THIRD POINT

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Second Quarter 2010 Investor Letter

All, too, will bear in mind this sacred principle, that though the will of the majority is in all cases to prevail, that will to be rightful must be reasonable; that the minority possess their equal rights, which equal law must protect, and to violate would be oppression.

– Thomas Jefferson, First Inaugural Address, 1801

A wise and frugal government, which shall leave men free to regulate their own pursuits of industry and improvement, and shall not take from the mouth of labor the bread it has earned - this is the sum of good government.

– Thomas Jefferson, Writings, 1743-1826

I predict future happiness for Americans if they can prevent the government from wasting the labors of the people under the pretense of taking care of the people.

– Thomas Jefferson, Letter to Thomas Cooper, 1802

One of the traditional methods of imposing statism or socialism on a people has been by way of medicine. It's very easy to disguise a medical program as a humanitarian project. Most people are a little reluctant to oppose anything that suggests medical care for people who possibly can't afford it.

– Ronald Reagan, http://www.youtube.com/watch?v=fRdLpem-AAs, 1961

You know, there's a lot of talk in this country about the federal deficit. But I think we should talk more about our empathy deficit - the ability to put ourselves in someone else's shoes; to see the world through the eyes of those who are different from us - the child who's hungry, the steelworker who's been laid-off, the family who lost the entire life they built together when the storm came to town. When you think like this - when you choose to broaden your ambit of concern and empathize with the plight of others, whether they are close friends or distant strangers - it becomes harder not to act; harder not to help.

– Barack Obama, Xavier University Commencement Speech, 2006

It is that fundamental belief, I am my brother's keeper, I am my sister's keeper that makes this country work. It's what allows us to pursue our individual dreams and yet still come together as one American family. E pluribus unum. Out of many, one.

– Barack Obama, Democratic National Convention Speech, 2004

I think when you spread the wealth around it's good for everybody.

–Barack Obama's Comments to Joe "the Plumber" Wurzelbacher, 2008

The secret of US success is neither Wall Street nor Silicon Valley, but its long-surviving rule of law and the system behind it... American system is said to be "designed by genius and for the operation of the stupid."

– General Liu Yazhou, Phoenix Magazine, August 2010

Review and Outlook

As we entered the second quarter of 2010, many measures of confidence and economic activity were showing consistent improvement, leading us to increase our exposures in select undervalued companies which we thought would benefit from a favorable economic environment. Most pundits initially attributed the subsequent turn in the markets and investor sentiment to the Greek crisis, concern over the Euro, the Oil Spill in the Gulf, and vague rumors concerning faltering Chinese growth. However, it is apparent to us that the turning point in both investor and consumer confidence came on April 16th, with the filing of the government's suit against Goldman Sachs over its mortgage CDO activities. This politically-laced lawsuit was a tipping point for shaky investor confidence against an increasingly worrisome landscape of new laws and proposed regulations that are perceived by many market participants to promote "redistribution" rather than growth, and are contrary to free market ideals.

As every student of American history knows, this country's core founding principles included non-punitive taxation, Constitutionally-guaranteed protections against persecution of the minority, and an inexorable right of self-determination. Washington has taken actions over the past months like the Goldman suit that seem designed to fracture the populace by pulling capital and power from the hands of some and putting it in the hands of others. For example, a well-intentioned government program gone awry is the new CARD Act that restricts banks from repricing interest rates on borrowers who fail to meet their revolving credit obligations. The effect of this legal prohibition has been to force the banks to raise the interest rate paid by *all* borrowers, to compensate for losses they are now being forced to take on delinquent borrowers. The effect is a redistribution of wealth from people who pay their debts on time to those who do not.

Laws and regulations such as these justifiably raise questions about this government's commitment to free-market capitalism and the articulated rule of law. Arguably unconstitutional Bills of Attainder, such as the special "Enterprise Tax" proposed to be levied on hedge fund managers and other managers of private partnerships who wish to sell their management companies (ostensibly in order to extend unemployment benefits beyond the current 99 weeks) send a vivid message that this Administration is operating from a playbook quite different from the one we are used to as American business people; a thought that chills all participants in these free markets.

On the other hand, it is not hard to understand the source of the popular distrust in capitalism today. Many people see the collapse of the sub-prime markets, along with the failure and subsequent rescue of many banks, as failures of capitalism rather than a result of a vile stew of inept management, unaccountable boards of directors, and overmatched regulators not just asleep, but comatose, at the proverbial switch. When we hear the chorus of former executives and regulators exclaim that the crisis was "impossible to see coming", while at the same time walking away with millions or going on to greater levels of responsibility in government, it is both puzzling and demoralizing. It is easy to see why so many people have concluded that the entire system is rigged.

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This crisis of trust in our system is not limited to inept executives in regulated financial institutions who bury their shareholders and then walk away with ill-gotten sacks of loot. Having analyzed hundreds of proxy statements from the outside and having had the "pleasure" of sitting on several corporate boards, giving me a chance to walk the sausage factory floor, I have personally witnessed the incompetence of many boards of directors. One can only conclude that the incentive systems put in place for directors reward luck and station more than they do talent, skill or creation of shareholder value.

Not all boards are bad, of course. Private equity firms have a terrific model of appointing energetic members of their firms and outside experts to oversee the affairs of the companies they govern. They tend to have real "skin in the game", spend days reviewing strategy and other matters, and have their own staffs to analyze numbers produced by the company. Board fees tend to be irrelevant to the members of such firms as they are keenly focused on strategies to deleverage and to create long/medium term shareholder value. Even some public companies have similarly engaged corporate boards.

However, many of the boards we have come across are populated by individuals who rely on the stipends they receive from numerous corporate boards and thus appear motivated primarily to ensure continuing board fees, first-class air travel and accommodations, and a steady diet of free corned beef sandwiches until they reach their mandatory retirement age. We are therefore encouraged by the recently finalized proxy rules, which will ease the nomination and election of directors by shareholders.

All of the above leads us to conclude that America faces not only a crisis of confidence among consumers unwilling to spend and businesspeople unwilling to invest, but also a crisis of leadership. So long as our leaders tell us that we must trust them to regulate and redistribute our way back to prosperity, we will not break out of this economic quagmire. One can hope only that this Administration, composed of brilliant academics that have had experience in creating the very regulation and overseeing the very institutions that have failed, has learned from its mistakes and will set us down the right path. Perhaps our leaders will awaken to the fact that free market capitalism is the best system to allocate resources and create innovation, growth and jobs. Perhaps they will see the folly of generating greater deficits by "investing" in programs that lead to corruption and distortions of the system. Perhaps too, a cloven-hoofed, bristly haired mammal will become airborne and the rosette-like marking of a certain breed of ferocious feline will become altered. In other words, we are not holding our breath and are focused instead on navigating these murky waters for the benefit of our funds.

As capital allocators, it is important to remain dispassionate amid the volatility. We have given a great deal of thought about the impact that public policy has on individual companies, industries, and the economy generally. It was this decision framework that led us to shed our investments in large cap US banks in January due to concerns over increasing regulatory headwinds (in advance of the announcement of the Volcker Rule). We have also sold other regulated industries and eliminated our position in Wellpoint, an

HMO that is a statistically cheap stock owned by several hedge funds, but which we saw as being overly exposed to unpredictable government regulation.

On the other hand, our perspective on the government's increased willingness to use its regulatory muscle enhanced our short positions in the for-profit education space. Indeed, this summer certain government actions taken regarding these companies served to accelerate the unfolding of our thesis on these names.

As we discussed in June's letter and on our Quarterly Investor Call a few weeks ago, we began to bring our gross and net exposures down significantly throughout May, primarily in our equities portfolio. We continued this process through the remainder of the Second Quarter, carving out most positions without definitive hard catalysts on the equity side, also reducing positions in Europe, and avoiding sectors entirely where US government intervention remains likely. Gross and net exposures in our portfolio today are at their lowest levels since March 2009, and have been decreasing all summer in accordance with our political and economic framework.

Additionally, we have initiated a number of "asymmetrical" trades using derivatives, options, and debt securities to hedge against extraordinary global events. We have budgeted the cost of such trades to amount to approximately 1% of fund assets per annum but may increase that to 2% (or more) should opportunities arise.

While we are concerned about this environment and have responded, we retain high conviction in our portfolio. We expect our mortgages and post-reorganization equity positions to produce solid gains over the long-term. We have added to the risk arbitrage portfolio in recent months, and we are encouraged that this August has been the most active month for M&A volume this year. We remain excited about the risk-arbitrage opportunities that will abound should this spike in deals continue. However, we still expect anemic growth in the US for the remainder of the year, and for markets to remain insecure and choppy. We are aware that our opinion is certainly not contrary in the sense that the sidelines is perhaps the most "crowded trade", and the market could very well experience sharp rallies. So far, at least, we have done a reasonably good job neither getting suckered into chasing rallies nor panicking into inevitable corrections. Leading up to the November elections, we will be alert for opportunities to redeploy capital into what may turn out to be a rapidly changing landscape.

Second Quarter 2010 Results

As you know, the Second Quarter was challenging for just about everyone, Third Point included. However, we have bounced back nicely and through four weeks of August our funds are up 14-16% year to date. Set forth below are our results through June 30, 2010 and a brief discussion of selected positions that impacted the portfolio during the quarter.

	Third Point Partners LP	S&P TR	CS Event Driven
2010 Second Quarter	-3.5%	-11.4%	-2.8%
2010 YTD Performance (6/30)	12.7%	-6.7%	1.8%
Annualized Return Since Inception	21.6%	6.4%	10.6%

The top winners for the quarter were Chrysler, Short A, Short B, Short C, and Short D. The top losers for the quarter were Liberty Media Interactive, PHH Corp, Fortis, WellPoint Inc and Barclays.

Assets under management at July 1, 2010 were $3.3 billion.

Performance for the quarter was driven primarily by gains in mortgage securities, our short portfolio, and select private positions, while equity special situations, especially those in the financial sector, produced the greater losses.

Credit Investments/Post-Reorganization Equities

Our significant positions in post-reorganization equity securities were some of our worst performers during the Second Quarter. These types of assets have been material contributors to the firm's performance in the past, as these companies often are positioned to benefit from the strong fundamental and technical tailwinds that follow after businesses emerge from restructurings. Despite the difficult period of performance, we maintain high conviction about the positions we hold in this asset class.

Primarily because of the nature of their ownership base, these issues can be particularly vulnerable during periods of market tumult. As we have explained in the past, there is typically very limited financial information available on these companies, there is usually little or no analyst coverage, and many holders – either former lenders not interested in equity upside or distressed strategy hedge funds for whom the life cycle of the investment is complete – are already looking for an exit. Generally, a long-only holders' base has yet to be established.

As a result, post-reorganization securities typically underperform in market sell-offs. From the April 30th market peak to the Second Quarter's end, the S&P sold off 13% and we saw post-reorg equities off anywhere from 3% (Delphi, which we own, and which reported excellent results in the period) to almost 60% (SuperMedia, the former Yellow Pages business, which we don't own). As would be expected, the worst performance came in post-reorganization equities that were 1) smaller or less liquid, 2) saddled with highly leveraged balance sheets even post-bankruptcy or 3) in cyclically-exposed industries. We have consciously chosen to put your capital to work in larger and very conservatively capitalized reorganizations, which mostly outperformed their peers during this period.

Our poorest performing post-reorganization equity position for the Second Quarter was Lyondell, which was off approximately 28% from April 30 to June 30. Given our lower conviction in the strength of the economic recovery and our general apprehension about owning companies with cyclical exposures, we naturally revisited our thesis on Lyondell both in terms of relative and absolute valuation. For the reasons described below, we remain bullish on the story.

The company released exceptional Second Quarter earnings (consistent with our general thesis of why we love post-reorg equities, one sell-side analyst noted "this may be the largest earnings beat we have ever seen"). Indeed the company's Second Quarter YTD EBITDAR exceeded its entire FY2010 budget. As of today, the stock has rebounded nicely and most that follow it are once again considering the normalized earnings power of the company and have increased their estimates of profitability and value accordingly. We eagerly await the eventual listing on the NYSE, perhaps soon after Labor Day. This catalyst, along with the gradual transition of the ownership base and the company's continued operational improvements, earnings performance and free cash flow generation should provide for excellent price appreciation into the future. Thus, we have kept Lyondell in the portfolio in size.

The good news about post-reorganization equities is that the window of pain is relatively short for quality companies that traditional investors will care about. Lyondell is one such company. We have built our portfolio of these equities with the long-only community in mind, and we believe they will yield positive results for our investors over time.

Mortgage Securities

Our mortgage portfolio continued to perform well during the Second Quarter and has produced positive returns each month in 2010. It represents between 15-20% of AUM across all funds, and each underlying bond continues to be roughly $5-$15M of capital invested, for a diversified holding.

The back-end portion of the re-REMIC structure of Alt-A and Prime securities constitute about 50% of the current mortgage book. In our modeled base case, these investments carry an approximately 20% YTM and do not take principal impairments. Re-REMICs are created to allow banks, insurance companies and money managers, who are ratings constrained, to continue to hold downgraded non-agency residential and commercial mortgage securities. A bank that follows Basel II could see its capital charge increased 20-30 times for a bond it holds if it is downgraded from AAA to BB, and so to them, ratings are critical.

Re-REMIC structures create "New AAA" bonds by restructuring the cash flows of a downgraded (formerly AAA) bond into 2 new bonds with different priority for prepayments and losses. The "front-end" or New AAA bond is sold to ratings constrained buyers for less than a 5% yield. Third Point has been able to purchase the back-end or unrated tranche for a 20% yield. While we are 2nd priority in terms of principal repayment, we receive current interest with a high teens yield.

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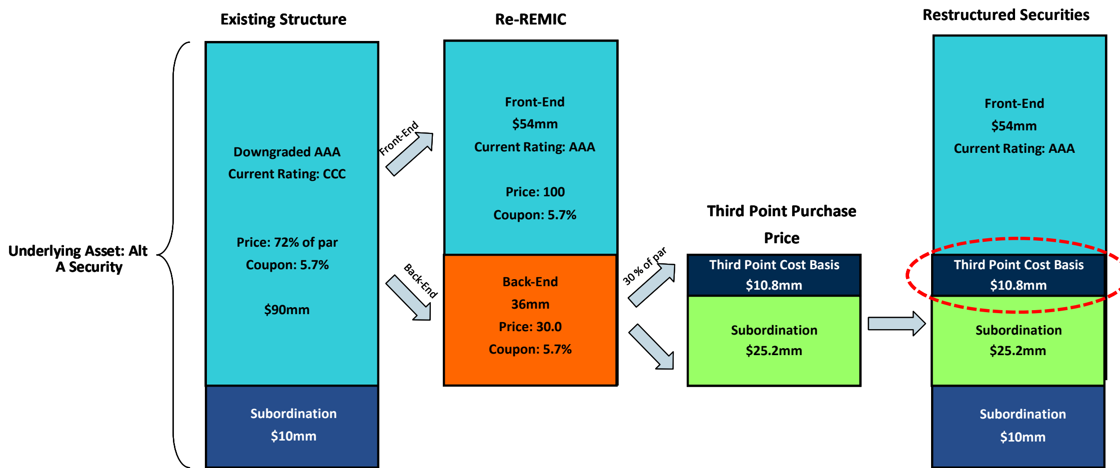
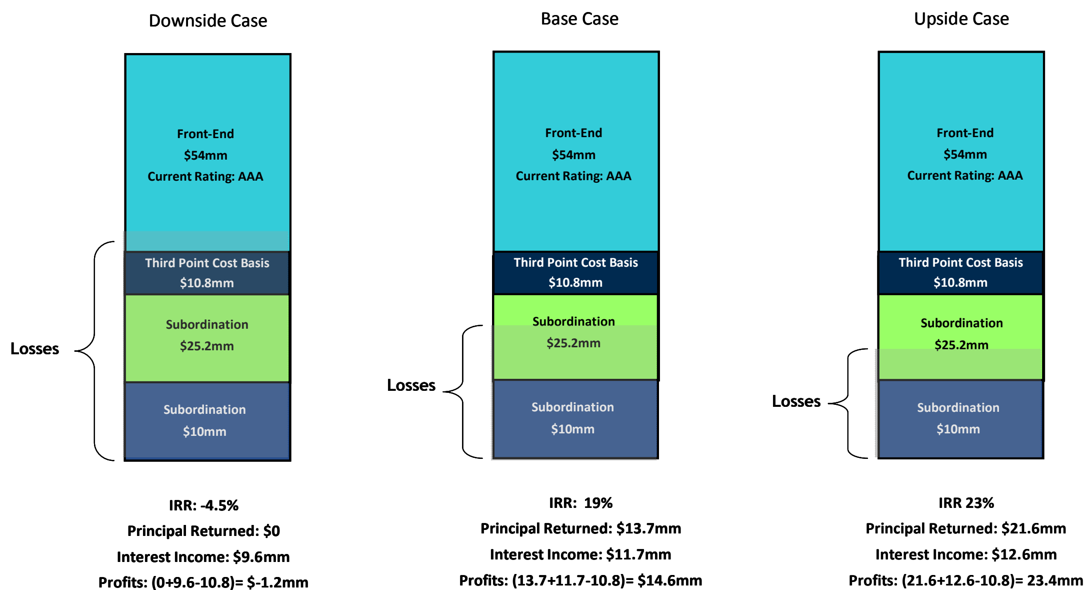
In a stylized example, assume Third Point purchased $90M of a super senior Alt-A bond for $64.8M, or 72% of par. This bond currently has $10M of subordinated bonds beneath it to absorb losses. In a re-REMIC transaction, we would split our $90M bond into two new securities: a front-end piece of $54M and a back-end piece of $36M. The front-end piece would get sold to a ratings constrained buyer at par for $54M, leaving Third Point with a back-end piece with $36M of face value for which we have paid $10.8M.



As you can see below, our base case return implies a $13.7M principal recovery on our $10.8M of invested principal. Additionally, we anticipate receiving $11.7M of interest over the life of our bond for a total yield to maturity of ~19%. In our downside case, our $10.8M of principal is lost, but we earn $9.6M of interest over the life of our bond for an implied annualized loss of 4.5%. In our upside case, we recover more principal and return 23%.



Our base case assumptions imply a further reduction in home prices of approximately 8-9% nationally, with far more severe price declines in certain regions. Given the favorable risk/reward in these securities and the limited downside given conservative assumptions and good pricing, we have a constructed an approximately $300M portfolio of back-end re-REMICs and remain excited about this opportunity.

New Employee

Edmund Choo joined Third Point in 2010. Previously, he was an Event Driven Trader at Polygon Investments where he focused on equity trading across multiple strategies including risk-arbitrage, event-driven, and long-short. Prior to Polygon, Ed was an Associate in the Equity Arbitrage Sales & Trading group at Morgan Stanley. He graduated cum laude from Princeton University with a B.S.E. in Operations Research and Financial Engineering. He is a great addition to the team.

Quarterly Investor Webcast and Conference Call

Our second Quarterly Performance Review and Business Update was presented via webcast and conference call on August 3rd, and nearly 200 investors participated or listened to the replay. The slides that accompanied the webcast are available from Investor Relations.

Please feel free to contact Investor Relations or me directly with questions or thoughts.

Sincerely,

Daniel S. Loeb

The performance data presented represents that of Third Point Partners L.P. All P&L or performance results are based on the net asset value of fee-paying investors only and are presented net of management fees, brokerage commissions, administrative expenses, and accrued performance allocation, if any, and include the reinvestment of all dividends, interest, and capital gains. The performance above represents fund-level returns, and is not an estimate of any specific investor's actual performance, which may be materially different from such performance depending on numerous factors. All performance results are estimates and should not be regarded as final until audited financial statements are issued.

While the performances of the Funds have been compared here with the performance of a well-known and widely recognized index, the index has not been selected to represent an appropriate benchmark for the Funds whose holdings, performance and volatility may differ significantly from the securities that comprise the index. Investors cannot invest directly in an index (although one can invest in an index fund designed to closely track such index).

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