



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
www.baronpoint.net

Baron Point Research Quarterly
3Q2009

Each quarter Baron Point issues a research commentary on current intermediate-term market trends, followed by a discussion of various fund management techniques, including for risk controls which 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 on the next page. **If you have any comments please feel free to email Baron Point at info@baronpoint.net or telephone +1 (212) 248-2733 x702.**





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Can the broader market indices rise for a time despite the lack of new growth stock leadership?



Baron Point research has found that a specific characteristic – *new growth stock leadership exerting itself en masse at new all-time highs* – has been present in every new secular bull market of the post-World War II era. This characteristic, however, is not present now. The upturn since March 2009 has been led by institutionally over-owned stocks rallying-off-the-bottom; that is, decimated stocks regaining a small fraction of their prior price values, rather than the emergence of new growth leadership.

Baron Point’s proprietary quantitative investment screening algorithms locate growth stocks that meet some of the strongest fundamental and quantitative criteria employed in exchange listed stocks. In prior new secular bull markets, the system located and positioned into some of the greatest growth stock winners of all-time as they emerged as leaders portending the beginning of a new secular bull market. Currently, however, such leadership has yet to broadly emerge, causing us (and many other managers) to proceed with caution despite the fact that the broader indices have been rising.

What does current market leadership look like?

Stocks buoyed by huge government loans, loan guarantees, or buying incentives are the main leadership so far, with names such as American International Group, Inc. (AIG), Bank of America Corporation (BAC), Citigroup (C), CIT Group (CIT), Freddie Mac (FRE), Fannie Mae (FNM), Ambac Financial Group (ABK), MBIA (MBI), and Ford Motor Company (F) being at the epicenter of government intervention. Several of these stocks have experienced gains of 350% or more off of their secular bear market lows.

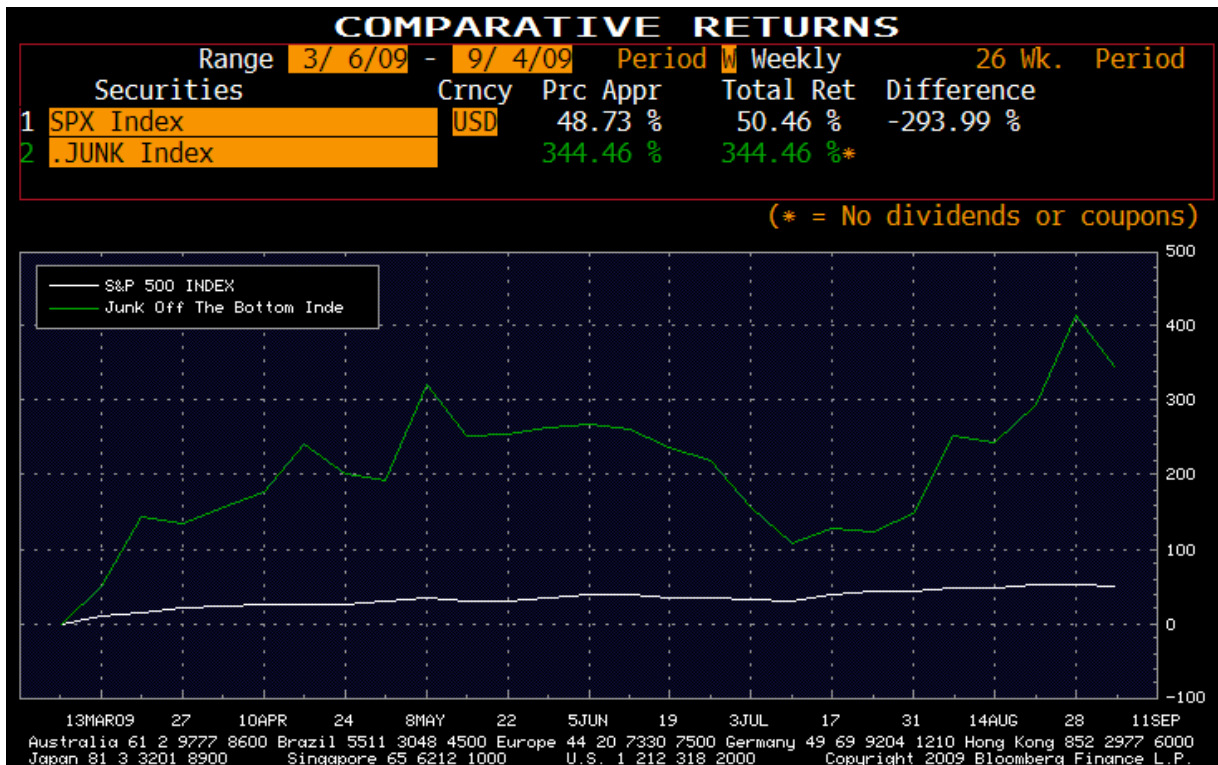
While this seems like a heady percentage for a stock to move, remember that most of these stocks’ movement was from the low single digits to the mid-to-higher single digits. Also consider that one of these firms is technically bankrupt (AIG), one is widely thought to be insolvent (C), several have the U.S. government as a majority owner (FRE and FNM), and the two large reinsurers (ABI and MBI) are hardly on firm financial footing given their capital-to-liability ratios. Furthermore, their trading volume has been so massive (some of these stocks have traded more than a billion shares in a single day), that it is safe to assume that the moves are a result of speculative activity, hardly a high quality fundamental base for growth stocks, and certainly not in and of itself a harbinger of a new secular bull market.

"Junk Off The Bottom" Index Composition	
COMPANY NAME	TICKER
American International Group, Inc.	AIG
Bank of America Corporation	BAC
Citigroup	C
CIT Group	CIT
Freddie Mac	FRE
Fannie Mae	FNM
Ambac Financial Group	ABK
MBIA	MBI
Ford Motor Company	F

Source: Choice Alternative Investments, Ltd. and certainly not in and of itself a



The activity in these issues has earned them a place in a Baron Point-designed equally weighted index that we refer to as the “Junk Off The Bottom Index” using data since September 2007. (i.e., dating to the beginning of the secular bear market). This Index continues to outperform since the March lows.



Perception or Reality?

As you may recall, we discussed the concept of “**Creative Destruction**” in our 2Q/2009 *Baron Point Research Quarterly*. A process applicable to today’s market, this phrase was coined in the 1940’s by the famed 20th century economist and Harvard University Professor Joseph Schumpeter. Schumpeter describes the process as follows: “Creative Destruction occurs when the old ways of doing things are “endogenously” destroyed and replaced by new ways.”

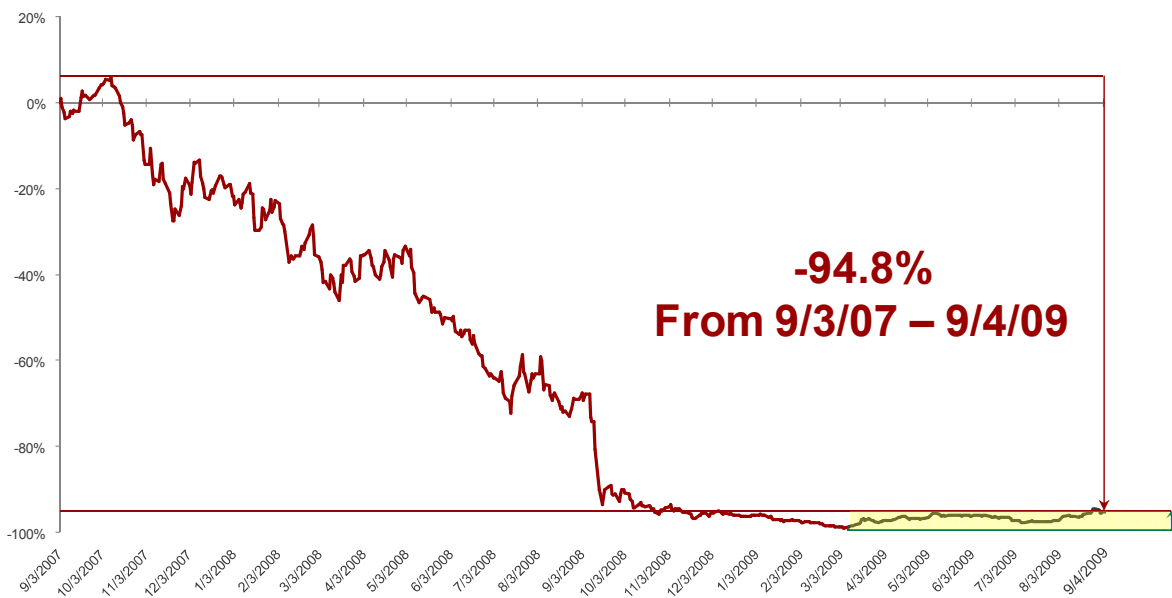
In his most famous work, Capitalism, Socialism and Democracy, he states, “the fundamental impulse that sets and keeps the capitalist engine in motion comes from the new consumers, new goods, new methods of production or transportation, new markets, and new forms of industrial organization that capitalist enterprise creates.”

This is a clue as to why Baron Point’s research indicates that **new growth stock leadership tends to emerge and lead new secular bull market moves**, as opposed to leadership by prior bull market stars and fallen market icons (e.g. please see 2Q/2009 *Baron Point Research Quarterly*’s examination of the original components that made up the Dow Jones Industrial Average and General Electric (GE) as the only company that still exists in its original form).



The chart below puts this phase of Creative Destruction into perspective since the beginning of the current secular bear market, highlighting the **perception** of the March 2009 rally versus the **reality** of what the current counter-trend represents in a larger context. As you can see, the up move in these issues is merely a blip up compared to the collapse that preceded it.

**Performance of “Junk Off The Bottom” Index
Since Bear Market Commencement, 9/3/07 through 9/4/09**

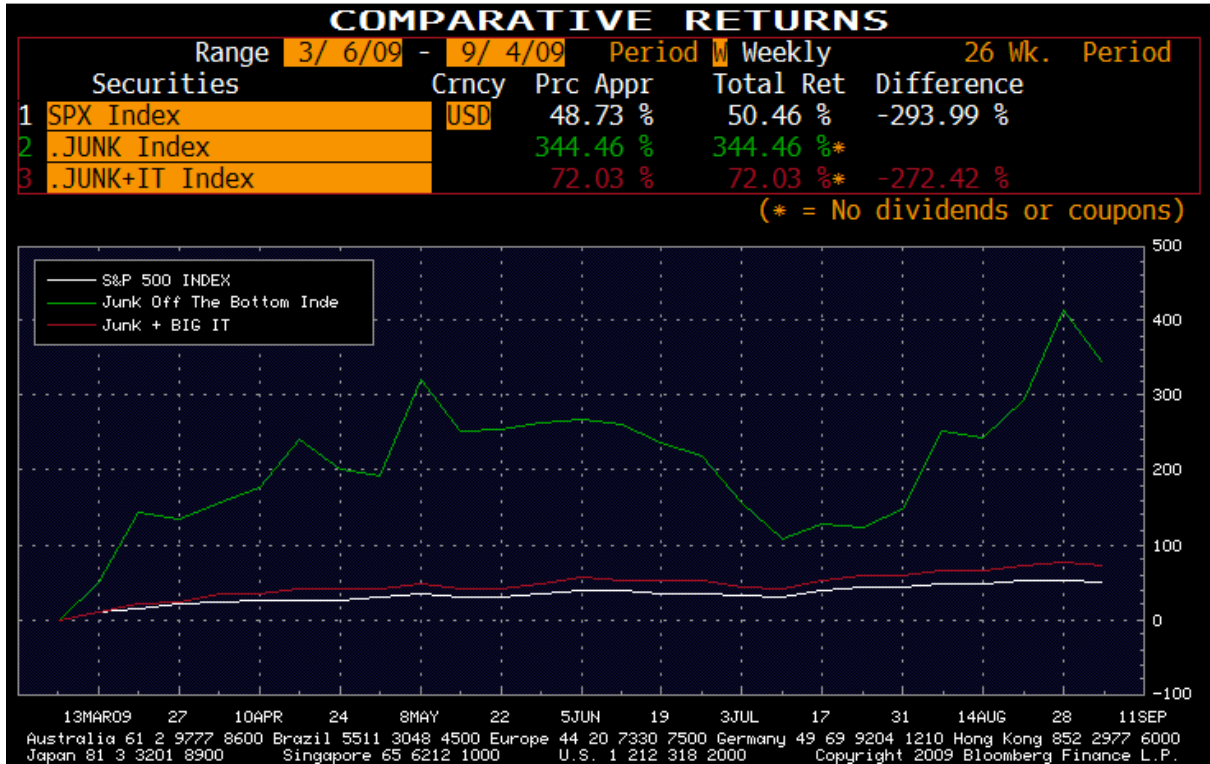


Source: Bloomberg Professional and Choice Alternative Investments, Ltd.

+349.8%
From 3/5/09 – 9/4/09

To get a better look at possible leadership and consider their effect on the post-March 2009 rally, we add some large cap technology names to our Junk Off The Bottom Index. These heavily owned large cap Information Technology (“BIG I.T.”) companies – Apple (AAPL), Amazon (AMZN), Oracle (ORCL), Intel (INTC), IBM (IBM), and Qualcomm (QCOM) – have all caught a strong bid in the counter-trend rally, and we would expect them to add to the Junk index’s overall strength.

However, the opposite is true: we find that adding these issues, despite the fact that they have rallied hard off the March lows, actually dilutes the equally weighted Junk Off The Bottom Index’s performance significantly.



Additionally, as displayed in the table below, not a single BIG I.T. or Junk Off The Bottom stock is at or has traded through its all-time highs, or even above the prior bull market's high point (e.g. some of the stocks mentioned have never eclipsed their dot com bubble levels of the 2000 bust). As trend followers who gravitate towards all-time highs, we cannot yet consider these issues to be serious leadership in a new secular bull market trend, but rather movers in a counter-trend rally.

Selected "Junk Off The Bottom" Stocks

	ABK	FNM	CIT	FRE	MBI	C	BAC	F
% from High in Prior Cycle	-98.26%	-98.01%	-97.55%	-97.35%	-91.79%	-91.49%	-68.97%	-57.13%
Current Share Price*	1.67	1.77	1.51	1.97	6.24	4.85	17.09	7.43
Prior Bull Market Cycle Highs	96.10	89.02	61.59	74.20	76.02	57.00	55.08	17.33

Average: -87.57%

Selected Large Cap Technology Stocks (BIG I.T.)

	INTC	AMZN	QCOM	AAPL	IBM	ORCL
% from High in Prior Cycle	-43.09%	-21.98%	-19.62%	-16.09%	-9.64%	-6.79%
Current Share Price*	19.64	78.87	45.72	170.31	117.46	21.97
Prior Bull Market Cycle Highs	34.51	101.09	56.88	202.96	129.99	23.57

Average: -19.53%

* As of September 4, 2009
Source: Bloomberg Professional



More evidence of low quality stocks leading a counter-trend rally

Another clue pointing to the lack of new growth leadership and thus the low quality nature of the stocks leading the counter-trend rally since March is the performance of those stocks with the lowest financial quality, relative to higher quality stocks.

Ford Equity Research, Inc. is an independent equity research firm that has created quantitative stock selection models for over three decades. Its "Quality" rating is based upon a number of factors that indicate a company's overall financial strength and earnings predictability such as debt level, earnings history, and industry stability. According to *Ford Equity Research*, from March through August 2009 stocks holding their lowest quality ratings (C or C-) have gained nearly triple those rated of highest quality (A- or higher). *One would expect more high quality leadership participation at the onset of a new secular bull market than we are currently seeing.*

Baron Point research indicates a similar lack of quality growth leadership setting up for a new secular bull market, so far.

Let's turn our attention to Baron Point's proprietary screening algorithms. Baron Point employs disciplined selection criteria based on quantitative searches of several fundamental and technical factors that identify a small, rotating universe of growth stocks that have the propensity to outperform during equity bull markets.

Baron Point's quantitative searches locate growth stocks with outstanding fundamentals and signal proper buy points just before or when these stocks are experiencing big moves up. The located growth stocks have some of the most consistent and highest earnings growth, highest return on equity measures, demonstrate strong relative price strength compared to the general market and their peers, and tend to be found within the strongest stock groups in the market at the time they are engaged by the Fund.

Despite the counter-trend rally, Baron Point's quantitative searching as of this writing reveals a mere **ten** names that meet the superior fundamental screening criterion the Fund uses for candidacy into the portfolio, and several were engaged at proper buy points, and are held by the Fund.

What is very unusual is that *if this is the beginning of a new secular bull market, as opposed to a counter-trend rally in a larger overall secular bear market, there is an utter lack of high quality new growth leadership emerging thus far.*

To put these proprietary search results into perspective, generally, at the beginning of new secular bull markets these same screens produce approximately **100**, and very often more growth stocks for further analysis and investigation for potential portfolio candidacy. In fact, in Fund Management's 16+ years of trading the system, and as a result of significant research and analysis of new secular bull market periods of the post-World War II era, there is usually so much momentum in great new growth stock ideas at the start of new secular bull markets, that what Fund Management needs to do is focus on the growth stocks already held in the portfolio, pyramid, and ride the robust move continually up, through new high ground. However, thus far, that has not been the case.



Another troubling characteristic is the lack of a growing list of ideas during this counter-trend rally. A highly typical condition in the early phases of a new secular bull market is that the list of ideas generated *always* expands as new growth leaders emerge and exert themselves, fueling subsequent legs of the new secular bull market higher. Again, since March 2009 this has not yet been the case.

Growth stock candidate results, during the March 2009 to present rally, are between 80-90% less than Fund Management experienced at the outset of prior new secular bull markets. Secular bull markets produce 100+ growth stock candidates that the Fund's proprietary search algorithms locate. Moreover, as this rally progresses, we find less candidates.

To illustrate this point, below is a summary of the recent search results from Baron Point's proprietary screening algorithms:

- **22** ideas in April;
- **21** ideas in May;
- **20** ideas in June;
- **23** ideas in July;
- **15** ideas in mid-August; and
- **10** ideas at the end of August.

We now turn our attention to examine the characteristics of this current market environment in the context of the Fund's recent performance.



The Fund's historical post-drawdown performance

The Fund's modest drawdown year-to-date highlights its lack of correlation to the greater market, and can actually be seen as a unique opportunity for investors with longer-term investment horizons to participate in the Fund at attractive levels.

The foundation of the Fund's strategy is long / short, and it seeks to outperform both its peers and general market averages when it aggressively engages a market that is conducive to new growth leadership, a necessary characteristic of all prior post World War II secular bull markets. Additionally, if a secular bear market remains intact, whipsaw losses can be quickly erased and easily forgotten, as the Fund's equity approaches all-time high ground.

Obviously, current market action since the March 2009 lows is very important, as this sets the psychological tone for the marketplace and is how many investors measure performance. However, statistics continue to show that the Fund is independently correlated to the general market. As a result, a snap value judgment based on a myopic view of the current counter-trend behavior misses the main point associated with the long-term added value of the Fund's fundamentals and returns over time, through both bull and bear market cycles.

Accepting periods of whipsaw, and the feeling of frustration that results from drawdown are key when seeking growth opportunity in the Fund. Therefore, as always, Fund Management sticks to the system and remains positive and patient, willing to take a number of small losses over time seeking to position itself properly to capitalize during the equity run ups that generate outsized gains. For those investors evaluating the Fund, this is the perfect time to take advantage of the Fund's long-term investment philosophy and allocate with a dollar cost averaging approach into a full position in the Fund.

Fund Management's exposure to the Fund's performance is impacted by drawdown as a substantial percentage of our net worth is exposed together with our investors, despite the fact that the Fund continues to demonstrate independent correlation. It is important to note that the Fund did not suffer the 50%+ declines of the secular bear trend in equities, peak-to-trough, from 2007 – 2009. In fact, the system was net positive during this period. As a result, the Fund has much less to make up relative to the overall market indices and many of its competitors, some of which are undergoing a complete overhaul of their investment strategies, and others which have simply wound down.

As the Fund's quantitative screens reveal a robust universe of growth stock leadership with broadening breadth, Fund Management participates. It adheres to the system it knows and works conservatively within the drawdown, preserving capital rather than changing its strategy.

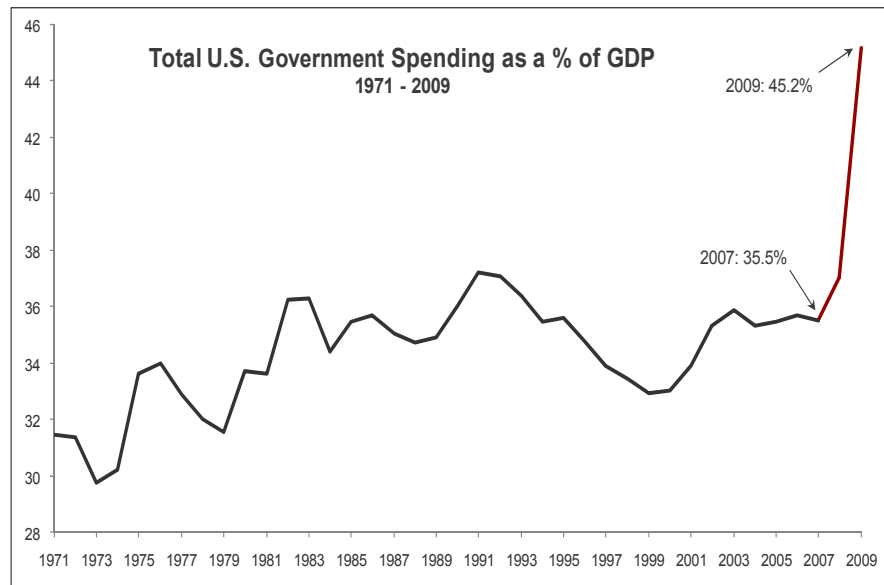


Conclusion

As discussed in this research, Baron Point quantitative models are delineating that the breadth of this market is still not conducive to new growth stock leadership.

The reason for this is that since March 2009, the market uptrend stems from the result of aggressive government intervention, which has led to enormous amounts of liquidity being pumped into the system, and the clearing of inventory via government programs.

Prior post-World War II economic cycles have been driven by credit formation leading to capital formation which fostered and solidified new growth stocks leadership and a new secular bull market in stocks. All of this signaled an upturn in the general economy, better prospects for employment, and an increase in the overall standard of living.



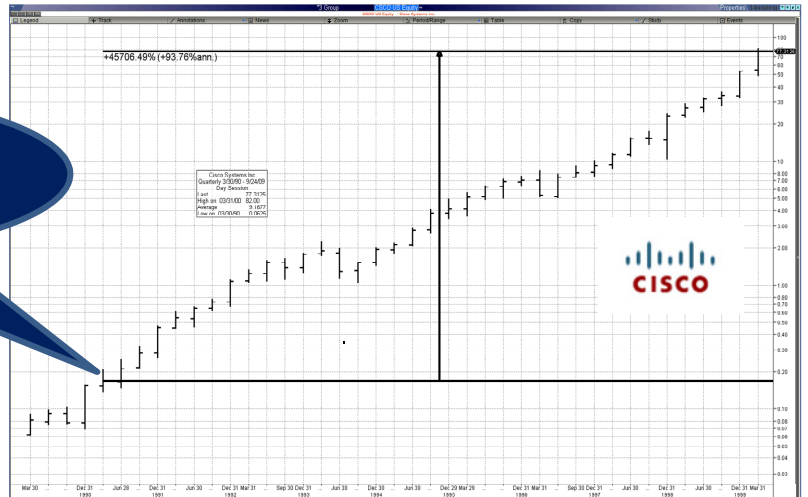
Source: Total U.S. Government Spending includes Federal Spending/Revenues, Intergovernmental Transfers, State and Local Spending/Revenues drawn from the actual U.S. Census and U.S. Budget data, in addition to State/Local Government Finances. Selected data from 2006-2009 is interpolated from previous census and local government reports.

However so far in this cycle, government subsidized mandates influence heavily institutionally owned stocks that rally from their bear market nadirs. New growth stock leadership lags noticeably. The authorities seem to focus their intensions on re-flating laggards, some of whom Schumpeter would tell us the free market was moving to “Creatively Destroy”. Nevertheless, and despite the attempts “to put Humpty Dumpty back together again,” new growth stocks are the innovators of the economy (e.g. see Cisco System (CSCO), EMC Corp. (EMC), Microsoft (MSFT), in 1991, not 2009). All started out as new growth stocks and emerged at all-time highs in a new secular bull market. Baron Point sticks to its proprietary systems, locating superior growth stock candidates hitting all-time new highs, and positions at proper buy points as and when they occur.

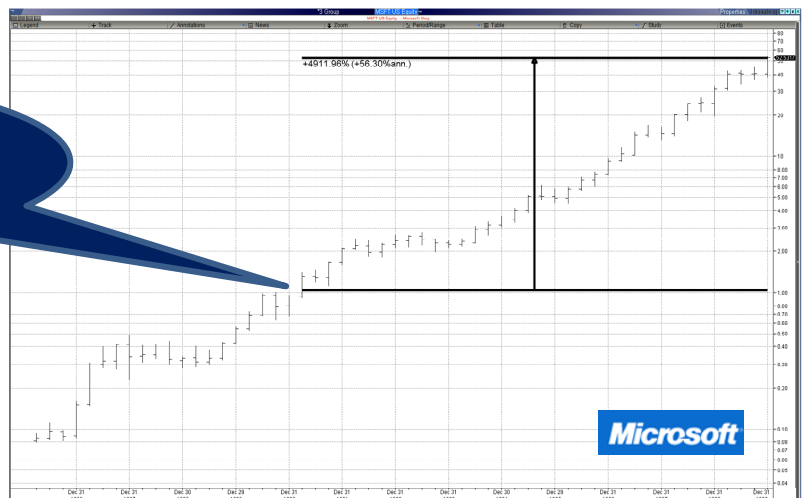
The Fund is significantly ahead of the market averages since inception, and also since the secular bear market broke. Accordingly, we continue to preserve capital and remain focused on the cardinal rule of hedge fund investing which is “protect capital at all times,” especially when trading through a drawdown period. As evidenced by a robust track record dated back to 1993 through many market cycles, the Fund has the tools and experience to generate gains as a broader secular bull market trend with new growth stock leadership emerges, while remaining protected if the secular bear trend re-emerges.
New growth stocks leadership circa 1991



Cisco Systems, Inc.
Initial Public Offering
February 16, 1990
45,706% Move from here in 1991



Microsoft Corporation
Initial Public Offering
March 14, 1986
4,911% Move from here in 1991



EMC Corporation
Initial Public Offering
June 16, 1986
37,216% Move from here in 1991

