2010 Hedge Fund Industry Review

February 2011 **Industry Review**

2010 Highlights and Key Points[1]

- Hedge funds, as measured by the Dow Jones Credit Suisse Hedge Fund Index (the "Broad Index"), are up 10.95% for 2010, posting positive performance for seven out of twelve months in 2010

- Performance was largely positive across strategies with eight out of ten sector indexes posting positive performance in 2010; top performers included Global Macro (+13.47%), Event Driven (+12.63%) and Managed Futures (+12.22%)

- Individual fund returns were more concentrated in 2010 as 82% of all funds posted positive performance

- On an asset-weighted basis, an estimated 81% of funds have surpassed previous high water marks as of December 31, 2010

- Research of returns from January 1996 through December 2010, indicates that smaller hedge funds (less than $100M AUM), have historically outperformed larger hedge funds (greater than $500M AUM) by 3.95% annually

- Including performance gains, we estimate current industry assets under management (AUM) grew to $1.7 trillion as of December 31, 2010 up from $1.5 trillion on December 31, 2009

- The industry saw an estimated USD $8.5 billion in inflows for the fourth quarter, bringing overall inflows to $22.6 billion for the year. This represents the largest annual inflows into the space since 2007

- Hedge funds produced relatively better risk-adjusted returns than traditional asset classes in 2010 as managers continued to employ a diverse range of investment strategies. Overall hedge funds posted returns on par with global equities with nearly a quarter of the risk

[1] All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to the accuracy, completeness or reliability of such information.

2010 Market Highlights

- European Sovereign debt was a primary concern throughout the year as rating agencies downgraded the government bonds of Euro members Spain, Portugal and Greece.
- July saw the passing of the Dodd Frank bill, which requires increased transparency measures on hedge funds managing over $150 million.
- As of September, consistent performance enabled hedge funds to surpass their previous high water marks, ending the drawdown which occurred between June 30, 2008 and December 31, 2008.
- In October, China implemented its first rate hike since 2007, as its central bank raised its one-year lending and deposit rate by 25 basis points reflecting increased concerns over inflation.
- In November, the United States Federal Reserve officially announced that it would engage in a second round of quantitative easing in order to stimulate the economy.

The Year in Review

While 2010 officially marked the end of the "Great Recession" [2] overall markets were characterized by increased volatility across sectors. In the first quarter, global markets began to exhibit turbulence as concerns over European sovereign risk and general uncertainty about the global economic recovery emerged. However, government efforts, including a second round of quantitative easing, appeared to ease investor uncertainty and stimulate aggregate demand. Despite a brief sell off in November, the majority of markets were able to recoup all of their early losses by year end.

The volatility of global markets presented managers with various opportunities to demonstrate their ability to generate positive performance despite shifts in overall market direction. To many investors, this may have signaled a return to the "absolute return" tradition of many hedge fund strategies and as a result, we saw an increasing investor interest returning to the hedge fund space.

As illustrated in Figure 1, eight out of ten sectors in the Broad Index posted positive performance in 2010 with six sectors posting returns in the double digits. Overall 82% of all funds generated positive performance. Among the top performing sectors for the year were Global Macro (+13.5%), Event Driven (+12.6%) and Managed Futures (+12.2%).

Figure 1: 2010 Hedge Fund Index Performance Statistics by Sector

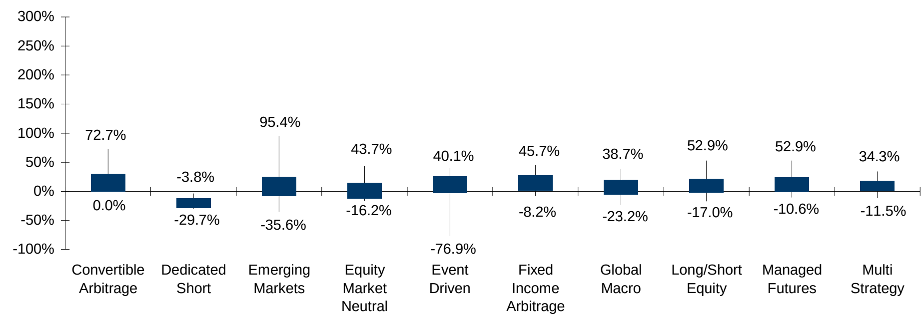
	Sector Weights	2010 Returns	2010 Volatility	2010 Sharpe Ratio	Number of Positive Funds	Number of Negative Funds	Best Performin g Fund	Worst Performing Fund	2009
Broad Index	**100.0%**	**11.0%**	**6.0%**	**1.82**	**377**	**84**	**95.4%**	**-76.9%**	**18.6%**
Convertible Arbitrag	1.6%	11.0%	4.5%	2.40	22	-	72.7%	0.0%	47.3%
Dedicated Short	0.2%	-22.5%	18.3%	-1.24	-	7	-3.8%	-29.7%	-25.0%
Emerging Markets	7.2%	11.3%	8.6%	1.31	61	16	95.4%	-35.6%	30.0%
Equity Market Neutr	2.1%	-0.8%	6.8%	-0.14	12	10	43.7%	-16.2%	4.1%
Event Driven	25.1%	12.6%	7.0%	1.78	61	5	40.1%	-76.9%	20.4%
Fixed Income Arbitr	4.9%	12.5%	2.7%	4.64	23	3	45.7%	-8.2%	27.4%
Global Macro	20.2%	13.5%	3.7%	3.62	26	10	38.7%	-23.2%	11.6%
Equity Long Short	20.9%	9.3%	9.1%	1.00	116	26	52.9%	-17.0%	19.5%
Managed Futures	4.8%	12.2%	12.4%	0.97	28	5	52.9%	-10.6%	-6.6%
Multi-Strategy	13.0%	9.3%	4.7%	1.96	28	2	34.3%	-11.5%	24.6%
S&P 500		15.1%	19.3%	0.77					26.5%
Dow Jones Global Index		11.9%	20.6%	0.57					32.0%
Barclays Global Agg. Bond Index		5.5%	6.6%	0.82					6.9%
DJ-UBS Commodity Index		16.8%	19.2%	0.87					18.9%

Source: Dow Jones Credit Suisse Hedge Fund Index, Bloomberg. 2011. All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse and Dow Jones Indexes have not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to the accuracy, completeness or reliability of such information. Past performance is no guarantee or indicator of future results.

[2] Source: The National Bureau of Economic Research, September 2010.

Figure 2 depicts the range of dispersions as well as the bulk of returns across each of the Broad Index sectors in 2009 and 2010. As demonstrated below, the overall performance of managers within most sectors was more concentrated in 2010 than in the prior year. Several factors likely contributed to this increased concentration, including the relatively defensive positions put on by many managers seeking to hedge against potential downside movements. Overall, there were no negatively performing funds in the Convertible Arbitrage sector in 2010. Conversely, no fund in the Dedicated Short Sector finished the year in positive territory.

Figure 2:
2010 Sector Return Dispersion



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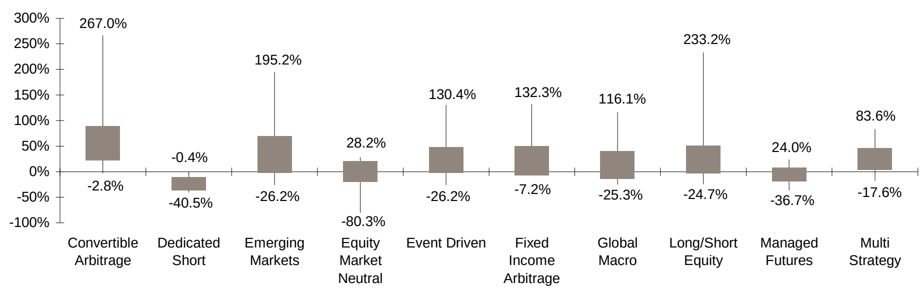


Note: The boxes above represent the bulk of returns that lie one standard deviation from the mean assuming a normal distribution.
Source: Dow Jones Credit Suisse Hedge Fund Index. 2011. All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse and Dow Jones Indexes have not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to the accuracy, completeness or reliability of such information. Past performance is no guarantee or indicator of future results.

Sector Focus

While the majority of strategies posted positive returns in 2010, the three top performing sectors – Global Macro, Event Driven and Fixed Income Arbitrage – each posted double digit returns for the year as well as positive performance in many of the months when global equity markets were down. Below, we examine the key drivers of success for each of these strategies.

Global Macro:
Global Macro managers posted positive performance in ten out of twelve months in 2010. Global imbalances following the actions of central banks around the world helped create thematic trading opportunities for many managers who found opportunities in the uncertain market environment. Following QE2 and amid concerns over a weak dollar, many managers were also able to profit from trades in commodities including metals, grains and softs after observing strong demand from emerging markets.

Event Driven:
Event Driven strategies posted positive performance in nine out of twelve months in 2010 and have seen an increase in investor interest as subsectors including distressed credit have posted relatively strong returns. Following the financial crisis, the Event Driven distressed credit space has seen a rise in investment opportunities as many banks were forced to sell off assets whose credit quality had worsened following the European debt crisis. Further contributing to opportunities in the space was the passing of the Basel III accord, which implemented new liquidity and funding requirements requiring banks to mark down loan assets and increase liquidity.

Fixed Income Arbitrage:
Fixed Income Arbitrage was among the strongest performers in 2010 after posting eleven months of positive performance. Managers in the space profited from the macroeconomic environment in 2010, taking advantage of market inefficiencies resulting from the intervention of central banks. These opportunities appear to remain viable as the long term effects of the monetary policies employed to curb the financial crisis continue to unwind.

Hedge Funds Surpass High Water Marks

The positive performance of hedge funds in 2010 enabled the Broad Index to exit its most significant drawdown to date with the index surpassing its previous peak performance level (high water mark) in September. While the Broad Index has fully recovered all negative performance from the financial crisis, an examination of individual fund performance as well as the overall industry assets which remain impacted suggests that the recovery of managers has been varied across strategies.

Figure 3a represents the percentage of the number of overall funds within each sector which have recovered from the drawdown. Based on this analysis, our research indicates 57% of funds within the industry have fully recovered. On an individual sector basis, 82% of Convertible Arbitrage hedge funds have fully recovered from their previous high water marks while 60%-70% of Global Macro, Fixed Income Arbitrage and Event Driven funds have also recouped all prior losses.

Figure 3a:
Percent of Funds Above/Below HWM by Number of Funds

Strategy	% Above HWM
Convertible Arbitrage	81.8%
Dedicated Short Bias	0.0%
Emerging Markets	58.4%
Equity Market Neutral	45.5%
Event Driven	65.2%
Fixed Income Arbitrage	69.2%
Global Macro	63.9%
Long/Short Equity	51.4%
Managed Futures	51.5%
Multi-Strategy	56.7%
Industry	**57.3%**

Figure 3b:
Percent of Funds Above/Below HWM by Percentage of Assets

Strategy	% Above HWM
Convertible Arbitrage	84.9%
Dedicated Short Bias	0.0%
Emerging Markets	70.5%
Equity Market Neutral	86.8%
Event Driven	83.1%
Fixed Income Arbitrage	93.7%
Global Macro	96.7%
Long/Short Equity	71.9%
Managed Futures	65.9%
Multi-Strategy	73.1%
Industry	**80.9%**

Source: Dow Jones Credit Suisse Hedge Fund Index. 2011. All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse and Dow Jones Indexes have not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to the accuracy, completeness or reliability of such information.

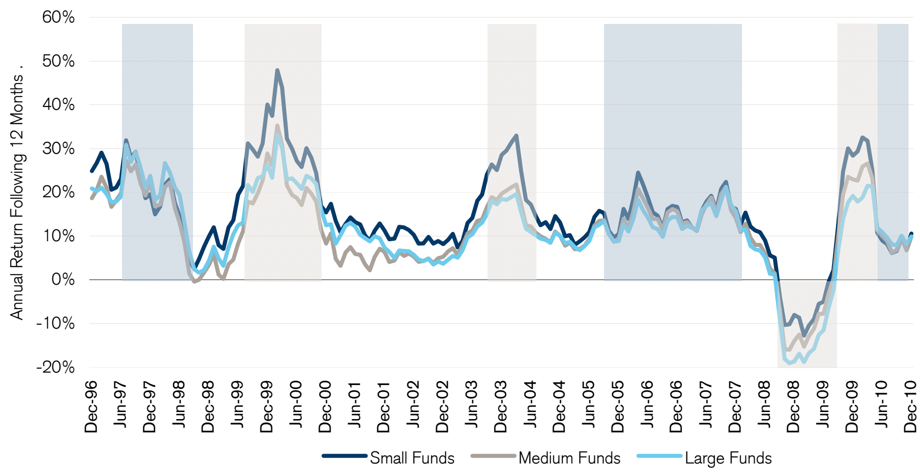
However, as fund sizes vary, using an equal-weighted approach to determine the number of affected funds may not provide a fully comprehensive measure of the impact of drawdowns in the industry. Using an asset-weighted approach, the data provided in

Figure 3b demonstrates the percentage of overall fund assets within each sector which recovered as of December 31, 2010. Based on these findings, we estimate that an overall 81% of assets within the industry have surpassed their previous high water marks. Among the top performing sectors, Global Macro and Fixed Income Arbitrage recovered 97% and 94% of fund assets respectively.

Does Fund Size Play a Role in Performance?

In reviewing the ability of funds to recoup market losses, we have also examined the correlation between fund size and fund performance. Figure 4 below illustrates the annual performance of small (less than $100 million), medium ($100-$500 million) and large (more than $500 million) hedge funds from January 1996 to December 2010. In this diagram, the y-axis plots the forward rolling twelve month returns of each designation of funds described above.[3]

Figure 4:
Fund Size and Performance (January 1996 – December 2010)



Source: Dow Jones Credit Suisse Hedge Fund Index. 2011. All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse and Dow Jones Indexes have not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to the accuracy, completeness or reliability of such information. Past performance is no guarantee or indicator of future results.

Figure 3 reveals some interesting trends in the historical difference between large and small fund performance. Notably, the regions highlighted in blue illustrate periods where the difference between large and small funds was more concentrated while regions in grey illustrate periods when smaller funds outperformed larger funds by a noticeable margin. As shown in the chart, the periods in grey have tended to occur during significant market movements. In periods of more consistent market performance, the spread has historically narrowed.

This divergence in performance may be due to the traditional operational structure and client base of smaller funds. For instance, it may be easier for smaller funds to enter into and exit trades if there are fewer decision makers to consult. Additionally, risk and return targets may differ between small and large funds; as hedge funds grow and take on more institutional-type clients, investor tolerance for risk may decrease, limiting some positions. As such, while the data suggests that small funds outperform large funds by approximately 3.95% annually, it does not take into consideration on average the risk taken to produce these returns or the investment strategy employed.

[3] Returns are calculated on an average forward rolling 12 month basis. For example, the historical AUM of each fund is analyzed on a monthly basis and each fund is classified as small, medium or large as of that date. For small funds, the performance shown above represents the average rolling return of the performance of all funds which were classified as small in the 12 months following the AUM analysis. The process is repeated on a monthly basis for each size bracket of hedge funds.

Asset Flows

As seen in Figure 5, our data suggests overall industry grew assets by approximately $8.5 billion in the fourth quarter. We estimate the industry saw inflows of approximately $22.6 billion in 2010, the highest inflows since 2007. Overall, total industry AUM is currently estimated at $1.7 trillion.

On a nominal basis, the Global Macro and Event Driven sectors have experienced the highest asset flows in 2010 with $16.8 billion and $13.8 billion in new assets flowing into each strategy respectively, while the largest outflows were seen in the Multi-Strategy sector which lost $16.9 billion. The strong 2010 inflows into Global Macro and Event Driven may represent a reflection of investors' desire for exposure to more tactical strategies which have historically been able to withstand more volatile market conditions.

Figure 5: 2010 Quarterly Industry Flows

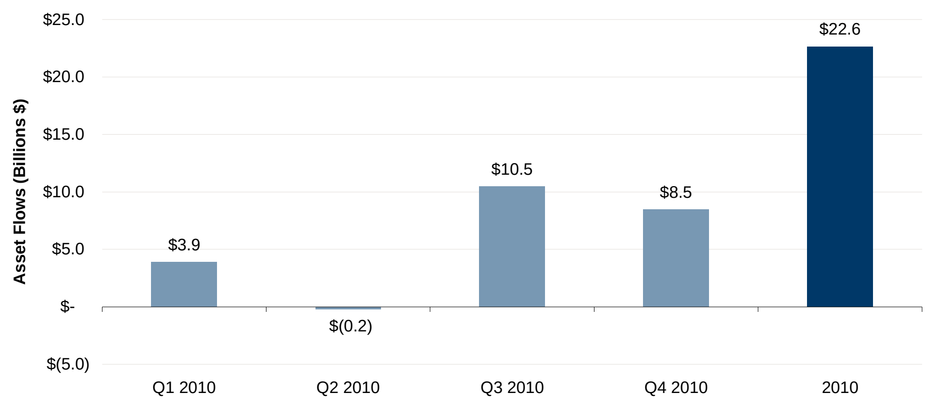
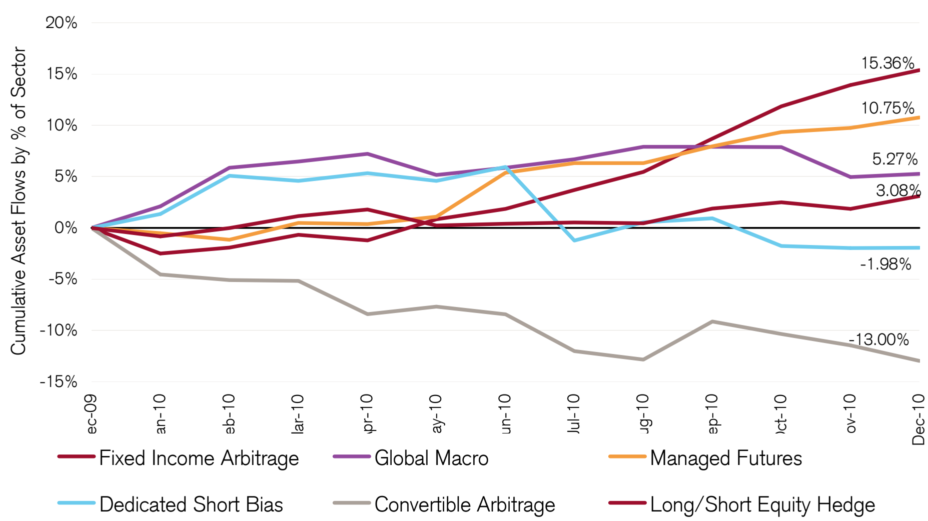


Figure 6: Strategy Industry Flows by Percentage of AUM in 2010



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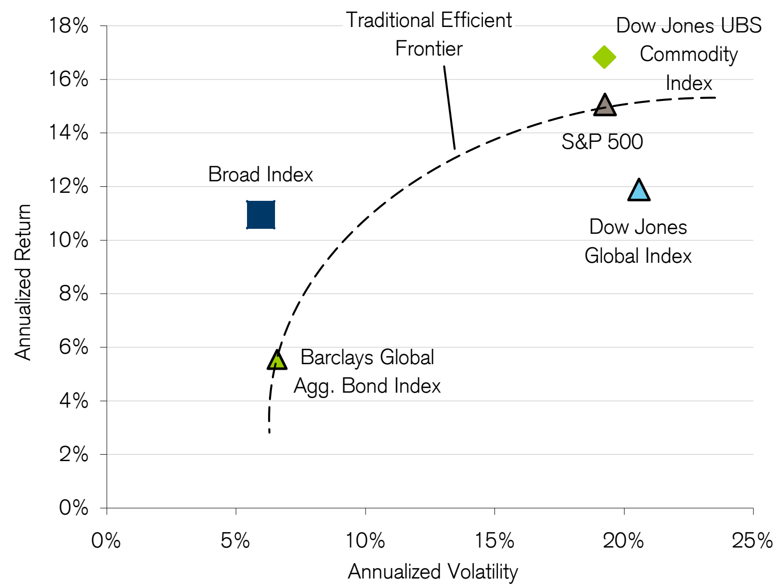
On an asset weighted basis, as illustrated in Figure 6, the sectors which saw the greatest inflows relative to their overall size in the industry were Fixed Income Arbitrage and Managed Futures (with inflows of 15.36% and 10.75% respectively). Conversely, the Convertible Arbitrage and Dedicated Short Bias sectors saw outflows of -13.00% and -1.98% respectively.

A Deeper Look at Performance

Following the rebound in global markets in 2009, hedge funds continued to generate positive performance in 2010, which for many signaled a return to the absolute return profile traditionally associated with the industry.

In 2010, hedge funds posted a Sharpe Ratio of 0.78, which is higher than global equities, as represented by the Dow Jones World Index (0.10), global fixed income indexes, as represented by the Barclays Global Aggregate Bond Index (0.50) and global commodity indexes, as represented by the Dow Jones UBS Commodity Index (0.22). As shown in Figure 7, the Broad Index performed in line with equity and commodity indexes, while maintaining lower overall volatility than global fixed income markets. This risk/return profile is unique to hedge funds, suggesting the incorporation of hedge funds into an overall portfolio allocation could provide diversification benefits.

Figure 7: 2010 Risk/Return Comparison (Jan 10 – Dec 10)



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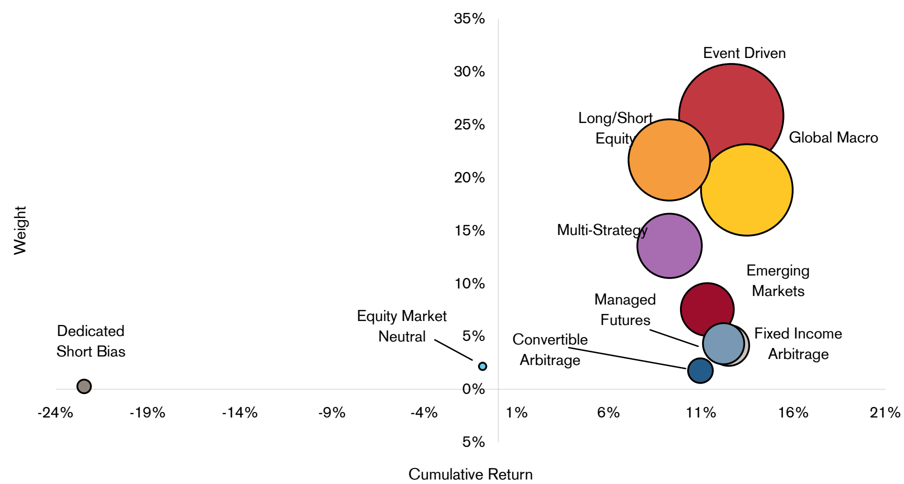
Note: Investments in hedge funds are speculative and involve a high degree of risk. Please see "Important Legal Information" on page 10 for important disclosures regarding the data and information contained herein and the views and opinions expressed in this material. Please see page 9 for information on the indexes presented herein.

Figure 8 illustrates the year-to-date performance contribution for each of the individual sectors within the Broad Index. The size of each bubble illustrates the impact that each sector has had on overall Broad Index returns, i.e. Event Driven and Global Macro are the two sectors which have most positively contributed to returns in 2010. On the other hand, while both Dedicated Short and Equity Market Neutral have underperformed, they have not significantly detracted from overall index performance on an asset-weighted basis.

Figure 8: Broad Index Performance Drivers (Jan 10 – Dec 10)



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Looking to the Year Ahead

Crucial to the positive performance seen in the hedge fund space in 2010 was the relatively strong performance of several key strategies including Event Driven, Fixed Income Arbitrage and Global Macro, each of which produced double digit returns in 2010.

The ability of hedge funds to generate positive performance throughout the year, despite increased volatility in overall markets, has prompted renewed investor interest in the space. However, as sentiment has shifted and investors focus on the risks of hedge fund investing, evidence suggests that today's investors are increasingly requiring more liquid, transparent and cost effective solutions for accessing the asset class. In addition, there has been a renewed focus on manager reputation and track records as well as their strong operational platform and oversight.

The ability of the overall hedge fund industry to surpass previous high water marks was perhaps one of the most important measures of fund viability to occur in 2010. In the two years since global markets bottomed out, hedge funds have returned a cumulative 31.55% – signifying a 5.67% gain over their pre-crisis highs. In addition, according to our research, over 80% of hedge fund assets have now surpassed previous high water marks.

In conclusion, the ability to navigate difficult markets, as demonstrated by fund managers in 2010, in combination with the diversification benefits associated with the space has highlighted the viability of the asset class (subject to the risks of hedge fund investing). Finally, positive asset flows indicate that investor interest has begun to return as evidenced by inflows of $22.6 billion, the largest seen in the space in 3 years.

Endnotes

The Dow Jones Credit Suisse Hedge Fund Index is compiled by Credit Suisse Hedge Index LLC and Dow Jones Indexes, the marketing name of CME Group Index Services, LLC. It is an asset-weighted hedge fund index and includes only funds, as opposed to separate accounts. The Index uses the Credit Suisse database, which tracks over 8,000 funds, and consists only of funds with a minimum of US$50 million under management, a 12-month track record, and audited financial statements. It is calculated and rebalanced on a monthly basis, and shown net of all performance fees and expenses.

Dow Jones Global Index: The Dow Jones Global Index is a broad yet investable measure of the global stock market. It targets 95% coverage of markets open to foreign investment. The index currently tracks 51 countries, including 25 developed markets and 26 emerging markets.

Barclays Global Aggregate Bond Index: A market-value-weighted index of government securities, mortgage-backed securities, asset-backed securities and corporate securities, each with a maturity of over one year, designed to simulate the universe of bonds in the market.

S&P 500 Index: The Standard & Poor's 500 Index is a capitalization-weighted index of 500 stocks. The index is designed to measure performance of the broad domestic economy through changes in the aggregate market value of 500 stocks representing all major industries. Investors cannot invest directly in an index.

Dow Jones-UBS Commodity Index: The Dow Jones-UBS Commodity Index is a composite index of commodity sector returns, representing an unleveraged, long-only investment in commodity futures that is broadly diversified across the spectrum of commodities.

Important Legal Information

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