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®	+1.92%	+19.69%
S&P 500 (DRI)	+5.26.%	+28.55%
LIPPER MUTUAL FUNDS	+3.69%	+34.21%
CORRELATED* HEDGE FUNDS	+1.70%	+22.18%
NON-CORRELATED** HEDGE FUNDS	+1.26%	+12.69%
GLOBAL HEDGE FUNDS	+3.75%	+26.75%

PERCENTAGE OF CORRELATED* MANAGERS OUTPERFORMING THE:

	DEC	YTD
S&P 500 (DRI)	10%	33%
Lipper Mutual Funds	22%	26%

TOP (3) PERFORMING:	DEC		YTD
Latin America	+5.84%	Latin America	+70.19%
Pacific Rim	+4.80%	Financial Equities	+36.25%
Emerging Markets	+4.15%	Healthcare & Biotech	+32.60%

BOTTOM (3) PERFORMING:	DEC		YTD
Pacific Rim	-2.37%	Short Biased	-20.31%
Short Biased	-0.65%	Market Neutral	+1.62%
International	-0.30%	Fixed Income	+2.74%

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

MARKET SUMMARY - DECEMBER 2003

As December came to a close, the stock market officially returned to the black on an annual basis for the first time since 1999. After three straight years of dismal performance, the equity markets roared back to life in 2003. December saw the S&P 500 return +5.26%, bringing year-to-date returns to +28.55%. All major market indices finished in positive territory for the first time in four years as early fears of conflict in Iraq and weakness in the U.S. economy subsided as the year went on.

The Hennessee Hedge Fund Index advanced +1.92% in December and advanced +19.69% for the year. Entering 2003, most fund managers were keeping an eye on the prospects for war and carefully watching economic indicators for signs of weakness. **As the year went on, managers increasingly noted that**

the Federal Reserve's aggressive monetary policy, when combined with the current white house administrations tax cuts, were producing the desired effects on the economy. These factors, when taken into consideration with the resolution of conflict in Iraq and robust consumer spending in the United States, helped spur the equity markets. The return of the retail investor into the market also helped spur speculative stock buying to heights similar to what was seen in 1999. Long/short equity managers that focused on these out of favor, high beta stocks were the biggest beneficiaries of the rise in the equity markets for the year. **Because of this run up in high beta stocks, many managers adjusted their portfolio exposure levels to be more net long as the year went on, realizing that fighting for their shorts was not paying off.** The nimbleness of hedge funds again shone through as many managers quickly adjusted their positions following the March and April run-up of the S&P to capture market gains for the rest of the year.

The S&P 500 declined –3.10% in the first quarter as the market sold off, fearing potential conflict and weakness in the U.S. economy. GDP growth in the fourth quarter of 2002 further exacerbated these fears as it grew only +1.3%. Unemployment weighed on the market as well, as the overall unemployment rate kept rising and job losses continued to mount. As the quarter dragged on, volume on the NYSE remained extremely light as most traders waited for the uncertainty surrounding Iraq to be resolved. Additionally, potential problems with North Korea added a new dynamic to the fear present in the markets. Managers began the quarter conservatively positioned and ended the quarter in much the same stance. Managers held low net exposures and high levels of cash throughout the quarter. Even though the conflict in Iraq seemed resolved by the end of March, many managers felt that the fundamentals in the economy had not yet improved.

As the first quarter closed, managers did begin to note that there were some positive technical signals in the market that could send the market higher in the near term. **Managers pointed out that in March, volume was better on up days than down days, indicating that larger investors believed a short-term floor had been found. Managers could not have been more right, as the S&P 500 advanced +15.41% in the second quarter.** The equity market surge was no doubt driven by the quick conclusion to the war in Iraq and better than expected earnings announcements for the first quarter. The equity markets continued their surge even with a lackluster GDP growth figure of +2.0% for the first quarter. Also, the Federal Reserve cut rates 25 basis points to a 45 year low in late June on Fed fears of deflation and continued weakness in the labor market. Though funds were still conservatively positioned by historical standards, over the course of the quarter managers began increasing their exposure to the market in order to participate in the strong rally. As the third quarter approached, managers were cautiously watching for an economic and earnings recovery and were ready to react either way should they surprise or disappoint.

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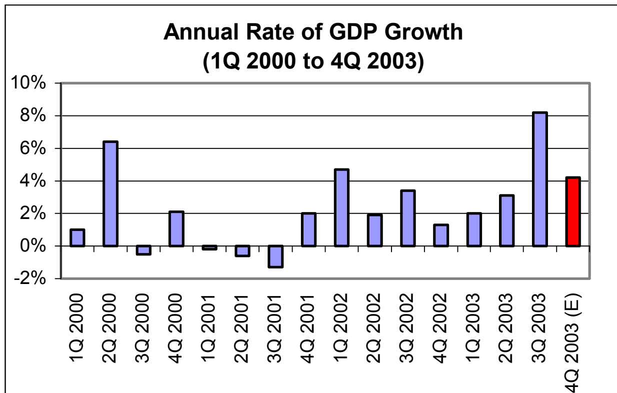


The third quarter saw the S&P 500 fall back to rationality as it advanced +2.56%. Early in the quarter the markets were driven by a surprisingly robust GDP growth figure of +3.1%. This easily topped expectations but hedge funds remained wary as most of the growth seemed to be driven by defense spending (defense spending increased 44.1% in the quarter).

Stocks rallied in the fourth quarter, as the S&P 500 advanced +12.13%. The U.S. economy continued its recovery in the quarter as consumer confidence remained high, unemployment rates continued to decline, and the economy continued to add jobs. The third quarter GDP growth rate astounded the street as it came in at a scintillating +8.2%. **As the equity market surged through the year, managers increased their net exposures to take advantage of any upside in the markets.** Managers repeatedly noted that the run-up in high beta stocks with poor fundamentals presented an opportune environment for stock-picking. Managers are seeing a robust two-sided market as 2004 begins, with ample ideas on both the long and short side.

As further evidence of the increase in speculative investing within the equity markets in 2003, the following statistics paint a clear picture. In 2003, on the NYSE, the performance of high beta, low price stocks outperformed low beta, high price stocks. **Stocks less than $1 have appreciated 379%, $1-$5 have appreciated 65%, $5-$10 have appreciated 35%, $10-$20 have appreciated 22%, $20-$40 have appreciated 17%, $40-$80 have appreciated 13%, and stocks greater than $80 have appreciated only 8%.**

As we enter 2004, managers are approaching the year with optimism. **Many feel that while the direction of the equity markets is far from certain, expectations are for a solid two-sided market.** While managers' net exposures have risen continuously since the first quarter of 2003, they have begun to pare back their exposures moderately in the past month. Heading into 2004, managers will be looking at the following consensus to mold their view on the market's direction:

a) Current expectations are for US GDP to grow at a 4.3% rate in 2004. **Managers are looking for businesses to increase their capital expenditures and take the lead in creating GDP growth in the coming year.** 2003 saw consumer spending lead the economy and with the current levels of debt running so high for the individual consumer, managers feel that in the absence of a pick up in business spending, the economic recovery could falter.

b) Earnings for the S&P 500 in the first quarter are expected to increase 22.4%, according to First Call. Again, **managers will be looking for strong earnings and profit growth from this round of earnings.** In particular, managers will keep a careful watch on capital expenditures.

c) Managers are still concerned about a consumer debt bubble, exacerbated by the 45-year low in interest rates (1.0%). **Even with a new round of tax cuts scheduled to take place this year, managers feel the debt burden on the average consumer is quite high.**

d) Current deficits (trade, budget, and current account) run by the U.S. government are at all time highs and **managers have noted that should the current administration's policies not produce a robust job recovery, economic prospects could be adversely affected.**

e) The current U.S. recovery has been a jobless recovery to date. Heading into the 2004 election year, the unemployment rate and number of jobs added to the economy will be paramount to any reelection prospects of President Bush. **Managers are keeping a close eye on this, viewing those numbers as the last key cog remaining for the President to fulfill in his reelection effort.**

With the economy showing continued momentum heading into 2004, economists are increasingly stating that they are seeing solid growth, improvement in the labor market and growing corporate profits. **Manag-**

ers are less inclined to comment on market direction, but there is little doubt that though they are positioned conservatively, they feel 2004 could provide an ideal market for hedged portfolios.

HEDGE FUND PERFORMANCE
SUMMARY - DECEMBER

The Hennessee Hedge Fund Index® advanced +1.92% for the month of December, with the markets finishing 2003 on a strong note. The major indices all advanced in December, as the Dow Jones Industrial Average advanced +6.86%, the S&P 500 rose +5.26%, and the NASDAQ advanced +2.20%. **For 2003, the Hennessee Hedge Fund Index® gained +19.69%,** with the Dow Jones Industrial Average up +25.33%, the S&P 500, up +28.55% and the NASDAQ, up +50.01%.

For the entire year, correlated managers (long/short equities) advanced +22.18%, while non-correlated managers (event driven/arbitrage) advanced +12.69% and global managers ended up, +26.75%. The top performing styles for the year were Latin America (+70.19%), Financial Equities (+36.25%), and Healthcare and Biotech (+32.60%). The worst performing styles during 2003, were Short Biased (-21.26%), Market Neutral (+2.04%), and Fixed Income (+2.88%).

The Hennessee Latin America Index gained +70.19% in 2003. After a horrendous 2002, Latin American stocks had their best year since 1991. In 2003, Argentina's economy rebounded, while investors became confident that Brazil's new President, Luiz Inacio Lula da Silva could lead the country out of dire straits. The global economic recovery, coupled with low interest rates helped stocks around the world, but most important has been the spike in demand for commodities, helping resource rich countries like Brazil. The best example of investor exuberance in the emerging markets could be seen by Brazil's Capitalization bond, a benchmark for the country's sovereign debt, which rose to a price above par for the first time.

The Hennessee Financial Equities Index rose +36.25% in 2003. With the economic recovery underway, investors rotated capital out of defensive names and into stocks that would have operating leverage to the economy, such as financials. Many blue chip financial companies reported solid earnings due to previous cost cutting measures and a general pickup in business. Specifically, financial stocks were helped by an increase in merger and acquisition activity, securities underwriting, and mortgage origination.

The Hennessee Healthcare and Biotech Index advanced +32.60% for 2003. While large cap pharmaceutical companies had a dismal year, HMOs, biotechnology, and healthcare sectors all turned in strong returns for 2003. The continued economic recovery convinced investors to rotate away from "defensive" drug stocks, hurting the group already reeling from disappointing earnings and weak pipelines. Genentech's positive news in May on phase III clinical trials for Avastin sparked the 2003 biotech rally. Biotech stocks also benefited from the FDA's desire to quicken the approval time for new drugs.

The Hennessee Short Biased Index was the worst performing index for 2003, falling –21.26%. In a reversal from 2002 in which Short Biased was the best performing index, 2003 was one of the worst environments for dedicated short sellers in recent memory. When momentum takes control over fundamentals, and the market rise rapidly, all stocks rise with the tide. Dedicated short sellers had very few places to hide as the markets rose sharply through the year.

The Hennessee Market Neutral Index rose +2.04% in 2003. With short selling being so difficult this year, many managers were unable to produce strong gains for the year. Many managers were short high beta, speculative stocks, and these stocks saw the biggest gains during the year.

The Hennessee Fixed Income Index rose +2.88% in 2003. The third quarter of 2003 was difficult for fixed income managers. July was particularly challenging with volatility surging and Treasury yields backing up. August proved to be a little better, but arbitrageurs suffered losses in the first days of the month, and and very few were able to post positive results by the end of the month. Mortgage-backed securities took a hit in the third quarter, as the increase in volatility in the fixed income arena hurt the MBS market.

STYLE PERFORMANCE SUMMARIES – DECEMBER

Value
(YTD: +24.11% / DEC: +2.71%)

The Hennessee Value Index advanced +2.71%, while the S&P 500 advanced +5.26% for the month of December. For 2003, value managers produced solid returns on a risk-adjusted basis, as many capitalized on energy and commodity related stocks, as well as homebuilders. **The Hennessee Value index advanced +24.11%, while the S&P 500 advanced +28.55% for 2003.** Small cap stocks outpaced their larger brethren in 2003, as the Russell 2000 advanced +47.25%, with both value and growth components both performing well. Value managers made most of their performance from their long portfolios, as most were unable to avoid losses on their short portfolios.

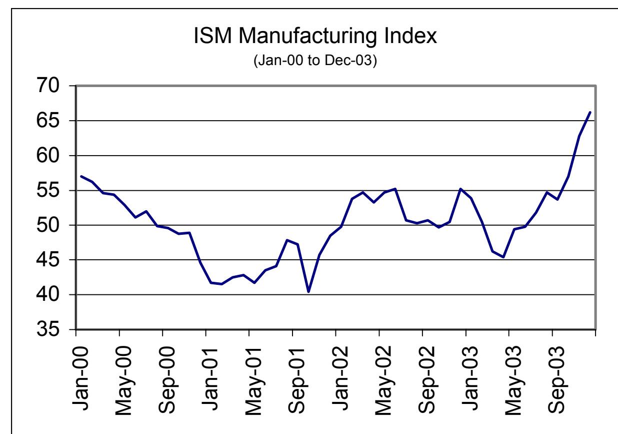
The first quarter of 2003 had a strong start, but faded quickly on a weak economic picture and an unstable geopolitical situation. Many value managers questioned whether the American consumer could support the economy, especially in the absence of strong corporate spending. Managers were also concerned about the hot housing market, and opined as to whether it would continue. The S&P 500 continued to slide mid quarter, as the war in Iraq looked more and more like a reality, and concerns over North Korea and Iran were brought to the forefront.

Higher than expected jobless claims, a decline in consumer confidence, and a worrisome trade imbalance dampened the belief of an economic recovery. Automakers reported disappointing February sales and indicated they were cutting production. The trend of higher energy prices had begun, as the world braced for possible disruptions to oil and natural gas supplies. Many value managers used the weak market to accumulate shares in their favorite stock picks. The worries over the economy took a backseat to the war with Iraq, as investors were glued to their television sets eager to see "shock and awe". The travel industry was impacted the most, and airlines were again hit hard.

The markets roared back in the second quarter, with a U.S. rout in Iraq, investors turned their attention to the economy and the earnings season. IBM and GE reported better than expected earnings, fueling optimism that more companies would follow. Managers were skeptics, and believed that cost cutting and a weak dollar were the reasons for better earnings figures, not true earnings growth. **Value managers were helped by their exposure to homebuilders, which performed well.** Most managers were unable to make money on their shorts, in what was considered a momentum driven rally.

The markets continued their climb in May, led by more speculative names. Value managers were also able to participate in the rally, as they benefited from utility stocks, which rose due to the federal legislation that reduced the tax rate on stock dividends. The second quarter ended in a choppy trading environment but was positive. **Nonetheless, it was a difficult quarter for value because speculative stocks, favorite shorts of value managers, increased the most.**

A brief sell-off started the third quarter, fueled by rising interest rates, but the S&P 500 ended positive in July, stuck in a trading range**. Managers continued to grumble that fundamentals and valuations had decoupled.** August was an important month, as a large amount of economic data was released. The U.S. manufacturing sector expanded, as the ISM Index jumped to 54.7 in August from 51.8 in July.



The re-importation of prescription drugs from Canada became the hottest topic of debate, and put the Medicare Drug Benefit legislation on the front burner. While this legislation made headlines, the healthcare sector treaded water, as investors focused on other sectors that would benefit more from a recovering

economy.

The summer blackout in the Northeast and Midwest was more of a headline than any real concern, but helped bring the country's energy plans in the spotlight. Energy prices continued to rise, and oil prices spiked.

The end of the third quarter was a roller coaster month for equity markets, but managers thought it was a better stock picking market. Commodity related stocks and homebuilders helped value managers produce positive returns even though the S&P 500 fell in September. Homebuilders released good earnings and reported increasing backlogs. The loss of jobs to China and India was a major headline, amid mounting concerns over a lack of job creation in the U.S.

The markets continued their upward movement in the fourth quarter, with growth stocks the favorites. Homebuilders continued to be strong, as industry stalwarts, Lennar and Hovnanian reached 52-week highs. Some value managers were hurt from their long exposure to the hospital sector, which took a hit over news of debt concerns in a number of companies. Merger activity in the managed care sector also hurt overall returns as some managers were short the target companies in the following deals, Anthem/Wellpoint and United Health/Mid-Atlantic Medical. **The end of the year brought additional good economic news, and lent support for higher commodity prices, a positive for managers who had positions in oil/gas exploration and production companies.**

The fourth quarter was again another difficult period for healthcare, as investors continued to rotate out of "defensive" healthcare and into economically sensitive names, as good earnings could not help these stocks. By the end of the fourth quarter the passage of the Medicare Drug Benefit legislation was a positive for many healthcare companies, most notable rural hospitals and nursing facilities.

Most value managers have been skeptical of the economic recovery, but over the past six months many managers have decided not to fight the tape and have moderately increased net exposure. Managers believe that stock prices will no longer move on the news of an economic recovery, but on the ability of individual companies to execute their company plans. **Stock picking should take on more of an importance in 2004, playing into the style of value managers.**

Growth
(YTD: +22.27% / DEC: +1.27%)

The Hennessee Growth Index advanced +1.27%, while the benchmark NASDAQ Composite Index advanced +2.20% for the month of December. 2003 turned out to be a good year for growth managers, as the technology, biotechnology and retail sectors produced strong returns for the year. **The Hennessee Growth Index advanced +22.27%, while the NASDAQ advanced +50.01% for 2003.** Similar to value managers, most growth managers made all of their performance on their long portfolios, and suffered losses on their short portfolios.

Growth managers entered the first quarter of 2003 nervous about the geopolitical situation, and the imminent conflict with Iraq. The economic outlook also was bleak as companies announced poor earnings and issued weaker future outlooks. The most shocking Wall Street headline came from AOL Time Warner when it announced a $100 billion net loss, the largest in U.S. corporate history. Technology stocks were weak, especially the semiconductor sector, which sold off on negative sales news. The retail sector also declined on war worries and poor weather across the U.S.

By the end of the first quarter, semiconductor stocks and retailers had bounced back, but investors had many macro issues to be concerned about. The outcome of the war in Iraq was still not certain, as news channels continually reported that the U.S. military's supply lines were stretched too thin, and military pundits felt that we lacked troop strength. Besides the war, the SARS outbreak, higher energy prices, and the uncertain economic picture led to increased volatility in the markets. **Managers complained that it was a difficult time to be a stock picker because individual stock price movements became more correlated to the overall market moves.**

The second quarter was the best quarter of 2003 for growth managers and the markets as a whole.

With major combat operations over in Iraq, investors poured money into equity mutual funds, especially aggressive growth funds. This helped kick off a dramatic rally in markets, led by high beta stocks. America's success in Afghanistan and Iraq, coupled with the belief that Bush's economic stimulus package would lead to growth, helped investor confidence. The rally continued in May based on improved corporate earnings, the Fed's action to lower interest rates, President Bush's tax cut package and the containment of the SARS epidemic. During the second quarter, the dollar began its slide downward, a benefit for large U. S. multinational corporations.

The AMEX Biotech Index soared in May, up +20.5%, as Genentech's positve phase III trials for Avastin spurred investor interest in the biotech sector. Better earnings and sales after two years of poor performance in biotech, coupled with the FDA's desire to move faster through the approval process buoyed the sector. Furthermore, consolidation in the software application sector signaled the possibility that the merger and acquisition environment was moving in a positive direction. Peoplesoft announced the acquisition of JD Edwards, and Oracle followed up with a hostile bid for Peoplesoft.

During the second quarter, as the rally picked up steam, managers found it nearly impossible to make money by shorting stocks, in what would turn out to be one of the worst years in recent memory for short selling. Many managers became pessimistic on the market, and felt that the rally was not justified based on overall business fundamentals. With the market rising so fast, so quickly, short interest on the big board actually crept up.

The third quarter was an interesting time for the markets, as the NASDAQ rallied again even though insider selling reached historically high levels, usually a bearish sign. Yet, market action was positive, with many stocks at new highs and good breadth. Evidence that the economic recovery was underway was witnessed by interest rates, which spiked up during the quarter. **Money began to flow into cyclical stocks, companies that had the most operating leverage and would benefit the most from an economic recovery.** Financials had a great start to the third quarter due to better earnings, larger dividends and share repurchase announcements.

After an initial sell-off in August, the markets bounced back, as small cap stocks, technology and consumers lead the way. Announcements by Intel and Texas Instruments that third quarter revenues would be higher than previously thought helped propel the technology sector higher**. Many managers continued to question whether valuations were overextended and kept net exposures low.** By the end of the third quarter, the rally had paused and there was a spike in volatility.

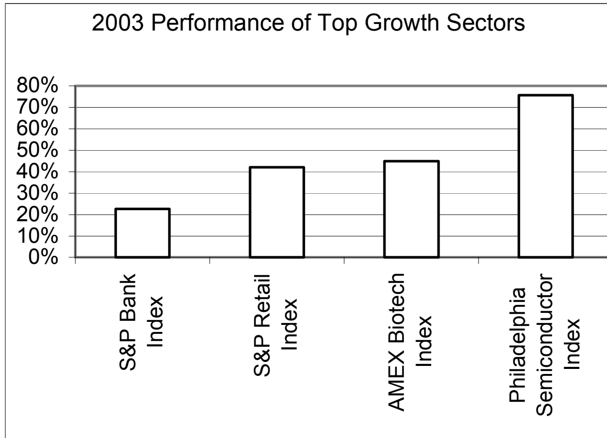
The retail sector received a positive boost as Wal-Mart and Gap announced better than expected sales for September, the back to school shopping season. Managers were mixed on retail, cautious as to whether retail sales were actually improving, or if the increases were just a short-term up tick.

Terrorist attacks in Turkey and Saudi Arabia coupled with the tenuous security situation in Iraq weighed on the markets in the fourth quarter. Even with these events and the worries they caused, the markets posted further advances on a slew of positive economic news. Data suggested a pick-up in the job market and strong earnings were reported across various industries. **Margin debt reached new record highs, and indicated that speculation had crept back into the market.**

The Philadelphia Semiconductor Index rose 18% for the month of October, as semiconductor companies, such as Qualcomm, announced demand for chips was surprisingly strong**. Financials also had a strong October to cap off a good year, with low interest rates, a relatively steep yield curve, improved credit quality and the pick-up in M&A, all helping to lift the industry's profits.**

There was a sharp rise in retail stocks, and the S&P Retail Index was up +40% year-to-date by the end of October. An increase in consumer spending, flat labor costs, and tight inventories heading into the Christmas shopping season propelled the sector even higher. The Christmas season turned out to be a mixed bag for retail, as companies that cater to lower income households reported poor sales. Managers commented that the retail sector became a great area of the market for long/short managers.

As 2004 begins, managers believe there are many reasons to be optimistic. The economic recovery seems to be genuine, consumer spending remains robust, and there is more confidence among business leaders about their company's prospects. After three years of cost cutting, managers believe that the technology sector will benefit from an increase in capital expenditures. Still, managers are aware of a number of issues that can negatively affect the market, most notably, the ongoing threat of possible terrorist attacks and the continued slide of the U.S. dollar.



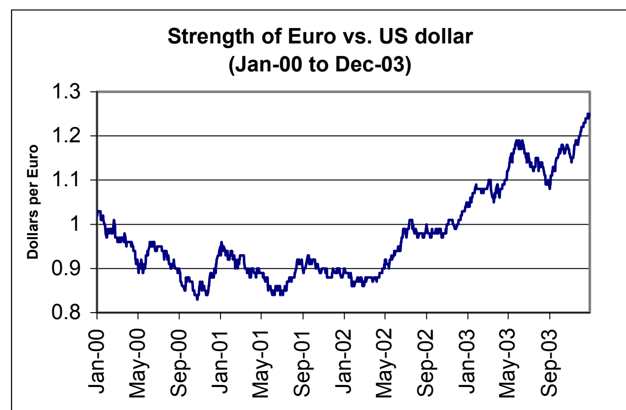
Macro
(YTD: +18.71% / DEC: +3.62%)

The Hennessee Macro Index advanced +3.62% during the month of December to bring the performance for the year to +18.71%.

Macro managers began 2003 with conviction that the year would possess identifiable trends for them to exploit in world markets. **After a difficult year in 2002, managers were confident that trends in gold, the U. S. dollar, and the euro would provide a solid platform for their strategies to perform.** In particular, reflation of the global economy was the main theme for macro portfolios. For the most part, managers were able to perform well as the strategy produced annual positive performance for the first time since 2000.

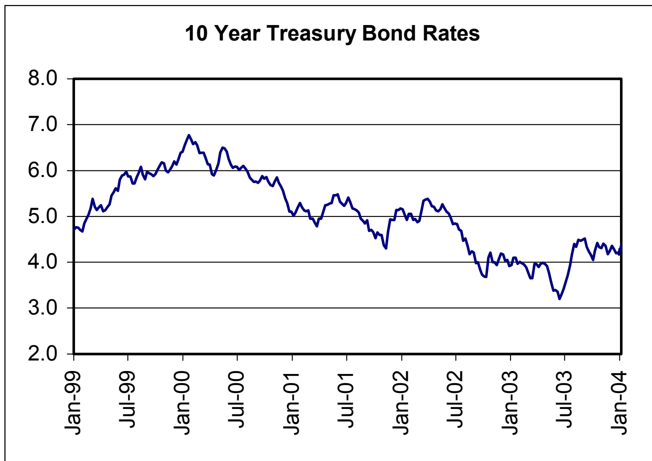
Managers posted a solid first quarter as they focused on the continued decline of the U.S. dollar and the appreciation of gold prices. They were continuously asking themselves how high gold would rise and at the same time, how low the dollar could fall. **Gold continued to gain steam as a safe haven asset, and the looming conflict with Iraq no doubt enhanced the move of assets towards gold.** Conversely, as uncertainty surrounding the conflict in Iraq affected the price of gold, it also affected the value of the U.S. dollar. The dollar continued to depreciate throughout the quarter as foreign governments reduced their exposure to U.S. paper assets. The dollar received a minor jolt to the upside in March as the war came to a quick conclusion, but that rally was short lived as it continued its depreciation in the second quarter. **In addition, managers pointed to 20-year lows in treasury yields and the declining dollar as an added incentive for foreign investors to move towards hard assets.**

The second quarter was an extremely robust quarter. Early in the quarter, managers were paid handsomely for their short dollar trade. The interest rate discrepancy between the U.S. and Europe, as well as the high U.S. current account deficit, were the main themes behind this trade. Managers continued to short the dollar versus the euro but not due to any conviction in the European economy. **In fact, they continuously stated that their trade was not a bet on European prospects, but rather that the euro was the best candidate to take on the other side of the short dollar trade.** In May, U.S. Treasury Secretary John Snow stated that the dollar's recent slide was part of "really fairly modest realignments" in currency exchange rates, and currency traders took this as a sign that the U.S. had abandoned its strong dollar policy. This further depreciated the dollar as the quarter progressed. In June though, the dollar appreciated versus the euro (the euro went from 1.18 to 1.16 for the month), but managers were still able to post positive returns as gains in equities and commodities offset their losses.



The third quarter brought about a much different environment than macro managers had endured in the first two quarters of 2003. From June 13 until mid-July, Treasury yields rose faster than they had at any point since the late 1980's. The severe move in yields produced losses for many traditional bond investors as the yield on 10-year bonds increased to 1.33%. **Macro managers were able to limit their losses in the month, even with the spike in bond yields, due to the continued depreciation of the dollar.** As the summer wore on, August saw a slight reversal of the dollar trade as solid economic news (an upward revision to the 2nd quarter GDP) in the U.S. emboldened investors that the recovery was real. As a result, the dollar turned in a few weeks of strong performance. Of note was the performance of gold in the month of August. Gold prices continued to advance even when the dollar was performing well. **This broke the traditional trend that gold prices come under pressure in the face of a strong dollar. Hedge fund managers noted that buyers of gold had begun to ignore currency markets as global uncertainties had further solidified gold as a quality asset.**

The fourth quarter saw the same dominant themes as



the first and second quarters of 2003. In it, macro managers took advantage of the continuing decline of the U.S. dollar and advancing price of gold to post moderate gains. The quarter saw the euro set all time highs against the dollar and gold prices reach seven-year highs. **Managers noted that though gold prices were at these decade long highs, that the gold run-up of 2003 could be the early stage of a long-term bull market for the commodity.**

The past year not only proved to be a solid year for gold, but for commodities in general. An improving global economy spurred demand as countries began consuming commodities at a quicker pace than in years past. China also came on board as a strong manufacturing base, creating strong demand for commodities such as aluminum, copper, silver, etc. **Managers were able to take advantage of this, especially with respect to silver, which saw a large increase in price over the course of the year.**

Macro managers see 2004 as a continuation of the themes present throughout the past year. Managers are expecting that since 2004 is an election year, the current administration will keep monetary policy loose and will keep fiscal spending strong in a bid to gain reelection. Managers believe that these policies will help to keep pressure on the U.S. dollar, resulting in a continuation of the dollar trade managers had in their portfolios for most of last year. Managers also see gold continuing its run in 2004 as it is turning into a solid alternative asset on top of it being a commodity. **Managers have noted that it could be a beneficiary of the depreciating dollar as investors who feel they have too much exposure to the euro and other foreign currencies may take larger positions in gold.** Macro managers believe that the world markets are ripe with opportunity in 2004, and are looking towards another solid year of performance.

Distressed
(YTD: +26.78% / DEC: +1.91%)

The Hennessee Distressed Index generated a solid +1.91% return during December, rounding out the year with a 26.78% gain. During the year, the Index posted a positive return every single month and finished the year as the **6th best performing hedge fund strategy**. In 2003, the credit wave lifted all boats in the distressed and high yield waters. **Hedge fund managers in this strategy reported one of their most profitable years** as interest rates at 45-year lows and an improved economic picture made access to financing cheaper for distressed companies. **The credit market was the golden child as spreads failed to lose steam and continued to narrow throughout the year**. Most hedge fund managers viewed the **tightening to be drastic and positioned their portfolios ac-**

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

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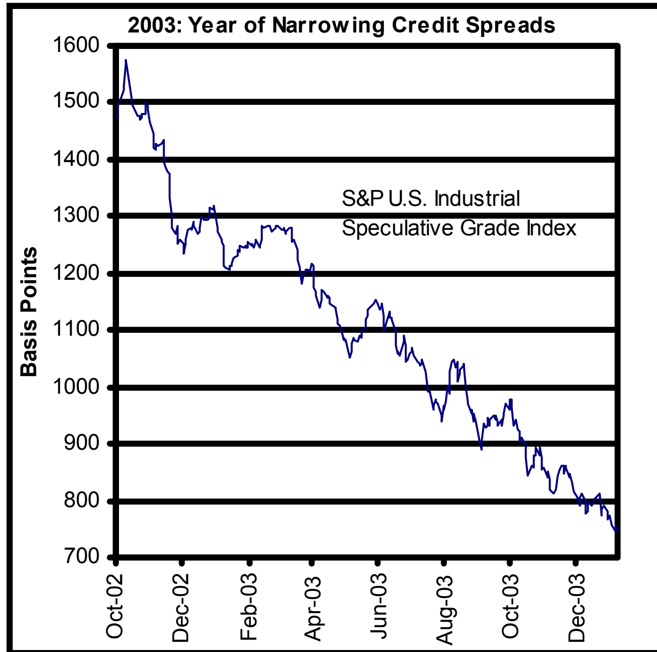
Style	Definition	Term	Level
MACRO	*Dominant investment theme is to capitalize on changes in the global macroeconomic environment through participation in the various capital markets. A top-down methodology allows managers of this strategy to utilize all asset classes (equities, bonds, currencies, derivatives) 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*

cordingly in case the distressed market experienced a setback. Typically, they did this by the use of shorts and ETFs such as the S&P 500 depository receipts.



Similar to equities, where the poorest quality and most speculative names outperformed, within distressed the lowest credit quality names experienced the largest run-up. By September, CCC-rated bonds were up +42% for the year, followed by B-rated bonds up +16.5%, BB-rated up +10.9%, and investment-grade bonds up +8%.

The CSFB Distressed Index finished the year with a 47.95% return and the CSFB High Yield Index managed to finish with a 27.93% gain. In comparison, the S&P 500 gained 28.68% for the year.

During the first quarter, distressed hedge funds managed to generate returns in a market environment with heightened uncertainty. The Iraqi war in March did little to shrug off demand for the distressed asset class. With the default rate beginning to stabilize, distressed assets began to build a base as **investors were on a search for yield and shrugged off the news in Iraq**. Hedge fund managers began to see a decoupling between the equity and distressed bond market as fundamentals and technicals improved in the latter. Before the war, several managers were pricing a 150 basis point widening in credit spreads. **By the time the war started, credit spreads did not widen substantially, indicating demand for the asset class remained strong**. By March, concerns started surfacing about the drastic spread tightening from October 2002 levels, but consensus among most distressed managers was that upon resolution to the war, **spreads still had more room to tighten.**

In the second quarter, the Hennessee Distressed Index reported its best quarter in terms of performance for 2003. The credit wave continued on the heels of an improving credit market, a declining default rate, falling number of bankruptcy filings, and a declining downgrade/upgrade ratio.

The postwar rally not only propelled equities higher, but distressed assets as well. Managers reported sizable gains in their portfolios, specifically in the lowest grade credits. The industries under the most pressure and most leveraged by mid 2003 were the best performing in the distressed asset class. **Hedge fund managers continued to focus on the run-up in distressed and were diligent in taking profits by selling into rallies.**

The Federal Reserve's monthly survey of senior loan officers indicated an **improvement in credit conditions**. Along those lines, evidence surfaced that the **percentage of banks tightening their lending standards fell from 22% at beginning of the year to 9% by April.**

Asbestos-related names traded up during the latter half of the second quarter as a bill was introduced to cap liabilities on claims. The cable sector also offered attractive opportunities as bonds of Adelphia and Charter Communications among several others moved higher. Several managers reported holding senior secured debt of the companies. **By mid-year, distressed managers who held onto "landmines" such as the bonds of Adelphia, WorldCom (MCI), and Qwest since the meltdown in summer of 2002 had recouped most, if not all, of their losses.**

The treasury market took a nosedive in July as U.S. budget deficit figures released in July exacerbated an already ailing bond market that was overvalued. From mid June to the end of July, the yield on the 10-year Treasury note increased from 3.11% to 4.4%. The pain was felt in the high yield market with the Merrill Lynch High Yield Index, CSFB Distressed and High

Yield Indexes all reporting negative returns. Managers **who did report gains in July generated them from capital structure arbitrage trades and outright shorts, as many of their long distressed bond positions fell with the market.**

As the third quarter progressed, the distressed and high yield markets maintained their strong performance even as many investors were on vacation. During the late summer months as is typical, the distressed market was quiet. Nonetheless, economic data continued to surface pointing to a healthy recovery, which helped push inflows into high yield mutual funds and kept the market for distressed buoyant. During September, even with the S&P 500 down a percent, investors continued to bid distressed assets higher.

Distressed players that we speak to reportedly increased their exposure to late-stage bankruptcy equities during the third quarter. The inherent volatility in this asset class tended to keep exposure low to this asset class, but with a strong stock market and attractive fundamentals, the risk/reward profile kept managers invested. A good number of distressed hedge fund managers had achieved a large amount of their gains during the third quarter from these equities. **By August, the on-going concern from investors focused on the huge run-up and the question surfaced, "will the same type of returns be generated in 2004?"** With 400 companies under Chapter 11 protection, managers remained confident with the number of ideas surfacing. In addition, **the recovery value of defaulted bonds increased to 40% in August, higher than the 22% in 2002 and 30% in 2001**.

With the Fed announcing in October that it has no intention of tightening monetary policy in the foreseeable future, investors continued to pound the pavement to search for yields in riskier assets. **Distressed bond yields in certain industries were pushed to their lowest levels since the 1980's.** The distressed market was "too good to be true." Credit spreads narrowed considerably since October 2002. **Some managers cognizant of a correction ramped up their hedges with many believing the credit market had run ahead of fundamentals**. During October, the CSFB Distressed Index generated a 5.2% return, closely in line with the S&P 500 performance. **During the fourth quarter, hedge fund managers continued to reduce position sizes and locking in profits as they had for most of the second half of the year.**

The release of the strong 8.2% GDP figure during the third quarter was further evidence that the economy was clearly on the mend. Corporate profits for the third quarter rose 10.6% annually, the sharpest jump since 1992. The positive data kept managers searching for yield. **The European distressed market became an area of increased activity for U.S. distressed managers as the landscape was less exploited than the U.S.**

The Parmalat scandal created some activity in an otherwise uneventful December. Disclosure of accounting irregularities at the Italian-based company provided some **trading opportunities** for managers. Short positions, as with most of the year, mitigated gains in the month as the distressed market unexpectedly experienced some strength. On the flip side, long distressed bond positions generated the bulk of returns for managers with moderate profits from capital structure arbitrage trades and late-stage bankruptcy plays. **Managers are moving up the capital structure into more senior secured bank and bonds**. Capital structure arbitrage trades in selective names appear attractive to hedge fund managers as the spread in some issues have narrowed considerably.

Aside from favorable technicals, hedge fund managers believe an **increase in M&A in 2004 will benefit their strategy, as investors rotate out of distressed into merger arbitrage making the market less saturated**. The drastic narrowing of credit spreads is still a concern for managers. Managers believe the amount of distressed paper in the market will keep them busy for next few years.

Merger Arbitrage
(YTD: +9.89% / DEC: +1.26%)

The Hennessee Merger Arbitrage Index generated a +1.26% gain in December finishing out the year with a +9.89% return. The Hennessee Merger Arbitrage Index ranked 18th of the 23 sub-indices in terms of performance for 2003.

The year 2003 was a pivotal year for M&A (most notably during the second half of the year). **Signs of an**

improving economy and a rising stock market sparked a renewed interest in pursuing mergers once again. After two years of repairing balance sheets, companies began thinking about growth via acquisitions and were aided by a receptive funding environment, which made it cheaper to fund deals. The year was also characterized by deals taking a bit longer to consummate as board directors were much more skeptical (due to accounting/corporate governance issues) than in the past.

In 2003, global M&A volume was 10% higher than in 2002, totaling $1.33 trillion versus $1.21 trillion in 2002 (the 2003 figure is still 61% lower than 2000 levels, when volume reached $3.4 trillion). The same trends in worldwide M&A activity were seen in **U.S. deal flow, as dollar volume increased 19% from 2002 levels, with the fourth quarter volume doubling to $209.4 billion.**

As for number of deals, there were approximately 1,300 more transactions this year than in 2002. The trend improved significantly towards year-end, as **deal activity rose 30% in the fourth quarter from the same period a year ago.**

In 2003, cross-border merger activity with Europe more than doubled to $75.4 billion, helping to reverse a 3-year slump in deal flow. Arbs believe the increase in activity is the result of a strengthening in the U.S. economy, a recovery in stock prices, and growing confidence of U.S. executives on the prospects of their businesses. The dollar's depreciation against the Euro and the British Pound did little to halt activity (conversely European acquisitions of U.S. companies fell nearly 70% from 2002) with our overseas brethren. The most notable cross-border deals were $9.4 billion Amersham PLC (UK) /GE deal and $5 billion Wella AG (Germany)/Procter&Gamble deal.

By the middle of 2003, it was believed by most merger arbitrage managers the downturn in the M&A cycle reached a bottom. Every month since, deal activity increased modestly and peaked in October after the Labor Day weekend. By the end of October, managers saw two of the largest U.S. deals of the year, one being the largest globally (see chart for largest global M&A deals in 2003).

Merger activity began the year at a tepid pace due in most part to heightened uncertainty surrounding Iraq. Arbitrageurs invested cautiously and despite a lethargic start, were able to generate gains by trading around their positions. Aside from war jitters, arbs were **optimistic about the New Year as many companies were already in the process of deleveraging and valuations in certain sectors were attractive** enough to spur buying interest. With the market moving on headline news in March, arbs focused on preserving capital and as a result, resorted to cash.

The second quarter opened up strongly for the markets on the heels of a post war rally and better than expected news on the earnings front. Arbs reported a favorable environment for deal spreads benefiting nicely from the bounce in the equity market. **With the war ending and investor confidence up, arbs began to hear of corporate boards looking to make acquisitions**. In April, First Data announced an offer for Concord EFS for $7.3 billion, making it the largest U.S. deal for the year. From the start, arbs reported volatility in the spread as it faced antitrust concerns. Nonetheless, some arbs stayed in the deal and experienced unrealized losses. The following month PeopleSoft announced an offer for JD Edwards and days after, Oracle launched a hostile bid for PeopleSoft prompting a lot of noise in the merger arbitrage community. **Oracle's surprise announcement hurt arbs who were invested in the JD Edwards/PeopleSoft deal, because they were short PeopleSoft**. Not long after, Oracle raised their offer on PeopleSoft. Arbs continued to stay invested in JD Edwards/PeopleSoft deal and felt it would survive with the worst case scenario being Oracle acquiring both companies.

Several of the largest deals of the year were announced during the third quarter. These included $3.4 billion Pechiney/Alcan, $2.6 billion Neuberger Berman/Lehman Brothers, $5.6 billion Advance PCS/Caremark, and $10.1 billion John Hancock/ Manulife. The third quarter continued to see a surge in deal flow with $50 billion in deals surfacing in July alone, making it the busiest month thus far in the year. Arbs had reported being fully invested, a far cry from the 50% invested in July 2002. Merger arbs were adding more names to their portfolios and reported crowding in certain names. News highlight during the quarter focused on the Concord EFS/First Data deal whose spread

widened as concerns deepened with the DOJ on the combined company's dominance in the pin and debit card market. Nonetheless, arbitrageurs were gaining more confidence in deal flow, as strong economic data points were announced. The beginning of the fourth quarter was reminiscent of the year 2000 when mega-mergers were the norm. **October was the busiest month for mergers in over two years. The two largest U.S. deals were announced on the same day during the last week of October, specifically the $49 billion FleetBoston/Bank of America deal and $16 billion WellPoint Health/Anthem deal.** During the quarter, merger arb managers continued to reduce their cash position and were adding more names to the portfolio. Though deal activity slowed from its rapid pace in October, arbs continued to report an improved environment for their strategy towards the end of the quarter.

In December, arbs reported a solid finish to the year and believed it was a month that rewarded skill and experience. New deals in the month were FedEx's $2.4 billion cash deal for Kinko's, Pfizer's $1.3 billion offer for Esperion Therapeutics, and Provident Financial's $642 million merger with First Sentinel Bancorp. **Some arbs had doubled their position in the Concord EFS/First Data deal when former's stock price hit a low and experienced a nice gain in the month when the companies announced a settlement with the Department of Justice to solve their antitrust problem.**

Going forward, arbs believe deal flow will continue to pickup, particularly within financials, healthcare, and consumer products sectors. **We may also see European counterparts bidding for U.S. companies** and within Germany, it's expected the financial sector will see consolidation. With most economists predicting 4% GDP growth in 2004 merger arbitrage managers are expecting to see more deals ahead and more opportunities to make money.

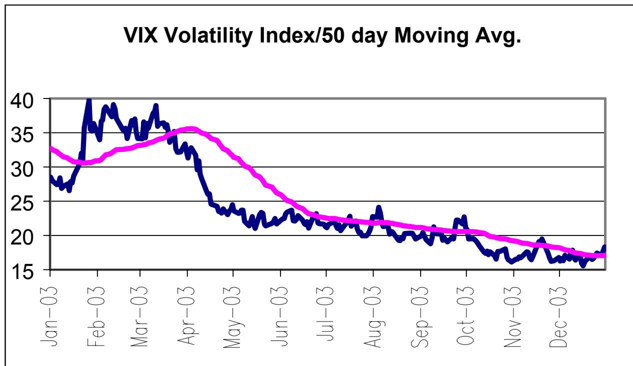
Largest M&A Deals of 2003

ACQUIRER (Country)	TARGET (Country)	ANNOUNCED	DEAL VALUE (Billions)
Bank of America (U.S.)	FleetBoston Financial (U.S.)	10/27	$49.3
Ing C Olivetti (Italy)	Telecom Italia (Italy)	3/12	$27.8
Deposit Insurance Japan (Japan)	Resona Bank (Japan)	6/10	$16.7
Anthem (U.S.)	WellPoint Health Networks (U.S.)	10/27	$16.4
St. Paul (U.S.)	Travelers Ppty Casualty (U.S.)	11/17	$16.1
Yukosneftegaz (Russia)	Sibneft (Russia)	4/22	$13.6
General Electric (U.S.)	Vivendi Universal (U.S.)	10/8	$12.0
Manulife Financial (Canada)	John Hancock Finl Svcs (U.S.)	9/28	$11.1
D/S Svendborg (Denmark)	D/S 1912 (Denmark)	5/6	$9.9
General Electric (U.S)	Amersham (U.K.)	10/10	$9.4
Liberty Media (U.S.)	QVC (U.S.)	7/3	$7.9
BP PLC-Russian Assets (Russia)	Alfa,Renova-Russian Assets (Russia)	2/11	$7.6
Oracle (U.S.)	PeopleSoft (U.S.)	6/6	$7.5
First Data (U.S.)	Concord EFS (U.S.)	4/2	$7.2
France Telecom (France)	Orange (France)	9/1	$7.1
News Corp (Australia)	Hughes Electronics (U.S.)	4/9	$6.9
IDEC Pharmaceuticals (U.S.)	Biogen (U.S.)	6/20	$6.8
China Telecom (China)	China Telecom-Fixed Line Asset (China)	7/14	$5.6
Caremark Rx (U.S.)	AdvancePCS (U.S.)	9/2	$5.6
Alcan (Canada)	Pechiney (France)	7/7	$5.3
William Morrison Supermarkets (U.K.)	Safeway (U.K.)	1/9	$5.2
Great-West Lifeco (Canada)	Canada Life Financial (Canada)	2/17	$4.7
Investor (Germany)	TCHIBO Holding (Germany)	11/17	$4.5
Koch Industries (U.S.)	Invista (U.S.)	8/31	$4.4
Investor (U.S.)	Ondeo Nalco (U.S.)	9/4	$4.4

Convertible Arbitrage
(YTD: +9.37% / DEC: +0.36%)

Despite a number of negative factors, convertible arbitrageurs ended the year having made a respectable 9.37% return, as measured by the Hennessee Convertible Arbitrage Index.

Performance in the strategy was particularly strong during the first quarter, when equities sold off, while volatility spiked to near record highs both as a result of the impending war with Iraq. During the same period bond floors stayed very resilient as major cost cutting initiatives, lower interest rates, and better access to capital helped companies clean up balance sheets and improve their cash flow



coverage. **Consequently convertible arbitrageurs had a windfall, since the long side of their portfolios (convertible bonds) remained firm, while their shorts (equities) sold off, all the while benefiting from abundant trading opportunities created by the higher volatility.** During the first quarter, we noticed a discernable shift in hedge fund portfolios from investment grades to lower quality paper as managers speculated (correctly) that 2003 would be a good year for the high yield and distressed asset class.

Second quarter brought with it a deluge of new issues. With most companies having sat on the sidelines in the months leading to the war, they came to market in droves as the much of the uncertainty regarding the war disappeared with the fall of Baghdad. The momentum in new issuance carried throughout the quarter, making it the busiest quarter on the record in terms of new deals. Domestically, some $41 billion in convertible bonds was brought to the market by eager underwriters, overwhelming the $250 million (at the time) domestic convertible universe. **Not surprisingly, the tremendous supply put pressure on valuations in the secondary market, making June the first (but not the last) down month for convertibles in 2003.** Amidst the near hysteria, some issuers were able to get away with prices that would have been unheard of only a short while ago. One that caused quite a stir was a deal by Yahoo. Taking advantage of the ripe environment, Yahoo sold $750 million of convertible bonds with zero coupon and yield, 68.5% premium, and a 50% implied volatility, which was higher than implied volatility on Yahoo's listed options. Many investors passed on the deal, saddling CSFB (the main underwriter of the deal) with quite a bit of unsold inventory. The bonds headed south by five points, shortly after hitting the secondary market, leaving CSFB with millions in losses on their inventory.

Third quarter turned out to be one of the most difficult periods for the convertible arbitrage strategy, as many things went wrong all at once. **Dividend risk went from being a non-issue to one of the most prominent hazards in the asset class. Call in risk increased significantly as rising equities took bonds closer to the money and continued low interests gave companies an incentive to refinance at lower rates. Liquidity also suffered as it does usually during the summer months, although rumors of a couple of large sellers widened bid/ask spreads in the universe making trades more costly. Interest rates shot up dramatically in July (so much that the month turned out to be the second worst performing month in treasuries) handing some mighty losses to any manager who did not have a significant interest rate hedge on. And if all the above were not enough, volatility drifted below the psychological 20 level (as measured on the VIX) dampening gamma trading opportunities.** Fortunately continued tightening in credit spreads (one of the only areas where any profits were made) allowed hedge fund managers to recoup other losses ending the quarter just slightly better than flat.

The losing streak ended in fourth quarter, as the index produced three months of back-to-back positive returns, despite a continued downward spiral in volatility. As the VIX set a seven-year low, convertible managers increasingly relied on the yield on their portfolios and the continued contraction in credit spreads resulting from a recovering economy to generate positive returns. New issuance remained strong, while pricing improved slightly, although there were very few cheap deals right out of the gate. In total, some $97 billion new paper was brought into the market, making 2003 the second heaviest year after 2001 when new issuance stood at $115 billion. **However, one must put in context that during the same period nearly $57 billion of existing paper was taken out of circulation through redemptions, call ins, put backs, and refinancings.** Of all the new issuance, roughly 44% was used to repay existing debt (convertible or other). In aggregate the U.S. convertible universe expanded for the year reaching nearly $300 billion in market capitalization.

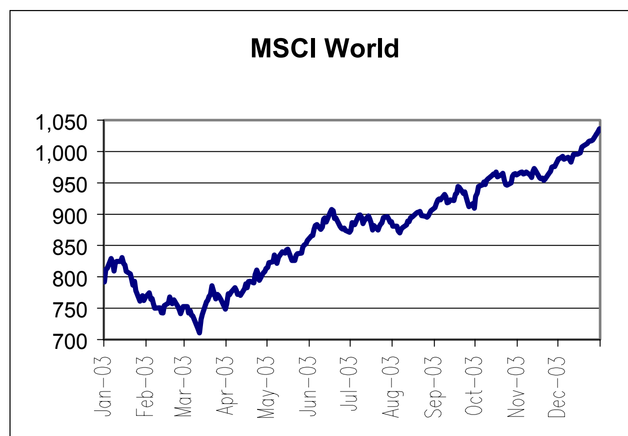
2004 will most likely be a challenging year for con-

vertible managers. With credits having had a dramatic run up since late 2002, there are arguably not a whole lot of opportunities left in credits. There will undoubtedly be opportunities in individual credits, but they will be more situations specific (requiring strong research), rather than overall credit improvement in the assets class as witnessed in 2003. With interest rates expected to begin their ascent in mid 2004, the low premium investment grade segment of the market is likely to suffer, although most hedge fund managers being cognizant of the risk, have at least partial interest rate hedges on and should be protected in the event of a rate spike. New issuance is expected to remain strong, only slightly trailing the near $100 billion issued in the 2003, however general consensus is that pricing on these deals will continue to be on the rich side, leaving fewer opportunities in the primary market. It is harder to predict the direction of volatility. While historically, volatility has been muted during times of economic recovery, any shocks caused by geopolitical events, Fed decisions, events leading to the election, or a free falling dollar could send it significantly higher, creating windfall profits for convertible managers, who are well positioned to take advantage of any spike on the VIX. **Consequently, convertible arbitrage, while not expected to repeat past performance, should remain a good hedge in portfolios with exposure to equities.**

International (YTD: +22.70% / DEC: +3.26%)

Although off to a challenging start, 2003 turned out to be a very profitable year for international investors. U.S. investors investing in foreign markets received a boost from the weakening dollar, as in some cases their returns were doubled after accounting for appreciation of foreign currencies against the dollar. MSCI World (in US $) posted a 30.81% return, while the Hennessee International Index posted a +22.70% during the same period. It is worth mentioning that **hedge funds due to their conservative nature tend to hedge currency exposure, and consequently did not benefit greatly from the dollar's slide.**

The first quarter was particularly weak as the uncertainty regarding the war with Iraq kept many investors on the sidelines at the same time increased the risk premium they required from equity investments. Growth in the euro zone was sluggish and in fact remained so for the remainder of the year, despite major improvements in the U.S. GDP. **Frustrated by the lackluster pace in restructuring of the labor force, German politicians began speaking publicly on the topic of layoffs, deeming them necessary in order to keep Germany (and Europe in general) competitive with the more nimble U.S. and Asia.** With German unemployment already at 11%, the German public was wary of the trend, although most investors agree that a more flexible labor force is beneficial to Europe in the long run. In Venezuela the economy looked as if it were beginning to unravel as a national walk out (protesting the rule of President Chavez) brought economic activity to a standstill. In Korea, investor confidence was shattered after an Enron-like scandal involving SK global came to surface. It also became apparent that the strong consumer spending that had fueled GDP growth in Korea was mainly financed by skyrocketing credit card debt. Much of this debt was later found uncollectible, forcing banks to take massive write-downs and tighten their lending standards (both negative for equities).



There was a noticeable bounce in equities in the second quarter, following the conclusion of the conflict with Iraq. However, Asian markets remained weak due to the outbreak of the SARS virus and its impact on the economy. Employees were sent home en mass and schools and universities were shut down for days. After some initial blunders, the Asian governments reacted swiftly to contain the virus and provide fiscal stimuli (lowering taxes, guaranteeing bank loans, waving certain municipal fees…), which

eventually helped reverse the effects. **The European Central Bank cut interest rates by another 0.50% in the second quarter, and German Chancellor proposed an accelerated $18 billion tax cut package to jumpstart the stagnant economy.** The Argentinean economy, which had been reeling from years of depression like contraction, began to show signs of improvement mid-year earning praise from the otherwise critical IMF. Mexican stocks got a boost from a pledge by the banking industry that it will make credit more available to businesses and consumers alike.

Much of the positive momentum carried over into the third quarter, with markets around the globe showing positive performance. **Stocks in France continued to rise, although they lagged much of their European counterparts as it became apparent the GDP might register only a miniscule gain if at all.** The topic of the Yuan's (the Chinese currency) peg to the dollar received much attention during the third quarter, as U. S. manufacturers continued to shed jobs. Treasury secretary, John Snow, became rather vocal on the topic, convincing the group of G7 nations to release a statement calling for less intervention in currencies in an apparent jab to China. The Chinese hit back later advising foreigners not to meddle in their business, but did soften their stance later in the year. In Latin America, Brazil began its long-awaited easing monetary policy and Argentina reported a 17.5% jump in industrial production in a clear sign of improvement in that region.

As the year came to a close, global markets followed the lead of U.S. equities finishing the year very strong. **Bank of England surprised some investors by raising interest rates by 0.25% in November, leading to speculation that rest of Europe and eventually United States may not be far behind.** Emerging market investors were jolted following the arrest of the head of Russia's largest oil company and the subsequent freezing of its shares. The move was likely motivated by politics and reminded investors of the political instability associated with the less developed markets and its impact on the business world. Eastern Europe began to attract capital as investors shifted capital to the region particularly to countries such as Poland, which are expected to join the EU in 2004. Even Japan began showing visible signs of improvements driven by strong interest for its exports. It is anticipated that the country's GDP may rise nearly 3% in 2003. The banking minister also took the bold and unprecedented move of warning bank executives that in the absence of clear improvements in profits, their jobs may be in jeopardy. **In Argentina, anecdotal evidence pointed to a better climate ahead in lending and better access to capital markets, which are thought to be the last hurdle to overcome in the country's nascent recovery.**

Looking ahead, barring unforeseen geopolitical events or a currency crisis, the fundamental picture seems encouraging, pointing to another healthy year for equities. **Economists expect domestic GDP growth to be 4.3% in 2004, with first half being stronger of the two.** The cost cutting measure taken by U.S. companies will transform minor expansions in their revenues into impressive gains in profits. With the bulk of the monetary stimuli behind us, it remains to be seen how the U.S. economy will fare on its own in 2004. Hedge funds expect monetary policy to remain accommodating through the first half, at which time a slow but gradual tightening process could follow. Opportunities in Europe will be more situation specific, since as similar GDP growth is unlikely in the region. The strengthening of the euro against the dollar is serving to restrict the global competitiveness of the dominant manufacturers in Europe, which in turn will limit GDP growth. **Chances of a recovery in Japan are improving as the Banking sector moves along the gradual but slow process of reform and all eyes will be on China to see how the country deals with the explosive growth.**

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:

“The incumbent administration will pull out all of the economic stops it can to get reelected. This means **monetary policy will remain loose and fiscal spending will stay strong**.”

“We believe the convertible market will be favorable in 2004 based on stable interest rates, low inflation, decent economic growth, and a fairly active issuance calendar**.”**

“**We see opportunities in small and mid-cap sectors** as the massive withdrawal of ‘sell side’ analysts have left these sectors under-researched**.”**

“We are long the Euro as we see it appreciating towards the $1.40 level.”

“We are long oil as prices have been rising due to the weakening U.S. dollar and the fact that there is increased economic activity but **drilling for new reserves have not kept up with production.”**

“We are **long the Bund** and **short the U.S. 10 year note.”**

“**The economy has not strengthened to the point that the Fed is willing and/or able to raise rates**, and an increase now could undermine the nascent recovery.”

“**We continue to believe that we are still in the midst of a long term secular bear market** and that substantial gains for the broader averages from these levels will be hard fought.”

“We are long Indonesian banks as they have single digit earnings multiples and double digit dividend yields, as well as **Japanese banks** as reflation takes hold.”

“We see **Chinese authorities trying to rebalance growth away from import** and back towards export sectors.”

“We are short the overdone Australian dollar and overvalued Chinese Yuan.”
“We believe there is **a small probability for more than a 10% adjustment in the Chinese Yuan.** A widening of the bands to allow **a 3%-5% appreciation is more likely.”**

“We are remaining long gold and silver. Gold is a commodity, an alternative financial instrument, and a option for those looking to diversify away from the Dollar but not take on added Euro or Yen risk**.”**

“We are short regional US banks and US homebuilders.”

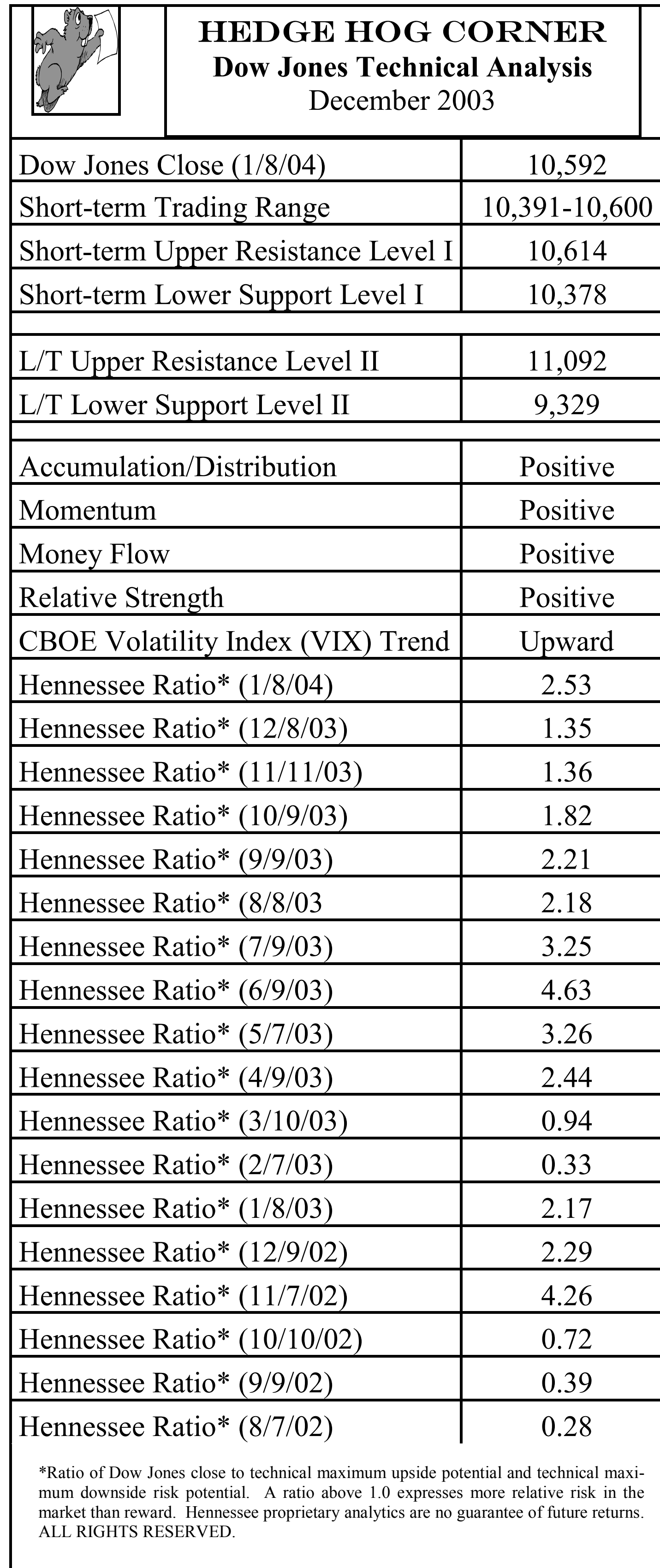
“**We are still short the U.S. dollar** as the negative real interest rates, which come as a result of the loose monetary policy, is not good for the U.S. dollar**.”**

“The **failure for Euroland to create a prosperous free trade zone** and the emergence of policies that are diluted to the lowest common denominator **creates many soft spots in European countries’ economic development.”**

“We are long the Brazilian real due to its recent sideways trading vs. the US dollar at a time when other currencies were appreciating**.”**

“Going into 2004, **we are long industrials and communications** and **short consumer non-cyclical and utilities.”**

“We are long semi-conductors and software companies in the long run, but the key to the near term is **determining to what extent improving fundamentals are already factored into prices.**”

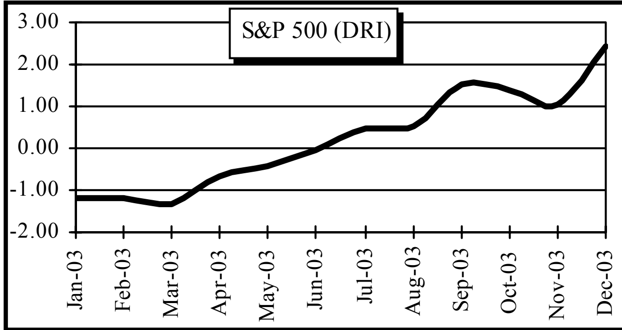


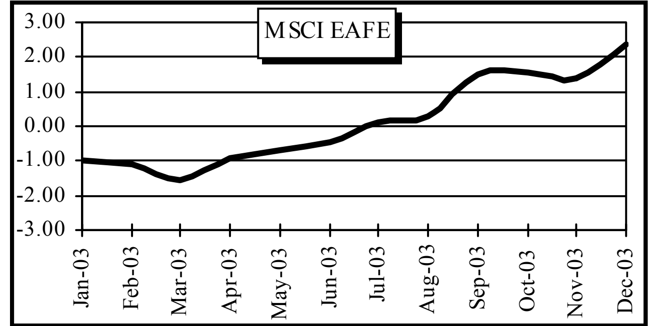
HEDGE HOG CORNER
Dow Jones Technical Analysis
December 2003

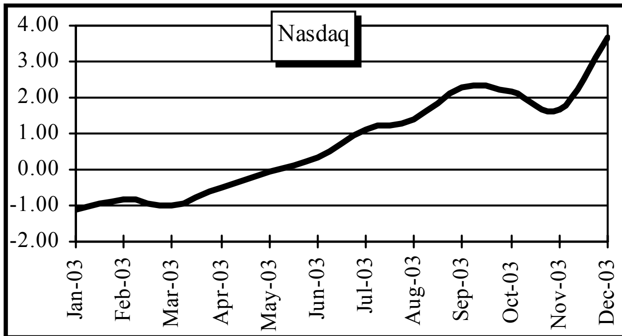
Dow Jones Close (1/8/04)	10,592
Short-term Trading Range	10,391-10,600
Short-term Upper Resistance Level I	10,614
Short-term Lower Support Level I	10,378
L/T Upper Resistance Level II	11,092
L/T Lower Support Level II	9,329
Accumulation/Distribution	Positive
Momentum	Positive
Money Flow	Positive
Relative Strength	Positive
CBOE Volatility Index (VIX) Trend	Upward
Hennessee Ratio* (1/8/04)	2.53
Hennessee Ratio* (12/8/03)	1.35
Hennessee Ratio* (11/11/03)	1.36
Hennessee Ratio* (10/9/03)	1.82
Hennessee Ratio* (9/9/03)	2.21
Hennessee Ratio* (8/8/03	2.18
Hennessee Ratio* (7/9/03)	3.25
Hennessee Ratio* (6/9/03)	4.63
Hennessee Ratio* (5/7/03)	3.26
Hennessee Ratio* (4/9/03)	2.44
Hennessee Ratio* (3/10/03)	0.94
Hennessee Ratio* (2/7/03)	0.33
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

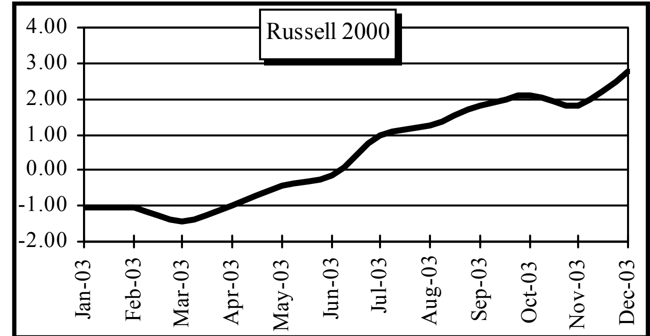
*Ratio of Dow Jones close to technical maximum upside potential and technical maximum downside risk potential. A ratio above 1.0 expresses more relative risk in the market than reward. Hennessee proprietary analytics are no guarantee of future returns. ALL RIGHTS RESERVED.

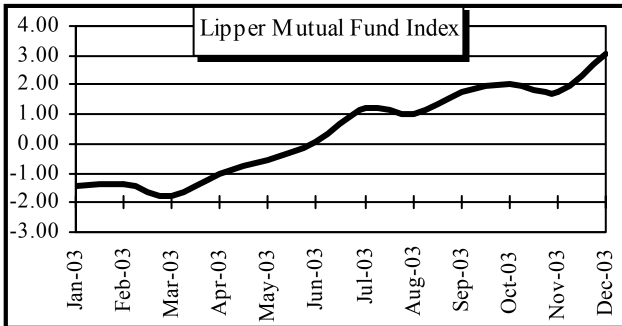
12 MONTH ROLLING SHARPE RATIO

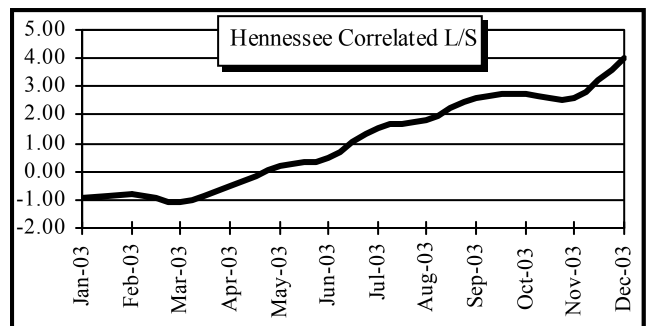








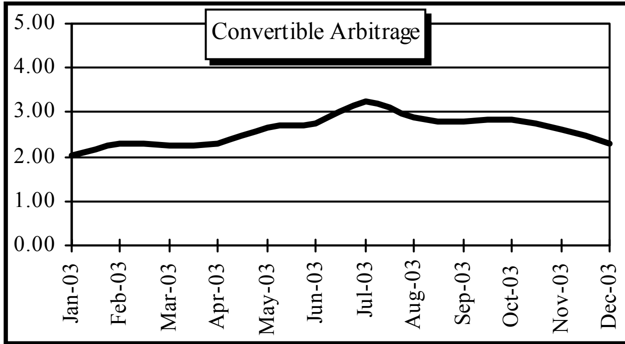


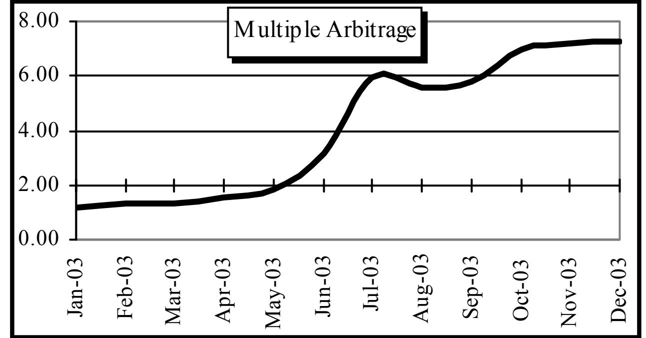


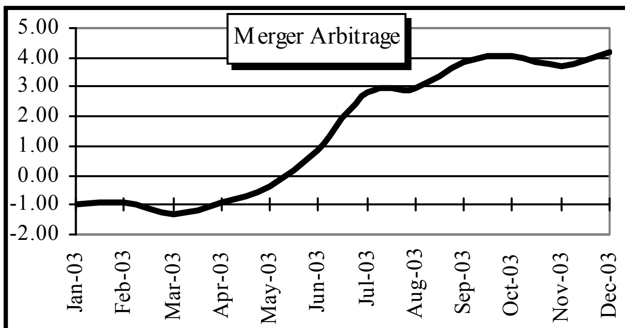
$$\textit{Sharpe Ratio} = \frac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$$

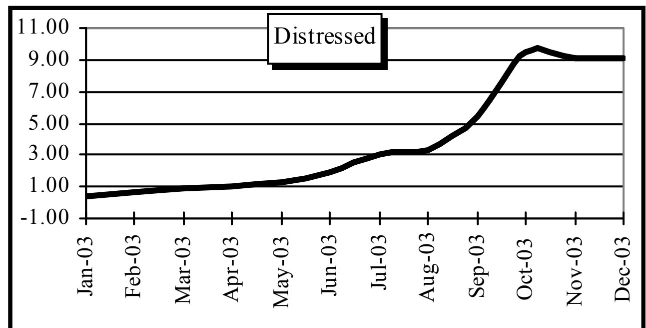
****90 day T-bill***

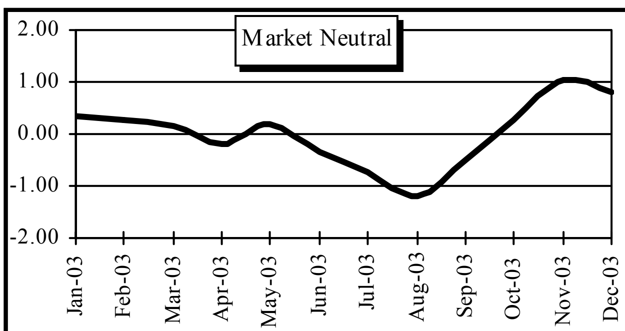
12 MONTH ROLLING SHARPE RATIO

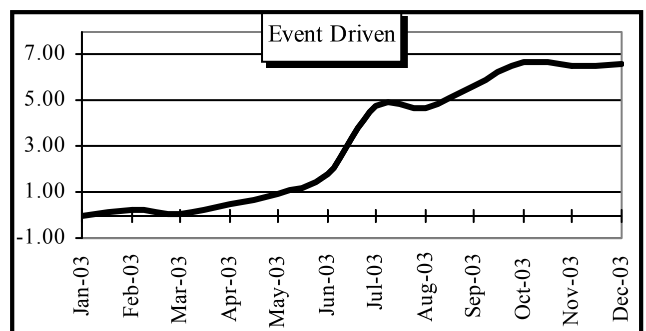








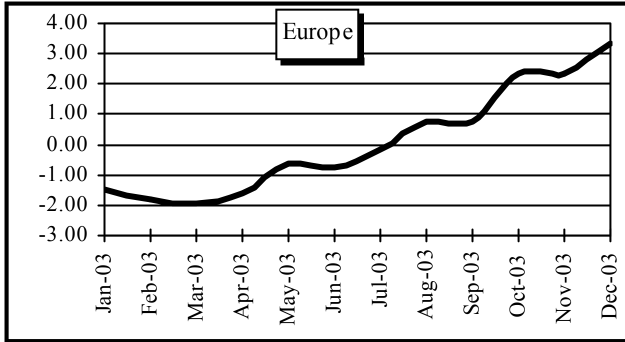


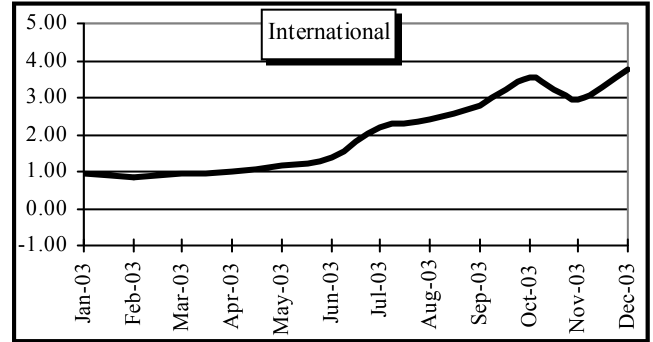


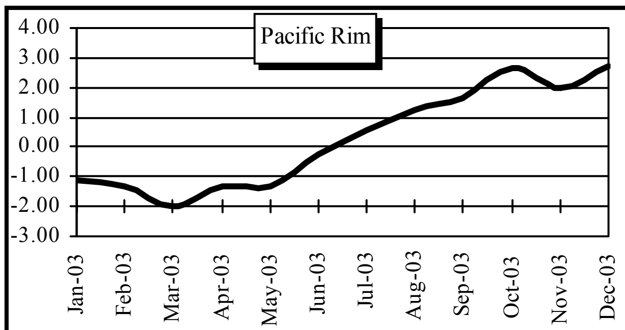
Sharpe Ratio = $\dfrac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$

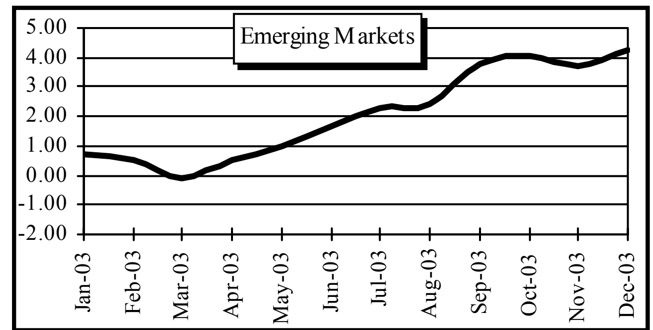
****90 day T-bill***

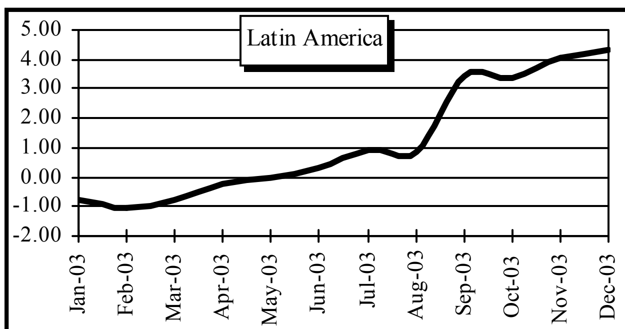
12 MONTH ROLLING SHARPE RATIO

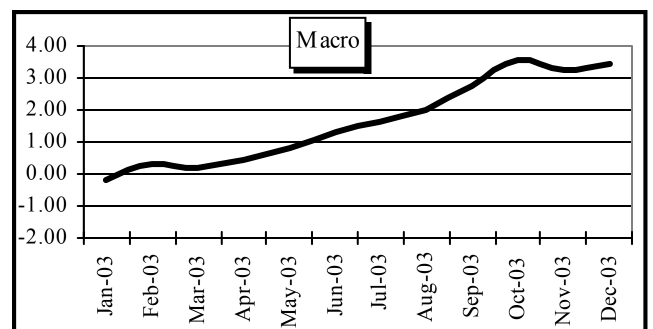








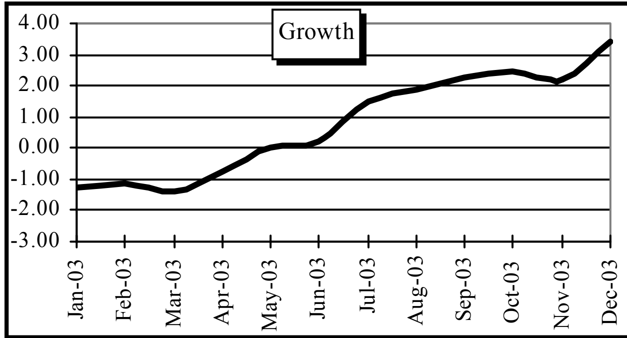


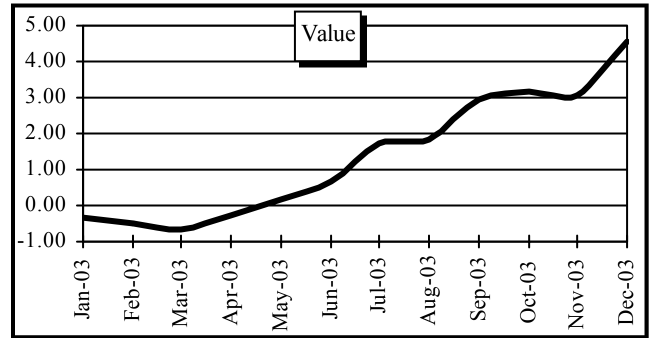


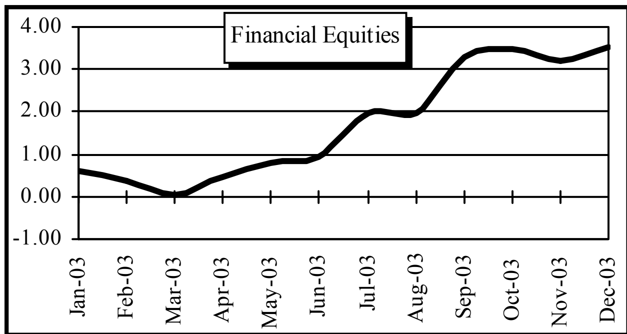
$$\textit{Sharpe Ratio} = \frac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$$

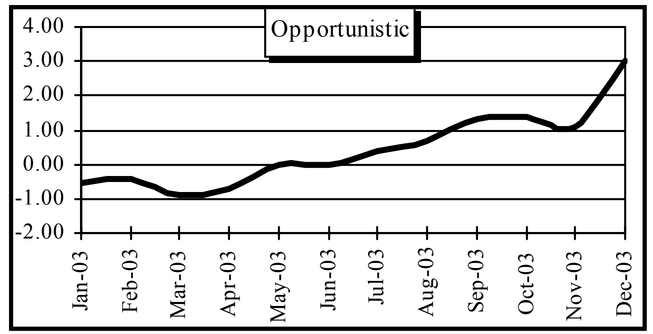
****90 day T-bill**

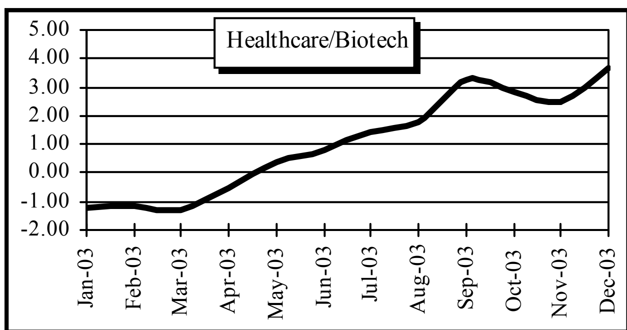
12 MONTH ROLLING SHARPE RATIO

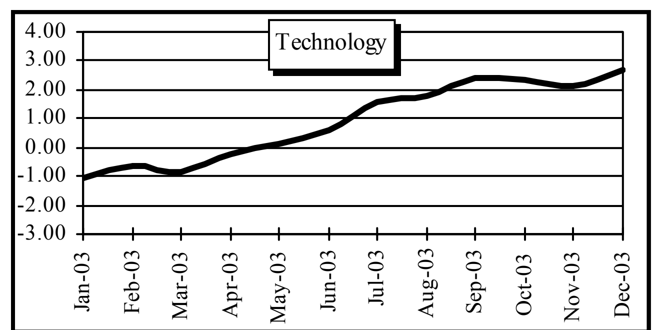












Sharpe Ratio = $\dfrac{\textit{Annualized Return - Risk Free Rate of Return *}}{\textit{Annualized Standard Deviation}}$

***90 day T-bill**

HENNESSEE HEDGE FUND RANKINGS ®

2003 (Net) MONTHLY NET	YTD	JAN	FEB	MAR	APRIL	MAY	JUNE	JULY	AUG	SEPT	OCT	NOV	DEC
CONVERTIBLE ARBITRAGE	19	2	3	9	18	17	22	20	22	10	15	10	21
DISTRESSED	6	3	7	4	9	12	4	7	13	2	9	6	11
EMERGING MARKETS	7	18	6	18	5	9	8	11	5	6	10	12	3
EUROPE	16	21	12	6	20	14	15	16	4	22	8	13	13
EVENT DRIVEN	11	4	9	8	12	13	9	12	15	14	12	9	7
FINANCIAL EQUITIES	2	20	22	7	2	3	12	2	7	9	2	4	10
FIXED INCOME	21	7	8	19	19	18	21	19	18	21	22	20	19
GROWTH INDEX	10	17	19	13	10	4	11	5	6	19	7	7	16
HEALTHCARE AND BIOTECH	3	13	17	2	6	2	2	1	9	5	19	14	9
HIGH YIELD	13	1	2	3	4	19	3	21	19	12	17	15	14
INTERNATIONAL	9	22	10	20	8	7	7	9	8	8	6	17	5
LATIN AMERICA	1	19	23	1	1	10	5	14	2	1	1	1	1
MACRO	12	5	1	22	16	5	19	22	3	3	20	22	4
MARKET NEUTRAL	22	15	13	16	22	21	20	18	20	16	18	19	20
MERGER ARBITRAGE	18	12	11	17	15	16	14	13	16	13	16	18	17
MULTIPLE ARBITRAGE	17	6	4	10	17	20	17	15	17	7	14	11	18
OPPORTUNISTIC	15	14	20	21	14	8	13	10	11	18	13	5	12
PACIFIC RIM	5	16	15	23	11	11	1	3	1	4	3	23	2
REGULATION-D	20	8	5	11	21	22	18	17	21	11	21	16	8
SHORT BIASED	23	23	16	15	23	23	23	23	23	20	23	21	23
TECHNOLOGY	14	11	14	12	13	15	16	8	10	23	4	8	22
TELECOM AND MEDIA	4	9	21	14	3	1	10	4	14	15	5	2	15
VALUE	8	10	18	5	7	6	6	6	12	17	11	3	6

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 GROUP LLC
HEDGE FUND ADVISORY

HENNESSEE HEDGE FUND INDICES ®

HENNESSEE
HEDGE FUND REVIEW®
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2003 (Net)	YTD	YTD RANK	% of mgrs. >S&P, YTD	JAN	FEB	MAR	APRIL	MAY	JUNE	JULY	AUG	SEPT	OCT	NOV	DEC
CONVERTIBLE ARBITRAGE	**9.37%**	**19**	**8%**	2.92%	1.12%	0.55%	1.36%	1.39%	-0.59%	-0.65%	-0.78%	1.33%	1.19%	0.86%	0.36%
DISTRESSED	**26.78%**	**6**	**41%**	2.14%	0.61%	1.04%	3.46%	2.78%	2.32%	1.41%	1.30%	2.59%	2.87%	1.58%	1.91%
EMERGING MARKETS	**24.49%**	**7**	**56%**	-0.24%	0.61%	-0.36%	4.19%	3.54%	2.04%	0.73%	2.70%	1.57%	2.59%	0.73%	4.15%
EUROPE	**13.45%**	**16**	**10%**	-0.35%	0.12%	0.88%	0.63%	2.57%	0.93%	0.38%	2.80%	-0.41%	3.03%	0.67%	1.51%
EVENT DRIVEN	**19.10%**	**11**	**53%**	1.94%	0.42%	0.60%	2.47%	2.64%	1.94%	0.68%	0.82%	0.95%	1.69%	1.01%	2.46%
FINANCIAL EQUITIES	**36.25%**	**2**	**33%**	-0.32%	-1.24%	0.83%	8.32%	6.18%	1.50%	3.17%	2.30%	1.33%	5.81%	1.83%	2.04%
FIXED INCOME	**2.88%**	**21**	**14%**	1.26%	0.48%	-0.44%	0.83%	1.37%	-0.26%	-0.44%	0.19%	-0.32%	-0.36%	-0.26%	0.83%
GROWTH	**22.27%**	**10**	**38%**	-0.14%	-0.92%	0.30%	2.72%	5.69%	1.61%	2.43%	2.60%	0.03%	3.43%	1.43%	1.27%
HEALTHCARE AND BIOTECH	**32.60%**	**3**	**52%**	0.41%	-0.83%	1.57%	3.97%	7.93%	3.02%	4.96%	1.87%	2.19%	0.89%	0.59%	2.27%
HIGH YIELD	**18.44%**	**13**	**0%**	2.99%	1.12%	1.18%	4.56%	1.27%	2.66%	-0.78%	0.09%	1.02%	1.07%	0.50%	1.48%
INTERNATIONAL	**22.70%**	**9**	**25%**	-0.41%	0.22%	-0.62%	3.48%	3.86%	2.13%	0.95%	2.27%	1.37%	3.80%	0.47%	3.26%
LATIN AMERICA	**70.19%**	**1**	**88%**	-0.29%	-3.24%	7.08%	13.97%	3.52%	2.24%	0.39%	5.58%	6.13%	10.13%	4.14%	5.84%
MACRO	**18.71%**	**12**	**46%**	1.57%	2.25%	-0.76%	1.50%	4.56%	0.15%	-1.33%	2.93%	2.54%	0.88%	-0.47%	3.62%
MARKET NEUTRAL	**2.04%**	**22**	**0%**	0.24%	-0.17%	-0.20%	-0.36%	0.74%	-0.10%	-0.34%	-0.02%	0.68%	0.93%	0.08%	0.54%
MERGER ARBITRAGE	**9.89%**	**18**	**8%**	0.49%	0.15%	-0.26%	1.78%	1.81%	1.00%	0.56%	0.32%	0.99%	1.15%	0.24%	1.26%
MULTIPLE ARBITRAGE	**12.06%**	**17**	**10%**	1.57%	0.67%	0.52%	1.49%	1.11%	0.71%	0.38%	0.31%	1.50%	1.34%	0.83%	1.02%
OPPORTUNISTIC	**14.04%**	**15**	**17%**	0.26%	-0.97%	-0.62%	1.81%	3.74%	1.22%	0.92%	1.55%	0.41%	1.64%	1.61%	1.74%
PACIFIC RIM	**28.67%**	**5**	**33%**	-0.10%	-0.56%	-2.18%	2.48%	3.15%	3.14%	2.85%	6.47%	2.29%	5.35%	-1.79%	4.80%
REGULATION-D	**8.26%**	**20**	**20%**	0.76%	0.62%	0.51%	0.40%	0.63%	0.48%	0.27%	-0.02%	1.03%	0.52%	0.47%	2.28%
SHORT BIASED	**-21.26%**	**23**	**0%**	-0.93%	-0.68%	0.12%	-4.91%	-3.66%	-2.94%	-2.53%	-1.60%	-0.20%	-4.74%	-0.38%	-1.04%
TECHNOLOGY*	**14.77%**	**14**	**17%**	0.65%	-0.31%	0.40%	1.97%	2.15%	0.88%	1.18%	1.81%	-0.62%	4.59%	1.12%	0.14%
TELECOM AND MEDIA	**30.39%**	**4**	**8%**	0.70%	-1.24%	0.30%	4.56%	8.55%	1.71%	2.68%	1.11%	0.70%	4.38%	2.42%	1.32%
VALUE	**24.11%**	**8**	**34%**	0.66%	-0.90%	0.88%	3.72%	4.46%	2.14%	1.60%	1.50%	0.52%	2.59%	2.03%	2.71%
HENNESSEE HEDGE FUND INDEX	**19.69%**		**30%**	**0.70%**	**-0.24%**	**0.42%**	**2.76%**	**3.59%**	**1.43%**	**1.25%**	**1.61%**	**1.01%**	**2.64%**	**1.10%**	**1.92%**
CORRELATED**	**22.18%**		**33%**	**0.26%**	**-0.87%**	**0.47%**	**3.11%**	**4.92%**	**1.74%**	**2.13%**	**1.98%**	**0.43%**	**2.94%**	**1.51%**	**1.70%**
NON-CORRELATED**	**12.69%**		**19%**	**1.63%**	**0.52%**	**0.41%**	**1.69%**	**1.66%**	**0.82%**	**0.24%**	**0.24%**	**1.32%**	**1.48%**	**0.77%**	**1.26%**
GLOBAL	**26.75%**		**39%**	**-0.04%**	**0.02%**	**0.33%**	**3.84%**	**3.51%**	**1.81%**	**0.75%**	**3.61%**	**2.01%**	**4.03%**	**0.47%**	**3.75%**
S&P 500 W/DIV	**28.55%**			-2.60%	-1.55%	1.00%	8.28%	5.25%	1.28%	1.69%	1.93%	-1.06%	5.65%	0.83%	5.26%
DJIA	**25.33%**			-3.45%	-2.02%	1.28%	6.11%	4.37%	1.53%	2.76%	1.97%	-1.49%	5.67%	-0.19%	6.86%
LIPPER MUTUAL FUNDS	**34.21%**			-1.72%	-1.61%	0.41%	7.55%	7.00%	1.88%	2.37%	3.47%	-0.69%	6.08%	1.90%	3.69%
MSCI EAFE (USD) PRICE	**35.29%**			-4.23%	-2.47%	-2.39%	9.38%	5.66%	2.19%	2.31%	2.16%	2.92%	6.17%	2.08%	7.77%
RUSSELL 2000	**45.39%**			-2.85%	-3.13%	1.12%	9.37%	10.62%	1.67%	6.17%	4.50%	-1.96%	8.31%	3.46%	1.90%
NASDAQ	**50.01%**			-1.09%	1.26%	0.27%	9.18%	8.99%	1.68%	6.92%	4.35%	-1.30%	8.13%	1.45%	2.20%
LEHMAN BROS. INT. GOVT. CORP.	**4.30%**			-0.01%	1.41%	0.10%	0.76%	2.01%	-0.07%	-2.72%	0.24%	2.53%	-0.94%	0.14%	0.87%

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