CLIFFWATER LLC

## Hedge Fund Market Commentary – November 2011

The pattern of the European crisis driving risk premia across the globe continued in November. As serious liquidity concerns revolved around European banks and borrowing costs for Italy, Spain and France were rising, equities were falling across the globe. Then, on November 30th, The Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Federal Reserve, and the Swiss National Bank coordinated with each other to lower the cost of short-term dollar funding for banks by 50bps. Markets rallied, recovering a decent portion of losses before the month closed. The S&P 500 ended down -0.2%, European markets finished down -4.5% (in dollar terms), and emerging markets fell -6.7%. The intra-month volatility was exacerbated by the failure of the so-called Super Committee to reach a deal on the U.S. budget. However, bullish investors were rewarded with marginally positive economic data on industrial production, job losses, and housing. Credit markets declined -2.8%, nearly three-quarters of the loss experienced in August.

Exhibit 1: 2011 Market Performance

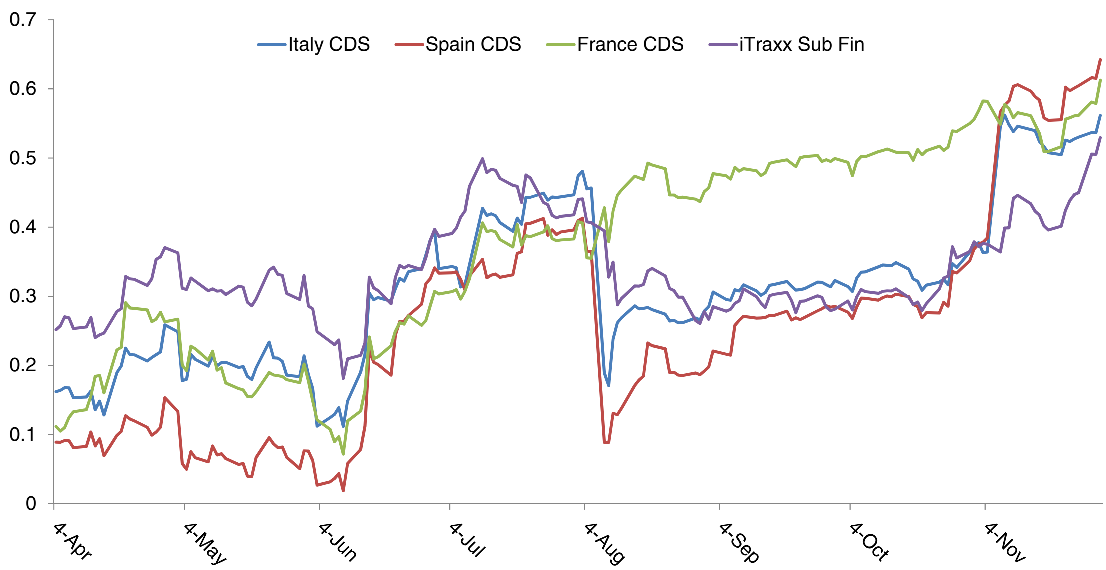
| Index | November | YTD 2011 | FYTD* | Calendar 2010 | Calendar 2009 | Calendar 2008 |
|---|---|---|---|---|---|---|
| Equity | | | | | | |
| S&P 500 | -0.2% | 1.1% | -4.7% | 15.1% | 26.5% | -37.0% |
| Russell 2000 | -0.3% | -4.8% | -10.4% | 26.9% | 27.2% | -33.8% |
| MSCI Asia Pacific | -6.6% | -6.6% | -14.7% | 17.3% | 37.9% | -41.6% |
| MSCI Europe | -4.5% | -9.1% | -17.1% | 4.5% | 36.8% | -46.1% |
| MSCI Emerging Mkts | -6.7% | -17.2% | -18.0% | 19.0% | 78.3% | -53.5% |
| DJ REIT | -3.9% | 4.5% | -5.8% | 28.1% | 28.5% | -39.2% |
| S&P 500 Financials | -4.8% | 1.1% | -15.9% | 12.1% | 17.2% | -56.6% |
| Fixed Income | | | | | | |
| Barclays Aggregate | -0.3% | 6.7% | 3.8% | 6.5% | 5.9% | 5.2% |
| Barclays Treasuries | 0.5% | 8.8% | 6.4% | 5.9% | -3.6% | 20.1% |
| Barclays TIPS | 0.6% | 13.5% | 7.3% | 6.4% | 11.4% | -2.4% |
| Barclays High Yield | -2.8% | 2.3% | -2.6% | 15.1% | 58.2% | -26.2% |
| Barclays Bank Loan | -0.9% | 0.6% | -1.9% | 9.7% | 53.8% | -29.5% |
| AAA ABX (Subprime) | -7.0% | -31.7% | -18.0% | 32.3% | -7.8% | -43.2% |
| Barclays Municipals | 0.2% | 8.6% | 4.0% | 2.4% | 12.9% | -2.5% |
| 3 mo.Libor | 0.0% | 0.1% | 0.0% | 0.4% | 0.7% | 3.1% |
| Alternative | | | | | | |
| DJ UBS Commodity | -2.2% | -9.9% | -7.6% | 16.8% | 18.9% | -35.7% |
| Hedge Funds | | | | | | |
| HFRI Fund of Funds** | -0.6% | -4.9% | -4.6% | 5.7% | 11.5% | -21.4% |
| HFRI Fund Weighted** | -1.0% | -4.5% | -5.2% | 10.3% | 20.0% | -19.0% |
| Dow Jones Credit Suisse | -0.8% | -2.3% | -3.9% | 10.9% | 18.6% | -19.1% |

* Fiscal YTD from June 30, 2011

** 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.

For many months, numerous headlines have appeared associating equity market gyrations with the varying sentiment surrounding the European sovereign and banking crisis. Exhibit 2 provides some backing for these assertions – it shows the rolling 3-month correlations of the S&P 500 Index daily moves with daily changes in 5-year CDS (credit default swap) spreads on Italy, Spain, France, and an index of subordinated debt in European financial companies[1]. Both the upward trend and high absolute value of the correlations are notable features of the data.

Exhibit 2
Rolling 3-month correlations of S&P 500 with European Sovereign and Financials Credit Spreads




Also evident is the sharp drop in the measured correlation on August 8th for both Italy and Spain – on this date both country's bonds were the target of European Central Bank (ECB) buying program, and the S&P fell nearly -7%. French bonds were not part of the ECB's program. Many hedge funds have made use of sovereign shorts, particularly Italy and Spain, to help offset the risk of long positions in economically sensitive equities and corporate bonds. The inconsistency in correlations between the equity market and certain sovereign issuers indicates the difficulty in relying on any one instrument to hedge risk, and helps explain why certain funds underperformed back in August relative to what their net exposures suggested. In November, correlations have increased again, suggesting that sovereign hedges were more effective this past month.

Despite this, hedge funds struggled to generate profits amidst the volatility during November. The broader HFRI Fund-Weighted Index fell -1.0%, and the Dow Jones Credit Suisse Hedge Fund Index lost -0.8%. Hedge funds of funds fared slightly better, down -0.6%, according to HFRI. Exhibit 3 reviews hedge fund performance by strategy.

[1] The graph actually displays the inverse correlation, since a compression in credit spreads is associated with a rise in equity markets.

Exhibit 3: Hedge Fund Performance by Major Strategy Category

| Strategy Indices | November | YTD 2011 | FYTD* | Calendar 2010 | Calendar 2009 | Calendar 2008 |
|---|---|---|---|---|---|---|
| Arbitrage/Relative Value | | | | | | |
| HFRI** | -0.2% | 0.4% | -2.6% | 11.5% | 25.8% | -18.0% |
| Dow Jones CS-Convert | -0.6% | 0.5% | -3.1% | 11.0% | 47.3% | -31.6% |
| Dow Jones CS-Fixed Income | 0.5% | 4.3% | 0.7% | 12.5% | 27.4% | -28.8% |
| Event Driven | | | | | | |
| HFRI | -0.5% | -2.4% | -5.4% | 11.7% | 25.0% | -21.8% |
| Dow Jones Credit Suisse | -1.1% | -8.4% | -9.5% | 12.6% | 20.4% | -17.7% |
| Equity Long/Short | | | | | | |
| HFRI | -1.7% | -7.1% | -8.1% | 10.5% | 24.6% | -26.7% |
| Dow Jones Credit Suisse | -1.5% | -6.5% | -7.2% | 9.3% | 19.5% | -19.8% |
| Global Macro/CTA | | | | | | |
| HFRI | -0.5% | -3.6% | -1.4% | 8.2% | 4.3% | 4.8% |
| Dow Jones CS-Macro | 0.0% | 6.0% | 4.6% | 13.5% | 11.6% | -4.6% |
| Dow Jones CS-Managed Futures | 0.2% | -4.9% | -1.6% | 12.2% | -6.6% | 18.3% |
| Multi-Strategy | | | | | | |
| HFRI | -0.1% | -0.9% | -2.5% | 13.4% | 24.6% | -20.3% |
| Dow Jones Credit Suisse | -0.9% | 1.7% | -2.6% | 9.3% | 24.6% | -23.6% |

* Fiscal YTD from June 30, 2010
** 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.

Equity long/short funds were the worst performers, underperforming both the S&P 500 and the Russell 2000. Event driven funds also lost over a percent. Global macro funds were flat to slightly down, despite benefitting from a declining Euro and a continued rally in Treasuries.

Eli Sokolov
December 22, 2011