

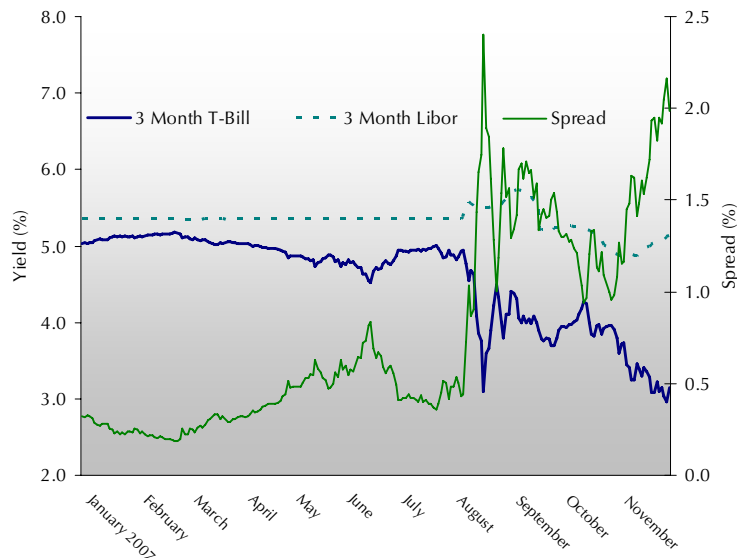
Hedge Fund Market Commentary – November 2007

November’s market returns looked a lot like those in August, and unfortunately ended any hope for a quick return to normalcy. Record-high oil prices and the evolving consequences of subprime losses have put pressure on the economy from both the demand and supply side. Like in August, investors in November responded to these economic headwinds with a classic flight to quality. Treasuries and investment grade corporate bonds were the only major asset classes to experience positive returns for the month (see Exhibit 1). Investors even began questioning the safety of holding cash, as disclosures of subprime losses within SIVs held by cash pools made headlines. The good news was a willingness by both the Fed and Treasury to take action amidst the continuing problems. The bad news is that both institutions may prove ineffective in stemming the credit crunch. Despite a cut in the federal funds rate, Libor remained relatively unchanged, causing the spread between Libor and T-bill rates to again rise to the 2% record high reached in August (see Exhibit 2). Thus the Fed’s actions did little to ease the protective stance banks have taken over their capital.

Exhibit 1: 2007 Market Performance

Index	November	October	Year to Date
DJ Wilshire 5000	-4.45%	1.90%	6.26%
MSCI EAFE	-3.24%	3.97%	14.35%
MSCI Emerging Mkts	-7.08%	11.22%	38.75%
DJ Wilshire REIT	-9.72%	1.15%	-12.92%
Lehman Aggregate	1.79%	0.90%	6.60%
Lehman Treasuries	3.07%	0.79%	8.93%
Lehman High Yield	-2.17%	0.60%	1.58%
Lehman Bank Loan	-1.53%	1.01%	1.80%
Libor	0.40%	0.43%	4.87%
HFRI Fund Weighted	-1.93%	2.84%	9.65%

Exhibit 2: Libor, T-bills, and Spread
(Source: Bloomberg)



Hedge fund returns were negative for the month, but less so compared to the losses suffered in the equity markets. The HFRI Fund Weighted Composite Index returned -1.93% for the month but is still up a healthy 9.65% for the year-to-date. The worst performing hedge fund sector was equity long/short, down -2.92%. The average equity L/S fund has significant positive exposure to the markets, and thus the loss in the index is not surprising. However, the index return hides the dispersion in stock-selection skill which differentiates quality funds from below average funds. Many hedge funds managed to navigate through November with minimal losses, while others fared very poorly. Event-driven hedge funds also experienced a difficult month, off -2.19%. The recent collapse of some M&A deals along with a declining market sent deal spreads sharply higher, creating a difficult month for hedge funds with exposure to buyouts and mergers. As one measure of investor sentiment surrounding corporate deals, the average price spread¹ on the 16 billion dollar plus deals set to close in December 2007 jumped from 6.5% to 12.7%. This is a very high number considering the short time period to deal closing dates.

The popular ABX shorts remained good trades, with both the BBB and AAA ABX Indices continuing their decline, bolstering performance for a number of hedge funds engaged in these trades. In fact, short credit positions, particularly in subprime, have become very popular trades even among hedge funds without a credit focus. In addition, banks and insurance companies have looked to the ABX indices to hedge their long exposure to individual ABS issues. This has helped place tremendous selling pressure on the index, driving prices to levels that some feel are too low. To understand this, it is worth examining the structure and mechanics of these indices.

The ABX Indices are credit default swaps (CDS) referencing 20 of the largest home equity mortgage backed securities.² There are different ABX indices for different tranches of the underlying assets. For example, the ABX AAA Index references the AAA tranches of 20 subprime ABS bonds. The holder of a long position in the ABX (i.e., a seller of protection) receives monthly payments at a fixed percentage of the notional value of the underlying reference assets. In return, long investors are required to deliver payment to short investors in case of either a write down on a reference asset, or a shortfall in the interest or principal payments. Conversely, a short ABX position (i.e., a buyer of protection) pays a monthly credit spread but is made whole should a default or delinquency occur. The rate one pays (short) or receives (long) is determined in advance by averaging quotes from independent dealers. This rate, which does not change, roughly represents the credit spread on the pool of reference assets at the time of index initiation, and equates to an index price of 100. At this price, the CDS is considered to have zero value, and thus no cash would be exchanged between the buyer and seller of protection at the initiation of the contract. However, as the market spread rises (falls), the index price falls (rises). The difference between the index price and 100 is roughly the percentage of notional that is exchanged upfront between the buyer and seller.³

As demand has increased among investors looking to short subprime, the prices of the ABS indices have declined. It may turn out that the performance on the underlying subprime loans will be better than that implied by the depressed ABX prices. Such a realization could catch off guard those hedge funds that have strayed outside of their area of expertise and core strategy in an effort to boost profits or construct hedges through short ABX positions.

In another area of the credit markets, spreads on high yield loans widened in November, leading to mark-to-market losses for opportunistic bank loan funds, but also better pricing for those with

¹ Price spread equals target or acquisition price minus market price.

² Technically, only the ABX.HE indices are linked to home equity ABS. There are separate ABX indices for other ABS assets. However, it is common to see the ABX.HE indices simply referred to as the ABX indices.

³ The actual mechanics of trading in the ABX indices are more complicated. For more detail, visit <http://www.markit.com>

remaining capital to deploy (see Exhibit 3). The desire by many banks to take risk off of their balance sheets should continue to present favorable entry points for those funds that are not yet fully invested.

As the markets continue to be volatile, quality hedge funds across strategies should be able to identify many value opportunities. The funds with limited leverage and consistent and focused strategies will be best suited to turn those opportunities into long-term profit amidst the short-term mark-to-market swings.

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December 17, 2007

Exhibit 3: Average Loan Price and Spread in Lehman High Yield Loan Index
(Source: Lehman Brothers)

