HENNESSEE GROUP LLC
HEDGE FUND ADVISORY
Your Strategic Partner in Hedge Fund Investing
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HENNESSEE HEDGE FUND REVIEW®

MARKET SUMMARY	1
HEDGE FUND PERFORMANCE SUMMARY	4
STYLE PERFORMANCE SUMMARIES	5
Hedge Funds - December	
Value	5
Growth	7
Macro	8
Distressed	10
Merger Arbitrage	12
Convertible Arbitrage	13
International	17
MONTHLY FEATURES	
Feature Section: 2001 Industry Growth	3
Hennessee Hedge Fund Style Definitions®	14
Hennessee Hedge Hog Corner®	20
12 Month Rolling Sharpe Ratio	23
Hennessee Hedge Fund Rankings®	27
Hennessee Hedge Fund Indices®	28

	DEC	YTD
HENNESSEE HEDGE FUND INDEX®	+1.60%	+3.98%
S&P 500 (DRI)	+0.88%	-11.89%
LIPPER MUTUAL FUNDS	+2.79%	-8.12%
CORRELATED* HEDGE FUNDS	+2.11%	-1.34%
NON-CORRELATED** HEDGE FUNDS	+0.53%	+8.66%
GLOBAL HEDGE FUNDS	+1.99%	+1.43%

PERCENTAGE OF CORRELATED* MANAGERS OUTPERFORMING THE:	DEC	YTD
S & P 500 (DRI)	71%	89%
Lipper Mutual Funds	30%	82%

TOP (3) PERFORMING:	DEC		YTD
Latin America	+10.01%	Financial Equities	+15.59%
Financial Equities	+3.53%	Convertible Arbitrage	+15.13%
Value	+3.37%	Short Biased	+12.65%

BOTTOM (3) PERFORMING:	DEC		YTD
High Yield	-1.60%	Latin America	-10.40%
Short Biased	-0.87%	Growth	-3.71%
Multiple Arbitrage	+0.14%	Regulation-D	-3.46%

*CORRELATED: Long/Short Equity; **NON-CORRELATED: Event/Arbitrage and Short Bias.

MARKET SUMMARY - DECEMBER 2001

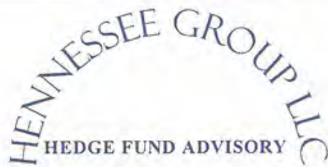
Amidst a year marked by terrorism, military action and recession, stock markets across the globe fell once again, as the S&P 500 declined –11.9% and the MSCI EAFE fell –22.5% during 2001. Following its –10.14% decline in 2000, the S&P 500 has now fallen for two consecutive years, the first time this has occurred since 1977-78. **Fortunately for investors, the stock market has not fallen three consecutive years since 1939-41, leading most to believe that the equity markets will return to positive performance for 2002.**

Hedge funds compared well in relative terms, as the Hennessee Hedge Fund Index advanced +1.60% for the month of December to bring year-to-date performance to +3.98%. **Most hedge funds held large amounts of cash and maintained low net exposures throughout the majority of the year**, as they recognized the weakness in the US economy and its potential effects on corporate earnings and stock prices. Hedge funds

Hedge funds continued to separate themselves from the traditional equity indices, as the Hennessee Hedge Fund Index has now outperformed the S&P 500 by 290 basis points (on an annualized basis) with significantly less volatility since 1987.

The common theme for the entire year was the continued tug of war between punk fundamentals and high amounts of liquidity. Unlike most recessions, an asset bubble, as opposed to an overheated consumer, created the current condition. **As such, the three leading economies in the world (US, Europe and Japan) shrank together for the first time since 1974.** The collapse in business investment (especially on technology), compounded by the September 11 attacks and its effect on consumer spending, pushed the US into recession for the first time in a decade.

In response, the US Federal Reserve cut interest rates eleven times to 1.75%, the lowest Fed funds rate since 1961. Low inflation (and even deflation), allowed the Fed the flexibility to ease as much as needed. Several promising rallies faded into bear market rallies, as investors continued to change their focus between the weakening economy and the fact that the Fed was lowering rates and increasing money supply. As such, volatility remained at the same levels as 2000, but clearly higher in comparison to the 1990s. The tug of war was strongest in the technology sector, as money chased higher risk technology stocks while fundamentals continued to weaken for PCs, optical communications, and semiconductors.



Your Strategic Partner in Hedge Fund Investing

E. Lee Hennessee
Chairman

Charles J. Gradante
President and CEO

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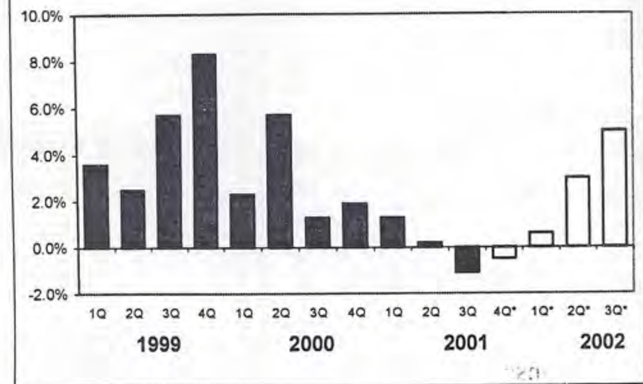


2001 began with a surprise from Greenspan and Co., as the Fed funds rate was cut by 50 basis points in an attempt to stave off the forthcoming recession. In response to the Fed's actions (50 basis point cut on January 3 and 50 basis point cut on January 30) and Greenspan's public support for the Bush tax cut, the stock market rallied sharply in January. In fact the Nasdaq rallied 14% on January 3, the largest one day percentage gain in the Nasdaq's history. Unfortunately, the Fed's actions were too late, as the economy continued to show signs of deterioration and the gains were promptly given back in February and March due to poor earnings reports and economic data. The Nasdaq led the decline, falling 33.6% during February and March.

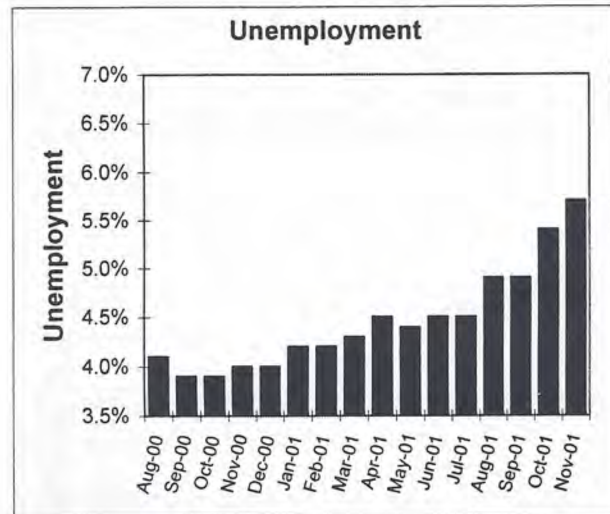
The stock market rallied in April as the debate continued about the depth and breadth of the economic slow-

down. Furthermore, President Bush sent rebates to taxpayers and many investors speculated that the checks would help prop up the economy. Following April's rally, the stock market remained range bound for the remainder of the spring and summer, as volume and volatility were low for the period. Meanwhile, the economy continued to deteriorate, as business spending fell off of a cliff. Furthermore, profit margins fell drastically to perhaps the worst level since World War II. The stellar performance of the market during the summer months set the stage for the third quarter's disaster.

The third quarter was one of the worst quarters in the history of the stock market. The gains of the second quarter were relinquished due to a rash of negative earnings announcements and the realization that the US economy was mired in a recession. By this point, the Fed's interest rate cuts were not being realized by businesses, and the consumer and fears of the Fed "pushing on a string" were arising. At the beginning of September, the major indices broke through key support levels, only to fall even sharper following the terrorist attacks on the World Trade Center and the Pentagon on September 11. After the market closed for four sessions, the S&P 500 fell 11.6% during the week of September 17 on heavy volume, in what many termed a capitulation and an end to the bear market of 2000-2001.

In response to the terrorist attacks, the Fed opened up the money supply spigots and continued to lower interest rates hoping to mitigate the effects of the attacks on the consumer and business activity. The lack of inflation (some investors/economists consider the current state of the economy to be deflationary), allowed the Fed the maximum flexibility to lower rates to their liking. As such, the stock market rallied from its September lows, ending the prolonged bear market that had been in effect since January 2000. Furthermore, investors rotated money out of fixed income into equities following the excellent gains in US Treasury Bonds during the year.

In general, hedge funds have been slowly buying stocks and increasing their net exposures over the past two months. While the bear market rallies that occurred throughout 2002 were void of improving fundamentals, most believe that the current rally is in tandem with improving fundamentals across most aspects of the economy. At the same time, some risk does persist, namely in the form of higher unemployment. The question most fund managers have is not when the recovery will occur, but how strong the recovery will be.



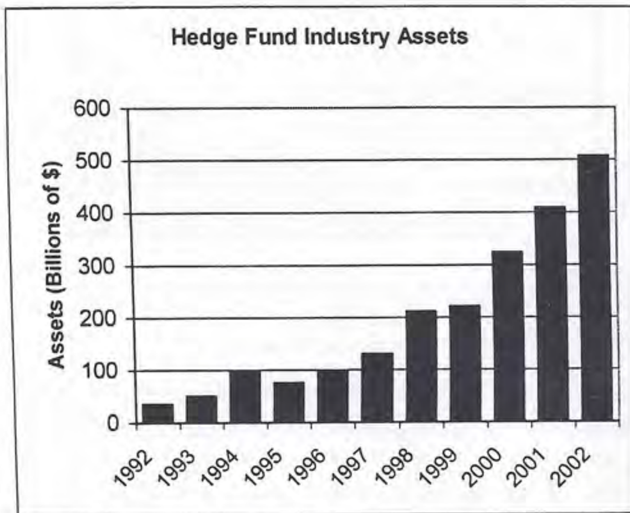
Going forward, most investors believe that the stock market will be up next year, albeit muted from the outsized returns that investors received from 1997 to 1999. **If the above scenario plays out, 2002 will be an ideal market for hedge funds, as they will have the opportunity of making money on both the long and short side of their portfolios.** It's been a while since hedge funds have made money on both sides, as most made little on their shorts in 1999 and subsequently made little on their longs in 2000 and 2001.

FEATURE SECTION: 2001 INDUSTRY GROWTH

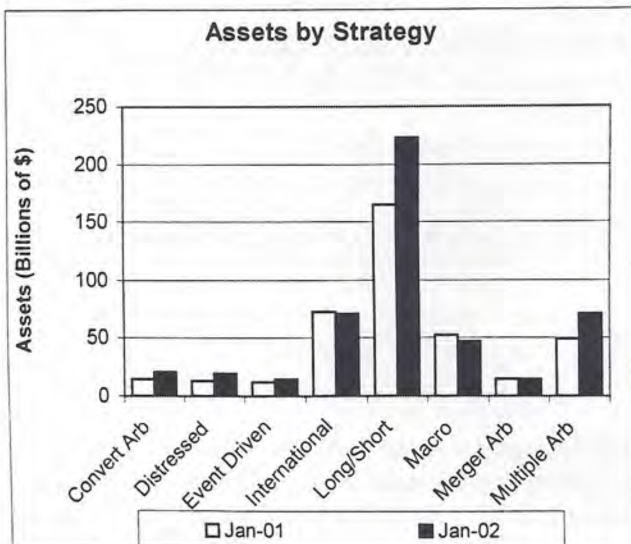
Hedge funds have outperformed the S&P 500 for the third consecutive year, once again proving hedge funds' value in a well-diversified portfolio. The Hennessee Hedge Fund Index® gained +3.98% net of fees in 2001, while the S&P 500 declined –11.89%, the Dow Jones Industrial Average declined –7.10%, and the Nasdaq declined –21.04%.

Preliminary results indicate that the hedge fund industry experienced record inflows of $86 billion during 2001. Including growth due to performance,

assets grew 24% to $507 billion from $408 billion at the end of 2000. Strategies that experienced the most inflows included long/short equity (inflows of $55.7 billion or 34%), multiple arbitrage (inflows of $17.8 billion or 37%), distressed (inflows of $5.2 billion or 38%), and convertible arbitrage (inflows of $3.5 billion or 24%). Conversely, macro (outflows of $6.2 billion or 12%) and merger arbitrage (outflows of $0.2 billion or 2%) experienced outflows during 2001.



Several factors contributed to hedge funds' superior performance in 2001. Most hedge funds recognized the weakness in the US economy and equity markets early in the year and adjusted their portfolios accordingly. By maintaining a low net exposure to the market and high levels of cash (tools not available to mutual funds), they were able to avoid the majority of the equity market's downturn.



Hedge funds have once again successfully navigated through one of the most difficult markets in the last twenty-five years.

HEDGE FUND PERFORMANCE SUMMARY - DECEMBER AND YEAR-END

Hedge funds demonstrated their ability to make money in 2001's turbulent market as the Hennessee Hedge Fund Index posted a +3.98% gain for the year. For the month of December, hedge fund managers fared well with a +1.60% gain. In comparison, all major indices finished 2001 in red, with the Dow Jones down –7.10%, S&P 500 down –11.89%, and Nasdaq falling –21.04%. Hedge fund managers were able to outperform the markets due to their risk management skills, especially their ability to short equities and move to cash when appropriate.

Correlated managers (long/short equities) advanced +2.11% in December, lifting their performance for 2001 to +1.34%. Non-correlated managers (event driven/arbitrage) produced a modest +0.53% gain, bringing performance to +8.66% in 2001, while global managers gained +1.99% in December, bringing its performance to +1.43% in 2001. For December, the top three performing styles were Latin America (+10.01%), Financial Equities (+3.53%), and Value (+3.37%). The worst performing styles during December were High Yield (-1.60%), Short Biased (-0.87%), and Multiple Arbitrage (+0.14%). **For the Year 2001, the top three performing styles were Financial Equities (+15.59%), Convertible Arbitrage (+15.13%), and Short Biased (+12.65%). The worst performing styles during 2001 were Latin America (-10.40%), Growth (-3.71%), and Regulation-D (-3.46%).**

The Hennessee Financial Equities Index gained an impressive +15.59% in 2001. The largest factor contributing to the performance of the financial sector was the Fed's aggressive easing campaign in 2001, which helped lower costs for banks to raise capital. More-

over, regional banks, thrifts, and savings and loan banks flourished during the year due to increased activity in the mortgage market, as homeowners refinanced at record pace to take advantage of the low interest rates.

The Hennessee Convertible Arbitrage Index posted a +15.13% gain in 2001. **The inability of the equity market to supply capital forced issuers to turn towards the convertible bond market for alternative financing.** As a result, 2001 was a record-breaking year for new issuance due in part to interest rates being cut eleven times during the year. In particular, large capitalization names flooded the issuance calendar with zero coupon issues. Convertible arbitrageurs were appeased both by the high volume of issuance and the aftermarket prices, which were met with great demand from both hedge funds and investors. Volatility played a large part in hedge funds' performances, with managers producing decent returns by trading gamma and adjusting their hedge ratios accordingly. Lower credit issues were of main concern throughout the year, especially when companies were plagued with downgrades by ratings agencies due to tight lending regulations.

The Hennessee Short Biased Index finished 2001 up +12.65%. Short biased managers enjoyed near perfect market conditions for their style, with all of the major equity indices down significantly for the year. The run-up of the markets in the boom years of the 1990's could not be sustained in the face of a recessionary environment, replete with lower earnings, much tighter credit, and a series of bankruptcies plaguing all sectors. Once again, short biased managers demonstrated their expertise by betting against the markets, such as the one witnessed in 2001.

The Hennessee Latin America Index was the worst performing index for the second year in a row, plunging –10.40% in 2001. The region's high correlation to the U.S. economy and the Nasdaq did not bode well for their markets. Political instability in some countries also ran rampant through the region, resulting in credit problems for some nations. In particular, Argentina faced huge economic and banking problems, further exacerbated by their default on $142 billion in debt; the largest amount of sovereign debt defaulted ever. Moreover, the global slowdown reduced export demand, further hurting the nation's economic system. Illiquidity, always a problem in the region, was even more of a factor in the volatile markets of 2001. In general, managers who were able to make money throughout the year, steered clear of Argentina.

The Hennessee Growth Index fell –3.71% in 2001. During the year, the technology/telecom sector downturn continued to run its course, with the Nasdaq falling –21.04% by year-end. Growth experienced a wild ride with many of the market rallies in the year short-lived. Thus, most managers were hurt as both their long and short positions went against them. Those managers that made money saw most of the gains from the short side. A variety of managers took a defensive posture by maintaining low net exposures and treading cautiously.

The Hennessee Regulation-D Index declined –3.46% in 2001. Credit quality was a major factor for performance in this sector as banks continued to turn their heads away from cash-strapped names in need of financing. Mounting bankruptcies and escalating defaults also added to the mix, making funding inaccessible to companies, thereby driving performance down for managers as their holdings went against them.

HEDGE FUND STYLE SUMMARIES - DECEMBER AND YEAR-END

Value
(YTD: +11.31%/ DEC: +3.37%)

Value managers enjoyed another outstanding year, as the Hennessee Value Index advanced +11.31% in 2001. This return far surpassed the S&P 500's –11.89%, the Dow Industrial's –7.10%, and the Nasdaq's –21.04%.

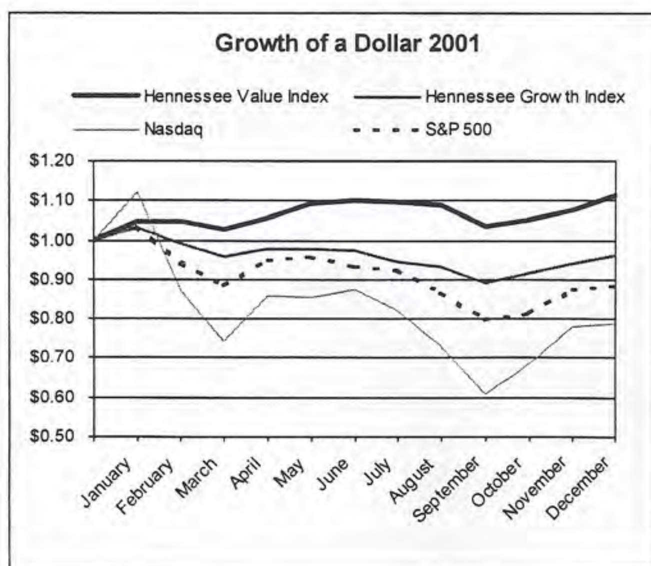
Value stocks started the year with a bang, as the Hennessee Value Index returned +4.82% in January. As the first quarter progressed, value stocks continued to outperform, but not as dramatically. When all was said and done, the Hennessee Value Index closed the quarter up +2.94%, which far surpassed the –12.12% for the S&P 500 and –25.51% for the Nasdaq.

The first quarter saw a continued shift from the

momentum investing of companies with no sound business plan to the value-oriented approach, examining price-to-earnings ratios and balance sheets. Value managers were able to preserve capital by examining the fundamentals of a company, such as cash flow, inventory, and stream of earnings.

The Federal Reserve cut rates twice in January and again in March for a total of 150 basis points. As the Fed continued to cut rates, value managers added to their exposures, specifically small-caps, as these companies found it easier to borrow, giving them more capital to fund their growing operations. In terms of sectors, managers honed in on healthcare, utilities, energy, and financials.

The second quarter of 2001 was quite different from the first, in that growth stocks rebounded with a vengeance. What did not change, however, was the domination of small-caps issues. The Russell 2000 Value Index returned +11.6% for the quarter, a figure that bested all other major styles with the exception of small-cap growth stocks, which gained +18.0%.



Defensive sectors like pharmaceuticals, consumer staples, and energy trailed the market, as investors rotated out of "safe" sectors into more aggressive cyclical sectors such as technology, biotechnology, and consumer cyclicals. As the quarter came to a close, managers continued to increase their net exposures as the fate of the economy became clearer.

Value stocks, specifically large-caps, proved to be the safest segment during the third quarter. During the market pullback in August, managers trimmed their exposures, as the major market indices approached the lows that they set in March and April. Many managers did, however, increase their long exposure to companies that tend to do well regardless of the economy, while decreasing their exposure to economically cyclical companies.

Toward the end of the quarter, the rotation into small-caps that had been apparent over the prior six months reversed course. Given the uncertainty that resulted from the September 11 tragedy, liquidity dried up in the small-cap universe and stock prices declined, as investors tend to seek large, stable companies in times of crisis.

As to be expected, managers with exposure to the airlines, insurance, leisure, and travel sectors were hurt badly following the terrorist attacks. Prior to the attacks, select hedge fund managers were opportunistically buying airline stocks, recognizing their low valuations and the potential upside if the U.S. economy were to rebound. When the market reopened on September 17, airline stocks were hit the hardest, as the AMEX Airline Index fell -47% during September.

The fourth quarter saw a major rebound in growth stocks at the expense of their value brethren. October was the first time in several months that value trailed growth. Most value managers maintained fairly low net exposures and high levels of cash, as they did not buy into the massive upward momentum that drove the markets.

Although growth sectors outperformed value, some value sectors did manage to perform well during the final quarter of 2001. Consumer cylicals, such as autos and homebuilders, and basic materials did manage to perform well. The zero-percent financing offered by automobile makers bolstered shares, as the sector rose +10% for the quarter. Another sector that managed to buck the growth trend was airlines. **Recognizing that these stocks were deeply oversold and that lower fuel costs would improve margins, several managers bought airlines during the quarter. Their purchases paid dividends, as the AMEX Airline Index jumped +30% for the quarter.**

Going forward, managers disagree as to whether value or growth will dominate the investing scene. Some managers stated that there has been a long-term shift to value, due to a realization that investors must do significant research into company fundamentals. In addition, they expressed their intent to play valuations, rather than sectors. They will look for good earnings, good management, solid return on assets and equity, and some dividends. Other managers, however, believe that value has had its day (actually, value has had the past two years) and that there is so much money on the sidelines that investors will jump in without worrying too much about earnings or valuations.

Growth
(YTD: -3.71%/ DEC: +2.42%)

Growth managers closed 2001 with a solid December, gaining +2.42% for the month, to bring the loss for the year to –3.71%. In comparison, the benchmark Nasdaq Composite Index advanced +1.03% in December, bringing its loss for 2001 to –21.85%.

Growth managers entered 2001 with low net exposures in response to the uncertain outlook for the economy and the stock market. The Nasdaq started the year with a strong January rally, aided by the "January effect" and an infusion of capital from the sidelines. Growth hedge funds did not meaningfully participate in the rally, but were validated in their decision to maintain low net exposures as the first quarter progressed. The Nasdaq lost –25.51% for the quarter as the likelihood of a recession loomed as a dark cloud.

Growth hedge funds declined –4.19% during the first quarter, thanks to low net exposures that insulated them from the carnage. Companies issued a stream of downward earnings guidance caused by decreased demand, overcapacity, and inventory surpluses. Companies began what would become a series of layoff announcements. Internet bellwether Amazon.com and technology leader Lucent Technologies announced significant cuts of employees, with Amazon laying off 1,300, or more than 10% of its workforce, and Lucent laying off 16,000, or approximately 15% of its workforce.

During the first quarter, the U.S. Fed began the first of what would be eleven cuts in the target for federal funds rate. Fed funds, which stood at 6.5% entering 2001, ended the first quarter at 5% after three 50 basis point cuts. Managers noted that the stock market had historically rallied after the Fed cut rates, and some entered the second quarter expecting a strong response to the Fed action. However, most managers maintained low net exposures due to high levels of uncertainty.

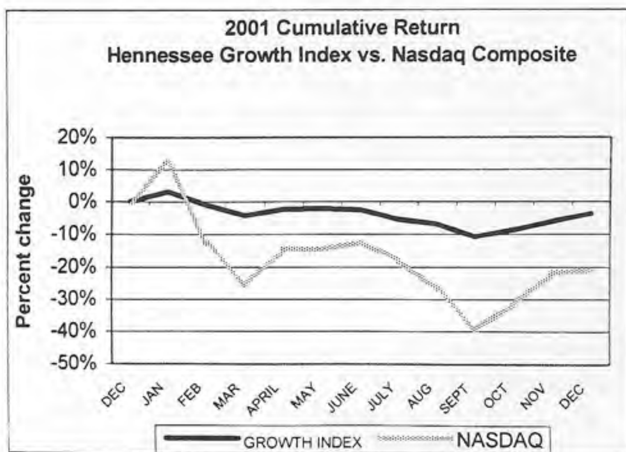
The second quarter was marked by an April Nasdaq rally of +15.00%, caused in part by optimism regarding lower interest rates and aggressive fiscal policy. Internet stocks, along with Networkers, Biotech, and to a lesser degree, Telecom, exhibited strong performance. The consensus for a fourth quarter economic recovery gained momentum in April. However, it began to lose steam as the second quarter progressed, with the Nasdaq advancing a total of +17.41% for the second quarter. In comparison, growth-oriented hedge funds gained +1.72% for the quarter. The low exposures that protected managers from the negative pressures of the first quarter prevented hedge funds from participating in the market surge in a meaningful way. As the quarter came to a close, companies were beset with a lack of earnings visibility.

The third quarter was one of the most brutal on record for the Nasdaq, which recorded a –30.62% loss. Growth managers fared better, but still declined significantly, losing –8.37%. Expecting a summer rally, some managers had entered the quarter with higher net exposures. However, the quarter opened with a rash of layoffs across several industries. Troubled giant Lucent Technologies announced another round of layoffs, amounting to nearly 50,000 employees. Other companies, including Du Pont, Hewlett Packard, and IBM announced job reductions as well. **It was becoming increasingly evident that there would be no economic recovery before some time in 2002, and the markets acted accordingly.**

Consumer spending, which had kept the U.S. economy afloat to that point, was seemingly susceptible to negative sentiment caused by job losses. Managers had been looking for capitulation by consumers as a sign of a market bottom. As the consumer confidence wavered in late August, managers began to identify long positions that they believed would provide them

with the greatest opportunity for profit in the early stages of a recovery. However, the September 11 attacks sent the markets sharply downward and shook confidence and sentiment to the core. Investors pulled money out of the market, especially from growth names. The technology and biotech sectors, which had been experiencing prior difficulty, hit new lows. Managers positioned portfolios more defensively in response, cutting gross exposures, as the risk premium in the market skyrocketed.

The fourth quarter began on an uncertain note, with the U.S. experiencing significant declines in confidence and sentiment, as measured by the Conference Board and the University of Michigan surveys. The outlook for technology looked even grimmer, with IT spending nonexistent. However, the Nasdaq posted a strong rally of +30.13% for the quarter, albeit from 3-year lows. Growth managers, which had been in most cases successful preserving capital thus far, gained +7.83% in the quarter. **The low net exposures that allowed managers to preserve capital earlier in the year prevented them from capturing the upside performance of the market.** While companies were still experiencing difficulty, some began to beat earnings estimates. Additionally, the National Bureau of Economic Research announced that the U.S. economy had indeed entered a recession in March 2001. Cognizant that all recessions since World War II have lasted between 8 and 16 months, economists began predicting a recovery by mid 2002.



As growth managers enter 2002, they have begun to put more money to work, adding to net long and gross exposures. 2002 is projected to experience improved economic conditions and a stronger stock market. However, managers have stressed the importance of stock selection, they belief profitability will be more difficult than current valuations suggest. In particular, while orders for technology companies have stabilized, many companies are trading at over 40 times projected 2002 earnings. Managers believe that the recent run-up in the market has made it susceptible to a sharp pullback. **Therefore, while they intend to participate in the rally, managers assert that risk management is key to preserve any gains achieved**.

Macro
(YTD: -1.07% / DEC: +1.22%)

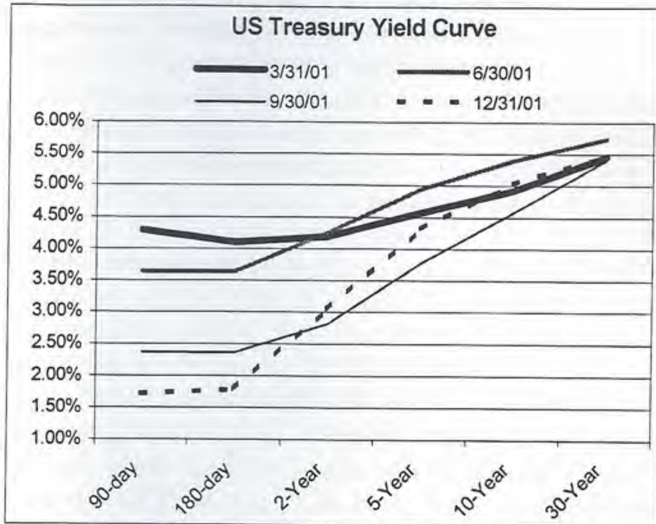
The Hennessee Macro Index posted outstanding relative performance, but negative absolute performance, as it returned -1.07% for 2001. All in all, it was a tame year for macro hedge funds, as returns for the Index remained in a tight range all year long - - the lowest monthly return was -0.99% (April), while the highest was +1.22% (December).

Macro managers started the year with conservative equity positioning, as most believed that the effects of the slowing economy had not been fully realized. Those managers shifted their attention to fixed income, especially the U.S. Treasury market. A surprise rate cut by the Federal Reserve on January 3, coupled with a much-anticipated cut on January 31, sent yields lower across all maturities. The yield on the two-year, the most sensitive to Fed monetary policy, fell to 4.57% on January 31 from its close of 5.09% on December 31.

In terms of currencies, the euro traded in the 90- to 95-cent range and many managers predicted that it would reach parity by year-end, as European growth was expected to retreat at a slower pace than in the U.S. **The first portion of the year also saw increasing short interest in the yen.** Managers asserted that the Bank of Japan was running out of options in terms of spurring economic growth and that they would be forced to sell yen, thus lowering the value of the currency, in order to spark demand for Japanese goods.

The second quarter of 2001 saw a flurry of rate cuts, as the Fed lowered the Fed funds rate from 5.00% to

3.75%. **Although many economists forecasted an uptick in the economy by late 2001, macro managers were far more skeptical.**



Managers fared rather poorly in the fixed income arena during Q2, especially as the quarter came to a close. The yield curve unexpectedly flattened due to a 25-bps rate cut by the Fed. A 50-bps cut had been priced into the market and investors interpreted the lesser cut to signify that the easing cycle was abating. Subsequently, however, the yield curve steepened as it became clear that the Fed would most likely cut rates in August. This flip-flopping of the yield curve caught managers by surprise and offset gains achieved elsewhere.

An area where macro managers excelled during the second quarter was currencies, as many correctly predicted that the yen would fall against the dollar. Managers profited from long USD/short JPY spreads. Euro vs. dollar trades were fairly active during the quarter, as the euro continued its slide. The currency started the quarter at 0.87 USD and fell to 0.85 USD by quarter's end.

The Federal Reserve continued to hammer short-term rates during the second quarter, as the Fed funds rate was slashed once in August and again in September, bringing the rate to 3.00% by mid-September. **During July and August, managers that were long short-term Treasuries performed quite well, as the two-year note hit an all-time high at the end of August, yielding of 3.62%.** In the few weeks following the terrorist attacks of September 11, the Treasury curve widened significantly, as bills to bonds steepened by 90 bps and the spread between two-year and 10-year Treasuries widened by 47 bps over that span.

Currency trades were rough for many managers due to rapidly changing global perceptions. Entering the quarter, managers had anticipated the yen to weaken against the dollar. Unfortunately, those managers that were long USD/short JPY suffered, as the yen started the quarter at 125 per USD and proceeded to drop to 119 per USD by quarter's end. Although the euro saw gains in the third quarter - - starting the quarter at $0.85 and finishing at $0.91 - - most managers were disappointed, as they expected the currency to rally more than it did.

The fourth quarter was an interesting one for macro managers, with volatility abound. Profits were broadly distributed among equity and foreign exchange markets. The quarter was, by far, the best one for macro managers, as the Hennessee Macro Index returned +1.07% in October, +0.23% in November, and +1.22% in December.

The quarter commenced with a surprise move by the Fed, which announced that it would stop selling 30-year bonds. **This sparked a huge rally in the bond market, sending prices on the long bond to their largest one-day gain in a decade. Unfortunately, this caught most managers by surprise and, as a result, billions of dollars were reportedly lost.**

Both the euro and yen suffered relative to the dollar in the fourth quarter, as investors felt confident that the U.S. was on the path to economic recovery. Many macro managers reported gains on foreign exchange trades, as they bet that the euro would be hurt by a sluggish European Central Bank. Whereas U.S. regulators had been flexible in responding to deteriorating demand and supply conditions, their European counterparts had been lethargic.

The yen was hit extremely hard in Q4 due to continuing economic weakness in Japan. Even contrarian managers that had hoped for a turnaround eliminated exposure to the country. **Most have agreed that aggressive policy measures have been lacking, reflecting continuing problems within the country's banking system and failure to implement long overdue structural reforms.**

Going forward, due to declining energy prices, ending of an inventory cycle downturn, recovery in the equity market, and stronger consumer and business sentiment, managers expect an economic recovery in the U.S., although the speed and strength of that recovery remains unclear. Many managers expect Treasury yields to trend upward, as the budget surplus shrinks and investors look ahead to a recovering economy. **In terms of currencies, managers expect continued weakness in Japan, as a weaker currency may be a necessary component of any anti-deflationary policy.** Some suggest that a move in the yen to around 150 would relieve the deflationary burden. **As for the euro, managers expect it to reach parity by spring of 2002, but then fade as the year comes to a close.** Although the European central banks have more room to cut rates, the euro will most likely weaken as a global recovery emerges and investors begin to shift capital from Europe to the U.S. in the belief that the U.S. would be the earliest and largest beneficiary of a rebound.

Distressed
(YTD: +9.63%/DEC: +0.14%)

Distressed managers finished December on a positive note with the Hennessee Distressed Index up a modest +0.14%. The Hennessee Distressed Index had a great year with only two months of negative performance. For the year, managers were up +9.63%. In comparison, the index was up +2.38% in 2000.

Three major factors contributed to an increase in the supply of distressed securities in 2001: a record level of high yield issuance in the late 1990's beginning to default during the year, rising number of companies hit with asbestos litigations faltering, and industry/sector-wide recessions. In addition, poor performance in the overall markets and declining corporate profitability added fuel to the U.S. economy's downward spiral, further accelerating companies into bankruptcy.

The major news in the first quarter was Finova Corporation's filing for Chapter 11 protection. The lender of mid-size companies defaulted on its loan repayments, creating the largest U.S. default ever. Also, data emerged in the quarter, that companies defaulted on a record $31.8 billion in debt as of March-end, making it the worst quarter for defaults. As the face value of the distressed debt market surpassed $500 billion, managers sifted through the mounting supply of distressed debt. One area that managers found opportunities was health care, with several nursing homes emerging from bankruptcy. Moreover, it was apparent to managers that strong credit analysis was crucial to success in their investing, especially among the tech/telecom carnage that dominated almost a third of bankruptcy filings.

It was evident by June 2001 that the U.S. economic slowdown exacerbated the speed at which companies would falter into distress. Distressed managers were up +5.61% for the second quarter. By mid-year, managers continued to eye the retail, manufacturing, chemicals, and an unlikely sector, telecom for areas to invest. The Fed's aggressive stance in 2001, during May, in particular, aided the high yield market by giving issuers accessibility to refinance their obligations. The biggest news in April was Pacific Gas and Electric's Chapter 11 filing for creditor protection. California's largest utility company faced mounting losses from it restrictions on imposing higher power costs to its customers. A variety of managers bought different levels of bonds within its capital structure and firmly believed the company still was set to emerge from bankruptcy due to it sheer size and importance to California's economy.

In the telecom arena, Winstar Communications, cash-strapped for funding, filed for bankruptcy protection. One of the most widely held bonds by managers were

Nextwave's as the company received favorable ruling on its wireless spectrum licenses that were auctioned off when the company faced bankruptcy. By mid-year, some managers expressed concerns over the Moody's report on the downgrade/upgrade ratio in June, which showed a bottom in creditworthiness. Equally important was a report showing **worldwide defaulted debt at $58 billion, outpacing the $42 billion that defaulted in all of the year 2000.** As with most of the year, key data continued to surface further giving managers more of a selection for their portfolios.

By the end of June, a list of building, chemical, and auto-parts makers flooded the markets with escalating asbestos claims. Most notable names on the list were Owens-Corning, USG Corp., Armstrong World Industries, W.R. Grace, and Federal-Mogul Corp. These names were severely affected by high litigation costs, thereby slashing their revenue guidance.

Following the September 11 terrorist attacks in New York and Washington D.C., the US economic slowdown was propelled into a recession. As a result, Moody's extended its forecast of the default rate to 13% for 2002 understanding that bear market would last longer than expected. Across the globe, markets were shaken up by the terrorist acts, which propelled more companies into bankruptcy. In the third quarter, distressed managers were up +3.47% further exhibiting their ability to make money regardless of the market's direction. The events of September 11 caused spreads of treasuries over high yields to widen significantly, thereby affecting the performance of junk bonds, in which, the majority of which hover in the distressed arena. The Merrill Lynch High Yield lost –6.96% in September, it's largest monthly drop ever. Despite the poor performance of the index, distressed hedge funds still managed to eke out a +0.36% gain in September.

Many managers continued to sift through retail and paid close attention to textile, steel, and furniture sectors for more positions to add to their portfolio holdings. In August, Finova emerged from bankruptcy as a result of Warren Buffett's financial backing and Midway Airlines, like many more airlines in the coming months, filed for Chapter 11. Throughout the third quarter, many of the same holdings from previous months continued to provide gains to managers' portfolios. There were some positions that negatively affected performance, in particularly, Finova's bonds. The company's exposure to aircraft financing and resort lending caused it to take a direct hit to its performance after the September attacks.

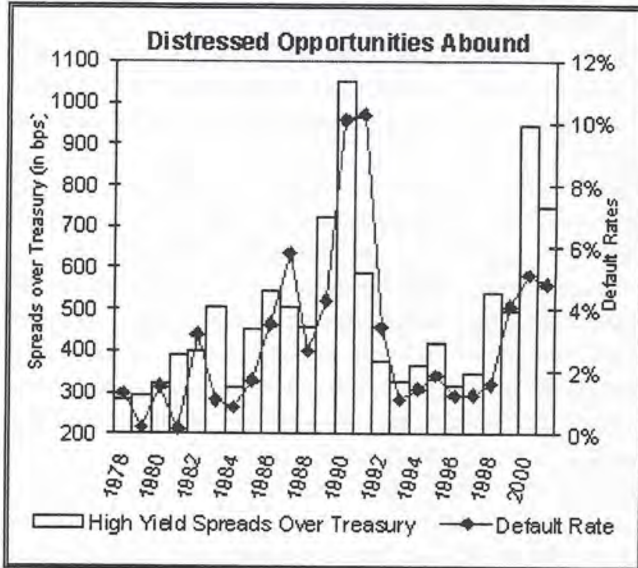
Managers continued to exhibit good performance into the fourth quarter. By November, high yield mutual funds saw seven straight weeks of net inflows, indicating to investors that potential returns could be achieved in this risky asset class. Variety of managers pointed to data in November, showing a leveling off of the 12-month rolling default rate. In addition, the number of defaulted issues began to recede during the month, further indicating that it would be an opportune time for investors to take advantage of distressed investing. Notable bankruptcies for the quarter included steel companies Bethlehem Steel and Geneva Steel Holdings, and most importantly Enron.

By December, managers grew somewhat optimistic as Enron fell under the weight of serious financial problems. Worldwide, financial markets were shaken, causing spreads to widen and affecting credit sensitive issues. The bankruptcy was the largest U.S. corporate bankruptcy ever and long term implications would be severe. Some investors were appeased by the bankruptcy, such as distressed managers. **It was evident that Enron's restructuring process would offer interesting capital structure arbitrage opportunities in the coming years.**

The positive performance of the junk bond market also helped paint a better environment for managers as the Merrill Lynch High Yield Index gained +7.4% for the year. Though 2001 was a tough environment to make money for investors, managers investing in distressed companies faced minimal obstacles in achieving returns.

The outlook for 2002 remains very positive for distressed investing. Various indicators such as the default rate peaking and high volume of high yield issuance paint a optimistic picture for this style of investing. On the other hand, the supply/demand imbalance remains a focal point for most investors as they debate whether this is a ripe time for distressed investing. One can argue that an increased supply coupled with little demand will drive prices down, thereby adversely affecting the performance of this asset class.

Despite this argument, **many managers believe the added liquidity and the Fed's aggressive easing will create more of a buyer's market for distressed as companies will have easier access to finance their operations, further driving bond prices higher.**



Merger Arbitrage (YTD: +3.84%/DEC: +0.77%)

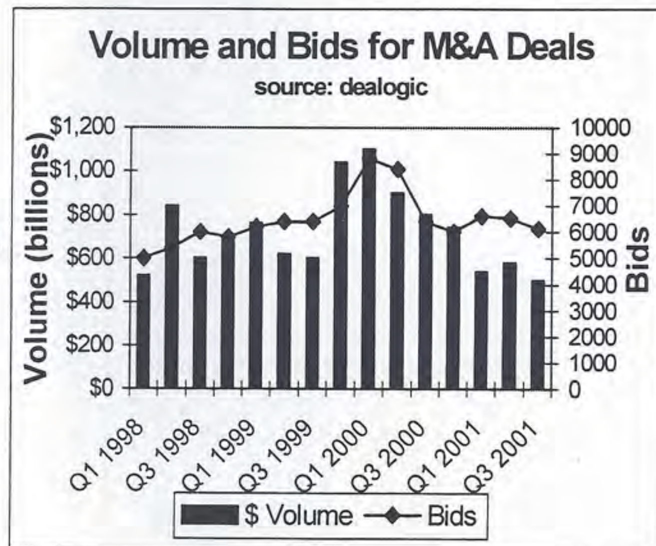
Merger arbitrage hedge funds recorded modest gains in December, advancing +0.77%, bringing their performance to +3.84% in 2002. The positive returns of merger arbitrage amid the losses of the equity indices (S&P 500 –11.89%, DJIA –7.10%, Nasdaq –21.04%) demonstrated the need for non-correlated styles in well-diversified hedge fund portfolios.

After a strong +17.49% return in 2001 on a record $3 trillion in merger activity, managers entered 2002 with more modest expectations. Strategic deals had dominated the landscape in 2001, while the high cost of capital kept leveraged buyers out of the market. The AOL/Time Warner mega-merger closed in January, creating the world's largest internet and media company. Managers hoped that this would jump-start 2002, and indeed, merger arbitrage recorded a robust +1.46% return in January. However, merger arbitrage funds were only able to post +1.56% return for the first quarter, as deal flow nearly ground to a halt and some high profile deals, such as Honeywell/GE and IBP/Tyson Foods, encountered trouble. Nevertheless, managers did find a number of promising deals in which to invest, such as Ralston Purina/Nestle, SDLI/JDS Uniphase, American General/AIG, and Alza/Johnson & Johnson

The second quarter got off to a rough start, with a total of 12 deals breaking in April. However, merger arbitrage managers, who gained +0.75% during the month, were able to dodge most of these bullets due to careful research and hedging. Deals that failed in April included Agile Software/Ariba, Entergy Corp./Florida Power and Light, and Enron's Portland General Division/Sierra Pacific Resources. In Europe, regulators blocked the EMI/Bertelsmann merger, citing market share concerns. On the bright side, at least for the short-term, Honeywell/GE received approval from U.S. regulators, resulting in gains for merger portfolios. The last hurdle to the deal would be European Union anti-trust officials, which most thought would approve the deal, albeit with some reservations. Wachovia/First Union, Quaker Oats/Pepsico, Bank of Scotland/Halifax, Voicestream Wireless/Deutsche Telecom, Dime Bancorp/Washington Mutual, Banacci/Citigroup, and Galileo/Cendant were deals that managers invested in as the quarter progressed. The energy industry also witnessed significant deal flow, following an increase in equity valuations due to power generation supply shortages. Managers were able to ultimately profit from several energy mergers, including Barrett Resources/Williams Companies, HS Resources/Kerr McGee, Ultramar Diamond Shamrock/Valero, and Belco Oil and Gas/Westport Resources. These deals helped fuel a strong May, with merger arbitrage returning +1.65% for the month. However, managers gained 1.58% for the second quarter, due to a –0.81% loss in June. While a few deals encountered trouble as the quarter came to a close, such as IBP/Tyson, US Airways/United Airlines, and Williamette/ Weyerhauser, the blockage of the Honeywell/GE merger by European regulators was largely responsible for the losses. Merger arbitrage managers had widely invested in this deal, with some holding it a major position in their portfolios, especially after it received U.S. regulatory approval earlier in the year.

As the third quarter began, deal activity slowed to an even more lethargic pace. A number of deals were announced, such as Sensormatic/Tyco, Cooper Indus-

tries/Danaher, Hughes Electronics/Echostar, Mitchell Energy/Devon Energy, C-MAC Industries/Solectron, and Compaq/Hewlett Packard. **However, the terrorist attacks of September 11 sent shock waves through the industry, causing spreads to widen significantly.** Merger arbitrage hedge funds lost –2.74% in September and –0.99% for the entire third quarter. Managers reduced positions sizes and exited tentative positions altogether, as the level of uncertainty increased. Indeed, some companies invoked *force majeure* clauses in attempts to exit deals in the wake of the terrorist attacks. In addition, speculation abounded that several more companies would try to back out of deals.



The fourth quarter was marked by relative calm and steady, if modest, positive performance by managers. Merger arbitrage returned +1.66% for the quarter, with positive gains posted each month. Several widely invested deals closed in the quarter, such as Texaco/Chevron, Sensormatic/Tyco, Heller Financial/GE, Wisconsin Central/Canadian Pacific, Ultramar/Valero, C-MAC/Solectron, and Ralston Purina/Nestle. A number of mergers experienced difficulty during the quarter, as well. The spread between Cooper Industries/Danaher widened on concern about Cooper's exposure to asbestos-related litigation. Compaq/Hewlett Packard encountered problems as members of the Hewlett and Packard families voiced opposition to the merger. However, the highest profile deal that met trouble, and ultimately broke, was Enron/Dynegy. Off-balance sheet transactions and a series of negative disclosures compelled Dynegy to cancel its bid for the one-time energy trading powerhouse Enron. The likely bankruptcy of Enron reverberated through the industry, causing spreads to widen as the full implications of the situation were analyzed.

While managers were satisfied by the strong relative performance for merger arbitrage during 2001, they believe that the outlook for 2002 is more promising. Managers note that the U.S. Fed has cut rates 11 times in 2001, bringing the Fed Funds target to +1.75%. Consolidation activity in several sectors, including technology and telecom, is expected to heat up in response to the increased liquidity in the market. In addition, financial buyers have large amounts of capital that they will likely put to work as valuation multiples have decreased. Furthermore, deal pricing is expected to gain strength as banks once again begin lending. The European arena is also anticipated to pick up in 2002 and provide opportunities for profit. **Managers, who are holding significant cash reserves, are generally optimistic for the industry and plan to put more money to work as deal flow improves.**

Convertible Arbitrage
(YTD: +15.13%/DEC: +0.62%)

The Hennessee Convertible Arbitrage Index produced a modest +0.62% gain for December. The year 2001 was an exceptional year for the non-correlated strategy, as the Hennessee Convertible Arbitrage Index finished in second place, by gaining +15.13% for the year. In comparison, the S&P 500 lost –11.89% and the Lehman Intermediate Government/Corporate Bond Index ended with a +9.58% gain.

A tough equity market and a slow IPO environment in 2001 made it an attractive year for convertible bonds. Convertible arbitrage managers were able to reap gains from a busy convertible bond environment due to the record level of issuance and attractive pricing, as companies looked for an alternative way to raise capital. A volatile stock market, the lowest Fed Funds Rate in 40 years, and numerous companies reducing costs to cope with the economic slowdown helped fueled issuance this year. In addition, volatility in the stock market made investors weary as companies' earnings guidances and announcements

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HENNESSEE HEDGE FUND STYLE DEFINITIONS®

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STYLE	DEFINITION	Typical Holding Period of Manager's Position	Expected Volatility
CONVERTIBLE ARBITRAGE	This type of arbitrage involves the simultaneous purchase of a convertible bond and the short sale of the underlying stock. Interest rate risk may or may not be hedged.	Medium Term	Low
DISTRESSED	Primary investment focus involves securities of companies that have declared bankruptcy and/or may be undergoing reorganization. Investment holdings range from senior secured debt (uppermost tier of a company's capital structure) to the common stock of the company (lower tier of the capital structure).	Medium/Long Term	Moderate
EMERGING MARKETS	This strategy focuses on investing in lesser-developed, non-G7 countries whose financial markets provide exploitable pricing inefficiencies. Popular geographic regions include Latin America, Eastern Europe, the Pacific Rim and Africa. Asset classes range from equities and bonds to local currencies.	Short/Medium Term	High
EUROPE	Style predominately entails investing in and shorting of European equities that may include peripheral eastern and central regions.	Medium Term	Moderate
EVENT DRIVEN	This strategy can include merger arbitrage, distressed, liquidations, and spin-offs in addition to value driven special situation equity investing. Usually dependent on an "event" as the catalyst to release the position's intrinsic value.	Medium Term	Moderate
FINANCIAL EQUITIES	Style predominately entails investing in and shorting of stocks within the financial sector (banks, thrifts, brokerage, insurance, etc.).	Medium/Long Term	Moderate
FIXED INCOME	Employs a variety of fixed income related strategies ranging from relative value based trades (basis, TEDs, yield curve, etc.) to directional bets on interest rate shifts. Style also includes credit related arbitrage, which typically involves the purchasing (or selling) of corporate issues and the simultaneous selling (or purchasing) of government issues.	Short/Medium Term	Moderate
GROWTH	Style predominately entails investing in and shorting stocks of companies that exhibit an acceleration (or deceleration) of earnings growth, revenues and market share.	Medium Term	Moderate
HEALTHCARE/ BIOTECH	Style predominately entails investing in and shorting of medical related stocks, which include biotechnology, pharmaceuticals, HMO's, medical information, etc.	Medium Term	High
HIGH YIELD	Style predominately entails investing in and shorting of non-investment grade corporate bonds, which offer attractive coupon yields. Interest rate risk may or may not be hedged.	Medium Term	Moderate
INTERNATIONAL	Participants of this style tend to be bottom-up stock pickers within global regions that are undergoing economic changes.	Medium Term	Moderate
LATIN AMERICA	Style predominately entails investing in and shorting of equity and/or debt within the various Latin American regions.	Medium Term	High

HENNESSEE HEDGE FUND STYLE DEFINITIONS®

MACRO	*Dominant investment theme is to capitalize on changes in the global macroeconomic environment through participation in the various capital markets. A top-down methodology allows managers of this strategy to utilize all asset classes (equities, bonds, currencies, derivatives) available in the global capital markets.*	*Medium Term*	*High*
MARKET NEUTRAL	*Long and short equity exposure with nearly no dollar net exposure. In theory, systemic market risk is greatly reduced by being dollar, beta, sector and market cap neutral. Strategies within this style range from quantitative modeling ("black box" or statistical arbitrage) to fundamental pairs trading.*	*Short/Medium Term*	*Low*
MERGER ARBITRAGE	*Style typically involves the simultaneous purchase of stock in a company being acquired and the short sale of stock in its acquirer. Many merger arbitrage managers attempt to mitigate deal risk by engaging only in strategic takeovers after they are announced.*	*Medium Term*	*Moderate*
MULTIPLE ARBITRAGE	*Category includes hedge funds that employ more than one arbitrage strategy. Portfolio manager opportunistically allocates capital among the various strategies in order to create the best risk/reward profile for the overall fund. Common strategies include merger arbitrage, convertible arbitrage, fixed income arbitrage, long/short equities pairs trading and volatility arbitrage.*	*Medium Term*	*Low*
OPPORTUNISTIC	*Long/short equities managers who maintain a flexible net exposure to reflect the changing dynamics of the market on a minute-to-minute or daily day trading basis. Managers typically utilize technical and/or fundamental analysis. Portfolio turnover can be high as managers implement trading disciplines such as tight stop losses and defined exit target prices.*	*Short Term*	*Low/ Moderate*
PACIFIC RIM	*Style predominately entails investing in and shorting of Japanese and other Asian equities. Many managers also include Australia and New Zealand as regional investment choices.*	*Medium Term*	*High*
REGULATION D	*The investments are fully hedged in the form of convertible securities, which are convertible into common stock of the issuers at floating prices set at a discount to the historical price of the stock. The investment is typically held until the registration of the underlying common stock is declared effective by the SEC (normally 75 to 90 days) at which time the manager can sell the registered shares in the public markets and realize the hedged spread between the market price and the discount conversion price of the stock.*	*Short Term*	*Low/ Moderate*
SHORT BIAS	*The majority of the portfolio consists of short sales, usually fundamental, technical or event driven. This style can be used as a hedge for long-only portfolios and by those who feel the market is approaching or in a bearish cycle.*	*Medium Term*	*High*
TECHNOLOGY	*This style predominantly entails investing in technology-related sectors.*	*Medium Term*	*Moderate*
TELECOM/ MEDIA	*Style predominately entails investing in and shorting of stocks in the telecommunications and media industries, which include telecommunication services, fiber optics, cable services, publishing, entertainment, programming, broadcasting, etc.*	*Medium Term*	*High*
VALUE	*Style predominately entails investing in undervalued equities which trade below intrinsic value. Undervalued securities may be defined as, but not limited to, equities with low price-to-earnings ratios or low price-to-book value ratios. Managers also focus on companies that generate substantial free cash flow and pay special attention to the use of the cash to retire debt, institute share repurchase programs, and other methods to realize shareholder value.*	*Long Term*	*Moderate*

continued to disappoint. Credit spreads fluctuated as a result of the uncertainty in the stock market and record numbers of downgrades and bankruptcies surfaced. Moreover, 2001 marked a milestone, as the largest amount of corporate defaults came in at $125 billion. The ever increasing list of companies unable to make payments on their debt because of the recessionary environment caused credit spreads in certain issues to widen significantly.

Despite the Christmas holiday season and many people on vacation, December was an active month for new issuance with most of the new deals trading well in the after market. Managers finished the month up +0.62% and were quite surprised by the activity in the convertible issuance market, with one of the largest deals in the month, Calpine hitting the market on December 20th. The issue was met with great demand from both outright buyers and managers alike, pushing the original amount of issuance from $400 million to $1.2 billion. Managers' appetite for risk lessened as the year-end approached. Traditionally a slow month, managers reported subtle volatility and saw treasury yields narrow. **Before year-end, many managers cashed in on the profit taking and close out positions before year-end.**

The record new issues in 2001 topped $104.7 billion with 210 deals coming to market versus 145 deals worth $61.7 billion in 2000. The largest amount of issues during the year not surprisingly, were zero-coupon convertibles. **The three largest issues were Verizon's $3 billion convertible issued in May that matures in 2021, Merrill Lynch's zero-coupon issue also issued in May that matures in 2031, and Tyco's zero-coupon convertible that came to market in February that matures in 2021.** The year was also characterized by large offerings in which, a staggering 27 issues came to market in 2001 that were greater than $1 billion.

For the first quarter, convertible arbitrageurs were up +6.09% as demand from the hedge fund community and outright buyers was solid. **Due to the TMT failure in 2000, hedge fund managers gravitated towards "old economy" names in beginning of 2001 as credit quality was of utmost importance.** With the Nasdaq declining –25.51% by the end of March, managers remained cautious sifting through technology-related issues hitting the market. A number of energy and health issuances came to market during the quarter. The largest issues during the period were zero-coupon convertibles such as Enron's $1.25 billion offering and Cendant's $899 million issue. In addition, the Fed's interest rate cuts lead to some buying in tech and financials. Credit spreads did not widen significantly in the quarter, though stocks prices did head south. With doubts of creditworthiness, many high yield bonds were hurt and many more were downgraded.

By May, new issuance reached a record monthly high of $20.9 billion. Though managers selectively bought issues with credit quality being the main driver, the increased supply negatively impacted the performance of convertibles as prices went down and causing premiums to contract. For the second quarter, seven issues over $1 billion hit the market, which included two of the biggest issuers of the year, Merrill Lynch and Verizon. Other notables were Electronic Data Systems, Washington Mutual, Calpine, Nextel, International Paper and Nortel, which were all met with sufficient demand. By the end of June, convertible managers advanced +2.42% for the second quarter. **It was apparent by now that hedge fund managers comprised a third of market share in convertibles.** By the summer months, various managers expressed their disdain about contingency convertibles, or so called "CoCos" which were received unfavorably by some managers due to their adverse tax treatment to investors. Concerns were also raised about the rushed overnight sales of some convertibles as many managers believed investors didn't have the chance to fully understand what they were buying.

Prior to mid-September, volatility remained low as the summer months were uneventful. Managers who traded volatility were hurt as they were unable to trade and profit around their delta hedges. In addition, the first part of the third quarter was characterized by stable credit spreads and a steady flow of issuance, which surpassed 2000's total issuance. In the third quarter, 26 new deals came to market, totaling $16.55 billion.

The attacks on September 11th had a devastating impact on the convertible markets as only three new issues came to market. **Following the aftermath, managers were hurt as their most credit-sensitive convertibles were pounded, as investors retreated to higher credit issues. On September 20th, volatil-**

ity, as measured by the CBOE's VIX Index, skyrocketed to 49.04, the highest close for the year, with investors scrambling to unload riskier low credit positions. Conversion premiums expanded once again with equity prices falling lower. As with most of the year, managers maintained low leverage and held cash as they treaded cautiously.

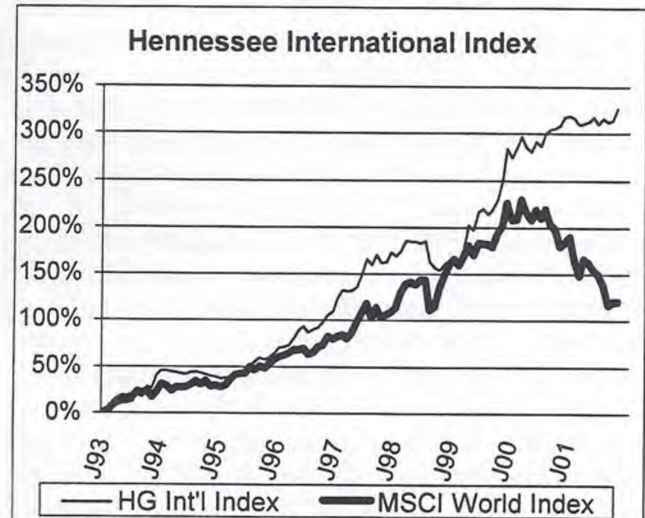
In the fourth quarter, managers digested the optimistic news on an economic recovery in the near term and began to look towards high yield bonds for investment opportunities. Most importantly, the rally in technology stocks spurred some buying interest from managers and helped lower the conversion premium in their portfolios.

Going forward, many managers believe issuance will remain strong in 2002, but not surpass 2001 levels. Some managers firmly believe the Fed's aggressive fiscal and monetary stimulus set forth in the past year and a half is taking its effect on the U.S. economy. Moreover, a variety of managers are optimistic about economic outlook and that it will have a positive effect on the stock market as investors gain more reassurance. **There is concern that the Fed's bias will change as the economy rebounds and as such, may hinder the new issuance calendar.** Until then, managers remain optimistic about the New Year and their performance going into 2002.

International
(YTD: +4.63% / DEC: +1.93%)

Hedge fund managers with an international mandate had an exceptional year given the adversities they faced in 2001. **For the year, the average international hedge fund manager was able to outperform most major indices as the Hennessee International Index was up +4.63% for all of 2001, while the traditional MSCI World Index returned –17.83% during the same period.** The results show that, once again, hedge fund managers appear able to achieve better returns than their traditional (long only) counterparts.

Never before has the importance of deploying strategies that can hedge been so clear as it has been in 2000 and 2001. Hedge fund managers, through their ability to control market exposures by shorting stocks and holding cash, have had strong results, which were clearly evident since the markets weakened in 2000.



European hedge fund returns may have been a disappointment in 2001, but relative to traditional asset managers, performance was quite strong. While the Hennessee European Index gained +0.73% in December, it ended down –3.18% in 2001. Yet, this is ahead of the MSCI Europe Index, off –21.23% for the year. **The disappointment stops there. Reviewing the three-year cumulative returns shows the Hennessee Europe Index up +48.66% versus the MSCI Europe Index down -19.30% since 1999.**

In what had the possibility of being a disastrous year, Asian hedge fund strategies returned solid gains due to a strong fourth quarter rally. The Hennessee Pac Rim Index gained +2.24% in December and +8.42% during the fourth quarter as Asian markets reacted to the global rally. **When compared to traditionally managed equity portfolios, like the MSCI Pacific, which lost –26.21% for the year, hedge fund performance from Asia was strong, up +4.82%.**

The Hennessee Latin America Index advanced +10.01% during December. Argentina and Brazil rebounded sharply during the month, rising +52.9% and +13.8% respectively. **Yet, by years end, hedge funds in the region were down -10.40% on average versus the MSCI Latin America Index down –4.31%.**

Emerging market hedge funds were up +2.82% for December as they, too, participated in the rally. **The**

Hennessee Emerging Markets Index returned +10.29% for the year beating the MSCI EM Index, which was down -4.91% in 2001.

All in all, hedge fund managers with global exposures have beaten their traditionally managed peers for 2001. However, it was a difficult path which most followed. In an extremely volatile year, several noteworthy events contributed to performance.

During the first quarter, most managers were calling for two or three quarters of slow growth, which they believed would impact the markets. Wisdom at the time called for a fourth quarter rally as the impact of the slowdown curtailed and normalcy returned.

All the talk was about 'soft landings' and the debate was between having a U-shaped or V-shaped recovery. The strong returns in December 2000 continued into January as the Fed started the year with a surprise rate cut. As a result, most central banks followed suit and markets in Europe, Asia and Latin America rallied in January. Yet, while manager's had expected that an economic slowdown would impair returns, none were ready for the sell-off in February.

In what had been expected to be a difficult marketplace to navigate, at the beginning of 2001, managers and strategists alike were calling for Europe to be a safer haven for returns than the U.S. It was thought that Europe was somewhat insulated from the US markets which might serve to protect it during a protracted US slowdown. Europe was expected to buoy some less attractive returns from the US, Asia and the other emerging markets.

European markets, led by tech and telecom stocks, sold down sharply in the first quarter. Furthermore, Nasdaq related fears transcended Asian and Latin American markets heavily dependant on US trade pushing them lower. By the end of the quarter, events outside the US were straining most global economies. Furthermore, Germany and France were showing clear signs of economies in a slowdown as GDP growth projections were cut two times during the quarter from 4.75% to 3.0% to 2.0% for the year.

Japan was falling deeper into its 10-year recession. A well publicized banking crisis and political pressures surrounding its Minister of Finance caused Japanese markets to drop –8.9% in the first quarter. To make matters worse, Moodys downgraded the Japanese Government Bond ratings. And certainly, China's decision to keep a US military plane did not help soothe regional tensions.

Through the second quarter, there was generally more bad news regarding corporate earnings and the slowing global economies. As managers and analysts were revising their forecasts down, global markets were actually positive with the S&P up +5.9% on the heels of a –11.8% first quarter loss. However, most international managers were not positioned appropriately to participate in the rally, opting to remain cautious amid the deteriorating fundamentals.

European managers, fearing the whipsaw markets from the prior quarter, were conservatively positioned. Economic data did not make a compelling case for investment and many managers had reduced their exposures. Furthermore, it was felt that the ECB was not keeping up in the global effort to lower interest rates. The result was that European markets ended down for the second quarter. Interestingly, second quarter year to date losses were –18.2% in US dollar terms; yet in local euro terms, down –10.4%.

Latin America, struggling with the internal debt issues of Argentina, also saw troubles. Managers that had been avoiding Argentina all along now had a new problem to contend with: Brazil! Argentine Minister of Finance, Domingo Cavello, the principal architect of the Argentine-US Dollar peg from 1990, was busy shopping a new concept: adjusting the currency peg and restructuring Argentine debt to stave off default. Brazilian equity and debt markets weakened and the real began its nose-dive. The only good news seemed to come from Mexico where market returns remained strong, the currency held up and one of the largest mergers (Citigroup/Banacci) was announced.

During the third quarter, bad got worse and the global economies completely fell apart. In July, US corporate earnings continued to soften and the weakening started to spread to earnings from corporations outside the US. Furthermore, there was an epidemic inability by corporations to project their earnings growth into the coming quarters. This caused markets to sell off in the US, followed by Europe and Asia. And in Latin America, Argentina's problems worsened as it became ap-

parent that it could not meet its debt payment schedule and default was a real possibility.

August was no better; massive restructurings, layoffs and pessimistic outlooks were met with continued deterioration of economic indicators. Hedge funds not already defensively positioned, scrambled to cut exposures as the Hennessee International Index gained +1.52% in a month where the S&P 500 lost -6.3%, Europe dropped -2.9% and the MSCI EAFE was off -2.7%.

Obviously, the quarters pinnacle event, occurring as the markets were already trending down, was September 11. Global markets all hit their lowest point in years during September.

What will be decided in the year to come is whether the market rally during the fourth quarter was the start of something new or just another bear market rally. By the fourth quarter 2001, massive liquidity injections by global central banks throughout the year, huge corporate restructurings and write downs had been announced, and selling not seen in decades had reduced stock prices to historical lows. Selective buying turned to strong buying as good news emerged regarding the war on terrorism. The quarter rallied and the Nasdaq gained +42.1% in the fourth quarter on the heels of its –30.1% third quarter losses. Similar performance was registered in European and Asian markets.

Market analysts and economists are now calling the end of the recession and arguing whether the second or third quarters will register positive growth. With their flexibility to move quickly in and out of the changing market conditions, hedge fund managers seem poised to again capture returns in the rebounding markets while limiting the losses in a decline. **The lesson learned in 2000 and 2001 is clear; investors don't necessarily need to beat the markets when they rise. Through hedging and disciplined downside risk management, steady returns can be achieved.**

The outlook for 2002 is not clear. Given the experiences from the past year, most would agree that European markets are not only more correlated to the US than previously believed, their economic indicators tend to lag those watched in the US. Most managers are not encouraged about Europe. GDP expectations are low and the ECB will likely continue to be cautious amid the politics. Criticized during 2001, the ECB has been careful not to lower rates aggressively to help spur growth in Germany and France fearing that it could potentially overheat the economies in Ireland and Portugal.

Other problems are also noted, namely that tech and telecom companies continue to carry massive debt loads. Furthermore, the insurance industry has been slugged and the airline industry is in trouble. With the uncertainty, managers expect that they will remain cautious.

Asia, in particular Korea, China and Taiwan, have been noted as a bright spot for 2002 as the region does well when the US economy rebounds. Yet, two questions confront the region. First, will the demand by the US for Asian electronics and tech related products continue? And second, what will the impact of a weakening yen have outside Japan? With some expecting it to fall to 140, the weaker yen could hurt exports in Korea , Taiwan and China.

Finally, many feel that the conclusion to Argentina's woes must be close. Flirting with default through 2001, suffering through five presidents in a two-week period, increasing unrest among the citizens, and currency devaluation, most believe the end is near. But the fallout remains unclear. Will it impact Argentina alone? How might Brazil be involved? Will it spread to Mexico, Portugal and Spain? Questions even rise on the future of the Hong Kong to Dollar currency peg.

One thing is for certain, Hedge fund managers have a proven track record for mitigating these global risks and even capitalizing on the uncertainty. Hedge fund managers believe they can continue to add to these results into 2002.

HENNESSEE HEDGE HOG CORNER™

The following are extracts from research related to hedge fund managers we monitor and do not necessarily represent the views of the Hennessee Hedge Fund Advisory Group:

"We believe that health care, cable TV, and defense can deliver strong growth in 2002, while automotive, capital goods, and companies with asbestos liabilities will continue to have problems."

"As we move to close out 2001, we are optimistic that the coming year will present us with a more favorable setting for our event strategies. **Distressed securities look poised to continue recent strength for the foreseeable future.**"

"**In 2002, we will maintain our exposure to the financial sector**, diversifying from banks and insurance companies to brokers, **in anticipation of a pick up in trading volumes and merger and acquisition activity.**"

"We are very friendly to the New Zealand dollar. **New Zealand's economy was one of the strongest in 2001 and should perform well in 2002.**"

"**As we start 2002, we are confident that the US and Germany will rebound modestly by year-end. Once again, Japan's prospects remain unclear** as the country has resorted to devaluing the yen in yet another attempt to revive its economy."

"The likelihood is that given the higher growth rates and lower valuations, **a reallocation to emerging markets will occur over the course of the year and only a modest amount of inflows would move valuations materially.**"

"Going into 2002, we are **net short large-cap pharmaceuticals.** We have modestly **reduced our net long position in hospitals** and remain **net short the managed care, distribution, and lab sectors.**"

"**We expect the US dollar to weaken**, as the combination of a slower pace of Fed easing and disappointing weak US economic data is exactly what caused the dollar to stumble at the end of 2000 and in the summer of 2001."

"**Stocks in the UK remain attractive**. Minimal inflation, looser monetary policy from the Bank of England, and appealing valuations are all positive factors."

"Indeed, as defaults are a lagging indication of business operations and bankruptcy filings tend to occur six to twelve months after a major economic slowdown, we expect the default rate to peak sometime in 2002. **There exists an enormous pipeline of opportunities as the result of the current recession.**"

"**We continue to be negative on Japan**. The country's long-stagnant underlying business environment has kept its market from offering the compelling misvaluations found in other markets."

"**Our greatest positive exposure is the Australian dollar**. A vibrant domestic economy, rising prices for Australian commodity exports, favorable interest-rate differentials, and the potential for greater inward merger and acquisition activity all bode well for this currency."

"**We expect the euro to reach parity by year-end**. This may seem like a bold forecast, but the percentage appreciation that we are looking for from current levels (under 11%) is less than the two last euro rallies."

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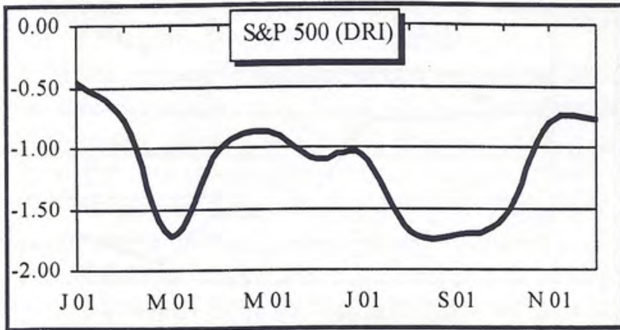
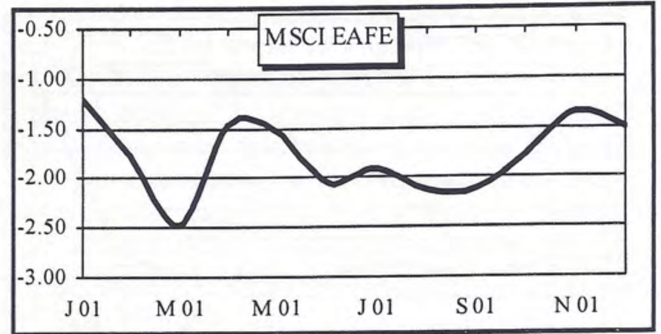
HEDGE HOG CORNER
Dow Jones Technical Analysis
January 2002

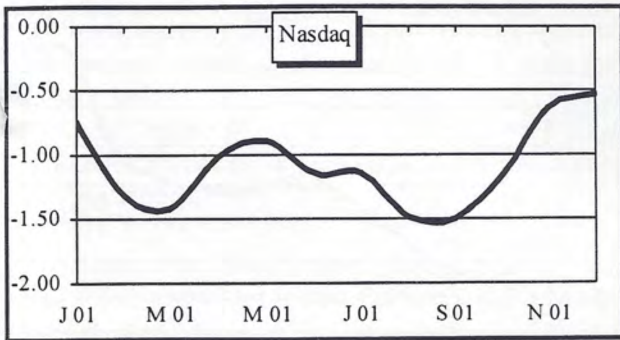
Dow Jones Close (1/11/02)	9,988
Short-term Trading Range	9,990-10,250
Short-term Upper Resistance Level I	10,350
Short-term Lower Support Level I	9,775
Long-term Upper Resistance Level II	11,240
Long-term Lower Support Level II	7,900
Accumulated Distribution	Neutral
Momentum	Neutral
Money Flow	Neutral
Relative Strength	Negative
Hennessee Ratio* (1/11/02)	1.67
Hennessee Ratio* (12/12/01)	1.45
Hennessee Ratio* (11/13/01)	1.14
Hennessee Ratio* (10/11/01)	0.52
Hennessee Ratio* (9/17/01)	0.01
Hennessee Ratio* (8/9/01)	0.71
Hennessee Ratio* (7/9/01)	0.74
Hennessee Ratio* (6/8/01)	2.00
Hennessee Ratio* (5/9/01)	4.29
Hennessee Ratio* (4/8/01)	0.70
Hennessee Ratio* (3/09/01)	1.14
Hennessee Ratio* (2/09/01)	1.14
Hennessee Ratio* (1/09/01)	1.11
Hennessee Ratio* (12/14/00)	1.31
Hennessee Ratio* (11/16/00)	0.69
Hennessee Ratio* (10/16/00)	0.55
Hennessee Ratio* (9/15/00)	0.63
Hennessee Ratio* (8/10/00)	1.69
Hennessee Ratio* (6/28/00)	1.00

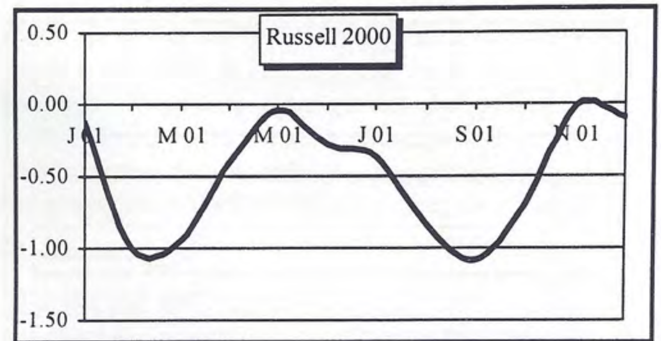
*Ratio of Dow Jones close to technical maximum upside potential and technical maximum downside risk potential. A ratio above 1.0 expresses more relative risk in the market than reward. Hennessee proprietary analytics are no guarantee of future returns. ALL RIGHTS RESERVED.

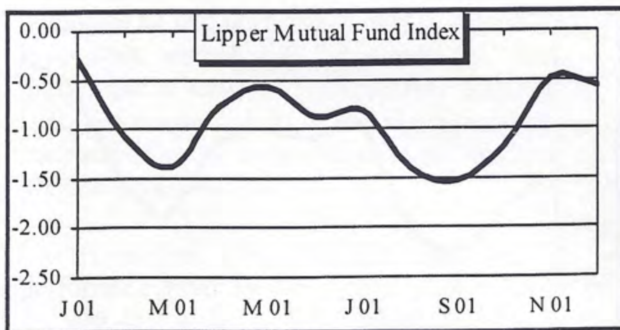
12 MONTH ROLLING SHARPE RATIO

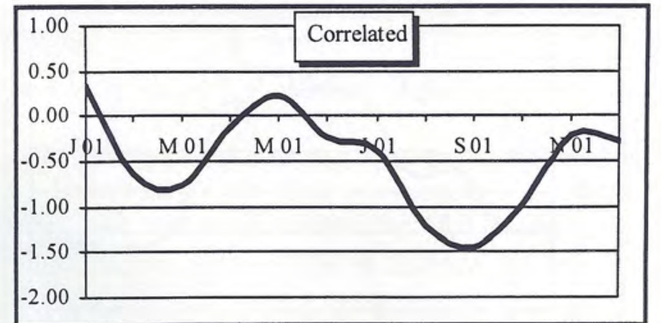








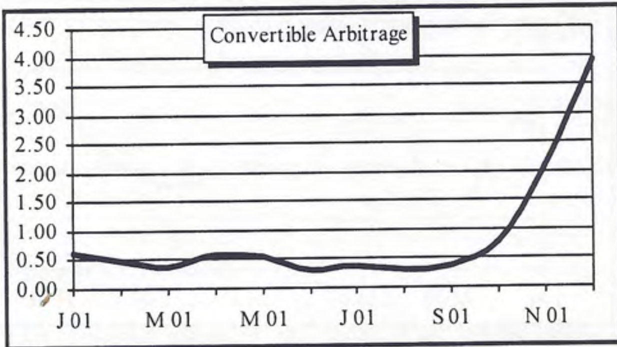


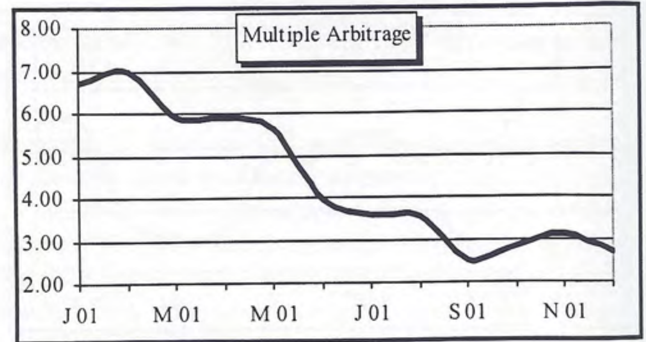


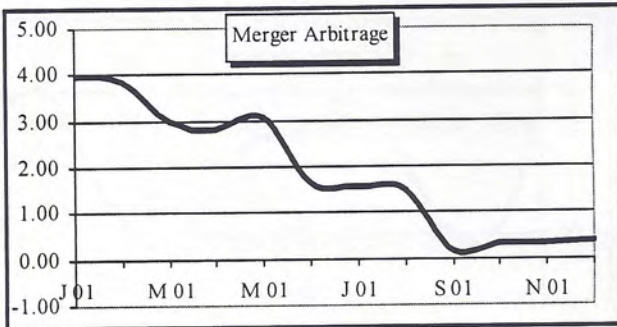
$$\textit{Sharpe Ratio} = \frac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$$

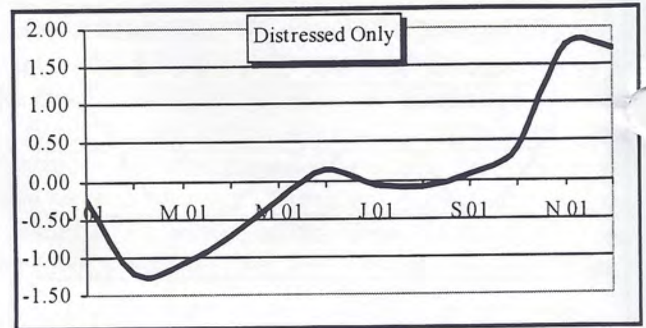
**90 day T-bill*

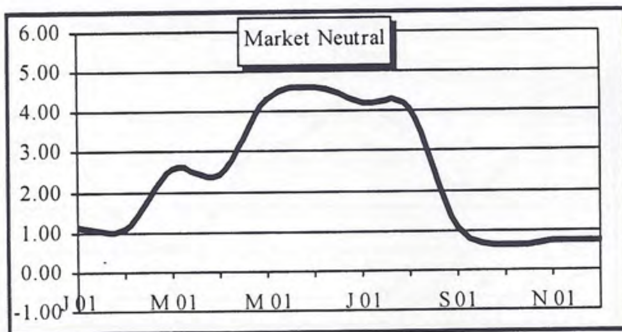
12 MONTH ROLLING SHARPE RATIO

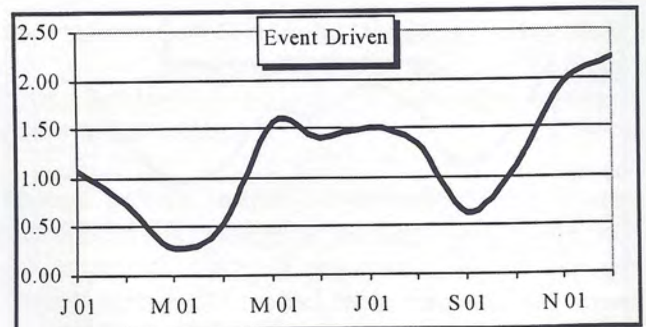








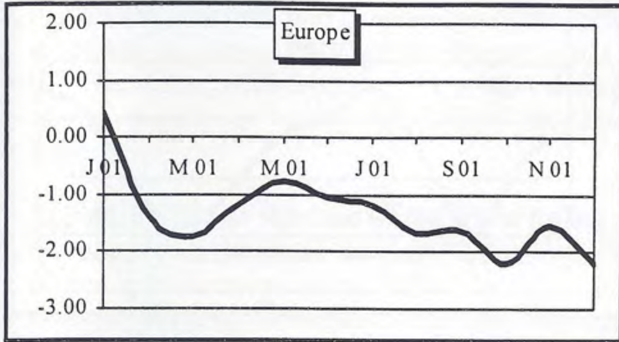


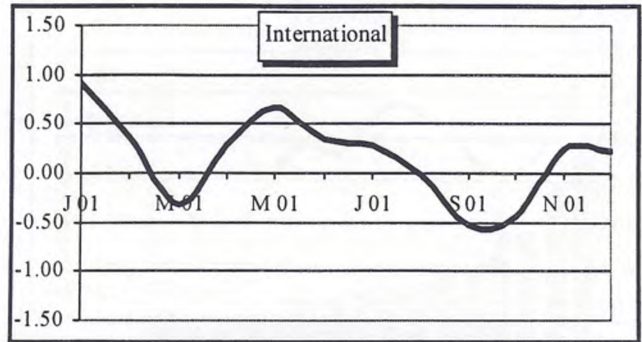


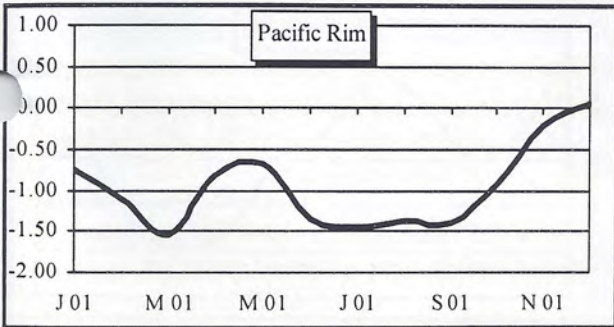
$$\textit{Sharpe Ratio} = \frac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$$

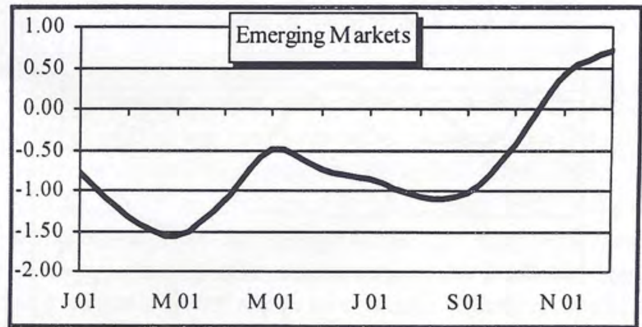
90 day T-bill

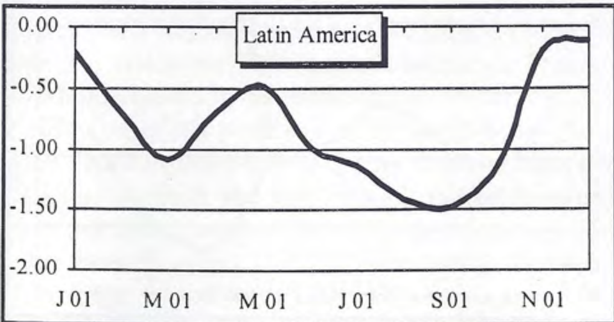
12 MONTH ROLLING SHARPE RATIO

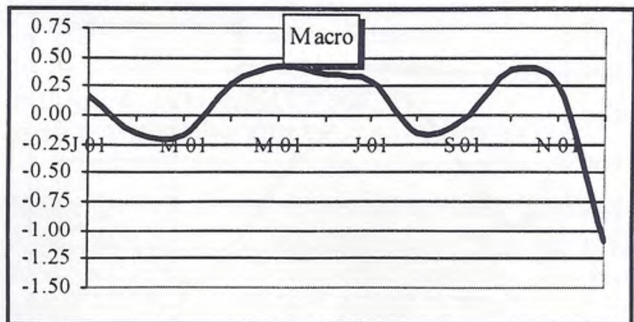








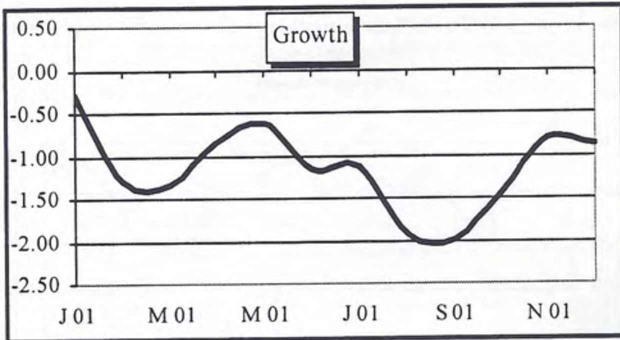


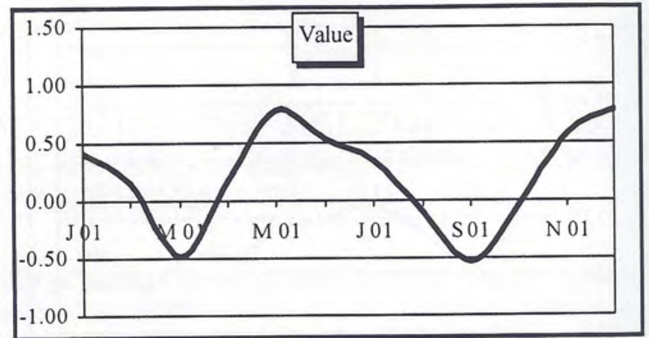


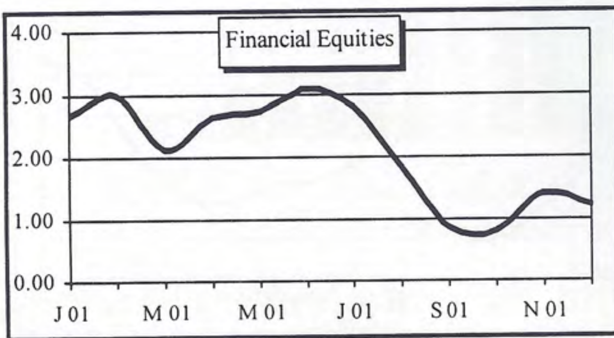
Sharpe Ratio = $\dfrac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$

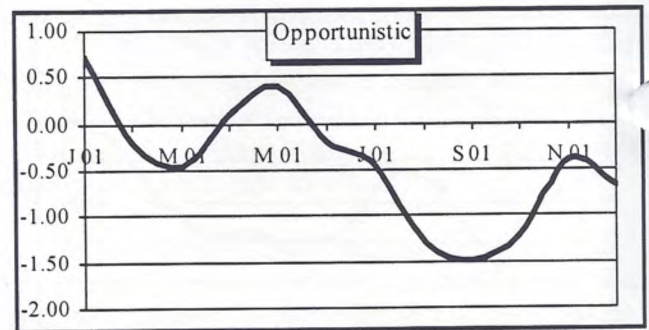
***90 day T-bill**

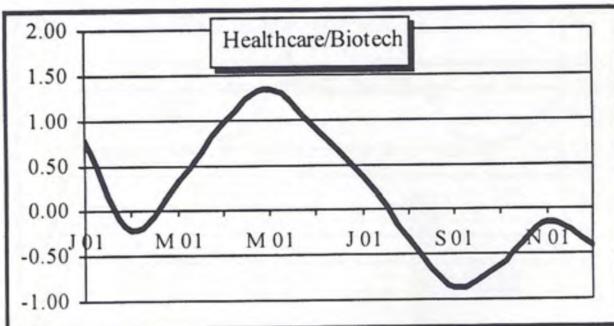
12 MONTH ROLLING SHARPE RATIO

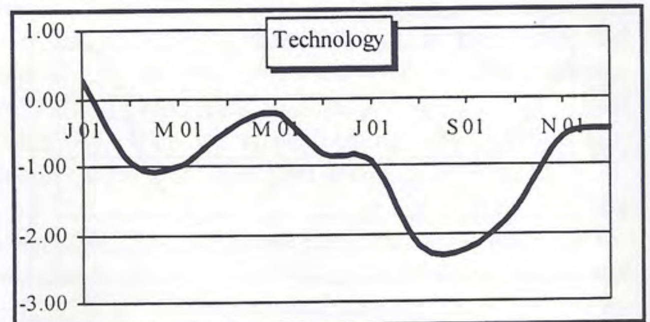












$$\textit{Sharpe Ratio} = \frac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$$

90 day T-bill

HENNESSEE HEDGE FUND RANKINGS®

2001 (NET) MONTHLY RANK	YTD RANK	JAN	FEB	MAR	APRIL	MAY	JUNE	JULY	AUG	SEPT	OCT	NOV	DEC
CONVERTIBLE ARBITRAGE	2	7	4	4	10	17	12	4	4	2	12	17	17
DISTRESSED ONLY	8	14	9	11	17	9	1	12	10	4	10	18	20
EMERGING MARKETS	6	5	16	18	16	5	10	21	9	15	4	3	4
EUROPE	20	20	15	13	13	19	18	11	14	8	21	21	15
EVENT DRIVEN	4	11	5	7	12	4	5	3	8	12	7	15	13
FINANCIAL EQUITIES	1	3	11	12	9	2	3	2	21	18	17	8	2
FIXED INCOME	9	18	8	2	18	11	20	9	2	3	11	22	9
GROWTH	22	9	22	21	6	20	19	18	19	20	2	7	5
HEALTHCARE/BIOTECH	19	22	21	22	1	1	2	22	18	22	1	2	18
HIGH YIELD	11	4	2	9	20	7	21	8	5	17	6	13	23
INTERNATIONAL	14	19	12	14	19	16	6	15	3	9	18	6	8
LATIN AMERICA	23	1	23	23	2	6	16	23	23	23	5	1	1
MACRO	16	21	14	6	22	22	17	13	13	5	14	20	12
MARKET NEUTRAL	12	17	6	3	14	15	11	7	11	10	20	14	16
MERGER ARBITRAGE	15	15	7	8	15	8	22	5	6	16	19	19	14
MULTIPLE ARBITRAGE	7	12	3	5	11	12	15	6	7	6	13	16	21
OPPORTUNISTIC	17	13	19	15	7	14	23	16	20	13	16	9	11
PACIFIC RIM	13	10	13	19	5	18	8	19	12	14	8	5	7
REGULATION D	21	16	17	16	21	21	9	20	16	11	15	11	10
SHORT BIASED	3	23	1	1	23	23	13	1	1	1	22	23	22
TECHNOLOGY*	18	8	20	20	4	13	14	17	22	19	3	4	19
TELECOM AND MEDIA	10	2	18	10	8	10	4	14	17	7	23	12	6
VALUE	5	6	10	17	3	3	7	10	15	21	9	10	3

The Hennessee Hedge Fund Indices® are calculated from performance data supplied by a diversified group of hedge funds monitored by the Hennessee Hedge Fund Advisory Group®. The Hennessee Hedge Fund Index® represents over 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 statistically representative of the larger Hennessee Universe of over 3,000 hedge funds and are net of fees and unaudited. Past performance is no guarantee of future returns. ALL RIGHTS RESERVED.

HENNESSEE GROUP LLC
HEDGE FUND ADVISORY

HENNESSEE HEDGE FUND INDICES®

HENNESSEE
HEDGE FUND REVIEW®
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2001 Net Monthly Return	YTD	YTD RANK	% of mgrs beat S&P 500 YTD	JAN	FEB	MAR	APRIL	MAY	JUNE	JULY	AUG	SEPT	OCT	NOV	DEC
CONVERTIBLE ARBITRAGE	**15.13%**	**2**	**100%**	3.61%	1.40%	0.98%	1.67%	0.46%	0.28%	0.88%	1.50%	0.99%	1.27%	0.56%	0.62%
DISTRESSED ONLY	**9.63%**	**8**	**90%**	2.10%	0.22%	-0.89%	0.49%	1.61%	3.43%	-0.70%	0.64%	0.36%	1.40%	0.51%	0.14%
EMERGING MARKETS	**10.29%**	**6**	**100%**	5.09%	-1.25%	-2.19%	0.70%	2.63%	0.57%	-3.13%	0.81%	-2.57%	2.33%	4.44%	2.82%
EUROPE	**-3.18%**	**20**	**79%**	0.10%	-1.22%	-1.22%	0.98%	0.35%	-0.25%	-0.60%	-0.49%	-0.99%	-0.74%	0.14%	0.73%
EVENT DRIVEN	**12.41%**	**4**	**100%**	2.56%	1.14%	-0.05%	1.02%	2.77%	1.03%	1.09%	0.92%	-1.90%	1.68%	0.75%	0.83%
FINANCIAL EQUITIES	**15.59%**	**1**	**89%**	5.96%	-0.61%	-1.18%	1.77%	4.08%	2.11%	1.89%	-1.84%	-4.10%	0.72%	2.68%	3.53%
FIXED INCOME	**7.83%**	**9**	**100%**	0.66%	0.27%	1.06%	0.48%	1.04%	-0.60%	0.14%	2.21%	0.70%	1.39%	-1.46%	1.74%
GROWTH	**-3.71%**	**22**	**84%**	3.12%	-3.87%	-3.36%	2.06%	0.15%	-0.48%	-2.99%	-1.49%	-4.11%	2.51%	2.70%	2.42%
HEALTHCARE/BIOTECH	**-2.99%**	**19**	**88%**	-3.09%	-3.65%	-5.76%	7.45%	4.56%	3.21%	-7.23%	-1.33%	-5.14%	4.19%	4.47%	0.60%
HIGH YIELD	**7.36%**	**11**	**50%**	5.57%	2.46%	-0.76%	-0.46%	1.93%	-0.65%	0.40%	1.02%	-3.91%	1.98%	1.47%	-1.60%
INTERNATIONAL	**4.63%**	**14**	**68%**	0.34%	-0.73%	-1.60%	0.31%	0.58%	0.99%	-1.26%	1.52%	-1.07%	0.52%	3.11%	1.93%
LATIN AMERICA	**-10.40%**	**23**	**25%**	10.02%	-8.79%	-8.77%	3.16%	1.98%	-0.04%	-7.55%	-5.15%	-15.83%	2.27%	12.09%	10.01%
MACRO	**-1.07%**	**16**	**83%**	-0.03%	-0.95%	0.02%	-0.99%	-0.70%	-0.16%	-0.70%	-0.34%	0.29%	1.07%	0.23%	1.22%
MARKET NEUTRAL	**6.14%**	**12**	**100%**	1.01%	1.09%	0.99%	0.83%	0.65%	0.34%	0.45%	0.54%	-1.14%	-0.18%	0.77%	0.64%
MERGER ARBITRAGE	**3.84%**	**15**	**100%**	1.46%	0.53%	-0.43%	0.75%	1.65%	-0.81%	0.79%	1.00%	-2.74%	0.51%	0.37%	0.77%
MULTIPLE ARBITRAGE	**9.70%**	**7**	**100%**	2.24%	1.41%	0.63%	1.03%	0.90%	-0.03%	0.53%	0.93%	-0.18%	1.09%	0.64%	0.14%
OPPORTUNISTIC	**-1.59%**	**17**	**87%**	2.12%	-2.57%	-1.68%	2.01%	0.77%	-1.08%	-1.51%	-1.75%	-2.40%	0.78%	2.51%	1.38%
PACIFIC RIM	**4.82%**	**13**	**90%**	2.68%	-0.91%	-2.67%	2.22%	0.42%	0.60%	-3.09%	0.36%	-2.44%	1.57%	4.02%	2.24%
REGULATION D	**-3.46%**	**21**	**100%**	1.11%	-1.60%	-1.73%	-0.89%	0.07%	0.58%	-3.11%	-0.73%	-1.30%	0.90%	1.80%	1.49%
SHORT BIASED	**12.65%**	**3**	**88%**	-4.20%	9.18%	4.88%	-11.75%	-0.96%	0.28%	2.46%	5.80%	13.41%	-1.11%	-2.78%	-0.87%
TECHNOLOGY***	**-2.09%**	**18**	**84%**	3.21%	-2.88%	-3.08%	2.27%	0.83%	0.18%	-1.95%	-3.16%	-4.10%	2.45%	4.12%	0.44%
TELECOM AND MEDIA	**7.60%**	**10**	**100%**	6.23%	-2.41%	-0.87%	1.87%	1.14%	2.08%	-1.13%	-1.17%	-0.62%	-1.35%	1.59%	2.31%
VALUE	**11.31%**	**5**	**100%**	4.82%	-0.14%	-1.74%	2.64%	3.56%	0.77%	-0.33%	-0.66%	-5.07%	1.46%	2.51%	3.37%
HENNESSEE HEDGE FUND INDEX	3.98%		89%	**2.65%**	**-1.16%**	**-1.68%**	**1.70%**	**1.40%**	**0.43%**	**-1.30%**	**-0.42%**	**-2.77%**	**1.42%**	**2.22%**	**1.60%**
HENNESSEE CORRELATED*	1.34%		89%	**2.98%**	**-2.46%**	**-2.83%**	**2.72%**	**1.78%**	**0.34%**	**-2.18%**	**-1.56%**	**-4.24%**	**2.08%**	**2.97%**	**2.11%**
HENNESSEE NON-CORRELATED**	8.66%		98%	**2.27%**	**0.91%**	**0.08%**	**0.84%**	**1.30%**	**0.53%**	**0.40%**	**0.88%**	**-1.03%**	**0.99%**	**0.67%**	**0.53%**
HENNESSEE GLOBAL	1.43%		78%	**2.23%**	**-1.69%**	**-2.19%**	**0.91%**	**0.76%**	**0.33%**	**-2.17%**	**-0.08%**	**-2.73%**	**0.97%**	**3.29%**	**1.99%**
S&P 500 (DRI)	**-11.89%**			3.55%	-9.12%	-6.33%	7.77%	0.67%	-2.43%	-0.98%	-6.26%	-8.08%	1.91%	7.67%	0.88%
DJIA	**-7.10%**			0.92%	-3.60%	-5.87%	8.67%	1.65%	-3.75%	0.19%	-5.45%	-11.08%	2.57%	8.56%	1.73%
LIPPER MUTUAL FUNDS	**-8.12%**			3.56%	-7.92%	-6.30%	7.50%	1.09%	-0.85%	-2.52%	-4.14%	-10.77%	4.15%	6.91%	2.79%
MSCI EAFE US $	**-22.50%**			-0.07%	-7.45%	-6.91%	6.74%	-3.82%	-4.23%	-1.86%	-2.71%	-10.26%	2.53%	3.61%	0.58%
RUSSELL 2000	**1.03%**			5.13%	-6.68%	-5.03%	7.72%	2.30%	3.25%	-5.43%	-3.35%	-13.59%	5.75%	7.62%	6.02%
NASDAQ	**-21.04%**			12.23%	-22.39%	-14.48%	15.00%	-0.27%	2.37%	-6.17%	-10.94%	-16.98%	12.77%	14.22%	1.03%
LEHMAN BR[illegible] INT. GOVT/CORP	**8.98%**			1.64%	0.95%	[illegible]77%	-0.26%	0.56%	0.37%	2.08%	1.00%	1.46%	1.66%	[illegible]0%	-0.55%

The Hennessee Hedge F[illegible]dices® are calculated from performance data supplied by a diversified group of hedge funds monitored by the Hennessee Hedge Fund Advisory Gro[illegible]. The Hennessee Hedge Fund Index® represents over half of the capital in the industry and is an equally-weighted average of the funds in the Henne[illegible] Hedge Fund Indices®. The funds in the Hennessee Hedge Fund Index® are statistically representative of the larger Hennessee Universe of over 3,000 hedge funds and are net of fees and unaudited. Past performance is no guarantee of future returns. ALL RIGHTS RESERVED. ***CORRELATED:** Long/Short Equity; ****NON-CORRELATED:** Event Driven/ Arbitrage and Short Bias.