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### Hedge Fund Market Overview

An outstanding 2<sup>nd</sup> quarter has brought most global capital markets (please see Exhibit 1) into positive territory for year to date returns. Dissipating depression fears, improved liquidity, and the positive impacts of government monetary, fiscal, and credit market intervention contributed to the market recovery. Investors who took advantage of historical spreads in credit at the beginning of the year were rewarded with returns of 25% or more for high yield and bank loans. Risk adverse assets such as Treasuries unperformed.

At the start of the year, we noted the positive backdrop for hedge funds: less competition, high and declining market volatility, and price aberrations such as wide credit spreads. Hedge funds took advantage of this environment producing positive strong returns of 9.4% (as measured by HFRI Fund Weighted Index) for the first six months of 2009. Hedge funds exceeded the 3.2% six month return for the S&P 500 Index.

Many hedge fund trends seen in 2008 have since reversed in 2009. For example, besides hedge funds that are dedicated short sellers, global macro funds were the best performing hedge fund strategy in 2008, up 5% versus -21% for hedge funds overall. But global macro funds are lagging in 2009, up just 1% versus 5% for hedge funds overall.

### Exhibit 1: 2009 Market Performance

Index	June	YTD 2009	FYTD*	Calendar 2008
<b>Equity</b>				
Wilshire 5000	0.4%	4.4%	-26.4%	-37.2%
S&P 500	0.2%	3.2%	-26.2%	-37.0%
Russell 2000	1.5%	2.7%	-25.0%	-33.8%
MSCI EAFE	-0.5%	8.4%	-8.1%	-43.1%
MSCI Emerging Mkts	-1.3%	35.7%	-28.4%	-53.5%
DJ Wilshire REIT	-3.5%	-13.1%	-37.7%	-39.2%
S&P 500 Financials	-2.1%	-3.4%	-40.3%	-56.6%
<b>Fixed Income</b>				
Barclays Aggregate	0.6%	1.9%	6.1%	5.2%
Barclays Treasuries	-0.2%	-4.3%	12.4%	20.1%
Barclays TIPS	0.5%	6.2%	-1.1%	-2.4%
Barclays High Yield	2.9%	29.1%	-3.4%	-26.2%
Barclays Bank Loan	4.6%	33.5%	-5.4%	-29.5%
AAA ABX (Subprime)	-2.4%	-15.6%	-52.4%	-43.2%
Barclays Municipals	-0.9%	6.4%	3.8%	-2.5%
3 mo.Libor	0.1%	0.6%	2.0%	3.1%
<b>Alternative</b>				
DJ UBS Commodity	-1.9%	4.6%	-47.1%	-35.7%
HFRI Fund of Funds**	0.4%	5.3%	-15.2%	-21.4%
HFRI Fund Weighted**	0.1%	9.4%	-10.2%	-19.0%

\* Fiscal YTD from June 30, 2008

\*\* 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.

Two of the best performing strategies in 2009 have been multistrategy and credit (or relative value) hedge funds, both up 13% for the first six months. Also impressive is the performance of equity long/short hedge funds. They are up 12% as a group in 2009 while the S&P 500 Index is up 4%. We believe that many hedge funds quickly restructured their portfolios at the end of 2008 and have since been able to take full advantage of the investment opportunities presented at the beginning of this year.

Other technical factors have turned positive for hedge funds. Net cash inflows (contributions minus redemptions) turned positive in the last two months of the 2<sup>nd</sup> quarter. Counterparties and lending markets have also stabilized but at lower levels of lending.

While risky assets have continued to rally in July, we continue to have moderate long term expectations for traditional asset classes such as equities. We believe that diversification and alpha generation will be the keys to institutional investors' future success. A well constructed hedge fund portfolio with top tier managers will serve investors well.

## Private Equity Market Overview

The current problems in the private equity market are akin to sitting in your car at a train crossing watching a long, slow train go by. You have seen a lot go by, you know more is coming, and you know it will eventually end. The collapse in fundraising, transactions, liquidity, portfolio company fundamentals, and partnership performance began about a year ago. We have seen at least three poor quarters go by and we have more coming, but it is likely to end at year end or in early 2010. As in previous cycles, new investments (mostly distressed and value buyouts) will lead the private equity market out of the abyss. Liquidity, valuations, performance, and fundraising will follow.

According to Dow Jones, fundraising in the last quarter remained at the 'beggar' levels of the 1st quarter. Total private equity fundraising in the first six months of 2009 totaled \$54.9 billion (source: Dow Jones). This level was 64% below a year ago levels and it was the lowest amount since 2005. Few investors have allocation room for new commitments and those that do are focused on opportunistic funds such as secondaries and distressed. Fundraising by secondary funds totaled \$13.9 billion in the first six months of 2009 or almost one-third of the total. During the first half, 73 buyout funds raised \$28.7 billion (73% below the same period in 2008) and 51 venture capital funds raised \$5.1 billion (63% below the same period in 2008). We expect fundraising, other than opportunistic strategies, to remain weak until the supply of undrawn capital is reduced. Estimates of undrawn capital among private equity funds globally exceed \$800 billion (source: Private Equity Intelligence).

The 2nd quarter of 2009 (the part of the train that just went by) was a continuation of the 1st quarter. According to Thomson Financial, global private equity deal volume was at an anemic level of \$15.1 billion in the 2nd quarter versus \$17.8 billion in the 1st quarter. The lack of financing, reluctance of PE firms to make capital calls, and sticky seller expectations contributed to the low deal volume. There were "green shoots" in the buyout market however: distressed debt investors had a very good quarter with the price rally in bank loans and bonds; a number of value buyout deals have been announced including bank acquisitions by Carlyle, MatlinPatterson, Blackstone, and WL Ross; and an increase in all-equity deals such as the recently announced acquisition of Bankrate by Apax. While these deals are a drop in the bucket when compared to the undrawn capital the buyout funds still have, these are the type of deals we would expect to occur at a market bottom. Venture capital investment activity also remained moribund in the 2nd quarter with \$3.7 billion invested in U.S. companies versus \$7.6 billion invested in the prior year period.

Private equity realizations remained weak in the 1<sup>st</sup> half of 2009. According to Deal Logic, only \$20.8 billion of exit transactions occurred in the first six months. That figure is the lowest on record since 2001 and 82% below the same period of 2008. The decline in operating results and the lack of financing for secondary and strategic acquisitions continue to challenge buyout exits. While well short of a damn break, IPOs of venture capital backed companies increased from zero in the 1st quarter to five in the 2nd quarter (source: NVCA). The dollar value of M&A activity for venture capital funds also increased in the 2nd quarter from 1st quarter from \$0.7 billion to \$2.6 billion.

As forecasted, private equity returns continue to decline. After large write-downs in valuations in the 4th quarter of 2008, most partnerships had moderate write-downs in the 1st quarter of 2009. Rising public market valuations should provide some support to valuations and performance in the 2nd half of 2009. However, we expect some valuation declines in the 3rd quarter due to cash flow challenges of portfolio companies. If the economy and public equity valuations stabilize, the primary risk for private equity valuations will be the impact of debt refinancing and bankruptcies.

In summary, the train of bad news for private equity is still crossing and we have another few quarters before it passes. The bad news will pass and, more importantly, good investment opportunities exist today. We continue to focus our clients' attention on distressed investment strategies, secondaries, and value buyouts.

## Real Estate Market Overview

Fundamentals across U.S. real estate property sectors continue its downward trend in the 2<sup>nd</sup> quarter; trailing behind broader economic indicators. Unlike previous cycles, slowdown in tenant demand driven by a recessionary economy is the key driver as opposed to oversupply. Current industry consensus estimates expect declines for private real estate values in the 30% to 50% range from peak mid-2007 levels. Performance of real estate partnerships continue to decline with observed returns of -10% to -25% in the 1<sup>st</sup> quarter of 2009.

For the 2<sup>nd</sup> quarter of 2009, the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index returned -5.20% (-6.70% from capital losses, 1.50% from net income). Within property types, the Retail sector declined the least, returning -3.03%. The Apartments, Hotel and Industrials sectors returned -5.13%, -5.46%, and -5.09%, respectively, while the Office sector trailed, returning -6.52%.

Lack of available financing, wide bid-ask spreads and sellers reluctant to accept current level of price declines continue to limit transaction activity. While

many lenders favor loan restructuring and extensions over foreclosures, it does further postpone the price discovery process. During the 2<sup>nd</sup> quarter, there were \$6.6 billion of sales volume for properties over \$5 million with an average capitalization rate of 7.35%. The breakdown within property types and corresponding capitalization rates consisted of \$2.1 billion in Apartments (6.78%), \$1.8 billion in Office (8.44%), \$1.4 billion in Industrial (7.89%) and \$1.3 billion in Retail (7.33%).

The U.S. CMBS market remains shut to origination activities as there was no issuance in the 1<sup>st</sup> half of 2009. The market is also facing significant near-term debt maturities that are unlikely to qualify for refinancing. A recent research report by Deutsche Bank estimates the figure to be \$410 billion of loans maturing between 2009 and 2018. Government programs (i.e.: TALF) may provide some relief, however timing and execution may be complicated.

Shares within the U.S. REIT market experienced a significant rally, gaining 28.8% in the 2<sup>nd</sup> quarter after posting declines of 31.9% in 1Q09 and 38.8% in 4Q08. Improved investor sentiment and successful equity offerings contributed to the rally. From late March through the end of the 2<sup>nd</sup> quarter, REITs issued approximately \$13 billion of new equity which served to improve balance sheets, and reduced solvency concerns.

In the European markets, improvements in recent business and consumer surveys have led to increased optimism, however it is tempered by rising vacancy rates and falling rental levels in the European office market. Retail sales growth remains negative due to adverse effects of rising unemployment, and a growing number of retailers have filed for bankruptcy. Similar to the U.S., real estate transaction activity remains modest in most European markets due to lack of financing, however transaction activity in the U.K. has picked up, especially for prime assets, providing greater visibility on pricing and suggesting that the market could be closer to bottoming than the rest of the European continent.

Weakness in the Asian economies moderated in the 2<sup>nd</sup> quarter. Unemployment continued to edge higher but inflation eased. China experienced a dramatic recovery in transaction volumes and price increases ranging from 5-20% in response to government stimulus measures. Improvements were also seen in Hong Kong and Singapore.

In summary, while it may be difficult to forecast how long the recession will last or how well real estate partnerships will perform; many general partners are financially sound, have dry powder for investments and are staffed to manage through difficult periods. We recommend that clients consider investment

firms with tested portfolios and asset managers who have navigated past real estate downturns and are grounded in underwriting fundamentals. Many more GPs have instituted quarterly update calls, however, questions regarding near-term debt maturities, refinancing or restructuring issues, and investment level performance should be addressed in detail. We continue to be proactive in our communication with general partners, insisting on frequent updates and recommend the same for investors. Clients should also position themselves to consider a diversified allocation to equity and debt distressed/opportunistic investments for 2010 and also to pursue secondary investing.

## Real Asset Market Overview

The private real asset sectors including infrastructure, timber, and energy/natural resources continue to be challenged by a lack of new investments, valuation write-downs, few realizations, and a difficult fund raising environment. By way of contrast, public real asset sectors have seen increasing interest from institutional and retail investors, as the inflation vs. deflation debate rages. Inflation proponents highlight the government's money-printing press, and deflation proponents rely on the economy's slack in production and unemployment as evidence that prices can't rise significantly in the near term. In the coming quarters we believe that all real assets will become increasingly important to investors portfolios.

Timberland prices are beginning to ease with managers beginning to apply 8-10% discount rates in their models. Overall, expected returns for timber portfolios remain low compared to historical numbers.

Infrastructure investing is in the midst of a stormy season, as several managers have been forced to pull their funds from the fund raising market and other publicly traded vehicles have also been forced to fold and liquidate assets. Large infrastructure assets remain few and far between, especially in the U.S. Notwithstanding the turbulence, there remains a substantial presence of funds raising capital for infrastructure. This is having an impact on fees and we are beginning to see the traditional 2 and 20 fee structure feel some pressure.

Investment managers of commodity, natural resource equity, and Treasury Inflation-Protected Securities (TIPS) products report seeing significant institutional interest and inflows. TIPS and commodity ETFs and mutual funds have also been recipients of significant investor inflows. MLPs are also getting more attention. MLPs provide investors a liquid alternative to the energy space, specifically in the stable inflation adjusted midstream sector.

The NCREIF Timberland Index returned -1.20% for the second quarter, and is now negative year-to-date (-0.48%). We expect continued pressure on timberland write downs as the markets for timber products continue to be depressed.

The TIPS market was almost flat for the quarter (Barclays Capital U.S. TIPS Index +0.66%), capping a year of higher than average volatility. TIPS returned almost 6% year-to-date, but most of that gain came during March, shortly after the Fed announced its intentions to buy up to \$300 billion in treasury securities, including TIPS. Five year breakeven rates rose somewhat during the second quarter, reaching 1.5%, before falling back to 1.0%, compared with 2.1% one year ago, and after having fallen below zero during the fourth quarter of 2008.<sup>1</sup>

Major commodity indices posted double-digit gains in the second quarter (Dow Jones-UBS Commodity Index +11.67%, S&P Goldman Sachs Commodity Index +19.24%). The steep rise reflected strength in industrial metals, especially nickel, lead, and copper (based in part on stockpiling by China) and energy, reflecting increased international demand for gasoline and fuels in emerging markets. Natural gas futures, still in steep contango, continue to reflect record-high inventories, although reductions in future supply appear imminent.

Natural resource equities and mid-stream energy MLPs rose sharply during the quarter (S&P North American Natural Resources Index +18.24%, Alerian MLP Index +19.32%). Cyclical natural resource equities, which were previously priced at steep recession levels, rebounded strongly as some evidence of "green shoots" in the economy appeared. MLPs were aided by the ability of several companies to raise funds (both debt and equity) in the capital markets. In addition, the cost of capital seems to be decreasing for MLPs, which is positive. On 5/7/09, Kinder Morgan Energy Partners (BBB-rated) issued two tranches of debt: \$300 million of 6-year debt at a 5.63% coupon and \$700 million of 11-year debt at a 6.85% coupon, which compares to the average 2009 investment grade new issuance coupon rate of 8.0%. The debt offerings were priced at 232 and 354 bps, respectively, above the ten year treasury yield.<sup>2</sup>

While cap rates are rising in timber, we remain cautious about prospective returns in the asset class. The infrastructure sector remains cloudy; there are certainly investment opportunities, and managers pursuing those opportunities, but nothing which is compelling us to act immediately on at this juncture. Private energy funds will see attractive opportunities to make investments for the next couple of years, and investors with capital to put to work may be handsomely rewarded. Additionally, MLPs offer public market exposure to this

space and are getting more institutional investor attention than ever. We still view TIPS as more attractive than traditional Treasuries, but less so compared to earlier months. Commodities and commodity-linked equities rose sharply since the March equity bottom, so a pause in the rally, or even a modest pullback, would not be a surprise.

<sup>1</sup> Barclays Capital

<sup>2</sup> Wachovia Capital Markets, LLC

## Cliffwater Research

To obtain copies of Cliffwater research papers, including those listed below, please visit our website: [www.cliffwater.com](http://www.cliffwater.com).

Update on TALF and PPIP Investment Opportunities	Jul 2009
Overview of Infrastructure Investing	Jan 2009
Impact of the Credit Crisis on Wealth	Oct 2008
Navigating the Credit Crisis: Where Do Investors Go From Here?	Sept 2008

## Update on Cliffwater

Recent hires include Marcelo Kim and Myriam Nassif. Marcelo joins us as an Associate in our hedge fund research team. Prior to joining Cliffwater, Marcelo worked as an Advisory Associate with KPMG, where he performed internal audits and financial statement audits for financial services clients. Myriam joins us as an Associate in our private equity research team. Prior to joining Cliffwater in 2009, Myriam was a Senior Financial Statement Auditor at Deloitte & Touche, LLP, where she focused on audits of real estate companies, benefit plans, and not-for-profits.

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