

Hedge Fund Market Commentary – April 2010

Unlike in March, when markets rallied globally, major indices were mixed in April. The S&P 500 added 1.6%, aided by positive expectations for corporate earnings. Non-U.S. equities were held back however by the continued debt problems plaguing Europe, which sent the MSCI Europe index down -2.7%, and the index for European financial institutions down nearly 5%. The biggest drop occurred on April 27th, when S&P downgraded the debt of both Greek and Portugal. High yield debt continued the upward trend which began in early 2009, with positive mutual fund flows contributing to nearly unceasing demand for higher yielding securities.

Exhibit 1: 2010 Market Performance

Index	April	YTD 2010	FYTD*	Calendar 2009	Calendar 2008
Equity					
Dow Jones 5000	2.1%	8.4%	33.5%	28.6%	-37.2%
S&P 500	1.6%	7.1%	31.2%	26.5%	-37.0%
Russell 2000	5.7%	15.0%	42.5%	27.2%	-33.8%
MSCI EAFE	-1.7%	-0.8%	21.2%	32.5%	-43.1%
MSCI Emerging Mkts	1.3%	3.7%	36.2%	78.3%	-53.5%
DJ REIT	7.1%	17.6%	73.9%	28.5%	-39.2%
S&P 500 Financials	1.4%	12.7%	36.7%	17.2%	-56.6%
Fixed Income					
Barclays Aggregate	1.0%	2.8%	6.9%	5.9%	5.2%
Barclays Treasuries	1.1%	2.2%	3.0%	-3.6%	20.1%
Barclays TIPS	2.4%	3.0%	8.0%	11.4%	-2.4%
Barclays High Yield	2.3%	7.1%	29.9%	58.2%	-26.2%
Barclays Bank Loan	1.0%	5.8%	20.9%	53.8%	-29.5%
AAA ABX (Subprime)	15.8%	28.0%	76.3%	-7.8%	-43.2%
Barclays Municipals	1.2%	2.5%	8.7%	12.9%	-2.5%
3 mo.Libor	0.0%	0.1%	0.3%	0.7%	3.1%
Alternative					
DJ UBS Commodity	1.9%	-3.2%	10.0%	18.9%	-35.7%
Hedge Funds					
HFRI Fund of Funds**	1.0%	2.5%	8.6%	11.5%	-21.4%
HFRI Fund Weighted**	1.3%	3.8%	13.7%	20.0%	-19.0%
CS/Tremont	1.5%	4.6%	15.8%	18.6%	-19.1%

* Fiscal YTD from June 30, 2009

** Hedge Fund Research, Inc. ("HFR") is the source and owner of the HFR data contained or reflected in this report and all trademarks related thereto.

Hedge funds experienced another positive month. The HFRI Fund Weighted Index and HFRI Fund of Funds Index were up 1.3% and 1.0%, respectively, while the CS/Tremont Index was up 1.5%. All strategies were positive for the month. Exhibit 3 shows the performance of the different hedge fund strategies, as defined by HFRI and CS/Tremont.

Exhibit 3: Hedge Fund Performance by Major Strategy Category

Strategy Indexes	April	YTD 2010	FYTD*	Calendar 2009	Calendar 2008
Arbitrage/Relative Value					
HFRI**	1.6%	5.4%	17.6%	25.8%	-18.0%
CS/Tremont-Convert	1.7%	5.3%	25.2%	47.3%	-31.6%
CS/Tremont-Fixed Income	1.9%	5.6%	20.3%	27.4%	-28.8%
Event Driven					
HFRI	1.4%	6.0%	20.5%	25.0%	-21.8%
CS/Tremont	2.3%	7.2%	21.0%	20.4%	-17.7%
Equity Long/Short					
HFRI	1.4%	4.3%	15.9%	24.6%	-26.7%
CS/Tremont	0.2%	3.0%	13.7%	19.5%	-19.8%
Global Macro/CTA					
HFRI	1.0%	0.9%	3.8%	4.3%	4.8%
CS/Tremont-Macro	2.0%	4.7%	12.9%	11.6%	-4.6%
CS/Tremont-Managed Future:	2.2%	4.4%	5.3%	-6.6%	18.3%
Multi-Strategy					
HFRI	2.0%	7.0%	18.9%	24.6%	-20.3%
CS/Tremont	1.2%	3.8%	15.2%	24.6%	-23.6%

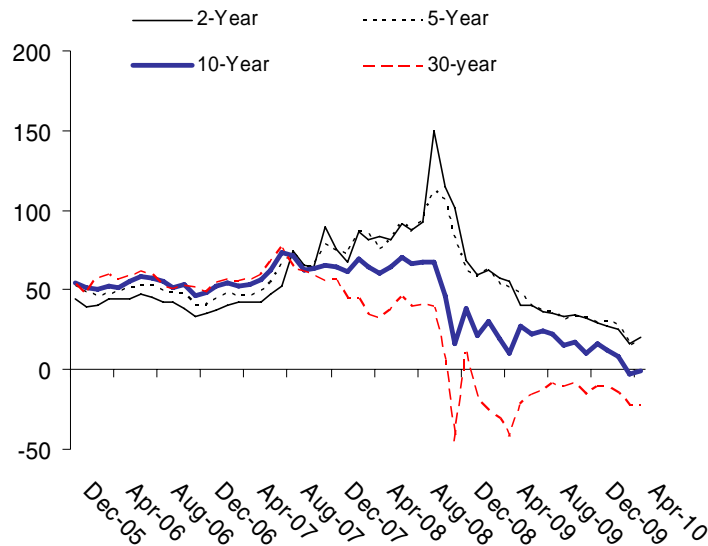
* Fiscal YTD from June 30, 2009

** Hedge Fund Research, Inc. ("HFR") is the source and owner of the HFR data contained or reflected in this report and all trademarks related thereto.

Equity long/short funds, which form the largest constituency within the HFRI Index, gained 1.4% according to HFRI. The same strategy as measured by the CS/Tremont Index was up only 0.2%. Cliffwater observed that many larger, institutional quality funds had a difficult month in April. Higher beta stocks, often dubbed "low quality," and heavily shorted by many hedge funds, outperformed during the month. Highlighting this difference, the Russell 2000 Value index, which comprises many small-cap stocks priced low relative to book value (reflecting higher perceived risk), gained 6.9%, compared with the S&P 500 gain of only 1.6%. Even funds with positive net exposures had negative returns in April, as their short books disproportionately outperformed their long books. The "junk rally" in April could be one reason why the CS/Tremont equity long/short index, which is asset-weighted and generally contains higher quality funds, lagged the HFRI equity long/short index, which is equal-weighted and contains a much greater number of funds. Such differences highlight the importance of understanding index construction and composition when relying on indices as benchmarks.

While not of great importance in parsing recent hedge fund performance, one trade common among some macro and fixed income arbitrage funds nonetheless deserves particular attention this month. The trade is one which bets on the normalization of dollar swap spreads, which have become negative at both 10 and 30-year maturities as shown in Exhibit 3.

Exhibit 3: Swap Spreads at Various Maturities (in basis points)
December 2005 through April 2010



Swap spreads measure the difference between the fixed rate offered on government debt securities and the fixed rate that determines the payments exchanged between parties in an interest rate swap. In such a swap, one party exchanges a series of payments at a pre-determined fixed rate for the receipt of a series of payments based on a floating rate, typically LIBOR. The global market size for such swaps as of December 2009 was \$427 trillion¹, dwarfing the total amount of sovereign debt globally. Swaps are widely used by both issuers of debt – i.e. corporations – and debt investors to manage interest rate risk.

In theory, the swap spread should be positive – i.e., the fixed rate on swaps should exceed the fixed rate on Treasuries, since LIBOR contains credit risk, namely the risk of counterparty default. However, after dropping for many months, swap spreads relative to longer-dated 10 and 30-year maturity Treasuries have become negative. As mentioned above, some hedge funds have been placing bets that these spreads will re-normalize – i.e., that the markets will correctly price U.S. government debt as bearing less risk than derivatives backed by financial institutions. Negative swap spreads may seem counterintuitive, especially coming out of a severe financial crisis which began with these very same financial institutions, and led to a massive flight of capital to Treasury securities. However, as some have argued, the solution to the financial crisis essentially involved a transfer of risk from banks to the Government, causing ballooning debt levels. As this explanation goes, the large budget deficit will place even further demands on the Government to increase borrowing, exacerbating the risk of a re-pricing of the sovereign risk in Treasuries. This explanation may have certain merits; however, there are also strong technical factors contributing to the pricing anomaly described above.

One of these factors is based in the large increase in fixed rate debt issuance which we highlighted in last month's commentary. The same corporations issuing debt are seeking to hedge their negative duration exposure by entering into swaps which allow them to exchange their fixed rate obligations for floating rate payments. This increased demand to "receive fixed" in swap parlance has put downward pressure on the fixed rate established in swap contracts. At the same time, the Treasury is issuing massive amounts of new debt, which drives Treasury

¹ International Swaps and Derivatives Association. This number includes cross-currency swaps, which involves the exchange of payments in different currencies.

yields higher, but does not affect the swaps market directly because the Government does not hedge its own duration risk.

Hedge funds betting that swap spreads will turn positive again are doing what many hedge funds thrive on – i.e., providing liquidity to a dislocated market. In this case, they are entering into “pay fixed” swaps (and buying Treasuries), helping meet market demand while earning a premium for doing so. Of course, the trade, which typically involves the use of leverage, is not risk-free. The funds are betting that the fundamentals underlying swap pricing will eventually overcome the supply/demand imbalances in the swaps markets. Even if this does occur, short or medium-term fluctuations could affect the profitability of the trade, requiring careful liquidity and risk management. In the meantime, some will continue to point to the negative swap spreads as an indicator that the pace of borrowing by the Government is unsustainable.

Eli Sokolov
May 18, 2010

The views expressed herein are the views of Cliffwater only through the date of this report and are subject to change based on market or other conditions. All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. This report is being distributed for informational purposes only and should not be considered investment advice. The information we provide does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Past performance does not guarantee future performance.