

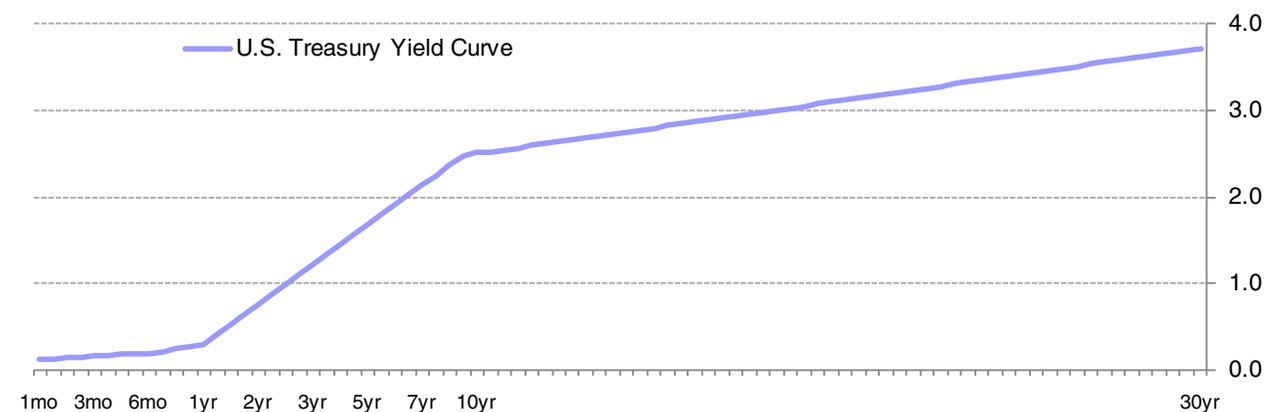
## Alternative Investment Group

October 11, 2010

### OBSERVATIONS ON TODAY'S CAPITAL MARKET OPPORTUNITIES

In the last few months, many investors have asked us to share our views on various segments of the capital markets and investment opportunities going forward. We summarize below our observations which are based on our own analysis as well as discussions with managers, consultants and other investment industry professionals.

**Government bonds** are trading at such low yields (0.4% for 2 years, 2.5% for 10 years, and 3.7% for 30 years) that they are unlikely to play a significant role in providing the yield needed for the distribution requirements of endowments, foundations and pension funds. Bonds have recently attracted a lot of money (\$196 billion to bond mutual funds year to date through August 31) which looks to us like return-chasing based on positive returns in 2008 and 2009, a period of falling interest rates resulting primarily from government intervention. However, the only way bonds can make an attractive total return in the future would be for yields to decline even further, which seems unlikely as government purchases slow down, corporations continue to borrow long-term at favorable rates, and the economy gradually stabilizes. More likely, interest rates will rise over time as the massive increase in the money supply flows into the financial system. Indeed, the forward rates two years out are all higher than today at 1.6%, 3.4%, and 4.3%, respectively, for 2-year, 10-year and 30-year maturities, implying a loss of principal.

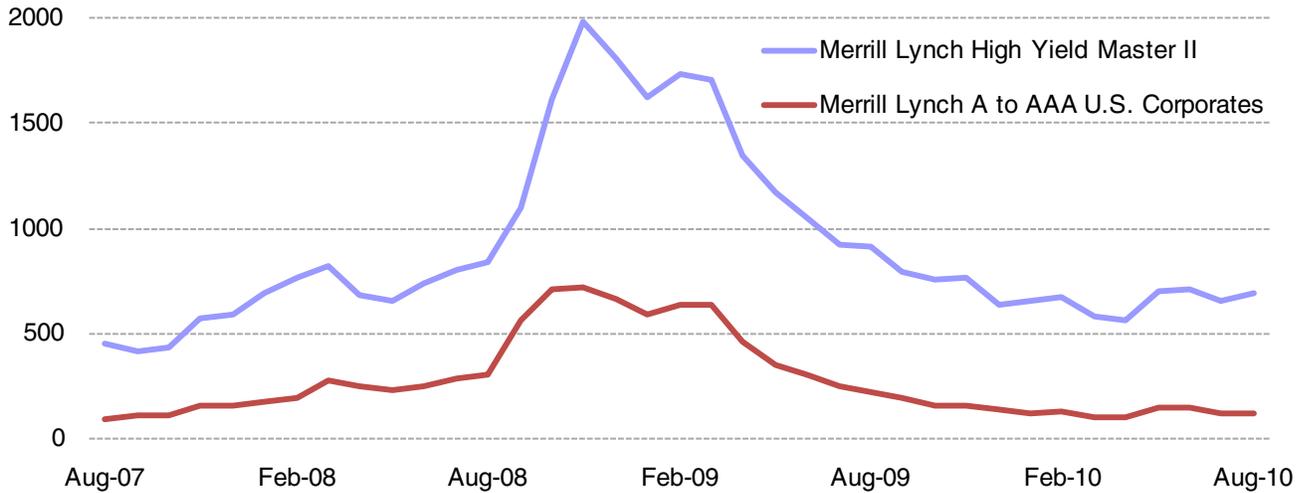


Source: Bloomberg

**Investment Grade and High Yield Corporate Bonds** are paying better yields (about 1.5% yield to maturity today for A to AAA rated corporate bonds and 7.8% yield to maturity for B-rated high yield bonds) but are also at risk if interest rates rise or if companies run into trouble from an extended recession. While bonds used to be an attractive complement to stocks, the correlation between them has risen. For example, the correlation between stocks and investment grade bonds for three years ending August 2010 is 0.44 vs. -0.20 for the prior three years, therefore providing less risk reduction than previously.

During the last 18 months, corporate spreads compressed dramatically as shown in the following chart, providing very attractive returns for investors. However, given current spreads, the prospect for earning similar returns going forward is less rosy.

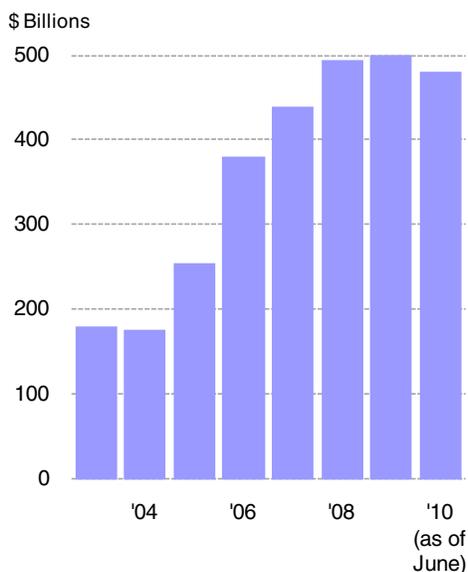
**High Yield and Investment Grade Bond Spreads**



Source: Bloomberg

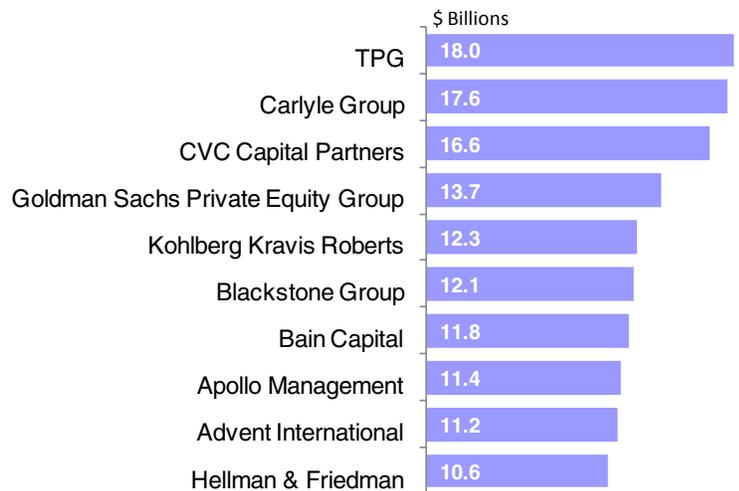
**Private Equity/LBOs** has at times provided very attractive returns, often by employing heavy leverage at low interest rates and selling the company. Lenders are much less willing to play this game today and there is a tremendous amount of money on the sidelines that needs to be invested, as shown below. Many institutional investors are overweighted in non-marketable assets as their marketable holdings have declined. They are therefore looking to reduce, rather than increase, their allocation to private holdings, so this area looks tough for the foreseeable future.

**Uncommitted Capital:  
Global leveraged buyout funds**



Source: Prequin

**Uncommitted Capital:  
Largest amounts by firm**

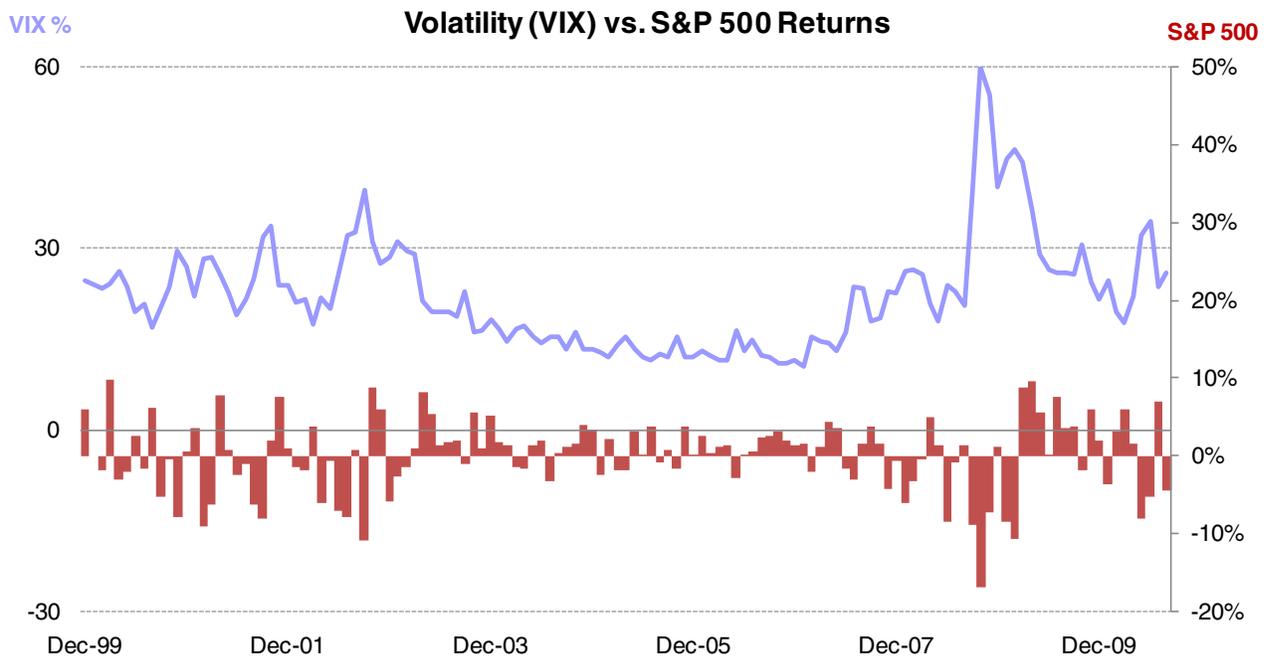


Source: New York Times

**Corporate Mergers and Acquisitions**, without a private equity intermediary, appear quite strong as companies work to grow their top and bottom lines. Corporate America is sitting on \$1.8 trillion in cash and some of this is being used to fuel acquisitions to compensate for sluggish organic growth. Through mid-August, global M&A activity stands at \$1.7 trillion, up 24% from the same period last year. Alternative Investment Group uses several “event-driven” managers who emphasize, among other things, investment in companies that may be attractive acquisitions.

**Venture Capital** has been attractive in the past and someday will be attractive again, especially for investors who put a high priority on responsible investing. However, today’s environment is extraordinarily difficult for start-up companies focused on just surviving. The IPO market remains sluggish, diminishing a major exit avenue for venture capital funds. Reflecting these problems, venture returns have been low and partnerships are having trouble raising capital.

**Marketable Stocks** are likely to remain highly volatile, as shown in the VIX chart below, as investors bounce between fear (S&P 500 down 31% from 2001 to 2002 and down 37% in 2008) and greed (S&P 500 up 26% 2009). Through August this year, investors have taken about \$22 billion out of equity mutual funds. Pension funds are avoiding stocks because stock volatility flows through to create volatile earnings. Endowments, foundations and pension funds are reducing their marketable stock exposure because the volatility makes it difficult to make long-term commitments. Although corporate earnings are currently strong, most of these earnings increases have come from cutting costs rather than revenue growth. From a valuation standpoint, stock prices eventually have to follow earnings. Slow revenue growth in the midst of a sluggish economy, coupled with higher taxes and more regulation, could hurt corporate earnings and depress stock prices over time.



Source: Bloomberg

**Leveraged Hedge Funds** will probably shrink dramatically as lenders reduce their available financing and investors shy away from the volatile returns, redemption gates and illiquidity they have experienced in recent years.

**Unleveraged Long/Short Hedge Funds** will likely lag in a strong stock market rally. However, they will likely outperform long-only stocks and provide good capital protection in a weak market, using the short side as a

strong hedge against the exposure of long positions. For an investor seeking to reduce the pain of market declines, while retaining exposure to upward market movements, including fundamental unleveraged long/short equity as a balance to volatile long-only equities, seems to be an attractive addition to a portfolio. Not surprisingly, flows into hedge funds have been positive this year as investors think more about risk reduction in a weak investment environment.

### **Summary**

Investors today are faced with the challenge of generating investment returns in a low growth environment. Many are flocking to asset classes that have worked recently, such as Treasury securities or corporate bonds, that have posted positive returns as interest rates declined post the 2008 financial crisis. However, this may very well be a short-sighted strategy, akin to investing using the rear view mirror.

We continue to believe that unleveraged long/short equity funds are especially appropriate for investors who want to maintain exposure to the capital appreciation potential of equities while minimizing sharp downdrafts in their portfolios. With regard to specific opportunities, we believe that growth opportunities in international, particularly emerging markets such as China, India and Brazil, remain attractive. A long/short approach allows investors in developed and emerging markets not only to participate in economic growth but also profit, through short positions, from overvalued companies. We also like event-driven opportunities in which managers unlock value by identifying a catalyst such as a merger, acquisition or restructuring, and which have much lower correlations to general equity market movements.

Our experience at Alternative Investment Group continues to support our conviction in fundamental long/short equity. Since investment inception in 1996 and 1998, Alternative Investments, L.P. and Alternative Investments Institutional, L.P., respectively, have earned over three and five times the return of the S&P 500, with substantially lower volatility. In each of the 20 months when the S&P 500 declined 5% or more, both funds have not only done better but have produced positive returns in roughly half of those months.

It seems clear that the dramatic events beginning in 2008, and the governmental responses worldwide, have fundamentally changed the investment environment, and investors may expect both volatile markets and lower equity returns than in the past. We look forward to discussing these issues with our investors and continuing to find the best managers worldwide to earn positive returns with strong capital protection.

## **IMPORTANT NOTES**

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### **PAST PERFORMANCE IS NOT INDICATIVE OF FUTURE RESULTS.**

The investment returns shown are calculated on a time-weighted total return basis by Alternative Investment Group, L.L.C., the General Partner of the domestic Funds. The investment returns reflect the deduction of estimated Incentive Allocations allocated to Alternative Investment Group, L.L.C., the General Partner of the domestic funds and estimated Incentive Fees charged by Alternative Investment Group Services, L.P., the Investment Manager for the offshore fund/feeders, as well as, Management Fees paid to Alternative Investment Group Services, L.P., the Management Company, and all operating expenses (which include all fees and incentive allocations paid to the Funds' underlying hedge fund managers (the "Portfolio Managers"). Portfolio Managers reinvest dividends and income generated by their investment activity. Accordingly, the Funds' results reflect reinvestment of dividends and income by the Portfolio Managers. The investment returns are for an investor admitted at inception of a Fund. The investment return for an investor admitted after inception of a Fund or who has added or withdrawn capital since inception would differ from the returns reflected herein.

On July 1, 2007, we established Alternative Investments Institutional Master Fund, Ltd. ("Master Fund") to hold the manager investments of Alternative Investments Institutional, L.P. Alternative Investments Institutional, L.P. became a feeder to the Master Fund. On August 1, 2007 and October 1, 2007, respectively, we created two additional feeders: Alternative Investments Institutional, Ltd. and Alternative Investments Institutional Euro, Ltd., both offshore corporations open to U.S. tax-exempt and non-U.S. investors.

The difference in returns among the Alternative Investments Institutional feeder funds is due primarily to the difference in incentive fee schedule which was changed for investors joining the fund starting March 1, 2003. The investment return shown for each Alternative Investments Institutional feeder fund is for an investor admitted at inception of each Fund. The return for Alternative Investments Institutional, L.P. reflects incentive fees for investors who joined the fund before March 1, 2003, while the return for Alternative Investments Institutional, Ltd. reflects incentive fees for investors who joined the fund on or after March 1, 2003. The investment return for an investor admitted after inception of a fund or who has added or withdrawn capital since inception would differ from the returns reflected herein.

On a monthly basis, Alternative Investment Group provides each investor with an Investor Statement which shows the estimated dollar appreciation or depreciation of the account from investment inception. In addition, on a semi-annual basis, every June 30th and December 31st, Alternative Investment Group also includes in the Investor Statement the investor's actual percentage return from investment inception.

The Funds' investment program is speculative and entails substantial risks, including a risk of loss.

The S&P 500 Index is the Standard & Poor's Composite Index of 500 stocks. The S&P 500 Index Hedged (EUR) is designed to represent returns for those Global index investment strategies that involve hedging currency risk but not the underlying constituent risks. Investors employing a currency-hedged strategy seek to eliminate the risk of currency fluctuations and are willing to sacrifice potential currency gains. This index is calculated by hedging beginning of period balance using rolling one- month forward contracts. The MSCI World ex-U.S. Hedged Index is a free float-adjusted market capitalization index designed to measure global developed market equity performance. Funds of funds invest with multiple managers through funds or managed accounts. The Funds' portfolio may consist of securities that vary significantly from those in the S&P 500 Index and the MSCI World ex-U.S. Hedged Index. The Funds' performance is not intended to reflect the performance of the S&P 500 Index or the MSCI World ex-U.S. Hedged Index, which are provided for comparison purposes only. The S&P 500 and MSCI World ex-U.S. Hedged indices reflect reinvestment of income.