

## Media Release

### All Pain, No Gain for Convertible Arbitrage Funds in 2008

New York, November 20, 2008 **The Convertible Arbitrage sector started the year strong with over half of the funds in the space posting positive returns as of June 1. Today, all funds are in negative territory as Convertible Arbitrage managers have seen six years of performance wiped out in less than six months.**

Convertible Arbitrage managers began the year on a high note—the sector had generated cumulative returns of over 100% between January of 2000 and January of 2008, while annualized returns over the same period were close to double digits. Today, a majority of those returns have been wiped out as funds in the sector have given back six years of gains in the past five months. Cumulative returns have come down from over 100% to 40% (a level not seen since September of 2002) and annualized returns have dropped to 4% over the same period. Based on October performance, the sector is down almost 30% year to date and is currently the worst performing sector in the Credit Suisse/Tremont Hedge Fund Index (“Broad Index”).

Over 81% of Convertible Arbitrage managers generated positive returns in 2007, and many funds held strong through the beginning of 2008, however no managers have been able to remain in positive territory after the events of the past few months. Market volatility has contributed to the considerable dispersion of performance across funds in the space. Monthly returns for the sector have ranged from 1.5% to -12.3% in 2008; however, the difference between the top and bottom returns of individual managers has been more pronounced. Five funds in the index have seen monthly return differences of greater than 25% between January and October of this year, while only two of the funds in the space have experienced differences of less than 10% between their best and worst month.

According to the Credit Suisse/Tremont hedge fund database, Convertible Arbitrage currently represents approximately \$24 billion in assets under management and approximately 2% of the Credit Suisse/Tremont Broad Index. There were outflows of approximately 4% from the space in October, however this figure is expected to increase as managers who have implemented gate provisions or suspended the calculations of funds’ net asset values may not yet be reporting outflows. It is estimated that approximately one third of funds within the Convertible Arbitrage sector of the Broad Index have currently imposed gate provisions, suspended net asset value calculations or have been otherwise impaired by the adverse market conditions. However, as has occurred after past incidences of market turmoil, the dislocation in the sector may also lead to future opportunities.

#### Overview

Despite average performance being positive through the first part of this year, the last five months have proved to be difficult for the sector, especially September and October. The events of the past two months—namely, the nationalization of Fannie Mae and Freddie Mac, the bankruptcy of Lehman Brothers and the implementation of short sale bans globally— have contributed to much of the substantial loss in the space.

Fannie Mae, Freddie Mac and Lehman Brothers were each significant issuers and holders of convertible preferred shares and

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the fallout from their failures has been far reaching. The effective “wiping out” of Fannie and Freddie convertible preferred shares that occurred after their nationalization, combined with the direct and indirect losses stemming from Lehman issued shares, resulted in severe de-valuations of convertible securities.

The key component of any Convertible Arbitrage strategy is a hedge fund manager's ability to capitalize on pricing inefficiencies between convertible securities and share prices of the issuing company's stock. The various shorting bans implemented by countries worldwide, including the September rulings by the U.S. Securities and Exchange Commission and the UK Financial Services Authority, compromised managers' abilities to delta hedge their own positions. Further, managers were largely unable to sell underlying convertible positions, as potential buyers were also not able to hedge their current exposure.

While the shorting ban has been lifted in the US, managers are feeling little relief as lending pressures persist. Many prime brokers, severely affected themselves by the current credit crisis, are becoming more risk averse and have increased margin requirements as convertible valuations have decreased. As a consequence, managers have no option but to continue selling, in many cases at drastically reduced prices, in order to raise cash to meet increasing margin demands. Because the market for lower grade convertibles has effectively dried up, managers have little choice but to sell higher quality assets, as well as their most liquid holdings, in order to generate cash. As a result, the securities that remain in many portfolios are frequently holdings that managers could not readily sell. Prior to September, margins were typically around 15%. Today, margins are being called upwards of 30% and are increasing daily.

#### Manager Reactions

In addition to margin calls, fund managers are also raising cash to accommodate an anticipated increase in redemption requests this year. As a whole, institutional investors seem to be taking a long term view of the situation, however managers remain concerned that redemptions could rise sharply and many are evaluating the possibility of suspending redemptions or imposing gate provisions. Managers are cautious that suspending redemptions could result in even tighter lending conditions, and as a result many funds are instead opting to impose gate provisions as a means of preserving the fund's capital. Some managers are also offering reduced performance fees on new investments made by existing clients as a means of increasing liquidity while offering existing investors an incentive to stay invested for what they believe will be unparalleled opportunities going forward.

If the implementation of gate provisions and suspended redemptions are successful in restricting redemptions, managers hope that lenders will again become more comfortable with the Convertible Arbitrage strategy, which could help stabilize this sector.

#### The Road Ahead

It is interesting to note that historically, periods of significant hedge fund redemptions have in many cases been followed by periods of significant returns. The most notable example in the Convertible Arbitrage space occurred in 2005 when GM and Ford debt was downgraded. As a result, credit-default swaps widened sharply while company stock prices rose. Many hedge funds suffered losses on both sides of the trades which lead to a massive sell-off in the sector. Cumulative returns in the 24 months following that drawdown totaled almost 26%.

Many hedge funds believe that in order for Convertible Arbitrage managers to emerge from this crisis successfully, new buyers will need to step in. Currently, hedge funds account for approximately 70% of all convertibles holders in the US (long only



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managers make up a significant portion of holdings in Europe), which is problematic since many are facing substantial redemptions and don't have the capacity to buy. However, the current attractive valuations in the strategy have begun to entice some pension funds and non-traditional investors to invest.

Some Convertible Arbitrage managers in the Credit Suisse/Tremont Hedge Fund Index have expressed plans to launch new funds to take advantage of current opportunities. New players such as pension funds, insurance companies and certain hedge funds, particularly Multi-Strategy managers who have stayed on the sidelines with dry powder to invest, appear to be entering the space, providing hope that the added liquidity and diversification will help stabilize the markets and funds will be in a position to profit from the unique investment opportunities that have been created. Most managers believe that the current valuations of convertibles are attractive and those managers who survive this downturn will likely stand to profit.

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