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Hedge Fund Market Overview

Markets extended their gains in December, with the S&P 500 Index returning a relatively modest 1.9% for the month and the high yield bond market rising 3.3%. Equity markets exhibited high intra-stock dispersion, with small-cap stocks surging over 8%, closing the performance gap which had persisted for most of the year. Mortgage-backed securities had a particularly strong month, as exemplified by an over 20% return to the ABX. A broader overview of recent performance across markets is shown in Exhibit 1.

Exhibit 1: 2009 Market Performance

Index	December	YTD 2009	FYTD*	Calendar 2008
Equity				
Dow Jones 5000	2.8%	28.6%	23.1%	-37.2%
S&P 500	1.9%	26.5%	22.6%	-37.0%
Russell 2000	8.1%	27.2%	23.9%	-33.8%
MSCI EAFE	1.5%	32.5%	22.2%	-43.1%
MSCI Emerging Mkts	4.0%	78.3%	31.4%	-53.5%
DJ REIT	7.0%	28.5%	47.9%	-39.2%
S&P 500 Financials	-1.5%	17.2%	21.4%	-56.6%
Fixed Income				
Barclays Aggregate	-1.6%	5.9%	4.0%	5.2%
Barclays Treasuries	-2.6%	-3.6%	0.8%	20.1%
Barclays TIPS	-2.2%	11.4%	4.9%	-2.4%
Barclays High Yield	3.3%	58.2%	21.3%	-26.2%
Barclays Bank Loan	3.1%	53.8%	14.3%	-29.5%
AAA ABX (Subprime)	23.3%	-0.6%	48.6%	-43.2%
Barclays Municipals	0.3%	12.9%	6.1%	-2.5%
3 mo.Libor	0.1%	1.1%	0.5%	3.1%
Alternative				
DJ UBS Commodity	2.0%	18.9%	13.7%	-35.7%
Hedge Funds				
HFRI Fund of Funds**	0.9%	11.6%	6.0%	-21.4%
HFRI Fund Weighted**	1.3%	20.1%	9.6%	-19.0%
CS/Tremont	0.9%	18.6%	10.6%	-19.1%

* Fiscal YTD from June 30, 2009

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Hedge funds once again performed well in December. The HFRI Fund Weighted Index was up 1.3%, while the HFRI Fund-of-Funds Index was up 0.9%. For 2009, the HFRI Fund Weighted Index gained 20.1% and the HFRI Fund-of-Funds Index returned 11.6%.

Exhibit 2 shows the performance of different hedge fund strategies, as defined by HFRI and CS/Tremont. All major strategies with the exception of global macro enjoyed positive returns for December. Macro funds, which outperformed last month, were hurt in December by falling gold prices and a large jump in long-term interest rates.

Exhibit 2: Hedge Fund Performance by Major Strategy Category

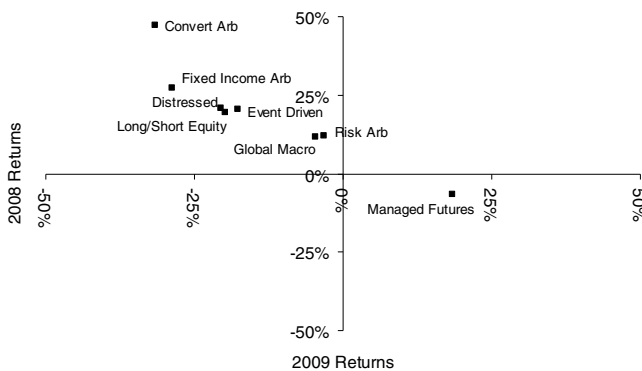
Strategy Indexes	December	YTD 2009	FYTD*	Calendar 2008
Arbitrage/Relative Value				
HFRI**	2.1%	26.0%	11.7%	-18.0%
CS/Tremont-Convert	2.2%	47.3%	18.9%	-31.6%
CS/Tremont-Fixed Income	0.8%	27.4%	13.9%	-28.8%
Event Driven				
HFRI	3.0%	25.9%	14.5%	-21.8%
CS/Tremont	2.3%	20.4%	12.9%	-17.7%
Equity Long/Short				
HFRI	2.3%	25.0%	11.5%	-26.7%
CS/Tremont	1.7%	19.5%	10.4%	-19.8%
Global Macro/CTA				
HFRI	-1.4%	4.2%	2.8%	4.8%
CS/Tremont-Macro	-1.4%	11.6%	7.9%	-4.6%
CS/Tremont-Managed Future:	-5.0%	-6.6%	0.9%	18.3%
Multi-Strategy				
HFRI	2.0%	24.4%	10.9%	-20.3%
CS/Tremont	1.2%	24.6%	11.0%	-23.6%

* Fiscal YTD from June 30, 2009

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Looking back over the last two years, a clear pattern has emerged which underscores the importance of a long-term perspective in managing portfolios of hedge funds. Specifically, any adjustments to strategy weightings after 2008 which favored the best performers over that year would have been detrimental to overall portfolio returns. As shown in Exhibit 3, the worst performing hedge fund strategies in 2008 were the best performing strategies in 2009, and vice versa.

Exhibit 3: 2008 vs. 2009 Hedge Fund Performance by Strategy



Source: Credit Suisse/Tremont

This is a pattern which investors are perhaps used to seeing in public market returns – riskier markets underperform in downturns and outperform in recoveries. Yet this explanation seems somewhat counterintuitive when discussing hedge funds, which are designed to provide alpha. However, as demonstrated in academic literature even before the 2008 credit crisis, each hedge fund strategy has unique sensitivities to a unique set of markets/factors. In a period like 2008-2009, when lines between different markets blurred as correlations tended towards one, the equation governing hedge fund returns simplified, and the number of relevant factors declined. In the most oversimplified model, strategies that by their nature were more exposed to a liquidity crisis underperformed in 2008, and outperformed in 2009 when liquidity flowed back into the markets. Were the liquidity crisis to have deepened in 2009, a strategy rotation into, for example, global macro and managed futures may have proven smart, but only in retrospect.

One should not be surprised to see a similar pattern when applying the same analysis to the universe of individual hedge funds, at least those which survived the entire two-year period. Just as each strategy has unique exposures to common market factors, so does each hedge fund, ideally with an alpha component attached. Investors should balance their portfolios among funds which underperform in certain conditions and those which outperform in similar conditions, always striving for the greatest alpha, not the greatest return.

Private Equity Market Overview

The private equity market weathered a perfect storm in 2009 as firms suffered an inability to fundraise, exit opportunities remained sparse, and deal activity slowed to low levels. While 2009 thoroughly tested the resolve

of fund managers and limited partners alike, deal activity, exits and performance in the fourth quarter improved. Market participants remain cautiously optimistic that the recent momentum in the private market will carry forward into 2010.

Fundraising remained slow throughout 2009. According to Thomson Venture Economics, worldwide private equity capital commitments totaled \$18.8 billion in the fourth quarter, a 23% decrease from the \$24.5 billion raised in the third quarter of 2009. Total worldwide commitments for the year amounted to \$118.7 billion, 72% lower than the \$428.3 billion raised in 2008. The low totals were not limited to one region in particular. In 2009, U.S. funds raised \$79.4 billion (a 71% decrease from 2008), European funds raised \$20.3 billion (a 79% decrease), Asia funds raised \$14.7 billion (a 64% decline), and Latin America funds raised \$223.5 million (an 89% decline). As firms continue to decrease the target commitment sizes of their new funds, it is difficult to speculate if fundraising will return to the levels seen in 2007 when firms raised over \$440 billion in capital.

Deal activity also suffered in early 2009 as leverage was difficult to obtain and firms found fewer acquisition targets in the marketplace. Worldwide private equity disbursements equaled \$93.2 billion in 2009, a 35% decrease from 2008 when disbursements totaled \$144.3 billion. Venture capital firms invested \$57.4 billion in equity in 2009, a 40% decrease from \$96.1 billion in 2008. Buyout firms did not fare much better as they invested \$49.5 billion in equity in 2009, a 23% decrease from the \$64 billion invested in 2008. While deal volume remained low for 2009 as a whole, the fourth quarter did show signs of improvement. Worldwide private equity firms invested \$39.1 billion in equity in the fourth quarter, a 45% increase over the \$26.9 billion invested in the third quarter. Blackstone was especially active in the quarter, as it acquired Busch Entertainment from Anheuser-Busch InBev for \$2.7 billion and a 50% stake in the Broadgate Office Complex from British Land Co for \$1.7 billion. The largest deal of the quarter (and of all 2009) was the \$11.0 billion acquisition of Delphi Corporation, led by two hedge funds, Silver Point Capital and Elliott Management (Source: Reuters Buyouts).

The difficulty firms had acquiring companies can largely be attributed to an inability to acquire leverage from the bank loan markets in early 2009. Debt markets were primarily closed to firms attempting to acquire companies through buyouts and they proved to be mainly accessible to refinancing current portfolio positions. This trend is clearly quantified by the low purchase and leverage multiples in 2009. Leverage multiples in 2009 equaled 3.7 times EBITDA and purchase multiples equaled 7.7 times EBITDA. Both numbers are low in comparison to 2008, when deals had an average leverage multiple of 4.8 times EBITDA and purchase multiples were 9.1 times EBITDA. Leverage and pricing started to increase during

the fourth quarter, as leverage multiples reached 3.9 times EBITDA and purchase multiples equaled 7.9 times EBITDA. Overall, buyout managers are contributing more equity to investments as average equity contributions exceeded 50% of transaction value in 2009. Although leverage is becoming more accessible, private equity managers have reported that financial buyers are bidding up prices on competitive deals. Additionally, the increase in the public markets has led private sellers to have high return expectations.

Total exit proceeds amounted to \$59.1 billion in 2009, an 88% increase over 2008. The increase in total exits was driven by M&A activity, which accounted for \$51.7 billion, or 87%, of all exit activity. The dramatic boost in M&A exits in 2009 compared to 2008 was largely driven by the \$28.1 billion acquisition of Alltel Corporation by Verizon Wireless. While buyout backed IPOs remained low compared to historical levels, the fourth quarter was strong, as sixteen companies went public generating \$4.7 billion. Venture backed companies exited primarily through M&A in the fourth quarter, generating \$8.3 billion. Venture backed IPOs, however, decreased 40% during the fourth quarter, with offer amounts totaling \$349 million. Market participants are very optimistic of total exits in 2010. Improved economic conditions and the potential increase in the capital gains tax should lead to an increased incentive to exit portfolio companies (Source: Reuters Buyouts). As existing stocks come closer to fair value, venture-backed IPO activity is expected to increase in 2010, with 33 companies currently on file for public offerings as of February 1, 2010. Ironwood Pharmaceuticals is expected to be one of the larger IPOs of early 2010 with a target capital raise of \$173 million (Source: Wall Street Journal).

Along with deal activity and exits, performance was also strong in the latter half of 2009. Private equity firms (buyouts, energy, growth equity and mezzanine) generated a return of 6.24% in the third quarter, pushing the year-to-date returns to 7.43% as of September 30, 2009. Venture capital firms generated a return of 2.30% in the third quarter, making up for the dismal first half of 2009 to bring year to date returns to -0.28% as of September 30, 2009. The increase in both buyout and venture performance is due to the increased fair value of portfolio companies and exit events. As the public markets soared in 2009, market comparables boosted private company valuations (Source: Cambridge Associates).

The private equity environment experienced a roller coaster ride in 2009, as the performance decline during the first half of 2009 was somewhat eased by a strong climb in the fourth quarter. It remains to be seen whether the increase in investment activity, exits and performance can be sustained going forward, but the recent momentum has led market participants to be

increasingly optimistic about what is to come in 2010. Cliffwater believes that both operationally focused buyouts and debt for control funds present attractive opportunities for 2010. As the markets continue to fluctuate, adding value to portfolio companies by improving management, governance, and operations is a reliable performance driver. Cliffwater is also seeing opportunities to invest with top tier venture firms as traditional Limited Partners are not making new commitments. Outside the U.S., opportunities exist in Asia, Europe, and Latin America as regional and country focused teams execute tested strategies.

Real Estate Market Overview

While economic conditions have improved from the first half of 2009, double digit unemployment and net monthly job losses finished the year. Commercial real estate fundamentals continued to deteriorate during the 4th quarter of 2009, albeit at a slower pace. While a tentative economic recovery is in progress, measures of economic health important to commercial real estate, including job growth, consumer spending and confidence, will continue to lag in the near term and temper the pace of recovery. For the 4th quarter of 2009, the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index produced a total return of -2.11% (1.60% from net income, -3.71% from capital losses). While the index's performance has been improving over the past several quarters, it is still near 30-year lows. The primary driver of the index's poor performance continues to be the unprecedented pace of write-downs. Within property types, the Retail sector led with a -0.92% return. The Apartment, Industrial and Office sectors returned -1.81%, -2.59% and -2.75%, respectively, while the Hotel sector trailed with a return of -3.63%.

Although rising from an extremely low base, transaction volume is increasing as seen in the pick up over the past two quarters. During the 4th quarter of 2009, transactions increased in all but the industrial sector. 102 properties were sold during the quarter for \$2.2 billion with an average sales price of \$22 million per transaction. This compares to the 90 properties sold for \$1.9 billion with an average sales price of \$21 million per transaction in the 3rd quarter of 2009. The NCREIF current value capitalization rates for the four major property types for the 4th quarter were: Apartment (6.0%), Retail (7.0%), Industrial (7.2%) and Office (7.2%). The average NCREIF transaction cap rate was 8.4% during the 4th quarter, a decrease of 5 basis points from the prior quarter.

Multi-family pricing appears to have been the least affected due to relatively strong occupancies and a still functioning credit market primarily provided by Fannie Mae and Freddie Mac. Conversely, retail

properties remain more adversely affected due to weak consumer spending, concerns about the viability of certain retailers and the lack of available credit. Wide bid-ask spreads continue to drive a stagnant transaction market. Most sellers have been unwilling to transact at depressed pricing levels and lenders have favored extensions and restructurings over foreclosures.

Little has meaningfully changed over the past quarter in the permanent financing market for commercial real estate. Federal agencies provided guidance to banks and financial institutions during the quarter that encouraged restructurings of performing loan balances, despite diminished operating cash flows and depreciated collateral values, as opposed to taking losses and write-downs. Financial institutions such as life insurers are beginning to lend again, however, it is based on very different risk profiles than years past and primarily consists of higher quality assets and at lower loan-to-value (LTV) ratios. Developers Diversified Realty (DDR) successfully issued the first new TALF-supported CMBS deal in November after the market was closed for the last 17 months. Two more deals that did not participate in TALF financing were also completed in December signaling investors' appetite back into the securitized market. For the homebuilding industry, private equity firms have surfaced as a new source of funding. According to a recent report, more than 40 U.S. homebuilders teamed up with at least 22 private equity funds in raising \$12 billion in 2009 to acquire and complete development projects and other residential real estate deals.

Shares within the U.S. REIT market continued to rally in the 4th quarter, gaining 9.4%. On a full year basis, the sector returned 28.0% for 2009. REITs issued more than \$20 billion in new equity since late March, boosted by the improved economic outlook and the sentiment that asset values may not decline as much as previously expected. Additional equity issuance is expected in 2010 as REITs look to capitalize on distressed acquisition opportunities. Given the significant run-up in stock price and the sector trading at an approximate 25% premium to downward adjusted asset values, performance for the sector will likely be modest over the next year. Unsecured lending rates have continued to narrow and as of the 4th quarter, Baa unsecured corporate bonds yielded 5.31% compared to an average of 6.50% for commercial mortgage rates. Over the course of the past year, REITs raised \$10 billion in unsecured corporate debt, providing a distinct advantage over single asset borrowers.

The European real estate markets continued to recover during the 4th quarter benefiting from increased exports. Margins within the commercial

real estate lending market are falling while LTVs are rising on new loans, however, rental rates and occupancy continue to be negatively impacted by the broader economy. The U.K. market fared better than the rest of the continent as a result of transparency in pricing, improved capital values and an increase in investor activity. Similar to the U.S., the strength and sustainability of the recovery will continue to depend largely on a decline in unemployment, stabilization in the consumer balance sheet and a functioning financial system.

Asian economies, in particular China and Hong Kong, improved during the quarter. Lower unemployment and an increase in consumer confidence has resulted in higher retail sales. Transaction volume in the residential sector continued to improve across the region with pricing likely to increase 10-15% in the next year in Hong Kong and Singapore. Within the office sector, vacancy was higher in Japan while stabilizing in both Hong Kong and Australia. Rental rates have also stabilized in several markets as landlords are reluctant to accept rent reductions in anticipation of stronger tenant demand in 2010.

The private equity real estate marketplace has changed dramatically over the past two years, with the days of cheap debt and highly leveraged deals now serving as a memory. We continue to believe that the next several years could emerge as a special investment opportunity as distressed sellers and fallen property prices lay the groundwork for smart and disciplined investors to create value. While leverage and falling capitalization rates created financial value in the recent past, a disciplined, focused and back to fundamental value investment approach will be required in the new real estate landscape. We favor experienced managers that have actively reflected on lessons learned from this cycle, teams that have worked together over many years and a disciplined investment approach that can comfortably evaluate all segments of the capital stack.

Real Asset Market Overview

Real Assets including infrastructure, timber, energy, and natural resources are producing a mixed bag of results. Infrastructure funds continue to be plagued by a lack of available deals on the public side, though are participating in privately owned energy transactions. The U.S. based timber industry continues to experience low demand and low pricing for pulp and sawtimber products. Prices have been at these low levels since early 2008, yet timberland prices, while beginning to decline, have been slow to adjust. Timberland performance as reported by the NCREIF Timberland Index has finally begun to

reflect the lower demand and pricing, producing a -4.76% annualized return during 2009 with the 4th quarter of 2009 producing the lions share of the decline, a -4.55% return. Energy and natural resource funds have both an ample universe of potential investments and a moderate base of demand for their end-product. Funds in market for these strategies are seeing strong LP interest.

Private funds are beginning to see more investor interest as the liquidity constraints they experienced over the last year have begun to ease. However, liquid real assets including TIPS, commodity futures, MLPs, REITs, and natural resource equities remain a favorable alternative among investors.

MLPs produced significantly high performance during 2009 generating a 76.4% total return for the year as measured by the Alerian MLP Index. Much of this performance was due to a rebound in unit prices that had been pushed down due to forced selling from hedge funds and the unwinding of swaps held by Lehman Brothers. MLP fundamentals had remained strong throughout the crisis with increasing EBITDA and continuing dividend distributions to their shareholders. As 2009 progressed, MLPs were one of the few industries able to obtain debt capital and were some of the few companies able to issue stock in secondary offerings at attractive pricing. While we do not expect a repeat of the performance generated by MLPs during 2009, we do anticipate MLPs to perform well as energy demand and energy infrastructure needs continue to grow.

Several timberland funds were either launched or were close to launch during the last part of 2009. The geographic focus of these funds is global with GPs noting poor fundamentals in the U.S. market. New strategies are emerging as well. Some managers are looking to transform marginal agricultural land into tree plantations. These strategies will focus on acquiring inexpensive land and planting fast growing hardwood tree species.

Private infrastructure funds have been unable to deploy much of the more than \$60 billion of un-called capital at their disposal. As reported by Preqin, the number of completed infrastructure transactions globally during 2009 was 130, a decline from the 2008 high of 194 transactions. The lack of available credit for large infrastructure deals and a slow process for transferring public assets into private management are the primary reasons for the decline. Infrastructure asset valuations are mixed and will take more time to recover to their pre-recession highs. Some toll roads are beginning to see increased traffic, while airport enplanements decreased during 2009 from 2008 and container traffic at major North American ports experienced a

slight increase in volume from a year ago. Infrastructure funds have focused on energy, waste management, water and waste water projects over the past year. Many of these assets are already in private hands, allowing funds to avoid time consuming and costlier public asset auction processes. Publicly listed infrastructure funds appear to be completing their debt restructuring efforts and are beginning to move forward. There have been a few sales of assets from these funds but less than many un-listed funds had hoped for. New infrastructure funds continue to roll out, although few are having successful fund raising efforts. There are two infrastructure debt funds being marketed, catering to equity funds that are having difficulty obtaining traditional bank debt.

Commodity futures posted a 19% one year and 9% quarterly total return ending December 2009 as measured by the Dow Jones UBS Commodity Total Return Index. Most commodity futures curves remain in contango where the cost of a future delivery of a commodity is lower than the present delivery price, though on average, the curves are beginning to move back to a normal backwardated position. Chinese demand for commodities and restocking of depleted inventories globally have helped to keep commodity prices stable. Energy prices have stabilized as well and will likely rise in the coming year with increased demand.

The Barclays Capital U.S. TIPS Index returned 1.76% for the quarter, outperforming Treasuries (-1.30%). Break-even inflation rates rose across the yield curve by 50 to 90 basis points. Break-even rates are now 2.24% at the five year maturity and 2.39% at the ten year maturity. There has been increased investor interest in TIPS, as evidenced by publicly announced TIPS searches and funded mandates. We expect TIPS issuance to increase in 2010, but at a slower pace than the increase of Treasuries issuance.

Cliffwater Research

To obtain copies of Cliffwater research papers, including those listed below, please visit our website: www.cliffwater.com.

2010 Asset Allocation Report: The Re-Engagement of Risk	Jan 2010
Asset Allocation Update	Oct 2009
Update on TALF and PPIP Investment Opportunities	Aug 2009
Private Equity Secondary Market	Mar 2009
Overview of Infrastructure Investing	Jan 2009

Update on Cliffwater

Cliffwater will be speaking at the following conferences in the first quarter. We hope to see you there.

OPAL Investment Education Symposium, Feb. 8-10
New Orleans, LA

IMN Public Funds Summit, March 1-3
Huntington Beach, CA

Additionally, Elina Ploskin joined us in January as an Analyst in our New York office and as a member of our hedge fund research team. Prior to joining Cliffwater in 2010, Elina was an Investment Banking Analyst at Fox-Pitt Kelton Cochran Caronia Waller.

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