SOUTHPAW CAPITAL

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Dear Partners,

The market has apparently lost its sense of directional amnesia and remembered that it is *supposed to* engage in a slow upward climb. After creating a thick cushion of positive returns on the year we consider it essential to avoid sinking down even one inch of the market incline that has been arduously ascended. We finished the quarter on a disappointingly weak note, but essentially kept pace with the rising market on a gross-of-fees (but net of expenses) basis for the full quarter and handily beat the average hedge fund. We were fortunate to match the market's ascent despite taking on significantly less risk and having lower exposure to the market, ending at 61.5% net long exposure and below a 50% beta-adjusted net exposure. The lower net exposure is not necessarily indicative of a directional market bet, but rather an increasing number of attractive shorting opportunities, as well as a few short positions getting more attractive (read: going against us), thus raising gross short exposure and slightly lowering net exposure.

Southpaw Value Fund, LP

ESTIMATED NET MONTHLY PERFORMANCE | 2012				
PERIOD	**SVF (Net)**	**SVF (Gross)**	**HFRX (Gross)**	**S&P 500 TR**
JANUARY	7.04%	8.88%	1.72%	4.48%
FEBRUARY	5.72%	7.11%	1.42%	4.32%
MARCH	3.90%	4.80%	-0.02%	3.29%
1st QUARTER	**17.57%**	**22.23%**	**3.14%**	**12.59%**
APRIL	-3.44%	-4.06%	0.12%	-0.63%
MAY	-1.13%	-1.29%	-1.69%	-6.01%
JUNE	-0.21%	-0.16%	-0.29%	4.12%
2nd QUARTER	**-4.73%**	**-5.45%**	**-1.86%**	**-2.75%**
JULY	2.26%	2.84%	0.54%	1.39%
AUGUST	3.04%	3.77%	0.51%	2.25%
SEPTEMBER	0.07%	0.16%	0.39%	2.58%
3rd QUARTER	**5.45%**	**6.88%**	**1.45%**	**6.35%**
OCTOBER				
NOVEMBER				
DECEMBER				
4th QUARTER	**0.00%**	**0.00%**	**0.00%**	**0.00%**
YEAR TO DATE	**18.11%**	**23.52%**	**2.69%**	**16.44%**

"I have no data yet. It is a capital mistake to theorize before one has data. Insensibly one begins to twist facts to suit theories, instead of theories to suit facts." – Sherlock Holmes

A fact challenging your basic assumptions is rarely observed. Ideas are like possessions we are unwilling to part with. In what is now known as the Gulf of Tonkin Incident, President LBJ chose to twist facts and believe that North Vietnam had attacked a US destroyer, when it is now well known by historians that in the classified intercepts surrounding the event top US officials were really discussing a battle that was provoked by the US two days earlier. After the initial naval battle on August 2nd, the President ordered a second US destroyer to cruise up the Gulf. On the night of August 4th, both ships reported coming under attack via torpedoes. The number of supposed witnesses was low and physical evidence never manifested. Following this confrontation on a second attempted "innocent passage," LBJ ordered retaliatory bombings against North Vietnam and requested the congressional resolution to pursue the war. Whether or not the US' strategy of communist containment was appropriate is not the point, but the point is rather that someone will twist events and facts to fit their pre-conceived world views. F. Scott Fitzgerald said the true measure of top-notch intelligence is the "ability to hold two opposing ideas in the mind at the same time and still retain the ability to function." Ignoring incoming data that contradicts a previously held view can often lead to disastrous consequences. While clearly self-aware of this psychological pitfall, we are by no means immune from its potential hindering effects. We believe one way to avoid this cerebral phenomenon at its most extreme is if one reads a certain side of an argument—let's say a positive write-up of a stock, then one should immediately seek out the opposing or negative view. Even more ideal would be to only start with primary data sources, in order to avoid anchoring to anyone else's opinion—this is Southpaw's preferred M-O.

The need for a hard catalyst in micro-cap land is as great as it's ever been-- a cheap stock can stay cheap, and an expensive stock can stay dear, as the stocks are on the wrong side of the ETF/fund flow divide. The best ideas implemented at the wrong time are indistinguishable from losers and thus should be considered exactly that. "Ripeness is all." wrote Shakespeare in the tragic play King Lear. Value investors often proclaim—usually in a surprisingly befuddling or proud manner—that they do not believe in "timing the market." If by timing one means switching out of asset classes, or entirely switching in and out of the market, and recklessly speculating on short term market fluctuations, I would whole-heartedly agree with this notion. But if by timing one means waiting patiently for panic or euphoria to enter and exit positions, pegging purchase prices strictly to valuations instead of personal sentiments, and pre-identifying catalysts for re-valuation, then I believe market timing is the *only* way to go. Ideally, we would be capable of taking a control or activist role and exerting some influence by applying a ripening agent to our investments. Getting a major theme correct often transcends and trumps the minutiae, but the timing is relevant for an investor or else the results can be as dark and depressing as the story of King Lear.

Back in November 2011 at a popular investor conference a panel of fund managers with combined assets of $25-50 billion were highlighting their top stock picks. Several of the ideas were related to the general economic upturn and the speakers were particularly optimistic on the auto cycle (as we were and still are). In the Q&A I pointed out that well over an hour had gone by and no one had mentioned housing and asked if they were similarly optimistic on the housing cycle or they had any ideas there. No one suggested any ideas and in fact, the responses to my question were negative. Building materials were subsequently the best performing industry the following quarter and home builders have been one of the best performing industry groups in 2012. Ignoring for a second that this was a tiny sample size and may not have been representative of all market participants, the sentiment observed by us that day of well-informed professionals was very real. The foundation for a powerful rally was in place. Now the housing related names have escalated into full, and by most measures, excessive valuations, and we've found selective shorting/hedging opportunities within the space. As is usual the stock prices have moved well in advance of a fundamental shift. We have now mostly shifted out of our building materials names including Louisiana Pacific,

Norbord, and Owen's Corning. Being contrarian by nature is half the battle. I once tried to get George to read a best-selling book on contrarian investing strategies and he refused—even The Immortal Bard could appreciate that irony!

Purchasing a stock simply because its hated or unloved is not necessarily a good idea, but we find the laggards are a good place to start looking. One of the worst performing commodities and the related industry has been natural gas and gassy E&P stocks. One investment we've made is WPX Energy (WPX), a spin-off from a larger parent, Williams Companies that began trading on 1/3/12. Since being spun-off, WPX has underperformed the S&P 500 by over 30%. Statistically, spin-offs on average realize their greatest relative returns in the second year following the distribution. When gas prices hit under $2/mcf, which was below the cost of extraction for most producers, we became very interested in the space. Here are a few observations about natural gas and our chosen vehicle to gain exposure:

- The long-term future for natural gas is bright. More industrial and petrochemical plants are opening up in the US, power plants are switching to natural gas, and vehicle manufacturers are all beginning to release CNG-powered vehicles.
- Coming into the year the industry had over-drilled and combined with a record warm winter season, gas inventory was hitting 5-year record highs.
- To put the price decline in perspective, natural gas in the US earlier this year was cheaper adjusted for inflation than any time in the last 20 years. Historically, there has been a tightly correlated relationship between the price of oil and natural gas. For many years, oil prices (as measured in $ per barrel) were typically 6-12x natural gas prices (as measured in $ per MMBtu). By 2012 this ratio had exceeded 30x -- a severe disconnect with historical trends. A barrel of oil has roughly 6x the energy content of an MMBtu of natural gas. If the fuels were perfect substitutes (which they aren't), oil prices would thus tend to be 6x natural gas prices.
- The average nat gas rig count in 4Q11 was 874, today it is at 437; a 50% decline from less than one year prior; This is the lowest level in 13 years. The "gas equivalent rig" metric has fallen by even more as some drillings are inaccurately classified as gas directed.
- Our research and discussion with E&P CEOs indicate that the initial daily production of prolific dry-gas shale wells may produce 15-25 million cubic feet of gas while a shale oil well might produce 3-5 mcf, ~1/3 as much gas.
- Several of the largest producers have guided flat to negative gas production for the second half of 2012.
- With ~50% of daily natural gas production coming from tight gas and shale gas formations, combined with the very steep decline curve for unconventional wells, we believe the increased gas production from associated oil wells is not enough to entirely replace this lost production.
- Taking into account the number of rigs in each basin, the percentage of production that is gas, and the average production rates, we believe that >4 oil directed wells need to be drilled to match production from one gas-directed well in an unconventional gas formation (e.g. Bakken oil wells vs. Haynesville gas wells).
- We looked for a company that had the following characteristics: strong balance sheet to weather the storm, assets with above average well economics, potential to grow production at attractive rates when prices rebounded, plenty of reserves, and lastly was statistically undervalued.
- WPX has three primary basins they operate in: Piceance, Bakken, and Marcellus.

We've been gradual buyers of WPX shares on weakness over the last several months. We've picked up a prominent E&P company at the following valuation metrics (we've adjusted Enterprise Valuation calculation to exclude WPX's 68.95% stake in Apco, as we view this as an excess asset):

Selected Trading Comps	Enterprise Value			Reserves	Debt to
	12 EBITDAX	Proven Mcfe	Flowing Mcfe/pd	% Gas	EBITDAX
Exco Resources (XCO)	7.8x	$2.50	$5,913	99%	4.2x
Ultra Petroleum (UPL)	4.7x	$1.07	$6,278	96%	2.1x
Quicksilver Resources Inc. (KWK)	5.8x	$0.98	$6,558	76%	4.6x
Median for All Mid-Cap E&Ps	5.9x	$2.75	$11,667	59%	1.4x
WPX Energy (WPX)	3.0x	$0.75	$2,633	75%	.8x
Discount to Peers	-49%	-73%	-77%	n/a	n/a

Whether it was based on proven reserves in the ground (ignoring upside optionality of 2P and 3P reserves), price paid per flowing Mcfe or cash flow multiples we think WPX is a cheap stock, and combined with low leverage we feel safe holding it as they can survive any market environment. We are much less sanguine on the prospects for sustained high oil prices so have executed this as a pair trade with offsetting shorts. In closing, we believe WPX is one of the most undervalued gas focused E&P stocks investors can buy. After asking several of our friends at energy focused funds why WPX deserves such a discount, none were able to provide real credible reasons why. Our surmise is one day the market will wake up and realize how cheap WPX is and its shareholders will be rewarded for their contrarian view.

It is always much easier to find a convincing alibi than strive for consistent achievement. An achievement, or in this case short term return record, does not settle anything permanently—the game never ends. A good month, quarter, or year for us proves nothing—we must still prove our worth anew each day. Many fund managers bemoan the fact that things are not as easy as they used to be. When a manager has mentally conceded to a valid alibi for not attempting to achieve alpha they are fixed, so to speak, for life. As a relatively bad year for active management the most common alibis are that we've mutated into a macro driven environment, correlations are too high, only central bank liquidity matters, etc. The habitual market intervention (which could be enough to make a cadaver get up and tap dance) and persistent inefficiencies can indeed be frustrating, thus the constant chorus of comments that the "system is broken" and that things have "never been more uncertain." While these are all valid points, albeit hopefully temporary, conceding to one of these alibis is like an animal giving up and dying due to some slight seasonal weather changes, forgoing the natural progression of evolutionary forces and adapting in order to increase their chances of survival. Kangaroo Rats, for example, seal off their underground dens to block out midday desert heat and have specialized organs in the nasal cavity that help them recycle the moisture from their own breathing. They have extraordinary kidneys that have evolved for extracting the maximum amount of water so they have the most concentrated urine of any mammal. We relish the uncertainty in individual names as long as we calculate the downside risks to be limited. We want to be adaptive like Kangaroo Rats, extracting necessary alpha from a (believed to be) barren environment.

Heraclitus, one of the earliest teachers of creative thinking, is well-known for his observation that all things are in flux. Change is constant: You cannot step in the same river twice. The river changes because fresh waters are flowing in around you. Rivers—and markets—thus exhibit the fascinating fact of becoming different yet remaining the same, which is why one can learn from mistakes and presumably get better over time. The markets are structurally the same: the players come and go, securities come into and go out of existence, and the macro environment is constantly different, but human nature and the necessary analytical framework never changes.

For the time being we do not judge ourselves by the modest harvest we reaped last month or this quarter, but by the seemingly superb seeds we've scrupulously sown. A disciplined investment approach must be endured not for its own sake, but for what lies beyond the diligent process and immediate future. In the meantime, we will continue to do our best to pick the investments that are truly ripe and in future periods hope the fruits of our labor will become increasingly apparent for our Partners.

The third quarter concluded our first full year in business. Thank you again to our indispensable service providers and early Partners for your support. As always, please let us know if you have any questions, comments, or we can be of assistance to you in any way.

Best Regards,

Southpaw Capital, LLC

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