LION CAO

ASSET MANAGEMENT

Market Musings

March 29th

Are we really getting ready for the turn?

I think the answer is **maybe**. I just read a Goldman Sachs economic report which was remarkably encouraging as were comments in the NY Times, even David Rosenberg of Merrill Lynch would not say that it was not possible. Then again, Nouriel Roubini has continued to say that we will continue to have a negative GDP for the rest of this year into next. I do think that **the stock market rally** we have been experiencing is NOT the real thing and is a Bear Market Rally or in other words a **"dead cat bounce"!**

However, to some degree we are making many of the necessary turns to prepare for our approach to a recovery. The open question is how many turns will it take until we see the runway lights.

HEADLINES—FOCUS ON SAFE LANDING

The **last Musings** started with Headlines and it was **about auto bailouts, Madoff, other crooks, and TARP**. I can't even begin to list all of the **recent financial headlines** since President Obama was inaugurated, but we are familiar with many and not necessarily in order of when they were announced: **Stimulus, Budget proposal, EU rejection, Populism, Geithner's fumbles/recovery, and of course AIG outrage** and flip flops by many on that topic, and today the **firing of GM's CEO** by the president, etc….

However there is a headline which I think is really **about hope and how great America is and can be in the future**. Beyond all of the difficult financial news we are all dealing with is the remarkable story of US Airways flight 1549 **which crash-landed in the Hudson River on January 15th under the command of Captain Chesley "Sully" Sullenberger** with no lives lost. While it started as a routine flight only 90 seconds into it, the plane hit a flock of birds and lost power in both engines. Sully managed to ignore the air traffic controllers' advice of landing at La Guardia or Teterboro and took control and landed the plane in the Hudson as the only real choice. Three and half minutes was all the time he had to make his decisions and land, quite amazing.

Sully told Katie Couric on 60 Minutes that: **"My focus at that point (as he was gliding to the river) was intensely on the landing. I thought of nothing else."** Later in the interview he said: "I was sure I could do it". He added: "I think, in many ways, as it

turned out, my entire life up to that moment had been a preparation to handle that particular moment."

Indeed, as noted in the CBS article describing the above interview: "There couldn't have been a better man for the job: a former Air Force fighter pilot who spent nearly 30 years flying commercial aircraft, specialized in accident investigations, and instructed flight crews on how to respond to emergencies in the air."

SO….ARE WE ON THE RIGHT APPROACH?

One might legitimately ask while that is a great story why are you mentioning it here. Well, I was at a conference lead by an old friend Charlie Hess from Inferential Focus, a consulting firm which doesn't make predictions, but rather gathers massive amounts of current information and "infers" potential outcomes, and this was a topic of great interest.

They used this **wonderful story, which totally captured America's attention, as a metaphor for the US with hope for a "perfect landing for the economy."** However are many of the signals we are getting similar to the ground controllers advice… too much by the book, and is there too much expert rhetoric or Congress' pontifications? Don't we really need someone to **slide into the Captain's seat and make the hard decisions** and the "crew members" would do the things they should and not just be "lobbying for personalized revisions." This was an extremely fascinating "round table" discussion which leads me to think of **what has been going on recently in Washington**. Frankly, it has been most disappointing.

Let us go back to some of the headlines we have had over the first 69 days of the Obama presidency.

The **Stimulus** program, the **Appropriations bill** passed and the proposed Obama **Budget** in my mind clearly are more politically driven than many of us had expected! I think everyone, even Rush Limbaugh after his full quote was noted, **want Obama to succeed**. Most of us believed that what **Larry Summers had correctly stated was needed for a stimulus plan: a program which was Targeted, Timely and Temporary. We got none of that**! The Stimulus we got instead was a wave of new programs and long term solutions with **more money being spent in 2011 to 2019 than in 2009 and 2010** and only a modest 12% amount for shovel-ready infrastructure projects this year, almost no tax relief, etc. and the programs continue into the future with no cutoff. Unfortunately, about **one third to half of the stimulus will be absorbed by the states** which will have a cumulative deficit of $250 to $350 billion from 2009 to 2011.

The **Appropriations bill contained almost 9000 pork barrel programs** and Obama had said repeatedly he would not sign a bill with these kinds of earmarks. It is not a Bush left over bill, it was Obama's chance to "change" the ways of Washington and he did not take the opportunity to live up to that campaign promise. I see it as politics as usual**, not change**.

Similarly the **Budget proposal** really continues the concept of what one thinks might NOT be appropriate in this very difficult economic environment. We require leadership in dealing with the issues at hand and **NOT introducing a panoply of new huge programs** which will increase our debt drastically. It is a **$3.6 trillion budget blueprint, and by his own admission, redefines the role of government in our economy and society**. The budget more than doubles the national debt held by the public, **adding more to the debt than all previous presidents-from George Washington to George W. Bush-combined**. "A financial crisis is the worst time to change the foundations of American capitalism."(Per Michael J. Boskin in the NYT 3/6).

I may not be "fair and balanced" here, although I am trying to make a point! **From Karl Rove (**WSJ Op Ed 3/26):

> "Last fiscal year, the deficit was $459 billion. For this fiscal year, it was **$569 billion when Mr. Obama took office. Under his proposals, another $1.276 trillions will be added** to the deficit this year, for a total of $1.845 trillion…..By 2019 the debt would reach 82.4% of GDP, a level not seen since 1947. With astonishing candor **Peter Orszag,** the president's budget director conceded these levels of **deficits and debts were 'unsustainable**.' Federal spending will under Mr. Obama top $4 trillion this year. This translates into **28.5% of GDP—a level exceeded only at the height of World War II.** According to the president's plans, spending will thereafter slow for three years, but then grow faster than the economy for the next seven years and beyond…."

Furthermore, these programs in general according to the president are intended to **redistribute wealth** from taxes on higher income people, if you make over $250K you are now considered wealthy, and reduce the burden on the other 95% of "working people." Let me make this clear if there is any doubt, Rahm Emanuel the president's chief of staff, has been quoted as saying; **"a crisis should never be wasted."**

Getting back to our hero, Sully, I think what we have is an administration which has, thus far, not stayed focused, which has introduced too many, too soon, extremely ambitious plans on health care, education and the environment….all noble….but we need to face the here and now first in my view. That would require fiscal restraint on those programs and ideas which don't directly deal with the economic and banking/lending issues at hand. First and foremost we need to get the economy back on track which itself is an enormous and extremely complicated task. As Sully said; "**my focus at that point** was so intensely on the landing. I thought of **nothing else**." Clearly, a president and administration has to do more than walk and chew gum. We do have many things in the world which are dangerous and need his attention: Iraq, Iran, Afghanistan, North Korea, Pakistan, and now Mexico to name just a few.

One point I would make as I listened to the radio earlier today, **President Obama clearly said: "My first priority is the economy**." I hope he sticks with that sentiment, although his actions thus far do not seem to mimic his words.

We wish the president good luck at the G20 meetings this week with all of the resistance he will face from out global partners. We all have to be in this together, although with different approaches of course, but without building up the protectionism which seems to be creeping into country policies, including the US. A concerted **worldwide effort must be made to bring us out of the economic morass** from which the entire world is currently suffering. We are long past the notion that decoupling had occurred!

FED/TREASURY/FDIC—FULL SPEED AHEAD

> *So: I want to warn people from Nigeria, if you get any emails from Washington asking for money, it's a scam. Don't fall for it.*

There have been so many proposals, programs and initiatives that it would be far too ambitious for this note to comment about each specifically, but here are a few observations. **Bernanke and the Fed have mostly gotten good to excellent marks** from my readings. I believe that is a correct assessment. He has been a leader and focused on getting the banks and credit markets functioning properly. The expanded Term Asset Backed Securities Lending Facility (TALF) program of a few weeks ago recently added $200 billion to $1 trillion for AAA commercial MBS and newly issued AAA consumer-related ABS. More recently he initiated aggressive plans to purchase various securities in another program of up to $1.25 trillion, including $300 million to purchase 2 to 10 year Treasury securities. I think the Fed also has been extremely helpful in coordinating numerous efforts with the Treasury and when appropriate the FDIC.

While Geithner **started off disappointingly slow, he has been picking up momentum** and while there is tremendous debate on how successful his programs will be at least he has now moved forward with much more specifics than in the recent passed. We are still awaiting word on the outcome of the "Stress Tests" of the 25 largest banks. Then we will learn more about the recapitalization program and the specific fate of these banks.

It may be helpful to quote directly from **Geithner's Op Ed** in the WSJ on 3/23.

> "Over the past six weeks we have put in place a series of financial initiatives, alongside the Recovery and Reinvestment Program…We launched a broad program to stabilize the housing market by encouraging lower mortgage rates and making it easier for millions to refinance….a new capital program to provide banks with a safeguard against a deeper recession…..We started a major new lending program with Federal Reserve targeted at the securitizations markets critical for consumer and small business lending by directly purchasing securities…Today, we are announcing another critical piece of our plan to increase the flow of credit and expand liquidity.
> **Our new Public-Private Investment Program will set up funds to provide a market for the legacy loans and securities that currently burden the financial system….**

> The funds established under this program will have three essential design features. First, they will use government resources in the form of capital from the Treasury, and financing from the FDIC and Federal Reserve, to mobilize capital from private investors. Second, the Public- Private Investment Program will ensure that private-sector participants share the risk alongside the taxpayer, and that the taxpayer shares in the profits….third, private sector purchasers will establish the value of the loans and securities purchased under the program, which will protect the government from overpaying for these assets….initially $500 billion ….potential**…$1 trillion over time.”**

I have included a more detailed description by Goldman Sachs in the Appendix for those of you who want to go into much more detail. There are really two programs, one for loans and one for securities, which are quite different. The leverage can be as high as 6 to 1, although as suggested by a commentator, as the government is supplying half of the equity and 100% of the debt, one is actually receiving 12 to 1 leverage (or perhaps more, see Appendix)…interesting, as we now are creating almost as much leverage as caused us to get into this mess. However, "Greed got us into this mess, and it's clear that greed will have to get us out of it." Per Jason Trennert, Strategist, Strategas Research Partners.

There are some enthusiasts like Larry Fink of BlackRock and the folks from Pimco who see this as an interesting play. I think the **real question that is on so many people's minds is can you now trust our government to live up to the contracts which are agreed upon. Geithner says totally yes in this deal.** We however have seen Barny Frank and Charles Rangel change stripes very quickly and attack with a vengeance what they perceive to be a wrong…..and aggressively use the tax code or other means to get what change they wanted….legal or otherwise. Private capital and hedge funds seem to be very concerned about this possibility and have no desire to be directly under the auspices of those two, among others in Congress!! However, my view is that Congress and the president and his administration **will come to their senses and NOT allow such punitive or retroactive legislation to stand.**

WASHINGTON REFORM—THOUGHTFUL DEBATE??

> ***Let's set the stage: The problem with an investment bank balance sheet is that on the left side nothing's right and on the right side nothing's left.***

We worry a great deal about the speeches made recently by the president, Geithner and Barney Frank regarding a greater effort and oversight on regulation. I am not against regulation in fact I believe over the last 20 years**, regulation has been quite sufficient in most cases BUT most inadequately conducted by the regulators.** Examples of poor oversight include: Madoff, subprime lending, A.I.G.'s financial services unit, Washington Mutual, Wachovia, and of course Lehman, Merrill Lynch and Bear Stearns, as well a while back Enron and WorldCom, among others. The FDIC has so far done a

good job handling failed banks and in working with the Fed and Treasury to create mergers to salvage insolvent banks.

Today's NYT Editorial was titled "*Questions for Reform*". Below are a few excerpts from it.

> "Treasury Secretary Timothy Geithner sounded the right notes last week when he presented a first draft of the administration's plan to reform the financial system. He said the system had failed "in fundamental ways" and would require comprehensive overhaul. "**Not modest repairs at the margin," he told Congress, "but new rules of the game."**
>
> ….Geithner called for large hedge funds and private equity firms to register with the Securities and Exchange Commission, a move that could bring much needed disclosure and oversight to vast pools of capital that fed the bubble economy.
>
> Similarly Mr. Geithner called for oversight of unregulated derivatives, like the credit default swaps at the heart of the debacle of American International Group.
>
> …he called for a single **powerful regulator to police the most powerful institutions, presumably intervening to require more capital whenever sheer size and conflicting activities appear threatening….**No one disputes that this authority is needed in today's world to avoid calamitous bankruptcies and bailouts. The aim would be to make such takeovers as orderly as a bank seizure by the Federal Reserve Insurance Corporation.
>
> [*NOTE: the editorial goes on to question whether firms too large to fail should be permitted to exist and if we don't have the tools to change that currently, governments should be able to deal with these companies. The piece then asks the following question.*]
>
> **What are we trying to fix anyway?** The urgency to repair the financial system **is mainly political.** Crises create intense public awareness and with it, the opportunity for change that reform-minded officials do not want to squander. Even lawmakers who would prefer the status quo feel the pressure to act.
>
> But **does anyone understand with specificity what brought on the financial meltdown?**
> …..Without the **answers, which we do not yet have**, Congress and the administration **cannot be confident that they are coming up with the right reforms."**

There are areas that need further supervision and **certainly more active oversight** from existing regulations. What worries me is the political nature of all of this regulation discussion and the thought that legislation will be rushed through Congress in a knee jerk reaction. I think CDS and other derivatives should be traded on an exchange where there is **adequate transparency.** Changes are needed in **mark to market accounting** to more accurately reflect the value of securities/loans intrinsic value, probably using cash flows, not market prices created by forced market sales.

I don't know what it will mean for a "single powerful regulator" to be able to take over various types of companies if they are "too big to fail." The FDIC can take over banks as they are guaranteeing the deposits. What kind of an arrangement would we need for this super regulator to act….would there be any constraints, and where in the government do we have the talent to take over an A.I.G., Lehman, Citi or GM, etc.

> *Will they know?: What worries me most about the credit crunch, is that if one of my checks is returned stamped "insufficient funds". I won't know whether that refers to mine or the banks!*

I simply hope that a great deal of thought and debate goes into this entire area before the types of unintended consequences are felt as we have witnessed with Sarbanes-Oxley, among other legislation hastily put forward.

RECESSION/DEPRESSION/DEFLATION/ EXPANSION/ INFLATION

What a huge **topic to tackle and thus I will not even try**. I believe, however, that we are in a **massive recession**, clearly the worst in 80 years, and it now is 17 months old! In most of my readings the consensus seems to be that we will have another awful GDP drop in the first quarter and per Goldman and Merrill it will be -7.2% range which is horrendous to say the least. Most analysts/economists are also not seeing a turn away from the negative numbers until the third quarter and that may or may not be sustainable. Merrill points out that "all of the four ingredients that make up the recession call-industrial production, real sales, employment and real personal income excluding government transfers-are still in deep negative terrain". Of course Dr. Doom, Nouriel Roubini, is even more pessimistic and does not see a turn up until at least early 2010.

I am certainly not an economist, as I have stated frequently, so it is hard for me to say this is a depression but in many parts of the country and in many industries I believe it feels that way. **Unemployment** is at 8.2% and most commentators suggest a rise to 9+% and several of the pessimists are over 10%. **Housing** is still a disaster and may stop going down this summer but very few are saying it will start to go up from there. **Household wealth has declined by an unprecedented $20 trillion**; it will take many years for this to be rebuilt. As a consequence people are saving more and spending less…the new **Frugal Consumer**….unfortunately more savings by an individual is quite good but collectively with ALL of us saving more, there is a dearth in spending! It will take great

confidence to go back to even a modest amount of extra spending from where we are today.

Underemployed, along with the unemployed, which together is another statistic many are quoting, is at almost 15%, this adds in part time workers who want to be fulltime. Also 1 in 11 homeowners with a mortgage now is either delinquent or in foreclosure. Per Merrill: "We're not sure how to **classify such a macroeconomic backdrop, but it certainly is not a garden-variety recession.**" Goldman on the other hand had a long piece dated 3/9 called "*A Road Map to Stabilization in the US Economy*" in which they detail 12 key indicators which if many are positive will lead to stabilization by the middle of 2009. While there are lots of ifs in the piece, it is clear that they see signs of life among the many negatives existing. They see -7% and -3% for the first and second quarters, they believe **the second half will be up to a 1% rate,** not that different from the consensus forecast by Blue Chip Economic Indicators.

Depression, probably not, but I would put it damn close. The government is acting, and while one can be critical about many parts of the government activities, I believe they are doing virtually everything they can think of to keep this melt down from getting worse. Hopefully, as noted earlier, the president will have great luck in enlisting global support for concerted economic stimulus and regulatory reform at the G20 meetings – which is critical.

Deflation

All of these negative issues noted above are deflationary in nature. Goldman Sachs had a terrific piece on "*The Specter of Deflation*" dated 3/13 which is quoted below.

> "Although the recently enacted fiscal stimulus package should help stem the decline in real GDP, it will likely be insufficient to keep the "output gap" from growing to its highest level in postwar history. As a result, we expect core **inflation to slip into negative territory by the end of 2010**. Unless the economy rebounds strongly thereafter, the pace of deflation could deepen further in subsequent years. This would raise the real debt burden on households, businesses, and banks, and would thus make it even more difficult to resolve the financial crises.
>
> ….Fed officials might need to **expand their balance sheet by as much as $10 trillion** to make policy accommodative…..Balance sheet expansion on this scale is therefore probably undesirable.
>
> Our analysis suggests that **another fiscal stimulus package will be needed** before long to combat the deflation threat. In January, we argued for a package totaling $1.2 trillion in 2009-2010 and **$2 trillion over a 5 year horizon**. We still think that these are reasonable targets for the total stimulus that will ultimately be needed….

> Moreover, the model suggests that deflation would likely deepen in subsequent years unless a return to above-trend growth pushes the unemployment rate back down sharply. If unemployment instead stays at 10% the model projects a core **CPI of -0.6% in 2011 and -1.0% in 2012**. Again, this is despite the optimistic assumption that forward-looking long-term inflation expectations remain "fully-anchored" at 2.8% …
>
> *[Note: they go on to argue that monetary measures are unlikely to work on there own and that fiscal stimulus is needed and concluded with:]*
>
> **Hence, a forceful and front-loaded effort to stem the deterioration and the descent into deflation remains desirable."**

While I totally respect the views of Goldman's economists, my thesis is that the amount of global stimulus and monetary expansions will be so overwhelming that the world economies will begin their recovery probably in the latter part of 2010. When they do, the governments which restarted these economies will be unlikely to reverse course as quickly as they had initiated programs and the lack of unwinding will cause inflation to rise. It would not surprise me with all the debt that governments will be creating that they might not be tempted to inflate in order to be able to pay back these borrowings! I believe **global activity will not be curtailed for years to come and we will not continue to be mired in this slump. And I certainly hope I am right!!**

DEAD CAT BOUNCE NOW AND BULL AWAKENING?

I think the massive rally of over 20% from the lows of March 9th, which began to cool last Friday, is indeed a bear market rally. Although, we all would like the facts to be otherwise. Material from JP Morgan, Merrill, Goldman, Roubini and others have me convinced that **this is not the bull market rally yet**. JPM came up with a list in a Michael Cembalest note of 3//13 of about 9 reasons it could be and 12 that it is not yet a bull market. They summarized it however with: "…**we intend to wait**." There is some optimism coming from UBS and Barclays.

From ML 3/24:

> From 1929 to 1932, we saw four **20%+ rallies** in a long and drawn out near -90% slide. We also saw three of these in the 1937-42 bear phase. And there were two in the 2000-2002 tech wreck. And…**we have now seen two of these in the current bear market**--from the 752 intermediate low to the 934 intermediate high back on January 6th for a rebound of 24% (much like we have today). The 752 low was "supposed" to hold…but it did not.

…**Now the 676 closing low (666 intraday) on March 9th is deemed by many of the experts to have been THE low.** We are respectful of that view, but skeptical nonetheless.

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A **22% gain over 10 trading days is extremely rare**-last occurring in 1938.

Again ML in a piece on 3/26 titled *February Follies*:

> There is an old saying that the stock market is ruled by optimists and the bond market populated with pessimists. The winners are ultimately the realists. All we can say is that the enthusiasm that seems to have taken over the equity market in the last three weeks is beyond breathtaking and leaves us concerned that disappointment will set in, prompting a major reversal.
>
> From a near 13-year low in the S&P on March 9th, when a **depression mentality was starting to dominate the market mindset**, equities have since made their fastest advance in 70 years. Indeed, the stock market may have hit an oversold low three weeks ago and been ripe for a technical short-covering bounce. However, it has suddenly become the widespread view the economy and the earnings backdrop have turned the corner for the better. We advise caution, and here is why:
>
> 1) **Insufficient ratification** from other asset classes—*ML says no confirmation from the VIX which has stayed above 40 and no comparable move in the bond market.*
> 2) Environment not conducive to a **75% bounce** in earnings—*ML says the market is about at $70 operating EPS for the S&P and they are closer to $40.*
> 3) Second derivative on GDP growth is not improving—*ML doesn't believe the markets are trading off the second derivative and this* ***is not an equity based rally.***
> 4) Seasonal factors **skewing the February data**—*ML says that aggressive seasonal factors skewed all of the positive data and would not put much faith in those indicated numbers.*
> 5) **Unprecedented plunge** in corporate profits—*ML notes that corporate profits plunged in the 4Q at a 74% annual rate, financials at a record 97% annual rate and back to 1994 levels.*
> 6) Employment conditions **are not stabilizing**—*ML says unemployment will reach a 26 year high and will break to or through 10% by year end. And finally:*
> 7) **Downward pressure** on housing market remains—*ML asserts housing is the quintessential leading indicator and we are at 12.2 months supply currently and need to be at or below 8 months.*

One last thing from my friends at ML is that they do not see a recovery in private sector spending until the first quarter of 2010, which will mark the end of the recession. That signal is needed in their view before a bear market will end. This suggests **the bull market beginning perhaps in the fourth quarter** predating the end of recession by 4 to

6 months. However if one believes that the recession will end by summer, then this may be a real end to the bear market. However, I do not believe so.

OUR VIEW—BE PREPARED AND SEE THE RUNWAY LIGHTS

I think most things are a bit brighter than they were before the Obama inaugural but not yet much above a low dim. As indicated in my last Musings, this will continue to be a challenging year but one that is **filled with opportunities if we are able to have the courage to take advantage of them.**

An example of what **Lion Cao** and some of our investors have participated in thus far this year is the **IndyMac purchase from the FDIC** by JC Flowers and other large and successful players, including John Paulson, Steve Mnuchin from Dune Capital, as well as the investment arms of George Soros and Michael Dell. We look forward to achieving excellent returns by taking advantage of the opportunities to grow the business and reestablish it as a highly regarded bank and lender. Here is the link of the press release from the FDIC on the transaction:

http://www.fdic.gov/news/news/press/2009/pr09042.html

We mentioned in our December note that we were reviewing **opportunities in the "distressed" arena** for the purpose of creating a pool of three to take advantage of the dramatic changes in the marketplace. Since then, we have been talking with our investors, colleagues and friends to get a closer view of both the issues they are dealing with, as well as the desires they each have for their investment objectives. Most, if not all, had expressed a **great interest in receiving some kind of dividend and/or distributions** that would be available in a near term horizon.

We have also been vetting several additional **"distressed" funds, many of which are credit-oriented**, and are working to finalize the group of funds that we believe are most attractive for a new vehicle which we will be offering. We have identified several funds/investment vehicles which should provide a diversified "play" in the current distressed landscape with potentially **four funds that will comprise our "Quattro" offering.** We believe that having exposure to credit opportunities which can be purchased and held to maturity or redemption is an excellent part of a diversified strategy in the distressed area.

We have identified several such credit funds/extraordinary managers and are reviewing them with the current belief that buying mostly first lien bank paper, with extreme knowledge of the issuing companies, an ability to hold the paper to maturity or redemption, limited leverage and always matched to maturity, are ingredients of a successful strategy. **The structure** of most that we like at this point is to have an **intended investment period of 18 to 24 months**, somewhat front end loaded, and a **holding period of about 5 years.** The funds would take down the capital over the investment period and investors would start receiving distributions of interest

immediately, if not set off against capital calls. Most investments would be held to maturity or redemption and not traded, although of course opportunistic sales might occur. With many of these first lien loans at heavily discounted prices, particularly relative to the strength of the underlying company credit, the prospect of being redeemed at maturity or earlier at par is extremely high. The **returns unlevered would be in the high teens / early twenties** and if levered 1 to 1 almost double that and further if redeemed earlier than maturity at even higher IRRs.

We will be finalizing our diligence, and will have available our findings and materials once they are ready.

In addition, we are also **sourcing direct investment opportunities**, and some fund opportunities that may not fit into the Quattro concept, which we believe are unique and compelling; such as in **shipping and commodities or some combination of both.** We are happy to discuss these specific deals with you, if you have some interest.

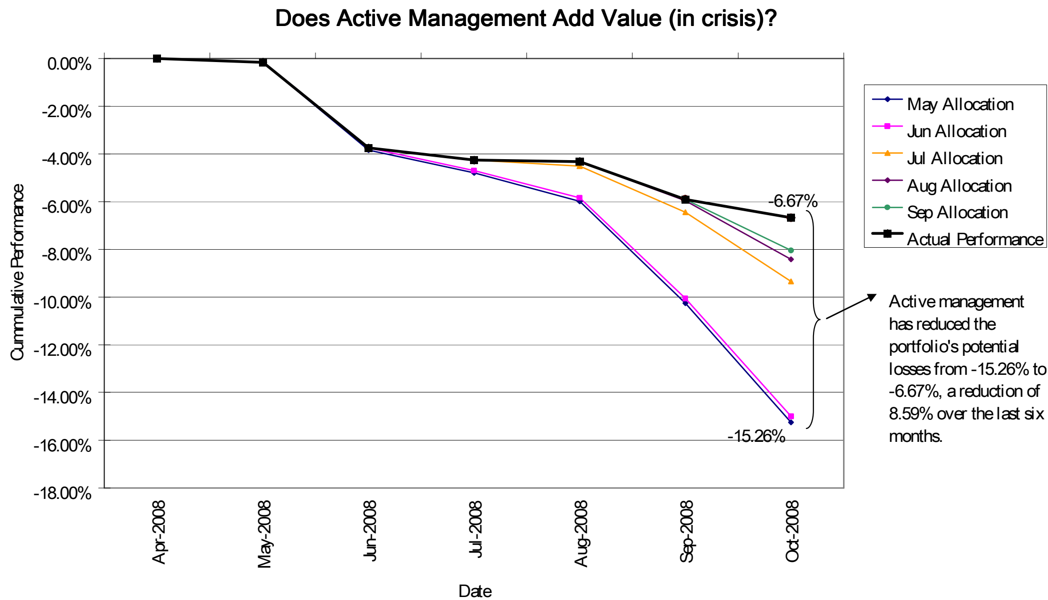
In the meantime, please feel free to contact us if you'd like to discuss any of the above, and/or if you have some additional thoughts. We are always interested in hearing from you, and **incorporating your feedback into our process**.

With respect to opportunities in **Asia,** we also continue to believe that the region remains an attractive area to invest, and that **pre-emptive, hyper-active portfolio and risk management do work!** Ajia Partners, our joint venture partners in Hong Kong, have been able to weather the storm well in 2008, and also in 2009 due to their active management. Results speak for themselves…in 2008; the Ajia Asian Fund-of-Funds was down -5.90%, compared to -21.68% and -43.23%, respectively for the Eureka Hedge Asia Pacific Fund-of-Fund Index ("Eurkea Hedge Asia") and the MSCI AC Asia Pacific Index ("MSCI AC Asia"). Thus far for year-to-date through February 2009, the Ajia Fund was down 49 basis points as compared to -1.72% for the Eurkea Hedge Asia and -16.06% for the MSCI AC Asia.

Back in June 2008, my partner Holly Cao visited with our portfolio manager Paul Heffner and his team at their offices in Hong Kong, and met with several of the underlying managers with the team. During this time, Paul had been very focused on diligence on the underlying funds' counterparty risks, as the condition of financial institutions continued to deteriorate worldwide. Given that and the progressive slowdown in Asia as a result, **Paul developed a very defensive outlook** for the rest of the year, and had made a strategic decision to **reduce dramatically the directional equity** exposure in the fund, while **increasing exposure to equity neutral strategies.**

See the chart below beginning in June 2008, which illustrates this change in the portfolio through the beginning of this year..

The chart below shows a back-test of how the portfolio would have performed had Paul kept the portfolio allocations constant since June 2008:



Had Paul's team remained a passive allocator, the Fund would have been down -15.26% vs. -6.67% for the six-months ending October 2008.

We thought these charts were very appropriate to show how **pro-active management and rigorous risk management can mean a dramatic difference in results,** particularly in times of crisis and market dysfunction.

We continue to always attempt to recognize the **proper balance between risk and reward** and bear that in mind in our efforts. We truly believe that we have the skills and perseverance to do that and the ethical compass to appropriately steer us in all that we do.

Please call or email with questions or comments. We do indeed enjoy hearing from you.

It is now Spring and hope for a new time of awakening and growth is upon us. At least we all hope so. We are glad this crazy quarter is just about over and the efforts/planting from all of the Obama/Bernanke stimulus will bear fruit soon!

Thanks for your support and good luck and as always Happy Landings!

DDL

David DeLeeuw
The Lion Companies
Co-Founder & Chairman
535 Madison Avenue
4th Floor
New York, NY 10022
T- 212-355-5500