CLIFFWATER LLC

Hedge Fund Market Commentary – October 2008

Stocks lost more than 25% of their value in just the last two months, something that had not occurred since the Crash of October 1987. It could have been much worse. At their lowest point on October 27th, stocks were down 41% year-to-date, matching the second (1973-74) and third (2000-02) largest stock market drawdowns ever. An 18% stock rally over the last 4 days of October lessened the blow. And we hope that the coming recession will not cause stocks to test the 83% stock drawdown that occurred during the Great Depression.

Exhibit 1 shows 2008 performance for the global stock, bond and commodity indices through October.

Exhibit 1: 2008 Market Performance

Index	October	September	FYTD*	CYTD**
S&P 500	-16.80%	-9.04%	-23.76%	-32.84%
Russell 2000	-20.80%	-7.97%	-27.35%	-34.16%
MSCI EAFE	-20.17%	-14.42%	-36.84%	-43.25%
MSCI Emerging Mkts	-27.38%	-17.53%	-47.00%	-53.27%
DJ Wilshire REIT	-32.38%	-0.42%	-19.20%	-31.54%
S&P 500 Financials	-21.92%	-6.36%	-21.69%	-44.97%
Lehman Aggregate	-2.36%	-1.34%	-2.83%	-1.73%
Lehman Treasuries	-0.11%	0.61%	2.19%	4.47%
Lehman High Yield	-15.91%	-7.98%	-23.38%	-24.38%
Lehman Bank Loan	-15.22%	-5.90%	-20.45%	-20.86%
AAA ABX (Subprime)	-10.90%	2.92%	-11.52%	-29.42%
Libor	0.34%	0.23%	1.27%	2.88%
DJ AIG Commodity	-21.28%	-11.53%	-43.09%	-27.59%
HFRI Fund of Funds	-7.27%	-6.33%	-16.68%	-18.74%

* FYTD - fiscal year to date assuming June 30 start
** CYTD = calendar year to date
*** 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.

The market declines turned severe on September 15th. That was when the U.S. Government failed to save Lehman, which filed for bankruptcy and is now in liquidation. The financial panic that followed even compromised the safety of money market fund assets. The Fed and Treasury quickly recognized the mistake they made with Lehman and took several actions to lessen the damage and restore order to the credit markets. But it took until October 27th before the stock and credit markets stabilized. That was the date the U.S. Treasury announced that $125 billion of the $700 billion TARP (Troubled Assets Relief Program) bailout plan passed by Congress on October 7th would be invested directly in the largest nine remaining commercial and investment banks. The markets seemed to gain some trust that the Government could successfully manage the credit crisis.

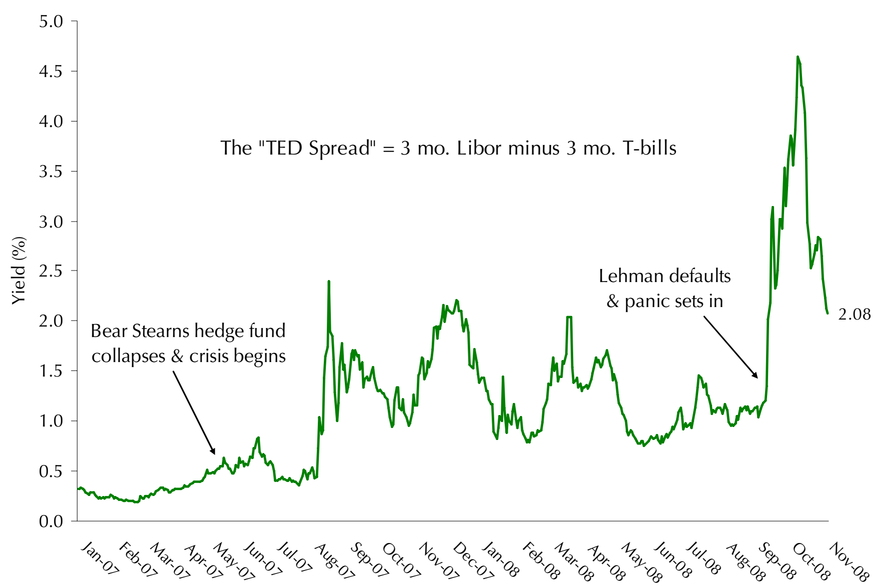
The difference in yield between 3 month Libor and 3 month Treasury bills is considered by most to be the best measure of a credit crisis. Libor is the rate at which large banks lend to each other and T-Bill rates are the rates at which large banks lend to the U.S. Government. Historically, the difference between 3 month Libor and 3 month Treasuries has been a very modest 0.25%, reflecting the high degree of confidence investors have placed in the creditworthiness of the private banking

Marina Towers • 4640 Admiralty Way, Suite 1101 • Marina del Rey • CA 90292-6623
Voice 310.448.5000 • Facsimile 310.448.5001

system. This difference in yields is often referred to as the "TED spread." As Exhibit 2 shows, the TED spread moved off its 0.25% "normal" level after the credit crisis began in June 2007, when a Bear Stearns hedge fund collapsed due to a large exposure to subprime mortgages. Over the next year the TED spread fluctuated at historically high levels - between 1% and 2% - as the crisis spread to other credit markets, including bank loans, SIVs, auction rate notes, municipal bonds, prime mortgages, and money market instruments. Large investment and commercial banks suffered unprecedented losses, and the U.S. Treasury and Federal Reserve took action to prevent the failures of Bear Stearns, Fannie Mae and Freddie Mac.

But after Lehman was allowed to default, investor panic pushed the TED spread up to 4.5%, a level it had never reached before. The volume of lending plummeted as well. Swift action by the world's governments to flood the markets with money and implement TARP-like bailout plans brought some liquidity back to the credit markets and the TED spread fell from record panic levels back to lower, but still high, crisis levels.

Exhibit 2: Libor minus Treasury bill Yields – A Measure of Investor Confidence

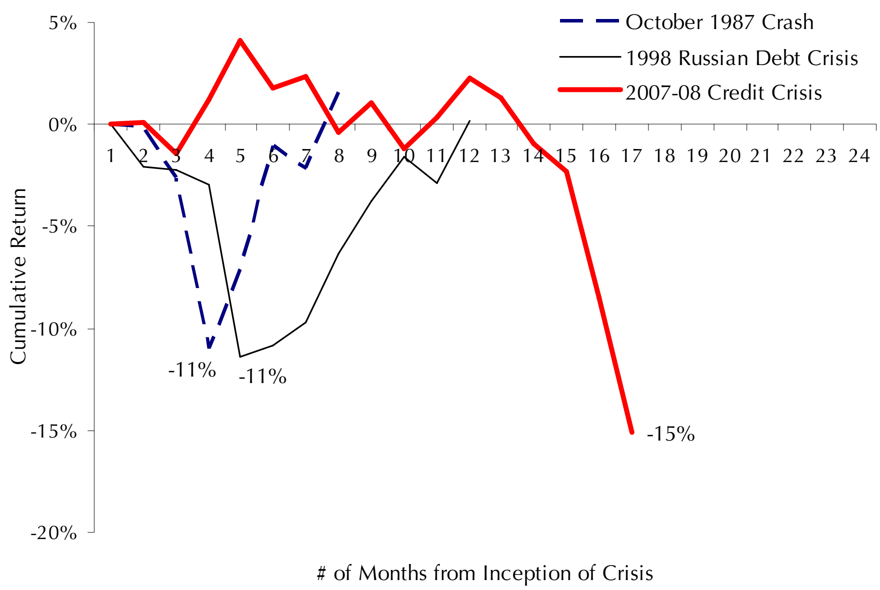


The good news is that as we enter November the TED spread continues to inch downward, suggesting that the credit markets are slowly healing. The bad news, particularly for the global stock markets, is the depth and length of the unfolding recession. As we have previously written, past recessions have been largely driven by business spending. This recession is driven by a fall off in consumer spending, so charting its future path is more difficult.

Hedge funds did well to preserve capital during the credit crisis until September. During the Sept-Oct months the HFRI Fund of Funds Index fell roughly 13%, its worst drawdown ever. Granted, these hedge fund losses were less than the 24% two-month drop in the S&P 500 Index, but will undoubtedly serve to undermine the idea that hedge funds are "absolute return" vehicles. Exhibit 3 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, until now, the worst on record for hedge funds.

As Exhibit 3 shows, hedge funds fell roughly 11% during their two most serious historical declines. Fortunately, hedge funds recovered as quickly as they declined, in a matter of a few months. The current 15% hedge fund drawdown was equally as fast, once it began, and is somewhat more severe. A quick recovery is possible and would be consistent with the past. However, this time around redemptions are expected to be considerably higher, which may dampen a recovery.

Exhibit 3: Hedge Fund Performance during Current and Past Financial Crises



Why are hedge funds overall performing so poorly? Industry "contraction" is the common denominator to several investment themes that are adversely affecting most hedge funds. Hedge funds are often cited as benefiting the markets by providing liquidity and price discovery. This argument holds true when hedge funds have a growing asset base to invest. However, in September and October hedge funds began to sell assets in massive amounts to meet investor redemptions and broker margin calls, and to reduce portfolio risk. The contraction was not limited to hedge funds. Proprietary trading desks at major investment banks, that often execute strategies similar to hedge funds, scaled back or were shut down completely. This resulted in the indiscriminate selling of billions of dollars in assets.

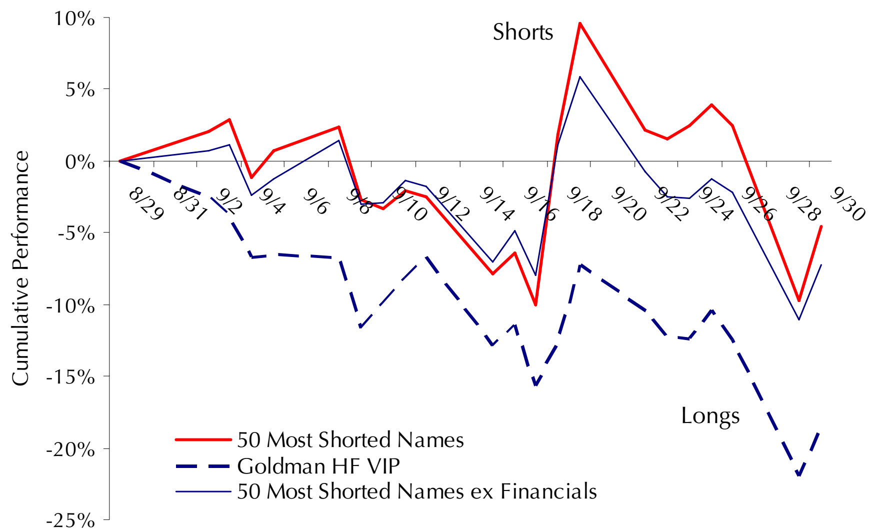
The collective "unwind" by hedge funds and others contributed to a drying up of liquidity and caused highly erratic pricing. Those funds which were unleveraged or had enough cash to meet margin calls could sustain these "mark-to-market" hits. However, many other funds were forced to cover their shorts or sell their leveraged long positions, locking in losses. Examples drawn from the performance of three hedge fund strategies – equity long/short, event driven, and credit – illustrate the impact of this contraction on hedge fund performance.

Our first example is equity long/short hedge funds, who suffered disappointing performance in September. Collectively, equity long/short funds fell over 8% that month, barely outperforming the 9% drop in the S&P 500 Index despite relatively low gross and net asset exposures entering the month. In fact, the average equity long/short fund had far less than a 50% net exposure going into September, suggesting an expected loss in the low to mid single digits.

Exhibit 4 helps explain why performance ended up worse than expected. It plots performance for the top 50 names held long by hedge funds (represented by the Goldman Sachs Hedge Fund VIP

Index) versus the performance of the 50 most shorted large cap stocks[1]. The most shorted names are determined by taking the 50 stocks with the greatest outstanding float held short as a percent of total float. While this measure does not isolate short positions of hedge funds versus other investors, it is recognized as a reasonable proxy for the top short positions held by hedge funds.

Exhibit 4: Performance of Top Long versus Top Short Positions



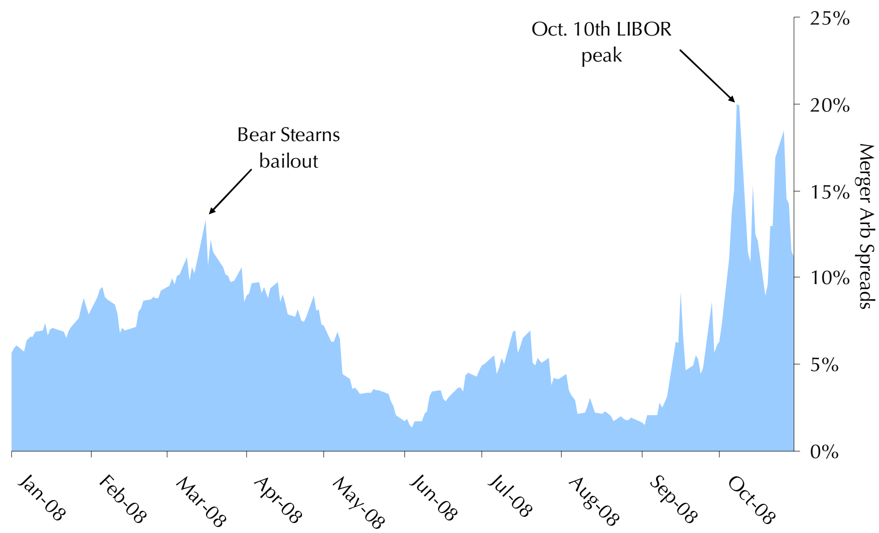
Source: Goldman Sachs, Bloomberg

Ideally, returns for short positions should be negative and returns for long positions should be positive. Second best is having the long positions doing better than the short positions. During September, the top short positions significantly outperformed the large long positions, gaining a 14% cumulative advantage by the end of September. The gap widened substantially on September 16th when the short ban was instituted on financial stocks, creating an artificial short squeeze in the banned stocks. The impact of the short ban was not limited to stocks on the banned list. To demonstrate this we also show the performance of the top 50 shorted names, excluding the 799 names on the banned list. The gap in this portfolio's performance relative to the VIP Index is nearly as large. This gap resulted from a significant unwinding of positions held in common by numerous hedge funds, and resulted in prices with little grounding in fundamental values. The gap narrowed in October, somewhat helping hedge funds, but not enough to overcome a much sharper decline in the market.

Our second example comes from the event driven category. Exhibit 5 plots average return spreads (acquisition price minus current price, divided by current price) for merger candidates during 2008. During September and October merger arbitrage spreads widened to near historic levels. In part this widening was due to many newly announced deals and legitimate fear that the falling economy would sabotage many expected acquisitions. However, spread widening occurred even in deals that had cleared regulatory and other structural hurdles, suggesting indiscriminate selling by market participants.

[1] The most shorted names are determined based on the percent of equity float held short.

Exhibit 5: Merger Arbitrage Spreads (deal size > $500m)



Source: Bloomberg

As severe as the losses were for funds generally, credit-oriented funds, our last example, suffered the most damage over the last two months. September was difficult for them, but it was not until October that the bottom truly dropped out. Two of the most striking examples of this were in bank debt and convertible bonds.

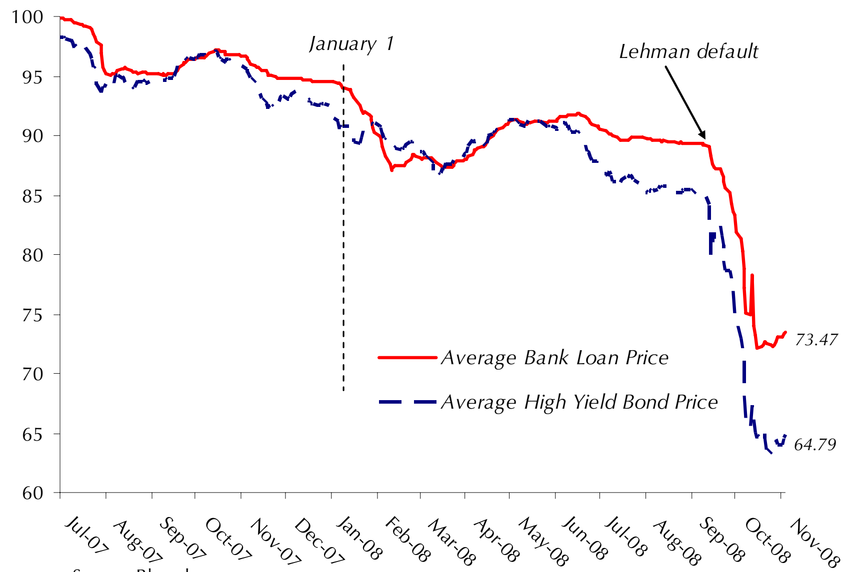
Traditional credit hedge funds had largely moved away from subordinated high yield bonds over the last few months and into senior, secured bank debt. In large part this was done to take advantage of what had been historically low prices on bank loans originated from LBO transactions and held by investment banks. Given the greater protection afforded by the senior positioning in the capital structure, and the tendency of bank loans to trade in a narrow range around par, many hedge funds felt comfortable using some leverage to purchase these senior bank loans. Unfortunately, this thinking proved to be incorrect because in the weeks following the Lehman default bank loan prices fell from the high 80s (par = 100) to the low 70s, driven down by growing need by all market participants to raise cash and the recognition that to do so required massive de-leveraging that could only be achieved by selling the most liquid assets, including bank loans.

Falling bank loan and bond prices in September led first to margin calls on the most levered of funds, creating further downward pressure on the market which led to the next round of de-leveraging, and so on, until prices dropped far enough to clear the weakest participants from the market.

Exhibit 6 shows the decline in the average price for bank loans held widely by hedge funds and other leveraged vehicles for the period June 30, 2007, when the credit crisis began, to November 5, 2008. Through the crisis bank loan and high yield bond prices traded down 10% to the low 90s and high 80s. After the Lehman default, bank loan prices cratered another 15 points (20%) and high yield bond prices fell 20 points (26%). At those price drops any leverage can be catastrophic.

Many credit managers do hedge some of their risk by buying default protection (buying CDX, LCDX is the same as shorting credit) on individual bonds or loans, or credit indices. Compounding the problems for credit hedge funds, the CDX index, which is widely used as a hedge against credit market deterioration, outperformed both loans and bonds, making hedging less effective.

Exhibit 6: Bank Loan and High Yield Bond Prices



Source: Bloomberg

The vicious de-leveraging cycle played out in the convertible bond market as well, where hedge funds execute arbitrage trades, buying the convertible bonds and shorting equities, to take advantage of mispricings in the conversion value of the bonds. Three major factors contributed to losses in these funds. First, many of the convertible bonds were in the financial sector. The ban on new equity shorting forced many funds to unwind their bond positions as they could no longer maintain their hedges. Second, falling stock prices depressed the prices of the bonds. The third and most damaging factor was that lines of credit allotted to these funds, most of which use significant leverage, were pulled, creating additional massive forced selling. As a result of all of these pressures, convertible arbitrage hedge funds fell almost 12% in September and 20% in October.

The best prognosis we can offer to investors exasperated by continued declines is that the contraction in hedge fund assets will end. The trends contributing to contraction – redemptions, deleveraging, and defensiveness – will give way to capital eager to take advantage of the unfolding value-rich environment. First, funds have largely prepared for expected redemptions, by both raising cash and executing their rights to limit redemptions to a fixed percentage of assets. These "gate provisions" are common in the industry, and are designed to protect investors from forced selling of assets into a distressed market. Also, much of the preexisting leverage has been significantly scaled back, and exposures have dropped to among the lowest levels in history. Lastly, some of the external threats to hedge funds have eased as central banks have acted to restore liquidity to the remaining investment banks.

Looking forward, hedge funds largely remain defensive, and will likely be slow in deploying the cash amidst a bleak economic environment. However, fewer assets chasing an ever growing set of opportunities should prove very beneficial to the industry and its investors over the next few years.

Eli Sokolov
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