

## Hedge Fund Market Commentary – December 2007

Investor uncertainty about mortgage defaults, Fed action, oil prices, and recession produced high intra-month price volatility, though month-end returns were largely flat. The new discovery was that the subprime contagion had invaded the normally calm municipal bond market through the back door. Bond insurers, whose guarantees are critical to helping municipalities place their debt, themselves face possible bankruptcy after getting caught guaranteeing subprime CDO debt. This could lead to cutbacks in local and state spending as it becomes more expensive to fund projects. (Some local governments will face a 1-2 punch when higher interest costs are coupled with losses in short-term portfolios from SIV holdings.) The next shoe to drop may be asset backed securities linked to credit card debt, as recession puts further pressure on pocketbooks, causing consumers to default on card payments. Exhibit 1 provides a chronology of the credit contagion to date.

Exhibit 1: Credit Contagion Chronology

Jan-May	June	July	August	September	October	November	December	January '08
Mortgage Lenders	Subprime, CDOs	Bank Loans	Quant Funds	SIVs	Cash Funds	Bond Insurers	Municipals	Bank Rescue, ABS

A performance summary for major market indices is shown in Exhibit 2. Given all that the market went through in the second half of the year, it is surprising they did so well, though early January losses tell us that the turmoil is not over.

Exhibit 2: 2007 Market Performance

Index	December	November	Year to Date
DJ Wilshire 5000	-0.61%	-4.45%	5.61%
MSCI EAFE	-2.26%	-3.24%	11.76%
MSCI Emerging Mkts	0.36%	-7.08%	39.24%
DJ Wilshire REIT	-5.32%	-9.72%	-17.56%
Lehman Aggregate	0.28%	1.80%	6.97%
Lehman Treasuries	0.08%	3.07%	9.01%
Lehman High Yield	0.29%	-2.17%	1.87%
Lehman Bank Loan	0.32%	-1.53%	2.13%
Libor	0.42%	0.40%	5.31%
HFRI Fund Weighted	0.61%	-2.03%	10.24%

Hedge funds showed a modest increase in December, with a 0.61% return. For the entire year the HFRI Fund Weighted Index of hedge funds returned a strong 10.24%.

Not all hedge fund portfolios are alike, and the HFRI Fund-Weighted Index in particular is dominated by equity long/short funds, due largely to the sheer number of funds running this strategy. Most of the positive performance in the HFRI Fund-Weighted Index was driven by equity long/short funds and emerging market funds, which, as shown in Exhibit 3 below, posted 2007 returns of 10.65% and 25.03%, respectively. Though a few fixed income funds correctly timed the subprime collapse and profited by shorting the ABX indices, most credit funds, having long credit exposure, did not fare as well in an environment of sharply widening spreads. In addition, event-driven funds performed particularly poorly in the second half of 2007 as deteriorating credit conditions contributed to the failure of some large LBO-financed deals. Thus a well-balanced hedge fund portfolio with more exposure to credit, event-driven, and other strategies, would likely have underperformed the HFRI Fund-Weighted Index in 2007, as would one that underweighted emerging markets.

HFRI Style Index	Jan-Jun 2007	Jul-Dec 2007	Jan-Dec 2007
HFRI Emerging Markets	14.70%	9.01%	25.03%
HFRI Equity Hedge	8.02%	2.43%	10.65%
HFRI Event Driven	8.39%	-1.34%	6.94%
HFRI Fixed Income	2.68%	-0.12%	2.56%

The real test for hedge funds, particularly those with a long-term value strategy, will come in future months as managers search for mispriced securities amidst market volatility and negative investor sentiment. In an upcoming report, we will look more closely at how the opportunity set may evolve for distressed credit hedge fund strategies in particular.

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