

## A Quarterly Newsletter

### INSIDE THIS EDITION

### PAGE

Hedge Fund Market Overview	1
Private Equity Market Overview	2
Real Estate Market Overview	3
Real Asset Market Overview	4
Cliffwater Research	5
Update on Cliffwater	5
Contact Us	5

### Hedge Fund Market Overview

Asset prices were up sharply again in September. Lower rated bond and loan performance has been particularly impressive, climbing close to 50% in 2009. Emerging market equities, which underperformed in August, rallied over 9% in September on expectations that the emerging economies will benefit disproportionately from a global recovery. Overall, U.S. economic data continues to show improvement though there are certainly plenty of concerns that inflation and sluggish growth (“stagflation”) might be the ultimate byproduct of the current fiscal stimulus and monetary expansion.

Exhibit 1: 2009 Market Performance

Index	September	YTD 2009	FYTD*	Calendar 2008
<b>Equity</b>				
Dow Jones 5000	4.1%	21.5%	16.3%	-37.2%
S&P 500	3.7%	19.3%	15.6%	-37.0%
Russell 2000	5.8%	22.4%	19.3%	-33.8%
MSCI EAFE	3.9%	29.6%	19.5%	-43.1%
MSCI Emerging Mkts	9.1%	64.2%	21.0%	-53.5%
DJ REIT	7.0%	17.7%	35.4%	-39.2%
S&P 500 Financials	2.0%	21.2%	25.5%	-56.6%
<b>Fixed Income</b>				
Barclays Aggregate	1.1%	5.7%	3.7%	5.2%
Barclays Treasuries	0.8%	-2.3%	2.1%	20.1%
Barclays TIPS	2.1%	9.5%	3.1%	-2.4%
Barclays High Yield	5.7%	49.0%	14.2%	-26.2%
Barclays Bank Loan	3.3%	48.4%	10.2%	-29.5%
AAA ABX (Subprime)	14.4%	-15.2%	26.7%	-43.2%
Barclays Municipals	3.6%	14.0%	7.1%	-2.5%
3 mo.Libor	0.1%	0.8%	0.3%	3.1%
<b>Alternative</b>				
DJ UBS Commodity	1.6%	9.1%	4.2%	-35.7%
<b>Hedge Funds</b>				
HFRI Fund of Funds**	1.6%	9.7%	4.3%	-21.4%
HFRI Fund Weighted**	3.0%	17.2%	7.0%	-19.0%
CS/Tremont	2.7%	14.6%	6.9%	-19.1%

\* Fiscal YTD from June 30, 2009

\*\* 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.

Hedge funds posted another strong month. The HFRI Fund Weighted Index earned an estimated 3.0% in September while the HFRI Fund-of-Funds Index returned 1.6%. For the calendar year-to-date, the HFRI Fund Weighted Index is up 17.2% and the HFRI Fund-of-Funds Index is up 9.7%.

The 7.5% lag in fund-of-funds performance compared to direct hedge fund investments is unusually pronounced this year. Fund-of-funds returns typically lag behind direct hedge fund indices, but only by 1% to 2% in most years, and most of that difference is thought to be the extra layer of fees. We are not certain why there is such a large difference this year, but we suspect that performance for many of the fund-of-funds may be hurt by their liquidity problems, and that in turn may have caused them (1) to hold more cash than is typical, (2) to redeem from the better hedge funds that have proven to be the best source of cash, and (3) higher concentrations in poorer performing and illiquid hedge funds that can't be liquidated.

Exhibit 2 shows the performance of different hedge fund strategies, as defined by HFRI and CS/Tremont. All major strategies gained in September, with little dispersion across strategies.

Exhibit 2: Hedge Fund Performance by Major Strategy Category

Strategy Indexes	September	YTD 2009	FYTD*	Calendar 2008
<b>Arbitrage/Relative Value</b>				
HFRI**	2.4%	20.5%	6.8%	-18.0%
CS/Tremont-Convert	3.3%	40.1%	13.0%	-31.6%
CS/Tremont-Fixed Income	2.9%	22.2%	9.2%	-28.8%
<b>Event Driven</b>				
HFRI	4.2%	20.4%	9.6%	-21.8%
CS/Tremont	2.0%	13.8%	6.7%	-17.7%
<b>Equity Long/Short</b>				
HFRI	3.6%	21.6%	8.5%	-26.7%
CS/Tremont	3.4%	16.8%	7.9%	-19.8%
<b>Global Macro/CTA</b>				
HFRI	1.9%	4.5%	3.0%	4.8%
CS/Tremont-Macro	2.7%	9.0%	5.4%	-4.6%
CS/Tremont-Managed Futures	3.2%	-4.0%	3.7%	18.3%
<b>Multi-Strategy</b>				
HFRI	3.4%	21.3%	7.9%	-20.3%
CS/Tremont	2.2%	19.9%	6.8%	-23.6%

\* Fiscal YTD from June 30, 2009

\*\* 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.

In a virtuous circle, hedge funds continue to increase their net investment, generating strong returns for their investors, and to a lesser degree helping to buoy the overall markets. According to a study by Morgan Stanley Prime Brokerage, global equity hedge funds have steadily increased both gross and net exposures since March. Net exposures have increased from the mid-teens in March to above 40% as of the end of August. Gross exposures have grown from about 120% to just under 150% over the same period. Some, if not a majority, of this increase occurs naturally as long investments outperform short investments in a rising market. Funds that actively trade can offset this effect and maintain exposures within target ranges, but for many funds the increase in exposures is an intentional expression of confidence in the markets. Should this confidence prove justified, 2009 could end as one of the best years on record for hedge funds. Given the pain experienced by investors in 2008 and the first few weeks of 2009, that would be welcome news for many.

### **Private Equity Market Overview**

As expected, fundraising, investment pace and liquidity showed little to no improvement during the third quarter. Private equity performance was up modestly during the second quarter, buoyed by an up-tick in the stock and credit markets. Whether the rebound in performance is sustainable is open for debate but the market is showing signs of life heading into the fourth quarter.

Worldwide private equity fundraising came to a virtual halt during the third quarter as limited partners remained selective in their allocations. According to Thomson Venture Economics, only 104 private equity funds raised capital with total commitments of \$19 billion, the lowest total capital raised for a quarter since the first quarter of 2004. In the third quarter of 2008, 259 funds raised \$95.5 billion. Year-to-date, worldwide private equity fundraising totaled \$90.0 billion versus \$364.4 billion through the first three quarters of 2008.

According to Preqin's Private Equity Investor Survey, 59 of 100 limited partners surveyed did not make any new commitments during the first half of 2009. Forty-three investors said they expected to make fewer investments in the next 12 months than in previous years. Few investors have an allocation for new commitments and those that do are shying away from large buyout funds and focusing on shorter-term, cash flow-generating strategies such as secondaries and distressed debt. Thirty-two percent of investors surveyed cited small- and middle-market buyouts as an area of interest as well. Middle-market buyout firm Charlesbank Capital Partners raised its seventh fund with relative ease, hitting its hard cap of \$1.5 billion in September after only five months of fundraising.

During the first three quarters of 2009, 61 buyout funds raised \$49.6 billion (76% below the same period in 2008) and 241 venture capital funds raised \$18.0 billion (66% below the same period in 2008). We expect fundraising, other than opportunistic strategies, to remain weak until the supply of undrawn capital is reduced and funds can generate meaningful liquidity from their current funds. Estimates of dry powder among private equity funds globally exceed \$1 trillion (Source: Preqin).

Deal volume continues to be low, driven by a lack of financing, fewer companies in the marketplace, and an ongoing standstill among bidders and sellers on price expectations. Global private equity disbursements totaled \$53.9 billion year-to-date versus \$118.0 billion in the first three quarters of 2008. Third quarter buyout activity was up 27% from the prior quarter. As an alternative to new acquisitions, buyout firms are seeking consolidation plays, capitalizing on low valuations for capital-starved companies to build off of their existing platforms. Forty-five percent of third quarter deal activity took the form of add-on acquisitions (Source: Thomson Venture Economics). KKR's acquisition of Oriental Brewery Co. (from Anheuser-Busch InBev and Silver Lake) and Index Ventures and Andreessen Horowitz's acquisition of Skype (from eBay) were a welcome sign for large buyout players. The transaction values of Oriental Brewery Co. and Skype, notably both non-U.S. companies, each broke one billion dollars, though are still a far cry from the deals done at the peak of the market including TXU (\$45 billion) and Harrah's (\$17 billion). In October, CVC and Blackstone also took advantage of InBev's liquidity issues, acquiring divestments with transaction values of \$2.2 billion and \$2.7 billion, respectively. Buyout firms are able to raise a modest amount of debt but are financing deals with more conservative capital structures than in years past. Venture capital activity was up 21% from \$12.2 billion to \$14.9 billion, though the number of deals was down 68%. We expect investment pace to pick up in 2010, albeit at a below average pace from prior years. Private equity firms will continue to spend time working with their existing portfolio companies.

Private equity exit activity incurred an up-tick in the 3<sup>rd</sup> quarter of 2009, though the IPO and M&A markets continue to be challenged. Disclosed buyout M&A activity rose from \$1.0 billion to \$4.2 billion during the quarter. Carlyle took top honors, selling a subsidiary of Vought Aircraft Industries to Boeing for more than \$1 billion (Source: Reuters Buyouts). IPO activity continues to be weak, with three buyout-backed companies listing for an average offer amount of \$438 million during the quarter. Venture returns continue to be polarizing. The venture capital M&A market has shown signs of life this year with the \$2.1 billion acquisition of Data Domain (backed by NEA and Greylock Partners) by EMC. In October, Cisco announced an agreement to acquire

Starent Networks (backed by Matrix Partners and Highland Capital) for \$2.9 billion. The dollar value of M&A activity for venture capital funds decreased from \$2.6 billion in the second quarter to \$1.2 billion in the third quarter but is up from \$0.7 billion in the 1<sup>st</sup> quarter. Only three venture-backed companies went public during the quarter with an average IPO offer amount of \$190 million. While the venture capital IPO market continues to be anemic, the average annual offer amount is up considerably from prior years. From 2002 to 2008, the average venture-backed IPO offering was \$93.4 million with a peak of \$121.0 million in 2004.

Rising public market valuations provided some support to valuations and performance during the second quarter. U.S. private equity (buyouts, energy, growth equity and mezzanine) returns were up 4.3% during the second quarter and 1.1% for the first half of the year. Venture capital returns were up a modest 0.2% during the quarter (Source: Cambridge Associates). However, we expect some valuation declines in the third quarter due to cash flow challenges of portfolio companies. The primary risk for private equity valuations is impending debt refinancing, cash needs, and bankruptcies. Buyout-backed bankruptcies totaled 52 in the first half of 2009 and 72 over the last 12 months ending in June versus 49 in all of 2008 (Source: PE Hub). Default rates hit 12.0% in September with Moody's forecasting an increase in default rates to 12.5% by year-end. The impending maturity cliff faced by leveraged loan issuers flattened modestly during the quarter, with leveraged loan issuers extending \$10.3 billion of pre-2009 loan maturities during the quarter and defaulting on \$4.1 billion, reducing total debt coming due by year-end 2012 by 11% to \$94.2 billion. However, nearly \$900 billion of debt matures in 2010 to 2014. (Source: S&P LCD).

We are cautiously optimistic about the near-term outlook for private equity. The current markets are providing investors with an opportunity to be more selective about their manager relationships and to limit their commitments to top-tier funds. The current environment should allow funds that have been prudent about capital deployment to invest in companies at attractive valuations. We currently favor distressed debt, Asia-based funds, and direct secondary opportunities and believe that capital constraints facing many investors will provide our clients with an opportunity to access the best names in venture capital.

### **Real Estate Market Overview**

The decline in real estate valuation continued to moderate during the quarter. For the 3<sup>rd</sup> quarter of 2009, the National Council of Real Estate Investment Fiduciaries (NCREIF) Property Index returned -3.32%

(-4.88% from capital losses, 1.56% from net income); a significant improvement from the index's return of -8.29% in the 4<sup>th</sup> quarter of 2008. Within property types, the Apartment sector declined -3.00%. The Retail, Office and Industrials sectors trailed with returns of -3.14%, -3.30%, and -3.94%, respectively, while the Hotel sector returned -4.47%.

Fundraising within private equity real estate has been dismal following the global financial downturn over the past 12 months. According to the private equity real estate database Preqin, the amount of capital raised has been consistently declining since 4<sup>th</sup> quarter 2008, reaching a low of \$4.9 billion across 17 funds in the 3<sup>rd</sup> quarter 2009. This represents a reduction of 88% compared to the \$41 billion raised across 55 funds one year ago. Of the funds that closed, most did so below their fundraising target. 24% of funds raised in 2009 have closed below 49% of original fund size, 31% have closed between 50-79% of original fund size and 27% have closed between 80-99% of original fund size. Similarly, of the funds that are still fundraising, target fund sizes have been reduced significantly, many by 50% or more and the fundraising period is becoming much longer.

The credit markets remain largely closed to commercial real estate during the third quarter. Transaction volume is down approximately 80% from past years with bid-ask spreads still wide. There has been no CMBS issuance as many are waiting for the outcome of the first offerings of commercial mortgaged-backed securities that will take advantage of the Term Asset-Backed Securities Loan Facility, or TALF program. Developers Diversified Realty (DDR) is working with the Federal Reserve on such a deal and will use the proceeds to repay existing debt. Life insurance companies, traditionally a large source of financing, are beginning to lend again. However, lending sizes are down significantly and loan to value (LTV) ratios have declined from 65% to 45-50%.

During the 3<sup>rd</sup> quarter, there were \$9.3 billion of sales volume for core properties over \$5 million with an average capitalization rate of 7.78%. The breakdown within property types and corresponding capitalization rates consisted of \$2.5 billion in Apartments (7.24%), \$3.9 billion in Office (8.33%), \$1.3 billion in Industrial (8.72%) and \$1.6 billion in Retail (7.67%).

Shares within the U.S. REIT market continued to rally in the third quarter, gaining 33.3%. The return of the credit markets, as evidenced by the almost sixty offerings raising more than \$17 billion this year, and the general sentiment that the worst is behind us contributed to the rally. Every subsector within the NAREIT Equity Index had gains with lodging and office REITs returning 46% and 43%, respectively. Regional mall and shopping center stocks also

gained 41% and 25%, respectively, as consumers spending is beginning to return.

Recovery in the European markets is beginning to take hold, although there are significant variations between countries and regions. Economies within the Euro zone, including Germany, France, the Netherlands, Belgium and Austria are benefiting from exports and increases in consumer expenditure. Central and eastern European markets continue to lag and have seen limited recovery in property prices. Demand for well-located, long-term leased properties is increasing; CBRE reported sales volume increased to €4.4 billion in the U.K., up 5% from the previous quarter and volume of €1.5 billion in France, doubling its sales volume from the previous quarter.

As a result of an increase in government intervention and bank lending, capital values, liquidity and economic growth numbers have increased in certain Asian markets. This was particularly evident in China, Hong Kong and Singapore. However, an oversupply of office properties in these markets will continue to put downward pressure on rents. In Japan, personal consumption continued to contract on a year over year basis. With limited debt financing, Japan is also the only major market in Asia where distressed opportunities are available, particularly in the office and multifamily sectors.

In summary, the pace of the economic recovery will depend on reduction in unemployment, increase in capital spending and housing sector recovery. Economic indicators, including the Case-Shiller Index, reinforce the general perception that the formation of a bottom in the economy is in process. Selected areas including San Diego, Denver, Washington, DC, Boston and Chicago have seen increases in home prices over the past 5 months. However, the length and speed of the recovery is still a hotly debated topic. We continue to recommend that clients commit capital to a diversified allocation of real estate equity and debt distressed/opportunistic investments, albeit at a measured and selective pace for 2010 and beyond. Fallen property prices and the distressed environment have left the market with potential bargains and opportunity for positive returns. Real estate cap rate spreads to U.S. Treasury yields are at record highs, which historically have served as a reliable indicator of above-average investment performance three to five years into the future. Investors should focus on investment firms with tested portfolio and asset managers who have navigated past real estate downturns and are grounded in underwriting fundamentals. It is also essential that managers are able to communicate their understanding of the changing real estate environment, and adapt their strategies accordingly to source deals and produce returns.

## Real Asset Market Overview

The fundamentals for increasing inflation are in place, though it appears inflation is missing its cue. Notwithstanding, institutional investor interest in real assets is steady to increasing. Several funds have announced allocations to real assets or inflation linked assets over the prior months and we anticipate more to follow. Some investors have targeted as much as 20% with a typical allocation between 5% and 10%.

Liquidity remains an overpowering influence on the investing choice between public and private structures. Allocations to commodity futures, TIPS, natural resource stocks, and MLPs continue to outpace commitments to privately structured funds focusing on infrastructure, timber, and agriculture. Funds in the mining and materials sector are seeing activity, as are midstream energy and energy infrastructure focused funds.

New timberland funds continue to be brought to market, though there does not appear to be a real correction in timberland prices. The prudent or minimal use of leverage on most timberland investments (timber REITs excluded) has likely kept most timberland owners out of the distressed category which may be keeping prices up.

Privately structured agriculture and materials and mining funds are beginning to see more interest as China continues its global investment in commodities and natural resources. Investment in pure farmland agriculture remains difficult due to a lack of investment vehicles, either private or public. The number of pure mining and material investment funds is also small though there are a handful of managers who have demonstrated track records and continue to raise funds.

The fundraising environment for infrastructure is difficult with several funds in the market closing their fundraising and some closing their operations. The remaining large infrastructure funds are seeing significant amounts of competitive capital for the few large globally based infrastructure transactions in the market. As reported by Preqin, there is more than \$67 billion of un-invested and un-called capital from infrastructure and energy funds, \$37 billion of which is targeted for North America. In the U.S., small- to mid-size existing private investments rule the opportunity set. The energy and water sectors remain key targets for U.S.-based funds. Existing funds are also writing down valuations. The transportation sector has been the hardest hit with ports taking the biggest write downs. However, toll road traffic counts have stabilized and are increasing as are non-U.S. airline capacities.

Debt for infrastructure funds is available, though it requires more banks to obtain the large amounts generally associated with infrastructure transactions. Managers are in turn reducing the amount of debt used. The early infrastructure investment approach of leveraging assets to 90% or 95% is no longer an option. Some managers are going as far as to underwrite investments with no leverage at all. Finally, as mentioned last quarter, infrastructure fund fees continue to come down from the traditional 2% management fee and 20% carry. We are seeing some existing funds changing their fee structures in order to be competitive with new funds opening with lower fees.

Investment managers of commodity, natural resource equity, and Treasury Inflation-Protected Securities (TIPS) products continue to report significant institutional interest and inflows. TIPS and commodity ETFs and mutual funds have also been recipients of significant retail investor inflows. Institutional investment in the MLP space is growing. Public pensions have been the most active, although foundation and endowment investors are taking a hard look as well.

The TIPS market reported a 3.1% increase for the quarter as measured by the Barclays Capital U.S. TIPS Index. TIPS have returned 9.5% year-to-date; about half of that gain came during March, shortly after the Fed announced its intentions to buy up to \$300 billion in treasury securities, including TIPS. Ten year breakeven rates ended the third quarter almost unchanged at 1.77%. However, they moved somewhat during the quarter, beginning at 1.76%, falling to 1.5% in July, before rising to 2.0% in early August and settling back to 1.77% by quarter-end. Historical average ten year breakeven rates are 2.5% - 3.0%.

Major commodity indices posted mixed results during the third quarter (Dow Jones-UBS Commodity Index +4.25%, S&P Goldman Sachs Commodity Index -1.79%). Energy prices have rebounded and the wheat market has increased almost 25% from October 2008. However, crude oil inventories remain at historically high levels, this year's global wheat crop is potentially the second highest in history and copper inventories are as well high. A strong China GDP, Chinese restocking, and a weakening dollar are the center of the current commodities performance.

During the quarter, natural resource equities and mid-stream energy MLPs continued to experience double digit performance (S&P North American Natural Resources Index +17.33%, Alerian MLP Index +14.03%). The demand for natural resources in rebounding Asian economies, notably China, has prompted the performance for companies focused on the production and servicing of natural resources.

We still view TIPS as more attractive than traditional Treasuries, but less so compared to earlier months. Commodities and commodity-linked equities have

risen sharply since the March equity bottom, so a modest pullback would not be a surprise. We remain opportunistic with respect to privately structured timber, infrastructure and agriculture funds and are positive with respect to energy and mining and materials funds.

## Cliffwater Research

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

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
Impact of the Credit Crisis on Wealth	Oct 2008

## Update on Cliffwater

Cliffwater will soon announce details regarding our new Winter Luncheon Series where Steve Nesbitt will discuss the future of alternatives in multiple cities across the U.S. We will provide more details shortly.

Marne Gorman joined us in September as a Director in our hedge fund research team. Prior to joining Cliffwater in 2009, Marne was a Principal in the Investment Group at Khronos LLC where she was responsible for all aspects of the hedge fund research process. Previous experience includes working in the Investment Banking Division at Goldman Sachs.

## Contact Us

Cliffwater LLC 4640 Admiralty Way 11 <sup>th</sup> Floor Marina del Rey, CA 90292 Tel: (310) 448-5000 Fax: (310) 448-5001	Cliffwater LLC 888 Seventh Avenue Suite 602 New York, NY 10019 Tel: (212) 245-0320 Fax: (212) 245-0193
--	---

[www.cliffwater.com](http://www.cliffwater.com)

Email: [info@cliffwater.com](mailto:info@cliffwater.com)

Contact: Thomas Lynch or Danielle London

*The views expressed herein are the views of Cliffwater only through the date of this report and are subject to change based on market or other conditions. All information has been obtained from sources believed to be reliable, but its accuracy is not guaranteed. This report is being distributed for informational purposes only and should not be considered investment advice. The information we provide does not take into account any investor's particular investment objectives, strategies, tax status or investment horizon. Past performance does not guarantee future performance.*