

Hedge Fund Market Commentary – February/March 2008

The reinforcing cycle of deleveraging and asset deflation proved especially vicious in March, almost taking down Bear Stearns in a classic “run on the bank.” Even Lehman Brothers and Merrill Lynch seemed just a few rumors away from collapse, as the threat of a systemwide breakdown prompted swift action by the Federal Reserve to engineer the purchase of Bear Stearns by JP Morgan and to add liquidity to a panicked marketplace. Major asset classes largely recovered from their mid-month lows, so that overall March returns, shown in Exhibit 1 below, disguised significant intra-month market volatility.

The credit contraction at the heart of the economic slowdown continued to rattle U.S. equity markets and many sectors of the fixed income markets, driving capital to the safety of Treasuries, which are up 4.4% year-to-date. At the same time, surging commodity prices (up 12.3% in February alone) combined with more worrying economic news prompted a revival of the long-dormant term “stagflation.” This may limit the Fed’s ability to continue to lower interest rates, clouding the outlook for a recovery.

Exhibit 1: 2008 Market Performance

Index	March	February	January	Year to Date
DJ Wilshire 5000	-0.69%	-3.02%	-6.05%	-9.52%
MSCI EAFE	-1.00%	1.52%	-9.20%	-8.82%
MSCI Emerging Mkts	-5.16%	7.31%	-12.53%	-10.99%
DJ Wilshire REIT	6.65%	-3.77%	-0.48%	2.14%
Lehman Aggregate	0.34%	0.14%	1.68%	2.17%
Lehman Treasuries	0.69%	1.14%	2.54%	4.43%
Lehman High Yield	-0.34%	-1.36%	-1.33%	-3.02%
Lehman Bank Loan	-0.06%	-2.15%	-3.45%	-5.57%
Lehman Municipals	2.86%	-4.58%	1.26%	-0.61%
Libor	0.28%	0.25%	0.38%	0.92%
DJ AIG Commodity	-5.27%	12.28%	4.23%	10.92%
HFR1 Fund Weighted ¹	-2.00%*	1.86%	-2.59%	-2.77%*

* 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.

We can now begin to say with some confidence that the subprime crisis that began in 2007 is taking on proportions of size and duration that rival many past periods of market distress. Exhibit 2 compares market returns experienced in the current subprime crisis with returns during four prior “stress test” periods.

Exhibit 2: Market Performance during Modern Financial Crises
(Returns are not annualized)

Period	Start Date ¹	End Date ²	# of Months	S&P 500	EAFE	EM Equities ³	Lehman Agg	High Yield	Lev Loan	Hedge Funds ⁴
'07-'08 Subprime	May-07	Mar-08	10	-12.2%	-8.4%	10.5%	7.9%	-5.7%	-6.8%	-1.0%
'00-'02 Internet Bubble	Dec-99	Dec-02	36	-37.6%	-43.3%	-36.8%	33.5%	-2.2%	8.9%	8.1%
'98 Asian Crisis	Jul-98	Aug-98	1	-14.5%	-12.4%	-28.9%	1.6%	-5.5%	0.2%	-7.5%
'94 Fed Rate hikes	Jan-94	Apr-94	3	-5.8%	-0.5%	-12.5%	-4.9%	-4.7%	1.9%	-5.6%
'87 Crash	Sep-87	Nov-87	2	-28.0%	-13.2%	-32.1%	4.4%	-0.5%	NA	-3.4%

¹ Month end

² The end date for the Subprime Crisis is not yet known so data is shown through March 31, 2008.

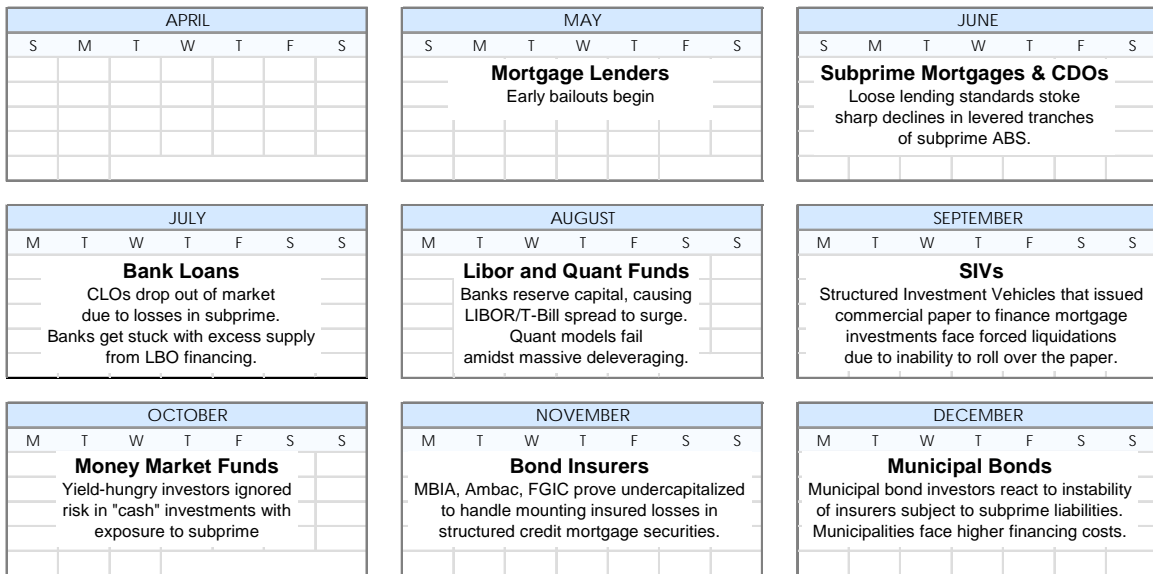
³ Returns prior to 1988 are from S&P/IFC. Returns since 1988 are from MSCI.

⁴ Returns prior to 1990 are from Hedgefund.net. Returns since 1990 are from HFRI.

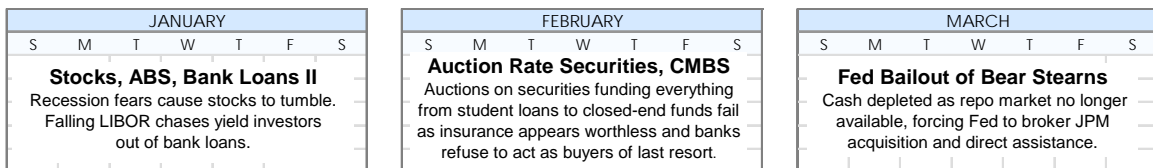
The subprime crisis has now lasted 10 months, longer than three of the four prior crisis periods. Exhibit 3 shows a calendar of how the initial subprime collapse in early 2007 created a series of subsequent market disruptions, mostly in the different terrains of the credit markets, that led up to the remarkable bailout of Bear Stearns in March.

Exhibit 3: Timeline of the Subprime Contagion

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While the subprime story may not yet be over, some noticeable characteristics are now taking shape.

Hedge funds, though shaken by the market turmoil, have managed to preserve most of their capital, falling -1.0% over the 10 month period. This compares favorably to the '98 Asian Crisis, when hedge funds fell -7.5% in just one month, as well as to the short lived 1994 Fed Crisis and 1987 Crash when hedge funds fell -5.6% and -3.4%, respectively. However, while hedge funds

recovered relatively quickly from those past crises, the current subprime crisis has been protracted and has gotten worse as it goes along.

The strength of the emerging equity markets is another remarkable difference in this current crisis. Emerging markets, said to catch a cold when the developed markets sneeze, have thus far performed well above expectations, up 10.5% since the current crisis began compared to returns of -12.2% and -8.4%, respectively, for the S&P 500 and EAFE Indices.

At the other end of the spectrum, the leveraged bank loan market has received an unusual beating compared to past crises. This is undoubtedly due to their role in CDO vehicles which have made them particularly vulnerable as financial institutions deleverage. A source of capital preservation in past crises, the leveraged bank loan market has fallen -6.8% over the past 10 months.

Finally, as capital has flowed out of risky assets, it has boosted returns in the safer segments of the fixed income market, as represented by the 7.9% return for the Lehman Aggregate Bond Index. This behavior is typical of most crisis periods, with the exception of 1994 when a series of unexpected interest rate hikes by the Federal Reserve caused bond prices to fall.

A comparison of the five crisis periods demonstrates that no single asset class has been able to consistently protect capital. That being true, the best investment strategy is diversification.

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