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PROTECTING CAPITAL DURING MARKET DOWNTURNS

Non-Directional Hedge Funds Minimize Drawdowns and Lower Volatility for Investors

The health of the global economy and the sovereign debt crisis remain the central concerns to investors in 2010. As worries mount, investors are once again questioning the state of the financial markets and are increasingly looking for ways to minimize losses and protect capital in the event of another significant market correction. The Hennessee Group analyzed its Hennessee Hedge Fund Indices® to determine which strategies have outperformed the S&P 500 Index during times of crisis, specifically which hedge fund strategies generated attractive risk-adjusted returns while providing downside protection.

5 Worst S&P 500 Drawdowns (Jan-93 to Jun-10)

In its analysis, the Hennessee Group first isolated the worst five drawdown periods for the S&P 500 Index dating back to 1993 and used the three main Hennessee Hedge Fund Sub-Indices (see “Description of Hennessee Hedge Fund Indices” below for more details) as proxies to identify which hedge fund strategies have historically protected capital the best during strong market sell-offs. While all hedge funds strategies provide significant downside protection, analysis shows that non-directional strategies, such as arbitrage and event driven strategies, were best at minimizing drawdowns, protecting capital and lowering volatility.
<table>
<thead>
<tr>
<th>Event</th>
<th>Time Period</th>
<th>S&amp;P 500</th>
<th>Hennessee Hedge Fund Index</th>
<th>Hennessee Arbitrage/Event Driven Index</th>
<th>Hennessee Long/Short Equity Index</th>
<th>Hennessee Global/Macro Index</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sovereign Debt Crisis</td>
<td>5/10 - 6/10</td>
<td>-13.20%</td>
<td>-4.30%</td>
<td>-2.50%</td>
<td>-4.60%</td>
<td>-4.60%</td>
</tr>
<tr>
<td>Credit Crisis</td>
<td>11/07 - 2/09</td>
<td>-52.60%</td>
<td>-19.40%</td>
<td>-19.30%</td>
<td>-20.60%</td>
<td>-23.60%</td>
</tr>
<tr>
<td>Tech Bubble</td>
<td>9/00 - 9/02</td>
<td>-46.30%</td>
<td>-0.10%</td>
<td>8.40%</td>
<td>-4.40%</td>
<td>-0.60%</td>
</tr>
<tr>
<td>Long-Term Capital Management</td>
<td>7/98 - 8/98</td>
<td>-15.60%</td>
<td>-7.40%</td>
<td>-5.10%</td>
<td>-8.10%</td>
<td>-14.50%</td>
</tr>
<tr>
<td>Global Bond Meltdown</td>
<td>2/94 - 6/94</td>
<td>-7.80%</td>
<td>-0.40%</td>
<td>-0.10%</td>
<td>2.10%</td>
<td>-5.30%</td>
</tr>
<tr>
<td><strong>Average</strong></td>
<td></td>
<td>-27.10%</td>
<td>-6.32%</td>
<td>-3.72%</td>
<td>-7.12%</td>
<td>-9.72%</td>
</tr>
</tbody>
</table>

**Sovereign Debt Crisis (May-10 to Jun-10):** The growing sovereign debt crisis has put into the question the sustainability of the global economic recovery and has subsequently resulted in a sharp sell-off in the equity markets in 2010. Despite a double digit loss for the S&P 500 Index, all hedge fund sub-strategies have participated in a third or less of the drawdown. The Arbitrage/Event Driven Index protected capital best with a -2.5% loss versus a -13.2% loss for the S&P 500 Index.

**Credit Crisis (Nov-07 to Feb-09):** What started out as a serious credit crunch evolved into a much broader financial crisis that resulted in a widespread economic slowdown and massive sell-off across nearly every asset class. The Arbitrage/Event Driven Index provided the most protection, participating in only 36% of the drawdown (-19.3% vs. -52.6% for S&P 500). Merger arbitrage (-1.2%), fixed income (-8.5%) and multiple arbitrage (-13.2%) were particularly strong performers on a relative basis during this time period.

**Tech Bubble (Sep-00 to Sep-02):** The bursting of the technology bubble was another challenging period for the financial markets. The Hennessee Arbitrage/Event Driven Index generated a gain of +8.4%, as the S&P 500 Index fell -46.3% over the same time period. Convertible arbitrage (+16.6%), multiple arbitrage (+18.2%) and merger arbitrage (+5.5%) were particularly strong performers during this time period.

**Long-Term Capital Management (Jul-98 to Aug-98):** The markets came under pressure in 1998 due to the Russian debt crisis and the failure of Long-Term Capital Management. The Hennessee Arbitrage/Event Driven Index once again was the top performing index, participating in only a third of the S&P 500 Index drawdown (-5.1% vs. -15.6% for S&P 500). Multiple arbitrage (-2.6%), convertible arbitrage (-3.0%), and merger arbitrage (-3.7%) were particularly strong performers on a relative basis during this time period.
**Bond Meltdown (Feb-94 to Jun-94):** Rising global interest rates in 1994 caught investors off guard and caused bond prices to plunge dramatically. The Arbitrage/Event Driven Index and Long/Short Equity Index were able to once again protect against the -7.8% drawdown in the S&P 500 Index. The Arbitrage/Event Driven Index slipped only -0.1% over the same time period, led by managers in event driven (+7.1%), distressed (+4.2%), and multiple arbitrage (+2.6%).

**All S&P Down Months:**

The downside protection of hedge funds is also evident when analyzing the monthly returns of the Hennessee Hedge Fund Indices versus the S&P 500. **In months when the S&P 500 declined in value, hedge funds, on average, participated in less than 30% of the loss.** The Hennessee Arbitrage/Event Driven Index was once again the most successful at protecting capital in down markets with an average loss -0.1% a month versus the S&P 500 Index average loss of -3.9%. The Hennessee Long/Short Equity Index generated an average loss of -0.9%, while the Hennessee Global/Macro Index averaged a loss of -1.0%.

![Down Market Analysis: Average Performance in S&P Down Months (Jan-93 to Jun-10)](image)

The ability to protect capital in the down markets has allowed hedge funds to greatly outperform the S&P 500 Index on both an absolute and risk-adjusted basis. Since 1993, all three Hennessee Group Hedge Fund Sub-Indices have outperformed the S&P 500 Index with a fraction of the volatility. While the Hennessee Long/Short Equity has been the top performer on an annualized return basis (+10.2%), the Hennessee Arbitrage/Event Driven Index has generated a comparable return of +9.9% with lower volatility. The Arbitrage/Event Driven Index has generated the highest Sharpe ratio among the hedge fund indices and is much higher than S&P 500 Index (1.81 vs. 0.52).
**Risk vs. Return Chart (Jan-93 to Jun-10)**

<table>
<thead>
<tr>
<th>Benchmark</th>
<th>Annualized Return</th>
<th>Annualized Standard Deviation</th>
<th>Sharpe Ratio</th>
</tr>
</thead>
<tbody>
<tr>
<td>Hennessee Hedge Fund Index</td>
<td>9.9%</td>
<td>6.7%</td>
<td>1.41</td>
</tr>
<tr>
<td>Hennessee Arbitrage/Event Driven Index</td>
<td>9.9%</td>
<td>5.2%</td>
<td>1.81</td>
</tr>
<tr>
<td>Hennessee Long/Short Equity Index</td>
<td>10.2%</td>
<td>7.6%</td>
<td>1.29</td>
</tr>
<tr>
<td>Hennessee Global/Macro Index</td>
<td>10.1%</td>
<td>9.8%</td>
<td>1.02</td>
</tr>
<tr>
<td>S&amp;P 500</td>
<td>7.0%</td>
<td>14.5%</td>
<td>0.52</td>
</tr>
</tbody>
</table>

*Note: Results are net returns. Sharpe ratio is return minus the risk-free rate divided by standard deviation.*

**CONCLUSION**

With the numerous headwinds that still remain for the economy and financial markets, the Hennessee Group believes it is important for investors to not only revisit their overall allocation to hedge funds, but also think strategically about their underlying hedge fund strategy exposures to identify which are most likely to outperform going forward, particularly in the event of a market-sell-off. As seen in this analysis, while all hedge fund strategies have provided excellent downside protection in prior bear markets, as well as good risk-adjusted returns over the longer-term, certain hedge fund strategies, namely non-directional strategies in the arbitrage category, have historically shown the greatest ability to protect capital during market downturns. Depending on one’s own risk/return objectives, investors should give consideration to non-directional, arbitrage strategies when constructing hedge fund portfolios, particularly as we continue to navigate through these uncertain times.
HEDGE FUND STRATEGIES THAT COMPRIZE EACH GROUP:

Long/Short Equity Index:
The index is an equally weighted average of all the hedge fund managers that comprise the Financial Equities, Growth, Healthcare/Biotech, Value, Market Neutral, Opportunistic, Short Biased, Technology, and Telecom/Media style indices.

Event Driven/Arbitrage:
The index is an equally weighted average of all the hedge fund managers that comprise the Convertible Arbitrage, Distressed, Event Driven, Fixed Income, High Yield, Merger Arbitrage, Multiple Arbitrage, and PIPES/Private Financing style indices.

Global/Macro:
The index is an equally weighted average of all the hedge fund managers that comprise the Asia – Pacific, Emerging Markets, Europe, International, Latin America, and Macro style indices.

OR FOR FURTHER DETAILS ON THE HENNESSEE HEDGE FUND INDICES VISIT:

About the Hennessee Group LLC
Hennessee Group LLC is a Registered Investment Adviser that consults direct investors in hedge funds on asset allocation, manager selection, and ongoing monitoring of hedge fund managers. Hennessee Group LLC is not a tracker of hedge funds. The Hennessee Hedge Fund Indices® are for the sole purpose of benchmarking individual hedge fund manager performance. The Hennessee Group does not sell a hedge fund-of-funds product nor does it market individual hedge fund managers. For additional Hennessee Group Press Releases, please visit the Hennessee Group’s website. The Hennessee Group also publishes the Hennessee Hedge Fund Review monthly, which provides a comprehensive hedge fund performance review, statistics, and market analysis; all of which is value added to hedge fund managers and investors alike.

Description of Hennessee Hedge Fund Indices®
The Hennessee Hedge Fund Indices® are calculated from performance data reported to the Hennessee Group by a diversified group of over 1,000 hedge funds. The Hennessee Hedge Fund Index is an equally weighted average of the funds in the Hennessee Hedge Fund Indices®. The funds in the Hennessee Hedge Fund Index are derived from the Hennessee Group’s database of over 3,500 hedge funds and are net of fees and unaudited. Past performance is no guarantee of future returns. ALL RIGHTS RESERVED. This material is for general information only and is not an offer or solicitation to buy or sell any security including any interest in a hedge fund.