

Hedge Fund Market Commentary – July 2007

The financial markets changed dramatically during the final two weeks of July, potentially reversing a steady bull market that began in 2003. The S&P 500 was down 6.3% in just the last eight trading days of the month and liquidity in the corporate bond market virtually disappeared. Predictably, US Treasury bonds rose in a “rush to quality.” By month-end, as shown in Exhibit 1, all risky asset classes reported negative returns.

Exhibit 1: 2007 Market Performance

	July	Year to Date
DJ Wilshire 5000	-3.40%	3.90%
MSCI EAFE (net)	-1.47%	9.11%
DJ Wilshire REIT	-7.85%	-13.35%
ML High Yield II	-3.14%	-0.18%
Lehman Aggregate	0.83%	1.82%
Lehman Treasuries	1.66%	2.69%

Some of the largest declines were in the real estate securities and credit markets. REITs continue to be the worst performing market sector as subprime mortgage problems have begun affecting real estate valuations. The Merrill Lynch High Yield Master II Index suffered its worst monthly decline since the summer of 2002, when reports of accounting fraud caused corporate bond prices to fall sharply.

What Happened?

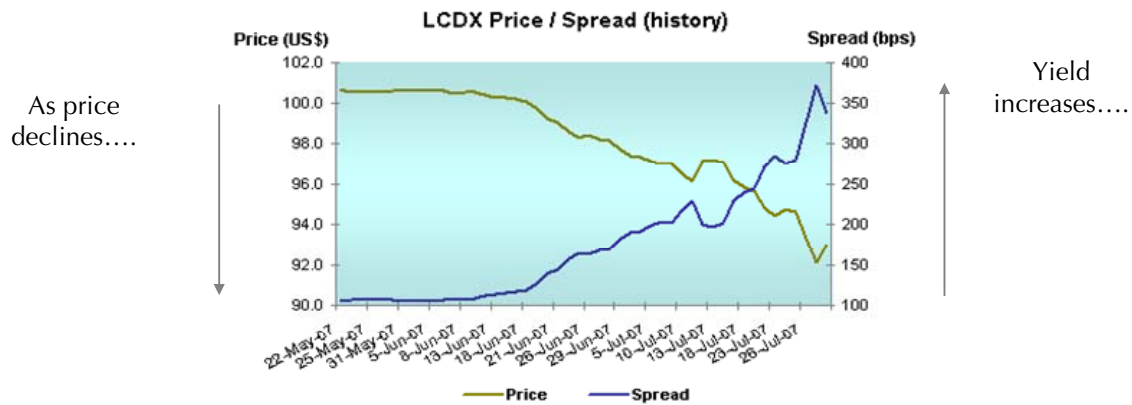
Bond traders revolted. Buyout firms have been taking advantage of excess liquidity, a strong global economy and low interest rates to purchase companies using low cost debt with few covenants. Much of this debt has been in the form of non-investment grade bank loans which the investment banks resell to institutional buyers. Almost half of the debt has been used to form investment pools called collateralized debt obligations (“CDOs”). The CDO issues securities backed by the bank loans but with different levels of seniority. Some investors purchase the senior CDO securities, which are rated investment grade and are relatively low risk. Others purchase junior CDO securities offering high returns but also high risk.

The growing overall demand for CDO securities and, in turn, bank debt, helped push bank loan and high yield bond spreads to historic lows, giving further incentive to buyouts. In many cases investment banks provided bridge loans to finance these purchases and it is estimated that there is a back log of \$300 - \$500 billion of these bridge loans that the banks need to find long term buyers for.

The favorable lending environment began to change in late June and rapidly deteriorated during the last two weeks of July. Investors increasingly worried about the health of the consumer and the state of the real estate market as losses in subprime mortgages began to mount. Demand for CDO debt dried up as many of the buyers of these securities were the same investors that suffered losses on CDOs backed by subprime mortgages. This all unfolded as investment banks were trying to place the new debt of many large buyout transactions. The result was that more than 40 of the buyout debt deals have been postponed or restructured.

The investment banks were left holding a large amount of unsold debt on their balance sheets. Additionally, they have a large pipeline of future debt commitments that they are worried they will not be able place at prices originally negotiated with the buyout firms. Sensing these new risks, banks hedged their positions by shorting an index of bank loans and engaged in a fire sale of assets at substantially discounted prices just to get the debt off their balance sheets. The impact of the hedging activity and the distressed sales was particularly felt in the bank debt market because most of the buyout deals in recent years were financed using bank debt.

Exhibit 2: Price and Spread Change on an Index of Bank Loans



Source: Markit. The LCDX is a measure of 100 equally weighted bank loan credit default swaps.

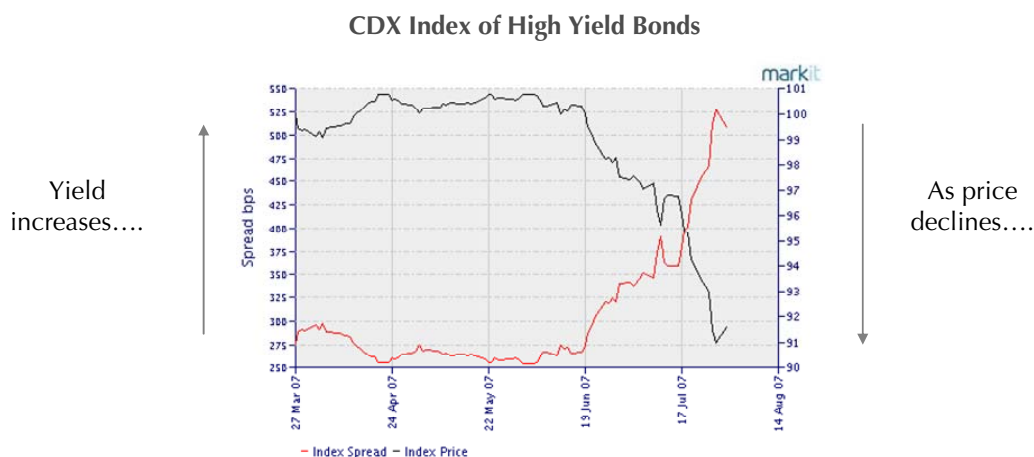
Exhibit 2 shows the price and corresponding credit spread for the LCDX, which is a measure of 100 bank loan credit default swaps. As shown by the blue line, the spread (right axis) went from 120 basis points in May to over 350 basis points in July, a 230 basis point widening. Correspondingly, the price (shown in red and measured by the left axis) went from \$100 to \$92, an 8% decline.

High yield bonds were also affected by the re-pricing of credit in July. Exhibit 3 shows the price and corresponding spread for the CDX, which is a measure of 100 high yield bond credit default swaps. As shown by the red line, the spread over Treasuries (left axis) went from 250 basis points in May to over 525 basis points in July, a 275 basis point widening. Correspondingly, the price (shown in black and measured by the right axis) went from \$100 to \$91, a 9% decline.

The result was a sharp re-pricing of credit risk over a very short time period. Concerns spread to the stock market, particularly in the finance sector, despite a week where many companies, such as Ford, reported positive earnings. Thus far, the widening of credit spreads and stock market decline is not reflective of the health of the underlying companies.

As a result of this spread widening, in particular with spreads on loans widening out as much or more than those on bonds, credit arbitrage strategies suffered losses. A final consequence of July's turmoil was investment losses in merger arbitrage strategies as investors in targeted companies began to question whether all the announced buyout deals would be completed given the uncertainty surrounding their financing.

Exhibit 3: Price and Spread Change on an Index of High Yield Bonds



Source: Markit. The CDX is a measure of 100 equally weighted high yield bond credit default swaps.

Summary

Investors in hedge funds expect an “absolute return.” This means protecting capital when markets decline. Protecting capital does not mean absolutely no losses, just that they will be small when they occur. As a group, hedge funds mostly accomplished this mandate in July. While hedge fund index returns are not yet available we expect July returns will be between 0% and -1%, bringing year-to-date index returns to between 6% and 7%. That will still put them on a double digit pace for 2007. Credit, merger arbitrage, and equity strategies are likely to be hardest hit but losses on individual funds are unlikely to exceed 3% to 4%. There are at least some notable exceptions.

While the sharp widening of credit spreads has happened before, the reason for it this time is unprecedented. However, that’s always the case when a crisis hits. Many managers are now taking advantage of the downturn to purchase attractive assets at lower valuations. Despite the most recent pain, if the economy does not turn down, hedge funds may be positioned to reap long term gains.

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