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TO:	Limited Partners
FROM:	Investor Services – Elaine Mann, Beth Mills, and Meredith Odom
RE:	Excerpt from Third Quarter Letter to Partners
DATE:	October 10, 2008

In advance of the September report package, which we anticipate mailing to partners on October 24, we thought it would be helpful to provide an excerpt from Seth Klarman's September quarter-end letter. This excerpt provides context to the performance estimate e-mail sent on October 9 and offers insight to the current market opportunities.

Please let us know if you have any questions. Thank you.

The partnerships lost ground amidst September's extreme financial turmoil. Equities were hard hit and bargain-priced performing corporate debt became considerably cheaper by month-end. Roughly half of our decline came from a number of downward valuation adjustments on private and real estate holdings that we took at month-end to conservatively reflect current market conditions. Included in the write-downs was a sharp reduction in the carrying value of our interest in the buyout of Chrysler to reflect current market conditions. Our credit default swap hedging position was one particularly bright spot for the portfolio.

The S&P 500 plunged a further 22% over the first seven trading days of October, as the crisis steadily worsened. Since peaking on October 9, 2007, the S&P declined nearly 42% over the ensuing 12 months. The selling panic is accelerating primarily because of growing fear of a severe economic downturn, which would in some cases justify lower prices, and the urgent need by many mutual funds and hedge funds for cash to meet margin calls and redemptions. There is a crush of elephants all trying to get through the revolving door at once. In capital markets, price is set by the most panicked seller at the end of a trading day; value, which is determined by cash flows and assets, is not. This is both the challenge and the opportunity of investing: to carefully sift through the markets to find the greatest divergence between price and value, and to concurrently avoid the extreme emotions of the crowd and, indeed, to take a stand against them. Today, there are prices that discount complete disaster, where investors are being extremely well compensated for providing liquidity to those who have become desperate. The only difficulty is in not knowing how low prices may go, how much pain you must be prepared to incur before you reap exceptionally likely and considerable gain.

The U.S. financial system has been experiencing unprecedented carnage. In September alone, we witnessed the government conservatorship of mortgage lenders Fannie Mae and Freddie Mac, the largest bank failure in U.S. history (WAMU), the

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announced assisted takeover of the even larger Wachovia Bank, the $600 billion bankruptcy of Lehman Brothers, the governmental rescue of insurance giant AIG through an $85 billion secured loan (augmented by a further $37.8 billon loan in October), and the unprecedented announced $700 billion federal bailout of the U.S. financial system (signed into law in early October). Late in September and continuing into October, numerous major European banks had to be rescued by their governments. A large money market fund (The Reserve Primary Fund) lost so much money on the Lehman bankruptcy ($785 million) that their NAV fell from the customary $1.00 to $0.97, causing a run on other money market funds and prompting a hasty federal guarantee for all money market fund investors. Most hedge funds and other investment vehicles posted dismal results for the month and quarter, and a number appear to be on life support or in liquidation. With each successive day, the interconnectedness of global financial markets becomes increasingly apparent; the ill health of one institution infects the rest, like the falling of one domino toppling successive others. With events moving at such great speed, every day feels like an eternity.

As the quarter wore on, there was a nearly complete seizing-up of credit, with no financial institution willing to trust any other because of a lack of transparency, legitimate concern about capital shortfalls and further losses, and uncertainty over the inability to meet upcoming debt maturities or to refinance. Recognition of the contagion effects of a deeper contraction in credit on both the financial system and the general economy prompted government intervention. The merits of the approved plan are dubious, especially because purchasing bad debt from financial institutions will not necessarily achieve the stated goal of stimulating lending, even as it may reward, at taxpayer expense, those who made the bad loans. However, it can be hoped that any plan, even this deeply flawed one, may be part of a process that restores some confidence in the system.

Baupost took advantage of increasingly panicked selling during the quarter to add to our distressed debt holdings. Hedge funds and mutual funds facing redemptions and foreign institutions losing confidence in the U.S. purged financial sector bonds at fire-sale prices as the month progressed and anxiety mounted. We have, thus far, completely avoided investing in the debt of banks at either the operating company or holding company level, both of which are subordinated to the claims of a bank's depositors and therefore subject to a complete wipeout in the event of a failure. But many worthwhile debt instruments were dumped alongside the highly risky ones. To offer one example, in September we initiated a position in Washington Mutual (WAMU) covered bonds (a special type of bond secured by an over-collateralized pool of fairly good quality performing mortgages) at prices averaging 74 cents on the dollar. Our assessment was that if WAMU survived, we would earn a 15.4% yield to maturity in 2011. In the event of a failure of WAMU, these bonds would either be assumed by a healthy acquiror, become backed by cash that was placed into a trust for the benefit of the bondholders, or, less likely, receive the valuable mortgage collateral. At our purchase price, any of these scenarios would have been the same or better than the 15.4% base case. As it turned out, our bonds were assumed by JP Morgan as part of its takeover of WAMU and have traded up in price.

Overall, we added several new performing corporate debt names to the portfolio during the quarter, while increasing several other positions at prices that reflect exceptionally attractive mid-to-high teens to 30% or higher yields to maturity with maturities ranging generally from one to five (and occasionally as long as eight) years. The purchases were made at levels where even in the event of bankruptcy filings for these companies (which, in general, we do not expect), we still anticipate achieving strong returns with what we believe would be limited trading downside and very little risk of principal loss. When we talk to the management teams, they confirm our basic assessment that these companies have sufficient liquidity to meet upcoming debt maturities and that asset values remain sufficient to cover liabilities.

In perilous times such as these, the instinct of many is to go into cash. Anticipation of client redemptions, the angst of large losses, and the pressure of margin calls on leveraged portfolios cause investors to do just about anything to limit their pain. Many are selling holdings they would prefer to hold or even add to because they have no choice. By contrast, we have been cautious going into this period. We employed no leverage, held substantial cash balances, and had little exposure to financials and cyclicals. As such, we are less shocked than most at recent developments and better positioned to act, making us one of a limited number of buyers able and willing to take advantage of recent dislocations. The chaos is so extreme, the panic selling so urgent, that there is almost no possibility that sellers are acting on superior information; indeed, in situation after situation, it seems clear that investment fundamentals do not factor into their decision-making at all. As always, we cannot predict where or when the bottom of the market will be reached. We believe the odds are high, though, that the purchase of adequately-covered senior debt at deeply discounted prices from these urgent sellers will prove to be very profitable investments for Baupost.

Amidst the chaos, we also added to a few equity positions that have been clobbered by particularly urgent sellers. Two publicly traded oil and gas partnerships, both heavily owned by Lehman Brothers, fell sharply immediately after Lehman's bankruptcy filing, to levels where we purchased large blocks at mid-teens or higher annual yields based on current distributions that are largely locked-in for five years through hedges, and at prices roughly half of the value of these companies' proven energy reserves.

Our real estate area has been fairly quiet; commercial real estate markets worldwide are largely frozen right now. There are few transactions taking place, as financing is extremely difficult to obtain, and fundamentals in many products and markets are quickly deteriorating. Buyers, including ourselves, are interested only at levels far below where sellers are currently willing to transact, although we expect more urgency to develop among the sellers in the months ahead. Meanwhile, we are beginning to see some opportunities to invest in real estate at appropriately discounted levels through distressed public and private debt purchases.

Another area that has until very recently been generally uninteresting but should heat up significantly is the non-financial corporate debt sector. As the economy slows, we expect a great deal of corporate financial distress, especially in the debt of companies owned by private equity firms through leveraged buyouts. The great majority of these

situations have secured bank debt that still mostly trades at levels above where we find it attractive, while their unsecured debt is too speculative to hold even at today's somewhat discounted levels. We expect to become increasingly active in corporate debt in the months ahead and are directing our internal analytical efforts in this direction.

In this era of meltdown and bailout, we lament that this whole mess was somewhat predictable. Publicly traded financial institutions face short-term pressure for earnings growth, and quarterly earnings comparisons make it next to impossible for anyone to stand apart from the crowd. Congress regularly pressured Fannie Mae and Freddie Mac to expand lending to benefit those who wouldn't traditionally qualify for a home loan, paving the way for the excesses that ensued. New financial products -- mostly derivatives or structured products of one sort or other -- were created to grow profits, but have predictably proven to be fair weather creations; these thinly sliced tranches of securitized capital structures often become impossible to analyze when the initial assumptions fail to hold. Massive leverage -- 25 to 30 times for large investment banks -- compounded the cost of even minor mistakes to market-threatening proportions. A highly leveraged financial system is always to some degree a house of cards, vulnerable to a small crack in an obscure part of the foundation. It is shocking, yet in a way not that surprising, that decades of financial excess are being reversed in a matter of weeks.

Baupost, as a long-time participant in the financial markets, has always confronted serious risks. Our ongoing response to omnipresent risk is to attempt to mitigate as much as we can, intelligently and affordably, while willingly incurring only those risks for which we are being well compensated. This is why for 26 years we have held our cash directly in U.S. Treasury bills or in money market funds that invest only in U.S. Government securities. When we need our cash, we always want it to be there, fully intact. Because we are human and can make mistakes, and because we never want to be forced to sell investments at an inopportune time, we never use recourse leverage on our portfolios. This has been an expensive decision much of the time, in that leverage magnifies returns. But it is not a decision we ever regretted, because the downside risk of leverage is far too great. Capital preservation is always far more important than capital enhancement. Similarly, we are not fans of short-selling, other than for a very limited amount of direct hedging, because it exposes you to theoretically unlimited loss and involves significant counterparty, systemic, and regulatory risk. Finally, we made the decision years ago never to participate in stock lending, which caused us to forgo fees from that activity. Fortunately, amidst today's chaos, we control all of our long positions and are not exposed to the risk of unreliable and even insolvent counterparties.

Over the 26 years we have been in business, Wall Street regularly came calling with fancy new derivatives involving computer models and Greek letters, conceived by their armies of mathematics PhD's. Some of these offerings were so exotic that we couldn't understand them without great strain; we were always highly suspicious that we were at enormous risk of getting picked off. So we simply said no thanks. Most of today's troubles could have been avoided if more people had had the sense to just hang up the phone.

Simply put, the financial market collapse and bailout makes us sick. We are deeply saddened that things have gone so far wrong – sad for our country, sad for people who have lost their jobs and their net worths, and sad that Wall Street's toxic waste is washing up on Main Street. We are greatly concerned about the enormous moral hazard that is being created by our government as it once again bails out financial institution losses and props up failed institutions. When there is no price for incurring excessive risk, more will be borne. When there is no cost for failure, there will be more and more of it. Previous bailouts led to excesses that triggered today's crisis. Today's mother-of-all-bailouts, if nothing else changes regulatorily or policy-wise, could reasonably be expected to lead to even greater problems down the road.

Perhaps most sadly, our country and the system that has brought the world so much prosperity is in danger of becoming discredited. Years of excess, enabled by spineless and economically ignorant politicians, weak-kneed regulators, greedy investment bankers, and an acquiescent and shortsighted populace have backed our country into a corner where we may uncomfortably find ourselves for some time. Severe economic fallout is starting to be felt; businesses, consumers and even not-for-profits are in the process of cutting spending and hunkering down. The government is outlaying enormous sums of money that it doesn't have, doing everything in its power to arrest the downward spiral.

The global financial system, which effectively allowed the dollar to serve as the world's reserve currency for many years, also enabled our nation's lax behavior, and it wouldn't be surprising to see the era of dollar hegemony come to an end. At a minimum, the dollar will likely weaken over time, perhaps in a hurry, and gold may further strengthen. Longer term, U.S. interest rates may well rise, if foreigners need to be financially cajoled to continue holding dollar-denominated assets. The extraordinary and unpaid-for financial market bailout should add to inflationary pressures over time, especially when the economy begins to recover from the current economic downturn. Against this possibility, Baupost has built a sizable position in low-cost inflation protection for the next three to five years.

One of the greatest threats Baupost faces in this environment is that the rules are subject to change without notice. As mentioned earlier, we have never had material involvement in short selling (currently, two positions totaling under one percent of assets, both directly hedging long exposures); in contrast many funds employ short selling as an essential component of their business plans. Those managers are wondering today if their business plans still make sense and if their businesses are still viable. Who knows what other rules could change by government fiat, as they favor palliatives over predictability and search for scapegoats?

There is likely more carnage to come. The economic downturn could be vicious and protracted. But some securities prices discount Armageddon; for these, the downside risk is limited, the upside phenomenal. No one enjoys a sharp market downturn, with mark-to-market losses, growing panic, and economic dislocation. Yet a downturn is a necessary precursor to an upturn; the seeds of recovery and eventually of substantial profit are sown amidst the carnage. The world is not ending; the great majority of people

will remain employed and make their mortgage payments. Successful investing always requires a long-term perspective; this has never been truer than at this moment in time.