

Hedge Fund Market Commentary – October 2007

If August was the month when investors feared the worst, and September the month of renewed confidence, October was the month that proved neither sentiment will rule the Street just yet. Investor uncertainty was one theme that did tie the last three months together as evidenced by continued large daily moves in virtually all capital markets. The S&P 500 Index managed a healthy 1.6% return in October, but only after recovering from a mid-month drawdown of 1.6%. A summary of other market indices is shown below in Exhibit 1.

The credit markets could best be described as unsettled in October. High yield credit spreads had tightened considerably during October, but ended up higher than they were at the beginning of the month (see Exhibit 2). The ABX indices comprising both AAA and BBB subprime-backed bonds also declined further in October and are trading below their August lows. Public disclosures of subprime losses suffered by large banks helped to reduce uncertainty around the financial impact of the housing downturn and to drive down the LIBOR/T-bill spread from 1.43% to 0.98%. However, the spread still remains well above its historical average, reflecting the continuing perception that banks' capital reserves will be weighed down by losses in subprime and LBO bridge loans.

The general market unease seemed to stay within U.S. borders, as non-U.S. markets and in particular emerging market equities once again gained substantially in October. Investment grade and government credit also fared well, as dollars shifted into safer asset classes and expectations grew of further interest rate declines.

Exhibit 1: 2007 Market Performance

	October	September	Year to Date
DJ Wilshire 5000	1.90%	3.60%	11.21%
MSCI EAFE	3.97%	5.36%	18.21%
MSCI Emerging Mkts	11.22%	11.05%	49.39%
DJ Wilshire REIT	1.15%	3.91%	-3.55%
Lehman Aggregate	0.90%	0.76%	4.78%
Lehman Treasuries	0.79%	0.54%	5.68%
Lehman High Yield	0.60%	2.62%	3.83%
Lehman Bank Loan	1.01%	2.06%	3.38%
Libor	0.43%	0.46%	4.24%
HFRI Fund Weighted	NA	2.71%	8.80%*

* Through September

NA = not available

Hedge funds benefited from October's volatility. Early indications are that October returns will come in between 1.5 and 2.0%. Event-driven funds in particular should report good results stemming from a significant narrowing in merger arbitrage spreads (see Exhibit 3) and the successful closing of two large mergers. Many hedge funds also profited from shorts on the subprime sector, and looking forward, many are hoping to buy into the downturn, purchasing either subprime assets or leveraged loans from distressed sellers. Given the continuing downward trend in the ABS market, the opportunity set for buyers of subprime appears to be large and growing. But what about the leveraged loans, which many managers set up special funds to buy? As shown in Exhibit 4, loan

prices have actually rebounded since the August lows, and indications from recent sales of loans by overburdened banks suggests prices below 96 will not be attainable.

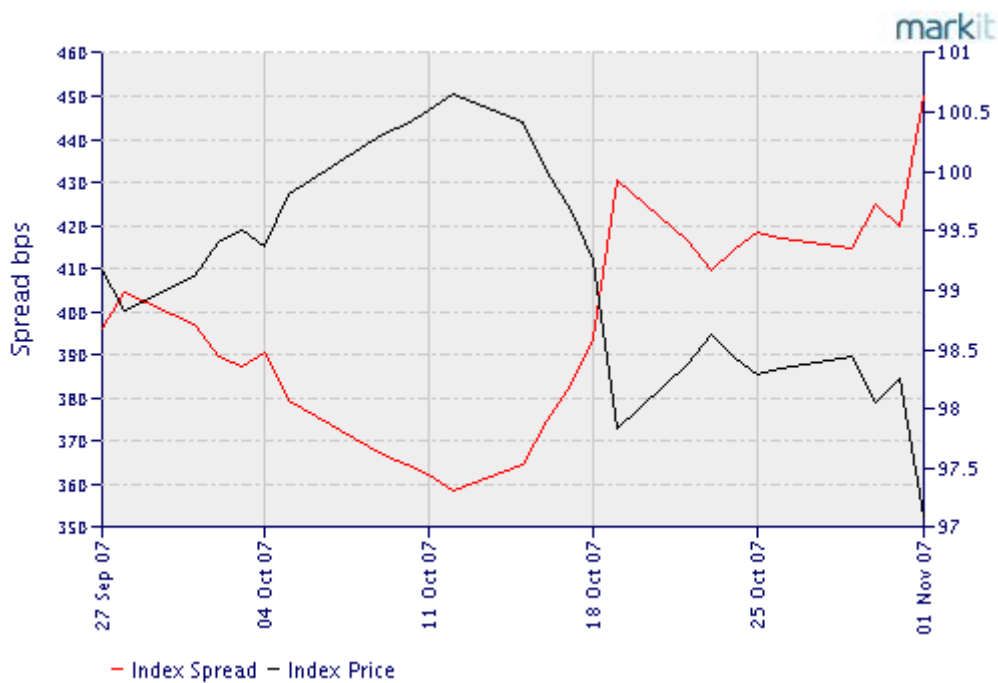
Ultimately, the quality of the opportunity for buyers of these loans will be determined by supply and demand. September and October saw the supply picture change dramatically with the announcement that LBO sponsors were backing out of the \$8 billion Harman and the \$25 billion Sallie Mae acquisitions. Should more of these private equity buyers seek to terminate the planned deals, the backlog and potential supply of bank loans would decrease. Adding to the supply risk is the possibility that banks will simply keep the loans on their balance sheets and record losses. However, if subprime losses are as bad as the most pessimistic fear, this would be less likely.

As noted above, the uncertainty over these losses is creating volatility in the markets. Paralleling this uncertainty is the uncertainty over how the subprime assets are being priced by hedge funds (as well as other institutions such as banks and insurance companies). Many are carrying heavily impaired assets on their balance sheets at valuations which may or may not reflect realizable value. An October 12th article appearing in the Wall Street Journal forced this issue further into the public domain. The article described how disappearing liquidity for these assets has and will continue to require holders to use "fair value" techniques in the absence of traded prices.

Starting with fiscal years beginning this November, all hedge funds with audited financial statements will have to conform to a new GAAP standard for determinations of "fair value" called FAS 157. FAS 157 defines three fair value methodologies: "marking to market", which applies to exchange-traded securities with readily available market quotations, "marking to matrix", which applies to infrequently traded over-the-counter assets for which multiple broker-dealer quotes are available, and "marking to model", which applies to highly illiquid assets with little or no third-party pricing available. The grey line between the latter two categories crosses through the universe of asset-backed securities and structured credit products held in large quantities by hedge funds, potentially creating more confusion for hedge funds working with their auditors to provide accurate and transparent financials. The process will likely take some time for both hedge funds and their auditors to adjust to, but investors should benefit from the increased clarity provided by the FAS 157 guidelines.

Eli Sokolov
November 7, 2007

Exhibit 2: High Yield CDX Index



Source: Markit

Exhibit 3: Merger Arbitrage Spreads
 August 31, 2007 through October 31, 2007
 Deals Closing between Nov. 1 and Dec 31 valued at over \$1 billion

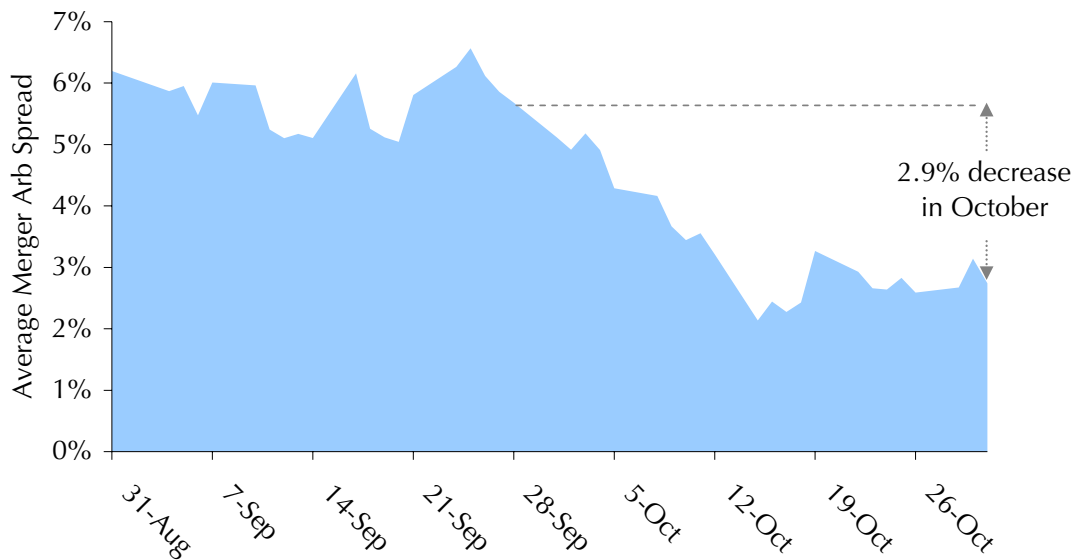
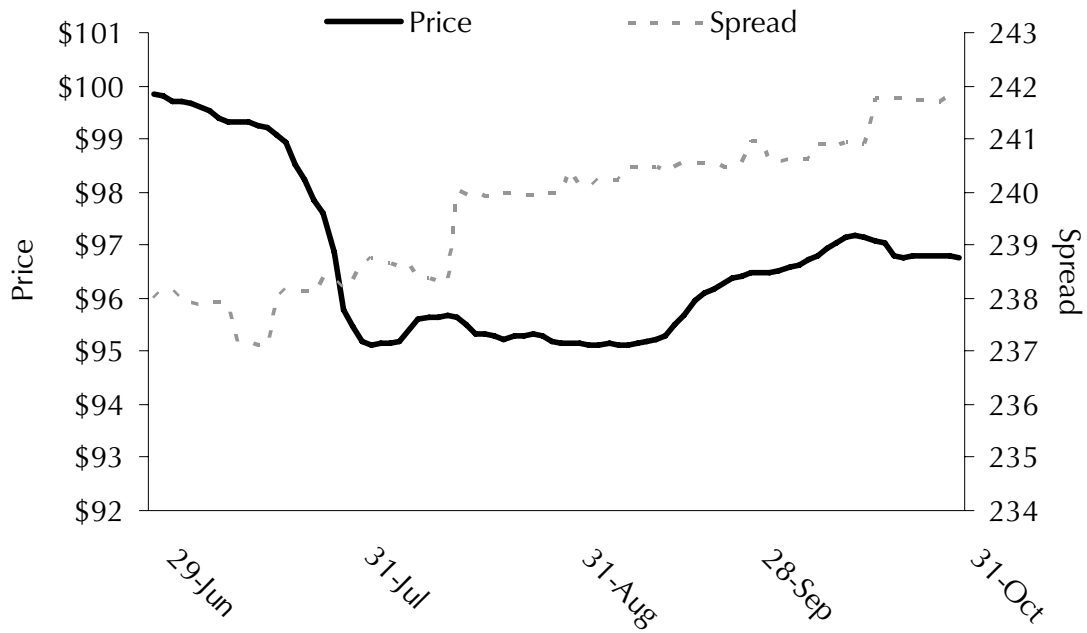


Exhibit 4: Average Loan Price and Spread In Lehman High Yield Loan Index



Source: Lehman Brothers