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Market Neutral Strategies: A Key Component of Asset Allocation in All Markets

Over the past few years, performance of traditional asset classes has not differentiated to the extent investors might have expected. Many alternative investment strategies have provided low correlation while traditional assets such as equities and bonds were increasingly correlated.

That all changed during an 18-month period from mid-2007 through 2008. During this time, virtually all equity asset classes, including most alternative strategies, moved in the same direction—dramatically downward.

However, one alternative investment strategy—equity market neutral strategies—continued to provide little correlation despite extreme market volatility. This paper:

- Examines financial market history to demonstrate that market neutral equity strategies have typically provided lower volatility and correlation, especially during volatile markets
- Documents data related to market neutral as a potential source of absolute return
- Reviews how market neutral strategies work and why they may be a key component of any asset allocation policy
- Reviews issues associated with changing attitudes about alternative investments and hedge funds, and
- Assesses changing investor perceptions of what to expect from alternative investment managers.

Market Neutral Performance: A Look Back

In 2008, the Dow Jones Industrial Average fell 33.8%, the NASDAQ declined 40.4%, and the Standard & Poor's 500 (S&P 500) lost 38.5%.¹ Prices declined across all sectors and capitalizations.

Internationally, results also were poor. The *Financial Times* Stock Exchange (FTSE) Index dropped 31%.² France's Cotation Assistée en Continu (CAC) and Germany's Deutsche Aktien Index (DAX) both fell by more than 40%.³ and Japan's Nikkei lost 42%.⁴ The Morgan Stanley Capital International (MSCI) Emerging Markets index lost 54% in 2008.⁵

Record price declines were matched by unprecedented volatility with the Chicago Board Options Exchange (CBOE) Volatility Index (VIX), reaching 81.48 on November 20, 2008.

Investors with exposures to alternative investment strategies were sometimes able to mitigate some of the losses during 2008. Although Hedge Fund Research Indices (HFRI) Composite Index posted a loss of -18.36% in 2008, the equity market neutral category held up quite well to the broader universe, producing a return of -6.20% for the 12-month period ended December 31, 2008.⁶ Other asset classes, including real estate, private equity and venture capital, also finished 2008 down sharply.

Exhibit 1: Correlation of Returns (to the S&P 500)

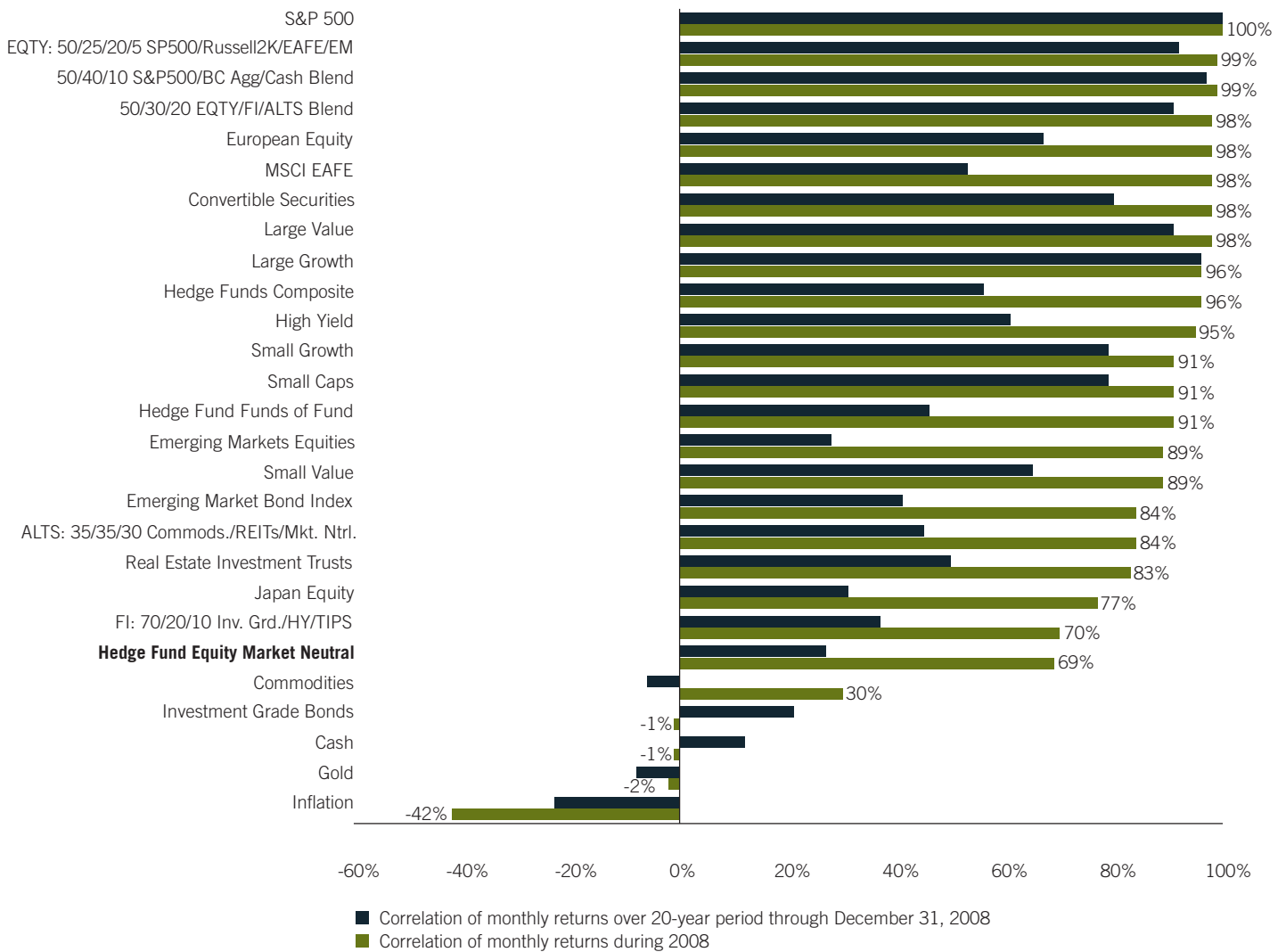


Exhibit 1: Correlations of S&P 500 to other assets during 2008 and over a 20-year period ending December 31, 2008.
 Source: Haber Analytics, FMRCo.

Exhibit 1 presents the increased correlation of assets and strategies in 2008 compared with their historical norms. The chart shows both the low historical correlation of equity market neutral strategies over a 20-year period ended December 31, 2008, as well as its lower relative correlation for the 12 months ended on December 31, 2008.

These numbers reinforce the fact that equity market neutral strategies may provide a

measure of stability when correlations of most other equity asset classes converge. Asset classes that offer low correlation during extreme volatility promise to continue as an important element for investors who seek to limit volatility.

The Case for Market Neutral Strategies in All Markets

A well-constructed market neutral strategy, where dollar, beta, capitalization, industry

and other exposures are truly neutralized, is designed to offer little to no correlation with the markets.

A market neutral strategy can provide investors many advantages, including low correlation to other assets and potentially higher risk-adjusted returns while using lower leverage relative to other long/short and hedge fund strategies.

Exhibit 2: Rolling 1-Year Returns (Selected Market Indexes)

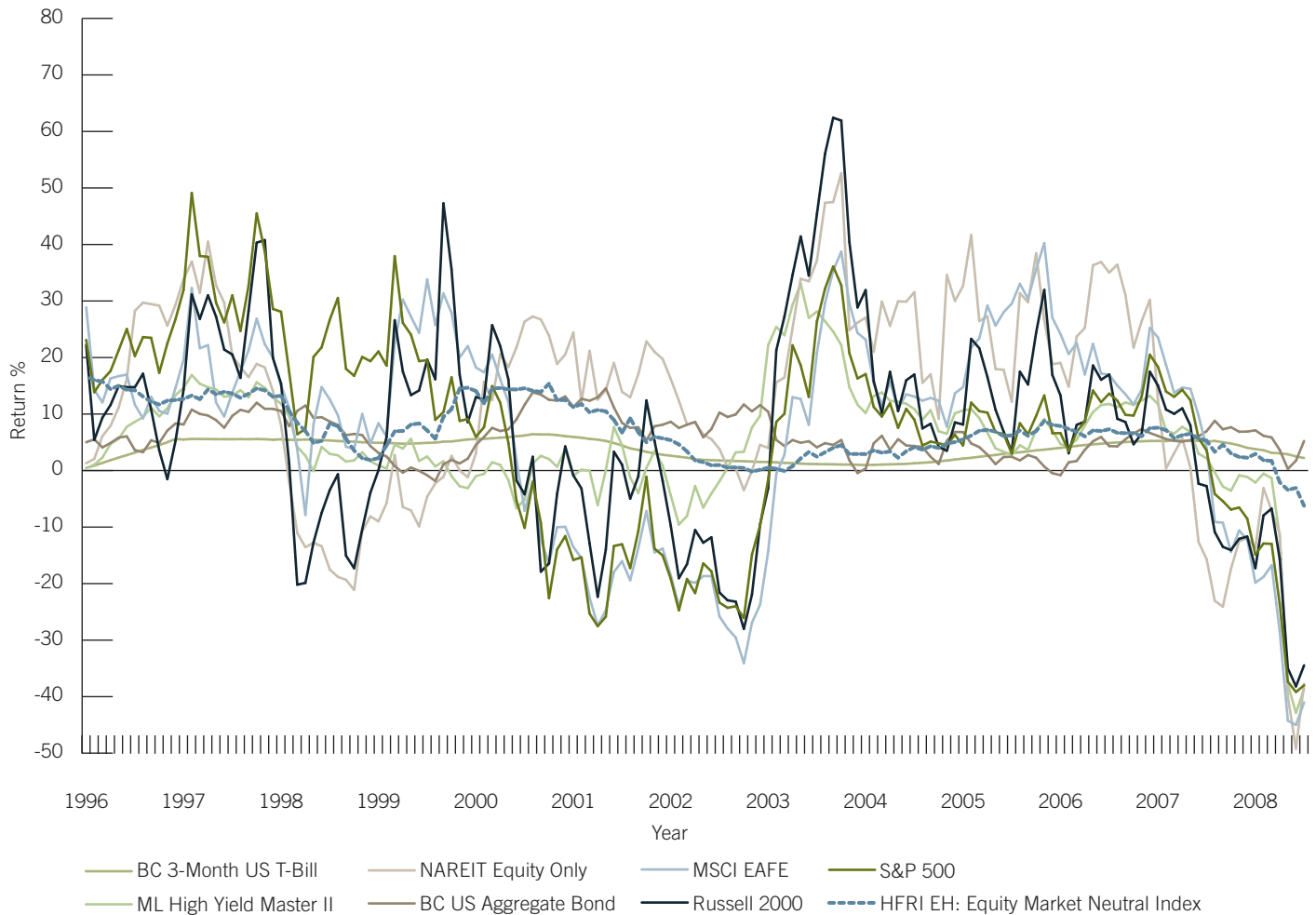


Exhibit 2: Market neutral returns compared to other asset class returns—June 1996 through December 2008—shows the relative low volatility of market neutral strategies.

Source: Pyramis Global Advisors

Low correlations to traditional asset classes.

A well-constructed market neutral strategy can mute poor performance from other asset classes in down markets. Exhibit 2 visually compares rolling one-year returns for market neutral strategies to the one-year returns of other traditional asset classes over time.

Generally designed to produce consistent returns, this strategy may provide diversification benefits in many environments, giving investors another risk management tool to reduce overall volatility in their portfolios.

Exhibit 3 on page 4 shows how, when including a market neutral strategy with stock and bond investments, a correlation of 0.25 may increase a portfolio's total returns and reduce volatility.

While offering low correlation to other asset classes, market neutral strategies often vary and correlate only mildly among different market neutral managers, depending on the strategy's tilt toward decreasing volatility or increasing returns. This is true when comparing similar managers and particularly true when

comparing different strategies, such as fundamental versus quantitative.

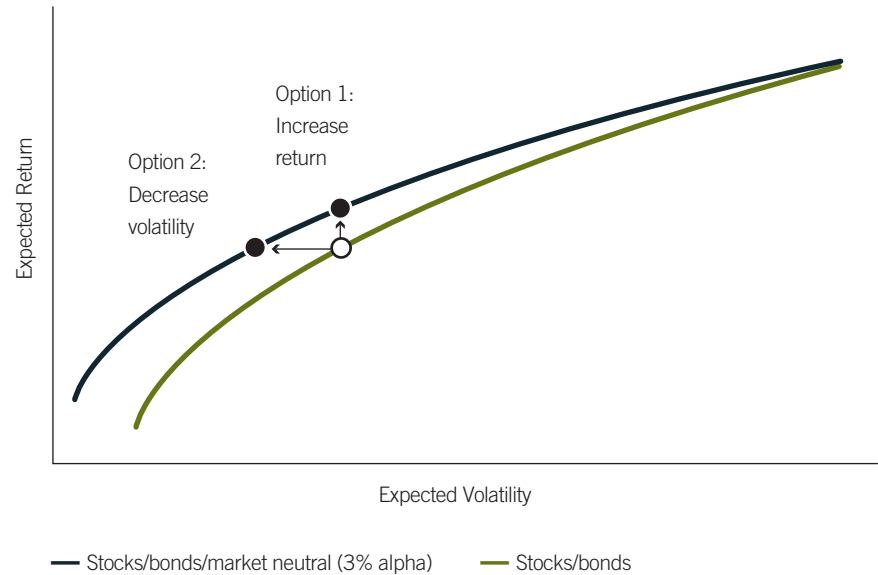
Exhibit 4 on page 4 shows how correlations differ among various asset classes including investment-grade fixed income (represented by the Barclays Capital U.S. Aggregate Bond Index), equity market neutral strategies, (Hedge Fund Research Inc. Equity Hedge: Equity Market Neutral Index), international equities (MSCI Europe, Australasia and Far East (EAFE) Index—Net), U.S. large- and small-capitalization equities (S&P 500 and Russell 2000 indexes, respectively), real

estate investment trusts (National Association of Real Estate Investment Trusts), high-yield bonds (Merrill Lynch U.S. High Yield Master II Index) and short-term money fund investments (Barclays Capital 3-Month Treasury Bill Index). What is striking is that the correlation of market neutral strategies to an equity benchmark, such as the S&P 500, is similar to correlations to fixed-income indexes in the high yield bond and 3-Month Treasury Bill (T-bill) sectors.

Low correlations to non-traditional asset classes. As noted previously, market neutral strategies are generally uncorrelated with stock and bond returns. Additionally, they are only mildly correlated to hedge funds. Exhibit 5 on page 5 shows that market neutral strategies have a small to medium correlation with nine other larger groups of hedge fund strategies.

Because market neutral strategies, even within hedge fund groupings, add relatively little correlation, adding a market neutral strategy may reduce overall portfolio risk significantly. This is of particular importance in recent years as not only stock and bond

Exhibit 3: Adding Market Neutral Investing to a Stock and Bond Portfolio Helps Reduce Volatility and Enhance Returns



Source: Pyramis Global Advisors

correlations, but international and domestic equity correlations, have grown closer.

Yet, while international equity correlations have risen, international market neutral

strategies produced mostly uncorrelated returns, even when using similar investment models. Given recent market volatility among virtually all asset classes, market

Exhibit 4: Correlations* of Market Neutral Strategies to Other Assets through December 31, 2008

	HFRI EH: Equity Market Neutral	S&P 500	Russell 2000	NAREIT Equity Only	MSCI EAFE (Net)	Barclays Capital U.S. Aggregate Bond	ML High Yield Master II	Barclays Capital 3-Month U.S. T-bill
HFRI EH: Equity Market Neutral	1.00							
S&P 500	0.19	1.00						
Russell 2000	0.24	0.76	1.00					
NAREIT Equity Only	0.04	0.45	0.57	1.00				
MSCI EAFE (Net)	0.24	0.82	0.74	0.45	1.00			
Barclays Capital U.S. Aggregate Bond	0.08	(0.00)	(0.06)	0.12	0.01	1.00		
ML High Yield Master II	0.12	0.58	0.60	0.65	0.61	0.24	1.00	
Barclays Capital 3-Month US T-bill	0.28	0.08	(0.03)	(0.00)	(0.06)	0.14	0.01	1.00

* Correlation is based on monthly returns for the period from June 30, 1996 through December 31, 2008.

Source: Pyramis Global Advisors

Exhibit 5: Correlations* of Market Neutral Strategies to Other Hedge Fund Strategies

	Equity Market Neutral	Convertible Arbitrage	Dedicated Short Bias	Emerging Markets	Event Driven	Fixed-Income Arbitrage	Global Macro	Long/Short Equity	Managed Futures	Multi-Strategy
Equity Market Neutral	1.00									
Convertible Arbitrage	0.20	1.00								
Dedicated Short Bias	(0.12)	(0.23)	1.00							
Emerging Markets	0.16	0.46	(0.57)	1.00						
Event Driven	0.28	0.67	(0.58)	0.76	1.00					
Fixed-Income Arbitrage	0.33	0.80	(0.16)	0.44	0.54	1.00				
Global Macro	0.06	0.39	(0.15)	0.52	0.43	0.45	1.00			
Long/Short Equity	0.17	0.43	(0.67)	0.71	0.71	0.36	0.49	1.00		
Managed Futures	(0.03)	(0.08)	0.06	(0.05)	(0.09)	(0.05)	0.26	0.07	1.00	
Multi-Strategy	0.36	0.77	(0.19)	0.40	0.57	0.71	0.36	0.47	0.03	1.00

* Correlation is based on monthly returns for the period from June 30, 1996 through December 31, 2008.

Source: Pyramis Global Advisors, Credit Suisse/Tremont Hedge Fund Indices

Exhibit 6: Risk-Adjusted Returns* of Market Neutral Strategies and Other Assets

Market Index/Asset Class	Monthly Sharpe Ratio	Inception of Data
Barclays Aggregate Bond Index	0.68	January 1990
Credit Suisse/Tremont Hedge Fund Index	0.59	January 1994
HFRI EH: Equity Market Neutral Index	1.09	January 1990
ML High Yield Master II	0.41	January 1996
MSCI EAFE (Net)	0.10	January 1990
Russell 2000 Index	0.28	January 1990
S&P 500 Index	0.18	January 1990

* Monthly risk-adjusted returns as measured by Sharpe Ratio for each asset class are calculated since inception for each asset class.

Source: Pertrac, Pyramis Global Advisors

neutral strategies have provided one of the few areas of stability.

Higher risk-adjusted returns. Most institutional investors are focused on producing attractive risk-adjusted returns and risk budgets are critical components of their asset allocation decisions.

Exhibit 6 compares risk-adjusted returns for a number of asset classes over specific periods of time since the inception of data for each asset class through December 31, 2008. The time periods include 19 years of historical risk-adjusted returns for investment-grade fixed income, equity market neutral, international equities, and U.S. large- and small-capitalization equities. In addition, the chart shows 15 years of risk-adjusted return experience for hedge fund strategies (Credit Suisse/Tremont Hedge Fund Index) and 13 years of performance history for high-yield securities. Equity market neutral strategies

Exhibit 7: Rolling 1-Year Returns (Selected Hedge Fund Indexes)

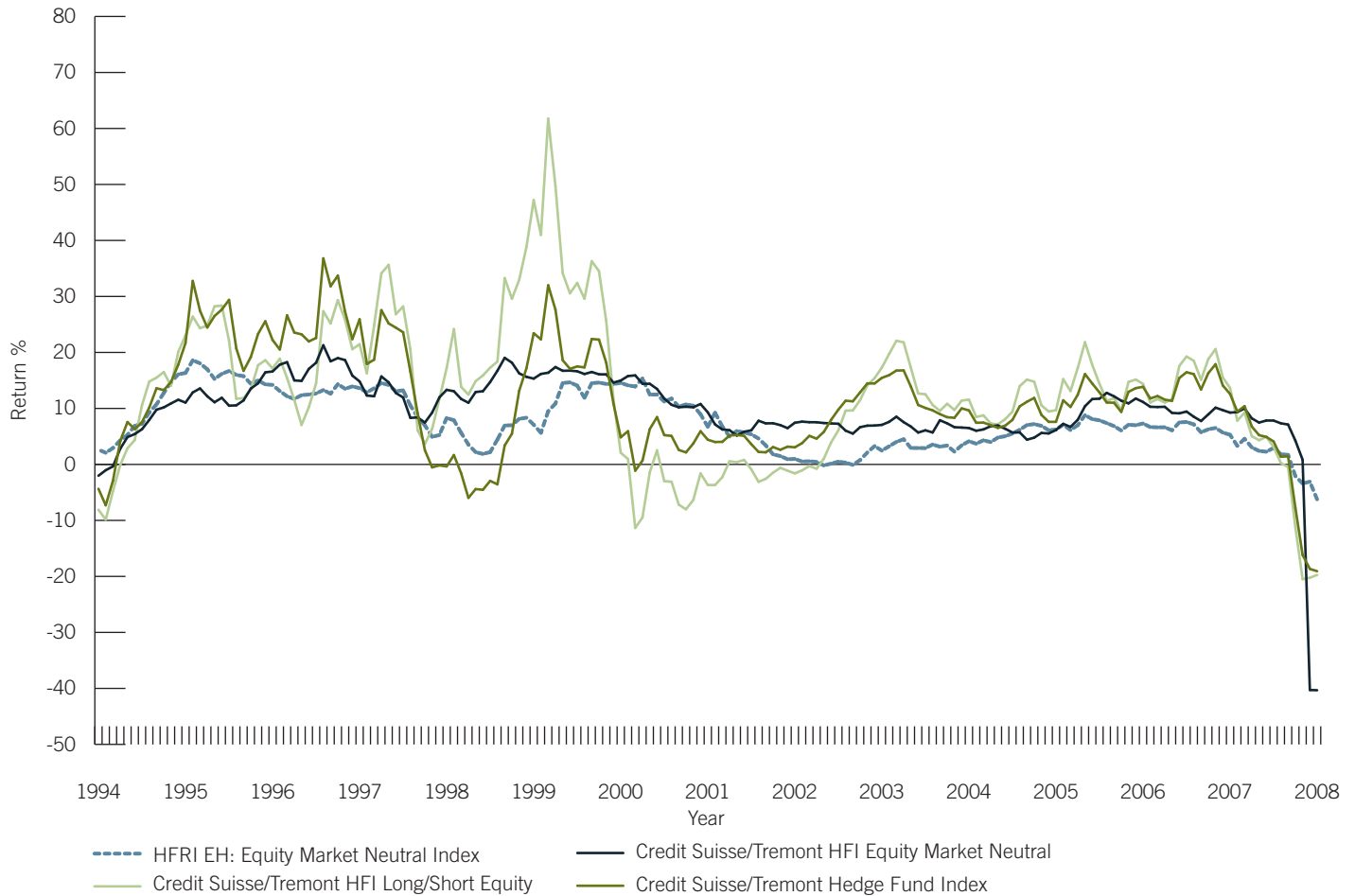


Exhibit 7: Returns of market neutral strategies juxtaposed with returns for hedge fund strategies—January 1993 through July 2008 show relatively low volatility. * The November monthly and 12-months ended November 30, 2008 returns for the Credit Suisse/Tremont HFI Equity Market Neutral Index were skewed as a result of the impact of two funds in the index fully invested in funds managed by Bernard L. Madoff Investment Securities LLC.

Source: Pyramis Global Advisors

have earned a higher risk-adjusted return than any of the other classes over the 18 years of returns included in the calculations cited for equity market neutral strategies.

Consistently lower volatility over market cycles. While most hedge funds strive for an absolute return, a market neutral strategy can provide zero beta exposure. Market neutral strategies offered lower volatility compared to

long-only and other long/short strategies during 2008. Exhibit 7 shows that market neutral strategies provided relatively lower volatility as measured by one-year returns in all markets dating back to 1993, a time that included a recession in 2001–2002, other bear markets in 1997 and 1998, and a handful of sharp market rallies through December 31, 2008.

During this time, market neutral strategies endured during the tech bubble bursting, the

Asian financial crisis, the Russian debt crisis, and other events that roiled the markets. Also important to note, market neutral strategies accomplished this while maintaining lower leverage on average than other long/short and hedge fund strategies.

Market Neutral Performance: A Look at Why

Broad equity markets declined 20% to 25% from September through October 2008, which some cite as the height of market volatility in 2008. Market neutral strategies, on average, essentially broke even during that same time period. To better understand why these strategies navigated this two-month period, it is important to understand how they work.

In fact, the recent market volatility spotlighted some of the unique characteristics that, when combined, help explain why the inclusion of a market neutral strategy can make sense. As with most hedging strategies, they strive to provide absolute return—an all-weather component of an overall portfolio in good times and in bad. This feature, in which a return is expected on top of a typical T-bill return, certainly helped in the last year when equity markets fell substantially and T-bills struggled to above 0%.

In practice, equity market neutral managers pair long and short positions of securities with similar characteristics, expecting to benefit from positive performance with their long positions and negative performance on the short position. Because securities with a variety of similar characteristics are paired, theoretically, the portfolio should not be affected by sector-wide or market-wide events, thus reducing risk.

Market Perspectives: Implications of 2008 for Hedge Funds and Other Asset Managers

Many investors had expected hedge fund performance to provide an offset to other asset classes' returns, given the original intent of hedge funds, but many of these strategies also were battered in 2008. Created originally to produce absolute returns and reduce volatility, many hedge funds changed tactics during the market run-up, essentially becoming net long managers. While this produced large returns when markets rose, the group suffered for moving from its roots during the recent slide, declining more than 23% in 2008.⁷

According to several leading prime broker studies, hedge funds had an average net exposure—the average difference between their long and short investments—of 47% toward the end of 2007. One year later, that percentage dropped dramatically to 17%⁸ as hedge fund managers pursued more traditional hedging strategies as compared to strategies intended to generate higher returns.

Market events in 2008 will have even more far-reaching influence on the industry going forward. As previously noted, managers are reducing their risk and bringing their net exposure closer to zero. Managers are also making a dramatic shift within sectors and capitalization. Price attrition has reduced net exposure in some areas, such as ownership of Russell 3000 stocks, which fell from 4.5% to 3.5% in the third quarter of 2008 alone. Hedge funds also flocked late in 2008 to financials, with more gross assets and the greatest short exposure in the sector. The percentage of large-cap holdings also declined during the third quarter.⁹

During 2008, assets under management (AUM) declined among hedge funds, not only due to negative market performance, but also because of net redemptions of \$155 billion through December 31, 2008, the largest annual outflow on record after years of dramatic inflows.¹⁰ That compares with net

inflows of more than \$194 billion in 2007, according to *FINalternatives*.¹¹ One estimate has hedge fund AUM falling from \$2 trillion to \$1.25 trillion during the coming year.¹² Another speculates AUM could fall below \$1 trillion.¹³

The number of hedge funds, previously estimated at around 10,000, could shrink to half that number.¹⁴ Another forecast suggests that up to 80% of all hedge funds could disappear in the coming year.¹⁵ Fewer managers will result in a higher concentration of assets among the larger asset managers.

The past year also has affected the way surviving hedge funds conduct business. Stunned by unprecedented outflows, some hedge fund managers have changed redemption practices, either by increasing advance notice requirements, by instituting gates, or by shutting down redemptions entirely.¹⁶ Redemptions posed additional problems for hedge fund of funds, whose different notice requirements often didn't match the notice or lockup expiration required by individual managers. The beginning of redemption restrictions may have, in fact, contributed to the run on hedge funds in the fall and winter of 2008.

In another trend portending industry change, the number of proprietary trading desks and the leveraged capital they deploy is significantly contracting. The past year saw changes in this area such as JP Morgan acquiring Bear Stearns, Bank of America acquiring Merrill Lynch, Lehman Brothers declaring bankruptcy, and Goldman Sachs and Morgan Stanley becoming bank holding companies.¹⁷ This change, combined with the reduced number of hedge fund managers, may significantly reduce the “crowding effect” on many trades, resulting in more long and short alpha opportunities for remaining managers in the future.

Many of the firms referenced above also provided prime brokerage services to hedge fund managers. With fewer customers and service providers, and changes to their

business models, many managers will find it difficult to obtain the necessary services to conduct their operations. This is especially true as many investors are requiring their managers to have a multiple prime broker arrangement.

Investors are sure to focus on the operational integrity, compliance, and ethics of their asset managers after issues related to investor fraud and malfeasance captured the headlines at the close of 2008. Information about management and operational aspects that many hedge fund firms have been reluctant to share will be at the top of investors' lists.

An early 2008 report from PricewaterhouseCoopers (PwC) illustrates this changing tide. When the report was published last March, investors overwhelmingly cited performance as the top factor in choosing a manager. However, performance was much less important when asked why investors terminate a manager. Rather, transparency and the quality of compliance and risk management were cited as the top two reasons to dismiss a manager.¹⁸

In response to these investor concerns, look for client reporting to improve dramatically. Incredibly, PwC found that less than half of the hedge fund managers polled reported their management fee structure, leverage, risk controls, and potential conflicts of interest, while only one-third reported how they value assets.

Attributes to Look for in a Market Neutral Manager

With recent history providing stark lessons, investors are likely to significantly increase their efforts when performing their fiduciary due diligence responsibilities to interview and monitor managers. Several regulatory and industry groups have compiled comprehensive guides for evaluating alternative investment managers. The President's Working Group on Financial Markets released a pair of reports early in 2009. The first, *Best Practices for Hedge Funds* was submitted by the group's Asset Managers Committee. The second, *Principles and Best Practices for Hedge Fund Investors*

was produced by the group's Investors' Committee. Both offer helpful insight and guidance for investors as they assess prospective alternative investments managers. If you would like a copy of these documents, please contact us at www.pyramis.com. General topics discussed in those papers include:

Is the firm established? The growing ranks of former managers make it paramount that investors establish a firm's experience.

What is the firm's experience? Years as an investment manager don't give investors an itemized look at a firm's experience. How did the manager weather the most recent market turmoil? How has the firm fared during other recessions and bear markets? Past experience won't guarantee future results, but a look at the past can give investors insight into possible approaches.

What are the manager's capabilities?

Because of the lack of benchmark constraints, a true market neutral manager needs to have the capability to look at the world, notwithstanding the recent correlation of international and domestic equities. A firm with global research capabilities increases both risk management and buying opportunities. Likewise, the manager should be broadly versed in all sectors, not just a handful.

What are the expected risk-adjusted returns?

Alternatives managers have reduced net exposures dramatically amid the recent market turbulence and tightening of the credit markets. The decline in net exposure suggests alternatives managers may employ more classic hedged strategies and may be less dependent on levered long strategies. This change will magnify the manager's skill in stock selection and alpha generation. Prospective investors might analyze a manager's risk-adjusted returns as a barometer of the manager's skills.

What will the manager disclose? As investors demand less risky approaches given the events of 2008, a firm's risk management framework will be one of the deciding factors when choosing a manager.

According to PwC, poor risk management and compliance was a top reason for firing managers in 2008.¹⁹ It may become a deciding factor in choosing a manager going forward. To that end, investors might question prospective managers about their compliance practices, performance reporting, and fee structure.

Potential Applications of a Market Neutral Strategy

Despite the volatile recent past and ongoing investor concerns, we believe institutional investors are likely to continue to take advantage of alternative investments such as market neutral strategies for two primary reasons. First, they have little to no correlation with other investments and sometimes even to each other. Second, the diversification benefits remain an important risk mitigation tool, especially when markets decline.

As a result of the unique characteristics of a fundamentally based market neutral strategy, the applications for its implementation can be numerous.

Fixed-Income Replacement or

Complement—Market neutral strategies can act as a fixed income replacement, producing bond-like volatility with potentially higher risk-adjusted returns. Market neutral strategies generally have a significant cash component to investment returns and, since the returns have little to no correlation with stocks and bonds, can perform the role of a short duration defensive bond allocation, which can lower the risk of both the fixed-income category and the total portfolio asset mix.

This strategy can also act as a hedge when interest rates rise, as the cash-like return component increases with rising interest rates without the decline in asset prices that would occur in traditional bond portfolios.

Equity Portfolio Replacement or

Complement—An equity market neutral strategy can replace or complement existing long-only or other long/short equity portfolio allocations. The low correlation with other

equity asset classes and short investing tactics can differentiate the equity market neutral allocation from other equity portfolios in a plan's investment policy.

Alternative Investment Allocation Core

Strategy—Similarly, because the equity market neutral strategy involves what have historically been considered hedge fund strategies—specifically, long/short strategies—an equity market neutral portfolio allocation can serve to diversify a plan's other hedge fund allocations. Importantly, based on historical performance patterns, the equity market neutral strategy can deliver relatively higher risk-adjusted returns at a lower volatility level than other hedge fund allocations within a plan's allocations.

Complement to Current Quantitative Market Neutral Strategy

—For those investors who already have implemented a quantitatively based market neutral strategy, the portfolio can achieve even greater diversification by complementing like strategies that use different approaches. For example, an investor who has equities exposure with a quantitative market neutral strategy may opt to pair it with a fundamental market neutral strategy, especially if correlation between the two is low.

Portable Alpha—The alpha generated from market neutral strategies can be “ported” to other asset classes, such as investment-grade fixed income or large-cap equities. A market neutral portfolio is made up of three main pieces: the long equity positions, the shorted equity positions, and a cash pool resulting from selling the short positions. Because the long and short portions cancel each other out to a net zero equity exposure and the remaining exposure is cash, the portfolio benchmark is the risk-free rate (T-bills). By equitizing the cash pool, the market neutral alpha can be ported to other markets, usually via futures or swaps.

A New Reality, a Realistic Approach

In light of the market losses of 2008 and the uncertainty, investors would be prudent to examine the benefits of a market

neutral strategy as a core component of a well-diversified portfolio. Although each investor's implementation of this strategy may vary, market neutral strategies could provide attractive non-correlated risk-adjusted returns.

Going forward, investors are more likely to focus on attributes of managers that have been rendered even more important as a result of market and other issues. Investors are expecting changes in transparency, operational practices, and risk management structures that reflect the desire of institutional investors that asset managers' middle and back office operations be of the same high caliber as their investment efforts. ■

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Endnotes

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- ⁴ “Nikkei up but logs biggest annual drop ever in 2008,” *Reuters*, January 1, 2009.
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- ⁷ Hedge Fund Research Indices, www.hedgefundresearch.com.
- ⁸ Goldman Sachs Hedge Fund Trend Monitor, November 21, 2008.
- ⁹ Hennessee Group, *mmexecutive.com*, January 21, 2009.
- ¹⁰ “HFR: Hedge fund redemptions hit record,” *Pensions & Investments*, January 21, 2009.
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- ¹³ “Hedge funds try to cope,” *Forbes*, January 7, 2009.
- ¹⁴ “Hedge funds meet their match,” *Barron's*, January 5, 2009.
- ¹⁵ “Barclays adds voice to bleak hedge fund outlook,” December 23, 2008, www.wealth-bulletin.com.
- ¹⁶ “Hedge funds make it hard to say goodbye,” *The Wall Street Journal*, April 10, 2008.
- ¹⁷ “Barclays adds voice to bleak hedge fund outlook,” December 23, 2008, www.wealth-bulletin.com.
- ¹⁸ “Transparency versus returns: The institutional view of alternative assets,” PricewaterhouseCoopers, March 2008.
- ¹⁹ “Transparency versus returns: The institutional view of alternative assets,” PricewaterhouseCoopers, March 2008.

Glossary of Indices

Barclays Capital Aggregate Bond

Index (BC Agg): The BC Agg Bond Index is an unmanaged market value-weighted index representing securities that are SEC-registered, taxable, and dollar denominated. This index covers the U.S. investment-grade fixed-rate bond market, with index components for a combination of the Barclays Capital government and corporate securities, mortgage-backed pass-through securities, and asset-backed securities.

Barclays Capital 3-Month U.S. Treasury

Bill Index: The Barclays Capital 3-Month U.S. Treasury Bill Index is an unmanaged market value-weighted index of investment-grade fixed-rate public obligations of the U.S. Treasury with maturities of three months, excluding zero coupon strips.

Chicago Board Options Exchange

Volatility Index® (VIX®): The VIX is a key measure of market expectations of near-term volatility conveyed by S&P 500 stock index option prices. Since its introduction in 1993, VIX has been considered by many to be the world's premier barometer of investor sentiment and market volatility.

Cotation Assistée en Continu (CAC): CAC is an electronic trading system implemented at the Paris Bourse, the French stock exchange, in 1986. The acronym is also used to refer to the CAC 40 which is a stock index provided by the Paris Bourse.

Credit Suisse/Tremont Hedge

Fund Index: Credit Suisse/Tremont Hedge Fund Index is an asset-weighted benchmark of hedge fund performance derived from the Credit Suisse/Tremont database. The analytical models used provide a set of tools for asset class benchmarking, peer group analysis, and industry-wide research.

Deutsche Aktien Index (DAX 30): The DAX 30 Index is a blue-chip stock market index consisting of the 30 major German companies trading on the Frankfurt Stock Exchange.

Dow Jones Industrial Average (DJIA): The DJIA is an unmanaged index of common stocks comprised of major industrial companies and assumes reinvestment of dividends.

Financial Times Stock Exchange

Index (FTSE 100): The FTSE 100 Index is a share index of the 100 most highly capitalized United Kingdom companies listed on the London Stock Exchange. The index began on January 3, 1984, with a base level of 1000; the highest value reached to date is 6950.6, on December 30, 1999.

Hedge Fund Research Indices (HFRI): The HFRI Indices are equally weighted performance indexes, used by numerous hedge fund managers as a benchmark for their own hedge funds. The HFRI are broken down into four main strategies, each with multiple substrategies. All single-manager HFRI Index constituents are included in the HFRI Fund Weighted Composite, which accounts for over 2000 funds listed on the internal HFR Database.

Merrill Lynch U.S. High Yield

Master II Index: The Merrill Lynch U.S. High Yield Master II Index is an unmanaged market value-weighted index of all domestic and Yankee high-yield bonds, including deferred interest bonds and payment-in-kind securities, and is not an investment vehicle. Qualifying bonds must have maturities of at least one year, a minimum amount outstanding of \$100 million, a fixed coupon schedule, a credit rating lower than BBB-Baa3 and not be in default.

The Morgan Stanley Capital International Europe, Australasia and Far East (MSCI EAFE) Index:

The MSCI EAFE Index is an unmanaged market capitalization-weighted index of equity securities of companies domiciled in various countries. The index is designed to represent the performance of developed stock markets outside the United States and Canada and excludes certain market segments unavailable to U.S.-based investors. The Net version of the EAFE Index adjusts for withholding taxes applicable to Massachusetts Business Trusts.

National Association of Real Estate Investment Trusts (NAREIT)—Equity Only Index:

The NAREIT—Equity Only Index is a market capitalization-weighted index that tracks the common shares of all tax-qualified real estate investment trusts, excluding mortgage and hybrid real estate investment trusts, listed on the New York Stock Exchange, American Stock Exchange, and NASDAQ.

NASDAQ Composite Index: The NASDAQ Composite Index is an unmanaged market capitalization-weighted index that is designed to represent the performance of the National Market System which includes over 5,000 stocks traded primarily over-the-counter and not on an exchange.

Russell 2000® Index: The Russell 2000® Index is an unmanaged market capitalization-weighted index measuring the performance of the smallest 2,000 companies in the Russell 3000 Index.

Standard & Poor's 500 Index (S&P 500®):

The S&P 500® is an unmanaged market capitalization-weighted index of 500 common stocks chosen for market size, liquidity, and industry group representation to represent U.S. equity performance.



Risks of Market Neutral Investing

An investment is speculative, involves a high degree of risk and volatility, and is suitable only for those investors willing to risk losing some or all of their principal investment and who have the experience and ability to evaluate the risks and merits of an investment. Such investment, if available in a privately-offered fund, will generally not be freely redeemable, transferable, listed on any exchange and will not be tradable.

Investment is subject to, among other things, risks associated with market neutral strategies, short sales, non-U.S. securities, emerging markets, currency and currency hedging strategies, options, non-diversification, relative value strategies, the use of leverage and derivatives, counterparty risk and conflicts of interest.

Short sales in general, or of types of securities, have been restricted in certain markets in response to recent market events and other types of restrictions may be imposed at any time. Furthermore, additional costs may be incurred in connection with short sale transactions and the ability to continue to borrow a security is not guaranteed. As a result, these restrictions and costs and any future restrictions may prevent the full implementation of any market neutral investing strategy and may have a material adverse effect on the strategy.

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