



BARON POINT FINANCIAL

Dealing With Periods Of Higher Downside Volatility

By

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**Re-write of the 2nd verse
of Michael Jackson's Classic, Thriller**

You hear the door slam and realize there's nowhere left to run
You feel the cold hand and wonder if you'll ever see the sun
You close your eyes and hope that this is just imagination
But all the while you hear the creature creep'in up behind
You're out of time

Chorus

Cause its you're Margin Clerk
There aint' no second chance against this forced liquidation with forty eye
You know it's you're Margin Clerk
You're fighting for your life inside of killer, thriller margin calls



Margin Clerk



Fund Manager



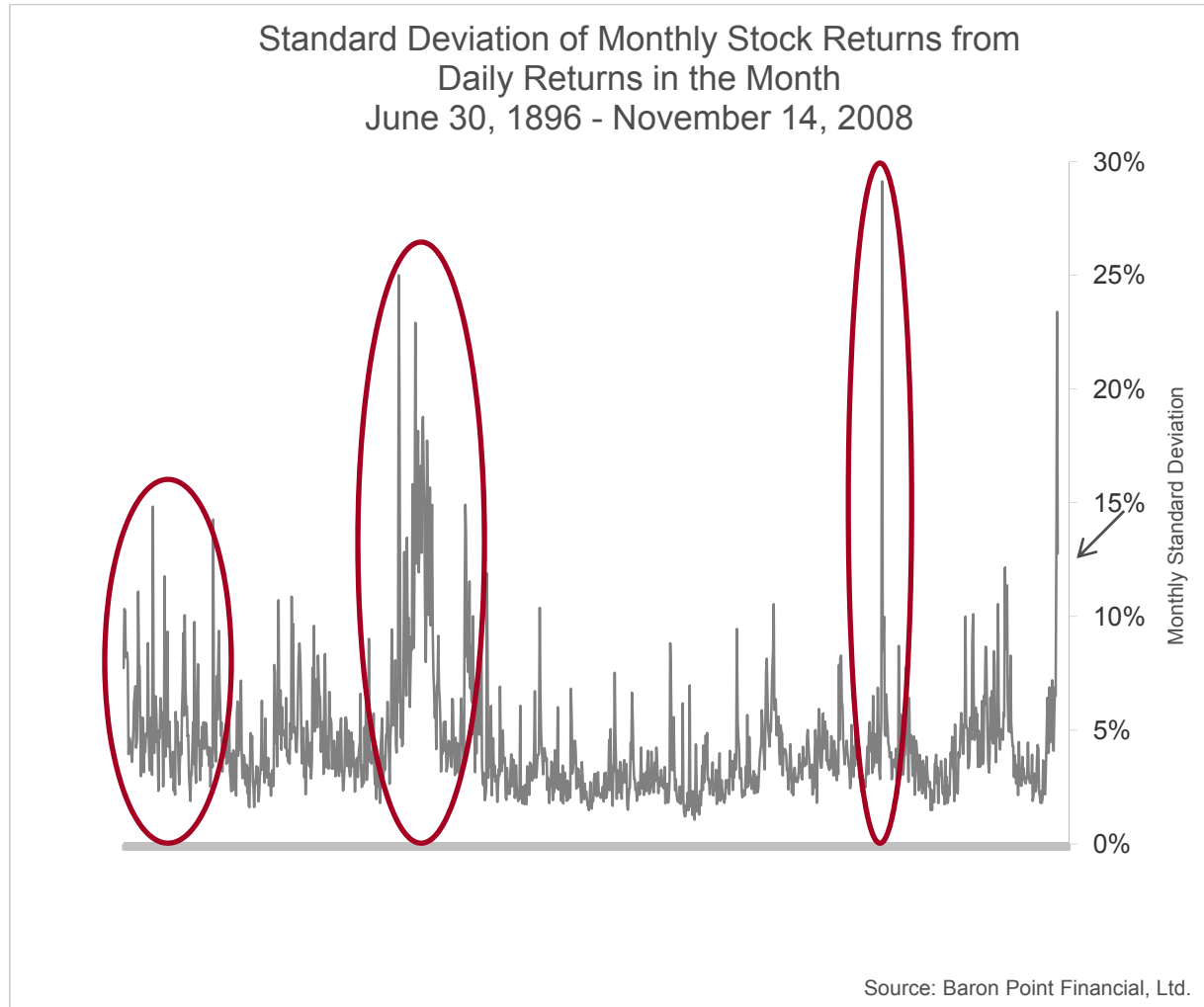
A 25 year Boom and Bust Cycle and some major bourses are back to **Thriller** Levels!



The media likes to call the current volatility in the stock market unprecedented? Our research reveals.....



As of November 14, 2008



So, how does one hedge
fund manager deal in this
environment?

Past performance is not necessarily indicative of future results.



- **Identifying, Testing and Following Investable Trends, Bull or Bear**
 - Pattern recognition algorithms and trailing stop-loss entry/exit techniques
 - Seeking outsized growth potential in intermediate term trends (weeks to months)
- **Scale In & Out**
 - Ride winning positions, cut losers and build on strength of Fund II's equity curve
 - Manage overall position and aggregated portfolio risk exposure
- **Superior risk control**
 - Apply objectively
 - Stop-loss based sizing of securities and portfolio positioning on entry
 - Trailing stop-loss based Entry/Exit techniques
- **Capital preservation**
 - Use of the above techniques plus the broad use of low risk instruments
 - Thorough counterparty risk management processes and procedures

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Identifying, Testing and Following Investable Trends, Bull or Bear

Bull Run Example
Dot-Com'ed or Debt Bomb



Bear Move Example
Panic About the Dollar



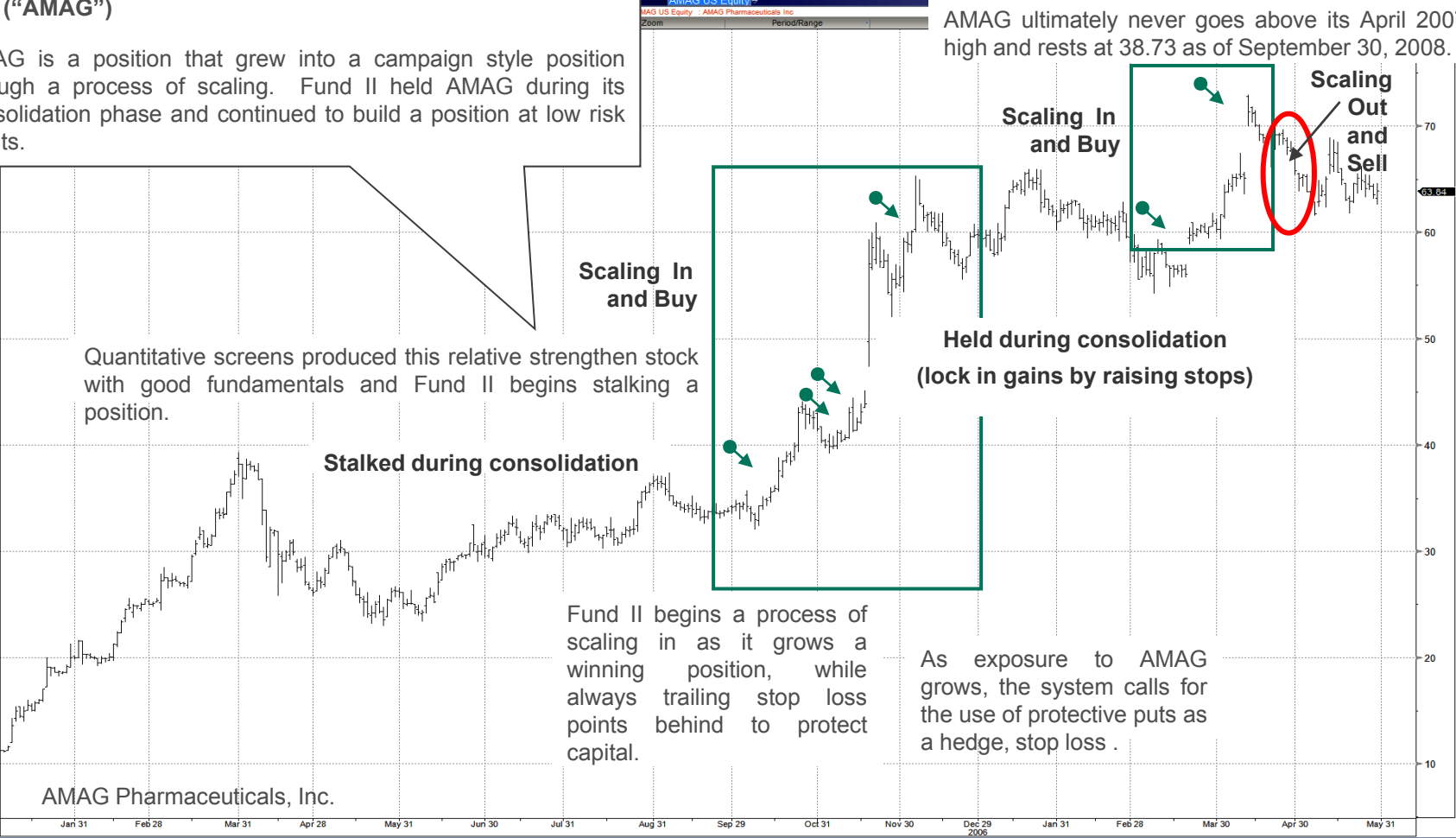
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Scale In & Out

Aborted Campaign after success, AMAG Pharmaceuticals, Inc. ("AMAG")

AMAG is a position that grew into a campaign style position through a process of scaling. Fund II held AMAG during its consolidation phase and continued to build a position at low risk points.

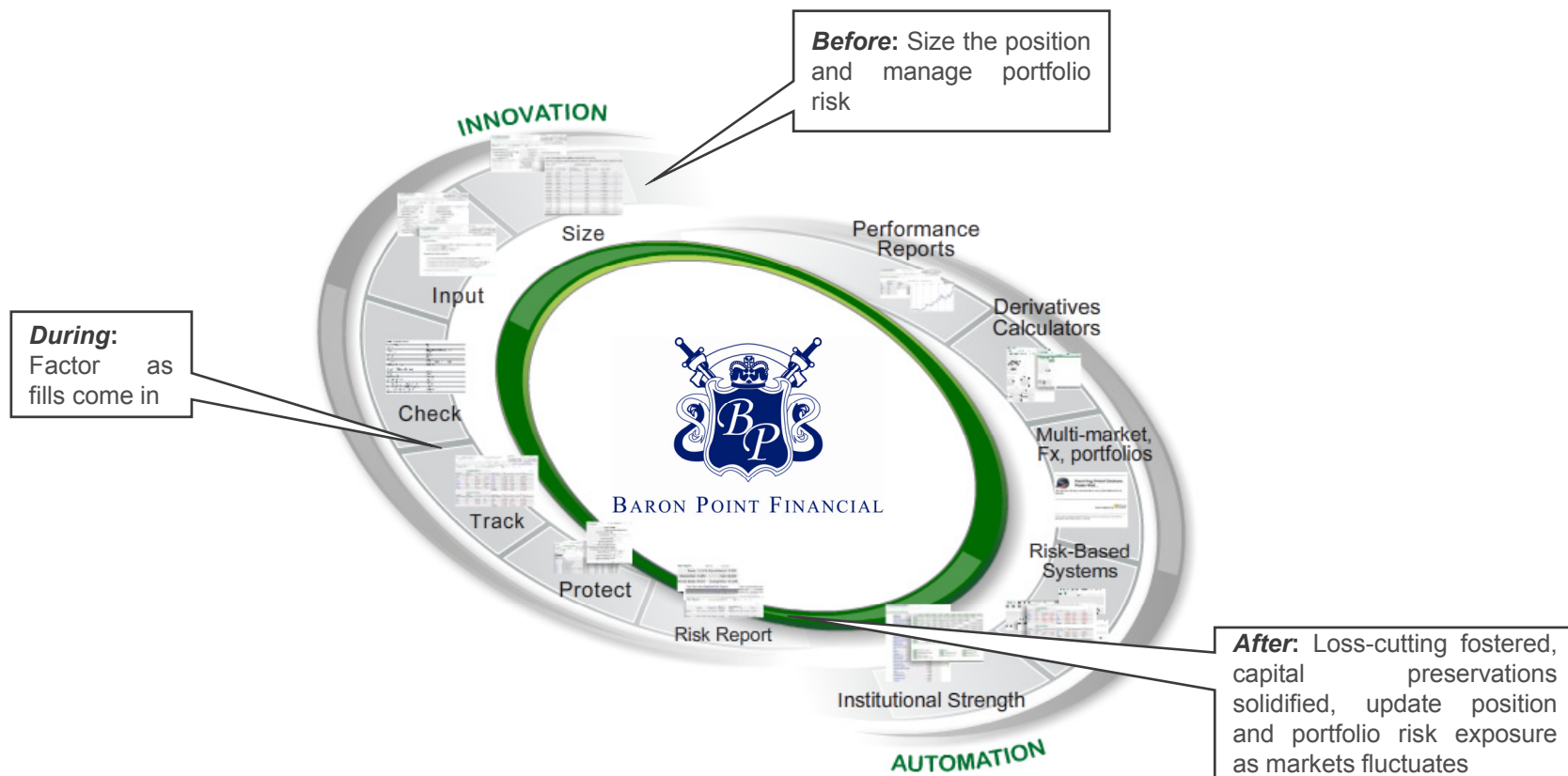


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Superior Risk Control

- Take responsibility for risk *before, during, and after* investment action is taken
- Discipline, Oversight and Objective call to action. Fund Management needs objective actionable limits.



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Capital preservation, first and foremost goal

- Plan to forfeit the risk quickly if preliminary position is not **in the money**
- Stop-loss points automated and planned strict enforcement position-by-position
- Aggregated portfolio risk continuously calibrated
(e.g., both how fast and the impact of the Fund's loss potential)
- Constantly monitor counterparty exposure
(e.g., counterparty risk strategy to align with stop-out philosophy, multiple counterparties, quick to abort where there are signs of trouble)



Capital preservation, first and foremost goal

	NARROW STOP LOSS Faster when feeling aggressive	WIDE STOP LOSS Slower when feeling defensive
S M A L L E R P O S I T I O N	<p>Tight Strong Trend</p> <p>STOP: 2.5% to 5% of price RISK: 1% to 5%</p>	<p>Wide Late Trend</p> <p>FLATTEN OUT or; STOP: 15% to 20% of price RISK: 1% to 2.5%</p>
L A R G E R P O S T I O N	<p>Wider Early Trend</p> <p>STOP: 5% to 10% of price RISK: 2.5% to 5%</p>	<p>Loose Saw Tooth Trend</p> <p>STOP: 10% to 15% of price RISK: 2.5% to 5%</p>

Risk Matrix: Speed v. Impact

Accept feelings and calibrate exposure according to confidence and conviction. You have to determine your personal stop and risk tolerance. Then, follow your system, ride your winners, cut your losers and manage aggregated portfolio risk.

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Constantly monitor counterparty exposure

FROM COPULA FUNCTIONS TO DISTRIBUTIONS

- A copula function $z = C(u,v)$ is defined as
 1. z, u and v in the unit interval
 2. $C(0,v) = C(u,0) = 0$, $C(1,v) = v$ and $C(u,1) = u$
 3. For every $u_1 > u_2$ and $v_1 > v_2$ we have
$$V_C(\mathbf{u},\mathbf{v}) = C(u_1,v_1) - C(u_1,v_2) - C(u_2,v_1) + C(u_2,v_2) \geq 0$$
- $V_C(\mathbf{u},\mathbf{v})$ is called the volume of the copula C
- **Sklar theorem:** each joint distribution $H(X,Y)$ can be written as a copula function $C(F_X,F_Y)$ taking the marginal distributions as arguments, and vice versa, every copula function taking univariate distributions as arguments yields a joint distribution.



TAIL DEPENDENCE

- Copula functions may be used to compute an index of *tail dependence* assessing the evidence of simultaneous booms and crashes on different markets

$$\lambda_L(v) = \Pr(F_X \leq v | F_Y \leq v) = \frac{\Pr(F_X \leq v, F_Y \leq v)}{\Pr(F_Y \leq v)} = \frac{C(v,v)}{v}$$

$$\lambda_U(v) = \Pr(F_X > v | F_Y > v) = \frac{\Pr(F_X > v, F_Y > v)}{\Pr(F_Y > v)} = \frac{1 - 2v + C(v,v)}{1 - v}$$



Our counterparty exposure measures



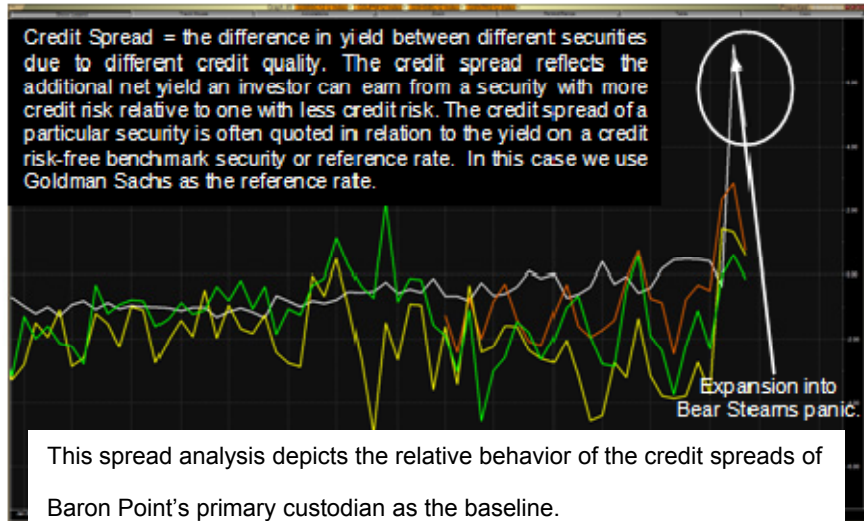
Constantly monitor counterparty exposure

1. **Limit the amount of single entity exposure** by maintaining multiple and redundant (prime) brokers, trading, custodial and banking relationships. This spreads out the concentration risk of a catastrophic credit event (i.e. no matter how unlikely that may seem).
2. **Require segregated/custodial accounts in Fund II's name** (e.g. rather than holding assets in a counterparty's name) to compliment margin accounts held at counterparties. If you don't need margin, move it to a **Type 1 cash account**.
3. Regular **reviews of relevant legal counterparty agreements** and changes in relationship structuring.
4. **Develop real-time systems that constantly monitor and evaluate** – on a daily basis – counterparties' market activity.
 - i. Pricing of fixed incomes spreads
 - ii. Equity and option activity
 - iii. Credit Default Swaps (institution, group, country)

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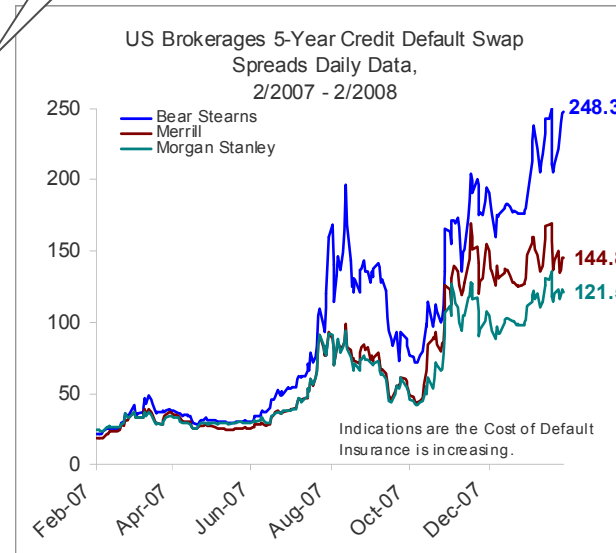
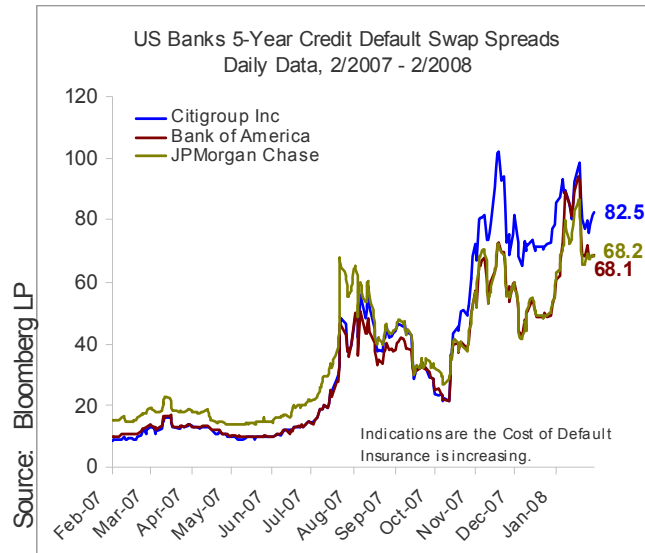
Constantly monitor counterparty exposure



As per Baron Point's Counterparty Risk Manual, Fund Management knows that in bear markets *return of capital* mind is equally as important as seeking *return on capital*.

Hence the firm engages its policies and procedures, and moves to an acute state of counterparty sensitivity given the potential for bank failures and a wide spread financial panic, a la a 1907 analogue is deployed.

5 Year Note Spread (with Bear Stearns Example) - Weekly



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Constantly monitor country exposure



1<GO> to save Deal, 2<GO> to save curve source
CREDIT DEFAULT SWAP CPU: 122

Deal Information		RED Pair:	Spreads		Date
7) Reference: United States of America					
Counterparty: [REDACTED] Deal#: [REDACTED]			Curve Date: 10/29/08		
Ticker: / [REDACTED] Series: [REDACTED] Privilege: U User			Benchmark: S 45 M Mid		
Business Days: EUR [REDACTED] Settlement Code: EUR			EU BGN Swap Curve		
Business Day Adj: 1 Following Currency: EUR			Sprds: C Contributor AAsk		
B BUY Notional: 10.00 MM Amortizing: N			218252 EUR Senior IMMI		
Effective Date: 10/30/08 Knock Out: N Month End: N			Par Cds Spreads Default		
Maturity Date: 12/20/13 Day Count: ACT/360			Flat: N (bps) Prob		
Payment Freq: Q Quarterly First Cpn: 12/22/08			6/22/09 29.89 0.0032		
Pay Accrued: T True Next to Last Cpn: 9/20/13			12/21/09 29.89 0.0057		
Curve Recovery: I True Date Gen Method: I IMM			12/20/10 37.00 0.0133		
Recovery Rate: 0.40 Debt Type: 1 Senior			12/20/11 39.20 0.0206		
Deal Spread: 42.000bps 9) Upfront Fee: 0.00%			12/20/12 41.00 0.0284		
Calculator Mode: 1 Calc Price			12/20/13 42.00 0.0360		
Valuation Date: 10/30/08 Model: J JPMorgan			12/21/15 43.00 0.0509		
Cash Settled On: 11/3/08			12/20/18 44.00 0.0730		
Price: 100.00000000 Repl Sprd: 42.000 bps			Frequency: Q Quarterly		
Principal: 0.00 Sprd DV01: 4,624.61			Day Count: ACT/360		
Accrued: 0.00 Days: 0 32) Sprd KRR			Recovery Rate: 0.40		
Market Val: 0.00 IR DV01: .00					

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OLD Bloomberg Symbol: ZCTO CDS EUR 10Y Crrncy

NEW Symbol: **CONDOM**

Predicating the Change?

Predicating the Change?

- A condom allows for inflation
- It halts production
- It destroys the next generation
- It protects a bunch of pricks, and
- It gives the implementer a sense of security while you are actually being screwed.



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