

FINANCIAL FIX: CUMULUS WEATHER FUND



Fund's gross notional allocations between strategies, since inception
Source: PCE Investors

Focus:

Portfolio focuses on weather events - seeking to assess the effects of short-term weather on underlying asset prices - and trading only when fundamentals and weather signals are aligned

Default allocations of 40% each to the commodity and equity portfolios and 20% to weather derivatives

Equities universe: 500 international large and mid caps

Commodity universe: energy and environmental commodities

Weather derivatives: a diversified portfolio - excluding catastrophe bonds and similar "fat tail" structures

Strengths: ability to detect and profit from events missed by the broader market

Weaknesses: not always possible to eliminate all non-weather risks

Opportunities: under-informed markets provide very high risk-adjusted returns

Opportunities are identified using a quantitative model with a discretionary overlay to filter, structure and execute trades. Trades are structured according to the expected impact of the weather event and may be through the underlying asset or through derivatives. The weather effect is isolated using a variety of hedging techniques, including index futures, sector baskets, pair's trades, cross-asset trades and calendar spreads. Risk is reduced by systematic purchase of options.

Threats: non-weather factors can sometimes outweigh weather factors

Risk

□ = low □ = low/moderate □ = moderate □ = moderate to high □ = high

Weather risk: □□□□ **this is the primary risk**

Ability to identify and exploit weather related trading ideas: □□□□

Geographical risk: □□□□ **broad based with occasional conc. in one specific region**

Market risk: □□□□

Correlation among asset classes in portfolio: □□□□

Correlations within an asset class:

Stocks: □□□□

Commodities: □□□□

Weather events: □□□□

the primary goal of the weather derivative portfolio is to generate returns without directional or correlation risk and the fund structures its portfolio accordingly, with a variety of positions in different seasons across many locations in Europe, North America and Asia

Leverage used: average 1.28, highest since inception approx 3

Liquidity risk: □□□□

the fund could unwind all positions in one business day without material loss – in particular the weather derivatives market trades USD100 bn per year and our entire exposure to those assets is less than USD20 mn, i.e. 5% of an average day's volume

weather derivatives are almost unique in financial markets in having prices that are not influenced by market sentiment because the temperature will not be impacted by rises in interest rates or market crashes]

weather derivatives have maximum payouts ensuring losses are contractually limited even in the theoretical situation that weather risk and liquidity risk occurred together

Key man risk: □□□□

Performance Parameters

□ = insufficient □ = adequate □ = satisfactory □ = good □ = outstanding

Avg. no. of positions held in the portfolio: **around 25 but quite variable depending on prevailing opportunities**

Annualised volatility since inception is: **13.42%**

Fund tends to outperform:

Low volatility markets with unusual weather

Fund tends to underperform:

In periods of very high market volatility with no exceptional weather events

FINANCIAL FIX: CUMULUS WEATHER FUND - II

Based on your stress tests, probability of fund experiencing a sigma 5 events and anticipated loss:

The Fund actively minimises its tail risk and invests several % of AUM each year in options to protect against adverse events (for example, oil call options and equity index put options)

The Fund considers a large number of scenarios and quantifies the "worst case" loss of less than 5% with all positions losing money simultaneously (including spreads blowing apart)

Suitability of inclusion in:

A conservative portfolio: ☒ ☐ ☐ ☐ ☐






A balanced portfolio: ☒ ☒ ☒ ☒ ☐

An opportunistic portfolio: ☒ ☒ ☒ ☒ ☐

Capacity that can be managed: USD:400 mn

Annual expense ratio: the fund spends approx 3-4% per year on options to minimise tail risks


Outlook

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

Barriers to entry: High

Performance hinges on possession and ability to apply weather expertise

Edge is very persistent due to the high barriers to entry and the increasing importance of weather as a factor in financial markets

Scope for a weather fund: 

The fund does not focus on extreme conditions (like hurricanes) but on equally important but more subtle conditions like warmer than normal weather which, for example, moved the oil price by USD10 this winter

Ability to the fund to deliver uncorrelated returns to:


CSFB Hedge Fund Index: 0.411, r2 0.17

GSCI Total Return Index: 0.203, r2 0.04

Brent Crude: 0.071, r2 0.01

S&P: 0.168, r2 0.03

Ability to deliver targeted returns over:

The next 12 months:  very high

Over the next 3-5 years: high

Investment Insights

Targeted annual net returns: 20% (21% net for 2006 and 11% net 2007 YTD)

Target audience: institutional investors, HNWI - minimum subscription price is USD1m

Level of complexity: moderate to high

To optimise returns, recommended avg. holding period: 1 year

because the fund is systematically long volatility and can have out-sized returns in some periods, and because weather patterns can conspire against the fund for a few months

Available to investors: globally

Base currency: USD

Other currencies the fund is available in: GBP, EUR

Liquidity: monthly with 90 days redemption notice; no lock ups

Transparency: fairly high

PCE Investors is authorised by the Financial Service Authority

Fee structure: 2% management; 20% performance

PRACTITIONER'S POINT

Asset Backed Securities



George Tintor has 15 years of experience in originating, developing, executing complex structured financial transactions

Based on your experience, what makes an investment in asset-backed securities lucrative?

The basic value in asset-backed securities, including collateralised debt obligations and collateralised loan obligations, is derived from the ability to tranche the capital structure transactions, from AAA to "equity" classes. This allows for an efficient distribution of the underlying risk to investors with varying risk profiles. As a result asset-backed securities achieve a higher yield at any given rating level than traditional fixed income securities.

Skilled fund managers go a step further as they are capable of identifying and exploiting relative value opportunities prevalent in the asset-backed security market. These can be very profitable and are caused by: supply/demand imbalances, complexity premiums, rating agency inconsistencies, etc.

How sensitive are such investments to economic fundamentals? Are such investments capable of delivering "uncorrelated" returns?

The collateral underlying asset-backed securities can be very sensitive to economic fundamentals. Collateral can range from portfolios of corporate bonds and loans to residential and commercial mortgages. When investing in asset-backed securities, it is important to determine how the value of the security will be affected by deterioration in the value of the collateral.

"Uncorrelated" returns can be achieved either by employing relative value strategies in the asset-backed security market or by investing in junior or distressed tranches on a value-oriented basis. The

latter approach requires an in-depth bottom-up security analysis as the objective is to "buy cash flow" cheaply enough to cover hedging costs, withstand collateral losses and still meet return targets.

The underlying risk of an asset can be transferred; transformed, spread, diversified, diminished - but it still exists. Elaborate.

The development of the credit default swap market and securitisation techniques have actually improved the ability of banks and investors to manage credit risk. The emergence of a very active, liquid and efficient credit derivative market gives the financial system the ability to price, hedge, buy and sell credit risk - something that did not exist a decade ago. As a result, credit risk is distributed far more widely today than ever before.

Can one systematically control, mitigate and even eliminate unwanted asset-backed security risk?

The main risks faced by hedge funds investing in asset-backed securities are credit default risk, credit spread risk and liquidity risk. The first two can be mitigated by diversification: the holding of short-spread-duration securities, portfolio and security-specific short positions in the credit default swap market and by implementing sophisticated surveillance systems. Liquidity risk can be mitigated by embracing term financing facilities and by holding excess capital.

What criteria do you apply to managers you are looking to invest with?

A key element of our due diligence process is to determine how a fund will perform during a period of market stress. In the current benign credit environment, with tight spreads and low default rates, we seek funds that are positioned to generate consistent positive performance during a period of widening credit spreads and increasing default rates. We assess the manager's ability to withstand a severe market shock and to benefit from the distressed opportunities that would emerge.

Credit rating agencies play a pivotal role in analysing and assessing risk. Do you agree? How well do they play this role?

Credit rating agencies do indeed play a key role in assessing risk. In fact, the increasing demand for structured credit products can be partly attributed to the rating agencies' ability and willingness to rate new structures. Nevertheless, those investors who buy asset-backed securities based on ratings alone, do so at their peril. From our experience, the value generated by top fund managers can often be attributed to what is called "rating agency arbitrage."

Is liquidity still a major constraining factor?

No. Today it is possible to get multiple dealer quotes for almost all asset-backed securities. This represents a substantial improvement over the situation a few years ago, when junior and distressed asset-backed security tranches were generally illiquid. Nevertheless, in a period of market stress, liquidity could dry up fairly quickly.

What are the new instruments? What are their limitations?

The pace of innovation and technological advancement experienced by credit markets since the late 1990s has been extraordinary. New instruments, such as asset-backed security credit default swaps and synthetic structured credit tranches, are constantly being developed and offer new ways of getting exposure to or hedging credit risk.

The main limitation of some of the newer instruments is that the market for them can be thin and there is a potential lack of liquidity. Investors need to be aware of this.

Remarks, comments... Our outlook for the performance of asset-backed security hedge funds over the next 12 to 24 months is positive. Relative value and distressed investment opportunities are expected to rise. In particular, significant distressed opportunities are expected to present themselves in the second half of 2007, in the US asset-backed security market, as recent vintages backed by sub-prime mortgages suffer from deteriorating collateral pools. The best managers have already positioned themselves for this downturn by investing in short-duration, seasoned securities and by hedging their portfolios against credit spread and default risk.

FINANCIAL FIX: INGENIOUS VENTURES - MUSIC VCTS

Focus: Venture Capital Trusts (VCTs) provide an innovative opportunity, with significant downside protection, to invest in a portfolio of music companies (each, an Investee Company) that will be engaged in the creation and exploitation of intellectual property rights.

Strengths: managed by Ingenious Ventures - which is the venture capital arm of Ingenious Media plc, a specialist media finance business. It has proven experience of successfully structuring, promoting and managing investment opportunities across the entertainment industry and is the largest VCT of its kind in the UK with over GBP15 mn of funds under management.
Weakness: liquidity constraints

Opportunity: The immediate and long-term future of the recorded music industry is perceived as positive, with the uptake of digital and mobile distribution platforms driving overall revenue growth. This allows talented artists to continue building capital value in their intellectual property. By investing at an early stage, the Company believes that it will be able to obtain a beneficial position in the revenue streams of the Investee Companies as well as ensuring that significant distribution licences and/or minimum royalty agreements are put in place.

Threats: Changes in legislation concerning VCTs in general could restrict or adversely affect the ability of the Company to meet its objectives and/or reduce the level of returns that would otherwise have been achievable.

Risk Assessment

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

Investee company's ability to identify, secure and place a rights exploitation contract: ☐☐☐☐☐

Risk of "default"/ investment turning sour: ☐☐☐☐☐

Ability to recover full value of collateral in case of a default: ☐☐☐☒ collateral can easily be recovered

Ratio of Investee companies that have out performers vs. underperformer: too early to say

Risks posed by: constraints on selling the Invest company: ☐☐☐☐☐

Risk posed by loss of VC status: ☐☐☐☐☐

Risk posed by changes in legislation concerning VCTs in general: ☐☐☒☐☐

Risk posed by liquidity constraints: ☐☐☐☐☐

Competition: ☐☐☐☐☐ "there is none"

Especially from music stars/groups that launch themselves on the web: ☐☐☐☐☐ plan on working with them

Impact of free download of music on the internet: ☐☐☒☐☐

Key man risk: ☐☐☒☐☐

Performance Parameters

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

Ability to secure level of sales in recorded music and associated artists' rights generally ☒☒☒☐☐

Ability to earn dividends and realise capital ☒☒☒☐☐

Ability to identify talent ☒☒☒☐☐

Ability to forge deals with "established brands", with unknowns that have the potential ☒☒☒☒☒

Suitability to:

Inclusion in a conservative portfolio ☒☒☐☐☐

In a balanced portfolio ☒☒☒☐☐

In an opportunistic portfolio ☒☒☒☒☐

Annualised expense ratio: 2.5%

Ability to deliver uncorrelated returns to other asset classes

Equities ☒☒☒☒☐

Bonds ☒☒☒☒☐

Hedge funds ☒☒☒☒☐

Outlook

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

Scope for music VCTs: ↑

Barriers to entry are high - need high level of contacts in the industry

Conditions for relative out-performance Hit driven business

Conditions for relative under-performance : "flops"

Investment Insights

Min. holding period: 5 years

Base currency of share: GBP

Transparency provided: fairly high

Risk/reward compensation: moderate

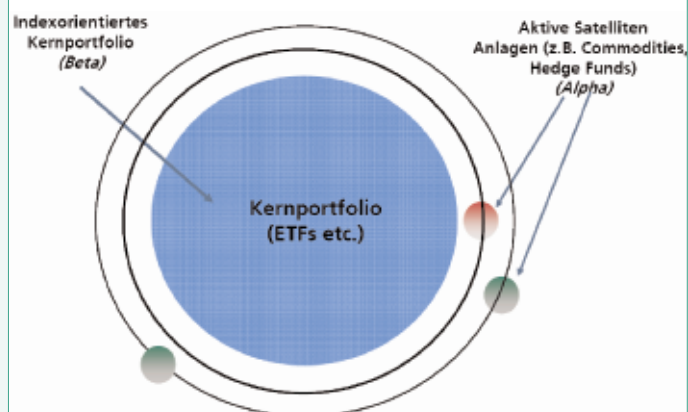
ELECTRONICALLY TRADED FUNDS

Although ETFs have been around for almost a decade, why have they only gained popularity over the last few years?

Since they were first launched in Europe in April 2000, ETFs have demonstrated impressive annual asset growth rates between 39% and 78%. As with any new financial instrument it requires some time for investors to learn about its benefits for them to invest.

Institutional investors that dominated the ETF market in its early stages appreciate ETFs for their liquidity, transparency and cost-efficiency. UBS Global Asset Management has therefore decided to launch an institutional ETF share classes specifically targeted to meet their needs. More recently, private investors have discovered ETFs as a cost-efficient tool to implement short term tactical shifts and to improve portfolio diversification.

Core /satellite approach to investing



Source: UBS Global Asset Management

What were the limitations back then and what did it take to thaw the ice?

ETFs combine the mutual fund world with the trading flexibility of stocks. While this structure offers new investment opportunities for investors, it presents certain challenges for the product issuers: European fund regulators had to feel comfortable with a new fund product that investors would typically not subscribe or redeem but purchase and sell like any blue chip stock on an exchange.

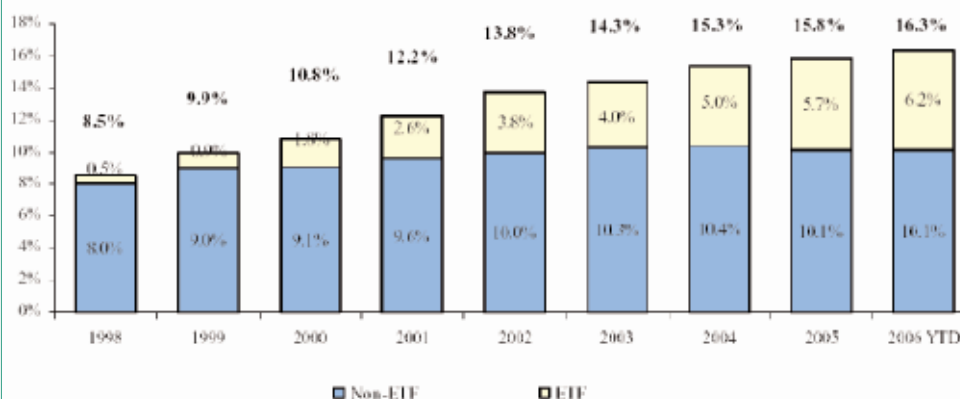
Moreover, it requires an educational process to understand the true liquidity of ETFs. Essentially ETF liquidity is identical to the liquidity of the constituent stocks in the index and not the observed liquidity in the secondary market which is usually a small fraction of the former.

Do you believe there is a recognizable shift in the way assets are being allocated now - i.e. as a percentage - the amount being allocated to "passive" instruments is on the rise? Is this a trend for the near term?

We can observe a general trend towards passive investing in Europe which ETFs and other passive vehicles benefit from.

Compared to the US where around 16% of all equity fund assets are indexed the share in Europe is around 8% and expected to rise.

As a percentage of total stock wealth in the US...



Source: Morgan Stanley Research, Strategic Insight. YTD = Year-to-date as of 30. August 2006



Dr. Christian Gast is Head UBS Exchange Traded Funds

What are the constraints posed by ETFs and the risks involved?

ETF investors gain exposure to a diversified basket of securities as represented in the underlying index of the ETF. The index provides a diversified portfolio of stocks and thereby reduces the risk compared to investments made in single stocks.

However, the investor is still exposed to the general risk posed by equity investments.

Building on ETFs – what is the next generation of hybrid products an investor can expect? When? What sort of risk reward profile will they have and how affordable will they be?

There is a general trend of ETFs expanding out of the passive space into more active type of investing. Examples are ETFs providing leverage, a capital protection or ETFs based on fundamental indexes.

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