

## Hedge Fund Market Commentary – July 2008

In a pattern reminiscent of March, when a falling market was revived by the bailout of Bear Stearns, the markets swung in July surrounding fears of a collapse of Fannie Mae and Freddie Mac. Investors discounted the possibility that with a continued downturn in housing, the equity of both government sponsored entities could easily be negative. They relied instead on signals from the Treasury and Fed indicating intent to intervene. Financial stocks rebounded quickly, rallying over 25% from the closing low on July 15<sup>th</sup> to end the month up over 7%. The broader domestic market ended the month slightly down, while developed international and emerging markets fell over 3%. Credit markets continued their decline, with high yield bonds dropping 1.3%. Falling oil prices helped drive commodities down almost 12%, and also contributed to the market rally in the second half of the month. A performance summary of major market indices is shown in Exhibit 1 below.

Exhibit 1: 2008 Market Performance

Index	July	Quarter to Date	Year to Date
DJ Wilshire 5000	-0.85%	-0.85%	-11.68%
MSCI EAFE	-3.20%	-3.20%	-13.44%
MSCI Emerging Mkts	-3.72%	-3.72%	-15.11%
DJ Wilshire REIT	2.89%	2.89%	-0.57%
S&P 500 Financials	7.14%	7.14%	-24.71%
Lehman Aggregate	-0.08%	-0.08%	1.04%
Lehman Treasuries	0.42%	0.42%	2.66%
Lehman High Yield	-1.33%	-1.33%	-2.62%
Lehman Bank Loan	-0.80%	-0.80%	-1.31%
Lehman Municipals	0.38%	0.38%	0.40%
AAA ABX (Subprime)	-3.36%	-3.36%	-22.92%
Libor	0.23%	0.23%	1.83%
DJ AIG Commodity	-11.86%	-11.86%	12.14%
HFRI Fund Weighted***	-2.35%*	-2.35%*	-3.54%*

\* Initial Estimate

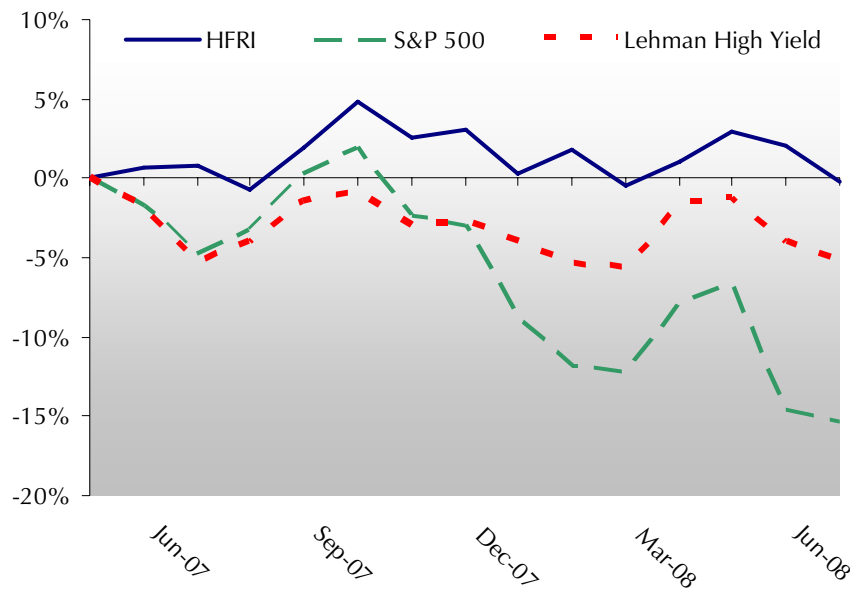
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The sudden turnaround in financials and drop in energy prices created havoc for many hedge funds which had structured their portfolios to bet against such a scenario. In fact, the large buildup in short positions in financials among hedge funds likely aided the sector's rally, in what is known as a "short squeeze." This occurs when rising prices force margin calls upon investors who borrowed stock to sell short. These margin calls compel short sellers to cover their shorts, which they do by buying shares on the open market, driving prices up even further and forcing more margin calls. The net result for hedge funds of the rally in financials, fall in oil prices, and other factors was a negative HFRI index return of 2.35%, based on initial estimates.

July's volatile markets were an unwelcome reminder to many investors that shorting is not simply buying in reverse – it is a leveraged bet, and thus involves greater risk. It is partly for this reason that hedge funds demand higher fees than traditional investment managers – a skilled short seller can add significant value to investors' portfolios, but there are few people with the investment and trading skill to successfully manage a short portfolio.

Many managers argue that the market has been miserly in rewarding skill of any kind recently, with prices reflecting technical more than fundamental factors. Despite this, hedge funds have significantly outperformed broader markets since the subprime crisis began last year, as shown in Exhibit 2.

Exhibit 2: Hedge Fund Relative Performance during Subprime Crisis



During the period from May 31, 2007 through July 31, 2008, annualized hedge fund returns have outperformed high yield bonds by 4.1% and equities by 12.8% (annualized). Judged on their ability to preserve capital in down markets, hedge funds have on average met expectations.

Of course, there is no “average” hedge fund to invest in, and investors incur risk in selecting only the managers they believe to be the most skilled. This risk has increased since the subprime crisis began, as variation in monthly returns among individual hedge fund has risen significantly. This is demonstrated in Exhibit 3, which shows the monthly difference between the first quartile return (25<sup>th</sup> percentile) and the third quartile return (75<sup>th</sup> percentile) for a broad universe of hedge funds covering the four year period ending June 30, 2008.<sup>1</sup> Until a year ago, the monthly dispersion among hedge funds, as measured by this mid-50% range, was between 2% and 3%. Since then it has climbed noticeably, pointing again to the importance of fund selection and the benefits of having a diversified portfolio of hedge funds.

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August 10, 2008

<sup>1</sup> Exhibit 3 is based on a universe of over 2500 funds selected on the criteria that they have at least a 3 year track record as of May of 2007. A 3 year return history is a common requirement among institutional investors considering investment in a hedge fund. Constructing the universe with an ending date of May of 2007 helps reduce both survivorship bias, by including partial returns for failed funds, and reporting bias, by including partial returns for funds that ceased to report following significant drawdowns.

Exhibit 3: Dispersion in Hedge Fund Returns before and during the Subprime Crisis

