Hedge fund industry commentary Q4 2006

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General market environment in Q4 2006

A relatively uneventful fourth quarter provided a stable environment. Equity markets surged ahead as benevolent circumstances allowed them to maintain momentum and follow the path of least resistance upwards. The oil price was broadly stable and fixed income markets were range-bound, allowing fundamentals to come to the fore. Fears for the US economy and wider political instability were largely pushed to the background as the quarter offered good returns.

The S&P 500 gained 6.29% during the quarter. Continuing moderate growth and a benign inflationary outlook proved a winning situation for equities. An increased appetite for risk pushed Energy and Materials into the top spot for sector performance after a poor third quarter. Healthcare trailed home last, hit by the Democratic victory in the US midterm elections. The same holds true for the full year 2006, demonstrating the continuing allure of the natural resource sector, though performance was very concentrated at the beginning and end of the year, respectively. Small caps outperformed large caps in another reversal from the previous quarter as the Russell 2000 increased a handy +8.55%.

In Europe, the MSCI Europe rose +6.74%. Healthcare was also an underperformer on the Old Continent while

Industrials and Telco's powered ahead. The strong showing of energy was reflected less in the specific sector, but more in national markets where the energy-heavy Norwegian market was a top performer at +19.82% for the OBX. Japanese markets finished a poor year with a mixed quarter. Small cap underperformance continued as positive performance from the Nikkei and Topix contrasted with further drops in the TSE2 (-0.87%) and the Mothers index (-8.57%). Emerging markets delivered the strongest growth globally with China as the best performer followed by major markets in Latin America as well as Russia.

The main fixed income markets saw a lot of range-bound trading in the last quarter of 2006. Short-term rallies were followed by light sell-offs, leaving rates relatively unchanged. In the US, the market was pricing in rate hikes for Q2 of 2007, but as the quarter progressed it became clear that the Fed has no inclination to cut rates any time soon. Inflationary pressures remain too high to give the Fed room to manoeuvre and as the market came to realize this, the Eurodollar contracts started to reflect the Fed keeping rates on hold for the foreseeable future.

The 10y Treasury reached a yield of 4.83% in October, and then rallied back to 4.42%. It ended the quarter at 4.70% as a consequence of strong economic data coming out. The market continues to be torn between soft housing data, strong employment figures and lingering inflation pressures and we expect this to continue into the first quarter. Europe saw a similar pattern with the 10y rate touching a low of 3.67% in early December, but ending the year at 3.94% after a strong sell-off. The ECB hiked rates by 25 bps during the quarter, putting the short-term lending rate at 3.75% with the expectation of one or two more rate hikes to come in 2007. The European curve has flattened markedly during the last 12 months with the difference between short-term and long-term rates being only marginally positive. The growth picture in Japan fizzled in the latter half of 2006 as a raft of disappointing data came out, giving the Bank of Japan no room to hike rates. In our view, only a pickup in domestic demand will allow the BoJ to make its next move. Volatility remains at multi-year lows in both industrial countries and emerging markets, which is largely credited to the stable macroeconomic environment, significant developments in the financial markets, and improvements in monetary policy across the globe.

Crude oil traded within a range for much of the period and finished slightly down at -3% over the quarter. Natural gas rode up on a weather-driven rally through November but then gave back much of the gains in December to finish +12%. Base metals saw mixed performance again; the LME index was virtually flat at -0.5% but the smaller metals of Zinc and Nickel were again star performers at +27% and +13.5% respectively during the quarter. Commodity index performance reflected the differences in their composition; the energy-heavy Goldman Sachs Commodity Index was -5.7% while the broader DJ-AIG was +4.1%.

In currency markets, the USD came under some pressure and succumbed in November, losing ground against other major currencies, though this reversed somewhat in the final month of the year. The EUR/USD rate ranged between 1.25 and 1.33, while the USD/JPY cross ranged between 114.90 and 119.78 during the quarter.

Performance of hedge funds in Q4 2006

In a generally bullish quarter, all strategies with the exception of short selling were positive. Equity based strategies were particularly strong, with emerging markets being the stand-out performer. Sector specialists came home second, closely followed by event driven and merger arbitrage funds. Macro and CTA funds were negative in the third quarter but turned things around to more than compensate during a strong fourth quarter. The FTSE Hedge investable index was positive (+2.66%), compared to the non-investable HFR Fund of Funds index (+5.33%) and the

Table 1 I Hedge Fund returns Q4 2006

Hedge Fund Strategy	Ret Q4 2006
FTSEhx	**2.66%**
HFR Funds of Funds	**5.33%**
HFR Hedge Funds	**5.20%**
CSFB/Tremont Hedge Funds	**3.82%**
Convertible arbitrage	2.77%
Emerging markets	11.42%
High yield	3.01%
MBS arbitrage	2.05%
Sector specialists	6.01%
Statistical arbitrage	3.96%
Fixed income arbitrage	1.61%
Relative value arbitrage	4.49%
Distressed securities	4.97%
Merger arbitrage	5.65%
Event driven	5.90%
Long/short equity	5.38%
Market neutral equity	2.53%
Macro	5.47%
CTAs	3.12%
Short-selling	-1.75%
MSCI World	**8.02%**
JPM Global Bonds	**1.59%**

Source: FTSE; HFR; CSFB; Barclay Trading Group Ltd.; MSCI; JP Morgan non-investable HFR Hedge Funds index (+5.2%).

Directional Equity Strategies. Directional Equity managers overall continue to have a large net long bias and as such much of the returns was driven by performance of underlying markets. Long/Short US managers delivered about +5% for the quarter on average. It is noteworthy that US managers did well every month of the quarter, even in December when small cap stocks underperformed the S&P. Most of those who fared better had exposure to small cap stocks, Energy, Materials and Consumer Discretionary. Long/Short European managers also did very well for the quarter, adding just over 5% and capturing most of the MSCI Europe performance. Many managers would have benefited from exposures to small caps and oil service companies. It is precisely these exposures that enabled European hedge funds to deliver positive performance even in November when the MSCI Europe ended in negative territory. Japanese managers had a more difficult environment once again than their overseas counterparts, delivering barely positive number of +0.72% for the quarter. While the broader indices were positive, the small cap sectors to which most these managers have been quite exposed for a while, were negative for yet another quarter. Hedge funds in the emerging market space delivered stellar performance overall for the quarter. All of the regional funds did well, particularly those exposed to Latin America. On a country level, Chinese managers reaped the biggest rewards as the underlying markets posted remarkably high returns. At the bottom end of the league table were funds with high exposures to Korea and Thailand.

Relative Value Equity Strategies. Merger arbitrage and event driven hedge funds had a very strong quarter. The HFRI Merger Arbitrage Index gained 5.65%. Merger volumes were very strong in the fourth quarter. The largest transaction was the consolidation in the Norwegian oil service sector between Statoil and Norsk Hydro. Due to the complexity of the deal, the spread trades at an attractive level. Private equity firms continued to be very active, and are involved in the largest transactions, such as Equity Office Property Trust, Harrah's Entertainment or Clear Channel Communication. Several transactions received hostile bids from strategic buyers, benefiting positions by hedge funds in target companies. Looking at different regions, while the US has seen higher volumes in the quarter, most hedge funds generated a vast majority of their profits in European exposure, as bidding wars such as MAN/Scania/VW or around Endesa continued to be profitable. There were only limited opportunities in risk arbitrage in the Asian-Pacific region, with the exception of Australia, where the market for corporate control was very strong. The IPO flow continued in Asia, especially China, where ICBC raised USD22b in October. Amongst the few investments that cost event driven funds money were EMI, that again rejected a private equity bid; and Arcelor Brazil, where an enforced minority squeeze out by the parent company was offered at disappointing terms.

Convertibles arbitrage funds had another profitable quarter. The index increased by 2.77%. Implied convertible volatilities declined over the quarter, both in the US and in Europe. Realized short-term volatility also decreased in December as the holiday period began. The credit environment was favourable, as credit spreads continued to contract, albeit at a slower pace than in previous quarters. Through an implied volatility lens, the convertible market continues to have only limited attraction as pricing remains at fair values. Anecdotally, convertible funds have taken more equity market risk and benefited from the strong equity markets. Another important driver was new issuance in the US with USD25b aggregated volume and attractive pricing of certain bonds, especially the USD 4.95b Ford issue. The primary market became also more active in Asia, but Europe and Japan were lacking.

Quantitative managers had a positive quarter. The HFRI Equity Market Neutral Index gained 2.53%. Valuation and momentum were the most profitable factors of longer-term models. Residual returns from takeover activity influenced funds differently, as some managers were able to recoup some of the losses that were generated by holding short

positions in companies subject to merger bids from earlier quarters. Short-term traders had a very strong quarter as the HFRI Statistical Arbitrage Index gained 3.96%. Both technical signals as well as medium term factors were strong contributors.

Directional Fixed Income Strategies. Long/Short Credit managers performed well during the fourth quarter (+3.01%) as spreads remained range bound. An unusual amount of high yield paper came to the market, with November alone counting for USD32b of issuance, 50% of which was related to LBO activity. The market remained unfazed in view of all this supply and absorbed it readily. CDO structures were a main driver behind this demand with one good deal pricing another. Credit funds were able to take advantage of attractive primary deal spreads and also benefited from several themes that had been running for a while. These were airline, auto and energy exposures. In particular Northwest, Ford, GM and GMAC were great performers during the quarter.

Distressed managers had a phenomenal run in Q4 (+4.97%) as a number of legacy distressed situations such as Enron and Adelphia paid out. Other names that contributed were Dura Automotive, Delphi, Federal Mogul and Delta. Recovery rates remain at all times high across the capital structure. However, the opportunity set going forward is limited as low interest rates, a robust economy and strong corporate balance sheets lead to low default expectations for the next 3 quarters.

In Emerging Markets, investor sentiment was running high going into the fourth quarter. This proved beneficial, as

managers took advantage of movements in rates in Mexico and Brazil, rallying FX markets, tightening credit spreads and higher equity markets, in particular in Asia. Thailand was one of the main exceptions as the Central Bank tried to impose capital controls.

Asset based lending continues to deliver steady returns. Although returns in certain areas such as insurance have declined due to increasing competition, the market is expected to grow further in terms of strategies and geographies covered.

Relative Value Fixed Income Strategies. Fixed Income Arbitrage managers posted positive performance during the quarter (+1.61%). Large contributions came from curve positions and directional positions in Europe and the UK and to a lesser extent the US. Opportunities in Japanese rates were muted for the quarter. Although not spectacular, returns of Fixed Income Arbitrage managers in 2006 was in line with past performance, posting a +7.29% gain.

MBS Arbitrage managers put in a solid quarter (+2.05%) as OAS levels remain near recent lows on lower agency supply and strong demand by US banks and Asian buyers. In the ABS space, concerns continue to rise regarding the deteriorating credit performance of loans originated in 2006. The ABX index BBB tranche widened markedly in December. The outlook for CMBS remains robust as valuation of the underlying collateral remains relatively attractive.

Commodity Strategies. Commodity markets picked up in the fourth quarter after a ragged summer but there was no extensive year-end rally comparable to that seen in the wider equity and bond markets.

Relative value commodity managers had a good quarter in general with particularly strong performance in the final month of the year. Oil markets were hanging on the words of OPEC as the oil-producing cartel found the recent heady drop in prices against its liking. Production quotas of the group were cut by 1.2m barrels/day in October and by a further 0.5m barrels/day in December, though concerns remain about the willingness of members to abide by their commitments. The US natural gas market weighed up the contrasting factors of cool weather in October and a quick cold snap in late November against healthy storage supplies. December settled the argument firmly in favour of the bears however, as the month turned out to be one of the warmest on record and gas quickly succumbed to the downward pressure through the month.

Base metals continued to be attractive for hedge funds in the fourth quarter though signs of physical supply response and demand reductions led to some caution. Copper had taken the lead in the metal run-up earlier in the year but rising inventory levels at the exchange warehouses signaled a reduction in market tightness. The 3-month LME contract responded accordingly, falling back below the USD6,500/ton price last seen in April. Zinc and nickel were linked to their own dynamics and however and bukked the trend to register solid price rises as lagging supply and low inventories pushed the market higher.

Agricultural markets continued to attract high interest with regular reports of new ethanol plants and regulations to introduce crop-derived fuels for transportation. This quarter also demonstrated the flip side of the markets however as some traders and funds were punished in a large move in the wheat market. Positioning for continued weakness in this market was a popular strategy during the summer but in October a rapid price rally caused a reversal in the Chicago wheat spreads that left some funds nursing losses and actually pushed some Board of Trade locals under completely. Corn was sucked into the resulting turmoil but has since responded more to the continually dropping estimates of crop availability to register impressive gains.

Insurance linked strategies closed out a profitable year with no significant events occurring to spoil the gains. Capital requirements prompted by the losses of 2005 and

Table 2 I Hedge Fund returns

Hedge Fund Strategy	Q4 2006	Ret pa 2000-2006	Ret pa 1994-2006	Stdev pa 2000-2006	Corr MSCI 2000-2006
FTSEhx (investable, net of fees)	**2.66%**	**6.30%**	**n/a**	**3.03%**	0.35
HFR Funds of Funds (non-investable, net)	**5.33%**	**6.26%**	**7.68%**	**4.43%**	0.58
HFR Hedge Funds (non-investable, gross)	**5.20%**	**7.77%**	**7.02%**	**4.74%**	0.37
CSFB/Tremont HFs (non-investable, gross)	**3.82%**	**7.73%**	**n/a**	**2.79%**	0.25
Emerging markets	11.42%	14.32%	11.49%	10.69%	0.76
Distressed securities	4.97%	13.02%	12.40%	4.63%	0.50
Event driven	5.90%	10.79%	13.52%	5.84%	0.71
MBS arbitrage	2.05%	9.05%	9.65%	3.70%	0.09
Relative value arbitrage	4.49%	8.75%	9.84%	2.14%	0.38
Macro	5.47%	8.17%	10.07%	5.60%	0.29
Convertible arbitrage	2.77%	8.22%	9.34%	3.33%	0.08
High yield	3.01%	7.62%	7.63%	3.46%	0.48
Long/short equity	5.38%	7.66%	14.27%	8.04%	0.73
Merger arbitrage	5.65%	7.52%	10.23%	3.40%	0.45
Short-selling	-1.75%	5.75%	0.66%	21.11%	-0.71
Fixed income arbitrage	1.61%	6.60%	6.04%	2.30%	0.07
Market neutral equity	2.53%	6.07%	7.98%	2.77%	-0.04
CTAs	3.12%	5.48%	5.71%	7.68%	-0.14
Sector specialists	6.01%	5.95%	14.15%	13.94%	0.65
Statistical arbitrage	3.96%	4.79%	7.64%	3.74%	0.60
MSCI World	**8.02%**	**0.62%**	**7.23%**	**13.89%**	1.00
JPM Global Bonds	**1.59%**	**5.84%**	**7.03%**	**2.94%**	-0.31

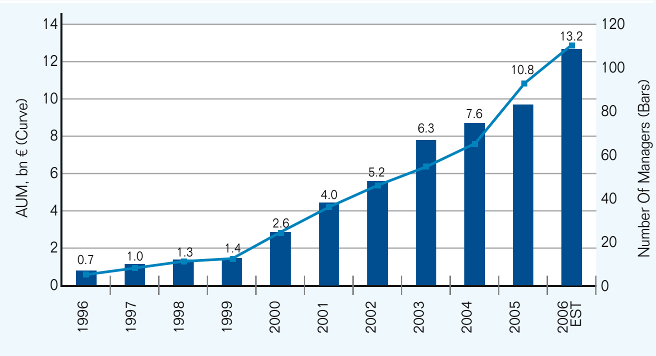
Source: Harcourt, HFR, MSCI, JPM, FTSE, CSFB

Harcourt celebrating 5 years on ground in Nordic region

As the first global fund of hedge fund manager, Harcourt established an office in Stockholm in 2001 with client service and research capabilities dedicated to the Nordic region.

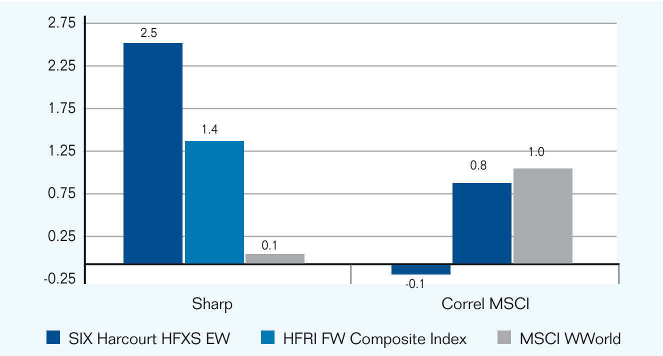
In the Nordic region, Harcourt saw a hedge funds industry emerging with talented managers and professional investors increasingly embracing the absolute return philosophy. This has been proven right; the graphs illustrate the size and performance of the Nordic industry in recent years. Both in terms of asset growth and risk adjusted performance, the Nordic region has achieved impressive results.

Nordic hedge fund growth (1996 – 2006)



Source: Harcourt Research

Risk adjusted performance and correlation (2001-2006, hedged SEK)



Source: Harcourt Research, Hedge Fund Research, MSCI (SEK hedges by Harcourt)

Also for Harcourt's Nordic operation local presence, the period has been prosperous. During the five years Harcourt has attracted institutional capital and partnerships across the whole region. Harcourt Nordic has established itself as an active participant in the region's hedge fund development and education vis-à-vis investors, hedge funds and media alike. To create a regional benchmark, Harcourt was also instrumental in launching the first Swedish hedge fund index (SIX Harcourt HFXS index) during 2005.

The five year anniversary of Harcourt Nordic was celebrated with a dinner reception which media reported was populated by the "local hedge fund elite". We thank all our business partners in the Nordic region for the past 5 years and are looking forward to an exciting future.

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increased regulatory conditions should also underpin the market for the new contract year in 2007.

Directional Multi-Asset Class. Macro managers finished the year on a positive note (+5.47%). They were able to capitalise on positive sentiment in the equity markets, strong currency movements (as the USD finally weakened against a basket of currencies at the end of November) and positive emerging markets. In each month, macro managers posted positive returns, with only commodity positions weighing on performance. Going into 2007, we expect a number of trends to materialise and volatility in the markets to pick up, both of which should be positive for the performance of macro funds. Macro managers disappointed somewhat in 2006 (+8.75%). The performance in the 4th quarter saved the year, but the period from May till September was particularly difficult.

Long-Term Trend-Following CTAs had a good quarter (+3.12%), taking advantage of a number of clear trends in the markets. In particular, the USD/JPY cross proved beneficial in November and equity markets also contributed significantly to the good performance. Interest rates were tougher to trade, since no clear trends developed during the quarter. This range trading environment is typically difficult for CTAs. Energy positions were negative in October and November, but losses were pared in December as CTAs put on positions benefiting from the negative trend in energy prices. Short-Term CTAs had a good October and November, but gave back some of their performance in December, as they got stopped out of positions on several occasions without finding a trend. Going into 2007, the strategy should perform well if trends develop and volatility picks up.

Outlook for Q1 2007

In our view, the hedge fund strategies with the highest return potential for the next quarter are Long/Short Japanese equities, Long/Short Emerging Markets equities, Merger Arbitrage and Event Driven. A generally benign outlook is backed by strong mergers and acquisitions activity, potential expansion of P/E ratios and low corporate default rates. The ongoing search for yield continues however and investors remain willing to pursue risky assets. With a near-consensus opinion that the US will experience a 'soft landing' and almost universal bullishness for 2007, it is worth remembering that any deviation from these expectations will quickly change the market outlook.

We expect returns from diversified funds of hedge funds to maintain a range of Libor+500 bps pa with contained volatility.