

OPTIMA FUND MANAGEMENT LLC
A New Year's Perspective
January 19, 2010

"Memory is deceptive because it is colored by today's events."
-Albert Einstein

Review of Last Year:

**There is little
in 2009's
opening
letter that we
would re-
write with
the benefit of
hindsight**

The purpose of Optima's year-end letter is to briefly review how markets unfolded in 2009 and, more importantly, to focus on the period ahead. This year will be marked by manifold challenges. Markets do not respect the calendar; to look at 2009, without looking at 2008, would be to see less than half the complete picture. Markets move in cycles, not 365-day periods, yet to review both years would crush Cicero's dictum that *"brevity is the cornerstone of eloquence."* That noted, the waves still emanating from 2008 will be felt for years to come, both rising and falling, and it will, along with 1929 and 1987, be studied ad nauseam. We will not add to the reams of reports written about the causes of the market turmoil, and rather focus on the recent effect on markets and look forward at how best to navigate the year ahead.

There is little in 2009's opening letter that we would re-write with the benefit of hindsight. The central, bullish points were reasonably dissonant with consensus at the time with the market in free fall. Indeed, in October 2008, bearishness was approaching new lows and in the (October 8) words of market commentator James Cramer, it was the time to *"take [your money] out of the stock market right now, this week."* ... We stand by our opening quote: ***"Many an optimist has become rich by buying out a pessimist."***

The Following is an Analysis of Key Statements Made in Last Year's Letter ...

"Where are we now? Undeniably, we are in the midst of the gravest financial crisis since the Great Depression, (however) we are confident that an improved, functional system will emerge in coming quarters."

Since this was written, 2009 bond issuance was up 16.6% year-on-year, the TED Spread contracted by -86% and the LIBOR-OIS Spread contracted by -87%.

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

The US economy definitely responded: GDP is estimated to have grown at an annual rate of 2.2% in Q3 2009 compared to contracting by -2.7% in Q3 2008 and -5.4% in Q4 2008.

Consumer Confidence ended December 2008 at 66.6. It has since risen to 77.7, and intermodal traffic (tracking the real economy's movement of goods) totaled 141,699 trailers and containers, up 14.2% from a year ago.

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

The Stimulus Package pledged \$787 billion in government expenditure. This included tax cuts, funds for education and health care, and various contracts, grants and loans. An estimated total of \$790 billion was actually spent in 2009.

The Treasury's TARP program allowed them to purchase or insure up to \$700 billion of "troubled assets and Congress worked out a \$25 billion loan for the US Auto Bailout.

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

At the end of 2008, there was an estimated \$3.8 trillion of sidelined cash in money market funds. Money market fund asset levels steadily decreased over 2009 leveling off at \$3.3 trillion as of December 29, 2009.

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

Throughout 2009, high yield spreads tightened by 814 basis points and corporate spreads tightened by 288 basis points.

From the equity bottom on March 9, 2009 through year-end, high yield spreads tightened by 779 basis points and corporate spreads tightened by 383 basis points. Over that same period, the Dow Jones appreciated 59.3%, the Russell 2000 was up 82.2%, the NASDAQ was up 78.7%, and the S&P 500 was up 64.8%.

"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 major US indices performed very strongly throughout 2009. Dow Jones: +18.8%, S&P 500: +26.5%, Russell 2000: +27.2%, and the NASDAQ: +43.9% (2009 YTD performance).

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

During 2009, the Goldman Sachs Commodity Spot Index was up +50.3% and Oil as measured by the Bloomberg WTI Cushing Crude Oil Spot Price was up +77.9%.

"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."

From January 1, 2009 to December 3, 2009, the dollar fell -7.2% against the euro, -2.6% against the yen and -11.8% against the pound. From December 3, 2009 through 2009 year-end, the dollar rallied 5.1% against the euro, 5.4% against the yen and 2.3% against the pound.

“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.”

After this was written, gold went up 24.4% in 2009.

“And we concluded: 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.”

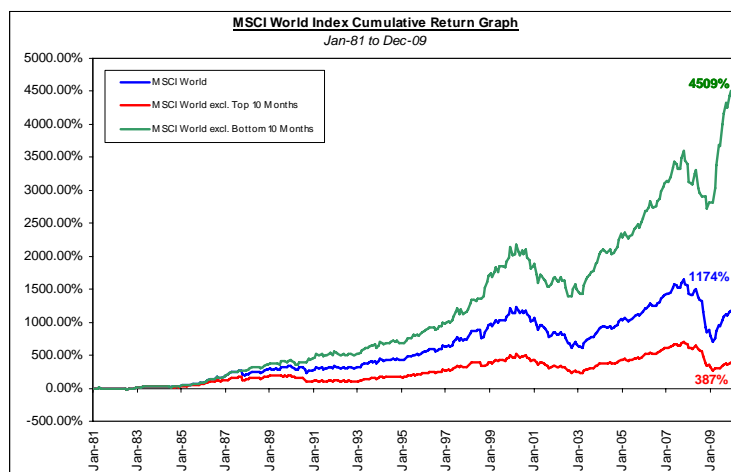
2009 proved to be a profitable year for Optima and its investors.

Optima’s 2010 Outlook:

Hedge funds should have enjoyed a strong tailwind from rising markets but underperformed long-only investments. Why?

Systemically, as noted above, performance is always measured over time and inconveniently market cycles do not coincide with the time it takes for the earth to circle the sun

There are two types of reasons for this: i) systemic reasons, and ii) cyclical reasons. Systemically, as noted at above, performance is always measured over time and inconveniently market cycles do not coincide with the 365 days it takes for the earth to circle the sun (i.e. the calendar year). In the long run, avoiding large “down moves” in the long-only indices results in a far greater payoff to investors than capturing “up moves.”



Source: MSCI, Optima Analysis

Much of the skill in investment management lies in avoiding the sharp declines or large “down moves.” As can be seen in the chart above, an investor in the MSCI World since January 1981 would have earned 1,174%.

An investor who missed the ten best months (out of all 384 months) would have gained 387% or almost 800% less.

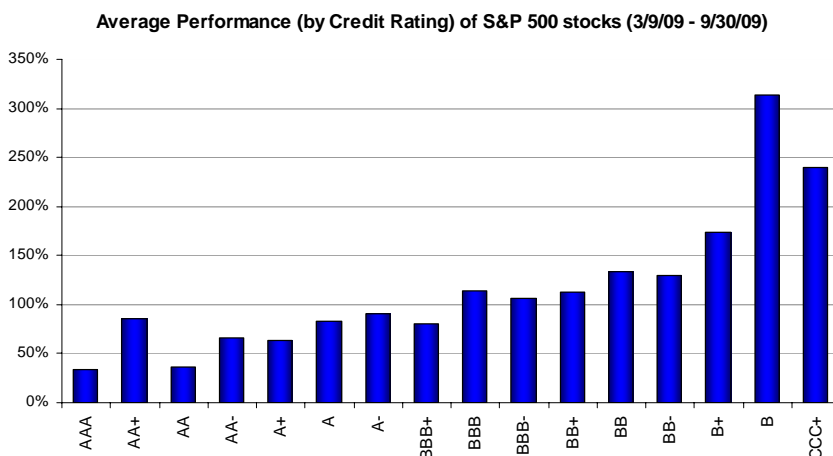
However, an investor who avoided the ten worst months would have earned 4,509%, nearly 3.8 times the return of the long-only investor.

The S&P 500 total return was negative for the ten years ended 2009, yet this decade was composed of four years with returns over 10%....

The math of financial losses is clear, but Wall Street has a very real incentive to forget it. If one starts with \$100 and loses -37.0% (if invested in the S&P 500), as long-only managers generally did in 2008, one is down to \$63.00. To return to the original \$100 one will need about 60%, or just over 5 years of 10% returns to get back to the investor’s starting point. Given the market’s tendency to experience slow increases and explosive declines, Wall Street’s tendency is to encourage investors to “forget” the negative returns of years past. The S&P 500 total return was negative for the ten years ended 2009, yet this decade was composed of four years with returns over 10%, all “excellent years.” You can still drown in a river with an average depth of 3 inches...

Hedge fund managers, in general, understand this and tend to be defensively positioned during down markets while systemically maintaining a defensive posture through the bottom of sharp reversals. The March reversal (bottoming out March 9, 2009) was indeed severe with the previous 4 weeks seeing stocks plummet -22%, followed by a nearly symmetrical rally of +27% in the following 4 weeks.

Cyclically, this reversal created investment conditions that were as extraordinary as they were temporary. Those conditions run counter to the core investment strategy of many managers. To illustrate two facets of the situation:

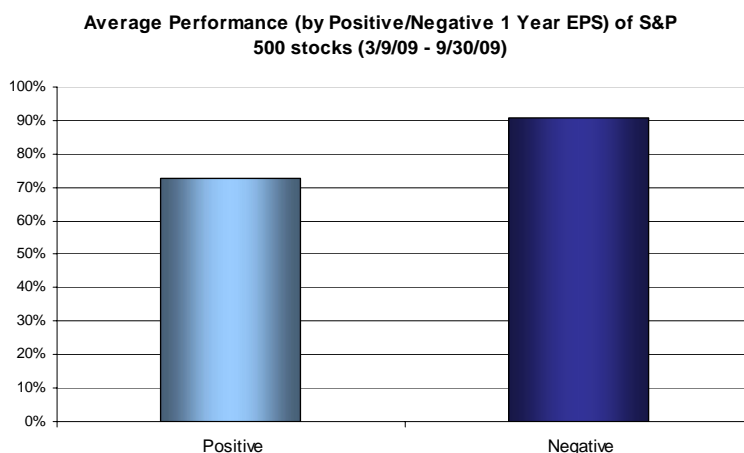


Source: S&P, Optima Analysis

The chart above is astonishing. It shows the March to September performance of S&P-member stocks broken out by credit rating. Every sector with “junk credit” (BBB) or worse increased by more than 100% from the lows in March, with the worst-rated stocks more than doubling or even tripling. Typically, hedge funds tend to be long high-quality companies and hedge by shorting lower quality names. Of the managers that did underperform, a tremendous portion of that underperformance is a direct impact of those hedges. Again, these stocks – that surged 200-300% – are not volatile, small-cap gold names, but rather S&P-member companies. Extraordinary conditions.

The chart below is also extraordinary:

Stocks with the largest negative earnings outperformed stocks with positive earnings ... extraordinary conditions



Source: S&P, Optima Analysis

The stocks with the largest negative earnings outperformed stocks with positive earnings. The worse the company performed versus expected earnings, the larger the rally. Again, extraordinary conditions.

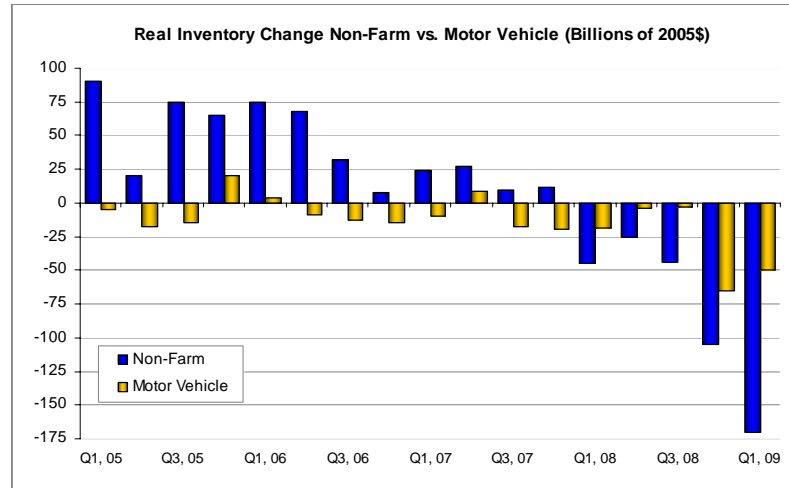
We received an extraordinary number of inquiries about the fundamental background for global investments from our investors. We address a number of these here:

Is It Over? Are We Truly Out of the Recession? What Makes You Think So?

Yes. The US will post positive GDP growth in the coming months. This result is not only from favorable “year-on-year” results, but also from economic fundamentals. The sustainability of it will require a return of the retail consumer; while we are confident this will happen, the potential strength of the consumer is mixed.

Inventory rebuilding alone will drive strong numbers in the start of 2010

One of the powerful drivers of growth will be inventory rebuilding. In “traditional” recessions, sales unexpectedly drop below expectations and ‘involuntary inventory’ building occurs. These unsold goods reduce the need for additional production. Initially, warehouses fill up and eventually layoffs occur, thus reducing demand further. This lower demand leads to (as you would expect) more inventory buildup and the traditional recession soon ensues, feeding on itself. This recession was markedly different:



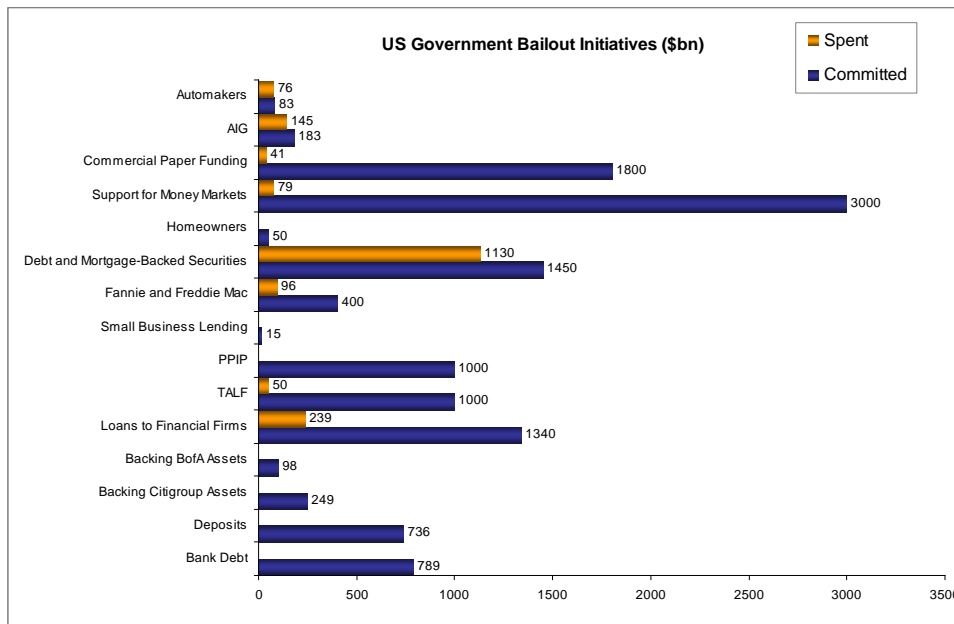
Source: US Department of Commerce

In this cycle, inventory growth was nonexistent as far back as the middle of 2006 and was negative by Q1 2008. The inventory numbers we see today are unsustainably low. With the global rise of *kanban*, the “just-in-time production techniques pioneered by the Japanese,” companies are reluctant to turn away orders and risk their spot in the economic supply chain. Inventories decline when production finally falls short of demand. At this point, it is common that production dramatically rebounds. “Overshoots” are powerful forces in the economy; in the first part of 2009, 14% of US GDP was in the form of business investment and simply collapsed, falling -38% year-on-year. That alone would have dragged GDP down by -5.4% (of GDP growth). In reality, the remaining 86% of GDP was actually positive and hence the moderate decline of -3.6% over that period. The US economy is inherently investment driven, and by the third quarter of 2009, that section of the economy was growing at a rate of over 11%. This correction of the “overshoot” will continue: business investment remains 20% below 2008 levels and replacement alone will drive this upward. Housing, the epicenter of the quake, remains at levels of homebuilding that are barely half the construction levels seen during the 1960s when the US population was approximately less than today (~194 million in 1965 versus ~308 million in 2009). Automobile inventories remain depleted on a year-on-year basis as well. This area was also a major drag on the economy but is now poised for a major bounce.

Much of the stimulus merely shifted consumption from a future date to the present....

Much of the stimulus merely shifted consumption from a future date to the present, most notably the “*cash for clunkers*” initiative. It remains true, however, that both fiscal and monetary policies are hugely stimulative and less than 30% of the February stimulus capital has been spent. In the first stage of the crisis, much time was wasted with the change in administration and the building of the “safety net.” Now, for better or worse the net is built and stands ready to support the economy should it have a serious reversal. The chart below illustrates how little has actually been spent by the US Government compared to what has been committed.

The “safety net” is built, and much of it is unspent

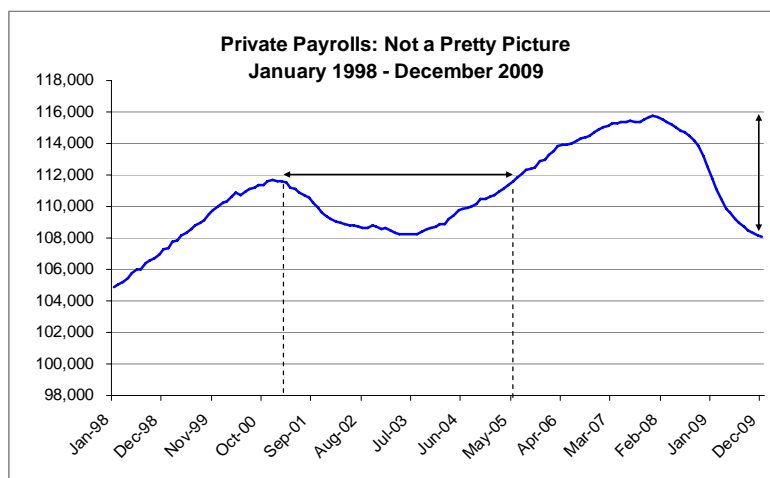


Source: US Treasury, Federal Reserve, Bloomberg, Wall Street Journal, Optima Analysis

One way or another this non-traditional recession will have a non-traditional end.

Technically that may be so, but the Economy does not “Feel Right.” So, when will the ‘Real’ Pace of Activity Return?

Here, the answer is more depressing. This recession lost over 8.4 million jobs in the private sector:



Source: US Department of Labor

The economy will not feel strong until we are back to at least the employment level we started with

Despite the (sure to be touted) monthly gains, the economy will not feel strong until we are, at a minimum, back to the employment levels we started with. How long will that take?

Realistically, it will not occur until the middle of the decade:

Jobs Lost Since Peak (Dec. 2007, Seasonally Adj.) Including Benchmark	-8.2 million
Lowest Level Since Including Benchmark	Jan. 1999
Loss Recouped By: Meager Recovery: +100k/month Moderate Recovery: +250k/month	Early 2017 Late 2012

Source: US Department of Labor, Optima Analysis

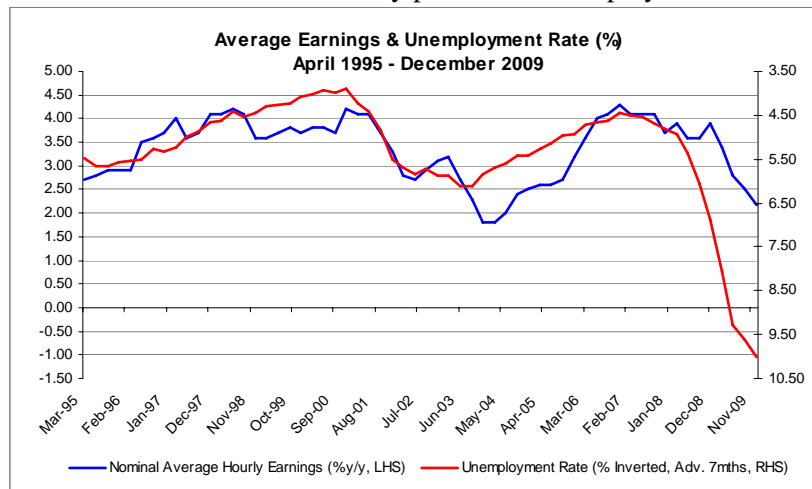
But jobs will return, and soon. In this recession - along with cutting inventory - companies shed jobs at a tremendous rate. Productivity rose 8.1% year-on-year as more workers were cut to reduce production.

Inflation? Should we be Concerned?

Concerned? Yes. Afraid? No, not yet. There is tremendous concern with investors reviewing everything from arcane statistics on “MZM money supply” versus “monetary velocity” numbers to the fact that Federal Reserve Chairman Bernanke refinanced his mortgage (thought to be formerly floating at 4.125%) to a fixed-rate, 30-year mortgage around 5%. The basis of this concern lies in the words of Milton Friedman: *“Inflation is always, and everywhere a monetary phenomenon”* and we discussed it in our mid-year note more at length. In that note we mentioned the intense debate between the deflationary camps and those who see inflation, each with Nobel Prize winners to argue their case. Our expectation remains that inflation will be a risk, but that risk remains a long way away and is still beyond the horizon of investors.

The chart below illustrates part of the basis for our expectations. Unemployment and wage growth in America are tightly linked. A rise in unemployment will lead wages downward with about a seven-month lag. If the relationship in the chart below holds, wage pressure will simply not be an issue throughout 2010 and beyond. What was the total number of strikes in the US involving more than 1,000 people in 2009? Four. Two of those were by public sector employees....

Our expectation remains that inflation will be a risk, but that risk remains distant



Source: US Department of Labor

We see nothing to change our mid-year view: *“It is important to note the typical lag between increased monetary creation and inflation tends to be around 3.5 years. We are confident that inflation will stay low until well after our year-end letter, but the danger is to the upside, not deflation.”* The appearance of true monetary inflation is years away.

So When will the Fed Tighten?

The market sees Fed tightening as early as June. That is too soon.

The Fed Funds futures market sees a 50/50 chance of a tightening at the June 23, 2010 meeting followed by a gradual tightening of only 25 bps by year-end. We think the dynamic may differ, and, more than most cycles, the Fed’s action will matter to markets. Why? Liquidity is driving asset valuations from credit spreads and stock prices to foreign exchange rates and the “carry trade.”

The first step in the process of soaking up all this liquidity is beginning: the alphabet soup of liquidity facilities, including “ABCP, MMF, CPFF, PDCF and TSLF” will expire on February 1, 2010. Liquidity swaps with other central banks will also end by that date. Amounts provided by the Term Auction Facility will be scaled back “in early 2010.” The Term Asset-Backed Securities Loan Facility will stop non-commercial mortgage-backed loans on March 30 and all loans on June 30. Furthermore the FOMC will conclude its planned purchases of agency debt and agency mortgage-backed securities by March 31. The de-facto tightening process is beginning and our expectations for the appearance of strong growth in the first quarter will increase the market expectations of tightening early in the year. We think that will not happen until later, but when it does it will be more pronounced than the gentle 25 bps by year-end currently priced into Fed Fund futures.

Persistent unemployment will hold them back

Our basis for this assessment is split between the expectation of solid growth numbers being announced at the start of the year and what we believe will be a very sticky unemployment rate. It is hard to raise rates when approaching difficult mid-term elections, especially when unemployment remains ‘abnormally’ (but to us predictably) elevated. The basis of this is a truism in public policy circles: what you pay more for, you will get more of.

Regular & Extended Unemployment Benefits		
Regular	26 weeks	All States
Emergency Unemployment Comp (approved Jun-08)	+20 weeks +13 weeks If Jobless Rate >6%	All States 48
Federal State Extended Benefits	+20 weeks If Jobless Rate >6.5% +13 weeks If Jobless Rate >6%	39 29
3 rd Extension	+13 Weeks If Jobless Rate >8.5%	27
4 th Federal Benefit Extension	6 weeks	
Maximum	99 Weeks	

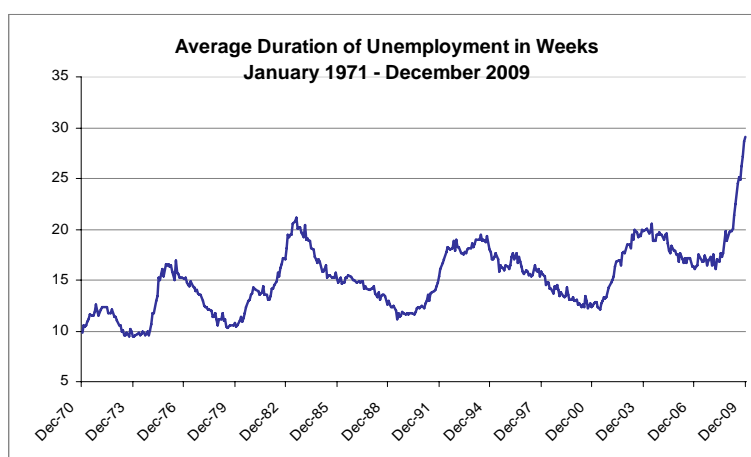
Source: US Department of Labor, Bloomberg, Optima Analysis

As can be seen in the table above, states with unemployment rates over 8.5% (all the major ones) will offer Federal, State and local unemployment benefits for a 99-week period. After that, many states still keep paying with another 20 weeks available to the unemployed. This extension occurred over a series of little-noticed “extensions”, altering the very liquid structure of the US labor markets. Before this

Longer term unemployment numbers will remain stubbornly high

Congress, there had never been a period where one could be paid for almost two years by the government. As a result, while we will see initial claims decline as economic activity picks up, longer term unemployment numbers will remain persistently high, and with it the unemployment rate.

Firms are always cautious at the end of cycles. Given key questions about federal policies, as well as lingering uncertainties in the credit markets, firms have been even more reluctant to hire. So far, they have been able to meet demand by spiking productivity, but this is a very short-term solution. As final demand continues to pick up and as needed inventory restocking begins, firms must start expanding payrolls.



Source: US Department of Labor

So How Will All this Impact the Equity Markets?

The next “big wave” is liquidity reduction

The next “big wave” is liquidity reduction and successful managers will ride that wave. Markets will rise as long as rates stay stable and the system is awash in capital. The year-on-year factors will create what may well look like the much desired “V”-shaped recovery. However, the appearance of strong growth and the appearance of unlimited capital availability will likely be a mirage, replaced by a less perfect investment environment. We expect to be commenting on that in our mid-year letter. That said, as long as the environment is that supportive, it is hard to see the ‘liquidity rally’ in asset prices ending. But it will: the Fed is removing the punchbowl from the party. The withdrawal of many of the liquidity programs brings a stop to the “quantitative easing” part of the policy response and effectively commences the early stages of tighter monetary policy. At some point the markets need the global consumer to enter the equation and that will be problematic.

Continued market strength until either the economy slows, or the Fed pre-announces tightening

Disposable Personal Income (DPI) vs. Consumption Growth			
Nominal Data	Ann % Change		
	DPI	Cons.	Diff
1960-Present	7.10%	7.20%	-0.10%
1960's	6.9%	6.8%	0.1%
1970's	10.4%	10.4%	0.0%
1980's	8.1%	8.3%	-0.2%
1990's	5.5%	5.9%	-0.4%
2000's	4.6%	4.5%	0.1%
2003-2006	5.8%	5.9%	-0.1%
2008-Present	1.6%	0.0%	1.6%

Source: US Department of Labor, US Commerce Department, Optima Analysis

As can be seen in the chart above, Disposable Personal Income (basically, after-tax income) equals Consumption over time. This relationship has held since before the 1960s; it has held over every subsequent decade and even during what many perceive to be the credit-fuelled boom of 2003-2006. As discussed above, income growth will likely be restrained by excess capacity in the labor markets and saving may yet rise. As a result, the prospect for the 60+% of the US economy that is driven by consumption cannot be viewed as vastly supportive.

We would expect a continuation to the supportive markets until the Fed makes it clear that it will move to the next stage when they actively withdraw funds from the system and raise the Fed Funds Rate. At that point a key underpinning of the market will appear shakier and volatility will be a likely result.

... And the Fixed Income Markets?

The supply situation for bonds is little understood, but will play a major role in the period ahead

If the equity markets were in a sweet spot, the fixed income markets were absolutely in a candy land in 2009. The background to the demand side of this year's rally is well known: inflation has gone down and demand skyrocketed as "flight to quality" trades drove the wave of liquidity into the global debt markets. What is less well known, and will matter greatly in the period ahead, was the supply situation. In 2009, total new fixed income issuance in US dollars declined from \$2.05 trillion to \$1.75 trillion, a drop of \$300 billion. This is reasonable: the credit markets were basically shut down for the first quarter and demand for loans generally dropped in a recession as expansion plans were curtailed. When one looks at the Fed balance sheet, it becomes evident that the US Government bought about \$1 trillion in mortgage-backed securities, another \$150 billion in Agency bonds and enough treasuries to reduce the total net bond issuance denominated in US dollars to only \$200 billion in new bonds for the entirety of 2009. Fed purchases will stop in March with most of the programs 80% or 90% complete. What happens then? Of the \$2.2 trillion in bond issuance expected, the Fed has the capacity to buy about \$200 billion. After that, the market has to find real buyers....

In treasuries alone, 2010 coupon issuance is projected to be \$1.8 trillion, a 45% increase from the \$1.3 trillion in 2009 and a multiple of the \$255 billion in the Treasury sold in 2008. To further challenge Secretary Geithner, over 40% of total US Treasury bonds currently placed have a maturity of less than one year – effectively the highest on record. Additionally, they will have to be rolled over, barring a return of "flight to quality." Look for rates to rise, particularly in longer maturities.

What about the Dollar?

The issuance of substantial debt will, at some yield level, create foreign demand for US dollars with which to buy the bonds

The dollar is driving markets as it approaches some short-term extremes. The issuance of substantial debt will, at some yield level, create foreign demand for US dollars with which to buy the bonds. As the Fed tightens policy (later than expected by the markets as we noted above) it will be supportive as well. Earlier in the year there may be some support from the inventory-led "pop" in growth. As long as the yuan remains undervalued, the US dollar will work its way lower, but that path will not be linear. The period ahead may see pockets of strength in that trajectory.

Any "Big Picture Issues" that are Out There?

There are so many it is daunting and that is without revisiting the now depressingly "systemic" issues of terrorism and the seeming intractability of the global imbalances caused by the yuan. In this note we



will restrict ourselves to two: the global rise in political uncertainty and the dismal climate for small and medium sized businesses in America today – the largest short-term issue of all.

Politics has intruded into the private sector, and markets, to a level not seen since the 1970s, when President Nixon took the US off the gold standard and declared “I am a Keynesian now.” This year the markets will endure substantial additional political uncertainty as a result of the electoral cycle.

Politics has intruded into the private sector, and markets, to a level not seen since the 1970s....

In the United States, the elections on November 2, 2010 will decide the composition of all 435 seats in the House of Representatives and one-third of the Senate. President Obama’s approval ratings immediately after his election were not expected to last by any seasoned observer. The decline, however, to the lowest level of a “first year” incumbent is certainly beyond the norm, with over 60% of independent voters displeased. Mid-term elections are basically a referendum on the President and the Democratic control of the Senate, at least, is in great doubt. In Europe, it seems unlikely Labor will continue to rule in the UK, but it may well end up with a weak “parliament” with no clear majority for any party. Emerging Europe will see notable changes: Hungary, Poland, Ukraine, the Czech Republic, Latvia and Slovakia will experience elections.

Alone amongst the western world’s incumbents, feeling relatively comfortable, is Australian Prime Minister Kevin Rudd who is widely expected to win another term.

In general, social unrest is rising, from increased tension in Greece and Latvia to street riots in Iran. If food prices rise, it will only exacerbate the global issues.

Small business’ health: The single largest issue facing the economy today.

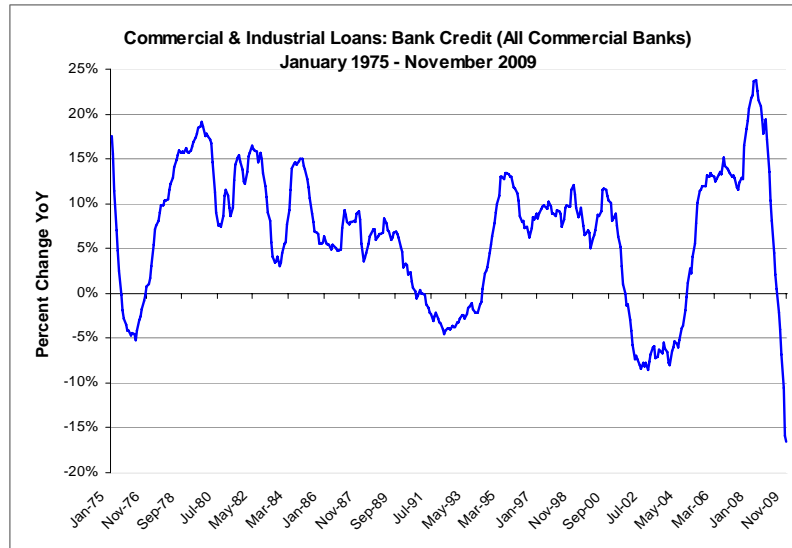
The credit crunch, as viewed from the offices of New York Stock Exchange-listed companies, is over. Credit spreads are back to normal, bond issuance, for all but the worst junk issuers, can be achieved and the banks are happy to syndicate loans. In many cases, decades of poor business decisions by labor and management were nationalized and effectively removed from their balance sheet.

Companies with less than 500 employees represents 99% of all employer firms in the US

For companies in the storefronts, behind the corporate towers, the crunch is still very much there. This matters. Companies with less than 500 employees represent 99% of all employer firms in the US. They employ about half of all private sector employees and generated 60 to 80 percent of net new jobs annually over the last decade. Moreover, they create more than half of non-farm private GDP.

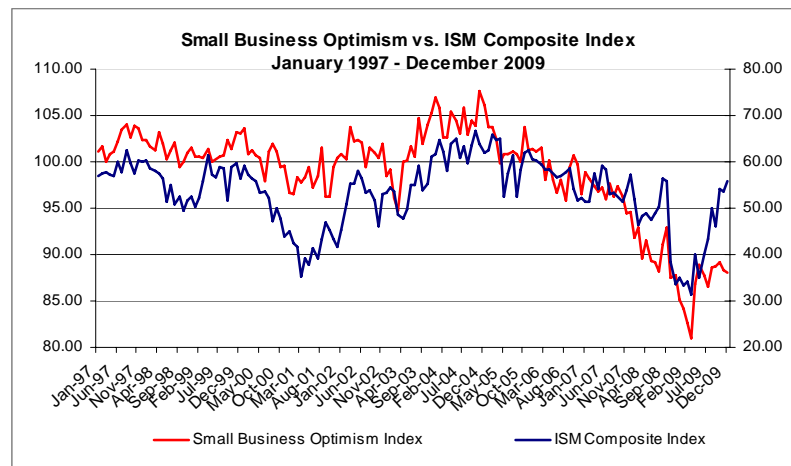
As can be seen in the chart on the following page, commercial and industrial loans are still contracting over -15% year-on-year, and the total loan amount issued by banks is down -27.5% from the peak in August 2000 and is at levels not seen since September 2002.

Loans collateralized by non-residential real estate have been described by the Federal Reserve as “nearly non-existent.” Banks are not lending, with some preferring to sit on record reserves at the Fed while others nurse hair-thin capital adequacy ratios. Loans are particularly key for start-up companies. A recent Kauffman Institute study found that companies in that category (under five years) account for nearly two out of every three jobs created.



Source: US Federal Reserve

There are other environmental issues that are perceived as hostile as well. For the first time in decades, “regulation” shot above “insurance” for “competition from big business” and “inflation” emerged as the leading concern for small-business owners. The National Federation of Independent Business (NFIB) recently issued a report on the topic. “The ‘turbulence’ created when Congress is in session is often debilitating [with] this year being one of the worst,” the authors wrote in a commentary to the report. “Themes including ‘tax more,’ ‘tax the rich even more,’ ‘VAT taxes,’ higher energy costs due to Cap & Trade, mandates and taxes for health care, threats of ‘stimulus II,’ incomprehensible deficits the list goes on and on.” As a result, we see small business confidence far below a comparable measure of large business confidence, again something we have not seen in years.



Source: National Federation of Independent Business, Institute for Supply Management

The National Federation of Small Business was not even invited to the Presidential “Jobs Summit”

This malaise in the small business sector is not getting as much press as issues impacting large listed stocks; indeed, the National Federation of Independent Business was not even invited to the Presidential “Jobs Summit.” Small business capital expenditures and near-term plans for new capital



investments remain stuck at 35-year lows and only 7% of small businesses see the next few months as a good time to expand. Lastly, only 8% of small businesses report job openings, compared to 14%-24% in 2008, depending on the month and 19%-26% in 2007.

We've covered the US, but what about other Developed Economies? Europe? Japan?

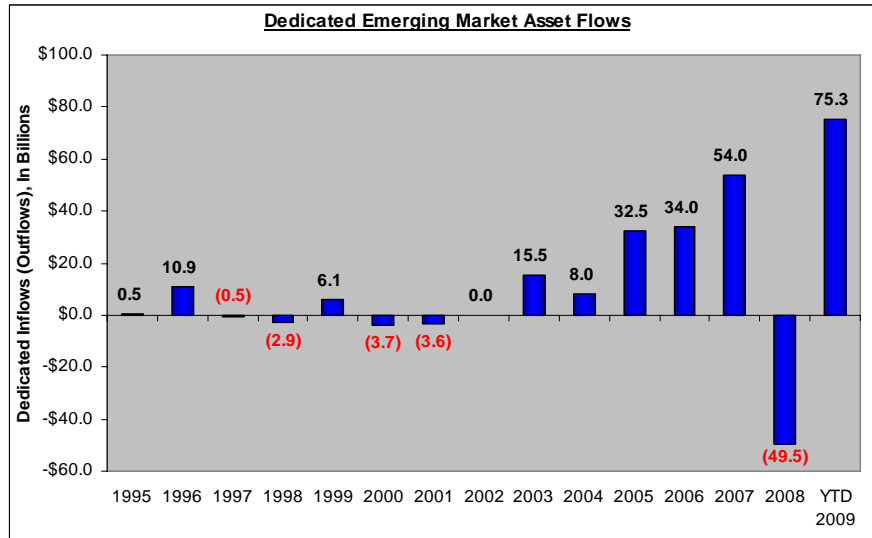
The general expectation is that Germany and France will fare better than Greece, Spain and Ireland

Optima concedes that while there are always opportunities to capitalize upon (thus our belief in hedge funds), as relates to Europe this year, one is advised to navigate with caution. This sentiment rests primarily upon the expectation that quantitative easing will be withdrawn. Fiscal deficits are already at eyebrow-raising levels and governments are not in a position to push that much higher. Further concern arises from questionable end-demand especially as incentive programs that existed in 2009 are unlikely to be renewed in 2010 (i.e. autos), modest cost-cutting measures (i.e. a 2009 push to minimize unemployment) and rising commodity prices (i.e. China demand). To be clear, not all countries face the same future. The general expectation is that Germany and France will fare better than Greece, Spain and Ireland. While the euro impacts all, its movement will have a greater impact on the latter given their domestic economies cannot be relied upon.

The outlook for Japan is not promising. To begin, economic strength is heavily dependent upon exports. Yen strength and very modest overseas recoveries are not supportive on this front. A transition to domestic economic growth is essentially absent especially when compared to China's progress. Competitiveness has been an issue as well given neighboring Korea has not only caught up to (if not somewhat surpassed) Japan's technological evolution, but has also benefited from relative weakness in its won. Though the DPJ achieved a monumental win over the LDP in 2009, the true test is whether they can also secure a majority via upper house elections in July (the DPJ presently relies upon a partnership with two coalition parties for strength in the upper house). If the DPJ succeeds, the government will theoretically be able to carry out policy without restraint. Thus far, the match between goals and execution has been spotty. Additionally, while there has been an interesting move from public spending on highways to subsidies for families with children, it remains to be seen whether these types of actions will produce a positive sea change for the entire nation. Furthermore, the nation's 200% debt-to-GDP ratio has yet to be addressed. However, the vast bearishness on Japan is an interesting data point with diehards pointing to this as a bullish signal (arguing as well the unreasonably low valuations against improved earnings and balance sheets). Furthermore, unlike other Central Banks that have already raised rates or are expected to, the BoJ will likely continue providing liquidity in the foreseeable future.

What about the Emerging Economies?

Emerging markets assets performed extremely well in 2009 on the back of decreased risk aversion, improving fundamentals and significant capital inflows (see chart below). On a relative basis, emerging markets assets outperformed their developed markets peers as monetary, political and structural reforms were appreciated by market participants in light of the "emerging markets-like" crisis that afflicted developed markets over the past 24 months.

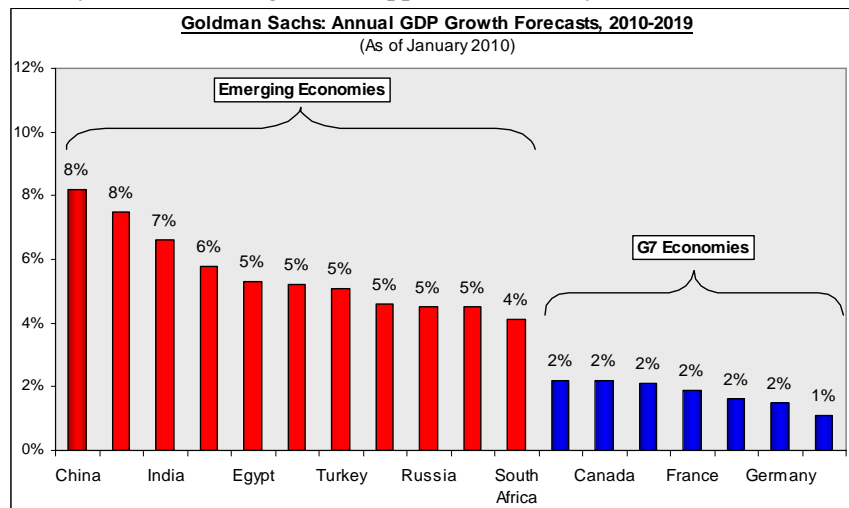


Source: EPFR, Morgan Stanley

Broad economic indicators continue to point toward a V-shaped recovery within emerging economies

Divergent monetary policy expectations and recovering corporate earnings are likely to make for a volatile 2010 as markets try to reconcile fundamentals with expectations. While the majority of emerging economies have committed to maintaining loose monetary policies during the first half of 2010, improving fundamentals and shrinking output gaps could challenge markets during the second half as improving growth prospects clash with fears of premature policy tightening. It is our expectation that the timing and magnitude of monetary tightening will significantly influence overall market direction.

Broad economic indicators continue to point toward a V-shaped recovery within emerging economies; however, given these indicators tend to lead underlying fundamentals we believe that market participants will closely scrutinize corporate earnings to confirm the recent rally. We expect fundamentals to improve but we also recognize that earnings expectations are quite formidable given current valuation levels. At the secular level, we firmly believe that emerging economies will outperform developed markets (see chart below); however, we do recognize the cyclical challenges that exist due to the significant rally witnessed in 2009 and differing cyclical growth and monetary policy expectations. Our underlying investments reflect this view as we continue to maintain a long-biased portfolio with tactically oriented managers that appreciate these dynamics.



How Does the 2010 China Story Look?

The general expectation is that China will continue to grow strongly in 2010

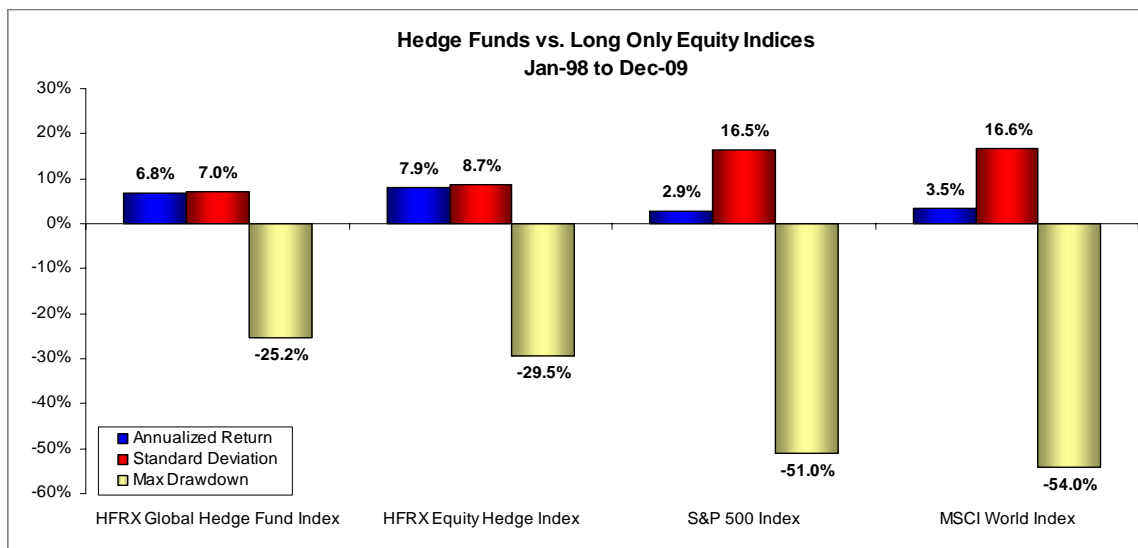
The general expectation is that China will continue to grow strongly in 2010. The recent release of China's December PMI of 56.5 against November's 55.2 is encouraging. Just before Christmas, the government announced that it will meet its commitment to spend 1.18 trillion yuan before year-end 2010. However, the concern arises from speculation that the economy could overheat and compel the government to moderate its actions. Thus far, we have already seen how unsteady the market can be on the slightest hint of a liquidity retrenchment. In August, the Shanghai 'A' share index took a greater than -20% hit largely on concerns that lending curbs by the government would dramatically alter China's growth path. Valuation-wise, while managers are still finding attractively valued stocks, the number of these opportunities and the magnitude of the discounts is less. In summary, the shift to economic growth through domestic consumption has largely worked while export growth is expected to improve in 2010 (even if only at the margin). The key this year is to monitor the government's actions with respect to guiding which components of the economy grow and by how much, such that inflationary pressures and asset bubbles are kept at bay.

Hedge Fund Industry:

Investors have increasingly looked at the total returns versus long-only alternatives and are investing more as a result

The industry continues to face challenges that are often inflicted from within such as legal and ethical lapses by managers. Yet, fundamentally, we sense a real sea change in attitude by investors. After a year in which headlines were focused on the "evils" of hedge funds, investors have increasingly looked at the total returns versus long-only alternatives and are investing more as a result:

Hedge funds have outperformed their long-only equivalents in return terms, with markedly lower volatility



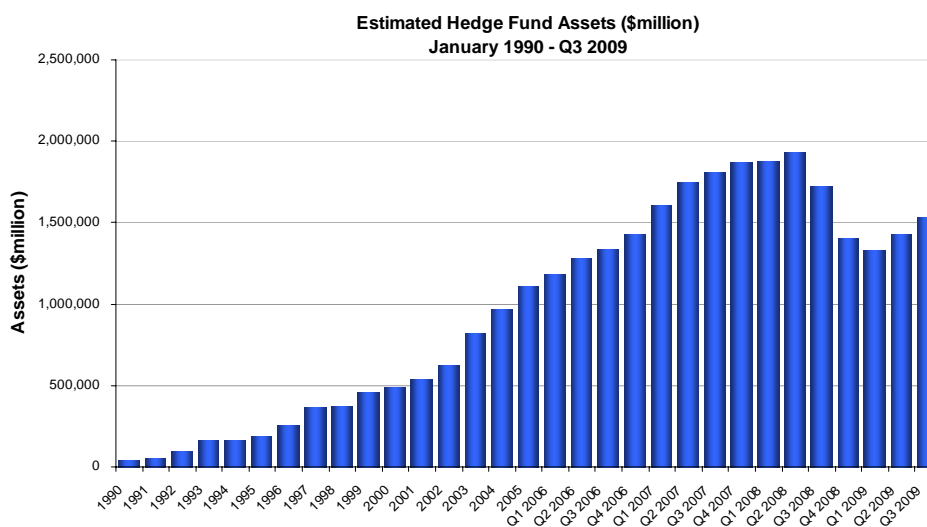
Source: HFR, S&P, MSCI

The chart above makes the case. Hedge funds (as measured by two common indices) have outperformed their long-only equivalents in return terms, with markedly lower volatility (as measured by standard deviation) and a lower "fear factor." They also exhibit much lower maximum declines in asset values, as illustrated by the "Max Drawdown" figures in the chart above. From Royal Dutch

Shell and Leicestershire County in the UK to the TWU pension fund in Australia, international pensions have seen increasing allocations. In the US, names as diverse as Boeing and the Small Business Council are investing, as are institutions from all corners of the country (from Florida State to the Connecticut Investment Council and from the Alaska Retirement Management Board to Texas Teachers).

Nearly \$150 billion was invested into hedge funds in the first nine months of 2009, according to a study by Barclays. Even more recently on January 5, 2010, it was announced that New York state's pension, the third-largest fund in the US, invested \$300 million with hedge funds in November 2009. As you can see below, hedge fund flows have turned positive:

Hedge fund flows have turned positive



Source: HFR

And the number of new fund launches continues to increase every quarter.

Conclusion:

The environment for hedge funds continues to improve. The anomalous market conditions that constrained relative performance in 2008 and the stock market, for all its volatility, are returning to a more traditional posture. Companies that are missing earnings are being punished, and companies that perform well are being rewarded with higher prices. This is allowing skilled managers to once again profit from the ability to see the true value of the company and not to find their skills overrun by technical factors as panicked money flows in and out of assets.

The US economy will face challenges, but on a global basis opportunities abound. In 2008, hedge funds protected on the downside and in 2009, they participated in the upside. Versus long-only investors, most hedge fund investors are more prosperous for it, and as the extraordinary conditions we all lived through abate, hedge funds will likely continue to offer better returns with lower volatility.

In our previous year-end piece, we wrote about the dangers of selling at what we perceived to be a coming low in the market (*i.e. selling stocks after they are at a near 10-year low and buying them back*



The year ahead will not be as “good” as the last nine months of 2009, but it will not be 2008

later is a sure way to lock in losses and minimize participation in a rally). Our message now is different, but related. Many investors, after such shocks, either “freeze up” and do nothing, or forget the lessons of a lifetime and allocate as if every day going forward was the potential start of another period like the last 18 months.

As Einstein noted in our opening quote, *“Memory is deceptive because it is colored by today's events.”* The year ahead will not be as “good” as the last nine months of 2009, but it will not be 2008. Investing via the “rear view mirror” is always a risk. **The visibility up the road is not pristine, but the tried and true investment techniques that have worked before will work again.**

The information and opinions in this report were prepared by Optima Fund Management (“Optima”). Optima has no obligation to tell you when opinions or information in this report change.

This report is based on public information. Optima makes every effort to use reliable comprehensive information, but we make no representation that it is accurate or complete. We are not offering to buy or sell any securities mentioned or soliciting an offer to buy or sell them.

Sources include but are not limited to US Government statistics, MSCI Barra, S&P, Bloomberg, Sanford Bernstein Research, The Wall Street Journal, Merrill Lynch Research, Deutsche Bank Research, Goldman Sachs Research and other sources identified within the body of this report.

The securities or strategies mentioned in this report may not be suitable for all investors. Investors must make their own investment decisions based on their own investment objectives and financial position. Optima recommends that investors independently evaluate each issuer, security or strategy discussed, and use any independent advisers they believe necessary. PAST PERFORMANCE IS NO GUARANTEE OF FUTURE RESULTS. Release Date: January 19, 2010.