EUROFIN CAPITAL
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An Investor's Diary

MARCH 2010

03/10

UCITS III: Great News for Investors

I have spent much of the last week listening to learned investment professionals debate the impact of the UCITS III directive on the European investment scene, particularly in the once exclusively off-shore alternative investment realm.

To be honest, I am a bit of a fan of UCITS III and an early one at that. Long ago - in 2004 - I created the UCITS III version of a then exotic total return bond fund, which invested in sovereign emerging market debt. This week, I met managers who have launched or are launching UCITS III funds investing in commercial property, long/short equity, market neutral equity, and global macro strategies. So I am quite pleased by the market's evolution and by the wide range of investment opportunities now available to investors.

Critics, most of whom unsurprisingly have a vested interest in the status quo, have dismissively called compliant hedge fund strategies "hedge fund lite", because UCITS III funds cannot pursue the full range of strategies available to an offshore hedge fund and because of the UCITS III liquidity requirements (at least bi-monthly). This criticism rather misses the point, I think. The "constraints" of UCITS III have little if any impact in terms of either management or – more critically – performance. The UCITS III format offers the flexibility required for all but the most exotic or illiquid of hedge fund strategies. And I view bi-monthly liquidity as a key point: events in 2008 and 2009 showed that illiquid strategies were more roller coaster than active management, more market beta than any pretence whatsoever of manager alpha. In case you are wondering, I am talking about leveraged loans, convertible bond, and long bias equity strategies.

The whole point of including a hedge fund in your portfolio allocation – within equal or lower risk parameters – is to generate additional returns, over and above those delivered by a particular benchmark. In fact, the whole premise of investing in a hedge fund – rather than in an inexpensive, pure Beta ETF – is that its manager is supposed to add Alpha value within his chosen asset class. If he fails to achieve this, he should not be in business. In my view, those who invested in expensive Beta tracking hedge funds frankly deserved to be disappointed. For Fund of Fund managers the UCITS III Directive will hopefully be a big wake-up call. Bad managers (and there are many) should be put out of business: their due diligence processes were lamentable and their self-proclaimed ability to make money in all market environments has been shown to be woefully untrue. Just an example: Ask a Fund of Fund manager whether his FoF has a long or short volatility position. If he understands the question, that is a big plus as many managers do not. If he does not understand or if he tells you he is short volatility, stand up, shake his hand and leave the room immediately, it will be the best investment decision you will probably make. Just think of the endowments and public pension funds whose investment portfolios were decimated due to ill-advised allocation to illiquid strategies, where the manager's value added was in fact nothing more than the use of excessive leverage.

Many investors want access to alternative investment and total return strategies, but have been unwilling or unable to make such investments because of understandable issues, including the unfavourable domicile of the underlying funds, the lack of investment transparency, lack of diversification, poor risk management, penalising liquidity structure, and a due diligence void where crucial third party providers have often been subject to minimal regulatory oversight. Aggrieved investors, pensioners and trustees demanded greater regulation and their demands are being heeded. The UCITS III Directive addresses most of these key issues, allowing many investors and their advisors to re-assess their investment strategies and allocate assets to liquid alternative investments. In fact, such is the appeal of the UCITS III format that non-European investors now view UCITS III as a quality "Global Brand". The European Fund and Asset Management Association (EFAMA) just published a report indicating that the Asia Pacific region accounted for 35 per cent of Luxembourg's new business in 2009.

Regulatory change has arrived in *Europaland* and in the UK. I have little doubt that it will arrive in a broadly similar format in the USA as well. As institutional investors across Europe and beyond allocate assets to UCITS III vehicles, managers should benefit from these significant inflows. Increased demand from investors should lead to more competition amongst managers, including institutional fund managers, which will want a presence in this space to serve their own client base. I think this will make fee structures more attractive for investors. It should also drive poorly performing fund managers out of business. Sadly for them, unlike the banks, such managers will not be able to ask for a bailout from their government!

I confess that, for once, I am happy with a new set of regulations. The UCITS III Directive is great news for investors – and particularly for institutional investors – as well as for managers.

James M.M. Edwards
Chief Investment Officer

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Quarterly Investment Committee Update

Our March IC meeting had for its backdrop Obama Healthcare, Greece bailout or not, and equity markets hitting 12 month highs. This led to some interesting debates!

We first concluded that the economic positioning has continued to move towards the right hand side of our chart. All the criteria for the "Recovery" stage are fulfilled, except that the Central Bank Liquidity Cycle remained abundant, with little sign of change in the next 3 months at least.

Today's Key Themes, which should remain at the forefront for a while, include:

- The Global Economy has recovered.
- Central Bank liquidity provision is still available at the moment
- Debt: Sovereign debt ratios; rollovers and sustainability.
- Commercial Real Estate: Still awaiting the bad news as default rate increases.
- China and the commodity markets. What is really driving prices?

Our biggest concerns relate to the Sovereign space. Greece has highlighted the precarious position in which many countries now find themselves. The need to either pay down, in reality roll-over, debt is a pressing and potentially perilous issue hanging over markets.

At the time of this writing, the EU seems to have cobbled together some sort of contingent financing package for Greece. This is essentially a game of bluff. The EU hopes that simply by saying that if needed, money is available, market participants will breathe a sigh of relief as spreads fall and everyone goes merrily on their way buying Greek and other government debt. Having lived through the humiliation of seeing the British Pound ejected from the ERM, which had a similar construct, I am not so sure that markets will breathe and carry on buying.

As a result of this concern over Government bond markets, we are equally sure that corporate bonds trade too tightly, as many now trade inside Government yields. We think this position will reverse: We would go Long Govvies, Short Corporates.

Overall, relative to our Composite Index, we have reduced our allocation to both Bonds and Equity this month and continue to use a 20 % exposure to Alternatives as a less directional proxy for Equity markets.

VIEWS

- **Maintain Hedge Fund exposure, with an equity directional bias proxy.**
- **Look for new Private Equity Funds.**
- **Maintain exposure to Commodities.**

PORTFOLIO

- **Composite Index: 40% Bonds, 50% Equity, 10% Cash.**
- **10Q1 Weighting: 30% Bonds, 45% Equity, 5% Cash and 20% Alternatives.**

CURRENT

NORMAL BUSINESS CYCLE	OVERHEATING	SLOWDOWN	RECESSION	RECOVERY
CENTRAL BANK LIQUIDITY CYCLE	TIGHT	EXPANSIONARY	ABUNDANT	CONTRACTIONARY
YIELD CURVE	FLAT	INVERTED	STEEP	STEEP
MARKET LIQUIDITY	ABUNDANT	CONTRACTING	TIGHT	EXPANDING
MARKET SENTIMENT	RISK SEEKING MOMENTUM DRIVEN	PRUDENT TILT TOWARDS BONDS	RISK AVERSE CASH IS KING	OPTIMISTIC LIQUIDITY DRIVEN
PREFERRED TRADITIONAL ASSET CLASS	STOCKS COMMODITIES REAL ESTATE	CASH BONDS	BONDS	STOCKS COMMODITIES HIGH YIELD FX + EM
PREFERRED HF STYLE	EQUITY HEDGE	RELATIVE VALUE ARBITRAGE	TACTICAL TRADING	EQUITY HEDGE
SUB-STYLE: PERFORMERS	EQUITY MOMENTUM RISK ARBITRAGE	VOLATILITY TRADING CTA CREDIT/VOL ARB	SHORT SELLING MARKET NEUTRAL CONVERTIBLE ARB	DISTRESSED RISK ARBITRAGE CARRY FX / CREDIT EMERGING MARKETS
SUB-STYLE: HEDGERS	VOLATILITY ARB	MARKET NEUTRAL	EQUITY VALUE	CTA

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