

Hedge Fund Market Commentary – June 2008

The pessimists won in June, emptying the market of the gains enjoyed in April and May. Once again, financials stocks were at the center of the chaos, with the S&P 500 Financials Index falling 18.4%, bringing total year-to-date losses to almost 30%. These numbers are even more stunning considering that they represent the performance of the largest financial companies. Not surprisingly, U.S. Treasury prices rose in a flight to quality. Commodities prices continued their upward spiral.

Exhibit 1: 2008 Market Performance

Index	June	May	Year to Date
DJ Wilshire 5000	-8.13%	2.09%	-10.92%
MSCI EAFE	-8.16%	1.16%	-10.15%
MSCI Emerging Mkts	-10.02%	1.85%	-11.83%
DJ Wilshire REIT	-11.08%	0.23%	-15.27%
S&P 500 Financials	-18.37%	-6.09%	-29.73%
Lehman Aggregate	-0.08%	-0.73%	1.13%
Lehman Treasuries	0.79%	-1.17%	2.23%
Lehman High Yield	-2.80%	0.36%	-1.31%
Lehman Bank Loan	0.27%	0.89%	-0.51%
Lehman Municipals	-1.13%	0.61%	0.02%
AAA ABX (Subprime)	-10.83%	-6.87%	-20.23%
Libor	0.22%	0.23%	1.60%
DJ AIG Commodity	9.10%	2.73%	27.23%
HFR1 Fund Weighted***	-0.68%*	1.86%	-0.75%*

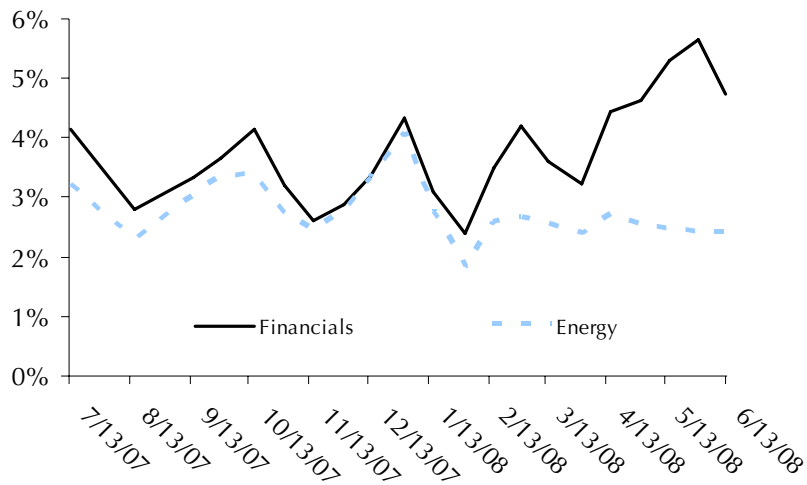
* Initial Estimate

*** 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.

Our last commentary noted that hedge funds have adopted a more defensive posture following significant losses in the first quarter of 2008. The initial estimates for June returns seem to validate this hypothesis – the HFR1 index was down -0.68%, despite losses of over 8% and almost 3% for equities and high yield bonds, respectively. In contrast, hedge funds fell 2.7% in January when equity and high yield markets lost 6.1% and 1.3%, respectively. One way in which hedge funds are expressing defensiveness is by betting against the most vulnerable sectors and concentrating long positions in more favorable sectors. Two sectors that highlight this trend are financials and energy. Exhibit 2 shows the average short interest ratio for large cap financials stocks and energy stocks since June, 2007.¹ The short interest ratio is the shares held short as a percentage of average daily trading volume.

¹ The stocks selected for purposes of this computation are those comprising the Financials and Energy SPDR Sector ETFs, which are designed to track the performance of the respective S&P 500 Sector Indices.

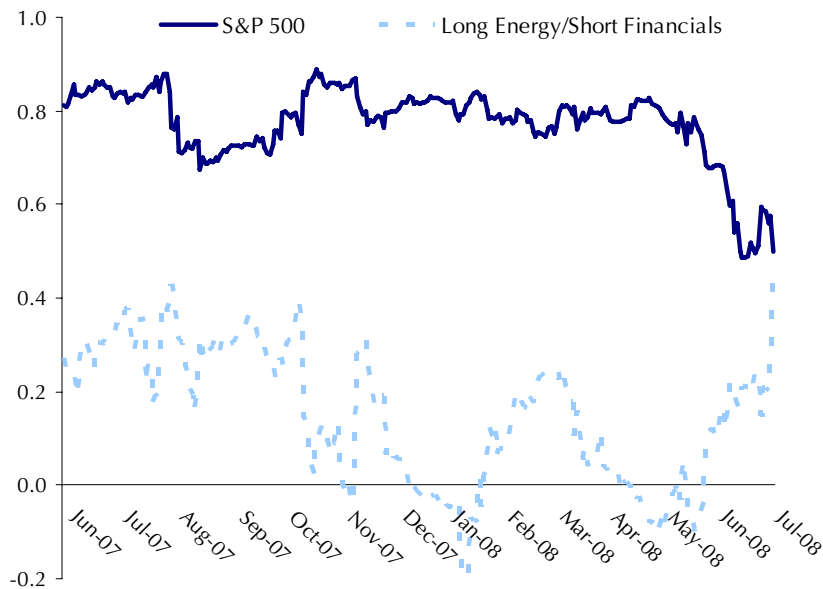
Exhibit 2: Average Short Interest Ratio of Financials and Energy Stocks



Source: Bloomberg

Since the beginning of 2008, the short interest ratio for financials stocks has risen considerably, while the ratio for energy stocks has stayed flat. This trend is largely reflective of the actions of hedge funds, which are the dominant players in the shorting business. Moreover, this trend is showing up in hedge fund returns. Exhibit 2 shows the 20-day rolling correlations of the HFRX Equity Hedge Index² returns with both the returns to the S&P 500 and the returns to a simple strategy that buys energy stocks and shorts financials.

Exhibit 3: 20-Day Rolling Correlations of Equity Long/Short Hedge Funds with the S&P 500 and a Long Energy/Short Financials Strategy



Source: HFR, Bloomberg

² The HFRX index was used because it is updated daily. The same analysis was conducted using the HFRI monthly index returns, yielding similar results.

As shown above, in recent weeks hedge funds have exhibited less correlation with equity markets as a whole, but higher correlation with a portfolio that is long energy and short financials. A similar result was observed for a simple strategy of being long consumer staples and short consumer discretionary – a typical positioning going into a recession.

Executed properly, and with a degree of luck, sector or market timing tactics can be very beneficial to investors in equity long/short hedge funds. However, high fees demand that managers seek a more sustainable and dependable source of excess returns by conducting extensive due diligence on individual companies. The analysis above reveals nothing about the ability of hedge funds to do so, but past results indicate that the best managers have earned positive alpha consistently over time. Going forward, as the markets slowly return to normalcy, Cliffwater expects that these funds will be in an even better position to outperform their peers.

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