

Hedge Fund Market Commentary – August 11, 2011

Economic Overview

In early 2009 we described three possible economic scenarios coming out of the 2008 Financial Crisis: Recovery, Stagflation, and Deflation, to which we assigned probabilities of 60%, 20%, and 20%, respectively. Massive monetary (TARP, QE1) and fiscal (\$800 billion Spending Package) stimulus marginalized the Deflation scenario and left Recovery and Stagflation as the two likely paths. Real U.S. economic growth turned positive in the second half of 2009 at low core inflation, albeit driven by Government spending. Stimulus appeared to be working.

Going into 2010, uncertainty surrounded whether private sector spending (business, consumer, and net exports) would pick up and replace government spending when stimulus ebbed. Those early concerns proved correct when economic growth and spending slipped last summer (except for modest business inventory spending and export growth). But the Fed provided a reprieve last August, announcing a renewed monetary stimulus through QE2, which was followed by renewed economic growth, though modest compared to most recoveries.

Economic growth has again slipped in 2011. The Fed ended QE2, the stimulus money has been spent, consumers continue to repair their balance sheets by spending less, and corporations are hoarding cash rather than investing. It also appears that help from abroad is waning as exports to Europe and emerging markets are leveling off. Though the Fed's implicit efforts to devalue the dollar might help spur exports again, it is difficult to see it being a difference maker.

We see today a world characterized by what Keynes called a “liquidity trap” where businesses won't invest and consumers choose saving over spending, indifferent to low interest rates because of uncertainty or because they are still carrying too much debt. We do not know how long this state of the world will last and are skeptical whether authorities have the means anymore to direct impactful change. This state is definitely new; we hope it is not normal. Underneath, we believe in a natural business cycle that at some point will, unaided, generate drivers of sustainable growth. In the meantime, investors should position portfolios that are diversified across economic scenarios, focused on risk control, and wary of potential investment bubbles that might manifest from zero interest money over the next several years.

Market Overview

The two-year rebound in asset prices through June was driven by an earnings recovery, improving balance sheets, and continued low interest rates. The subsequent unexpected announcements in July and August of a U.S. slowdown and worsening European sovereign debt crisis have caused equity markets to plummet by around 15%. As of this writing, markets are extremely volatile, and we expect this to continue until the global economic picture becomes clearer. Our belief is that a U.S. slowdown (double dip) probably produces a maximum stock price drawdown of 20-25% from recent highs. However, things could get far worse if the European debt crisis becomes a banking crisis that undermines the normal workings of the financial system in Europe. If that happens, contagion could reverberate worldwide with consequences similar to, though not likely as bad as 2008. What is different this time is a much better capitalized banking system in the United States.

Exhibit 1 shows the path of the Financial Crisis measured by the S&P 500 Index drawdown. The 21% endpoint for the Financial Crisis is as of August 10th. While the depth and length of the recent Crisis had been most similar to the 1973-74 Bear Market, the recent double dip drawdown in August has put the market on a path more similar to the Internet Bubble.

Exhibit 1: Comparison of S&P 500 Index Drawdowns over Four Market Crises

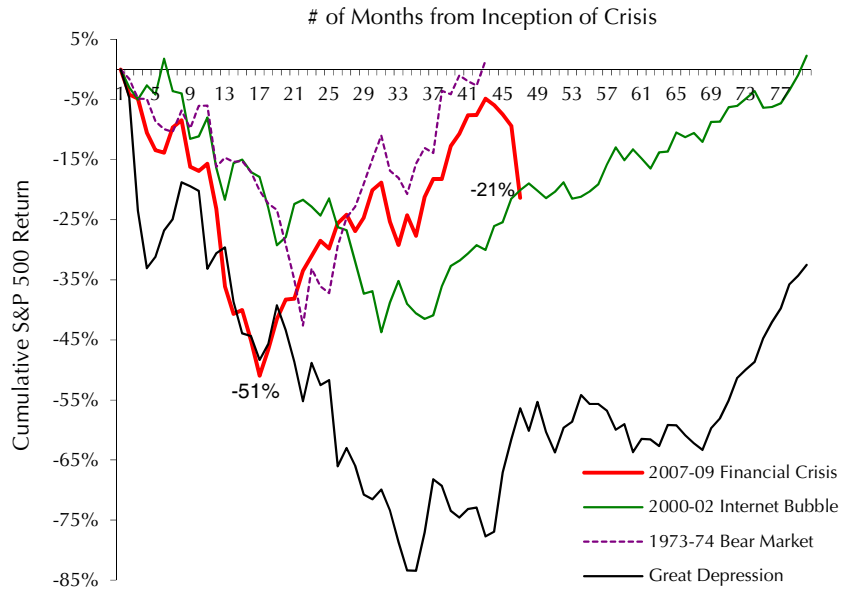


Exhibit 2 on the next page contains historical returns across a range of market indices.

Exhibit 2: 2011 Market Performance

Index	MTD	2011			Calendar	Calendar	Calendar
	Through August 10	July	(through July)	FYTD*	2010	2009	2008
Equity							
Dow Jones 5000	-13.8%	-2.3%	4.0%	-2.3%	17.5%	28.6%	-37.2%
S&P 500	-13.2%	-2.0%	3.9%	-2.0%	15.1%	26.5%	-37.0%
Russell 2000	-17.1%	-3.6%	2.4%	-3.6%	26.9%	27.2%	-33.8%
MSCI EAFE	-14.0%	-1.6%	3.7%	-1.6%	8.2%	32.5%	-43.1%
MSCI Emerging Mkts	-13.7%	-0.4%	0.5%	-0.4%	19.0%	78.3%	-53.5%
DJ REIT	-14.6%	1.8%	13.0%	1.8%	28.1%	28.5%	-39.2%
S&P 500 Financials	-17.8%	-3.6%	-6.6%	-3.6%	12.1%	17.2%	-56.6%
Fixed Income							
Barclays Aggregate	2.0%	1.6%	4.4%	1.6%	6.5%	5.9%	5.2%
Barclays Treasuries	2.8%	1.8%	4.1%	1.8%	5.9%	-3.6%	20.1%
Barclays TIPS	3.6%	3.9%	10.0%	3.9%	6.4%	11.4%	-2.4%
Barclays High Yield	-4.8%	1.2%	6.2%	1.2%	15.1%	58.2%	-26.2%
Barclays Bank Loan	-4.1%	0.1%	2.6%	0.0%	9.7%	53.8%	-29.5%
AAA ABX (Subprime)	-12.3%	8.0%	-10.1%	8.0%	32.3%	-7.8%	-43.2%
Barclays Municipals	1.8%	1.0%	5.5%	1.0%	2.4%	12.9%	-2.5%
3 mo.Libor	0.0%	0.0%	0.2%	0.0%	0.4%	0.7%	3.1%
Alternative							
DJ UBS Commodity	-4.9%	3.0%	0.3%	3.0%	16.8%	18.9%	-35.7%
Hedge Funds							
HFRF Fund of Funds**	NA	0.7%	0.4%	0.7%	5.7%	11.5%	-21.4%
HFRF Fund Weighted**	NA	0.8%	1.5%	0.8%	10.3%	20.0%	-19.0%
Dow Jones Credit Suisse	NA	NA	NA	11.9%	10.9%	18.6%	-19.1%
HFRX Global	-3.6% ***	-0.1%	-2.2%	-2.2%	5.2%	13.4%	-23.3%

* Fiscal YTD from June 30, 2011

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*** Through August 9th, 2011

Hedge Fund Commentary

Hedge funds, while experiencing losses in August, are generally performing in line with expectations given the composition of their portfolios. Unlike 2008, leverage levels are lower and many managers have cleansed their portfolios of illiquid assets. What is similar to 2008 is high volatility across global equity markets and renewed concern about the health and stability of financials. Many global bank stocks are trading 50% off their 52-week highs. Not surprisingly, most of the poor hedge fund returns in August have come from equity long/short strategies and event-driven strategies with large exposures to equities. Below are summary observations, by hedge fund strategy, on current viewpoints and positioning.

Credit/Distressed

- Credit managers are generally bearish.
- Managers are contrasting this market with 2008.
 - Today's market is more about bigger macro risks and slow growth
 - 2008 was a credit crisis with too much leverage in the system
 - Consequently, credit managers believe there are still attractive opportunities in long positions in credit

- Creditors just need to get paid whereas equity investors need growth (or very low multiples) to make money
- Most short exposures have increased, particularly in sovereigns and other cyclical credits, and are in investment grade names, which have limited downside (spreads are tighter) with significant upside if contagion strikes.
- Managers are more focused on credit selection and non-correlated, catalyst-driven investments.
- High yield markets are down about 4.5% through August 9th.
 - At the end of July, high yields spreads were 489 bps over (Treasuries); as of August 9th they moved out to 636 bps over
 - Leverage loan spreads moved from 265 bps over to 444 bps over
 - Investment grade spreads moved from 96 bps over to 110 bps over
- High yield and leveraged loan flows are negative in August.
 - Heightened concern about technical selling from retail investors
 - Technicals have really been driving the market in 2010 and early 2011 as investors reached for yield
- Most long/short credit managers have been performing relatively well in August but managers more exposed to distressed, post re-org equity and Europe have lost money, particularly those with a heavier weight in financials.
 - Some credit managers have actually made money in this market; this is primarily due to their larger short exposure, bearish views and tactical trading

Event-Driven

- Funds have taken down gross exposure and added to their short positions.
- Funds have reduced non-core, less liquid positions.
- Managers have sought to focus more on hard catalyst positions that have less economic sensitivity.
- Funds that are looking to add risk exposure are doing so in M&A positions that are attractive on a spread basis and aren't subject to financing risk.
- Most managers don't think this is a repeat of 2008 as companies and financial institutions are in better shape.
- Europe is seen as the wild card and some funds have sovereign CDS exposure while others are not comfortable with this exposure.

Market Neutral

- Fixed income arbitrage managers that focus on G7 government bond markets remain cautiously positioned in the US and are careful to remain neutral to duration, particularly given the recent grind-down in yields. However, the elevated level of volatility in fixed income markets should lead to strong short-term profit-making opportunities in basis trades and auction concession trades.
- Many fixed income arbitrage managers have mostly or entirely reduced risk in European government bond markets given poor liquidity and wide bid-ask spreads, which make it difficult to make profitable trades net of commissions and market impact costs. Germany is slightly better but managers are cautious here as well given the uncertain resolution of the evolving sovereign debt crisis.
- Fixed income arbitrage managers with exposure to structured credit were hurt by the recent weakness in RMBS, particularly subprime. While these managers generally remain well-hedged, inconsistent liquidity and wide bid-ask spreads has led to mark-to-market losses.
- Volatility arbitrage managers with a long volatility bias are finally and unsurprisingly making money given the recent spike in the VIX. Long volatility managers with a tactical trading focus should also be benefiting from the extreme recent volatility.

Multi-Strategy

- Multi-strategy managers with exposures to emerging markets, commodities or high beta equities (like financials) have been badly hurt recently.
- Many managers have increased their cash holdings and reduced allocations to convert arbitrage and merger arbitrage due to an unattractive opportunity set in these strategies, which are traditionally core areas of focus for many multi-strategy managers.

Macro

- Macro managers in general have fared well over the past 2 weeks.
- Macro managers are trading tactically. Some macro managers had been structurally bearish and had their portfolios positioned to take advantage of a sell off – with moderate success. In a perverse way, the downgrade of US debt created a sell-off in the equity markets, which led investors to run to cover in the safety of US Treasuries and the USD.
- Medium to long term CTAs have been positioned with what has worked over the past 3 months: long equities, long commodities, and long fixed income. Long equity and long commodity positions are suffering losses and the hope is that long fixed income will protect the portfolio. So far, it appears that this has generally been the case. The longer-term CTAs are not making money.
- Many managers are bullish the gold story and have price targets anywhere between \$2,000-\$5,000.

Equity Long/Short

- Equity long/short managers have been reducing their overall gross and net exposures over the last few months and have significantly reduced both gross and net exposure in August. Many have added additional market hedges to further reduce net exposure.
- Fundamental, company-specific news have been overwhelmed by macro and short term technical factors. Many managers are making very few material changes to their portfolio and are planning to “weather the storm” as their fundamental views on their top positions remain unchanged.
- Managers are opportunistically adding to their long high-conviction names that have sold off significantly during the first part of August.

We will continue to keep you current as events unfold. Feel free to call us with any questions.

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