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

HENNESSEE
HEDGE FUND REVIEW®

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	DEC	YTD
HENNESSEE HEDGE FUND INDEX®	-0.58%	-3.43%
S&P 500 (DRI)	-5.90%	-22.19%
LIPPER MUTUAL FUNDS	-4.46%	-18.77%
CORRELATED* HEDGE FUNDS	-2.09%	-8.25%
NON-CORRELATED HEDGE FUNDS**	+1.23%	+2.10%
GLOBAL HEDGE FUNDS	-0.05%	-1.01%

PERCENTAGE OF CORRELATED* MANAGERS OUTPERFORMING THE:

	DEC	YTD
S&P 500 (DRI)	87%	88%
Lipper Mutual Funds	83%	86%

TOP (3) PERFORMING:	DEC		YTD
Short Biased	+3.05%	Short Biased	+15.84%
Latin America	+2.90%	Convertible Arbitrage	+8.96%
Distressed	+2.77%	Financial Equities	+6.69%

BOTTOM (3) PERFORMING:	DEC		YTD
Opportunistic	-3.53%	Healthcare and Biotech	-17.09%
Healthcare and Biotech	-2.67%	Latin America	-16.81%
Growth	-2.64%	Growth	-11.39%

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

MARKET SUMMARY - DECEMBER 2002

December concluded another dismal year for the stock market, as the S&P 500 fell –5.90% to bring year-to-date losses to –22.19%. All major market indices finished in the red for the third consecutive year, marking the first time since 1939-1941 that the indices have fallen three years in a row.

The Hennessee Hedge Fund Index declined –3.43% in 2002, marking the first time since its inception in 1987 that it has lost money. For the most part, short portfolios did not have sufficient impact on protecting capital as they had in 2000 and 2001. Coming into 2002, most fund managers recognized more rational valuations following the previous two years of market declines, making it **difficult for managers to short aggressively.** Furthermore, given the inherent risk of maintaining large

short exposures and the subsequent market volatility in 2002, short positions were often times covered by risk management policies. Two types of long/short equity strategies made money in 2002: a) funds that were willing to short aggressively and convert their portfolios to a net short position or b) funds that maintained very low net exposures (+10% to –10%) while exhibiting skillful stock picking.

The S&P 500 advanced +0.25% in the first quarter, as a tight trading range ensued 2001's fourth quarter rally. GDP growth accelerated to 5.0% in the quarter, as consumer confidence improved due to the strength of the equity markets in the fourth quarter of 2001. Despite the economic improvements, the stock market stayed in a trading range, presumably because of high

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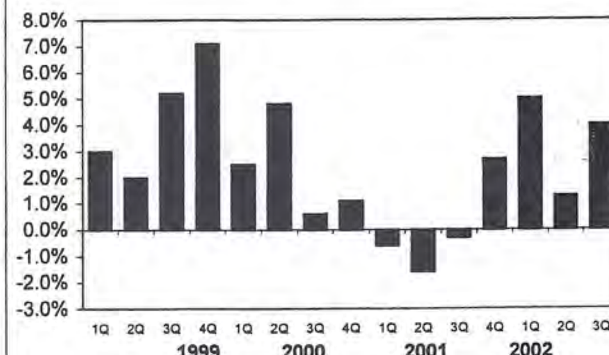
valuations and the overhang of accounting uncertainty. Those managers that were able to make money during the quarter did so by trading aggressively and avoiding any landmines in their long portfolios.

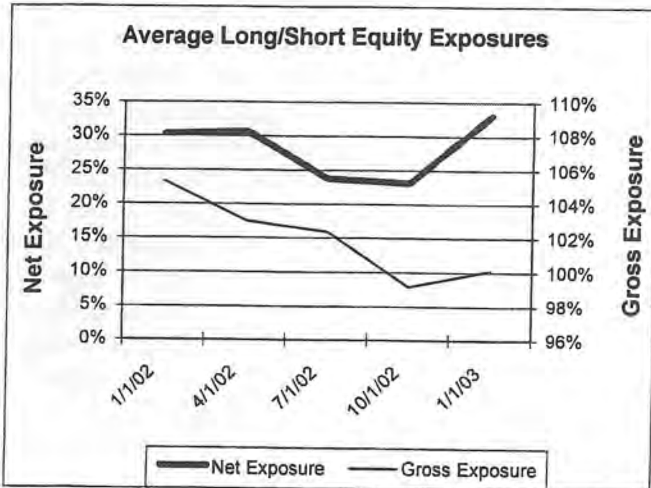
As the first quarter closed, corporate governance issues began making headlines, as Tyco and Adelphia (in addition to many others) surfaced with accounting problems. The second quarter once again was a continuation of the "gloom and doom" experienced in 2000 and 2001. The S&P 500 declined –13.4%, predominately caused by a valuation contraction and not necessarily earnings disappointments. In tandem with the equity markets, corporate bond spreads widened. Accordingly, Treasuries advanced due to a rapid reallocation from equities to bonds.



As corporate scandals began filling the front pages of newspapers across the country, consumer confidence began to wane, leading to skepticism that the US economy was poised to re-enter recession due to weakness in the consumer. As such, the S&P 500 declined –17.3% in the third quarter. In particular, July was the toughest month for many hedge funds, as WorldCom announced its accounting fraud and later filed for bankruptcy protection. The increase in volatility and volume during September's decline led many to claim that investors had reached capitulation.

Stocks rallied in the fourth quarter, reminiscent of the liquidity driven rally of the fourth quarter of 2001. Despite no apparent change in economic and corporate fundamentals, the S&P 500 advanced +8.2%. The Fed continued to cut interest rates, as the

Fed Funds rate was lowered to 1.25% in October.



Despite widespread optimism by most Wall Street strategists, most hedge funds remain cautious. Strategist continue to point to the fact that the stock market has not fallen four consecutive years since 1929-1932 and only happened once in the 19th century, from 1836-1839. **While net exposures have risen slightly over the past quarter, they still remain low by historical standards** (see graph below). Despite the sell-off of December, all of the major market indices remain in a tight trading range between their 50-day and 200-day moving average. In the near term, most managers can be expected to maintain their current positioning until these indices or selected stocks move out of the trading range. Looking out further, **most managers see both risk and opportunity, but are unwilling to take a significant bet in either direction.**

To shift from their current positioning, most hedge fund managers will be looking at changes from the following consensus to determine their view on the market's direction:

a) Current expectations are for US GDP to grow 2.5% to 3% rate in 2003. A significant pickup in business investment could increase GDP growth, while a pull-back in consumer spending could lead the economy into another recession.

b) A recent report indicated that earnings expectations have declined in the past six months. Currently, **Standard and Poor's is estimating operating earnings for the S&P 500 to be $55.55 in 2003, an increase of 18.8%.** This equals a valuation of 16 times 2003 earnings. Managers recognize that earnings could decline or a valuation contraction could continue.

c) While fears regarding a double dip recession have been alleviated (at least for the time being), **many are concerned about a consumer debt bubble,** exacerbated by 40-year lows in interest rates. Furthermore, given that the stock market has cost investors approximately $10 trillion (as measured in market value by the Wilshire 5000) from its peak in March 2000, the spending power of consumers is theoretically much less than three years ago.

d) While the future risk of terrorist attack will likely persist through 2003, a quick end to a war with Iraq could potentially boost investor and consumer confidence. That said, a clean war is far from certain.

e) President Bush (backed by the Republican Congress) appears determined to pass **a $670 million fiscal stimulus package.** In particular, the repeal of the double taxation of dividends has been estimated by the White House to boost the equity markets by 10%.

HEDGE FUND PERFORMANCE SUMMARY - DECEMBER

Hedge funds had a frustrating year, mostly due to the high volatility of the equity market, as the Hennessee Hedge Fund Index lost –3.43%. For the month of December, hedge fund managers ended down -0.58%. In comparison, all of the major indices were significantly down for the year, as the Dow Jones Industrial Average declined –16.76%, the S&P 500 declined –22.19%, and the Nasdaq declined –31.52%. Hedge fund managers were able to mitigate losses due to their low net exposures and other risk management techniques.

For the entire year, correlated managers (long/short equities) declined –8.25%, while non-correlated managers (event driven/arbitrage) advanced +2.10% and global managers ended down –1.01%. The top performing styles for the year were Short Biased (+15.84), Convertible Arbitrage (+8.96%), and Financial Equities (+6.69). The worst performing styles during 2002 were Healthcare and Biotech

(-17.09%), Latin America (-16.81%), and Growth (-11.39).

The Hennessee Short Biased Index gained +15.84% in 2002. The largest factor to this style's performance was the negative performance of the equity markets. Corporate fraud, the weak U.S. economy, and the uncertain geopolitical situation weighed on the markets for most of the year. Short biased managers enjoyed another good environment for their strategy, similar to that of 2000 and 2001. Popular stocks among short biased managers included Tyco, IBM, AOL, JP Morgan and GE. Many of the accounting issues that were the focus of Wall Street throughout the year were initially researched by managers looking for attractive short ideas. **Interestingly, aggressive accounting has been something that short biased managers have researched for many years, however, it wasn't until 2002 that the entire market began to take notice.**

The Hennessee Convertible Arbitrage Index finished up +8.96% for 2002. While new issuance of convertibles was strong, it failed to match 2001's record pace, and therefore returns of the strategy lagged as well. Furthermore, the majority of convertible bonds entered 2002 "busted" (or far out of the money) due to declining stock prices, and therefore, most convertible arbitrage portfolios became highly sensitive to credit risk. As credit spreads widened in the summer due to corporate governance issues, many convertible arbitrage managers experienced small losses, although most were able to avoid significant losses by hedging their credit risk. **Fortunately, leverage remained low in the strategy by historical standards, which allowed for funds to buy into the market's rally during the fourth quarter when credit spreads tightened.**

The Hennessee Group Financial Equities Index gained +6.69% for 2002 even though the BKX Bank Index was down –11.64%. **Managers benefited from long positions in mortgage finance companies and thrifts that benefited from low interest rates.** Fannie Mae and Freddie Mac were also manager favorites, as 40-year lows in interest rates caused families to refinance their homes. Managers also made money short large banks (JP Morgan, Citibank, Bank of America) that declined in value due to the worsening credit quality on their loan portfolios.

The Hennessee Healthcare and Biotech Index was the worst performing index for 2002, falling –17.09%. This sector was marked by scandal, disappointing new drugs, and a lack of leadership by the FDA. **Most importantly, investors' aversion for risk increased in 2002, and highly volatile biotech stocks sold off as a result.** As the entire sector approached valuation multiples not seen since 1994, some biotech companies were selling below their cash values. The FDA went without a commissioner for most of the year, which, according to many managers, caused the approval process for new drugs to slow down dramatically. Pharmaceutical companies continued to decline, as investors became aware of weakening drug pipelines. While hospitals and HMOs were the lone bright spot throughout the year, Medicare reimbursement issues at Tenant Healthcare adversely affected hospitals toward the latter part of the year.

The Hennessee Latin America Index declined –16.81%, primarily due to risk aversion of investors following uncertainty in global equity markets. In particular, **Brazilian equities fell due to mounting debt problems** during the first half of the year. While investors initially disapproved of the recently elected president, Lula Da Silva, the equity makrets rose in the fourth quarter. Unfortunately, prosperity in Brazil was met with turmoil in Venezuela due to a nationwide labor strike.

The Hennessee Growth Index declined –11.39% for 2002 due to the overall slide in the major markets. Value stocks were again in vogue in 2002, as investors sought safe havens and dumped high beta stocks. Managers that felt the economy would pick up got hurt when they increased their net exposures to capture a market rally. Technology stocks continued to be beaten down, as **corporate spending on technology failed to live up to expectations.** Finally, biotech stocks sold off due as investors became more risk averse and retail stocks fell due to concerns about the US consumer.

STYLE PERFORMANCE SUMMARIES - DECEMBER

Value
(YTD: -2.91% / DEC: -1.42%)

Value managers fell –1.42% in December, with year to date performance down –2.91%. In comparison, the S&P 500 DRI (dividends reinvested) was down -5.85%, bringing its performance to -22.19% for the year. Value hedge funds did well on their short positions, but lost more money on their long positions.

Value managers had a better first quarter than their growth counterparts. Small cap and mid-cap value stocks performed well during February, despite the fact that the markets were down. The SEC filed civil fraud charges against three top executives of Tyco International, including former CEO, L. Dennis Kozlowski. The sight of the three men in handcuffs capped an investigation that had begun in January. Tyco had been a value manager favorite. A very select group of technology stocks attracted value managers because of their low stock prices. **Still, the high volatility in the equity markets convinced investors to seek safe havens, propelling value stocks higher.** It seemed some managers were buying into the idea that the there will be a U.S. economic recovery, as they picked up financial, banking, and mortgage companies. By the end of the quarter, managers were worried of a possible momentum shift from value to growth.

The second quarter was a nightmare for the equity markets. **Despite positive economic data, the markets sold off due to investors' mistrust for corporate governance.** WorldCom, a value favorite, dropped a bombshell on June 26 when it announced its financial statements were inaccurate. For most of the quarter, value managers were able to keep losses to a minimum because they kept net exposures low. Small cap stocks historically perform well in a slow growth, high volatility environment and this helped value managers during this quarter. Market, economic, and world instability drove investors to buy companies with strong fundamentals, transparent financials, and solid cash flows. "Hot money" chased names in cyclical sectors, like automobiles and financials, leading to rich valuations. Managers felt that some traditional value sectors approached full value and saw better opportunities among growth sectors like biotech and healthcare.

The third quarter saw the market in the doldrums again as the "baby was thrown out with the bath water." July was a terrible month across all market caps. Initially, managers saw similarities to the 1973/1974 bear market in which value stocks (especially small-caps) had a phenomenal run. That feeling changed when liquidity dried up in some of the small-cap stocks, causing concern for some managers. There was a "flight-to-quality" away from equities as money flowed into fixed income securities. **Beta hedging did not provide as much downside protection as anticipated. Low beta stocks declined in a similar fashion to high beta stocks due to mass liquidations of mutual funds.** Some value managers used the market downturn to seize upon opportunities that were too good to pass up.

The market rallied during the fourth quarter but managers did not fully participate because of their low net exposures. Financial stocks performed well due to the narrowing of credit spreads. Consumer staple stocks got hurt as money was rotated out of this sector. Retail was mixed as the U.S. economy sputtered along and consumer confidence declined. Tenet Healthcare, a position in some value portfolios, was rocked by an SEC investigation into the company's business practices. Corporate pension funding spooked investors, as companies may be forced to add capital to their underfunded pension plans. **Many managers attributed the positive performance of the markets to a "technical bounce" and felt it would not last.** This proved to be true as the markets declined in December. Consumer confidence plunged during December, leaving it just above the nine-year low reached in October. The myriad number of issues abroad and the weak holiday shopping season put the stamp on a forgettable year for the equity markets.

Looking ahead to 2003, managers will have to navigate through very murky waters. The geopolitical situation has not been this intense for quite some time. Iraq, Korea, and Venezuela are hot spots that could profoundly affect the equity markets. **Besides war and the possibility of rising oil prices, another large-scale terrorist attack against the U.S. could also do serious damage to the economy.** On the flip

side, resolution of any of the above conflicts could be a boon to the capital markets. Bedsides these global events, the problems of decreasing margins, rising costs, and management integrity at U.S. firms will continue to weigh down the markets.

Growth (YTD: -11.39% / DEC: -2.64%)

The Hennessee Growth Index declined -2.64% in December, bringing its year to date performance to -11.39%. In comparison, the benchmark Nasdaq Composite Index declined –9.69% in December, bringing its year to date performance to –31.52%. Growth hedge funds did well on their short positions, but lost more money on their long positions.

Growth managers entered 2002 with low net exposures, but were cautiously optimistic going forward. Their optimism faded fast **as the "January effect" was nowhere to be found, and instead was replaced with the "January witch hunt."** The fallout from Enron and the accounting irregularities that plagued other large companies got the year off on the wrong foot. Similar to the first quarter in 2001, growth hedge funds were spared the carnage and mitigated their losses by keeping their net exposure low. The first two months of the quarter managers saw a rotation to old economy "value" names. Productivity remained strong through the recession, but the positive economic data could not prevent the market from declining. By the end of the quarter, growth managers benefited from the equity rally. Consumer spending was robust and the housing sector remained strong, which led managers to believe that the market was pricing almost optimal conditions into the market. Managers felt that trouble would follow due to the overly optimistic expectations in the markets.

The negative view of the equity markets by growth managers proved to be correct for the second quarter. Accounting irregularity issues and a lack of capital expenditures by companies weighed on the markets during the quarter. Technology stocks were hit hard, especially in the semiconductor sector. Telecom stocks did poorly as excess capacity and lack of capital spending by corporations led many managers to believe that a shakeout would take place sometime in the future. With the telecom sector reeling, the WorldCom bankruptcy and fraud really put the stamp on a dreadful quarter. The biotech sector declined from news on the Imclone scandal. This incident undermined valuations across the board and damaged management credibility in the industry. Companies were selling below their cash value, with the industry penalized because of an isolated incident. The FDA, which was without a commissioner, slowed its approval process for drugs, hurting investor sentiment for the sector. Due to the negative news in the biotech industry, there was a net outflow of capital in the sector due to investor skittishness. Some managers believed an economic recovery was imminent and increased their exposure, which subjected them to the market downturn. The second group of managers remained skeptical of an economic recovery, and maintained low net exposures, which helped mitigate losses.

The third quarter was a period of time most managers would like to forget. As losses mounted, managers went into a capital preservation mode to prevent further capital erosion. Although hedge funds anticipated this rough period, most were not prepared for the carnage that took place in September. In the technology sector, slashed capital expenditures continued to weigh on the sector. The semiconductor sector had a terrible quarter; Intel dominated the headlines when it announced it was lowering its 3rd and 4th quarter estimates.

Against the grain, the biotech sector did well in July, as investors snapped up beaten down stocks. The rest of the quarter was very different for biotech. From a valuation standpoint, the sector dropped to multiple valuations not seen since 1994. The pressure mounted on the FDA to appoint a commissioner to speed up the drug approval process.

The lone bright spot was media, as advertising recovered after one of the worst slumps ever. Investor sentiment though was mixed on this sector due to the market backdrop. Managers believe that the industry is being driven by auto companies offering zero percent financing and political campaign ads, and that the true health of the sector will come to light in the first quarter of 2003.

The retail sector had one of the worst holiday shopping seasons in recent history. Initially, sales seemed

brisk but that was due to retailers lowering prices to boost demand, which hurt profit margins. Recovery forecasts for the U.S. economy were pushed back and the consensus among managers was that things would get worse before they got better.

In the fourth quarter managers were not able to fully participate in the rally because of their low net exposures. The market was led by the technology sector, most notably semiconductor, computer, and software stocks. The semiconductor sector rallied without an improving fundamental picture, convincing many managers the rally would not last. The health-care sector was mixed on worries that the recent troubles in the industry were not isolated cases.

Going forward, if the macro environment stabilizes and business fundamentals improve in growth stocks, managers see a positive second half of the year in 2003. At the current time, the probability of a stable geopolitical environment seems wishful thinking as the U.S. seems poised to attack Iraq for its lack of cooperation with the U.N. Managers will continue keep their net exposure low until they have conviction that the markets are truly in a recovery mode.

Macro (YTD: -3.02% / DEC: +1.23%)

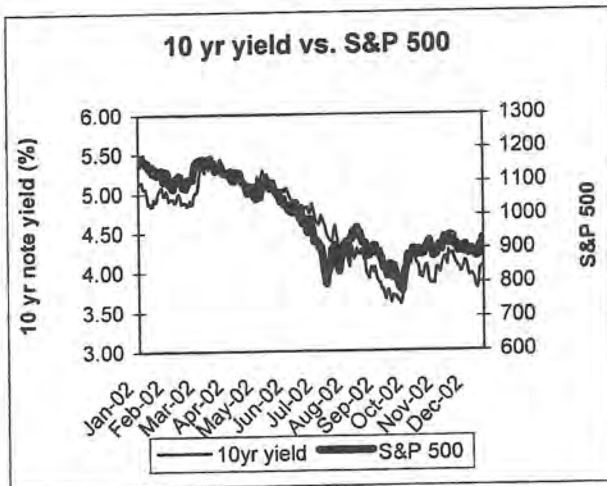
The Hennessee Macro Index advanced +1.23% during the month of December to bring the performance for the year to –3.02%.

Macro managers began 2002 optimistically. Macro investing, once popular in the early 90's, had fallen out of favor as the stock market logged impressive gains in the late 90's. However, macro managers believed that 2002 would provide a good environment for their strategies, as they thought that **several trends would manifest themselves over the course of the year.** While several of the trends did indeed come to pass, unprecedented volatility disrupted trading, as managers were stopped out of positions that they were ultimately correct on.

Macro managers turned in an unexciting first quarter, losing just less than a percent. In January, the US economy showed signs of improvement, with the Fed leaving rates unchanged at 1.75% and manufacturing improvement. Some took this as a sign that interest rates would stabilize, which they did for the quarter. The market remained fairly stable as well, with the S&P 500 starting the year at 1155 and ending the first quarter at 1144. Managers also **expected the euro, which began the year approximately at .90, to improve against the dollar**. However, as the quarter progressed, the euro actually weakened slightly on perceived US strength. Managers had begun to short the yen against the dollar on the belief that the Japanese government would try to devalue the currency in order to stimulate the export-driven economy. Managers were profitable in this trade, as the yen began the year around 124 and declined to 134 as the quarter came to a close.

During the second quarter, macro managers delivered similar performance as the first quarter, declining by more than one percent. As the charts show, the second quarter was the precursor the breakout third quarter. Interest rates gradually declined, as did the equity market. Gold and the euro picked up momentum. For the most part, managers were able to benefit from these developments. The yen, however, proved to be another story. The yen advanced from 134 to 118 during the second quarter on hopes that the government would be successful in enacting reforms. Managers gave back any gains that they had achieved during June as the equity market declined severely in June and July, losing over -7% each month. Managers were not prepared for the volatility that accompanied the decline.

Macro managers endured a difficult beginning to the third quarter, losing over –2% in July, but rallied toward the end of the quarter to gain back most of the losses and finish the quarter down under one percent. Interest rates and the market moved in lockstep, as nervous investors fled to quality. An economic recovery, which seemed to be unfolding earlier in the year, now seemed doubtful, inflicting losses on the portfolios of managers that had been anticipating a recovery. Managers lost money on the short yen trade, as the yen reached 115 during July. Even gold, which had been a steady performer for the first half of the year, lost ground in the early part of the third quarter. Nevertheless, managers were able to profit from long positions in the euro and US Treasuries. **Unprecedented sustained levels of volatility made it difficult for managers to hold positions, even when they were ultimately correct.** Risk management disciplines caused managers to exit positions as prices gyrated wildly during the quarter.



Macro managers experienced difficulty in the beginning of the fourth quarter much like they did in the third, although these losses were due to a sudden market surge rather than decline. However, the similar factor was the volatility associated with the move. Managers attributed part of the move to a technical snap back rally from oversold conditions and rebalancing of portfolios from fixed income to equities. Nevertheless, the 10-year note rallied into November, where the yield hit 3.58%. The euro rallied at year-end, along with gold, **rewarding managers that had been bullish on both for most of the year.** This allowed managers to achieve positive performance in the fourth quarter, and springboard them into what they believe will be a strong 2003.

Macro managers assert that 2003 will have a number of identifiable trends. Managers expect gold to make a run to $400 an ounce from the current $350, although they concede that pullbacks are likely along the way. They expect the euro to maintain its strength and the US stock market to be generally weak, especially prior to resolutions to the Iraq and North Korea situations. While they do not expect interest rates to go much lower, they do expect treasuries to maintain a bid as long as global instability remains a factor. Macro managers believe that they will be successful implementing their strategies in 2003, using disciplined risk management to preserve capital.

Distressed (YTD: +2.49%/DEC: +2.77%)

Year 2002 was a tumultuous, roller-coaster ride for distressed managers. It marked the toughest year for distressed managers since 1998. Final results show that the Hennessee Distressed Index produced a +2.77% gain for December, which brings the year's total return to +2.49%.

A record number of bankruptcies, defaults, and an endless string of accounting scandals characterized the year 2002. Very few predicted the events that plagued the high yield and distressed market as greed from the late 1990's led to unflattering revelations on balance sheets and jail time for some. Fortunately, as the year came to a close, the early October rally sparked interest once again for the asset class and injected liquidity back into the distressed market. With the extreme volatility exhibited throughout the year, **managers made most of their money on their outright shorts and capital structure trades.**

The theme for the first quarter 2002 was "enronitis." Following the largest bankruptcy filing ever by Houston-based Enron, a huge cast of doubt loomed over Wall Street as investors began to question the validity of corporate disclosure practices and financials. The Hennessee Distressed Index still managed to edge up +1.4% during the quarter, despite investors' mistrust of Corporate America. The quarter still had its share of

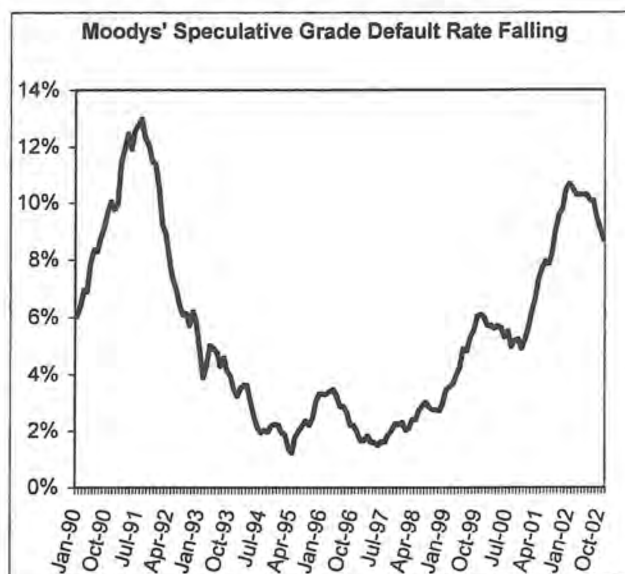
bankruptcies as companies such as Kmart, Global Crossing, and Adelphia, among others, filed Chapter 11. The market for distressed bonds was favorable for hedge fund managers as they made money mostly in their capital structure arbitrage trades. In addition, **the telecom sector provided great short opportunities as the entire sector faced a glut of capacity and bleak demand for its services and products.**

During March, the global market rally pushed high yield and distressed bond prices higher. The renewed optimism led investors to pour $6 billion into high yield mutual funds (usually a good indicator for sentiment towards junk bonds) while the Merrill Lynch High Yield Index finished the month up +2.5%. In addition, the deleveraging process forced many companies to cut costs and sell assets while ratings agencies had a laundry list of companies to downgrade.

Just when hedge fund managers were able to take a breather, **the second largest long distance carrier, WorldCom revealed that they had hidden approximately $3.8 billion in losses during June.** The scheme involved filing expenses as capital expenditures, which inflated its earnings by depreciating the company's expenditures over several years. As a result, WorldCom bonds that were worth $30 billion dropped to $4.5 billion. The news shook the financial markets and in particular, the high yield market as the Merrill Lynch High Yield Index dropped –7.8% in June alone, making it the worst month ever for the asset class. Quite a number of managers held the bonds in their portfolios and were deeply impacted. Tyco also entered the news as its CEO Dennis Kozlowski was charged with tax evasion and forced to resign, while Adelphia reports fraud by its founding family the Rigas.'

All 13 sectors that comprised Merrill's High Yield universe were in the red for June. The major selloff was exacerbated by a number of downgrades in the quarter, which put further pricing pressure on the asset class. Managers who traded actively were the beneficiaries of this type of volatile market, whereas managers who held on to their long distressed bond positions saw their holdings depreciate. Sectors hit the hardest were telecom, cable, and energy. Unfortunately, many managers reported an overhang in supply and not enough demand, especially, as **WorldCom bonds alone accounted for 10% of the high yield market.**

Then in July, drowning under a huge debt burden, **WorldCom threw in the towel and filed for Chapter 11 protection from its creditors. The filing represented the largest bankruptcy ever** as the company reported $107 billion in assets at the time. Though majority of managers already exited their positions, there were some who still held the bonds and experienced huge markdowns as liquidity dried up completely. By month-end, the Merrill Lynch High Yield Index fell another –4% bringing their year's return to –9%, making it the worst performer in its asset class. **In July alone, 27% of the high yield market traded at distressed levels (1,000 basis points over treasuries) breaking the record 8% set in 1998 while the default rate peaked at close to 11% (see chart on next page).** In addition, distressed managers reported that the average high yield bond price traded at 70 cents to the dollar.



In August, the quiet passing of the SEC's August 14 deadline for public companies to verify the accuracy of their financials spurred a rally during mid-month. This proved to be short-lived as geopolitical issues came to the forefront as tensions increased in the Middle East. By the end of September, there was a flight to quality towards US Treasuries. The 10-year note saw its yield fall to 3.73%, its lowest yield in almost 40 years. Due to the absence of liquidity, hedge fund managers tried actively to maintain a diversified portfolio and more importantly, to hold smaller position sizes. The only significant area of

profitability was in short equity positions. On the bankruptcy front, USAirways filed for Chapter 11. It was no surprise by month-end that by September, the Hennessee Distressed Index's third quarter return came in at –4.27%.

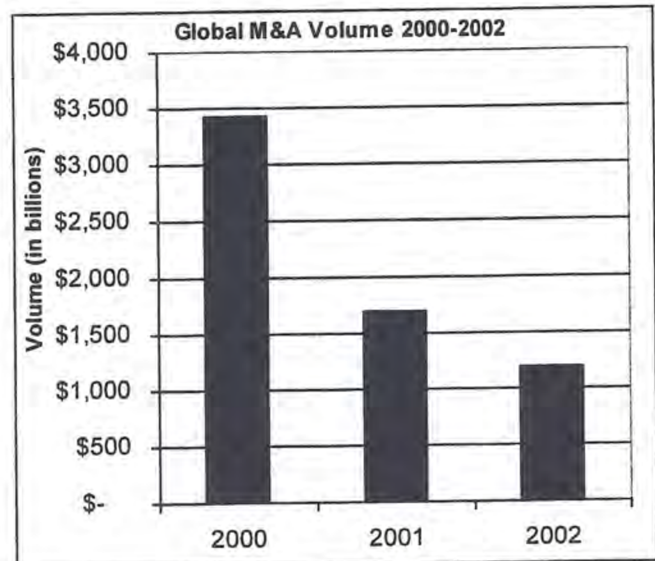
The credit markets continue to be unforgiving as credit spreads hit an all-time high on October 10. **The spread above US Treasury peaked at 1,086 basis points vs. US treasuries as intra-day volatility had run rampant.** Debt issuance by this time had dried up completely. By November, volatility, which previously reached levels of 50 or more (VIX Index), now contracted to 30, while spreads over US Treasuries narrowed to 810 basis points. Hedge fund managers reported gains from their long distressed positions as liquidity came back to the market. In fact, **in November, the Merrill Lynch High Yield Index and DLJ Distressed Index had a good month as they gained +6.3% and +8.4%, respectively. It was one of the best months ever for high yield securities. It was reported that the rock bottom prices in the distressed market due to the fire-sale of assets throughout the year had attracted interest from large institutions for the asset class.**

The Hennessee Distressed Index produced a +5.13% return for the fourth quarter. The concerns of credit quality that were evident throughout the year subsided as a renewed optimism for high yield bonds reduced the risk premium investors demanded for the asset class. Going forward, most ratings agencies expect the **default rate to continue its downward trend dropping to 6.7% by the third quarter 2003 but don't expect it to return to the average 3.5% until 2004.** A drop in the default rate coupled with a full swing in the deleveraging process managers believe will signal better years for distressed hedge fund managers ahead.

Merger Arbitrage
(YTD: -1.24%/DEC: +0.28%)

As the year 2002 drew to a close, merger arbitrageurs finished December with a +0.28% gain. Despite double-digit losses in the three major equity indices, the Hennessee Merger Arbitrage Index was still able to end the year down only –1.24%.

Hedge fund managers reported a very difficult year for their strategy as deal volume all but dried up. In 2002, global merger activity totaled approximately $1.2 trillion, down close to 30% year over year and almost 70% from the frivolous heydays of the year 2000. In addition, the number of deals dropped 17% from 2001 and was the lowest number since 1993.



In a year plagued by weak stock prices, accounting scandals, and geo-political tensions in the Middle East, **most arbitrageurs were under-invested due to the bleak deal flow environment and were equally impacted by the heightened volatility which ensued in a market where investors lost confidence in Wall Street's 'honest' practices. The steep deal flow drop can be contributed to lack of telecom activity, which comprised the majority of volume in the late 1990's.** Unlike the year 2000, larger deals were few while smaller deals populated the M&A landscape. **The largest deal of the year was Pfizer's $60 billion acquisition of Pharmacia.** In addition, companies were reluctant to partake in merger activity with the economy unstable.

Hedge fund managers saw a fair share of activity related to their strategy during the first quarter though several deals broke. In general, managers benefited from a number of deal closings most notably, Willamette/Weyerhaeuser, Dime Bancorp/Washington Mutual, Dal-Tile/Mohawk Industries, and West Coast Energy/Duke Energy. The accounting frenzy spurred

by Enron in 2001 subsided towards the end of the quarter, which benefited spreads, although there were some deals that broke. In particular, Tyco's offer for C.R. Bard fell by the wayside amid concern about accounting practices at the firm. Interestingly, several hedge fund managers didn't report significant losses as they continued to hold a short position on Tyco, which declined (instead of appreciating) during January offsetting their losses from holding C.R. Bard.

The first quarter also saw Northrop Grumman announce $11 billion hostile bid for TRW, but the deal was not favorable enough for some managers as concerns were raised that the assumption of TRW's debt would jeopardize Northrop Grumman's investment-grade rating among other concerns. In addition, Comcast's offer to buy AT&T Broadband received a lot of interest from managers. The spread on the deal widened and then narrowed by the end of the quarter as concerns were raised on the telecom sector. Another noteworthy deal was Shell's $1.9 billion offer for Pennzoil-Quaker State. **The first quarter saw improved deal flow, but managers still remain under-invested, as risk levels were high.**

News of fraud at WorldCom in the second quarter shook the market and added to the waning investor confidence that was sparked by Enron. Merger arbitrageurs finished June down -1.96%, which left the Hennessee Merger Arbitrage Index down –0.77% for the first half of the year. **Despite revelations at WorldCom, managers reported a modest amount of deal flow and no significant changes in spreads up until mid-June when they blew out due to the company revealing fraud.** The Compaq/Hewlett Packard deal came to the forefront although many arbitrageurs stayed away from the deal. Despite winning approval for the deal, Hewlett Packard's Carly Fiorina faced opposition from Walter Hewlett who filed a lawsuit against Compaq to avert the deal. The court dismissed the suit thereby allowing the deal to progress in its approval process.

The consensus among managers by this time in the year was to minimize their risk given historically low rate of returns for the strategy. Notable new deals in which managers were invested were Nestle/Dreyer's Grand Ice Cream, Unilab/Quest Diagnostics, Trigon Healthcare/Anthem, Hispanic Broadcasting/Univision, and Del Monte's buyout of HJ Heinz. Some of the more widely held deals during the quarter were Immunex/Amgen, TRW/Northrop Grumman, AT&T Broadband/Comcast, and Pennzoil-Quaker State/Shell.

There was much discussion brewing in Europe as the European Commission opened the doors for policy changes, which would allow more mergers to succeed. It was also the first time ever that the European courts overruled four deals that the European Commission decided against.

By mid-summer, volatility had escalated to extreme levels spurred in part by WorldCom's bankruptcy. **It was no surprise that the third quarter was one of the most difficult periods for managers as the Hennessee Merger Arbitrage Index fell –2.30% due to corporate governance concerns.** In a turn of events, by mid-August, the arbitrage community was aided by the SEC August 14 deadline, which was received with praise as no additional fraudulent acts surfaced. Despite the poor performance of the market in September, there was a decent amount of deal flow for the quarter. Hedge fund managers alike positioned their portfolios defensively against the market doldrums by maintaining cash in their portfolios and not remaining fully invested. Also, in the quarter, the Federal Trade Commission approved both Pennzoil-Quaker State/Shell and AT&T Broadband/Comcast, deals that many managers reported as sources of profit.

On the heels of a market rally that extended into October and November, merger arbitrage regained its footing as overall positive sentiment towards equities created a better environment for the strategy. **Managers were encouraged and increased their gross exposures to its highest for the year.** After isolating their interest in TimeWarner Entertainment, AT&T's merger with Comcast secured approval from the FCC. In addition, the largest deal of the year, $60 billion Pharmacia/Pfizer deal stumbled as the FCC requested more information from both parties. Many feared the deal would be extended an extra four months prolonging the process, thereby the spread on the deal widened spurred in part by institutional holders dumping their shares. During the quarter, several managers reported realized gains in Golden State Bancorp/Citigroup deal, as it received regulatory approvals in late October.

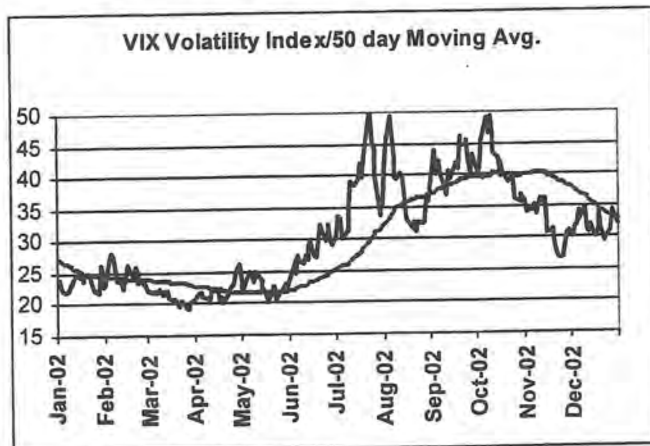
In 2002, managers witnessed a drop in assets in their

strategy as proprietary desks and multiple arbitrage managers decreased their allocation to the style. In addition, investors shied away as they saw deal flow dry up significantly in the US. Though deal volume will not reach the exorbitant amount seen in the late 1990's and 2000, hedge fund managers believe 2003 will be a better year for their strategy as consolidation takes place across many industries that have been beaten down in the past three years.

Convertible Arbitrage (YTD: +8.96% / DEC: +1.59%)

The convertible arbitrage model proved its resiliency in 2002, by producing a near 9% return in one of the most difficult years for the strategy. Keeping in mind that equity and high yield markets both ended the year with losses, those with an allocation to the strategy were grateful to their good fortune, not to mention their consultants.

Convertible arbs began 2002 on a good note. New issuance looked as if it were on pace to set yet another record following a spectacular 2001, with $10B+ worth of new paper flooding the markets monthly. **Large blue chip companies such as Ford and Merrill Lynch raised billions issuing convertible bonds, further lending credibility to the fairly young asset class.** Additionally, as the lower credit names such as Tyco and Gap found it increasingly more difficult to tap the commercial paper market, they increased their reliance on convertible bonds as a cheap and reliable source to raise capital. The new offerings were easily absorbed by the market, as appetite for convertibles had been increasing steadily since the late nineties. On the flip side, volatility as measured by the VIX remained low, making it more difficult to generate returns by trading volatility. This trend (tame volatility) led numerous managers to look for return elsewhere, in particular by placing more of the bets on the credit component of the convertible bond rather than the embedded option. **Consequently more and more convertible arbitrage portfolios began taking on characteristics of a bond fund and became more exposed to adverse credit conditions.** Economic activity in the first quarter showed signs of revival, with most economic data points hinting to recovery. The GDP growth in the first quarter was an impressive 5%, although a good portion of this growth was fueled by an inventory build up following a near halt of economic activity post September 11. **The robust (but in retrospect transient) pick up in economic activity led some money managers to assume that a rate increase may soon be in the works.** In response, many began bringing down their duration (interest rate sensitivity) by various measures, one being the short selling of treasury bonds.



The situation began to take a turn in the second quarter, when WorldCom and Adelphia both shocked the markets with their confessions of fraud and accounting games. Investors' mistrust and their reluctance to bear risk blew out credit spreads slamming the bond portion of the convertibles, just as most managers had increased their exposure (refer to previous paragraph). Regardless of their prospects, bonds sold off across the board. At first the pain was contained in the telecom sector, however, it quickly spread to other sectors as well, hurting just about anyone with exposure to credit. Before the news of WorldCom hit he wires, prominent investor, Warren Buffet, pulled off a memorable deal. The issue in effect was set up as a negative coupon convertible bond, where the buyer of the bond would end up paying Berkshire Hathaway (the issuing entity) 0.75% over the life of the bond. Although demand for the issue was strong (it was upsized to $400M from the original $250M), it appealed more to the traditional investors who liked the idea of a near the money call on Berkshire's equity with a solid bond floor.

There was little relief in sight early in the third quarter, as credit spreads continued to expand and new issuance ground to a halt. **Fear and mistrust among**

market participants reached hysteria, as the VIX spiked to 57, a level not seen since the 1987 crash. Amidst the uncertainty, the price for credit protection skyrocketed, as demand for credit default swaps jumped at a time when not many were willing to be the seller (in essence the insurer) of these instruments. This made hedging of credit a more costly proposition, eating into returns for those who still opted to use them. Others, who found the price for safety too rich, chose to sell short the equity as a hedge to their credit exposure, a decent, but not perfect methodology. The interest rate hedges that we discussed earlier, turned out to be costly and a drag on returns in the third quarter. The fear that followed the corporate scandals and possibility of war with Iraq created a massive flight to quality, as investors sold off their risky assets and moved the capital to safer instruments, mainly government treasuries. The rally in treasuries further depressed returns, as many managers were short these bonds as their interest rate hedge.

First investment grade bonds in October, and later the less credit worthy high yields in November staged an impressive come back, as credit spreads narrowed dramatically within a span of two months. Liquidity improved and the new issuance market came back to life by offering up a slew of issues that were devoured by a hungry and well-capitalized investor base. The rate of defaults slowed to 8.5% as measured by Moody's, well below the 11.4% peak reached earlier in the year, another encouraging sign for those betting on a sustained recovery, although credit upgrades are still few and far in between.

The outlook going forward is one of cautious optimism. Barring any external shocks such as a messy war, terrorist attacks, or a large unexpected bankruptcy (which may cause a systemic liquidity crisis), we may see a slow but gradual improvement in credits. Given that most convertible arbs entered 2003 with a higher credit exposure than the previous year, any improvement in credit spreads will positively affect their performance. **With roughly half of the convertible universe busted, we may see a considerable number of deal restructurings in 2003, where the issuers and holders of the bonds renegotiate the terms of the deal in such a way as to benefit both parties, not to mention their friendly investment banker.** In exchange for pushing out the maturity, the issuers may agree to exchange the out of the money (busted) convertible, with one that is in the money. The issuer benefits by postponing the redemption of these bonds, and delays an outlay of cash at these uncertain times. The investor ends up with a bond that is in the money and is therefore able to set up his/her arbitrage trades. As old issues are taken out and replaced by new ones, liquidity in the market improves. Just as in the market for treasuries where newer issues (also referred to as on the run) enjoy better liquidity than the older ones (off the run), the newer convertible issues are more liquid than the older ones. Of course the investment banks will also benefit, as they are commonly the facilitator of these exchange deals. As we emphasized throughout the year, the key issue going forward will be credit research. We were encouraged to see many hedge funds make additional hires in their credit research department, and believe that in the coming year, firms that have put together a more seasoned credit team will outperform.

International
(YTD: +3.37% / DEC: -0.52%)

International equity markets suffered yet another year of double digit losses with the MSCI World Index selling off –21.06% in 2002. Hedge fund investors took solace in these funds' ability to short and reduce exposure in times of market distress, as evidenced by the +3.37% gain by the Hennessee International Index. The international hedge fund managers were able to pull yet another year of positive returns. In fact the index has had consistent mid-single digit returns for each of the past three years.

The year 2002 began with economic weakness across the globe, political unrest in Latin America, and a global war against terrorism. The year ended without a conclusive resolution to any of the above. **Hedge funds entered 2002 cautiously. They were encouraged by the massive liquidity that central banks around the globe had been injecting into their respective economies, yet unenthusiastic because a clear improvement in fundamentals and profitability were elusive.** Therefore, net exposures were cut slightly and most funds took long positions in defensive sectors, while shorting the speculative, highly leveraged issues. The euro continued to show signs of

HENNESSEE HEDGE FUND STYLE DEFINITIONS®

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

resilience, and it appeared that the trend (strengthening of the euro) might persist throughout the year. Most managers viewed this as a double-edged sword as a strong euro would make European products less competitive in the global market place flooded with cheaper Asian made goods. On the other hand, a stronger European currency would attract foreign capital that was leaving the weaker U.S. dollar. **In retrospect, one could argue that the largest benefit of a strong euro was not fully capitalized on by the European Central Bank.** Unlike the Fed, the ECB stood pat for most of the year, leaving rates in 3% range. The logic was that inflation (which has always been more of a concern for Europeans than their American counterparts) usually follows an aggressive easing policy. On the surface, they were justified. Readings on inflation kept registering above the 2% limit (it was 2.7% in May) throughout the first half of the year. However, a more forward looking central bank might have seen the strong euro as a pre-cursor to easing inflationary pressures, and acted quicker to cut rates. ECB in fact did cut rates in December by half a percentage point, by which time growth in most European economies, in particular Germany had approached zero.

During the second quarter, Japan took center stage of the global economy, as most economic data points began to show sequential improvements. By April, unemployment had fallen to 5.2%, exports had been picking up, and wholesale prices seemed to be stabilizing. By May the Japanese government formally announced that a bottom had been reached in economic activity, citing the country's strong exports. Bank of Japan, eager to maintain the export led recovery, periodically stepped in to buy dollars, trying to prevent the yen from rising too much too fast, which would make Japanese products less attractive abroad. **At times during the second quarter, it appeared that a full-scale trade war might erupt between the U.S. and the rest of the world. President Bush's protectionist policies angered European, Asian, and even Canadians alike, paving the way for what may be tense trade negotiations in the years ahead.** Investors sold off Brazilian equities throughout the quarter, convinced that the labor-friendly leftist presidential candidate, who had been leading the polls would be Brazil's next President. Mr. Da Silva had positioned himself as the friend of the common man, and scrutinizer of big business. Being Latin America's largest and most influential economy, the fears in Brazil spread throughout the continent, as investors predicted a gradual shift to the left in South American countries.

Third quarter brought with it renewed fears of deflation, as inflation dropped to 1.5% in England. A report showed the prices of food declining by 2%, while clothing and footwear prices had fallen by some 6% year over year. An indicator gauging business sentiment in Germany turned negative and continued to decline throughout the third quarter, calling into question the existence of a recovery in Europe's largest economy. The weakness felt in Germany and England (among others) at the very least lessened the chances of a rate increase in Europe, as had been the expectation (and the ECB's bias) for most of the year. **The lack of a clear turnaround in the U.S. (by then, some were thinking a double dip recession was a possibility) put the brakes on Japan's fragile recovery.** Unlike the United States, Japan produces more than it consumes, and is therefore very dependent on a healthy end market for its products ranging from electronics to automobiles and industrial equipment. With economic activity in rest of the world, and in particular United States muted at best, only a strong consumer led spending could have sustained the recovery in Japan. Well, the consumers did not loosen their purse strings (just as they had not done so in nearly a decade) dashing any hopes of a full recovery. In Brazil, markets stopped bleeding momentarily in the wake of a $30B financing package from the IMF, but soon resumed their sell-off in anticipation of a shift of power in the fall presidential election, and the possibility that the new government will default on the country's debt payments.

Most markets around the globe started off the fourth quarter with back-to-back rallies in October and November. The prospects of an immediate war with Iraq had lessened, and some were betting on a strong Christmas season in the western economies. **With Germany's economy on life support (37,000 corporate bankruptcies expected in 2002; one in ten German workers unemployed) the ECB finally parted with its crippling fear of inflation and decided to cut rates by fifty basis points, and left the door open for more cuts to come.** In Japan focus turned to the newly appointed banking minister. Mr. Takenaka shook things up by suggesting that he will be pressuring banks to dispose of their non-performing loans and in doing so "no bank or company was too big to fail". As is the case in Japan, this stance was met with staunch opposition and it is not yet clear if the objective will be accomplished. Bank of Japan severely slowed down the aggressive purchase of equities from banks that it had begun months earlier, reason: Once they sell, the banks have to book the loss, something they do not want to do that right before they report their year-end financials. Q: We all know the banks have these losses on their balance sheets, so why would they play these accounting games? A: That's the way they do things in Japan. South Korea, which had enjoyed a broad based consumer led recovery throughout the year, faced the threat of war with its friendly neighbor up north. Additionally, investors began to call into question the strong consumer spending, which seemed to be fueled by debt, as consumers were recently introduced to unsecured personal lines of credit (credit cards). Brazil and Argentina both saw their respective markets climb, although they both finished the year deep in the red. The newly elected leftist President did not turn out to be the evil most had feared (at least not as of the date of this newsletter), as he has pledged to make economy, and not social policy the focal point of his administration. The IMF agrees so far, displaying confidence in Mr. Da Silva's pledge to honor the country's debt obligations.

The outlook for 2003 is dependent on many hard to predict elements, but primarily it is linked to the recovery in the U.S. The overhang of war with Iraq and North Korea, and the continued threat of terrorism is keeping a lid on consumer and business confidence and a clear resolution to these issues seems elusive at best. **The rapid pace of globalization and the breaking down of trade barriers, while beneficial in the long run, will continue to create growing pains for established economies.** As countries such as China and Russia enter the global market with their cheap products and labor, they will exert pressure on competitors, making it difficult to successfully raise prices. This trend will continue to squeeze margins, possibly for years to come, unless it is mitigated by gains in manufacturing productivity. The more social European economies, not having been able to shed employees fast enough (as witnessed in the U.S.) in response to the global slow down, will emerge with weaker balance sheets and may face increased difficulty competing with their nimbler American and Asian counterparts. Eastern European economies may be the beneficiary, as western corporations fed up with their strict labor laws, may shift their production facilities to these and other Asian and Latin American countries.

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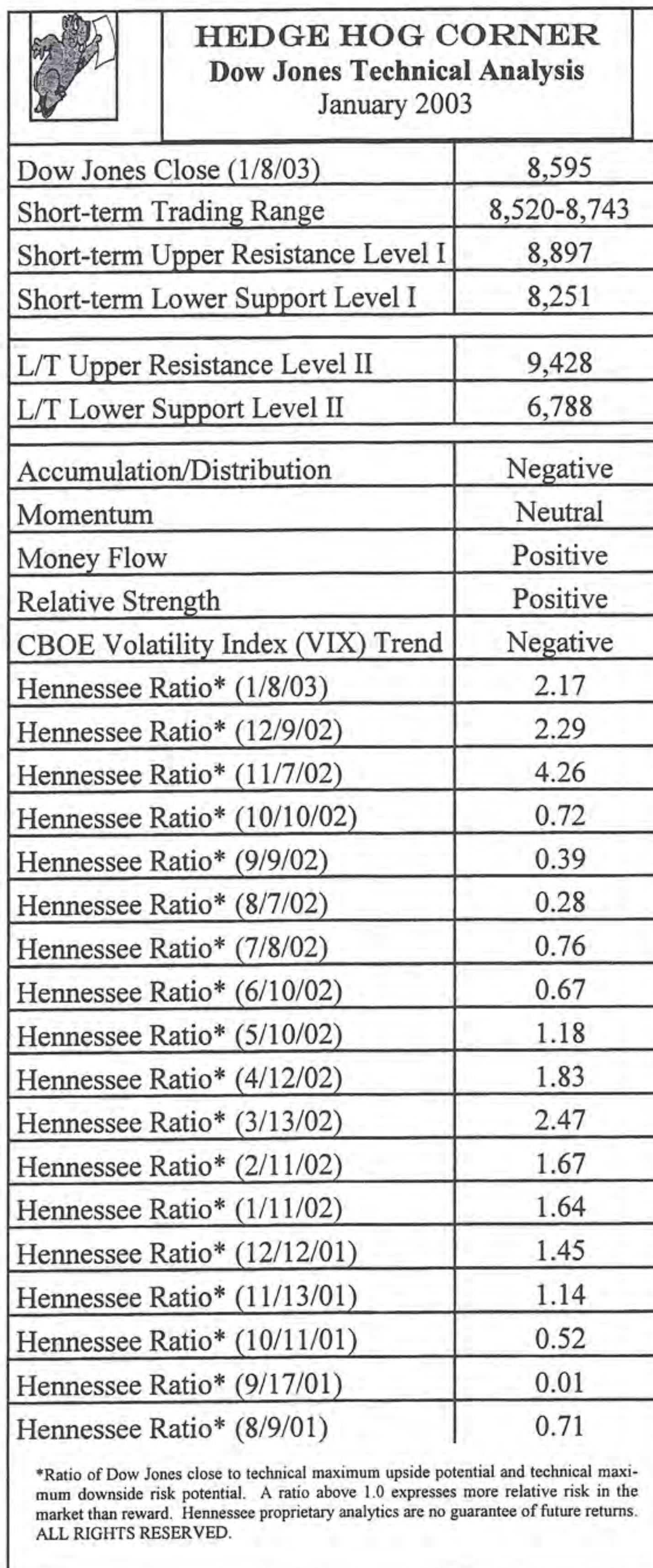

HEDGE HOG CORNER
Dow Jones Technical Analysis
January 2003

Dow Jones Close (1/8/03)	8,595
Short-term Trading Range	8,520-8,743
Short-term Upper Resistance Level I	8,897
Short-term Lower Support Level I	8,251
L/T Upper Resistance Level II	9,428
L/T Lower Support Level II	6,788
Accumulation/Distribution	Negative
Momentum	Neutral
Money Flow	Positive
Relative Strength	Positive
CBOE Volatility Index (VIX) Trend	Negative
Hennessee Ratio* (1/8/03)	2.17
Hennessee Ratio* (12/9/02)	2.29
Hennessee Ratio* (11/7/02)	4.26
Hennessee Ratio* (10/10/02)	0.72
Hennessee Ratio* (9/9/02)	0.39
Hennessee Ratio* (8/7/02)	0.28
Hennessee Ratio* (7/8/02)	0.76
Hennessee Ratio* (6/10/02)	0.67
Hennessee Ratio* (5/10/02)	1.18
Hennessee Ratio* (4/12/02)	1.83
Hennessee Ratio* (3/13/02)	2.47
Hennessee Ratio* (2/11/02)	1.67
Hennessee Ratio* (1/11/02)	1.64
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

*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.
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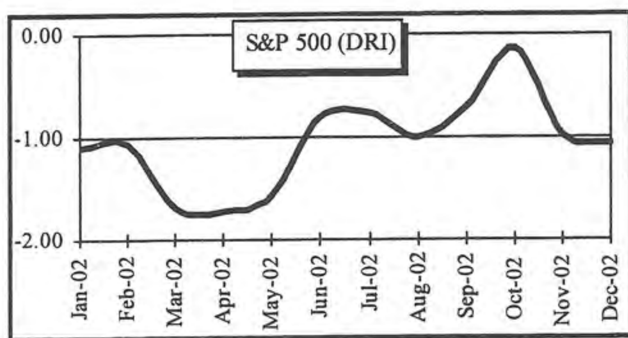
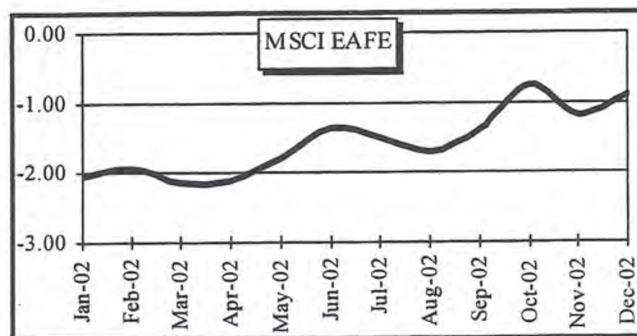
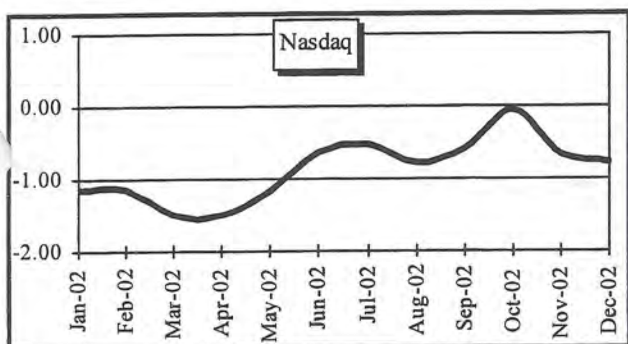
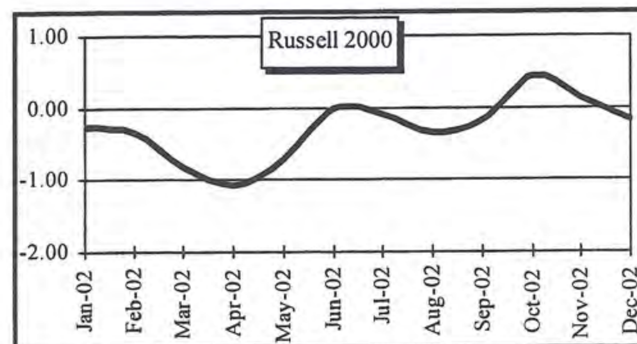
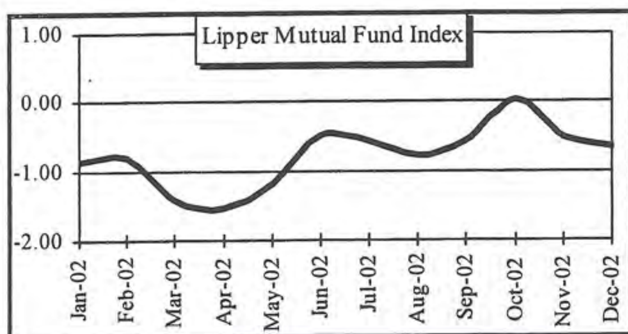
12 MONTH ROLLING SHARPE RATIO

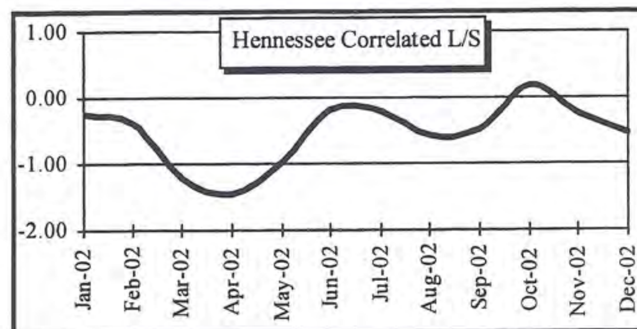








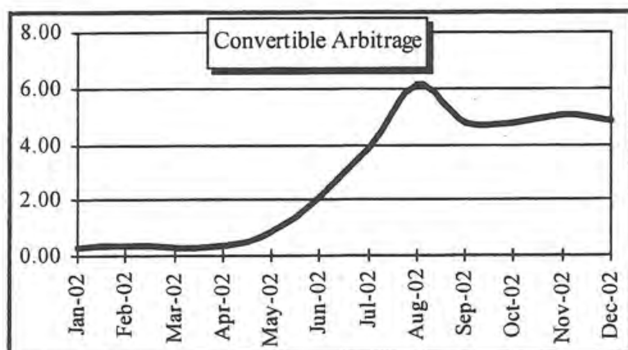


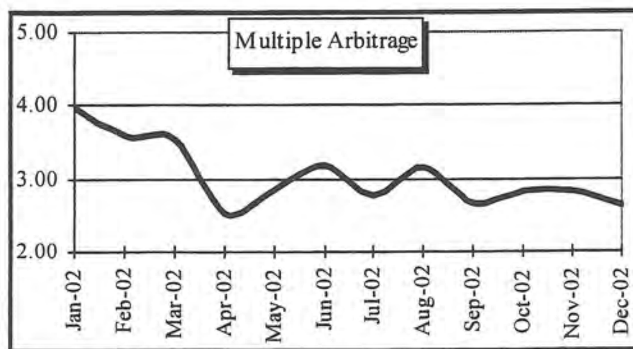


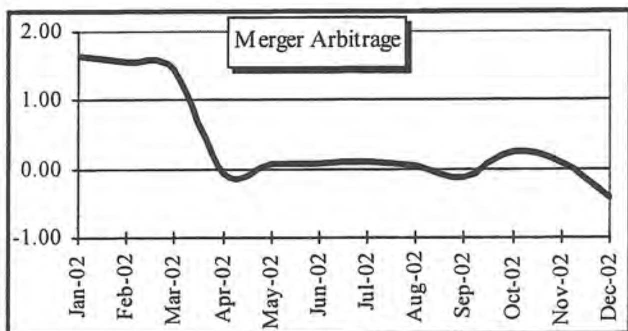
$$\textit{Sharpe Ratio} = \frac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$$

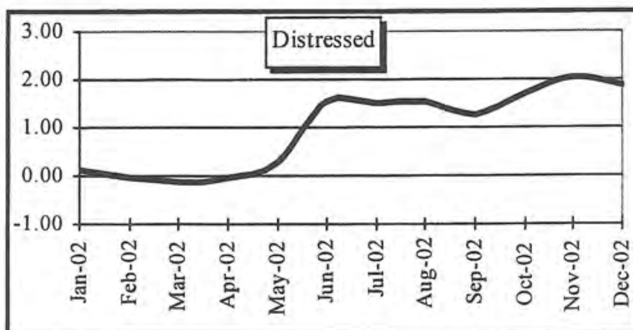
90 day T-bill

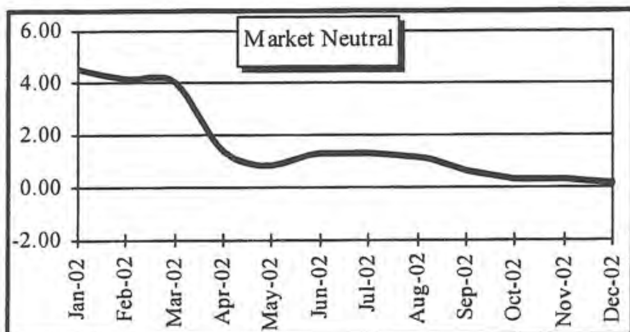
12 MONTH ROLLING SHARPE RATIO

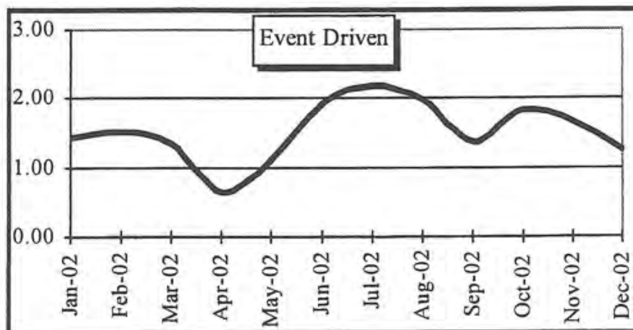








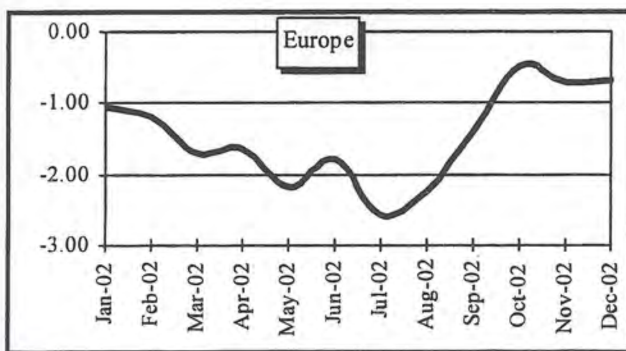


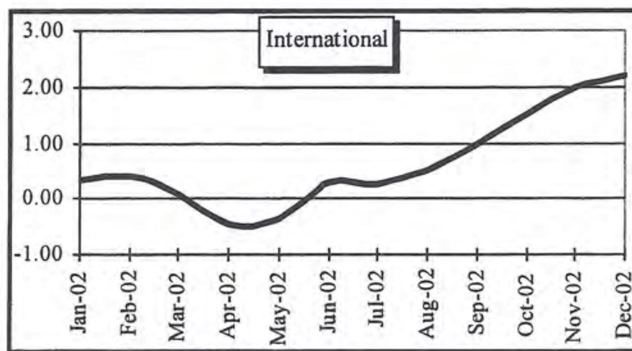


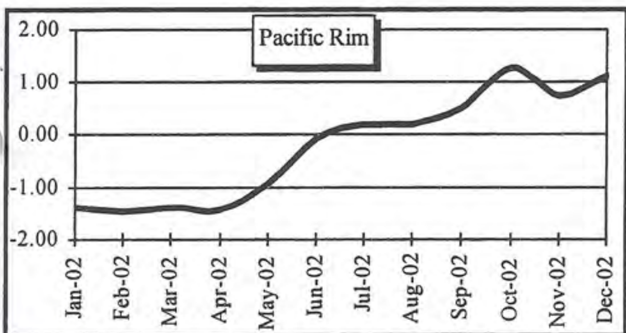
$$\textit{Sharpe Ratio} = \frac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$$

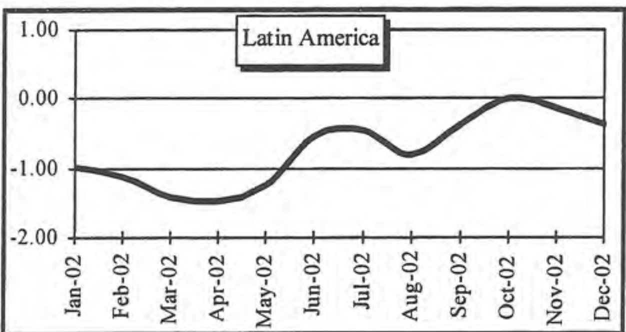
****90 day T-bill***

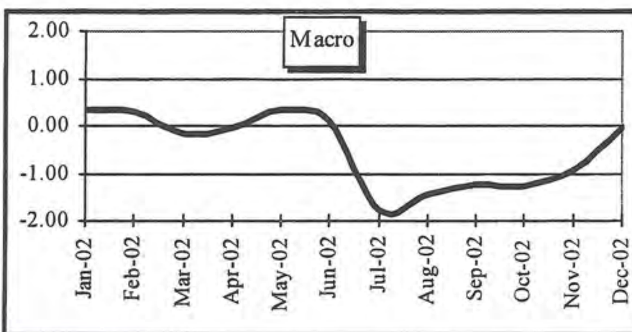
12 MONTH ROLLING SHARPE RATIO







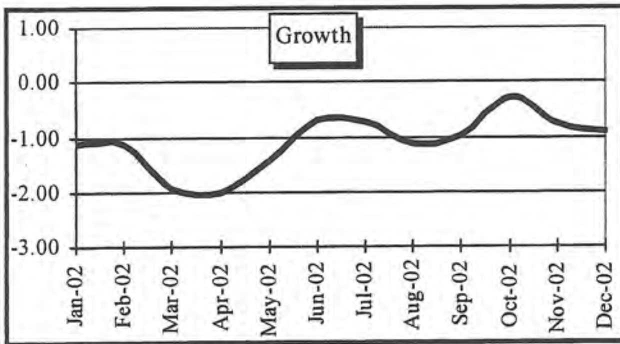


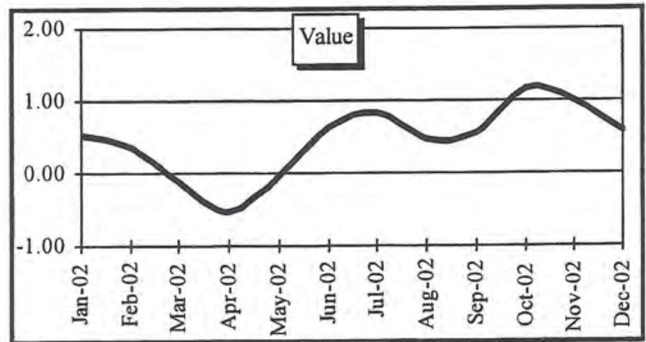


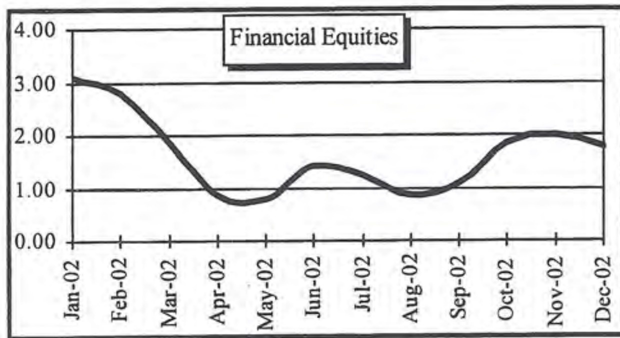
Sharpe Ratio = $\dfrac{\textbf{\textit{Annualized Return - Risk Free Rate of Return *}}}{\textbf{\textit{Annualized Standard Deviation}}}$

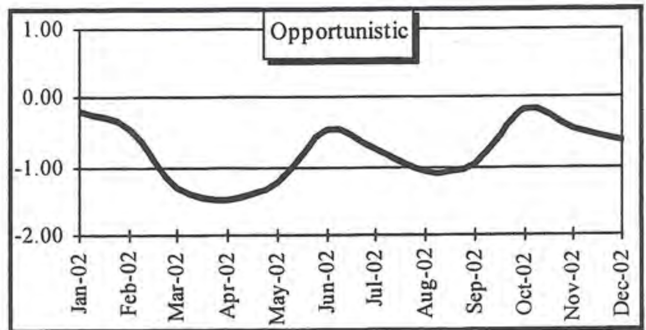
***90 day T-bill**

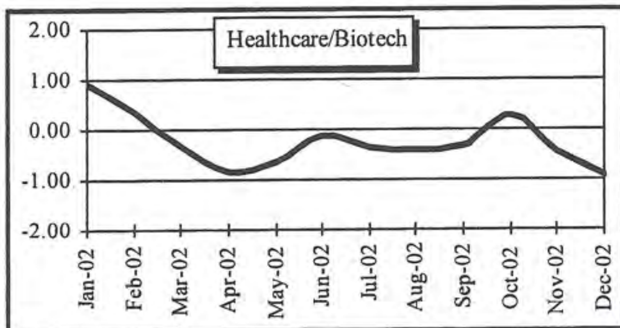
12 MONTH ROLLING SHARPE RATIO

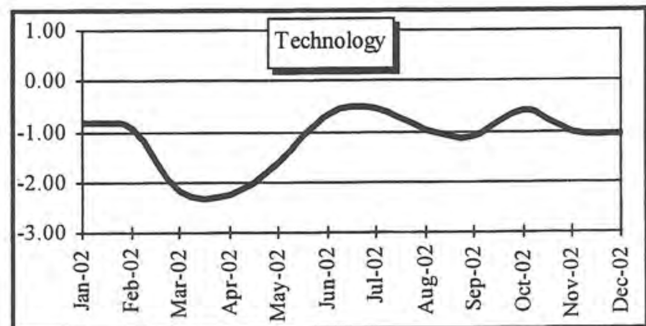












Sharpe Ratio = $\dfrac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$

***90 day T-bill**

HENNESSEE HEDGE FUND RANKINGS®

2002 (Net) MONTHLY NET	YTD	JAN	FEB	MAR	APRIL	MAY	JUNE	JULY	AUG	SEPT	OCT	NOV	DEC
CONVERTIBLE ARBITRAGE	2	6	10	15	6	11	5	7	11	2	11	10	5
DISTRESSED	8	4	15	17	5	5	8	11	17	13	16	8	3
EMERGING MARKETS	5	2	3	7	11	16	14	6	4	16	6	13	13
EUROPE	15	14	5	12	14	12	4	14	22	15	20	16	17
EVENT DRIVEN	10	11	17	11	12	10	17	17	6	5	14	14	6
FINANCIAL EQUITIES	3	9	7	1	2	3	9	20	2	21	2	7	12
FIXED INCOME	4	13	8	16	7	6	2	3	7	8	18	20	4
GROWTH INDEX	21	20	20	4	20	21	18	21	15	11	10	5	21
HEALTHCARE AND BIOTECH	23	23	22	2	23	22	22	13	21	22	4	6	22
HIGH YIELD	17	5	18	8	3	20	19	22	16	12	23	4	10
INTERNATIONAL	7	7	6	19	4	4	11	16	3	9	7	11	16
LATIN AMERICA	22	21	1	10	17	23	23	23	1	23	1	21	2
MACRO	14	16	16	22	10	9	13	9	5	4	22	18	7
MARKET NEUTRAL	9	15	13	18	13	7	3	2	8	7	17	22	8
MERGER ARBITRAGE	11	10	14	13	15	14	12	10	13	6	12	15	14
MULTIPLE ARBITRAGE	6	8	9	14	9	8	7	4	10	3	13	12	9
OPPORTUNISTIC	19	18	19	3	18	18	20	18	18	20	9	1	23
PACIFIC RIM	12	1	4	6	19	2	15	8	20	10	21	17	18
REGULATION-D	16	17	12	20	16	15	6	12	12	18	15	19	11
SHORT BIASED	1	3	2	23	1	1	1	1	23	1	19	23	1
TECHNOLOGY	18	19	23	9	21	19	10	15	14	14	3	9	20
TELECOM AND MEDIA	20	22	21	21	22	17	21	5	19	17	5	3	15
VALUE	13	12	11	5	8	13	16	19	9	19	8	2	19

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® is believed to represent 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 believed to be 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 HEDGE FUND INDICES®

HENNESSEE GROUP LLC — HEDGE FUND ADVISORY

HENNESSEE HEDGE FUND REVIEW®

www.hennesseegroup.com

2002 (Net)	YTD	YTD RANK	% of mgrs. >S&P, ytd	JAN	FEB	MAR	APRIL	MAY	JUNE	JULY	AUG	SEPT	OCT	NOV	DEC
CONVERTIBLE ARBITRAGE	**8.96%**	**2**	**100%**	1.36%	-0.03%	0.70%	1.01%	0.16%	0.11%	-1.55%	0.43%	1.55%	0.86%	2.47%	1.59%
DISTRESSED	**2.49%**	**8**	**100%**	1.92%	-0.67%	0.11%	1.31%	1.00%	-1.62%	-2.41%	-0.06%	-2.03%	-0.50%	2.81%	2.77%
EMERGING MARKETS	**5.33%**	**5**	**100%**	2.62%	1.17%	1.97%	0.51%	-0.23%	-2.35%	-1.42%	1.26%	-2.20%	1.98%	1.74%	0.30%
EUROPE	**-3.81%**	**15**	**100%**	0.47%	0.98%	0.96%	0.36%	0.09%	0.22%	-2.55%	-0.88%	-2.12%	-1.37%	0.94%	-0.90%
EVENT DRIVEN	**-0.22%**	**10**	**100%**	0.88%	-0.75%	1.52%	0.48%	0.24%	-3.08%	-3.26%	0.96%	-0.11%	0.12%	1.63%	1.29%
FINANCIAL EQUITIES	**6.69%**	**3**	**100%**	1.04%	0.83%	4.29%	1.95%	1.57%	-1.73%	-5.20%	2.09%	-4.72%	2.94%	3.53%	0.41%
FIXED INCOME	**5.47%**	**4**	**100%**	0.56%	0.37%	0.52%	0.97%	0.95%	0.81%	-0.09%	0.92%	-0.76%	-0.79%	0.22%	1.68%
GROWTH	**-11.39%**	**21**	**86%**	-0.69%	-2.19%	2.57%	-1.33%	-1.41%	-3.52%	-5.87%	0.04%	-1.27%	1.09%	3.54%	-2.64%
HEALTHCARE AND BIOTECH	**-17.09%**	**23**	**59%**	-3.67%	-2.91%	3.54%	-3.23%	-2.04%	-5.25%	-2.53%	-0.54%	-4.72%	2.42%	3.54%	-2.67%
HIGH YIELD	**-6.00%**	**17**	**50%**	1.71%	-0.85%	1.90%	1.82%	-0.76%	-3.62%	-7.04%	-0.04%	-1.33%	-2.15%	3.67%	0.99%
INTERNATIONAL	**3.37%**	**7**	**100%**	1.25%	0.96%	-0.22%	1.38%	1.11%	-1.76%	-2.68%	1.74%	-1.02%	1.29%	1.92%	-0.52%
LATIN AMERICA	**-16.81%**	**22**	**50%**	-1.21%	4.71%	1.61%	-0.02%	-4.04%	-9.05%	-11.84%	8.48%	-15.48%	8.98%	0.07%	2.90%
MACRO	**-3.02%**	**14**	**100%**	0.37%	-0.68%	-0.59%	0.52%	0.37%	-2.07%	-2.29%	1.02%	0.25%	-1.84%	0.72%	1.23%
MARKET NEUTRAL	**1.94%**	**9**	**95%**	0.47%	-0.27%	-0.06%	0.41%	0.54%	0.72%	0.56%	0.85%	-0.52%	-0.61%	-1.32%	1.16%
MERGER ARBITRAGE	**-1.24%**	**11**	**95%**	0.94%	-0.41%	0.79%	0.09%	-0.19%	-1.96%	-2.36%	0.27%	-0.21%	0.52%	1.03%	0.28%
MULTIPLE ARBITRAGE	**4.90%**	**6**	**100%**	1.13%	0.09%	0.75%	0.60%	0.37%	-0.99%	-1.15%	0.52%	0.36%	0.38%	1.75%	1.01%
OPPORTUNISTIC	**-9.49%**	**19**	**97%**	-0.22%	-2.02%	2.62%	-0.32%	-0.64%	-4.28%	-3.31%	-0.22%	-3.15%	1.20%	4.30%	-3.53%
PACIFIC RIM	**-1.30%**	**12**	**100%**	2.63%	1.04%	2.02%	-1.13%	2.38%	-2.59%	-1.84%	-0.49%	-1.25%	-1.58%	0.76%	-1.07%
REGULATION-D	**-5.31%**	**16**	**100%**	0.09%	-0.09%	-0.43%	-0.02%	-0.22%	-0.72%	-2.47%	0.33%	-2.69%	-0.24%	0.33%	0.73%
SHORT BIASED	**15.84%**	**1**	**100%**	2.09%	2.83%	-3.87%	2.89%	2.72%	4.20%	2.66%	-1.11%	4.26%	-1.02%	-3.43%	3.05%
TECHNOLOGY*	**-8.12%**	**18**	**85%**	-0.68%	-4.58%	1.82%	-1.60%	-0.68%	-1.76%	-2.56%	0.14%	-2.06%	2.48%	2.73%	-1.42%
TELECOM AND MEDIA	**-10.49%**	**20**	**100%**	-2.06%	-2.24%	-0.50%	-2.54%	-0.47%	-4.48%	-1.32%	-0.24%	-2.57%	2.08%	3.79%	-0.21%
VALUE	**-2.91%**	**13**	**94%**	0.69%	-0.06%	2.46%	0.63%	0.01%	-2.93%	-4.78%	0.84%	-3.12%	1.25%	3.81%	-1.42%
HENNESSEE HEDGE FUND INDEX	**-3.43%**		**92%**	**0.35%**	**-0.80%**	**1.53%**	**-0.08%**	**-0.19%**	**-2.38%**	**-3.27%**	**0.52%**	**-1.71%**	**0.87%**	**2.39%**	**-0.58%**
CORRELATED**	**-8.25%**		**88%**	**-0.45%**	**-1.85%**	**2.63%**	**-0.76%**	**-0.77%**	**-3.29%**	**-4.56%**	**0.29%**	**-2.53%**	**1.54%**	**3.58%**	**-2.09%**
NON-CORRELATED**	**2.10%**		**98%**	**1.10%**	**-0.34%**	**0.63%**	**0.66%**	**0.28%**	**-1.20%**	**-1.90%**	**0.46%**	**-0.28%**	**0.05%**	**1.44%**	**1.23%**
GLOBAL	**-1.01%**		**95%**	**1.19%**	**1.14%**	**0.80%**	**0.42%**	**0.34%**	**-2.30%**	**-3.13%**	**1.34%**	**-2.49%**	**0.67%**	**1.20%**	**-0.05%**
S&P 500 W/DIV	**-22.19%**			-1.44%	-1.97%	3.76%	-6.07%	-0.74%	-7.12%	-7.80%	0.60%	-10.87%	8.84%	5.85%	-5.90%
DJIA	**-16.76%**			-1.01%	1.88%	2.95%	-4.40%	-0.21%	-6.87%	-5.48%	-0.84%	-12.37%	10.60%	5.94%	-6.23%
LIPPER MUTUAL FUNDS	**-18.77%**			-1.33%	-3.21%	5.13%	-2.52%	-1.39%	-6.64%	-8.64%	0.41%	-8.12%	5.23%	6.39%	-4.46%
MSCI EAFE (USD) PRICE	**-17.52%**			-5.36%	0.57%	5.11%	0.45%	0.93%	-4.14%	-9.94%	-0.47%	-10.88%	5.30%	4.42%	-3.42%
RUSSELL 2000	**-21.33%**			-1.04%	-2.74%	8.04%	0.83%	-4.54%	-5.09%	-15.18%	-0.37%	-7.34%	3.10%	8.80%	-5.72%
NASDAQ	**-31.52%**			-0.84%	-10.47%	6.58%	-8.51%	-4.29%	-9.44%	-9.22%	-1.01%	-10.86%	13.45%	11.21%	-9.69%
LEHMAN BROS. INT. GOVT. CORP.	**9.82%**			0.52%	0.79%	-1.52%	1.65%	1.00%	0.86%	1.18%	1.49%	1.79%	-0.39%	-0.09%	2.18%

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