September 2008 and Beyond

Short Term:

· The consensus expectation is for recession and a hard landing particularly in US and Europe with a protracted trough before recovery. There is some disagreement over the outlook for emerging markets but sentiment is beginning to deteriorate. The short term, however, is a poor guide for the medium to long term.

· All markets are trading on liquidity and not on fundamentals. Opportunities abound for the unlevered investor.

· Market attention was focused on the proposed Troubled Asset Relief Program, a 700 billion USD bailout of the US banking system. The substance and material impact of the Program is limited and the majority of its utility was in shoring up confidence in the financial system. Debating the Program and delaying it has blunted its signaling value.

· The hedge fund industry is facing large scale redemptions starting first from investors exiting funds of funds, and funds of funds redeeming from their hedge funds to meet their redemption needs. Most funds have calendar quarter redemption dates and the September redemptions have been known for some time. Aggregating the outflows from the annual redemption funds with those that are quarterly and monthly, implies that December will be a highly risky month for hedge funds and the markets in which they invest, as gross exposures are reduced in large scale. It is expected that a significant number of hedge funds may not survive.

· A large number of hedge funds will be suspending redemptions. A Prisoner’s Dilemma situation now exists where strong holders need to redeem ahead of weak holders. Hedge funds will not have the liquidity to meet the expected volume of redemptions.

Medium Term:

· Falling stock prices and house prices will have knock on effects on consumer confidence and thus consumption plans.

· Increased credit spreads have raised the cost of debt and will impact corporate profitability going forward. Availability of credit from cash strapped banks will also be reduced. Demand for credit will be impacted by expectations of consumer confidence and exports which will be dampened by slowing economic growth elsewhere.

· Economic data from around the world are indicative of a severe economic slowdown. Inflation is unlikely to be a problem at least in the developed world.

· The influence of liquidity will remain for a time. However, as the velocity of capital outflow slows, asset prices will come to be driven more by fundamentals than by momentum.

· Regulatory changes almost always follow large dislocations in financial markets and recessions. One can expect the financial sector to be regulated as a public good. There is much uncertainty here as regulators do not have the best access to information, can make errors in policy, are often driven by politics before economic efficiency, and plan over different time horizons.

· The CDS markets, and more generally the OTC markets, are likely to be regulated and moved on exchange.

· Investors will take some time to regain their risk appetite. As they do, they are likely to realize the risks in liquidity mismatches inherent in various investment vehicles from hedge funds, to structured products, to banks. Many hedge fund strategies which are sound and logical, fail because of liquidity mismatches. The closed ended fixed term fund, the investor vehicle of choice in private equity, is well suited to many hedge fund strategies. One could argue that with greater certainty of outcome than private equity, and with greater certainty of maturity in arbitrage, such investor vehicles are even more appropriate for hedge fund strategies. Examples of such structures arose in 2005 in the structured credit markets, triggered by the credit ratings downgrades in the US auto sector.

· Investors are likely to be wary of highly leveraged investments and will scrutinize more closely the magnitude and structure of levered investments. Many credit hedge fund strategies are levered implicit providers of capital to the economy. Leveraged provision of credit is a strategy that has most visibly failed not only in hedge funds, but banks as well. Here lies a two fold opportunity. For the Asset Based Lender, a beleaguered banking industry provides them the opportunity to take market share and to grow in scale. For businesses, Asset Based Lenders are an efficient source of credit, providing more responsive client service, bespoke financing solutions and thus more flexible pricing. For the investor, Asset Based Lending Funds provide the opportunity to participate in the new banks, lending institutions without the excessive leverage, complex and opaque proprietary trading books, sprawling organizations and overall operational and financial complexity.

· The face of hedge fund investing will change. Before Aug 2007, hedge fund analysis focused on the skill, talent and integrity of the manager, the operational infrastructure and mostly investment issues. While the astute investor scrutinized the investor base, the importance of this consideration in the greater scheme of things was not as high as it will be going forward. Henceforth, the stability of the equity base and of funding will be a major consideration. For established funds with a long list of legacy investors, this analysis is complicated, more so than for a small or medium sized fund with an anchor seeder that has stable capital and can offer marketing support to strategically build the asset base. Risk management will include policies, limits and guidelines for funding as well as for the investor base. Transparency to the structure, if not the identities, of the investor base will be important.