

2011 Hedge Fund Review

Performance

Exhibit 1 reports asset class and hedge fund performance for 2011 and prior calendar years.

Exhibit 1: 2011 Market Performance

Index	Calendar			Calendar	Calendar	Calendar
	2011	Dec	FYTD*	2010	2009	2008
Equity						
MSCI ACWI	-7.4%	-0.2%	-11.5%	12.7%	34.6%	-42.2%
S&P 500	2.1%	1.0%	-3.7%	15.1%	26.5%	-37.0%
Russell 2000	-4.2%	0.7%	-9.8%	26.9%	27.2%	-33.8%
MSCI Asia Pacific	-14.9%	0.4%	-14.4%	17.3%	37.9%	-41.6%
MSCI Europe	-10.5%	-1.5%	-18.3%	4.5%	36.8%	-46.1%
MSCI Emerging Mkts	-18.2%	-1.2%	-19.0%	19.0%	78.3%	-53.5%
S&P 500 Financials	-17.1%	1.8%	-14.4%	12.1%	17.2%	-56.6%
Fixed Income						
Barclays Aggregate	7.8%	1.1%	5.0%	6.5%	5.9%	5.2%
Barclays Treasuries	9.8%	1.0%	7.4%	5.9%	-3.6%	20.1%
Barclays TIPS	13.6%	0.0%	7.3%	6.4%	11.4%	-2.4%
Barclays High Yield	5.0%	2.7%	0.0%	15.1%	58.2%	-26.2%
3 mo.Libor	0.2%	0.0%	0.0%	0.4%	0.7%	3.1%
Alternative						
DJ UBS Commodity	-13.3%	-3.8%	-11.0%	16.8%	18.9%	-35.7%
Hedge Funds						
HFRI Fund of Funds**	-5.6%	-0.4%	-5.3%	5.7%	11.5%	-21.4%
HFRI Fund Weighted**	-5.0%	-0.4%	-5.7%	10.3%	20.0%	-19.0%
Dow Jones Credit Suisse	-2.5%	-0.2%	-4.1%	10.9%	18.6%	-19.1%

* Fiscal YTD from June 30, 2011

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Hedge funds struggled in 2011. The HFRI Fund Weighted Index fell -5.02% for the year, only the third calendar year loss in the Index's 22 year history.¹ All of the losses came in the third quarter when global equities² fell -17.43% and the HFRI Fund Weighted Index dropped -6.74%, a mini-tail event caused by the European Sovereign Debt Crisis, reminiscent of 2008.³

Third quarter hedge fund losses were proportional to those experienced in the fourth quarter of 2008. In both cases hedge fund losses averaged 40% of overall stock losses. The consistency is discomfiting as we would believe that most hedge funds put in place stronger risk controls post-2008. What *did not* transpire in the subsequent fourth quarter of 2011 was a meaningful hedge fund bounce back. The HFRI Fund Weighted Index returned just 1.06% in the fourth quarter, while global equities climbed 7.35%. Instead, we would have expected a more robust 3% to 5% rebound by hedge funds.

¹ The other negative years are -19.03% (2008) and -1.45% (2002).

² Global equity returns are measured by the MSCI All Country World Index (Free) – Net.

³ Global equities fell -22.37% in the fourth quarter of 2008.

The -5.02% HFRI Fund Weighted Index return for 2011 is broken down into its three sources – Libor, beta and alpha – in the rightmost column in Exhibit 2.

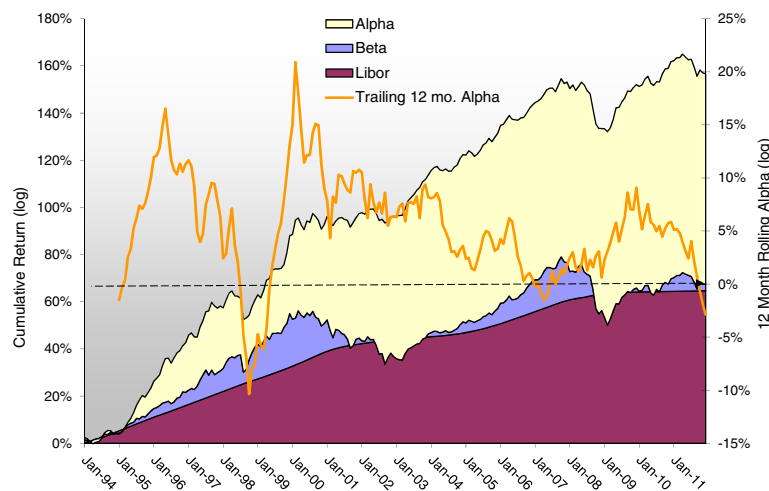
Exhibit 2: Sources of Hedge Fund Return

Return Source	Hedge Fund Return Attribution			
	Periods ending Dec 2011			
	18 Years	10 Years	5 Years	1 Year
Alpha	5.22%	3.80%	2.96%	-2.79%
Beta*	0.22%	0.03%	-2.13%	-2.51%
Libor	3.66%	2.28%	1.87%	0.28%
Total	9.10%	6.11%	2.70%	-5.02%
Alpha Risk	3.98%	3.03%	3.27%	1.77%
Inf Ratio	1.31	1.25	0.91	-1.58

* Beta measured relative to MSCI ACWI Index

We estimate that the average hedge fund produced a negative -2.79% alpha for calendar 2011 and that beta exposure detracted another -2.51%. Exhibit 2 also displays sources of hedge fund return covering longer periods. Over the trailing 10 and 18 years alpha has accounted for 3.8% and 5.22%, respectively, of the HFRI Fund Weighted Index return. The longer term trend of hedge fund alpha is illustrated in Exhibit 3.

Exhibit 3: Sources of Cumulative Hedge Fund Return



The top line in Exhibit 3 shows cumulative percentage return for the HFRI Fund Weighted Composite Index, which is the combination of the alpha, beta, and Libor area segments. In combination, the three return segments grew 157% over the entire 18 year period, the cumulative (log) return of the HFRI Fund Weighted Composite Index. Visual inspection shows that the two largest components of the HFRI Fund Weighted Composite Index return were alpha, the top segment, and Libor, the bottom segment, with returns from beta being the smallest component.

Also shown in Exhibit 3 is the rolling 12 month hedge fund alpha, which uses the right hand scale. Over time, alpha has varied and averaged roughly 5% per year. However, as in 2011, hedge funds have experienced negative alpha in years of financial distress. Historically, alpha returns

quickly pick up when markets recover. We would hope for the same type of recovery in 2012 as occurred after 1998 and 2008.

Exhibit 4 displays hedge fund strategy index returns, including those reported by index providers HFRI and Dow Jones Credit Suisse.

Exhibit 4: Hedge Fund Strategy Returns

Strategy Indices	Calendar			Calendar	Calendar	Calendar
	2011	Dec-11	FYTD*	2010	2009	2008
Market Neutral						
HFRI**	0.5%	0.5%	-2.5%	11.5%	25.8%	-18.0%
Dow Jones CS-Convert	1.1%	0.6%	-2.4%	11.0%	47.3%	-31.6%
Dow Jones CS-Fixed Income	4.7%	0.4%	1.1%	12.5%	27.4%	-28.8%
Event Driven						
HFRI	-2.8%	-0.1%	-5.8%	11.7%	25.0%	-21.8%
Dow Jones Credit Suisse	-9.1%	-0.8%	-10.3%	12.6%	20.4%	-17.7%
Equity Long/Short						
HFRI	-8.3%	-0.9%	-9.2%	10.5%	24.6%	-26.7%
Dow Jones Credit Suisse	-7.3%	-0.9%	-8.0%	9.3%	19.5%	-19.8%
Global Macro/CTA						
HFRI	-3.8%	0.0%	-1.5%	8.2%	4.3%	4.8%
Dow Jones CS-Macro	6.4%	0.4%	5.0%	13.5%	11.6%	-4.6%
Dow Jones CS-Managed Future	-4.2%	0.8%	-0.8%	12.2%	-6.6%	18.3%
Multi-Strategy						
HFRI	-1.3%	0.2%	-3.0%	13.4%	24.6%	-20.3%
Dow Jones Credit Suisse	1.8%	0.1%	-2.4%	9.3%	24.6%	-23.6%

* Fiscal YTD from June 30, 2010

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Equity Long/Short

Most of the responsibility for poor hedge fund performance falls with equity long/short strategies, which comprise roughly 46% of the weight of the HFRI Fund Weighted Index.⁴ The HFRI Equity Hedged Index returned -8.25% for 2011, below the MSCI ACWI return of -7.35%. While HFRI Equity Hedged Index fell -26.65% in 2008, by comparison, it was much better than the -42.20% drop in the MSCI ACWI that year.

The performance anomaly for equity long/short managers as a group has several dimensions. While the S&P 500 Index returned a positive 2.02% for the year, this was the best performing equity index and heavily weights the largest capitalization U.S. based stocks. Equity long/short hedge funds historically favor small and value oriented stocks which did poorly in 2011. Small stocks underperformed large stocks by over 6% in 2011 and value stocks underperformed growth stocks by 5%. Emerging market stocks, which fell -18.17% in 2011, are also an overweight in equity long/short portfolios and are difficult to short as well.

Moreover, there was a general de-risking of equity long/short portfolios during the third quarter as equity values fell amid real concerns for a repeat of 2008. For example, Cliffwater equity

⁴ The HFRI indices are equal weighted and equity long/short hedge funds represent 46% of all hedge funds by number. Asset-weighted, equity long/short hedge funds represent 27% of total hedge fund assets, a sizable difference.

long/short managers on average reduced gross and net equity exposure from highs of 195% and 55%, respectively, early in the year to lows of 158% and 34%, respectively, by the end of the third quarter. According to Morgan Stanley, the average equity long/short manager brought gross and net exposure down from highs of 157% and 67%, respectively, early in the year to lows of 136% and 39%, respectively, by late in the third quarter.

While de-risking controls losses – as hedge funds are expected to do – it can also be costly if markets sharply rebound and leave hedge funds unable to participate fully on the upside and making loss protection look very costly. This is the misfortune that struck many equity long/short funds that increased hedges in August and September and found themselves left out of the fourth quarter market recovery. This was particularly true for more bottom-up buy and hold hedge fund managers while others that incorporate more aggressive trading and macro inputs were better able to navigate the tough environment.

Market Neutral

Market neutral strategies, which include fixed income arbitrage, volatility arbitrage, tail risk management, and convertible arbitrage, largely performed well in 2011 by successfully limiting exposure to equity and credit markets, notably outperforming during the months of August and September.

Fixed income arbitrage managers benefited from significant amounts of sovereign debt issuance and temporary valuation discrepancies caused by large scale government intervention programs such as QEII and the EFSF. Managers also profited from dislocations within structured credit markets and widening of cash/CDS bond basis within corporate credit markets. Fixed income managers were generally conservatively positioned due to constrained liquidity across many markets, including historically deep markets such as European sovereign debt. Many managers reduced leverage, increased unencumbered cash levels and reduced the expected time horizon for their “arbitrage” trades in order to remain nimble in this environment. Furthermore, many managers implemented either explicit or implicit “tail risk hedging” strategies, which benefited from elevated levels of financing stress, widening CDS spreads in corporate bond markets and “flight to quality” trades during the second half of 2011.

Volatility arbitrage managers generated strong profits in 2011, while managers with long volatility positions performed particularly well. Tail risk hedging funds, many of which were launched after the 2008 financial crisis, also generated outsized returns, particularly during months such as August and September, which experienced large drawdowns across equity markets and spikes in implied volatility. Volatility arbitrage managers were consistently profitable throughout the year by exploiting short-term pricing discrepancies in options caused by a number of factors, including:

- Long-only investors and hedge funds attempting to hedge their portfolios from future downside losses or lock-in profits during “risk-on” months’
- Higher trading activity from ETFs, levered ETFs and high frequency traders, which led to increased levels of implied correlation across equity markets,
- Elevated levels of implied skew across the volatility surface, which led to puts trading relatively rich to calls and increased demand for out-of-the-money options, and
- Increased regulation, including Dodd-Frank, which led to lower levels of proprietary trading activity in the volatility asset class and greater opportunities for hedge funds to serve as the liquidity provider.

After two years of strong returns following the 2008 financial crisis, convertible arbitrage funds were generally flat to modestly down in 2011. Convertible arbitrage managers generated decent returns during the first half of 2011 but new issuance remained weak and the asset class was generally perceived to be priced at fair or slightly rich levels (relative to the securities’ underlying components). Convertible bonds were correlated with equity markets during “risk-off” months

such as August, especially more credit-sensitive securities such as “busted converts.” Many convertible arbitrage managers were focused on these more credit-sensitive names and experienced mark-to-market losses during the third quarter. In addition, liquidity conditions deteriorated, particularly in Europe and Asia, and managers reduced their leverage and increased hedges (particularly credit and interest rate hedges). During this period, both investment grade and non-investment grade convertible spreads widened significantly and also lagged the equity market during “risk-on” rallies such as October 2011.

Credit/Distressed

Credit hedge fund returns ranged from down 5% to up 5%. Long-biased managers with exposure to equity, distressed, and stressed securities underperformed, while long/short credit managers outperformed. Credit managers operated in an environment characterized by heightened volatility surrounding global economic concerns and in particular the sovereign debt crisis in Europe.

For most long-biased credit managers, it was a difficult year to generate profits. The HFRI Distressed-Restructuring Index, which is somewhat representative of the long-biased credit universe, was down -2.40%. The Barclays High Yield Bond Index actually gained about 5% for the year, but prices declined, with the index generating an 8% cash return from coupon payments. Hedge funds in large part failed to capitalize on these gains for a few reasons – credit quality, sector allocation, geographic allocation, and equity allocation. Hedge funds in this space tend to be in lower-rated credits than the average bond in the index, and moving down the credit quality spectrum equated to a more marked widening of spreads. Moreover, being in lower-dollar price securities, hedge funds benefited less from the interest rate rally that helped mute the price decline in the index. Going into August, hedge funds were also more tilted toward financials and structured credit, where much of the distressed opportunities could be found, as well as more heavily invested in Europe and in equities than in the prior year. The Pan-European High Yield Index was down nearly -6%, with financials weighing heavily into the losses, and equity markets declined substantially over the summer. Many managers looked to hedge these risks with short positions focused on Europe, including corporate credit indices and sovereigns. However, they were insufficiently hedged going into August. They cut risk at that time primarily through increasing hedges and reducing equities, and consequently benefitted less from the rebounds both in late August and in October. Funds that performed better than average tended to be more concentrated in event-driven situations and particular equities (e.g. Delphi) that defied the market.

Performance for credit long/short managers ranged from flat to up 5%. The HFRI RV Fixed Income Corporate Index was up 0.69% for 2011. The majority of hedge funds in this universe do not rely on carry to generate returns, and 2011 was a year where carry drove performance across credit strategies in the long-only universe. Within the credit long/short space, managers often run with neutral to negative carry, and instead generate profits through active trading. The high volatility in 2011 provided attractive opportunities to trade, despite a decline in liquidity presenting challenges. Liquidity was especially limited in early October and in the last two weeks of the year when volume was extremely low. At the same time, managers who relied heavily on fundamental credit work were not rewarded due to the high levels of correlation. Despite these factors, most credit long/short posted gains in 2011. Drivers of performance included event-driven positions, which benefited from re-financings, and non-traditional credit positions, including tobacco and municipal positions. The primary detractors were long positions in Europe, unsecured debt, equities, and hedges. The sovereign hedge trade in particular was difficult to profit from as rapidly fluctuating sentiment on Europe caused a whipsaw effect on sovereign spreads. A popular short trade that made money in 2011 was shorting various mortgage insurers. This thesis played out throughout the year as the market began to realize that these companies were becoming insolvent due to high default rates.

The performance of asset-backed credit managers was fairly wide-ranging, with some managers posting low double-digit losses and others large double-digit gains. The markets were very

supportive until mid-February, when concerns over large sales of mortgage-backed securities (“RMBS”) caused dealer support and bids to disappear as investors recognized that prices had become rich over a multi-year rally period. Managers that outperformed in the non-agency space were underweight subprime, overweight prime, shorter in duration, and earlier in vintage. Also, some managers did particularly well timing their hedges (generally broad index hedges) effectively. In the derivatives space, managers investing in interest-only agency and non-agency securities continued to do very well as both interest rates and prepayments remained low.

Event Driven

Most event driven managers found 2011 to be an exceptionally frustrating period. The extreme levels of volatility, intense focus on macro driven issues and high correlations across securities made it a difficult environment to navigate. Funds that had lower exposure to equities and higher exposure to credit and arbitrage situations tended to generate better performance. The HFRI Event Driven index was down -2.84%.

The volatile environment led many event driven funds to cut gross and net exposure throughout the year as well as to reduce exposure to non-core, soft catalyst positions. The high level of stock correlation made it difficult to generate positive performance in any position without a definitive hard catalyst. The reduction in exposure served to mitigate continued volatility after an exceptionally difficult August and September, but it also prevented managers from participating in the rally that took place at year-end.

The focus for many funds was on investing in hard catalysts with definable time lines. Mergers, corporate breakups and distressed restructurings were the most profitable strategies for most funds. However, there was a great deal of volatility in some widely held restructuring situations which caused further mark to market losses. Post reorganization equities hurt a number of managers that overstayed their welcome. Special situation equities which require selling into the broader market in a more discretionary manner were the biggest detractors from fund returns. The difficult macro environment led corporate executives to postpone decisions which often resulted in events being delayed or not performing as expected.

M&A activity got off to a strong start in 2011 but stalled in the second half of the year with the onset of the European debt crisis. For the entire year, 2011 deal volume was up 38% to \$448 billion and deal count at 145 was 16% higher than in 2010. Despite solid transaction volume, the diversified event driven funds generally had low exposure to merger arbitrage (less than 15% on average) as spreads were narrow with the 2011 inter-week average weekly median annualized spread at approximately 5.4% which is lower than historical averages. Hedges, including shorts on indices and sovereign shorts had mixed results given the dramatic shifts in the market. The higher returning event funds in 2011 were ones that had success in short investments and/or ran more net neutral. Timing was critical for hedging in a year characterized by range trading and two spikes in volatility around the Japan earthquake and the U.S. losing its AAA rating.

Activist funds generated mixed results with many ending the year flat to up slightly. Monthly performance was volatile which was to be expected given the long biased nature of activist funds. Although management was inclined to cooperate with activist funds, the market didn’t necessarily reward target company’s achievements. Activist managers continue to find attractive opportunities in light of depressed stock valuations.

Global Macro

There was a wide dispersion in 2011 of returns for discretionary macro hedge fund managers, but in general, the global macro strategy was unable to produce positive returns. The HFRI Macro Index finished down -3.78% for the year. Most macro managers carried a bearish portfolio tilt throughout the year that benefited during “risk off” months, but their portfolios were whipsawed during “risk on” months. The slowly unfolding European crisis led to choppy equity and currency

markets that proved difficult for most managers to trade. The best performing discretionary managers were those that maintained a long fixed income bias and kept their portfolios tactical with well diversified exposures. Commodity-focused macro funds suffered through a very difficult 2011.

One of the most profitable trades for discretionary macro managers this year was long fixed income (i.e. receiving rates) in both developed and emerging markets. As global growth slowed and inflation expectations subsided throughout the year, central banks cut rates and expectations for further rate hikes diminished. Managers made money receiving rates in Brazil, Australia, the US, and in Europe. The most profitable trade in August was long receiver swaptions in the front end of the European fixed income curve. As the market sold off and ECB rate cuts became consensus, discretionary managers were able to produce solid asymmetric returns.

Currency trading was frustratingly difficult for many managers. After the Japanese disaster in March, many managers were long Yen based on expectations of repatriation of Japanese-denominated assets. Ultimately, the yen ended the month down -2.5% on a trade weighted basis as the G7 intervened to stem the currency's sudden appreciation. At the beginning of the year, most managers were positioned short the USD versus commodity-backed currencies (ZAR, AUD, CAD) and the currencies of select EM sovereigns with strong balance sheets and low levels of debt (BRL, HKD, RMB). This trade worked for the first half of the year; the Brazilian Real hit a 12-year high against the dollar in July despite the finance minister's best efforts to fend off speculators with a barrage of capital controls. However, although the Chinese Yuan held relatively steady, the currencies of most other major emerging markets, including India, Brazil, Mexico, and South Africa, all suffered deep declines versus the dollar in 2011. This trade caused significant pain for those macro managers who failed to trade tactically in the second half of the year. Trading the Euro also caused pain for most global macro managers. Despite the ongoing European financial crisis, the Euro traded up to 1.48 in May and many managers suffered losses in the first half of the year on their Eurodollar shorts. The Euro finished 2011 down slightly from where it started. Equity and credit trading provided mixed results for managers and were generally much smaller portfolio components than rates and currency. Managers hit their loss limits by mid-year in long emerging markets/short developed market equity positions, but continued to make money throughout the year tactically trading indices from both the long and short sides.

Commodities took a volatile path over the course of the year. Most commodities finished the year lower than they started, but Brent crude oil and gold finished the year +14% and +9%, respectively. Managers generally invested long in commodities throughout the year as geopolitical tensions and inflationary fears fueled a strong rally in precious metals, but positions were whipsawed over the summer and by the end of the year, most metals finished in the red. Managers that continued to have long commodity positions suffered significant losses by year-end.

The HFRI Macro-Systematic Diversified Index, comprised primarily of CTAs, finished the year down -3.58%. In general, 2011 was a frustrating year for trend-following strategies, which are the dominant component of CTA performance. Although the markets were highly volatile in 2011, the price action in most markets was characterized by short-term reversals of large magnitude rather than the sustained moves that benefited trend-following in 2008. The one exception was fixed income, where sustained downward moves in interest rates (excluding certain European countries) provided a strong opportunity set. As a result, sector allocation was an important driver of CTA returns this year. Managers with higher risk allocations to fixed income generally fared better than those with more risk allocated to equity, currency, and commodity markets. In addition, managers with a longer average holding period fared better, as they were less likely to be whipsawed than managers with a shorter horizon.

Large CTAs continued to focus their research efforts on improving execution, as capacity in the space is primarily constrained by market impact and liquidity. In addition, many managers have

continued to expand their research into non-trend following strategies in order to reduce correlation to the broader trend following universe and reduce susceptibility to trend reversals.

Multistrategy

There was significant dispersion among multistrategy funds, with returns ranging from -15% to +15%, depending on the mix of underlying strategies and geographic focus. Many funds with a primary focus on fundamental equity long/short and credit strategies generated losses, particularly if they were overweight higher beta sectors such as financials. Managers with a focus on macro, quantitative or structured credit strategies generally fared better. From a geographic perspective, multi-strategy managers with a focus on Europe generally lost money, particularly if they stayed fully invested during the second half of the year and did not implement top-down macro overlays or tail risk hedges. Several of Cliffwater's approved multi-strategy hedge funds added value by managing risk levels and strategy allocations from a top-down perspective. These funds employed some of the same loss mitigation techniques that they did during the 2008 financial crisis, such as increasing the level of cash held at the overall fund level and maintaining a primary emphasis on liquidity across all strategies.

While 2011 was a difficult year with volatile returns for most investment approaches, some strategies fared better than others. Fundamental equity long/short was the most difficult strategy for many multi-strategy hedge funds, particularly during the second half of the year. Many markets and sectors were not trading on fundamentals, and stock level correlation reached an all-time high of over 80% during this time period. Managers that were focused on shorter-term tactical trading strategies performed better than those with longer-term holding periods. From a geographic perspective, many managers struggled in Europe and Asia but did better in the US, particularly if they avoided financials, focused on more defensive sectors and maintained low net exposures. In addition, managers allocated capital to equities in their merger arbitrage strategies as deal flow increased and spreads were relatively attractive during the second half of 2011.

Multi-strategy managers with a long-biased approach to corporate credit or distressed investing struggled during the second half of 2011 as credit markets traded down with other risky asset classes and lagged the equity markets during "risk-on" months. Several common distressed investments, including Lehman and Tribune, benefited from positive news in 2011 but were adversely affected by some forced selling and mark-to-market losses. Structured credit continued to be a bright spot for many multi-strategy funds for the year, although liquidity deteriorated in many sectors of the market during volatile months such as August and September. Nevertheless, the strategy was generally positive for the year and managers continued to deploy additional capital to the sector, both in their flagship funds and sidecar vehicles.

Multi-strategy managers with allocations to discretionary macro, managed futures or statistical arbitrage strategies were generally profitable in these areas. Discretionary macro and managed futures strategies profited from elevated levels of financial stress in the U.S. and Europe and strong "flight-to-quality" rallies during "risk-off" months. Statistical arbitrage strategies also made money, particularly event-driven signals which benefited from price over- or under-reactions to news and shorter-term technical signals.

Finally, some managers devoted additional capital and/or investment resources to their macro overlay/tail risk hedging strategies. These strategies served to mitigate drawdowns during risk-off months such as August and September and allowed funds to make higher conviction fundamental bets while controlling the resulting market exposure. Funds generally employed a multi-asset class approach to this strategy, initiating trades such as S&P 500 put spreads, gold call options or Euribor-OIS spreads, which benefited from increased financial stress in the Eurozone.

Operational Developments in 2011

Hedge fund managers put a high priority on mitigating counterparty risk in 2011, primarily by adding professionals dedicated to managing counterparty risk. The recent bankruptcy of MF Global has reinforced hedge fund efforts to diversify counterparty risk by utilizing multiple execution and prime broker relationships. In addition, many hedge funds have established traditional custodial relationships in order to segregate securities and cash balances away from prime brokers. Managers have also increased their understanding of the differences between the U.S. and non-U.S. asset protection and bankruptcy rules and generally strive to maintain assets with U.S. broker-dealers in order to protect investors through more investor friendly U.S. regulations. Lastly, hedge funds have increased their focus on counterparty selection and ongoing due diligence that includes monitoring of prime and execution brokers' stock prices, evaluating CDS spreads and reviewing the financial strength of each counterparty.

The creation of a strong internal compliance program also remained a high priority for hedge funds in 2011, pushed by increased regulatory requirements. The passage of the Dodd-Frank Financial Reform Bill mandated that every U.S. hedge fund manager with at least \$150 million of assets in the U.S. must register with the SEC by March 30, 2012. Managers that have not yet registered are developing internal compliance policies and procedures to ensure they meet the SEC guidelines. Third party compliance consultants and external legal counsel have been retained by these managers to review current policies and offer guidance on how to develop and strengthen internal policies. Hedge funds also prepared for the additional reporting requirements under SEC registration, including the Form PF and Form ADV. Lastly, managers trading derivatives are anticipating the creation of a centralized clearing facility for swaps and are assessing how this development may affect their current operational processes including trade settlement, reporting and financing.

Hedge fund managers have been providing greater transparency to investors regarding their firm's operational controls and the existence and valuation of assets. One development is a "fund transparency report" that is generated by the fund's administrator to provide information on the existence and valuation of assets, ASC 820 classifications and counterparty exposure. Some managers now utilize auditors to perform SAS 70 reviews of the firm's control structure; others undertake third party operational risk assessments and certifications.

Legal Developments in 2011

In 2011, hedge fund managers continued to entice a more stable group of investors to invest in their funds by creating new share classes that offer more favorable fees in exchange for longer lock-ups. In 2008 and 2009, many high net worth investors and fund-of-funds made substantial withdrawals from hedge funds to accommodate their liquidity needs. As a result, hedge funds have been targeting institutional investors who have a longer term view. In addition to creating new share classes, hedge fund managers also reduced and/or eliminated investments in illiquid securities and the use of side pockets. Typically, institutional investors already have exposure to illiquid investments through other allocations such as private equity.

Hedge fund managers also continued to offer opportunistic funds to take advantage of inefficient markets. Examples of opportunistic investments include bank loans, mortgages and structured credit. Given the more illiquid nature of these securities and, in turn, the longer holding period, these funds have typically taken the form of private equity closed end vehicles. Private equity structures are different from hedge fund open end vehicles because investors cannot liquidate their investment in a private equity fund until the fund's investments are realized. In light of the longer lock-up, managers of these vehicles are typically subject to stricter investment limitations, governance provisions and greater legal liability, among other provisions. While some hedge fund managers have provided for the appropriate protections in their documents to address the need for greater protections, others have viewed these investments from more of a hedge fund

perspective and have been reluctant to include the necessary provisions. Cliffwater is continuing to educate these managers about what types of protections investors should have when investing in these longer term vehicles.

Finally, a small number of hedge fund managers continued to follow the lead of some of their peers by selling interests in their firms to larger firms and/or strategic investors. When these transactions occur, Cliffwater seeks to ensure that the economics are fair and continue to align the interests of the investment professionals and the funds' investors; determines whether the new owners have any control over the day-to-day operations and investment decisions of the firm or if they have any veto rights with respect to extraordinary events; and confirms that the key employees have committed to remain at the firm for a specified period of time. Cliffwater believes that this will be a growing trend among hedge funds to enable them either to assist in the transition of management from the founders to the next generation of firm leaders or to help increase their investor base, among other reasons.

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