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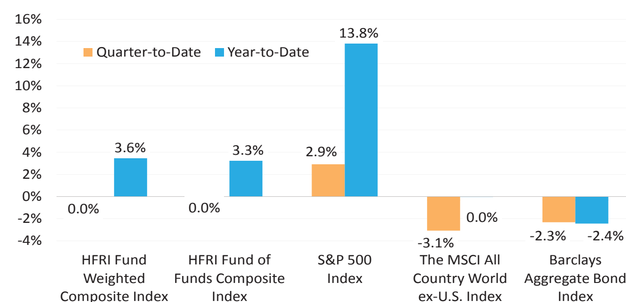
HEDGE FUND REVIEW

SECOND QUARTER 2013

Losses were pronounced in non-agency residential mortgage-backed securities later in the quarter.

HFRI AND COMPARABLE INDICES PERFORMANCE

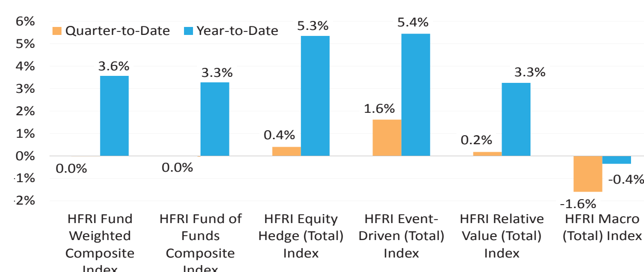
Returns in U.S. Dollars



Data sources: HedgeFund Research, S&P, MSCI, and Barclays
As of June 30, 2013

HFRI INDICES PERFORMANCE

Returns in U.S. Dollars



Data sources: HedgeFund Research, S&P, MSCI, and Barclays
As of June 30, 2013

- Investors enjoyed a strong start to the second quarter as hedge funds built on robust return generation from the first few months of 2013. That momentum, however, quickly abated following a speech from Federal Reserve Chairman Ben Bernanke on May 22 in which he alluded to the potential reduction of the Fed's bond-purchase stimulus program. In reaction to Bernanke's comments, fixed income and credit markets realized a sudden and significant spike in interest rates. Investors' apprehension was only exacerbated in mid-June after the Federal Open Market Committee (FOMC) released their statement indicating the increased potential for a "tapering" of the QE III program. This less dovish posture from the Fed rattled the markets, causing a larger widening in rates, as well as a number of ripple effects, including increased correlations among assets, spikes in volatility, and a broad sell-off in risk assets.

- Performance among hedge fund strategies was mixed in the second quarter, with distressed-focused managers performing best. Global macro and emerging market-oriented managers were the laggards for the quarter.

- The HFRI Fund Weighted Composite Index and the HFRI Fund of Funds Composite Index, broad proxies for hedge fund performance, both garnered positive returns in April and May. That performance, however, was offset in June as hedge funds realized their first monthly loss since October 2012. Both the HFRI Fund Weighted Composite Index and the HFRI Fund of Funds Composite Index finished flat for the second quarter.

- The HFRI Equity Hedge (Total) Index compared favorably to global equity indices, gaining 0.4% for the quarter. Longer bias managers, particularly those with material exposure to Europe, Asia, and emerging markets, generally suffered the weakest performance, as those regions declined more than the U.S.

- Hedge equity managers that reduced risk that latter half of the quarter preserved earlier gains and low net/market neutral managers were generally the best performers within long/short equity. The HFRI EH: Market Neutral Index was up 1.3%.

- Managers specializing in emerging market regions suffered the most difficult performance during the second quarter, with the HFRI Emerging Markets (Total) Index down 2.7%. All of the Emerging Market sub-strategies realized losses, with Latin American-focused managers detracting the most. Poor performance among Latin American managers was attributed largely to a sharp sell-off in Peru and Brazilian equities. The MSCI Indices for those countries declined 27.5% and 17.3%, respectively. While negative, the HFRI Emerging Markets (Total) Index compared favorably to traditional long-only emerging market indices, including the MSCI Emerging Markets Index (in U.S. dollars), which was down 7.9% for the second quarter.

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- Despite fears of reduced stimulus and significant widening of bond rates and spreads during the quarter, the HFRI Relative Value (Total) Index return was slightly positive at 0.2%. Structured credit opportunities, which had been successful as of late, realized mixed performance. Losses were pronounced in non-agency residential mortgage-backed securities later in the quarter. While residential mortgages were a headwind for many managers, other relative value specialists such as convertible bond, fixed income, and capital structure arbitrageurs, were profitable.

- Risk-adjusted returns were particularly strong among fixed income/credit arbitrage hedge funds, which took advantage of pricing dislocations between cash bonds and synthetic securities, as well as credit indices and underlying single-name securities. These temporary price anomalies were due in large part to investors de-risking interest rate exposure as a result of “tapering” concerns.

- The HFRI Event-Driven (Total) Index gained 1.6% and was the strongest performing strategy group in the second quarter. The non-directional, catalyst-driven bias to event-driven investing contributed to positive returns, as managers avoided much of the volatility and sell-off in risk assets in June. Event-driven managers were buoyed by a diverse set of corporate transactions and distressed/restructuring opportunities. The HFRI ED: Distressed/Restructuring Index gained 2.4% for the quarter and was one of the strongest performing sub-strategies, due to larger events such as Sallie Mae’s split and MBIA’s settlement with Bank of America.

- Despite healthy deal flow activity during the quarter, equity exposure and increased volatility were headwinds for merger arbitrageurs. Some of the more noteworthy deal announcements during the quarter included two pharmaceutical transactions, in which Valeant Pharmaceuticals acquired Bausch & Lomb for $8.7 billion and Actavis purchased Warner Chilcott for $8.5 billion. In addition, Softbank increased its offer to $21.6 billion for Sprint, and the Dell leveraged buyout remains of interest for several event-driven and activist investors. The HFRI ED: Merger Arbitrage Index was up slightly, landing at 0.4% for the quarter.

- The HFRI Macro (Total) Index declined 1.6% for the quarter. Discretionary and systematic managers both struggled with swift and severe reversals within several asset classes following talk of Federal Reserve “tapering.” Some of the larger themes that detracted from global macro managers’ portfolios included long positions in global equity indices (emerging markets as well as Japanese equities in June), long rates (U.S. Treasuries and German Bunds), and currency trading (unwinding of carry trades in several emerging market currencies due to slowdown concerns in China and a rise in U.S. rates). Short positioning within base and precious metals and agricultural commodities was generally accretive for macro portfolios. The price of gold and silver decreased 23.4% and 31.6%, respectively, during the quarter, while coffee fell 15.0% and corn was down 9.0%.

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Information on any indices mentioned can be obtained either through your consultant or by written request to information@feg.com. **RES-5300-F ENV 8-2-2013**