CLIFFWATER LLC

INVESTMENT ADVISORY SERVICES

Los Angeles • New York

PFM Hedge Fund Operations Due Diligence Report
Partner Fund Management, L.P.

December 2011

Investment Due Diligence Report provided under separate cover.

Hedge Fund Operations Due Diligence Report

Firm Name:	Partner Fund Management, L.P.			
Fund Name:	PFM Diversified Fund, L.P. PFM Diversified Fund A.I., L.P. PFM Diversified Offshore Fund, Ltd. PFM Diversified Offshore Fund A.I., Ltd. PFM Diversified Offshore Institutional Fund, Ltd. (ERISA) PFM Meritage Fund, L.P. PFM Meritage Offshore Fund, Ltd.			
Style:	Equity Long / Short		**Location:**	San Francisco, CA
Review Date:	November 2011		**Reviewer:**	[redacted]

Operations Score: [redacted]			
1. Business Management	[redacted]	4. Valuation	[redacted]
2. Trading and Investment Operations	[redacted]	5. Risk Management	[redacted]
3. Financing and Counterparty Risk	[redacted]	6. Investor Related Practices	[redacted]

Summary

Partner Fund Management, L.P. ("PFM" or "the manager") is a global long / short equity fund that was established in 2004 by Christopher James. The firm is based in San Francisco and has additional offices located in New York, London and Hong Kong. PFM currently manages $4.9 billion across four investment strategies and has 73 full time employees. The non-investment team is led by a Chief Financial Officer, a Director of Operations, a Compliance Officer and a General Counsel. PFM has been registered as an Investment Advisor with the SEC since 2008.

PFM's team of 43 non-investment professionals effectively manages all trading and business operations and meets nearly all industry operational best practices except in two areas. The first departure from best practices is the manager does not utilize an internal accounting system as the administrator is responsible for maintaining the sole complete set of books and records. However, this departure does not seem to materially increase operational risk as the fund's trade operations group reconciles P&L with the [redacted] on a daily basis. In addition, the Chief Financial Officer performs a detailed review of the NAV calculations at each month end. The second departure is that there are two portfolio managers included on the firm's internal Pricing Committee. This departure from best practices does not materially increase operational risk as the majority of committee members are non-investment professionals, including the Chief Financial Officer and Chief Compliance Officer.

Section 1: Business Management

Score: [redacted]

PFM meets all business management best practices which assess firm organization, compliance, investor protections and disaster recovery.

Darin Sadow serves as PFM's Chief Compliance Officer ("CCO"). The manager has been registered with the SEC since 2008 and has a developed a detailed compliance manual including a Code of Ethics. Personal trading is permitted by employees in open ended mutual funds and US Treasury securities without pre-approval of the CCO. Liquidating stock transactions for employees and investing in external hedge funds are subject to pre-approval, however. Duplicate brokerage statements must be provided directly to the compliance department. Soft dollar usage complies with the safe harbor provisions of

Section 28(e). PFM utilizes expert consulting networks as a component of their internal research process. Strict compliance policies related to their usage includes the CCO participating on calls with consultants, developing scripts that must be communicated prior to a call and the monitoring of consultant usage.

PFM has developed a comprehensive disaster recovery plan to ensure the manager can continue to operate effectively due to a failure or disruption of operations. Trades can be executed from any of the manager's four offices should any become inaccessible. In addition, all employees have VPN access to their relevant files and business applications. The firm backs up data nightly and utilizes virtual servers. PFM currently maintains D&O and E&O insurance coverage up to $15 million and may consider increasing the coverage limit in the near future.

Best Practices Comparison

Organization and Governance		Yes	No
1	[redacted]		
2			
3			
4			
Compliance			
5	[redacted]		
6			
7			
8			
9			
10			
11			
12			
13			
14			
Investor Protections			
15	[redacted]		
16			
17			
18			
19			
20			
21			
22			
23			
24			
Disaster Recovery			
25	[redacted]		
26			
27			

Background

Criteria	Cliffwater Comments
Firm structure: [redacted]	[redacted]
Fund structure and domicile [redacted]	[redacted]
Compliance policies: [redacted]	[redacted]
Specific policies: [redacted]	[redacted]
Legal proceedings	[redacted]

[redacted]	[redacted]
Regulatory authorities: [redacted]	[redacted]
Systems and platforms: [redacted]	[redacted]
IT staff size and turnover:	[redacted]
Backup procedures: [redacted]	[redacted]
Business continuity and disaster recovery plan: [redacted]	[redacted]
Insurance coverage: [redacted]	[redacted]

[redacted]

Section 2: Trading and Investment Operations **Score:** [redacted]

PFM meets all trading and investment operations best practices which assess outside service providers, infrastructure, trading and accounting processes, counterparty monitoring and cash management except that the manager does not maintain an internal accounting system. The administrator is responsible for maintaining the official books and records; however, this departure from best practices does not seem to materially increase operational risk as the manager's trade operations group reconciles P&L with the [redacted] on a daily basis. In addition, the Chief Financial Officer performs a detailed review of the NAV calculations at each month end.

[redacted] serves as the funds' independent administrator. [redacted] also provides middle office functions which include performing a daily reconciliation of cash and positions and the identification and resolution of trade breaks. [redacted] are the fund's prime brokers and the [redacted] serve as custodians for cash balances. [redacted] and [redacted] are retained as legal counsel to advise the funds on domestic and Cayman matters, respectively.

Effective January 1, 2012, [redacted] will replace [redacted] as the fund administrator and middle office provider. PFM decided to change providers and consolidate these functions as they desired enhanced real time reporting and daily valuation capabilities, in addition to a more robust technology platform and collateral management services. The manager has been working with [redacted] and [redacted] in parallel for several months to ensure a smooth transition. It is expected that the cost PFM will be paying to [redacted] will be the same, if not less, than the fees paid to [redacted] for the administration and middle office services combined. [redacted] will remain an integral counterparty for the firm related to prime brokerage and trade execution, however.

Trade orders to be executed are entered into [redacted] the firm's order management system. At least 80% of the trades are executed electronically via [redacted] connections. Trades orders are generally allocated to each fund on a pro-rata basis based on individual fund assets under management, which is updated daily by the administrator. Electronic trade files are automatically provided to the prime brokers and the administrator directly from [redacted] Any trade breaks are reviewed and reconciled by the manager, in conjunction with [redacted] Cash wires for fund expenses require at least two authorized signatures from the manager and the approval from the administrator in order to be processed.

Best Practices Comparison

Outside Service Providers		Yes	No
28	[redacted]		
29			
30			
Infrastructure			
31	[redacted]		
32			
33			
34			
35			

36	[redacted]
Trading Practices	
37	[redacted]
38	
39	
40	
41	
42	
43	
44	
45	
Core Accounting Processes	
46	[redacted]
47	
48	
49	
50	
51	
Cash, Margin, and Collateral Management	
52	[redacted]
53	
54	
55	
56	

Entity and Contact	Onshore	Offshore
Prime Broker	[redacted]	
Administrator	[redacted]	
Audit	[redacted]	
Legal	[redacted]	
Tax	[redacted]	
Other (including custodian if not PB)	[redacted]	
Changes in providers (3 yrs)	[redacted]	

Entity and Contact	Onshore	Offshore
	[redacted]	
Any issues encountered in audit of firm or its products?	[redacted]	

Criteria	Cliffwater Comments
Organizational Structure: [redacted]	[redacted]
Control structure and oversight [redacted]	[redacted]
Trading team: [redacted]	[redacted]
Types of securities traded [redacted]	[redacted]
Trading practices: [redacted]	[redacted]
Trade flow process: [redacted]	[redacted]

	[redacted]
Trade confirmation and reconciliation: [redacted]	[redacted]
Specialized groups [redacted]	[redacted]
Reconciliation process with administrator: [redacted]	[redacted]
Cash movements: [redacted]	[redacted]

Section 3: Financing and Counterparty Risk **Score:** [redacted]

PFM meets all financing and counterparty monitoring best practices which assess how the manager finances its portfolio and manages its cash.

The funds primary sources of financing are margin provided by the prime brokers and via the use of derivative transactions governed by ISDA master agreements. Gross exposure will not generally exceed 200%; therefore PFM does not require financing by the prime broker beyond Regulation T margin levels nor has the fund negotiated term margin agreements. The manager has negotiated nine bi-lateral ISDA agreements to support its over-the-counter transactions. PFM is focused on monitoring the financing rates charged by its counterparties and proactively renegotiate terms as appropriate. Excess cash is maintained at custodial relationships with either the [redacted] or [redacted] and held in either a tri-party repo structure or invested in FDIC protected bank accounts.

Best Practices Comparison

	Financing and Counterparty Risk	Yes	No
57	[redacted]		
58			
59			
60			
61			
62			
63			
64			
65			

Background

Criteria	Cliffwater Comments
Sources of financing: [redacted]	[redacted]
Counterparties and terms of arrangements: [redacted]	[redacted]
Prime broker financing: [redacted]	[redacted]
Repo agreements [redacted]	[redacted]
ISDAs [redacted]	[redacted]
Other (i.e. CDOs, debt offerings, etc.)	[redacted]

Section 4: Valuation **Score:** [redacted]

[redacted]

PFM meets all valuation best practices except that two portfolio managers are included on the Pricing Committee. However, this departure from best practices does not materially increase operational risk as the majority of committee members are non-investment professionals, including the Chief Financial Officer and Chief Compliance Officer.

[redacted] is responsible for the monthly valuation of the portfolio based on prices provided by third party vendors. The pricing sources are outlined in a pricing matrix that is approved by the manager each December. The matrix denotes the pricing sources by product type and the pricing methodology. The firm's primary pricing sources include [redacted] for listed equities and [redacted] for Bank Debt and Credit Default Swaps. PFM reviews the portfolio valuations during the month-end closing process. The administrator also provides data related to pricing verification on a quarterly transparency report.

As noted above, PFM has established an internal Pricing Committee. The Committee meets on a quarterly basis, or as needed, to review valuation procedures and review any positions that may require a determination of fair value. However, the need to determine fair value positions is rare as there are no Level 3 assets in the Diversified Fund.

Best Practices Comparison

Valuation Personnel		Yes	No
66	[redacted]		
67			
Valuation Policy			
68	[redacted]		
69			
70			
71			
72			
73			
74			
75			
76			
77			
78			
Pricing Sources and ASC 820(formerly FAS 157)			
79	[redacted]		
80			
81			
82			
83			
84			
85			
86			
87			
88			
Positions with No Readily Ascertainable Market Value			
89	[redacted]		
90			

91	[redacted]
92	
93	
94	
Valuation Procedures	
95	[redacted]
96	
97	
98	
99	
100	
101	
102	
103	
104	
105	
106	
107	
108	
109	

Background

Criteria	Cliffwater Comments
Month end closing process [redacted]	[redacted]
Valuation of exchange traded (level 1) assets: [redacted]	[redacted]
Valuation of OTC / illiquid instruments / private placement (level 2 and 3) assets [redacted]	[redacted]

[redacted]

Section 5: Risk Management

Score: [redacted]

PFM meets all risk management best practices. Risk management is primarily the responsibility of William Smith (Macro/Risk analyst) and Ian De Weerdt (Risk/Data analyst). Mr. Smith focuses on hedging and macro themes and Mr. De Weerdt focuses on risk reporting. PFM has also established a Risk Management Committee to provide an oversight function related to risk management processes and control policies. [redacted] and proprietary systems are utilized as risk management tools.

Risk is actively managed on the position and portfolio level using a variety of measures and reporting tools. The manager conducts stress tests to evaluate the sensitivity of the portfolio to scenario analysis and historical stress events. PFM is also highly focused on maintaining a liquid portfolio and limits individual position size to 5% at cost for both longs and shorts. The portfolio is constructed to manage gross exposure to between 80% and 140%. In addition, the risk management process includes the hedging of market risk and currency exposure, as appropriate.

A non-market risk committee has also been established to focus on counterparty exposure and the insurance needs of the organization. The committee monitors the CDS spreads of each prime broker and execution counterparty. The manager will cease trading with a particular broker if spreads widen significantly. Cash is also actively transferred from a prime broker to custodial accounts at either the [redacted] or [redacted] to mitigate counterparty exposure and further manage liquidity.

Best Practices Comparison

Structure		Yes	No
110	[redacted]		
111	[redacted]		
112	[redacted]		
113	[redacted]		
114	[redacted]		
115	[redacted]		
116	[redacted]		
117	[redacted]		
118	[redacted]		
119	[redacted]		
Risk Manager			
120	[redacted]		
121	[redacted]		
122	[redacted]		
123	[redacted]		
124	[redacted]		
125	[redacted]		

Risk Limits and Testing	
126	[redacted]
127	
128	
129	
130	
131	
Leverage and Liquidity Risk	
132	[redacted]
133	
134	
135	
136	

Background

Criteria	Cliffwater Comments
[redacted]	[redacted]
Liquidity risk and funding: [redacted]	[redacted]

Section 6: Investor Related Practices **Score:** [redacted]

PFM meets all disclosure and investor terms best practices. The fees are calculated based on the audited financial statements and based on the dollar of value added. The lock-up provisions protect the fund from having to liquidate the portfolio at a discount to meet investor redemptions. There are no gate provisions in the investor liquidity terms.

Investors can expect to receive monthly NAV statements from the administrator within five to ten business days after month-end. PFM will provide monthly performance estimates within three business days after each month-end. Additional portfolio information related to sector and regional exposures, as well as performance attribution statistics is provided by the manager on a monthly basis. The administrator also provides transparency reports detailing assets held by counterparty and price verification on a quarterly basis.

PFM's financial statements are audited by [redacted] and have always been issued with an unqualified opinion. The audited financial statements and schedule K-1's are generally provided to investors by March 15th, which is timelier than the industry standard. Fund expenses from 2008 to 2010 averaged 18 basis points for both the onshore and offshore funds, which is slightly lower than 22 and 20 basis points for the onshore and offshore funds, respectively, for Cliffwater's approved equity long / short managers. The fund expenses include audit fees, tax, legal, administration, offshore director fees and a portion of the E&O and D&O insurance premiums.

Best Practices Comparison

Initial Disclosures		Yes	No
137	[redacted]		
138			
139			
140			
141			
142			
143			
144			
145			
Fees and Expenses			
146	[redacted]		
147			
148			
149			
150			
151			
Ongoing Information Provided to Investors			
152	[redacted]		
153			
154			
155			
156			

157	[redacted]
158	
159	
160	
Financial Statement and Tax	
161	[redacted]
162	
163	
164	
165	
166	
Investor Terms	
167	[redacted]
168	
169	
170	

Background

Criteria	Cliffwater Comments
[redacted]	[redacted]
Fund financial and tax statements: [redacted]	[redacted]

Criteria	Cliffwater Comments
[redacted]	[redacted]

Meeting History

Date	Location	Cliffwater Attendees	Manager Attendees
November 10, 2011	San Francisco, CA	[redacted]	Graham Low (Business Development), Kimberly Summe (General Counsel), Eric Moore (Chief Financial Officer), Linda Fitzgerald (Director of Operations)
November 17, 2011	New York, NY (conference call)	[redacted]	Darin Sadow (Chief Compliance Officer)

Appendix: Glossary

Administrator	A service provider such as Citco or International Fund Services that handles administrative responsibilities such as calculating the fund's NAV on a monthly basis, sending the investors performance reports, and maintaining the official books and records of the fund.
Fair Value (ASC 820)	FASB Statement No. 157, Fair Value Measurements ("ASC 820"), defines fair value as "*the price that would be received to sell an asset or paid to transfer a liability in an orderly transaction between market participants at the measurement date*." Cliffwater reviews valuations according to the Fair Value hierarchy established by ASC 820, the three levels of which are described below.
Level 1 assets	Liquid assets with readily observable prices, and therefore a reliable market value. Level 1 assets typically include stocks, bonds, mutual funds, and any other assets that have a regular "mark to market" pricing mechanism.
Level 2 assets	Assets with a value based on market inputs that are not directly observable on a central exchange. These assets are often priced via quotations from dealers. An example of a level 2 asset is a credit default swap which is typically priced via indicative quotations from broker dealers.
Level 3 assets	Illiquid assets with a value that cannot be determined by observable measures. The fair value of a Level 3 asset can only be estimated by using significant assumptions as inputs to the valuation model. Illiquid private equity investments are an example of this type of asset. Each manager may derive its own internal valuation policy regarding the classification of Level 3 assets depending on available pricing sources, or other factors, however.
Leverage	The use of explicit debt (i.e. borrowing) or implicit debt (i.e. derivatives) to achieve investment positions that exceed invested capital (NAV), thereby amplifying return but also increasing risk. A common leverage calculation is the ratio of gross notional exposure to invested capital. For example, a $100 investment in BP stock coupled with a $100 short sale of Exxon stock yields gross notional exposure of $200. Leverage in this example can be described in at least two ways: a. The portfolio has 200% gross exposure (equal to $200 gross notional exposure divided by $100 NAV) b. The portfolio is one time (1x) levered (equal to $100 in debt divided by $100 NAV)

	As illustrated in the example, the $200 gross notional exposure equals the absolute value total of both $100 long ("gross long") and $100 short ("gross short") asset exposures. The measurement of gross notional exposure varies by asset class: • *Equities* – the market value of long and short positions • *Corporate Debt and Municipal Bonds* – the market value of long and short positions • *US Treasuries (and other highly rated government debt)* – the market value of long and short positions, adjusted to a 10 year bond equivalent maturity (approximate 9 year duration), so that a $100 exposure to a 2 year duration bond is recognized as a lower risk compared to a $100 20 year duration bond. The $100 3 year duration bond is said to have a $33 10 year bond equivalent exposure ($100 times 3, divided by 9) while the $100 20 year duration bond is said to have a $222 10 year bond equivalent exposure ($100 times 20, divided by 9) • *Options* – the delta adjusted exposure rather than the total notional value of the underlying reference asset. Delta adjusted exposure represents the implied shares/holdings necessary to hedge the options position • *Credit Default Swaps* – total notional exposure of the underlying reference credit • *Interest Rate Swaps* – total notional exposure (expressed as 10-year bond equivalent, per the duration adjustment process described above) to reference security or index • *Futures/Forwards* – total notional exposure to reference security or index
Net Asset Value (NAV)	A fund's total assets less total liabilities.
Notional Exposure	The total dollar exposure represented by a position. Due to leverage, this amount may be greater than the equity in the position. For example, a CDS contract offering $1 million of protection has a notional value of $1 million even though the cost of the contract itself is likely to be a small fraction of that amount.
Gross Long	The total notional exposure of all long positions in a portfolio. Long positions benefit from increases in securities prices.
Gross Short	The total notional exposure of all short positions in a portfolio. Short positions benefit from decreases in securities prices.
Net	The difference between a portfolio's gross long and gross short exposures. A net long position indicates a higher portion of long positions in the portfolio, and that the portfolio should generally benefit from an increase in asset prices. A net short position indicates the opposite.
Total Gross	The sum of a portfolio's gross long and gross short exposures.
Operations Score	A measure of how well the firm meets best practice standards on a scale of A (meets all best practice standards) to F (does not meet several best practice standards). A rating of "C" or lower indicates Cliffwater believes the firm's departure from best practices could hurt returns or lead to the misappropriation of firm assets.
Prime Broker	A prime broker custodies assets, provides settlement services, facilitates the borrowing of securities for short positions, and may provide performance reporting for hedge funds. JPMorgan, Goldman Sachs, Morgan Stanley and UBS are large prime brokers.
Side Pocket	A segregated portion of a portfolio that may be used to hold illiquid, less frequently priced securities. Once a holding is placed in a side pocket, only current investors participate in its performance. Subsequent investors do not share in the gains/losses associated with assets previously placed in side pockets. Performance fees are paid when side pocket investments are realized. Assets placed into side pockets are not available for withdrawal until the investments are realized.
Soft Dollars	Commission credits from trading securities that can be used to pay for research or other services that brokers provide to hedge funds and that are intended for the benefit of investors. Most funds operate under the SEC 28e safe harbor rules that restrict soft dollar use to research only.
Unencumbered Cash	Unencumbered cash is equal to cash holdings less margin requirements.