

## Hedge Fund Market Commentary – February 2009

Recognition that the economy is in “shambles” (Warren Buffet’s description) for the foreseeable future pushed stock prices down even further. The S&P 500 Index fell -10.7% in February, bringing year-to-date losses to -18.2%. Bond prices fell in a departure from recent months as the prospects of ballooning budget deficits pushed interest rates slightly higher. The Barclays Aggregate Bond Index fell -0.4% in February and is down -1.3% for the calendar year. Bank loans offer one small bright spot. These senior loans, which have caused problems for the banks, have so far bottomed at around 65¢ on the dollar and have begun to inch upward. Year-to-date, the Barclays Bank Loan Index is up 7.3%. This is a market sector that is receiving increasing net cash flows from both hedge funds and private equity firms. Exhibit 1 reports February market index returns for the major asset classes.

Exhibit 1: Market Index Performance through February 2009

Index	February	YTD 2009	FYTD*	Calendar 2008
<b>Equity</b>				
DJ Wilshire 5000	-10.4%	-17.7%	-42.0%	-37.2%
S&P 500	-10.7%	-18.2%	-41.5%	-37.0%
Russell 2000	-12.2%	-21.9%	-43.0%	-33.8%
MSCI EAFE	-10.2%	-19.0%	-48.7%	-43.1%
MSCI Emerging Mkts	-5.7%	-11.9%	-53.5%	-53.5%
DJ Wilshire REIT	-21.9%	-36.0%	-54.1%	-39.2%
S&P 500 Financials	-18.1%	-39.7%	-62.7%	-56.6%
<b>Fixed Income</b>				
Barclays Aggregate	-0.4%	-1.3%	2.8%	5.2%
Barclays Treasuries	-0.5%	-3.4%	13.4%	20.1%
Barclays TIPS	-2.0%	-0.3%	9.3%	-2.4%
Barclays High Yield	-3.1%	1.7%	-23.9%	-26.2%
Barclays Bank Loan	0.6%	7.3%	-23.9%	-29.5%
AAA ABX (Subprime)	-5.3%	-1.8%	-32.5%	-43.2%
Barclays Municipals	0.5%	4.2%	1.6%	-2.5%
3 mo.Libor	0.1%	0.2%	1.7%	0.0%
<b>Alternative</b>				
DJ AIG Commodity	-4.4%	-9.6%	-54.3%	-35.7%
HFRI Fund of Funds**	--	0.8%	-18.0%	-20.0%
HFRI Fund Weighted**	-0.4%	-0.4%	-17.3%	-18.8%

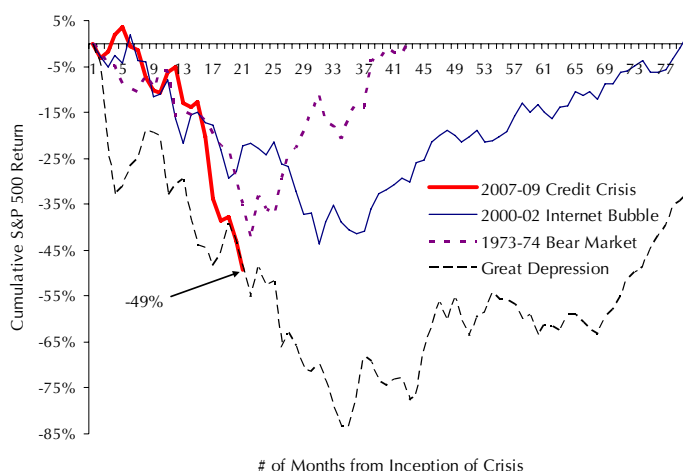
\* Fiscal YTD from June 30, 2008

\*\* The February return for the HFRI Fund Weighted Index is estimated using the HFRX Global Hedge Fund Index. HFRI Fund of Funds YTD and FYTD returns are through January 2009. 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.

Exhibit 2 shows the drawdown in stocks (S&P 500 Index) from the inception of the credit crisis in June 2007 through February 2009 and compares it to the three worst historical stock market drawdowns. Losses during the current bear market now total -49% and exceed the -43% losses experienced during the 1973-74 and 2000-02 bear markets.

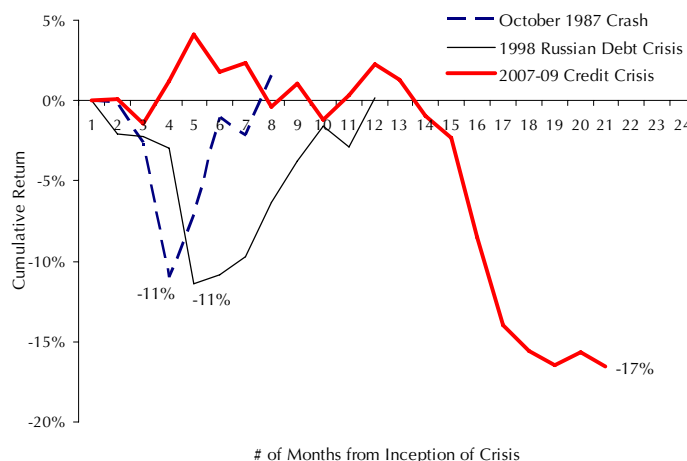
The fact that the current decline exceeds all Post WWII bear markets is disquieting, but not entirely surprising, given the economic fundamentals. GDP contracted roughly 3% during the two worst postwar recessions, 1973-74 and 1981-82. GDP contracted almost 2% during the fourth quarter of 2008 alone (unannualized), and the total contraction will most certainly exceed 3%. While severe, the recent decline is still modest in comparison to the 23% GDP contraction during the Great Depression. We remain hopeful that we will be able to say the same a year from now.

Exhibit 2: A Comparison of the Four Worst Bear Markets



The historical comparisons for hedge fund returns are no more favorable. 2008 was a disappointing year for hedge funds. Exhibit 3 plots hedge fund performance during the current crisis and compares it to hedge fund performance during two prior crises – the October 1987 stock market crash and the 1998 Russian debt crisis – which were the worst on record for hedge funds until now. The current -17% drawdown is now more severe than the two earlier -11% hedge fund drawdowns. While the reputation of hedge funds as “absolute return” investments was damaged, hedge fund losses were far below those suffered by the stock market. Moreover, thus far 2009 is turning out far better for hedge funds. While the S&P 500 Index is down -18.2% for the first two months and the Barclays Aggregate Index is off -1.3%, hedge fund indexes are roughly flat to slightly negative.

Exhibit 3: Hedge Fund Performance during Current and Past Financial Crises



Hedge fund returns are better understood in the context of the tumultuous changes the hedge fund industry is going through:

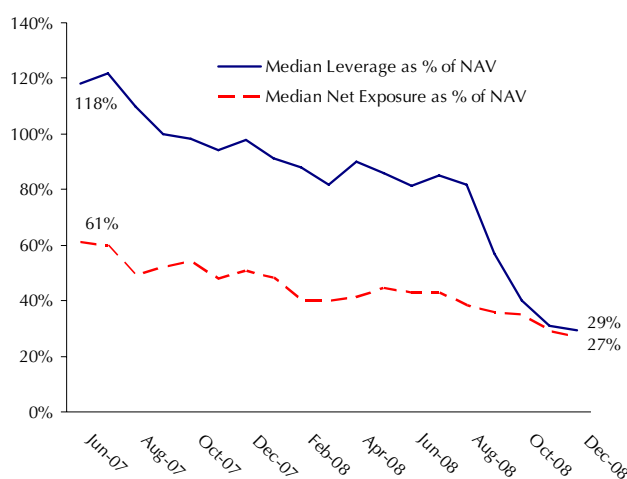
- Leverage has been dramatically reduced, such that at year-end 2008 the median hedge fund had close to zero leverage. Exhibit 4 plots median leverage<sup>1</sup> levels for a representative sample of over 300 hedge funds from June 2007 through December 2008. Leverage used by hedge funds dropped precipitously, particularly during the September through November 2008 time period. At year-end, the average hedge fund used very little leverage, equal to 29% of net assets. As of the end of December, one-third of the hedge funds in our sample were running with no leverage. This compares with just 10% one year earlier. Moreover, the amount of cash being held by unlevered funds has

<sup>1</sup> Leverage equals long and short asset positions minus NAV. A value of 0% indicates zero leverage. A value of 100% indicates that NAV – investor capital – has been levered 1 time.

increased by almost a factor of three in the last 12 months. Net asset exposure, equal to gross longs minus gross shorts, also fell from 61% of NAV to 27% of NAV at December 31.

- The hedge fund industry, as represented by those funds which report to the HFR database, has shrunk considerably from an estimated \$1.9 trillion at the beginning of 2008 to \$1.4 trillion in assets at year-end. This estimate for year-over-year losses is likely too conservative, as it fails to account for a large amount of the true year-end redemptions. Regardless, this was the first time hedge fund assets fell since the Asian Crisis in 1998.<sup>2</sup> We expect hedge fund assets to continue to fall in 2009 due to significant levels of year-end “gated” redemptions and increasing liquidity issues at endowments, which are large hedge fund investors.
- The number of hedge funds dropped from 7,600 to 6,800.<sup>3</sup>

Exhibit 4: Hedge Fund Leverage and Net Asset Exposure



All of the returns figures we have reported for the hedge fund industry are based on the widely cited HFR family of indices. These indices aggregate performance across a broad portfolio of funds that may be very different in composition from any given investor’s hedge fund portfolio. One key difference is that Macro funds have a disproportionately large influence on HFRI returns.

HFRI divides hedge funds into four broad strategy groups – “equity hedge,” “event-driven,” “macro,” and “relative value” – with five to eight subcategories for each broad strategy. Exhibit 5 lists the four strategy groups and their subcategories along with 2008 beginning and ending weights and 2008 returns.

Hedge fund strategies and subsectors, as defined by HFRI, are listed in the far left in Exhibit 5. Columns 1 to 4 show sector weightings at December 31, 2007. Columns 5 to 8 show weightings as of December 31, 2008. Weightings based upon hedge fund assets under management (“AUM”) in columns 1, 2, 5 and 6 and weightings based upon number of hedge funds (“# Funds”) in columns 3,4,7 and 8 are displayed. *Importantly, the HFRI Index is weighted by number of funds (# Funds), not assets under management.* Column 9 reports calendar 2008 returns by sector and reflect the equal weighted (# Funds) approach used by HFRI.

The most important takeaway from Exhibit 5 is the strong performance of Macro hedge funds during 2008, up 5.18%. We estimate that the HFRI Fund Weighted Composite Index would have returned -23.45%, or five percentage points below its -18.36% reported return for 2008 if Macro hedge funds were not represented in the Index.

There are two reasons for stronger Macro hedge fund performance during downturns. The first is that they generally invest in very liquid, high quality securities that don’t suffer during a “flight to quality.” The second is that it is during macroeconomic crises that the underlying securities traded by Macro funds exhibit the most volatility, presenting opportunities to earn outsized returns. In 2007 and 2008, many Macro hedge funds were successful in predicting changes in exchange rates and interest rates, including the sharp steepening of global yield curves. In addition, many hedge funds classified by HFR as Macro use *trend-*

<sup>2</sup> HFRI 2007/2008 Industry Reports

<sup>3</sup> HFRI 2007/2008 Industry Reports

following protocols that will do well when markets go through changes that continue well beyond expectation. These commodity trading advisors (“CTAs”) represent well over one-half of all macro hedge funds. Their performance is particularly attractive during periods when the markets are very distressed or ebullient, but do not perform as well over most other time periods when markets “mean-revert.”

Exhibit 5: Year End Sector Weights and 2008 Sector Returns for HFRI Fund Weighted Composite Index

	1				2				3				4				5				6				7				8				9			
	Dec 31, 2007 HFRI Sector Weights								Dec 31, 2008 HFRI Sector Weights																											
	AUM Weights	Total AUM (millions)	Weights by # Funds		AUM Weights	Total AUM (millions)	Weights by # Funds		2008 Return*																											
<b>Equity Hedge</b>	41%	\$762,875	58%		4,425	32%	\$450,833	50%		3,395	-26.16%																									
Equity Market Neutral	7%	\$54,774	13%		561	6%	\$28,898	12%		417	-6.20%																									
Fundamental Growth	13%	\$101,386	18%		787	13%	\$59,916	22%		735	-31.61%																									
Fundamental Value	62%	\$471,991	49%		2,188	63%	\$281,861	42%		1,434	-17.76%																									
Energy	7%	\$56,987	6%		268	6%	\$27,185	7%		243	-36.90%																									
Technology/Healthcare	4%	\$31,964	6%		264	5%	\$21,956	7%		223	-16.72%																									
Short Bias	1%	\$5,950	1%		63	1%	\$5,771	2%		54	28.62%																									
Quantitative Directional	7%	\$56,987	7%		295	6%	\$24,931	5%		182	-21.62%																									
Multi-Strategy	0%	\$0	0%		-	0%	\$316	3%		108	-4.43%																									
<b>Event-Driven</b>	23%	\$431,044	14%		1,100	24%	\$335,029	13%		883	-21.26%																									
Merger Arbitrage	7%	\$29,354	11%		117	5%	\$15,244	10%		88	-4.62%																									
Special Situations	56%	\$243,152	46%		504	59%	\$198,304	42%		374	-18.09%																									
Distressed/Restructuring	26%	\$113,839	30%		335	25%	\$82,819	31%		273	-24.94%																									
Activist	8%	\$35,259	5%		52	10%	\$32,263	7%		65	-37.01%																									
Private/Reg D	1%	\$4,267	4%		48	1%	\$3,685	3%		29	-5.12%																									
Credit Arbitrage	1%	\$4,526	4%		44	1%	\$2,479	3%		31	-21.14%																									
Multi-Strategy	0%	\$0	0%		-	0%	\$235	3%		23	-33.86%																									
<b>Macro</b>	11%	\$203,471	9%		676	20%	\$278,605	17%		1,170	5.18%																									
Discretionary Thematic	78%	\$158,178	58%		391	56%	\$155,378	30%		347	-5.23%																									
Systematic Diversified	7%	\$14,548	20%		136	25%	\$69,428	39%		460	17.70%																									
Systematic Currency	9%	\$17,987	7%		44	11%	\$30,368	11%		131	0.58%																									
Systematic Commodity	0%	\$936	1%		6	2%	\$5,266	7%		81	-0.77%																									
Multi-Strategy	6%	\$11,822	15%		98	7%	\$18,137	13%		151	-3.19%																									
<b>Relative Value</b>	25%	\$470,842	19%		1,433	24%	\$342,628	20%		1,359	-16.77%																									
Fixed Income - Convert	10%	\$46,566	18%		253	6%	\$22,202	15%		207	-34.67%																									
Fixed Inc - Asset Backed	5%	\$21,800	11%		155	7%	\$23,162	14%		185	0.08%																									
Fixed Income - Corporate	16%	\$76,088	16%		226	17%	\$57,219	17%		230	-21.73%																									
Volatility	1%	\$5,603	7%		98	2%	\$5,619	11%		147	-21.73%																									
Yield Alternatives	1%	\$6,921	3%		46	1%	\$3,529	6%		83	-22.22%																									
Multi-Strategy	67%	\$313,863	46%		655	67%	\$230,897	37%		507	-19.93%																									
<b>Totals</b>	100%	\$1,868,419	100%		7,634	100%	\$1,407,095	100%		6,807	-18.36%																									

\* Returns in red are estimates by Cliffwater based upon sector constituents. HFRI does not publish returns for these sectors.

Macro managers represented 39% of the HFRI Index in 1993, but their weighting declined to just 11% at the start of 2008. They have now rebounded to represent 17% of the HFRI Index by number of funds and 20% by assets under management. This increase is largely due to the tendency of some hedge funds to closely protect their track records during periods of underperformance, and report returns to databases when performance is strong.

Given the biases and discrepancies between the HFRI Fund Weighted Index and many institutional hedge fund portfolios, many institutional investors look instead to the HFRI Fund of Funds Index as a relative benchmark. In 2008, the HFRI Fund of Funds Index fell -20.0%, well over a percentage point more than the HFRI Fund Weighted Index. The lower return for the HFRI Fund-of-Funds Index is due to fewer reporting biases mentioned above and secondly to their lower exposure to Macro hedge funds and higher exposure to Event-Driven hedge funds.

There is risk in starting down the path of adjusting benchmarks to suit portfolios. However, when there are clear biases in an index, they need to be accounted for in making relative judgments. There is also a risk to being swayed by recent returns into making decisions that affect the long-term. A conscious choice to under-weight or over-weight Macro funds, for example, should be made strategically, not based on an index standard. At Cliffwater we believe it is important to keep the focus on finding skilled managers, who, when put together in a portfolio offer the possibility to earn alpha from a diverse set of markets and strategies.

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