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PALOMA PARTNERS

July 24, 2015

Dear Investor:

Paloma International Limited (the "Fund") had a solid start to the year led by Algorithmic strategies, which proved well-suited to the first half's roller coaster markets. The category was up in five of six months including periods in which the markets came under rather significant stress.

We first began to invest in Algorithmic/Quantitative strategies more than twenty-five years ago. I'm not sure that I would have predicted then that very significant opportunities would still exist in quantitative trading a quarter century later. It seemed that the smart PhDs toiling away in the area would eventually, wipe out all profitable inefficiencies. And at various times, based on diminished perceived opportunities, we did dramatically reduce our allocation to quant. Given all that, I'm especially pleased that some of what I've seen in Algorithmic in recent years, particularly from the top performing managers, reminds me at times of the excitement of the early years. One can never predict future performance and there is substantial risk in all strategies. Still, our build-up in Algorithmic over the last several years so far continues to play out very nicely.

It's also worthwhile to note that Algorithmic overtook Credit Relative Value as the Fund's leading contributor in the first half of the year. In the last several years, Credit performed very strongly thanks to strategies aimed at taking advantage of the opportunities created by the collapse in structured credit prices during the financial crisis of 2007-2009. We're pleased that we were able to extract significant value from this area, and that the residential mortgage-backed securities portfolio at the heart of this category still continues to perform well, albeit at a smaller size. This rotation in strategy leadership does highlight one of our core beliefs: different strategies work better at different times and nothing works all the time.

Similarly, it's been interesting to note the divergence in the performance of various Algorithmic sub-categories this year. In general, we've seen strong results from shorter term and catalyst-driven strategies, while performance in the more traditional statistical arbitrage strategies has been less successful. As I like to say, there's nothing magical about a strategy just because it has "quantitative" or "algorithmic" in the name— again, some will work and some won't. Even when one likes an investing category, it's valuable to be diversified.

Despite the overall solid start to the year, we were unhappy with some strategies. Our long-running core Long/Short manager had a disappointing start to the year which caused negative results in the strategy. Based on the manager's performance over the last few years, we decided to end our relationship with the exception of one ongoing event driven position.

The Capital Structure/Volatility category was negative in the first half of the year as volatility did not respond as much as one would expect to some individual stock and macro surprises. As we have observed this year, Volatility strategies can play an important role in giving balance to the portfolio in times of stress. We feel that our Volatility managers have provided an important degree of portfolio protection this year at a reasonable cost in a less than ideal environment. Nevertheless, over time we expect these strategies to be a net contributor to portfolio performance.

All of these manager and strategy shifts are designed to lead to one unchanging goal: to be opportunistic amid evolving market opportunities and produce a low correlation return that's valuable and not easily accessible to investors.

In the remainder of this letter I'll provide a brief overview of all of our Fund strategies; give you some thoughts on the current market environment; and tell you about an important hire. As always, we welcome your comments and questions.

STRATEGIES

As discussed, **Algorithmic** had a good start to the year. I believe we've become a partner of choice to some of the great practitioners in the space as demonstrated by some recent hires, but given the number of new managers we've hired in the last few years, we will undoubtedly have disappointments as well. That being said, we continue to seek great, experienced talent and continue to very closely follow the Algorithmic space—which is truly a world of its own—to be positioned to take advantage of additional opportunities.

Credit Relative Value was positive for the first half with the largest contribution continuing to come from residential mortgage-backed positions. Contributions also came from distressed and catalyst driven high yield strategies and from a shorter-term liquid bond trading strategy. Despite the positive results, good risk-adjusted opportunities in credit continue to be limited. Last year, we brought on a European credit manager as we expected that the more challenging and evolving economic environment in Europe would produce interesting opportunities. That thesis hasn't really played out, and earlier this year we decided to limit our relationship with this manager to their quantitative credit strategy.

Capital Structure/Volatility has become an important focus for us. We currently like Volatility for a number of different reasons. Volatility trading opportunities can arise as a result of structural factors in the markets (such as banks needing to hedge certain risks at particular times). These scenarios can give rise to the type of relative value opportunities with low correlation to markets that we've always prized and pursued. Also, I think it's fair to say that volatility trading has been somewhat out of favor in the hedge fund world. That unpopularity tends to lead to reduced capital allocations and to increased availability of interesting talent. Finally, we believe that Volatility is generally a good complement to our significant Algorithmic allocation. Algorithmic strategies have historically experienced periods of greatest stress in falling/pressured markets and Volatility strategies have historically tended to do well in those times. Our goal over the long run is to capture alpha from manager skill and innovation in all strategies—that is what leads to the solid, low correlation returns that hedge fund strategies should be providing. Nevertheless, strategies that are also diversifying within the Fund are obviously attractive.

Our largest **Event Driven** manager had good results in the first half of the year as a major position came to fruition. We were pleased with the results but don't currently expect to add managers in this area, which we significantly cut back last year.

As discussed, **Long/Short** was negative in the first half. However, a newly added Long/Short manager was nicely positive for the period. This manager, who is now our only manager in Long/Short, has a longer-term fundamental approach. We're excited about his trading philosophy and ideas, and we've asked him to grow his portfolio in the second half of the year.

In **Asia Strategies** we benefitted from public Chinese equity positions. As you know Chinese markets surged in the first half of the year before experiencing a steep decline at the end of June. Our Asia Strategies area is focused on our investments in the Cathay private equity funds. As I've said previously, I continue to be optimistic about China's economic story despite the slowdown in the country's growth rate over the last few years. After decades of investing in China I am respectful of the country's determination and record in moving forward. This year, certain factors such as margin lending and government intervention are leading to extreme volatility. However, I believe these factors will eventually settle and markets will find a reasonable balance.

Fixed Income had a slightly positive first half. The strategy is positioned to capture yield curve normalization and we believe it will become more interesting as the Federal Reserve finally starts taking its first steps in tightening monetary policy.

UNCERTAIN TIMES

When Bill Gross, the preeminent bond investor of the last twenty years, chooses the metaphor of death to characterize the current investing environment, I think we should at least consider whether we may be on the threshold of disturbing markets. In his May investment outlook (*"A Sense of an Ending"*, Janus Capital Group Investment Outlook, May 2015) Gross wrote: "As it is, in 2015, I merely have a sense of an ending, a secular bull market ending with a whimper, not a bang. But if so, like death, only the timing is in doubt. Because of this sense, however, I have unrest, increasingly a great unrest. You should as well."

Gross is not the only one to use troubling metaphors lately in describing trading markets. There was New York University Professor Nouriel Roubini in a May research piece (*"The Liquidity Time Bomb")*: "The combination of macro liquidity and market illiquidity is a time bomb." A recent report (*"Six Trends to Know, Six Risks to Hedge")* by Gross' old shop Pimco warns: "[there is a] greater likelihood of flash crashes, air pockets and trading volatility." And Goldman Sachs president Gary Cohn noted: "The problem is on the days when you need liquidity, it probably won't be there."

It's difficult to know to what extent these warnings have resonated or not in the markets. There have been so many troubling predictions lately that it's possible, ironically, that they will actually cause some to ignore the underlying issues. But that doesn't mean these concerns are going away and I believe we're well advised to ponder them carefully.

With these warnings in mind, I have tended particularly to wonder lately about one investment strategy that has been very popular in the last few years: risk parity. Risk parity essentially argues that investors should abandon the traditional core policy portfolio based on a 60-40 (stock-bond) allocation and instead embrace portfolios that have risks equally balanced across asset classes (stocks, bonds, commodities). Essentially the idea is to begin with an optimal, diversified portfolio based on underlying risk—in practice, more bonds and less stocks—and then lever up to achieve a desired expected return. The argument is to swap the traditional equity focused risk of a conventional 60-40 portfolio for a more bond heavy portfolio—with leverage. A risk parity portfolio should benefit from greater diversification and arguably from investing in assets (bonds) with higher historical Sharpe Ratios. The general theory is very sensible and intellectually quite attractive—but theory does not always translate into results.

I have two concerns about risk parity. Obviously we're in a market where bonds seem to have more than typical downside risk—so investing in a levered bond portfolio is arguably problematic. Additionally, one wonders whether interest rate shocks, as the U.S. Federal Reserve begins to normalize interest rate policy, could lead to a break down in historical asset class correlations, which would somewhat upend diversification expectations for risk parity portfolios. We don't participate in this long only part of the investment business—as a participant or a competitor—so to some degree this concern is academic for us.

My second concern, which may be more relevant to all market participants, is that some risk parity managers appear to be planning to actively manage these levered portfolios in turbulent markets. If so, I believe there could be some interesting moments down the line. I only know what's publicly available in the press about these strategies—and I believe there are substantial differences between various risk parity products—but the proposition that levered positions can be adjusted in chaotic markets should be closely examined. Markets, with the exception of the most liquid and deep trading arenas, have a way of freezing in times of stress. Liquidity can disappear overnight.

I am old enough to remember other products that veered badly off course. Some of you may recall the popular 1980s financial product "portfolio insurance" which was designed by very smart, well intentioned people to protect large institutional portfolios in falling markets. Instead of offering protection, many argue that portfolio insurance ended up exacerbating the stock market crash of 1987. I am not comparing risk parity and portfolio insurance—they are extraordinarily different—and risk parity products offered by different firms are not created equal. Nevertheless, I believe it's important to question the assumptions built up during the bull markets of the last several decades as well as the last few years. Recent capital markets developments—ETF proliferation, bond market issuance, diminished dealer participation, and increased retail investment access—are not trivial and they will have an impact when markets turn down—whenever that should be.

As always the markets will have the final verdict. If risk parity strategies perform well on the downside of markets I'm sure they will become even more popular and esteemed. If not, I do wonder if we may find ourselves waking up to another historic day.

ORGANIZATIONAL NEWS

I'm pleased to announce that Stu Hendel, a true veteran of the prime brokerage and hedge fund world, will be joining us on August 1 as Chief Operating Officer of Paloma Partners Management Company. In a long career, Stu has served as global head of prime brokerage units at Morgan Stanley, UBS and Bank of America. He also previously served as chief operating officer of hedge fund Eton Park. I have known Stu for over 20 years and I am very happy that he is joining Paloma.

I'm also very pleased to let you know that, in June, *Institutional Investor* magazine named the Paloma Funds *Early Stage Hedge Fund Investor of the Year* at its annual hedge fund awards dinner in New York. We were honored to receive this award from such a prestigious publication, and especially pleased to be recognized in this category, defined by the magazine as managers who provide "seed or first day capital", which is indeed a core part of our investing philosophy.

We are focused on what lies ahead in 2015. We expect a challenging investment environment, as many economies struggle with lackluster growth and monetary policies across the globe begin to diverge. As always, we will do our best to find the right balance between risks and opportunities.

Sincerely,

PALOMA PARTNERS ADVISORS LP
By: Paloma Partners Advisors Inc., its general partner

By: ______________________________
S. Donald Sussman
President

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No guarantee or representation is made that the Fund's investment program, including, without limitation, its investment, objectives, diversification strategies, or risk monitoring goals will be successful and investment results may vary substantially over time. Investment losses may occur from time to time. Nothing herein is intended to imply that the Fund's investment methodology may be considered “conservative”, “safe”, “risk free”, or “risk averse”. Economic market and other conditions could also cause the Fund to alter its investment objectives, guidelines and restrictions. Any discussion or illustration of investment diversification, concentration, targets, guidelines, leverage parameters, or limits, is purely for discussion purposes only and should not be construed as establishing any formal investment guidelines or restrictions for the Fund. The only formal investment guidelines or restrictions applicable to the Fund, if any, will be those described in the Fund's Offering Memorandum. The Fund may make illiquid Investments. Paloma Management’s risk management protocols should not be considered an assurance that losses will not be incurred. There may be risks which are not monitored or controlled by Paloma Management and risks that may be greater than forecasted, especially in unusual market conditions. Risk characteristics may change on a daily basis. Total exposure figures may not tally due to rounding.

The Fund is not intended to be a complete investment program and is suitable for sophisticated investors independently capable of evaluating the risks associated with an investment in the Fund. There is no guarantee that the Fund will achieve its investment objectives now or in the future. An investment in the Fund: is speculative and may involve a high degree of risk; could result in a loss of all, or substantially all of investors’ capital; may be leveraged which can increase investment risk; may have volatile performance; can be highly illiquid, investors may be required to retain their exposure to investments for an indefinite period of time; is not freely transferrable, there is no secondary market for the Fund’s interests and none is expected to develop; may involve complex tax structures and delays in distributing important tax information, and; is subject to substantial fees and expenses offsetting profits.