BARON POINT FINANCIAL

The Seagram Building
375 Park Avenue, Suite 2607
New York, New York 10152
Tel +1 212 248 2733
Fax +1 212 504 3101
info@baronpoint.net

Baron Point Research Quarterly

First Quarter 2008

"Dealing with Periods of Higher Downside Volatility"

This is the first in a planned series of regular quarterly research reports that will investigate timely topics that impact Baron Point Financial ("Baron Point"). Each quarter we intend to describe current intermediate term market trends, followed by a discussion of various fund management including risk control techniques we employ and the manner in which they may come into play during those trends.

A summary table of contents is shown below. **If your interest is more towards the areas of techniques Baron Point adopts or emphasizes in adapting to the current environment, go directly to Page 8. If there are any comments or questions please feel free to email us at info@baronpoint.net or telephone +1 (212) 248-2733 x701.**

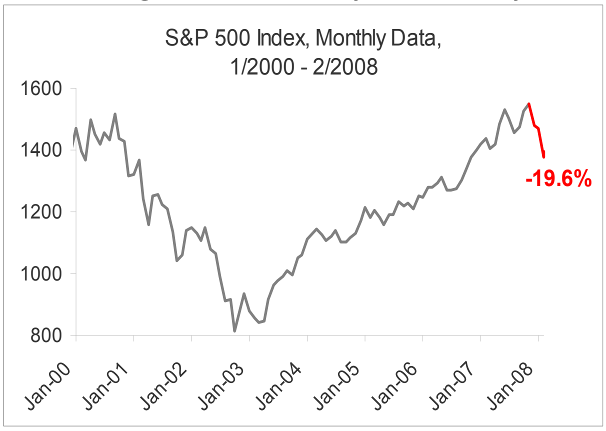
Table of Contents

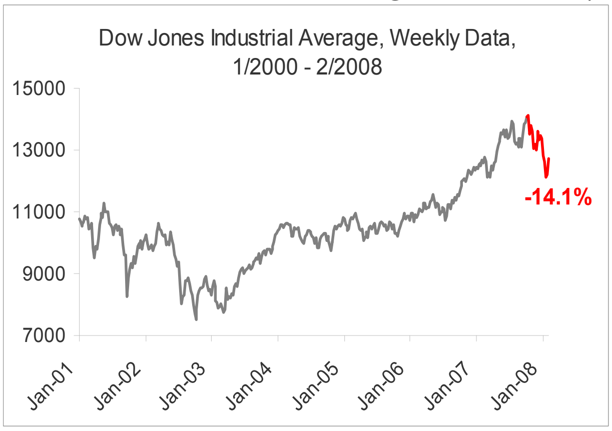
Disclaimer and Notices

Part I — Market Analysis

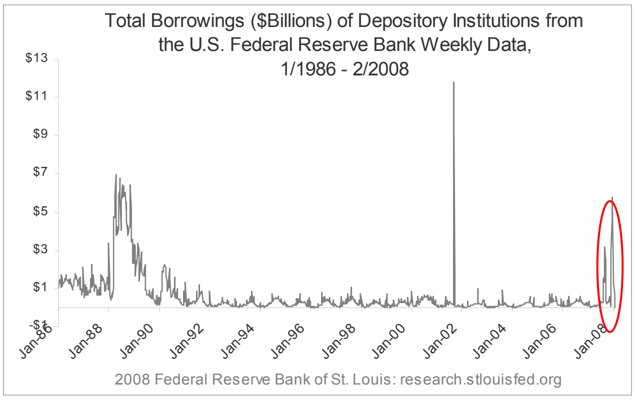
The U.S. Markets

As of early January 2008, investors turned aggressively defensive based on deteriorating global growth expectations and a belief that a U.S. downturn was on the horizon. The U.S.'s Dow Jones Industrial Average tumbled more than -5.09% in the first five trading days of the year, the second-worst January five day start since the Dow was first published on May 26,1896 (e.g. the worst being the first five days of January 1978, -5.61%, and the third worst being 1901, -5.08%).

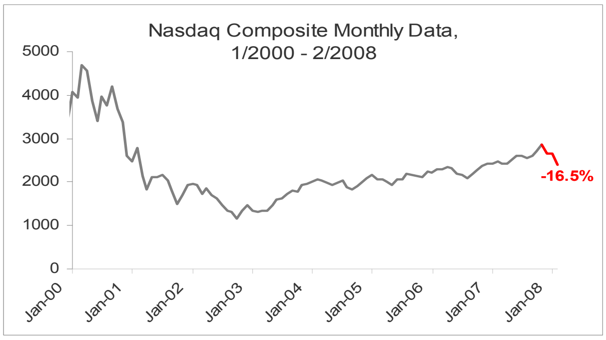


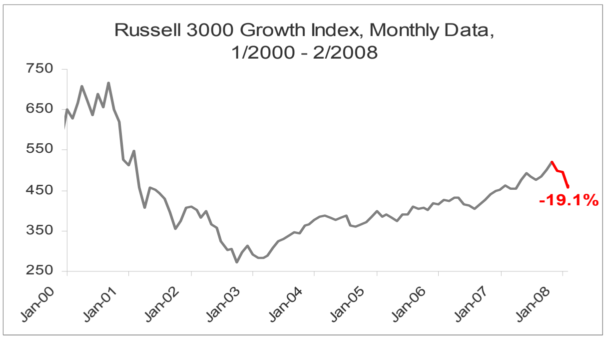


The first trading session of 2008 ended with the S&P 500 at 1447.16, barely above its August 17, 2007 close of 1445.94, the point at which the Federal Reserve began easing interest rates. In fact, by year-end 2007, the Fed Funds rate dropped by 1.00% and the Discount Window rate by 1.50%, resulting in $4.5 billion of Discount Window borrowing and $40 billion of de facto Discount Window borrowing — all simply to maintain approximate stock price levels of the S&P 500 at the close of trading January 2, 2008.



As January's rout continued, the S&P 500 closed -6% for the month, and down -19.6% for the month, a near bear market indicator. The U.S. Federal Reserve reacted by cutting the Fed funds rate .75% to 3.50% and nine days later, again, by .50% as Total Borrowings of Depository Institutions from the Federal Reserve spiked. While these actions may have averted the worst, many market watchers believe a bear market has already begun, or at least is unavoidable. The Nasdaq Composite Index and Russell 3000 Growth Index also took significant losses in January as well. From their short term October 2007 highs the Nasdaq lost -16.5% and the Russell 3000 dropped -19.1%.



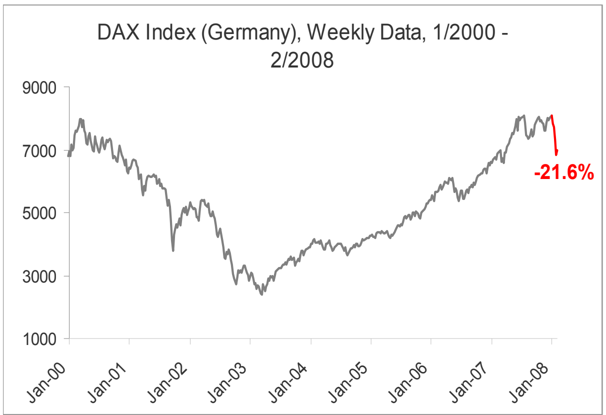


Source: Bloomberg LP and Choice Alternative Investments, Ltd.
Unless otherwise indicated

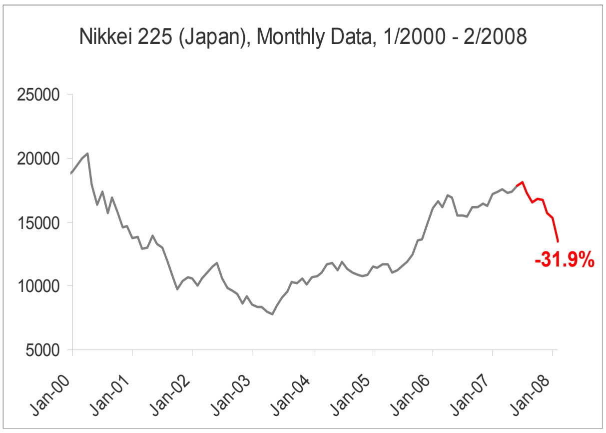
BARON POINT FINANCIAL

International Markets

Global markets have moved in tandem during this downside volatility, with Japan's Nikkei 225, the world's second largest economy coming off -31.9% from its highs, Germany's DAX Index, the world's third largest economy -21.6% and a darling of the emerging markets boom time, the Shanghai SE Composite in China falling -31.4% from its parabolic boom time highs.

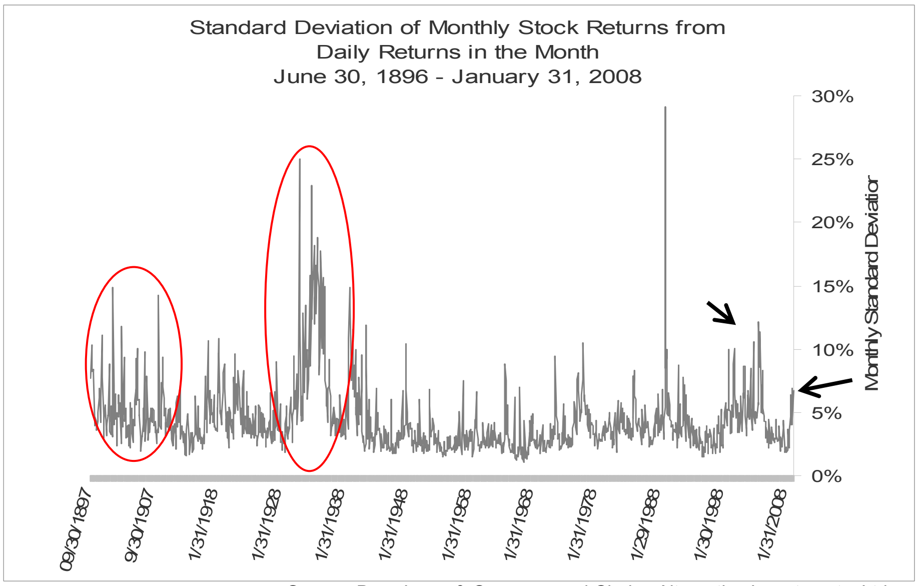


All of this seems to indicate that there is a risk emanating from the U.S. that could have repercussions globally and that the global investment environment for equities remains highly unsettled and in a bear market contraction.



Source: Bloomberg LP and Choice Alternative Investments, Ltd.

Relentless media coverage may lead one to believe that the high daily volatility in the major stock indices is unprecedented. However, according to Baron Point's research, current volatility (as measured by the standard deviation of monthly stock returns from daily returns back to 1896), although moving up, is not yet out of line with many market cycles. Volatility has been higher as recently as the U.S. technology bubble of the late 1990's and into the recession of the early 2000 cycle. More dramatic, the 1930's and late 1800's into the early turn of the last century witnessed prolonged and increasingly volatile periods.

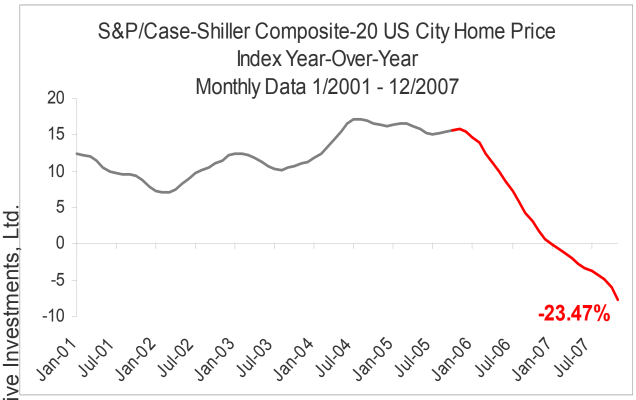


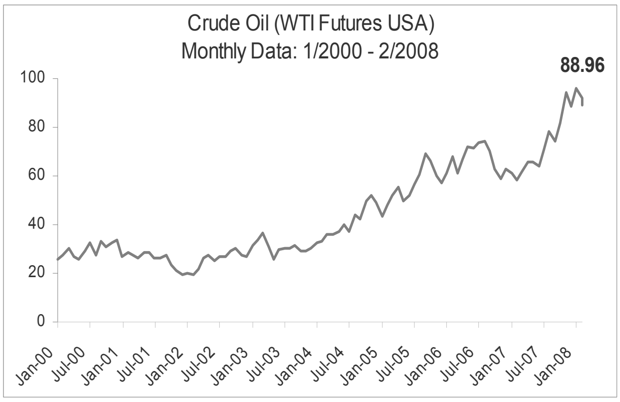
Source: Dow Jones & Company and Choice Alternative Investments, Ltd.

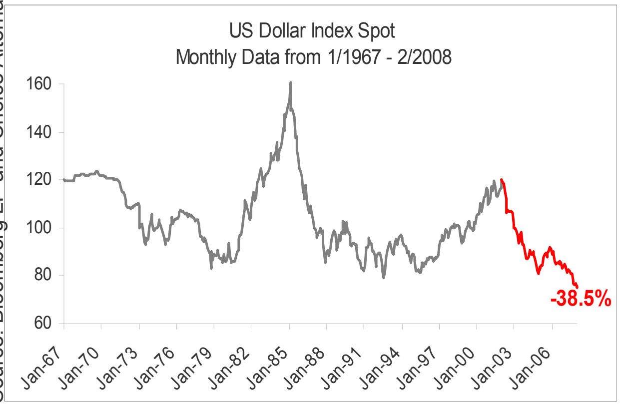
We take this to indicate that markets can become *much more* volatile, and prudent investors should prepare for the swings that define such activity.

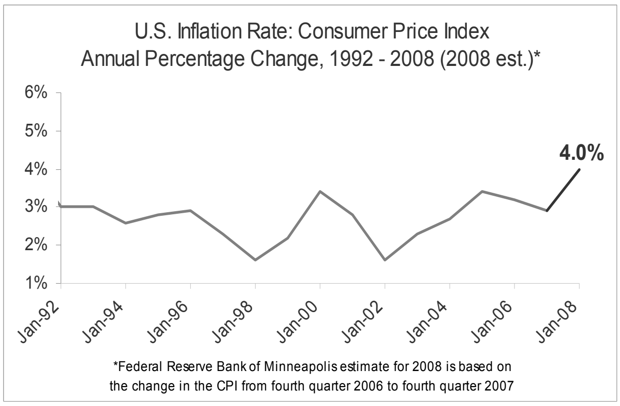
Potential Causes of Volatility

Uncertainty causes volatility, and for now, down. This is a time of great unease in the U.S. markets. Numerous factors, such as the subprime mortgage meltdown, liquidity crises in various markets, a bursting housing bubble, near $100 oil, a declining dollar, and the potential for inflation to re-emerge have led to speculation that the U.S. is about to enter its first recession.









Source: Bloomberg LP and Choice Alternative Investments, Ltd.

At the moment investors seek answers to fundamental questions such as: Are we in a bear market? How long will it take for U.S. housing to recover? Will the Federal Reserve continue cutting rates, and what impact will that have? Will the prolonged high price of energy and high food prices force inflation to re-emerge? The lack of clear answers has created increased downside volatility in the equity markets.

The U.S. economy is already slowing, and the effects will undoubtedly spread abroad. However, some claim that while the global economy will certainly slow, a world recession isn't inevitable – in fact, less than a 10% probability.

Here is a sampling of these opinions:

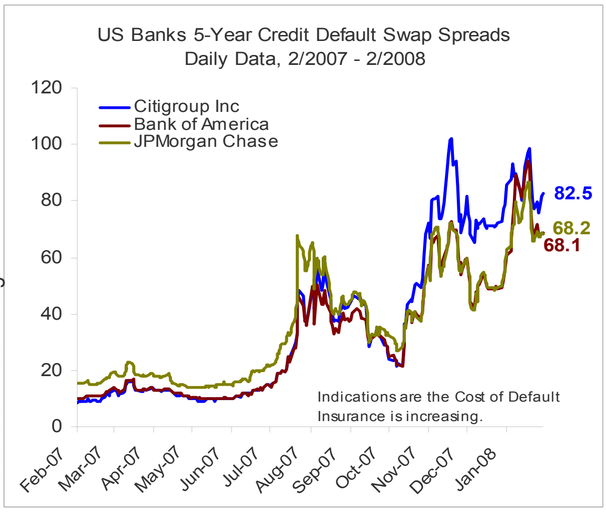
- *“While we continue to believe the U.S. economy will grow, there's no doubt it will grow at a slow pace and the downside risks have grown." -- U.S. Treasury Undersecretary David McCormick.*
- *“The problems in the credit markets are spreading, they are spreading to the consumer sector." -- Merrill Lynch & Co., Inc., CEO John Thain*
- *“If the U.S. consumer retrenches, it will hurt even the strongest foreign economies.” – Goldman Sachs Group, Inc., CEO Lloyd Blankfein.*
- *On the probability of a global recession, “A close call” -- Morgan Stanley Asia Chairman Stephen Roach*

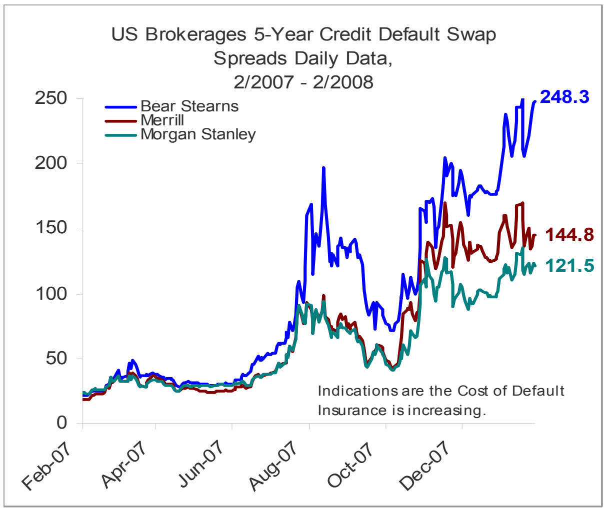
Until recently, U.S. and global demand has been driven by low interest rates and the extension of liberal credit to non-creditworthy consumers via various forms of financial engineering. The subsequent credit implosion has created the worst U.S. housing market decline in decades (see first chart above left of S&P/Case-Schiller USA Composite on prior Page 3).

This eroded growth in the U.S. economy, limited borrowing channels for all but the most established and highly rated companies, generated historic losses, and triggered management changes at banks and brokerages including Citigroup, Merrill Lynch, and Bear Stearns.

According to data compiled by Bloomberg, the world's largest financial companies have incurred $146 billion US in losses from securities tied to subprime mortgages so far, and four of the five biggest U.S. securities firms lost about $83 billion US of market value last year, almost 90 percent of their net income since 1999. The deteriorating credit environment is illustrated by the major spikes in the price of credit default swap ("CDS"), essentially a form of insurance against default (See charts below). This points to continuing uncertainty rather than an emergence of balance sheet stability for financials. Credit default swaps of European and Asian financial institutions indicate a similar trend.

Source: Bloomberg LP





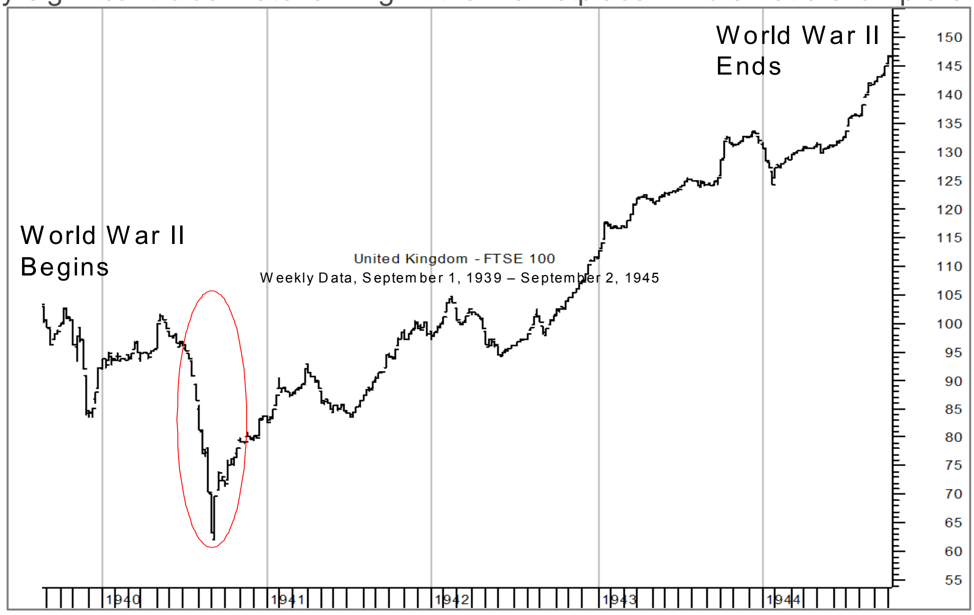
The Federal Reserve has taken action, but lower interest rates alone may not fix the problem. The current elephant in the room is the possible downgrading of the financial guarantee insurers, which could result in ratings downgrades to the bonds backed by the insurers, leading to a flight of capital from such investments. This is a significant fear for investors everywhere, especially in the money market and pension industry where ratings downgrades can force a cascading liquidation of lower graded issues to maintain compliance with investment policy parameters.

U.S. legislators have announced a bipartisan economic stimulus package including tax rebates. But even this, while welcome, may do only a little to reverse the current environment. Logistics may delay payments to consumers for several months, and the details of the package suggest it may not have the desired effect even if enacted in timely fashion. The tax rebate elements of the stimulus package are primarily targeted at more affluent consumers, who may not immediately spend them, and the rest of the package consists of business tax breaks intended to promote investment and hiring. Given the current mood of corporate retrenchment, it's not clear whether firms will utilize such breaks in the projected manner.

Taking a look back so we can see forward

Over the long run, economic prospects for sustainable growth and its impact on earnings are what drive stock prices. If the current growth level is increasing or the collective market's psyche is confident in prediction of strength, stocks tend to rise. If the current level of growth isn't thought to be sustainable, or as we find ourselves now, in a position of continued credit market unwind, stocks will stagnate and fall. In short, stocks have their greatest upside when there is the maximum room to grow in the economy. A bottomed out economy has the greatest room for sustainable growth.

The silver lining is - no matter what their cause - market downturns have always ended with the down cycle marked by significant bids materializing in the marketplace. A dramatic example of this is the grim times during World War II. The British stock market bottomed out in mid-September 1940 and started rising again during the truly grim days of the Battle of Britain (July to October 1940 and circled in red to the right). This is a time when the Germans were splintering London with bombs and preparing to invade the U.K. That was the bottom, and in fact, the equity markets sensed a major turning point some five years before this horrible war concluded in September 1945.



Source: FTSE International Limited and Choice Alternative Investments, Ltd.

US financials raised $84 billion US selling equity stakes since financial stocks assumed their downtrend. Since then, billionaire investor Warren Buffett submitted a firm bid to shore up the municipal portion of the financial guarantee insurers with an $800 billion US bid. This firm bid could serve to backstop the insurers and put the municipal bond insurance problem behind it. Thus leaving the CDO portion for insures to deal with. In return, Buffet would gain 33 percent of that market, not a bad deal.

As the industry prepares for potential negative news on either the economy or more losses to be recognized by financials, Merrill Lynch & Co. index data show bank bonds have returned 2 percent this year, already, the most of any investment-grade debt. These spreads will eventually contract as new entry points arise for value based investors. As bids firm, the equity market will begin a process of consolidation and re-building. Low risk opportunities for sustained bullish positions will eventually occur. Various technical indicators give Baron Point an idea of where to look for those low risk entry points.

However for now, the credit unwind continues. Baron Point remains adaptive, and follows the intermediate term trend down with a bearish trading bias - vigilant of capital preservation - while looking to grow capital with a scaled approach.

Baron Point Financial

How Investor's Could Deal with Periods of Higher Downside Volatility

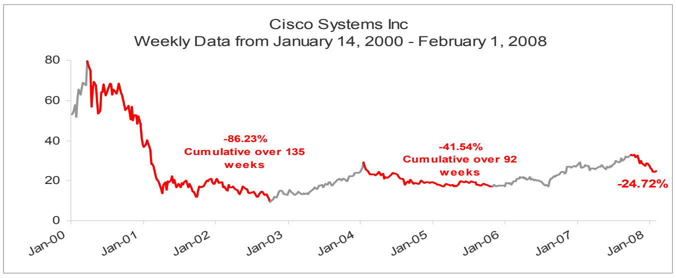
Global markets seem acutely sensitive to reductions in demand and growth, especially with many major commodities still trading at or near all time highs. Given that we could face a period of heightened volatility, as discussed earlier, what strategic and tactical steps should a prudent hedge fund manager employ to successfully navigate these choppy seas?

Growth is always Baron Point's long term goal. However, periods of uncertainty, high volatility, and/or high risk/low reward opportunity demand a *primary* initial focus on capital preservation. We evolved our system to avoid catastrophic capital losses. Highly levered assets in a finance based economy can move quickly to the downside, and by the time you smell smoke, the fire may already be out of control. When markets perceive a change in the wind such as an implosion in the increasingly opaque world of structured financial products, protection of assets and return *of* capital become tantamount. It's better to have reserves in a safe harbor, and with strategic cash on hand we are prepared to redeploy in low risk/high reward opportunities that appear as the market continues deliberately down, or begins to bottom out.

Lack of liquidity, complacency, and the frailties of the human psyche can limit preventive action. We know as long as capital is preserved, sooner or later high reward tradable trends with low risk entry points will develop on the bull or bear side of the market. Our system seeks to exploit these intermediate trends, up or down, for gain. What does this all mean? Below are various standard trading postures, with a brief description of their pros and cons in the current environment.

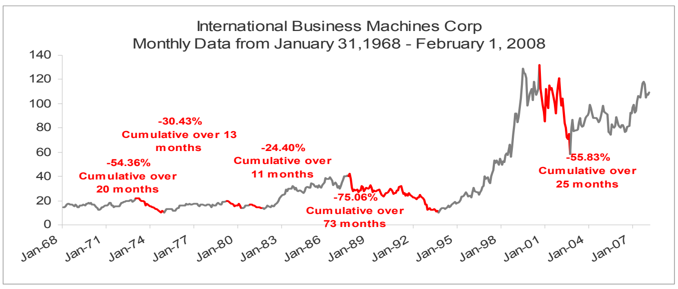
- Buy and Hold (Dollar cost averaging) in individual securities

Over long periods of time Dollar Cost Averaging is – mathematically - a justifiable strategy. It seemingly eliminates the stress of market forecasting and short term position entry timing. Unfortunately, most investors don't have the fortitude to adhere to this strategy, which *must* be consistent, and *must* employ a very long investment horizon. In the real world, when serious losses materialize, investors often panic and throw in the towel – understandably, usually somewhere near the bottom.



Furthermore, dollar cost averaging dictates that an investor *must* diversify properly. If not, they run the risk of catastrophic loss. A widely held U.S. technology issue is Cisco Systems, Inc. ("CSCO"). Long term buy-and-holders in CSCO watched their shares go down -86% from March 2000 to October 2002. Additionally, they would have had to endure a -41.5% directionless volatility or whipsaw from January 2004 through August 2006 and most recently a -24.7% bear market move from the November 2007 highs to a point. Note CSCO is still -72.8% off of its all-time high point seven years ago. This type of loss or directionless volatility occurs over multiple securities and time frames.

Examples abound, and for illustrative purposes we provide another chart of International Business Machines Corp. ("IBM"). Someone who bought IBM in June 1968 would have made no net price progress on a monthly basis and had to



Source: Bloomberg LP and Choice Alternative Investments, Ltd.

endure five whipsaws of between -30% and -75% through February 28, 1995 (25 years), or roughly 1/3 of an average person's life. This does not take into account that more catastrophic experiences can occur for a buy and holder as in the bear market of the early millennium, many rode internet and telecom to $0.

- Tactical Reallocation among Asset Classes

Tactical reallocation attempts to protect capital by utilizing inverse correlations among various asset classes. As with buy and hold, investors must possess a long investment horizon, a steady hand, and strong stomach.

Furthermore, they must correctly analyze current market conditions in order to make the proper allocations. Finally, many analyses demonstrate that asset class correlations cluster during periods of extreme market trauma, thereby providing little or no diversification or protection during the periods that demand it (e.g. markets have a tendency to positively correlate the most when under traumatic stress).

- Distressed Investing

The current environment is beginning to create an abundance of distressed securities, and many hedge and private equity funds are starting to become more aggressive investors in such issues. While we believe this to be a potentially profitable strategy, it has never been a strategy we employ, primarily due to the illiquidity which is necessarily part of the process. Additionally, it is an extremely specialized field unto itself.

Since distressed investing is extremely capital intensive and requires a long-term investment horizon, typical distressed fund lock-up periods tend to be much longer than we, and most investors, prefer. In short, we prefer to stick to our area of expertise, which is trend following in liquid instruments with a high degree of mark-to-market risk control.

- Trend Following

Trend following, the strategy that we employ, demands capital preservation during trendless markets in preparation for the carefully phased position building that seeks to maximize profits during trending markets.

Trend following generates positive returns because trends occur in virtually all markets some of the time. Trend followers create models to capture these long term trends while limiting the cost of doing so by tactically limiting downside losses (through the use of protective stop loss orders). Disciplined loss cutting culls out the losers, while we hold our winners for their potential to generate outsized positive returns in the portfolio.

The cost of capturing trends occurs when trends seem to appear but ultimately stagnate, or reverse. That cost equals the difference between the entry price of buying/selling the particular security, and the stop loss price put in place. This trading approach creates a limited downside risk, and the continuation of the trend creates the large upside potential. This is the definition of "cutting losses short and letting profits run."

Of course, there are periods when trends continually fail to materialize or extend themselves. This is just part of what happens to a trend follower. Trend following managers must maintain discipline and focus during these times as they wait for the emergence of superior risk/reward opportunities. For us, January 2007 though August 2007 was such a period: frustrating but necessary. Within the strategic framework of trend-following, what tactical elements should we employ?

Part II — A Disciplined, Adaptive Approach

Tactics Emphasized by Baron Point

Baron Point's risk management and trend following process consists of several components subject to adjustments for dealing within change market circumstances including:

- Measurement of entry point risk and diligent adherence to exit point departure,
- Position sizing algorithms and measuring "risk to sector equity" and "total portfolio risk to equity",
- Importance of sector rotation and movement into non-correlated trending markets to exploit tradable trends in other liquid securities,
- Long and short selling dexterity, and
- Use of cash as a strategic investment and a formal element of risk management.

Each of these is reviewed further below.

Measurement of entry point risk and diligent adherence to exit point departure. Risk management is of utmost importance to any trend follower. Baron Point uses adaptive proprietary portfolio management algorithms to evaluate risk before the entry of any trade. This proprietary technology enables the Fund Manager to determine the risk of the individual trade, given a predetermined exit point based on various technical factors. Additionally, the ongoing monitoring of portfolio win/loss percentage and the profitability expectancy of each individual trade factor into both the determination of a trade's entry point, the positioning of stop/loss points, and the trade's position size within the portfolio.

Baron Point uses various proprietary trade exit strategies for both losing and winning positions. Winning positions rely on time exit components as most important trends take time to complete. Other exit strategies employed rely on technical factors that occur at the end of specific trends, overall market condition, and volatility parameters.

Position sizing algorithms and measuring "risk to sector equity" and "total portfolio risk to equity". Baron Point calculates position sizing on a sliding percentage scale *before*, *during* and *after* positions are taken. Under this asymmetric sizing methodology, larger positioning for new allocations are made after winning streaks and as protective stops rise following the winning development of the trend in the portfolio. The Fund Manager positions smaller amounts during losing streaks and utilizes cash as a strategic investment during low reward/high risk periods. Baron Point employs position sizing algorithms which vary depending on security liquidity, price strength, stage of the trend, and overall condition of market indices. The algorithms vary from aggressive to conservative in both initial/overall position size and speed of initial stop-loss exits. Additionally, the Fund Manager also controls the aggregated amount of risk carried by security group, sector exposure, and for the portfolio as a whole.

Importance of sector rotation and movement into non-correlated trending markets to exploit tradable trends in other liquid securities. Baron Point places a greater importance on sector rotation than market timing. In general, Baron Point seeks to buy the strongest securities in a relatively limited number of strong groups. When shorting, Baron Point seeks the weakest securities in deteriorating sectors. Although the overall market may be volatile and/or trendless, there are sometimes sectors or pockets of sectors that trend and present lower risk/higher return scalable entry points. The Fund Manager uses various proprietary screening technologies to monitor and uncover such sectors and match their correlation to the overall market and the portfolio. Sector rotations in to inversely correlated sectors can add investment gains as they present tradable opportunities when other markets are trendless.

Part II — A Disciplined, Adaptive Approach

Tactics Emphasized by Baron Point (Continued)

Long and short selling dexterity. Baron Point is a directionally biased, long and short strategy. Baron Point tends to do particularly well as trends extend in a deliberately bullish or bearish direction. Baron Point is able to short profitably as a bear, as well as win on the long side as a bull; this promotes flexibility and adaptability during sustained intermediate term trends of either direction.

Use of cash as a strategic investment and a formal element of risk management. Many long only hedge funds and the majority of mutual funds are constrained by mandates requiring that they be near or fully invested at all times. Baron Point operates under no such restrictions. The Fund Manager is quite comfortable moving into cash or cash equivalents if that is the best strategy during a particular place in a market cycle. While this would seem to offer obvious benefits, it is not a common tactic of many funds. This is especially true in the aggressive equity growth arena where — as many investors may now find out the hard way — exposure or leverage all the time can be overused and a dangerous shortcut to investment returns. Risk cuts both ways.

Conclusion

Each of the risk management and trend following processes discussed above, has been more fully adapted and implemented for dealing with the current tumultuous market circumstances outlined in this piece, and these revised methods have been emphasized since September 2007 for our trading as the marketplace has become increasingly bearish.

If you would like to see the full positive impact, examine the monthly results in the January 2008 Fact Sheet, inclusive of the recent period that appears to have been a particularly difficult time for the general investment community.

If the Fact Sheet is not attached, please feel free to email us at info@baronpoint.net or call +1 212 248 2733 x701 and request it; we would be happy to provide it to you.