

7 August 2008

HDF Briefing

July 2008: a difficult month for long-short equity; promising for Fixed Income

A difficult month for long-short equities

July was a difficult month for equity hedge fund managers: alpha generated over the second quarter of 2008 was destroyed in July because of a high rotation between sectors. Many fund managers had taken long positions on raw materials and energy, and short positions on the financial and retail sectors.

However, July saw:

- a significant correction in oil prices, triggered by a number of factors, such as the fear of a stronger slowdown in global economic growth, or the bankruptcy of an energy broker which had to close its long positions.
- a rebound in financial stocks, following the rescue of Freddie Mac and Fannie Mae, the introduction by the financial regulatory authorities of rules temporarily making short selling more difficult, and an oversold situation in the sector.

The following table shows the different performances of these sectors:

| | July 2008 | YTD |
|-------------------------------|-----------|--------|
| DJ Stoxx 600 | -1.9% | -22.2% |
| DJ Stoxx 600 Banks | +3.0% | -30.7% |
| DJ Stoxx 600 Basic Res | -12.2% | -6.0% |

It therefore appears that sector performances in July have differed from trends seen since the start of the year. Furthermore, movements have also been amplified by the lack of liquidity during the summer months. Most of our fund managers are convinced that these movements are just a correction but not a reversal in the trend. However, some have managed to be highly responsive in July, for example by selectively investing in financial stocks, selling energy-related companies, or even directly selling commodity futures.

Since the start of last summer (over 13 months), the fall of our long-short equity funds of funds has been close to, or better than, one third of that of the equity markets:

| From start-July 2007 to end-July 2008 | |
|---------------------------------------|---------------|
| HDF Global Opportunities | -5.6% |
| HDF Xiphias Int'l. (€est.) | -9.0% |
| MSCI World (div. reinvested) | -25.2% |
| HDF Europe Long-Short | -6.3% |
| HDF Eurovest (€est.) | -9.2% |
| MSCI Europe (div. reinvested) | -26.0% |

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<http://www.hdf-finance.com>

+33 1 4417 1234

investorsrelations@hdf-finance.fr

Many opportunities

We still believe that equity strategies represent a reservoir of alpha opportunities over the next few months. Indeed, macro-economic upheavals (slower growth, significant rises in raw materials prices, inflation in the cost, and even scarcity, of credit) are changing the rules of the game: some companies will be better able to cope with these difficult conditions than others, which will create both buy and sell opportunities for our fund managers. These opportunities should be transformed into performance over the medium term (over the next 12 to 18 months), as was the case after the shocks of 1998.

New opportunities in Fixed Income

In Fixed Income, the depth of markets has improved on interest rates (fixed income derivatives and government bonds) and on currencies. This increased liquidity should enable opportunities described in our [HDF Briefing of 15 July](#) to be converted into returns over the next few months.

These include:

- Increased volatility and changes in yield curve shapes, as a result of changes in inflationary expectations over time, coupled with interventions by central banks, which are split between controlling inflation, supporting growth and stabilising the financial system.
- The presence of "abnormal" differences in valuations between instruments, following forced sales by investors in search of liquidity in the first half of 2008.

On credit markets, banks which are having difficulties raising capital are continuing to make forced sales of portfolios. Once again, new opportunities are arising, but we need to wait until these flows of forced sales taper off before investing.

Conclusion

There is a long winding and dangerous path before the markets get back to normal. However, we remain confident in our fund managers' ability to capture the many opportunities in selection of stocks and financial instruments – both buying and selling – on a large number of markets.