



IQ TACTICAL MARKET UPDATE 15th August 2007

'Some reckon large-scale redemption requests today by investors could result in "irrational" markets' is a comment we see today in the Financial Times.

For anyone worried hedge funds could spark another market crisis today is a red letter day: the final chance for investors to put in demands for their money back by the end of September at many funds using standard redemption terms needing 45 days notice.

By tomorrow, hedge funds with these terms will know exactly how much cash they must find to repay share holders: cash they are likely to find by selling their investments. Large-scale redemptions may prompt big sell-offs: something BNP Paribas analysts say could cause "irrational" markets.

The impact that hedge funds can have on markets was seen last week. Japanese, European and US markets were rocked by sell-offs at some of the biggest quantitative – or computer driven – funds as they cut gearing, losing money in the process.

If investors in the hedge fund sector get cold feet that could cause much greater turmoil thanks to the heavy leverage used by many fund managers.

For the time being, many managers and others involved in the sector reckon redemptions are likely to be focused on the two types of hedge funds worst affected so far this year: credit funds with exposure to US sub-prime and quantitative funds.

"I would expect to see [an] outflow in quant strategies just based on the fact that anyone with stop-losses would be pulling their funds" declared the head of European prime broking at one large bank.

"It will not be indiscriminate selling" said another banker. "But everyone invested in credit funds is poring over their assets and asking what are they invested in and what are their financing terms".

Others forecast the "hot money" – often managed by Swiss-based funds of hedge funds – will flee from the sectors that have been worst affected towards less-leveraged fund sectors. Research by Lehman Brothers published this month showed the average quantitative fund – in the equity market neutral and statistical arbitrage categories – allowed withdrawals just under once a quarter.

But the average hedge fund across all strategies demand nearly six months notice with recent investors locked up for more than a year, making a broad exodus impossible.

Alex Allen, chief investment officer of fund of hedge funds Eddington Capital Management, said many managers had already cut borrowing to free cash for possible repayments. Risks of being unprepared for redemptions were shown by investors in structured credit in May and June.

First sign of problems at funds run by Bear Stearns, Braddock Financial and United Capital Markets in the US were when they suspended redemptions. Australia's Basis Capital also had to impose a block on withdrawals because it could not sell its investments in illiquid structured credits.

A group of other funds – some money market or mutual funds – has also suspended redemptions. Illinois – based Sentinel Management was yesterday reported to have asked regulators to allow it to suspend redemptions.

But the ability to close to redemptions – or to impose "gates" which many hedge funds can use to prevent more than 10% or 15% of assets being withdrawn in any quarter – could also help to limit the impact on markets by preventing fire-sales of assets to meet withdrawal requests.

At IQ we utilise funds of hedge funds within appropriate client strategies and therefore remain of the opinion that the alternative elements of those portfolios within which they contained remain suitable long term investments and no immediate action is required at this point.

We are keeping this situation under review and will make tactical changes as deemed appropriate.

This IQ Tactical Market Update is not an invitation to buy, sell or switch holdings. We recommend that appropriate advice is taken before any action is undertaken. The value of shares and the income from them can go down as well as up and you may get back less than the amount invested. Past performance is not a guide to the future. Exposure to single country markets increases potential volatility.

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