HENNESSEE GROUP LLC
HEDGE FUND ADVISORY

500 FIFTH AVENUE, 47TH FLOOR
NEW YORK, NY 10110
TEL: 212-857-4400 FAX: 212-768-8190
WWW.HENNESSEEGROUP.COM

COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

SENATOR RICHARD SHELBY, *CHAIRMAN*

FULL COMMITTEE HEARING ON THE *"REGULATION OF THE HEDGE FUND INDUSTRY"*

JULY 15, 2004

WRITTEN TESTIMONY OF

CHARLES J. GRADANTE

MANAGING PRINCIPAL, THE HENNESSEE GROUP LLC

This version includes verbal statements made at the Senate Hearing

OPENING STATEMENT

Good afternoon Chairman Shelby, Ranking Member Sarbanes, and members of The Committee. My name is Charles Gradante and I am a managing principal of the Hennessee Group, a firm that provides investment advice and ongoing monitoring services to investors in hedge funds including endowments, foundations, and pensions.

Our founder Elizabeth Lee Hennessee has been advising investors since 1987 and we have been providing research on the industry since 1995. Some of our research is in my written testimony.

My testimony bias is a reflection of my career background in several related areas:

- I have been a President and C.E.O. of a U.S. National Bank subject to OCC oversight;
- I also have operating experience in proprietary trading and risk management on Wall Street;
- I have Investment experience in venture capital and private equity investing;
- Also relevant is my testimony before the House Banking Committee on Long-Term Capital Management in October 1998; and
- My participation on the SEC Roundtable in May 2003.

I hope my testimony will help frame some of the issues regarding the proposed registration of hedge funds. The most important point I would ask the member of this Committee to take from my testimony is that at issue is not the protection of the retail investor, we all want that. At issue is not the need to monitor the markets for systemic risk, we all want that as well.

What is at issue is how to approach the concerns raised by the SEC without inhibiting the entrepreneurial spirit of the industry that provides liquidity, contrarian research and pricing efficiency to the markets. I respectfully encourage this Committee to heavily weight Chairman Greenspan's comments made to this Committee on hedge fund registration recently.

Of the many factors surrounding the registration of hedge funds, I would like to address five of those factors briefly and perhaps offer insights to a less intrusive, perhaps less expensive, approach to hedge fund oversight.

HENNESSEE GROUP LLC
HEDGE FUND ADVISORY

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INTRODUCTION

A. Hennessee Group LLC (Hennessee Hedge Fund Advisory Group)

- Provides investment advice to investors in hedge funds
- Creates private portfolios of hedge fund managers designed to meet specific financial objectives of the client (Hennessee Hedge Fund Select Program®)
- Provides manager and portfolio monitoring services to clients
- Provides investment advisory services only for hedge fund investors; no products offered (i.e., no fund of hedge funds)
- Clients include individuals, family offices, endowments, foundations and pension plans.

B. Charles J. Gradante – Relevant Background To Testimony

- Venture Capital and Private Equity Investments
- Proprietary Trading and Risk Management
- President and C.E.O. of a U.S. National Bank
- Hennessee Group LLC, Managing Principal
- Testified before the House of Representatives Committee on Banking and Financial Services regarding Long-Term Capital Management (October 1998)
- Panelist on SEC Roundtable on Hedge Funds (May 2003)

II. HEDGE FUND REGISTRATION – SITUATION DYNAMICS

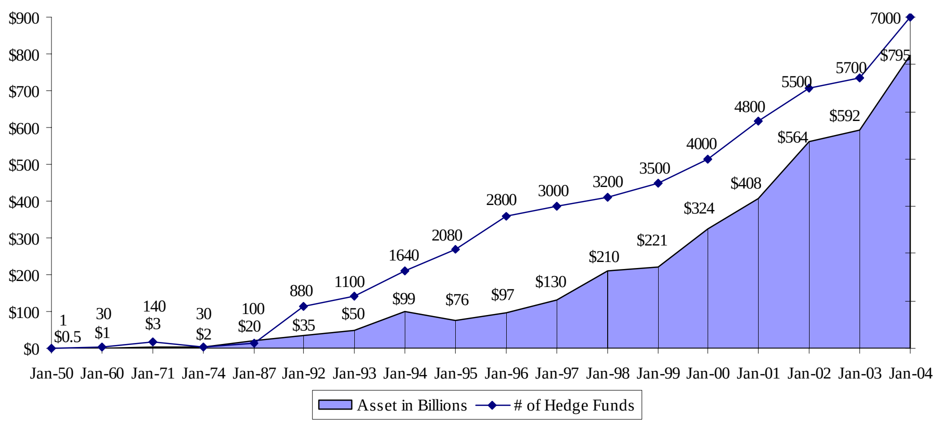
The following are a few of the current “situation dynamics” which surround the general issue of whether or not to register hedge funds.

A. There is a General Fear Of Hedge Funds And Belief That Hedge Funds Pose A Threat To The Stability Of The Markets.

- Long-Term Capital Management debacle is at the heart of this fear
- Potential systemic risk was of concern to the Federal Reserve Bank

B. Many Believe That Hedge Funds Are The Fastest Growing Money Management Sector And Their Activities Must, Therefore, Be Monitored.

Hedge Fund Assets vs. Number of Hedge Funds



Source: Hennessee Group LLC 2004 Industry Research

C. There Is A General Perception That We Have A Hedge Fund Crisis And That Hedge Funds Are Prone To Fraudulent Activities

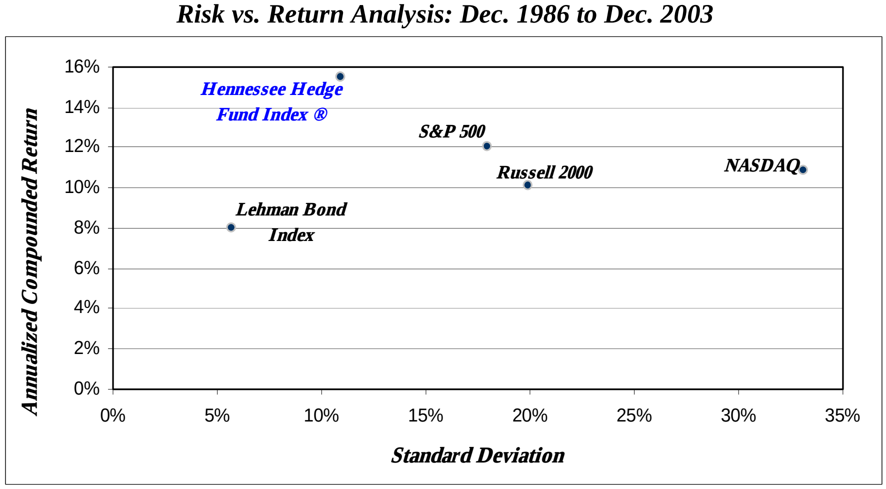
- This perception is fostered by media sensationalism

D. Many Believe That We Need To Ensure A Level Playing Field For All Investors

- All Investors, especially retail investors, should have access to investment strategies normally only available to the wealthy
- Hennessee has identified over 15 “hybrid” mutual funds that manage money in long/short format

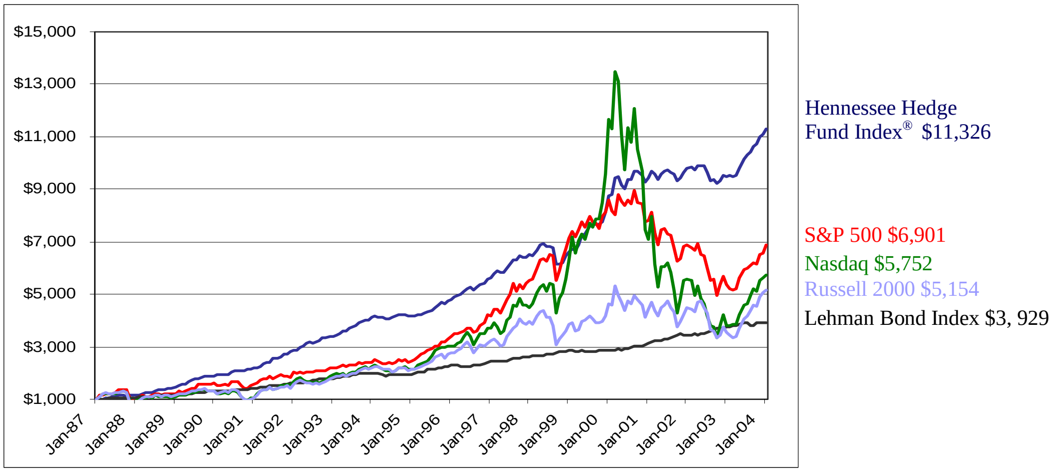
E. If Hedge Funds Are Offered To Retail Investors, They Need To Be Protected By Regulatory Oversight Of Hedge Funds.

Hedge Funds Versus Comparative Benchmarks
Risk vs. Return Analysis: Dec. 1986 to Dec. 2003



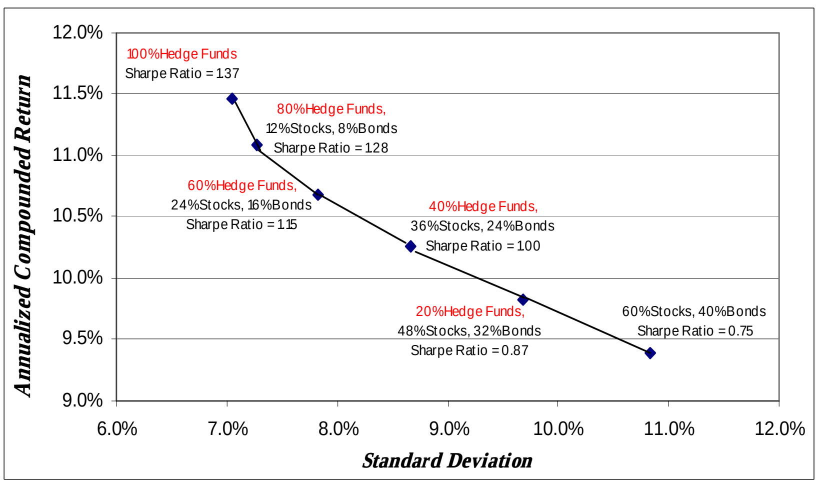
Source: Hennessee Group LLC

Hedge Funds Versus Comparative Benchmarks
Growth of $1000: Dec. 1986 to Dec. 2003



Source: Hennessee Group LLC

The Value Added of Hedge Funds in a Diversified Portfolio
Efficient Frontier Analysis: Dec. 1992 to Dec. 2003



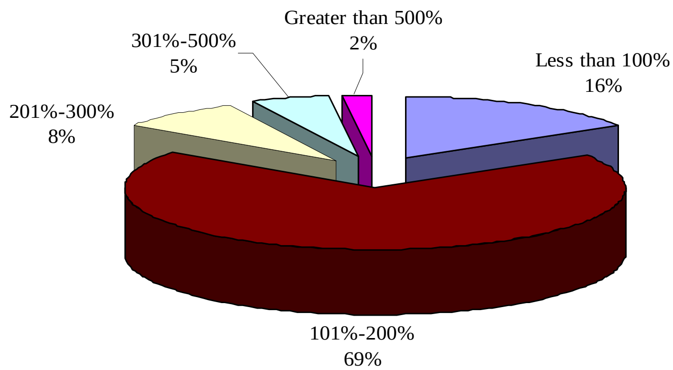
Source: Hennessee Group LLC

III. HEDGE FUND REGISTRATION – COMMENTARY AND OPINION

A. What Can Be Done To Mitigate The General Fear Of Hedge Funds And Systemic Risk

- According to Hennessee Group research, 85% of hedge funds are within Reg T leverage and only 2% use more than 5 to 1 leverage.

Maximum Historical Gross Exposure (Long Plus Shorts)



Source: Hennessee Group LLC 2004 Industry Research

- As I testified before the House Banking Committee in October 1998, Long-Term Capital Management implemented an extremely bad business model which was compounded by poor banking practices resulting in excessive leverage and counterparty risk. The lending banks failed to use standard bank lending due diligence.
    - I believe as an ex-banker, that the "Star" system of lending…reminiscent of real estate lending practices in the 1980's was prevalent with LTCM. How else could LTCM obtain the leverage it did without defrauding the banks; which I don't believe they did.
- ***The SEC has regulatory oversight for investment bank lending and the OCC has oversight for commercial bank lending. Therefore, the infrastructure is already in place to track excessive leverage.***

B. Are There Less Intrusive More Cost-Effective Ways To Monitor Hedge Fund Activity

- Ninety five percent (95%) of all hedge funds use one of the top **10 Prime Brokers** who are registered broker dealers and regulated by the SEC.
- Hedge funds use Prime Brokers for trade execution, clearing, settlement, financing, securities lending, P&L reporting and risk management, and other services.

- Ninety five percent (95%) of all U.S. onshore hedge funds use one of **five accounting firms** to perform annual audits of their books.
- All U.S. offshore hedge funds use one of **four administrators** to calculate daily or monthly Net Asset Values (NAV).
- As stated earlier, most hedge fund leverage comes from two regulated sources: investment banks and commercial banks (cash and derivative leverage).
- Hedge funds file Treasury bond and currency position reports with the Federal Reserve Bank (Forms, FC-1, FC-2 and FC-3).
- Hedge funds file reports with the CFTC and NFA (Form 40, 102)
- Hedge funds file reports with the SEC related to security ownership (13F, 13D and 13G).
- The top 100 hedge funds constitute more than 50% of the industry's assets.
- ***The expense and the related benefits associated with direct regulation of hedge fund activity can perhaps be made more cost-effective by proactive indirect monitoring through coordination with prime broker, accounting, administrator, investment bank and commercial bank relationships. Many of which are already under regulatory oversight.***
- If you want to monitor the size of the industry, why not poll the accountants and administrators.
- If you want to monitor the leverage in the industry, why not ask the banks.
- We don't need registration to get this kind of information flow to interested parties.

C. Is There A Hedge Fund Crisis And Are Hedge Funds Prone To Fraudulent Activities

- The hedge fund industry is not in a crisis. Misdeeds of a few have resulted in a backlash against the industry.
- The SEC has stated that the incidence of fraud is no more prevalent in hedge funds than anywhere else.

- ***Most frauds could have been curtailed by the "gate keepers" of the industry:***
  - **Lawyers**: background check and disclosure of criminal or regulatory infractions in hedge fund offering memorandum.
  - **Administrators**: only accept third party marks (i.e., no "trader marks"). Administrators perform monthly NAV calculations for offshore funds. If done for onshore funds, it would reduce valuation fraud.
  - **Accountants**: only accept third party marks; mail K-1 statements and annual audits directly to limited partner not the general partner.
  - **Prime Broker**: highlight unusual DVP (Delivery Versus Payment) activity.

D. Can A Level Playing Field Exist For All Investors

- A level playing field can be achieved by expanding current mutual fund regulations to permit greater access to hedge fund trading strategies and tactics by existing mutual fund hedge funds.
  - ***Some examples of these mutual funds that are "hedge fund like" are Prudent Bear (BEARX), Calamos Market Neutral A (CVSIX), Needham Growth (NEEGX), Merger Fund (MERFX).***
- This will allow retail investors access to hedge fund strategies in a mutual fund format with regulatory oversight.
- ***The basic regulatory infrastructure currently exists in mutual funds. With some modification in the areas of: restricted shorting, performance fees, liquidity and leverage, the retail investor can invest in a hedge fund with the protection of regulatory oversight.***

E. The Retail Investor Needs To Be Protected

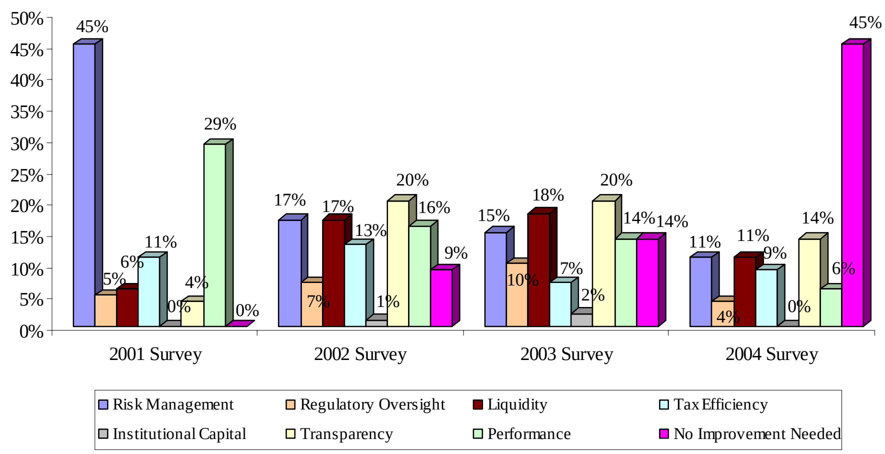
- In line with III. (D), retail investors would be investing in mutual funds registered under the Investment Company Act, which would operate like hedge funds.

- All sales to retail investors should be made by a Series 7 registered representative; practicing rule 405 (suitability).
- Hedge funds or fund of hedge funds that choose to manage retail or ERISA assets would be mandated to register as Registered Investment Advisers (25% rule for ERISA).
- ***It is important to note that, Hennessee research indicates that hedge fund managers do not want to manage retail assets.***

IV. SUGGESTED REGISTRATION EXCLUSION FOR CERTAIN HEDGE FUNDS

- Hedge funds that do not manage ERISA assets would be exempt.
- Hedge funds that do not manage retail assets would be exempt.
- ***The expense associated with registration of all hedge funds above $25 million would disproportionately benefit wealthy sophisticated investors who have been deemed by regulators not to need this degree of oversight.***

Aspects of the Hedge Fund Industry That Need Improvement



Source: Hennessee Group LLC 2004 Investor Research

Hedge Fund Investor Participants: 116 from all investor types including high net worth individuals, family offices, foundations, corporations, endowments, public and private pensions, and funds of hedge funds.

The respondent's investable assets totaled $96 billion.

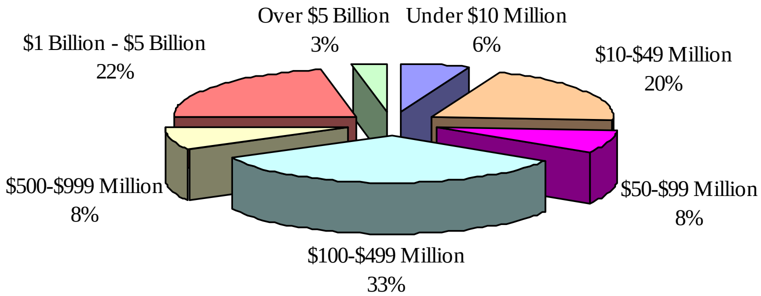
- The hedge fund industry has been consistently maturing, as evidenced by the increase in investors who feel there is no need for improvement (45%).
- This is further evidenced by the decreasing concern for risk management (from 45% in 2001 to 11% in 2004) a 76% reduction.
- ***Only 4% of investors surveyed feel there is a need for more regulatory oversight.***
- Hedge fund managers would not be opposed to new financial criteria for an accredited investor.
- ***The Hennessee Group believes registration should be market driven and not mandated. Hedge funds should be allowed to freely segment and target client markets. Those hedge funds that solely target accredited or qualified investors (other than ERISA) should not be mandated to register.***

V. HENNESSEE GROUP RESEARCH RELATED TO REGULATORY OVERSIGHT OF HEDGE FUNDS

A. Application of Hennessee Research

- Hennessee Group's research regarding regulatory oversight should only be used as an indicator of an industry trend and should not be extrapolated for the hedge fund industry as a whole (in terms of absolute numbers of hedge funds registered or not registered).
- Of the Hennessee Group's research population, only 6% were managers with less than $10 million. We believe this low representation does not negate the findings for the industry growth, capital structure and portfolio composition sections of our research because size is not a key determinant of action in these areas.

2004 Hennessee Group Manager Survey Participants by Hedge Fund Asset Size



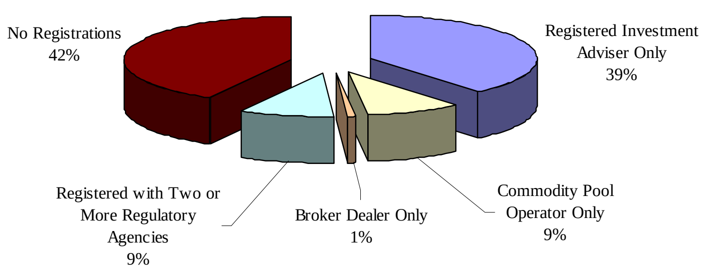
Source: Hennessee Group LLC 2004 Industry Research

Manager Participants: 789 hedge funds managed by 174 management companies representing $144 billion in assets

B. Registrations

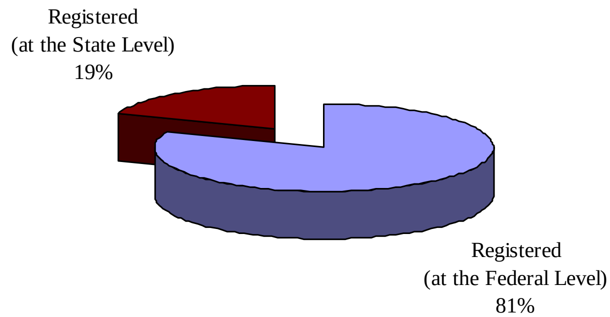
- Due to market forces predominantly driven by trust and ERISA fiduciaries, hedge funds are finding it necessary to become Registered Investment Advisers in order to attract capital from these sources. Thirty nine percent (39%) of the hedge funds in our research were Registered Investment Advisers at the State or Federal (SEC) level. Ten percent (10%) were registered with the NASD, or CFTC, nine percent (9%) were registered with two or more regulatory agencies (i.e., SEC, NASD, CFTC) and 42% were not registered with any regulatory agency.
- ***It is also reasonable to conclude that a significant portion of hedge fund assets are already registered with either the SEC, NFA, NASD, CFTC, or State agencies. Fifty eight percent (58%) of hedge funds in our research were registered with at least one agency already.***

Hedge Fund Registration



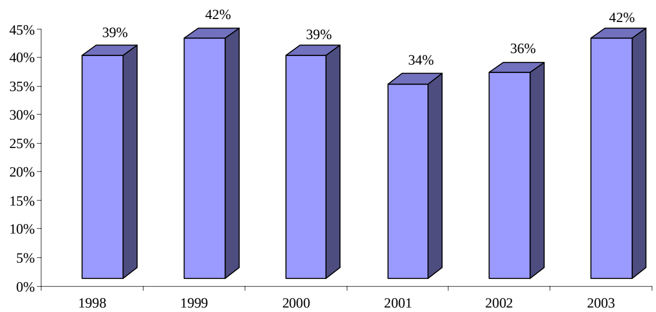
Source: Hennessee Group LLC 2004 Industry Research

Registered Investment Advisers



Source: Hennessee Group LLC 2004 Industry Research

Hedge Funds with No Registration



Source: Hennessee Group LLC 2004 Industry Research

- ***The Hennessee Group supports the position that the registration of hedge funds should be market driven.*** Those hedge funds or fund-of-funds that want to sell to the retail market should be registered. In this way, we can protect the retail investor without inhibiting the free determination of hedge fund investment objectives and their use of investment strategies.
- ***The integrity of the entrepreneurial spirit of the hedge fund industry should be protected and we believe this protection is essential to the concept of an "open market place".***
- The market place benefits directly from the entrepreneurial nature of hedge funds, least of which is contrarian research (i.e., uncovering of Enron, Tyco and WorldCom). Also, hedge funds provide added liquidity and a more efficient market pricing mechanism.
- ***A mandate to register hedge funds above $30 million in assets seems to have benefits that will not justify the regulatory oversight expense.*** As

stated earlier, the investor demands are already driving the need for registration. Let the sophisticated wealthy investor choose between registered products and non-registered products as they currently do with venture capital, private equity and other unregistered limited partnerships, offered by regulated broker dealers and retail brokerage firms.

- ***In other words, the degree of regulation should be a function of investor needs.*** We need to protect the retail investor and, at the same time, allow capital formation to meet other more sophisticated investor needs whether they are hedge funds, venture capital or private equity.
- ***It seems inconsistent to permit sophisticated investors to have ownership in a risky startup venture capital company through an unregistered private placement but not allow that same person an investment in a less risky unregistered hedge fund.***
- **The issues facing the hedge fund industry and regulation alike may be better served through:**
    - Adoption of "Sound Practices for Hedge Fund Managers."
    - Self regulation with broader regulatory filings.
    - Investor education.
    - Indirect systemic risk monitoring by Regulators through hedge fund "gate keepers" and banks.
    - Increased risk transparency (especially off balance sheet exposure and counterparty risk).
    - Third party pricing (eliminate "trader marks").
    - Inclusion of third party background check in offering memorandums.
    - Tightening of "accredited investor" and "suitability" rules.
    - Direct mail of annual audits and K-1's from auditor to limited partner.
    - Expanded disclosures (financial and operational) related to "Sound Practices."
    - Disclosure to hedge fund limited partners of monetary penalties paid by registered hedge funds for regulatory infractions.

VI. THE FEAR FACTOR: ARE HEDGE FUNDS IMPLEMENTING A STRATEGY THAT IS FUNDAMENTALLY OPPOSED TO THE WAY AMERICAN MARKETS HAVE EVOLVED

A. Hedge Fund Shorting And The Farmer

- The concept of hedging a long position by executing a short position is not a new concept. The concept was developed long before A.W. Jones began hedging market risk of his long positions by shorting stock in 1949. Perhaps the A.W. Jones hedge fund model was an off-shoot of the hedging practices farmers have been employing since the 18th century. As a practice, farmers can be simultaneously long and short the commodity they harvest for sale to the end user market.
- This occurs when a farmer sells a crop before it is harvested in the forward or futures market to lock in a price today against a future delivery of that crop at a specified date in the future. Essentially, the farmer sells short a portion of his planned harvest to hedge against the possibility of a decline in market prices for his crop.
- The farmer, the end users of the crop, and the commodities speculators, all have different objectives but together they provide liquidity, hedging and an efficient pricing mechanism fundamental to a mature open commodities market.
- ***Perhaps the concept of hedging employed by the great American farmer is the cornerstone of the hedging concept applied by hedge fund managers today. The negative perception of hedging strategies used by hedge funds is not merited.***

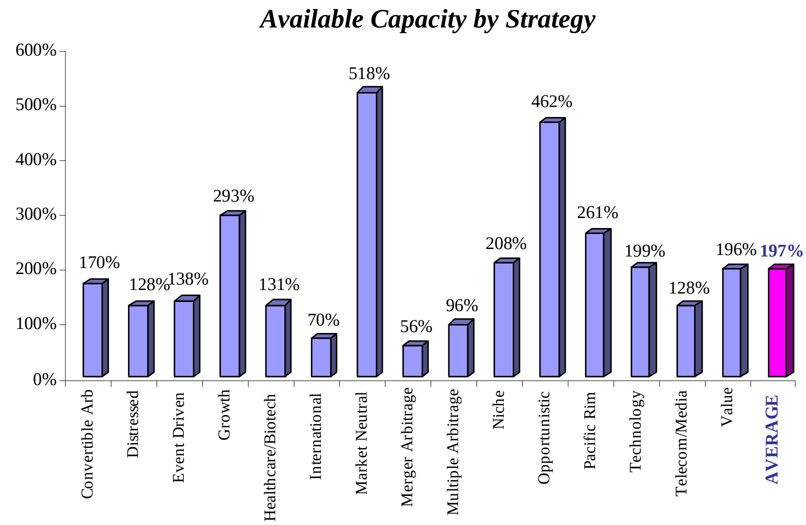
B. A.W. Jones Was Not The First "Hedge Fund"

- Admittedly, Alfred Winslow Jones was the first to go long and short stocks in a "limited partnership" format, however, he was not the first to implement the strategy in the stock market. ***Investment banks were long and short stock as far back as the 1920's***. This should not diminish Mr. Jones' pivotal importance to the hedge fund industry but perhaps put hedge funds in a broader context.

- ***Hedge funds can be described as investment bank proprietary trading desks wrapped into a limited partnership*.** Every conceivable hedge fund strategy: distressed bonds, high yield bonds, fixed income arbitrage, merger arbitrage, long/short equity, convertible arbitrage, emerging markets, day trading, etc. are all executed on the proprietary trading floors of investment banks. Many of these strategies also appear at commercial banks as well. The areas of stock picking, arbitrage trading, use of derivatives, leverage and risk management, to name a few, are virtually identical in both the hedge fund and institutional proprietary trading at investment banks and commercial banks. However, while the methods overlap, the degree of sophistication can vary from one hedge fund to another.
- **The fear and media hype associated with hedge fund strategies is not merited**. One could make the case that the first "hedge funds" were the investment banks who are among the largest long/short players in the market today. The practice of being long and short securities while using leverage has been practiced on Wall Street for decades and therefore should not be viewed as some new "wildcat" money making scheme that just got rolling in the 1990's.
- ***The hedge fund strategy is integral to the evolution of the American Markets and is an extension to the strategies and tactics used by proprietary traders on Wall Street and commercial banks. Hedge funds are not a new phenomenon and the level of fear surrounding the way hedge funds manage assets is without merit.***

VII. THE FUTURE ECONOMICS OF SHORTING AND ITS IMPACT ON THE GROWTH IN THE HEDGE FUND INDUSTY

- Recent forecasts, by third party surveys, of hedge fund asset growth have placed the industry at $4 trillion by the year 2010. Hennessee Group's Annual Manager Research for 2004 indicates that, on average, hedge fund managers believe they have available capacity for 197% of new assets. At $795 billion, Hennessee Group research would extrapolate that nearly $1.6 trillion of new capacity is currently available ($2.4 trillion total asset management capacity).



Source: Hennessee Group LLC 2004 Industry Research

- This spread between the industry's perceived total available capacity recorded by Hennessee's 2004 Manager Research ($2.4 trillion) and the $4 trillion estimate for 2010 by other independent researchers, seems feasible from a growth rate per annum point of view. However, the demand will be met in one of the following ways: (a) hedge fund managers will go beyond capacity limits they currently foresee according to Hennessee Group research; (b) new capacity will be added by new managers entering the industry who will manage the new capital added to the industry or; (c) a combination of both will take place.
- ***Elasticity of supply of new managers is of concern to the Hennessee Group.***
- The growth in new managers may be stymied because the industry has evolved to the critical point where "success breeds more success" in attracting new capital. Consequently, upstart hedge funds may not get substantial new capital inflow until the well established hedge funds with available capacity are closed to new capital or have performance issues before they attain their desired capital level.

- ***The industry is at the early stages of its maturation where new upstarts may be "squeezed out" in competing for new capital by the more established players.***
- ***Hennessee Group believes estimates of $4 trillion by 2010 are extrapolations that may not take into account the greater difficulty, and therefore slower growth rate, new hedge funds will have in attracting new capital.*** New hedge funds are entering the industry at a time when a significant portion of the industry is already established with respectable track records of 5 or more years who are also capable and willing to take on substantial new capital.
- ***Elasticity of supply of stock to borrow to maintain traditional hedge ratios is of concern to the Hennessee Group.***
- Hennessee Group's analysis indicates the growth in demand for stock to borrow by hedge funds is estimated at $300 to $350 billion (44% short exposure on $795 billion). Shorts would need to grow to $1.8 trillion by 2010 to maintain the historical 44% short hedge ratio for all strategies combined (at $4 trillion). ***(See long/short exposure chart in Section IX)*** although hard statistics are not available as to the amount of stock available for stock borrow over and above what is actually used in the market, Hennessee Group's research indicates at least a verbal confirmation from a few stock loan departments and managers that the demand for stock to borrow is more difficult to satisfy than just four years (4) ago. Hennessee manager research reports indicate sporadic "buy-ins" and the need to pay stock lenders far more frequently than ever before (i.e., negative "short rebate" to hedge fund managers). Although not a major problem at this time, unchecked dislocations between supply of stock to borrow and demand will present portfolio risk management issues and perhaps the use of less familiar techniques to achieve the same hedge.
- ***Ultimately, the concept of being simultaneously long a security (whether bond or stock) and short a security will be challenged on the short side not the long side***. Either the stock loan function on Wall Street will keep pace with demand or, if not, "negative short rebates"

and "buy-ins" will increase, creating the need to rethink today's hedge fund portfolio business model.

- ***In conclusion, capacity for asset growth of the total hedge fund industry is a function of the survivorship of new manager talent and the industry's ability to borrow stock to sell short and, thereby, maintain the "hedged" strategy that characterizes hedge funds today. The amount of stock available to borrow will ultimately put a "ceiling" on the assets managed by hedge funds provided hedge funds stay true to historical hedging ratios. For hedge funds to maintain their historical allocation to shorts of 44%, at $4 trillion in assets in the year 2010, the industry would need $1.8 trillion of shorting capacity. To physically borrow sufficient securities economically and maintain the integrity of the "A.W. Jones Model" the demand for stock borrows would likely exceed supply creating a need to rethink the A.W. Jones model to successfully achieve the targeted hedging objective. If the supply of stock to borrow could not meet demand then the industry would hit a "ceiling" in growth unless the industry accepted larger net long exposure or adopted the use of derivatives to replace stock shorting. Neither condition (larger net long positions or greater use of derivatives to simulate short hedging) would be desirable.***
- ***The elasticity of the long only industry to manage new assets is greater than the hedge fund industry. Concerns that the hedge fund industry will overtake the long only industry is without merit.***

VIII. SOME COMMON MISPERCEPTIONS ABOUT HEDGE FUNDS DURING THE RECENT BEAR MARKET

The following are direct quotes from the media about hedge funds.

A. "Hedge Funds Are Known For Making High Stakes Bets In Bonds And Currencies."

- This description of hedge funds who make directional bets in bonds and currencies applies to about 3% of the assets in the industry (i.e., macro managers). Over 50% of the industry's capital is in long/short equity trading and the balance consists of relative value arbitrage, event driven arbitrage and other arbitrage strategies. None of these strategies (are making "high stakes" bets on bonds and currencies).

- Of the $795 billion in hedge funds approximately:
  - $24 billion is in macro (at least 50% of assets are in the cash market with the balance in futures and options)
  - $357 billion is in relative value, event driven arbitrage and other arbitrage strategies
  - $414 billion is in long/short equity
- Pure futures managers (CTA's), like macro hedge fund managers, also make directional bets in bonds and currencies. However, historically they have not been considered hedge funds by Hennessee Group since 100% of the risk is in futures. While all managers who use futures are required to register with the CFTC, managers who only trade futures are not considered by Hennessee Group to be hedge funds.
- ***These CTA's are often lumped together with hedge funds, which confuse investors by distorting statistics related to leverage, portfolio turnover and fund failure rates.***
- According to Hennessee Group research, the typical macro manager started as a long/short equity hedge fund but because of asset growth they added futures and options as a secondary core competency.
- ***It is misleading to define the entire hedge fund industry by using macro managers or Long-Term Capital Management as the proxy.***

B. "An Investigation Of Hedge Funds Is Needed Because They Are Driving The Market Wild."

At the fringe, hedge funds (if they act in unison) can exaggerate moves in a stock or the broad averages momentarily but this is not believed to be the rule when you consider other influences on market movements, such as:

- Mutual Fund redemptions were a major negative force in the recent bear market.
- Program trading can amount to 40% of a given day's volume on the NYSE. Little of this, if any, is hedge fund related.

- Proprietary trading in stocks, bonds and currencies by commercial banks and investment banks can be incorrectly attributed to hedge fund trading by Wall Street experts.
- Large "gap downs" in price, can appear to be caused by hedge fund shorting, but are actually due to the lack of buyers coupled with imbalances on exchange specialists books.
- Market Makers, exchange specialists and block traders also perform "hedge fund like" trades to hedge out overnight risk, "flatten" intra-day net exposure or provide liquidity to clients.
- Institutional money managers use derivative "portfolio overlays" to hedge the long bias of their equity portfolios resulting in an offsetting short of a basket of stocks in the equity cash market by the issuer of the "portfolio overlay".
- Putting the industry in perspective, the global markets are estimated at $40 trillion versus hedge funds at $800 billion.
- ***Many players on Wall Street and institutional money managers can act in a manner similar to hedge funds making it difficult to isolate the "real" versus the "perceived" impact of hedge funds on the market. The media magnifies the negative perception by reporting hedge funds as the cause for sudden shifts in the market direction and gapping down in stocks. Although many look to blame hedge funds for the duration and depth of the recent bear market, the fact is that the hedge fund industry, as a whole, was on the sidelines (see IX.(D)).***

C. "The Shorting By Hedge Funds Has Caused Us To Stop Lending Securities."

- In 1931, after a study of the 1929 crash was completed, the NYSE concluded that:
  - ***"The real cause of declining securities was not short selling but the lack of buyers against forced sellers."***
- The 1991 Congressional report on short selling by the House on Government Operations stated that:
  - **"Short selling plays an important and constructive role in the markets and that many complaints about short selling are not**

soundly based and may be a result of a poor understanding of short selling."

- Lending of securities to facilitate shorting should be encouraged. ***Shorting provides liquidity and enhances the efficiency of the market's pricing mechanism.***

IX. THE ROLE OF HEDGE FUNDS IN MAJOR MARKET DISTURBANCES

A. The Stock Market Crash Of 1929

- The first hedge fund, A.W. Jones Company LLC, appeared in 1949.

B. The 1970's Bear Market

- Approximately 100 hedge funds
- No influence on bear market
- Most lost money due to inability to borrow stock…"stock loan meltdown" (i.e., "buy-ins")

C. The Crash of 1987

- Approximately 100 hedge funds
- No real influence on crash
- Mixed performance among hedge funds
- Stock loan still a problem but to a lesser degree than in the 1970's

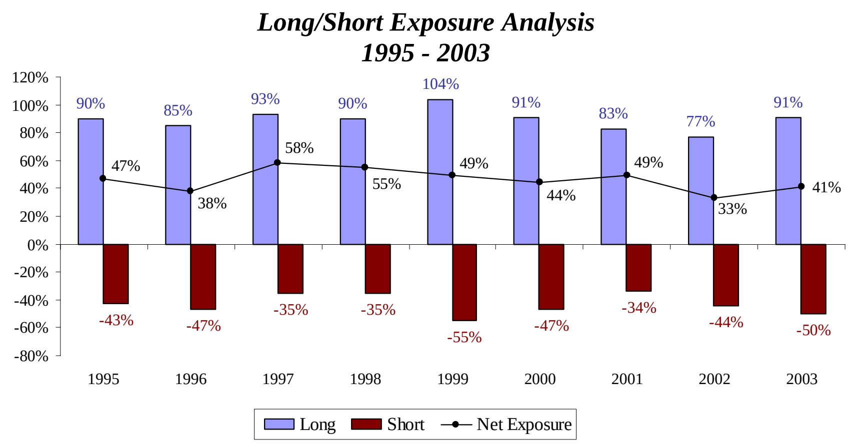
D. The Bear Market of 2000 – 2002

Year	Long/Short Equity Hedge Fund Managers	Arbitrage, Event Driven Hedge Fund Managers	S&P 500	NASDAQ
2000	9.20%	9.38%	-9.09%	-39.28%
2001	1.34%	8.66%	-11.88%	-21.04%
2002	-8.19%	1.90%	-22.10%	-31.52%

- ***The above performance statistics, sourced from the Hennessee Hedge Fund Index®, does not support the notion that hedge funds (as a***

group) accentuated the bear market through their shorting activity. However, "Short only" managers (1% of hedge fund assets) were +29.93%, +12.65% and +15.84% respectively for the years 2000, 2001 and 2002.

- During the recent bear market, a small number of long/short equity managers made large directional bets on the short side and profited. Nonetheless, the majority of hedge funds had a net long bias throughout the bear market and predominately acted in an asset preservation mode as evidenced by their performance.
- ***Hedge funds were net buyers of stocks during the recent bear market and had little impact on the depth or duration of the market decline.***



Source: Hennessee Group LLC 2004 Industry Research

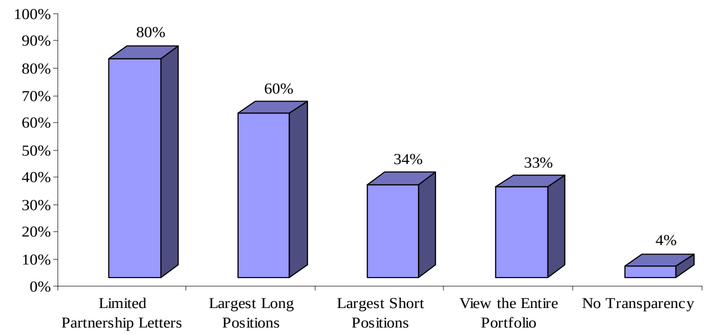
X. CURRENT TRENDS IN THE HEDGE FUND INDUSTRY

A. Six (6) Trends Recognizable To Hennessee Group:

- Increased registration as a Registered Investment Adviser, Commodity Pool Operator or Broker Dealer by hedge funds.
- Exponential growth in Fund-of-Funds from $20 billion in 1994 (20% of the industry) to $191 billion in 2004 (24% of the industry).
- Exponential growth in institutional investing from $60 billion in 1998 (29% of the industry) to $254 billion in 2004 (31% of the industry).
- A significant reduction in "Qualified Audits" due to an increase in disclosure by hedge funds in annual financial audits.

- Greater public accessibility to hedge fund selection information and performance databases through internet and print media.
- Increased transparency to investors.

Methods of Reporting Transparency
2003



Source: Hennessee Group LLC 2004 Industry Research

- ***Segmentation of hedge funds into three (3) target markets:***
  - 3c1 and 3c7 ***unregistered*** hedge fund entities focused on high net worth individuals and institutional capital formation that does not require registration as an investment adviser.
  - 3c7 ***registered*** hedge fund entity seeking institutional capital formation that requires registered investment adviser status.
  - Retail sector offering of ***registered*** hedge fund products (single manager and multi-manager funds and fund-of-funds) by banks, mutual fund investment management companies, and other financial institutions.

XI. HOW COMPARABLE ARE HEDGE FUNDS TO INVESTMENT COMPANY ACT MANAGERS

A. Areas Of Least Comparability Between Hedge Funds And Investment Company Act Managers

- Daily third party pricing by a custodian for U.S. onshore hedge funds
- Full transparency
- Diversification rules

B. The Hedge Fund Industry Is Maturing Due To Market Forces

As the industry matures, the Hennessee Group has recognized a more common use of:

- Independent pricing services (monthly).
- Major accounting firms.
- Sophisticated investment risk monitoring (i.e., VAR, etc.).
- Real-time trader P&L systems.
- Daily mark-to-market.
- Formal back office daily reconciliation of cash and securities.

Hedge funds are becoming more structured in the way they operate. Over the last decade, the Hennessee Group has seen an evolution from the stereotype "three guys in a room with a coffee pot" to a more sophisticated sense of business management, broader organizational structures and an effective deployment of technology, especially in the area of client reporting, risk management and back office operations.

XII. HAS THERE BEEN A TRANSITION OVER THE YEARS TO INCREASE THE AMOUNT OF RISK HEDGE FUNDS TAKE ON

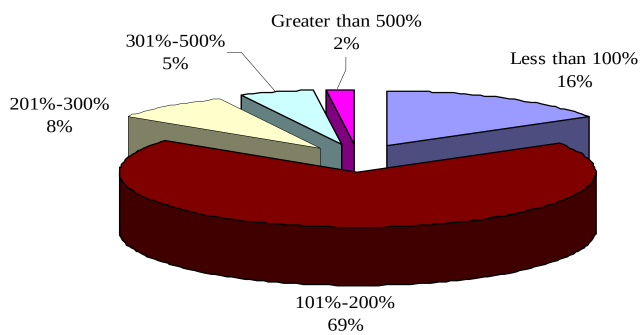
A. Some Misperceptions About Hedge Fund Risk

- Many feel that assuming risk creates a risky investment. Hennessee Group believes that hedge funds as a whole expose themselves to risk in an intelligent way.
- Shorting is not necessarily a risky strategy. The intelligent use of shorting and derivatives by hedge funds can reduce risk.
- Hedge fund managers add risk with consideration to the portfolio as a whole and the prudence of the strategy.
- Making an investment, which in of itself assumes greater risk, does not necessarily increase the risk of the overall pool provided that the risky asset has low correlation to the other portfolio assets (Modern Portfolio Theory).

B. Has Risk Increased Over The Years For Hedge Funds

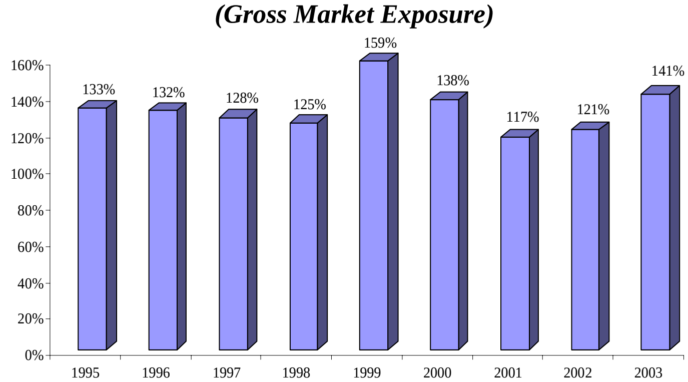
- Three key risk measures are: (a) ***volatility risk*** as defined by the standard deviation of performance; (b) ***leverage*** as defined by gross market exposure; (c) ***portfolio risk*** as defined by net market exposure.
- The standard deviation for a diversified hedge fund portfolio (using the Hennessee Hedge Fund Index® as a proxy) is much less than the broad market of diversified securities (S&P 500). From 1987 to present, Hennessee Group research indicates that the S&P 500 has averaged 18% standard deviation while the Hennessee Hedge Fund Index® was 11.25% for the same period. (see Risk vs. Return chart, section II (E)).
- Leverage used by hedge funds is often exaggerated by the media. Eighty-five percent (85%) of hedge funds in our research have historically never exceeded Reg T. Those that do exceed Reg T (200%) are arbitrage strategies (i.e., convertible arbitrage, merger arbitrage, etc.). For the major portion of the industry, average gross exposure (longs plus shorts) ranged from a high of 159% in 1999 to a low of 117% in 2001.
    - ***Pure CTA's (i.e., 100% futures) are excluded from Hennessee Group's Annual Research (See VIII. (A))***

Maximum Historical Gross Exposure (Long Plus Shorts)



Source: Hennessee Group LLC 2004 Industry Research

Portfolio Leverage 1995 - 2003 (Gross Market Exposure)



Source: Hennessee Group LLC 2004 Industry Research

- Portfolio risk management has greatly improved as the industry has evolved. More managers are imposing position limits and stop losses. Where diversification is an issue (i.e., sector funds), hedging techniques are being used to reduce that risk. Value At Risk (VAR) modeling is common among larger hedge funds.
- ***Performance in the most recent bear market (2000 – 2002) would be one way to measure risk exposure of the average hedge fund***. A diversified portfolio of hedge funds during the bear market indicates risk management was successful. According to the Hennessee Hedge Fund Indices®, the percent of managers who outperformed the S&P 500 in 2000, 2001 and 2002 were 87%, 89% and 92% respectively.

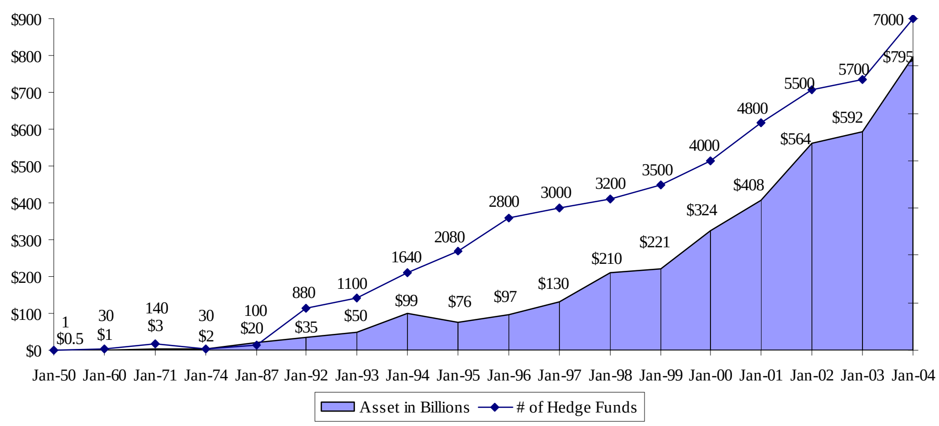
XIII. GROWTH OF THE HEDGE FUND INDUSTRY

- ***It is fair to conclude that the overall industry's understanding of the asset growth is an extrapolation of independent research and databases and not a science.*** Despite this flaw, most sources, including the Hennessee Group LLC, estimate assets in the hedge fund industry at approximately $800 billion (Hennessee is at $795 billion). Estimates above $800 billion usually include non-U.S. hedge funds (i.e., Europe, Asia).
- The Hennessee Group has been tracking industry asset growth and performance for the hedge fund industry since 1987. Hennessee's data in 1987 was nearly all inclusive since there were less than 100 hedge fund managers and our founder, Elizabeth Lee Hennessee, was able to document their assets and performance directly as a by product of her career in institutional sales and hedge fund advisory services.
- Beginning in 1990, E. Lee Hennessee had asset and performance history that statistically included between 90% and 95% of the industry. However, as the decade progressed, the industry grew from 100 managers and $20 billion in assets in 1987 to 880 managers and $35 billion in 1992. During this period of growth, the Hennessee Group performed research to extrapolate manager and asset growth. Since the industry was highly concentrated around the original 100 managers (and

more concentrated around Soros, Steinhardt, Robertson and Levy), any inaccuracies in the data regarding assets were statistically insignificant. However, by the mid-90's, the hedge fund industry became so dispersed that the Hennessee Group instituted its first formal annual industry research in January 1995. At that time, the handful of managers who had constituted over 60% of the industry assets had fallen to one-third (33%). Extrapolation through Hennessee Group's Annual Manager Research became the most practical method of obtaining a perspective on the industry.

- The chart below represents the Hennessee Group's industry growth data. The data prior to 1994 was extrapolated from Hennessee Group's manager database encompassing 90% or more of the estimated industry capital. ***The annual Hennessee research, beginning in January 1995 through January 1999, typically researched anywhere from 40% to 60% of the industry's assets and extrapolated overall industry growth based on this significant sample size. From January 2000 to present, our manager research has studied asset growth on no less than approximately 20% of the estimated industry.***

Hedge Fund Assets vs. Number of Hedge Funds

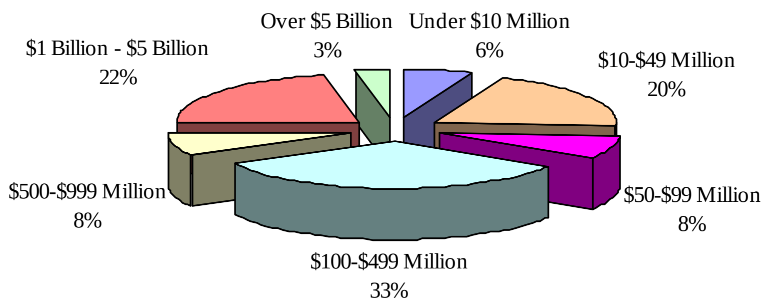


Source: Hennessee Group LLC 2004 Industry Research

XIV. HENNESSEE GROUP ANNUAL INDUSTRY RESEARCH

The Hennessee Group has been conducting its annual industry research since January 1995. The January 2004 research report encompassed 174 management companies with 789 hedge funds totaling $144 billion of hedge fund assets. Participants came from a cross section of all hedge fund strategies and asset sizes.

2004 Hennessee Group Manager Survey Participants by Hedge Fund Asset Size



Source: Hennessee Group LLC 2004 Industry Research

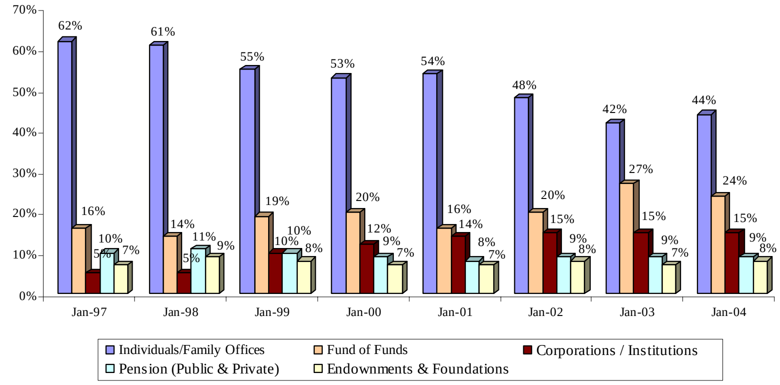
Manager Participants: 789 hedge funds managed by 174 management companies representing $144 billion in assets

The basic conclusions from this research were as follows:

A. Capital Structure

- Hedge fund industry assets increased 34%, to $795 billion, in 2004 on a year-over-year basis. Since the beginning of the bear market, hedge fund assets have increased 145% ($324 billion to $795 billion).
- Of the 34% increase in total assets, 20% was due to performance and 14% from new capital.
- Individuals and family offices continue to represent the largest source of capital for hedge funds, comprising 44% of total industry assets, up from the prior year's level of 42%.
- The fastest growing source of new capital is fund-of-funds, increasing from 16% in 2001 to 24% in 2004.

Hedge Fund Sources of Capital
(Percentage by Investor Type)
January 1997 - 2004



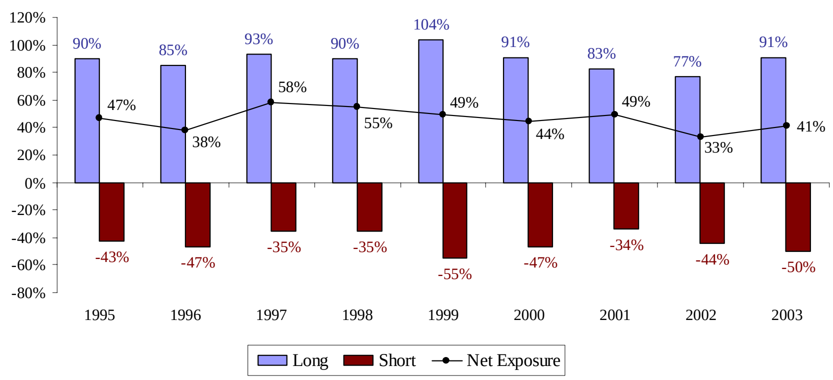
Source: Hennessee Group LLC 2004 Industry Research

- The average hedge fund manager aspires to manage $703 million in capital.
- The average hedge fund can increase its capital by 197% from its current level.

B. Portfolio Composition

- Hedge funds underperformed the broader equity market indices in 2003, as the Hennessee Hedge Fund Index® was up +19.69% net of fees versus the NASDAQ (+50.01%), S&P 500 DRI (+28.55%), and DJIA (+25.33%).
- Since 1995, with the exception 1999, the average hedge fund used little to no margin.
- The average hedge fund gross exposure (longs plus shorts) was 141%, refuting the notion that hedge funds are a highly levered asset class.

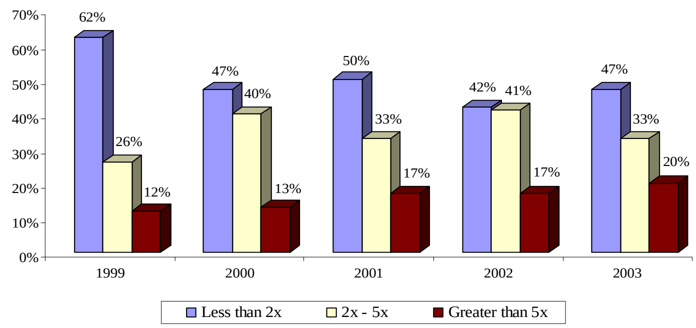
Long/Short Exposure Analysis
1995 - 2003



Source: Hennessee Group LLC 2004 Industry Research

- On average, hedge funds have the highest short exposure (-50%) since 1999 when it was -55%, expressing concerns over the markets explosive liquidity driven performance in 2003.
- 84% of hedge funds have not had their historical gross exposure exceed 200%.
- The average portfolio manager turns their portfolio over 3 times per year (a 26% increase from 1999). This increase in turnover is largely due to the increase in market momentum and volatility.

Portfolio Turnover Rate
1999 to 2003

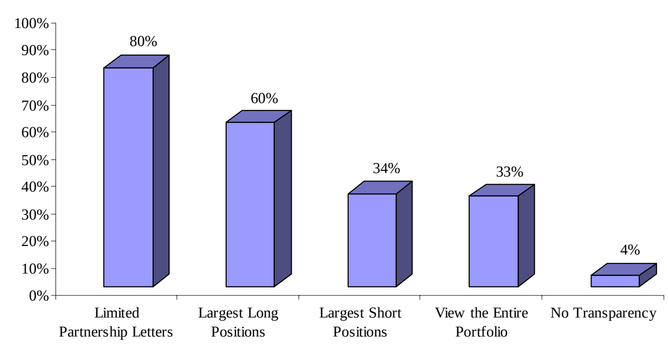


Source: Hennessee Group LLC 2004 Industry Research

C. Transparency

- 33% of hedge funds researched provide their investors with access to the entire portfolio.
- 8% of hedge funds researched expect to increase transparency in 2004.
- The number of hedge funds who have websites has increased 67% since 1999 (from 36% to 60%).

Methods of Reporting Transparency
2003

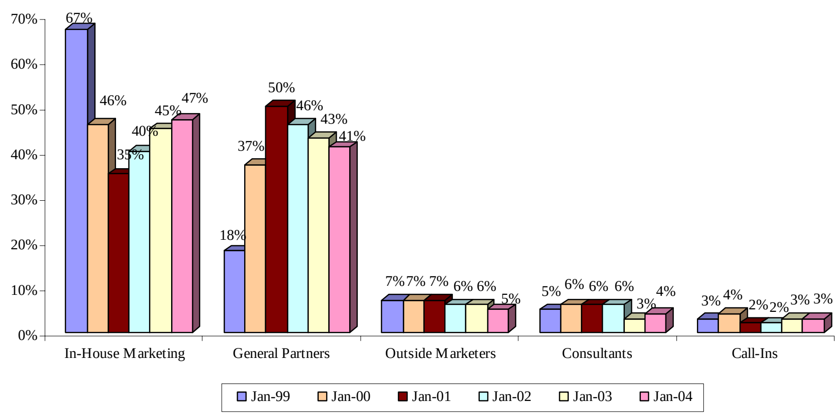


Source: Hennessee Group LLC 2004 Industry

D. Capital Raising

- The vast majority of capital (88%) comes from general partners, employees and in-house marketing efforts.

Hedge Fund Capital Raising



Source: Hennessee Group LLC 2004 Industry Research

E. Available Capacity For Asset Growth

- ***On average, hedge fund managers believe they have available capacity for 197% in new assets.*** This can be translated to mean that the industry, which is approximately $800 billion, can add another $1.6 trillion and grow from current levels to approximately $2.4 trillion. At 15%, 20% and 25% annualized compounded growth, it will take 8, 6 and 5 years respectively to reach $2.4 trillion. (see *Available Capacity by Strategy* chart, Section IV)

HENNESSEE GROUP LLC
HEDGE FUND ADVISORY

Hennessee Hedge Fund Indices® 1987 - 2003

STYLE	1987-2003 Average Annual Return	1987-2003 Standard Deviation	YEARLY RETURNS (NET OF FEES) 2003	2002	2001	2000	1999	1998	1997	1996	1995	1994	1993	1992	1991	1990	1989	1988	1987
Convert Arbitrage Index	10.18%	6.54%	9.37%	8.68%	15.13%	8.61%	16.20%	5.98%	9.88%	10.44%	19.19%	-8.87%	14.55%	14.82%	15.08%	5.45%	14.36%	7.14%	
Distressed Index	18.25%	16.54%	26.78%	1.88%	9.63%	2.38%	24.80%	-6.49%	11.29%	21.20%	20.81%	6.81%	28.86%	16.44%	34.75%	13.20%	11.32%	43.84%	60.23%
Emerging Markets Index	24.35%	41.31%	24.49%	5.02%	10.29%	-9.35%	47.12%	-30.06%	14.32%	18.57%	-7.58%	6.75%	54.63%	17.48%	74.85%	27.60%	127.35%	97.20%	
Europe Index	11.79%	15.06%	13.45%	-3.72%	-3.18%	13.45%	36.57%	19.14%											
Event Driven Index	20.09%	29.87%	19.10%	-0.43%	12.41%	10.87%	24.36%	-2.54%	22.74%	18.54%	12.94%	6.82%	38.56%	26.17%	26.45%	10.13%	12.86%	131.50%	12.40%
Financial Equities Index	22.95%	22.83%	36.25%	6.29%	15.59%	27.83%	4.63%	-19.20%	37.94%	29.58%	37.51%	8.69%	25.89%	27.94%	8.73%	80.29%	45.40%		
Fixed Income Index	6.11%	8.58%	2.88%	5.35%	7.83%	5.08%	14.64%	-14.13%	7.24%	15.38%	17.37%	1.36%	7.90%						
Growth Index	17.40%	17.12%	22.27%	-11.64%	-3.71%	-3.22%	53.20%	20.09%	15.29%	17.43%	27.68%	0.77%	18.33%	24.50%	44.41%	15.51%	39.30%	22.04%	13.35%
Healthcare/Biotech Index	19.62%	30.59%	32.60%	-17.03%	-2.99%	62.75%	60.53%	8.85%	15.47%										
High Yield Index	15.43%	22.28%	18.44%	-7.12%	7.36%	-9.99%	8.34%	-7.27%	13.97%	23.09%	17.41%	2.37%	17.71%	32.34%	48.57%	75.19%	17.88%		
International Index	17.00%	17.67%	22.70%	2.64%	4.63%	9.11%	44.35%	-3.03%	24.18%	21.33%	14.48%	-1.88%	38.72%	19.07%	62.77%	0.76%	25.68%	9.35%	13.73%
Latin America Index	23.21%	49.71%	70.19%	-15.90%	-10.40%	-12.54%	74.11%	-37.59%	9.61%	28.07%	-12.12%	31.65%	14.41%	16.25%	83.32%	20.70%	145.50%	97.20%	
Macro Index	13.29%	16.07%	18.71%	-3.50%	-1.07%	5.89%	7.90%	4.13%	17.18%	17.57%	18.27%	-16.54%	41.50%	17.98%	33.96%	18.42%	43.76%	22.10%	-2.16%
Market Neutral Index	8.74%	5.51%	2.04%	1.73%	6.14%	7.12%	-0.84%	5.05%	12.30%	16.14%	11.50%	5.98%	4.32%	10.22%	16.66%	11.24%	16.45%	15.34%	9.41%
Merger Arbitrage Index	12.78%	15.05%	9.89%	-1.07%	3.84%	17.49%	16.03%	7.71%	14.26%	13.78%	15.52%	7.29%	23.39%	24.35%	17.95%	0.72%	16.32%	58.69%	-14.01%
Multiple Arbitrage Index	10.35%	5.59%	12.06%	5.11%	9.70%	19.78%	16.31%	4.75%	11.63%	14.61%	10.52%	3.32%	7.99%	10.05%	18.94%	1.90%			
Opportunistic Index	16.67%	12.11%	14.04%	-8.32%	-1.59%	10.63%	37.23%	16.69%	15.89%	18.47%	19.98%	3.96%	25.70%	19.91%	38.33%	12.12%	19.26%	25.34%	26.12%
Pacific Rim Index	18.64%	34.39%	28.67%	-1.99%	4.82%	-6.52%	81.12%	-8.86%	1.09%	6.86%	-0.49%	-7.84%	35.99%	19.02%	41.00%	34.50%	109.20%		
Regulation D Index[1]	9.89%	12.70%	8.26%	-6.26%	-3.46%	4.75%	30.58%	24.68%	13.11%	12.53%									
Short Bias Index	0.65%	21.23%	-21.26%	15.84%	12.65%	29.93%	-9.91%	-23.30%	7.11%	-17.77%	-28.40%	11.54%	-4.16%	-3.58%	-23.33%	43.32%	22.35%	12.87%	22.77%
Technology Index	22.77%	32.80%	14.77%	-8.07%	-2.09%	12.44%	101.53%	44.03%	13.00%	21.19%	37.27%								
Telecom and Media Index	7.43%	21.03%	30.39%	-11.62%	7.60%														
Value Index	15.93%	10.71%	24.11%	-2.92%	11.31%	3.66%	24.58%	-0.96%	25.59%	21.33%	20.45%	1.96%	20.52%	19.13%	28.16%	6.02%	25.88%	25.94%	24.31%
HENNESSEE HEDGE FUND INDEX®	**15.34%**	**10.95%**	**19.69%**	**-3.51%**	**3.98%**	**7.61%**	**32.59%**	**1.77%**	**15.58%**	**17.22%**	**15.23%**	**0.81%**	**21.34%**	**18.50%**	**31.80%**	**14.76%**	**30.37%**	**26.26%**	**15.24%**
HENNESSEE CORRELATED**	15.86%	11.70%	22.18%	-8.19%	1.34%	9.20%	41.88%	9.44%	20.61%	19.81%	25.33%	2.49%	18.80%	18.12%	28.60%	10.08%	24.67%	19.29%	15.61%
HENNESSEE NON CORRELATED***	12.27%	8.63%	12.69%	1.90%	8.66%	9.38%	14.59%	2.46%	13.61%	15.93%	16.19%	1.93%	17.76%	14.02%	17.96%	9.92%	11.90%	38.92%	5.65%
GLOBAL/ MACRO	14.58%	17.98%	26.75%	-1.45%	1.43%	1.34%	42.73%	-13.62%	16.90%	19.08%	11.09%	-5.09%	42.07%	14.52%	42.30%	10.61%	40.85%	19.29%	1.10%
S&P 500	12.05%	17.97%	28.69%	-22.10%	-11.88%	-9.09%	21.04%	28.58%	33.38%	22.96%	37.57%	1.32%	10.07%	7.64%	30.46%	-3.11%	31.68%	16.61%	5.25%
DJIA	10.57%	14.73%	25.33%	-16.76%	-7.10%	-6.15%	25.19%	16.11%	22.65%	26.02%	33.46%	2.15%	13.73%	4.15%	20.33%	-4.34%	26.96%	11.85%	2.26%
Russell 2000	8.80%	19.57%	45.39%	-21.57%	1.03%	-4.21%	19.64%	-3.44%	20.54%	14.78%	26.21%	-3.18%	17.01%	16.35%	43.68%	-21.47%	14.20%	22.37%	-9.34%
NASDAQ	10.83%	33.11%	50.01%	-31.52%	-21.04%	-39.28%	85.61%	39.62%	21.64%	22.70%	39.92%	-3.20%	14.75%	15.46%	56.86%	-17.82%	19.25%	15.41%	-5.25%
Lehman Bond Index	7.57%	5.02%	4.30%	9.82%	8.98%	10.10%	0.39%	8.42%	7.86%	2.89%	15.30%	-2.33%	8.78%	7.58%	16.13%	8.29%	14.23%	7.59%	2.30%

Description of Hennessee Hedge Fund Index®

The Hennessee Hedge Fund Indices® are calculated from performance data supplied by a diversified group of hedge funds monitored by the Hennessee Group LLC. The Hennessee Hedge Fund Index® is believed to represent at least half of the capital in the industry and is an equally weighted average of the funds in the Hennessee Hedge Fund Indices®. The funds in the Hennessee Hedge Fund Index® are believed to be statistically representative of the larger Hennessee Universe of over 3,500 hedge funds and are net of fees and unaudited. Past performance is no guarantee of future returns.

About the Hennessee Group LLC

Hennessee Group LLC is a Registered Investment Adviser that consults hedge fund investors on asset allocation, manager selection, ongoing monitoring of hedge fund managers and asset reallocation. Hennessee Group LLC can act as a discretionary or non-discretionary adviser.