



# Phaunos Timber Fund

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## Foreign Currency Risk in a Globally Diversified Timber Portfolio To Hedge or Not to Hedge? That is the Question.

### Executive Summary

Phaunos Timber Fund Limited (“Phaunos” or the “Fund”) is a globally diversified timberland portfolio with a Net Asset Value (“NAV”) of US\$595 million as of the last audited date of 31 December 2010. The reporting currencies in many of the Fund’s investments are non-US dollar currencies (e.g. Brazilian Real, New Zealand Dollar and Norwegian Krone). Phaunos is denominated in US dollars and is therefore exposed to currency translation risk when both the operating earnings and balance sheets of such investments are translated from these local currencies into US dollars (“USD” or “US\$”). Currently, Phaunos’ portfolio is un-hedged against currency translation risk, except for the limited use of hedging of operating cash flows in some investments.

The following paper primarily addresses the question of whether or not to hedge currency translation exposure of the NAV of a globally diversified timber portfolio. This topic is relevant as Phaunos’ reported changes to NAV solely due to currency gains and/or losses for each six month reporting period from 31 December 2007 through 31 December 2010 are as high as \$37.45mm (or approximately 6% of NAV) per period. Although the gains or losses have tended to reverse in subsequent periods, there remains material volatility in period to period results solely due to currency translation effects. To explore this volatility further, a 10 year back-test was conducted of the portfolio as it existed on 30 June 2010 (which is approximately the date when the Fund became fully invested). This back-test showed that the Fund would have experienced volatility due to currency translation effects that ranged from minus 18.74% to positive 11.59% per six month period during this ten year test period. The back-test also showed that the average gains/losses were about 5% per period and that these gains/losses tended to reverse over time. We then explored four alternatives that could be employed to reduce the NAV volatility due to currency effects. None of these four alternatives are currently attractive, which is why Phaunos is presently un-hedged against currency translation risk.

**Phaunos' Historical Reported Currency Gains or Losses**

Phaunos was launched in December 2006 and has reported the following currency translation gains or losses since inception through 31 December 2010. These translation effects are comprised of the sum of (a) the "Foreign currency translation reserve" for those non-USD denominated assets directly consolidated onto Phaunos' balance sheet, plus (b) the translation effects of the non-USD denominated financial assets reported at fair value through profit and loss. This latter impact is reported as "Unrealised foreign exchange movement" as shown in the notes to the financial statements. Other currency effects not relating to translation effects are excluded from the table below, as the main purpose of this paper is to look at currency translation risks.

Category	31-Dec-10	30-Jun-10	31-Dec-09	30-Jun-09	31-Dec-08	30-Jun-08	31-Dec-07
Foreign currency translation reserve	\$ 21,604,672	\$ 7,013,534	\$ 14,748,390	\$ (2,492,598)	\$ (8,126,442)		
Unrealized FX movement brought forward	\$ (486,261)	\$ (486,261)	\$ (341,306)	\$ (341,306)	\$ 92,670	\$ 92,670	
Unrealized FX movement for the period	\$ 12,408,351	\$ (10,452,296)	\$ (144,955)	\$ (466,654)	\$ (433,976)	\$ 266,489	\$ 92,670
Translation Reserve Plus Unrealized gain (loss)	\$ 33,526,762	\$ (3,925,023)	\$ 14,262,129	\$ (3,300,558)	\$ (8,467,748)	\$ 359,159	\$ 92,670
Change 6 Month Period to Period	\$ 37,451,785	\$ (18,187,152)	\$ 17,562,687	\$ 5,167,190	\$ (8,826,907)	\$ 266,489	

As can be seen in the above table, Phaunos' six month actual change in NAV due to foreign translation gains or losses can be material. For example, the time period from 30 June 2009 to 31 Dec 2009 showed a net positive movement of US\$17.6 million or about 3% of the NAV. However, the following six month period showed a virtual net reversal of this gain, followed by a large positive movement in the latter half of 2010. The cumulative inception to date impact to Phaunos' balance sheet as of 31 December 2010 was a positive US\$33.5mm (see above table). This cumulative impact is about 5.6% of Phaunos' total NAV of US\$595mm as reported on 31 December 2010.

We next asked: "Should the volatility generated by currency movements be hedged to minimize movements in NAV attributable to currency translation effects?" To address this question, we back-tested the translation exposure of Phaunos' NAV for a 10 year period.

**10 Year Back-test**

The historical audited record of Phaunos is four years in duration, which is a limited historical dataset to analyze currency risk. To provide a longer time series, we did a back-test of Phaunos' hypothetical currency volatility over a ten year period. Since Phaunos' portfolio was effectively fully invested as of 30 June 2010, we selected that date to back-test from. In addition to translating and consolidating Phaunos' 30 June 2010 financial statements using the appropriate exchange rates for the 30 June 2010 reporting period, we also used the historical exchange rates for each prior 6 month period retroactively for the prior ten years. The translations and consolidations for each reporting period used the following assumptions:

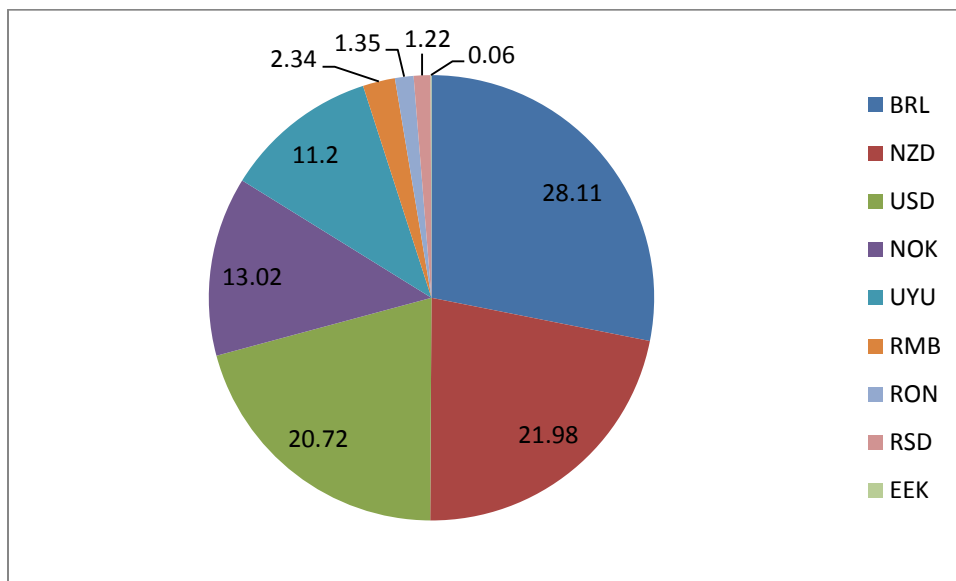
- Phaunos' portfolio as it existed as of 30 June 2010 does not change in its construction over time.
- Accounting rules employed in preparing the 30 June 2010 financial statements remain unchanged.
- The consolidation model used to prepare Phaunos' 30 June 2010 financial statements remains constant, except for the use of the relevant exchange rates for each reporting period.

There are three important points about the above assumptions that need to be discussed before we summarize the results.

1. The Phaunos portfolio as of 30 June 2010 had the approximate exposures to various local currencies as shown below in the pie chart. The major foreign currency exposure at that time was to the New Zealand dollar (“NZD” or “NZ\$”), Norwegian Krone (“NOK”), and Brazilian Real (“BRL” or “R\$”). This foreign currency exposure is assumed to remain constant over the 10 year time period.
2. Also note that the assumptions imply that Phaunos’ timber operations are ‘frozen’ at 30 June 2010. This static approach assumes no future timber growth, income or other movement except as reported in the 30 June 2010 financial statements. This assumption eliminates any change in weightings of currency exposure over time due to changes in NAV resulting from non-currency factors. This static method is used to study potential currency translation effects over time to Phaunos’ NAV as it existed on 30 June 2010.
3. The consolidation model reports gains or losses incurred on translation of the net assets of Phaunos’ non-US denominated operating subsidiaries. As Phaunos’ Uruguayan and China investments are denominated in USD for reporting purposes, these assets have no impact on the foreign currency translation reserve through the consolidation process. As a result, the back-test does not fully account for the exposure to the Uruguayan peso or China RMB.

**Chart #1**

Phaunos’ approximate currency exposure based on the percentage of NAV (as of 30 June 2010)



NOTE: This backward looking test is not meant to suggest that future exchange rate volatility (and thus NAV volatility due to currency translation effects) will repeat this historical pattern. Actual future volatilities could differ markedly from the results as shown in the backward test.

**Table #1**

The 10 year back-test is based on the following historical exchange rates:

	EUR	BRL	RSD	EEK	NOK	RON	AUD	NZD
30/06/2000	0.95530	1.80350	11.61000	16.39040	8.57510	2.13400	0.59770	0.46910
31/12/2000	0.93950	1.95000	12.51000	16.66420	8.83520	2.58900	0.55700	0.44250
30/06/2001	0.84730	2.31050	68.74000	18.46210	9.32780	2.91700	0.50990	0.40490
31/12/2001	0.89030	2.31050	66.04240	17.72490	8.97200	3.17550	0.51050	0.41670
30/06/2002	0.98950	2.80650	61.20430	15.91240	7.50090	3.35050	0.56340	0.48680
31/12/2002	1.05040	3.54000	59.64310	14.90050	6.92520	3.34750	0.55950	0.52340
30/06/2003	1.14830	2.86250	57.60650	13.63740	7.23320	3.28850	0.67080	0.58620
31/12/2003	1.25640	2.89000	57.60650	12.45650	6.68470	3.25960	0.75220	0.65510
30/06/2004	1.21690	3.09800	59.59520	12.81200	6.94610	3.34070	0.69470	0.63200
31/12/2004	1.35560	2.65600	58.30350	11.55330	6.07520	2.91430	0.78290	0.71970
30/06/2005	1.20940	2.35900	68.64000	12.93750	6.54460	2.97840	0.76190	0.69600
31/12/2005	1.18330	2.33550	72.49960	13.22340	6.74910	3.11270	0.73360	0.68040
30/06/2006	1.27850	2.16450	66.70000	12.23820	6.22390	2.80100	0.74230	0.60920
31/12/2006	1.31890	2.13570	60.49000	11.86010	6.24490	2.56370	0.78830	0.70370
30/06/2007	1.35380	1.93400	58.24000	11.55740	5.88840	2.30280	0.85010	0.77240
31/12/2007	1.45830	1.77900	54.03560	10.73450	5.44130	2.45170	0.87670	0.76580
30/06/2008	1.57360	1.59620	49.89200	9.94340	5.09490	2.31920	0.95690	0.76070
31/12/2008	1.39530	2.31450	64.36810	11.21130	6.96150	2.88820	0.70470	0.58650
30/06/2009	1.40500	1.96270	66.71380	11.14070	6.42430	2.99700	0.80750	0.64590
31/12/2009	1.43310	1.74200	67.10130	10.91760	5.78990	2.95280	0.89780	0.72600
30/06/2010	1.22790	1.79921	85.32423	12.74210	6.48887	3.55897	0.84690	0.68950

Exchanges rate quotes above shown as per the standard convention of base currency hierarchy: EUR>NZD>USD> Other Currencies

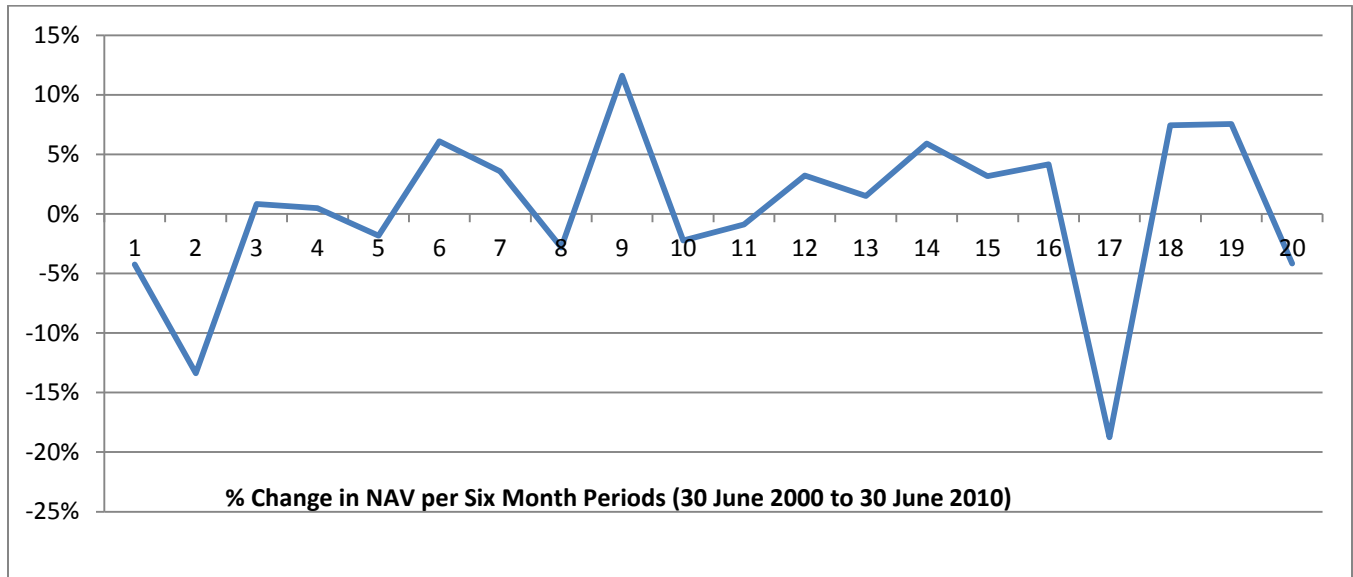
All the currency rates are from Bloomberg, except the starting rates on 30 June 2010 which are from Reuters and are the same rates as were used to prepare Phaunos' financial reports for that date.

**Table #2 - Results of 10 Year Back-test**

Modeled change in Phaunos' NAV due to Currency Translation Effects

Period	From	To	% Change in NAV
1	30-Jun-00	31-Dec-00	-4.25%
2	31-Dec-00	30-Jun-01	-13.38%
3	30-Jun-01	31-Dec-01	0.84%
4	31-Dec-01	30-Jun-02	0.47%
5	30-Jun-02	31-Dec-02	-1.83%
6	31-Dec-02	30-Jun-03	6.09%
7	30-Jun-03	31-Dec-03	3.57%
8	31-Dec-03	30-Jun-04	-2.81%
9	30-Jun-04	31-Dec-04	11.59%
10	31-Dec-04	30-Jun-05	-2.24%
11	30-Jun-05	31-Dec-05	-0.90%
12	31-Dec-05	30-Jun-06	3.21%
13	30-Jun-06	31-Dec-06	1.49%
14	31-Dec-06	30-Jun-07	5.92%
15	30-Jun-07	31-Dec-07	3.18%
16	31-Dec-07	30-Jun-08	4.16%
17	30-Jun-08	31-Dec-08	-18.74%
18	31-Dec-08	30-Jun-09	7.44%
19	30-Jun-09	31-Dec-09	7.54%
20	31-Dec-09	30-Jun-10	-4.16%
	Simple average of period changes		0.36%
	Average (based on absolute values of period changes)		5.19%
	Standard Deviation		7.08%

**Chart #2 – Graph of Results of 10 Year Back-test**



The results shown above in Tables #2 and Chart #2 may offer insights into how a globally diversified portfolio denominated in US\$ (and exposed to a basket of currencies similar to that as shown in Chart #1) might be impacted under various currency conditions. It should be noted that this time series includes the 2008-2009 global financial crisis which resulted in a sudden strengthening of the US dollar and thus a large translation loss as shown in test period #17 above. This global financial crisis is arguably a reasonable stress test to gauge approximate levels of maximum period to period movements. It is interesting to note this unrealized loss was subsequently largely reversed with unrealized gains in subsequent periods. For the entire 10 year period, the simple average semi-annual period change was a positive 0.36%, with positive changes mostly offset by negative changes. However, the mean change in value for six month periods expressed in absolute value terms was 5.19%, meaning that the average change in any period was plus or minus 5.19%. The standard deviation was 7.08%, meaning that for any single six month period there is a 68% probability that the change would be within plus or minus 7.08% of the simple mean average of 0.36% (i.e. between +7.44% and -6.72%).

Although not a rigorous proof, the data suggests that over longer time horizons, the currency effects to the NAV are mean reverting as these cumulative changes are empirically nearly offsetting, with the mean change near zero (a positive 0.36%)<sup>1</sup>. This result is consistent with financial theory that currencies mean revert over time in order to maintain relative purchasing power parity. However, the graph and data also demonstrates shorter term material volatility in the NAV due to currency translation effects. Although these gains and losses are unrealized, this level of volatility could be of concern to investors. Therefore, we next explored hedging alternatives that could be used to theoretically reduce this performance volatility. We also discuss the costs and risks associated with these hedging strategies.

<sup>1</sup> This result is consistent with the slow but gradual weakening of the Nominal Broad Dollar Index (see page 13) over the same 10 year time horizon.

**Possible Hedging Alternatives, and associated Costs and Risks**

There are a number of methods that theoretically could reduce the volatility of Phaunos' NAV due to currency translation effects. These methods include:

1. Sell the portfolio's foreign currency NAV positions for future delivery of US\$ at the forward rate in effect at the beginning of the reporting period. This transaction would theoretically reduce the NAV volatility due to currency translation effects for the duration of the contract.
2. Use Futures in a manner similar to #1 above.
3. Buy currency Put options which would allow the Fund to participate in local currency gains but minimize downside risk.
4. Reposition the portfolio to include more USD denominated investments.

**Alternative #1: Sell Currency Forward**

Phaunos' New Zealand investment in Matariki Forestry Group ("Matariki") represents about 22% of the NAV of Phaunos' portfolio as of 30 June 2010. Matariki's functional currency is New Zealand dollars ("NZ\$") which is one of the top ten traded currencies worldwide. Therefore, the NZ\$ is a good currency to investigate the use of a hedge.

The Treasury Desk of a large international bank offered Phaunos a package that would hedge NZ\$ for one, three, six, and twelve month periods. This would give the Fund protection against depreciation of the NZ\$ but would also lock Phaunos into a deal that would limit participation in currency gains. The quoted forward rates were based on a spot rate as of 22 June 2010. The forward NZ\$/USD rate quotes (i.e. NZ\$1 = US\$X) were:

Term	Value Date*	Forward points	Outright rate	Credit Line
Spot Value	22/Jun/2010	na	0.7050	US\$ 0
1 month	30/Jul/2010	-0.0028	0.7022	US\$ 18,500,000
3 months	30/Sep/2010	-0.0065	0.6985	US\$ 26,400,000
6 months	31/Dec/2010	-0.0123	0.6927	US\$ 38,400,000
12 months	30/Jun/2011	-0.0240	0.6810	US\$ 54,500,000

\* Forward value dates have been carried forward to month end

On 22 June 2010, let's assume that Phaunos had chosen to hedge its Matariki forward until 31 December 2010. The NAV for Matariki on 22 June 2010 was approximately NZ\$178.64<sup>2</sup>mm. Therefore, to hedge this NZ\$ exposure, Phaunos could have chosen to sell NZ\$178.64mm forward to 31 December 2010 and buy US\$ at the quoted forward rate of US\$0.6927 per NZ\$. At the quoted rate, this effectively equates to a commitment to pay NZ\$178.64mm on 31 December 2010 and receive US\$123.74mm. However, the quote was for a non-deliverable forward which is not settled by making the respective payments. Instead, non-deliverable forwards are settled on a net basis as will be shown later.

<sup>2</sup> Matariki's reported value on 30 June 2010 was US\$123.17mm at a spot rate on that date of 0.6895 (from Table #1), yielding a NZ\$ value of \$178.64mm. In NZ\$, this is the assumed beginning NAV on 22 June 2010 that could be hedged using a hedge ratio of 1.

The value at expiration of a currency short derivative position<sup>3</sup> is equal to:

$$[\text{Notional principle amount of derivative}] \times [\text{Forward Rate @ issuance} - \text{Spot Rate @ expiration}]$$

For example, if the NZ\$/US\$ spot rate on 31 December 2010 finished below 0.6927 [let's assume 0.6500], then Phaunos would receive a net positive cash inflow of US\$7.63mm as calculated as follows:

$$\text{NZ\$178.64mm} \times [0.6927 \text{ US\$/NZ\$} - 0.6500 \text{ US\$/NZ\$}] = \text{Derivative value at expiration}$$

$$\text{NZ\$178.64mm} \times [0.0427 \text{ US\$/NZ\$}] = \text{US\$7,627,928}$$

During the same time period the value of the underlying timber portfolio would show an accounting translation loss<sup>4</sup> of US\$7.05mm, calculated as follows:

$$\text{Value of NZ\$178.64mm @ beginning spot rate of 0.6895 US\$/NZ\$} = \text{US\$123,170,000}$$

$$\text{Value of NZ\$178.64mm @ spot rate of 0.6500 on 31 December 2010} = \underline{\text{US\$116,116,000}}$$

$$\text{Net currency translation loss on underlying timber assets} = \text{US\$ -\$7,054,000}$$

Note that the currency derivative produces a realized gain of US\$7.63mm, while the underlying timber portfolio reports a translation loss of US\$7.05mm, yielding a total net small gain of US\$0.58mm. The realized gain in the derivative offsets the unrealized translation losses of the underlying timber assets. Hence the portfolio is largely hedged against currency movements in the NZ\$/US\$.

Conversely, if the spot rate on 31 December 2010 finished above the forward rate of 0.6927, it can be shown that the derivative would produce a realized loss and the underlying asset would produce an unrealized currency gain. Again, the net change due to currency translation effects would be reduced by employing the hedging strategy. However, while this hedging strategy minimizes currency translation risks, it adds three material negative effects to the portfolio:

1. Increases the cash drag of the Fund as more cash is held for use as collateral.
2. Increases the solvency risk of the Fund as losses in the derivative position could exceed Phaunos' total available cash.
3. Adds a new risk that the hedging strategy is improperly constructed.

**Cash Drag is Increased:** In order to enter into a forward currency derivative, the quoting bank required US\$38.4mm in collateral from Phaunos. While the normal practice is for investment funds to use their assets as collateral, the vast majority of Phaunos' assets cannot be taken into custody and therefore are unsuitable for use as collateral. The result is that Phaunos would have to provide cash as collateral. This would mean that US\$38.4mm would be tied up and unavailable to the Fund. In addition, at the settlement of the derivative contract, the bank would either require a settlement in cash or allow the contract to be rolled forward for an additional period with an adjustment made to the collateral requirements. The former settlement is a cash settlement, whereas the latter approach generates a debit/credit position with the bank that Phaunos would need to account for on its books.

<sup>3</sup> This is a short position as in this example we are assuming the derivative is for the sale of NZ\$.

<sup>4</sup> This simple analysis ignores any operating gains or losses. In actuality, timber grows and is harvested and, as a result, there would be additional income and unrealized gains (losses) that would need to be considered. Theoretically, the hedge needs to account for the period ending NAV, not the period beginning NAV.

**Solvency Risk Increases:** By entering into a currency hedge, currency translation risk has been minimized, but solvency risk has increased. The use of derivatives can add material solvency risk. For example, a Brazilian Company, Aracruz Celulose SA, had nearly US\$2 billion in currency losses in 2008 and was forced to merge with Votorantim Celulose e Papel.

**Risk of Improper Hedge Construction:** The above hedging strategy assumes the proper hedge ratio is 1 (i.e. sell forward into USD the entire starting NAV expressed in NZ\$, which is NZ\$178.64mm in the above example). Theoretically, the hedge ratio should be selected that minimizes the mean variance of the movement in NAV due to currency risk. It is highly unlikely that the optimum hedge ratio is 1. Instead, the optimum ratio may be materially different from 1 and is difficult to determine. Therefore, there is a risk that the hedging strategy is improperly constructed. In short, a new risk has been added as further explained below.

Total currency risk is comprised of (1) transaction exposure, (2) economic exposure, and (3) translation exposure. The above example mostly deals with translation exposure (consolidation of the financial statements into the home currency). However, economic exposure is likely material in this example. Economic exposure is the effect that a change in currency has on the economics of the underlying business. Such changes can be material for a timber investment in New Zealand where much of the timber is sold for export. For example, if the NZ\$ weakens versus the US\$, there will be a negative impact when the balance sheet is translated into US\$. However, a weak NZ\$ improves the ability for New Zealand timber to be sold into the export market as this market is usually denominated in US\$. Therefore, in this example, the translation effect is negative, but the economic effect is positive. These two currency risks may tend to offset over time. Therefore, if a hedge ratio of 1 is selected to eliminate the translation risk (but not the economic risk), the total currency risk may have actually increased due to the hedge, not decreased. In short, there is a new risk to the Fund that the hedging strategy has been improperly constructed.

#### **Alternative #2: Buy NZ\$/US\$ Futures**

The *Chicago Mercantile Exchange* (“CME”) offers an NZ\$/US\$ Futures contract that expires on calendar quarter ends and has time to expiry of 3, 6, 9 and 12 months. Based on Matariki’s portfolio value of NZ\$178mm, Phaunos would need 1,780 contracts to hedge 100% of the Matariki portion of its portfolio. However, the entire number of traded contracts for the 3 month expiry date was a little over 3,500 contracts. Phaunos would be at the risk of the market makers in the event that it took 1,780 contracts as it would represent approximately 50% of the total market. Note that there is no trading in the 6-12 month contracts.

The use of a Future to hedge Phaunos’ NAV would have the same net result of hedging using a Forward, both would increase the solvency risk and cash drag on the portfolio.

In summary, the use of a Forward (Alternative #1) or the use of a Future (Alternative #2) both are unattractive. We next analyzed the use of Options as a hedging strategy.

#### **Alternative #3: Buy an Option**

We analyzed the purchase of a Put option to sell NZ\$ forward. This strategy is comparable to buying insurance against the weakening of the NZ\$ against the US\$. For example, if the NZ\$ weakens past the strike price of the Option, then the Option has value which partly offsets the underlying translation loss of the timber assets<sup>5</sup>. The losses are not fully offset for two reasons. First, the cost of the Option has to be recouped. Second, the loss is only insured on losses below the strike price, not losses between the strike price and the beginning spot rate.

However, one advantage of the use of an Option is that if the currency moves in a favorable direction, the investor lets the then worthless Option expire and captures the gain on the currency movement. The investor has downside protection, while retaining all of the upside (less the cost of purchasing the Option).

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<sup>5</sup> Assuming the notional amount of the Option is the same as the beginning value of the underlying asset.

The price of a one year Option to sell NZ\$178mm in one year's time at the current spot rate quoted on Bloomberg at 30 June 2010 was approximately US\$8.4mm. This Option would provide some protection to the Fund against currency depreciation on NZ\$178mm for one year while allowing the Fund to participate in any upside (by not exercising the Option). The US\$8.4mm represents the premium payable and is the maximum outlay possible. It would be paid on inception of the contract and is not recoverable.

If the Fund was prepared to take more of the currency movement risk, it would be possible to purchase a less expensive Option, but this would provide less insurance protection. This strategy would be similar to buying insurance with a very high deductible.

Currently, the strategy of purchasing a Put option is very expensive, requiring actual cash payments of over US\$8mm merely to offset unrealized losses that tend to reverse over time. This 'insurance' would provide some protection against translation fluctuations that (through 31 December 2010) have been a maximum of US\$37mm on a six month period to period basis (see page #1). In the future, if currency volatilities decrease, such Option strategies would be less costly and this strategy might be more attractive.

Additionally it is possible to combine Call and Put options that would result in different payout/protection profiles. Such more complex alternatives were not analyzed in detail at this time.

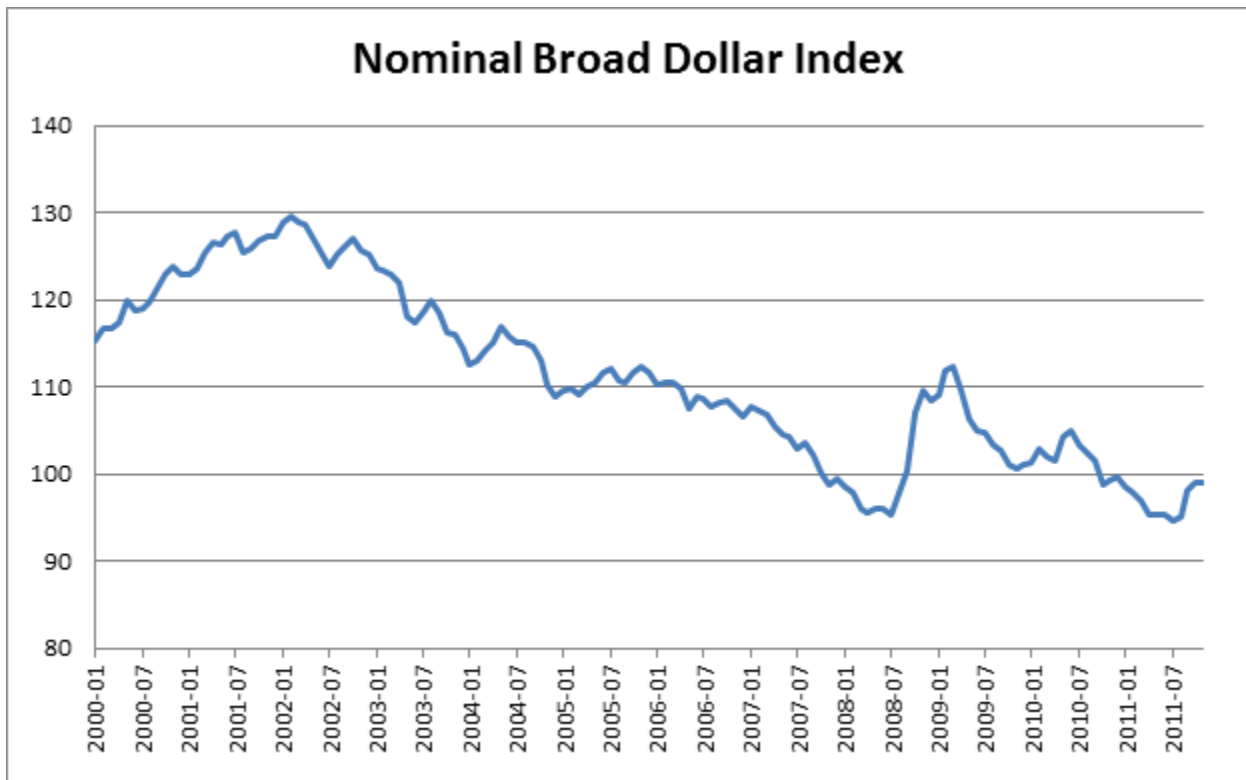
#### **Alternative #4: Buy more US\$ denominated Investments**

As of 30 June 2010, approximately 21% of Phaunos' portfolio was not impacted by currency exposure. This percentage was comprised of USD cash held for working capital, plus Phaunos' two US investments (GreenWood Tree Farm Fund LP, and NTP Timber Plus+ Fund I, LP). Adding more USD denominated investments would lower the currency risk of Phaunos. Such a strategy is a risk avoidance strategy rather than a hedging strategy. However, this strategy would migrate the Fund away from its investment mandate of being a globally diversified timber investment vehicle and more into a USD timber investment vehicle. It would also concentrate risk into USD which may not be desirable as explained in the next section.

#### **Further Discussion**

##### ***Some investors may prefer an un-hedged portfolio.***

One significant disadvantage of Alternatives #1, 2, and 4 is that by minimizing the translation risk, the opportunity to benefit from positive currency movements is foregone. Hedging would not be advantageous if there was a systematic long-term weakening of the US dollar. Such a weakening can be seen in the following graph of the Nominal Broad Dollar Index (which is a weighted average index of the foreign exchange values of the US dollar against the currencies of a large group of major US trading partners). If investors believe this trend will continue, then they likely would choose an un-hedged portfolio, thus retaining the potential to benefit from positive foreign currency translation gains into US\$. [Granted, other investors might not be concerned with this downward trend, arguing that the downward trend will eventually mean revert.]



***If an investor wants to hedge his portfolio, the most efficient hedge is one that is customized for the investor's entire portfolio.***

To construct a proper hedge, the hedge should be constructed by taking into account the entire portfolio, not just a portion of the portfolio. Phaunos is likely a small portion of most investors' over-all portfolio. Also, some of these investors may already have currency overlay strategies in place to address their total portfolio currency risk resulting from their holding of both Phaunos and other foreign assets. For investors with existing hedging programs, an additional hedge by Phaunos at the asset level may prove counterproductive.

***Hedging is not cost free. In fact, it can be quite expensive.***

While the cost of hedging is explicit in the use of strategies involving the use of Options (i.e. the purchase price of the Option), the use of Forwards or Futures to hedge currency risks can be material. The total cost of the hedge for Forwards and Futures includes (i) the bid-ask spread differential between buying and potentially selling the derivative, plus (ii) the 'cost of carry'. This latter cost depends on the differential interest rates between the two currencies involved in the hedge. Depending on the interest rate differentials, this can be either a benefit (called a 'positive carry'), or a cost (called a 'negative carry'). Lately, US interest rates are running less than most foreign interest rates, which results in a negative carry. For example, if we had used a Brazilian Real example, the negative carry would have been about 9% on an annual basis.

***Not all hedging is the same.***

The above hedging discussion addresses the issue of whether to hedge Phaunos' NAV. As we have shown, hedging the NAV involves offsetting unrealized NAV changes with realized changes of the value of the derivative. This can create significant solvency risk and can be expensive to implement. Therefore, hedging of the NAV is not currently being used within

Phaunos. However, there are other types of transactions where hedging could prove to be more useful. For example, there are three general types of transactions that can create realized gains or losses (i) initial purchase of a forest asset, (ii) operating the asset, and (iii) final sale of the asset. These transactions may be better suited to employ hedging strategies as these may involve two offsetting realized gains and loss positions. Such offsetting realized positions may have less chance of creating undue solvency risk.

**Conclusion**

The NAV of Phaunos is currently un-hedged for the following reasons:

- The use of Forwards/Futures would materially increase the amount of cash needed to be held in reserve for use as collateral or as margin. This increases the cash drag on the Fund’s performance, plus margin calls could increase the Fund’s solvency risk.
- The use of Options is presently very costly. The implied cost of other hedging strategies can also be quite high.
- Using derivative creates a new risk that the hedging strategy is improperly constructed.
- If investors want to hedge Phaunos’ translation currency exposure, investors should consider creating their own customized hedge for their total portfolio (not just the Phaunos portion of their portfolio).
- Other investors may prefer an un-hedged return. For example, long term investors may be willing to accept NAV volatility due to currency effects if they believe currency gains and losses will tend to balance out over time. While other investors may prefer exposure to a basket of foreign (versus US\$) denominated assets, as this diversifies their risk of holding merely US\$ denominated assets.

While hedging currently appears unattractive, the decision to hedge (or not to hedge) the NAV of the Fund could change in the future for a variety of reasons. For example:

- The price of using Options could materially change, making this alternative more attractive.
- The currency mix of the Fund could change over time, resulting in a change in the overall currency risk exposure.
- The value of a particular currency could materially deviate from its long-term ‘fair value’ trading range which could result in a need to revisit the cost/benefits of using hedges.

<p><b>FOURWINDS CAPITAL MANAGEMENT (TIMBER GROUP)</b>                  Authors:                  Mason Browne, CFA, Director of Global Investments and Acquisitions                  Qin Hai Xia, Director of Investments and Acquisitions                  Madonna McNichol, Senior Financial Officer</p>	<p><b>FUNDAMENTALS OF PHAUNOS TIMBER FUND</b></p> <table border="0"> <tr> <td>Listing Date</td> <td>20 Dec 2006</td> </tr> <tr> <td>Shares outstanding (Ordinary)</td> <td>537.1</td> </tr> <tr> <td>Latest unaudited NAV (30 June 2011)</td> <td>US\$1.16</td> </tr> <tr> <td>Number of investments/countries/continents</td> <td>11 / 9 / 6</td> </tr> </table>	Listing Date	20 Dec 2006	Shares outstanding (Ordinary)	537.1	Latest unaudited NAV (30 June 2011)	US\$1.16	Number of investments/countries/continents	11 / 9 / 6		
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<p><b>ABOUT FOURWINDS CAPITAL MANAGEMENT</b>                  FourWinds is a specialist in global commodities and natural resources with products investing across energy, metals, agriculture, timber, water, waste, and alternative energy.</p> <p>FourWinds Capital Management (US), Inc.                  60 State Street, 37th Floor, Boston, Massachusetts 02109                  Email: <a href="mailto:info@fourwindscm.com">info@fourwindscm.com</a>                  Website: <a href="http://www.FourWindsCM.com">www.FourWindsCM.com</a></p>	<p><b>THE FUND</b>                  Phaunos Timber Fund Limited is an LSE-listed investment fund (PTF) managed by FourWinds Capital Management. It invests in timberland and timber-related assets that enhance its timberland returns. For additional information on the fund, please visit <a href="http://www.PhaunosTimber.com">www.PhaunosTimber.com</a>.</p> <p><b>CORPORATE BROKERS</b></p> <table border="0"> <tr> <td>VSA Capital Limited</td> <td>Winterflood Investment Trusts</td> </tr> <tr> <td>14 Austin Friars</td> <td>The Atrium Building, Cannon Bridge House</td> </tr> <tr> <td>London EC2N 2HE</td> <td>25 Dowgate Hill, London EC4R 2GA</td> </tr> <tr> <td>Contact: Andrew Monk</td> <td>Contact: Jane Lewis</td> </tr> <tr> <td>+44 (0) 203 005 5000</td> <td>+44 (0) 207 638 9571</td> </tr> </table>	VSA Capital Limited	Winterflood Investment Trusts	14 Austin Friars	The Atrium Building, Cannon Bridge House	London EC2N 2HE	25 Dowgate Hill, London EC4R 2GA	Contact: Andrew Monk	Contact: Jane Lewis	+44 (0) 203 005 5000	+44 (0) 207 638 9571
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