One for the History Books: Hedge Fund Performance in 2008

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By the Numbers: Key Statistics of 2008

<table>
<thead>
<tr>
<th>-19%</th>
<th>Performance of Credit/Suisse Tremont Hedge Fund Index (&quot;Broad Index&quot;)</th>
</tr>
</thead>
<tbody>
<tr>
<td>-42%</td>
<td>Performance of the MSCI World Index</td>
</tr>
<tr>
<td>5%</td>
<td>Performance of the Barclays (formerly Lehman) Global Aggregate Bond Index</td>
</tr>
<tr>
<td>1.5 trillion</td>
<td>Estimated hedge fund industry AUM</td>
</tr>
<tr>
<td>582 billion</td>
<td>Total estimated hedge fund industry assets lost</td>
</tr>
<tr>
<td>149 billion</td>
<td>Estimated assets lost as a direct result of investor redemptions</td>
</tr>
<tr>
<td>6</td>
<td>Number of years since the hedge fund industry has seen net asset losses</td>
</tr>
<tr>
<td>21%</td>
<td>Percentage of hedge funds posting positive returns</td>
</tr>
<tr>
<td>14%</td>
<td>Percentage of funds finishing the year with positive, double digit returns</td>
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</table>

The hedge fund industry as a whole suffered significant losses in 2008 following a number of extraordinary events that rocked financial markets worldwide. The Broad Index, a diversified, asset weighted hedge fund index comprised of 496 underlying hedge funds, finished the year down 19%,7 while the MSCI World and S&P 500 indices lost 42% and 37% respectively. As equity markets fell, investors moved to fixed income investments in a general flight to safety, leading to gains of 5% for the Barclays Global Aggregate Bond Index for the year.

Table 1: Index Returns (January 2008 – December 2008)

<table>
<thead>
<tr>
<th></th>
<th>Broad Index</th>
<th>MSCI World</th>
<th>S&amp;P 500</th>
<th>Barclays Global Aggregate Bond</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cumulative Return</td>
<td>(19.1%)</td>
<td>(42.1%)</td>
<td>(37.0%)</td>
<td>5.2%</td>
</tr>
<tr>
<td>Monthly Standard Deviation</td>
<td>2.8%</td>
<td>6.8%</td>
<td>6.1%</td>
<td>1.8%</td>
</tr>
</tbody>
</table>

The majority of losses occurred in September and October as hedge funds registered two of the worst months of performance in the history of the Broad Index. However, despite significant losses, hedge funds fared better than broad equity indices overall by limiting drawdowns and maintaining considerably less volatility. As shown in Chart 2, the Broad Index posted a maximum drawdown of 19.5% in 2008, compared to 44% for the MSCI World Index. A drawdown of 10% was the most significant decline recorded by the Barclays Global Aggregate Bond Index.

Chart 1: Comparative Index Returns  
(Sep 08 – Oct 08)

Chart 2: Maximum Drawdown of Hedge Funds, Equities and Global Government Bonds in 2008

Source: Credit Suisse/Tremont Hedge Fund Index, Bloomberg. All data was obtained from publicly available information, internally developed data and other third party sources believed to be reliable. Credit Suisse has not sought to independently verify information obtained from public and third party sources and makes no representations or warranties as to accuracy, completeness or reliability of such information.

1. All data as of December 31, 2008.
2. Broad Index returns are calculated monthly and are shown net of underlying fund manager fees.
4. Drawdown is defined as the peak to trough drop in an investment.
While overall performance of the hedge fund industry was negative, not all strategies finished the year in the red. Managed Futures and Dedicated Short Bias managers posted double digit returns of 18.3% and 14.9%, respectively. And while the face of the hedge fund industry will surely change over the coming months and years, managers now argue that hedge funds are uniquely positioned to capitalize on the upturn as they have following past market downturns.

<table>
<thead>
<tr>
<th>Broad Index</th>
<th>Cumulative Return</th>
<th>Monthly Standard Deviation</th>
<th>Maximum Drawdown</th>
<th>No. of Positive Funds</th>
<th>No. of Negative Funds</th>
<th>Best Performing Fund</th>
<th>Worst Performing Fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Convertible Arbitrage</td>
<td>(31.6%)</td>
<td>4.8%</td>
<td>(31.6%)</td>
<td>1</td>
<td>21</td>
<td>12%</td>
<td>(61%)</td>
</tr>
<tr>
<td>Dedicated Short</td>
<td>14.9%</td>
<td>5.6%</td>
<td>(10.3%)</td>
<td>7</td>
<td>2</td>
<td>68%</td>
<td>(49%)</td>
</tr>
<tr>
<td>Emerging Markets</td>
<td>(30.4%)</td>
<td>4.5%</td>
<td>(30.6%)</td>
<td>2</td>
<td>67</td>
<td>27%</td>
<td>(78%)</td>
</tr>
<tr>
<td>Equity Market Neutral</td>
<td>(40.3%)</td>
<td>11.7%</td>
<td>(42.7%)</td>
<td>9</td>
<td>12</td>
<td>36%</td>
<td>(100%)</td>
</tr>
<tr>
<td>Event Driven</td>
<td>(17.7%)</td>
<td>2.3%</td>
<td>(17.7%)</td>
<td>9</td>
<td>67</td>
<td>33%</td>
<td>(75%)</td>
</tr>
<tr>
<td>Fixed Income Arbitrage</td>
<td>(28.8%)</td>
<td>4.6%</td>
<td>(29.0%)</td>
<td>8</td>
<td>24</td>
<td>14%</td>
<td>(65%)</td>
</tr>
<tr>
<td>Global Macro</td>
<td>(4.5%)</td>
<td>3.4%</td>
<td>(14.9%)</td>
<td>19</td>
<td>18</td>
<td>66%</td>
<td>(69%)</td>
</tr>
<tr>
<td>Equity Long Short</td>
<td>(19.8%)</td>
<td>3.5%</td>
<td>(21.3%)</td>
<td>19</td>
<td>147</td>
<td>47%</td>
<td>(77%)</td>
</tr>
<tr>
<td>Managed Futures</td>
<td>18.3%</td>
<td>3.4%</td>
<td>(7.1%)</td>
<td>28</td>
<td>3</td>
<td>93%</td>
<td>(4%)</td>
</tr>
<tr>
<td>Multi-Strategy</td>
<td>(23.6%)</td>
<td>2.8%</td>
<td>(23.6%)</td>
<td>4</td>
<td>29</td>
<td>26%</td>
<td>(93%)</td>
</tr>
</tbody>
</table>

The Year in Review

A combination of unprecedented market events led to extreme market volatility and extraordinary government intervention this year, both of which have affected the hedge fund industry and prompted the de-leveraging of hedge fund portfolios. One of these events alone may have resulted in a major market impact on hedge funds, but the combination of these events exacerbated market stress. The following section provides a review of some of the most noteworthy developments of 2008: the bankruptcy of Lehman Brothers, the implementation of the short sale ban, the impact of various government intervention measures and the scandal involving Bernard Madoff.

Lehman Brothers Bankruptcy

To put Lehman Brothers bankruptcy in perspective, it is estimated that Lehman controlled approximately 5% of the global prime brokerage business, or approximately $100 billion. However, our analysis indicates that many hedge fund managers, with the fall of Bear Stearns still fresh in their minds, had moved their Lehman assets to other prime brokers in anticipation of the bankruptcy filings. As a result, there was significant prime broker diversification already in place by the time Lehman failed, mitigating the negative effect of the company’s collapse on the overall hedge fund industry. However, smaller funds that relied on fewer prime brokers were harder hit, and certain sectors with a large percentage of smaller funds were significantly impacted.

As a result of this event, it is expected that many funds will continue to expand the number of prime broker relationships they maintain, which should help increase diversification and in turn, mitigate the impact the failure of any one firm on the overall industry. Based on manager feedback, funds are now monitoring their prime broker relationships more closely than ever and many have increased the number of prime brokers they work with in order to maintain diversification and prudently manage counterparty risk.

Short Sale Ban

The short sale bans implemented globally in response to weakening financial markets significantly affected certain sectors, such as Convertible Arbitrage (see “All Pain, No Gain for Convertible Arbitrage Funds in 2008” available at www.hedgeindex.com). However, because the measures were temporary and applied mainly to new positions (although regulations vary by regulator and jurisdiction), the bans appear to have had only a limited impact on overall hedge
fund performance. In general, the disclosure provisions did prevent some trading as many funds were unwilling to disclose proprietary information on their trading models and in turn reduced existing short positions. The bans and varying disclosure requirements are ongoing in many jurisdictions. Going forward, it is expected that the lifting of various short selling bans could provide a little more flexibility and improve liquidity within the markets.

Government Intervention

Government intervention in various forms has been a recurring theme in the banking industry since early October when a global coordinated effort to lower interest rates was undertaken by several central banks in order to inject liquidity into the markets.

Looking forward, the impact of the rescue initiatives is still unclear as all of the capital has not yet been deployed and how it will be used has not been fully delineated. Recent initiatives could generate more opportunities within the credit space. For example, the U.S. Term Asset-Backed Securities Loan Facility (TALF), which was established to help improve market conditions by providing liquidity for asset-backed securities, could lead to a possible investment shift from “safe” investments, such as treasuries, to securities in the asset-backed space. This could possibly begin to create opportunities, specifically in the Relative Value sectors.

Madoff Investment Securities

One of the most astonishing events of the year occurred in December when Bernard Madoff, president of Bernard L. Madoff Investment Securities LLC, was charged with securities fraud by federal prosecutors in New York on December 11th and was sued by the SEC for an alleged multi-billion dollar Ponzi scheme. While the investigation is ongoing at this time, and it is yet too early to predict how this event will impact the overall hedge fund industry, an event of this magnitude leads many managers to anticipate that a tighter and more stringent regulatory framework will be applied to the hedge fund industry in the coming years.

As many financial firms are subject to direct oversight by a regulator, and especially given the current financial crisis, it is expected at a minimum that hedge funds will be required by regulators to register and report to some extent. Specifically, many expect a round of “quick fixes” targeted at predatory lending and investor protection, followed by longer term systemic alterations which should more clearly define the roles of regulators and international regulating regimes and powers. Many managers indicate that if these efforts are aimed at protecting investors by increasing the standards of operational due diligence, some form of increased regulation could in fact boost investor confidence and be an added benefit to the hedge fund industry.

Hedge Fund Performance in 2008

Hedge funds as an asset class, as represented by the Credit Suisse/Tremont Broad Index, posted their first double digit loss in history in 2008. On an individual sector basis however, there were strategies which consistently performed well.

As illustrated in Table 3, the Managed Futures sector ranked as a top performing strategy during each quarter this year. Posting a return of 18.3%, the strategy finished with the best yearly returns overall. Dedicated Short Bias was the second best performing sector. The strategy ranked sector was among the top three performing sectors for three out of four quarters this year, returning 14.9% for the year.

5. Madoff managed the assets of some hedge funds that are part of the CS/Tremont Broad Benchmark Index and related portfolios.
The Best and Worst Performing Strategies in 2008

Managed Futures
Sector Weight: 4.2%
YTD Performance: 18.33%

The Managed Futures sector typically performs well during market downturns. The strategy demonstrated a +16% return during the collapse of Long Term Capital Management (August 1998 – August 1999) and -28% during the technology bubble burst/September 11th crisis (March 2001 – March 2003). In 2008, Managed Futures funds have generally benefited from short exposure to equities and commodities, and long exposure to treasury bonds and US dollar trades.

Dedicated Short
Sector Weight: 0.7%
YTD Performance: 14.87%

The sharp downturn in equity markets led to strong positive returns for Dedicated Short Bias managers. The strategy is expected to continue generating positive returns as long as financial market conditions remain relatively unstable, however it may be difficult for the sector to maintain attractive risk/return characteristics thereafter.

Emerging Markets
Sector Weight: 7.4%
YTD Performance: -30.41%

Emerging markets managers struggled this year as continuing trends, such as a further strengthening of the US Dollar and falling commodity prices, hurt investors in the space and emerging equity markets fell across the globe. However, efforts to improve conditions have resulted in recent gains as emerging markets currencies began to appreciate in December after falling for most of the fourth quarter. The outlook is improving for the strategy as inflation in many countries has reached record lows, helping to boost spending and strengthening the economies of many emerging market nations.

Convertible Arbitrage
Sector Weight: 1.9%
YTD Performance: -31.59%

Convertible arbitrage managers were significantly affected by the global bans on equity short-selling which limited managers’ abilities to delta-hedge their own positions. While further selling pressure may continue in the near future, conditions in the space are expected to improve over the long term as with other relative value strategies. Wider credit spreads and high levels of equity volatility will likely attract corporations to issue convertible securities as opposed to traditional funding, which should lead to an increased number of opportunities in the space. Additionally, an increasing number of corporations have been opportunistically buying back their convertible bonds, as it is a cost-effective way for them to extinguish debt and improve their balance sheets. To those who believe that issuing companies themselves recognize and understand their own valuation and credit quality better than all others, this could be considered a positive sign for the eventual stabilization of the convertible market.

Equity Market Neutral
Sector Weight: 3.5%
YTD Performance: -40.32%

Losses in the Equity Market Neutral sector occurred almost exclusively as a result of the scandal surrounding Bernard Madoff, as Madoff managed the assets of some hedge funds in the space. Equity Market Neutral managers otherwise posted slightly negative returns in 2008.

Note: Past Performance is no guarantee or indicator of future results.
7. All Data as of December 31, 2008.
More than 1 out of every 5 hedge funds in the Broad Index generated positive performance in 2008, with nearly 1 in every 7 funds posting returns greater than 10%.

In the Managed Futures sector, 90% of funds posted positive returns for the year and 87% saw returns of greater than 10%. In the Dedicated Short Bias space, 78% of funds finished in positive territory, with all 78% posting returns in the double digits.

In general, there was a wide range of dispersion between the individual fund returns within each sector. Chart 3 depicts the range of the dispersion, as well as the bulk of the returns, which are shown as the dark blue boxes (one standard deviation from either direction of the mean). It is expected that dispersion levels should decrease in periods of recovery.

**Chart 3: Fund Dispersion Analysis (January 2008 – December 2008)**

Note: Past Performance is not a guarantee or indicator of future results.

**Major Factors Shaping Hedge Fund Performance**

**Volatility and Deleveraging**

Volatility remains a key factor affecting the overall hedge fund industry, and continued elevated levels of volatility have forced hedge fund managers to de-lever and reduce risk along with the financial community as a whole. The reduction in leverage has allowed many managers to better navigate some of the reversals in the marketplace; however, it has also led investors to question whether hedge funds can attain the same level of returns without using elevated levels of leverage going forward.

The Volatility Index (VIX), a common measure of market risk, experienced its largest swing on record in the third quarter after jumping 40 points between beginning of September and end of October. As shown in Chart 4, both hedge fund and equity indices fell sharply as volatility increased to extreme levels. Hedge funds managed to limit losses on the downside in comparison to equities, losing 12% during the spike while the MSCI World decreased by 28% during the same period. The level of losses has fallen since volatility began to retract in November.

**Chart 4: Volatility and Hedge Fund Performance**

Note: Past Performance is not a guarantee or indicator of future results.
Elevated market volatility has continued to intensify the de-leveraging effect on the hedge fund industry this year, and the pressure to de-lever was further compounded by an increased cost of funding. Managers experienced a consistent reduction of capital available for lending activities in the market which resulted in an ongoing increase in funding costs for essentially all market participants. The difference between LIBOR and the overnight index swap (OIS) rate, known as the Libor-OIS spread, widened to a new high for the year, signaling a decreased willingness to lend. Looking back over 2008, average spreads were less than 1% for most of the year, however they began to increase sharply in mid-August and peaked around 3.6% on October 10th. While spreads have since come down, they remain significantly above historic levels.


The rise in funding costs has forced levered investors to reduce position sizes and as a result, funds are holding a greater percentage of their portfolios in cash. Many managers believe that these increased cash balances will likely provide an opportunity set for hedge funds when the markets begin to stabilize. And while managers are decreasing leverage and in general plan to use less leverage in the future, many believe that higher volatility (faster convergences) and the reduction of market participants (proprietary trading desks, hedge funds) will lead to greater market inefficiencies going forward. This leads many managers to believe they can achieve the same returns with lower leverage in the future.

Redemptions and Suspensions

Fund redemptions and suspensions are two aspects of the hedge fund industry which are clearly on the minds of investors. Initial industry feedback suggests a substantial percentage of industry outflows will come from private investors, and as much as 25% to 30% of private client investments could be redeemed by early 2009. In general, institutional investors have maintained their exposure and are taking advantage of the fact that quality funds, which had previously been closed, are now ready to accept new business again.

It is interesting to note that historically, periods of significant hedge fund redemptions have in many cases been followed by periods of significant returns. One of the most notable examples occurred in the Convertible Arbitrage space in 2005 when GM and Ford debt was downgraded. Credit-default swaps widened sharply while company stock prices rose, triggering a massive sell-off in the sector. Cumulative returns in the 24 months following that drawdown totaled almost 26%. A similar sell-off occurred in the Global Macro space in 1994, when the strategy shrunk by 30% from $60 billion to $40 billion. Cumulative performance for the sector was up 64% between January of 1995 and December of 1996.

It is extremely difficult to assess the current number of funds which have suspended redemptions or imposed gate provisions to date, however there is some early indication of the level of distress within the industry. Based on a sample set of funds reflective of the Broad Index, it is estimated that 25% of funds can currently be classified as "impaired," meaning they have either suspended redemptions, imposed gate provisions or have side-pocketed distressed assets in an attempt to separate illiquid assets from the liquid assets within the portfolio.
Considering what is known and/or expected in terms of performance and investor redemptions, these preliminary estimates may not fully reflect the current environment, and are subject to change as additional information is obtained. Credit Suisse/Tremont plans to continue to update these statistics in future reports as additional information becomes available.

Asset Flows

It is estimated that the industry lost 29% of assets, totaling $582 billion in 2008. Of total losses in the industry, approximately $149 billion were lost as a direct result of investor redemptions. This marks the first time the hedge fund industry has seen net asset outflows since the fourth quarter of 2002. Total assets under management for the industry are now estimated to total approximately $1.5 Trillion.

Chart 6 illustrates the shift in sector allocations within the Broad Index in 2008. Both Managed Futures and Dedicated Short bias sector allocations increased within the Broad Index, following positive performance in both strategies during the year. Other notable changes included a gain of over 4% in the Global Macro sector, which was the third best performing strategy for the year. On the other hand, Long/Short Equity, which previously held the largest weighting in the index, lost almost 6% for the year. Event Driven is now the largest sector in the Index, gaining over 3% to increase its weighting to 27%.

Chart 6: Broad Index Sector Allocation Changes (January 2008 – December 2008)

Fund Liquidations

It is expected that as many as one third of hedge funds may close as the current crisis continues. In general, larger funds seem to be better insulated from adverse market events, and it is thereby anticipated that a lower number of smaller funds will survive the crisis relative to the larger funds.

Based on the latest available data as of the end of October, it is estimated that 17% of hedge funds within the Credit Suisse/Tremont hedge fund database have ceased operations. Of the $582 billion hedge funds lost in 2008, $149 billion was lost due to investor redemptions. Total industry assets now total $1.5 trillion.

Approximately 7% of hedge funds liquidated between January and October.

Fund liquidations calculated based on funds no longer reporting to the database as of October 30, 2008.
Looking Back

2008 was clearly a difficult year for most asset classes, including hedge funds. Current hedge fund drawdowns rank among the worst in the history of the asset class. Looking back at Broad Index data over the last two decades, significant drawdowns were also experienced in three other years: 1994, 1998 and 2003. The recovery time in each of these three cases was somewhere between 13 and 15 months, and looking at cumulative performance for both 12 and 24 month periods after each of these drawdown events, data suggests that the consequent performance was fairly strong:

- After 1994, hedge fund performance was up 22% after 12 months and 49% after 24 months
- After October 1998, hedge fund performance was up 13% after 12 months and 34% after 24 months
- After March 2003, hedge fund performance was up 17% after 12 months and 25% after 24 months

Looking Forward

While overall performance for the industry was negative in 2008, there remain a number of skilled managers with the ability to generate alpha despite adverse market conditions. This is suggested by the fact that more than one out of every five hedge funds in the Broad Index generated positive performance in 2008, with nearly one in every 7 funds posting returns greater than 10%.

The events of 2008 certainly highlighted some of the changes that seem to be necessary in the industry. As a result of the Lehman Brothers bankruptcy, hedge funds have increased the number of prime broker relationships which has led to greater diversification and better managed counterparty risk. Further, it is expected that the role of governments and regulators will most likely increase in the hedge fund space going forward. Government oversight could result in more transparency and better due diligence, mitigating the chances of an event, such as the one involving Bernard Madoff, from happening again. Increased regulation could also serve to bolster investor confidence, a plus for the industry.

Governments globally have already undertaken a number of unconventional moves in an effort to stabilize markets and many of these actions could lead to increased opportunities. The U.S. Federal Reserve’s move to shift troubled assets from private to public balance sheets by purchasing agency debt and mortgage-backed securities, could lead investors away from treasuries and toward potentially higher yielding securities, thereby creating opportunity in the relative value space. For the most part, hedge funds have viewed government actions to date as positive, and many believe the interventions should stabilize markets in the long term.

Volatility, another major factor in 2008, is expected to remain at high levels through 2009. As managers adjust to operating in elevated levels of volatility, opportunities may arise as less efficient markets may provide managers the opportunity to generate higher returns with less leverage. The current challenge for many managers however, is to continue to de-lever and manage cash levels in the event of client redemptions and higher margin requirements.

As in the past, increased redemptions certainly pose a threat to the general hedge fund community. However, in 2001, both the Equity Market Neutral and Long/Short Equity sectors lost 10% of assets, but came back to produce cumulative returns of 15% in the following two years. These comparisons suggest that after a period of time during and following drawdowns, many hedge fund managers recovered lost ground and generally outperformed equity markets during the post-crisis period.

It is also important to note that not all investors are redeeming and in fact, the current attractive valuations in some strategies have begun to entice some non-traditional investors to invest. For instance, new investors such as pension funds, insurance companies and certain hedge funds holding large cash balances, are indicating that the current attractive valuations in the convert-
ible space may provide investment opportunities in that sector. Many managers also believe that the increased cash balances currently being held on the books should provide an opportunity set for hedge funds when the markets begin to stabilize.

It is anticipated that post-crisis, a leaner hedge fund industry may emerge with a nucleus of skilled, experienced managers. With fewer hedge funds and a reduction in proprietary trading done by investment banks, hedge funds could have an opportunity to exploit market inefficiencies and therefore, potentially generate significant alpha.
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Contact Information

Credit Suisse Tremont Index LLC
Eleven Madison Avenue
New York, NY 10010
United States
+1 212 538 0583
hindices.ir@credit-suisse.com
www.hedgeindex.com