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Optima Fund Management
A New Year's Perspective
January 13, 2009

*“In the words of one of my more sympathetic correspondents,
it has turned out to be an 'Annus Horribilis'.”*

- Queen Elizabeth II

“Many an optimist has become rich by buying out a pessimist.”

- Robert Allan

**Where are we
now?**

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Depression.**

So where are we now? Undeniably, we are in the midst of the gravest financial crisis since the Great Depression. The facts are clear in every sector – car sales declining to levels not seen in over a quarter century, housing prices 25% off their peak in 2006, consumer confidence the lowest on record. These facts are well disseminated and read like a litany of woe. That does not mean, however, that these problems – and the consequent economic impacts – are comparable to the Great Depression. Not even remotely.

From the timely and aggressive policy response to falling oil and commodity prices, there are hopeful signs. Most important is the proven resilience and adaptability of the US economy. Already meaningful progress has been made in restructuring the financial market to deal with the new, less-leveraged reality. While pain still lies ahead, we are confident that an improved, functional system will emerge in coming quarters.

We are not being unrealistically positive. Figures released in 2009 for the end of 2008 will indicate a steep contraction in real GDP, potentially larger than the current market consensus. The US is and will be in a recession. However, we do expect that the return of the economy to a respectable, if somewhat below potential, growth path will be visible by our mid-year letter, as will the bottom of the housing market in the US. This will surely be a much worse downturn than the modest recessions of 1990-91 and 2001, but we suspect that it will not quite match the severity of the worst economic cycles of the 1970s-80s. With inflation sure to be lulled by this slowdown (but not defeated, we fear), the FOMC will likely leave rates at ultra low levels until summer.

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Clearly there are considerable downside risks to this scenario. In particular, we are concerned about the state of financial markets in the rest of the world. Europe and other regions are experiencing similar troubles as the US but their institutions are even more leveraged and, in several cases, have been far more reckless. There is little doubt that the housing situation, particularly in parts of Southern Europe, will continue to adjust downward after the US has bottomed.

Policy responses were disjointed, but applied early and aggressively. The economy will respond.

Why do we take this view? First and foremost, US policymakers acted early and aggressively. While that response has not been perfect and a greater initial focus on liquidity injections/special facilities rather than rate cuts would probably have done more to protect the credit markets, the Fed is clearly on a better, more evenly applied, track now. Many also believe that it was a huge mistake to let Lehman Brothers as a regulated entity fail given how intertwined it was with other firms. Nevertheless, the Treasury-led bailout does appear to be bearing fruit. In contrast, **the 1930s Fed mishandled the Great Depression.** Among other things, it failed to appreciate the impact of deflation and thus kept policy far too tight. **Chairman Bernanke will not repeat such an error – if anything he has proved too sensitive to deflation.**

In fact, the Fed response has been earlier and more aggressive than in almost any previous cycle. Although this has been an extraordinary crisis, it is difficult to picture a **severe, multi-year downturn given such ultra-accommodative policy.** **Indeed, inflation-led pressure afterward is much more plausible, though that will depend on how deftly the Fed reverses course.** In any case, that is an issue for another day. Meanwhile, fiscal policy was also brought to bear sooner than in most cycles. The reality is that the structural issues caused by excessive sub-prime lending have morphed into a cyclical downturn. The structural issues will take time, but the cyclical component will run its course. In our letter from last year we noted:

“Now is not the time for the highly leveraged or opaque strategies predicated on mis-priced derivatives or perceived errors in esoteric bond pre-payment models. Managers focusing on corporate events or highly leveraged fixed income strategies will have a more difficult environment indeed.

And, while early in 2008, we remain confident that the managers who have the enduring skill of picking winners and losers in the stock market, or of finding value in the rubble of the credit

markets, will welcome increased volatility as they will have a greater opportunity set from which to choose than they have seen in years, as will Macro managers.”

We have received numerous insightful questions from our investors and we include a few below for your consideration:

Thus far all government actions have failed to stop the decline. What makes you think they will work in the future?

Stunning amounts of money are there to assist the economy. What is lacking is credibility that it will actually be spent.

“*Money alone sets all the world in motion, not talk*” was written by Publilius Syrus in 100 BC and it still applies to this day. When the attitude in Washington D.C. was that it was a “Wall Street problem,” this led to only a trickle of policy responses and a hesitancy to act as witnessed by the decision to let Lehman Brothers fail. Once it became clear that this would spread from Wall Street to Main Street and the right decision was made to “rescue” remaining financial institutions, we moved to another extreme – an uncoordinated torrent of disparate plans.

Collectively, these sums are massive, but they have not yet gained market credibility as the money is largely unspent:

- **Credit Markets (\$3.2 trillion)**
- **Financial Institutions (\$3.5 trillion)**
- **Other: Citigroup, AIG, and Bear Stearns aid (\$490.8 billion)**
- **Mortgage Market (\$674.57 billion)**
- **Money Market Funds (up to \$50 billion)**
- **Foreign Central Banks Cash (\$165 billion)**
- **Foreign Central Bank credit lines: Unlimited**
- **Total - \$8.1 trillion**

The sum is nearly 50% of the entire annual domestic production of the US, and that is *before* a certain “economic stimulus package Version Two” for consumers, a certain jump up in infrastructure spending, further loans to GM and Ford. It was also before the “unlimited” commitments to Central Banks. Again, this money will “set the world in motion” when it stops being perceived as being only “talk.” As for timing, this simply will not happen between administrations. President Elect Obama’s administration wants to direct the process and the exiting Bush administration simply lacks the time in office to be able to further act. But it is also true that it need not be fully spent to have the desired effect; the market needs only to believe that it will truly be spent to set the wheels in motion.

If government capital primes the pump, there is plenty of private sector cash ready to flow into assets.

What “wheels” will go in motion? As of year-end, investors held \$8.85 trillion in cash, bank deposits and money market funds, equal to 74% of the market value of US companies, the highest ratio since 1990. Cash holdings matter, as they are the dry powder needed to move asset prices when invested. Cash holdings peaked one month before equities began to recover during the two longest recessions since World War II. In July 1982, cash as a percentage of the US stock market’s value rose to 95% before a 20-month bear market ended and the S&P 500 began a six-month, 36% advance.

Similarly, cash-on-hand reached \$604.5 billion in September 1974, representing a record 1.21 times US stocks’ capitalization. That preceded a 31% gain in equities between October 1974 and March 1975. The current cash levels are before the government disbursements noted above, and Americans are, for the first time since the creation of Individual Retirement Accounts, putting more retirement money into cash and fixed income than into equities. Given the tax-free nature of these accounts, they should more naturally be in actively managed equities.

Yes, but we are in uncharted territory: no one has ever seen anything like this.

True but every crisis is unique. In the case of this event, we have never seen such a decline in house prices and have never seen such a policy response either. The US market downturn is approximately -51.93% and the average decline in the last 11 bear markets (spanning over seventy years) is about -32%. In the early 1970s we saw a decline of -48%, and the bursting of the tech stock bubble took markets down -49%. Each of these had unique drivers as well.

Uncertainty undeniably remains: why would a rational investor not sell stocks and buy them back later?

Selling stocks after they are at a near 10-year low and buying them back later is a sure way to lock in losses and minimize participation in a rally. Are many investors selling out? Certainly. Year-to-date, we have seen net outflows not only from hedge funds, but also from mutual funds. However, this is very rare and only the third time since the “Crash of 1987.” What happened after investors took out more money than they put in 1987? A 12-year bull market. When was the next time? 2002. What happened after that? A five-year bull market. This is the third time, and

Earnings, credit and high yields on bonds will be a headwind for stocks, but also form the basis of a rally.

We know what has caused sharp declines in equities. What factors have we seen that have caused sharp rallies?

the past may repeat itself. However, there are impediments to a broad stock market rally.

In the longer run, earnings estimates remain an issue. They are still well above recessionary levels and, if we trade down to historic price earnings levels, the broad market will fall further. In the shorter run, the impediments lie in the credit markets. The first problem is more obvious: leverage is a normal part of the economy. From consumers borrowing to buy cars to corporations borrowing to expand capacity, credit must flow for the market to rise. The second is more subtle. Money flowing into the stock market is risk capital and it will gravitate to risk-adjusted opportunity. With the Merrill Lynch High Yield Bond Index offering a yield of over 20.81% risk capital will be attracted to the debt of the companies before it will go into the equity. This “low hanging fruit” must be removed before investors reach for the higher risks and returns obtained through the purchase of equity.

The corollary is clear: when credit resumes, the effect will be leveraged. Demand from consumers and corporations will be expected to rise, improving profits. Credit spreads will narrow and money will flow into equities, thus raising valuations.

We have had a terrible year, with declines over -30% in the US equity markets being echoed around the world. In the past, what has caused markets to rally more than 30%? Is that a possibility this time?

Truly extraordinary years (up or down) are by definition hard to predict. However, they do have precursors that students of the market have observed over the years. **We will now examine the most recent major (30% or more) rallies, along with the upward movement of the relevant market index:**

- (1) 1933. +57%. Franklin Roosevelt reflatd the economy and stocks moved up sharply after the Great Depression sell-off.
- (2) 1935. +47%. Confidence returned to the banking system, abundant credit returned and the auto sector led the market higher.
- (3) 1954. +52%. A shift from the Federal Reserve to easing (after an inflation scare) to avoid fears of another depression altered expectations in the market.

(4) 1958. +43%. Corporate confidence fell after the Soviet Union successfully launched the world's first satellite, Sputnik, but the combination of heavy federal spending and the Federal Reserve moderating rates drove institutional investors back into stocks.

(5) 1975. +37%. Stocks rallied after reaching a post-1929 low in price/earnings when a sharp rise in bank failures caused the Fed to ease credit sharply following the collapse of the Bretton Woods system and the 1973 oil crisis.

(6) 1995. +36%. Chairman Greenspan's abrupt tightening in 1994 depressed equity markets and 1995 was a rebound rally, with shares soaring as Japan cut rates and led global re-liquefaction.

In reviewing these we do see a pattern. "*Bounce Back*" is the first common theme. A decline is not a necessary condition to ensure a sharp rise (for example, 1928's rally (+43%) followed upon 1927's rally (+37%)). However, it is clear that lower stock prices often precede significant rallies:

- The 1908 boom (+45%) following the Panic of 1907.
- The Great Crash of 1929 was extended for a period decline but was followed by the largest rally of the century in 1933 (+53%), and was followed by the fourth largest rally in 1935 (+47%).
- In 1954 (+52%), a rally followed an 11% decline in 1953 as capacity utilization and consumer purchases fell at such a rate that fear of depression gripped the markets.
- The lesson from the 1958 (+43%) rally is similar, as it was preceded by the 13% decline of the Dow in 1957.
- The period before the 1975 (+37%) rally was similarly grim, with recession, inflation and disastrous governmental action driving price earnings to the lowest level since 1929.

"*Easing Credit*" is another near-universal theme of substantial rallies:

- The end of the "Panic of 1907" would not have led to the boom in 1908 if JP Morgan had not stopped the US banking crisis.
- Expansion of bank credit (then in the form of increased gold reserves) was key to the boom in 1935.
- The mid-year 1954 easing was key to that year's performance, while the Federal Reserve's unexpected reverse course to an easing

in late 1957 preceded the 1958 rally, which was fuelled by further rate cuts throughout the year.

- As recently as 1995, the Greenspan Federal Reserve surprised markets by reversing a previous tightening bias and easing as a result of the Mexican financial crisis. This liquidity was aided by the Bank of Japan's sharp rate cuts of the same year.

The pattern is clear: low stock prices and an unexpected increase in credit availability have been precursors to all but one rally this century.

The pattern before all these major rallies of the century does tend to be clear: stock prices start from a depressed level, and a sudden, exogenous, event puts fear of inflation on the back burner in the mind of the Fed. As the system becomes (unexpectedly) re-liquefied the stock markets very quickly reflects the new economic reality.

There are many theories about what proceeds a truly extraordinary year, from "long cycles" to unexpected technological change such as advances, including railroads and internet. The one combination we have seen since 1900 in all but one case (in 1928) is the combination of depressed prices and an easing of credit availability. It is also true that in every case forecasting via the rear-view mirror has repeatedly proven to be an expensive error. At the start of every strong year, the press is almost universally negative and almost universally wrong.

How will things look under an Obama Presidency?

As always, we try to remain apolitical in our evaluation of these matters and look for the direction from the future resident of 1600 Pennsylvania Avenue.

In taking a very early view of an incoming administration, it is important to keep two things in mind. First, while presidents usually try to take the credit and are forced to accept the blame for the economy's ups and downs, respectively, *the role of fiscal and regulatory policy is usually marginal in the outcome of economies.* Yes, extremely bad policy can have a very deleterious effect. For example, Jimmy Carter's credit controls led to an instant recession in 1980. But most executive initiatives can do relatively little, for good or ill, to a \$14-trillion economy although they are often perceived by the public as having a large impact.

Second, most presidents have discovered that *grand plans tend to be dashed by hard political and economic realities.* Ronald Reagan, for example, came into office promising the biggest tax cut in history and he delivered. Barely two years later, however, he was forced by deficits and

**Personnel
impact
policy.**

political pressures to sign one of the largest tax increases in history. During the course of the campaign, Obama scaled back his proposed tax increases at least twice; he said before the election that any hike, even on the "rich," would likely have to wait until the economy recovers.

Obama's first critical decision, the one which will set the tone for his first term and may well determine if there is a second, is his choice of Tim Geithner as Treasury Secretary. The first few Bush Treasury Secretaries were marginal policy figures. Because the bailout and financial problems are not going to become easier anytime soon, the Treasury Secretary will surely continue to be the dominant economic policy figure. **Geithner is well schooled in crisis management:** from his role at the Treasury dealing with the crises in Brazil, Mexico and Indonesia to spearheading the Federal Reserve's response to Bear Stearns and Lehman Brothers, he has very deep and specific experience in some of the issues that face the economy today.

Appointees to the EPA, FDA, Departments of Energy and Commerce, for example, can impose regulations that influence the economic growth rate. Nonetheless, the success or failure of Geithner will dominate almost any other decision.

Monetary policy has a far more far-reaching impact on the economy. That is why the Fed was established as an independent body. Moreover, Chairman Bernanke and the other four sitting Fed governors are all Bush appointees. Still, the Fed is not immune to presidential influence and Obama will have a considerable impact.

Bernanke's term as Chairman expires in January 2010. Democrats have not appointed a new Fed chairman since Paul Volcker in 1978, so Obama may be anxious to name his own chairman. Regardless, considering that he gives every indication of wanting to keep the job, Bernanke will try to work as closely with the White House as he can. Also, Obama will be able to put his imprint on the Fed immediately by appointing three members of the board of governors and another vacancy comes up in January 2010.

Nonetheless, Bernanke and, we hope, Obama realize that any overt compromise of the Fed's independence could undermine its credibility, leading to major repercussions in the markets. Moreover, past presidents have enjoyed the benefit of insulation from an independent Fed undertaking necessary but unpopular action.

**Spending and
taxation**

Undoubtedly, taxes will go up and go up a lot, over the next four years. But it is unlikely that they will be raised in 2009. In fact, Obama has said that he favors letting the Bush tax cuts expire rather than repealing them earlier. However, even if Obama were to abandon all his promised new programs, which he will not do, the need to pay for the bailout, Fannie Mae, etc. will demand more revenue. Still, even if the economy begins to recover as we expect, recession talk will dominate all of 2009, especially since, as a lagging indicator, the jobless rate should continue to rise for some time. Few members of Congress would likely want to raise taxes under such circumstances.

In 2011, however, the Bush tax cuts expire, meaning an automatic and massive tax hike. At a minimum, the top personal tax rates will increase. Capital gains rates will likely go up as well though it may be a while before people have any gains to tax. For the near term, the financial bailout will trump most new social programs. Obama will likely boost spending prodigiously on both social programs and infrastructure; much of it will be financed through deficits.

**Regulations,
financial and
otherwise**

Obama will certainly expand the regulatory reach of every agency. There are sure to be restrictions on activities, most of which no rational CEO would want to do anyway. The costs of doing business will rise somewhat. But, by and large, the financial sector moves faster than Congress and regulations will be dealt with as they always have been.

**Trade frictions,
not trade wars**

Finally, the last thing anyone should do in a global downturn is start a trade war, as the Smoot-Hawley Tariff Act did in 1930. Candidate Obama ran as a vehement critic of NAFTA and free trade in general but stopped short of promising a repeal. Moreover, he largely dropped the issue once he won the nomination so, while he may not expand free trade, it is unlikely to be restricted.

What is the outlook for commodities, green or otherwise?

The laws of supply and demand have not changed but they need time to function. The stunning price rises we have seen in commodities emerged partly due to the sharp and still present jump in demand for resources from industrialization in South and East Asia. The subsequent crash in prices occurred before the traditional market response arrived, in the form of greater supply coming to market. Why the delay in new supply? Lags are increasing. Experience is a great teacher and extractors of almost all

The laws of supply and demand still apply in commodities. Prices will rise.

The “green theme” continues, driven by government policy and the need for energy security.

commodities have learned from previous, financially painful, experience about the danger of meeting a rise in price with oversupply. Lags are also increasing globally as resources are becoming more restricted and environmental concerns are delaying projects that had been in the “review and planning stage,” often for years. Only recently was there real evidence of companies making the large capital investments needed to capture new capacity in core commodities, and most of these projects were still in the planning stages when prices reversed. They are, yet again, on hold as investors wait to see if price levels stabilize at levels that justify new investment.

More important to investors than the cause is the effect: supply has not adjusted to the demands that will be present when economies return to normal growth, much less any economic boom. The result will be higher prices and another violent price cycle. The initial rate of that rise will be tempered by the recent experience of speculators but we do feel it will occur. When oil went over \$140 in the summer, so many ideas that seemed impractical, from wind and solar power to hydrogen fuel cells and electric cars, were suddenly viable and in “the imminent future”, both for economic and environmental reasons. With oil \$100 a barrel lower and the world in recession, it now may appear that much of the impetus was economic. This is only partially true, and only for those projects that did not have either social or governmental backing. President Elect Obama has repeatedly pledged at least \$150 billion for renewable energy projects, and that is before green house gas initiatives. In England and the Continent, governments have committed to reducing greenhouse gasses by 80% before 2050. Those projects will continue. It is also clear that there is another “non-green” reason to expect these efforts to continue and that is energy security. Reducing reliance of foreign oil, subject to the whims of increasingly unstable régimes, will become a policy goal that will only augment existing environmentally based momentum.

What is your outlook for the dollar?

The dollar has benefited from “safe haven” status. It is a powerful statement that the dollar has rallied on foreign purchases despite short term rates that are effectively zero in nominal terms and are negative after inflation. As the crisis abates, the dollar will loose some of that “safe haven” premium, and weaken. Later in the year, the retirement of debt will support the dollar, as will the understanding that the US, while the center of the housing mess, has moved faster to address the issue. Certain countries, including the UK and the southern European region, have also

seen tremendous leverage in their economies and, as this comes unwound, the euro and the pound are likely to come under the greatest pressure.

While the strength of the yen has served to protect Japan from some inflationary commodity-related price pressure (as oil is denominated in dollars), it is in the interest of all to see the dollar/yen exchange rate return to over 100 yen. However, this may not happen. If there is a greater relative supply of an item, in this case currency, its value should drop. This would argue for a decline in the dollar. Overall, however, Western central banks are printing money at comparable rates to offset the deflationary pull of declining asset prices. If both the ECB and the Fed print currency, then neither will strengthen versus the other as the *relative* supply stays the same. Indeed, it is not inflationary if they only print the amount needed to “offset” the decline in the broad money supply.

The dollar will fall as it loses “safe haven” status, but the extent of leverage in Europe and unwanted yen strength will support the dollar later.

The risks to this scenario are two-fold. The first is that the Central Banks are not coordinating their injections in to the system. Timing matters and, for example, more US dollars could appear in the global system before they are “offset” by more euros or pounds. The second risk is if they go a little bit too far and unwittingly inject excess money in the system, then the dollar will decline sharply. This would subject the economy to monetary inflation and the subsequent pain of removing the excess liquidity. Central banks have, for years, avoided even remotely running the risks associated with large capital injections, preferring to raise and lower interest rates to adjust economic activity.

The current situation requires more aggressive responses than historic lows in global central bank rates and so they must go down a riskier path. Traditionally, the conservative response to this is to hold the only “currency” that can not be printed, which is gold. If the Central Banks err, Asian investors, who have better economic fundamentals supporting their currencies, may well turn to gold as a store of wealth. The natural resource economies, many of whom recall the debasement of the dollar after the 1970’s oil crisis, may also look to gold as a stable asset. “Modern” Western investors tend to be more skeptical of gold as an asset class, but if momentum develops in the price of gold, they will jump aboard and this will push prices higher as well.

What is the outlook for the Hedge Fund industry?

Optima believes that despite the typical abundance of negativity in the media, the primary lesson to be learned from 2008 is that exposure to

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The closure of many smaller hedge funds will not have the impact portrayed by the press.

In the fund of funds industry, over 80% of assets are controlled by fewer than 10% of those fund of funds like Optima, with assets over \$1 billion.

well-run hedge funds remains a critical element of investing. One can not rely strictly on a portfolio of “long only” investments to create a portfolio for the long run. The S&P 500 plummeted -37.0% in 2008 compared to the “long/short” HFRX Equity Hedge Index, which declined -25.5%. While we are certainly not endorsing negative returns, in the face of the unprecedented volatility and market developments in 2008, we think that being “less negative” by 1200 basis points has merit.

Two quotes are appropriate when considering the outlook for the hedge fund industry. In the short run, one cannot help but think of the famed boxer Joe Louis “*Everybody’s got plans...until they get hit in the head*”, but our longer-run view is closer to Friedrich Nietzsche’s, “*What does not kill me, makes me stronger.*” The hedge fund industry is no doubt shaking out and, as in all such culling, it will be the weakest that do not make it. The industry will emerge stronger and it will have evolved. In the experience of Optima, we have long thought barely one hedge fund in ten had the characteristics needed to potentially excel and, in recent years, the number of transparently unqualified managers has, if anything, increased beyond anything we thought possible as recently as five years ago.

That said, the hedge fund industry is generally hugely misunderstood and this has exacerbated the hyperbole about an industry “collapse.” People think of the large, household names in funds but the truth is that the hedge fund industry is highly stratified. Of the 7,477 funds estimated to be active at the end of Q3 2008, over 3,400 were under \$50 million in assets. Indeed, the smallest of funds (those under \$50 million) account for only 1.74% of assets in the industry. These mini-funds are, in our experience, often inherently weaker. It is hard, at that size, to have the resources to survive an extensive decline below the high water mark. It would in no way surprise us to see thousands of funds close, but that will not have the impact on the industry as indicated by the facile analysis of the numbers seen in the press.

The same forces will apply to the fund of funds industry as over 80% of assets are controlled by fewer than 10% of those fund of funds, like Optima, with assets over \$1 billion. Recent scandals have only raised the bar on having expertise in risk management and infrastructure for both hedge funds and fund of funds. Any possibility of the hedge fund industry avoiding regulation has disappeared with the revelations around Bernie Madoff. The loss of capital to a scam such as that allegedly perpetrated by Madoff is a black mark on the industry, but the press is becoming increasingly unable to distinguish between fact and reality.



For example, it is not a “typical fund” and the Madoff structure was completely unlike ANY fund we have seen in all our years in the industry. In fact, it was not even structured as a fund until recently. While regulators may have had challenges identifying fraud at Madoff, most experienced hedge fund of fund managers did not. As noted in the Financial Times on January 5, “*Fabio Savoldelli, chief investment officer of Merrill Lynch Investment Management prior to its 2006 merger with BlackRock, sounded the warning internally years ago. One of Merrill's financial advisers, who deals with clients worth tens of millions of dollars, recalled that Mr. Savoldelli said he was suspicious of Mr. Madoff's returns eight years ago.*”

Conclusion

There is no doubt a split on the outlook for the economy in the months ahead. What we have seen, however, is managers in every sector describing the extraordinary opportunities they see within their field of expertise. Interestingly, many of these opportunities are uniquely accessible to hedge funds. Before general prices rise, the relative value of assets will have to come into alignment. Yields on selected corporate bonds are far higher than their credit risk would justify, yet Treasury yields’ rising (as they must) will reduce the returns for long only investors. Bankruptcies, debt restructuring and simply mis-priced equities are the “bread and butter” of the hedge fund community, yet very difficult to capture for long-only investors.

For those who are invested in funds with the expertise and the liquid assets to capture these opportunities, 2009 may not be an “Annus Mirabilis” to completely offset this “Annus Horribilis,” but it may well afford investors a strong opportunity to profit from the harsh results of 2008.

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