

QUARTERLY MARKET COMMENTARY

Fourth Quarter 2004

With the help of October, November, and December 2004 market performance economies ended on a good note. Equity and fixed income markets ended the year with a positive return. Again this quarter, we saw small cap US securities out-

perform

large cap

US

securities

and value

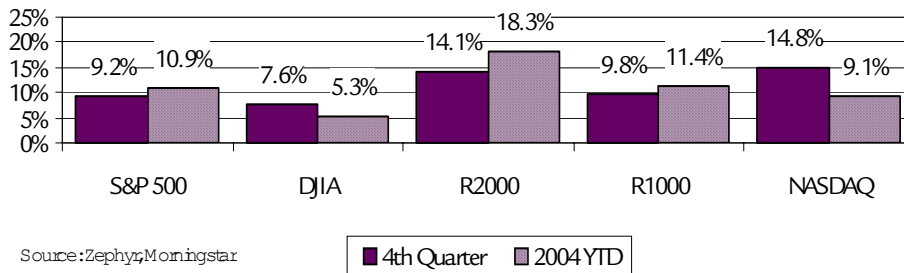
companies

managed

to post

higher returns than their growth company counterparts.

Returns on Major U.S. Stock Market Indices



Equity and fixed income markets ended the year with a positive return.

The S&P 500 Index saw a 10.8% rise in 2004, with 9.2% coming from the fourth quarter. Much of this fourth quarter gain came from the information technology and consumer discretionary sectors of the market which realized a 13.4% and

13.1% gain,

respectively.

Hardware

companies

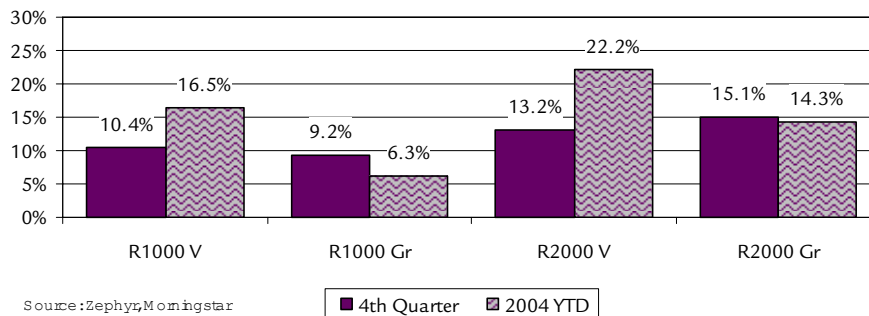
contributed

significantly

to the

increase of the information technology sector. Within the S&P 500 Index, the energy sector was the worst performer of the quarter, but still managed to post

Russell Size and Style Indices



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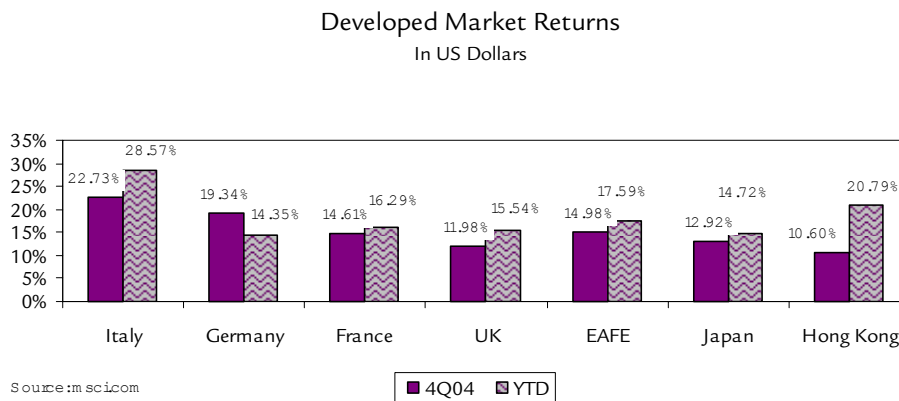
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a gain of 4.2%. The low performance was aggravated when crude inventories moved above the five year average in December for the first time in 2004. This caused crude oil prices to drop during the month. Prices for natural gas fell during the quarter due to an approximate 10% increase of inventories; however, prices for natural gas and crude oil still remain significantly higher than in 2002 or 2003.

The US economy has continued on the path to recovery. GDP grew at 4.4% for 2004, which is a marked increase from the 2003 growth rate of 3%. The Labor Department has reported that wages and benefits grew 0.7% during the quarter. The modest increase has not dampened consumer spending which rose 3.8% during 2004. Business spending on equipment and software (+13.4% in 2004) has helped to contribute to economic growth during the year. Despite the high business spending this year, consumer spending typically accounts for approximately two-thirds of economic activity in the US. With US savings rates decelerating, the American consumer is helping to boost the economy.

Internationally, developed markets thrived during the fourth quarter as well as throughout 2004. The MSCI EAFE Index rose by 17.5% for the year with almost 15% of that coming from the fourth quarter. All developed markets included in the EAFE

Index posted gains for the fourth quarter; however,



Greece (32.6%) and Austria (29.2%) managed to lead the pack. The returns for the international markets this quarter and on a year-to-date basis seem to be

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evenly spread among Europe, the Pacific, and the Nordic countries.

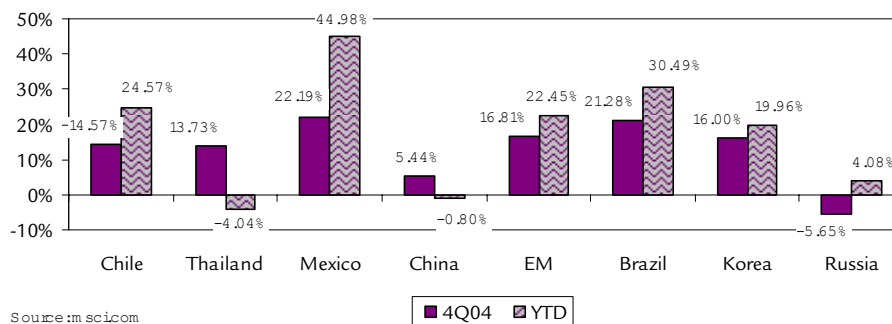
While the developed markets exceeded our already high expectations, the emerging markets managed to boom during the fourth quarter. The MSCI Emerging Markets Index outpaced the EAFE and domestic indexes significantly this year by posting gains for 2004 of almost 22.5%, with 16.8% of the gain in the fourth quarter.

The only negative returns during the fourth quarter in emerging markets

came from Russia. Their (-5.5%) return proved to have little affect on the index when coupled with the 30%+ returns of Hungary, Czech Republic, Colombia, Jordan, and Poland – not to mention the 9 other nations whose returns were all over 20% for the quarter.

The dollar has continued to drop during the fourth quarter despite a rising stock market and two 0.25% increases in interest rates since September 30th. Much to the chagrin of the European Central Bank (ECB), the values of the euro continued to appreciate in comparison to the dollar. The ECB fears that the euro is rising too rapidly and this will negatively impact their trade with non-European Union nations as their goods become more expensive on a relative basis. While there are many factors at work with any exchange rate valuation, a large reason the euro has changed so dramatically versus the dollar has to do with China.

Emerging Market Returns
In US Dollars



The MSCI Emerging Markets Index outpaced the EAFE and domestic indexes significantly this year by posting gains for 2004 of almost 22.5%, with 16.8% of the gain in the fourth quarter.

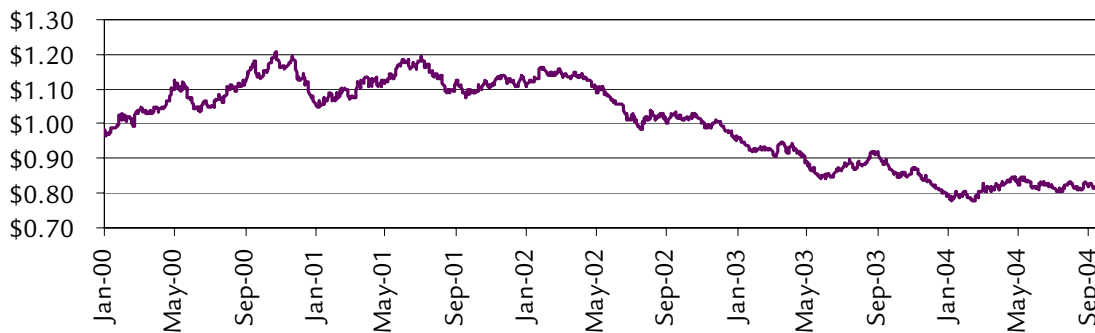
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With large year-over-year increases in GDP, China's economy is booming. Due to their increasingly important role in the global economy, they were invited to the last G7 economic summit. China contributes significantly to the global economy by producing many of the goods sold in industrialized nations. They provide inexpensive labor and have proven to be efficient trading partners with much of the western world. Yet, their currency, the yuan, remains pegged to the dollar despite encouragement from the United States and the European Union to allow it to float.

Value of the Dollar per Euro
Through December 2004



Source: The Federal Reserve

Given the substantial and growing US current account deficit, the dollar would typically decrease in relation to other currencies. The fact that the yuan cannot appreciate relative to the dollar has left the euro taking the majority of the increase versus the dollar. The concern by the ECB is that their goods will become too expensive for people abroad thus damaging their economy. This pressure can be somewhat alleviated by allowing the yuan to float.

As it is now, approximately 13% of US imports come from China. So as to not lose a favorable trading status with nations other than the US, the Chinese government needs to keep the yuan, and thus the dollar, artificially high. They

***Approximately
13% of US im-
ports currently
come from China.***



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have propped up the US dollar by purchasing US Treasury bills in their central banks. If the yuan is floating, the exchange rate of the yuan in comparison to the dollar will rise. The fear for China is that industries will leave and find other places to do business where more favorable exchange rates provide less expensive labor and supplies.

The United States could curb a decrease in the dollar, but there is no desire to do that in the short term. The macroeconomic policies of the US benefit from a lower exchange rate in the short term. It will enable the US to pay off debt, balance out the trade deficit (as Americans buy more domestically and foreigners import more US goods), and increase investments.

While China is wary of the negative ramifications of a floating currency, they do stand to benefit as well. For 2004, China saw their economy, as measured by GDP, increase by 9.5%. Beijing has recognized that they are in danger of having an overheated economy. They are also aware that the benefits of a floating exchange rate include having the ability to move interest rates and having control over their own monetary policies. This will enable them to invest more in their own economy rather than purchasing US T-bills.

The expectation is that China will loosen its exchange policy sometime during 2005, but not completely allow it to float. We anticipate that China will do a type of fixed floating rate, where the yuan will be allowed to float above or below the dollar by some percentage. This will allow them to cool their economy without the negative effects of a sudden jump in exchange rates. It will also enable them to slowly incorporate a more flexible exchange rate.

Looking forward, we expect that we have not seen the end of a depreciating dollar. Once China and other Asian nations allow their currencies to float, the dollar will drop a little further, but could possibly see a slight jump compared to

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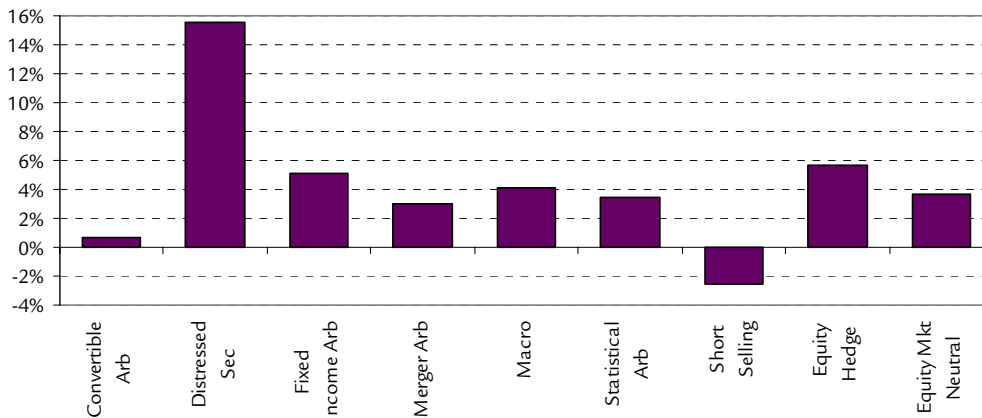


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the euro. We are currently seeing positive signs of an economic recovery; US GDP grew by 4.4% in 2004, which is close to the 4.5% GDP growth of 1999. However, the economy will not turn around overnight. As a nation, the US is in a large current account deficit and this could take years to rectify. We anticipate a continued growth in the US economy, but at a reasonable pace. We expect the foreign markets, both developed and emerging, to outperform in the short-term (3 to 5 year time horizon).

Hedge Fund of Funds followed many of the trends that could be seen in other traditional assets classes throughout 2004. Investor worries about rising interest rates, energy, and the outcome of the US election provided resistance against any positive trend forming for the first three quarters of 2004. However, the election results seemed to be what many strategies needed to post strong gains in November and December. The Fed's measured increase in short term rates to 2.25% coupled with strong overseas buying and subdued inflation allowed for modest increase in 10-year Treasury Bonds prices and therefore a much flatter yield curve which reduced gains in some of the "carry" trades found

Year-to-Date Performance Update (11/04)



in fixed income arbitrage strategies. Through November, Distressed Debt trades and Long/Short Equity (Equity Hedge) continued their out performance of other hedge fund strategies thanks in part to strong November gains. Keep in

We are currently seeing positive signs of an economic recovery; US GDP grew by 4.4% in 2004, which is close to the 4.5% GDP growth of 1999.

Distressed securities and Long/Short Equity trades outperformed other strategies in 2004.



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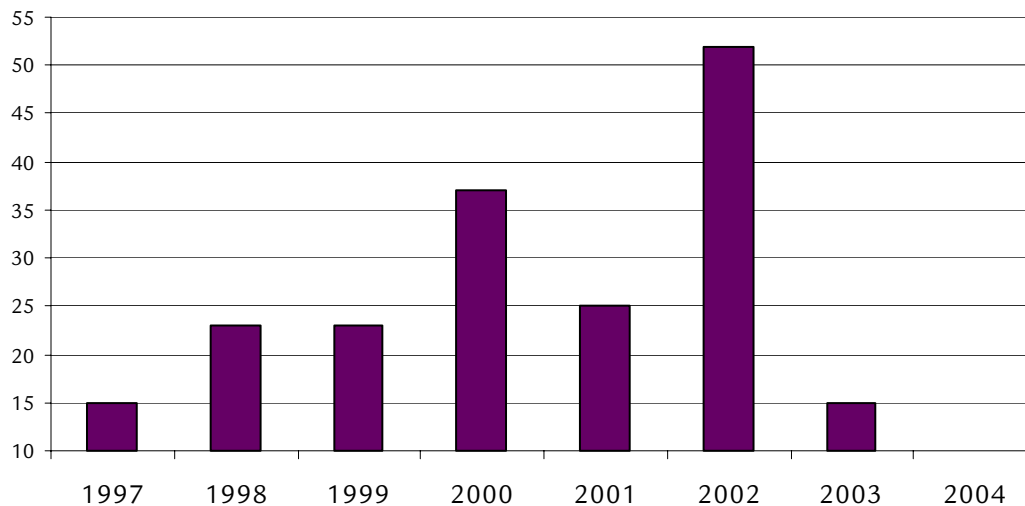
mind, these figures do not include December performance which was generally a strong month as well for most strategies.

One of the biggest stories to unfold in 2004 was the lack of volatility in the equity markets. This has most assuredly removed opportunities for hedge fund managers, specifically opportunistic Long/Short Equity managers, to take advantage of mis-pricings created by increased volatility. In 2004, there were no days in which the S&P 500 index gained or lost 2%.

2004 was an exceptionally docile year with regard to significant market fluctuations. On average over the previous 7 years, the S&P 500 experienced moves of greater than 2% 27 times.

2004 was an exceptionally docile year with regard to large daily market fluctuations (+/-2%).

Days When S&P 500 Changed +/-2%

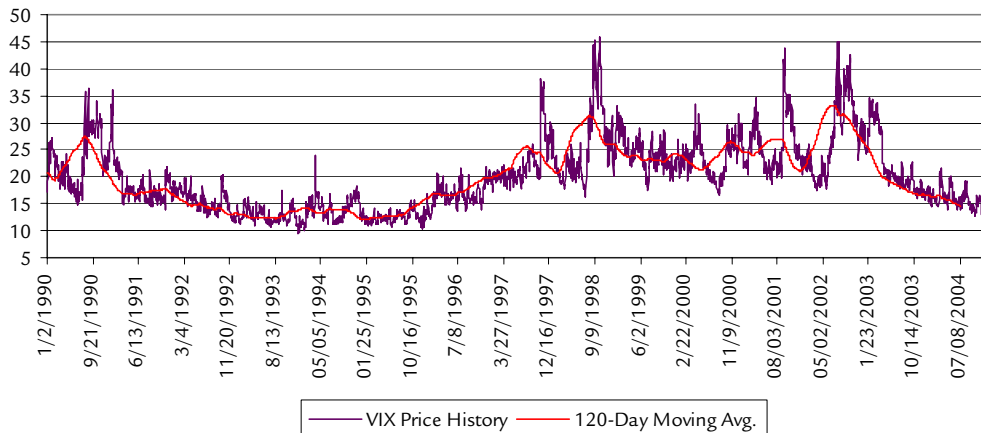


Additional volatility analysis shows just how rare the low volatility we experienced in 2004 is. The VIX index tracks the expected volatility of equity markets as revealed by the price at which investors buy and sell equity options.



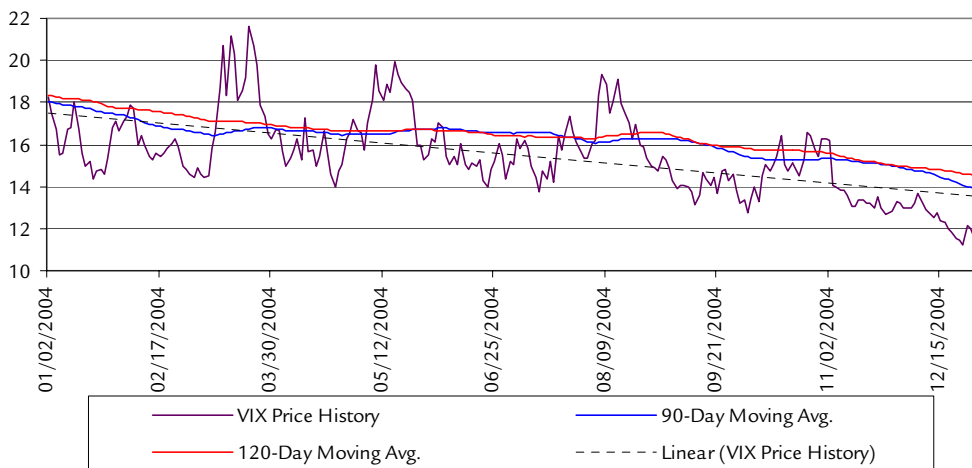
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VIX Price History



As of December 31, 2004 the VIX was trading at lows not seen in 10 years. Analysis of last year's volatility shows that volatility has progressively decreased over the year and that it's trending even lower.

VIX Price History (2004)



One final general market observation that is true of both traditional and alternative strategies has been the investor's willingness to assume added risk to supplement their returns. In the alternatives space investors have increased their appetite for leveraged products and less liquid investments, all signifying that

Stock market volatility as measured by the VIX remains extremely low. The VIX is trading at lows not seen in 10 years.



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investors are return hungry and less risk adverse. We remain watchful that the strategies and structures hedge fund of funds are implementing to satisfy investors needs for increased returns are not to the detriment of their attractiveness.

Looking forward it's obvious to us that these trends in volatility cannot continue and with the move back to historical norms will come added opportunities for managers in the Long/Short Equity strategy and others to add returns. Additional positive moves in interest rates will also add wind to the sails of managers carrying short sale rebates on their books as the cash that those managers hold can be invested in higher returning money market instruments.

If you have any questions, please feel free to contact the Investment Committee of WaterStreet Investment Consultants at 512-334-3300 or 866-747-3300

Investor risk appetites manifested itself in the hedge fund industry as increased demand for leveraged product and funds adding illiquidity to increase return.

Current trends in volatility cannot continue and with pending increases in interest rates, higher returns in hedge funds and fund of funds should result.



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Trade, Exchange Rates, and Budget

	Trade balance*, latest 12 mos		Current Account Balance				Exchange Rate		Budget balance % of GDP 2004‡
			\$bn		The Economist poll		trade weighted**		
			latest 12 mos		% of GDP, forecast		1990=100		
				2004	2005	Dec 28th	year ago		
Australia	-16.6	Oct	-36.2	Q3	-5.9	-5.4	86.2	86.9	0.7
Austria	-0.1	Sep	-1.1	Sep	-0.5	-0.6	103.3§	102.8	-1.5
Belgium	20.5	Sep	13.0	Jun	3.2	3.2	103.6§	103.0	-0.1
Britain	-103.2	Oct	-47.4	Q3	-2.5	-2.7	102.3	100.3	-3.2
Canada	49.6	Oct	26.7	Q3	2.7	2.3	92.6	87.7	1.1
Denmark	9.5	Oct	6.2	Oct	3.0	2.6	107.6	107.0	0.9
France	-5.2	Oct	-3.1	Oct	0.2	0.2	107.2§	106.4	-3.7
Germany	189.1	Oct	91.5	Oct	3.3	3.1	105§	103.9	-3.9
Italy	0.1	Oct	-11.8	Oct	-0.9	-1.0	76.4§	75.8	-2.9
Japan	135.8	Oct	169.9	Oct	3.5	3.4	136.0	136.8	-6.5
Netherlands	35.6	Oct	21.0	Q3	2.9	3.0	103.2§	102.4	-2.9
Spain	-68.5	Sep	-41.3	Sep	-3.3	-3.6	77.6§	77.1	-1.1
Sweden	22.5	Nov	26.2	Q3	7.3	6.6	84.0	82.5	0.5
Switzerland	7.9	Oct	45.9	Q2	11.7	11.2	114.1	111.8	-1.6
United States	-634.0	Oct	-603.2	Q3	-5.5	-5.6	89.5	95.3	-4.4
Euro Area	94.7	Oct	47.3	Oct	0.5	0.5	94.8	92.4	-2.9

*Merchandise. Australia, Britain, France, Canada, Japan, and United States imports fob, exports fob. All others cif/fob. **Bank of England except §IMF, October average. ‡OECD forecast.

Source: The Economist, Jan 1-7, 2005

Output, Demand, and Jobs

% change on a year ago

	GDP		The Economist poll GDP forecasts		Industrial Production		Retail Sales (volume)		Unemployment % rate		
	latest	qtr*	2004	2005	latest		latest		latest	year ago	
Australia	3.0	Q3	3.6	3.1	4.6	Q2	5.7	Q3	5.2	Nov	5.7
Austria	2.7	Q3	1.7	2.1	7.4	Oct	2.2	Sep	4.5	Oct	4.6
Belgium	2.9	Q3	2.5	2.1	3.2	Oct	2.7	Sep	12.8	Nov†	12.5
Britain	3.1	Q3	3.2	2.4	-1.9	Oct	6.1	Nov	4.7	Oct††	5.0
Canada	3.3	Q3	2.9	3.1	3.6	Oct	5.0	Oct	7.3	Nov	7.5
Denmark	1.9	Q3	2.2	2.2	-3.3	Oct	6.5	Oct	6.3	Oct	6.0
France	2.0	Q3	2.2	1.9	1.4	Oct	2.3	Oct	9.9	Oct	9.9
Germany	1.3	Q3	1.4	1.4	1.9	Oct	-2.6	Oct	10.8	Nov§	10.5
Italy	1.3	Q3	1.2	1.5	-0.5	Oct	-3.6	Oct	8.1	Apr	8.7
Japan	2.6	Q3	3.9	1.9	4.3	Nov	-2.2	Sep	4.5	Nov	5.1
Netherlands	1.5	Q3	1.2	1.3	0.3	Oct	-0.7	Sep‡	6.4	Nov**	5.6
Spain	2.6	Q3	2.6	2.5	-7.0	Oct	0.2	Oct	10.5	Oct	11.2
Sweden	3.9	Q3	3.4	2.8	5.0	Oct	7.9	Nov	4.9	Nov†	5.4
Switzerland	1.8	Q3	1.8	1.8	3.5	Q3	-1.0	Oct	3.9	Nov†	4.0
United States	4.0	Q3	4.4	3.5	3.8	Nov	4.3	Nov	5.4	Nov	5.9
Euro Area	1.8	Q3	1.8	1.7	1.0	Oct	-0.2	Oct	8.9	Oct	8.9

*% change on previous quarter at an annual rate. †Not seasonally adjusted. ‡New Series. ††Aug-Oct; claimant count rate 2.7% in Nov. §EU

Source: The Economist, Jan 1-7, 2005



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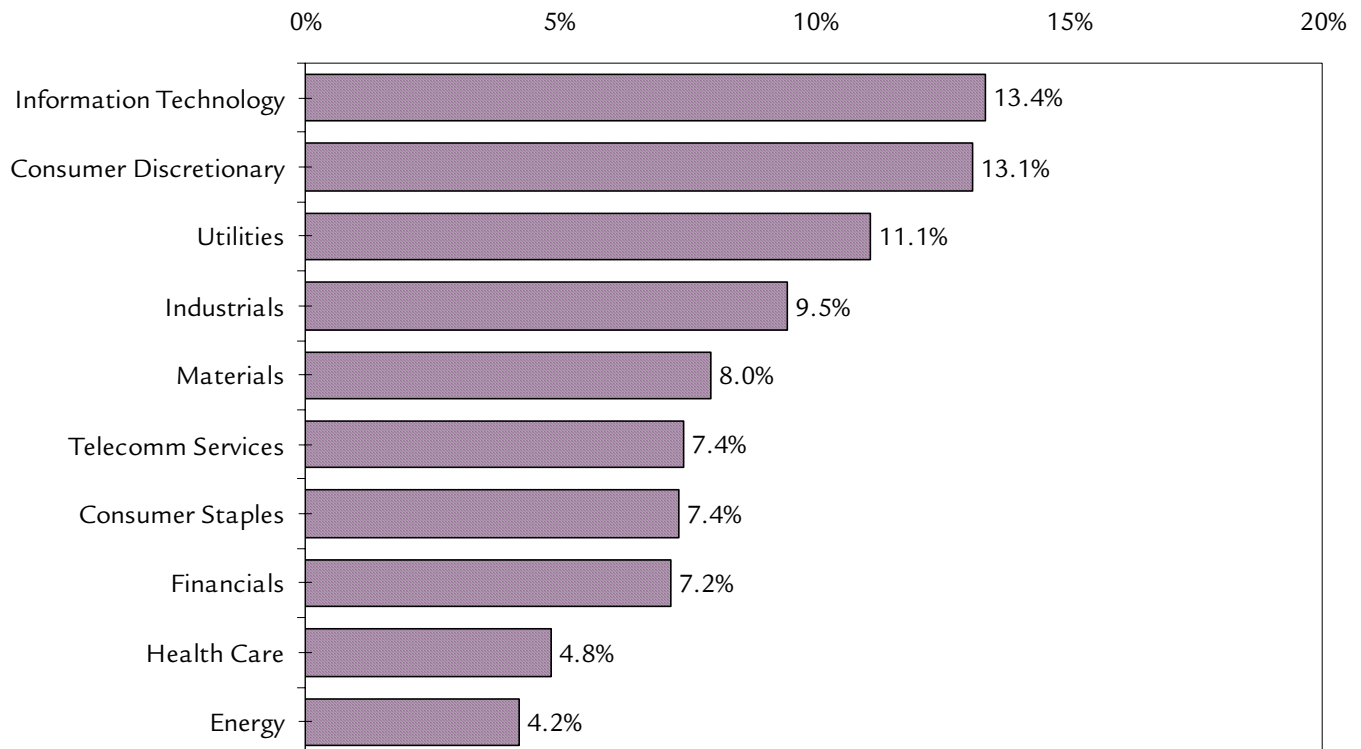
Prices and Wages

% change on a year ago

	Consumer Prices			Producer Prices			Wages/Earnings		
	latest		year ago	latest		year ago	latest		year ago
Australia	2.3	Q3	2.6	6.1	Q3	-0.1	3.7	Q3	5.1
Austria	2.3	Nov	1.3	5.6	Nov	2.7	2.0	Nov	2.3
Belgium	2.3	Dec	1.7	5.6	Nov	-0.3	2.4	Oct	1.8
Britain	1.5	Nov*	1.3	3.5	Nov	1.7	4.1	Oct**	3.6
Canada	2.4	Nov	1.6	5.4	Oct	-4.0	2.6	Sep	3.0
Denmark	1.3	Nov	1.5	3.2	Nov	0.6	2.9	Q3	3.7
France	2.0	Nov	2.3	3.1	Nov	0.8	2.7	Q3	2.9
Germany	2.0	Dec	1.1	4.1	Nov	1.3	0.9	Sep	2.6
Italy	2.0	Nov	2.5	4.4	Oct	0.7	2.7	Oct	2.6
Japan	0.8	Nov	-0.5	2.0	Nov	-0.5	1.4	Nov	0.1
Netherlands	1.3	Nov	2.0	6.9	Oct	-0.2	1.0	Nov	2.4
Spain	3.5	Nov	2.8	5.2	Nov	1.3	2.2	Q3	3.1
Sweden	0.5	Nov	1.4	2.9	Nov	-1.6	3.0	Sep	2.5
Switzerland	1.5	Nov	0.5	1.9	Nov	-0.2	1.4	2003	1.8
United States	3.5	Nov	1.8	5.1	Nov	3.4	2.4	Nov	2.2
Euro Area	2.2	Nov	2.2	4.0	Oct	0.8	2.0	Q3	2.8

*New Series. RPI inflation rate 3.4% in Nov. **Aug-Oct.

S&P 500 Economic Sectors Fourth Quarter 2004



Source: standardandpoors.com



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Large Cap vs. Small Cap
Returns on Russell 1000 Minus Russell 2000



Value vs. Growth
Returns on Russell 1000 Growth Minus Russell 1000 Value



Source: Zephyr, Morningstar

Index	4Q 04	1 Year	3 Years	5 Years	10 Years
S&P 500	9.23%	10.88%	3.59%	-2.30%	12.07%
Russell 1000	9.80%	11.40%	4.27%	-1.76%	12.16%
Russell 2000	14.09%	18.33%	11.48%	6.61%	11.54%
Russell 2000 Growth	15.08%	14.31%	5.79%	-3.57%	7.12%
Russell 2000 Value	13.20%	22.25%	16.50%	17.23%	15.17%
Russell 1000 Growth	9.17%	6.30%	-0.18%	-9.29%	9.59%
Russell 1000 Value	10.38%	16.49%	8.57%	5.27%	13.83%
MSCI EAFE Index	15.36%	20.70%	12.31%	-0.80%	5.94%
MSCI Emerging Markets	17.27%	25.95%	22.77%	4.62%	3.30%
Lehman US Aggregate Bond Index	0.95%	4.34%	6.20%	7.71%	7.72%
Lehman US Municipal Bond	1.25%	4.47%	6.44%	7.21%	7.06%
Lehman US Treasury Long	1.44%	7.69%	8.83%	10.07%	9.57%
Citigroup Non-U.S. Dollar World Govt Bond	10.64%	12.14%	17.48%	8.77%	7.33%
Citigroup 3-month T-bill	0.44%	1.24%	1.34%	2.79%	4.00%

Source: Zephyr, Morningstar



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International Developed Market Performance				
Source: Morgan Stanley Capital International				
	In Local Currency		In US Dollars	
	4Q'04	2004	4Q'04	2004
REGIONS				
EAFE	6.51%	10.18%	14.98%	17.59%
EURO	8.14%	8.39%	18.35%	16.80%
EUROPE	6.73%	9.43%	15.56%	17.85%
PACIFIC	6.10%	12.32%	13.67%	17.19%
THE WORLD INDEX	7.77%	9.49%	11.59%	12.84%
WORLD ex USA	6.49%	10.29%	14.81%	17.78%
NATIONAL INDICES				
AUSTRALIA	10.03%	21.73%	19.07%	26.65%
AUSTRIA	18.11%	57.02%	29.25%	69.21%
BELGIUM	7.89%	29.52%	18.07%	39.58%
CANADA	6.25%	11.73%	12.23%	20.50%
DENMARK	1.13%	19.36%	10.73%	28.75%
FINLAND	6.55%	-3.58%	16.61%	3.91%
FRANCE	4.73%	7.92%	14.61%	16.29%
GERMANY	9.05%	6.12%	19.34%	14.35%
GREECE	21.22%	31.06%	32.66%	41.24%
HONG KONG	10.24%	20.93%	10.60%	20.79%
IRELAND	8.62%	29.14%	18.88%	39.16%
ITALY	12.14%	19.31%	22.73%	28.57%
JAPAN	4.98%	9.69%	12.92%	14.72%
NETHERLANDS	6.21%	1.27%	16.24%	9.13%
NEW ZEALAND	5.87%	17.98%	13.14%	29.80%
NORWAY	5.43%	36.21%	17.18%	49.62%
PORTUGAL	2.74%	13.08%	12.44%	21.85%
SINGAPORE	3.38%	14.24%	6.61%	18.84%
SPAIN	13.77%	16.40%	24.51%	25.43%
SWEDEN	6.12%	23.75%	16.25%	33.99%
SWITZERLAND	4.14%	4.60%	14.36%	13.77%
UNITED KINGDOM	5.55%	7.73%	11.98%	15.54%



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International Emerging Market Performance				
Source: Morgan Stanley Capital International				
	In Local Currency		In US Dollars	
	4Q'04	2004	4Q'04	2004
REGIONS				
EM (EMERGING MARKETS)	8.82%	13.21%	16.81%	22.45%
EM ASIA	7.28%	5.06%	14.01%	12.23%
EM EASTERN EUROPE	4.86%	21.52%	11.73%	32.09%
EM EUROPE	6.55%	23.03%	14.50%	33.37%
EM EUROPE & MIDDLE EAST	9.56%	21.17%	16.26%	28.84%
EM LATIN AMERICA	13.44%	27.59%	19.81%	34.77%
NATIONAL INDICES				
ARGENTINA	7.97%	26.27%	8.31%	24.57%
BRAZIL	12.67%	20.14%	21.28%	30.49%
CHILE	4.24%	16.83%	14.57%	24.57%
CHINA	5.10%	-0.68%	5.44%	-0.80%
COLOMBIA	19.37%	90.98%	32.69%	125.66%
CZECH REPUBLIC	19.02%	53.58%	35.56%	76.59%
EGYPT	19.70%	115.41%	22.96%	118.78%
HUNGARY	18.92%	63.38%	30.87%	87.51%
INDIA	17.69%	10.96%	24.54%	16.46%
INDONESIA	24.84%	59.30%	23.19%	44.54%
JORDAN	33.49%	59.11%	33.49%	59.11%
KOREA	4.28%	4.22%	16.00%	19.96%
MALAYSIA	6.03%	11.81%	6.03%	11.81%
MEXICO	19.45%	43.82%	22.19%	44.98%
MOROCCO	-0.78%	10.35%	6.97%	17.62%
PAKISTAN	12.47%	12.46%	12.16%	8.61%
PERU	-0.45%	-4.05%	0.85%	-0.22%
PHILIPPINES	4.50%	25.47%	4.80%	24.12%
POLAND	12.22%	26.92%	31.68%	58.59%
RUSSIA	-5.65%	4.08%	-5.65%	4.08%
SOUTH AFRICA	7.49%	18.72%	23.55%	40.67%
SRI LANKA	1.70%	16.18%	0.83%	7.81%
TAIWAN	5.70%	-0.56%	13.30%	6.54%
THAILAND	6.66%	-5.91%	13.73%	-4.04%
TURKEY	15.03%	32.90%	28.42%	38.46%
VENEZUELA	4.14%	31.50%	1.09%	45.45%