



LAHDE CAPITAL MANAGEMENT

January 21, 2008

The equity and credit markets have begun the year with a big fat thud. Meanwhile, all three of our funds have experienced sizable gains during the month of January. Month to date performance estimates, as of the close on January 18, for each fund are below:

U.S. Residential Real Estate Hedge V, Class A – up 17%

U.S. Residential Real Estate Hedge V, Class B – up 23%

Commercial Real Estate Hedge – up 61%

Short Credit Fund – up 15%

The Santa Claus rally caused a relatively nominal down tick in each fund during December. That rally was as real and as long lasting as Mr. Claus’s annual visit. Results for December, as well as for the full year are presented below, net of all fees. For the record, our return before performance fees for U.S. Residential Real Estate Hedge V, Class for 2007 was 1,087.2%. Our annual audit is currently being performed by Rothstein Kass. We are confident that audited performance will not be materially different than the numbers presented below.

Performance Data for U.S. Residential Real Estate Hedge V, LP - Class A

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2006	-	-	-	-	-	-	-	-	-	-	0.4%	-0.1%	0.4%
2007	11.4%	49.7%	-8.4%	-19.1%	1.3%	48.4%	113.1%	7.6%	-4.0%	97.3%	21.7%	-1.6%	869.8%

Performance Data for U.S. Residential Real Estate Hedge V, LP - Class B

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2007	-	-	-	-5.4%	-2.0%	25.4%	91.5%	2.7%	-8.3%	53.8%	11.3%	-3.7%	245.5%

Performance Data for Commercial Real Estate Hedge, LP

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2007	-	-	-	-	-	-	-	-	6.1%	33.8%	15.7%	-6.3%	53.9%

Performance Data for Short Credit Fund ***Estimate

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Year
2007	-	-	-	-	-	-	-	-	-	-	-	-5.7%	-5.7%

The Recession

After an endless stream of rhetoric from the media and our government about how, “Everything is going to be alright,” the Federal Reserve, as well as everyone else, is now talking about the possibility of a recession. Some pundits believe we are already in a recession. I fall into that camp. It amazes me that the markets blissfully cheered when Ben Bernanke essentially announced that he would act more like his predecessor, Alan Greenspan. That is, he claimed he would aggressively cut the Fed Funds rate, if needed. Ok, fine. But wait, isn’t Alan Greenspan largely responsible for the ills we are facing today? After all, he so drastically and irresponsibly cut rates that subprime lenders were able to thrive and suck every last drop of equity from

homeowners during this period. His actions also led to the belief that risk had disappeared from nearly every financial instrument in existence. Furthermore, Mr. Greenspan actually sat in front of Congress and professed that every American should take out an adjustable rate mortgage. In the words of a drunken Scotsman, “For #%@!’s sake?” The markets are actually cheering Ben Bernanke for acting like the man who got this country in the mess in the first place.

Bush and everyone else seem to want to avoid a recession. Of course, every politician wants to avoid a recession. But is that what this country really needs? Recessions are a normal part of the business cycle. They weed out the excess and punish foolishly overleveraged companies. It is now socially unacceptable to have a recession, but is it good policy for the long-run? No. Recessions usually entail a deleveraging of an economy, meaning companies use money to pay down excessive debts rather than using capital to expand operations. This country, the individuals, the companies and our government need to deleverage. Leverage is completely out of control. One has to wonder why nearly every capital infusion that our major banks have received recently has been from foreign entities. Why is this? The answer is simple. Collectively, this country does not have any equity left!!!! All we have is debt. If this were not the case, then we would have had domestic buyers bailing out our banks, but we don’t. Private equity firms can’t pony up the cash. Their main source of capital WAS debt. (It is ironic that they call themselves private equity). Our banks are not bailing each other out, because they don’t have any equity. Hedge funds are mostly tapped out, because they often use leverage excessively. So we have to turn to real money players, like oil rich nations and Asian countries. These countries have produced goods and saved capital, while so many Americans sat around, got fat watching their gigantic screen TVs, and pissing all of their savings away. This is why the U.S. needs to go offshore to find capital to bail out its pathetic banks.

A recession is like a hangover. It serves a purpose. It tells the body and the mind, “Dude, you totally overdid it. Think seriously before you do that again.” A recession makes people more frugal, something that is lost on most Americans. Of course, you can avoid a hangover by shooting up a good dose of heroin. In fact, your “day after” would likely be a blissful experience. But this is hardly what a doctor would order. And the only way to avoid the hangover is to keep shooting up indefinitely. This is the Fed’s answer to our over-leveraged situation – provide cheaper leverage. Strawberry fields forever....until you die anyway.

On the other hand the Fed just might have the right formula, for inflation that is. Print more dollars, you get more inflation. While inflation is a destructive force for those with a positive net worth denominated in dollars, most Americans have boatloads of debt. Inflation makes those debts look smaller. This policy is like walking a tightrope though. If you overdo it, you end up with hyperinflation. This seems like a plausible outcome, hence my fondness for precious metals. Another scenario is stagflation ala 1970s. That is, a situation in which inflation is high, but wages are not keeping up with inflation. Thus, consumers cannot spend as much and the economy stagnates. In other words, individuals end up with fewer goods for the same amount of work. And the markets cheered Bernanke for promising this?

Residential Real Estate

Standard and Poor’s on January 16 increased its estimate of cumulative losses for subprime mortgage pools originated during 2006 from 14% to 19%. Previously, the rating agencies would notch up their estimates 1% or 2% each time. Now we are up to 5% increments. We are not done seeing these estimate revisions. Remember, only now are the first of these loans written during 2006 experiencing resetting monthly payments. We believe home prices will continue to decline throughout the remainder of the year. Lower home prices will increase the severity of the losses and cause further revisions. Loan modifications – forget about it. Bush touted that he would help 1.2 million homeowners. Industry experts placed the number at more like 250,000 to 500,000. Millions are in trouble in the subprime world, but millions more are facing rising monthly payments, who are classified as Alt-A or prime borrowers. When it is all said and done, everyone will know someone who has gone through foreclosure.

Our Residential Fund continues to operate and will likely continue to experience gains for many months before we liquidate it.

Commercial Real Estate

The CMBX market opened the year with a downward trajectory that has largely continued to date. The Commercial Mortgage Securities Association Conference was held in Miami, January 6th through the 8th. I had this premonition that more bad news than good news was going to come out of this event. So, while traders were waking up on Monday, the 7th in Miami with wicked hangovers, I was hitting their bids. Granted, since they were away from their screens, their bid/offer spreads were unusually large. This did not bother me. I shorted anyway. On Wednesday, the 9th, traders returned to their desks, then began selling and shorting. And so went the month.

Several news items weighed on the market. Centro Properties, the largest strip mall owner put itself up for sale, as it was having difficulty refinancing its debt. Office vacancies rose for the first time in four years. With Wall Street and other industries laying off thousands of workers, vacancies will likely continue to increase and rents will head south. On January 16, a large Las Vegas casino developer defaulted on a \$760 million loan, as it failed to find someone stupid enough to refinance its loans. Finally, Harry Macklowe, a legendary New York commercial real estate developer/owner, has been having trouble refinancing loans taken on to acquire buildings at the absolute top of the market. As a result, he has put his trophy property, the GM Building, as well as other buildings up for sale. Are we seeing a pattern here? It looks a lot like subprime residential. No one can get a loan! Poor guys. This will take a long while to unwind.

Short Credit Fund

Our weightings and exposure are little changed from last month. That is, approximately 70% of the notional value of our positions are credit default swaps on banks and broker/dealers or indices that reference them. The remaining 30% of our positions are credit default swaps on the various CDX indices, which reference broad baskets of corporate credits. We have not found ways to short credit card or auto backed ABS that we find attractive. Although we continue to search, as we believe these ABS are the next dominoes to fall.

Our Corporate Debt Thesis in a Nutshell

Consumers slow spending.

- └─> Companies' income and cash flow decline.
- └─> Cash Flow to Interest Coverage ratios decline.
- └─> Companies' debt looks riskier.
- └─> Risk premiums on corporate debt increase, increasing borrowing costs.
- └─> Companies re-evaluate spending and personnel needs.
- └─> Workers are laid off.
- └─> Return to top, downward spiral continues.

Short Credit Fund will profit if corporate risk premiums increase.

Top Five Reasons Our Banks are Broke

- 1) Remember when they told us this "subprime thing" was a contained problem. LOL!!! Well, ok so now they admit it *was* a big problem, but it is mostly behind them. Try again. Tail-risk was covered in my letter dated October 10, 2007, so I will just sum it up briefly. You cannot know right now just how bad the losses will be. How far will home prices fall? How long will prices continue to fall? Just exactly how much fraud was in the system? There are many other unknowns, that can significantly affect the value of the banks' subprime related holdings. And don't believe them if they tell you they have rid themselves of it. To whom would they sell this crap, each other? No one is stupid enough to buy it at prices the banks are keeping these assets on their books, so the banks prefer not to sell. Or else they would have to take even bigger losses than they have already disclosed. Do you think they are using the worst case scenario in their models????

- 2) Commercial real estate is imploding for nearly all the same reasons as subprime imploded, just with about a nine month lag – the second domino. Banks lent money to commercial builders, and private equity takeover shops. Many of these deals are already going south and the banks were caught holding these loans, as the secondary market evaporated. Read the company press releases carefully and you will see losses from commercial properties loans. It is really early in the game on this front.
- 3) Banks made bridge loans for the leverage buyout and private equity frenzy, which they intended to sell to investors. That market has gone south rapidly. Banks have recently only been able to complete the sales of the best deals and even there, they had to retain a portion of the deals and recorded a loss on the sale. Imagine how bad the worst deals are. Think Internet bubble all over. Domino Three.

For those of you who have read my biography, you would know that I worked for a long/short distressed debt hedge fund between 2004 and 2006. This was unfortunate, because 2003 was a blockbuster year for distressed debt, but distressed debt became an increasingly crowded space thereafter. Typical distressed debt buyers began competing with private equity and LBO shops. The interesting thing about private equity is that investors commit capital to them, but the private equity shops do not start earning fees until the committed capital is put to work. So, their motivation went from doing deals that made sense to just getting any deal done, because most deals did not really make sense. That is why they have analysts though. Analysts build models that can support any valuation, however ridiculous it is (see Internet Bubble). The difference between private equity and hedge funds are that hedge funds get management fees from day one, but only make the real money by getting things right. We, my prior employer and I, sat there between 2004 and 2006 in utter amazement as the really crappy companies that we analyzed, were being bought at cash flow multiples that were usually reserved for high quality growing companies. Add the fact that the overly optimistic cash flow projections will never be realized in a recessionary environment to the ridiculous multiples paid and you have a recipe for a lot of really bad deals that will end in bankruptcy. Have fun with those bridge loans big boys.

- 4) Recently we have seen weakness in consumer spending show through in credit cards. Of particular interest is that American Express, often viewed as having more affluent customers, just announced dramatically rising delinquencies. After consumers squeezed all they could out of their home equity lines of credit or refi's, they turned back to their credit cards until they finally broke. Credit cards, like mortgages and autos, also have a subprime category. This category for credit cards, as well as autos, grew sharply in recent years right alongside subprime mortgage. Might this be a problem?
- 5) As if the preceding four points were not worrisome enough, credit default swaps (CDS) could potentially be the biggest problem of all. People have been saying this for years and the system hasn't broken yet. So what, right? What is different this time? Sure, there have been major blow-ups before in the world of credit default swaps, Enron and Worldcom to name two. However, today we are talking about a blow-up of magnitude never before seen. Credit default swaps on subprime MBS did not exist prior to 2005. Within a year of their debut, between the ABX, CDS on single name deals, and CDS on CDOs, etc, the notional value outstanding soared to roughly one trillion dollars. The total value of all CDS outstanding is estimated to be a staggering \$45 trillion. As long as nothing bad happens, this should not be a problem. If a single company fails, e.g. Enron, the system can handle it. However, when you have a complete meltdown of virtually all securitized products (a staple of our financial system currently), it is entirely impossible to guess what the result might be. I don't really want to think about it, but that leads us to.....

Counterparty Risk – The Irony of our CDS Positions

Lately, I am frequently asked, “Isn't there irony in the credit default swap positions you hold against banks. You are betting that the banks fail, but you are making these bets with the very banks you are betting will

fail.” The answer is simply, yes that is correct. Have I lost my mind? No. It is complicated, but I will attempt to explain. We have CDS directly on eleven different banks and an index of European banks in Short Credit Fund. I do not think the entire financial system will melt down overnight. In fact, I think the coordinated effort by the government, the media and the banks has been remarkable in forestalling the inevitable. That being said, I think that the unwind will happen over time. The government will flood the markets with money to keep them operating smoothly. More foreign capital will be needed to save our banks. It will be messy, very messy, but it will bleed slowly. Sure, I expect some casualties. New Century could not be saved. Likewise, we do not need all the investment banks that are currently standing. If one or two of them fail, the world would not end. It has happened before. However, when it does happen, you can bet your last dollar that the risk premium on the CDS for ALL of the banks will skyrocket. That is where we make the real money.

I have made a small fortune because I was well ahead of this extremely complicated game. I have a reputation for being early. Sometimes you can be too early and it is painful waiting. Sometimes after the pain, comes great reward. I plan on getting yours and my money off the table well before the complete collapse of the system. If one of our counterparties fails, we have cross protection with other counterparties to cover that loss. If all of them fail, you will have much bigger problems to worry about than our hedge fund.

Regional Banks

While I believe that our major banks are all essentially hedge funds using dizzying, uncontrollable amounts of leverage, I believe our regional banks could be in even worse shape. First, there is the simple fact that generally speaking the people running these banks are not as smart as those running the larger banks. This made the regional banks easy prey for the deceptive large banks to sell their AAA rated CDOs to. This situation is not that different from the S&L crisis that was exacerbated by regional banks’ holdings of toxic waste sold to them by none other than the largest banks.

Second, regional banks are not too big to fail. Don’t expect the government to bail out these banks. It will be too busy bailing out large banks.

Third, regional banks made loans to commercial and residential developers. I believe many of these parties, the banks and the developers, will have their heads handed to them over the next year.

My Predictions for 2008

The housing market has zero chance of a broad based recovery in 2008. Certain markets could improve, but more likely housing will continue its downward spiral and likely accelerate.

Commercial real estate will be the “subprime” of 2008. Commercial property valuations will fall for the next two to five years. CMBS investors will get crushed.

Corporate debt will sour, causing risk premiums to widen to historical highs.

Auto and credit card backed debt will also be the “subprime” of 2008. We are already seeing this. This was subprime to start with.

Given my expectations for the battered state of the economy by election time, I predict that the Republican ticket below, has as good a chance as any Republican ticket to win the Presidency.



Finally, I predict that at least one of our funds will take a top ten spot in the universe of hedge funds, if not the top spot (again).

U.S. Government Acquired by Ameriquest for a Paltry \$2.3 Million!!!

Do you think the U.S. Government has your back and is looking out for your best interests? Try again. The Wall Street Journal published an article on December 31, 2007 detailing political contributions made by formerly one of the largest subprime lenders, Ameriquest. Among the contributions totaling \$20 million, were contributions to both national parties. In fact, Ameriquest gave \$1.23 million to the Republican National Committee and \$1.05 million to the Democratic National Committee. In the words of a distraught and flabbergasted hedge fund manager, “What the f*ck?” Pick a side already. Is this even legal? This was actually the modus operandi of subprime lending institutions at the time. Legislation that would have reigned in the criminal industry of subprime mortgage lending was repeatedly defeated by the lobbying efforts of more than 100 financial institutions. Your tax dollars and government hard at work watching out for you.

Good luck in the coming year, which will likely be a very tough one for this country.

Best regards,

Andrew Lahde, CFA
Portfolio Manager
Lahde Capital Management, LLC

Results include investment of dividends and interest and are calculated net of all fees and expenses including a management fee (1%) and performance fee (20% of profits). Performance is calculated by the independent administrator, but has not been audited. Past performance does not guarantee future results. This information is not an offer or solicitation to invest in the Fund. Investments may only be made to qualified investors through delivery of the Private Placement Memorandum, which among other things explains the risks of making an investment.