

HDF

MONTHLY STRATEGIES

UPDATE

July 2010



August 20th, 2010

Equity Strategies

Long/Short Equities

U.S.

After two months of large losses, the US equity markets bounced back in July. The S&P 500 Index rose 6.9% during the month, but despite this, the Index remains flat for the year. Investors seem unable to make a persistent stance on the US recovery. This has led to significant market volatility with stock prices unable to follow through on a general trend. But at least for the month of July, equities were buoyed by 2nd quarter corporate earnings numbers which were primarily better than expected. Also, the fiscal situation in Greece and in the rest of the PIIGS moderated as commitments to austerity measures gave the investors some comfort that a financial epidemic emanating from Europe is not imminent and even unlikely. Some favourable results in European bank stress tests did not hurt either.

From a sector standpoint, Materials (+11.9%), Industrials (+10.1%), and Energy (+8.3%) led the way, reflecting some good fundamental results from companies at the forefront of economic activity. Healthcare lagged substantially, up by only 1% during the month. Oil prices also rose substantially on both higher demand and anticipation of the resumption of growth worldwide.

Currently, investors in the US market are concerned over the dissipating effects of the stimulus package given that unemployment continues to hover near 10% and wages are not improving. In fact, the fear is a deflationary scenario. With US interest rates remaining at rock bottom levels, the Fed would have difficulty fighting such a scenario if economic growth is stagnant. While company fundamentals continue to improve for many firms, there is uncertainty on what the 2nd half of the year will bring. Investors also have to contend with what is happening outside of the US, some of which could have material impact on US companies. Europe is not out of the woods yet and China continues to maintain a delicate balance of slowing down the overheating real estate market without choking off growth in the rest of their economy.

In July, our equity long/short manager focused on the Transportation sector was able to post good results as they continue to have high conviction that many companies in their universe have strong revenue and profit improvements to deliver the rest of the year, but are well undervalued by the Street. Their frequent contact this year with management teams in the sector allowed them to discern that business is doing much better than the valuations being accorded the stocks they hold. This manager also monitors and is keenly aware of leading economic indicators that relate to economic goods being moved across the globe – whether by railroads, trucks, ships or air freights. Thus, this year, they have tended to be more optimistic than most in how global economic growth is progressing and were able to capitalize (i.e. buy low/increase position sizes) when macro factors dominated stock trading and improving company fundamentals were being ignored. As a result, the manager has materially outperformed the S&P 500 YTD.

The M&A/IPO markets are experiencing continued strength in deal activity (with \$29bn of US transactions in July), providing opportunities for event driven portfolio managers.

Asia

Global stock markets rallied in July despite European uncertainties and ongoing concern of a double dip recession. The MSCI AC Asia Pacific was up 5.6% with significant dispersion amongst countries. India lagged with almost flat or slightly positive performance while Chinese markets registered gains of more than 10%. Even if the Chinese economic growth continued to slow, the market moved in the opposite direction as the expectation for further tightening has been reduced. The performance in July was done in low transactions volumes, and some mutual funds in the domestic China A share market were reported to have cash balances of as high as 30% of their AUM. The market needs further good news for a more sustainable rally. Exposure wise, our managers are between 10% and 30% net long with gross exposure around 100%

Europe

July was a month of strong rebound for European markets: the MSCI Europe finished with a +4.9% performance. In that context, European Long/ Short equity managers had a nice positive performance.

The dispersion between sectors and countries was high, and the riskier areas of the market led the rally. Banks in particular had a huge rebound (+14.7%) after the results of the stress-tests were positive, and as it appeared that Basel rules should be friendlier than originally thought. Our managers were relatively cautious on the sector because of its high volatility and inherent risk, and therefore benefited only to a limited extent of that bounce. Insurance was the second best performer, with a +8.2% performance, followed by basic resources (+7.5%). Defensive sectors were the laggards, as the health care sector returned -5.5% while food & beverage dropped 1.1%. In terms of countries, Spain had a very strong rebound as investors flew to the riskier areas of the market, and returned +13.3%. Small caps also rebounded strongly (+6%).

Performances among managers were very widespread, and range from negative to low double-digit. Those having a strong rebound either had a financials bias or a true net long positioning. Our fund specialized on financials had turned to a significant net long position at the end of June and therefore benefited fully from the upside. We had one event-driven fund being hurt on the short side due to an unexpected bounce on some of its short position on Spain.

Our managers have increased at the margin their gross exposure after the earnings season proved better than the consensus and as macro fears have somewhat diminished. They remain however moderate, in particular at a time when volumes are thin in the market.

The number of M&A deals in Europe was limited, as is traditionally the case in summer. There was a number of bids however, as Tomkins received an offer from Onex Corporation and Canada Pension Plan Investment Board, and Reckitt made an offer on SSL International. There was also some pre-merger activity with GDF Suez potentially buying International Power.

Fixed Income and Relative Value Strategies

Fixed Income Arbitrage & Long/Short Fixed Income

Fixed Income managers performed mildly in July as gains from bond and volatility relative value strategies did not offset losses in macro and cross currency strategies.

Macro dichotomies started to exacerbate in the summer, with deterioration of the US economy (weak U.S. employment figures and consumer spending), recovery in some large European economies (Germany, U.K.), slowing growth in China and Brazil and accelerating growth in India and Singapore.

The front ends of the curve rallied driven by declining fears about inter banking liquidity. The belly of the curves outperformed (pricing in expectations of a sustainable Fed zero rate policy for the next two years), with convexity hedging during the rally helping the moves. Swap spreads and LIBOR/OIS spreads continued to come in as risk aversion continued to ease.

Our FI arbitrage fund managers are positioned to take advantage of expected continued low rates in developed world (through liquid rates and volatility strategies), expected outperformance of the Emerging Market fixed income portfolio, FX and FI volatility and the potential increase of mortgage pay down following the recent decrease in US long yields.

Long/Short Credit

Long/Short Credit managers generated negative performance this month as they were positioned for a bearish environment. The "Barclays cash high yield" and "investment grade" indices returned 3.46% and 1.92% respectively, while the European "High grade" and the "Crossover" indices tightened from 131bps to 105bps and 585bps to 479bps respectively.

Our more tactical L/S credit funds scaled back their shorts to finish the month modestly long and increased their single name positions. In the same time, our more fundamental credit managers are turning more cautious on the bond markets, given the recent rally. They, however, share the argument that the short term variance in market views opposed to negative long term fundamentals (structural world imbalance), will create an environment of continued volatility with attractive opportunities.

Capital Structure Relative Value

Capital structure arbitrage managers generated positive performance in July due to the rally in risky assets. The convertible bond books benefited from investors' inflows in specialized funds, as these assets are providing interesting hedges to equity. One of our fund managers took advantage of the relative cheapness of credit versus equity from mid June until the publication of the bank stress tests (end of July) as a consequence of the European sovereign debt crisis.

Macro and Trading Strategies

Global Macro

Global macro managers generated negative performance as they were surprised by the powerful rally across most risky assets. This move was driven by the results of European banks "stress tests" in the last week of July

(only 7 of the 91 banks failed the test with a modest Eur 3.5bn capital shortfall), as well as strong corporates earnings and the easing of sovereign stresses in Europe. Equities rallied and volatility decreased sharply: VIX fall by 31% from 34.5 to 23.5. Treasuries resisted very well with US Government 10yr yield at 2.91% (down 3bps).

The main losses came from the rally of the Euro vs. the USD (+ 6.6% to 1.30) and the sharp bounce back of base metals (copper up by 12.2% and aluminium up by 10.9%).

The strong upswing of oil price was also difficult to catch: WTI price declined sharply the first two days of July bottoming at \$72.60/barrel before rallying gradually to \$78.95 (+8.75%) at the end of the month.

Systematic Trading

Systematic trading funds based on mid/long term trend following strategies achieved poor returns in July. Nevertheless, high frequency trading and statistical arbitrage were positive.

In the mid/long term space, the losses were driven by significant reversals in the trends of some assets. The worst performing sectors were equity indices, as stocks rallied, and currencies as the Euro and British pound strongly reversed the negative trend against the US dollar from the first half of 2010.

For statistical arbitrage, July experienced normalizing market conditions sustained by a good earning season. In this improving environment, technical components were still mixed but with good signs of recovery, while fundamental components fully brought their share of diversification and had a clear positive contribution to the monthly performance.

In the shorter term space, despite the quiet markets, the high frequency component performed constitutently through the month and continued to contribute positively to performance.