INVESTMENT ADVISORY SERVICES

Los Angeles • New York

Hedge Fund Investment Due Diligence Report
Gracie Credit Opportunities Fund, L.P.
Gracie International Credit Opportunities Fund, Ltd.

September 2011

Operations Due Diligence Report provided under separate cover.

Hedge Fund Investment Due Diligence Report

Firm Name:	P&S Credit Management, L.P.		
Fund Name:	Gracie Credit Opportunities Fund, L.P. Gracie International Credit Opportunities Fund, Ltd.		
Fund/Strategy Assets:	$2.3 billion		
Style:	Credit	**Location:**	New York
Review Date:	September 2011	**Reviewer:**	[redacted]

Summary

People and Organization: P&S Credit Management ("Gracie" or the "manager") was founded in 2004 by Daniel Nir. The credit strategy launched in July 2004, and with the addition of a credit team from Calyon headed by James Palmisciano in April 2005, Gracie shifted the focus of its credit strategy from distressed to global long/short with a macro overlay. Gracie currently has 30 employees including 18 investment professionals and is headquartered in New York. The firm manages $2.3 billion in one credit strategy. Senior members of the firm have a substantial portion of their net worth invested in the funds. Gracie expects to be registered with the SEC by early 2012.

Investment Strategy and Process: The Gracie Credit Opportunities Fund ("GCOF" or the "fund") is a global long/short credit strategy focused on liquid credit instruments. Gracie combines a fundamental core credit portfolio with a macro overlay to dampen volatility and focus on risk adjusted returns. The fund typically has 100 to 200 trades in the portfolio expressed through cash or derivative instruments from investment grade to distressed companies. The portfolio is actively traded with typical holding periods of four months. Gracie invests globally and expects that a significant portion of fund investments will be outside the U.S.

Performance: GCOF has generated strong risk adjusted performance. From July 2004 to July 2011, the fund has produced an annualized net return of 11.79% with a 5.20% standard deviation, resulting in a 1.67 Sharpe ratio.

Risk Management: Gracie Credit uses a multi-portfolio manager approach to managing risk and making investment decisions. The three portfolio managers collaborate among themselves and with the investment team on a regular basis. Gracie utilizes proprietary models to assess and manage portfolio risk, including stress testing and risk analysis scenarios. In addition, Gracie is focused on maintaining a liquid portfolio, and this is one of the main factors monitored through the firm's risk management process.

Operational Analysis: Gracie's team of 12 non-investment professionals effectively manages all trading and business operations. The manager has institutional-quality processes and controls which includes detailed trade confirmation and reconciliation procedures and a strong internal compliance program. In addition, Citco, the administrator, performs an independent review of the valuations determined by the manager on a monthly basis. No material departures from best practices were identified during Cliffwater's operational due diligence.

Investment Terms: The fund's investment terms are in-line with other top-tier credit managers. Gracie charges a 2% management fee and a 20% performance fee with a modified high water mark. The fund imposes a 12 month soft lock on each contribution, with an early withdrawal penalty of 3%. The fund offers quarterly liquidity with a 90 day notice. In addition, the fund offers monthly liquidity with a 90 day notice, subject to a 6% redemption penalty (9% during the soft lock). Gracie also offers an institutional share class (Class D) with a 1.5% management fee and a 20% performance fee with a two year soft lock. The institutional share class has a $125 million minimum. There is a 25% fund level gate.

Recommendation

The Gracie Credit Opportunities Fund is recommended for investment in the credit category.

This report reflects information only through the date hereof. Our due diligence and reporting rely upon the accuracy and completeness of financial information (which may or may not be audited by the fund manager) and other information publicly available or provided to us by the fund manager, its professional staff, and through other references we have contacted. We have not conducted an independent verification of the information provided other than as described in this report. Our conclusions do not reflect an audit of the investment nor should they be construed as providing legal advice. Past performance does not guarantee future performance. The information contained herein is confidential commercial or financial information, the disclosure of which would cause substantial competitive harm to you, Cliffwater LLC, or the person or entity from whom the information was obtained, and may be protected from disclosure by applicable law.

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People and Organization

P&S Credit Management ("Gracie" or the "manager") was founded in 2004 by Daniel Nir. The Gracie Credit Opportunities Fund ("GCOF" or the "fund") was launched in July 2004, and with the addition of a credit team from Calyon headed by James Palmisciano in April 2005, Gracie shifted the focus of its credit strategy from distressed to global long/short with a macro overlay. Gracie currently has 30 employees including 18 investment professionals and is headquartered in New York. The firm manages $2.3 billion in one credit strategy. Senior members of the firm have a substantial portion of their net worth invested in the funds. Gracie expects to be registered with the SEC in early 2012.

James Palmisciano is the CIO and the head Portfolio Manager for GCOF. Prior to joining the Investment Manager in April 2005, Mr. Palmisciano was a Managing Director and co-head of CLCM, a proprietary, multi-strategy credit fund within Calyon. Prior to joining Calyon in 2003, Mr. Palmisciano was a Director with Deutsche Bank in New York, where he was a top-ranked Credit Derivative Strategist. He was also responsible for fundamental research for Deutsche Bank's proprietary credit trading operation and managed a joint venture between the credit derivative and commercial mortgage backed securities groups. Prior to joining Deutsche Bank in 1999, Mr. Palmisciano spent nine years as an Analyst covering the financial sector at Moody's Investors Service, the Federal Reserve Bank of NY and the FDIC. He holds an M.B.A from Fordham University (Honors) and a B.S. in Finance from the State University of New York at Buffalo.

Manbir Singh is a Portfolio Manager for GCOF focused on the macro portfolio and emerging markets. Prior to joining the Investment Manager in April 2005, Mr. Singh was a Managing Director and Global Head of Credit and Equity Proprietary Trading at Calyon. Prior to its merger with Calyon, Mr. Singh was the Global Head of Credit Trading at Credit Lyonnais from 2001 to 2004. From 1993 to 2000, he was Managing Director and Portfolio Manager at New World Investments Management, L.P., an emerging markets hedge fund. Mr. Singh holds an M.B.A. from the University of Chicago and a B.S. from the University of Alberta.

Michael Robertson is a Portfolio Manager for GCOF focused on the core credit portfolio. Prior to joining the Investment Manager in 2005, Mr. Robertson was a Managing Director at Calyon from 2003 to 2005. Prior to Calyon, he was an Institutional Investor ranked sell-side analyst at UBS from 2000 to 2003, and an industrial analyst at Paine Webber from 1997 to 2000, and an industrial analyst at Deutsche Bank, from 1995 to 1999. Mr. Robertson has an M.B.A. from Columbia University and a B.A. in Finance from the University of Texas.

Alex Koundourakis is the Head Trader for GCOF. He was previously a Managing Director at Calyon from 2004 to 2005. Prior to Calyon, Mr. Koundourakis was a Vice President in credit sales at Merrill Lynch from 2001 to 2004, and a senior broker heading global credit derivatives at Cantor Fitzgerald from 1995 to 2001. He holds a B.A. in Political Science from Western Maryland College.

Daniel L. Nir is the original founding partner of P&S. Mr. Nir has not been actively involved in the investment process for GCOF since 2005. Subsequent to closing the equity strategy in 2008, his role had been more focused on marketing and serving as a consultant to the investment team. Prior to founding Gracie, Mr. Nir was a general partner of and investment analyst for Gotham Capital, a private investment firm. Mr. Nir is a graduate of the Wharton School of the University of Pennsylvania.

Gracie has experienced slow but steady asset growth since the firm's inception. The manager is currently operating at peak assets, with the majority of assets in one core credit strategy. Gracie manages three separate accounts outside GCOF, two of which are managed *pari passu* to the fund. The third separate account is a small convertible bond strategy that transferred to Gracie with the recent hire of a convertible bond specialist. The firm's founder, Daniel Nir, managed a long-biased equity fund from 1999 to June 2008. This fund was technically managed under a separate management company. Mr. Nir decided to close the fund in May 2008. Although performance was strong (14% annualized returns since inception) and assets were over $1 billion, Mr. Nir felt it was becoming more difficult to manage a long-biased equity strategy given the state of the market in 2008. Mr. Nir closed the fund and the majority of the capital was

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returned to investors within a couple of months. Gracie is focused on managing one core credit strategy and has no current plans to raise another fund. The manager has concentrated its marketing efforts on long-term institutional investors. Gracie believes capacity for GCOF is around $4 billion. A history of the firm's assets under management can be found in Exhibit 1.

Exhibit 1: Gracie Assets under Management ($ millions)

Year End	Total Firm Assets	GCOF	Separate Accounts
2004	45	45	-
2005	32	32	-
2006	473	473	-
2007	759	759	-
2008	833	833	-
2009	1,351	1,351	-
2010	1,908	1,877	82
July 2011	2,151	1,926	230

On November 1, 2010, Moelis & Company Gracie Holdings LLC ("Moelis") purchased 100% of the equity interests in the General Partner. Moelis is a global investment bank that provides financial advisory and asset management services to a broad client base, including corporations, institutions and sovereigns. Gracie retained complete autonomy over the investment process and portfolio management decisions. Moelis is not involved in the day-to-day operations of the manager.

Prior to the Moelis transaction, Mr. Nir owned of the manager with the four senior investment professionals owning the remaining interests. Mr. Nir has not been actively involved in portfolio management since 2008 when he closed the equity fund, and consequently he did not have a significant role within the firm's investment process. The Moelis transaction enabled Mr. Nir to monetize his interests, as wells as provide Gracie with a long-term strategic partner. Gracie believes this transaction will enhance the viability of the firm and enable thse manager to continue to attract talent. As part of the Moelis transaction, the four senior investment professionals involved with GCOF signed five year employment contracts. In addition, Gracie will have the first right to approve or acquire an interest in any credit fixed-income related strategies which Moelis is interested in developing or acquiring.

The fund is organized in a master-feeder structure. Gracie Credit Opportunities Fund, L.P., a Delaware limited partnership, is the onshore feeder. Gracie International Credit Fund, Ltd., a Cayman Islands exempted company, is the offshore feeder. Both funds invest substantially all of their assets in the master fund, Gracie Opportunities Master Fund, L.P.

Gracie has a quality client base that includes about 360 investors across fifty relationships. The investor base is concentrated with the top ten clients comprising of the fund. The current client mix in the fund includes hedge fund of funds sovereign wealth funds, corporate pensions, state pensions and insurance companies high net worth and family office investors and insider capital . Insider capital includes investments from the four senior investment professionals at Gracie, Mr. Nir and several senior individuals from Moelis. The two managed accounts are longstanding Gracie investors, both of which are institutional hedge fund of fund investors.

Mr. Palmsciano is the CIO and is ultimately responsible for all investment decisions. He heads a team of two senior portfolio managers, eight senior analysts, four analysts and three traders. The three portfolio managers have worked together for over eight years and the investment professionals have an average of ten years of experience. Mr. Singh is the portfolio manager focused on global macro and emerging markets, and Messrs. Palmsciano and Robertson are focused on the core credit portfolio.

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Gracie has a stable investment team and has not experienced any turnover on the investment team at any level since the firm's inception. The manager has continued to strengthen the team, adding three analysts over the last several years. Two of these additions were analysts with expertise in convertibles, and one was a fundamental equity analyst. The analysts and traders are compensated through [redacted] Exhibit 2 depicts Gracie's employee base by functional area, while Exhibit 3 provides biographical data on the manager's key investment and operations personnel.

Exhibit 2: Gracie Personnel Count

	Involved with the GCOF	Firm-Wide	Departures Within Last 3 Years
Investment Professionals:	**18**	**18**	
Chief Investment Officer	1	1	-
Portfolio Managers[1]	3	3	-
Research Analysts	12	12	-
Traders	3	3	-
Risk Management[2]	-	-	-
Operations/Back office:	**12**	**12**	
Operations	4	4	-
Accounting/Administration	5	5	3
Information Technology[3]	0	0	-
Legal/Compliance	1	1	-
Investor Relations	2	2	2

[1] Mr. Palmisciano is dually listed as the CIO and a PM
[2] The portfolio managers are also the risk managers
[3] IT is outsourced to a third party provider that provides staff onsite full-time

Exhibit 3: Gracie Key Investment and Operations Professionals

Name	Title	Years at Gracie	Years Exp.	Prior Experience/ Education
James Palmisciano	CIO and PM, Core Credit	6	21	Calyon, Deutsche Bank U. of Chicago MBA, State U. of NY BS
Manbir Singh	PM, Global Macro and EM	6	22	Calyon, NWI Management U. of Chicago MBA, U. of Alberta BS
Mike Robertson	PM, Core Credit	6	18	Calyon, UBS Columbia MBA, U. of Texas BA
Paul Gill	Senior Analyst, Global Macro	5	22	Bear Stearns, Lyford Capital Hofstra MBA, U. Penn BS
Ben Hough	Senior Analyst, Latin America	6	21	Bassini Playfair Wright Williams College BA
Eric Fitzgerald	Senior Analyst, Investment Grade	6	7	Deutsche Bank Princeton BSE
Scott Richman	Senior Analyst, Municipals	3	6	Lehman Brothers U. Penn BS
Jeff Toback	Senior Analyst, Convertibles	1	16	Ellington, BNP/CooperNeff U. Penn BS
Alex Koundourakis	Head Trader	6	16	Calyon, Merrill Lynch Western Maryland College BA
Marc Friedman	COO	7	19	PromoMedia Concepts Tufts BA

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Investment Strategy and Process

GCOF is a global long/short credit strategy focused on liquid credit instruments. Gracie combines a fundamental core credit portfolio with a macro overlay to dampen volatility and focus on risk-adjusted returns. The fund typically has 100 to 200 trades in the portfolio expressed through cash or derivative instruments from investment grade to distressed companies. The fund has historically maintained a short bias and has been short carry (paying more in premiums/carry than receiving on interest) since inception. The portfolio is actively traded with typical holding periods of four months. Gracie invests globally and expects that a significant portion of fund investments will be outside the U.S.

Gracie's philosophy is to view the credit cycle in four phases and to manage the core portfolio by adjusting the sub-strategy allocations accordingly (see below).

- *Rich/normalized phase*: characterized by unsustainable low default rates, excessive leverage and lack of credit differentiation. Gracie focuses on short opportunities in this phase.

- *Normalized/distressed phase*: characterized by normalized but rising default rates with significant balance sheet de-leveraging. The fund will generally maintain balanced long and short opportunities in this phase.

- *Distressed/normalized phase*: characterized by stabilized and declining default rates and forced asset sales. Long opportunities dominate the portfolio in this phase.

- *Normalized/rich phase*: characterized by declining default rate, growing leverage and lack of risk aversion. In this phase, the fund will generally maintain a balance between long and short opportunities.

Gracie seeks to hedge the directionality of the credit portfolio and add alpha through an opportunistic macro strategy. The fund has two primary strategies as described below:

- *Core credit:* 100 to 175 long and short positions expressed through cash or derivative instruments from investment grade to distressed companies. This is an actively traded portfolio with a typical holding period of four months. Gross attribution: +3.2% (YTD 2011), +6.8% (2010), +23.3% (2009), +15.7% (2008), +19.8% (2007).

- *Macro:* 10 to 25 core themes across global markets. These trades are typically structured with quantifiable downside. This strategy manages the broader market risks, enhances or neutralizes portfolio directional bias and capture high risk/reward opportunities. Gross attribution: -2.4% (YTD 2011), -1.3% (2010), -3.1% (2009), +6.7% (2008), +3.2% (2007).

Investment decisions for the core credit portfolio are made based on a fundamental and quantitative research process that enables Gracie to assess market conditions and isolate long and short credit investment opportunities. Gracie believes that combining fundamental research and technical trading, they can find investment opportunities that may be overlooked by market. The manager expects to take a forward looking and analytical approach to determine if and when the market does not recognize such events or trends. Gracie will use its fundamental and technical trading expertise to value and analyze an opportunity and structure the trade with the best risk-reward payoff. The majority of exposure in the credit portfolio will be in investment grade and high yield corporate credits and, to a lesser extent, convertible bonds. The fund's allocation to distressed investments will generally be less than 10%.

In addition to the core credit portion of the portfolio, Gracie also looks for opportunities outside the credit markets and will invest in macro themes that offer favorable risk/reward dynamics. These "macro" investments will at times seek to hedge the directionality of the core credit portfolio. At other times, the manager may seek directionally long or short specific trades based on opportunities in the market irrespective of exposures in the core credit portfolio. The investments in the macro portfolio are structured

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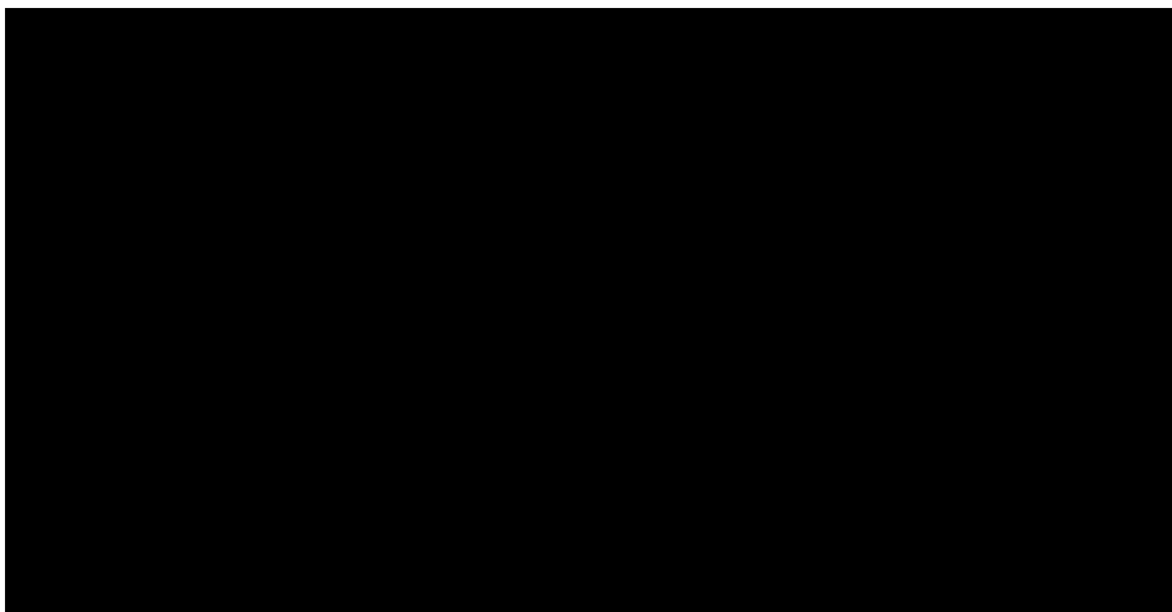
with a defined downside and generally include options, interest rate swaps, currencies, commodities and equities.

Ideas are sourced through a variety of channels, including the investment team's network of dealers, advisors, lawyers, analysts, portfolio managers and industry executives. Both the portfolio managers and analysts source ideas for the fund, although the portfolio managers generally initiate the ideas for larger positions and themes in the fund. Analysts use proprietary models augmented with external research to form both fundamental and technical opinions on a specific trade. The analyst will also conduct financial statement analysis and build cash flow models to ensure they are focused on the right part of the capital structure. Portfolio managers work closely with the analysts during this process. Investment decisions are reviewed and discussed among the portfolio managers prior to execution. Within the core credit portfolio, Gracie typically legs into trades and builds the positions over time as conviction grows. Within the macro portfolio, positions are structured with a view towards optionality and a quantifiable downside. Gracie does not make formal allocations to specific strategies. Rather, Gracie seeks to deploy firm resources to opportunities and strategies that have the most favorable risk/return payoff. This allocation will change in response to market conditions. Exhibit 4 shows the historical strategy allocations of the fund.

Exhibit 4: GCOF Historical Strategy Allocations (% of gross assets)



Gracie has an opportunistic approach to investing, and fund exposures will change with the opportunity set. The fund's net notional exposures have averaged -75% since inception. During times of market volatility, GCOF will typically increase the liquidity and short exposures in the portfolio. In 2007, Gracie believed there was a large disparity between realized actual default rates and expected default rates. Consequently, Gracie focused on carefully selecting long positions and concentrating short positions in companies with a high probability of default. As shown in Exhibit 5, Gracie aggressively reduced balance sheet exposure in mid-2008 as market volatility increased. In the 2nd quarter of 2009, Gracie added convex long positions to adapt to the rapid change in market direction. Gracie also established opportunistic hedges to protect the downside in case of a market disruption. Going forward Gracie anticipates choppier markets, and the fund is positioned to take advantage of further volatility. The core credit portfolio is positioned slightly long while the macro portfolio is positioned short with a focus on optionality, including equity puts, European sovereign shorts and several currency trades. Gracie believes the fund should remain nimble in this market particularly given the uncertainty in Europe. Exhibit 5 shows GCOF's historical notional exposures.

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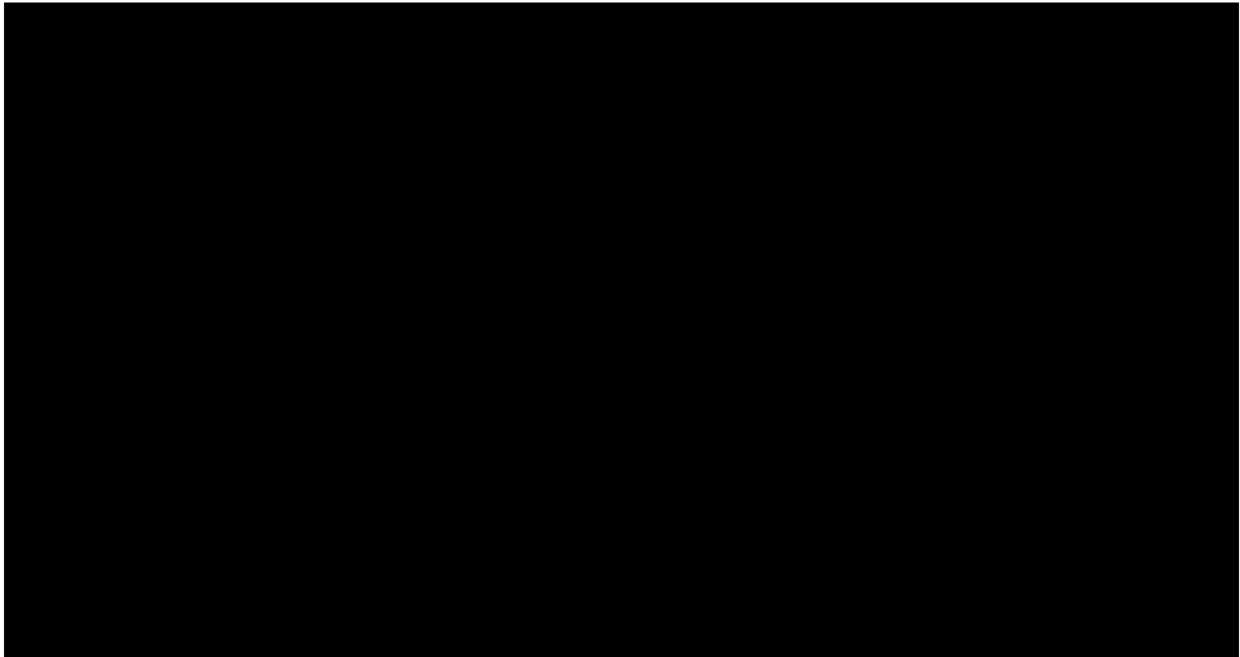
Exhibit 5: GCOF Notional Exposures



Some examples that illustrate Gracie's investment strategy follow.

Trade examples

Short credit:

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Long credit:

Macro trade

Portfolio Characteristics

GCOF is diversified across industry, sector, issuer and asset class and currently has 167 positions, 149 in the core credit portfolio and 18 in the macro portfolio. Most exposure in the core credit portfolio is focused on corporate credit, but the macro portfolio will invest opportunistically across asset classes, including equities, FX and rates. Currently, 37% of the fund's total gross exposure is in single name CDS, 19% in CDS indices, 13% in corporate bonds, 12% in equities, 6% in FX trades, 5% in interest rate swaps, 5% in convertible bonds, 2% in municipal bonds and 1% in loans. The majority of the short exposure in corporate debt is currently in CDS positions (buying protection). The fund has 64% of its gross assets invested in the U.S., 26% in Europe and 10% in Asia and Emerging Markets.

Most positions in single issuers are sized and hedged to limit anticipatable loss to 1% to 2% of NAV. Core long positions are sized between 1% and 3% of NAV, and larger positions may range from 3% and 5% of NAV. The top 10 long issuers generally represent between 10% and 25% of NAV and the top 10

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short positions (includes notional exposure of CDS) generally represent between 20% and 40% of gross exposure. Short positions within the core credit portfolio are primarily expressed through CDS and cash bonds. The macro portfolio uses a wider range of instruments to structure trades. Gracie has the ability to place up to 5% of NAV into sidepocket investments but the manager has never made any side pocketed investments. Investors also have the option to elect out-of side pocket investments. Gracie focuses on maintaining a liquid portfolio and the fund does not invest in private equity, private issues or other illiquid securities. Additional portfolio characteristics are shown in Exhibit 6.

Exhibit 6: GCOF Portfolio Characteristics

Total number of positions	
Types of securities	
Gross notional exposure as % of NAV	
Gross long notional exposure as % of NAV	
Gross short notional exposure as % of NAV	

Performance

GCOF has generated strong risk adjusted performance since inception. From July 2004 to July 2011, the fund has produced an annualized net return of 11.79% with a 5.20% standard deviation, resulting in a 1.67 Sharpe ratio. Additional performance statistics and comparative data can be found in Exhibits 7 and 8.

Fund Return

GCOF's annualized return of 11.79% exceeds the HFRI Event-Driven Index, which posted a 7.09% return over the same period. This performance places GCOF in the top 16% of all funds within the event-driven universe. The fund was up over 18% in 2008, as both the core credit strategy and the macro strategy contributed to performance. Within core credit, Gracie generated strong returns within the short portfolio and avoided large drawdowns in the long portfolio by cutting exposures. The macro portfolio was also a significant contributor, which included one of the more profitable trades of the year (long short-term interest rates in Brazil).

On a historical basis, fund performance has been positively correlated with increases in market volatility. This reflects the manager's preference for investing in attractive risk/reward profiles from both the long and short side. During periods of low volatility, it has been more difficult for Gracie to find opportunities that will outperform the broader credit markets. This was the case in 2006 and 2010, when the Barclays High Yield Credit Bond Index was up 11.87% and 15.11%, respectively.

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Fund Risk
GCOF's risk levels (standard deviation of return) are well below the universe of hedge funds and for other credit hedge funds. Since inception, GCOF has generated a standard deviation of 5.20%, which compares favorably to the 8.89% standard deviation of the median event-driven fund.

Risk Adjusted Return
The fund has generated a 1.67 Sharpe ratio since inception in July 2004, which is in the top 6% among hedge funds within the event-driven strategy universe.

Betas
The first section of the exhibit shows regression coefficients on major market indices since the fund's inception. All the T-statistics are low, which indicates that most of the values are statistically insignificant and we cannot draw conclusions based on the results of this regression. The F stat (P-value) is also above 0.05, which indicates that the multiple regression as a whole is statistically insignificant.

Other
The fund has a low R-squared to both the HFRI Fund Weighted Index (0.00) and the HFRI Event-Driven Index (0.02), which suggests strong diversification potential within a broad hedge fund portfolio. Finally, the distribution of returns reflects the positive skew of fund returns. The fund has only had nine drawdowns across 85 months of performance, with the largest drawdowns occurring in October 2008 (-360 bps) and June 2010 (-180 bps).

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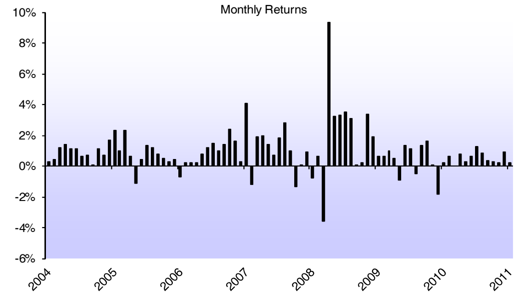
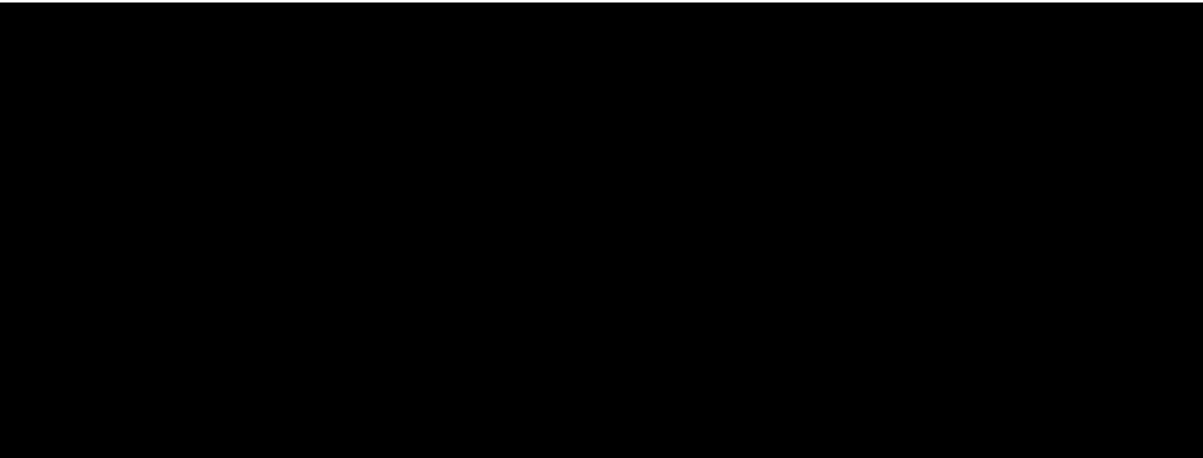
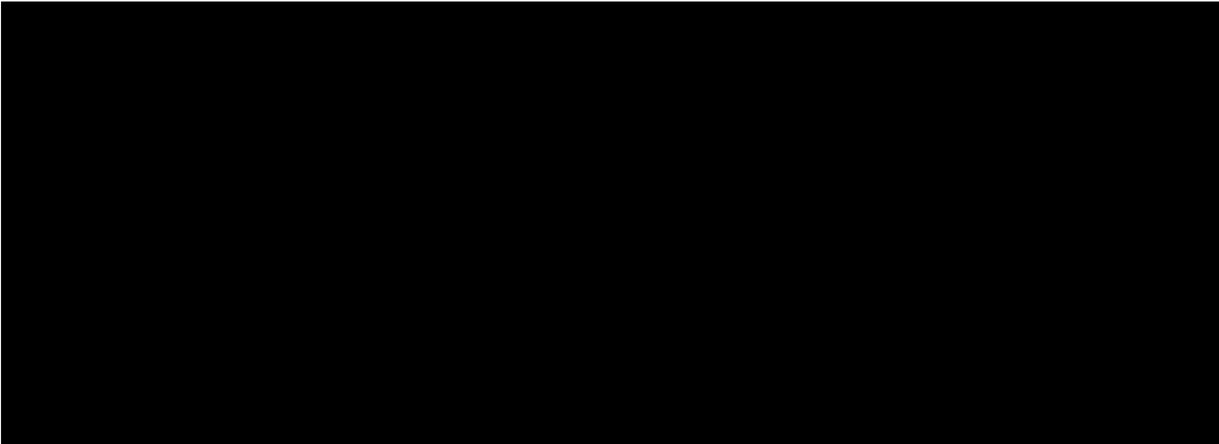
Exhibit 7: GCOF Performance

Fund Return	1-Year	3-Years	5-Years	Inception
Gracie Credit Opportunities Fund L.P.				
S&P 500 TR				
Barclays Aggregate Bond Index				
3 Month Libor Rate				





	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year	HFRI FW
2011	1.23%	0.81%	0.38%	0.30%	0.21%	0.88%	0.21%						4.09%	1.23%
2010	1.10%	-0.50%	1.30%	1.60%	0.10%	-1.80%	0.20%	0.60%	0.00%	0.80%	0.30%	0.62%	4.36%	10.25%
2009	3.50%	3.10%	0.10%	0.20%	3.40%	1.90%	0.60%	0.60%	1.00%	0.50%	-0.90%	1.30%	16.30%	19.98%
2008	1.80%	2.80%	1.00%	-1.30%	0.02%	0.90%	-0.80%	0.60%	-3.60%	9.30%	3.20%	3.30%	18.02%	-19.03%
2007	1.50%	1.00%	1.40%	2.40%	1.60%	0.30%	4.10%	-1.20%	1.90%	2.00%	1.40%	0.70%	18.40%	9.96%
2006	1.30%	1.20%	0.80%	0.50%	0.30%	0.40%	-0.70%	0.20%	0.20%	0.20%	0.80%	1.20%	6.57%	12.89%



"Percentile Rank" provides the percentile ranking for the fund. Our convention is to rank values such that lower percentile rankings reflect more favorable outcomes. For example, a 25% percentile rank for Sharpe ratio reflects a high value while a 25% rank for standard deviation reflects a low value.

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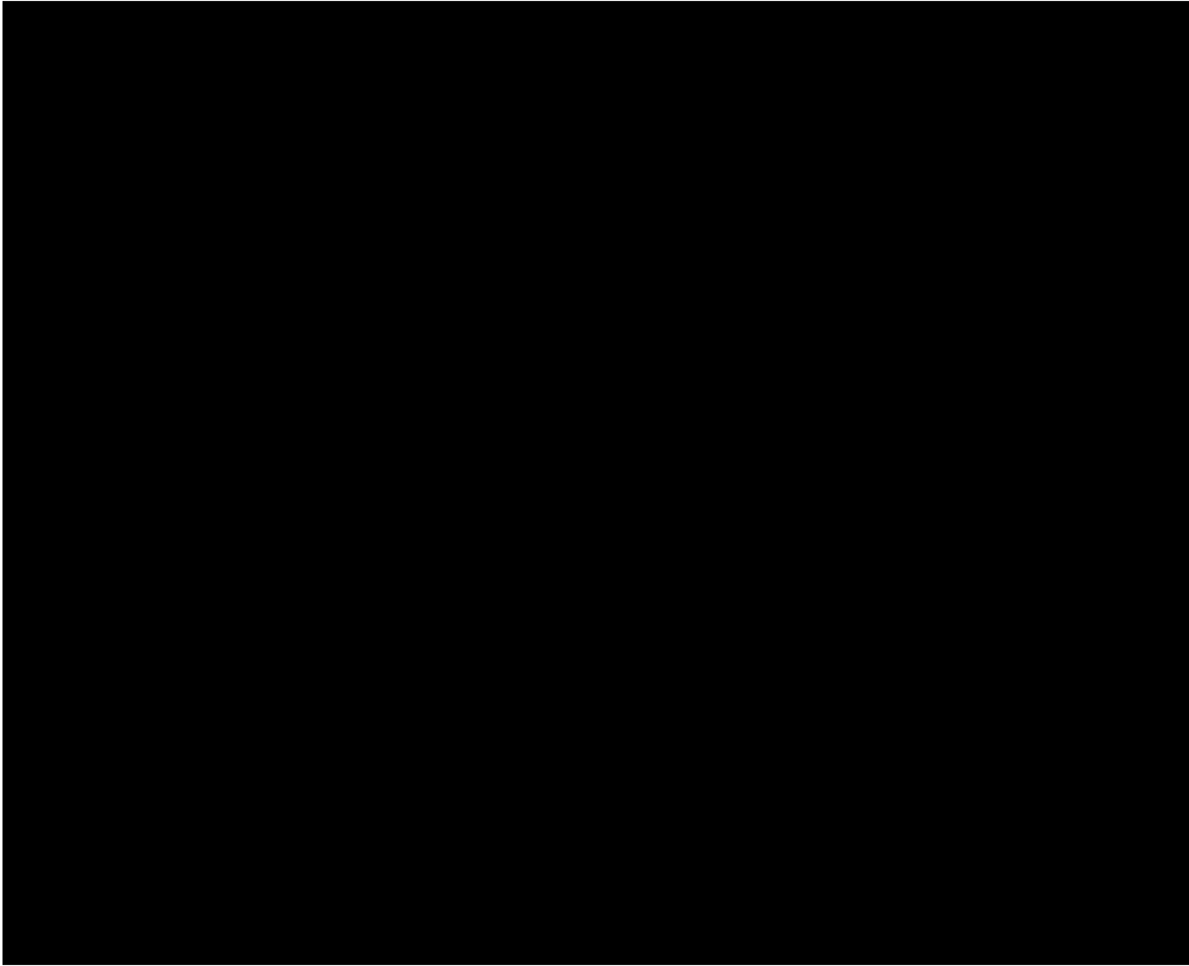
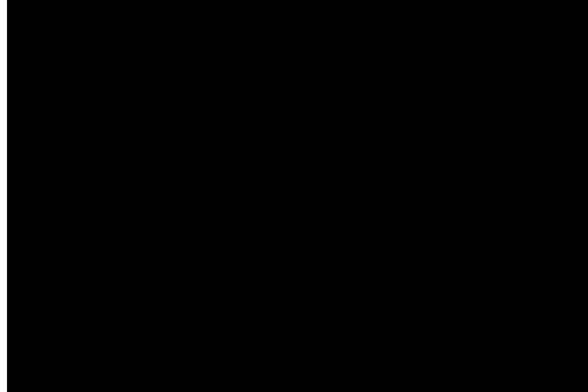
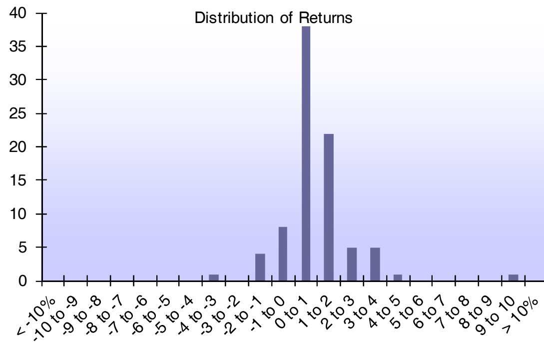
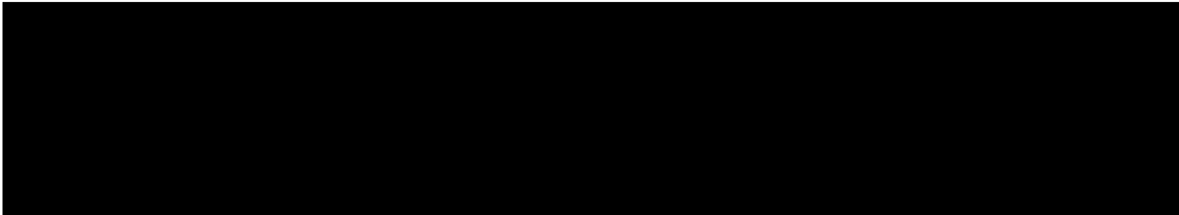
Exhibit 8: GCOF Risk Characteristics









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Risk Management

Gracie uses a multi-portfolio manager approach to managing risk and making investment decisions. The three portfolio managers, Messrs, Palmisciano, Singh and Robertson, collaborate among themselves and the investment team on a regular basis. Each position in the portfolio is the responsibility of one of the three portfolio managers. Gracie believes the cross-accountability between the portfolio managers encourages robust day-to-day risk management that is informed and supported by the firm's customized risk management tools. The manager values the flexibility to respond to changes in the markets as needed, and uses target allocations and guidelines as well as stress testing to assess portfolio risk. Gracie has the ability to exceed these guidelines when the portfolio managers feel that this is appropriate under the circumstances. All portfolio decisions, including those motivated primarily by risk assessment, are made by the portfolio managers, often following discussion with other team members.

Gracie utilizes proprietary models to assess and manage portfolio risk, including stress testing and risk analysis scenarios. In addition to other metrics, the portfolio managers routinely stress test the portfolio against certain credit-spread moves. Additionally, Gracie uses customized portfolio monitoring and testing programs. Portfolio risk management tools generally use data from Bloomberg's Asset and Investment Manager (AIM) system.

Gracie is focused on maintaining a liquid portfolio, and this is one of the main factors monitored through the firm's risk management process. The majority of the funds' positions receive multiple broker quotes per day from several dealers, and the portfolio managers closely monitor spreads and ratings as indicators of liquidity. Additionally, the operations team reviews the unencumbered cash as well as the potential buying power available on a regular basis. Positions are marked at bid and ask prices for long and short positions, respectively, which assists in liquidity analysis. Under normal market conditions, Gracie estimates it could liquidate at least 90% of the portfolio within 45 days.

Investment Terms

<u>Summary Comments</u>

The fund's investment terms are in-line with other top-tier credit managers. Gracie charges a 2% management fee and a 20% performance fee with a modified high water mark. The fund imposes a 12 month soft lock on each contribution, with an early withdrawal penalty of 3%. The fund offers quarterly liquidity with a 90 day notice. In addition, the fund offers monthly liquidity with a 90 day notice, subject to a 6% redemption penalty (9% during the soft lock). Gracie also offers an institutional share class (Class D) with a 1.5% management fee and a 20% performance fee with a two year soft lock. The institutional share class has a $125 million minimum. There is a 25% fund level gate. Up to 5% of each investor's NAV may be placed in side pockets, and investors elect to participate or opt out of side pocket investments upon their initial investment. Cliffwater recommends clients opt out of side pocket investments.

Term	
Fees and Expenses	
Management Fee	Onshore: 2% Offshore: Class A: 2% Class D: 1.5%
Performance Fee	Onshore: 20% Offshore: Class A: 20% Class D: 15% In each case, subject to a reduced performance fee of 10% (onshore and Class A offshore) or 7.5% (Class D offshore) during periods when recouping 225% of prior losses
High Water Mark	Yes, modified
Hurdle Rate	No
Fee Payment Frequency	Quarterly management fees, annual performance fee
Fund expenses	Onshore: 32 bps Offshore: 40 bps
Typical fund expenses	Investment expenses (interest expense, custodial fees, commissions, research-related fees, travel costs), administrator expenses, insurance

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	premiums, organizational expenses, and legal, audit, and accounting fees
Offsets to expenses	None
Subscriptions	
Minimum initial investment	Onshore: $5 million Offshore: Class A: $5 million Class D: $125 million
Minimum subsequent investments	Onshore: $1 million Offshore: Class A: $1 million Class D: $5 million
Frequency	Monthly
Timing	First day of each month
Notification period	Three business days
Other subscription provisions	None
Redemptions	
Frequency	Quarterly option or monthly option
Timing	Quarterly option – last day of each quarter Monthly option – last day of each month that does not fall on quarter-end
Notification period	90 days
Gate	25% fund level gate (quarterly)
Distribution of proceeds	Partial withdrawals (<95%) – paid within 30 days Complete withdrawals (≥95%) – 90% paid within 30 days, balance paid within 10 days after completion of audited financials Distributions can be made in cash or in kind
Suspension provisions	The General Partner (onshore) or Board of Directors (offshore) may suspend redemptions
Other withdrawal provisions	None
Liquidity	
Lock-up	Onshore: one-year lock-up on each contribution Offshore: Class A: One-year soft lock-up on each contribution Class D: Two-year soft lock on each contribution
Early withdrawal penalties	3% redemption fee if redeem at quarter-end during the first 12 months (onshore and Class A offshore) for 24 months (Class D offshore). The fund charges a 9% fee (i.e. an additional 6% if redeem during the lock-up or 9% after the lock-up) if redeem on the last day of a month that does not fall on quarter-end. All redemption fees are paid to the fund
Key man provisions	Yes, on either Mr. Palmisciano or Mr. Singh
Transferability	Only with the prior written consent of the General Partner (onshore) or Board of Directors (offshore)
Side pockets for illiquid investments	Up to 5% of each investor's NAV. Investors elect to participate or opt out of side pocket investments upon their initial investment. Cliffwater recommends clients opt-out of side pocket investments.
Side Letters	Several investors have side letters with MFN rights

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Appendix: Glossary

Administrator	A service provider such as Citco or International Fund Services that handles administrative responsibilities such as facilitating subscriptions/redemptions, calculating the fund's monthly NAV, reporting performance, and maintaining the official books and records for the fund.
Alpha	That portion of a fund's total return that is attributable only to manager skill and which excludes return attributable to general market (i.e. stock) movements. A fund's total return is comprised of three return components: alpha, beta, and Libor.
Beta	Measure of a portfolio's return sensitivity to a market index. The higher the beta coefficient, the greater the sensitivity to the market. A portfolio with a beta of 1.0 should move directly in line with the market index. Lower beta portfolios have lower risk and hedge funds exhibit an average equity market beta of 0.30. Hedge funds with lower beta are generally viewed as desirable.
Beta Return	That portion of a fund's total return that is attributable to general market (i.e. stock) movements. It is generally calculated by multiplying the fund's portfolio beta times the market return net of Libor. A fund's total return is comprised of three return components: alpha, beta, and Libor.
Credit Default Swap (CDS)	A swap contract that acts as a form of insurance for the buyer against a loan or bond default. The buyer pays a percentage of the security's principal (premium), at periodic intervals in exchange for a guaranteed payment of principal in the event of default. If the borrower/security defaults, the CDS buyer can exchange or "swap" the defaulted loan security for a monetary payment equal to the principal value of the loan. The CDS premium payment is generally equivalent in percentage to the "credit spread" on a risky bond.
Convexity	A measure of the sensitivity of a bond's duration to changes in interest rates. Most fixed income portfolios have *negative* convexity, meaning that duration rises as interest rates rise, furthering losses in a rising interest rate environment. And when interest rates fall, duration declines, limiting security gains. Mortgage securities, for example, have significant negative convexity. Securities and portfolios structured to have *positive* convexity are not common and come at a cost of lower yield, but have the advantage in periods of market volatility.
Correlation	A statistical measure of how two securities or indices move in relation to each other. Two securities move perfectly in line with one another if their correlation is 1.0 and move in opposite directions if their correlation is -1.0. This statistic is often cited when gauging the diversification benefits of alternative assets within an equity dominated institutional portfolio and where most traditional equity managers have a correlation of 0.95 or higher with the stock indices. Hedge funds generally exhibit a much lower 0.70 correlation to the equity markets and produce overall diversification benefits where adding more stock managers does not.
Credit Strategy	See Hedge Fund Strategies.
CTA	See Hedge Fund Strategies
Delta-adjusted	A concept applied to derivatives, particularly options or securities with option-like features such as convertible securities. Delta measures the change in value of the derivative in relation to the change in value of the underlying security referenced by the derivative, rather than the value of the derivative security itself. For example, the delta-adjusted beta of an in-the-money S&P 500 index option equals 1.0 because the change in option value and index value is the same for a small 1% change in the S&P 500 index. For an out-of-the-money option, the delta-adjusted beta would be less than 1.0. The delta-adjusted exposure of a portfolio is a measure of the extent to which the portfolio as a whole will participate in stock market movements. It is equal to the sum of the weighted deltas of all individual options in the portfolio plus all equity investments.
Derivative	A security whose price is derived from the value of one or more of the underlying reference entity, commonly the price of another security. Examples include options, futures, forwards, and swaps. Derivatives can be used to hedge risk, speculate, or establish arbitrage positions.
Global Macro Strategy	See Hedge Fund Strategies
Distressed Strategy	See Hedge Fund Strategies
Drawdown	Refers to the cumulative investment loss experienced by a hedge fund, measured from the point of peak NAV to the NAV low. *Max* drawdown refers to the largest drawdown experienced by a hedge fund.

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Early Withdrawal Penalty	A fee assessed to investors that redeem assets prior to the expiration of a "soft" lock-up. The penalty is a percentage of assets, typically 2% to 5%, and these fees are generally paid to the fund to the benefit of remaining investors.
Event Driven	See Hedge Fund Strategies
Equity Long/Short	See Hedge Fund Strategies
Expense Ratio	All direct expenses charged to the fund vehicle, divided by NAV. Fund expenses typically include organizational, legal, compliance, audit fees, administrative fees, directors' fees and expenses, and fund-related insurance costs. Fund expenses should exclude costs associated with managing the investment portfolio such as management fees, brokerage fees, and research expenses. Also, charges related to entering into, maintaining, and financing a position are not included in the ratio. The fund expense ratio ranges between 10 and 30 basis points, depending upon the asset size of the fund and what types of expenses are charged to the fund.
Exposure	The value of security positions (excluding cash) as a percent of net asset value (NAV). For example, if security positions are valued at $100 and NAV also equals $100, then the portfolio is said to have a long exposure of 100%. If instead, the security positions are valued at $50 with the rest in cash, the long exposure is said to be 50%. Leverage (borrowing) allows exposures to exceed 100% and shorting can allow exposures to be negative. For example, a manager that holds $100 in stock (100% long exposure) and also borrows $100 in stock (from a securities lender) and sells that stock short in the market (100% short exposure), is said to have a total exposure of 200% (100% long exposure plus 100% short exposure).
Notional Exposure	Notional exposure, as opposed to physical exposure, includes the value of reference securities/indexes of derivative securities and swaps in the calculation of exposure. For example, a hedge fund manager with a 50% long exposure to stocks may also have sold a Russell 3000 index futures on contracts worth 50% of fund NAV as a market hedge. While no physical securities are shorted, the futures positions have a "notional" value equal to 50% of NAV. Total gross notional exposure in this example is 100%, equal to the 50% long physical stock positions plus the 50% short futures contract. The most common industry practice is to include notional values in the calculation of portfolio exposures.
Gross Long	The total notional exposure of all long positions in a portfolio. In the example above, gross long exposure equals 50%. Gross long positions benefit from increases in securities prices.
Gross Short	The total notional exposure of all short positions in a portfolio. In the example above, gross short exposure equals 50%, the notional value of the short Russell 3000 futures contracts. Short positions benefit from decreases in securities prices.
Net Exposure	Net exposure equals the difference between a portfolio's gross long and gross short exposures. In the example above, the portfolio has a net exposure of 0%, equal to the 50% gross long exposure minus the 50% gross short position. A positive net long exposure 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 exposure indicates a higher value of short positions in the portfolio, which will likely produce profits if security values fall.
Total Gross	The sum of a portfolio's gross long and gross short exposures. Gross exposure in the example above equals 100%, equal to the 50% gross long exposure plus the 50% gross short exposure.
Fair Value (FAS 157)	FASB Statement No. 157, Fair Value Measurements ("FAS 157"), 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*." FAS 157 established a fair value hierarchy consisting of three levels 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, generally via a central exchange.
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. Most derivative securities are considered Level 2 assets even though the valuation for the underlying security may be readily available on a central exchange.
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 and other factors.

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	Best practice is for the hedge fund manager to use an independent external valuation firm to price Level 3 assets. As a further protection to investors, Level 3 assets are often placed in side pockets by the manager. (See Side Pockets.)
Fund of Funds	An investment vehicle managed by a third party that invests in a portfolio of underlying hedge funds.
Gate	A restriction on the amount that investors can redeem from a hedge fund in a given period. Gates are designed to help prevent problems associated with large redemption requests during a specific period. Fund level gates establish this limit as a percentage of all holdings in the fund, potentially allowing redeeming investors to receive a percentage greater than the gate amount. Investor level gates limit each investor's withdrawal to a specific percentage of their account.
General Partner	In a limited liability partnership, which is the legal form most hedge funds operate within, the general partner is responsible for the management and investment decisions for the hedge fund while the investors are limited partners.
Hedge Fund	An investment portfolio that seeks long term net of fee returns similar to equities (7%–9% annually) with less than one-half the risk of equities.
Hedge Fund Strategies	Hedge funds employ many investment approaches to create non-market related returns. While there is no standard industry classification, the eight strategy descriptions below are often used by practitioners.
Market Neutral	A hedge fund style that aims to profit from the discrepancy in valuation between related securities, which may include equities, fixed income, derivatives, etc. An example is convertible arbitrage, which attempts to exploit the mispricing between embedded options in convertible bonds and the underlying security.
Credit Strategy	A hedge fund style that typically invests in high yield and high grade bonds, bank loans, credit default swaps and structured products. Managers use fundamental credit analysis to identify mispriced debt instruments and express their views through long and short positions.
Distressed	A hedge fund style that seeks to take advantage of corporate securities in default, under bankruptcy protection, in distress or heading toward such a condition, or in liquidation. Some distressed managers attempt to add value by becoming actively involved in the restructuring process.
Event Driven	A hedge fund style that aims to profit from the mispricing of securities related to hard and/or soft catalysts. Examples include mergers (merger arbitrage), restructurings, bankruptcies, litigation, regulatory and legislative changes. Activist investors who seek value creation through board participation or management changes are also included in this category.
Equity Long/Short	A hedge fund style that primarily allocates capital to long and short positions in equities and equity derivatives. Exposures range from net long to market neutral to dedicated short. Some equity long/short funds focus on specific sectors (e.g., technology and healthcare) or regions (e.g., Asia and Europe).
Macro - Discretionary	A hedge fund style focused on employing a top-down approach to invest in any market in order to capture extended market movements. Global macro managers generally have broad mandates to invest globally across all asset classes. These managers tend to employ leverage and have exposure to global interest rates, currencies, commodities and equities.
Macro - CTA	A hedge fund style that trades currencies, interest rates, equity markets and commodities using technical systems premised mostly on the notion that market indices will trend over time, thus portfolio positions will move in the same direction as markets. "CTA" designates Commodity Trading Advisor, a regulated advisor that generally follows this hedge fund style.
Multi-Strategy	A hedge fund style that opportunistically allocates capital to various hedge fund strategies and uses diversification to reduce asset-class and single-strategy risks. Ideally, multi-strategy portfolio managers tactically shift capital among strategies in order to capitalize on current market opportunities. Some multi-strategy funds act as a collection of traders, while others have a more formal organizational structure.
HFRI	Hedge Fund Research, Inc. (HFRI) is a leading provider of hedge fund manager and hedge fund index information to investors. Dow Jones Credit Suisse is another leading provider of similar information.
HFRI Fund of Funds Index	A monthly return index of approximately 2,000 hedge fund of funds. Returns are self reported, equal weighted, and net of all fees. HFRI reports that the average management fee charged by the fund of funds manager is 1.5% with an average incentive fee of 5%. This is on top of fees charged by the underlying hedge funds.

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HFRI Fund Weighted Index	A monthly return index of approximately 3,000 hedge funds. Returns are self reported, equal weighted, and net of all fees.
HFRI Universe	HFRI makes available hedge fund universes and sub-universes in order to rank individual hedge funds against peer groups.
HFRX Indices	HFRI also maintains *daily* return indices that are equal weighted returns of a small group of hedge funds that offer daily valuation.
High Water Mark ("HWM")	The market value that a portfolio must exceed before performance fees can be assessed. The HWM is the highest net asset value previously achieved, and ensures that the manager does not earn performance fees on gains until previous losses are fully recaptured.
Modified HWM	The less common modified HWM allows the manager to earn a reduced (i.e. one-half) performance fee during recovery, with the full performance fee resuming after recovering earlier losses (e.g. between 150-250% of prior losses). A modified HWM is said to help managers retain talented employees during weak performance periods.
Hurdle Rate	The minimum return a manager must generate before performance fees can be earned. Hurdle rates are uncommon for hedge funds, but when they are present they are often based on cash benchmarks such as 3-month Treasury bills.
Information Ratio("IR")	Commonly used measure of a manager's risk-adjusted alpha. The information ratio equals alpha return divided by alpha risk, where both alpha return and alpha risk are typically calculated using statistical regression where the independent variable is a market index. The information ratio is generally viewed by practitioners as the most significant measure of a hedge fund's performance. Any information ratio above 0.5 is generally viewed as very attractive.
Key Man Provision	A legal provision that permits investors to immediately withdraw from a fund without penalty if certain key professionals are no longer involved in the management of the fund.
Leverage	The use of explicit debt (i.e. borrowing) or implicit debt (i.e. derivatives) to achieve investment positions that exceed invested capital (NAV). The use of leverage may amplify returns but may also increase risk. However, if leverage is achieved by adding short exposure that offsets an existing long position, portfolio risk might actually decline due to the use of leverage. 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
Limited Partner	Investors are limited partners in the hedge fund and are "limited" in that they have no voice in hedge fund investment or operational matters, and their losses are limited to amounts invested.
Limited Partnership	A legal structure usually consisting of one general partner who is the investment manager and many limited partners who put up assets to form a fund investment. The most important feature of a limited partnership is that the limited partners have limited liability as

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	long as they do not participate in the control of the investment fund.
Liquidity	The ease with which a hedge fund can convert its holdings to cash. Funds with greater liquidity can close out of positions more easily and with fewer costs.
Lock-up	The period of time before an investor is eligible to redeem assets from a hedge fund. Lock-ups of one or two years are typical. The liquidity of the strategy and underlying positions typically influences the length of the lock-up. For example, distressed funds typically have longer lock-up periods than macro and equity long/short funds.
Hard Lock-Up	Assets can not be redeemed during the lock-up period.
Soft Lock-Up	Assets may be redeemed prior to expiration of the lock-up period, but an early withdrawal penalty must be paid to the fund.
Long positions	Long positions describe securities that were purchased. Long positions benefit from increase in securities prices.
LIBOR (Libor)	Refers to the London Interbank Offered Rate (LIBOR), which is a daily reference rate based on the interest rates at which banks borrow unsecured funds from other banks in the interbank lending market. Libor is a cash rate that serves as the base rate for most floating rate corporate debt and is highly correlated with short-term interest rates. Historically, Libor rates average 20 basis points above Treasury bill rates, a difference often referred to as the TED spread. The TED spread is often viewed as a measure of market stress that can reach levels of 100 basis points or more during financial crises.
Management Fee	Compensation paid by investors to the management company of a hedge fund. Management fees are typically used to pay for the investment manager's operating expenses, including office rent, employee salaries, research and systems. Management fees typically range from 1% to 2% of NAV.
Macro - Discretionary	See Hedge Fund Strategies
Margin	Cash posted as collateral with a broker or exchange to satisfy the trading requirements of derivative contracts.
Initial Margin	Cash or positions posted as collateral with a broker or exchange to satisfy the initial regulatory or internal margin requirements of listed or over the counter securities purchased with borrowed funds.
Variation Margin	Cash or positions that may be required to be posted as collateral with a broker or exchange to satisfy additional variation margin requirements of listed or over the counter securities purchased with borrowed funds. Variation margin payments may be required if securities purchased with borrowed funds decline significantly in value from the initial holding date.
Margin-to-equity ratio	The percentage of portfolio capital posted as collateral or "margin" with a broker or exchange (i.e., margin capital divided by total capital) against a portfolio of positions. In a portfolio composed entirely of derivative contracts, this number represents the percentage of encumbered cash in the portfolio. This is a common measure of leverage used by systematic macro managers, since it is proportional to the amount of notional exposure per dollar of capital. For example, if one systematic macro portfolio has a higher margin-to-equity ratio than another, all else being equal, the former portfolio has higher leverage.
Master-Feeder Fund Structure	A fund structure which allows for onshore and offshore fund vehicles to be managed as a single portfolio. Onshore and offshore funds are aggregated into one "master" portfolio.
Master Fund	The master fund is that part of a master-feeder structure into which the feeder funds invest and which manages the single combined investment portfolio. The master fund is generally a non-US corporate entity.
Feeder Funds	Two separate legal entities, one a U.S. onshore partnership and the other a non-U.S. offshore corporation, which accommodates investor groups with different tax and regulatory needs.
Max Drawdown	The greatest investment loss experienced by a hedge fund, measured from peak (prior highest cumulative return) to valley (subsequent lowest cumulative return).
Middle and Back Office	The non-investment side of a hedge fund's operations. Includes accounting, administration, legal, investor relations, compliance and other miscellaneous non-investment functions. Hedge funds may outsource some of these operations to third-party administrators or prime brokers.
Net Asset Value (NAV)	A fund's total assets less total liabilities.
Notification Period	The advance notice period (generally 30 to 90 days) required to submit subscription or redemption documents for investing in or redeeming from a fund.
Offshore Fund	Hedge funds which are registered/domiciled in offshore jurisdictions such as the Cayman Islands, British Virgin Islands, and Luxembourg. Offshore funds provide eligible investors with tax benefits and regulatory relief. Because offshore funds are administered outside of

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	the U.S., non-U.S. investors and tax exempt U.S. investors such as ERISA pension funds and endowments can take advantage of tax benefits.
Onshore Fund	A fund with a U.S. legal domicile that operates under U.S. regulatory authorities and U.S. tax law. Most onshore funds are limited partnerships registered under Delaware law.
Performance (Incentive) Fee	The general partner's share of the profits, net of management fees and expenses. The performance (incentive) fee is typically 20% of net profits.
Prime Broker	A prime broker custodies assets, provides trade settlement, facilitates the financing of positions, and may perform other services. JPMorgan, Goldman Sachs, Morgan Stanley and UBS are some of the largest prime brokers.
Coefficient of Determination (R^2)	The Coefficient of Determination or R-squared (R^2) is the square of the correlation coefficient and identifies the percentage of variability of one variable that is explained by another variable. For example, hedge funds have an average correlation coefficient of 0.70 with the S&P 500 Index. The coefficient of determination (R^2) is 0.49, meaning that 49% of hedge fund risk is explained by the movements in the S&P 500 index.
Return	Hedge fund returns represent the percentage change in period to period NAV and are calculated net of all fees and expenses, including accrued manager fees and incentive fees.
Serial Correlation	The correlation between current and past returns. In an efficient market, there should be no correlation between returns from one period to the next. Some hedge funds, particularly credit oriented funds, exhibit positive serial correlation which indicates that security pricing may be "sticky" and not change from period to period.
Sharpe Ratio	Commonly used measure of a manager's risk-adjusted alpha in relation to a risk-free asset (i.e. T-bill or Libor). The Sharpe ratio is equal to total return, minus Libor, divided by portfolio standard deviation. A high Sharpe ratio indicates that a manager has generated high risk-adjusted returns.
Short Position	Short positions describe securities that are borrowed (generally from a dealer or securities lender) and sold. Short positions will benefit from decreases in securities prices.
Side Letter	An addendum to the partnership and subscription agreement which stipulates key terms for a particular investor, such as negotiated fee levels, MFN (Most Favored Nation) clauses, transparency requirements, or special liquidity terms.
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 sold.
Skew	Skew measures the tendency of returns to deviate from a normal or symmetrical distribution. Given two return distributions with the same mean and standard deviation, the distribution with the higher positive skew would be more desirable. Several hedge fund strategies exhibit return patterns that have negative skew, meaning that losses tend to be larger than gains. A good example is merger arbitrage where profits are limited but more common and losses are less common but larger.
Sovereign Security	A debt security issued by a national government either within a given country or in a major financial center and denominated in either the issuer's currency or a foreign currency.
Stop Loss	A trading order or automated rule to sell a security when it reaches a pre-specified price. The purpose is to limit a manager's loss on an individual security if the position experiences a decline in price.
Standard Deviation	A common quantitative measure of investment risk to show the variability from the expected return or past returns of a manager. A low standard deviation represents a lower level of risk and a high standard deviation indicates a higher level of risk.
Stress Testing	A common risk management tool to evaluate the potential impact of a particularly severe set of market conditions on an individual security or portfolio. Stress testing is intended to simulate the impact on a portfolio of a hypothetical market move (i.e. S&P 500 down -10%, credit spreads widen by 500 bps). Scenario analysis is intended to simulate the impact on a current portfolio of a past market scenario (i.e. September 11th or post-Lehman bankruptcy).
Suspension Provisions	A hedge fund provision that allows the manager to stop all redemptions at their discretion, generally to deal with very extraordinary market circumstances.
Swap	An over-the-counter bi-lateral derivative contract that permits investors to receive one instrument or set of cash flows in exchange for a different instrument or set of cash flows. A common example is an interest rate swap, which permits investors to receive a fixed rate of interest in exchange for paying the current floating market rate.

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Global Macro	See Hedge Fund Strategies
Tail Risk	A form of risk that arises when portfolio returns deviate from a “normal” or symmetrical distribution and exhibit “fat tails” where there is a greater frequency of large losses and large gains versus what would be predicted. Tail risk is usually associated with downside risk in an extreme scenario.
Tracking Error	Measure of the standard deviation of the manager’s excess return versus a benchmark.
Transferability	The terms under which an investor may sell ownership rights to another investor. Typically requires the approval of the manager or administrator.
Unencumbered Cash	Unencumbered cash is equal to cash balances maintained in the portfolio in excess of regulatory or house margin requirements.
Unrelated Business Taxable Income (UBTI)	U.S. pensions and endowments enjoy special tax exempt status for income and gains earned on securities portfolios. However, when those entities are thought to abuse their status, such as when they use leverage to enhance returns or invest directly in businesses, they are subject to unrelated business taxable income, or UBTI. Since many hedge funds use leverage to enhance returns, their gains are potentially taxable to even traditionally tax exempt institutions. ERISA pension plans and endowments who have invested in hedge funds often invest in offshore hedge funds, because the offshore vehicles are structured to avoid UBTI. Public pension systems generally invest in onshore hedge funds despite potential UBTI because they believe sovereignty makes them exempt from federal taxation.

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