

Dear Partners,

2007 was a remarkable year across global markets, though clearly 2008 has proven to be perhaps exponentially more dramatic and eventful. As you know, given wild moves in the market and portfolio this year, we wanted to provide an integrated perspective on the past 20 months, an assessment of key factors that have affected the portfolio, and just as importantly, a discussion of our perspective and positioning for the times ahead.

It is clearly an extraordinary (and dangerous) environment – what began as dramatic fundamental economic developments have collided with market and technical factors to create a stunning level of chaos in both markets and economies. This is the first major global economic inflection point we have witnessed in the ‘new’ era of interconnected global markets, and with high velocity investors (hedge funds) as significant players...so far it has not been pretty.

2007 was a strong year for us, on both an absolute and relative basis. As you will see in later sections of this letter, 2007 performance was not a function of a few lucky big bets, but rather a diverse array of successful investments, with very few big mistakes...in short, largely a perfect year for us. The first half of 2008 was solid, relative to the environment. **In sharp and dramatic contrast, the last quarter has been abysmal,** and we are sorry to have let you down with the terrible performance of the portfolio. As extraordinary as the environment has been, that is not a good excuse – we clearly underestimated the potential damage to us from chaotic moves elsewhere. We had reduced exposures into mid-year, but still maintained meaningful exposure levels hoping to profit from dislocation already evident in markets...only to walk into the buzzsaw of a market that has become exponentially more chaotic. Fundamental ‘disruptions’ were created by wild swings in commodities and growth sentiment. This was followed by remarkable degrees of hedge fund disruption, as funds rushed to unwind positions and ‘de-risk’. These events then intersected with the crisis in financial markets triggered by US credit concerns. While nervous about the economic environment, we thought the opportunity to profit from dislocation and chaos was also remarkably high. Candidly, in hindsight we grew a bit overconfident in our ability to navigate treacherous waters. Regardless, clearly we ended up sailing right into a perfect storm.

We still believe that stunning levels of market dislocation have created ‘once in a generation’ opportunities in markets. However, the danger level present in markets has soared higher as well; therefore, we have also moved aggressively to reshape the portfolio so that it can profit in the stressed environment we expect to continue. Most of all, we are very determined to ensure that the drawdown we have just experienced will never happen again. We (employees and related parties) are the largest investors in our fund; for 14 quarters we have delivered quality and quantity of returns that were among the best in the business, but this last quarter has been as unacceptable to us, as it must be to you. As a result, we have very aggressively and dramatically reduced risk levels in recent weeks, and as importantly, we have been shifting portfolio exposures toward areas where we expect compelling returns with less volatility and hedge fund overlap. This process has been painful, but we feel necessary, so that we can enter the new quarter with a portfolio that is fresh and well-positioned for a dangerous but potentially lucrative environment.

For years, there has been virtual consensus in markets that strong economic growth elsewhere in the world would help offset a weakening US economy (and also drive continued demand for commodities). In reality, for the past five years, this view has generally been the right view – developing economies have been the engine for growth in the world. However, this view of ‘global decoupling’ became gospel over time, and markets became perhaps too comfortable assuming these trends were certain to continue. The only key risk to global growth was perceived to be the degree to which the US might ‘drag down’ the rest of the world.

The global decoupling thesis truly took hold of international markets with a vengeance last September. Markets concluded the US credit crisis was likely to damage only the domestic US economy, and therefore the gap between the strength of the global economy and the weakness of the US domestic economy would continue to expand. In turn, these views coalesced into a central focus on commodities (which are dominated by Emerging Market demand). As 2008 began, markets increasingly became

manically focused on 'winners and losers' from commodities. The skyrocketing prices of most commodities caused investors to flee toward commodity rich countries and industries, and away from commodity users. As a result, an accelerating focus on the 'rest of the world' vs. the domestic US economy morphed ultimately into an even narrower focus on commodities. Commodities themselves started correlating to an extreme degree, and every stock seemed to either have high positive or high negative correlation to commodity prices.

However, mid-year economic data threw markets for a loop – the US unexpectedly strengthened substantially, while Asian and European economies showed significant signs of unexpectedly rapid deterioration. Given how crowded the belief in strong international growth was, the mid-year data served as the spark for a wild rush from one side of the ship to the other...sparking a plunge in international markets, foreign currencies, and commodities. In short, everything that had gone up in the past few years was dumped by investors as they fled in the other direction.

In particular, this wild July reversal in markets caused a large amount of damage to many hedge funds, who were clearly in 'extreme agreement', in turn leading to substantial risk reduction at many funds. Therefore, what was a panicked reaction to fundamental factors in July became a hedge fund unwinding event in August, with several sizable funds forced to liquidate. Finally, another round of credit fears, somewhat independent of all of this, triggered the panic in US financials, and spurred a round of even broader market panic in September. Significant concern about potential failures of prime brokers, and even greater fears of massive redemptions have led to a remarkable retrenchment by the hedge fund community. Unfortunately, selling has beget selling, as risk reduction and unwinding create spillover pressure on other funds with overlapping holdings.

We have been strong believers that the shift in share of global growth and wealth away from the US is real and structural, and we have been strong believers in the increasing supply-demand tension for raw materials. However, as you know, we were skeptical of the extreme degree to which investors took the global decoupling thesis. Our view has quite consistently been that, in an interconnected world, it is almost impossible for countries to suffer or soar in isolation. Both cyclical (weakening global growth) and structural (developing nation growth) factors are important – for the past five years, both were aligned; in the next few years, they are likely to be opposed. As a result, one should expect ongoing market 'manic depressive' behavior, as markets vacillate between fear of cyclical slowdown and optimism over international economies.

Ironically, the mid-year data that sparked the fundamental reassessment of the world by investors was not inconsistent with our expectations (though we also believe it is largely a temporary factor). We have been a strong believer in the export/manufacturing 'renaissance' in the US, and in fact import substitution (domestic manufacturing recapturing share from imports) was in fact responsible for the entirety of strong US growth in 2nd quarter US GDP. Likewise, while believers in the long term story in some materials and manufacturing industries, we thought the last surge in commodity prices was largely 'fluffy' and would lead to some demand destruction. We did not anticipate, however, the degree to which this would spark a wild rush for the exits, and the degree to which this chaos would further splash across many other areas of our portfolio.

Ultimately, regardless of our macro views, we have always tried to construct our portfolio to be a group of diverse and somewhat independent company or industry investments, rather than one big macro bet. The goal has always been to balance enough diversity to avoid wild volatility with enough concentration to achieve depth and impact in our views. While that was still true this year, it was also true that the increasingly narrow focus of markets was resulting in some 'bunching up' of positions in our portfolio as well. Our portfolio has always had a blend of company views (hedged with other companies in that industry) and industry views (hedged with broader market or sector exposures). In reality, the blend this year certainly had greater emphasis on industry views, relative to companies. This was largely a matter of opportunity at the time, rather than a strategic shift. However, the surge in correlation and volatility in markets caused far greater correlation, and volatility among our portfolio investments. In addition, the increasing chaos in markets resulted in little focus on 'Company A vs. Company B'; the only things that mattered seemed to be macro factors, as well as a desire to 'get out' by investors. There has been little

in recent months that has been a fundamental 'miss' for us; but it has been a period in which stock price performance has had absolutely no correlation to fundamentals. This kind of environment is not unprecedented (we lived through it in the Asian Crisis, 1998, 1994, etc). The breadth and speed of this 'wave', and the degree of chaos it caused have been the surprise factors.

We will outline our previous and current portfolio exposures in greater detail later, as well as discuss specific contributors to performance this year. We had tried to balance the portfolio so that it would not suffer extreme damage in the scenario that unfolded (which we had consistently viewed as our 'worst case' scenario). However, simply put, we clearly underestimated the degree of crowding in many positions, and the degree to which fundamentals would get drowned by hedge fund unwinding, and then broader market chaos. Ironically, on a fundamental basis, it has been a solid quarter, in that earnings and events at relevant companies have generally been in line with our expectations. However, fundamentals have been overwhelmed by macroeconomic fears and environmental factors.

It is always important to keep a fresh perspective in markets, and ensure that portfolio positioning is sensible based on the best available facts, logic, and outlook. While conviction in investments is critical for any successful investor, that conviction must also be thoughtfully recalibrated as facts and the environment change materially.

What are our basic assumptions going forward?

- Risks to the global economy and financial markets remain very high, and have escalated with recent government policy response fumbles. Sometimes panic can be quite self-fulfilling or circular. Severe damage has been done to the 'infrastructure' of financial markets, and it will take some time to see if these structural cracks can be repaired. In particular, credit markets are simply a mess, resulting in high 'shock risk' for the global economy (particularly areas sensitive to credit). Given the level of damage done in the financial system, I think we have to assume that we remain in a difficult and tense environment for some time to come...continued stress in financial markets and continued uncertainty about the global economy.
- Events of the year have increased stress on the hedge fund industry as well. We have previously argued that the growth of hedge funds has itself created evolutionary pressure - hedge funds have grown from being opportunistic investors circling the market for opportunities, to actually being a core part of the market itself. This transition from 'sniper to infantry' is a significant one - while not necessarily bad, it is a big change, and requires a thoughtful, evolutionary response. However, fund flows, general stress in financial markets, and regulatory changes are all adding to the evolutionary pressures on the industry. Ultimately, we do think that the hedge fund industry model is likely to be tested and re-shaped in ways that may be quite meaningful.
- Danger levels are clearly extremely high. However, it is also true that dislocation has created profit opportunities that are the best I have seen in my 18-year career. Danger has created severe dislocation - but just as in prior 'danger' periods (the Asian crisis, 1998, and 1990), these moments of chaos are often followed by periods of extraordinary return. We see this in markets and in our portfolio - even when factoring in high degrees of pessimism, select opportunities are truly remarkable. Put simply, markets are a train wreck and there is substantial opportunity to profit handsomely from dislocation. However, in a world where 'everything is on sale' we have chosen to shift chips towards areas that we expect to be more removed from the global storm. We are excited about return potential, but we are also very focused on ensuring that the last quarter (or anything like it) can never be repeated.

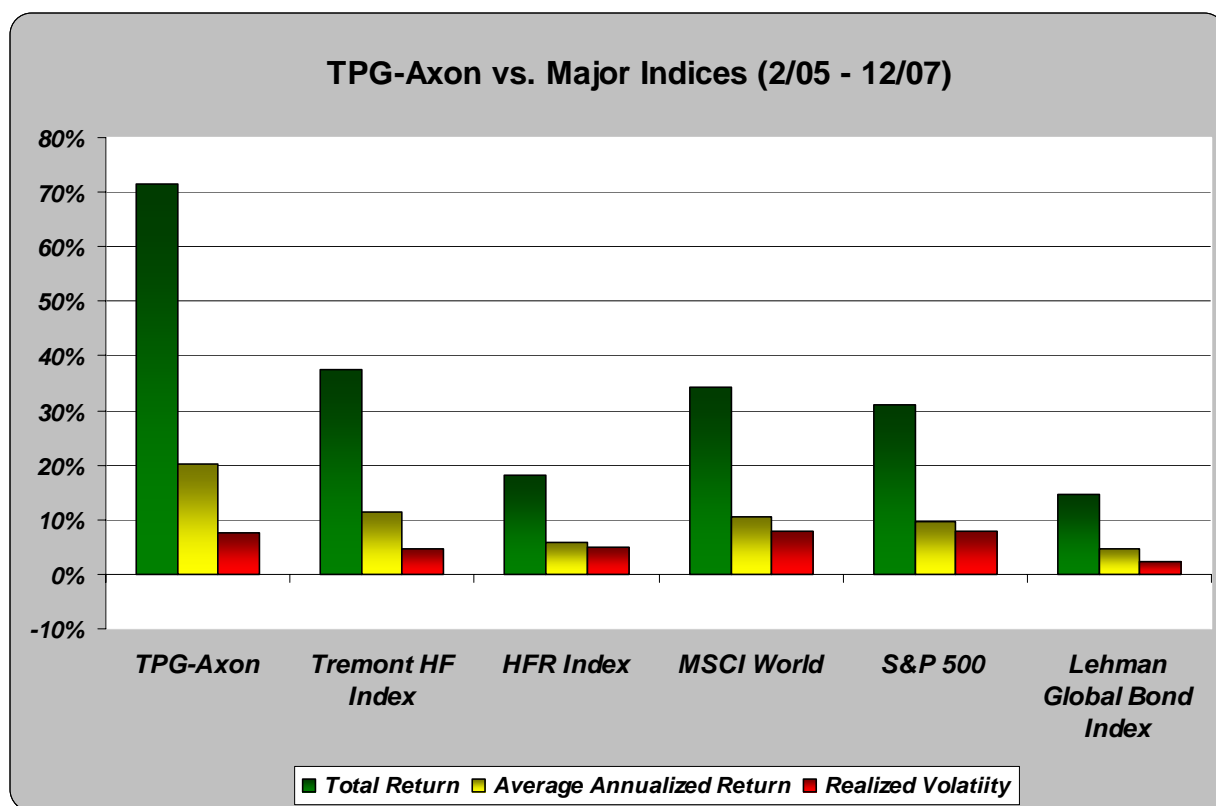
As a result, we have incurred a great deal of additional pain in the past eight weeks in order to substantially reshape our portfolio. We want to make sure that we have a portfolio that is fresh and durable; and perhaps most importantly, structured to profit despite a difficult environment. Risk has come down sharply, but not just because of quantity of exposures, but rather their nature as well. It has been a terrible performance for the quarter, exacerbated by the costs of very substantial portfolio shifts. However, we do feel that the net result is a portfolio that is well-positioned for a dangerous environment.

We have had 14 quarters of strong performance since our launch, and one quarter of horrendous performance. A wild environment, and perhaps some overconfidence in our positioning, contributed to the past quarter – regardless, we need to make sure that the last quarter is an aberration and that performance going forward, even in a difficult environment, is consistent with the quality and quantity of returns we have had in prior years.

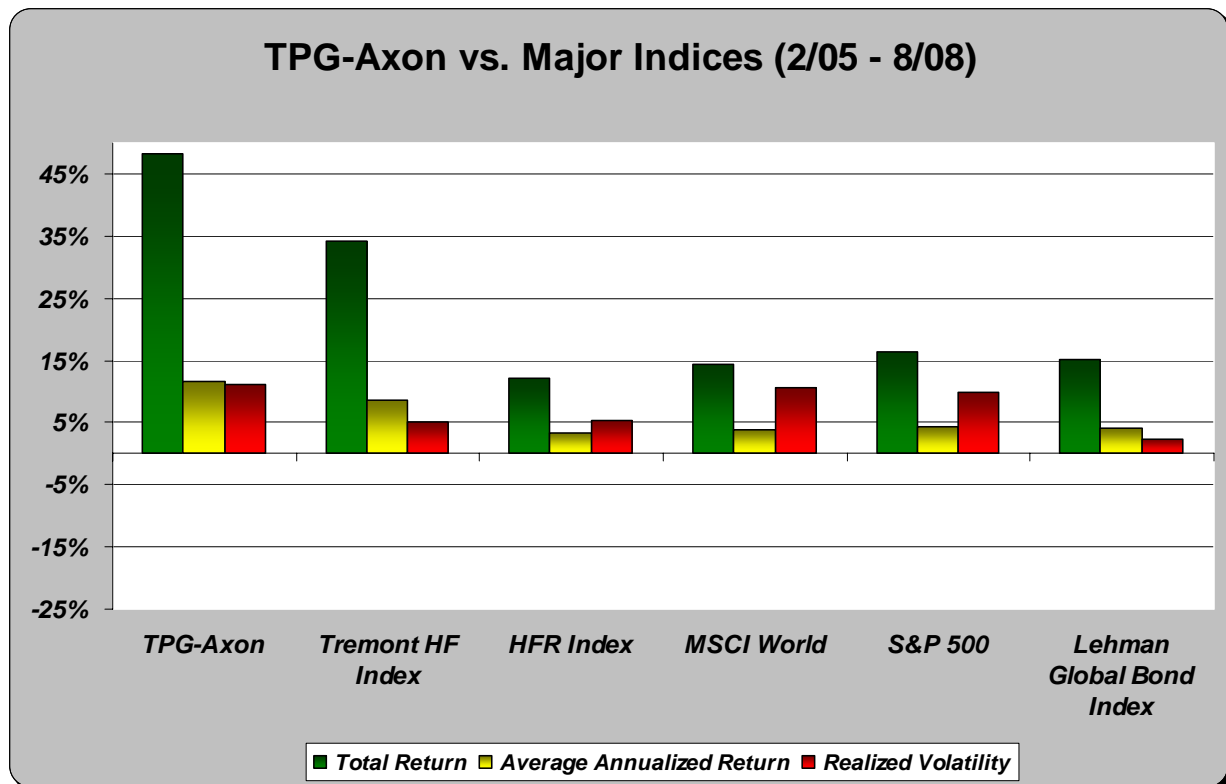
Candidly, we would note that we do not believe that either 2007 or 2008 (YTD) results are likely to be representative. 2007 was a year in which almost all of our portfolio themes worked well, both due to good work, and good luck. As we noted in prior letters, returns were clearly well above what one should consider sustainable levels. Likewise, the past quarter (in 2008) has also been quite extraordinary; we would particularly expect that the level of volatility we have experienced in the past few months is not representative, and have taken fairly significant steps to avoid a repeat, even assuming a difficult market environment.

Prior to discussing factors in depth, it is worth reviewing our key goals. As we have consistently noted, we are focused on generating strong, equity-like returns. However, we have always noted that quality of returns matters as well, and therefore, a good investor must be focused on critical factors such as volatility and correlation as well. Our first 3 ½ years (through June 2008) have been quite consistent with our goals – we generated strong returns, with little correlation to markets, and quite manageable volatility/drawdown. Overall, we were pleased that we had delivered both quantity and quality of returns consistent with our expectations, and that compared quite favorably with most benchmarks or comparables.

The graph below shows relative performance of the portfolio against market and hedge fund benchmarks, through 2007.



However, we are in September of 2008, and in many ways 2007 seems like ancient history. Clearly, the last few months have been in wild contrast to the 3 ½ years that preceded it, and the net result is drawdown and volatility that is simply inconsistent with our goals. The chart below shows our performance, including the first eight months of this year.



To be clear, we are enthusiastic about opportunities, even in the context of a dangerous market and economic environment. The degree of extreme dislocation present in markets is almost always fertile ground for future returns. Certainly from a 'bottoms up' perspective, there are truly remarkable opportunities, both on a relative and absolute basis, and across a diversity of industries, geographies and asset classes. It has been a perfect storm for us, but nevertheless one that we should have done a better job of protecting against. It has left remarkable opportunities in its wake, however, and we are enthusiastic about those opportunities, even as we are mindful of elevated danger levels. Candidly, some of what is happening in markets is absurd. Nevertheless we need to balance our enthusiasm for opportunities with recognition that these are dangerous times, and the danger may not subside anytime soon.

As we have reshaped the portfolio, key elements of current positioning include:

- In a chaotic environment, it may well be that a smaller (and even perhaps slightly less hedged) portfolio is better than a larger, hedged portfolio. Therefore, we have moved to significantly lower gross exposures.
- We think it would be a mistake not to play some (sensible) offense in this environment - this is exactly the environment that a strong firm should be able to exploit. We understand that the environment is dangerous, and clearly we have struck the wrong balance between risk and reward in the past few months. And yet, just as in periods such as the Asian Crisis, and the 1998 LTCM unwind, it is also a time when investors are truly getting paid remarkable sums to take risk.

The two caveats are clear: 1) it may take time for investments to work, but the returns to them should be compelling, and 2) the danger of shock outcomes is high. Therefore we must make sure we pursue opportunities with a healthy respect for 'shock' risk in markets.

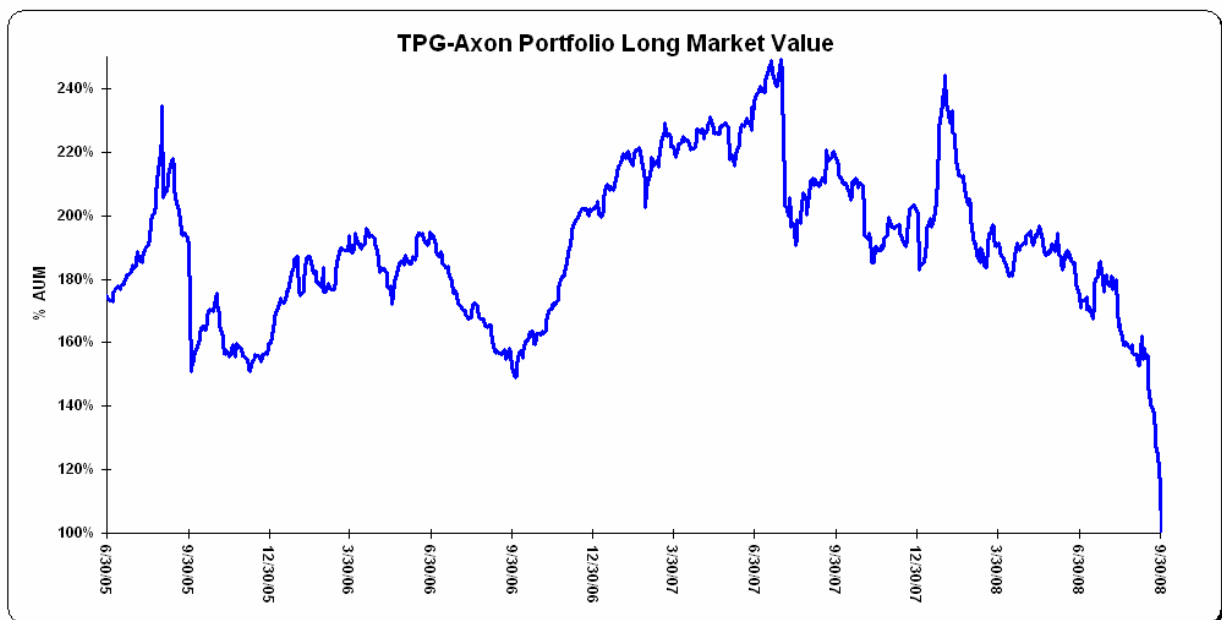
- We expect substantial stress in the hedge fund community from redemptions in months ahead. In our case, we have strong and diverse partners. In addition, about half of our capital is on hard-locks and all of our capital has 1/8 per quarter gradual redemption limits. Therefore, for us, candidly, redemptions are not that relevant...returns will be the critical determinant of fund size. Most funds do not have this luxury, and it does appear that one should expect significant unwinding of positions from funds under redemption stress in months and quarters ahead.
- Much of the chaos of recent months has come from high-velocity investors rushing from one side of the fundamental ship to the other at the same time...fundamentals have mattered little in recent months; rather, who owns a stock (and what they are doing) has been the primary determinant of performance. We do not want our portfolio to continue to suffer unusual damage due to unwinding elsewhere. Therefore, we have aggressively moved to reduce or exit exposures to investments we feel are very crowded, and highly volatile because of their ownership.
- In addition, (and most importantly) there are a wide array of compelling opportunities in markets today. However, since many things are 'on sale', we would rather select the subset that are as high quality and away from the 'pack' as much as possible. Therefore, we have shifted our risk chips aggressively away from investments in the center of the (hedge fund and market) storm, and towards opportunities that are more diverse and durable. Put differently, when assessing an array of opportunities, we have placed a higher premium than usual on quality, liquidity, and differentiation. Therefore, our exposure to stocks that are less liquid, heavily hedge fund owned, and highly volatile has been quite dramatically reduced. In particular, we think there is extreme danger in months ahead in small capitalization stocks owned largely by hedge funds. Our portfolio has always been heavily weighted towards larger capitalization, liquid stocks, and that is even more true today (by design) than ever.
- This shift is not just defensive, however, but opportunistic as well. Unlike normal environments, we are finding large numbers of investment opportunities where the quality of the company/investment is high, and yet the return profile is exceptional. Even 'boring' bets offer much greater payoffs than normal – as a result, it just doesn't make any more sense to deal with the headache factor of stocks that are wildly volatile and heavily hedge fund owned.
- The combination of these measures has considerably reduced portfolio predicted volatility – VaR has dropped substantially, and predicted volatility (which had jumped to 18%) has declined to the low teens. (While our realized volatility has generally trended towards our predicted volatility in the past, in a chaotic environment, one should be prepared for the possibility of actual volatility to be far higher than predicted, and structure the portfolio accordingly).
- At launch, we generally described an expectation of 'teens' returns, accompanied by 'mid to upper single digit' volatility...put simply we were shooting for 12 to 17% returns, and expected annualized volatility of perhaps 7 -10% (which generally would correspond to VaR of approximately .8 to 1% of AUM). In our first two years, returns were in the middle to upper end of expectations, though volatility was at the lower end of expectations. As we have noted in past letters, both because opportunities are attractive, and because market volatility levels are generally higher, our volatility levels likely should be somewhat higher than in our first few years. However, recent levels were far too high, given market factors – VaR jumped as high as 1.9% and predicted volatility as high as 18%.
- Our general view is that volatility in the 10 – 13%, with corresponding VaR of 1 to 1.3% of AUM is a reasonable level, considering all factors - we have essentially moved back towards this range.

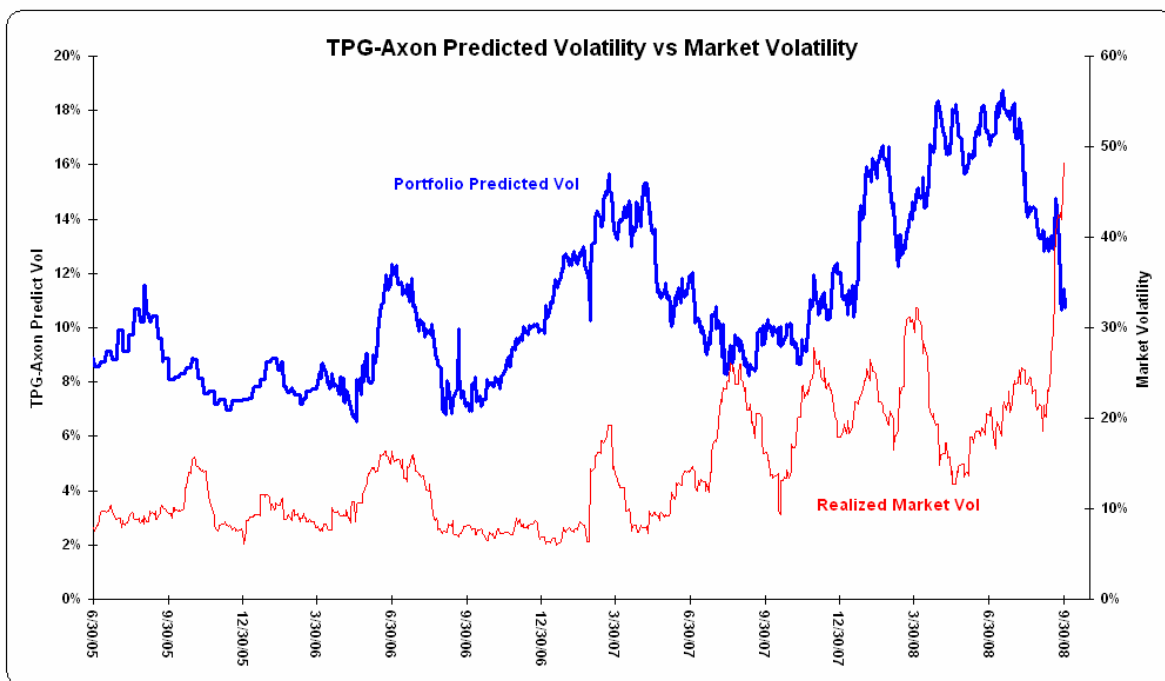
The dislocation in markets, and generally higher volatility levels, should mean that return prospects should be higher as well. In particular, we would be quite disappointed if returns from the current environment were not unusually attractive.

The graphs below show the evolution of some of our exposure and risk metrics. As you can see, the reshaping of the portfolio has brought exposures, risk, and predicted volatility down substantially. However, net of these moves, we feel confident that we have made changes necessary for us to:

- Attack opportunities we think are truly remarkable and compelling – market conditions are dangerous, and yet market dislocation is providing opportunities that are truly historic.
- Enable us to avoid continual headaches from the realistic possibility of sustained stress in the hedge fund, and economic, environment.
- Expect that the drawdowns and volatility of recent months will not be repeated. Please note that LMV has come down from a high of 2.5x to approximately 1.0x, and predicted portfolio volatility has trended down from 19% to close to 10%.

Overall, we will keep evaluating conditions with the best information we have, but generally feel confident that the portfolio enters the new quarter fresh, well-positioned, and durable.





Prior to diving into further details, we would highlight two additional important factors:

- We are immensely grateful for your support. Almost all of you have been our partners since launch, and your willingness to entrust your precious capital to us has been an honor and a privilege. We recognize that it took a leap of faith for you to invest in us at launch, given how unusual our prospective business model must have seemed at the time. And yet, you should know that there is no team more focused, and more driven, to reward and repay your trust in us. For most of the past 3 ½ years we have felt good about the job we have done in delivering returns; obviously that is not true about the last quarter, and we are focused on making sure it stays in isolation.
- We have consistently argued that to succeed in today's markets, one must have remarkable breadth (of understanding and capability), and yet be able to attack opportunities with tremendous depth and speed. We have worked tirelessly since launch to build a franchise that we hope is unparalleled in its ability to analyze developments and opportunities in all corners of the world, and yet succeed through an extreme level of focus on a select few opportunities. What enables this business model to work is our culture. We have focused on hiring only the best and brightest talent, developing our people organically, and creating a strategic and collaborative approach to investing. We do not want a team of mercenaries working in silos, with individual payouts, and narrow focus. Instead, we have a true team, who work together to identify and attack opportunities around the world. Our 'one team, one portfolio' approach is central to the firm's culture, and we believe remains our competitive advantage in a world that is increasingly complex and interconnected.

Much of the anxiety in global markets stems from the fact that we are at historic inflection points in the global economy. In this modern age, economies, markets, and investors are part of an interdependent system, woven together, each affecting the other. In addition to significant inflection points in major economies, there have been sweeping changes in the nature of markets and investors. All of these factors contribute to a landscape that we view as one of the most complex in several decades.

Much of the turmoil we have seen in global markets over the past year is an intersection of three major structural factors:

- **An end of an era of an 'amplified' US economy:** The credit crisis is in many ways the end of an era of an 'amplified' US economy - focused on increasing levels of asset-based consumption, and fueled by increasingly aggressive asset-based lending. The surge in consumption and the surge in consumer finance are two factors that have gone hand-in-hand. Accompanying the 10-12 year surge in US-centered consumption/borrowing was a focus on services & technology, and crises in key portions of the developing world. As a result, capital flowed disproportionately towards the US, and towards consumption and services. In the past few years, much of this has unwound with staggering speed...in just a few years, long neglected markets and asset classes (including developing markets and commodities) have rebounded with a vengeance, after years of 'under-investment'. However, the credit crisis has in many ways just been the last chapter of a bigger story...which has been an extraordinary diminishment in US wealth relative to the rest of the world in recent years, after equally extraordinary outperformance in the prior decade.
- **Increased globalization and inter-dependence of markets:** In the past, various parts of the global economy performed in moderate isolation...as an example, during the Asian crisis, US and Europe boomed, seemingly oblivious to the economic devastation in Asia. Over the past decade, the global economy has melted together to a dramatic degree, with significant linkage across companies, industries, geographies and asset classes. In today's world, what happens in one place has rapid and dramatic impact elsewhere. An investor cannot understand any specific geography without a broader understanding of global trends...and this linkage extends to asset classes as well. In a complex and interlinked world, the notion of independent and isolated niches simply does not make sense...rather, an investor has to understand what is happening everywhere, in order to invest well anywhere. Rapidly shifting trade flows, currency movements, and capital flows have woven together markets, and 'transmit signals' among them with increasing velocity.
- **Dramatic increase in market 'velocity':** Over the past few years, an enormous amount of capital has moved towards much faster moving vehicles, thus increasing the 'velocity' of market movements and reactions to developments (both good and bad). At the broadest levels, asset allocation (i.e. among large pension funds and endowments) has become much more varied. More importantly, however, as much as half of trading on many exchanges is done by hedge funds, rather than traditional money managers. Hedge funds have higher leverage, shorter holding periods, and bi-directionality relative to mutual funds...as a result, the shift in dollars to the hedge fund world have dramatically increased the speed with which those dollars move in markets, and the ability for the aggregate market to reverse direction rapidly. As hedge fund investors, we often forget that we are now a large portion of markets, and that 'crowded trades' have much more dramatic impact on markets than in years past. The net result is that market moves often happen at light speed, and response time to compelling opportunities is often very limited.

For investors, these changes have created both chaos and opportunity, and also raised the bar in terms of the skills needed to exploit these opportunities. Hedge funds can generate alpha in essentially two ways – we can asset allocate to attractive areas across geographies, industries, and asset classes, and/or we can outperform by selecting particularly attractive investments within a given area. In the long run, a good investor needs to be capable at both, since each skill complements and informs the other. Without, a solid understanding of trends across geographies and assets, one cannot understand specific investments. Yet, without the capability to understand specific areas in great depth, one cannot understand whether a broader trend is sensible and sustainable. At moments of great macroeconomic uncertainty, asset allocation skills (which place a premium on breadth) are often central, while in calmer environments, outperformance skills are more dominant (which place a premium on depth).

In the past, a hedge fund could achieve success by narrowly focusing on a specific asset class or region. However, in today's markets, one cannot succeed without a broad understanding of trends across

geographies and asset categories. Markets have become more complex and inter-linked, even as they move with a speed that is unprecedented...moves that used to take months or quarters, now take place in days or weeks. The combination of globalization and increased market velocity have created the critical challenge (and paradox) of maximizing both breadth and depth. An investor has to have the breadth necessary to understand trends and attack opportunity across the spectrum, and yet have the depth of skill and knowledge to take advantage of dramatic moves in a thoughtful, knowledgeable and rapid manner.

Since inception, we have focused on the need to reach across geographies, industries and asset classes to extract information and identify opportunities - and yet attack select opportunities with tremendous depth and focus. That has generally served us well. In recent months, wild shifts in sentiment regarding macroeconomic factors have overwhelmed everything else. Stocks have been driven by macroeconomic fears and technical factors (hedge fund de-risking in particular). Investors are not the least bit focused on specific comparisons across industries and geographies, resulting in severe dislocations and discrepancies in assumptions. And yet, this is exactly the kind of environment in which a thoughtful global investor ought to be able to plant the seeds for significant future profit.

INVESTMENT OUTLOOK

We have been cautious for some time about risk to the global economic environment. Simplistically, we believe that the past 15 years will likely prove to have been a 'golden era' for economic growth and profit margins, particularly in the US. Looking forward, one should expect a world in which economic risks are higher, growth is slower, and in which profit margins are much more constrained than in past years.

Admittedly, the systemic risks clearly seem to have increased markedly in recent weeks, with new and deep cracks emerging once again in the financial infrastructure of credit markets. Government response finally appears to be mobilizing across countries, but it remains to be seen whether it will be effectively implemented.

Significant differences in valuations and investor expectations have opened up among regions in recent months, with quite interesting and important investment implications. The chaos of recent months has caused a breakdown in cross-border 'synchronization'. Valuations and prices of stocks in similar industries but different geographies have diverged wildly in recent months – not surprisingly, in the midst of market turmoil, investors are less able or interested in comparing notes across geographies.

Ironically, however, the constant rush of globalization has meant that companies are increasingly manufacturing and competing across geographies, regardless of the location of their headquarters or stock listing. Therefore comparing the fundamentals of businesses in different regions has never been more relevant, even as the valuation across geographies has broken down in recent months.

Differentiation and dispersion of returns will likely remain at high levels in coming periods. Investors have wildly rushed in and out of sectors, geographies and markets in response to macro developments and newspaper headlines. In the wake of their stampedes, however, truly stunning discrepancies have appeared...both within and among sectors and geographies. Regardless of whether the world is ultimately 'happy or sad', at some point, seeds planted in the midst of this chaos ought to bear remarkable fruit.

In advance of more extensive discussions in subsequent sections, we highlight the following key factors in our portfolio positioning and outlook:

- The dominant story of the 1990's was the astonishing amplification of the US economy and US wealth relative to the world...the dominant story of this decade has been the equally astonishing decline in US wealth and relative significance. In many ways, the significance of this shift in economic growth and wealth is only beginning to be felt in markets.
- The 'Wall Street' liquidity crisis is in late innings...but we may be in early innings of an extended contraction of credit and US consumption on 'Main Street'. US Credit-to-GDP seems destined to decline, and consumption with it. However, while the credit crisis has impacted economies around the world, it is fundamentally a US problem. There was clear exuberance and credit growth in many parts of the world, but only the US has the trifecta of historically high household debt levels, significant potential loan losses, and significant oversupply of homes. Ultimately, the US household and US financials are the core of the problem. While these factors will inevitably spill over everywhere (and already have), the magnitude of the problem and the challenges of resolution will be much greater in the US than elsewhere.
- Ironically, global decoupling was THE most crowded trade in global markets last year. However, now investors are using the 'playbook' from 2003 and assuming that aggressive Fed action will result in a US-led consumer recovery and expansion in 2009. Within a matter of months, markets have swung from pessimism about the US relative to the global economy, to assuming that US

growth will be more robust than Asia (and Europe), AND have generally placed higher valuations on those higher expectations. On an absolute basis, US stocks have obviously declined, but on a relative basis, US valuations and earnings expectations have increased. While the Global Decoupling thesis had been taken to extremes, the extreme pendulum swing in the opposite direction is equally short-sighted, and presents tremendous investment opportunity.

- Valuations for Chinese stocks have declined to levels implying severe risk and/or no growth. Growth has clearly slowed in recent months, both due to global factors, inflation concerns, and the Olympics. However, while it is likely that China's growth will moderate, it is still likely to be substantial, and in particular, specific sectors in China will continue to benefit from strong, long term government infrastructure and investment programs.
- The implosion in credit and financials has created tremendous opportunity. We are highly focused on investment opportunities across the spectrum, particularly high quality financials with compelling valuations and whose earnings power/franchise is not 'leverage sensitive' and impaired. Ironically, in the carnage of financial stocks, one can find high quality companies who are actually winners, and whose franchise value and earnings power have arguably improved because of the credit crisis.
- Distressed mortgages are a compelling and unique opportunity, and will be an area of significant focus for us in coming periods. Over the past year we have seeded and built an effort (Roosevelt Management) with the capability to analyze and assess delinquent mortgage assets, and extract value from them. We are quite enthusiastic about the investment opportunity. While the business is complex and arcane, the dislocation in the delinquent mortgage market is extreme, and return prospects are very attractive. In addition, at the minimum, the knowledge base is highly complementary to our understanding of public companies.
- The "Dollar Bloc" (US – China – Middle East) has created massive global economic distortions through implicit and explicit currency pegs, and helped exaggerate the degree of dollar decline needed to change trade balances. After a stunning decline, the dollar finally does not look expensive, and many of the core economic imbalances that fueled the dollar decline are starting to reverse significantly. However, over the past five years, investors have gotten used to a steadily declining dollar, and may well have come to view its impact on companies and industries as organic rather than exceptional. In particular, US companies with significant international profits will swing from a substantial tailwind (for five years) to profits from currency translation, to a headwind, by year-end. Conversely, European companies with global operations have been steadily fighting a massive currency headwind for the past five years...and in just a few quarters, that will now become tailwind.
- The surge in commodities has been largely structural, not just cyclical – a 'perfect storm' of dollar decline, under-investment over the past decade, and growth in commodity intensive BRIC economies. The Asian crisis (and corresponding capital flight) enabled borrowing in the US, but also pressured commodity-linked developing markets...for the first time ever, all the major developing economies are 'switched on', and the impact on the distribution of global economic growth, as well as on the nature of economic growth has been dramatic. Speculative and cyclical factors have clearly played a role in the commodities surge of the past few years, but much of the speculative interest has been washed out, and even reversed. While cyclical headwinds are clear and significant, the carnage in commodities stocks does create potential at some point for remarkable opportunities, given the strength of the long-term story. We continue to believe that there are enormous differences among the supply-demand characteristics of various materials and commodities, and these differentiations will be more evident over time.
- The combination of dollar decline, US labor restructuring, and high cost of transportation have dramatically altered the trade landscape. The significant shift in manufacturing base away from the US (and principally towards Asia) is reversing aggressively, with US based manufacturing gaining significant share from imports for the first time in decades. As a result of this 'industrial

renaissance', we have seen tremendous investment opportunity in US manufacturing and heavy goods industries.

- Transportation (both rail and air) is an area that has suffered under-investment over the past decade. This under-investment has become apparent, and developing countries finally have the capital to invest in these areas...as a result, growth and profitability in relevant areas is surging and likely to remain strong for many years to come, almost irrespective of the economic landscape.
- Corporate profit margins in Japan have been steadily improving over the past decade, and have evolved from marginal levels to low, but respectable levels. In addition, sharply lower valuations, and some increased focus on capital discipline has resulted in select opportunities once again emerging in Japan. For the first time since 2005, high quality, well managed companies are trading (in some instances) at attractive valuations.

BUSINESS UPDATE

As the firm has grown, we have made significant changes, particularly in the past year, to enhance our franchise strength and evolve our leadership. Despite the chaos in the environment, we have strived to stay focused on our core strengths and key business principles:

- Our business model combined extreme breadth (in what we looked at), with extreme depth (in how we looked at things, and portfolio concentration).
- We bring a deep fundamental view to our investing, but apply it across the capital structure and investment spectrum.
- We have focused on hiring the 'best athletes', and developing our people organically, rather than building a patchwork team poached from other hedge funds. As in our past, we have found that organic development of talented people is perhaps the greatest strength a firm can have.
- We brought a team approach to everything we do... multiple people working together on every investment, each person working across sectors and geographies, and broad collaboration and discussion across the portfolio.
- We care deeply about the quality of the overall business, and have stressed the notion that in addition to just focusing on investing, we have to focus on all the other important functions that are critical for a high quality investment firm...operations, accounting, compliance, legal, etc. As with our investment team, we have tried to develop a team of people with both integrity and talent, and with a deep regard for achieving excellence in their efforts.

At launch, all of these things were unproven and somewhat unusual; today these are viewed as the key to whatever success we have achieved. For us, our team and culture have been the source of strength, in both good and bad environments. In some ways, the formula is similar to what we saw in our early days in the Arbitrage group at Goldman Sachs. We had a focus on hiring only the most exceptional people. We insisted on an environment in which facts, analysis, and logic were more important than opinions and hunches. We focused on collaboration, and were willing to 'lose' people that were exceptional but not collaborative. Lastly, and perhaps most important – we focused on developing people into future leaders themselves...in the hedge fund world, it is rare for people to truly develop broader skills.

In reality, our current business model is complex and broad; the only way we can achieve and maintain excellence is through a rigid focus on exceptional people, and an analytical and collaborative approach.

We have largely hit a point at which we do not want to grow the investment team much further. We have enough size to reach around the world, but risk being less elite, nimble, and cohesive if we expand much further. Therefore, we expect that our investment team size will grow modestly from here. We will continue to invest heavily in our business strength, and in addition, we will likely continue to build platforms through which we can tackle specific areas of special interest.

As you may remember, we began 2007 by instituting a radical change in our compensation philosophy. Most of our investment team (and key business team) were moved to partner-like participation in the firm. Each person has a share in the profits of the firm in advance, and the key variable driving their compensation during the year is the firm's performance. The 'shares' are reset each year to adjust for differential growth and capability, but at any given moment the incentive is to work together as a team and maximize the firm's future success. For a firm like ours, where teamwork and collaboration are crucial, we believed our compensation structure must match and support our investment philosophy.

In addition, at launch there was an extreme differential between partners and 'everyone else' on the team. The partners had all worked together for many years, and had proven their ability to both make money and lead. At this point, however, people's skills have blended into a spectrum, based on individual capabilities and their own rate of 'evolution'. Chronology and experience are often an overwhelming factor at the outset, but an irrelevant factor a few years later. As a result, earlier this year we named a number of new partners, bringing the total group to 11 (from the original 4).

In addition, we have created two leadership groups to coordinate key activities. Our **Management Committee** acts as the senior management of the firm, and directly oversees the business and management functions of the firm. In addition, we have created an **Investment Committee** to oversee portfolio strategy and ensure our investments remain strategic and cohesive. The growth in the number of partners reflects the growing diversity of strength in our firm; the establishment of the committees reflects a focus on ensuring we remain nimble and focused.

Last, but not least, on the personnel front, we are pleased to announce an important senior addition to the firm – David Weil, formerly a partner at Goldman Sachs, joined the firm as a Partner and member of the Management Committee. David was at Goldman for 15 years, during which he served as Chief Operating Officer of the Investment Management Division, Treasurer of Goldman Sachs, head of Finance & Operations for Goldman in Asia, and CFO for the firm's Whitehall (real estate) funds. David's primary responsibility will be as an 'operating partner', with a particular focus on driving key firm projects and hybrid investments. In addition, he and Michael Gismondi will work together to establish best practices for operations, risk, and controls. Overall, the pressure and demand on our business bandwidth continues to increase at an accelerating pace. In addition to complexity from investments, we will have inevitable complexity arising from increasing regulatory requirements in all parts of the world. Tax, legal, finance, and operational matters are mission critical, and failure in any of these areas can be 'life threatening'. While we have an exceptional team in all regards, and we continue to invest heavily in expanding and deepening our capabilities, David provides an invaluable enhancement of our efforts in all of these regards.

Other highlights on the business front include:

- We opened our London office in mid-2007, and have now essentially completed our geographic footprint.
- Overall firm headcount is now 135 people, comprised of 42 people on the investment team, and 93 people on the business team. We would expect only moderate growth in the core investment team. However, for specific areas of interest (such as credit and mortgages), we will build out specific platforms, in order to attain the depth we need to succeed, and yet not transform the core firm culture. In addition, we expect continued heavy growth in our business team, as we continue to invest in maximizing the quality of our operations, finance, legal, and other critical efforts.
- Perhaps most importantly, in 2007 we moved (with your support and consent) to significantly enhance the stability of the firm's capital. As you may recall, prior to the changes, there were limited restrictions on capital flow after the initial lockup period. After the changes, all of our capital is either on hard lockups, or subject to gradual withdrawal restrictions after the initial lockup period. As a result, we believe we have a more stable and predictable capital base than perhaps any other fund. For example, as of today, almost ½ of our capital remains on hard lockup, and all of our capital has 1/8 per quarter withdrawal limitations. Predictability and stability of capital have gone from being a luxury to a necessity in today's environment. We firmly believe that, over the long run, firms with strong teams, strong investor relationships, and strong capital will have a dramatic advantage in delivering returns.

Lastly, it has been an exhausting and eventful 4 years. We are proud of the results we have delivered for you in our first 3 ½ years, though profoundly disappointed by the last quarter. However, even as the world careens between emotional poles of optimism and fear, and danger levels remain elevated, we also remain excited about the ability to profit from this environment. These are remarkable times, but past

experiences in times of stress, and our current bottoms-up work, lead us to think that the profit potential is extraordinary as well.

We have invested heavily to develop the team and franchise to a point at which we can attack and exploit a complex world filled with danger and opportunity. With a healthy sense of paranoia, we continue to evolve and improve our firm in the hope of improving our capabilities each year. Most of all, we thank you for your support. It has been a breathtaking four years – both in financial markets, and for our evolution – and we remain intensely focused on delivering results for you in days ahead.

On behalf of the Partners,

A handwritten signature in blue ink, appearing to read "Dinakar Singh". The signature is fluid and cursive, with the first name "Dinakar" written in a larger, more prominent script than the last name "Singh".

Dinakar Singh.

LEGAL NOTES

- *Unless otherwise indicated, the data included in this letter combines the results, assets, and exposure of TPG-Axon Partners (Offshore), Ltd. and TPG-Axon Partners, LP.*
- *All data and analysis are unaudited and should not be used as the basis for any investment decisions. Calculations are based on internal analysis. While reasonable attempts were made to ensure that data and analysis are accurate and representative, there can be no assurance as to the accuracy of any figures shown.*
- *Unless stated otherwise, estimated fund returns are unaudited, subject to change, and net of all applicable fees (including management fees, incentive allocation and expenses). Please note that past performance is not a guarantee of future results.*
- *Inception to Date calculations measure returns to original investors, based on the two-stage draw of committed capital.*
- *Unless otherwise indicated, 'Assets' refers to the consolidated equity capital of the funds.*
- *Unless otherwise indicated, exposure calculations are based on the 'Delta Adjusted Equivalent' exposure of an instrument which, in general, represent the fair value of investments owned and sold but not yet purchased, plus the contractual (or notional) values of derivative financial instruments. Exposure figures are not representative when viewed in isolation, as they do not capture the substantial amount of hedges in the form of options, or non-equity hedges, such as CDS exposure. Portfolio shock analysis includes impact from options, and therefore provides a better indication of portfolio sensitivity to significant market moves.*
- *Exposure figures represent the fair value of investments owned, sold, or not yet purchased, plus the contractual (or notional) values of derivative financial instruments.*
- *There are significant differences between indices such as the MSCI World Index and S&P 500 Index and the investments held by the funds managed by TPG-Axon. The TPG-Axon funds are actively managed, use leverage and invest in securities that may have a greater degree of risk and volatility than those within such indices. Moreover, the indices do not reflect the reinvestment of income. The comparisons to these and other widely followed indices are provided for information purposes only.*
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