Hedge Fund Monthly Update

July 2012

	July	2012 YTD
Hedged Equity	1.2%	3.7%
Event Driven	0.7%	3.9%
CTA/ Quant Macro	4.7%	4.4%
Credit	0.8%	5.3%
Asia	0.1%	0.9%
Emerging Markets	-0.0%	-0.10%
Global Macro	0.9%	0.9%
RV/ Multi-Strategy	1.0%	3.9%
Average Fund in Sample	1.1%	3.2%

Market Indices	**July**	**2012 YTD**
MSCI The World Index Free- Net	1.3%	7.3%
JPM Global Aggregate Bond Index	1.1%	2.5%
DJ UBS Commodity Index TR	6.5%	2.5%

The above returns are early indications of performance and may change as funds report performance. Source: UBS, HFR, HFI, Eurekahedge

Market Summary

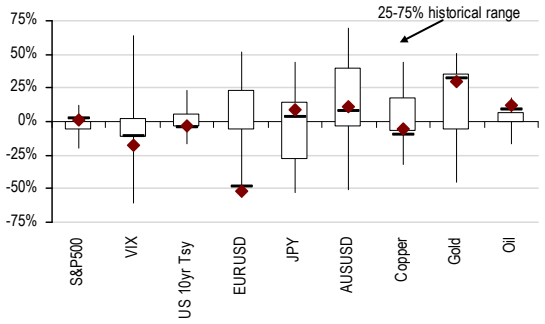
In July, global equity markets twice sold off on poor economic data (e.g. disappointing US job reports, slowing Chinese growth, Spanish yields hitting all time highs) only to rally each time on the hopes of policy makers taking more action. For example, the MSCI World Index declined -3.5%, rallied +3.3%, declined -3.7% and then rallied +4.3%; not an easy environment for investing. For July, the MSCI World Index returned +1.2%; the S&P 500 returned +1.3%; the MSCI Euro +3.0%; and the MSCI AC Asia Pacific +1.2%. Equity volatility levels increased, but not by much considering this price action (VIX +10.8%; VSTOXX +12.3%; VHSI +1.4%).

Investors continued to seek safe haven assets and developed market interest rates fell as government bonds rallied. US, German and Japanese yield curves were lower and flatter for the month. The US 10 yr rate declined 18 bps to 1.47%; the German 10 yr rate declined 30 bps to 1.29%; and the Japanese 10 yr declined 4 bps to 0.79%. Corporate credit markets remained firm and spreads tightened, most notably in Europe (Barclays EuroAgg Corporate Index +2.4%). Commodities continued to rally, and the DJ UBS Commodity Index returned +6.5%. Corn and wheat were both +20% for the month on continued drought fears in the US (wheat rallied +54.8% from June 15 to July 20). In currencies, the EUR weakened broadly, the JPY strengthened and the USD turned in mixed performance but was overall stronger for the month (Dollar Index +1.2%). Some of the biggest currency moves were against the EUR: Chilean Peso +6.9%; Aussie Dollar +5.6% and Yen +5.2%.

Spain and Italy re-introduced short sale bans in July. The Spanish ban is applicable across all equities for 3 months while the Italian ban is financials only and shorter in duration (expires on Sep 14th)[1].

Despite market volatility in July, positioning was largely stable across asset classes according to UBS research[2]. The chart below shows net speculative positioning in major asset classes on July 3 and then on July 17 after the first market sell off had taken place (MSCI World -3.5% from July 3 to July 12). Investors became slightly more positive on cyclical assets as they added to their positive positioning in AUD and oil, whilst the negative positioning in copper eased. There were no large changes in net speculative positioning.

Net Speculative position as % of Open Interest



♦ denotes Net speculative positioning as on 17-July-2012

— denotes Net speculative positioning as on 03-July-2012

Source: UBS Global Investment Strategy

Hedged Equity: +1.2% (max +10.5%; min -7.9%)

Hedged Equity managers, on average, navigated July quite well and returned +1.2% for the month. As equity markets dipped and rallied, equity managers maintained more cautious positioning with lower net exposures and this served them well, for the most part. By mid month, most equity markets indices were negative (e.g. MXWO -2.1%)

[1] UBS Securities Lending, Month in Review, July 2012
[2] UBS Global Positioning Summary, July 25 – Ramin Nakisa

yet many managers were positive at this point. It was the strong month end rally on Draghi's promise that the ECB is ready to do "whatever it takes" to save the Euro[3] that turned a relatively good month for hedged equity into a relatively average one. After Draghi's comment, global equity markets rallied in unison but most hedged equity managers did not participate given their continued cautiousness. The MSCI World index gained +4% in the two days after Draghi's statement.

Hedge funds reported solid gains in energy related names, and energy was the strongest performing sector in July (+3.3%[4]). Geopolitical concerns and potential supply disruptions resulted in oil reversing its two month decline (Brent +7.3%; WTI +3.6%) which was a positive for oil related stocks. Consumer Staples (+3.0%) and Healthcare (+2.1%) also outperformed, reflecting continued demand for defensive sectors in the current uncertain environment. The majority of cyclical sectors underperformed, underlining lower appetite for higher beta stocks: Consumer Discretionary (-0.9%); Materials (-0.42%); Industrials (+0.78%).

In terms of geography, peripheral Europe gave back some its gains from last month's relief rally. Spain (IBEX -5.1%), Greece (ASE -2.0%) and Italy (FTSE MIB -2.7%) all declined in July and hedge funds generated decent gains from shorts in these countries. Core Europe and the US, where funds are taking higher net long exposures, performed better and provided gains from long positions: DAX +5.5%; CAC 40 +3.0%; S&P 500 +4.0%. Asia and Emerging Markets are covered a little later in this document.

In early July, the UBS Global Equity Research team released an interesting report on hedge fund flows[5]. In the last two weeks of June, UBS clients turned net sellers of equities on a global basis. This change ended a 6-week streak of net-buying that was the longest consecutive period in two years. The biggest swing factor was our hedge fund client base. The strong net buying we saw from late April through early June was almost entirely driven by hedge fund activity. Our long-only clients remained net sellers. This changed in early June however when hedge funds re-joined their long-only peers in net-selling equities and proved the swing factor between UBS clients net buying versus net selling equities.

Hedge Fund and Long Only Net Flows

Source: UBS Client Flows, 4 week average

[3] Financial Times, Global Market Overview, August 2
[4] MSCI World Sector Index
[5] UBS Global Flow Watch, July 10 – Nick Nelson

Event Driven: +0.7%
(max +2.8%; min -1.1%)

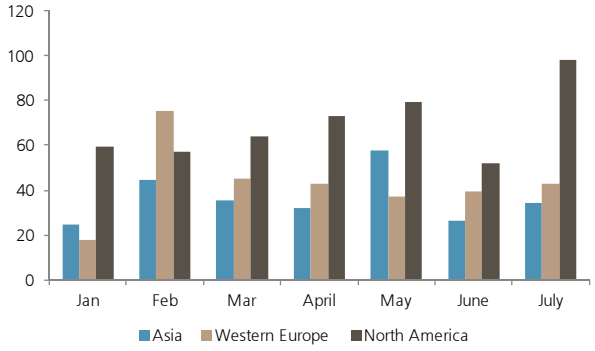
Event Driven managers turned in a positive month, returning +0.7%. Similar to Hedged Equity, many event driven managers have been cautious in how they have positioned their portfolios. However, Draghi's "whatever it takes" statement has had an impact on several event driven funds. Whether its buying call options to provide upside in case of a continued rally, or a more direct approach of increasing net exposure, many funds are reacting by taking additional risk. Several Event Driven managers continue to prefer positions in companies that are considered "high quality" and less risky (brand name products, strong balance sheets, capable management teams) with idiosyncratic catalysts associated with them.

United Technology's acquisition of Goodrich was completed in July, and this was a profitable position for hedge funds. Gains were also earned in long positions in Magellan Health Services on LBO speculation, and short positions in Best Buy and Safeway on false deal speculation.

Several event driven funds reported losses in Cove Energy, an oil and gas company that was the target of a competitive bidding situation involving Shell and PTT, a Thai energy company. After Shell withdrew their bid, the stock dropped -14% on July 16th. More broadly, funds suffered losses in shorts in European stocks and sovereigns that rallied along with the market.

July saw an uptick in merger activity by volume, but a small decrease in deal count. Globally, the announced deal count dropped -2.4% from June, with 2033 announced deals in July. Most deals were in North America (961), followed by Asia Pacific (672) and Western Europe (385). However, the dollar volume increased 14% from $158B to $180B.

2012 Deal Volume (Billions USD)



The largest announced deal in July was China's CNOOC announced acquisition of Canadian based Nexen for $17.4B. Other notable deals include Wellpoint acquiring Amerigroup for $4.5B; NRG's acquiring GenOn Energy for $4B; and Heineken acquiring Asia Pacific Breweries for $4.1B.

CTA/Quant Macro: +4.7%
(max +7.9%; min -2.0%)

CTAs, yet again, turn in a big number for the month, returning +4.7%. The good performance in July put many CTAs into positive territory for the year. The bulk of gains were earned in currency and fixed income markets. Losses were minimal, with short crude a common losing trade as crude reversed its recent trend lower and rose on the month (WTI +3.6%; Brent +7.3%).

The EUR declined against the USD (-2.9%), JPY (-5.2%) and AUD (-5.6%) and many CTAs hold short EUR positions in these crosses. The USD was stronger overall (DXY Index +1.2%), and most CTAs are long USD, so gains were also earned here.

Fixed income markets provided significant gains for CTAs. Long fixed income has now been a core trade for several years, and developed market interest rates fell in July as government bonds rallied. As noted in our market summary, US, German and Japanese yield curves were lower and flatter for the month. Indeed, many CTAs will have increased their risk allocation to fixed income following the price action in July.

Fears of damaged crops in the US from a recent drought continued to drive an upward surge in price in Corn and Wheat, with each gaining +20% for the month. This provided additional gains for CTAs which are generally long these contracts.

Equity market price action was choppy in July, and attribution from equities was mixed across CTAs. The strong rally at month end that continued into August has resulted in many CTAs initiating long positions in equity indices.

Global Macro: +0.9%
(max +6.5%; min –2.2%)

Global Macro managers earned positive returns in July, with a mean return of +0.9%. Macro managers, in general, hold a bearish view of the world and have their portfolios positioned accordingly.

In July, macro funds earned profits across different asset classes, with many trades having a risk-off or stress related theme. Gains were earned mostly in the first part of the month, and the performance of a lot of funds was determined by how much they locked in profits before the market rally at month end. Profitable trades included: short EUR, in particular against the USD (EUR/USD -2.9%); long USD more broadly; long developed market government bonds; short European sovereigns (Spanish yields all time highs of during July, with 5 yr CDS hitting 642 bps; stress trades in fixed income markets (TED spread, EURIBOR v government rates); and long volatility. In addition, many macro funds are also in the long agricultural commodities trade, so this was also a source of gains (see CTA section above).

We have commented before on how difficult the current environment is for macro managers: bad economic data results in rallying markets because of increased hopes that policy makers will take further action (e.g. QE3). Thus, when macro managers expect trades to be profitable (because of bad economic releases), they often end up losing money. This in part explains why macro funds have not had a better year, returning +0.9% year to date. One prominent global macro manager, with a long track record of success, recently returned $2B to investors, citing "trickier" markets[6].

In general, this trickier market environment translates in lower VaR levels for most macro funds, and fewer themes in portfolios. Macro managers, similar to other strategies, are striving to focus on higher conviction ideas. The lower VaR levels explain why macro funds did not produce larger returns in July, especially when compared to CTAs.

Asia: +0.1%
(max +3.9%; min -4.6%)

Asia based hedge funds, on average, were flat for the month despite the spirited late month rally on the back of Draghi's comments. Several Asian equity markets rebounded sharply and posted positive returns in July (HSI +1.8%, STI +5.1%, KOSPI +1.5%). Japan (Nikkei -3.5%) and China (CSI 300 -5.3%) fared poorly due to Yen strengthening and decelerating domestic economic growth. Asia funds reported positive attribution from shorts in materials; shorts in energy; long Chinese industrials; long consumer discretionary; and long information technology.

Similar to equity long short managers, many Asian funds did not participate in the relief rally since they were positioned rather conservatively. Entering July, most managers remained concerned over macro economic issues in Europe and China. The rally detracted from performance for some funds, and a few managers reported episodes of short squeezes. Managers note that fundamental analyses performed ahead of earnings seasons have proven to be quite effective. Their conviction to stay the course is meaningful against the backdrop of a regional earnings downgrade and revisions. Indeed UBS investment research[7] reported that stock return dispersion rose slightly last month from historical lows in Asia. Its too early to tell, but perhaps this represents a welcome change from the risk on, risk off environment to one driven more by fundamentals.

Credit: +0.8%
(max +3.1%; min -2.6%)

Once again, credit funds turn in positive performance for the month. Most credit markets were solidly positive in July as government yield curves declined and spreads also tightened. The Barclays US Corp HY index returned +1.9%, the CS Asian Corporate index returned +2.4%, and the Barclays EuroAgg Corporate index also returned +2.4%. High yield markets outside of the US did not fare as well, and the Markit iBoxx Global Developed ex-US HY index returned -0.55%.

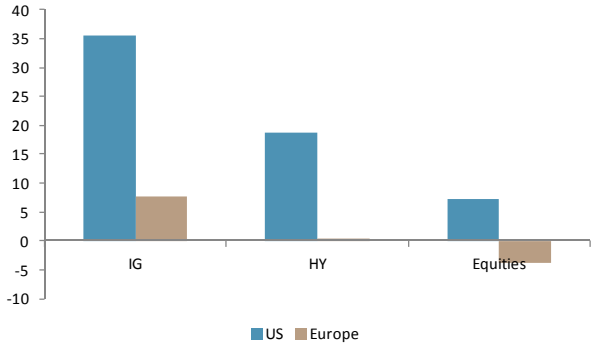
[6] Financial Times "Bacon to return $2B to investors", August 1
[7] Asia Style Monitor, Aug 3

The recent credit rally has been fueled by a lack of earnings surprises, greater demand for US domestic corporate debt and dwindling available supply[8]. On July 25th, IBM sold $1B in 10 year debt with a coupon of 1.875%, a record low interest rate for bonds of that maturity sold in the US, according to Dealogic[9]. The sale beat the previous record low of 2% in 10 year notes set by 3M in June.

Credit managers reported broad based gains but noted significant attribution from structured credit positions, notably RMBS and CMBS. This is a sector of the credit market that has outperformed year to date, but continues to generate solid gains. Some distressed situations also performed well, including popular names like TXU and Lehman. Several credits in Technology came under pressure in July, causing some losses.

Credit markets continue to benefit from positive inflows[10], particularly in the US. Fund flows in the US for the month as of July 25th were as follows : Investment Grade +$3.4B; High Yield +$5.1B; Leverage Loans +$521M; Equities +$3.6B. Year to date US inflows are as follows: Investment Grade +$35.5B; High Yield +$18.8B; Leverage Loans +$2.2B; Equities +$7.2B. In Europe, year to date fund flows through June are as follows: Investment Grade +$7.6B; High Yield +$324M; Equities -$3.9B[11].

Credit Inflows; US v Europe (USD Billions, YTD)[12]



Source: UBS Investment Research

Emerging Markets: -0.0% (max +2.3%; min -1.0%)

The MSCI EM index gained +1.6% in July, outperforming the MSCI World Index return of +1.2%. EMEA was the best performing region recording total returns of +2.6% over July beating both Asia (+2.1%) and LatAm (+1.3%).

Indonesia (+5.9%), Turkey (+3.9%) and Korea (+3.6%) were the best performing markets, while Peru (-3.8%), Czech Republic (-2.4%) and Morocco (-1.3%) all recorded negative returns over the month. Among BRIC nations, only India (-0.4%) slipped into negative territory[13].

There was no clear market leadership within sectors as a variety of defensive and cyclical sectors outperformed. Telecoms (+5.9%), Consumer discretionary (+3.3%) and Health Care (+3.1%) were the best performing sectors, while Utilities (+0.2%) and Industrials (+0.8%) were the laggards led by Materials (-0.3%). Materials was the only sector to produce negative returns last month[13].

Managers reported gains in Russian rail, Mexican Media, Phillipines construction and Venezuelan banking. Losses were reported in Turkish banking shorts and Indian tobacco (from the Indian government opening up the sector to competition). The emerging markets managers that we have spoken to had increased their net exposures by month end, but are maintaining liquid portfolios.

UBS Investment Research releases an emerging markets "country positioning scorecard" on a weekly basis[14]. This scorecard aims to identify the most and least overcrowded markets within emerging markets equities, based on asset inflows relative to history. The table below summarizes the recent scorecard from July 27.

Most Crowded	Least Crowded
South Africa	Poland
Philippines	Czech Republic
Thailand	Hungary
Indonesia	Morocco
Turkey	China

Prime Brokerage Exposures[15]

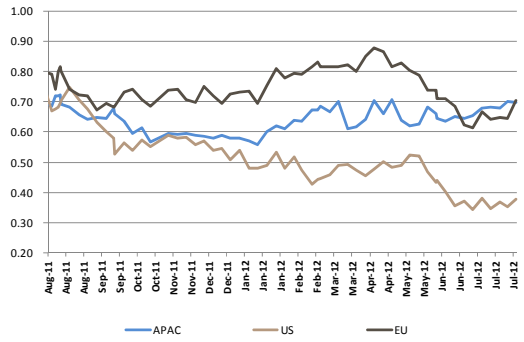
In our Prime Brokerage (PB) accounts, on average during July, funds increased longs, decreased shorts, increasing our regional PB net exposures while keeping gross exposure relatively unchanged.

Globally, across strategies, the average long exposure increased +1.5% to 129%, with the increase in long exposure mostly in EMEA (+4.5%) and APAC (+4.6%).
Short exposure decreased most notably in the US (-5.2%) and EMEA (-4.5%).

Consequently, we saw a increase in our PB net exposures in the US (34% to 38%), EMEA (61% to 70%) and APAC (65% to 70%). However, our PB regional net exposures for the US and EMEA remain significantly below their levels three months ago.

[8] UBS Global Credit Navigator, July 20 – Kevin McCarthy
[9] Financial Times, "Record low cost for IBM debt issue, July 25
[10] UBS US Weekly Fund Flows Report, July 27 – Kevin McCarthy
[11] UBS Global Credit Navigator, August 3 – Kevin McCarthy
[12] July flows are not included for Europe
[13] UBS Global Emerging Markets Strategy, August 2 – Nicholas Smithie
[14] Global Emerging Markets Fund Flows, July 27 – Nicholas Smithie
[15] From July 2 to August 2

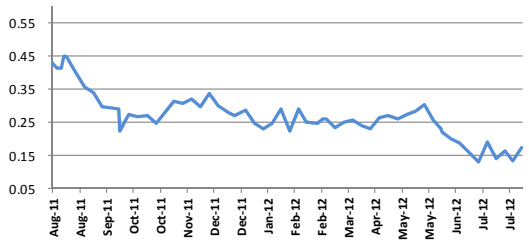
PB Regional Net Exposures



By strategy, equity long short managers increased their long exposure by a small amount (128% to 130%), decreased short exposure (114% to 112%), thus increasing our PB net exposure for equity long short from +13% to +18%.

Our PB net exposure for equity long short remains at multi-year lows, was +27% six months ago, and a year ago was +45%.

Global Equity LS PB net exposure



In terms of sector exposure, our books reflect a notable increase in long exposure in ETFs (+66%) and a decrease in long exposure in Utilities (-13.4%).

On the short side, our books reflect increased shorts in Telecommunications (+6.2%) and Consumer Staples (+4.8%).

Securities Lending[16]

US

On the U.S. stock loan desk, overall dollar volumes were down 6% month over month in July. From a skew perspective, flows were 51.3% to the short side. Our book saw 12 days net short vs. 9 days net cover for the month.

The bulk of activity on our desk revolved around 2Q earnings season. We particularly saw a lot of demand for securities in social media, for-profit education and grocery chains.

This past month we fielded an outsized increase of demand in a number of Health care names as there were a number of regulatory catalysts in that sector. Additionally, PRLB, a recent IPO, saw steady demand as its share price more than doubled in July.

Europe

Spanish 10-year bond yields surged to a new record of 7.64% mid-month and we continued to see strong demand for sovereign debt borrow across the region; however, demand has now shifted to the sources of capital, France and Germany.

Asia

Sector flows in Asia were again focused on Financials and Consumer Cyclicals. Within Financials, the flow centered on Chinese banks leading up to the surprise rate cut by China on July 4th. In the consumer sector, we saw demand across the high-end retail space after weaker than expected HK retail sales figures and poor quarterly results.

We also saw demand in Food names on regulatory/quality concerns and predictions that profitability will be hit by rising commodity prices. In Korea and Taiwan, demand was concentrated in Industrials, particularly Electronic names. 7752 Ricoh and 6753 Sharp were standouts as sales forecasts continue to be reduced.

Popular Short Themes

Health Care: stock loan borrow on names in this sector has increased and we have been seeing strong demand on the desk for many names including PRLB (recent IPO), ARNA, VVUS and DNDN.

Social Media: earnings season has proved costly for social media names, which face tough competition and slowing revenue growth. The stock prices of ZNGA, FB, GRPN and P have all declined over the past few weeks. We have seen the majority of supply in these names disappear off market feeds, and rates have increased as the shorts have become more crowded.

For-Profit Education: for-profit education names have continued to garner interest as enrollment rates have come under pressure and student loans are hotly debated in Congress. Earnings season provided no relief to these names as the borrow situation has further deteriorated.

Proteins: the current drought across the Midwest, which resulted in record high corn and soy prices, has also affected protein stocks. Increasing input costs have compressed margins, and we have seen a pickup in interest in a handful of names in the sector.

[16] UBS Securities Lending, Month in Review, July 2012

Capital Introductions Investor Update

On a monthly basis, our Capital Introduction team speaks to a large sample of investors in the U.S, Europe and Asia. Preferences for hedge fund strategies, as stated by investors in June, are summarized below.

Globally, on aggregate, most investors stated a preference for long short equity (19%, a decrease of -7% from last month). Macro was the next preferred strategy (11%, a decrease of -2% from last month), along with Credit (also 11%). Event Driven (8%), CTAs (7%), Stat Arb (6%) and Emerging Markets (5%) were also part of investor searches in July but to a lesser extent. Only 12% of investors stated a geographic bias, and these investors were mostly focused on Emerging Markets (5%) and Asia (3%).

In the US, most investors stated a preference for Equity Long Short (29%), followed by Macro (13%), CTAs (10%) and Event Driven (9%).

In Europe, most investors stated a preference for Credit (15%),followed by Emerging Markets and Macro (10% each).

In Asia, investor appetite was balanced across strategies this month.

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