

## FINANCIAL FIX: SAGE CREST II

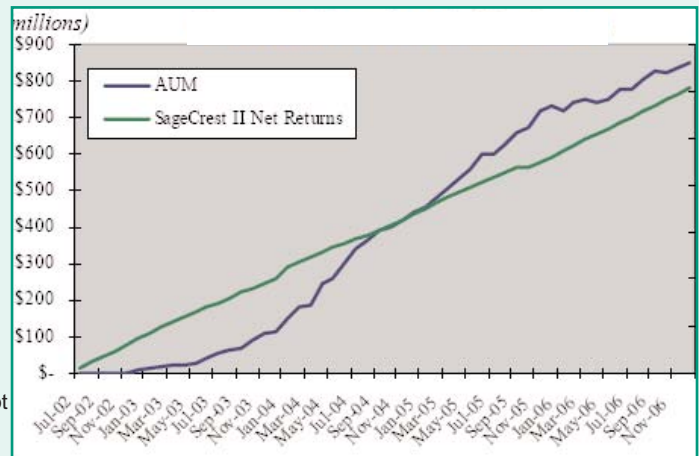
**Focus:** The fund's managers run a diversified portfolio of investments by participating in and originating small to middle market loans in overlooked and undervalued niches. Target sectors include consumer, asset-backed, and corporate obligations, as well as specialty finance, real estate and other markets offering high yield opportunities. All potential investments tend to be evaluated as "buy to hold" or value investments which would fit portfolio objectives if held until maturity. The annualised net annual returns (as per Feb. 2007): 10.84%

**Strength:** Diversification of portfolio, experience and depth of investment team; no down month since inception

**Weakness:** Fraud can never be completely eliminated; one year lock up

**Opportunities:** The managers currently see strong demand from borrowers - consolidation of the banking and specialty finance sectors have left smaller private companies without access to debt financing

**Threats:** Deconsolidation of the banking sector



Fund's returns since inception

Source: Windmill Management LLC

### Risk Assessment

☐ = low ☐ = low/moderate ☐ = moderate ☐ = moderate to high ☐ = high

Major risk: is fraud- t'is controlled by due diligence, experience, background checks, portfolio diversification, collateral and constant monitoring of borrowers

Ability to detect default risk (through the transparency provided and monitoring of borrowers): ☐ ☐ ☐ ☐ ☐

Ability to detect fraud (this drives the manager's due diligence): ☐ ☐ ☐ ☐ ☐

Diversification achieved in terms of collateral securing the loan: ☐ ☐ ☐ ☐ ☐

Ability to "correctly" value and gauge liquidity of the underlying asset: ☐ ☐ ☐ ☐ ☐

Importance allocated to reviewing the contingency clause of loans: ☐ ☐ ☐ ☐ ☐

Ability to recover full value of collateral in case of a default: ☐ ☐ ☐ ☐ ☐

LTV ratio: ☐ ☐ ☐ ☐ ☐

Efficiency achieved in putting capital to work: ☐ ☐ ☐ ☐ ☐

Leverage risk: (credit cost is relatively minimal): ☐ ☐ ☐ ☐ ☐

Currency risk: ☐ ☐ ☐ ☐ ☐

Key man risk: ☐ ☐ ☐ ☐ ☐

### Performance Parameters

☐ =insufficient ☐ =adequate ☐ = satisfactory ☐ = good ☐ = outstanding

Currently the fund had 52 issuers in its portfolio

Access to deal flow: ☐ ☐ ☐ ☐ ☐

Ability to secure loans with varying maturities: the typical length is 12 to 18 months but can range from 45 days to 3 years

Avg. loan duration: 18 months

Diversification by:

Geography: US concentrated

Sectors: 15

Instruments used include: senior secured debt, subordinated secured debt, mortgage obligations, consumer instalments contracts and corporate receivables

Investment layout: no more than 25% in an investment sector

Ability to perform in a rising interest rate environment: ☐ ☐ ☐ ☐ ☐

Ability to perform in a falling interest rate environment: ☐ ☐ ☐ ☐ ☐

Since inception consistency in delivering targeted net annual returns: ☐ ☐ ☐ ☐ ☐

### Outlook

↑ upside potential ↗ upside to range bound ↔ range bound ↘ range bound to down ↓ downside

Funds outlook on the space: Due to high deal flow the space remains attractive ↑

Funds ability to deliver targeted annual returns over:

The next 1 year ↑

The next 3-5 years: ↑

Barriers to entry: define: It is easy to make loans, but difficult to make the right ones

Conditions for the fund to outperform: continuing consolidation of banking and finance sectors

Conditions for the fund to under perform: flood of capital into markets, deconsolidation

Competition in the space: low

Ability to deliver uncorrelated returns: high

### Investment Insights

Target audience: Institutional and family investors

Level of complexity for an investor: low

To optimise returns, recommended avg. holding period: min 12 months

Geographic access: global

Base and other currencies fund is available in: USD

Fund offers (USP): consistent uncorrelated returns

Liquidity provided: quarterly with 60 days notice, one year lock up

Fees: management 1.5% and performance 20%

Transparency provided: willing to provide a high level of transparency depending on the client's needs

Registered with: SEC

## PRACTITIONER'S POINT

### Björn Englund, manages the Dog Fund and shares his experiences on catching “falling knives” using behavioural finance insights...



#### How has behavioural finance helped you catch “falling knives” (out of favour S&P stocks)?

While the hypothesis of an efficient market is widely embraced, it fails to explain some recurring investment anomalies that do exist. These anomalies can be explained by behavioural finance theories, which concede that some other factors are at play (some irrational - some rational). As human beings we tend to behave irrationally when we experience stress, fear, when we are emotionally charged etc. We also need to rationalise and hence tend to find comfort in known, recognised behaviour patterns such as following the rule of thumb; seek loss minimisation, move in herds etc.

Instead of relying solely on an in-depth fundamental analysis when purchasing or exiting equities, behavioural patterns can be observed and explain why certain equities are overpriced darlings, while others remain under priced black untouchable sheep (so called “Dogs” - because they bark and make noise once bought) - at least for a while.

When investing in an equity, we believe a reversal to its mean value occurs - ie built-up excesses tend to level out over time. Then its stable, fundamentally realistic value (in normal terms) emerges, usually in the course of a year, and will be priced into the market.

#### Why are some behavioural patterns “tradable”, while others not? How do you differentiate and identify the former and latter?

It is one thing to prove the existence of various anomalies - (very easy for back traders and statisticians), but quite another to try to profit from the same imperfections. There needs to be a credible, underlying rational otherwise there is no guarantee that these anomalies will persist in the future. Further, if they do persist, hidden costs, transaction fees and tax effects render as virtually impossible, their conversion into pure outperformance. In addition, capital tends to flow towards market inefficiencies, which in turn, cause the anomaly to disappear over a span of time.

In our Dog Fund's investment approach we have chosen to trade on few anomalies that combine the following virtues:

- a) easily understood
- b) offer a logical rational
- c) clearly defined
- d) minimal trading costs
- e) high probability of reoccurrence

#### Don't you run the risk, that at some point, the tradable behavioural patterns might change ...?

Of course, there is always a risk of changing patterns and behaviour. However, ceteris paribus, human beings seem to change their behaviour less often than many non-human-dependant patterns and time series.

Should, for example the taxation year and/or general elections be shifted/held during the summer months (instead of the present winter months), to be followed by mutual fund reinvestments in the same period... then, yes, we would also have to change tack for timing our trades.

#### Why did you choose to apply it to falling knives and not shooting stars?

We believe investors underestimate the prospects of underperforming equities, especially for large caps that have proven themselves in the past. We also believe professional investors have a tendency to “throw out” the very worst holdings of their portfolio (emotional as opposed to an informed decision based on in-depth fundamental analysis), in order to “erase” and “hide” their misjudgements for themselves and everyone else.

#### Does it lend itself to better performance?

Yes, based on our thinking we believe this investment approach has a sounder logic base, is a longer-lasting, recurring theme and should perform better especially when viewed from a risk/reward perspective ... as opposed to buying overpriced shooting stars. In a wider context, the discussion of value vs. growth can also be applied.

#### Why do you choose to apply it to the S&P 500 stocks only?

Herding tends to be most prevalent where the herds are the largest. In the US, institutions are drawn to using an advanced benchmark like the S&P 500. This is the reason why we have not applied our thinking to, for example, Europe, where EU benchmarking is less common, and where the herds of sheep (=fund managers and traders) are fewer and also fractionalised between different regions, trading barriers and thus benchmarks. At another level, we believe, in order for behavioural finance to be an integral part of an investors' overall investment process, it must be able to face the challenges faced by the toughest markets: trading large caps on Wall Street.

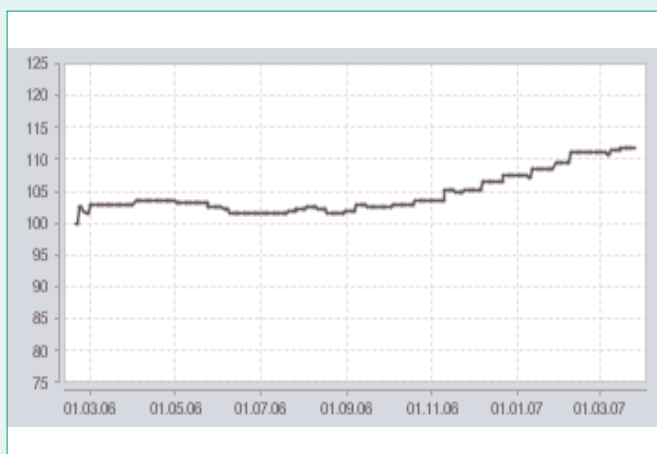
#### Who should be investing in such a strategy and why? What sort of net annualised returns can they expect?

Today, more than 90% of the Dog Fund's assets under management are institutional. Among individual investors it is only the most informed that can relate to behavioural finance - we think it takes a very special kind of manager to accept that they, as a group, are adding “negative” value. We try to profit from their aggregated incompetence. For our long-only Dog Fund we expect to outperform the US market with some risk-adjusted 50% higher returns per annum over a business cycle (for example, 15% versus the market's 10%). In our long/short mandates this outperformance is dependant on the leverage applied.

#### Comments/remarks...

“The king is naked” ...

## FINANCIAL FIX: PURE ALPHA CERTIFICATES



Certificate's performance graph

Source: Nomura International Plc.

**Focus:** The Nomura Pure Alpha Certificate's underlying, \*Südprojekt Fund Market Neutral DWS, takes a long position in potentially outperforming equity funds versus a short position in the relevant benchmarks. The result of this process is the outperformance of the target fund over its benchmark, which is typically leveraged by a factor of five. The ability to pick the right fund, and to enter and exit it at the right time, are crucial to the generation of alpha - and is achieved by running a proprietary model.

**Strengths:** The underlying fund's financial advisor, Südprojekt, have a proven track record of over 2 decades in fund research and underlying's manager, DWS, has pedigree; can be used for purposes of portfolio diversification; low cost of subscription; competitive fee structure; provides daily liquidity

**Weakness:** the certificate's underlying is sensitive to market movements

**Opportunities:** certificate structure provides access to an underlying hedge fund that has expertise, the ability to identify and invest in some of the best performing equity funds

**Threats:** although stress tests exist, the underlying's ability to sustain alpha generation in bear markets remains to be proven

### Risk Assessment

☐ = low 
 ☐ = low/moderate 
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 ☐ = moderate to high 
 ☐ = high

#### At the certificate level:

Major risk(s) the certificate is subject to: **Market risk from providing daily liquidity in the certificate despite the underlying only being tradable monthly. Risk is mitigated by a risk premium contained in the bid-offer spread**

Ability to track and control risk posed by Südprojekt Fund Market Neutral DWS underlying fund: ☐☐☐☐☐

Leverage related risk: **not applicable at the certificate level**

#### At the underlying\* level:

Diversification achieved via underlying\*: ☐☐☐☐☐

Geographic level: (Euro land, Europe, Germany, US, and potentially Japan): ☐☐☐☐☐

Sector level: (most large-cap equity funds): ☐☐☐☐☐

By market capitalisation: (mostly large-cap equity funds): ☐☐☐☐☐

Time horizons (avg. time invested in a fund): **1-3 months**

Avg. correlation among the various fund constituents: ☐☐☐☐☐

Underlying\*'s sensitivity to market risk: ☐☐☐☐☐

Underlying\*'s sensitivity to interest rate risk: ☐☐☐☐☐

Underlying\*'s sensitivity to currency risk: ☐☐☐☐☐

Underlying\*'s leverage (adjustable leverage of the long-short positions is systematically reduced in line with the manager's market outlook): ☐☐☐☐☐

Underlying\*'s annual expense ratio, specify (0.46%): ☐☐☐☐☐

Competition related risk faced by underlying: ☐☐☐☐☐ Key man risk: ☐☐☐☐☐

### Performance Parameters

☐ =insufficient 
 ☐ =adequate 
 ☐ = satisfactory 
 ☐ = good 
 ☐ = outstanding

#### At Certificate level:

Ability to deliver targeted returns in:

A rising market: ☐☐☐☐☐

Falling market: ☐☐☐☐☐

Sideway trending market ☐☐☐☐☐

Suitability to:

Inclusion in a conservative portfolio: ☐☐☐☐☐

Inclusion in a balance/ aggressive portfolio: ☐☐☐☐☐

#### At underlying\* level

Expertise in identifying the "out performers"

(75% of the fund's monthly performance since inception is positive): ☐☐☐☐☐

Ability to deliver uncorrelated returns = ☐☐☐☐☐

### Outlook

☐ upside potential 
 ☐ upside to range bound 
 ☐ range bound 
 ☐ range bound to down 
 ☐ downside potential

#### At certificate level:

Scope for a pure alpha certificate ☐

Barriers to entry in the space: **moderate**

Best case scenario: **all the selected funds in the underlying outperform their benchmarks and this outperformance is leveraged**

Worst case scenario: **majority of the selected funds in the underlying underperform their benchmarks**

Ability to achieve targeted performance:

Between 12-24 months: **high**

Ability to deliver uncorrelated returns: **high**

### Investment Insights

#### At certificate level:

Certificate's targeted annual net return: **9-12%**

Fee: **0.85%pa**

Target audience: **broad based**

Level of complexity at certificate level: **simple**

Traded on: **the Stuttgart Stock Exchange**

Base currency and available in: **EUR**

Liquidity provided: **daily**

To optimise returns, recommended avg. holding period: **min. 12 months**

## ETFS

**Focus:** of the **SPDR S&P Metals and Mining ETF** is to replicate as closely as possible, before expenses, the total return performance of the S&P Metals and Mining Select Industry Index (which is an equally weighted market cap index and represents the metals and mining sub-industry portion of the S&P Total Market Index). The sectors covered by the index include: coal and consumable fuels, aluminium, diversified metals and mining, gold, precious metals and minerals, steel.

The Index is rebalanced after close, on the third Friday, of the quarter ending month. The reference date for additions and deletions is after the closing of the last trading date of the previous month. A company is deleted from the index if the S&P Total Market Index drops the constituent. However, no companies are added between rebalancing.

**Strength:** the ETF provides exposure to the US metals and mining sector (Index constituents are chosen using the S&P select industry indices methodology); it is liquid; low cost; can be used for diversification and for hedging

**Weakness:** US concentration, capitalisation bias

**Opportunities:** in the case of most metals and minerals there exists a demand - supply dislocation which has been fuelled by rapid economic growth, especially in emerging economies

**Threat:** although the sector is poised to do well over the long term, it could be subject to market related set backs in the short term

### Risk:

Expertise in structuring index: **high**

Diversification achieved by the Index

Geographic: **US concentration**

Sector and at stock level: **broad based representation; but large cap concentration**

Price to book ratio: **3.06**

FY1 Price /Earning ratio: **14.56**

Ability to maintain low portfolio turnover: **yes**

Ability to keep transaction costs low: **yes**

Number of holdings 27 - weighted average market capitalisation: USD6,439.86 mn

### Performance

ETF's ability to deliver targeted returns in a rising: **high**

falling, sideways trending markets: **moderate**

Suitability to:

ETF's inclusion in a conservative portfolio: **good**

ETF's inclusion in a balanced portfolio: **good**

ETF's inclusion in an opportunistic portfolio: **good**

ETF's gross expense ratio: **0.35%**

### Outlook:

Scope for a metals and mining ETF: **high**

Conditions needed for a relative out performance: **bull market; sustained economic growth**

Conditions for an under performance :**economic downturn**

ETF's YTD change: **15.8%**

ETF's Ability to deliver targeted annual returns: **high**

Index's quarter-to-date-performance (as of 28.02.2007) : **10.17%**

Index's performance since inception on 19.6.2006 (and as of 28.02.2007): **25.72%**

### Investment::

Target audience: **broad based**

Level of complexity: **simple**

ETF offers: **sector diversification**

To optimise returns, recommended avg. holding period: **can be wielded opportunistically or used as a passive investment**

Available to investors: **globally**

Base currency of the ETF: **USD**

Liquidity provided: **daily** (individual ETF are non redeemable as fund trades can be executed in aggregation only); is marginable and can be **traded short**

Transparency provided: **high**

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