May 2010

	Jan	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	YTD
2007	-	1.72%	0.73%	3.19%	1.65%	0.45%	5.23%	-5.46%	9.00%	6.02%	-6.69%	2.04%	**18.18%**
2008	-3.50%	9.94%	-9.43%	0.30%	10.30%	-0.54%	-10.64%	-11.04%	-14.81	-14.60%	7.23%	11.83%	**-26.67%**
2009	5.50%	-0.07%	7.33%	4.32%	32.30%	-10.70%	3.40%	-1.60%	10.04%	-0.11%	6.39%	-0.12%	**65.75%**
2010	-7.55%	1.77%	-4.42%	5.22%	-2.24%								**-7.49%**

Inception (2/07)	**QB Partners (Net)**	**S&P 500 (ex dividends)**	**TLT Index (LT Treasuries)**	**LQD Index (Corporate Bonds)**	**HYG Index (High Yield)**	**CRB Index (Commodities)**
Return	**+ 32.89%**	-24.25%	10.29%	-0.40%	-17.24%	-15.41%
QB Alpha		**57.14%**	**22.60%**	**33.29%**	**50.13%**	**48.30%**

Past results may not indicate future performance. Returns herein reflect changes in Fund-level NAVs, net of all fees, charges and accruals, across investor classes. 2007 and 2008 returns have been audited by Deloitte & Touche. 2009 and 2010 returns are estimates. Year-to-Date and Inception performance figures are based on compounded changes in monthly NAVs. Returns to individual capital accounts may differ from results herein based on myriad factors. Differences between results herein and previously reported results reflect the adoption of fund level net returns, which include the returns of the General partner and affiliated Limited Partners who are not charged management and performance fees. The adoption of fund level net returns was made necessary in due to the 2010 addition of multiple investor classes.

We are pleased and excited to announce that our Cayman fund, QB Partners Ltd, is now open. Please contact Paul Brodsky (pbrodsky@qbamco.com) for further information.

Our *credit deflation* short positions helped hedge the portfolio in May from greater loss. The Fund performed well vis-à-vis commonly perceived "risk assets" in May (S&P 500 +5.96%; CRB +6.72%), and continues to enjoy comfortable return margins over various benchmarks since inception (see table above). As you know; however, the Fund does not seek Alpha as a formal objective. Rather, it seeks to capture positive risk-adjusted *real* returns over time (an objective we believe naturally captures Alpha).

As you may remember, we had been gradually increasing short positions in US and Chinese equity markets from December through April, (which had previously acted as a drag on returns), and had increased our short Euro position in April. These positions produced substantial gains in May that offset a good deal of losses derived from more strategic long positions in natural resource-linked equities.

We see uncommon opportunity presently in positioning assets strategically (see discussion that follows). Natural economic pressures continue to collapse global credit, which is continuing to pressure policy makers and politicians to intervene forcefully into the markets. *Rotating currency devaluations* are accelerating, which implies global investors are increasingly losing confidence in their home currencies.

We believe precious metals will continue gaining credibility among a widening band of global wealth holders. Gold and silver are cheaper than they have been in years, in our view, because their *optionality* is being greatly ignored. At current pricing they are tantamount to owning deep in-the-money calls on past global monetary inflation, and even deeper in-the-money calls when further easing is considered. Our PM weighting has never been higher. The current environment reminds us of a coiling spring and we believe volatility would benefit Fund returns.

Tyranny of the Short Term

We recently asked a friend in charge of polling for a large media company whether it is possible to manipulate survey responses. He said an objective pollster had to be careful about how questions are asked; noting the manner in which questions are phrased produces predictable responses. And then he said this: "Thinking is work. Cognitive function is a capital expenditure and people tend to husband their resources."

It occurred to us that his insight is consistent with our market experience; day-to-day asset values have less to do with investors' collective processing ability than with their willingness to apply what they know. As a result, investors seem most comfortable following discernable trends regardless of new information that should rationally alter their thinking. Such views seem to hold up to even casual observations and explain much about empirical capital flows.

We think contemporary investors in all shapes and sizes and with ostensibly different objectives have short-term investment horizons, whether stated or implied. The reason for this is easy to put one's finger on – investors in highly-levered markets <u>must</u> follow trends or else system-wide leverage will unwind. Further, the trend they follow must be an uptrend because the assets being levered also act as collateral for the leverage itself. Thus, the crowd stays put even as relative value declines.

This would seem to explain why financial asset markets repeatedly go too far in one direction (up) before suffering from "unforeseen events". It is not that few investors see it coming; it is that discounting future crowd behavior trumps discounting the present value of future income or gains.

Global policy makers seem to behave similarly. No one would accuse Von Havenstein, Norman and Strong then, or Summers, Bernanke, Geithner & Trichet today of dullness. However, it would be difficult to defend them against the charge of acquiescing to contemporaneous "political realities".

Politics is effectively giving the most people what they want when they want it. So, it seems policy makers that study and then base their decisions on "political economics" will always and predictably opt to save the economy from near term adversity. When the economy is highly levered, saving the economy from near-term adversity means saving the markets from near term adversity.

So we think policy makers are just as capable as investors are of anticipating potential dangers, and just as unwilling, in over-levered societies, to do anything about it. They cannot take the proverbial punchbowl away because they fear short-term output contraction and rising unemployment, which, in a de-levered economy, would be the natural economic digestion necessary to maintain a sustainable long-term growth path. So, they find themselves distorting natural economic equilibriums and then perpetuating those distortions, perhaps having to hide them from public recognition. They dig deeper holes.

And yet markets are not structured to care. Adverse selection takes hold over time among asset sponsors. The vast majority of investors that collectively price markets become trained to follow trends and not to think in terms of trend reversals or to invest in a counter-cyclical manner. The most successful investors become the ones conditioned and, perversely, disciplined enough to never bet against a secular uptrend.

More strategic investors may see the great imbalances and may marvel at the opportunities, but they are usually too early. They also do not receive adequate financial sponsorship capable of enforcing more sustainable equilibriums. They may be right but they are usually too small to matter and be respected.

The Prey – "Sophisticated Investors"

Most professional market participants have trained themselves to be sophisticated *micro-market* investors, strategists and tacticians looking for -- and dependent upon -- a rigid set of fundamental conditions to drive asset prices.

Consider that financial asset markets are sponsored mostly by large institutional investors acting as fiduciaries for others. A fiduciary's first obligation is to do no harm. The vast majority of fiduciaries would define "harm" in today's world as a contemporaneous mark-to-market loss. Is this prudent? Is a large pension fund with one year to 25 year future obligations investing rationally by trying to beat an index each month, or even by trying to avoid monthly or quarterly losses?

What about the professional fund manager investing on behalf of that pension fund? The reality is that most for-profit investment funds do not try to outrun the bear, only their competition. They are generally in the business of merchandising rigidly structured, often index-linked investment products to fiduciaries afraid of short term losses. They are not in the business of seeking positive risk-adjusted real returns over time, or even positive absolute nominal returns each month.

Investor intelligence is not easily defined in markets characterized by systemic distortions. A momentum trader picking up pennies in front of steamrollers may only care about the next penny. Is she less sophisticated than the value investor tearing apart balance sheets? (Maybe yes, maybe no -- depending upon results.) What about the line-worker that picks mutual funds from a menu of mutual funds offered by his company's pension plan based on whether he has heard their name before? Both may be "less sophisticated" than MBAs or CFAs, yet their relative ignorance may serve them better than a more experienced investor over an extended period of time.

Copious amounts of assets under management do not make investors smart or sophisticated, nor do stated objectives or risk controls, or rigid disciplines, or advisory groups, or fiduciary protocols. In fact, we would argue that risk of loss increases as extraneous layers in the decision making process are added that separate objective analysis from executing and maintaining investment strategies. By their very nature, most large institutions have a plurality of objectives.

Objectivity and independence should be one of the most highly valued principles, and while size does not necessarily preclude adherence to this principle, it usually does.

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There is a price for everything. Buyers and sellers disagree about the future direction of assets on every trade that occurs everywhere, on exchanges or over the counter. Otherwise there would be no trade or the trade would be executed at a different price. So, either there should be a rule that counterparties must have exactly equal levels of information and sophistication, (which would be silly), or it must be accepted that the value of opinions cannot be known coincident with trade executions. Like beauty, the *value* of assets at any given time must remain in the eyes of the beholders.

So then is an investment bank with public shareholders seeking good quarterly earnings supposed to care that an ostensibly sophisticated institutional investor sees more value in a sub-prime CDO than it does? Is there a commonly accepted presumption of a hierarchy of sophistication? Is one counterparty's fiduciary responsibility more important than the others'? Does one party have a fiduciary responsibility to the other if the lesser sophisticate is also a fiduciary over even lesser sophisticates? Who is supposed to decide which one is the lesser sophisticate? Congress?

Our friend in polling tells us it is much tougher for most people to disagree or to be negative than to say "yes" or to acquiesce. So to increase revenues then, a financial intermediary need only find a susceptible investor (a weak link) to whom dubiously priced merchandise may be jammed. To the decision maker at the institution buying the dross it is easier to have the issue go away immediately and not explain himself to the awesome bank than to disappoint a highly intelligent and fabulous representative of it.

While it would certainly be best for all market participants to behave ethically, natural market incentives have predatory principles associated with them. (Perhaps the markets would be best served if it was generally perceived that they are risky places where investors can and do lose money?)

Wall Street traders and banks may or may not be more sophisticated on average than the people and institutions that buy their merchandise (don't kid yourselves, they are), but they are most definitely more energetic about seeing that trades actually get done (and at the widest acceptable vig). This means it will always be unlikely that *all* "sophisticated" decision makers on the buy-side will say "no" to toxic assets about to go pear-shaped, pitched to them by highly regarded Wall Street institutions. All it takes is one large investor to say "yes" in a moment of weakness to get the deal done.

That "print" then sets a new pricing equilibrium in the market for similar product, much as an aberrant genetic mutation provides the basis for an evolutionary shift. One print means more transactions at the new, distorted level can be justified, which in turn rationalizes the initial distortion. While some may argue that markets are always efficient, being so does not necessarily mean they are always properly and rationally priced. They may adjust in proper proportion daily for all known data, but they may also adjust from ridiculous levels to even more ridiculous levels. *Price does not equal value.*

So size, financial complexity and price execution do not define investment sophistication. All investors – from a busy physician rebalancing his tech stock portfolio once a quarter to a professional cross market trader – should accept and internalize an uneven set of circumstances and invest by their wits.

The independent investor (of any size) has distinct advantages over levered professional arbitrageurs and gargantuan monolithic index tracking institutions. The only thing holding him back is insecurity that he does not know enough. Of course it is better to know more than less, but it is best to know enough, to be secure enough to accept what one does not know, and to recognize the market's weak spots.

What is a sophisticated investor? *We think a truly sophisticated investor is a capable analyst willing to take his or her own counsel and disciplined enough not to be over-influenced by irrelevant existential inputs. It is a willing saver that sees sporadic opportunity where price and value part.*

Exploiting Wayward Incentives & Manufactured Distortions

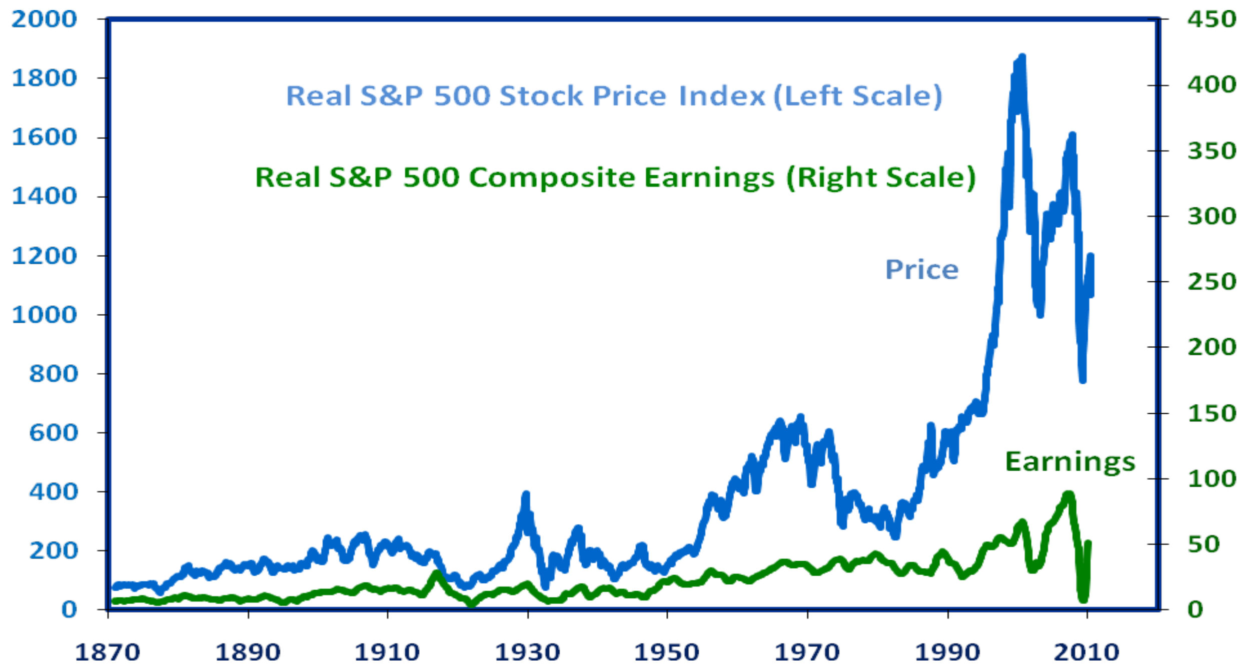
So markets are biased to rise most days due to perpetually easy monetary conditions and reliable trend-adhering investor sponsorship. As we have often noted, a secular uptrend in financial asset markets is the product of systemic credit build-ups channeled through banking systems.

The result of this leverage is mind blowing over time. Total global financial assets including stocks, bonds and unreserved bank loans amounted to about $214 trillion in the third quarter of 2008, while the global monetary base was only about $6.8 trillion.[1] This is almost 32 to 1 leverage in fiat currency terms.

[1] International Monetary Fund; Global Stability Report; October 2008

The total value of the world's above-ground gold supply (as a historic benchmark for sound money) at about $844 billion implies a global financial asset to gold ratio of 254:1.[2]

Logic dictates there must be decreasing *real* benefits to output and income from this massive global leverage. Robert Shiller's economics team at Yale provided the data for the graph below. It shows time-series of inflation-adjusted S&P earnings and the inflation-adjusted S&P 500 Index since 1870.



Source: Robert J. Shiller

The graph illustrates clearly that: 1) real corporate earnings have not risen materially over a long stretch of time; and 2) real index and earnings volatility have increased materially in recent times. The immense and widening gap separating real earnings from the index, as well as the obvious increase in volatility of both components of the graph implies that the massive systemic leverage added to the system in recent years has de-stabilized the economy and the markets. This should make intuitive sense to all. There is very little currency in circulation today to repay the whopping 32-fold claims on it.

We know there is a high and consistently growing bid for money to repay that immense and growing funding gap, given historically low interest rates today. On one hand, it seems entirely rational that sovereign yields are historically very low because there is such an enormous future demand for money embedded into the system. By investing in sovereign bonds, investors are capturing priority over all future claimants for money with which to satisfy claims. By implication, bond buyers (creditors) believe they have future claims on a scarce commodity -- fiat money. We would agree with the fundamental premise but disagree with its pragmatism.

Consider that there has been a long history of public sector intervention into private markets, such as implicit GSE backing that replaced fear of loss in the housing market with widespread lust for gains. More recent public interventions, in 2000 following the dot-com bubble and in 2008 amid the first wave of credit evaporation, further prove there are no limits to political willingness to intervene to ensure systemic loss protection, or what economists call "moral hazard".

[2] World Gold Council; Quarterly Gold and FX Reserves; Q3 2008

The *unspoken secular public policy that promotes moral hazard* is being manifest today in great force through quantitative easing, debt monetization, distaste among legislators to write germane lending regulations, and continuing socialization of real estate and financial asset losses. It seems highly likely that policy makers and politicians will extend this policy to inflate away the burden of their constituents' debt repayments. It is the method they have always used and it has recent precedent.

Within this environment, a very high present value of fiat money actually seems quite *irrational*. What creditors are not considering, in our view, is that policy makers are currently demonstrating that there will be an abundance of money. Fiat money may be scarce today but it will be abundant when needed.

Thus we believe bond investors are behaving irrationally by paying a high price to lock-in future fixed coupon and principal payments. Though they will no doubt take priority vis-à-vis levered financial asset investors and the majority of unlevered investors in over-levered markets that will be forced to sell their lesser claims to fund near term obligations, they will not have the purchasing power to actually buy assets. They see only the credit deflation that will hit equity investors and bond investors further down the capital structures. They are turning a blind eye to government-derived monetary inflation, and the reason they are doing this, we think, comes back to their incentive structure.

Ultimately, a Fallacy of Composition

Let's close the circle, tying together investor incentives with market distortions. The issue is one of micro-investing versus macro investing. Going back to our assertion about short-termism and investor sophistication, most financial asset investors today have incentive to see the trees but not the forest. Most are investing for nominal returns and the big presumption they share is that all money is the same, or that they can't do anything about fluctuating exchange rates (or that they are not paid to care about them).

If an equity investor believes XYZ Corp will surprise next month on the upside, and a million other investors think the same of a thousand other companies, they will invest accordingly. If a bond manager thinks Acme Widget debentures are historically cheap to Mega Doohickey notes, and millions of investors in a thousand other companies think the same, they too will invest accordingly.

Financial asset markets are priced by micro-investors for discrete expectations based generally on short-term mean reversions. There is a *fallacy of composition* at play, wherein the parts of the asset markets seem fairly priced to its participants yet the whole is woefully unstable. Investors and policy makers are guilty of functionally destroying their future real returns (investors) and capital markets (policy makers) by trying to meet today's micro-economic, micro-regulatory and micro-market objectives.

Consider, for example, the issues facing large fixed-income funds presently. Harley Bassman, a trader's trader, long highly regarded within Treasury, MBS and volatility circles, points out that US quantitative easing has distorted the MBS market so much that its largest buyers are being forced to take on significantly more risk to comply with their stated mandates.

Bassman notes the Fed now owns well over one-third of all outstanding fixed-rate MBS, yet these bonds have not been removed from indexes off which large investors are benchmarked. He does not know how money managers "intend to beat an index that doesn't exist," and observes that "the professional investing class as a whole cannot mathematically match the index without taking on substantial risk in other sectors."

Bassman fears corporate credit spreads may be bid to unjustifiable levels as investors grab incremental yield where they can find it, and that many investors will be forced to sell option premium to increase portfolio yields to match their indexes. He notes:

> "By effectively forcing the Index and Total Return managers to sell options to replicate the return profile of MBS (and match the yield of the unadjusted Aggregate Index), the Fed has found a mechanism to transfer risk from the market to itself. However, as time progresses, the portfolios of otherwise passive Index managers will become unstable with an increased usage of negatively convex derivatives." [3]

Bassman believes the markets should "be prepared for this to end badly if too many managers choose this path." We don't think Harley Bassman will be one who shrugs his shoulders and says; "who could have foreseen this?" The negative unintended consequences of active economic and market policy intervention keep coming and it seems highly unlikely they will stop.

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We think there is nothing left to do but wait and trade around our core positions. We have complete conviction that the current pricing of economies and markets will change substantially, given conditions and the predictable and ongoing behavior of investors and policy makers. While money may be ever expanding in the current regime, wealth is zero-sum. Our business is to anticipate and invest better than others, including the vast majority of market participants.

Global politicians and policy makers continue to be our allies in this endeavor. The more they seek to satisfy wayward near-term interests and imperatives, the sooner we believe wealth will flee leveraged financial assets and find less-leveraged, unleveraged, and even de-leveraged assets. The fundamental mispricing of real factors of production like wages and scarce commodities vis-à-vis leveraged capital assets is too wide to ignore and too great for the political dimension to suppress.

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[3] (QB note: Convexity is the rate of change of a bond's duration, and is measured as the second derivative of price with respect to yield. Negative convexity occurs when the shape of a bond's yield curve is concave, implying the bond's duration generally lengthens as interest rates rise and shortens as interest rates decline.