Lazard Insights Conference Call Series

Navigating the New Hedge Fund Environment While Remaining Diligent

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Agenda

- Review of 2008
- Current challenges
- A look forward

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2008: Black Swans and Fat Tails

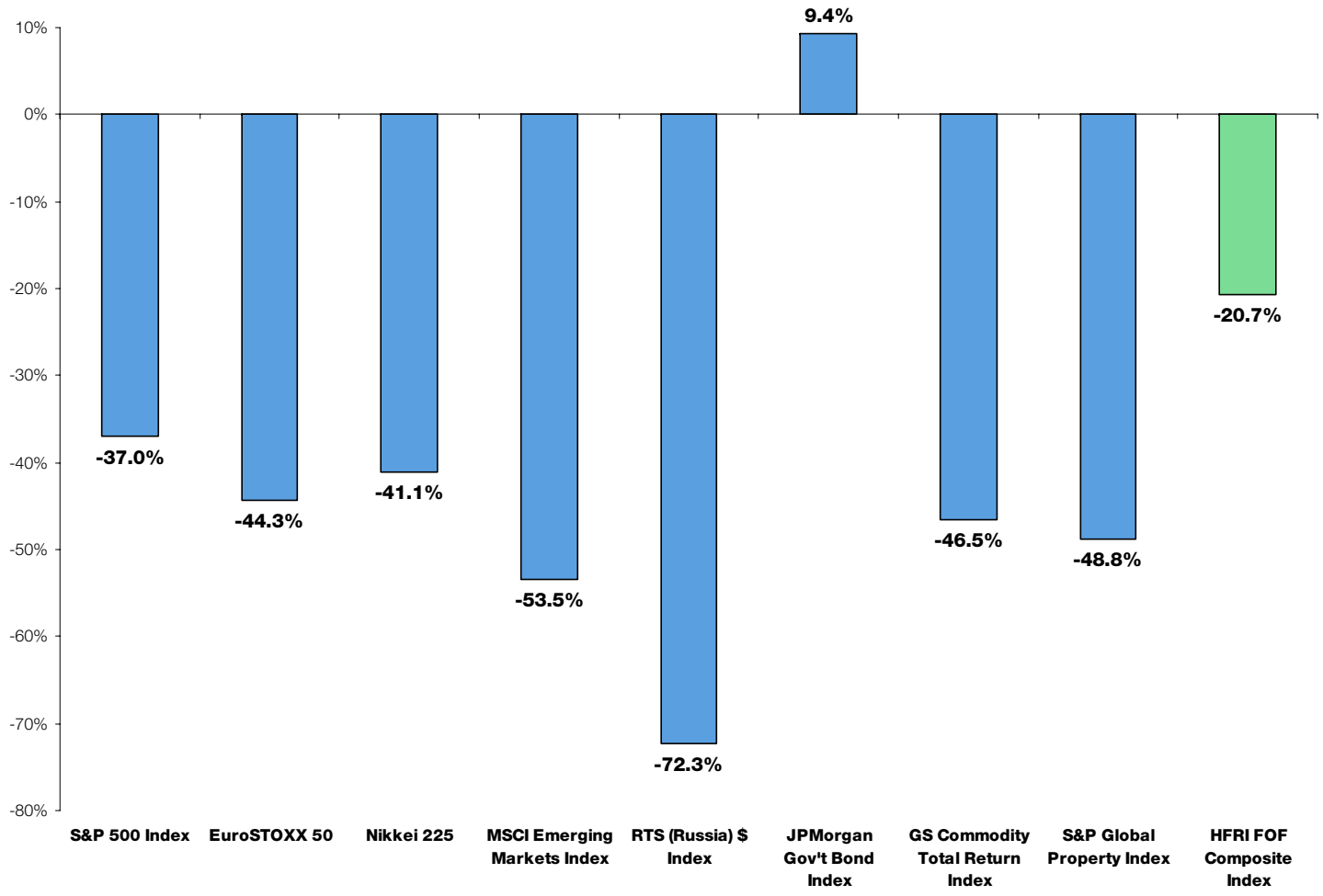
- **Black Swan Events:** Events that appear by complete surprise, and have a major impact; After appearing, they can only be explained in hindsight.

- **Fat Tails:** The statistical observation that fewer outcomes cluster near the average of a distribution of outcomes (e.g., monthly performance numbers), and that more observations populate the extremes either far above or far below the average than would be predicted by a normal (bell-shaped) distribution.

2008 Performance Review

Hedge Funds Down but Not Out

2008 was characterized by pervasive systemic risk issues, exaggerated by regulatory actions. Any investment strategy (traditional, hedged or otherwise) that required normally functioning price discovery and market clearing mechanisms was adversely affected.



As of December 31, 2008

Source: Bloomberg

Past performance is not a reliable indicator of future results.

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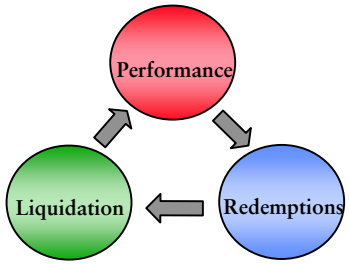
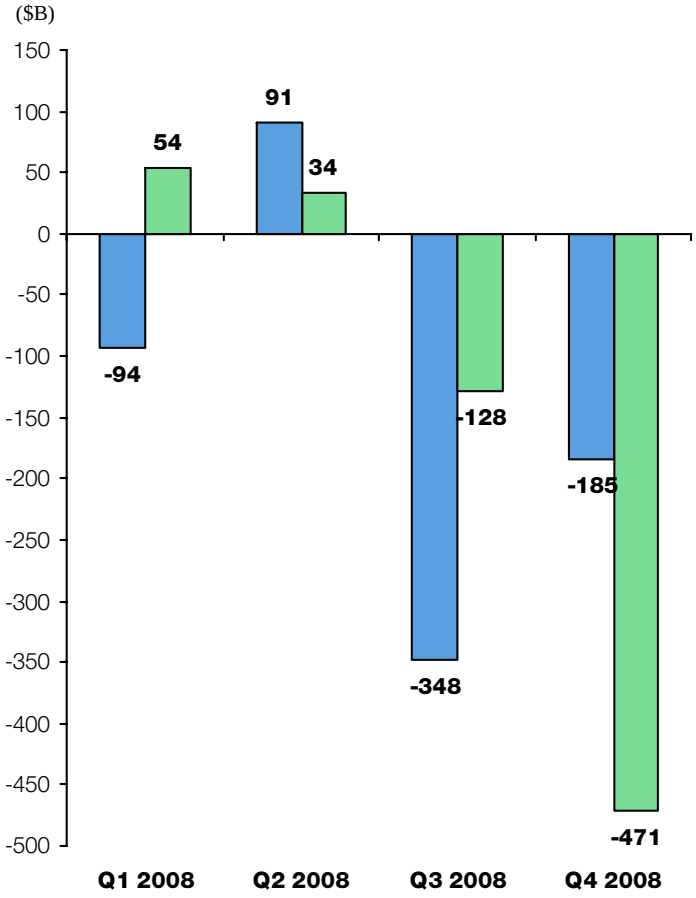
The Vicious Cycle: Performance, Redemptions, Liquidation & Leverage

Poor business planning and asset and liability mismatches were exposed in 2008.



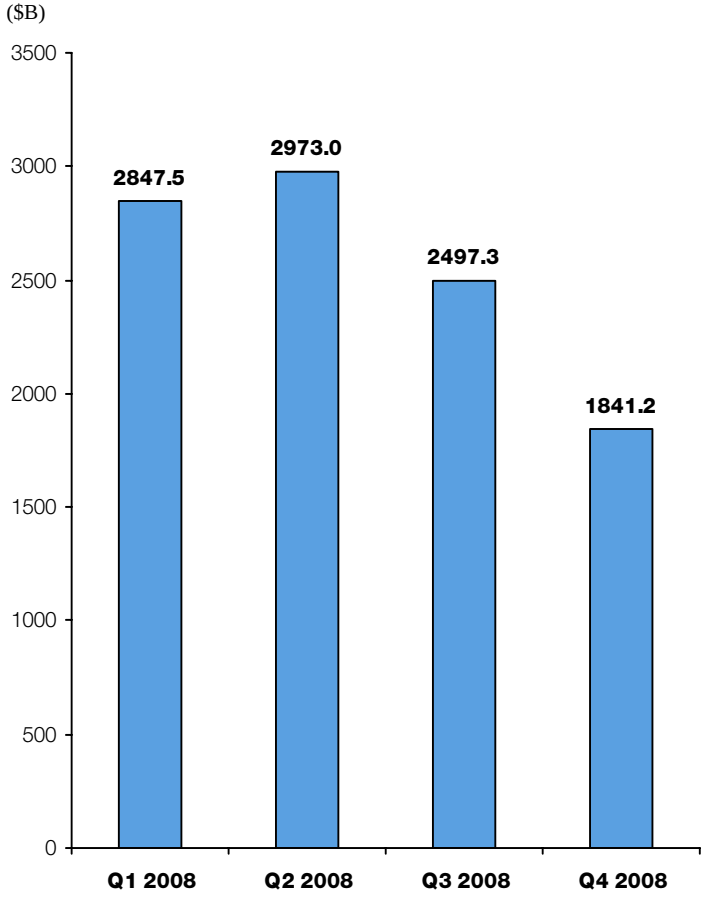
Estimated Hedge Fund Asset Flows



As a result of: Performance Asset Flows

Source: HFN (Channel Capital Group)

Estimated Hedge Fund Assets



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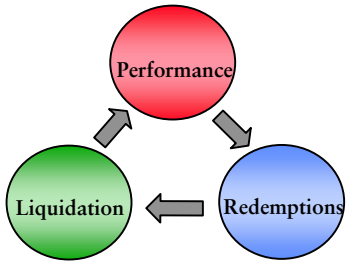
The Vicious Cycle: Performance, Redemptions, Liquidation & Leverage

Average hedge fund leverage fell to 1.4x by August 2008, and to 1.0x by year-end 2008.



The Cost of Borrowing Increases...

Typical "Haircut" or Initial Margin
(In percent)

	April 2007	August 2008
U.S. treasuries	0.25	3
Investment-grade bonds	0–3	8–12
High-yield bonds	10–15	25–40
Equities	15	20
Investment grade corporate CDS	1	5
Senior leveraged loans	10–12	15–20
Mezzanine leveraged loans	18–25	35+
ABS CDOs: AAA	2–4	95[1]
AA	4–7	95[1]
A	8–15	95[1]
BBB	10–20	95[1]
Equity	50	100[1]
AAA CLO	4	10–20
Prime MBS	2–4	10–20
ABS	3–5	50–60

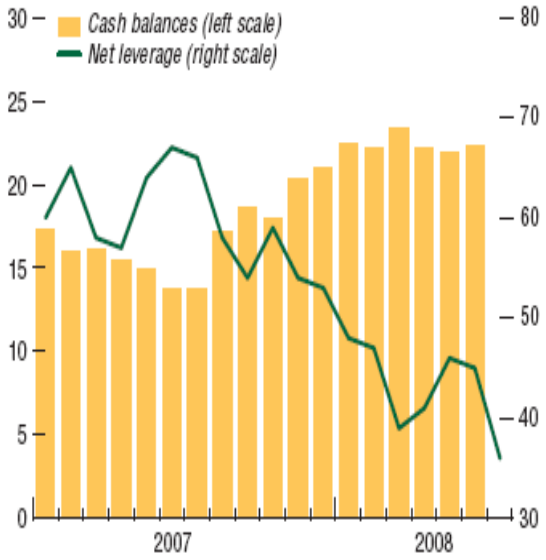
Sources: Citigroup; Morgan Stanley Prime Brokerage; and IMF staff estimates.

Note: ABS = asset-backed security; CDO = collateralized debt obligation; CDS = credit default swap; CLO = collateralized loan obligation; MBS = mortgage-backed security; RMBS = residential mortgage-backed security.

[1]Theoretical haircuts as CDOs are no longer accepted as collateral.

...and Leverage Decreases

Leverage and Cash Balances of Global Hedge Funds
(In percent)



Source: Morgan Stanley Prime Brokerage.

Note: Leverage defined as assets divided by equity capital cash balances as a percent of total assets.

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The Business Model Challenge

Attrition/consolidation is approaching: 30% to 50% of managers will likely close.

Business Viability Model for the Median Manager

Median fund size (start prior year)	$80 M
Median loss & distance from high water mark	20%
Remaining funds	$64 M
Redemptions pending or likely as a % of funds	20%
Funds under management (current year)	**$51.2 M**
Fund co. management fee	2%
Fund co. revenue until HWM achieved	$1.02 M
Annual operating costs (4 key staff, rent, all data, research, outsourced & service providers, T&E etc.)	$1.68 M
Available for bonuses & distributions	**$(0.65) M**

Source: Nick Gogerty, istockanalyst.com

Challenges for Key Players

We believe there will be many consequences of industry contraction.

Single-manager Hedge Fund

- Many will restructure
  - Illiquid versus liquid assets
  - Investor holders versus redeemers
  - Hybrids of above
  - Variations in fees, lockups, and PIKs

Prime Brokers

- Old business model irrevocably changed
- More selective in choosing clients
- Counterpart risk focus
- Focus on profitability excludes many smaller hedge funds
- New boutique providers emerging

Administrators & Custodians

- Contractual obligations and independent processes scrutinized

Auditors

- Timeliness
- Pressure to value illiquid assets accurately—likely to err on the side of conservatism

Investors/Allocators

- Need to meet (now) unfunded cash flow requirements
- Capital calls from private equity holdings
- How to rebalance portfolios
- Fiduciary and mandate reviews—pressure from trustees and constituents

Regulators

- Regime change—new player with new rules
- The SEC's credibility came under scrutiny, thus it is likely to be imperiously demonstrative

New Landscape

Some markets traded by LTCM remained dislocated for up to three years following the demise of that firm. The market events of 2008 were much more disruptive.

- Severe global economic slowdown with the real risk of something much worse
- How will the unprecedented imperative to delever and the unprecedented policy responses play out?
- Markets will remain dysfunctional for a long time, and policy responses are unlikely to quickly restore normalcy
- The enormous risk capital pools from banks' prop desks are gone, and will not return as long as public policy dictates capital allocation
- Leverage availability will be curtailed for the foreseeable future, and cost is prohibitive where it is available
- Increased regulatory risk—perceived "antisocial" behavior will be met with increased regulatory scrutiny at a minimum, and quite possibly retribution, regardless of the economic rationale

Winners and Losers

Event-driven example: U.S. fixed-income markets, excluding U.S. Treasurys, total approximately $33 trillion. About one third of that is distressed. AUM of hedge funds specializing in distressed investing total approximately $90 billion. Additional pools (including private equity) may take that to $300 billion—a significant supply/demand imbalance.

Relative Value

- Category most affected by leverage issues—muted outlook
- Fixed income and convertibles—overhang risk of residual unwinding and technical influences
- Positive convexity strategies thrive

Event Driven

- Many credit, distressed, special situations and activist funds liquidating
- M&A activity largely curtailed, but managers with free capital thriving on widest spreads ever
- Early in the credit cycle, corporate bonds were cheap, but defaults still low
- Massive supply imbalance creating an extraordinary opportunity, but not without risk

Long/Short

- Stock pickers should profit
- Lower net and gross exposures
- Regulatory risk (shorting)

Tactical Trading/Macro

- Fertile opportunities due to regulatory and economic changes
- Opportunities due to persistent global imbalances

Conclusion/Outlook

- Continued stress in the banking sector
- Potential overhang in the first quarter for additional redemptions due to:
  - Investors in gated funds redeeming elsewhere
  - Other investor portfolio impairments and cash needs
- Supply/demand imbalances will create opportunities…
- …but timing is difficult—no need to be early
- Increased regulation and wild cards—rules are changing daily
- Fees lower generally, but dispersion-differentiated products/services less affected
- Black swan events revealed many previously known but overlooked risks
- Hedge funds and fund of funds business models need to evolve, but survivors are likely to prosper

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