

### **DEXION ABSOLUTE LIMITED – INVESTOR CALL**

On 8 February 2010 Dexion Capital plc hosted an open Question and Answer audio web conference call with Aurora Investment Management L.L.C. (“Aurora”) the Investment Adviser to Dexion Absolute Limited (“the Company” or “DAL”).

Present on the call were:

**Roxanne Martino (“RM”)**, Partner, President, CEO and Portfolio Manager of Aurora

**Justin D. Sheperd (“JS”)**, Partner and Portfolio Manager of Aurora

**Ana Haurie (“AH”)**, Group Managing Director, Dexion Capital plc and Dexion Capital (Guernsey) Limited

An overview of the topics discussed and the views of the panel are summarised below.

A link to the audio replay of the call can be found on the Company’s website at [www.dexionabsolute.com](http://www.dexionabsolute.com) under Web Conference.

### **OVERVIEW OF MARKET ENVIRONMENT**

RM: 2009 saw substantial global fiscal and monetary support stabilising financial systems and the markets. The credit market started rallying and investors were more open to risk. As that was occurring, our managers were taking advantage of pricing dislocations in many areas. Many companies’ equity was priced for a complete failure as the year started, yet as the year progressed companies were able to shore up their balance sheets through equity issuances, debt re-structurings and cost reductions. The fundamentals of the companies were of great importance again as inner stock volatility correlation went from 60% (a historical high in the US market) at the end of 2008, down to 30% as the year progressed and with this we also saw credit spreads tighten. The beginning of 2009 also experienced a shortage of risk capital which our managers really took advantage of. Reduced competition from proprietary trading desks created outsized opportunities in credit, equities, event driven and generally across the board.

The strong environment in 2009 saw managers restructure their portfolios by using capital more promptly than we have seen in a very long time. At the end of 2008 and through to 2009, managers reduced exposures and leverage. From what would normally be a leverage of 2:1, we saw leverages of 1:1 thereby proving that managers were not using much of their balance sheets coming into 2009. Managers began expanding their exposures and their leverage as the year progressed, but still only at 1.3 which is considerably low for this kind of portfolio. However, with a low gross of about 130 and a low net of about 40, managers are still seeing many opportunities and reaping rewards from it.

As the equity market started rallying we often saw companies that were the weakest, having levered balance sheets and low earnings, rallying the most. This negatively impacted shorting for both the

long/short managers as well as the short selling ones. It was a varied year, but with a lot of opportunities and one that ended well.

## OVERVIEW OF STRATEGIES AND PERFORMANCE

We thought we would examine how our allocations have changed in response to these market conditions that we have seen. When 2008 ended we were looking ahead and adjusting our portfolio to capture the opportunities that we thought would emerge from the downturn which took place in 2008. We continued to shift capital in 2009 focusing on the Long/Short Credit and Long/Short Equity sectors as we have started doing in 2010.

At the beginning of 2009 we moved more capital into Long/Short Credit and moved capital away from the Activist sector. The largest allocation remains to Long/Short Equity. Within our portfolio we believe that this allocation for 2008 would have created a means for companies to restructure their balance sheets so we wanted to focus some capital in both the bankruptcies and restructuring area with Long/Short Credit as well as Long/Short Equity. The general lack of capital at the beginning of the year in 2008 meant that our managers had unusual opportunities and did very unusual things within their portfolios, which were beneficial for us. They continued to expand the balance sheets that they were using.

In the Long/Short Credit area we increased our component in credit by about 7%, which reflects the positive view that we have of that sector. Activist decreased about 4%, again we are moving capital away from the Activist sector. We feel that in that area there will be fewer opportunities for managers that are substantially long and working in sectors that perhaps will have some down drift from the decrease in business activities. In Long/Short Equities, we continue to have a strong view on that and we increased that by 2% and it remains our largest allocation. Multi-Strategy Opportunistic had a slight decrease of about 3%, representing manager changes rather than a top down view of that; Portfolio Hedge remained very robust with an increase in debt by about 1%.

Long/Short Credit is an area where we saw great opportunities. As we were coming out of the dislocations that we saw in 2008 we noticed that as had happened in the past when these dislocations happened, there is a natural supply/demand imbalance. When there is an investment grade bond lots of people can hold them. When they are downgraded less people can hold them and as the default rate goes up there is obviously a much higher supply of bonds in this category. Demand however goes down and in this crisis the demand was significantly lower as hedge funds' balance sheets were also low due to performance redemption and the decrease in leverage, but also proprietary banks and other natural alpha seeking capital was not in the market as it had been in the past.

Coming into 2009, one of the main areas our managers took advantage of was the financial sector which was clearly in the heart of the unsettlement. Our managers were involved with banks, insurance companies, brokers, all looking at companies that perhaps people were very scared about, but where our managers thought there may be a Government backed guarantee or where there may be answers on the

balance sheet that people weren't realising. A lot of the alpha that came out of that portion of the year was managers stepping in and taking positions when it was actually quite a scary time to do so.

As the year progressed it was becoming much more of an event driven strategy with longer term work outs and catalyst-driven investing. These things are a little less market driven although there are still just some value positions in there. When we talk about event driven we talk about those positions we have seen over the last couple of quarters. A company in the yellow pages area, or a company in the car parts area, where there are defined bankruptcy processes that they are going through and our managers are looking at the value they see coming out of the other side of this process and trying to take advantage of it.

Our managers are very focused on the individual instances and the individual security selection, so we have one manager who did very well in November in a position in a car parts company that came out of bankruptcy; he had actually been short that same company as they went into bankruptcy. Our managers are very focused on understanding each and every situation and we think there will be a higher dispersion of returns going forward and each and every situation will be unique.

Our largest allocation remains in Long/Short Equity. What we have seen over the years is that as intra stock correlation decreases from the unusual highs of 2008, our managers started reaping rewards. Obviously our managers can have very powerful portfolios, both benefiting from the longs and the shorts, if stocks trade based on their fundamentals. However, as they move towards more technical trading with correlation high it is very difficult for Long/Short managers to make money. As 2009 progressed, we moved away from those historical highs of intra stock correlations to more normalised numbers of about 30% eventually.

Our managers were able to reap rewards from that, specifically our European and Asian managers did very well in the environment. In Europe profit was made in large investment banks, the mining area, transportation and basic materials. In Asia we saw renewed risk appetite; we made money in emerging market banks. We made money in India, in financial services, real estate and infrastructure. Our long/short health care manager did extremely well - Biotech, Pharma, Health Care Services - and in the US we also did very well in industrials, health care and financials. It was a profitable year, not only in the Long/Short Equity sector globally, but also across many other sectors.

The Long/Short Equity return of 21.6% was generated with an average exposure through the year of about 52%; so the market implied return of 52%. This proved that our managers were able to add value with exposure management and stock selection, particularly on the long side, as the short side experienced some difficulties during the year.

In the Activist sector, increased equity market returns contributed positively. However we are decreasing our exposure in this sector with one manager already being sold during the year and another one currently on its way out. Gains were seen in Scandinavia, Europe and the US across a wide array of sectors with

benefits coming from cost reductions as well as many companies being able to shore up their balance sheets due to the credit markets loosening up. While we are decreasing our allocation to activists over time, they were able to reap a steady reward this year.

Multi strategy opportunistic had a good year compared to the more difficult 2008. Some of the themes we spoke about in equities and in credit were very important here. Our managers took advantage of some of the opportunities that came about in the basic materials space, in particular a gold producer, both in the US and globally towards the end of the year. One manager did well in Australia, while another manager did well throughout the year in Canada. The latter bought a position in an oil funds company that rallied throughout the year as the assets were marked too cheaply and there began to be a lot of strategic interest in the company from some of the larger players.

On the credit side our managers did well across the globe. European Hybrid Securities did well for our managers as did a valuation and investing in the Icelandic Bank situation. As the year progressed and the credit markets eased up a little, we also began to see more merger and event-driven activity and our managers were able to take advantage of that, both in spread trades as well as trades that became competitive bidding situations. We did add a manager focused on the global event driven area in November, therefore we continue to think there are some great opportunities for our managers in the multi strategy opportunistic space.

The most challenging area was certainly the Portfolio Hedge area. As our short sellers came into 2009 they were under allocated, missing the decrease in the markets in January and February. Unfortunately they started expanding their exposures as the market started rallying. We often saw some of the worst companies, the ones with the troubled balance sheets as well as really bad earnings which our managers tend to focus on, rallying the most. As we've expressed to you, we really believe in this Portfolio Hedge component as an integral part of how we manage this portfolio and we remain committed to it. Our managers remain allocated to themes such as technology, hospitality, consumer; if these businesses have troubles they're going to have a hard time surviving both with the decrease in the demand as well as some of the structures that they're operating these business under; those themes therefore remain widely in our portfolio.

Rounding out the six strategies is our Macro area which had a mediocre year of just over 9% return. Returns came from the Emerging Markets as well as the classic Macro managers who did well in fixed income, trading pretty consistently throughout the year, being long the front end of the curves in the US and elsewhere, and throughout the year being involved in steeper trades as well as flatteners. On the commodity side there were some trading profits, however it was not a strong contributor to performance.

In summary our outlook for 2010 remains positive for our managers. We remain firm believers in Long/Short Credit and that it will really have a lot to select from as companies are starting to continue to go through restructuring their balance sheets and adjusting their businesses for a reduced demand. We expect Event Driven Strategies to do well as companies seek acquisition, mergers and consolidations and

we already began seeing a pick up of this towards the end of 2009. As stock correlations return to a more normalised level we expect our Long/Short Equity managers will have a lot to do as there'll be a lot of winners and losers emerging during these volatile times. We believe our portfolio is well positioned to benefit from these conditions and their managers are nimble enough to capture these solid returns from them.

## QUESTIONS & ANSWERS

Q: Would you please elaborate on Tepper's outstanding performance in terms of the trades he made, his thinking, rationale, backing the trade and more importantly where to go from here and what opportunities is he seeing?

JS: He is one who took advantage of the dislocation and the financial space. He understood where he was with the Government and given that, he did not think that all of these institutions would go away and profit from it, as well as from areas in the Commercial Mortgage-Backed Securities ("CMBS") sector. He continues to see value, and a lot of things to invest in. He obviously does not expect a repeat of the performance that we had last year from him, and neither do we, but still a lot of event driven activity will end in the Long/Short Credit base and he still sees a lot of value in some of the same positioning he had earlier in the year.

RM: We are very positive about the opportunities that he sees because he is fully allocating his capital. He is a manager that tends to give the capital back if he really does not see a place to use it and he would not hesitate to do that, but today he is using all his capital and we are talking to him frequently about that opportunity; he certainly does seem very positive about it.

Q: Given the historic rally in credit in 2009, are you still allocating to Long/Short Credit, Distressed and Structured Credit i.e. Residential Mortgage-Backed Securities ("RMBS"), CMBS Managers, and if so where do you see the opportunities?

JS: We are allocating to Long/Short Credit managers because we think there are a lot of great opportunities there. We may not have the rally we had last year, but there is still going to be at least slow growth here in the US and globally and there will be companies that undergo distress who have to either do formal bankruptcies or restructurings. We have not made a specific allocation to the RMBS or CMBS space, but we do have managers both in the Long/Short Credit and the Multi-Strategy Opportunistic that are taking advantage of that. It allows us not to make as small of a decision or as narrow of a decision to go into that specific area when these managers can look at that opportunity set versus corporate credit and elsewhere.

RM: We are fairly optimistic because our managers are and so when we are talking to our managers about the opportunity set before them they think the year ahead will be full of opportunities. Even though we have just had a very robust year in Long/Short Credit they remain very positive about what will happen in the future.

JS: Further on that is that on September 1<sup>st</sup> we were able to add a great new manager to the area, someone who has been investing in Long/Short in distressed companies for well over 30 years. He has been an excellent addition to the portfolio so obviously it is important for us when we see good areas of opportunity to also have the talent to take advantage of that and we certainly feel we are in a position of strength on that point.

Q: I have got a question on the Thoroughbred and Palomino funds. They are a combination over 12% now; what sort of position size are you happy with that fund in general and any other individual positions?

RM: We substantially cut their position at year-end pulling capital back and some of the profitability that we had in that. It is a manager that we don't have the ability to adjust downward that frequently and so we took advantage of the liquidity that we had at year-end to reduce that exposure.

JS: He came into 2009 as our biggest position and he was our best performer so no change in our opinion of the manager, but obviously we had to reduce it to get it down to appropriate level.

Q: What will be the likely impact on hedge funds of the recently announced proposals by the US President to curtail the propriety trading activities of US banks, particularly in relation to the potential impact on liquidity in markets and prime broker relationships?

JS: I think there are couple of aspects to that. One is that there is the vocal proposal and obviously it is unclear what the final result will be and we will not comment on that, as it is unclear; also whether or not it will solve the problem intended. The way we see it is if there are large levered players that are taken out at this stage, while there may be some volatility around that, it will open up a wider opportunity set for hedge funds and the managers we invest in. In addition to that we think there will be a continued amount of talent that moves towards the hedge fund space that is no longer able to invest capital as they see fit, therefore we see some good benefits to our investing style.

RM: We are very positive about the changes because I think there is going to be a lot of talent leaving these institutions that these institutions won't have the benefit of and we can take a look at that and decide if it is something that we want to be involved in for many years to come.

Q: Could you provide an update on the one year plus liquidity bucket on the fact sheet in more detail; could you outline if any of this is still gated, liquidating or locked up?

AH: We recently published a portfolio liquidity profile in the circular calling for the class meeting for the continuation resolution; that is on page 25 of said circular. To run through it briefly, by 31<sup>st</sup> December 2011 the portfolio has 85.2% liquidity and by 31<sup>st</sup> December 2012 there is 93.3% liquidity; so that leaves 6.7% of the portfolio which is illiquid. Approximately 1.8% of that was invested in underlying funds that were gated or suspend realisations, or commenced liquidation proceedings and the balance of 4.9% is invested in designated investments or side pockets. As the date of publication of that document the liquidity profile of these underlying investments is unknown. [\[Please click here for a full version of the Circular\].](#)

Q: Will Long/Short Equity perform better than Long/Short Credit in 2010?

RM: It is certainly hard to have a crystal ball. Our biggest allocations are to both of those sectors and so of course we believe in both of them. I would say looking forward I think the long/short credit is the most likely to outperform, both due to the talent pool that varies there and also the concentration that the managers take, and just frankly that these are pretty trying times for many businesses. I think that what they have to choose from will continue to expand as businesses are forced into some type of restructuring and in some cases bankruptcies. It remains amazing to me some of the opportunities that our managers are seeing and so there is not a lot of risk capital out there seeking these opportunities so that the returns that we are seeing are really quite remarkable. In answer to the question, I would say Long/Short Credit however we believe that both will benefit from the conditions that we are seeing.

Q: What are your thoughts on quantitative Equity Market Neutral for this year?

RM: As you know, we really have not allocated to that strategy much over the time that we have managed our portfolios. We believe that a lot of those systems do well over certain market conditions, but can start performing quite poorly and it takes a while for the managers to identify the source of the dislocation that is causing the bad performance and so often you are down quite a bit before the managers can adjust what they are doing. So we have favoured fundamental Long/Short Equity over a quantitative approach historically and we will continue to do so.

JS: When we see the dislocations in the fundamentally based strategies they are easier for us to understand, and when appropriate, to actually commit more capital to those dislocations. On the quantitative side what we found is sometimes the reasons are a little more difficult to comprehend.

Q: The leverage of the portfolio was reduced sharply in 2008. What is it now and how will it change going forward?

RM: When we finished 2008 coming into 2009 the managers were not leveraged; it was about 1:1. As the months went by, they increased their balance sheets, but really still at a low of about 1.3; so they have not expanded much although did so as the year progressed. I would say that they would continue to expand as the year continues and they have some profits under their belt. I would expect further expansion. Historically this portfolio has been about 2:1 and so this is really quite low at 1.3. However, when we talk to the managers about their exposures many of them are saying the opportunity set is so robust that they don't just feel like they need to use leverage to take advantage of the opportunities, but they have so much to do they don't really need it.

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