

## Hedge Fund Market Commentary – May 2008

Investors continued in May to reverse the market trends that led up to the Bear Stearns collapse in March. Despite high oil prices and mixed economic news, equities and corporate debt generated positive returns, while Treasuries dropped by over 1%. Investors however were less bullish than they were in April – U.S. equities returned about 2% in May compared to almost 5% in April. The rally in May was also not as broad. In a sign that many still believe the credit crisis is ongoing, U.S. financial stocks declined roughly 6%. Early indications in June suggest that these investors may be right. Asian and Pacific stocks also underperformed. Exhibit 1 highlights the recent returns to major market indices.

Exhibit 1: 2008 Market Performance

Index	May	April	Year to Date
DJ Wilshire 5000	2.09%	4.97%	-3.04%
MSCI EAFE	1.16%	5.56%	-2.64%
MSCI Emerging Mkts	1.85%	8.10%	-2.01%
DJ Wilshire REIT	0.23%	6.16%	8.68%
S&P 500 Financials	-6.09%	6.54%	-13.91%
Lehman Aggregate	-0.73%	0.33%	1.21%
Lehman Treasuries	-1.17%	-1.72%	1.43%
Lehman High Yield	0.36%	4.31%	1.53%
Lehman Bank Loan	0.89%	4.14%	-0.78%
Lehman Municipals	0.61%	1.17%	1.16%
AAA ABX (Subprime)	-6.87%	10.87%	-10.55%
Libor	0.23%	0.22%	1.37%
DJ AIG Commodity	2.73%	3.56%	16.61%
HFRI Fund Weighted <sup>1</sup>	2.11%*	1.56%	0.13%*

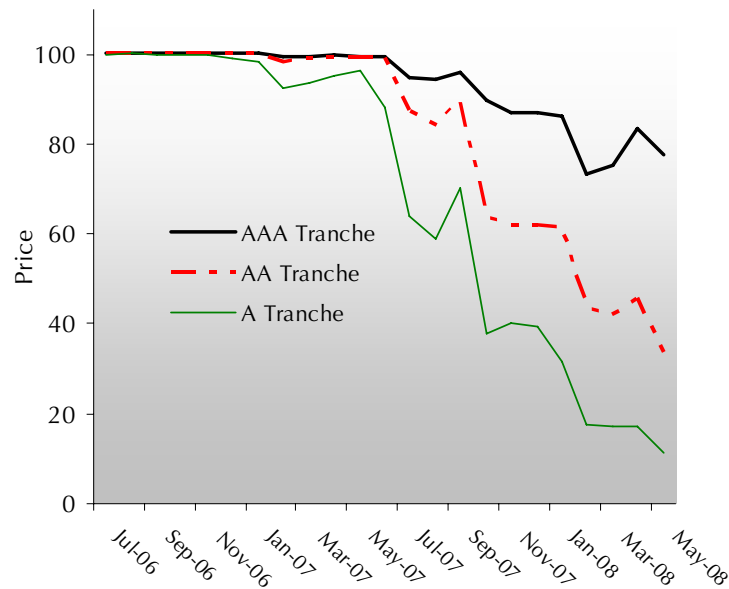
\* Initial Estimate

<sup>1</sup> 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.

Another sector that fell in May was the mortgage market. Some time has passed since this market, which served as the initial catalyst for the credit crisis, has been at the center of discussion. However, given its relation to the overall economy, it is worth revisiting, especially since the mortgage delinquency problems that began in the subprime sector have since extended to higher credit quality prime borrowers. Subprime mortgages showed more weakness in May despite easing liquidity pressures in the credit markets. Exhibit 2 shows prices for various tranches of the July 2006 vintage ABX index. This index is comprised of a portfolio of 20 subprime mortgage securities issued during the first half of 2006. The AAA tranche traded at 78 cents on the dollar at the end of May. Assuming a pessimistic 50% recovery rate on defaulted mortgages, this price implies a default rate of over 80% on subprime mortgages backing the ABS bonds.<sup>1</sup> This staggering figure helps explain why many hedge funds feel the risks in subprime are too great, and are eyeing distressed opportunities in the less risky Alt-A, prime mortgage, and Agency MBS sectors.

<sup>1</sup> This calculation assumes a combined subordination and overcollateralization of 20% on subprime ABS.

Exhibit 2: ABX Prices for July 2006 Vintage Subprime ABS



Source: Markit

Problems in the mortgage market aside, most hedge fund strategies performed well in May, generating an estimated return of 2.11% for the month and bringing year-to-date returns above zero for the first time. Year-to-date performance still lags LIBOR by over 1%, but exceeds domestic equity markets by about 3%. Should massive illiquidity return to the credit markets, there will no doubt be more trouble for hedge funds, but many are likely to be better prepared, having established a defensive posture to avoid being “twice bitten.” This should prove beneficial to investors who look to hedge funds for capital preservation, but will necessitate an extra level of diligence to identify hedge funds poised to outperform their peers.

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