OBSERVATORY CAPITAL MANAGEMENT LLP

The Observatory Credit Markets Fund

INVESTMENT STRATEGY

The Observatory Credit Markets Fund ("the Fund") is a trading-oriented, absolute return credit hedge fund. The Fund invests in three principal strategies (trading, relative value and fundamental) across four risk buckets (corporates, financials, emerging markets and cross markets). The Fund invests predominantly in European credit markets, but also is active in emerging markets, North America and Japan.

The Fund aims to maximise returns across its universe of markets, seeking profitable opportunities both across and within sectors. The capital allocation process ensures a diversification of the portfolio in order to minimise negative event risks and maximise opportunities. The Fund is managed with a high degree of liquidity, and portfolio risk is managed by incorporating short strategies using a range of cash and derivative instruments. The Fund typically targets a relatively low net exposure in the range of +/- 30% and gross exposure of 200% to 400%.

2014 YEAR IN REVIEW

The Observatory Credit Markets Fund had net returns of 3.31% in 2014. The Fund's accumulated return since its inception in July 2004 is 213.51%, which equates to an annualised return of 11.50%. The Sharpe ratio since inception is 1.57 with a 78.57% incidence of positive monthly returns. In 2014, the net returns were lower than our long term average.

In January, consensus views were hurt when equities and rates went down, credit widened, and emerging markets and Japan got smoked. Cash spreads initially rallied, along with other risky assets, before EM-induced volatility and spill-over from a weak jobs report spoiled the normal January fun. The macroeconomic backdrop showed signs of improvement, with Portugal, Greece and Cyprus outperforming. 'Normal service' resumed in credit markets in February, as a strong technical (a heavy redemption schedule and low supply volumes) asserted itself over January's wall of EM woe, a few negative data surprises and a lacklustre earnings season. Synthetics outperformed cash as hedges were unwound and skew became increasingly negative; sentiment towards the periphery improved further.

Credit was inevitably impacted by increasing geopolitical concerns in March, with rising aggravated tensions between Russia and the West over Ukraine and the annexation of the Crimean peninsula affecting markets. Central banks continued their role as the invisible hand supporting stellar credit market technicals, with central bankers a primary focus for markets. Expectations for additional European Central Bank ("ECB") easing, augmented by a fall in Eurozone inflation to its lowest level since 2009, contributed to an outperformance of peripheral sovereign CDS. In April, the spectre of unconventional ECB monetary policies and continued Federal Reserve doveishness becalmed market participants, whilst tension between Russia and Ukraine continued to build. Peripheral election results in May were generally market and reform positive, with the worry being the inexorable rise of rightist anti-EU parties in core countries.

In June, the main risk event was Draghi's expectation-beating series of measures, later followed by Yellen's dovish Federal Open Market Committee ("FOMC") rhetoric. However, cash markets suffered from primary market indigestion and gave up earlier gains, although synthetics were more resilient. The sell-off in the second half of the month was due to factors including weak Eurozone PMI data and a significant downward revision to US GDP, leading to a reassessment of economic risks. In July, cash was more resilient, particularly as supply abated, but synthetics ended the month weaker as markets digested a range of negative geopolitical and idiosyncratic factors and continued to fret about the likely path of monetary policy normalisation in the US in the face of data strength (4% annualised GDP growth in the second quarter). End of July weakness extended into early August; however, sentiment turned positive as the aggregation of negative factors, in particular the fall in inflation expectations, led to hopes for quantitative easing in Europe. This culminated with Draghi's dovish speech at Jackson Hole paving the way for expected ECB action at the September meeting. The markets' concerns about the future direction of Federal Reserve policy were partially offset by the focus on the likelihood of European quantitative easing ("QE"). A speech from the Federal Reserve vice-chair Stanley Fischer, in which he described the global recovery as disappointing, was taken as a dovish signal.

In September, bad news was finally interpreted negatively; markets faded central banks, fretting about leverage, growth and business models. Uncertainty regarding the Federal Reserve's trajectory and weak European data led to a decline in risk appetite. A dovish FOMC allayed some of these concerns, but scepticism about the likelihood and efficacy of increased ECB action led investors to move closer to home. Moving into October, concerns about growth and deflation prospects, both in the Eurozone and globally, were exacerbated by worries that other central banks were unwilling to pick up the slack being left behind by the end of the US Federal Reserve's quantitative easing programme. However, a combination of dovish comments from central bank officials in the US and the UK, and reports that the ECB was considering buying corporate bonds helped markets to regain their poise. A surprise expansion of the Bank of Japan asset purchase programme gave all risky assets a month-end fillip.

After October's volatility, market machinations in November largely revolved around ECB watching; from initial reports of disagreements between the ECB Governing Council to a speech on October 21st by Draghi stressing that the ECB 'will do what we must to raise inflation and inflation expectations as fast as possible'. The positive impact of these remarks was compounded by a surprise Chinese rate cut, suggesting that Chinese leadership was prepared to adopt a more active stance to prop up growth going forward, thus mitigating investor concerns. The most significant event during the course of the month was the Organisation of Petroleum Exporting Countries ("OPEC") meeting on November 27th in which a decision not to restrict oil production confirmed that the ongoing price war was about to become significantly messier.

In December, the fallout from a post-OPEC meltdown in oil prices continued. Markets opened tighter on ECB optimism, swooned into the Federal Reserve meeting and then recovered over the holiday period. Greek Prime Minister Samaras surprised markets by calling for early presidential elections, in which his candidate was subsequently defeated, leading to renewed 'Grexit' speculation. The dominant theme in 2014 was decompression and the outperformance of less risky and risk-free assets. Assets levered to liquidity and central banks outperformed those levered to economic growth.

OUTLOOK FOR 2015

Divergence remains the dominant theme for the year ahead, with performance in credit markets likely to fluctuate depending on the behaviour of regional credit cycles. Europe disappointed throughout 2014, as EM flattered to deceive in the first half of the year (initially surmounting a wall of worry surrounding current account deficits) only to succumb in the latter part of the year (along with large swathes of the US credit markets) to the meltdown in the commodities, and in particular oil.

We expect global growth to pick up moderately in 2015, although the global economy will remain poorly balanced. In DM, the US and UK are performing best - US growth should rise to 2.7% (vs. 2.1% in 2014) as a result of decreasing energy costs and changing fiscal policy. The good news extends to significant job creation, firming wage growth and stronger equity and real estate prices, but this could be countered by an aging population and tighter mortgage standards. The rest of the EU and Japan are behind, expected to grow at just 1.0% and 0.8% respectively. EM growth will remain subpar, with India the only potential bright spot due to expected reforms.

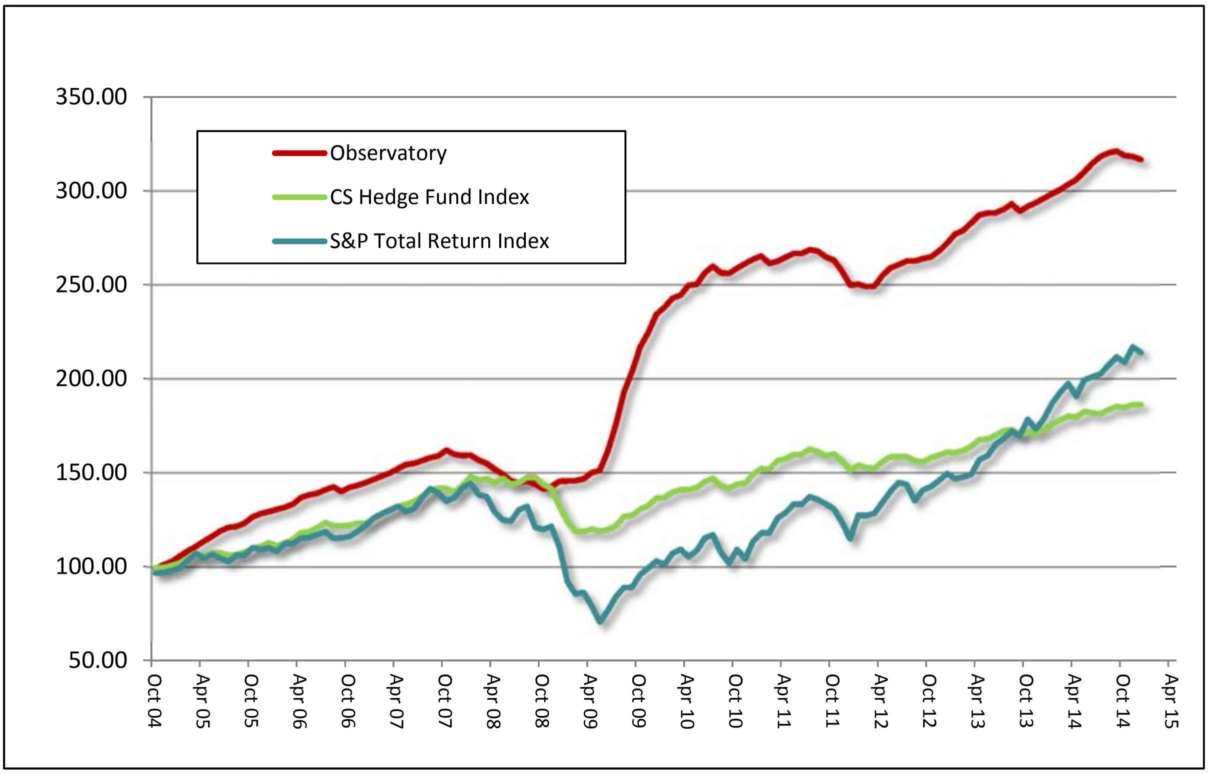
We favour DM credit over EM credit and, despite QE in the Eurozone, expect US credit to outperform European credit in both IG and HY given stronger growth and better valuations. In terms of credit quality, we have a low quality bias in the US and within European IG, but a higher quality bias in European HY and Asia.

The US has the strongest economy and perhaps the most mature credit cycle. This is most evident in the energy sector, where oil market woes and a long-term industrial revolution are impacting a sector accustomed to high commodity prices. At the opposite end are financials, where the cycle is much less advanced as regulation creates conservative bank business models and credit positive capital structures. The European cycle is in an earlier stage, where low growth and ECB stimulus remain supportive for higher quality credit.

However, growth is not robust enough to support HY credit. In Asia, we expect sluggish growth but no recession and we have a high quality bias.

In major credit markets, we see mid-cycle characteristics but acknowledge that pockets of the market have late-cycle exuberant characteristics. The unexpected and unusually low levels of yield have created a supply/demand imbalance in the markets, with corporates happy to issue at low all-in yield levels whilst yield-based buyers find it difficult to hedge liabilities. This has given investors a yield premium in spread terms, which should set credit markets up well for a 2015 spread compression. EM credit will be likely to underperform in the face of a stronger USD, weak commodity prices, rising treasury yields and still weak EM macro fundamentals. There is an increasing range of sovereign idiosyncratic stories: Russia, Argentina, Brazil and Venezuela to name but a few.

In this disjointed environment with a lack of safe assets, there is a great deal of money to be made and lost by gauging what is 'safe' and 'unsafe'. Greece 3-year bond yields went from 3.375% to 20% in 2014. The scope for melt-ups and melt-downs in yields means that, despite yield suppression, there is ample opportunity. The Holy Grail for us remains liquid, scalable opportunity sets.



Developed Market Financials:

The first half of the year was mostly bullish, with the exception of Banco Espírito Santo, which failed and required government intervention. By mid-year, the tone was deteriorating, with CoCo and AT1 yields rising and SX7E trending lower. The much anticipated ECB Comprehensive Assessment was mostly benign; however, European events were already moving to price in other risks, such as deflation and the worsening Greek political landscape. Our single worst performer of the year was BESPL LT2, but on a combined basis, it was in Greek banks. Many of our best performers were carryover trades from 2013, in names like Bank of Ireland, Banca Monte Dei Paschi, Commerzbank and BAWAG. With the ECB as regulator of Eurozone banks, we expect higher capital ratios to be on the agenda and this, combined with a low growth environment, will make bank equities underperform even in anticipation of ECB QE. CoCos and AT1 should perform reasonably well; however, idiosyncratic risks will make it difficult to be outright long the sector. In the new regime, banks will have much less state support and marginal names may be treated harshly, therefore warranting the optical excess spread. For the first quarter of 2015, we will be maintaining caution in the sector.

Developed Market Corporates:

It was a year of two halves. The HY bond market tightened 48bps in the first half of the year from 331bps over asset swaps to 282bps on June 20th, which corresponded to the tightest yields on record of 3.24%. Stretched valuations, global growth concerns and the termination of QE3 led to six months of consecutive outflows from the asset class, resulting in a 100bps widening to 382bps over asset swaps in the second half of the year. Conversely, the IG market benefitted from twelve months of consecutive inflows and a thick redemption schedule. We started the year at 98bps over asset swaps and rallied to 87bps, finishing the year at average yields of just 1.35%. Both HG and HY benefitted enormously from falling risk-free rates and generated annual total returns of 8.24% and 4.03% respectively. Primary market supply of €223bn in HG and €76bn in HY set new annual records. We profited from several idiosyncratic situations and long positioning in corporate hybrids. The corporate hybrid universe continued to prosper as investors hunted for yield and corporates looked to bolster capital structures and raise funds for M&A. Our bias was towards long duration HG corporate hybrids and our biggest wins were in VW, Orange and Merck.. We avoided the majority of the snakes but were stung on our long position in eDreams Odigeo. The company’s business model was called into question when British Airways and Iberia suspended ticketing access, which sent subordinated bonds into free fall.

Emerging Markets:

Emerging markets had a shaky start to the year as outflows, rates fears, FX volume and supply weighed heavy. However, central banks acted early with aggressive rate hikes in India, Turkey and Brazil, and treasuries trended tighter. The Russia/Ukraine conflict intensified and eventually lead to the annexation of the Crimea, which in turn prompted sanctions against Russia. Whilst this was clearly negative news for Russia and Ukraine, broad-based EM ended up benefiting as money rotated out of Russia. EM corporate issuance for the year stood at a bumper $364bn, with Chinese state-owned banks managing to print jumbo AT1 deals. There was plenty of corruption and corporate governance issues, with a politically motivated bank run at Bulgaria's KTB bank causing bonds to fall 95pt (our largest loss), and fraud at oil company Afren, property developer Kaisa, African Bank, Agile Property and state-owned Petrobras; these were generally contained, with the exception of Petrobras. Weak commodities - especially oil - caused shockwaves across markets, with Turkey and Asia benefiting but LATAM, Africa and Russia getting hit hard. The Middle East was the largest outperformer over the last year, even with lower oil and the Islamic State at its doorstep. We were positioned long throughout the year to benefit from this. We also successfully traded Essar Energy and 1MDB, giving our biggest wins.

Cross Markets:

2014 was an eventful year in both DM and EM sovereigns. In DM, the trajectory was, of course, tighter yields and spread compression (with the exception of Greece). There was significant volatility around key events, including various European elections, the Banco Espírito Santo crisis and the Ukraine crisis. However, with increasing expectations from the ECB, any material widening was faded as we closed the year at all-time low yields with Eurozone Sovereign QE widely expected in January 2015. Greece traded well until the end of September, when the market began to focus on Greece's plans to exit the IMF program early and on heightened political uncertainty. The Greek Strip lost all of its yearly gains and closed 2014 just 2pts lower; the curve inverted with the new 3y and 5y deals underperforming significantly. We had a mixed outcome as we made money from compression in T-bill yields but lost money on our holdings in short-dated Greece international bonds. We benefited from spread tightening in Portugal, Italy/Spain and Cyprus. In EM, the year was, to a large extent, dominated by a few key factors including: US rates, commodity prices and the Ukraine/Russia conflict. We benefited from our view on Ukraine meeting its 2014 maturities whilst continuing to deteriorate in the immediate term. We also benefited on holdings in Africa and we managed to capture some of the Argentina and Russia volatility. We lost money as a result of our exposure to oil exporters in Venezuela and Ecuador, as well as via shorts in Asian and CEEMEA cash after US rate movements.

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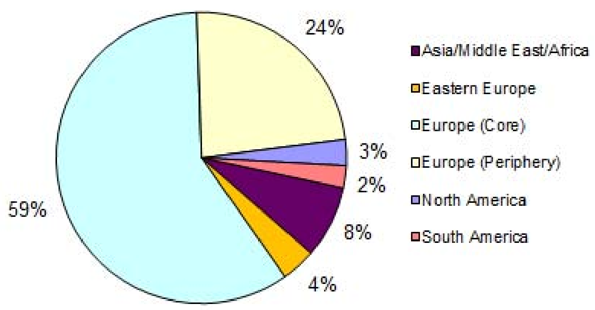
Portfolio Exposures

As of 31st December 2014

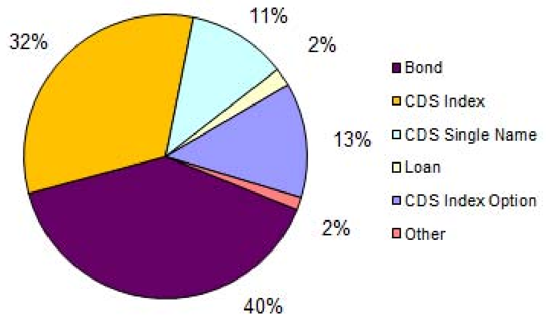
Gross Exposure by Geography

12m Average

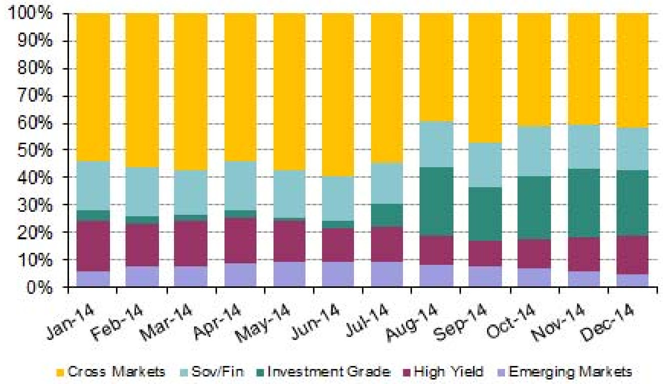


Gross Exposure by Instrument

12m Average

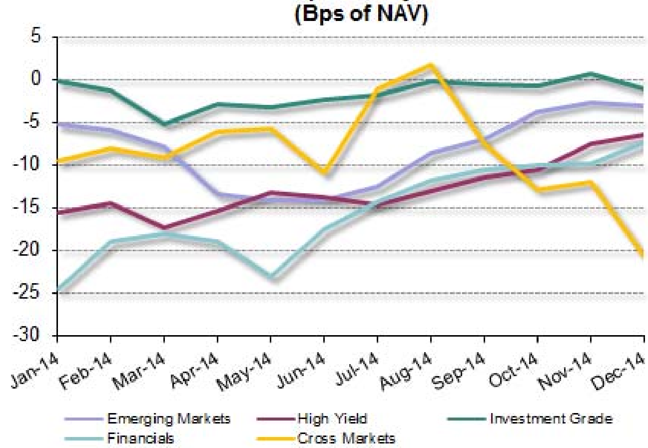


Gross Exposure by Bucket



Source: Observatory Capital

VAR Exposure by Bucket (Bps of NAV)



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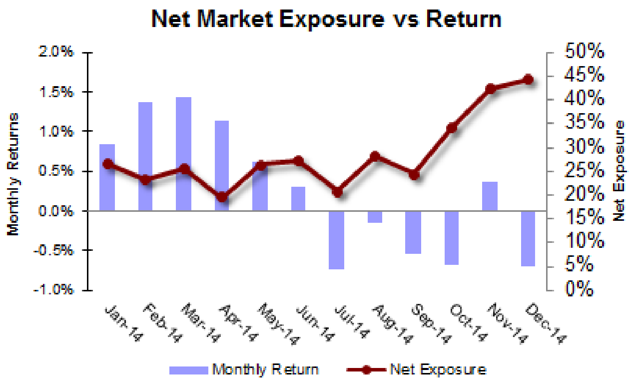
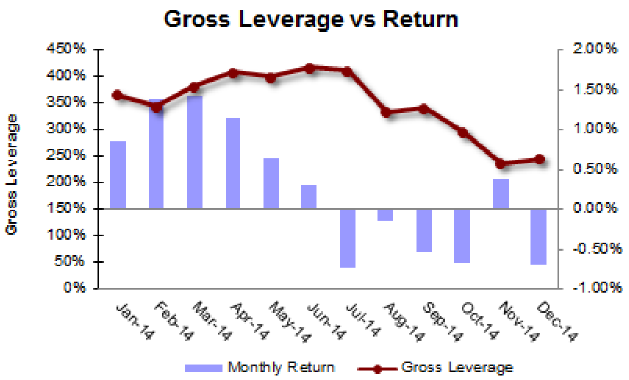
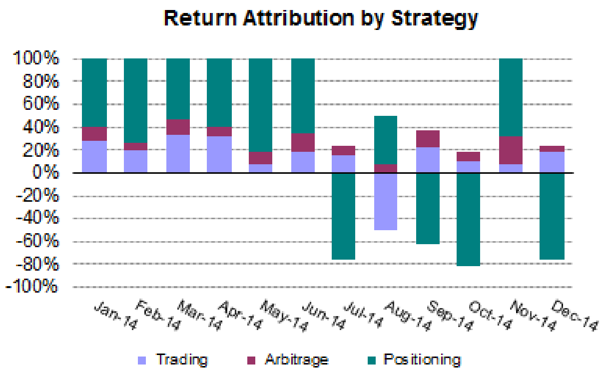
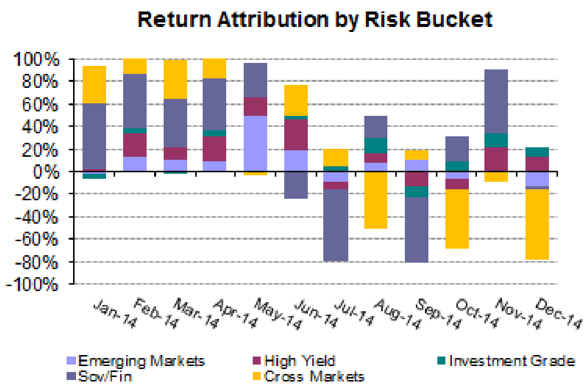
Returns Profile









Source: Observatory Capital

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