



Alternative Investment Report

Hedge Funds, Private Equity, and Real Assets Winter 2009 Update

The second half of 2008 witnessed many incredible headlines in the business pages, including:

- Lehman Brothers bankruptcy
- Commodity prices collapse
- Real estate fundamentals nosedive
- Bank and auto industry bailouts
- Barack Obama elected President
- Ponzi schemes revealed
- Fannie and Freddie nationalized
- US T-Bill rates hit zero
- Volatility index at crisis levels for months
- Global stocks lose almost 40%
- Russian stocks down 75%
- Hedge funds have worst year on record
- Private equity 'golden age' ends
- Merrill Lynch and Wachovia sold overnight
- The death of the investment bank business model
- Goldman Sachs and Morgan Stanley become banks

Most of the above are symptoms or results brought on by the deleveraging and near collapse of the global financial system. Some of the excesses in the system were readily recognizable as noted in prior missives. We made some portfolio adjustments to avoid the most extreme areas, but we did not foresee the speed and violence with which events have led to one of the worst economic contractions in the modern era.

The number of ways that investors have been impacted by the meltdown in the financial sector is almost too long to list. Assets presumed to be liquid became much less liquid. Money market funds were frozen, collateral investments from securities lending activities became impaired, and redemptions from hedge funds and open-end real estate funds with 90-day liquidity terms were suspended. A reduction in the demand for alternative investments is likely given a more sober view of portfolio liquidity and relative attractiveness of traditional assets. The desire to maximize performance will remain, but with a more thorough awareness of risk.

The table below is a summary of the performance of various alternative investment sectors.

December 31, 2008		Annualized Returns				
Hedge Funds	6 Mos	1 Year	3 Year	5 Year	10 Year	
HFRI Fund of Funds Index	-19.0	-21.0	-1.3	2.0	5.4	
HFRI Convertible Arbitrage Index	-29.1	-33.7	-7.8	-4.9	3.3	
HFRI Distressed Securities Index	-22.9	-25.1	-3.0	3.3	8.1	
HFRI Merger Arbitrage Index	-4.1	-5.0	5.1	5.1	6.6	
HFRI Equity Hedge Index	-23.5	-26.4	-3.1	1.6	7.0	
S&P 500 Index	-28.5	-37.0	-8.4	-2.2	-1.4	
Barclays Aggregate Bond	4.1	5.2	5.5	4.7	5.6	
Real Estate & Timber						
Wilshire REIT Index	-37.1	-39.2	-12.0	0.7	7.7	
NCREIF Real Estate (unleveraged)	-8.5	-6.5	8.1	11.7	10.5	
NCREIF Timberland Index (unleveraged)	3.8	9.5	13.7	14.3	9.1	
DJ-AIG Commodities	-49.4	-35.7	-8.6	0.2	7.6	
September 30, 2008						
Private Equity (Venture Economics)						
All Private Equity	YTD	1 Year	3 Year	5 Year	10 Year	
Buyouts	-6.9	-6.5	7.8	11.2	9.4	
Venture Capital	-7.8	-8.2	7.2	12.2	7.3	
	-5.2	-1.6	6.6	8.6	17.3	

HFRI Index data as reported by Hedge Fund Research Inc. HFRI are updated three times a month and consequently are subject to change.

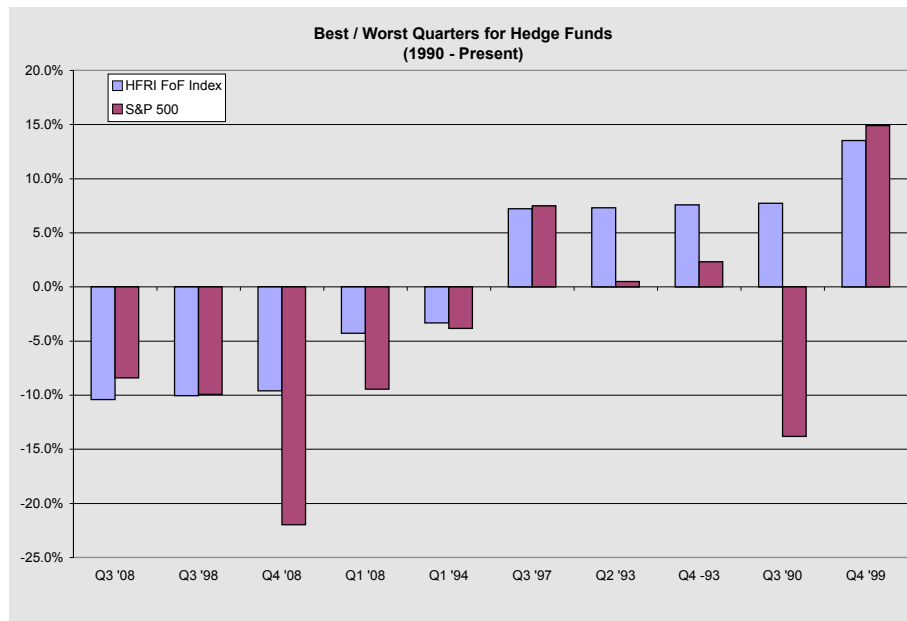
The main theme evident from the performance data is that there was almost no place to hide in the second half of 2008. Hedge funds as equity risk reducers had a good year, declining by only half as much as the S&P 500 index, but hedge funds as “absolute return” vehicles had a bad year, losing 21% on average versus a positive 5% return from US bonds. REITs and commodities declined more than equities, dropping 37% and 49%, respectively, during the fourth quarter, as the problems in the financial community bled over into the real economy.

The slowing economy led to a drop in the demand for commodities like oil and natural gas as well as industrial commodities while job losses and bankruptcies sapped the demand for commercial real estate. The first returns from real estate funds are coming in and are showing the largest drop in property values in 30 years. Unleveraged assets were off roughly 10% in the fourth quarter. Leveraged assets experienced similar declines magnified by mortgage debt. Illiquid funds will not report final net asset values for three or four months, but given the declines in comparables and increase in risk premiums, we could see some major declines in portfolio values by April 2009, when annual audited financials are due. Complicating the year-end reporting process is a more rigorous application of fair value reporting under the rule FAS157 and renewed fears of manager malfeasance.

HEDGE FUNDS

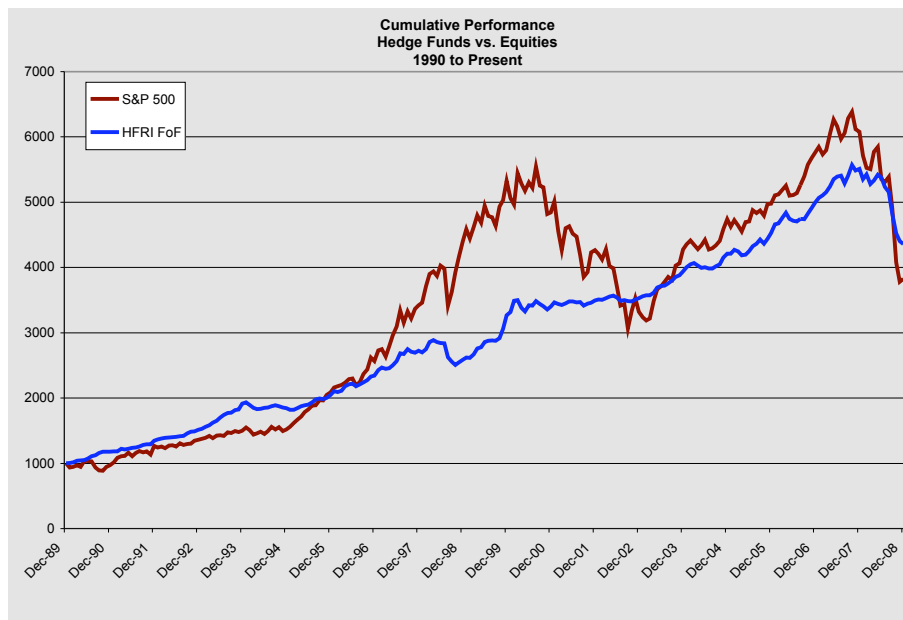
Hedge Fund Performance

The second half of 2008 will be studied and written about for decades to come. For hedge funds, it marked the worst period on record. In all, 2008 produced 3 of the 4 worst quarterly performances the industry has seen with Q3 and Q4 neck and neck for the worst.



The second half of 2008 saw an acceleration of the liquidity crisis, where the prices of most assets dropped dramatically. Uncertainty was at an all time high despite the actions of governments globally to restore confidence. We’ve long stated that a protracted liquidity crisis would be the most difficult environment for hedge funds and we’re experiencing such an environment at present.

Despite being mired in their “worst case scenario”, hedge funds managed to handily outperform most asset classes. Hedge funds, as represented by the HFRI FoF Index, lost 19% in the second half of the year and 21% for 2008. The S&P 500 was down 28.5% in the second half of the year and produced a loss of 37% for the full year. Further, despite hedge funds being at their trough, they have now outperformed equities over the last 1-, 3-, 5-, 10-, and 19-year periods. In fact, over the last 10-years, hedge funds have outperformed the S&P 500 by approximately 7% per annum.



Virtually every hedge fund strategy performed poorly in the second half of 2008 as asset prices collapsed. Convertible arbitrage was particularly hard hit as hedge funds, the predominant player in the convertibles market, deleveraged their portfolios. Moreover, liquidity dried up and certain equity hedges were banned. Distressed securities suffered as positions were re-priced to reflect materially lower recovery rates from the historical norm. Further, many funds began investing in distressed Residential Mortgage Backed Securities (RMBS), which suffered a substantial sell-off after the Treasury announced that it no longer intended to purchase such securities as part of the Troubled Asset Relief Program (TARP).

Long/short equity strategies suffered significantly also as the consensus trade of long energy / short financials collapsed and common holdings risk proved substantial. Deleveraging caused commonly held long positions to fall more sharply than short positions, creating sizable losses beyond what might have been expected given a portfolio's net exposure. Even traditional strategies suffered from unique issues that dampened their effectiveness. With short biased equity managers, short squeezes and bans disrupted portfolios, thereby diminishing their effectiveness. For short biased credit managers, the market experienced a dramatic widening of the bond basis which reduced returns on Credit Default Swap (CDS) hedges, the predominant form of credit protection.

For some global macro managers, profits were obtainable as significant volatility existed in all markets, with currencies and curve trades providing ample opportunities. Managed futures managers were the **big winners** during this time as significant trends developed across virtually all markets. Despite extremely poor strategy fundamentals, merger arbitrage was a relative performance safe haven, down approximately 4% in the second half of 2008 and 5% for the year.

Hedge Fund Outlook

Once the markets achieve some degree of stability in market liquidity, the outlook for hedge fund performance is extremely bright. However, with the current dislocations, hedge funds are not necessarily reliant on a market rebound to produce solid results. Breaking things down to their most basic level, difficult economic environments produce distinct winners and losers. As uncertainty abates and liquidity returns to the markets, capital will flow towards the expected winners and away from the probable losers. Such activity should prove beneficial to security selection strategies such as long/short equity and long/short credit. However, uncertainty remains high and it seems possible that even solidly positioned companies could wind up facing issues if the liquidity crisis continues or worsens.

In the distressed securities space, it seems likely that funds will have the opportunity to invest once again in the classic distressed play of "good companies, bad balance sheets". For funds with cash to invest, 2009 looks to be a year of building out a book of investments that will yield profits for many years thereafter. Bank debt and distressed RMBS are attractively priced as well. While massive deleveraging has created valuation dislocations, the performance of a pure "beta" play remains quite uncertain. Government activism and intervention remain a large risk. As governments engage in policy experimentation, the probability of unintended consequences increases. It is likely that risk management and security selection within markets will remain extremely important, despite the massive sell-off already experienced.

At present, one major challenge for hedge funds is maintaining a balance between survivability and opportunism, which is no easy task. Once liquidity stabilizes, opportunities will present themselves; however, making it to that point could prove difficult in the face of continued deleveraging, mounting investor redemptions, and government activism. In response to high uncertainty and volatility, many managers have reduced exposures dramatically. Going forward, fund managers and investors will likely adjust their assets and liabilities in light of current illiquidity.

Investor Redemptions

Investor redemptions during Q4 were seismic in nature for the hedge fund industry, further exacerbating many of the problems already hindering managers. Many funds reacted by reducing the degree of liquidity available to redeemers via gates, side-pockets, freezing redemptions, etc. This will likely cause the selling pressure from redemptions to spill over into Q1 2009 and potentially beyond. Many managers that met redemptions in full and on schedule are at risk of becoming sources of liquidity for investors given the reduction in liquidity by other fund managers. This “redemption contagion” may cause many previously sound funds to quickly become at risk as well. The net result is a heightened degree of common holdings risk; an issue that warrants continued monitoring.

Investment Fraud

Bernard Madoff made fraud a key topic for hedge fund investors once again. Our thoughts on fraud have been little changed from what we wrote just over 3-years ago following the Bayou scandal. The call for regulation will be loud and clear. Unfortunately, if proper regulation of Madoff’s broker/dealer had been conducted in the first place, this situation could have been avoided, or at least limited. Thus, the theme continues in which the failure wasn’t a lack of regulation of hedge funds, but was due to poorly conducted oversight in the areas of the market that are already regulated. The mantra must be for better, more effective regulation rather than for more regulation.

Credit Crisis

In our most recent issue, we mentioned that the credit crisis was then one-year old and lying at the crux were systematically overleveraged balance sheets amongst financial institutions - an issue that has yet to be resolved. This reality took hold of the markets in September and governments around the globe began the process of addressing this core problem. However, as we sit here now in February, despite the seemingly aggressive efforts of global governments, we remain mired in systematically overleveraged balance sheets amongst financial institutions. This issue must be adequately addressed before we can begin to emerge from this crisis.

PRIVATE EQUITY

Private Equity Performance

We hesitate to discuss the 2008 performance of private equity strategies because the return data available does not yet capture the fourth quarter. As such, a discussion of the numbers would be pretty meaningless. However, we will provide our best estimate of year-end net asset value adjustments.

Buyout valuations will have to be adjusted for both the public company comparables whose values are way down (GE has a trailing PE ratio of under 6 and a forward PE ratio of under 9). A full mark to market would leave little value in the equity of many companies bought over the the course of 2006-2007. Actual markdowns are unlikely to be that dramatic. A 10-20% decline in valuations for Q4 2008 is in line with some industry estimates, but that may be optimistic.

Venture capital performance for 2008 is likely to mask some underlying issues in slowing sales and the fact that many venture stage companies are cutting budgets and projects to conserve cash. Comps for early stage companies are unlikely to change much, but some late stage companies may face markdowns in line with public equities. Funds engaged in PIPE (private investment in a public entity) transactions have seen even more deterioration of value as these riskier companies have been thoroughly thrashed in the public markets.

Distressed and special situation funds will likely determine that they have lost value in junk debt positions and other asset backed type transactions. Those markdowns will be available earliest since such funds often report monthly or provide estimates. Overall performance will also be impacted by the extent to which investors’ auditors force even greater discounts from reported net asset values to comply with FAS157.

Secondaries v2.0

There is a compelling opportunity for investors to add quality investment relationships via direct secondary transactions in the current market. Investors may wish to call on some funds they have wanted to access, but that were not taking in new LPs last time around. These secondary transactions are about access, not price. General partners would like to find replacement LPs who are interested in being a long-term investor. Most secondary funds have little or no interest in committing to future funds, so a quality institutional investor is actually a preferred buyer. A fair price rather than a fire-sale offer and a willingness to act on small interests will help get a deal done.

VC Crisis of Confidence

Venture capital has not produced outsized returns since the internet explosion/implosion of 1995-2000. There has not been the type of robust IPO exit environment since then, and we are about to go through another recession without the benefit of a true up-cycle to ease the pain. It should not surprise any in the venture capital community that some LPs are losing faith in the model.

Recent press attention has been focused on the VC industry. Insiders complain that there are too many companies and not enough truly breakthrough technologies so there is not enough return impact being generated. The modest exit environment also would argue for less capital input if one is to generate VC-like returns. The problem is that there are very few revolutionary companies needing only a few million dollars to get going. What we do get are a lot of web 2.0 (social networks and user generated content) and SaaS (software as a service) companies. It's not that you can't make nice returns from such companies, but you are not getting the breathtaking returns of yore.

There may be some great stuff in university labs, but technology transfer in the US is described by venture capitalists as depressingly poor. There are only a handful of schools that are adept at getting technology out of the lab and into commercial enterprises. The VC industry and the community of technology transfer offices need to come together to develop a set of standards to make this process work better. In keeping America at the forefront of technology, it would be helpful if those responsible for fundamental research and those with a talent for commercialization could find a way to collaborate more effectively.

It is entirely possible that the demand for VC funds declines meaningfully and a handful of factors may make the situation worse than it might otherwise be: 1) the denominator effect will reduce the amount of available capital for a few years, 2) LPs may find that more compelling near-term opportunities are in distressed assets and secondaries and allocate capital to those sectors at the expense of new VC commitments, and 3) buyouts pretty reliably outperform coming out of recessions so capital should be allocated there as well. Roughly \$37 billion was committed to venture capital funds in 2008, and I fearlessly predict that 2009 venture capital commitments will be under \$12 billion excluding growth equity funds.

Buyouts

Large and mega buyouts led the private equity pack for the better part of the last cycle. Accommodative lenders along with economic expansion provided an almost perfect environment for buyout pros to ply their trade. However, along with good returns came ever-escalating valuations. High valuations and high debt loads are likely to be punished as portfolios get marked to market. Assuming valuations revert to more normal levels, the following table is a simplified version of what the mark to market on a fairly typical 2006-2007 buyout would look like.

	2006 Inception	2008 EBITDA Even	2008 EBITDA Up	2008 EBITDA Down
EBITDA:	\$20 MM	\$20 MM	\$25 MM	\$15 MM
EBITDA Multiple	9X	7X	7X	7X
Enterprise Value	\$180 MM	\$140 MM	\$175 MM	\$105 MM
Debt Multiple	6X			
Total Debt	\$120 MM	\$120 MM	\$120 MM	\$120 MM
Equity	\$60 MM	\$20 MM	\$55 MM	-\$15MM
MTM ROI		0.3X	0.9X	0.0X

If EBITDA has risen by 25%, it is almost enough to offset the decrease in enterprise value due to lower valuation ratios. However, given the state of the economy and the fact that a lot of buyouts are in the manufacturing and business service sectors, it may take heroic efforts just to keep cash flow flat. The result in that case is that the equity will have diminished by two-thirds, even though the company is operating at a similar level as at acquisition. The last case shows what happens if cash flow declines by 25% and valuation metrics decline. Since this is simply a mark to market exercise, this does not mean the company is dead – unless it has to refinance its debt. In a tight credit environment, the lenders would likely want to see the equity sponsor put in more capital as part of a refinancing. If the equity sponsor is unable to do so, the company would likely face a Chapter 11 bankruptcy and become fodder for a distressed equity investor.

Distressed

It appears that the next distressed cycle is finally starting in earnest. We are still well below the eventual peak level of bankruptcies, but the current default rate of 4% is on par with normal levels (about half the rate expected for 2009). There are fund managers that think there is another leg down coming for high yield bonds that would signal a time to buy aggressively. We already have placed capital with a number of firms in the space and will add to that in 2009.

REAL ASSETS

Real Estate

Commercial real estate fundamentals took a dramatic downturn in the fourth quarter. The slowing economy, layoffs, and business failures have increased vacancy rates in most markets, especially places like New York, where rents and valuations had been highest. We had anticipated a modest increase in cap rates to drive flat-to-negative mid-single digit net performance from Core real estate funds in 2008.

Through three quarters we were seeing performance ahead of expectations, especially given the weaker economy in the third quarter. Cash flow in most of our funds was still growing as of September 30. Fourth quarter returns for NCREIF (Core unleveraged returns) were -9.54% from asset values plus 1.26% of income for a total return of -8.29% in the quarter. Core real estate funds as tracked by the NCREIF ODCE Index had equity value declines of 12.1%, 1.16% of income, and a total return of -10.9%. The differences between the two indexes are that Core funds may own a wider range of properties than accounted for in the index and use modest amounts of leverage whereas the index has none. Historical calendar year returns for Core real estate sectors are presented below.

	2008	2007	2006	2005	2004	2003	2002	2001	2000
NCREIF	-6.5%	15.8%	16.6%	20.1%	14.5%	9.0%	6.7%	7.3%	12.2%
Apartment	-7.3%	11.4%	14.6%	21.2%	13.0%	8.9%	8.7%	9.3%	12.9%
Industrial	-5.8%	14.9%	17.0%	20.3%	12.1%	8.2%	6.7%	9.3%	14.0%
Office	-7.3%	20.5%	19.1%	19.5%	12.0%	5.7%	2.8%	6.2%	14.1%
Retail	-4.1%	13.5%	13.3%	20.0%	23.0%	17.1%	13.7%	6.7%	7.8%

The total return picture of commercial real estate is a lot more complicated than a 10% decline in asset values would indicate. As we stated above, the Core real estate returns were within our forecast range, but this is true only for the least risky assets. The re-pricing of risk has meant a significant widening of risk premiums for non-stabilized, leveraged, or development assets. Risk-averse lenders are making the refinancing of assets very difficult. New construction loans are extremely scarce, and even more so for larger projects. The inability to re-work the debt side of a commercial real estate balance sheet in the face of falling values will put certain investments and some entire funds at risk of a total wipeout of the equity.

The industry-wide belief that modest supply additions would dampen the downside of a cyclical decline was flat wrong. The current market problems are far worse than anyone inside the real estate industry anticipated. Of course, lots of things are far worse than anticipated. Vacancy rates are increasing across all major markets. Rents are falling. The retrenchment in commodities like steel and cement are lowering replacement costs, a rare phenomenon. The soft economy is also bringing down the cost of labor, one of the drivers of escalating development costs over the last five years.

Complicating the decline in fundamentals are the credit disruptions among commercial real estate lenders. The refinancing of a development project is very difficult at present. CMBS margin calls are making life difficult for anyone with such financing that was originally above 65% LTV. Add in increased costs for leasing, like higher tenant improvements and commissions, and many funds are re-underwriting their portfolios to much lower expected returns.

Safe vs. Sorry

Funds can get into trouble for a number of reasons in this type of economic environment. Deals underwritten based upon aggressive rent growth, leasing of large amounts of vacant space, and buying at a discount to replacement cost face the largest challenges in the next couple of years. Even so, the difference between a fund that survives to the other side of the recession and one that fails to return capital is likely to hinge upon the amount, source, and duration of the debt used to finance the assets.

Declining assets are hard to refinance. Properties financed with CMBS debt may need an equity infusion to pay down the debt to a specified threshold. If the manager does not have the needed capital (from undrawn investor commitments) to pay down the debt, the likely options are to try to get preferred equity which is costing 20%+ or sell assets at fire sale prices to raise the needed capital to avoid catastrophic losses.

Banks are having plenty of troubles right now, and lenders who have historically been flexible in dealing with problem loans may not be able to grant relief to a borrower that needs it. In some cases, the banker who arranged an original loan has left or his bank has been merged. Investors who borrowed capital from hedge funds or other non-traditional sources are likely regretting that choice. It is the fortunate general partner whose lenders have the flexibility and long-term view needed to successfully navigate a difficult period.

A stable source of debt combined with a long duration is the best scenario. Managers who used short-term funds with the expectation of selling assets inside of three years are in the worst position since asset sales are just not happening outside of the apartment sector where Fannie and Freddie still provide financing. Aggressive strategies can still weather this storm if the general partners were more conservative in arranging the debt.

Strategy Impacts

The real estate funds in the best shape are in the apartment or grocery anchored retail segments since those spaces are under less pressure than the office, hotel, or discretionary retail areas. Funds with plenty of reserved capital, those with low leverage, as well as newer funds from 2007 and 2008 are almost all in respectable shape. Troubles in the investment banking world will negatively impact the opportunity funds sponsored by those institutions. Vintage year diversification will really pay for those who only started investing in funds in 2004-2006 as those vintage years are facing the most challenges due to low reserves and high levels of maturing debt.

What's the good news? Well, new money can be invested at greatly reduced valuations versus just 6 months ago. The void in the debt markets is an opportunity to earn equity-like returns with a generous margin of safety if the market declines accelerate. Smaller deals that require less than \$30 million of debt are still able to be completed. Lastly, the number of me-too real estate fund wannabes will be trimmed as talent will be discernible from market-driven returns.

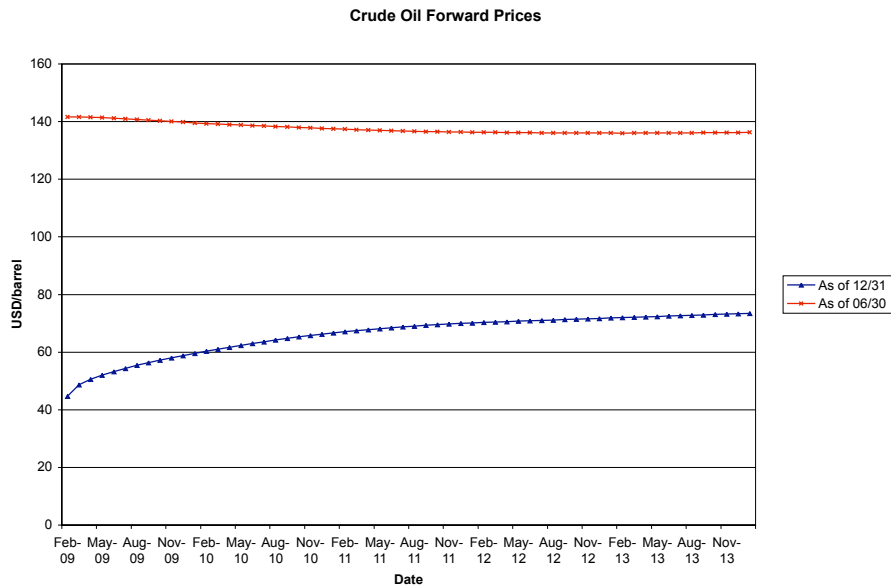
For 2009 we anticipate being heavily weighted to special situation real estate funds that can operate in both the debt and equity markets. Also, we may participate in the secondary market, but only where we can acquire underlying assets with relatively low leverage to avoid refinancing risk.

Commodities

Those who claimed that speculators were not an influence on the dramatic rise of commodity prices over the course of the first half of 2008 may want to re-think their stance. Deleveraging of financial institutions and hedge funds has coincided perfectly with the repricing of commodities in the second half of 2008. The hand of speculators seems to be all over the failure of SemGroup whose demise was hastened by the persistent increase in natural gas prices. This case is somewhat analogous to the collapse of Amaranth both in the failure of a firm to adequately police the trades of an individual as well as the role of hedge funds and other speculators in breaking the target firm by pushing prices until the other undercapitalized party capitulated.

Hedging commodity prices has always been a central part of the discussions of oil and gas investment funds. On one hand, hedging the commodity prices weakens the link between the investment and inflation. However, having a pure play on commodities means participating in both up AND down directions. In a normal market, we expect that inflation would coincide with weak performance in other parts of the portfolio and natural resources would serve as a hedge. Conversely, lower commodity prices would mean higher margins, lower inflation and interest rates, and strong equity performance.

Hedging is typically tied to the futures prices of the commodities. Funds that decided to place hedges on their energy production in mid 2008 have been rewarded for doing so. The futures curve for NYMEX oil contracts at June 30, 2008 and December 31, 2008 are below.



At this moment, low energy prices are a sign of a global economic slowdown and are also a reflection of the damage wrought on those leveraged speculators (like hedge funds), who had helped support prices over the last few years. With commodity prices down 60-70% off their peaks, we would expect to be losing money on energy investments. However, in forsaking purity for safety, our natural resource managers have protected capital in the face of a 60%+ decline in spot prices. I believe most of our clients will find this to be an acceptable trade-off.

Secondaries

The secondary market for private equity fund interests has been around since the early 1990s, but has grown dramatically over the last five years. It seemed that there was more capital than available opportunity as we saw prices (as a percentage of NAV) rise from the 85% range in 2004 to around 95% by mid 2007. Some buyout fund interests were trading at premiums to NAV and a few funds added leverage to generate acceptable returns.

The decline in the value of institutional portfolios combined with the demise or distress in financial institutions has created a glut of private equity fund interests in the secondary market. The secondary fund managers we know are busier than ever. Distressed sellers are seeing bids on assets of 50% of NAV or less. Some of the discount is due to adjusting valuations to more realistic levels and part is the typical liquidity discount for transacting in this market. Buyers expect that once valuations adjust to reflect the current environment they should still see discounts of 30%, the level one typically sees at the bottom of a cycle.

There are reports of some endowments selling assets into the secondary market, or at least intending to do so. It has also been rumored that some of the endowments decided that the market prices were too low to proceed as planned. If non-distressed sellers find market prices to be too low, they can hope prices rebound and wait out the current wave of selling. However, with so many sellers in the market, it could be a long wait.

Hammond Associates Alternative Investment Research Team

Michael Forestner, CFA
 Eric Rudy
 Dave McMillan, CFA
 John Schelich
 Cassie Rosenberger

Harry Leggat
 Kelly Frericks
 Michael LeVar, CFA
 Scott Zipfel, CFA
 Debbie Akins

Grant Leslie, CFA
 John Jackson
 Stephen Ewen, CFA
 Juleigh Schwartz