Hedge Fund Market Commentary – September 2009

Asset prices were up sharply again in September. Lower rated bond and loan performance has been particularly impressive, climbing close to 50% in 2009. Emerging market equities, which underperformed in August, rallied over 9% in September on expectations that the emerging economies will benefit disproportionately from a global recovery. Overall, U.S. economic data continues to show improvement though there are certainly plenty of concerns that inflation and sluggish growth ("stagflation") might be the ultimate byproduct of the current fiscal stimulus and monetary expansion.

Exhibit 1: 2009 Market Performance

Index	September	YTD 2009	FYTD*	Calendar 2008
Equity				
Dow Jones 5000	4.1%	21.5%	16.3%	-37.2%
S&P 500	3.7%	19.3%	15.6%	-37.0%
Russell 2000	5.8%	22.4%	19.3%	-33.8%
MSCI EAFE	3.9%	29.6%	19.5%	-43.1%
MSCI Emerging Mkts	9.1%	64.2%	21.0%	-53.5%
DJ REIT	7.0%	17.7%	35.4%	-39.2%
S&P 500 Financials	2.0%	21.2%	25.5%	-56.6%
Fixed Income				
Barclays Aggregate	1.1%	5.7%	3.7%	5.2%
Barclays Treasuries	0.8%	-2.3%	2.1%	20.1%
Barclays TIPS	2.1%	9.5%	3.1%	-2.4%
Barclays High Yield	5.7%	49.0%	14.2%	-26.2%
Barclays Bank Loan	3.3%	48.4%	10.2%	-29.5%
AAA ABX (Subprime)	14.4%	-15.2%	26.7%	-43.2%
Barclays Municipals	3.6%	14.0%	7.1%	-2.5%
3 mo.Libor	0.1%	0.8%	0.3%	3.1%
Alternative				
DJ UBS Commodity	1.6%	9.1%	4.2%	-35.7%
Hedge Funds				
HFRI Fund of Funds**	1.6%	9.7%	4.3%	-21.4%
HFRI Fund Weighted**	3.0%	17.2%	7.0%	-19.0%
CS/Tremont	2.7%	14.6%	6.9%	-19.1%

* Fiscal YTD from June 30, 2009
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Hedge funds posted another strong month. The HFRI Fund Weighted Index earned an estimated 3.0% in September while the HFRI Fund-of-Funds Index returned 1.6%. For the calendar year-to-date, the HFRI Fund Weighted Index is up 17.2% and the HFRI Fund-of-Funds Index is up 9.7%.

The 7.5% lag in fund-of-funds performance compared to direct hedge fund investments is unusually pronounced this year. Fund-of-funds returns typically lag behind direct hedge fund indices, but only by 1% to 2% in most years, and most of that difference is thought to be the extra layer of fees. We are not certain why there is such a large difference this year, but we suspect that performance for many of the fund-of-funds may be hurt by their liquidity problems, and that in turn may have caused them (1) to hold more cash than is typical, (2) to redeem from the better hedge funds that have proven to be the best source of cash, and (3) higher concentrations in poorer performing and illiquid hedge funds that can't be liquidated.

Exhibit 2 shows the performance of different hedge fund strategies, as defined by HFRI and CS/Tremont. All major strategies gained in September, with little dispersion across strategies.

Exhibit 2: Hedge Fund Performance by Major Strategy Category

Strategy Indexes	September	YTD 2009	FYTD*	Calendar 2008
Arbitrage/Relative Value				
HFRI**	2.4%	20.5%	6.8%	-18.0%
CS/Tremont-Convert	3.3%	40.1%	13.0%	-31.6%
CS/Tremont-Fixed Income	2.9%	22.2%	9.2%	-28.8%
Event Driven				
HFRI	4.2%	20.4%	9.6%	-21.8%
CS/Tremont	2.0%	13.8%	6.7%	-17.7%
Equity Long/Short				
HFRI	3.6%	21.6%	8.5%	-26.7%
CS/Tremont	3.4%	16.8%	7.9%	-19.8%
Global Macro/CTA				
HFRI	1.9%	4.5%	3.0%	4.8%
CS/Tremont-Macro	2.7%	9.0%	5.4%	-4.6%
CS/Tremont-Managed Futures	3.2%	-4.0%	3.7%	18.3%
Multi-Strategy				
HFRI	3.4%	21.3%	7.9%	-20.3%
CS/Tremont	2.2%	19.9%	6.8%	-23.6%

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In a virtuous circle, hedge funds continue to increase their net investment, generating strong returns for their investors, and to a lesser degree helping to buoy the overall markets. According to a study by Morgan Stanley Prime Brokerage, global equity hedge funds have steadily increased both gross and net exposures since March. Net exposures have increased from the mid-teens in March to above 40% as of the end of August. Gross exposures have grown from about 120% to just under 150% over the same period. Some, if not a majority, of this increase occurs naturally as long investments outperform short investments in a rising market. Funds that actively trade can offset this effect and maintain exposures within target ranges, but for many funds the increase in exposures is an intentional expression of confidence in the markets. Should this confidence prove justified, 2009 could end as one of the best years on record for hedge funds. Given the pain experienced by investors in 2008 and the first few weeks of 2009, that would be welcome news for many.

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