

CRISIS AND OPPORTUNITY

WHY NOW MAY BE THE BEST TIME TO INVEST



“Opportunity exists amid times of crisis.”

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Capturing the Moment

In summary, tremendous opportunity is always present for investors, even in “the eye of the storm,” but today it is essential to act or risk losing this timely advantage.

As with past periods of volatility followed by stabilizing markets, deep experience and discerning investment selection will prove essential to delivering consistent future outperformance.

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- Attractive hedge fund strategies also exist on a regional basis. For instance, the environment is more favorable for capital-structure arbitrage in Europe than in the U.S. This is due to the structural market factors that result in more actionable opportunities for hedge funds to exploit divergent values of debt and equity.

“Their ability and skill to effectively short stocks obviously make long/short equity funds one of the best resources available to investors seeking to weather negative and/or volatile equity markets.”

In Asia, maturing capital markets are finally providing a much deeper set of trading opportunities, as corporate debt issuance increases and expanding derivative markets allow hedge funds to execute more dynamic strategies.

- As new strategies emerge and “star” next-generation managers seek greater freedom to realize their full potential, opportunities abound to provide seed capital. With a significant shortage of capital available even to high-potential hedge fund managers, investors willing to provide such capital can be richly rewarded. This occurs through both fund returns and a share of fund economics traditionally captured only by the fund management.

Real Estate

- Now is the time to take advantage of opportunities to acquire distressed or revalued assets that dot the global real estate landscape.
- The global liquidity crisis is proving troublesome for smaller real estate players, while providing opportunities for larger companies that are able to take advantage of the resulting distress; investors currently need to look for un-levered, cash-on-cash deals.
- As stock markets have grown bearish, and as values have declined, it has become much more difficult to raise money to service their existing debt.
- Corporate expansion plans and developer pipelines have been put on hold as market fundamentals weaken, constraining capital and other resources.

“In light of credit defaults and capital scarcity, lenders are tightening standards for borrowers, including loan-to-value ratio requirements, repayment terms and credit sources.”

- Over-leveraged developers could find themselves cash starved due to high land payments. Ultimately, they might be forced to sell their inventory at a discount to improve liquidity, leading to further price corrections and opportunities for savvy developers that are cash-flush.
- In light of credit defaults and capital scarcity, lenders are tightening standards for borrowers, including loan-to-value ratio requirements, repayment terms, and credit sources.
- Weaker real estate players will be forced to partner with creditworthy real estate operating companies with strong balance sheets to mitigate borrowing risk and/or to provide much-needed credibility.
- The rising cost of oil has increased demand for energy-efficient, green building. The limited resources and taxed energy infrastructure of emerging market economies require intelligent use of materials and energy-efficient systems. This is especially true because of the future anticipated increase of commodity consumption.

As these three Chinese characters affirm to investors weighing decisions during turbulent times, **“In danger lies opportunity.”**

Translated into investment terms, superb opportunities often present themselves during periods of crisis. However, investors may fail to capitalize on this potential because they allow a limited-time advantage to drift away or disappear — which can occur in just a matter of months.

As we will examine, the ability for crisis to yield exceptional rewards is borne out repeatedly throughout the history of the global financial markets.

Although “watching and waiting” is initially the wisest approach to risk, actively re-entering the markets during past periods of extreme volatility would have yielded outsized profits once these markets normalized.

Six of these turbulent periods and their subsequent recoveries from 1982 to 2001 include:

1982 The Mexican Debt Crisis

1985 The U.S. Savings and Loan Crisis

1987 Collapse of the U.S. Equity Market

1997–1998 The Asian Economic Crisis

1998 Long-Term Capital Management (LTCM) Hedge Fund Collapse/Fixed Income Crisis/Russian Debt Default

2001 9/11 and the Tech Bubble Bursting

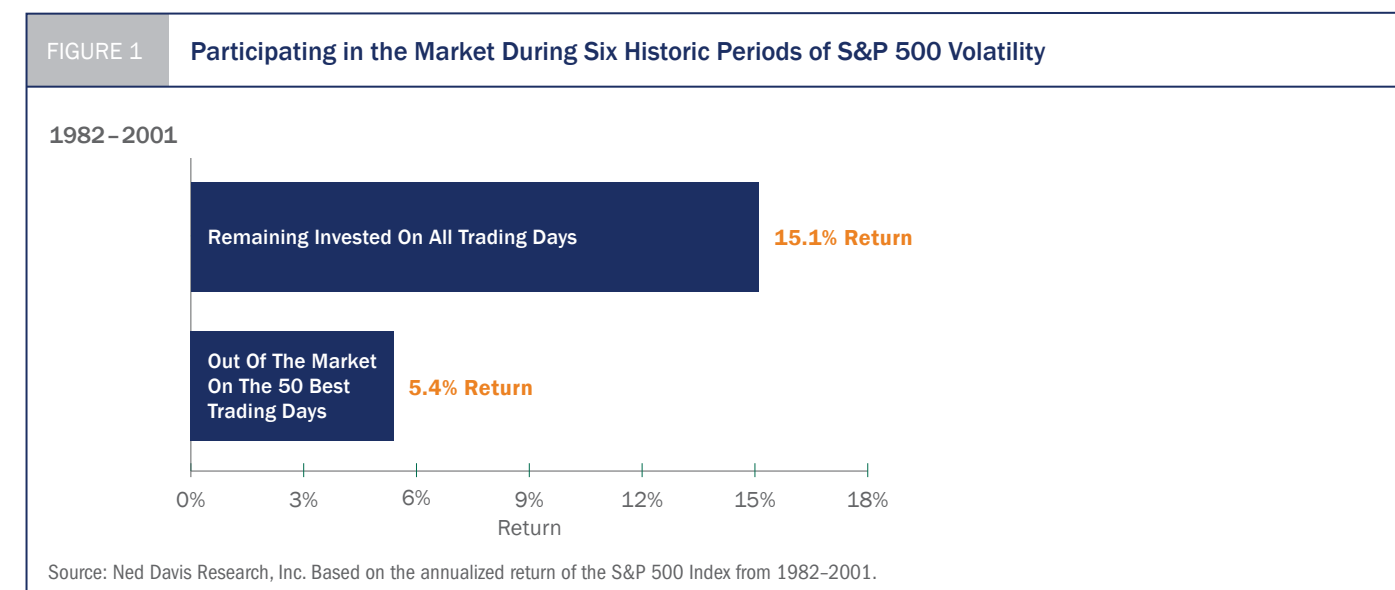
History reminds us that most exceptional investment opportunities are brief and fleeting. Capturing these opportunities requires the insight and courage to assume and maintain an appropriate level of risk across market cycles — and most importantly, in the face of market adversity.

It may be tempting to believe that you can benefit by exiting and re-entering the market at any time, adeptly avoiding periods of volatility and underperformance, but the odds are significantly stacked against such a strategy. Statistics show that in many markets, the majority of gains are actually generated during only a few narrow, but unpredictable, windows of time.

Staying the Course to Avoid Missing the Best Days

The S&P 500, for example, generated most of its positive performance on only 50 random trading days over the 19 years characterized by these six periods of high volatility from 1982 to 2001 (**Figure 1**).

Absent from the market on all or some of these key days, investors would easily have missed significant portions of the long-term gains they sought to achieve. In light of these considerations, we believe investors are best served by maintaining a long-term perspective and constant market exposure.



Past performance is not indicative of future results.

It is particularly important to ensure sufficiently diversified exposure to the wide range of distinct, yet often interrelated, opportunities that can arise during periods of market turbulence. In addition to staying in the market with balanced exposure, it also remains essential to take advantage of these opportunities as they arise.

For example, the recent and continuing corporate-credit-related dislocations have created a wide range of interwoven opportunities across asset classes. As a result, various managers and strategies are presenting diverse ways in which to capitalize on this favorable landscape. Investors would be well served to recognize the scope of these opportunities and ensure they access those investments that best fit their objectives.

One of these opportunities arises from the inventory of “hung debt” (deals that were never syndicated by financial institutions) that reduced corporate credit through much of 2008. As this type of credit dried up, opportunities arose for hedge funds and smaller private equity or mezzanine firms to fill this critical funding gap at spreads not seen in many years.

Many larger private equity firms with the expertise to execute complex transactions are buying this hung debt at very attractive discounts and financing terms.

“Timely ideas for profiting from the global opportunities presented by volatility span nearly all major asset classes...”

Numerous other opportunities either exist or will present themselves as the markets’ general loss of liquidity impacts numerous sectors and companies. Attractive buying opportunities have already emerged in more “traditional” areas, such as fixed income, where skilled managers have found buying opportunities among investors’ overreactions or financial distress.

However, although these fixed income opportunities remain traditional in nature, they must be selectively distilled from a wide variety of potential instruments that range from publicly distributed corporate bonds to more esoteric private placements.

- Private equity investors should recognize the increasing benefit of diversifying across both developed and emerging markets globally. Private equity in emerging market countries has become far less dependent on sweeping global trends and more driven by local market fundamentals.

- By definition, macro hedge funds seek to profit from upside “euphoria and mania” and downside “depression and panic.” These financial trends result from sizeable political, natural resource, capital market, currency or other macroeconomic shifts. As a result, volatile periods can provide macro hedge funds with significant opportunities to generate alpha for investors.

- Anticipating prolonged market turbulence, many event-driven hedge funds have been actively building cash in their portfolios and reducing leverage. This position now enables such managers to dynamically allocate capital through credit-oriented strategies, capitalizing on distressed situations and reduced valuations across companies and securities.

Hedge Funds

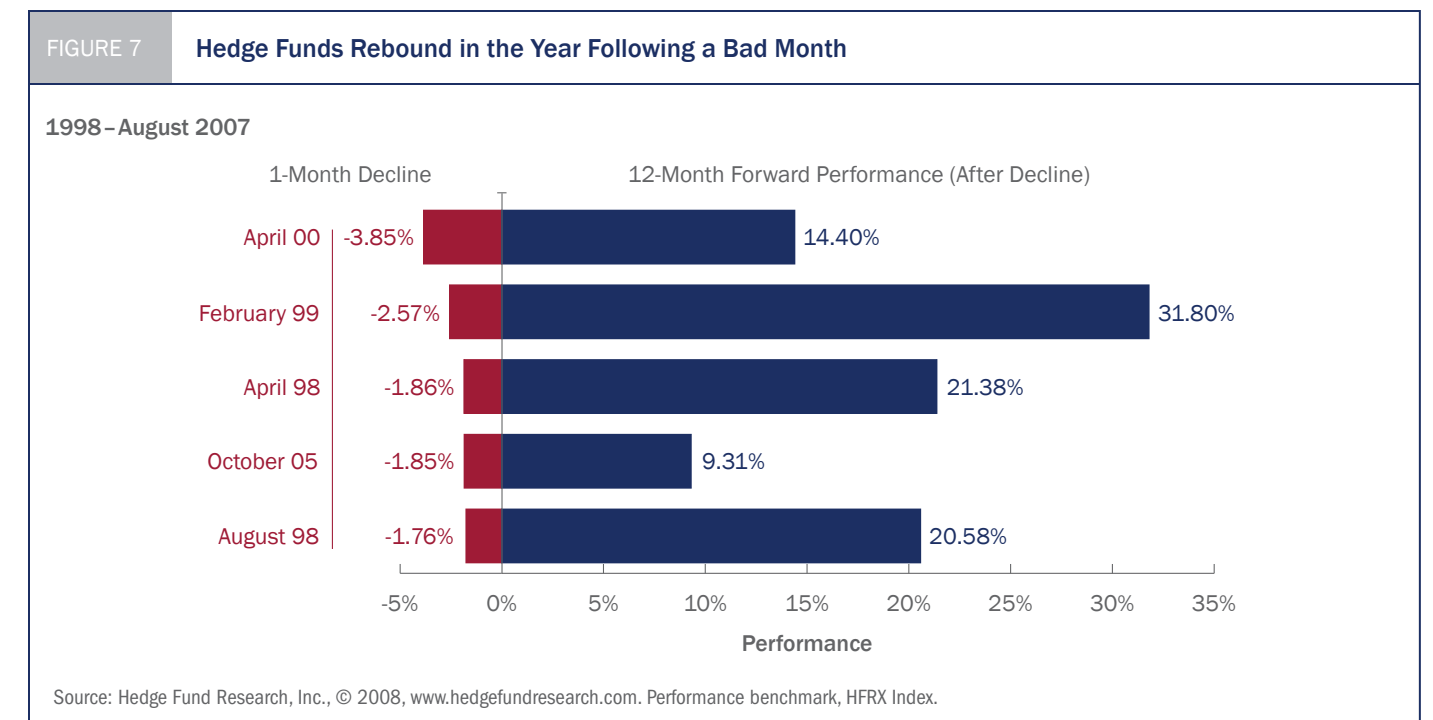
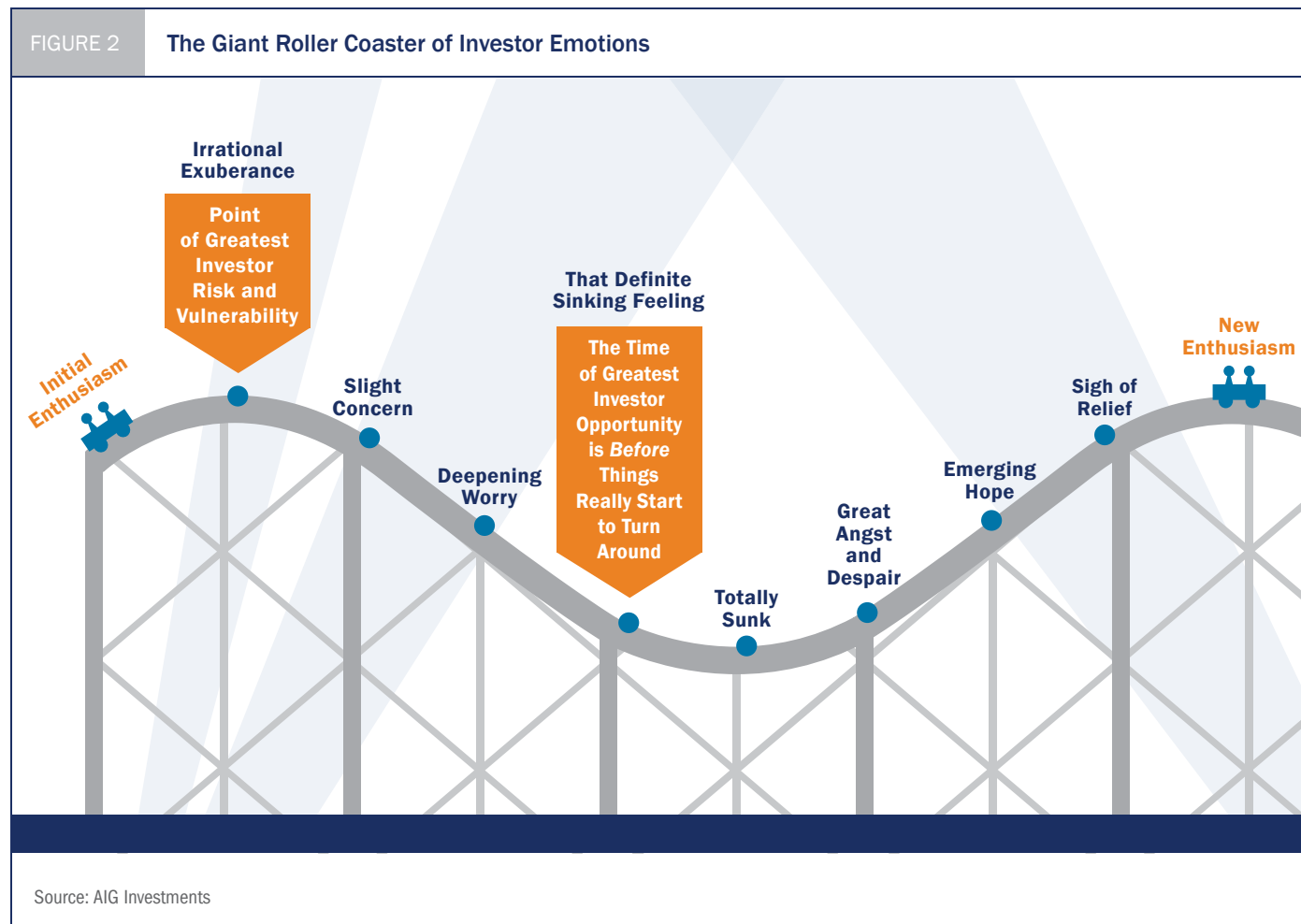
As evidenced by recent turmoil, hedge fund managers — like all market participants — may suffer during sudden drastic and unforeseen market movements. What sets hedge funds apart from “traditional” investors is flexibility, which has been repeatedly demonstrated in their ability to adjust to changing market dynamics.

As long as their portfolios and clients can withstand the volatility, hedge fund managers are often poised to take advantage of altered market conditions and profit handsomely in subsequent periods. Large hedge fund drawdowns have historically signaled high returns in the near future, as indicated in **Figure 7**.

Hedge funds comprise an incredibly diverse universe, and the opportunities they present differ across regions and strategies. What follows is a brief overview of selected potential opportunities across this universe that we believe investors should consider:

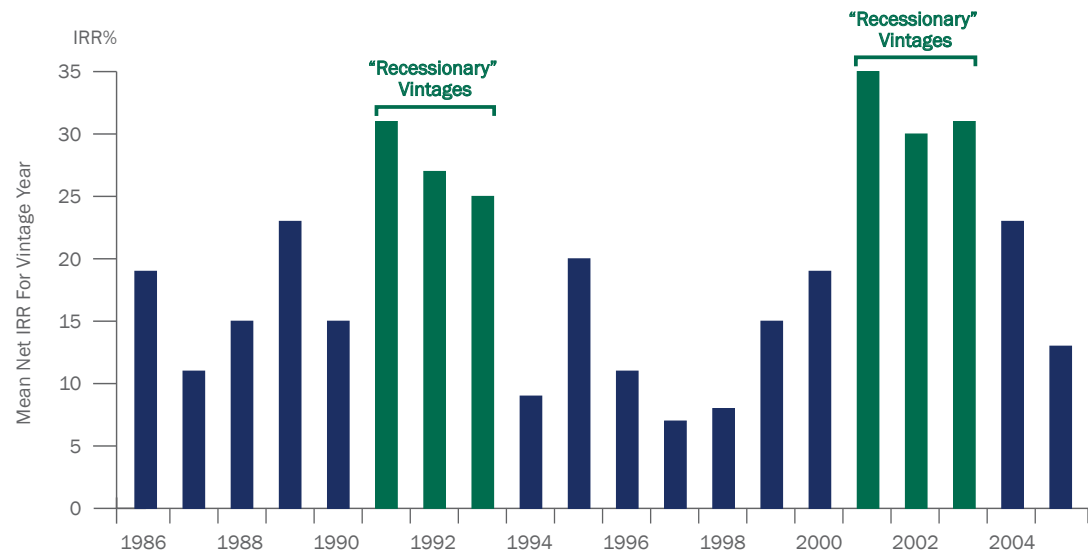
“...hedge fund managers are often poised to take advantage of altered market conditions and profit handsomely in subsequent periods.”

In the recent environment, for example, managers are acquiring senior secured paper in companies with sound capital structures. This senior secured paper is trading in the low-mid 80s, generating estimated 15–20% annualized returns on an un-levered basis.



Past performance is not indicative of future results.

FIGURE 6 Private Equity: Recessionary Vintages Have Delivered Attractive Returns



Source: Cambridge Associates LLC. Pooled mean net IRR to limited partners by vintage year as of 12/31/07. Vintage year funds formed since 2004 are too young to have produced meaningful returns. Analysis and comparison of partnership returns to benchmark statistics may be irrelevant. Past performance is not indicative of future results. This data was provided to AIG Investments at no charge.

institutions. Such firms' ability to mobilize and innovate to execute such transactions has provided them an unusual opportunity to generate equity-like returns with credit-like risk.

- Given the weak macro-economic climate, it is worth noting that private equity performance tends to be particularly strong for funds that begin their investing period in recessionary years.

“Investors should consider mezzanine and other credit-oriented private market strategies as viable platforms for generating strong risk-adjusted returns under current market conditions.”

As reflected in the performance of funds incepted around the recessionary periods of 1998 and 2002 in Figure 6, such funds tend to achieve stronger performance when investing during periods of economic uncertainty.

This strong performance likely results from a more attractive investment environment during periods of crisis, as well as a beneficial climate for existing investments in post-crisis periods.

- Investors must ensure their incumbent managers have the skill to manage their portfolio companies through difficult times. Meanwhile, investors must be able to identify those managers best able to manage risk, while capturing new opportunities in volatile periods.
- Investors should consider mezzanine and other credit-oriented private market strategies as viable platforms for generating strong risk-adjusted returns under current market conditions. Through these strategies, investors can benefit from performance that may be similar to the historic average return of private equity as an asset class, but with a lower risk profile.
- The global demand for liquidity and volatility across other asset classes is driving an attractive environment for acquiring mature interests in private equity funds. Large financial institutions and other distressed sellers have flooded the secondary private equity market in search of liquidity, and other investors are pursuing secondary-market transactions in an effort to rebalance their portfolios. These conditions are allowing secondary purchasers to acquire quality assets at deep discounts.

Volatility Leads to New Potential

These strategies present their own distinct risks and opportunities from which investors can choose. While each of these may be more or less attractive to any particular investor, the ability to illuminate and navigate the entire opportunity set allows an investor to convert a period of market “crisis” to one of “opportunity.”

Another key consideration for investors is recognizing how the structure of investment vehicles can enable investors to most effectively capture particular opportunities. For example, reduced liquidity in a fund with a “lock-up” allows a manager (and patient investors) to fully capitalize on the opportunities created when other investors desperately require liquidity.

In such a situation, the collective willingness of a fund's investors to accept this interim illiquidity allows the manager to ensure that holdings won't need to be liquidated before their potential is fully realized.

“Recent and continuing credit-related dislocations have created a wide range of interwoven opportunities...”

Similarly, investors' acceptance of “capital call” structures (as opposed to structures fully funded at inception), may best permit an opportunistic manager to exercise prudence in capturing opportunities as they appear — rather than feeling pressure to immediately put entrusted capital to work.

In short, it is best not to sit on the sidelines and retreat from market turbulence, but to capitalize on it in a manner that best meets an investor's ultimate investment objectives.

Whether through listed equity, fixed income or illiquid investments — if an investor has the fortitude to weather the ups and down of the Giant Roller Coaster of Investor Emotions (Figure 2) — opportunities clearly abound.

In particular, the exodus of many publicly owned financial institutions from assuming risk should keep the returns high for those whose resources allow for a longer-term perspective.

Timely ideas for profiting from the global opportunities presented by volatility span nearly all major asset classes, including fixed income, listed equities, private equity, hedge funds and real estate. Within each of these asset classes, astute investors are likely to identify an array of strategies and structures spanning the risk/return spectrum.

The following is a brief overview of some ways in which recent and ongoing market events are impacting major asset classes and creating a diverse universe of attractive opportunities:

Fixed Income

- Relative to many other asset classes, fixed income investments enable investors to generate returns from both the coupon and capital appreciation. Thus, in periods of asset-value erosion, fixed income coupons provide income that reduces portfolio-level total return volatility.
- Many asset classes only provide investors with capital appreciation as a means of return. As the past year of asset-value deflation has shown (Figure 3), the coupons paid to fixed income investors mitigated price erosion and enabled fixed income asset classes to significantly outperform equities in an otherwise weak year for the financial markets.

FIGURE 3 Comparison of Returns by Asset-Class Benchmarks

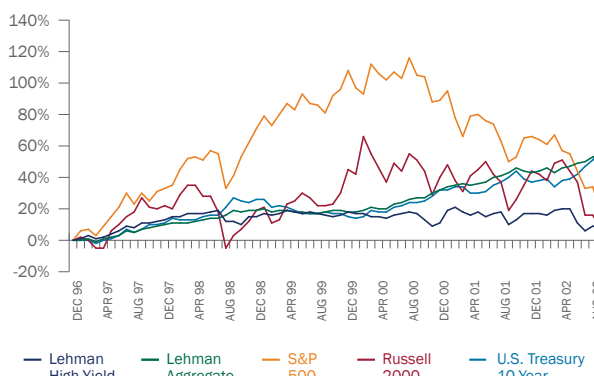
July 2007–June 2008	
Benchmark	Total Return
DJIA*	-13.28%
S&P 500*	-13.12%
NASDAQ Composite*	-11.18%
HFRX Global Hedge Fund Index (Investable)	-3.04%
Lehman Global Aggregate	+12.90%
Lehman U.S. High Yield (3% Capped)	-2.00%
Lehman U.S. High Yield Loans	-2.03%

* Gross dividends reinvested into index.
Source: Bloomberg

FIGURE 4 High Yield Can Deliver Lower Volatility in Difficult Markets Relative to Equities

January 1997–September 2002

	Annualized Return (%)	Cumulative Return (%)	Standard Deviation (%)
Lehman U.S. Corporate High Yield	1.29	7.67	8.15
Lehman U.S. Aggregate Bond Index	7.96	55.33	3.33
S&P 500	3.13	19.42	18.36
Russell 2000	1.29	7.65	22.95
Citigroup 10-Year Treasury	8.29	58.05	6.68

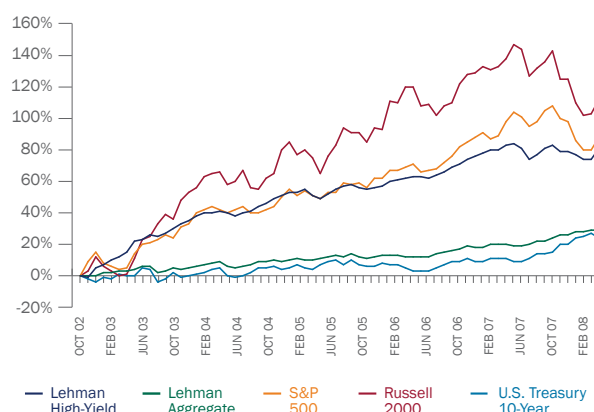


Source: Zephyr StyleAdvisor

FIGURE 5 Even Recently, High Yield Continues to Earn Comparable Returns to Equities with 35–40% Lower Volatility

October 2002–April 2008

	Annualized Return (%)	Cumulative Return (%)	Standard Deviation (%)
Lehman U.S. Corporate High Yield	11.24	81.24	5.94
Lehman U.S. Aggregate Bond Index	4.60	28.58	3.54
S&P 500	12.00	88.31	10.27
Russell 2000	14.36	111.53	14.98
Citigroup 10-Year Treasury	3.89	23.72	7.26



Source: Zephyr StyleAdvisor

- The diversity of fixed income total-return streams significantly reduces volatility. The past year has shown investors that volatility is not dead; rather it was just in hibernation.
- Relative to non-income producing asset classes, fixed income has shown much lower volatility over the past two longer-dated cycles. For example, from January 1997 through September 2002 (Figure 4), high yield investments provided investors with comparable returns to equities, but with only 35–40% of the volatility.
- The pattern repeated itself from October 2002 through April 2008 (Figure 5) when high yield returns were once again comparable to equities, but again reflecting only 35–40% of the volatility. Thus, proper diversification with fixed income can enhance portfolio returns and decrease volatility.
- In a disrupted financial market, there is a huge body of mispriced securities that can be purchased at very high yields. One way to benefit from this environment is to seek out a strategy that takes advantage of large-scale price dislocations prompted by the recent housing and mortgage crisis. Such a strategy would invest primarily in bonds that are high in the capital structure.
- In another example, the hybrid securities market has witnessed a notable surge in activity over the past year as companies, especially financials, have found hybrids a very efficient way to raise much needed new capital.
- Heavy issuance of hybrids coupled with the recent liquidity/credit crisis has led to meaningful underperformance of the asset class over the past year, causing hybrid yields to rise to unprecedented levels. This environment has created an attractive opportunity, concentrated in investment grade issuers, for both current income and total rate of return (TROR) investors with a longer-term horizon.
- Operating fundamentals across the bulk of high yield subsectors are still at acceptable levels. However, high yield spreads are approximately 300–350 basis points wide of their long-term historical averages, while default rates are 200–250 basis points inside of their long-term historical averages — all driven by weak technicals. This represents the classic “more sellers than buyers” scenario that typically drives prices low enough to attract new buyers.

- Because of maturities or covenant issues, a significant amount of leveraged loans will also need to be refinanced in the short to medium term. We believe that problems in the leveraged loan and collateralized loan obligation (CLO) markets will drive issuers to seek new structures for securing financing, providing unique opportunities.
 - Investors can seek out well-funded structures — closed-end products with permanent financing that are not subject to market to market calls. Or look for creditworthy companies that have outstanding debt in small amounts, where no liquid market exists.
 - Liquidity will likely continue to suffer in the lower-rated securities, primarily a result of the leverage unwind that is occurring currently. It took several years to create this leverage, so it will likely take a while to unwind it.
 - One fundamental change we need to experience is a stabilization of the housing market. This will lead to quantification of the losses, consolidation, asset sales and market-clearing levels on very illiquid securities.
- “...problems in the leveraged loan and CLO markets will drive issuers to seek new structures for securing financing, providing unique opportunities.”
- On the other hand, we believe that large, diversified financial companies provide the opportunity to invest in high quality corporates with sound balance sheets and limited prospects for default.
 - It is difficult to say exactly when liquidity will return, but it is likely to coincide with the stabilization of the health of the banks, brokers and insurance companies that dominate the U.S. financial system. In the interim, fixed income investors will be paid handsome coupons to ride out these problems, relative to other asset classes.

Listed Equities

- Now is the time to be both “optimistic” and “opportunistic” when evaluating the global equity markets as, once it returns, sound economic growth will drive corporate profits and stock valuations over the long term.
 - Investors should limit any exposure to businesses that are over-reliant on leverage, strong consumer spending, or accelerating economic growth to generate expanding earnings.
- “Emerging and frontier markets have outperformed developed markets over the past few years, but many have corrected substantially during the last few months, allowing for more attractive entry pricing.”
- As economic growth rates slow in many countries, earnings progression may be increasingly difficult to deliver. Companies with powerful internal-growth drivers present superior opportunities in this challenging environment.
 - Some companies and industries are better suited to offsetting the effects of a prolonged slowdown. Large-cap growth companies with strong cash positions and solid global footprints are the likeliest candidates for delivering outperformance and are currently often trading at reasonable valuations.
 - Emerging and frontier markets have outperformed Developed markets over the past few years, but many have corrected substantially during the last few months, allowing for more attractive entry pricing.

Private Equity

- Market dislocations also present an excellent opportunity for market participants in private equity. Time and again, private equity firms have been at the forefront of activity during such dislocations.
- An unprecedented credit dislocation in the private equity-related debt arena has created a unique buying opportunity for private equity firms, with several leading firms rapidly forming large, dedicated pools of equity capital and securing attractive seller financing to acquire “hung loans” from financial

Diversification does not protect against market loss. Past Performance is not indicative of future results.