

OPTIMA FUND MANAGEMENT LLC
A Mid-Year Perspective
July 19, 2010

FAUSTUS. Why, dost thou think that Faustus shall be damn'd?
MEPHISTOPHELES. Ay, of necessity, for here's the scroll in which thou hast given thy soul to Lucifer.
*Christopher Marlowe, **The Tragical History of Doctor Faustus**, 1604*

A baited banker thus desponds,
From his own hand foresees his fall,
They have his soul, who have his bonds;
*Jonathan Swift, **"The Banker"** 1720*

I want to come back as the bond market. You can intimidate everybody.
*James Carville, **Wall Street Journal**, 1993*

From the Code of Hammurabi to modern literature, writing is replete with admonitions against the dangers of, as economists define consumer borrowing, “exchanging greater present consumption for lower future consumption.” In all cases, at some point the bill comes due. The world has indeed enjoyed substantial “present consumption.” The central question is: “is this the point when the bill comes due?” Our central expectation is not the finality of the opening quote from Marlowe’s Faustus, who, having traded a life of power in return for his soul, finds he cannot delay the inevitable payment of the “debt,” but rather closer to St. Augustine’s famous prayer, “Give me chastity and continence, but not just now.” The indebted nations certainly all will pray for the “chastity and continence” needed to reverse years of chronic borrowing, “just not now.” The markets will settle down, and the developed countries generally will be able to defer the day of reckoning.

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There are, indeed, times when one would prefer, given the severity of outcome, to be proven wrong. In our last year-end letter we wrote:

Later in the year, the retirement of debt will support the dollar, as will the understanding that the U.S., while the center of the housing mess, has moved faster to address the issue. Certain countries, including the UK and those in the Southern European region, also have seen tremendous leverage in their economies and, as this comes unwound, the euro and the pound are likely to come under the greatest pressure.

In 2007, George Soros gave a seminal speech on his ‘Theory of Reflexivity,’ in which he noted the “inherent divergence” between the market participants’ changing views of the markets and the actual state of affairs. What we have witnessed in the Greek Crisis is classic reflexivity in

Yet the markets were in “market equilibrium” in 2007 with the cost of “flood insurance,” as measured by credit default swaps, almost EXACTLY the same to guarantee Germany or Greece.

action. The levels of Southern European debt were well known to all before the crisis, and they were in what classic investors would call “a state of equilibrium.” Investors knew that Greece was on the bottom floor of the tower of debt Europe had built, with Italy, Spain, Ireland and Portugal all on lower floors, and Germany on the top with the least amount of debt. When the flood came, and the creditors demanded repayment, it would be the countries trapped at the bottom of the tower of debt that would sustain the most damage. Yet the markets were in “market equilibrium” in 2007, with the cost of “flood insurance,” as measured by credit default swaps, almost EXACTLY the same to guarantee Germany or Greece.

Flood insurance for the home at the bottom of the valley cost the same as insurance for the home on the top of the mountain. In this environment, excesses are bound to occur until market participants recognize their error and the cycle of “reflexivity” occurs again in the financial markets. The same factors that were once irrelevant become harbingers of doom; an overshoot occurs and that overshoot “reflects” back onto the real economy. The “reflection” is clear: now even solid corporate borrowers, or weaker sovereigns, are finding difficulty in refinancing, and the euro is under extreme pressure. Real damage is done as the market impacts the economy, and then the economy impacts the market. Fortunately, the waves in this echo chamber abate over time, and a new equilibrium will emerge.

So what is Optima’s view?

We firmly believe talk of the U.S. sliding back into recession is wrong, and we can only build on what we wrote a year ago:

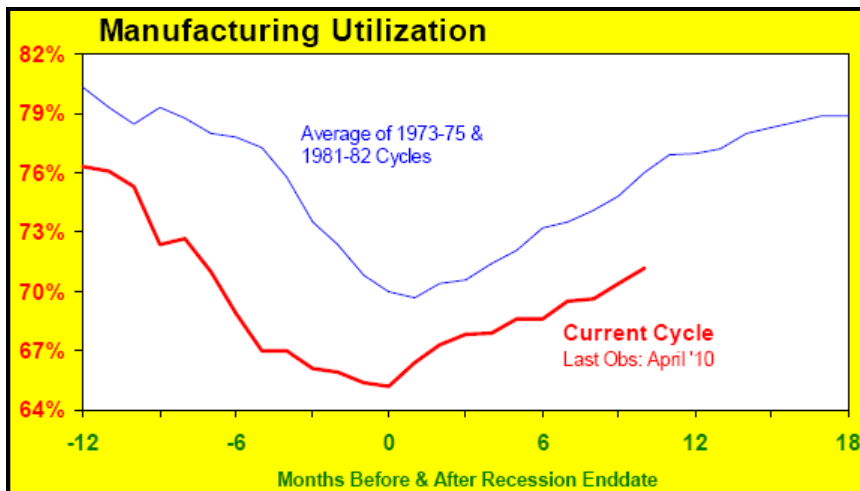
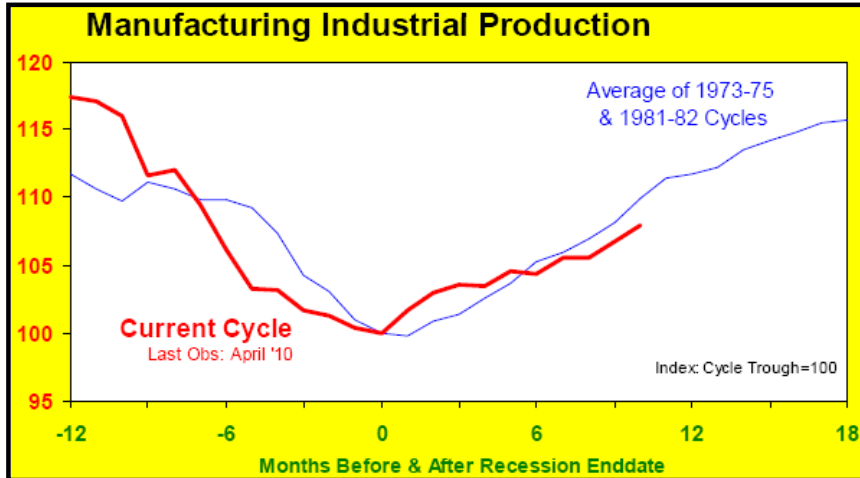
The strength of these deficit-financed growth phases will eventually fade, and we look for asset prices to give back some gains at that point. While the debate over what letter fits the recovery (‘V,’ ‘U,’ or ‘W’ shape?) continues, we look for a pattern more akin to a lightning bolt, with the growth phases offset by sharp reversals.

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The sharp “growth phase,” induced by stimulus, did indeed fade along with the rally in asset prices. The lightning bolt shape we described has come to pass, with numerous one-off factors, both domestic (e.g., the census bureau hiring, then firing, more than 500,000 people in a three-month period) and international, in the form of the Euro Crisis. We think the theme for the period ahead will be one of moderation, but are unequivocal; the U.S. and the Eurozone will have positive growth. There will be, as we see it, no double-dip. Deceleration is, however, what we will add to our outlook. Annualized GDP growth of 5.6% (in 4Q09) and retail sales up nearly 7% are simply untenable economic results.

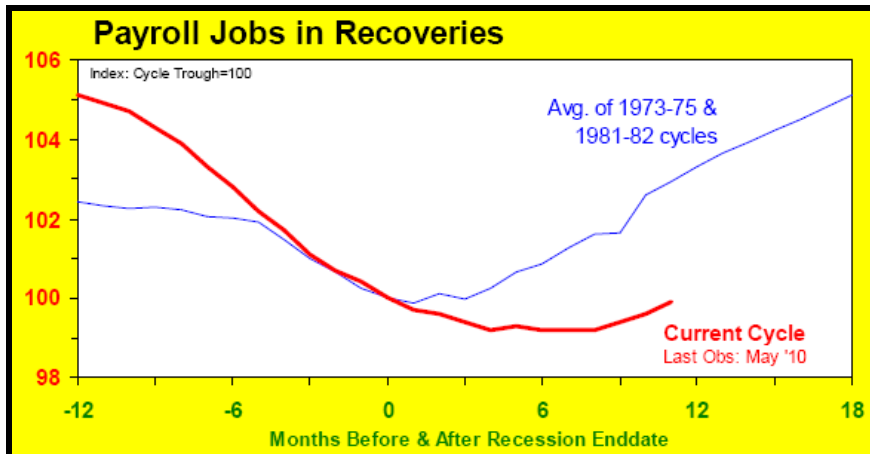
In many respects, this cycle is actually behaving very much in line with the past, especially in manufacturing. Below, we compare the performance of the U.S. economy to the previous deep recessions of 1973–75 and 1981–82. At least for the manufacturing sector, this recession is following a fairly typical pattern in both Industrial Production and Factory Utilization:

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What has differed from previous cycles is employment, which should have turned up by now:

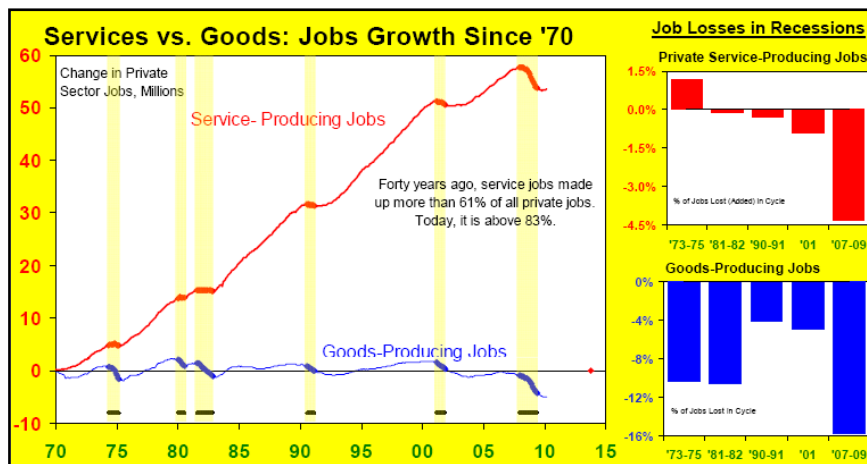
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Source: FMI, Optima Research

What is the basis of our assessment? While manufacturing is clearly on track, the weakness in this recession is concentrated in the service sector. As can be seen the chart below, service employment has been the major source of growth in employment in previous decades.

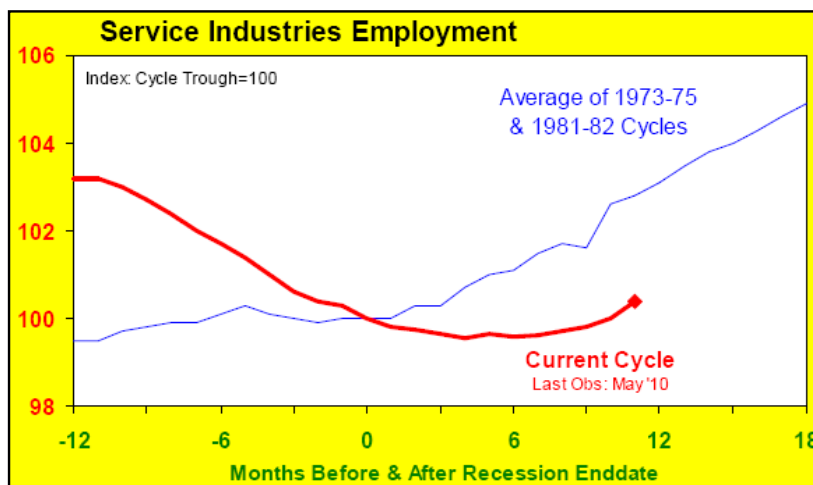
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Source: FMI, Optima Research

And while there is concern over the slowing pace of service sector growth, it is also true that 14 of the 16 sectors surveyed by the National Institute of Supply Management indicated increased activity in hiring and overall growth.

Moreover, it has largely been protected from decline in previous recessions. However, this is not so in the current cycle with the service sector dropping, whereas jobs growth was experienced in the previous declines. The biggest question is whether the service sector has turned the corner. To us, it appears to have done so (as seen in the chart below). And while there is concern over the slowing pace of service sector growth, it is also true that 14 of the 16 sectors surveyed by the National Institute of Supply Management indicated increased activity in hiring and overall growth. It is on the basis of this widespread and diversified growth in services that our expectation is based.



Source: FMI, Optima Research

We expect the recovery to be sub-par, but sustainable.

We expect the recovery to be sub-par, but sustainable. The situation globally is similar, as China and the bulk of Asia go from frenetic growth to a more sustainable basis, and Europe reverses course with the stimulus of a weaker currency, which helps exporters.

What is the situation in Europe?

This is not the end of the euro; this is not the beginning of a wave of sovereign debt defaults; and this is not the end of the global recovery.

In turn:

Will the euro break apart?

The euro is under pressure as never before. The single largest factor cited as the cause of marital divorces in America (34%) is “differences over attitude towards money.” The marriage of Germany with Greece and Italy requires intensive counseling, from the IMF and the ECB, as well as real flexibility to survive – and it will. The basis for the relationship is simple: mutual convenience. The threat made by France to leave the euro is farcical, and only serves to illustrate why it is linked inextricably to the euro. The French public sector debt is about 80% of GDP, and external debt (money owed to foreigners) runs about 190% of GDP. Those obligations remain predominantly euro denominated. If France, or any of the indebted European countries, left and resurrected the French franc, Greek drachma, Italian lira or Irish punt, the value of their currency would plummet. Alas, the obligations remain in euros. Thus, France’s debt-to-GDP ratio would increase in some proportion to the amount the independent French franc fell relative to the euro. Default would be inevitable.

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The euro will not disappear, and the weak countries will not leave, nor will the strong countries throw them out. The stronger Northern European nations look to exports as major parts of their economy. If the weaker countries leave, they would revert to the cycle of competitive devaluations that marked the cornerstone of their economic policy before monetary union. Need to spur exports and grow your economy in the short run? Devalue the lira again ... Given the overlap in export types, this would create competition in global markets that Germany and the other “Northern Rich” countries certainly would wish to avoid. This is not the first unhappy marriage that will last for the currency

Are we in for mass sovereign debt defaults?

Mass sovereign debt defaults are unlikely to occur at this point, but restructurings may occur in the future. In particular, Greece will crystallize the situation. Before Argentina defaulted in 2002, it had a debt-to-GDP ratio of 50%. Greece has a debt-to-GDP of 115%. The Argentine annual fiscal deficit going into default was less than 4%. The Greek deficit has been running at more than 13%. The situation is dire, and Greece cannot resolve this alone. It cannot devalue its

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currency and export its way out of debt, it cannot get there via the proposed austerity methods. The reality is a fiscal reduction of 10% of GDP in one year never has been done by any democracy. With unemployment surpassing 11%, a bloated public service, and polls indicating 51% of the public against austerity measures, Greece will not be the first to successfully have such a massive reduction. Even if successful in the 10% reduction, the Greek debt-to-GDP will reach 150% within five years; the only road is for the rest of the EU to assume the debt, or restructuring.

The EU can spend money now to delay the event, but the event will occur. France, Spain, Ireland and Italy all are on the same path, but are not approaching the end of the road. With Greece under 3% of the entire EU GDP, and a total workforce of only 4.5 million (less than half the population of New York City), the easy solution would be to delay any restructuring for years, and deal with the larger problem later. This is our central expectation. The markets fear that the financial crisis will escalate, that Portugal, Italy, Ireland, Greece, and Spain will default on sovereign debt, collapsing European banks. Such a financial shock could be several times the size of the Lehman implosion. It will not happen.

First, EU actions are, to date, helping. Second, Lehman collapsed when the global economy was well into recession; now, we are in a global recovery. Third, much of that credit crisis was due to uncertainty – the markets were not sure what “toxic” assets were worth. The markets have long ceased trusting the central banks’ assurance that “all is well in our financial system.” U.S. Supreme Court Justice Louis Brandeis put it best: “sunlight is the best disinfectant.” After correcting the illusion in Greek and other national budgets, the situation is more transparent, and the publishing of the European banks’ ‘stress test’ will further lift the clouds and allow investors to see better in the light. The solution will be painful for Europe, but there is an interim solution. The U.S. should remain relatively insulated for now.

Could the euro decline end the global recovery?

In a word, no. The U.S. recovery will slow with a decline in the euro, but countries can be counted on to do what is in their interest. While European Central Bank President Jean-Claude Trichet speaks of the “dangers” of a weak euro, in reality it appears to be his best hope for short-term regional growth:

It is not, however, a zero sum game; the decline in the euro has only a marginal impact on other economies, and the decline in trade will take several quarters to appear.

The following table shows the deviation from the baseline forecast for each period in the wake of a 10% depreciation in the trade weighted euro.

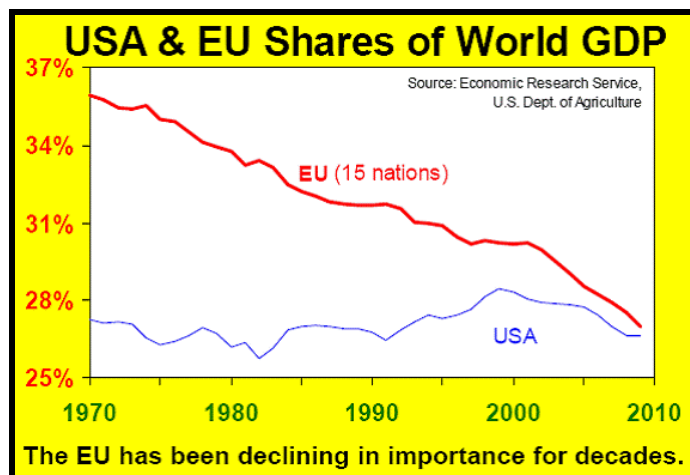
Statistic	Year One	Year Two	Year Three
Euro zone GDP	0.70%	1.30%	1.70%
Euro zone Inflation	0.30%	0.70%	1.00%
U.S. GDP	-0.10%	-0.20%	-0.20%
U.S. Inflation	0.10%	-0.10%	-0.10%
Japan GDP	0.00%	-0.10%	-0.20%
Japan Inflation	-0.10%	-0.10%	-0.10%

Source: WSJ, OECD, Deutsche Bank

As can be seen in the table above regarding the impact on Europe, a rise in GDP of 1.7% only at the cost of a marginal increase in inflation (1%) is a bargain too good to miss, especially as EU inflation is only 1.6%, and sure to go even lower in countries that are adopting austerity measures. It is not, however, a zero sum game; the decline in the euro has only a marginal impact on other economies, and the decline in trade will take several quarters to appear. The only question is how much.

At minimum, real growth throughout the euro area surely will decline as governments reduce spending and raise taxes. Both business and consumers are likely to retrench in this chaotic environment. Thus, EU demand for U.S. exports will fall. However, the EU accounts for only 15% of U.S. non-oil exports; lower growth there will shave only a modest fraction. The fact is that Europe increasingly has become a marginal player in the world economy.

The chart below is, for Europeans, a depressing sight:



Source: FMI, Optima Research

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Weakening demand in the EU is pushing down oil and other industrial commodity prices.

However, the Fed's prolonged ultra-easy stance is inherently destabilizing. The longer it delays, the greater the risks become.

The dollar will continue to strengthen in the short term, but if we are correct in our political assessment of Europe's resolve, it will stabilize as global stresses recede.

The harsh reality is that the importance of all 15 EU nations in global growth has been in a multi-decade decline. They simply have not met the challenge of rising competitiveness, first from the Japanese in the eighties, then the rise of Asian tigers in the nineties, and the consistent performance of the U.S.

It is also true, however, that generating exports via a declining currency is not a long-run solution to structural deficits. In the end, the economists' definition of borrowing is "exchanging greater present consumption for lower future consumption." This principal will apply to the current situation. However, despite the rhetoric, much government spending in Europe is structural and cannot be meaningfully reduced in the time period ahead. Short-term development projects will continue along. Wages, benefits and social wealth transfers are certain to continue in the short-run as well. While the crunch is coming, consumption will be – in our opinion – yet again deferred in the bulk of Europe.

On the other hand, the crisis is having some beneficial effects. Weakening demand in the EU is pushing down oil and other industrial commodity prices. Oil has fallen -20% from its mid-April highs and now close to the lowest level since the recession ended. U.S. long rates have dropped -75 bps. These second-order effects cannot offset the first-order weakness in the EU (which also pays for oil in now-more-expensive dollars). However, for the U.S., these compensating factors will limit much of the damage.

Even if there is no contagion, Fed Chairman Bernanke will likely seize on the crisis as another reason to delay rate hikes. The ECB had been laying the groundwork for reversing its accommodation, which would have put pressure on the Fed. Now, however, ECB officials are saying that, while they will not ease further, rate hikes no longer are on the horizon. Also, the stronger dollar will help limit domestic inflation. However, the Fed's prolonged ultra-easy stance is inherently destabilizing. The longer it delays, the greater the risks become. Investors are forced between untenably low rates at the bank and risky assets in the markets. Exacerbated by the "flash crash" in May, investors are increasingly quick to get out of stocks, and then either hopping in and out, as opposed to long-term investing.

So where is the dollar going? The dollar, as we noted in the past, responds to fear in the system. In times of stress, the dollar, the Swiss franc and the yen jump upward, then slowly decline. The rate of the dollar versus the euro, should Europe actually collapse in the near term, could soar to levels not seen in years, but this is not our expectation. A solid "wall of worry" is being built around what we still consider to be a low probability event. The dollar will continue to strengthen in the short term, but, if we are correct in our political assessment of Europe's resolve, it will stabilize as global stresses recede. The broad predictions of dollar-euro parity are overly extreme within our investment horizon.

The yen is more difficult. While Japan faces perhaps the greatest combination of debt and demographic challenges among the larger economies, the central fear of markets is instability of the financial system in each country. By this criterion, Japan stands above the rest of the G-8,

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with stable, well-funded banks. The yen has become the de facto reserve currency for Asia ex-Japan, and the region buys yen at the first sign of stress. This will support the currency until the storm passes; however, as global rates rise, money will flow out of the yen in search of higher yields.

In every letter we have written over the last year, we have mentioned the attractiveness of gold and hard assets. Gold remains, as we noted, “the only currency that can’t be printed.” The U.S. dollar and the yen are the two nicer houses in a bad neighborhood: they are where people go if they have to make a choice, but they would rather not be there at all. Gold is essentially a psychological trade; there is no “fundamental” value. A few thousand years of gold remain a store of wealth in times of stress, and that is unlikely to change soon. Easing financial stress will reduce the value in the shorter run, but gold will be where European investors store capital in the event of a deepening crisis. Investors also may revisit the role of non-real estate hard assets, typically timber and farmland, in portfolios. Timber has greater exposure to economic activity in two more economically depressed sectors, namely new house construction and newsprint. The former, new housing, appears to even the most optimistic observers to be constrained for some time, while the latter, newsprint, seem to be the raw material for a dying industry. In contrast, farmland continues to benefit from finite supply and the cyclical rise in demand from emerging markets, and has produced steady and increasingly more attractive yields for investors.

What is the impact of the financial reform act?

Most of the positive things that can be written about the act are a variation of “it could have been worse.” The 2,300-page “Restoring American Financial Stability Act of 2010” is expected to result in 1,200 new regulations and at least one new government department. As of now, none of the regulations have been written, and the tone of enforcement will be key; it really is too early to predict the exact impact beyond the rhetoric. The core of the challenge facing Congress is the adage, “if you’ve seen one financial crisis... you’ve seen one financial crisis.” There are few observers who would even go so far as to claim this bill would have even prevented the recent meltdown, had it been enacted before the event.

That said, it will constrain some speculation, and the \$600 trillion derivatives market will have greater transparency and more capital behind it. This alone is a real positive. For most Americans, the “Consumer Financial Protection Bureau,” which will be housed within the Federal Reserve, will have the greatest direct impact, regulating everything from credit card fees to mortgage brokerage. From the financial industry perspective, the constraints are manageable.

Some firms will feel the impact more, with JP Morgan impacted across its wide range of business, and Goldman Sachs, with its exposure to proprietary trading. However, in general, assets and talent will be transferred to affiliated broker dealers and few firms will need to meaningfully lower their exposure to alternative assets.



And the outlook for China?

Until significant positive changes occur, we hold a conservative outlook for Chinese equities in the shorter term. While China's economic growth has been intact and corporate earnings have generally been solid, the European sovereign debt crisis and the Chinese government's draconian tightening measures have not only compelled sentiment to turn negative but also pushed market participants to withdraw capital thus causing Chinese equities to slump dramatically. On the earnings front, there is concern that the strength of this year's number is largely due to 2009's low-base effect and will thus be tough to repeat in 2011.

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Simply put, whereas China's fiscal stimulus program significantly boosted investors' confidence in future economic growth and its equity markets, present tightening measures (and the natural human tendency to fear that more is to come) are having the opposite impact. Concern over potential interest rate hikes, higher Chinese property taxes and policies generally aimed at decelerating growth prevent the market from establishing a firm upward trend. It is acknowledged that the decline in Chinese equities may have priced in the markets' fears but new issues can, and have, arisen and need to be dealt with seriously. Wage inflation concerns driven by Hon Hai Precision's 70% wage hike further fans investors' worries that the Chinese government will implement additional measures to tame inflation and thus keep future economic growth at bay.

Wage inflation is also a concern to corporate management teams as both domestic and overseas employers may look outside China if they wish to maintain their profit margins. In the longer run, increased wages may translate into greater disposable income, thus helping a portion of the population contribute to domestic growth. As China's niche is that of low-cost producer, the fear is that production will eventually move to cheaper-labor countries, weakening domestic consumption and China's competitive advantage. Add to this Europe's continuing problems and slowing U.S. growth and the result is that China's vaunted export sector is also questioned. To be clear, opportunities continue to exist in Chinese equity markets but they are increasingly sector-specific and largely dependent upon which segments of the economy the government chooses to focus upon. These include healthcare, as the Chinese government aims to expand medical insurance coverage. In addition, the automotive sector, despite potential oversupply, may still receive a boost from mild government rebates.

Fundamentally, the Chinese government has been responsible in taking steps to tame inflation and speculation, and market participants are not appreciating the potential long-term, positive effects of a transition to sustainable growth. Market participants have been accustomed to unsustainable increases and will thus be disappointed when growth expectations are not met.

Until the Chinese government clearly changes its tone and enables sentiment to turn positive or speculative investors transition to accepting a longer-term, sustainable growth outlook, Chinese equities are likely to remain under pressure.

What are we seeing in Emerging Markets outside of Asia?

Thus far in 2010, non-Asian Emerging Market returns can be explained more through macro-related fears rather than fundamentally-driven realities. While the fundamental picture has remained favorable, fears over the European credit events and slowing global growth have constrained markets during the first half. That being said, it should be noted that a consolidation period is not uncommon given the recent strength in both fundamentals and asset prices over the past 18 months, and consistent with our “lighting-bolt shaped” recovery discussion.

Going forward, our view on non-Asian emerging markets (focusing primarily Emerging Europe and Latin America) remains favorable while recognizing the sentiment-driven, macro-biased influences within the underlying markets. Valuations, earnings and GDP growth remain firmly supportive of the longer term secular Emerging Markets story.

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In the Europe, Middle East and Africa (EMEA) MSCI region, we expect the recent volatility to continue over the near to medium term with clear directionality only returning when the region’s outstanding macro issues are resolved. The energy, materials and financials sectors comprise around 70% of the regional market capitalization and are significantly influenced by macroeconomic factors. Within the financials sector, what we hope to be diminishing concern over the Western European fiscal situation will help sentiment and risk appetite. The energy and materials sectors have been affected by the tug-of-war between inflation/disinflation and overall concerns about moderating global growth despite the fact that the IMF recently upwardly revised their regional growth forecasts.

In Latin America, we remain positive on the region’s improving fundamentals and note the strengthening GDP and corporate earnings; however, we recognize the disparities between index representation (materials/energy) and the underlying domestic demand strength (consumer discretionary, consumer staples, healthcare etc.). Broadly speaking, we expect Latin American markets to remain volatile for several reasons: 1) underlying economies are diverging, with differing central bank stances and policy pathways, 2) favorable domestic growth has to be reconciled with volatile asset flows based on the region’s commodity sensitivity (and global growth sensitivity) and 3) changing investor expectations for both inflation and earnings. That said, this will impact indices more than hedge funds, as they are not constrained to have the systemic long commodity bias present in the indices, but able to focus on individual investments that are driven more by local, positive factors.

In these environments, Optima continues to favor tactically-biased, non-directional managers that are able to exploit the inefficiencies created in volatile markets, and we remain particularly wary of funds that mimic local indices in their exposures.

Where are we on commodities?

We continue to have a positive outlook for commodities.

We continue to have a positive outlook for commodities, with demand from both retail and institutional investors, and solid real final demand.

Retail purchasers continue to be increasing exposure to a broad range of commodity ETFs. These investors have shown themselves to be reasonably stable through the recent disruption, with positive flows potentially indicating a longer term structural change in retail investor sentiment, likely driven by fears of inflation as investors seek out ways to preserve value.

There is an increasingly popular view of gold as “a store of wealth currency.”

With the global investing community’s hyper awareness of the “tail risks” associated with policy missteps in this exceedingly delicate environment, as well the possible results of a renewed debt crisis, gold has continued to find demand. There is an increasingly popular view of gold in the classic Keynesian definition of a currency as “a store of wealth.” Demonstrating this return to pre-Bretton Woods mentality, central banks were net purchasers of gold in 2009 after long periods of selling. The continued, widespread fear of inflation, especially in China, offers further support for gold purchasers.

In our view, the long-term, “super cycle” for agriculture continues.

In our view, the long-term, “super cycle” for agriculture continues: China’s import demand for agriculture has not slowed even if a slowdown in their economy has shown up in decreased demand for industrial commodities. This reflects a sea change in the needs of all developing nations to be able to feed themselves, as land and water become increasingly scarce. Inventory to consumption ratios for corn, wheat and soybeans are low and prices are relatively subdued, while demand will continue for industrial use of agricultural products.

From the BP oil spill disaster in the Gulf of Mexico to the resultant constrains on drilling, it seems likely to us that oil prices will continue to be well supported, and rising.

Base metal prices have been subject to huge fluctuations reflecting the boom-to-bust swings in investor sentiment. Looking beyond this, the industrial cycles underway in the developing world, and resulting capital expenditures will be hard to stop and thus should be supportive of base metal prices over the long term. Still, the watchful eye of the markets will react negatively to any perceived slowdown in this activity, with China particularly under microscopic scrutiny.

While we expect equity price support to result in strong oil prices, as it has historically, there has been a massive increase in year-on-year oil supply even as demand has risen sharply over the past six months. The major risk is that high storage levels result in elevated spare capacity which could depress oil prices, but this is only a short-term effect. From the BP oil spill disaster in the Gulf of Mexico to the resultant constrains on drilling, it seems likely to us that oil prices will continue to be well supported, and rising.

Overall, these macro-economic factors keep us supportive of commodity prices in general. At the “investment level” it is interesting to note that volatility in commodities is back to pre-financial crisis levels, while correlations between commodities and the S&P 500 are at all-time highs. This is creating a mispricing of risk in the space that hedge fund investors will certain exploit.

Conclusion:

... expect fear to moderate, and markets to generally rise....

The recent past has been characterized by “runs.” Runs on banks led to a “Bear Run” with stocks falling in proportion to their market capitalization in 2008. This was followed by a “Bull Run” in 2009, with higher risk assets soaring back. All these runs are characterized by indiscriminate action on the part of investors. While we expect this to moderate, and for markets to generally rise, this market background can not be expected to disappear.

... rising role of government in financial returns....

The combination of low interest rates, higher market risks and the high probability of continued shocks from Europe is inherently volatile. Moreover, into the equation we have to include another variable: the rising role of government in financial returns at every level of the investment process. We have long seen some government involvement in trying to impact currency levels and general economic activity. Now, however, we have the government determining which sectors are entirely “protected” (e.g. automobiles) and which ones will have companies operating by one set of rules (e.g. Citi and the “too big to fail” club) or another set of rules in the same industry (e.g. mid-size regional banks).

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Contrary to most previous markets, this is not a traditional “stock pickers” market. Traditional valuation skills will be of even greater importance, it is true, but successful managers will also need to be part macro-economist and part political scientist to navigate these waters. Furthermore, the ability to short stocks, as only hedge fund managers can do, will be invaluable. Managers with this expertise in equity long/short investing will thrive relative to their long-only peers. Managers with expertise in corporate events will similarly find greater returns for their skills. For managers in the “macro” investment space, this greater volatility will also offer unprecedented opportunity, if skillfully navigated, though risks will certainly be higher.

...hedge fund investors will perform well in this decreasingly volatile, and increasingly rational, environment.

Overall, however, the greatest challenge to investors is fear itself. The mini-crash and highly correlated market in May, the transition to realistic growth from the sharp “dash-for-trash” rally subsequent to the end of the recession and even the European crisis will pass. We would neither say the issues at the root of these events have disappeared, nor would we say that they will be solved in the next few months or years.

The market we refocus on is what we believe to be manageable levels of growth, and manageable levels of risk. In even the medium run, hedge fund investors will perform well in this decreasingly volatile, and increasingly rational, environment



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