EXHIBIT 27

GABRIEL CAPITAL, L.P.

A Delaware Limited Partnership

CONFIDENTIAL OFFERING MEMORANDUM

March 2006

General Partner:
450 Park Avenue
32nd Floor
New York, New York 10022

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The information contained herein is confidential and is furnished for informational purposes only. This Confidential Offering Memorandum supersedes all earlier disclosure concerning the Partnership.

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CONFIDENTIAL OFFERING MEMORANDUM

GABRIEL CAPITAL, L.P.

450 Park Avenue
32nd Floor
New York, New York 10022

Gabriel Capital, L.P., a Delaware limited partnership formed on January 1, 1991 (the "Partnership"), was organized to operate as a private investment partnership for the benefit of U.S. taxable investors. The Partnership's investment objective is to provide limited partners with a total return on their investment consisting of capital appreciation and income by investing in a diverse portfolio of securities. Generally, the Partnership will invest and trade in U.S. and non-U.S., marketable and non-marketable, equity and debt securities and options, as well as other evidences of ownership interest or indebtedness, including receivership certificates, and promissory notes and payables to trade creditors of distressed companies or companies in Chapter 11 bankruptcy proceedings, and commodities contracts, futures contracts (relating to stock indices, options on stock indices, commodities and options on commodities) and forward contracts. The Partnership will invest in the securities of corporations believed to be fundamentally undervalued. The Partnership will also make indirect investments with third-party managers, including investments through managed accounts and investments in mutual funds, private investment partnerships, closed-end funds and other pooled investment vehicles (including special purpose vehicles), which engage in similar investment strategies as the Partnership (collectively, "Other Investment Entities"). The Partnership expects to invest in private and restricted securities. The Partnership may utilize leverage when deemed appropriate by the General Partner (as defined below), including to enhance the Partnership's returns and meet withdrawals that would otherwise result in the premature liquidation of investments. **There can be no assurance that the Partnership's investment objective will be achieved.** (See "Investment Program.")

J. Ezra Merkin serves as the general partner of the Partnership (the "General Partner"). The General Partner has ultimate responsibility for the management, operations and investment decisions made on behalf of the Partnership. Gabriel Capital Corporation, a Delaware corporation (the "Management Company"), provides administrative and managerial services to the Partnership. All of the outstanding capital stock of the Management Company is owned or controlled by J. Ezra Merkin.

This Confidential Offering Memorandum relates to an offering of Class B limited partner interests in the Partnership (the "Interests") to certain investors that, if accepted, will become limited partners of the Partnership (each, a "Limited Partner" or "Class B Limited Partner"). The Partnership has issued Class A interests (the "Class A Interests") to investors (each, a "Class A Limited Partner", and together with the Class B Limited Partners and the General Partner, the "Partners"). The Partnership may offer Interests to prospective new Limited Partners as of the beginning of each quarter (or at such other times as the General Partner in its sole discretion may allow).

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Investors in the Partnership must be "accredited investors" as defined in Rule 501 under the Securities Act of 1933, as amended, "qualified purchasers" as such term is defined in Section 2(a)(51) of the Investment Company Act of 1940, as amended, (the " Company Act"), and must meet other suitability requirements. Interests may not be purchased by nonresident aliens, foreign corporations, foreign partnerships, foreign trusts or foreign estates, all as defined in the Internal Revenue Code of 1986, as amended (the "Code"), or by entities that are tax-exempt. Such investors may be eligible to invest in Ariel Fund Limited, a Cayman Islands exempted company that maintains a similar investment program as that of the Partnership. The General Partner, in its sole discretion, may decline to admit a prospective investor for any reason or for no reason, even if it satisfies the Partnership's suitability requirements.

Interests in the Partnership are suitable only for sophisticated investors (i) that do not require immediate liquidity for their investments, (ii) for which an investment in the Partnership does not constitute a complete investment program and (iii) that fully understand and are willing to assume the risks involved in the Partnership's investment program. The Partnership's investment practices, by their nature, may be considered to involve a substantial degree of risk. (See "Investment Program" and "Certain Risk Factors").

Prospective investors should carefully read this Confidential Offering Memorandum. The contents of this Confidential Offering Memorandum, however, should not be considered legal or tax advice, and each prospective investor should consult its own counsel and advisers as to all matters concerning an investment in the Partnership.

There will be no public offering of the Interests. No offer to sell (or solicitation of an offer to buy) will be made in any jurisdiction in which such offer or solicitation would be unlawful.

This Confidential Offering Memorandum has been prepared solely for the information of the person to whom it has been delivered on behalf of the Partnership and may not be reproduced or used for any other purpose. The dissemination, distribution, reproduction or other use of all or any portion of this Confidential Offering Memorandum or the divulgence of any of its contents other than to the prospective investor's financial, tax or legal advisors, without the prior written approval of the General Partner, is prohibited. Any person that receives this Confidential Offering Memorandum and does not purchase a Interest is requested to promptly return this Confidential Offering Memorandum to the General Partner. Notwithstanding anything herein to the contrary, each investor (and each employee, representative, or other agent of such investor) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of (i) the Partnership and (ii) any transactions described herein, and all materials of any kind (including opinions or other tax analyses) that are provided to the investor relating to such tax treatment and tax structure. Each person accepting this Confidential Offering Memorandum agrees to return it to the General Partner promptly upon request. This Confidential Offering Memorandum is accurate as of its date, and no representation or warranty is made as to its continued accuracy after such date.

The Partnership will not be registered as an investment company under the Company Act and, therefore, will not be required to adhere to certain operational restrictions and

requirements under the Company Act. The General Partner is not registered as an investment adviser under the Investment Advisers Act of 1940, as amended.

WHILE THE PARTNERSHIP MAY TRADE COMMODITY FUTURES AND/OR COMMODITY OPTIONS CONTRACTS, THE GENERAL PARTNER IS EXEMPT FROM REGISTRATION WITH THE COMMODITY FUTURES TRADING COMMISSION ("CFTC") AS A COMMODITY POOL OPERATOR ("CPO") PURSUANT TO CFTC RULE 4.13(a)(4). THEREFORE, UNLIKE A REGISTERED CPO, THE GENERAL PARTNER IS NOT REQUIRED TO DELIVER A CFTC DISCLOSURE DOCUMENT TO PROSPECTIVE LIMITED PARTNERS, NOR IS HE REQUIRED TO PROVIDE LIMITED PARTNERS WITH CERTIFIED ANNUAL REPORTS THAT SATISFY THE REQUIREMENTS OF CFTC RULES APPLICABLE TO REGISTERED CPOs.

THE GENERAL PARTNER QUALIFIES FOR THE EXEMPTION UNDER CFTC RULE 4.13(a)(4) ON THE BASIS THAT, AMONG OTHER THINGS (I) EACH LIMITED PARTNER IS EITHER (A) A NATURAL PERSON WHO IS A "QUALIFIED ELIGIBLE PERSON" AS DEFINED IN CFTC RULE 4.7(a)(2) OR (B) A NON-NATURAL PERSON THAT IS EITHER AN "ACCREDITED INVESTOR" AS DEFINED UNDER SECURITIES AND EXCHANGE COMMISSION RULES OR A "QUALIFIED ELIGIBLE PERSON AS DEFINED UNDER CFTC RULE 4.7; AND (II) INTERESTS IN THE PARTNERSHIP ARE EXEMPT FROM REGISTRATION UNDER THE SECURITIES ACT OF 1933 AND OFFERED AND SOLD WITHOUT MARKETING TO THE PUBLIC IN THE UNITED STATES.

NO OFFERING LITERATURE OR ADVERTISING IN WHATEVER FORM WILL BE EMPLOYED IN THE OFFERING OF THE INTERESTS EXCEPT FOR THIS CONFIDENTIAL OFFERING MEMORANDUM, STATEMENTS CONTAINED HEREIN AND WRITTEN MATERIALS SPECIFICALLY APPROVED BY THE GENERAL PARTNER. NO PERSON HAS BEEN AUTHORIZED TO MAKE ANY REPRESENTATION OR GIVE ANY INFORMATION WITH RESPECT TO THE INTERESTS, EXCEPT FOR THE INFORMATION CONTAINED HEREIN.

THE INTERESTS HAVE NOT BEEN FILED WITH OR APPROVED OR DISAPPROVED BY THE SECURITIES AND EXCHANGE COMMISSION OR ANY OTHER GOVERNMENTAL AGENCY OR REGULATORY AUTHORITY OR ANY NATIONAL SECURITIES EXCHANGE. NO SUCH AGENCY, AUTHORITY OR EXCHANGE HAS PASSED UPON THE ACCURACY OR ADEQUACY OF THIS CONFIDENTIAL OFFERING MEMORANDUM OR THE MERITS OF AN INVESTMENT IN THE PARTNERSHIP INTERESTS OFFERED HEREBY. ANY REPRESENTATION TO THE CONTRARY IS UNLAWFUL.

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IN MAKING AN INVESTMENT DECISION, INVESTORS MUST RELY UPON THEIR OWN EXAMINATION OF THE PARTNERSHIP AND THE TERMS OF THE OFFERING, INCLUDING THE MERITS AND RISKS INVOLVED.

EACH PROSPECTIVE INVESTOR IS INVITED TO MEET WITH THE GENERAL PARTNER TO DISCUSS WITH, ASK QUESTIONS OF, AND RECEIVE ANSWERS FROM, THE GENERAL PARTNER CONCERNING THE TERMS AND CONDITIONS OF THIS OFFERING OF THE INTERESTS, AND TO OBTAIN ANY ADDITIONAL INFORMATION, TO THE EXTENT THE PARTNERSHIP POSSESSES SUCH INFORMATION OR CAN ACQUIRE IT WITHOUT UNREASONABLE EFFORT OR EXPENSE, NECESSARY TO VERIFY THE INFORMATION CONTAINED HEREIN.

THESE SECURITIES ARE SUBJECT TO RESTRICTIONS ON TRANSFERABILITY AND RESALE AND MAY NOT BE TRANSFERRED OR RESOLD EXCEPT AS PERMITTED UNDER THE SECURITIES ACT OF 1933, AS AMENDED, PURSUANT TO REGISTRATION OR EXEMPTION THEREFROM. INVESTORS SHOULD BE AWARE THAT THEY MAY BE REQUIRED TO BEAR THE FINANCIAL RISKS OF THIS INVESTMENT FOR AN INDEFINITE PERIOD OF TIME.

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GABRIEL CAPITAL, L.P.

SUMMARY OF TERMS

The following is a summary of the principal terms of the Partnership (as defined below). The following summary is qualified in its entirety by the more detailed information set forth in this Confidential Offering Memorandum and by the terms and conditions of the Limited Partnership Agreement of the Partnership, as the same may be amended from time to time. This summary should be read in conjunction with such detailed information.

THE PARTNERSHIP:

Gabriel Capital, L.P., a Delaware limited partnership formed on January 1, 1991 (the "Partnership"), was organized to operate as a private investment partnership for the benefit of U.S. taxable investors. (See "The Partnership.")

Ariel Fund Limited, a Cayman Islands exempted company organized for the benefit of U.S. tax-exempt and non-U.S. investors, follows an investment program substantially similar to that of the Partnership (the "Offshore Fund"). The Offshore Fund and the Partnership will invest on a side-by-side basis, unless differences in the investments of the Offshore Fund or the U.S. Partnership are deemed to be in the best interest of the respective fund's investors.

INVESTMENT PROGRAM:

The Partnership's investment objective is to provide limited partners with a total return on their investment consisting of capital appreciation and income by investing in a diverse portfolio of securities. Generally, the Partnership will invest and trade in U.S. and non-U.S., marketable and non-marketable, equity and debt securities and options, as well as other evidences of ownership interest or indebtedness, including receivership certificates, and promissory notes and payables to trade creditors of distressed companies or companies in Chapter 11 bankruptcy proceedings, and commodities contracts, futures contracts (relating to stock indices, options on stock indices, commodities and options on commodities) and forward contracts. The Partnership will invest in the securities of corporations believed to be fundamentally undervalued. The Partnership will also make indirect investments with third-party managers, including investments through managed accounts and investments in mutual funds, private investment partnerships, closed-end funds and other pooled investment vehicles (including special

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purpose vehicles), which engage in similar investment strategies as the Partnership (collectively, "Other Investment Entities"). The Partnership expects to invest in private and restricted securities. The Partnership may utilize leverage when deemed appropriate by the General Partner (as defined below), including to enhance the Partnership's returns and meet withdrawals that would otherwise result in the premature liquidation of investments. **There can be no assurance that the Partnership's investment objective will be achieved.** (See "Investment Program.")

When the Partnership engages in investments through Other Investment Entities, fees, including performance-based fees, may be payable by the Partnership, in addition to the fees payable to the General Partner discussed below. In such cases, the General Partner will retain overall investment responsibility for the portfolio of the Partnership (although not the investment decisions of any independent money managers managing Other Investment Entities). Such arrangements are subject to periodic review by the General Partner and are terminable at reasonable intervals in the General Partner's discretion. The Partnership may withdraw from or invest in different investment funds and terminate or enter into new investment advisory agreements without prior notice to, or consent of, the Limited Partners (as defined below). (See "Certain Risk Factors – Independent Money Managers.")

From time to time, the General Partner may, in his sole discretion, acquire assets or securities that the General Partner believes lack a readily ascertainable market value or otherwise lack sufficient liquidity. Certain of these investments (not exceeding 40% of the net asset value of each Limited Partner's capital accounts, calculated at the time such investments are designated, and with such investments valued at cost) may be designated special investments (each a "Special Investment") to be put into separate special investment sub-accounts ("Special Investment Sub-Accounts"). In addition, existing investments may be designated Special Investments and will be valued at their carry value when so designated. **Interests in a Special Investment Sub-Account are allocated *pro rata* to those investors that are Partners (defined below) at the time a Special Investment is made (or**

designated). (See Special Investment Sub-Accounts; Allocation of Gains and Losses and Incentive Allocation.")

The General Partner will not permit more than the greater of 50% of the Partnership's capital and 25% of the Partnership's total assets (on a cost basis, giving consideration to hedging techniques utilized) to be invested in a single investment. Moreover, it will not permit more than 10% of the Partnership's capital to be placed at risk in a single investment. The General Partner will have the discretion to determine how much is at risk for purposes of this test.

The Partnership's investment program is speculative and may entail substantial risks. Since market risks are inherent in all investments to varying degrees, there can be no assurance that the Partnership's investment objectives will be achieved. In fact, certain investment practices described above can, in some circumstances, substantially increase the adverse impact on the Partnership's investment portfolios. (See "Certain Risk Factors.")

THE GENERAL PARTNER; MANAGEMENT COMPANY:

J. Ezra Merkin will serve as the general partner of the Partnership (the "General Partner"). The General Partner has ultimate responsibility for the management, operations and investment decisions made on behalf of the Partnership.

Gabriel Capital Corporation, a Delaware corporation (the "Management Company"), provides administrative and managerial services to the Partnership. All of the outstanding capital stock of the Management Company is owned or controlled by J. Ezra Merkin.

THE INTERESTS

This Confidential Offering Memorandum relates to an offering of Class B limited partner interests in the Partnership (the "Interests") to certain investors that, if accepted, will become limited partners of the Partnership (each a "Limited Partner" or a "Class B Limited Partner"). The Partnership has issued Class A interests (the "Class A Interests") to investors (each, a "Class A Limited Partner", and together with the Class B Limited Partners and the General Partner, the "Partners"). Class A Interests have different redemption rights and less exposure to Special Investments than the Limited Partner

Interests.

The General Partner may issue other classes of interests in the future that differ in terms of, among other things, rights, powers and duties, including rights, powers and duties senior to existing classes of Limited Partners. The General Partner may establish new classes of interests, and determine the terms of such classes, without approval of the existing Limited Partners. (See "The Interests.")

SPECIAL INVESTMENT SUB-ACCOUNTS

The Partnership will establish a Special Investment Sub-Account for each investment that the General Partner deems a Special Investment. Only persons that are Partners at the time such Special Investment Sub-Account is established shall participate in such Special Investment Sub-Account and their respective Interests therein shall be determined in accordance with their respective partnership percentages at the time such Special Investment Sub-Account is established. Any security position in a Special Investment Sub-Account shall not be considered to be a part of a Partner's capital account, except to the extent the investment or the proceeds of such Special Investment Sub-Account are reallocated to a Partner's capital account. Upon a sale, distribution to Partners or other disposition which shall constitute a "realization" of all or a portion of a Special Investment held in a Special Investment Sub-Account (including a determination by the General Partner, in his sole discretion, that such special investment should no longer be maintained in a Special Investment Sub-Account), the net proceeds of such investment will be allocated to the capital accounts of the Partners participating in such Special Investment Sub-Account in proportion to such Partners' participating percentages in such Special Investment Sub-Account.

In the event the Partnership makes an investment that the General Partner determines is a follow-up investment to a Special Investment held in a Special Investment Sub-Account (each a "Follow-Up Investment"), the participating Partners shall share in such Follow-Up Investment in proportion to their participating percentage interest in the related Special Investment Sub-Account; *provided, however*, that the General Partner, in his reasonable discretion, may permit additional Limited Partners to participate in such Follow-up Investment; *provided further, however*, that if a Limited Partner shall have withdrawn from the

Partnership, the General Partner shall equitably adjust the participating percentage interests of the remaining participating Partners to reflect such Limited Partner's withdrawal and non-participation in the Follow-Up Investment. In its discretion, the General Partner need not designate as a "Follow-Up Investment" an additional investment in the same or similar opportunity as the investment for which a Special Investment Sub-Account has been established. Such investment may be designated as a new Special Investment. (See "Special Investment Sub Accounts.")

MINIMUM SUBSCRIPTION: The Partnership may offer Interests to new Limited Partners as of the beginning of each quarter (or at such other times as the General Partner in its sole discretion may allow).

The minimum initial subscription is $1,000,000 for an Interest in the Partnership, subject to the discretion of the General Partner to accept lesser amounts.

ADDITIONAL CAPITAL CONTRIBUTIONS: Limited Partners of the Partnership may make additional capital contributions in amounts of at least $250,000 with the consent of the General Partner and subject to his discretion to accept other amounts. Each capital contribution of a Limited Partner will be credited to such Limited Partner's capital account.

SALES CHARGES: There are no sales charges payable to the General Partner or the Partnership in connection with the offering of Interests. (See "Sales Charges.")

FISCAL YEAR: The fiscal year of the Partnership will end on December 31 of each calendar year.

ALLOCATION OF GAINS AND LOSSES AND INCENTIVE ALLOCATION: Partnership loss for each accounting period will be allocated among the Partners in proportion to the balance in their respective capital accounts at the start of such period. At the end of each accounting period, each Partner's capital account will be increased proportionately to reflect Partnership income for each accounting period (including any increase reflecting such Partner's share of cash or value of securities or proceeds transferred from a Special Investment Sub-Account to the Partner's capital account (based upon its *pro rata* interest in such Special Investment Sub-Account) and decreased by the cash or value of securities transferred from such Partner's capital account to a Special Investment Sub-Account). Income

and loss for this purpose will include unrealized appreciation and depreciation on investments (other than unrealized appreciation or depreciation in a Special Investment Sub-Account).

Each Limited Partner's share of the Partnership's net income in excess of the Management Fee (defined below) for the accounting periods to date during that year (including any income or loss realized on investments previously held in Special Investment Sub-Accounts) will be allocated 20% to the General Partner (or to a designee as he shall direct) and 80% to such Limited Partner (the "Incentive Allocation"). Similar allocations will be made with respect to a Limited Partner's capital account at the time such Limited Partner withdraws capital from the Partnership. There is no "high water mark" concept in the calculation of Incentive Allocation. At his discretion, the General Partner may waive the allocations described above with respect to any particular Limited Partner.

Whenever income or loss is realized (or deemed realized) in a Special Investment Sub-Account, such income or loss will be allocated to all Partners having an interest in such account *pro rata* in proportion to their interest in such account, and then transferred to such Partner's regular capital account at the end of the accounting period. Notwithstanding the foregoing, if a Limited Partner withdraws all or substantially all of its capital account (becoming a "Withdrawn Limited Partner") before the realization (as described herein) of that portion of his capital allocated to a Special Investment Sub-Account, income realized or deemed realized subsequent to withdrawal will be allocated 20% to the General Partner (or to a designee as it shall direct) and 80% to such Withdrawn Limited Partner.

MANAGEMENT FEE; OPERATING AND OTHER EXPENSES:

On the last business day of each fiscal year of the Partnership and upon dissolution, an amount equal to 1% (prorated for periods of less than a year) of each Limited Partner's capital account balance at the beginning of such year plus such Partner's contributed capital during such year (including all amounts allocated to a Special Investment Sub-Account) will be charged against such Limited Partner's capital account and paid to the General Partner as a management fee (the "Management Fee"). At his discretion, the General Partner may waive the fees described above with respect to any particular Limited

Partner.

The Partnership shall (i) pay, or cause to be paid, all costs, fees, operating expenses and other expenses of the Partnership (including the costs, fees and expenses of attorneys, accountants or other professionals and the compensation of all personnel providing services to the Partnership, including, in the discretion of the General Partner, the General Partner) incurred in organizing the Partnership and in pursuing and conducting, or otherwise related to, the activities of the Partnership, and (ii) reimburse the General Partner for any out-of-pocket costs, fees and expenses incurred by him in connection therewith. The amount of any costs, fees and expenses incurred in connection with the purchase, sale or carrying of any security, including, but not limited to, brokerage and other transaction costs and margin interest expenses will be paid by the Partnership. Notwithstanding the foregoing, any investment expense relating specifically to a Special Investment Sub-Account will be charged against the capital accounts of the Partners participating in such Special Investment Sub-Account in proportion to their respective participating percentage interests therein.

In addition, the Partnership is responsible for certain expenses of the General Partner, including, but not limited to, rent and salaries of personnel. Historically, such expenses have not exceeded 1% of the Partnership's net assets, however, there can be no assurance that this will continue to be true in the future.

If any of the above expenses are incurred jointly for the account of the Partnership and any other investment funds or trading accounts sponsored or managed by the General Partner or his affiliates, such expenses will be allocated to the Partnership and such other funds or accounts in a manner as the General Partner considers fair and reasonable. (See "Management Fee; Expenses"; "Brokerage Commissions"; "Auditors"; and Financial Reports.")

WITHDRAWALS:

A Class B Limited Partner may withdraw all or part of such Limited Partner's capital account from the Partnership with respect to capital contributions made on or after February 1, 2006 at the end of the calendar quarter after the two year anniversary of the date such Interests were purchased (the "First Withdrawal Date"),

and, thereafter, on each anniversary of the First Withdrawal Date upon 45 days prior written notice to the General Partner.

A Class A Limited Partner may withdraw all or part of such Limited Partner's capital account from the Partnership on June 30 or December 31 of any fiscal year upon 45 days prior written notice to the General Partner.

Each date as of which a Limited Partner withdraws all or a portion of its capital account or withdraws from the Partnership is herein referred to as a "Withdrawal Date."

Excluding amounts allocated to Special Investment Sub-Accounts, the Withdrawing Partner will receive the amount of such Limited Partner's capital account (less reserves determined by the General Partner for contingent liabilities) within 90 days after withdrawal. All amounts remaining unpaid (less reserves) will begin to bear interest at a rate equal to a specified broker's call rate for the period beginning 30 days after the effective date of such withdrawal and ending 90 days after the effective date of such withdrawal.

A distribution in respect of a withdrawal may be made in cash or in kind, as determined by the General Partner in its discretion. In-kind distributions will be made to Withdrawing Limited Partners on a *pro rata* basis.

Limited Partners may not otherwise make withdrawals, and the Partnership does not plan to make *pro rata* distributions to Partners on an on-going basis.

SPECIAL INVESTMENT SUB-ACCOUNT WITHDRAWAL

Notwithstanding the foregoing, no withdrawal may be made by a Limited Partner from any portion of its capital account that is allocated to a Special Investment Sub-Account. If a portion of a Withdrawn Limited Partner's capital account has been allocated to a Special Investment Sub-Account, then, unless otherwise determined by the General Partner, the amount distributed to such Withdrawn Limited Partner will not include any interest of such Partner in such Special Investment Sub-Account. Such Partner will retain its interest in any Special Investment Sub-Account until the realization or deemed realization of the Special Investment relating to such Special Investment Sub-Account. Income realized or deemed realized

subsequent to withdrawal will be allocated 20% to the General Partner (or to a designee as it shall direct) and 80% to such Withdrawn Limited Partner. Any loss realized subsequent to such withdrawal shall be allocated to the Withdrawn Limited Partner. Upon the realization of a Special Investment of a Withdrawn Limited Partner which is held in a Special Investment Sub-Account, the proceeds allocable to that Withdrawn Limited Partner, after reduction for the Incentive Allocation, if any, will be paid to the Withdrawn Limited Partner.

In addition, if after giving effect to a withdrawal, a Limited Partner would be completely withdrawn from the Partnership except for its interest in one or more Special Investment Sub-Accounts, all or a portion of the proceeds with respect to such withdrawal may be reserved or held back to pay for the Management Fee expected to be earned over the life of the Special Investments. Upon the realization or deemed realization of the applicable Special Investments, any unused reserve or hold back shall be paid to such Limited Partner.

To the extent, the amount reserved or held back to pay Management Fees (as described above) does not cover Management Fees that would otherwise be payable over the life of the Special Investment, then such unpaid Management Fees may be paid out of profits, if any, earned in respect of such Special Investment for the period beginning from the time such shortfall begins to accrue until realization or deemed realization. "Accrued Interest" is the amount of interest earned on any amount held back that, at the time of calculation, has not been applied to the Management Fees in respect of any Special Investment Sub-Account of a Limited Partner that has withdrawn all or substantially all of its capital account.

COMPULSORY WITHDRAWAL; SUSPENSION OF WITHDRAWAL RIGHTS:

The General Partner may, in its sole discretion, terminate the Interest of any Limited Partner, in whole or in part, upon at least thirty days prior written notice.

The General Partner, by written notice to any Limited Partner, may suspend the withdrawal rights of such Limited Partner if the General Partner reasonably deems it necessary to do so to comply with anti-money laundering laws and regulations applicable to the Partnership, the General Partner or any of the

Partnership's other service providers. (See "Anti-Money Laundering Regulations" and "Outline of Partnership Agreement.")

DISSOLUTION:

The Partnership will dissolve upon the first to occur of the following: (i) a determination by the General Partner that the Partnership should be dissolved or (ii) the death, bankruptcy, retirement or insanity of the General Partner which prevents him from devoting substantially his entire time, skill and attention to the Partnership and other funds and managed accounts for a period of 90 days; (iii) December 31, 2015; or (iv) any event causing the dissolution of the Partnership under the laws of the State of Delaware.

RESTRICTIONS ON TRANSFER:

No Limited Partner or transferee thereof will, without the prior written consent of the General Partner, which may be withheld in his sole discretion, create, or suffer the creation of, a security interest in such Limited Partner's Interest. Except for sales, transfers, assignments or other dispositions (i) by last will and testament, (ii) by operation of law, or (iii) to an affiliate of a Limited Partner, without the prior written consent of the General Partner, which may be withheld in his sole discretion, no Limited Partner shall sell, transfer, assign, or in any manner dispose of such Limited Partner's Interest, in whole or in part, nor enter into any agreement as the result of which any person shall become interested with such Limited Partner therein. (See "Limitations on Transferability; Suitability Requirements.")

CERTAIN RISK FACTORS:

There can be no assurance that the investment objective of the Partnership will be achieved. Investments in illiquid securities and the use of short sales, options, leverage, futures and other derivative instruments may create special risks and substantially increase the impact of adverse price movements on the Partnership's portfolio. The Incentive Allocation to the General Partner may create an incentive for the General Partner to cause the Partnership to make investments that are riskier than it would otherwise make. Moreover, an investment in the Partnership provides limited liquidity since the Interests are not freely transferable, and the Partners will have limited withdrawal rights. (See "Certain Risk Factors.")

LEVERAGE:

The Partnership has the power to borrow and may do so when deemed appropriate by the General Partner, including to enhance the Partnership's returns and meet withdrawals that would otherwise result in the premature liquidation of investments. The use of leverage can, in certain circumstances, substantially increase the losses to which the Partnership's investment portfolios may be subject. (See "Certain Risk Factors.")

BROKERAGE COMMISSIONS:

Portfolio transactions for the Partnership will be allocated to brokers on the basis of best execution and in consideration of a broker's ability to effect the transactions, its facilities, reliability and financial responsibility and the provision or payment by the broker of the costs of research and research-related services which are of benefit to the Partnership, the General Partner or related funds and accounts. Accordingly, the commission rates (or dealer markups and markdowns arising in connection with riskless principal transactions) charged to the Partnership by brokers in the foregoing circumstances may be higher than those charged by other brokers who may not offer such services. The General Partner has not entered into, and does not expect to enter into, any written soft dollar arrangements.

Morgan Stanley & Co., Inc. (the "Prime Broker") currently serves as the principal prime broker for the Partnership, and clears (generally on the basis of payment against delivery) the Partnership's securities transactions that are effected through other brokerage firms. The Partnership is not committed to continue its relationship with the Prime Broker for any minimum period and the General Partner may select other or additional brokers to act as prime brokers for the Partnership. (See "Brokerage Commissions.")

CONFLICTS OF INTEREST:

The General Partner and his affiliates will provide investment management services to managed accounts and other investment partnerships or funds, some of which have similar investment objectives to those of the Partnership. Such activities may raise conflicts of interest. However, the General Partner or his affiliates, as applicable, will undertake to do so in a manner that is consistent with their respective fiduciary duties to the Partnership. (See "Conflicts of Interest.")

REGULATORY MATTERS:

The Partnership is not registered as an investment

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company and, therefore, is not required to adhere to certain operational restrictions and requirements under the Company Act.

The Partnership relies on the exclusion provided in Section 3(c)(7) of the U.S. Investment Company Act of 1940, as amended, which permits private investment companies to sell their interests, on a private placement basis, to an unlimited number of "qualified purchasers", as defined in Section 2(a)(51) of the Company Act.

The General Partner will claim an exemption under Commodity Futures Trading Commission ("CFTC") Rule 4.13(a)(4) from registration with the CFTC as a commodity pool operator and, accordingly, is not subject to certain regulatory requirements with respect to the Partnership that would otherwise be applicable absent such an exemption.

The General Partner is not registered as an investment adviser under the Investment Advisers Act of 1940, as amended. (See "The General Partner" and "Limitations on Transferability; Suitability Requirements.")

SUITABILITY:

Investors in the Partnership must be "accredited investors" as defined in Rule 501 under the Securities Act of 1933, as amended, "qualified purchasers" as such term is defined in Section 2(a)(51) of the Company Act and must meet other suitability requirements. Interests may not be purchased by nonresident aliens, foreign corporations, foreign partnerships, foreign trusts or foreign estates, all as defined in the Internal Revenue Code of 1986, as amended (the "Code"), or by entities that are tax-exempt. Such investors may be eligible to invest in the Offshore Fund which has a substantially similar investment program to that of the Partnership.

The General Partner, in its sole discretion, may decline to admit a prospective investor for any other reason or for no reason, even if it satisfies the Partnership's suitability requirements. (See "Limitations on Transferability; Suitability Requirements.")

TAXATION:

The Partnership operates as a partnership and not as an association or a publicly traded partnership taxable as a corporation for Federal tax purposes. Accordingly, the Partnership should not be subject to Federal income tax, and each Limited Partner will be required to report on

its own annual tax return such Limited Partner's distributive share of the Partnership's taxable income or loss. (See "Tax Aspects.")

ERISA AND OTHER TAX-EXEMPT ENTITIES:

Tax-exempt entities subject to the Employment Retirement Income Security Act of 1974, as amended, and other tax-exempt entities may purchase shares in the Offshore Fund, but will not be offered Interests in the Partnership.

AUDITORS:

BDO Seidman, LLP serves as the Partnership's auditor. The Partnership will provide to the Limited Partners unaudited financial statements within 35 days after the end of each calendar quarter (other than the last) and will furnish to them annual audited financial statements within 90 days after year end, and tax information as soon thereafter as practicable. Certain Limited Partners may have access to certain information regarding the Partnership that may not be available to other Limited Partners. Such Limited Partners may make investment decisions with respect to their investment in the Partnership based on such information.

LEGAL COUNSEL:

Schulte Roth & Zabel LLP, 919 Third Avenue, New York, New York 10022, acts as counsel to the Partnership in connection with this offering of Interests. Schulte Roth & Zabel LLP also acts as counsel to the General Partner and his affiliates. In connection with the Partnership's offering of Interests and subsequent advice to the Partnership, the General Partner and his affiliates, Schulte Roth & Zabel LLP will not be representing the Limited Partners of the Partnership. No independent counsel has been retained to represent the Limited Partners of the Partnership.

SUBSCRIPTION FOR INTEREST:

Persons interested in subscribing for Interests will be furnished with, and will be required to complete and return to the General Partner, subscription documents and other certain documents.

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THE PARTNERSHIP

Gabriel Capital, L.P., a Delaware limited partnership formed on January 1, 1991 (the "Partnership"), was organized to operate as a private investment partnership for the benefit of U.S. taxable investors.

Ariel Fund Limited, a Cayman Islands exempted company organized for the benefit of U.S. tax-exempt and non-U.S. investors, follows an investment program substantially similar to that of the Partnership (the "Offshore Fund"). The Offshore Fund and the Partnership will invest on a side-by-side basis, unless differences in the investments of the Offshore Fund or the U.S. Partnership are deemed to be in the best interest of the respective fund's investors.

INVESTMENT PROGRAM

The Partnership's investment objective is to provide limited partners with a total return on their investment consisting of capital appreciation and income by investing in a diverse portfolio of securities. Generally, the Partnership will invest and trade in U.S. and non-U.S., marketable and non-marketable, equity and debt securities and options, as well as other evidences of ownership interest or indebtedness, including receivership certificates, and promissory notes and payables to trade creditors of distressed companies or companies in Chapter 11 bankruptcy proceedings, and commodities contracts, futures contracts (relating to stock indices, options on stock indices, commodities and options on commodities) and forward contracts. The Partnership will invest in the securities of corporations believed to be fundamentally undervalued. The Partnership will also make indirect investments with third-party managers, including investments through managed accounts and investments in mutual funds, private investment partnerships, closed-end funds and other pooled investment vehicles (including special purpose vehicles), which engage in similar investment strategies as the Partnership (collectively, "Other Investment Entities"). The Partnership expects to invest in private and restricted securities. The Partnership may utilize leverage when deemed appropriate by the General Partner (as defined below), including to enhance the Partnership's returns and meet withdrawals that would otherwise result in the premature liquidation of investments. **There can be no assurance that the Partnership's investment objective will be achieved.**

When the Partnership engages in investments through Other Investment Entities, fees, including performance-based fees, may be payable by the Partnership, in addition to the fees payable to the General Partner discussed below. In such cases, the General Partner will retain overall investment responsibility for the portfolio of the Partnership (although not the investment decisions of any independent money managers managing Other Investment Entities). Such arrangements are subject to periodic review by the General Partner and are terminable at reasonable intervals in the General Partner's discretion. The Partnership may withdraw from or invest in different investment funds and terminate or enter into new investment advisory agreements without prior notice to, or consent of, the Limited Partners. (See "Certain Risk Factors – Independent Money Managers").

From time to time, the General Partner may, in his sole discretion, acquire assets or securities that the General Partner believes lack a readily ascertainable market value or otherwise lack sufficient liquidity. Certain of these investments (not exceeding 40% of the net asset value of each Limited Partner's capital accounts, calculated at the time such investments are

designated, and with such investments valued at cost) may be designated special investments (each a "Special Investment") to be put into separate special investment sub-accounts ("Special Investment Sub-Accounts"). In addition, existing investments may be designated Special Investments and will be valued at their carry value when so designated. **Interests in a Special Investment Sub-Account are allocated *pro rata* to those investors that are Partners (defined below) at the time a Special Investment is made (or designated).**

The General Partner will not permit more than the greater of 50% of the Partnership's capital and 25% of the Partnership's total assets (on a cost basis, giving consideration to hedging techniques utilized) to be invested in a single investment. Moreover, it will not permit more than 10% of the Partnership's capital to be placed at risk in a single investment. The General Partner will have the discretion to determine how much is at risk for purposes of this test.

The General Partner intends, to the extent circumstances permit, to adopt a selective approach in evaluating potential investment situations, generally concentrating on relatively fewer transactions he can follow more closely. The General Partner expects to primarily engage in distressed and bankruptcy investing (including private equity investments) and risk and other arbitrage transactions (including capital structure arbitrage transactions). The General Partner expects to frequently use hedging devices and will engage in short sales. There can be no assurance that any of the hoped-for benefits of the foregoing approach will be realized. Moreover, the General Partner reserves the right to deviate from the foregoing approach to the extent he deems appropriate. To the extent that the Partnership trades in commodities and futures and related options, the Partnership will incur additional risks. Because of the low margin deposits normally required in futures trading, the same risks as those resulting from leverage described below will be particularly present. In addition, due to market and regulatory factors, commodities and futures and related options may be less liquid than other types of investments.

The General Partner reserves the right to alter or modify some or all of the Partnership's investment strategies in light of available investment opportunities to take advantage of changing market conditions, where the General Partner, in his sole discretion, concludes that such alterations or modifications are consistent with the goal of maximizing returns to investors, subject to what the General Partner considers an acceptable level of risk.

The Partnership will execute its trades through unaffiliated brokers, who may be selected on a basis other than that which will necessarily result in the lowest cost for each trade. Clearing, settlement and custodial services will be provided by one or more unaffiliated brokerage firms.

* * *

The descriptions contained herein of specific strategies that the Partnership may engage in should not be understood as in any way limiting the Partnership's investment activities. The Partnership may engage in investment strategies that are not described herein, but that General Partner considers appropriate.

The Partnership's investment program is speculative and may entail substantial risks. Since market risks are inherent in all investments to varying degrees,

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there can be no assurance that the Partnership's investment objectives will be achieved. In fact, certain investment practices described above can, in some circumstances, substantially increase the adverse impact on the Partnership's investment portfolios. (See "Certain Risk Factors").

THE GENERAL PARTNER AND THE MANAGEMENT COMPANY

J. Ezra Merkin will serve as the general partner of the Partnership (the "General Partner"). The General Partner has ultimate responsibility for the management, operations and investment decisions made on behalf of the Partnership.

Mr. Merkin is currently general partner of Ascot Partners, L.P. and is involved in managing several offshore funds, including Ariel Fund Limited. Mr. Merkin was formerly the General Partner of Ariel Capital, L.P. from January 1, 1989 until December 31, 1991. Prior to that, Mr. Merkin served as a Managing Partner of Gotham Capital, L.P., an investment partnership, from 1985 to 1988. Mr. Merkin was associated with Halcyon Investments from 1982 to 1985 and with the law firm of Milbank, Tweed, Hadley & McCloy from 1979 to 1982. Mr. Merkin graduated from Columbia College magna cum laude and is a member of Phi Beta Kappa. He is an honors graduate of Harvard Law School. Mr. Merkin currently serves as chairman of the investment committee of two private endowment funds.

Gabriel Capital Corporation, a Delaware corporation (the "Management Company"), provides administrative and managerial services to the Partnership. All of the outstanding capital stock of the Management Company is owned or controlled by J. Ezra Merkin.

THE INTERESTS

This Confidential Offering Memorandum relates to an offering of Class B limited partner interests in the Partnership (the "Interests") to certain investors that, if accepted, will become limited partners of the Partnership (each a "Limited Partner" or a "Class B Limited Partner"). The Partnership has issued Class A interests (the "Class A Interests") to investors (each, a "Class A Limited Partner", and together with the Class B Limited Partners and the General Partner, the "Partners"). Class A Interests have different redemption rights and less exposure to Special Investments than the Limited Partner Interests.

The minimum initial subscription is $1,000,000 for an Interest in the Partnership, subject to the discretion of the General Partner to accept lesser amounts. Limited Partners of the Partnership may make additional capital contributions in amounts of at least $250,000 with the consent of the General Partner and subject to his discretion to accept other amounts. Each capital contribution of a Limited Partner will be credited to such Limited Partner's capital account.

The General Partner may issue other classes of interests in the future that differ in terms of, among other things, rights, powers and duties, including rights, powers and duties senior to existing classes of Limited Partners. The General Partner may establish new classes of interests, and determine the terms of such classes, without approval of the existing Limited Partners.

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SALES CHARGES

There are no sales charges payable to the General Partner, or the Partnership in connection with the offering of Interests.

FISCAL YEAR

The fiscal year of the Partnership will end on December 31 of each calendar year.

SPECIAL INVESTMENT SUB-ACCOUNTS

The Partnership will establish a Special Investment Sub-Account for each investment that the General Partner deems a Special Investment. Only persons that are Partners at the time such Special Investment Sub-Account is established shall participate in such Special Investment Sub-Account and their respective interests therein shall be determined in accordance with their respective partnership percentages at the time such Special Investment Sub-Account is established. Any security position in a Special Investment Sub-Account shall not be considered to be a part of a Partner's capital account, except to the extent the investment or the proceeds of such Special Investment Sub-Account are reallocated to a Partner's capital account. Upon a sale, distribution to Partners or other disposition which shall constitute a "realization" of all or a portion of a Special Investment held in a Special Investment Sub-Account (including a determination by the General Partner, in his sole discretion, that such special investment should no longer be maintained in a Special Investment Sub-Account), the net proceeds of such investment will be allocated to the capital accounts of the Partners participating in such Special Investment Sub-Account in proportion to such Partners' participating percentages in such Special Investment Sub-Account.

In the event the Partnership makes an investment that the General Partner determines is a follow-up investment to a Special Investment held in a Special Investment Sub-Account (each a "Follow-Up Investment"), the participating Partners shall share in such Follow-Up Investment in proportion to their participating percentage interest in the related Special Investment Sub-Account; *provided, however*, that the General Partner, in his reasonable discretion, may permit additional Limited Partners to participate in such Follow-up Investment; *provided further, however*, that if a Limited Partner shall have withdrawn from the Partnership, the General Partner shall equitably adjust the participating percentage interests of the remaining participating Partners to reflect such Limited Partner's withdrawal and non-participation in the Follow-Up Investment. In its discretion, the General Partner need not designate as a "Follow-Up Investment" an additional investment in the same or similar opportunity as the investment for which a Special Investment Sub-Account has been established. Such investment may be designated as a new Special Investment.

Special Investments will generally be carried at cost (or, in the case of assets previously acquired, at carrying value upon designation). Other assets and liabilities for which no such market prices are available will be assigned such value as the General Partner may reasonably determine. All other assets and liabilities of the Partnership (except goodwill) will be assigned such value as the General Partner may reasonably determine.

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ALLOCATIONS OF GAINS AND LOSSES; INCENTIVE ALLOCATION

Partnership loss for each accounting period will be allocated among the Partners in proportion to the balance in their respective capital accounts at the start of such period. At the end of each accounting period, each Partner's capital account will be increased proportionately to reflect Partnership income for each accounting period (including any increase reflecting such Partner's share of cash or value of securities or proceeds transferred from a Special Investment Sub-Account to the Partner's capital account (based upon its *pro rata* interest in such Special Investment Sub-Account) and decreased by the cash or value of securities transferred from such Partner's capital account to a Special Investment Sub-Account). Income and loss for this purpose will include unrealized appreciation and depreciation on investments (other than unrealized appreciation or depreciation in a Special Investment Sub-Account).

Each Limited Partner's share of the Partnership's net income in excess of the Management Fee (defined below) for the accounting periods to date during that year (including any income or loss realized on investments previously held in Special Investment Sub-Accounts) will be allocated 20% to the General Partner (or to a designee as he shall direct) and 80% to such Limited Partner (the "Incentive Allocation"). Similar allocations will be made with respect to a Limited Partner's capital account at the time such Limited Partner withdraws capital from the Partnership. There is no "high water mark" concept in the calculation of Incentive Allocation. At his discretion, the General Partner may waive the allocations described above with respect to any particular Limited Partner.

Whenever income or loss is realized (or deemed realized) in a Special Investment Sub-Account, such income or loss will be allocated to all Partners having an interest in such account *pro rata* in proportion to their interest in such account, and then transferred to such Partner's regular capital account at the end of the accounting period. Notwithstanding the foregoing, if a Limited Partner withdraws all or substantially all of its capital account (becoming a "Withdrawn Limited Partner") before the realization (as described herein) of that portion of his capital allocated to a Special Investment Sub-Account, income realized or deemed realized subsequent to withdrawal will be allocated 20% to the General Partner (or to a designee as it shall direct) and 80% to such Withdrawn Limited Partner.

MANAGEMENT FEE; EXPENSES

Management Fee

On the last business day of each fiscal year of the Partnership and upon dissolution, an amount equal to 1% (prorated for periods of less than a year) of each Limited Partner's capital account balance at the beginning of such year plus such Partner's contributed capital during such year (including all amounts allocated to a Special Investment Sub-Account) will be charged against such Limited Partner's capital account and paid to the General Partner as a management fee (the "Management Fee"). At his discretion, the General Partner may waive the fees described above with respect to any particular Limited Partner.

Partnership Expenses

The Partnership shall (i) pay, or cause to be paid, all costs, fees, operating expenses and other expenses of the Partnership (including the costs, fees and expenses of

attorneys, accountants or other professionals and the compensation of all personnel providing services to the Partnership, including, in the discretion of the General Partner, the General Partner) incurred in organizing the Partnership and in pursuing and conducting, or otherwise related to, the activities of the Partnership, and (ii) reimburse the General Partner for any out-of-pocket costs, fees and expenses incurred by him in connection therewith. The amount of any costs, fees and expenses incurred in connection with the purchase, sale or carrying of any security, including, but not limited to, brokerage and other transaction costs and margin interest expenses will be paid by the Partnership. Notwithstanding the foregoing, any investment expense relating specifically to a Special Investment Sub-Account will be charged against the capital accounts of the Partners participating in such Special Investment Sub-Account in proportion to their respective participating percentage interests therein.

In addition, the Partnership is responsible for certain expenses of the General Partner, including, but not limited to, rent and salaries of personnel. Historically, such expenses have not exceeded 1% of the Partnership's net assets, however, there can be no assurance that this will continue to be true in the future.

If any of the above expenses are incurred jointly for the account of the Partnership and any other investment funds or trading accounts sponsored or managed by the General Partner or his affiliates, such expenses will be allocated to the Partnership and such other funds or accounts in a manner as the General Partner considers fair and reasonable.

CERTAIN RISK FACTORS

PARTICIPATION BY INVESTORS IN THE PARTNERSHIP SHOULD BE CONSIDERED A HIGH RISK INVESTMENT. THE FOLLOWING SPECIAL CONSIDERATIONS AND RISKS TOGETHER WITH OTHER MATTERS SET FORTH ELSEWHERE IN THIS CONFIDENTIAL OFFERING MEMORANDUM SHOULD BE CONSIDERED CAREFULLY, BUT ARE NOT INTENDED TO BE AN EXHAUSTIVE LISTING OF ALL POTENTIAL RISKS ASSOCIATED WITH AN INVESTMENT IN THE PARTNERSHIP.

The Nature of Transactions Involving Reorganizations. The Partnership will purchase securities and other instruments at a discount to their expected value upon consummation of an announced or anticipated reorganization. Such purchases may be made at prices which are only slightly below such expected value but are substantially in excess of the market price of the securities or other instruments prior to the announcement of the reorganization. In addition, if the Partnership determines that the offer price for a security which is the subject of a tender offer is likely to be increased, either by the original bidder or by another party, the Partnership may purchase securities above the offer price; such purchases are subject to a high degree of risk. As a result, if the reorganization is not consummated or is delayed, the value of such securities or other instruments may decline significantly and the Partnership may sell them at a loss. In addition, if the ultimate value of the cash and/or securities distributed upon consummation of the reorganization is less than expected, the Partnership may realize a loss. The potential for loss may be increased by the Partnership's use of borrowings to purchase securities or other instruments.

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No proposed reorganization is certain to be consummated. There are several factors which may result in the termination of a reorganization. These include opposition by the management or shareholders of the company or companies involved in the reorganization; opposition by regulatory agencies whose approval may be required; litigation; a material adverse change in the business of the company or companies involved in the reorganization or the securities markets generally; passage of legislation by governmental entities restricting certain types of reorganizations; and other circumstances, including, but not limited to, the failure to meet certain conditions customarily specified in acquisition agreements. These factors may also cause significant delays, during which the Partnership's capital will be committed and interest charges on any funds borrowed to finance the Partnership's investments may be incurred.

The Partnership may also make certain speculative purchases and sales of securities. Such purchases and sales may include securities which the General Partner believes to be undervalued or overvalued, as the case may be, or where other companies in the same or a related industry have been the subject of reorganizations. If the Partnership purchases securities in anticipation of a reorganization, and a reorganization does not in fact occur, the Partnership may sell the securities at a material loss. Further, when securities are purchased in anticipation of a reorganization, a substantial period of time may elapse between the Partnership's purchase of the securities and the reorganization. During this period, a portion of the Partnership's capital would be committed to the securities purchased, and the Partnership may finance such purchases with borrowed funds on which it will have to pay interest.

The General Partner will attempt to assess risk in determining the nature and extent of the investment the Fund will make in specific securities. However, many risks cannot be quantified.

Non-marketable Obligations. Non-marketable obligations include promissory notes and other evidences of ownership or indebtedness, as well as payables to trade creditors of distressed companies and companies in Chapter 11 bankruptcy proceedings. These securities and instruments ordinarily remain unpaid unless and until the company reorganizes and/or emerges from Chapter 11. There can be no assurance that a reorganization plan favorable to the class of securities held by the Partnership will be adopted or that the subject company might not eventually be liquidated rather than reorganized. These obligations may be highly speculative and may have to be held for an extended period of time. The ultimate value realized upon redemption of such obligations depends upon the recapitalization or reorganization plan adopted in Chapter 11. There can be no assurance that the cash and/or securities, if any, ultimately received in redemption of the obligations will equal the Partnership's cost. In a Chapter 11 proceeding, there can be considerable delay in reaching accord on a restructuring plan acceptable to a bankrupt company's lenders, bondholders and other creditors and then getting that plan approved by the bankruptcy court, and during this period a portion of the Partnership's capital would be invested in the non-marketable obligations purchased, and the Partnership may finance such purchases with borrowed funds on which it will have to pay interest. Furthermore, there is a risk that the Chapter 11 reorganization will be unsuccessful and that the obligations will become worthless.

Arbitrage Transactions. The Partnership may purchase securities at prices often only slightly below the anticipated value to be paid or exchanged for such securities in a merger, exchange offer or cash tender offer which the Partnership determines is probable and

substantially above the prices at which such securities traded immediately prior to announcement of the merger, exchange offer or cash tender offer. If the proposed transaction appears likely not to be consummated or in fact is not consummated or is delayed, the market price of the security to be tendered or exchanged may be expected to decline sharply, which would result in a loss to the Partnership. Moreover, where a security to be issued in a merger or exchange offer has been sold short as a hedge in the expectation that the short position will be covered by delivery of such security when issued, failure of the merger or exchange offer to be consummated may force an arbitrageur to cover his short position in the market at a higher price than his short sale, with a resulting loss.

The consummation of mergers and tender and exchange offers can be prevented or delayed by a variety of factors, the likelihood of occurrence of which can be very difficult to evaluate. A tender or exchange offer by one company for the securities of another will often be opposed by the management or shareholders of the target company on the grounds that the consideration offered is inadequate or for a variety of other reasons. Even where a merger or tender or exchange offer has been agreed upon by the management of the two companies involved, its consummation may be prevented or delayed by intervention of a government regulatory agency; a shareholder's suit to enjoin the proposed transaction; in the case of a merger, the failure of the shareholders of the company to be acquired, and, where necessary, the acquiring company, to approve the merger; market conditions resulting in material changes in securities prices; and a variety of other circumstances. In case of a tender or exchange offer made for less than all outstanding securities of an issue with the provision that, if a greater number is tendered, securities will be accepted pro rata, a tendering arbitrageur may have returned to him, and be forced to sell at a loss, a portion of the securities tendered.

Other Transactions. The Partnership may also make certain purchases of securities as to which no extraordinary corporate transaction has been announced. Such purchases may include securities which the General Partner believes to be undervalued, or where a significant position in the securities of the particular company has been taken by one or more other persons or where other companies in the same or a related industry have been the subject of acquisition attempts. If the Partnership purchases securities in anticipation of an acquisition attempt or reorganization, and an acquisition attempt or reorganization does not in fact occur, the Partnership may sell the securities at a substantial loss. Further, when securities are purchased in anticipation of an acquisition attempt or reorganization, a substantial period of time may elapse between the Partnership's purchase of the securities and the acquisition attempt or reorganization. During this period, a portion of the Partnership's capital would be committed to the securities purchased, and the Partnership may finance such purchases with borrowed funds on which it will have to pay interest.

Proxy Contests. The Partnership may invest in securities of a company which is the subject of a proxy contest in the expectation that new management will be able to improve the company's performance or effect a sale or liquidation of its assets so that the price of the subject company's securities will increase to a price above that paid for the securities by the Partnership. If the incumbent management of the subject company is not defeated or if new management is unable to improve the company's performance or sell or liquidate the company, the market price of the securities of the subject company will typically fall to a price below that paid for the securities by the Partnership, causing the Partnership to suffer a loss. In addition,

even upon the successful completion of a proxy contest, the market price of the securities of the subject company may not rise to a price above that paid for the securities by the Partnership.

Options Transactions. The Partnership may engage from time to time in various types of options transactions, including hedging and arbitrage in options on securities. This activity is designed to reduce the risks attendant in short-selling and in taking long positions in certain transactions and may involve stock options on a registered option exchange and offsetting transactions in the underlying stock, or offsetting transactions in one or more options for stock. The Partnership also may take positions in options on stock of companies which may, in the judgment of the General Partner, be potential acquisition candidates in merger, exchange offer or cash tender offer transactions. If the potential acquisition candidate does not become the subject of a merger, exchange offer or cash tender offer, the Partnership may suffer a loss.

When the Partnership purchases an option, it must pay the price of the option and transaction charges to the broker effecting the transaction. If the option is exercised by the Partnership, the total cost of exercising the option may be more than the brokerage costs which would have been payable had the underlying security been purchased directly. If the option expires, the Partnership will lose the cost of the option. The ability to trade in or exercise options may be restricted in the event that trading in the underlying issue becomes restricted. Options trading may also be illiquid with respect to contracts with extended expirations.

In certain transactions the Partnership may not be "hedged" against market fluctuations or, in liquidation situations, the hedge may not accurately value the assets of the company being liquidated. This can result in losses, even if the proposed transaction is consummated.

Futures Contracts. The value of futures depends upon the price of the instruments, such as commodities, underlying them. The prices of futures are highly volatile, and price movements of futures contracts can be influenced by, among other things, interest rates, changing supply and demand relationships, trade, fiscal, monetary and exchange control programs and policies of governments, and national and international political and economic events and policies. In addition, investments in futures are also subject to the risk of the failure of any of the exchanges on which the Partnership's positions trade or of its clearinghouses or counterparties.

Futures positions may be illiquid because certain commodity exchanges limit fluctuations in certain futures contract prices during a single day by regulations referred to as "daily price fluctuation limits" or "daily limits." Under such daily limits, during a single trading day no trades may be executed at prices beyond the daily limits. Once the price of a particular futures contract has increased or decreased by an amount equal to the daily limit, positions in that contract can neither be taken nor liquidated unless traders are willing to effect trades at or within the limit. This could prevent the Partnership from promptly liquidating unfavorable positions and subject the Partnership to substantial losses or from entering into desired trades. In extraordinary circumstances, a futures exchange or the CFTC could suspend trading in a particular futures contract, or order liquidation or settlement of all open positions in such contract.

Forward Trading. Forward contracts and options thereon, unlike futures contracts, are not traded on exchanges and are not standardized; rather, banks and dealers act as principals in these markets, negotiating each transaction on an individual basis. Forward and "cash" trading is substantially unregulated; there is no limitation on daily price movements and speculative position limits are not applicable. The principals who deal in the forward markets are not required to continue to make markets in the currencies or commodities they trade, and these markets can experience periods of illiquidity, sometimes of significant duration. There have been periods during which certain participants in these markets have refused to quote prices for certain currencies or commodities or have quoted prices with an unusually wide spread between the price at which they were prepared to buy and that at which they were prepared to sell. Disruptions can occur in forward markets due to unusually high trading volume, political intervention or other factors. The imposition of controls by governmental authorities might also limit such forward (and futures) trading to less than that which the General Partner would otherwise recommend, to the possible detriment of the Partnership. Market illiquidity or disruption could result in significant losses to the Partnership.

Participation in Unfriendly Transactions. The Partnership may seek to initiate acquisition or restructuring transactions or proxy fights against the wishes of the subject company's management, or may actively participate in transactions of this sort initiated by others. Such transactions typically become embroiled in litigation, and participants therein may be found to have violated any of the many laws and regulations applicable thereto. This could impose substantial cost and expense (including litigation expense) on the Partnership, and subject it to various legal remedies such as injunctions against future participation in these transactions, disgorgement of gains, loss of voting rights or forced disposition of the investment. Participation in such transactions may also require the Partnership to make significant disclosure concerning its operations.

Short Selling. Short selling involves selling securities which are not owned by the short seller and borrowing them for delivery to the purchaser, with an obligation to replace the borrowed securities at a later date. Short selling allows the investor to profit from a decline in market price to the extent such decline exceeds the transaction costs and the costs of borrowing the securities. The extent to which the Partnership engages in short sales will depend upon the General Partner's investment strategy and opportunities. A short sale creates the risk of a theoretically unlimited loss, in that the price of the underlying security could theoretically increase without limit, thus increasing the cost to the Partnership of buying those securities to cover the short position. There can be no assurance that the Partnership will be able to maintain the ability to borrow securities sold short. In such cases, the Partnerhsip can be "bought in" (*i.e.*, forced to repurchase securities in the open market to return to the lender). There also can be no assurance that the securities necessary to cover a short position will be available for purchase at or near prices quoted in the market. Purchasing securities to close out a short position can itself cause the price of the securities to rise further, thereby exacerbating the loss.

Market Risk and Lack of Diversification. Substantial risks are involved in the acquisition or disposition of securities. Securities and their issuers are affected by, among other things: changing supply and demand; federal, state and governmental laws, regulations and enforcement activities; trade, fiscal and monetary programs and policies; and national and international political and economic developments. The concentration of assets in particular types of investments could subject the assets of the Partnership to increased volatility. The

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Partnership's investment plan does not constitute a balanced investment plan. The securities in which the Partnership may invest may be regarded as of high risk. Such securities are subject to a number of risk factors, including market volatility, creditworthiness of the issuer, liquidity of the secondary trading market, and availability of market quotations.

Leverage. The Partnership's anticipated use of short-term margin borrowings, investment in derivative securities and the use of repurchase agreements create certain risks to the Partnership. The use of leverage may increase the Partnership's risk of loss of capital or securities, as a relatively small price movement in an instrument may result in immediate and substantial loss. For example, should the securities pledged to brokers to secure the Partnership's margin accounts decline in value, the Partnership could be subject to a "margin call," pursuant to which the Partnership must either deposit additional funds with the broker or suffer mandatory liquidation of the pledged securities to compensate for the decline in value. In the event of a sudden, precipitous drop in value of the Partnership's assets occasioned by a market "crash" such as the one that took place in October 1987, the Partnership might not be able to liquidate assets quickly enough to pay off its margin debt. Consequently, fluctuations in the value of the Partnership's portfolio will have a significant effect in relation to the Partnership's capital. Although currently the Partnership utilizes leverage from time to time, as investment opportunities change (e.g., arbitrage opportunities increase) the amount of borrowings which the Partnership may have outstanding at any time may be large in relation to its capital. In addition, the level of interest rates generally, and the rates at which the Partnership can borrow in particular, will be an expense of the Partnership and therefore affect the operating results of the Partnership.

Derivatives. Derivative securities, in addition to being highly volatile and speculative, may be internally leveraged such that each percentage change in Interest rates will have a multiple effect on the derivative security. Certain positions therefore may be subject to wide and sudden fluctuations in market value, with a resulting fluctuation in the amount of profits and losses. Certain transactions in derivatives may expose the Partnership to potential losses that exceed the amount originally invested by the Partnership. Repurchase agreements are structured so that the Partnership sells securities to another party, usually a bank or other securities firm, and agrees to repurchase them at an agreed upon price and date. A repurchase agreement is the equivalent of borrowing money and pledging securities as collateral.

Risks of Litigation. Investing in distressed securities can be a contentious and adversarial process. Different investor groups may have qualitatively different, and frequently conflicting, interests. The Partnership's investment activities may include activities that are hostile in nature and will subject it to the risks of becoming involved in litigation by third-parties. This risk may be greater where the Partnership exercises control or significant influence over a company's direction. The expense of defending against claims against the Partnership by third-parties and paying any amounts pursuant to settlements or judgments would be borne by the Partnership and would reduce net assets. The General Partner will be indemnified by the Partnership in connection with such litigation, subject to certain conditions.

Lending of Portfolio Securities. The Partnership may from time to time lend securities from its portfolio to brokers, dealers and financial institutions such as banks and trust companies. The borrower may fail to return the securities involved in such transactions,

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particularly if such borrower is in financial distress, in which event the Partnership may incur a loss.

Portfolio Turnover. The Partnership currently does not have high portfolio turnover, however, to the extent certain strategies become a larger part of the Partnership's investment strategy (e.g., arbitrage strategies), portfolio turnover may be high. Typically, high portfolio turnover results in correspondingly high transaction costs, including brokerage commission expenses.

Overall Investment Risk. All securities investments risk the loss of capital. The nature of the securities to be purchased and traded by the Partnership and the investment techniques and strategies to be employed by it may increase such risk. Moreover, the identification of investment opportunities is a difficult task, and there can be no assurance that such opportunities will be successfully recognized by the Partnership. While the General Partner will devote his best efforts to the management of the Partnership's portfolio, there can be no assurance that the Partnership will not incur losses. Returns generated from the Partnership's investments may not adequately compensate Limited Partners for the business and financial risks assumed. A Limited Partner should be aware that it may lose all or a substantial part of its investment in the Partnership. Many unforeseeable events, including actions by various government agencies and domestic and international economic and political developments, may cause sharp market fluctuations that could adversely affect the Partnership's portfolio and performance.

Liquidity of Investments. The Partnership may invest in unregistered securities of publicly held companies, securities of privately held companies and other illiquid securities. Such investments may be difficult to value. They may, by their nature, entail a prolonged investment horizon from the initial investment date to final disposition. It may not be possible to sell such securities on short notice and, if possible, such sales may require substantial discounts. Certain of these investments may be designated Special Investments (as defined herein).

Currency Exchange Exposure. The Partnership may invest a portion of its assets in the securities of non-U.S. issuers and other instruments denominated in non-U.S. currencies, the prices of which are determined with reference to currencies other than the U.S. dollar. The Partnership, however, values its securities and other assets in U.S. dollars. The Partnership may or may not seek to hedge its non-U.S. currency exposure by entering into currency hedging transactions, such as treasury locks, forward contracts and futures contracts. There can be no guarantee that instruments suitable for hedging currency or market shifts will be available at the time when the Partnership wishes to use them, or that hedging techniques employed by the Partnership will be effective. Furthermore, certain currency market risks may not be fully hedged or hedged at all.

To the extent unhedged, the value of the Partnership's positions in non-U.S. investments will fluctuate with U.S. dollar exchange rates as well as the price changes of the investments in the various local markets and currencies. In such cases, an increase in the value of the U.S. dollar compared to the other currencies in which the Partnership makes its investments will reduce the effect of any increases and magnify the effect of any decreases in the prices of the Partnership's securities in their local markets and may result in a loss to the

Partnership. Conversely, a decrease in the value of the U.S. dollar will have the opposite effect on the Partnership's non-U.S. dollar investments.

Non-U.S. Investments. The Partnership may invest in financial instruments of non-U.S. corporations and governments. Investing in the financial instruments of companies (and, from time to time, governments) outside of the U.S. involves certain considerations not usually associated with investing in financial instruments of U.S. companies or the U.S. Government, including political and economic considerations, such as greater risks of expropriation, nationalization, confiscatory taxation, imposition of withholding and other taxes on interest, dividends, capital gains and other income, limitations on the removal of assets and general social, political and economic instability; the relatively small size of the securities markets in such countries and the low volume of trading, resulting in potential lack of liquidity and in price volatility; the evolving and unsophisticated laws and regulations applicable to the securities and financial services industries of certain countries; fluctuations in the rate of exchange between currencies and costs associated with currency conversion; and certain government policies that may restrict the Partnership's investment opportunities. In addition, accounting and financial reporting standards that prevail outside of the U.S. generally are not as high as U.S. standards and, consequently, less information is typically available concerning companies located outside of the U.S. than for those located in the U.S. As a result, the Partnership may be unable to structure its transactions to achieve the intended results or to mitigate all risks associated with such markets. It may also be difficult to enforce the Partnership's rights in such markets. For example, financial instruments traded on non-U.S. exchanges and the non-U.S. persons that trade these instruments are not subject to the jurisdiction of the Securities and Exchange Commission or Commodity Futures Trading Commission or the securities and commodities laws and regulations of the U.S. Accordingly, the protections accorded to the Partnership under such laws and regulations are unavailable for transactions on foreign exchanges and with foreign counterparties.

Counterparty Risk. Some of the markets in which the Partnership may effect transactions are "over-the-counter" or "interdealer" markets. The participants in such markets are typically not subject to the same credit evaluation and regulatory oversight as are members of "exchange-based" markets. In addition, many of the protections afforded to participants on some organized exchanges, such as the performance guarantee of an exchange clearinghouse, might not be available in connection with such "over-the-counter" transactions. This exposes the Partnership to the risk that a counterparty will not settle a transaction in accordance with its terms and conditions because of a dispute over the terms of the contract (whether or not *bona fide*) or because of a credit or liquidity problem, thus causing the Partnership to suffer a loss. Such "counterparty risk" is accentuated for contracts with longer maturities where events may intervene to prevent settlement, or where the Partnership has concentrated its transactions with a single or small group of counterparties. The General Partner is not restricted from dealing with any particular counterparty or from concentrating any or all of the Partnership's transactions with one counterparty. Moreover, the General Partner has no formal credit function which evaluates the creditworthiness of the Partnership's counterparties. The ability of the Partnership to transact business with any one or number of counterparties, the lack of any meaningful and independent evaluation of such counterparties' financial capabilities and the absence of a regulated market to facilitate settlement may increase the potential for losses by the Partnership.

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In addition, the counterparties with which the Partnership effects transactions may, from time to time, cease making markets or quoting prices in certain of the instruments. In such instances, the Partnership may be unable to enter into a desired transaction in currencies, or to enter into an offsetting transaction with respect to an open position, which might adversely affect its performance. Further, in contrast to exchange-traded instruments, forward, spot and option contracts on currencies do not provide a trader with the right to offset its obligations through an equal and opposite transaction. For this reason, in entering into forward, spot or options contracts, the Partnership may be required, and must be able, to perform its obligations under the contract.

The Partnership

Limited Liquidity. An investment in the Partnership provides limited liquidity since Interests in the Partnership are not freely transferable and the withdrawal rights of holders of the Interests are restricted. A Limited Partner may not withdraw any portion of its capital account that is allocated to a Special Investment Sub-Account, unless otherwise determined by the General Partner. A Limited Partner will retain its interest in any Special Investment Sub-Account until the realization or deemed realization of the Special Investment relating to such Special Investment Sub-Account. Because the Partnership may invest up to 40% of the net asset value of each Limited Partner's capital accounts in Special Investments, a Limited Partner may only be able to withdraw a portion of its capital account(s) for an indefinite period of time.

Effect of Limited Partner Withdrawal. A significant withdrawal of capital from the Partnership may cause a temporary imbalance in the Partnership's portfolio which may adversely affect the remaining Limited Partners.

Valuation of the Partnership's Assets. All securities, liabilities and other property will be assigned such values as the General Partner reasonably determines to be their fair market value and such values will be binding upon the Partners; provided that in the event a majority in interest of the Class A Limited Partners does not agree with any such determination, such disagreement will be submitted for resolution to a firm of independent certified public accountants (other than the partnership's auditors) which will be mutually agreed upon by the General Partner and the majority in interest of the Class A Limited Partners. Any determination made by such firm of independent certified public accountants will be final and binding upon the General Partner and Class A Limited Partners.

Required Withdrawals. The General Partner may cause any Limited Partner to withdraw from the Partnership in whole or in part. The withdrawal of such Limited Partner will be effective as of the date specified in such notice, which date shall not be less than 30 days after the date such notice is given. Such mandatory withdrawal may create adverse tax and/or economic consequences to the Limited Partner depending on the timing thereof in respect of the Partnership and the Limited Partner.

Layering of Fees. The Partnership may invest in Other Investment Entities. To the extent the Partnership invests in such Other Investment Entities, Limited Partners may be subject to management fees, incentive fees or allocations and expenses at both the level of the Partnership and the level of the underlying Other Investment Entities.

Reports to Limited Partners. The Partnership may offer certain Limited Partners additional information and reporting that other Limited Partners may not receive, and such information may affect a Limited Partner's decision to request a withdrawal of its Interests.

Competition. The securities industry generally, and the business of investing in reorganization related securities or instruments in particular, is extremely competitive, and is expected to remain so in the foreseeable future. As a result, the Partnership may under perform funds with similar investment strategies, or the market in general.

Success Dependent on General Partner. The success of the Partnership depends primarily upon the General Partner. The death or incapacity of J. Ezra Merkin would result in the dissolution Of the Partnership.

Incentive Allocation. The Incentive Allocation to the General Partner may create an incentive for the General Partner to cause the Partnership to make investments that are riskier or more speculative than would be the case in the absence of the Incentive Allocation. In addition, because the Incentive Allocation is calculated on a basis that includes unrealized appreciation of the Partnership's assets, it may be greater than if such allocation were based solely on realized gains. There is no "high water mark" concept in the calculation of Incentive Allocation.

In-Kind Distributions. A withdrawing Limited Partner may, at the sole and absolute discretion of the General Partner, receive property other than cash. Any investments distributed in-kind may not be readily marketable or saleable and may have to be held by such Limited Partner for an indefinite period of time.

Independent Money Managers. The General Partner may delegate investment discretion for all or a portion of the Partnership's funds to money managers, other than the General Partner, or make investments with Other Investment Entities. Although the General Partner will exercise reasonable care in selecting such independent money managers or Other Investment Entities and will monitor the results of those money managers and Other Investment Entities, the General Partner may not have custody over the funds invested with the other money managers or with Other Investment Entities. The risk of loss of the funds invested with other money managers or with Other Investment Entities may not be insured by any insurance company, bonding company, governmental agency, or other entity and the General Partner is not liable for any such loss. Independent money managers and managers of Other Investment Entities selected by the General Partner may receive compensation based on the performance of their investments as well as asset-based management fees. Performance-based compensation usually is calculated on a basis which includes unrealized appreciation of the Partnership's assets, and may be greater than if such compensation were based solely on realized gains. Further, a particular independent money manager or manager of an Other Investment Entity may receive incentive compensation in respect of its portfolio for a period even though the Partnership's overall portfolio depreciated during such period. The independent money managers and Other Investment Entities will trade wholly independently of one another and may at times hold economically offsetting positions.

Indemnification of the General Partner from Liability. The Partnership Agreement provides that the General Partner will not be liable for, and will be indemnified by

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the Partnership against, any act or omission if such act or omission is not the result of bad faith, gross negligence, recklessness, fraud or intentional misconduct. Such indemnification, however, shall not relieve the General Partner or his legal representative of any liability, to the extent that such liability may not be waived, modified or limited under applicable law (including, without limitation, liability under U.S. federal securities laws which, under certain circumstances, impose liability even on persons acting in good faith).

Other Activities. In addition to managing the Partnership, the General Partner will manage other funds and managed accounts, which may have similar investment objectives to the Partnership. The General Partner will allocate overhead expenses among the Partnership and the managed accounts on a fair basis, as determined by the General Partner. These other activities will require a substantial amount of the General Partner's time and effort.

Statutory Regulations and Non-Registration. The financial services industry generally, and the activities of hedge funds and their managers, in particular, have been subject to intense and increasing regulatory scrutiny. Such scrutiny may increase the Partnership's and the Management Company's exposure to potential liabilities and to legal, compliance and other related costs. Increased regulatory oversight can also impose administrative burdens on the Management Company, including, without limitation, responding to investigations and implementing new policies and procedures. Such burdens may divert the Management Company's time, attention and resources from portfolio management activities.

Liability for Return of Distributions. Under Delaware law, any Limited Partner who receives a distribution from the Partnership shall be liable to the Partnership for the amount of the distribution to the extent such amount was distributed at a time that the liabilities of the Partnership exceeded the fair value of its assets and the Limited Partner knew of the state of the Partnership's financial condition at the time of such distribution. Under Delaware law, a Limited Partner that receives a distribution from the Partnership will have no liability for the amount of the distribution after the expiration of three years from the date of the distribution.

Tax and Other Risks. Although the General Partner believes that the Partnership will be treated as a partnership for federal income tax purposes, no ruling has been, or will be, obtained from the Internal Revenue Service, to that effect and no opinion of counsel has been sought. If the Partnership is taxed not as a partnership but as a corporation it will, among other things, have to pay income tax on its earnings in the same manner and at the same rates as a corporation, and Partners would be subject to an additional tax on earnings distributed. If the Partnership is treated as a Partnership for U.S. federal tax purposes, Partners will be taxed on the Partnership's taxable income whether or not it is distributed. The General Partner does not intend to make distributions to the Limited Partners that reflect the taxable income of the Partnership and is not required to make any distributions except upon the withdrawal of capital by a Partner pursuant to the Partnership Agreement. Furthermore, a Limited Partner who withdraws capital from the Partnership in accordance with the Partnership Agreement may receive the amount so withdrawn in kind. Accordingly, in either such event, a Limited Partner may not receive sufficient liquid assets to pay income taxes attributable to his distributive share of Partnership income. Thus, Limited Partners may have to rely upon resources independent of their Interests to pay their obligations to the federal, state and local tax authorities.

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Factors Affecting Investments. There are a number of factors which may adversely affect the ability of the Partnership to pursue its investment strategy. There is a limited availability of debt financing for takeovers of highly leveraged companies. Mergers of a certain size require approval of the U.S. Federal Trade Commission (the "FTC") or other government agencies because of potential antitrust implications. It is possible at any time for the FTC or other governmental agency to more vigorously enforce the antitrust laws affecting mergers. In addition, there are state laws aimed at curbing takeovers and courts have given management greater authority to employ defensive measures in the face of hostile takeover attempts where management believes doing so is in the long-term interests of the company. Many companies generally have adopted various measures aimed at making takeovers more difficult and expensive. Similarly, changing economic conditions, accounting standards and tax and securities laws (among other factors) may impair the profitability of the types of transactions in which the Partnership intends to invest, adversely affecting its operations.

Terrorist Action. There is a risk of terrorist attacks on the United States and elsewhere causing significant loss of life and property damage and disruptions in global markets. Economic and diplomatic sanctions may be in place or imposed on certain states and military action may be commenced. The impact of such events is unclear, but could have a material effect on general economic conditions and market liquidity.

PAST RESULTS MAY NOT BE INDICATIVE OF FUTURE PERFORMANCE. NO ASSURANCE CAN BE MADE THAT PROFITS WILL BE ACHIEVED OR THAT SUBSTANTIAL LOSSES WILL NOT BE INCURRED.

The foregoing list of risk factors does not purport to be a complete enumeration or explanation of the risks involved in an investment in the Partnership. Prospective investors should read this entire Confidential Offering Memorandum and consult with their own legal, tax and financial advisers before deciding to invest in the Partnership.

CONFLICTS OF INTEREST

The General Partner and his affiliates will provide investment management services to managed accounts and other investment partnerships or funds, some of which may have similar investment objectives to those of the Partnership. The portfolio strategies the General Partner and his affiliates may use for other investment funds or accounts could conflict with the transactions and strategies employed by the General Partner in managing the Partnership and affect the prices and availability of the securities and other financial instruments in which the Partnership invest.

The General Partner has agreed to devote substantially his entire time and effort during normal business hours to the management of the Partnership and other investment entities managed by the Managing Partner, or their respective successors; provided, however, that the General Partner may act, consistent, however, with the foregoing, as a director, officer or employee of any corporation (including any corporation in which the Partnership is invested), a trustee of any trust, an executor or administrator of any estate, a partner of any partnership (including a partnership in which the Partnership is invested) or an administrative official of any other business entity, and may receive compensation and participate in profits in connection with

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any of the foregoing, and may trade in securities for his own account or for other accounts for investors including securities which are the same or different from those traded in or held by the Partnership. The terms of the Partnership Agreement do not restrict the General Partner or his affiliates from forming additional investment funds, from entering into other investment advisory relationships, or from engaging in other business activities, even though such activities may be in competition with the Partnership and/or may involve substantial time and resources of the General Partner or his affiliates. In the event the General Partner or any of his affiliates decide to engage in such activities in the future, the General Partner or his affiliates, as applicable, will undertake to engage in such activities in a manner that is consistent with their fiduciary duties, to the Partnership. Nevertheless, these activities could be viewed as creating a conflict of interest in that the time and effort of the General Partner and his affiliates will not be devoted exclusively to the business of the Partnership but will be allocated between the business of the Partnership and the management of the monies of other advisees of the General Partner and his affiliates.

When it is determined that it would be appropriate for the Partnership and one or more other funds and managed accounts managed of the General Partner or his affiliates to participate in an investment opportunity, the General Partner will seek to execute orders for all of the participating investment accounts, including the Partnership, on an equitable basis, taking into account such factors as the relative amounts of capital available for new investments, relative exposure to short-term market trends, and the investment programs and portfolio positions of the Partnership and the affiliated entities for which participation is appropriate. Orders may be combined for all such accounts, and if any order is not filled at the same price, they may be allocated on an average price basis. Similarly, if an order on behalf of more than one account cannot be fully executed under prevailing market conditions, securities may be allocated among the different accounts on a basis that the General Partner considers equitable.

The General Partner may share office space with third-party money managers. If the managers were to acquire inside information with respect to certain securities, the Partnership will be precluded from purchasing securities to which such inside information relates or be precluded from selling securities held by the Partnership that were purchased before the inside information was acquired.

Subject to internal compliance policies and approval procedures, the General Partner and his employees as well as members and employees of his affiliates, may engage, from time to time, in personal trading of securities and other instruments, including securities and instruments in which the Partnerships may invest. Any such trading will be either effected after the Partnerships have effected their transactions.

BROKERAGE COMMISSIONS

Portfolio transactions for the Partnership will be allocated to brokers on the basis of best execution and in consideration of a broker's ability to effect the transactions, its facilities, reliability and financial responsibility and the provision or payment by the broker of the costs of research and research-related services which are of benefit to the Partnership, the General Partner or related funds and accounts. Accordingly, the commission rates (or dealer markups and markdowns arising in connection with riskless principal transactions) charged to the Partnership by brokers in the foregoing circumstances may be higher than those charged by other

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brokers who may not offer such services. The General Partner has not entered into, and does not expect to enter into, any written soft dollar arrangements.

Investors in the Partnership may include fund of funds affiliated with brokers or, possibly, brokerage firms themselves. The fact that any such investor has invested in the Partnership will not be taken into consideration in selecting brokers (including prime brokers).

The Partnership's securities transactions can be expected to generate a substantial amount of brokerage commissions and other compensation, all of which the Partnership, not the General Partner or the Management Company, will be obligated to pay. The General Partner will have complete discretion in deciding what brokers and dealers the Partnership will use and in negotiating the rates of compensation the Partnership will pay.

Morgan Stanley & Co., Inc. (the "Prime Broker") currently serves as the principal prime broker for the Partnership, and clears (generally on the basis of payment against delivery) the Partnership's securities transactions that are effected through other brokerage firms. The Partnership is not committed to continue its relationship with the Prime Broker for any minimum period and the General Partner may select other or additional brokers to act as prime brokers for the Partnership.

From time to time, brokers (including the Prime Broker) may assist the Partnership in raising additional funds from investors, and representatives of the General Partner may speak at conferences and programs sponsored by the Prime Broker for investors interested in investing in hedge funds. Through such "capital introduction" events, prospective investors in the Partnership and the Offshore Fund have the opportunity to meet with the General Partner. Neither the General Partner nor the Partnership compensates the Prime Broker for organizing such events or for any investments ultimately made by prospective investors attending such events. However, such events and other services (including, without limitation, capital introduction services) provided by the Prime Broker may influence the General Partner in deciding whether to use such prime broker in connection with brokerage, financing and other activities of the Partnership. However, the General Partner will not commit to a broker to allocate a particular amount of brokerage in any such situation.

OUTLINE OF PARTNERSHIP AGREEMENT

The following outline summarizes the material provisions of each Limited Partnership Agreement of the Partnership (the "Partnership Agreement") that are not discussed elsewhere in this Confidential Offering Memorandum. This outline is only a summary and is not definitive, and each prospective Limited Partner should carefully read the Partnership Agreement in its entirety.

Limited Liability. No Limited Partner will be bound by or be liable for the repayment, satisfaction or discharge of any debts, liabilities or obligations of the Partnership except to the extent of (i) such Partner's capital account, and (ii) as may otherwise be required by applicable law.

Term. The Partnership will continue indefinitely upon the first to occur of the following: (i) a determination by the General Partner that the Partnership should be dissolved or

(ii) the death, bankruptcy, retirement or insanity of the General Partner which prevents him from devoting substantially his entire time, skill and attention to the Partnership and other funds and managed accounts for a period of 90 days; (iii) December 31, 2015; or (iv) any event causing the dissolution of the Partnership under the laws of the State of Delaware. Upon dissolution of the Partnership, no further business will be done in the Partnership's name except completion of any incomplete transactions and the taking of such action as shall be necessary for the winding up of the affairs of the Partnership and the distribution of its assets.

Management. The management of the Partnership will be vested exclusively in the General Partner. Except as authorized by the General Partner, the Limited Partners will have no part in the management of the Partnership and will have no authority or right to act on behalf of the Partnership in connection with any matter. The General Partner and his affiliates may engage in any other business venture, and neither the Partnership nor any Limited Partner will have any rights in or to such ventures or the income or profits derived therefrom.

Capital Accounts. Each Partner will have a capital account equal initially to the amount of cash or the value of property contributed by him. The General Partner may permit additional capital contributions and may admit new Limited Partners. The General Partner will not be personally liable for the return of capital contributions, and no interest will be payable thereon.

Withdrawals of Capital. A Class B Limited Partner may withdraw all or part of such Limited Partner's capital account from the Partnership with respect to capital contributions made on or after February 1, 2006 at the end of the calendar quarter after the two year anniversary of the date such Interests were purchased (the "First Withdrawal Date"), and, thereafter, on each anniversary of the First Withdrawal Date upon 45 days prior written notice to the General Partner.

A Class A Limited Partner may withdraw all or part of such Limited Partner's capital account from the Partnership on June 30 or December 31 of any fiscal year upon 45 days prior written notice to the General Partner.

Each date as of which a Limited Partner withdraws all or a portion of its capital account or withdraws from the Partnership is herein referred to as a "Withdrawal Date."

Excluding amounts allocated to Special Investment Sub-Accounts, the Withdrawing Partner will receive the amount of such Limited Partner's capital account (less reserves determined by the General Partner for contingent liabilities) within 90 days after withdrawal. All amounts remaining unpaid (less reserves) will begin to bear interest at a rate equal to a specified broker's call rate for the period beginning 30 days after the effective date of such withdrawal and ending 90 days after the effective date of such withdrawal.

A distribution in respect of a withdrawal may be made in cash or in kind, as determined by the General Partner in its discretion. In-kind distributions will be made to Withdrawing Limited Partners on a *pro rata* basis.

Limited Partners may not otherwise make withdrawals, and the Partnership does not plan to make *pro rata* distributions to Partners on an on going basis.

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Special Investment Sub-Account Withdrawal. Notwithstanding the foregoing, no withdrawal may be made by a Limited Partner from any portion of its capital account that is allocated to a Special Investment Sub-Account. If a portion of a Withdrawn Limited Partner's capital account has been allocated to a Special Investment Sub-Account, then, unless otherwise determined by the General Partner, the amount distributed to such Withdrawn Limited Partner will not include any interest of such Partner in such Special Investment Sub-Account. Such Partner will retain its interest in any Special Investment Sub-Account until the realization or deemed realization of the Special Investment relating to such Special Investment Sub-Account. Income realized or deemed realized subsequent to withdrawal will be allocated 20% to the General Partner (or to a designee as it shall direct) and 80% to such Withdrawn Limited Partner. Any loss realized subsequent to such withdrawal shall be allocated to the Withdrawn Limited Partner. Upon the realization of a Special Investment of a Withdrawn Limited Partner which is held in a Special Investment Sub-Account, the proceeds allocable to that Withdrawn Limited Partner, after reduction for the Incentive Allocation, if any, will be paid to the Withdrawn Limited Partner.

In addition, if after giving effect to a withdrawal, a Limited Partner would be completely withdrawn from the Partnership except for its interest in one or more Special Investment Sub-Accounts, all or a portion of the proceeds with respect to such withdrawal may be reserved or held back to pay for the Management Fee expected to be earned over the life of the Special Investments. Upon the realization or deemed realization of the applicable Special Investments, any unused reserve or hold back shall be paid to such Limited Partner.

To the extent, the amount reserved or held back to pay Management Fees (as described above) does not cover Management Fees that would otherwise be payable over the life of the Special Investment, then such unpaid Management Fees may be paid out of profits, if any, earned in respect of such Special Investment for the period beginning from the time such shortfall begins to accrue until realization or deemed realization. "Accrued Interest" is the amount of interest earned on any amount held back that, at the time of calculation, has not been applied to the Management Fees in respect of any Special Investment Sub-Account of a Limited Partner that has withdrawn all or substantially all of its capital account.

Required Withdrawals. The General Partner may, in its sole discretion, terminate the Interest of any Limited Partner, in whole or in part, upon at least thirty days prior written notice.

Suspension of Withdrawal Rights. The General Partner, by written notice to any Limited Partner, may suspend the withdrawal rights of such Limited Partner if the General Partner reasonably deems it necessary to do so to comply with anti-money laundering laws and regulations applicable to the Partnership, the General Partner or any of the Partnership's other service providers. (See "Anti-Money Laundering Regulations" and "Outline of Partnership Agreement").

General Partner Withdrawals. The General Partner may withdraw amounts from the Partnership at any time, provided that the General Partner will at all times maintain a sufficient capital investment in the Partnership so that the General Partner will, in the aggregate, be entitled to receive at least 1% of Partnership income, loss, taxable income, taxable loss and distributions of the Partnership.

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Withdrawal, Death, Bankruptcy or Adjudicated Incompetence, Etc. of a Limited Partner. In the event of the death, bankruptcy or adjudicated incompetency of a Limited Partner, the Interest of such Limited Partner shall continue until the later of (a) the first to occur of the last day of the fiscal year of the Partnership in which such event takes place (the "Year of Determination") or the earlier termination of the Partnership, and (2) the day 60 days after the date of such Limited Partner's death, bankruptcy or incompetency. If the Partnership is continued after the expiration of the Year of Determination, such Limited Partner will be deemed to have withdrawn from the Partnership (except as to any Interest in a Special Investment Sub-Account) as of the later of the last day of the Year of Determination and 60 days after the date of such Partner's death, bankruptcy or incompetency.

Types of Securities in which the Partnership May Invest. The Partnership may invest in and trade equity securities (including restricted equity securities), equity options, equity related convertible securities, interest-bearing or interest rate sensitive marketable securities (including those issued or guaranteed by the United States Government or agencies or instrumentalities of the United States Government), bonds, trade creditor claims and other evidences of ownership interest, currency and commodities contracts, options, futures and forward contracts with respect to any of the foregoing, and any other instruments which are traded in normal channels of trading for securities and commodities and to engage in transactions in connection with mergers, consolidations, acquisitions, transfers of assets, tender offers, exchange offers, recapitalizations, proxy fights, liquidations, bankruptcies or other similar transactions. The foregoing investments may be made directly or indirectly through mutual funds or other pooled investment vehicles, notwithstanding that fees (including performance-based fees) may be payable to the investment manager of such funds or vehicles by the Partnership.

Valuation of Partnership Assets and Liabilities. All securities, liabilities and other property will be assigned such values as the General Partner reasonably determines to be their fair market value and such values will be binding upon the Partners; provided that in the event a majority in interest of the Class A Limited Partners does not agree with any such determination, such disagreement will be submitted for resolution to a firm of independent certified public accountants (other than the partnership's auditors) which will be mutually agreed upon by the General Partner and the majority in interest of the Class A Limited Partners. Any determination made by such firm of independent certified public accountants will be final and binding upon the General Partner and Class A Limited Partners. No value will be attributable to the goodwill, if any, of the business and for the firm name of the Partnership. The costs of retaining such accountants will be paid by the Partnership.

Assignability of Interests. No Limited Partner or transferee thereof will, without the prior written consent of the General Partner, which may be withheld in his sole discretion, create, or suffer the creation of, a security interest in such Limited Partner's Interest. Except for sales, transfers, assignments or other dispositions (i) by last will and testament, (ii) by operation of law, or (iii) to an affiliate of a Limited Partner, without the prior written consent of the General Partner, which may be withheld in his sole discretion, no Limited Partner will sell, transfer, assign, or in any manner dispose of such Limited Partner's Interest, in whole or in part, nor enter into any agreement as the result of which any person becomes interested with such Limited Partner therein. In no event will a Limited Partner's interest in the Partnership, or any part thereof, be assigned or transferred to any Person unless the transferee executes

documentation reasonably satisfactory to the General Partner pursuant to which the transferee agrees to be bound by the Partnership Agreement and the General Partner is satisfied that such assignment or transfer (i) is not in violation of any applicable federal or state securities laws, (ii) will not result in the Partnership being considered to have terminated within the meaning of Section 708 of the Code, (iii) will not result in any General Partner being required to register under the Investment Advisers Act of 1940, as amended, and (iv) will not result in the Partnership being required to register under the Company Act and (v) will not cause the Partnership to be treated as a publicly traded partnership taxable as a corporation for U.S. federal income tax purposes. In connection with the preceding sentence, the General Partner will have the right to require a legal opinion of counsel satisfactory to him. Unless the foregoing conditions are met, no attempted assignment or transfer of a Limited Partner's interest in the Partnership, or part thereof, will be valid or binding on the Partnership. All expenses incurred in connection with any transfer pursuant to the foregoing provisions will be paid by the transferring Limited Partner. Notwithstanding any other provision of the Partnership Agreement to the contrary, no unit of Partnership Interest may be subdivided for resale into units smaller than a unit the initial offering price of which would have been at least $20,000.

Admission of New Partners. The General Partner may admit one or more additional Limited Partners at any time in its sole and absolute discretion. The General Partner may do all things appropriate or convenient in connection with the admission of any additional Limited Partner. Additional Limited Partners will be required to execute an agreement pursuant to which it becomes bound by the terms of the Partnership Agreement. The General Partner may also admit one or more additional general partners at any time in its sole and absolute discretion.

Amendments to The Partnership Agreement. The Partnership Agreement may not be amended except by a writing executed by the General Partners and by a majority in interest of the Limited Partners; provided, however, that (a) without the consent of all the Partners, no such amendment will change the Partnership to a general partnership, reduce the liabilities, obligations or responsibilities of the General Partners or increase the liabilities, obligations or responsibilities of the Limited Partners, and (b) without the consent of each Partner affected thereby, no such amendment will reduce the capital account of any Partner or alter or modify his interest in Partnership income, distributions or Partnership Losses; and provided further, however, that the General Partner may amend the Partnership Agreement without the consent of any of the other Partners to reflect changes validly made in the membership of the Partnership; to reflect changes in the capital accounts of the Partners resulting from operation of the Partnership Agreement and, subject to other provisos of the Partnership Agreement, to reflect the creation of additional classes of Limited Partners. Notwithstanding any of the foregoing provisions, the Partnership Agreement will be amended from time to time in each and every manner to comply with the then existing requirements of the Code, the Treasury Regulations and the rulings of the Internal Revenue Service affecting the status of the limited partnership as a partnership for federal income tax purposes, and no amendment will be proposed which will directly or indirectly affect or jeopardize the then status of the limited partnership as a partnership for federal income tax purposes.

Reports to Partners. The Partnership will provide to the Partners unaudited financial statements within 35 days after the end of each calendar quarter (other than the last) and will furnish to them annual audited financial statements within 90 days after year end, and tax information as soon thereafter as practicable.

Exculpation. The Partnership Agreement provides that the General Partner will not be liable, responsible or accountable in damages or otherwise to the Partnership or to any Limited Partner, successor, assignee or transferee except by reason of acts or omissions due to bad faith, gross negligence, recklessness, fraud or intentional misconduct, or by reason of actions taken in the knowledge that such actions were not within the stated purposes and powers of the Partnership.

Indemnification. The Partnership Agreement provides that the Partnership will indemnify, defend and hold the General Partner and, if expressly directed by the General Partner, the Partnership's agents, employees, advisors and consultants, harmless from and against any loss, liability, damage, cost or expense, including reasonable attorneys' fees, in defense of any demands, claims or lawsuits against the General Partner or such other persons, in or as a result of or relating to his capacity, actions or omissions as General Partner or as an agent, employee, advisor, or consultant, concerning the business, or activities undertaken on behalf, of the Partnership, including, without limitation, any demands, claims or lawsuits initiated by a Limited Partner or resulting from or relating to the offer and sale of the Interests, provided that the acts or omissions of such General Partner or other person are not the result of bad faith, gross negligence, recklessness, fraud or intentional misconduct, or such a lesser standard of conduct as under applicable law prevents indemnification hereunder, or were taken in the knowledge that such actions were not within the stated purposes and powers of the Partnership.

The General Partner, and any other indemnified person, will be entitled to receive, upon application therefor, advances to cover the costs of defending any claim or action against him; provided that such advances will be repaid to the Partnership if the General Partner or other person violated any of the standards set forth in the preceding paragraph. All rights of the General Partner and others to indemnification will survive the dissolution of the Partnership and the death, retirement, removal, dissolution, adjudicated incompetency or insolvency of either the General Partner or an agent, employee, or advisor, or others, provided that notice of a potential claim for indemnification hereunder is made by or on behalf of the person seeking such indemnification prior to the time distribution in liquidation of the property of the Partnership is made.

If the Partnership is made a party to any claim, dispute or litigation or otherwise incurs any loss, liability, damage, cost or expense (i) as a result of or in connection with the General Partner's obligations or liabilities unrelated to the Partnership business, or (ii) by reason of his bad faith, gross negligence, recklessness, fraud or intentional misconduct, or by reason of actions taken in the knowledge that such actions were not within the stated purposes and powers of the Partnership, the General Partner will indemnify and reimburse the Partnership for all loss, liability, damage, cost and expense incurred, including reasonable attorneys' fees.

TAX ASPECTS

CIRCULAR 230 NOTICE. THE FOLLOWING NOTICE IS BASED ON U.S. TREASURY REGULATIONS GOVERNING PRACTICE BEFORE THE U.S. INTERNAL REVENUE SERVICE: (1) ANY U.S. FEDERAL TAX ADVICE CONTAINED HEREIN, INCLUDING ANY OPINION OF COUNSEL REFERRED TO HEREIN, IS NOT INTENDED OR WRITTEN TO BE USED, AND CANNOT BE USED BY ANY TAXPAYER FOR THE PURPOSE OF AVOIDING U.S. FEDERAL TAX

PENALTIES THAT MAY BE IMPOSED ON THE TAXPAYER; (2) ANY SUCH ADVICE IS WRITTEN TO SUPPORT THE PROMOTION OR MARKETING OF THE TRANSACTIONS DESCRIBED HEREIN (OR IN ANY SUCH OPINION OF COUNSEL); AND (3) EACH TAXPAYER SHOULD SEEK ADVICE BASED ON THE TAXPAYER'S PARTICULAR CIRCUMSTANCES FROM AN INDEPENDENT TAX ADVISOR.

The following is a summary of certain aspects of the income taxation of the Partnership and its Limited Partners which should be considered by a prospective Limited Partner. The Partnership has not sought a ruling from the Internal Revenue Service (the "Service") or any other Federal, state or local agency with respect to any of the tax issues affecting the Partnership, nor has it obtained an opinion of counsel with respect to any tax issues.

This summary of certain aspects of the Federal income tax treatment of the Partnership is based upon the Internal Revenue Code of 1986, as amended (the "Code"), judicial decisions, Treasury Regulations (the "Regulations") and rulings in existence on the date hereof, all of which are subject to change. This summary does not discuss the impact of various proposals to amend the Code which could change certain of the tax consequences of an investment in the Partnership. This summary also does not discuss all of the tax consequences that may be relevant to a particular investor or to certain investors subject to special treatment under the Federal income tax laws, such as insurance companies.

EACH PROSPECTIVE LIMITED PARTNER SHOULD CONSULT WITH ITS OWN TAX ADVISER IN ORDER FULLY TO UNDERSTAND THE FEDERAL, STATE, LOCAL AND FOREIGN INCOME TAX CONSEQUENCES OF AN INVESTMENT IN THE PARTNERSHIP.

Tax Treatment of Partnership Operations

Classification of the Partnership. The Partnership operates as a partnership for Federal tax purposes that is not a publicly traded partnership taxable as a corporation. If it were determined that the Partnership should be taxable as a corporation for Federal tax purposes (as a result of changes in the Code, the Regulations or judicial interpretations thereof, a material adverse change in facts, or otherwise), the taxable income of the Partnership would be subject to corporate income tax when recognized by the Partnership; distributions of such income, other than in certain redemptions of Interests, would be treated as dividend income when received by the Partners to the extent of the current or accumulated earnings and profits of the Partnership; and Partners would not be entitled to report profits or losses realized by the Partnership.

UNLESS OTHERWISE INDICATED, REFERENCES IN THE FOLLOWING DISCUSSION OF THE TAX CONSEQUENCES OF PARTNERSHIP INVESTMENTS, ACTIVITIES, INCOME, GAIN AND LOSS, INCLUDE THE DIRECT INVESTMENTS, ACTIVITIES, INCOME, GAIN AND LOSS OF THE PARTNERSHIP, AND THOSE INDIRECTLY ATTRIBUTABLE TO THE PARTNERSHIP AS A RESULT OF IT BEING AN INVESTOR IN OTHER INVESTMENT ENTITIES.

As a partnership, the Partnership is not itself subject to Federal income tax. The Partnership files an annual partnership information return with the Service which reports the results of operations. Each Partner is required to report separately on its income tax return its distributive share of the Partnership's net long-term capital gain or loss, net short-term capital gain or loss and all other items of ordinary income or loss. Each Partner is taxed on its distributive share of the Partnership's taxable income and gain regardless of whether it has received or will receive a distribution from the Partnership.

Allocation of Profits and Losses. Under the Partnership Agreement, the Partnership's net capital appreciation or net capital depreciation for each accounting period is allocated among the Partners and to their capital accounts without regard to the amount of income or loss actually recognized by the Partnership for Federal income tax purposes. The Partnership Agreement provides that items of income, deduction, gain, loss or credit actually recognized by the Partnership for each fiscal year generally are to be allocated for income tax purposes among the Partners pursuant to the principles of Regulations issued under Sections 704(b) and 704(c) of the Code.

Under the Partnership Agreement, the General Partner has the discretion to allocate income, gains, losses, deductions and credits to take into account the differences between income for tax purposes and for Partnership book purposes. There can be no assurance that, if the General Partner makes such a special allocation, the Service will accept such allocation. If such allocation is successfully challenged by the Service, the Partnership's gains allocable to the Partners would be increased.

Tax Elections; Returns; Tax Audits. The Code generally provides for optional adjustments to the basis of partnership property upon distributions of partnership property to a partner and transfers of partnership interests (including by reason of death) provided that a partnership election has been made pursuant to Section 754. Under the Partnership Agreement, the General Partner, in its sole discretion, may cause the Partnership to make or refrain from making such an election. Any such election, once made, cannot be revoked without the Service's consent. The actual effect of any such election may depend upon whether any Other Investment Entities also make such an election. As a result of the complexity and added expense of the tax accounting required to implement such an election, the General Partner presently does not intend to make such election.

The General Partner decides how to report the partnership items on the Partnership's tax returns, and all Partners are required under the Code to treat the items consistently on their own returns, unless they file a statement with the Service disclosing the inconsistency. Given the uncertainty and complexity of the tax laws, it is possible that the Service may not agree with the manner in which the Partnership's items have been reported. In the event the income tax returns of the Partnership are audited by the Service, the tax treatment of the Partnership's income and deductions generally is determined at the limited partnership level in a single proceeding rather than by individual audits of the Partners. The General Partner, designated as the "Tax Matters Partner", has considerable authority to make decisions affecting the tax treatment and procedural rights of all Partners. In addition, the Tax Matters Partner has the authority to bind certain Partners to settlement agreements and the right on behalf

of all Partners to extend the statute of limitations relating to the Partners' tax liabilities with respect to Partnership items.

Mandatory Basis Adjustments. Under new legislation, the Partnership is generally required to adjust its tax basis in its assets in respect of all Partners in cases of partnership distributions that result in a "substantial basis reduction" (i.e., in excess of $250,000) in respect of the partnership's property. The Partnership is also required to adjust its tax basis in its assets in respect of a transferee, in the case of a sale or exchange of an interest, or a transfer upon death, when there exists a "substantial built-in loss" (i.e., in excess of $250,000) in respect of partnership property immediately after the transfer. For this reason, the Partnership will require (i) a Partner who receives a distribution from the Partnership in connection with a complete withdrawal, (ii) a transferee of an Interest (including a transferee in case of death) and (iii) any other Partner in appropriate circumstances to provide the Partnership with information regarding its adjusted tax basis in its Interest.

Tax Consequences to a Withdrawing Limited Partner

A Limited Partner receiving a cash liquidating distribution from the Partnership, in connection with a complete withdrawal from the Partnership, generally will recognize capital gain or loss to the extent of the difference between the proceeds received by such Limited Partner and such Limited Partner's adjusted tax basis in its partnership interest. Such capital gain or loss will be short-term, long-term, or some combination of both, depending upon the timing of the Limited Partner's contributions to the Partnership. However, a withdrawing Limited Partner will recognize ordinary income to the extent such Limited Partner's allocable share of the Partnership's "unrealized receivables" exceeds the Limited Partner's basis in such unrealized receivables (as determined pursuant to the Regulations). For these purposes, accrued but untaxed market discount, if any, on securities held by the Partnership will be treated as an unrealized receivable, with respect to which a withdrawing Limited Partner would recognize ordinary income. A Limited Partner receiving a cash nonliquidating distribution will recognize income in a similar manner only to the extent that the amount of the distribution exceeds such Limited Partner's adjusted tax basis in its partnership interest.

Distributions of Property. A partner's receipt of a distribution of property from a partnership is generally not taxable. However, under Section 731 of the Code, a distribution consisting of marketable securities generally is treated as a distribution of cash (rather than property) unless the distributing partnership is an "investment partnership" within the meaning of Section 731(c)(3)(C)(i) and the recipient is an "eligible partner" within the meaning of Section 731(c)(3)(C)(iii). The Partnership will determine at the appropriate time whether it qualifies as an "investment partnership." Assuming it so qualifies, if a Limited Partner is an "eligible partner", which term should include a Limited Partner whose contributions to the Partnership consisted solely of cash, the rule treating a distribution of property as a distribution of cash would not apply.

Tax Treatment of Partnership Investments

In General. The Partnership expects to act as a trader, and not as a dealer, with respect to its securities transactions. A trader is a person who buys and sells securities for its

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own account. A dealer, on the other hand, is a person who purchases securities for resale to customers rather than for investment or speculation. The Partnership has taken the position that its securities trading activity constitutes a trade or business for Federal income tax purposes. However, there can be no assurance that the Service will agree that the Partnership's securities activities will constitute trading rather than investing.

Generally, the gains and losses realized by a trader on the sale of securities are capital gains and losses. Capital gains and losses recognized by the Partnership may be long-term or short-term depending, in general, upon the length of time the Partnership maintains a particular investment position and, in some cases, upon the nature of the transaction. Property held for more than one year generally will be eligible for long-term capital gain or loss treatment. The application of certain rules relating to short sales, to so-called "straddle" and "wash sale" transactions and to Section 1256 Contracts (defined below) may serve to alter the treatment of the Partnership's securities positions.[1]

The Partnership may also realize ordinary income and losses with respect to its transactions. The Partnership may hold debt obligations with "original issue discount." In such case the Partnership would be required to include amounts in taxable income on a current basis even though receipt of such amounts may occur in a subsequent year.

The maximum ordinary income tax rate for individuals is 35%[2] and, in general, the maximum individual income tax rate for "Qualified Dividends"[3] and long-term capital gains is 15%[4] (unless the taxpayer elects to be taxed at ordinary rates - see "Limitation on Deductibility of Interest and Short Sale Expenses" below), although in all cases the actual rates may be higher due to the phase out of certain tax deductions, exemptions and credits. The excess of capital losses over capital gains may be offset against the ordinary income of an individual taxpayer, subject to an annual deduction limitation of $3,000. Capital losses of an individual taxpayer may generally be carried forward to succeeding tax years to offset capital gains and then ordinary income (subject to the $3,000 annual limitation). For corporate taxpayers, the maximum income tax rate is 35%. Capital losses of a corporate taxpayer may be offset only against capital gains, but unused capital losses may be carried back three years (subject to certain limitations) and carried forward five years.

There are a number of uncertainties in the Federal income tax law relating to debt restructuring. In general, a "significant modification" of a debt obligation acquired by the

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[1] Generally, in the absence of Regulations requiring it, the Partnership will not treat positions held through different investment advisory agreements or Other Investment Entities as offsetting positions for purposes of the straddle rules.

[2] This rate is scheduled to increase to 39.6% in 2011.

[3] A "Qualified Dividend" is generally a dividend from certain domestic corporations, and from certain foreign corporations that are either eligible for the benefits of a comprehensive income tax treaty with the United States or are readily tradable on an established securities market in the United States. Shares must be held for certain holding periods in order for a dividend thereon to be a Qualified Dividend.

[4] The maximum individual long-term capital gains tax rate is 20% for sales or exchanges on or after January 1, 2009. The 15% maximum individual tax rate on Qualified Dividends is scheduled to expire on December 31, 2008.

Partnership at a discount may be treated as a taxable event to the Partnership, with the resulting gain or loss measured by the difference between the principal amount of the debt after the modification and the Partnership's tax basis in such debt before the modification. However, other than for certain "safe harbor" modifications specified in Treasury Regulations, the determination of whether a modification is "significant" is based on all of the facts and circumstances. Therefore, it is possible that the Service could take the position that the restructuring of a debt obligation acquired by the Partnership at a discount amounts to a "significant modification" that should be treated as a taxable event even if the Partnership did not so treat the restructuring on its tax return.

Section 1256 Contracts. In the case of Section 1256 Contracts, the Code generally applies a "mark-to-market" system of taxing unrealized gains and losses on such contracts and otherwise provides for special rules of taxation. A Section 1256 Contract includes certain regulated futures contracts and certain other contracts. Under these rules, Section 1256 Contracts held by the Partnership at the end of each taxable year of the Partnership are treated for Federal income tax purposes as if they were sold by the Partnership for their fair market value on the last business day of such taxable year. The net gain or loss, if any, resulting from such deemed sales (known as "marking to market"), together with any gain or loss resulting from actual sales of Section 1256 Contracts, must be taken into account by the Partnership in computing its taxable income for such year. If a Section 1256 Contract held by the Partnership at the end of a taxable year is sold in the following year, the amount of any gain or loss realized on such sale will be adjusted to reflect the gain or loss previously taken into account under the "mark-to-market" rules.

With certain exceptions, capital gains and losses from such Section 1256 Contracts generally are characterized as short-term capital gains or losses to the extent of 40% thereof and as long-term capital gains or losses to the extent of 60% thereof. If an individual taxpayer incurs a net capital loss for a year, the portion thereof, if any, which consists of a net loss on Section 1256 Contracts may, at the election of the taxpayer, be carried back three years. Losses so carried back may be deducted only against net capital gain to the extent that such gain includes gains on Section 1256 Contracts. A Section 1256 Contract does not include any "securities futures contract" or any option on such a contract, other than a "dealer securities futures contract" (See "Certain Securities Futures Contracts").

Certain Securities Futures Contracts. Generally, a securities futures contract is a contract of sale for future delivery of a single security or a narrow-based security index. Any gain or loss from the sale or exchange of a securities futures contract (other than a "dealer securities futures contract") is treated as gain or loss from the sale or exchange of property that has the same character as the property to which the contract relates has (or would have) in the hands of the taxpayer. If the underlying security would be a capital asset in the taxpayer's hands, then gain or loss from the sale or exchange of the securities futures contract would be capital gain or loss. Capital gain or loss from the sale or exchange of a securities futures contract to sell property (i.e., the short side of a securities futures contract) generally will be short term capital gain or loss.

A "dealer securities futures contract" is treated as a Section 1256 Contract. A "dealer securities futures contract" is a securities futures contract, or an option to enter into such

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a contract, that (1) is entered into by a dealer (or, in the case of an option, is purchased or granted by the dealer) in the normal course of its trade or business activity of dealing in the contracts and (2) is traded on a qualified board of trade or exchange.

Mixed Straddle Election. The Code allows a taxpayer to elect to offset gains and losses from positions which are part of a "mixed straddle." A "mixed straddle" is any straddle in which one or more but not all positions are Section 1256 Contracts. Pursuant to Temporary Regulations, the Partnership (and any Other Investment Entities) may be eligible to elect to establish one or more mixed straddle accounts for certain of its mixed straddle trading positions. The mixed straddle account rules require a daily "marking to market" of all open positions in the account and a daily netting of gains and losses from positions in the account. At the end of a taxable year, the annual net gains or losses from the mixed straddle account are recognized for tax purposes. The application of the Temporary Regulations' mixed straddle account rules is not entirely clear. Therefore, there is no assurance that a mixed straddle account election by the Partnership will be accepted by the Service.

Possible "Mark-to-Market" Election. To the extent that the Partnership is directly engaged in a trade or business as a trader in "securities," it may elect under Section 475 of the Code to "mark-to-market" the securities held in connection with such trade or business. Under such election, securities held by the Partnership at the end of each taxable year will be treated as if they were sold by the Partnership for their fair market value on the last day of such taxable year, and gains or losses recognized thereon will be treated as ordinary income or loss. Moreover, even if the Partnership determines that its securities activities will constitute trading rather than investing, there can be no assurance that the Service will agree, in which case the Partnership may not be able to mark-to-market its positions.

Short Sales. Gain or loss from a short sale of property is generally considered as capital gain or loss to the extent the property used to close the short sale constitutes a capital asset in the Partnership's hands. Except with respect to certain situations where the property used to close a short sale has a long-term holding period on the date the short sale is entered into, gains on short sales generally are short-term capital gains. A loss on a short sale will be treated as a long-term capital loss if, on the date of the short sale, "substantially identical property" has been held by the Partnership for more than one year. In addition, these rules may also terminate the running of the holding period of "substantially identical property" held by the Partnership.

Gain or loss on a short sale will generally not be realized until such time that the short sale is closed. However, if the Partnership holds a short sale position with respect to stock, certain debt obligations or partnership interests that has appreciated in value and then acquires property that is the same as or substantially identical to the property sold short, the Partnership generally will recognize gain on the date it acquires such property as if the short sale were closed on such date with such property. Similarly, if the Partnership holds an appreciated financial position with respect to stock, certain debt obligations, or partnership interests and then enters into a short sale with respect to the same or substantially identical property, the Partnership generally will recognize gain as if the appreciated financial position were sold at its fair market value on the date it enters into the short sale. The subsequent holding period for any appreciated financial position that is subject to these constructive sale rules will be determined as if such position were acquired on the date of the constructive sale.

Effect of Straddle Rules on Limited Partners' Securities Positions. The Service may treat certain positions in securities held (directly or indirectly) by a Partner and its indirect interest in similar securities held by the Partnership as "straddles" for Federal income tax purposes. Investors should consult their tax advisors regarding the application of the "straddle" rules to their investment in the Partnership.[5]

Limitation on Deductibility of Interest and Short Sale Expenses. For noncorporate taxpayers, Section 163(d) of the Code limits the deduction for "investment interest" (i.e., interest or short sale expenses for "indebtedness properly allocable to property held for investment"). Investment interest is not deductible in the current year to the extent that it exceeds the taxpayer's "net investment income," consisting of net gain and ordinary income derived from investments in the current year less certain directly connected expenses (other than interest or short sale expenses). For this purpose, Qualified Dividends and long-term capital gains are excluded from net investment income unless the taxpayer elects to pay tax on such amounts at ordinary income tax rates.

For purposes of this provision, the Partnership's activities (other than certain activities that are treated as "passive activities" under Section 469 of the Code) will be treated as giving rise to investment income for a Limited Partner, and the investment interest limitation would apply to a noncorporate Limited Partner's share of the interest and short sale expenses attributable to the Partnership's operation. In such case, a noncorporate Limited Partner would be denied a deduction for all or part of that portion of its distributive share of the Partnership's ordinary losses attributable to interest and short sale expenses unless it had sufficient investment income from all sources including the Partnership. A Limited Partner that could not deduct losses currently as a result of the application of Section 163(d) would be entitled to carry forward such losses to future years, subject to the same limitation. The investment interest limitation would also apply to interest paid by a noncorporate Limited Partner on money borrowed to finance its investment in the Partnership. Potential investors are advised to consult with their own tax advisers with respect to the application of the investment interest limitation in their particular tax situations.

For each taxable year, Section 1277 of the Code limits the deduction of the portion of any interest expense on indebtedness incurred by a taxpayer to purchase or carry a security with market discount which exceeds the amount of interest (including original issue discount) includible in the taxpayer's gross income for such taxable year with respect to such security ("Net Interest Expense"). In any taxable year in which the taxpayer has Net Interest Expense with respect to a particular security, such Net Interest Expense is not deductible except to the extent that it exceeds the amount of market discount which accrued on the security during the portion of the taxable year during which the taxpayer held the security. Net Interest Expense which cannot be deducted in a particular taxable year under the rules described above can be carried forward and deducted in the year in which the taxpayer disposes of the security. Alternatively, at the taxpayer's election, such Net Interest Expense can be carried forward and

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[5] The Partnership will not generally be in a position to furnish to Partners information regarding the securities positions of the Other Investment Entities which would permit a Partner to determine whether its transactions in securities, which are also held by such Other Investment Entities, should be treated as offsetting positions for purposes of the straddle rules.

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deducted in a year prior to the disposition of the security, if any, in which the taxpayer has net interest income from the security.

Section 1277 would apply to a Limited Partner's share of the Partnership's Net Interest Expense attributable to a security held by the Partnership with market discount. In such case, a Limited Partner would be denied a current deduction for all or part of that portion of its distributive share of the Partnership's ordinary losses attributable to such Net Interest Expense and such losses would be carried forward to future years, in each case as described above. Although no guidance has been issued regarding the manner in which an election to deduct previously disallowed Net Interest Expense in a year prior to the year in which a bond is disposed of should be made, it appears that such an election would be made by the Partnership rather than by the Limited Partner. Section 1277 would also apply to the portion of interest paid by a Limited Partner on money borrowed to finance its investment in the Partnership to the extent such interest was allocable to securities held by the Partnership with market discount.

Deductibility of Partnership Investment Expenditures and Certain Other Expenditures. Investment expenses (e.g., investment advisory fees) of an individual, trust or estate are deductible only to the extent they exceed 2% of adjusted gross income.[6] In addition, the Code further restricts the ability of an individual with an adjusted gross income in excess of a specified amount (for 2006, $150,500 or $75,250 for a married person filing a separate return) to deduct such investment expenses. Under such provision, there is a limitation on the deductibility of investment expenses in excess of 2% of adjusted gross income to the extent such excess expenses (along with certain other itemized deductions) exceed the lesser of (i) 3% of the excess of the individual's adjusted gross income over the specified amount or (ii) 80% of the amount of certain itemized deductions otherwise allowable for the taxable year.[7] Moreover, such investment expenses are miscellaneous itemized deductions which are not deductible by a noncorporate taxpayer in calculating its alternative minimum tax liability.

Pursuant to Temporary Regulations issued by the Treasury Department, these limitations on deductibility should not apply to a noncorporate Limited Partner's share of the expenses of the Partnership to the extent the Partnership is engaged, as it expects to be, in a trade or business within the meaning of the Code. These limitations will apply, however, to a noncorporate Limited Partner's share of the investment expenses of the Partnership (including the Management Fee, payments made on certain derivative instruments (if any) and any fee payable to the managers of Other Investment Entities), to the extent such expenses are allocable to Other Investment Entities that are not in a trade or business within the meaning of the Code. The

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6 However, Section 67(e) of the Code provides that, in the case of a trust or an estate, such limitation does not apply to deductions or costs which are paid or incurred in connection with the administration of the estate or trust and would not have been incurred if the property were not held in such trust or estate. There is a disagreement among three Federal Courts of Appeals on the question of whether the investment advisory fees incurred by a trust are exempt (under Section 67(e)) from the 2% of adjusted gross income floor on deductibility. Limited Partners that are trusts or estates should consult their tax advisors as to the applicability of these cases to the investment expenses that are allocated to them.

7 Under recently enacted legislation, the latter limitation on itemized deductions has been reduced starting in calendar year 2006, will be further reduced starting in 2008, and will be completely eliminated in 2010. However, this legislation contains a "sunset" provision that will result in the limitation on itemized deductions being restored in 2011.

Partnership intends to treat its expenses attributable to the Other Investment Entities that are engaged in trade or business within the meaning of the Code or to the trading activity of the Partnership as not being subject to the foregoing limitations on deductibility, although there can be no assurance that the Service may not treat such expenses as investment expenses which are subject to the limitations.

The consequences of these limitations will vary depending upon the particular tax situation of each taxpayer. Accordingly, noncorporate Limited Partners should consult their tax advisers with respect to the application of these limitations.

A Limited Partner will not be allowed to deduct syndication expenses attributable to the acquisition of an Interest paid by such Limited Partner or the Partnership. Any such amounts will be included in the Limited Partner's adjusted tax basis for its Interest.

Recently enacted legislation includes a provision (adding a new Section 470 of the Code) which may defer certain deductions of the Partnership to the extent any direct or indirect investors of the Partnership are tax exempt persons, non-U.S. persons, and any domestic government organizations or instrumentalities thereof. If applicable, this provision could have an adverse effect on taxable investors in the Partnership. There is some uncertainty regarding the scope of the new provision and its applicability to the Partnership, which may be addressed in future guidance or legislation. Investors should consult their tax advisors regarding the consequences of this new provision with respect to an investment in the Partnership.

Application of Rules for Income and Losses from Passive Activities. The Code restricts the deductibility of losses from a "passive activity" against certain income which is not derived from a passive activity. This restriction applies to individuals, personal service corporations and certain closely held corporations. Pursuant to Temporary Regulations issued by the Treasury Department, income or loss from the Partnership's securities investment and trading activity generally will not constitute income or loss from a passive activity. Therefore, passive losses from other sources generally could not be deducted against a Limited Partner's share of such income and gain from the Partnership. Income or loss attributable to certain activities of the Partnership, including investments in partnerships engaged in certain trades or businesses, certain private claims or certain fundings of reorganization plans may constitute passive activity income or loss.

Application of Basis and "At Risk" Limitations on Deductions. The amount of any loss of the Partnership that a Limited Partner is entitled to include in its income tax return is limited to its adjusted tax basis in its Interest as of the end of the Partnership's taxable year in which such loss occurred. Generally, a Limited Partner's adjusted tax basis for its Interest is equal to the amount paid for such Interest, increased by the sum of (i) its share of the Partnership's liabilities, as determined for Federal income tax purposes, and (ii) its distributive share of the Partnership's realized income and gains, and decreased (but not below zero) by the sum of (i) distributions (including decreases in its share of Partnership liabilities) made by the Partnership to such Limited Partner and (ii) such Limited Partner's distributive share of the Partnership's realized losses and expenses.

Similarly, a Limited Partner that is subject to the "at risk" limitations (generally, non-corporate taxpayers and closely held corporations) may not deduct losses of the Partnership to the extent that they exceed the amount such Limited Partner has "at risk" with respect to its Interest at the end of the year. The amount that a Limited Partner has "at risk" will generally be the same as its adjusted basis as described above, except that it will generally not include any amount attributable to liabilities of the Partnership or any amount borrowed by the Limited Partner on a non-recourse basis.

Losses denied under the basis or "at risk" limitations are suspended and may be carried forward in subsequent taxable years, subject to these and other applicable limitations.

"Phantom Income" From Partnership Investments. Pursuant to various "anti-deferral" provisions of the Code (the "Subpart F" and "passive foreign investment company" provisions), investments (if any) by the Partnership in certain foreign corporations may cause a Limited Partner to (i) recognize taxable income prior to the Partnership's receipt of distributable proceeds, (ii) pay an interest charge on receipts that are deemed as having been deferred or (iii) recognize ordinary income that, but for the "anti-deferral" provisions, would have been treated as long-term or short-term capital gain.

Foreign Taxes

It is possible that certain dividends and interest directly or indirectly received by the Partnership from sources within foreign countries will be subject to withholding taxes imposed by such countries. In addition, the Partnership or the Other Investment Entities may also be subject to capital gains taxes in some of the foreign countries where they purchase and sell securities. Tax treaties between certain countries and the United States may reduce or eliminate such taxes. It is impossible to predict in advance the rate of foreign tax the Partnership will directly or indirectly pay since the amount of the Partnership's assets to be invested in various countries is not known.

The Limited Partners will be informed by the Partnership as to their proportionate share of the foreign taxes paid by the Partnership or the Other Investment Entities, which they will be required to include in their income. The Limited Partners generally will be entitled to claim either a credit (subject, however, to various limitations on foreign tax credits) or, if they itemize their deductions, a deduction (subject to the limitations generally applicable to deductions) for their share of such foreign taxes in computing their Federal income taxes.

Tax Shelter Reporting Requirements

The Regulations require the Partnership to complete and file Form 8886 ("Reportable Transaction Disclosure Statement") with its tax return for any taxable year in which the Partnership participates in a "reportable transaction." Additionally, each Partner treated as participating in a reportable transaction of the Partnership is generally required to file Form 8886 with its tax return. The Partnership and any such Partner, respectively, must also submit a copy of the completed form with the Service's Office of Tax Shelter Analysis. The Partnership intends to notify the Partners that it believes (based on information available to the Partnership) are required to report a transaction of the Partnership or the Other Investment Entities, and

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intends to provide such Limited Partners with any available information needed to complete and submit Form 8886 with respect to the transactions of the Partnership and the Other Investment Entities. In certain situations, there may also be a requirement that a list be maintained of persons participating in such reportable transactions, which could be made available to the Service at its request.

A Partner's recognition of a loss upon its disposition of an interest in the Partnership could also constitute a "reportable transaction" for such Partner requiring such Partner to file Form 8886.

Under new legislation, a significant penalty is imposed on taxpayers who participate in a "reportable transaction" and fail to make the required disclosure. The penalty is generally $10,000 for natural persons and $50,000 for other persons (increased to $100,000 and $200,000, respectively, if the reportable transaction is a "listed" transaction). Investors should consult with their own advisors concerning the application of these reporting obligations to their specific situations.

State and Local Taxation

In addition to the Federal income tax consequences described above, prospective investors should consider potential state and local tax consequences of an investment in the Partnership. State and local laws often differ from Federal income tax laws with respect to the treatment of specific items of income, gain, loss, deduction and credit. A Partner's distributive share of the taxable income or loss of the Partnership generally will be required to be included in determining its reportable income for state and local tax purposes in the jurisdiction in which it is a resident. A partnership in which the Partnership acquires an interest may conduct business in a jurisdiction which will subject to tax a Partner's share of the partnership's income from that business and may cause Partners to file tax returns in those jurisdictions. Prospective investors should consult their tax advisers with respect to the availability of a credit for such tax in the jurisdiction in which that Partner is a resident.

One or more states may impose reporting requirements on the Partnership and/or its Partners in a manner similar to that described above in "Tax Shelter Reporting Requirements." Investors should consult with their own advisors as to the applicability of such rules in jurisdictions which may require or impose a filing requirement.

The Partnership should not be subject to the New York City unincorporated business tax, which is not imposed on a partnership which purchases and sells securities for its "own account." (This exemption may not be applicable to the extent a partnership in which the Partnership invests, directly or through an Other Investment Entity, conducts a business in New York City.) By reason of a similar "own account" exemption, it is also expected that a nonresident individual Partner should not be subject to New York State personal income tax with respect to his share of income or gain realized directly by the Partnership.

Individual Limited Partners who are residents of New York State and New York City should be aware that the New York State and New York City personal income tax laws limit the deductibility of itemized deductions and interest expense for individual taxpayers at

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certain income levels. However, as described above, the Partnership expects to be in a trade or business within the meaning of the Code. Accordingly, although there can be no assurance, the foregoing limitations should not apply to a Limited Partner's share of any of the Partnership's expenses.

For purposes of the New York State corporate franchise tax and the New York City general corporation tax, a corporation generally is treated as doing business in New York State and New York City, respectively, and is subject to such corporate taxes as a result of the ownership of a partnership interest in a partnership which does business in New York State and New York City, respectively.[8] Each of the New York State and New York City corporate taxes are imposed, in part, on the corporation's taxable income or capital allocable to the relevant jurisdiction by application of the appropriate allocation percentages. Moreover, a non-New York corporation which does business in New York State may be subject to a New York State license fee. A corporation which is subject to New York State corporate franchise tax solely as a result of being a limited partner in a New York partnership may, under certain circumstances, elect to compute its New York State corporate franchise tax by taking into account only its distributive share of such partnership's income and loss. There is currently no similar provision in effect for purposes of the New York City general corporation tax.

Regulations under both the New York State corporate franchise tax and New York City general corporation tax, however, provide an exception to this general rule in the case of a "portfolio investment partnership," which is defined, generally, as a partnership which meets the gross income requirements of Section 851(b)(2) of the Code. New York State (but not New York City) has adopted regulations that also include income and gains from commodity transactions described in Section 864(b)(2)(B)(iii) as qualifying gross income for this purpose. The qualification of the Partnership as a "portfolio investment partnership" with respect to its investments through advisory accounts and Other Investment Entities must be determined on an annual basis and, with respect to a taxable year, the Partnership and/or one or more Other Investment Entities may not qualify as portfolio investment partnerships. Therefore, a corporate limited partner may be treated as doing business in New York State and New York City as a result of its interest in the Partnership or its indirect interest in nonqualifying Other Investment Entities.

New York State has enacted legislation that imposes a quarterly withholding obligation on certain partnerships with respect to partners that are individual non-New York residents or corporations (other than "S" corporations). Accordingly, the Partnership may be required to withhold on the distributive shares of New York source partnership income allocable to such partners to the extent such income is not derived from trading in securities for the Partnership's or the Other Investment Entities' own account.

Each prospective Partner should consult its tax adviser with regard to the New York State and New York City tax consequences of an investment in the Partnership.

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[8] New York State (but not New York City) generally exempts from corporate franchise tax a non-New York corporation which (i) does not actually or constructively own a 1% or greater limited partnership interest in a partnership doing business in New York and (ii) has a tax basis in such limited partnership interest not greater than $1 million.

ANTI-MONEY LAUNDERING REGULATIONS

As part of the Partnership's responsibility for the prevention of money laundering, the Administrator, the General Partner and his affiliates may require a detailed verification of a Limited Partner's identity, any beneficial owner underlying the account and the source of the payment.

The General Partner or the Administrator reserves the right to request such information as is necessary to verify the identity of a subscriber and the underlying beneficial owner of a subscriber's or a Limited Partner's Interest in the Partnership. In the event of delay or failure by the subscriber or Limited Partner to produce any information required for verification purposes, the General Partner may refuse to accept a subscription or may cause the withdrawal of any such Limited Partner from the Partnership. The General Partner, by written notice to any Limited Partner, may suspend the withdrawal rights of such Limited Partner if the General Partner reasonably deems it necessary to do so to comply with anti-money laundering regulations applicable to the Partnership, the General Partner or any of the Partnership's other service providers.

Each subscriber and Limited Partner will be required to make such representations to the Partnership as the Partnership, the General Partner and the Administrator will require in connection with such anti-money laundering programs, including, without limitation, representations to the Partnership that such subscriber or Limited Partner is not a prohibited country, territory, individual or entity listed on the U.S. Department of Treasury's Office of Foreign Assets Control ("OFAC") website and that it is not directly or indirectly affiliated with, any country, territory, individual or entity named on an OFAC list or prohibited by any OFAC sanctions programs. Such Limited Partner will also represent to the Partnership that amounts contributed by it to the Partnership were not directly or indirectly derived from activities that may contravene Federal, state or international laws and regulations, including anti-money laundering laws and regulations.

LIMITATIONS ON TRANSFERABILITY; SUITABILITY REQUIREMENTS

Each purchaser of an Interest must bear the economic risk of the investment for an extended period of time (subject to a limited right to withdraw capital from the Partnership or to transfer or assign Interests in the Partnership) because the Interests have not been registered under the Securities Act of 1933, as amended (the "Securities Act"), and, therefore, cannot be sold unless they are subsequently registered under the Securities Act or an exemption from such registration is available. It is not contemplated that any such registration will ever be effected, or that certain exemptions provided by rules promulgated under the Securities Act (such as Rule 144) will ever be available. The foregoing restrictions on transferability must be regarded as substantial.

Each purchaser of an Interest is required to represent that the Interest is being acquired for its own account, for investment and not with a view to resale or distribution. The Interests are suitable investments only for sophisticated investors for whom an investment in the Partnership does not constitute a complete investment program and who fully understand, are willing to assume and who have the financial resources necessary to withstand, the risks involved in the Partnership's specialized investment program and to bear the potential loss of their entire investment in the Interests.

Investors in the Partnership must be "accredited investors" as defined in Rule 501 under the Securities Act, "qualified purchasers" as such term is defined in Section 2(a)(51) of the Company Act and must meet other suitability requirements.

Each prospective purchaser is urged to consult with its own advisors to determine the suitability of an investment in the Interests, and the relationship of such an investment to the purchaser's overall investment program and financial and tax position. Each purchaser of an Interest is required to further represent that, after all necessary advice and analysis, its investment in an Interest is suitable and appropriate in light of the foregoing considerations. Prior to any subscription of Interests, each prospective purchaser must represent in writing, by completing and signing the subscription documents, that it meets the suitability standards referred to in this Confidential Offering Memorandum. The General Partner has the right to reject a subscription for any reason or for no reason.

Interests may not be purchased by nonresident aliens, foreign corporations, foreign Partnership, foreign trusts or foreign estates, all as defined in the Internal Revenue Code of 1986, as amended or by U.S. tax-exempt investors. Foreign investors and U.S. tax-exempt investors may be eligible to invest in the Offshore Fund that has a substantially similar investment program to that of the Partnership.

COUNSEL

Schulte Roth & Zabel LLP, 919 Third Avenue, New York, New York 10022, acts as counsel to the Partnership in connection with this offering of Interests. Schulte Roth & Zabel LLP also acts as counsel to the General Partner and his affiliates. In connection with the Partnership's offering of Interests and subsequent advice to the Partnership, the General Partner and his affiliates, Schulte Roth & Zabel LLP will not be representing the Limited Partners of the Partnership. No independent counsel has been retained to represent the Limited Partners of the Partnership.

AUDITOR; REPORTS

BDO Seidman, LLP serves as the Partnership's auditor. The Partnership will provide to the Limited Partners unaudited financial statements within 35 days after the end of each calendar quarter (other than the last) and will furnish to them annual audited financial statements within 90 days after year end, and tax information as soon thereafter as practicable. Certain Limited Partners may have access to certain information regarding the Partnership that may not be available to other Limited Partners. Such Limited Partners may make investment decisions with respect to their investment in the Partnership based on such information.

SUBSCRIPTION FOR INTERESTS

Persons interested in subscribing for Interests will be furnished with, and will be required to complete and return to the General Partner, subscription documents and other certain documents.

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ADDITIONAL INFORMATION

Representatives of the General Partner are available for a discussion of the terms and conditions of this offering and will provide any additional information, to the extent they possess it or can acquire it without unreasonable effort or expense, necessary to verify the information contained in this Confidential Offering Memorandum.

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EXHIBIT 28

GABRIEL CAPITAL GROUP

450 Park Avenue
New York, NY 10022
TELEPHONE 212 838-7200
FACSIMILE 212 838-9603

April 22, 2004

Mr. J. Ezra Merkin
450 Park Avenue
New York, NY 10022

Dear Mr. Merkin,

For the quarter ending March 31, 2004, an investment in Gabriel Capital, L.P. appreciated approximately 2.7% after all expenses and fees. The unaudited value of your investment in Gabriel stood at approximately $18,473,958.74 at March 31, 2004. Enclosed please find unaudited financial statements for the period ending March 31, 2004.

Lost in the Magic Kingdom

When is Disney World the "happiest place on earth," and when is it acres of confusing parking lots, all named after Disney characters, staring you in the face? A story in the *Wall Street Journal* in February raised the question and made us think about the plight of many investors. Imagine ending your day at Disney World, after hours of waiting on line with your kids for the restroom, some food, or the next attraction, in a futile search for your car amid the 46,172 parking spaces at the facility. The *Journal* described such a tourist, Jorge Herbozo of Ecuador, who could not recall whether he had parked in "Goofy" or "Dopey." Disney maintains a staff of helpful and calm guides who cruise the parking lots at night, trying to match the Herbozos of the world with their wheels. Fortunately for Señor Herbozo, his guide eventually followed the advice of eight-year-old Elena Herbozo, who insisted on looking at another section. Sure enough, the Herbozos' Ford Focus turned up where Elena had predicted, not in Goofy or Dopey but in Row 26 of "Pluto."

Often, investors in the Magic Kingdom of mutual and hedge fund managers do not know in which section they are parked. They might feel like they have come to visit the Kingdom of Golconda, where one cannot help becoming rich. Inevitably, however, they have to go home. When that time comes, it helps to know whether the car is parked in long/short, growth, value, small-cap, commodities, or some other lot. People don't always keep track of such things and, if they check, don't always remember. When markets go up, moreover, they see no real need to know where they are parked. It is when the tide rolls out that investors start looking in Goofy and then check in Dopey before turning to the Disney guides who may lead them to Pluto.

The *Journal*'s Herbozo story is all fun and games — except to Señor Herbozo — but it points to a serious issue for investors: How much do they know about where their money is parked? Mutual funds publish all the trees on a regular basis, and still their investors cannot see the forest. Too often, investors simply do not know their fund's approach — to say nothing of the conduct the mutual fund wants no one to know about. At our fund, as at many other hedge funds, we do not provide complete transparency, but we try to keep you informed of what we do and why we do it. We find complete transparency overrated, especially if it is not accompanied by, or even detracts from, *understanding*.

Understanding entails, at a minimum, a grasp of the asset classes in which the manager is active. The relationship among asset classes may vary, depending on opportunities in the market at a given time, but investors should have a decent idea of the areas in which their money is placed. (It goes without saying that if a manager claims to be trading convertible arbitrage or distressed debt, investors should be able to trust that assertion and not wake up to find out that they are really in platinum futures.) These days, our portfolio breaks down as follows:

CATEGORY	Long Market Value as % of Capital	Short Market Value as % of Capital	Net Market Value as % of Capital
Distressed Debt	16%	0%	16%
Debt or Equity Subject to a Deal or Legal Process	33%	0%	33%
Credit Opportunities	7%	0%	7%
Arbitrage of Related Securities	23%	-3%	20%
Long-term Equity	12%	0%	12%
Short Securities Outright and Portfolio Hedges	0%	-11%	-11%
Cash (Including Proceeds from Short Sales)	23%	0%	23%

Knowledge of asset classes, and even strategies or positions, is not the whole story. Within asset classes, there can be significant variation in (i) what risks the manager is prepared to take (ii) in exchange for what kinds of returns. Therefore, it is crucial that investors also understand risk.

Our goal, then, is to help you understand the section in which we are parked and, within that section, how much risk we take. We spend a lot of time — perhaps too much — talking about risk, because we want you to understand what it means to be one of our investors. (As we have noted, to our enduring chagrin, our reluctance to take on more risk helped to suppress returns in 2003.) Regardless of your fund's asset class, two questions go a long way toward defining risk: (i) How much *leverage* does your manager use? (In our case, almost none.) (ii) What *limits* does he place on position sizes? (We draw the line at 2.5% risk to opening capital, with no position to exceed 10% of the portfolio.) If you can answer these questions, you know what risks you are taking. If you cannot, you should try to learn more.

It is possible to have transparency without understanding. Indeed, we can imagine a hypothetical manager who has had stupendous risk-adjusted returns for many years. He may well disclose to investors all his positions but, so long as he has a proprietary black box approach, no one outside his firm really understands how results are achieved. Study the trees as they might, investors will fail to understand the forest. Our approach to disclosure favors understanding over transparency. We think an investor need not know about every car in the lot or even Row 26 (indeed, that such voluminous data may impede comprehension), but should know, as Elena Herbozo did, that she is in Pluto rather than Goofy or Dopey.

The Times They Are A-Changin'

Wall Street operates neither as a bear nor a bull, but as a shark. To survive, it needs a steady diet of deals, as it swims through the waters and lives off the fees that deals create. At the risk of being repetitive, our parking lot has been and continues to be underwriting the deals that Wall Street's corporate finance departments create. Each position is a little business on its own. As on design runways, fashions in deals change frequently. In good times, one can form capital by raising debt and retiring equity. In bad times, one forms capital by raising equity and retiring debt. The process is countercyclical: first, companies overpay for assets; then, they restructure. We continue to function as a pool of capital providing liquidity for the other side of whatever Wall Street deems fashionable, charging a high enough price to create a rate of return for our investors.

The nature of deals is constantly changing, and not only on Wall Street. The best deal of the quarter was the New York Yankees' extraction of Alex Rodriguez from the Texas Rangers. In effect, A-Rod's $25 million-per-year contract was a busted credit: Texas had managed to overpay for the very considerable value of his services. The Yankees came along with capital to enable Texas to clean up its balance sheet, and for this liquidity they charged a high price, giving less than equal value for A-Rod, in the form of Alfonso Soriano, and leaving Texas on the hook for a goodly portion of Rodriguez's salary. It is a neat trick to pick up arguably the best player in the sport without increasing payroll. For Soriano, it was a particularly bad night. As part of the trade, he was forced to 'fess up to his real age, which proved two years higher than either ball club had believed. Put yourself in Soriano's spikes: he went to sleep 26 years old and a New York Yankee and woke up (lo and behold) 28 and a Texas Ranger. When we provide capital to help underwrite a busted credit, we perform a function similar to the Yankees' in the A-Rod deal, and we hope to reap similar benefits.

Another first quarter deal served as an elegy for a Wall Street fashion popular earlier in the decade. It was as recently as April 2000 that AT&T offered 360 million shares of AT&T Wireless as a tracking stock. Tracking stocks were supposed to unlock the value of dynamic new enterprises owned by stodgy old companies. The IPO was priced at $29.50 a share, and the top, $36, was reached within a week. After that, the deluge, with a bottom of $3.15.

Now Cingular is buying AT&T Wireless for $15 a share. For shepherding AT&T Wireless to market as a fashionable tracking stock and then doing away with that structure when the fad passed, investment bankers — not bulls, not bears, but sharks — made a cool $350 million. We also made a few dollars, buying the stock as an arbitrage play about halfway between the bottom and the sale price to Cingular.

The Wall Street merry-go-round of deals keeps spinning. In recent years, AT&T investors received not only AT&T Wireless stock but, in a deal for the company's cable assets, shares in Comcast. And it is just that currency, Comcast stock, that has been offered in support of a hostile bid for the progenitor of Goofy, Dopey, and Pluto. When a company proposes a dramatic, landscape-altering acquisition, as in Comcast's bid for Disney, that is usually a sign of trouble at home. Consider GE's memorable failed (albeit friendly) bid for Honeywell, which signaled that GE's top line was heading south, the company needed acquisitions to continue growing, and a top had been reached for its cachet premium. A skeptical money manager (perhaps that is redundant) should assume that the message from the bidder in a hostile mega-merger to its own shareholders is: *Everything okay at home?*

Comcast is the largest cable operator in the United States and ostensibly has a monopoly. New technology, however, has vitiated the monopoly. In fact, we suspect that Comcast's bid is a signal that the company is concerned about programming costs. The bid has all the indicia of a suspect deal: it (i) is massive; (ii) is hostile; (iii) would be a merger of equals (with Disney shareholders owning 42.5% of the combined company); (iv) would send Comcast into new lines of business; and (v) depends on Comcast being able to restore growth to Disney businesses — theme parks and animation — far from Comcast's competencies.

When GE bid for Honeywell, one could see problems with the deal and still make money. The way to play the deal included shorting GE, which was consistent with the signals that GE had sent by proposing the deal in the first place. In the case of Comcast's bid for Disney, there was not much to do after Disney said no. One could short a bit of Disney, but only a bit: it is not the greatest idea to short a hot takeover stock, especially when a blowout bid could fall from the sky at any moment. Talk about feeling Dopey!

A Brief Tour of Pluto

Having spoken of our general location in the parking lot, we would like to give you a glance at a couple of the spots in which we have parked recently. We necessarily place our empirical focus on bottom-up analysis of securities that we think mispriced. The distressed and high yield markets provide opportunities for pricing inefficiencies because the average investor's understanding of debt securities is limited and pricing information is difficult to obtain. After spending a day at Disney World, you can't go back to your hotel room and check individual bond prices on Yahoo.com.

An example of successful bottom-up execution was our investment in Better Minerals and Aggregates ("BMA") 13% Senior Subordinated Notes due in 2009. BMA is the second largest domestic producer and distributor of silica, which is a raw material commonly used in glass products. Here are some recent year-end numbers on the business:

	2003	2002	2001	2000
Revenue ($mm)	182.5	300.5	307.9	300.3
Ebitda ($mm)	26.8	45.2	54.8	51.0
Debt/Ebitda	6.0	6.3	5.1	5.5
Debt/Ebitda-MaintCapEx	7.6	7.2	5.7	6.2
Ebitda/Int	0.9	1.4	1.5	1.4
Ebitda-MaintCapEx/Int	0.7	1.2	1.4	1.2
Law Suits	25,000	5,100	1,320	610

Although BMA generates predictable cash flows, its viability was clouded by personal injury lawsuits related to silica exposure and excessive leverage. Upon careful analysis, we concluded that litigation costs were manageable, thanks both to insurance and indemnification from BMA's erstwhile parent company. Further, the capital structure was flexible, so an event of default did not seem immediately likely. We bought the bonds in the third quarter of 2003, paying in the high 50s, and waited for the market to come around to our point of view while happily earning a cash yield in excess of 20%. Our wait was not long: we sold the position in the first quarter of this year, when the price passed 72, reaching our threshold where risk outweighed future return.

Whereas we found adequate empirical evidence to go forward with BMA, the lack of data is a reason to pass up investment opportunities. In March, Calpine, one of the largest independent power producers in the United States, issued $2.4 billion of operating company mortgage notes in a two-day "drive-by" road show. While the notes were issued to refinance debt at the holding company level, noteholders received collateral of generating plants via a special-purpose corporation, but the notes were non-recourse to the holding company. We were shocked at the limited financial data provided by Calpine. In determining whether to ante up for the deal, most investors were forced to apply heuristic measurements such as the debt/kilowatt ratio. This reminded us of the days when speculators were told to look at the ratio of enterprise value to access lines in valuing local Russian telephone companies. That is not our style, so we passed on the securities. Calpine's vision, stated in its annual report, is to become "the largest and most profitable power company in North America and a major international power company." The vision may become reality if the investment community pursues momentum investing, but if the focus returns to empirical evidence, as it typically does, Calpine may be a big brownout.

Being a bottom-up investor does not mean ignoring macro trends. An investment that we expect will provide a stable return even in an environment of rising interest rates is our holding in Aavid Thermal's 12.75% notes. Aavid makes heat management products for electronics and computation fluid dynamics software. In 2001, Aavid breached bank covenants and essentially ran out of cash, but its equity sponsor shrewdly came to the rescue by infusing cash and buying

in bonds on the cheap. Now the company is a more stable credit, having experienced a solid recovery in its electronics business and continued growth in its software division. Aavid's recent year-end numbers look like this:

	2003	2002	2001	2000
Revenue ($mm)	188.1	162.0	171.0	276.0
Ebitda ($mm)	35.7	22.0	7.0	39.0
Debt ($mm)	138.8	142.0	180.0	209.0
Debt/Ebitda	3.9	6.5	25.7	5.4
Debt/Ebitda-MaintCapEx	4.4	8.2	128.6	7.1
Ebitda/Int	2.0	1.2	0.3	2.1
Ebitda-MaintCapEx/Int	1.7	1.0	0.0	1.6

Thanks to a spread to Treasuries of over 825 basis points, Aavid's bonds are well-protected from rising interest rates, which in any event imply an improving economy and therefore continued growth in the company's performance. We carried the bonds at par at year-end; as of the close of the first quarter, we marked the position at 106. Although the bonds are not callable until 2006, we believe Aavid may want to lock in low interest rates and tender for bonds at higher prices. If not, we are happy to clip the coupon, earning a current yield of 12%.

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We want our partners, lest they get lost in the parking lot, to have a sense of what the portfolio as a whole is about, the approach we take to investing, and how we try to control risk. Without risk, there can be no returns above the Treasury rate. The key is to find tolerable risks that compensate our investors adequately. The last thing we want is for you to park a Lexus in the morning and leave in the evening with a Ford Focus. If that means that we must eschew dreams of sending you home in a Bentley, so be it. At least none of us will think we are parked in Goofy or Dopey.

Very truly yours,

J. Ezra Merkin
General Partner

GABRIEL CAPITAL, L.P.
STATEMENT OF INCOME
THREE MONTHS ENDED MARCH 31, 2004

UNAUDITED

REVENUES:	
NET GAINS ON SECURITIES	$15,216,211
DIVIDEND AND INTEREST INCOME	$53,699
TOTAL REVENUES	$15,269,910
EXPENSES:	
INTEREST EXPENSE	$93,830
OTHER EXPENSES	$969,481
TOTAL EXPENSES	$1,063,311
INCOME (Before all General Partner Fees)	$14,206,599

GABRIEL CAPITAL, L.P.
STATEMENT OF NET ASSETS
MARCH 31, 2004

UNAUDITED

ASSETS:	
BALANCES WITH BANKS & BROKERS	$113,796,859
INVESTMENT IN SECURITIES, AT MARKET	$364,815,066
OTHER ASSETS	$73,570
TOTAL ASSETS	$478,685,495
LIABILITIES:	
SECURITIES SOLD, AT MARKET	$59,043,375
OTHER LIABILITIES	$15,217,789
TOTAL LIABILITIES	$74,261,164
NET ASSETS (Excluding GP Fees)	$404,424,331

CONFIDENTIAL

EXHIBIT 29

GABRIEL CAPITAL GROUP

450 Park Avenue
New York, NY 10022
TELEPHONE 212 838-7200
FACSIMILE 212 838-9603

July 20, 2005

Dear ,

For the quarter ending June 30, 2005, an investment in Gabriel Capital. L.P. appreciated approximately 2.5% after all expenses and fees. For the first six months of 2005, an investment in Gabriel increased approximately 7.1%. Your investment in Gabriel Capital, L.P. had an unaudited value of approximately at June 30, 2005.

In accordance with federal laws, investment partnerships are required to provide individual investors with a copy of their Privacy Policy. Enclosed please find the Privacy Policy for Gabriel Capital, L.P. as well as the unaudited financial statements for the period ended June 30, 2005. Also enclosed are Gabriel's audited financial statements for the year ended December 31, 2004.

The following table reflects our portfolio's exposure, allocated among various investment strategies:

CATEGORY	Long Market Value as % of Capital	Short Market Value As % of Capital	Net Market Value as % of Capital
Distressed Debt	15%	0%	15%
Debt or Equity Subject to a Deal or Legal Process	34%	0%	34%
Arbitrage of Related Securities	20%	-1%	19%
Long-term Equity	11%	0%	11%
Credit Opportunities	6%	0%	6%
Short Securities Outright and Portfolio Hedges	0%	-17%	-17%
Cash (Including Proceeds From Short Sales)	32%	0%	32%

As always, we describe these categories in an Appendix to our letter.

The Markets

In the second quarter, the equities markets tossed and turned, as investor attention remained riveted on crude oil prices, which breached $60 per barrel — a 50% gain in the last year alone — and on bonds, which gained steadily, pushing yields below 4%. The dollar, meanwhile, posted its largest quarterly gain against the euro since 2001, rising 7.4% for the quarter, as the US economy outperformed Europe's. The dollar also gained 3.2% against the Japanese yen.

Early in the quarter, on April 10, stocks stumbled to their lowest levels since the presidential election. On April 21, after falling more than 900 points over seven weeks, the Dow Jones Industrial Average posted its best trading day in two years, gaining over 2%. The Dow had recorded four 100-point declines in six sessions before this big up day. The broader Standard & Poor's 500-Stock Index featured daily moves of one percent or more in either direction on seven days out of ten. The jury was still out on this sudden jump in volatility as the quarter ended, as bumpiness declined after these gyrations, only to return with a vengeance in June. In any case, within hours of the big up day, the debate on Wall Street changed from how low stocks would go to whether the rally was a one-day wonder or something more sustainable. Overall, equities turned in a mixed but generally unimpressive second quarter, with the Dow Jones declining 2.2%. The S&P 500 rose 0.9%, and the Nasdaq Composite Index climbed 2.9%, only partially reversing a steeper decline in the first quarter. For the first six months of the year, the Dow has lost 4.7%, the S&P 1.7%, and the Nasdaq a full 5.5%.

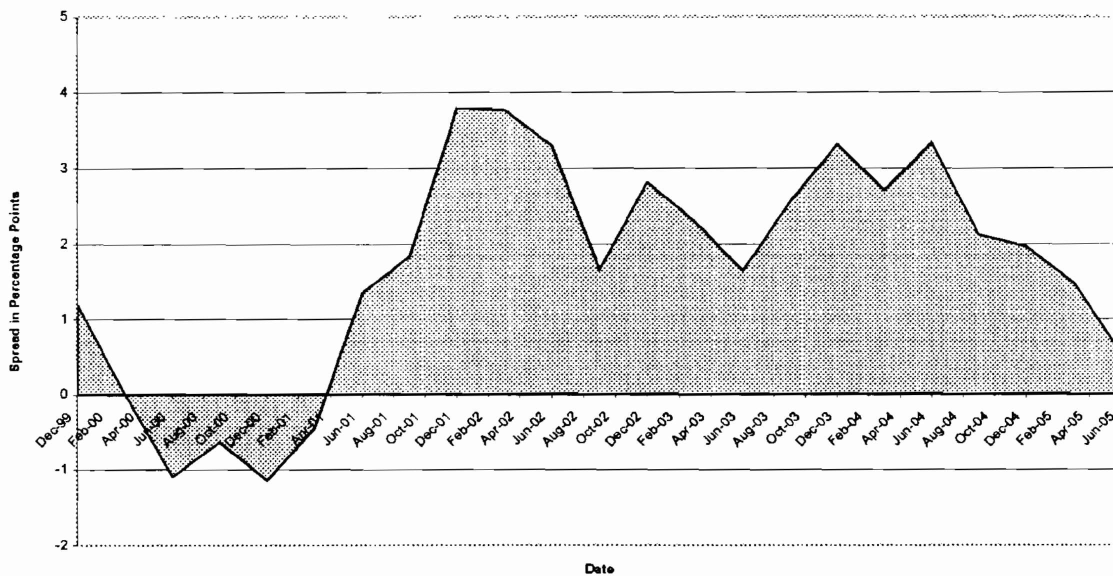
One might have expected at least as much turbulence in bond prices. Instead, they held up surprisingly well in the second quarter after the debt of General Motors Corporation and Ford Motor Company, two of the world's very biggest issuers of corporate debt, came crashing down. For much of the quarter, investors dumped GM and Ford bonds, causing prices to fall sharply and certain so-called correlation trades (which depend on all corporate bond prices moving in the same direction) to list badly. At one point, the annual cost of buying default protection on $10 million in investment-grade corporate debt jumped to almost $78,000 from about $52,000 at the beginning of the quarter. The market's bad case of nerves also pushed the spread between high-yield debt and Treasuries to more than 500 basis points in late May, nearly 100 basis points wider than at the beginning of the quarter. By the end of the quarter, however, the market had snapped back. The average price of default protection had fallen to about $60,000, and the average spread on junk-rated debt was a bit more than 400 basis points.

On the day the quarter ended, the Federal Reserve Board increased the rate on overnight loans between banks — the Fed Funds Rate — an additional quarter point, to 3.25%, the highest rate in more than four years and more than triple the low set almost exactly a year ago. The Fed suggested that its tightening campaign is not yet over. Bonds rallied on this news, with the yield on the 10-year Treasury — which had stood at 4.50% on March 31 — closing the quarter at 3.92%. Needless to say, the yield curve flattened considerably.

A Tale of Two Charts

I sometimes like to pontificate, or so my family and our quarterly letters suggest. This time around, I can save some verbiage concerning the credit markets by printing two simple charts. Figure 1 (below) shows the spread between the yield on 10-year Treasuries and the Federal Funds rate. Figure 2 (page 4) is an update of a chart that I shared with you a year ago, showing the spread of the Merrill Lynch High Yield Index over Fed Funds. What goes on *within each chart* has an impact on the movement of capital *from one chart to the other*, as investors look for a more hospitable environment in which to make money.

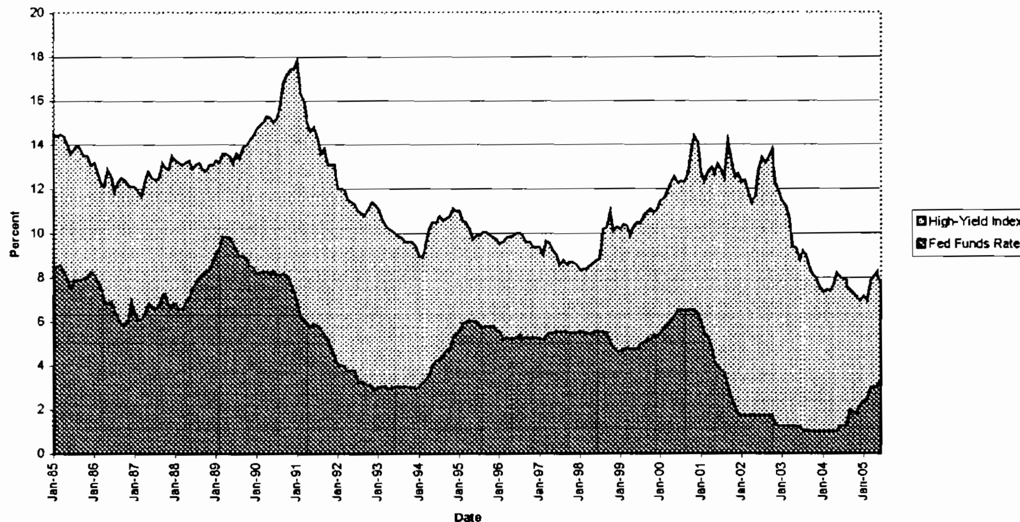
Figure 1
Yield Curve (10-Year Treasuries v. Fed Funds Rate, 2000-05)
Inversion Looming?



At the beginning of 2004, as Figure 1 shows, there was a gap of over 300 basis points between 10-Year Treasuries and Fed Funds. (The gap would have been closer to 400 points had we used the Fed Funds *target* rate set by the Federal Reserve Board rather than the level at which Fed Funds were actually trading.) With such a gap, a speculative lender could make a living off the mother, or at least the great-aunt, of all positive spreads: borrowing short-term, lending long-term, and pocketing the "carry." The lender's profits would be limited only by the quantity of leverage available and how well he wanted to sleep at night. Eighteen months later, the carry trade is hardly as appealing. As you can see, the spread is nearly gone, and we could even be

headed for an inverted yield curve, a phenomenon not seen since the first days of George W. Bush's presidency. This is the conundrum of our time: why have long-term yields failed to move upwards in lockstep with the Fed's persistent increases in short-term rates? One thing is no mystery, however. The near disappearance of the spread — at quarter-end, a mere 54 basis points — has sent capital scuttling from the carry trade into other forms of investing, not least into our neck of the woods. Chairman Greenspan has taken note. Last month, he fretted that low long-term rates might drive investors to take on too much risk in the search for higher returns. While hedge funds might seek to exploit temporary market inefficiencies, he observed, "most of the low-hanging fruit of readily available profits" has already been picked.

Figure 2
High Yield Index v. Fed Funds Rate, 1985-2005



In almost any kind of investing, returns have at least some connection to the risk-free rate of return, with investors demanding higher returns for greater risk. With this as background, we turn to Figure 2, which compares the Merrill Lynch High Yield Index to the Fed Funds Rate. This spread, quite different from the one depicted in Figure 1, serves as a proxy for the returns available for opportunistic capital, or the segment of our portfolio designed to create a rate of return. That segment, to a greater extent than our private positions, is tethered to the risk-free rate. Last year, we said of the tightening of the Figure 2 spread, in words not too different from Chairman Greenspan's warning of last month:

In the current compression, a gap of 1200 basis points in the latter part of 2002 has now shrunk to about 700 basis points, after closing to barely 600 at the start of this year. This six-quarter compression of yields has created a boondoggle for all asset classes for which the High Yield Index is a proxy. When the spread was at its widest, investors were paid handsomely for the risks they were taking. With today's tight spread, the reward for risk taking is substantially reduced.

The way life works, of course, is that at the time of wide spreads in 2002, with huge opportunities available for alternative investment, it was extremely difficult to raise capital in the area. Now that the spread is narrow and opportunities are fewer, money is flowing into alternatives. Or, as my mentor and friend Leon Levy was wont to say: When you have the ideas, you can't get the money; when you can get the money, you don't have the ideas. In this respect, investors in our sector do not behave so differently from retail stock market investors. There is a lot more enthusiasm for buying Google now that it is expensive than there had been when it was cheap.

As capital streams from the Figure 1 world of the carry trade to pursue the spreads that Figure 2 quantifies, we are faced with both good and bad news. The bad news is that tighter spreads reduce the buying opportunities in the Figure 2 world. The good news is that the new capital in this sector provides a cushion against the expansion of spreads. Of course, we must be alert, because there will come a day when the carry trade spread bulks wide again, and that will cause capital to return to the Figure 1 world, widening spreads — which is not to say depressing *values* — in our area.

Some of the Figure 1 capital has responded to the squeezing of the carry trade not by moseying over to our Figure 2 world but by concluding that the gods, or at least the dollar, must be crazy, and therefore making heavy macro bets in the Figure 1 world. Indeed, it seems that no less a deity than Warren Buffett is now betting on currencies, specifically, against the dollar. According to a June 20 *Bloomberg* report, Berkshire Hathaway has recorded $2.65 billion of gains betting against the dollar since 2002, though the position caused a $307 million first quarter loss. Not too shabby. At the close of the first quarter, Berkshire had *$21.8 billion* of currency forward contracts, and that's a number that will catch your attention.

Before you take Mr. Buffett to task, it is worth remembering a rule that works in any casino: When you're standing behind the man holding all the chips, don't say you don't like the way he plays. My general view of guessing currencies is that it's very much like trying to predict the Super Bowl winner: just because you got it right once, there is no reason to believe that you're going to get it right again. Mr. Buffett is playing a game that draws very little on his enormous strengths: adding value to particular, specific, and nuanced investment and business decisions — in other words, generating alpha. Currency speculation requires one to read only the first section, indeed, perhaps only the front page, of the *New York Times*; the business section can languish

unread. It is all macro and zero micro. What is more, to the extent that currency speculators are betting on the euro against the dollar, they risk choosing the greater train wreck over the lesser. It is a bit like the old Jewish joke describing the funeral in an Eastern European *shtetl* of the town thief. When all the townspeople gathered for the funeral, no one would agree to deliver a eulogy. The sexton pleaded, "Is there no one who will say something?" In response, someone finally got up in the back and said, "The brother? — he was worse!" Our business is not based on assessing the relative merits of the town thief and his brother. Instead, we try to redeem the fallen and turn them back into solid citizens.

Sowing and Reaping: When Is a Decent Quarter Made?

We are happy — or perhaps the right word is relieved — to report that we have had another decent quarter. Let us be clear on what a decent quarter means. As the Psalmist put it, "They that sow in tears shall reap in joy." The *real* decent quarter of which you read now came when we anxiously sowed in tears, be it a year or 18 months or two years ago. Now that it is time to report the results, we exhale with relief and reap sheaves that are the end result of that earlier work. That is almost a reporting or accounting function, as situations reach fruition and articulate their real value. It helps us that you understand that prior quarters, though they might have seemed lackluster, with returns flat or even down a bit, were actually quite good.

While we look backward to the results of the concluded quarter, it is even more important to look forward and consider what may be expected in the coming quarters. Though we are gratified that we are able to report decent returns, we are even happier that the quarter just ended was a good one not just for reaping but also for sowing. Our solution to the compression of spreads is finding market pockets that promise us better risk-adjusted returns. This is the biggest reason we love our private positions, 80% of which we buy in non-competitive situations. We are particularly enthusiastic about some large positions that we put on at the end of the first quarter. Thus far, they have contributed nothing to our profitability. The key is that they are sustainable businesses that throw off sustainable earnings, and that is where we find our alpha. We have every reason to hope that the new positions will drive the results for a good quarter (or quarters) down the road, at which point we will take a brief bow and immediately resume searching for additional opportunities.

I have made it sound easy, but there is a cost to all this, and not just the obvious one of foregone liquidity. As more of our positions are private, returns will become more lumpy. We mark the privates conservatively, and they can stay valued at cost for a long time, until there is a liquidity event. Therefore, we expect some more volatility in our returns, but with the goal that it will be volatility *within profitability*: i.e., sometimes more profitable, sometimes less, but rarely incurring a loss. The returns on the privates are not tied directly to the market, because this form of investment is a heavily value-added enterprise. Our contract with investors is essentially this: If we can (i) buy our positions the right way and (ii) control the timing of their sale, then we will have a very good chance to make money. The privates give us a chance to buy positions the right

way, because they are available at very attractive prices. It is equally important that we retain the ability to hold the privates until they ripen. The minute anyone else decides when to sell, we won't like the consequences. Our ability to designate investments in a "side pocket" (not to mention the tightened redemption provisions that will apply to capital invested after January 2006) protects against forced sales. Although we are hardly addicted to the side pocket — in fact, we have yet to use it — we value its availability.

An example, albeit felonious, of the importance of controlling purchase price and holding period was reported in the *New York Times* on May 5. Thieves pulled off without a hitch the carefully orchestrated heist of a shipping container, filled with 47,000 New York Yankees caps, contained in 212 boxes on 21 pallets. Investigators were puzzled: the caps, which had been ticketed for promotional giveaways at Yankee Stadium, were not standard fare for cargo heists. What is more, in early May, the Yankees were not playing well, and a police captain speculated of the thieves: "I think they had bad information of what was worthwhile to steal, or they grabbed the wrong trailer." At this writing, the Yankees are tussling for first place, and one can imagine them returning to the World Series. The cap thieves, so long as they can decide when to sell, may do very well indeed. Fortunately for us, our good buys in non-competitive situations are on the right side of the law, and we do not depend on fragile pitching arms or the aching backs of aging baseball stars to control the time of sale. Regrettably, I cannot hit a curveball or turn a double play, but I think we have some capacity for executing their investment equivalents — and when we win, the champagne is just as sweet.

Very truly yours,

J. Ezra Merkin
General Partner

APPENDIX

CATEGORIES OF INVESTMENTS

(1) *Distressed Debt* is an investment in the obligations of a company that is in serious trouble. The company may have filed for bankruptcy, or it may be about to. Its future is very much in doubt and its debt trades at relatively low prices. Our analysis of Distressed Debt contains financial and legal components. First, we must study valuations to figure out what is financially affordable; then, we consider what is legally permissible in a workout. When we find the answers to both questions promising, we invest. At this stage, we must rely entirely on our own work, because there is no external confirmation of valuations or process, let alone timing.

(2) At the next stage, after a bankruptcy filing, the company's securities may be *Debt or Equity Subject to a Deal or Legal Process*. Here, a plan of reorganization has been filed and the world therefore has a better idea what the securities are worth and what the timing may look like. This is the beginning of an arbitrage process, because we are underwriting the successful completion of a reorganization plan, the reward being the difference between the present and ultimate values of the securities. While significant uncertainties remain, the existence of a plan at this stage gives the first objective confirmation of the range of values that may be obtained.

(3) Still later, there are opportunities for *Arbitrage of Related Securities*. This happens when the securities that the reorganization plan brings into existence are available to trade. The package of securities may include senior secured debt, senior subordinated debt, new mezzanine debt, junior debt, preferred stock, and common stock. At this stage, one can hold the original debt while shorting fully valued or unattractive components of the package, or perhaps acquire a new long position while doing internal hedging.

(4) After the bankruptcy concludes, investment opportunities in *Long-term Equity* arise. For a month or two after a plan is confirmed and the company emerges from bankruptcy, one can still think of the company's securities as a bankruptcy play. After a couple of months, however, the bankruptcy is history. The decision to hold the securities beyond this point has to be predicated on the notion that they remain significantly undervalued.

Post-bankruptcy debt (as opposed to equity) fits under the rubric of *Credit Opportunities*. Also in this category are debt instruments that we do *not* believe will be subject to reorganization, our small portfolio of "dented" high-yields. This is debt that is not distressed, that is performing and should continue to perform. Whereas we can buy distressed debt for 30 or 40 cents on the dollar, we buy these dented high-yields in the 80s, happy to clip a substantial coupon and hoping for decent capital gains over time.

EXHIBIT 30

GABRIEL CAPITAL GROUP

450 Park Avenue
New York, NY 10022
TELEPHONE 212 838-7200
FACSIMILE 212 838-9603

January 20, 2007

Dear ,

For the quarter ending December 31, 2006, an investment in Ariel Fund Limited appreciated approximately 6.8% after all expenses and fees. For the year, an investment in Ariel appreciated approximately 17.7% after all expenses and fees. The unaudited net value of your investment stood at approximately at the close of the fourth quarter. The 2006 audited financial statements will be sent to you upon their completion.

The following table reflects our portfolio's exposure, allocated among various investment strategies:

CATEGORY	Long Notional Value as % of Capital	Short Notional Value as % of Capital	Net Notional Value as % of Capital
Distressed Debt	6%	0%	6%
Debt or Equity Subject to a Deal or Legal Process	26%	0%	26%
Arbitrage of Related Securities	26%	0%	26%
Long-term Equity	12%	0%	12%
Credit Opportunities	2%	0%	2%
Short Securities Outright and Portfolio Hedges	0%	-18%	-18%
Cash (Including Proceeds From Short Sales)	46%	0%	46%

As always, we describe these categories in Appendix 1 to our letter.

Nine Decades

For the financial markets, 2006 was more like two years than one. As investors tried to anticipate the Federal Reserve's next move during the first half, US stocks meandered along, then dove. A May squall in emerging markets caused equity volatility to jump to its highest level in three years and stocks headed toward their lows in early July. At mid-year, things looked gloomy, as oil nudged $80 a barrel and the Fed seemed set for further rate hikes. The markets reflected the pessimism, with the Dow Jones Industrial Average barely up on the year, the S&P 500 index down 2%, and the Nasdaq Composite off 8%.

For individual investors, the year really came down to how one reacted once the market made these lows in July. The subsequent rally in shares propelled the Dow into record territory and the S&P back to levels not seen since late 2000. The Dow finished the year up better than 16%, capping a nice four-year run that began with a 25% surge in 2003, a small gain of 3.2% in 2004, and a smaller loss of 0.6% in 2005. The Dow was joined in the black by the S&P 500 — up 13.6% for the year after losing 9% in 2004 and 3% in 2005 — and the Nasdaq, which gained 9.5% on the year. By year-end, oil had declined to $60 a barrel, perhaps the major propellant for the second-half rally in equities. Stocks also benefited from lower long-term interest rates, from stellar third quarter earnings, and from a near-record $1.75 trillion in merger and acquisition activity. Once it became clear — after 17 consecutive quarter-point increases — that the Fed had paused at its August meeting, the rally continued almost unabated through the fall, taking the Dow to record levels by October, surpassing a mark set in January 2000. The Dow went on to set twenty-two all-time highs, ending the year with a gain of 16.3%. All told, the index rallied by 1725 points in 2006. By way of absolute rather than relative perspective, it is amusing to note that the first 1725-point rally in the Dow's history took not half a year but *nine decades*: the index was founded in 1896 and did not close above the 1725 mark until March 11, 1986.

The dollar took a beating in 2006 — actually, two: one in the spring and one in November — as other countries began to diversify their foreign currency holdings. The euro was the primary beneficiary, rising above $1.33 Gold, too, benefited, achieving a 25-year high in May. In the bond market, Treasury yields fell from the levels reached in the summer, when the 10-year yield exceeded 5%, to below 4.5%, and finished at around 4.71%, as year-end economic readings were more robust than previously expected.

The forward march of stocks in 2006 appeared fairly broad. All ten big industry groups in the S&P 500 rose by at least 5%, led by an increase in the telecommunications sub-index of 32%. Energy followed with a rise of 22%, and healthcare and information technology were the laggards, gaining 5.8% and 7.7%, respectively. But the breadth of the rally was not all that it might seem to be. While the Dow's four-year rally may seem like an incredibly powerful generator of profits, the distribution of gains among the Dow components may surprise you.

The table below, which substitutes the S&P 100 for the S&P 500 and the Nasdaq 100 for the full Nasdaq of over 3,000 listings, highlights an interesting side of the 2006 rally in stocks.

A Peculiar Rally — The Winners Hide in Plain Sight

	1. Year-end 2006 change from pre-2006 high	2. Stocks reaching new highs in 2006	3. Stocks whose highs were set in 2000 or earlier
Dow 30	+6.3%	27%	63%
S&P 100	-20.7%	40%	48%
Nasdaq 100	-62.7%	35%	47%

The Dow is the only one of the three indices shown above that achieved new highs in 2006. The S&P 100 remained in the red and the Nasdaq 100 way underwater. (Recall that it took twenty-five years for investors to get back to the high-water mark that preceded the Crash of 1929, though at least they, unlike holders of Nasdaq issues, were collecting substantial dividends while they awaited salvation.) Note the paradox presented in the table: the Dow's recovery from the 2000-02 correction has been much more substantial than the partial recuperation of the S&P 100, to say nothing of the continuing disaster in the Nasdaq 100 (Column 1). And yet the latter two indices had more stocks achieve new highs in 2006 (Column 2), while well over half of the Dow's components peaked before 2001 (Column 3). The simple fact is that notwithstanding the Dow's huge lead in recovery (as shown in Column 1), almost two-thirds of its components set highs *before* the implosion and subsequent recovery. The message of the table is daunting: even with 20/20 hindsight, there is every chance that *an investor could do no right*. If he bought an index, Column 1 suggests that it had better have been the Dow, or else he would be very unhappy. But if an investor trying this at home was lucky enough to settle on the Dow, Column 3 suggests that he better have bought the entire Average. Had he picked his own stocks, the likelihood is that he'd be as unhappy as if he had dabbled in the Nasdaq 100.

To some extent, these counterintuitive numbers may be explained by the changing compositions of the indices. Some companies are added, others dropped. Beyond that, it is worth noting that the best of the indices is barely better than flat for a seven-year period. Imagine how much capital would remain with us if we had matched the indifferent record of one who bought the entire Dow 30 — let alone a disastrous purchase of the entire Nasdaq 100 — seven years ago. As lukewarm as the Dow's overall performance over this period has been, if you had picked five or ten Dow stocks at random in 2000, you would likely have found the issues that peaked before the bubble popped and thus done far worse. Again and again, we are reminded of the truth of a Wall Street cliché: it's a market of stocks, not a stock market.

Nonagenarian Niece

The main force driving the rise in equity prices last year was generously available debt, as the amount of capital in the area continued to grow. On the first business day of the new year, the *Wall Street Journal* looked back on 2006, observing: "A world awash in cash helped drive share prices higher and fueled frenetic merger activity in 2006." The

syndication of credit allows for mega-deals like the $5.9 billion mortgage that facilitated the purchase of Peter Cooper Village and Stuyvesant Town in New York City. As Robert Verrone, a managing director at the lead lender, Wachovia, explained: "Capital is plenty; it also is now a freely tradable commodity. We only originate financing for what we can sell; so long as we can sell it, we will originate it."

If the world is awash in cash, might inflation be a consequence? What is more, with the US running huge budget and trade deficits, might the dollar continue to weaken? The 2006 boom in inflation hedges such as art suggests that both questions should be answered affirmatively. Exhibit A in the case for inflation is the story of a Viennese couple of the early Twentieth Century, Ferdinand and Adele Bloch-Bauer. Ferdinand was a sugar magnate and supporter of the arts who, a century ago, took a shine to the painter Gustav Klimt, who in turn took a shine to Adele. Whether or not Klimt's relationship with Adele was anything more than an intellectual friendship, she was the only model he painted twice, first in 1907, when she was 29, and again, in a more subdued portrait, in 1912. In 1925, Adele lost her life to meningitis. After the Anschluss, the widower Ferdinand escaped to Switzerland, but his property, including the Klimt portraits, was confiscated. Last year, at the end of a lengthy process of litigation and arbitration, it was determined that the Klimt portraits properly belonged to Maria Altmann of Los Angeles, Adele's ninety-year-old niece, who put them up for sale.

In June, Ronald Lauder purchased *Portrait of Adele Bloch-Bauer I*, at that time just short of 100 years old, for his Neue Galerie in New York, paying a stunning $135 million. The only thing better than one Adele Bloch-Bauer is two. In November, *Portrait of Adele Bloch-Bauer II* was auctioned at Christie's, and went to an anonymous collector for a bargain price, relatively speaking: only $87.9 million. The *New York Times* dryly noted that the bidding frenzy for *Adele Bloch-Bauer II* and three landscapes by Klimt was fed by "great wealth being accumulated in world financial markets." No kidding. At a minimum, the boom in art prices suggests that very wealthy people believe classic works of art to be a safer store of value for at least some of their assets than the dollar, i.e., a good inflation hedge. The key question for people not spending eight or nine figures for works of art is whether all the money sloshing through the international economy will lead to inflation across the board, or perhaps affect only the prices of inflation hedges like rare Oriental carpets, exclusive real estate, or famous works by dead (or even living) artists.

Nonagenarian II

The debt market did not soar in an intellectual vacuum. Instead, the market as we know it today stems in large measure from the scholarship and advocacy of a man born in the year that Klimt painted his second portrait of Adele. In mid-quarter, Nobel laureate Milton Friedman, one of the most influential economists of the last half century, died in San Francisco at the age of 94. Professor Friedman achieved many breakthroughs in his field and was perhaps most famous for arguing the importance of the money supply as the prime determinant of inflation. His monetarist theories led him to place the blame for the national catastrophe of the Thirties squarely on the shoulders of the Federal Reserve Board. He pointed to the Fed's decision to drain money out of the economy as the culprit

that turned what might have been a garden-variety recession into the Great Depression, much as medieval doctors had enervated rather than helped their patients by bleeding them.

The structure of modern financial markets attests to Professor Friedman's influence. Today, we take open and unhindered financial markets for granted. When Professor Friedman first proposed floating (rather than fixed) exchange rates, they were considered inherently destabilizing, and it was widely agreed that governments needed to control the movement of capital across international borders. Today, the dollar fluctuates against almost all other currencies, and an entire industry in trading futures and options on interest rates and currencies flourishes.

Mr Friedman and his wife, Rose, wrote books and created a television series that extended their free-market ideas to a very large audience. In the Friedmans' view, the government is obliged to keep its hands off the economy. The only economic lever that Professor Friedman permitted the government to retain was the one that controlled the supply of money — a monetarist view that had fallen completely out of favor when he rescued it in the Fifties. In *Capitalism and Freedom*, the Friedmans wrote: "Political freedom means the absence of coercion of a man by his fellow men. The fundamental threat to freedom is power to coerce, be it in the hands of a monarch, a dictator, an oligarchy, or a momentary majority.... *By removing the organization of economic activity from the control of political authority, the market removes this source of coercive power*." The government's lighter hand built confidence, as investors had reason to expect that the rules would not be changed after they had made their purchases. In turn, the growth in confidence made the market what it is today and had the effect of transferring coercive power from the government to the market itself.

Professor Friedman died in a quarter that saw the market's hegemony increasingly secure and more widely established globally than ever before. Perhaps the greatest and sincerest tribute ever paid him — and telling testimony of the extent of his influence — was the famous line of Bill Clinton's political guru after the administration's policy advisors, a group not shy about asserting government control over economic issues, convened to consider grand plans, only to retreat in the face of the market's contrary views. James Carville ruefully observed: "When I come back, I want to come back as the bond market, because then you can intimidate *everybody*." This could have been Professor Friedman's epitaph.

The enormous growth in the debt market stems from a belief that the free market — not a central planner, nor a professor with tweed elbow patches, nor even the most powerful of computers — is the ultimate oracle. In the context of economic history, the universe of floating currencies, heavy international trade, and readily available debt is something of a brave new world. It is not as though the law of comparative advantage and the concept of the invisible hand were discovered last Tuesday, but these ideas had been in retreat for much of the Twentieth Century. They regained ascendancy and have

been put into successful practice only during the last quarter-century or so. That they have done so is largely attributable to the vision and pertinacity of Professor Friedman.[1]

Professor Friedman did not command armies, never held public office, and enjoyed no formal role in setting economic policy. What he had was the power of ideas, and with those ideas he remade our world. If Richard Nixon was able to say in the early Seventies that we are all Keynesians now, it was Friedman who managed to turn back the clock and remind policymakers that that government that governs least governs best. Indeed, Professor Friedman's views seem so obvious that one could say we are all Friedmanites now. We — investors and money managers alike — have all been incredibly lucky to live in a period of great prosperity and freedom, much of which is attributable to renewed acceptance of Professor Friedman's ideas. The two great chairmen of the Federal Reserve during this era, Paul Volcker and Alan Greenspan, implemented these ideas to great effect. Thus, it would not be entirely accurate to say that Professor Friedman had no divisions: his students comprised his army, and they applied his teachings to the levers of the economy in a masterly way. Milton Friedman was less well known for bons mots than was Lord Keynes, whose most famous aphorism was *In the long run, we are all dead*. It's hard to quibble with that, but even as Professor Friedman added another quantum of proof to that principle, his ideas show every sign of living on for well past his nine and a half decades.

Ninety-Nine Years

Professor Friedman's immense intellectual success has not only enabled and shaped the global capital markets we know today but has had a very practical effect on the way we manage your money. As you know, our first fifteen years in business focused almost exclusively on merger arbitrage and distressed investing, with the ratios between the two asset classes constantly adjusting but without much at all in our portfolio from outside those areas. These liquid markets became more and more efficient, however, and therefore less attractive for us, so we began to move capital into private, illiquid deals. Our effort has been to migrate from increasingly efficient markets to our private positions, where we enjoy both much more complete information about our investments and, thanks to our sourcing network, much less competition for our ideas. There, we have worked diligently to establish a reputation for creativity and reliability, which further enhances the access to ideas conferred by our sourcing advantage.

Our record of success with private positions has brought some larger transactions our way, and we now find ourselves participating in control stakes of large businesses. The commentator Michael Kinsley took the occasion of Professor Friedman's passing to offer

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[1] On occasion, perhaps Professor Friedman's ideas gave too little weight to certain considerations of social justice and perhaps overweighted the market's ability to solve some of the challenges we face today, such as rising inequality and externalities like global climate change. Nor has society adopted many of his libertarian views in the non-economic sphere. There are areas in which the market needs to be tempered rather than embraced, but history repeatedly teaches us that these are the exception rather than the rule.

a nod to his seminal role as defender of the capitalist faith and, at the same time, draw a distinction. "Capitalism is brilliant at setting the price of potatoes," Kinsley said. "But how good is it at setting the price of a large company?" Given the number of private positions we have taken in companies, Kinsley's comment got us to thinking. Even putting aside volatility and panics, how confident can we be that the market has priced a company accurately when many companies have experienced significant discontinuities among their market capitalization, their value in a private equity buyout, and their value upon subsequent resale to the public? Some, but surely not all, of the discrepancies can be explained by changing conditions and, it is hoped, improvements made by the private equity owners. That still leaves some explaining to do.

We are perhaps less cynical than Kinsley about the value that may be unlocked by private equity and less credulous than a classical economist who believes that market price is the last word on value. Acting on these beliefs, in recent years we have placed increased emphasis on our private positions. In our case, the vast majority of our private positions are acquired in non-competitive situations, thanks to our sourcing advantage. When a transaction is negotiated without competition, there is a better chance that the buyer is paying an acceptable price. In the fourth quarter, we took our private equity activity to a new level when we participated in the purchase from venerable General Motors, founded in 1908, of a majority interest in its finance arm, General Motors Acceptance Corporation. In this instance, the asset was not undervalued by the market; it was sold by a struggling parent that needed to raise cash. GMAC is a very large, profitable, and well-managed finance company, and we were very pleased to join in a transaction priced at a discount to tangible book value and at a very reasonable multiple of earnings. Aside from GM's need to achieve liquidity, the price was kept reasonable by the risk that the largest part of GMAC's business, auto finance, may suffer if GM's business does not bounce back. We hope to reduce GMAC's largest cost, borrowing, by achieving an improved credit rating as a result of our transaction, which has infused a large amount of fresh equity capital. Reduced borrowing costs should improve profitability. In addition, though GMAC has good management and a sound and conservative credit culture, we hope to exploit other opportunities to reduce costs in its mortgage, auto finance, and insurance businesses.

Our group of co-investors has majority voting control of GMAC and will oversee and control its ongoing management. In this connection, I have been asked to serve as Chairman of the Board of GMAC, and I have accepted that position. Day-to-day management of the business will remain under the supervision of GMAC's very competent CEO, Eric Feldstein, and his team, and I look forward to working with them to make this investment successful for GM, for our group, and for our investors.

• • •

In 1981, as a rather newly minted member of the bar, I found myself not only practicing law but teaching it as an adjunct professor. The question of how to give fair and meaningful grades troubled me. I wanted to maintain some sort of standards without becoming an arbitrary martinet. That year, I snipped a letter to the editor that appeared in

the *Wall Street Journal*, which I have kept ever since. It is a very small clipping, by now yellow with age. In its entirety, it reads as follows:

> To the Editor:
>
> A phrase in Prof. Toby's article hit home with special force in a way that provides a dramatic example of what has happened to "higher education" in my lifetime. Prof. Toby teaches at Rutgers University, now a state multiversity. I was graduated from Rutgers University in 1932, when it was still a relatively small, predominantly private university.
>
> The phrase that struck me was "many [students] arrive 10 or 15 minutes late" to class. In my four years at Rutgers, I received one grade of C. I received that because I frequently arrived a few minutes late to a course in European economic history, which met at 1:30 p.m. in a building as far as any on the campus from the restaurant where I waited tables to earn my meals. When I explained why I was late, the professor said: "You are at Rutgers to get an education, not to wait on tables," and refused to alter the grade. I may add that it was an excellent course.

The letter came from the Hoover Institution in Stanford, California. The writer was Milton Friedman.

Very truly yours,
Gabriel Capital Group

J. Ezra Merkin
President

APPENDIX 1

CATEGORIES OF INVESTMENTS

(1) *Distressed Debt* is an investment in the obligations of a company that is in serious trouble. The company may have filed for bankruptcy, or it may be about to. Its future is very much in doubt and its debt trades at relatively low prices. Our analysis of Distressed Debt contains financial and legal components. First, we must study valuations to figure out what is financially affordable; then, we consider what is legally permissible in a workout. When we find the answers to both questions promising, we invest. At this stage, we must rely entirely on our own work, because there is no external confirmation of valuations or process, let alone timing.

(2) At the next stage, after a bankruptcy filing, the company's securities may be *Debt or Equity Subject to a Deal or Legal Process*. Here, a plan of reorganization has been filed and the world therefore has a better idea what the securities are worth and what the timing may look like. This is the beginning of an arbitrage process, because we are underwriting the successful completion of a reorganization plan, the reward being the difference between the present and ultimate values of the securities. While significant uncertainties remain, the existence of a plan at this stage gives the first objective confirmation of the range of values that may be obtained.

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EXHIBIT 31

GABRIEL CAPITAL GROUP

450 Park Avenue
New York, NY 10022
TELEPHONE 212 838-7200
FACSIMILE 212 838-9603

October 20, 2008

Mr. J. Ezra Merkin
450 Park Avenue
New York, NY 10022

Dear Mr. Merkin,

For the quarter ending September 30, 2008, an investment in Gabriel Capital, L.P. decreased approximately 3.2% after all expenses and fees. For the first nine months of the year, an investment in Gabriel decreased approximately 3.9%. The unaudited net value of your investment in Gabriel Capital, L.P. stood at approximately $29,233,512.39 at the close of the third quarter. Enclosed please find unaudited financial statements for the period ending September 30, 2008.

The following table reflects our portfolio's exposure, allocated among various investment strategies:

CATEGORY	Long Notional Value as % of Capital	Short Notional Value as % of Capital	Net Notional Value as % of Capital
Distressed Debt	13%	0%	13%
Debt or Equity Subject to a Deal or Legal Process	22%	0%	22%
Arbitrage of Related Securities	33%	-7%	26%
Long-term Equity	24%	0%	24%
Credit Opportunities	3%	0%	3%
Short Securities Outright and Portfolio Hedges	0%	-30%	-30%
Cash (Including Proceeds From Short Sales)	42%	0%	42%

As always, we describe these categories in the Appendix to our letter.

No Place to Hide

The wonder of financial crises is the way that events move directly from impossible to inevitable, without even pausing at improbable. There were stunning, historic events in the final month of the third quarter. Fannie Mae and Freddie Mac were taken over by the government. Lehman Brothers filed for bankruptcy protection, Merrill Lynch was thrust into the arms of Bank of America, American International Group gave the government control of the company in return for an $85 billion loan (later significantly expanded), Washington Mutual was seized by federal regulators, several money market funds broke the buck, and regulators orchestrated the sale of Wachovia Corp. Meanwhile, Goldman Sachs and Morgan Stanley survived only as a result of large infusions of cash and a decision to give up the traditional Wall Street investment bank model, transforming themselves into bank holding companies so that they might borrow from the Federal Reserve directly. The government has introduced more dramatic and far-reaching financial policy changes in a matter of days than it had in decades, with primary, secondary, and tertiary consequences that will take years to identify, let alone play out.

In the quarter, the Dow Jones Industrial Average lost 4.4% and stood 23% lower than its peak last October. The Standard & Poor's 500 Stock Index was off 9% for the quarter and 26% from its high. The Nasdaq Composite Index dropped 9.2% in the third quarter and stood 27% lower than its multiyear high, set last Halloween. The S&P was down 20% from January 1, making it one of the world's best-performing equity markets, as Europe was off 25% to 35% and the Asian-Pacific markets 30% to 65%. All this occurred amid wrenching volatility: the Dow moved an average of 350 points over the last fourteen sessions of the month, currencies traded like they were commodities, gold prices moved like natural gas prices during a Gulf hurricane, and crude oil moved $25 in an hour.

This litany may meet your requirements for a bad quarter (it certainly does ours), but on a percentage basis it doesn't even break into the top ten down quarters for the S&P 500 and was only the 25th worst quarter of all time for the Dow. The third quarter, moreover, was merely prelude to what has followed since. In the first eight trading days of October, the Dow fell a further 22.1%, while the S&P lost 22.8% and the Nasdaq 21.2%, with extreme volatility leading to even more drastic intraday lows. It was not quite the stunning one-day drop of October 19, 1987, but after the carnage of the third quarter the investing public was hardly in a mood for a blitzkrieg bear market.

As bad as equities were, by far the worst turmoil was in the credit markets, especially following Lehman's bankruptcy filing on September 15. Credit is the lubricant that permits the capital markets to function. Fear began to dominate, causing both credit and confidence to disappear. Counterparty risk — "My money is sitting at Lehman, and there is no more Lehman; my money is at Morgan Stanley, maybe there won't be any more Morgan Stanley" — rushed to the top of investors' concerns and distrust reached a decades-high peak of pessimism. The three-month Treasury rate turned negative, the interest rate on one-day commercial paper jumped from 2.24% to 3.95% on the last day of the quarter, and LIBOR more than doubled overnight, effectively freezing the capital markets. Investors bailed out of any debt that was not backed by the US government, and lending between banks ground to a halt. Many businesses, even as

presumably solid as General Electric, AT&T, and Goodyear Tire & Rubber, could not borrow at all and those that could saw their costs soar.

In the high-yield market, S&P data for the second half of September showed 30% of issues meeting the definition of "distressed," that is, trading at 10 or more percentage points above Treasuries. The 30% figure represented a double over the course of three months and a leap of 23 percentage points since the turn of the year. As we move through October, the proportion is approaching 50%. That's quite a progression this year: from 7% to 15% to 30% to 50%.

Credit markets are barely a shadow of their former selves. Activity is down, counterparties are disappearing, trust is diminishing, and liquidity has evaporated. Restoring the proper function of the credit markets is key to establishing a durable bottom and ending the deleveraging process that increasingly shifted out of control, and went completely haywire following Lehman's bankruptcy filing. The return of a higher degree of predictability to the basics of the financial system — cash, collateral, and counterparty risk management — could no longer be accomplished by the private sector alone. Exceptional government action was needed to help reliquify, recapitalize, and reregulate the system.

Possibly a moment of capitulation came on October 14, as the government changed its approach from trying to solve a liquidity problem to addressing a solvency problem. On that date, the Treasury invested an aggregate of $250 billion in nine banks: Citigroup, JPMorgan Chase, Wells Fargo, Bank of America, Goldman Sachs, Merrill Lynch, Morgan Stanley, Bank of New York Mellon, and State Street Corporation. This rush of capital reminded me of a Chinese proverb: "It is easier to get nine women pregnant in one day than it is to get one woman to give birth in less than nine months." While you can accelerate conception as much as you'd like, gestation and birthing cannot be accelerated easily. The banks now have their capital — but will they be inclined to lend it?

Wherever one turned, the quarter was laced with arsenic. Owning stocks was painful, being short them was dangerous,[1] owning credit was punishing, and even holding cash presented problems, given heightened default risk in money markets. All of this helped motivate the government to take extraordinary steps in the past days and weeks. It will take years to fully absorb all of their consequences, intended and unintended.

A Feather, a Feather, My Kingdom for a Feather

For those living through their first financial meltdown, it has been a stunning experience. Even for those of us who have been around longer, it has been a painful reminder of how markets can overreact, just as surely on the way down as on the way up. When Alan Greenspan,

[1] Being short combined a couple of ways to lose money. First of all, the SEC outright banned selected short selling in some names. Second, this order came just as many funds were shifting prime brokers and forced to cover short positions due to difficulty in borrowing securities. This is a little bit akin to thinking one was playing a game of chess and being informed at halftime that the contest was indeed tackle football — with a lot of laterals (i.e., finding a new prime broker). The cold comfort for the shorts was that any concern about getting caught in a bear market rally seemed to have abated.

then Chairman of the Fed, delivered his "irrational exuberance" speech on December 5, 1996, the Dow closed at 6,437.10. This October 10, the Dow tumbled to an intraday low of 7,773.71, 45% off its all-time high, albeit still up a touch over 20% in the dozen long years since the Greenspan speech.

The market's slide serves as a reminder of how faithfully the past replays itself. John Kenneth Galbraith, by 1990 an octogenarian, could have been writing today's headlines when he published *A Short History of Financial Euphoria*, a paperback copy of which I keep on my desk. Galbraith's long life concluded in the spring of 2006, but his words of eighteen years ago are nevertheless a primer for what has transpired on Wall Street and Main Street in the aftermath of his passing:

> There can be few fields of human endeavor in which history counts for so little as the world of finance. Past experience, to the extent that it is part of memory at all, is dismissed as the primitive refuge of those who do not have the insight to appreciate the incredible wonders of the present....
>
> The rule is that financial operations do not lend themselves to innovation. What is recurrently so described and celebrated is, without exception, a small variation on an established design, one that owes its distinctive character to the aforementioned brevity of the financial memory. The world of finance hails the invention of the wheel over and over again, often in a slightly more unstable version. *All financial innovation involves, in one form or another, the creation of debt secured in greater or lesser adequacy by real assets.* [Emphasis added.]

The final sentence of the Galbraith quotation is at the nub of today's woes. Every Wall Street house is built on confidence. Financial firms — including investment banks, commercial banks, and some types of hedge funds (happily, not ours) — rely heavily on leverage: "the creation of debt secured in greater or lesser adequacy by real assets." These firms borrow short term and hold long-term assets. As soon as either the customers or the creditors of a company like Lehman or Merrill Lynch or Morgan Stanley or WaMu or Wachovia start to wonder about the security of the firms' capital, they become less inclined to do business with or lend to the firms, and much more likely to demand their money back. *The perception of weakness engenders weakness.* Over the last decade, many analysts have offered sophisticated, quantified, and varying measures of a company's health, but no spreadsheet looks scarier than a stock price barreling south with credit swaps that widen every day.

Is the importance of credibility, as determined by the markets, unique to Wall Street firms? Don't all companies worry about how their stock and debt trade? They do, but with a difference. For an ordinary industrial company that produces consumer goods, it seems a fairly safe assumption that profitability drives the stock price rather than the other way around. If Unilever's stock takes a hit this week, consumers will still buy ice cream from Ben and Jerry's or diet products from Slim Fast or toothpaste from Pepsodent. By contrast, when a financial firm's share price tumbles, the company's very ability to do business is compromised, not only because people's confidence is shaken, but because the decline may also lead to credit rating downgrades, which provoke further declines in bond prices, and so on. The death spiral can come stunningly

fast and become near impossible to escape. On one tumultuous Sunday, September 14, Merrill sold itself to Bank of America and Lehman declared bankruptcy. Arguably, Lehman's assets had not become significantly more toxic the day it filed for bankruptcy protection than they had been a week or two earlier. Because Lehman had access to an emergency liquidity line from the Federal Reserve Bank, it may not even have run out of money. *What Lehman did run out of was credibility.*

After Lehman failed, it became impossible for almost anyone to raise money. Banks were unwilling to lend to other banks, knowing from their own experience how much garbage the other banks had. No one was willing to make a loan or take risk. The credibility problem went system-wide, with a ubiquitous perception of counterparty risk. Trust had evaporated and counterparty risk was poison. The whole world began to say: "I will lend you only incredibly short (i.e., a day), and I will lend only to the US government. Even if I get only 30 or 40 basis points a year, that's fine with me. Indeed, even if on occasion the market requires me to pay the government for its pains in holding my money, that's okay, too."[2] Against such fears, the Fed's offer to solve liquidity problems by allowing investment banks to borrow at its window was unavailing. What good is the capital if everyone is afraid of the borrower to whom he lends it? That's how we have gone from five or six individual cases of distressed institutions to a global panic.

A long time ago, the late Joseph S. Gruss, a savvy investor if ever there was one, told me a story that plays on the critical assumption that short-term debt will always be available. A man crosses the street and borrows a feather from his neighbor. He takes it to the bank and borrows against it. With the credit, he buys another feather, and repeats the process till he has enough feathers to make a pillow. Eventually, he sells the pillow for a profit and does this enough times until he is able to put the proceeds into a pillow factory. He keeps doing that and selling pillows at a profit, and eventually builds more factories. It all works until the day the neighbor who lent him the first feather comes to the first factory and asks for the return of his loan. The lender reaches into the factory, pulls out a feather, and the entire factory collapses. At Bear Stearns, Lehman, and other firms, people are still trying to figure out who pulled out the key feather.

In a letter to investors following the second quarter of 2007 (that's 2007, not 2008), Jeremy Grantham said that he felt as though he were watching "a very slow motion train wreck." That metaphor has had plenty of time to work its way through Wall Street's subconscious, and by now it is one of the most popular descriptions of the market upheaval of the past five or six quarters. But if the news was out in advance, how did so many managers stay levered and get caught in the wreckage? Why didn't they take steps to preserve capital in the face of a widely-recognized problem? I'm not quite so sure of the answers, but one should note that the train wreck abruptly moved from slow motion to fast forward after Lehman's bankruptcy filing. That was when it became impossible to go long or short, and even difficult to hold cash. It was only then that managers who had been having perhaps unprecedented but nonetheless acceptable poor years

[2] The *Financial Times* of October 3 reported that GE, the "gold standard of corporate credit quality," had to raise $15 billion in capital to ease concerns regarding its financial health, that AT&T was unable to sell commercial paper other than overnight, and that Goodyear had to draw $600 million from its bank credit lines because it could not quickly access cash invested with a money market fund.

went from down 10% to much worse in two or three weeks. I am pleased and relieved to say that we operate in a part of the hedge fund platform that has not been destroyed.

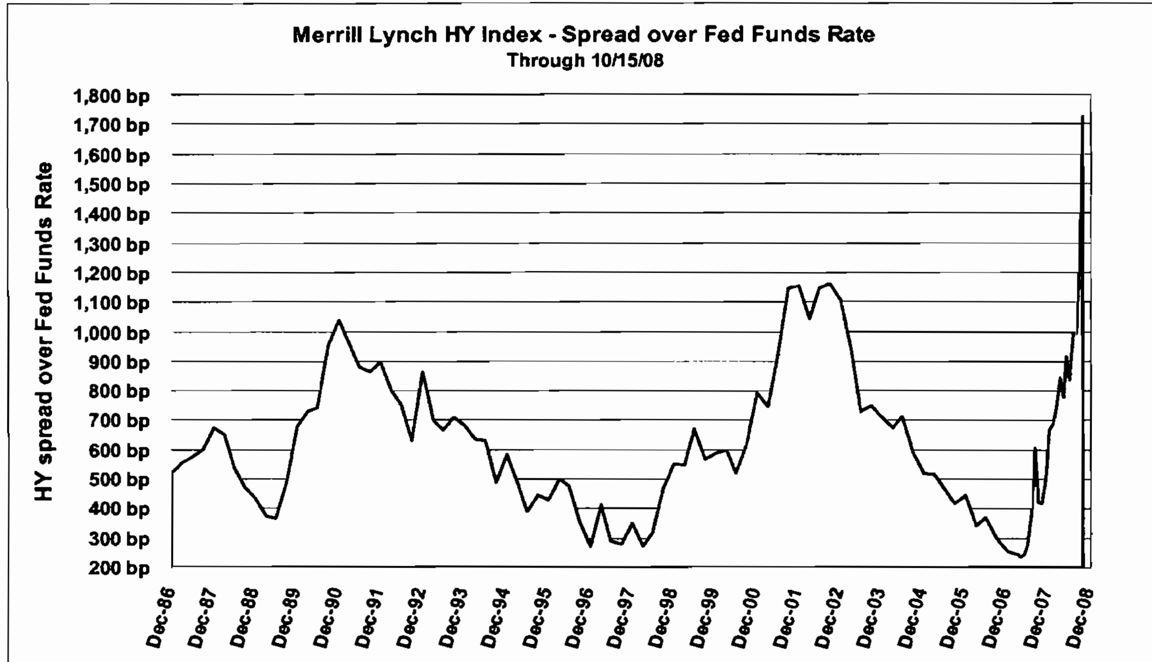
In large part, this is because we are not really a hedge fund, at least not in the sense of going long/short and leveraging a relatively small "trapped" or "captured" return. For the most part, we make money on the long side, and in opportunities presented in the world of credit. We take risk on the position sheet and manage risk on the balance sheet. That is, we run money in high-margin ideas that are managed in a very conservative way. As such, we are very different from the typical levered long/short hedge fund. Rather, in the simple English language use of the term, we hedge ideas. Our favorite hedge is to sell some of a position and thereby reduce risk. We prefer that to finding and selling a vaguely corresponding short that increases the aggregate broad exposure of the fund while weakening the power of an idea. Keep the idea powerful. It presents too much risk? Sell some.

The Rosetta Stone

The recent developments on Wall Street leave investors wondering when and how it will become safe to remove the money stuffed under their mattresses (or sitting in Treasuries) and put it back to work. It is impossible to call the precise bottom of a bear market. There is, however, a valuable indicator that gives us a sense of when investing opportunities are ripe. We have previously analyzed this gauge in two letters, first in July 2004 and again a year later. It is time to revisit that metric, the spread between the Merrill Lynch High-Yield Index and the return on 10-year Treasuries, because it will speak volumes about the current situation. (An October 15, 2008 update of the chart appears below.) By way of background, this is what we said about the chart when we first discussed it in the July 2004 letter:

> If 1% is the risk-free rate of return, how much better can an investor do by taking on greater risk? A good way to answer the question is to examine the spread between the Federal Funds Rate and the Merrill Lynch High Yield Index, which serves as a good proxy not just for high-yield bonds but distressed debt, convertible arbitrage, and alternatives in general — certainly for those who play spread relationships. Obviously, the Merrill Lynch Index will always produce higher yields. But how much yield will investors sacrifice for total safety? As shown on the chart below, the spread between these two measures has moved significantly over the last six quarters, as investors have become more sanguine (too sanguine?) and demanded less of a risk premium.
>
> We find the chart the best available picture of the world of alternative investing over the course of the past twenty years. There is no index available for, to take an example, convertible arbitrage, and we are happy to use high yield as a proxy for other forms of alternative investing. You will notice that the chart breaks down into four periods of dramatic moves: the expansion of the spread from 1989 to 1991, the compression from 1991 to 1998, the expansion from 1998 to 2002 (which kicked off with a spectacular spike in the summer of 1998), and the compression from 2002 to 2004. During periods of expansion, the wind is in our face; during compressions, at our back.

When we wrote this explanation a little bit over four years ago, the spread had narrowed from 1200 basis points to 700. The boom for the asset classes represented by the High Yield Index continued into early 2007 with further compression of the spread, which reached a wildly optimistic 279 basis points at the end of May. Since then, there has been a powerful expansion of the spread, making the unbearable summer of 1998 look, in retrospect, like a lark. The chart almost speaks for itself:



The spread's expansion means two things. First, the wind has been in our face — in almost everyone's face — with gale force. We have been managing credit opportunities for a couple of decades, and this has been by far the toughest environment in which we have operated. As of this writing, in mid-October, we believe that the additional losses incurred in our portfolio thus far this month in a very volatile market have not exceeded the losses sustained from January through September. In light of the ongoing turmoil in the markets, we may incur further losses by the time the month, or even the quarter, ends. We take some consolation in the way we played defense. Yes, there have been losses, including substantial markdowns of some of our private positions, but we successfully took several defensive steps to keep the story from becoming worse, much worse. Second, while no chart can call a bottom, today's wide spreads signal opportunity. Unless the financial world is about to come to an end — a possibility that remains highly unlikely, though concededly less so than a few months ago — this is not a time to panic. Oscar Wilde once remarked that "a cynic knows the price of everything and the value of nothing." At the moment, markets are at their most cynical, pricing assets lower and lower, but, of value, the markets know nothing. Indeed, as the chart suggests, value has been put on clearance sale.

Staying in the Game

On October 2, while the markets were continuing to roil, I found myself in an oasis of peace in Morningside Heights, at Columbia University. The business school was hosting a conference on value investing in commemoration of McGraw-Hill's publication of the sixth edition of Graham and Dodd's classic, *Security Analysis*, to which I had the honor of contributing one of the introductory essays. A *Wall Street Journal* reporter covering the event quoted an editor of

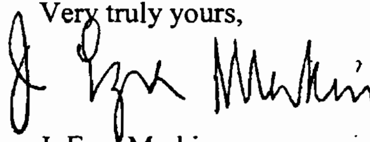
this edition, the outstanding investor Seth Klarman, finding the silver lining in the death of confidence: "Normally, as a buyer you have to compete with a lot of very, very smart competitors. But many of the smartest people are on the sidelines now because of redemptions, margin calls or panicked-out-of-their-mind selling. So you don't have to be as smart as you did before. You just have to be in the game."

In every crisis, cash becomes king. Investors around the world sell whatever they can to raise cash and, once they have cash, they simply sit on it. How long this goes on is anyone's guess. Eventually, investors will again be enticed by yield. When that happens, the balance will tip back toward trying to earn a risk-adjusted return. The recent volatility in the markets has led many investors to become extremely bearish and to hold much higher than normal levels of cash. Should the market ever stabilize, this hoard of cash may well lead to a significant rally, as investors (both money managers and those who entrust them with capital) re-engage. We hope you will continue to feel confident entrusting us with your capital. We will continue to do the things we have done on your behalf for over two decades, thereby keeping you in the game at a moment of maximum opportunity. We'll be no less cautious than we have been in the past, but when we see the inevitable opportunities, we'll really want to move.

In the short run, the markets are in an awful mess. That said, we live in a capitalistic world in which wealth accrues over time to the patient and intelligent owners of capital. Over the past century, the great American experiment with capitalism has survived wars, a Depression, deflation, inflation, and much more, all the while increasing the standard of living of the average American sevenfold. America has a widely diversified economy, an entrepreneurial class, a GDP of $14 trillion, and a household net worth estimated at $56 trillion. There is reason to believe it will muddle through. There is also reason to believe that well-run businesses will survive and perhaps even prosper from this chaos, and that shrewd capital-allocators with available cash will see one of the best bargain-hunting environments of the past three decades. For our investors, that means patience. We will all be better served if we take a multi-year rather than multi-month perspective. We hope you will stay in the game with us as we work to reverse those losses and take advantage of the opportunities generated by the dislocations of 2008. Accordingly, at year-end, the fund will be open to new capital from existing and new investors.

All investment cycles, whether bullish or bearish, contain within themselves the seeds of their own undoing. Understanding how this happens, and taking advantage of it, is called managing money. The challenges have never been greater and, perhaps commensurately, neither have the opportunities.

Very truly yours,



J. Ezra Merkin
General Partner

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EXHIBIT 32

GABRIEL CAPITAL GROUP

450 Park Avenue
New York, NY 10022
TELEPHONE 212 838-7200
FACSIMILE 212 838-9603

October 20, 2006

Dear

For the quarter ending September 30, 2006, an investment in Gabriel Capital, L.P. increased approximately 2.5% after all expenses and fees. For the first nine months of the year, an investment in Gabriel appreciated approximately 7.1%. The unaudited net value of your investment in Gabriel Capital, L.P. stood at approximately at the close of the third quarter. Enclosed please find unaudited financial statements for the period ending September 30, 2006.

The following table reflects our portfolio's exposure, allocated among various investment strategies:

CATEGORY	Long Notional Value as % of Capital	Short Notional Value as % of Capital	Net Notional Value as % of Capital
Distressed Debt	6%	0%	6%
Debt or Equity Subject to a De or Legal Process	20%	0%	20%
Arbitrage of Related Securitie	26%	-1%	25%
Long-term Equity	10%	0%	10%
Credit Opportunities	3%	0%	3%
Short Securities Outright and Portfolio Hedges	0%	-20%	-20%
Cash (Including Proceeds From Short Sales)	56%	0%	56%

As always, we describe these categories in the Appendix to our letter.

Revenge of the Blue-Chips

The quarter just ended was a triumph for the blue-chip investor. Falling energy prices and a suspension of interest rate increases were the stock market's best friends. The financial press recorded breathlessly the Dow Jones Industrial Average's flirtation with its record high, while paying less attention to the Standard & Poor's 500-stock index's best third quarter in nine years.

Despite these gains, for many stock market investors, particularly those who own mutual funds, the quarter's gains were more modest than the indices suggested. While the S&P 500 did rally 5.7% for the three months ending September 30, the average general domestic stock fund, as reported in the *Wall Street Journal*, gained less than half as much, or 2.5%. Among all domestic stock funds, including the single-sector portfolios, the average gain was also 2.5%, according to Morningstar.

Market leadership shifted noticeably during the summer months. Small cap stock funds had been mutual fund leaders since the bear market of 2000, with many funds speculating on the growth prospects of risky but fast-growing smaller companies. By contrast, the equity funds that performed best in the last three months were those that invested in large, stable blue-chip companies, whose shares in many cases had fallen to discounts to the overall market. Morningstar reported that the average large-cap value fund appreciated 5.2% in the third quarter, and 12% for the twelve months ending September 30, while the average small-cap fund, investing in growth-oriented stocks, *lost* 2.2% in the quarter and gained just 4.9% for the trailing twelve months.

The story was much the same in the debt market. As yields on 10-year Treasuries tumbled from 5.23% in early July to 4.63% by quarter's end, long-term Government bond funds posted third quarter gains of over 6.5%. For the cautious investor in both the stock and bond markets, it was a blue-chip bounty.

W(h)ither Amaranth? A Story of Probabilities and Consequences

It was not a bounty all over. By mid-September, it was a toss-up which plant had had a worse month: amaranth or spinach. Spinach, infected by E. coli, justified the disgust of generations of eight-year-old boys. But Amaranth, till then a high-performing hedge fund, lost over $6 billion with a failed directional bet on natural gas futures. As I write, spinach is back on supermarket shelves. Amaranth, however, will no longer be available in supermarkets or on Wall Street.

Perhaps you had never heard of amaranth before learning of the eponymous hedge fund, but the plant held a special place in the ancient mind. The Psalmist, evoking our craving for immortality, wrote in his first chapter, "And he shall be like a tree planted by the rivers of water, that bringeth forth his fruit in his season; his leaf also shall not wither; and whatsoever he doeth shall prosper." The Greek word for *unwithering* has taken on significance in the world of botany: *amarantos*. In *Paradise Lost*, Milton hailed the "immortal amarant," which would "never fade."

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Of course, Milton's *amarant* is today also known as *amaranth*, and the fund of that name will never fade from our memories.

The first principle of money management is: manage the risk. Imagine you had one *billion* dollars and you were offered an even-money bet for one *million* dollars on a throw of a die. The rules are simple: if the die comes up 1, 2, 3, 4, or 5, you win $1 million; if the die comes up 6, you lose $1 million. Not only would you be happy to take that bet, you would be irrational to decline it, because you enjoy a five-sixths chance of making $1 million and face no material forfeit if you lose. Now let us change the bet. Instead of a die, you are handed a six-shooter. Only one of the chambers contains a bullet, while the other five are empty. You are invited to put the gun to your temple and pull the trigger, with the proviso that if all you hear is a quiet click, you win $1 million. On the other hand, if the bullet is in the wrong chamber, you lose everything. Obviously, no one would accept that bet.

The two bets offer the same odds, with the player emerging victorious five out of six times. But while the *probabilities* are identical — an 83.3% chance of winning — the *consequences* could not be more different. In the world of investing, we cannot place our entire focus on probabilities. We must worry about *consequence-weighted* probabilities. This is a lesson that Amaranth failed to learn and that we, if anything, have over-learned.

The Wall Street version of Russian roulette — a game you should avoid even when the odds are nominally in your favor — is directional trading. The problem with Russian roulette investing is that being wrong just once can bring you to your knees. Thus, even when you bet on spreads returning to historical norms, you are taking on a great deal of risk, because markets go the way they are supposed to go, except when they don't. Most of the time, Amaranth's program would work, delivering steady profits. But there was always a small risk of a catastrophic failure. With that possibility given its appropriate weight, Amaranth, with its huge bets on natural gas futures, was playing a deadly game. It was with respect to another form of directional betting that one of the wisest investors I've known, the late Joseph S. Gruss, commented: "Over my entire life, I met only three people who knew anything about currencies — and none of them had much."

By Amaranth's calculation, it was not using heavy leverage. It claimed to deploy leverage at a ratio of "only" 4.4:1. Amaranth reached that figure by adding up all its long positions and subtracting its short positions. This calculation may have been insufficient, however. It made sense so long as assets maintained their usual correlations, thus permitting Amaranth to net the longs and shorts. Sometimes, however, assets depart from their usual correlations, in which case one must *add* the longs and the shorts. In that scenario, Amaranth's leverage ratio was over 20:1. Since none of us is omniscient, all money managers face the risk that things will go wrong. Leverage, however, is the magic ingredient that transforms a stubbed toe into a fractured pelvis. Combine heavy leverage with an inability to unwind positions because of a mismatch of assets and liabilities, and you have the potential for what Amaranth was to become: a replay of Long-Term Capital Management.

Amaranth's pitch reminded me of Sky Masterson's advice in *Guys and Dolls*:

> One of these days in your travels, a guy is going to show you a brand-new deck of cards on which the seal is not yet broken. Then this guy is going to offer to bet you that he can make the jack of spades jump out of this brand-new deck of cards and squirt cider in your ear. But, son, do not accept this bet, because as sure as you stand there, you're going to wind up with an ear full of cider.

The difference between Amaranth and the card trickster of *Guys and Dolls* was that the former had unwittingly set itself an impossible goal while the latter was well-prepared to achieve the implausible. What the two propositions had in common, however, was that they were too good to be true. In both cases, it is wise to heed Sky Masterson's advice: do not accept this bet. Perhaps one can afford an ear full of cider, but when the game is financial Russian roulette, the consequence-weighted probabilities demand that you stay on the sidelines. It is only in myth that we can expect immortality, in plant life or in life in general.

Arendt on Wall Street

When money managers raise capital, with their pitch books in four colors and symphonies in four movements, they offer endless explanations of how they have found creative ways to make money. Everybody is an innovator, at least in the telling, and sometimes the innovations are real. Whereas creativity and originality are the order of the day in capital formation, the methods of capital destruction are fewer and well-tested by dolorous experience. If Hannah Arendt were a financial correspondent, she might refer to the *banality of the blowup*. While there are hundreds of ways to make money, there are only a few classic ways to lose it. As we have seen all too often, the three tried-and-true methods of capital destruction are: (i) mismatch your assets and liabilities; (ii) use heavy leverage; and (iii) place directional bets. Sad to say, Amaranth hit the trifecta.

If Amaranth was placing such risky bets, how did it become such a darling of institutions? Wall Street is the great home of borrowed ideas, whether investment techniques, governance models, or even concepts that have established a purchase on popular culture. One such concept, for those who like to take their humiliation in steady but small doses, is speed dating. On Wall Street, the euphemism for matchmaking is "capital introduction." Recently, I spoke with a young man who had been to the Pierre Hotel for a capital introduction breakfast conducted in speed dating format. At the breakfast, hosted by one of the leading firms on the Street, he found himself one of six potential investors seated at a table, and he stayed for sessions with eight managers, who rotated from table to table to deliver pitches of six to ten minutes each. In the parade of managers who trooped before him, the young man found only one who made an outstanding positive impression. The presentation was music to his ears, stating a clear thesis,

cogently explaining trends in the industry, and backing up the argument — which was surely predicated on the presenter's good-faith belief in the firm's approach — with a history of superior results. The manager who stood above all others was, as you surely have guessed, Nick Maounis, the founder and CEO of Amaranth. My young friend was not the only one to be impressed by the Maounis pitch. Hedge Fund consultants loved the Amaranth proposition and recommended the fund highly to an audience that proved receptive. Amaranth found its way into the portfolios of over 200 of the funds of funds that did business with a leading consultant, more than any competing hedge fund. My friend proved lucky. A few days after he was wowed by Maounis, before he could commit any capital, news of Amaranth's misfortune broke.

Money Managers and Firefighters

At Gabriel, we try to avoid Russian roulette. We happily take a pass on positions with attractive return characteristics, but a significant though small risk of losing everything. We eschew such bets even for *single positions*, let alone for an entire portfolio. This is because we view ourselves as starting out with a disadvantage on each and every position. Life, as it were, is "the house." And, as Damon Runyon's Sam the Gonoph once said: "I long ago come to the conclusion that all life is six to five against."

To counteract the house's built-in six-to-five advantage, we have built our firm to establish an edge in sourcing, analyzing, negotiating, structuring, drafting, and closing deals. As these letters have emphasized for some years now, we have migrated from an emphasis on distressed investing and merger arbitrage into more of a deal shop, placing special emphasis on our private, illiquid positions. That is where we find the best opportunities and the greatest chance of reversing the house's advantage.

What is more, we intend to remain similarly vigilant about risk — about consequence-weighted probabilities. This is so even when, as now, the marketplace is not rewarding investors who have diligently constructed an edge, so much as it shows favor to reckless buyers numb to risk. For the time being, most Russian roulette players (the baleful tale of Amaranth aside) are facing the risk only of rubber bullets. We have built our firm to protect the downside, in the fear — no, the knowledge — that rubber bullets will eventually be replaced by live ammunition.

Aside from the version I conjured up, there is another kind of Russian roulette, played every day, in which victory means no great cash reward, but only that you get to come home and see your family. To commemorate the fifth anniversary of the 9/11 attacks, Peggy Noonan recounted in the *Wall Street Journal* the final message home of an FDNY captain stationed down the block from my children's elementary school.

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Captain Walter Hynes of the New York Fire Department's Ladder 13 dialed home that morning as his rig left the firehouse at 85th Street and Lexington Avenue. He was on his way downtown, he said in his message, and things were bad. "I don't know if we'll make it out. I want to tell you that I love you and I love the kids."

Firemen don't become firemen because they're pessimists. Imagine being a guy who feels in his gut he's going to his death, and he calls on the way to say goodbye, and make things clear. His widow later told the Associated Press she'd played his message hundreds of times and made copies for their kids. "He was thinking about us in those final moments."

Captain Hynes, 46 years of age, was only one of 343 New York City firefighters who gave their lives on 9/11. Four other firefighters from Ladder Company 13 — Thomas Hetzel, Dennis McHugh, Thomas E. Sabella, and Gregory Stajk, who ranged in age from 33 to 46 — also perished. As we mark five years from that tragic day, it is well to remember the distinction between the workmanlike and the heroic.

It is true that, like firefighters, money managers don't choose their profession because they're pessimists. Almost all investing is an inherently optimistic undertaking. (The shorts may be an exception, and they almost surely prove the rule. Over any medium- or long-term range, the money is to be made on the long side.) Still, if we are going to undertake that act of optimism, it had better be with the most realistic (even pessimistic) overlay, the one recalling that all life is six to five against.

In stark contrast, the optimism of firefighters is heroic, almost indescribable. Every day, they play Russian roulette with their own lives in order to save yours. Perhaps that is why boys since time immemorial have said they want to be firemen. But it's not a life for most adults, even those, like money managers, who are supposed to be comfortable with some risk.

Lately, and to a more pronounced extent in the most recent quarters, our traditional chart on the distribution of positions has shown a buildup of cash. That is not an accident. It is a statement of how much risk we are willing to take with your money. The consequence-adjusted probabilities dictate how to set up the portfolio. If we're not getting paid, we won't place the bet. More important, if the position sets up as likely to pay off, but we have to risk the presence of a bullet in one of six chambers, we won't place the bet. Firefighters risk their lives to undo the mistakes of others. To the extent we can control risk, we try to create circumstances where there won't be a fire at all. If we succeed in that endeavor, we will not be as heroic as New York's Bravest, nor will we achieve the unwithering brilliance of the amaranth. We will have been good fiduciaries for your capital, and that has a certain nobility of its own.

This letter began with a quotation from the first chapter of Psalms. I had occasion to hear it recited most recently at the funeral of my mother, Ursula Breuer Merkin, who passed away in July at the age of 86. While no human being can avoid the withering effects of time, my mother did better than most. She remained active and engaged until and even after she was diagnosed with lung cancer early this year. More important, she harnessed her energy toward noble causes, on both the global and familial levels. My mother was perhaps the most purposeful individual I've ever met, and she instilled in her children the sense of discipline and duty that animated her every action. She spent the first sixteen years of her life in Frankfurt, the next twelve in Israel (then Palestine), and the remainder — nearly six decades — in New York, where she embarked on what would be nearly half a century of devoted marriage to my father.

If I inherited any of my mother's outstanding characteristics, I hope I got a piece of her good judgment. She understood people and the dynamics between and among them, a quality honed by, and facilitating, her management of a house with six children. Those children — sometimes contentious, often interesting, and always devoted to her — survive, along with twenty-one grandchildren and two great-grandchildren. We will do well to emulate her model and to build on her foundation a legacy that is permanent and meaningful or, in a word, unwithering.

Very truly yours,

J. Ezra Merkin
General Partner

APPENDIX 1

CATEGORIES OF INVESTMENTS

(1) *Distressed Debt* is an investment in the obligations of a company that is in serious trouble. The company may have filed for bankruptcy, or it may be about to. Its future is very much in doubt and its debt trades at relatively low prices. Our analysis of Distressed Debt contains financial and legal components. First, we must study valuations to figure out what is financially affordable; then, we consider what is legally permissible in a workout. When we find the answers to both questions promising, we invest. At this stage, we must rely entirely on our own work, because there is no external confirmation of valuations or process, let alone timing.

(2) At the next stage, after a bankruptcy filing, the company's securities may be *Debt or Equity Subject to a Deal or Legal Process*. Here, a plan of reorganization has been filed and the world therefore has a better idea what the securities are worth and what the timing may look like. This is the beginning of an arbitrage process, because we are underwriting the successful completion of a reorganization plan, the reward being the difference between the present and ultimate values of the securities. While significant uncertainties remain, the existence of a plan at this stage gives the first objective confirmation of the range of values that may be obtained.

(3) Still later, there are opportunities for *Arbitrage of Related Securities*. This happens when the securities that the reorganization plan brings into existence are available to trade. The package of securities may include senior secured debt, senior subordinated debt, new mezzanine debt, junior debt, preferred stock, and common stock. At this stage, one can hold the original debt while shorting fully valued or unattractive components of the package, or perhaps acquire a new long position while doing internal hedging.

(4) After the bankruptcy concludes, investment opportunities in *Long-term Equity* arise. For a month or two after a plan is confirmed and the company emerges from bankruptcy, one can still think of the company's securities as a bankruptcy play. After a couple of months, however, the bankruptcy is history. The decision to hold the securities beyond this point has to be predicated on the notion that they remain significantly undervalued.

Post-bankruptcy debt (as opposed to equity) fits under the rubric of *Credit Opportunities*. Also in this category are debt instruments that we do *not* believe will be subject to reorganization, our small portfolio of "dented" high-yields. This is debt that is not distressed, that is performing and should continue to perform. Whereas we can buy distressed debt for 30 or 40 cents on the dollar, we buy these dented high-yields in the 80s, happy to clip a substantial coupon and hoping for decent capital gains over time.

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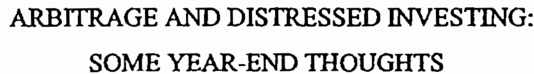
EXHIBIT 33

GABRIEL CAPITAL GROUP



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ARBITRAGE AND DISTRESSED INVESTING:
SOME YEAR-END THOUGHTS

In the year just ended, the merger arbitrage portion of our portfolio had gross appreciation of something over 20%. The distressed portion of the portfolio was up approximately 6% through three quarters, but it declined in the fourth quarter, leaving appreciation for the year at about 3%.

Distressed investing was mediocre at best for the first three quarters and then slumped in the fourth. It suffered from a bad environment, including: a disastrous high-yield market, a plunging equity market, and extremely unfavorable flows of capital out of the higher-risk fixed income markets, i.e., the performing high-yield market and the defaulted distressed market. Fortunately, arbitrage — a steady performer all year, including the troubled fourth quarter — played its intended role of maintaining steady gains and thereby helped salvage an acceptable year.

On a blended basis, our portfolio for the year comprised approximately 60% distressed positions and 40% arbitrage. One can argue — and quite cogently, at that — that we kept far too much of the portfolio on the distressed side. At the start of the second half, we did adjust the portfolio to place a greater emphasis on arbitrage, and this buffered the damage caused by the fourth quarter slowdown in the distressed portfolio.

For us, the creative challenge is how much capital to allocate to arbitrage, a steady producer that helps to pay the bills, and how much to distressed positions, where the real value-added opportunities lie. In almost any circumstance we can conceive, we would want distressed securities to comprise the majority of the portfolio. One way to look at last year is that we kept enough money in the commodity business of arbitrage to provide performance while waiting for the payday in distressed investing.

Even if we were inclined to load up on arbitrage, several factors militate against that approach. First, to acknowledge market realities, distressed securities are not sufficiently liquid to allow for wholesale re-adjustment of the portfolio. Second, in the next down market, arbitrage may be hurt much more, and not just in the short term, because of the increased frequency of broken deals. Third, we doubt that the arbitrage rally of the last two years will have legs. We would like to expand on this last point.

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The two major factors at work during this rally — the withdrawal of $10 billion in capital two-plus years ago thanks to the meltdown of Long-Term Capital Management, and the subsequent boom in deals — are unlikely to be replicated in tandem again. To the contrary, we see a large increase of capital in the business; three funds alone, each less than two years old, are managing over $2 billion apiece. What is more, slowdowns in the economy and in the stock market have historically put a damper on mergers and acquisitions. If we are in a down market and a down economy, we have to expect a decline in M&A activity, too — this, as significant amounts of capital continue to flow back into the sector.

It is worth appreciating the dimensions of the arbitrage rally we have enjoyed. In the fourth quarter, we placed our largest and most successful arbitrage bet of the year on a deal we featured in our most recent letter, the acquisition of Associates First Capital by Citigroup. In hindsight, this deal was a continuation of a two-year pattern of top-notch buyers acquiring large financial institutions. Taking the deals in chronological order, we participated in the following:

Target	Acquirer
Bankers Trust	Deutsche Bank
Republic National Bank	Hong Kong and Shanghai Banking Corporation
Donaldson Lufkin & Jenrette	Credit Suisse
PaineWebber	Union Bank of Switzerland
Associates First Capital	Citigroup
J.P. Morgan	Chase Manhattan Bank

It is no disrespect to the deals we may encounter in 2001 to say that we do not expect to see this quantity of high-quality targets and buyers in the coming year. In any event, spreads have tightened as capital has been lured back into the arbitrage business. It has reached the point that many arbitrage departments are laying off 10% to 20% of their capital into the senior paper of late-event bankruptcies, seeking arbitrage-like returns. This is emphatically not our approach.

We do not see ourselves as arbitrageurs who grudgingly invest in distressed securities in order to remain fully invested. We see ourselves as specialists in distressed investing who maintain an arbitrage portfolio in order to maintain performance and liquidity standards while we wait for the payoff in our preferred area.

Even assuming that arbitrage will allow us to clock steady monthly and quarterly returns, that is not entirely what we're after. Appearances to the contrary notwithstanding, we are not turning up our noses at 20% returns in arbitrage in order to make 3% in our favorite asset class. *Our credo is to buy assets at off-market prices, marked down significantly, to provide us with a large cushion in situations where we have every expectation of an event.* That we cannot count on monthly incremental gains will not deter us from committing a large portion of our capital to positions that promise significant returns, albeit after a long wait. As we apply this principle to the distressed portion of our portfolio, this may mean eschewing the senior securities and buying the oversold paper that eventually turns into equity.

The correct mix between arbitrage and distressed is elusive, largely because the compatibility between the two classes is not as clean as it once was. In our search for the proper mix, we offer not quite an absolute return approach, not quite a metronome's performance, and not quite a deep value discipline, though we partake importantly of aspects of all three. More than ever, to us, arbitrage is a way of paying the bills at the end of the month, while distressed is an attempt to create a pot of gold at the end of the rainbow.

The downtrodden prices of distressed securities offer an interesting contrast to the marks for Internet stocks in their brief, if exhilarating, heyday. The dot.coms were characterized by floats that were but a small percentage of shares outstanding. As such, the tail — what a marginal buyer was willing to pay for a piece of Internet action — wagged the dog of market capitalization. A market capitalization of $15 billion could be controlled by what investors would pay for $150 million of float, creating, for a fortunate few, a virtuous circle of increasing prices. In distressed investing, the marginal seller dictates the price. The louder he screams to his broker, "Get me out," the lower the price a distressed manager pays. This vicious (rather than virtuous) cycle creates attractive buying opportunities, but not without pain for the manager who must mark the distressed securities already in his portfolio to market every day. Writ large, when capital leaves the distressed business, the bad news for inventory prices is offset by the good news for bargain-hunting investors.

So, looking back on an acceptable if not spectacular year, we recall the wisdom of Samuel Bronfman, founder of the House of Seagram. When asked what he considered the most significant invention of the human mind, he answered, "Interest." The best we can say about our performance last year was that at least we adhered to Bronfman's Law, while keeping the upside calls for future appreciation. In times like these, that is not such a bad thing to be able to say.

• • •

Over the course of the last ten months, the market has rediscovered reason. Traditional valuation tools were hauled out of storage; momentum investing collapsed from exhaustion. As the NASDAQ bubble deflated, stunned investors found themselves discussing how the world had changed or, more accurately, changed back. The process of re-education can be drawn out, thus accentuating the pain, when the lesson is resisted. People — mostly, ordinary investors — expect the new metrics to come back. It will take time for them to realize that the golden era of calendar year 1999 and the first quarter of 2000 was a one-time phenomenon, unlikely to be repeated soon. The apex of this fifteen-month golden era came on March 10, 2000, when NASDAQ closed at 5,048.62. By year's end, NASDAQ had fallen nearly halfway off its peak.

The exuberant market of this golden era taught investors to buy on the dips. What can be left of that theory after twelve of the fifteen *best* days in the history of NASDAQ, as measured by percentage gains, occurred during its *worst* quarter ever? The lesson of buying on the dips finally has been shattered, at least until the next golden era. NASDAQ's shots of adrenaline, all too often followed by cold-water dousings, may be classic bear market rallies. To put matters in context, in the Dow Jones Index, thirteen of its fifteen biggest daily percentage gains took place from 1929 to 1933.

The golden era ended with a bang in 2000. NASDAQ was down 39.3% for the year, 47.4% from its high, 27.5% in the fourth quarter alone. The S&P 500 lost 9.25% and declined by 7.8% in the fourth quarter. The percentage losses, in the indexes and in leading individual stocks, were noteworthy, but they were not the whole story. It is not unheard of for a stock to drop two-thirds of its value in a year. What was new in 2000 was the size of the companies — a veritable Who's Who of Corporate America — that were so humbled, and thus the piles of money, in the hundreds of billions of dollars, that fell off the net worth table, as demonstrated by the following chart:

Company	2000 Decrease in Market Cap ($ bil.)	Calendar 2000 % Decline
Microsoft	373	62.9
Lucent	193	80.0
WorldCom	110	73.5
Yahoo!	98	86.1
AT&T	98	66.1
AOL Time Warner	92	41.3
Dell	85	65.8
Cisco	80	28.6

The numbers are even uglier when the decline is measured from the March 2000 top. And, after all that, stocks may still not be cheap today.

It is not just the rarefied valuations of high-tech stocks that should give investors pause, because the exuberance of the golden era was not limited to NASDAQ, or to companies that enjoyed but a shaky purchase on earnings. Take an industrial juggernaut like General Electric, one of the best-managed enterprises in the world. Jack Welch became CEO on April 22, 1981. From that day until the designation of Jeffrey Immelt as his successor 19½ years later, GE stock rose a staggering 6,220%, or 23.5% per year. A big part of this 62-fold growth was the investor's faith in equities in general and GE in particular. Mr. Welch entered office when GE's P/E ratio was 9. Had the ratio remained unchanged throughout his tenure, GE's increased earnings would have produced nine-fold growth in the stock price — still nothing to sneeze at — but not the explosion facilitated by a confidence-besotted P/E of 39.

If real companies with real earnings like GE may prove unable to duplicate their robust performance of recent years, what does this bode for the makeshift world of the dot.coms? During this golden era, the dot.coms entranced the market. The intoxicating rise of the NASDAQ enticed people who used to know better, rendering investors perfect marks for a scam first seen on the Broadway stage. In *Guys and Dolls*, a character named Big Julie showed up to challenge Nathan Detroit to a game of craps. The tools of Big Julie's trade were not standard-issue dice: they did not have dots, or at least not visible dots. Instead, Big Julie would have us believe, the dots were ensconced in his memory. Not surprisingly, if he wanted to roll a seven or eleven, so it was. Only in a world in which Big Julie seemed the soul of reason could a very successful and thoughtful money manager tell the *Barron's* Roundtable early in 2000, in the course of touting Critical Path, Kana Communications, MessageMedia, and DoubleClick:

> *I'll give you no numbers. I'll give you no prices. I am not going to tell you which ones are going to succeed or fail. I think they are all pretty good companies, and if you bought a package of these stocks over the next three to four years, you would do very well.... I hear this stuff all the time, about how it is a bubble, it's ridiculous. If you just use the numbers to do this stuff, number one, you won't buy them, which is probably a good thing for some people. But you will never understand the amount of change that's going on, and how much is still ahead of us.*

I'll give you no numbers. I'll give you no prices. What could be more like Big Julie than that? Whereas the characters in *Guys and Dolls* were wisely reluctant to play Big Julie's game, the market of our recent golden era handsomely rewarded those who did so and bought the dot.coms. Perhaps this is a clue to their name. A "dot.com" was a company whose earnings — past, present, or future — took the form of the dots on Big Julie's dice. During the year just ended, Big Julie exited stage right, replaced by a man wearing a green eyeshade and a sour disposition, who saw the blank cubes for what they truly were.

We have expatiated upon this golden era of equities only to better contrast what we seek to do. In a world of exuberant Big Julies, we have been lugubrious accountants. Rather than going gaga for growth or its possibility, we have stayed, occasionally to our chagrin, with old-fashioned dice: hard numbers and extremely conservative marks. Nevertheless, the assets in which we own an interest are very real. We believe that our numbers are incised very deeply into the dice, in very clear black and white. That is why we look forward to the next few rolls of the dice.

J. Ezra Merkin
January, 2001

EXHIBIT 34

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WE DO BEANS

What many investors had hoped would be another year of revival for stocks is shaping up as one that many would like to forget. All three major indices suffered losses in the first quarter. The Dow Jones Industrial Average and the S&P 500 each declined 2.6% and the Nasdaq fell over 8%. It was the Nasdaq's worst quarter since the third quarter of 2002, when it fell almost 20%. The last time Nasdaq had so poor a first quarter was in 2001, when it was in the grip of a horrendous bear market. A 7% first-quarter decline in the S&P's financial sector and the drop of 6% in the consumer discretionary sector reflected worries about higher interest rates and slower economic growth in the future. Utilities rose 4.5%, suggesting that investors were looking for a place to hide. Energy stocks performed best, buoyed 17.1% by the rise in the commodity price of oil. Telecommunications and information technology performed the poorest, falling 8.5% and 7.5%, respectively, and helping to push down the Nasdaq. Reflecting this weakness, two stocks, Microsoft and eBay, accounted for almost 18.5% of the S&P's total decline. One stock, American International Group, the insurance colossus that acknowledged improper accounting and then parted ways with its Chairman, CEO, and divine potentate, was responsible for about 8.5% of the S&P's decline.

The S&P started the quarter by falling 4%, then barreling up 5.3% to its highest close since the summer of 2001, only to fall 3.5% by the quarter's end. The roller coaster continued its ride early in April, as stock and bond markets rose, fell, returned to the starting gate, and started new stomach-turning trips. In early April, almost overnight, markets turned from worrying about inflation to worrying about slowing economic growth. Renewed emphasis on lackluster growth brought the yield on the 10-year Treasury down to 4.24% by April 15, just about where it had closed the years of 2004 and 2003. In the first one hundred days of this year alone, the 10-year yielded as little as 3.98% and as much as 4.64%. Fixed-income investors could not decide whether deflation was dead or slower growth, a mispriced currency, or earning disappointments posed an even bigger risk to the American economy. By the close of business on April 15, the Dow had declined 6.5% for the year, the S&P 5.7%, and the Nasdaq 12.3%. The Dow's post-Election Day rally, which crested on March 4 at a gain of 905 points, had given back all but 50 of those points by mid-April. In fixed income, equities, and oil markets, the roller coaster ran merrily along on fairly well-defined tracks, turning up as it hit support levels and down as it hit resistance levels, all the while churning the stomachs of as many riders as possible.

One trend remained as predictable as a Donald Rumsfeld press conference. For February, the United States reported a trade gap with the world that was the biggest ever, but probably not for long. America imported $161.5 billion in goods and services in February, an increase of about

1.6% over January, while exports were nearly flat at $100.5 billion. How long can the U.S. borrow about $2 billion a day to support its consumption habit? Some folks believe the situation can persist for a good, long time. "A trade deficit has been with us for most of the past three decades," commented Smith Barney senior economist Steve Wieting, on the day the February imbalance was announced. "Economic growth and investment opportunities in other developed economies are as exciting as watching paint dry, while U.S. demand is strong and its markets are the world's safest," opined *The Wall Street Journal* in early April. Others, including an arguably higher authority, were not so sure. "Altogether the circumstances seem to me as dangerous and intractable as any I can remember, and I can remember quite a lot," intoned former Federal Reserve Chairman and living legend Paul Volcker in a *Washington Post* piece that also ran early in April. "But as things stand, it is more likely than not that it will be financial crisis rather than policy foresight that will force the change."

• • •

The ongoing search for superior risk-adjusted returns necessitates openness to change. In some areas of alternative investing, margins have been squeezed uncomfortably tight. That is why, for example, we stopped doing merger arbitrage a few years ago. As you have gleaned from our last few letters, we have modified our deployment of capital to seek the credit-related strategies where the best margins are available. In particular, we emphasized in our letter for the third quarter of 2004 that our focus has turned increasingly to private investments. This time around, we would like to provide a more detailed outline of our evolving portfolio and, in this connection, discuss a corresponding revision to our fund's liquidity provisions that will apply to fresh capital entrusted to us in January 2006 and beyond.

A Tapestry of Asset Classes

We think of our portfolio as a tapestry of six threads of different colors, each representing one of the full range of debt-related asset classes in our repertoire. Many of the threads are proprietary, coming through the asset-based lending business and private distressed pipelines we have established in tandem with our friend Steve Feinberg and the Cerberus Group. *The pipelines enable us to offer access to investment ideas that combine high alpha with low beta and are not readily available.* Our fund partakes of positions that we choose from the portfolios of affiliated entities. At the same time, the mix of proprietary and non-proprietary streams, including all the different types of credits offered by the six threads woven into the tapestry, allows for salutary diversification and sufficient liquidity.

As with any tapestry, the warp and the woof are not identical. The warp consists of two colors of thread that are generally available and thus provide the account with some liquidity. Though we are hardly the only money managers in these asset classes, we bring to the table over thirty years' combined experience in bankruptcy investing. The woof contains four threads that are effectively private, where we enjoy a significant sourcing advantage. Hence, the woof is the source of our added value and enhanced alpha, for which we pay a price in liquidity. Often, the underlying pipeline is not available to outside investors, because some of the affiliated funds are closed, though access to these ideas may be obtained through our fund. We regularly update our view of how much capital should go into the warp versus the woof and how it should be

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allocated among the threads comprising each. Here are the six threads, beginning with the two that make up the warp:

1. We buy at discounts to face **"dented" high yield bonds**, which provide high cash income and capital appreciation upon recovery to par. The success of this strategy is driven by our ability to cherry-pick "money-good" bonds from credits suffering Wall Street's negative perception. Recently, we are seeing more and more attractive candidates in high yield, because of the outflows from in this sector and accompanying decline in liquidity. Occasionally, we identify solid companies that have been stigmatized by a credit crunch or an illiquid market. We are then fortunate to purchase money-good bonds at a discount. We make money from sellers who cannot or will not hold, allowing us to use our experience and knowledge of the sector to serve as lenders of last resort in a liquidity squeeze caused by forced sales. This practice is lucrative and provides ballast for the portfolio because interest payments provide current return while we wait for capital appreciation to be realized.

2. Probably the most competitively priced segment of our portfolio is trading in **public distressed names**. This is the staple of all manner of distressed investment funds. We allocate less capital to this area than we used to, because so many others play in this arena, thereby reducing alpha and increasing beta relative to the rest of the distressed world. We expect that distressed will encounter some rocky times, because the spread over Treasuries has lately been way too narrow, as discussed in our July 2004 letter (see the chart) and further in our January 2005 letter. Still, it is prudent to balance the portfolio by dedicating some capital to these relatively liquid names. Notwithstanding the rush of capital into this area, there remain some attractive opportunities. When the mound of new paper falls off the pier into the drink, distressed will become far more attractive, and we will be there with our nets to scoop up opportunities.

3. Moving from the warp to the woof, our fund engages in a relatively small quantity of **asset-based lending** in the United States, in conjunction with our affiliate Ableco. Finance industry consolidation, retrenchment by traditional asset-based lenders, and tighter credit have created a strong competitive environment for these vehicles. Banks and other traditional asset-based lenders have continued to withdraw from commercial finance and asset-based lending due to credit quality concerns and regulatory pressure. In addition, industry consolidation continues to shift the focus of many bank and non-bank lenders away from our sweet spot, the middle market. The remaining lenders focus on larger transactions of perceived higher quality, a perception that we do not invariably share. Though competition has heated up in this sector over the last eighteen months (following a post-September 11, 2001 reluctance to lend), our business has taken on the beneficial qualities of a franchise as it has become larger and better known, adding professionals and even an office. We mention asset-based lending as the first thread of the woof not because it currently occupies much of our fund's capital — it does not, though that may change as margins change — but because our sourcing networks in this field, which are by definition proprietary, bring us many other opportunities.

4. The largest class of opportunities thrown off by our asset-based lending pipeline, and a significant portion of what both our fund and Cerberus do, is **"private" distressed**. We like and understand middle-market companies, those with annual revenues between $50 million and $1

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billion. Their smaller capitalization allows us to dominate the restructuring; as you might expect, this means a big increase in alpha, at the cost of liquidity.

- With a large cap name, investors are stuck with publicly available numbers, and we know how dicey those can be. In the middle market, we can develop a better understanding of the quality of our investment because of the availability of significant due diligence information. In addition, the relative size of our position often allows us to control the process and play a role in the dénouement, thereby buffering some of the volatility that has roiled the debt markets.

- The deal flow in the middle market is far less cyclical than for the bigger names, for a simple reason: there simply are many more middle-market distressed opportunities than large ones. In addition, smaller companies are more susceptible to hiccups caused by management shortcomings or periodic industry dislocations.

- We pursue opportunities that are not available to other investors, many of them relatively new to the game, who have to invest large chunks of capital. Not only do we have a sourcing advantage, but positions too small to accommodate the capital they must invest are just the right size for us.

5. In recent years, we have gradually increased our portfolio's exposure to **private equity**, usually with a distressed flavor, which generally travels through our pipelines and, therefore, is not to be confused with heavily competitive "retail" private equity. Private equity is more volatile and requires more patience than passive participation in publicly traded securities, but it offers greater rewards. The time horizon for a private equity deal is usually in the range of eighteen months to four years. We mark the positions conservatively, typically keeping the marks at purchase price until there is a substantial, not to say indubitable, reason to mark them up. The private equity business also balances our portfolio in a manner similar to the way merger arbitrage once had because private equity, like arbitrage, is countercyclical to distressed investing. Private equity thrives in periods of growth and deal-making activity; distressed comes to the fore when exuberance fades and it comes time to remedy the excesses of a more high-spirited time.

Because of private equity's relatively long time horizons, we have planned the shift of capital into this field deliberately and carefully. For example, when we obtained your authorization to establish a "side pocket" for designated investments (an authority we have yet to invoke), one of the important considerations was to give ourselves the breathing room to pursue opportunities that come with a longer tail.

6. We have the benefit of proprietary sourcing not only domestically but also in the Far East. Thus, we purchase **U.S. distressed credits *sourced* in Japan** and backed by U.S. assets. Our friends at Cerberus have a very large group working in the Far East, giving us extraordinary access to a pipeline of credits that our cohort does not necessarily see. With Japanese banks in deep trouble, forced to move assets to clean up their balance sheets, investors can obtain valuable assets at bargain prices — but only if their maps tell them where to find the bargain

basement. Our friends in Asia have the right maps. Taking things yet a step further, our sourcing network in Japan is not limited to U.S. credits and assets. We use that network on occasion to purchase **distressed Far Eastern credits**, backed by Japanese assets.

Our portfolio increasingly will participate in all these ideas. The virtue shared by items 3-6 on the list — the woof — is their proprietary sourcing. It is not enough to know how to play an investment idea; first, you have to obtain *access* to the idea. Our team is perhaps uniquely situated in this regard. With a steady diet of opportunities that others either never see or are ill-equipped to seize, we are able to keep alpha high. That is, we add value in both our access to a wide range of ideas and in successful management of those ideas. This high alpha is accompanied by low beta: our returns are not correlated to those of large bankruptcies like WorldCom's, let alone to the broad equities markets.

Until recently, hedge funds tended to be vertically organized. As our fund evolves toward the tapestry described above, you will have an opportunity to invest in a fund with relatively lenient lockup provisions and gain access to ideas of sister funds that, *were* they not closed outright, would require significant and often long lockups. While our fund remains vertically organized, it has added horizontally an array of vertically organized pipelines and channels. Your money is managed as carefully as ever, but you have obtained broader access to investment ideas whose margins have not been arbitraged out.

New Liquidity Provisions

A recurring theme in our letters is the importance of a proper match between assets and liabilities. We have never been inclined to put all our weight on the accelerator; one foot is always tapping lightly on the brake to protect our downside. It's one thing to tap the brake, another to try driving with the parking brake engaged. We have tinkered with our liquidity provisions to reflect the evolution of our portfolio, adopting the still unutilized authority to designate investments to a "side pocket." Now, we think it wise to modify our redemption provision. *Money invested as of the January 1, 2006 subscription date and beyond* will be required to be committed for a minimum of twenty-five months.

As we increasingly invest in less-liquid assets, particularly in private equity, it is prudent to tighten our investors' liquidity rights, so that all investors are assured that our ideas will have time to play out. The new liquidity provision will reduce your co-investor risk: the concern that a rush of redemptions will lead to forced selling and a diminution in the value of every investor's stake. The new provision will also give us increased flexibility, as the side pocket already has, to focus on improving risk-adjusted returns rather than looking over our shoulders in apprehension of redemptions.

While the new liquidity provision makes sense for our portfolio regardless of any changes in the regulatory environment, a new Securities and Exchange Commission regulation regarding investment advisers also nudged us in this direction. Under the new rule, investment advisers with more than fourteen "advisees" will be required to register with the SEC. The Commission previously treated a pooled vehicle as a single "advisee," but the new rule provides that each

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investor in such a fund is a separate advisee. Thus, when the new rule takes effect, an adviser to a pooled vehicle with more than fourteen investors will be required to register, unless the vehicle falls outside the SEC's definition of a "private fund." That definition excludes pooled vehicles that require investors to commit their capital for a period longer than two years from the date they subscribed. As such, there will be no registration requirement for the adviser to such a vehicle.

Our new liquidity provision will have no effect on capital currently invested or new subscriptions made before the new provision takes effect on January 1. Because our portfolio's transformation has been gradual and we currently have the liquidity protection offered by the side pocket, we will be able to leave the existing liquidity provisions in place for all money invested before January 1, 2006. You have invested with us under the assumption that your investment would be rather liquid, and we are loath to alter that bargain. The interval in which the current liquidity provisions remain in place makes it possible, moreover, to gain access to our less liquid private ideas on liquidity terms more favorable than will be available to subsequent investments.

• • •

Midway through the first quarter, a California jury directed Nestle to pay over $15 million to a model-turned-kindergarten teacher named Russell Christoff. In 1986, Christoff posed for a photo that, without his permission or knowledge, has been used on the label for Taster's Choice instant coffee in the United States and seventeen other countries. How did Taster's Choice use the photograph for six years in the United States and seventeen in Canada without Christoff noticing? Why did he fail to notice his image on Taster's Choice labels until he shopped for Bloody Mary mix in a drugstore in 2002, only to have his eye wander toward his youthful visage? The plaintiff explained to the Associated Press: "I don't buy Taster's Choice. I do beans."

We enjoyed Mr. Christoff's story because it reminds us of our own. For the better part of two decades, we have been plugging away at distressed and other event-driven investing. You have not heard us shouting about private equity, because that is not what we did. But the taste of private equity that has found its way into our portfolio is not an alien ingredient to us; it is not "retail" private equity. Instead, it is a natural outgrowth of our bankruptcy and lending pipelines. Like Christoff's photo, our private equity positions have quietly been there all along. They comprise a vertical integration of our pipelines and, crucially, four out of five positions we bid on are non-competitive. We still do beans. Rather than freeze-drying the beans that emerge from our pipelines and selling them at a profitable markup to someone else who will brew them, we now are brewing beans ourselves. We hope you will find that they give off a pleasing aroma.

—J. Ezra Merkin
April 2005

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EXHIBIT 35

---X

IN THE MATTER OF

MADOFF CHARITIES INVESTIGATION

---X

120 Broadway

New York, New York

March 17, 2009

2:06 p.m.

EXAMINATION UNDER OATH of [redacted]

[redacted], pursuant to Subpoena, held at the

above place, date and time, before [redacted]

[redacted], a Notary Public of the State of

New York.

1

2 historically distressed debt and merger

3 arbitrage. And then during my time at

4 Gabriel there was a transition to much

5 less merger arbitrage, some high yield

6 investing and a fair amount of private

7 equity investing.

8 Q. None of which encompasses the

9 Madoff strategy, correct?

10 A. That's correct.

11 Q. Did you have an understanding

12 before December '08, did you have any

13 understanding of how much of Gabriel or

14 Ariel was invested with Mr. Madoff?

15 A. When you say any understanding,

16 I knew it was more than a nickel, and I

17 presumably would have gathered it was less

18 than 50 percent of the assets. Where it

19 was in that broad range, I don't know if I

20 could have told you accurately.

21 Q. As of April '05, would you have

22 been able to classify the Madoff

23 components in one of these six threads?

24 A. My understanding of what these

25 threads were meant to represent is that

1 [redacted]

2 **these were active investment strategies in**

3 **which the fund participated, which is not**

4 **the case with respect to the money that**

5 **was entrusted to Mr. Madoff.**

6 MR. ELLENHORN: Could I ask

7 something, Larry?

8 MR. BORTEN: Yes.

9 EXAMINATION BY

10 MR. ELLENHORN:

11 **Q. Is that distinction in any**

12 **material that was sent to any investor,**

13 **the distinction you just said?**

14 **A. I'm not aware one way or the**

15 **other.**

16 **Q. You say you're not aware one way**

17 **or the other. You saw the quarterly**

18 **letters that went out, didn't you?**

19 **A. I did.**

20 **Q. You saw them before they were**

21 **mailed?**

22 **A. I did.**

23 **Q. Did you ever see that**

24 **distinction being drawn in a quarterly**

25 **letter?**

1

2 table was not a feature of the letters. I

3 don't remember whether it was presented to

4 me by Mr. Merkin or .

5 Q. Do you remember the

6 circumstances under which they introduced

7 it into the letters?

8 A. Only in the broad sense that Mr.

9 Merkin deemed this information that he

10 wanted to share with investors.

11 Q. And in terms of the actual

12 categories, were you part of any

13 discussions about how to, how to -- what

14 categories to create?

15 A. No.

16 Q. Again, it's your understanding

17 that today that the Madoff component was

18 included in arbitrage of related

19 securities?

20 A. That's my understanding today.

21 Q. And not in the cash category?

22 A. I believe that's correct.

23 Q. That's based on a conversation

24 you had recently?

25 A. Correct.

1 [redacted]

2 A. So it states.

3 Q. So arbitrage of related

4 securities, as described here, relates to

5 companies that are at least in serious

6 trouble, if not actually in bankruptcy and

7 probably in bankruptcy; is that right?

8 A. That's what it appears to say.

9 Q. That is not the type of equities

10 that Madoff used in his options arbitrage

11 strategy; is that correct?

12 A. My understanding is that your

13 statement is correct.

14 Q. In terms of the rest of the

15 letter, is this the part that you partly

16 worked on generally and Mr. Merkin partly

17 worked on?

18 A. When you say "this," you mean

19 the rest of the letter?

20 Q. Pages two through eight.

21 A. Yes.

22 Q. Do you have any understanding of

23 why there is cash, a percentage of the

24 fund that's held in cash?

25 A. As a general matter?

1

2 case.

3 BY MR. BORTEN:

4 Q. So again, other than .

5 's trading activity for Gabriel,

6 the only thing that's happening at 450

7 Park is the winding down of these assets

8 that were left over after Teicher left or

9 really when Teicher came back in 1998?

10 A. I'm not sure I follow that

11 question. You mean what is happening at

12 Gabriel today?

13 Q. From 1998 until the present, in

14 terms of what's happening at 450 Park, the

15 investment decisions that are made there,

16 as I understand it, there are two types of

17 activity. There's the Cohanzick activity

18 which involves entering new positions and

19 existing positions and actively managing

20 the money, and then there are the ,

21 there is the winding down of positions

22 that were acquired prior to 1998 which I

23 take it is now overseeing?

24 A. That's correct, with the one

25 proviso as in the Gyrotron example,

1

2 **sometimes [redacted] is asking for more**

3 **capital in connection with a problem.**

4 **Q. In connection with ultimately**

5 **exiting his positions in a profitable way?**

6 **A. Correct.**

7 MR. BORTEN: I think this is the

8 last document. So this is 11.

9 [Document Bates stamped GCC-NYAG

10 0076781 was hereby marked as [redacted]

11 Exhibit 11 for identification, as of

12 this date.]

13 **Q. Are you familiar -- did I**

14 **identify this document?**

15 MR. BORTEN: It's a two-page

16 document beginning with the Bates

17 number GCC-NYAG 0076781. The second

18 page does not have a Bates stamp. It

19 was an attachment to the e-mail in

20 native format.

21 **Q. Are you familiar with this list**

22 **of J. Ezra Merkin controlled entities**

23 **that's on the second page?**

24 **A. I have seen it previously.**

25 **Q. Did you create it?**

EXHIBIT 36

GABRIEL CAPITAL GROUP

450 Park Avenue
New York, NY 10022
TELEPHONE 212 838-7200
FACSIMILE 212 838-9603

January 20, 2008

Dear

For the quarter ending December 31, 2007, an investment in Gabriel Capital, L.P. appreciated approximately 0.5% after all expenses and fees. For the year, an investment in Gabriel appreciated approximately 10.7% after all expenses and fees. The unaudited net value of your investment stood at approximately at the close of the fourth quarter. The 2007 audited financial statements and form K-1 tax information will be sent to you upon their completion.

The following table reflects our portfolio's exposure, allocated among various investment strategies:

CATEGORY	Long Notional Value as % of Capital	Short Notional Value as % of Capital	Net Notional Value as % of Capital
Distressed Debt	5%	0%	5%
Debt or Equity Subject to a Deal or Legal Process	21%	0%	21%
Arbitrage of Related Securities	36%	-4%	32%
Long-term Equity	26%	0%	26%
Credit Opportunities	3%	0%	3%
Short Securities Outright and Portfolio Hedges	0%	-28%	-28%
Cash (Including Proceeds From Short Sales)	41%	0%	41%

As always, we describe these categories in Appendix 1 to our letter.

A Year of Turmoil

2007 was a year of turmoil and scattered gains and, as it sputtered to a close, it refused to give anyone a sense of closure. For much of the year, investors (and possibly central bankers) could hang onto the hope that the financial markets' problems would be contained. But as housing woes and troubles with mortgage-backed securities spilled over into the broader credit markets and perhaps into the economy in general, investor assurance began to wane. Rather than providing any answers, the new year would present the problems in sharper and sharper relief, as markets declined.

The Standard & Poor's 500-stock index ended the year 2007 up 3.5%, slightly less than the rate of inflation. The Dow Jones Industrial Average closed up 6.4%. Reflecting growing investor worries, both indexes declined in the fourth quarter, a time when stocks often rise. For the Dow, it was the first fourth-quarter decline in ten years. While the broad market struggled under the weight of the credit crisis, which punished financials, home builders, and retailers, certain sectors like technology, energy, and materials posted remarkably strong gains. The Nasdaq Composite Index, which includes many technology stocks, ended the year up 9.8%, its single best year since 2003.

Ultra-conservative Treasuries and ultra-risky emerging markets both treated investors well. For the first time since 2002, when the last bear market ended, Treasuries outperformed the S&P 500, as investors sought a haven in Government debt. Including interest payments and appreciation in prices, Government-backed debt returned approximately 8.8% for 2007.

Investments with even the slightest whiff of risky subprime mortgages were battered. A Merrill Lynch index that tracks floating-rate securities backed by a broad basket of home loans fell 12.5% for the year, after including interest payments. The asset-backed securities indexes were down about 80% for the year. MBIA, a company that guarantees asset- and mortgage-backed securities, fell 75% for the year, and that decline was only a prelude to the company's performance in January.

Financial stocks sank almost 21% in 2007, and shares in the consumer discretionary sector, which includes home builders and retailers, tumbled almost 14.5%. Together, these two sectors accounted for about one-third of the S&P 500's valuation at the start of 2007; they account for about one-fourth now.

Concerned as investors were about risky investments at home, they remained convinced that growth abroad would be sustained, despite the developments in the American credit markets and perhaps the economy. Persuaded that the decoupling was for real, investors shifted billions of dollars from the developed world into the fast-developing economies in Asia, Africa, Eastern Europe, and Latin America. Shares in Shanghai and Shenzhen, China, were up about 180%; the Nifty 50 index in India was up a mere 74%, and the Bosvepa index in Brazil trailed close behind at 73%. By contrast, the Nikkei 225 index in Japan declined 5.3% for the year.

The growth in developing economies helped push up the prices of commodities like oil, which gained 58%; wheat, which gained 68%; and gold, which gained about 30%. The United States dollar fell against many currencies, including the Chinese yuan, the Japanese yen, the Indian rupee, the euro, the British pound, and the Canadian dollar. For the year, the dollar lost 7.5% of its value against a group of 26 currencies, according to a Federal Reserve trade-weighted index. The currency now stands at its lowest in a decade, according to the index. The dollar finished the year 9.6% weaker against the euro and 6.4% lower against the yen.

The corporate-debt market was sucked into the vortex of the subprime mortgage turmoil in 2007, as prices of many bonds and loans declined even as corporate defaults remained very low. The subprime downturn severely hurt many large banks and Wall Street firms, which took billions of dollars of losses and write-downs on the mortgage-related securities they held. The ensuing liquidity crunch in the credit and money markets created problems for other financial institutions and lenders, which found it more difficult and costly to raise short-term debt required to fund their operations.

A large volume of corporate debt is coming due in 2008. According to a JPMorgan Chase report, the total exceeds $600 billion, as compared to $485 billion in 2007. This means that many more borrowers will have to tap the markets for cash. About half of the refinancing will be for financial firms, which may have to pay hefty rates to obtain the refinancing they seek. Moreover, since some financial institutions may be forced to raise even more capital following further mortgage-related losses, they could crowd out other corporations and pressure the values of their debt.

In 2007, the additional interest that investment-grade corporate bonds paid over yields on Treasuries jumped to over 2%, on average, from under 1% the year before. The sharp widening of spreads was particularly characteristic of financial credits. Overall, investment-grade corporates returned about the same in 2007 as they did in 2006, 4.6% versus 4.4%, despite the widening, because of the decline in the levels of Treasuries. The yield on the benchmark 10-year Treasury fell to 4.033% at the end of 2007 from 4.708% a year earlier, as prices rose. As noted above, Treasuries outperformed all three major stock indexes and most other types of bonds, including interest payments and appreciation, returning just under 9% for the year.

Spreads on below-investment grade bonds over Treasuries — an important relationship for us — hit a record low of 2.4% toward the end of the second quarter of 2007. In the past six months they have widened to about 6%. (To keep things in perspective, the spread peaked at 12% during the summer of 2002.) Non-investment grade corporates returned about 2% for the year, as compared to about 11.75% in 2006.

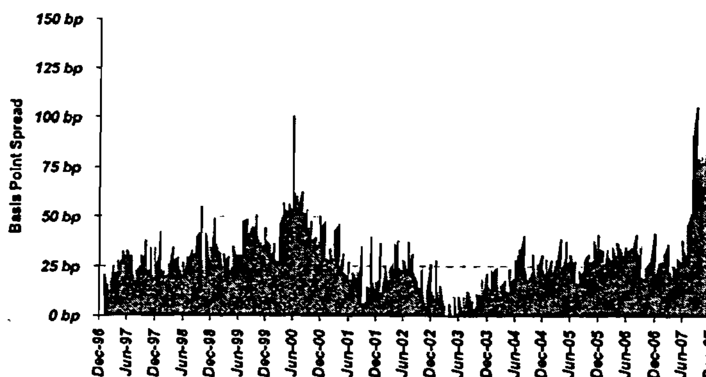
News Flash: Risk Is Risky

Since this past summer, and seemingly all at once, investors have moved from an extraordinary comfort with risk to a caution that borders on the pathological. Now that investors have awakened to the hazard inherent in risk and simultaneously decided they want nothing to

do with it, the question for policymakers is how to restore perspective, and with it stability, to the markets.

I believe that the restoration of order and confidence will not be instantaneous, let alone the product of a *diktat*. In some ways, it is a binary matter. Either we will fix the situation or we will not. If the masses decide to take on risk again, voting with their feet (or wallets) in favor of greed over fear, credit will flow again, albeit on less generous terms. Greed is likely to carry the day over fear, as it usually does, but one must at least pause over the possibility of an epochal victory for fear, as when our grandparents experienced the Big One in the 1930s. The timing of mass psychology is, of course, not a simple matter. While we wait for human nature to reassert itself and a bottom to be formed, investors are not unlike six-year-olds in the back seat during a long car ride. Every five minutes or so, they ask plaintively: "Are we there yet?"

The interplay between greed and fear can best be demonstrated graphically. A good snapshot that demonstrates the dramatic and sudden repricing of risk is the spread between the interest rates investors earn on one-year certificates of deposit and one-year Treasury notes. The chart below, which runs from 1997 through 2007, shows that the spread typically resides between 20 and 40 basis points. If Treasuries are risk-free, CDs are close enough to risk-free that investors have demanded only a very small premium. During the turbulent summer of 1998, the spread broke out beyond 40 basis points, and you will notice one major spike in the chart, to 100 basis points, as the tech bubble popped in early 2000. By that autumn, the spread had closed to under 40 basis points, and even the shock of 9/11 did not cause the spread to widen beyond that point.



So what to make of recent events, as last summer investors pushed the spread beyond 40 basis points all the way past 100, took a breather down to 60, and then spiked in the fall to 130? This seems like an over-reaction, as a market that had seemed blithely unconcerned suddenly became afraid of its shadow. But there is no iron law that this fear must dissipate within 90 or 180 days.

In our most recent letter, we discussed the opening of the long-imagined Northwest Passage. Within the normally frozen sea linking the Pacific and the Atlantic oceans north of Canada, a fully navigable passage became ice-free for the first time in modern history. While scientists expected this to occur eventually as a result of global warming, the speed with which it took place was unexpected. A government sea-ice researcher said: "I'm shocked daily, looking at the maps." Substitute our chart for sea-ice maps, and you get an idea of the quandary facing our economic regulators. We don't have maps that show us how to navigate these seas. If investors feel so burned by the housing dive and the ensuing credit crunch that they eschew all risk, neither the Fed nor anyone else has the tools to get them to put money out again, not until the pain of 2007 recedes far enough from memory that opportunities to make money entice once more.

The governmental agency on the front lines of this struggle is, as always, the Federal Reserve Board. Thus, to the extent that this letter sounds like a review of our third quarter letter, we must apologize for the failure of life to divide itself into neat acts and scenes. The credit crisis and the Fed's attempts to deal with it remain *the* story of 2007. Certainly, the problem did not evaporate when we flipped the calendar from September 30 to October 1, nor when we made the transition from the old year to the new. That we are in the midst of an ongoing process is evidenced when one holds side by side our April 2007 letter — with its reference to Wile E. Coyote, Road Runner, and the dangers of looking down — and the December 22, 2007 *Financial Times*, which featured the headline, "This was the year the coyote looked down." What we see today is a bigger systemic problem than the stock market crash of 1987 or the Russian default and Long-Term Capital Management blow-up of 1998. Therefore, it may not be possible to restore confidence — and, with it, financial stability — with gestures grand or small, or anything less than a global change of mind.

The Guns of August

In retrospect, history appears inevitable. All the flow, the sweep of drama, triumph, and tragedy, appears to us as if it could not possibly have transpired any differently. The investment business creates a habit of mind that pushes one to look backwards, the better to form comparisons to contemporary problems and challenges, and create a framework for analysis. Almost all serious investors sift and compare, forming the habits of mind of historians. Consider one of the great *what-ifs* of history, which I find myself mulling over these days. Was the First World War inevitable? If the assassin's bullet had missed Archduke Ferdinand, would the entire course of the twentieth century have changed for the better? Conversely, would it all have happened more or less the same way regardless of who served as Kaiser or Prime Minister, or was carrying a weapon, at the relevant hour? In his history *The Pity of It All*, Amos Elon reviews the competing arguments and concludes:

> All such abstract, anecdotal, and grand theories merely obscure the real reason for war: the recklessness and lack of judgment of a few politicians. [Walter] Rathenau [Germany's Foreign Minister during the Weimar Republic] famously claimed that two hundred elderly men who knew one another controlled the fate of Europe and the world. He should have added the old truism that in war millions of young men butcher millions of other young men

who have done them no harm and whom they have never met — all on behalf of a few old men who know one another only too well.

Without belittling the enormous human suffering caused by war, this passage puts me in mind of today's markets, where we are looking at a "reverse World War I," a case where "millions of young men (and women)" control the fates of "a few old men who know one another only too well." The fact is that a very large number of investors around the world will determine the success or failure of the few central bankers and politicians who are trying to repair the broken financial system. We stand at a crossroads in the market: a couple of hundred key central bankers and politicians might all agree on what should be done and, in fact, do everything right — and, because they are at the mercy of millions of risk-takers (or risk-shunners), still fall short of a solution. In wartime, national leaders can order young men to march into battle, on pain of imprisonment, or worse. In the anonymous and impersonal markets, central bankers and other government officials can adjust incentives and tinker at the margins, but they cannot make the masses do their bidding.

As far as the financial (i.e., credit) markets are concerned, the very sophisticated plumbing underlying the contemporary economy is broken. Therefore, the Fed must drench — nay, drown — the world in liquidity. Now is not the time for subtle combinations of liquidity injections. Attempts at a finely tuned response, as in the three shoes dropping in last quarter's letter, are passé, and the Fed has opened the floodgates.

Considering how difficult the Fed's job is, one should not criticize the institution casually, but, were it my call, I would not have let so much of the plumbing go into disrepair so quickly. The Fed has permitted the financials to come down very far very fast. Monoline businesses, which operate in one specific financial area, are at death's door. These companies, like Ambac and MBIA, "wrap" debt for companies and other issuers. They have made enormous guarantees for relatively low premiums. If they are called upon to back up too many of these guarantees and are unable to do so, it will be a disaster not merely for the monolines and their shareholders, but for the economy as a whole. Meanwhile, the nation's biggest mortgage lender, Countrywide Financial, has been acquired just one step short of expiring. A year ago, Countrywide was regarded as the Goldman Sachs of mortgage lending, except, unlike Goldman Sachs, it had no competition. If MBIA, whose credit swaps traded a year ago for about 15 basis points above Treasuries, was the gold standard of the monolines, then Countrywide was the analogue among mortgage lenders, with its credit swaps trading a year ago at an investment-grade 30 basis points above Treasuries. At the end of 2007, those spreads had widened to 314 basis points for MBIA and 1,002 for Countrywide. (Even Goldman Sachs, which got subprime right, saw its spread open from 21 to 67 over the course of the year.) The story was similar on the equity side. MBIA's common stock began 2007 in the 70s and ended the year under 20, Countrywide's common plunged from the mid-40s to under 10, and both have declined further early in the new year. Investors in the two stocks saw $26 billion of value wiped out.

As we survey the financial battlefield amidst the rout of 2007-08, we note the absence of longstanding pillars of the landscape, now completely gone. To the historically inclined, the picture must look a bit like the Confederacy must have as the smoke began to clear in 1865. How

the mighty are fallen! In the elegiac words of The Band's classic composition *The Night They Drove Old Dixie Down*:

> Virgil Caine is the name, and I served on the Danville train,
> 'Til Stoneman's cavalry came and tore up the tracks again.
> In the winter of '65, we were hungry, just barely alive.
> By May the tenth, Richmond had fell, it's a time I remember oh so well.
>
> The night they drove old Dixie down, and the bells were ringing,
> The night they drove old Dixie down, and the people were singing....
>
> Now I don't mind chopping wood,
> And I don't care if the money's no good.
> Just take what you need and leave the rest,
> But they should never have taken the very best.

• • •

A monumental case of easing is underway, and now the Fed is down to one limited tool. All its easing can do is provide more liquidity, which of course is of paramount importance. This is far from the whole ballgame, however. At this writing, pricing in the credit and equity markets has been adjusted for *liquidity* (of which there is precious little), but not yet for *credit risks* only beginning to emerge. The Fed can drench the markets in liquidity, but it can do only so much for the credit risks out there. For bad credits, there is no silver bullet; instead, we must wait for the system to absorb them. The leverage has to be unwound, and the pain, therefore, could get substantially worse. As the *Financial Times* put it on January 19 of the monolines' severe difficulties: "The longer-term risk is that these types of business cannot be resurrected and the result is a permanent increase in the cost of capital for swathes of the US and European economies."

William McChesney Martin, who served as Chairman of the Fed for nearly 19 years, famously said that his job was "to take away the punch bowl just as the party gets going." When Alan Greenspan assumed the position, his unspoken promise to the markets was quite different: *My job is to keep the party going, including spiking the punch bowl when necessary.* In effect, the premise was: Let's avoid a recession at all costs. Lord knows, banks got with the program and the good times rolled.

As I look ahead and think about how to protect our portfolio, I go over and over the following prognostications: there is (i) a decent chance we are in a recession, (ii) a fairly decent chance we are in an inflationary environment, and a (iii) naggingly decent chance of a full-fledged financial crisis coming down the pike within the next couple of quarters. While I believe that the massive markdown of loans creates a deflationary environment, thus lowering the risk of inflation below what the Fed has seemed to fear, the money manager's predicament remains: how do you play all these possibilities at the same time?

Our Response to the Dislocation

We have to structure our portfolio with a view toward protecting your capital in case the existing maps, like the outdated maps of the Northwest Passage, fail to represent reality accurately once again. What is more, while a speedy recovery is a consummation devoutly to be wished, we do not take it as the most likely scenario. Recovery from the current crisis is more likely to be a process — indeed, given the scope of the damage, a lengthy and painful one — than a rapid V-curve.

While we wait for markets to stabilize, we take comfort that the deals we play hold a low correlation to broad markets. Through significant changes to our preferred asset classes, the markets in general, and the broader domestic and international economy, low correlation has been a constant for us for two decades. It costs us some upside during boom markets, but it buys us stability, along with positive compounding, for the long haul. This remains true even as more of our portfolio has shifted to longer term, less liquid investments, because our sourcing networks allow us to buy positions well. When one buys at a good price, the formula for success is fairly simple. A combination of time, diversification, and the avoidance of across-the-board mistakes allows good buys to mature into profitable sales. In 2007, we also shorted a few things, including financials, along the way, which contributed to performance. Regrettably, the shorts were not big enough; in times like this, they almost never are.

Our best answer to the puzzle that faces investors as well as the Fed — are we dealing with recession, inflation, or a meltdown? — is to play defense. Thus, we are sitting on plenty of cash (see the chart on page 1). We remain excited about the upcoming opportunities, because the distressed credit cycle is in full swing and the corporate credit cycle is on its way, right behind. Thus, we expect opportunities to deploy our cash in the coming quarters, both in the asset-backed and corporate markets. As always, however, we will be quite content to miss calling the absolute bottom. Once a bottom has formed, there will be plenty of opportunity to catch the rebound on the way up.

The rabbis of the Talmud put a gloss on the Biblical account of the splitting of the Red Sea. The waters did not part, they tell us, until someone overcame the enormous natural reluctance to be the first to wade into the sea. In their rendering, this man was Nachshon, the son of Aminadav and brother-in-law of Aaron the High Priest. Throughout the millennia, schoolchildren have known of Nachshon's incredible courage and have sometimes used his name to describe an initiator.

We are not interested in emulating Nachshon. Instead, we will be very happy to be followers, tagging along onto the dry land of stabilized markets. Though the courageous get paid the most for their audacity, they can also end up on the bottom of the sea. That's not for us. We prefer the more muted risk and are willing to accept the reduced upside, not to mention the anonymity, of being the second, or third or fourth, one in. By the same token, when prices get ridiculously low, we plan to start deploying our cash, even at some risk of catching a falling knife. Cash is not merely a defensive tool but an offensive weapon, too, and we hope to use it to generate the type of risk-adjusted returns our investors expect.

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Talent and Genius

For hedge funds in the unsettled and unsettling year 2007, any returns above the mid-teens required successfully identifying the real mispriced asset class and thereby, perhaps, making the score of a lifetime or at least the last twenty-five years. The right bet — being short subprime, an asset class that was nearly wiped out — required real vision. One may ask why this should be so. After all, we've been hearing for years that there is a real estate bubble that is sure to pop. So where is the vision in acting upon that belief? That we have been hearing about the impending crash *for years* is a big part of the explanation. As Judge Richard A. Posner, no shabby economist (as well as, in his day job, an outstanding jurist), recently put it:

> The subprime mortgage "crisis" follows a classic pattern that should help us to understand the inevitability of intelligence failures (Pearl Harbor, the Tet Offensive, the Egyptian-Syrian surprise attack on Israel in October 1973, 9/11, and so on *ad nauseam*). These failures typically are not due to lack of essential information or absence of warning signs or signals, but to lack of precise information concerning time and place, without which effective response is impossible except at prohibitive cost. Alarms over risky mortgage practices had been sounded for years, and ignored for years. Someone, whether a home buyer or an investment bank buying home mortgages, who had heeded the warnings when they were first made, or indeed until years later, would have left a good deal of money on the table.

It has been easy to call a real estate bubble but quite difficult, and potentially very expensive, to call the season in which it would pop. The same was true of the tech bubble of the late 1990s and early part of this decade. As they watched their friends get rich, investors needed courage to get out of the risky asset classes, let alone to short them.

The philosopher Arthur Schopenhauer observed: "Talent hits a target no one else can *hit*; genius hits a target no one else can *see*." *Seeing* the subprime target before the deterioration began required genius. Artistic flair, inborn skill, and a preternatural sense of the markets occasionally coalesce into genius. One cannot but admire this rare combination, but pulling it off regularly is not my idea of a business plan. We aspire not to genius but to talent. We seek to combine some feel for the markets with research, hard work, and pounding the pavement. Indeed, we would not object to being considered even *moderately* talented. The combination of some talent and a lot of diligence got us through a rocky 2007, and we hope to employ the same formula to good if not better effect in calmer years ahead.

Very truly yours,

J. Ezra Merkin
General Partner

APPENDIX 1

CATEGORIES OF INVESTMENTS

(1) *Distressed Debt* is an investment in the obligations of a company that is in serious trouble. The company may have filed for bankruptcy, or it may be about to. Its future is very much in doubt and its debt trades at relatively low prices. Our analysis of Distressed Debt contains financial and legal components. First, we must study valuations to figure out what is financially affordable; then, we consider what is legally permissible in a workout. When we find the answers to both questions promising, we invest. At this stage, we must rely entirely on our own work, because there is no external confirmation of valuations or process, let alone timing.

(2) At the next stage, after a bankruptcy filing, the company's securities may be *Debt or Equity Subject to a Deal or Legal Process*. Here, a plan of reorganization has been filed and the world therefore has a better idea what the securities are worth and what the timing may look like. This is the beginning of an arbitrage process, because we are underwriting the successful completion of a reorganization plan, the reward being the difference between the present and ultimate values of the securities. While significant uncertainties remain, the existence of a plan at this stage gives the first objective confirmation of the range of values that may be obtained.

(3) Still later, there are opportunities for *Arbitrage of Related Securities*. This happens when the securities that the reorganization plan brings into existence are available to trade. The package of securities may include senior secured debt, senior subordinated debt, new mezzanine debt, junior debt, preferred stock, and common stock. At this stage, one can hold the original debt while shorting fully valued or unattractive components of the package, or perhaps acquire a new long position while doing internal hedging.

(4) After the bankruptcy concludes, investment opportunities in *Long-term Equity* arise. For a month or two after a plan is confirmed and the company emerges from bankruptcy, one can still think of the company's securities as a bankruptcy play. After a couple of months, however, the bankruptcy is history. The decision to hold the securities beyond this point has to be predicated on the notion that they remain significantly undervalued.

(5) Post-bankruptcy debt (as opposed to equity) fits under the rubric of *Credit Opportunities*. Also in this category are debt instruments that we do *not* believe will be subject to reorganization, our small portfolio of "dented" high-yields. This is debt that is not distressed, that is performing and should continue to perform. Whereas we can buy distressed debt for 30 or 40 cents on the dollar, we buy these dented high-yields in the 80s, happy to clip a substantial coupon and hoping for decent capital gains over time.

EXHIBIT 37

1
2
3
4 STATE OF NEW YORK
OFFICE OF THE ATTORNEY GENERAL
5 --x
6 In Re:
7 MADOFF CHARITIES INVESTIGATION
8 --x
9
10
11 Martin Act Testimony Under Oath of [redacted]
12 [redacted], held at The Office of the Attorney
13 General, 120 Broadway, New York, New York 10271, on
14 the 26th day of February 2009, commencing at 10:40
15 a.m. before [redacted], a Shorthand Reporter
16 and Notary Public of the State of New York, pursuant
17 to Notice.
18
19
20
21
22
23
24
25

1

2 : And he also said you add in

3 the short market value, because when you sell short

4 you gain cash. So you can't do it without that.

5 Q I understand you have to add proceeds of

6 short sales, but isn't the other part just the cash

7 you have?

8 A I thought I had said that it's the cash

9 and any other balance sheet type item that remains,

10 receivable or payable.

11 Q All right.

12 Where in here is the Madoff investment

13 categorized?

14 : And "here," again, you mean

15 Exhibit 5?

16 Q In this table in Exhibit 5?

17 A The capital allocated to the Madoff

18 accounts is in the arbitrage of related securities.

19 Q Could you please turn to the last page of

20 this exhibit? And read paragraph 3. Not out loud,

21 just read it to yourself.

22 (Witness peruses document.)

23 Q Is that an accurate description of the

24 securities that were custodied or held at Madoff?

25 A This description talks about debt

1 [redacted]

2 securities. All these descriptions kind of talk

3 about the distressed and bankruptcy type investments.

4 The Madoff securities, other than the last

5 sentence, which talks about our new long positions

6 while doing internal hedging. That -- that would

7 describe the Madoff strategy, which was a --

8 Q What's the part that describes --

9 A Just the last -- the last phrase.

10 "Require new long position while doing internal

11 hedging." That --

12 Q So your understanding is that the first

13 line -- the second sentence I should say, which

14 begins on the first line, "This happens" -- "this"

15 meaning arbitrage of related securities -- "happens

16 when the securities that the reorganization plan

17 brings into existence are available to trade."

18 Is it your understanding that that has

19 nothing to do with the last sentence? That the last

20 sentence is no longer talking about securities that

21 our reorganization plan brings into existence?

22 A Yeah, I --

23 Q When did you begin --

24 [redacted]: I'm sorry, what was the last

25 answer?

1

2 A In reading it -- it doesn't seem to -- I

3 mean, it does seem to tie to the last sentence.

4 Q And therefore would not apply to Madoff

5 assets?

6 A It doesn't seem to.

7

8

9 Q What was the basis for your putting the

10 Madoff -- and when I say basis, how did you or how

11 did Gabriel decide to include the Madoff figure in

12 the arbitrage of related securities?

13 A I believe it was when we first started

14 doing this -- this table, in conversations with Ezra,

15 that that was the appropriate category.

16 And in fact, it's my understanding that

17 that is in fact what he does. It's a basket of

18 securities set up against an options strategy, and

19 that would be an arbitrage.

20 Q So your understanding is the four-word

21 description in the table is accurate?

22 A I'm sorry?

23 Q You're suggesting that these four words,

24 "arbitrage of related securities," could describe

25 Madoff?

EXHIBIT 38

From: [redacted]
Sent: Fri, 19 Dec 2008 18:44:20 GMT
To: [redacted]
Subject: RE: Investor Letters

Dear [redacted] Thanks for the letters.
We were trusting and investing with MR EZRA MERKIN .We never knew that that ASCOT FUND was not investing its money and giving it to third-party people to invest .Why GABRIEL CAPITAL was not investing the money of ASCOT FUND?
Please inform us since when ARIEL FUND invested with MADOFF 27% of its capital?.ARIEL FUND invests in DISTRESSED securities .What MADDOF has to do with DISTRESSED DEBT?
Many thanks and looking to hear from you [redacted]

Subject: Investor Letters
Date: Fri, 19 Dec 2008 11:19:23 -0500
From: [redacted]
To: [redacted]

Attached are copies of the letters you requested.

---

check out the rest of the Windows Live™. More than mail–Windows Live™ goes way beyond your inbox. More than messages

EXHIBIT 39

From: [redacted]
Sent: Fri, 12 Dec 2008 11:36:30 GMT
To: [redacted]; Merkin, J. Ezra
Subject: Gabriel Capital-is ALSO affected by Madoff?

EXHIBIT 40

Gabriel Capital, L.P.

Financial Statements
Year Ended December 31, 2007

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Gabriel Capital, L.P.

Financial Statements
Year Ended December 31, 2007

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GCC-NYAG 0035730

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Statement of cash flows	19
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GCC-NYAG 0035731

BDO Seidman, LLP
Accountants and Consultants

330 Madison Avenue
New York, New York 10017
Telephone (212) 885-8000
Fax (212) 697-1299

Independent Auditors' Report

The Partners
Gabriel Capital, L.P.
New York, New York

We have audited the accompanying statement of assets and liabilities of Gabriel Capital, L.P. (the "Partnership"), including the condensed schedule of investments, as of December 31, 2007, and the related statements of income, changes in partners' capital, and cash flows for the year then ended. These financial statements are the responsibility of the Partnership's management. Our responsibility is to express an opinion on these financial statements based on our audit.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Partnership's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinion.

As discussed in the summary of business and significant accounting policies, the financial statements include investments and investments sold, not yet purchased aggregating $666,821,967 (approximately 55% of partners' capital), whose values have been estimated by the General Partner in the absence of readily ascertainable market values. We have reviewed the procedures used by the General Partner in arriving at its estimate of value of such securities and have inspected underlying documentation and we believe the procedures are reasonable and the documentation appropriate. These values may be higher or lower than the values that would have been used had a ready market for the investments existed, and the differences could be material.

In our opinion, the financial statements referred to above present fairly, in all material respects, the financial position of Gabriel Capital, L.P. as of December 31, 2007, and the results of its operations and its cash flows for the year then ended in conformity with accounting principles generally accepted in the United States of America.

BDO Seidman, LLP

May 30, 2008

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GCC-NYAG 0035732

Gabriel Capital, L.P.

Statement of Assets and Liabilities

December 31, 2007	
Assets	
Investments, at fair value (Notes 2 and 3)	**$1,154,351,707**
Investments purchased under agreement to resell (Note 2)	**21,766,763**
Cash and cash equivalents held at brokers (Note 2)	**342,744,674**
Interest receivable	**2,815,680**
Total assets	**1,521,678,824**
Liabilities	
Investments sold, not yet purchased, at fair value (Note 2)	**108,901,768**
Investments sold under agreements to repurchase (Note 2)	**10,097,665**
Capital withdrawals payable	**189,218,843**
Accrued expenses	**2,369,568**
Interest payable	**591,086**
Total liabilities	**311,178,930**
Commitments (Note 7)	
Net assets (partners' capital) (Notes 6 and 9)	**$1,210,499,894**

See accompanying notes to financial statements.

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Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments:		
	Common stock:		
	United States:		
	Auto parts and equipment	.10%	$ 1,242,952
	Banks	.06	731,968
	Coal	.05	583,129
	Commercial services	.04	470,648
	Communications equipment	.04	435,564
	Diversified financial services	.20	2,520,823
	Electric	.05	599,492
	Electronics	.02	253,330
	Engineering and construction	.02	207,417
	Food processing	.06	716,665
	Healthcare	.07	826,838
	Index	.05	565,669
	Insurance	.08	1,019,352
	Internet	.19	2,248,780
	Manufacturing	.07	804,714
	Media	.06	690,639
	Mining	.11	1,353,703
	Oil and gas	.04	526,210
	Pharmaceuticals	.07	815,917
	Real estate investment trusts	.04	474,426
	Retail	.26	3,096,149
	Semiconductors	.07	893,100
	Technology	.46	5,633,126
	Telecommunications	.19	2,262,153
	Other	.08	990,042
	Total United States (cost $28,247,764)	2.48	29,962,806
	Austria:		
	Other (cost $47,899)	-	51,476
	Bermuda:		
	Other (cost $456,568)	.04	450,018

See accompanying notes to financial statements.

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Gabriel Capital, L.P.

Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments (continued):		
	Common stock (continued):		
	Canada:		
	Other (cost $977,804)	**.02%**	**$ 287,603**
	France:		
	Financial services (cost $691,511)	**.05**	**584,164**
	Great Britain:		
	Other (cost $89,608)	**.01**	**88,272**
	Germany:		
	Other (cost $430,257)	**.04**	**501,495**
	Hong Kong:		
	Banks (cost $705,001)	**.14**	**1,637,815**
	Israel:		
	Banks	**3.59**	**43,501,784**
	Computers	**.08**	**972,186**
	Total Israel (cost $34,418,319)	**3.67**	**44,473,970**
	Italy:		
	Other (cost $384,458)	**.03**	**359,908**
	Japan:		
	Other (cost $539,051)	**.05**	**571,727**
	Norway:		
	Food processing	**.04**	**506,127**
	Other	**.05**	**671,648**
	Total Norway (cost $1,123,768)	**.09**	**1,177,775**
	Russia:		
	Other (cost $-0-)	**.01**	**93,736**
	Ukraine:		
	Other (cost $98,389)	**-**	**14,129**
	Total common stock (cost $68,210,397)	**6.63**	**80,254,894**

See accompanying notes to financial statements.

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Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments (continued):		
	Preferred stock:		
	United States:		
	Aerospace and defense	.04%	$ 448,656
	Automotive	.13	1,538,490
	Home builders	.08	976,525
	Leisure products	.63	7,630,388
	Media	.13	1,569,460
	Real estate investment trusts	.05	599,184
	Retail	.13	1,627,984
	Other	.01	80,509
	Total United States (cost $15,747,332)	1.20	14,471,196
	Canada:		
	Airline	.78	9,455,806
	Other	-	313
	Total Canada (cost $3,415,980)	.78	9,456,119
	Total preferred stock (cost $19,163,312)	1.98	23,927,315
	Debt securities:		
	United States:		
	Airlines	.03	351,299
	Auto manufacturers	.28	3,444,788
	Auto parts and equipment	.30	3,691,450
	Banks	.60	7,221,804
	Commercial services	.20	2,407,190
	Distribution	.13	1,582,050
	Energy-alternate sources	.09	1,069,735
	Entertainment	.07	810,770
	Food distributors	.11	1,305,978
	Food processing	.06	755,310

See accompanying notes to financial statements.

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Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments (continued):		
	Debt securities (continued):		
	United States (continued):		
	Government:		
28,275,000	U.S. Treasury Bill, due 2/21/08	**2.33%**	**$ 28,154,831**
28,275,000	U.S. Treasury Bill, due 2/28/08	**2.32**	**28,136,453**
28,275,000	U.S. Treasury Bill, due 3/6/08	**2.32**	**28,119,488**
28,275,000	U.S. Treasury Bill, due 3/13/08	**2.32**	**28,100,261**
28,275,000	U.S. Treasury Bill, due 3/20/08	**2.32**	**28,078,206**
28,275,000	U.S. Treasury Bill, due 3/27/08	**2.32**	**28,058,414**
28,275,000	U.S. Treasury Bill, due 4/10/08	**2.32**	**28,021,939**
28,275,000	U.S. Treasury Bill, due 4/17/08	**2.32**	**28,008,650**
28,275,000	U.S. Treasury Bill, due 4/24/08	**2.31**	**27,988,574**
28,275,000	U.S. Treasury Bill, due 5/1/08	**2.31**	**27,964,541**
28,275,000	U.S. Treasury Bill, due 5/8/08	**2.31**	**27,947,858**
28,275,000	U.S. Treasury Bill, due 5/15/08	**2.31**	**27,928,913**
12,000,000	U.S. Treasury Bill, due 2/14/08	**.99**	**11,956,350**
19,400,000	U.S. Treasury Note, 4.625%, due 3/31/08	**1.61**	**19,466,686**
	Other	**.66**	**7,946,025**
	Healthcare-services	**.08**	**979,590**
	Household products/wares	**.30**	**3,686,566**
	Insurance	**.05**	**594,925**
	Iron/steel	**.04**	**495,550**
	Manufacturing	**.04**	**530,000**
	Media	**.14**	**1,737,580**
	Miscellaneous manufacturers	**.04**	**473,025**
	Multi-utilities	**.18**	**2,182,680**
	Oil and gas	**.17**	**2,014,000**
	Packaging and containers	**.09**	**1,093,125**
	Restaurants	**.03**	**356,531**
	Semiconductors	**.14**	**1,688,950**
	Telecommunications	**.37**	**4,463,195**
	Transportation	**.09**	**1,113,000**
	Other	**.25**	**3,166,939**
	Total United States (cost $417,053,136)	**34.95**	**423,093,219**

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Gabriel Capital, L.P.

Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments (continued):		
	Debt securities (continued):		
	Argentina:		
	Sovereign (cost $620,212)	**.05%**	**$ 620,100**
	Canada:		
	Other (cost $262,719)	**.02**	**215,019**
	Germany:		
	Auto parts and equipment	**.45**	**5,424,831**
	Industrial machinery	**.07**	**845,018**
	Real estate	**3.43**	**41,562,203**
	Total Germany (cost $48,849,520)	**3.95**	**47,832,052**
	Great Britain:		
	Other (cost $51,940)	**.01**	**216,618**
	Italy:		
	Financial services (cost $3,139,818)	**.22**	**2,631,603**
	Japan:		
	Nonperforming loans	**.07**	**904,450**
	Real estate	**.36**	**4,355,980**
	Resorts	**.52**	**6,265,096**
	Thrifts and mortgage finance	**.04**	**454,051**
	Total Japan (cost $1,788,227)	**.99**	**11,979,577**
	Mexico:		
	Other (cost $-0-)	**-%**	**24,342**
	Total debt securities (cost $471,765,572)	**40.19**	**486,612,530**

See accompanying notes to financial statements.

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Gabriel Capital, L.P.

Condensed Schedule of Investments

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	December 31, 2007		
	Investments (continued):		
	Private equity:		
	United States:		
	Auto parts and equipment:		
104,648,515	Chrysler Holding LLC	**6.57**	**79,526,295**
	Other	**.52**	**6,318,926**
	Automobile manufacturers	**1.36**	**16,422,540**
	Automotive retail	**.15**	**1,817,552**
	Building products	**.36**	**4,382,524**
	Consumer services	**.03**	**324,727**
	Department stores	**.09**	**1,047,619**
	Diversified banks	**.03**	**419,320**
	Diversified capital markets	**.80**	**9,743,835**
	Diversified financial services:		
81,583,821	General Motors Acceptance Company LLC	**5.50**	**66,589,158**
	Other	**2.18**	**26,437,013**
	Food retail	**.47**	**5,725,548**
	Healthcare equipment	**.09**	**1,106,091**
	Movies and entertainment	**.18**	**2,202,281**
	Paper products	**1.00**	**12,131,591**
	Pharmaceuticals	**1.03**	**12,495,791**
	Real estate	**1.14**	**13,782,729**
	Retail	**.03**	**331,856**
	Wireless telecommunication services	**.05**	**628,842**
	Other	**.06**	**743,598**
	Total United States (cost $219,262,909)	**21.64**	**262,177,836**

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Gabriel Capital, L.P.

Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments (continued):		
	Private equity (continued):		
	Austria:		
	Commercial banks (cost $48,202,597)	4.27%	$ 51,707,752
	Bermuda:		
	Reinsurance (cost $27,984,493)	2.31	27,984,751
	Canada:		
	Other (cost $14)	-	14
	China:		
	Construction (cost $13,833,549)	1.10	13,270,512
	Germany:		
	Real estate management (cost $535,207)	.18	2,177,128
	Great Britain:		
	Application software	1.24	14,959,007
	Asset management and custody banks	.30	3,499,968
	Consumer electronics	.09	1,040,960
	Department stores	.22	2,722,094
	Total Great Britain (cost $21,005,953)	1.85	22,222,029
	Japan:		
	Advertising	.09	1,071,885
	Financial services	.37	4,503,285
	Real estate	1.71	20,746,190
	Other	.04	436,260
	Total Japan (cost $14,144,653)	2.21	26,757,620
	Korea:		
	Beverage (cost $3,342,225)	.31	3,693,934
	Taiwan:		
	Real estate (cost $1,657,746)	.14	1,697,015
	Total private equity (cost $349,969,346)	34.01	411,688,591

See accompanying notes to financial statements.

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Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments (continued):		
	Limited partnerships:		
	United States:		
	Airlines	**.11%**	**$ 1,341,745**
	Diversified – distressed investments:		
	Cerberus Institutional Partners, L.P. – Series 2	**1.34**	**16,196,015**
	Cerberus Institutional Partners, L.P. – Series 3	**2.83**	**34,264,263**
	Cerberus Institutional Partners, L.P. – Series 4	**1.44**	**17,422,355**
	Other	**1.32**	**15,965,451**
	Retail	**.38**	**4,578,455**
	Real estate	**3.19**	**38,662,044**
	Total limited partnerships (cost $80,754,095)	**10.61**	**128,430,328**
	Loan participations:		
	United States:		
	Aerospace and defense	**.04**	**434,021**
	Pharmaceuticals	**.04**	**488,446**
	Other	**.02**	**295,616**
	Total United States (cost $38,709,799)	**.10**	**1,218,083**
	Hong Kong:		
	Other (cost $-0-)	**.02**	**210,227**
	Japan:		
	Diversified banks (cost $2,794,374)	**.23**	**2,794,374**
	Total loan participations (cost $41,504,173)	**.35**	**4,222,684**

See accompanying notes to financial statements.

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Gabriel Capital, L.P.

Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894		Fair value
	Investments (continued):			
	Call options:			
	United States:			
	Index	.18%	$	2,221,042
	Other	.07		771,860
	Total United States (cost $3,266,006)	.25		2,992,902
	Bermuda:			
	Other (cost $403,898)	.02		257,835
	Total call options (cost $3,669,904)	.27		3,250,737
	Put options:			
	United States:			
	Other (cost $60,951)	.01		121,265
	Forward currency contracts:			
	Various currencies	.01		79,231
	Mortgage-backed securities:			
	United States:			
	Real estate management	1.02		12,314,005
	Real estate investment trusts	.25		3,084,663
	Other	.01		118,309
	Total mortgage-backed securities (cost $15,786,543)	1.28		15,516,977
	Credit default swaps:			
	United States:			
	Diversified financial services	.07		782,652
	Mortgage real estate investment trusts	.05		613,513
	Thrifts and mortgage finance	.07		839,338
	Other	-		26,816
	Total United States (cost $102,068)	.19		2,262,319

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Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments (continued):		
	Credit default swaps (continued):		
	Great Britain:		
	Other (cost $-0-)	-%	$ 28,272
	Total credit default swaps (cost $102,068)	**.19**	**2,290,591**
	Index swaps:		
	United States:		
	Other (cost -$2,997,683)	(.25)	(3,067,635)
	Europe:		
	Other (cost $51,165)	-	3,192
	Total index swaps (cost -$2,946,518)	**(.25)**	**(3,064,443)**
	Warrants:		
	United States:		
	Internet	.05	544,416
	Other	-	490
	Total United States (cost $524,859)	**.05**	**544,906**
	China		
	Other (cost $-0-)	.04	476,101
	Total warrants (cost $524,859)	**.09**	**1,021,007**
	Total investments (cost $1,048,564,702)	**95.37%**	**$1,154,351,707**

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Gabriel Capital, L.P.

Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments sold, not yet purchased:		
	Common stock:		
	United States:		
	Asset management and custody banks	.08%	$ 932,046
	Banks	.13	1,601,545
	Diversified financial services	2.71	32,823,176
	Food processing	.06	706,159
	Index	1.90	22,879,454
	Real estate investment trusts	.17	2,059,013
	Other	.16	2,106,491
	Total United States (proceeds $62,605,673)	5.21	63,107,884
	Germany:		
	Banks (proceeds $331,536)	.03	342,937
	Great Britain:		
	Building products	.14	1,710,985
	Thrifts and mortgage finance	.33	3,941,066
	Total Great Britain (proceeds $6,743,501)	.47	5,652,051
	Total common stock (proceeds $69,680,710)	5.71	69,102,872
	Debt securities:		
	United States:		
	Auto parts and equipment	.03	391,210
	Broadcasting and cable TV	.07	815,922
	Building materials	.03	390,053
	Commercial services	.07	830,220
	Computer and electronics retail	.05	559,782
	Financial services	.03	418,400
	Healthcare	.05	634,312
	Publishing	.05	546,168
	Restaurants	.05	622,185
	Retail	.17	1,948,782
	Sovereign	1.77	21,380,624
	Utilities	.31	3,680,307
	Other	.12	1,663,366
	Total United States (proceeds $34,246,005)	2.80	33,881,331

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Gabriel Capital, L.P.

Condensed Schedule of Investments

December 31, 2007

Number of shares/face value	Description	% of net assets of $1,210,499,894	Fair value
	Investments sold, not yet purchased (continued):		
	Debt securities (continued):		
	Mexico:		
	Other (proceeds $216,617)	.02%	$ 216,618
	Total debt securities (proceeds $34,462,622)	**2.82**	**34,097,949**
	Forward currency contracts:		
	British pounds	(.04)	(455,657)
	Euro	.34	4,135,825
	Israel shekel	.05	578,028
	Various currencies	.03	398,238
	Total forward currency contracts	**.38**	**4,656,434**
	Call options:		
	United States:		
	Other (proceeds $328,024)	-	66,893
	Put options:		
	United States:		
	Other (proceeds $491,787)	.05	520,820
	Preferred stock:		
	United States:		
	Other (proceeds $-0-)	-	1,200
	Credit default swaps:		
	United States:		
	Diversified financial services	.13	1,609,055
	Other	-	(1,627)
	Total credit default swaps (net proceeds $1,138,153)	**.13**	**1,607,428**
	Index swaps:		
	United States:		
	Other (proceeds -$687,914)	(.10)	(1,151,828)
	Total investments sold, not yet purchased (proceeds $105,413,382)	**9.00%**	**$ 108,901,768**

See accompanying notes to financial statements.

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Gabriel Capital, L.P.

Statement of Income

Year ended December 31, 2007	
Investment income:	
Interest	$ 22,655,920
Dividends	8,132,206
Total investment income	**30,788,126**
Expenses:	
Professional fees (Note 5)	13,257,042
Investment advisory fees (Note 4)	12,020,348
Administrative expenses (Note 5)	10,666,694
Interest	2,990,754
Dividends on investments sold, not yet purchased	690,388
Clearing related expenses	60,085
Total expenses	**39,685,311**
Net investment loss	**(8,897,185)**
Net realized gain on investments	**147,102,517**
Net change in unrealized gain on investments	**(11,246,060)**
Net earnings, including change in unrealized appreciation, from investments in limited partnerships	**36,750,221**
Net income (Note 6)	**$163,709,493**

See accompanying notes to financial statements.

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Statement of Changes in Partners' Capital

Year ended December 31, 2007

	General partner	Limited partners Class A	Limited partners Class B	Total
Balance, January 1, 2007	$ 47,210,706	$983,484,369	$134,871,108	**$1,165,566,183**
Capital contributions	-	-	123,512,676	**123,512,676**
Capital withdrawals	(52,565,310)	(189,723,148)	-	**(242,288,458)**
Net income (Note 6):				
Pro rata allocation	3,794,597	130,857,307	29,057,589	**163,709,493**
Special allocation	31,734,292	(25,922,774)	(5,811,518)	-
Balance, December 31, 2007	**$ 30,174,285**	**$898,695,754**	**$281,629,855**	**$1,210,499,894**

See accompanying notes to financial statements.

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Gabriel Capital, L.P.

Statement of Cash Flows

Year ended December 31, 2007	
Cash flows from operating activities:	
Net income	$ 163,709,493
Adjustments to reconcile net income to net cash used in operating activities:	
Net realized gain on investments	(147,102,517)
Net change in unrealized gain on investments	11,246,060
Net earnings, including change in unrealized appreciation, from investments in limited partnerships	(36,750,221)
(Increase) decrease in:	
Investments purchased under agreements to resell	(21,766,763)
Purchase of investments	(4,555,502,441)
Proceeds from sale of investments	4,423,154,255
Interest receivable	(50,575)
Increase (decrease) in:	
Investments sold under agreements to repurchase	10,097,665
Purchases of investments to cover investments sold, not yet purchased	(220,590,221)
Proceeds from investments sold, not yet purchased	267,263,155
Interest payable	591,086
Accrued expenses	1,121,659
Total adjustments	**(268,288,858)**
Net cash used in operating activities	**(104,579,365)**
Cash flows from financing activities:	
Capital contributions	119,262,676
Capital withdrawals	(53,069,615)
Net cash provided by financing activities	**66,193,061**
Net decrease in cash and cash equivalents held at brokers	**(38,386,304)**
Cash and cash equivalents held at brokers, beginning of year	**381,130,978**
Cash and cash equivalents held at brokers, end of year	**$ 342,744,674**
Supplemental disclosure of cash flow information:	
Interest paid	$ 2,513,177
Noncash financing activity:	
Capital withdrawals payable	$ 189,218,843

See accompanying notes to financial statements.

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1. Significant Accounting Policies

Business

Gabriel Capital, L.P. (the "Partnership") is a Delaware limited partnership formed to invest in and trade financial instruments.

Class A limited partnership interests ("Class A") were issued to limited partners prior to February 1, 2006. Class A will no longer be issued by the Partnership. Each Class A limited partner may withdraw all or a portion of its capital account on June 30 or December 31. Class B limited partnership interests ("Class B") were issued to limited partners subsequent to February 1, 2006. Each Class B limited partner may withdraw all or part of such limited partner's capital account from the Partnership at the end of the calendar quarter after the two-year anniversary of the date such interests were purchased and annually thereafter.

Cash and Cash Equivalents

The Partnership considers all highly liquid instruments purchased with an initial maturity of one month or less to be cash equivalents.

Investment Transactions and Portfolio Valuation

The Partnership records investment transactions on a trade date basis. Revenues and expenses are recorded using the accrual method. Unrealized gains and losses are reflected in the statement of income.

Investments and Investments Sold, Not Yet Purchased

Investments listed on a national exchange are valued at the last sales price on the date of valuation. Investments not listed on a national exchange are valued at their last sales price on the date of valuation or, if such price is not available, the investments are valued based on the low "bid" price (for investments) and on the high "ask" price (for investments sold, not yet purchased) at the close of business. Investments are made in both marketable and not readily marketable financial instruments directly, and also through the use of investment partnerships and sub-advisors.

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Investments in certain equity and debt securities, limited partnership interests, private equity, preferred stock and loan participations are not readily marketable and are stated at fair value as determined by the general partner. These fair values may be higher or lower than the values that would have been used had a ready market existed, and the differences could be material. Investments and investments sold, not yet purchased, in not readily marketable securities at December 31, 2007 amounted to:

	Investments	Investments sold, not yet purchased
Call options	$ 2,221,042	$ -
Common stock	6,572,162	470,376
Debt securities	78,155,835	216,618
Mortgage-backed securities	15,516,977	-
Private equity	411,688,591	-
Preferred stock	20,701,342	-
Limited partnerships	128,430,328	-
Loan participations	4,222,684	-
Totals	$667,508,961	$686,994

Investments Purchased Under Agreements to Resell and Investments Sold Under Agreements to Repurchase

Transactions involving purchases ("reverse repurchase agreements") of investments under agreements to resell or sales of investments under agreements to repurchase ("repurchase agreements") are treated as collateralized financing transactions and are recorded at their contracted resale or repurchase amounts plus accrued interest, as specified in the respective agreements. These investments include U.S. Treasury obligations and mortgage-backed securities and represent short-term collateralized financing transactions that are carried in the statement of assets and liabilities at their contractual amounts.

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As of December 31, 2007, the Partnership pledged collateral consisting of investments worth $21,380,625 on open reverse repurchase agreements of $21,766,763. In addition, the Partnership held collateral consisting of investments worth $12,314,005 on open repurchase agreements of $10,097,665 at December 31, 2007.

Investments in Limited Partnerships

The limited partnerships invest and trade in domestic and foreign debt and equity securities and derivative products.

Financial Instruments With Off-balance Sheet Risk

The Partnership and certain limited partnerships in which it invests enter into various transactions involving derivatives and other financial instruments. These financial instruments include, but are not limited to, forward foreign currency contracts and credit default, index and equity swaps. These derivative financial instruments are used to conduct trading activities and manage market risks and are, therefore, subject to varying degrees of market and credit risk. Derivative transactions are entered into for trading purposes or to hedge other positions or transactions.

These activities may expose the partnerships to risk that the counterparty is unable to fulfill its contracted obligations and the partnerships may have to purchase or sell the financial instrument underlying the contract at a loss.

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Foreign Currency Contracts

The Partnership and certain limited partnerships in which it invests may enter into forward foreign currency exchange contracts primarily to hedge against foreign currency exchange rate risks on its non-U.S. dollar denominated investment securities. When entering into a forward exchange currency contract, the partnerships agree to receive or deliver a fixed quantity of foreign currency for an agreed-upon price on an agreed-upon future date. These contracts are valued daily, and the partnerships' net equity therein, representing unrealized gain or loss on the contracts as measured by the difference between the forward foreign exchange rates at the dates of entry into the contracts and the forward rates at the reporting date, is included in the partnerships' statements of assets and liabilities.

Credit Default, Index and Equity Swaps

Upon entering into a credit default or equity swap, the Partnership is required to transfer to the counterparty an amount of cash, U.S. Government securities, or other assets, equal to a certain percentage of the contract amount (initial margin deposit). Subsequent payments known as "Variation Margin" may be made or received by the Partnership depending on the fluctuations in the fair value of the underlying security. The Partnership recognizes a gain or loss equal to the changes in the underlying asset. These instruments involve market risk, credit risk, or both kinds of risk, in excess of the amounts recognized in the statement of assets and liabilities. Risks arise from the possible inability of counterparties to meet the terms of their contracts and from movement in currency, securities values and interest rates.

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The Partnership enters into credit default swap contracts which are agreements in which the Partnership pays fixed periodic payments to a counterparty in consideration for the right to sell the debt of the debtor named in the agreement to the counterparty at par value of the referenced debt instrument in the event that the debtor defaults in payment. Risks arise from the possible inability of counterparties to meet the terms of their contracts. The unrealized gains or losses on open credit default swap contracts are included in the statement of assets and liabilities, with net changes in unrealized gains or losses included in the statement of income.

Total Return Swaps

The Partnership utilizes total return swap contracts as economic substitute for certain investments in securities. Total return swap contracts are arrangements whose valuation and resultant gain or loss are based upon the fair value fluctuations of underlying securities. These instruments involve both market risk and credit risk in excess of the amounts recognized in the statement of assets and liabilities. Risks arise from the possible inability of counterparties to meet the terms of their contracts and from movement in currency and securities values and interest rates. The unrealized gains or losses on open total return swaps are included in the statement of assets and liabilities, with net changes in unrealized gains or losses in the statement of income.

Investments Sold, Not Yet Purchased

The Partnership and certain limited partnerships in which it invests have sold investments they do not own in anticipation of a decline in the fair values of those investments. A gain, limited to the price at which the partnerships sold the investment short, or a loss, unlimited in amount, will be recognized upon the termination of a short sale. These obligations are recorded on the partnerships' financial statements at the December 31, 2007 fair value of these investments. There is an element of market risk in that, if the investments increase in value, it will be necessary to purchase the investments at a cost in excess of the price reflected in the statement of assets and liabilities.

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Option Writing

When the Partnership writes an option, an amount equal to the premium received by the Partnership is recorded as a liability and is subsequently adjusted to the current fair value of the option written. Premiums received from writing options that expire unexercised are treated as realized gains from investments by the Partnership on the expiration date. The difference between the premium and the amount paid on effecting a closing purchase transaction, including the brokerage commissions, is also treated as a realized gain, or, if the premium is less than the amount paid for the closing purchase transaction, as a realized loss. If a call option is exercised, the premium is added to the proceeds from the sale of the underlying security or currency in determining a realized gain or loss. If a put option is exercised, the premium reduces the cost basis of the securities. The Partnership as writer of an option bears the market risk of an unfavorable change in the price of the security underlying the written option.

Foreign Currency

Investment securities and other assets and liabilities denominated in foreign currencies are translated into U.S. dollar amounts at the date of valuation. Purchases and sales of investment securities and income and expense items denominated in foreign currencies are translated into U.S. dollar amounts on the respective dates of such transactions.

The Partnership does not isolate that portion of the results of operations resulting from changes in foreign exchange rates on investments from the fluctuations arising from changes in market prices of securities held. Such fluctuations are included with the net realized and unrealized gain or loss from investments.

Capital Withdrawals Payable

Capital withdrawals payable represent the unpaid portion of capital withdrawals as of December 31, 2007.

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Income Taxes

No income tax provision has been made in the accompanying financial statements since the partners are required to report their respective shares of the Partnership income in their individual income tax returns.

Use of Estimates

The preparation of financial statements in conformity with accounting principles generally accepted in the United States of America requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the year. Actual results could differ from those estimates.

New Accounting Pronouncements

In September 2006, the Financial Accounting Standards Board ("FASB") issued Statement of Financial Accounting Standards ("SFAS") No. 157, "Fair Value Measurements". This standard clarifies the definition of fair value for financial reporting, establishes a framework for measuring fair value and requires additional disclosures about the use of fair value measurements. SFAS No. 157 is effective for financial statements issued for fiscal years beginning after November 15, 2007 and interim periods within those fiscal years. As of December 31, 2007, the Partnership does not believe the adoption of SFAS No. 157 will impact the amounts reported in the financial statements. However, additional financial presentations and disclosures will be required about the inputs used to develop the measurements of fair value and the effect of certain of the measurements reported in the statement of income for a fiscal year.

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In June 2006, the FASB issued FASB Interpretation No. 48 ("FIN 48"), "Accounting for Uncertainty in Income Taxes", which establishes that a tax position taken or expected to be taken in a tax return is to be recognized in the financial statements when it is more likely than not, based on the technical merits, that the position will be sustained upon examination. FIN 48 is effective for fiscal years beginning after December 15, 2007. The Partnership does not believe that the adoption of FIN 48 will have a material impact on its results of operations or its financial position.

2. Brokerage Agreements

The Partnership has prime brokerage agreements and, along with limited partnerships in which it invests, agreements with various brokerage firms to carry their accounts as a customer. The brokers have custody of the partnerships' investments and, from time to time, cash balances which may be due from these brokers.

These securities and/or cash positions serve as collateral for any amounts due to brokers or as collateral for the open swap contracts, investments sold, not yet purchased or investments purchased on margin. The securities and/or cash positions also serve as collateral for potential defaults of the partnerships.

The partnerships are subject to credit risk if the brokers are unable to repay balances due or deliver securities in their custody.

3. Related Party Transaction

The general partner serves as Chairman of the Board of Directors of General Motors Acceptance Company LLC, an investee company.

4. Investment Advisory Fees

The Partnership agreement provides for an annual fee of 1% of the limited partners' capital balance invested during the year, as defined, to be paid to an affiliated entity wholly owned by the general partner. Such fees aggregated $12,020,348 for the year ended December 31, 2007.

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5. Administrative and Other Expenses

The Partnership shares office space and various expenses with other related entities, which allocate a pro rata portion of these expenses to the Partnership. Such allocated expenses aggregated $23,637,884 for the year ended December 31, 2007 and are comprised of $10,666,694 in administrative expenses and $12,971,190 in professional fees.

6. Allocation of Net Income

Partnership net income, as defined, is allocated to each partner based on the ratio of that partner's capital account to the total capital accounts of all partners and is allocated for each accounting period, as defined, during a fiscal year.

The general partner receives a special allocation at the end of each calendar year equal to 20% of the net income allocated to each limited partner during the year. For the year ended December 31, 2007, the special allocation to the general partner was $31,734,292.

7. Commitments

At December 31, 2007, the Partnership is committed to invest up to $21,750,000 of additional capital in one limited partnership.

The Partnership invests in one limited partnership which has a lock-up date through December 31, 2009. The Partnership may not withdraw all or any portion of its investment prior to December 31, 2009.

8. Financial Highlights

The financial highlights represent the Partnership's financial performance for the year ended December 31, 2007.

An individual partner's performance may vary based on different financial arrangements related to investment advisory fee, special allocation and/or the timing of capital transactions.

Total return is computed based on the change in a limited partner's capital account during the year, adjusted for capital contributions and withdrawals.

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The operating expense and net investment income ratios do not reflect the effect of any special allocation.

Limited partner	Class A	Class B
Total return before special allocation	13.38%	13.38%
Special allocation	(2.68)	(2.68)
Total return after special allocation	10.70%	10.70%
Percentages to average net assets:		
Operating expense ratio	2.64%	2.64%
Special allocation	2.48	2.48
Total expenses and special allocation	5.12%	5.12%
Net investment income ratio	.73%	.73%

9. Subsequent Capital Transactions

For the period from January 1 to May 30, 2008, the Partnership received capital contributions approximating \$3,410,000 and paid capital withdrawals approximating \$1,050,000.

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EXHIBIT 41

From: [redacted]
To: [redacted]
Date: 5/8/2008 12:41 PM
Subject: J. Ezra Merkin - Materials Requested
Attachments: Our Approach (January 1994).pdf; What We Bring To The Table (July 1999).pdf ; In A Market That Can Draw Blood, The Type O Approach to Investing .pdf; A rbitrage and Distressed Investing (January 2001).pdf; Special Investment Po ol (January 2002).pdf; Cycles Asset Classes and Scams (April 2002).pdf; Vol atility and Creative Destruction (October 2002).pdf; White Tigers Pad Throu gh Our Office (October 2003).pdf; Paying Rent in the Year of Living Dangero usly (January 2004).pdf; Ariel 06Q1.pdf; Ariel 06Q2.pdf; Ariel 06Q3.pdf; Ar iel 06Q4.pdf; Ariel 07Q1.pdf; Ariel 07Q2.pdf; Ariel 07Q3.pdf; Ariel 07Q4.pd f; Ariel 08Q1.pdf; Ascot Partners.pdf; Ascot Partners Summary of Net Return s.pdf

Mr. [redacted],

Mr. Merkin is looking forward to your visit on Thursday, May 15th at 5:00PM. Our office is located at 450 Park Avenue, between 56th and 57th Streets, Suite 3201.

Per [redacted]s request, I have attached several recent quarterly letters for Ariel Fund Limited along with information about our Ascot Partners, L.P., each of which assumes different risks and strategies. I have also included a number of essays that you may find of interest.

Should you have any questions, please do not hesitate to call.

Thank you.

[redacted]

For Ezra Merkin

[redacted]

Gabriel Capital Group

450 Park Avenue

Suite 3201

New York, NY 10022

[redacted]@gabrielcapital.com

EXHIBIT 42

From: [redacted]
Sent: Mon, 15 Dec 2008 01:17:38 GMT
To: Merkin, J. Ezra
Subject: repair

Ezra,

I really, really want to believe that this whole affair is a sin of omission versus something else.....

I believe you are honest and I believe you care about your clients and your reputation.....You were enticed and sucked into the easy money offered via madoff which has now been revealed but hopeful making a mistake does not change your character........

It is your character that I appeal to for you have put me into a compromised position. The most valuable interaction you could have with me at this time is to provide me with a detailed listing of Gabriel and Ariel's portfolio (including all cash accts, leverage etc) as well as a statement that details exactly what the madoff exposure could be. I appreciate the other night that you said it was "a maximum of 25% hit to Gabriel/ariel" and if this is all you can say fine but I am appealing here to a long relationship we have had, this is info I need on Monday if possible and I am happy to send someone from my NY office to copy or collect in person if that is easier.....thanks for considering.....

The thing I really don't understand is that since we asked you and [redacted] directly to detail all PB accts and you represented you did not have one at madoff securities (again I think you are honest) you had to have Bernie trading for you in a segregated separate account at a major PB firm, just trying to figure out how the cash (which was audited every year and would not of been fake) would of left this account to pay off Bernie's issues – I have ideas but this piece of the puzzle is not fitting, realize this piece is more sensitive right now and maybe you can't respond, but the detail on portfolio you certainly can respond and you of all people know how critical it is at this moment for me to be able to look my clients in the eyes and give them answers on this issue........

[redacted]

[redacted]

EXHIBIT 43

From: [redacted]
Sent: Mon, 22 Dec 2008 15:56:41 GMT
To: Merkin, J. Ezra
Subject:

Dear Ezra,

I was very distressed to hear that Madoff was in our Gabriel portfolio. As a long time holder in Madoff ($3.9M), plus our children ($2.5M), we never, ever would have invested in Gabriel had we been properly advised of the Madoff investment. The last thing we expected was to add to our present Madoff holdings. I certainly should have been advised from the beginning of our investments and also in subsequent annual reports. In addition, we paid a charge of 1.5%, which we never paid at Madoff. A lack of due diligence is also apparent. How much if any due diligence was done on the balance of the investment?

My office will be calling to set up a meeting during the week of January 12th for the two of us (your office or lunch?).

My deepest personal regret for your personal anguish. I join you as a significant loser in both Madoff and Gabriel and expect you to do what is proper and right for [redacted] [redacted]

Holiday greetings. May future holidays be brighter.

Yours truly,

[redacted]

EXHIBIT 44

From: Victor Teicher
Sent: Sat, 13 Dec 2008 08:03:09 GMT
To: Merkin, J. Ezra
Subject:

I guess you did such a good job in fooling a lot of people that you ultimately fooled yourself.

While the attached article details many of the obvious clues suggested fraud; more simply, a man's name tells you who he is: Madoff made off with the money.

EXHIBIT 45

From: Victor Teicher
Sent: Fri, 12 Dec 2008 04:38:13 GMT
To: Merkin, J. Ezra
Subject:

The Madoff news is hilarious; hope you negotiate out of this mess as well as possible; I'm yours to help in any way I can; unfortunately, you've paid a big price for a lesson on the cost of being greedy.

EXHIBIT 46

From: [redacted]
Sent: Sun, 06 May 2001 14:14:31 GMT
To: J. Ezra Merkin
BCC: [redacted]
Subject: Madoff

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http://interactive.wsj.com/articles/SB989019667829349012.htm

Barron's Features

Don't Ask, Don't Tell

Bernie Madoff is so secretive, he even asks investors to keep mum

By ERIN E. ARVEDLUND

Two years ago, at a hedge-fund conference in New York, attendees were asked to name some of their favorite and most-respected hedge-fund managers. Neither George Soros nor Julian Robertson merited a single mention. But one manager received lavish praise: Bernard Madoff.

Folks on Wall Street know Bernie Madoff well. His brokerage firm, Madoff Securities, helped kick-start the Nasdaq Stock Market in the early 1970s and is now one of the top three market makers in Nasdaq stocks. Madoff Securities is also the third-largest firm matching buyers and sellers of New York Stock Exchange-listed securities. Charles Schwab, Fidelity Investments and a slew of discount brokerages all send trades through Madoff.

But what few on the Street know is that Bernie Madoff also manages $6 billion-to-$7 billion for wealthy individuals. That's enough to rank Madoff's operation among the world's three largest hedge funds, according to a May 2001 report in MAR Hedge, a trade publication.

What's more, these private accounts, have produced compound average annual returns of 15% for more than a decade. Remarkably, some of the larger, billion-dollar Madoff-run funds have never had a down year.

When Barron's asked Madoff Friday how he accomplishes this, he said, "It's a proprietary strategy. I can't go into it in great detail."

Nor were the firms that market Madoff's funds forthcoming when contacted earlier. "It's a private fund. And so our inclination has been not to discuss its returns," says Jeffrey Tucker, partner and co-founder of Fairfield Greenwich, a New York City-based hedge-fund marketer. "Why Barron's would have any interest in this fund I don't know." One of Fairfield Greenwich's most sought-after funds is Fairfield Sentry Limited. Managed by Bernie Madoff, Fairfield Sentry has assets of $3.3 billion.

A Madoff hedge-fund offering memorandums describes his strategy this way: "Typically, a position will consist of the ownership of 30-35 S&P 100 stocks, most correlated to that index, the sale of out-of-the-money calls on the index and the purchase of out-of-the-money puts on the index. The sale of the calls is designed to increase the rate of return, while allowing upward movement of the stock portfolio to the

strike price of the calls. The puts, funded in large part by the sale of the calls, limit the portfolio's downside."

Among options traders, that's known as the "split-strike conversion" strategy. In layman's terms, it means Madoff invests primarily in the largest stocks in the S&P 100 index -- names like **General Electric**, **Intel** and **Coca-Cola**. At the same time, he buys and sells options against those stocks. For example, Madoff might purchase shares of GE and sell a call option on a comparable number of shares -- that is, an option to buy the shares at a fixed price at a future date. At the same time, he would buy a put option on the stock, which gives him the right to sell shares at a fixed price at a future date.

The strategy, in effect, creates a boundary on a stock, limiting its upside while at the same time protecting against a sharp decline in the share price. When done correctly, this so-called market-neutral strategy produces positive returns no matter which way the market goes.

Using this split-strike conversion strategy, Fairfield Sentry Limited has had only four down months since inception in 1989. In 1990, Fairfield Sentry was up 27%. In the ensuing decade, it returned no less than 11% in any year, and sometimes as high as 18%. Last year, Fairfield Sentry returned 11.55% and so far in 2001, the fund is up 3.52%.

Those returns have been so consistent that some on the Street have begun speculating that Madoff's market-making operation subsidizes and smooths his hedge-fund returns.

How might Madoff Securities do this? Access to such a huge capital base could allow Madoff to make much larger bets -- with very little risk -- than it could otherwise. It would work like this: Madoff Securities stands in the middle of a tremendous river of orders, which means that its traders have advance knowledge, if only by a few seconds, of what big customers are buying and selling. By hopping on the bandwagon, the market maker could effectively lock in profits. In such a case, throwing a little cash back to the hedge funds would be no big deal.

When Barron's ran that scenario by Madoff, he dismissed it as "ridiculous."

Still, some on Wall Street remain skeptical about how Madoff achieves such stunning double-digit returns using options alone. The recent MAR Hedge report, for example, cited more than a dozen hedge fund professionals, including current and former Madoff traders, who questioned why no one had been able to duplicate Madoff's returns using this strategy. Likewise, three option strategists at major investment banks told Barron's they couldn't understand how Madoff churns out such numbers. Adds a former Madoff investor: "Anybody who's a seasoned hedge- fund investor knows the split-strike conversion is not the whole story. To take it at face value is a bit naïve."

Madoff dismisses such skepticism. "Whoever tried to reverse-engineer \, he didn't do a good job. If he did, these numbers would not be unusual." Curiously, he charges no fees for his money-management services. Nor does he take a cut of the 1.5% fees marketers like Fairfield Greenwich charge investors each year. Why not? "We're perfectly happy to just earn commissions on the trades," he says.

Perhaps so. But consider the sheer scope of the money Madoff would appear to be leaving on the table. A typical hedge fund charges 1% of assets annually, plus 20% of profits. On a $6 billion fund generating 15% annual returns, that adds up to $240 million a year.

The lessons of Long-Term Capital Management's collapse are that investors need, or should want, transparency in their money manager's investment strategy. But Madoff's investors rave about his performance -- even though they don't understand how he does it. "Even knowledgeable people can't really tell you what he's doing," one very satisfied investor told Barron's. "People who have all the trade confirmations and statements still can't define it very well. The only thing I know is that he's often in cash"

when volatility levels get extreme. This investor declined to be quoted by name. Why? Because Madoff politely requests that his investors not reveal that he runs their money.

"What Madoff told us was, 'If you invest with me, you must never tell anyone that you're invested with me. It's no one's business what goes on here,'" says an investment manager who took over a pool of assets that included an investment in a Madoff fund. "When he couldn't explain \ how they were up or down in a particular month," he added, "I pulled the money out."

For investors who aren't put off by such secrecy, it should be noted that Fairfield and Kingate Management both market funds managed by Madoff, as does **Tremont Advisers**, a publicly traded hedge-fund advisory firm.

E-mail comments to editors@barrons.com

URL for this Article:
http://interactive.wsj.com/archive/retrieve.cgi?id=SB989019667829349012.djm

EXHIBIT 47

HEDGE

MAR

Issue No. 89
May 2001

Madoff tops charts; skeptics ask how

By Michael Ocrant

Mention Bernard L. Madoff Investment Securities to anyone working on Wall Street at any time over the last 40 years and you're likely to get a look of immediate recognition.

After all, Madoff Securities, with its 600 major brokerage clients, is ranked as one of the top three market makers in Nasdaq stocks, cites itself as probably the largest source of order flow for New York Stock Exchange-listed securities, and remains a huge player in the trading of preferred, convertible and other specialized securities instruments.

Beyond that, Madoff operates one of the most successful "third markets" for trading equities after regular exchange hours, and is an active market maker in the European and Asian equity markets. And with a group of partners, it is leading an effort and developing the technology for a new electronic auction market trading system called Primex.

But it's a safe bet that relatively few Wall Street professionals are aware that Madoff Securities could be categorized as perhaps the best risk-adjusted hedge fund portfolio manager for the last dozen years. Its $6–7 billion in assets under management, provided primarily by three feeder funds, currently would put it in the number one or two spot in the Zurich (formerly MAR) database of more than 1,100 hedge funds, and would place it at or near the top of any well-known database in existence defined by assets.

More important, perhaps, most of those who are aware of Madoff's status in the hedge fund world are baffled by the way the firm has obtained such consistent, nonvolatile returns month after month and year after year.

Madoff has reported positive returns for the last 11-plus years in assets managed on behalf of the feeder fund known as Fairfield Sentry, which in providing capital for the program since 1989 has been doing it longer than any of the other feeder funds. Those other funds have demonstrated equally positive track records using the same strategy for much of that period.

Lack of volatility

Those who question the consistency of the returns, though not necessarily the ability to generate the gross and net returns reported, include current and former traders, 16▶

HEDGE UPDATE

Michael Berger catches a jail break

New chapters have been written in the continuing saga of **Michael Berger's Manhattan Investment Fund**, with the admitted fraudster's apparently inevitable jail term deferred when his counsel quit. Meanwhile, the civil cases against the 'deep pockets' associated with Berger—his prime broker **Bear, Stearns**, his auditor **Deloitte** 2▶

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Did you know that Bernie Madoff may be the best risk-adjusted hedge fund portfolio manager?
Cover

Read one European pension fund investor's comments about its foray into hedge funds
Page 13

Last year there was a huge spread between the winners and losers in the technology sector. What did the winners do right?
Page 14

◄1 other money managers, consultants, quantitative analysts and fund-of-funds executives, many of whom are familiar with the so-called split-strike conversion strategy used to manage the assets.

These individuals, more than a dozen in all, offered their views, speculation and opinions on the condition that they wouldn't be identified. They noted that others who use or have used the strategy—described as buying a basket of stocks closely correlated to an index, while concurrently selling out-of-the-money call options on the index and buying out-of-the-money put options on the index—are known to have had nowhere near the same degree of success.

The strategy is generally described as putting on a "collar" in an attempt to limit gains compared to the benchmark index in an up market and, likewise, limit losses to something less than the benchmark in a down market, essentially creating a floor and a ceiling.

Madoff's strategy is designed around multiple stock baskets made up of 30–35 stocks most correlated to the S&P 100 index. In marketing material issued by Fairfield Sentry, the sale of the calls is described as increasing "the standstill rate of return, while allowing upward movement of the stock portfolio to the strike price of the calls." The puts, according to the same material, are "funded in large part by the sale of the calls, [and] limit the portfolio's downside.

"A bullish or bearish bias can be achieved by adjusting the strike prices of the options, overweighting the puts, or underweighting the calls. However, the underlying value of the S&P 100 puts is always approximately equal to that of the portfolio of stocks," the marketing document concludes.

Throughout the entire period Madoff has managed the assets, the strategy, which claims to use OTC options almost entirely, has appeared to work with remarkable results.

Again, take the Fairfield Sentry fund as the example. It has reported losses of no more than 55 basis points in just four of the past 139 consecutive months, while generating highly consistent gross returns of slightly more than 1.5% a month and net annual returns roughly in the range of 15.0%.

> "This has been a good period to do this kind of stuff"

Among all the funds on the database in that same period, the Madoff/Fairfield Sentry fund would place at number 16 if ranked by its absolute cumulative returns.

Among 423 funds reporting returns over the last five years, most with less money and shorter track records, Fairfield Sentry would be ranked at 240 on an absolute return basis and come in number 10 if measured by risk-adjusted return as defined by its Sharpe ratio.

What is striking to most observers is not so much the annual returns—which, though considered somewhat high for the strategy, could be attributed to the firm's market making and trade execution capabilities—but the ability to provide such smooth returns with so little volatility.

The best known entity using a similar strategy, a publicly traded mutual fund dating from 1978 called Gateway, has experienced far greater volatility and lower returns during the same period.

The capital overseen by Madoff through Fairfield Sentry has a cumulative compound net return of 397.5%. Compared with the 41 funds in the Zurich database that reported for the same historical period, from July 1989 to February 2001, it would rank as the best performing fund for the period on a risk-adjusted basis, with a Sharpe ratio of 3.4 and a standard deviation of 3.0%. (Ranked strictly by standard deviation, the Fairfield Sentry funds would come in at number three, behind two other market neutral funds.)

Questions abound

Bernard Madoff, the principal and founder of the firm who is widely known as Bernie, is quick to note that one reason so few might recognize Madoff Securities as a hedge fund manager is because the firm makes no claim to being one.

The acknowledged Madoff feeder funds—New York-based Fairfield Sentry and Tremont Advisors' Broad Market; Kingate, operated by FIM of London; and Swiss-based Thema—derive all the incentive fees generated by the program's returns (there are no management fees), provide all the administration and marketing for them, raise the capital and deal with investors, says Madoff.

Madoff Securities' role, he says, is to provide the investment strategy and execute the trades, for which it generates commission revenue.

[Madoff Securities also manages money in the program allocated by an unknown number of endowments, wealthy individuals and family offices. While Bernie Madoff refuses to reveal total assets under management, he does not dispute that the figure is in the range of $6 billion to $7 billion.]

Madoff compares the firm's role to a private managed account at a broker-dealer, with the broker-dealer providing investment ideas or strategies and executing the trades and making money off the account by charging commission on each trade.

Skeptics who express a mixture of amazement, fascination and curiosity about the program wonder, first, about the relative complete lack of volatility in the reported monthly returns.

But among other things, they also marvel at the seemingly astonishing ability to time the market and move to cash in the underlying securities before market conditions turn negative; and the related ability to buy and sell the underlying stocks without noticeably affecting the market.

In addition, experts ask why no one has been able to duplicate similar returns using the strategy and why other firms on Wall Street haven't become aware of the fund and its strategy and traded against it, as has happened so often in other cases; why Madoff Securities is willing to earn commissions off the trades but not set up a separate asset management division to offer hedge funds directly to investors and keep all the incentive fees for itself, or conversely, why it doesn't borrow the money from creditors, who are generally willing to provide leverage to a fully hedged portfolio of up

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to seven to one against capital at an interest rate of Libor-plus, and manage the funds on a proprietary basis.

These same skeptics speculate that at least part of the returns must come from other activities related to Madoff's market making. They suggest, for example, that the bid-ask spreads earned through those activities may at times be used to "subsidize" the funds.

According to this view, the benefit to Madoff Securities is that the capital provided by the funds could be used by the firm as "pseudo equity," allowing it either to use a great deal of leverage without taking on debt, or simply to conduct far more market making by purchasing additional order flow than it would otherwise be able to do.

And even among the four or five professionals who express both an understanding of the strategy and have little trouble accepting the reported returns it has generated, a majority still expresses the belief that, if nothing else, Madoff must be using other stocks and options rather than only those in the S&P 100.

Bernie Madoff is willing to answer each of those inquiries, even if he refuses to provide details about the trading strategy he considers proprietary information.

And in a face-to-face interview and several telephone interviews, Madoff sounds and appears genuinely amused by the interest and attention aimed at an asset management strategy designed to generate conservative, low risk returns that he notes are nowhere near the top results of well-known fund managers on an absolute return basis.

Lack of volatility illusory

The apparent lack of volatility in the performance of the fund, Madoff says, is an illusion based on a review of the monthly and annual returns. On an intraday, intraweek and intramonth basis, he says, "the volatility is all over the place," with the fund down by as much as 1%.

But as whole, the split-strike conversion strategy is designed to work best in bull markets and, Madoff points out, until recently "we've really been in a bull market since '82, so this has been a good period to do this kind of stuff."

Market volatility, moreover, is the strategy's friend, says Madoff, as one of the fundamental ideas is to exercise the calls when the market spikes, which with the right stock picks would add to the performance.

In the current bearish environment, when some market experts think the fund should have been showing negative returns, albeit at levels below the benchmark index, managing the strategy has become more difficult, says Madoff, although performance has remained positive or, as in February, flat.

The worst market to operate in using the strategy, he adds, would be a protracted bear market or "a flat, dull market." In a stock market environment similar to what was experienced in the 1970s, for instance, the strategy would be lucky to return "T-bill like returns."

Market timing and stock picking are both important for the strategy to work, and to those who express aston- 18▶

Certified Public Accountants & Business Advisors

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- Structuring real estate financing
- Structuring real estate equity raise-ups

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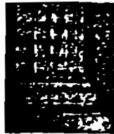

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◄17 ishment at the firm's ability in those areas, Madoff points to long experience, excellent technology that provides superb and low-cost execution capabilities, good proprietary stock and options pricing models, well-established infrastructure, market making ability and market intelligence derived from the massive amount of order flow it handles each day.

The strategy and trading, he says, are done mostly by signals from a proprietary "black box" system that allows for human intervention to take into account the "gut feel" of the firm's professionals. "I don't want to get on an airplane without a pilot in the seat," says Madoff. "I only trust the autopilot so much."

As for the specifics of how the firm manages risk and limits the market impact of moving so much capital in and out of positions, Madoff responds first by saying, "I'm not interested in educating the world on our strategy, and I won't get into the nuances of how we manage risk." He reiterates the undisputed strengths and advantages the firm's operations provide that make it possible.

Multiple stock baskets

Avoiding market impact by trading the underlying securities, he says, is one of the strategy's primary goals. This is done by creating a variety of stock baskets, sometimes as many as a dozen, with different weightings that allow positions to be taken or unwound slowly over a one- or two-week period.

Madoff says the baskets comprise the most highly capitalized liquid securities in the market, making the entry and exit strategies easier to manage.

He also stresses that the assets used for the strategy are often invested in Treasury securities as the firm waits for specific market opportunities. He won't reveal how much capital is required to be deployed at any given time to maintain the strategy's return characteristics, but does say that "the goal is to be 100% invested."

The inability of other firms to duplicate his firm's success with the strategy, says Madoff, is attributable, again, to its highly regarded operational infrastructure. He notes that one could make the same observation about many businesses, including market making firms.

Many major Wall Street broker-dealers, he observes, previously attempted to replicate established market making operations but gave up trying when they realized how difficult it was to do so successfully, opting instead to acquire them for hefty sums.

> "The strategy is the strategy and the returns are the returns"

[Indeed, says Madoff, the firm itself has received numerous buyout offers but has so far refused any entreaties because he and the many members of his immediate and extended family who work there continue to enjoy what they do and the independence it allows and have no desire to work for someone else.]

Similarly, he adds, another firm could duplicate the strategy in an attempt to get similar results, but its returns would likely be unmatched because "you need the physical plant and a large operation" to do it with equal success. However, many Wall Street firms, he says, do use the strategy in their proprietary trading activities, but they don't devote more capital to such operations because their return on capital is better used in other operations.

Setting up a proprietary trading operation strictly for the strategy, or a separate asset management division in order to collect the incentive fees, says Madoff, would conflict with his firm's primary business of market making.

Commissions suffice

"We're perfectly happy making the commissions" by trading for the funds, he says, which industry observers note also gives the firm the entirely legitimate opportunity to "piggyback" with proprietary trading that is given an advantage by knowing when and where orders are being placed.

Setting up a division to offer funds directly, says Madoff, is not an attractive proposition simply because he and the firm have no desire to get involved in the administration and marketing required for the effort, nor to deal with investors.

Many parts of the firm's operations could be similarly leveraged, he notes, but the firm generally believes in concentrating on its core strengths and not overextending itself. Overseeing the capital provided by the funds and its managed accounts, he says, provides another fairly stable stream of revenue that offers some degree of operational diversification.

Madoff readily dismisses speculation concerning the use of the capital as "pseudo equity" to support the firm's market making activities or provide leverage. He says the firm uses no leverage, and has more than enough capital to support its operations.

He notes that Madoff Securities has virtually no debt and at any given time no more than a few hundred million dollars of inventory.

Since the firm makes markets in only the most highly capitalized, liquid stocks generally represented by the S&P 500 index, a majority of which are listed on the NYSE, as well as the 200 most highly capitalized Nasdaq-listed stocks, says Madoff, it has almost no inventory risk.

Finally, Madoff calls ridiculous the conjecture that the firm at times provides subsidies generated by its market making activities to smooth out the returns of the funds in a symbiotic relationship related to its use of the capital as a debt or equity substitute. He agrees that the firm could easily borrow the money itself at a fairly low interest rate if it were needed, and would therefore have no reason to share its profits. "Why would we do that?"

Still, when the many expert skeptics were asked by MAR/Hedge to respond to the explanations about the funds, the strategy and the consistently low volatility returns, most continued to express bewilderment and indicated they were still grappling to understand how such results have been achieved for so long.

Madoff, who believes that he deserves "some credibility as a trader for 40 years," says: "The strategy is the strategy and the returns are the returns." He suggests that those who believe there is something more to it and are seeking an answer beyond that are wasting their time. ■

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EXHIBIT 48

DRAFT

BOARD OF TRUSTEES
INVESTMENT COMMITTEE

AUGUST 30, 2000

MINUTES

A meeting of the Investment Committee of the Board of Trustees was held in the offices of Mr. J. Ezra Merkin at 4:00 p.m. on Wednesday, August 30.

Present: Mr. J. Ezra Merkin; Chairman,

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The Committee then discussed the issue of potential conflicts of interest regarding members of the Board of Trustees and the Investment Committee. The issue was raised for discussion at this meeting because [redacted], a member of the Investment Committee, recently started a hedge fund called [redacted] and asked the Committee to consider investing in it. Mr. Merkin asked the Committee if they wanted to invest with someone who serves on the Committee. [redacted] said that he would not invest with a Committee member because it becomes harder to make impartial decisions involving the investment when the general partner or investment manager of the fund is sitting next to you at the Committee meetings. [redacted] also stated that the Board of Trustees should make the policy, not the Investment Committee. [redacted] disagreed, stating that the Committee should make a recommendation to the Board, and he added that the Board already has a conflict of interest policy in place. [redacted] concurred, and told the Committee that the current policy is any Board member may do business with [redacted], as long as it is fully disclosed once a year. If the business involves bidding, the Board member must bid just like any other firm, and the Board reserves the right to reject any potential business arrangement. [redacted] added that [redacted]

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called and asked him to convey a message to the Committee since he could not attend the meeting. [redacted]'s opinion is that no member of the Committee should do business with [redacted]. However, since the Committee has made exceptions in the past, he does not feel it is fair to become restrictive at this time. In addition, whatever amount the Committee invests in [redacted] should be withdrawn from the funds Mr. Merkin manages for [redacted]. This would maintain the current level of [redacted] funds invested with Committee members. The Committee did not agree with [redacted]'s suggestion. [redacted] said the Committee has been searching for a [redacted] for quite some time, and [redacted] may fulfill [redacted] need. [redacted] recommended

Material Redacted

that the Executive Committee of the Board should pre - approve this potential investment since [redacted] has a two-year lock – up period. Mr. Merkin commented that he doesn't want the Executive Committee running the Investment Committee, and that sometimes conflicts of interest are good, because you want competent investment professionals to serve as Committee members. [redacted] stated that all of the Committee members are professionals, and the Committee

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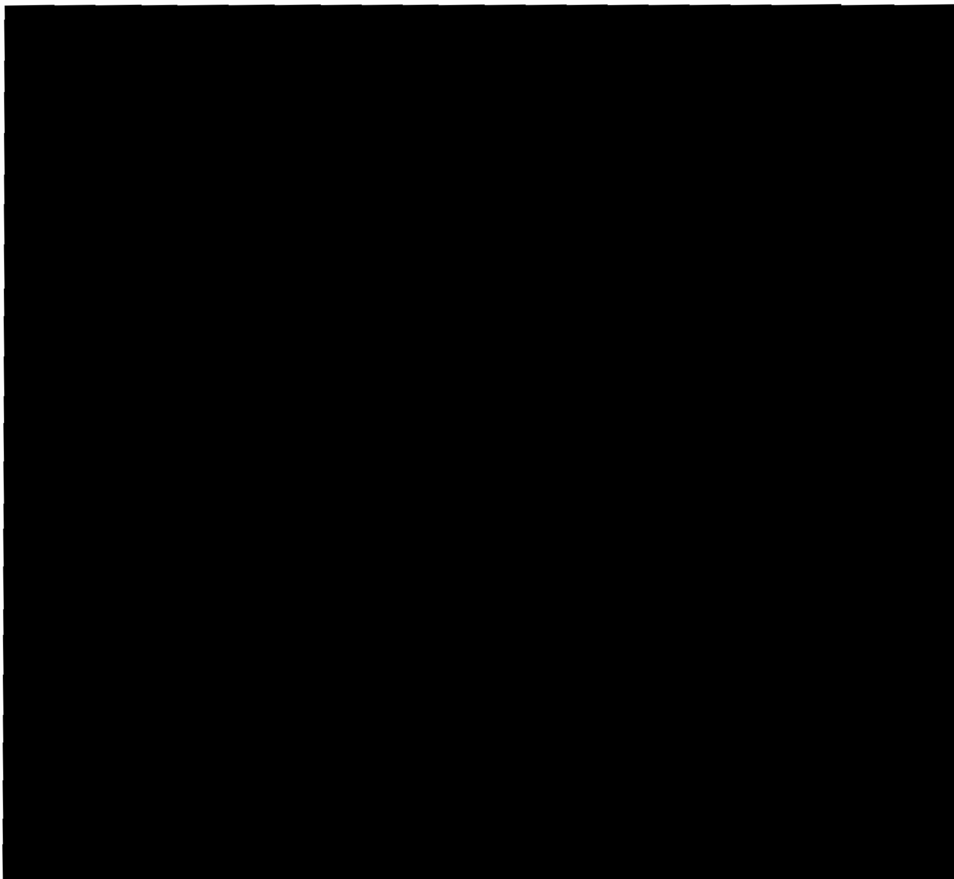
should choose the best people to manage ████'s assets, regardless if they serve on a board or committee.

Mr. Merkin asked ████ to bring this topic up for discussion at the next meeting of the Executive Committee of the Board of Trustees on September 19 and report back to the Committee at it's next meeting, September 20.



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