

Navigating the Credit Crisis: Where Do Investors Go From Here?

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Long-term investors are struggling to comprehend the ramifications of current events on their portfolios and asking themselves what actions, if any, should be considered to stem the fall in asset values and to better position asset classes for a clearly different future. **Our view is that, short-term, investors should not materially change their current stock and bond allocations as long as it does not potentially undermine operating or liquidity needs.** The desire among fiduciaries to sell stocks and other risky assets to preserve capital in turbulent markets is a natural one but **history has shown that acting on that impulse proves equally costly in lost upside when markets turn up.**

Some very smart people argue that this crisis “is the worse they’ve ever seen.” This somehow makes it “different” from past crises and, therefore, we should take exception to an asset allocation discipline that took so long to learn and has worked so well. They may be right. The probability of financial panic is not zero, and if that happens and the government fails to act, we are in for trouble. Organizations with shorter term operating responsibilities (liabilities) need to weigh seriously this scenario in their thinking. However, our warning is simply that following the “flight to safety” in bad times has proven to be very costly in the long term because markets will more likely have rebounded by the time it seems “safe” to re-enter.

We have been recommending that clients continue to diversify their portfolios into alternative investments – private equity, hedge funds, and real assets – to lower volatility and enhance returns. That recommendation does not change because of the current crisis. However, we do expect that this crisis will offer useful lessons that will help in the construction and monitoring of alternative portfolios.

We revisit each of the major traditional and alternative asset classes below, providing an update on prospective returns and risks.

Stocks

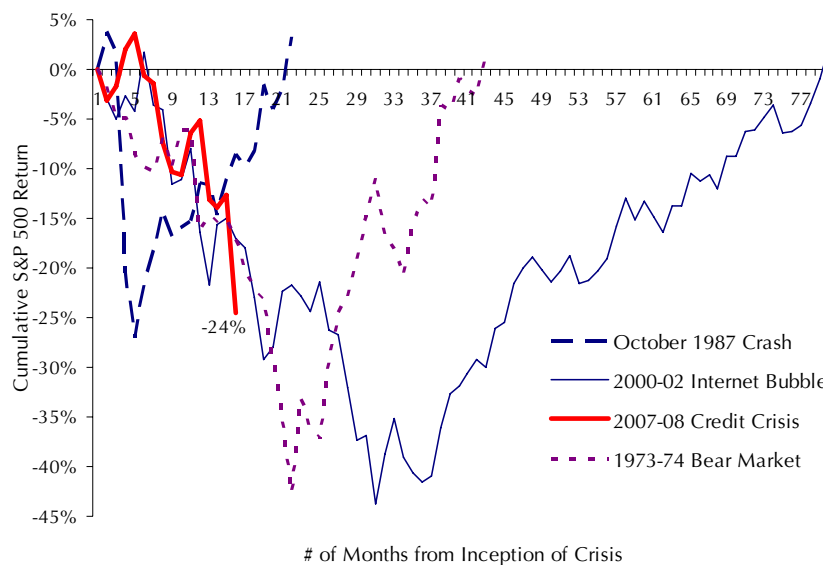
Stock market movements are virtually impossible to predict over the short term, but some historical reference points might help gauge risks and opportunities. Through Monday’s (Sept 29) close, stock prices have dropped 14% for the month and 23% calendar year-to-date (28% if you consider the world stock markets). Bonds are up 2% year-to-date. Falling stock prices and rising bond prices are typical of past crises where bonds (primarily Treasuries) benefit from a flight-to-safety and recession fears push stocks downward.

How bad could it get for stocks? Exhibit 1 compares the current stock market decline with the three worst stock market periods of the last half century. The starting point is the month each crisis began. The 24% cumulative stock decline witnessed in the current crisis (June 30, 2007

start) is less than the 27% loss in 1987 and well short of the 45% declines in both the 1973-74 and 2000-02 periods. The 1987 crisis lasted only a few months with no subsequent recession or decline in corporate earnings. The more severe 1973-74 and 2000-02 stock declines did correspond to economic recessions and declines in corporate earnings of 20% and 30%, respectively.

While a recession is uncertain at this time, consensus earnings forecasts for 2009 are 15% below 2007 earnings and comparable to 2004 earnings levels. **Based on current consensus earnings forecasts and Monday's S&P closing price, our dividend discount model produces a long term stock return forecast of 8.1%, not particularly noteworthy given stocks' price decline this year and a chaotic environment.** This modest return forecast for stocks also suggests that equity long-short hedge funds with their lower beta might not be at a significant disadvantage relative to the higher beta stock indexes and long-only managers.

Exhibit 1: Past Stock Market Declines (S&P 500 Index)



Bonds

Fixed income is at the center of the crisis, causing yield spreads on all borrowers to soar to record levels. The possibility that lenders will not lend at any price may ultimately force Congress to pass an unpopular \$700 billion bailout plan. Underestimating losses on the \$2.5 trillion in bad mortgages¹ has brought down many of the largest U.S. financial institutions, which in turn is crippling other credit markets that depend upon them.

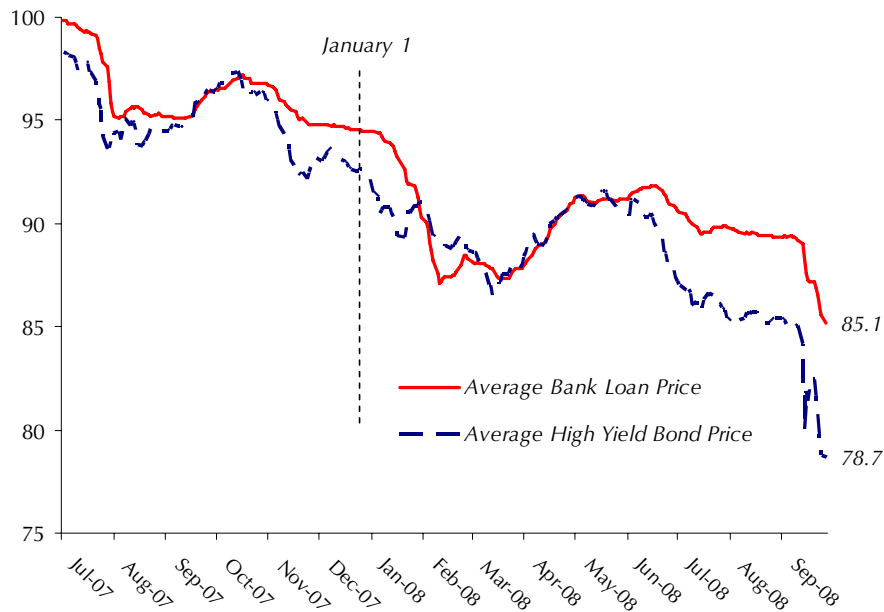
The opportunities in bonds look attractive on their face. Two of the more popular non-mortgage institutional credit markets are high yield bonds and bank loans. Exhibit 2 plots the deterioration in their prices since June 30, 2007. Bank loans, whose median price had never before been below \$95, were trading at \$86 (per \$100 of principal) at the close of Monday. The average high yield

¹ Subprime, Alt-A, and Option ARM mortgages

bond price was trading at \$79, nearing the lows of the 1990-91 Junk Bond crisis and the accounting scandals of 2001-02.

These depressed prices create yields close to 10% for bank loans and 13% for high yield bonds. Of course that assumes no defaults. Past crisis periods produced 5 year default rates of 7.25% with 45% recovery rates for bonds, 70% for loans. Applying those past metrics, **we expect high yield bonds to return 9% and bank loans to return 8%, unleveraged and net of default losses. Both bank loan and high yield bond opportunities look attractive compared to stocks. Their advantage compared to 4% Treasury yields is also significant except for the chance of a worsening crisis.**

Exhibit 2: Past Stock Market Declines (S&P 500 Index)



We believe that investors should take advantage of the potential attractiveness of credit securities through hedge funds and distressed private equity funds that specialize in credit and distressed securities. The upside is great but so are the risks and we believe that the greater flexibility found in hedge funds allows for better risk management.

Hedge Funds

Hedge funds are seeing potentially historic investment opportunities but a hostile operating environment. There are five factors currently weighing on hedge funds that could negatively affect their future performance:

1. *Reduced Leverage.* Hedge funds apply leverage to strategies that exhibit low volatility. These include market neutral strategies such as fixed income arbitrage, market neutral equity long-short strategies, and convertible arbitrage. Historically, these strategies did not provide the return necessary to attract investors on an unlevered basis and leverage was used to increase return and risk. The credit crisis increased the risk of these strategies and,

as a result, leverage has been reduced. For example, the median leverage ratio (gross asset exposure) for market neutral managers has declined from 5:1 when the crisis began to less than 2:1 today. The affect on returns is unclear and depends upon whether the unleveraged opportunities can offset the reduced leverage. **It should be noted, however, that the average of all hedge fund strategies, pre-Crisis, had a leverage ratio of 2:1, and higher levered hedge funds had 3:1 ratios. Both are well below the 20:1 leverage ratios run by investment banks and 10:1 ratios for commercial banks.**

2. *Short Sale Restrictions and Disclosure.* On September 19th the SEC issued two emergency orders directed at institutional investment managers that engage in short selling. Both orders are currently slated to terminate on October 2, 2008, but can be extended for a total of 30 calendar days. The first order prohibits new short selling of certain financial stocks. Initially, the restricted list of stocks totaled 799, but the SEC has added approximately 100 more, now including companies such as General Electric and General Motors. Most observers do not expect the short selling restriction to be extended. The second order requires investment managers running \$100 million to disclose all new short selling activity via "Form SH." The rule requires weekly reporting of new short sales to the SEC and public disclosure with a two week lag, with exceptions for market makers, statistical arbitrage traders, and hedgers. In addition, certain international regulators have amended their short sale rules, and in one case (Australia) have temporarily prohibited short selling altogether with limited exceptions. **It is too soon to draw any conclusion about the SEC short selling orders because they are likely to be modified, if not completely reversed as many view short selling as a sound investment strategy.**
3. *Fewer Prime Brokers.* The loss of prime brokers and the downsizing of the survivors will likely cause some hedge funds to go out of business or change strategies. In the recent race to switch prime brokers only the larger firms have been unaffected.
4. *Redemptions.* **Redemptions, in our opinion, pose the more serious threat to hedge funds over the short term because they can activate potential negative feedback loops if the fund does not have protections in place.** Firstly, redemptions force partial liquidation of the portfolio, depressing values. This is exacerbated by strategies relying on leverage – more securities have to be sold – and perhaps less liquid securities. Secondly, investors who otherwise would like to stay in a fund may decide to redeem to protect their assets from uncertain redemptions of others. Thirdly, most prime brokers have triggers with hedge funds that allow them to renegotiate services (i.e. leverage amounts and cost) if NAV (net asset value) drops by a certain amount (i.e. 25% over a given year). The hedge fund industry has benefited from significant positive net cash flow over the past ten years. However, 2008 is shaping up to be one of the worst performance years for hedge funds which will likely cause several types of investors, such as high net worth and fund-of-funds, to move money elsewhere. And the better performing hedge funds will not be immune to redemptions because they, more so than poor performing managers, are likely to have the liquidity that some investors are seeking.

It is impossible to get a good fix on redemptions until they are communicated to hedge fund managers over the next few days as the quarter closes, but as of today we do not see any unmanageable exodus of asset among top tier hedge funds. This is despite what is shaping up to be one of the worst months on record for hedge funds. Early indications are that some hedge fund indices may be down as much as 8% for September, though we believe that larger hedge funds won't be down nearly that much. If the worst case hedge fund return bears out for September, the cumulative hedge fund loss (drawdown) would be

roughly 10%, close to the 11% drawdowns experienced during the 1987 Crash and the 1998 Russian Debt Crisis. During both those past crisis periods, however, hedge fund returns quickly rallied from their lows and recovered their drawdown in less than a year.

5. *Government Intervention.* The government has been changing market rules and creating uncertainty which has been very disruptive to hedge fund strategies. More regulation is certainly coming and it is hard to predict at this time what affect it will have.

These challenges aside, we believe that the hedge fund industry will adapt to a new financial order and continue to be the preferred vehicle for investors seeking “alpha.”

Private Equity

While we expect the coming year to present a private equity market that is slower in many ways – investment pace, deal volume, distributions, and fundraising – **we believe that the recent market events will create opportunity for private equity managers across all strategies.**

1. *Investment Pace.* **Overall, we expect private equity firms to draw down capital at a slower rate during the next 12 months.** The slower investment pace will be a stark contrast to the pace of investment during the prior three years. A lack of available leverage will slow buyout activity. We expect some managers to move towards growth equity investing and all-equity buyout deals in the short term until banks resume lending.
2. *Exit Strategy.* **Realizations will be fewer in the short term.** Both venture capital and buyout managers will have fewer options for exiting investments during the coming year. Venture managers will be dependent on an opening in the public equity markets as well as acquisition activity from corporate buyers. Buyout managers will be largely dependent on the credit and equity markets, as well as on the health of large corporate acquirers.
3. *Secondary Market Activity.* **We expect banks to provide the greatest buying opportunity to secondary market investors.** Banks will sell their limited partner interests in private equity funds. Banks may also sell their direct ownership interests in private equity backed companies. During the past five years banks were active co-investors in private equity buyouts.
4. *Company Defaults.* We expect the rate of corporate defaults to continue to increase, particularly among industrial and consumer oriented companies. Private equity backed companies will be vulnerable if they do not have a flexible capital structure and adequate capital reserves.
5. *Fair Value Write-Downs.* 2008 will be the first year that private equity managers enter an economic downturn under the new fair value guidelines. Managers will value their private companies in line with public market comparables. **We expect to see a greater degree of value write-downs in the active portfolios of private equity managers, particularly for companies purchased in 2006 and 2007.**
6. *Vintage 2009.* **We expect distressed managers to have the greatest opportunity in the coming year.** Purchase prices for buyout transactions in the United States and Europe remained high in the first half of 2008. However, pricing should become attractive for buyout and growth equity managers focused on the U.S., Canada, and Europe markets

during the next several years. It will take most managers considerably longer to raise a vintage 2009 or 2010 fund as limited partners grapple with the volatility of the public markets. The pace of fundraising in the first half of 2008 declined 39% from the first half of 2007.

7. *Geography.* The opportunity set for private equity investors in Asia will be somewhat different from their U.S. and European counterparts. Asia based investors tend to use less leverage in their investments. We also expect China, India, and other growing economies to be less affected by deterioration in the U.S. financial markets.

Commercial Real Estate

Recent market events could present historic real estate investment opportunities not seen since the RTC days of the early 1990s.

1. *Real Estate Fundamentals.* The fundamentals for commercial real estate have been relatively stable as vacancy rates remain healthy. However, the prospects of a potential recession will place upward pressure on vacancy rates.
2. *Supply and Demand.* **Unlike the excess supply that magnified the last real estate downturn of the early 1990s, this potential downturn will likely be driven by shrinking demand.** Supply side risk on the commercial real estate front has been mitigated by rising construction costs which have put a damper on new, speculative construction. Additionally, the current lack of construction financing will continue to keep commercial construction at bay, mitigating any supply side risk.
3. *Sectors.* **The financial centers, such as London and New York, will be hit the hardest as continued consolidation in the financial sector will bring demand for office space to a halt and create excess office space.** Consumer spending is expected to decline which will have a negative effect on retail and industrial properties. There may be a silver lining for apartments as declining home values shift demand to rental housing. However, the excess supply of condos and homes may work its way into the rental market and offset potential gains.
3. *Leverage.* **The major blow to commercial real estate will come from past leverage.** The cheap cost of financing and relaxed lending standards of the past allowed buyers to achieve higher returns. The current credit crisis has caused lending standards to tighten and loans at higher loan to value ratios are no longer available. Buyers who took advantage of cheap debt and higher loan-to-value ratios may risk default as opportunities to refinance are extremely limited.
4. *Vintage Years.* Real estate managers who were highly leveraged and invested heavily over the past few years (Vintages 2006 and 2007) will most likely be facing valuation challenges. However, those real estate managers who were disciplined and prudent with leverage may have the greatest opportunity to take advantage of the emerging distressed real estate environment. **Vintage years 2008, 2009 and 2010 may produce outsized returns for opportunistic real estate funds, not seen since the early 1990s.**

Real Assets

Publicly traded real asset investments such as TIPS, commodities, and natural resource stocks have seen increased volatility as well as other asset classes but their correlations have remained low relative to most traditional asset classes. In fact, while most asset class correlations rise in crisis periods, the opposite occurs with real assets. Generally speaking, **the top performing pension and endowments were able to produce positive returns last fiscal year because they had significant real asset allocations.** We continue to believe in the diversification advantages of real assets and believe return opportunities in private energy and other natural resources will be particularly attractive. **Investors who are underweighted should also consider new investments in real assets thereby taking advantage of lower commodity prices as global economic growth slows.** Finally, concern over the long term impact of recent monetary stimulus is warranted. Investors should consider real assets as a strategic hedge for higher levels of inflation in the future.

Conclusion

Investors should not lose sight of what we believe will be significant opportunities in the months ahead as they manage current portfolio brushfires created by the Credit Crisis. For those in the beginning stages of diversifying into alternatives, we believe that no time could be better. For those who already have alternative exposures near allocation targets, we suggest that you give consideration to making above-normal commitments with the expectation that distressed/value funds generally have a shorter cycle that will not create as much of long term liquidity demand on the portfolio. That said, as fiduciaries we will all need to work hard to find the right balance between investment opportunity and risk in the new financial order.

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