Strategy Focus Report

Finance Sector Funds

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Overview: Finance Sector Hedge Funds

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Finance sector hedge funds have been the worst performing group of hedge funds in the universe of strategies and sectors tracked by HFN in the last two years. In the last twelve months (LTM) ending January 2008 the HFN Finance Sector Average was one of only two HFN benchmarks with negative performance. The second was the HFN Long Only Average, however finance sector funds were -6.23% in the LTM while long only funds were -1.13%.

Finance sector hedge funds have had to operate in an extremely difficult environment during this timeframe, but there is a belief that one should expect more from hedge fund managers. Hedge funds operating in specific sectors are expected to be *the* experts in the field. How can it be that finance sector hedge funds, despite being in a less than ideal sector, haven't been able to provide even slightly positive returns, on average, to investors? The answer to skeptics of finance sector hedge funds can be expressed in two ways; 1) they may not realize exactly how awful finance sector equity markets have been and, 2) on a relative basis, finance sector hedge funds have outperformed their closest benchmark by more percentage points than any other equity related hedge fund sector in the last twelve months.

Relative Performance

Since 2001, the average finance sector hedge fund has returned a cumulative +80.25% compared to -1.82% for the S&P 500 Finance Sector Index (S&P Finance Sector). This is the equivalent of a compound annual return of +8.67% for finance sector hedge funds and -0.02% for the S&P Finance Sector.

In the last twelve months, as losses in the finance sector have become headline news and the U.S. economy is facing (if not already in) a recession, the average finance sector hedge fund was -6.23% compared to -21.87% for the S&P Finance Sector; over 1500 basis points higher. Compared to other hedge fund strategies facing difficult environments, the relative performance of finance sector hedge funds has been outstanding. For example; during the last twelve months when the S&P 500 was -2.30%, the average long/short equity hedge fund returned +5.19%, or produced less than half the relative outperformance of finance sector funds.

The following pages analyze finance sector fund performance and asset flows to determine which funds have performed best and how the niche has grown during one of the most difficult periods for an equity sector in recent memory.

Figure 2: 12mo rolling returns from January 2001 - January 2008

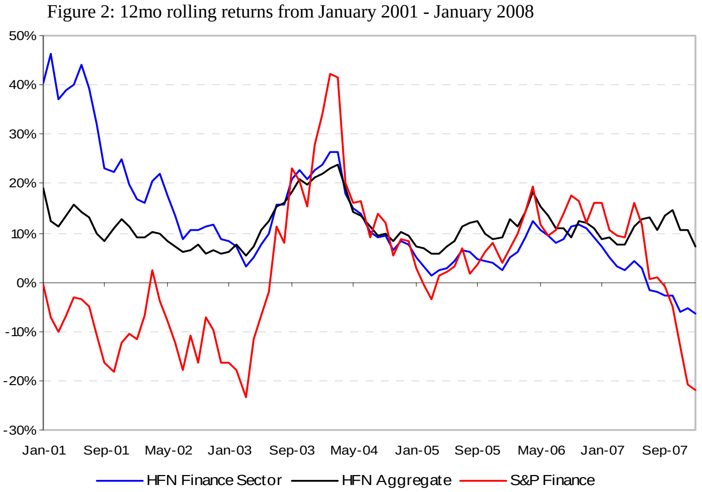
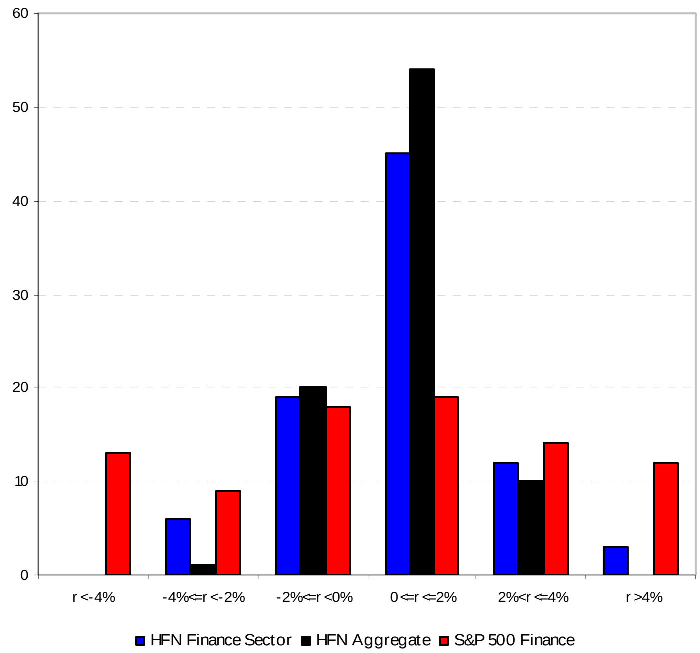


Figure 1: Distribution of Returns from 1/2001-1/2008



	HFN Finance Sector Average	HFN Hedge Fund Aggregate Average	S&P Finance Sector
Latest Returns			
Jan-08	-1.22%	-2.10%	-0.61%
Last 3 Months	-4.06%	-3.06%	-13.85%
Last 6 Months	-1.41%	0.60%	-12.79%
Last 9 Months	-5.35%	3.76%	-21.64%
Last 12 Months (LTM)	-6.23%	7.06%	-21.87%
Last 24 Months	0.47%	16.41%	-9.26%
Last 36 Months	5.45%	31.35%	-2.92%
Return Statistics			
Avg Annual Cmpd Return from 1/2001	8.67%	10.65%	-0.26%
Avg Cmpd Monthly Return from 1/2001	0.70%	0.85%	-0.02%
Average Monthly Return, LTM	-0.53%	0.57%	-2.04%
Cumulative Return from 1/2001	80.25%	104.79%	-1.82%
Largest Monthly Gain from 1/2001	4.55%	3.81%	12.05%
Largest Monthly Loss from 1/2001	-3.94%	-2.10%	-11.86%
% Down Months from 1/2001	29.41%	24.71%	47.06%
Risk Statistics			
Annualized Standard Dev from 1/2001	8.99	11.33	13.88
Annualized Standard Dev, LTM	10.19	11.49	13.77
Annualized Sharpe Ratio from 1/2001	1.28	1.34	-0.53
Annualized Sharpe Ratio LTM	0.23	1.29	-6.99
Sortino Ratio (MAR=8%) Bottom 25% from 1/2001	-0.29	-0.35	-0.72
Sortino Ratio (MAR=8%) Middle 50% from 1/2001	0.44	0.34	-0.72
Sortino Ratio (MAR=8%) Top 25% from 1/2001	1.19	1.31	-0.72
Downside Deviation(8%) Median from 1/2001	1.69%	2.05%	3.21%
Sortino Ratio (MAR = 8%) Bottom 25%, LTM	-1.99	-1.21	-2.07
Sortino Ratio (MAR = 8%) Middle 50%, LTM	-1.24	-0.06	-2.07
Sortino Ratio (MAR = 8%) Top 25%, LTM	0.90	1.59	-2.07
Monthly Downside Deviation(8%) Median, LTM	2.39%	2.24%	4.47%
Maximum Drawdown from 1/2001	-7.57%	-3.06%	-29.99%
Months in Max Drawdown	14	3	21
Months to Recover	N/A	N/A	17
Annual Returns			
2007	-5.45%	10.61%	-20.84%
2006	9.25%	11.00%	16.18%
2005	2.59%	8.99%	3.75%
2004	7.75%	9.51%	8.23%
2003	22.85%	21.18%	27.93%
2002	8.68%	5.74%	-16.42%

Total Asset Levels and Flows

Total asset levels in finance sector hedge funds (*Figure 3*) have grown steadily despite the difficult market environment over the past four years. Total estimated assets in funds focusing on the finance sector were $38.0 billion at the end of Q4 2007. This compares to the estimated $134.6 billion in Energy, $26.1 billion in Healthcare and $34.6 billion in Tech sector funds.

Since Q4 03, finance sector fund assets have grown at an annualized rate of 46.76% compared to 34.75% for the hedge fund industry. In 2007 alone, total assets rose by $6.1 billion, due in large part to inflows in the first two quarters. Poor performance in the second half led investors to withdraw an estimated $2.4 billion. Most of the redemptions were in Q4, which ended up being the first quarter on record in which finance sector funds experienced net redemptions.

New investments in finance sector funds in 2007 accounted for 88% of the rise in total asset levels. The sector's organic growth rate (increase in total assets excluding performance) in 2007 of 5.1% is a vast decrease from 57.9% growth in 2006.

Performance by Fund Size

Figure 4 shows return rankings for all finance sector funds in the HFN database. The range of smaller funds, with less than $20mm in AUM, contained by far the worst performing funds as the 75th and 90th percentile ranked small funds were -20.37% and -30.14% in the LTM. Funds in the $20-$100mm range produced the lowest median return of -6.65%.

Larger funds not only had the lost the least, but also produced the best 10th percentile performance. The very largest finance sector funds, those with >$500mm in AUM produced a median return of +10.90% which is even better than the median LTM return for all funds in the HFN database in the same asset range, +7.44%. The relatively outstanding performance for the larger finance sector funds reversed in January as funds with >$500mm in AUM were -5.65%.

Regional Specializations

The major problems facing the finance sector were born in the U.S. housing markets. What the world has learned is that while the problems may have begun in the U.S., they were not contained. The performance of finance sector funds by regional specialization mirrors this contagion.

The LTM performance of U.S. focused finance sectors funds of -6.01% is significantly worse than those with a focus in Europe, +0.49%, or with a global focus, +6.32%. More recently however the performance of U.S. focused funds has shown improvement while those with a European and Global focus have worsened. In January, U.S. focused finance sector funds returned an average of +0.41% comapared to -0.62% for Europe focused and -6.95% for global focused funds. *Figure 5* illustrates the more rapid recent descent of the Europe and global focused funds compared to those investing in U.S. markets.

Market Capitalization Breakdown

Figure 6 on the following page illustrates another important aspect of the progression of the problems in the finance sector which is that the issues started small and expanded rapidly.

HFN is able to track returns for hedge funds investing in small cap as well as mid/large cap financial services companies. Figure 6 shows that the best performance during the prime time for the U.S. housing boom came from funds investing in small cap equities. The smallest capitalized sub sector of the S&P Finance Sector is real estate development followed by several REIT (Real Estate Investment Trusts) sectors, property management and regional banks in the Southwest.

The implication is that these smaller cap sectors were the best performers during the housing bubble, the first to be negatively impacted by its contraction and then the larger sub sectors of the financial sector, which had been feeding off this expansion,

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Figure 3: Total asset levels in finance sector hedge funds, in US$ millions from Q4 2003 through Q4 2007.
Source: HFN Q4 2007 Hedge Fund Asset Flow Report

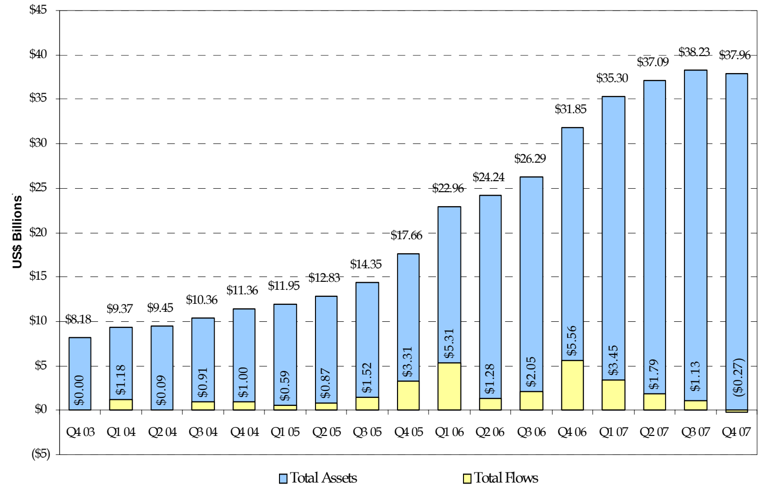


Figure 4: LTM performance of all Finance Sector funds in the HFN database, through January 2008, ranked by percentile and fund size

Finance Sector Hedge Funds	<20mm	20 - 100	100 - 500	500mm+
Total Funds	19	24	11	8
10th Percentile	22.21%	12.28%	34.67%	26.16%
25th Percentile	8.93%	2.10%	12.49%	16.53%
50th Percentile	-1.30%	-6.65%	1.92%	10.90%
75th Percentile	-20.37%	-9.74%	-3.66%	7.45%
90th Percentile	-30.14%	-16.69%	-5.37%	5.83%

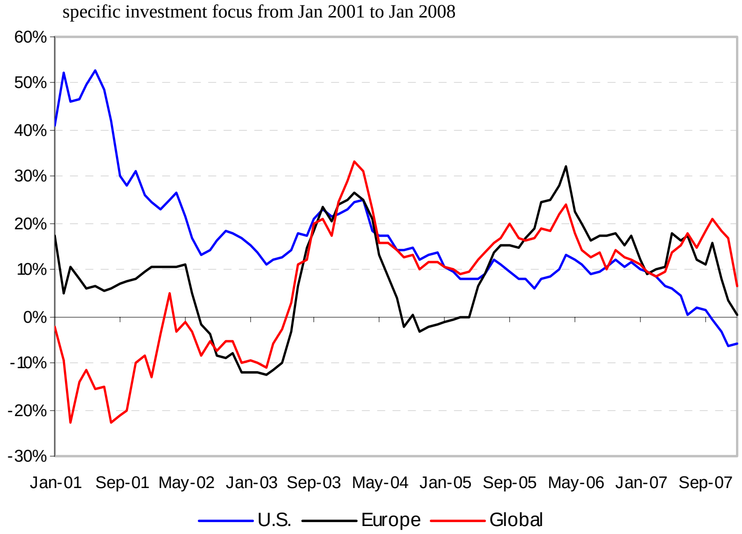
Performance by Fund Size

	January	**Last 3 Months**	**LTM**
Less than $20 million	-1.66%	-5.01%	-6.78%
$20 - $100 million	-0.63%	-4.75%	-3.92%
$100 - $500 million	-7.21%	-8.92%	0.76%
Greater than $500 million	-5.65%	-5.43%	14.90%

Performance by Regional Focus

	January	**Last 3 Months**	**LTM**
U.S.	0.41%	-3.92%	-6.01%
Europe	-0.62%	-6.06%	0.49%
Global	-6.95%	-6.20%	6.32%

Figure 5: 12mo rolling returns for finance sector funds based on regional/country specific investment focus from Jan 2001 to Jan 2008



began to feel the pain. This can be seen through the sharp drop of performance from funds investing in small caps beginning in 2007 and the larger cap focused funds falling towards the end of the year.

Going Forward

The beginning of 2008 has shown that the road forward for the finance sector is going to be rocky. Should there be a turnaround in the financial sector in 2008 it will likely have a very different catalyst and composition than the sector had in 2003 and early 2004.

Unfortunately for many of these small cap sub sectors the covers have been pulled back and the faults of the mechanism which spurred growth for so long has been exposed. The securitization machine which led to the housing market boom in the U.S. is essentially dead and the form in which it was present for the past several years will likely remain dead.

The finance sector in developed markets is in a state of flux with a host of negative influences looming and positive ones beginning to appear. The ongoing negatives include the likelihood of more pain to be felt in the large cap banks from smaller credit related bubbles formed over the last several years from commercial real estate, consumer credit and auto loans. The light on the horizon may be the steepening yield curve in the U.S. which should benefit net interest margins (the difference between interest earned on lending and interest owed on borrowing, i.e. deposits) in the more traditional banking sectors.

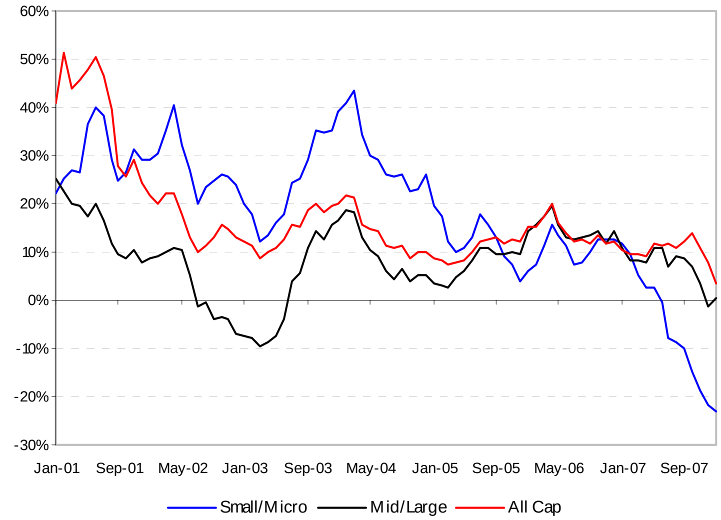
What hedge fund managers will need to do in 2008 to prevent further outflows is to both avoid the potential time bombs which may still be present in the mortgage and structured credit related markets and identify new sources of outstanding returns. An example may be emerging market financial sectors offering similar opportunities seen in the U.S. and Europe in 2003-2005. An example of which is the ongoing development of securitization regulation in India.

The average hedge fund operating in the finance sector in the last year perhaps deserve a hard pat on the back. While their negative performance on average has been disappointing, their relative outperformance has been admirable. 2008 will likely be a defining year for these funds as an environment which favors experience presents itself.

Performance by Equity Market Cap Focus

	January	Last 3 Months	LTM
Small/Micro Cap	-1.46%	-7.89%	-22.84%
Mid/Large Cap	2.89%	-2.08%	0.54%
All Cap	-3.12%	-5.06%	3.26%

Figure 6: 12mo rolling returns for Finance Sector funds based on equity market cap focus from Jan 2001 to Jan 2007



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