

October 02, 2009

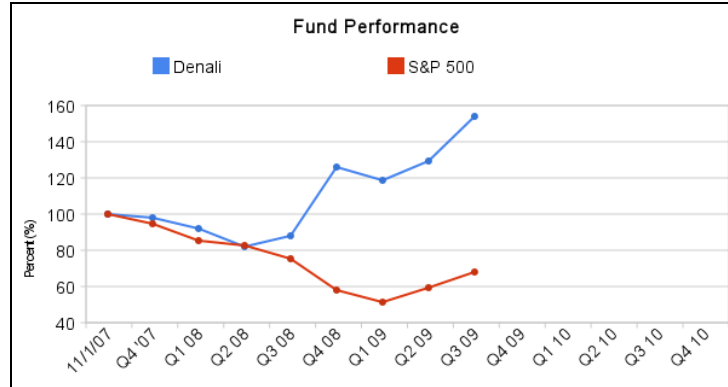
To: All Limited Partners
Re: Third Quarter 2009, Letter to Partners

Dear Partners:

Please find below material information regarding Denali Investors funds.

Performance

For Q3 2009, Denali Investors funds returned +18.9% and the S&P 500 returned +15.0%. For the year, Denali Investors funds returned +22.3% and the S&P 500 returned +17.0%. Since inception, Denali Investors funds returned +53.9% and the S&P 500 returned -31.8%.



General Comments

"Professional investors" the last year - <http://www.youtube.com/watch?v=t8GTHXTErIc>

The third quarter of 2009 has been marked by a continued upward surge in the markets, in stark contrast to recent fear and dislocation. From the lows reached far back in March of this year, when the S&P broke to 667, we have seen a rally of nearly 60%.

The markets continue to demonstrate bipolar qualities in earnest. Earlier this year, market surveys showed over 80% of investors were bearish. A recent update now shows over 80% of investors are bullish. That is quite an entertaining shift. Perhaps the effects of the unprecedented globally

coordinated government actions have allowed people to regain a sense of normalcy, if not simply of being a safer distance from the precipice. Unprecedented actions were taken to “save the day.”

However, such actions have consequences. One consequence is that these unprecedented globally coordinated actions have resulted in a large scale Mr. Magoo type scenario. So called “professional investors,” thanks to government actions, have emerged alive, albeit rather injured, from impossibly unfortunate investment predicaments. They were stuck in unhedged positions and by virtue of having been stuck in those positions, now find themselves inadvertently outperforming for 2009 thanks to the current historic market rally. In effect, they have surfaced from the dynamite factory still holding a lit match. However, it is a very serious matter for those entrusting capital to such managers given it is surely only a matter of time before danger revisits.

So while most of the market has turned bullish and already seems to have selectively forgotten the past year, I remain much more skeptical. It is appropriate to recall the significant stock market rallies during the Great Depression, which included a whopping 67% gain in the Dow in 1933. Those rallies seem absurd in retrospect. Yet 76 years later, here we are again. But given the greater story rhymes rather than repeats, perhaps it is more appropriate to try to position a fund for survival regardless of the direction of the market.

As we consider our opportunity set, one of the most important factors remains investor psychology/behavior. The investment fishbowl that we inhabit contains limited examples of behavior to emulate but many more of what to avoid. Current market stress has revealed more than investors realize about their true temperament. With many burned quite badly in 2008, they are hoping against hope that a healing process will result in full recovery of assets, despite lingering emotional damage from broken promises and misplaced trust. These once trusting investors are looking for answers, solutions, and peace of mind. Not without irony, they are seeking ever more certainty in an increasingly uncertain world (rather than trying to understand and manage the uncertainty that is inherent in it).

So while the market gyrations and machinations have rendered many market participants unable to think and act clearly, we must maintain a stable internal compass, and make full use of our practical sensibilities. It is critical, regardless of our recent performance or legacy positions, that we maintain a steady temperament, consistent research process, and clear thinking about the current opportunity set before us.

Given the erratic nature of the market, I have become increasingly optimistic about our opportunity set. The uncertainty and dislocation are a blessing to value investors, not because we enjoy uncertainty or dislocation, but because of the opportunities they create. Our strategy has remained consistent throughout and I am selectively employing our flexible and tactical approach congruent with our investment framework.

As explained below, so far this year, I feel we have made money for the right reasons. This has been a very busy quarter for us.

Our Investment Framework

Based on the recent and continuing upheaval in the markets, it becomes worthwhile to revisit the fundamentals of our investment framework and to reevaluate the manner in which they hold us in good stead through current and future turbulent times. Although our partners already adhere to our investment mindset and believe in the validity of the tenets (which we consider sensible and logical), we know that most managed capital does not align with our framework.

Our basic structure (the allocation groupings and the incentive structure) is based on the Buffett partnerships from the 1950's. Today, most people associate Buffett with a buy-and-hold-forever philosophy. However, most people do not know how he first created wealth for his investors and himself. What the popular view discounts is that Buffett began his career managing a hedge fund that was value-based and heavily involved in special situations. Basically falling into two categories, his "Generals" were undervalued stocks (still studied by many today) and his "Workouts" were special situations investments (unstudied by almost all).

Generals & Workouts: The Generals tend to produce returns that are more greatly affected by the overall market performance, as with rising or falling tides. The Workouts tend to provide market agnostic returns and tend to have more attractive risk-reward profiles in downturns. Much of Buffett's consistency in outperformance even during years in which the markets declined is attributable to his special situation investments. Critically, the combination of the two is much more powerful than either one alone in producing absolute returns over an extended time frame.

The validity of this portfolio structure strikes me as powerful, simple, and elegant. In my view, those that focus only on one category at the exclusion of the other are at a fundamental disadvantage. The inherent balance in the combined structure is why Buffett himself said he expected, although could not guarantee, to outperform in bear markets and underperform in bull markets. By having a balanced tool kit, a portfolio remains flexible in allocating to the most promising opportunity set that presents itself.

Flexible mandate: We have a flexible mandate that allows us to look at any opportunities that may be attractive. Certain funds that are designed to fit into a 'style box' remain captive to a certain sector, geography or asset class. The problem for such fund managers is that capital can flood out as easily as it floods in (i.e. technology sector funds in 1999 versus 2000 or energy specific funds in 2008 versus 2009). Also, they become captive to a slice of the market when it is no longer attractive and are simultaneously prevented from areas that are attractive. Whether bargains are available or not is immaterial. The order of the day is to sell. As a generalist, our flexible mandate allows us to look at opportunities across the spectrum.

Concentration: Another advantage is our concentration of investments into our best five to ten investment ideas. Our opportunistic style of investing allows us to wait for investments with highly favorable risk-reward profiles and requisite margins of safety. Allocating more capital to really good ideas, which do not come around too often, simply makes sense. This builds a portfolio one idea at a

time, such that performance over time correlates to the outcome of those ideas rather than to the market. On the flip side, the typical mutual fund holds about 80 positions, which practically guarantees below average performance and explains why 80% of them underperform the market simply due to frictional costs.

Cash: Another advantage is the ability to maintain net cash in the absence of other opportunities. Many funds must be fully invested according to the fund's mandate. A fund manager must then perhaps buy at a time that may not be prudent or sell at a time that is even less prudent. Our ability to hold cash is a great advantage, especially as the current market dislocation unfolds. The use of leverage can be extremely dangerous. As has become apparent, investments that were mediocre at best were made to look superior in cooperative markets through the use of easy borrowing.

Alignment of Interests: We eat our own cooking. I have the lion's share of my net worth in the fund and I will continue to keep my assets in the fund. The idea is if we do well, we all do well together. I can assure you that my focus is on judiciously growing partners' capital. The fund manager, whose responsibility is to protect and shepherd capital, should not be exempt from the downside risk. One should cast a very skeptical eye at managers who consistently pull their fees out of the funds they manage.

So how is our fund positioned?

We were quite active during the quarter as a result of a great deal of research and effort. Starting the year, I expected many actionable ideas, which has proven to be the case, despite the increase in the indices. Many interesting opportunities presented themselves during the quarter. A cross section is provided in the next section.

Currently, one area of particular focus is capital structure arbitrage. Share spreads between common classes are at historic levels. Spreads between common and preferreds are also at historic levels. Consistent with last year, the merger arbitrage area continues to provide interesting opportunities. Another area of activity is in corporate liquidations, the idea being that some companies provide greater value dead than alive. From the pool of potential liquidations, the opportunity lies in determining recovery value and the defined timeframe for return of capital.

Unlike 2008, there are fewer interesting partial self-tender offers today, which is a function of management teams wanting to preserve cash. However, there appears to be instead an increased interest in self-tendering for debt at a discount (an understandable shift).

Longer term, as a consequence of the current environment, there will be interesting opportunities that arise from the upcoming bankruptcy wave. As companies restructure, they will create exit structures for which various tranches of value will fall into hands of rather unwilling and unnatural holders, creating an incredible opportunity set.

With the focus on capital preservation, I believe our patience will be rewarded with actionable bargains with highly skewed risk-reward profiles. We will simply continue to pick ideas we consider worthwhile.

Investment Updates

This section provides an update on our special situation investments.

Special situations include misunderstood and mispriced companies, spin-offs, restructurings, bankruptcies, distressed securities, distressed bonds, merger arbitrage, etc.

The advantage of allocating capital to these special situations is two fold:

- 1) The risk reward ratio can be highly favorable. In many cases, a special situation unlocks pre-existing value that has been embedded or ignored by the market.
- 2) The unlocking of value is not correlated to the stock market, but rather through company level actions and outcomes.

Investing in these special situations goes back to the core of our investment framework. This is especially relevant in the current environment, one in which many are concerned about subprime and recession. These examples should help demonstrate that Denali's results will be determined by the outcome of these individual opportunities, not the noise in the overall stock market. Ironically, it is more like gambling, and less like investing, to put money blindly into broader indexes. Again, it is not the short term performance of the stock market or the fund that matters to us.

The only reason Denali was started was to provide absolute returns and beat the market over the long term. I believe these types of investments position us very well to do just that.

Updates for Q3 2009:

Q3 2009 Liquidation 1: In this situation, the Company (Co) was trading at a price significantly below its liquidation value. Co was at \$10 per share in Q2 2009. There are three main drivers of value in this situation. 1) There is about \$22 per share in cash. 2) Co has already approved the plan of liquidation and dissolution. 3) Near-term resolution of a legal issue that is very definable and the market price assumes more than the possible worst case scenario. Hence, we have free upside optionality such that the near-term catalyst results in an outcome range of \$10 – \$20 per share. Having initiated the position in Q2 2009 at \$10, the price is now \$16.

Q3 2009 Liquidation 2: In this situation, the Company (Co) was trading at a price significantly below its liquidation value. Co was at \$10 per share in Q2 2009. There

are three main drivers of value in this situation. 1) There is about \$13 per share in cash. 2) Co has already approved the plan of liquidation and dissolution and will make an initial distribution of \$7 during the third quarter. 3) The remaining assets will be distributed during the third of fourth quarter. Hence, we have a \$3 cost basis such that the near term catalyst results in an outcome range of \$3 – \$6 per share. Having initiated the position in Q2 2009 at \$10, we have received the initial distribution of \$7 and are waiting for the remaining distribution of \$3 - \$6 per share.

Q3 2009 A / B Share Spread: In this situation, the Company (Co) has two classes (Common A, Common B) of common stock that historically trade close to parity (given economic parity). Typically if Common A traded at \$10, Common B would trade at \$10.50 or less. During Q2 2009, Common A traded at \$10 per share and Common B traded to \$22 per share. The main drivers of value in this situation: 1) A shares and B shares are economically equivalent. 2) Forced selling and non fundamental pressures ease. Hence, we have a directionally agnostic net-zero position (meaning the dollar value of the long position equaled that of the short position) created during Q2 2009 at historic spreads (\$10 A share vs. \$22 B share) that has since largely collapsed (\$10 A share vs. \$13 B share) to our benefit. Having initiated the position in Q2 2009, we have traded around the value disparity.

Q3 2009 Spinoff: In this situation, the Company (Co) was trading at a significant discount to our valuation analysis. Co was at \$10 per share in Q3 2009. There are three main drivers of value in this situation. 1) The major catalyst of the spinoff itself was expected to unlock value. 2) Both the parent company and the spinoff company are high quality market leaders. 3) Our investment position (long strangle using options) allowed us to benefit from a wide range of outcomes. Hence, we created free upside optionality with minimal downside risk. Having initiated the position in Q3 2009 at \$10, the price is now \$20.

A Special Thanks to Our Investors

Denali Investors is fortunate to 1) be extremely selective in the manner we make investments, and 2) have partners with a long-term value perspective in combination with outstanding professional and personal character. The firm is lucky, and rare, in this regard.

One of the most important differences is that our investor base understands that a stock at a 75% discount to intrinsic value can change to a 70% or 80% discount, simply due to short-term noise. The short-term 20% move from the entry point is understood as largely meaningless and that the eventual realization of intrinsic value is our focus.

It is a true pleasure to go to work everyday on your behalf.

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I thank you for your trust and support. And thank you for the referrals!

Next Opening: January 1, 2010

Openings for both the Accredited and Offshore Fund are on a quarterly basis. Existing partners of either fund can add assets in increments of \$50,000 at each opening.

The minimum initial investment for DIAF is \$100,000. To invest in the fund one must be an accredited investor as defined by the SEC. Openings are on the 1st of each quarter.

The minimum initial investment for the DIOL is \$100,000. To invest in the Offshore Fund, one must be a non-US accredited offshore investor or tax-exempt account such as IRAs. Openings are on the 1st of each quarter.

Please note that all new assets received are subject to the two-year lockup period. Funds received by January 1, 2010, for example, will be open for redemption on January 1, 2012.

Miscellaneous

Please feel free to visit if you are in the midtown area.

I have posted letters and documents to the site so that you may refer to them at your convenience.

As mentioned, should you have any questions or follow up, please feel free to contact me anytime at (646) 964-5355 or kbyun@denaliinvestors.com.

Respectfully,



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