Not The Absolute Return Letter

A New Equity Fund with a Different Approach

*Please note that this is **not** the Absolute Return Letter. Our policy is not to market our products and services in that letter. However, today we take the unusual step of writing to all our subscribers to inform them of our new equity offering which we believe is truly unique. It is our first ever equity product and our first UCITS III fund (i.e. it is not a hedge fund – everyone can invest in it). If you invest in stocks, you should read on.*

Introduction

Absolute Return Partners LLP ("ARP") will shortly be launching its first equity fund (subject to regulatory approval). To-date, the strategy has only been made available as an asset management service to two family offices. It has never been offered as a fund product before, but the strong track record of the two live European portfolios since 2005 has encouraged us to bring this successful concept to a much wider audience.

The investment strategy is the brainchild of Peter Andersen, in association with ARP who will provide the volatility overlay. Peter has extensive experience within the investment management industry, having worked in research and fund management for firms such as Bankhaus Metzler, Credit Suisse Asset Management and Union Investments, and most recently as the CEO of Stockrate Asset Management.

Peter started to develop his fundamental equity investment strategy about 15 years ago. In the early years the data quality was not good enough, and the computing power not strong enough, for him to fully test his ideas, so it wasn't until 2004-05 that the approach was considered robust enough to present to prospective investors. Since then the two founding investors have remained invested in the Europe-focused strategy.

Investment Process

50 stocks are selected each year for the global portfolio on the basis of information gathered from annual reports published by more than 100,000 companies from all over the world.

The overriding aim is to eliminate all possible sources of subjective risk, notably:

1. Forecasting risk
2. Benchmark risk
3. Valuation risk
4. Manager risk

Hence both earnings forecasts and valuation are <u>ignored</u> in the assessment of each company in the universe. *This makes the approach unique and distinguishes the strategy from virtually all other actively managed equity products*. Whereas few active managers are prepared to ignore valuation, our research suggests that you are better off without taking it into consideration.

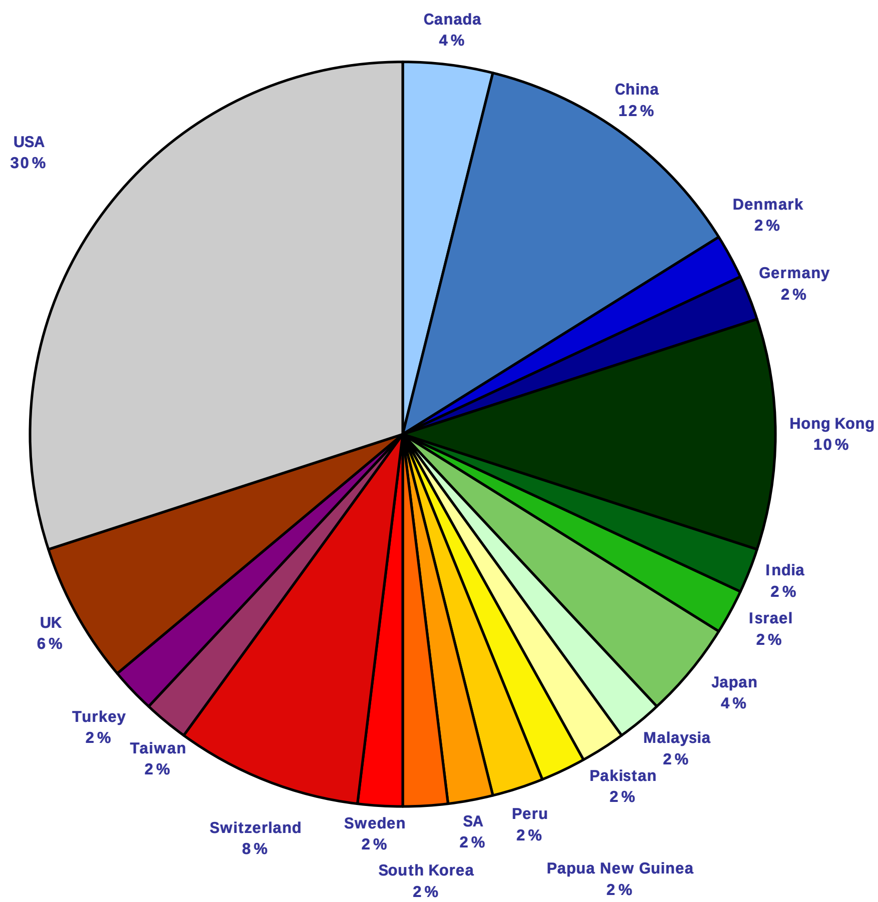
A crucial element of the process is a screening of the history of more than 100,000 companies' annual reports up to 20 years back with the objective of identifying the companies with the strongest earnings power and the highest quality balance sheets.

Earnings power: The earnings power of each company is computed by calculating a series of key ratios for each year. The earnings power represents a measure of a company's ability to benefit from its business model in different macro scenarios over time. The companies with the strongest earnings power tend to stay highly rated in all scenarios with limited variance, whereas the less good ones tend to fluctuate.

Financial strength: The quality of the balance sheet represents the company's ability to remain in good shape through thick and thin. The stronger the balance sheet, the more financial flexibility and strategic manoeuvrability a company will have. The rating is computed by calculating a series of balance sheet-based key ratios for each company.

A total of 16 key ratios are calculated every year for each company and, together, they represent a rating for each company in the universe. Each rating is an absolute measure for each company. In order to "globalise" the approach, the entire universe of companies is ranked from high to low. The investment manager can thereby identify the relative placing of each company in a system of coordinates. By following each company's track record from year to year, a clear picture of the best companies becomes visible.

Exhibit 1: 2010-11 Global Portfolio



Source: Peter Andersen, Bloomberg. Indicative asset allocation.

Following this, each company on the 'top 50' short list is analysed – and continuously monitored - for certain factors which could make the company non-investable. The investment manager looks at factors such as:

- Quality of input data;
- Liquidity (free float as well as daily trading volume);
- Ownership (too much concentration?);
- Potential ethical and/or politically sensitive issues;
- Transparency of business model.

Occasionally, when a company on the shortlist does not pass the quality check, it will be replaced with the next candidate on the rating list. Once each and every company has been approved for investment, the capital is allocated evenly to the names on the short list. The procedure is repeated annually with the portfolio being re-balanced every 1st June. Inflows and outflows during the course of the year are apportioned on a pro-rata basis in line with the weightings at the time.

No less than 20 countries are currently represented in the global portfolio (see exhibit 1). The list is an eclectic blend of global and local brands.

Competitive Advantages

The competitive advantage lies in the know-how and experience of the management team and the highly disciplined investment process. The uniqueness of the process lies within its structure; it relies on vast amounts of historical data but greatly reduces most traditional elements of risk stemming from excessive use of forecasting, valuation and benchmarks. The investment approach is easy to communicate and challenges traditional investment theory.

Track Record

Encouraged by his early success in Europe, Peter started to apply the same approach to other geographies, and he found that the approach works well all over the world. Using the same 16 key ratios as he used when creating the European portfolio in 2005, Peter created a global portfolio going back to 1995, a US portfolio going back to 1987, and various other regional portfolios going back to 2005. The results are illustrated in exhibit 2 below and speak for themselves. Please note that throughout his work Peter has picked 25 names for the short list with the exception of the global list which consists of 50 names (in order to get appropriate diversification).

Exhibit 2: Track Record[1]

Portfolio	Since*	Benchmark	Benchmark Return p.a.	Our portfolios Return p.a.**	Outperformance Ratio***
Global	1995	MSCI World	5.5%	18.7%	100%
US	1987	S&P-500	7.2%	22.7%	87%
Europe	2000	Stoxx-600	-3.6%	9.1%	90%
EAP ex Jap	2005	MSCI EM-J	1.5%	31.9%	100%
Japan	2005	MSCI Japan	-0.1%	11.0%	100%
EM	2005	MSCI EM	12.9%	24.3%	100%

Source: Peter Andersen, Bloomberg

Since the last re-balancing took place on 1st June this year, the MSCI World Index is up 11.6% whereas Peter's global portfolio is up 17.5% (both

[1] *Live portfolio on European equities 2005-2009. Other portfolio returns are pro-forma, using the same investment methodology. All returns have had 1.75% deducted to reflect management fees and other costs. No performance fees have been deducted. Outperformance ratio = Percentage of years outperforming relative to benchmark.*

through the end of September). A word of warning, though: In our experience, whereas the portfolio has outperformed its benchmark in the vast majority of years, the same thing cannot be said from month to month. Periodically, the portfolio has underperformed its benchmark significantly from month to month and also occasionally from quarter to quarter, but rarely from year to year.

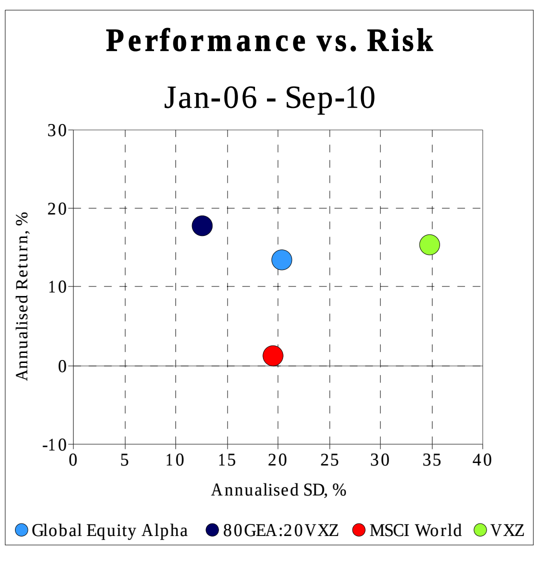
Hedging Volatility Risk

In order to reduce the volatility risk in the portfolio - which will be relatively high given the fact that only 50 stocks are selected – we will employ a volatility 'overlay'. In practice, we invest only $80-85 of every $100 coming into the fund in the 50 stocks. The remaining $15-20 will be invested in volatility instruments (swaps, futures or ETNs). As you may be aware, volatility is strongly negatively correlated with equities, hence the stability enhancing effect.

We have run the portfolio returns including the volatility hedge going back to January 2006 when volatility first became an investable asset class. As you can see from exhibit 3 below, adding the volatility overlay reduces volatility significantly – from about 20% to 12-13% – which is what you would expect. Even better, the total return over the period is also enhanced as a result of the volatility hedge.

We would be the first to admit that the hedged strategy has benefitted from the extreme amount of volatility over this particular period. In more benign markets one would still expect the volatility hedge to smooth returns with the effect of lowering overall volatility but, at the same time, the hedge would be expected to reduce the total return modestly.

Exhibit 3: Risk Return Profile



Source: Peter Andersen, Bloomberg

Final Remarks

At Absolute Return Partners, we pride ourselves on 'Outside the Box' solutions. Long term followers of our firm will have noticed that we haven't done much historically in the equity space. The reason is simple – we didn't believe we could add much value. We sincerely believe we have come up with something unique with this new product.

We are now in the process of building a book of demand for a targeted launch date in mid-November. We anticipate being able to distribute the offering documents in the next 4 weeks. Should you be interested in learning more, we would like to hear from you. Please call us on +44 20 8939 2900 or send an email to info@arpllp.com. You can also access the full powerpoint presentation on the new equity offering, including all the terms and conditions, by clicking on this link:

http://www.arpllp.com/page.asp?section=000100030005

Tricia Ward & Niels C. Jensen
8th October, 2010

Risk Warning