

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

On 10 June 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:

**Scott Schweighauser (“SS”)**, Partner, CIO and Portfolio Manager of Aurora

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

**Robin Bowie (“RB”)**, Chairman of Dexion Capital plc

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**

SS The story of 2010 so far has been a continuation of trends seen emerging in 2009. Risk appetite has returned to the markets with a considerable narrowing of risk premia, including credit spreads, driving managers’ performance.

The economic data coming through has broadly been very positive. The stimulus package and normalcy returning to the financial markets has benefited our hedge fund managers and risk takers in general. The first quarter saw strong performance across all of the sectors except for portfolio hedge. There were positive returns in each month, and this trend continued into April where there was strong performance. With the backup in the markets in May and a greater appreciation for some of the macro elements that may provide challenges, there was a decline in our performance.

Returns so far this year, through April, have been generated by our two largest sectors, the Long/Short Credit sector and the Long/Short Equity sector. Long/Short Credit managers had benefited from a continuation of risk-seeking on the part of investors who are focused on credit and spreads have narrowed. Our managers had allocations to very idiosyncratic positions which have benefited them, primarily in the financial sector where they benefited from a resurgence of profitability in that market and a rebound in valuations, providing many interesting opportunities. Our managers have branched out into more diversified positions in industrials and cyclically-orientated types of positions, which have been of benefit. Long/Short Equities managers have had very good returns so far this year, both on a risk-adjusted basis and an absolute basis. The ability of our managers to capture alpha in the first four months of the year has been very good. This was challenged in May, but through April managers have taken advantage of disparities in security valuations on both long and the short side in the US, Europe and Asia, with our internationally-focused managers having provided the best returns for this portfolio.

In the Multi-Strategy Opportunistic sector, we have also seen solid returns, as there was a migration of capital into more event-driven positions, taking advantage of the corporate activity we have seen emerging as strategic buyers and strategic alliances have driven stock market activity. These managers have also benefited in equity and debt positions all of which has provided a very nice opportunity set.

The portfolio hedge strategy, quite naturally, has been challenged by the robust movement in the market during the first four months. The back-up in the market in May provided an opportunity for our managers to show their mettle, providing a welcome buffer for the portfolio.

Finally, our Macro managers have treaded water this year. Strong moves in yield curves and in interest rates have both benefited and hurt. We remain optimistic that our managers will have tremendous opportunities with the numerous underlying macro economic trends that will provide them with pretty robust opportunities going forward.

In terms of our outlook for the markets, with the May backup resulting from a greater level of uncertainty in Greece and the rest of Europe, there is more concern about the potential for illiquidity to permeate the markets. The flash crash, with the very precipitous drop over a very short amount of time in stocks in the U.S., reinforced the notion that the markets can be very fragile. In terms of our managers' response to May's increased volatility, we expect the portfolio exposure to have declined in the month of May. We have modest levels of leverage which we will address later in the call, but the expectation that going forward the markets can and will be volatile, and that factor is built in to how people are managing their portfolios right now.

## **OVERVIEW OF STRATEGIES AND PERFORMANCE**

JS I will talk about the current portfolio positioning, touching on it in three areas: strategy level, manager level and manager look-through level, also on some areas touched on by Scott, a little deeper on the balance sheet uses that they are currently experiencing.

At the strategy level there have not been a lot of changes since the call in February. I will take a moment to go through the changes we made to get the portfolio to its current positioning. Long/Short Equity was increased back to its historic range at the start of the year and is still the largest strategy in the portfolio. We believe that there are some very interesting dynamics for this strategy, intra-stock correlations which continue to be at the high end of our historic range, though not as high as 2008 but as these normalise we believe there will be great opportunities. There is also a lot of latent alpha in the portfolio, they have come down a little and the managers have taken advantage of this, however they went back up in May which caused it to be a little more of a difficult month but we believe in the long-term there are a lot of dislocations still in the markets for these managers to take advantage of. Long/Short Credit is at the high end of its exposure range that it has been, we made a rather dramatic increase in this strategy at the end of 2008 to take advantage of the crisis that was unfolding which worked very well for us in 2009 and into 2010. We continue to be very encouraged by what we are seeing in this strategy although it is going to

have a different make up than it has had for most of 2009 and as we discussed on our call in February, it is going to be a very event-driven idiosyncratic market going forward. We do not believe that returns in 2009 can be replicated but we think that we will get some very high quality returns as our managers take advantage of companies that are undergoing distress in what will likely be a slower growing economy, as well as some of the stress that we are seeing in the European marketplace which we think in the future can add to a lot of opportunities for these managers.

We have decreased our activist allocation, one in lieu of the better opportunities we just covered but also due to some exogenous potential headwinds that these managers can have due to their net long equity exposure as well as some of the capital markets dependence that they may have in some of their strategies. We are comfortable with the allocation that we have but it is a little off the high we have had.

At the manager level we have been quite busy. We have added five new managers to the portfolio over the last couple of months, two of them are more classic to what we have done, very bottom up manager selection and three which again are managers we feel very good about but that fall into a theme within our portfolio hedge area. I will give an overview of the five managers. The first manager we added is a Global Event driven manager, a fund which we participated in on day one. As many people are aware we have done this many times in the past, we were invested on day one, with over 30% of the managers that we have investments with and 50% we were invested within the first year. This is an extremely experienced manager that we have known for over 10 years, he was formerly managing a portfolio within a multi-strategy hedge fund that we were familiar with. We have known the manager for a long time, known that he is a money maker, a good steward of capital and a good business builder so it is an investment which we are excited to have. The second manager we added is a commodities orientated manager to our Macro area, making two commodities managers within this area, although we believe they complement each other quite well. This manager is a little more directional in focus, extremely experienced with well over 20 years in the markets and the team he is currently trading with. He is very well known and respected with a particular expertise in the oil and energy space. The other three managers fall within a theme. In our Portfolio Hedge area coming out of 2008, we realised that specific asset classes could have events that are unforeseen affect the prospects for them. One example is in 2008 where the short selling ban made equity short selling a little more difficult. We have sought to diversify that allocation with some tail risk managers with a few small allocations to managers, and we have now added three managers all in relatively small size, each falling into one of the buckets that we are looking at within this area. The first manager falls into the specific macro risk bucket and who would do well in a specific macro event which we think could be a negative for risk assets elsewhere in the world. This manager would do well in a yield curve steepening or in a higher interest rate environment. The second manager falls into a bucket finding cheap protection across the globe with put like characteristics but across the asset classes so he could be involved in equity puts, risk reversals, spread trades but also credit spreads. Back in 2008 we had two managers focused on being short credit, or perhaps funding spreads, LIBOROIS or currency positions perhaps the Euro or something of that nature. The third manager is more in the bucket of just long

volatility I but with a little more straddle orientation than put orientation, a manager who has expertise in scouring the global options markets, finding volatility at very cheap prices, being able to put that into the portfolio and waiting for events that may cause volatility to spike. Obviously in a highly rising volatility environment other risk assets, which may be elsewhere in our portfolio, may not be performing as well. So far this year two managers have come out of the portfolio, both out of the macro area. In our constant quest to have the best portfolio we can we have to make tough decisions at times and the two managers came out in lieu of some the other opportunities we were seeing.

The final area to touch on is to look through to our underlying managers and what their balance sheets look like. There is a chart on the Monthly Portfolio Review that shows it has been relatively consistent for the year with the dip down at the start of the year when we were preparing for the DAB-level corporate action but it has been pretty consistent at 1.5 to 1. We do not have the data updated for 1 June yet but anecdotally talking to the managers with the heightened macro risk and volatility in the market, we certainly have seen some managers take some risk management precautions to pull back their exposure a little. As we have talked to managers over the last couple of months, while they are all acutely aware of what is happening in the world, we found them extremely engaged, pragmatic and looking forward to taking advantage of the opportunities.

SS: As many of you know, we go through an annual blank sheet review process which allows us to recalibrate the portfolio, taking a fresh look at the manager set, the composition of how we have allocated the capital within the portfolio, and to clean house. We have scheduled this year's blank sheet review for August. At present it is hard to anticipate what major changes might result, because we feel very positively disposed towards the allocations that we currently have, in terms of both strategies and managers. The world is a very interesting place right now, and as the opportunity set unfolds we will also see different areas of risk exposed, and that will inform our decisions in August and allow us to plan for the 2011 portfolio.

## QUESTIONS & ANSWERS

Q: What are the biggest risks to hedge funds over the next 12-24 months? Do you envisage a return of prime brokerage risks as in late 2008?

SS: That is an excellent question because it really speaks to the freshness of concerns that people have. Right now, any kind of exogenous shock which is unforeseen is going to provide the biggest challenge to any risk-seeking strategy, including hedge funds. Whether that takes the form of sovereign default risk in Europe, an abrupt Chinese economic slowdown, a currency crisis, a commodity crisis, no one quite knows. I think managers are prepared to move quickly and we expect that we will see a reasonable reduction in their balance sheets as a result of May's volatility.

It is hard to forecast with any great prescience what could happen and how it would unfold. Crises are generally very path-dependent and chaotic in their nature. I think what really matters is how well managers

can adjust to the changing market conditions and how quickly they reduce exposure in their balance sheets. There was a very direct correlation in 2008 between managers' performance and the size of their balance sheets, and also between managers' performance and how quickly they reduced their exposure to what was the very chaotic condition of the market. We expect that if things do go wobbly, if there is irrational pricing in the market, if liquidity is driving asset prices, then we will see a very abrupt increase in the risk premium in the market, and we would expect that the performance for any risk-based strategy to suffer as a result. As Justin mentioned, one of the very proactive steps that we are taking to address that type of risk in the portfolio is through the addition of these tail risk funds. We are anticipating that when we get to our full allocation as we add these managers to the portfolio, that they will end up being somewhere between 2-3% of our allocation. One of the other areas that we are allocating to in the portfolio hedge component on a more reliable basis is S&P futures and put options to provide a more constant level and more real-time ability for us to adjust our exposures within the portfolio. We hope that if we do go through a period like that, which is obviously not guaranteed, that the results would be substantially better than the results we experienced in 2008.

JS Two things that I will add to that on the prime brokerage side, while our managers have always been extremely diligent in their prime brokerage relationships and understanding their counterparty risk, I think in the post 2008 environment, multiple prime brokers and moving cash outside the prime brokerage system are some of the increased proactive events that our managers have taken advantage of and really they continue to understand their relationships, hypothecation agreements, re-hypothecation agreements and such, I think they have been as diligent and more diligent as they have ever been. Also interesting in terms of the macro risks, as Scott was speaking, I was thinking of a comment that one of our managers made that has to be taken into consideration is, there has been a little reversal in terms of economic activity and risk premia, where economic activity goes down then risk premia go up. It also seems to be as risk premia go up a lot of people are focused on it and economic activity gets worse. So we have to watch for that, I think our managers are very aware of the potential knock on effects of risk assets across the globe, which is a really interesting concept to think of.

SS Managers today are more savvy when it comes to all of these issues. I always like to quote Nietzsche, "What doesn't kill me makes me stronger" and that is the case for hedge fund managers today. They are savvier, they are smarter, they are much more nimble and, I think, are going to be much more aggressive in an adverse market environment.

Q: **Has the recent flash crash had any impact on the managers' portfolios?**

JS Not specifically, obviously it was a big down day in the market and that will have its effect on managers and they have to take that into consideration. What's interesting is we had the flash crash, the rebound and then a slow grind to those levels, which is something to think about. I think our managers on those specific days navigated things well but obviously it was a little unsettling for all market participants, but that one specific event in itself was not a huge event.

SS We don't allocate capital to algorithmic traders, we don't have any stat arb or any systematic types of traders in the portfolios, so any effect that existed on that day was secondary and tertiary.

**Q: Have there been any significant changes in liquidity of the portfolio this year?**

JS No there have not been significant changes, we have continued to see some of the illiquid assets (and these were all put out earlier in this year in terms of the circular) continue to be worked off. Managers generally, I would say, have a liquid profile, and the one area where managers have a little more restrictive liquidity that we have taken advantage of and which is important, is within the Long/Short Credit area but over the last few months there has not been a significant movement in that direction.

SS One of the things that obviously will be foremost on peoples' minds as Sterling has weakened relative to the Dollar, is the liquidity of the portfolio relative to our ability to maintain the currency hedges. I think we have been ahead of the curve on maintaining liquidity in the portfolio to address that. We are in a net cash position right now, we anticipate that we will continue to be in a net cash position for a while. We have worked with managers where we have redemptions right now to accelerate their payment to us. In fact, one manager with whom we have a 31 July redemption will be paying us a month early to ensure that we have plenty of liquidity available to address any potential weakness in the currency markets.

JS The cash level is against a dollar move of 11.5% against the Sterling and 20% for the Euro.

RB Just adding to that answer, if you looked at the over twelve month liquidity in the portfolio at the end of 2008, beginning of 2009, it rose up to about 45% or 48% of the portfolio and that is currently sitting at 22% as of 1 April, so that is very much more liquid as a portfolio.

**Q: What discount level to NAV is deemed sectoral going forward and what discount management mechanisms are favoured?**

RB Just to remind people of how we look at this, we look at this in two ways. We look at an absolute level of discount and we look at the discount against the peer group as it is our belief as a Board that you can stretch the discount relative to the peer group but you can't ignore it. In other words, if the peer group is at 15% you can probably get it down to about eight or seven but you can't get it to zero so you have to take into account what is going on in the market as a whole. We think that the current level of discount, which is about 11% is too high and we will use the mechanisms that the Board has used before very effectively I think, to deal with discounts in other words, buybacks, etc. We did buy back 490 million during the late 2008 and 2009 so we are definitely not shy in this department and we have some liquidity and we realise that it is not in investors' interests to have big discounts so we will act when we think it is appropriate to do so.

**Q:** Please could you comment on the new hedge funds that you are seeing being launched? I have read recently of a number of senior departments from investment bank prop desks to set up new funds.

**JS** We continue to be very excited about the opportunity set in regards to new managers. A number of those people that you are reading about we are in conversations with, talking to, and evaluating. No definitive decisions have been made, but we think there is a great crop of managers out there for us to evaluate, things for us to consider in the blank sheet process, as Scott mentioned that we will be going through coming up and we are very enthusiastic about it.

**SS** I think the imposition of the Volcker rule either directly or by subtle force is a good thing for us in many different respects. Number one, it should accelerate the talent flow from places like investment banks and commercial banks into the hedge fund space. Number two, we anticipate it will reduce the amount of subsidised risk capital flowing around the markets which will price risk better and provide better opportunities for us. There will be much greater alpha available for fewer players, and it will cement and really reinforce the position that hedge funds are really the place to be for risk-based capital going forward. The flexibility that hedge fund managers have in their ability to generate alpha in both the long and the short side will trump both long-only investing and again, the subsidised risk taking that has been going on within the commercial and investment banks. We are quite excited about the prospects for the talent and the opportunity set for many years to come.

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