

## Hedge Fund Market Commentary – Mid December 2008

Discouraging news continued to unfold in November and December:

- a. Unemployment accelerated to 6.5% in October and rose again in November to 6.7%, a 15 year high. Economists expect unemployment to peak at 8.4%.
- b. U.S. retail sales took a record 2.8% drop in October and fell another 1.8% in November.
- c. Home starts fell 4.5% in October, worse than the 3.0% drop in September.
- d. Mortgage delinquencies rose to 10% (1 in 10 mortgages) at the end of September, a record. Subprime delinquencies, including foreclosures, reached 33% at the end of September
- e. Year-over-year U.S. auto sales dropped 32% in October to 838,000 and fell 37% in November to 747,000. By comparison, auto executives in Washington were basing their restructuring plans on annual sales of 11 million (917,000 per month).
- f. CPI fell 1.0% in October and a record 1.7% in November.
- g. Home prices dropped 3.4% in the third quarter, 11.9% for the trailing nine months.
- h. The NBER announced the U.S. recession started a year ago. Economists expect it to end in mid 2009.
- i. The Federal Reserve had to rescue Citicorp by investing an additional \$20 billion (on top of the \$15 billion original TARP investment) and guaranteeing \$300 billion in troubled balance sheet assets.
- j. Wall Street executives were denied year-end bonuses.

It is now becoming clear that the scale of the recession will likely be proportional to the magnitude of events leading up to it, but hopefully not worse. Exhibit 1 reports major market index returns for periods ending Monday, December 15, 2008.

Exhibit 1: 2008 Market Performance through December 15, 2008

Index	Dec MTD*	November	October	FYTD	CYTD
DJ Wilshire 5000	-3.1%	-8.0%	-17.6%	-32.9%	-40.2%
S&P 500	-3.0%	-7.2%	-16.8%	-31.3%	-39.5%
Russell 2000	-4.3%	-11.8%	-20.8%	-33.9%	-40.1%
MSCI EAFE	3.9%	-5.4%	-20.2%	-37.9%	-44.2%
MSCI Emerging Mkts	6.8%	-7.6%	-27.4%	-47.7%	-53.9%
DJ Wilshire REIT	2.0%	-24.6%	-32.4%	-37.8%	-47.3%
S&P 500 Financials	-6.1%	-18.5%	-21.9%	-40.1%	-57.9%
Lehman Aggregate	2.0%	3.3%	-2.4%	2.4%	3.5%
Lehman Treasuries	2.3%	5.3%	-0.1%	10.1%	12.6%
Lehman High Yield	-2.7%	-9.3%	-15.9%	-32.4%	-33.3%
Lehman Bank Loan	-5.5%	-8.2%	-15.2%	-30.9%	-31.3%
Lehman Municipals	-3.1%	0.3%	-1.4%	-6.8%	-6.8%
AAA ABX (Subprime)	-7.4%	-22.3%	-10.9%	-36.3%	-49.2%
Libor	0.2%	0.2%	0.3%	1.4%	3.1%
DJ AIG Commodity	-7.3%	-7.0%	-21.3%	-50.9%	-42.0%
HFRF Fund of Funds***	-0.7%	-1.9%	-6.0%	-17.1%	-20.0%

\* Through Dec 15

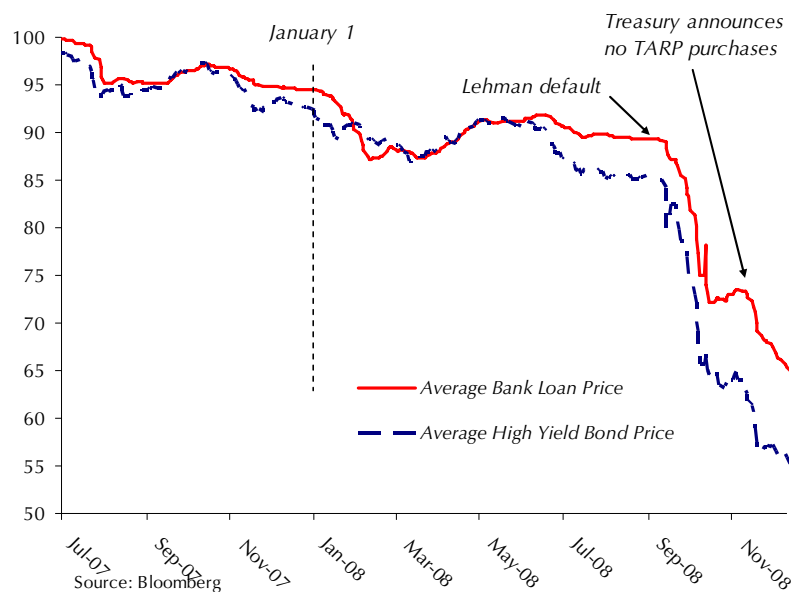
\*\* From June 30

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Equity markets, hopeful for the “not worse” scenario, outperformed credit markets, which have fallen sharply across multiple sectors. The US Treasury announcement on November 17<sup>th</sup> not to use TARP money to buy “toxic assets” from financial institutions caught debt investors by surprise and pushed mortgage debt to new lows. Banks that had been hoping to sell assets to the government through TARP on generous terms were instead compelled to seek open market bids for their mortgage assets, including securities and whole loans. The confusion and erosion of faith surrounding the Treasury’s announcement also added to the downward pressure on other segments of the credit markets. As of December 15, high yield bonds, bank loans, and AAA subprime mortgage securities sell for 55¢, 65¢, and 44¢ cents on the dollar, respectively. A massive amount of capital shifted away from credit risk and to the relative safety of Treasuries. The yield on three month T-bills fell below zero for the first time ever and Treasuries have returned 8% in just over six weeks. Ironically, the reaction to the TARP revision has helped to lower the borrowing costs to the Treasury of implementing its bailout measures. Hopefully this will further stimulate government action.

Exhibit 2 tracks the recent history of corporate credit prices.

Exhibit 2: Bank Loan and High Yield Bond Prices

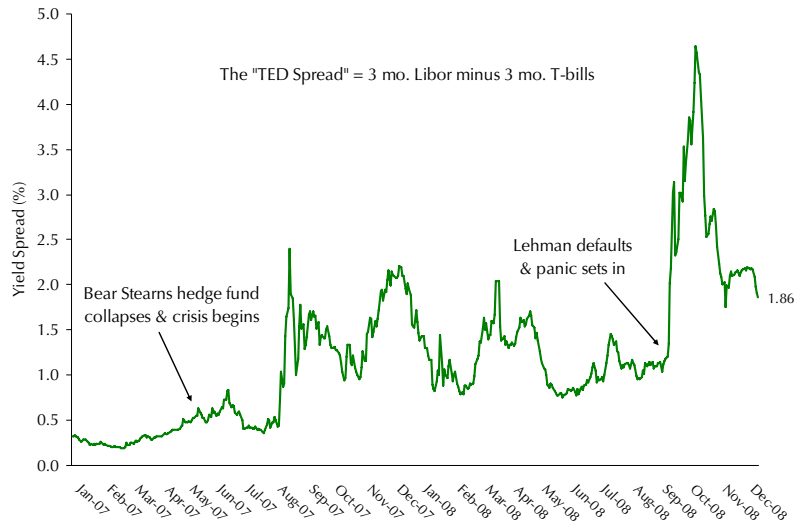


The trend shown in Exhibit 2 reflects more than technical pressures. Credit fundamentals are deteriorating as the economy weakens. Bankruptcies are up considerably from a year ago.

The good news is that the “TED spread”, while still well above the historical level of 0.25%, has stabilized at pre-Lehman default levels and is creeping downward, as shown in Exhibit 3.<sup>1</sup> The bad news is that there is still a dearth of capital being lent by banks. Excess reserves at banks rose to \$559 billion at the end of November, compared with about \$2 billion a year earlier. Much of this money has come directly from TARP.

<sup>1</sup> The TED spread is the difference in yield between 3 month Libor and 3 month Treasury bills and is considered to be a key measure of a credit crisis. Libor is the rate at which large banks lend to each other and T-bill yields reflect rates that large banks lend to the U.S. Government.

Exhibit 3: Libor minus Treasury bill Yields – A Measure of Investor Confidence



The lack of available credit will not only contribute to more corporate bond defaults but could depress recovery rates as well. Typically, companies in bankruptcy depend on debtor-in-possession (“DIP”) financing to maintain operations. Without this capital, the value of companies’ assets could suffer considerably in bankruptcy, leading to lower payouts to creditors.

Hedge funds are generally skilled at navigating through the maze of fundamental risks associated with debt and equity investments. But the overwhelming technicals of contraction and deleveraging have caused major headaches for the many hedge fund managers that find these instruments fundamentally attractive. This has been particularly true for credit strategies, which once again underperformed other hedge fund strategies as a result of the continued unwinding of leverage and falling bids on increasingly illiquid debt securities. While November’s loss of -1.9% for the HFRI Fund of Funds Index was modest by recent standards, it adds to a string of negative months causing the longest sustained drawdown in the history of the industry.

Exhibit 4: Hedge Fund Performance during Current and Past Financial Crises

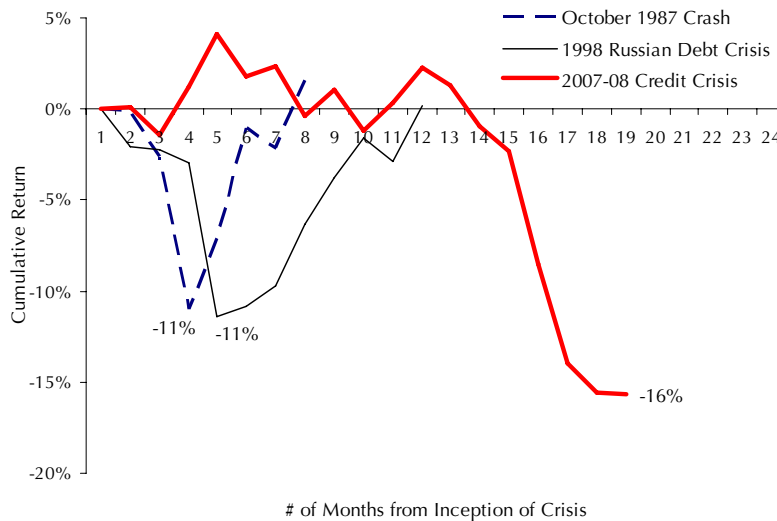
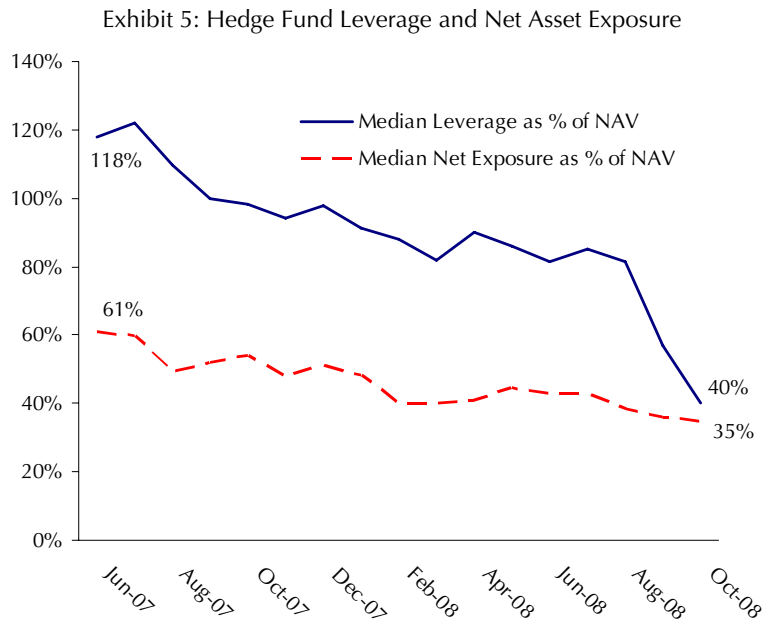


Exhibit 4 plots hedge fund performance during the current crisis and compares it to hedge fund performance during two prior crises – the October 1987 stock market crash and the 1998 Russian

Debt Crisis – which were the worst on record for hedge funds until now. The current 16% drawdown is now more severe than the two earlier 11% hedge fund drawdowns.

Concurrent with the declining hedge fund returns is a reduction in their use of leverage. Exhibit 5 plots median leverage<sup>2</sup> levels for a representative sample of over 300 hedge funds from June 2007 through October 2008.



The decline in hedge fund leverage has been most pronounced in September and October. As of the end of October, 25% 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 increased by almost a factor of three in the last 12 months.

It would be easy to pick on hedge funds and conclude that their own selling has led to their underperformance. While partly true, this conclusion would ignore the disappearance of massive amounts of capital from commercial banks, proprietary trading desks, producers, consumers, and other influential agents in the markets and economy. We believe that the imbalance between capital needed and capital available will eventually, if slowly, resolve.

As it does, hedge funds should once again be able to earn rewards from their fundamental research. They demonstrated this with their strong performance following the collapse of the Internet bubble. For example, equity hedge funds outperformed the market on the downside by shorting companies with flawed business models. Distressed debt funds then stepped in to earn outsized rewards on the upside by identifying profitable restructuring opportunities. Through these and other examples, hedge funds have shown that when they take measured risks that others are unwilling to pursue, their investors benefit.

Eli Sokolov  
December 16, 2008

<sup>2</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.