

## Hedge Fund Market Commentary – September 2007

Markets rebounded in September, ignited by the Federal Reserve's unexpectedly large one-half percentage point cut in the fed funds rate. The markets largely dismissed the concern that such a dramatic Fed move may signal deep concerns on the part of central bankers, and instead demonstrated a renewed confidence in the Federal Reserve to guide the market through the subprime collapse. Many believe that the credit market has bottomed and that normalcy is returning, though lending remains limited and at higher spreads. The spread between Libor and T-bill yields, despite falling from 1.52% to 1.43% during September, remains well above the historical average of 0.52%, indicating continuing reluctance among banks to part with capital. International developed and emerging markets fared very well, with the MSCI EAFE and MSCI EMF indexes, buoyed by a weakening dollar, surging 5.36% and 11.05%, respectively, as shown in Exhibit 1. We expect that the HFRI Fund Weighted Index return for September will be between 1.0 and 1.5% when results are published next week, offsetting August losses.

Exhibit 1: 2007 Market Performance

|                    | September | August | Year to Date |
|--------------------|-----------|--------|--------------|
| DJ Wilshire 5000   | 3.60%     | 1.39%  | 9.13%        |
| MSCI EAFE          | 5.36%     | -1.50% | 13.70%       |
| MSCI Emerging Mkts | 11.05%    | -2.13% | 34.32%       |
| DJ Wilshire REIT   | 3.91%     | 5.91%  | -4.64%       |
| Lehman Aggregate   | 0.76%     | 1.28%  | 3.85%        |
| Lehman Treasuries  | 0.54%     | 1.57%  | 4.86%        |
| Lehman High Yield  | 2.62%     | 1.36%  | 3.21%        |
| Lehman Bank Loan   | 2.06%     | 0.39%  | 2.35%        |
| Libor              | 0.46%     | 0.44%  | 4.02%        |
| HFRI Fund Weighted | NA        | -1.32% | 6.17%*       |

\* Through August

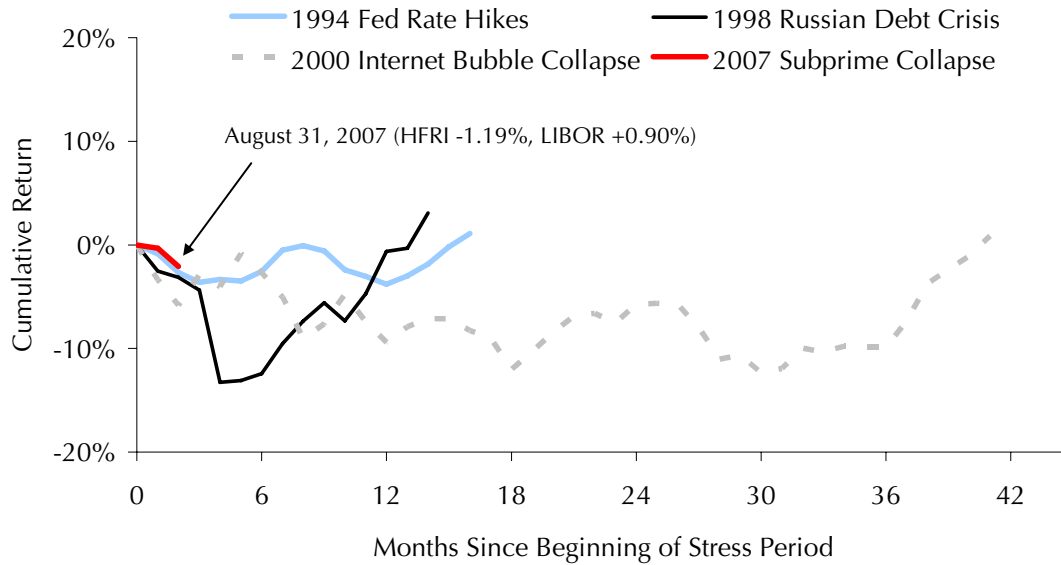
NA = not available

In defiance of many predictions, no major hedge fund collapses occurred in September. However, it is fair to say that hedge funds are still in the middle of a difficult period. In our last monthly commentary we described the events beginning in July as a possible stress test for hedge funds, with high leverage and shrinking liquidity causing many funds to underperform Libor. Exhibit 2 displays excess performance of the HFRI Fund-Weighted Composite Index over Libor during the recent July-August time period compared with excess returns during three notable stress periods for hedge funds: the 1994 Fed rate hike, the 1998 Russian Debt Crisis, and the 2000 Internet Bubble Collapse. Though hedge funds underperformed LIBOR by 2.09% through August, the positive returns likely to be reported in September will result in cumulative losses for the three months to be below 1% and comparatively minor against the backdrop of the three historical crisis periods.

The biggest challenge for investors in hedge funds will be how to identify profitable investments in this environment. We believe that hedge funds targeting bank loans and subprime mortgages present a great, but possibly short-lived, option for investors. Other longer-term opportunities should be created by the subprime fallout. Rising corporate defaults should produce a favorable

environment for traditional distressed strategies, and we expect higher inflows into distressed funds as a result. However these funds still depend on favorable economic conditions upon exit from investments. So as long as the subprime story does not end in a recession, cautious optimism remains a good approach.

Exhibit 2 - Cumulative Performance of HFRI Fund Weighted Composite Index vs. Libor



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