Recommendation on Phase IV of Hedge Fund Implementation Plan

To: RISIC
Prepared: January 17, 2012
From: Thomas Lynch, CFA, Managing Director

The purpose of this memo is to provide RISIC with a summary of Cliffwater's recommendation for Phase IV of the Hedge Fund Implementation Plan. To date, six funds were approved for Phase I in September, six funds were approved for Phase II in October, and five funds were approved for Phase III in November. Phase IV, as presented in this memo, recommends two funds

Cliffwater has presented to the RISIC an investment plan for hedge funds. The goal of the plan is to reduce volatility in the ERSRI portfolio (or the "Fund") as well as individual long-only asset classes and to improve the Sharpe Ratio of the Fund.

The overall investment plan calls for an allocation of 15% of the Fund to hedge funds. The hedge fund allocation will consist of three components, grouping hedge funds strategies by associated market beta. As shown in Table 1 below, 8% of the 15% hedge fund allocation will be made to equity related strategies (i.e. equity long/short and event driven strategies) and they will be allocated to the Fund's global equity allocation. Similarly, 5% of the 15% hedge fund allocation will be made to absolute return strategies (i.e. global macro and multi-strategy) and they will be allocated to the Fund's real return allocation; 2% of the 15% hedge fund allocation will be made to fixed income strategies (i.e. credit and relative value strategies) and they will be allocated to the Fund's fixed income allocation.

Table 1.

	RISIC Policy		Recommended Hedge Fund Allocations		Recommended Structure	
	% Target	$ Target	% Target	$ Target	# Funds	$/Fund
Cash	3%	$210				
Fixed Income	20%	$1,400	2%	$140	3	$47
Real Estate	8%	$560				
Real Return	11%	$770	5%	$350	7	$50
Global Equity	51%	$3,570	8%	$560	10	$56
Private Equity	7%	$490				
	100%	$7,000	15%	$1,050	20	$53

Recommendations on individual hedge funds will be subject to the following:

1. Completion of investment due diligence by Cliffwater
2. Completion of operations due diligence by Cliffwater
3. A recommendation to invest by Cliffwater
4. A review of the hedge fund's fit within the Hedge Fund Implementation Plan

Cliffwater recommends that the Hedge Fund Implementation Plan be executed in multiple phases over a six month period with a recommendation on two to six managers per phase. Cliffwater is currently recommending Phase IV which consists of two managers. Table 2 lists the managers that are recommended. The appendix to this memo includes a summary of our recommendation report for each manager.

Table 2.

Asset Class	*Strategy*	*Manager/Fund*	*Recommend Amount (Millions)*
Global Equities	Long Short Equities	Partner Fund Management/Diversified Fund	$60
Fixed Income	Credit	Brigade	$50

Table 3 below shows Cliffwater's recommendation for the share class of each fund and the terms and conditions. For Partner Fund Management (PFM) Diversified, Cliffwater is recommending that half the allocation (the maximum allowed by the manager) be invested in share class B and half the allocation be invested in share class A1.

Table 3.

Fund	*Share Class*	*Mgt Fee*	*Performance Fee*	*Redemption Period*	*Lock-up*
Brigade	On Shore	1.5%	20%	Quarterly	2 Year Soft
½ PFM	On Shore/B	1.75%	17.5%	Quarterly	3 Year Soft
½ PFM	On Shore/A1	1.75%	17.5%	Every 3 Years	3 Year Hard

Appendix – Manager Recommendation Summaries

Brigade Capital Management

People and Organization: Brigade Capital Management, LLC ("Brigade" or the "manager") is a multi-strategy credit hedge fund that was founded in 2006 by Don Morgan. Mr. Morgan previously managed senior members of Brigade's current investment team during his tenure at MacKay Shields, a longstanding investment firm focused on high yield investments. Brigade manages $8.2 billion in high yield and credit strategies, including $4.8 billion in the flagship fund, the Brigade Leveraged Capital Structures Fund ("LCSF" or the "fund"). Brigade has 54 employees, including 24 investment professionals. The firm is headquartered in New York with a research office in Zurich. Brigade has been registered with the SEC since February 2009.

Investment Strategy and Process: The fund employs a multi-strategy credit long/short strategy that invests throughout the capital structure of primarily U.S. leveraged companies. Brigade seeks long-term growth of capital through all market environments with a focus on the preservation of capital. The manager employs four core strategies, which include long/short credit, distressed debt, capital structure arbitrage and long/short equity. Brigade seeks to minimize volatility and provide alpha generation through an active short portfolio. The portfolio is diversified with 100 to 150 trade ideas. Average core positions sizes are generally between 1% and 2%.

Performance: Brigade has generated strong risk adjusted performance since inception. From January 2007 to June 2011, the fund has produced an annualized net return of 8.17% with a 7.96% standard deviation, resulting in a 0.77 Sharpe ratio.

Risk Management: Much like other top-tier credit managers, Brigade seeks to mitigate losses by performing deep fundamental research and maintaining a diversified portfolio. The fund maintains limits on leverage, individual position sizes and sector exposures. Mr. Morgan serves as both the portfolio manager and risk manager and he utilizes the firm's resources to help him evaluate and quantify risk. Brigade has developed proprietary systems that monitor the portfolio liquidity and other risks in real time. In addition, a formal risk management committee meets weekly to assess the liquidity and other risk factors in the portfolio.

Operational Analysis: Brigade's team of 30 non-investment professionals effectively manages all trading and business operations. The firm's overall trading volume is approximately 50 trades daily across a wide range of credit products. Brigade has developed strong trading, operations and risk processes and platforms to manage the variety of products and strategies. The operations and accounting teams are headed by experienced industry professionals and firm turnover has been minimal. Brigade maintains a focus on managing and reducing counterparty risk by reviewing exposures across its clearing and execution relationships on a regular basis. No material departures from operational best practices were identified during Cliffwater's operational due diligence.

Investment Terms: Brigade's terms are in line with other top-tier credit managers. The fund charges a 1.5% management fee and a 20% performance fee. The fund has a 2 year soft lock up on each contribution. Any amounts redeemed before the end of the soft lock will be subject to a redemption fee equal to 5% in the first year and 3% in the second year. The fund offers quarterly liquidity with a 60 day notice.

Partner Fund Management

People and Organization: Partner Fund Management LP ("PFM" or the "firm") was founded in September 2004 by Chris James. Previously, Mr. James was a co-founder and portfolio manager at Andor Capital Management. The firm currently manages $4.8 billion across four investment strategies including the flagship PFM Diversified Fund ("fund"). PFM is based in San Francisco, and has satellite offices in New York, London, and Hong Kong. The firm has a total of 73 employees including 28 investment professionals, with [redacted] voting partners. Internal capital represents approximately [redacted] of total AUM. PFM has a high quality and seasoned investment team, with core members that have worked together for over 10 years.

Investment Strategy and Process: PFM Diversified Fund is a global long / short equity fund which seeks to exploit thematic core investments that offer multi-year secular growth. The combination of bottom up and top down analysis gives the fund an edge over pure bottom up stock pickers. The investment process utilizes detailed fundamental industry and company analysis across geographies, with a focus on identifying catalysts. Top down macro and sector views play an important role and help direct capital allocation. The portfolio is actively traded with high portfolio turnover, due to flexible exposure management and rotation of capital among themes and core positions.

Performance: The fund has generated strong absolute and risk adjusted returns since inception, with significant evidence of alpha generation. From inception in November 2004 through October 2011, the fund has generated an annualized return of 9.8% with volatility of 7.4%, resulting in a Sharpe ratio of 0.95.

Risk Management: The fund employs a flexible approach to managing exposure in response to heightened levels of market volatility and correlation, which has helped protect capital in difficult market environments. This includes actively reducing gross and net exposure, position concentration, and factor risk, particularly as the fund approaches a -3% intra-month drawdown. Macro hedges are also tactically utilized to reduce risk. The fund has an 8% volatility target. To help achieve this, the fund is managed with moderate levels of gross (80% to 140%) and net (+10% to +50%) exposure. The portfolio is highly liquid and diversified across geographies, sectors, and number of positions. Positions are sized such that no single name is greater than 2 days trading volume (100% of past 20 days). Longs are limited to 7% and shorts limited to 5% at market.

Operations Analysis: Partner Fund Management has established strong internal procedures and controls to ensure the firm meets nearly all operational best practices. The manager has been registered with the SEC since 2008 and continues to strengthen its internal compliance policies. PFM is focused on counterparty diversification and has established relationships with several prime brokers and custody banks. A non-market risk committee has also been created to monitor and mitigate counterparty and business risk. No material deviations from best practices were identified during Cliffwater's operational due diligence.

Investment Terms: The fund is offered in three share classes. The 2% and 20% fee quarterly share class has a 1 year soft lock and is hard closed. The firm offers discounted fees of 1.5% and 17.5% for longer lock up share classes, including a 3 year soft lock class followed by quarterly liquidity and a rolling 3 year hard lock class (investors can redeem up to 15% of their initial investment at any time with quarterly notice).