CLIFFWATER LLC

Hedge Fund Market Commentary – October 2009

Equities retreated modestly in October, with the S&P 500 Index returning -1.9% for the month. Credit markets fared slightly better, aided by continued favorable technicals as strong demand for new issue high yield bonds supported prices. A broader overview of recent performance across markets is shown in Exhibit 1.

Exhibit 1: 2009 Market Performance

Index	October	YTD 2009	FYTD*	Calendar 2008
Equity				
Dow Jones 5000	-2.6%	18.4%	13.3%	-37.2%
S&P 500	-1.9%	17.1%	13.5%	-37.0%
Russell 2000	-6.8%	14.1%	11.2%	-33.8%
MSCI EAFE	-1.3%	28.0%	18.0%	-43.1%
MSCI Emerging Mkts	0.1%	64.4%	21.2%	-53.5%
DJ REIT	-4.5%	12.3%	29.3%	-39.2%
S&P 500 Financials	-6.0%	14.0%	18.0%	-56.6%
Fixed Income				
Barclays Aggregate	0.2%	6.4%	4.5%	5.2%
Barclays Treasuries	0.0%	-2.3%	2.1%	20.1%
Barclays TIPS	0.7%	11.6%	5.0%	-2.4%
Barclays High Yield	0.6%	52.6%	17.0%	-26.2%
Barclays Bank Loan	-0.2%	48.6%	10.4%	-29.5%
AAA ABX (Subprime)	-0.6%	-15.8%	25.9%	-43.2%
Barclays Municipals	0.1%	11.7%	4.9%	-2.5%
3 mo.Libor	0.1%	0.9%	0.3%	3.1%
Alternative				
DJ UBS Commodity	3.3%	12.6%	7.7%	-35.7%
Hedge Funds				
HFRI Fund of Funds**	-0.1%	9.7%	4.3%	-21.4%
HFRI Fund Weighted**	0.0%	16.9%	6.7%	-19.0%
CS/Tremont	0.2%	15.2%	7.5%	-19.1%

* Fiscal YTD from June 30, 2009

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Hedge fund performance was muted for the month of October. The HFRI Fund Weighted Index was essentially flat, while the HFRI Fund-of-Funds Index was down -0.1%, indicating a slowdown in the performance gap between the two indices. For the calendar year-to-date, the HFRI Fund Weighted Index is up 16.9% and the HFRI Fund-of-Funds Index is up 9.7%.

Exhibit 2 shows the performance of different hedge fund strategies, as defined by HFRI and CS/Tremont. Equity long/short funds and to a lesser extent macro funds held back the indices in what was otherwise a good month for hedge funds. The underperformance of equity hedge funds can be attributed to the downturn in markets in the last week of October. The negative performance of the HFRI macro index was driven largely by managed futures funds, which tend to be "long momentum," a strategy which was hurt by the sudden reversal in markets.

Exhibit 2: Hedge Fund Performance by Major Strategy Category

Strategy Indexes	October	YTD 2009	FYTD*	Calendar 2008
Arbitrage/Relative Value				
HFRI**	1.6%	22.8%	9.0%	-18.0%
CS/Tremont-Convert	1.9%	42.6%	15.1%	-31.6%
CS/Tremont-Fixed Income	2.5%	25.0%	11.8%	-28.8%
Event Driven				
HFRI	1.1%	21.2%	10.2%	-21.8%
CS/Tremont	0.4%	15.2%	8.0%	-17.7%
Equity Long/Short				
HFRI	-0.5%	20.6%	7.6%	-26.7%
CS/Tremont	-1.2%	15.3%	6.6%	-19.8%
Global Macro/CTA				
HFRI	-0.8%	3.3%	1.9%	4.8%
CS/Tremont-Macro	0.3%	9.4%	5.8%	-4.6%
CS/Tremont-Managed Future	-2.2%	-6.3%	1.2%	18.3%
Multi-Strategy				
HFRI	1.1%	22.5%	9.2%	-20.3%
CS/Tremont	1.1%	21.9%	8.6%	-23.6%

* Fiscal YTD from June 30, 2009

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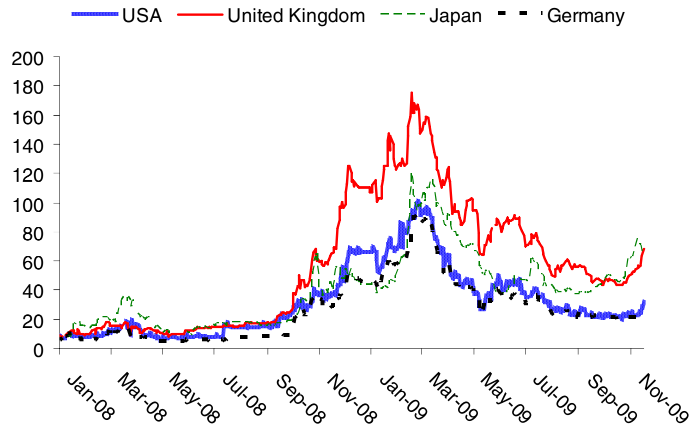
One of the criticisms faced by the hedge fund industry after last year's losses is that hedge funds failed to effectively hedge the market downturn. This "failure" has forced a re-evaluation by many investors and hedge fund managers. Investors who had expectations that hedge funds should be largely immune to market downturns have gained a better understanding of the role hedge funds play in an investment portfolio, and the measurable benefit they have provided to such portfolios in this market cycle. Hedge fund managers, many of whom had relied solely on their skills at bottom-up analysis of securities, have realized that a top-down element to portfolio management can be complementary to their strategies.

One such investment theme pursued by hedge funds has been the search for cheap optionality to guard against tail risk. A fortunate subset of managers could claim early adherence to such practice through, for example, successful shorting of the subprime mortgage market in 2007. Others are hoping that the next time a trade so obviously smart in hindsight appears, they won't be too late or tunnel-visioned to benefit from it. One manifestation of this change in approach is the popularity of shorting sovereign bonds of at-risk countries in the developed markets. The thesis is that the default of a country such as the United Kingdom, Ireland, Greece, or others would represent a catastrophic risk to the financial system. For a relatively low annual premium, investors can insure against this risk through credit default swaps. Exhibit 3 shows the recent history of these insurance premiums, which have risen noticeably in just the past few weeks.

Exhibit 3: Sovereign Bond CDS Spreads (in basis points)



Another popular trade has been to hedge against a sharp rise in inflation. The risk of a weakening dollar and run-away inflation has been a prominent subject of debate this year among economists, market theorists, and investment practitioners. Investors are scrambling to insure that their allocation to real assets is optimal, and investment managers are eagerly offering new products designed to protect against inflation. Some hedge fund managers, particularly those with a large fixed income component to their portfolios, have looked for inexpensive ways to implement an inflation hedge, trying to avoid the crowds rushing into commodities.

Most of these trades have become more expensive. Exhibit 3 shows three historical charts – the price of gold, the implied volatility of interest rate options, and the break-even inflation rate. The first chart plots the climb in the price of gold, occurring as concerns over U.S. and global inflation leads to renewed demand for gold as a store of wealth. The second two charts show the cost of inflation-protection trades implemented in the over-the-counter (OTC) derivatives and Treasury Inflation-Protected Securities ("TIPS") markets.

Exhibit 4: Indicators of Costs to Hedge Inflation Risk

The OTC market offers multiple ways to bet on interest rates – in this case, to bet on an increase in nominal rates associated with a rise in inflation. One measurement of the cost of such trades is the implied volatility of swaptions (see footnote below)[1]. By this measure, the cost of purchasing options on interest rates has risen since the first signs of crisis in 2007. In 2009 alone, implied volatilities have jumped by over 20 bps. There are many factors driving this trend – it is not just from investors hedging against inflation, but the direct result is an increase in cost for investors looking to do so.

The TIPS market presents a more direct hedge against inflation, as coupon payments are tied to inflation through a CPI-adjustment to the principal on the bonds. Hedge funds can place a bet on inflation by purchasing TIPS on a stand-alone basis or in conjunction with short positions in nominal Treasury bonds, which fall in price when inflation expectations rise. The break-even inflation rate tracks the yield differential achieved through such a long-short trade, and in an economic sense, depicts the inflation rate needed to compensate TIPS investors for the lower nominal yield relative to Treasuries. As the break-even rate has risen, the relative value of TIPS versus nominal Treasuries has declined.

As inflation-protection trades have become more popular, they have become less attractively priced, but still can yield substantial gains in the event of a surge in inflation and/or inflation expectations. Investors should expect that many hedge funds will continue to implement these and other macro-themed trades with perceived asymmetric payoffs to guard against extreme events.

Eli Sokolov
November 18, 2009

[1]A swaption is a kind of option that gives investors the right to enter into an agreement in the future to pay a fixed rate in return for receiving the going market rate at the time the option is exercised (in this case, the reference rate is the 5-year Treasury rate, and the option expiration is in 5 years). If rates increase substantially due, for example, to inflation, this right can be very valuable. The cost to purchase this right is proportional to the implied volatility of the option, much like in the market for equity options. Put another way, swaption implied volatility is fixed income analog to the more well-known VIX index, which depicts equity volatility implied by options on the S&P 500 index.