

Hedge Fund Market Commentary – May 2009

Markets continued their surge in May. U.S. equities were up over 5%, while developed market foreign equities and emerging market equities rose 12% and 17%, respectively. All major equity indices are now positive for the year. Credit markets also sustained their rally, with high yield bonds and loans up between 6 and 7%. The worst performing asset class in May and for 2009 has been U.S. Treasuries. Rising rates, particularly at intermediate and longer-term maturities, have depressed the value of Government bonds. The one exception has been the TIPS market, which returned 2% in May as investors purchase protection from the threat of inflation. This same sentiment was expressed in the commodity market, which rose 13% in May with oil rebounding to over \$65 per barrel.

Exhibit 1: 2009 Market Performance

Index	May	YTD 2009	FYTD*	Calendar 2008
Equity				
Wilshire 5000	5.3%	4.1%	-26.7%	-37.2%
S&P 500	5.6%	3.0%	-26.4%	-37.0%
Russell 2000	3.0%	1.2%	-26.1%	-33.8%
MSCI EAFE	12.0%	9.0%	-30.9%	-43.1%
MSCI Emerging Mkts	17.1%	37.6%	-27.5%	-53.5%
DJ Wilshire REIT	2.6%	-10.0%	-35.4%	-39.2%
S&P 500 Financials	13.3%	-1.4%	-39.0%	-56.6%
Fixed Income				
Barclays Aggregate	0.7%	1.3%	5.4%	5.2%
Barclays Treasuries	-1.0%	-4.1%	12.6%	20.1%
Barclays TIPS	2.1%	5.7%	-1.6%	-2.4%
Barclays High Yield	6.7%	25.5%	-6.1%	-26.2%
Barclays Bank Loan	6.1%	27.6%	-9.6%	-29.5%
AAA ABX (Subprime)	5.1%	-12.5%	-50.6%	-43.2%
Barclays Municipals	1.1%	7.4%	4.8%	-2.5%
3 mo.Libor	0.1%	0.5%	2.0%	3.1%
Alternative				
DJ AIG Commodity	13.0%	6.7%	-52.3%	-35.7%
HFRI Fund of Funds**	3.1%	4.6%	-15.7%	-21.4%
HFRI Fund Weighted**	5.6%	9.8%	-9.9%	-19.0%

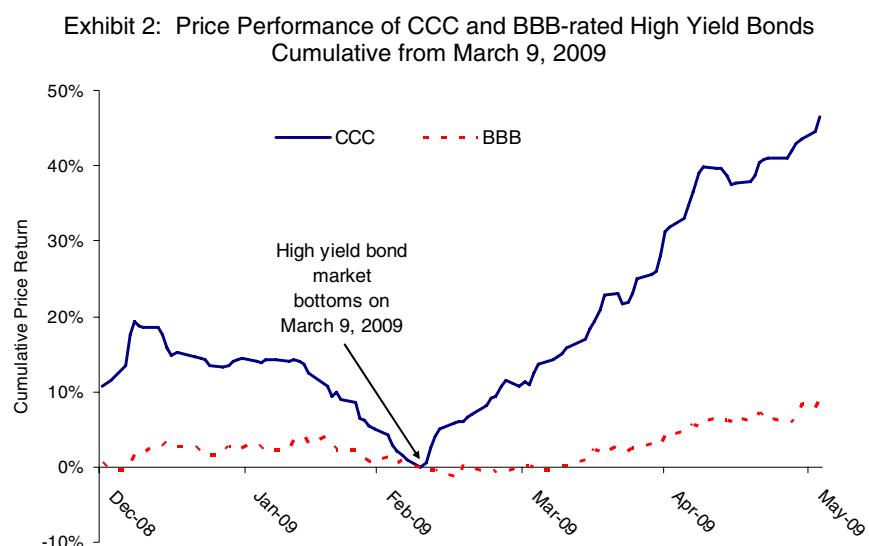
* Fiscal YTD from June 30, 2008

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Hedge funds performed better in May than they did in April. The HFRI Fund of Funds Index, which is viewed as representative of institutional portfolios, rose an estimated 3.1% for the month, while the HFRI Fund Weighted Index estimated return was 5.6%, driven primarily by equity long/short funds which were up an estimated 7.1%.

Many equity long/short funds outperformed their April numbers. The late March and April stock rally was characterized by an upswing among fundamentally weaker companies which hedge funds are more likely to be short than long. In May, the market disproportionately rewarded stocks more favored by hedge funds.

Similar to the recent rally in high-beta, lower quality stocks, bonds with lower credit ratings have significantly outperformed investment-grade credits, creating a so-called “junk rally” in 2009. Exhibit 2 shows the average bond price in the Barclays CCC and BBB corporate indices since the beginning of 2009. Lower quality bonds have substantially outperformed even the lowest-rated investment-grade bonds, with bond prices reaching levels last witnessed in September of last year. In 2009, significant capital has flowed into the high yield market through mutual funds and other institutional buyers. Combined with a limited supply new issuance, this demand has driven up prices.



Source: Barclays

Somewhat counter-intuitively, the spreads in stressed credits have tightened at the *beginning* of what will likely be a prolonged surge in defaults. While benefiting the short-term performance of distressed funds, this trend can actually be disadvantageous to distressed managers in the long run. In past distressed cycles, distressed funds have generated a portion of their returns through tactical purchases in a down-trending credit market, earning a premium by providing liquidity to a market dominated by sellers. In this cycle, hedge funds were contracting, not buying, at the same time that spreads were widening. Now, with significant cash on the balance sheets of hedge funds and a renewed appetite for investing, funds are facing a sharply up-trending market with fewer opportunities to capture liquidity discounts. There is enough dispersion around the trend to create attractive buying opportunities in specific credits, but cash deployment has been slowed by the rally, if only because many fund managers remain skeptical that the fundamentals justify the higher prices.

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