



SPENCER CAPITAL MANAGEMENT, LLC

January 28, 2008

Dear Partner,

In the first part of this letter we explain our performance in 2007, discuss selected long investments, review our short philosophy and conclude with our goals for 2008. The following sections discuss our investment philosophy and process and have not changed materially from prior years. The letter concludes by introducing our Advisory Board. We are fortunate to have such terrific people serve on our Board, and I am very grateful to each of them for their time and wise counsel.

The table below summarizes the performance of the Spencer Capital Opportunity Fund, LP, the Spencer Capital Opportunity Fund II, LP and the Spencer Capital Offshore Opportunity Fund, Ltd.

	Spencer Capital Opportunity Fund, LP, net return¹	Spencer Capital Offshore Opportunity Fund, Ltd., net return²	Spencer Capital Opportunity Fund II, LP, net return³	S&P 500 Index net return⁴
2000	12.36%			(7.45%)
2001	25.27%			(11.88%)
2002	24.48%			(22.10%)
2003	28.73%			28.69%
2004	11.81%	5.83%		10.88%
2005	16.53%	16.09%		4.9%
2006	22.24%	23.81%		15.79%
2007	(12.80%)	(13.19%)	(17.68%)	5.49%
Since Inception	213.28%	31.34%	(17.68%)	16.17% ⁵

These performance figures are net of fees and expenses reflected in the current fee structure (i.e., 1.5% management fee and 20% performance allocation); the actual returns for the Onshore Fund from 2000 through 2002 and for the Offshore Fund for 2004 were different because seed investors paid lower fees.

¹ Data prior to January 1, 2003, are from Kenshu, LLC, an investment partnership continuously managed by Dr. Shubin Stein with the same investment strategy as the Spencer Funds. The inception date was November 1, 2000, and the 2000 return includes returns for November through December. See *History and Operational Update* at page 16.

² The Offshore Fund inception date was May 1, 2004.

³ The inception date of the Spencer Capital Opportunity Fund II, LP was January 1, 2007.

⁴ Includes reinvested dividends.

⁵ From November 1, 2000.

Our Performance in 2007

In 2007, many of our investments declined, more than offsetting the excellent performance of our shorts. This performance is disappointing but not surprising because we knowingly take the risk of short-term price volatility in our pursuit of situations that we believe will perform well over several years. Still, underperformance is never easy to experience. The silver lining is that today we are very excited about what we own, and we are seeing many more great opportunities in the market than we have seen in years. This is a great time to put money to work.



We accept that the markets often undervalue companies – even when they have started down the path to improved earnings and operations. We often view a declining stock price as an opportunity to lower the average cost of our investment (after we reevaluate the data and test our thesis). Over a longer period of time the market generally gets the price right, particularly after a value-unlocking event.

Usually, individual stocks declining in price don't affect such a large part of our portfolio or occur all at the same time. This year, the impact of the declines was magnified by the unusual trading volatility in the stock and bond markets as the credit bubble began to unwind and consumer spending weakened. In addition, many quant funds, which can have a significant effect on short-term market prices, experienced trading problems, withdrawals of investor capital and deleveraging.

We have held credit default swaps (CDS) on a set of specific companies for some time now, and for many years we lost small amounts of money as the five-year contracts amortized without the occurrence of any events. Last year, however, our CDS contracts generated significant profits as the credit and real-estate crises unfolded. These profits cushioned some of the impact of these crises on our long positions, and also provided capital to invest in increasingly undervalued stocks. The CDS investments are discussed in more detail below.

2007 proved the worth of some of the tests we use to mitigate psychological biases. We believe that having the correct psychological make-up to cope with volatility is a fundamental requirement for achieving good long-term results. It allows us to understand, and take advantage of, the differences between the prices of our investments and what we think they are worth. And it mitigates the human tendency to, during good times, focus too much on the upside and during bad times, focus too much on the downside.

Over the past seven years we have made significant profits from selectively buying more when our investments decline in price. Before we invest we ask ourselves how we will behave if the stock goes down significantly after we purchase it. Will the pain from losing money be offset by the excitement caused by being able to buy more at an even cheaper price, thereby providing the expectation of increased future gains? Or, might worries about the risks in the investment be heightened, rendering us incapable of buying, or even causing us to decide the investment was a mistake and sell? These questions are both a test of our underlying theses and preparation for the psychological problems presented by losses.

We continue to ask these questions as we hold our investments, and today the answers support our strong continued commitment to our investments. For many years we have profitably invested in various types of turnaround situations, including: (1)



companies with multiple divisions, where one was underperforming and masking the superior economics of the other parts of the company; (2) companies experiencing inventory problems due to fashion risk, such as an apparel company with good operations that ordered too much denim in a season; (3) companies with a product mix problem, as McDonalds had several years ago when its menu was out of touch with consumer preferences; and (4) companies with core IT infrastructure problems, as Borders and Sears have. We like those situations where the problems can be identified and addressed.

The key, however, is not to buy too early because it can take a long time to fix problems which have often been caused by years of poor management and capital investment decisions. Of course, we also have to be careful not to let an opportunity pass. For 2007, we wish we bought Borders later and at better prices; we believe the opportunity remains a great one.

Selected Long Ideas

As noted above, it is uncommon, but not unprecedented, for several of our stocks to lose money at the same time, especially in light of improving business fundamentals and pending catalysts that will unlock value. Because we are now in one of those times we thought it might be helpful to discuss a few of our investments to illustrate our investment philosophy.

Borders Group, Inc. (BGP)

Borders is one of country's largest book sellers, primarily through its super stores. We owned its chief competitor, Barnes & Noble, Inc., in the past and have followed the book industry for many years; this year we made a significant investment in Borders and have worked closely with Management on prioritizing and articulating a strategic plan for fixing the company's problems and improving corporate governance.

Prior to the current CEO, George Jones, getting involved, Borders suffered through many years of poor management and underinvestment in critical areas, such as inventory management. Over the past twelve months several significant steps have been taken to improve the company's performance. Management has announced and begun: a sale of its overseas stores; to scale back its unprofitable mall based stores; and investment in better human and technological resources to address the inventory and merchandising problems.

The company has also appointed an excellent shareholder representative to the Board, Michael G. Archbold. We believe that Mr. Archbold is the ideal candidate to represent shareholders and help oversee Management's efforts at fixing the company's



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inventory problems. He has had a very successful and directly relevant career, including posts as the Chief Financial Officer of Autozone Inc. and the Booksellers division of Barnes & Noble, Inc. – two companies well known for their excellent inventory controls. In addition, the company recently announced its appointment of a representative of Pershing Square Capital Management, LLC to its Board. We know the people at Pershing well; they are excellent stewards of shareholder capital and we are thrilled that they have agreed to take a Board seat.

We believe this company is significantly undervalued. It currently has about a \$550 million market capitalization, and, over the next few years, we believe it can extract \$400 million of excess working capital, achieve earnings power of over \$150 million of after tax free cash flow, and pay off all of its debt. As these improvements occur we believe Boarders will be worth at least \$30/share versus today's price of about \$10.

Crosstex Energy Inc. (XTXI)

XTXI is the general partner of Crosstex Energy, LP (XTEX), a midstream natural gas company with strategic assets in fast growing gas producing areas such as the Barnett Shale in Texas. Crosstex has long-term, fixed fee contracts with producers to move natural gas from the well-head to take-away interstate pipelines; therefore, it is not very sensitive to commodity gas prices. Using its existing footprint of pipes and relationships with producers, Crosstex is able to invest capital at high incremental rates of return in organic growth projects. This method of growth appears safer and offers a higher probability of success for the company versus many of its competitors.

In 2008, cash flows from pipeline projects completed in 2007 should serve as catalysts for Crosstex. We expect free cash flow per share to double in 2008 versus 2007. In addition, Management will likely pursue additional organic growth and potential acquisitions which will further increase cash flow. We believe XTXI, with its excellent management team, high return on capital growth opportunities, and clear catalysts is worth at least \$55/share within one to two years versus today's price of about \$33.

Resource America, Inc. (REXI)

REXI is a specialized asset manager with multiple lines of business that trades at 10x 2008 earnings. In the next twelve months, we anticipate that REXI will unlock the value of its rapidly growing commercial finance subsidiary, LEAF, via a spin-off or partial sale.

We believe that LEAF alone is worth close to the current market cap, and REXI has two other lines of business plus net cash and investments. REXI should continue to take advantage of opportunities for its own account and outside investors, having just



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formed a special purpose acquisition corporation (SPAC). Insiders own nearly 15%, and our interests are aligned. Although it is difficult to know with precision REXI's full worth – many of its subsidiaries are young and growing quickly – we believe there is a good margin of safety in the investment and believe REXI is worth at least \$30/share over the next two to three years versus today's price of about \$13.

Teekay Corporation (TK)

TK is the leading midstream marine company in the world. It is the general partner of several publicly traded subsidiaries (Tickers: TGP, TOO, and TNK) through which it transports a significant portion of the world's crude oil as well as oil products and liquefied natural gas via tankers of various sizes. The Teekay management team has proven itself to be very financially savvy over many years and has created a tanker asset management platform that should grow significantly during the coming years, resulting in valuable management and incentive fees to TK. Importantly, Management plans for the parent company to sell tanker assets to its subsidiaries and plans acquisitions of third party tankers in 2008, driving these fee income streams. We believe that today's sum-of-the-parts valuation of TK is \$65-\$70/share, versus a current stock price of \$44/share, with significant optionality from TK's ownership of the general partners of its three subsidiaries and their incentive fees. Our target price for TK is \$100/share in two to three years.

Winn-Dixie Stores, Inc. (WINN)

WINN is an underperforming regional supermarket chain in the Southeast. Margins are presently 1/6th of industry average. WINN currently trades for 6.2x 2008 EBITDA and 9% of 2008 sales. WINN emerged from bankruptcy in late 2006 with a strong balance sheet and a new management team to execute a turnaround. Margins should improve dramatically as stores are remodeled and merchandising is improved. Moreover, in November 2008, the limitation on the transfer of net operating losses expires, opening the door for a strategic transaction. Our target price for WINN is \$45/share over three years, more than double the current price of about \$18.

A Review of our Short Philosophy

The type and amount of short investments in the portfolio has varied widely over the past seven years and will likely continue to do so. Despite how well these investments have worked for us in 2007 it is important to emphasize that the overwhelming majority of our profits have and will come from long investments. The 2007 short book described below illustrates our general short philosophy.



Our short investments traditionally serve one or more of three purposes: (1) to hedge risk intrinsic to one of our long investments; (2) as alpha shorts, where we expect to generate profits from the security itself; and (3) as super-catastrophe hedges, that will help protect our clients from severe events that would have a significant impact on the financial markets, such as war, terrorism, or massive natural disasters.

Whenever possible we express our short opinion on a company via instruments that allow us to risk a fixed amount of money and afford us the opportunity for significant profits if the idea works out. Often this means buying a put option on a stock or a credit default swap (CDS) on a bond. The nature of these instruments is such that we know exactly how much money we are risking, which is not true when a stock or bond is directly shorted.

The combination of the types of situations to which we are attracted, and the nature of the instruments we use to express our opinions, results in a short book that tends to lose small amounts of capital most of the time but also offers the possibility of enormous profits. For many structural and psychological reasons, events that are perceived as drastic but unlikely are frequently mispriced in the financial markets.

For the past several years our research led us to the conclusion that many participants in the real-estate and structured finance industries were taking risks for which they were being significantly undercompensated, and that several of those involved were committing either fraud or technically legal, but very poor, accounting practices. Based on our research, we identified several companies that we thought were exposed to these risks and that could become insolvent under certain scenarios.

Monoline insurance companies, such as MBIA Inc. and Ambac Financial Group, Inc., and first-loss mortgage insurers, such as The PMI Group, Inc. and MGIC Investment Corporation, offer good examples of companies involved in businesses where it seems they were paid too little for the risks they were taking and the incentives for Management to reserve appropriately were perverse.

Monoline insurance companies provide services to the capital markets by selling credit enhancements for bonds and synthetic products. Historically their main business was helping United States municipalities, with the ability to levy taxes, to access the capital markets in an efficient manner by selling municipal bonds that were “wrapped”, or insured, by the monoline insurer. During the past decade they have become increasingly involved with the investment banking machines that create and sell an ever-increasing array of synthetic products. Often these products have risks that are combined in novel ways, and there is little data available to understand loss frequency and severity and to determine fair prices for the insurance the monoline sells.



Mortgage insurers sell insurance to people who buy homes using mortgages that are greater than 80 percent of the value of their homes. Over the past several years the Federal Open Market Committee lowered interest rates and commercial banks increasingly lent money using creative mortgage structures, changing the nature of, and the risks associated with, lending to these home buyers. The attendant increase in real estate prices nationwide provided the psychological fuel to the fire for those wanting to buy homes, by whatever means, or mortgage structure, necessary.

In both industries, participants often receive bonuses in the year deals are closed on the assumption that those deals are profitable and the risks insured will not be realized. This dynamic helped create scenarios in which, we believed, companies were at best under-reserved for future potential losses.

Until recently, the world disagreed. One year ago it cost just 20-35 basis points to buy credit default swaps on most of the companies involved in these areas. Now those same contracts change hands for between 500 and 900 basis points.

Given that everyone from the White House to the average citizen wants to have faith in the financial system, it is difficult to short the institutions that could pose systemic risk if they failed. American history is replete with examples of financial companies not marking their assets and liabilities correctly in a timely manner – and of US government intervention when the stress level in the capital markets gets too high.

Understanding these issues led us to look for ways to express our beliefs yet limit our risk if the companies “got away with it.” Credit default swaps served this purpose well. For many years we lost small amounts of money as the five year contracts amortized and no events occurred, and in 2007 we harvested significant profits as the credit and real-estate crises began to unfold.

In the beginning of January we sold the last of our corporate credit default swaps. Importantly, these profits provided us funds to invest in the increasingly undervalued stocks of companies we own, lowering our cost basis and setting us up for higher eventual profits.

Our Goals for 2008

Looking forward to 2008, it is impossible to know how long the current credit crisis this will last, if we are already in a recession, and what actions the government will take to address these risks in this election year. As the media reports daily, the world has had easy access to too much capital for too long. Many people, corporations and hedge funds took on excessive debt and then compounded this mistake by investing in poor



risks. This situation is now reversing, severely disrupting certain parts of the financial system, and triggering fears of a recession.

The best way we know to weather the storm and prosper in the future is to fill our portfolio with companies that have the following characteristics:

- Good balance sheets, so the credit crises will not disrupt their business and might even create opportunities to take business from other companies or acquire them outright.
- Value-enhancing events or fixable problems that will catalyze improved corporate performance even if there is a recession.
- Capable management teams that can successfully execute their business plans.

In summary, we analyze investment opportunities and focus on those that we believe offer excellent returns with little risk of permanent loss of capital. This should help us achieve our goals over a multi-year period and behave rationally during periods of short-term volatility.

Investment Goals

The Fund aims to compound investors' capital at a rate of 20% per year. We may never have a year with an exactly 20% return, but we will be satisfied if our long-term average meets this goal.

We look for investments that are unlikely to lose money in a realistic worst-case outcome and that may either double or better in a realistic high-case outcome within three years or may increase in price by 50% within twelve months of purchase.

One common characteristic of our investments is their potential to be volatile – meaning lose money – within the investment time-frame, which is why the Funds have been volatile at times and will continue to be so in the future.

Generally we see opportunity where several events obscure a company's 12-month earning power but do not affect the company's long-term economics. We categorize these situations as event-driven because they are often created by company-specific events such as distribution or working-capital problems rather than general market conditions.

While we are willing to invest in companies of any size, our favorite ideas tend to be large-cap out-of-favor companies covered by many sell-side analysts, who assign



“hold” and “sell” ratings to the stocks because the anticipated catalysts that will trigger price increases have uncertain timing or are more than 12 months away.

In these situations, an investor takes time risk but not value risk. Because so many people involved with companies experiencing difficulties focus on fixing problems quickly, turnarounds often occur faster than expected. Thus, the patient investor who plans on waiting several years for investments to work out often reaps the benefits of early value realization. In effect, the buyer with a long-term focus usually gets a free call option on a short-term turnaround.

Portfolio Management

We strive to have 10 great ideas. Typically these ideas are reflected in 10 to 30 securities.

A. Idea Generation and Analysis

We find ideas by conducting quantitative screenings of financial databases and qualitative screenings of news and Securities and Exchange Commission databases.

Quantitative screening involves designing search criteria based on valuation and operational metrics, such as (i) low enterprise value-to-sales ratios or (ii) improving operating margins combined with a decreasing number of shares outstanding. These types of searches help quantify the difference between a company’s current earning power and its historic one, and are an early guide to what its future earning power might become.

Qualitative screening involves searching for certain SEC filings or news that includes words often associated with interesting situations. Reports of “accounting scandals” or “share repurchases” or “spin-offs” often provide useful leads.

After selecting an idea, we conduct enough research to determine if it is worth pursuing at the present time. If it is not, we stop researching, pending more information or a change in a security price, or we may decide to shelve the idea permanently because an identified risk precludes comfort regardless of price.

Our research process is organized into four steps that are iterated multiple times for each idea: formulate a thesis; create a strategy to collect the needed data that will support or refute the thesis; execute the data collection; analyze the data and test the thesis. We combine financial-statement analysis with reading trade journals. We speak with management teams and industry participants to learn about the target company and its competitors. We investigate the industry dynamics affecting the competitive



landscape, and we continue to research and test ideas after investments are made. Through this process, we maintain the flexibility to address each idea in the way most suited to its unique issues while still following an explicit, formal process that can be analyzed and improved over time.

B. Mistakes

One of the most difficult aspects of investing is that incorrect reasoning will sometimes yield a good result, and correct reasoning may yield a poor result. Because success over time is predicated on the results of correct reasoning applied to many situations, not the lucky outcome of poor reasoning, it is important to learn the right lessons. An important part of our analysis involves identifying and learning from our mistakes.

While it is certainly less painful to examine the mistakes of others, examination of our own mistakes is also crucial to improving our process and returns. This usually takes the form of a growing checklist of investment considerations; but occasionally we conduct a formal analysis and presentation of a mistake: we ask what research and theses led to the investment, what occurred to reveal the mistake, what actions we took to deal with the problem, and what lessons can be learned. A review serves the dual purpose of searing the mistake into the minds of those involved and educating others on the research team so that they may avoid similar problems in the future.

C. Trading Strategy and Portfolio Risk Analysis

Creating the trading strategy starts with examining the target company's capital structure. The cash and synthetic securities that trade on the company's debt and equity are then evaluated, and a security (or combination of securities) is chosen to create the most attractive risk-reward profile. The trading strategy for a given idea can be as simple as buying common stock or as complicated as buying the credit default swaps on 10 different companies.

The trading strategy is informed by an analysis of portfolio risk. Typically there are five to eight big ideas that we believe to be very safe and that will probably take a few years to work out, and a few smaller ideas that are options on the long and short side. The portfolio's ownership of synthetic investments, such as calls, puts, and credit default swaps, varies widely as opportunities change, but usually ranges from 5-20% of the total.

Often we choose a strategy that has a lower potential return but a higher probability of having any return. For example, when purchasing call options, we prefer to purchase long-dated, deep-in-the-money call options. These securities have lower break-even points than out-of-the-money call options on the same company, yet these



in-the-money securities require more capital and will yield a lower percentage return than the more speculative out-of-the-money calls when the underlying company does well. Options sizing is predicated on notional value and, as a result, the economic impact on the portfolio comes from the performance of the company underlying the option more than the option chosen. For example, if we want the portfolio to have 10% exposure to a stock, we may buy stock equal to 10% of the portfolio, or buy 50% in-the-money long-dated calls with 5% of the portfolio, or buy at-the-money long-dated calls with only 2% of the portfolio. In each case, the economic impact on the entire portfolio will be similar for ideas that work well, but different for ideas that perform poorly.

A common trading strategy we employ is to isolate an investment in a holding company or spin-off situation by purchasing the stock of the holding company and shorting its ownership in subsidiaries. Because these different stocks often have different types of owners, ranging from income investors to growth investors, the implied value of the parent company – calculated by its stock value less its ownership in other publicly traded companies – is volatile. This frequently presents compelling opportunities. When the portfolio is invested in several of these types of capital-consuming trades, including spin-offs and other capital-structure trades simultaneously, it is occasionally necessary to utilize a limited amount of portfolio leverage in order to create exposure to the investment opportunity. For example, in a spin-off, if the parent company's stock is \$30 per share and embedded in that stock is ownership of \$20 worth of the partially spun-off subsidiary, then one needs to buy \$30 of the parent stock and short \$20 of spin-off stock to create a \$10 investment in the parent company. Although these investments are often capital inefficient and can take years to work out, the potential returns and level of safety for capital invested can make them attractive.

D. Volatility

Volatility is the key to successful long-term investing.

Most investors focus on an investment's performance over the coming few quarters or, at most, the next year. The more these investors buy and sell securities, whipsawing prices up and down irrespective of companies' long-term values, the greater the opportunities for investors with multiyear time horizons.

In the short term this volatility may generate losses but it also – more importantly – creates opportunities to invest at increasingly attractive prices that have ever-higher probabilities of being profitable in the future.



E. Leverage

In addition to appreciating the risks and benefits of leverage for companies and portfolios, we believe that prudent investing requires the Funds to be financially stable and to maintain buying power in order to profit from financial crises that will inevitably occur. Doing so will be an important factor in generating future returns, just as it has been instrumental in achieving returns in the past.

We consider operational leverage, balance-sheet leverage, security leverage, and portfolio leverage when evaluating the safety and profit potential of an investment.

1. Operational Leverage

Operational leverage is the relationship between a change in revenue and a change in operating cash flow. In this dynamic, companies with high fixed-operating costs often experience significant changes in their economic situation with only minor changes in revenue. We look for companies that are experiencing operational events, such as integrating an acquisition or moving operations offshore, which hide their real earning power.

2. Balance-Sheet Leverage

Balance sheet leverage is the amount of money that a company has borrowed to fund operations. The differences in the types of borrowed money can make a significant difference in a company's ability to survive a crisis. We prefer companies that do not use floating-rate short-term debt with operational and asset coverage covenants. This type of debt is among the most popular with managements because it has a relatively low monthly interest expense. Of course, earnings will be higher only as a result of increased interest-rate risk and business risk. As owners, we prefer companies to have no debt. If they need debt, we prefer portfolio companies to forgo the lower monthly payments of short-term, floating-rate instruments for the safety of having capital that is not callable and that is locked up for long periods at a fixed rate.

3. Security Leverage

Security leverage refers to leverage embedded in certain derivatives, such as call options on stocks or credit default swaps on bonds. Buying securities with this form of leverage increases the volatility of the price on a day-to-day basis, relative to buying the underlying asset upon which the derivative's value is based. Nonetheless, these securities have certain advantages, including multiyear contracts allowing for purchase or construction of long-term options; fixed financing costs; noncallable debt provisions, so purchasers cannot be forced to terminate the investments early but have the ability to do



so; and nonrecourse debt characteristics, so problems with one investment do not taint all investments in a portfolio.

4. Portfolio Leverage

Like other floating-rate recourse forms of debt, portfolio leverage – or margin – offers the benefit of lower monthly costs in exchange for the risk of losing money if things go poorly.

Behavioral Finance and Mental Models

Understanding how the human brain receives information and makes decisions is central to improving any intellectual process, from research in molecular biology to security analysis. This is particularly important to examine now that it is known that decisions are affected by subconscious biases, both innate and acquired, causing systematic and predictable misjudgments. Some important types of systematic cognitive errors – forces important in the psychology of decision-making – are: denial bias, incentive bias, scarcity bias, and envy/jealousy bias. The existence of these cognitive biases mandates the use of multiple decision-making models and problem-solving techniques in order to protect ourselves and recognize them at work in others. In our research process, we make a concerted effort to systematically seek out data that is contrary to our beliefs, use checklists during data analysis, and study mistakes to guard against potential biases and careless errors.

A. Denial Bias

Everyone prefers to ignore unpleasant realities. Denial occurs when one holds onto beliefs in the face of contradictory evidence. This causes cognitive dissonance – anxiety resulting from an inconsistency between reality and one’s beliefs. Most of us try to avoid cognitive dissonance through still further denial, and attempt to resolve the conflict quickly, usually by discounting or rationalizing the unpleasant evidence.

B. Incentive Bias

Incentives cause a subconscious overweighting of factors that lead to outcomes that are most beneficial for the decisionmaker and an underweighting of ones that lead to undesirable outcomes.

Incentive bias is one of the most dangerous and insidious biases because it often results in poor decisions or advice from good, well-intentioned people. Surgeons sometimes honestly recommend surgery to patients, believing it to be the best treatment, when the decision regarding an invasive or noninvasive treatment plan is inadvertently



prejudiced by the pecuniary interests of the doctor. Similarly, executives and directors often seek out data that supports decisions that are in their own best interests rather than the interests of the company's owners, who they are supposed to be representing. At Spencer we have had meetings with company directors who sincerely believe they are acting in shareholders' interests while making decisions that directly benefit themselves at the expense of shareholders.

Denial works closely with incentive bias, allowing the decision maker to ignore the painful reality of a self-serving choice.

C. Commitment and Consistency Bias

People often resist change and make errors in judgment by twisting or ignoring information that contradicts an existing belief. Public pronouncements of intent or closely held beliefs exacerbate this bias. The more people make public statements the more they believe what they are saying. Put another way, not only do we say what we think, but also we think what we say. Therefore there is enormous power in speaking because it fundamentally affects our beliefs and our ability to correctly analyze new information. This dynamic has been used for years by leaders of sales meetings, political rallies and religious gatherings – places where groups of people make public statements that are reinforced by the consistency and other biases. All this underscores the importance of actively seeking out negative information and making concerted efforts to examine accepted situations with fresh eyes unclouded by the status quo.

In his book Influence, Robert Cialdini discusses this pressure as studied by a pair of Canadian psychologists observing racetrack gamblers. He reports that the researchers found bettors were much more confident of their horses' chances of winning after placing a bet than they were before selecting entries to back. "The reason for the dramatic change is ... our nearly obsessive desire to be (and to appear) consistent with what we have already done. Once we have made a choice or taken a stand, we will encounter personal and interpersonal pressures to behave consistently with that commitment. Those pressures will cause us to respond in ways that justify our earlier decision." (2007 ed., 57)

D. Pattern-Recognition Bias

Human beings instinctively attempt to impose patterns on their experiences and surroundings. A natural and appropriate learning tool, pattern recognition helps us apply lessons learned from our mistakes. However, pattern recognition can be detrimental when one attempts to predict a future outcome based on a pattern that is not relevant to the current reality.



This bias often appears in investors who believe that the recent trading pattern of a stock predicts its long-term performance. It has even been institutionalized by professional money managers and the boards of major American corporations that use the recent volatility of a stock to determine the fair price for long-dated options, even when common sense and history show that the former has no bearing on the latter.

E. Social-Proof Bias

Everyone is strongly influenced by the opinions of others. In many ways, a short-term move in the stock market offers a classic example of peer pressure. When the price of a stock rises, this proves that many people agree with the decision to buy. When the price of a stock drops, this reflects that many people agree the stock should be sold. When these psychological stressors become extreme, it is of paramount importance to understand the true value of the business one owns through share ownership. Without this perspective, it is very difficult to resist the enormous pressure to follow the crowd.

F. Contrast Bias

Humans experience things on a relative scale: room-temperature water feels hot when experienced immediately after being outside in the cold. Our intellects and emotions are subject to these same variations. If a person anticipates unrealistically high returns, the disproportionate disappointment felt upon receiving results that are below expectations may lead to irrational decisions. This bias works hand-in-glove with the social-proof bias when a stock that has been flat or rising suddenly starts to drop. These biases often cause overshooting as the stock falls significantly further than is merited by the event causing the drop.

G. Scarcity Bias

Hard-to-find items carry greater perceived value than those present in abundance. People who view an opportunity as fleeting are more likely to make a hasty, poorly reasoned decision. Investment fads and rising security prices feed upon this tendency, so it is important to understand that an analysis made under circumstances of perceived scarcity is often inadequate and biased.

H. Envy/Jealousy Bias

People often base their happiness and satisfaction on their perceived position relative to their social peers. The strong desire to keep up with others often leads investors to make the mistake Warren Buffett warns against when he cautions his shareholders not to risk what they have and need for what they want but do not need. The envy/jealousy bias must be carefully considered whenever a risk-reward analysis is



undertaken to prevent desire for the potential reward from causing an underweighting of risk.

History and Operational Update

The domestic Fund was started in November 2000 as Kenshu, LLC. Originally the Fund had one partner and less than \$1 million under management. The corporate form and the name of the domestic Fund changed on January 1, 2003, on the advice of counsel who advised that a limited partnership form would better suit the growing Fund.

Rothstein Kass has been the auditor since the Fund began operations.

In May 2004, the Spencer Capital Offshore Opportunity Fund, Ltd., began operations to allow non-U.S. investors to invest with us. In 2007 we opened a 3(c)(7) fund, the Spencer Capital Opportunity Fund II, LP. These Funds are managed very similarly, with new ideas added to each ratably, so that over time they should have similar returns.

In 2007, we created our advisory board. The distinguished and accomplished Robert Fink, Rafael Mayer, Erinch Ozada, Ted Seides and Andrew Tsai have agreed to serve. Each has been very helpful in the past, and we look forward to their expertise as we continue to grow as a company. More information about each of them can be found in our updated presentation materials.

Thank you for your continuing partnership and interest.

Sincerely,

Ken Shubin Stein, MD, CFA

Note: Past performance is no indication of future returns. Spencer Fund performance figures are net of fees and expenses and represent reinvestment of incomes. Stated results are believed to be correct but are subject to revision and audit adjustment. The charts, graphs and descriptions of investment and market history and performance contained herein are not representations that such history or performance will continue in the future or that any investment scenario or performance will even be similar to such chart, graph or description. The foregoing is not advice as to which securities to buy or sell, or when to buy or sell such securities, and is not intended to assist persons in making those decisions. Under no circumstances is this letter to be used or considered as an offer to sell, or a solicitation of any offer to buy any security. Any such offering may be made only by means of a private placement memorandum and subscription agreement that will be furnished to prospective investors on request.