the scope of operational due diligence will expand to include numerous checks and evaluations of a manager’s business operations, service providers, financial statements and legal documents.

Greater Transparency

The creation or restructuring of several regulatory bodies likely will be another part of the movement toward greater transparency. This may include designated professionals or departments to oversee and monitor systemic risks posed to the markets by certain participants (hedge funds included), with the power to limit the actions of these participants – possibly including their ability to take on certain levels of leverage, and/or to take on levels of exposure that poses a systemic risk to the market. While some additional regulations may be warranted, we believe that regulators will be cognizant of the fact that smart regulation and the enforcement of existing regulations is just as important as increasing the amount regulation imposed on managers.

With additional transparency will come additional responsibility and accountability. Hedge fund of funds managers and other fiduciaries who allocate to hedge funds will be held to account if they do not use the increased information received prudently. Hedge fund of funds managers and fiduciaries without the necessary scale and resources to commit to analyzing the data, and to conducting the deep due diligence necessary to say “we did a thorough job” will find it increasingly hard to survive and will operate at increased risk. Indeed, the Madoff scandal served to expose several hedge fund of funds that were more focused on asset gathering than deep due diligence.

¹ “Oversight of Private Pools of Capital” Is Firmly on the Reform Agenda - What It Might Mean for U.S. Fund Managers, Shearman & Sterling LLP, January 30, 2009.

Summary

As the balance of power in the hedge fund industry tilts toward investors, we expect managers to be more open to raising their degree of transparency if warranted.

We urge investors to use the current environment as an opportunity to review their managers with respect to transparency, with the goal of encouraging the managers to better align their interests with those of investors. Managers that adopt such a mindset will be proactive in trying to stay ahead of regulatory trends and will be more competitive. These managers will be prepared with the information regulators, auditors, and investors require.

Regulation of Credit Default Swaps (CDS)

A CDS contract can be used as a hedge or insurance policy against the default of a bond or loan. Hedge funds exposed to meaningful credit risk in certain trades can shift some of that risk by buying protection in a CDS contract.

The market for CDS is over the counter and unregulated, and the contracts often get traded so much that it is hard to know who stands at each end of a transaction. There is the possibility that the risk buyer may not have the financial strength to abide by the contract's provisions, making it difficult to value the contracts. The **leverage** involved in many CDS transactions, and the possibility that a widespread downturn in the market could cause massive defaults and challenge the ability of risk buyers to pay their obligations, adds to the uncertainty.

The trading processes for CDS are undergoing change. Regulators will likely insist that CDS begin to trade on an exchange, or via a centralized clearinghouse, instead of as over-the-counter transactions negotiated between two parties through an ISDA agreement. We believe this will be a positive development. Most importantly, it will help to keep the systemic risk to the financial system in check, by limiting the ability of any one participant to overextend itself (at least on the exposure that entity takes on trades conducted through the exchange). Should a participant fail, the required cash margin posted by the participant, and risk mitigating contract specifications imposed by the exchange should result in far less chaos than what transpired following Lehman's failure. It will also likely reduce the friction costs of doing transactions (e.g. negotiating and monitoring multiple ISDAs with various counterparties), thereby allowing managers to hedge their portfolios or take directional exposure quickly and efficiently.

2008 Will Impact Fees across the Hedge Fund Industry

The difficulties experienced in 2008 have led many managers to revisit their fee structures. Below we discuss our views on how fees will change, and our opinions on proper incentive structures for managers.

Fees – Hedge Fund Managers

Quite simply, we expect **management fees** to compress. Management fees will be lowered to more appropriately reflect the necessities of paying ongoing expenses of the business. In our view, management fees should be less about increasing the wealth of the principals, and more about paying for the operating expenses of the business in terms of salaries, overhead, etc., and ideally with enough left over to generate a modest net profit for the management company. Over the past few years we have witnessed a portion of managers who abide by this principle, and others who frankly seem to completely reject it. As the balance of power shifts in the investor's favor, those in the last category must and will change, which we obviously view as a positive. This also means that pass through fees will be less and less acceptable.¹

Performance fees should pay managers handsomely when they perform well. That said, many investors will hesitate to pay performance fees on returns that are heavily influenced by beta, which is notably the case among strategies that require managers to invest in attractive opportunities with a long bias. Going forward, we believe that investors will need to better understand the degree to which performance reflects beta, and should demand that performance fees be charged accordingly.

Increasingly, investors will demand that performance fees are charged after exceeding some hurdle. Naturally, the hurdle will likely have some association to the beta that the manager is taking. All of this puts more of a duty on the investor to understand what beta each underlying manager is taking as well. Another option to more appropriately align performance fees with investor interests may be for managers to charge performance fees based on a longer investment cycle, as opposed to taking fees each year that performance is positive. This may smooth out the fees and avoid overpayments during windfall years, thereby

ensuring that years such as 2008 where most managers were down, impact the wealth of the manager as much as the investor. Further, a longer calculation period may lessen the risk of managers taking excessive risk in a single year, perhaps to recoup losses and get back above water. One approach that investors may employ to achieve these changes to the performance fee structure is to invest with managers via a separate account. In this way, investors have the ability to tailor a fee structure that better aligns their interests with the managers.

We believe that principals should also be prepared to either keep working capital on the balance sheet of their management company, or to otherwise reach into their own pockets to support the business when performance fees are not sufficient, for example covering the costs of paying junior people. Similar to expectations placed on other industries, we believe some form of capitalization by hedge fund management companies will be increasingly demanded.

High-water marks² exist to protect investors. Following 2008, we have seen several managers attempt to modify their high-water marks, so as to charge performance fees even though they have lost money for their investors since they last charged these fees. Often this is done by lowering the “performance fee” percentage charged to investors until the high-water mark is reached, and then resetting the percentage upward to its previous level.

¹ While not standard industry practice, certain managers *pass through* expenses directly to investors. These expenses may include overhead, capital expenditures, salaries, and even bonuses for professionals. This often results in the majority, or perhaps the entire management fee being allocated to net income (i.e. the principals of the management company) instead of covering operational costs. These fees are also in addition to performance fees charged.

² A high-water mark is a performance threshold that a hedge fund manager must exceed before charging performance fees. In other words, investor returns must be positive, or “above water.” If a manager incurs a loss in one year, the loss typically is carried forward to the following year. The manager must recoup that loss (i.e., exceed the high-water mark) before charging any performance fees.

Generally we view this as negative, and in some cases borderline egregious. As mentioned above, we believe that management fees be used to keep the business operating, and that managers offset any shortfalls with performance fees paid by investors during previous profitable periods.

Managers with pedigrees will have less negotiating leverage than before, and should expect investors to be more skeptical and to push back on egregious terms. Last year proved that managers with the finest pedigrees were far from infallible, with many suffering losses as bad or worse than others in the industry with less impressive credentials. In addition to such managers charging fair fees, they should also expect no leniency in various other areas of due diligence, and must be more receptive to supplying information and addressing investor concerns.

Although we believe that fees will and should compress, we also support the notion of managers being compensated if they perform. Hedge funds will continue to attract the best and brightest investing talent, and that talent should be paid if justified by performance.

Summary

As the balance of power in the hedge fund industry tilts toward investors, we expect managers to be more open to revising their fee structures if warranted.

We urge investors to use the current environment as an opportunity to review their managers with respect to fees, with the goal of encouraging the managers to better align their interests with those of investors. Managers that adopt such a mindset will be proactive and stay ahead of industry trends.

Opportunities in the Secondary Markets

The recent liquidity challenges are likely to present more opportunities for stable investors, as activity in the secondary market continues to increase. The *secondary market* for hedge fund shares is still in its initial stages. In understanding how the secondary market works and why it exists, one can look at the drivers of supply and demand:

Supply side

On the *supply side*, investors wishing to sell their allocations usually do so for several reasons:

- 1) **Distressed hedge funds, many times driven by a bad capital structure:** If a hedge fund manager's portfolio is impaired, investors often want to simply exit as quickly as they can, even if it means selling at a rather steep discount. Frequently, the hedge fund will be leveraged, and under these circumstances the manager will be forced to sell higher-quality, more-liquid positions to satisfy counterparties. In this case, the remaining portfolio may be illiquid, and the value of the assets may be uncertain. The result is often a suspension of investor withdrawals. Although the discount at which the fund shares are offered in the secondary market may be quite large, investors must be cautious about intrinsic value.
- 2) **Distressed hedge fund investors are themselves desperate for liquidity:** In this case, a fund may have limited or suspended redemptions due to outsized investor redemptions driven by investors who themselves have large liquidity concerns. This situation can happen when managers allow their investor base to become concentrated with investors who are not on a sound liquidity footing. These investors may be required to meet redemptions of their own. One such example in 2008—hedge fund of funds that were leveraged and wrapped inside structured products, in which case the structured product manager was forced to redeem from the hedge fund of funds to bring leverage ratios back into balance. Many of the hedge funds in this category have high quality assets, reasonable performance, and modest portfolio liquidity that unfortunately became stressed in 2008 given the severe redemptions from select investor types. Depending on how

desperate the investor is for liquidity, the resulting discounts can be substantial.

- 3) **Funds with well-thought-out liquidity terms:** Before the wave of redemption suspensions that occurred in 2008, these fund shares were the vast majority transacted in the secondary market. In this case, the hedge fund manager was prudent in restricting liquidity and managed his or her capital structure well. The portfolio may hold assets that are very high quality, and may or may not be illiquid. However, the manager's terms restrict investors from withdrawing capital, usually through lock-ups, and those locked-up investors have occasionally put their shares up for sale in the secondary market.

As one might expect, the best opportunities in terms of value are often found in the latter two categories. Stable investors should stand equipped to capitalize on these opportunities.

Demand side

On the *demand side*, the situation leading to a hedge fund's shares being listed needs to be understood by investors in detail before making a bid. To determine the appropriate bid, investors need to gauge (or in some cases guess) not only how much a seller needs to sell and what discount he is likely willing to accept, but more important the quality of the hedge fund manager and portfolio on a stand-alone basis.

We believe the standard due diligence process and proper evaluation of the fund are essential before investing, even if the discount is attractive. For hedge fund of funds managers, the secondary markets present unique opportunities to buy shares of managers, at attractive discounts, that already exist on platforms and that have been vetted through the due diligence process.

The other important criterion to evaluate is the value of underlying portfolio holdings, and whether there is upside in the securities held in the fund. This requires a higher degree of transparency in many cases.

The intersection of supply and demand

The secondary market for hedge funds is the intersection of supply and demand. There are two primary facilitating parties that make the market work:

- 1) **Specialist agencies** capture data on shares available for sale and, to a much lesser extent, those sought by investors. They then attempt to match sellers with buyers.

Generally, agency firms' key strengths are their technology platforms and/or relationships throughout the hedge fund industry. Investors can quickly check listings on a firm's website to determine if fund shares are available. Since the level of information each firm provides on the shares being offered varies considerably, we encourage investors using agencies to do their homework.

Some agencies may not have actual deals that are in the market, and might instead be trying to create transactions. In this way, they are analogous to a mergers-and-acquisitions investment banker who meets with many companies in his industry and, through his intimate knowledge of these companies, proposes strategic deals for managements to consider. Specialist agencies are paid a small percentage of the assets that trade hands.

- 2) **Investment banks** may structure transactions with set valuation metrics, bidding procedures and completion timelines. These deals typically are arranged as arm's-length transactions in which the bank sets up the most efficient structure for buyers and sellers to find each other at a common price. Investment banks are paid upon completion of a deal.

Recently, the hedge fund manager Plainfield Asset Management hired Credit Suisse to conduct a Dutch auction for one of its hedge funds. Plainfield's goals were to provide both liquidity for investors wishing to redeem and an opportunity for others to add to their positions at a discount. More than \$150 million traded hands in this transaction.

Each secondary transaction is different

There are important factors investors need to consider. Below are just several examples:

- 1) **Is the high-water mark attached to the transaction?** If purchasing shares where the NAV is below the high-water mark due to negative performance, investors need to know if the high-water mark will reset to the current NAV upon a change in beneficial ownership, or if they get to keep the embedded loss post-transaction. A substantial difference in fees can result, which can be factored into the bid value.
- 2) **What share class is available in the secondary market?** Many hedge funds have much different fees and liquidity terms, or even underlying investments (e.g., side pocket eligible), depending on the share class.
- 3) **Do liquidity restrictions reset?** Similar to the high-water mark consideration, does a change in beneficial ownership after a secondary transaction result in a reset of investor lock-ups or other liquidity restrictions, or does the seasoning embedded in the shares transfer to the new investor? Again, depending on the situation, shares that do not reset should be more valuable, possibly justifying a higher bid.
- 4) **What is the transaction charge?** Investors pay a fee for each transaction. The fee varies, but may be 50-100 basis points or more.

Equity participation

In addition to secondary transactions, another area of opportunity driven by the liquidity challenges is an increased ability to gain **equity participation with managers**. Whether through a revenue sharing arrangement or other equity ownership (or phantom ownership) agreement, managers who face challenges in maintaining or building their business in this environment may look to hedge funds of funds as key investors in their funds, and in exchange grant equity participation. We expect these situations will be more abundant in 2009. The net result will be the possibility for enhanced returns for investors.

Summary

We believe that the number of available transactions in the secondary market will increase, particularly due to liquidity issues that have forced fund shareholders to sell on a distressed basis. Stable investors should see these transactions as attractive opportunities to exploit.

Investors wishing to sell hedge fund shares that they are unable to redeem are often willing to sell them at a substantial discount, by as much as 20%-30%. For managers or strategies where the hedge fund of funds has a very high conviction, we believe purchasing these shares in the secondary market should deliver attractive incremental profits for investors.

The Importance of Liquidity Management in 2009

We feel strongly that one of the most important determinants of success in 2009 for hedge fund investors will be prudent and proactive liquidity management.

2008: Liquidity under stress

Hedge funds' liquidity experienced severe stress in 2008, when managers were forced to meet outsized redemptions and, often simultaneously, reduce leverage to meet the demands of prime brokers and/or counterparties.

To make matters worse, in order to raise this capital, managers often had to sell (or buy to cover short positions) significant percentages of their fund holdings in illiquid market conditions and at distressed prices. Many managers instead chose to suspend redemptions entirely, or carve out their illiquid positions and distribute them in kind to investors in the form of a liquidating vehicle.

Monitoring underlying liquidity via redemption cycles, notice periods, gating provisions and maximum sidepocket usage was not enough in 2008, as the actions of many managers rendered such efforts futile.

2009: Liquidity under scrutiny

With the lessons of 2008 now behind us, we strongly feel that prudent and proactive liquidity management will be one of the most important determinants of success for hedge fund investors in 2009.

Investors will need to be much more discerning about liquidity when evaluating managers. Our own analysis concentrates both on the liquidity of a manager's portfolio and the liquidity terms a manager offers to investors.

Studying a fund's terms, investor base, amount of leverage employed and underlying exposures will remain critical to a proper due diligence process. So will scenario analysis, which allows investors to consider various what-ifs and be better

positioned to exit a vulnerable fund before it is forced to suspend redemptions or issue fund holdings in kind.

A mini-case study in liquidity assessment

The liquidity assessment process must be considered dynamically. While a fund's redemption terms are important, many other variables can have an impact as well. Let's use a hypothetical example including the considerations that need to be vetted before a decision to invest can be made.

Assume that a credit hedge fund manager has the following liquidity terms:

- Two-year hard lock-up¹, followed by one-year soft lock-up with 2% penalty
- Semiannual liquidity with 90-day notice
- 20% fund-level gate with priority²
- 10% maximum-allowed sidepocket usage

Note: 25% of portfolio is illiquid and valued by manager

We recommend that investors use this information to raise and satisfactorily resolve the following questions before investing.

Does the manager's portfolio warrant liquidity that is so restrictive? If yes, should it be even more restrictive?

The liquidity of the fund's assets must be assessed. In certain cases, managers may be offering liquidity that is too generous, in which case it might make sense to propose that the manager revise these terms with the investor base. Credit managers typically run portfolios that are less liquid, so the restrictions we have described may be appropriate.

Does the manager employ leverage? If so, what form(s) does it take—prime broker financing, OTC swaps with ISDAs, futures, options, etc.?

This is a critical piece of information, since leverage providers often will demand that their capital be returned if the fund's equity declines by some threshold amount. Because leverage providers have a first call on capital (i.e., before redeeming investors), they can put a manager in a precarious position if the redemption terms are not structured appropriately.

For instance, if a manager receives redemptions large enough to cause fund assets to fall by some trigger amount—which, in turn, forces an unwinding of a swap or the return of capital to a financing provider—then the manager must sell assets in sufficient quantity both to meet redemptions and pay back the leverage provider. Such forced sales may cause the fund's value to fall further, which may mean additional triggers are hit and/or may spur further redemptions.

If our credit manager invests with leverage, the 20% fund-level gate may not be sufficient to prevent this, depending on how the trigger is written. For instance, if AUM falls by more than 25% due to investor withdrawals, there effectively is a 5% performance cushion: The fund could decline due to performance by only 5%—the difference between the 25% AUM trigger and the 20% fund-level gate—before the trigger is breached. The manager would then be forced to begin liquidating assets in earnest and possibly at depressed prices, which would negatively affect remaining investors.

As we saw in 2008, this kind of situation might very well force the manager to wind down a fund or suspend redemptions in order to avoid breaching asset-level triggers embedded in financing agreements. Understanding a manager's financing terms is vital, therefore, in assessing the liquidity offered to investors.

Who are the other investors in the fund in terms of their seasoning (i.e. how long they have been invested), concentration levels and liquidity needs?

If the majority of the fund's AUM is with seasoned investors who have owned shares beyond the lock-up period, then a gate—whether investor-level or fund-level—becomes even more important for new investors. The latter have no flexibility to redeem their assets even if the majority of the other investors redeem. In

satisfying these redemptions the manager may be forced to liquidate the most-liquid assets first, potentially leaving remaining investors with a less-liquid portfolio.

The same principle applies if the fund has one or two very large investors. We prefer that the manager restrict these investors' redemption options to protect remaining investors.

Another way of assessing a fund's investor base is in terms of client type (i.e., individuals, institutions, funds of hedge funds, etc.). For example, if the fund has significant pools of capital invested that are also seeking liquidity, the manager is at a greater risk of receiving unmanageable withdrawals if proper restrictions are not in place.

In 2008, many hedge fund of funds faced significant withdrawals from their own investors, which forced them to seek liquidity from underlying managers with the least restrictive terms. Several hedge fund of funds were also wrapped inside structured products, including principal-protected notes. Since many such structures were leveraged vehicles, leverage-ratio requirements forced them to quickly withdraw from the underlying hedge fund of funds upon only a minimal decline in performance. This, in turn, put enormous pressure on the hedge fund of funds to redeem from their underlying managers.

The message: Before investing alongside other investors, it is important to understand whether a hedge fund manager has significant pools of capital that are also susceptible to withdrawals due to client redemptions and/or delevering.

Our credit manager's specified liquidity terms appear reasonable, since they should allow him to control and satisfy redemptions given the fund's lock-ups, fund-level gate and lengthy (90-day) liquidity notice period.

¹ A lock-up is a restriction on redeeming any capital out of the fund. It can be "soft," where any amounts withdrawn are subject to a redemption penalty during the initial period, or "hard," where there are no withdrawals for a specified initial period, or a combination of each.

² Gates are restrictions that managers impose on redemptions. They are usually spelled out in the terms offered by the fund, and expressed as a percentage of the fund's AUM (a "fund-level gate") or the amount invested by any one investor (an "investor-level gate"). For instance, in the case of a 25% fund-level gate, if cumulative redemptions from the fund exceed 25%, each investor's redemption is reduced, pro rata, by an amount sufficient to bring the total redemptions down to 25%. Further, for the portions unable to be redeemed due to a gate being triggered, managers have provisions or terms that spell out when the remaining portion is due to be paid (these "clean-up" or "priority" provisions are common). For instance, if amounts not redeemed are guaranteed to be paid within six months after the redemption period, the fund has a "six-month clean-up."

But the gate's priority clause is reason for concern. Once the gate is hit or it even looks like it may be hit, the clause can encourage investors to submit redemptions to ensure that they are in a priority position for the following period. This could create the hedge fund equivalent of a run on the bank. Unfortunately, priority clauses are fairly common.

Does the manager have any existing side letters with current investors that allow for preferential liquidity?

If so, new investors should consider pushing for side letters as well. Letters should include a "most favored nation" clause that precludes other investors from receiving better liquidity; and key man provisions, which waive redemption restrictions if one or more key personnel leave the management company.

We encourage new investors to ask about side letters. Not doing so can leave a large hole in their understanding of the manager's true liquidity and redemption situation.

Can the manager manipulate the fund's liquidity by moving items into and/or out of the sidepocket portfolio?

Sidepockets are typically for the fund's most illiquid assets and are not subject to the same redemption terms as the remaining assets. As the items in the sidepocket are liquidated, performance fees usually are charged on realized gains, and redeeming investors receive their capital as investments roll off.

Investors should try to learn when positions can be moved into a sidepocket, how they are valued, whether performance fees are charged, etc. Sidepockets should not be used as a fund gate to curtail redemptions. Ideally, assets should be designated as sidepocket items when purchased.

How does the fund value its assets?

To re-state the case study, the credit fund has 25% of its assets as relatively illiquid and valued by the manager. Assuming that redemptions are significant, an unscrupulous manager can mark down the value of these holdings below what he believes is their true value, and satisfy redemptions reflecting this markdown. Remaining investors reap the benefit of a future markup or—when the securities either mature or are sold—their realized value.

What if assets are marked too high? Given a positive outlook on credit as a hedge fund strategy and considering 2008's steep sell-off in credit and related securities like ABS and MBS, this question is both important and timely.

Effectively, if the securities are marked too high, then new investors end up diluting the losses of existing investors. Exhibit 1 illustrates how new investors in a fund that has not been appropriately marked down to true value can immediately subject their investment to losses if realized, and offset losses that should be borne by existing investors.

A deep dive into valuation procedures (which will be facilitated in the future by increased portfolio transparency demanded by regulators) is thus very important. It may be appropriate to insist that the manager hire an independent valuation agent to mark assets. In this same context, we also recommend that investors review the fund's auditor and invest through a separate-account structure.

Exhibit 1: High marks can hurt new investors

Assumes an investment of \$20mm in a hedge fund with current AUM of \$100 Values in \$ millions

	Pre-investment	Post-investment
Fund NAV stated value	100	120
Actual asset value*	90	110
Investor % loss/gain if realized	-10%	-8%
Amount of existing fund investor's realizable loss, offset by new investor		-2%

* Includes fair value of securities held prior to investment, plus cash invested by new investor.

Separate accounts offer attractive benefits

We are seeing an increase in the usage of separate accounts across the hedge fund industry. Separate accounts allow investors to own not only each position in their account, but also the liquidity of each position (or lack thereof, in some cases).

While having a separate account may be more operationally cumbersome and require additional administrative and infrastructure resources, its benefits should outweigh the incremental costs. The chief benefits are increased transparency (because the investor holds the actual positions) and control.

If investors are concerned about a commingled fund's liquidity terms or its investor base, we note that a separate account's

liquidity is dependent only on the liquidity of the actual positions in the marketplace—not on the manager’s redemption terms. In some cases, the investor will directly hold assets less liquid than under the commingled fund’s redemption terms, so the trade-off will have to be justified. One such positive trade-off may be that the price entry point into these positions will be “true” and not based on the manager’s marks.

We expect the use of separate accounts to increase even more for strategies where the underlying positions’ liquidity is less of a concern and less complex. Equity long/short is a particularly good example. Investors can get real-time access to the equity holdings of their separate account, allowing for closer monitoring and better management of exposure to crowded stock investments.

For hedge fund of funds, hiring a manager to run a separate account also provides more flexibility to set investment guidelines (e.g., concentration limits, liquidity guidelines, etc.) and structure unique fee arrangements.

Summary

We intend our discussion to paint a partial picture of how complex a thorough liquidity assessment of a hedge fund manager can be. A proper assessment requires many more datapoints than simply the fund terms and a high-level description of its holdings.

Our key point is that investors should strive to fully understand the liquidity profile not only of a fund, but also its manager. Doing so offers the benefits of greater transparency and flexibility, as well as potential downside mitigation.

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Contacts:

Douglas Smith, CFA

212-648-2622 | douglas.x.smith@jpmorgan.com

Pascal Bougiatiotis (London)

+ 44 0-207 742 22 74 | pascal.bougiatiotis@jpmorgan.com

Calvin Ho, CFA (Hong Kong)

calvin.y.ho@jpmorgan.com

Lysandre Bouvard, CFA (Geneva Advisory)

41 22 744 12 13 | lysandre.bouvard@jpmorgan.com

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