

Hedge Fund Market Commentary – January 2008

“There are known knowns; there are things we know we know. We also know there are known unknowns; that is to say we know there are some things we do not know. But there are also unknown unknowns -- the ones we don't know we don't know.” - Donald Rumsfeld

These words addressing politics and war could also apply to the January financial markets. Global markets tumbled in reaction to the “known knowns” coming from bleak economic reports and a growing list of “known unknowns” that include mortgage defaults, credit tightening, recession and inflation. The Fed did react quickly, lowering both the fed funds rate and the bank discount rate by 75 basis points. But, while the Fed’s actions temporarily calmed markets, investors now appear to be pondering “unknown unknowns.” Exhibit 1 below details the final January tallies for major market indices.

Exhibit 1: 2008 Market Performance

Index	January 2008	December 2007	Year to Date 2008
DJ Wilshire 5000	-6.05%	-0.61%	-6.05%
MSCI EAFE	-9.20%	-2.26%	-9.20%
MSCI Emerging Mkts	-12.53%	0.36%	-12.53%
DJ Wilshire REIT	-0.48%	-5.32%	-0.48%
Lehman Aggregate	1.68%	0.28%	1.68%
Lehman Treasuries	2.54%	0.08%	2.54%
Lehman High Yield	-1.33%	0.29%	-1.33%
Lehman Bank Loan	-3.45%	0.32%	-3.45%
Libor	0.38%	0.42%	0.38%
HFRF Fund Weighted ¹	-1.80%*	0.51%	-1.80%*

* Initial Estimate

¹ 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.

International equity markets, which had been enjoying a long period of outperformance relative to the US equity market, fell especially hard. Not surprisingly in a “flight to safety,” U.S. Treasuries rallied strongly and returned 2.54% for the month.

The credit markets were hammered in January, especially bank loans whose losses exceeded supposedly more risky high yield bonds. When the same thing happened in July and August investors referred to it as a “technical dislocation,” and a recovery in October seemed to confirm this. At the time we noted in our market commentary that distressed bank loan investors would likely have to settle for entry prices of 96 and above. January proved differently and demonstrated that the credit markets remain unhinged. Indications are that hedge funds in January were able to buy distressed bank loans at an average price in the high 80’s, with some purchases in the mid-70’s (see Exhibit 2). Many of these funds began buying last fall, but were not fully invested going into

2008. Thus while mark-to-market losses were large in January, the long-term prospects look to be very positive absent massive defaults.

Hedge funds in general proved far from immune to the market turmoil, falling an estimated -1.80%. This number is likely to be revised downward as more funds report their numbers. Equity long/short funds appear to have been especially hard hit, with losses greater than -4%. While investors often look to hedge funds as uncorrelated investments that preserve capital in down markets, January provided a reminder that correlations are hard to predict and often are revealed at the worst times. That said, hedge funds did on average outperform the markets.

Eli Sokolov
February 8, 2008

Exhibit 2: Average Loan Price and Spread in Lehman High Yield Loan Index

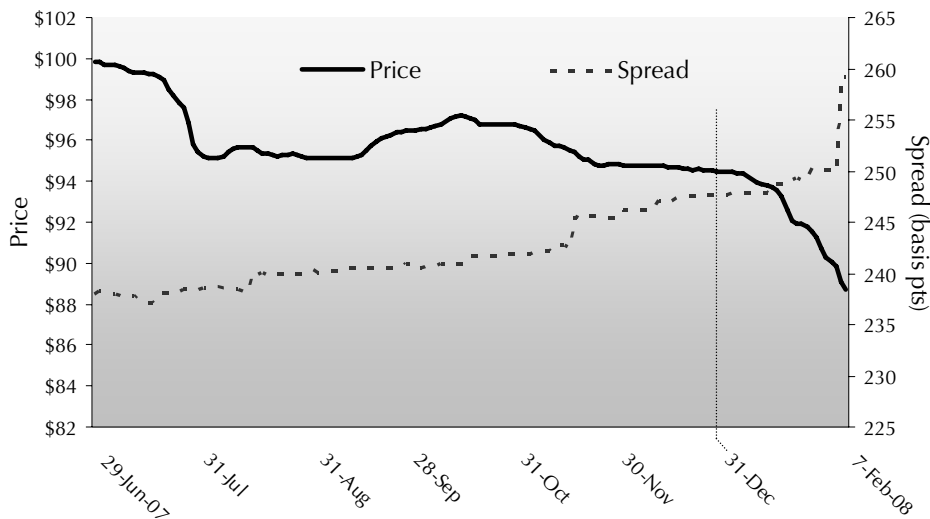


Exhibit 3: Price on ABX Index (AAA/AA Structured Mortgage Securities)

