

Hedge Fund Market Commentary – March 2009

After revisiting 12 year lows, the markets surged in the final three weeks of March, responding positively to a number of events. A combination of multiple government programs designed to ease the housing crisis and restore liquidity contributed to the optimism. So too did the slowdown in some of the negative economic trends witnessed in the 4th quarter of 2008. Capital flowed into multiple markets, with equity and credit securities moving up in price. Financials benefitted disproportionately, climbing 18%, following the easing of fears that more major banks, including Citibank, would collapse. Exhibit 1 below provides returns to major asset classes.

Exhibit 1: 2009 Market Performance

Index	March	YTD 2009	FYTD*	Calendar 2008
Equity				
DJ Wilshire 5000	8.7%	-10.6%	-37.0%	-37.2%
S&P 500	8.8%	-11.0%	-36.4%	-37.0%
Russell 2000	8.9%	-14.9%	-37.9%	-33.8%
MSCI EAFE	6.4%	-13.9%	-45.4%	-43.1%
MSCI Emerging Mkts	14.3%	0.7%	-46.9%	-53.5%
DJ Wilshire REIT	3.2%	-33.9%	-52.6%	-39.2%
S&P 500 Financials	17.9%	-28.8%	-56.0%	-56.6%
Fixed Income				
Barclays Aggregate	1.4%	0.1%	4.2%	5.2%
Barclays Treasuries	2.2%	-1.3%	15.9%	20.1%
Barclays TIPS	5.8%	5.5%	15.7%	-2.4%
Barclays High Yield	3.2%	4.9%	-21.5%	-26.2%
Barclays Bank Loan	2.0%	9.5%	-22.4%	-29.5%
AAA ABX (Subprime)	-24.1%	-25.5%	-57.9%	-43.2%
Barclays Municipals	0.0%	4.2%	1.6%	-2.5%
3 mo.Libor	0.1%	0.3%	1.8%	3.1%
Alternative				
DJ AIG Commodity	3.6%	-6.3%	-52.6%	-35.7%
HFRI Fund of Funds**	0.0%	0.5%	-19.1%	-21.4%
HFRI Fund Weighted**	1.8%	0.5%	-17.5%	-19.0%

* Fiscal YTD from June 30, 2008

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Hedge funds returns were generally flat for March. The HFRI Fund of Funds Index, a more reliable index of institutional hedge fund performance, returned -0.01% for the month. The HFRI Fund Weighted Index reported a 1.8% return for the month. This equal weighted index of all hedge funds has an almost 60% weighting to equity long/short managers, which were up 3.4% as a group in March. The HFRI Fund Weighted Index return is often revised downward as lower return funds tend to report with a lag.

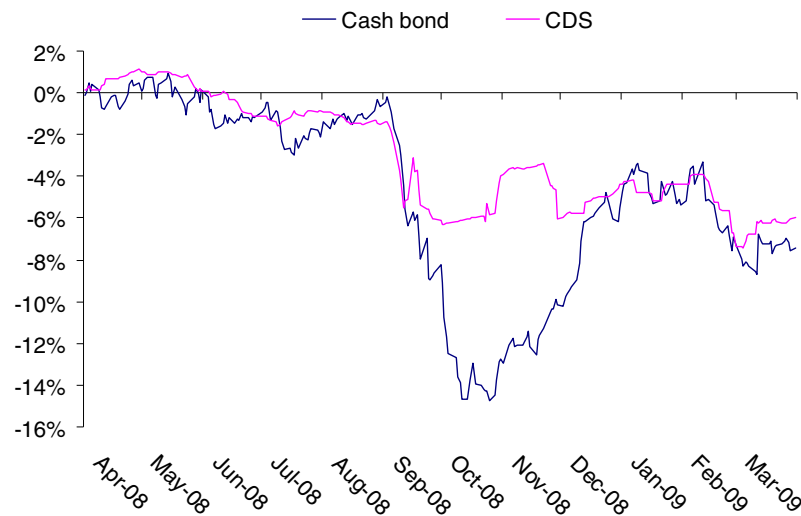
The HFRI Fund of Funds Index returned 0.5% and equity long/short funds returned 0.4% for the first quarter, far better than the -11.0% return for the S&P 500 Index. The capital protection characteristic expected from hedge funds has apparently returned after many missteps in 2008. Much of this improved risk control is attributable to a general reduction in hedge fund leverage – 45% of hedge funds are now unlevered – and larger cash positions.

One of the better performing hedge fund strategies in 2009 has been “relative value,” which is up 4.7% for the year. Many of the funds in this category invest in credit markets, attempting to earn returns that are independent of market direction. Among the tactics they employ is to invest long in one bond and short in another from the same issuer, where the bonds have different priority in the capital structure or maturity dates. Another tactic involves targeting mispricing in bonds that have embedded options.

A key component to fixed income relative value strategies is the use of credit default swaps (“CDS”) to gain short exposure to bonds. This market operates differently than the cash bond market, as it is contractually based rather than dependent on an exchange of cash for securities. The underlying economics and payout profiles differ between the cash bond market and the CDS market. However, they are designed to closely track each other under normal conditions. A deleveraging event, such as the one in the 4th quarter of 2008, can cause significant distortions in the cash bond-CDS relationship, particularly because most of the strategies that invest in both markets have historically used significant leverage.

Exhibit 2 shows the performance of the cash and CDS markets for investment grade corporate bonds since April of 2008. Beginning in September of 2008, amidst the collapse of Lehman Brothers and the subsequent rush to reduce credit risk, the investment grade cash bond market significantly underperformed the CDS market, as the unwinding of relative value positions put opposite pressures on the two markets.

Exhibit 2: Relative Performance of Investment Grade Corporate Bonds and CDS



Source: Barclays

A more pronounced effect took place in the high yield and convertible bond markets, where most of the leverage was being deployed. In 2009, much of the mispricing reversed. The so-called “basis trade,” which involves the purchase of a bond and the shorting of that bond through the CDS market, has become very profitable for fixed income relative value funds, particularly those that focus on convertible bonds.

Eli Sokolov
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