

GEMS MONTHLY REVIEW

(October 2008)

1) Market meltdown continues in October, with market indices down sharply

The dramatic equity drawdown that began in October 2007 culminated in an enormous sell-off in October 2008. Despite a rebound in prices at the end of the month, October 2008 belongs with other Octobers (October 1987 and October 1929) as one of the worst months in market history. The S&P ended the month down -20.3%, the NASDAQ was down -20.8% and the Russell 2000 Index was down -27.8%. Additionally, the MSCI World was down -20.7%, the MSCI Europe was down -16.7%, the FTSE 100 was down -13.4%, the Topix was down -17.3% and the MSCI Emerging Index fell -29.9%.

The bond markets were also unable to avoid the market onslaught in October, with the Merrill Lynch US Corporate Master Index down -7.3%, the US High Yield Master Index down -16.9%, and the US High Yield C Rated Index down -22.7%. In the commodities market, the Goldman Sachs Commodity Index was down -26.6% in the month, with crude oil off -31.8% and Gold down -11.9%. The continued deleveraging and portfolio unwindings hit all asset classes simultaneously, with little discrimination between the quality of different securities.

October 2008 was probably the worst month in markets in more than 40 years. Although October 1987 saw a large equity drawdown, at least bonds rallied during that sell-off. This time around, stocks, bonds and commodities were all "off" simultaneously and no asset class escaped the crisis without significant damage.

2) Gems Performance

In the midst of this momentous market drawdown, Gems' Portfolios held up relatively well during October. Once again, the problem was not the direction of the markets so much as the liquidity issues within markets. Although our managers were relatively market neutral throughout the month, they continued to suffer from both basis risk and mark-to-market risk, due to the huge market dislocations.

We continue to believe that our conservative portfolio management stance has been rewarded during the current market crisis. Looking at the period from the beginning of the credit contraction (in late 2006, when the sub-prime mortgage market started to crack), the Gems Portfolios are positive and are significantly outperforming all other indices.

Gems Portfolios Performance 24 Months							
Fund / Index	Month End	Month End	Total Return	Car	Year Std	Semi Std	Draw Down
Gems Recovery Regular USD	Oct 08	Oct 06	24.51%	11.58%	10.92%	6.66%	-15.42%
Gems Multi-Strategy I Regular USD	Oct 08	Oct 06	10.55%	5.14%	8.53%	5.66%	-13.12%
Gems Low Volatility Regular USD	Oct 08	Oct 06	8.12%	3.98%	7.33%	5.21%	-11.82%
HFRI FOF: Conservative Index	Oct 08	Oct 06	-6.05%	-3.07%	7.44%	6.76%	-15.56%
HFRI FOF: Diversified Index	Oct 08	Oct 06	-6.94%	-3.53%	8.96%	7.88%	-19.07%
HFRX Distressed Securities	Oct 08	Oct 06	-12.48%	-6.45%	9.23%	8.98%	-20.02%
Nasdaq Composite Index (^IXIC)	Oct 08	Oct 06	-27.29%	-14.73%	20.89%	19.28%	-39.81%
S&P 500	Oct 08	Oct 06	-29.70%	-16.15%	17.20%	16.64%	-37.47%
MSCI World Index Net	Oct 08	Oct 06	-29.99%	-16.33%	19.37%	18.50%	-41.85%
MSCI Europe - Net	Oct 08	Oct 06	-34.03%	-18.78%	23.15%	22.01%	-48.45%

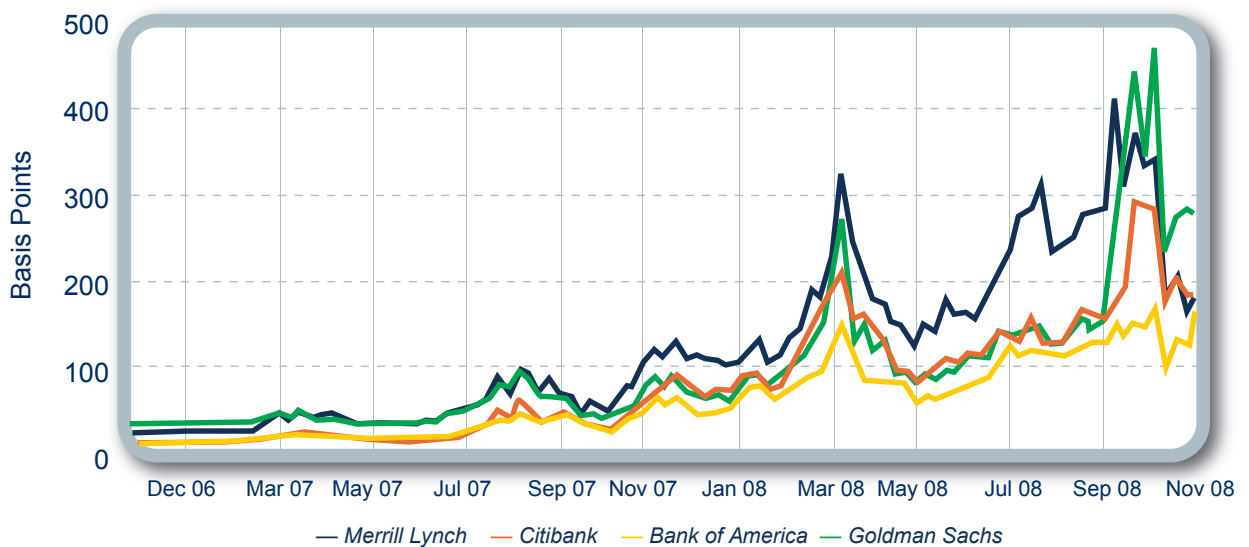
Source: Gems Investment Research / Date : October 08

3) Search for stability in the financial markets

The direction in markets continues to be negative and investors are searching for signs that the financial stability programme led by the U.S. Treasury department is starting to take effect. The emphasis of the global stabilisation programme is now on a concerted effort to prop up major financial institutions. Instead of buying securities, the Treasury is choosing to provide equity and direct support to large retail and investment banks. If effective, this will reliquify the capital markets and provide a sounder basis for asset prices which, fundamentally at least, are trading cheaply.

A good measure of the progress in the capital markets is the CDS spread of major financial institutions. If the stabilisation program starts to work, the immediate beneficiaries will be the large financial institutions. Our underlying managers will also be amongst the first market participants to benefit from the stabilisation, since they will be able to move quickly to take advantage of reliquifying markets. Currently, our managers are cautious and waiting for technical signals to go back into the markets.

Financial Sector CDS Spreads



Source: Bloomberg / Period: November 06 through November 08

In order for the financial sector to operate efficiently, CDS spreads for generic investment bank credit should be close to the 100 b.p. level. As the picture above shows, many financials continue to exhibit high risk levels.

The stabilisation program is also designed to revive the credit markets, which have been frozen for most of the year. Both Investment grade and high yield corporate spreads continue to trade at historic highs. The high yield market has implicit assumptions in today's prices. As the stabilisation takes effect, the credit spreads should start to return to more normal levels, especially in the investment grade sector.

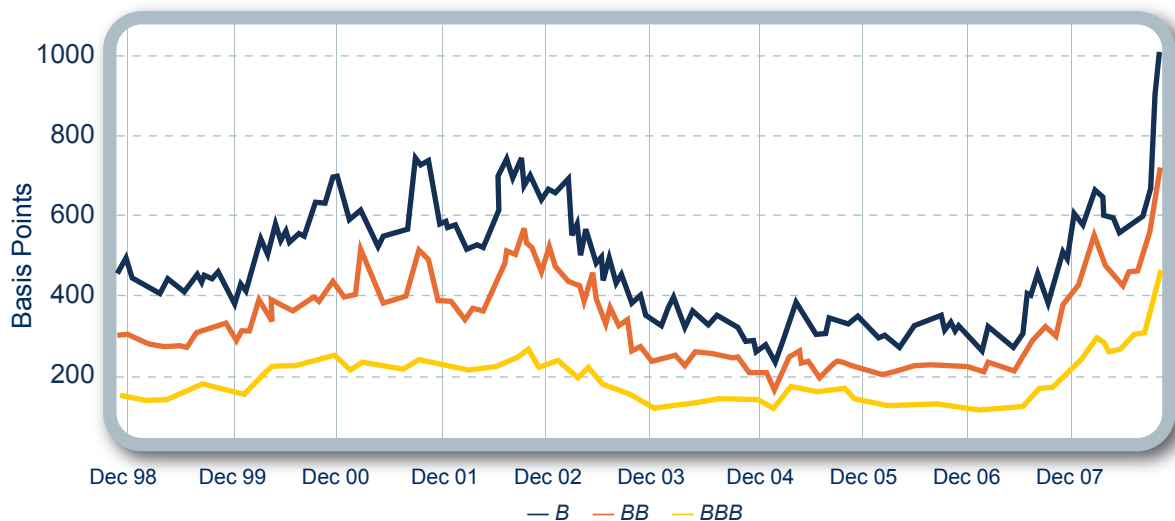
US Investment Grade 5 Year Credit Spread



Source: Bloomberg / Period: November 06 through November 08

The huge increase in credit spreads (and simultaneous fall in bond prices) has affected the Gems Portfolios. Besides the mark-to-market losses in the underlying manager portfolios, there are also realised losses as managers reduce positions. Furthermore, with the credit market exhibiting much more volatility than in the past, there is enhanced basis risk in the underlying portfolios, especially on a monthly NAV basis.

US Non Investment Grade Credit Spreads



Source: Bloomberg / Period: November 06 through November 08

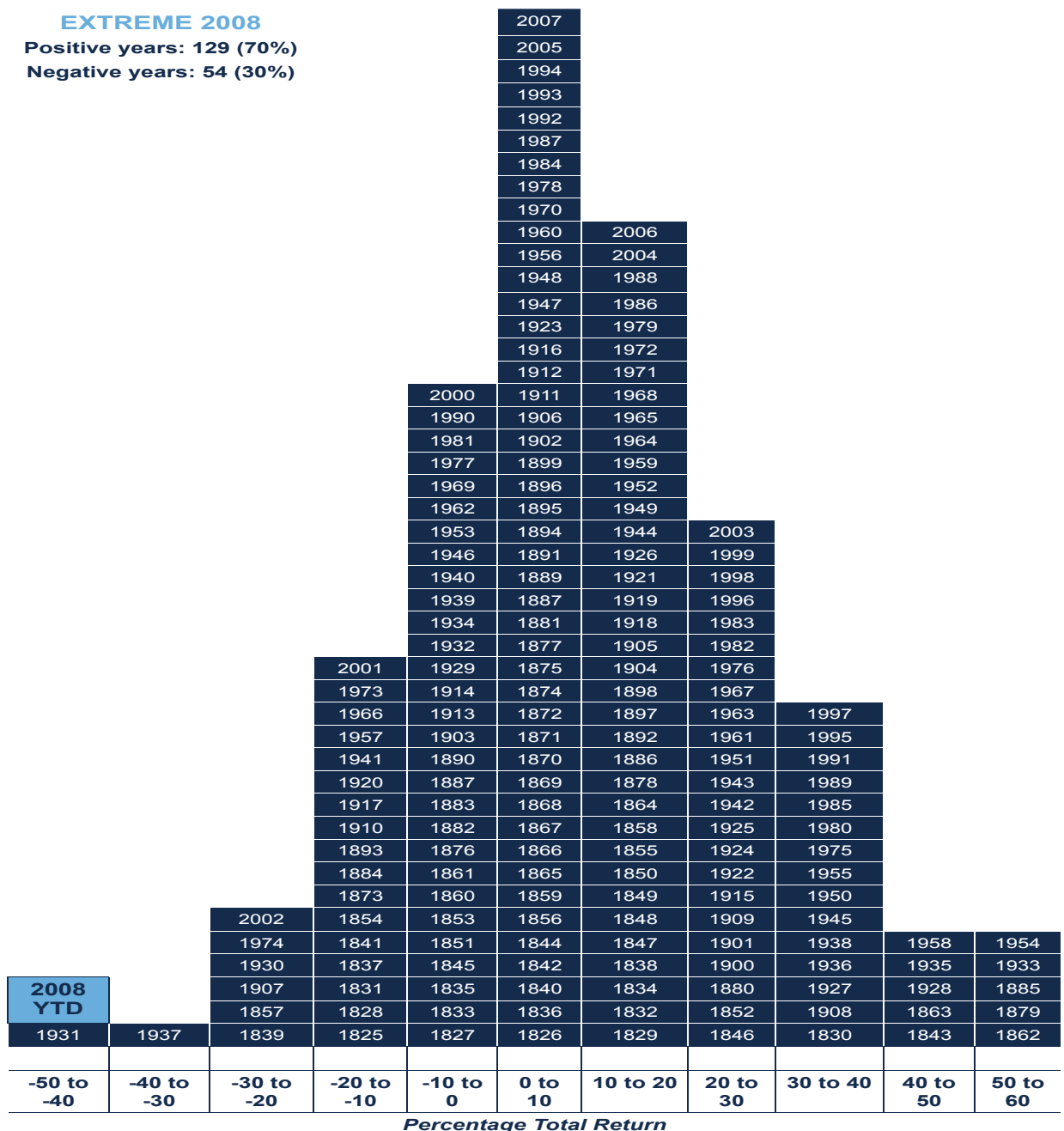
Despite the gloomy economic forecasts, much of the excess spread in today's markets is a function of illiquidity. So far in 2008, there have been only 83 new issues of high-yield debt. In 2006 and 2007, there were as many as 1,000 deals a year, which demonstrates the stark difference in liquidity between the credit bubble (2004-2007) and the current credit crunch.

4) Gems Portfolios are cautious on market direction, but will benefit significantly from lower risk premia.

Gems Portfolios are positioned to benefit from a decrease in risk premia and a return to more normal capital markets. This is very different from positioning the Portfolios for directional moves in the equity and credit markets. As markets stabilise and risk premia decrease, strategies such as merger arbitrage, convertible arbitrage and credit strategies should do well. Meanwhile strategies like CTAs and Macro should be able to take advantage of short and medium term trends in the market. This is not a market directional position, because with the uncertainty in the macroeconomic outlook, it is possible that the bear market will continue. For Gems' Portfolios, it is not a significant market rebound that matters. What is more important is that liquidity and normal trading conditions should return to the capital markets.

S&P Index from 1825 to 2007 incl. YTD 2008

EXTREME 2008
Positive years: 129 (70%)
Negative years: 54 (30%)



The recent market drawdown has clearly been a “large” standard deviation event. There is reason to be worried about the macroeconomic picture. After years of credit expansion, the current credit contraction is affecting both consumers and businesses. With banks unwilling to loan and businesses unable to invest, the employment and personal consumption outlook looks weak. Lower interest rates by the Fed have yet to work and investors are looking at a long term picture of low bond and equity yields. In this type of environment, Gems’ Portfolios can prove the advantage of relative value, “alpha” investing. Even in the unbelievably difficult market conditions of 2008, Gems Portfolios have been able to outperform equity indices by 40% and hedge fund indices by 500 b.p. This long term outperformance is crucial in today’s investment environment, in which passive index investing is a losing proposition. The experience of weathering the crises of the past can only serve to help Gems to navigate the current crisis successfully.

Sincerely,

Gems Research Team

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