November 1, 2010

Dear Partner:

Greenlight Capital, L.P., Greenlight Capital Qualified, L.P. and Greenlight Capital Offshore (collectively, the "Partnerships") returned 4.6%, 4.4% and 4.2%[1] net of fees and expenses, respectively, in the third quarter of 2010, bringing the respective year to date net returns to 6.9%, 6.1% and 5.0%.[1]

We had very few significant portfolio changes this quarter. We established no significant new long positions. The S&P 500 almost reversed its loss from the second quarter and advanced 11.3%. Our longs rose a little more than the S&P 500, while our shorts on average rose a good deal less than the index. We had several company specific events that aided the performance of the short portfolio. Our largest and only significant loser was Moody's, where we gave up about half our gain from the prior quarter. Pfizer, last quarter's largest loser, recovered its entire second quarter loss. The other significant contributors to our performance were Arkema, CIT Group and Lanxess. Arkema and Lanxess announced very strong results in the second quarter and raised guidance for the full year by considerable amounts. CIT demonstrated progress in executing its turnaround.

By far the most remarkable development during the quarter was the shift in Federal Reserve policy. It was only a few months ago that the Fed was outlining its exit strategy from its previous aggressive easing actions, highlighting how it would reduce the size of its expanded balance sheet. Since then, the economy has failed to achieve the hopes of the most optimistic analysts, but it has performed better than the more bearish forecasts.

The perception of this modest macroeconomic shortfall has caused the Fed to reverse course. In its communication after its most recent meeting, the Federal Open Market Committee (FOMC) wrote, "Measures of underlying inflation are currently at levels somewhat below those the Committee judges most consistent, over the longer run, with its mandate to promote maximum employment and price stability." This is entirely new language and it is the first time the FOMC has officially declared it has a specific inflation target. It is now widely understood the Fed would like inflation to be between 1.7% and 2.0%. Subsequent to this statement, the Fed has conditioned the market to expect a substantial second round of Quantitative Easing (QE2) through additional purchases of Treasury securities.

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[1] These returns are net of the modified high-water mark incentive allocation of 10% and reflect the returns for partners who were invested on or prior to January 1, 2008. For partners who participated in our most recent capital opening, their individual results will reflect our standard 20% incentive allocation. The disparity in the returns for the Partnerships for 2010 is due mainly to differences in weightings of historical positions.

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Quantitative Easing or QE is a euphemism for monetization of government debt or simply the electronic equivalent of "printing money." We have been expecting that eventually the Fed would be forced to monetize the debt (either during the next recession or if the Treasury ceased to be able to find buyers of its debt at acceptable rates) with dire consequences. This potential outcome is part of the reason we own gold, which has rallied sharply in response to the Fed's new tack. However, we are quite surprised to see the Fed react so aggressively to the relatively mild failure to achieve the most bullish economic forecasts at a time when interest rates across the curve are already low.

Other than satisfying the political need to "do something," we believe it is doubtful that QE2 will be successful; it is hard to see how it will lower unemployment materially. With rates as low as they are, there are very few economic decisions in the real economy (like corporations deciding to build factories or hold inventories, or individuals buying houses and automobiles) that are constrained by interest rates. We believe a significant drag on economic activity has been the result of overly-burdensome regulatory initiatives, our challenged fiscal situation, legal uncertainty created by the erosion of the rule of law, and unpredictable tax policy. A further psychological drag comes from a general feeling that the last crisis was dealt with by kicking the can down the street by failing to resolve insolvent loans and sweeping the problems under the rug through optical illusions like rigged stress-tests. Corporations and consumers are acting conservatively because they fear an eventual relapse.

The prior round of QE has led to a build-up of excess bank reserves, indicating that bank lending activity is not constrained by a lack of low cost funding. Few people we speak with believe that QE2 will significantly lower unemployment or that ten years from now we will look back and say that QE2 was a good idea.

QE2 is much more likely to be successful in creating inflation and speculation in financial instruments. It is perverse that on the heels of suffering the after-effects of the collapse of the internet bubble and then the real estate bubble (both of which the Fed disclaims responsibility for creating or supporting), the Fed would like to encourage the formation of yet another asset bubble. One Fed official recently indicated that one goal of QE is to keep "asset prices higher than they otherwise would be." An FOMC member added that he didn't know "what the word bubble means." How about a rule where if you don't know what a bubble is, you can't serve on the Fed?

Unfortunately, the inflation may not come in the areas that the Fed hopes. Setting aside the possible understatement of official inflation measures, the biggest component of the CPI is owner's equivalent rent. This is the amount of money that economists estimate that homeowners would hypothetically pay to rent their own houses from themselves. It is going to take a lot of QE to make this measure rise far enough to achieve a higher rate of official inflation. However, it will be much easier to generate price increases for things that (unlike owner's equivalent rent) consumers and businesses have to pay for, including food, energy and other commodities. We have already seen signs of this. While the Fed hopes that a rising

stock market will support economic growth by stimulating demand through a "wealth effect," it is quite likely that QE2 will slow the economy by raising food and energy prices, which would act as a tax on consumers and businesses.

Notably, there are a number of FOMC members who have spoken out against further QE. This sets up a divided vote and a possible decision to forego QE2. However, it appears that the members calling for immediate action have prevailed and the FOMC has conditioned the market to expect an announcement of further treasury security purchases after this week's FOMC meeting. While the meeting is a possible defining moment in how the authorities intend to act and may be a last, best chance to stop this potentially harmful policy, the current composition of voting members at the FOMC makes this unlikely.

It seems there are very few holders of long-dated treasuries who actually plan to hold them for their duration. With the Fed potentially purchasing trillions of dollars of long-dated bonds, speculators are willing to buy government bonds in an effort to front run the Fed's future purchases. Amusingly, the Fed calls this "expectations management" and is quite pleased that rates are reacting prior to its actions.

There has been a lot of discussion about whether the rally in long-term government debt makes equities more valuable. The Fed would certainly like to convince the market that it does. Some academic theories, like the capital asset pricing model, use the government bond rate – the so-called "risk-free rate" – as a key input in equity valuation. One new problem with this method is that the government bond rate is increasingly controlled by the Fed. This creates a potential flawed analysis if one tries to determine the value of equities, which are comparatively less controlled, with a key input coming from manipulated government interest rates rather than market determined rates.

The apparent manipulation of the long-end of the treasury curve risks sending false signals to policy makers and equity investors alike. With the Fed as a large participant in the government bond market, policy makers may miss signals of higher inflation and declining willingness of third parties to finance government debts. Of course, they could look at the price of gold as an alternative measure of market concern. Equity and debt investors could err by using a false "risk-free" rate in evaluating security prices.

We can't say whether the Federal Reserve will succeed in creating another asset bubble, but we wouldn't bet against it. As we have seen, such a bubble would be fraught with risk both for investors and for the real economy. Should the market determine that QE2 failed and the economy deteriorates due to high oil prices or for other reasons, owning too many equities could eventually prove hazardous.

In the meantime, being net short into a bubble could also prove to be painful. Our strategy remains to have a modest net long position. We will ignore the comparisons between government bonds and stocks and attempt to construct and maintain a bottom-up portfolio of longs and shorts where each investment has favorable risk-reward characteristics. Of course,

this construct will dramatically underperform long-only equity indexes in periods of vertical ascent, as we saw this quarter. But we will sleep better at night.

The notable positions closed during the quarter were:

Closed Security	L/S	Avg Entry Price	Avg Exit Price	IRR	Comments
ATP Oil & Gas • equity • debt	L	 $7.82 64%	 $14.06 91%	 +162% +87%	We expected the company to be revalued once its new Telemark field came online, which happened. Sold when the Gulf drilling moratorium was imposed.
Downer EDI Ltd	L	AUD 6.74	AUD 3.86	-98%	Reported disappointing cost over-runs in a key project. We thought something named "Downer" was a long. Oops.
EMC Corp	L	$11.28	$14.63	+40%	Found core storage business attractively priced. Sold after meaningful appreciation.
Ford debt	L	43%	87%	+143%	We bought secured bank debt at a discount to cash on the belief that Ford would survive and have sufficient assets to cover the loan. Ford's turnaround has been even quicker and stronger than we anticipated.
Lockheed Martin Corp	L	$85.14	$68.90	-39%	Got spooked by a deteriorating outlook for defense spending, and lower cash flows and margins than we initially thought.
Nestle SA	L	CHF 42.44	CHF 53.07	+29%	Large global consumer company we bought at a compelling valuation ahead of the sale of their Alcon unit. Sale happened and we exited closer to fair value.
Corinthian Colleges Inc	S	$16.94	$11.61	+91%	Correctly identified exposure to new government regulations. Covered too early.
Office Depot Inc	S	$6.91	$4.18	+67%	Weakest retailer in a highly competitive category that was expensive on earnings (none) and priced in a turnaround that hasn't materialized.
Royal Caribbean Cruises Ltd	S	$15.15	$29.25	-123%	It looked like it might not survive the recession due to high leverage, cash outflows and exposure to a weakened consumer. The consumer stabilized.

In October David discussed our long-standing short position in the St. Joe Company (JOE) at the Value Investing Congress. You can find the slideshow presentation on our website. The response to the presentation has been generally positive. Nonetheless, sell-side defenders have done what they always do, call us names.

One JOE defender wrote, "it appears Greenlight has cherry-picked a few select pieces of documentation, placed them completely out of context or without full disclosure as to what they represent, and then developed a thesis supported by rainy-day pictures and incomplete math."

Another JOE defender wrote, "In the spirit of advancing a holistic thesis on St. Joe that reflects the firm's upside as well as downside potential, we reviewed Greenlight Capital's Oct. 13 presentation at the Value Investing Congress for analysis that would disconfirm our positive thesis on the intermediate- and long-term prospects at St. Joe. Our look at the underpinnings of Greenlight's bearish bet on the stock suggests that much of the hedge fund's detractions seem backward-looking and in some cases factually inaccurate."

The first defender tried to nitpick certain facts in our presentation. We reviewed the critique on a lengthy call with the authors and believe our facts and conclusions are correct and that their report is the one that is filled with errors.

Both defenders tried to focus investors on the long-term value supported by so-called discounted cash flow (DCF) analyses.

The first defender's DCF analysis arrived at a $22 per share value. In addition to containing implausible hockey stick projections, the model is replete with math and accounting errors. For example, the DCF calculation assumes $4.9 billion of undiscounted after-tax free cash flow over the forecast period even though total EBITDA is forecasted at $3.8 billion, taxes at $1.2 billion and capital expenditures at $1.4 billion. A more traditional use of arithmetic would suggest undiscounted free cash flow closer to $1.2 billion.

The second defender's DCF analysis came to a value of $50 per share. In its report the defender calls the model "pragmatic." We obtained the DCF model from the analyst. At first, we thought it was a discounted *revenue* model that ignored all expenses including the cost for JOE to develop land, corporate overhead and taxes. If you ignore the expenses, even General Motors would be a very attractive investment. But then, we contacted the author who wrote back to us:

> "Given the complexity and long-term nature of the company's projects, we decided that a traditional income/cash flow statement approach would yield unsatisfactory results very early on. In the model you reviewed, we merely tried to estimate the value of the company's landholdings based on development initiatives over time that should in-turn bring accretion in the value of the company's portfolio. Importantly, we are not modeling revenue."

So, we looked again. And we saw that the cash flows being discounted back were even higher than the projected revenue on the author's 5-year earnings model on another page of his spreadsheet. This is a good way to avoid an "unsatisfactory" result. We recast the defender's DCF model to include the revenues on his earnings model and changed the gross margin assumption on developed properties from 100% to the historical 35% that JOE achieved before the real estate market collapsed (current margins are negative), and included corporate overhead and taxes. This revised DCF calculates JOE's value to be about $5 per share under those assumptions. JOE shares closed the quarter at $24.87 each.

Greenlight hired analyst Anand Kinkhabwala in August, breaking our record for longest last name. Anand began his career in 2003 as an analyst at Evercore Partners focused on both M&A advisory and private equity investing and then joined Perry Capital in 2004, focusing on energy and industrials investments. In 2006, Anand joined his portfolio manager from Perry Capital to launch Blackstone Kailix, an equity-focused hedge fund. Welcome Anand! Also, London-based analyst Richard Owen left in October to pursue more entrepreneurial activities. We wish him well.

In December, John Wiley & Sons will release the paperback edition of David's book, *Fooling Some of the People All of the Time, A Long Short and Now Complete Story.* This edition includes a new Epilogue section that concludes the story, which was still in progress when the hardcover edition was published. After declining almost all interview requests for the last two and a half years, David intends to make appearances and grant a few interviews in support of the book's publication.

Please mark your calendar for our next Partners' Dinner, scheduled for Tuesday, January 18, 2011. The meeting is scheduled to take place at the American Museum of Natural History. We will send out a formal invitation in the coming months.

At quarter end, the largest disclosed long positions in the Partnerships are Arkema, CIT Group, Ensco, gold, Pfizer, and Vodafone Group. The Partnerships had an average exposure to equities and fixed income (excluding credit derivatives, gold and foreign currencies) of 98% long and 63% short.

"Some people use half their ingenuity to get into debt, with the intention of using the other half to avoid paying it."

-- George Dennison Prentice

Best Regards,

Greenlight Capital

Greenlight Capital, Inc.