



BARON POINT FINANCIAL

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Baron Point Research Quarterly 1Q2009

Each quarter we issue research describing current intermediate term market trends, followed by a discussion of various fund management techniques, including risk control, we employ and the manner in which they may come into play during those trends. This research is intended to complement the regular Monthly Commentary included with our monthly returns update.

A summary table of contents is shown below. **If you have any comments please feel free to email Baron Point at info@baronpoint.net or telephone +1 (212) 248-2733 x701.**

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Overview

It can now be said that the current bear market in stocks, down -54.43% peak-to-trough, is the second worst market decline since 1856. This fact highlights that a great deal of the downside damage has already been done in the recurring cycle of creation and destruction that normally takes place in an open and free market system.

All markets must be approached with diligent and unwavering risk control, but bear markets especially demand adherence to what George Soros, when testifying before the U.S. Congress this past November, articulated as the “cardinal rule of hedge fund investing”: “**protect capital during down markets.**” *First and foremost, Baron Point has and will continue to preserve capital while it implements its patented risk control system while aiming to scale in for growth as market trends evolve.*

Market trends develop as events are discounted; uncertainties become known or rationalized, quickly, as individual stock price trends are influenced. Controlling risk and protecting capital while staying optimistic is critical, no matter what direction the trend, because *periods of great crisis always lead to emerging opportunities for those who adapt and are nimble.*

In this research piece, we will discuss the current bear market and compare it with two others of significance, the current stimulus and tax plans of the new U.S. President’s Administration, and the Fund’s path moving forward.



Bear Market Profile when the US Economy is in a Recession

As discussed in our 3Q08 *Baron Point Research Quarterly*, when a bear market in stocks coincides with an economic recession, price declines can be most treacherous. The current bear market demonstrates **no** difference. To benchmark certain macro characteristics of the current bear market (**2007 – TBD**) against others in the past, we chose two comparisons: a bear market that many present-day participants lived through (**1973 - 1974**), and the worst bear market on record (**1929 – 1932**).

The table below depicts bear stock markets that coincided with business cycle recessions dated by the U.S. National Bureau of Economic Research, the authority in the United States that maintains the official chronology of the U.S.A.'s business cycle since 1856, and is the official arbiter of U.S. recessions.

Bear Markets when US is in a Recession										
Bear No.	Start Date			End Date			Length (months)	Start Value	End Value	% Change
1	31	December	1856	31	October	1857	10.0	15.94	7.99	-49.87%
2	30	September	1860	31	May	1861	8.0	13.81	10.50	-23.97%
3	2	March	1874	29	June	1877	39.9	35.68	22.08	-38.12%
4	30	June	1881	30	June	1884	36.0	36.24	27.21	-24.92%
5	31	August	1892	31	August	1893	12.0	47.04	35.50	-24.53%
6	31	October	1895	7	August	1896	11.2	45.09	28.66	-36.44%
7	10	September	1897	25	March	1898	6.5	55.82	42.00	-24.76%
8	26	April	1899	24	September	1900	17.1	77.14	52.96	-31.35%
9	19	January	1906	15	November	1907	21.9	103.00	53.00	-48.54%
10	30	September	1912	24	December	1914	26.8	94.15	53.17	-43.53%
11	31	October	1919	25	August	1921	21.8	118.92	63.91	-46.26%
12	3	September	1929	8	July	1932	34.2	386.10	40.56	-89.49%
13	8	September	1932	27	February	1933	5.6	81.39	49.68	-38.96%
14	10	March	1937	31	March	1938	12.7	195.59	97.46	-50.17%
15	16	July	1957	22	October	1957	3.8	523.11	416.15	-20.45%
16	2	December	1968	26	May	1970	17.8	994.65	627.46	-36.92%
17	11	January	1973	9	December	1974	23.1	1067.20	570.01	-46.59%
18	27	April	1981	9	August	1982	15.4	1030.98	769.98	-25.32%
19	17	July	1990	11	October	1990	2.8	3024.26	2344.31	-22.48%
20	22	May	2001	21	September	2001	4.0	11347.00	8062.34	-28.95%
21	19	March	2002	24	July	2002	4.2	10673.10	7532.73	-29.42%
22	22	August	2002	10	October	2002	1.6	9076.94	7197.49	-20.71%
23	11	October	2007	TBD			16.0	14198.10	6469.95	-54.43%
					Worst Bear		34.2			-89.49%
					Median		12.7			-36.44%
					Average		15.32			-37.23%

Source: Baron Point Financial, Ltd., National Bureau of Economic Research, Inc., and Dow Jones & Co.



Benchmarking the current bear market against two past bear markets

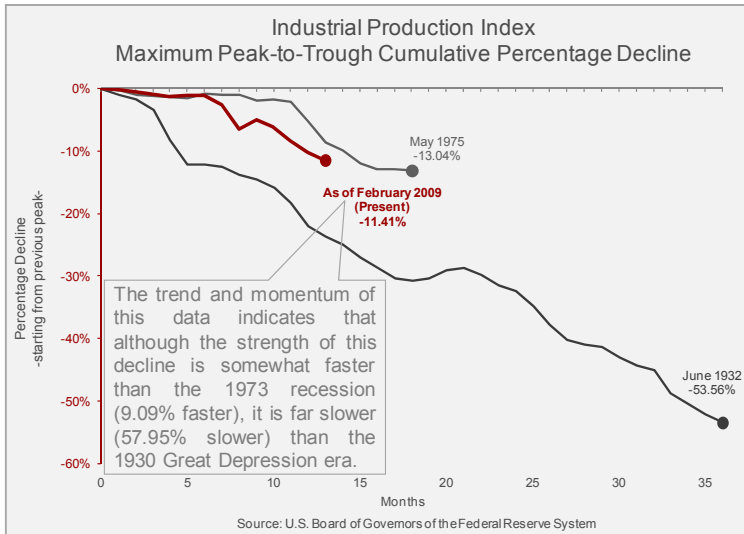


The painting above, an 1888 ukiyo-e print by Hanabusa Itchō, depicts the famous parable of the blind monks examining an elephant. Because each only touches a part of the elephant, each has an incomplete notion of its entirety. In similar fashion, and given the complex and dynamic nature of markets, market participants are always dealing with an incomplete picture.

A market tenant often reiterated is that markets “dislike uncertainty.” The current wide and whipsawing range that seems to form is a function of the markets attempt to deal with the uncertainties we face. The fact that the magnitude of this bear market make it the second worst bear market on record, speaks to the significance of the events of this cycle, and we must respect the larger trend that is still in place.

The Fund follows the intermediate trend of the market, first and foremost. Fund Management looks to market history and isolates individual indicators which from a technical, and also common sense, perspective for valuable and actionable guidance. Drawing on these historical precedents helps Fund Management develop hypotheses to guide efforts in seeking to identify and position into evolving trends.

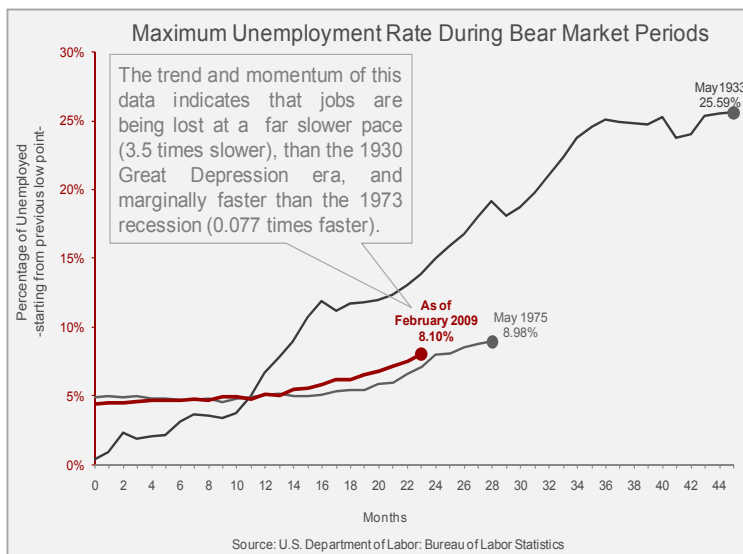
On the following page we briefly contrast how this works with two broad economic indicators, namely industrial production and the unemployment rate, and the price return of the Dow Jones Industrials Average to gauge the power of the current bear market trend, relative to two other bear market eras, starting in 1973 and 1929.



Industrial Production, one of the oldest statistical reports on the economy, is the measure of physical output in factories, mines and utilities.

Since it is a measure of actual volume of output in goods-producing industries uninfluenced by prices, industrial production is one of the more important macro-economic indicators.

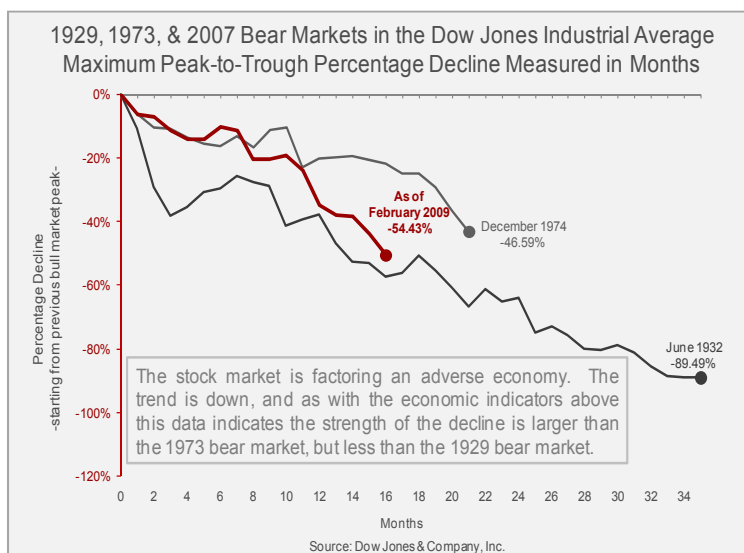
The trend and momentum of this data indicates that although the strength of this decline is somewhat faster than the 1973 recession (9.09% faster), it is far slower (57.95% slower) than the 1930s Great Depression era.



Job losses + loss of credit = loss of spending dollars. This leads to the loss of demand for products and services.

At this juncture, the U.S. seems to be well into a deflationary spiral driven by job losses causing the Unemployment Rate to rise.

The trend and momentum of this data indicates that jobs are being lost at a far slower pace (3.5 times slower), than the 1930s Great Depression era, and marginally faster than the 1973 recession (0.077 times faster).



The stock market, the trend we trade, is factoring an adverse economy and is down, despite a current rally occurring. As with the economic indicators above this data indicates the strength of the decline is larger than the 1973 bear market, but less than the 1929 bear market.

An essential element mitigating the damages in the 1930s was government policy. Currently, there are broad ranging policies considered or recently enacted by the U.S. government. In the next section we briefly describe some of those policies.



The new American President and hope for change

On January 20, 2009 newly-elected U.S. President Barack Obama entered office on the electorate's wave of hope that he would quickly implement policies that would forestall a repeat of the Great Depression of the 1930's for America.

According to data compiled by Bloomberg, the Dow Jones Industrial Average fell as much as -31.99% since Election Day (November 4, 2008) and -21.15% since Inauguration Day (January 20, 2009), the fastest drop under a new president in at least 90 years. The positive aspect of the fast market decline may be that it represents a quick and harsh discounting of the damaging aspects of the Obama plan. So much so that bad aspects are bound to be adjusted, stall, or change for the better by 2010 and 2011.

Operating within a historical paradigm that recognizes the benefits of Keynesian-style government spending to slow or break a deflationary downturn, President Obama has recently proposed or initiated three large scale policies, and continued one from the prior administration.

These four policies are:

Troubled Asset Relief Program (TARP)
The American Recovery & Reinvestment Act
Proposed Housing Plan
Deficit Reduction proposals within the 2010 Budget

Problem #1: The Freezing of Institutional and Consumer Credit **Proposed Solution: The Troubled Asset Relief Program (TARP)**

The Troubled Asset Relief Program ("TARP") was designed to unfreeze credit markets and reliquify America's major banks. TARP allows the U.S. Treasury to purchase or insure up to \$700 billion of "Troubled Assets." Troubled Assets are defined as: 1) residential or commercial mortgages and any securities, obligations, or other instruments that are based on or related to such mortgages, that were originated or issued before March 15, 2008, the purchase of which the Secretary of the Treasury determines promotes financial market stability, and 2) any other financial instrument that the Secretary of the Treasury and the Federal Reserve determine the purchase of which is necessary to promote financial market stability, after transmittal of such determination to the appropriate committees of Congress.

In short, TARP allows the Treasury to purchase illiquid, difficult-to-value assets from banks and other financial institutions. The targeted assets can be collateralized debt obligations (CDOs); the intention is to improve their liquidity, thus allowing participating institutions to stabilize their balance sheets and avoid further losses.

Officials hope that once trading of troubled assets resumes, their prices will stabilize and ultimately increase in value, resulting in gains to both participating banks and the Treasury itself. The concept of future gains from Troubled Assets comes from a government and financial services industry opinion that these assets are oversold, as only a small percentage of all mortgages are in default, while the relative fall in prices represents losses of a much higher default rate not to be reached.

Another important goal of TARP is to encourage banks to resume more lending, both to each other and to consumers and businesses. If TARP can stabilize bank capital ratios, it should theoretically allow them to increase lending instead of hoarding cash to cushion against future, losses from troubled assets. Increased lending equates to 'loosening' of credit, which the government hopes will restore order to the financial markets and improve investor confidence in financial institutions and the markets. As banks gain

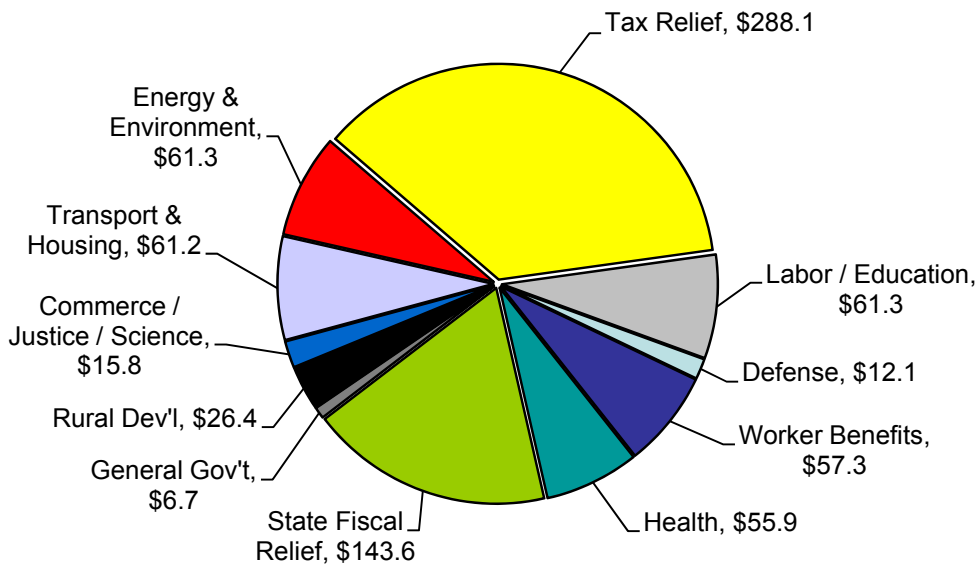


increased lending confidence, the interbank lending interest rates should decrease, further facilitating lending.

TARP's first \$350 billion was released on October 3, 2008, and Congress voted to approve the release of the second \$350 billion on January 15, 2009. As of February 9, 2009, \$388 billion had been allotted, and \$296 billion spent.

Problem #2: Accelerating Job Losses and the Resultant Drop in Consumer Demand
Proposed Solution: The American Recovery & Reinvestment Act

On February 17, 2009 President Obama signed into law the American Recovery and Reinvestment Act (the "Recovery Act"), a \$787 billion package of tax cuts and government spending designed as a first step in halting America's recessionary slide. The principal aim of the Recovery Act has been alleged as job retention and creation. Its sheer size makes it nearly unique in America's history; eclipsed only by the variety of programs undertaken in the 1930's to mitigate the effects of the Great Depression.



Additionally, the scope of the Recovery Act is unprecedented. Unlike usual fiscal policies – a single large tax cut, or project specific spending program – it reaches into every department and agency of the federal and state governments. It hopes to engender creativity and commitment all across government, causing fresh thinking in every topic area: energy, communications, transportation, education, health care, housing, federal land use, and many others.

Manufacturers and construction companies have suffered mightily during the recession; these two major components of the economy lost 318,000 jobs in January 2009 alone. These sectors will see more money to upgrade the nation's electrical grid, renovate aging schools, and improve public transit. Direct infrastructure work includes \$27 billion to repair highways and bridges.



Problem #3: Accelerating Home Foreclosures among Most Income Segments
Proposed Solution: Obama's Proposed Housing Plan

The plan's intent is to slow down the collapse in home prices and the escalating home foreclosure rate. It aims to help over-indebted households cope by keeping debt service costs low while allowing time for incomes to rise gradually, hopefully with the assistance of partial recovery in house prices.

The Obama administration is betting that most homeowners choose to remain in their homes if monthly payments are made more affordable - even if their home price is less now than the outstanding mortgage. So the plan revolves almost entirely around bringing down monthly payments, primarily through reducing the interest rate on home loans, and has little to say about writing down the principal.

Problem #4: Escalating Budget Deficits
Proposed Solution: Deficit Reduction Proposals within Obama's 2010 Budget

President Obama inherited a deficit for 2009 of about \$1.2 trillion, which will rise to more than \$1.5 trillion, given initial spending from his recently enacted stimulus package. In his weekly radio and Internet address on February 21, Mr. Obama said his first budget, presented later that week, was "sober in its assessments, honest in its accounting, and lays out in detail my strategy for investing in what we need, cutting what we don't, and restoring fiscal discipline. We can't generate sustained growth without getting our deficits under control."

In that budget, Mr. Obama set a goal to cut the annual deficit at least in half by the end of his term. The reduction would come in large part through Iraq troop withdrawals and higher taxes on the wealthy. In addition, he has proposed to tax the investment income of hedge fund and private equity partners at ordinary income tax rates, which are now as high as 35% and could return to 39.6% under his plans, instead of at the capital gains rate, which is 15% at most.

Mr. Obama also intends to let the Bush tax cuts on income, dividends and capital gains lapse after 2010 for individuals who make more than \$250,000 a year. But while the top rate for income would rise to 39.6%, the top rate for capital gains and dividends would be 20%. As for war costs, Mr. Obama's campaign projected that withdrawing combat troops from Iraq would save about \$90 billion a year.

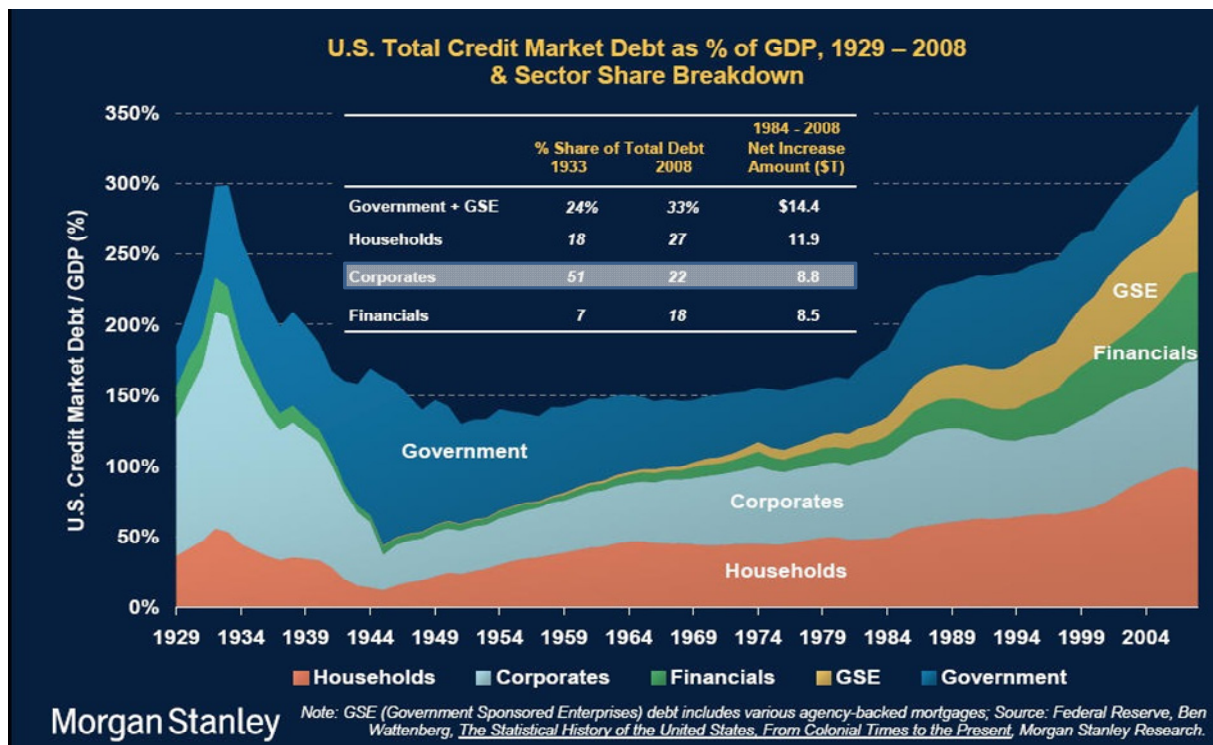
Measured against the size of the economy, the projected \$533 billion shortfall for 2013 would mean a reduction from a deficit equal to more than 10% of the Gross Domestic Product — larger than any deficit since World War II — to 3%, which is the level that economists generally consider sustainable. Mr. Obama's aides project deficits at about that level through 2019.

We believe that the prior and current Administration's focus and vigorous response to the bear market has, so far at least, stemmed some of the potential damage. At the very least, history shows that large and immediate government intervention is much better than doing nothing and hoping for the best.



So, where do we go from here?

This is a particularly bad bear market by historical standards. This bear market coincided with a peaking credit cycle for American households, undercapitalized financials facing enormous credit unwind and default, and a global economic slowdown with simultaneous recessions in many of the world's largest economies creating enormous pressure. Hence, as mentioned, it is currently the second worst bear market on record since 1856, exceeded only by the 1929-1932 bear market. Interestingly, though, debt percentages in the U.S. corporate sector are relatively contained, when compared to other periods as the chart from Morgan Stanley depicts.



It must be expected that a repeating cycle of creation and destruction exists in both economies and stock markets. Although the situation is better understood now, and a significant amount of economic damage has been discounted, a bear market is still a bear market until the trend proves otherwise. Although currently (as of mid-March 2009) the stock market is working off an oversold condition driven by the hardest hit Financials, the larger, intermediate-term, trend is still down.

As Fund Managers, we are cognizant that markets look the worst at the bottom, before they begin to “climb the wall of worry.” However, strong bottoms and lasting bull markets are built on a base of new growth stock leadership moving to new highs, **not** a particularly oversold group of stocks bouncing from their bottom (e.g. currently the Financials are the major leadership of rallies). Therefore, a structural necessity to a sustained bull market is currently lacking according to Baron Point’s proprietary research and models. Hence, the Fund protects capital during the down market, works within a bearish



intermediate-term trend, and moderates expectations to fit with the temporal nature of down-trending markets.

Conclusion

Investment success, in our opinion, is about **riding winners, cutting losers, and managing risk**. For the Fund, process wise, bull, bear, or trading range, very little changes in our system. Now, as always, we:

1) **Preserve Capital**, first and foremost.

2) **Control Risk**: The Fund always employs a patented risk-based system and Fund Management is cognizant of the varying temporal nature of down-trending markets – in bull markets profitable moves are large and continue to run over long periods, and in bear markets profitable moves are smaller and develop (and end) much more rapidly.

3) **Practice diligent counterparty risk management**: Casual assumptions in risk management are still, in the current environment, extremely dangerous. Therefore, Fund Management continues to monitor and take decisive action that helps support return of capital by managing counterparty exposure through proprietary analytics and methods.

4) **Employ leverage prudently**: As the Fund normally employs very little leverage a fraction of the time invested; Fund Management continues to do the same as this bear market unfolds.

5) **Hold realistic expectations**: A bear market demands lessened expectations, both qualitatively and quantitatively. For instance, any short-side unleveraged trading can only by definition yield a maximum 100% gain. In a bull market stocks regularly move 200%, 500%, or more than 1,000%.

6) **Scale In for Outsized Growth Potential**: By scaling cautiously and following a trend to build a position (but without excess leverage, see #4 above), the Fund captures portions of moves, over time, seeking outsized returns. Fund Management tests the hypothesis first with smaller exposure, and scales in to larger positions as the Fund's equity and the position trends in its favor; this significantly lessens downside risk when a position does not work out.

Baron Point implements these adaptive risk management and trend following processes to navigate in all market environments. It is these simple, yet robust, procedural tenants that promote longevity and ultimate success.

If you would like to discuss anything in this paper or any other topic, email us at coppola@baronpoint.net or call +1 212 248 2733 x702.