

## Hedge Fund Market Commentary – August 2011

After suffering double digit losses in the first half of the month, the S&P 500 Index entered a volatile path to partial recovery, ending down slightly more than -5%. The non-U.S. markets were not so lucky, finishing August with a -9% loss, driven by a renewed sovereign crisis in Europe. A review of major market returns is shown in Exhibit 1.

Since our last update, the Federal Reserve Board, led by Chairman Ben Bernanke, has given no specific indication of plans for a third round of quantitative easing, or QE3. However, at a speech in Jackson Hole, WY, Mr. Bernanke acknowledged the declining economic outlook and assured the public that the Fed would continue to search for policies to help prevent another recession. Investors have speculated that one likely option is for the Fed to sell shorter-term bonds and use the proceeds to purchase longer-dated bonds. This “twist” operation, so called because of the twisting effect on the yield curve, would in theory lower longer-term interest rates to help stimulate lending. Already, ten-year rates are near 60-year record lows. Meanwhile, fiscal policymakers and the White House were discussing a potential new stimulus measure, which has since been brought before Congress.

### Exhibit 1: 2011 Market Performance

Index	August	YTD 2011	FYTD*	Calendar 2010	Calendar 2009	Calendar 2008
<b>Equity</b>						
Dow Jones 5000	-6.0%	-2.3%	-8.1%	17.5%	28.6%	-37.2%
S&P 500	-5.4%	-1.8%	-7.3%	15.1%	26.5%	-37.0%
Russell 2000	-8.7%	-6.5%	-12.0%	26.9%	27.2%	-33.8%
MSCI EAFE	-9.0%	-5.7%	-10.5%	8.2%	32.5%	-43.1%
MSCI Emerging Mkts	-8.9%	-8.5%	-9.3%	19.0%	78.3%	-53.5%
DJ REIT	-5.5%	6.8%	-3.8%	28.1%	28.5%	-39.2%
S&P 500 Financials	-9.6%	-15.5%	-12.8%	12.1%	17.2%	-56.6%
<b>Fixed Income</b>						
Barclays Aggregate	1.5%	5.9%	3.1%	6.5%	5.9%	5.2%
Barclays Treasuries	2.8%	6.0%	3.7%	5.9%	-3.6%	20.1%
Barclays TIPS	0.8%	10.9%	4.8%	6.4%	11.4%	-2.4%
Barclays High Yield	-4.0%	1.9%	-2.9%	15.1%	58.2%	-26.2%
Barclays Bank Loan	-4.7%	-2.2%	-4.6%	9.7%	53.8%	-29.5%
AAA ABX (Subprime)	-12.8%	-21.6%	-5.9%	32.3%	-7.8%	-43.2%
Barclays Municipals	1.7%	7.2%	2.7%	2.4%	12.9%	-2.5%
3 mo.Libor	0.0%	0.0%	-0.1%	0.4%	0.7%	3.1%
<b>Alternative</b>						
DJ UBS Commodity	3.0%	0.3%	3.0%	16.8%	18.9%	-35.7%
<b>Hedge Funds</b>						
HFR1 Fund of Funds**	-2.7%	-2.6%	-2.3%	5.7%	11.5%	-21.4%
HFR1 Fund Weighted**	-2.5%	-1.5%	-2.2%	10.3%	20.0%	-19.0%
Dow Jones Credit Suisse	-2.2%	0.1%	-1.5%	10.9%	18.6%	-19.1%

\* Fiscal YTD from June 30, 2011

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Relative to the equity markets, hedge funds performed well in August. On an absolute basis however, hedge funds had their worst month since May 2010. The broader HFRI Fund-Weighted Index fell -2.5%, and the Dow Jones Credit Suisse Index fell -2.2%. Funds of funds were also down -2.7%, according to HFRI.

Exhibit 2 reviews hedge fund performance by strategy.

Exhibit 2: Hedge Fund Performance by Major Strategy Category

Strategy Indexes	August	YTD		Calendar	Calendar	Calendar
		2011	FYTD*	2010	2009	2008
Arbitrage/Relative Value						
HFRI**	-1.8%	1.3%	-1.8%	11.5%	25.8%	-18.0%
Dow Jones CS-Convert	-1.8%	1.6%	-2.0%	11.0%	47.3%	-31.6%
Dow Jones CS-Fixed Income	0.0%	4.1%	0.6%	12.5%	27.4%	-28.8%
Event Driven						
HFRI	-3.5%	-0.7%	-3.7%	11.7%	25.0%	-21.8%
Dow Jones Credit Suisse	-6.6%	-6.2%	-7.4%	12.6%	20.4%	-17.7%
Equity Long/Short						
HFRI	-4.2%	-3.5%	-4.5%	10.5%	24.6%	-26.7%
Dow Jones Credit Suisse	-4.3%	-4.0%	-4.7%	9.3%	19.5%	-19.8%
Global Macro/CTA						
HFRI	0.2%	-0.2%	2.0%	8.2%	4.3%	4.8%
Dow Jones CS-Macro	2.2%	6.2%	4.8%	13.5%	11.6%	-4.6%
Dow Jones CS-Managed Futures	0.2%	0.7%	4.2%	12.2%	-6.6%	18.3%
Multi-Strategy						
HFRI	-1.3%	0.3%	-1.4%	13.4%	24.6%	-20.3%
Dow Jones Credit Suisse	-1.3%	3.7%	-0.7%	9.3%	24.6%	-23.6%

\* Fiscal YTD from June 30, 2010

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Dispersion among individual hedge fund returns was unusually wide in August. Based on a report by a large prime broker, the difference between the 75<sup>th</sup> percentile and the 25<sup>th</sup> percentile among hedge fund returns was over 5% in August.

Not surprisingly, equity long/short and event-driven managers were the worst performers, reporting returns of -4.2% and -3.5%, respectively. These strategies typically exhibit relatively high equity and credit beta. Within the event-driven category, managers with higher equity exposure underperformed those with a greater credit focus.

Relative to other months when the S&P 500 Index suffered large drawdowns, the performance of equity long/short funds in August was disappointing. Exhibit 3 shows relative performance of the S&P 500 and equity hedge funds across the 10 months since 2006 in which the S&P 500 declined by more than 5%.

Exhibit 3: Equity Long/Short Hedge Funds  
Ten Most Recent S&P Drawdowns of -5% or Greater

Month	S&P 500	HFRI EH	Ratio
Jan-08	-6.0%	-4.5%	0.75
Jun-08	-8.4%	-2.4%	0.29
Sep-08	-8.9%	-8.1%	0.91
Oct-08	-16.8%	-9.5%	0.56
Nov-08	-7.2%	-3.8%	0.53
Jan-09	-8.4%	-0.9%	0.10
Feb-09	-10.7%	-2.2%	0.21
May-10	-8.0%	-4.1%	0.51
Jun-10	-5.2%	-1.9%	0.35
Aug-11	-5.4%	-4.2%	0.77

In August, equity hedge funds captured 77% of the downside. The only month in the above sample in which hedge funds delivered worse relative performance was September 2008, when a short-selling ban had negative technical repercussions for hedge funds' short portfolios. One of the reasons for the high downside capture in August is that hedge funds cut risk as the market was declining, thus not participating as much in the recovery. Hedge funds that did so were trying to limit losses in a market that had strong downside momentum and overhanging macroeconomic risks.

Macro and CTA managers were the best performers. In fact, a key differentiator in August for returns on portfolios of hedge funds was the size of the allocation to these strategies. Many discretionary macro managers benefited from bearish views expressed through rate and currency positions, while CTA managers benefited from strong positive momentum in Treasuries, offset for some by equity positions due to the mid-month reversal.

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