

In 2008, Perry Partners experienced its first annual loss in the 20 year history of the firm. We are deeply disappointed and apologize for these results.

Despite last year's negative performance, Perry Capital is poised to move ahead. Financial dislocation is likely to persist across many asset classes and geographies for some time. We believe we are entering a period with an abundance of mispriced securities and are diligently working to capitalize on the problems of 2008. Historically, post-crisis has been the sweet spot of the investing cycle. We have positioned the Fund in anticipation of a lengthier, and likely bumpier, recovery from this bear market, and hope that business conditions in the alternative asset management industry settle down allowing us to pursue investing in these dislocated markets.

Over the past eighteen months virtually all assets declined substantially in value. Correlation between disparate asset classes approached nearly 100%, and what started as deterioration in the value of single family mortgages morphed into a widespread bear market that impacted everything from commodities to healthcare stocks to sovereign debt. Illiquid assets have been especially punished. This differs from the 2000-2002 bear market when many of the troubled investments were venture capital type businesses that traded on hyper-inflated hopes. Since those were not securities that value oriented investors generally consider, hedge funds performed positively during that cycle by either avoiding or taking advantage of the dot-com and telecommunication carnage.

### **Bear Market Lessons**

The current bear market is having a considerable impact on the minds of investors. Trust in the financial system is waning, and it will likely take some time before confidence returns. Investors, by and large, tend to overweight their most recent experience. Currently this is reinforcing more cautious behavior, and this recency bias will persist until the first of the value-oriented risk takers demonstrate success. While this process will draw capital back into the market, it seems unfathomable that the securitization machine will come back in any form resembling the prior one. Securitization injected an incredible amount of financial leverage into the system and allowed risk to be spread well outside the banking system. The artificial growth in GDP that was generated by asset securitization is probably gone for many years, though unfortunately the debt hangover remains with us today.

This bear market has taught the financial community some expensive lessons. The following is a chart of investment maxims that have been recently debunked.

<b>MAXIM</b>	<b>WHY?</b>	<b>WHAT WENT WRONG?</b>
AAA rated bonds provide safety of principal.	Moodys modeled default probability for AAA was 0.0001%. Since 1990, there were no AAA defaults.	Ratings agencies did not understand the underlying collateral and had a significant conflict of interest evaluating these securities. AAA's in many asset backed categories have been, and will continue to be, impaired.
National housing prices can never go down. Housing is a regional market.	In the 1980's oil bust, Texas housing was weak, but the rest of the country held up. In the 1990's, California was weak but the rest of country was okay. There is no recent data to indicate that national housing prices could fall.	Excessive financing led to an unsustainable bull market in housing. Overbuilding, speculations and a breakdown in the securitization market caused the Case-Schiller home price index to decline 23% from its peak. Housing markets everywhere are in disarray.
Money market funds (MMF) are safe.	MMFs provided daily liquidity, slightly higher yields than bank accounts, and were often guaranteed by the underlying financial institution.	In reaching for yield, MMFs bought asset-backed securities collateralized by subprime mortgages. Many funds "broke the buck."
Buy and hold Blue Chip companies.	Generally regarded as the safest equity investments. Bigger companies were usually less susceptible to volatility, mismanagement and fraud.	AIG, the world's largest insurer, fell 97%. Citigroup, the world's largest bank, fell 76%. GE, the world's largest industrial company, fell 54%.
Buy stocks at book value.	Historically, these securities were overlooked, ignored, boring companies that often ended up as diamonds in the rough.	Financials went to book value...on their way to near-zero value. Book value as a static statistic does not work when asset values are plummeting. During asset deflation, leverage destroys equity value very quickly.
Buy on dips in the stock market.	This strategy has worked very well since 1982 with the possible exceptions of 1987, 1990 and 2000.	Every dip since 2007 has been a better chance to sell than buy. Every time the market looked poised to bottom, it did not.
Diversification will protect you.	A widely held view has been that equity markets around the world would offer diversification.	During the financial asset meltdown, correlations of equity bourses around the world have been close to 100%.
Do not bet against the American consumer.	The consumer stayed strong during the 2002 recession. Consumers continued to borrow and spend throughout the last recession. The savings rate kept declining.	Retail sales are very weak; Auto sales down 30-40%. Consumers are retrenching. Fear of job losses is causing a vast increase in savings at the expense of consumption.

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In economic recessions, the rich will keep spending. Luxury brands are non-cyclical growth businesses.	The Dot-com bubble burst had no material effect on luxury goods. Demand for high-end products seemed to be immune.	The high-end retailers are suffering more than low end. Wal-Mart is doing okay while Neiman Marcus sales declined by over 22% in Q4. Wealth destruction affecting the affluent is causing a major slowdown in luxury goods.
The Chinese RMB is undervalued and will continue to appreciate versus the US Dollar.	Politicians called for China to let currency appreciate. Currency had been on a slow, managed appreciation.	The Chinese were engineering a stronger Renminbi beginning in mid '05 (under intense pressure from US) during which time the currency rallied 18%. From mid July to early December last year, the Renminbi 3 month forward curve declined by 6% when emerging market currencies broke down.
Control inflation and the economy will be fine.	Low inflation since early 1980's has been a powerful driver for the U.S. economy.	Asset deflation potentially threatens all financial institutions. This will be a more serious threat than manageable inflation.
Invest in the BRICS. These countries represent the best growth economies and relatively stable political systems in the world.	Brazil GDP Growth: 6% pre 2008 Russia GDP Growth: 7% pre 2008 India GDP Growth: 9% pre 2008 China GDP Growth: 10% pre 2008	These markets could not survive weakness in the US economy. Brazilian market (Bovespa) down 41%. Russian market (RTS) down 74%. India market (Sensex) down 53%. Chinese market (Shanghai A) down 65%.
North American auto sales can't be less than 14 million units annually.	SAAR (Seasonally Adjusted Annual Rate of Sales) hasn't dipped below 12 million units annually since Dec 1982.	2009 SAAR could be at sub 10 million. This weakness is causing major stress on the manufacturing sector in the economy.
Big banks will not fail.	The US Government understands the need to maintain confidence and avoid a run on the bank.	Lehman Brothers, with over \$600 billion of assets failed. Confidence in the rest of the system eroded.

The above chart highlights that widely accepted doctrines often fail. Our recent performance is particularly disappointing given our skepticism about many of these maxims and the bearish macro view we have expressed since Q3 2007 (e.g., our short subprime investment). Despite our cautious macro view, we failed to execute on enough disaster protection hedges and some of our hedges actually hurt us.

#### **Q4 Review**

The Fund's negative performance came from three primary areas: our European share class arbitrage position in Volkswagen, significant mark downs to our global sidepockets & other

illiquid investments, and investing prematurely in US leveraged loans on an unhedged basis.

In accordance with our valuation policy, we have been writing down the fair value of our sidepockets & other illiquid investments. In most cases, the loss of value is likely to be a permanent impairment. The industry's private equity investments of 2006-2007 are almost certainly going to be the poorest performing vintage in the history of the asset class. Most of these deals will not withstand high financial leverage combined with poor economic conditions and will end up being restructured. In some cases our funds might benefit from opportunities in a different part of the capital structure. We continue to actively manage our existing portfolio of private deals and will realize value wherever possible.

The Fund currently has 29% of its capital in credit, and of this, 78% is in corporate, stressed credit at an average price of approximately 50% of par. The remainder is in mortgage credit at less than 50% of par. There is ample room for price appreciation on the credit investments and the interest income on the current credit allocation provides the Fund with an approximate 9% cash-on-cash yield. As the cycle evolves, we expect some of our investments will need to be restructured before maturity. These investments can still be successful depending on their value coming out of restructuring. The vast majority of our credit position is in senior secured paper, and in past cycles, similar debt has fared well in restructuring.

## **2009 Outlook**

Today's macro environment is different and more dominant than it has been in the past. We have never seen this level of fiscal and monetary stimulus in the US, and it is unclear what the ramifications will be. We invest in securities where we see the best fundamental risk/reward. However, over the past quarter, portfolio construction was more important than security selection.

There are approximately \$33 trillion of fixed income securities in the United States. One could argue they are all mispriced: government securities too high; every other bond too low. This supply/demand mismatch is creating one of the most compelling investing environments in our generation, and both the organization and the Fund are positioned to capitalize on this. However, if we enter into a true deflationary period, then the US government securities will continue to go up and everything else may fall further.

We are entering 2009 with a healthy cash position in the Fund. Our intention is to use a substantial portion of this cash to fund new investments with a heavy emphasis on the following four areas in credit: First, we anticipate a surge in defaults and will focus on buying securities of companies going through a restructuring. Second, we will concentrate on distressed special situations with a legal or process catalyst to drive value. Third, we will look for short opportunities, either outright or through capital structure arbitrage.

Finally, we will look for senior securities and asset-backed securities which will include RMBS, CMBS, credit card loans, student loans, auto loans and other securitized products.

These securities are extremely complex, both technically and fundamentally. Our firm's strength is our rigorous due diligence process. The combination of legal and analytical expertise our team possesses has helped us identify good investments, and we are confident that despite the challenges of today's market, we will resume achieving superior long term results.

Our highest priority continues to be the safeguarding of our investors' assets. As the largest firmwide investor, we are confident in our abilities to achieve our desired results. We are incredibly fortunate to have such a knowledgeable investor base, one that routinely demonstrates its understanding and support of our investment philosophy. As we pursue new opportunities for investment success, we appreciate the continuing support of our investors.

### **Operational & Compliance Update**

In light of the news surrounding Bernard Madoff, we wanted to highlight the strength of our extensive global back office team. Our financial operations, accounting, legal, and compliance staff is experienced, highly trained, controls oriented and responsive. We have always endeavored to set industry compliance standards and have been SEC (US) registered since 2000, FSA (UK) registered since 2001, and SFC (HK) registered since 2006. Our operations team reconciles our internal accounting records to statements provided by our external custodians on a daily basis. Furthermore, Citco acts as our third party administrator for the offshore fund, and in order to establish the monthly NAV, Citco performs daily reconciliations and valuations for the offshore fund. Additionally, PricewaterhouseCoopers audits our financial records and investment valuations on an annual basis. We would encourage all of our investors to review our audited financial statements and invite you to visit our New York office to discuss our policies and procedures in person.

In order to assess your eligibility to participate in profits and losses from "new issues" (generally defined as initial public offerings in the US), please let us know if your eligibility has changed since your last certification to us. If we do not hear from you, we will assume that your status has not changed.

As always, your thoughts and comments are welcome. Please note that your individual account statement will follow shortly. Feel free to contact Jamie Parrot at (212) 583-4088/ [jparrot@perrycap.com](mailto:jparrot@perrycap.com) or Harlan Saroken at (212) 583-4059/ [hsaroken@perrycap.com](mailto:hsaroken@perrycap.com) with any questions.

## CONFIDENTIALITY NOTICE

This letter is confidential and intended solely for the use of shareholders in connection with their investment in the Fund. This letter and its contents may not be shared with any other person except your legal counsel and accountants without the prior written permission of Investment Manager. Notwithstanding anything to the contrary herein, each shareholder (and each employee, representative or other agent of such shareholder) may disclose to any and all persons, without limitation of any kind, the tax treatment and tax structure of (i) the Fund and (ii) any of the Fund's transactions, and all materials of any kind (including opinions or other tax analyses) that are provided to such investor relating to such tax treatment and tax structure

*Past performance is not a guarantee of future results. There can be no assurance that these or comparable returns will be achieved by Perry Partners' investments, either individually or in the aggregate. All returns shown above reflect the reinvestment of dividends and interest and the deduction of all fees and expenses. Although we believe that the performance goals set out in this letter are realistic, it is possible that they will not be achieved and that you could even lose a substantial portion of your investment. The information contained in this letter represents neither an offer to sell nor a solicitation of an offer to buy any securities. Securities in this fund will only be offered through a current offering memorandum and appropriate subscription documents. Copies of the offering memorandum may be obtained from Jamie Parrot (jparrot@perrycap.com) or Harlan Saroken (hsaroken@perrycap.com) in our New York office and will be made available upon request. Offers will not be made in any jurisdiction in which the making of an offer or the acceptance thereof would not be in compliance with the laws of such jurisdiction. Investors should read the Confidential Private Offering Memorandum carefully, especially the "Risk Factors" section, before making a decision to invest in Perry Partners. Additional information is available through our password protected website ([www.perrycap.com](http://www.perrycap.com)).*

# PERRY Partners International

Quarter Ending December 31, 2008

## Estimate Exposure Report

	Perry Partners International	S&P 500 (Total Return)	Barclays HY Credit Index	
<b>MTD Performance</b>	-1.00% EST	1.06%	7.68%	
<b>QTD Performance</b>	-19.27% EST	-21.94%	-17.88%	
<b>YTD Performance</b>	-26.80% EST	-37.00%	-26.15%	
<b>Performance Attribution by Strategy</b>				
	<b>MTD</b>	<b>QTD</b>	<b>YTD</b>	
Equities	North America	0.97%	-0.66%	-2.23%
	Latin America / Other	0.00%	0.00%	-0.03%
	Europe	0.22%	-5.32%	-7.95%
	Asia	-0.28%	-0.47%	-2.10%
	<u>0.91%</u>	<u>-6.45%</u>	<u>-12.31%</u>	
Credit	North America	1.36%	-7.29%	-10.77%
	Latin America / Other	0.00%	0.00%	0.01%
	Europe	0.02%	0.10%	0.12%
	Asia	-0.22%	-0.47%	-0.39%
	<u>1.16%</u>	<u>-7.66%</u>	<u>-11.03%</u>	
Credit Derivatives	North America	-0.01%	-0.71%	3.93%
	Latin America / Other	0.00%	0.17%	0.06%
	Europe	0.06%	1.49%	1.08%
	Asia	-0.02%	0.10%	0.60%
	<u>0.03%</u>	<u>1.05%</u>	<u>5.67%</u>	
Private/Real Estate	North America	-0.60%	-2.86%	-3.35%
	Latin America / Other	-0.23%	-0.27%	-0.30%
	Europe	-1.40%	-1.86%	-3.66%
	Asia	-0.18%	-0.43%	-0.46%
	<u>-2.41%</u>	<u>-5.42%</u>	<u>-7.77%</u>	
Macro Hedge	-0.69%	-0.79%	-1.36%	
<b>Total Performance Allocation</b>	<b><u>-1.00%</u></b>	<b><u>-19.27%</u></b>	<b><u>-26.80%</u></b>	
<b>Portfolio Exposure by Strategy (as a % of Capital)</b>				
	<b>Long</b>	<b>Short</b>	<b>Number of Strategies*</b>	
Equities	North America	9%	-8%	15
	Latin America / Other	0%	0%	0
	Europe	1%	-1%	3
	Asia	5%	-4%	9
	<u>15%</u>	<u>-13%</u>	<u>27</u>	
Credit	North America	28%	-1%	24
	Latin America / Other	0%	0%	0
	Europe	0%	0%	0
	Asia	1%	0%	1
	<u>29%</u>	<u>-1%</u>	<u>25</u>	
Credit Derivatives	North America	2%	-2%	4
	Latin America / Other	0%	0%	0
	Europe	2%	-28%	4
	Asia	0%	-1%	1
	<u>4% **</u>	<u>-31% **</u>	<u>9</u>	
Private/Real Estate	North America	4%	0%	5
	Latin America / Other	1%	0%	1
	Europe	3%	0%	5
	Asia	1%	0%	1
	<u>9%</u>	<u>0%</u>	<u>12</u>	
<b>Total Portfolio Exposure***</b>	<b><u>57%</u></b>	<b><u>-45%</u></b>	<b><u>73</u></b>	
<b>Fund Capital (in millions)</b>	\$6,025			
<b>Firmwide Capital (in millions)</b>	\$8,346			
<b>Top Exposure</b>				
Top 5 Long Positions (as a % of Capital)	11.42%			
Top 5 Short Positions (as a % of Capital)	-14.97%			

The fund maintains a 34% position in Treasury money market funds which it considers to be cash & cash equivalents and are therefore excluded from the above analysis.

\* The strategy count includes only those strategies that are at least 15 basis points of the portfolio.

\*\* Please note this is a non risk-adjusted notionalized number which costs the fund approximately \$19 million annually to maintain. In addition, this report does not reflect the market value of those positions in which the firm is both the buyer and seller of protection on the same reference obligation even if such positions are held at different counterparties.

\*\*\* In addition to the above, the firm hedges exposures to certain macro-economic related risks. These include, but may not be limited to, fixed income products and currencies. These positions augment our portfolio hedges and add diversification benefits to the firm overall.