CLIFFWATER LLC

Hedge Fund Market Commentary – July 2009

Stock and bond markets rallied again in July, as investors grew increasingly optimistic that the recession will end this year. Economic indicators and earnings reports defied low expectations, changing the argument from one of when the recovery will occur to how long it will last. Exhibit 1 reports asset class returns through July 31.

Exhibit 1: 2009 Market Performance

Index	July	YTD 2009	FYTD*	Calendar 2008
Equity				
Dow Jones 5000	7.8%	12.6%	7.8%	-37.2%
S&P 500	7.6%	11.0%	7.6%	-37.0%
Russell 2000	9.6%	12.5%	9.6%	-33.8%
MSCI EAFE	9.1%	18.3%	9.1%	-43.1%
MSCI Emerging Mkts	11.3%	51.1%	11.3%	-53.5%
DJ REIT	10.4%	-4.1%	10.4%	-39.2%
S&P 500 Financials	8.9%	5.1%	8.9%	-56.6%
Fixed Income				
Barclays Aggregate	1.6%	3.5%	1.6%	5.2%
Barclays Treasuries	0.4%	-3.9%	0.4%	20.1%
Barclays TIPS	0.1%	6.3%	0.1%	-2.4%
Barclays High Yield	6.1%	38.4%	6.1%	-26.2%
Barclays Bank Loan	4.7%	41.0%	4.7%	-29.5%
AAA ABX (Subprime)	14.9%	-23.1%	-44.9%	-43.2%
Barclays Municipals	1.7%	8.2%	1.7%	-2.5%
3 mo.Libor	0.1%	0.7%	0.1%	3.1%
Alternative				
DJ UBS Commodity	2.4%	7.1%	2.4%	-35.7%
Hedge Funds				
HFRI Fund of Funds**	1.5%	6.7%	1.5%	-21.4%
HFRI Fund Weighted**	2.4%	12.2%	2.4%	-19.0%
CS/Tremont	2.4%	9.7%	2.4%	-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 have so far performed very well in 2009. The HFRI Fund Weighted Index[1] and the CS/Tremont Index[2] – both indexes of direct hedge funds – are up 12.2% and 9.7%, respectively, for the year while the HFRI Fund-of-Funds Index[3] – an equal weighted index of hedge fund-of-funds is up 6.7%. Such large return discrepancies between direct hedge fund and fund-of-funds indexes are unusual. Differences in strategy allocations and fewer biases in fund-of-funds indexes are likely explanations, with the volatile market events over the last year magnifying these differences. Most institutional hedge fund investors continue to believe that the HFRI Fund of Funds Index is the better measure of investable hedge fund performance and give it greater weight in evaluating performance.[4]

[1] Equal weighted index of approximately 4,000 individual hedge funds.
[2] Asset weighted index of approximately 500 larger and institutionally oriented hedge funds.
[3] Equal weighted index of approximately 1,500 hedge fund-of-funds
[4] Cliffwater continues to study this issue but the lack of complete transparency into index construction methodology and underlying fund-of-funds allocations has made conclusions difficult to reach at the time of this writing.

Exhibit 2 shows HFRI and CS/Tremont Index performance by hedge fund strategy. Most hedge fund strategies performed very well this year which likely helped stem investor redemptions. Net cash outflows from hedge funds fell from 9% of total assets in the 4th quarter of 2008 to just 3% of total assets in the 2nd quarter of this year.[5]

Exhibit 2: Hedge Fund Performance by Major Strategy Category

Strategy Indexes	July	YTD 2009	Calendar 2008
Arbitrage/Relative Value			
HFRI**	3.0%	16.0%	-18.0%
CS/Tremont-Convert	5.4%	30.7%	-31.6%
CS/Tremont-Fixed Income	3.8%	16.1%	-28.8%
Event Driven			
HFRI	2.4%	12.6%	-21.8%
CS/Tremont	2.8%	9.7%	-17.7%
Equity Long/Short			
HFRI	3.3%	15.8%	-26.7%
CS/Tremont	2.6%	11.1%	-19.8%
Global Macro/CTA			
HFRI	0.6%	1.8%	4.8%
CS/Tremont-Macro	1.8%	5.2%	-4.6%
CS/Tremont-Managed Futures	-0.8%	-8.2%	18.3%
Multi-Strategy			
HFRI	2.9%	15.9%	-20.3%
CS/Tremont	2.9%	15.6%	-23.6%

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The Global Macro/CTA strategy category continues to demonstrate its ability to diversify a hedge fund portfolio. In 2008, when hedge funds as a group performed poorly, Global Macro/CTA performed well. So far in 2009, Global Macro/CTA returns have lagged the other hedge fund strategies but are still positive.

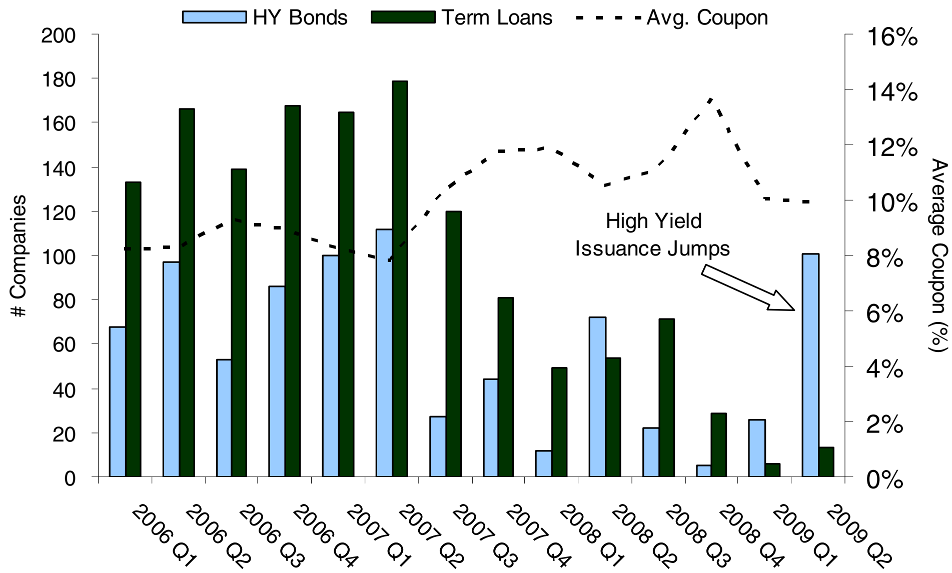
Hedge funds in the Event Driven category, particularly those focused on credit investing, have been among the stronger performers in 2009. These funds have benefited from a dramatic turnaround in credit markets. For example, high yield loans, which traded as low as $63 (par = $100) on March 10, 2009, surged to $87 as of July 31, very near pre-Lehman bankruptcy levels. The credit rally has triggered a virtuous cycle whereby narrowing spreads have lowered the cost of financing to companies, leading to an increase in bond issuance, and consequently greater investor optimism. While financing rates are still high by historical standards, they are more manageable for companies than they were in the months prior to April 2009.

Exhibit 3 shows quarterly data on the number of companies accessing capital markets through the issuance of high yield bonds and bank term loans, along with the average coupon on the high yield bonds. The number of companies issuing high yield bonds jumped from almost none during the last quarter of 2008 to over 100 during the second quarter of 2009. The reopening of capital

[5] HFR Global Hedge Fund Industry Report, Second Quarter 2009

markets has also allowed many companies to better manage their debt through exchanges and refinancings.

Exhibit 3: Corporate High Yield Debt Issuance



Source: Bloomberg

With the new-issue CLO market mostly shut down and capital coming instead from high yield mutual funds, bond issuance has exceeded loan issuance. Investor demand for lower seniority debt, often with relaxed covenants, may help companies manage their balance sheets in the near-term. However, the consequences for investors are unclear, and depend largely on the pace of the economy. Some hedge fund managers have argued that pushing debt maturities into the future in an environment of deteriorating corporate fundamentals merely delays and exacerbates problems. Event Driven fund managers are aware of these risks, and still have a preference for first-lien, secured debt over unsecured bonds. Moreover, their portfolios, in addition to containing short investments, include long investments tied to events that are less beta-oriented than refinancings. Together, these tactics should help the funds to outperform the market should credit spreads widen again, a possibility that investors in general seem to be discounting.

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