Hedge Fund Market Commentary – March 2010

Equity markets rallied feverishly in March, with the S&P 500 Index up 6.0% and the MSCI EAFE Index up 6.3%. In contrast to earlier in the year, investors appeared only minimally concerned that a sovereign debt crisis could emerge and stall economic progress. An overview of performance across markets is shown in Exhibit 1.

Exhibit 1: 2010 Market Performance

Index	March	YTD 2010	FYTD*	Calendar 2009	Calendar 2008
Equity					
Dow Jones 5000	6.2%	6.2%	30.7%	28.6%	-37.2%
S&P 500	6.0%	5.4%	29.2%	26.5%	-37.0%
Russell 2000	8.1%	8.9%	34.9%	27.2%	-33.8%
MSCI EAFE	6.3%	0.9%	23.3%	32.5%	-43.1%
MSCI Emerging Mkts	8.1%	2.4%	34.5%	78.3%	-53.5%
DJ REIT	10.2%	9.8%	62.4%	28.5%	-39.2%
S&P 500 Financials	8.9%	11.2%	34.9%	17.2%	-56.6%
Fixed Income					
Barclays Aggregate	-0.1%	1.8%	5.8%	5.9%	5.2%
Barclays Treasuries	-0.9%	1.1%	1.9%	-3.6%	20.1%
Barclays TIPS	0.1%	0.6%	5.5%	11.4%	-2.4%
Barclays High Yield	3.1%	4.6%	26.9%	58.2%	-26.2%
Barclays Bank Loan	2.4%	4.8%	19.8%	53.8%	-29.5%
AAA ABX (Subprime)	7.3%	10.5%	52.3%	-7.8%	-43.2%
Barclays Municipals	-0.2%	1.3%	7.4%	12.9%	-2.5%
3 mo.Libor	0.0%	0.1%	0.2%	0.7%	3.1%
Alternative					
DJ UBS Commodity	2.4%	-5.0%	7.9%	18.9%	-35.7%
Hedge Funds					
HFRI Fund of Funds**	1.7%	1.5%	7.6%	11.5%	-21.4%
HFRI Fund Weighted**	2.7%	2.6%	12.3%	20.0%	-19.0%
CS/Tremont	2.2%	3.1%	14.1%	18.6%	-19.1%

* Fiscal YTD from June 30, 2009
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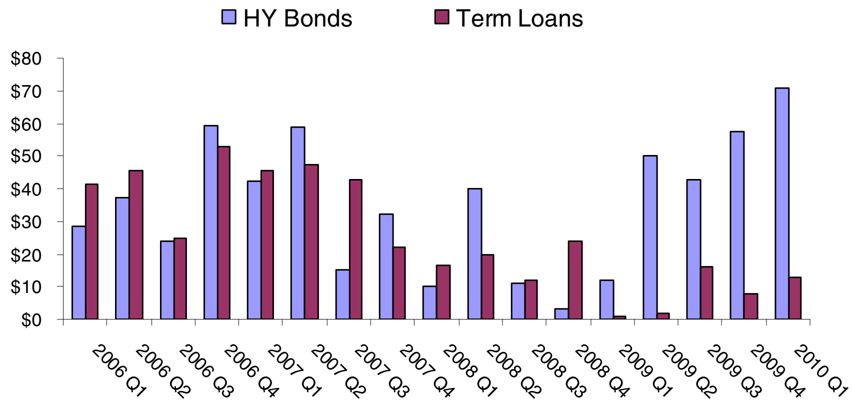
The improving economic outlook has been a large contributor to the market rally, but the technical factors have also been prominent. With Treasury yields remaining low, the demand for risky assets has been brisk. One example of this is the strength of the new issue high yield market. Last July we commented on the dramatic rebound in high yield issuance, and how it has helped alleviate debt management issues for many companies, and reinforce the rally in credit. Exhibit 2 shows how the trend has continued, with the dollar amount of high yield issuance in the first quarter of 2010 reaching a record high.

Exhibit 2: High Yield and Leverage Loan Issuance (in $billions)



Source: Bloomberg

Strong demand has more than absorbed this new supply, with spreads continuing to come down, in turn making it easier for companies to issue new debt. The net new supply is considerably less than the gross supply, as many companies have been using the proceeds from high yield bond issuance to repay bank debt with nearer-term maturities. Looking backward, the impact of this phenomenon on credit-focused hedge funds has been to boost returns. Looking forward, the new issuance is extending the opportunity set for distressed credit funds, as many companies have postponed their financial troubles to a later date. Thus, while default rates are lower than had been predicted last year, they will likely stay above average for a longer period of time.

Hedge funds enjoyed a very good March after a modest start to the year. The HFRI Fund Weighted Index and HFRI Fund of Funds Index were up 2.7% and 1.7%, respectively, while the CS/Tremont Index was up 2.2%. Exhibit 3 shows the performance of different hedge fund strategies, as defined by HFRI and CS/Tremont.

Exhibit 3: Hedge Fund Performance by Major Strategy Category

Strategy Indexes	March	YTD 2010	FYTD*	Calendar 2009	Calendar 2008
Arbitrage/Relative Value					
HFRI**	1.5%	3.6%	15.6%	25.8%	-18.0%
CS/Tremont-Convert	2.1%	3.5%	23.1%	47.3%	-31.6%
CS/Tremont-Fixed Income	1.4%	3.6%	18.0%	27.4%	-28.8%
Event Driven					
HFRI	3.2%	4.7%	19.0%	25.0%	-21.8%
CS/Tremont	2.9%	4.8%	18.3%	20.4%	-17.7%
Equity Long/Short					
HFRI	3.4%	3.0%	14.4%	24.6%	-26.7%
CS/Tremont	3.0%	2.8%	13.5%	19.5%	-19.8%
Global Macro/CTA					
HFRI	2.0%	0.2%	3.2%	4.3%	4.8%
CS/Tremont-Macro	0.4%	2.6%	10.7%	11.6%	-4.6%
CS/Tremont-Managed Future	4.3%	2.1%	3.0%	-6.6%	18.3%
Multi-Strategy					
HFRI	2.1%	5.1%	16.8%	24.6%	-20.3%
CS/Tremont	1.4%	2.6%	13.9%	24.6%	-23.6%

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All strategies were positive for the month. Not surprisingly, equity long/short funds were among the best performers, up over 3% amidst gains of over 6% in global developed equity markets, and 8% in emerging market equities. Credit funds also posted significant gains, with high yield bonds and loans up 3.1% and 2.4%, respectively. The strong correlation between market returns and hedge fund returns which has persisted for many months suggests that hedge funds may not be well positioned to absorb a sudden and sharp downturn in markets. Indeed, Cliffwater believes that, as represented by the indices, the hedge fund industry, and in particular equity long/short funds, are highly exposed to a market retraction. However, institutional absolute return portfolios, which generally have lower betas than the indices, should fare relatively better should such a situation occur.

Eli Sokolov
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