



COMMENTS OF HENNESSEE GROUP LLC

FOR THE

U.S. SECURITIES AND EXCHANGE COMMISSION

ROUNDTABLE ON HEDGE FUNDS

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I. HEDGE FUND OVERVIEW

A. Hedge Funds And The Farmer

The concept of hedging a long position by executing a short position is not a new concept. It wasn't developed in the 1950's by A.W. Jones. In fact, farmers have been hedging market risk for several hundred years by being simultaneously long and short the commodity they harvest for the end user market.

This occurs when a farmer sells a crop before it is harvested in the forward or futures market, to lock in a price today against a future delivery of that crop at a specified date in the future. Essentially, the farmer can be a short seller and a hedger against the possibility of a decline in prices but obligated to deliver the crop at the specified price, regardless of whether prices rise or fall.

The farmer, the end users of the crop, and the commodities speculators, all have different objectives but together provide liquidity, hedging and an efficient pricing mechanism fundamental to a mature open commodities market.

Perhaps the concept of hedging employed by the great American farmer and the commodities market is the cornerstone of the hedging concept applied by hedge fund managers today.

B. A.W. Jones Was Not The First

Admittedly, Alfred Winslow Jones was the first to go long and short stocks in a limited partnership format, however, he was not the first to implement the strategy, investment banks were. This should not diminish Mr. Jones' pivotal importance to the hedge fund industry but perhaps put hedge funds in a broader context.

Hedge funds are nothing more than proprietary trading desks wrapped into a limited partnership. Every conceivable hedge fund strategy: value investing, distressed bonds, high yield bonds, merger arbitrage, long/short equity, convertible arbitrage, emerging markets, day trading, etc. are all executed on the proprietary trading floors of investment banks. Many of these strategies appear at commercial banks as well. The methods of stock picking, developing arbitrage trades, use of derivatives, leverage and risk management, to name a few, are virtually identical in both the hedge fund and institutional proprietary trading at investment banks and commercial banks. However, while the methods overlap, the degree of sophistication can vary from one hedge fund to another.

Nonetheless, one could make the case that the largest hedge funds are the investment banks.

II. SOME COMMON MISCONCEPTIONS ABOUT HEDGE FUNDS

The following are direct quotes from various articles written about hedge funds.

A. “Hedge Fund Are Known For Making High Stakes Bets In Global Stocks, Bonds And Currencies.”

This description of hedge funds who make directional bets on global stocks, bonds and currencies applies to about 6% of the assets in the industry (i.e., macro managers). Over 60% of the industry’s capital is in long/short equity trading and the balance of 34% consists of relative value arbitrage, event driven arbitrage and other arbitrage strategies. None of these strategies (94% of industry capital) are making “high stakes bets on global stocks, bonds and currencies.”

It is misleading to define the entire hedge fund industry by using macro managers or Long-Term Capital Management as a proxy.

Of the \$600 billion in hedge funds approximately:

- \$36 billion is in macro
- \$204 billion is in relative value, event driven arbitrage and other arbitrage strategies
- \$360 billion is in long/short equity

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

On the margin, hedge funds (if they act in unison) can move a stock or move the broad averages momentarily but this is not believed to be the rule when you consider other influences:

- Mutual Fund redemptions have been a major force in this bear market.
- Program trading can amount to 40% of a given day’s volume on the NYSE. Little of this, if any, is hedge fund related.
- Portfolio liquidations by insurance companies to monetize losses due to terrorism and natural disasters.
- Proprietary trading in stocks, bonds and currencies by commercial banks and investment banks can look like hedge fund trading.

- Institutional managers using derivative “portfolio overlays” to hedge the long bias of their equity portfolios can result in an offsetting short of a basket of stocks in the cash market by the issuer.

In short, many institutions act in a manner similar to hedge funds. Putting the industry in perspective, the global markets are estimated at \$30 trillion versus hedge funds at \$600 billion.

C. “The Reckless Shorting By Hedge Funds Has Caused Us To Stop Lending Securities.”

In 1931, after a study of the 1929 crash was completed, the NYSE concluded that:

“The real cause of declining securities was not short selling but the lack of buyers against forced sellers.”

The 1991 Congressional report on short selling by the House on Government Operations stated that:

“Short selling plays an important and constructive role in the markets and that many complaints about short selling are not soundly based and may be a result of a poor understanding of short selling.”

See Section VI for more detail on shorting.

III. GROWTH OF THE HEDGE FUND INDUSTRY

A. Do We Have A Good Grasp Of The Size Of The Hedge Fund Market? What Is It?

It is fair to say that the overall industry’s understanding of the growth is an extrapolation of independent research and databases and not a science. Despite this flaw, most sources, including the Hennessee Group LLC, estimate assets in the hedge fund industry at \$600 billion.

The Hennessee Group has been tracking industry asset growth and performance for the hedge fund industry since 1987. Hennessee’s data in 1987 was nearly all inclusive since there were less than 100 hedge fund managers and our founder, Elizabeth Lee Hennessee, was able to document their assets and performance directly as a by product of her career in institutional sales and hedge fund advisory services.

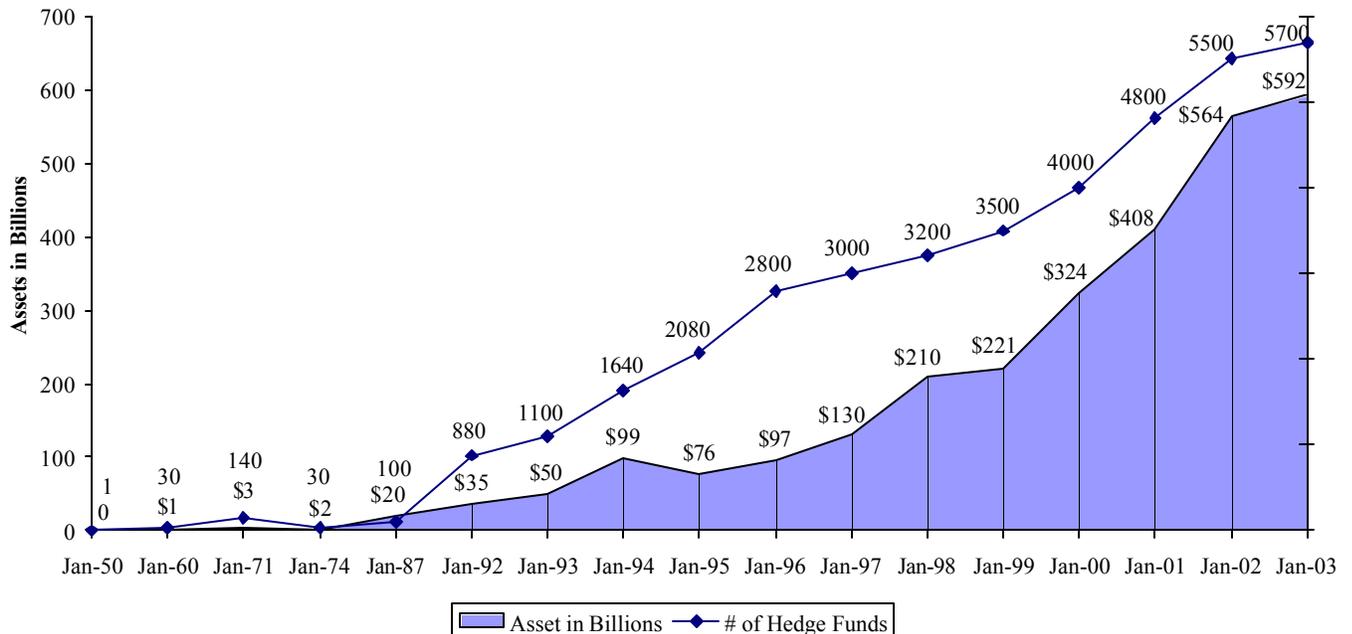
Beginning in 1990, E. Lee Hennessee had asset and performance history that statistically included between 90% and 95% of the industry. However, as the decade progressed, the industry grew from 100 managers and \$20 billion in assets in 1987 to 880 managers and \$35 billion in 1992. During this period of growth, the Hennessee Group performed research to extrapolate manager and asset growth. Since the industry was highly

concentrated around the original 100 managers (and more concentrated around Soros, Steinhardt, Robertson and Levy), any inaccuracies in the data regarding assets were statistically insignificant. However, by the mid-90's, the hedge fund industry became so dispersed that the Hennessee Group instituted its first formal annual industry research in January 1995. At that time, the handful of managers who had constituted over 60% of the industry assets had fallen to one-third (33%). Extrapolation through manager surveys became the most practical method of obtaining a perspective on the industry.

The chart below represents the Hennessee Group's industry growth data. The data prior to 1994 was extrapolated from manager surveys encompassing 90% or more of the estimated industry capital. The surveys beginning in January 1995 through January 1999 typically researched anywhere from 40% to 60% of the industry's assets and extrapolated overall industry growth based on this significant sample size. From January 2000 to present, our manager research has studied asset growth on no less than 23% of the estimated industry.

Our most recent research report included 193 management companies and 793 hedge funds totaling \$137 billion (23%) of the industry, estimated at \$592 billion as of January 2003.

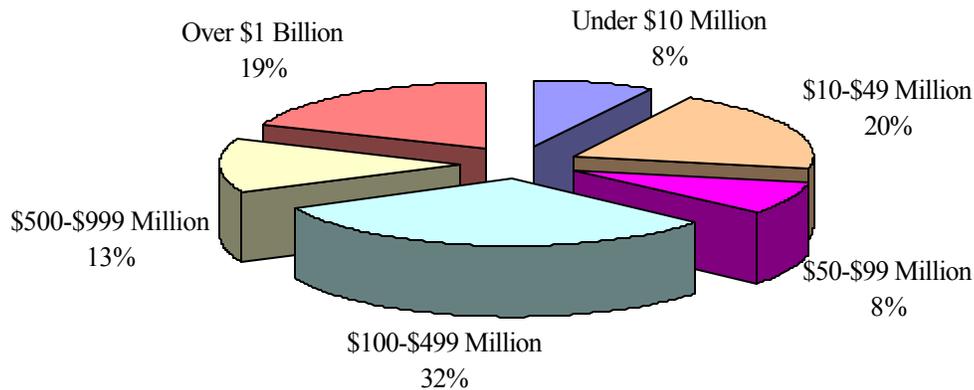
Hedge Fund Assets vs. Number of Hedge Funds



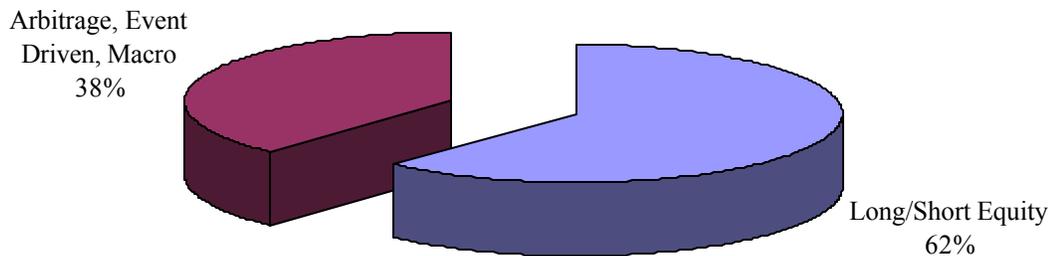
IV. HENNESSEE GROUP ANNUAL INDUSTRY SURVEY

The Hennessee Group has been conducting its annual industry surveys since January 1995. The January 2003 research report encompassed 193 management companies with 793 hedge funds totaling \$137 billion of hedge fund assets. Participants came from a cross section of all strategies and asset sizes.

2003 Hennessee Group Manager Survey Participants by Hedge Fund Asset Size



2003 Hennessee Group Manager Survey Participants



The basic conclusions from this survey were:

A. Capital Structure

- Hedge fund industry assets increased 5%, to \$592 billion, in January 2003 on a year-over-year basis. Since the beginning of the bear market, hedge fund assets have increased 83% (\$324 billion to \$592 billion).

- Total asset growth in 2002 was the lowest growth in any year since the survey began in January 1995. Likewise, the growth in hedge fund managers was the lowest on record at 3.5% (year-over-year) from 5500 to 5700 managers.
- Individuals and family offices continue to represent the largest source of capital for hedge funds, comprising 42% of total industry assets but down from the prior year's level of 48%.
- The fastest growing source of new capital is fund-of-funds, increasing from 16% in 2000 to 27% in 2002.
- The vast majority of capital (88%) was sourced by the general partner/employees and in-house marketing efforts.
- The average hedge fund manager aspires to manage \$693 million in capital.
- The average hedge fund can increase its capital by 142% from its current level.

B. Portfolio Composition

- Hedge funds outperformed the broader equity market indices in 2002, as the Hennessee Hedge Fund Index[®] declined -3.43% net of fees versus the NASDAQ (-31.52%), S&P 500 DRI (-22.19%), and DJIA (-16.76%).
- Hedge funds continue to position their portfolios defensively, as 2002 has the lowest net exposure (33%) in the history of Hennessee's research.
- For the last three years, hedge funds have not utilized margin to any significant degree and have continued to decrease their long exposure as it became increasingly difficult to find opportunities on the long side.
- The average hedge fund gross exposure was 121%, further dispelling the notion that hedge funds are a highly levered asset class.
- While gross exposure in 2002 increased slightly from the prior year, this increase was entirely due to hedging as short exposure increased from 34% to 44% while long exposure decreased from 83% to 77%.
- 84% of hedge funds have not had their historical gross exposure exceed 200%.
- The average portfolio manager turns their portfolio over 3 times (a 30% increase from 1999). This increase in turnover is largely due to the increase in market volatility.

- As volatility increased in a declining equity market, hedge funds increased their portfolio turnover in an effort to minimize losses and take gains wherever possible.

C. Transparency and Industry Registration

- 20% of hedge funds researched provide their investors with access to the entire portfolio.
- 8% of hedge fund researched expect to increase transparency in 2003.
- The number of hedge funds who have websites has increased 75% since 1999 (from 36% to 63%).
- 50% of hedge funds researched were Registered Investment Advisors, with either State or Federal agencies.
- 25% of hedge funds researched were registered with CFTC, NASD or NYSE.
- 25% of hedge funds researched were not registered with any regulatory body (NYSE, NASD, SEC, CFTC).

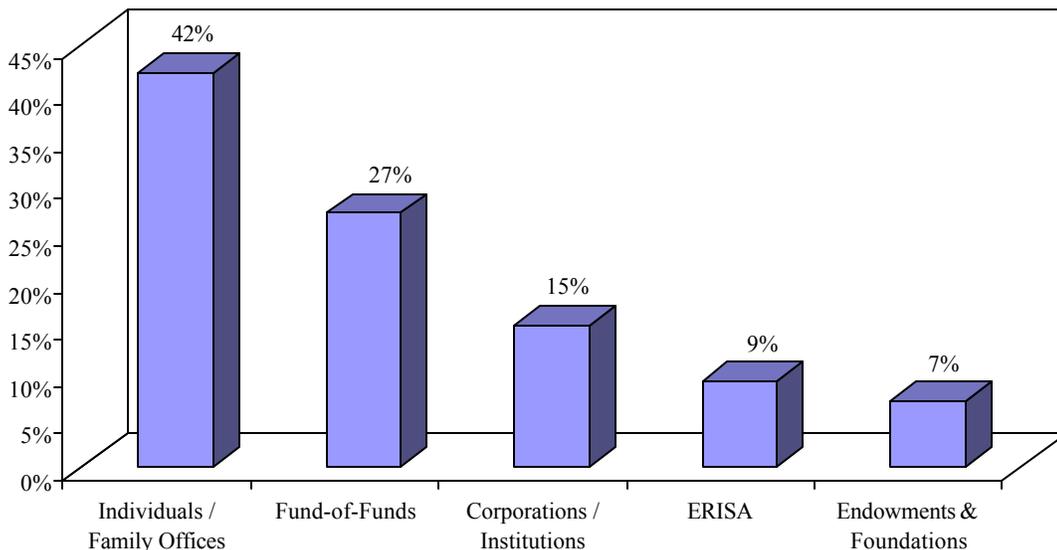
V. CAPITAL STRUCTURE

A. Sources Of Capital

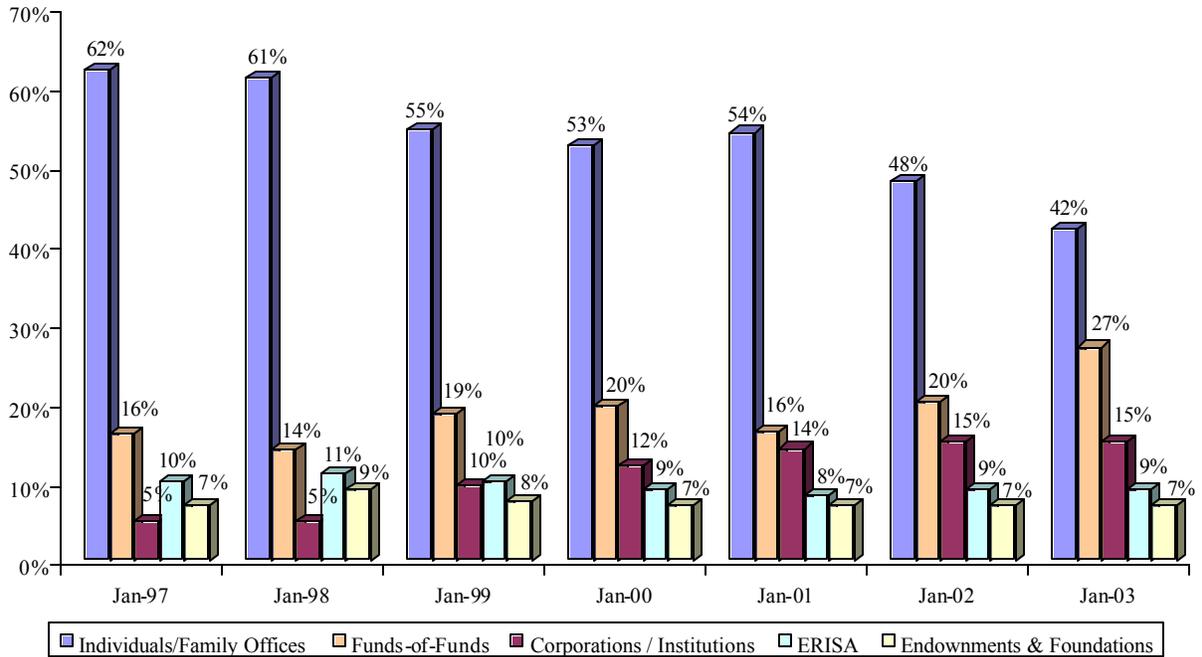
Direct investing by high net worth individuals and family offices has always been the largest single source of capital to the hedge fund industry. Nonetheless, direct investing by individuals and family offices is declining as a percent of the industry’s capital base.

In terms of percentage and absolute dollars, fund-of-funds have become the second largest source of capital for the hedge fund industry.

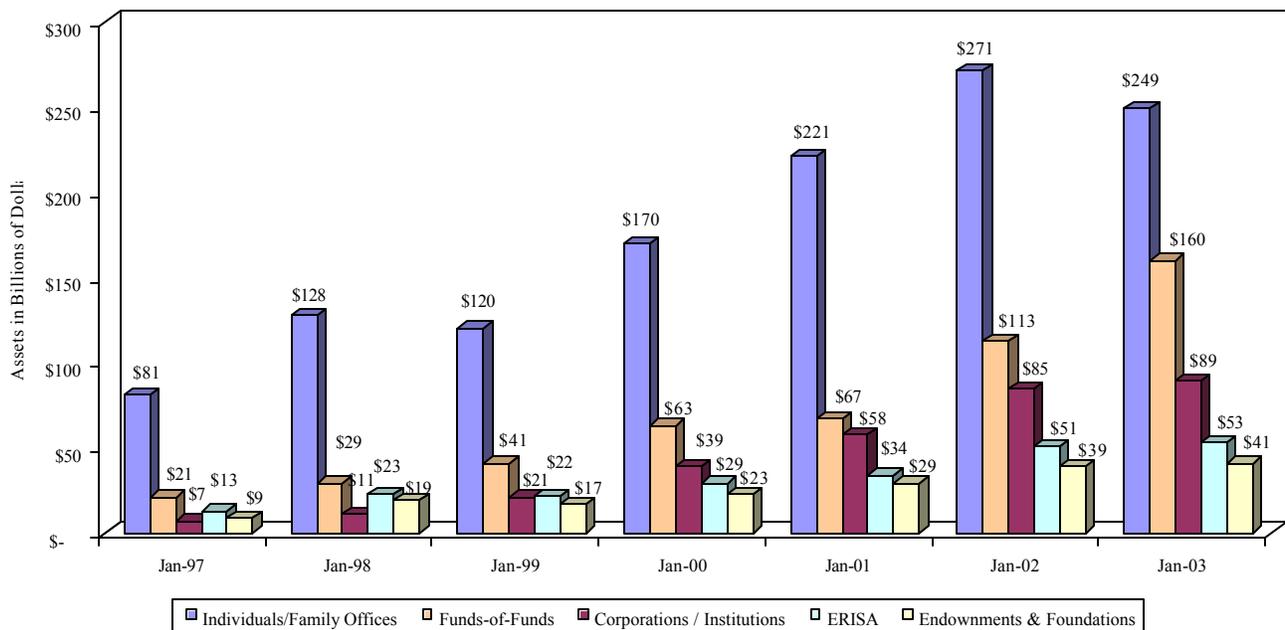
Hedge Fund Sources of Capital as of January 1, 2003



Hedge Fund Sources of Capital from January 1, 1997 to January 1, 2003
(As a Percent of Total)

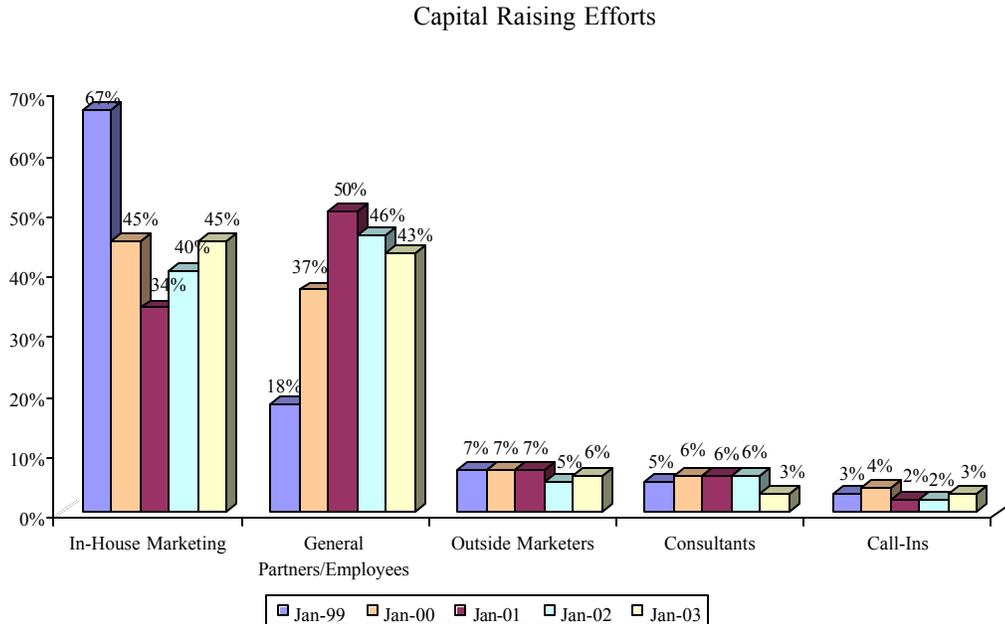


Hedge Fund Sources of Capital from January 1, 1997 to January 1, 2003
(In Dollar Terms)



B. Capital Raising

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



C. Available Capacity For Asset Growth

On average, hedge fund managers believe they have available capacity for 142% in new assets. This can be translated to mean that the industry, which is approximately \$600 billion, can add another \$900 billion and grow from current levels to approximately \$1.5 trillion. At 15%, 20% and 25% annualized compounded growth, it will take 7, 5 and 4 years respectively to reach \$1.5 trillion.

This available capacity estimate differs considerably from estimates recently published that the industry will grow to \$2 trillion in the year 2005. Therefore, either: (a) hedge fund managers will go beyond capacity limits they currently foresee according to Hennessee Group research or; (b) new capacity will be added by growth in new managers who will take on new capital added to the industry or; (c) a combination of both will take place.

The growth in new managers may be stymied because the industry has evolved to the critical point where “success breeds more success” in attracting new capital. Consequently, upstart hedge funds may not get substantial new capital inflow until the well established hedge funds with available capacity are closed to new capital or have performance issues before they attain their desired capital level.

We believe estimates of \$2 trillion in 2005 are pure linear or exponential extrapolations and may not take into account the greater difficulty, and therefore slower growth rate, new hedge funds will have in attracting new capital. New hedge funds are entering the industry at a time when a significant portion of the industry is already established with respectable track records of 5 or more years who are also capable and willing to take on substantial new capital.

The industry is at the early stages of its maturation where new upstarts may be “squeezed out” in competing for new capital by the more established players.

VI. HEDGE FUND PORTFOLIO COMPOSITION

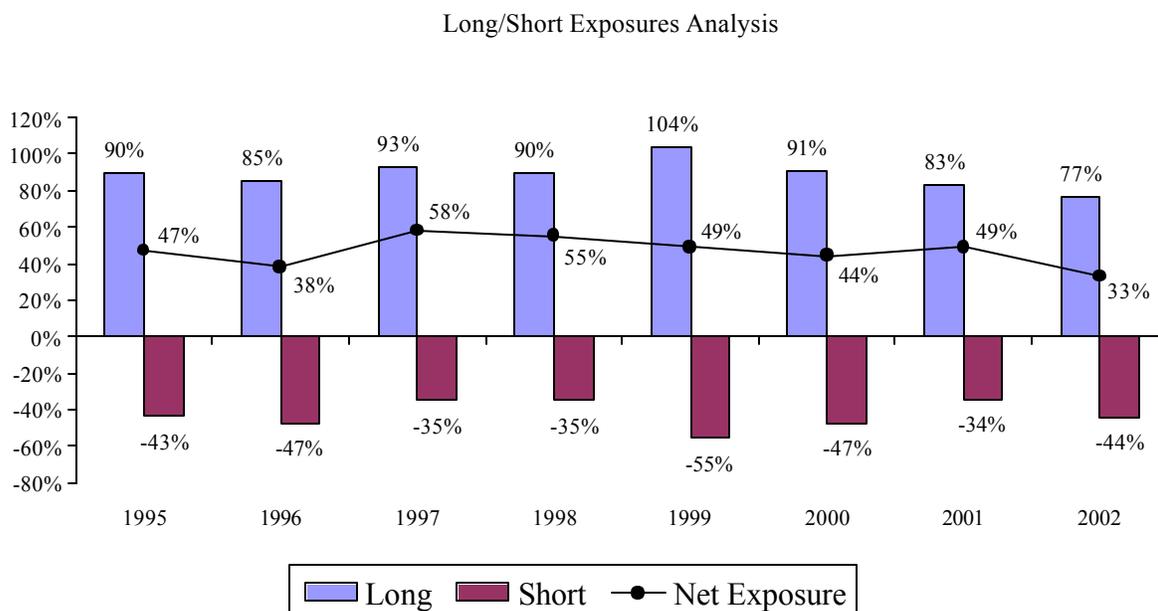
A. Equity Long/Short Exposures

As a generalization, it is not true that equity long/short hedge funds (as a group) were net short the recent bear market. In fact, hedge funds on the whole were net long during the bear market with preservation of capital as the main objective, not “pressing the short side” for profit, but for preservation.

The Hennessee Hedge Fund Indices^a supports the notion that preservation of capital (not “wild shorting” of the market for profit) was the objective of equity hedge fund managers as a whole during the bear market:

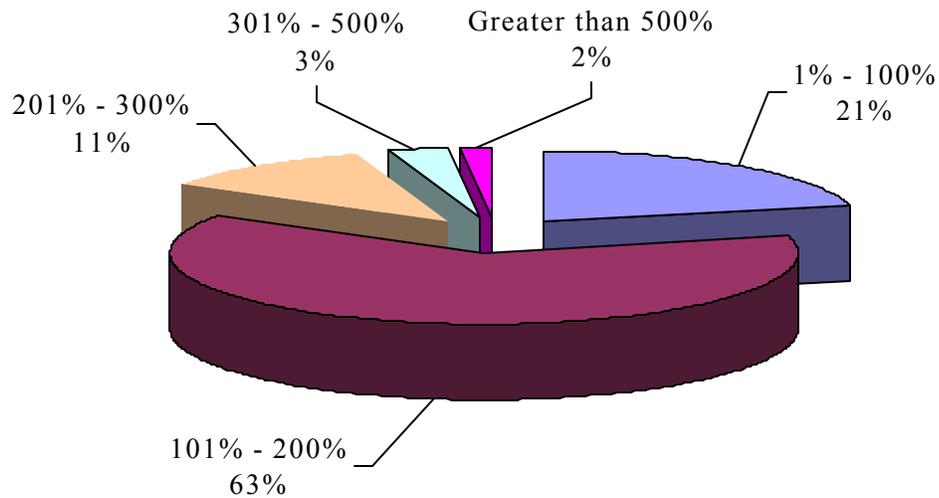
Year	Long/Short Equity Hedge Fund Managers	Arbitrage, Event Driven Credit Risk	S&P 500
2000	+9.20%	+9.38%	-10.14%
2001	+1.34%	+8.66%	-11.89%
2002	-8.25%	+2.10%	-22.19%

The following charts were extracted from Hennessee Group research pertaining to Long/Short Equity hedge fund managers:



The following chart includes long/short equity and arbitrage strategies:

Maximum Historical Gross Exposures Since Inception (Long plus Short)



B. Leverage

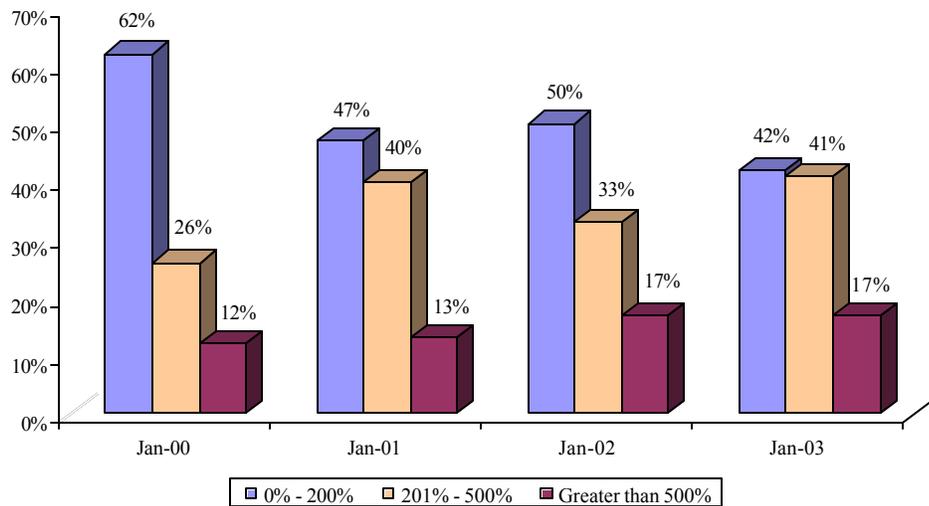
According to Hennessee Group's research, it is incorrect to conclude that the hedge fund industry as a whole is "wildly levered". It is important to note that 84% of hedge funds in Hennessee Group's research use less than Reg T leverage (200% of capital). Only 2% use leverage in excess of 500% (predominately convertible arbitrage).

CTA's are excluded from Hennessee research in order to be consistent with the historical description of hedge funds as unregulated entities. CTA's are regulated by the CFTC. Despite the growing registration of hedge funds with State and Federal agencies, Hennessee Group continues to believe that CTA's are not hedge funds because their roots are in commodities trading (i.e., derivatives market) and not securities trading (i.e., cash market). Hennessee Group recognizes that there is not one simple answer and that the definition of a hedge fund is controversial. Although the Hennessee Hedge Fund Indices[®] include a macro manager sub-index, pure CTA's are excluded. Macro managers in the Hennessee Group Index and annual Hennessee Group industry research have more than 50% of their portfolio exposure in the cash market.

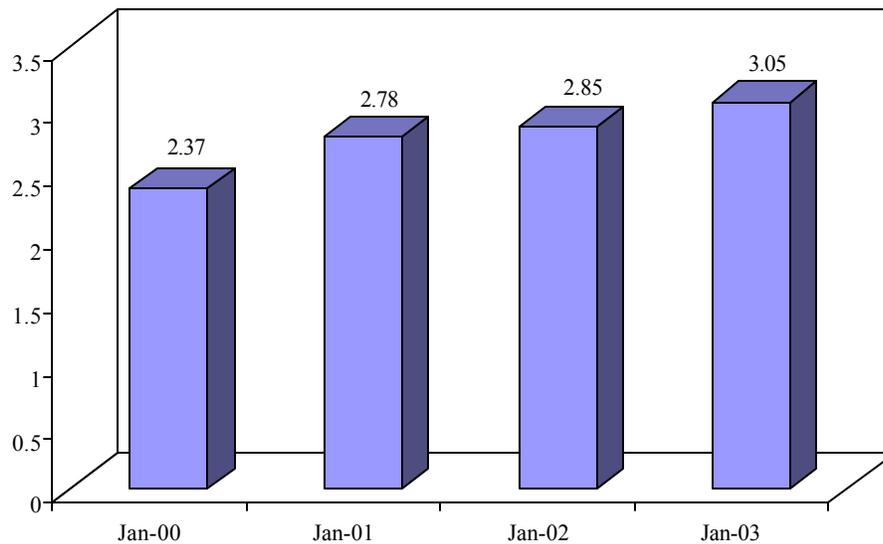
C. Portfolio Turnover Rate

Hennessee Group's research indicates that it is incorrect to characterize the hedge fund industry as "cowboy day traders" who turn their portfolio over every day or two. On the margin, there may be some managers who have extremely high portfolio turnover rates, however, this is not characteristic of the industry as a whole.

Portfolio Turnover Rate January 2000 to January 2003



Average Portfolio Turnover Rate January 2000 to January 2003



VII. REGULATORY OVERSIGHT

A. Application of Hennessee Research

Hennessee Group’s research regarding regulatory oversight should only be used as an indicator of an industry trend and should not be extrapolated for the hedge fund industry as a whole (in terms of numbers of hedge funds registered or not registered).

However, in terms of capital under management that is also under some form of regulatory oversight, it is reasonable to presume that a major portion of the industries' capital is registered with either the SEC, NASD, CFTC, NYSE or State agencies.

Of Hennessee Group's research population, only 8% were managers with less than \$10 million. We believe this low representation does not negate the findings for the industry growth, capital structure and portfolio composition sections of our research because size is not a key determinant of action in these areas.

However, size of the hedge fund is a key determinant as to whether or not to register with a regulatory agency. Hennessee Group research indicates that one-third of the industry has less than \$10 million in assets (mainly startups). These clearly are unlikely candidates for registration and, therefore, the research should not be applied to the population of hedge fund managers (i.e., 6000) but instead to the capital managed that is under regulatory oversight of at least one agency.

B. Registrations

Due to market forces predominantly driven by trust and ERISA fiduciaries, hedge funds are finding it necessary to become Registered Investment Advisers in order to attract capital from that market. Fifty percent (50%) of the hedge funds in our research were Registered Investment Advisers at the State or Federal (SEC) level. Twenty-five percent (25%) were registered with the NASD, NYSE or CFTC and 25% were not registered with any regulatory agency.

VIII. CURRENT TRENDS IN THE HEDGE FUND INDUSTRY

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

- increased registration as a Registered Investment Adviser, Commodity Pool Operator or Broker Dealer
- exponential growth in Fund-of-Funds from \$20 billion in 1994 to \$160 billion in 2002 (27% of the industry)
- exponential growth in institutional investing from \$53 billion in 1998 to \$175 billion in 2002 (30% of the industry)
- a reduction in "Qualified Audits" due to lack of disclosure in annual audit
- greater public accessibility to hedge fund information through internet and print media

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

IX. ARE HEDGE FUNDS BECOMING MORE COMPARABLE TO MUTUAL FUNDS? SHOULD HEDGE FUNDS COMPLY WITH THE INVESTMENT COMPANY ACT OR INVESTMENT ADVISERS ACT?

A. Areas Of Least Comparability Between Hedge Funds And Mutual Funds

- daily third party pricing by a custodian for U.S. onshore hedge funds
- full transparency
- diversification rules

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

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

- independent pricing services (monthly)
- migration away from smaller accounting firms to the majors
- sophisticated investment risk monitoring (i.e., VAR, etc.)
- real-time trader P&L systems
- daily mark-to-market
- formal back office reconciliation of cash and securities

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

However, in comparing hedge funds to mutual funds, Hennessee Group believes the question of registering hedge funds as mutual funds should be market driven. Those hedge funds or fund-of-funds that want to tap the retail market should become mutual funds.

Mutualization of hedge funds should not be a mandate but a choice. In this way, we can protect the retail investor without inhibiting the free determination of hedge fund investment objectives and their use of investment strategies. The integrity of the entrepreneurial spirit of the hedge fund industry should be protected and many believe this protection is essential to the concept of an “open market place”. Many benefits to the market place are a direct result of the entrepreneurial nature of hedge funds, least of which is contrarian research (i.e., Enron, WorldCom), added liquidity and a more efficient market pricing mechanism.

A mandate that all hedge funds register as a Registered Investment Adviser seems to have benefits that will not justify the regulatory oversight expense. Besides, as stated earlier, the market is driving the need for registration. Let the sophisticated accredited investor choose registered products versus non-registered products as they currently do with venture capital, private equity and other limited partnerships.

In other words, the degree of regulation should be a function of market needs. We need to protect the retail investor and, at the same time, allow capital formation to meet other investor needs whether they are hedge funds, venture capital or private equity.

It does not seem reasonable to permit sophisticated accredited investors to have ownership in a startup venture capital company through an unregistered private placement but not allow investment in an unregistered hedge fund by that same individual.

In short, the Investment Company Act is not the only way to protect investors and we are not in a hedge fund crisis.

The issues facing the industry and regulation alike may be better served through:

- investor education
- systemic risk monitoring
- risk transparency
- more frequent third party pricing
- tightening of “accredited investor” and “suitability” rules

X. HAS THERE BEEN A TRANSITION OVER THE YEARS TO INCREASE OR DECREASE THE AMOUNT OF RISK HEDGE FUNDS TAKE ON?

A. Some Misconceptions About Risk

- *Many feel that assuming risk creates a risky investment. Hennessee Group believes hedge funds as a whole expose themselves to risk in an intelligent way.*
- Is shorting necessarily a risky strategy? The intelligent use of shorting and derivatives by hedge funds can reduce risk.
- Leverage doesn't always mean you are taking on more risk. Banks are levered 20 to 1.
- Hedge fund managers add risk with respect to the portfolio as a whole and the prudence of the strategy.
- Making an investment, which in of itself assumes greater risk, does not necessarily increase the risk of the overall pool.

B. Has Risk Increased Or Decreased Over The Years?

- Three key risk measures are: (a) *volatility risk* as defined by the standard deviation of performance; (b) *leverage* as defined by gross market exposure; (c) *portfolio risk* as defined by net market exposure.
- The standard deviation for a diversified hedge fund portfolio appears to the Hennessee Group to be much less than the broad market of diversified securities (S&P 500). From 1987 to present, Hennessee Group research indicates that the S&P 500 has averaged 18% standard deviation while the Hennessee Hedge Fund Index[®] was 11.25% for the same period.
- Leverage used by hedge funds is often exaggerated. Eighty-four percent (84%) of hedge funds in our research have historically never exceeded Reg T. Those that do exceed Reg T (200%) are arbitrage strategies (i.e., convertible arbitrage, merger arbitrage, etc.). For the major portion of the industry (long/short equity), average gross exposure ranged from a high of 159% in 1999 to a low of 117% in 2001. Only 2% of the managers researched used leverage above 500%.

See VI. B. for rationale to exclude CTA's from Hennessee Group's research.

- Portfolio risk management has greatly improved as the industry has evolved. More managers are imposing position limits and stop losses. Where diversification is an issue (i.e., sector funds), hedging techniques are being used to reduce that risk. Value At Risk (VAR) modeling is common among larger hedge funds.

- Performance in this bear market (2000 – 2002) would be one way to measure risk. A diversified portfolio of hedge funds during this current bear market indicates that risk management has been successful. According to the Hennessee Hedge Fund Indices[®], the percent of managers who outperformed the S&P 500 in 2000, 2001 and 2002 were 87%, 89% and 92% respectively.

XI. WHAT TYPES OF SERVICES DO CONSULTANTS PROVIDE?

A. Value Added Nature Of Consulting Services

Consultants are value added and can provide a useful service to investors. We haven't surveyed the consulting industry, so Hennessee Group can only speak from its own vantage point.

The value that hedge fund consultants provide is similar to the value consultants provide pensions, endowments, foundations, and government entities, which is fundamentally the analysis of the customer's investment needs and assistance in determining asset allocation, manager selection, and ongoing monitoring.

Hedge fund consultants can be of special value in evaluating hedge fund investments because:

- It is an industry that is relatively difficult to learn about from public information.
- Hedge funds are less transparent. Consultants can provide the value of discernment about a strategy.
- The instruments and strategies used by hedge funds can be generally more complex than what you find in traditional money management, so hedge fund consultants can be value added in identifying inherent strategy risk.
- Determinations about suitability and what is in the best interest of the client can be a difficult exercise without a consultant.
- The client needs to understand several potentially misleading terms used in the industry, for example: (a) "ABSOLUTE RETURN" really means non-correlated returns, which can be negative and; (b) that "MARKET NEUTRAL" is not neutral to risk.
- Hedge fund consultants provide professional expertise in evaluating investment opportunities, especially in arbitrage strategies.

B. What Types Of Services Do Consultants Provide?

- We need to first distinguish consultants in the traditional world vs. hedge fund consultants.
 - Traditional consultants do NOT manage money. However, hedge fund consultants may have discretionary and non-discretionary accounts...the discretionary business could also include a hedge fund-of-funds.

Hedge fund consultants provide the following services:

- ***Assist the client in determining suitability***
 - Lock-up/liquidity requirements
 - Net worth
 - Source of income
 - Other current asset allocations
 - Past experience with hedge funds
 - Perception risk vs. actual risk of the investment
 - How risky the investor thinks it is vs. the actual risk of the investment
- ***Assist the client in determining how to best deploy hedge funds***
 - Performance objectives
 - Perceived risk vs. actual risk (i.e., Long-Term Capital Management)
 - Time horizon for investments
- ***Asset allocation and portfolio construction***
- ***Education***
- ***Ongoing manager and portfolio performance monitoring through standardized reporting***
- ***Future portfolio recommendations***

Description of Hennessee Hedge Fund Index[®]

The Hennessee Hedge Fund Indices[®] are calculated from performance data supplied by a diversified group of hedge funds monitored by the Hennessee Group LLC. The Hennessee Hedge Fund Index[®] is believed to represent at least half of the capital in the industry and is an equally weighted average of the funds in the Hennessee Hedge Fund Indices[®]. The funds in the Hennessee Hedge Fund Index[®] are believed to be statistically representative of the larger Hennessee Universe of over 3,000 hedge funds and are net of fees and unaudited. Past performance is no guarantee of future returns. ALL RIGHTS RESERVED.

About the Hennessee Group LLC

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